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GEORGIA'S GROWTH EXPECTATIONS MARRED BY CONCERNS ABOUT NEGATIVE SPILLOVERS FROM REGIONAL ECONOMIES

Growth

On 4 October 2016, the IMF's flagship *World Economic Outlook* (WEO) publication updated its projections of the main global macroeconomic indicators. According to the WEO,

“Global growth is projected to slow to 3.1 percent in 2016 before recovering to 3.4 percent in 2017. The forecast, revised down by 0.1 percentage point for 2016 and 2017 relative to April, reflects a more subdued outlook for advanced economies following the June U.K. vote in favor of leaving the European Union (Brexit) and weaker-than-expected growth in the United States. These developments have put further downward pressure on global interest rates, as monetary policy is now expected to remain accommodative for longer”.

In contrast, Georgia's real GDP growth forecast for 2016 was revised upward to 3.4% from the projected 2.5% in April. For Georgia's neighboring countries, the IMF predictions were as follows: Turkey 3.3%, Armenia 3.2%, Azerbaijan -2.4%, and Russia -0.8%.

The IMF's projection for real GDP growth in Georgia in 2017 was revised upward to 5.2% from the predicted 4.5% in April. This is the highest projected regional growth rate and is certainly very encouraging. Despite this, Georgia remains a small economy, where GDP growth has always been highly correlated to the economic performance of its large trading partners. Sluggish regional demand may thus generate negative spillovers and put the brakes on GDP growth in the country.

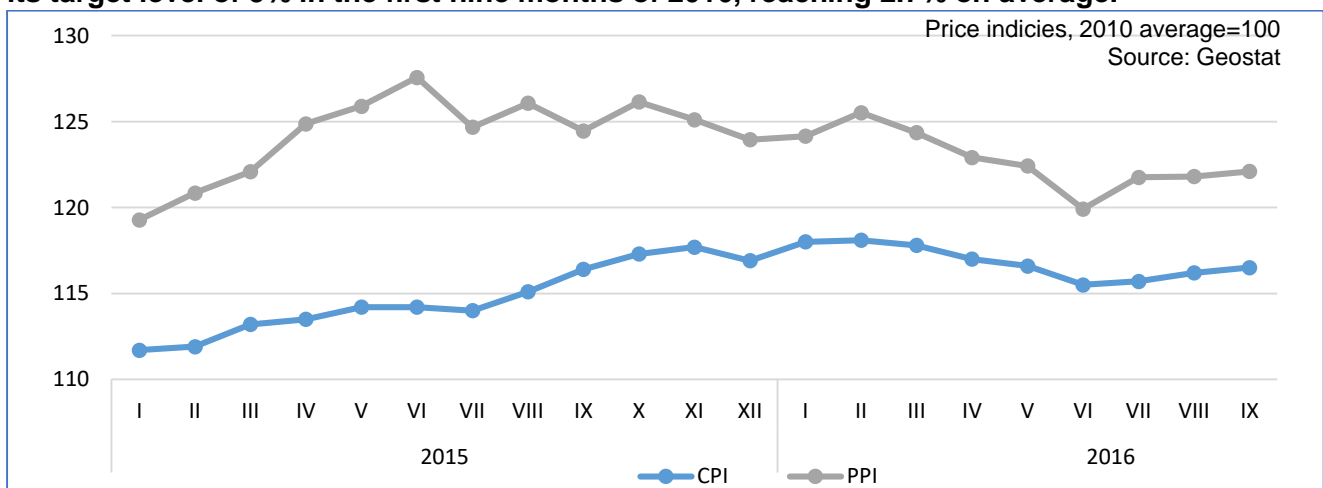
Energy demand

Total electricity consumption increased by 4.3% YoY in September. The electricity consumption through distribution companies (for households and business needs) increased by 6.2%, while direct consumers (large companies) decreased their consumption by 15.9% YoY. Import of electricity constituted only 3% of total consumption.

