CHALLENGES TO THE GEORGIAN ECONOMY AGAINST THE BACKGROUND OF INTERNATIONAL SANCTIONS AGAINST RUSSIA

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Table of Content

Introduction

Russia's aggression against Ukraine and the start of a war in the region have a significant impact on the Georgian economy. The current review discusses the dependence of the Georgian economy on the economies of neighboring and friend countries. The study analyses the current state and expected dynamics in trade, remittances, foreign direct investment, and the energy market.

Assessing the dependence of the Georgian economy on Russia will allow us to identify challenges and support the increase of access to information. Identifying existing opportunities will help us concentrate more on developing the economic policies needed for the country and increasing the efficiency of public policy to overcome the economic challenges the country is facing.

The study discusses two scenarios – Medium and Strict. The medium scenario does not foresee the imposition of additional restrictions on Russia, as an aggressor country, by Georgia and discusses the economic impact of the existing sanctions. The strict scenario envisages the possibility to impose visa requirements on Russian citizens, due to increased risks, and monitoring the free flow of capital. This is expected to lead to trade restrictions.

Expected losses of the Georgian economy reach -$114 mln without additional restrictions imposed on Russia. In the case of imposing additional restrictions, in the context of security and economic diversification, economic losses can rise to -$500 mln. Additional -$386 mln loss, which is only 2% of GDP in 2021, can be offset by Georgia's closer cooperation with Western partners.

Main findings:

Georgian economy is expected to lose -$114 mln according to the medium scenario and -$500 mln according to the strict scenario. Decrease in exports, remittances, and investments are compensated by increasing tourism revenues and decreasing imports, which reduces the outflow of money from the country.

Exports are expected to decline by approx. 7% (-$300 mln) in 2022, compared to 2021. Reductions are expected mainly to Russia (-42%), Belarus (-33%), and Ukraine (-50%). Increasing exports to other countries will slightly mitigate the effect of reduction. The export will decrease by approx. –$525 mln in case of strict scenario.

In 2022, imports are also expected to decline by approx. $174 mln (-$450 mln with strict scenario), **along with the exports.** Decreased foreign direct investments and economic activities leads reduce imports. However, the increased number and duration of visits to the country slightly offset this decline.

This year, even with an interruptions of remittances from Russia, the Georgian economy will not lose more than $89 mln according to the medium scenario (-$116 mln with the strict scenario), and total remittances will not decrease by more than 4%. Dependence on Russian remittances has been declining sharply since 2008. Russia's share in total remittances fell from 65% to 16% during this period and is expected to decline further in 2022.

Tourism revenues are expected to rise by +$456 mln in 2022 (+$153 mln with a strict scenario), compared to 2021. Total revenue is expected to be $1.7 bln (with a 27% share of Russian citizens). The number of visitors and the duration of stay increase.

Electricity imports from Russia can be replaced by imports from neighboring and friendly countries. Electricity imports from Russia accounted for 9% of total consumption in 2021 and can be easily replaced by increased imports from friendly countries.

This year, as a result of the increased risks in the region, investments are expected to drop by -$350 mln (-$450 mln with a strict scenario), which can be offset by increased integration with the US and the EU.

Economic losses

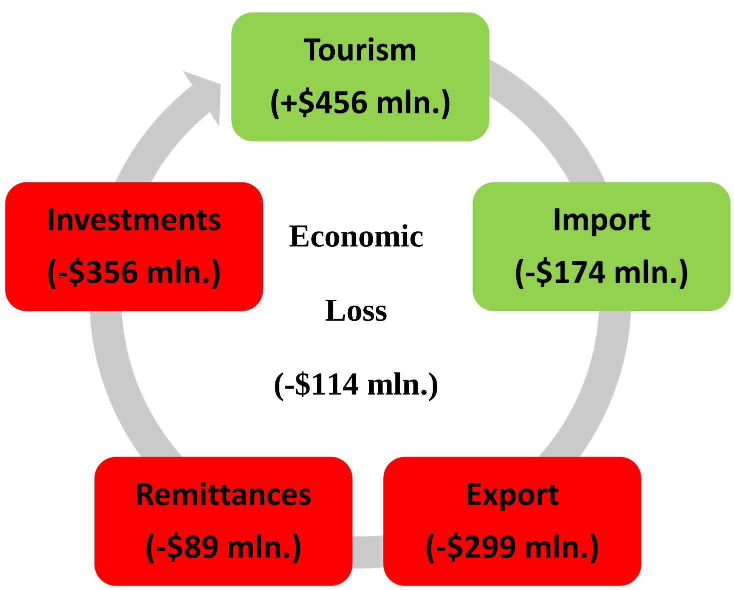
For the purposes of analysis of potential economic losses, we consider medium and strict scenarios:

