



# GEORGIAN ECONOMIC OUTLOOK 2015-2016:

EXTERNAL SHOCK AND INTERNAL  
CHALLENGES





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# PREFACE

Within the framework of the Core and Institutional Support Project for the EPRC, and with the financial support of the Think Tank Fund of the Open Society Foundations, we present the ninth report: *Georgian Economic Outlook – 2015-2016: External Shock and Internal Challenges*. This paper covers the major economic developments in the country over the past year and a half and highlights ongoing challenges that need to be addressed with due diligence by economic policymakers and other relevant institutions. The majority of the data used in this report was obtained from the official web-sites of the National Statistics Office of Georgia, the National Bank of Georgia, the Ministry of Finance of Georgia, and the International Monetary Fund. The report features a special *Issue in Focus: Currency Depreciation and Policy Response*.

## KEY FINDINGS

2015 was a year of challenges for the Georgian economy. With the events unfolding in the region and decreasing demand in Georgia, the economic growth proved modest which, despite a positive growth, is backslide for developing countries like Georgia. The main problem for the private sector and consumers was the depreciation of the national currency lari – the trend that persisted throughout the entire year. With the high dollarization rate of loans and a notable currency imbalance between income and expenditure, the depreciation of lari posed serious threat to borrowers both in business and consumer sectors. Nevertheless, the financial stability in the country, inter alia, owing to a correct policy pursued by the National Bank of Georgia, was not endangered while the inflation was contained within the target limits. The foreign direct investments (FDI), despite a slight decrease on the previous year's indicator, remained at a high level – something which is very important for the future growth.

# ISSUE IN FOCUS: CURRENCY DEPRECIATION AND POLICY RESPONSE

The depreciation of the national currency lari (GEL) which started in November 2014 and continued through 2015, was the main challenge faced by the Georgian economy. For a myriad of reasons, which we will try to analyze below, the lari depreciation reached its peak at 40 percent over that period, decreasing to 35 -36 percent by the end of 2015.



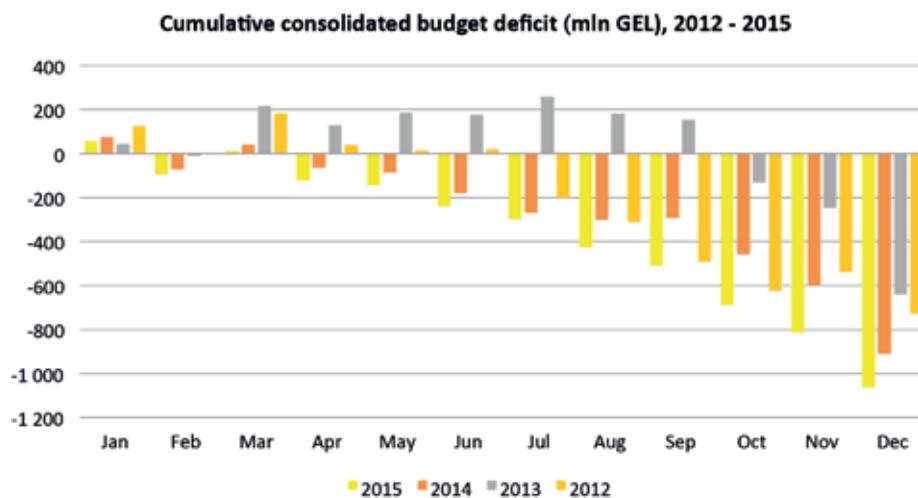
*Source: National Bank of Georgia.*

The main cause of depreciation was a serious shock of the balance of payment, clearly seen from the annual data, when in 2014 the current account deficit almost doubled as compared to 2013 and did not change much in 2015 either.

Million US dollars	2013	2014	2015
Current account	-937.6	-1,753.0	-1,640.8
a. Goods	-3,492.6	-4,280.4	-4,302.8
b. Services	1,405.5	1,297.8	1,455.5
c. Income	-316.1	-204.3	-401.7
d. Current transfers	1,465.6	1,433.9	1,608.2
Capital and financial account	979.3	1,826.7	1,726.6
Capital account	134.1	109.7	63.5
Financial account	845.2	1,717.0	1,663.1
a. Direct investments	829.0	1,343.1	1,209.2
b. Portfolio investments	-36.6	207.4	-156.0
c. Financial derivatives	-2.4	8.2	-1.8
d. Other investments	9.9	125.0	512.2
e. Reserve assets	45.2	33.4	99.4
Net errors and omissions	-41.6	-73.7	-85.8

Source: National Bank of Georgia.

The chronology of shock can be clearly seen by looking at quarterly data. The first shock of current account was observed in 2013, though it was of one-off nature and mainly resulted from uneven spending of the budget as seen from the figure below.



Source: Ministry of Finance of Georgia.

In contrast to this shock, another shock, which was observed at the end of 2014, entirely resulted from exogenous factors. Although the current account deficit was worsening during the first three quarters of 2014, the main blow came in the fourth quarter of the year when the quarterly deficit of the current account hit the highest level since the second quarter of 2008. The result was instant – lari started to depreciate, reaching 40 percent depreciation rate in several months.

Million US dollars	QI 2013	QII 2013	QIII 2013	QIV 2013
Current account	-237.7	-200.4	-62.5	-437.1
a. Goods	-745.3	-876.1	-861.3	-1,009.9
b. Services	256.9	375.5	515.5	257.6
c. Income	-107.0	-75.5	-72.5	-61.0
d. Current transfers	357.8	375.8	355.9	376.2
Capital and financial account	257.4	194.9	66.8	460.2
Capital account	20.8	39.3	36.9	37.1
Financial account	236.6	155.6	29.9	423.1
a. Direct investments	236.9	170.7	253.9	167.5
b. Portfolio investments	-31.1	-94.6	-73.8	162.9
c. Financial derivatives	0.0	-1.4	-0.2	-0.7
d. Other investments	123.3	132.1	-86.2	-159.3
e. Reserve assets	-92.5	-51.2	-63.8	252.7
Net errors and omissions	-19.7	5.5	-4.3	-23.2

Million US dollars	QI 2014	QII 2014	QIII 2014	QIV 2014
Current account	-353.3	-425.0	-272.3	-702.5
a. Goods	-848.0	-1,065.7	-1,094.3	-1,272.4
b. Services	215.4	337.8	517.9	226.7
c. Income	-75.7	-64.3	-66.8	2.4
d. Current transfers	355.0	367.2	370.9	340.8
Capital and financial account	364.7	411.7	296.8	753.5
Capital account	12.6	30.5	24.4	42.2
Financial account	352.2	381.2	272.4	711.3
a. Direct investments	251.3	142.1	484.9	464.8
b. Portfolio investments	-16.6	206.9	4.9	12.2
c. Financial derivatives	3.0	0.3	1.0	3.9
d. Other investments	-114.3	-71.6	45.7	265.1
e. Reserve assets	228.8	103.4	-264.0	-34.9
Net errors and omissions	-11.4	13.2	-24.5	-51.0

Million US dollars	QI 2015	QII 2015	QIII 2015	QIV 2015
Current account	-463.2	-354.4	-301.1	-522.1
a. Goods	-972.1	-981.3	-1,164.7	-1,184.7
b. Services	216.7	334.9	604.0	299.9
c. Income	-49.2	-128.5	-181.0	-43.1
d. Current transfers	341.4	420.5	440.5	405.8
Capital and financial account	445.5	389.2	338.1	553.9
Capital account	17.0	17.2	12.6	16.6
Financial account	428.4	372.0	325.4	537.2
a. Direct investments	127.7	328.2	477.6	275.8
b. Portfolio investments	-86.6	7.7	-38.0	-39.1
c. Financial derivatives	2.4	-4.5	-0.5	0.8
d. Other investments	200.2	60.8	-109.7	360.9
e. Reserve assets	184.8	-20.2	-4.0	-61.2
Net errors and omissions	17.7	-34.8	-36.9	-31.8

