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30 YEARS of DIPLOMATIC RELATIONS

# POLICY PAPER

## Invasion of Ukraine, global sanctions against Russia, and economic consequences for Georgia

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## Introduction

On February 24th, 2022, Russia invaded Ukraine. This event not only marked the collapse of a painstakingly built global security architecture and destroyed the lives and livelihoods of millions of civilians in the heart of Europe, it also put the world on the brink of the largest nuclear, humanitarian, and ecological catastrophe since WWII. This brutal and unprovoked act of aggression on the part of an autocratic nuclear state against a peaceful, democratic neighbor resulted in an unprecedentedly swift and severe economic response from the developed world. Almost overnight, Russia became the most-sanctioned nation in the world, surpassing even Iran and North Korea in the number and extent of economic, financial, and technological sanctions.

## The scope and scale of the sanctions

Most painful and immediate were the financial sanctions, wherein most Russian banks were cut off from SWIFT, the world's top financial messaging service. Visa and Mastercard ceased to operate in Russia, effectively making Russian debit/credit cards inoperable outside the country. In addition, the Russian Central Bank's foreign exchange assets held in the US, EU, and Japan were frozen.

Other sanctions included countries (US, Canada) banning purchases of Russian oil, while others (the EU) were considering measures to reduce their dependence on Russian oil and gas. Technological sanctions affected exports to Russia of "semiconductors, telecommunications equipment, software, lasers, aviation and space systems, oil-refining machinery" on the part of major tech industry producers, including South Korea, Taiwan, Japan, the US, and the EU.

In addition, the private sector responded with a wave of major consumer, energy, and financial companies/brands either exiting or otherwise limiting their presence in the Russian market (McDonalds, H&M, Adidas, Shell, BP, Exxon Mobil, and many others).

## Effects on the Russian economy

As a result of the sanctions, consumer price inflation in Russia in March accelerated to 15.7% annually, the highest value since September 2015. Interest rates increased to 20%, while the Kremlin announced a policy of nationalizing foreign enterprises that exited the market, currency controls, and price caps. Russia's GDP is expected to fall to -10% according to EBRD. This is over three times the -3% growth rate during the height of the pandemic. The value of the ruble fell to an historic low on March 7, 2022 (about 140 RUB per USD), even as oil prices shot above 100 dollars per barrel and the RCB banned foreign currency sales in exchange by banks. The ruble recovery since then has been driven primarily by strict capital controls deemed unsustainable in the long term.

