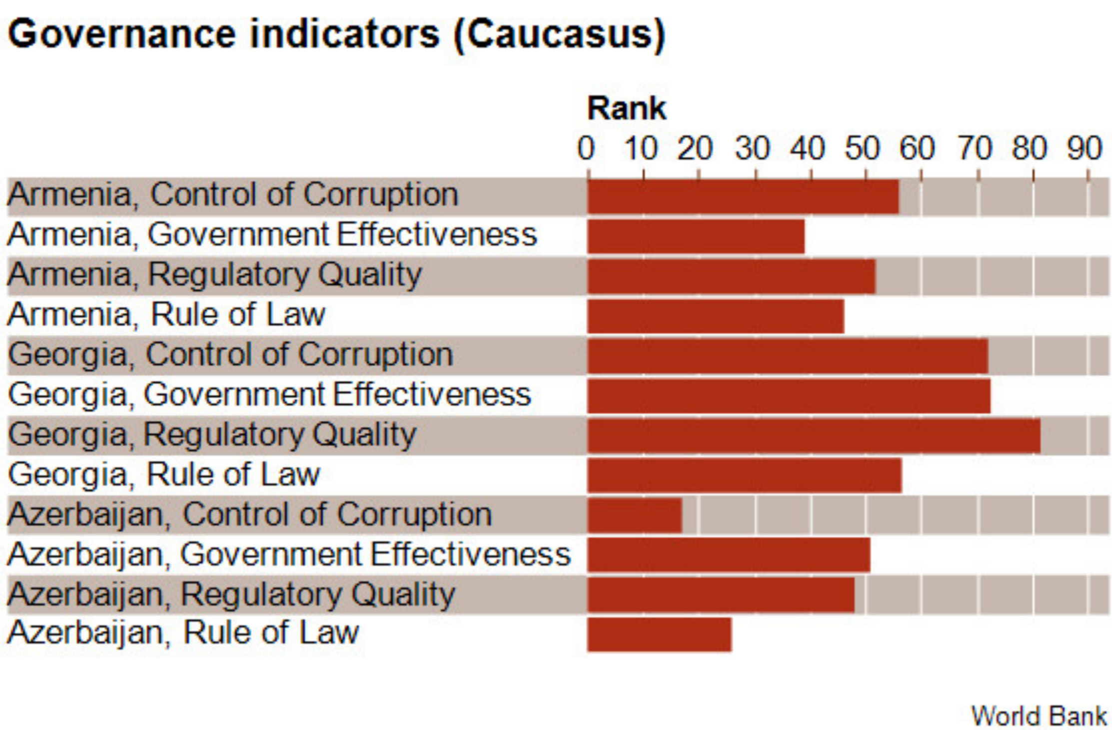
Georgia: Sound macroeconomic policies, but a nation deeply affected by its geopolitical situation | Credendo

Upcoming elections against a tense political backdrop

In December 2023, Georgia was granted "conditional" EU candidate status in view of the country implementing reforms in nine areas, including de-oligarchisation and the reduction of political polarisation. This status accurately represents the current political situation in Georgia. After all, ever since it came to power in 2012, the ruling Georgian Dream (GD) party has dominated the scene, while the United National Movement (UNM) of former reformist President Saakashvili has been relegated to the sidelines. Scheduled for October 2024, the upcoming parliamentary elections will take place against a tense political backdrop characterised by a fragmented opposition, deep mistrust between the GD and the opposition and a polarised society, as highlighted by the mass protests against the "foreign agents" bill. While some protests may arise during the election period, notably amid the recent initial approval of a law curbing LGBT+ rights, overall policy continuity is expected. Institutional quality remains high for the region, even if the rule of law and control of corruption have deteriorated in recent times, as indicated by the World Bank's governance indicators (see graph below showing data for the Caucasus region).



Relations with Russia have improved, while ties with the EU deteriorate

The Georgian constitution mandates that the government pursue greater integration with both the EU and NATO. However, commitment to EU and NATO integration has weakened under the rule of the GD, which is also trying to deepen ties with Russia and China. Recently, relations with Russia –

