Georgian Economic Outlook

Stagnation or Not

2013 Economic Review

7th Report

Economic Policy Research Center (EPRC)

October 2013

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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 seventh report: Georgian Economic Outlook – 2013.

This paper covers the major economic developments in the country over the past year 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.

Key Findings

- Economic growth in Georgia slowed down starting from the end of 2012 due to the decreased FDI and election related uncertainty. Three out of four indicators have decreased: there has been a decrease in aggregate demand, investments, and the government spending;

- Projected 6% Gross Domestic Product (GDP) growth could not be achieved, and even the adjusted estimate of 3-4% real annual growth is questionable; EBRD forecasts a 3% economic growth in 2013, IMF prognosis is even less - 2.5%;

- The Countries in transition as a whole are experiencing slowdown, especially in Russia, and Turkey that might have also caused worsened economic outlook for Georgia. Average economic growth of the Transition Countries is 2.2% in 2013, with a modest recovery expected in 2014;

- Economic growth marked in the recent years was largely due to the government activities in the economy. Scaling down such projects before the private sector takes over is also unjustified, the consequences of such actions is proved by the economic and budgetary indicators that we face today;

- It has been almost a year that Georgian economy is facing deflation. Main cause of deflationary processes in Georgia are claimed to be decrease in demand;

- There is a decrease in the number of employed in the business sector by roughly 6% as of the second quarter 2013. Number of employed in the construction sector has decreased by 34%;

- Almost all fields saw a decrease in the number of employees except for agriculture, due to the active governmental programs directed to this field and a much smaller formal employment base than in other sectors of the economy;

- In the Human Capital Report Georgia lags behind as benchmarked against neighboring countries and the region as a whole. In the education pillar Georgia ranks 74th among 122 countries and 102nd in the workforce and employment pillar.

- Declining trend of FDI in Georgia is further maintained in 2013. Global FDI fell by 18%, due to global economic fragility and policy uncertainty. Most of the sectors saw a declining trend in Georgia. Significant increase in investments was observed in the fields of energy, mining and transport and communications, while the largest decrease in the construction sector.

- Remittances are still the most reliable and less volatile sources of external monetary inflows and are almost twice as much as the FDI inflow. Flows are still stable from the EU zone countries, one excep-

tion is Spain; money transfers from this country have decreased by 15% in the first 9 months of 2013.

- External trade tendencies have shown a positive trend in terms of an 11% increase in exports in the first 8 months of 2013 as compared to the same period last year. According to the 8 month data, as compared to the same period in 2012, we observe a 56% increase in the export of mineral waters in monetary terms, and 67% increase in wine export. It should be noted that this is not a very distinguished growth; Georgian exports have grown by 30% from 2010 to 2011, and another 8% from 2011 to 2012;

- On the other hand, imports have shown a declining trend (4% decrease) that has not been the case since 2009. The most significant decrease up to 40% is observed in wheat imports (in monetary terms). Re-opening of the Russian market not only resulted in an increase in exports but also in Imports - a 43% increase was observed as of 8 months in 2013, as compared to the same period last year.

Economic Growth in Georgia

Economic growth in Georgia slowed down starting from the end of 2012 due to the decreased FDI and election related uncertainty. Three out of four indicators have decreased: there has been a decrease in aggregate demand, investments, and the government spending. The only indicator improved is the net exports; however this improvement was not so drastic to overweigh a fall in all other categories.

As expected and presented in policy briefs on budget performance by EPRC, projected 6% Gross Domestic Product (GDP) growth could not be achieved, and even the adjusted estimate of 3-4% real annual growth is questionable. At the same time, 2013 budget performance also represents a challenge, in the given situation the government will have difficulties in collecting the projected revenues, thus resulting in expenditure cutting. EBRD forecasts a 3% economic growth in 2013[1], IMF prognosis is even less - 2.5%. According to the preliminary data based on the VAT taxpayer's turnover average growth for the 8 month period equals 1.6%, which is 0.1% higher as compared to the second quarter average. It is noteworthy that since May 2013 change in VAT payer's turnover as compared to the previous year's indicator was outright negative, amounting to -3.5% in July 2013.

