GALT & TAGGART RESEARCH

Georgian Economy
Clear Skies and Tailwinds

Georgia | Economy
August 8, 2017

Executive Summary

The Georgian economy gained traction quickly in 1H17, growing by 4.5% as external demand stabilized and the government initiatives strengthened consumer demand and business confidence. This is a meaningful acceleration, following subdued growth in 2015-16 due to weaker external environment.

In 1H17, combination of goods export growth, robust tourist arrivals, recovery in remittances and modest increase in imports improved the current account deficit and stabilized the currency.

Price pressures have re-emerged in 2017 due to one-off factors related to excise tax hikes, and annual inflation came in at 7.1% in June. The NBG reacted by moderately tightening monetary policy, raising the policy rate to 7.0% from 6.5% at end-2016. However, the price pressures are likely to be transitory, and we expect no further rate hike this year. We also expect inflation to decline rapidly in 2018 toward the 3.0% target once the effects of the excise tax increases fade.

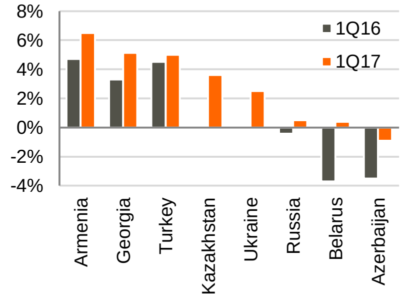
Better-than-expected growth strengthened the government's fiscal position in 1H17. With growth expected to remain above the budgeted level, the government is in a position to deliver its planned fiscal stimulus without jeopardizing the fiscal accounts and maintain fiscal discipline as agreed with the IMF.

The GEL strengthened in 1H17, reflecting favorable external conditions and the related uptick in growth. The National Bank intervened with close to US$ 90mn purchase in 1H17 to curb the GEL's appreciation pressure. Our calculations suggest that the currency's fair value against the US$ is close to 2.35 and that it is currently slightly undervalued. We do not expect any dramatic movements this year and see the GEL at 2.3 versus the US$ in the medium term.

Contrary to expectations, the Georgian economy hasn't suffered from recent economic uncertainties in Turkey. The trade balance with Turkey improved by 13.0% y/y in 1H17 despite the GEL's real appreciation against the TRY. Investments from Turkey rose by 42.1% y/y in 1Q17 and we expect solid US$ 300mn FDI from Turkey this year. Remittances also continue to grow. While tourist arrivals from Turkey fell by 15.9% y/y in 1H17, this was more than offset by the strong growth in arrivals from other countries.

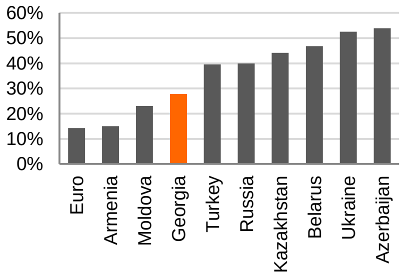
We revise our 2017 GDP growth forecast up to 4.7% from 4.3%, as we expect the government's budgetary focus on infrastructure spending and corporate tax reform to boost investments.

Figure 1: Real GDP growth rates



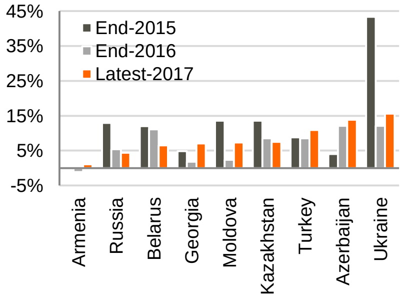
Source: National statistics offices

Figure 2: Currency weakening vs US$



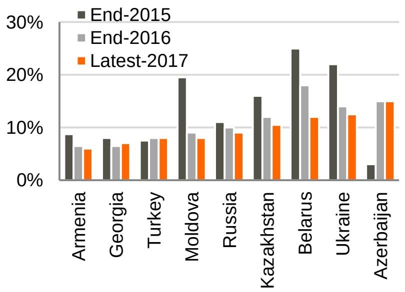
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – 28 July 2017

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

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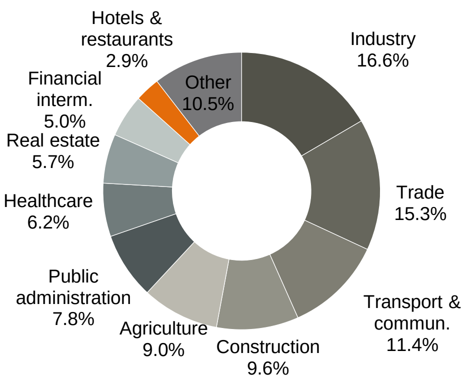
Recent economic developments

Stronger external demand helped GDP grow by 4.5% y/y in 1H17. A surge in goods exports, robust tourist arrivals, strong growth in remittances and modest growth in imports improved the current account balance and stabilized the currency.

