GALT & TAGGART RESEARCH

Georgian Economy
Better than Expected Growth

Georgia | Economy
December 21, 2017

Executive Summary

Georgia has been experiencing a pick-up in growth in 2017 on the back of stronger economic performance of its major trading partners and an improved business environment locally. Exports, tourism revenues, and remittances rose significantly. The resulting boost in net exports and domestic demand drove growth, with real GDP expanding 4.9% in 10M17. Fiscal policy supported growth as the government boosted capital spending, while current spending was contained. The fiscal deficit narrowed as revenues overperformed due to better-than-expected growth. Georgia's business friendly environment continues to attract foreign investors, with FDI reaching all-time high in 9M17, while strongly growing tourism revenues and recovery in goods exports help the current account deficit to narrow.

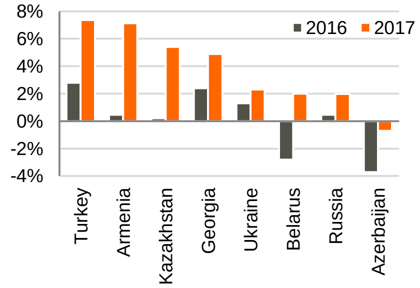
The National Bank of Georgia raised its monetary policy rate three times in 2017, bringing it from 6.5% to 7.25% to tackle rising inflation expectations. Annual inflation increased to 6.9% in November 2017, largely reflecting the effect of higher excise taxes. We expect inflation to decline in 2018 toward the NBG's target of 3.0%, once the effects of the excise tax increases fade.

The GEL partly gained its value against the US$ without central bank interventions. The GEL's recent weakness has been seasonal, predominantly driven by negative expectations built up over the past three years. This, however, reversed in December due to foreign funds inflow. Our calculations suggest that the GEL is currently fairly valued against the US$. As both short and medium-term fundamental factors affecting the GEL remain favorable, we expect the currency to strengthen to 2.4 vs the US$ in the medium term.

The 2018 budget reflects the government's commitment to restrain current spending and increase growth-enhancing infrastructure investment. As a result, the fiscal deficit is expected to narrow to 3.0% of GDP in 2018, in line with the IMF-supported program.

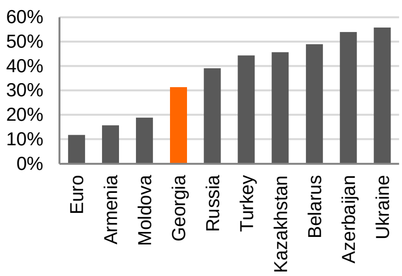
We revise our 2017 GDP growth projection up to 5.0% from 4.7%, and forecast 5.4% growth in 2018. Our outlook is based on continued recovery in Georgia's main trading partners, a sustained reform program targeting higher capital spending and an enhanced business climate. We also expect the country's prudent macroeconomic policy framework to remain steady.

Figure 1: Real GDP growth rates



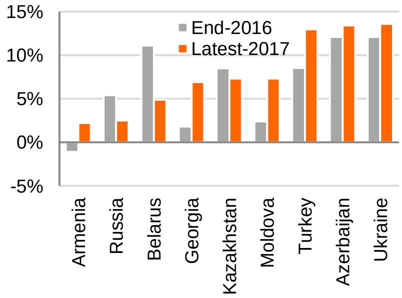
Source: National statistics offices
Note: 10M figure for Georgia, Armenia, Russia, Kazakhstan, Azerbaijan and Belarus; 9M for Ukraine and Turkey

Figure 2: Currency weakening vs US$



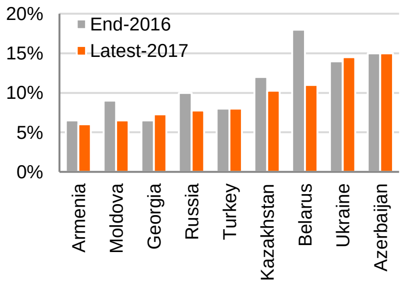
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – 19 Dec 2017

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

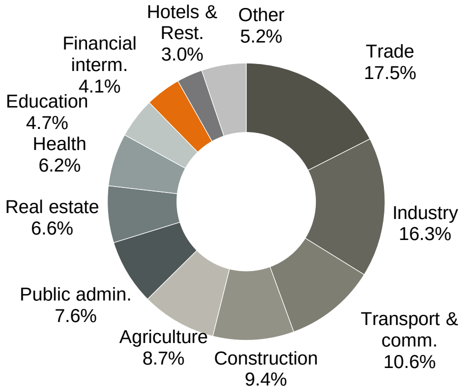
Eva Bochorishvili
Economist | evabochorishvili@gt.ge | +995 32 2401 111 ext. 8036