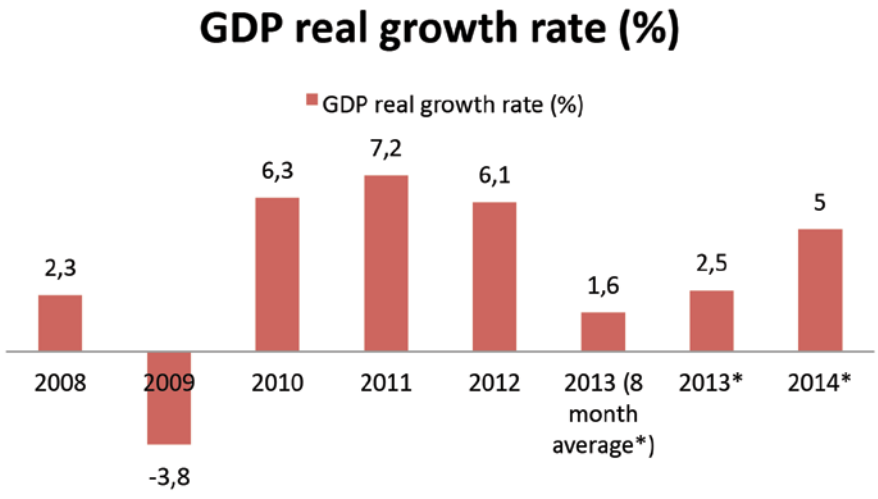
Last time that the country's economy has experienced a slowdown or even a negative growth was following the global crisis and the war (f.1). Afterwards, for three years the growth was quite stable. The Countries in transition as a whole are experiencing slowdown, especially in Russia, and Turkey that might have also caused worsened economic outlook for Georgia. Average economic growth of the Transition Countries is 2.2% in 2013, with a modest recovery expected in 2014[2].Growth in the region remains stable for the oil exporter countries, while oil importer countries are performing poorly. As to the region, together with Georgia, growth in Armenia is also predicted to decelerate this year, due to slower growth in agricultural sector and budget underspending. The latter is named as a major cause for decelerated growth in Georgia as well. According to IMF, other factors contributing to slower growth are declining private investments and weak credit growth. Some recommendations include allowing policies that are accommodative for productive spending to support demand[3].

1 http://www.ebrd.com/pages/research/economics/data/macro.shtml#structural

2 Regional Economic Prospects in EBRD Countries, May 2013. http://www.ebrd.com/downloads/research/REP/rep-may-2013.pdf

3 International Monetary Fund.World Economic Outlook. October 2013. Transitions and Tensions.http://www.imf.org/external/pubs/ft/weo/2013/02/pdf/text.pdf

Figure 1 GDP real growth rate (%) www.geostat.ge, www.imf.org



Major challenge for the new government is mainly mobilizing private sources of financing for supporting investments in key sectors[4], in the conditions of declining foreign direct investments (FDI).

A decline is observed in credit activity of the banks, expressed in a decline in turnover of the business sector. The National Bank of Georgia (NBG) has reduced the monetary interest rate to a record low 3.75%; however in the conditions of deflation the real interest rate is higher than the nominal one. Therefore, a possibility of further reducing the interest rate might be cautiously considered if the potential for boosting aggregate demand and spending is obvious.

During an economic slowdown, the state can play an important role, through correct fiscal policies by means of budgetary tools to smoothen downturn and avoid a crisis. In the period of economic stagnation, when the private sector is reluctant or cannot manage to create economic stimuli without the state intervention, the state has the possibility to stimulate economy through targeted fiscal policy. If we take into account that infrastructural projects are the part of the expenditures, that stimulates and fosters economic activity, it would have been justified and of most importance to finance such projects by the state. However, according to the statement made by the government of Georgia, implementation of such a policy is unjustified, since infrastructural projects should be financed by the private sector. As a matter of fact, economic growth marked in the recent years was largely due to the government activities in the economy. It should be further noted that scaling down such projects before the private sector takes over is also unjustified, the consequences of such actions is proved by the economic and budgetary indicators that we face today. This is especially relevant given the fact that Georgia still needs large basic infrastructural projects, which are rarely financed by private sector only. In this regard, elaboration and implementation of public-private partnership schemes might be desirable.

4 ibid

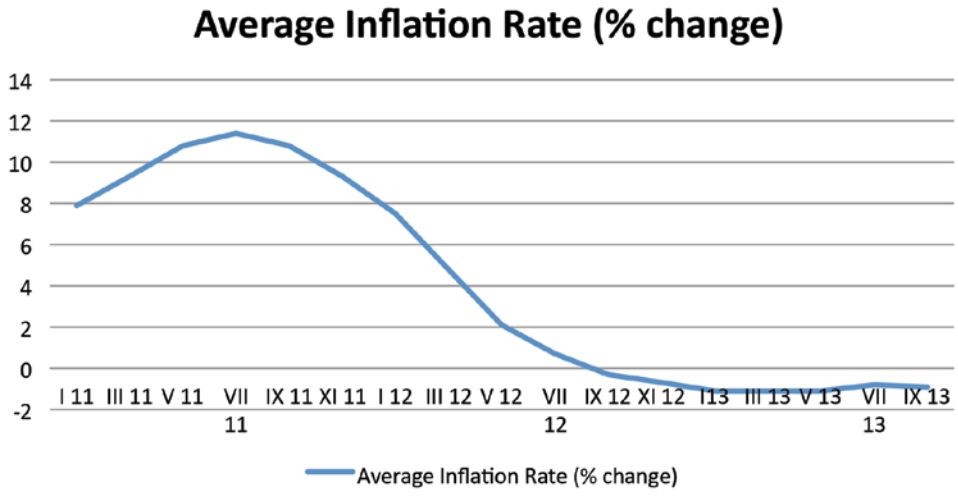
As a matter of fact, the new draft budget of 2014 that is passed on to the parliament for review is still heavily socially oriented, with an increase of expenditures allocated to the social and healthcare, as well as education, not much has changed in terms of infrastructural expenditures. However, an increase in expenditures in the field of education is highly welcomed; our organization has provided a number of recommendations in this regard, when discussing the problem of structural unemployment as the major cause of high number of jobless or underemployed people in the labor force, we shall elaborate on the concept later on in the paper. Moreover, a drastic increase in social expenditures during a slowdown is not the right path to take, since this will result in a heavier budgetary burden.

