Georgia | Economy
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Georgian Economy
Strong Balance Sheet

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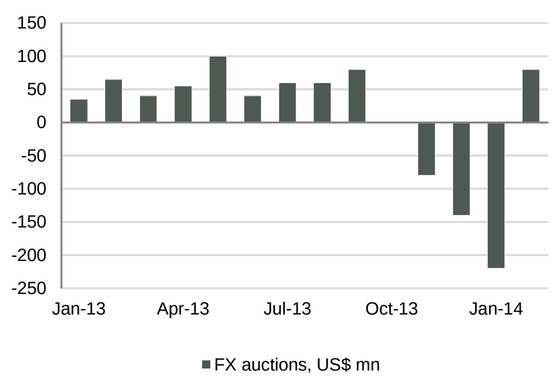
Recent months have seen turbulence in Emerging Markets (EMs) resulting in a depreciation of EM currencies and a deterioration of economic outlook. Georgia experienced currency depreciation as well. But our analysis shows that contrary to EMs, the problems in Georgia were mainly driven by domestic factors, and timely interventions by the National Bank of Georgia succeeded in smoothing the lari's fall. As the year-end domestic problems expired, lari regained some of its value and the NBG started to buy foreign exchange through currency auctions. Going forward, the weaknesses in neighboring Turkey, Russia and Ukraine will weigh in 2014, while real appreciation of Euro will benefit Georgian exporters to Europe. Domestic risks consist of a widening fiscal deficit, which will likely be financed through local currency borrowings pushing banks' financing costs upwards. On the positive side, undeveloped capital market along with a strong sovereign balance sheet will minimize (or entirely negate) possible negative impacts of the Fed's taper. Moreover, a slight depreciation of the real lari exchange rate vs. euro and expected EU free trade agreement will support the current upward trend of export to Europe. Finally, a cheaper lari will help the tourism industry as well by attracting European visitors.

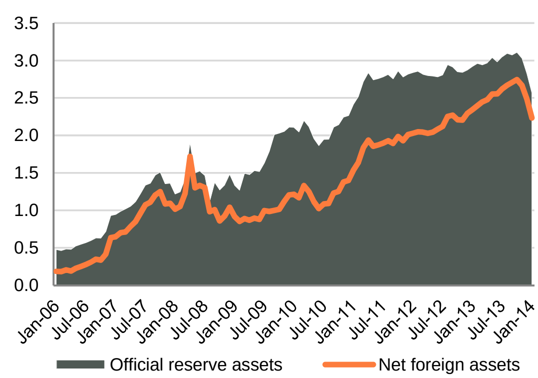
Despite recent turbulence, Georgia's net international reserves increased 8% in 2013 to US$ 2.5bn. In 2013, the national bank conducted 41 currency auctions, buying US$ 575mn and selling US$ 240mn, netting at positive US$ 335mn. From November 2013 through to December 2013 the NBG has been selling US$ into the market. As a result, net reserves declined from a peak of US$ 2.75bn in October to US$ 2.5bn in December 2013. Currency sales were necessary to halt and/or smooth a depreciation of the GEL. The market intervention seems to have been successful, especially when compared with the effect of currency auctions in EM peers like Russia and Turkey, whose currencies have lost far more value.

