Trade shocks and possible remedies: Georgian experience and lessons learned

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Structure

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2. Assessment of the impact of the trade shock
3. Policy measures undertaken by the Georgian authorities to reduce the impact of the trade shock
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1. Georgia‘s trade shock of 2005/2006

- Following the so-called “Rose Revolution” and Georgia’s westward orientation, Russia and Georgia experienced increasing tensions in their bilateral relations
- Starting in 2005 Russia undertook a number of measures to put pressure onto the Georgian government, including:
  - Trade restrictions for Georgia’s main export products to Russia
  - Blockage of transport links between Georgia and Russia
  - A sharp increase in the price of Russian gas to Georgia
  - Limiting visas for Georgian nationals working in Russia
- In this policy briefing, we focus on the impact the Russian measures had on exports of Georgia to Russia
- Thus, we deal with the “trade shock” Georgia experienced in 2005/2006

Chronology of the trade shock

Date	Event
December 2005	Russia bans imports of agricultural products from Georgia
January 2006	Sharp increase in the price of Russian gas to Georgia
March 2006	Russia bans imports of Georgian wine, wine products, brandy and champagne
May 2006	Russia bans imports of Georgian mineral water
October 2006	Russia suspends road, rail, air and water transport links to Georgia
October 2006	Russia stops issuing entry visas to Georgian citizens
January 2007	Another sharp increase in the price of Russian gas to Georgia

Source: Tbilisi State University 2007

Objective and research questions

- In this policy briefing we focus on the trade shock experienced by Georgia and its implication for Georgian exports and the economy

Questions:

- How did the Russian trade ban affect the Georgian economy?
- How long did it take to redirect and recover lost exports?
- Which instruments were used to mitigate the negative impact?
- What are the lessons for other countries (potentially) affected by similar trade shocks?

2. Assessment of the impact of the trade shock

What was the magnitude of the trade shock?

2005:

- Georgia's exports to Russia before the trade shock:
  - Total value: USD 153 m
  - 18% of total exports
  - 2.4% of GDP

2007:

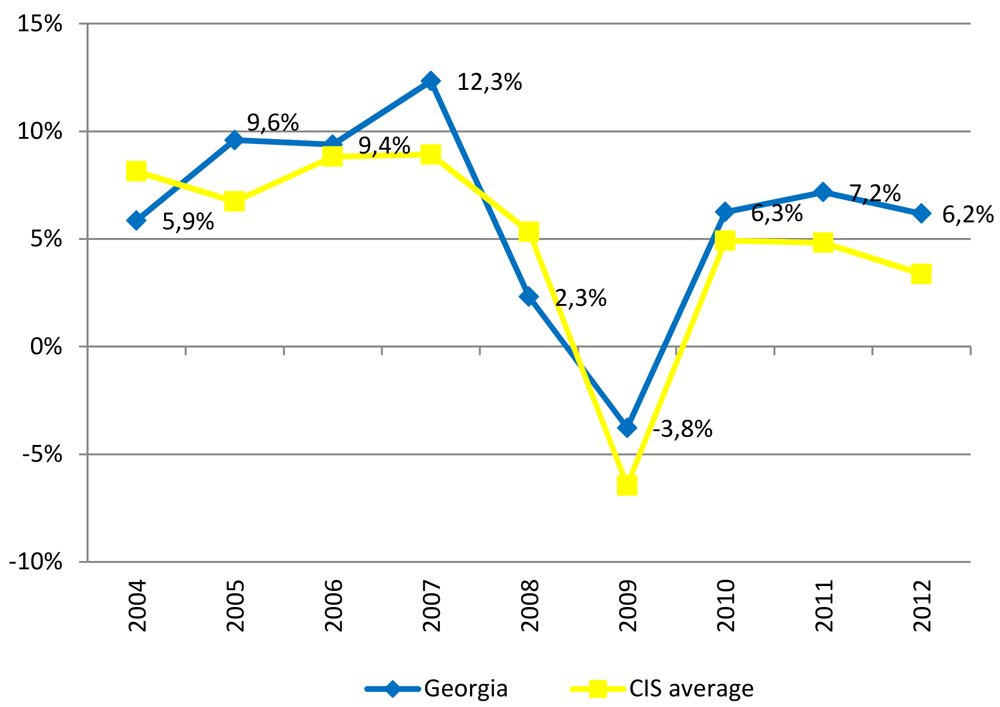
- Georgia's exports to Russia after the trade shock
  - Total value: USD 45 m
  - 4% of total exports
  - 0.4% of GDP

➢ Within two years Georgia lost exports worth 2.0% of GDP

Question: What were the implications for aggregate exports and for GDP?