Recent economic developments

Economy increased by 4.9% in 10M17, beating expectations. Georgia has been experiencing a pick-up in growth in 2017 on the back of stronger economic performance of its major trading partners. Exports rose by 29.4% y/y in 10M17 and tourism revenues increased 28.2% y/y. Similarly, remittances recovered significantly (+19.7% y/y) with a positive impact on consumption. In 10M17, the government boosted capital spending by 25.4% y/y to support growth, while current spending growth was contained at 5.0% y/y. The resulting boost in domestic demand and net exports drove growth with real GDP expanding 4.9% in 10M17, according to GeoStat's rapid estimates. We revise our 2017 growth projection to 5.0% from 4.7% previously estimated. We also project the Georgian economy to grow 5.4% in 2018 based on a continued recovery in the country's main trading partners, a sustained reform program targeting higher capital spending and an enhanced business climate. We also expect the country's prudent macroeconomic policy framework to remain steady.

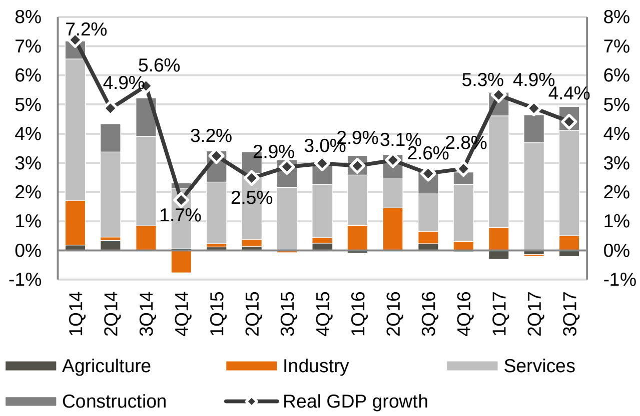
By sector, GDP growth was broad-based in 9M17. Hotels and restaurants was the fastest-growing sector, expanding by 12.0% y/y, followed by construction (+11.7% y/y), mining (+7.1% y/y), financial intermediation (+7.0% y/y), and real estate operations (+6.9% y/y), reflecting the widespread recovery in external demand and improved business and consumer confidence locally. Agriculture (-2.7% y/y) was the only sector in a downturn in 9M17.

Figure 5: Nominal GDP structure 9M17



Source: GeoStat

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

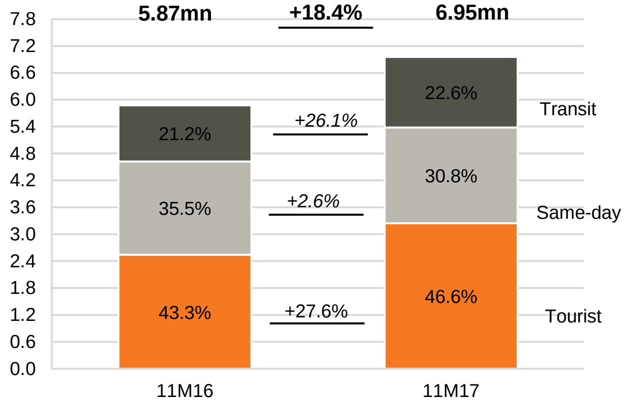


Source: GeoStat

Tourism revenues already surpassed 2016 full year amount at US$ 2.6bn in 11M17 – an increase of 27.3% y/y. Total international arrivals in 11M17 increased by 18.4% y/y to almost 7.0mn visitors, fueled by growth in tourist arrivals (+27.6% y/y), accounting for 46.6% of total arrivals. Transit visitors (+26.1% y/y) and same-day arrivals (+2.6% y/y) were also up. The number of visitors increased from all traditional visitor countries except Turkey (-3.2% y/y), although arrivals from Turkey are up since July 2017. The largest contributors to the growth in arrivals were Russia (+33.4% y/y) and Armenia (+14.9% y/y) in 11M17. Arrivals from the EU were also up 22.6% y/y to almost 308,000 visitors, with Germany, Poland and the UK accounting for a third of the growth.

