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RESEARCH

Georgian Economy

Russia's Impact Fully Absorbed by Lower Oil Prices

Georgia | Economy

December 2, 2014

Georgia is continuing to grow robustly by 5.9% y/y in 9M14 despite Russia's economic slowdown and regional turbulence. We expect the solid performance to continue. Remittances, the biggest exposure for Georgia to Russia, remain resilient, as a decline in Russian transfers was fully offset by higher remittances from other countries. Our estimates suggest that negative impact on Georgia arising from Russia's economic troubles could reach one-time 1.16% of GDP, but this is more than offset by country's savings on oil products, estimated at 1.7% of GDP. Spillover effect from other countries, like Azerbaijan, Armenia and Turkey are limited, while negative impact from Ukraine crisis seems already absorbed. Weaker external environment may put moderate pressure on lari, but falling oil prices are helping economy to maintain strong growth and improve external accounts. Moreover, as we have pointed out in previous reports, the Georgian economy benefits from a stable macroeconomic environment, prudent monetary and fiscal policies, a business-friendly environment, and a healthy banking sector. This is reflected in increasing investment from local and international investors.

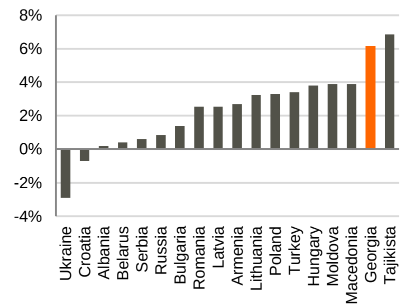
Georgia's economy remains resilient to the economic slowdown in Russia and increased regional geopolitical risks. Georgia's economy expanded by 5.9% y/y in 9M14 despite economic troubles in Russia and the regional tensions.

In this report, we examine Georgia's direct links with Russia to estimate the potential spillover effect, and we estimate the indirect effects on Georgia, via Georgia's key partners Azerbaijan, Armenia, Turkey and Ukraine, economies which are important for Georgia's exports, remittances, investments and tourism sector to varying degrees.

In 9M14 Georgia's exposure to Russia was the following:

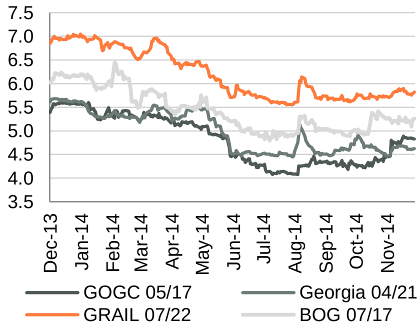
- Remittances from Russia accounted for 50.5% of total money transfers, or 4.6% of GDP
- Exports to Russia accounted for 9.9% of total exports, or 1.8% of GDP
- Arrivals from Russia accounted for 15.3% of total arrivals and receipts from Russian tourists reached 1.8% of GDP
- FDI from Russia accounted for 9.2% of total inflows, or 0.3% of GDP in 1H14

Figure 1: Real GDP growth 1H14, %



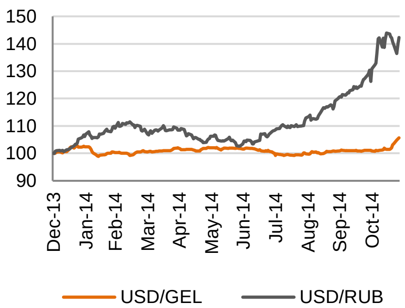
Source: Statistical offices of respective countries

Figure 2: Georgia Eurobonds, YTM (%)



Source: Bloomberg

Figure 3: Exchange rate performance



Source: Bloomberg;
Note: 31 December 2013=100

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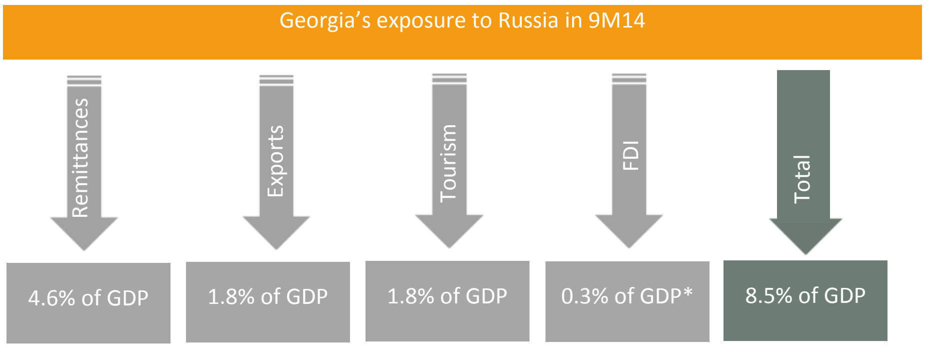
Georgia-Russia links