Figure 1: NBG interventions, net buying (selling) of US$, mn



Source: NBG

Figure 2: NBG gross and net international reserves, US$ bn



Source: NBG

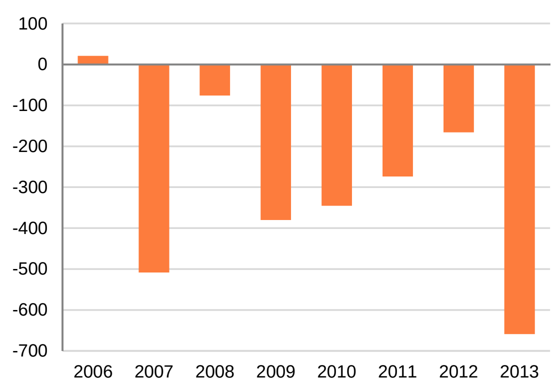
Following temporary depreciation pressures, the lari has appreciated since early February. From October 21, when it began to slide, until the end of 2013, the lari lost 4.4% against the US$, and another 2.7% from December 31 to February 1 when it peaked at GEL 1.7824/US$. Since then, it gained 2.5% to GEL 1.7387/US$ on February 24. This reversal allowed the NBG to re-reverse its auctions and buy FX. Following the sale of US$ 220mn in January, the NBG held four purchase auctions in February and bought US$ 80mn. Still, the GEL continued to strengthen vs US$, which suggests the factors behind the depreciation pressures had already expired. Along with the purchase auctions, the NBG also increased its refinancing rate 25bps to 4% in reaction to positive economic developments. Recovering economic activity and the rate hike will strengthen the local currency but this could be balanced by US$ purchases by the NBG. We believe these pressures largely balance to keep the exchange rate broadly stable at the current level. Although it is higher than the recent historical average, we believe it will be beneficial for the economy, particularly for exports and tourism.

A budget deficit in recent months and a pick-up in imports are the likely reasons for the temporary lari devaluation. The 9M13 budget surplus of GEL 358mn (US$ 215mn)[1] turned to deficit in 4Q13. While the 4Q is traditionally a deficit quarter, the size of the shortfall in 2013 was the largest ever at GEL 659mn (US$ 387mn). The government may have financed a part of the deficit by accessing its deposits at the NBG, thereby increasing the money supply. The government's deposits at the NBG fell to GEL 488mn (US$ 281mn) in November and increased slightly to GEL 566mn (US$ 326mn) in December, the lowest levels since late 2009. We think the government's conservative fiscal policy of the first nine months of 2013 and the NBG's FX purchases, followed by a sudden fiscal expansion in 4Q13 led to a sudden shortage of US$. This drove the GEL/US$ weakness, which forced the NBG to reverse its FX buying policy.

Widening deficit could force the government to resort to local currency borrowings. The possibility of deficit financing via local currency markets is a good option for public finances, especially while the US Fed's tapering policy saps US$ liquidity from global markets. However, in Georgia's undeveloped and shallow market, additional state borrowing will drive borrowing costs higher for local banks.

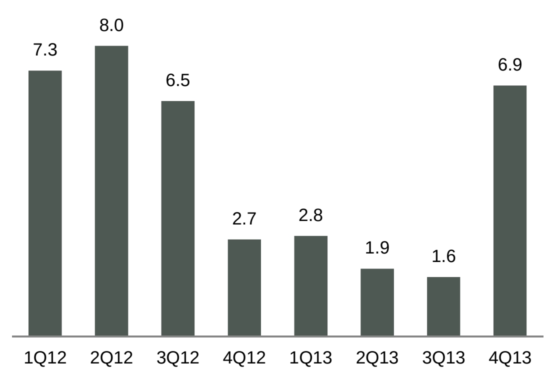
Rebounding economic growth in 4Q13 pushed up imports, boosting demand for FX. Following weak growth at below 2% in the 2Q and 3Q, GDP growth surged to 7% in the 4Q. Naturally, the growth pushed up demand for imports which surged 22% and 21% in November and December after a 4% decline in 10M13.

