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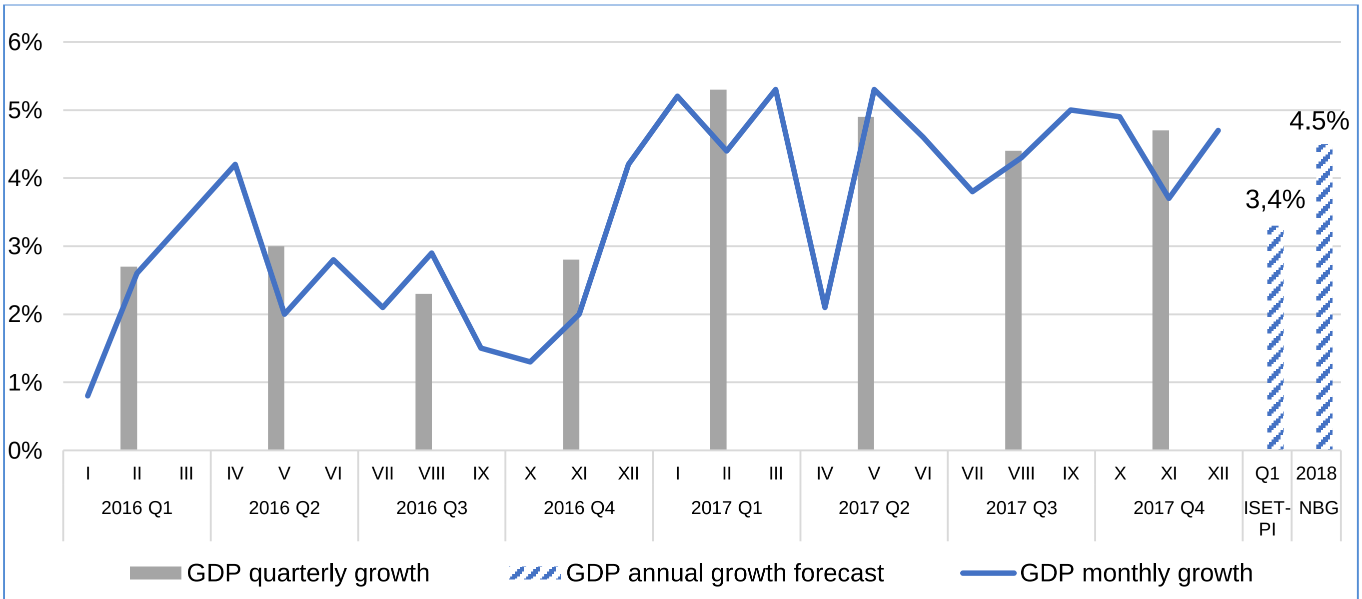
GEORGIAN ECONOMY IN 2017 – A YEAR IN REVIEW



Real GDP Growth, ISET-PI Forecast, YoY Change
Source: GeoStat, ISET-PI

Economic growth in 2017

Among the pleasant surprises early this year, were the figures for Georgia's economic growth in 2017. According to GeoStat estimates, **Georgia's real GDP grew by 4.8% year over year (YoY) in 2017**. This result moderately surpassed the ADB, EBRD, IMF and World Bank's last growth projections of 4.2%, 3.9% 4.0%, and 3.5% growth, respectively. The National Bank of Georgia's (NBG) 4.5% growth projection also slightly underestimated Georgia's economic growth in 2017. The real winner in this race was ISET-PI's annual GDP growth forecast. In November 2017, we predicted 4.7% YoY growth, and since then our updated forecasts indicated 4.8% real GDP growth.

Yet, compared to neighboring countries (in particular Armenia and Turkey), Georgia's performance was quite modest. According to the latest World Bank estimates, Turkey enjoyed 6.7% annual growth – driven by improved external demand from the EU, fiscal expansion and the low GDP base of the previous year. However, due to political instability, massive depreciation of the lira and double-digit inflation, the growth rate of the Turkish economy is expected to slow to 3.5% YoY in 2018. Signs of economic recovery were observed in Russia as well. The country's 1.5% growth in 2017 was driven by a variety of factors: increased oil prices on the world market, an improved trade balance, huge infrastructure projects, a stabilized exchange rate and low inflation. These positive developments in Russia were transmitted to Armenia through remittances and trade channels. Economic growth in Armenia was the highest in the region (an impressive 7.7% in 2017, up from 0.2% in the previous year). The country benefitted in particular from higher metal prices, which drove up industrial output and exports. In Azerbaijan, real GDP growth was flat at 0.1%, but was recovering from the 3.8% contraction of 2016. A tightened monetary and fiscal policy in the country failed to curb pressure on prices, and inflation reached 13.4% YoY. However, on a positive note for Azerbaijan, the non-oil sector grew by 2.7% YoY. Another important economy is China, as Chinese ambitions to expand its economic influence can have a powerful impact on the entire region. In 2017, China became the third largest trade partner of Georgia. Therefore, China's 6.9% growth rate for the year comes as good news for our country.

Table 1: Real GDP Growth in Partner Economies Source: World Bank, National Statistics Offices and Central Banks

Country	2016	2017	2018 (forecast)	2019 (forecast)
Armenia	0.2	7.7	3.8	4.0
Azerbaijan	-3.1	0.1	0.9	1.5
China	6.7	6.9	6.4	6.3
Georgia	2.8	4.8	4.2	4.7
Russia	-0.2	1.5	1.7	1.8
Turkey	3.2	6.7 (WB)	3.5	4.0
Europe and Central Asia	1.7	3.8 (WB)	2.9	3.0

How much do we depend on our neighbors?

How much does the economy of Georgia depend on other countries? The table below gives an idea about linkages with partner countries with respect to trade, foreign direct investment, remittances and number of international arrivals in 2017. Darker colors correspond to stronger linkages and, consequently, stronger spillover effects from other countries. For example, we can see that the EU and Russia each absorbed high shares of Georgian exports, at 24% and 14% respectively. These countries are also the main sources for Georgian remittances (31% and 33% respectively). Thus, positive economic developments in the EU and Russia have strong positive effects on the Georgian economy.

The data also show that the spillover effects from large and fast-growing economies like China are still limited. However, China's increasing importance as a trade partner (a FTA between Georgia and China came into force on 1 January 2018) and a source of foreign investments will amplify its positive (and negative) influence on the Georgian economy in the future.