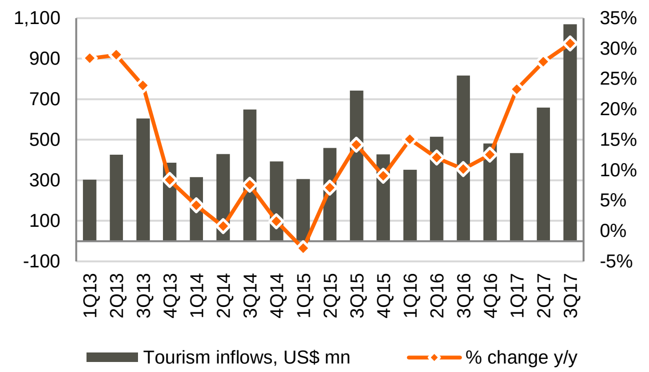
Visitors continued to increase from non-neighboring countries like Israel, India and Saudi Arabia. Given this robust growth in tourist arrivals, we have revised our tourism revenue projections up to US$ 2.7bn (+27% y/y) for 2017.

Figure 7: International arrivals by type



Source: GNTA

Figure 8: Tourism inflows

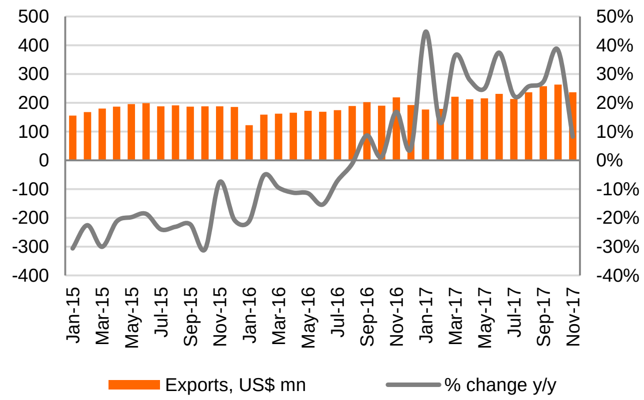


Source: NBG
Note: NBG's preliminary data for 3Q17

Recovery in regional economies drove export growth up 27.0% y/y to US$ 2.4bn in 11M17. Exports to the CIS markets increased 56.5% y/y (42.2% of total, mainly Russia, Azerbaijan, Armenia and Ukraine). Exports to the EU rose by 12.8% y/y (23.8% of total) and exports to other countries (mainly China, Turkey, Iran and US) increased by 10.8% y/y (34.0% of total). Among Georgia's major export products, copper, ferroalloys, used cars, wine, pharmaceuticals, spirits, mineral waters and fertilizers increased, while nuts and gold exports declined.

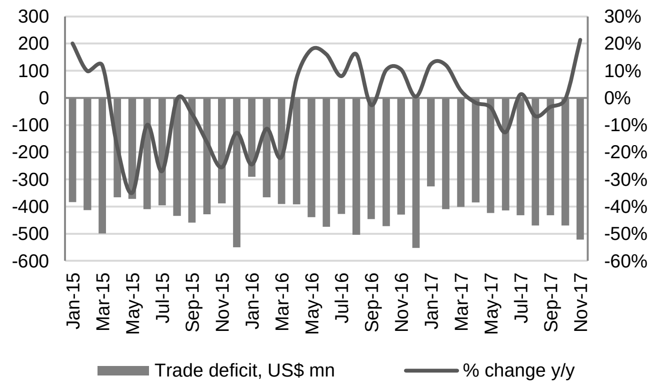
Imports grew by a moderate 8.8% y/y in 11M17. Growth in imports slowed to 4.1% y/y in April-August before increasing 11.3% y/y in September-November 2017, indicating increased demand as well as higher commodity prices. As a result, trade deficit widened 1.2% y/y in 11M17. Notably, there was a one-off import of aircrafts in Nov-17. Excluding this one-off item, the trade deficit was flat in the reporting period.