On 6 October, Georgia started running its first wind farm in the Gori and Kareli municipalities. The “Energy Development Fund” made a total investment of 34 million USD in the project, with the EBRD providing a 25 million USD loan. This power plant will satisfy part of the national electricity demand during winter. The total installed capacity of the plant is 20.7 MW, and the annual electricity generated is expected to be 88 GWh, which is about 44% of the installed capacity of the plant.

Inflation

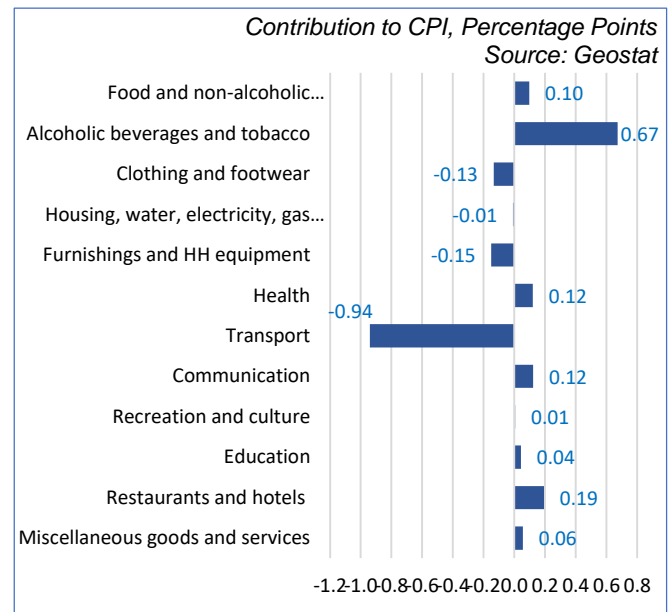
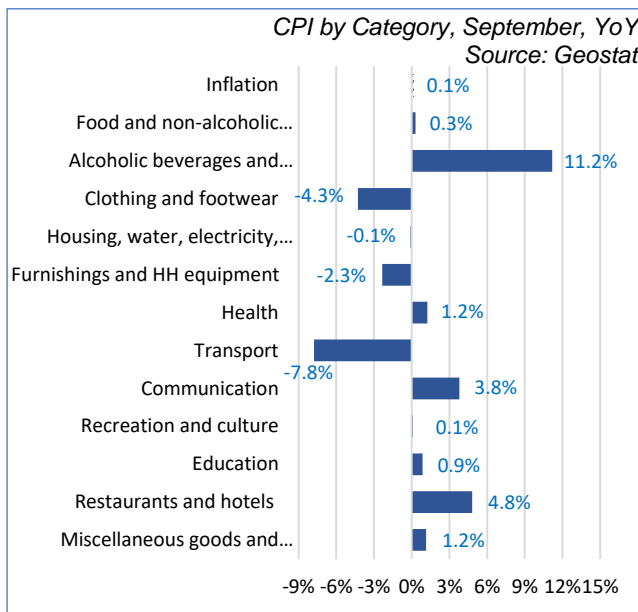
The annual **Consumer Price Index (CPI)** stood at 0.1% YoY in September. **Inflation was well below its target level of 5% in the first nine months of 2016, reaching 2.7% on average.**





More detailed price data suggest that the 0.1% YoY CPI inflation in September was mainly driven by two product categories: alcoholic beverages & tobacco, and restaurants & hotels. Taken together, these categories contributed about 0.86 percentage points to inflation. Alcoholic beverages & tobacco saw an 11.2% YoY increase in prices, mainly due to a hike in excise taxes introduced in January 2016, as well as an increased inflow of tourists. The price increase in the restaurants & hotels category was 4.8% YoY, while the prices in other categories increased insignificantly in September.

