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RESEARCH

Georgian Economy
Every Cloud Has a Silver Lining

Georgia | Economy

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Executive Summary

Georgia's key positives lie in its economic and trade diversification, the success of implemented reforms, its macroeconomic resilience, low public debt level and strong banking sector. These factors insure economic resilience in the face of upcoming Russian sanctions on Georgia's tourism and possibly on wine industry. Dealing with Russian sanctions is not a new challenge for Georgia. The 2006 Russian embargo forced Georgia to redirect its focus from Russian market, which expanded export destinations and improved quality of Georgian products. This also deepened economic ties with the rest of the world, with EU-Georgia free trade agreement signed in 2014, followed by free trade deals with China and other countries. We believe that upcoming Russian sanctions will further intensify Georgia's economic diversification, use potential of new large markets – EU and China, and enhance its institutions.

Georgia's exposure (as defined by combination of four channels: exports, tourism, remittances and FDI) to Russia accounted for 9.3% of GDP in 2018. Notably, since 2013 Georgian exports to Russian market increased significantly as trade was restored. Georgia also gained popularity among Russian visitors. Dependence on remittances from Russia has been reduced in recent years as EU became another alternative of Georgian migrants, while FDI from Russia is generally low.

In short, recent Russian sanctions expected to weigh on Georgian economy, but unlike 2006 Russian embargo, the country is better placed to deal with negative shocks. Summing up:

- We forecast sanctions to reduce Russian arrivals by 47% y/y in 2H19, while we forecast visitors from other countries to increase by 15% y/y in the same period, fully compensating reduced Russian visitors as well as sector revenues.
- We expect tourism revenues to be flat y/y in 2H19 at US$ 1.9bn in contrast of our initial growth projection of 12.3% y/y at US$ 2.1bn in 2H. Overall, we estimate tourism revenue loss of US$ 200mn in 2019 from reduced Russian arrivals. Therefore, we revise tourism revenues forecast for the full 2019 year at US$ 3.4bn (+6.9% y/y) from our initial projection of US$ 3.6bn.
- Georgian wine export to Russia stood at US$ 114.5mn (3.4% of total exports) in 2018 and exports reached US$ 51.2mn in 5M19. We estimate revenue loss from possible Russian embargo on Georgian wine at US$ 58mn in 2H19. Notably, wine makers expected to adjust to market conditions quickly and redirect their product to other destination markets, as Georgian wine is popular worldwide, unlike 2006.
- We expect real GDP growth at 4.3% in 2H19 as Russian sanctions expected to subtract 0.7ppts (US$ 260mn revenue loss or 1.6% of GDP) from Georgia's real GDP growth. We expect 2019 full year growth at 4.5%, as economy expanded at an estimated 4.8% in 1H19.
- We expect average GEL/US$ to remain close 2.7-2.75 in 2H19 and GEL to strengthen at 2.6 in 2020 as we do not expect additional pressure on GEL from Russian sanctions, but short term volatility due to uncertainty. Importantly, GEL remained undervalued by 7% vs US$ in 1H19 despite significant improvement in external balance. GEL weakness was mostly related to NBG's FX purchases (US$ 216mn in 1H19) as well as other factors (FX reserve requirement, negative expectations from TRY depreciation, etc.). Our exchange rate projection considers different factors, including adequate international reserves and no FX purchases needed from NBG currently to comply with IMF program target, as well as external inflows from recent corporate Eurobond placements and trade balance in check.

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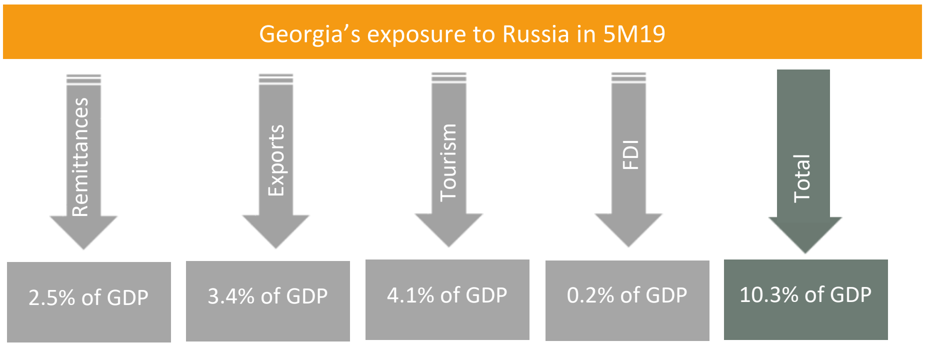
Georgia-Russia economic links

