Georgian Economy
Turning the Corner

Georgia | Economy
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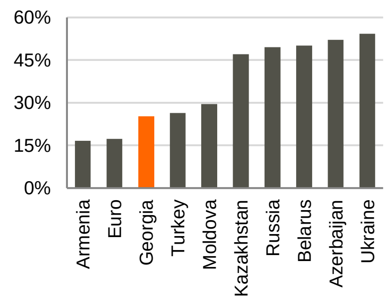
The effectiveness of Georgia's institutional setting and growth model has been demonstrated once again in 2015 - despite external pressures, macro stability has been maintained and the banking sector is on solid footing. The economy appears to have turned the corner since Feb-16, following a relative slowdown in the previous two months, which was a result of the latest regional and global turbulence. Tax revenues increased 14.1% y/y, after a slight dip in the previous month, while tourism arrivals delivered a stellar performance, increasing 23.9% y/y in Feb-16. New government initiatives to boost growth and the appointment of a new central bank governor reinvigorated business confidence. Improved sentiment translated into a stronger GEL, which has outperformed its major trading partner currencies in Mid-March, prompting NBG to intervene on the FX market and purchase US$. A pick-up in oil prices and the associated improvement in economic prospects for Georgia's major trading partners also contribute positively to the country's economic outlook. With external downside risks lessened along with sound domestic fundamentals, we see potential for up to 5.0% growth in 2016.

The Georgian economy seems turning the corner in February 2016. Output expanded 2.8% y/y in 2015, with all sectors in the green except manufacturing (-4.9% y/y), which was negatively affected by reduced production of beverages and tobacco due to an excise tax increase and a marginal drop in trade (-0.3% y/y). Investments remained the main engine of growth, with FDI hitting US$ 1.4bn (9.7% of GDP). Construction posted strong double-digit growth (+15.2% y/y), thanks to the new gas pipeline construction by BP and a pick-up in public infrastructure spending. The growth trend slowed in Dec-15 and Jan-16 on the back of various global and regional headwinds, after 5.3% y/y growth in Nov-15. However, sound fundamentals kept the economy on track to return to normal growth. In February, tax revenues were up 14.1% y/y and tourism arrivals posted spectacular growth (+23.9% y/y).

Price pressures are manageable. Annual consumer inflation was recorded at 5.6% in Feb-16, unchanged from the previous month and slightly above the central bank's target of 5.0%. Drivers of price growth remain unchanged since Apr-15: depreciation-related pass-through effect, one-off increase in the electricity tariff in Aug-15, and excise tax increases on tobacco and alcoholic beverages. With a decrease in inflation expectations, NBG kept its policy rate unchanged at 8.0% at the two monetary committee meetings this year. Low world commodity prices on oil and food, weaker demand, and tighter monetary policy have kept price pressures manageable. We see inflation decelerating to below the NBG target starting Apr-16, as transitory factors dissipate.

GEL recovers some ground, while the newly elected NBG governor feeds trust in the continuation of prudent monetary policy-making. Decline in exports and remittances was more than compensated by a drop in total imports, which fell on the back of reduced consumer goods imports, leading the external adjustment in 2015. The trend has persisted in 2M16, as imports declined further due to a high base effect, while exports and remittances appear to have bottomed out in February. Despite the adjustment, global and regional factors fed into GEL weakness in early 2016. The trend has reversed since March, with the GEL appreciating by 7% against the US$ in the first 3 weeks of March. With oil prices recovering some ground and the FED funds rate unchanged, Georgia's major trading partner currencies have also strengthened, but to a lesser degree than GEL/US$. To forestall a radical appreciation of the GEL, compounded by anticipated deposit de-dollarization, the central bank intervened on the FX market twice in March, with a total purchase of US$ 15mn

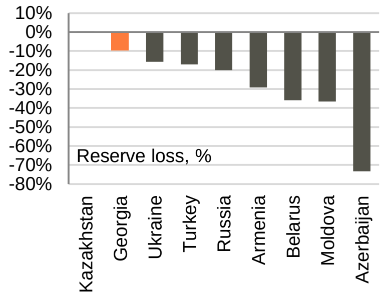
Figure 1: Currency weakening vs US$



Source: Bloomberg

Note: US$ per unit of national currency, 1 Aug 2014 - 15 Mar 2016

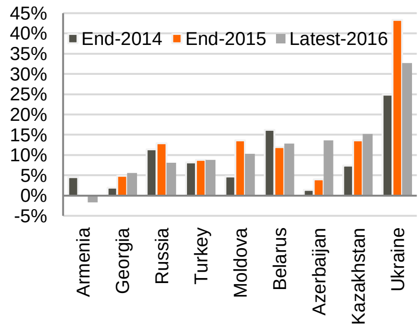
Figure 2: National Bank reserves (% change)