Figure 4: Georgia's exposure to Russia, 9M14

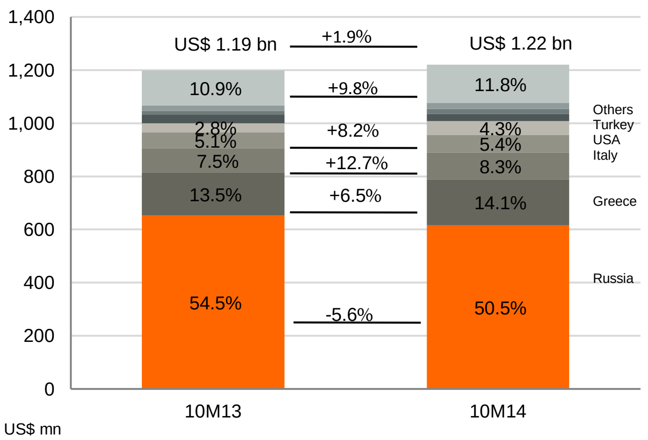


Source: G&T Research
** In 1H14*
Note: Receipts from Russian tourists calculated from per visitor spending in 9M14

Remittances are the biggest exposure to Russia. Remittances from Russia accounted for 50.5% of total, or 4.6% of GDP in 9M14. Despite a 4.4% y/y fall in the contribution from Russia in 9M14, total transfers grew by 2.9% y/y. Russian shortfall was fully offset by higher remittances from Europe, the US and Turkey.

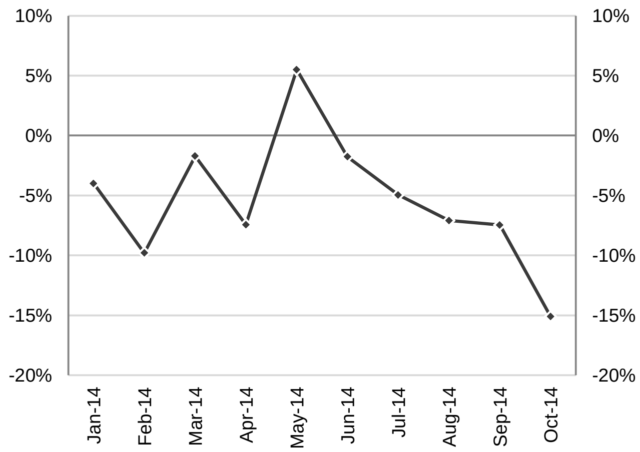
Total negative impact from the drop in remittances from Russia could account for 0.7% of GDP. As decline in Russian remittances reached 15.1% y/y in October and we may expect this level of drop to continue, this could result in a negative impact of 0.7% of GDP on a run rate. Despite Russian shortfall, remittances grew 1.9% y/y in 10M14, as higher remittances from other countries continued to offset Russian shortfall.

Figure 5: Remittances – 10M14 vs 10M13



Source: NBG

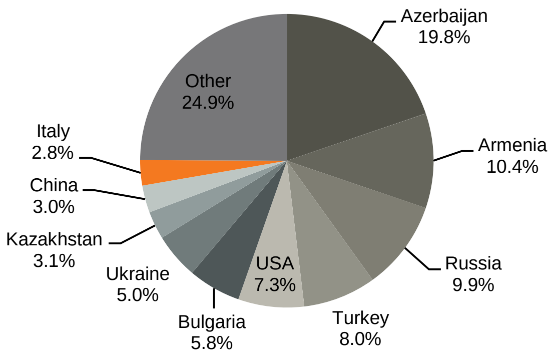
Figure 6: Remittances from Russia, % change y/y



Source: NBG

Russia accounted for 9.9% of Georgia's total exports in 9M14, but this share is still about half of the pre-embargo level, and exports to Russia accounted for just 1.8% of GDP in 9M14.

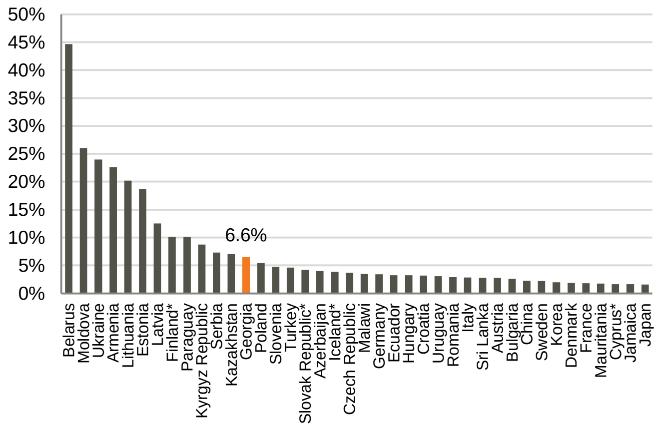
Figure 7: Georgian exports by country, 9M14



Source: GeoStat

The low volume of Georgian commodity exports that go to Russia and their low share of GDP demonstrate that Georgia's dependence on the Russian market is limited. Of the 40 countries to which the Russian market is important to varying degrees, Russia is a far more important destination for other European economies than it is for Georgia.