Figure 9: Exports



Source: GeoStat

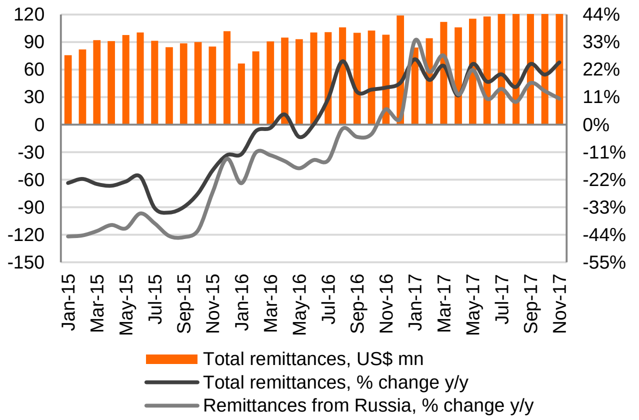
Figure 10: Trade deficit



Source: GeoStat

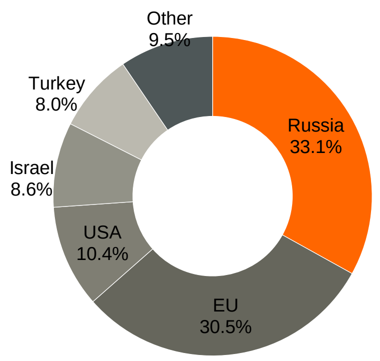
Migrant remittances increased 20.2% y/y in 11M17 but remain below pre-crisis 2013-2014 levels. A stronger RUB and continued growth in other major remitting countries helped remittances to increase to US$ 1.2bn in 11M17. Money transfers increased significantly from major remitting countries such as Russia (+16.2% y/y), the EU (+13.8% y/y, mainly Italy and Greece), the US (+13.4% y/y), Israel (+99.1% y/y) and Turkey (+26.2% y/y). Notably, despite this growth, Russia's share of the total remittances remains at 33.1% – well below the pre-2014 level of 50%. Remittances from the EU remain stable at 30.5% of the total. We expect remittances to increase 20% y/y in 2017 to US$ 1.4bn.

Figure 11: Money transfers



Source: NBG

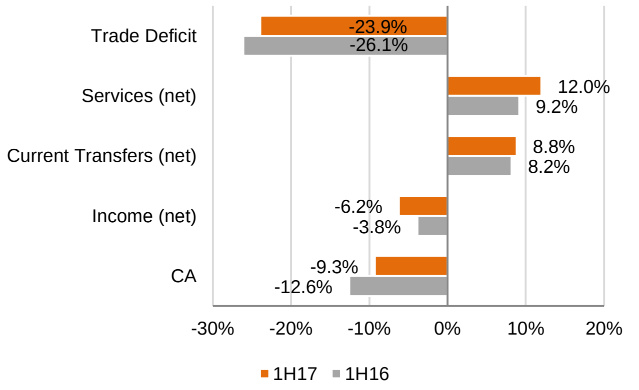
Figure 12: Money transfers by country, 11M17



Source: NBG

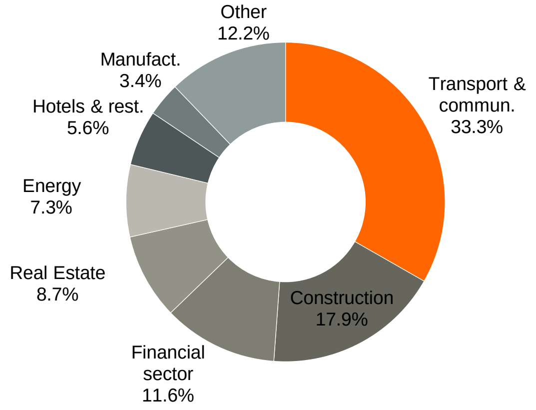
Georgia's current account (CA) deficit shrank to 9.3% of GDP in 1H17 from 12.6% in 1H16, driven by improved goods trade balance (-5.4% y/y). The positive balance in services, fueled by tourism inflows, and net transfers covered 87% of the goods trade deficit compared to 67% in 1H16. The negative income balance (6.2% of GDP) was up 66.5% y/y, mostly due to reinvestments. Net FDI, down 4.3% y/y (9.1% of GDP), financed almost the entire CA deficit, with a small part financed by other investments. Reserves were up by US$ 173.3mn in 1H17 as the capital and financial account was higher than the CA. Given the strong growth in external earnings, we expect the CA deficit to decline to 9.9% of GDP in 2017 from 12.8% in 2016 and to improve further in 2018 at 9.7% of GDP.