Source: IMF

Note: From Aug-2014 to Jan-2016, (Kazakhstan as of Dec-2015); Armenia's reserves exclude a US$ 500mn Eurobond issued in March 2015

Figure 3: Annual inflation



Source: National statistics offices

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(the first interventions on the purchasing side since August 2014). To preserve the competitiveness of Georgian exports, given the modest inflation and declining M2, NBG may opt to fill reserves by purchasing FX in the amount of US$ 200-250mn. We expect GEL/US$ to remain in the 2.2-2.3 range in the medium term. The appointment of a new NBG governor, a long-time IMF economist with no political affiliation, instills confidence in continued prudent monetary policy-making, though election-related political pressure could result in GEL strengthening further to 2.0 vs US$, in our view.

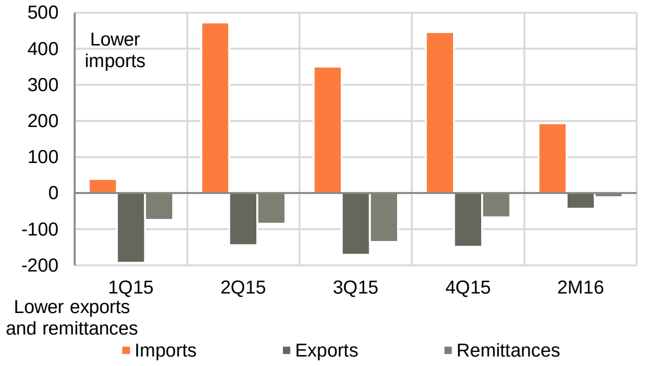
Boosting growth and maintaining fiscal discipline remain the top priorities. The government put forth a four-pillar reform program, extensively communicated with private sector players, aimed at boosting growth in the face of regional headwinds. Measures to further liberalize tax and customs procedures, amongst others, include the introduction of the Estonian model, which envisages the application of corporate income tax to only distributed profits; undistributed profits, reinvested or retained, will be exempt starting January 1, 2017. We estimate that this measure will generate approximately GEL 1.5bn in additional private sector investments, inclusive of bank credit, in the medium term. Other reform measures include creating a single window principle for the provision of government services to legal persons, speeding up the implementation of strategic infrastructure projects, and tailoring the education system offerings to labor market demands. Apart from targeting growth, the government remains prudent in managing public finances. Since 2016, certain items of personal income tax revenues (GEL 300mn in 2016) are redirected from the central government budget to local governments. In order to ensure efficient spending of these funds, the government has initiated changes, currently being discussed in parliament, which would require local governments to use these revenues for infrastructure projects only (the new norm to remain in force through 2021).

The banking sector remains on solid footing. Amidst multiple downgrades across the region, the Georgian banking sector has remained profitable and maintained credit ratings with a stable outlook. ROE reached 17.6% in 4Q15, up 0.1ppts y/y. NPLs remain in comfortable territory, at 2.7% at end-2015 and 3.3% in Feb-16 (up 0.1ppts y/y). Low credit growth in 2015 led to ample liquidity, despite a spike in deposit dollarization. With sound fundamentals and the recent pick-up in consumer and business confidence, there is a possibility for healthy growth in bank credit, in our view.

Sound fundamentals, prudent policy-making, and new opportunities could feed a material upturn in growth in 2016. Tourist arrivals are expected to increase significantly, as Georgia is the most viable alternative for tourists (mostly Russians) who used to travel to countries like Egypt, Turkey, and other destinations in this region. In addition to safety, Georgia offers cheap leisure services - an important factor given the regional economic situation. We believe that these factors will attract an increasing number of tourists from Russia, Azerbaijan, Armenia, Turkey, Ukraine, etc. Additionally, the easing of visa requirements for Iranians and the removal of sanctions on Iran will likely result in a significant influx of tourists from Iran (visa regulations were lifted on February 15, 2016, followed by an immediate 80% y/y growth in Iranian arrivals in Feb-16). With tourism revenues reaching circa 13.0% of GDP in 2015, an increase in international arrivals will contribute significantly to Georgia's growth in 2016. Additionally, Georgia is benefitting from an uptick in goods transit from Ukraine and Turkey to Central Asia and beyond, given the restrictions imposed on these countries by Russia.

