Georgian Economy
Growth, Currency and Policy

Georgia | Economy
November 5, 2019

Executive Summary

Recent months have highlighted the extent of the impact of negative expectations on Georgian macro environment. Growth remained strong at 5.7% in 3Q19, but excessive GEL depreciation saw inflation rise to 6.9% in October – higher than initially forecast. External demand and fiscal policy remain the key growth drivers in 2019. Separately, construction has recovered in recent months and domestic investment is increasing, supported by bank credit. In addition, S&P followed Fitch and Moody's in upgrading Georgia's sovereign credit rating by one notch in October 2019.

Amid a continued improvement in the external balance, the GEL, at close to 3.0/US$, was significantly undervalued through July-October. With currency weakness triggering inflation, the NBG conducted currency interventions, tightened policy, and decreased the reserve requirement on FX deposits, but to no great effect. We do not see the need for further rate hikes to address medium-term inflation trends (annual inflation is already likely to converge to the 3.0% target from 2Q20), but we expect the NBG to relax FX liquidity further to support the GEL. We also believe that the NBG needs to adopt a more balanced approach to de-dollarization as growth in GEL lending along with a lack of confidence in the GEL and a related increase in dollar deposits have proved to be one of the major factors in the currency's weakness lately. In our view, this could be addressed by reducing the floor on GEL lending. This is also desired considering reduced FDI and government's shift to domestic borrowing in 2019 revised budget and beyond. We acknowledge benefits of de-dollarization process, but we see this as a long-term process through capital market development.

If the GEL stabilizes at the current level of 2.96/$ over the next few weeks, this would imply that annual inflation could remain close to 7.0% through end-year. Deceleration in price growth from 2Q20 will likely enable the NBG to cut rates by 100-150 bps in 2020, in our view.

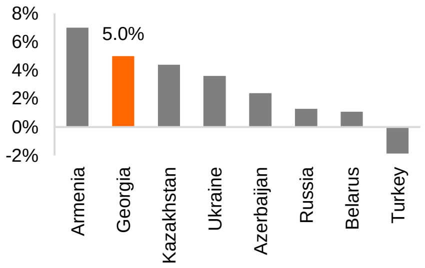
After recent monetary policy tightening, we keep our growth forecast at 4.5% for 2019, but see pressure on growth in 2020. Monetary policy rate hikes will soften demand for GEL lending, but growth in FX liquidity will keep FX interest rates low, thus supporting bank lending in FX. Therefore we expect bank lending to grow above the nominal GDP growth rate in 2020.

Strong growth in exports and a drop in oil and import-intensive FDI have improved the external balance markedly, resulting record low current account deficit of 4.6% of GDP in 1H19. We expect a weaker currency to trigger further improvement in the trade balance, supporting a better-than-expected improvement in the current account deficit to below 5.0% of GDP in 2019.

Budget spending is smoother this year with fiscal deficit at 37% of annual plan in 9M19, compared to the surplus a year ago. 2020 budget framework remains healthy with the deficit at 2.7% of GDP and current spending at 23% of GDP despite significant growth in social spending.

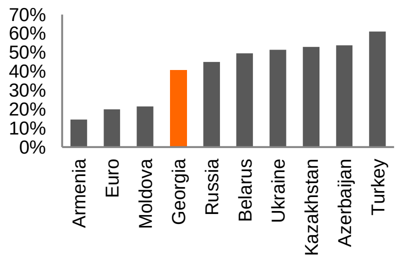
We expect Georgia to deliver 4.7% growth in 2020, supported by external demand and domestic investment. If the NBG keeps the policy rate unchanged throughout 2020 and parliamentary elections weigh on business confidence, 2020 growth could soften to 4.0%. If Russia's ban on direct flights is lifted, this could produce a positive shock to growth. Additionally, Georgia's Prime Minister has recently met with a number of corporate sector representatives to address different issues hindering business decision-making in the country, which bodes well for future growth. Government also requested extension of ongoing IMF program by one year to strengthen credibility of government policies.

Figure 1: Real GDP growth rates, 8M19



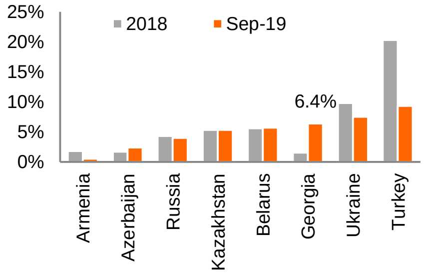
Source: National statistics offices
Note: 1H data for Turkey and Ukraine

Figure 2: Currency weakening vs USD



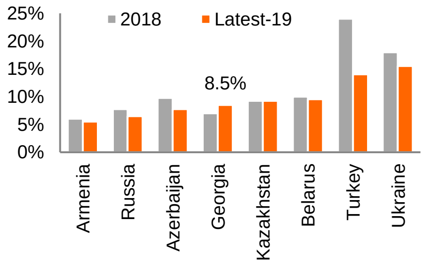
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – September 2019

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

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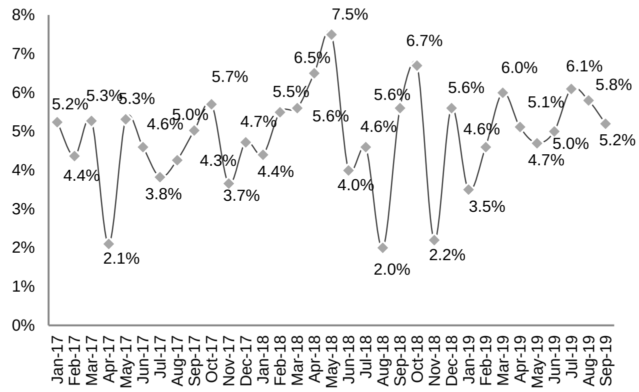
Better than expected growth in 9M19, growth expected at 3.5% in 4Q19