Figure 13: CA deficit as % of GDP



Source: NBG, GeoStat

Figure 14: FDI by sectors, 9M17

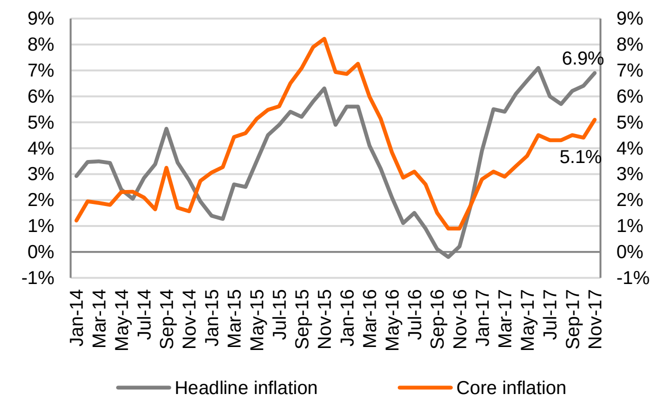


Source: GeoStat

FDI at all-time high in 9M17, reaching US$ 1.3bn or 12.1% of GDP. FDI increased substantially in construction (+204.1% y/y), hotels and restaurants (+287.1% y/y) and real estate (+68.9% y/y) sectors. Meantime, investments were down in transport and communication (-24.7% y/y) sector explained by completion stage of BP gas pipeline construction. Azerbaijan topped the list of investors with US$ 378mn (-11.3% y/y), with Turkey coming second at US$ 259mn (+81.4% y/y). Along with planned investment programs of cross-country significance such as the Anaklia deep sea port and hydro energy projects, Georgia's business-supportive environment and the growing numbers of free trade agreements will lead to further strong FDI inflows to Georgia in the medium term.

Headline inflation rose to 6.9% in November 2017, mainly due to excise tax hikes. Firming world commodity prices and excise tax increases on fuels and tobacco have been putting pressure on prices since January. Annual inflation came in at 6.9% in November 2017 – above the NBG's target of 4.0%. Notably, 3.0ppts of the price growth was due to excise-tax-related increases. With overall price growth driven broadly by fuel and food prices, core inflation remained below the headline figures throughout 2017 and came in at 5.1%. To curb inflationary expectations, the NBG increased the policy rate to 7.0% in 1H17 from 6.5% at end-2016 and communicated no further rate increase throughout 2017. However, NBG increased the key rate on 13 December by 25 basis points to 7.25%, to curb the increased pressure on prices from the nominal effective exchange rate depreciation. We forecast inflation to come in at 6.4% in end-2017. As the price pressures are transitory, inflation is expected to decline in 2018 close to the 3.0% target once the effects of the excise tax increases fade.

Figure 15: Annual inflation



Source: GeoStat

Figure 16: US$/GEL exchange rate

Source: NBG

The GEL partly gained its value against the US$ without central bank interventions. 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 then strengthened further at the beginning of April. The NBG intervened in the FX market and purchased US$ 129.8mn during April-August 2017 in an effort to maintain the economy's competitiveness and also build up its reserves. Despite the interventions, the GEL strengthened 9.0% vs the US$ in 8M17. The currency then started weakening vs. the US$ again in September 2017, losing 10.7% of its value between 1 September and 30 November and falling from 2.43 vs US$ to 2.72. The lack of fundamental reasons behind this depreciation, coupled with foreign funds inflow, resulted in the GEL gradually regaining some lost ground, starting 1 December, without central bank intervention, strengthening by 6.8% to 2.5 vs US$ as of 21 December. We view GEL's recent weakness as a combination of different factors:

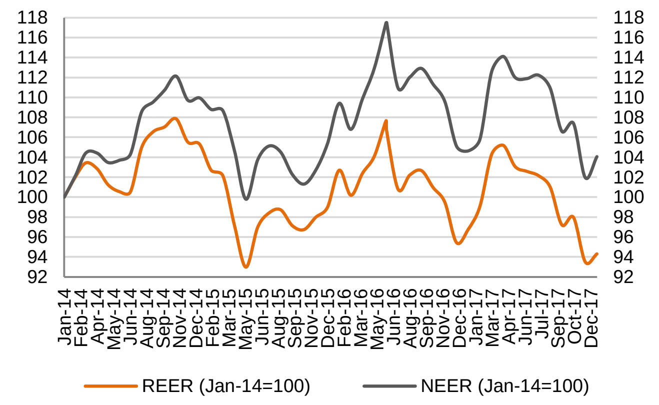
1) Negative expectations – stemming from the year-end GEL weakness that has prevailed over the last three years;

2) Seasonality – the GEL is usually stronger in the summer during the tourist season and weaker afterwards when there is some additional demand on FX from seasonal imports (energy imports, the New Year-related imports);

3) Turkish lira movements – some market participants view the GEL as being closely linked to movements in the Turkish lira; however, there is no evidence from the trade, tourism or financial channels to explain the strong fundamental link of these two currencies. Importantly, Georgia runs significantly lower structural inflation and this factor alone should reduce the correlation of the two currencies over the medium term.