- Medium Scenario does not envisage imposition of additional restrictions on Russia, as an aggressor country, by Georgia, and discusses the economic impact of the existing sanctions.
- Strict Scenario considers the possibility for Georgia to impose visa regulations on Russian citizens because of increased risks and monitoring the free flow of capital. This is expected to lead to trade restrictions.

Medium Scenario: The government of Georgia does not impose additional restrictions.

In 2022, the expected loss of the Georgian economy be $114 mln within the medium scenario. The loss is mainly caused by the expected decline in investments, exports, and remittances. The loss is slightly offset by the expected increase in Russian visitors and their spending, coming from neighboring countries as a result of sanctions, which will be reflected in the tourism sector and declining imports.

Graph 1: Expected economic loss 2022 – medium scenario

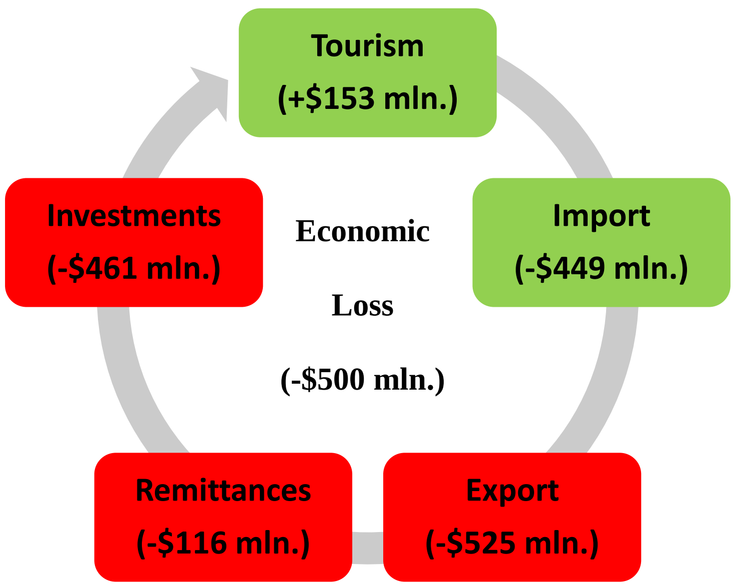


Source: IDFI

Strict Scenario: The government of Georgia imposes visa requirements on Russian citizens, suspends trade, and monitors the free flow of capital.

According to this scenario, the expected loss of the Georgian economy is approx. $500 mln, in 2022. The result envisages that visa requirements will reduce the revenues from Russian citizens, remittances from Russia will no longer be carried out after April, and trade with Russia will be restricted, which will reduce revenues from exports. However, declining imports and entering new markets offset the losses to some extent.

