Georgian Economy
Empowering Private Sector to Drive Growth

Georgia | Economy
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Executive Summary

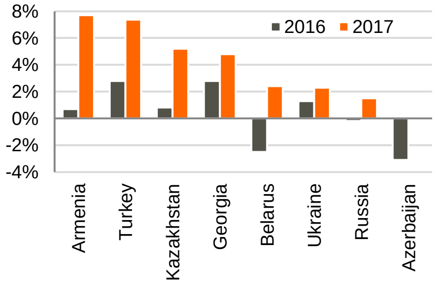
Georgia delivered strong economic performance and achieved significant milestones in 2017. It became the ninth easiest place to do business globally, according to the latest World Bank *Doing Business* report. The resilience of the economy has been acknowledged by a one-notch sovereign credit rating upgrade from Moody's. Trust in Georgia's growth model was demonstrated by record high reinvestment by foreign companies in 2017, when the economy grew by an estimated 4.8%. Increased external demand for goods and services originating in Georgia made net exports the main driver of growth in 2017 for the first time since 2013. Tourism posted a stellar performance, with inflows in the sector totaling US$ 2.8bn. The government boosted capital expenditure while the fiscal deficit reduced to 3.9% in 2017 from 4.1% in 2016. Importantly, reinvestment by foreign companies almost doubled and reached c.US$ 600mn in 9M17, indicating investors' trust in Georgia's growth model and the success of the profit tax reform introduced in 2017.

Inflation retreated to 4.3% in January 2018, and we expect it to decrease to close to the 3.0% target in 2018 after temporary price pressures seen in 2017. In line with lower inflation, we expect the National Bank of Georgia (NBG) to cut the policy rate by 50bps from the current 7.25%. We also expect the GEL to strengthen to 2.40 vs the US$, which should also lessen price pressures from imported inflation. We think that the NBG will intervene and build reserves to preserve competitiveness in case the GEL significantly appreciates vs the US$.

The government's commitment to containing current spending growth and increasing the fiscal space for capital spending has been demonstrated by recently approved remuneration law. Moreover, the government has reduced the processing time and administrative procedures for refunding VAT claims. This together with profit tax reform should strengthen the financial position of corporates, increase investment and support private sector-driven growth.

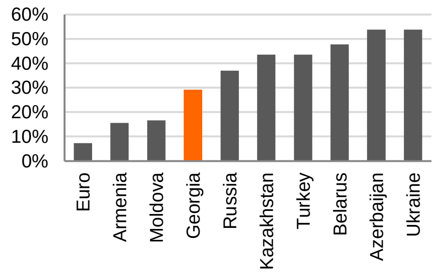
We maintain our GDP growth forecast at 5.4% for 2018. This forecast is based on 1) better-than-expected growth momentum among Georgia's main trading partners; 2) commencement of large investment projects (Anaklia, Nenskra); 3) acceleration of the positive impact from growth-enhancing reforms by the government; and 4) overall improvement in consumer and business confidence locally. In addition, we see the expected monetary easing as positive for the growth outlook.

Figure 1: Real GDP growth rates



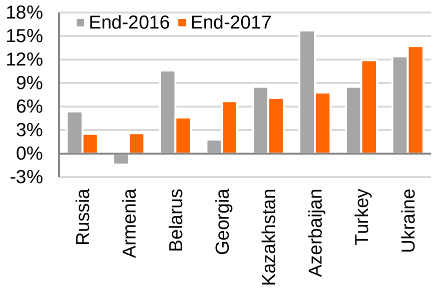
Source: National statistics offices, preliminary data
Note: 9M for Ukraine and Turkey and annual figure for the rest

Figure 2: Currency weakening vs US$



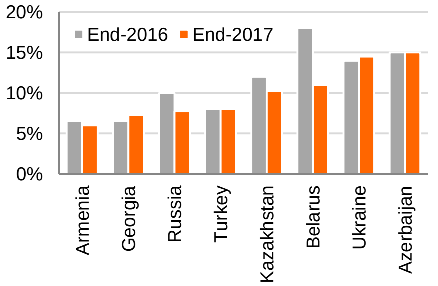
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – 14 Feb 2018