Figure 3: Budget balance, 4Q, GEL mn



Source: MoF

Figure 4: GDP growth rate, y/y, %



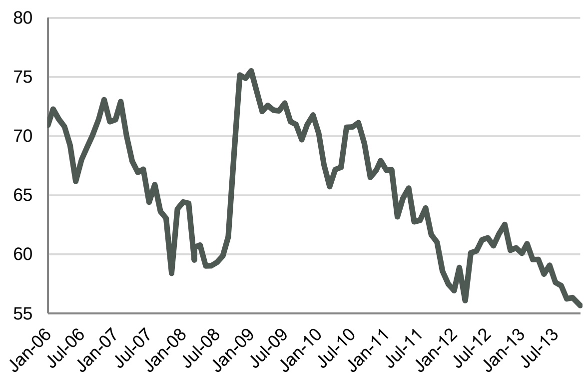
Source: NBG

In contrast to EMs with developed capital markets, the US Fed's taper decision has no direct channel of transmission into the Georgian economy. The Fed's decision to taper drove a substantial outflow of capital from Turkey and Russia that put pressure on their currencies. However, Georgia's low level of capital market development means that the only channel of transmission might be through bank deposits. However, currency deposit data indicate that the de-dollarization of the Georgian economy continued well into December 2013, reaching a peak since December 1997. There are signs that this trend may have reversed slightly in January (according to a survey by the NBG, the ratio of FX deposits to M2

[1] All currency conversions made using NBG spot exchange rates.

increased from 45% in December 2013 to 48% in January 2014. This was still lower than in January 2013). If true, we believe it will be temporary.[2]

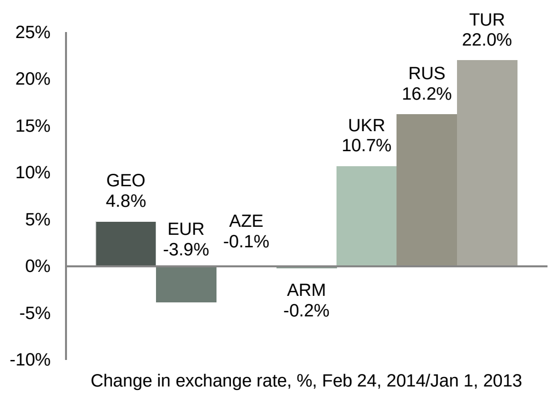
Figure 5: Dollarization ratio, %



Source: NBG

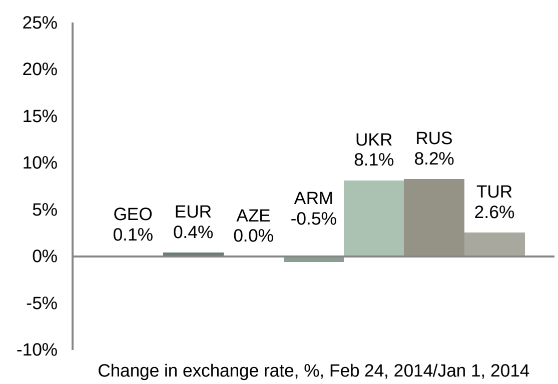
Among Georgia's main export partners, the GEL only appreciated against the Russian and Turkish currencies, which account for 13% of its total exports. Most likely, this trend will negatively affect Georgian exports to Turkey and Russia. Over the long-run, though, it will benefit imports, given that these economies account for 25% of total imports.

Figure 6: USD/local currency fluctuations, Jan 1, 2013 to Feb. 23, 2014



Source: Yahoo Finance, NBG, CBAR

Figure 7: USD/local currency fluctuations, Jan 1 to Feb 23 2014



Source: Yahoo Finance, NBG, CBAR

[2] January data not yet released

Box 1. Georgia: Strengths and advantages

Georgia's exposure to the vulnerable trio

Turkey, Russia, and Ukraine ("risky" economies) experienced financial market vulnerabilities towards the end of 2013. Massive capital outflows resulted in currency depreciations and worsening economic outlooks. Despite geographic proximity, a detailed analysis of transmission channels suggests that deteriorations in these countries will have limited impact on Georgia. The most direct transmission channels are exports and foreign direct investment. As the table below shows, these three countries accounted for 20% of Georgian exports and 11% of FDI. In export markets Georgia is much more dependent on Azerbaijan, Armenia and the EU, whose macroeconomic outlook is broadly stable. Moreover, the lari depreciated recently against the currencies of these economies, which, will further support Georgian exports to these markets, in our view.