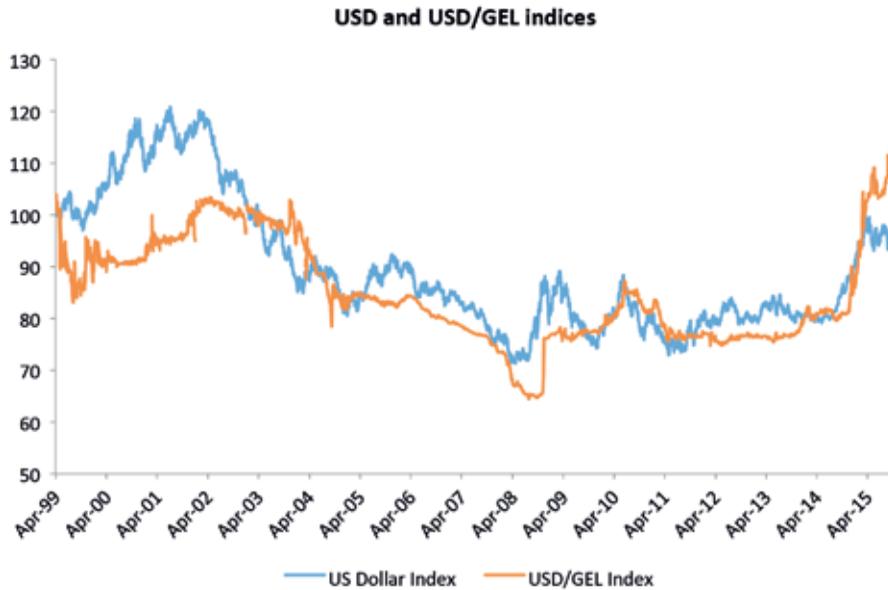
Source: National Bank of Georgia.

The shock of balance of payment was the result of three simultaneous factors – global, regional and local factors.

The key among global factors was the high economic growth in the USA in 2014, reaching 2.5 percent. As a result, the US Fed began a gradual withdrawal from the so called quantitative easing program<sup>1</sup> through which the country increased its balance sheet by almost three trillion US dollars over the period between 2007 and 2013.<sup>2</sup> Such a policy significantly lowered the value of US dollar compared to other world currencies and was a sources of significant capital inflows in developing countries. It must be also noted that interest rates in the United States were quite low even long before 2007, while the FDI inflows to Georgia were record high and therefore, the strengthening of Georgian lari against US dollar was a natural development. Thus, abandoning quantitative easing meant the end of cheap US dollar era for developing countries, which is clearly shown by the dynamic of USD index (effective exchange rate).

<sup>1</sup> Quantitative easing is an unconventional monetary policy, when a central bank, with interest rates close to zero, can buy assets on a large scale and thus stimulate economic growth.

<sup>2</sup> <https://www.stlouisfed.org/publications/regional-economist/january-2014/the-rise-and-eventual-fall-in-the-feds-balance-sheet>



*Source: Authors' estimations, Bloomberg.*

It is noteworthy that lari started to depreciate against US dollar much later than the USD index started to rise. The reason for that was the situation in the regions and the events that unfolded in the European Union.

The Fed's withdrawal from the quantitative easing program almost precisely coincided with the change in the monetary policy of the European Central Bank. Mario Draghi, the President of the European Central Bank, said in April 2014 that given low inflation rate, the quantitative easing was a subject of discussion,<sup>3</sup> while in January 2015, the launch of expanded asset purchase program was officially announced.<sup>4</sup> Markets reacted instantly – euro began to depreciate in May 2014, much earlier than the European Central Bank started to buy assets. As a result, euro depreciated by almost 20 percent during 2014 while in 2015, it fell below the 1.15 notch.

<sup>3</sup> <http://www.theguardian.com/business/2014/apr/03/european-central-bank-meets-as-deflation-fears-grow-business-live>

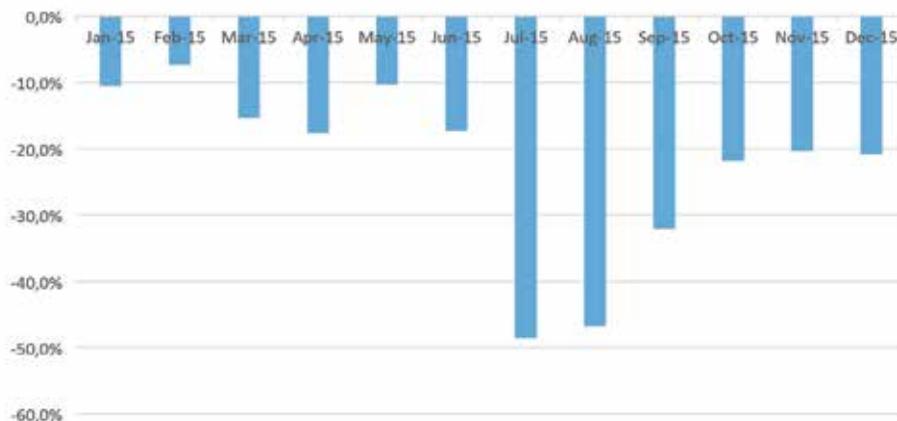
<sup>4</sup> [https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html)



Source: National Bank of Georgia.

With the depreciation of euro against dollar not representing a problem for Eurozone residents, income in USD of Georgians living in the EU decreased notably and with it, that part of remittances which entered from the Eurozone. Meanwhile, the situation in Greece - the second important source of remittances to Georgia (in 2011-2014, comprising 12.8 percent of all remittances) after Russia - has worsened significantly due to debt crisis in the country. In summer 2015, after Greek banks had been prohibited to make transfers abroad and the cash withdrawal had been limited to 60 euros a day, the remittances from Greece to Georgia plummeted by more than 90 percent. Overall, remittances from the EU dropped by 23 percent in 2015, proving to be a significant pressure on the lari exchange rate.

Remittances from the EU (annual change)

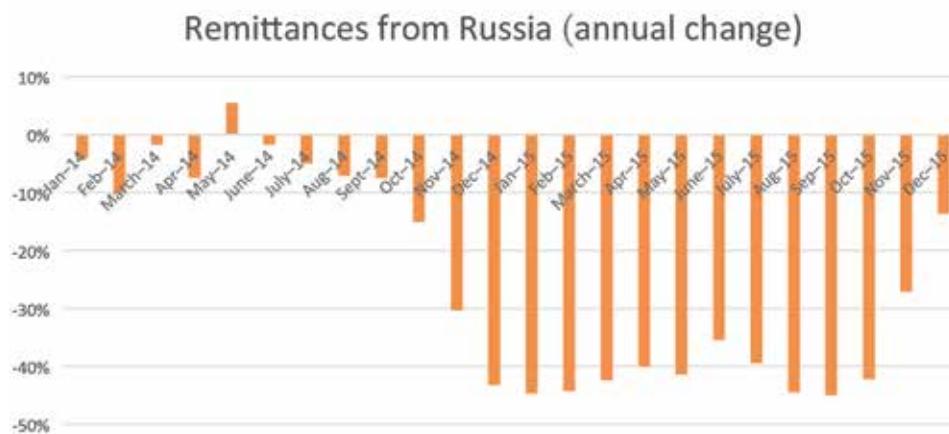


Source: National Bank of Georgia.

Developments in Russia and the region, especially the Russia-Ukraine war and sanctions imposed on Russia because of this war, made the strongest exogenous influence on the Georgian economy and in particular, the lari exchange rate.