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

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Economic developments

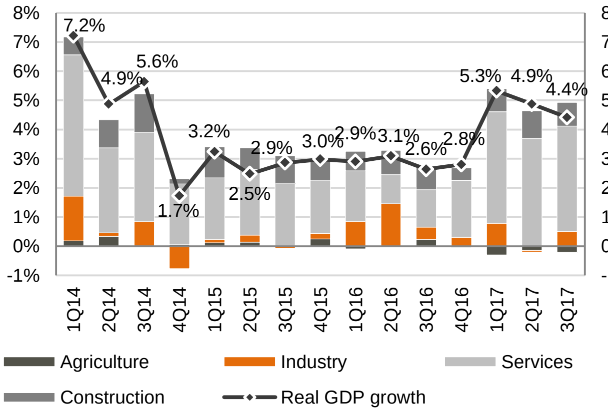
Net exports driving growth in 2017 for first time since 2013. GDP growth was 4.8% y/y in 2017 based on GeoStat's preliminary data, higher than projected by the government and IFIs but 0.2ppts below our forecast. With the GDP data subject to revision at end-March, we believe there is still a possibility of upside revision to the preliminary figure and maintain our growth projection of 5.0% for 2017. Based on our estimates, the recovery in external demand drove growth as goods exports surged (+29.1% y/y) in 2017, tourism posted a stellar performance (+27% y/y), while goods imports rose moderately (+9.4% y/y). Remittances also increased strongly by 19.8% y/y, supporting private consumption. Improved consumer and business confidence locally helped solid credit portfolio growth and boost in public investments enhanced economic activity.

We maintain our growth projection of 5.4% for 2018, supported by better-than-expected growth momentum among Georgia's main trading partners, the commencement of large investment projects (Anaklia, Nenskra), an acceleration of the positive impact of the government's growth-enhancing reforms, and an overall improvement in consumer and business confidence locally. In addition, we see the expected monetary easing as positive for Georgia's growth outlook.

GeoStat's 9M17 figures already reflect a considerable improvement in foreign demand for Georgia-originated products and services. Net exports made the highest contribution (+3.8ppts) to the 4.8% growth in 9M followed by consumption (+0.6ppts), reflecting gains in private consumption, while government consumption was down. The rest was contributed by investment.

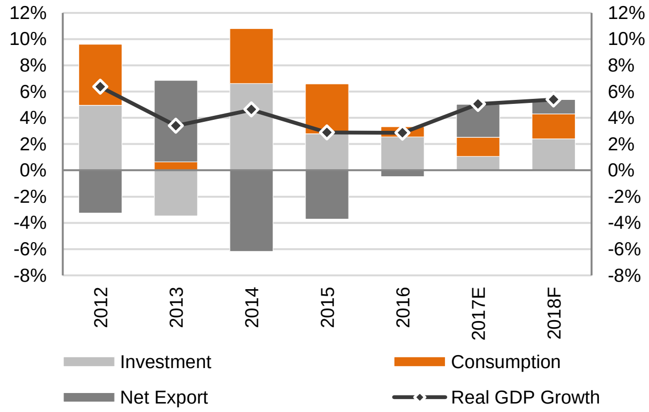
GDP growth was broad-based in 9M17. Hotels and restaurants was the fastest-growing sector, expanding by 12.0% y/y, driven by a surge in tourists visiting Georgia. Construction was the second-best performer (+11.7% y/y) followed by mining (+7.1% y/y), financial intermediation (+7.0% y/y), real estate operations (+6.9% y/y) and trade (+6.4%). Agriculture (-2.7% y/y) was the only sector to see a downturn in 9M17, remaining in the red despite various government initiatives in recent years.