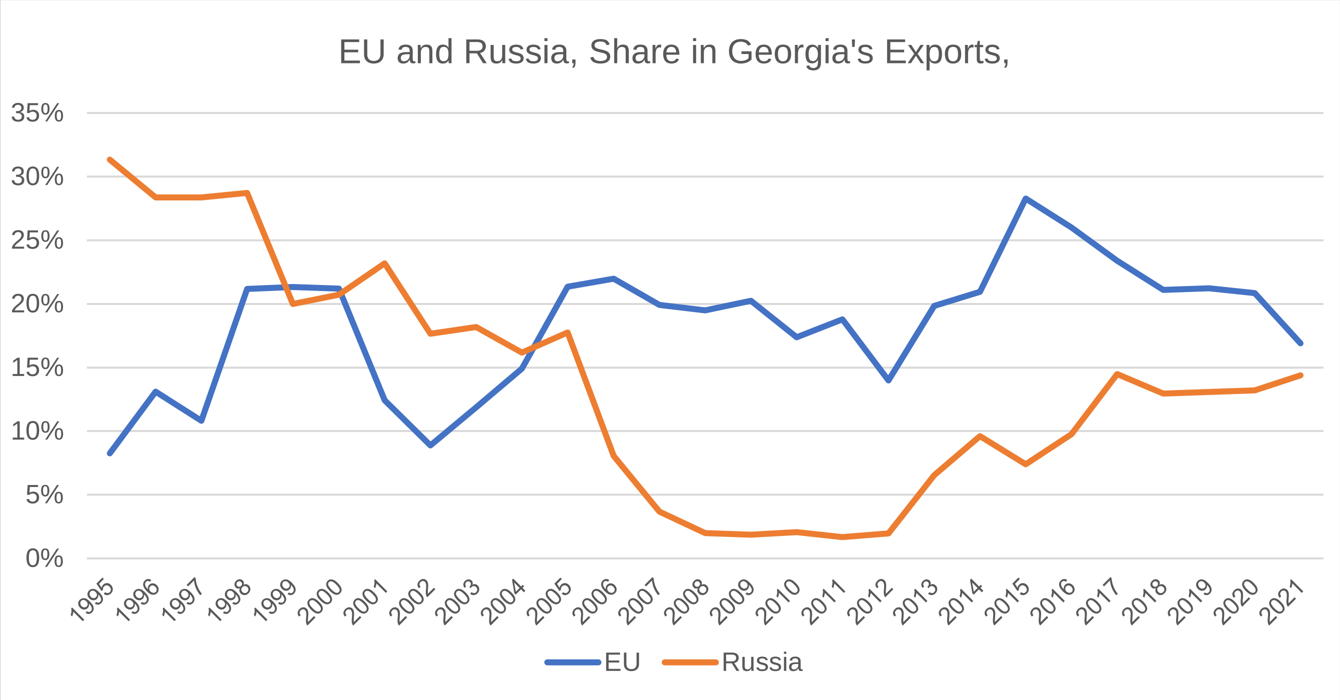
## The economic spillover into Georgia

What are the main channels through which the combination of war in the region and global sanctions on Russia can spill over and damage Georgia's economy?

### *External sector dependencies*

Georgia has historically been dependent on Russia for foreign goods trade, remittances, and tourism. This dependency has often been weaponized by Russia, in particular with bans on Georgian wine exports in 2006 and most recently a commercial flight ban in 2018. Although some of these dependencies have declined over time (e.g., remittances), the COVID-19 pandemic led to an increase in the Russian market's share in Georgian exports (as can be seen in Figure 1 below).

**Figure 1: Russia and EU, share in Georgian exports**




Dependencies in other external sectors can be traced in the tables below.

One can see that Russia's share in Georgian remittances declined significantly since 2015, even though as a single country, Russia still remains the top source of remittances for Georgia.

**Figure 2: Georgia's external dependence on partner countries: share of total, % in 2015 and 2021.**

| **2015** | Export | Import | FDI | Remittances | Tourism |
|---|---|---|---|---|---|
| Russia | 7% | 9% | 3% | 40% | 15% |
| Azerbaijan | 11% | 7% | 34% | 1% | 22% |
| Armenia | 8% | 2% | 1% | 1% | 23% |
| Ukraine | 3% | 6% | -2% | 2% | 2% |
| China | 6% | 8% | 4% | 0% | 0% |
| EU | 29% | 29% | 47% | 30% | 4% |
| Turkey | 9% | 18% | 4% | 6% | 20% |
| USA | 5% | 4% | 1% | 9% | 1% |

