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Georgia: Put to the test by the war in Ukraine

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Summary: A small Western Asian country, Georgia has an outward-looking economic model, mainly based on services such as trade and tourism. The Georgian economy is thus highly vulnerable to external shocks and was hard hit by the Covid-19 crisis, with a recession of 6.8% in 2020, the worst since 1994. In light of these characteristics and the country's economic ties with Russia and Ukraine, most observers expected the Georgian economy to be adversely affected by the conflict between these two countries.

However, these anticipated negative effects have not materialized and economic growth remained buoyant in 2022 (+10.1%, after the rebound of +10.5% in 2021). This was in particular due to a recovery in tourism and an explosion in migratory and financial flows from Russia. These factors have also contributed to a reduction in the fiscal and current account deficits (-2.6% of GDP and -4.0% of GDP, respectively) and an appreciation of the lari. In 2023, growth is expected to have remained above its potential (6.2% according to the International Monetary Fund – IMF) and the fiscal and current account deficits would appear to have been contained.

But the war in Ukraine has served as a reminder of the risk of a Russian invasion of Georgia in response to its distance from Russia's sphere of influence. In this respect, the government is pursuing a balanced policy between the aspirations of a large segment of the population, with more than 80% in favor of European Union (EU) membership, and gestures of appeasement towards Moscow. This situation does not only affect the social climate, it also casts doubt over the outcome of the EU accession process. Indeed, Georgia submitted an application for EU membership in February 2022 and finally obtained the status of official candidate in late 2023. The government's ambiguous position also has an impact on the economic situation, as reflected in the suspension of the IMF program following the adoption of the amendments to the Central Bank's organic law (National Bank of Georgia – NBG).

Despite two decades of sustained growth, there has only been a marginal improvement in the standard of living of Georgians and there are persistent socioeconomic challenges, in particular unemployment, poverty and inequalities. Furthermore, in view of the aging of the population and the lack of major reforms, potential growth is expected to decline by about 5% in the medium term, and 3% in the long term. In this context, it is essential to accelerate the economic catch-up and this will require the implementation of reforms in the sectors of education and connectivity.

Thematic area: **Macroeconomics**

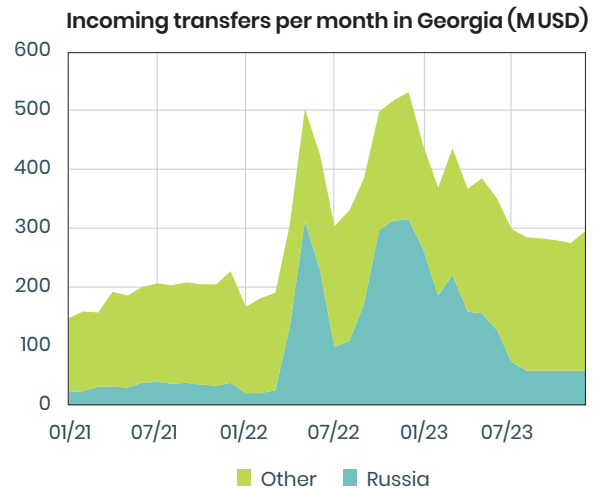
Geographical area: **Georgia**

1. The Georgian economy has largely benefited from the inflow of Russian citizens in connection with the war in Ukraine

The anticipated negative effects of the conflict in Ukraine have not materialized at this stage. When the war broke out, most observers expected the Georgian economy to be adversely affected by the conflict, in particular through a decline in trade and migrant remittances and a rise in food and energy prices, given the economic ties between Georgia and the two warring countries. In the World Economic Outlook (WEO) of April 2022, the IMF thus projected a slowdown in real GDP growth to 3.2% in 2022 (after +10.5% in 2021). Rather, growth has remained buoyant (+10.1%), benefiting from the explosion of migratory and financial flows from Russia and its positive effects on the economy. Georgia was even one of the countries with the highest economic growth in 2022. On the demand side, growth has been driven by trade in goods and services and, to a lesser extent, investment. At the same time, both private and public consumption have contributed negatively to growth, as the consumer spending of Russians who had recently arrived in Georgia is recorded as tourist revenues for one year. Economic growth is estimated to have remained above its potential (around 5%) in 2023, at 6.2% according to the latest IMF forecasts (October 2023). In the medium term, growth is expected to move closer to its potential, as the migratory and financial flows start to ease. The IMF projects that it stand at 4.8% in 2024 and 5.2% in 2025.

