

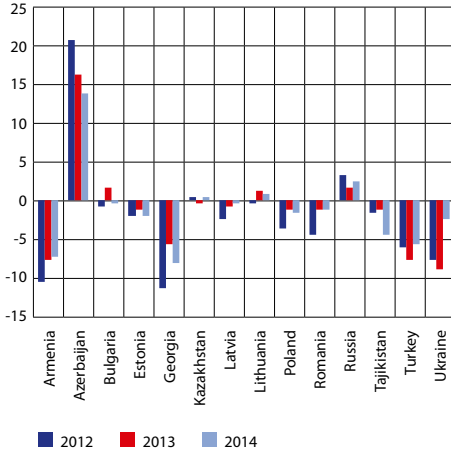
FOCUS ON RUSSIA: **Georgia under Russian Expansionism and Financial Crisis**



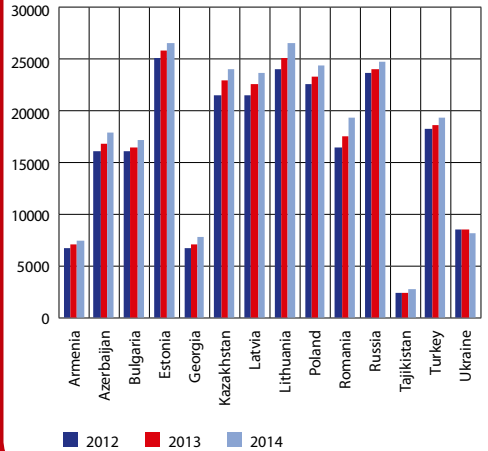
IMF WORLD ECONOMIC OUTLOOK

INTERNATIONAL MONETARY FUND (IMF), OCTOBER 2014

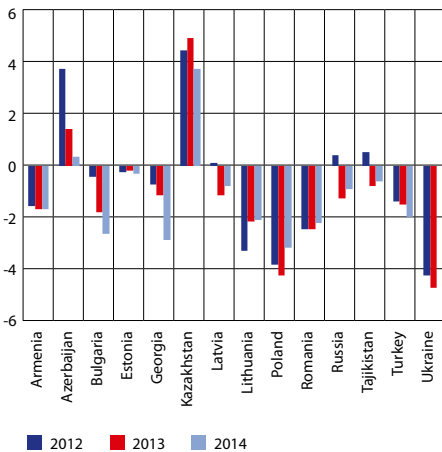
Current Account Balance, % of GDP



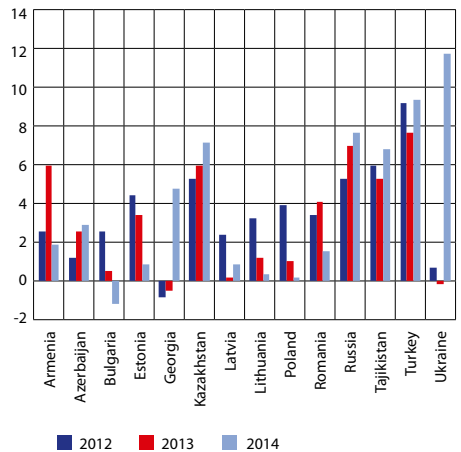
GDP per Capita, PPP Dollars



Budget Deficit, % of GDP



CPI Inflation





GEORGIA AND THE NEIGHBORS is an analytic periodical covering economic, financial, and business trends in Georgia's neighboring countries and in the major trade partners. The aim of the brief is to scrutinize the potential implications of the key political and economic developments taking place within the region or in the world. Georgia's policy and business community are the primary audience of the brief. The analyses and projections made by the Georgia and the Neighbors are based on the extensive research and consultations in Georgia and in the countries in focus. It is being compiled by the EPRC's in-house experts and the outsourced consultants.



Armenia



Azerbaijan



Belarus



Bulgaria



Estonia



Georgia



Iran



Kazakhstan



Kirgizstan



Latvia



Lithuania



Moldova



Romania



Russia



Tajikistan



Turkey



Turkmenistan



Ukraine



Uzbekistan

GLOBAL INNOVATION INDEX

By World Intellectual Property Organization, Johnson Cornell University, and INSEAD Business School

Rank	Country	Score	Percentage Rank
...			
40	Mauritius	40.9	0.73
41	Barbados	40.8	0.72
42	Croatia	40.7	0.71
43	Moldova, Rep.	40.7	0.7
44	Bulgaria	40.7	0.7
45	Poland	40.6	0.69
46	Chile	40.6	0.68
47	Qatar	40.3	0.68
48	Thailand	39.3	0.67
49	Russian Federation	39.1	0.66
50	Greece	38.9	0.65
51	Seychelles	38.6	0.65
52	Panama	38.3	0.64
53	South Africa	38.2	0.63
54	Turkey	38.2	0.63
55	Romania	38.1	0.62
56	Mongolia	37.5	0.61
57	Costa Rica	37.3	0.61
58	Belarus	37.1	0.6
59	Montenegro	37	0.59

Rank	Country	Score	Percentage Rank
...			
60	TFYR of Macedonia	36.9	0.58
61	Brazil	36.3	0.58
62	Bahrain	36.3	0.57
63	Ukraine	36.3	0.56
64	Jordan	36.2	0.56
65	Armenia	36.1	0.55
66	Mexico	36	0.54
67	Serbia	35.9	0.54
68	Colombia	35.5	0.53
69	Kuwait	35.2	0.52
70	Argentina	35.1	0.51
71	Viet Nam	34.9	0.51
72	Uruguay	34.8	0.5
73	Peru	34.7	0.49
74	Georgia	34.5	0.49
75	Oman	33.9	0.48
76	India	33.7	0.47
77	Lebanon	33.6	0.46
78	Tunisia	32.9	0.46
79	Kazakhstan	32.8	0.45
80	Guyana	32.5	0.44

FOCUS ON RUSSIA:

Georgia under Russian Expansionism and Financial Crisis

Financial crisis and economic recession in Russia is official now (Aslund, A., Dec 2014). The Government of Russia has unveiled an anti-crisis plan (Финмаркет, Jan 28, 2015), already widely criticized by Russian observers (Forbes, Jan 31, 2015). The third financial crisis in less than 20 years comes together with the heightened aggression and expansionism of Moscow in the wider region. In addition to Georgia and Ukraine, where Moscow rolled in its military and occupied territories, tensions are high in Armenia (the guardian, Jan 15, 2015), Moldova (European Forum, May 2014), and even Baltic countries (The Atlantic, Jan 21, 2015). Hence, the possible risks and effects to look for are twofold – economic and financial impact and threats to states' territorial integrity and security in the region.

In 1998 when Russia defaulted on its debt and devalued the ruble, impact on almost all post-Soviet countries, and especially on smaller economies closely tied to Russian market, was immense. Remittances decreased sharply as unemployment and devaluation hit Russian labor market. Exports to Russia were also cut across the board. At that

time, at least 30 percent of Georgia's total exports went to Russia and remittances were the vital source of income for many families. The crisis in Russia caused significant shakes in Georgia's hardly stabilized economy – newly introduced Georgian Lari depreciated again. Thanks to Russian embargo in 2006, Georgian economy is not as dependent on Russia as it was in 1990s, but Russia is still the second largest trade partner¹ and still one of the major sources of remittances. The first effects of Russian crisis are already felt both in Tbilisi and Yerevan (Financial Times, Dec 2014). The purpose of this report is to look at many other areas where the impact of the crisis may be seen in short or medium term and assess the potential scope.

Expansion of the military conflict in Ukraine and alarming mood across the Caucasus, Eastern Europe and Baltic States is only adding on the economic and financial volatility. Official Moscow has voiced number of threatening messages addressed to neighboring states and given its actions in Georgia in 2008 and yet again failed cease-fire in Ukraine, these threats do not seem unrealistic. Now that Tbilisi's diplomatic efforts to normalize relations with Moscow have failed

(ტაბულა, Jan 30, 2015), Georgia is trying to remain as neutral as possible when referring to Russia (netgazeti.ge, Dec 26, 2014). Pros and cons of this policy and impact on future Russia-Georgia relations are also addressed in this report.

RUSSIA TODAY

Sanctions and their impact

The conflict with Ukraine turned out hard to digest for Russian economy. In addition to the heavy costs imposed by the prolonged, although unrecognized, military operations in Eastern Ukraine and the administrative and financial strain of absorbing the Crimean peninsula, the sanctions imposed by the USA, European Union and the most of the OECD to derail Russia from its “Drang nach Westen”² has taken its toll on Russia. The sanctions’ package imposed by “the West” includes numerous diplomatic and economic measures, such as asset freezes and visa bans, prohibition of imports originating from Crimea/Sevastopol, ban on purchase of Russian long-term (longer than 30 days of maturity) financial instruments (US Treasury Department, Sept. 12, 2014), sanctions against dealing with major Russian banks (Bank of Moscow, Gazprombank OAO, Russian Agricultural Bank, Sberbank, VEB, and VTB Bank), etc. ([10], [11]). Australia, Canada, Japan, New Zealand, and Switzerland have also

imposed various sanctions on Russia, Crimea, and the separatist Ukrainian territories.³ The sanctions imposed by the latter countries are mostly directed at politicians and individuals. A detailed list of companies sanctioned as well as the sanctions imposed can be found below in the table 1.