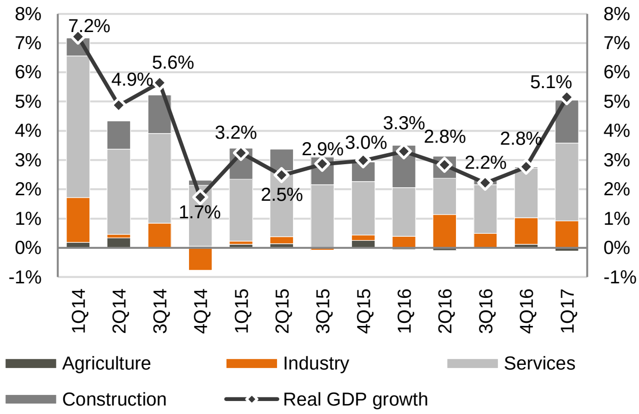
By sector, GDP growth was broad-based in 1Q17. Real GDP growth was 5.1% y/y in 1Q17 – the highest level since 3Q14. Construction was the fastest-growing sector, expanding by 21.6% y/y, followed by communications (+11.5% y/y), hotels and restaurants (+8.7% y/y) and manufacturing (+8.0% y/y), reflecting the widespread recovery in external demand and improved business and consumer confidence locally. Agriculture (-1.5% y/y) and public administration (-1.3%) were the only sectors in the red in 1Q17. Based on GeoStat preliminary estimates, growth was 4.0% in 2Q17, indicating 1H17 growth of 4.5% y/y. The 2Q figure was pulled down by growth unexpectedly slowing to 2.1% y/y in May, which can be attributed to a temporary slowdown in construction.

Figure 5: Nominal GDP structure 1Q17



Source: GeoStat

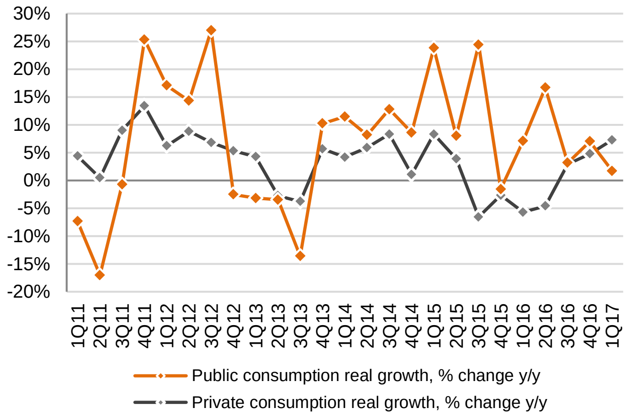
Figure 6: Real GDP growth and contribution to growth y/y



Source: GeoStat

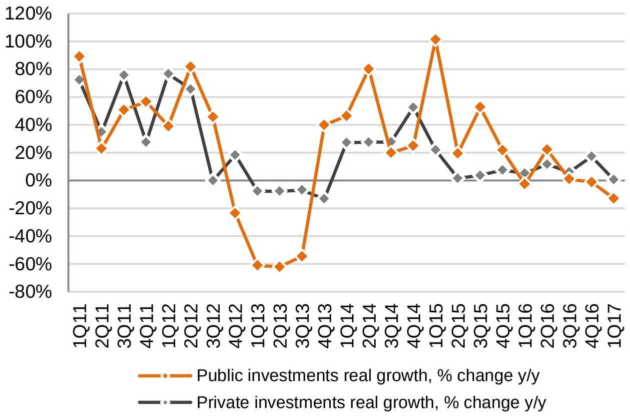
Private domestic demand drove growth in 1Q17. Private consumption increased by 7.3% y/y in real terms in 1Q17, supported by a 22.3% y/y increase in money transfers and 17.9% y/y growth in credit supply. Meanwhile, real public consumption was down 5.6% y/y, in line with the government's plan to reduce current expenditure, bringing total consumption growth to 4.6% y/y. Investment fell by 0.7% y/y in 1Q17 in real terms, as 0.5% growth in private investment was not sufficient to offset a 13.4% fall in public infrastructure spending due to seasonal factors. However, the government accelerated infrastructure spending in 2Q and real public investments increased by 25.8% y/y in the quarter (our estimates). Net exports contributed +1.2ppts to growth, as surge in exports largely absorbed a rise in imports.

Figure 7: Real consumption growth



Source: GeoStat, Galt & Taggart Research

Figure 8: Real investments growth



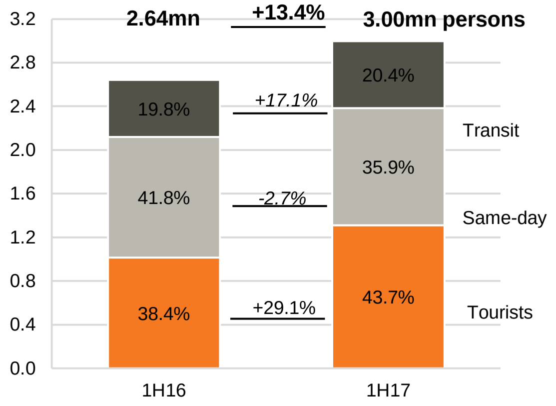
Source: GeoStat, Galt & Taggart Research

We expect the planned fiscal stimulus and continued improvement in the external environment to fuel growth in 2H17. We see the government's budgetary focus on infrastructure spending and corporate tax reform boosting investment in 2H17 and beyond. We also expect a continued recovery in trade partner countries to support export revenues, remittances and tourism arrivals. Furthermore, the recently signed free trade agreement with China should broaden the country's export base. While there are still risks to growth from the external sector, as new sanctions on Russia may reduce positive spillovers of the Russian recovery, these risks seem minimal given the diversified nature of the Georgian economy. Moreover, we expect fiscal stimulus to mitigate any slowdown in external markets. Therefore, we revise our 2017 growth projection up to 4.7% from 4.3%.

Tourist arrivals surged to 1.3mn visitors, boosting tourism revenues to US$ 1.1bn in 1H17 – an increase of 26.0% y/y. Total international arrivals increased by 13.4% y/y to 3.0mn, fueled by growth in tourist arrivals (+29.1% y/y) and transit visitors (+17.1% y/y). These largely offset a 2.7% y/y fall in same-day arrivals in 1H17. The number of visitors increased from all traditional visitor countries except Turkey (-15.9% y/y). The largest contributors to the growth in arrivals were Armenia (+16.2% y/y) and Russia (+27.5% y/y). With 3.2x growth, Iran became the fifth largest source of visitors, replacing Ukraine (+18.8% y/y) in 1H17.

