



Georgian Economy Let's Float Together

Georgia | Economy
December 29, 2015

Azerbaijan's central bank moved to a floating exchange rate on December 21, causing an immediate 32.3% devaluation of the AZN against the US\$. While Azerbaijan is Georgia's important trading partner, its already reduced share (dominated by re-exports) in Georgian exports minimizes the potential negative impact of the devaluation on Georgia's trade balance. Moreover, Georgia's well diversified export markets limit the potential impact of turbulence in any particular trading partner economy. We believe that Georgia will continue to benefit from Azeri tourist arrivals. FDI from Azerbaijan should also hold up in the medium term thanks to the ongoing regional infrastructure projects of strategic importance. We expect that devaluation-related price increases in Azerbaijan and moderate inflation growth in Georgia will partially contain the extent of the GEL's real appreciation vs the AZN. Overall, we do not expect a material impact on the GEL from the recent AZN devaluation due to the sizable external adjustment of the Georgian economy that has already taken place.

Azerbaijan is the top destination for Georgian exports (mostly re-exports), but its share in total exports has fallen sharply over the last two years. Georgian exports to Azerbaijan accounted for 11.5% of total exports in 11M15 compared to 19.0% in 2014 and 24.4% in 2013. In 11M15, exports to Azerbaijan more than halved (-54.7% y/y) to US\$ 231.3mn, driven by a 58.8% y/y drop to US\$ 138.9mn in re-exports (mainly cars), which accounted for 60% of total Georgian exports to Azerbaijan. Car re-exports have been on a downward trend since April 2014 due to the introduction of Euro 4 regulations, compounded by new regulations on car loans in Azerbaijan. Exports of Georgian origin to Azerbaijan have also suffered, down 46.7% y/y to US\$ 92.4mn in 11M15 on the back of lower demand. We expect the recent AZN devaluation to result in a further drop in Georgian exports to Azerbaijan. However, it will not have a sizable negative impact on Georgia's trade balance, given Azerbaijan's already reduced share and its dominance by re-exports, which create less value-added for the economy. Moreover, the savings from the associated contraction in car imports to Georgia and a lower oil import bill should help minimize potential negative impact.

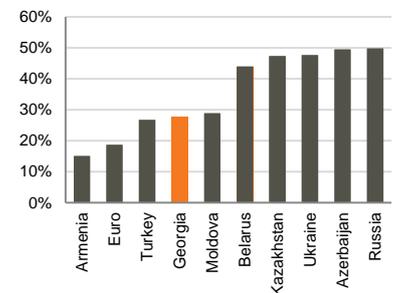
Despite the AZN's 25.1% devaluation against the US\$ in February 2015, tourist arrivals from Azerbaijan have been increasing, and we expect this trend to continue. Geographical proximity and relative cheapness played an important role as Azeri arrivals increased 8.9% y/y in 11M15 to 1.3mn (23.5% of total arrivals), with the strong upward trend particularly noticeable since April. Faced with even lower real incomes, some Azeris will probably stop travelling to Georgia. But Georgia will likely attract Azeris who used to travel to more expensive destinations. These factors may offset each other, thereby minimizing any negative impact on Azeri arrivals. Moreover, the expected increase in arrivals from Russia due to the current Russia-Turkey standoff and the volatile security situation in Egypt could compensate for any drop in arrivals from Azerbaijan.

We do not expect a material decline in Azeri FDI to Georgia in the medium term as investments that are crucial for the Azeri economy have already been authorized. Azerbaijan topped the list of investors in Georgia with US\$ 172.7mn (+56.4% y/y) in 3Q15, the highest quarterly level since records started, and US\$ 392.0mn (+55.3% y/y) in 9M15. The FDI was primarily driven by the BP-related US\$ 2bn gas pipeline expansion for carrying additional gas volumes via Georgia to Turkey and Europe and the Baku-Tbilisi-Kars railway project. Azeri investments will likely decline upon completion of these projects, but the shortfall will be partially offset by the stream of revenue that the projects will generate for Georgia.

