Georgian Economy

Navigating Regional Turbulence

Georgia │ Economy

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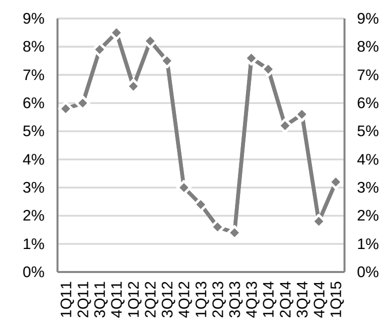
The Georgian economy grew 2.5% y/y in 5M15 against a backdrop of regional turbulence, characterized by falling oil prices, currency depreciations, and negative spillover from Russia's recession. The resulting lower remittances and exports, coupled with increased private consumption, exacerbated external imbalances in 1Q15, pressuring the GEL. With limited FX intervention, the NBG allowed the exchange rate to absorb most of the shocks while relieving the pressure on the real economy. Exchange rate flexibility precluded sizable reserve losses, and greater policy transparency supported stronger market fundamentals compared to other regional economies. The weaker GEL has been taking a toll on imports since April. This, coupled with a spike in tourist arrivals, has moderated the depreciation pressure, and the GEL has stabilized. Despite high dollarization, NPLs remain under control at 3.4%, and financial intermediation is stimulating the economy. Falling oil prices contained inflation in 1H15, though expectations of higher inflation in 2H15 spurred the NBG towards monetary tightening by increasing the policy rate to 5.5% on 1 July. Despite the slower growth, tax revenues increased 11.9% y/y, and were above the budgeted amount in 1H15. However, faced with lower growth than previously anticipated, the government revised the 2015 budget with the aim of maintaining the deficit target of 3.0% of GDP. Overall, economic diversification and timely policies, along with the floating exchange rate regime, have helped Georgia to emerge from the regional turmoil relatively unscathed. Despite a lower growth outlook and substantial external risks, Georgia has managed to keep its macro fundamentals healthy, which will provide a base for a quick pickup once regional turbulence subsides.

Economic growth decelerates to 2.5% in 5M15, though still appears healthy in the regional context. Against the backdrop of regional turbulence related to falling oil prices, currency depreciation, and negative spillovers from Russia's slowdown, Georgia performed well in the regional context, with its GDP expanding 2.5% in 5M15. While the growth is low by Georgian standards and external risks shape the growth outlook, medium to long term economic fundamentals remain strong, supporting a still positive (albeit weaker) outlook.

Private consumption continues upward trend despite depreciation, with investment driving growth in 1Q15. The positive trend in private consumption continued despite depreciation related uncertainty, rising 4.1% y/y in 1Q15, fueled by credit growth. Private investment, accounting for 90.3% of total investment, increased 22.0% y/y, driving growth in the quarter. Public investment increased 73.4% y/y in 1Q15, though from a lower base.

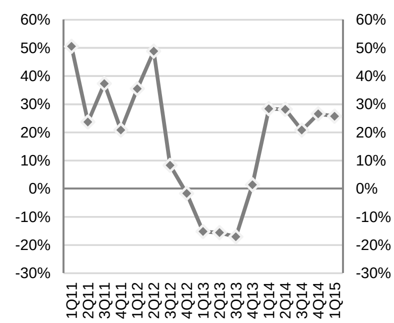
Strong private demand intensifies external imbalances in 1Q15; current account deficit widens to 14.1% of GDP, pressuring the GEL. Private consumption growth fed imports in 1Q15, preventing external adjustment. Imports fell 7.3%, mainly due to lower fuel prices. Unlike imports, exports shrank a significant 26.0% y/y in 1Q15, resulting in the trade deficit increasing 14.2% y/y. This, combined with tumbling remittances (-26.1% y/y) and weaker tourism proceeds (-2.9% y/y), pressured the GEL. As a result, the current account deficit widened 4.0ppts y/y to 14.1% of 1Q15 GDP.