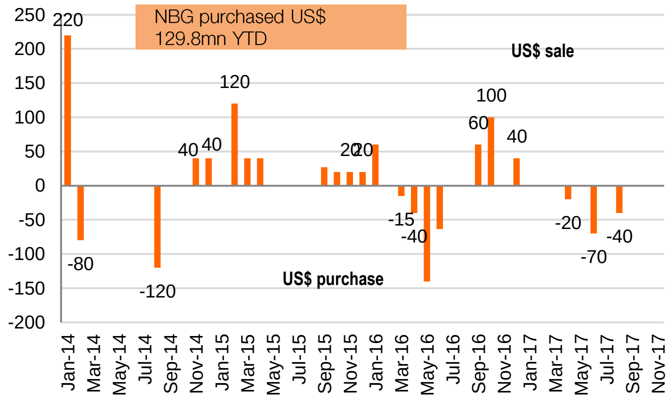
The recent depreciation has boosted the GEL's competitiveness as the REER weakened during May-November 2017, mostly due to increased competitiveness toward US$, RUB and EUR. Our calculations suggest that the GEL is currently fairly valued against the US$. As both short and medium-term fundamental factors affecting the GEL remain favorable, we expect the GEL to strengthen towards 2.4 against the US$ in the medium term.

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



Source: NBG, G&T Research
Note: Index growth means appreciation of GEL, decline means depreciation of GEL; Forecast for December 2017

Figure 18: NBG net interventions (US$m)

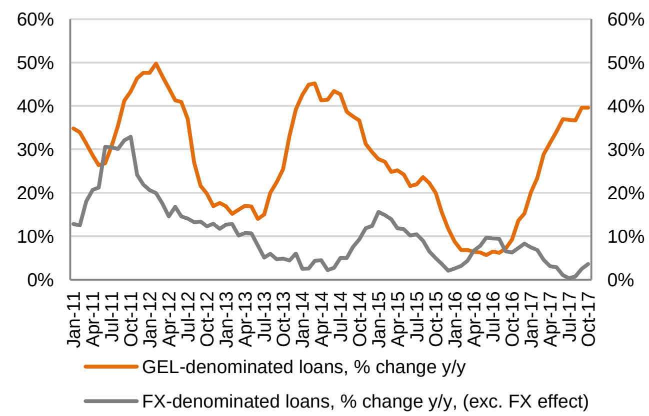


Source: NBG

Banking sector credit supported growth. A 29.9% expansion in the retail loan book drove the credit portfolio up 24.4% y/y to GEL 21.1bn in 10M17. Excluding FX effects, the loan portfolio was up 16.6% y/y in 10M17 vs 7.3% y/y in 10M16.

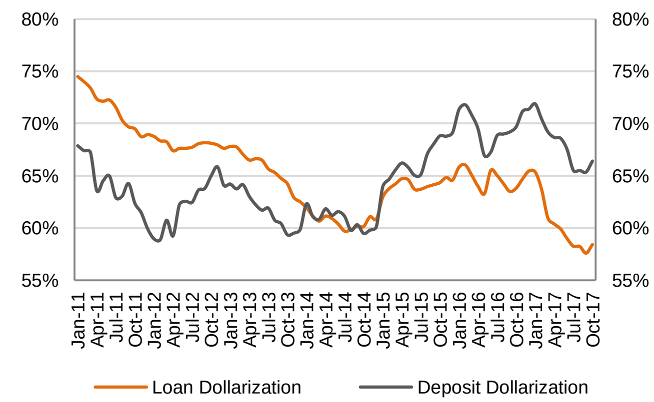
The loan dollarization ratio was down to 58.4% in October from 65.5% in December 2016, supported by the central bank's de-dollarization initiatives and the related growth in GEL lending (de-dollarization of existing US$-denominated loans and issuance of retail loans up to GEL 100,000 only in local currency). US$-denominated loans grew by a mere 3.6% y/y in 10M17. The deposit dollarization ratio has been on a downward trajectory since January 2017; however, the recent depreciation of the GEL increased deposit dollarization to 66.4% (+1ppts m/m) in October 2017, while the ratio is down 5ppts from the December 2016 figure. NPLs remained low at 3.4% (-0.5ppts y/y and +0.3ppts m/m) in 10M17.