Table 1: Linkages with Partners, 2017 *Source: GeoStat, NBG, GNTA*

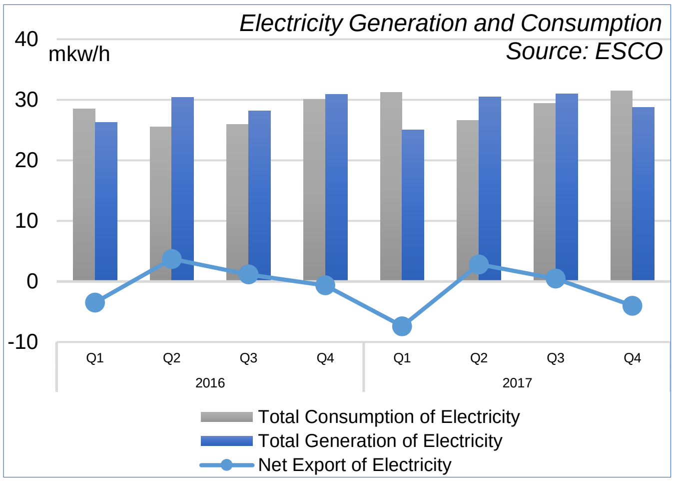
Partner	Export	Import	FDI*	Remittances	Int. Arrivals
Armenia	8%	4%	0%	1%	23%
Azerbaijan	10%	8%	28%	1%	22%
China	8%	9%	3%	0%	0%
EU	24%	28%	33%	31%	4%
Russia	14%	10%	1%	33%	18%
Turkey	8%	17%	19%	8%	17%
Ukraine	5%	6%	1%	2%	3%
USA	4%	3%	4%	10%	1%
Total**	**2 727 971**	**7 979 435**	**1 346 482**	**1 379 463**	**7 554 936**

*FDI data is calculated for the first three quarters of 2017
** In million USD, International arrivals in million people

Overall, the economies of Georgia and the whole region are continuing to recover from the sluggish growth of previous years. For Georgia, the recovery is due to improvements in both the external and domestic environment. Accelerated economic growth in trade partner countries and rising metal prices caused a spike in exports, increased money transfers and boosted tourism. On the domestic front, improvements in consumer and business confidence, the growth of government expenditure and private lending, and the corporate income tax reform, all stimulated domestic investment and consumption. Downside pressure on Georgia's growth came from the hike in excise taxes on fuel and increasing oil prices on international markets. These factors led to higher inflationary expectations and induced monetary tightening, which further hurt growth.

Electricity – tariffs go up, but can we blame "BitFury"?

Total consumption of electricity, a common proxy for aggregate demand, increased by 7.7% YoY in 2017. The electricity consumption of direct consumers spiked by 18.1% compared to 2016, reflecting increasing prices of manganese alloys on the world markets and, consequently, higher demand for electricity from one of the largest exporters and employers in Georgia – the company "Georgian Manganese". The company was able to recover its production volumes after the hard times it experienced in 2016. Electricity consumption through distribution companies also showed a significant increase of 6.5% YoY.



In 2017, electricity exports increased by 22.7% YoY, and constituted 5.9% of the total generation (686 million KWh); while electricity imports tripled (+212.6% YoY) and constituted 12.6% of the total consumption (1,497 million KWh). As a result, Georgia ended up as a *net importer* of electricity in 2017 (since 2011, Georgia has only been a *net exporter* in electricity once, in 2016).

On 27 December, the Georgian National Energy and Water Supply Regulatory Commission (GNERC) revised electricity tariffs for 2018-2020 upwards. **Tariffs were increased between 1.25–1.56 tetri,** depending on the electricity distributor and the number of kilowatts consumed. **This is an approximate 6-12% increase in electricity tariffs.** According to the chairperson of the GNERC, the main reasons for the increase in utility fees were an increase in the investment costs of distribution companies, associated with the need to satisfy increased demand for electricity, as well as the rehabilitation of existing transmission lines and the construction of new ones. This decision was met with harsh criticism from the opposition and the general population, who blamed the tariff and import hike on one of the biggest private cryptocurrency mining companies in the world - “BitFury”. This company (along with a large number of small individual bitcoin miners in Georgia) certainly contributed to the increase in electricity demand. However, putting the blame for the tariff and import increases on “BitFury” alone may be misguided. Here are two important reasons why:

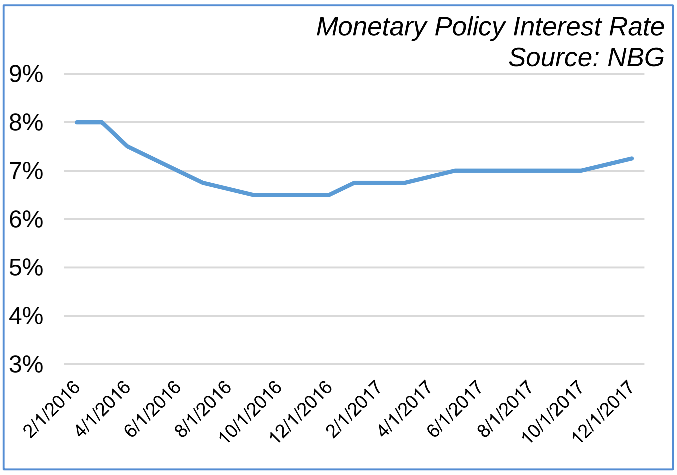
a) Electricity tariffs differ for businesses and for households; for businesses, prices depend on the voltage stage. BitFury uses high voltage stages and demand for this type of electricity does not affect demand for lower voltage stages;
b) In 2017, the price of imported electricity was in general lower than domestic prices, justifying the spike in imports.

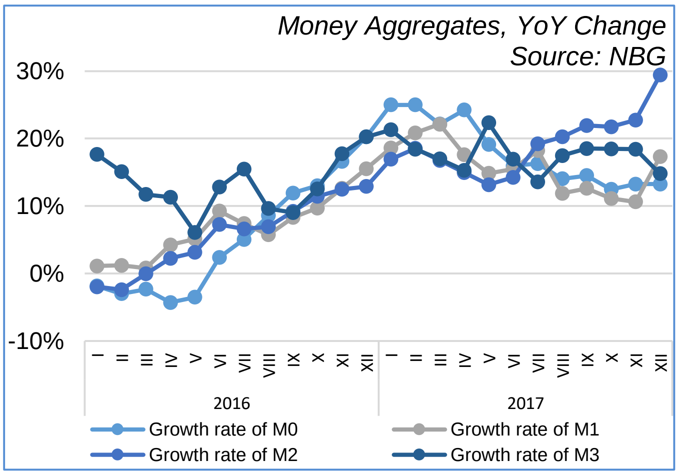
It is worth mentioning, however, that “BitFury” does have a huge advantage over a host of other businesses in Georgia: since the company is located in the Tbilisi Free Zone, it is exempt from VAT, which automatically means it pays a 18% lower electricity tariff than other companies located outside that area.

Money markets and inflation: what will drive money and price growth in 2018?

After the monetary easing of 2016, the year **2017 was characterized by monetary policy tightening**. The NBG gradually increased the refinancing rate from 6.5% to 7.25% to curb inflationary expectations, which were affected by several one-time shocks, such as the rise of excise tax, the increase in oil prices on the world market and the depreciation of the nominal effective exchange rate in the last quarter of 2017. Due to these factors, the NBG failed to keep inflation close to its target level of 4% in 2017. However, under the existing circumstances adopting a much stricter monetary policy would have harmed growth and deepened unemployment. According to the current forecast, holding other things constant, the monetary policy rate will decrease from the second half of 2018 by 5-6 percentage points, while inflation is expected to decline and approach its long-run target rate of 3%.

