Georgian economy – Navigating Regional Instability

Georgia | Economy
October 23, 2018

Executive Summary

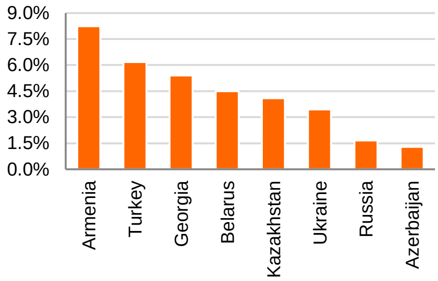
Economic growth in Georgia accelerated to 5.4% in 1H18, supported by booming tourism and significantly increased exports and remittances. These flows provided positive spillovers to the major sectors of the economy, but the increased demand also translated into strong import growth and worsened the trade deficit. The growth lost momentum and slowed to an average of 3.3% in July-August, based on GeoStat's rapid estimates, resulting in 8M18 growth of 4.8%. This slowdown is mostly explained by reduced construction activity due to underspending on government infrastructure projects. Given the current volatility in regional markets and increased external risks, we revise our growth forecast down from 5.4% to 5.0% for 2018. We also expect growth to soften to 4.3% in 2019 mostly due to tighter credit conditions. Importantly, Georgia's macro fundamentals remain strong given its prudent fiscal and monetary policies and flexible exchange rate. Therefore, we believe that Georgia's growth outlook remains robust in the face of increased external risks.

Annual inflation remained close to the NBG's 3.0% target through 9M18, coming in at 2.7% in September. The NBG maintained a moderately tight monetary policy stance due to increased risks from imported inflation in 1H18, cutting the key rate by 0.25bps to 7.0% in July. We expect annual inflation at 2.9% in 2018 and at 3.9% in 2019, reflecting pass-through impact of GEL depreciation and higher world commodity prices. We also anticipate the monetary policy rate to remain at 7.0% until mid-2019.

The GEL has weakened against the USD since August, reflecting deteriorating sentiment toward EM currencies after the TRY collapse. Despite the GEL weakness vs the USD, the GEL's strengthened NEER and REER since May-18 enabled the NBG to intervene in the FX market and to purchase US$ 112.5mn during the April-September period with the aim to build reserves. We expect the GEL's seasonal weakness to continue until end-2018, and we see GEL being close to 2.7-75 vs USD till the end of the year, while we see GEL close to 2.5 vs USD in medium term.

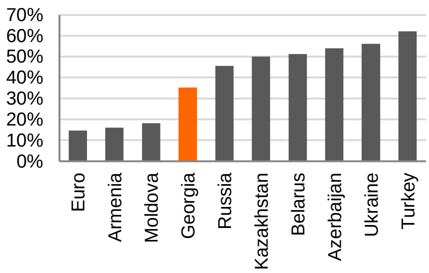
The 2019 draft budget reflects the government's commitment to contain current spending and increase growth-enhancing infrastructure investment. As a result, the fiscal deficit is expected to narrow further to 2.6% of GDP in 2019 – in line with the IMF-supported program.

Figure 1: Real GDP growth rates, 1H18



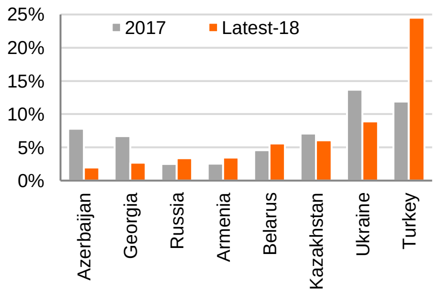
Source: National statistics offices

Figure 2: Currency weakening vs USD



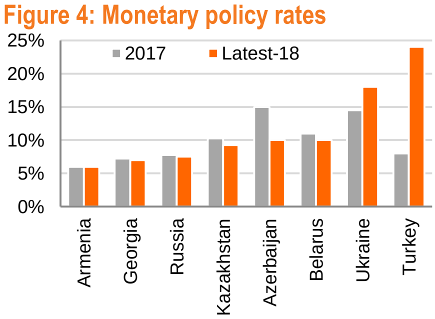
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 –18 October 2018