Consumer Price Index (CPI)

It has been almost a year that Georgian economy is facing deflation. As of September 2013, monthly inflation rate in Georgia is -0.1 percent (f.2). According to Geostat the largest impact on the price levels was due to the introduction of universal healthcare as well as government subsidies for child delivery services.

From a layperson perspective deflation is a good thing, since it leads to lower prices and increases real income, thus the purchasing power of the citizens. However, deflation is most of the time rather harmful, since falling prices actually inflate the real burden of debt and reduce incentives to produce with negative implications on effectiveness of the monetary policy. Moreover, deflation is fundamentally related to the risk of major systemic shocks in the financial markets[5].

Figure 2 Average Inflation Rate (% Change) www.geostat.ge



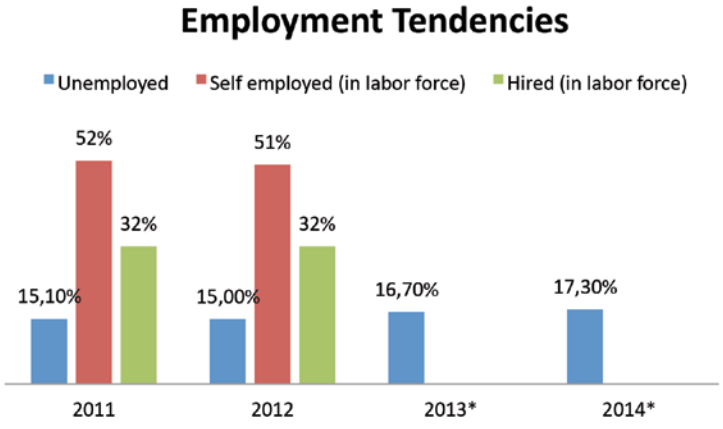
5 Fleckenstein M., Longstaff F., Deflation Risk. NBER Working Papers. July 2013.

Main cause of deflationary processes in Georgia are claimed to be decrease in demand. Decrease in demand on the other hand is usually the result of slow economic growth and rising unemployment. In case of Georgia this slump in demand was followed by the political uncertainty in the country due to the 2012 Parliamentary elections and has been ongoing all the way through 2013 presidential elections. Deflation can be further deepened by decreasing the size of government and investment spending, which was the case in 2013, when the government dramatically cut the infrastructural spending. Persistent deflation can lead to a number of negative outcomes such as falling profits for the enterprises, shrinking employment and income of the population, which in its turn increases the real value of loans for the companies and individuals. Both inflation and deflation interfere with the smooth running of the economy, however economists believe that moderate deflation is more damaging than moderate inflation[6]. An extreme example to this is a decade of deflation in Japan. Interest rates were continuously lowered for stimulating inflation, resulting in a zero interest rate in 1999[7], that finally ended in July of 2006.

Employment

Deflation is usually due to high unemployment, resulting in decreased demand, thus a prerequisite for a recession. The issue of unemployment or more precisely low levels of formal employment is an ongoing issue in Georgian reality (f.3). Out of total workforce only 32% are formally employed, more than half of the labor force is self-employed, while unemployment indicator is as high as 15% with a projected growth to above 17% in 2014 according to the latest data by IMF.

Figure 3 Employment Tendencies www.geostat.ge, www.imf.org



6 NBER.Deflation.http://www.nber.org/feldstein/deflation.pdf

7 Takatoshi, I., Mishkin F.S., Two Decades of Japanese Monetary Policy and the Deflation Problem. National Bureau of Economic Research. 2004. http://www.nber.org/papers/w10878.pdf?new_window=1

Even though unemployment figures for 2013 are not yet available, there is a decrease in the number of employed in the business sector by roughly 6% as of the second quarter 2013 (f.4), as compared to the previous year. If we look at the business sector employees according to the activity types, the largest decrease is observed in the construction, number of employed in the sector has decreased by 34% (f.5). Almost all fields saw a decrease in the number of employees except for agriculture, due to the active governmental programs directed to this field and a much smaller formal employment base than in other sectors of the economy.