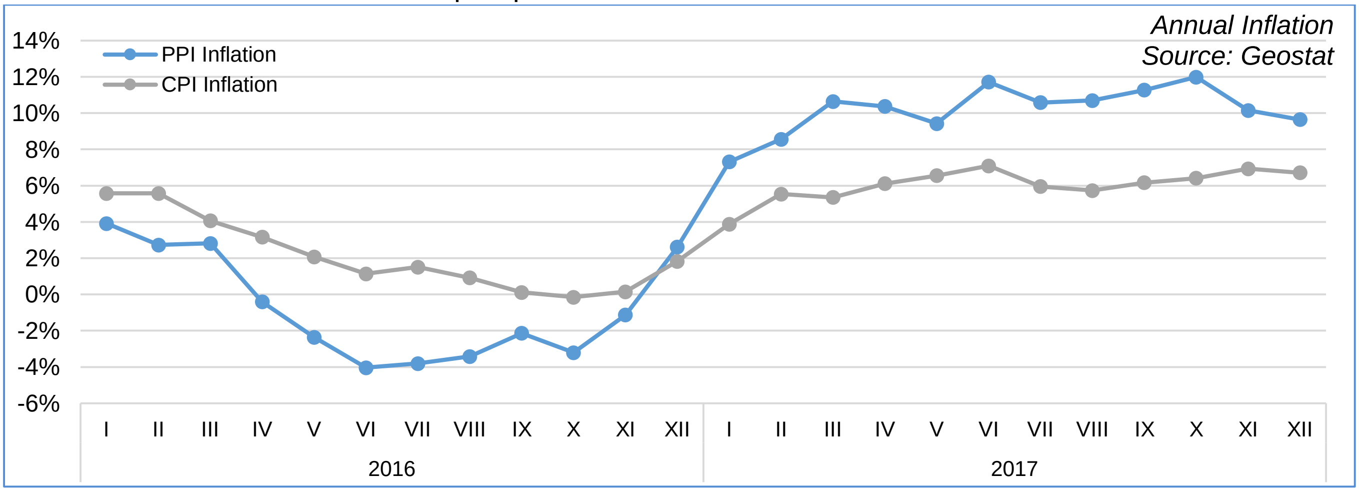
The NBG’s policy did not have a strong effect on the growth rates of monetary aggregates. Growth rates of both M1 (narrow money) and M2 (broad money, excluding foreign currency denominated deposits) increased to 17% and 29.4% respectively in December 2017. The expansion was mainly due to very strong credit growth from commercial banks.





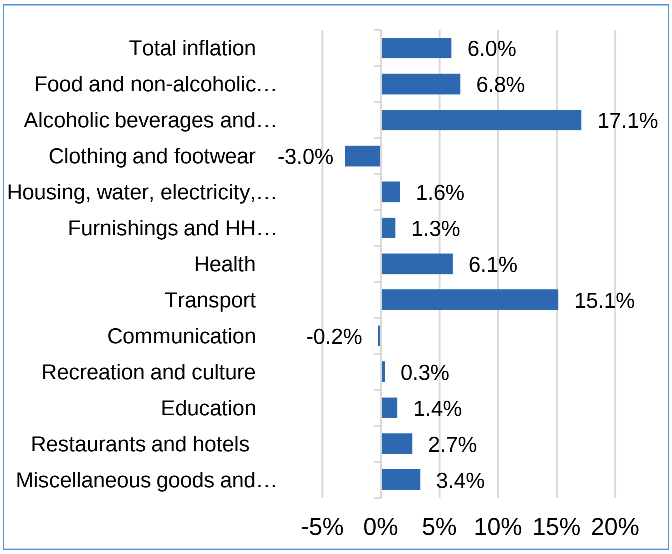
Both producer and consumer prices in Georgia showed high growth in 2017. CPI annual inflation was 6%, while producer prices increased by 10.2%. The year-on-year hike in prices was mainly caused by the following factors:

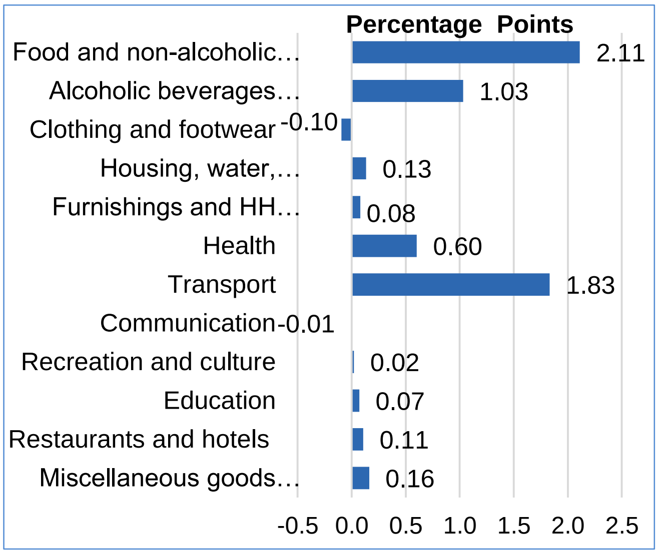
a. Supply side pressure due to a hike in excise taxes on fuel, tobacco products, and car imports.
b. Sharp fuel price increases (23.7% YoY) on the international market. For Georgia, this meant an increase in transportation prices and, indirectly, an increase of domestic production costs.
c. Nominal depreciation of the Georgian lari in annual terms with respect to partner countries, which contributed to the rise of import prices.



The product categories that exhibited the highest price growth in annual terms were alcoholic beverages & tobacco, as well as transport. Prices for these product categories increased by 17.1% and 15.1% YoY respectively in 2017. Food prices were indirectly affected by higher fuel prices. Moreover, the rise of meat and dairy prices was driven by the increase in exports of live bovine animals and sheep (especially to Iraq and Iran), reducing the supply of meat and dairy on the local market. These upward pressures on the CPI and PPI led to higher inflationary expectations and provided justification for a tighter monetary policy stance by the National Bank of Georgia. Prices for clothing and footwear (-3% YoY) and communication (-0.2% YoY) were the only categories that slightly lowered annual inflation in 2017.

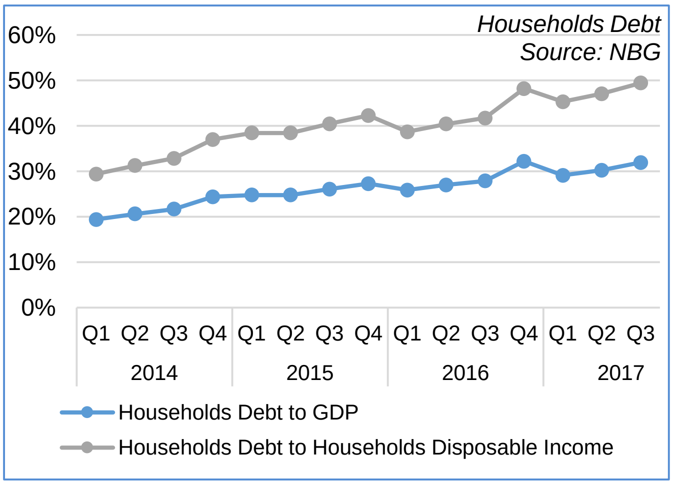
In 2018, inflation will strongly depend on external factors, such as economic growth in partner countries, the nominal effective exchange rate, and oil and food prices on international markets. Among domestic factors, the structure of government spending, the size of the budget deficit, and the business and consumer confidence indices will affect prices. **The recent hike in electricity tariffs will definitely put upward pressure on inflation in the upcoming year.**

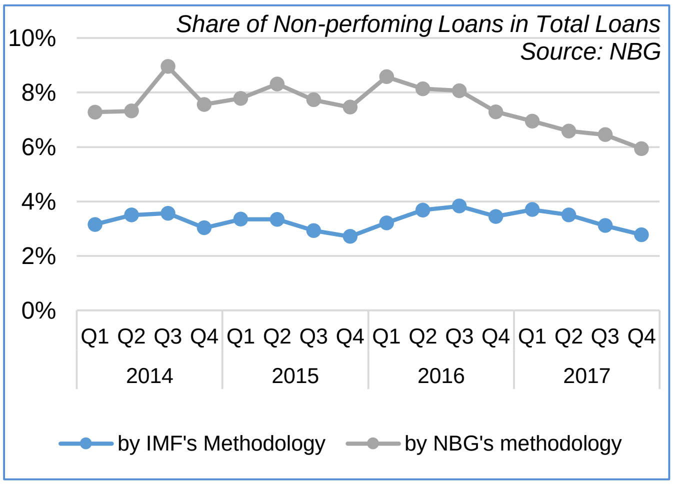




Retail credit, household debt surge. The NBG continues to work on improving financial sector resilience.