Georgia's exposure to Azerbaijan		
% of GDP	9M14	9M15
Re-exports	3.5%	1.2%
Geo-originated exports	1.2%	0.7%
FDI	2.1%	3.8%
Tourism revenues	2.3%	2.9%
Remittances	0.1%	0.1%
Total	9.3%	8.7%

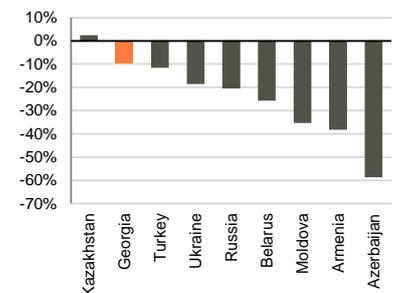
Source: GeoStat, G&T Research

Figure 1: Currency weakening vs US\$



Source: Bloomberg
Note: US\$ per unit of national currency, period: 1 Aug 2014 - 21 Dec 2015

Figure 2: National Bank reserves (% change)



Source: IMF
Note: From August 2014 to October 2015; Armenia's reserves exclude a US\$ 500mn Eurobond issued in March 2015

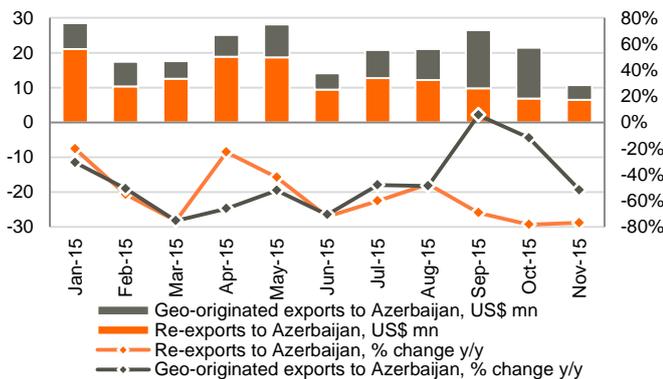
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Increased price pressure in Azerbaijan following the AZN nominal depreciation will prevent significant real appreciation of the GEL vs the AZN. In 2015, inflation was higher in Georgia (6.3% in November) than in Azerbaijan (3.7% in November). However, expected price hikes in Azerbaijan will push up Azeri inflation, while price increases are expected to be lower in Georgia. Therefore, we do not expect a sizable real appreciation of the GEL vs the AZN. While this appreciation will reduce competitiveness of Georgian exports to Azerbaijan, the already reduced share of the Azeri market in Georgia's total exports will limit the impact. Moreover, some Georgian items are price inelastic (e.g. pharmaceuticals) or popular (e.g. mineral waters) in Azerbaijan and demand for them will likely persist despite exchange rate movements.

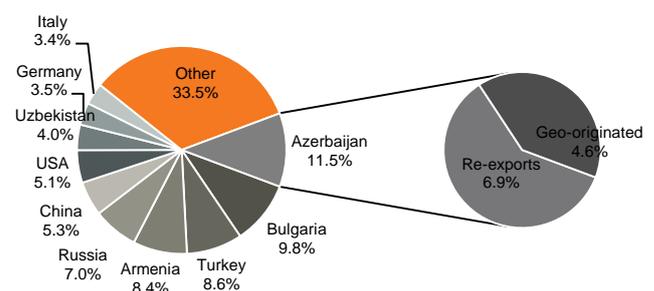
Overall, we do not expect a material impact on the GEL from the recent AZN devaluation. We believe that this move was necessary to address Azerbaijan's deteriorating external balance in light of the continued fall in oil prices. Otherwise, Azerbaijan would have faced more severe economic problems, with negative spillovers on other regional economies. Georgia has already experienced a sizable external adjustment in 11M15: the drop in imports (US\$ 1.2bn savings, excluding donated C-hepatitis medicine imports) was more than sufficient to compensate for the lower earnings from exports and remittances (US\$ 955mn loss). Falling world oil prices, resulting lower oil import bill, is another positive factor partly compensating the shortfall from external earnings and supporting external adjustment.