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

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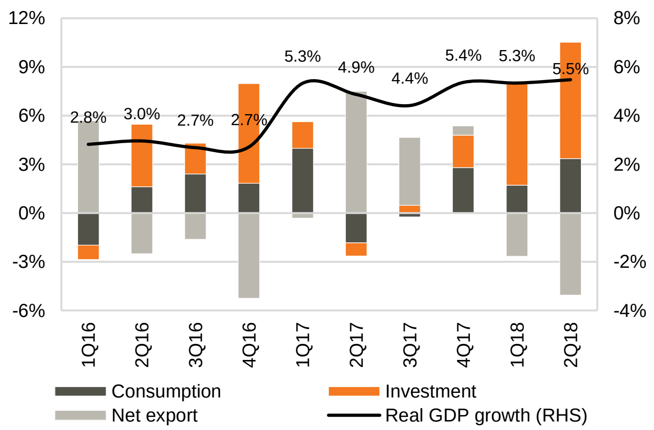
Economic development

Growth accelerated markedly in 1H18 before slowing in July and August. The Georgian economy expanded by 5.4% y/y in 1H18 with growth at 5.5% in 2Q and 5.3% in 1Q, according to GeoStat. The growth was broad-based, led by financial intermediation (+16.2% y/y), real estate operations (+13.6% y/y), mining (+9.7% y/y), trade (+7.9% y/y), manufacturing (+7.6% y/y) and hotels and restaurants (+7.5% y/y). Meanwhile, construction – the major engine of growth in 2014-17 – contributed nothing, partly explained by the completion of the BP gas pipeline and the slowdown in public infrastructure spending in 2Q. On the demand side, strong growth in tourism and remittances had positive spillovers into private consumption and investment. The latter was a key growth factor in 1H, contributing 6.3ppts, while private consumption contributed 1.4ppts, and net exports – negative 3.9ppts as increased demand fueled imports.

In July and August, the economic growth lost momentum and slowed to an average of 3.3% based on GeoStat's rapid estimates. As a result, the 8M18 figure fell to 4.8% from 5.4% in 1H18. Although no sufficient data is currently available, we think that this slowdown may be explained by reduced construction activity due to underspending in government capex and a slowdown in private construction related to tightened procedures for granting construction permits.

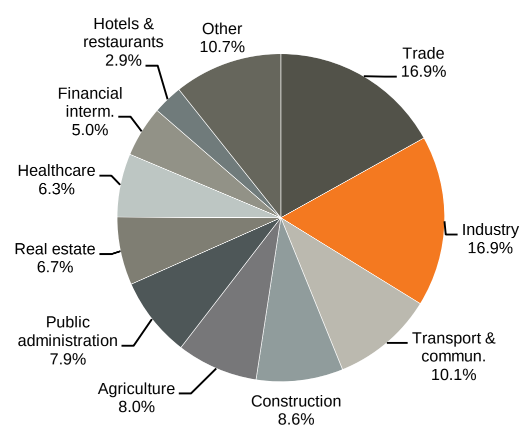
Given the increased downside risks to growth from the external sector (Turkey and volatility in regional financial markets), the likelihood of negative shocks to our growth forecast has increased since 1H. There are also domestic factors that may hinder growth, including uncertainties related to the 28 October 2018 presidential election, and the new NBG regulations slowing retail lending growth. Therefore, we have revised our GDP growth projection for 2018 down to 5.0% from 5.4%. This forecast incorporates an expected acceleration in government spending in 4Q and positive spillovers from tourism, remittances and FDI. We expect growth to moderate to 4.3% in 2019, due to new NBG regulations on mortgages, which will likely negatively affect business activity before an adjustment takes place.

