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RESEARCH

Georgian Economy
Steaming Ahead

Georgia | Economy
April 20, 2017

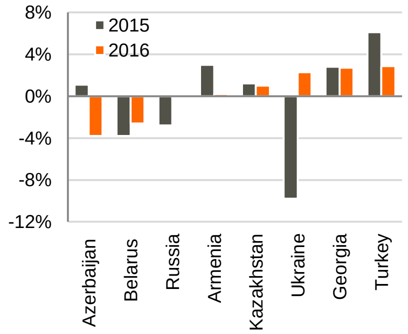
Georgia's flexible exchange rate and economic diversification once again braced the economy against external headwinds in 2016. Growth remained stable at 2.7% while price pressures have been contained with year-end inflation at 1.8% y/y. With the better external environment, economic activity rebounded strongly in 2017 with GDP growth of 4.8% y/y in 2M17. The GEL's appreciation since mid-February and Georgian citizens' recently granted visa-free travel to the EU are boosting consumer and business confidence. The government's four-pillar reform program and related increase in infrastructure spending, alongside new tax exemptions for the corporate sector, are expected to boost investment growth. The better external environment due to firming world commodity prices and the moderate recovery in partner countries' economies are expected to have a positive impact on goods exports and remittances throughout 2017. Moreover, significant growth in tourism revenues is anticipated with Georgia being a cheap and popular tourist destination, as well as solid FDI of US$ 1.7bn. These factors are boosting the country's growth outlook, with the economy expected to grow by 4.3% in 2017.

Developments in 2016

Most resilient economy in the region in 2016. The Georgian economy remained resilient despite the external headwinds hampering performance since end-2014. Growth remained stable at 2.7% y/y in 2016, which we view as fairly solid compared to the country's major trading partners. The construction sector grew by 8.1% in 2016 as a whole despite the slowdown in 2H16, attributed to the high base in 2015. Importantly, the two largest sectors of the economy posted growth – manufacturing (+4.8% y/y) and trade (+1.8% y/y) – reflecting the recovery in both external and domestic demand, supported by firming world commodity prices and increased remittances in 2H16. Robust tourist arrivals drove the strong 9.9% y/y growth in the hospitality sector. Financial intermediation rose 9.3% y/y. Real estate operations was the other fastest-growing sector at 6.7% y/y despite uncertainties related to GEL depreciation. Transport (-0.7% y/y) and communications (-0.2%) were the only sectors to post a modest contraction in 2016. Growth in agriculture was flat despite various government-supported programs in the sector.

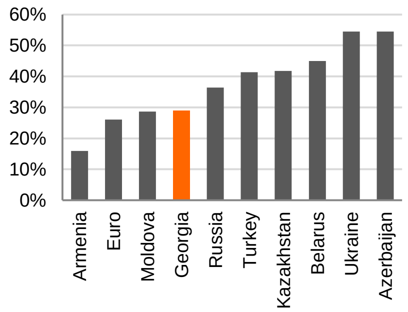
Investments drove growth in 2016; recovering private demand also supported growth in 2H16. Investments increased by 7.9% y/y in real terms in 2016 as FDI related to strategic projects and residential construction increased private investments by 10.5% y/y. Government investments fell 4.2% y/y in real terms, as infrastructure spending slowed significantly in 4Q16. Private consumption recovered in 2H16, bringing the 2016 growth figure to +1.2% y/y. This was supported by growth in remittances since June 2016 and an 18.5% y/y expansion (excluding FX effect) in the retail credit supply. Strong growth in services exports largely compensated drop in goods exports. At the same time, imports recovered in the 4Q. As a result, net exports contribution to GDP was negative 0.9ppts compared to negative 3.7ppts in 2015.

Figure 1: Real GDP growth rates



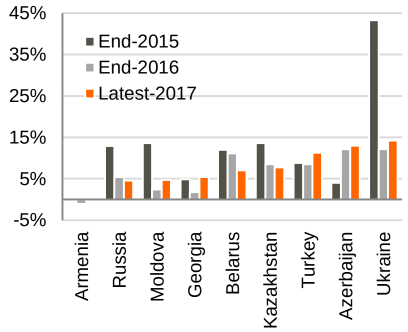
Source: National statistics offices

Figure 2: Currency weakening vs US$



Source: Bloomberg
Note: US$ per unit of national currency, 1 Aug 2014 – 31 Mar 2017

Figure 3: Annual inflation



Source: National statistics offices

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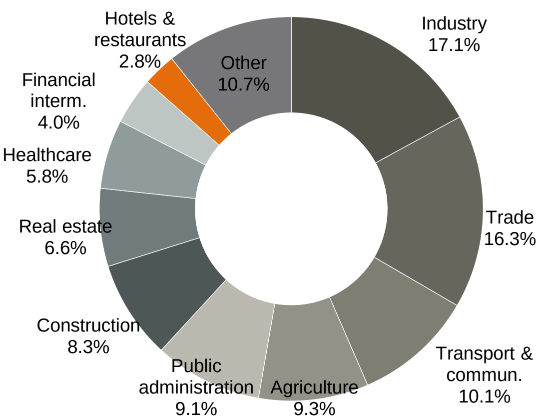
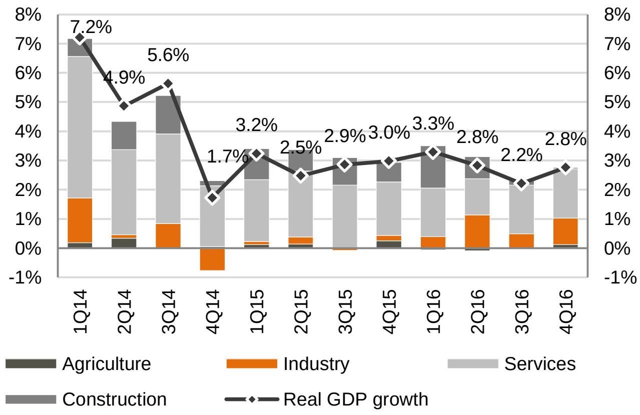
Figure 4: Nominal GDP structure



