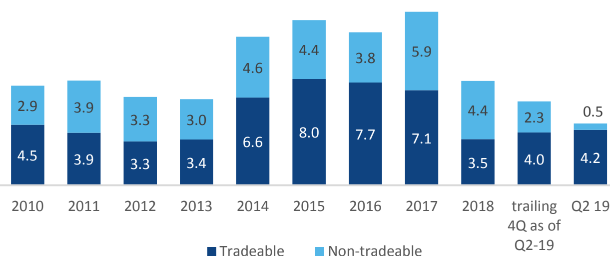
FDIs down, but external balance reasonably strong

FDI inflows by components

mln USD	Q1-18	Q2-18	Q3-18	Q4-18	Q1-19	Q2-19
Total	**324**	**404**	**367**	**171**	**286**	**187**
of which:						
Equity	141	283	215	164	78	133
Reinvestments	185	104	125	24	106	55
Debt	(2)	17	27	(17)	102	(1)

Source: Geostat

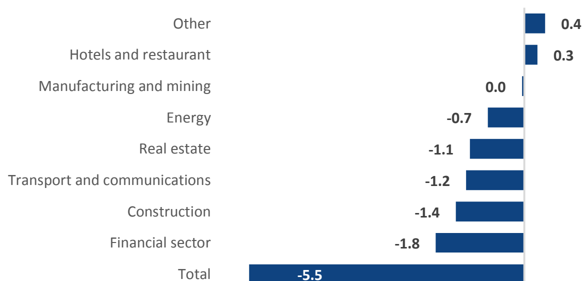
FDI inflows by tradeable and non-tradeable* sectors
(% of GDP)



Source: Geostat, TBC Research estimates

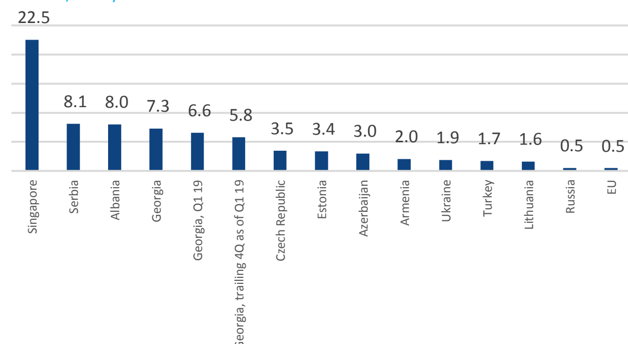
**Tradeable sector includes: agriculture, manufacturing, mining, energy, hotels and restaurants, Transport and communications. Non-tradeable sector includes construction, healthcare, real estate, Financial sector and other services*

FDI inflows
(YoY, % of GDP, trailing 4Q as of Q2 19)



Source: Geostat

Net FDI inflows
(% of GDP, 2018)



Source: World Bank, the NBG

FDI's down but still at 4.7% of GDP in Q2 2019

FDI inflows were down by 53.7% YoY in Q2 2019 and came in at 4.6% of GDP as compared to 9.7% a year ago – a somewhat higher than expected reduction.

In terms of the sectors, over the last four quarters ending in Q2 19 the drop was mostly on the account of the financials (-283mln or -1.8% of GDP), construction (-220 mln USD or -1.4% of GDP) and transport and communication (-185 mln USD or -1.2% of GDP). Over the same period, FDI inflows also weakened in real estate and energy sectors, while remained relatively stable in manufacturing and mining and went up in hotels and restaurants.

Lower FDIs in financial, especially in non-bank, and real estate sectors are likely caused by the tighter retail lending as well as construction permits' regulations. While the decline of FDIs in the construction is assessed as negative development, FDI outflows related to the subprime lending primarily in non-bank financial institutions, should be seen as a necessary by-product of the stronger responsible lending rules, including the 50% ceiling on interest rates, being in our view a positive development. At the same time, FDIs in the construction will likely recover reflecting strong fundamentals of the housing market (see TBC Economic Review: Insight #8 and TBC Capital housing market assessments). This view is also supported by the recently increased construction permits and recovering growth dynamics in residential construction in July as well as by possible strengthening of slower mortgage financing together with some contribution of internal installments (see note on GDP growth).

