Georgian Economy – Growth Gaining Momentum

Georgia | Economy
May 25, 2018

Executive Summary

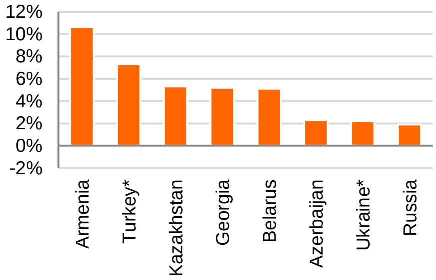
The Georgian economy delivered strong 5.2% y/y growth in 1Q18, fueled by firmed external demand. Goods exports, tourism revenues and remittances continued their strong double-digit growth rates. Government capital spending, which more than doubled y/y, and increased reinvestments by businesses were other growth drivers. Improved consumer sentiment supported bank loans to increase 21.6% y/y excluding FX effects.

Inflation decelerated sharply to 2.5% in April 2018 once excise tax effects faded. The NBG has kept its policy rate at 7.25% since the start of the year as it believes that the factors affecting inflationary risks have not yet sufficiently weakened. The NBG considers the policy rate cut in 2H18 and expects annual inflation to remain close to the 3.0% target level in 2018. It purchased US$ 20mn in April, limiting the GEL's appreciation vs the USD. Macroeconomic factors affecting GEL remain favorable and considering Georgia entering active tourism season we expect the GEL to be close to 2.4 vs the USD in the medium term, despite current volatility in major trading partners' currencies. We think that the NBG will continue purchasing FX in case the GEL appreciates significantly against its major trading partners' currencies.

Based on 1Q18 fiscal data, the government remains committed to containing current spending growth and capital spending acceleration. We believe that the fiscal deficit will reach 2.8% of GDP in 2018 as agreed with IMF.

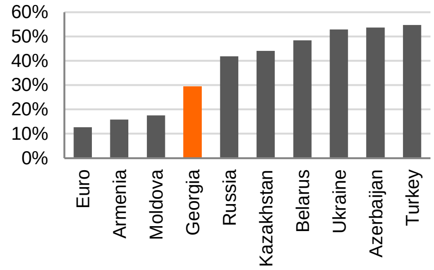
We maintain our forecasts and expect GDP growth of 5.4% for 2018. Our projection is strengthened by favorable external conditions, ongoing government reforms and improved consumer and business confidence locally. However, risks to growth may still come from the external sector.

Figure 1: Real GDP growth rates, 1Q18



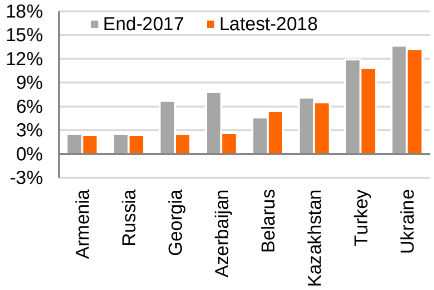
Source: National statistics offices
Note: 4Q17 for Ukraine and Turkey

Figure 2: Currency weakening vs USD



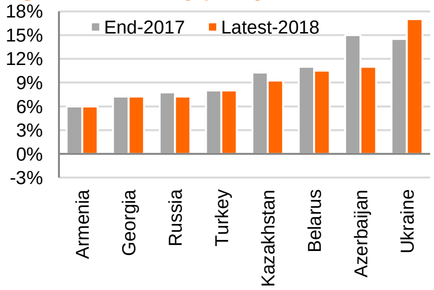
Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – 24 May 2018