Georgia is exposed to Russia via tourism, goods exports and remittances, while FDI from Russia is generally low. Financial ties are limited with only one Russian bank operating in the country. Georgia gained energy independence from Russia since 2006, and it imports natural gas mainly from Azerbaijan.

In 5M19, Georgia's exposure to Russia accounted for 10.3% of GDP through the following channels:

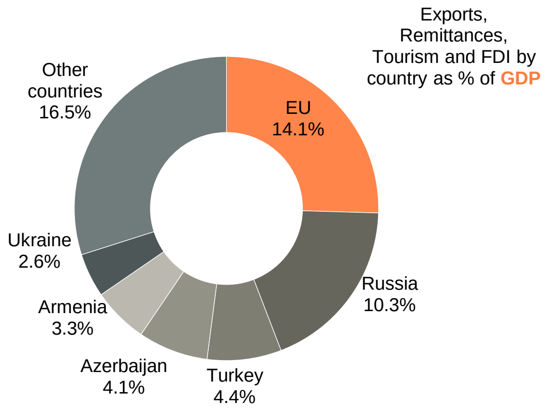
- Remittances from Russia accounted for 24.7% of total money transfers, or 2.5% of GDP.
- Exports to Russia accounted for 14.9% of total exports, or 3.4% of GDP.
- Arrivals from Russia accounted for 21.6% of total arrivals, and receipts from Russian tourists reached 4.1% of GDP.
- FDI from Russia accounted for 0.2% of GDP in 1Q19.

Figure 1: Georgia's exposure to Russia in 5M19



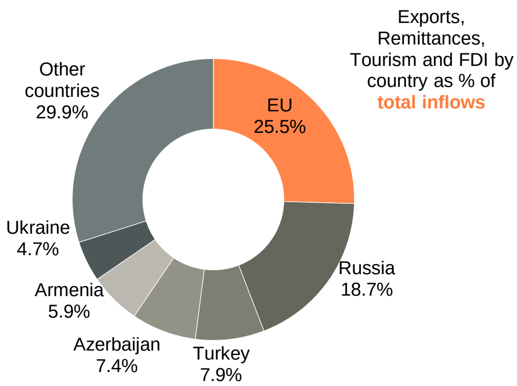
Source: NBG, GeoStat, GNTA, G&T Research
Note: FDI as of 1Q19

Figure 2: Georgia's exposure to partner countries, 5M19



Source: Geostat, NBG, GNTA, Galt & Taggart

Figure 3: Georgia's exposure to partner countries, 5M19



Source: Geostat, NBG, GNTA, Galt & Taggart

Tourism

Tourism is the largest exposure to Russia and accounted for 4.1% of GDP in 5M19. A temporary travel restrictions by President Putin to cancel all flights from Russia to Georgia starting on 8 July 2019 expected to weigh Georgia's tourism industry, however we believe it will boost diversification of source markets and further emphasis on improving service quality and attracting high yielding visitors in the medium term.