Impact on Georgia's economic performance

Real GDP annual change, in %



Source: IMF WEO, Georgia Office for National Statistics

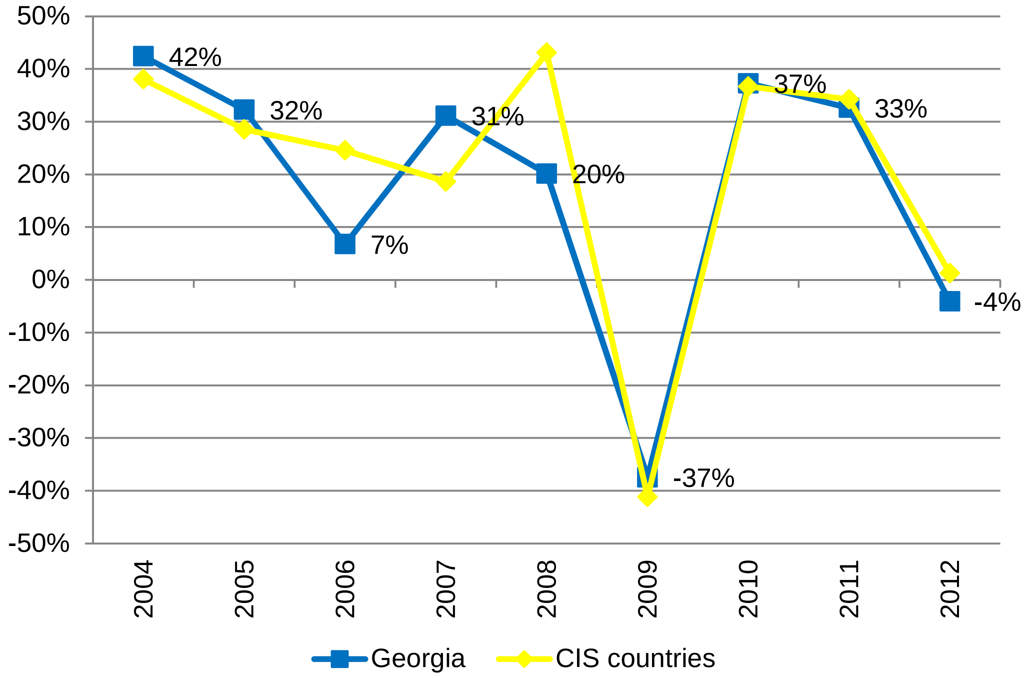
- GDP growth did hardly slow following the trade shock
- Indeed, annual real GDP growth reached 9.4% in 2006 and even accelerated to 12.3% in 2007
- Agriculture was the only sector which experienced an output decline, with output falling by12% yoy in 2006
- Indeed, Georgia outperformed regional neighbours consistently apart from 2008

<u>Conclusion</u>

- The trade shock did not noticeably affect economic growth, as measured by GDP

Impact on export growth

Exports annual change, in %



Source: IMF WEO, Georgia Office for National Statistics

- Exports growth did slow in 2006
- However, this slowdown was only temporary
- Georgia's exports recovered quickly in 2007 increasing by 31%
- Georgia's export performance has been in line with its regional counterparts over the last couple of years

<u>Conclusion</u>

- Despite the importance of the Russian market for exports, the trade shock did not lastingly affect Georgia's export performance

Summary of the quantitative assessment

- Russia was an important trade partner before trade shock occurred
- Exports to Russia amounted to 2.4% of GDP and 18% of all exports in 2005
- Russian measures led to a 70% decline in Georgian exports to Russia
- Despite this considerable magnitude of the shock, there was no significant impact on GDP or export performance
- The Georgian economy absorbed the trade shock quickly and well

Question:

- Why did the trade shock not have an overall negative impact, as anticipated by many observers?