Figure 1: Real GDP growth



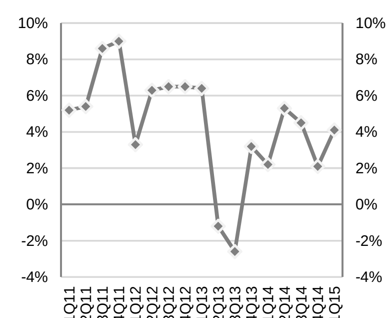
Source: GeoStat

Figure 2: Investments real growth



Source: GeoStat, Galt & Taggart Research

Figure 3: Private consumption real growth



Source: GeoStat, Galt & Taggart Research

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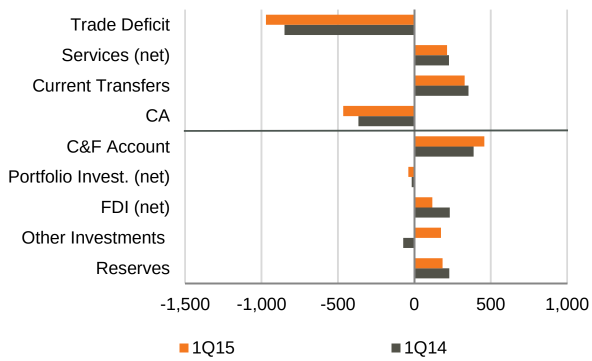
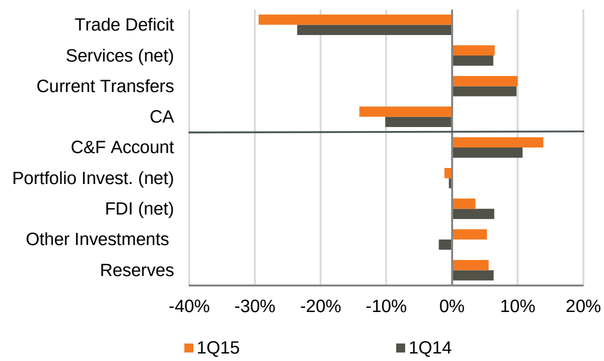
On the financing side of the CA deficit, FDI's share decreased y/y (net FDI was just 3.6% of GDP in 1Q15 versus 6.4% in 1Q14), while the share of other investments increased to 5.3% of GDP from a negative figure in 1Q14. The remaining imbalance was compensated for by reserves, which decreased by US$ 184.8mn, or 5.6% of GDP. However, FDI is likely to pick up in the coming quarters, in our view, due to BP's pipeline related investments, the government's privatization plans, as well as other ongoing activities.

Figure 4: BOP, 1Q15 vs 1Q14, US$ mn



Source: NBG

Figure 5: BOP, 1Q15 vs 1Q14, % of GDP



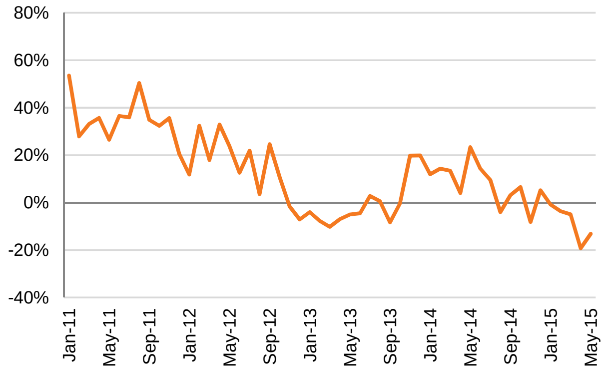
Source: GeoStat, NBG

Tourism shows resilience in face of regional economic repercussions. Tourist arrivals increased 3.5% y/y in 1H15; arrivals growth was 14.7% y/y in May and 9.3% y/y in June, after having been subdued in 1Q15. Being a cheaper destination has helped Georgia to remain attractive. Scheduled events for the remainder of 2015 (the Youth Olympic Festival and various business and cultural events) along with the recent (June 2015) easing of visa regulations should support the upward trend in tourism, in our view.