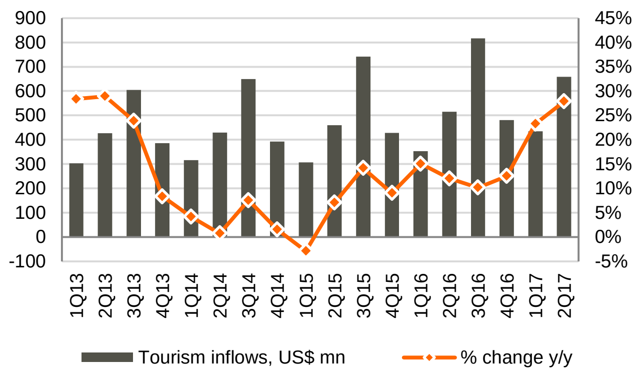
Notably, tourist inflows are becoming more diversified as arrivals are increasing from non-neighboring countries like Israel and India, and arrivals from EU are also on an upward trajectory. Georgia became a popular tourist destination, and we expect strong tourist arrivals throughout 2017. We project tourism revenues to increase by 20.0% y/y to US$ 2.6bn in 2017.

Figure 9: International arrivals by type



Source: GNTA

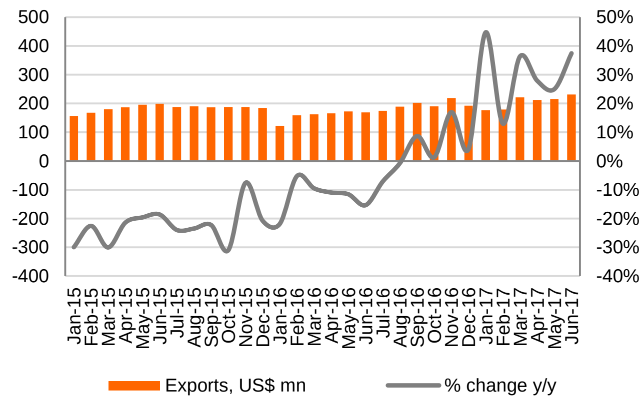
Figure 10: Tourism inflows



Source: NBG
Note: NBG's preliminary data for 2Q17

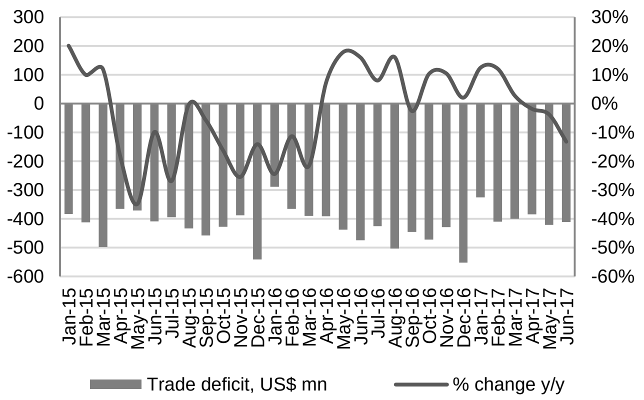
Goods exports increased drastically in 1H17. Weak external demand and low commodity prices weighed on export growth in 2015-2016. However, as oil prices firmed and the economies of Georgia's oil-exporting trading partners recovered, 1H17 exports to CIS markets rebounded 61.2% y/y (38.4% of the total). Exports to the EU also rose by 30.4% y/y (23.9% of the total), while exports to other countries (mainly China, Turkey, US) increased by 8.7% y/y (37.7% of the total). As a result, total exports grew 30.1% y/y in 1H17. Among the major products, exports of copper, ferroalloys, wine, mineral waters, pharmaceuticals and spirits increased, while, fertilizers, nuts and gold exports decreased. Our calculations suggest that in real terms, exports were up 18.7% y/y in 1H17.