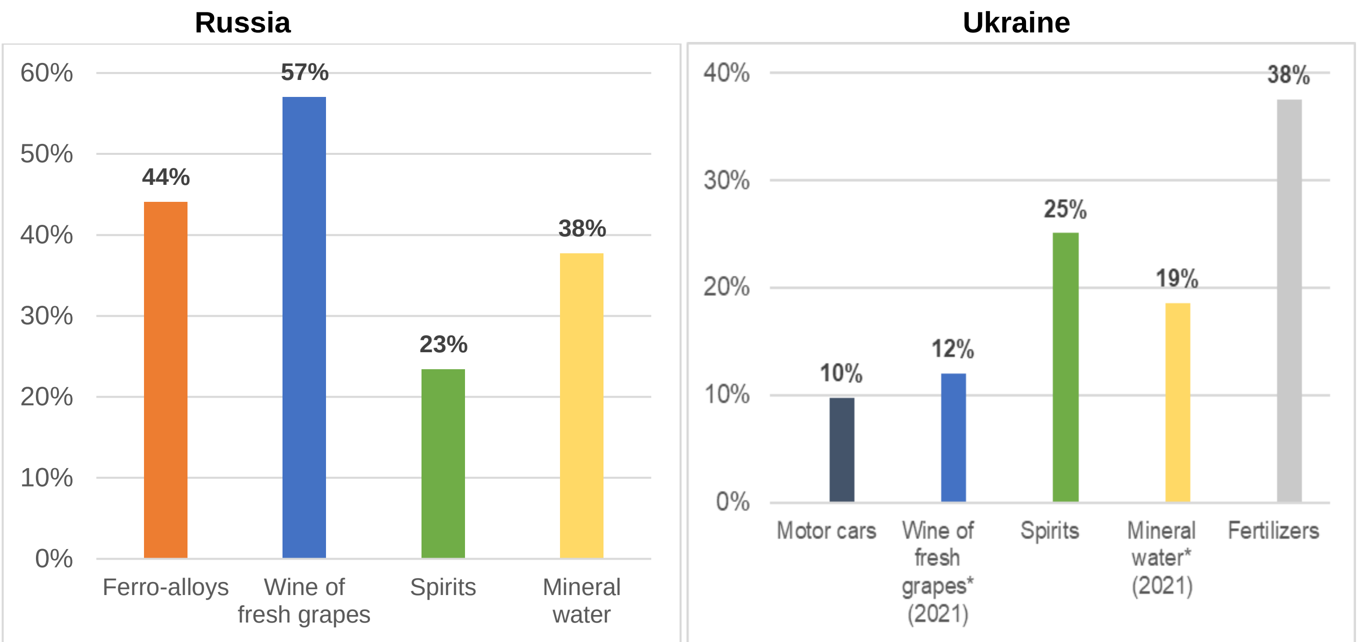
Source: NBG, Geostat

| **2021** | Export | Import | FDI | Remittances | Tourism |
|---|---|---|---|---|---|
| Russia | 14% | 10% | 5% | 16% | 11% |
| Azerbaijan | 13% | 6% | 0% | 3% | 4% |
| Armenia | 6% | 4% | 1% | 0% | 9% |
| Ukraine | 7% | 5% | 1% | 3% | 8% |
| China | 15% | 9% | 2% | 0% | 0% |
| EU | 17% | 23% | 28% | 49% | 7% |
| Turkey | 8% | 18% | 6% | 2% | 17% |
| USA | 5% | 6% | 1% | 14% | 1% |

We can also see from the figures above that Georgian dependency on Russia for exports and imports is not overly large. However, dependency for certain products is very high. For example, Georgia exports close to 60% of its wine and 40% of its mineral water to Russia.

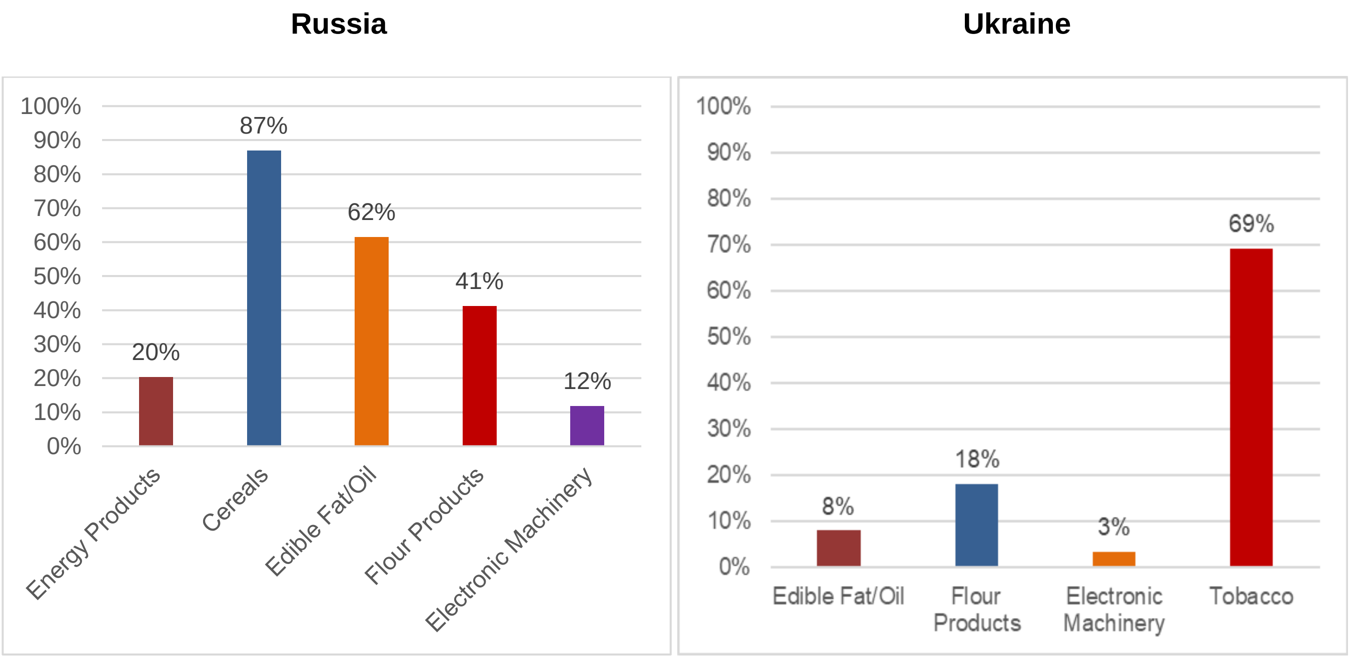
Ukraine is also an important export market for some Georgian products, including alcohol, mineral water, and fertilizers.

**Figure 3. Share in Georgia's exports, by product (%), 2019**




Georgia is also highly dependent on Russia for imports of cereals, flour products, and cooking oil**.** SMEs are especially vulnerable to disruption of trade with Russia, because the cost of trading, as well as transportation and logistics costs with the European market, are significantly higher.

