Macroeconomic Review – March Issue

Slowdown of growth continues in January: lari depreciation against the US dollar not enough to lift exports

The economic slowdown of the closing months of 2014 continued in January 2015, with the growth of real GDP amounting to only 0.5%. ISET-PI's GDP forecast is not optimistic either, with GDP growth in the first quarter of 2015 expected to be 0.5% (see GDP Forecast). The 5% economic growth initially forecasted by the government of Georgia, the 5.5% predicted by the ADB and the 4.2% predicted by the EBRD in September 2014 each seem quite out of reach now. In early March, the IMF mission lowered its forecast to 2%.

Consumer sentiment, as measured by the Consumer Confidence Index (CCI), has been decreasing over recent months and the index dropped to a new historical minimum in February. Consumers seem to be concerned about inflation linked to the depreciation of the Georgian lari against the US dollar.

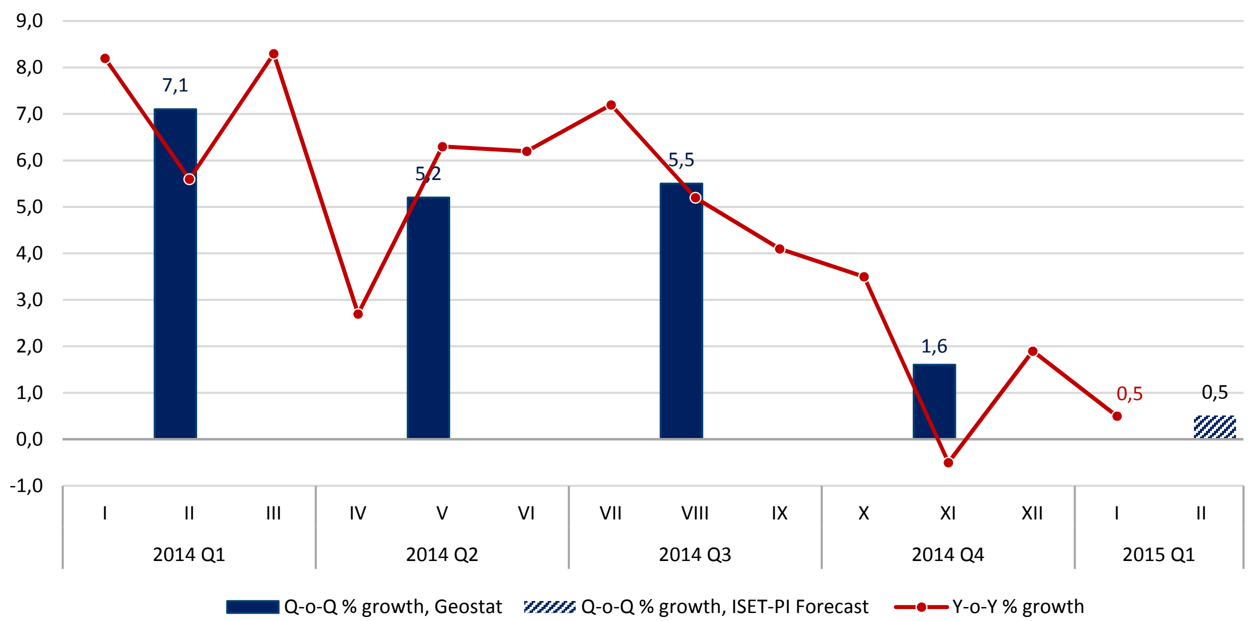

Chart 1. Y-o-Y (red line) and Q-o-Q (blue bars) % growth rate of real GDP.
Growth rate for Q1 2015 represents ISET-PI forecast (*dashed blue bar).
Source: GeoStat, ISET-PI

However, as the Geostat data shows, the inflation rate is actually fairly low. Average prices on consumer goods increased by 1.3% compared to February 2014. In January, prices were only 0.1% above the average level in month-on-month terms. There is a paradox concerning inflationary expectations. After the lari depreciation one of the main worries was (and still is) a price increase on imported goods. However, according to the National Bank of Georgia's monthly report, there was actually a deflation of 1.5% on imported consumer goods in January. This can be partially explained by the fact that the currencies of Georgia's main trade partners also significantly depreciated against the USD – in some cases outpacing the depreciation of the lari. As a result, the real and nominal effective exchange rate of the lari depreciated only very slightly.

