Dependence on Russia: Why Georgia is different from Ukraine

Georgia | Economy
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Despite a similar political past with Ukraine and similar economic diversity, the respective paths of Georgia and Ukraine and their economic relations with Russia have split over the last decade. This was a result of differences in reform initiatives, in the internal political climate, and the Russian embargo on Georgia that forced it to redirect its focus. Georgia's key positives lie in its trade diversification and lower export exposure to Russia, its limited energy dependence on Russia, the success of implemented reforms, its macroeconomic resilience, lower public debt levels, stronger banking sector, and the underdevelopment of the stock market, which shields Georgia from negative shocks. In short, Georgia is unlikely to experience any of the economic troubles Ukraine is currently facing.

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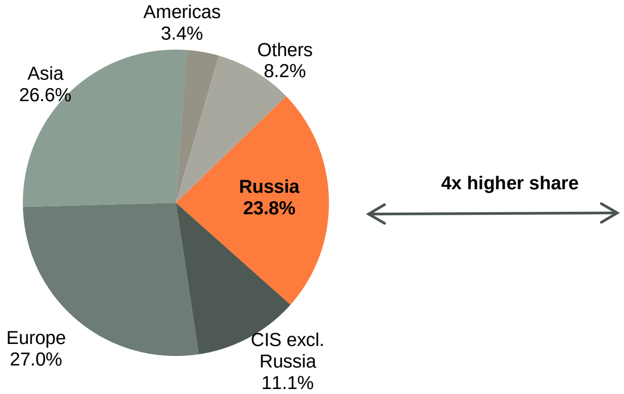
Trade with Russia: Much lower exposure for Georgia

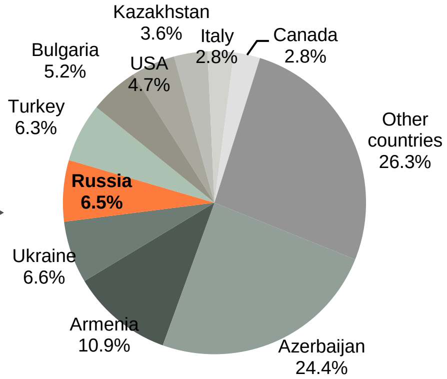
The share of trade turnover (both export and import in total trade) with Russia is 4x higher in Ukraine than in Georgia. In 2013, Russia accounted for 6.5% (US$ 190mn) of Georgian exports and 23.8% (US$ 15.1bn) of Ukrainian exports. Over the last 8 years the share of exports to Russia has averaged 24.7% in Ukraine and just 3.5% in Georgia.

Figure 1: 2013 export by country, Ukraine



Source: UkrStat

Figure 2: 2013 export by country, Georgia

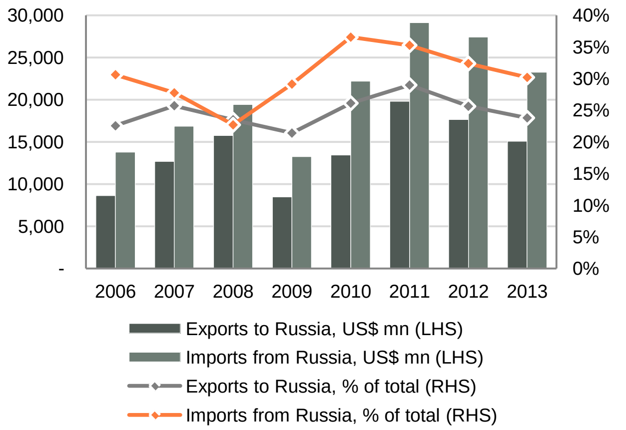


Source: GeoStat

After Russian embargo of 2006, Georgia's exports to Russia decreased from 18% in 2005 to 8% in 2006 and 2% in 2008-2012. The embargo forced Georgian producers to redirect exports to other CIS countries, the EU, and the Middle East. The upcoming signing of the DCFTA with the EU and the recent depreciation of the lari against the euro will further support Georgian exports to EU markets, in our view. Exports to Russia picked up in 2013 as Russia opened its borders to Georgian wines but accounted for only 6% in total export growth in 2013 (for further details see our report from March 7, 2014). Even without Russia, Georgian exports have more than tripled since 2005 to US$ 2.9bn in 2013. However, recent foreign trade outcomes suggest that dependence on the Russian market (mainly wine, mineral water and agricultural products) is increasing. In 1Q 2014, Russia's share in total Georgian exports went up further by 3.2ppts to 9.7% and this trend will continue, in our view.

