BANK OF GEORGIA RESEARCH

Limited Economic Impact from Russia-Ukraine Stand-Off

Georgia | Economy
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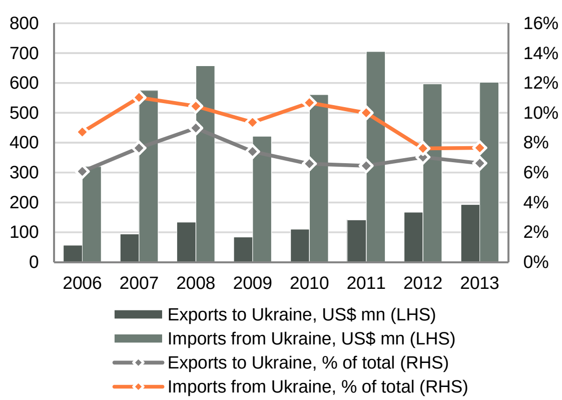
The tensions in Crimea and the possibility of a marked deterioration in Ukraine-Russia relations raise a number of questions about the impact on the Georgian economy. Georgia's advantage lies in the relative diversification of trade flows and other external channels, partly thanks to the Russian-imposed trade embargo in 2006. With the exception of wine, Georgian exports are more geared towards Azerbaijan, Armenia, and the EU rather than Ukraine and Russia, and imports can be substituted relatively easily. The wine industry could be hit, although the effect won't be substantial for the economy as wines account for just 4% of total exports. Russian and Ukrainian FDI accounted for less than 5% of the total over 2006-2012. FDI inflows are diversified, with Netherlands being the largest investor at 10% of the share followed by the UK, Turkey and the UAE, each accounting for 9% of total FDI over 2006-2012. We believe FDI from the EU will continue to grow as Georgia prepares to sign an Association Agreement that includes provisions to establish Deep and Comprehensive Free Trade Areas (DCFTAs) in 2014. Money transfers seem like one of the more likely items to be impacted and Russia and Ukraine account for 57% and 1.7% respectively of total money transfer net inflows. Money transfers are, however, resilient to trade and outright conflicts – money transfers from Russia continued to grow even after the Georgia-Russia armed conflict in 2008.

Export exposure is limited

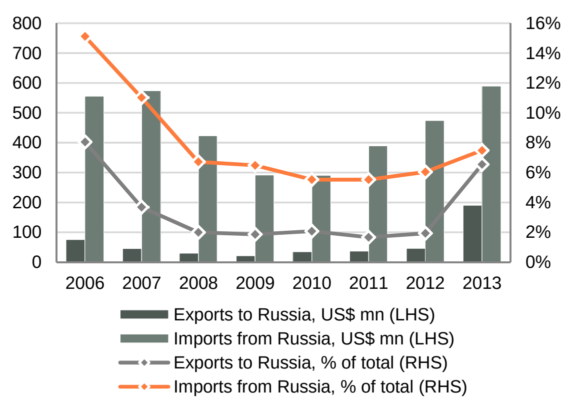
Limited export exposure. In 2013, Ukraine accounted for 6.6%, or US$ 193mn, and Russia for 6.5%, or US$ 190mn, of Georgian exports. Ukraine's share has remained largely stable around 7% over the last 8 years, while Russia has been effectively closed to Georgian companies since 2006 as a result of a Russian trade embargo. Exports to Russia did rise in 2013, mainly as Russia opened its borders to Georgian wines, but Georgia's export exposure to Russia remains limited. Importantly, the 22% y/y growth in exports in 2013 was broad-based; the EU was the real engine of growth, while Russia and Ukraine accounted for just 6% and 1% of the increase, respectively.

Figure 1: Georgia's foreign trade with Ukraine



Source: GeoStat

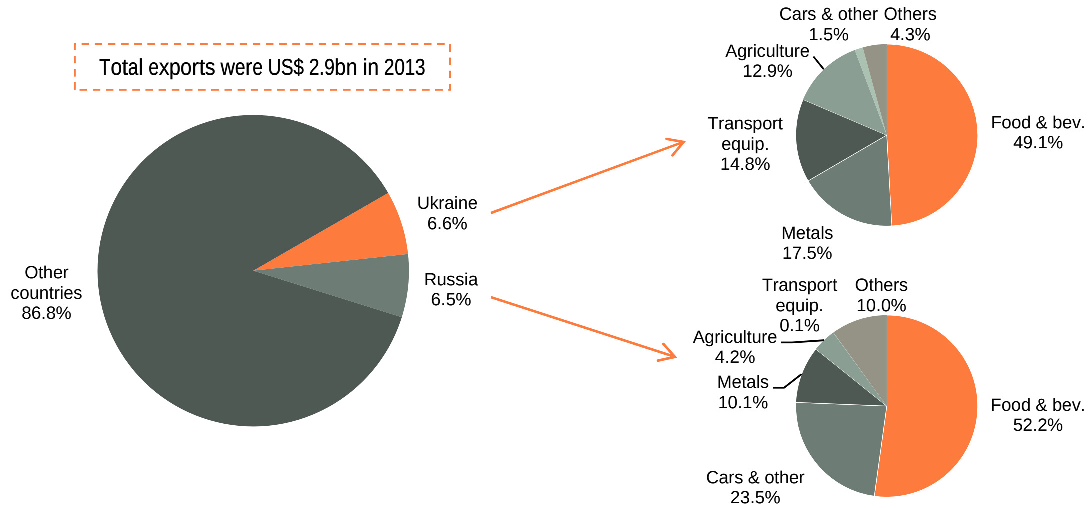
Figure 2: Georgia's foreign trade with Russia