Falling imports and growth in tourist arrivals have helped alleviate pressure on the GEL since mid-May. The weaker GEL, lower commodity prices, and the slowing economy resulted in significant adjustments in imports after 1Q15; they decreased 19.3% y/y in April and 13.1% y/y in May. The fall in imports was significantly higher excluding one-offs (free supplies of hepatitis C medicine) - 30.8% y/y in May, 25.5% y/y in April-May, and 13.3% y/y in 5M15. We calculate that a 9-10% y/y decline in imports in 2015 would be sufficient to outweigh the lower export earnings. The decreased imports, along with the considerable spike in tourist arrivals, have helped to ease pressure on the GEL, which has stabilized against the USD since mid-May.

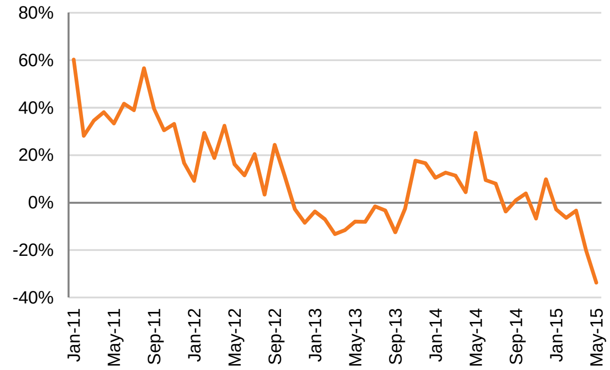
Our calculations suggest that, given the current trend of imports, further radical adjustment could even generate GEL appreciation pressure, which may not be desirable. However, with REER reaching its lowest level in five years, there is probably room for appreciation without hurting the economy. NEER data for June already indicate a reversal in the exchange rate. Alternatively, the NBG could opt to buy FX to increase its reserves, thereby preventing real appreciation.

Figure 6: Gross imports, % change y/y



Source: Geostat, Galt & Taggart Research
Note: 3month moving average

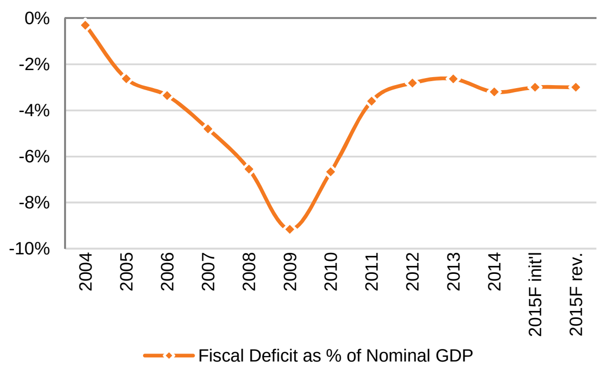
Figure 7: Imports excluding re-exported commodities, % change, y/y



Source: Geostat, Galt & Taggart Research
Note: 3month moving average, excluding imports of cars, copper and pharmaceuticals, as bulk of these commodities are re-exported

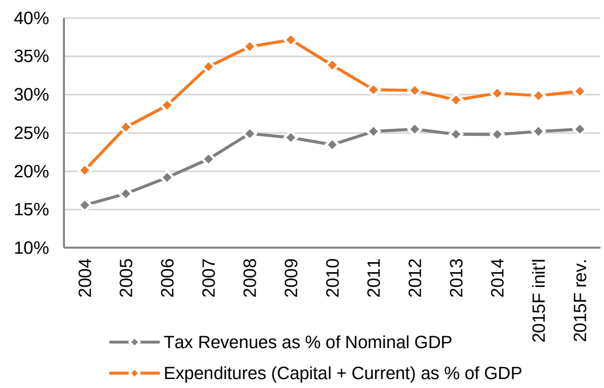
Government is committed to fiscal discipline and maintaining the fiscal deficit at 3.0% of GDP. Faced with lower growth than envisaged in the 2015 budget (approved in December 2014), and with financing needs arising from the June 2015 flooding in Tbilisi, the government has revised the 2015 budget document, which is currently being discussed by parliament. The revised document is based on 2.0% growth and 3.0% inflation assumptions (5.0% and 4.0% respectively in the 2015 budget law). The revised document maintains the planned fiscal deficit at 3.0% of GDP in 2015, preventing import growth. While tax and total expenditure ratios remain almost unchanged compared to the 2015 budget law (25.5% and 30.4%, respectively), public debt/GDP increases 6.5ppts to 43.7%, driven by a depreciation-related spike in external debt/GDP.

