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# Georgian Economy
# Stay Confident - Fundamentals are Strong

Georgia | Economy
August 7, 2019

## Executive Summary

Georgia's economic growth was strong at 4.9% in 1H19, helped by continued improvement in trade balance as well as supportive monetary and fiscal policies. The monetary policy rate cut in the beginning of 2019 stimulated GEL lending making credit portfolio growth healthier. At the same time, acceleration of public infrastructure spending made fiscal stance expansionary but fiscal deficit projected below 3.0% of GDP in 2019 with contained current spending.

Improved external balance enabled NBG to build reserves in 1H19, which stood at record-high US$ 3.7bn. NBG's FX purchases along with other measures strengthened GEL liquidity. This stimulated de-dollarization and growth, but limited GEL's appreciation trend - short-term cost for long-term benefit.

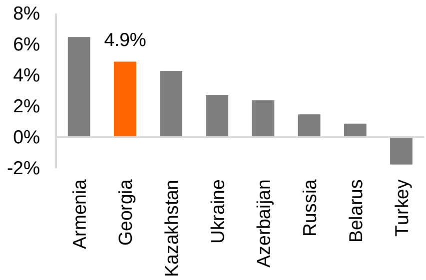
Rise in inflation from March-19 mostly reflected one-off factors of higher tobacco excises, keeping currency pressures muted on prices as demand was weak. Russia's flight ban and temporary political uncertainty triggered by the visit of the Russian parliament delegation at the end of June weighed further on currency through negative expectations. The GEL reached its historic lows at GEL2.97/$ on 1 August 2019, as negative expectations were mounting despite better than expected tourism data in July and positive macroeconomic dynamics.

With an aim to limit market overreaction, the NBG intervened on the FX market and sold US$ 32.8mn out of offered US$ 40mn on 1 August. As a result of this intervention the GEL quickly strengthened by 2.9% from GEL2.97/$ to 2.89 during 1-2 August, before weakening again. The intervention followed the central bank's statement that despite positive foreign and domestic macroeconomic dynamics, the GEL's recent excessive depreciation related to tourism shock and negative expectations, created risks to price stability. NBG also committed to use other monetary policy tools to support the currency if needed. Importantly, the GEL's REER and NEER weakened by more than 10% y/y, hinting at excessive undervaluation of the currency.

As fundamentals remain strong and fresh data on July tourism is better than projected, the GEL reflects the lack of confidence currently. Lower GEL deposit growth and a shift from GEL to FX-deposits along with stronger GEL borrowing cause short-term currency pressure.

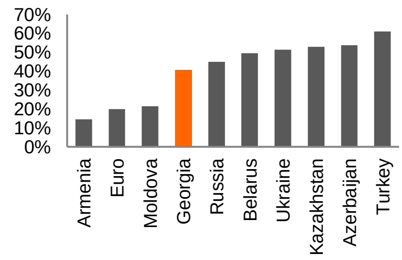
With GEL's REER and NEER weakened and CA deficit set to shrink in 2019 helped by lower imports, we see GEL extremely undervalued – by 10-13% currently. We expect GEL to strengthen toward 2.75-2.80 against US$ through 2019 and further to 2.60-2.65 in 2020. Moreover, recent rise in treasury yields indicate that market already priced in possible policy rate hike from NBG on 4 September meeting, which will also be GEL-positive.

### Figure 1: Real GDP growth rates, 1H19



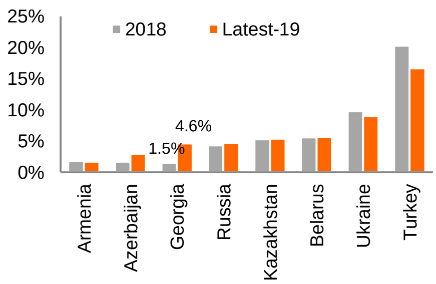

*Source: National statistics offices*
*Note: G&T estimate for Turkey and Ukraine*