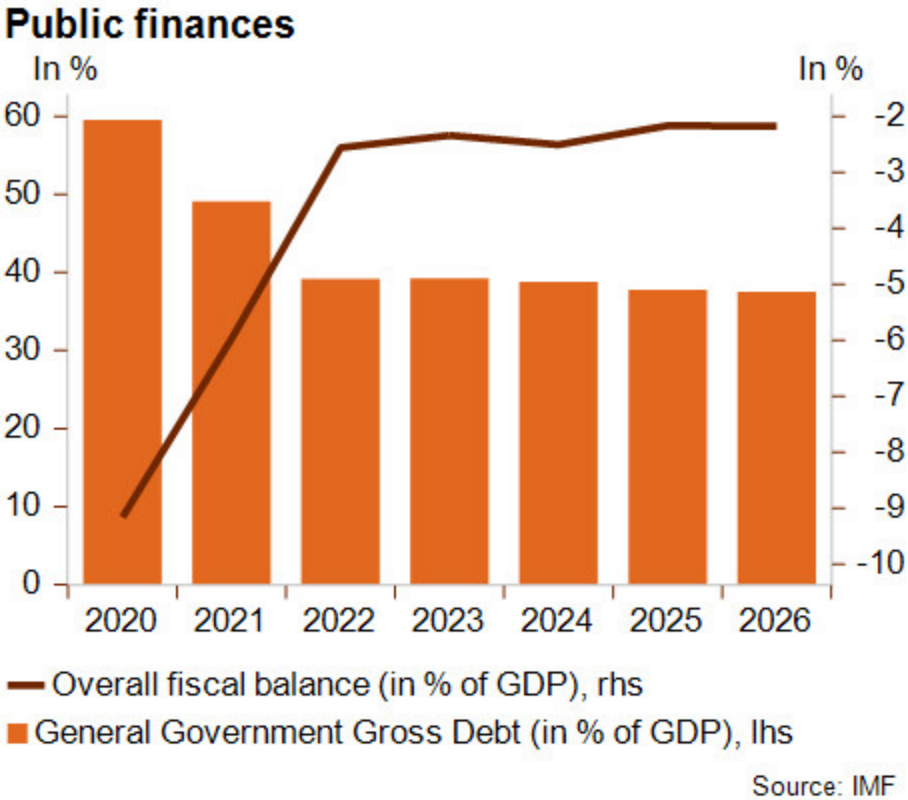
which had been strained by Russia's invasion of Georgia in 2008 and its recognition of the independence of Abkhazia and South Ossetia – have improved. This improvement is evidenced by Russia's resumption of flights and a visa-free regime for Georgians. Furthermore, Georgian authorities have refused to support Western sanctions against Russia, exposing the entities that help to circumvent these sanctions to the risk of secondary sanctions from the West, and alongside Azerbaijan, Armenia and the EU (with which Georgia signed a Deep and Comprehensive Free Trade Agreement in 2016), Russia is one of Georgia's main trade partners. Notwithstanding frustrations on both sides – for Georgia's part, in relation to the conditional candidate status for EU membership, and for the EU, concerns about the recent reintroduction of the "foreign agents" bill, which is not compatible with accession to the EU – the EU continues to be an important partner for Georgia. However, unless there is a reversal of current trends and a return to the EU pathway, relations between the two are set to deteriorate.

Georgia enjoys good relations with its neighbouring countries, namely Turkey, Armenia and Azerbaijan. Its location as well as the strained relations between Armenia and Azerbaijan position the Caucasus republic as a strategic partner for existing pipelines and the development of the Middle Corridor, a trade route that links China to the EU and bypasses Russia.