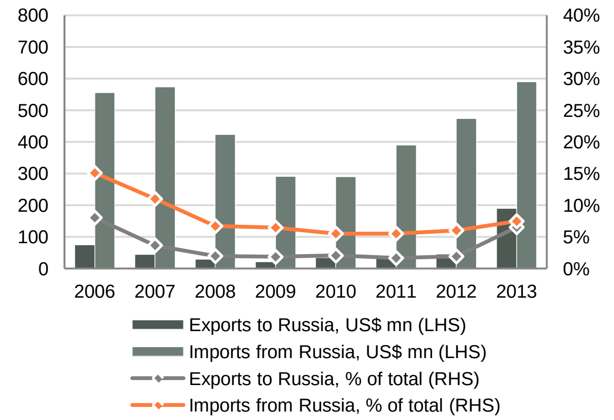
Georgia is more dependent on the Azerbaijani and Armenian export markets at 24.4% and 10.9% of total exports in 2013, respectively. Russia, meanwhile, is Ukraine's number one trading partner with 23.8% of total exports in 2013.

Figure 3: Ukraine's foreign trade with Russia



Source: UkrStat

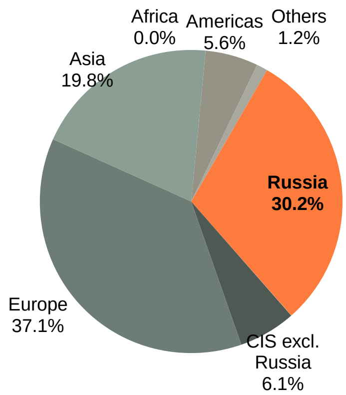
Figure 4: Georgia's foreign trade with Russia



Source: GeoStat

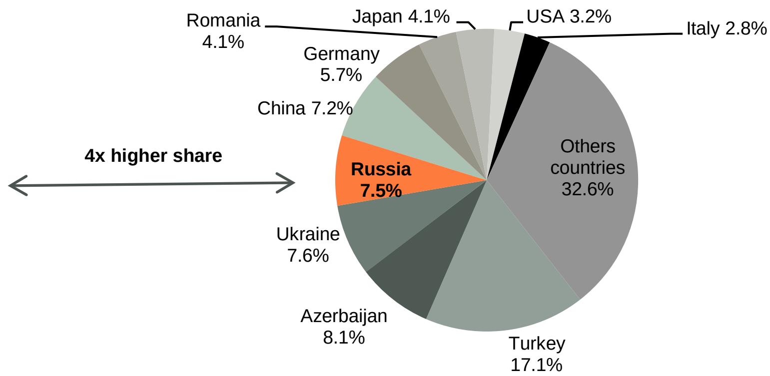
Russia's share in Ukraine's imports is high at 30.2% compared to 7.5% in Georgia. Natural gas is the main imported commodity from Russia for Ukraine and the opportunities for diversification are limited in the near-term.