Source: GeoStat

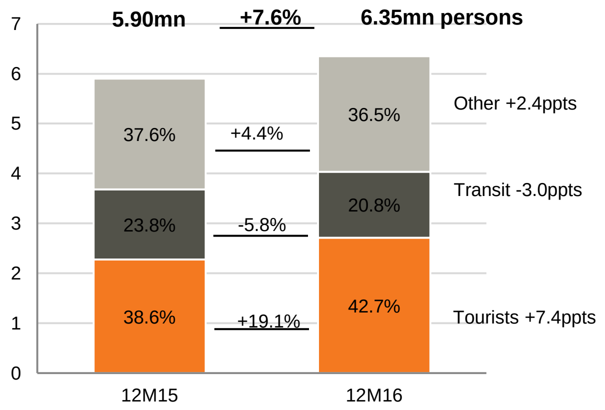
Figure 5: Real GDP growth and contributions to growth, y/y



Source: GeoStat

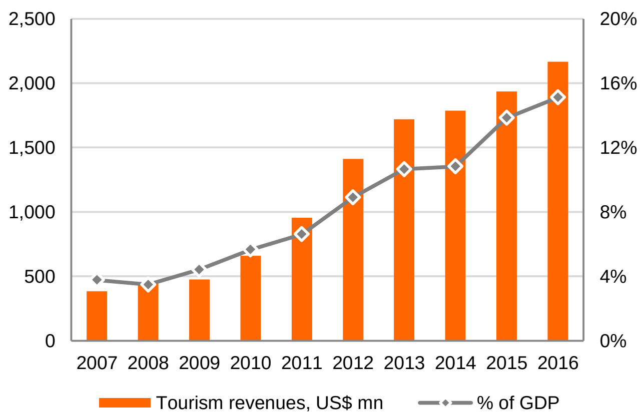
Tourism remained one of the main engines of growth throughout 2016, fueling services exports. Total international arrivals increased by 7.6% y/y to 6.4mn persons, fueled by a surge in tourist arrivals, up 19.1% y/y to 2.7mn persons in 2016. The number of other visitors (transit passengers and others) reached 2.7mn (+1.2% y/y). Arrivals were up not only from neighboring countries (Armenia, Azerbaijan, Russia, Ukraine, Iran) but also from the EU and other distant countries such as India, Philippines, UAE, Israel and Saudi Arabia. On a monthly basis, the slowdown in the growth of total arrivals in June and July was connected to the weather-related temporary closure of a customs check-point with Russia, as well as the drop in arrivals from Turkey, likely due to Ramadan and the temporary travel restrictions related to failed coup introduced by the Turkish government in mid-July (some restrictions were relaxed at the beginning of August). A series of entertainment events across Georgia in 2016, plus the safety and cheap services that the country offers, were the major factors attracting more visitors. Notably, services exports, fueled by tourism inflows at US$ 2.2bn (15.1% of GDP), have surpassed goods exports for two years in a row and averaged 22.9% in 2015-2016 – 1.7ppts over the same figure for goods exports.

Figure 6: International arrivals by type



Source: GNTA

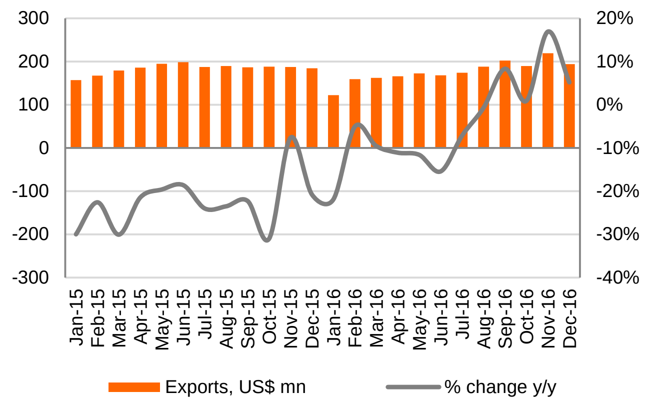
Figure 7: Tourism inflows



Source: NBG, GeoStat

Goods exports resumed growth since September 2016 after two years of decline. Weak external demand and low commodity prices continued to weigh on export growth in 1H16; however, the pace of the export decline fell significantly in July and August 2016, registering 7.2% y/y and 1.3% y/y declines respectively compared to an average drop of 12.4% y/y in 1H16. Despite growth in exports over September-December 2016, exports were down 4.2% y/y to US$ 2.1bn in 2016 as a whole due to reduced export earnings from the EU (-11.5% y/y, 27.0% of total) and CIS (-12.3% y/y, 34.9% of total). Exports to other countries increased (+11.9% y/y, 38.1% of total) as exports to China, South Korea, Switzerland, Iraq and Saudi Arabia surged. Major exports like copper, nuts, wine, gold, and spirits exports increased in 2016, while ferro-alloys, pharmaceuticals, fertilizers and car exports decreased. Imports also started picking up from May 2016 but mainly on the back of capital goods imports; however, rising world commodity prices, increased private demand and anticipated tax hikes on cigarettes and oil products also drove growth in consumption goods imports through October-December 2016. In annual terms, imports were flat, down just 0.1% y/y to US$ 7.3bn.