Figure 5: Contributions to real GDP growth, %



Source: GeoStat, Galt & Taggart Research

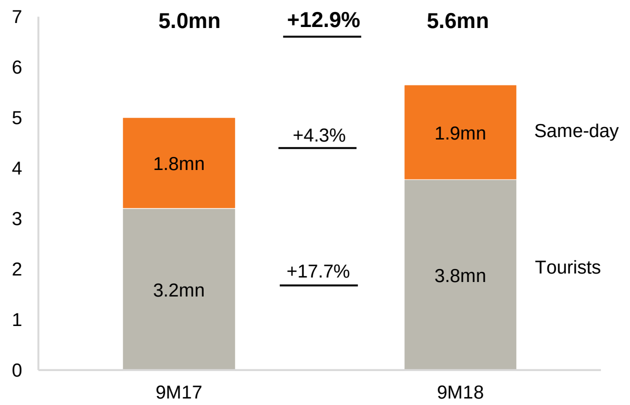
Figure 6: GDP structure by sector, 1H18



Source: GeoStat

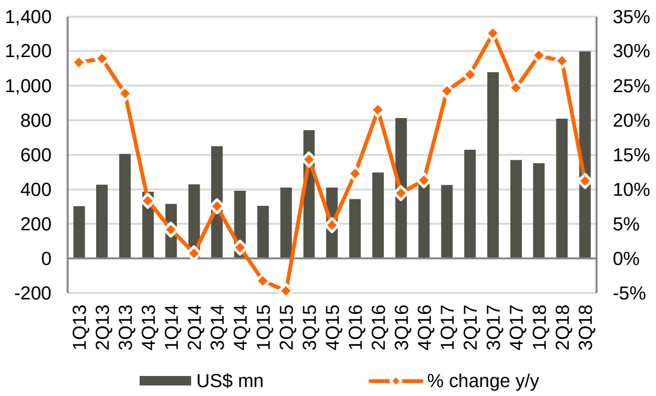
Tourist arrivals reached 3.8mn in 9M18, exceeding the country's population of 3.7mn. Tourism revenues grew by 20.0% y/y to US$ 2.6bn over the same period, and we expect the full-year figure to rise to US$ 3.2bn. Total international arrivals, which combine tourists and same-day visitors, rose by 12.9% y/y to 5.6mn. A 17.7% y/y (66.8% of the total, or 3.8mn persons) increase in tourist arrivals was the major driver of the growth in total arrivals as same-day arrivals increased by a modest 4.3% y/y. Russia was the largest contributor (+22.9% y/y, or 1.1mn visitors) to arrivals growth in 9M18. Among the traditional sources of visitors, arrivals increased strongly from Azerbaijan (+10.9% y/y) and Turkey (+17.2% y/y), while there was a slowdown from Iran and Armenia in 9M18. Notably, arrivals from Iran have been falling since June and intensified in September, dropping by 41.6% y/y in that month likely affected by US sanctions on Iran. Arrivals from the EU rose by 36.2% y/y to over 310,000 with Poland and Germany driving the growth. Among non-neighboring countries, there was also notable visitor growth from Israel, India, Saudi Arabia, the US and Kazakhstan. We expect 4.7mn tourists (up 19% y/y) in 2018, which incorporates further declines in visits from Iran and Turkey and growth from all other major markets.

Figure 7: International arrivals by type, mn persons



Source: GNTA

Figure 8: Tourism inflows

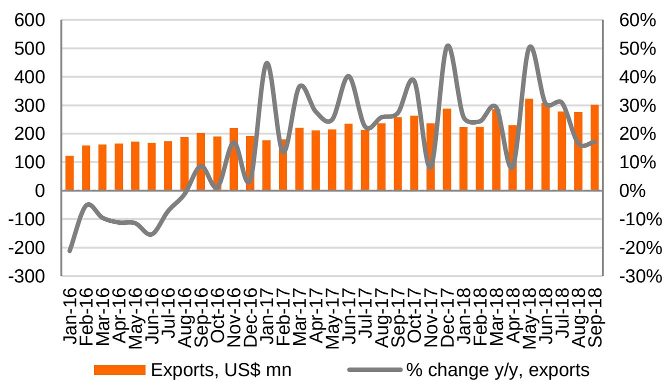


Source: NBG, Galt & Taggart Research

CIS markets absorbed most Georgian exports in 9M18 with Azerbaijan driving the growth. Total exports increased 25.7% y/y to US$ 2.4bn in 9M18 as growth strengthened in regional economies. Exports to CIS markets in particular increased by 47.2% y/y (47.5% of the total) with notable increased demand from Azerbaijan, Russia, Armenia, and Ukraine. Exports to EU countries rose by 13.2% y/y, accounting for 21.8% of the total. Exports to other countries (mainly Turkey, China, US and Iran) increased by 12.9% y/y (21.9% of the total). Among Georgia's major export products, copper, used cars, ferro-alloys, wine, spirits, tobacco and mineral waters increased strongly, while pharmaceutical exports growth was moderate. We expect exports to grow 23.1% y/y in 2018 as a whole.

