



Georgian Economy

GEL – Expected Adjustment

Prudent macroeconomic policy-making and strong growth in external earnings helped the GEL remain immune to the sell-off in regional currencies until early August 2018. However, the TRY's collapse on 10 August affected the GEL through the expectations channel when the currency lost 3.9% in one day against the USD trading at 2.57 on Bloomberg. Taking into account the ongoing currency crisis in Turkey and sour global sentiment in EM currencies, we expect the US\$/GEL rate to weaken to around 2.7 compared to our previous 2.6 projection for end-2018. The gradual adjustment in the US\$/GEL rate is likely a necessary correction to rectify the GEL's real gains against the TRY and RUB – Georgia's two largest trading partners. We also believe that depending on FDI/tourism inflows and import performance, pressure on the GEL might subside in August–September 2018.

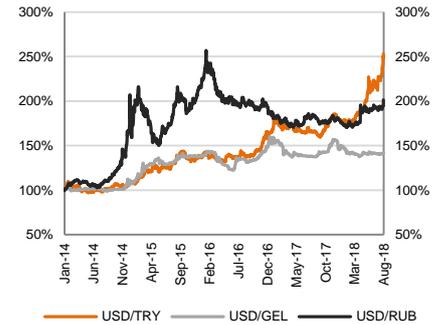
Strong market fundamentals made GEL immune from contagion in regional currency sell-off until early August 2018. Strong double-digit growth in exports (+28.5% y/y), growing remittances (+18.3% y/y), and impressive tourism inflows (+28.9% y/y) in 1H18, totaling an aggregate increase of US\$ 774mn (+26.6% y/y), helped Georgia's economic growth to accelerate to 5.7% in 1H18 and the GEL to appreciate 5.7% against the USD. The currency remained strong compared to its regional peers despite changes in the cabinet in May and strong imports growth (+22.9%) as consumer and business confidence strengthened due to booming tourism and fresh tax cuts from the government targeting small and medium enterprises. In the meantime, Georgia's major trading partners' currencies – the RUB and TRY – were losing ground against the USD, resulting in the GEL's real appreciation against these currencies (+6.4% and +14.6% in June 2018, respectively). Moreover, strong external inflows allowed the NBG to buy US\$ 87.5mn during the year to build up its reserves and keep the economy competitive.

The deepening currency crisis in Turkey in early August and the RUB weakness related to the new US sanctions started to have an effect on the lari at the beginning of August. The GEL weakened against the USD to reach 2.47 as of 9 August 2018, losing 0.8% from 1 August. It then lost 3.9% in one day to hit 2.57 on Bloomberg on 10 August. We believe that the latter was a result of market reaction to the collapse of the Turkish lira through the expectations channel (see our note dated 28 May 2018). This adjustment means that lari has actually corrected against major currencies, preserving its competitiveness.

We expect inflation to remain within the NBG's 3.0% target level in 2018. Annual inflation has fallen notably since the start of 2018, coming in at 2.8% in July 2018 as the increase in prices related to the increase in the excise taxes has dissipated. Increased risk of imported inflation was the main reason why the NBG kept its monetary policy rate unchanged at 7.25% at its first four monetary committee meetings this year (January, March, May and June) before cutting it by 0.25 bps to 7.0% (in July) due to reduced pressures on inflation coming from the sharp appreciation of the GEL's nominal effective FX rate. Although we anticipate seasonal depreciation of the GEL until end-2018, at the same time we expect inflation to remain close to the NBG's 3.0% target level in 2018. Our projection takes into account the NBG's commitment to price stability and significant policy space to respond to inflationary pressures along with muted demand side pressures as salaries and government current spending growth is moderate.