The government also plans to increase public infrastructure spending and is actively pursuing pro-business measures, dramatically strengthening business expectations. Expected off-budget spending related to Parliamentary elections (Oct-16) constitutes another positive factor for growth. With sustained macro stability, planned fiscal stimulus, stable monetary policy, anticipated surge in tourism, strong private investor interest in Georgia, higher business confidence, and the bottoming out of partner countries' economies, we expect a considerable pick-up in economic activity, which could result in up to 5.0% growth in Georgia in 2016.

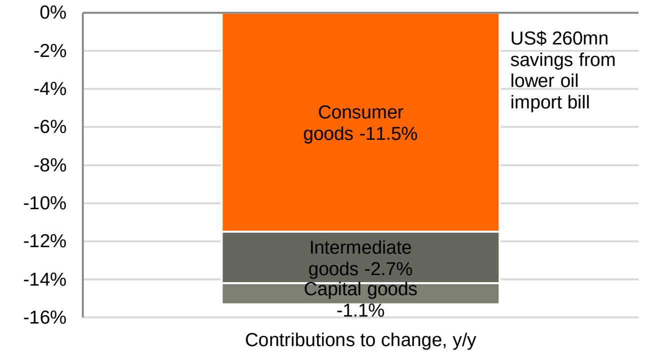
Figure 4: Exports, imports, remittances, US$ mn change y/y



Source: GeoStat, NBG

Note: Imports excluding one-offs

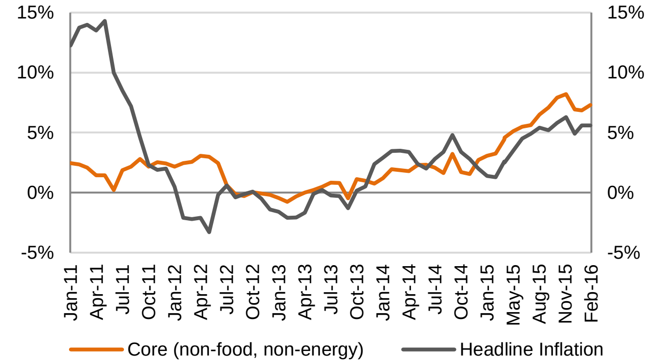
Figure 5: Contributions to imports decline in 2015



Source: GeoStat

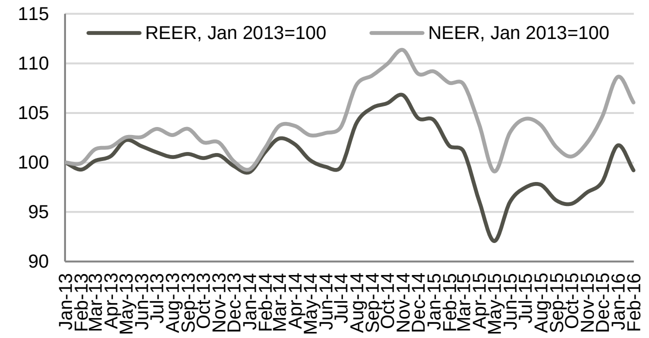
Note: Imports excluding one-offs

Figure 6: Annual CPI inflation



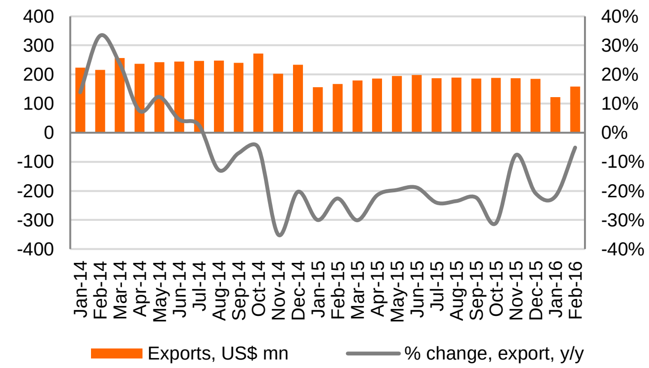
Source: GeoStat

Figure 7: NEER/REER (January 2013 = 100)