Figure 8: Exports

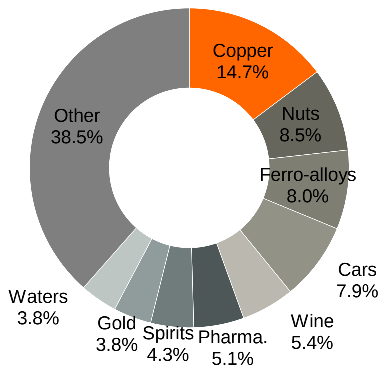


Source: GeoStat

Figure 9: Imports and contributions to import growth

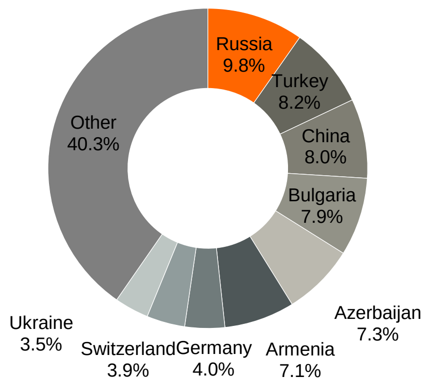
Source: GeoStat

Figure 10: Exports by product, 2016



Source: GeoStat

Figure 11: Exports by country, 2016

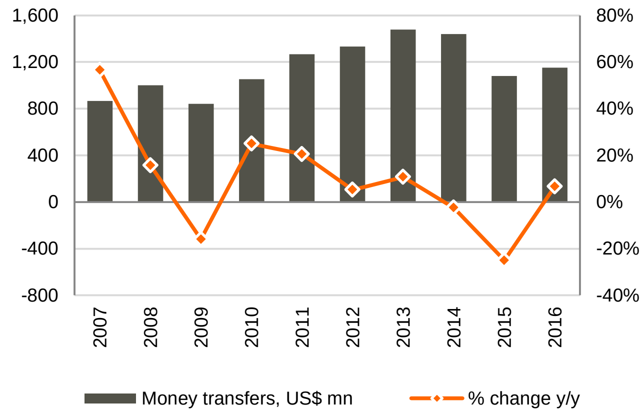


Source: GeoStat

Migrant remittances up since June 2016, supporting private demand. Remittances to Georgia were hampered since end-2014 by unfavorable regional and global developments. Money transfers fell significantly with Russian remittances down to 39.8% of the total in 2015 from almost 50% in 2014, and Greek contributions also down due to the banking crisis in summer 2015. This negative trend in money transfers continued until mid-2016. However, remittances have been increasing since June 2016, bringing the full-year 2016 figure to US$ 1.2bn (8.0% of GDP), up 6.6% y/y. Money transfers increased significantly from major remitting countries like the US (+27.6% y/y), Greece (+5.8% y/y), Italy (+11.2% y/y), Turkey (+26.3% y/y), Israel (+84.7% y/y), Spain (+15.3% y/y) and Germany (+12.0% y/y), which jointly accounted for 50.6% of the total, more than compensating for the lower amount from Russia (-

8.8% y/y, 34.3% of total). Remittances from Russia have, however, recovered since November 2016 due to the RUB appreciating against the US$ in 4Q16.