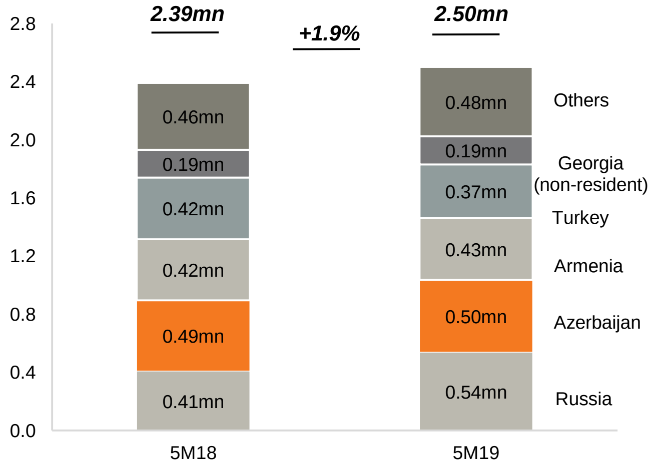
Given the fact that c. 70% of Russians visit Georgia by road, we think that flight ban will directly impact only 30% of Russian visitors. As Georgia is cheaper than many other tourism destinations, and some Russian visitors are driving to Georgia for gambling with limited other alternatives, we do not expect banning flights to fully reduce Russian visitors. On top of these, Russians may also fly to Georgia by different transit routes. Considering this, we expect Russian arrivals to reduce by c. 47% y/y in 2H19 vs. growth of 31.4% y/y in 1H19. At the same time we expect arrivals from other countries to grow by 15% y/y in 2H19, fully compensating reduced visits from Russia. This will bring total tourist arrivals to Georgia at an estimated 4.9mn in 2019, up 3.5% y/y (our initial forecast was 5.3mn tourists in 2019). Notably, per visitor spending by Russians at US$ 482 in Georgia is one of the lowest and visitors from Germany, Poland, Ukraine and Israel, rapidly growing markets currently, spend substantially larger amounts. We expect tourism revenues to be flat y/y in 2H19 at US$ 1.9bn in contrast of our initial growth projection of 12.3% y/y at US$ 2.1bn in 2H. Considering fall in Russian arrivals, we expect tourism revenues at US$ 3.4bn (+6.9% y/y) in 2019 vs. initial projection of US$ 3.6bn. We do not rule out less negative impact on tourism industry considering active promotional campaign to visit Georgia by different foreign channels as well as supporting schemes by government and private sector representatives.

Table 1: Tourist arrivals and revenues scenario considering Russian sanctions

Arrivals and revenues	2018	2019F	2019F	2020F
	Actual	Initial forecast, G&T	Revised forecast, G&T	Revised forecast, G&T
Total International visitors, mn persons	7.2	7.7	7.5	8.1
y/y growth	*11.1%*	*6.6%*	*4.2%*	*8.0%*
Total tourists, mn persons	4.8	5.3	4.9	5.3
y/y growth	*16.9%*	*11.4%*	*3.5%*	*7.7%*
o.w Russian tourists, mn persons	1.1	1.2	0.9	0.8
y/y growth	*27.3%*	*18.0%*	*-17.9%*	*-3.0%*
Tourism Revenues, US$ bn	3.2	3.6	3.4	3.8
y/y growth	*19.1%*	*12.3%*	*6.9%*	*10.0%*

Source: GNTA, NBG, Galt & Taggart
Note: International arrivals combine tourist and same day arrivals
Revised forecasts incorporate effect of Russian ban on Flights to Georgia, and envisages 47% y/y reduction in Russian arrivals to Georgia in 2H19 and growth in other international arrivals by 15% y/y in the same period. 2020 forecast incorporates prolongation of Russian flight ban

Figure 4: International arrivals to Georgia



Source: GNTA

Figure 5: International arrivals: Russia and others

Source: GNTA

Trade with Russia

Russia is Georgia's 2nd largest trading partner after Turkey. Georgia mostly imports petrol and wheat from Russia and Georgia's major export products to Russia are ferro-alloys, wine, mineral waters and fruits.

Exports to Russia picked up since 2013 as Russia opened its borders to Georgian wine. As a result of 2006 Russian embargo Georgia's exports to Russia decreased from 18% of total in 2005 to 2% in 2008-2012. Russia's share started to pick up since 2013 as trade relations restored. Currently Russia is top export market with 15% of total in 5M19, followed by Azerbaijan.