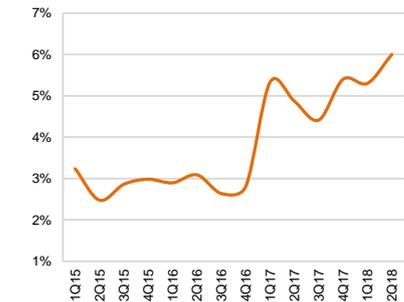
Depending on the dynamics of the TRY, we expect the US\$/GEL to reach 2.7 at end 2018. The FX data shows that over the last 6 months the 10% depreciation of TRY vs US\$ caused GEL to depreciate by 1.2% vs US\$, which is in line with our model-based estimate. Taking into account the ongoing currency crisis in Turkey, we expect the US\$/GEL rate to weaken to around 2.7 compared to our earlier projection of 2.6 for end-2018. We also believe that depending on FDI/tourism inflows and the performance of imports, pressure on the lari might subside in August/September 2018.

Figure 1: Exchange rate performance



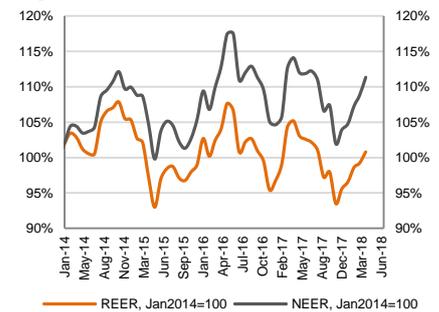
Source: NBG

Figure 2: Real GDP growth, %



Source: GeoStat

Figure 3: Lari's NEER and REER



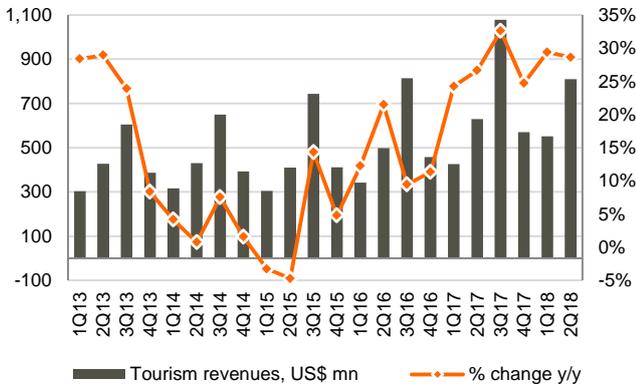
Source: NBG

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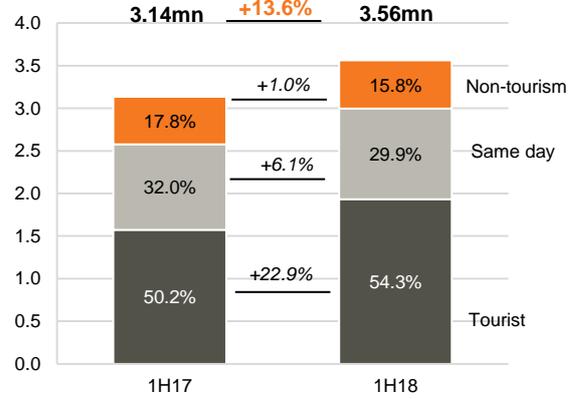