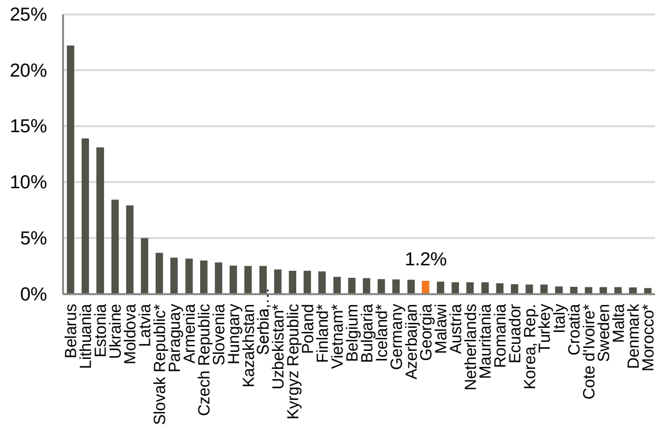
Figure 8: Russia's share of total exports (2013)



Source: WTS

** As reported by each country. In case of absence of 2013 export data, 2012 statistics is used*

Figure 9: Exports to Russia as a percentage of GDP (2013)



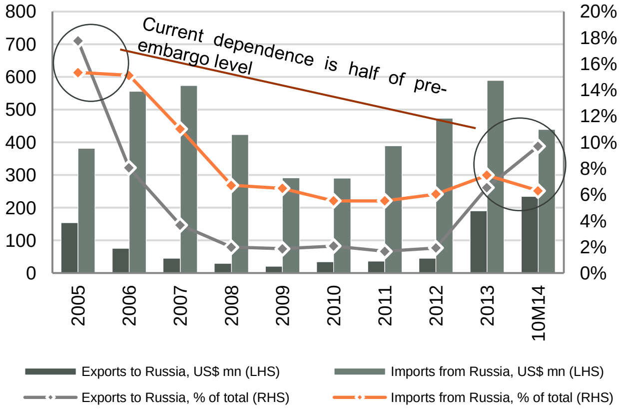
Source: WTS

** As reported by each country. In case of absence of country's export data, Russia's imports statistics for the corresponding country is used*

Export growth to Russia was anticipated to slow, as the recent increase was a result of a low base effect. The rapid expansion of Georgia's exports to Russia during 2013-mid-2014 was the result of a resumed trade relations since Spring-2013, lower base playing a key role in maintaining high growth rates. As was anticipated, export growth started to normalize: the growth rate has been slowing since April 2014, and it even turned negative in October, when exports decreased 17.7% y/y.

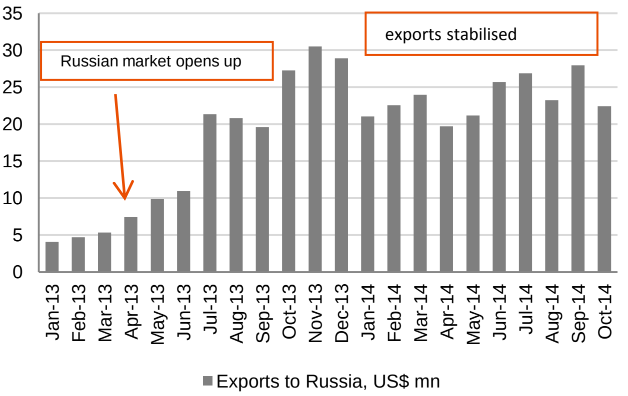
Given normalization in export growth and Russia's economic slowdown, we may anticipate that negative impact from the further decline in Georgia's exports to Russia could reach 0.36% of GDP. As Georgia is facing a new reality, we expect that export drop to Russia could reach 20% due to combined effect of export growth normalization and Russia's economic slowdown. The estimated negative impact could be 0.36% of GDP on a run rate.

Figure 10: Trade with Russia



Source: GeoStat

Figure 11: Exports to Russia



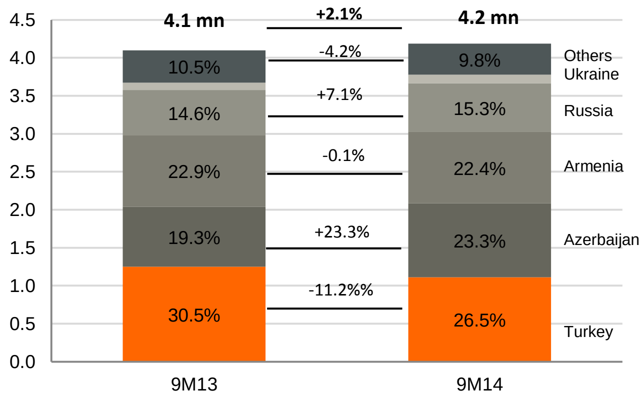
Source: GeoStat

Arrivals from Russia increased 7.1% y/y and accounted for 15.3% of total arrivals and receipts from Russian tourists reached 1.8% of GDP in 9M14.

Given the fact that Georgia is cheaper than some other destinations, we do not expect economic developments in Russia to have a substantial impact on the number of Russian visitors. As Georgia is cheaper than some other tourism destinations, and some Russian visitors are driving to Georgia for gambling with limited other alternatives, we do not expect economic developments in Russia to have a substantial impact on the number of Russian visitors.