The indebtedness of the Georgian population continued to grow in 2017. Household debt as a share of GDP has been growing in recent years, reaching 31.9% in Q3 2017 (**4 percentage points (pp) higher than in the same period of 2016**). The household debt to disposable income ratio constituted 49.4% in Q3 2017 (7.7 pp higher than in the same quarter of 2016).





Yet, despite the increase in household debt indicators, the share of non-performing loans (NPL) in total loans declined. This could in part be explained by the strict lending standards of commercial banks, as well as by the fact that de-dollarization policies may have eased currency mismatch problems among Georgian households and led to fewer defaults. Moreover, the National Bank of Georgia continued the process of convergence with Basel III standards by toughening capital adequacy requirements and introducing additional buffers for systemically important banks (TBC, BOG and Liberty Bank). These steps are expected to increase banking sector resilience to financial cycles, reduce the probability of a failure of large banks, decrease concentration and encourage competitiveness.[1]

The profitability of the Georgian banking sector increased significantly in 2017. The profit of the banking sector reached 869 million GEL (a 13% YoY increase). Total loans (stocks) granted by commercial banks

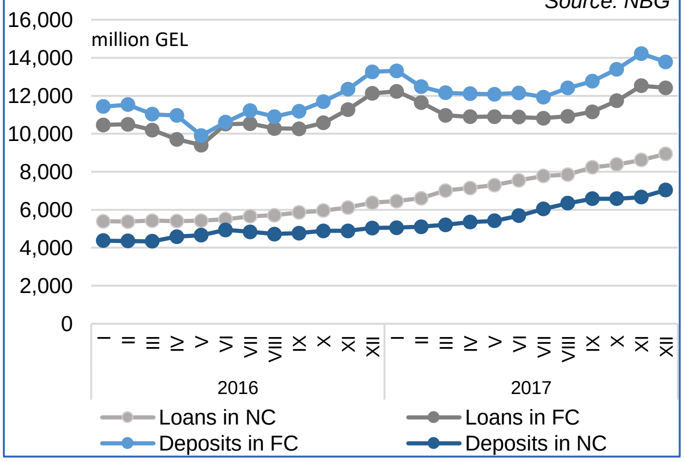
[1] For more information, see: https://www.nbg.gov.ge/index.php?m=340&newsid=3248&lng=eng

to businesses and households increased by 15.5% YoY. This increase was driven mainly by retail credits, which surged by 20.3% YoY. Business loans rose by 10.2% YoY in 2017.

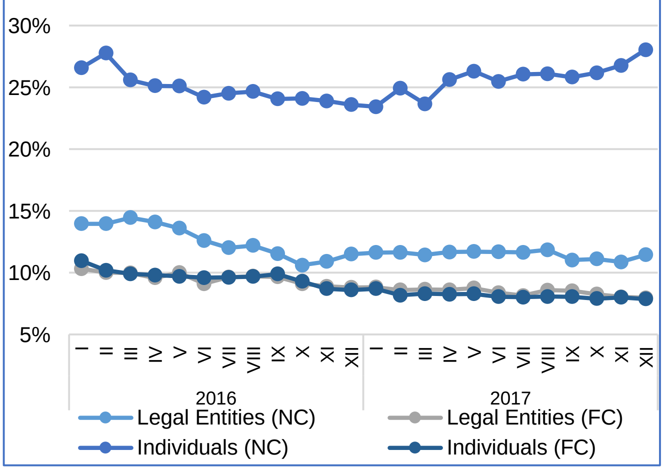
Total loans (stocks) granted by commercial banks, excluding interbank loans, amounted to 21.4 billion GEL at the end of 2017, representing a 15.5% YoY increase. **This increase was driven mainly by retail credits, which surged by 20.3% YoY.** Business loans also increased significantly, by 10.2% YoY in 2017. A larger credit portfolio stimulated growth by affecting consumption and investment. In terms of currencies, the growth of the loan portfolio was primarily driven by a **significant increase in national currency loans (+40.4% YoY)**. The stock of loans granted in foreign currency increased by 2.4%.

Total deposits (stocks) of enterprises and households in commercial banks amounted to 20.8 billion GEL, which was a 13.8% YoY increase. **Deposits of households increased by 16.2% YoY, while deposits of businesses showed an 11.3% YoY increase**. In terms of currencies, the growth in stock of national currency deposits grew substantially, by 39.7%, while the stock of foreign currency deposits increased by 3.9%.

Loans and Deposits in Commercial Banks by Currencies (stocks; excluding interbank loans)
Source: NBG



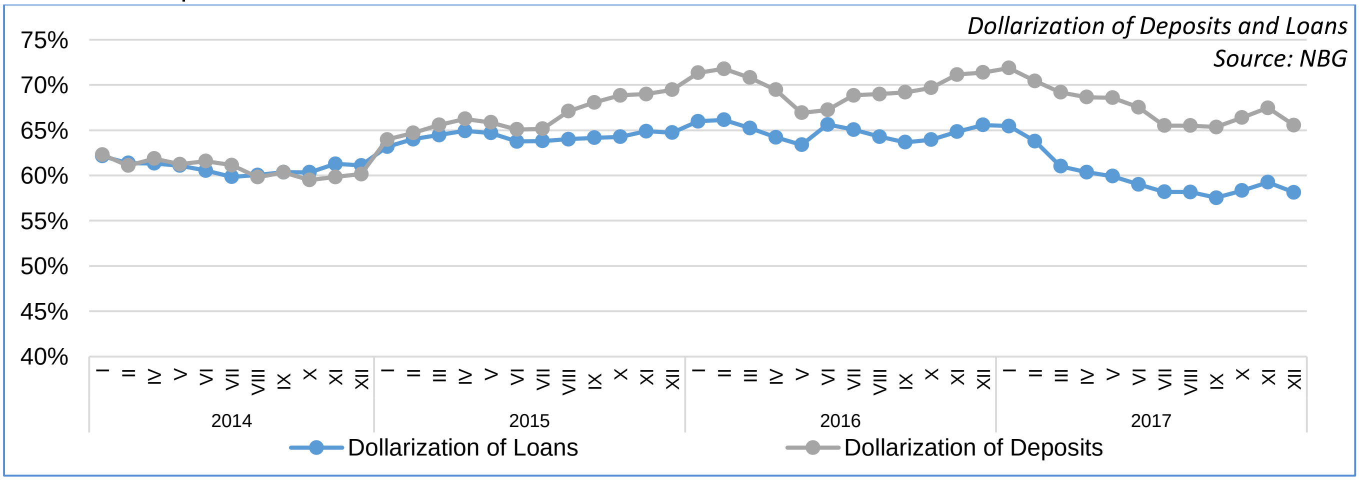
Market Interest Rates on Loans
Source: NBG