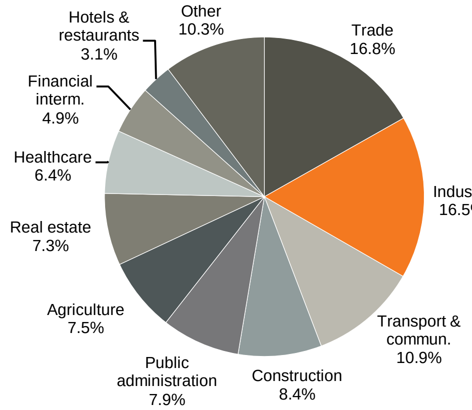
Georgia's economy has grown rapidly and consistently this year. Growth was 4.7% y/y in 1H19 and remained broad-based despite weakness in the construction sector that mostly reflected the completion of the BP gas pipeline. Growth was strong at 5.7% y/y in 3Q19 (6.1% in July, 5.8% in August, and 5.2% in September) according to Geostat's initial estimates, as construction recovered and service sectors continued growing. We expect softer growth of 3.5% in 4Q19 due to last year's high base and keep our 2019 growth forecast at 4.5%.

Figure 5: Monthly real GDP growth, %



Source: Geostat

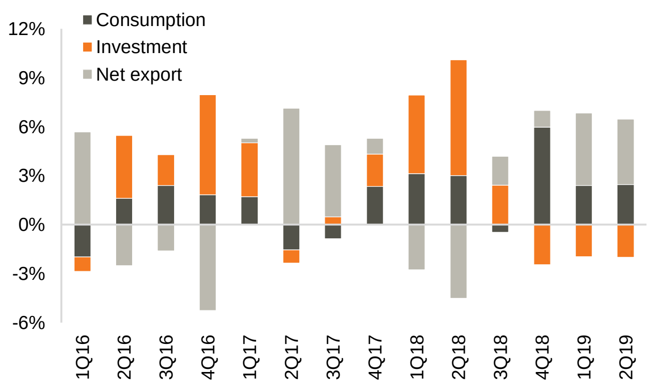
Figure 6: GDP structure by sector, 1H19



Source: Geostat

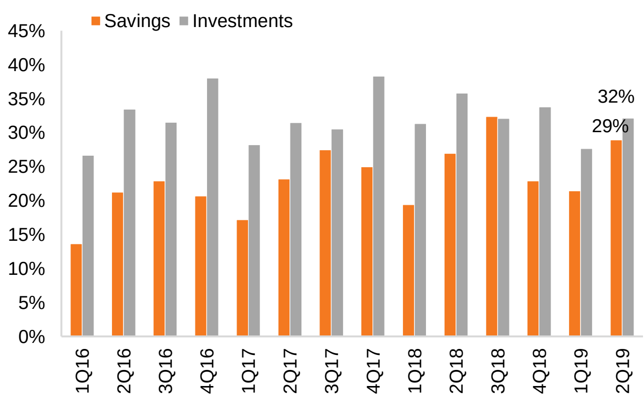
External sector boosted goods exports and remittances. This, combined with reduced imports, made net exports a positive contributor to growth in 1H together with consumption. Notably, after a tourism boom in 1H19, arrivals have slowed. However, they still posted growth of 1.4% y/y through July-September despite reduced Russian tourists due to Russia's ban on direct flights to Georgia from 8 July. In addition, the banking sector's credit portfolio expanded by a solid 14.6% y/y excluding FX effect in 9M19, and corporate loan book is expanding at a faster rate. This will be beneficial for growth potential, in our view. Fiscal policy was expansionary in 9M19, with a deficit at 37% of annual plan, compared to the surplus in 9M18. This reflects an acceleration in public capital spending of 57.9% y/y in 9M19.

Figure 7: Contribution to real GDP growth



Source: Geostat, Galt & Taggart

Figure 8: Savings and investment to GDP



Source: Geostat

We expect growth at 4.7% in 2020. If the NBG keeps the policy rate unchanged throughout 2020, and parliamentary elections weigh on business confidence, growth could soften to 4.0% in 2020. The economy is likely to benefit from regional economies, where export growth has been stronger than expected in recent months. Tourism and remittances from the EU and other countries are also expected to grow. If Russia's ban on direct flights is lifted, this could produce a positive shock to growth. We expect bank lending to grow by 9-12% y/y excluding FX effects in 2020. In addition, Georgia's Prime Minister has recently met with a number of corporate sector representatives to address different issues hindering business decision-making in the country, which bodes well for future growth and government also requested extension of ongoing IMF program by one year to strengthen credibility of government policies.

BOX 1: S&P upgrades Georgia to BB from BB- on improved economic resilience

This month, S&P upgraded Georgia's sovereign credit rating by one notch, leaving the country just two notches from investment-grade status. Moody's upgraded Georgia's credit rating to this level in 2017, followed by Fitch in February 2019.

The S&P rating upgrade reflects Georgia's comparatively strong growth in recent years. Amid a challenging external environment, the economy has had success in attracting funds from abroad to finance its investment needs, and it has relatively strong institutions in a regional comparison.

Georgia sovereign credit ratings

FitchRatings	Moody's Investors Service	Standard & Poor's
BB	**Ba2**	**BB**
Stable	Stable	Stable
Affirmed	Affirmed	Upgraded
Aug-2019	Sep-2019	Oct-2019

Source: Rating agencies

According to S&P, further improvement in the rating is constrained by GDP per capita of $4,300 in 2019, which remains low in a global comparison, as well as by balance-of-payment vulnerabilities, including import dependence and sizable external liabilities.