### Figure 2: Currency weakening vs USD



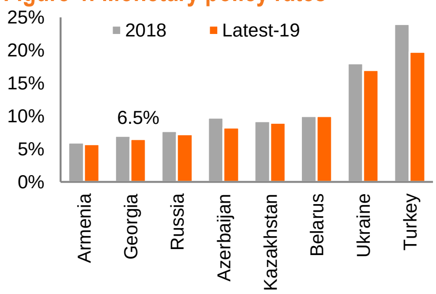

*Source: Bloomberg*
*Note: US$ per unit of national currency, 1 Aug 2014 – 7 August 2019*

### Figure 3: Annual inflation




*Source: National statistics offices*

### Figure 4: Monetary policy rates




*Source: Central banks*

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**Improved external balance enabled NBG to build reserves in 1H19.** Double-digit growth in exports (+11.5% y/y), growing remittances (+8.0% y/y) and tourism inflows (+7.0% y/y) in 1H19 combined with 4.9% y/y reduction in imports improved external balance by US$ 555mn from these components. This is already reflected in improved current account balance, with deficit halved to 6.2% of GDP in 1Q19. 2Q statistics not yet available but preliminary data hints to continued improvement in current account.

The improved external balance enabled NBG to purchase US$ 216mn on the FX market to build reserves. The FX purchases along with other instruments (1 week refinancing loans, etc.) strengthened GEL liquidity. NBG also increased reserve requirement on FX deposits since May 2019 to support de-dollarization process. The GEL liquidity was absorbed by growing economy and was in line with increased demand as interbank interest rates remained close to the NBG's policy rate of 6.5%. If more liquidity than what demanded were offered, market interest rates would fall below the policy rate. As the economy grew, M2 increased in the range of 16-25% y/y during 1H19 - same growth levels were recorded in 2017-18 and is in line with our M2 growth projection of 19.2% y/y at end-2019. From M2 components the GEL deposits growth was affected by de-dollarization measures and growth in national savings (effect of profit tax reform since 2017, as untaxed reinvested profits are deposited at bank accounts).

**GEL is 10-13% undervalued currently.** The GEL usually followed seasonal pattern in 2015-18 – stronger in summer due to tourism season and weaker at year-end due to increased energy imports. GEL was on appreciation trend in the beginning of 2019 despite NBG's FX purchases in the amount of US$ 186mn in Jan-Feb 2019. These purchases along with slight increase in deposit dollarization from May and FX purchases for investment flows weakened the currency at around 2.7 vs. US$ compared to equilibrium rate of 2.6. However, at the end of Jun-19, Russia's direct flight ban to Georgia and talks on possible Russian embargo (not realized) on Georgian wine and mineral waters as well as temporary political uncertainty triggered by the visit of the Russian parliament delegation at the end of June weighed further on currency through negative expectations. The GEL reached its historic lows at GEL2.97/$ on 1 August 2019. Notably, extremely negative assessments of the Russian flight ban impact on Georgian economy from government representatives, analysts, and certain number of private sector players resulted in mounting uncertainties and excessive volatility of the currency. On the positive note, tourist arrivals slowed but still posted growth of 1.0% y/y in July 2019. Notably, the number of Russian arrivals reduced less than expected - down 6.4% y/y in July, largely compensated by increased Russian arrivals through land border and via alternative transit flights. Moreover, visitors from EU, CIS countries, Turkey and Asia continued growing.

To counter excessive depreciation, the NBG intervened on the FX market and sold US$ 32.8mn out of offered US$ 40mn on 1 August. As a result of this intervention the GEL quickly strengthened 2.9% from GEL2.97/$ to 2.89 during 1-2 August, before weakening again. The intervention followed the central bank's statement that despite positive foreign and domestic macroeconomic dynamics, the GEL's recent excessive depreciation related to tourism shock and negative expectations, created risks to price stability. NBG also noted that it will again intervene on the currency market in the coming days and use other monetary policy tools to support the currency if needed. Importantly, the GEL's REER and NEER weakened by more than 10% y/y, hinting at excessive undervaluation of the currency.