According to Wall Street Journal, although the sanctions imposed so far have been narrowly targeted, their indirect effect is much broader, with the unexplainable decision of Russian authorities to ban food imports from Western countries that imposed sanctions only adding to the inflationary pressures. Throughout the 2014 the ruble has depreciated by 82.5 percent; the trough being 68.46 ruble to 1 US dollar on December 16th – a staggering 108 percent depreciation. Between 30 September 2013 and 31 January 2015, the ruble has significantly depreciated both against the US dollar and the Euro - 113.5 percent and 78.3 percent respectively. This is a serious threat to the Russian economy, growth of which fell to 0.6 percent in 2014 (RosBusinessConsulting, Feb 2, 2015).

The Central Bank of Russia had several unsuccessful attempts to normalize the depreciation. It has increased the key interest rate by the largest margin since 1998 – from 10.5 percent to 17 percent (Bloomberg Business, Dec 16, 2014). This rapid rise in interest rates had natural-

ly played its role in the overall economic slowdown. The Central Bank has also intervened on the foreign exchange market. Hence, from September 2013 to January 2015, Russia's foreign exchange reserves have declined by 37.7 percent and at the moment stand at a 4-year minimum and 22 percent below the all-time maximum, with the Central Bank ready to intervene again. The sales of the US dollar have not taken place since May 2014. One way Moscow is trying to alleviate the burden of

currency depreciation for the firms and individuals, is to push for the use of national currencies in mutual payments with China, India, Iran, Egypt, and Turkey (Sputnik, Feb 9, 2015). Russia and China have been working on putting the US dollar aside since 2010 (The New York Times, Dec 14, 2010). If effectively implemented, this might weaken the US dollar in the long-term, but on the initial stage this will only decrease the trade of ruble and US dollars, adding on to the rubles devaluation.

Table 1. List of companies sanctioned in relation to the Ukraine crisis. As of November 20, 2014

Companies/entities	Description	Sanctioned by
<i>Different types of restrictions on capital markets and on trading in dual-use goods and technologies were imposed on these companies involved in military production.</i>		
Almaz-Antey (OAO)	A state-owned research and production enterprise engaged in manufacturing of weapons, ammunition, and specialized electronics	USA, EU, Canada, Switzerland, Australia, Norway, Lichtenstein
Altair Science and Technical Centre	Developer of weapons and military electronics. Part of Almaz-Antey (OAO)	Canada
Dolgoprudnenskoye SPP (OAO)	State scientific production plant specializing in manufacturing air defense systems and civil machinery	USA, Canada
Kalashnikov (OAO)	State-owned concern engaged in production of rifles and other weapons	USA, EU, Canada, Switzerland, Norway
Kalinin Machinery Plant (OAO)	State-owned plant specializing in manufacturing machinery for military and civil purposes	USA, Canada
KBP (OAO)	State-owned research bureau, specializing in Development of weapons	USA, Canada
KRET (OAO)	State-owned concern engaged in production and development of specialized electronics	USA, Canada
Mytischinskiy Mashinostroitelnyy Zavod (OAO)	Factory in Moscow oblast specializing in manufacturing military and civil machinery. Partially controlled by the state.	USA, Canada

NIIP (OAO)	Tikhomirov Scientific Research Institute of Instrument Design. A state entity specializing in development and production of electronic systems for military and civil purposes	USA, Canada
NPK Uralvagonzavod (OAO)	State-owned producer of railway wagons and military machinery	USA, EU, Switzerland, Norway
NPO Bazalt (OAO)	State-owned research and production enterprise engaged in weapons and ammunition manufacturing	USA, Canada, EU, Switzerland, Norway
NPO Machinostroyeniya (OAO)	State-owned research and production enterprise engaged in weapons and ammunition manufacturing	USA, Canada
Sozvezziye (OAO)	State-owned concern engaged in production and development of specialized electronics	USA, Canada
United Shipbuilding Corporation (OAO)	State-owned shipbuilding corporation	USA, Canada
NPO Vysokotochnye Komplekсы	Developer and manufacturer of high-precision weapons, parts, and components. Controlled by the Rostec state corporation	EU, Switzerland, Norway
OPK Oboronprom (OAO)	A group of companies specializing in manufacturing military machinery. Controlled by the Rostec state corporation	EU, Switzerland, Norway
Rostec State Corporation	State corporation consisting of about fifty companies involved in design and manufacturing of hi-tech products for civil and defense sectors	USA
RT-Chemcomposite (OAO)	Group of companies providing military and civil chemical solutions. Controlled by the Rostec state corporation	EU, Switzerland, Norway
RT-Stankoinstrument (OAO)	Group of companies providing military and civil engineering solutions. Controlled by the Rostec state corporation	EU, Switzerland, Norway
Sirius (OAO)	Group of more than 20 companies involved in development and production of electronic for military and civil purposes. Controlled by the Rostec state corporation	EU, Switzerland, Norway
Tekhnologii Mahinostroyeniya	Machine Engineering Technologies Holding. Group of companies engaged in development and manufacture of artillery ammunition and special chemicals. Controlled by the Rostec state corporation	EU, Switzerland, Norway
Tulsky Oruzheiny Zavod (OAO)	State-owned weapons production factory	EU, Switzerland, Norway
United Aircraft Corporation (OAO)	State corporation consisting of more than twenty companies engaged in aircraft and aerospace engineering	EU, Switzerland, Norway

Companies/entities	Description	Sanctioned by
<i>Capital market restrictions imposed on Russian banks, investment companies, and enterprises owned by the sanctioned individuals</i>		
Aquanika (OOO)	Manufacturer of non-alcoholic beverages and mineral waters; Owned by Gennady Timchenko	USA, Canada, Australia
Avia Group (OOO) and Avia Group Nord (OOO)	Providers of business aviation services; Co-owned by Gennady Timchenko	USA, Canada, Australia
Bank Rossiya	Bank owned by several individuals from the sanctions list	USA, Australia
IC Abros (OOO)	Investment company wholly owned by the Bank Rossiya	USA, Canada
Sobinbank (OAO)	Bank wholly owned by Bank Rossiya	USA, Canada
Investcapitalbank (OAO), SMP Bank (OAO)	Banks controlled by the Rotenberg brothers	USA, Canada, Australia
RNKB (OAO)	Russian National Commercial Bank, operates in Crimea and allegedly controlled by the republic's authorities	EU, Switzerland, Norway, Lichtenstein, Australia
STG Holdings Limited	Cypriot holding company controlled by Gennady Timchenko	USA, Canada
Stroytransgaz Group and Transoil (OOO)	A group of construction companies and rail freight operator controlled by Gennady Timchenko	USA, Canada, Australia
Volga Group	Investment and management company owned by Gennady Timchenko	USA, Canada, Australia
Zest (ZAO)	Leasing company in St. Petersburg, formerly owned by Bank Rossiya	USA, Canada
Sberbank	Russia's largest bank; state-controlled	USA, Canada, EU, Switzerland, Japan
VTB Bank (OAO)	The second largest Russian bank. State-controlled	USA, Canada, EU, Switzerland, Japan
Gazprombank (OAO)	Russia's third largest bank, partially owned by the state	USA, Canada, EU, Switzerland, Japan
Bank of Moscow (OAO)	The fifth largest bank in Russia. Controlled by the VTB bank	USA, Canada
Vnesheconombank (VEB)	Russian state owned development bank	USA, Canada, EU, Switzerland, Japan
Russian Agriculture Bank (OAO)	Russian state-owned bank	USA, Canada, EU, Switzerland, Japan

<i>Sanctions imposed in the field of oil exploration and production, and various capital market restrictions in the oil and natural gas sector</i>		
Gazprom (OAO)	World's largest producer of natural gas. State-controlled.	USA
Gazprom Neft (OAO)	One of the four largest oil companies in Russia. State-owned.	USA, EU, Switzerland, Norway
Lukoil (OAO)	Russia's second largest oil company. Privately owned	USA
Novatek (OAO)	Russia's largest independent natural gas producer	USA, Canada
Rosneft (OAO)	Russia's largest oil company. State-owned	USA, EU, Switzerland, Norway
Surgutneftegaz (OAO)	A large, privately-owned Russian oil company	USA
Transneft AK (OAO)	State oil pipeline network operator	USA, EU, Switzerland, Norway
Feodosia	Crimean oil and oil products bulking company confiscated by the new Crimean authorities	USA, Canada, EU, Switzerland, Lichtenstein, Norway, Australia, Japan
Stroygazmontazh (OOO)	Gas pipeline construction company controlled by Arcady Rotenberg	USA, Canada, Australia

Source: RISKADVISORY. Consolidated list of Ukraine-related sanctions and restrictive measures

In 2014 the net capital outflows from Russia reached 151.5 billion US dollars, compared to 66.1 billion US dollars a year before (Business Insider, Jan 19, 2015).⁴ Unsurprisingly, this level of the outflow is not covered by the FDI inflow. Bloomberg reports an estimated 50 percent drop in foreign investment in Russia, compared to 2013 (Bloomberg Business, Jun 5, 2014).