According to the NBG, around 100,000 Russian citizens relocated to Georgia in 2022 in connection with the war in Ukraine, representing 3% of the Georgian population and 6% of the population of Tbilisi and Batoumi, the two largest cities in the country. This population is young (average age: 31), urban and highly educated, attracted by favorable conditions of entry (no visa required for one year) and taxation (no income or property tax).

Figure 1 – An explosion of financial flows, especially from Russia

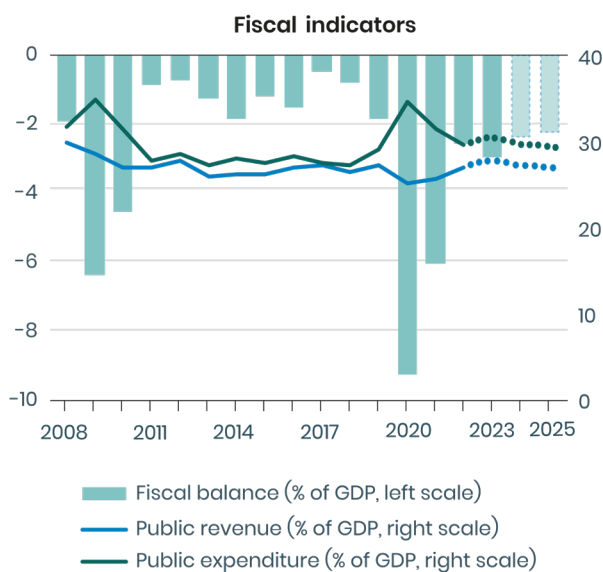


Source: NBG.

This Russian immigration has had a positive effect on the Georgian economy, mainly through two channels: an increase in migrant remittances and an upturn in tourism, related to the fact that foreigners entering Georgia are recorded as tourists for one year before being considered as immigrants. The amount of the remittances entering Georgia thus increased by 83% year-on-year in 2022 to \$4.4 billion, representing about 18% of GDP. This explosion in remittances over the period was driven by the increase in remittances from Russia, which increased fivefold in 2022 to \$2.1 billion, representing 8% of GDP and 47% of total remittances. In 2023, the level of remittances was lower than in 2022, but remained high at \$4.1 billion, including \$1.5 billion from Russia. In addition, Georgia received 4.7 million tourists in 2022 (against 1.7 million in 2021), including 23% from Russia, the main source of tourism ahead of Turkey according to the figures of the Georgian National Tourism Administration (GNTA). However, it should be noted that this level falls well below that of 2019 which stood at 7.7 million. Tourism revenues thus reached \$3.5 billion in 2022 according to the NBG, almost three times higher than in 2021, and even 8% higher than their level in 2019. In particular, revenues

from Russian tourism reached \$891 million in 2022 (against \$152 million in 2021), representing 25% of the total. This upturn continued in 2023, with a 45% increase in tourist arrivals year-on-year at the end of the third quarter (at 4.8 million), and a 29% increase in revenues (\$3.3 billion). However, recent months have seen the first departures of Russians, either to destinations considered more “welcoming” or to Russia.

Figure 2 – An upturn in public finance indicators



Source: IMF (WEO).