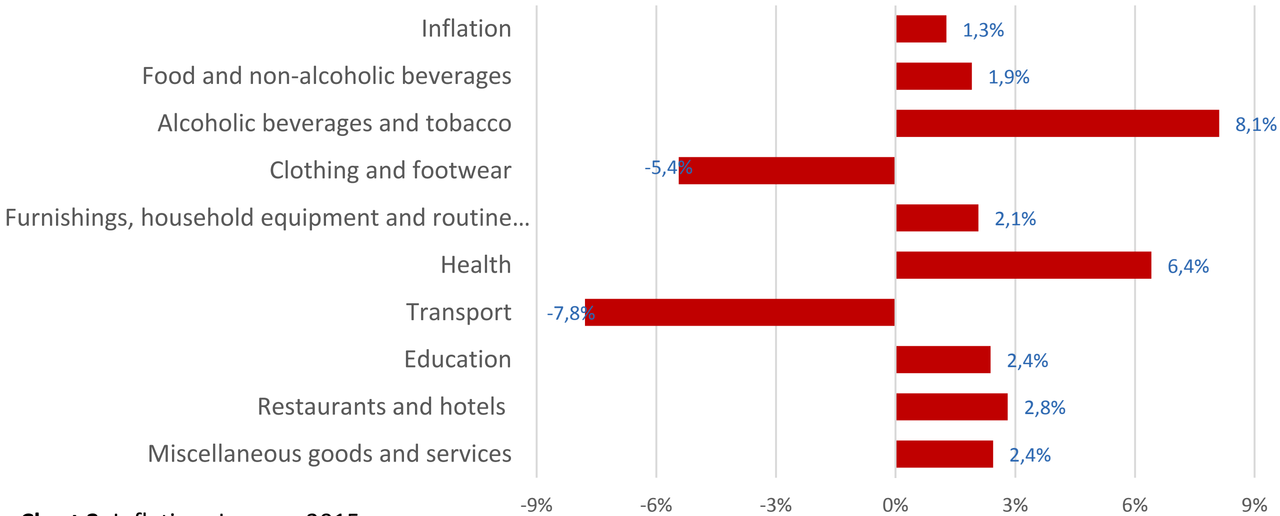

Chart 2. Inflation, January 2015
Source: Geostat

As one can see on **Chart 3**, the lari depreciated by 2% in real and nominal terms in December. In January, both exchange rates were quite stable, and in February the lari deprecated by 1% in nominal terms compared to the basket of trading partner currencies. Thus, the significant depreciation against the USD did not provide a sufficient boost to Georgian exports, mainly because the lari did not depreciate enough against trading partner currencies.