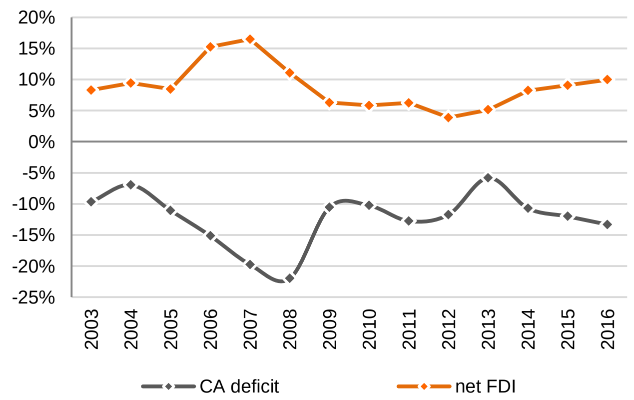
Figure 12: Money transfers



Source: NBG

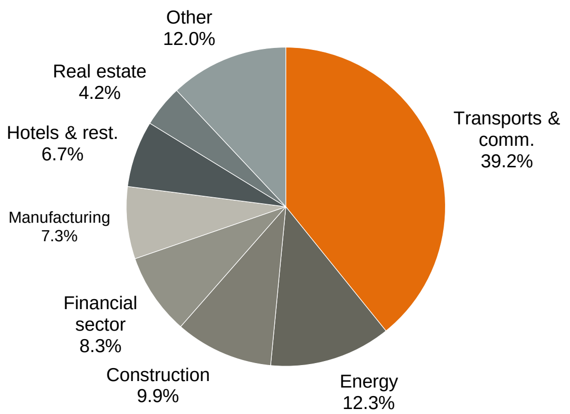
FDI remained a key source of external financing in 2016 with net FDI compensating for 74.9% of CA deficit. Georgia's current account deficit widened to 13.3% of GDP from 12.0% in 2015. Deterioration mainly reflected the negative income account (reinvested profits and dividend payments to foreign investors) widening to 5.8% of GDP in 2016 from 2.3% in 2015. Notably, the negative balance in the goods trade, traditionally the major cause of the CA deficit, fell 3.5% y/y to US$ 3.8bn (26.5% of GDP) as exports and imports both fell annually (though both were up in 4Q16). The positive balance in services, fueled by tourism inflows, and net transfers were sufficient to compensate for 71.8% of the goods trade deficit compared to 65.5% in 2015. FDI, up 5.4% y/y to US$ 1.7bn (11.6% of GDP), was the key source of external financing; flows were directed mainly towards the transport, energy and construction sectors. Other investments also increased to 7.8% of GDP, bringing Georgia's gross international reserves up by US$ 245mn in 2016.

Figure 13: CA deficit and net FDI, as % of GDP



Source: NBG, GeoStat

Figure 14: Inward FDI by sector, 2016

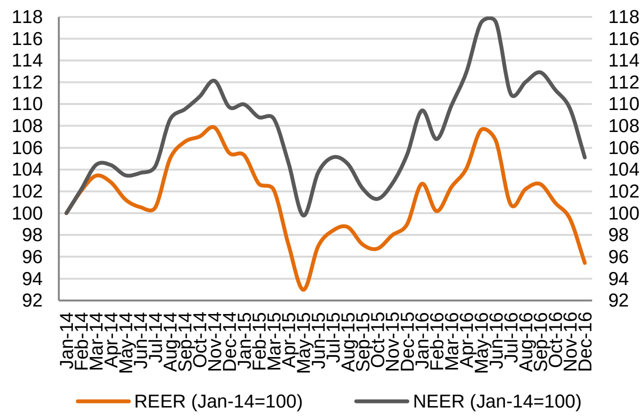


Source: GeoStat

Inflation has decelerated significantly since March 2016; annual inflation was 1.8%, far below the NBG's target of 5.0%. Weaker aggregate demand, low global oil and food prices, and last year's high base have caused overall price growth to decelerate since the end of spring 2016. Annual inflation fell by 1ppt per month in the four months from March to June, partly reflecting the trade weighted nominal appreciation of the GEL (+8.7% y/y). Inflation continued falling until November before increasing to 1.8% in December, reflecting the weakening GEL and firming world oil prices. The NBG reacted to the weak inflation and persistently low global commodity prices by gradually cutting its policy rate to 6.5% at end-2016 from 8.0% at the start of the year.

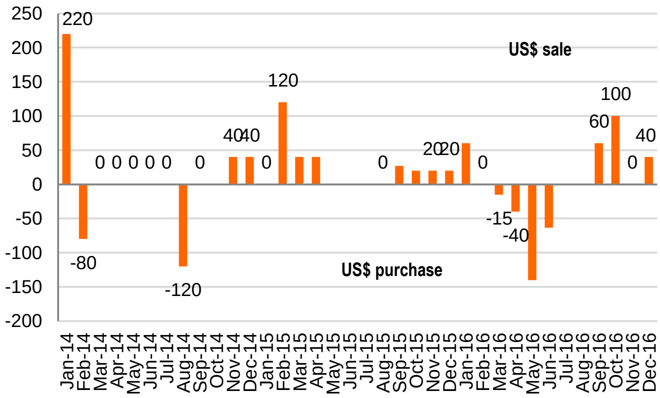
The GEL's 9.5% depreciation over 2016 was largely caused by global movements in US$. The GEL strengthened from end-March to mid-June 2016, while its major trading partners' currencies remained weak. This resulted in the nominal effective exchange rate strengthening by 17.7% y/y in May 2016 and the real effective exchange rate also gaining 15.8% y/y. The central bank intervened in the FX market to forestall any further appreciation, purchasing a total of US$ 258.4mn over March-June 2016, though we believe that more aggressive intervention was required. The GEL weakened from mid-June, and stabilized at around 2.34-2.35 per US$ in mid-August. Growing uncertainty in global and regional financial markets, a stronger US$ following the elections in the US, and domestic factors renewed pressure on the GEL in 4Q16. This, coupled with rising imports, resulted in the GEL falling 12.0% y/y against the US$ in 4Q16, and losing 9.5% over 2016 as a whole. The NBG sold a total of US$ 140mn from October 3 to December 20 to limit the radical fluctuations of the currency, bringing net interventions to almost zero in 2016. This policy allowed the GEL to weaken and follow the trend of emerging market currencies, supporting to competitiveness; The GEL's real effective exchange rate depreciated by 3.6% y/y in December 2016, mostly due to its increased competitiveness against the EU and Russia.