Graph 2: Expected economic loss 2022 – strict scenario

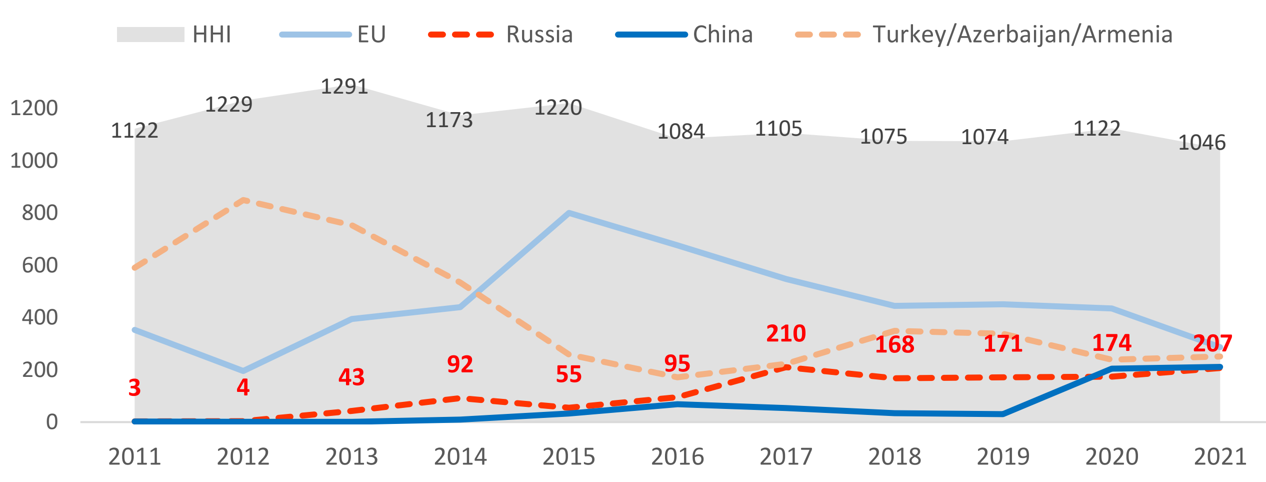


Source: IDFI

External Trade: Exports are expected to decline more than imports

According to the Export Concentration Index, Georgia's dependence on Russia has increased sharply since 2012. Export concentration declines in the EU, mainly due to increased exports to Russia and China. Overall, the rate of diversification of the Georgian export market has not changed significantly in recent years. However, with high dependence on Russia, Georgian exporters face the obvious danger that they might struggle to enter new markets in the short term.

Graph 3: Export concentration index* 2011-2021

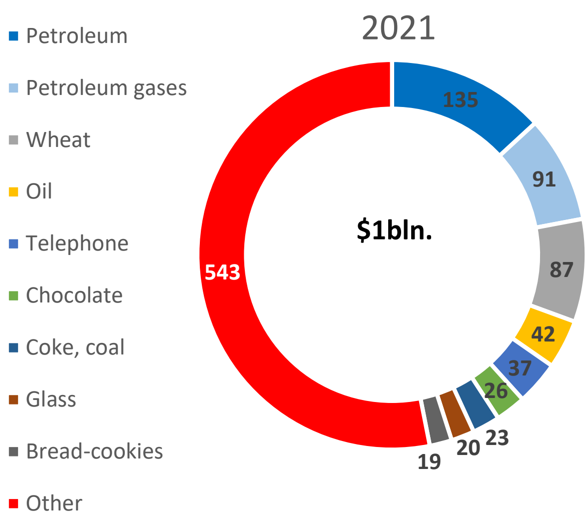


Source: Geostat, IDFI

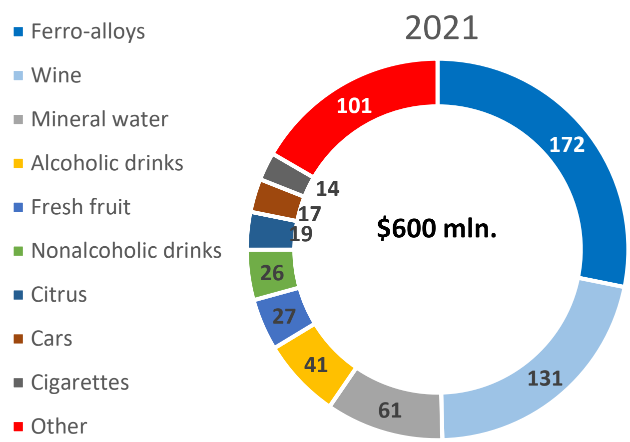
Note: * Calculations are based on Herfindahl–Hirschman index.

In 2021, a total of $1 bln worth of goods were imported from Russia and $600 mln worth of goods were exported. Substitution of Russian imports will be somewhat expensive. However, this will be the price paid for the freedom of Georgia's economy.