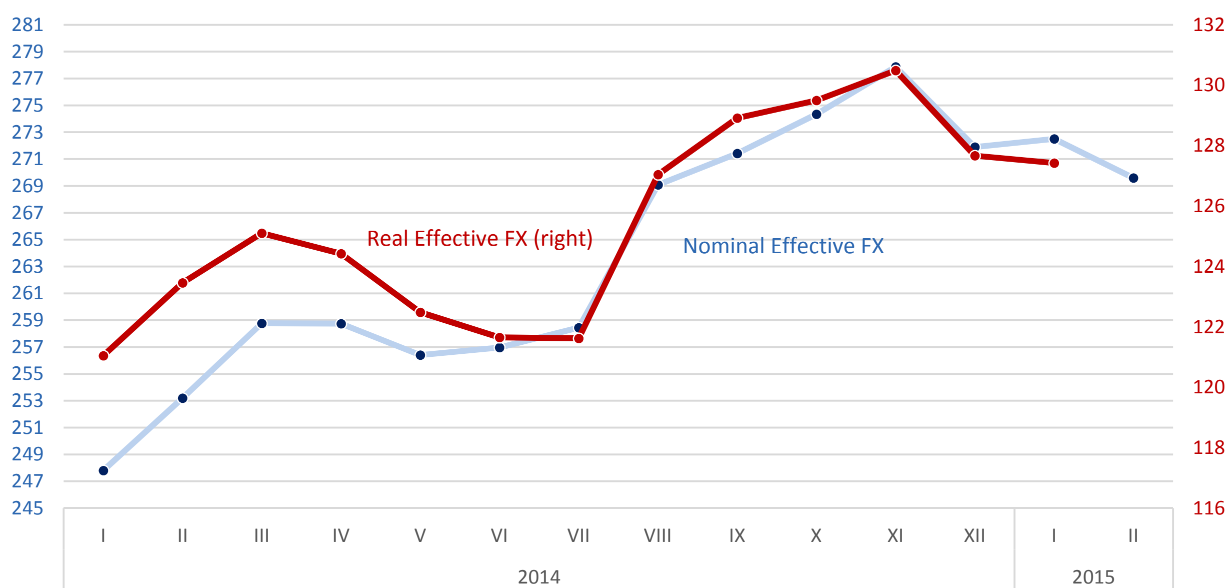

Chart 3. Real and nominal effective FX
Source: National Bank of Georgia

Interestingly, the shares of both loans and deposits denominated in foreign currency increased in January. Loan dollarization increased by two percentage points to 63%. Similarly, deposit dollarization rose by four percentage points to 61% (see **Chart 4**). While it seems logical that people would start saving more money in USD after the sharp lari depreciation, the trend towards an increasing dollarization of loans is harder to explain. One straightforward reason for this is that dollarization measures are calculated only after converting the total volumes of loans and deposits into a common currency – the lari – at the going exchange rate. Lari depreciation would thus artificially inflate the amount of dollar deposits and loans. The real change in dollarized money volumes can be calculated by comparing the increase in dollar deposits to the rate of lari depreciation over the reporting period. This calculation reveals that in January the real volume of dollar loans remained almost the same as in the previous month (loans in foreign currency increased by 9.4% compared to December, but the lari depreciated by 9.2% against the dollar). The real volume of dollar deposits also increased only slightly. It seems that the sharp lari depreciation did not significantly change the currency composition of people's lending and saving portfolios.