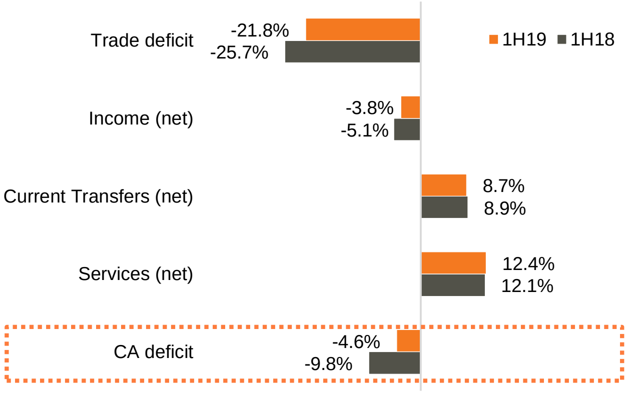
S&P expects the Georgian economy to grow faster than other countries in the region in the coming years. It sees Georgia's long-established floating exchange rate regime as particularly important in dealing with a weaker external environment. Exchange rate adjustments, among other things, have helped preserve the stability of the financial system and allowed Georgia to avoid the credit crunch that hit some other countries in the region in recent years and aggravated other economic problems.

Record low current account deficit in 1H19

CA deficit stood at record low 4.6% of GDP in 1H19. The improvement mostly reflected a significant reduction in the 2Q19 deficit, which was 3.2% of GDP, down from 8.2% in 2Q18. A reduction in the merchandize trade deficit was the major reason for the improvement in 2Q, as exports increased and imports reduced. The negative income balance also was down as reinvestments reduced. Positive components of the CA were supported by growth in tourism and in current transfers. Portfolio investments were the major funding category of the deficit in 2Q (14.2% of GDP) followed by net FDI (3.2% of GDP), which reduced y/y. Higher inflows on the funding side increased international reserves by US$ 241mn in 2Q.

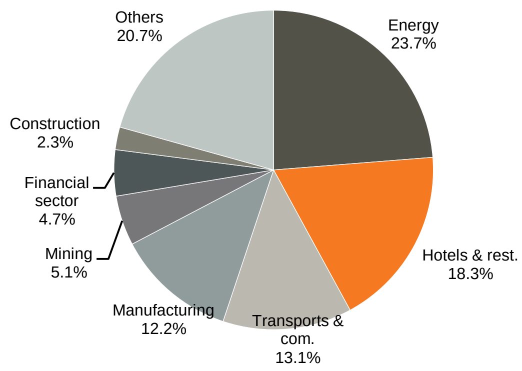
Based on preliminary information, FDI was down 34.9% y/y in 1H19, reflecting the completion of the BP gas pipeline and a reduction of debt liabilities and reinvestments. The energy sector was the largest FDI recipient in 1H, followed by hotels and restaurants, manufacturing and transport. The Netherlands topped the list of investors, followed by Turkey and the US. We expect FDI at c.6% of GDP in 2019, lower than in previous years, as the implementation of major investment projects, including the Anaklia deep sea project, are delayed.

Figure 9: CA balance and its components, % of GDP



Source: Geostat, NBG

Figure 10: FDI by sector, 1H19



Source: Geostat

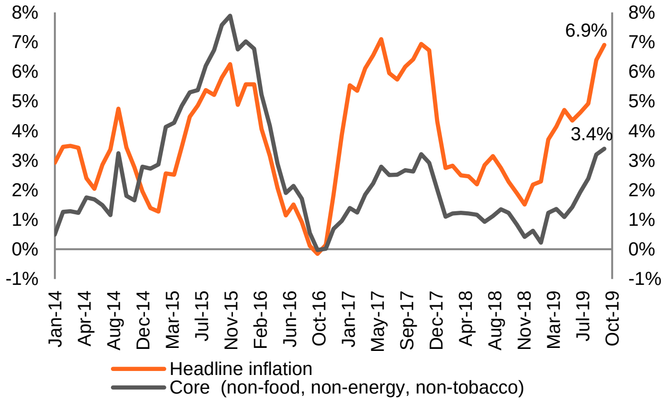
Monetary policy tightens

GEL is 10% undervalued by our estimates. Despite continued improvement in the external balance, negative expectations related to Russia's flight ban have weighed on the currency since end-June. Separately, tourism arrivals softened but still recorded positive growth. Despite arrival growth, the NBG's preliminary estimates indicate that tourism revenues fell by 6.9% y/y in 3Q19, reflecting reduced spending in US$ terms due to GEL depreciation. Importantly, improvement in the goods trade balance fully offset the tourism revenue decline in 3Q19. Meanwhile, lack of confidence, an increase in deposit dollarization of 1.9pp in four months to 63.9% as of September, and conversion of FX loans into GEL put additional pressure on the currency.

To curb currency depreciation, the NBG increased its key rate on 4 September and again at its extraordinary meeting on 25 September, by 50bp each time, bringing the refinancing rate to 7.5%. The NBG tightened the policy rate further at its 23 October meeting by 100bp. The regulator noted that this tightening aimed to reduce inflationary pressures stemming from GEL depreciation. It also made a second sell-side intervention on 27 September and sold US$ 40mn after selling US$ 32.8mn on 1 August. Shortly thereafter, the central bank announced a 5pp reduction in the FX reserve requirement, effective from 17 October. These measures stabilized the GEL at c. 2.97/$, unchanged through September-October. YTD, the GEL has weakened 9.9% against dollar from 2.67 to 2.97. The GEL's nominal and real effective exchange rates also weakened, by 13.4% y/y and 11.2% y/y respectively, supporting competitiveness but increasing imported inflation. We see GEL's average rate close to 2.8/$ in 2020, weaker than our initial forecast.