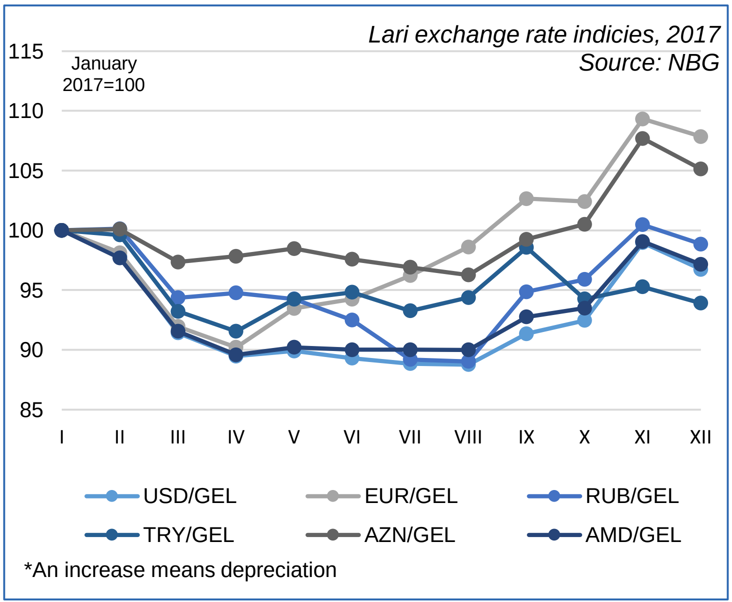
Dollarization rates of non-bank deposits and loans decreased in 2017: the dollarization of deposits fell by 5.8 pp, while loans were less dollarized by 7.5 pp. The fact that dollarization declined during the year despite fluctuations with the lari's nominal exchange rate, indicates that the macro-prudential mechanisms implemented by the NBG earlier in 2017 had the desired effect.

At the same time, the de-dollarization policy affected lending rates: the artificially-induced surge in demand for retail loans in national currency among physical persons led to an increase in retail borrowing rates for individuals and households, while for legal entities loans in national and foreign currencies became cheaper.

Dollarization of Deposits and Loans
Source: NBG



Exchange Rates. Is the winter time depreciation of GEL a self-fulfilling prophecy?



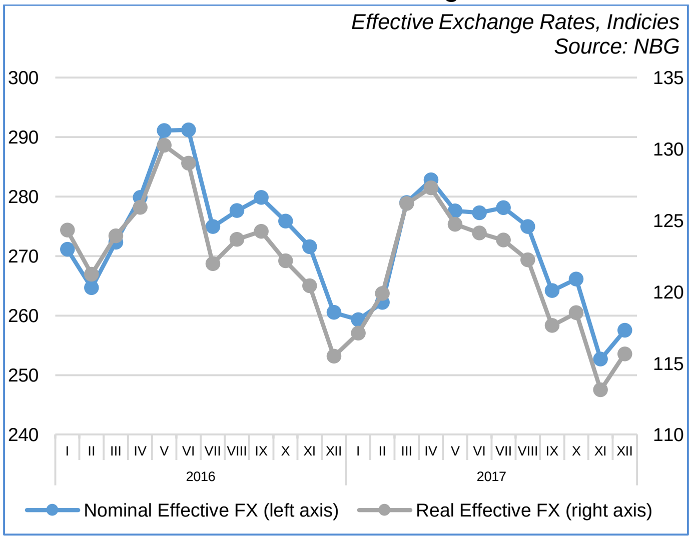
In 2017, the GEL nominal exchange rate repeated the patterns of 2016: appreciation in the beginning of the year, followed by stabilization and then a subsequent depreciation in the fourth quarter.

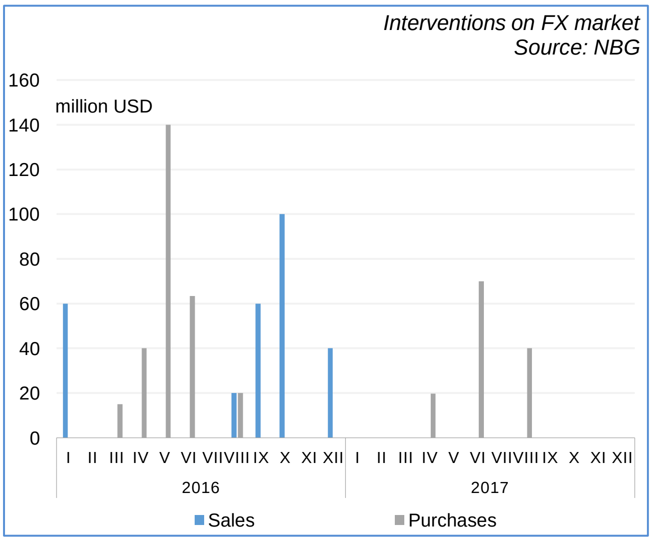
The exchange rate appreciation was caused by a boom in exports, increased money inflows and strong FDI statistics. In the last quarter of 2017, however, the lari depreciated once again, while the trade balance deficit widened. This was in part due to the invasion of the Asian stink bug (brown marmorated stink bug), which drastically decreased exports of hazelnuts by 50% YoY (valued at about 90 million USD). The foreign currency revenues from hazelnut exports go directly to the foreign exchange market and probably strengthen the exchange rate more than the export of any other product. Another explanation for the depreciation of the lari in the last months of the year is related to the expectations of the private sector: during the last two years, the lari depreciated (for various reasons) in the winter period. In anticipation of another depreciation wave, market participants may have sold lari and bought foreign currency, thus making depreciation a self-fulfilling prophecy.

In 2017, the lari lost value (7.8% YoY) against the euro due to the global appreciation of the euro that started in summer, while the USD/GEL nominal exchange rate showed a moderate appreciation of 3.3% YoY. At the same time, the **lari depreciated against the Azerbaijani manat by 5.1%, while gaining against the Russian ruble (1.3% YoY), Armenian dram (2.9% YoY), and Turkish lira (6.1% YoY).**

These currency trends were reflected in the effective exchange rates. **In 2017, the Georgian lari on average slightly depreciated in both nominal and real terms by 2.4% and 2.2% respectively**. Georgian exports became relatively cheaper, while import prices rose for Georgian households and companies.