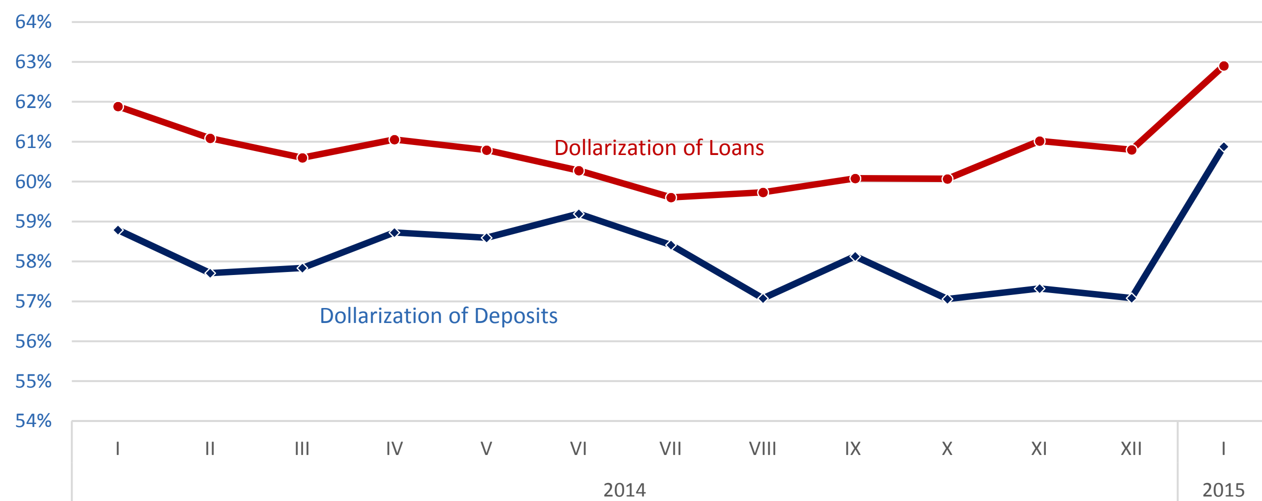

Chart 4. Dollarization of loans and deposits
Source: National Bank of Georgia

Deposits continued to increase in January. Domestic currency deposits increased by 21%, while those in foreign currency rose by 31%. Similar to the reasoning outlined above, part of this increase (15%) was due to the lari depreciation as compared to January 2014. Moreover, the volume of longer-term deposits increased by more than 35% (see **Chart 5**). The volume of lari time deposits rose by 55%, and those in foreign currency increased by 30% (unadjusted for depreciation).

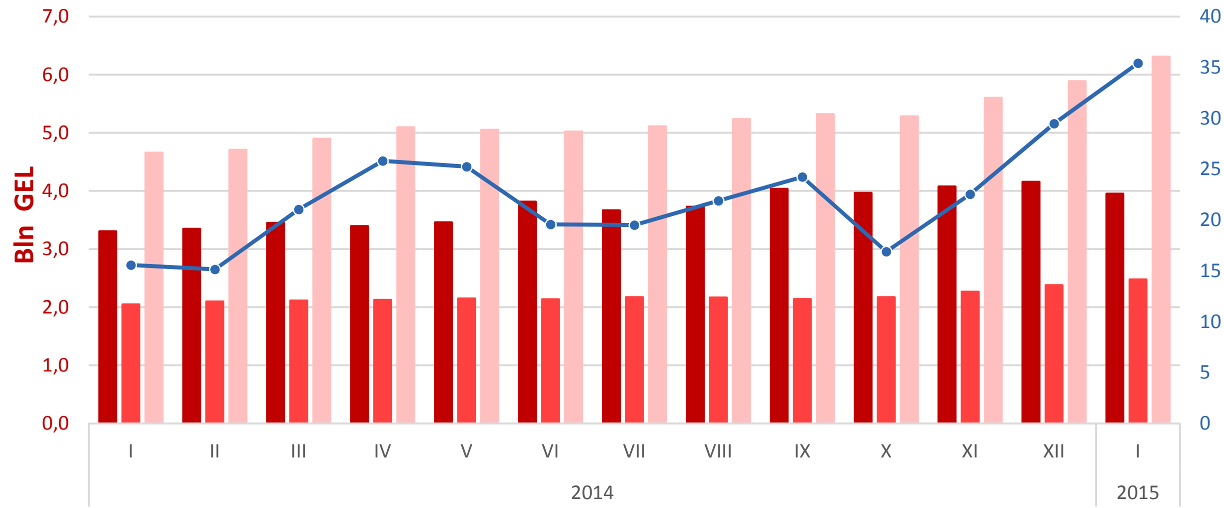

Chart 5. Deposits
Source: National Bank of Georigia

As one would expect, the pessimistic trends in foreign trade continued in January. Exports decreased by 30% compared to the same month of 2014, while imports did not change much. Volumes of exports and imports amounted to 156 million and 538 million USD, respectively. The breakdown of export data by destination shows that exports to CIS countries decreased by 51%, increased by 35% to EU countries, and decreased by 39% to other countries. The drop in exports to CIS countries was mainly driven by the decrease of exports to Ukraine (77%), Russia (62%), Kazakhstan (55%), Armenia (52%) and Azerbaijan (23%). Among the other countries group, export decreases affected the US (50%) and Turkey (42%), while exports to China actually went up (163%). The increase in exports to EU countries were largely driven by Italy (33%) and Bulgaria (41%).