At the same time, four product categories saw a YoY decline of prices in September. Transport prices fell the most, registering a 7.8% drop (making a -0.94 pp contribution to total inflation). Prices of housing, water, electricity, gas and other fuels registered a negative change for the first time in 2016. This is mostly explained by the fact that the level change in electricity tariffs happened in September last year, and the effect of that tariff hike receded in the October 2016 data.



The **Producer Price Index (PPI)** was 1.9% lower YoY in September 2016. Producer prices fell the most for manufacturing products, in particular textiles (-25.2% YoY), machinery and equipment (-20.5% YoY), chemical products (-17.7% YoY), and basic metals and fabricated metal products (-13.1% YoY). Average prices for the entire manufacturing sector decreased by 4.1% YoY, contributing -3.43 pp to the overall PPI change. Only prices for the supply of electricity, gas, and water showed a significant increase of 13.7% YoY, contributing 1.79 pp to the overall PPI change.

In monthly terms, both the CPI and PPI increased by 0.3% compared to August. The low and even negative dynamics in the consumer and producer price indices was caused by low commodity prices on world markets and sluggish internal and global demand.

Tourism

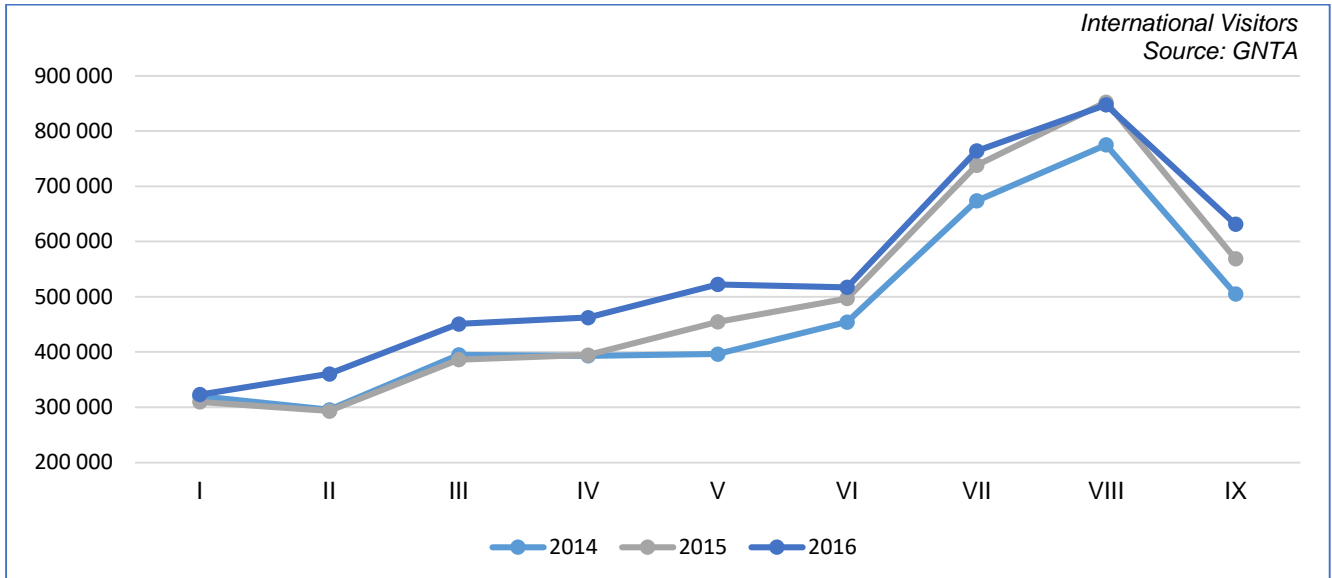
In September 2016, 631,302 international visitors entered Georgia - an 11.0% YoY increase. Of these, 77.1% arrived by land, 21.3% by air, 0.6% by sea and 1% by railway. Visitors who stayed in Georgia for 24 hours or more (defined as “tourists”) constituted 39.9% of the total, or 305,814 persons – a **34.2% YoY increase**.