Figure 4 Business Sector employees. www.geostat.ge

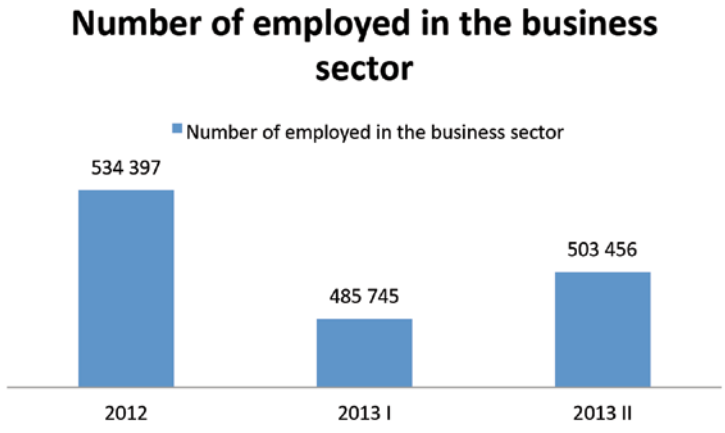
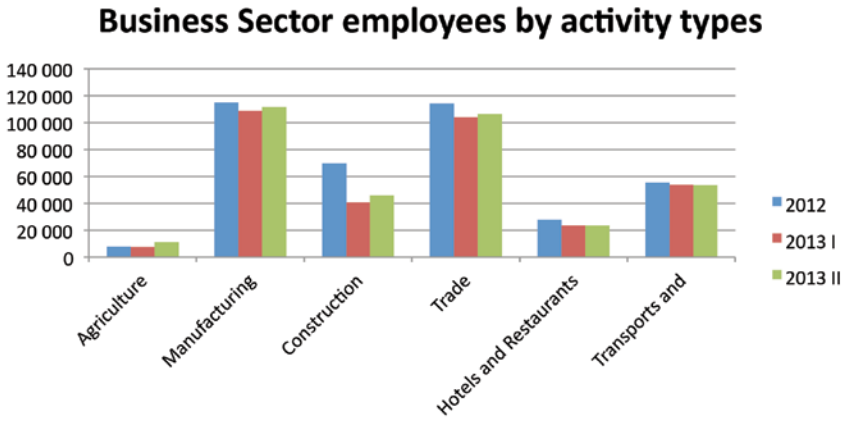


Figure 5 Business sector employees by activity type www.geostat.ge



Moreover, we have been persistently talking about the so-called skill mismatch and inadequate workforce to be a main cause for high unemployment levels in Georgia. A recent report on human capital[8] that overviews

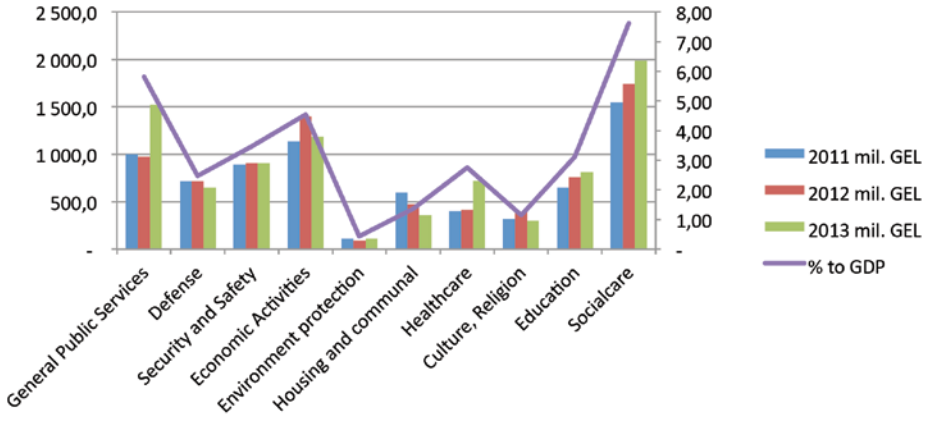
8 World Economic Forum.The Human Capital Report. 2013.

how well is a country's human capital prepared for the demands of competitive economies, and presents role model countries that succeeded in productively investing in health, education and talent of their people, thus translating these investments into productivity for the economy. The index contains Education pillar indicators relating to the quality and quantity of education on primary, secondary and tertiary levels that affects the present and future workforce; and Workforce and Employment pillar that quantifies the experience, talent, knowledge and training in a country's working-age population. Georgia lags behind in both pillars as benchmarked against neighboring countries and the region as a whole. In the education pillar Georgia ranks 74th among 122 countries and 102nd in the workforce and employment pillar.

We indeed agree that education system modernization is a real problem to the country. Major problem lays in primary and secondary education, since these are primary drivers of the economy. Substantial amount of economic literature demonstrates rather rigorous correlation between economic growth and primary schooling. The correlation between higher and tertiary education with the economic growth is less clear cut. This is evidently demonstrated in East Asian countries. Unfortunately, according to the World Bank statistics, Georgia spends much less in relative terms on public primary education than former Soviet Union countries such as Ukraine, and Armenia. In the course of the recent years sums allocated to the sphere of education have increased and reached around 3.2% of GDP as of 2013 (f.6). We appreciate various incentive schemes being developed by the GoG in primary education, but still think that given the levels of wages in education, achievement of serious results will be extremely difficult. We also suggest that at least 4% of GDP should be secured for education to guarantee consistent and quality economic growth, as demonstrated by empirical evidence from many countries.

In addition, given the very low level of salaries, the profession of a teacher remains to be rather non prestigious. Quality of public schooling in the country leaves better to desire. Recent results of teacher's qualification exams show an alarming trend, majority of the teachers were unable to pass the required minimum in the tests. Problem probably lies in the fact that primary education is not linked to the requirements of higher education and market. The improvement of financing of the primary schooling system should be focused on improvement of quality of numeracy and literacy skills of the pupils. Namely good literacy and numeracy skills are necessary for quality work force for the country that is transiting from the resources based to efficiency based growth model.