As fundamentals remain strong and fresh data on July tourism is better than projected, the GEL reflects the lack of confidence currently. This results in lower GEL deposit growth and/or a shift from GEL to FX-deposits along with stronger GEL borrowing, which causes short-term currency pressure. After decreasing from Jan-19, deposit dollarization started rising since May-19 reaching 62.4% in June, up 1.6ppts y/y. Negative expectations are also reflected in change of GEL deposit structure in Jun-19 - accelerated growth in GEL demand deposits and lower growth in time deposits.

With GEL's REER and NEER weakened more than 10% y/y and CA deficit set to shrink in 2019 due to lower imports, we see GEL extremely undervalued – we assess undervaluation by 10-13% currently. We expect GEL to gain strength as negative expectations from tourism slowdown and political uncertainty expected to fade. Moreover, recent rise in treasury yields indicate that market already priced in possible policy rate hike from NBG on 4 September meeting, which will also be GEL-positive. We expect GEL to strengthen toward 2.75-2.80 against US$ through 2019 and further to 2.60-2.65 in 2020.

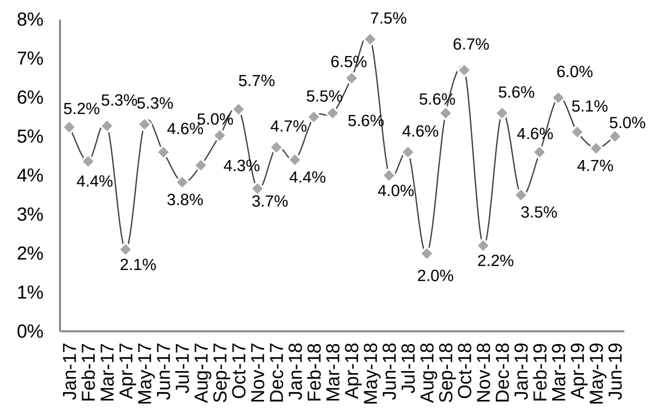
Price increases from March 2019 mostly reflected one-off shocks related to excise tax hikes on tobacco. Annual inflation came in at 4.6% in July 2019, above the NBG's 3% target. Tobacco excises added 1.3ppts to overall inflation. Core inflation was 1.9% (non-food, non-energy, non-tobacco), suggesting weak demand-side pressures. NBG reduced key rate twice in the beginning of 2019, keeping on hold afterwards. Anticipated increase in imported inflation due to weak GEL is the only potential source of price pressure currently. Therefore, there is likelihood of rate hike by NBG on its 4 September committee meeting. Notably, weak world commodity prices on fuels and food and GEL's anticipated appreciation may contain price growth at manageable levels. We expect inflation to remain at 4-5% at end-2019 before reaching 3% in 2020 as one-off factors fade.

## Better than expected growth in 1H19, growth expected at 4.3% in 2H19

Georgia's economy grew rapidly and consistently. Growth was 4.9% y/y in 1H19 and remained broad-based despite weakness in construction sector. External markets boosted goods exports and remittances. After tourism boom in 1H19, tourist arrivals slowed but still posted growth of 1.0% y/y in July 2019 despite Russia's ban on direct flights to Georgia from 8 July 2019. In addition, banking sector credit portfolio expanded by 14.2% y/y excluding FX effect, sustainable growth and composition of portfolio healthier. Public capital expenditures accelerated markedly from 2Q19, with spending increasing 24.5% y/y in 1H19. Tax revenues increased 7.9% y/y and current spending growth was 11.9% y/y in 1H19. Overall, fiscal policy was expansionary in 1H19 with deficit at GEL 133.5mn compared to surplus of GEL 239.3mn in 1H18.

