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# Quarter 3 reality check for Georgia: low vaccination rates, higher inflation and tepid FDI emerge as new challenges

## Economic Growth

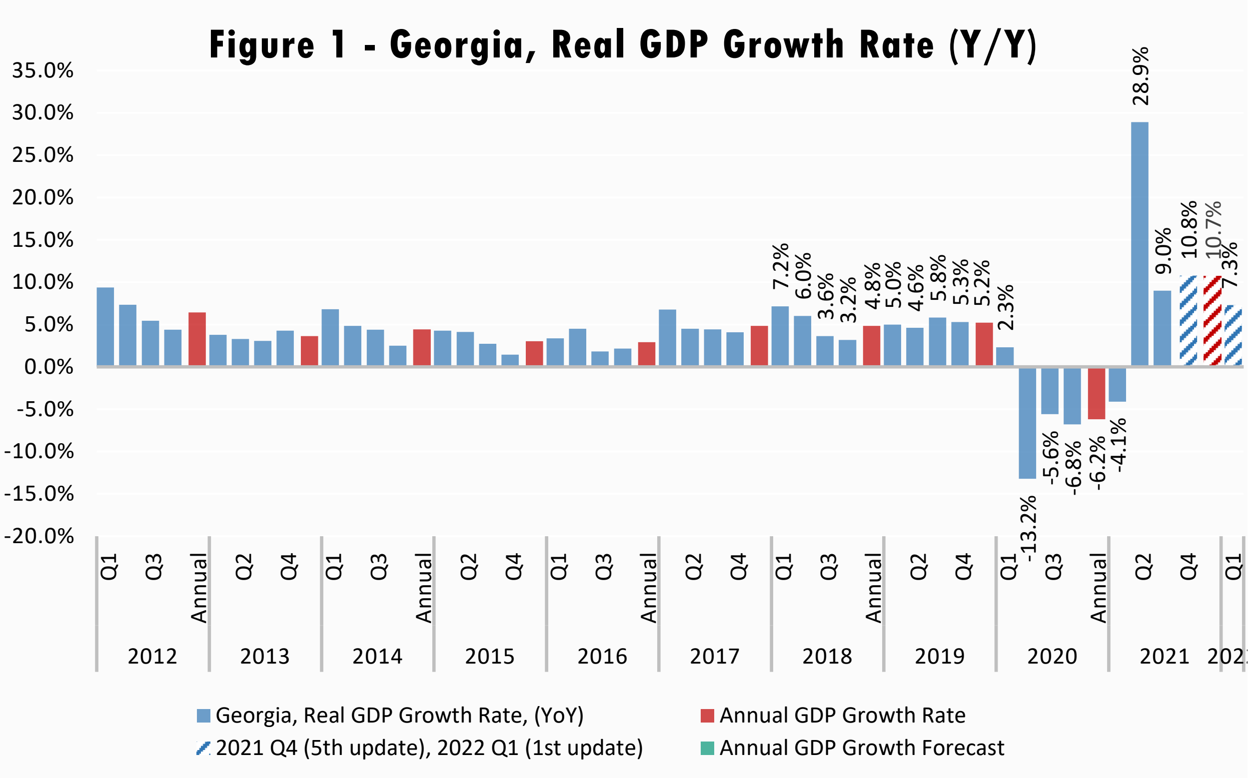
The global economy continues to recover in Q3 2021 following the deep economic crisis caused by the COVID-19 pandemic. The growth accelerated as a result of the easing of virus- containment restrictions in most countries. According to the IMF forecast (October 2021), global GDP will grow 5.9% year over year (y/y), which is a downward adjustment from the previous estimate of 6% (July 2021). The adjustment reflects a downward revision of growth projections for advanced economies and low-income developing economies. The respective drivers are supply disruptions and the slower than anticipated mass vaccination in developing economies. While the majority of the population (58%) in advanced economies is fully vaccinated, the rest of the world is lagging behind with only 36% of the population in emerging market economies and less than 5% of the population in low-income developing countries being fully vaccinated (for comparison, in Georgia about 28.9% of population is fully vaccinated). These factors drove down the annual growth forecasts for the low-income developing economies by 0.6 percentage points (pp) compared to July estimates.

The expected growth rates for the United States and the Euro area are 6% and 5% respectively, while Chinese economy is expected to grow by 8%. Furthermore, Russia is expected to grow by a moderate 4.7% y/y, while Turkey's expected growth rate is projected to be 9% y/y.