Arrivals from Russia may even grow as Russians formerly going to European countries may divert to the cheaper Georgia. Russian tourists reached around 27mn in European countries with spending of around US$ 33bn[1] and even 1% of this amount could significantly boost Georgia's tourism sector, if some Russian tourists divert to Georgia as a cheaper alternative.

Figure 12: International arrivals, mn



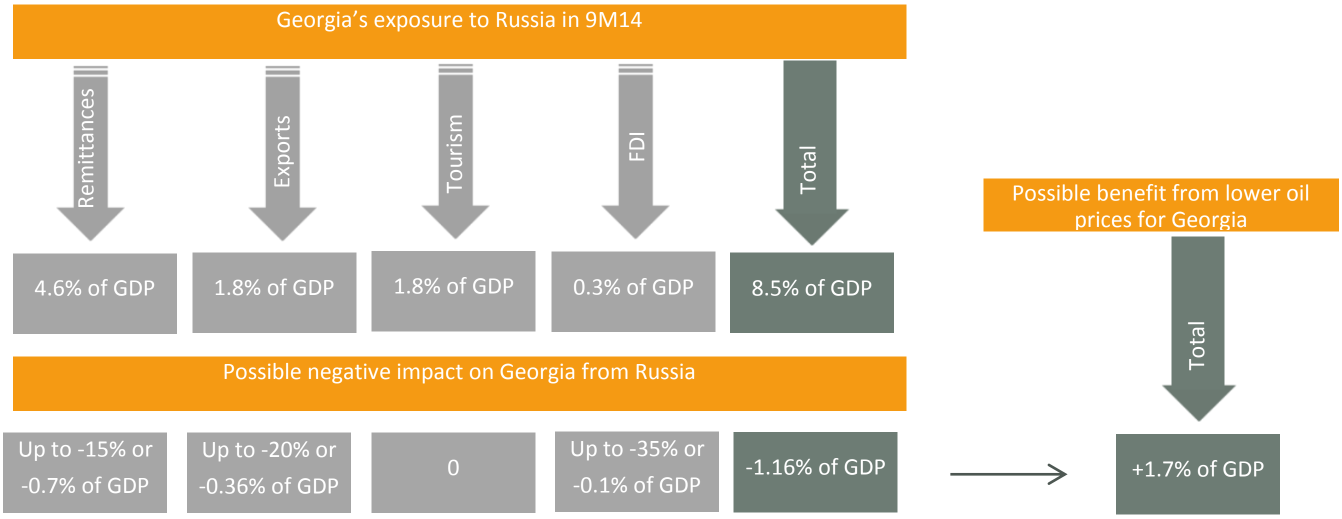
Source: GNTA

[1] Calculations based on 2012 data provided by the European Commission

Financial links to Russia are limited. Russia's share of FDI inflows accounted for 9.2% of total inflows or just 0.3% of GDP in 1H14 and Russia's share in total cumulative FDI over the period 2012-1H14 remains low at 2.7%. We anticipate that negative impact of Russia's slowdown on FDI could reach 0.1% of GDP on a run rate. One Russian bank has a subsidiary operating in Georgia, but it accounts for just 5% of total banking sector assets.

In a nutshell, anticipated negative impact on Georgia arising from Russia's economic slowdown could reach 1.16% of GDP, but lower oil prices (oil is a major imported commodity for Georgia) benefiting Georgia 1.7%+ of GDP on a run rate could be more than sufficient to fully offset negative impact from Russia.

Figure 13: Possible negative impact vs possible benefit for Georgia



Source: G&T Research

Impact of Russia's Slowdown on Georgia's Economic Partners – Azerbaijan, Armenia, Turkey and Ukraine

Georgia continues to benefit from closer economic ties with Azerbaijan, Armenia and Turkey, though managing to grow faster than these economies and it seems that Georgia might have already absorbed the effect of Ukraine crisis. Current economic links to these economies are as follows:

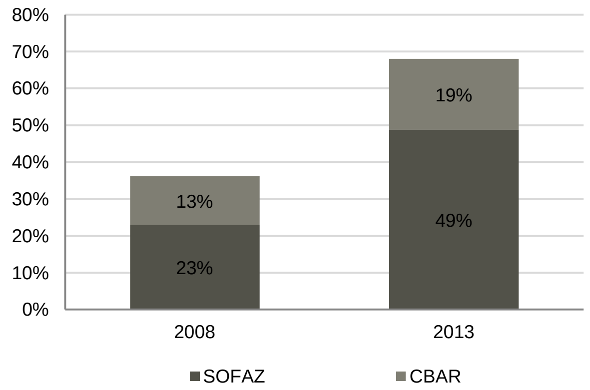
- Exports in 9M14: Azerbaijan was the top export destination for Georgian products followed by Armenia, Turkey came the fourth and Ukraine was the seventh
- FDI in 1H14: Azerbaijan accounted for 29.7% and Turkey's share was 13.2% in total FDI inflows
- Tourism in 9M14: Turkey was the top country by international arrivals (26.5% of total). Azerbaijan was the country with the second most visitors (23.3%), followed by Armenia (22.4%) and Ukraine accounted for 2.7% of total arrivals
- Remittances in 9M14: Turkey was in the top 5 countries sending remittances to Georgia and accounted for 4.2% of total remittances