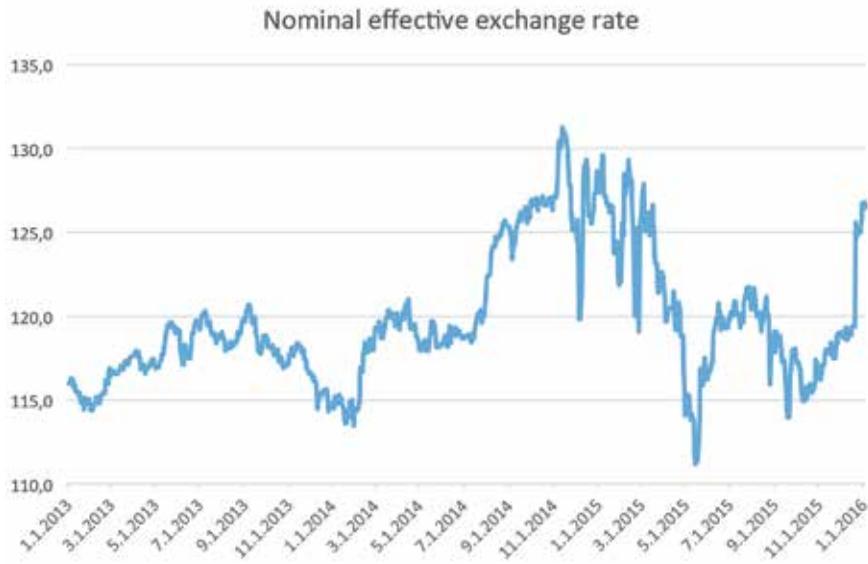
The depreciation of Ukrainian hryvnia and decreased demand in Ukraine, resulting from the war and crisis, had a strong negative implication on the competitiveness of Georgian exports. The share of Georgian exports to Ukraine fell from 6.6 percent in 2013 to 2.5 percent in 2015. Similarly, the share of Russia in Georgian exports went down from 9.6 percent in 2014 to 7.4 percent in 2015.

Sanctions imposed on Russia coupled with a sharp drop in oil prices led to significant depreciation of Russian ruble, reaching 120 percent over the period from January 2014 to the end of 2015. Apart from its negative impact on Georgian exports, the depreciation of ruble most severely hit the volume of remittances from Russia, which reduced by 39 percent during 2015. Bearing in mind that traditionally, Russia is the main source of remittances to Georgia and in 2009-2013, some 53.5 percent of total remittances were from Russia, the scale of effect of this development on the balance of foreign currency flows and consequently, the lari exchange rate is apparent.



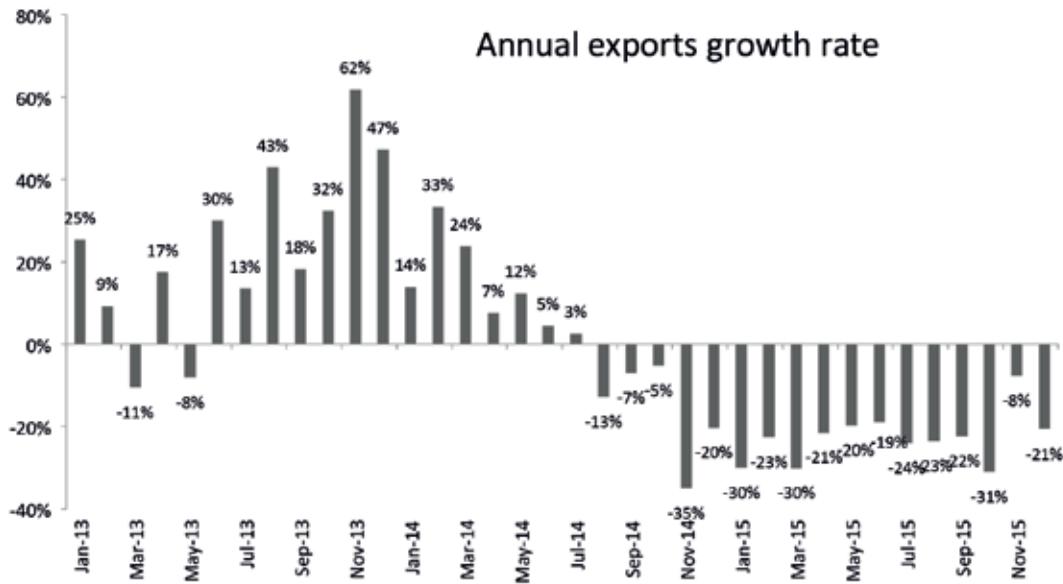
*Source: National Bank of Georgia.*

It is noteworthy that due to depreciation of currencies of almost all main trade partners against lari, the nominal effective exchange rate of lari strengthened throughout 2014 until it started to depreciate against US dollar.



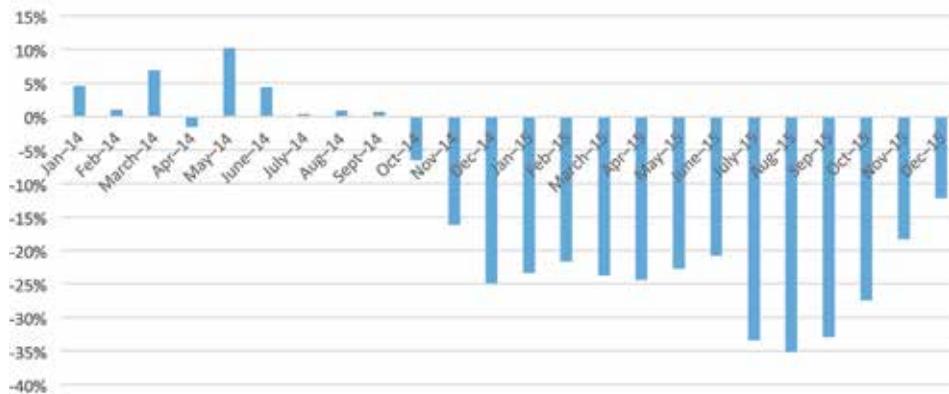
Source: National Bank of Georgia.

As a result, export reduced (similarly to remittances) though import did not decrease until mid-2015.

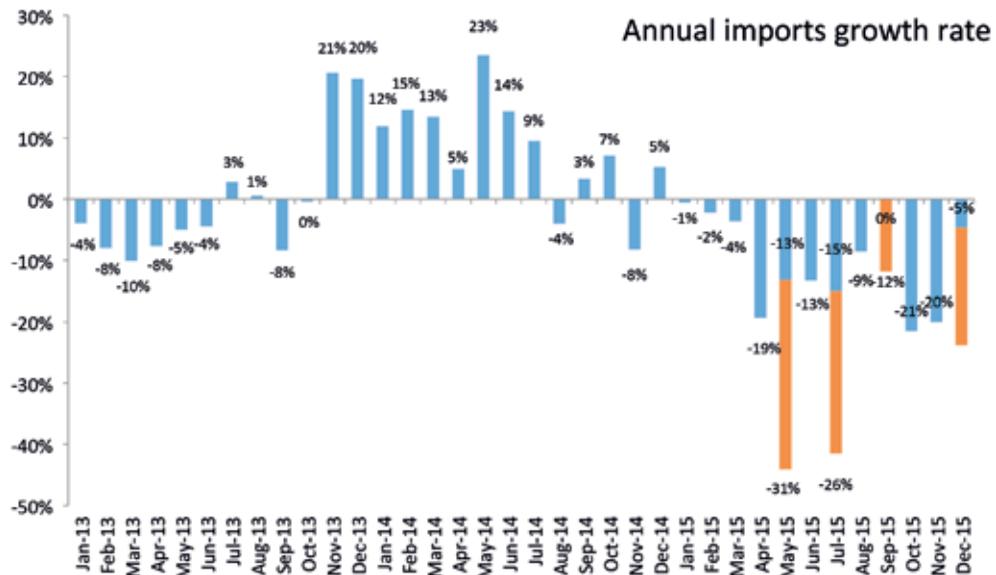


Source: Geostat.

## Annual change in remittances



Source: Geostat.



Source: Geostat.

At the end of the day, the depreciation entailed the correction of the balance of payment; the drop in exports was followed by the drop in imports in the second and third quarters of 2015, caused both by the depreciation and the decrease in the demand on consumer goods.

All in all, in 2014-2015 Georgia lost around 1 billion USD worth inflows, significantly affecting the lari exchange rate. This pressure stopped only after the outflows decreased by the same amount and towards the second half of 2015, the lari exchange rate got stabilized at a new notch - 2.49 GEL/USD.

Throughout all this period there were repeated complaints about the activity of the National Bank of Georgia (NBG), being, first, blamed for depreciation and then, for the scale of depreciation. That all these accusations were unfounded can be proved, if anything, by similar development in the region.