Figure 5: Real GDP growth and contribution to growth



Source: GeoStat

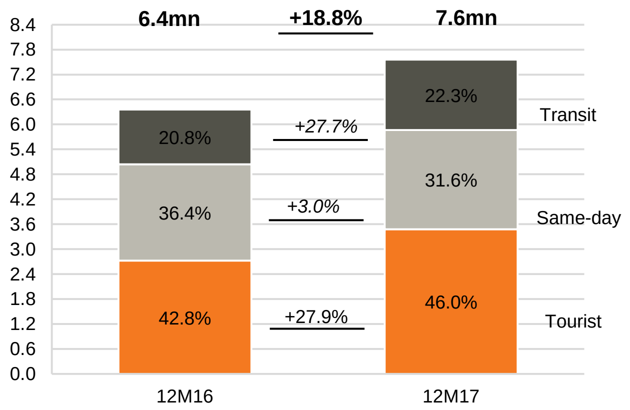
Figure 6: Real GDP growth decomposition



Source: GeoStat, G&T Research

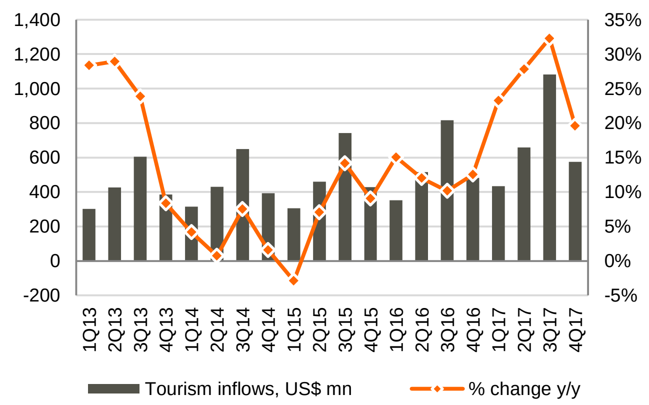
Tourism revenues exceeded expectations in 2017, amounting to US$ 2.8bn or 18.2% of GDP – an increase of 27.0% y/y. Total international arrivals in the year increased by 18.8% y/y to almost 7.6m visitors, fueled by 27.9% y/y growth in tourist arrivals, which accounted for 46.0% of the total. As regional trade recovered, the number of transit visitors also increased significantly, by 27.7% y/y, while same-day arrivals posted a minor growth of 3.0% y/y. By country, the largest contributors to the growth in arrivals were Russia (+34.1% y/y) and Armenia (+14.8% y/y). Arrivals from the EU were up 21.9% y/y to almost 322,400. Visitors from Israel, India and Saudi Arabia were significant contributors to growth among non-neighboring countries. Georgia is already a popular tourist destination but its potential has not yet been fully realized. The government's ongoing initiatives in the sector are essential in this regard. It recently commenced talks with China to extend the visa-free travel arrangement for organized tourism from China. Moreover, Georgia-China economic ties are strengthening within the framework of a free trade deal. Taken together, these initiatives will likely boost tourism revenues in the coming years. We expect tourism revenues to come in at over US$ 3.1bn (+13% y/y) in 2018.