Skyrocketing interest rates, capital and deposit outflow, and devaluation of national currency are of course overwhelming already troubled financial and banking sector in Russia. The Central Bank had to step in to bail out one of the top 30 banks, Trust Bank

in December 2014 and Russian Duma has passed the bill allocating 1 trillion rubles (16.5 billion US dollars) to boost the liquidity. Analysts, state or banking sector representatives are careful in their assessments of the situation, but almost all sides agree that the worse for the Russia's banking sector is still to come. (Business Insider, Jan 28, 2015; Reuters, Jan 23, 2015; The Moscow Times, Jan 17, 2015; the guardian, Dec 22, 2014).

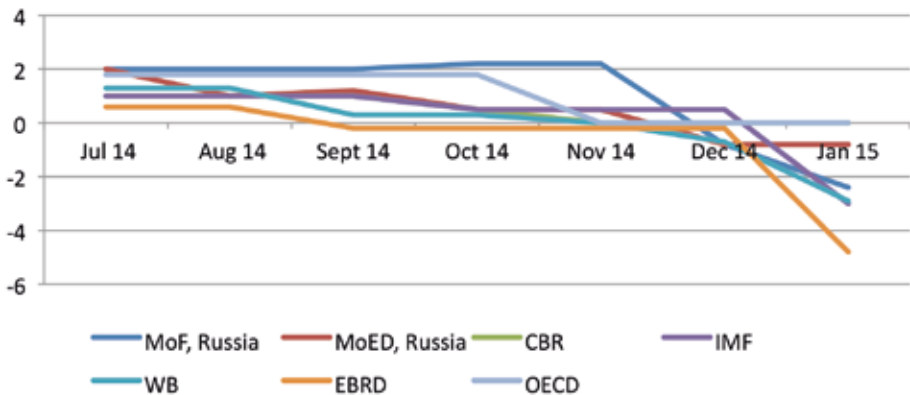
At the moment Russia's credit rating is still investment grade with Fitch (BBB) and Moody's (Baa1), however Standard & Poor's has downgraded Russia to BB+ - to the so called junk territory (The Guardian,

Jan 2015). At the same time, both Fitch and Moody's, who have rated Russia in mid-January 2015, have given the country a negative outlook, with a possible room for a further downgrade (Moody's, Jan 2015; The Guardian, Jan 2015).

Different governmental and international agencies have already changed their fore-

casts of the economic growth in Russia from the second half of 2014 through 2015 (RusBusinessConsulting, Jan 14, 2015). Most of the international organizations (apart from the OECD) are considering the situation to be worse than Russian government agencies, but the downward trend in forecasts is visible for all the entities given on the graph.

Chart 1. 2015 Economic Growth in Russia – Different Forecasts



The graph 1 shows that the sentiments within Russia are also somewhat divided. Some Russian experts (Expert Online, Feb 6, 2015) attribute the existing dire economic situation to the errant monetary and fiscal policy, rather than to the sanctions and/or to the drop in oil prices. They promote the idea of monetization of the economy – essentially pumping money in the financial sector to stimulate the real sector.

The government itself expects a quite lean 2015. The Ministry of Economic Development has adjusted the macroeconomic prognosis downwards and based the forecast on the oil price of 50 US dollars. The Ministry has forecasted the GDP to drop by 3 percent and inflation to reach 12 percent (Expert Online, Feb 1, 2015). It expects the investments in the fixed capital to drop by 13 percent, and decline in industry at 1.6 percent; the net

outflow of the capital is expected to hit 115 billion US dollars.⁵

The Government of Russia has published a so-called anti-crisis plan (Government of Russia, Jan 27, 2015) to alleviate the shocks and ensure the sustainable economic development of the country. It covers seven main directions, including import substitution, supporting the development of small and medium business, compensation of inflation costs for pensioners and large families, and optimization of budget costs. The plan provides both for the 11.4 percent⁶ inflation indexation of pensions and 10 percent decrease in state expenditures in 2015, while leaving the defense expenditures unchanged. In other words, this is an austerity plan.

Bullish reactions towards the sanctions imposed on Russia ranges from being completely complacent, mostly within general population, with the popular witticism “don’t make our Iskanders⁷ laugh,” to retaliating (Аргументы и Факты, Feb 13, 2015), with possible counter-sanctions including moratorium on repayment of external debt and leaving the WTO. This kind of siege mentality instilled in the population by the Russian government can somewhat explain the still sky-high rating of Putin (HTB, Feb 13, 2015), despite current and potential future economic hardship. This is undoubtedly helped by the Russian propaganda machine, which through embellishing the truth, giving the half-truth or just outright lies, creates a rose

tinted picture of reality. An example would be the recent article in Izvestia⁸ (Известия, Feb 9, 2015), where US Treasury Secretary Jack Lew is said to have suggested necessity of softening the sanctions against Russia. In reality (CNBC, Feb 9, 2015) the quote was “our preference would be to ratchet them down because that would be the best thing for the economy in Europe and the best thing for stability, but that would require Russia living by its commitments and pulling back and honoring the sovereignty of Ukraine.”

Overall, it can be safely assumed that the long-term impact of economic sanctions, even if their scope is not extended, can be at the very least detrimental for the Russian economy.

INTERNAL CHALLENGES TO RUSSIAN ECONOMY

If sanctions are relatively recent external phenomenon burdening the Russian economy, widespread corruption, huge bureaucratic apparatus, administrative inertia, and a dire need for structural reforms are the internal phenomena hindering Russia’s economic development ever since it has moved to the market economy.

At present Russia is the 6th country in the world by GDP based on purchasing power parity (IMF, 2014). However, unlike other major players in the world economy, Russia’s economic growth is mostly driven by the revenues generated by the energy sector, with

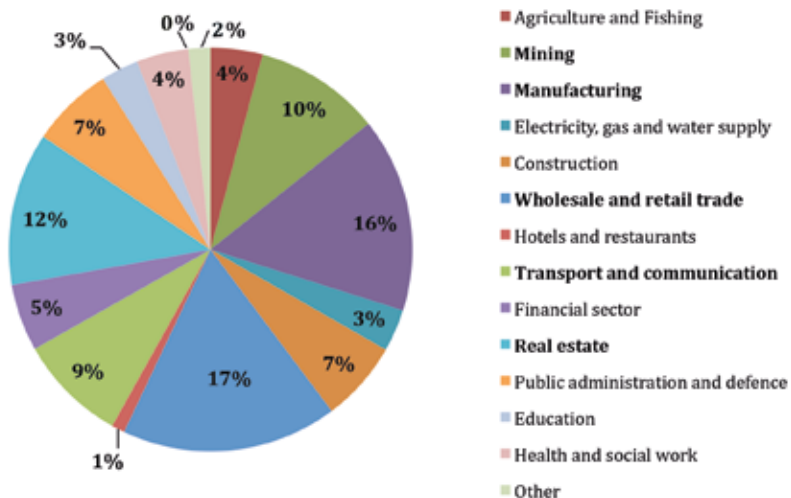
state-owned Gazprom being the world's largest natural gas exporter and one of the world's largest companies. According to the World Bank data, in 2012 oil, natural gas and coal accounted for 17.1 percent of Russian GDP (World Bank database), whereas the US Energy Information Administration states in its report on Russia that "oil and gas revenues accounted for 52 percent of federal budget revenues and over 70 percent of total exports in 2012" (EIA, Mar 2014). Furthermore, the export of precious metals and stones and chemicals account for the 11 percent and 6 percent respectively (FSSS Foreign Trade).

Clearly, Russian economy is highly dependent on natural resources. And even though Russia owns vast reserves (75 trillion US dollars in total value (The Countries)), leading all other nations in the size

of both natural gas and timber reserves, having the second largest deposits of coal and the third largest deposits of gold (24/7 Wall st.), and being the 8th in oil reserves (EIA, Energy Statistics), its economic growth since 1999 has been quite uneven, with a pronounced downward trend, even excluding the 2009 crisis, when the GDP fell by huge 7.8 percent.