Figure 3: Annual inflation



Source: National statistics offices

Figure 4: Monetary policy rates



Source: Central banks

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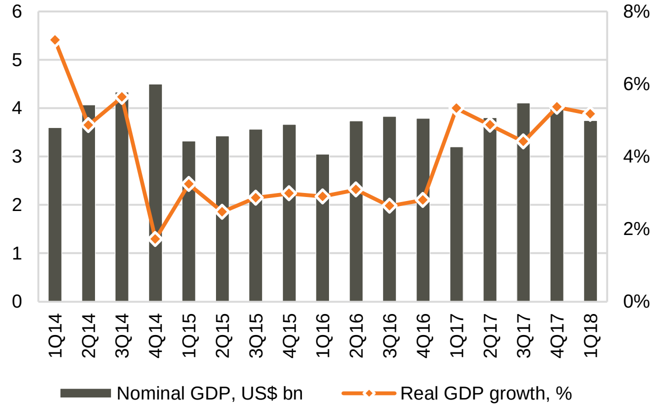
Growth gaining momentum. The Georgian economy grew by 5.2% y/y in 1Q18 based on Geostat's rapid estimates after expanding 5.0% in 2017. Firmed external demand was a major driver of growth as exports (+27.0% y/y), tourism revenues (+29.1% y/y) and remittances (+22.4% y/y) continued to post strong double-digit growth rates. Growth sources were also diversified by sector as economic activity accelerated in manufacturing, trade, real estate operations, construction, and hotels and restaurants in 1Q18. We maintain our GDP growth forecast of 5.4% for 2018, while major risks to growth still stem from the external sector in our view.

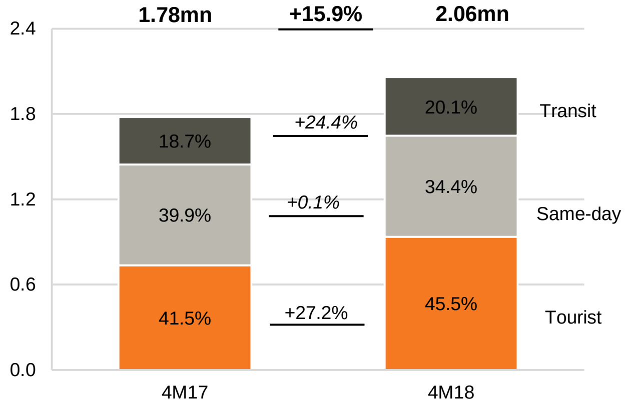
Figure 5: Real GDP growth by quarter, % change, y/y



Source: GeoStat
Note: Rapid estimate for 1Q18

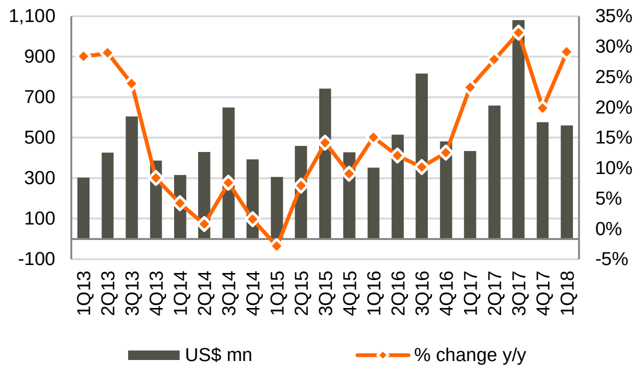
Tourism booming. In 4M18, total international arrivals (tourists, transit and one-day arrivals combined) increased by 15.9% y/y to 2.1mn visitors. Tourism revenues increased by 28.7% to US$ 800mn in 4M18. This growth was fueled by tourist arrivals, which increased 27.2% y/y, accounting for 45.5% (0.9mn person) of the total arrivals. As regional trade recovered, transit visitors also increased significantly by 24.4% y/y while same-day arrivals remained flat. Arrivals increased strongly from Georgia's top markets with Russia – up 31.2% y/y, Turkey – up 23.9% y/y and Iran – up 69.3% y/y, jointly accounting for 42.6% of the total. Arrivals from the EU rose 24.1% y/y to over 80,800, with Poland, Germany and the UK accounting for 37.6% of the growth. Among non-neighboring countries, visitor growth from Israel, India and Saudi Arabia was most notable. We expect 4.2mn (+21.2% y/y) tourists in 2018, above Georgia's local population of 3.7mn. We also expect tourism revenues to increase 22.4% y/y to US$ 3.4bn in 2018.

