

## Georgia's macroeconomic situation in light of Russian sanctions

On 21 June, Russia announced a ban of direct flights to/from Georgia. The ban will not only have a strong impact on the tourist industry, but will also affect the macroeconomic situation, given the importance of tourism for the Georgian economy.

The estimated impact of Russian sanctions on GDP amounts to 1 percentage point. As a result, we expect a slowdown in real GDP growth from 4.7% in 2018 to 3.6% in 2019. Expectedly, the Georgian Lari has come under pressure: since 21 June, the Lari depreciated by about 4.5% against the US dollar.

As a consequence, inflation will be somewhat higher than previously expected. This will be the case, because of the "pass through" effect of a depreciated currency on consumer prices.

Moreover, we expect the previously improved current account deficit ("only" 7.9% of GDP in 2018) to deteriorate by around 1 percentage point, as foreign exchange inflows from the tourist sector will be hit.

The Georgian government has already reacted to the sanctions, offering economic support to vulnerable businesses. This will most likely make fiscal policy more expansionary, thus leading to a higher, but manageable, budget deficit.

In total, the shock will be significant, but manageable. Both monetary and fiscal policy have been prudent in the last years, which allowed to build up buffers. In the long-run, it will be crucial for Georgia to increase its efforts to diversify its economy in order to be less vulnerable to external shocks – something GET Georgia has been advocating in the past.

### Announcement of Russian sanctions

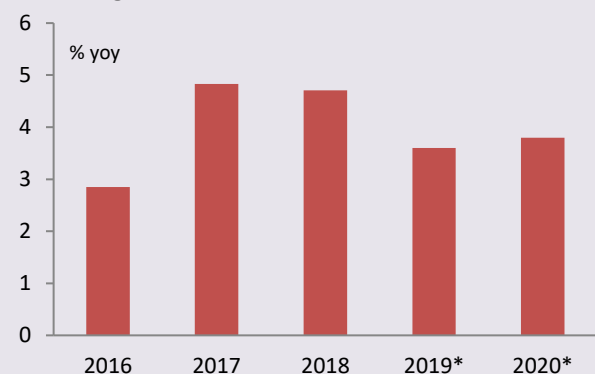
On 21 June 2019, the Russian government announced a ban of direct flights to/from Georgia, which came into effect on 8 July. All this followed after protests in Tbilisi occurred against a Russian MP, who spoke (in Russian) from the parliamentary speaker's chair in the Georgian parliament. Both Georgia and Russia are blaming each other for what happened, cumulating in the Russian sanctions.

At the moment, it is unclear how long these sanctions will be in place as well as whether more sanctions will follow. Assuming that direct flights from Russia to Georgia will be banned throughout 2019, this will have significant implications for the Georgian economy.

### The effect on economic growth

Before the announcement of the Russian sanctions, GDP growth was estimated at 4.6% in 2019. Now, we expect GDP growth to be diminished by about 1 percentage point (pp), meaning that the economy will grow by only 3.6% in 2019. Should the sanctions also be in place in the following year, we expect that GDP growth will be reduced at least by 1 pp in 2020 as well.

### Real GDP growth

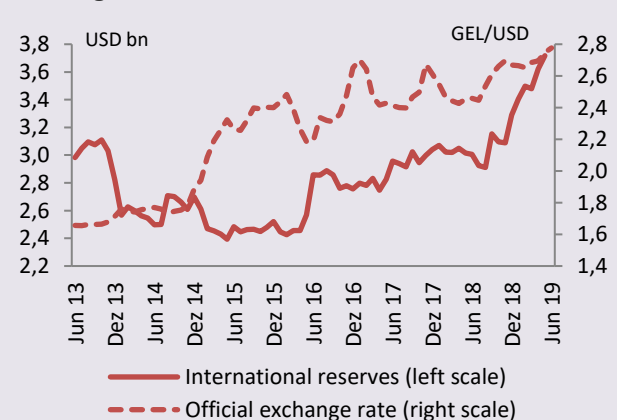


Source: IMF June 2019; \*Forecast, adjusted for preliminary estimates of effect of Russian sanctions on GDP

### Russian sanctions, the Lari and its implications

Of course, the announcement of the Russian sanctions also has its effect on the Georgian Lari, which has been under mounting pressure for some time already. Since 21 June, the Lari depreciated by about 4.5% against the US dollar, reflecting the unease that many feel with the new regime of sanctions in place.

### Exchange rate and international reserves



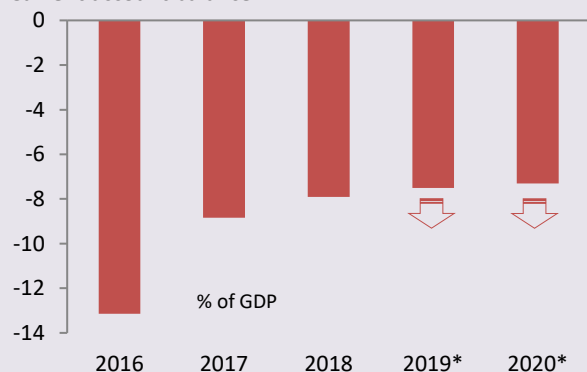
Source: National Bank of Georgia

A depreciated currency usually finds its way through the economy in many ways. For example, inflation, which was expected to stand at 3.8% in 2019, will most likely be higher. This is the case, because a depreciated

Lari makes imports relatively more expensive, which in turn weights on inflation. For Georgia, this is especially true as the pass-through of imported inflationary pressures is still high. This will be a challenging situation for the National Bank (NBG). However, its prudent monetary policy in the past, which included a stable inflation rate in 2018 and the building up of reserves, pays off now.

Georgia’s current account deficit has continuously improved in recent years, standing at “only” 7.9% of GDP in 2018. The main drivers of this development have been a strong growth in export of services (mostly tourism) and remittances. However, this positive trend will most likely slow down or even reverse as a reaction to a decline in Russian tourism inflows. In 2018, Russian tourists accounted for about 20% of visitors. Though most of the Russian tourists come by car, it is the ones who come by plane, who spend most and who are now banned.

Current account balance



Source: IMF 2019; \*Forecast; forecast likely to underestimate current account deficit in light of Russian sanctions

**Fiscal policy under pressure**

Fiscal policy in Georgia has been prudent in 2018 with a budget deficit of 2.5% of GDP. In 2019, the budget deficit will most likely be higher. Responsible for this, on the one hand, is a surge in public investments as there have been some delays in the previous year. On the other hand, there will be a loss of tax revenues in the course of the Russian sanctions. This automatically means that the budget deficit increases, given that the fiscal policy stance is hold constant. Currently, it seems that the fiscal policy could even be more expansionary as governmental support to the tourism industry has already been announced.

**Conclusion and outlook**

Russian sanctions will not only affect the tourist sector, but the whole economy. However, the impact will be manageable, mostly thanks to a prudent monetary and

fiscal policy in recent years in the context of an IMF programme. This shows once again that prudent policies pay off.

The outlook is uncertain. At the moment, it is unclear how long the sanctions will be in place or whether they could even intensify. For example, Russian authorities recently announced to intensify quality controls of certain Georgian wineries exporting to Russia.

These new developments make clear that the diversification of the economy is of utmost importance. As of today, Georgia relies too much on services and especially on tourism. A further development of industry and the agro-food sector is necessary to re-balance the economy, as repeatedly emphasized by GET Georgia in the past.

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