A perilous road ahead: the Georgian economy at the start of Russia's war on Ukraine

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Summary

Russia's invasion of Ukraine has profoundly affected nearly every aspect of the global economy, from food and energy security to supply chains and financial markets. The World Bank (June 2022) estimates that the 2021 5.5% rebound global growth is therefore expected to drop to 2.9% y/y in 2022. This slowdown has also been caused by fading pent-up demand from the pandemic, high inflation, and the withdrawal of policy support in major industrialized economies. The International Monetary Fund suggests that the United States and Eurozone are projected to expand by 3.7% and 2.8%, respectively, while China is expected to grow by 4.4% in 2022, a decline from the estimated 8.1% growth in 2021. In addition, the World Bank anticipates moderate growth from Georgia's neighbors this year: Armenia (+3.5% y/y), Azerbaijan (+2.7% y/y), and Turkey (+2.3% y/y). The Russian economy, on the other hand, is expected to fall by 8.9% y/y. Moreover, supply chain disruptions, increasing energy prices, and worsening financial conditions have all led to downward revisions for projected growth in advanced economies. The economic growth in advanced economies is expected to reach only 2.6% in 2022 – 1.2 pp below previous forecasts. Expansion in emerging market and developing economies (EMDEs) have equally been adjusted downwards, measuring 3.4% y/y compared to the 6.6% growth of 2021.

According to Geostat's latest GDP growth estimates, the Georgian economy grew by 14.4% y/y in the first quarter of 2022 (due to eased travel restrictions, accelerating growth in partner economies, and recovering production processes), which had a positive effect on Georgia's external trade balance. Prior to Russia's invasion of Ukraine, the Georgian economy was recovering from the pandemic, which was also supported by increased domestic activity and external demand. Besides growing exports and a gradually increasing number of tourists, in the first two months of 2022 there was a significant rise in instant money transfers.

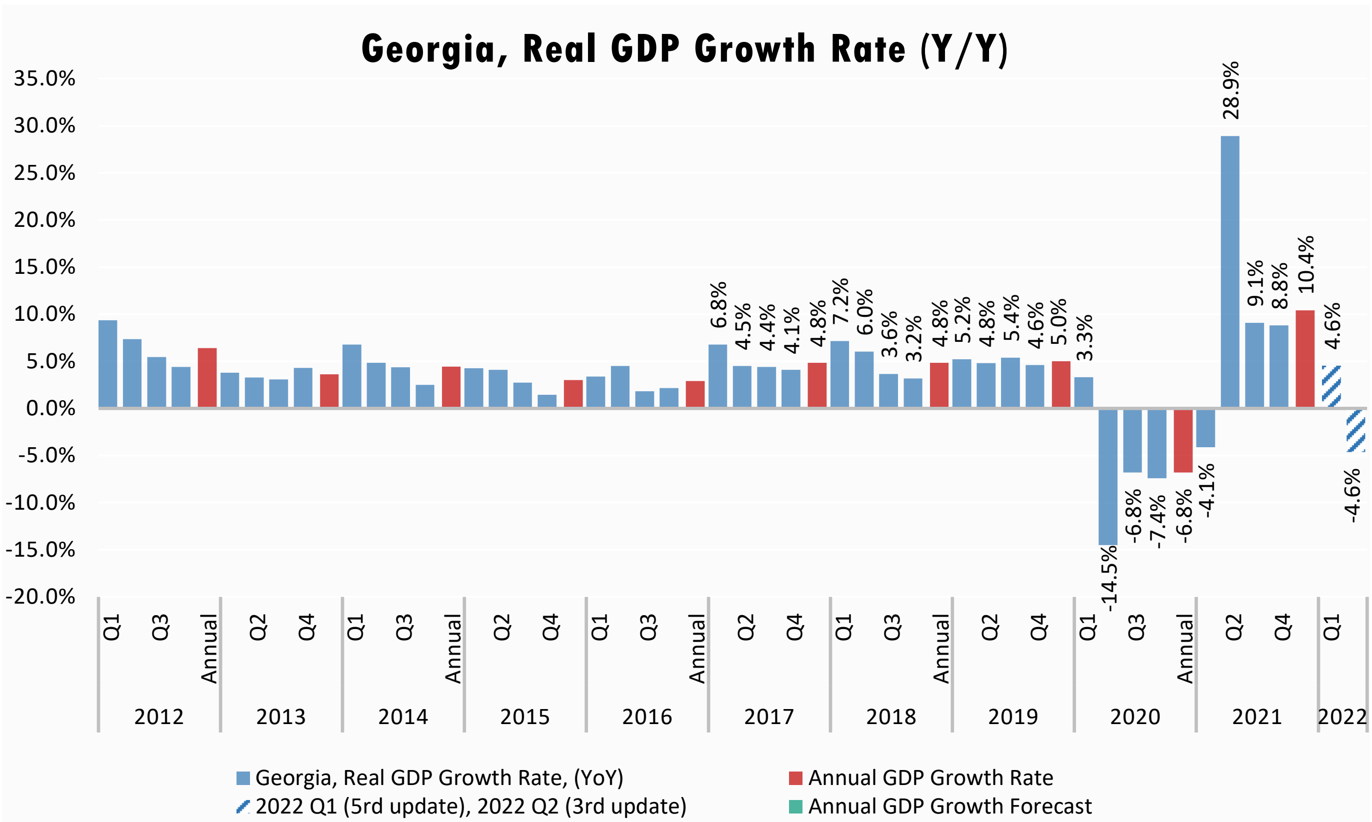
However, the war and the resulting financial sanctions on Russia have led to a significant decline in inflows from both Russia and Ukraine (for example, in Q1 2022 compared to the same period of last year, net money inflows from Russia decreased by 4.9 mln. USD, while net inflows from Ukraine dropped by 12.9 mln. USD, driven by the drastic fall of inflows in March 2022). Moreover, Georgia's sovereign risk premium[1] has risen due to the troubling geopolitical situation in the region, which typically leads to a greater risk of lower foreign investment and currency depreciation.[2]