Figure 19: Loan portfolio growth



Source: NBG

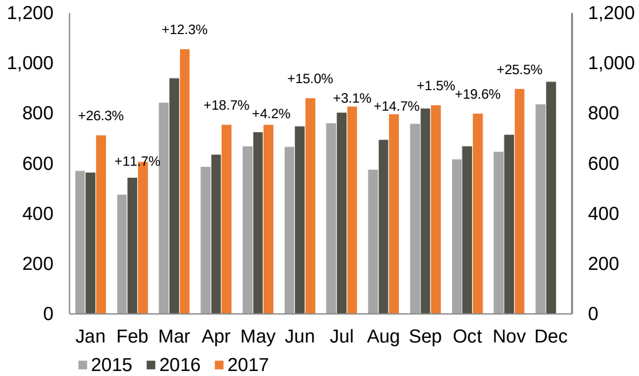
Figure 20: Dollarization



Source: NBG

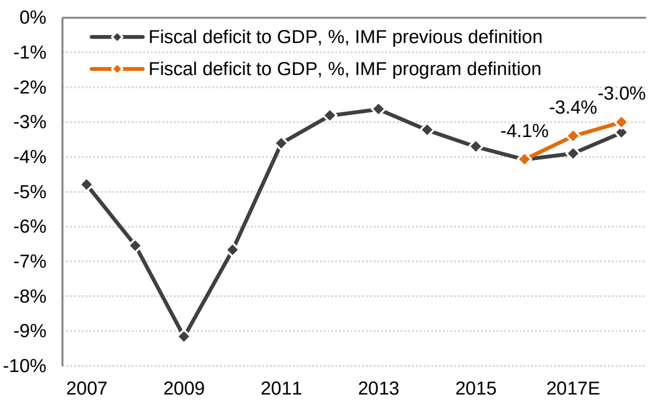
2017 budget revised to reflect higher-than-budgeted tax revenue performance and increased capex, while fiscal deficit down to 3.4% of GDP from 3.9%. Better-than-expected growth helped tax revenues to rise by 13.3% y/y to GEL 8.9bn in 11M17 (vs the budgeted increase of 8.6% y/y). Notably, we expect GEL 650mn to be retained by businesses for reinvestment – the effect of the corporate income tax reform (only distributed profits taxed) introduced in January 2017. Parliament approved revisions to the 2017 budget document, reflecting higher growth and higher related revenues (the 2017 revised budget is based on 4.5% GDP growth and 5.5% GDP deflator projections vs. 4.0% growth and 4.0% deflator previously approved). Current spending has been reduced in real terms, with budgeted nominal growth of 4.0% y/y. Capital spending and net lending were revised upward (GEL 241mn increase, +41.8% y/y), reflecting increased financing for ongoing public infrastructure projects as well as projects planned for 2018. In 2017, the fiscal deficit is projected to fall to 3.4% of GDP from 3.6% previously forecast, based on IMF-supported program framework (which incorporates privatization proceeds above the line; this is equivalent of 3.9% and 4.1% of GDP, respectively, by previous program definition).

Figure 21: Tax revenues, GEL mn and % change y/y



Source: MOF

Figure 22: Fiscal deficit



Source: MOF, IMF, G&T Research

2018 budget document aims to contain current spending growth, while targeting higher capital expenditure and lower deficit. The budget framework, already approved by the parliament, is based on 4.5% GDP growth and 3.5% GDP deflator projections. The fiscal deficit is set at 3.0% of GDP based on the fiscal framework agreed with the IMF and public debt at 43.1% of GDP. Tax revenues are projected at 25.3% of GDP (+5.3% y/y). Growth in tax revenues reflects increases in VAT and personal income tax revenues, while revenues from corporate income tax, an excise tax on tobacco (due to reduced consumption), an excise tax on cars (recently imports of hybrid and electric cars are on the rise, taxed at a lower rate) and an excise tax on communications (abolished) are reduced compared to 2017 budgeted figure. Current spending remains almost flat in real terms (+4.0% y/y), accounting for 23.5% of GDP down from 24.4% of GDP in 2017. Capital expenditure and net lending are projected at 8.0% of GDP (+3.4% y/y) and, will be directed towards enhancing Georgia's road, water and wastewater infrastructure as well as building a new airport in Kutaisi and Business House in Tbilisi.

Disclaimer

This document is strictly confidential and has been prepared by JSC Galt & Taggart ("Galt & Taggart"), a member of BGEO group plc (‘Group”) solely for informational purposes and independently of the respective companies mentioned herein. This document does not constitute or form part of, and should not be construed as, an offer or solicitation or invitation of an offer to buy, sell or subscribe for any securities or assets and nothing contained herein shall form the basis of any contract or commitment whatsoever or shall be considered as a recommendation to take any such actions.