Graph 4: Import from Russia 2021



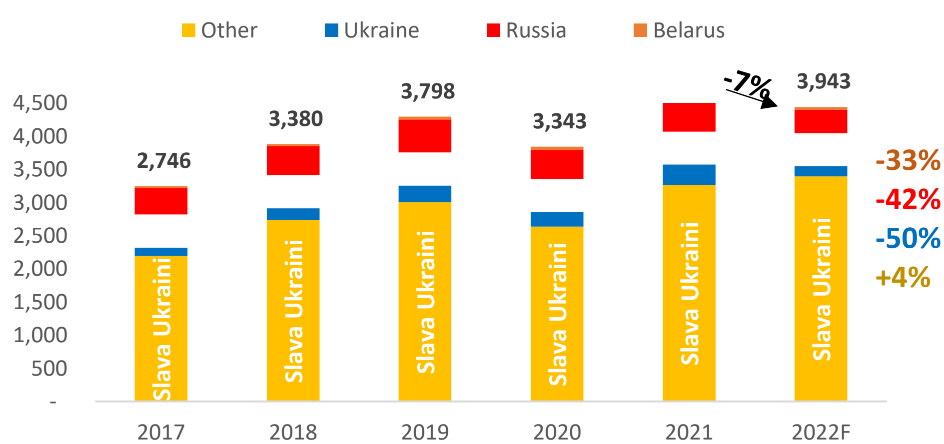
Graph 5: Export to Russia 2021



Source: Geostat, IDFI

In 2022, exports are expected to decline by approx. 7%, compared to 2021. Reductions are mainly expected to Russia (-42%), Belarus (-33%), and Ukraine (-50%). An increase in exports to other countries will slightly mitigate the effect of reduction. However, overall, the economy is expected to lose $300 mln within the medium scenario (-$525 mln within a strict scenario).

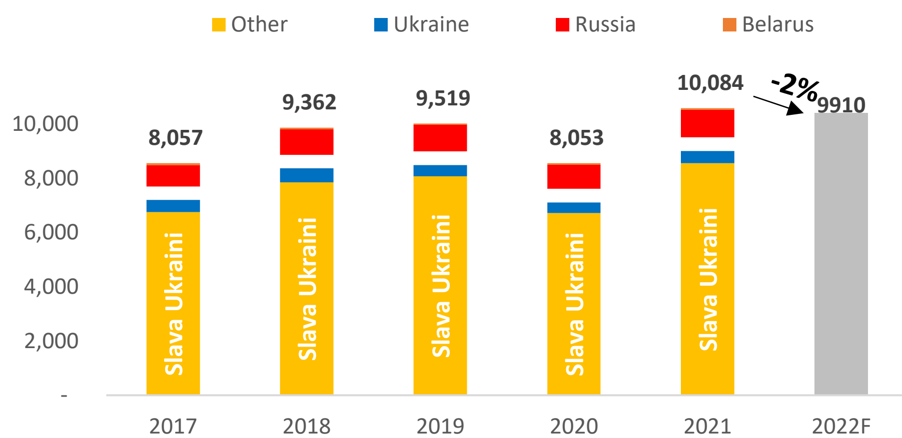
Graph 6: Georgia's Export (mln USD)



Source: Geostat, IDFI

In 2022, along with the decline in exports, imports are also expected to decline by approx. $174 mln (-2% YoY) according to the medium scenario (-$449 mln with strict scenario). Decreased foreign direct investments and economic activity are reducing imports. However, the expected increase in tourism revenues offsets this decline. In addition, the price of imported goods is expected to increase by 20%, on average, as a result of replacing Russia, Belarus, and Ukraine.