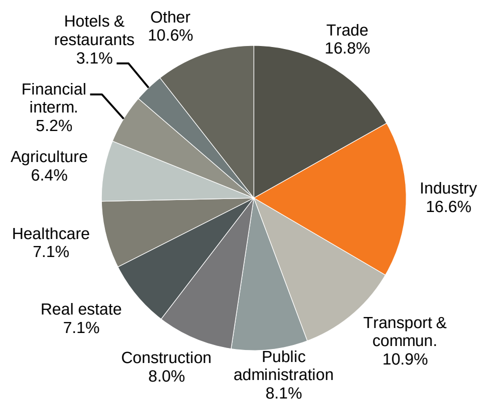
We expect real GDP growth at 4.3% in 2H19 as Russian sanctions expected to subtract 0.5ppts (US$ 200mn revenue loss or 1.2% of GDP) from growth. We expect 2019 full year growth at 4.5%, as economy expanded at an estimated 4.9% in 1H19. Track record of implemented reforms and enhanced business environment will enable Georgia to generate 5-6% in medium term. Moreover, ongoing reform measures to boost capital markets, overhaul education system and enhance economic diversification create room for further expansion.

## Figure 5: Monthly real GDP growth, %



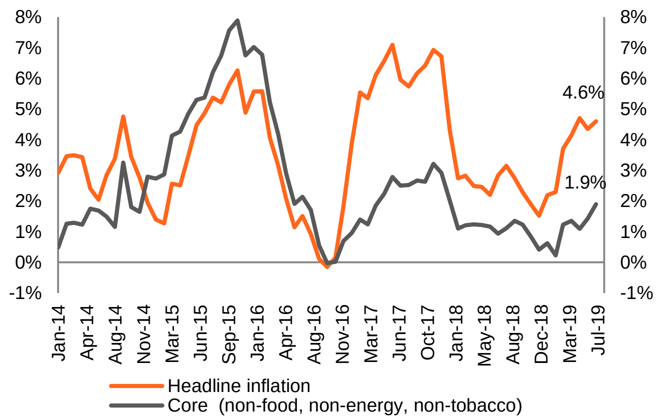

*Source: Geostat*

## Figure 6: GDP structure by sector, 1Q19



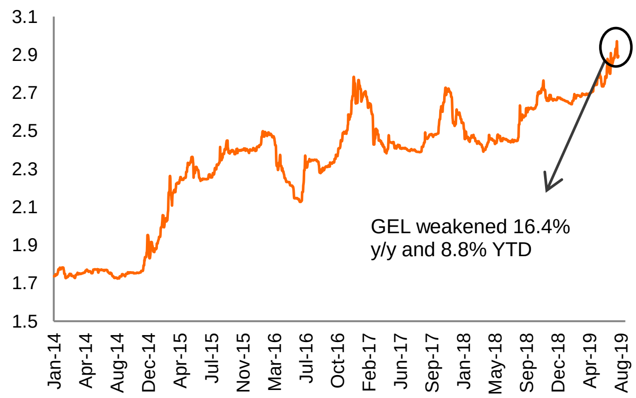

*Source: Geostat*

## Figure 7: Annual inflation



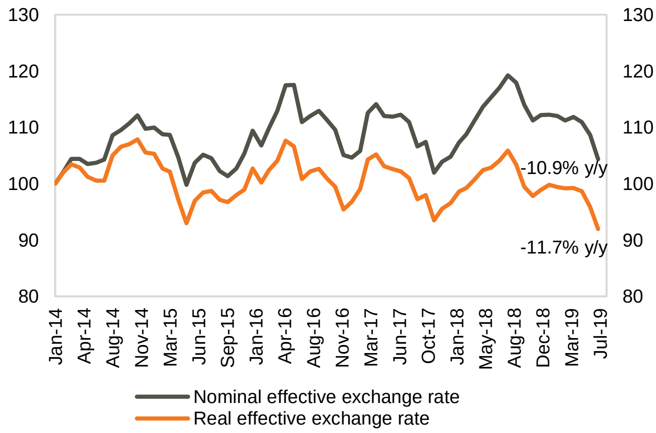

*Source: Geostat*

## Figure 8: USD/GEL exchange rate



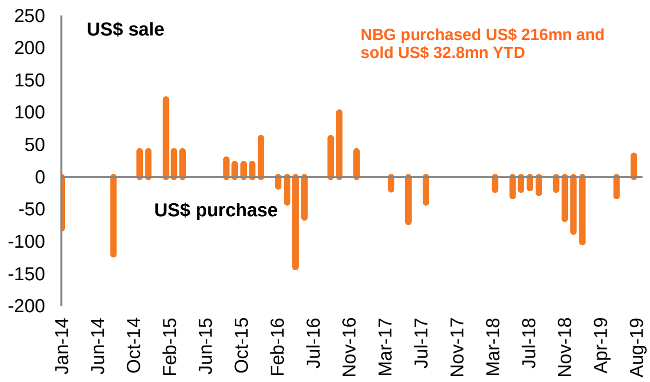

*Source: NBG*

## Figure 9: GEL's NEER/REER, January 2014 = 100



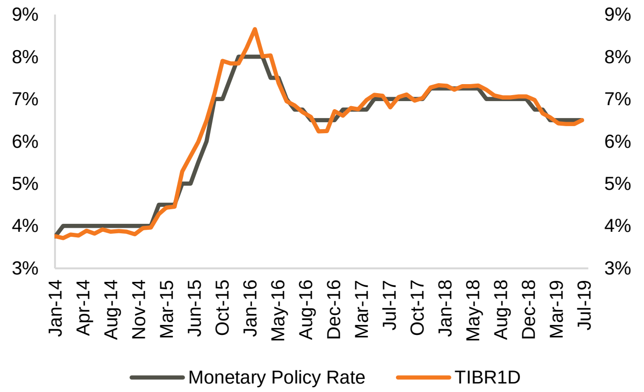

*Source: NBG*
*Note: G&T estimate for Jul-19 REER. Index growth means GEL's appreciation and decline means GEL's depreciation*