Galt & Taggart is authorized to perform professional activities on the Georgian market. The distribution of this document in certain jurisdictions may be restricted by law. Persons into whose possession this document comes are required by Galt & Taggart to inform themselves about and to observe any and all restrictions applicable to them. This document is not directed to, or intended for distribution, directly or indirectly, to, or use by, any person or entity that is a citizen or resident located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would require any registration or licensing within such jurisdiction.

Investments (or any short-term transactions) in emerging markets involve significant risk and volatility and may not be suitable for everyone. The recipients of this document must make their own investment decisions as they believe appropriate based on their specific objectives and financial situation. When doing so, such recipients should be sure to make their own assessment of the risks inherent in emerging market investments, including potential political and economic instability, other political risks including without limitation changes to laws and tariffs, and nationalization of assets, and currency exchange risk.

No representation, warranty or undertaking, express or implied, is or will be made by Galt & Taggart or any other member of the Group or their respective directors, employees, affiliates, advisers or agents or any other person as to, and no reliance should be placed on, the fairness, accuracy, completeness or correctness of this document and the information contained herein (and whether any information has been omitted from this document) and no reliance should be placed on it. This document should not be considered as a complete description of the markets, industries and/or companies referred to herein. Nothing contained in this document is, is to be construed as, or shall be relied on as legal, investment, business or tax advice, whether relating to the past or the future, by Galt & Taggart any other member of the Group or any of their respective directors, employees, affiliates, advisers or agents in any respect. Recipients are required to make their own independent investigation and appraisal of the matters discussed herein. Any investment decision should be made at the investor's sole discretion. To the extent permitted by law, Galt & Taggart, any other member of the Group and their respective directors, employees, affiliates, advisers and agents disclaim all liability whatsoever (in negligence or otherwise) for any loss or damages however arising, directly or indirectly, from any use of this document or its contents or otherwise arising in connection with this document, or for any act, or failure to act, by any party, on the basis of this document.

The information in this document is subject to verification, completion and change without notice and Galt & Taggart is not under any obligation to update or keep current the information contained herein. The delivery of this document shall not, under any circumstances, create any implication that there has been no change in the information since the date hereof or the date upon which this document has been most recently updated, or that the information contained in this document is correct as at any time subsequent to the date on which it is supplied or, if different, the date indicated in the document containing the same. No representation or warranty, expressed or implied, is made by Galt & Taggart or any other member of the Group, or any of their respective directors, employees, affiliates, advisers or agents with respect to the accuracy or completeness of such information.

The information provided and opinions expressed in this document are based on the information available as of the issue date and are solely those of Galt & Taggart as part of its internal research coverage. Opinions, forecasts and estimates contained herein are based on information obtained from third party sources believed to be reliable and in good faith, and may change without notice. Third party publications, studies and surveys generally state that the data contained therein have been obtained from sources believed to be reliable, but that there is no guarantee of the accuracy or completeness of such data. Accordingly, undue reliance should not be placed on any such data contained in this document. Neither Galt & Taggart, any other member of the Group, nor their respective directors, employees, affiliates, advisors or agents make any representation or warranty, express or implied, of this document's usefulness in predicting the future performance, or in estimating the current or future value, of any security or asset.

Galt & Taggart does, and seeks to do, and any other member of the Group may or seek to do business with companies covered in its research. As a result, investors should be aware of a potential conflict of interest that may affect the objectivity of the information contained in this document.

This document is confidential to clients of Galt & Taggart. Unauthorized copying, distribution, publication or retransmission of all or any part of this document by any medium or in any form for any purpose is strictly prohibited.

The recipients of this document are responsible for protecting against viruses and other destructive items. Receipt of the electronic transmission is at risk of the recipient and it is his/her responsibility to take precautions to ensure that it is free from viruses and other items of a destructive nature.

Economist
Eva Bochorishvili | evabochorishvili@gt.ge

Economist
Lasha Kavtaradze | lashakavtaradze@gt.ge

Head of Analytics Unit
Giorgi Iremashvili | giremashvili@gt.ge

Analyst
Ioseb Kumsishvili | ikumsishvili@gt.ge

Address: 79 D. Agmashenebeli Avenue, Tbilisi 0102, Georgia
Tel: + (995) 32 2401 111
Email: research@gt.ge