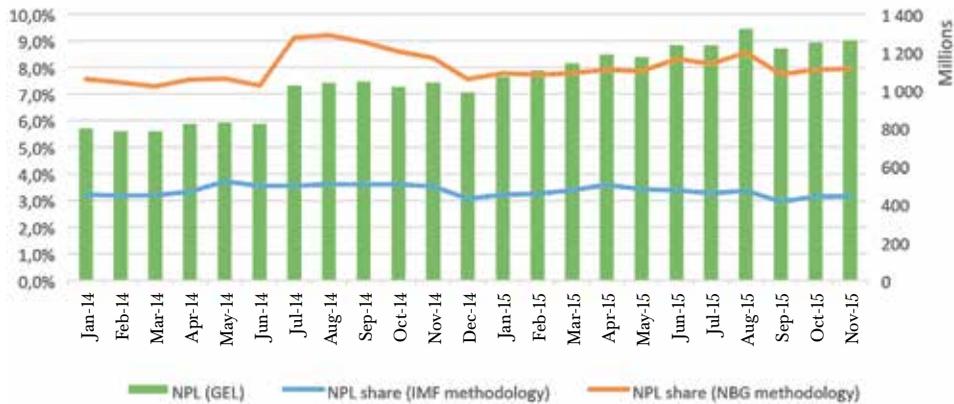
	Depreciation since the beginning of 2014	Depreciation since the beginning of 2015
Russia	99.7%	15.3%
Ukraine	171.5%	37.6%
Turkey	33.9%	23.2%
Azerbaijan	103.8%	103.8%
Kazakhstan	62.7%	37.1%
Armenia	17.2%	0.9%
Moldova	44.4%	20.6%
Georgia	33.9%	23.5%

Use of monetary policy instruments in the countries of the region				
	Sale of reserves, 2014 (mln USD)	Sale of reserves, 2015 (mln USD)	Inflation	Policy rate
Russia	125,000	30,000	15.6%	11.0%
Ukraine	14,000		55.3%	30.0%
Turkey	6,500	2,700	6.8%	7.5%
Azerbaijan	2,500	7,630	4.5%	3.0%
Kazakhstan	28,000		3.9%	5.5%
Armenia	770	130	4.2%	10.5%
Moldova	660	400	8.3%	17.5%
Georgia	100	200	4.9%	6.0%

With the exception of Armenia, local currencies of all other countries of the region notably depreciated against USD and the scale of this depreciation was larger than in Georgia. The sale of reserves in all these countries sharply exceeded Georgia's corresponding indicator (reserves in percentage) and these sales of reserves did not prove sufficient to stop depreciation in any of those countries. Moreover, the policy rate in the majority of the countries was higher than the policy rate in Georgia. Overall, the policy of the National Bank of Georgia proved absolutely correct in the long term: maintaining a floating exchange rate to allow the correction of the balance of payment by the exchange rate influence; refraining from excessively restricting overall demand (by increasing interest rates) to spare the economy from entering the recession; using interventions only when sharp fluctuations in the exchange rate are observed; curbing inflation expectations by increasing interest rates.

It should also be mentioned that the depreciation of Georgian lari against US dollar is a big problem because of high dollarization rate in the country and a significant currency imbalance between income and expenditure. A large-scale depreciation of lari, due to a high dollarization rate, could have created significant risks to the financial stability; however, these risks did not materialize which can be seen from the dynamic of the share of nonperforming loans.

## Nonperforming loans (NPL)



Source: National Bank of Georgia.

All in all, one may say that the policy implemented by the National Bank of Georgia (NBG), in the given circumstances, was optimal though unpopular. The NBG resisted the temptation of wasting reserves and instead, focused on a long-term development and mitigation of risks. When comparing it with other countries of the region, it is obvious that the policy was absolutely justified. Yet another important point was that the monetary policy of the NBG, despite a general dynamic of austerity, was not marked with sharp leaps which would have pushed the country towards the recession and even if the depreciation was stopped, would have proved devastating for the already weakened economy.

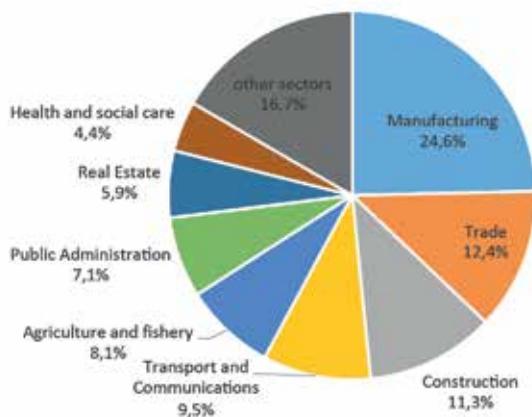
In late 2015 and early 2016, as a result of drop in oil prices on world markets, Russian and Azerbaijani currencies came to face serious problems, with the Russian ruble hitting the rock bottom and the Azerbaijani Central Bank no longer able to maintain the fixed exchange rate, allowing its national currency, manat, to float freely on 20 December 2015. As a result, manat depreciated by almost 50 percent at once. The panic that emerged on the Russian and Azerbaijani markets had serious implications for the currency market of Georgia and Georgian lari reversed to the depreciation trend, reaching a historically record high point of depreciation – 2.4985 lari against 1 USD, on 28 January 2016. However, after the panic subsided on the Russian and Azerbaijani markets, oil prices began to rise; at the same time, net currency inflows to Georgia began to increase owing to enhanced tourism and decreased imports and lari started strengthening. By May 2016, the depreciation decreased by 11 percent on its peak indicator.

At this stage, one may assume that the influence of external shocks affecting the depreciation of lari has been exhausted and given optimistic forecasts regarding tourism and foreign direct investments, one may expect the stability of lari exchange rate, with a slight tendency towards strengthening. Considering these circumstances, the National Bank of Georgia, for the first time in the past two years, eased the monetary policy by decreasing the refinancing rate by 50 basis points.

# ECONOMIC GROWTH IN THE COUNTRY

Over the past three years, the economic growth of Georgia was slow by standards of the developed countries: 3.4% in 2013, 4.6% in 2014 and 2.8% in 2015.<sup>5</sup> Such a slowdown of economic growth, as compared to the previous period, was conditioned by numerous idiosyncratic as well as regional and global factors; however, while the economic slowdown in 2013-2014 may be attributed to the decrease in foreign direct investments, which was caused by ambiguity related to the change in power and perhaps, the adoption of economically unjustifiable laws,<sup>6</sup> 2015 proved very challenging to the Georgian economy because of developments in the region and economic problems that emerged in neighboring countries.

GDP by sectors, 2015



Source: Geostat.

In 2015, the real GDP of Georgia grew by 2.8 percent. In contrast to previous years, the growth was more or less even throughout the year, ranging between 2.5 percent and 3.2 percent on a quarterly basis.

In 2015, almost one fourth of Georgia's GDP accounted for industry though its share in the growth was negative (-0.15 percent) mainly due to decrease in manufacturing and stagnation in other fields. The largest contribution to the GDP growth in 2015 was made by the construction sector, accounting for 0.8 percentage points of the entire 2.8 percent growth. Especially worth noting is the stagnation

<sup>5</sup> By preliminary estimates.

<sup>6</sup> For example, a moratorium on the sale of agricultural land, or toughening of visa regulations.

in trade sector, resulting from the economic slowdown: while the share of this sector in the GDP growth comprised 0.8 percentage points in 2014, a corresponding indicator of 2015 was little below 0. The past three years also saw a slower growth of financial sector: while before 2013 (with the exception of 2008-2009 crisis years) this sector showed a two-digit growth, a corresponding indicator of the past three years stood at 8.8 percent, on average, and the contribution of the sector to the growth decreased.