Azerbaijan (+7.6% YoY), Armenia (+4.2% YoY), Russia (+31.3%) and Turkey (-21.5% YoY) continued to be the top origin countries for international arrivals in September. Once again, Iran (+571.9% YoY), India (+132.0% YoY), and Saudi Arabia (+83.1% YoY) showed a dramatic increase in the number of arrivals, which underlines Asia’s great tourism potential for Georgia.

The government partially managed to prolong the tourist season. The graph below suggests that the increase in the number of international arrivals was greater for non-season months than it was in June-August 2016. The low growth rate of the number of arrivals between June-August 2015 and 2016 could

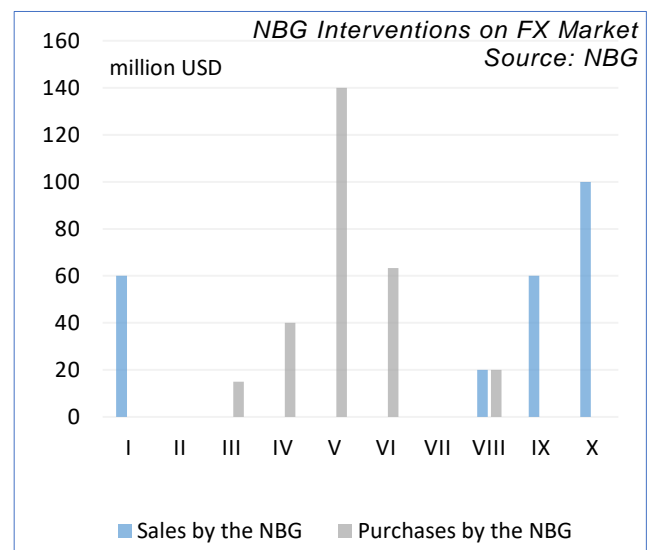
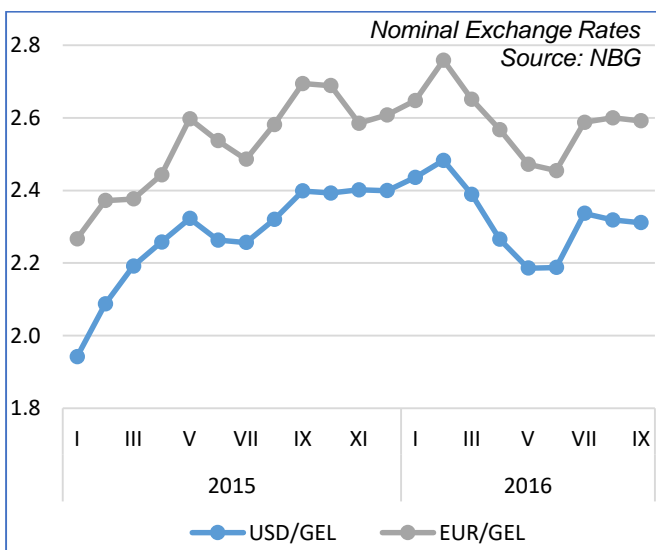


signal that the tourism capacity in these months has already been reached (given existing infrastructure constraints). Tourists might be deterred by the high seasonal prices in Georgia, compared to other popular tourist destinations. Alleviating the shortage of hotels, restaurants and rooms during peak season months could push prices down and help keep the Georgian tourism industry competitive.