Figure 6 Budgetary spending according to different categories. www.mof.ge, www.geostat.ge

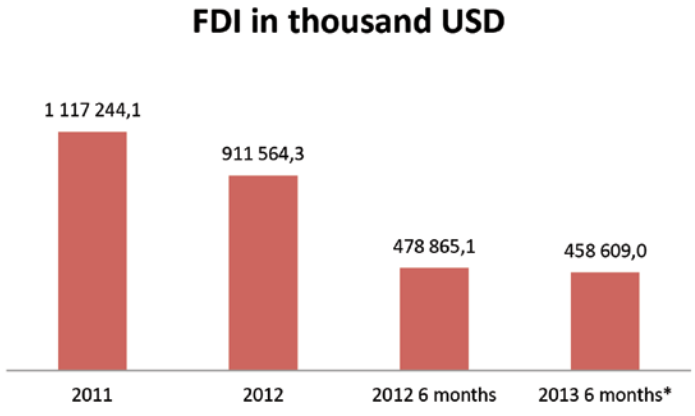


External Sector

FOREIGN DIRECT INVESTMENTS (FDI)

Declining trend of FDI is further maintained in 2013; in 2012 a 20% decrease was observed as compared to 2011. Although, in 2012 31%, as compared to only 15% in 2011, of all FDI were directed towards Greenfield investments[9], i.e. investments in new business initiatives that are more productive in generating growth and employment opportunities. When comparing 6 months of 2013-2012 a slight decline is detected (f.7). It is noteworthy that global FDI fell by 18%, due to global economic fragility and policy uncertainty. Overall FDI inflows to the developing regions have decreased in the past months, while FDI inflows to least developed countries hit a record high[10]. Moreover, outflows from developed countries fell globally. As of 2012 FDI inward stock for Georgia, i.e. the total value of the capital and reserves in the economy attributable to an enterprise residing in a different country equaled 10, 615 million USD[11].

Figure 7 Foreign Direct Investments in thousand USD www.geostat.ge



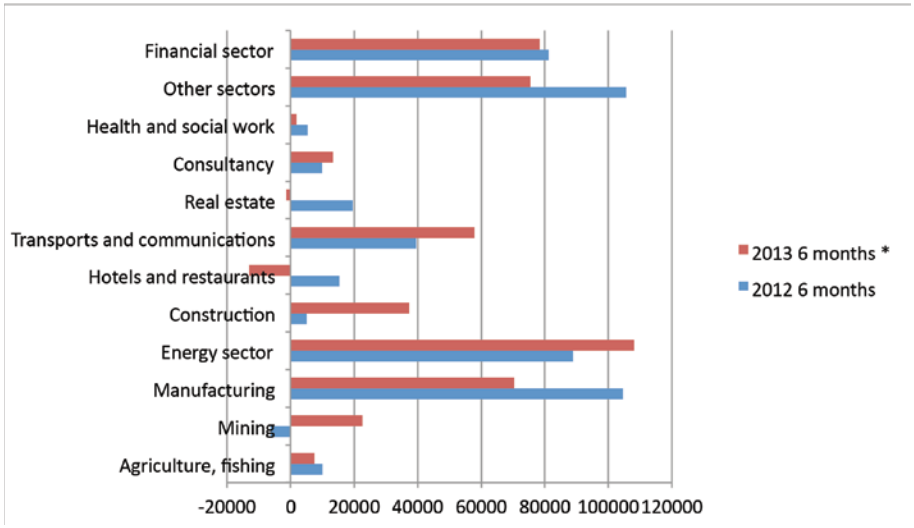
When observing foreign investments form sectoral perspective (f.8), we can conclude that most of the sectors saw a declining trend. Significant increase in investments was observed in the fields of energy, mining and transport and communications, while the largest decrease in the construction sector.

9 Global Investment Report 2013.http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf

10 ibid

11 ibid

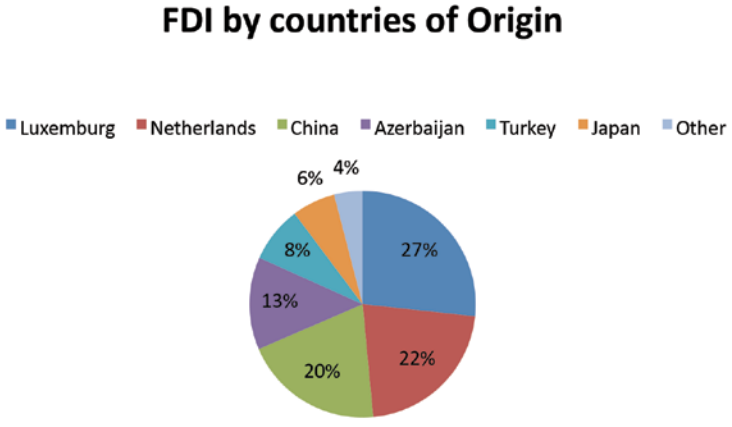
Figure 8 FDI by sectors www.geostat.ge



Negative number in FDI is not necessary related to net direct outflow, but rather is due to decreasing liabilities of resident companies.