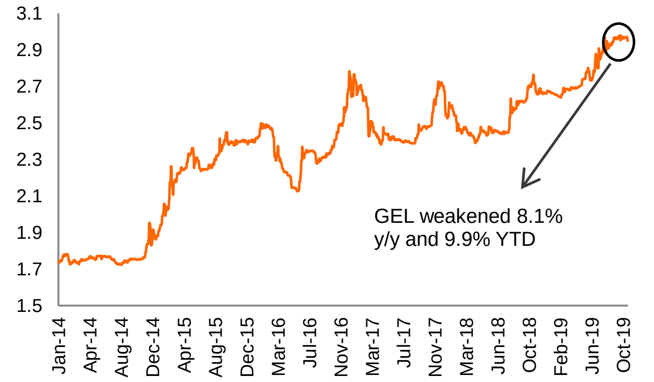
Inflation accelerated due to GEL weakness, coming in at 6.9% in October. If the GEL stabilizes at the current level of 2.96/$ in the next few weeks, this would imply that annual inflation could remain close to 7.0% through end-year. We think it could be even higher, with the weakening currency having stronger impact on price growth than an appreciating currency on price declines. We expect inflation to decelerate in 2020 due to a base effect and tighter policy, which should enable the NBG to cut the key rate by about 100-150bp from 2Q20. We forecast annual average inflation at 2.9% in 2020. We do not see the need for further rate hikes to address medium-term inflation trends (annual inflation is already likely to converge to the 3.0% target from 2Q20), but we expect the NBG to relax FX liquidity further to support the GEL.

Figure 11: Annual inflation



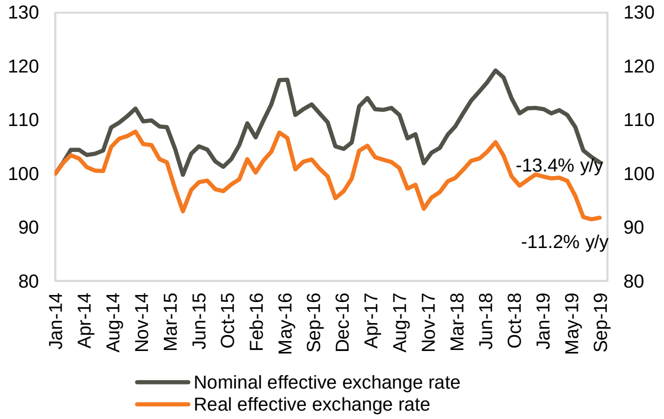
Source: Geostat

Figure 12: USD/GEL exchange rate



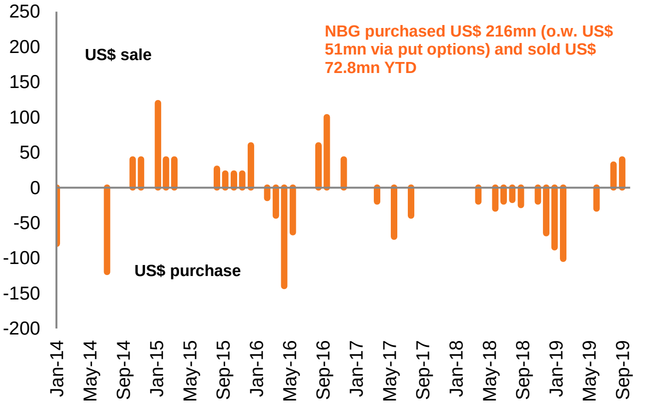
Source: NBG

Figure 13: GEL's NEER/REER, January 2014 = 100



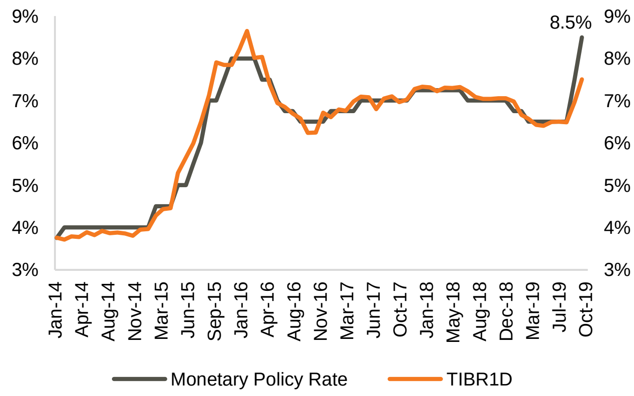
Source: NBG
Note: Index growth means GEL's appreciation and decline means GEL's depreciation