Figure 11: Exports



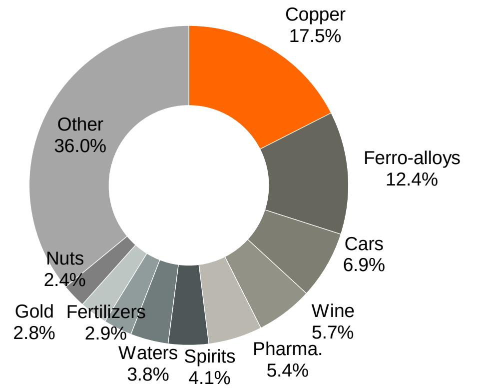
Source: GeoStat

Figure 12: Trade deficit



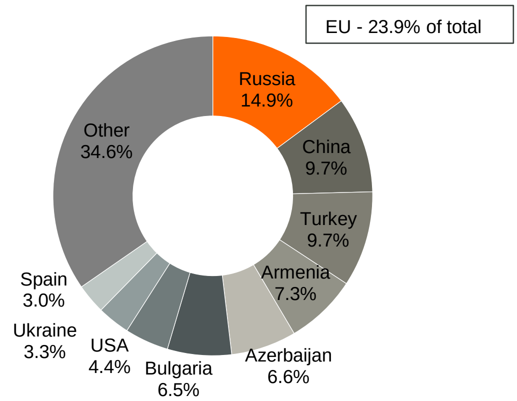
Source: GeoStat

Figure 13: Exports by product, 1H17



Source: GeoStat

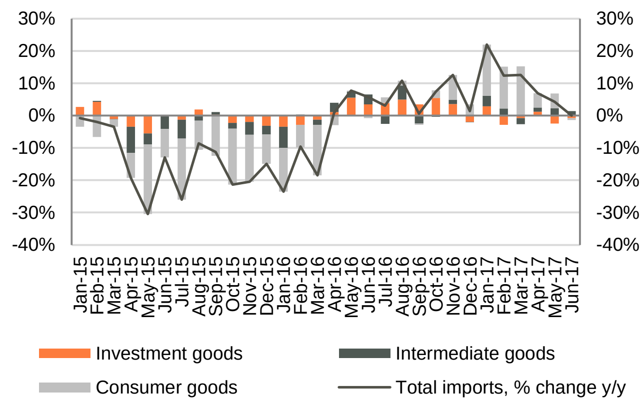
Figure 14: Exports by country, 1H17



Source: GeoStat

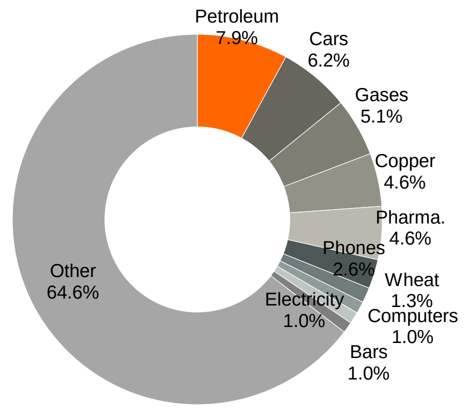
Imports growth slowed in 2Q17, which we view as temporary. Growth in imports slowed to 3.6% y/y in 2Q17 from 15.1% y/y growth in 1Q17. As a result, the trade deficit was almost flat, increasing by only 0.2% in 1H17. In 2H17, we expect firming world commodity prices and acceleration in infrastructure projects to moderately increase imports, while exports are likely to continue robust growth given the low base of last year.

Figure 15: Imports and contribution to import growth



Source: GeoStat

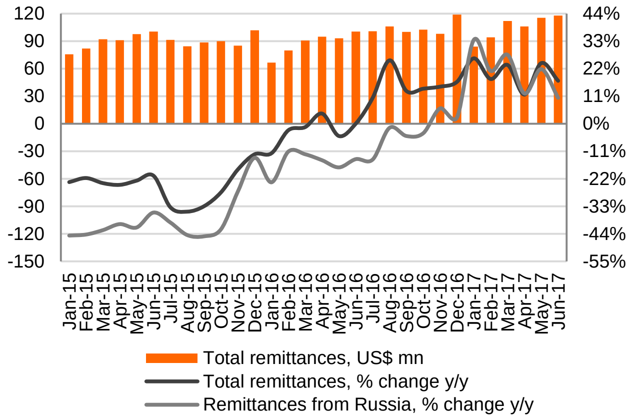
Figure 16: Imports by product, 1H17



Source: GeoStat

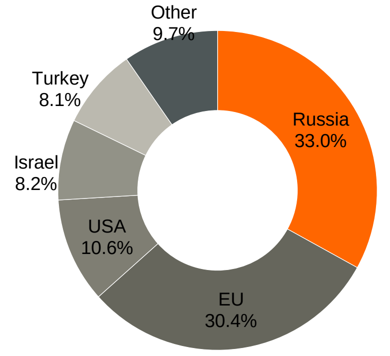
Migrant remittances recovered due to a stronger RUB and the continued growth from other remitting countries. Recovery in money transfers started in June 2016, and growth accelerated further at end-2016 as remittances from Russia rebounded due to strong RUB. In 1H17, remittances increased 19.7% y/y to US$ 0.6bn. Money transfers increased significantly from such major remitting countries as the US (+17.9% y/y), Italy (+10.2% y/y), Greece (+7.4% y/y), Israel (+98.8% y/y), Turkey (+30.6% y/y), and Spain (+9.8% y/y), which combined accounted for 50.1% of the total. Notably, despite the growth, Russia's share of remittances remains at 33.0% of the total, well below the pre-2014 level of 50%. Remittances from the EU remain stable at 30.4% of the total, and with the appreciation of the EUR vs the US$, we expect the dollar value of remittances to further increase strongly throughout 2017.

Figure 17: Money transfers



Source: NBG

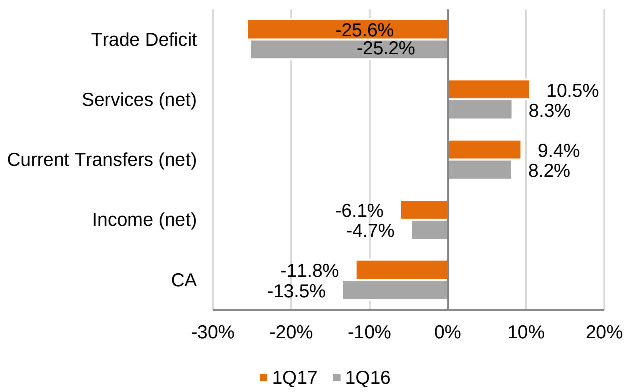
Figure 18: Money transfers by country, 1H17