These favorable conditions have contributed to an upturn in most of the macroeconomic indicators, partly as a result of the associated appreciation of the lari. The fiscal deficit thus fell below the target of 3% of GDP in 2022 (2.6% of GDP, after 6% of GDP in 2021), whereas the budget forecasted a deficit at 4.4% of GDP. This was due to the dynamism of the economy (in particular the increase in VAT revenues) and is expected to continue in both 2023 and 2024. Public debt fell to 40% of GDP (after 50% of GDP in 2021 and 60% of GDP in 2020) due to the economic recovery, but also and especially the appreciation of the lari (+13% in 2022, +0.5% in 2023), as 75% of debt is held by non-residents and is foreign-currency denominated. In the medium term, it is expected to stabilize at this level according to the IMF’s baseline scenario.

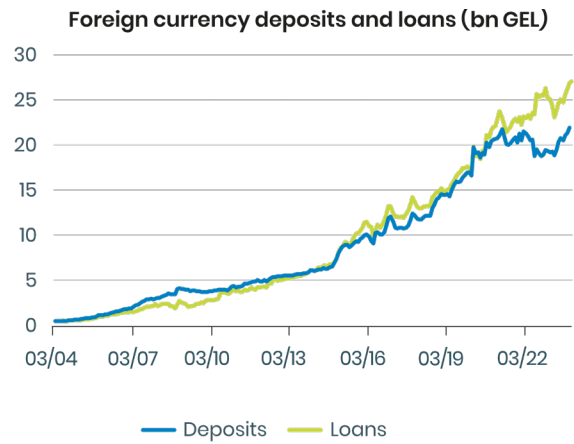
In addition, the appreciation of the lari brought down external debt (40% is contracted by the public sector) to 78% of GDP in 2022 (after 100% of GDP in 2021). Finally, along with the moderation in commodity prices and monetary tightening, it has contributed to the decline in inflation. The latter has been below the NBG’s target (3%) since April 2023, after more than two years above this level, which in turn enabled the NBG to initiate monetary easing in May (-200 basis points to 9%).

In this context, the current account deficit, which is structurally high (at 9.4% of GDP in the 2010s), was also substantially reduced in 2022, to 4.0% of GDP (after 10.4% of GDP in 2021). However, the IMF estimates that it increased to 6.1% of GDP in 2023, in view of a decline in exports and remittances. Nonetheless, the financial account surplus, with net inflows of foreign direct investment (FDI) and portfolio investments at more than 6% of GDP in 2022, has enabled the NBG to continue to build up reserves. At the end of 2023, they reached a historical level, at \$5 billion, the equivalent of 4.2 months of imports of goods and services, which is barely adequate according to the IMF.

The impact of the war in Ukraine on the Georgian financial sector has been more mixed, but the NBG has so far been in control of the associated risks. This impact has mainly been through i) the Russian immigration coupled with substantial financial inflows, and ii) the international financial sanctions imposed on Russian banks, including the Georgian subsidiary of the Russian bank VTB. A portion of the Russian money entering into Georgia has been deposited in local banks in the form of foreign currency deposits (+14% year-on-year in 2022, +17% in 2023), but this has not countered the decline in the dollarization of deposits, due to the concomitant increase in the share of deposits in lari by residents. Another portion has been invested in the real estate sector, which has resulted in an increase in both purchase and rental prices. No steps have been taken to control prices, as the authorities do not appear to be concerned about this trend. In terms of the sanctions, the NBG has set up a dedicated department to ensure that local banks comply with them. Furthermore, the

assets and liabilities of VTB Georgia have been transferred to two other small banks, in order to contain spillover effects to the entire banking system. Finally, the tightening of the macro-prudential framework, including increased liquidity requirements, reduces the risk of financial instability that could result from a reversal in international capital flows, in particular from Russia.