In terms of FDI, EU-originated investments account for close to half of the total. We believe EU FDI will continue to grow as Georgia prepares to sign an Association Agreement with the EU that includes provisions to establish Deep and Comprehensive Free Trade Areas (DCFTAs) in 2014. This will more than offset any potential fall in investment from Turkey, Ukraine, and Russia. We should keep in mind, however, that an association agreement with the EU may actually increase FDI from "risky" economies as they would like to benefit from easier exports to European markets. While Turkey has similar arrangements with the EU, Turkish investors will be attracted by cheaper labor costs in Georgia. Ukrainian and Russian investors, on the other hand, will be attracted given that their countries do not have similar arrangements.

Georgia's highest exposure to these countries is via its tourism sector. 30% of international arrivals to Georgia in 2013 were from Turkey. Turks benefit from a shared land border, passport-less entry, the availability of one-day tours, and many more factors. Turkey disappointed last year, partly as a result of the weaker lira and political uncertainty. In 2014, the stats for arrivals from Turkey will be driven by the low base of 2013, and will depend on the strength of Turkish lira and Turkey's domestic growth. Overall, Turkish holidaymakers still make up the largest proportion of tourist arrivals in Georgia, followed by Armenians (24% in 2013), Azerbaijanis (20%) and Russians (14%).

Imports are another channel of transmission. Turkey, Russia, and Ukraine account for 32% of total imports. Depreciations in these countries will make their products cheaper and boost demand, which will lead to higher demand for FX, creating pressures on lari. On the positive side, cheaper imports would bring cheaper inputs for Georgian producers and cheaper goods for consumers. However, there is a need for a detailed analysis of the data to see whether imports will compete with local producers. In that case cheaper imports may drive down profit margins for Georgian firms. Overall, however, imports from these countries account for a relatively small share of the pie. Therefore, we believe the impact of currency depreciations will remain manageable, possibly with some benefits to Georgia in 2014.

Table 1: Georgia's exposure to selected economies, 2013

	Imports, US$ mn	Exports, US$ mn	FDI, US$ mn (2012)	Arrivals (thousand)
Turkey	1,346	183	81	1,597
Russia	589	190	20	767
Ukraine	602	193	-1	127
Azerbaijan	638	710	59	1,076
Armenia	182	316	6	1,292
Other CIS	154	212	3	30
EU	2,271	608	440	209
Other	2,092	497	303	294
Total	**7,874**	**2,909**	**912**	**5,392**
Risky	*2,538*	*566*	*100*	*2,492*
Safe	*5,337*	*2,343*	*811*	*2,901*
Exposure	***32.2%***	***19.5%***	***11.0%***	***46.2%***

Source: GeoSTAT, NBG, GNTA

What sets Georgia apart, among others?

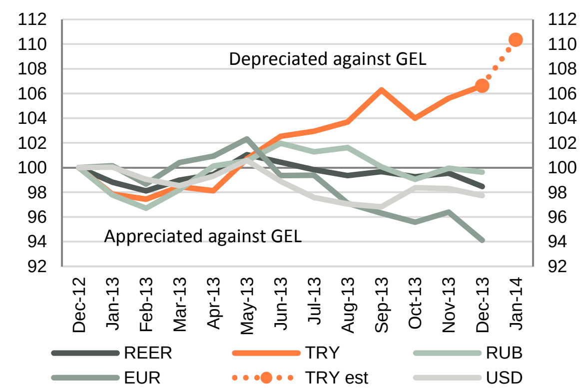
Georgia reaps the benefits of the underdevelopment of its capital markets. Following the dot-com crisis, global economies expanded rapidly on the back of ample liquidity in global markets. EMs benefitted via unprecedented inflows of FDI, portfolio, and other investments (loans from abroad). EMs with developed capital markets amassed substantial amounts of hot money that drove short-term growth and drove currency appreciation. This abundance was a result of extremely accommodative policy by major global central banks that was further fed by quantitative easing in the US. However, as the US economy started to show signs of recovery, the Fed decided to unwind its QE. As a result, EMs began experiencing an outflow of capital, leading to depreciations and worsening economic outlooks. Fortunately – in this case – Georgia lacks a sufficient level of capital market development that could have been a magnet for the hot money of years past. Instead, Georgia has benefited from the liquidity abundance through the FDI channel. FDI inflows to Georgia increased from US$ 131,000 in 2000 to US$1.8bn in 2007, and it financed 87% of the total current account deficit. FDI slowed in the following years but remained the major source of external financing as opposed to hot money. In 2012 it financed 49% of Georgia's external deficit compared to 18% in Turkey. As a result, Georgia is not vulnerable to sudden capital flight as other emerging economies.