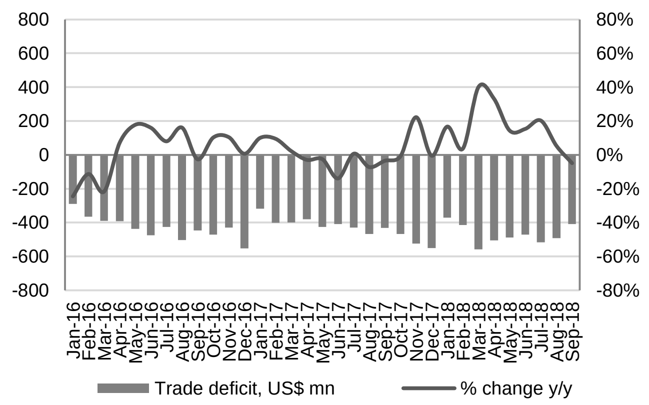
Strong import growth widened trade deficit by 15.5% y/y in 9M18. High world commodity prices along with rising domestic demand led to 19.1% y/y import growth in 9M18. Imports increased substantially from Russia (+24.8% y/y), China (+34.7% y/y) and Turkey (+11.4% y/y), while by commodities a significant increase was on the back of higher oil import bill (+32.2% y/y). It has to be noted however that import growth slowed in August and September to an average 6.3% y/y reflecting softer GDP growth in the same period.

Figure 9: Exports



Source: GeoStat

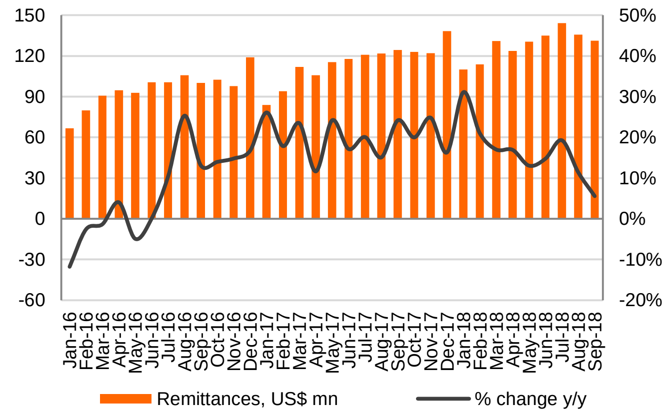
Figure 10: Trade deficit



Source: GeoStat

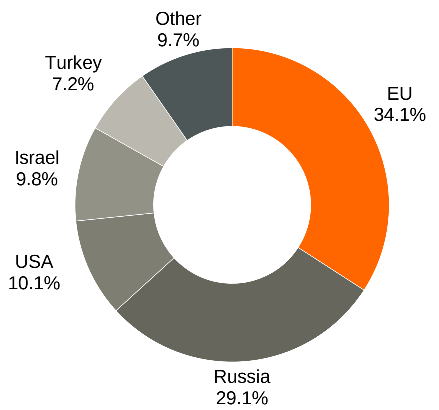
Remittances increased 16.0% y/y to US$ 1.2bn in 9M18. They increased significantly from all major remitting areas: EU (+31.1% y/y), Israel (+34.3% y/y), Azerbaijan (+27.7% y/y), Ukraine (+11.2% y/y) and USA (+11.4% y/y), while growth in remittances moderated from Russia (+1.3% y/y) and Turkey (+3.7% y/y). As a result, the EU's share in total remittances continued to rise, reaching 34.1% of the total, while Russia's share fell to below 30% of the total. We expect remittances to increase by 15% y/y to US$ 1.6bn in 2018 as a whole.

Figure 11: Money transfers



Source: NBG

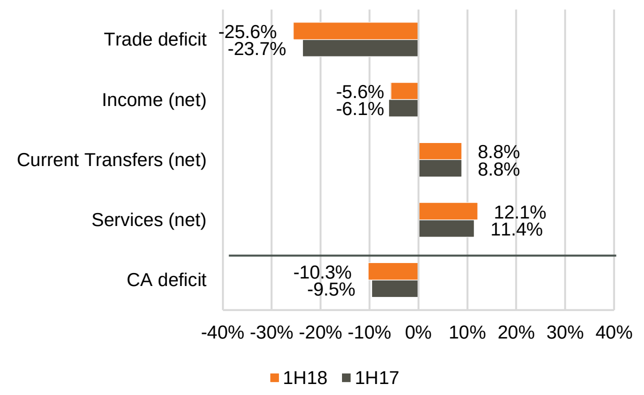
Figure 12: Money transfers by country, 9M18