Figure 7: International arrivals by type



Source: GNTA

Figure 8: Tourism inflows

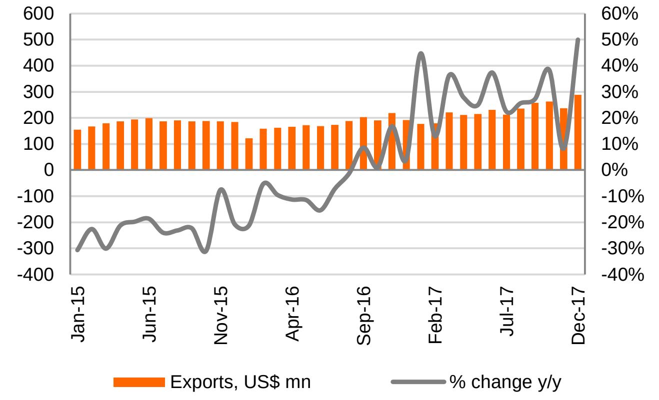


Source: NBG
Note: NBG's preliminary data for 4Q17

CIS markets drove export growth in 2017, while exports to the EU and other countries also increased. Exports increased by 29.1% y/y to US$ 2.7bn, above expectations. A recovery in Russia, resumed car re-exports to Azerbaijan and overall positive spillovers to the region from Russia's recovery as well as a low base supported a 60.0% y/y increase in exports to CIS, which accounted for 43.3% (+8.4ppts y/y) of total exports in 2017. Exports to EU countries rose by 13.0% y/y (23.7% of the total) with further growth constrained by the bad harvest for nuts. Exports to other countries (mainly Turkey, China, US and Iran) increased by 12.2% y/y (33.0% of the total). Among Georgia's major export products, copper, ferro-alloys, used cars, wine, pharmaceuticals, spirits, mineral waters and fertilizers increased, while nuts and gold exports declined. With growth gaining momentum among Georgia's major trading partners and the free trade deal with China effective since start-2018, we see further upside and expect exports to grow by 13-15% y/y in 2018.

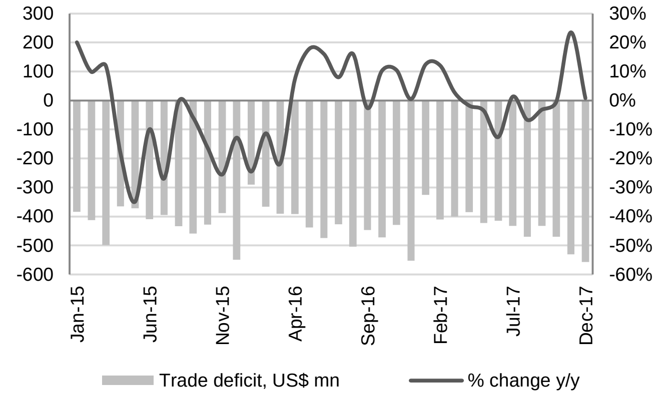
Imports grew by a moderate 9.4% y/y in 2017. Increased domestic demand and higher world commodity prices were the major drivers of import growth in 2017. The strong growth in exports largely absorbed the moderate growth in imports, and the trade deficit widened by just 1.4% y/y in 2017. Notably, excluding a one-off import of aircraft in November, the trade deficit was flat in the reporting period.

Figure 9: Exports



Source: GeoStat

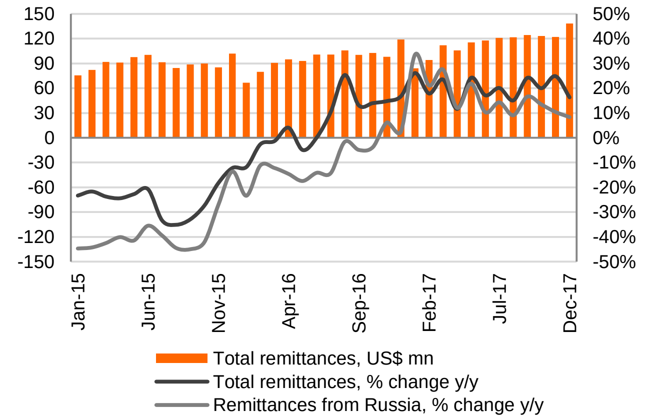
Figure 10: Trade deficit



Source: GeoStat

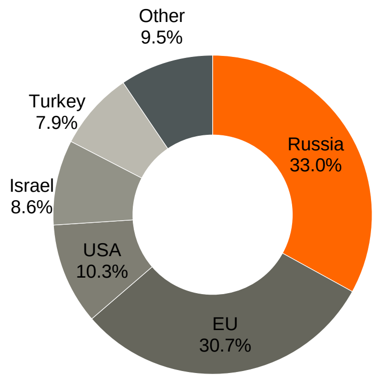
Remittances increased 19.8% y/y in 2017, amounting to US$ 1.4bn, or 9.1% of GDP. They increased from all major countries: Russia (+15.4% y/y), Italy (+17.9% y/y), Greece (+13.4% y/y), the US (+11.2% y/y) and Israel (+96.1% y/y). Notably, Russia accounted for 33.0%, followed by the EU at 30.7% of the total. We expect remittances to increase by 12% y/y in 2018 to US$ 1.5bn.