## Figure 10: NBG's net interventions, US$ mn



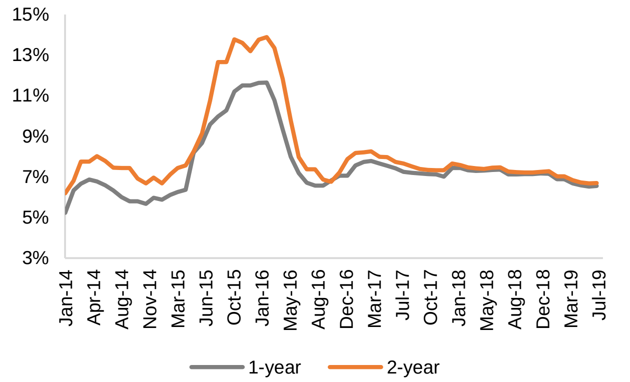

*Source: NBG*

## Figure 11: Monetary policy rate and TIBR 1 Day



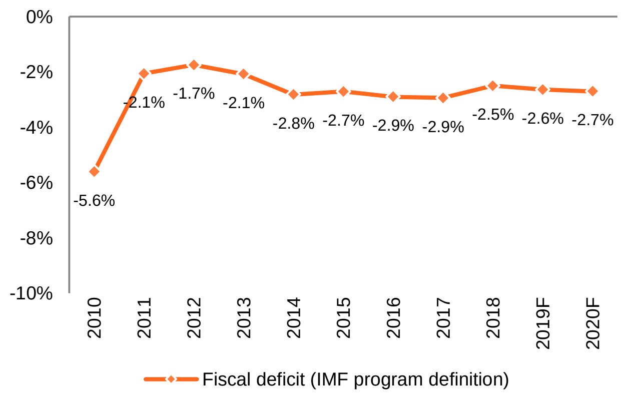

*Source: NBG*

## Figure 12: Interest rates on treasury securities



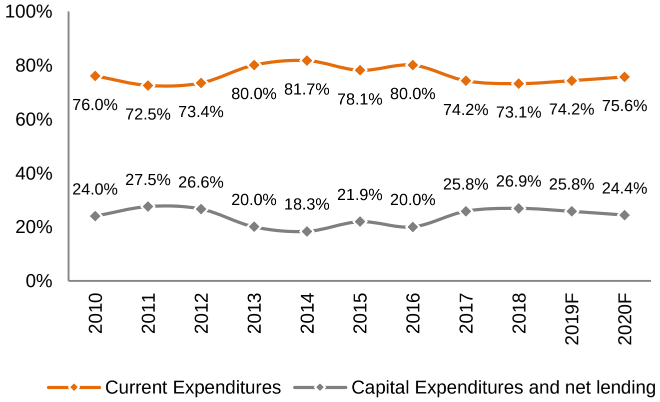

*Source: NBG*

## Figure 13: Fiscal deficit



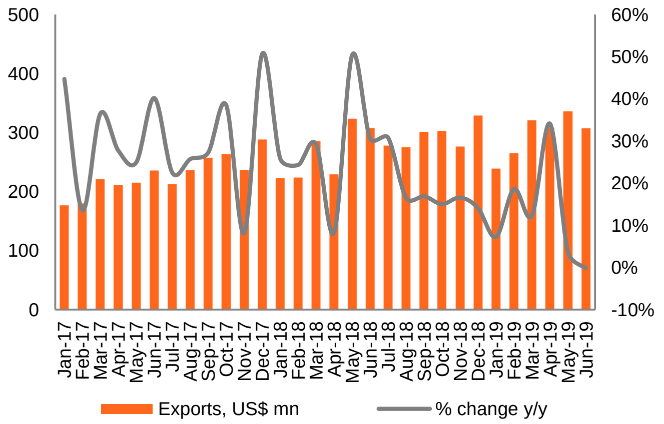

*Source: MOF*
*Note: Deficit calculated as net lending / borrowing minus budget lending*