Georgia-Azerbaijan links

The economy of Azerbaijan has little export exposure to Russia, which mitigates the indirect effects on Georgia of Russia's economic slowdown. Russia accounted for 4.0% of Azerbaijan's total exports, or 1.3% of GDP in 2013. Large reserves and few economic ties with Russia reduce the impact of Russia's slowdown on Azerbaijan. Falling oil prices, though, will have negative impact on Azerbaijan. However, we expect that, thanks to macro prudential policies of the previous years, Azerbaijan could be able to mitigate its negative impact. Its strong external balance and reserves provide strong cushion against medium term oil price fluctuations. In fact, compared to other oil producing countries, Azerbaijan managed previous case of falling oil prices in 2009 relatively better. Despite 36% fall in oil price in 2009 Azerbaijani GDP grew by 9.3%, AZN exchange rate remained stable and external and fiscal balance stayed in the surplus territory, albeit lower than in the previous year. Stability of AZN came with relative cost as CBAR's reserves declined by US$ 1.1 bn from US$ 6.5bn in 2008 to US$ 5.4bn in 2009. However, with current reserves at US$ 14.2bn in 2013, the similar cost is far more affordable, especially given commitments by the authorities to keep manat stable.

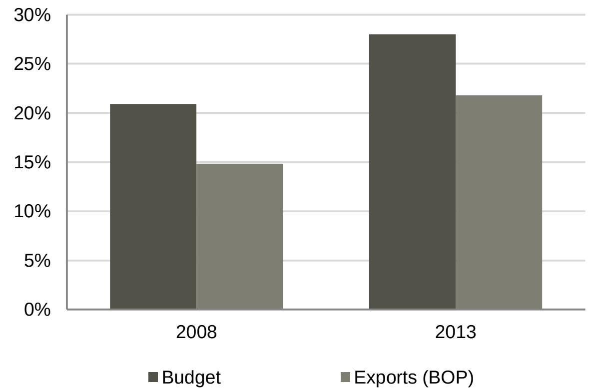
Azerbaijan: 2008/2009 versus 2013. By 2013 Azerbaijan international reserves reached US$ 50.0bn (68.0% of GDP) compared to US$ 17.7bn (36.2% of GDP) in 2008; in consolidated budget share of non-oil revenue increased from 21% in 2008 to 28% in 2013; while current account surplus is below its 2008 level, share of non-oil inflows increased from 14.8% (US$ 5.1bn) in 2008 to 21.8% (US$ 8.4bn) in 2013. However, it should be noted that government expenditures have increased substantially from 2008 to 2013 and are budgeted to increase further in 2014. Even at US$ 90 per barrel set in 2015 budget, government expects deficit in the consolidated budget at 8.7% of GDP. Falling oil prices can further increase budget deficit as oil prices at US$ 70 per barrel can lead to US$ 6.4bn less revenue compared to actual 2013 budget revenue. This problem, nevertheless can be mitigated by relatively easier cut in capital spending and rest of the financing can be easily available either through external capital markets (given low borrowing costs for Azerbaijan) or increasing transfers from SOFAZ.

Figure 14: Reserves, % of GDP



Source: SOFAZ, CBAR, AzSTAT

Figure 15: Non-oil flows in budget and exports, % of total



Source: Ministry of Finance of Azerbaijan Republic, CBAR

A one-off factor resulted in a fall in Georgian exports to Azerbaijan. In April, Azerbaijan banned the import of older cars. Consequently, car imports from Georgia fell sharply, resulting in a 18.6% y/y decline in Georgian exports to Azerbaijan in 9M14. However, excluding the car trade (re-exports with minor value added to the

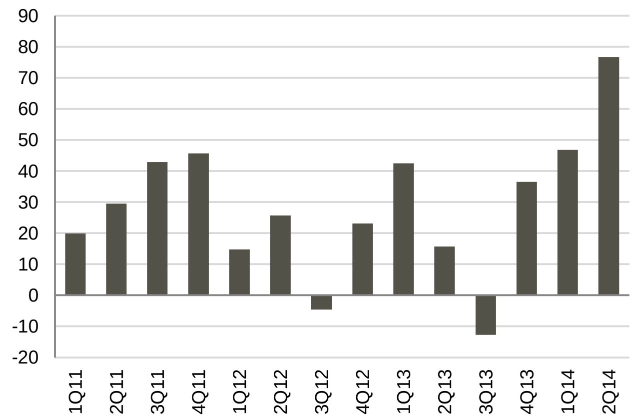
Georgian economy), exports fell by just 3.1% y/y on the back of falling cement and meat exports. Further fall in oil prices will probably remain a drag on these categories of goods.