In Georgia, after a 29.8% y/y spike in the second quarter, the economic growth slowed down to an estimated 9% y/y in the third quarter[1]. In part, this growth was driven by the base effect (i.e., a recovery from a significant economic contraction in the corresponding quarter of last year). However, **the current economic activity has exceeded the level observed in Q3 of 2019, albeit by a small amount.** The third quarter growth was driven by an accelerated domestic and external demand. The latter improved even compared to the same period in 2019. Exports and remittances have increased on yearly basis, along with a noticeable growth in the number of international visitors. The accelerating domestic demand was driven by strengthening credit activity, continued fiscal stimulus and the 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.

Taking these dynamics into account, NBG (October 2021) has revised the growth forecasts for the Georgian economy upward from 8.5% y/y to 10% y/y in 2021. Accelerating domestic consumption supported by strong fiscal stimulus and credit activities will be the main driver of economic growth this year. **Based on October data, ISET-PI's GDP forecast places the 2021 annual real GDP growth at 10.7% y/y.** (Figure 1 below)

[1] Geostat




The slower than expected vaccination process, the emergence of new, more transmittable variants of the Coronavirus and the re-imposition of restrictions in some countries have resulted in uncertainties and additional risks to global growth. Rising commodity prices on international markets put pressure on inflationary expectation, hence, central banks around the world have tightened monetary policies further. Continued growth of inflationary expectations could cause increase in policy rates in advanced economies, which would tighten financial inflows for developing and emerging markets.

## Inflation

In Q3 2021, annual CPI inflation rose to 12.3% – this is 9.3 pp higher than the targeted 3%. Among the main drivers of inflation were increased Food prices (15.4% y/y) and Transportation (+21.8% y/y). These categories contributed 7.8 pp to the overall inflation. All other product categories except for Communication saw an annual increase in prices. Most notable price changes were observed in the following product categories: Housing, water, electricity, gas and other fuels (+11.5% y/y), Health (10.5% y/y), Furnishings and HH equipment (+12.2% y/y), Restaurants and hotels (10.9% y/y), Alcoholic beverages and tobacco (6.8% y/y).

High inflation in Q3 was mainly driven by increased food and oil prices on the international market. Since the beginning of the year oil prices have been rising. This, together with the Covid-19 related restrictions in the transportation sector have put upward pressure on the transportation costs. Thus, as an import-dependent country, Georgia saw increasing prices of international shipping and traded goods, including food.

In addition, in the third quarter Lari exchange rate stabilized against the US dollar, with nominal effective exchange rate appreciating in annual terms by 1.4% y/y. In September Inflation on imported goods reached 17.8% while on the local products prices were higher by 8.6%. This can be interpreted as an additional sign that current inflation is mainly driven by increased global market prices.

Going forward, the end of government price subsidy programs on utility bills and some food products (which artificially reduced inflation in the previous periods) automatically implied further increase in prices on these goods and services. According to NBG, contribution of utility bills to inflation is 1.7pp. There is a 9.2% increase in prices in the healthcare group (0.7 pp inflation) per year, which is mainly stipulated by the increase in the price of medicines.

Furthermore, as the deviation from the inflation target is mainly driven by the increase in the international prices and transportation costs, as well as the increase in the utility prices, according to the NBG forecast, inflation rate will keep above the target in the short-run. However, from the second quarter of 2022, as a result of strict monetary policy (NBG has been keeping tight monetary policy, increasing the policy rate by 1 pp in April, 0.5 pp in August and again by 0.5 pp in December 2021) and weakening exogenous shocks, inflation will start to stabilize.

Finally, as the food takes up 28.9% in the consumer basket, increased prices on food products have strongly affected Georgian population, especially pensioners and low-middle class. The persisting trend of high annual food inflation along with the economicimpacts of COVID-19, has exacerbated food insecurity. This poses additional risks of rising poverty and widening inequality in the country.

## External sector: trade, tourism, remittances, FDI

As restrictions related to Covid-19 started to get lifted and countries began to reopen, an y/y improvement in external demand has been observed. This was reflected in the increased trade of goods and money transfers into Georgia. The FDI, however, continued to decline during this period.