By looking at the FDI by countries, we once again see that FDI is heavily reliant on one-off, large scale investments; Georgia does not seem to have a stable partner. According to the first two quarters of 2013, Luxemburg has generated the largest amount of investments, more than 26% this is the largest inflow recorded from this country. Netherlands together with Azerbaijan, Turkey are relatively consistent sources of FDI, Netherlands account for 22% of total inflows, Azerbaijan for 13% and Turkey 8%. As a matter of fact investments from China have increased dramatically and currently account for 20% of total inflows, thus being on the third place (f. 9).

Figure 9 FDI by countries of Origin 6 months 2013 www.geostat.ge



REMITTANCES

Remittances, considered as a reliable source of foreign exchange and household income, have dropped in many Eastern European countries, where they are important contributors to countries' GDP. The decline is especially evident in the remittances originating in the Eurozone that started its declining trend in the second half of 2012, thus weakening income and domestic demand[12]. As a matter of fact the latter trend does not hold true for Georgia, where remittances are still the most reliable and less volatile sources of external monetary inflows and is almost twice as much as the FDI inflow (f.10).Remittances have increased by around 9% as compared to 9 months of the previous year. When observing remittance inflows by countries, we see that the flows are still stable from the EU zone countries, one exception is Spain, money transfers from this country have decreased by 15% in the first 9 months of 2013 (f.11), mainly due to high unemployment and economic crisis.

Figure 10 Remittances www.nbg.ge

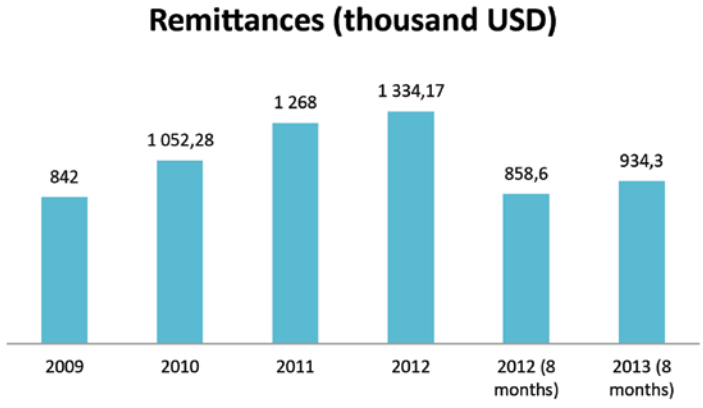
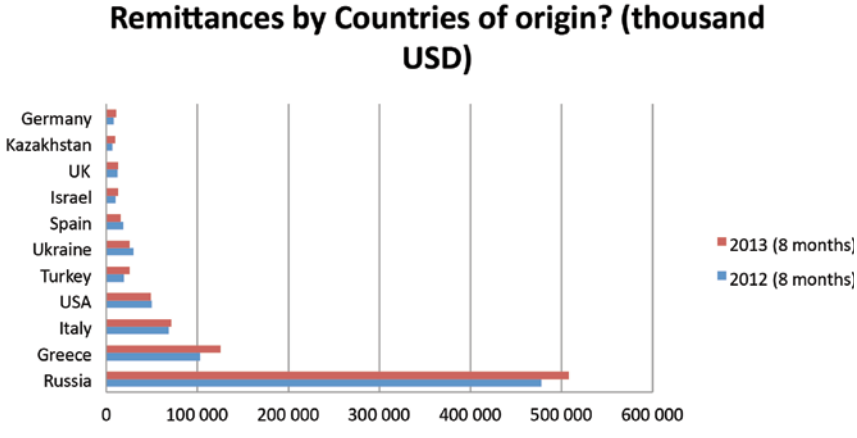


Figure 11 Remittances by sender countries www.nbg.ge



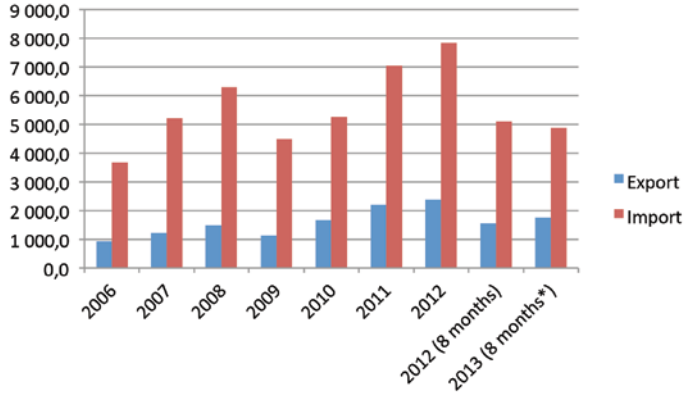
12 European Bank for Reconstruction and Development (EBRD) Regional Economic Prospects.http://www.ebrd.com/downloads/research/REP/rep-may-2013.pdf

TRADE

External trade tendencies (f.13) have shown a positive trend in terms of an 11% increase in exports in the first 8 months of 2013 as compared to the same period last year. It should be noted that this is not a very notable growth; Georgian exports have grown by 30% from 2010 to 2011, and another 8% from 2011 to 2012. Increase in exports is mainly due to the re-opening of the Russian market for Georgian wines and mineral waters in summer of 2013. Since the given data only covers 8 month period, we are unable to entirely grasp the true effect that the Russian market had on Georgian export tendencies. Moreover, starting from October 14th Russian market accepts some sorts of Georgian fruits after a 7 year embargo. Some of the produce includes – nuts, citrus, grape, apple, pear, and quince[13].