Figure 15: NEER/REER (January 2014 = 100)



Source: NBG
Note: Index growth means appreciation of GEL, decline means depreciation of GEL

Figure 16: NBG's net interventions, US$ mn

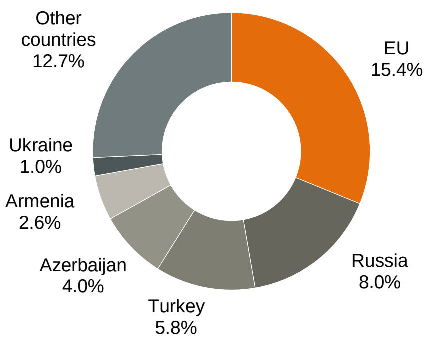


Source: NBG

Despite the GEL depreciation and high rates of dollarization, the banking sector was one of the fastest growing sectors in 2016. Conservative regulation, strict banking supervision and proactive management of dollarization have helped maintain banking sector stability. The average capital-adequacy ratio remained above 16%; the overall liquidity ratio was high at close to 40%; and ROE reached 22.1% in 2016. The 23.2% expansion in the retail loan book drove the credit portfolio growth, up by 18.9% in 2016. Despite a loan-dollarization rate of over 65%, the share of NPLs remained low at around 3.4%.

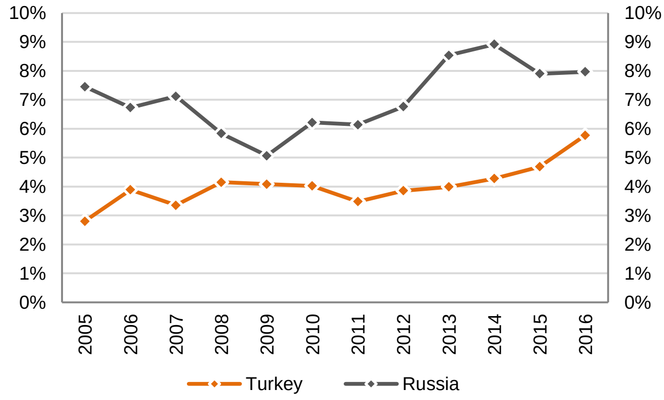
Georgia's well diversified exposure to partner countries minimizes potential negative impact from turbulence in any particular market. Georgia's exposure to its partner countries through exports, remittances, tourism revenues and FDI is quite diversified, with the EU accounting for one third of overall earnings. In recent years, economic ties with other countries (e.g. China as a source of exports earnings and FDI inflows, and Iran for tourism) have also intensified, benefiting the economy. Notably, Georgia's exposure to Russia remains close to the pre-embargo levels of 2005 (8.0% of GDP) with the tourism sector increasingly benefiting from Russian arrivals. Exposure to Turkey has remained stable, averaging at 4.0% of GDP over the past decade. The pick-up in exposure to Turkey in 2016 to 5.8% of GDP was predominantly caused by a 3.8x increase in foreign investment from Turkey. Measures under the EU-Georgia DCFTA and the government's four-pillar reform program are expected to further diversify the country's economic linkages, which will continue to minimize the potential negative impact on Georgia's economy from turbulence in any particular country.

Figure 17: Georgia's exposure to partner countries through exports, remittances, tourism and FDI, as % of GDP



Source: GeoStat, GNTA, NBG, G&T Research
Note: BP related FDI excluded from Azerbaijan and included in EU

Figure 18: Exposure to Russia and Turkey through exports, remittances, tourism and FDI, as % of GDP



Source: GeoStat, GNTA, NBG, G&T Research

Tax revenues were above planned figure, though fiscal deficit widened to 4.1% of GDP in 2016 from 3.7% in 2015. Tax collection rose by 9.7% to GEL 8.8bn (25.9% of GDP) in 2016, exceeding the initial budgeted figure by GEL 101mn. However, the 11.5% y/y growth in current expenditure related to increased social benefits widened the deficit to 4.1% of GDP in 2016, above the initial 3.0% target. Capital spending and net lending were mostly flat (0.7% y/y) and accounted for 95.1% of the budgeted figure. Underspending in capital expenditures resulted in an increase in government deposits by GEL 90.3mn in 2016 compared to the planned reduction of GEL 111mn.

Comprehensive reforms to boost growth and enhance economy's resilience to external headwinds

To revive growth in the face of regional headwinds, the government set out a four-pillar reform program in February 2016, which is currently being implemented. The program focuses on fostering structural changes in the Georgian economy to boost growth:

1. **Economic reform** is focused on further supporting the private sector in driving growth. In this regard, reform measures are directed to further improve Georgia's business environment and introduce significant tax incentives. Measures to further liberalize tax and customs procedures, amongst others, include the introduction of the Estonian model, where corporate income tax is only levied on distributed profits; undistributed profits, reinvested or retained, are exempt, starting January 1, 2017 (changes to tax code were adopted by parliament in May 2016). This measure is expected to generate additional private sector investment and to create new jobs in the medium term. According to USAID's assessment, corporate income tax reform will add 1.5% to growth within 18 months. The government also plans to continue and expand programs to support entrepreneurship, innovation, and business start-ups.

2. **Education reform** is proposed to ensure the development of human capital and its effective involvement in the country's development process. The government plans to introduce a dual system in professional education, which implies a work-based learning approach through public-private partnerships. Higher education will be based on the needs and demands of the economy; priority disciplines will be determined based on labor market analysis, and efforts will be directed to enhance the labor force's effectiveness and readiness for labor market demands.

3. **Infrastructure investments** are expected to improve the relationships between towns and villages, to promote high-quality sustainable tourism development, and to transform Georgia into a transport and logistics hub connecting Europe and Asia. The government intends to develop a special plan for the entire country as well as for municipalities, villages and coastal regions, including master plans for established tourist destinations and for places of untapped tourism potential. Under this infrastructure development component, the government plans to construct more than 800km of road infrastructure, with construction costs estimated at US$ 3.5bn, including completing construction of the east-west highway by 2020. Other infrastructure priorities include projects to improve the country's water supply, sanitation, and solid waste management. The government also plans to provide internet infrastructure for an additional 800,000 persons. With this measure, more than 90% of Georgia's population will have access to the internet. Infrastructure schemes are expected to enhance Georgia's importance in the region and its potential as transit and logistics hub.