Figure 3 – An increase in foreign currency loans and deposits

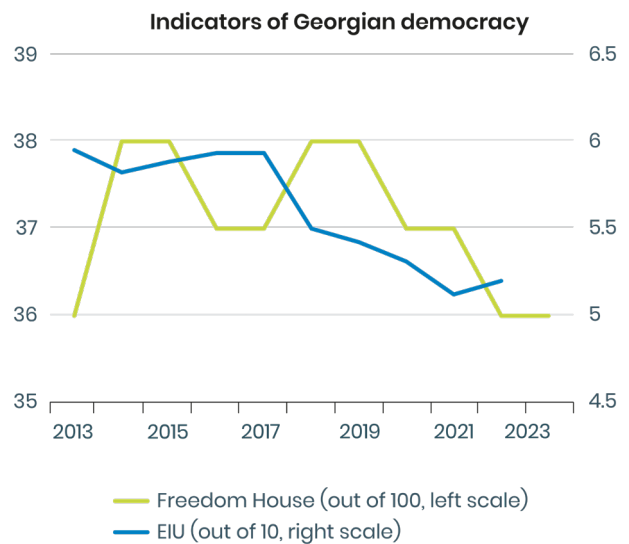


Source: NBG.

2. The war in Ukraine has also widened the gap between the government’s position and the aspirations of a large proportion of the population

Georgian democracy has been seemingly weakened in recent years. Georgian political life has been dominated by the Georgian Dream–Democratic Georgia (KO-DS) party since 2012, and more specifically by its founder, Bidzina Ivanichvili, the richest man in the country who made his fortune in Russia. He was Prime Minister in 2012–2013 and leader of the party between 2018 and 2021, and continues to unofficially control the main levers of power. This influence translates into patronage and polarization, which comes with an increase in the number of cases of corruption and clientelism, the controversial appointment of judges at the Supreme Court, and a policy to damage the credibility of civil society organizations. The regime is thus considered “hybrid” in the Democracy Index 2022 of The Economist Intelligence Unit (EIU), which ranks Georgia 90th out of 167 countries (behind Armenia and Ukraine, 82nd and 87th, respectively), with a score going down since 2018.

Figure 4 – A weakening of Georgian democracy



Source: EIU, Freedom House.

This tendency has become more marked since the outbreak of the war in Ukraine. The Georgian population remains traumatized by the war of August 2008, which resulted in Russian occupation and the de facto loss of the separatist provinces of Abkhazia and Southern Ossetia, representing 20% of the territory. It has widely shown solidarity with the Ukrainians since the Russian invasion of 2022. However, the position of the Georgian authorities is much more ambiguous. While they support Ukraine in its fight for its national sovereignty, they refused to vote in favor of the Western sanctions against Russia and have since shown signs of appeasement towards the latter. In March 2023, the ruling party thus tried to pass a law on “foreign agents”, derived directly from a Russian law of 2012. In May, direct fights with Russia were restored at Russia’s initiative, whereas the EU policy is to suspend flights. Finally, in September, the KO-DS party initiated impeachment proceedings against President Salomé Zourabichvili, who is accused of having violated the Constitution by going on a tour of Europe without its consent. These proceedings failed on 18 October. While this position of equilibrium lessens the risk of a further Russian invasion in the short term, it affects the social climate, given that 80% of the population aspires to become a member of the EU. At the same time, this position increases the polarization and makes the outcome of the EU accession process uncertain.

In March 2022, in the wake of the outbreak of the war in Ukraine, Georgia submitted an application for EU membership, at the same time as Ukraine and Moldova, whereas it had initially only envisaged doing so in 2024. In June 2022, the European Commission, which gives an opinion on applications for accession, only gave it a “European perspective” and not the status of official candidate (which, in contrast, was obtained by Ukraine and