Source: GeoStat

Georgia is more dependent on Azerbaijan, Armenia, and the EU in exports, whose macroeconomic outlooks are broadly stable. Moreover, the lari slightly depreciated recently against the euro, which will further support Georgian exports to EU markets, in our view.

Figure 3: Breakdown of Georgian exports to Ukraine and Russia, 2013



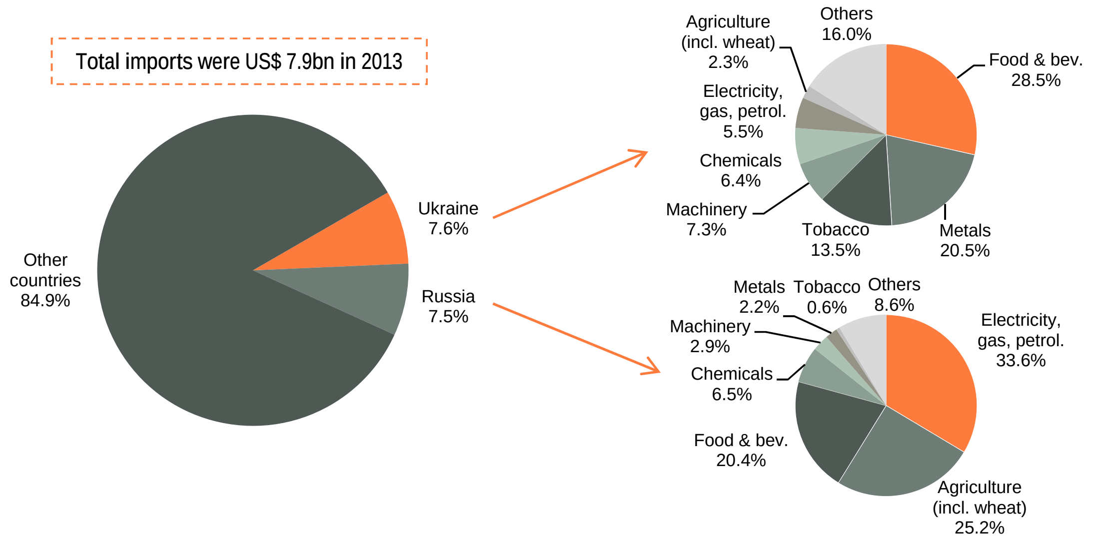
Note: Breakdown by countries is from GeoStat, by products from WB (World Integrated Trade Solutions)
Source: GeoStat, WB

Diversification as a result Russian embargo of 2006. In 2005, the year prior to the Russian embargo, Georgia exported US$ 154mn to Russia (mainly agricultural products), 18% of total exports. The embargo drove a 23% y/y decline in Georgian agricultural exports in 2006, while total exports did not decline, but added only 8% y/y vs. 34% a year earlier. The embargo forced Georgian producers to redirect exports to other CIS countries, the EU, and the Middle East. As of 2013, even without Russia, Georgian exports have more than tripled since 2005 to US$ 2.9bn and exports to the EU have grown 3.7x to hold 21% of total. Eventually Georgian exporters learned to be adaptive to changes, and gained expertise in exporting to far more competitive and challenging markets like EU. Therefore, overall economy is less vulnerable to Russia now than in 2006.

The substitutability of imports

Imports from Ukraine and Russia are substitutable. The main imports from Ukraine and Russia are food and consumables which can be easily substituted from Turkey and the EU. Oil and gas imports represent only 11% of total consumption as most of the energy products are imported from Azerbaijan. Wheat it is a global commodity and given Georgia's access to the sea and the relative proximity to Kazakhstan, wheat imports can also be substituted. As to imports of metals from Ukraine (mainly rebar), Georgia's domestic production has already substituted large share of imports and there is an ample capacity to substitute further. These products represent four largest import items from Russia and Ukraine.