Source: NBG

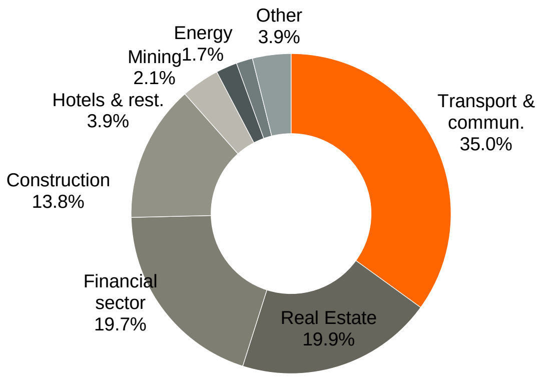
Georgia's current account (CA) deficit shrank to 11.8% of GDP in 1Q17 from 13.5% in 1Q16. Notably, the negative balance in the goods trade, traditionally the major cause of the CA deficit, increased by 5.6% y/y as both exports and imports were up in 1Q. However, the positive balance in services, fueled by tourism inflows, and net transfers covered 80% of the goods trade deficit compared to 65% in 1Q16. The income balance (-6.1% of GDP) was up 34.7% y/y, mostly due to reinvestments. Net FDI, up 7.2% y/y (11.0% of GDP), financed almost the entire CA deficit, with a small part financed by other investments. FDI flows were directed mainly towards the transport, real estate and financial sectors. Reserves were up by US$ 60mn in 1Q17, as the capital and financial account was higher than the CA. Given strong growth in external earnings, we expect CA deficit to decline to 12.0% of GDP in 2017 from 13.5% of GDP in 2016.

Figure 19: CA deficit as % of GDP



Source: NBG, GeoStat

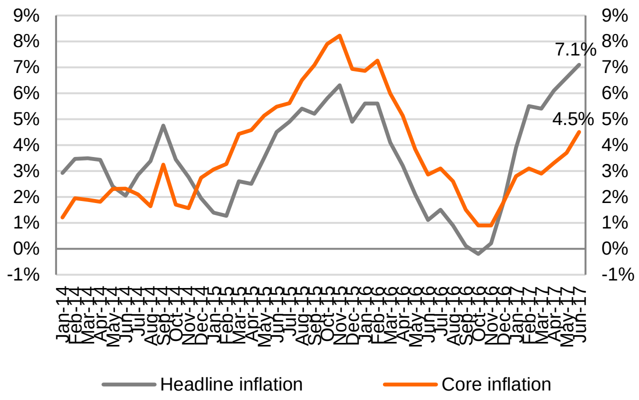
Figure 20: Inward FDI by sector 1Q17



Source: GeoStat

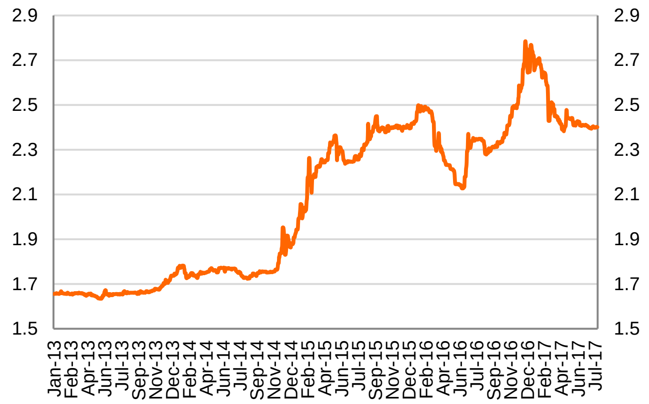
Headline inflation rose to 7.1% in 1H17 mainly due to excise tax hikes. Firming world commodity prices, the lagging effect of the weaker GEL and excise tax hikes have been putting pressure on prices since January. Annual inflation came at 5.4% in 1Q17 and increased further in 2Q17 to 7.1%, above the NBG's target of 4.0%. Notably, 2.6ppts of the price growth was due to excise-tax-related increases in fuel and tobacco prices. With overall price growth driven broadly by fuel and food prices, core inflation remained below headline at 4.5% in 1H17. Being committed to price stability the NBG increased the policy rate to 7.0% in 1H17 from 6.5% at end-2016, in response to increased inflation expectations. In line with the NBG's guidance, we do not expect further rate hikes in 2017, as the NBG considers the price pressures as transitory. We forecast inflation to come in at 6.2% in 2017 and decline rapidly in 2018 toward the 3.0% target once the effects of the excise tax increases fade.

Figure 21: Annual inflation



Source: GeoStat

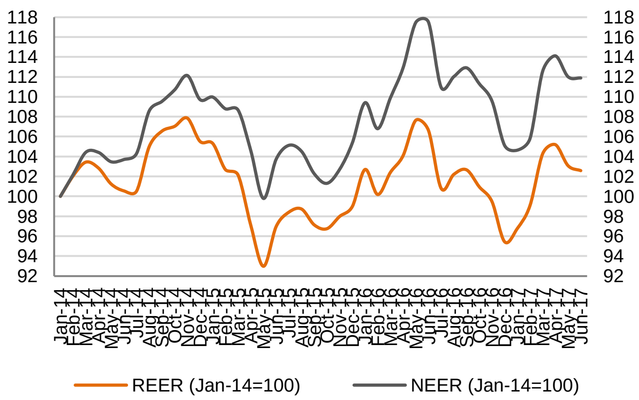
Figure 22: US$/GEL exchange rate



Source: NBG

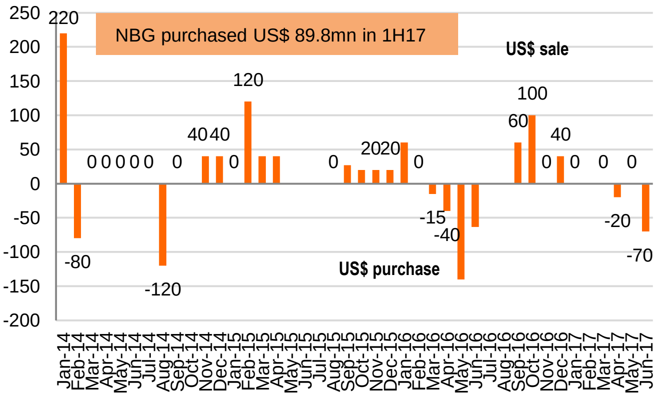
The GEL's strength reflects favorable external conditions and the related uptick in growth. After a weak start to 2017, the GEL started appreciating in mid-February, reflecting stronger external earnings and the pick-up in economic activity. The currency has been stable at 2.4 vs the US$ since February, showing a 10.0% appreciation in 1H17. As other regional currencies also gained, the GEL's real effective exchange rate appreciated slightly in March and April. The GEL started strengthening further in the beginning of April and fell below 2.4 vs the US$. The NBG intervened in the FX market in April and June, with total purchases of US$ 89.8mn in 1H17, which was likely an effort to maintain the economy's competitiveness. As the GEL's appreciation path slowed due to these interventions, the REER has weakened slightly in recent months. Our calculations suggest that the GEL's fair value against the US$ is close to 2.35 and that the currency is currently slightly undervalued. We do not expect any dramatic movements this year and see the GEL at 2.3 vs the US$ in the medium term.