## Figure 14: Expenditures: current vs. capital



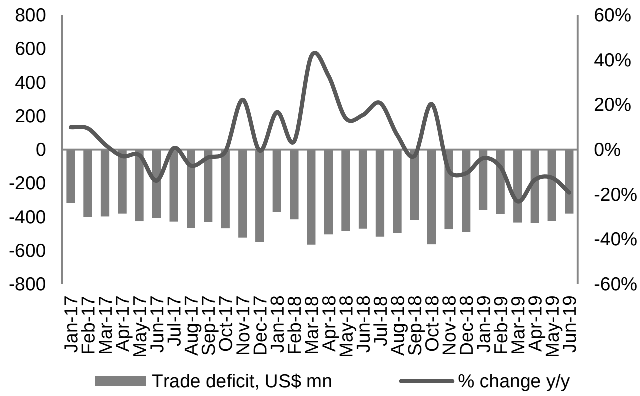

*Source: MOF*

## Figure 15: Exports



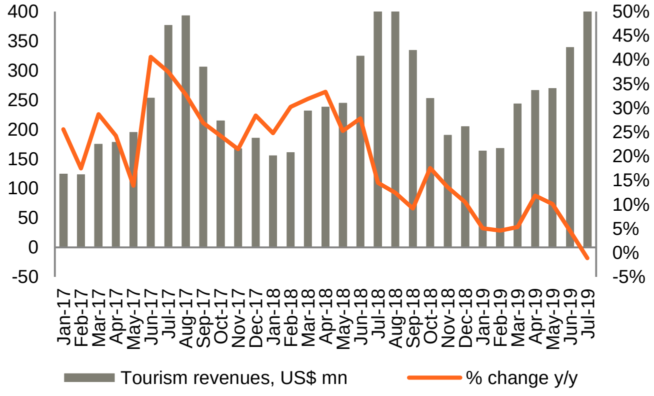

*Source: Geostat*

## Figure 16: Trade deficit



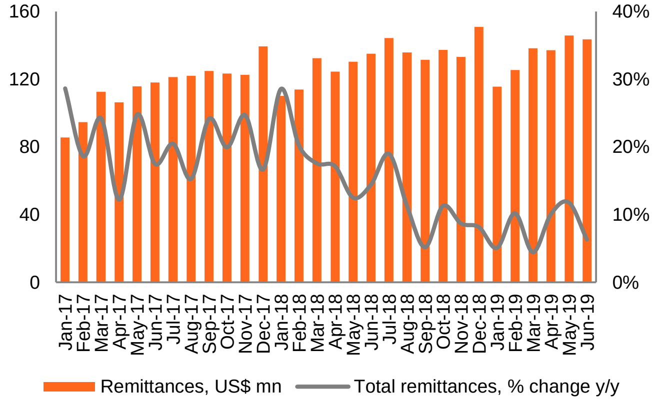

*Source: Geostat*

**Figure 17: Tourism inflows**




*Source: Geostat, NBG*

**Figure 18: Money transfers**




*Source: Geostat, NBG*

## Macro Data and Forecasts

| Georgia | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018E | 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 | 41.1 | 44.6 |
| 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 | 15.1 | 16.2 | 16.3 |
| 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 | 4,047 | 4,346 | 4,369 |
| 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% | 4.8% | 4.7% | 4.5% |
| 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% | 2.6% | 4.0% |
| 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% | 1.5% | 4.7% |
| GEL per US$, average | 1.81 | 1.78 | 1.67 | 1.49 | 1.67 | 1.78 | 1.69 | 1.65 | 1.66 | 1.77 | 2.27 | 2.37 | 2.51 | 2.53 | 2.78 |
| Population, mn | 4.2 | 4.2 | 4.1 | 4.1 | 4.0 | 3.9 | 3.9 | 3.8 | 3.8 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| **Government Finances** | | | | | | | | | | | | | | | |
| Budget revenues, % of GDP | 24.2% | 26.8% | 29.3% | 30.7% | 29.3% | 28.3% | 28.2% | 28.9% | 27.7% | 27.9% | 28.2% | 28.4% | 28.9% | 28.8% | 28.3% |
| Budget expenses, % of GDP | 25.8% | 28.6% | 33.7% | 36.4% | 38.3% | 34.0% | 30.7% | 30.6% | 29.4% | 30.3% | 30.5% | 31.0% | 30.4% | 30.1% | 30.8% |
| Budget balance, % of GDP | 2.2% | 3.4% | 0.8% | -2.0% | -7.8% | -4.6% | -1.0% | -0.6% | -1.2% | -2.1% | -1.2% | -1.5% | -0.9% | -0.8% | -2.2% |
| Public debt, % of GDP | 40.0% | 32.0% | 25.5% | 31.2% | 41.1% | 42.4% | 36.5% | 34.8% | 34.7% | 35.7% | 41.4% | 44.4% | 44.8% | 45.0% | 46.7% |
| **External Sector** | | | | | | | | | | | | | | | |
| Current account, US$ 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 | -1.2 | -1.1 |
| 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% | -7.7% | -6.8% |
| 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 | 8.9 | 9.7 |
| 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 | 10.8 | 11.2 |
| 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 | 1.1 | 1.4 |
| 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% | 5.5% | 6.1% |
| 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 | 2.8 | 3.5 | 3.0 | 3.4 | 4.5 | 5.1 | 6.0 | 6.8 | 6.7 | 7.1 | 8.6 | 9.9 | 10.9 |
| Bank loan portfolio, % of GDP | 14.6% | 19.2% | 26.6% | 30.6% | 28.0% | 29.3% | 30.9% | 32.4% | 38.5% | 43.6% | 50.4% | 55.6% | 58.9% | 64.7% | 67.0% |
| 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% | 6.75% |

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

# Disclaimer



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