**Figure 4. Share in Georgia's imports by commodity/product, % share of total, 2020**



## *Global price increases for key commodities*

The Russo-Ukrainian war is already driving up prices of key commodities, in particular oil and wheat. The **price of wheat** on the world market had already increased to 332 USD per metric ton in January 2022, which represents a 38% increase year-on-year. This is already higher than the average year-on-year wheat price increases in the year before. Since then, US prices went up to 361 USD per mt (9.8 USD per bushel). The reason for such steep price increases is that Russia and Ukraine together make up about one third of the world's wheat exports. Following the war, Moscow announced plans to suspend grain exports to some countries in the Eurasian Economic Union until its own home market is secure. Meanwhile, Ukraine announced that wheat plantations could be reduced by 39% this spring due to Russia's military invasion.

The oil price increases are also expected to have a substantial impact on inflation rates going forward. For example, in February 2022, global oil prices already increased over 55% year on year, which resulted in a nearly complete pass through to consumer gas and electricity prices in Georgia (45.8% increase between Feb. 2021 and Feb. 2022). This contributed 3.7 percentage points to the inflation in the country.

Needless to say, the double shock of wheat and fuel price increases pose an immediate danger to groups of the population who are already at risk of poverty. According to Geostat's food balance sheets, domestic consumption of wheat flour in 2020 was on average 1294 Kcal per day. This roughly means that in Georgia between 52%-65% of daily calories come from wheat products (this value is high relative to developed countries, but lower than in some developing countries. For example, in the UK the share of bread in the daily diet is 20%, while in some parts of Africa it is as high as 80%). Thus, one can expect that an increase in the price of wheat may affect household budgets in a significant way.

The Georgian Lari withstood the initial shock which drove the USD/GEL exchange rate up by 14% (to 3.402) since February 22nd. However, the GEL has since managed to regain much of its value. Currently the price of USD in terms of GEL is just 4% above the February 22nd value. Going forward, the GEL exchange rate may depend on several external factors, including the extent of economic and trade disruptions caused by the war, as well as the geopolitical outlook affecting both tourists' and investors' sentiments.

## *Migrants from Russia and Refugees from Ukraine*

In the first five weeks of war, Georgia saw an influx of tens of thousands of Russians escaping sanctions and/or the unfavorable political environment at home. The country also welcomed thousands of refugees from Ukraine, mainly escapees from Kharkiv and besieged Mariupol. Many of them were denied the opportunity to leave via Ukrainian controlled territories and had to go to Russia, from where some try to make their way to Georgia.

On an official level, refugees from Ukraine who claim asylum in Georgia are treated much in the same way as Georgian IDPs from Abkhazia or South Ossetia (i.e. eligible for an allowance of 45 GEL per month, state health insurance, right to live in an asylum facility for those who seek shelter). In addition, Ukrainian children are eligible to enroll in state schools and kindergartens. At the same time, many private companies and citizens in Georgia offered additional help with shelter, education, medical aid, clothing and jobs for refugees and their families. At least some of the refugees are expected to make their way on to Europe, Canada, or the US. This process may be complicated by the fact that often refugees coming from the East of Ukraine travel only with internal IDs, or without any documents. Since Ukrainian consulates are currently unable to issue international passports, this means some refugees will need to stay and possibly claim longer-term asylum in Georgia.

So far, the biggest impact of this in-migration has been on the real estate market, which saw an unprecedented jump in residential rental and sales prices. Anecdotally, rental prices in Tbilisi increased nearly twofold in the first few weeks of March.

The influx of migrants (especially from Russia, who are more likely to have an independent foreign source of income) may have an ambiguous effect on the Georgian economy. On the one hand, the influx may be squeezing the real estate market, but, at the same time, it may boost money inflows from abroad, and increase domestic spending and consumption.

### *Is Georgia at risk of becoming a ground for sanction evasion?*

After the sanctions on Russia's financial system were imposed, some Russian companies started to register their businesses in Georgia. While some of the businesses may have had genuine motives for establishing themselves in Georgia, others may see the country as ground for evading sanctions. Some argue that this poses a real danger for Georgia becoming akin to Belarus, which helped Russian businesses evade sanctions in 2015-2016.

However, at this point, the laws of Georgia prevent the country from being incompliant with the most severe and wide-ranging international sanctions. The Georgian financial system remains fully in compliance with the international sanctions on Russian banks. In addition, according to the National Bank of Georgia, the country's commercial banks and card processing systems do not cooperate with the Russian "Mir" payment system. Moreover, trade in dual-use goods is covered under the legislation of Georgia, and meets international transparency standards. This basically means that it would not be possible to officially "slip though" an arms export/re-export deal with Russia undetected by the public or international partners.

Thus, at least for now, Georgia is not seen as the ground for systemic sanctions evasion by Russia. However, as international pressure piles on the Russian economy, it would be prudent for the Georgian government to remain vigilant about potential loopholes and to forcefully crack down on any attempts to smuggle prohibited goods via the Georgian territory, thus protecting the country's reputation in the eyes of the international community.