Figure 11: Money transfers



Source: NBG

Figure 12: Money transfers by country, 2017

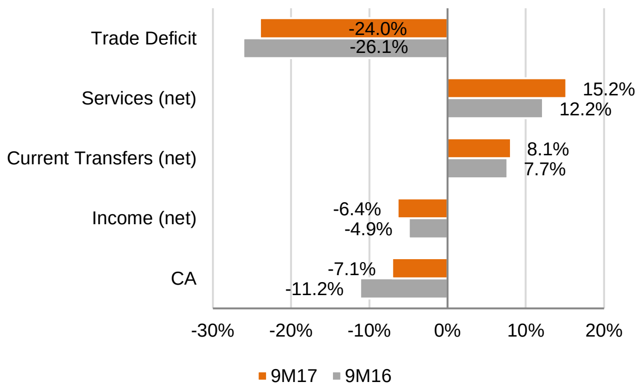


Source: NBG

The current account (CA) balance adjusted for reinvestment turned positive in 3Q17 at 2.8% of GDP. In the quarter, the current account deficit declined to a record low 2.9% of GDP, while the 9M17 CA deficit improved to 7.1% of GDP from 11.2% in 9M16. For the first time in Georgia, the CA balance was positive in 3Q17, adjusted for reinvestment. Importantly, reinvested earnings of foreign entities almost doubled to reach c.US$ 600mn in 9M17, indicating investors' trust in Georgia's growth model and demonstrating the success of the profit tax reform introduced in 2017. While reinvestment of foreign earnings widened the CA deficit, it was also reflected in the financial account with a positive figure, thus having zero effect on the balance of payments. In 9M17, the goods trade deficit improved by 3.9% y/y as exports surged. The positive balance in services, fueled by tourism inflows, and net transfers almost fully covered (97%) of the goods trade deficit compared to 76% in 9M16.

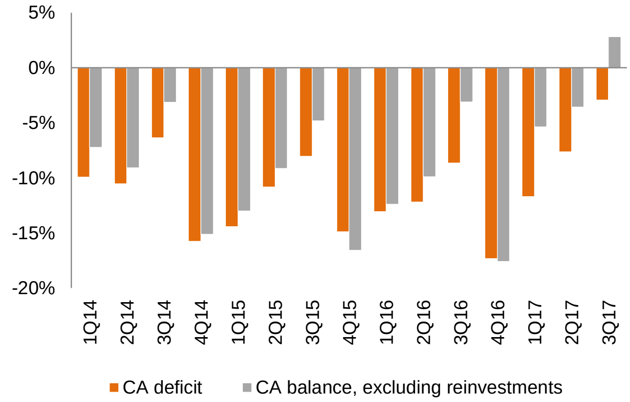
Net FDI was up 20.5% y/y (10.5% of GDP), more than enough to finance the entire CA deficit. Improved external position supported reserves to increase by US$ 227.7mn in 9M17. We expect the CA deficit to print in single digit in 2017 and to improve further in 2018. We project FDI at US$ 2.0bn in 2018 as the profit tax reform expected to further fuel reinvestment in Georgia. In addition, in 2018, the US$ 2.5bn Anaklia deep sea port project and US$ 1.0bn Nenskra HPP project are expected to enter the construction stage. Growth in foreign investment is also anticipated in relation to China's Belt and Road initiative, with Georgia being part of the program's transport corridor.

Figure 13: CA deficit as % of GDP



Source: NBG, GeoStat

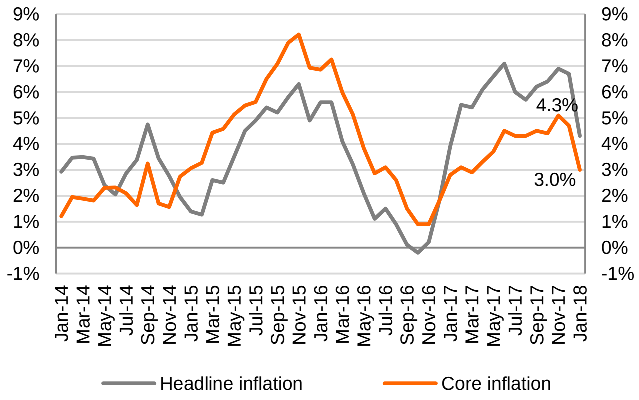
Figure 14: CA balance: original vs. adjusted (% of GDP)