Real exchange rates in the region were affected as well. As the chart below shows, falling exchange rates resulted in a real appreciation of the lari against the Turkish lira, making exports from Georgia to Turkey more expensive. Calculations based on January inflation figures indicate that the real GEL/TRY exchange rate increased another 3% m/m in January. As mentioned above, though, Turkey accounts for only 6% of total exports.

The lari's real exchange rate against the euro has depreciated. In the medium to long term this will benefit Georgian exporters to EU and will make Georgia price-competitive for European visitors. Moreover, the upcoming EU Association Agreement will further support Georgian trade with the EU.

There are strong indications of a coming lari stabilization. Recovering growth, which will make Georgia an attractive place for international investors, targeted NBG interventions, which balance the amount of lari in circulation, and recovering exports and stronger tourism in the spring will support the lari further. Moreover, January and February are the slowest tourist months, accounting for only 10% of total annual international arrivals. Generally, tourist arrivals grow from March, and the peak season from April to October accounts for 61% of all foreign arrivals.

Figure 8: Real exchange rate, Dec 2012=100



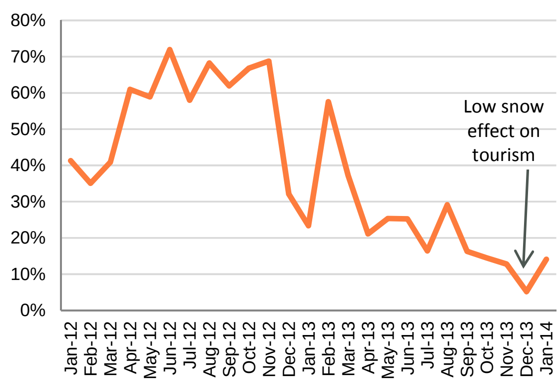
Source: NBG, BoG Research Note: REER: Real Effective Exchange Rate

Figure 9: Georgia's trade with Ukraine and Turkey

Source: Geostat

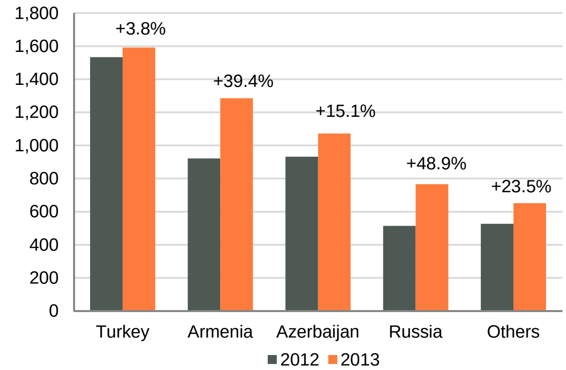
The number of international visitors continued to increase y/y, albeit at a slower rate than in 2012. Growth from April to December 2013 slowed to 18% y/y from 61% in the same period in 2012. The slowdown was even more pronounced in the last four months of the year, with y/y growth dropping to 13% and 5% in November and December, respectively, partly due to low snowfall in December. Annual growth in international visitors came in at 21% in 2013 vs. 57% in 2012. However, boosted by the visitors from Russia, Armenia and Azerbaijan, international arrival in January 2014 increased by 14% y/y, above 5% recorded in December 2013.