The economic slowdown of Georgia was also reflected in forecasts of international organizations. According to 2015 October forecast of the International Monetary Fund (IMF), the economic growth of Georgia in 2015 was estimated at 2 percent and in 2016 at 3 percent.<sup>7</sup> Moreover, in its forecast published in April 2016, the IMF downgraded the 2016 forecast to 2.5 percent while estimating the growth of 4.5 percent in 2017.<sup>8</sup> Forecasts of the World Bank are relatively optimistic too, putting the economic growth of Georgia at 3 percent in 2016, 4.5 percent in 2017 and 5.0 percent in 2018.<sup>9</sup> These forecasts are based on the slackened economic activity in the region, the persistence of economic recession in Russia (by forecasts, Russia will see economic slowdown in 2016 as well and the reversal of this trend in 2017) and general dissatisfaction with the economic development inside Georgia. According to results of a survey of the US National Democratic Institute conducted in March 2016, economy is the most important issue for the population of the country with a mere 2 percent of respondents evaluating the economic situation positively. By the same survey, the top three most serious problems of the country are unemployment (57 percent), rise in prices/inflation (35 percent) and poverty (30 percent). As many as 66 percent of population assess the economic situation in the country as bad or very bad, putting the blame for that on the mistakes made by the current government (81 percent) and former government (59 percent) and problems of global economy (53 percent). Some 65 percent of the population consider themselves unemployed (it must be noted that this indicator has not been less than 60 percent since April 2010, thus clearly indicating that the key economic problem of the country is the employment and lack of jobs).<sup>10</sup> This is a paradox itself bearing in mind that Georgia is a leader in the World Bank's Doing Business index (being ranked as the 24<sup>th</sup> in the past two years).<sup>11</sup> Moreover, Georgia is traditionally among top ten countries by ease of starting business (sixth place), property registration (third place) and taking out loan (seventh place). It is worth to note that in one of components of this index, namely, resolving insolvency, Georgia is the 101<sup>th</sup> which means that there might be a number of entrepreneurs who carry a burden of unsuccessful business projects making it difficult to dump the "ballast" and start a new activity – the process ease of which is necessary for the efficient operation of private sector.

It is worth to note Georgia's indicators in yet another important international rating – the Global Competitiveness Index; the edition of this index for the years 2015-2016 ranks Georgia the 66<sup>th</sup>.<sup>12</sup>

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7 <http://www.imf.org/external/pubs/ft/reo/2015/mcd/eng/pdf/mreo1015ch3.pdf>

8 <http://www.azernews.az/region/95125.html>

9 <http://pubdocs.worldbank.org/pubdocs/publicdoc/2016/1/948841452266268379/Global-Economic-Prospects-January-2016-Regional-Overview-ECA.pdf>

10 [https://www.ndi.org/files/NDI%20Georgia\\_March%202016%20poll\\_Public%20Issues\\_ENG\\_vf.pdf](https://www.ndi.org/files/NDI%20Georgia_March%202016%20poll_Public%20Issues_ENG_vf.pdf)

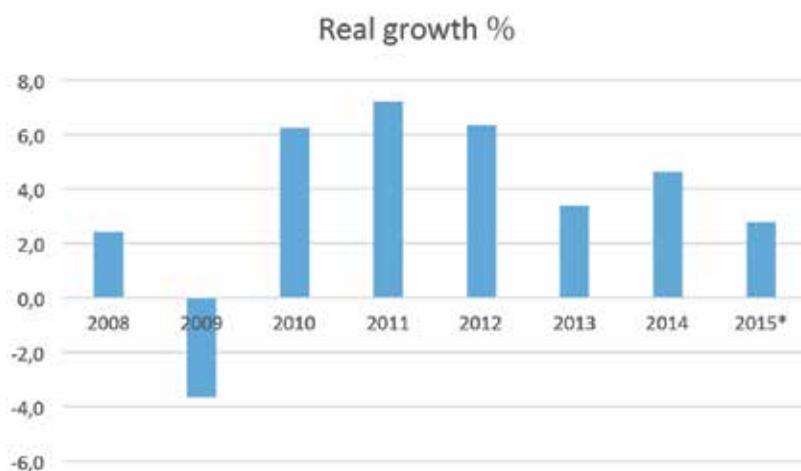
11 <http://www.doingbusiness.org/data/exploreeconomies/georgia/>

12 <http://reports.weforum.org/global-competitiveness-report-2015-2016/economies/#indexId=GCI&economy=GEO>

According to pillars of this index, the biggest problems for Georgia are market size, business sophistication and innovations. Close look at this index makes Georgia's leading positions in terms of ease of starting business obvious; however, more interesting are those components in which Georgia's positions are below 100 (among 140 countries covered by the index). These are local supplier quantity (137<sup>th</sup>) and financing through local equity markets (133<sup>th</sup>). Georgia is poor at cluster development (120<sup>th</sup>), access to venture capital (119<sup>th</sup>), ability to attract talent (117<sup>th</sup>), local supplier quality (117<sup>th</sup>), availability of scientists and engineers (113<sup>th</sup>), quality of demand conditions (114<sup>th</sup>), and quality of the educational system (101<sup>th</sup>). Despite a certain degree of subjectivity, these indicators clearly reflect the areas where reforms are needed, highlight those segments of competitiveness which impede the economic development of Georgia.<sup>13</sup>

Overall, Georgia is developing faster than the CIS region which showed a negative average growth in 2015 (-2.6 percent) and as expected, this recession has continued into 2016.<sup>14</sup>

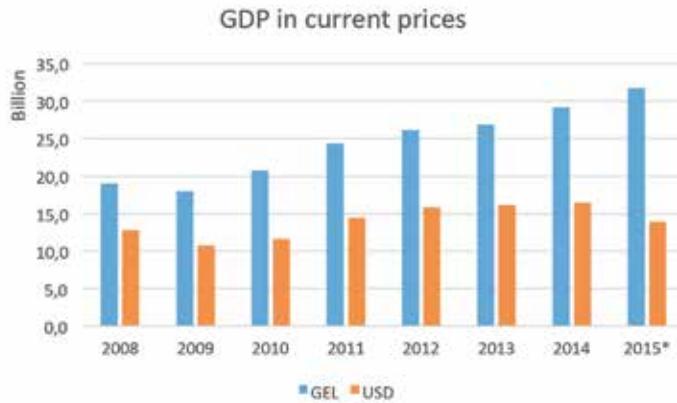
As regards nominal GDP indicators, the GDP of 2015 at current prices made up GEL 31.7 billion, up by 8.7 percent as compared to a corresponding indicator of 2014. At the same time, one should say that over the same period, the GDP per capita increased by 30.1 percent (from GEL 6491.6 to GEL 8497.5), as a result of the population census which revealed that the number of population of Georgia stands at 3.7 million. The result of this census explains as well that despite a significant depreciation of lari, the GDP per capita increased by 1.8 percent in USD (from 3676.2 to 3743.1).



Source: Geostat.

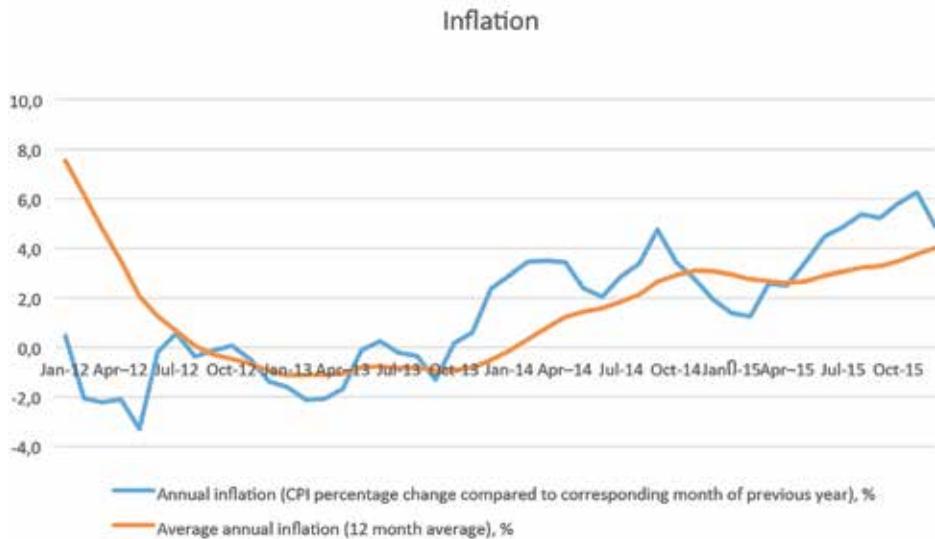
13 One should mention separately the downgrading by 24 places of national income to GDP ratio (from 72 to 96) as this indicator is especially important for sustainable economic development of the country.