Source: GeoStat, NBG, G&T Research

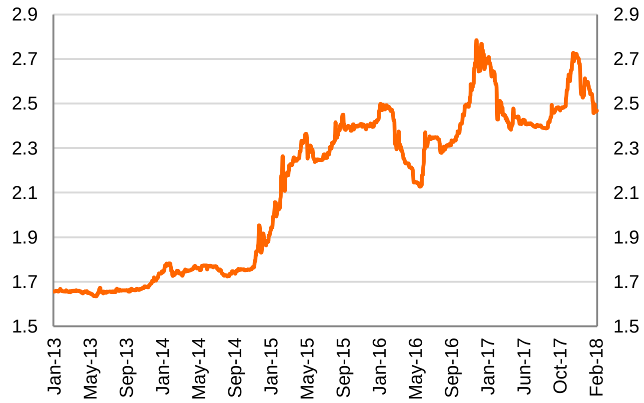
Annual inflation came in at 6.7% in 2017 and is expected to be close to the 3.0% target in 2018. Nearly 40% of the price growth was due to excise tax-related increases, and core inflation remained close to the NBG's target of 4.0% throughout 2017. Inflation retreated to 5.7% in August before increasing to 6.9% in November and 6.7% in December 2017. The NBG raised the policy rate in 1H17 to 7.0% from 6.5% at end-2016, and no further rate hike was anticipated by the market. However, by the end of 2017, additional price pressures arose from the GEL's NEER depreciation, which prompted the NBG to raise the monetary policy rate by 25bps to 7.25% in December to curb a depreciation-related increase in inflation expectations. Annual inflation retreated to 4.3% this January, and core inflation came in at 3.0% as the effect of last year's excise tax increases faded away. The NBG expects inflation to be close to the 3.0% target in 2018. While it kept the policy rate unchanged at its January meeting, it however signaled the rate cut to 6.75% by the end-2018. We see the room for further rate cut in 2018 to 6.5% as we expect inflation to converge to 3.0% inflation target faster than forecasted by NBG currently. In 2018, increased administrative tariffs for water and electricity (0.3ppts effect on inflation according to NBG), as well as a potential increase in world commodity prices, are the major factors likely to put upward pressures on prices. On the other hand, the fading effect of excise tax increases and the GEL's expected appreciation will likely drag prices down. Importantly, we do not expect demand side pressures on prices as projected GDP growth is still below potential. We forecast annual average inflation at 3.3% in 2018.