4. **Governance reform** envisages improvement of the quality of public services and the efficiency of public institutions. To achieve these goals, the government plans to establish a "Business House", where businesses will receive services based on a single-window principle, similar to how ordinary citizens currently receive services at public service halls. The single-window principle is expected to save businesses' time and resources in interacting with governmental agencies. The government also plans to enhance existing online public services as well as introduce new distant services and optimize fees.

In addition, to enhance Georgia's external sustainability, the NBG introduced a 10-point de-dollarization action plan at end-November 2016, including reforms to expand the use of the GEL in the economy, to address the high dollarization in the banking sector, and to support domestic savings in the economy through capital-market development. The major tenets of the plan are as follows:

1. Increasing access to long-term local currency loans to enhance the monetary transmission mechanism and widen the list of eligible collateral for providing commercial banks with sufficient liquid assets to transform short-term deposits into long-term loans. In line with IMF recommendations, the NBG also plans to introduce the Basel III liquidity coverage ratios, with the national currency treated preferentially. A number of different measures will also be combined to develop Georgia's capital markets, including: a) issuing so-called highly liquid "benchmark" bonds with predictable emission calendars for the next five years; b) introducing a "primary dealers" institute, requiring banks to participate in the primary auctions of government securities to ensure the liquidity of the secondary market for all market participants; and c) implementing pension reform from 2018 to contribute to Georgia's economic growth by increasing demand for long-term instruments, as well as ensuring the creation of long-term local currency resources.

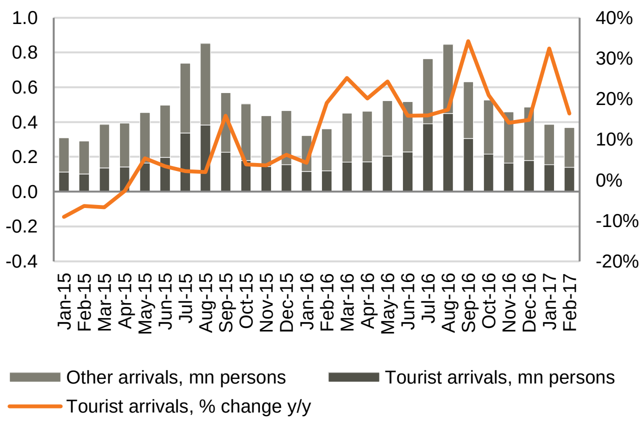
2. De-dollarizing existing US$-denominated loans alongside new de-dollarization measures. Under the central bank's new de-dollarization schemes, changes already adopted by parliament, inter alia, include issuance of retail loans of up to GEL 100,000 only in local currency, and ceiling on interest rates and charges (effective 100% pa) imposed for credit institutions.

3. Alongside mandatory quotation of real estate in GEL, authorities plan to promote the implementation of a safe service for real estate transactions – an "escrow" account service. This measure aims at avoiding the risks and reducing the costs of real estate transactions for both buyers and sellers. This service will be implemented in cooperation with Georgia's National Agency of Public Registry and will be optional for consumers.

Developments and outlook for 2017

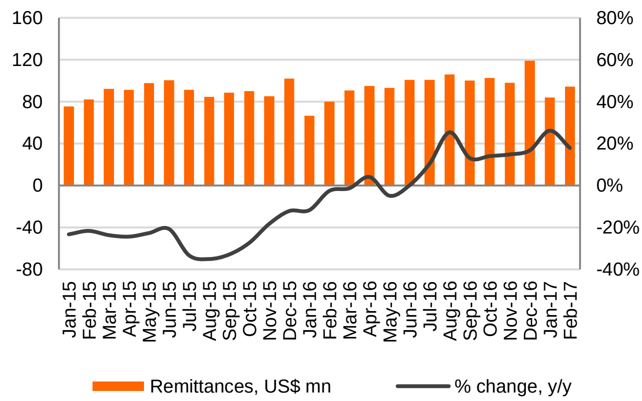
2017 started with significant improvements in external flows. This combined with Georgian citizens' recently granted ability to travel to the EU without a visa, is strengthening consumer and business confidence. The better external environment has driven significant increases in exports (+26.6% y/y), remittances (+21.6% y/y) and the tourism sector (arrivals up 24.3% y/y), bringing 2M17 real GDP growth to 4.8% y/y. Credit growth also gained traction increasing 12.1% y/y in 2M17 as compared to 4.6% y/y growth in 2M16 (excluding FX effect).

Figure 19: International arrivals



Source: GNTA

Figure 20: Money transfers



Source: NBG

New program with IMF is a vote of confidence in the authorities' monetary and fiscal policies. An IMF team visited Tbilisi from February 15 to March 1, 2017 to discuss a three-year economic program for the country totaling US$ 285mn, approved by IMF Executive Board on 12 April 2017. The program supports the government's comprehensive economic reform agenda and focuses on enhancing Georgia's fiscal sustainability, reducing external vulnerabilities, and strengthening its monetary and fiscal institutions. Over the program period, total external support is expected to reach US$ 750mn including budget support from EU, WB, ADB and AFD. On top of this, the program envisages attracting bilateral and multilateral support to finance infrastructure investments.

