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NEWSLETTER

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GEORGIA

War in Ukraine: moderate effect on Georgia

Russia's invasion of Ukraine triggered severe Western sanctions. The resulting recession in Russia will also affect Georgia's economy. Goods exports are likely to be only moderately affected as there is potential for Georgia to become a substitute supplier to Russia. Effects on tourism are ambiguous at the moment. While vacation tourism may decline, the recent influx of Russians to Georgia will increase tourism revenues.

Main risk factors are a decline in remittances and higher oil prices. The latter will also be a driver for inflation. Tight monetary policy will need to be maintained and the necessary fiscal consolidation will allow only limited additional stimulus.

Despite the war in Ukraine, Georgia's economy is expected to grow by 3.5%. This would be about two percentage points less than in previous estimates. The effect is thus relatively moderate.

Introduction

The Russian invasion and war in Ukraine will have significant effects not only on the two countries involved, but also on the rest of the region. Due to the massive sanctions against Russia, the Russian economy is expected to shrink by 10% and face a high inflation of 20% in 2022. For Georgia, the risk for a strong decline in Russian remittances and increased oil prices are the most crucial factors. Goods exports are likely to be less affected and the net effect on tourism is still unclear.

Only limited effect on goods exports

In 2021, (domestic) exports to Russia amounted to USD 555 m and accounted for 18% of total exports. Agro-food products are most important with 63% of total exports.

The overall impact on exports to Russia is driven by three effects: 1) price and income effect, 2) substitution effect and 3) reorientation. We estimate the decline in exports to Russia due to the price and income effect by comparing the observed response in 2015 vs. 2013 and assuming that exports will demonstrate the same "benchmark response" this year. However, this drop may be alleviated if Georgia can become a substitute supplier for countries that do not export certain goods to Russia anymore (substitution effect). Lastly, a drop in exports to Russia may be offset by reorientating exports to other destinations (reorientation effect).

Estimation of impact on goods exports

(USD m)	Exports to RUS, 2021*	Est. loss to RUS	Est. total loss
Ferro-silico-manganese	172	-28	0
Wine of fresh grapes	130	0	0
Mineral waters	60	0	0
Spirits	41	-17	-17
Flavored waters	26	0	0
Peaches, nectarines	24	-12	-12
Mandarins, tangerines	16	-4	-4
Fresh / chilled potatoes	14	-3	-3
Apples	8	0	0
Cranberries, blueberries	5	-3	-3
Other products	58	-26	-26
Total	**555**	**-93**	**-65**
% of GDP	**3.0%**	**-0.6%**	**-0.4%**

*Sources: WITS, ITC Trade Map, own estimates (see GEO/PB/01/2022 for details); * only domestic exports*

Among the top-10 exports to Russia, the substitution effect may significantly reduce the initial (negative) price and income effect. Overall, we estimate that exports to Russia decline by approx. USD 93 m (0.6% of GDP). Total decline in exports is expected to be even lower at USD 65 m (0.4% of GDP) as a result of potential reorientation of ferro-silico-manganese.

Ambiguous effects on tourism

Tourism is similarly affected by the effects outlined above. Russia's GDP decline will lower the propensity to spend money on tourism. However, some Russian tourists might choose Georgia as an alternative destination. A third important effect is the influx of (high-skilled) Russians, whose expenditures will (temporarily) increase tourism revenues. Early indicators such as the strong increase in rents in major cities suggest this is a sizeable factor. While it is too early for a comprehensive forecast, a massive reduction in tourism revenues seems unlikely given the circumstances.

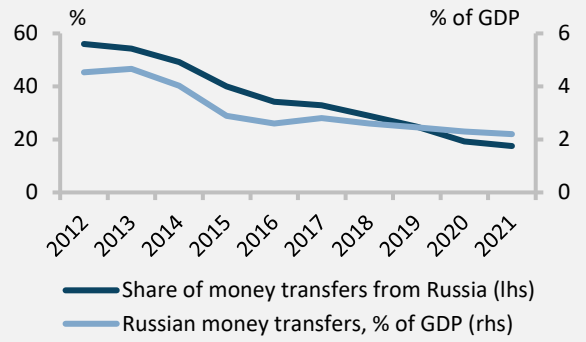
Risk of a sharp decline in remittances

Remittances are an important factor for the Georgian economy and a key driver of private consumption. While the share of remittances from Russia has been on a downward trend for years, it was still equal to around 2.2% of GDP in 2021.

We estimate that the expected downturn of the Russian economy and Western sanctions on Russia could reduce remittances sent from Russia to Georgia by

around 50% in 2022. This would imply an overall drop in remittances by USD 210 m or 1.0% of GDP.

Money transfer inflows from Russia



Source: National Bank of Georgia

Energy price shock, but energy security not at risk

Georgia's oil imports are well diversified, with Russia accounting for approx. 25% of total. Gas imports from Russia are very low (6%). However, oil prices have risen sharply worldwide. Even accounting for the price discount of Russian Urals oil compared to Brent, this could imply additional costs for Georgia of around USD 380 m (2.1% of GDP). Overall, this is a sizeable effect that will contribute to an increase of the already high current account deficit (2021: 9.8% of GDP).

Macroeconomic implications

Recent estimates by IFIs and the National Bank put growth in 2022 at around 3.5%, but uncertainty is high. This would imply a drop of around two percentage points compared to pre-war estimates. This is relatively modest compared to other countries in the region.

The increase in commodity prices creates inflationary pressure, as food (33.1%) and energy (9.0%) have high weights in the CPI basket. In February, inflation reached 13.7% yoy. The National Bank reacted by raising the policy rate to 11.0%. This is an important step to prevent an increase in inflation expectations. The Lari experienced strong depreciation at the beginning of the war. However, it has since appreciated and currently stands at around 3.10 GEL/USD, which is roughly the same level as at the beginning of the year. The National Bank's foreign exchange reserves (USD 4.0 bn) are still intact and allow some room for interventions. Given high inflation, the tight monetary policy stance will need to be maintained. Fiscal policy (which provided strong stimulus in 2020 and 2021) will need to be consolidated this year and can only provide limited additional support compared to pre-war forecasts.

Outlook

The war in Ukraine presents the second challenge for Georgia shortly after COVID-19. However, the effects are likely to be smaller this time. A key question for the coming months will be the influx of migrants from Russia (as well as Belarus and Ukraine). Mainly of them are high-skilled (e.g. in the IT sector). While they create pressure on the housing and renting market, they also represent an economic potential.

The recent staff-level agreement with the IMF on a new Stand-By Arrangement (USD 289 m) will provide financial buffers and strategic guidance. It also serves as a signalling device to the international community that Georgia will continue its sound macroeconomic policies.

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This newsletter is based on the Policy Briefing "Economic implications on Georgia of the war in Ukraine and sanctions against Russia".

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**Advisory activities in Belarus are currently suspended.*