Figure 6: International arrivals by type



Source: GNTA

Figure 7: Tourism inflows

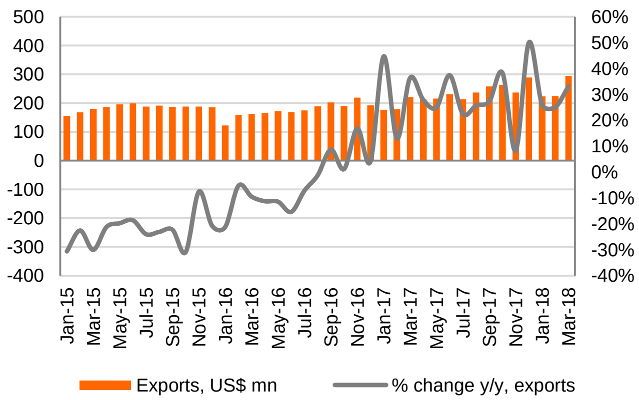


Source: NBG
Note: NBG's preliminary data for 1Q18

Exports continued strong double-digit growth, up 27.0% y/y in 1Q18. Resumed growth in the CIS markets absorbed most of Georgia's exports (+48.0 y/y, 41.4% of the total) with increased demand from Azerbaijan, Armenia and Ukraine. Exports to EU markets also increased strongly by 31.4% y/y, accounting for 28.6% of the total. Exports to other countries (mainly Turkey, China, US and Iran) increased by 3.5% y/y (30.0% of the total). Among Georgia's major export products, copper, ferro-alloys, used cars, wine, mineral waters and fertilizers increased, while pharmaceuticals exports declined. We expect exports to grow by 18.4% y/y in 2018.

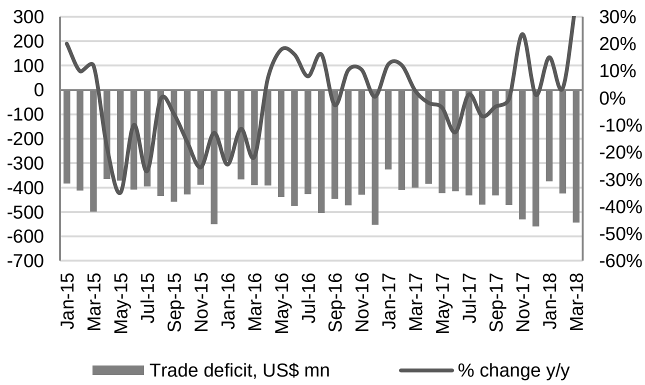
Imports also increased strongly by 22.2% y/y in 1Q18. Rising commodity prices and acceleration in economic activity were the major reasons behind this growth. However, there were also one-off imports of mixed goods. As a result, the trade deficit widened by 19.8% y/y in 1Q18 while excluding one-offs, the trade deficit increased by 14.5% in the reporting period.

Figure 8: Exports



Source: GeoStat

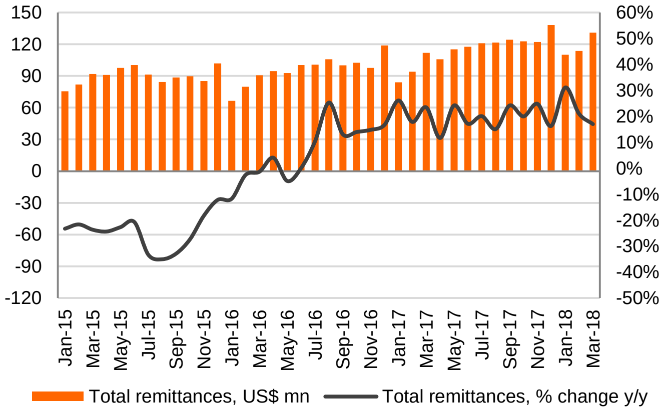
Figure 9: Trade deficit



Source: GeoStat

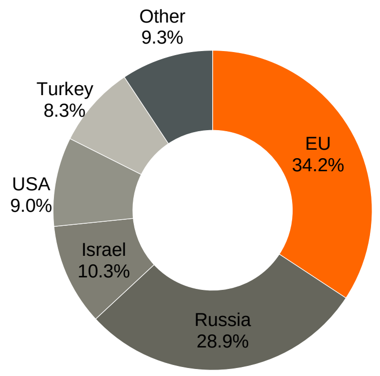
Remittances increased 22.4% y/y to US$ 355mn 1Q18. The EUR's appreciation significantly increased the dollar value of EU remittances (+35.4% y/y) in the quarter, increasing its share to 34.2% of total remittances from 30.9% in 1Q17. Despite the 7.7% y/y growth, Russia's share was down to 28.9% of the total in 1Q18 from 32.8% in 1Q17. Remittances from other major countries also increased significantly with Israel up 62.0% y/y and Turkey up 27.3% y/y. We have revised our forecasts and now expect remittances to increase by 15% y/y (up from 12% y/y projected previously) to US$ 1.6bn in 2018.