3. Measures undertaken to reduce the negative impact

The reasons for the low impact of the trade shock were threefold:

i. Sound macro-economic policy and intensive cooperation with international partners provided **macro-economic stability**

ii. Successful implementation of **economic reforms** before and after the trade shock boosted growth

iii. Government undertook **measures to promote and diversify trade**

i. Macro-economic stability and cooperation with international partners

- Fiscal Policy
  - Only moderate budget deficit of 2.2% of GDP in 2005 before trade shock
  - Thus, some room for fiscal stimulus and/or to absorb lower revenues
- Monetary Policy
  - Flexible exchange rate policy helped to absorb shock
  - Central bank could support exporters with Lari depreciation
- IMF support
  - Since 2004 Georgia had a three year USD 144 m IMF loan in place
  - Reviews on track, so in March 2007 another USD 21 m tranche disbursed
- EU support
  - 2007-2010: USD 120 m support through European Neighbourhood Policy instruments

Conclusion: Sound macro-economic policy key to absorb shock

ii. Economic reforms programme

- The trade shock hit Georgia at a time when the economy already had started to reap the benefits of an ambitious economic reform programme, consisting of (among others):
  - **Tax reform** which reduced the number of taxes from 21 to 6
  - **Customs reform** which greatly reduced tariff and non-tariff trade barriers
  - **Administrative burden**: Number of licenses and permits reduced by 90%
  - **Justice reform**: Reduced corruption and improved contract enforcement

- Result: In the 2013 “Doing Business Report” Georgia achieved rank 8 – a huge improvement compared to rank 137 in 2004 before the reforms

Conclusion: An ambitious economic reform programme contributed to substantial FDI inflows and to strong economic growth, thus mitigating the effects of the trade shock

iii. Trade promotion and diversification

- Before and after the trade shock the Georgian government – with help of its international partners – undertook increased efforts to promote and redirect trade
- Free trade agreements
  - 2006: GSP+ trade preferences extended by EU which abolished most import tariffs for Georgian products exported to the EU
  - 2008: Georgia – Turkey Free Trade Agreement
  - Since 2010 DCFTA with the EU negotiated
- Trade promotion and facilitation
  - Aforementioned customs reform abolished import tariffs for 86% of products (compared to only 25% in 2005)
  - Several technical assistance projects aimed at promoting trade

4. Lessons learned

Important lessons can be drawn from the Georgian experience in 2005/2006:

- Trade shocks will inevitably hurt some sectors of the economy, such as agriculture and the beverages industry in Georgia
- However, good economic policy and an appropriate reaction to the trade shock can considerably help to absorb the trade shock and to limit the overall negative impact of the trade shock
- Three aspects are here of crucial importance:
  - Macro-economic stability
  - Economic reforms
  - Active trade policy

Implications for Ukraine

- Ukraine has been confronted with threats of trade sanctions from Russia, in case of signing the association agreement with the EU that includes creation of DCFTA
- In many ways, the situation is similar to that experienced by Georgia in 2005/2006:
  - In both cases, the share of exports to Russia in total exports is significant, but not dominant (18% in the case of Georgia and 25% in for Ukraine)
  - The magnitude of the trade shock in Georgia amounted to 2.0% of GDP, while the corresponding magnitude of the shock in the case of Ukraine would amount to 1.7% of GDP (see our policy briefing PB/04/2013), assuming the shock consists of a change in the trade regime of Russia vis-à-vis Ukraine
- Thus: Georgian experience suggests that, while some sectors of the Ukrainian economy would suffer from a Russian trade shock, the implications for overall exports and for GDP are manageable, provided Ukraine implements an appropriate policy, as was the case in Georgia
- Consequently, Georgian experience supports our view that threats of Russian trade sanctions are no reason for not signing an AA with the EU