Figure 8: Fiscal deficit



Source: MOF

Figure 9: Tax revenues and expenditures to GDP

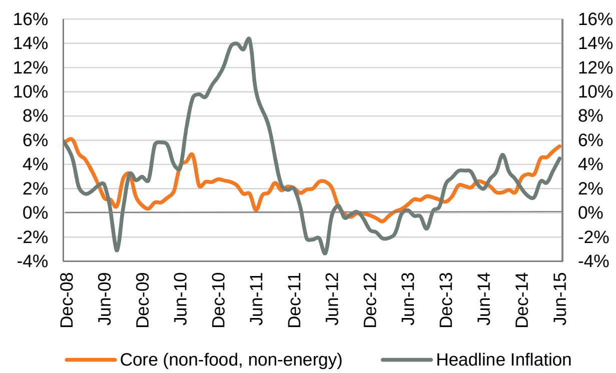


Source: MOF, GeoStat

1H15 budget tax revenues came in above expectations, though annual figure is revised down by GEL 200mn. Tax revenues increased 11.9% y/y in 1H15 to 102.9% of the budgeted amount. Despite this upward trend, the government reduced its tax revenue plan by GEL 200mn to reflect the lower growth forecast. The major downward revisions affected excise and customs duties (already far behind the budgeted numbers in 1H15) and personal income tax revenues (partly reflecting savings in public sector wages). Meanwhile, the profit tax revenue plan was increased by GEL 51mn (to reflect the sum already collected).

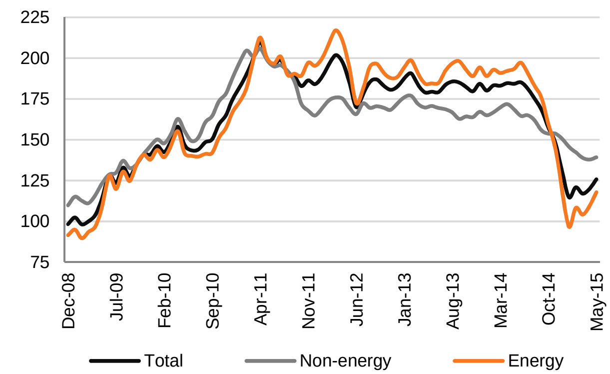
Inflation started to pick up recently and was recorded at 4.5% y/y in June 2015; being committed to price stability, the NBG responded with a key rate increase. Price increases in food, healthcare, alcoholic beverages and tobacco were drivers of inflation in 2015. Lower fuel prices supported the downward pressure on prices. However, currency depreciation increased expectations of inflation, and the inflation target of 5.0% in 2015 prompted the NBG to respond with monetary tightening, increasing the policy rate three times during the year. The policy rate was recently raised by 50 basis points to 5.5%, and the NBG signaled a further gradual increase to 6.5% by the end of the year.