Figure 15: Annual inflation



Source: GeoStat

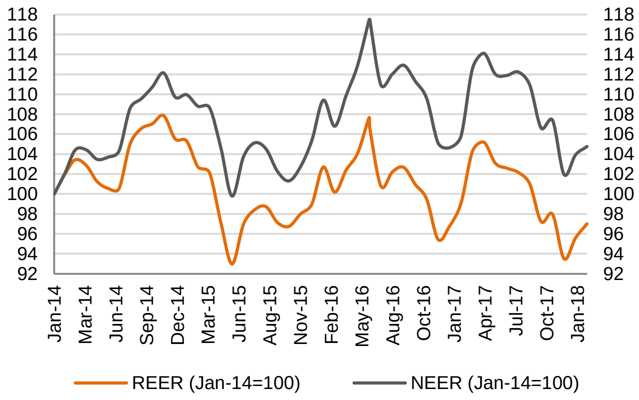
Figure 16: US$/GEL exchange rate



Source: NBG

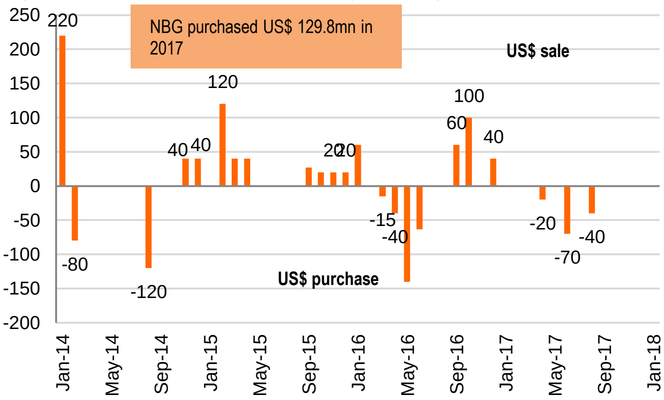
The GEL has gained against the US$ since December. The GEL's strength in April-August 2017 enabled the NBG to build reserves, and it purchased nearly US$ 130mn. GEL weakness last October-November broadly reflected negative expectations, stemming from end-year GEL's depreciation in 2014-2016. At the same time macroeconomic factors remained favorable: the CA deficit was at a historical low in 3Q17, and external inflows were on a strong upward trajectory. With no economic reasons for the year-end depreciation, the GEL quickly regained value against the US$ after 1 December, appreciating by 5% to 2.59 in December from 2.72 in November. The currency continued its strength in 2018 and appreciated 4.7% against the US$ as of February 21. We see room for further GEL strength in medium term, with the currency approaching 2.40 vs the US$. We expect the NBG to intervene in the event of excessive appreciation, in line with its aim to build reserves.

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 REER Jan -18.

Figure 18: NBG net interventions (US$ mn)

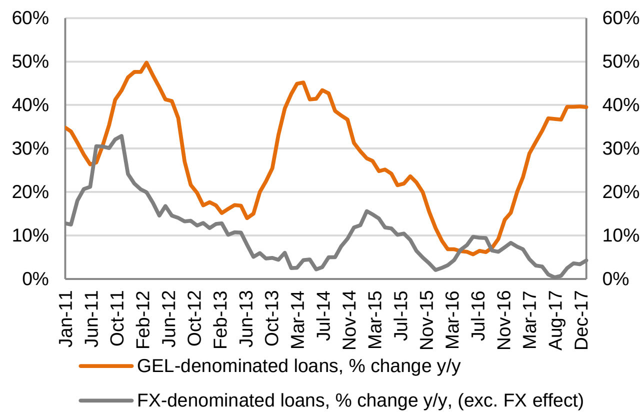


Source: NBG

Strengthening consumer confidence sees loan portfolios grow. A 19.4% expansion in the retail loan book drove the credit portfolio up 17.9% y/y to GEL 22.3bn in 2017. Notably, corporate loan growth also accelerated at the end of the year. Supported by the central bank's de-dollarization initiatives, the loan dollarization ratio was down 8.5ppts to 56.9% in December from 65.4% in December 2016. Notably, US$-denominated loans, excluding exchange rate effects, grew by a mere 4.3% y/y in 2017 vs 8.3% y/y in 2016. The deposit dollarization ratio also had a downward trajectory in

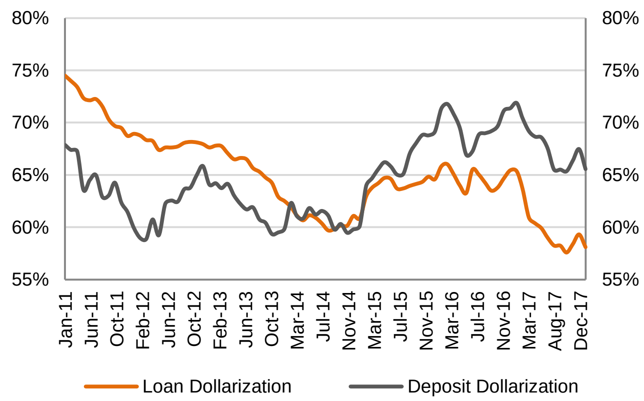
2017, falling 5.8ppts to 65.6% from 71.4% in December 2016. NPLs reduced by 0.7ppts y/y to 2.8% in 2017. With growth gaining momentum in 2018 along with anticipated increase in local investments, we expect credit portfolio to increase 13-15% y/y in 2018.