Figure 14: NBG's net interventions, US$ mn



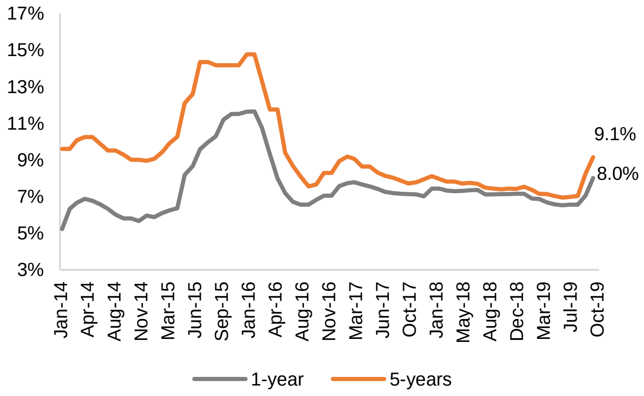
Source: NBG

Figure 15: Monetary policy rate and TIBR 1 Day



Source: NBG

Figure 16: Interest rates on treasury securities



Source: NBG

Banking sector supports growth

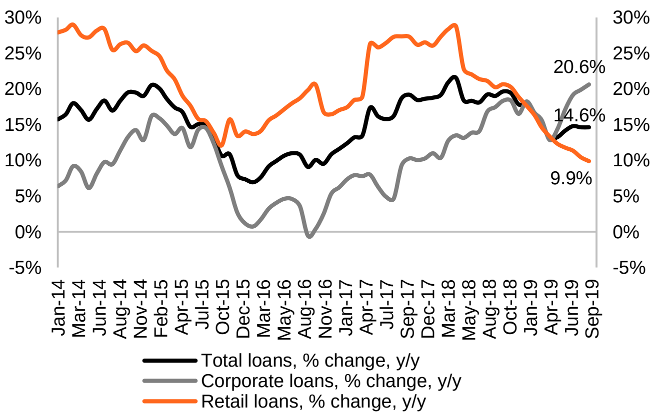
Banking sector remains resilient despite GEL depreciation. NPLs were at 2.6% in 9M19, one of the lowest levels worldwide.

As expected, corporate lending accelerated in 2019. The banking sector credit portfolio increased by 14.6% y/y in 9M19 excluding FX effects, down from 19.0% y/y a year ago (in nominal terms, growth was 21.3% y/y in 9M19). The slowdown in credit growth reflects the NBG's tighter retail lending standards (loan-to-value and payment-to-income ratios). In 9M19, the retail loan book increased 9.9% y/y, while the corporate loan book went up by 20.6% y/y excluding FX effects. Mortgages increased by 19.4% y/y excluding FX effects and drove retail lending. Loan dollarization fell to 55.0% (-0.6ppts y/y) in 9M19, and deposit dollarization increased to 63.9% (+1.4ppts y/y).

Recent monetary policy rate hikes will soften demand for GEL lending, but growth in FX liquidity will keep FX interest rates low, thus supporting bank lending in FX, in our view. Therefore we expect bank lending to grow above the nominal GDP growth rate in 2020, in the range of 9-12% excluding FX effect.

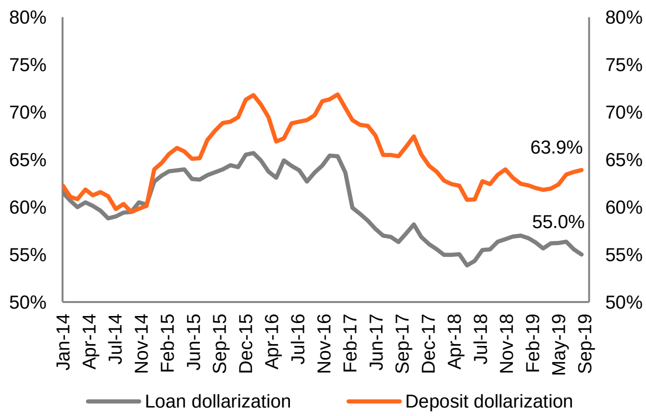
We believe that the NBG needs to adopt a more balanced approach to de-dollarization as growth in GEL lending along with a lack of confidence in the GEL and a related increase in dollar deposits have proved to be one of the major factors in the currency's weakness lately. In our view, this could be addressed by reducing the floor on GEL lending. This is also desired considering reduced FDI and government's shift to domestic borrowing in 2019 revised budget and beyond. We acknowledge benefits of de-dollarization process, but we see this as a long-term process through capital market development.

Figure 17: Bank loans growth (excluding FX effect)



Source: NBG

Figure 18: Loan and deposit dollarization



Source: NBG

Government targets 2.7% deficit in 2020 draft budget

The government revised 2019 budget document, adopted by parliament in October 2019. In the revised budget document, deficit is maintained at 2.6% of GDP, but deficit funding structure shifted from external to domestic borrowing. This shift is related to delays in the implementation of large-scale investment projects funded by IFIs and acceleration of investment projects funded by budgetary funds, keeping public capex level unchanged. For these purposes, in 2019 revised budget, government increased net domestic borrowing to GEL 900mn vs. initial plan of GEL 500mn, and reduced net external borrowing plan by the same amount. The changed deficit funding structure may create some pressure on GEL, as capex is generally import-intensive and FX borrowing partially curbs pressure on local currency.

Budget spending in smoother this year compared to previous year, when deficit funding took place in last quarter. In 9M19, budget was expansionary with fiscal deficit at GEL 434mn (37% of annual plan) vs. surplus of GEL 370mn in 9M18. In 9M19, public capex increased by 57.9% y/y, while current spending grew by 12.9% y/y.

Government has also submitted to parliament an initial draft of the 2020 state budget, which sets economic growth at 5.0% and the GDP deflator at 3.0% for 2020. The fiscal deficit is set at 2.7% of GDP. The government also plans to continue to refund VAT arrears to businesses and has allocated GEL 550mn for this purpose. The 2020 budget document expected to be adopted by parliament in December 2019, after 3 hearings required by budget law.

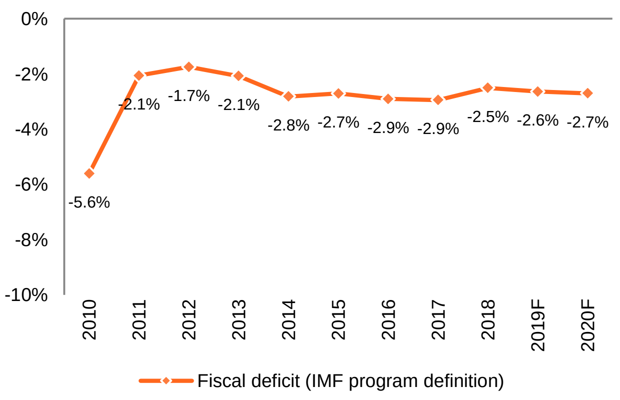
Current expenditures. The 2020 budget targets growth in pensions, salaries, social benefits, but total social spending will remain below 10% of GDP. It has been at this level since 2014. Overall, the ratio of current spending to GDP is set at 23.2%, down from 25-26% in previous years. The government was more ambitious previously, aiming to bring current spending down to 20% of GDP by 2022, but the new budget framework maintains current spending at 23.2% of GDP through 2023.