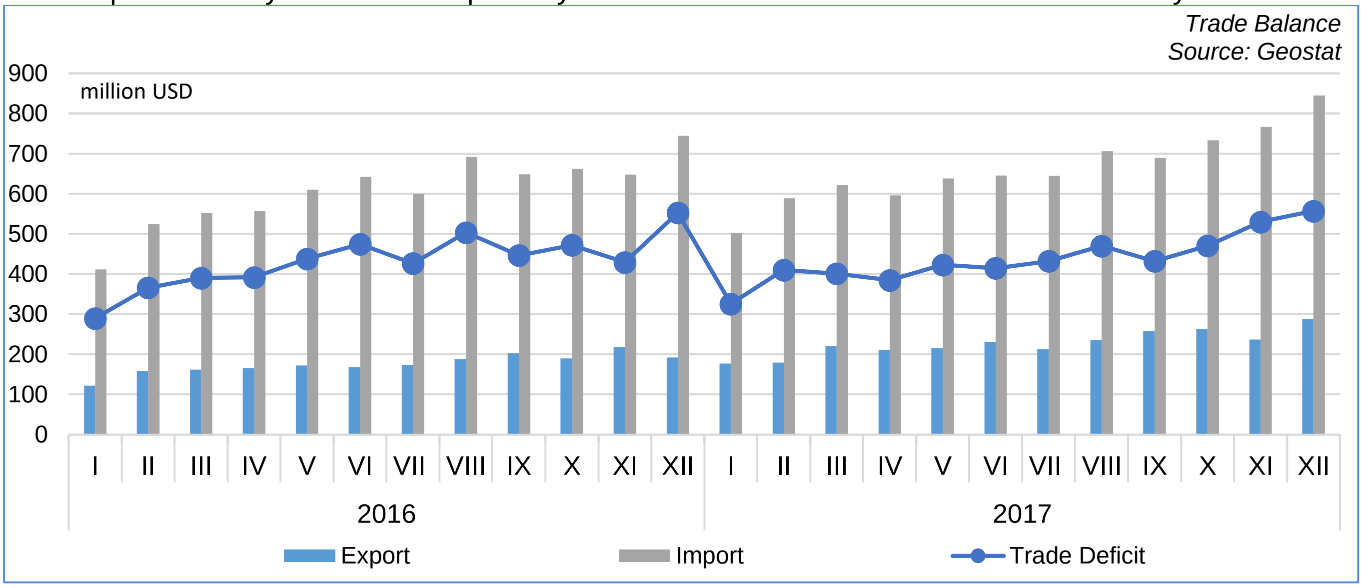
It is worth mentioning that the NBG did not perform any foreign currency selling auctions in 2017, while the total amount of purchases made in auctions constituted 129.75 million USD. This was a tiny intervention compared to the 280 million USD in sales and 278.35 million USD in purchases made in 2016 to curb fluctuations on the exchange market.





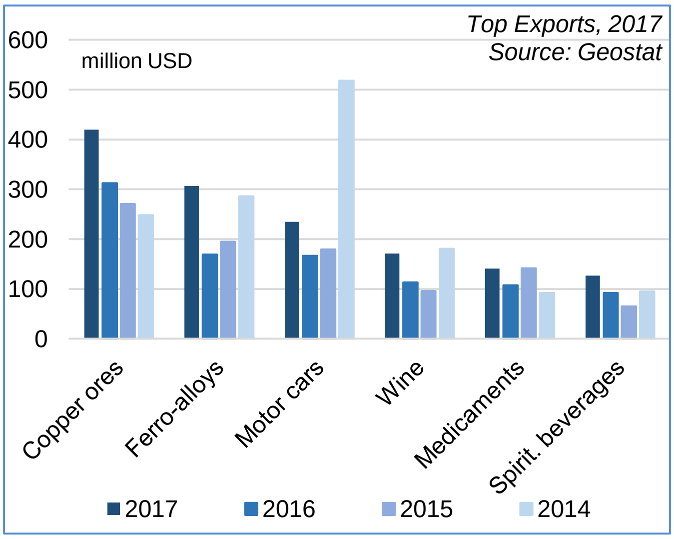
Trade: total exports recover, but are still suffering from low diversification

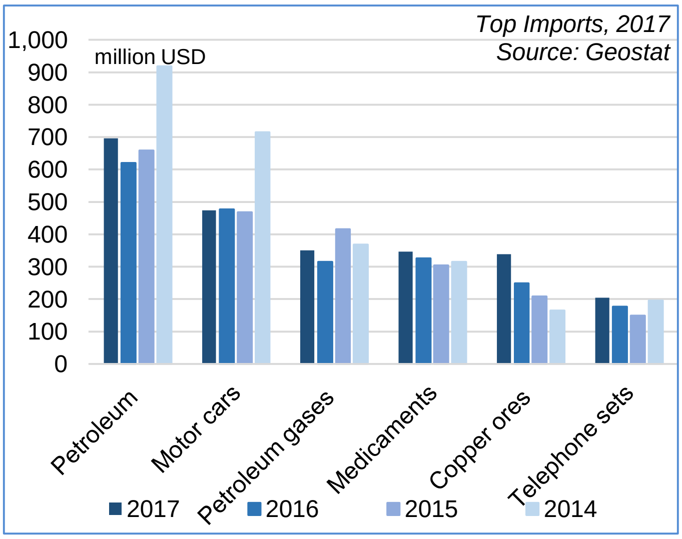
Trade conditions were good for Georgia in 2017. After two consecutive years of export contraction, Georgia showed positive dynamics in external merchandise trade. Trade turnover increased by 13.8% YoY. Exports rose by 29.1% and imports by 9.4% YoY. The overall trade deficit widened by 1.4% YoY.



The boost in exports was primarily driven by improved external demand conditions and a surge in metal prices. Ferro-alloys and copper ores prices spiked by 81.3% and 34.4% YoY respectively. Car re-exports (+41% YoY), wine (+50.6% YoY), medicaments (+30.9% YoY), and spirituous beverages (+37.8% YoY) were the other main drivers of the export hike in the reported period. **The bad news is that the structure of Georgian exports is still characterized by low diversification** – the top ten export commodities accounted for 63.3% of total exports.

The structure of imports was more diversified – the top ten import commodities accounted for 34.8% of total imports. Import of copper ores (36.1% YoY), which are used for re-export, was the main driver of the imports increase. It seems that excise tax had a significant impact on the imports of fuel. Despite a 12.3% YoY increase in import values, the fact that oil prices on international markets went up by an average

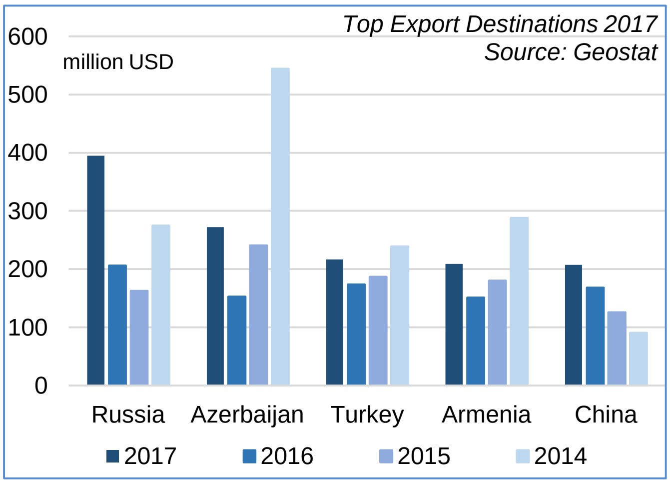


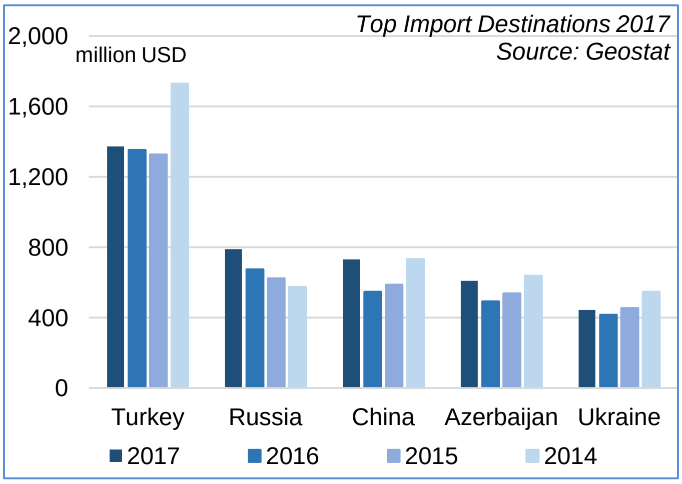


23.3% YoY (IMF crude oil prices) suggests that the quantity of imported petroleum decreased by about 8.9% (authors' calculations). It turns out that the price elasticity of demand for fuel is higher in Georgia than is assumed by general economy theory.