14 <http://www.focus-economics.com/regions/cis-countries>



Source: Geostat.

## CONSUMER PRICE INDEX AND INFLATION



Source: National Bank of Georgia

In contrast to 2012-2013 years, 2014 and 2015 saw the growth of inflation rate with the lari depreciation largely contributing to it. At the same time, it should be noted that the actual inflation rate, established by the National Bank of Georgia and now standing at 5 percent, exceeded the inflation target only in the second half of 2015, though by the end of the year it fell below it again. Moreover, the average annual inflation has been below this indicator since March 2012.

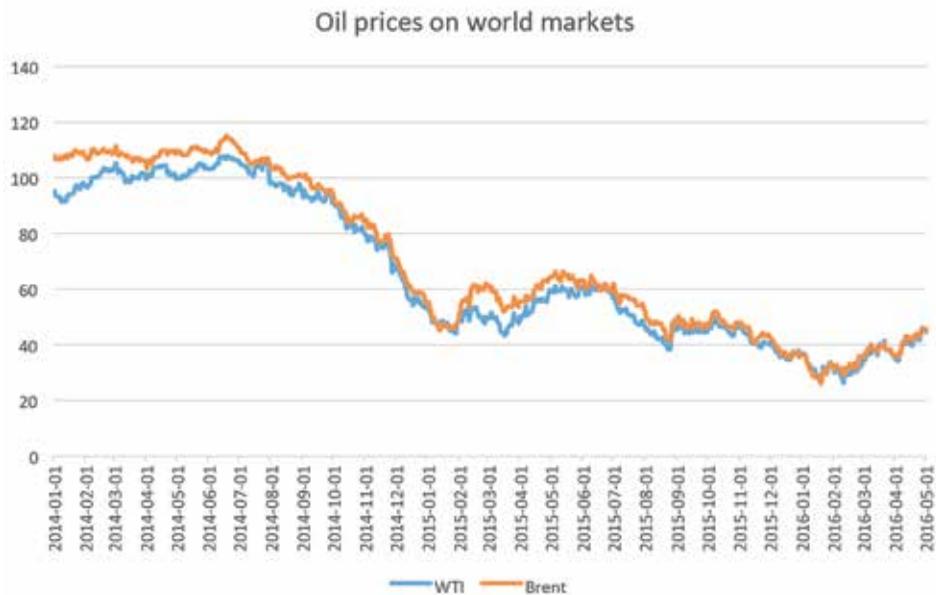
An important role in curbing inflation, despite the sharp depreciation, was played by decreasing food prices which has been observed on the world market for the past 2.5 years and the scale of which was especially notable throughout 2015.<sup>15</sup>



Source: Food and Agriculture Organization of the United Nations (FAO)

Therefore, although there were fears of sharp increase in import prices, the decrease in world prices, along with the drop in oil prices, had a significant curbing effect on the growth of consumer prices in Georgia. It should also be noted that during 2015, the National Bank of Georgia raised a monetary policy rate several times to curb inflation expectations.

<sup>15</sup> <http://www.fao.org/worldfoodsituation/foodpricesindex/en/>



Source: St. Louis Fed.

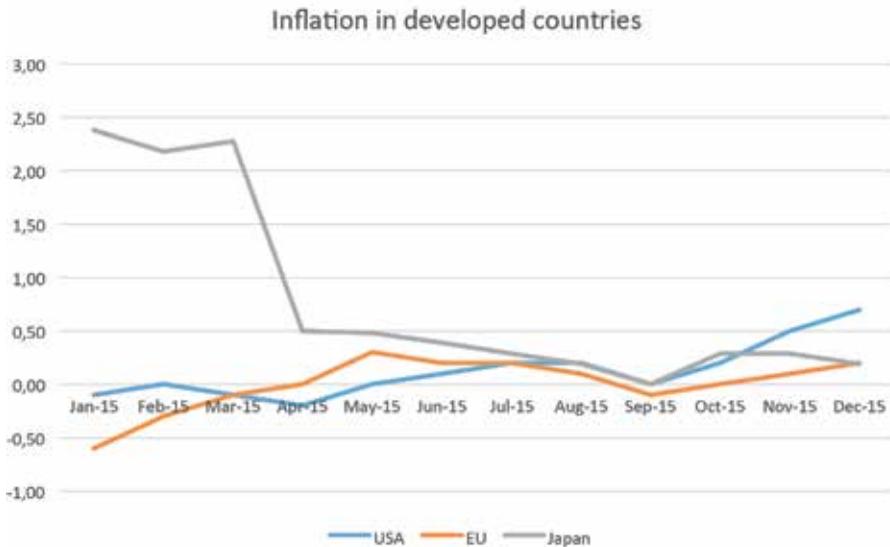


Source: FAO



Source: National Bank of Georgia.

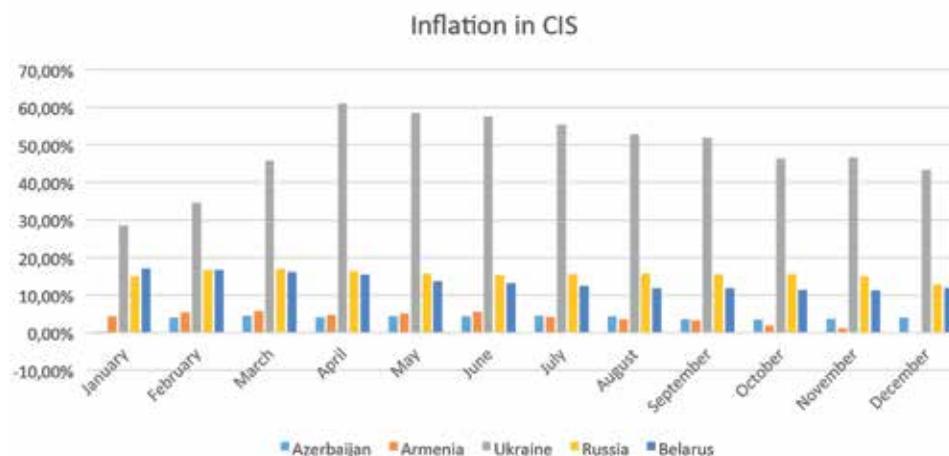
At the same time, the inflation in the EU countries and the United States was close to zero in 2015; moreover, at the beginning of the year, a relatively higher inflation was seen in a traditionally low-inflation-rate country - Japan, though this trend reversed in the second half of the year.



Source: Statistics offices of corresponding countries.

In 2015, the inflation rate in the countries of Southern Caucasus was lower than in Georgia; moreover, while the fluctuation was quite limited in Azerbaijan (excluding January 2015 when it fluctuated within the range of 3.4 percent - 4.5 percent), the inflation showed a notable decrease in Armenia resulting in deflation in December.

On the other hand, a two-digit inflation persisted in Russia, Ukraine and Belarus throughout the year. The inflation was especially high in Ukraine because of macroeconomic and political instability in the country; however, from the second half of the year, it showed a downward trend.



Source: Statistics offices of corresponding countries.