Figure 10: Monthly y/y change in international visitors



Source: GNTA

Figure 11: Number of international visitors by country, '000



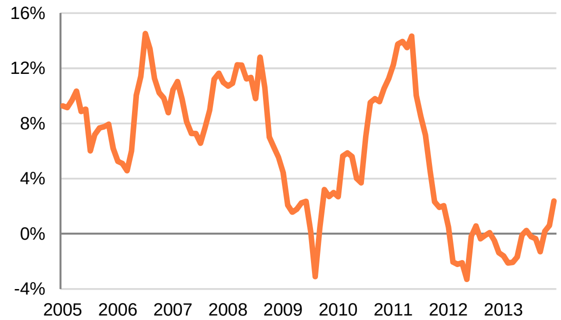
Source: GNTA

A notable development was weak growth in Turkish visitors. Arrivals from Turkey increased just 4% vs. 108% in 2012, and this affected the overall growth rate. Turkey's share of total arrivals fell 5ppts y/y to 30% in 2013. Excluding Turkish visitors, the number of tourists increased 30% in 2013. In 2014, two main factors will drive international arrivals from Turkey: the low base of 2013, following only 4% growth rate, provides a good starting point for a rebound. On the other hand, the depreciating Turkish currency and weaker domestic growth will reduce the number of Turkish tourists travelling abroad. Snow (or rather the absence of it) was another factor that caused a fall in visitor numbers over the winter months. The inadequate winter 2013/2014 snowfall resulted in cancelations at many hotels. Overall, Turks still make up the largest proportion of tourist arrivals in Georgia, followed by Armenians, Azeris, and Russians.

Inflation

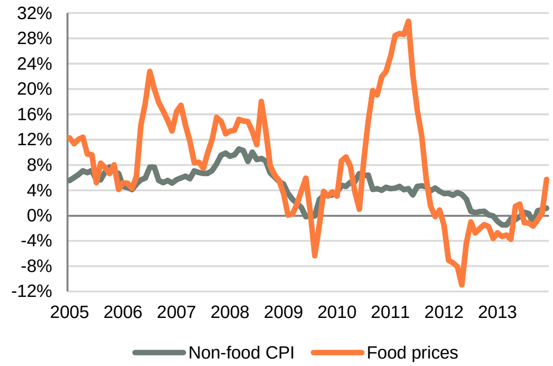
The recent pick up in y/y monthly inflation will probably have a limited impact on annual 2014 inflation. Georgia is experiencing deflation for the second year in a row. Despite the recent pick up in y/y monthly inflation, annual average inflation CPI remained below zero, mainly on the back of a drop in food prices (down 0.7%). Food prices (and to a lesser extent alcohol, tobacco and utilities prices) rebounded in December, rising 5.7% y/y, but this was not enough to push annual average food price inflation above zero. Contrary to the annual average, CPI rose 2.4% y/y in December 2013 vs. 0.6% in November. Non-food CPI, which is generally far less volatile, remained subdued, with prices posting modest increases of 0.8%, 0.9% and 1.2% y/y in October, November, and December, respectively.

Figure 12: Change in consumer prices, % y/y



Source: GeoSTAT

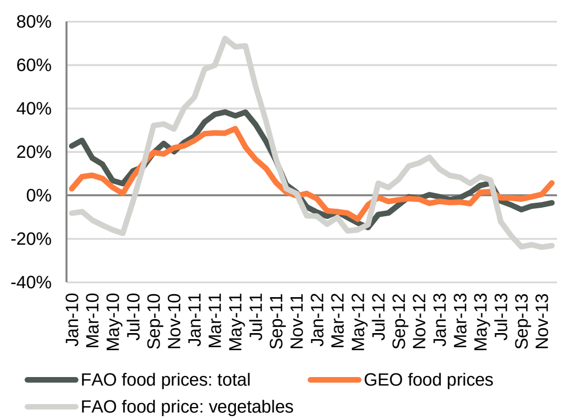
Figure 13: Change in food and non-food prices, % y/y