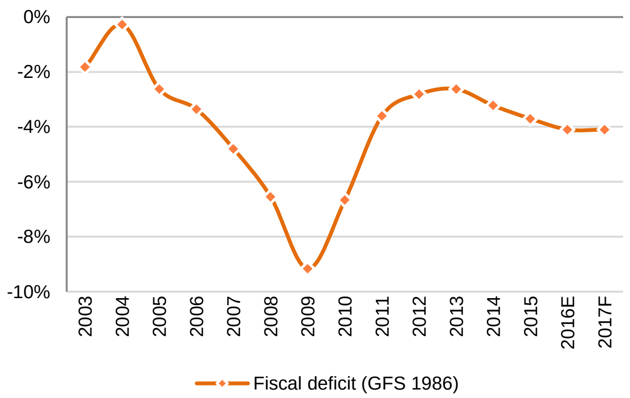
2017 budget (approved by parliament on December 14, 2016) reflects increased spending for measures outlined in four-pillar reform program. The 2017 budget framework is based on 4.0% GDP growth and 4.0% GDP deflator projections, sets the fiscal deficit at 4.1% of GDP and public debt at 44.2% of GDP.

To put the fiscal accounts on a sustainable path, the government introduced expenditure-consolidation as well as revenue-generation measures in the 2017 budget (without these measures, the government's reform initiatives under the four-pillar reform program would widen the fiscal deficit to 6.0% of GDP):

1) **Based on fiscal consolidation measures, current expenditure is set to increase by 3.1% y/y to GEL 9.1bn in 2017.** The 2017 current expenditure reflects: 1) the full-year effect of the increased old-age pension, introduced in July 2016 (from GEL 160 to GEL 180 per month); 2) the full-year effect of a GEL 200 monthly pension for inhabitants of the country's mountainous regions, introduced in September 2016; 3) a GEL 65mn one-off subsidy to fund the voluntary conversion of individuals' US$-denominated bank loans into GEL; 4) the 10% cut to administrative expenditures, generating GEL 100mn in savings; 5) the abolition or reduction of various budget programs, and 6) the dissolution or reorganization of a number of budgetary organizations. Meanwhile, capital spending and net lending are budgeted at GEL 2.9bn (+24.5% y/y) in 2017.

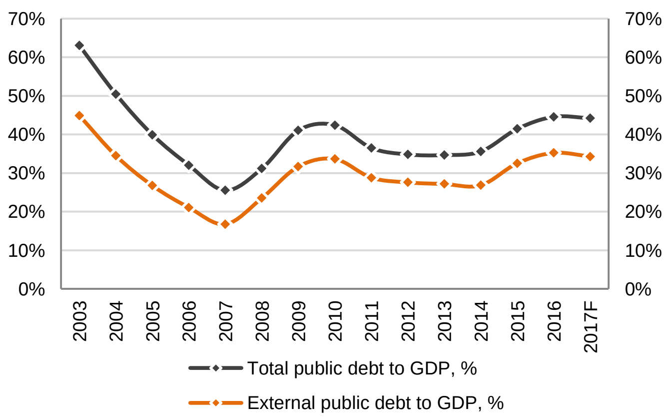
2) **To compensate for the shortfall due to profit tax reform, based on consultations with the IMF** and taking into account the limitations under the Economic Liberty Act, the government has increased excise taxes on tobacco, cars and fuels. Corporate income tax revenues in 2017 are estimated to be GEL 500-600mn lower compared to the 2016 budgeted figure due to the reform. As a result of excise tax hikes and certain other changes, total tax revenues in the consolidated budget are set at GEL 9.5bn (+8.6% y/y) for 2017, accounting for 26.5% of projected GDP.

Figure 21: Fiscal deficit as % of GDP



Source: MOF, GeoStat

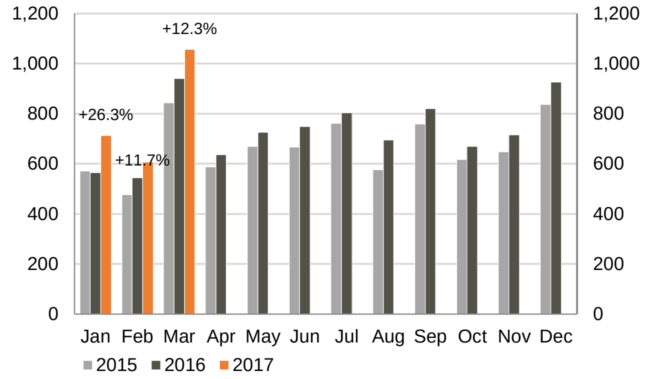
Figure 22: Public debt as % of GDP



Source: MOF, GeoStat

Government fiscal position is strong as growth fueled tax revenues in 1Q17. Tax revenues increased by 16.0% y/y in 1Q17 to GEL 2.4bn – 107.4% of the budgeted amount. Better-than-expected growth and increased imports in the wake of the GEL's depreciation and trade-related VAT collection appear to be the major reasons for this. Government deposits rose by GEL 320mn during the same period, strengthening the government's fiscal position to meet the obligations envisaged in the 2017 budget.