It is hard to see this dependence in the GDP picture offered by the Russian Federal State Statistics Service. The 2014 GDP was mostly composed of manufacturing and mining (more than 26 percent together), wholesale trade (17 percent), and real estate (12 percent), followed by transport and communication (9 percent), construction (7 percent), and public administration (also 7 percent).

Chart 2. Gross value added by economic activity in 2014



Source: Federal State Statistics Service, Russia in figures

In the international community, the weakness of Russian economy is widely explained by the lack of comprehensive structural reforms back in the years of transition, inefficiencies in factor allocation across the economy, and immaturity of market institutions. These drawbacks were for years masked by the economic growth stimulated by large investment projects, continued increase in public wages, and transfers – all fueled by the sizeable oil revenues (World Bank, Mar 2014, p. iii). However, tensions in the economy resurfaced earlier than the crisis in Crimea and conflict with Ukraine started. When the major infrastructure projects came to an end in early 2013, the spare capacity was immediately felt in the economy; consumption remained the sole growth driver (World Bank, Mar 2014, p. iv), which plunged to 1.3 percent in the end of 2013.

Administrative burdens are another problem that the private sector has to overcome in Russia. According to the latest (2011) Business Environment and Enterprise Performance Survey (BEEPS), the situation has improved since 2008 BEEPS, however the regulatory obstacles are still high: the average time needed to obtain various licenses vary from 47 days (for import licenses) to 130 days (for construction-related permits); 49 percent of respondents consider tax administration to be an obstacle in doing business; BEEPS found that “excessive red tape can provide public officials

with more opportunities to deliberately slow down processing to increase the incentives for firms to pay bribes. The BEEPS data are consistent with this idea: regions with more burdensome regulation exhibit a higher incidence of corruption” (World Bank, Feb 2013, p. 7).

According to the World Bank Doing Business, Russia has initiated a number of pro-business reforms in the recent years (World Bank Group, Doing Business), but it is hard to assess their impact when the overall economic situation in the country is so volatile.

Some of the administrative reforms carried out in Russia in 2011-2015.

- Russia made it easier to start a business by eliminating three requirements – to deposit the charter capital before company registration, to notify tax authorities of the opening of a bank account, and to have the bank signature card notarized before opening a company bank account.
- Russia simplified property registration and transfer by eliminating the requirement to obtain cadastral passports on land plots, by simplifying the procedures and implementing effective time limits for processing transfer applications, and by eliminating the requirement for notarization and introducing tighter time limits for completing the registration.

- Russia made dealing with construction permits easier by eliminating several requirements for project approvals from government agencies and by reducing the time required to register a new building and by introducing a single window for all procedures related to land use.
- To ease the trade across borders, Russia has introduced an electronic system for submitting export and import documents, reduced the number of physical inspections, and reduced the number of documents required and thus, lowered the costs associated with documenting.
- To ease the administrative burden of paying taxes, Russia simplified the compliance procedures for value added tax and promoted the use of tax accounting software and electronic services. On the negative side, Russia has increased the social security contribution rate for the employers.
- Russia made getting electricity simpler and less costly by setting standard connection tariffs and eliminating many procedures previously required.
- Russia made filing a commercial case easier by introducing an electronic case filing system.
- Russia introduced a series of legislative measures in 2009 to improve creditor rights and the insolvency system.

World Bank Group, Doing Business

Another problem damaging economic growth and private sector development, according to the World Bank, is the state capture, that is “the actions of individuals, groups or firms, both in the public and private sector, to influence the formation of laws, regulations, decrees and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials” (World Bank, Feb 2013, p. 18). According to Transparency International’s 2013 Corruption Perceptions Index, Russia is ranked 127th out of 177 countries and is 28th out of 28 countries in Bribe Payers Index (2011). Despite some improvement in the CPI ranking (from 143rd in 2011), the level of corruption is still very high and according to the Russian Anti-Corruption Civil Society Center “Clean Hands” around 46 percent of the GDP are in the “corruption shadow” with the average bribe amount being equal to 5,600 US dollars (**Ассоциация Адвокатов России за Права Человека**, 2014).

RUSO-GEORGIAN ECONOMIC TIES

Trade – Current trends

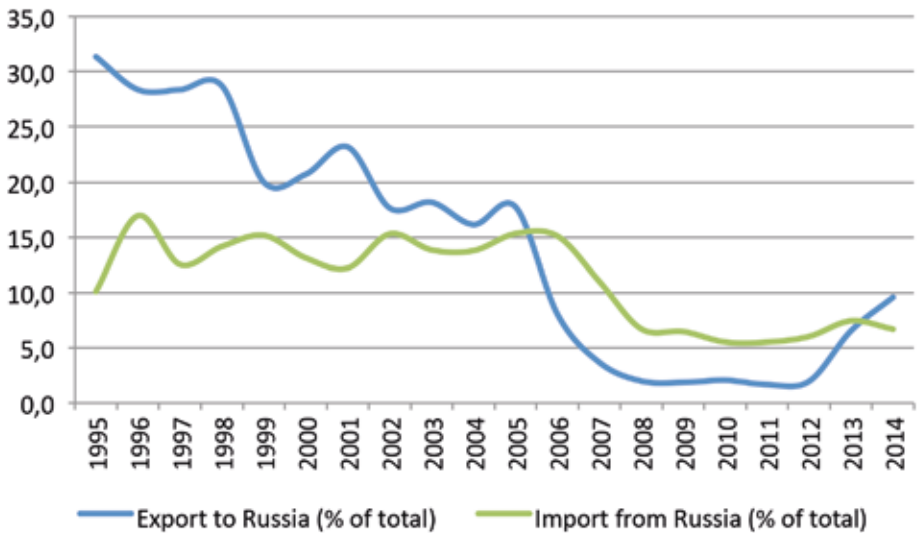
In 2013 Russia was the fourth largest export destination for Georgian goods, with total exports of 190.1 million US dollars representing 6.6 percent of total Georgian exports. Russia was also the fourth larg-

est importer in Georgia, with total value of imports of 587.8 million US dollars and 7.5 percent share. Ongoing financial crisis in Russia already took its toll on bilateral trade. Throughout the 2014, Georgian exports to Russia have declines in absolute value, although the share in total exports reached 9.6 percent. Export volume in January 2015 however, depicts clearer signs of the crisis. Compared to same period in 2014, exports went down from 21 to 8 million US dollars a month, which is roughly a 62 percent decline. Exports to Russia in January constituted little more than 5 percent of the total.

Import from Russia also fell to 6.7 percent of the total and shrank by about 10 million

US dollars last year. However, compared to January 2014, imports in the same period in 2015 went up by 16.7 percent. Given the scale of the devaluation of Russian ruble (more than 100 percent), only 16.7 percent increase is very modest and can be explained only by the parallel devaluation of Georgian lari by about 30 percent. It is expected that Russian imports will remain on more or less the same level, because its attractiveness (cheaper price) is counterbalanced by lower price of Georgian lari, which is anticipated to stabilize at around 2 to 1 against the US dollar. Cheaper lari will decrease the appetite of Georgian consumers for imported products across the board.

Chart 3. Georgia's trade with Russia, shares in total export and import



Source: National Statistics Office of Georgia

As long as Georgia sticks with the current neutral political position in-between Russia and the West, yet another embargo on Georgian products is not likely. However, prolonged economic slowdown in Russia due both to sanctions and to declining oil prices (Brent crude oil dropped to 49.60 US dollars by the end of January 2015) leads to natural decline in exports to Russia. Of course, Georgia's export constitute only an insignificant part in Russia's total imports (roughly around 0.1 percent) and is composed of mostly wine, fresh fruit, and food products, items that are not highly sensitive in times of crisis. Given Russia's latest ban on food products from EU countries, Georgian export should feel even less

pressure. But if the economic crisis goes so far that ordinary Russians have to adjust their "family food basket," Georgian exporters will also need to adjust. Besides, Russia was the fourth largest market for Georgian products in 2013, even the modest decline in demand has a significant impact on Georgian side.