Source: NBG

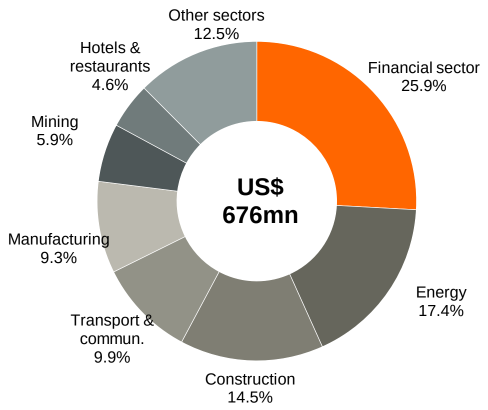
CA deficit widened to 10.3% of GDP (+0.7ppts y/y) in 1H18 as the goods trade deficit was up. The positive balance in services, fueled by tourism revenues (+28.9% y/y) and net transfers (+11.7% y/y), offset the 81.8% goods trade deficit in 1H18. Net FDI and other investments were major funding sources of the CA deficit. We project the CA deficit to come in at 9.4% of GDP for full-year 2018 and 9.0% of GDP in 2019. FDI is expected to reach circa US$ 1.9bn (flat y/y) in 2018, supported by the commencement of large infrastructure projects (Anaklia sea port and Nenskra HPP).

Figure 13: CA deficit as % of GDP



Source: NBG, GeoStat

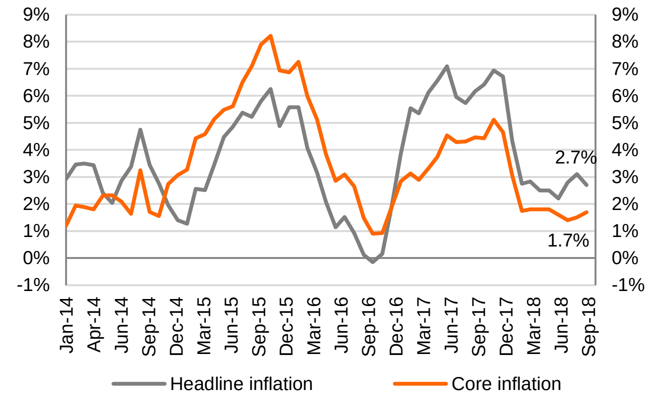
Figure 14: FDI by sector, 1H18



Source: GeoStat

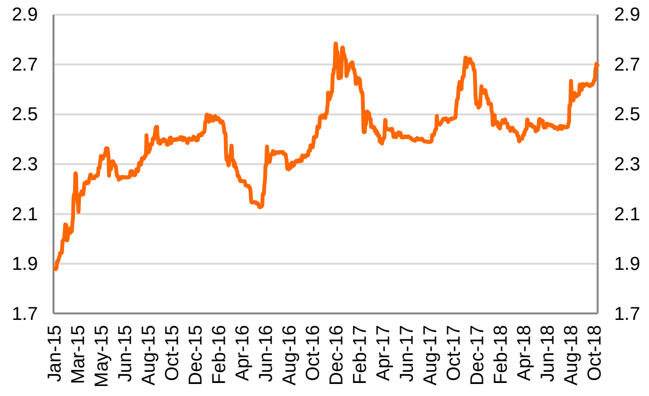
Annual inflation remained close to the NBG's 3.0% target through 9M18. Annual inflation decelerated sharply from the start of 2018 as the effects of last year's excise tax hikes faded. Although inflation was just 2.2% in June, the NBG maintained its moderately tightened monetary policy stance due to increased risks from imported inflation before cutting the key rate by 0.25bps to 7.0% in July. This move was somewhat unexpected by the market as many central banks have recently maintained or increased their policy rates to support their currencies in the wake of the ongoing rate hikes in major advanced economies. We see this move reflecting GEL's stronger NEER and REER than previously expected as well as supporting the affordability of local currency funding. The NBG expects inflation to be close to its 3.0% target in 2018 and we project average annual inflation of 2.9% in 2018 and 3.9% in 2019 due to pass-through effects from the GEL's depreciation as well as higher world commodity prices. We also expect the monetary policy rate to remain at 7.0% until mid-2019.