Capital expenditures set at 7.6% of GDP in 2020. This is below the 8.5% level of the last two years but is high compared to 2013-16 levels (5-6% of GDP).

Tax revenues. The government plans tax revenue growth at a rate below nominal GDP growth, with the tax-to-GDP ratio projected at 25.0% in 2020 (slightly down compared to 2019E). Corporate income tax revenues are set to increase at the fastest pace in 2020 (+11.1% y/y), reflecting profits from BP's new pipeline operation.

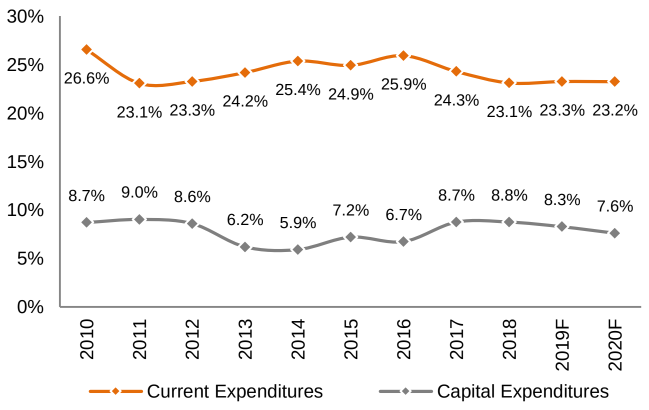
Deficit funding. The ratio of total public debt to GDP is set at 45.0% in 2020 (2019E 44.3%), reflecting a reduced share of external debt (2020F 34.7% vs. 2019E 35.2%) and an increased share of domestic debt (2020F 10.3% vs. 2019E 9.2%). Notably, the government plans to increase deposits by GEL 500mn, which will mostly be deposited in the banking sector.

Figure 19: Fiscal deficit



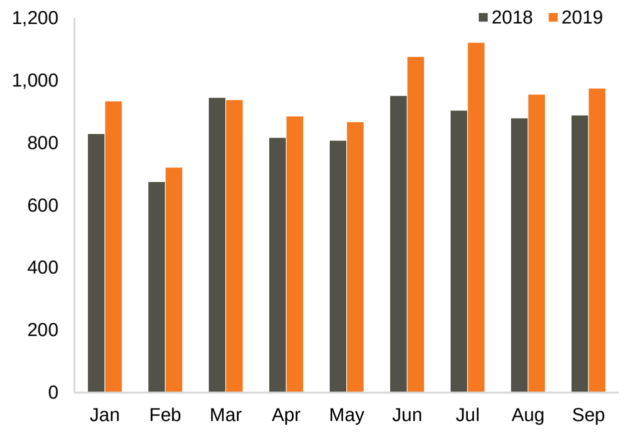
Source: MOF, consolidated budget
Note: Deficit calculated as net lending / borrowing minus budget lending