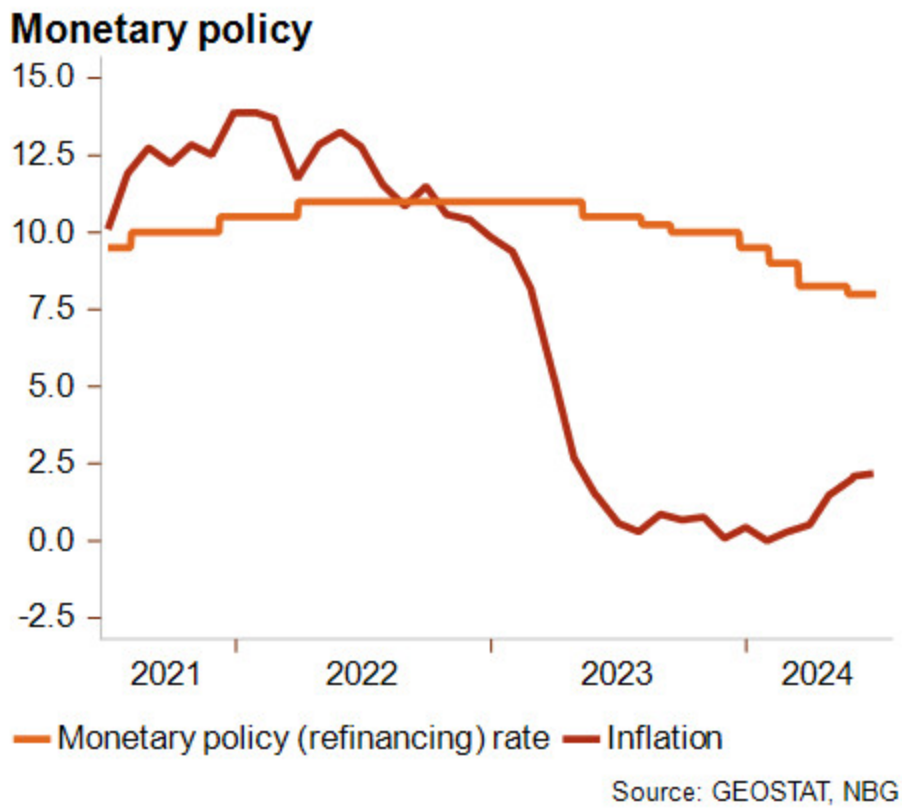
Sound macroeconomic policies

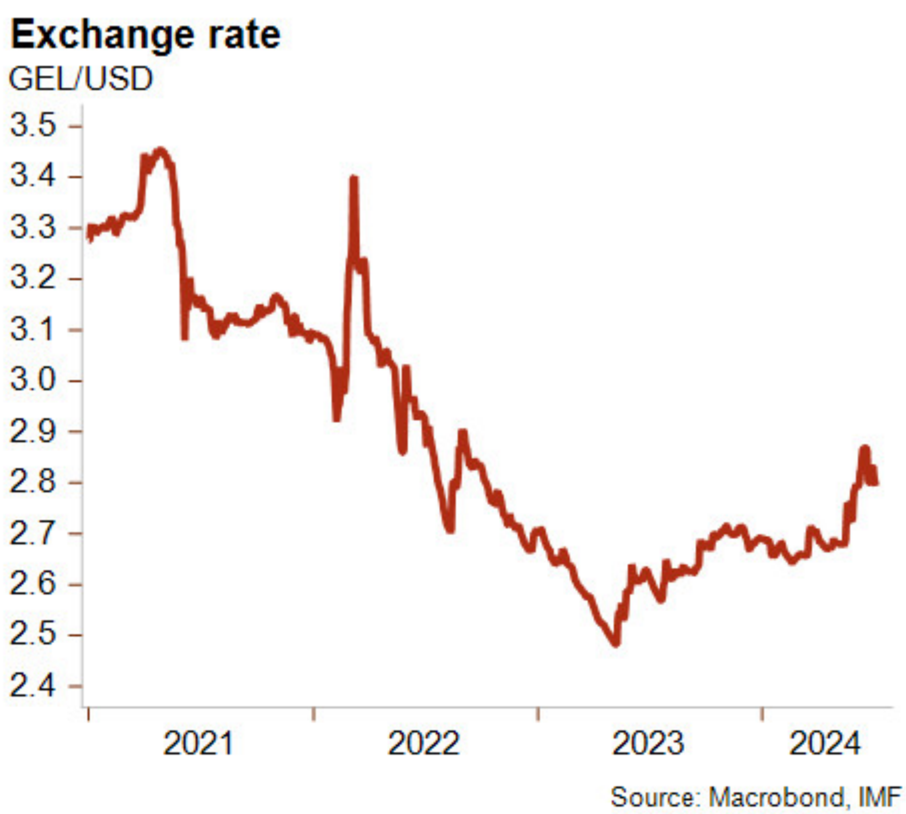
The macroeconomic situation of this open economy has improved in recent years: Georgia's economic growth performance (+9.7% on average in 2021-23) has been spectacular amid a rebound from its Covid-19 downturn (real GDP of -6.3% in 2020), large Russian financial inflows triggered by the war in Ukraine, strong tourism sector and investments. While some of these factors are cyclical, others are more structural, such as its sound macroeconomic policies, while MLT growth projections remain solid at around 4.5%. Nevertheless, challenges persist due to a difficult geopolitical situation, weak productivity, significant skill mismatches due to a poor education system and weak infrastructure.

The authorities have sound monetary and fiscal policies in place. Fiscal policies are relatively prudent, with a focus on maintaining public debt at around 40% of GDP in the medium term – below the fiscal rule ceiling of 60% of GDP. During favourable periods, the authorities maintained a primary surplus or a limited deficit, and reacted swiftly when necessary. For instance, the economy was supported during the Covid period, which led to a surge in public debt to 59.6% of GDP in 2020 (see graph below representing the general government gross debt and overall fiscal balance in % GDP), which then decreased to 39.2% of GDP in 2023. This commitment to responsible fiscal policies is expected to continue in the years ahead.