Figure 10: Money transfers



Source: NBG

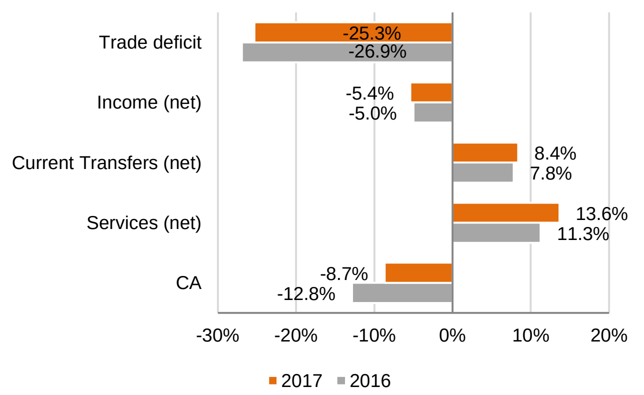
Figure 11: Money transfers by country, 1Q18



Source: NBG

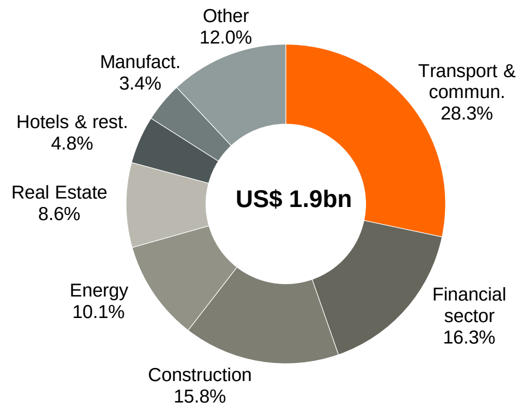
CA deficit reduced to 8.7% of GDP in 2017 from 12.8% in 2016. Strong growth in exports coupled with moderate growth in imports reduced Georgia's goods trade deficit by 1.6ppts to 25.3% in 2017. Notably, a positive service balance, fueled by strong growth in tourism revenues (+27.0% y/y) and net transfers, managed to finance 87% of the trade deficit in 2017, up from 71% in 2016. Markedly, reinvestments more than doubled to US$ 712mn, reflected in a slight deterioration of the income balance. FDI, hitting a record high of US$ 1.9bn (up 16.2% y/y), remained the major source of current account deficit funding. We expect FDI to reach US$ 2.0bn in 2018, supported by reinvestment as well as the commencement of the large infrastructure projects (Anaklia sea port and Nenskra HPP). We project the CA deficit to improve slightly to 8.6% of GDP in 2018.

Figure 12: CA deficit as % of GDP



Source: NBG, GeoStat

Figure 13: FDI by sector, 2017

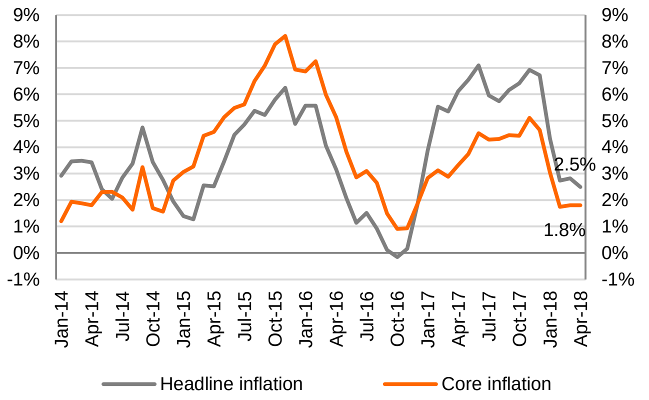


Source: GeoStat

Annual inflation is below the NBG's 3.0% target level. Inflation has been declining from the beginning of 2018 as the effect of last year's excise tax increases dissipated. Annual inflation was 2.5% in April and core inflation also reduced to 1.8%. Despite inflation coming in below the target, the NBG kept its monetary policy rate unchanged at its last three monetary committee meetings (in January, March and May). The decisions took into account increased inflationary risks stemming from: 1) the GEL's

NEER depreciation at end-2017, and 2) the recent depreciation of the RUB and TRY and increased risks of imported inflation. The NBG expects inflation to be close to its 3.0% target in 2018, which signals a rate cut to 6.75% by end-2018. We maintain our inflation forecast and expect average annual inflation of 3.3% in 2018.