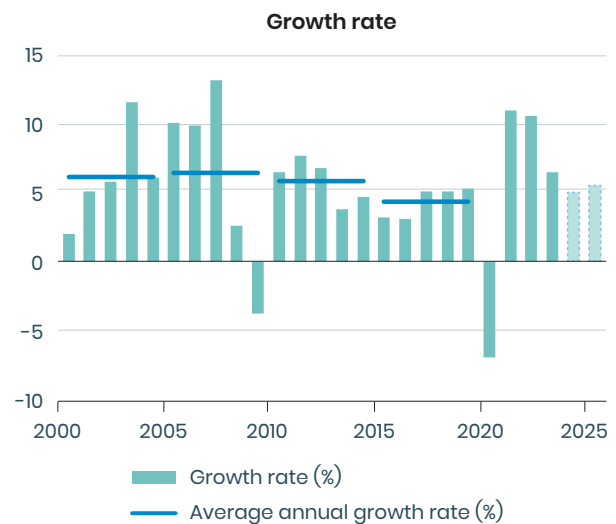
Moldova) due to the decline observed in certain aspects of democracy. This European perspective was combined with 12 priorities to be implemented by the end of 2023. These priorities included an end to political polarization, an improvement in press freedom and the independence of courts, electoral reforms, and “de-oligarchization”. In December 2023, the European Council finally gave Georgia candidate status, considering that it had made efforts towards 9 of the 12 priorities.

This political shift has an impact on the economic situation, as shown by the implications of the amendments to the NBG Law. On 20 June 2023, the Georgian Parliament adopted the amendments to the NBG’s Organic Law, thus bypassing the veto issued by the President on 23 February. These amendments, which include an increase in the number of executive members on the Board of Directors (from four to five, while the number of non-executive members remains at four), comes with a risk of a loss of credibility and independence. The proposed amendment had also been widely criticized by the IMF and by the NBG itself. The adoption of these amendments prompted the IMF to postpone the Second Review of the program indefinitely, namely a three-year Stand-By Arrangement for \$280 million, which had been supporting the public finance consolidation since 2022 (including a better management of public investment and revenue generation, and a reform of state-owned enterprises). These concerns were further compounded by the institution’s refusal, in September 2023, to apply the US sanctions against Georgian citizens and in particular the former Prosecutor General, Otar Partskhaladze, a close ally of Bidzina Ivanichvili. This decision led to the resignation of three of the four vice-presidents of the NBG and an advisor to the President.

3. Beyond the favorable situation, the persistence of socioeconomic challenges underscores the need to continue the economic catch-up

Driven by the structural reforms implemented from the mid-2000s onwards, the Georgian economy has generally shown dynamic growth over the last two decades. The structural reforms undertaken under the governments of Mikheil Saakashvili (including the fight against corruption and tax evasion, the reduction of bureaucracy, increased flexibility of the labor code, the lowering of customs barriers, and privatizations), following the Rose Revolution in 2003, have created an attractive business environment. Georgia has thus rapidly climbed in the World Bank’s Doing Business ranking, from 112th place in 2006 to 7th place in 2020, the date of the last publication. Since 1994, the Georgian economy has also benefited from successive IMF programs, which have paved the way for recurrent support from other donors, such as the World Bank and Asian Development Bank. In this context, the country’s average annual growth rate stood at 5.8% in the 2000s and 4.9% in the 2010s. Despite its trade openness and the resulting vulnerability to external shocks, the Georgian economy even proved to be fairly resilient to the successive shocks until 2020, with the exception of 2008-2009, which were marked by the double shock of the war with Russia and the international financial crisis. Like everywhere else, the health crisis weighed heavily on the Georgian economy, with the country experiencing a recession of 6.8% in 2020, the worst since 1994.