Figure 16: Georgian exports to Azerbaijan, US$ mn, 2014

Source: GeoStat

FDI from Azerbaijan to Georgia is increasing. FDI from Azerbaijan increased by 10% and 388% y/y in 1Q14 and 2Q14 respectively, reaching US$76.7mn in 2Q14, the highest quarterly level since records started. We do not expect falling oil prices could reverse this trend as FDI from Azerbaijan increased by 24.6% even in 2008/2009 while oil prices dropped by 36%. However, any possible drop in FDIs, resulting from lower oil prices, could be balanced by upcoming infrastructure investments discussed below.

Figure 17: FDI from Azerbaijan, US$ mn



Source: GeoStat

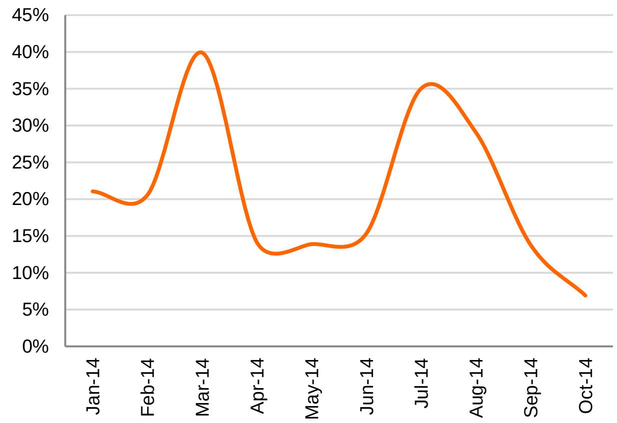
Regional infrastructure projects will feed Georgian growth in the next few years. Georgia is an important link in the east-west transshipment lines that originate in Azerbaijan and finish in Turkey. Oil pipeline projects (Baku-Tbilisi-Ceyhan oil pipeline, Baku-Tbilisi-Supsa oil pipeline, South Caucasus Gas pipeline) continue to have a positive impact on Georgia's economic status. Expected to be operational by the end of 2015 or early 2016, the Baku-Tbilisi-Kars railway will connect the Azerbaijani railway network to the Georgian and Turkish networks.

In addition, FDI of US$ 2bn for pipeline expansions in the course of next 4 years will provide further support to Georgian growth. This pipeline will carry additional gas volumes via Georgia to Turkey and Europe and 20% of this FDI will be spent on local services.

Infrastructure investments described above could be more than sufficient to offset possible negative impact from slower growth in Azerbaijan. While slower government capital spending resulting from lower oil prices may cause slower growth in Azerbaijan, affecting Georgian exports (currently 3.6% of GDP) and FDI into Georgia (currently 1.6% of GDP), upcoming Infrastructure investments could offset possible negative impact on Georgia.

Tourism sector benefited from increased arrivals from Azerbaijan in summer and arrivals continue growing but at a slower rate. In terms of tourist arrivals from Azerbaijan, Georgia had another successful summer season. In July and August, arrivals from Azerbaijan increased by 32.0% y/y and continue growing, though at a slower rate.

Figure 18: Arrivals from Azerbaijan, % change y/y



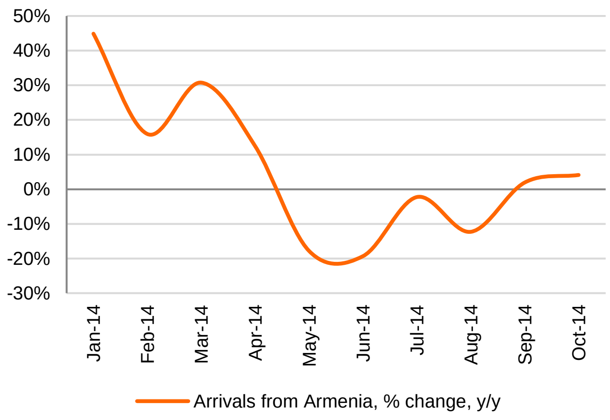
Source: GNTA

Georgia-Armenia links

Slowdown in Russia has moderately affected Georgia through Armenia. Armenia's economy is closely linked to Russia, as Russia accounts for 90% of Armenia's remittances, 22.6% of Armenia's total exports, or 3.2% of GDP in 2013 and significant investments. However, Armenia is benefiting from lower oil import bill and gets gas cheaper from Russia, a big benefit for the economy.

Tourist arrivals from Armenia decreased by just 0.1% in 9M14 but continue to grow. As Georgia is a cheaper destination for Armenians and transportation networks are well developed and cheap due to geographical proximity, we expect Georgia's tourism sector to continue benefiting from Armenian visitors. In October we saw an increase in Armenian arrivals by 4.1% y/y resulting 0.4% y/y growth in Armenian arrivals in 10M14.