Figure 14: Annual inflation



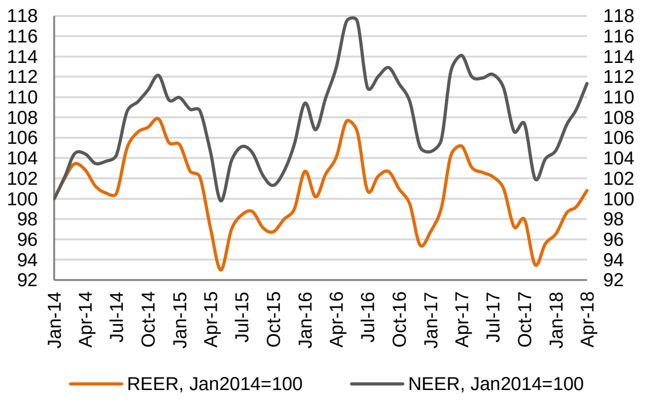
Source: GeoStat

Figure 15: USD/GEL exchange rate

Source: NBG

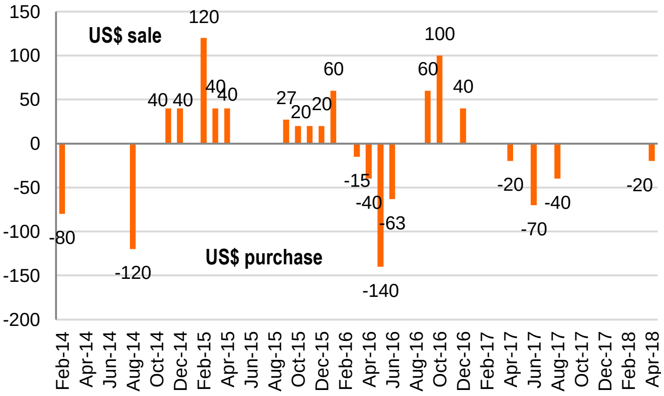
GEL is close to its fair value. The GEL has been appreciating since December 2017. The appreciation strengthened in the beginning of April with GEL hitting below 2.4 vs the USD and the NBG purchased US$ 20mn to limit further appreciation. The GEL depreciated slightly from mid-April in the range of 2.43-2.47 against the USD. This can be explained by deteriorated trade balance in March-April, as well as negative expectations from TRY and RUB depreciations. However, macroeconomic factors supporting FX rate remain favorable and considering Georgia entering active tourism season we expect the GEL to be close to 2.4 vs the USD in the medium term despite current volatility in major trading partners' currencies. We also expect reduced end-year volatility in FX.

Figure 16: NEER/REER (January 2014 = 100)



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

Figure 17: NBG's net interventions (US$ mn)

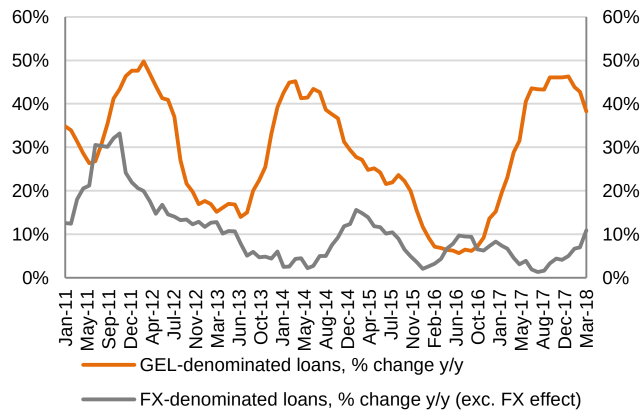


Source: NBG

Loan portfolio supported growth. A 27.1% expansion in the retail loan book drove the credit portfolio up 18.0% y/y to GEL 22.2bn in March 2018. Excluding FX effect, the loan portfolio was up 21.6% y/y in March 2018 vs 13.0% y/y in March 2017. We also estimate that NBG's new regulations on consumer lending (capping loans for unjustified revenues at 25% of equity) will reduce total loan portfolio growth by just 1ppt. Considering this, we expect the loan portfolio to grow by 16% y/y in 2018.