Trade in 2006-2014

On the whole, the composition of trade with Russia didn't change much since 2006, with certain goods (such as oil, gas, electricity, wheat, etc.) always being in the most traded list. Imports have been much more homogenous – in 2014 top-10 most

Table 3. Georgian Trade with Russia – Most Traded Goods in 2006 – 2014

Import	In 1,000 USD	Export	In 1,000 USD
petroleum gases & other gaseous hydrocarbons	902,880	wine of fresh grapes, grape must nesoi	184,650
wheat and meslin	823,597	Waters, natural etc. not sweetened etc. ice & snow	111,136
oil (not crude) from petrol & bitum mineral etc.	360,147	electrical energy	101,916
electrical energy	200,387	ferroalloys	86,247
chocolate & other food products containing cocoa	137,433	motor cars & vehicles for transporting persons	73,266
sunflower-seed, safflower or cottonseed oil, not ch mod	74,660	ethyl alcohol, undenat, und 80% alc, spirit bev etc	29,190
food preparations nesoi	73,482	parts of railway or tramway locomotives or r stock	17,605
sausages & prep, mixed condiments, mustard flour etc.	69,353	citrus fruit, fresh or dried	16,871
wheat or meslin flour	66,146	manganese ores & concentrates including mangnfrs iron ores	14,132
bread, pastry cakes etc. comm wafers, empty caps etc.	64,728	motor vehicles for transport of goods	12,838
Total Import	2,772,812	Total Export	647,851

Source: National Statistics Service of Georgia

traded goods are almost the same as they have been throughout the last 8 years. Russian imports to Georgia were not affected by the embargo, but plummeted in the aftermath of the global financial crisis of 2008. The electricity imports though, were quite high in early 2000s, but after peaking in 2003 at 13 percent, it started to decline, and in 2007 and 2010 Georgia was a net exporter of electricity to Russia.

Georgia's export list shows more heterogeneity, however, top five products have virtually not changed. Ferroalloys, cars, and electricity were dominating the exports in every single year since 2006. Its share in Georgia's overall exports has been steadily declining throughout most part of the recent history, culminating in the Russian embargo of 2006. At that time, exports dropped to almost zero, with the exception of electricity, ferroalloys, and manganese ores.

Nevertheless, it can be safely argued that the impact of the 2006 Russian embargo on Georgia was far lower than initially feared. GDP growth remained strong in 2006 and 2007, and there was no significant blow to employment (in fact, it decreased in these two years). The surge of inflation in mid-2006 is mostly attributed to monetary factors, rather than embargo. The wine and mineral water exports were seriously hit by the embargo, but there was an evident growth well above the trend in a number of other sectors of the economy (such as financial sector, processing or communications). On the whole,

one can assume that Russian embargo rather than pulling Georgian economy back, pushed it forward, forcing Georgian entrepreneurs to find new markets for their goods.

To ease the pressure from the embargo, Western technical and financial assistance to Georgia has increased significantly. This provided an important resource for the economy. In 2007 IMF predicted a cost of Russian embargo on Georgia's current account deficit to reach 4 percent of the GDP (IMF, Mar 2007). However, Georgian economy withstood the blow and continued strong and sustainable growth. In the aftermath of the embargo Turkey became Georgia's leading trade partner and remains such till today.

Another embargo is not anticipated today, but if it happens, it is believed to have even weaker effect on Georgian economy. In the past 8 years, Georgian producers have grown stronger and diversified their export markets. Potential embargo may be hurtful, but it will be overcome much faster and with fewer losses than in 2006.

Prolonged economic recession in Russia holds much more danger for Georgia than any embargo Moscow could impose. The recession affects not only certain Georgian products and producers, but all export products, investments, financial sector, and more importantly, it affects Georgian emigrants in Russia, who are one of the major sources of remittances to Georgia.

Table 4. Georgian Trade with Russia – Most Traded Goods in Jan-Aug 2014

Import	Thousands of USD	Export	Thousands of USD
Wheat and meslin	132,416.6	Wine of fresh grapes, grape must nesoi	111,425.2
Petroleum gases & other gaseous hydrocarbons	75,265.9	Waters, natural etc., not sweetened etc., ice & snow	66,381.3
Oil (not crude) from petrol & bitum mineral etc.	47,686.5	Ethyl alcohol, undenat, und 80% alcohol, spirit beverages, etc.	17,552.8
Electrical energy	41,622.0	Ferroalloys	16,885.5
Chocolate & other food products containing cocoa	17,082.3	Motor cars & vehicles for transporting persons	16,433.3
Sunflower-seed, safflower or cottonseed oil, not ch mod	16,753.1	Citrus fruit, fresh or dried	9,063.7
Medicaments nesoi, mixed or not, in dosage etc.	11,893.8	Electrical energy	4,964.7
Sauces & prep, mixed condiments, mustard flour etc.	11,752.8	Nuts nesoi, fresh or dried	3,982.2
Bread, pastry cakes etc. comm wafers, empty caps etc.	9,273.3	Waters, sweetened etc & other nonalcoholic beverages, nesoi	3,814.5
Glass containers for packing etc. & glass closures	9,058.9	Tubes, pipes etc., seamless, iron nesoi & steel	2,644.0
Food preparations nesoi	8,791.3	Ginger, saffron, tumeric, thyme, bay leaves etc.	2,581.8
Total Imports	381,596.5	Total Exports	255,729.0

Source: National Statistics Office of Georgia

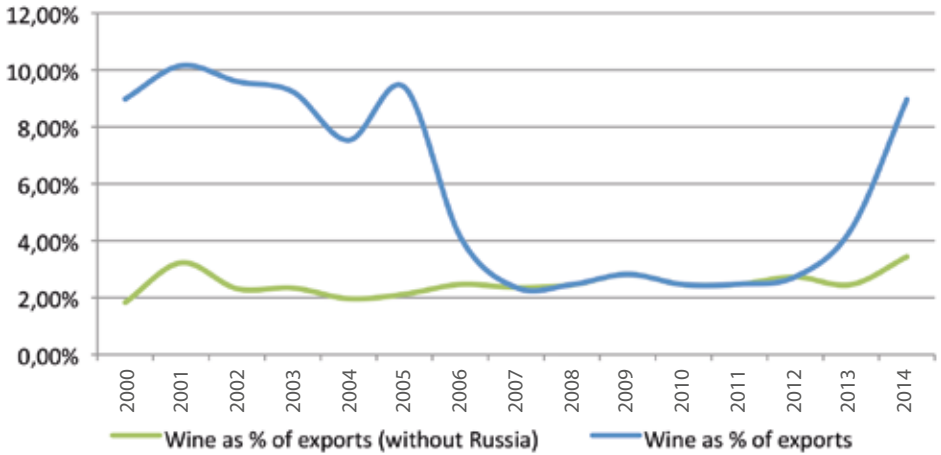
Wines and Mineral Waters

A new government cabinet elected in Georgia in 2012 has changed Georgia's stance towards Russia and achieved the repeal of the embargo. This was immediately reflected on the exports. Already in 2014 exports to Russia reached 9.6 percent of the total and brought the highest ever annual wine export income for Georgia. The wines and mineral waters have quickly regained their leading positions

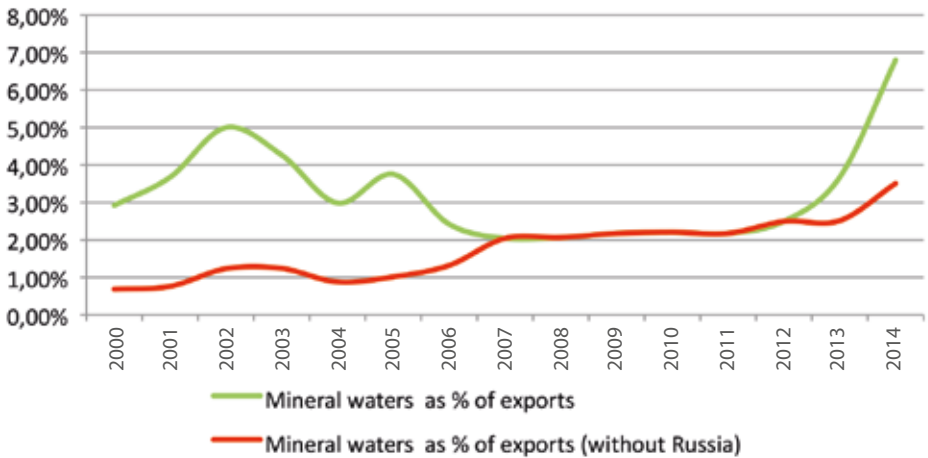
as main exports to Russia. However, it needs to be stressed that the importance of Russian market for these sectors of the Georgian economy is not as high as it used to be.

The share of wine products in total Georgian export is on average up to 7 percent only. Due to the embargo the overall quality of Georgian wines have increased significantly and have more capacity to penetrate other markets,

Chart 4 and 5. Percentage shares of wine and mineral water exports with and without Russian market.



Source: National Statistics Office of Georgia



Source: National Statistics Office of Georgia

meeting stricter quality controls (The Financial, Oct 2014). Georgian mineral water producers have also started to target markets other than Russian. Today, without Russian market, Geor-

gian wine exports are pretty much stable at around 2.5 percent. The mineral water exports have demonstrated more steady increase independently from Russian market.