Figure 3: Exports to Azerbaijan



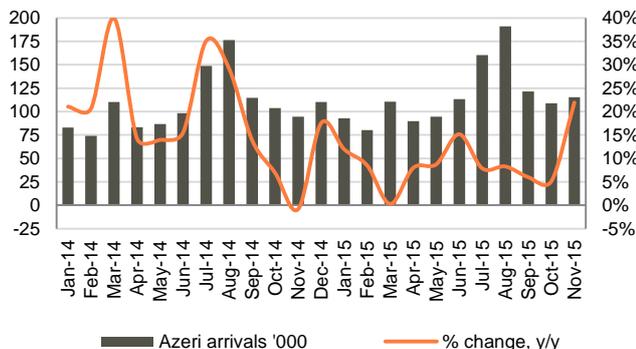
Source: GeoStat

Figure 4: Georgian exports by country: 11M15



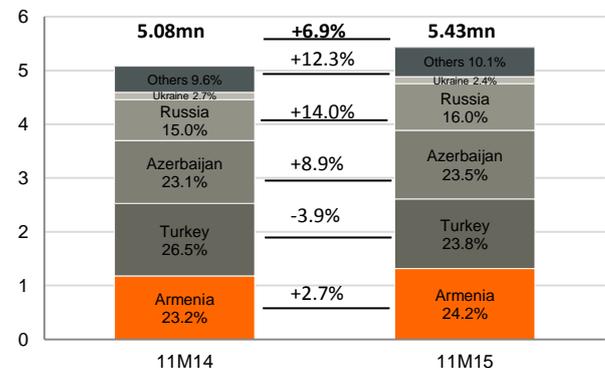
Source: GeoStat

Figure 5: International arrivals from Azerbaijan



Source: GNTA

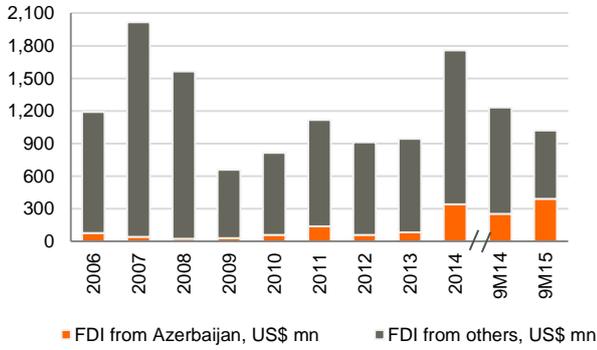
Figure 6: International arrivals (mn) and growth: 11M15 vs 11M14



Source: GNTA

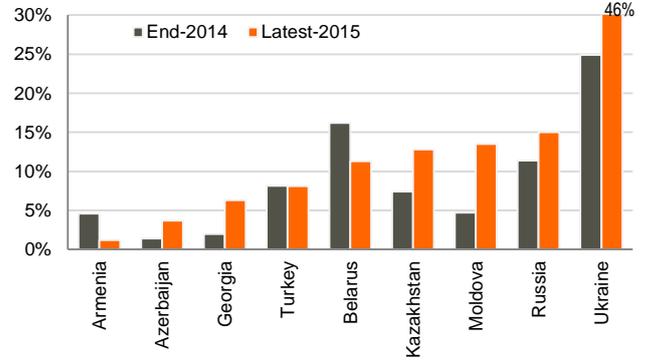


Figure 7: FDI to Georgia



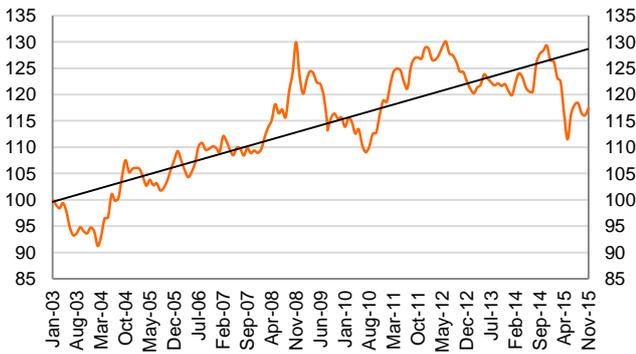
Source: GeoStat

Figure 8: Annual inflation



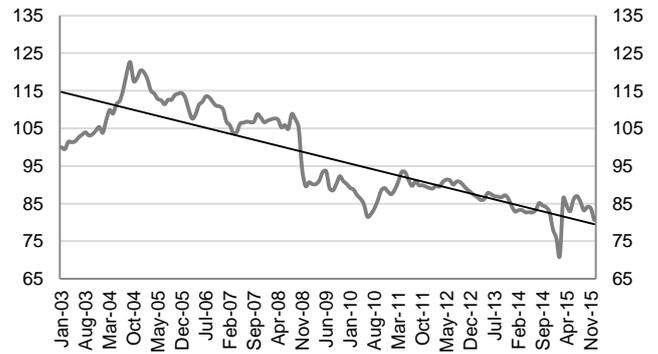
Source: National Statistics offices
Note: Latest November 2015

Figure 9: GEL's REER (January 2003 = 100)



Source: NBG

Figure 10: GEL/AZN RER, (January 2003 = 100)



Source: NBG, G&T Research



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