Figure 23: NEER/REER (January 2014 = 100)



Source: NBG
Note: Index growth means appreciation of GEL, decline means depreciation of GEL

Figure 24: NBG's net interventions (US$m)

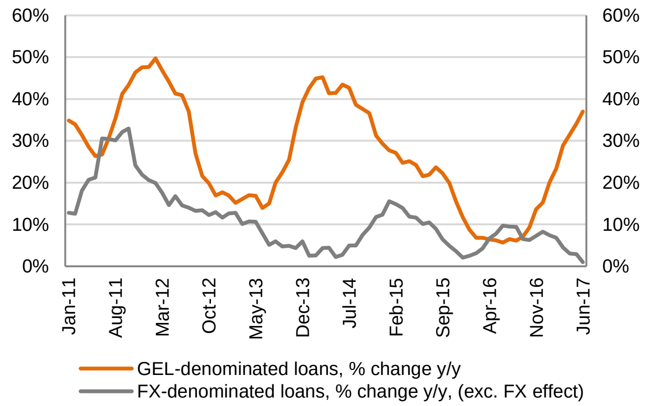


Source: NBG

The uptick in growth, combined with improved expectations, has fueled banking sector credit growth. A 29.9% expansion in the retail loan book drove the credit portfolio up by 17.9% y/y to GEL 19.3bn in 1H17. Excluding FX effects, the loan portfolio was up 13.4% y/y in 1H17 vs 8.2% y/y growth in 1H16.

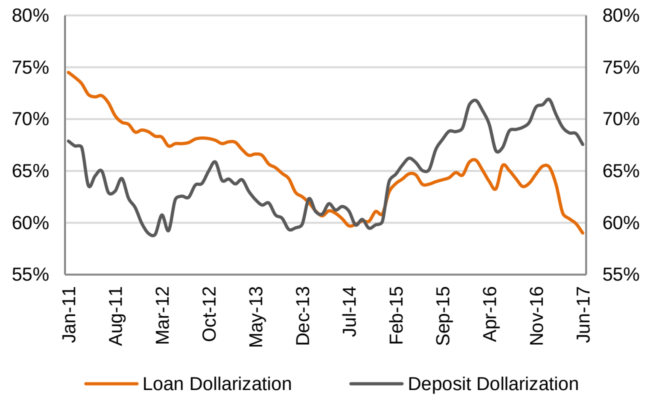
Measures under the central bank's new de-dollarization schemes (de-dollarization of existing US$-denominated loans and issuance of retail loans up to GEL100,000 only in local currency) resulted in robust expansion in GEL lending while US$-denominated loans grew by a mere 3.8% y/y in 1H17. This pushed the loan dollarization ratio down to 59.0% in June from 65.5% in December 2016. Deposit dollarization also retreated to 67.5% from 71.4% over the same period as the stronger GEL improved consumer sentiment on the currency. NPLs remained low at 3.5% (-0.2ppts y/y), and ROE was 24.9% in 1H17.

Figure 25: Loan portfolio growth



Source: NBG

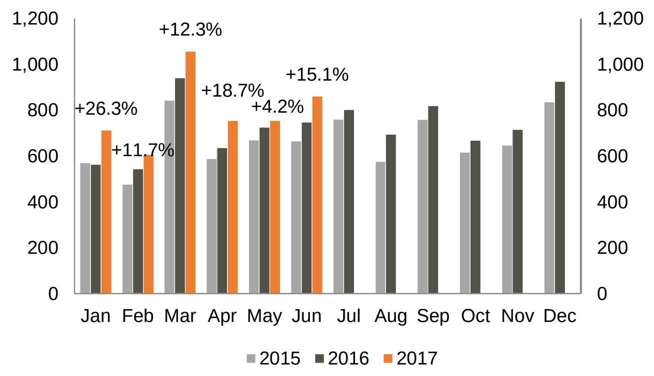
Figure 26: Dollarization



Source: NBG

In 1H17, tax revenues were higher than expected. Consolidated budget tax revenues rose by 14.2% y/y to GEL 4.7bn in 1H17 and accounted for 105.4% of the budgeted amount. Better-than-expected growth and higher inflation compared to the budget framework (the 2017 budget is based on 4.0% GDP growth and 4.0% GDP deflator projections) were the reasons for the stronger tax collection. Notably, in 1H17 GEL 120mn were retained by businesses for reinvestments - the effect of the corporate income tax reform (only distributed profits taxed) introduced in January 2017.