Figure 19: Arrivals from Armenia



Source: GNTA

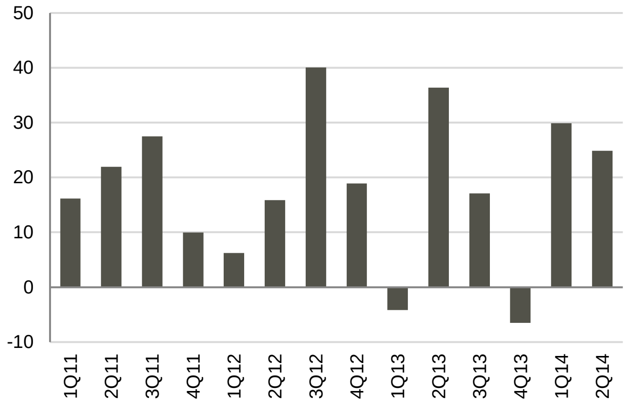
However Russia's slowdown and Armenia's integration in Eurasian Economic Union could have negative impact on Georgian exports to Armenia. Georgian exports to Armenia increased by 0.7% in 9M14. However, in 10M14 exports fell by 3.3% y/y. As major part of exports to Armenia remain car re-exports (re-exports to Armenia accounted for 66% of Georgia's total exports to Armenia in 2013), with low value-added for the economy, we do not expect that Georgia will significantly suffer from this decline. Armenia's accession to the Eurasian Economic Union may further reduce Georgia's exports. However, the impact could be lessened if Georgia negotiates tariff exclusions, and this seems plausible as both countries are WTO members and being a landlocked country, virtually all freight moving to and from Armenia uses Georgian roads, rails and ports.

Georgia-Turkey links

The economy of Turkey has little export exposure to Russia, which mitigates the indirect effects on Georgia of Russia's economic slowdown. Russia accounted for 4.6% of Turkey's total exports, or 0.8% of GDP in 2013. On top, declining oil prices are benefiting the economy.

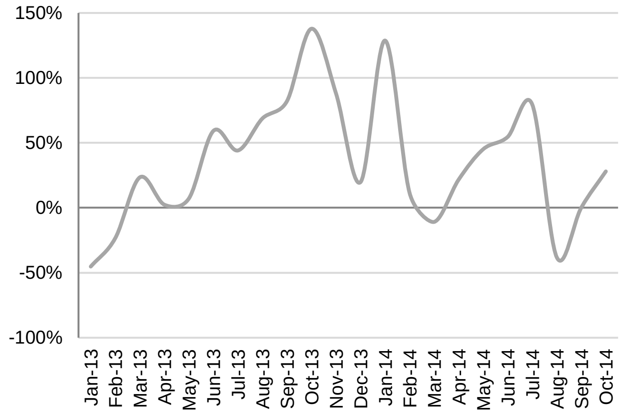
FDI from Turkey and exports to Turkey continue to grow. Investment from Turkey increased by 70.2% y/y in 1H14, highlighting that Turkish investors believe in the resilience of the Georgian economy. Exports to Turkey also performed well, increasing by 27.3% y/y in 10M14, while total exports grew by 5.2% y/y in the same period.

Figure 20: FDI from Turkey, US$ mn



Source: GeoStat

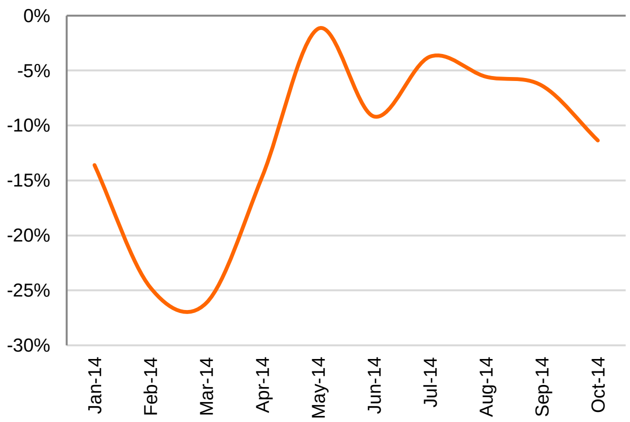
Figure 21: Georgian exports to Turkey, % change, y/y



Source: GeoStat

However, arrivals from Turkey fell by 11.2% y/y in 10M14 compared to 10M13. Slower economic growth and the weaker lira are probably the main reasons for the falling number of arrivals from Turkey. However, the data does not indicate an acceleration of the decline, which is a good sign for Georgia.

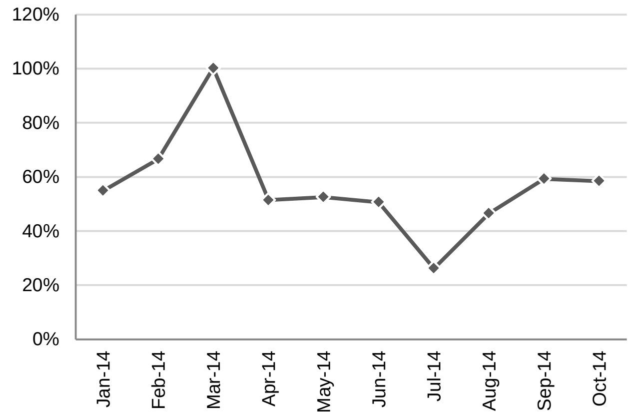
Figure 22: Arrivals from Turkey, % change y/y



Source: GNTA

Remittances from Turkey grew by a robust 54.9% y/y in 10M14, and the recent interest rate cuts by the Turkish Central Bank are expected to provide employment opportunities in Turkey, which could have a positive spillover effect on Georgian workers in Turkey.

