NEWSLETTER

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Reduction of Georgia's current account deficit: a new trend?

Traditionally, Georgia has a high current account deficit, which averaged 13% of GDP between 2007 and 2016. This has caused some concern, as it makes the country vulnerable to external shocks. However, in the last two years, Georgia's current account deficit has been declining, standing at "only" 7.7% of GDP in 2018.

This positive development has come mostly on the back of an increase in exports of services, which is the result of a booming tourism sector. Moreover, remittances have been strong, reaching record levels of about USD 1.6 bn in 2018.

In contrast, Georgia's trade deficit has even increased in 2018, amounting to roughly USD 5.8 bn. This has been the case even though exports have grown relatively stronger than imports.

Currently, the country's current account deficit is financed mostly through FDI. However, this could change as many investment projects are about to be finalised.

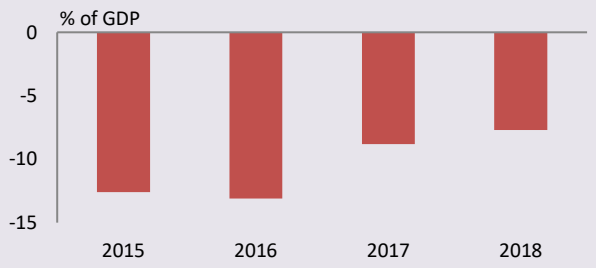
At the same time, Georgia is tapping new domestic financing sources in the form of the recently created pension fund. This should bump up national saving rates, and thus decrease the current account deficit. Importantly, this also illustrates the often overlooked macroeconomic relevance of the pension reform.

As a result, we expect that the current account deficit further declines, but that some of the financing could shift from FDI to external debt. Therefore, it is important that Georgia attracts new FDI. Moreover, Georgia should step up its efforts to promote the export sector in order to reduce its large trade deficit.

Reduction of the current account deficit

Georgia's current account deficit has been declining for the second year in a row, standing at 7.7% of GDP in 2018. Though still substantial, this has been a clear improvement to previous years, in which Georgia faced double-digit deficits for most of the time.

Current account balance



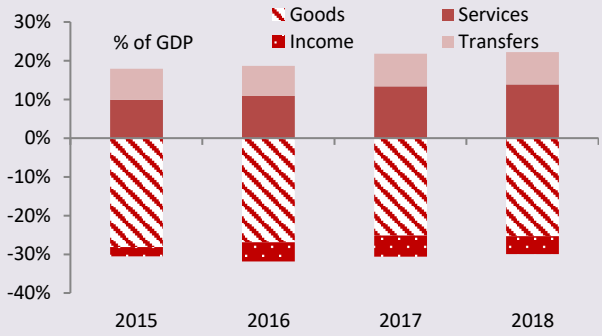
Source: NBG, Geostat

One of the main drivers for the reduction of the current account deficit has been the surge in exports of services. Behind this trend stands a booming tourism sector. In 2018, tourism revenues cracked the USD 3 bn mark for the first time. Also, tourism inflows reached record levels of 4.8 m in 2018, exceeding the country's population, which stands at 3.7 m.

Another important reason for the decline in the current account deficit has been the increase in remittances, which reached all-time highs of roughly USD 1.6 bn in 2018. This development has come on the back of an economic upswing in the region as many Georgians working abroad have seen a rise in their incomes, which allowed them to send more money back to Georgia.

Despite the relatively stronger growth in exports of goods to imports, Georgia's trade deficit increased, standing at USD 5.8 bn in 2018. This clearly is Georgia's external weak point, which needs to be addressed by stepping up structural reforms as well as increased investments in export related industries.

Components of the current account balance

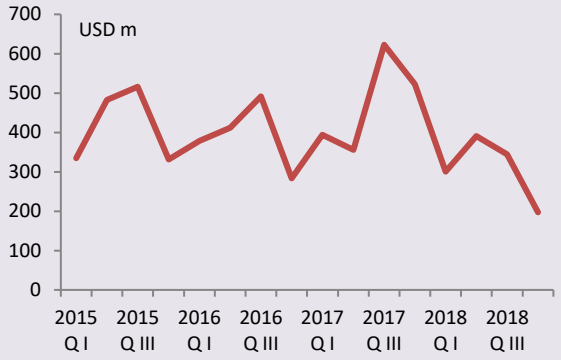


Source: NBG,Geostat

Outlook: deficit declines but the financing is shifting

Currently, Georgia finances its current account deficit mostly through foreign direct investments (FDI). As this doesn't change debt levels, it poses less of a threat to the macroeconomic stability of the country. However, FDI levels are on a downward trajectory as major projects – such as BP's south Caucasus gas pipeline – have been finalised. This means that the financing of Georgia's current account deficit could shift to more debt related instruments, which could threaten its external stability. Therefore, it is important that the country finds ways to attract new sources of FDI.

Foreign direct investments (inflows)



Source: Geostat

At the same time, national savings are expected to increase. This is due to the recent creation of the Georgian pension fund, which is capital-based. Of course, this effect is dependent on the assumption that Georgians do not reduce their previous savings in the amount that they make payments to the pension fund. However, international research shows that this is mostly not the case. As a result of increased domestic savings, the current account deficit declines. This becomes clear when considering that the current account deficit is nothing more than the difference between national savings and investments.

Going along with an improvement in the export sector, Georgia has the potential to further reduce its current account deficit in the coming years. In fact, this view is in line with many expert opinions, e.g. "Galt & Taggart Research" expects the current account deficit to narrow to 5% of GDP by 2025.

Conclusion

In the last two years, Georgia has been able to reduce its current account deficit by an extensive margin. This clearly is a positive development as it increases the country's external stability. Interestingly, the decrease has come mostly on the back of spurred exports of services and remittances.

In contrast, the country's trade deficit has even increased, which calls for more efforts towards structural reforms (e.g. ownership of agricultural land, insolvency law) as well as increased investments in export related industries. With many free-trade agreements signed (including the DCFTA), Georgia already has an important institutional cornerstone in place to fully reap the benefits of its export sector.

Looking ahead, the financing of Georgia's current account deficit could shift from FDI to other more risky liabilities such as external debt as many FDI related investment projects are about to be finalised. Therefore, efforts to attract new FDI have to be stepped up in order to prevent the building-up of external vulnerabilities.

At the same time, new domestic funding sources in the context of the recently established Georgian pension fund will reduce some of the external financing needs. This will further decrease the country's current account deficit and could indeed pave the way for a new trend.

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