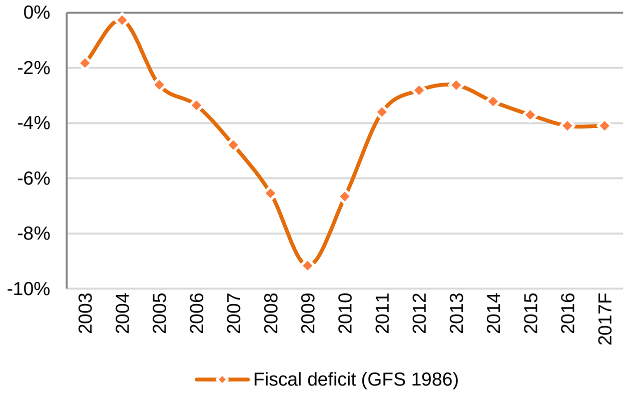
Figure 27: Tax revenues, GEL mn and % change y/y



Source: MOF

Public infrastructure spending accelerated in 2Q17 after falling in 1Q17. The consolidated budget was in surplus in 1Q17, as capital spending was down 9.2% y/y, while the revenue stream was above the budgeted figure. As infrastructure spending accelerated in 2Q17, capital expenditure (+34.1% y/y) and net lending (+109.4% y/y) both increased strongly. Meanwhile, current expenditure rose by 8.9% y/y in 2Q17 after growing 7.3% y/y in 1Q17. Overall, 1H17 fiscal deficit accounted for only 18.5% of the total 2017 budgeted amount (4.1% of GDP). Budget infrastructure spending is expected to accelerate in 2H17, widening the fiscal deficit. Meanwhile, we do not see material effect on GEL from increased spending, as acceleration will reflect increased capital spending financed mainly by external borrowing. We expect the fiscal deficit to comply with the budgeted amount in 2017 as agreed with IMF.

Figure 28: Fiscal deficit as % of GDP



Source: MOF, GeoStat

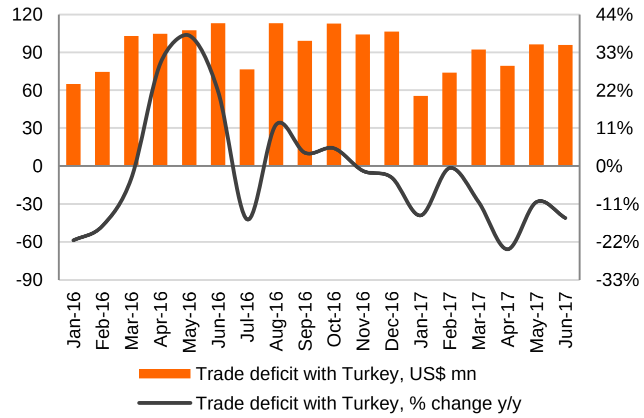
The state budget in 1H17 remained broadly in line. Current expenditures accounted for 95.4% of the budgeted amount. Capital spending stood at 91.1% of the planned amount due to a slowdown in 1Q17, but was still an improvement compared to the 80.1% execution rate last year. Higher-than-budgeted revenues, combined with underspending in current and capital expenditure, resulted in an increase in government deposits of GEL 291.6mn compared to the planned reduction of GEL 83.7mn in 1H17.

Assessment of spillover impact from Turkey

Contrary to expectations, the Georgian economy hasn't suffered from recent economic uncertainties in Turkey. Turkey is Georgia's largest trading partner, being traditionally a top source of imports, and it was the third largest export market in 1H17.

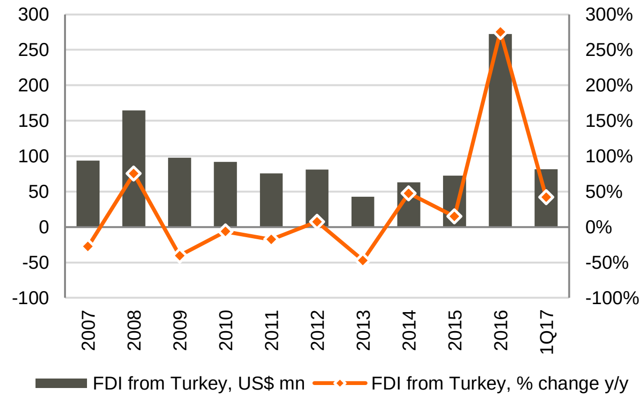
The trade balance with Turkey improved by 13.0% y/y in 1H17 despite the GEL's real appreciation against the TRY. The depreciation of the Turkish lira since 2014, especially in Spring 2017, has raised concerns that cheap imports from Turkey could flood the Georgian market. However, despite the real appreciation of the GEL vs the TRY in 1H17, exports to Turkey rose by 12.9% y/y while imports were down 9.0% y/y, bringing the trade deficit down. Notably, the major adjustment in Georgia's imports in the wake of the GEL's depreciation in 2015 came on the back of a 23.2% y/y reduction in imports from Turkey. This likely indicates that Georgian importers tapped cheaper markets.

Figure 29: Trade deficit with Turkey



Source: GeoStat

Figure 30: FDI from Turkey

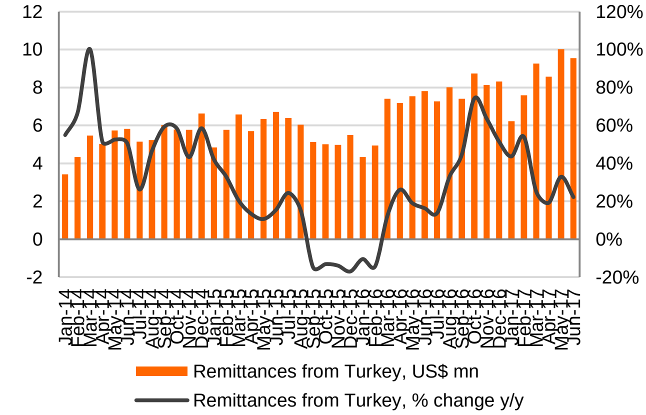


Source: GeoStat

FDI and remittances from Turkey continue to grow strongly. Investment from Turkey increased by 42.1% y/y in 1Q17 and accounted for 20.2% of the total, continuation of the trend prevailing in 2015-2016. This highlights that policy uncertainty in Turkey, combined with Georgia's business-friendly environment, is resulting in capital moving from Turkey to Georgia. We expect FDI from Turkey to reach US$ 300mn this year and be directed toward energy, manufacturing, hospitality and transport sectors. Remittances from Turkey grew by a robust 30.6% in 1H17, and Turkey's share in total remittances has been increasing in recent years.