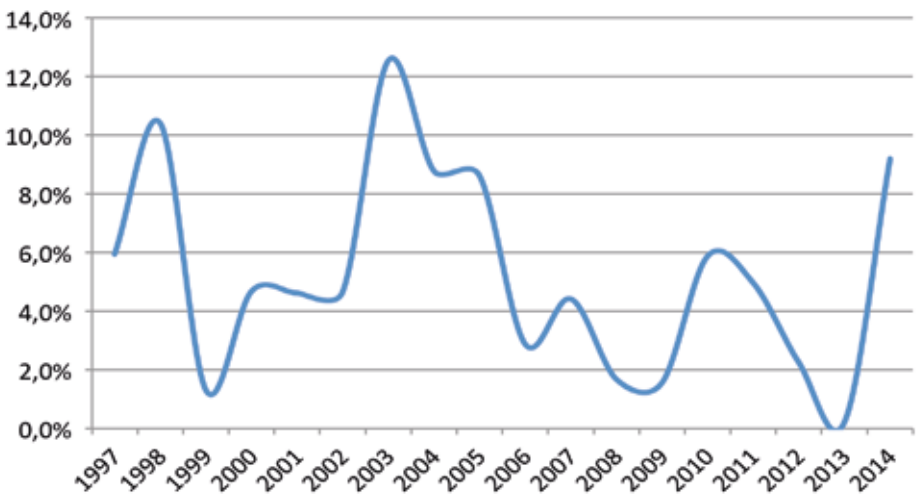
Foreign Direct Investments

Unlike the bilateral trade, Russian direct investments in Georgia did not have any pronounced trend, instead – a number of ups and downs throughout the years. The only notable feature of these series is a jump from 0.2 percent in 2013 to 9.2 percent in the first half of 2014. In this period of time investments were made in processing industry, transport and communications, and financial sector. Similarly large-scale investments were made back in 2003, when INTER RAO UES entered Georgia.⁹

From 2009 onwards,¹⁰ the largest Russian investments – 95.1 million US dollars –

were made in transport and communications sector, presumably mostly due to the Beeline mobile operator entering Georgian market. It is followed by investments in the financial sector – 40.8 million US dollars, presumably invested by the VTB Bank. And lastly, almost 33 million US dollars have been invested in the food processing in the first three quarters of 2014. Investment in other sectors has been relatively modest, not exceeding 5 million US dollars. On the whole, Russia contributed an insignificant 3.42 percent of FDI to Georgia since 2007. It has to be emphasized, that despite the 2006 embargo, Georgia remained open to Russia and Russian investors.

Chart 6. Share of Russian Direct Investments in Georgia



Source: National Statistics Office of Georgia

Given the financial sanctions against large Russian companies, its corporate sector may resort to developing and emerging markets in search of yield. Considering that Georgia is not likely to join these sanctions (at least that is the signal sent by the respective government agencies so far), there might be an increase of Russian direct investments in Georgia in the coming year. The magnitude of the increase will depend both on economic activity in Georgia and the willingness of Russian corporations to diversify their portfolio to include relatively small-sized markets.

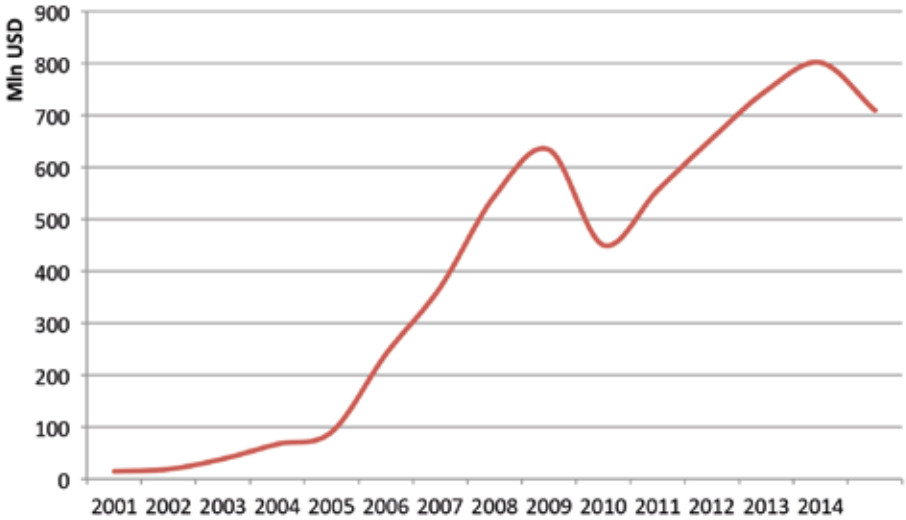
Remittances

For Georgia Russia is an extremely important source of remittances, with total amount of capital inflows through this channel reaching staggering 5.936 billion US dollars since the 2000. This corresponds to 54.3 percent of total remittances during that period. Given that the share of remittances from Russia has fluctuated between 47 and 60 percent, one can easily see how important Russia is as this particular source of income. Apart from an understandable drop in remittances in the post-crisis period and taking into account a pronounced seasonality in transfers, overall the trend is definitely increasing, despite the decline in Russia's economic growth rates compared to the early 2000s. Remittances from Russia will most likely remain hugely important for a large part of the population in the

years to come, and while not the single most important source of foreign currency inflows in Georgia, the importance of these flows cannot be underestimated.

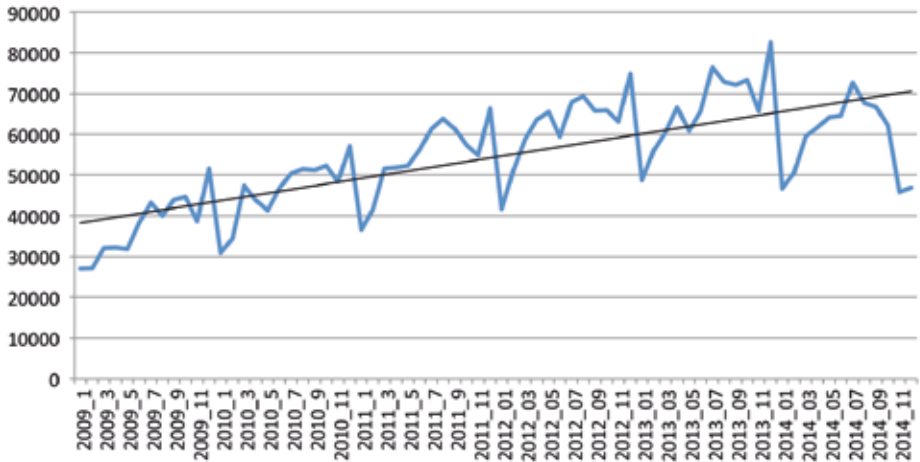
Despite the large-scale deportation of Georgians from Russia in 2006, the overall number of expulsion orders (around 4,600) and subsequent deportations (around 2,300) was negligible compared to the total Georgian diaspora in Russia (around 1 million by different estimates) and thus, could not have had any significant impact on the remittances. As the latest wave of recession started, Russian authorities once again increased pressure on migrant workers by introducing new regulations and exams for those willing to stay and work in Russia legally. Representatives of migrant associations believe that together with the devaluation of the ruble, stricter and more expensive regulations will encourage many migrants to leave. They estimate that between 25 to 50 percent of immigrant workers will leave starting from January 2015 (The Interpreter, Dec 2014; Business Insider, Dec 2014). This mostly concerns to workers from Central Asian countries, but certain share of Georgian immigrants will also face more difficulties. Because there is no data on how many immigrant Georgians are already Russian citizens or have a permanent residence or work, and how many struggle with the immigration system to stay, it is hard to estimate the scale of the impact on Georgian diaspora.

Chart 7. Remittances sent from Russia to Georgia annually



Source: National Bank of Georgia

Chart 8. Monthly Remittances sent from Russia to Georgia since 2009



Source: National Bank of Georgia

In January 2015, Georgia received 23.3 percent less remittances compared to the same period in 2014. Unsurprisingly, the most

significant decline was visible in the inflows from Russia – from 46.7 million to 25.8 million US dollars in a month, which is a 44.7 percent

decline. And this drop does not account for the money transferred through informal means. Furthermore, in fall 2014 transfers from Georgia to Russia were significantly higher compared to the same period or any other month in the past years – if the average monthly transfer from Georgia in the first three quarters of 2014 was 5 million US dollars, in the last quarter it varied between 6 to 9 million US dollars.

These trends were reflected on the exchange rate of Georgian lari in the past months. Until the end of November 2014, lari was quite steadily fluctuating around 1.75 against the US dollar, but in the last three months (December-January-February) it lost 30 percent of its value against the dollar. Of course, only external factors, let alone Russia, could not cause the whole extent of depreciation. But it is certain that the drop in foreign currency remittances exacerbated the downward pressure on GEL/USD exchange rate caused by the weakened domestic economy, growing imports (particularly in November and December), and shrinking exports (y-o-y exports growth has been negative for the last six months of 2014).