The geographic composition of trade also changed in 2017. **Exports to CIS countries increased by 59.9% YoY and constituted 43.3% of total exports.** This increase was mainly driven by export growth to Russia (+91.3% YoY) and Azerbaijan (78.1% YoY). Exports to EU countries increased by 13.2% and those to other countries rose by 12% YoY in 2017. The increased importance of the Russian market for Georgian exporters contains political risks for producers in light of previous embargos. While Georgia still needs time to finish the process of harmonization to take full advantage of the Association Agreement and DCFTA with the European Union, the recently signed FTA with China, which came into force in January 2018, is expected to boost exports to China quite rapidly.

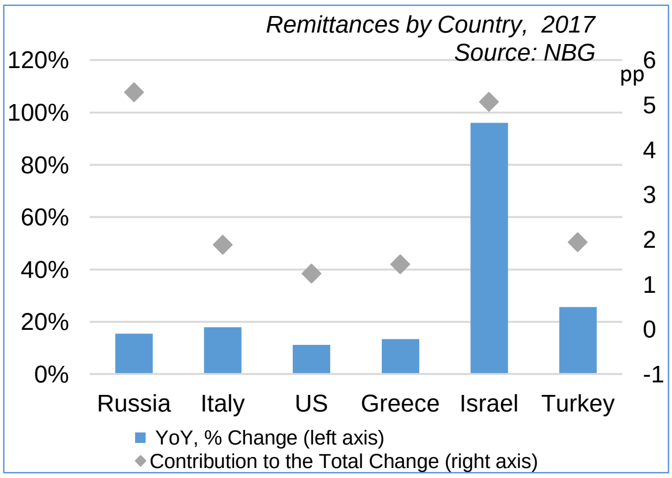
Remittances: Israel emerges as one of the fastest growing source countries.

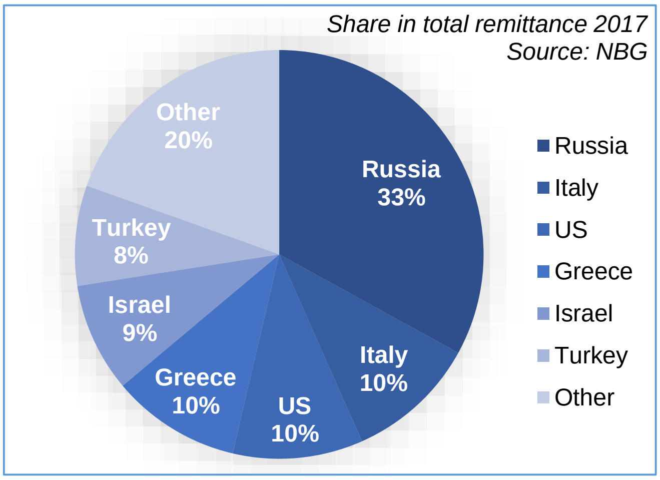




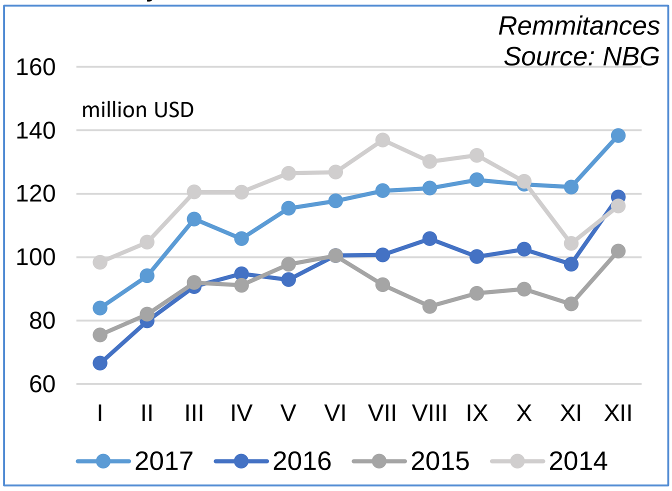
According to GeoStat, **the volume of total remittances to Georgia amounted to 1,379 million USD in 2017, a 19.8% YoY increase**. The recovery of remittances is a clear sign that the economies of Georgia's partner countries continue to improve. All top source countries of money inflows to Georgia showed a notable increase: Russia (+15.4% YoY), Italy (+17.9% YoY), the United States (+11.2% YoY) and Greece (+13.4% YoY).

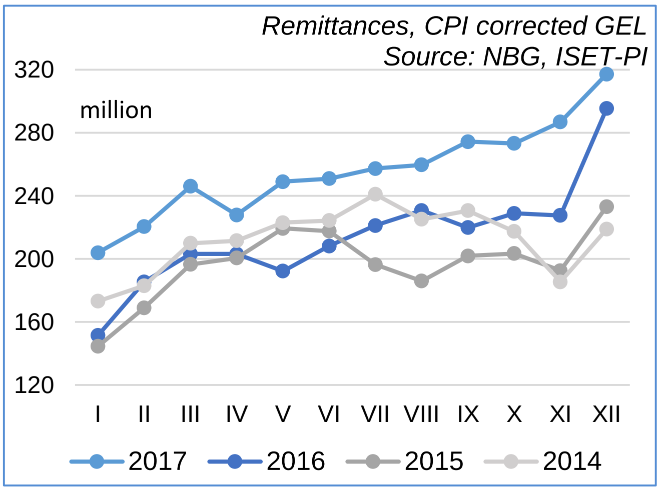
Money inflows from Israel showed unprecedented annual growth of 96.1%. This stemmed from the wave of Georgian emigration that started in 2014 when the countries ratified a visa-free regime. Following this, many Georgians stayed in Israel illegally or sought asylum there after finding it to be an outstanding country in which to work and send money back to their homeland. Israel overtook Turkey (+25.6% YoY) to become the fifth biggest source of money inflows from Georgia in 2017.





Despite the positive dynamics in 2017, money inflows were still 4.3% behind 2014 levels. However, the exchange rate depreciation and moderate levels of inflation have boosted the purchasing power of remittances. Remittances in CPI adjusted lari terms, which measures the purchasing power of money inflows to Georgia, showed a 19.5% and 20.6% YoY increase compared to 2016 and 2014 respectively. Thus, remittances were an additional external factor that stimulated economic growth in 2017. Moreover, remittances are a source of foreign currency inflows into the country and are important for lari exchange rate stability.





International Arrivals: Asia shows a huge potential as a source of tourism for Georgia.

In 2017, there were 7,554,936 international arrivals to Georgia, which was **a 18.8% YoY increase**. Of these, 77.8% arrived by land, 20.7% by air, 1% by rail and 0.5% by sea.