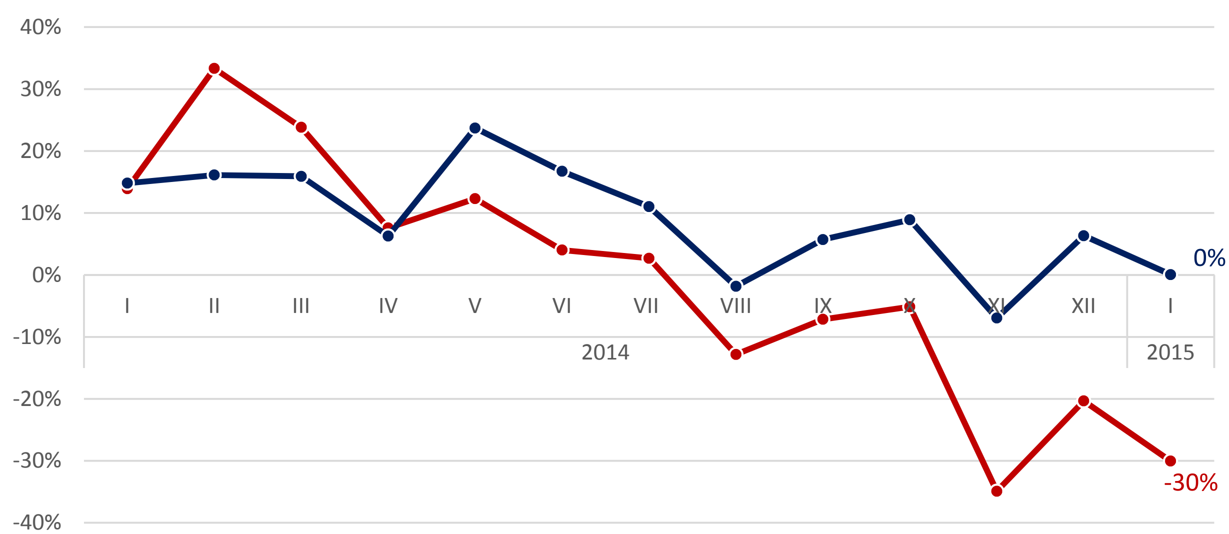

Chart 6. Growth rate of export and import
Source: Geostat

As for the composition of exported goods, in January the main export products were cars (14% of total exports), nuts (12%), copper ores and concentrates (11%), and Ferro-alloys (7%). Ferro-alloys exports decreased by 66% in annual terms, wine exports were down by 65%, cars by 49%, and mineral waters by 27%. In contrast, the export of copper ores and concentrates increased by 119%, nuts by 101%, and iron by 42% (see **Chart 7**).