Graph 7: Georgia's Import (mln USD)

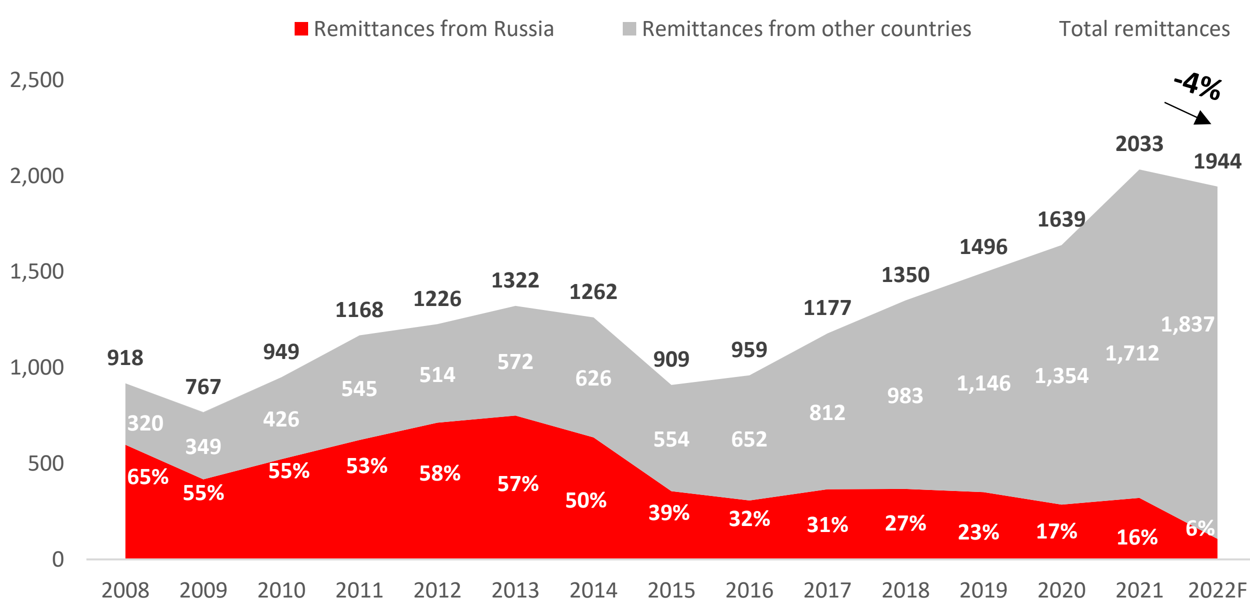


Source: Geostat, IDFI

Remittances: Dependence on Russia sharply declines

This year, Georgia's economy will not lose more than $89 mln even with an intermission of the remittances from Russia, and total remittances will not decrease by more than 4% according to the medium scenario (-$116 mln within the strict scenario). Dependence on Russian remittances has been declining sharply since 2008. Russia's share in total remittances fell from 65% to 16% during this period and is expected to decline further in 2022.