Figure 23: Tax revenues

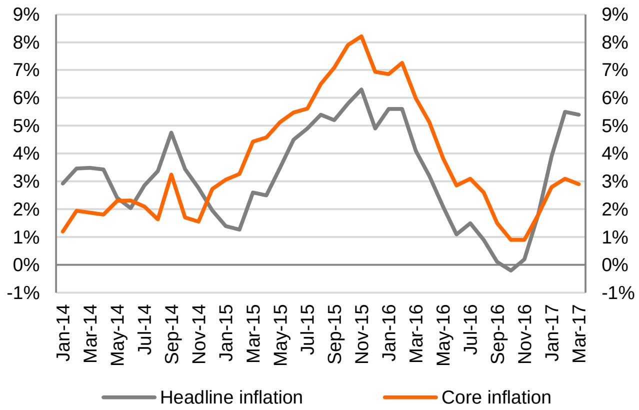


Source: MOF

Headline inflation expected to increase to 6.2% in 2017 driven by excise tax hikes; core inflation expected at 3.0%. Firming world commodity prices, the lagging effect of the weaker GEL, and excise tax hikes have put pressure on prices since January 2017. Annual inflation came in at 3.9% in January 2017, inched up to 5.5% in February, and remained flat in March at 5.4%. The NBG reacted to increased inflationary expectations by modestly increasing its policy rate from 6.5% at the beginning of 2017 to 6.75% currently, as core inflation remained stable at 3.0% in 1Q17. As overall price growth will be driven by one-off factors and inflated by last year's low base, the NBG will tolerate inflation above the target level of 4.0% in 2017 and announced a possible increase in the policy rate up to 7.0% by end-1H17. However, the GEL's appreciation may reduce price pressures, and we expect inflation to come in at 6.2% in 2017 and decline rapidly in 2018 toward 3.0% target once the effects of the excise tax increases fade.

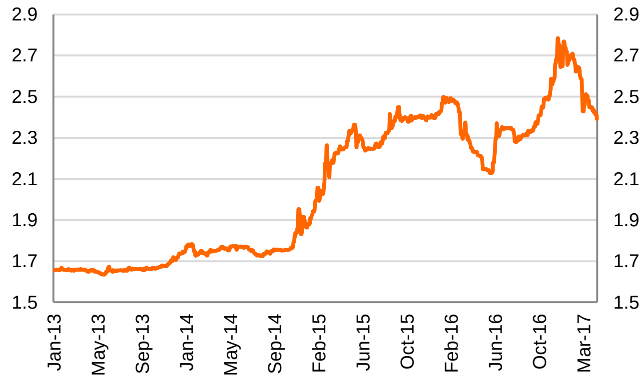
Robust external earnings and increased economic activity have supported stronger GEL since mid-February 2017. Global US$ strengthening and market overreaction resulted in the GEL weakening to a record low of 2.77 against the US$ on January 9, 2017. Supported by increased economic activity the GEL started strengthening since mid-February, and appreciated 9.5% against the US$ at 2.40 YTD. As other regional currencies also gained, the GEL's real effective exchange rate changed little. We expect the GEL to strengthen further to 2.30-2.35 against the US$ in the coming months. We believe that this will be healthy for the economy along with simultaneous appreciation of the currencies of Georgia's major trading partners and higher expected GDP growth in Georgia. Otherwise, the NBG is likely to be tempted to intervene to smooth any excessive appreciation in the GEL to maintain the economy's competitiveness. On 12 April 2017, NBG intervened in the FX market for the first time since the start of the year and bought US$ 10mn, followed by another purchase of US$ 9.8mn on April 18.

Figure 24: Inflation dynamics



Source: GeoStat

Figure 25: US$/GEL exchange rate



Source: NBG

Better external environment and implementation of government four-pillar reform program will feed growth in 2017. Despite uncertainties relating to the Turkish economic outlook, geopolitical tensions (Russia-Ukraine), and volatile global financial conditions, growth in the region is expected to recover in 2017. Growth in Russia is expected to have positive spillover effects for Georgia's trading partners. Along with this positive development, Georgia's accommodative business environment may attract capital from regional economies, as seen in 2015-16, as political and policy uncertainties take their toll on investments. The government's budgetary focus on infrastructure spending and easier corporate tax treatment are expected to boost investments this year and beyond. Visa-free travel to the EU, granted on March 28, 2017, is another major success for Georgian foreign policy following the signing of the Association Agreement and the related free-trade agreement (DCFTA) with the EU in 2014. These endorsements, in our view, will further improve business opportunities for small- and medium-sized entrepreneurs in Georgia through intensified direct contact, and will further strengthen investors' interest in the country.

We expect growth to accelerate to 4.3% in 2017 from 2.7% in 2016. A 15% increase in exports (after two years of contraction), a 13% increase in remittances, strong tourism inflows (projected at US$ 2.5bn, +13% y/y) and FDI of US$ 1.7bn are expected to markedly support economic activity in Georgia. Current account deficit projected to decline to 12.5% of GDP in 2017 from 13.3% in 2016. Meanwhile, investments, both public and private, are expected to remain the country's main engine of growth. We believe that continuation of the authorities' prudent monetary and fiscal policies, implementation of the government's four-pillar reform program, realization of benefits related to the EU DCFTA, and the eminent free-trade agreement with China will have a positive impact on Georgia's macroeconomic outlook and strengthen its positioning as a regional service hub economy, with GDP growth projected at 4.3% in 2017 and expected to average 5.5% annually from 2018-2020.

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