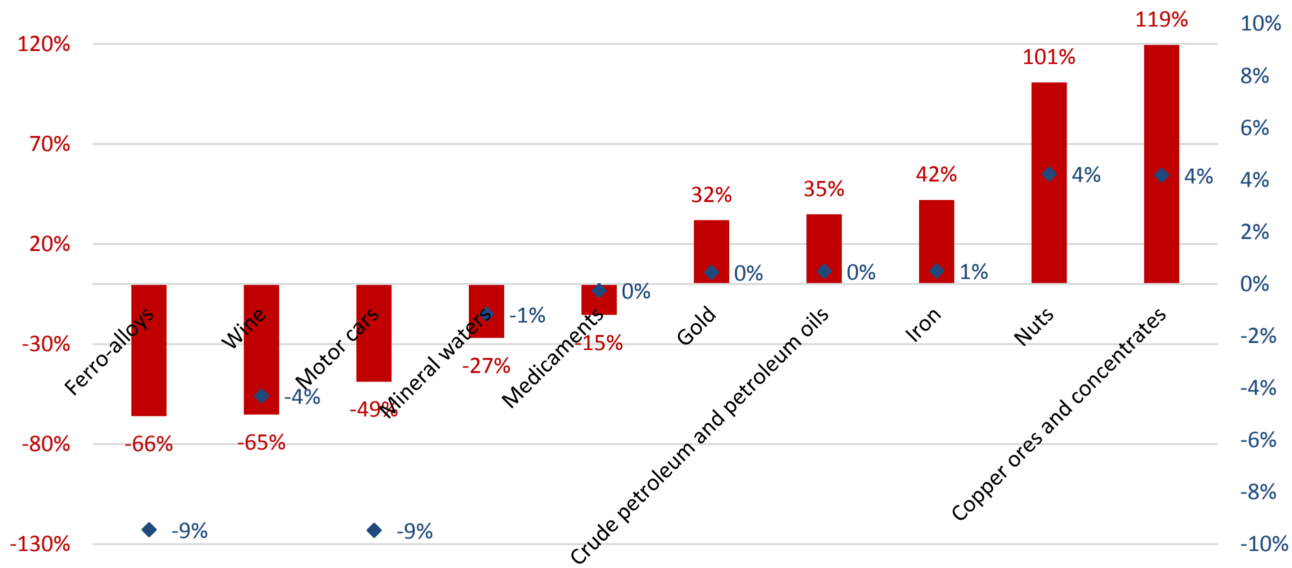

Chart 7. Growth of main export products, January 2015
Source: Geostat

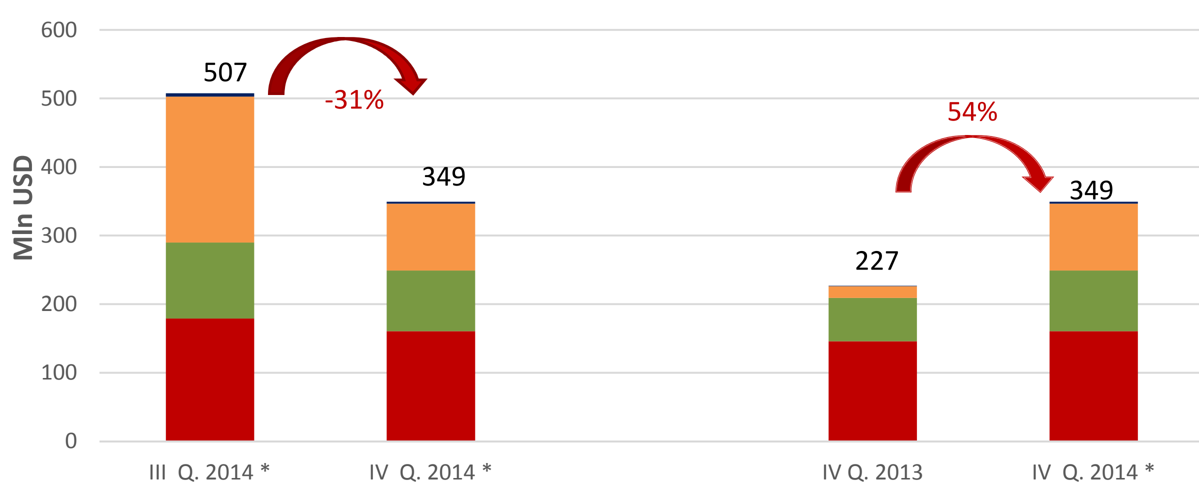

Chart 8. FDI
Source: Geostat

In 2014, foreign direct investment (FDI) in Georgia had an annual increase of 35% and amounted to 1.27 billion USD – the highest recorded level of FDI since 2008. This increase was primarily driven by large investment flows recorded in the third and fourth quarters of the year. FDI to Georgia was exceptionally high in the third quarter, totaling 507 million USD. Direct investments subsequently decreased, amounting to 349 million USD in the fourth quarter. However, fourth quarter FDI was still 54% higher than the volume of FDI reported in the corresponding period of 2013 (see **Chart 8**).