Figure 5: 2013 import by country, Ukraine



Source: UkrStat

Figure 6: 2013 import by country, Georgia



Source: GeoStat

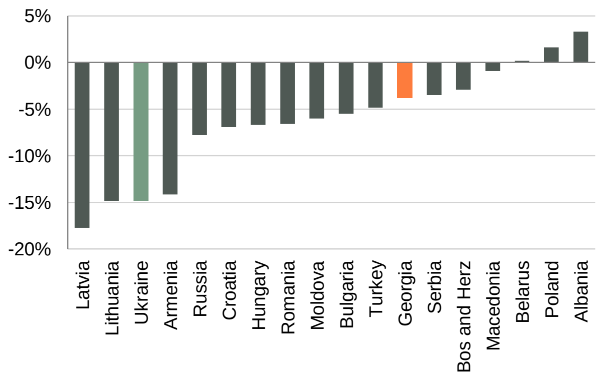
Difference in energy dependency

Since 2006, Georgia has imported gas mainly from Azerbaijan. Georgia changed its key supplier after Gazprom hiked gas prices several times and after a series of other incidents. Over 2006-2009, Gazprom's gas sales to Georgia declined from 1.6bcm to 0.1bcm and leveled off at 0.2bcm for the next 4 years. Markedly, total energy imports (mainly electricity) from Russia to Georgia increased 28.5% in 2013 y/y, but the diversified energy supply channel structure limits Russia's potential energy leverage against Georgia, in our view. Meanwhile, Ukraine's share averaged 8.9% of Gazprom's total gas sales volume over 2006-2012 while Georgia' share averaged 0.1% for the same period.

Key differentiator: Georgia's economic resilience

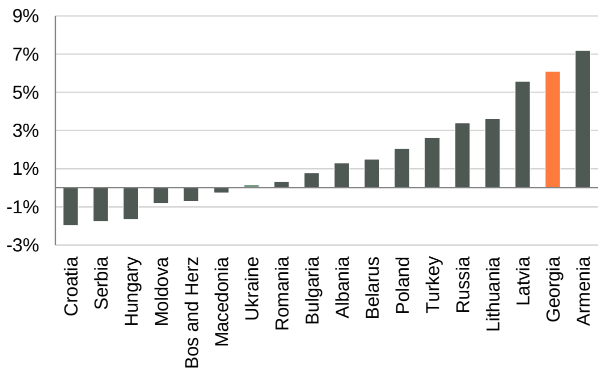
In 2009, after the armed conflict with Russia coincided with the global financial crisis, Georgia's GDP contracted just 3.8% and recovered strongly over the next two years, with 6.3% and 7.2% growth.

Figure 7: Real GDP growth in 2009 vs. peers



Source: IMF

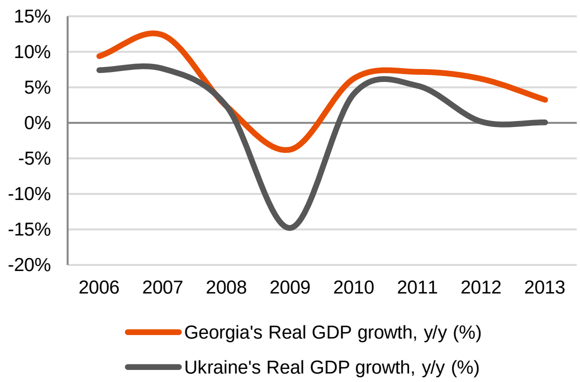
Figure 8: Real GDP growth in 2012 vs. peers



Source: IMF

In contrast, Ukraine was hit severely by the global financial crisis and has remained vulnerable. The economic contraction was much more severe at 14.8% in 2009 compared to Georgia's 3.8% decline. The reason for that could lie in the lack of sufficient reforms in Ukriane targeting the liberalization of the economy.

Figure 9: Real GDP growth, Georgia vs. Ukraine



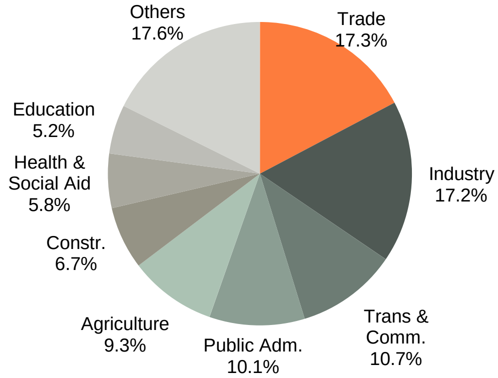
Source: IMF

The Georgian economy's robust rebound was largely the product of pre-crisis reforms and successful implementation of the international donor support. Reforms program including anti-corruption measures that led to a stronger framework for accountability, streamlined tax and customs administration system, diversified exports and energy supply structures, and business-friendly reforms produced economic benefits. As a result, the economy growth averaged 6% in 2006-2012 with strong performance in both the real and financial sectors. The recent economic slowdown has been driven by the transition of political power (parliamentary and presidential elections in October 2012 and September 2013, respectively). GDP started to recover in Q4 2013 as a result of increased public spending and continued strong growth performance at 7.3% in Q1 2014 mainly driven by exports.