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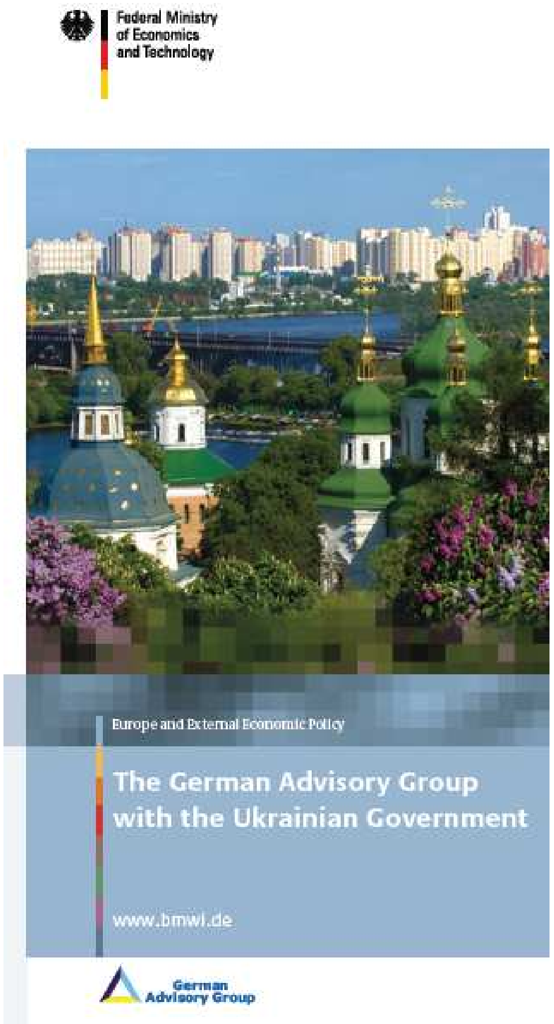


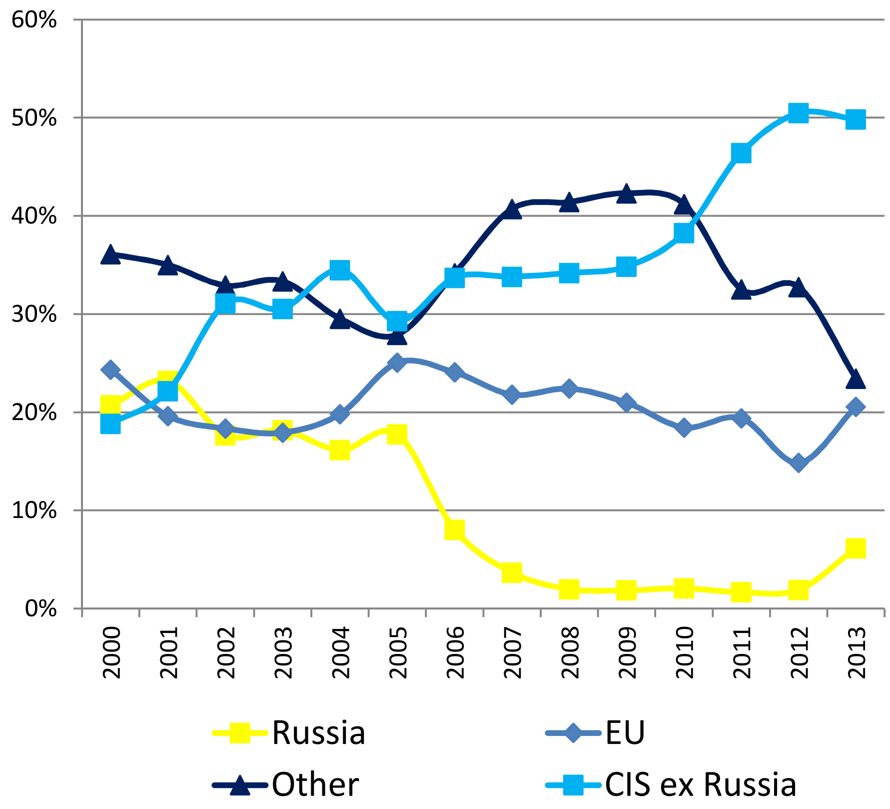
Appendix

Content:

i. Relative importance of Georgian exports to Russia
ii. Export structure 2005 vs. 2010
iii. Structure of Georgian exports to Russia in 2005
iv. Impact on beverage exports