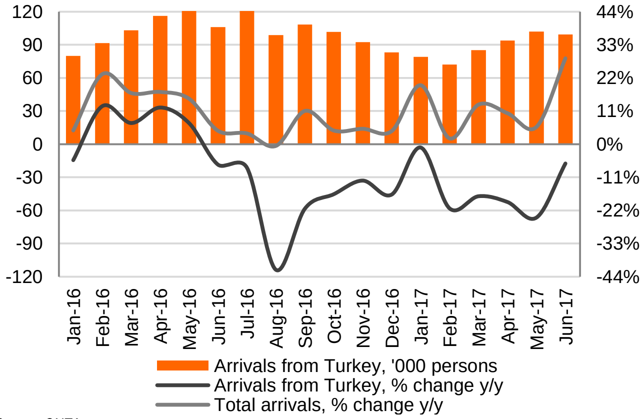
On the other hand, visitor arrivals from Turkey fell by 15.9% y/y in 1H17. Temporary travel restrictions (related to the failed coup) introduced by the Turkish government in 2016 as well as ongoing renovation works on the Turkish side of the Georgia-Turkey customs check-point have been weighing on Turkish arrivals since June 2016. As a result, the share of Turkish arrivals declined to 17.7% of the total in 1H17 from 23.9% in the same period last year. While robust growth from other countries fully offset this drop, recent data show that the pace of the drop in Turkish arrivals is slowing, which is a good sign for Georgia.

Figure 31: Remittances from Turkey



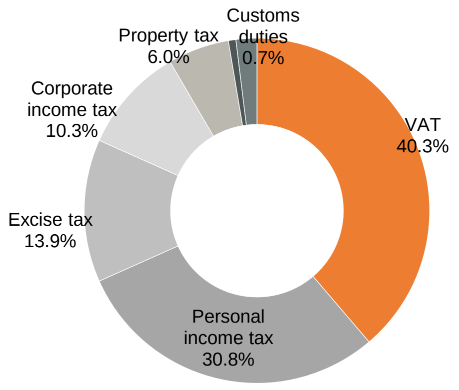
Source: NBG

Figure 32: Tourist arrivals from Turkey



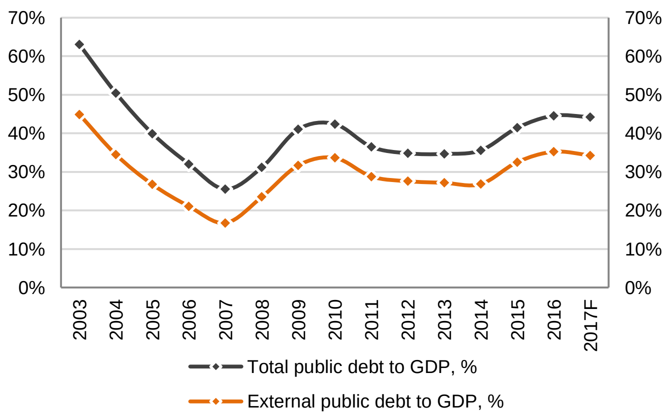
Source: GNTA

Figure 33: Tax revenues by type, 1H17



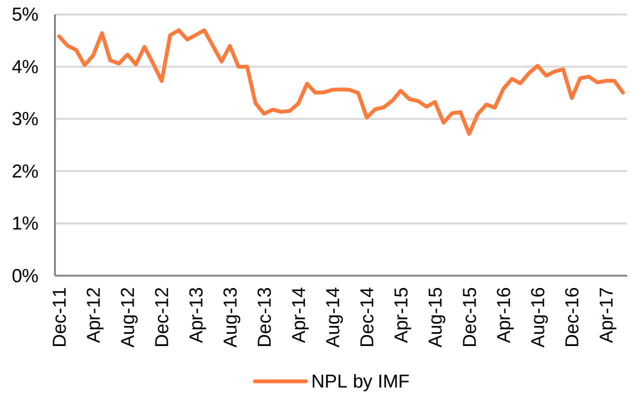
Source: MOF

Figure 34: Public debt as % of GDP



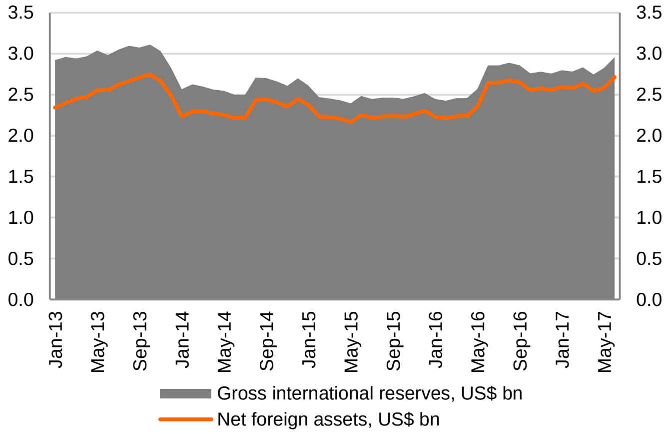
Source: MOF, GeoStat

Figure 35: NPLs



Source: NBG

Figure 36: International reserves



Source: NBG

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