In 2014, Georgia's top investor countries were the Netherlands (26%), Azerbaijan (24%) and China (15%). The investments were structured as follows: 27% of FDI was invested in the transport and communication sector, 23% in the construction sector, 13% in the manufacturing sector and 8% in the energy sector.

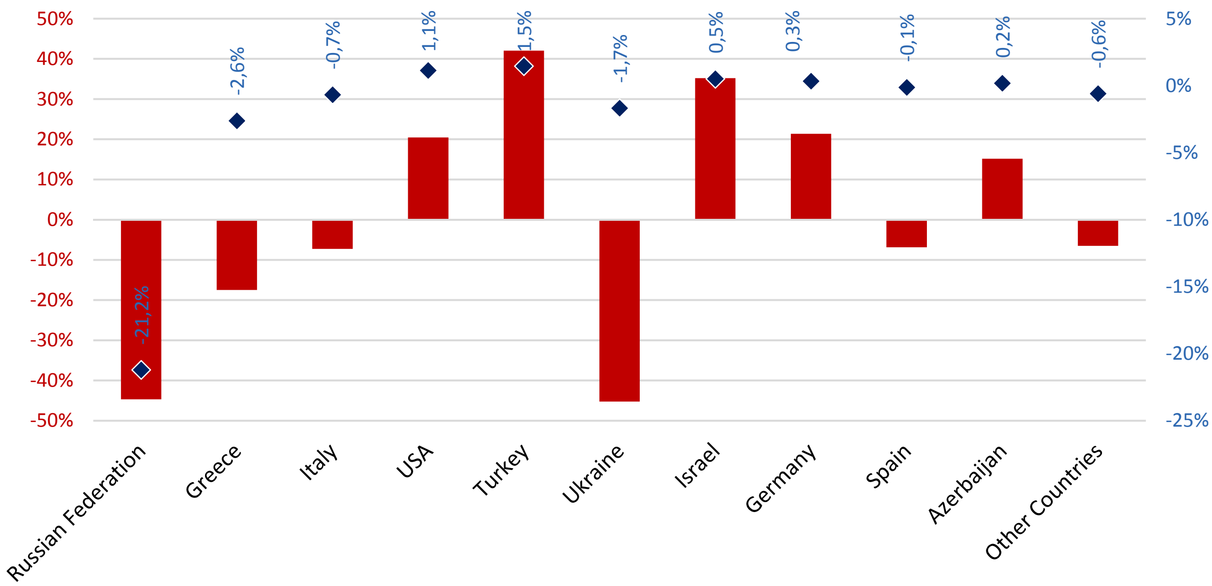

Chart 9. Remittances
Source: National Bank of Georgia

As one would expect, January 2015 continued to be a bad month for the flow of remittances to Georgia. Remittances decreased by 23% annually and amounted to 75 million USD. This decline was mostly driven by a decrease of money transfers from Russia (-45%), Greece (-17%) and Ukraine (-45%). At the same time, remittances increased from Turkey (42%), the USA (20%) and Israel (35%).

Overall, the general macro trends of January 2015 show that the Georgian economy continues to suffer from external pressures, specifically those coming from neighboring countries. Meanwhile, instead of depreciating too much, the Georgian lari seems to have paradoxically depreciated too little against trading partner currencies to significantly help exporters. The unfavorable situations on both currency markets and foreign trade sectors are, however, to some extent mitigated by soft global prices on vital imported commodities, such as food and oil.