Reform differences: Drivers of the Georgian economy

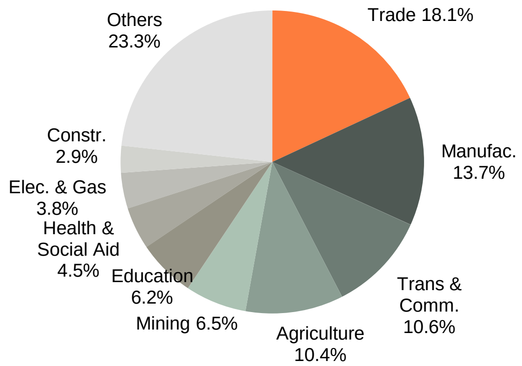
Both Georgia and Ukraine started the post-Soviet transition to a market economy in the early 1990s. Both countries shifted to more democratic and West-leaning governments in the early 2000s. However, the development path has since diverged in the extent of reforms that have been implemented and institutionalized even though both countries have diversified GDP bases.

Figure 10: Georgia's nominal GDP structure, 2013



Source: GeoStat

Figure 11: Ukraine's nominal GDP structure, 2013

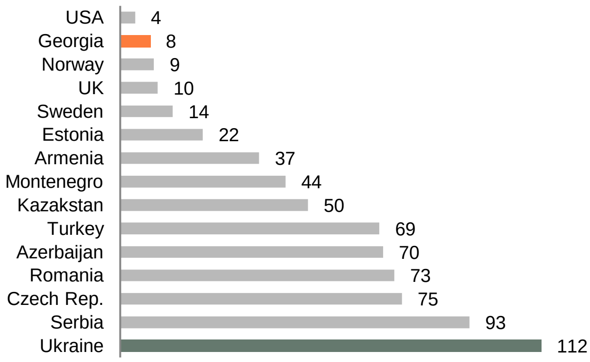


Source: NBU

As a reflection of the improvements Georgia moved up from 100th in 2006 of the World Bank-IFC Doing Business ranking to 9th in 2013 and 8th in 2014. Implemented reforms shaped Georgia's stronger economic foundations, limited dependence on Russia, and increased public sector effectiveness with corruption free government. Georgia slashed the number of taxes from 21 in 2004 to just 6 now.

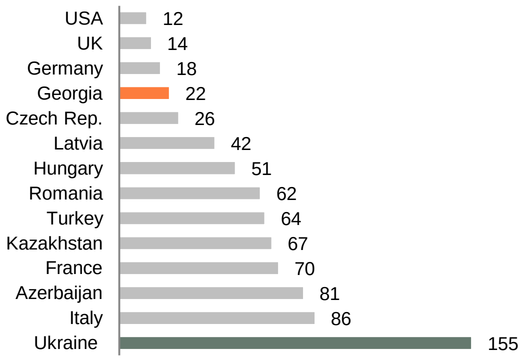
Ukraine on the other hand delayed its reform program. The country has barely improved in the World Bank-IFC Ease of Doing Business Survey, sitting at 112th in 2014, up from 124th in 2006.