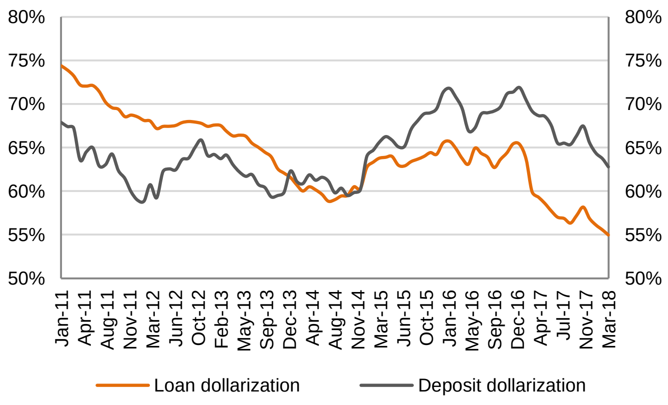
The loan dollarization ratio was down to 55.0% (-5.0ppts y/y) in March 2018, supported by the central bank's de-dollarization initiatives. The deposit dollarization ratio fell to 62.8% (-6.4ppts y/y) in March 2018. NPLs reduced by 1.3ppts y/y to 2.4%.

Figure 18: Loan portfolio growth



Source: NBG

Figure 19: Dollarization

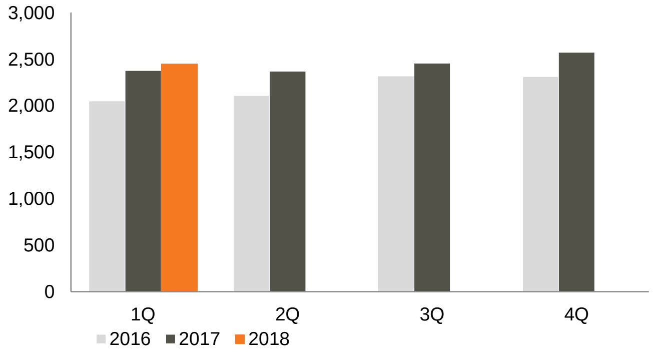


Source: NBG

The budget deficit is expected to reduce to 2.8% of GDP in 2018. In 1Q18, tax revenues increased by 3.1% y/y to GEL 2.4bn (104.4% of planned amount). The VAT (+10.8% y/y) and personal income tax (+11.4% y/y) posted strong increases. Meanwhile, corporate income tax revenues decreased by 9.1% y/y, suggesting increased reinvestment. We expect reinvestment to reach c.GEL 680-700mn during 2018. Current spending was flat y/y while capital spending surged by 135.4% y/y in 1Q18.

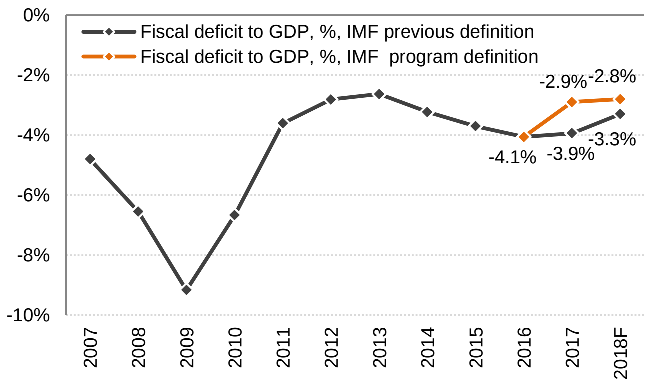
As current spending growth is contained, we expect the consolidated budget deficit to reduce to planned 3.3% of GDP in 2018 from 3.9% in 2017. This is equivalent of 2.8% fiscal deficit in 2018 (down from 2.9% in 2017) under the current IMF program definition.

Figure 20: Tax revenues, GEL mn



Source: MOF

Figure 21: Fiscal deficit



Source: MOF, IMF, G&T Research

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