Considering the dynamics observed in Q1 2022, NBG (May 2022) revised its growth forecast for real GDP from 5% y/y down to 4.5% y/y. It is still expected that increasing domestic credit activity will be a major contributor to growth. Based on data from February, ISET-PI's GDP forecast placed the annual real GDP growth for 2022 at 10.7% y/y.

[1] Calculated as the difference between 10-year Georgian governmental bonds and the 3-month treasury bills rate, the risk premium stands at 9.32% (as of 31 March 2022), compared to 8.51% from the same period last year.

[2] It should be noted that Georgia's unique position as a regional safe haven for migrants and Russian assets allowed the country, somewhat, to buck expectations in April and May. Due to the constantly evolving situation in the region and the elite repression reported in Russia, it is currently difficult to predict whether asset transfers to Georgia will be temporary or permanent.

Figure 1. *GDP forecast for Georgia*



Source: ISET-PI Leading Indicators GDP forecast, based on February 2022 data

Inflation

According to recent Geostat data, annual inflation in the Consumer Price Index (CPI) stood at 13.2% in Q1 2021, 10.2 pp higher than the targeted 3%. The Russia-Ukraine war initiated a strong impulse for a worldwide price growth that has since been transmitted to the Georgian market. Among the main drivers of inflation were higher food prices, with a 17.1% y/y increase. The rise in food price contributed 5.5 pp to annual inflation, with bread, cheese, oil, and sugar being the main contributors to inflation in this category.

The next notable contributors to inflation were housing, water, electricity, gas, and other fuel prices. These products combined added 3.9 pp to the overall inflation rate. On the one hand, the impact of utility subsidies on inflation ended in March, which helped ease inflationary pressure. On the other hand, the Russia-Ukraine war significantly increased fuel prices on the international market, and the inflow of Russian tourists has increased local housing prices, putting further upward pressure on inflation.

The remaining inflation was transmitted to the Georgian market via globally surging prices. Nevertheless, according to one NBG forecast, despite this strong shock, inflation is predicted to gradually decline by the end of 2022 due to a tight monetary policy stance alongside the anticipated supply shock exhaustion.

External Sector: Trade, Tourism, Remittances, FDI

The first quarter of 2022 was characterized by increasing external demand, which was fueled by recovering production and strong economic growth by Georgia's trade partners. This led to a decline of the current account balance. The CA deficit meanwhile rose by 163.6 million compared to Q1 2021 and amounted to

13% of the quarterly GDP, compared to a 12.5% deficit observed in the same period of 2021. Despite decreasing Russian capital in Georgia (which fell by $11.2 million), foreign direct investment reached 568 million USD, with major investments coming from Spain, the United Kingdom, Turkey, China, the Netherlands, and the USA.

Georgia's external merchandise trade expanded by 39.7% y/y, fueled by increased export and import. The negative trade balance, however, worsened, reaching 1,573 million USD. It should be mentioned that both exports and imports were higher compared to the same period of 2021, highlighting that the base effect is not the sole contributor to this growth.

The registered export of goods increased by 43.3% y/y. Exports to China were major contributors to overall growth (+13.5 pp y/y), reflecting increased demand for copper ores and concentrates. Due to increased demand for construction machinery and mineral fertilizers, exports to Armenia increased substantially (from a regional perspective). A considerable rise in the export of ferroalloys and ferrous scrap also drove up exportation to Turkey. On the other hand, due to armed conflict, export to Ukraine dropped remarkably, although exports to Russia had no considerable annual change. Among EU countries, exports to Bulgaria increased greatly, owing to the higher sales of copper ores and concentrates. The USA also had increased demand for ferroalloys, which contributed 6.5 pp to the overall growth of exports.