Figure 12: Ease of Doing Business, 2014



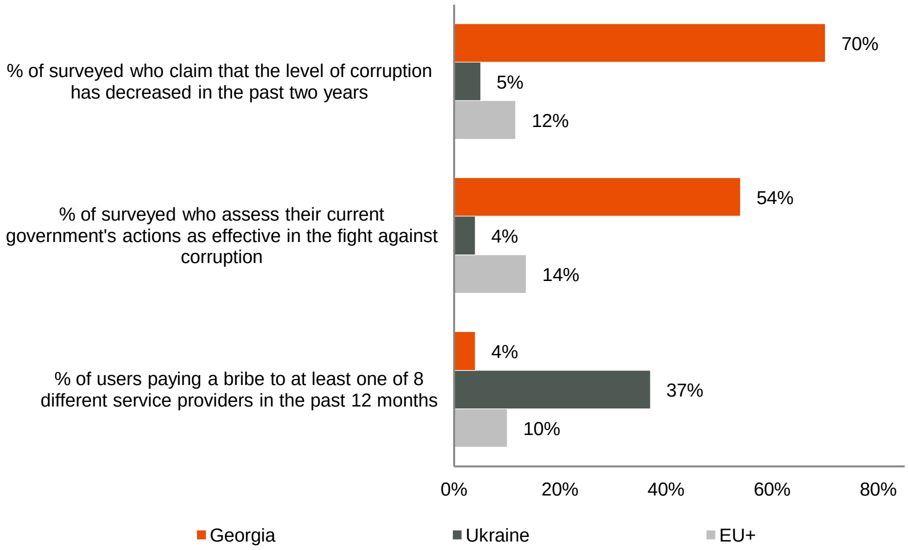
Source: Doing Busines, WB

Figure 13: Economic Freedom Index, 2014



Source: Heritage Foundation

Figure 14: Transparency International Global Corruption Barometer, 2014

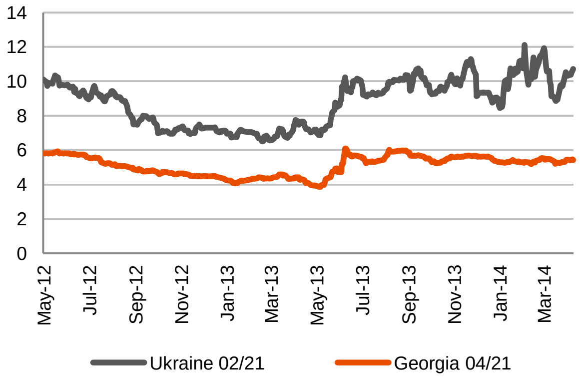


Source: Transparency International, BoG Research

The repercussion on financial markets

Georgia's sovereign Eurobonds have performed better than Ukraine's even before the recent tension. Ukraine's sovereign bond yield fluctuated more than Georgia's even before the start of tensions with Russia, and the recent developments have pushed Ukrainian yields further up as investors have re-priced risk. The yield spread between the two sovereigns widened to 5.3ppts in late April from 3.2ppts in October 2012 (the date of Georgia's parliamentary elections).

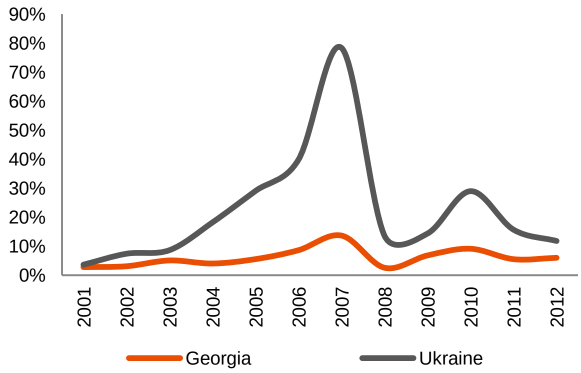
Figure 15: Sovereign bond yield comparison, %



Source: Bloomberg

Georgia's underdeveloped stock market limits the impact of external shocks. Georgia's market capitalization-to-GDP averaged 6.1% over 2001-2012, well below Ukraine's 22.4%. This shelters Georgia from negative external shocks and market turmoil. As a result of the global financial crisis, Ukraine's market capitalization-to-GDP dropped from 78.3% in 2007 to 13.5% in 2008 and Georgia's fell from 13.7% to 2.6% for the same period.