## EXTERNAL SECTOR

### FOREIGN DIRECT INVESTMENTS

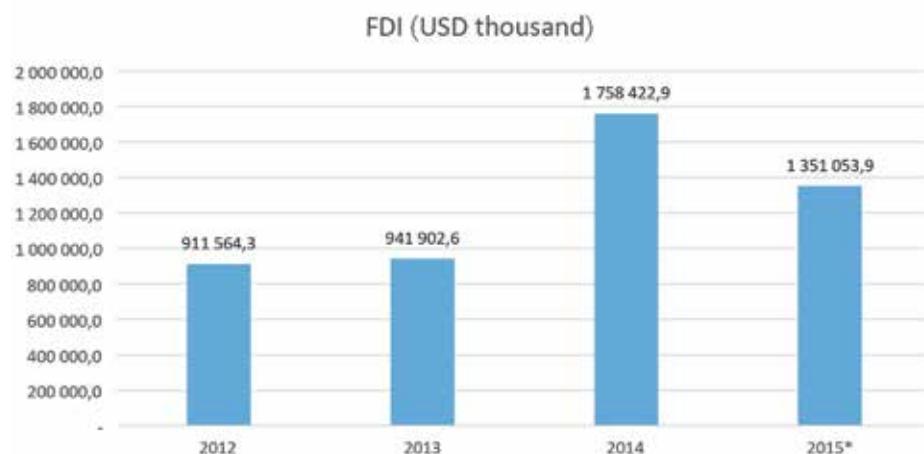
By preliminary data, 1.351 billion USD foreign direct investments entered Georgia in 2015. If 2014 disregarded, this is the highest indicator since 2008 and a notable progress compared to 2012-2013 when the amount of FDI was less than 1 billion USD.

The slowdown in investment flows was observed globally over the past few years. In particular, in 2014, the global FDI showed a 16 percent decrease on the indicator of the previous year, making up 1.23 trillion USD. This was mainly caused by the fragility of global economy, ambiguity of policy for investors and increased geopolitical risks.<sup>16</sup> FDI inflows to developing countries increased with China becoming the largest receiver of FDIs.

<sup>16</sup> World Investment Report, 2015, pg. 30 ([http://unctad.org/en/PublicationsLibrary/wir2015\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf))

According to forecasts, FDIs are expected to increase globally; in particular, a target for 2015 is 1.4 trillion USD further increasing to 1.5 trillion USD in 2016 and to 1.7 trillion USD in 2017. However, this forecast has risks too – ongoing difficulties in the Eurozone, potential effect of various conflicts, and vulnerability of developing economies which may impede the forecasted growth.<sup>17</sup>

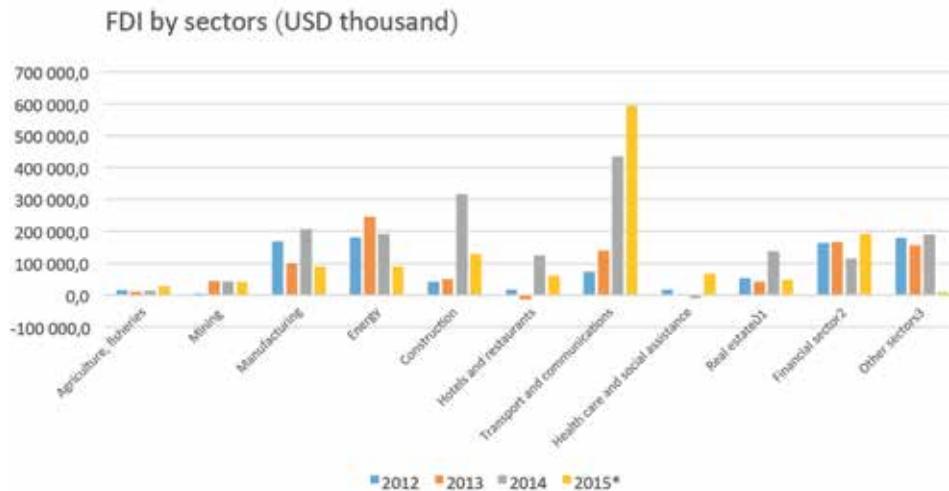
FDI inflows to Georgia in 2015 can be categorized by their origin into three main groups – the EU countries, the CIS countries and other countries. The share of EU countries in total FDIs stood at 37.7 percent (509 million USD of which almost 3/5 came from the United Kingdom and the Netherlands); the share of CIS countries comprised 43 percent (582.8 million USD with Azerbaijan amongst being a clear-cut leader in the group with 541.8 million USD flowing into Georgia from this country in 2015) and the share of other countries made up 15.8 percent (213.4 million USD; the lion’s share of this amount, almost 80 percent, accounting for the USA, Turkey and China). It should be also noted that Georgia saw net capital outflow to several countries too. In 2015, the total of 124.8 million USD left the country with the bulk of to Japan (39.2 million), British Virgin Islands (29.2 million), Cayman Islands (29.1 million) and Ukraine (17.1 million).



Source: Geostat.

By sectoral distribution, the largest chunk of investments in the past two years was received by the transport and communications sector – above 1 billion USD in total, thus comprising 33 percent of investment inflows over that period. Other large receivers of foreign direct investments were the construction and the financial sectors.

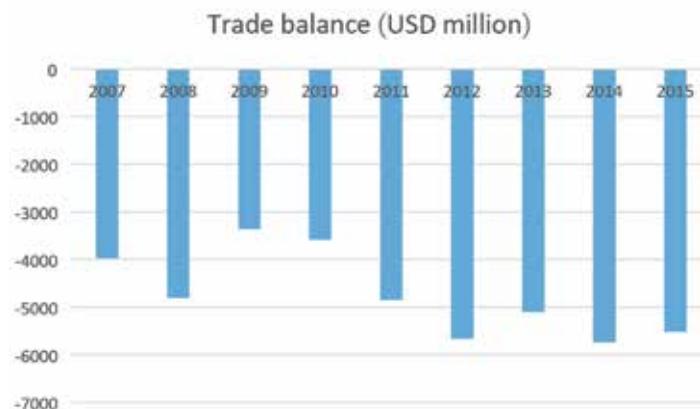
<sup>17</sup> Ibid.



Source: Geostat.

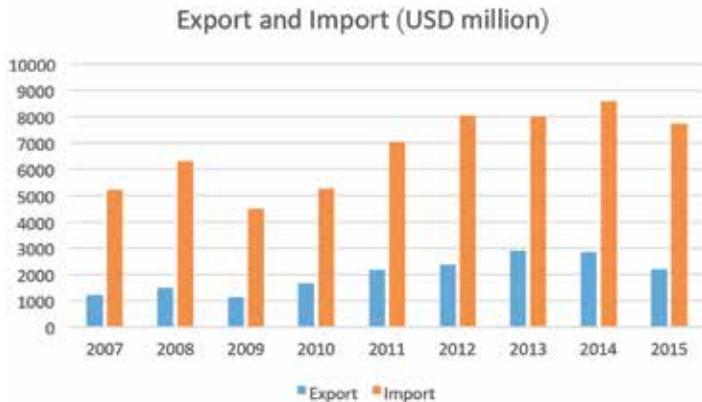
## TRADE

Compared to 2014, the year 2015 saw the decrease both in trade deficit and trade turnover of Georgia. While in 2014, the total external trade made up 11.454 billion USD and the deficit comprised 5.733 billion USD, in 2015 these indicators shrank by 13.3 percent and 3.6 percent, respectively, to 9.933 billion and 5.525 billion US dollars. The main factor causing this change was the influence of pressure on the lari exchange rate during the year which we discussed in detail separately and therefore, will not dwell on it in this part of our analysis.



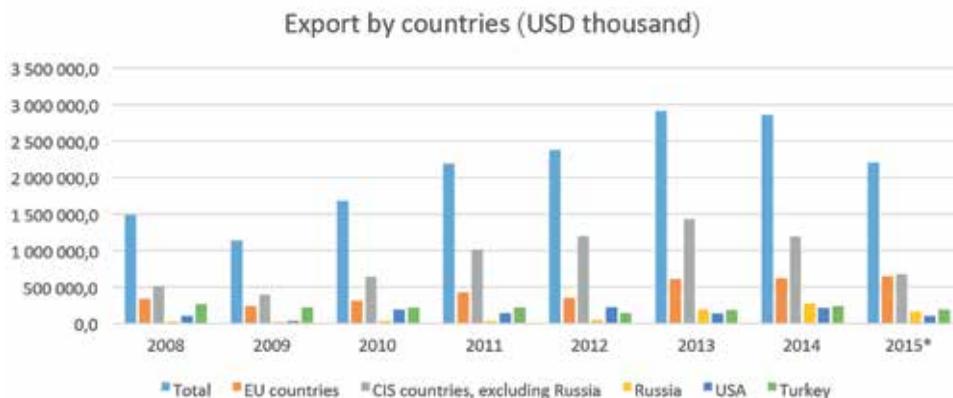
Source: Geostat.