Source: GeoSTAT

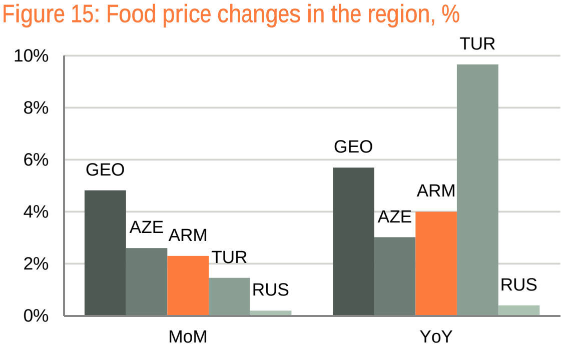
The recent pick-up in inflation was probably driven by substantial increase in prices of some vegetables which we believe is temporary. Global food prices declined 3.4% y/y in December and increased slightly (0.2%) compared to November, whereas food prices rose 4.8% m/m in Georgia. In comparison to neighboring countries, Georgia experienced the largest hike in food prices in December on a m/m basis. In y/y terms, prices increased the most in Turkey. This supports the view that the spike in food prices was related to domestic developments rather than international or regional issues.

Figure 14: Change in food prices, % y/y



Source: GeoSTAT, FAO

Figure 15: Food price changes in the region, %



Source: GeoSTAT, AzSTAT, TUIK, RusSTAT, Arm STAT

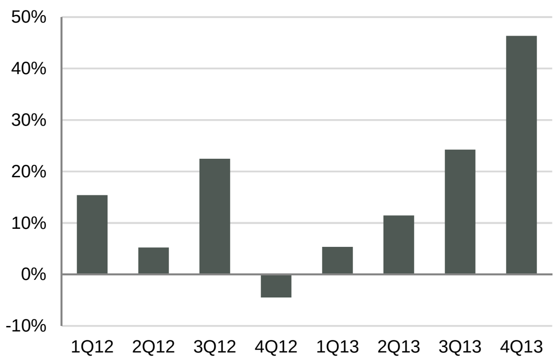
Global food prices are forecasted to remain flat. This, combined with appreciation pressures on the lari and the NBG's commitment will bring inflation lower, well within the NBG's annual target of 6%, in our view. Global vegetable prices are expected to fall further over the next few years. However, this fall will be partially offset by increasing meat and dairy prices, as demand for these will increase in countries such as China and India, where improved lifestyles are resulting in a shift in food preferences from vegetables to meat. However, as recent data indicates, global prices do not affect Georgian prices immediately. We believe the impact will be with some lag. Therefore, falling food prices of late 2013 will probably start affecting Georgian inflation starting in 2Q14. According to GeoSTAT, the main food products feeding inflation in December were potatoes, greens and eggplants. Among them, the potato price in December 2013 had almost doubled y/y.

Foreign Trade

Exports have taken a decisive step upwards. Following a volatile 2012, Georgian exports recovered in 2013 and established a stable upward trend. November and December posted record high exports at US$ 312mn and US$ 293mn, respectively. Annual growth rates also point to a recovery. Exports in 2013 reached US$ 2.9bn, up 22% y/y. The quarterly y/y growth rate increased to 12% in 2Q13, 24% in 3Q13, and 46% in 4Q13. In contrast to the volatility of previous years, there was an obvious positive trend in 2013. We believe that, on the back of the recent one time depreciation of GEL, exports will continue to perform well in 2014.

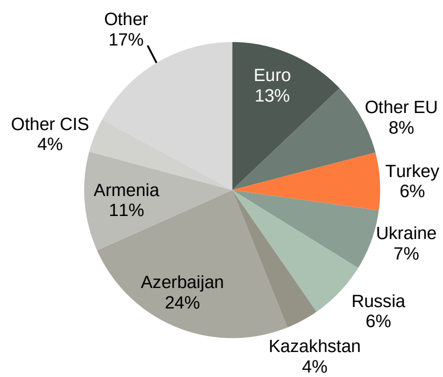
Export growth was broad-based. The main drivers were exports to Russia (less than 1/3 of the growth), Bulgaria, Spain, Ukraine, and Germany. It was natural to expect Russian exports to pick-up as the previous year provided an extremely low base. However, even without Russia, exports boomed. Ex-Russia exports increased 9%, 17% and 35% in 2Q13, 3Q13, and 4Q1, respectively. The main concern in terms of exports is Turkey, where the local currency has been falling faster than the lari. This has already taken a toll: 4Q13 exports to Turkey increased just 3% y/y. Nevertheless, Turkey accounts for just 6% of total exports.