Figure 16: Stock market capitalization-to-GDP



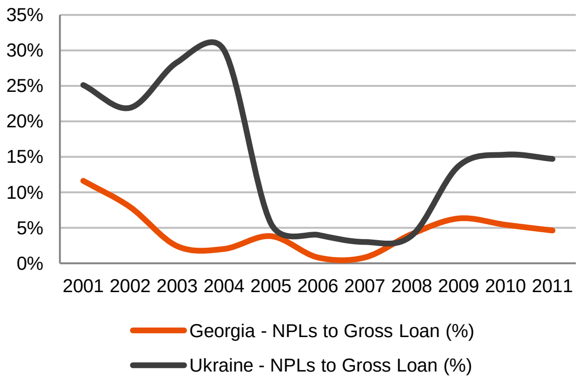
Source: WB

Banking sectors: Georgia's banking sector is on solid basis

Georgia's banking sector is on solid basis. Georgian banks are highly capitalized with capital adequacy ratio of 17.2% in 2013 (local standards, 25.2% with Basel I); NPLs declined to 3.2% by end-February 2014. As deposit growth was impressive and averaged 25.4% in last 4 years, loan to deposit ratio has been tightening and currently is at 110%.

Georgia's banking system was resilient during the global financial crisis and raised few concerns; Non-performing loans rose from 0.8% in 2007 to 6.3% in 2009 and came down below 5.0% in 2011 to the current 3.2%. Ukraine's NPLs picked up from 3.0% in 2007 to 13.7% in 2009 and current political tensions puts further pressure on its deterioration.

Figure 17: Non performing loans, Georgia and Ukraine

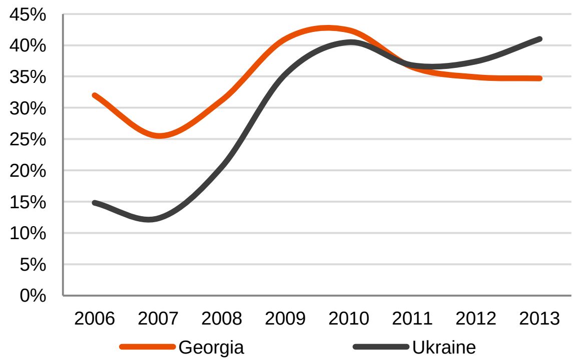


Source: WB, IMF, BoG Research

Public debt: Georgia is less levered than Ukraine

Georgia's lower public debt ratios vs. Ukraine offer leeway to increase debt stock in the case of adverse shocks. Georgia entered the global financial crisis with more debt than Ukraine, but the trend in each country has diverged since. Ukraine's public debt was at 41.0% of GDP in 2013 and growing, while Georgia's is at a more sustainable level at 34.7% of GDP. Both countries took on additional debt in reaction to the global financial crisis, with Debt to GDP ratio increasing from 25.5% to 42.4% for Georgia and from 12.3% to 40.5% for Ukraine in 2007 and 2010 respectively.

Figure 18: Public debt-to-GDP

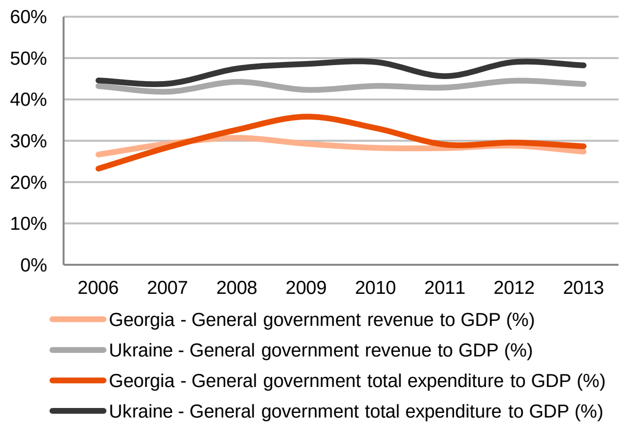


Source: IMF, MOF

Furthermore, general government spending-to-GDP is significantly lower in Georgia. Government spending in relation to GDP has been comfortably flat below 30% in recent years in Georgia and has remained there even after the government increased social spending in 2013-2014. The only exceptions were in 2009-2010, when the government undertook countercyclical spending to mitigate the effects of the armed conflict with Russia and the global financial turmoil.