As usual, the highest share of total visitors to Georgia were from neighboring countries – Armenia, Azerbaijan, Russia and Turkey. Taken together, visitors from neighboring countries constituted 80.1% of the total visitor flow. However, dramatic growth was seen in visitors from Iran (+118.3% YoY) and Saudi Arabia (+164.6% YoY) in 2017. The high growth in those numbers emphasize the huge potential of Asia in terms of tourism development for Georgia.

Table 3: International Arrivals by Country *Source: GNTA*

	Country	2016	2017	Change	Change %	Share %
1	Armenia	1,496,437	1,718,016	221,579	14.8%	22.7%
2	Azerbaijan	1,523,703	1,694,998	171,295	11.2%	22.4%
3	Russia	1,038,750	1,392,610	353,860	34.1%	18.4%
4	Turkey	1,256,561	1,246,745	-9,816	-0.8%	16.5%
5	Iran	147,937	322,938	175,001	118.3%	4.3%
6	Ukraine	174,858	193,002	18,144	10.4%	2.6%
7	Israel	92,215	125,319	33,104	35.9%	1.7%
8	India	36,410	59,732	23,322	64.1%	0.8%
9	Kazakhstan	48,849	56,765	7,916	16.2%	0.8%
10	Saudi Arabia	21,257	56,247	34,990	164.6%	0.7%
11	Poland	44,436	52,284	7,848	17.7%	0.7%
12	Germany	40,915	51,445	10,530	25.7%	0.7%
13	Belarus	37,110	47,984	10,874	29.3%	0.6%
14	U S A	34,250	42,645	8,395	24.5%	0.6%
15	UK	19,198	26,852	7,654	39.9%	0.4%

The year 2017 was very successful for Georgia in terms of **international tourism**. The number of tourists (visitors who stayed in Georgia for 24 hours or more) constituted 3,478,932 people, a **27.9% YoY increase**. These tourists brought 2.2 billion USD to Georgia in the first three quarters of 2017, which was 29% more than in the same period of the previous year. Tourism was one of the main drivers of economic growth in 2017 and one of the main sources of foreign currency inflow. It is expected that the **total export of tourism services in 2017 will be higher than the total export of goods**, which constituted 2.7 billion USD.

Table 4: International Arrivals by Type of Visit *Source: GNTA*

Type of Visit	2013	2014	2015	2016
24 hours or more	2 065 296	2 229 094	2 281 971	2 714 773
Transit	1 188 791	1 114 036	1 400 835	1 321 000
Same-day visit	2 138 216	2 172 429	2 218 288	2 315 052
Total	5 392 303	5 515 559	5 901 094	6 350 825

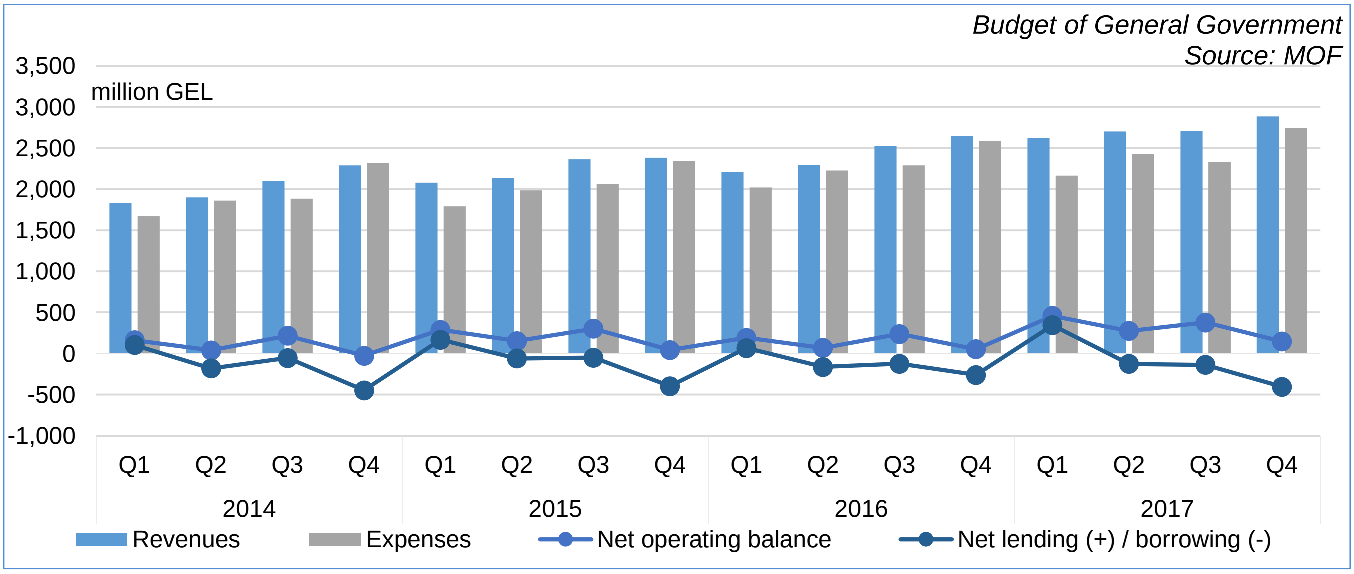
Public Finances – winning a gamble on the economy

Initially, the budget plan for 2017 contained huge risks associated with the mobilization of revenues. The main sources of which were an increase of liabilities (both domestic and foreign) and a hike of excise taxes on gas and fuel, cigarettes, and automobiles (projected to finance the CIT reform). However, the better-than-expected economic development in 2017 mitigated these risks. **General government total revenues amounted to 10.9 billion GEL, a 12.9% YoY increase**. Revenues from taxes increased by 11.3% YoY and constituted 9.8 billion GEL. Very strong VAT (+25.4% YoY) and personal income tax (+20.9% YoY) collections outweighed the less-than-planned revenues from excise tax (+35.6% YoY) and the expected drop of profit tax revenues. The latter decreased by 28.4% YoY, suggesting that the CIT reform gave businesses incentives to reinvest their profits.

At the same time, expenses of the general government amounted to 9.8 billion GEL, a 5.9% YoY increase. The government started to decrease current expenses, and the compensation given to employees thus declined by 5.9% YoY in 2017. Further optimization and a reorganization of current public spending was announced in December 2017. Other categories of expenses all rose – use of goods and services (+10.2% YoY), interest payments (+19.3%% YoY), subsidies (+23.2% YoY), grants (+1.3% YoY), social benefits (+4.4% YoY) and other expenses (+7% YoY).

In the reported year, the net acquisition of nonfinancial assets by the government grew by an impressive 53.6% YoY (1.6 billion GEL), which can be explained by higher capital expenditures.

Overall, due to strong tax collection **the general government budget deficit decreased by 32.4% YoY to 324 million GEL.**



Overall, 2017 was quite a good year for Georgia

The 2017 was marked by faster growth, a recovery of exports, effective reform efforts (e.g. the larization and CIT reforms) and a significant boost in the tourism sector. On the negative side, Georgia's existing external weaknesses were still apparent in the 2017 data: low diversification of the export sector, reliance on primary commodities and re-exports – all significantly increase the future vulnerability of the economy. The increase in household indebtedness is also a cause for concern, despite the fact that banking sector stability appears intact. Tackling these issues with relevant policies should be at the top of the agenda for policy makers in the coming year.