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Turkish Lira depreciation: moderate effect on Georgia

From January to August 2018, the Turkish Lira depreciated by 42% against the Georgian Lari, raising concerns about the ability of the Georgian economy to withstand the pressure, given extensive economic links between the countries.

Our research on key links – trade in goods and services, remittances, FDI and banking sector – showed that the Lira depreciation impact should be moderate, unless Turkey's currency crisis turns into a full-fledged economic crisis. Key exposure channels are imports of goods, exports of services and remittances.

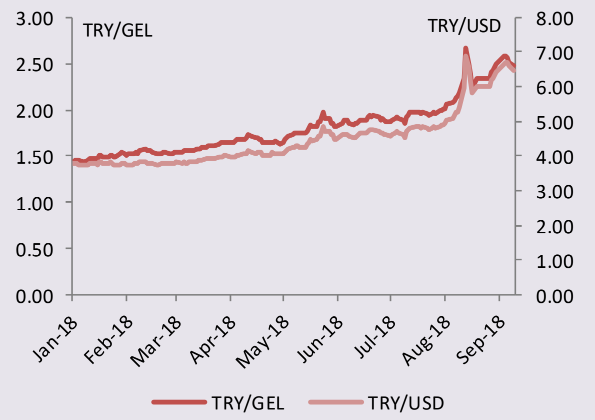
Total exports of goods are largely shielded from the shock due to the high share of raw materials and intermediate products in its structure, the demand for which is much less sensitive to exchange rate fluctuations. Georgian producers of final goods exporting to Turkey, especially in the textile sector, have been already negatively affected, and this impact can exacerbate.

Regarding FDI from Turkey, future inflows will be negatively affected by lower financial capacity of Turkish investors.

Turkish lira depreciation

From January to August 2018, the Turkish Lira depreciated by 42% vs the US dollar and the Georgian Lari, including a hike in August.

Turkish Lira nominal exchange rate



Source: Central Bank of the Republic of Turkey

Turkey is an important trade partner for Georgia and thus linked with the Georgian economy. This raises the question to what extend the Georgian economy will be able to withstand the pressure caused by the rapid depreciation of the Lira.

Turkey accounted for USD 1,590 m or 15% of Georgia's goods trade, about 16% of incoming tourists and a significant inflow of remittances and FDI in 2017.

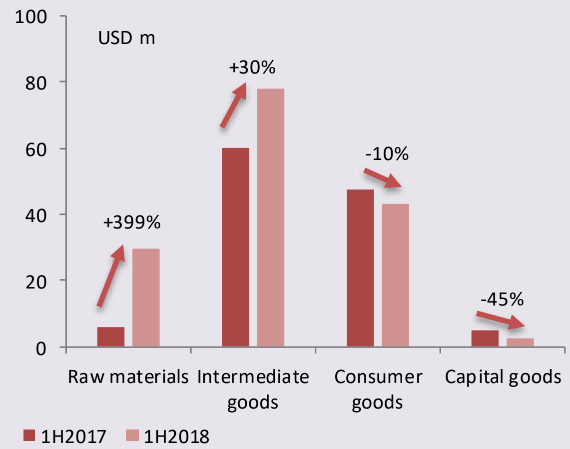
However, the actual shock on the Georgian economy is not as large as the nominal depreciation suggests. The impact depends on the real exchange rate, which also takes inflation into account. In real terms, the Lira depreciation vs. the Lari amounted to 20% since January 2018, which is significant, but much less than in nominal terms.

Trade in goods

Another important factor for the effect of the depreciation is the structure of trade. Increased global value chains affect the sensitivity of trade in inputs to foreign exchange rate shocks.

In the first half of 2018, Georgian goods exports to Turkey increased by 30% driven by shipments of raw materials and intermediate products in the context of global value chains. At the same time, exports of final goods, both for consumption and investments, dropped significantly. Textile exports to Turkey are especially affected both due to the drop in Turkish internal demand and reduced profit margins of the production outsourcing to Georgia.

Georgia's exports of goods to Turkey, 1H2018 vs. 1H2017



Source: UN ComTrade, WITS, authors' estimates

As long as the 'global value chain' effect remains and the demand for Georgian inputs into the Turkish production stays high, the impact of the Lira depreciation on the Georgian exports remains small and sector-specific. Textile producers are especially under risk, as about 70% of total Georgian exports go to Turkey, and the production is concentrated in the Adjara region.

Imports of goods from Turkey accelerated in the first half of 2018 compared to the first half of 2017. The future impact of the Lira depreciation on imports could be even more pronounced. Estimates based on product-level price sensitivity of Georgia's imports show that imports from Turkey could increase by about 1.9% of GDP due to the Lira depreciation. Nevertheless, the expansion of aggregate imports will be much smaller as Turkish products partly substitute imports from other countries such as China.

Trade in services

Georgia does not collect statistics for bilateral trade in services, thereby making the impact assessments in service trade less definite. The only well-documented category in Georgia-Turkey trade in services is exports of tourist services. In the first half of 2018, the inflow of visitors from Turkey continued to grow at impressive 20%, while their per-person spending remained stable. However, the accelerated depreciation is expected to negatively affect the visitors' future behaviour and thus Georgian exports. Imports of services will grow alongside with goods imports, exerting pressure on trade balance.

Remittances

The inflow of remittances from Turkey was USD 109 m or 8% of total in 2017, growing strongly at 26% yoy. In the first half of 2018, the growth of remittances continued at a slower pace. However, in August, remittances dropped by 26% yoy, bringing the monthly inflow back to the level observed at the beginning of 2017. There are two key channels of the Lira depreciation impact on remittances. First, the remittances reduce as Lira earnings drop when they are denominated in US dollars. Second, higher living expenses in Turkey negatively affect remittances as migrants have to cope with the Turkish inflation and thus can transfer less money to Georgia. The reduction of remittances is likely to continue.

Foreign direct investments

Turkey is an important investor in Georgia with FDI inflows at USD 286 m or 15% of total in 2017. After strong growth in 2017, FDI from Turkey turned negative in the first quarter of 2018, driven by the sale of Turkcell shares to Silknet. The deal was planned as part of a new regional strategy of the Turkish telecom company and does not relate to the Lira depreciation. However, the Lira depreciation reduces the financial capacity and risk appetite of Turkish investors to launch new projects in Georgia, negatively affecting future direct investments inflows.

Financial sector

Two Turkish banks operate in Georgia, but their role is very limited. Cumulatively, they own about 1% of assets of the Georgian banking system and work mostly with Turkish firms. So far, there has been no observed change in the behaviour of these banks due to the Lira depreciation, and the expected future impact remains minor.

Conclusions

The Turkish Lira depreciation has a moderate impact on the Georgian economy unless Turkey's currency crisis turns into a full-fledged economic crisis. The key exposure channels for Georgia are imports of goods, exports of services and remittances. The high share of raw materials and intermediate goods in exports to Turkey help to sustain exports, although final goods producers, especially in the textile sector, are exposed to a negative shock. The flexible exchange rate policy implemented by the National Bank and a geographical diversification of exports will help Georgia to withstand the pressures.

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A more comprehensive analysis is provided by the Policy Briefing PB/06/2018 "Economic impact of Turkish Lira depreciation on Georgia".

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The German Economic Team advises the Government of Georgia on economic policy issues since 2014. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.

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