Mixed blessings of recovery: what does Georgia's best quarter since the pandemic tell us?

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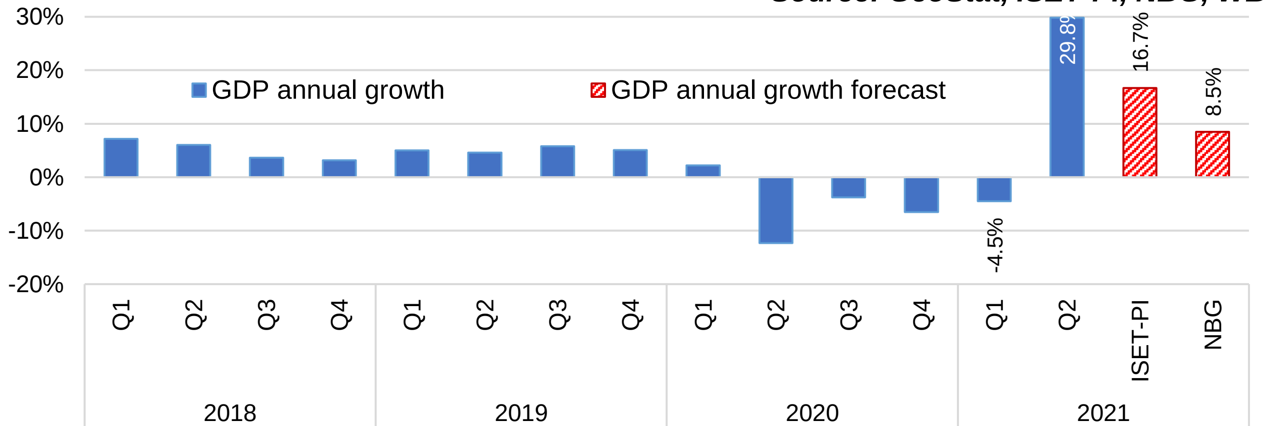
Economic growth

The global economy continues to recover in Q2 2021 following the deep economic crisis caused by the COVID-19 pandemic in 2020. The growth accelerated as a result of the easing of virus-containment restrictions in most countries. IMF (July 2021) estimates that global GDP growth will reach 6% year over year (y/y) in 2021. Though this rebound is uneven – compared to the previous estimates (April 2021), growth projections for emerging markets and developing economies are revised downward. This is driven by slower than anticipated mass vaccination in the developing economies, where infection rates remain quite high and various restrictions are still in place. In contrast, mass immunization is more successful in developed countries. Together with additional fiscal support announced in some of the countries in the second half of 2021 it drove the annual growth forecast for advanced economies up by 0.5 percentage points (pp).

United States and Euro area are projected to expand by 7% and 4.6%, respectively, while the Chinese economy is expected to grow by 8.1%. In addition, Georgia's neighbors Russia and Turkey are each projected to show moderate growth this year: 4.4% and 5.8% y/y respectively.[1]

According to Geostat's latest GDP growth estimates, Georgia's economy spiked by 29.8% y/y in Q2 of 2021. Although the growth was partially driven by the base effect (due to significant contraction experienced in the corresponding quarter of last year), the current level of economic activity has even exceeded the level observed inQ2 of 2019 by 12.7% y/y. This positive development was driven by rebound in both domestic and external demand. The latter improved as exports of goods and remittances increased considerably, while tourism revenues partially recovered in Q2 of 2021. Significant improvement in domestic demand is partially explained by so called "pent-up demand" – consumers who were holding off purchases during a recession (in 2020), built up a backlog of demand that was unleashed when signs of a recovery emerged. Strong fiscal stimulus and improved credit activity were additional factors behind the rebound in domestic demand in Q2 of 2021.

Real GDP Growth, Y/Y Change
Source: GeoStat, ISET-PI, NBG, WB



[1] Updated growth figures for Armenia and Azerbaijan are not provided in July 2021 World Economic Outlook of IMF. According to April's publication, these economies are projected to grow by 1% and 2.3% y/y respectively in 2021

Considering the dynamics, NBG (July 2021) revised its growth forecast upward from 4% y/y to 8.5% y/y in 2021. Domestic consumption, pushed by strong fiscal stimulus and credit activities, will be the main driver of economic growth this year. Based on July data, ISET-PI's GDP forecast places the 2021 annual real GDP growth at 16.7% y/y.