Figure 4: Tourism inflows



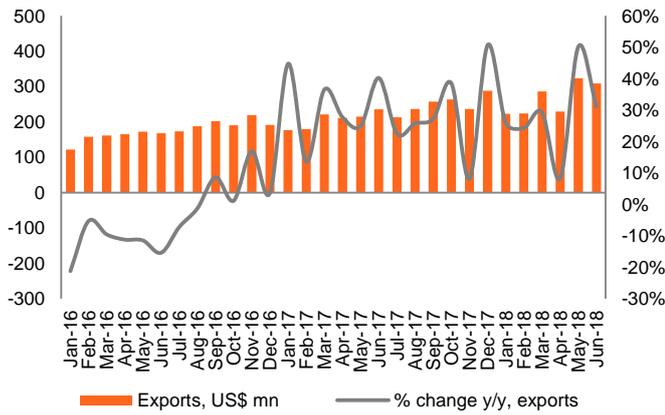
Source: NBG

Figure 5: International arrivals, 1H18 vs 1H17



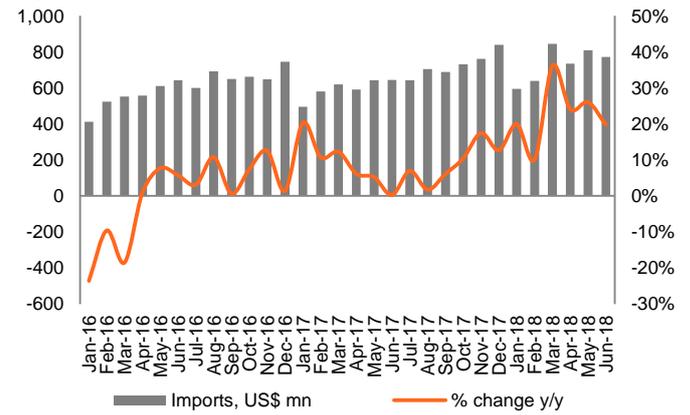
Source: GNTA

Figure 6: Exports



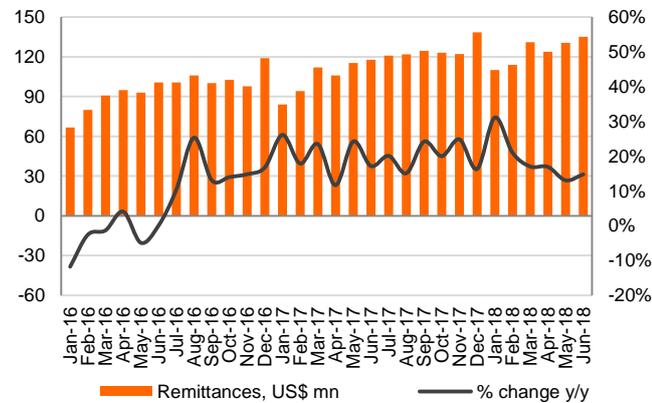
Source: GeoStat

Figure 7: Imports



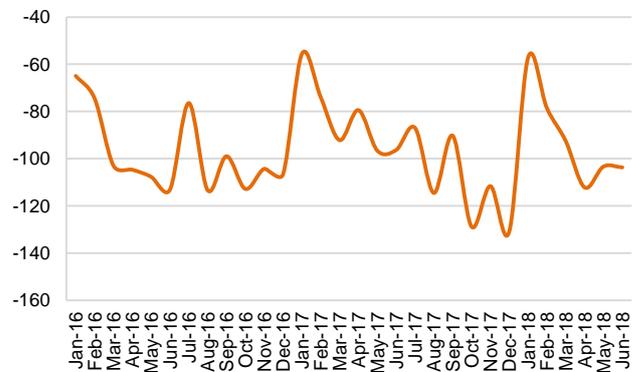
Source: GeoStat

Figure 8: Remittances



Source: NBG

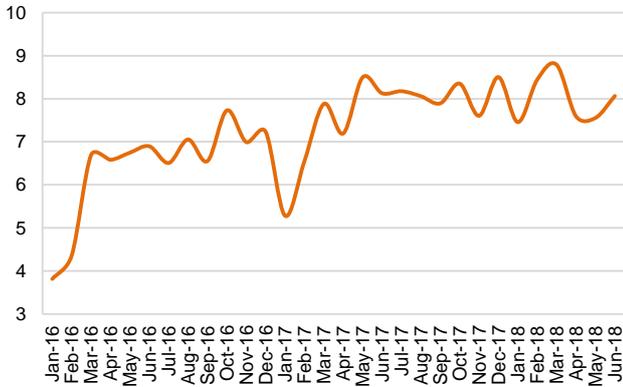
Figure 9: Goods trade balance between Georgia and Turkey, US\$ mn