The rise in export was driven by the increased export of intermediate goods (due to increasing prices on such goods); although the contribution from consumer and investment goods remained only moderate. The driver behind the increased trade of intermediate goods was the notable exports of copper ores and concentrates. The re-export of telephone sets drove growth in the export of consumer goods, while a major contributor to the increasing export of investment goods was the re-export of aircraft parts.

Imports rose by 35.7% y/y, which was instigated by accelerating economic activities and higher internal demand. Imports from regional countries rose significantly, with Turkey and Azerbaijan being the main drivers. Furthermore, China, Brazil, Bulgaria, and certain other regions, also played an important role in these rising imports. Contrarily, imports from the USA dropped due to the reduced trade of motor cars. Due to repressed demand brought on by the pandemic, the markup on new vehicles has started to rise, which itself has induced many owners of older vehicles to keep their cars for longer periods. This ultimately means there are fewer cars available for import and re-export.

The import of consumer and intermediate goods were major contributors to overall growth in importation. Higher trade in petroleum products, medicines, and motor cars propelled the import of consumer goods, while increases in intermediate goods reflect the greater import of copper ores and concentrates, and of petroleum gases. Considering investment goods, larger purchases of automatic data processing machines and their units are driving imports upwards. It should be mentioned that increasing global prices in USD terms also contributed to the escalating value of imports. For instance, petroleum and petroleum oil imports rose by 72% y/y, which was mostly driven by the 61% increase in the price of energy products on the global market.

The easing of travel restrictions has recently stimulated tourism. The number of international visitors increased almost fourfold y/y, yet this remains below figures from the same period in 2020 (representing a 53.8% decline). This upsurge in visitor numbers is also explicable under the base effect, as tourism remained at a standstill for almost the entirety of 2020. While 51% of travelers derived from neighboring countries, additional visitors from Israel, Iran, and Saudi Arabia also had a significant positive effect on the overall growth of visitor numbers. This increase in international visitors had a correlating positive effect on revenues from these travelers – which rose by a factor of 7.4 in Q1 2022. The revenue, however, is still

31.9% below the equivalent levels observed in 2019, which suggests that the sector has yet to recover fully.

According to NBG statistics, total gross remittances (inflows) into Georgia amounted to 545.3 million USD in Q1 2022, a 9.2% annual increase. The Russia-Ukraine war had a negative effect on remittances in March. Compared to the same time period in 2021, inflows from Russia and Ukraine declined by 11.4% and 53.2%, amounting to 71.3 and 10.6 mln. USD, respectively. At the same time, the money inflow from Greece decreased by 13.03% (y/y) and equaled 51.3 mln. USD.

Nevertheless, money transfers increased from the following countries: Italy by 18.4% (y/y), the USA by 9.3% (y/y), and Israel by 7.6% (y/y), and they contributed to the overall volume of transfers by 18.7%, 12.2%, and 8.4%, respectively. Kazakhstan is another country worth noting as a main contributor of inflows into Georgia. In the first quarter of 2022, money transfers from Kazakhstan increased by 340.3% compared with the same period in 2021, and they contributed 5.12% to the overall volume of transfers.

Foreign direct investment in Georgia amounted to 568.2 million USD in Q1 2022, recording a 328.8% increase compared with the preliminary data from Q1 2021. This rise in FDI stemmed largely from re-investments, and it was mainly directed towards energy (41.6%), finance (19.5%), real estate (14.3%), manufacturing (6.6%), and transport (4.1%) sectors.

Public Finances

The total revenue of the general budget amounted to 4,508.7 million GEL, a rise of 33.5% y/y that was predominantly driven by increased tax collection (+38.4% y/y). The collection of personal income tax (+45.4% y/y), profit tax (60.5% y/y), and VAT (+33.7% y/y) primarily contributed to this upsurge. Further revenues amounted to 270.9 million GEL, showing 14.2% growth compared with the first quarter of the previous year. However, current governmental expenditures also rose by 12.6% y/y in the reported quarter (amounting to 3,825.1 million GEL).

From this expenditure, spending on grants has been reduced by 17% (y/y), while spending on the following categories has been increased: subsidies (+21.9% y/y), use of goods and services (+26.6% y/y), compensation for employees (+8.5% y/y), and other expenses (+32.3% y/y). In addition, the Georgian government increased capital spending, and the net acquisition of non-financial assets increased by 13.1% y/y, amounting to 644.8 million GEL in Q1. The first quarter of 2022 recorded a budget surplus of 38.8 million GEL.

Governmental debt decreased by 1.7% y/y and amounted to 29,826.7 million GEL. From this total, domestic debt increased by 6.1%, while foreign debt decreased by 3.5%. The share of foreign debt in the total figure stood at 79.2%, indicating the higher exposure of foreign debt to exchange rate volatility.