The emergence of more deadly and resistant variants of the virus, slower than expected vaccination process and re-imposition of COVID-related restrictions in some countries created uncertainties and further risks to global growth. Uncertain political environment in Georgia and hotly contested October's local self-government elections only exacerbate existing risks. Additionally, elevated inflation caused by high commodity and food prices creates additional downside risk for the global and Georgian economic prospects. If inflation expectations continue to grow further, a reassessment of the monetary policy (increase in policy rates) in advanced economies would tighten external financial conditions for developing and emerging markets.

Inflation

In Q2 2021, annual CPI inflation rose to 8.3% – 5.3 pp higher than the targeted 3%. Among the main drivers of inflation were increased transportation (17.3% y/y) and food prices (+5% y/y). These categories contributed 3.9 pp to the overall inflation. All other product categories saw an annual increase in prices, except for communication. Most notable price changes were observed in the following product categories: Health (+12.9% y/y), Restaurants and hotels (12.1% y/y), Furnishings and HH equipment (+10.5% y/y), Housing, water, electricity, gas and other fuels (8.1% y/y), Alcoholic beverages and tobacco (7.4% y/y).

High inflation in Q2 was mainly driven by increased food and oil prices on the international market. Since the beginning of the year oil prices have been rising and now stood at three-year high, as global demand started to recover. Due to increased oil prices and pandemic-related restrictions, international transport and logistic costs remain high, which affects the final prices of international shipping and traded goods, including food. As a result, world food prices reached ten-year high.

In addition, despite the fact that Lari exchange rate stabilized against US dollar, nominal effective exchange rate depreciated in annual terms (-4.3 y/y). Moreover, according to NBG (July 2021) the contribution of utility bills to annual inflation rose from 0.3 pp to 1.7 pp as natural gas tariffs increased in Tbilisi since June.

Going forward, inflation is expected to continue rising, with elevated oil and food prices further transmitting to local prices. The end of government price subsidy programs on utility bills and some food products (which artificially reduced inflation in the previous periods) automatically imply further increase in prices on these goods and services In addition, an upswing in aggregate demand which was observed in Q2 of 2020, will no longer counterbalance the above-mentioned inflationary pressures. Under NBG's monetary policy report, "high inflation is expected to persist in the short run, and average inflation for 2021 will exceed 9%". Considering mounting inflation pressures, NBG has continued to tighten monetary policy, and increased the policy rate by 1 pp in April and 0.5 pp in August 2021.

The persisting trend of high annual food inflation over the last few years, together with the economic impacts of COVID-19, has exacerbated food insecurity and threatens to increase poverty. Furthermore, due to high aggregate inflation, monetary policy cannot be used to support economic growth; rather, as it tightens to curb inflation, it may slow down economic recovery in the future.

External sector: trade, tourism, remittances, FDI

As countries started to gradually lift COVID-19 related restrictions and reopen economies, external demand significantly improved compared to the same period of 2020. This was reflected in the increased trade of goods and money transfers into Georgia. The FDI, however, continued to decline during this period.

In the second quarter of 2021, Georgia's external merchandise trade expanded by 46.7% y/y, driven by increase in both exports and imports. Due to the above-mentioned increase, and given that import values are significantly higher than exports, the negative trade balance widened by 46% and constituted 1,301 million USD. However, both exports and imports were higher than Q2 2019, indicating that Q2 growth was not just due to recovery from a low base. It should be noted that domestic exports increased by 41.8% y/y in Q2 2021.

