Analysis

Georgia's Expansion Halts

By Molly Corso, Tbilisi

Abstract

While Georgia has been affected by the global crisis, early estimates gave the government reason to hope the country would be able to escape the worst of the financial downturn due to large foreign aid inflows and international support for the banking sector. However, local economists and global observers like the International Monetary Fund (IMF) are now predicting zero growth in 2009 and a more protracted recovery period than originally expected.

The End of the Boom

With double digit growth rates and rocketing foreign direct investment inflows, the Georgian economy was a post-Soviet success story until the boom deflated during the third quarter of 2008. According to government data, the country's real gross domestic product (GDP) – which is growth rate adjusted for inflation and price changes – increased by 45 percent since 2004. Georgia's boom was based on several underlying factors, including aggressive economic reforms, high levels of foreign direct investment (FDI) and an expanding banking sector.

Under President Mikheil Saakashvili, the Georgian government has put an emphasis on streamlining business regulation and laws. Most significantly, it simplified the tax code and overhauled the customs code. The business community and foreign investors have praised the government's campaign to end the rampant corruption that stifled business under former President Eduard Shevardnadze. Banks and the financial sector have also flourished since the Rose Revolution; major investment in the sector, as well as Georgia's improved international credit rating, helped usher in the country's short-lived "boom" from the end of 2006 through 2008.

During the height of the economy's growth, FDI quarterly inflows averaged a half a billion dollars and the government projected over $2 billion in foreign investments in 2008. According to data from the department of statistics, the economy received just shy of $1.3 billion last year. The government had bet on continued growth in 2008 to finance ambitious employment and spending schemes put into place by former Prime Minister Lado Gurgenidze in January 2008. However, growth abruptly slowed following the dual shocks of a short, disastrous war with Russia and the global recession.

Georgia's Double Whammy – and Surprise Silver Lining

The Georgian economy was grappling with the affects of the August 2008 war with Russia when the bottom dropped out of the world economy in October. Faced with plummeting foreign direct investments and banks struggling to shore up liquidity, the Georgian government depended on massive foreign aid packages to protect its currency reserves – which were tapped to uphold the lari during the war and post-war period – and provide the banks with enough funds to ease public concerns and bolster trust.

A $750 million stand-by loan from the International Monetary Fund (IMF) in early September was followed by a $4.5 billion foreign aid pledge by major international donors in Brussels in October, days before the global economy slid into recession. The banking sector also received additional financing from the International Financial Corporation, the European Bank for Reconstruction and Development and the Asian Development Bank, as well as other international financial institutions.

The timing of the Brussels Donors Conference was fortunate: there is little doubt that the pledged foreign aid – which the Georgian government believes will cushion the sharp fall in investments – has played a vital role in buffering the Georgian economy from some of the affects of the global crisis over the past several months. According to the Georgian government, funds pledged during the donors' conference have already started to come in; the total amount is slated to arrive over a three-year period.

Gloomy Prognosis for 2009

On May 10, the IMF issued a report stating that economies in the Caucasus region, including Georgia, Armenia and Azerbaijan, will likely be more adversely affected by the crisis as it continues to develop in the west and impede trade demand, as well as access to international credit. Initial prognoses by both international observers – like the IMF – and the Georgian government projected a sharp slowdown in economic growth through 2009, estimating less than 3 percent growth this year. Now, the IMF believes there might be zero growth in the region and the recovery could be protracted, depending on the policies put in place locally and globally to offset the recession.

Unlike western economies, Georgia has no real exposure to the "toxic" debts that are wreaking havoc in more

developed countries. The risks facing Georgia are second-tier economic shock waves: the contraction of the global economy due to the recession and lower demands and the lack of financing available from international credit markets.

In the local economy, there are also signs that the recession is deeper and more entrenched than the government has previously indicated. Local and international economists are looking at three main indicators – investment inflows, trade, and tax revenues – to gauge the impact of the global financial crisis on the Georgian economy.

Currency Inflows: the Lifeline of the Georgian Economy

The Georgian government has relied on increasingly large currency inflows to finance the country's growth since the Rose Revolution. According to government data, foreign direct investments have surged over the past three years, topping at over $700 million during the third quarter of 2007 alone. Initial government estimates for 2008 placed foreign investment at over $2 billion; in reality, the country received just over $1 billion in FDI last year. The Prime Minister's Office forecasts even less for 2009.

Remittances from overseas have also decreased over the past several months as Georgians working abroad are unable to earn enough money to support their families at home. According to IMF data, remittances to Georgia made up less than 10 percent of the country's total GDP. While that is less than in neighboring Armenia, it represents an important source of income and buying power for many Georgian households. According to a recent EBRD study on remittances in Azerbaijan, Georgia and Moldova, half a million people receive remittances in each country, although source countries vary greatly. The study found that while the individual sums were not large, more than 80 percent of recipients use the money for basic needs like food, housing, clothing and medicine.

Local economists maintain remittance levels dropped about 25 percent in March. During a presentation on April 1, Prime Minister Nika Gilauri downplayed any real impact from remittance reduction. However the May IMF report notes that as the Russian and global economies continue to contract, adversely affecting currency rates, migrant workers will have fewer opportunities to send money home. That will reduce the buying power of Georgian households, and represent fewer inflows into the national budget from sales and taxes.

According to Gilauri, the government is calculating that the combined impact of the anticipated donor inflows and the IMF stand-by agreement, coupled with the limited amount of foreign direct aid still coming into the country, the Georgian budget will not face any real shortages.

The concern, however, remains that the decrease in foreign currency inflows – which the government used to offset the country's trade deficit – could create problems for the economy.

Trade: Imports Down, Exports Contracting

One weakness of the Georgian economy is its large trade deficit. Prior to the August 2008 war and the global recession, the deficit ballooned as imports reached over $7 billion – nearly two times the number of exports. While there have been significant reductions on both sides of the equation, economists note that the 30 percent drop in imports is a serious indicator of the lack of local demand – a sign of how the recession is affecting the Georgian market.

Anecdotal evidence supports this; Georgian businesspeople complain about the lack of sales. However, according to government data, tax revenues have been impressive – despite a 5 percent cut in personal income tax, revenues were just over 320 million lari in March. That is a 41 million lari drop from last year.

Financial revenue collection has also been robust: the Prime Minister's office reports that it was 573.2 million lari in March – up from 499.5 million lari in March of 2008. However local economists believe tax revenues did not meet the government's April expectations.

Conclusion

The Georgian economy has fared well under the first wave of shocks from the global financial crisis. However, international observers like the IMF believe the economy will suffer more in future months as the recession deepens in the region. Georgia is not at risk of any fallout from "toxic" debts; bigger threats lie in the secondary affects of the recession, including less trade and demand on the international market and extremely limited access to international credit.

To date, the Georgian government has worked hard to present a picture of an economy still performing strongly despite the pressures of the global crisis and the August war with Russia. However, there are an increasing number of indicators that the Georgian economy is more adversely affected than was forecast last year.

About the author
Molly Corso is a freelance journalist based in Tbilisi, Georgia. She also works as the editor of Investor.ge, an English-language business magazine.