Figure 15: Annual inflation



Source: GeoStat

Figure 16: USD/GEL exchange rate

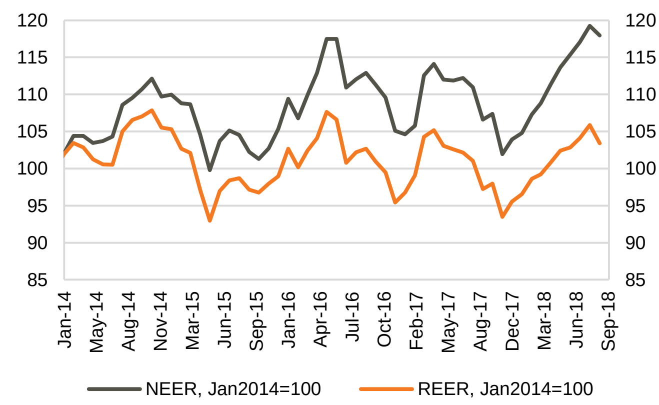


Source: NBG

GEL broadly stable during Jan-Jul 2018 before hampered by TRY collapse in Aug-18. Strong external inflows from tourism, remittances and exports and the related uptick in growth supported the GEL to appreciate 4.8% against the USD from January to early August when regional currencies weakened. The GEL's NEER and REER also strengthened from May-18, reflecting gains against the RUB and TRY. However, the collapse of the Turkish Lira at the beginning of August affected the GEL through the expectations channel, weakening 9.2% to 2.70 against the USD as of 22 October compared to 1 August. The GEL's strengthened NEER and REER had enabled the

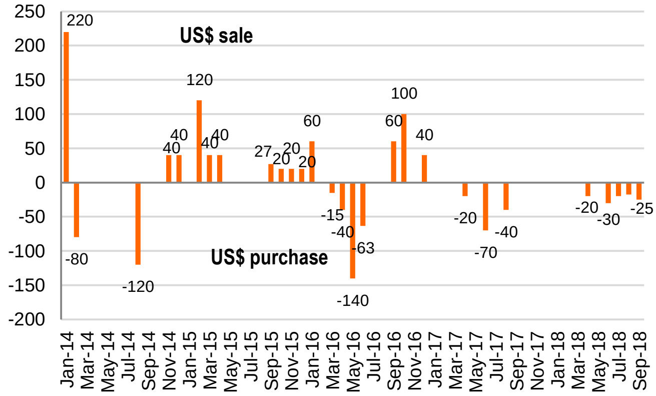
NBG to build up its reserves through purchasing US$ 112.5mn over April-September 2018. We expect seasonal GEL weakness in 4Q with an average level of 2.70-2.75 against the USD while the expected increase in government spending may put additional pressure on the local currency. The GEL's seasonal weakness usually reflects New Year-related import growth, energy import growth, fewer tourists visiting over the period and negative expectations for year-end GEL weakness built over 2014-17. We see GEL close to 2.5 vs USD in medium term.

Figure 17: NEER/REER (January 2014 = 100)



Source: NBG
Note: Index growth means GEL's appreciation and decline means GEL's depreciation

Figure 18: NBG's net interventions (US$ mn)



Source: NBG

Georgia's exposure to Turkey in 9M18

Tourism remains Georgia's largest exposure to Turkey. Turkish arrivals increased strongly over Jan-Aug 2018 before decreasing 9.1% y/y in September as the effects of the TRY's depreciation weighed on travelers. As a result in 9M18 arrivals from Turkey increased 17.2% y/y. Revenues from Turkish tourists stood at US$ 342.4mn in 9M18 and accounted for 13.4% of the total tourism income. Notably, average spending per Turkish arrival in Georgia is the third lowest (US$ 384) after Azeri and Armenian visitors.

9M18	Turkey, US$ mn	Turkey, % change y/y	Total excluding Turkey, US$ mn	Total excluding Turkey, % change y/y	Turkey's share in total, %
Exports	194.6	17.6%	2,253.5	26.5%	7.9%
Tourism revenues	342.4	17.2%	2,217.5	20.4%	13.4%
Remittances	82.8	3.7%	1,072.6	17.1%	7.2%
Imports	1,059.3	11.4%	5,617.4	20.6%	15.9%
Trade deficit	864.7	10.0%	3,364.0	17.0%	20.4%

Source: GeoStat, NBG, GNTA, Galt & Taggart Research

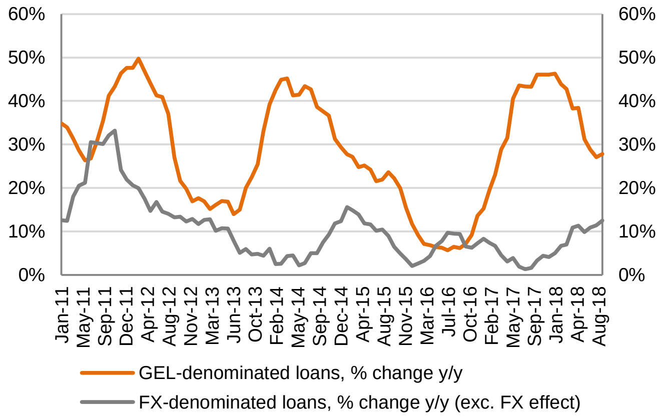
Remittances from Turkey grew by 3.7% y/y in 9M18, accounting for 7.2% of the total, down 0.8ppts y/y. Remittances from Turkey grew from January before falling 25.6% y/y in August and 24.1% y/y in September. This drop was fully absorbed by continued increase in remittances from the EU and other countries.