Compared to the previous year, imports to Georgia decreased significantly (by 10 percent) and comprised 7.729 billion USD. At the same time, the decrease in exports, due to reasons discussed below, was larger, amounting to 23 percent; as a result, the total exports from Georgia made up 2.204 billion USD in 2015, which is the lowest indicator since 2011. The problems in Georgian exports in 2015 showed once again how unreliable is Russia as a trade partner and how damaging is for Georgia to depend on that market even though the decrease in the trade with Russia this time was not as much caused by political decisions as by economic problems of the country.



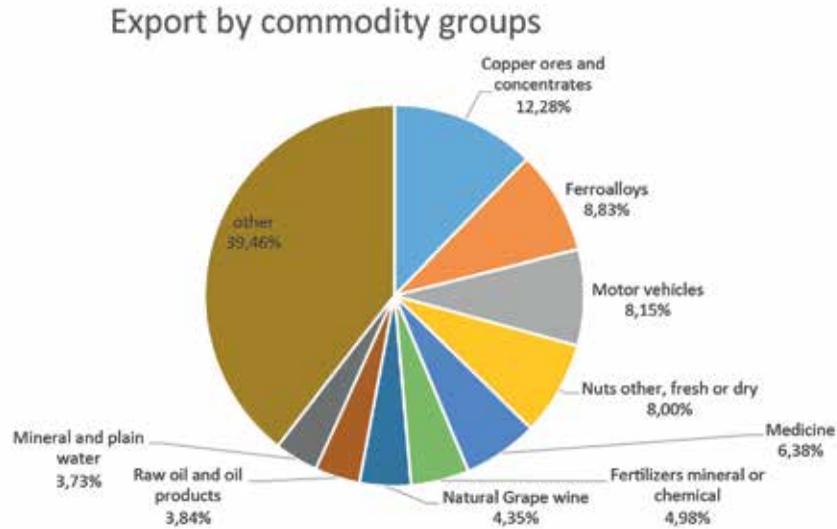
Source: Geostat.

Despite an overall reduction in trade, positive trends were maintained in the trade with the European Union. In 2015, the trade with the EU saw a 3.6 percent rise reaching 646.4 million USD, which is itself a welcoming development. At the same time, a sharp drop was observed in Georgian exports to almost all other large trade partner countries or regions – by 42.7 percent to the CIS (of which 40.7 percent drop in exports to Russia and 55.8 percent drop in that to Azerbaijan, Georgia’s two largest partners in the region), by 49.8 percent to the USA and 21.9 percent to Turkey. The decrease in exports to the USA is especially worth noting because the depreciation of lari against US dollar should have affected this indicator for the better.



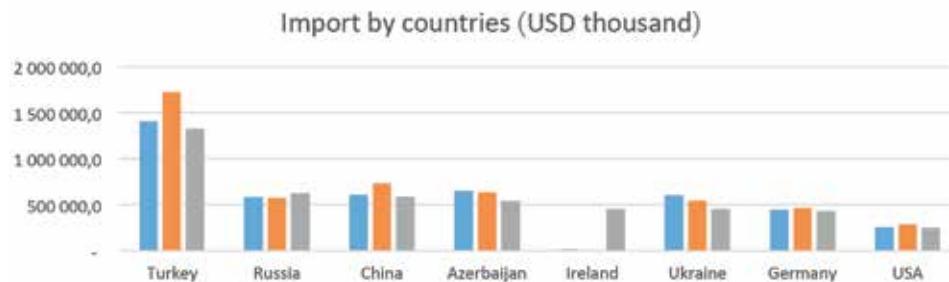
Source: Geostat

Georgia's main export commodity in 2015 was copper ores and concentrates, comprising 12.28 percent of total exports. Re-export of motor cars was also relatively large though its share in the total export shrank as compared to previous years. It is noteworthy that hazelnuts is the fourth largest export commodity of Georgia, which, due to almost halving of wine exports, now represents the main agricultural export of Georgia.



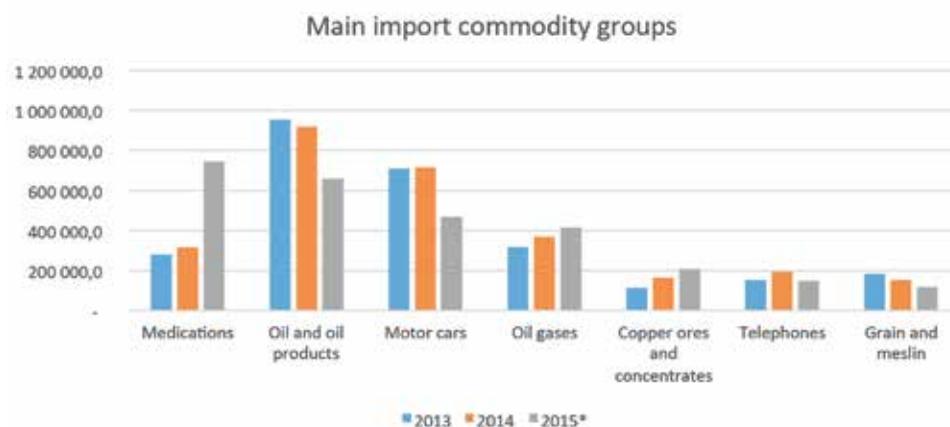
Source: Geostat.

The largest import partner of Georgia is Turkey again, though its share in total imports decreased compared to 2014 (from 22.3 percent to 17.2 percent). The EU share in total imports increased by almost two percentage points, reaching 32.6 percent. As regards other countries, one should note a notable rise in the share of imports from Ireland – from 0.1 percent in the total imports in 2014 to 5.9 percent in 2015. The reason of such increase is the import of medication for Hepatitis C from Ireland.



Source: Geostat.

Medications made it into the group of leading import commodities mainly because of import of medications against Hepatitis C. However, since these medications were purchased by means of special grants, this part of imports did not affect the current account deficit. A sharp drop in world oil prices resulted in the reduction of the share of oil and oil products import (from 11.9 percent in 2013 to 8.5 percent in 2015). The share of motor cars also dropped, assumedly due to shrinkage of re-export market.



Source: Geostat.

## CONCLUSIONS AND POLICY RECOMMENDATIONS

According to various forecasts, the economic growth in Georgia in 2016 is expected to be around 3 percent. This is a rather low indicator, but taking into account the situation in the region a faster growth is not likely. It should also be noted that 2016 is the election year (as well as 2017 and 2018) and one should expect high fluctuations in the economic activity at the end of the year.

The experience of 2014-2015 years suggests that a special attention should be paid to external shocks. Even though the second and third quarters of the year are expected to see increase in currency inflows (and consequently, the strengthening of lari exchange rate), economic policy makers should consider possible risks of depreciation towards the end of the year and take precautions against exogenous shocks. In this regard, interventions of the National Bank of Georgia on the currency market (in particular, purchases of US dollars which were made in April and May 2015) are important to avoid the excessive strengthening of lari rate and to mitigate changes in the lari rate.

## RECOMMENDATIONS

- Similar to the previous year, the National Bank of Georgia should implement an adequate monetary policy to exogenous shocks, including currency interventions aimed at protecting lari rate against excessive fluctuation.
- De-dollarization strategy should be continued in the long-term.
- The government should distribute expenditures and deficit as evenly as possible throughout the year.
- A strategy for mitigating exogenous shocks (diversification of markets) should be drawn up.
- A strategy for encouraging foreign investments and tourism in the long term should be developed.
- Georgian export sector should be encouraged within the framework of marketing programs as well as other grant and subsidy programs.
- Special attention should be paid to issues of potential cooperation between Georgia and Iran in the fields of energy and trade (see, the EPRC report “Georgia and Iran”).





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