Ukraine's higher government spending in 2012-2013 on the back of pension and wage increases and energy subsidies pumped up the spending-to-GDP ratio to 48% and widened the budget deficit, which was covered by additional debt. As a result, Ukraine's budget deficit at 4.3% of GDP and 4.8% of GDP in 2012 and 2013 respectively was higher than Georgia's 2.9% in 2012 and 2.7% in 2013.

Figure 19: General government expenditure/ revenue to GDP

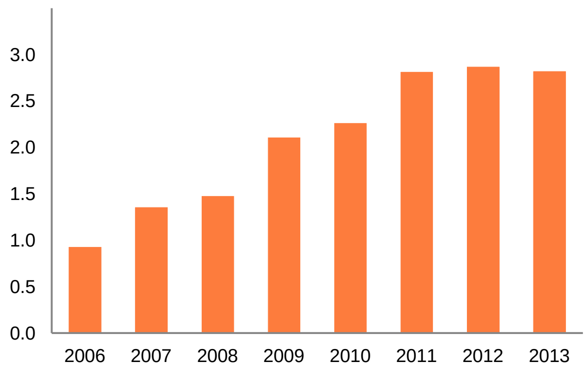


Source: IMF

Differences in exchange rate policies

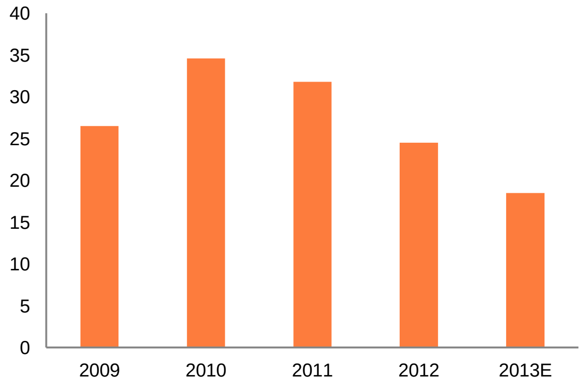
A floating exchange rate policy helps Georgia adjust external imbalances without jeopardizing official reserves, while Ukraine's currency peg and reserves-based defense of the hryvnia led to a depletion of the reserves and forced the bank to abandon its peg recently. The National Bank of Ukraine's (NBU) foreign reserves declined to US$ 18.5bn, or just 2.2 months of imports. Meanwhile, Georgia's floating exchange rate policy helps adjust external imbalances by allowing currency fluctuations and maintaining a strong reserves position, currently at 3.4 months of imports.

Figure 20: NBG official reserve, US$ bn



Source: NBG

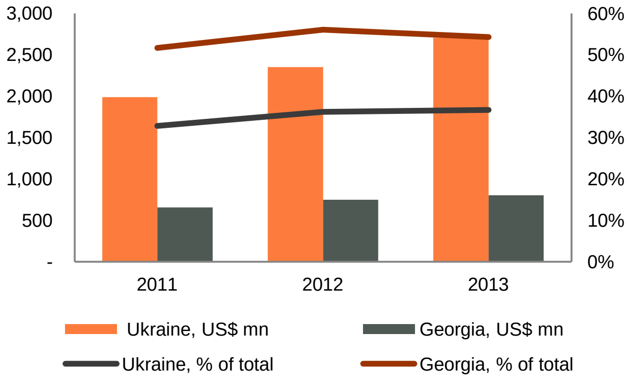
Figure 21: NBU official reserve, US$ bn



Source: IMF

Georgia's largest exposure to Russia is via money transfers (a proxy for remittances), which accounted for 54.2% of total money transfers in 2013, or around 5% of GDP. Russia also holds the largest share of Ukraine's remittances, but at a lower 36.7%, or 2% of GDP in 2013. Transfers to Georgia from Russia continued to increase even after the embargo in 2006 and the armed conflict in 2008, with just a minor decline in 2009. We, therefore, don't expect a significant drop in transfers.

Figure 22: Remittances from Russia to Georgia and Ukraine



Source: NBG, NBU, BoG research

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