Graph 8: Remittances 2011-2022F

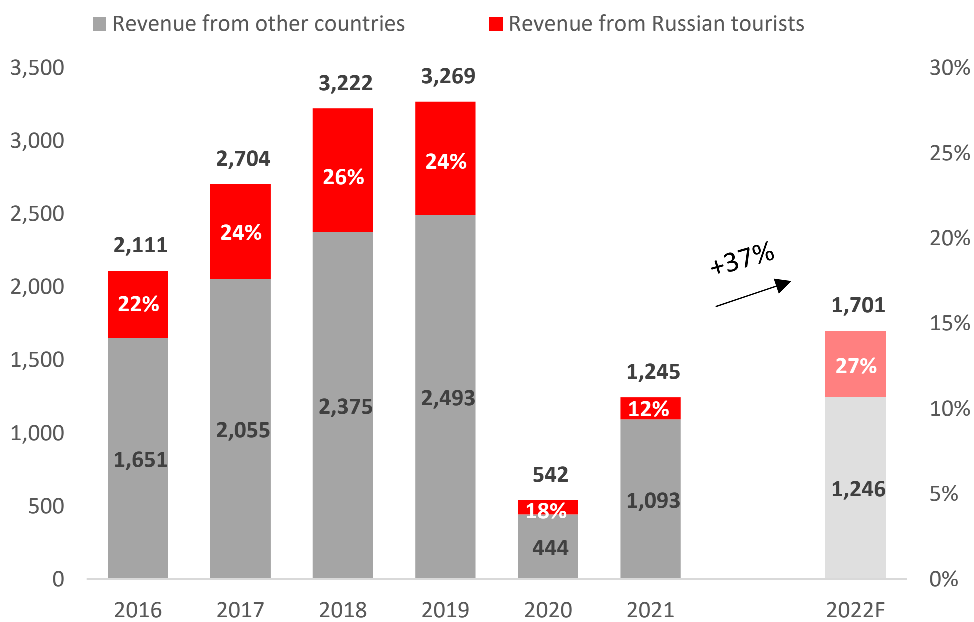


Source: Geostat, IDFI

Tourism: Tourism revenues will increase in 2022 and are expected to reach about half of 2019's result

In 2022, revenues from the tourism sector are expected to increase by $456 mln according to the medium scenario (+$153 mln with the strict scenario), compared to 2021, and makeup reach to $1.7 bln. As a result of the sanctions, the expenditures of Russian citizens coming from the neighboring country are expected to reach $450 mln with the medium scenario (27% of total tourism expenditures). In the case of a strict scenario, the loss will decrease to $150 mln. The increase in spending from Russian citizens is due to an increase in the number of entries and the duration of stay. At the same time, with the end of the Covid-19 pandemic, tourism revenues (excluding Russian citizens) will increase up to $1.2 bln.

Graph 9: Revenues from tourism (mln. USD)



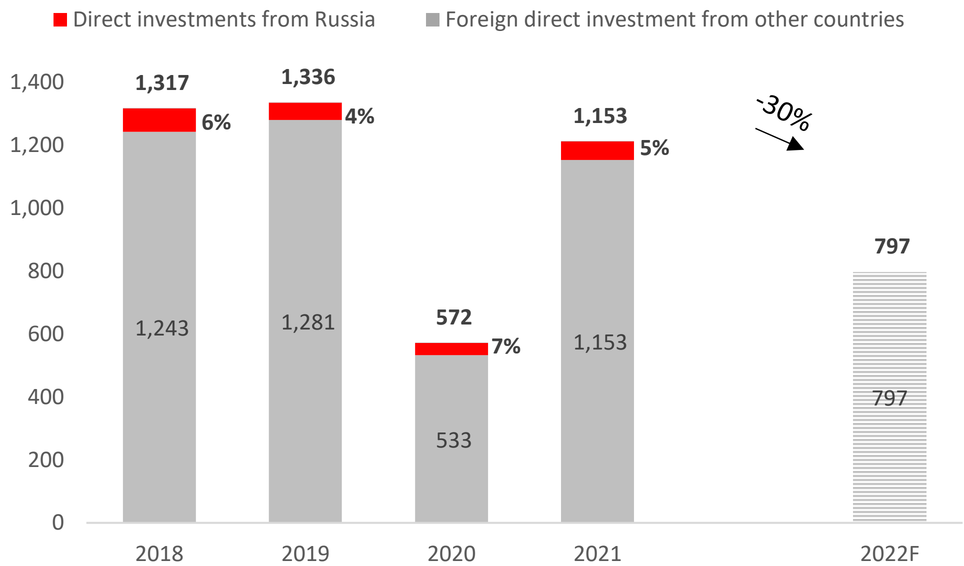
Source: The National Bank of Georgia, Geostat, IDFI

Investments: Increased risks in the region hurt investments in the short term but support new opportunities

As a result of the increased risks in the region, investments are expected to decrease by -30% this year, therefore, the economy will lose approx. $350 mln according to the medium scenario (-$461 mlnwithin the strict scenario). Russia's share in foreign direct investments has been negligible, 5% on average, in recent years. Consequently, the termination of the investments from Russia will not have a significantly negative effect on the economy, this year. However, investments are expected to decline from other countries.

Attracting companies that left Russian markets is a new opportunity. To achieve this goal, the government must carry out reforms, and develop and implement the right policies.