Figure 20: Expenditures: current vs. capital, % of GDP



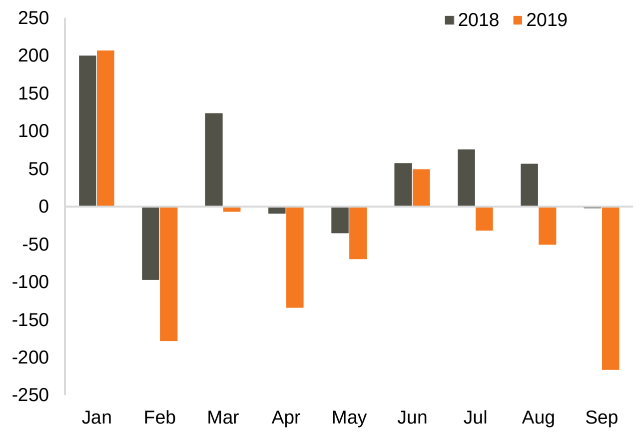
Source: MOF, consolidated budget

Figure 21: Tax revenues by months, GEL mn



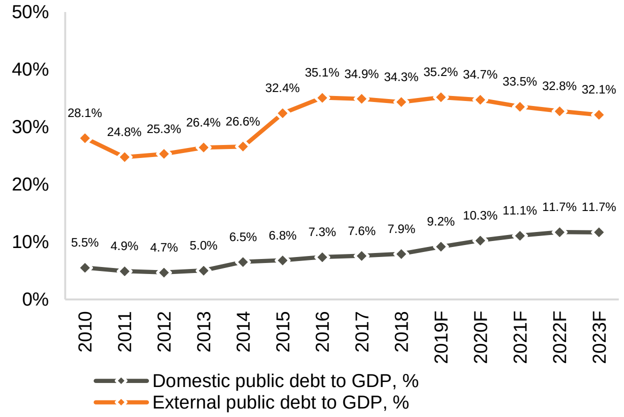
Source: MOF, consolidated budget

Figure 22: Fiscal balance by months, GEL mn



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

Figure 23: Public debt structure

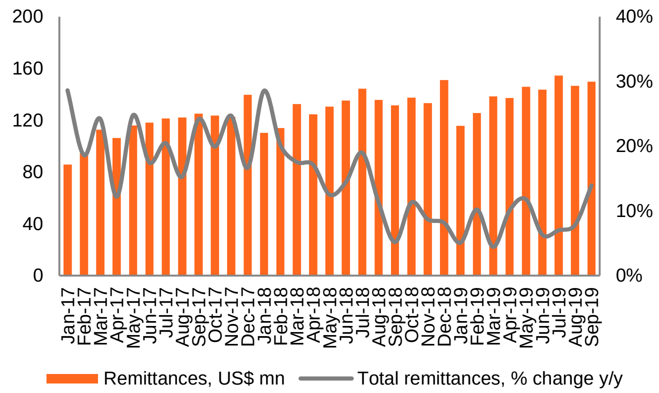


Source: MOF, consolidated budget

Remittances up from EU, down from Russia

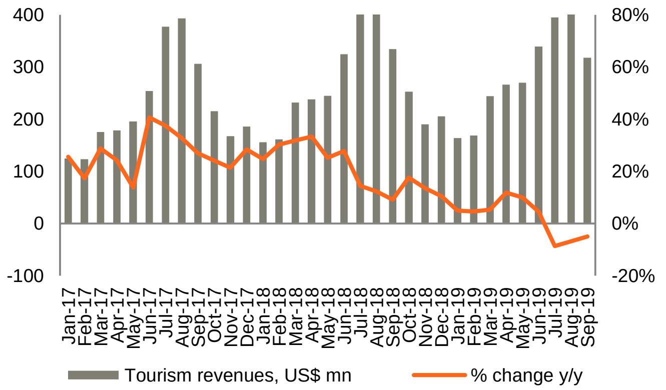
Remittances increased by a solid 8.5% y/y to US$ 1.3bn in 9M19. This growth was supported by significantly increased remittances from EU countries (+22.4% y/y, 38.6% of total) as well as the US, Ukraine and Israel. Remittances from Russia fell 7.9% y/y in 9M19, bringing its share down to 24.6% of the total from 29.0% a year ago. Notably, remittances from Turkey have recovered since August due to last year's low base. We forecast remittances at US$ 1.7bn in 2019 and at US$ 1.8bn in 2020.

Figure 24: Money transfers



Source: Geostat, NBG

Figure 25: Tourism inflows

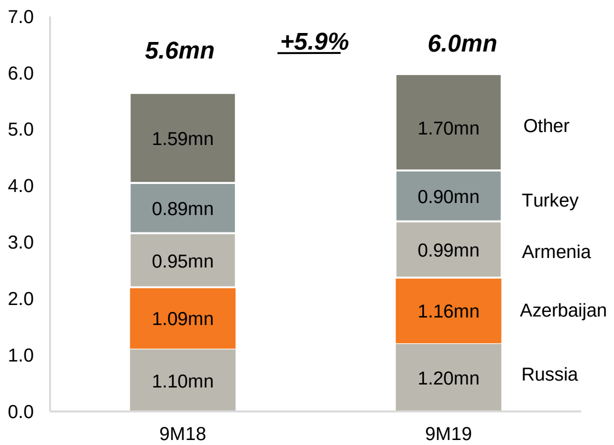


Source: Geostat, NBG

Softer tourist arrivals after several years of record-breaking growth

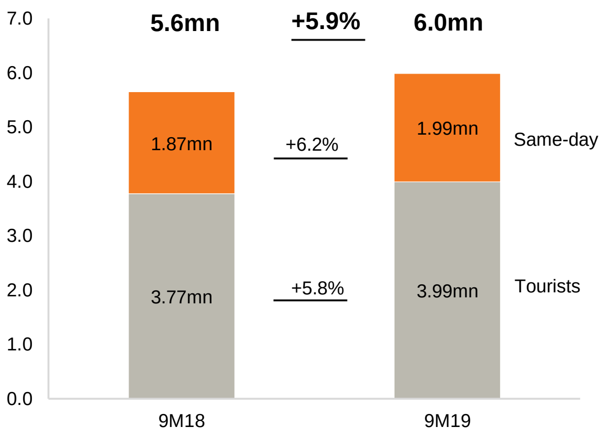
Total international visitors (tourists and same-day arrivals combined) stood at 6.0mn (+5.9% y/y) persons in 9M19. Out of total visits, tourist trips increased 5.8% y/y, accounting for 66.7% of total arrivals. Same-day arrivals were up 6.2% y/y in 9M19, supported by increased arrivals from Turkey. Of the top markets, Russia was the largest contributor to arrival growth due to strong growth in 1H19, followed by Azerbaijan and Armenia. Visitors from the EU increased 24.1% y/y to over 385k. Notably, tourist arrival growth slowed to 1.4% y/y through July-September compared to 10.0% y/y growth in 1H19, reflecting significantly reduced arrivals from the largest source markets Russia and Iran. From non-neighboring markets, visitors from the EU, Ukraine, Israel, Saudi Arabia and Kazakhstan continue travelling to Georgia in rising numbers. We forecast that 1mn tourists will visit Georgia in 4Q19, bringing total tourist arrivals to 5mn persons (+5.2% y/y) in 2019. We forecast tourism revenues at US$ 3.4n (+4.3% y/y) in 2019 down from our initial forecast of US$ 3.6bn (+12.3% y/y).