Figure 5 – Sustained growth over the last two decades

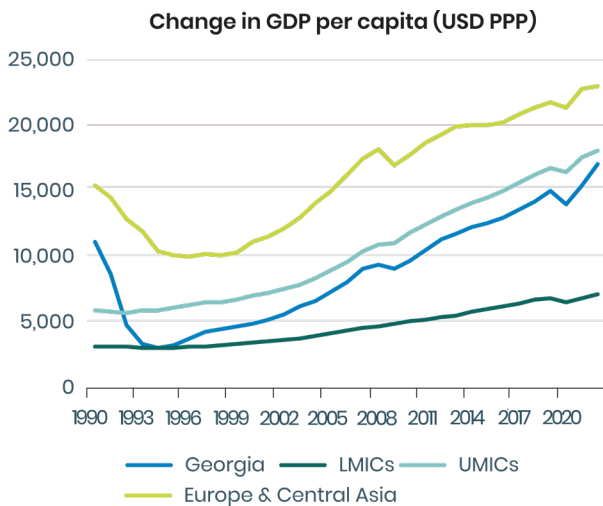


Source: IMF (WEO).

Despite several years of strong growth, there has only been a marginal improvement in the standard of living of Georgians and there are persistent socioeconomic challenges. With a per capita income of \$5,620 in 2022 (Atlas method) according to the World Bank, Georgia has been an upper-middle-income country (UMIC) since 2018. At \$17,034 in purchasing power parity (PPP) terms in 2022, Georgia’s per capita GDP has doubled since 2005. However, it is below the UMIC average (\$18,097 PPP in 2022) and the average of the Europe and Central Asia region (\$22,768 PPP, excluding high-income countries). While the high level of growth over the last decade has reduced poverty and inequalities, the latter remain high compared to other countries in the region. Consequently, the World Bank’s relative poverty rate (percentage of the population living on less than the \$3.65 PPP poverty line) has been stable since 2015 and stood at 19.5% in 2021 (latest data available). At 34.5% in 2022, Georgia’s Gini coefficient has been in continuous decline since 2017, but remains one of the highest in the region. Finally,

the unemployment rate had fallen to 15.6% at the end of 2023 according to Geostat, in comparison to both 2022 (17.6%) and 2021 (20.6%). But it does remain high in absolute terms, especially among young people (42.4% among 15-24 year-olds at the end of 2022). This situation explains why many Georgians continue to leave the country to settle abroad (mainly in the USA and EU). It is estimated that one million Georgians are currently living outside Georgia.

Figure 6 – A gradual improvement in the standard of living of Georgians



Source: World Bank (WDI).

The continuation of the economic catch-up will require the implementation of structural reforms. While Georgia's potential growth is currently estimated at between 4.5 and 5% in the medium term, the World Bank expects it to fall to around 3% in the long term, in view of the aging of the population and the lack of major reforms. To increase its productivity and continue its economic catch-up, the Georgian economy needs to address two main structural constraints: education and regional connectivity. Georgia lags behind its peers in terms of human capital formation, which is more attributable to the poor quality of the training provided than to difficulties in accessing education (which is at the same level as the other countries in the region). It is for this reason that Georgian companies often have difficulty finding manpower with training geared to their needs. The government is well aware of the need to reform the education system and initiatives do exist, but they have so far produced few results. Despite a favorable geographical position, there is a low level of trade and energy connectivity, in particular due to the lack of logistical skills and the weak infrastructure (especially for storage and railways). This situation explains why Georgian trade is mainly based on low value-added goods and services, and on re-exportation to neighboring countries. The government's efforts to attract foreign investment and accelerate the diversification of the economy (in particular through the creation of Enterprise Georgia), along with the investments in infrastructure projects seen as priorities (such as the East-West highway, a submarine cable and Anaklia Port), have yet to deliver completely on their potential.

List of acronyms and abbreviations

EIU	The Economist Intelligence Unit	IMF	International Monetary Fund
EU	European Union	KO-DS	<i>Kartuli Otsneba-Demok'rat'iuli Sakartvelo</i> (Georgian Dream-Democratic Georgia political party)
GEL	Georgian Lari	NBG	National Bank of Georgia
Geostat	National Statistics Office of Georgia	WDI	World Development Indicators
GNTA	Georgian National TOURISM Administration	WEO	World Economic Outlook

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