Exchange rates

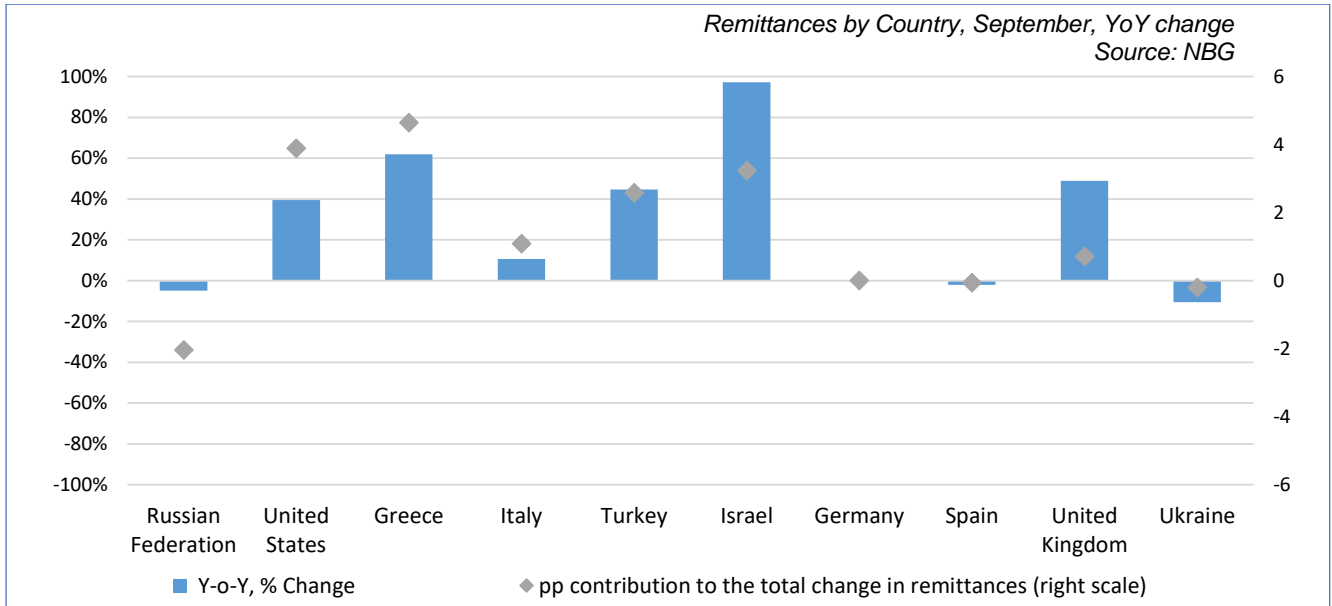
The average monthly USD/GEL exchange rate in September was 2.31, and the EUR/GEL rate stood at 2.59. At the end of September, the lari started to depreciate against the US dollar, which was caused by several big transactions of Georgian firms connected with foreign debt servicing. In this regard, the NBG performed net sales of 60 million USD in two auctions. However, in the beginning of October (before the parliamentary elections), the lari exchange rate against the USD experienced additional pressure through the expectation channel. The NBG intervened in the foreign exchange market once again by selling 60 million USD before the elections and an additional 40 million USD on 12 October, after the elections. As a result, the NBG managed to smooth the lari depreciation against the dollar – the lari lost only 1.8% between the first intervention in September and the last intervention in October. The nominal effective exchange rate showed a 0.6% devaluation of the lari in the same period.





Remittances

In September 2016, remittance inflows to Georgia amounted to 100.2 million USD, which was a 13.1% YoY increase. Money transfers from Greece (+61.9% YoY), the United States (+39.5% YoY), Israel (+97.2% YoY) and Turkey (+44.7% YoY) contributed 14.4 pp to the total remittances change. The -4.9% YoY decrease of money inflows from Russia was the main factor checking the total growth of remittances in September. The slowed inflows from Russia contributed -2.03 pp to the overall remittances change in September.



The diversification of money inflows improved in September, with only 35% of total remittances now coming from Russia. The United States became the second largest source of money inflows to Georgia (12% of total remittances). The shares of Greece and Italy in September were 11% and 10% respectively.

However, data suggests that the economic crises in Russia and Greece contributed more to the diversification than the stable growth of money inflows from the United States, Turkey, and Israel.