On the other hand, imports have shown a declining trend (4% decrease) that has not been the case since 2009. The most significant decrease up to 40% is observed in wheat imports (in monetary terms) (f.14). This decrease is partially due to the decrease in international cereal prices by 15% from January 2013 to August 2013 (f. 15). Decrease in prices started from the end of 2012 and is still the case. A 15% decrease in the wheat prices could not have resulted in a 40% decrease in wheat imports in monetary terms, one explanation to this is an excess supply in 2012 that was stocked up. On the other hand a 5% decrease in the import of petroleum products can be directly translated into a decrease in consumption, since in light of the unrest in the east prices on oil and oil products have been on the rise since June 2013[14]. A considerable 20% increase is detected in the medicine imports, the latter could be related to the government programs and increased public financing of the healthcare system. Imports of motor cars have been on the rise, which also represents one of the leading export products of Georgia (re-exported to the neighboring countries and Central Asia). Re-opening of the Russian market not only resulted in an increase in exports but also in Imports - a 43% increase was observed as of 8 months in 2013, as compared to the same period last year.

Figure 12 Trade tendencies thousand USD www.geostat.ge



13 Ministry of Agriculture and Food of Georgia.National Food Agency.News.Retrieved on October 16th, 2013.http://nfa.gov.ge/index.php?lang_id=GEO&sec_id=35&info_id=931

14 The Economist.Worried Wells.Retrieved on October 16th, 2013.http://www.economist.com/blogs/freeexchange/2013/09/oil-prices?zid=298&ah=0bc99f9da8f185b2964b6cef412227be

Figure 13 Imports by products thousand USD www.geostat.ge

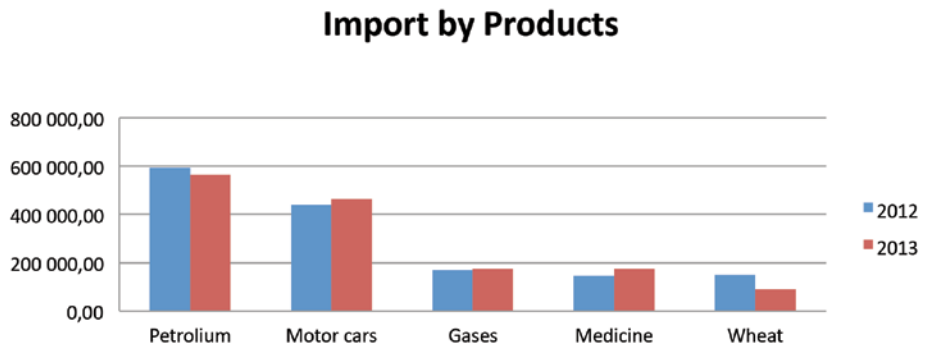
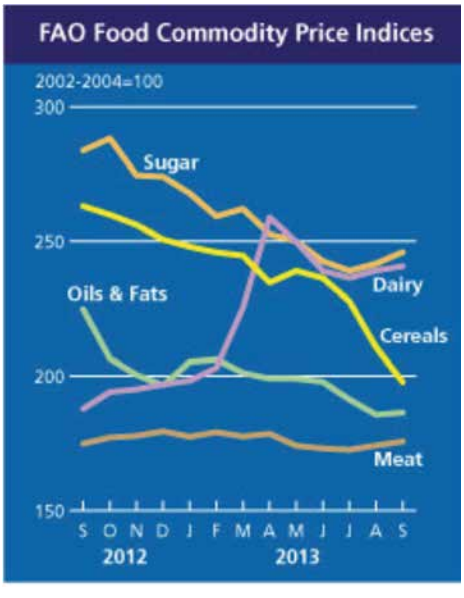
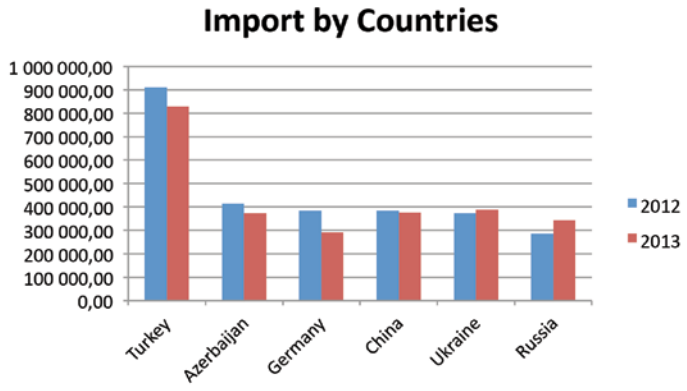


Figure 14 Commodity Price Indices. www.fao.org



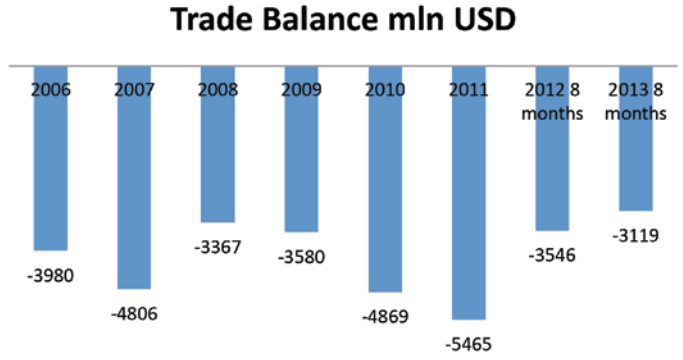
Import has decreased from most of the trade partner countries except for Russia and the Ukraine (f.15).