Figure 23: Remittance growth from Turkey, % change, y/y



Source: NBG

Georgia-Ukraine links

Georgia might have already absorbed the effect of Ukraine crisis, the negative impacts of which have already materialized. Exports were hit the hardest, but the effect on the tourism sector was positive as we have seen increase in arrivals, and the impact on remittances was not significant to Georgia.

Exports to Ukraine decreased by 13.6% y/y in 10M14, but Georgia's total exports grew by 5.2% y/y. As a result, Ukraine's share of Georgia's total exports decreased to 5.0% in 10M14 from 6.0% in 10M13. The decline in exports to Ukraine was fully offset by increased exports to other countries.

In 2013, remittances from Ukraine accounted for just 3.1% of total money transfers, or 0.3% of GDP. Money transfers decreased further by 21.2% y/y in 10M14, but as Ukraine accounted for just a minor share of the total, the impact was not substantial on Georgia.

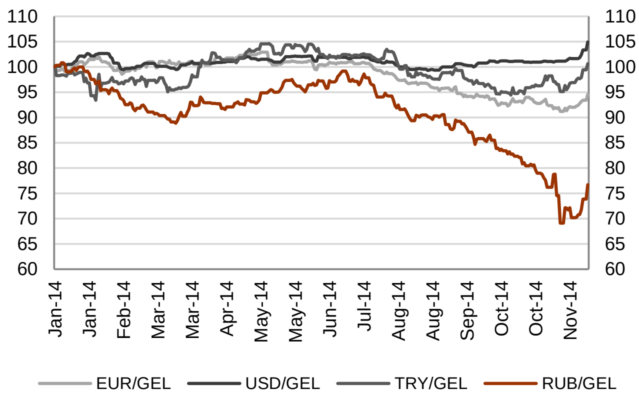
Financial links to Ukraine, as with Russia, are also limited. FDI inflows are low (0.8% of the total cumulative FDI in 2012-1H14), and there is only one Ukrainian bank subsidiary operating in Georgia, accounting for just 3.2% of total banking sector assets.

Number of Ukrainian visitors is limited. Given that tourist arrivals from Ukraine increased by 16.8% y/y in 10M14, accounting for 2.7% of total arrivals, the effect of the Ukrainian crisis on the Georgian tourism sector was small, but positive.

Impact on exchange rate

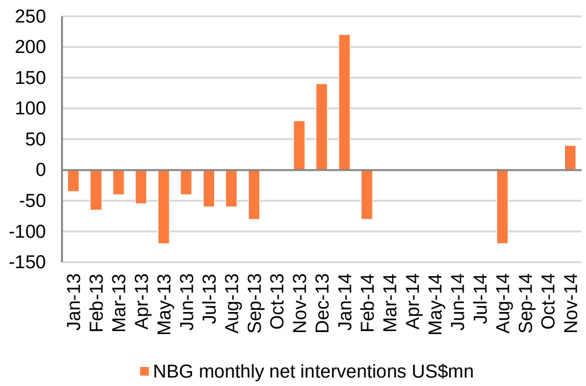
The lari remained mostly stable against the US$ in 2014, however weaker external environment put moderate pressure. From February to mid-November 2014 lari remained mostly stable against the US$. The NBG intervened in the FX market and purchased US$120mn to build reserves in August. Since November 2014, the lari has shown greater volatility, depreciating by 3.8% against the US$, a development anticipated by weaker external accounts and an acceleration of government spending. However, the NBG intervened in the FX market to support the lari on November 25 by selling US$ 40mn. Lari seems stabilized now and stopped further losing its value, however we expect moderate depreciation pressures to remain. However a floating exchange rate policy helps Georgia to adjust external imbalances without loss of reserves.

Figure 24: Exchange rates



Source: NBG, rebased Dec2013=100

Figure 25: NBG FX interventions



Source: NBG
Note: Negative sign imply accumulation of reserves

Low oil price is a big benefit for Georgia

Low oil prices are helping Georgia to maintain high growth and improve its current account deficit. Oil is Georgia's major imports, accounting for 11.2% of total imports in 9M14. As oil prices continue to decline and it seems sustainable, we expect a benefit of US$ 280-300mn or 1.7%+ of GDP on a run rate. This is a big benefit for the country, which is more than sufficient to compensate negative impact of Russia's slowdown and weaker external environment.

All in all, there has been a limited negative impact on Georgia arising from Russia's economic slowdown and the regional geopolitical tensions. This is a result of Georgia's diversified external channels and limited direct exposure to Russia. Declining oil prices is another big benefit for the economy, helping to sustain strong growth and improve current account.

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