Relative importance of Georgian exports to Russia

Export shares of selected trading partners

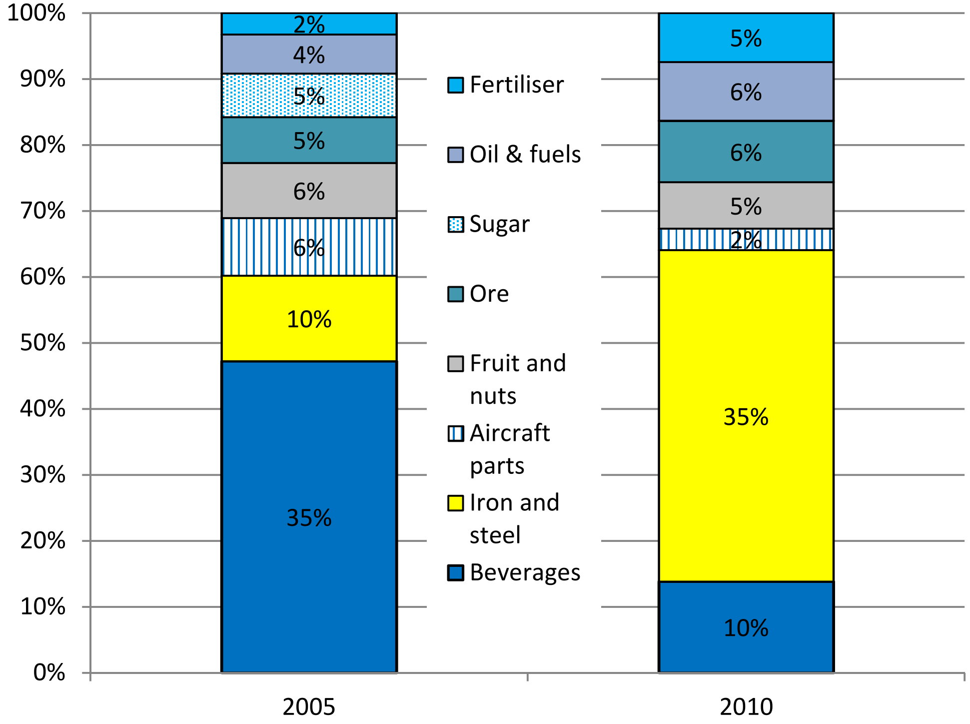


Source: Georgia National Office for Statistics

- In 2005, 18% of Georgia's exports shipped to Russia
- Russia was an important trading partner, but not dominant
- Georgian trade was relatively well diversified
- Diversification of exports result of active trade policy
- Contributed to absorb trade shock
- Similarity to Ukrainian export structure, which is also well diversified