Figure 10: Inflation dynamics in Georgia



Source: GeoStat, NBG

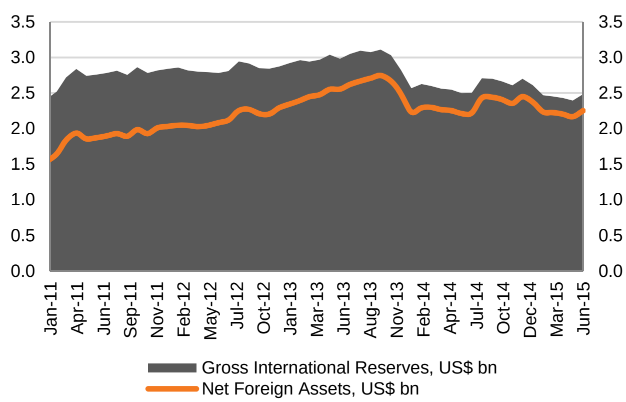
Figure 11: World prices



Source: IMF
Note: index, 2005=100

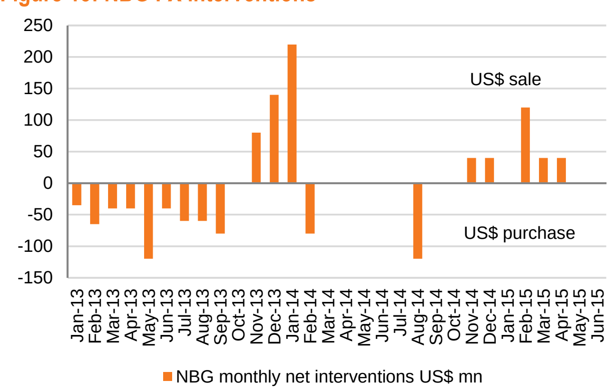
Gross foreign reserves stood at US$ 2.5bn as at end-June 2015, sufficient to finance 3.0 months of merchandise and services imports. The NBG intervened moderately at the beginning of 2015 to support the GEL, shrinking reserves. However, the trend was reversed in June when reserves picked up 3.8% m/m. As there were no interventions after April 28, the increase in reserves was probably due to the government's FX operations. With lower public external debt repayments in 2015 and the NBG's declaration that supporting the GEL using its reserves is counterproductive, we expect reserves to remain within a US$ 2.4-2.5bn range in 2015. We do not rule out the possibility of the NBG replenishing its reserves through interventions in August (tourism season). This would prevent any GEL appreciation that might impact the competitiveness of Georgian exports and cause imports to rise.