Remittances from Russia represent an extremely important factor in keeping the inflows and outflows of US dollars in balance. Any disruption in this balance may and will become a significant short- and possibly medium-term problem for Georgia's current account balance.

TOURISM

Georgia was and is a popular tourist destination among the residents of Russian Federation. In 2014 14.7 percent of all visitors to Georgia came from Russia. Compared to the same period in 2014, in January 2015 there was roughly 7 percent decline in the number of visitors. Even though Russia still maintains the 4th place among top 15 visiting nations, a clear declining trend is evident. Given that overall drop in visitors compared to Jan 2014 was 3 percent, decline in Russian visitors is more than double of the average and almost twofold of the broadly discussed drop in Iraqi or Iranian visitors.¹¹

It is broadly believed, that Russia will not be able to get out of this recession quickly. Hence, the downward trend of visitors from Russia is expected to continue and most probably drop more significantly. Given that tourism is estimated to contribute about 6 percent to the Georgian GDP, reaching 1.4 billion US dollars of revenue in the first three quarters of 2014, on average 3 to 5 percent drop in the number of visitors equals roughly 5 to 8 million US dollar loss on monthly basis. This is going to be another negative factor influencing Georgia's current account balance, especially in summer months.

ENERGY POLICY

Fossil fuels were the leading contributor to Russia's GDP growth starting from the early

2000s. However, there are grounded fears and forecasts that oil and gas revenues will not be able to push the economy for much longer (ERI RAS, 2014). The long-term and 'inherent' structural problems and technological backwardness of the sector was exacerbated by the sanctions imposed over the Ukraine/Crimea crisis and the drop in the price of oil.

The way Russia has been managing its energy sector for the last two-three decades is extremely inefficient. The huge state subsidies allocated to the sector and a lack of transparency has been a heavy load for the economy. According to the International Energy Agency (IEA), the total implied subsidies for Russian consumers for fossil-fuel consumption equaled 46.2 billion US dollars in 2012 (that is 2.3 percent of the GDP). At the same time, according to the WWF-Russia and the International Institute for Sustainable Development research (IISD, 2012), the number of direct and indirect state policies are subsidizing and lowering the costs of the energy sector producers. These policies, inter alia, include (earth track, Apr 2012):

- Increasing large subsidies to Arctic oil and gas production;
- Government loans and loan guarantees (often for billions of dollars) at below market rates;
- Lax enforcement of environmental regulations;

- Property tax exemptions and below-market tariffs for pipelines;
- Tax evasion through the use of transfer pricing;
- Special terms in production sharing agreements and widespread municipal tax breaks for, and ownership of, energy-related enterprises.

According to the Global and Russian Energy Outlook to 2040, published by the Energy Research Institute of the Russian Academy of Sciences and the Analytical Centre of the Government of Russia, "the contribution of the energy sector to Russian GDP will decrease by nearly 50 percent over the coming decades" (energy post, Jul 2014). The reasons cited by the authors (in different scenarios) include: shift in the energy demand from Europe and developed Asia to developing Asia (China, India, South East Asia) as well as Middle East and Africa – thus changing the export market for Russian suppliers; changing demand in Europe itself, which, given the current political situation, will try to diversify away from Russian sources; Emergence of new and expansion of current producers in oil (Iran, Iraq, Brazil) and gas (Iran, Qatar, Turkmenistan, and recently discovered fields in East Africa), causing drop in oil and gas prices and pushing out Russian supplies, shrinking its market niche.

Increasing profitability of hydraulic fracturing or fracking – a process used for the extraction of low-permeability resources, a

shale gas or a tight oil, is another challenge for Russia's energy sector. At the moment, around quarter of Russia's oil comes from the low-permeability reserves, with the use of fracking technology and US made pumps. However, in September 2014, "the United States and European Union imposed sanctions on leading Russian energy companies, including Rosneft and LuKoil, preventing U.S. and EU firms from supporting their exploration or production activities in deep water, Arctic offshore or shale projects" (The Moscow Times, Sept 2014). Given that Russia has never invested in developing needed technologically on its own, the extraction of hard-to-extract gas or oil will become a challenge. Considering the declining trend of oil price and the edge to Russia's competitors, extraction of shale gas and/or tight oil will not be profitable for some time. Sanctions alone could cost around fifth of Russia's oil production.

To counter the sanctions, Russia started to look for alternatives in China and Turkey. In May 2014 Russia and China signed a huge deal on gas export, envisioning the supply of 38 billion cubic meters of natural gas annually for 38 years. This deal is worth 400 billion US dollars and is going to be realized through the Power of Siberia pipeline, to be completed by 2019. In November 2014 another contract was signed, under which Russia will provide China with 30 billion cubic meters per annum through Altai pipeline.

The later connects western Siberia and China (Bloomberg, Nov 2014). Despite the scale and the bravado with which these agreements were signed, they are viewed rather skeptically around the globe. First of all, it is going to take at least 4-5 years to complete the construction of the needed pipelines. Large scale projects like this are very costly and are rarely implemented according to the schedule. Furthermore, the price of gas in the first contract is tied to the oil price, which has dropped from 109 in May to 49.60 US dollars by the end of January, significantly reducing the original contract value as a result.¹²

Moscow's another favorite – South Stream Project, an offshore gas pipeline to connect Russia to the southern Europe through the Black Sea (bypassing Ukraine route), was officially cancelled in December 2014, after almost 2 years of works (Financial Times, Dec 2014). South Stream was a controversial project in many ways, but increased construction costs due to financial sanctions on Russian banks and Gazprom are believed to be the reason of the final decision. Instead, Russia announced a new deal with Turkey according to which Russia will deliver its natural gas to Turkey, thus, growing Ankara's role as a regional gas hub. At the same time, Russia will cut the price for Turkish consumers by 6 percent and increase the volume. In a given situation, Russia-Turkey deal is probably a win-win

for both sides, however, compared to the initial strategic scale of the South Stream, the later project is a clearly losing game for Russia. For Turkey, on the other hand, this is an undeniably beneficial move, which clearly signals the Realpolitik embraced by Turkish leadership. This should be a strong signal for Georgian foreign policy decision-makers too.

Link to Georgia's Energy Sector

One of the cornerstones of Russia's 'energy empire' was the monopoly on supplying European markets with not only Russian, but Caspian and Central Asian energy resources. That is why Moscow strongly opposed the development of an alternative transit route for the Caspian, and potentially Central Asian, oil and natural gas through the Caucasus (Erdemir, H., 2009). Nevertheless, both Baku-Supsa and Baku-Tbilisi-Ceyhan oil pipelines and Baku-Tbilisi-Erzurum gas pipelines became reality in the past two decades. Although, Moscow was rather successful in bringing down the Nabucco project, envisioned as an extension of the Baku-Tbilisi-Erzurum line to the west till the Central Europe and to the east through Caspian Sea to Turkmenistan.

Despite the failure of the Nabucco project, Georgia's role as another transit hub is already recognized, not only for the energy resources, but for other types of cargos, as a part of the Silk Road east-west corridor.

Recently, Russia's largest state-owned oil company – Rosneft has expressed interest in Georgia's transit capacities and purchased a 49 percent of the Petrocas Energy Group in December 2014 (Rosneft, 2014). It is too early to judge whether this is just an attempt of a publicly traded company to diversify its portfolio and invest in developing markets (see the Foreign Direct Investment chapter of this report), or an attempt to invest in a strategic field of the country considered as a backyard of Russian empire. Petrocas owns the oil retail and logistics chain in Georgia, Armenia, and Azerbaijan, but more importantly, it is a co-owner of the Poti oil terminal. Petrocas and Rosneft plan to transport oil products to Armenia via Georgia (Agenda.ge, Mar 2014), and have ambitious plans for increasing cargo transit through Georgia (Agenda.ge, Feb 2015).

Despite the far-reaching goals, Rosneft is an uneasy investor, not only because it is sanctioned by the US and the European Union and because its controlling package (more than 69 percent) is owned by the Russian state, but also because it is violating Georgia's law on the occupied territories. In 2009 Rosneft signed an agreement with the de-facto Abkhazian authorities which gave the company the right to explore Abkhazia's Black Sea coast for oil and natural gas (RFE/RL, Dec 2009), the actions are illegal according to Georgian legislation.