2006 Russian embargo improved the quality of Georgian products and diversified destination markets, we expect the same to happen now. The 2006 Russian embargo forced Georgian producers to redirect exports to other CIS countries, the EU, and other countries. Russia may impose sanctions on Georgian wine based on recent enouncements from authorities. However, unlike 2006, the sector can withstand sanctions better considering improved quality, popularity of Georgian wine worldwide, success on international markets and functional free trade deals with EU and China. Russia was the only consumer of Georgian wine before 2006, and now Georgian wine is popular in EU, China, US and other markets. In 5M19, Russia accounted 62% of total wine export from Georgia, up 13.4% y/y. Embargo, if introduced, will result wine exports to Russia to fall by US$ 58mn in 2H19, and we expect Georgian producers to redirect their products to other markets.

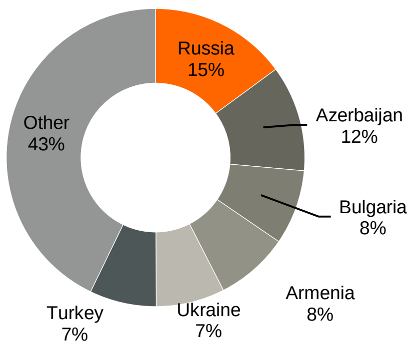
Georgia's exports to Russia, US$ mn		
	5M18	**5M19**
Ferro-alloys	57.8	61.7
Wine	45.1	51.2
Mineral waters	21.1	25.8
Centrifuges; filteting or purifying machinery	4.4	15.7
Spirits	7.4	12.2
Other products	35.1	52.1
Total exports to Russia	**171.0**	**218.7**
Georgia's total exports	**1,284.1**	**1,466.7**

Source: GeoStat

Georgia's imports from Russia, US$ mn		
	5M18	**5M19**
Petroleum	81.7	79.2
Wheat	42.4	26.2
Coke and semi-coke of coal	16.7	14.5
Coal	11.9	12.1
Gas	7.4	11.6
Other products	217.2	205.9
Total imports from Russia	377.2	349.6
Georgia's total imports	**3,623.4**	**3,492.8**