The increase in exports was driven by the greater export copper ores and unwrought aluminum to China; motor cars and motor vehicles for the transport of goods to Azerbaijan; ferro-alloys, natural grape wines and mineral waters to Russia; motor cars, automatic data processing machines and chemical fertilizers to Ukraine; metal waste and scrap, and clothes to Turkey. Concurrently, the exports of medicaments to Uzbekistan, copper ores to Bulgaria and Spain, and semi-manufactured gold to Switzerland Azerbaijan showed negative annual growth in Q2. The main destination markets for Georgian export products in Q2 were China (16.9% of the total), Russia (14.7%), Azerbaijan (13.1%), Turkey (8.3%), and Ukraine (6.7%). The top ten destination countries for Georgian exports accounted for 78.9% of total exports, thus underlining the problem of low export diversification.

Imports amounted to 2,368 million USD in Q2 2021. This figure was mainly driven by the increased import of petroleum (+126.7% % y/y), copper ores (+40.7% y/y), motor cars (+25.4% y/y), motor vehicles for the transport of ten or more persons (+9798.0% y/y) and goods (139.3% y/y), and telephone sets (+125% y/y). While wheat and meslin (-22.6% y/y), petroleum gases (-6.6%), and sugar (-12.2% y/y) were the main products driving imports downward in Q2. The main source markets for Georgian imports were Turkey (18.4% of the total), Russia (10.3%), China (7.6% y/y), the USA (5.7%), and Ukraine (5%). Imports were more diversified compared to exports, as the top ten source countries for Georgian imports accounted for only 66.2% of total imports.

As travel restrictions were eased and mass immunization campaigns started in most of the countries including Georgia, international tourism started to gradually recover. However, slow vaccination process and continuation of virus-containment restrictions hindered the tourism sector in Georgia. The number of international visitors increased 3 times, while the revenues from foreign travelers increased 8.5 times y/y in the second quarter of 2021. Such a notable upsurge in tourism figures is driven by a low base effect, as in Q2 of 2020 tourism industry was in a standstill. Compared to the same period of 2019 international visitors and revenues from international travel are still down by 82.4% and 72% y/y respectively.

By NBG estimations, the volume of total remittances to Georgia amounted to 583.7 million USD in Q2 2021, an impressive 53.5% annual increase. All primary source countries for money inflows also showed a positive growth trend, especially Azerbaijan (+122% y/y), Ukraine (+100.8% y/y), Germany (+75.8% y/y), USA (+64.5% y/y), Russia (+59.1% y/y), Spain (+48.9% y/y), Italy (+40.8% y/y), and Greece (+28.1% y/y). Money transfers from Kazakhstan, Moldova and Tajikistan spiked more than 3 times compared to Q2 of 2020 potentially indicating the wave of emigration of workers from Georgia to these countries in the recent past.

Foreign direct investment to Georgia according to preliminary statistics amounted to 234.2 million USD in Q2 2021, which is 2.6% lower than the data from Q2 2020. Majority of FDI was directed towards the financial, energy, manufacturing, and real estate sectors. Most other sectors showed negative FDI growth which was due to transfer of ownership from non-resident to resident companies. With uncertainty in both global and local economies, we expect FDI to remain at a low level in 2021.

Public finances

The total revenue of the general budget amounted to 3,491.7 million GEL, a rise of 22.7% y/y – largely driven by an increased tax collection (+24.8% y/y). Collection of VAT (+66.3% y/y), excise (+27.7% y/y) and custom duties (+21.8% y/y) contributed the most in the increase. Other revenues amounted to 412.9 million GEL, while it was nearly zero in the second quarter of the previous year.

As mentioned earlier, Q2 was characterized by strong fiscal support. Current governmental expenditures increased by 26.9% y/y in the reported quarter (amounting to 3,765.6 million GEL). This growth was driven by higher spending on all categories: social benefits (+17.6% y/y), other expenses (+54.4% y/y), subsidies (+60.6% y/y), and use of goods and services (+29.4% y/y). In addition, the Georgian government continued its course of high capital spending – the net acquisition of non-financial assets increased by 30.2% y/y to 827.8 million GEL in Q2.

Strong fiscal stimulus resulted in a budget deficit of 1101.7 million GEL (+45% y/y), as increased revenues were balanced out by accelerated current and capital spending. Governmental debt increased by 32% y/y and amounted to 29,570 million GEL. The share of foreign debt in the total debt stood at 80.7%, indicating higher exposure of foreign debt to exchange rate volatility.