Figure 19: Loan portfolio growth



Source: NBG

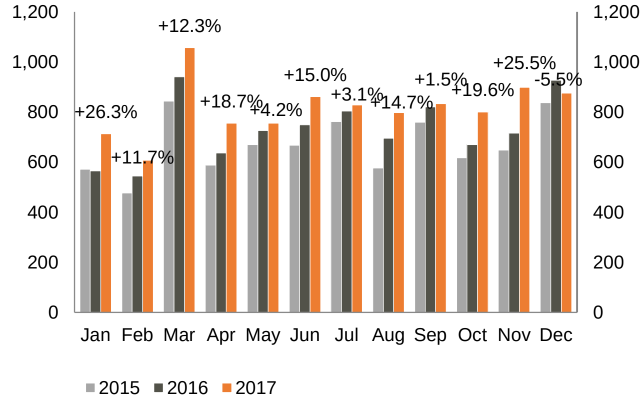
Figure 20: Dollarization



Source: NBG

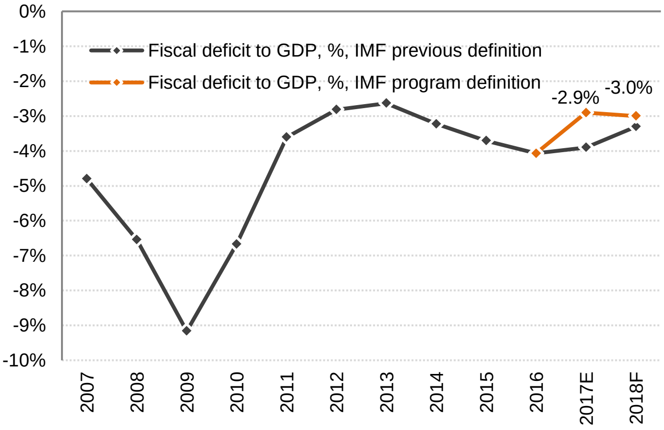
The budget deficit reduced to 3.9% of GDP in 2017 from 4.1% in 2016, in line with the revised budget. The 2017 budget was revised in November to reflect better-than-expected tax revenues and the related reduction in the fiscal deficit. Based on our estimates, the fiscal deficit complied with the budgeted figure of 3.9% of GDP (though it was at 2.9% of GDP under the IMF-supported program definition, lower than the agreed figure of 3.0%). Importantly, a 44.9% y/y increase (almost GEL 1bn) in capital spending was the main factor behind the deficit as the current spending increased by 4.2% y/y (1.7% y/y reduction in real terms). Tax revenues slightly overperformed, increasing by 11.3% y/y to GEL 9.8bn in 2017 vs the budgeted increase of 10.9% y/y, mostly due to VAT revenues coming in GEL 102.6mn higher than expected. We estimate that the corporate income tax reform in 2017 allowed GEL 600-650mn to be retained by businesses for reinvestment. The public debt remained flat at 44.7% of GDP in 2017, in line with the budgeted figure.

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



Source: MOF

Figure 22: Fiscal deficit



Source: MOF, IMF, G&T Research

Ongoing reform measures are expected to keep the deficit at 3.3% of GDP in 2018. The budget reflects the government's commitment to contain current spending growth (freezing it in real terms) while allowing higher capital expenditure, in line with the four-pillar reform program. That said, the recently approved remuneration law will contain wage growth (law sets salary ceilings for different grades of civil servants and consolidates current bonuses into the base salary, which will make wage bill growth consistent with the projections), and ongoing measures will target an increase in the efficiency of public spending and social programs. A pension reform to be launched in the 3Q18 is expected to increase domestic savings. Moreover, the government has reduced the processing time and administrative procedures for refunding VAT claims to five days from one month since January, and it plans to move to an automated system for VAT refunds by September. These initiatives, together with profit tax reform, will likely strengthen corporates' financial positions and increase investment – a significant demonstration of the government's support to private-sector-driven growth.

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