Export structure 2005 vs. 2010

Exports by type of product (HS 2 digit) 2005 vs. 2010

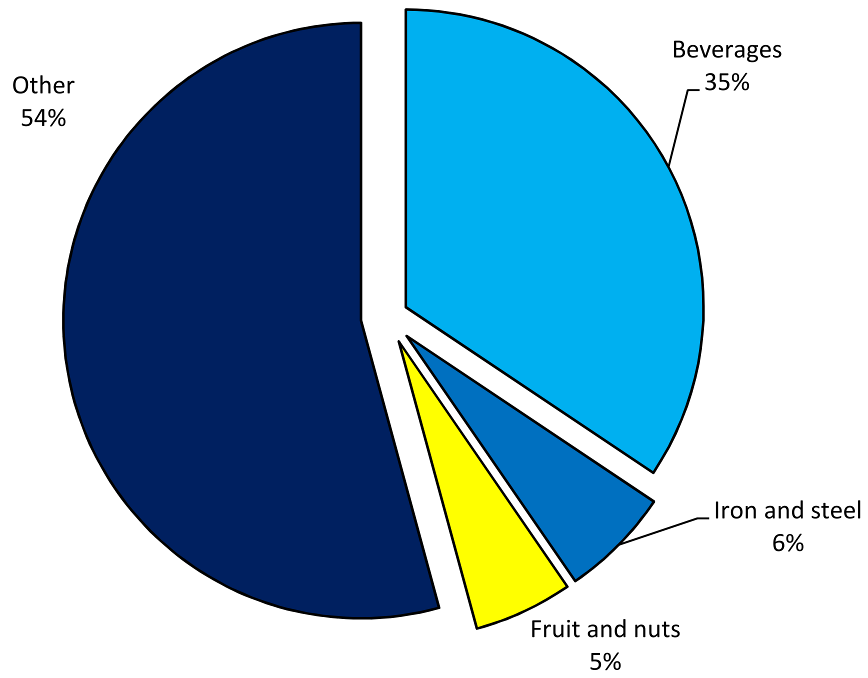


Source: Worldbank WITS database

- In 2005 – before start of trade ban – Georgian exports dominated by beverages (mostly wine and mineral water)
- As well as agricultural products (mostly fruits and vegetables)
- Iron and steel products accounted for 10% of exports
- In comparison, in 2010 much stronger focus on industrial products
- Especially iron and steel products experienced increase of export share from 10% in 2010 to 35% in 2010

Structure of Georgian exports to Russia in 2005

Exports to Russia by type of product,
% share of total exports to Russia in 2005 (HS 2 digit)

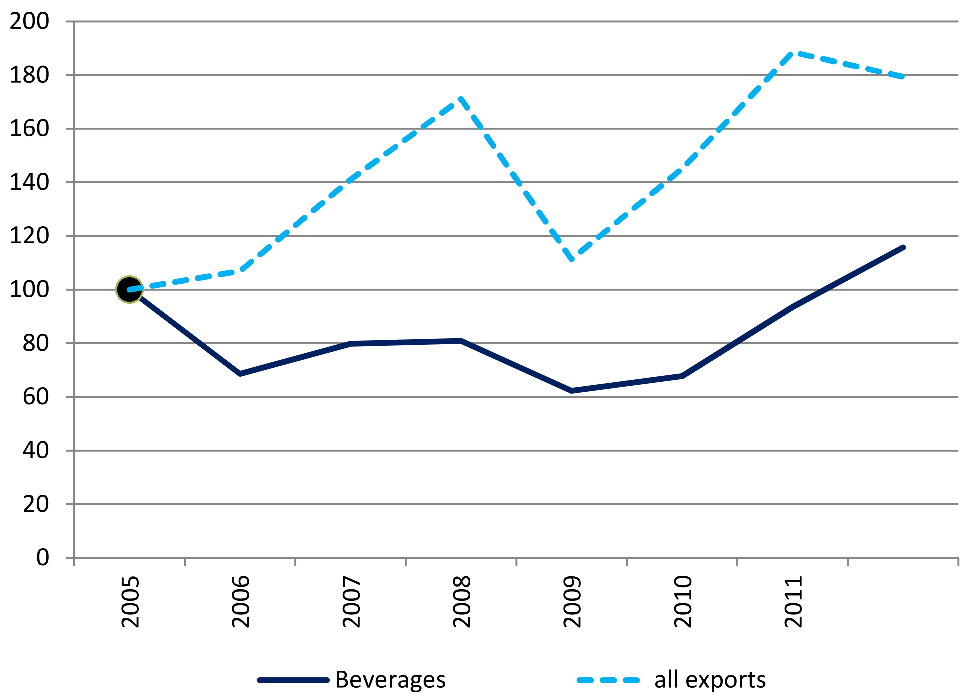


Source: Worldbank WITS database

- Main products exported to Russia in 2005 were wine and mineral water (Borjomi and Nabeghlavi), which accounted for about one third of export value
- Russia also important market for iron and steel as well as for fruits and nuts
- Remaining two thirds spread over a large number of product categories
- Thus, beverage producers mainly affected
- Shock for other industries not so severe, as spread out over wider range of sectors

Impact on beverage exports

Development of beverages following trade ban



Source: Worldbank WITS database

Question: Being the main industry affected from the trade ban, how did beverage exports fare after trade ban in 2005?

How quickly did they recover, if ever?

- Russia accounted for 64% of entire beverage exports in 2005
- Beverage exports to Russia declined by 68% in 2006 and disappeared altogether in 2007
- However – despite disappearance of Russian market – value of total beverage exports declined by only 28% in 2006
- Slight recovery in 2007; however, exports of beverages took until 2011 to fully recover to 2005 levels