Goods trade deficit with Turkey widened 10.0% y/y or US$ 78.9mn in 9M18 as exports to Turkey rose by 17.6% y/y while imports increased by 11.4% y/y. In contrast, Georgia's total trade deficit excluding Turkey widened 17.0% y/y as import growth from other countries, including Russia and China, was more pronounced.

Solid loan portfolio growth, up 23.3% y/y in 8M18, supported private investment and consumption growth. The credit portfolio rose 19.0% y/y at the end of August, excluding FX effects. Importantly, corporate loan book growth accelerated 21.9% y/y vs 11.6% y/y increase a year ago. Meanwhile, consumer loan growth slowed to 22.9% y/y from 29.5% y/y last year, the likely effect of the NBG's retail lending restrictions since May 2018. Growth supported healthy credit expansion with NPLs falling 0.7ppts y/y to 2.6% in 8M. We expect the loan portfolio to grow 16% y/y in 2018. Given the NBG's new regulations on mortgages, with limitations based on applicants' level of income to take effect from November 2018, we expect retail loan growth to soften and corporate lending to increase in 2019.

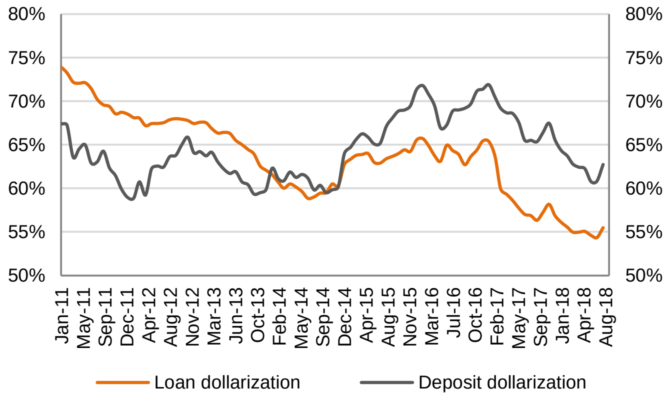
The improved consumer mood towards the national currency saw deposit dollarization decline to 60.8% in July before increasing to 62.7% (still down 2.8ppts y/y) in August as the GEL depreciated. Loan dollarization was also down, supported by the central bank's de-dollarization initiatives; however, more affordable interest rates on FX loans and anticipation that the NBG would tighten financing conditions triggered demand with loan dollarization increasing slightly compared to previous months to 55.5% (still down 1.4ppts y/y) in 8M18. To support de-dollarization, the NBG reduced the reserve requirement for GEL funding to 5% from 7% and increased the requirement on short-term foreign-currency funding to 25% from 20%.

Figure 19: Loan portfolio growth



Source: NBG

Figure 20: Dollarization



Source: NBG

Budget in surplus in 8M18, fiscal deficit planned at 2.8% of GDP for 2018. In 8M18, revenue generation was strong as tax revenues increased 6.8% y/y to GEL 6.8bn (103.3% of the planned amount) and other revenue items increased 19.3% y/y. Spending lagged behind the budgeted figures as current spending was flat y/y while capital spending and net lending increased by 1.4% y/y in 8M18. This resulted in a budget surplus of GEL 375.3mn in 8M18. Spending is expected to accelerate in 4Q as annual deficit is planned at 2.8% of GDP, which may put additional pressure on the GEL as part of the planned spending is import-intensive.

2019 draft budget submitted to parliament targets further reduction in deficit to 2.6% of GDP. The 2019 draft budget aims to contain current spending growth while targeting higher capital expenditure and a lower deficit. The budget framework submitted to parliament is based on 4.5% GDP growth and 3.5% GDP deflator projections. The fiscal deficit is set at 2.6% of GDP based on the fiscal framework agreed with the IMF and public debt is projected at 42.2% of GDP. Tax revenues are projected at 24.8% of GDP (-0.3ppts y/y). The draft budget is subject to two further revisions with a final document expected to be adopted by parliament in December.