RUSSIAN EXPANSIONIST POLITICS AND POSSIBLE RISKS FOR GEORGIA

Even though Russian attention is mostly diverted towards Ukraine and its EU/NATO aspirations, Georgia cannot be considered “safe” either. In fact, no country in the so called ‘Russian sphere of influence’ can feel secure from both, Moscow’s military and territorial expansionism and from the side-effects of its economic recession and possibly upcoming internal political turmoil. Russian officials continue voicing threatening messages with regard to Georgia’s foreign policy course (Agenda.ge, Feb 2019). Despite Tbilisi’s conciliatory rhetoric (Civil.ge, Feb 2019), it is hard to predict how long this fragile balance will last and what exactly can trigger an aggression from Russian side.

Russia has opened markets for Georgian products and is participating in diplomatic talks with Georgia in different formats (Geneva talks, Prague meetings between Zurab Abashidze and Grigory Karasin), meanwhile it is reinforcing hostile activities in Georgia’s occupied territories. Russian forces remain in Samachablo and with their silent consent the de-facto government has been moving the border deeper in the Georgian territory (Human Rights in Georgia, Sept 2013). Prior to the Sochi Olympics, Russia itself moved the state border 11 kilometers into the breakaway Abkhazia territory, as a part of a broader

security zone around Sochi (Civil.ge, Jan 2014). The far-reaching plans of Russia were confirmed in November 2014, when an agreement was signed between the runaway region and Russia. The agreement ratified by the Duma on January 23, 2014, places the military forces in the region under the joint command and sanctions the joint patrolling of the border (The Guardian, Nov 2014). The treaty effectively annexes the Abkhazia region and hence, makes it even harder to normalize relations between Georgia and Russia. Samachablo region (aka South Ossetia) intends to sign a similar agreement with Russia in February (Ministry of Foreign Affairs of Russia, Jan 2015). According to de-facto South Ossetian President Leonid Tibilov, the Ossetian side has sent a draft treaty on alliance and integration to Russia (The Georgian Times, Feb 2015).

At the same time, Russia is interested in increasing and improving the transport routes to Georgia. Moscow has been pushing the revival of Abkhazia railway for years now and, recently announced a new transport project – the Dagestan-Kakheti highway. Interestingly, the construction of the highway connecting Russia to Georgia started without the prior discussions and agreement reached with official Tbilisi. It has to be also stressed, that the project of rebuilding this road surfaced in the beginning of 2008 too (Vatchagaev, M., Oct 2014). In Georgia, however, the

reactions varied from negative and suspicious to almost welcoming (Georgia Today, Oct 2014). In case of increased hostility between the two countries, this highway, unlike the existing connecting routes, is not passing through the breakaway territory (Psou highway, Roki tunnel) and is not closed for a significant time every year due to the weather conditions. Hence, it is rather logical to assume that it might be used for transporting both - Dagestani goods and military equipment.

Overall, the situation in the region is far from placid. The ongoing military confrontation between Russia and Ukraine represents a threat to the peace and to economic growth in the region as a whole. Increasing alienation of the two major powers in the region – Russia and Turkey – from the western values and international community also contains long-term risks for the region. The two are transforming into natural allies (Balci, B., Feb 2015).

CONCLUSIONS AND RECOMMENDATIONS

Economic recession and possible political turmoil will not end quickly. It is expected to last more than a year and will affect Georgia and other countries in the region in many ways. Although another embargo from Moscow is not anticipated at this stage of Russo-Georgian bilateral relations,

it is believed that Georgian wine and mineral water exporters are much better prepared for such a scenario. Today, both wine and mineral water exports are more diversified and of a better quality. This does not apply to Georgian fruit and herb exports though.

Long-term recession in Russian economy will have much broader impact on Georgia, than a feared ban on certain products. Recession leads to drop in trade, especially Georgian exports, remittances, and tourism. All three directly correlated with Georgia's account balance and hence, to exchange rate of lari. Compared to last year, Georgia's trade turnover with Russia is down by 62 percent, remittances from Russia were down by 45 percent in January, and number of visitors – by 7 percent. Furthermore, Russian recession has a domino effect in the region. Aside from Ukraine, where Georgia's trade turnout is down by 77 percent compared to January 2014, crisis strongly influences consumers and investors in Central Asian countries, Armenia, Azerbaijan, and even Turkey.

Therefore, in the short and medium-term:

- Georgian business and the state should prepare for declining trade with Russia and other major partner countries in the region; hence, both relevant state institutions and

- private companies should pay more attention to and take full advantage of the opportunities created by the free trade agreement with the European Union.
- Declining trade, touristic flows and remittances should be expected not only from Russia and Ukraine, but from other neighbouring countries as well, which will have a lasting effect of the exchange rate of Georgian lari.
- Although Russia was never a major source of direct investments in Georgia, current sanctions and recession may motivate both large Russian companies and small businesses (as it happened in case of Ukraine) to either diversify their portfolio and invest in Georgia or completely relocate their operations to Georgia. Whereas small and medium size Russian business would be very welcome in Georgia, investments by large, and often state-owned, Russian companies should be scrutinized more carefully.
- The military confrontation between Russia and Ukraine increased political risks in the region. Despite mostly positive outlook at the moment, there is a possibility of increase in the risk-premium for Georgia and drop in its investment ratings.
- EU/NATO accession process became even more important in the light of the conflict. Georgia should maintain its foreign policy course and further accelerate the process, as this is the cornerstone for not just long-term security and political values, but for badly needed economic growth and political survival in the immediate future. At the same, it should be well-understood in Tbilisi, that the outcomes of the Ukrainian crisis will be reflected on the public and political mood here in Georgia as well as in the European capitals.
- Strained relations between EU and Moscow, and sanctions imposed on Russia may change the oil/gas flows between the east and west in a matter of few years. It will take at least four-five years until Russia's new strategic outlook (China and Turkey) are realized, meanwhile Georgia may take an advantage to increase transit through its territory. A joint public-private strategy highlighting possible development of energy projects in the short and medium term would be an important document, helping both government and business sector in discovering opportunities and setting their priorities in this respect.

FOOTNOTES

1 With the 10 percent share in Georgia's total exports, Russia is sharing the title of the second top export destination country with Armenia.

2 Thrust towards the west (German).

3 Some countries, like Serbia – a long-time partner of Russia, and Turkey – an important trade partner, declined to join the sanctions.

4 Other estimates indicate more optimistic 125 billion US dollars (<http://daily.rbc.ru/photoreport/29/12/2014/549df5479a794792e5567938/9.shtml>)

5 Given the outflows for 2014 (above) this forecast may even seem a tad optimistic.

6 CPI inflation in 2014

7 A mobile theater ballistic missile system produced and deployed by the Russian Federation (http://en.wikipedia.org/wiki/9K720_Iskander).

8 A long-running high-circulation daily broadsheet newspaper in Russia.

9 In 2003 INTER RAO UES purchased 75 percent of electricity distribution company "Tbilisi Electric Grid", briefly "Telasi" (total capital - 112 429 418 GEL). At the same time, INTER RAO UES invested in three generating companies (MtkvariEnergy, Khrami I, and Khrami II), although the total amount of investment is not known, since GeoStat does not publish the FDI breakdown by country and sector.

10 The detailed breakdown of FDI by countries and sectors is not available before 2009.

11 New regulations for foreign citizens traveling to Georgia were introduced in September 2014. However, for Iranian citizens, Georgia unilaterally abolished visa free regime in July 2013.

12 The precise formula of the gas price, which is tied to "an oil basket" (<http://www.gazprom.ru/press/news/2014/may/article191417/>) is unknown, but the costs of the oil price drop in any case will be significant

ABOUT EPRC & GEORGIA AND THE NEIGHBORS

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GEORGIA & RUSSIA IN 2014

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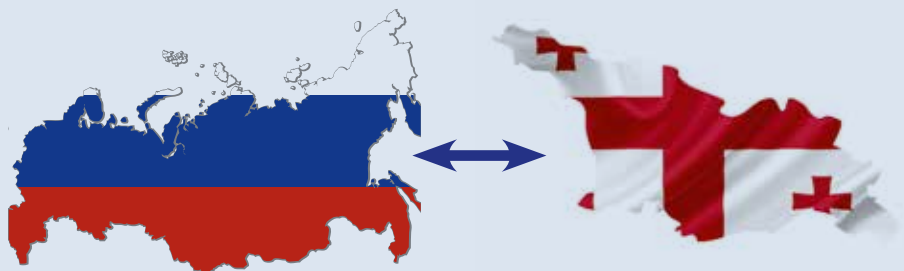
REMITTANCES
FROM RUSSIA
AMOUNTED TO 709
MILLION USD

810,233

810,233 VISITORS
ENTERED GEORGIA
FROM RUSSIA

\$66mIn

FOREIGN DIRECT
INVESTMENTS FROM
RUSSIA WERE 66
MILLION USD



\$275mIn

EXPORT TO RUSSIA AMOUNTED TO
275 MILLION USD

\$577mIn

IMPORT FROM RUSSIA WAS
577 MILLION USD.



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