Figure 15 Import by Countries thousand USD www.geostat.ge



An increase in exports paired with a decrease in imports resulted in improved terms of trade for Georgia. Negative trade balance for the 8 months of 2013 equals -3119 million USD (f.16). Current account balance as percentage of GDP is projected to improve in 2013 to equal -6.5% a decrease from -11.5%, however is expected to further increase to -7.8% in 2014[15].

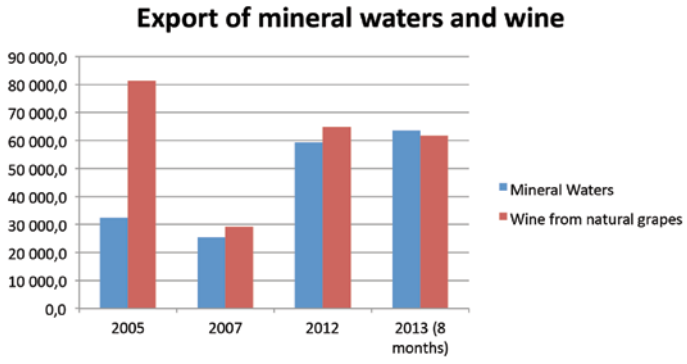
Figure 16 Trade balance www.geostat.ge



By looking at export tendencies of mineral waters and wine from natural grapes, we see a drastic decline in export in monetary terms following the Russian embargo in 2006. However, already in 2012 Georgian producers seem to have found new markets and diversified their export portfolio. Following the reentry into the Russian market in spring/summer 2013, export volumes of these two product categories have somewhat increased, however the information only covers the data till August 2013, which is not representative enough. According to the 8 month data, as compared to the same period in 2012, we observe a 56% increase in the export of mineral waters in monetary terms, and 67% increase in wine export (f.17).

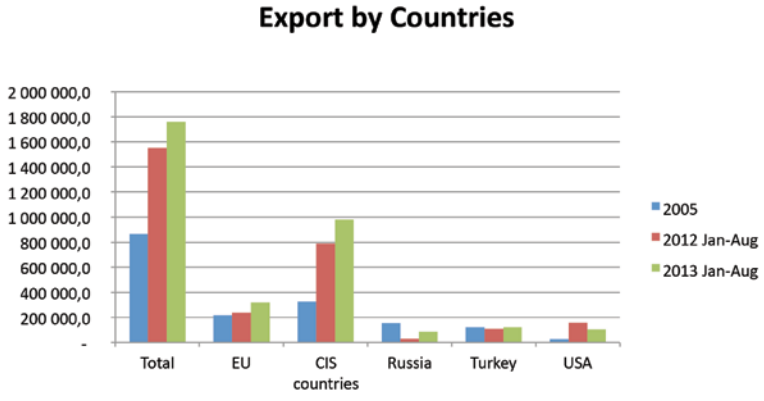
15 European Bank for Reconstruction and Development (EBRD) Regional Economic Prospects.http://www.ebrd.com/downloads/research/REP/rep-may-2013.pdf

Figure 17 Export of mineral waters and wine in thousand USD



Export in monetary terms has increased from most of the trade partner countries and country groups, except for USA. Export to Russia increased by 50%. Although Azerbaijan is the largest export partner with 27% of total export turnover (f.18).

Figure 18 Export by Countries thousand USD www.geostat.ge



Recommendations

The government should work on the preparation of a long-term economic strategy to present clear development directions and create a foreseeable environment for economic actors of the country that will be necessary for attracting more investments in the country. At the same time, we believe that taking additional social liabilities by the state is not the way to proceed. Additional social liabilities will be justified only after the economic situation is improved and more or less sustainable growth is achieved.

Given the global downturn and inauspicious growth prospects, the task of the government should be to pursue prudent fiscal and monetary policies, which might be embodied in moderate stimulation of economy and reasonable budgetary spending with obviously positive effects on growth. Scaling down infrastructural projects before the private sector takes over is unjustified, the consequences of such actions is proved by the economic and budgetary indicators that we face today. This is especially relevant given the fact that Georgia still needs large basic infrastructural projects, which are rarely financed by private sector only. In this regard, elaboration and implementation of public-private partnership schemes might be desirable.

Consistent policy initiatives will promote the sense of stability and certainty, thus increasing business activities and overcoming demand driven shocks.

An important point is pursuing activities for easing market entry for newly established businesses and fostering truly competitive environment.

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