The finalization of BP's South Caucasus Pipeline Extension project* still affects the annual growth rates negatively as reflected in lower FDIs in transport sector, however, its impact is waning.

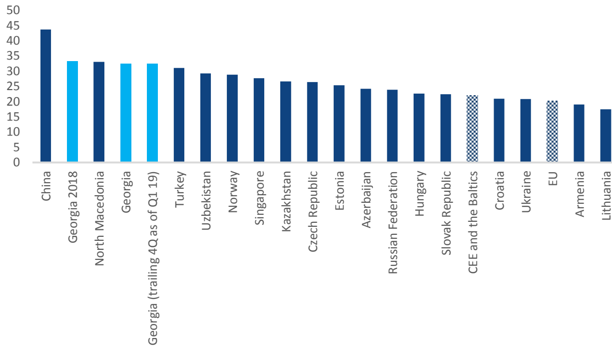
Breakdown of FDIs by tradeable/non-tradeable sectors indicate that the non-tradeable sector was the main driver of the reduction (construction, financial sector). At the same time, FDIs in tradeable sector remained more stable and comparable to the levels seen before the BP's large scale project started in 2014.

Based on the Q2 FDI data, we re-estimate our latest projection of around 20% decline of FDIs (see July monthly update) for the FY 2019 in USD terms to around 30%. Taking into account base effects, still significant drop is expected in Q3 2019 before recovering in the last quarter of the year.

Overall, FDI inflows at around 5-6% of GDP, excluding large scale projects, are broadly comparable to the levels in 2010-13, being still strong from the international perspective. At the same time, when the large scale projects like Anaklia Deep Sea Port and hydropower investments including Namakhvani and Nenskra HPPs are in a more active phase, FDIs will well exceed 5-6% of GDP.

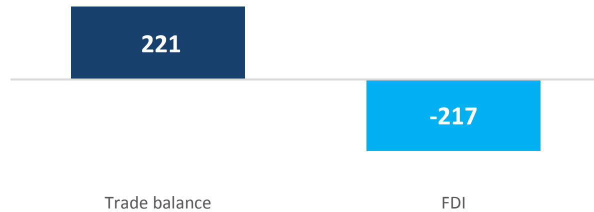
**According to BP, the project's total cost was around 2 billion USD with approximately 80% import component.*

Gross capital formation
(2017, % of GDP)



Source: World Bank, Geostat

YoY change of trade balance* and FDI in Q2 2019
(mln USD)



**Q2 BoP based trade in goods balance data will be available by the end of September likely with even stronger improvement in balance of trade in goods.*

Source: Geostat

Despite lower FDIs, gross fixed capital formation is strong

Despite the reduction of FDIs, the level of the gross capital formation remains strong supported by higher domestic savings (see note on Q1 GDP growth) and strong business lending. Also, shift of public expenditure towards the capital spending (see note on fiscal) keeps the investments strong.

From the trend growth perspective, even with FDI inflows at 5-6% of GDP, we still think Georgia's potential growth rate is around 5%. The latest, April 2019 IMF's trend growth assessment equaled to 5.2% (see note on WEO April 19 projections).

Trade balance improvement offsetting lower FDIs

The decline of FDIs in Q2 2019 was fully offset by the improved balance of trade in goods. At the same time, recently released Geostat/GNTA survey results indicate higher per visitor spending in Q2 2019 YoY, possibly leading to the adjustment of tourism inflows' figures for Q2 2019*. Correspondingly, estimated drop of inflows in July may also be revised upwards. In addition, recently released weakly data indicates a sizeable improvement in tourism growth (see note on tourism).

These factors, taken together with the continued growth of remittances and favorable financing conditions internationally, enables to argue that the external balance is reasonably strong. Therefore, also taking into account strong inflation pressures, we stick to our view that the GEL is heavily undervalued (see note on the GEL, inflation and the policy rate).

**Estimates of tourism inflows were revised downwards previously by the NBG citing the weaker GEL and less per visitor spending in USD terms as reasons for the adjustment. This also has contributed to an estimated 58 mln USD YoY reduction of tourism inflows in July being itself offset by improved trade balance over the same month (+83 mln USD).*

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