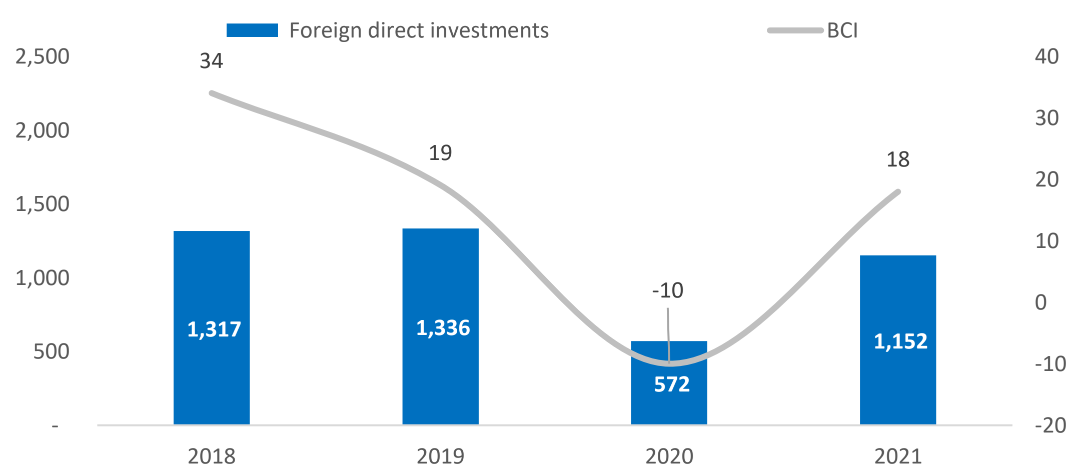
Graph 10: Foreign direct investments (mln. USD)



Source: Geostat, IDFI

The Business Confidence Index (BCI) is highly correlated with foreign direct investments (FDI). The reason for worsened BCI in recent years are deteriorated investment climate along with the COVID-19 pandemic. The unstable political environment, legal disputes with investors, delays in the implementation of important international infrastructural projects, lack of qualified human capital, and migration reduce the country's attractiveness to investors.

Graph 11: Foreign direct investments (mln. USD) and BCI



Source: ISET-PI, Geostat, IDFI

Due to the current geopolitical developments, it is expected that Russian investments will inflow from various offshore zones. Nowadays, it is difficult to analyze the FDI from offshore zones investor countries. However, the analysis of 2020 and 2021 data shows that investments from offshore zones have fallen sharply, resulting in -$320 mln and -$44 mln, respectively. The negative FDI from certain countries in 2020 and 2021 can be caused by the outflow of financial resources from Georgia to these countries, as well as the transfer of ownership of the enterprise to Georgian residents. After that, the investment is no longer be considered FDI.

Table 1: Foreign direct investment (million USD) from offshore zones

Country	2016	2017	2018	2019	2020	2021
Cyprus	-6.5	12.9	-86.4	23.7	-42.7	-27.7
The Bahamas	0.0	0.1	0.2	-2.8	-3.4	0.1
Baileys	6.6	2.1	3.2	-11.2	-12.7	-39.8
Virgin Islands	37.3	-23.0	-49.0	-34.7	-69.7	-11.6
Cayman Islands	8.7	-1.6	3.1	-3.7	3.0	2.5
Gibraltar	0.5	1.9	1.0	1.2	0.4	-1.4
Lebanon	0.5	2.4	1.4	2.2	4.6	0.9
Liechtenstein	5.6	2.9	1.9	0.5	1.0	-0.3
Mauritius	6.2	-7.8	1.7	4.0	-0.5	-0.2
Marshall Islands	4.2	2.9	1.9	34.0	6.8	21.3
Panama	77.7	27.2	77.0	76.8	-210.1	-7.7
Philippines	0.0	0.0		0.0	0.0	0.1
Seychelles	-4.5	5.2	3.4	3.1	-0.9	19.8
Total	136.2	25.0	-40.6	93.1	-324.2	-43.9