The central bank has an inflation-targeting framework and a relatively flexible exchange rate regime, but its independence was weakened in 2023. The monetary authorities had responded swiftly to stem inflation pressures in 2021-22, however, in 2023, inflation decreased sharply (see graph below representing the refinancing rate set by the Central Bank and consumer price inflation) due to a combination of factors, including interest rate cuts, lower commodity prices and the appreciation of the Georgian lari in 2023. Since then, the lari is again under pressure and has depreciated in 2024 (see exchange rate graph below in which an increase represents depreciation).

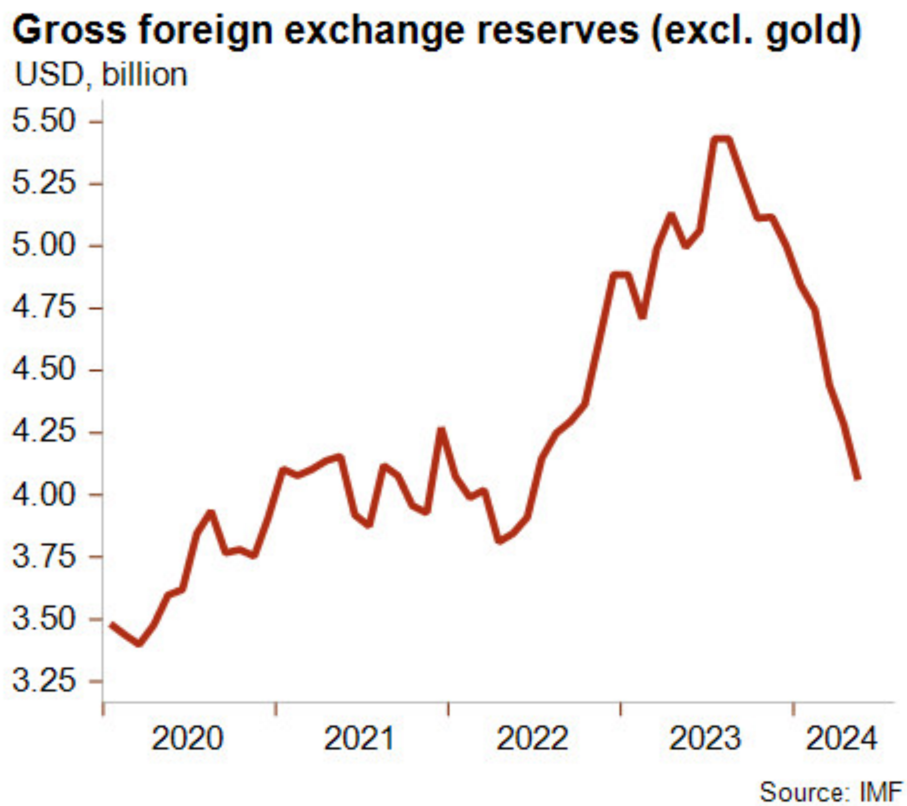




Gradual narrowing of the current account deficit

Over the last decade, the large current account deficit gradually narrowed thanks to the growing tourism sector and, more recently, a cyclical surge in remittances linked to the arrivals of Russian migrants. Despite the expected widening of the current account deficit to around 5.5% of GDP this year (see graph), its relative narrowing is a positive risk factor.

The financial risk has decreased sharply over the past few years, driven by a drop in external debt ratios. Approximately half of the MLT external debt consists of public debt, primarily owed to multilateral creditors, while private debt is largely associated with intercompany loans, which to a certain extent mitigate the risk. The debt service ratio has also decreased compared to its historical average – albeit not to its 2022-23 level – and is expected to remain moderate. Despite the recent sharp decrease in foreign exchange reserves (see graph below), liquidity remains above its 2022 level, but is a factor to watch. In this context, the short-term political risk is classified in category 4/7 with a negative outlook, while any further significant reduction in gross foreign exchange reserves may lead to a downgrade of the country's short-term political risk classification.



A stable MLT political risk

The delicate balance between further EU integration, improving relations with Russia and strengthening ties with China highlight the challenging geopolitical context that the Caucasus republic is facing. However, Credendo has upgraded its MLT political risk rating to category 5 amid a gradual reduction of external debt and debt service indicators, and a narrowing of the current account deficit. Moreover, the commitment to responsible fiscal policies and inflation targeting has helped to support macroeconomic stability and this is expected to continue.

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