Source: GeoStat

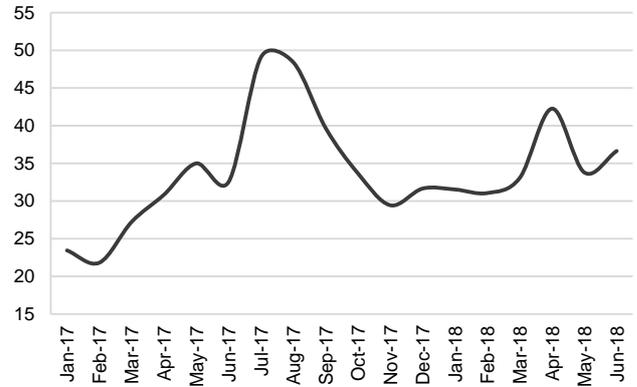


Figure 10: Net remittances with Turkey, US\$ mn



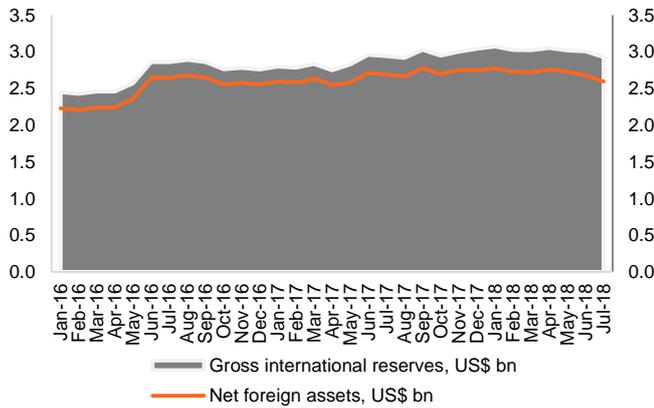
Source: NBG

Figure 11: Tourism revenues from Turkey, US\$ mn



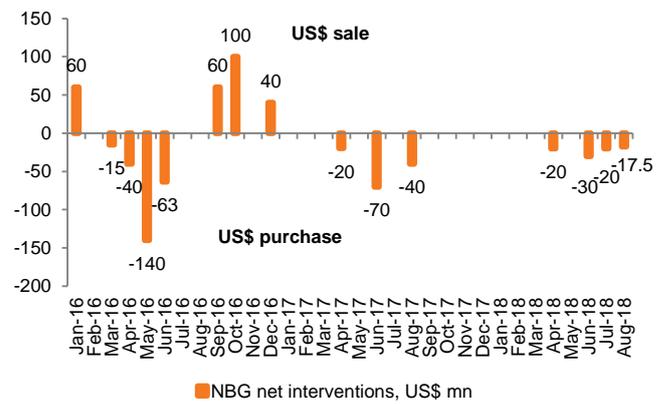
Source: GNTA, GeoStat, G&T research

Figure 12: International reserves



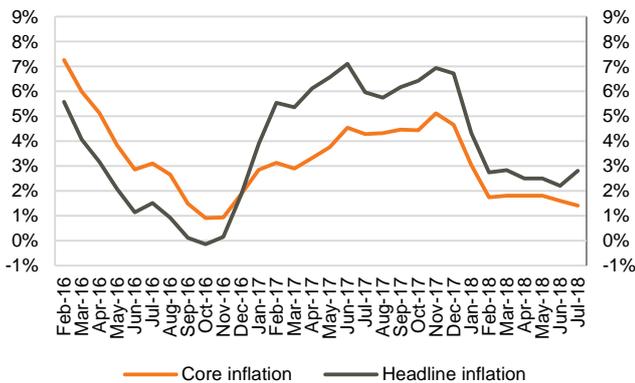
Source: NBG

Figure 13: NBG FX interventions



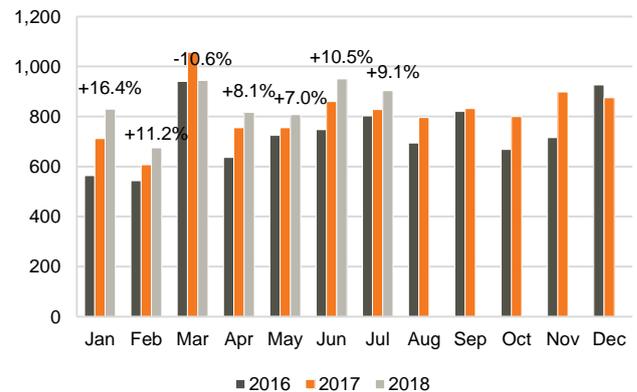
Source: NBG

Figure 14: Annual CPI inflation



Source: GeoStat

Figure 15: Tax revenues, US\$ mn



Source: MOF



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