NEWSLETTER

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The Georgian economy on a stable growth path

The Georgian economy is developing well: GDP increased by 2.7% in 2016 and is expected to grow by 4.0% in 2017. On the demand side, public investment is a key driver for growth this year. On the supply side, construction and services remain the strongest contributors to growth.

A significant increase in excise taxes at the start of this year drove up consumer prices. As a result, inflation is expected to reach an average of 6.0% this year, which is higher than the inflation target of 4.0%. However, a significant reduction of inflation is forecast for next year.

Exports of goods are traditionally rather weak in Georgia, thus contributing to a large trade deficit. At the same time it should be emphasised that Georgia is a net exporter of services, especially in the tourism sector. The current account deficit will reach 13% of GDP in 2017 and continues to be financed by strong FDI inflows that amount to 11% of GDP.

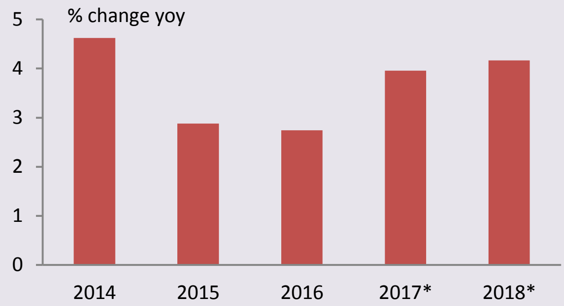
The budget deficit for this year is scheduled to amount to 3.7% of GDP. It foresees a major shift from current to investment expenditures, with positive long-term implications on economic growth.

GDP growth driven by public investment

In spite of weak growth of the regional trade partners, Georgia maintained a stable growth path during 2016 with its GDP increasing by 2.7%. This year, economic growth was originally forecast to reach 3.5%. However, the economy performed better than expected, such that the IMF forecast was revised to 4.0% for 2017 just recently. The main reason for this development on the demand side is stronger public investment. It remains to be seen whether the expectation that higher public investment would be accompanied by a rise in private investment will realize. Besides these internal factors, economic growth is also supported by a recovering external sector. On the supply side, the construction and services sectors (in particular tourism) continue to be the growth drivers.

It is a positive achievement that the Georgian economy exhibited stable positive growth rates even under difficult external conditions in 2014-2016. The growth trend is expected to continue with GDP increasing by almost 4.2% in 2018. However, potential for yet higher growth rates exists. Furthermore, growth remains unbalanced with an underdeveloped industrial sector and a small and stagnating agricultural sector.

Real GDP growth



*Source: IMF; *Forecast*

Excise taxes drive up inflation in 2017

Several reasons had dampened inflation during 2016. Due to weak aggregate demand, low oil prices and a high base effect from the previous year, prices had increased by only 2.1%. In 2017, however, inflation will increase significantly to 6.0% on average. This comes after a strong increase of excise taxes for fuel, cars, tobacco and gas, which affect the price level. In response, the National Bank of Georgia (NBG) increased its policy rate from 6.5% to 7.0% in early 2017 in order to keep inflation in the target corridor. In 2018, the effect of increased excise taxes will weaken and inflation is expected to meet its target of 3.0%.

Persistently large trade deficit

As in previous years, the Georgian trade balance continues to be negative, which is mainly due to weak export values. In 2016, imports remained almost unchanged and exports decreased by 4.2% due to low commodity prices. As Georgian exports are dominated by a few commodities, they strongly reflect the development of world market prices.

However, a closer look at Georgian exports reveals an interesting picture: Goods exports account for only 47% of the country's total exports. The remaining 53% are made up by services. In fact, Georgia is a net exporter of services. In 2016, exports of services increased by 10% and imports by 11%. Transport and tourism are the sectors contributing most to the positive services balance. The revenues generated by the tourism sector exceed total goods exports.

Trade in goods and services

Source: Geostat

Current account and exchange rate

The structural weakness of goods exports is the main reason for the persistently negative current account balance. The IMF forecasts the country's current account deficit to reach almost 12% of GDP in 2017. Also in 2018 this is not to change significantly. So far, strong FDI inflows accounting to 11% of GDP provide a stable financing of the current account deficit. However, the persistent current account deficit remains a source of risk.

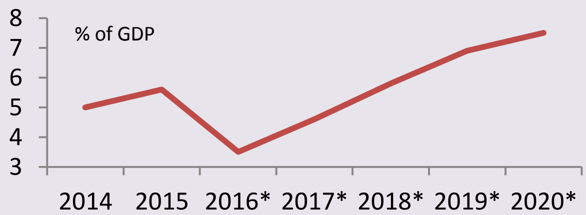
The NBG's flexible exchange rate policy allows for rapid economic absorption of external shocks. In 2014-2016, the exchange rate had reacted to strong fluctuations of the main trading partners' exchange rates. In the recent past, the NBG had carefully intervened by buying US dollar in order to increase the country's international reserves as stipulated in the IMF programme.

Growth-oriented budget in 2017

In the context of parliamentary elections in 2016, when the corporate tax reform was discussed and increased public investment was announced, it was feared that the budget deficit might increase to 5% of GDP in 2017. However, after elections the ruling party took measures to counterbalance the budget. In particular, excise taxes were increased significantly and the budget deficit is planned at "only" 3.7% of GDP in 2017. The new IMF programme stipulates the continuation of the consolidation process: The budget deficit is to be reduced to 2.8% by 2020.

As it has been announced in the election campaign, public investment is planned to increase strongly from 6.5% of GDP in 2016 to 7.5% in 2020. This implies an immense budgetary reallocation from current to investment expenditures, with a positive long-term impact on economic growth.

Public investment



*Source: IMF, *Preliminary data/Forecast*

Conclusions and outlook

The Georgian economy is on a stable growth path. The reallocation of government expenditures from consumption to investment is in our view a very positive step, with long-term implications for the future of the country. And the IMF programme provides a good economic policy framework for stability in the coming years.

At the same time, policy measures should be taken to reduce the dependency on services and secure a more balanced economic growth. The current focus on services should be complemented with measures to promote agriculture and industry. In such a way, the strong exposure to global commodity prices and the large trade deficit could be reduced, thus keeping macroeconomic risks at bay.

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Note: This updated version of Newsletter 18/2017 reflects the new forecasts of the recently published IMF World Economic Outlook (October 2017).

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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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