Figure 26: International visitors by country



Source: GNTA

Figure 27: International visitors by type

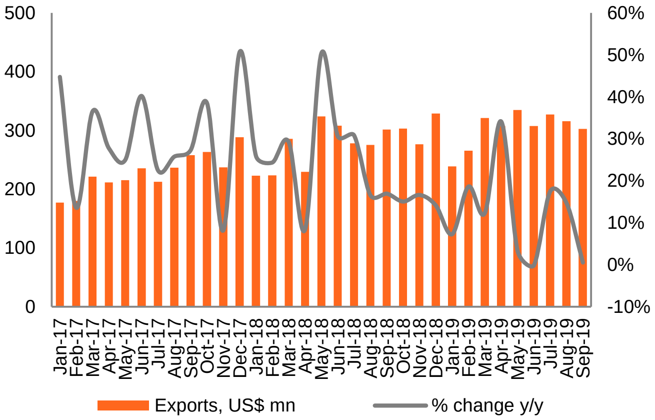


Source: GNTA

Foreign trade

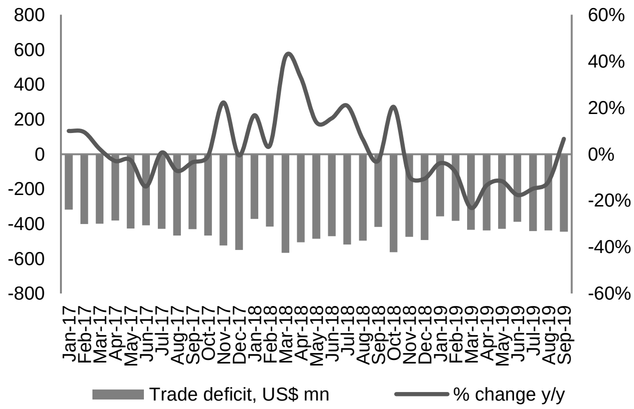
CIS markets absorbed most Georgian exports in 9M19. Total exports increased 11.1% y/y to US$ 2.7bn in 9M19. Exports to CIS markets increased by 23.2% y/y (52.6% of the total), with notable increased demand from Azerbaijan, Russia, Armenia, and Ukraine. Exports to EU countries rose by 16.3% y/y, accounting for 22.8% of the total. Exports to other countries reduced by 11.3% y/y (24.6% of the total), reflecting lower exports to Turkey, the US and China. Among Georgia's major export products, copper, used cars and pharmaceuticals, which are mostly re-exports, increased strongly. These are exported to CIS as well as EU markets. Among exports of Georgian origin, wine and mineral water increased, while ferro-alloys declined. We expect export growth to remain supported by nut exports to the EU, as the harvest is better this year compared to 2018. Contrary to exports, imports declined 3.3% y/y, and as a result the trade deficit reduced by 11.6% y/y in 9M19. The reduction in imports reflected savings on oil imports as well as lower FDI-related imports as the BP gas pipeline was completed.

Figure 28: Exports



Source: Geostat

Figure 29: Trade deficit



Source: Geostat

Macro Data and Forecasts

Georgia	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019E	2020F
GDP and Prices															
Nominal GDP, GEL bn	13.8	17	19.1	18	20.7	24.3	26.2	26.8	29.2	31.8	34.0	37.8	41.1	45.0	48.8
Nominal GDP, US$ bn	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	16.0	17.7
Nominal GDP per capita, US$	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	4,298	4,764
Real GDP, % change y/y	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%	4.7%
CPI Inflation, average	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%	5.0%	2.9%
CPI Inflation, eop	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%	7.0%	1.7%
GEL per US$, average	1.78	1.67	1.49	1.67	1.78	1.69	1.65	1.66	1.77	2.27	2.37	2.51	2.53	2.81	2.75
Population, mn	4.2	4.1	4.1	4.0	3.9	3.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Government Finances															
Budget revenues, % of GDP	26.8%	29.3%	30.7%	29.3%	28.3%	28.2%	28.9%	27.7%	27.9%	28.2%	28.4%	28.9%	28.8%	28.2%	27.4%
Budget expenses, % of GDP	28.6%	33.7%	36.4%	38.3%	34.0%	30.7%	30.6%	29.4%	30.3%	30.5%	31.0%	30.4%	30.1%	30.9%	30.4%
Fiscal balance (-deficit), % of GDP	2.2%	0.4%	-2.9%	-6.9%	-5.6%	-2.1%	-1.7%	-2.1%	-2.8%	-2.6%	-3.0%	-2.9%	-2.5%	-2.6%	-2.7%
Public debt, % of GDP	24.2%	19.2%	23.6%	30.9%	33.6%	29.6%	30.0%	31.4%	33.1%	39.2%	42.4%	42.4%	42.2%	44.2%	44.8%
External Sector															
Current account, US$ bn	-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	-0.8	-0.9
Current account, % of GDP	-15.1%	-19.7%	-22.0%	-10.5%	-10.3%	-12.8%	-11.9%	-5.9%	-10.8%	-12.6%	-13.1%	-8.7%	-7.3%	-4.8%	-5.3%
Exports of goods and services, US$ bn	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	9.6	10.5
Imports of goods and services, US$ bn	4.4	5.9	7.5	5.3	6.1	8	9.2	9.3	10.1	8.7	8.5	9.4	10.8	11.0	12.0
Net Current transfers, US$ bn	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	1.4	1.4
Net FDI, US$ bn	1.2	1.7	1.4	0.7	0.7	1.0	0.8	0.9	1.4	1.4	1.2	1.7	0.9	0.8	1.1
Net FDI, % of GDP	15.2%	16.6%	11.2%	6.3%	6.3%	6.9%	4.8%	5.7%	8.7%	10.1%	8.6%	11.2%	5.7%	5.0%	6.0%
Gross international reserves, US$ bn	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	3.5	3.6
Financial sector															
Bank loan portfolio, US$ bn	1.5	2.7	3.9	3.0	3.4	4.6	5.3	6.0	7.0	6.7	7.1	8.6	9.9	10.7	11.8
Bank loan portfolio, % of GDP	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%	67.1%	67.4%
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%	8.50%	7.00%

Source: NBG, MOF, Geostat, Galt & Taggart Research

Note: Fiscal balance according to IMF Program Definition

Disclaimer

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