Figure 4: Breakdown of Georgian imports from Ukraine and Russia, 2013



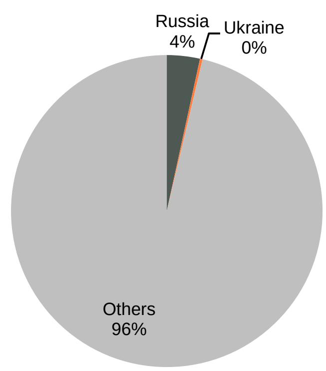
Note: Breakdown by countries is from GeoStat, by products from WB (World Integrated Trade Solutions)
Source: GeoStat, WB

Tourism, FDI and money transfers

If tourism declines, the effect would be limited. Russia and Ukraine accounted for 14% and 2%, respectively, of international arrivals in 2013. A full loss of Russian and Ukrainian visitors (highly unlikely) in 2013 would have resulted in US$ 200-250mn loss of travel inflows based on our estimates. The annual number of tourists to Georgia has grown steadily from 1.1mn in 2007 to 5.4mn in 2013, and we believe other countries could substitute any material loss of tourist revenues from Russia and Ukraine.

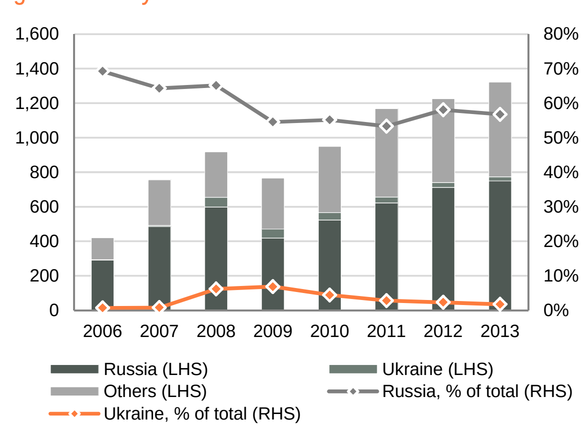
FDI inflows are diversified. Netherlands was the largest investor over 2006-2012 holding a 10% share of total FDI and followed by UK, Turkey and UAE each accounting for 9%. Russia accounted for only 4% of total FDI, while Georgians were net investors in Ukraine in over 2006-2012. We believe EU FDI will continue to grow as Georgia prepares to sign an Association Agreement with the EU that includes provisions to establish Deep and Comprehensive Free Trade Areas (DCFTAs) in 2014.

Figure 5: Share of cumulative FDI over 2006-2012



Source: GeoStat

Figure 6: Money transfers from Russia and Ukraine



Source: NBG

Georgia's largest exposure to Russia is via money transfers (a proxy for remittances), which accounted for 57% of net money transfers in 2013, or around 5% of GDP. Ukraine is negligible in terms of money transfers – just 1.7% of total 2013 net transfers. The transfers from Russia continued to increase even after the embargo in 2006 and the armed conflict in 2008, with just a minor decline in 2009. We, therefore, don't expect a significant drop in transfers, no matter the outcome of the Russia-Ukraine stand-off.

Stress-testing the impact on the Georgian lari

Even if ruble and hrivna depreciate 30% and 50%, respectively, lari will remain largely stable (at only 0-6% risk of depreciation). Our sensitivity analysis suggests that lari is not expected to devalue in order to maintain the real effective exchange rate (REER, a major indicator of competitiveness) steady.

The sensitivity analysis is designed to estimate the simulated effect of potential devaluations in Ukraine and Russia. The model is based on hryvnia, ruble and lari exchange rates, as well as inflation rates in each country. Ukraine and Russia account for around 6.6% and 6.5% of total exports, meaning their weight in the REER is minimal compared to Georgia's other trading partners. In our cautious scenario, we assume 50% hryvnia depreciation and 30% ruble depreciation. Naturally, depreciations gear up inflation, and we assume a 20% increase in prices in Ukraine and 10% in Russia. For Georgia, we assumed average annual inflation at a moderate 3% and in the USA at 2%.

The goal of the analysis is to simulate the size of a potential GEL devaluation against the US$ in order to keep the REER flat if the hryvnia and ruble fall against the US$. Our analysis yields an annual average exchange rate in 2014 of GEL/US$ 1.7315 for the REER to remain flat, which is 4.1% higher than in 2013. Actually the average exchange rate since the beginning of the year has stayed above that level, suggesting that it will need to fall down a little bit for REER to remain flat. Current levels will benefit exporters overall as Georgian products will be cheaper in real terms in the US$ denominated markets. In Ukraine and Russia, however, in case if "cautious" scenario realizes, real exchange rate of lari against hryvnia and ruble will be appreciated by 23% and 17% respectively.

Table 1: Devaluation scenarios and the GEL/US$ exchange rate

	Devaluations, %		Inflation Rate, %				lari/US$	
	hryvnia	ruble	Ukraine	Russia	Georgia	USA	Exchange rate	% change
Scenario 1	30	20	15	5	3	2	1.7136	3.0%
Scenario 2	50	30	20	10	3	2	1.7315	4.1%
Scenario 3	75	40	20	10	3	2	1.7659	6.2%

Source: NBG, BOG Research

Disclaimer

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