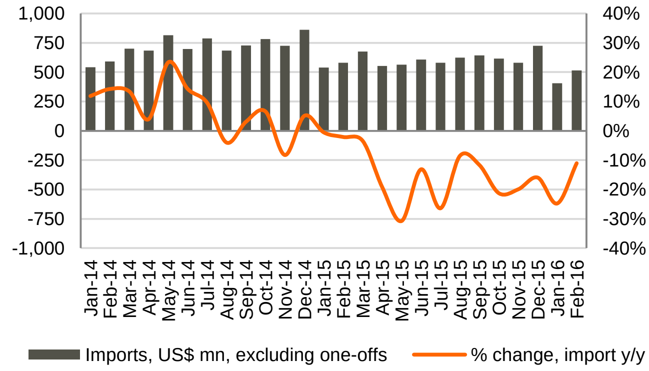
Source: NBG

Figure 8: Exports



Source: GeoStat

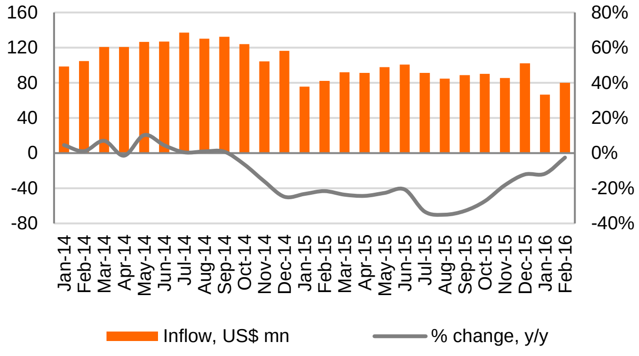
Figure 9: Imports



Source: GeoStat

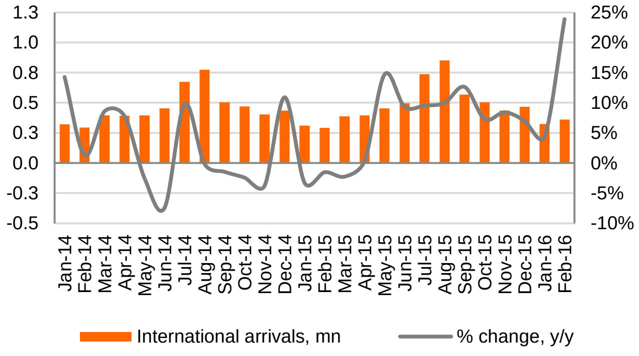
Note: Imports excluding one-offs

Figure 10: Money transfers



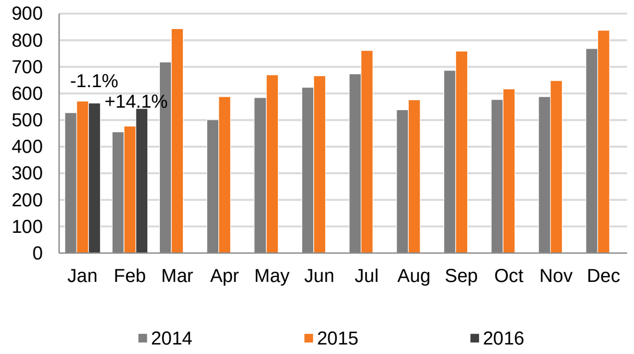
Source: NBG

Figure 11: International arrivals



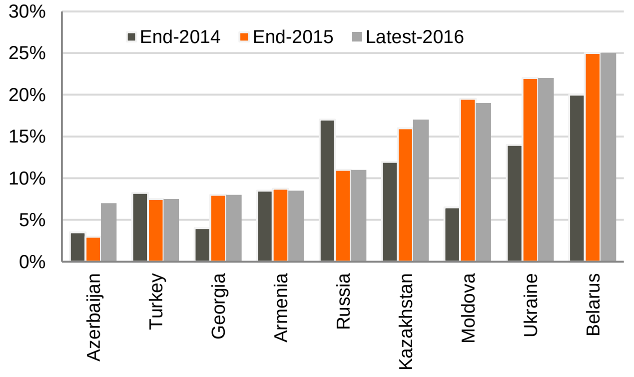
Source: GNTA

Figure 12: Tax revenues, GEL mn



Source: Treasury Service

Figure 13: Monetary policy rates



Source: Central banks

Note: Latest data as of 16 March 2016

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