Georgia's external merchandise trade expanded by 24.2% y/y, driven by increase in both exports and imports. As imports grew more than exports, the negative trade balance has increased by 27.5% and reached 1,586 million USD. It needs to be emphasized, however, that **both exports and imports were higher compared to the same period of 2019**, meaning that a base effect is not the sole contributor to this growth.

Increase in the exports of goods was driven by increased demand for consumer and intermediate goods. Exports of investment goods, on the other hand, contributed only moderately to the overall growth of exports. The drivers of exports were ferro-alloys and natural grape wines to Russia (exports to Russia contributed the most to overall growth of exports – 4.7 pp annually); motor cars and telephones to Azerbaijan; ferro-alloys and ferrous scrap to Turkey; copper ores and concentrates of copper to China and hazelnuts and other nuts to Italy. The main destination markets for Georgian export products in Q2 were China (17.2% of the total), Russia (14.8%), Azerbaijan (14.2%), Ukraine (7.14%) and Turkey (8.3%). The top ten destination countries for Georgian exports accounted for 78.36% of total exports, thus underlining the problem of low export diversification.

In the third quarter of 2021, imports amounted to 2,143 million USD, a 25% increase over Q3 of the previous year. The main contributors to this growth were petroleum (+84.4% y/y), Automatic data processing machines and units thereof (+279% y/y) and human and animal blood (+368% y/y). The imports of these products contributed 5.3pp, 2.4pp and 2.1pp to growth of imports respectively. The products that drove imports downward in Q3 were wheat and meslin (-0.47pp), motor cars (-0.35pp) and electrical energy (-0.29pp).

Due to universal vaccination programs, international tourism has been partially revived and tourism revenues have begun to rise gradually. Yet, the slow rate of vaccination and the restrictions that have been left in place negatively affected the tourism sector. Still, the number of international visitors grew by 417.2% y/y and tourism revenues increased by a factor of 13.3 y/y. Yet, the revenues are still nearly 50% lower than in the same period of 2019, as the figures were mainly driven by a base effect, increasing from nearly zero levels in Q3 of 2020.

By NBG estimates, in Q3 2021 the total remittances to Georgia amounted to 623.1 million USD in volume, a 10.2% annual increase. Most of the primary source countries for money inflows showed positive growth trends. The largest contribution to total growth were made by transfers from the Kazakhstan (+209.4% y/y, the largest increase compared to the Q3 2020), EU (Italy and Germany being the leaders), USA and Russia. On the other hand, money transfers from Ukraine, Turkey and Greece have declined compared to the Q3, 2020 (-32.6%, -10.5 and -3.8% y/y respectively). Money transfers from Kazakhstan, Moldova and Tajikistan spiked more than 2 times compared to Q3 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 299 million USD in Q3 2021, which is 1.4% lower compared to Q3 2020. Majority of FDI was directed towards the real estate, manufacturing, energy and transports and communications sectors. Negative FDI growth is associated with transfer of ownership from non-resident to resident companies, coverage of the liabilities and basic stock equity decreases. 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 3,866.5 million GEL, a rise of 33.9% y/y – mostly driven by increased tax collection (+32.4% y/y). Collection of Personal income tax (+64.2% y/y), profit tax (30.3% y/y) and VAT (+22.7% y/y) contributed the most to the increase. Other revenues amounted to 321.2 million GEL, showing 49.2% growth compare with the third quarter of the previous year.

Third quarter was characterized by strong fiscal support. Current governmental expenditures increased by 6.9% y/y in the reported quarter (amounting to 3,713.5 million GEL). Compared to the third quarter of 2020, spending on grants and interests have been reduced by 71.4% and 6.3% y/y respectively, however spending on all other categories has increased: subsidies (+39.7% y/y), other expenses (+8.6% y/y), and use of goods and services (+13.7% y/y). In addition, the Georgian government reduced capital spending – the net acquisitionof non-financial assets decreased by -17.2% y/y, amounting to 898.6 million GEL in Q3.

Strong fiscal stimulus resulted in a budget deficit of -745.6 million GEL (55.4% y/y improvement), as increased revenues were balanced out by accelerated current and capital spending. Governmental debt decreased by 6.6% y/y and amounted to 28,887.1 million GEL. Domestic debt decreased by 4.4%, while foreign debt increased by 9.5%. The share of foreign debt in the total debt stood at 81%, indicating higher exposure of foreign debt to exchange rate volatility.