Figure 16: Georgian export growth, % y/y



Source: GeoSTAT

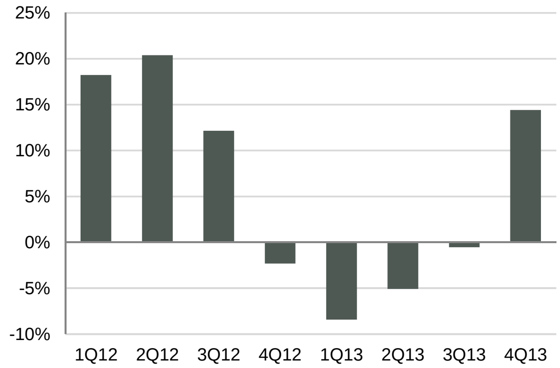
Figure 17: Exports breakdown by countries in 2013



Source: GeoSTAT

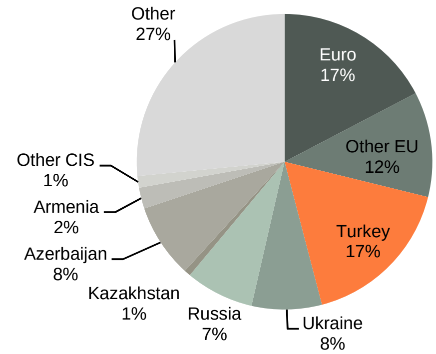
The economic recovery may also boost imports. Since late 2012, the process of political change has put a strain on investment and consumption. An improved economic and political outlook now may be igniting demand and driving imports up. Imports increased 14% y/y in 4Q13 even though total 2013 imports added just 0.4% y/y to US$ 7.9bn. We expect the economic recovery to continue in 2014 and to feed import growth. The growth in exports should still outpace imports in 2014.

Figure 18: Import growth import growth, % y/y



Source: GeoSTAT

Figure 19: Import breakdown by countries in 2013



Source: GeoSTAT

With relatively strong macroeconomic fundamentals, we believe the GEL/US$ rate will remain stable in 2014. The economic recovery, a committed Central Bank, and rebounding exports will support GEL/US$ exchange rate stability. We believe an expansionary fiscal policy at the end of 2013 resulted in a sudden depreciation of the GEL against the US$. The NBG has smoothed that trend via market interventions since November 2013. Moreover, we believe that the recent depreciation of the GEL was a necessary adjustment that will help exports and tourism, thereby contributing to economic growth. While the GEL appreciated against currencies of immediate neighbors (Turkey and Russia), in real terms it slightly depreciated against the US$ and Euro, potentially benefitting exports to other economies and making Georgia attractive to tourists from the EU and the US. With these macroeconomic fundamentals we believe the GEL exchange rate will remain flat, with some probability of a slight nominal appreciation in 2014.

Conclusion

The recent devaluation of the lari has introduced several concerns regarding Georgia's vulnerability to capital outflows and its economic outlook. Unfortunately, coincidence of the devaluation with turbulence in global capital markets has led to the belief among investors that Georgia is being affected by the US Fed's taper decision and experiencing capital flight, as other EMs are. Contrary to those concerns, the recent lari devaluation was driven by domestic developments, including an end-of-year surge in public expenditures and an economic recovery that has spurred imports, rather than external factors. Moreover, several macroeconomic factors required a partial devaluation. Following a minor overshoot at the end of January, the lari's devaluation halted and we expect the exchange rate to remain broadly stable at the current level over the medium term. Structural factors indicate that Georgia is different and relatively insulated from vulnerable EMs thanks to underdeveloped capital markets and weak transmission channels from those countries. Moreover, robust external financing over the previous decade (mainly through FDI) means Georgia is not vulnerable to Fed taper. Taking all these factors into consideration we believe Georgia is positioned well for the challenges of 2014 and will perform better than peer economies.

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