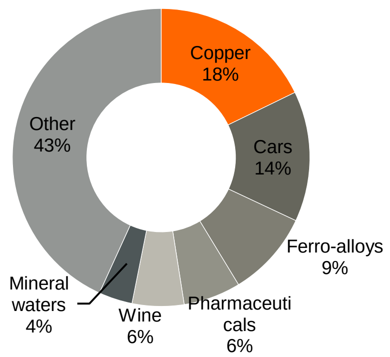
Source: GeoStat

Figure 6: Exports by country, 5M19



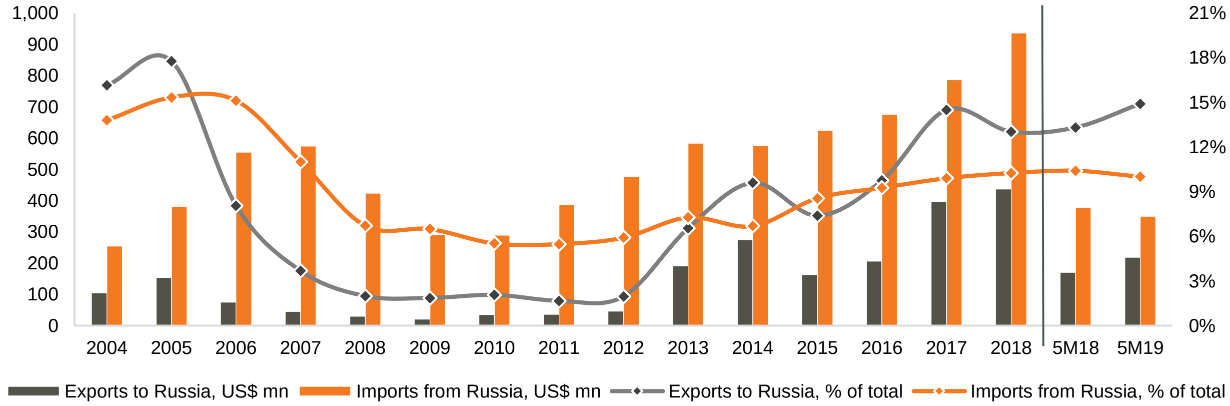
Source: Geostat

Figure 7: Exports by product, 5M19



Source: Geostat

Figure 8: Trade with Russia

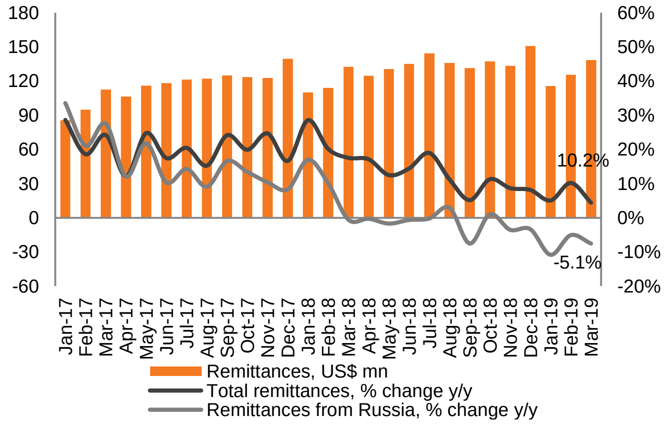


Source: GeoStat

Remittances

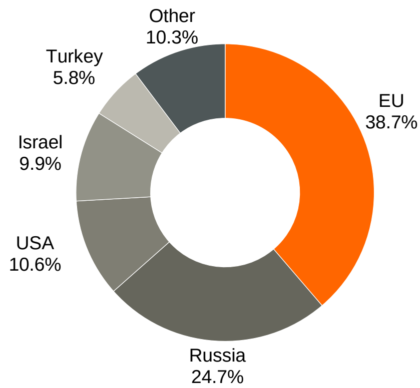
Georgia's dependence on migrants working in Russia has been reduced in recent years. Currently Russia accounts for 25% of total remittances or 2.5% of GDP, down from 53% of total in 2010. Notably, remittances from Russia are on a downward trajectory in 5M19, while total transfers increased by 8.3% y/y. Russian shortfall was fully offset by higher remittances from EU, the US and Israel.

Figure 9: Money transfers, US$ mn and growth, 5M19



Source: NBG

Figure 10: Money transfers by country, 5M19



Source: NBG

Energy

Georgia gained energy independence from Russia since 2006. Imports from Russia made up only 1.7% of Georgia's natural gas consumption and 1.5% of electricity consumption in 2018. Georgia managed to significantly reduce energy dependency on Russian market by launching South Caucasus Pipeline (SCP) to import natural gas from Azerbaijan and improving interconnection capacity for electricity trading with Turkey and Azerbaijan.

Natural gas - after the launch of SCP in late 2006, Georgia started receiving cheap gas from Azerbaijan, as a transit fee for natural gas transported from Baku to Turkey though Georgia. As a result imports from Russia were fully replaced by Azeri gas, shrinking Russia's share to only 1.7% in 2018. Georgia's imports from Russia slightly increased in 5M19 reaching 4.1% of total gas imports (vs 2.8% in 5M18), related to changes in commercial terms for gas transit from Russia to Armenia.

Electricity - 75% of Georgia's electricity demand is satisfied by local generation through HPP. Import dependency in electricity sector stood at 26.5% of total in 2018: direct electricity imports (11%) and electricity generated from thermal power plants (15.5%), which work on imported natural gas. Notably, after commissioning of new 500kV interconnection line with Azerbaijan, electricity imports from Russia were gradually replaced by imports from Azerbaijan, reducing Russia's share from 95% of total imports in 2013 to 13.7% of total in 2018. Enhanced interconnection capacity gives Georgia possibility to choose import provider among all 4 neighboring countries based on commercial terms. Overall, Russian electricity imports made up only 1.5% of total electricity consumption in Georgia in 2018. In 5M19 imports from Russia accounted for 12% of total imports, however, it was entirely directed to Abkhazian region to compensate the deficit between Enguri's generation and the region's consumption.

Banking sector links to Russia is limited. One Russian bank has subsidiary operating in Georgia, accounting for 3.8% of total banking sector assets as of May 2019.

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