Macro Data and Forecasts

Georgia	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
GDP and Prices															
Nominal GDP, GEL bn	11.6	13.8	17.0	19.1	18.0	20.7	24.3	26.2	26.8	29.2	31.8	34.0	38.0	41.7	45.3
Nominal GDP, US$ bn	6.4	7.8	10.2	12.8	10.8	11.6	14.4	15.8	16.1	16.5	14.0	14.4	15.2	16.5	18.0
Nominal GDP per capita, US$	1,643	2,008	2,635	3,326	2,823	3,073	3,844	4,250	4,341	4,438	3,755	3,857	4,068	4,428	4,824
Real GDP, % change y/y	9.6%	9.4%	12.6%	2.4%	-3.7%	6.2%	7.2%	6.4%	3.4%	4.6%	2.9%	2.8%	5.0%	5.0%	4.3%
CPI Inflation, average	8.2%	9.2%	9.2%	10.0%	1.7%	7.1%	8.5%	-0.9%	-0.5%	3.1%	4.0%	2.1%	6.0%	2.9%	3.9%
CPI Inflation, eop	6.2%	8.8%	11.0%	5.5%	3.0%	11.2%	2.0%	-1.4%	2.4%	2.0%	4.9%	1.8%	6.7%	3.0%	3.8%
GEL per US$, average	1.81	1.78	1.67	1.49	1.67	1.78	1.69	1.65	1.66	1.77	2.27	2.37	2.51	2.53	2.52
Population, mn	4.2	4.2	4.1	4.1	4.0	3.9	3.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.7
Government Finances															
Budget revenues, % of GDP	24.2%	26.8%	29.3%	30.7%	29.3%	28.3%	28.2%	28.9%	27.7%	27.9%	28.2%	28.4%	28.7%	28.1%	27.3%
Budget expenses, % of GDP	25.8%	28.6%	33.7%	36.4%	38.3%	34.0%	30.7%	30.6%	29.4%	30.3%	30.5%	31.0%	30.3%	29.8%	29.5%
Budget balance, % of GDP	2.2%	3.4%	0.8%	-2.0%	-7.8%	-4.6%	-1.0%	-0.6%	-1.2%	-2.1%	-1.2%	-1.5%	-0.9%	-1.3%	-1.9%
Public debt, % of GDP	40.0%	32.0%	25.5%	31.2%	41.1%	42.4%	36.5%	34.8%	34.7%	35.7%	41.4%	44.4%	44.6%	42.6%	42.2%
External Sector															
Current account, US$ bn	-0.7	-1.2	-2.0	-2.8	-1.1	-1.2	-1.8	-1.9	-1.0	-1.8	-1.8	-1.9	-1.3	-1.5	-1.6
Current account, % of GDP	-11.1%	-15.2%	-19.8%	-22.0%	-10.6%	-10.3%	-12.8%	-11.9%	-5.9%	-10.8%	-12.6%	-13.1%	-8.8%	-9.4%	-9.0%
Exports of goods and services, US$ bn	2.2	2.6	3.2	3.7	3.2	4.1	5.3	6.0	7.2	7.1	6.2	6.2	7.6	9.3	10.3
Imports of goods and services, US$ bn	3.3	4.4	5.9	7.5	5.3	6.1	8.0	9.2	9.3	10.1	8.7	8.5	9.4	11.4	12.5
Net Current transfers, US$ bn	0.4	0.5	0.7	1.1	1.0	1.1	1.3	1.4	1.5	1.4	1.1	1.1	1.3	1.4	1.5
Net FDI, US$ bn	0.5	1.2	1.7	1.4	0.7	0.7	1.0	0.7	0.9	1.4	1.3	1.2	1.6	1.7	1.7
Net FDI, % of GDP	8.5%	15.3%	16.5%	11.1%	6.3%	6.1%	6.8%	4.6%	5.6%	8.5%	9.6%	8.1%	10.7%	10.6%	9.4%
Gross international reserves, US$ bn	0.5	0.9	1.4	1.5	2.1	2.3	2.8	2.9	2.8	2.7	2.5	2.8	3.0	3.3	3.6
Financial sector															
Bank loan portfolio, US$ bn	0.9	1.5	2.7	3.9	3.0	3.4	4.5	5.1	6.2	7.2	7.1	8.0	8.9	10.0	11.0
Bank loan portfolio, % of GDP	14.5%	19.1%	26.5%	30.5%	27.9%	29.3%	30.9%	32.4%	38.1%	43.6%	50.4%	55.6%	58.6%	60.6%	61.2%
Monetary policy rate, %	..	..	..	8.00%	5.00%	7.50%	6.75%	5.25%	3.75%	4.00%	8.00%	6.50%	7.25%	7.00%	7.00%

Source: NBG, MOF, GeoStat, Galt & Taggart Research
Note: Government budget balance according to IMF's GFS 2001

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