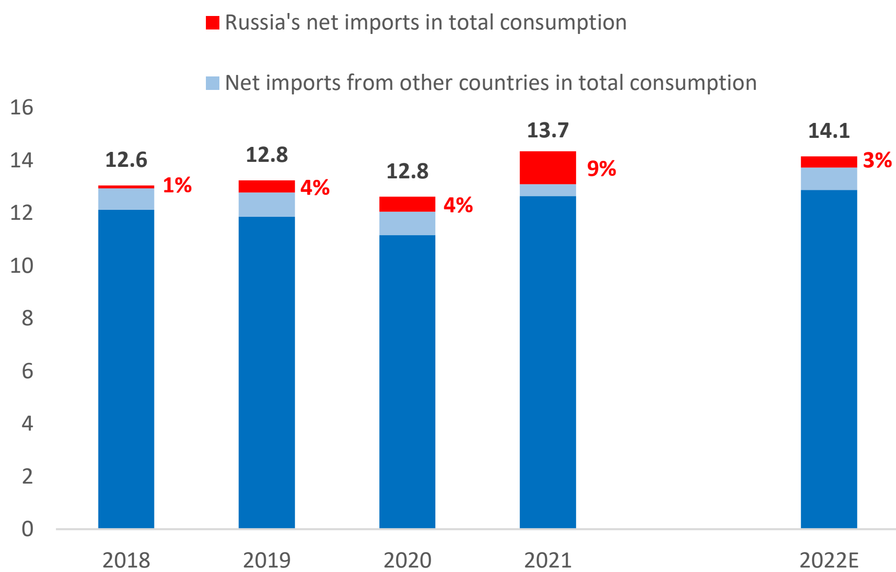
Source: ISET-PI, Geostat, IDFI

In general, the risks of money laundering have increased in Georgia, due to the imposed sanctions on Russia. The European Union, the United Kingdom, the United States, and Canada have banned all transactions with Russia. It is noteworthy, that the sanctions were applied to Russian banks, excluding them from the international payment system SWIFT. Japan has also declared to impose restrictions on transactions of Russia's central bank. At the same time, New Zealand, Taiwan, and Australia have introduced restrictions against the aggressor country, which include the termination of trade and various economic sanctions against Russian oligarchs.

Energy: Neighboring and friendly countries must replace Russia

Imported electricity from Russia can be replaced by neighboring and friendly countries if desired. The share of Russian electricity imports in total consumption is not high and can be painlessly replaced with increased imports from other countries. Georgia’s independence in the electricity sector is high. Russia’s share in electricity imports has been growing in recent years and reached its maximum in total consumption in 2021, taking into account the growing electricity consumption in Abkhazia and the rehabilitation of the Enguri HPP.

Graph 12: Electricity consumption (TWT H) and Russia's share in total consumption (including Abkhazia)



Source: ESCO, IDFI

Recommendations

Replacing imports from Russia is important for the diversification of the Georgian economy and requires the active involvement of the government. Diversification of export markets depends on increasing the quality of goods, finding new markets, and requires significant support.

Georgia's dependence on Russia has sharply increased since 2012, according to the Export Concentration Index. This happened at the expense of replacing the EU market. Therefore, entrepreneurs are at high risk and are expected to receive significant losses this year.

The country needs to accelerate its integration within the European Union and take effective steps to improve the investment environment, in response to socio-economic challenges.

The unstable political environment, legal disputes with investors, delays in the implementation of important international infrastructural projects, lack of qualified human capital, and migration make Georgia less attractive to investors and significantly reduces the chances attract investments from the companies that left the Russian market.

In 2021, there was a sharp decrease in foreign direct investment, and the Business Confidence Index has also deteriorated compared to recent years. Due to the increased risks in the region, investments are expected to decline even more in 2022.

It is important to establish strict monitoring of the free capital flow in terms of the aggressor country and appropriate restrictions in response to existing threats.

The Georgian government, the National Bank, and the private sector need to consider that, in parallel with sanctions against Russia, there are increasing reputation risks and possibilities of money laundering in Georgia. This could pose greater harm to the country compared to individual restrictions.

The European Union, the United Kingdom, the United States, and Canada have banned all transactions with Russia. The sanctions were imposed on Russian banks, excluding them from the SWIFT international payment system. At the same time, Japan, New Zealand, Taiwan, and Australia have introduced restrictions against the aggressor country, which include the termination of trade and various economic sanctions on Russian oligarchs.

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