Figure 12: NBG foreign reserves



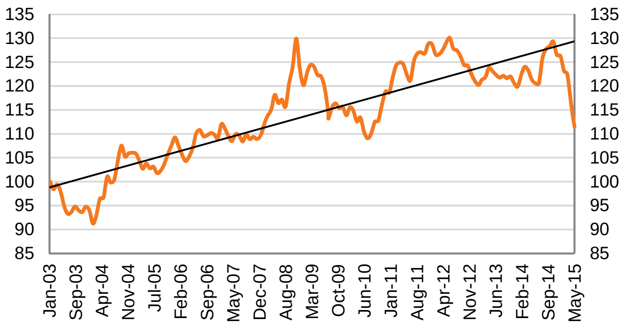
Source: NBG

Figure 13: NBG FX interventions



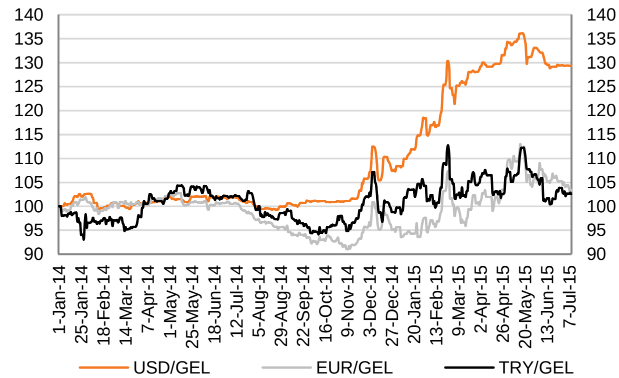
Source: NBG

Figure 14: REER



Source: NBG
Note: rebased, Jan2003=100

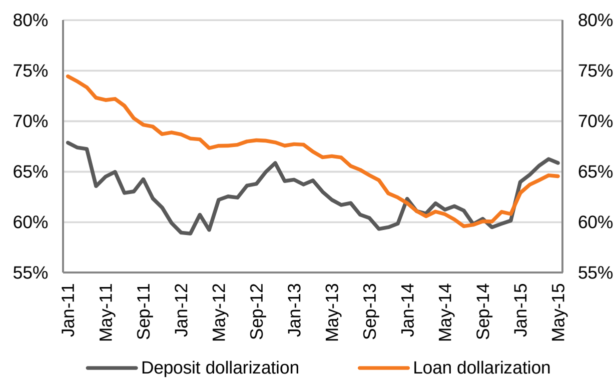
Figure 15: GEL exchange rate



Source: NBG
Note: rebased, Jan2014=100

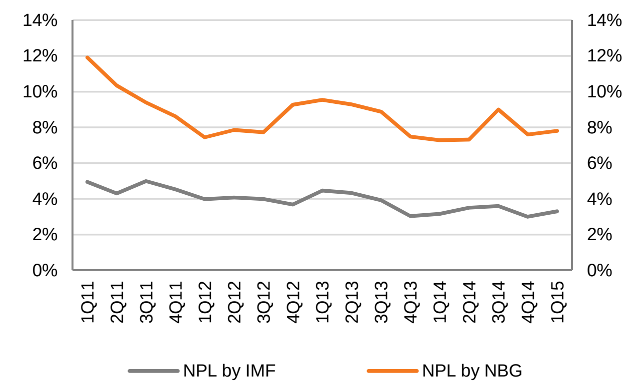
Banking sector is adequately capitalized and profitable with NPLs under control, despite high dollarization. Despite the depreciation since November 2014, consumer sentiment toward the GEL remained positive, preventing the conversion of GEL deposits. Deposit dollarization started picking up from January 2015 but remained relatively stable in the following months and even decreased slightly in May. Customer deposit dollarization stood at 65.9% in May, up 5.7ppts from end-2014. NPLs stood at 3.4%, down 0.3ppts y/y in May (at 3.3% in 1Q15 and at 7.8% by the NBG's more conservative definition). The banking sector remains profitable – ROE reached 12.7% in 1Q15, down just 2.9ppts y/y.

Figure 16: Dollarization



Source: NBG

Figure 17: NPLs



Source: NBG

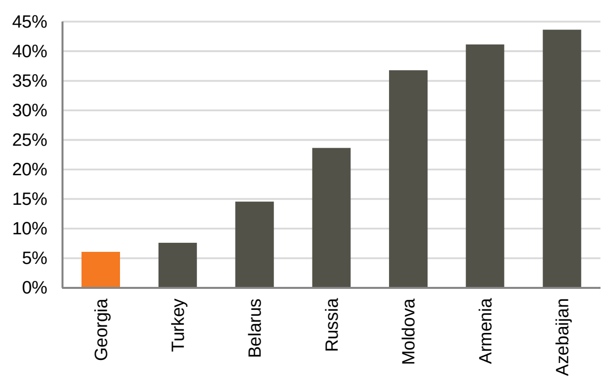
Georgia vs. Regional Economies

Stronger dollar weighed on regional currencies and economies; however, depth of currency crisis and policy responses differed across countries.

Georgia spent a considerably smaller share of its reserves supporting the GEL compared to regional economies. With their different exchange rate regimes, the central banks in Armenia, Moldova, Russia, Azerbaijan and Belarus lost a significant share of their reserves. They continued to support their currencies with no success. In Georgia, however, the floating exchange rate regime enabled the central bank to pursue limited interventions to defend the GEL, with a total net sale of US$ 160mn over May 2014-May 2015. As a result, over that period, Georgia's international reserves shrank by just 6.0% – some 25.9ppts lower than the average reserve losses of the abovementioned regional economies.

Interventions have not shielded regional currencies from sharp depreciation. Over May 2014–May 2015, the GEL weakened 30.0% against the dollar. In Armenia, where reserves were used extensively, the local currency only lost 15.8% against the dollar. In contrast, the MDL weakened 31.3%, the AZN 34.1%, the BYR 47.6% and the RUB 50.0%.

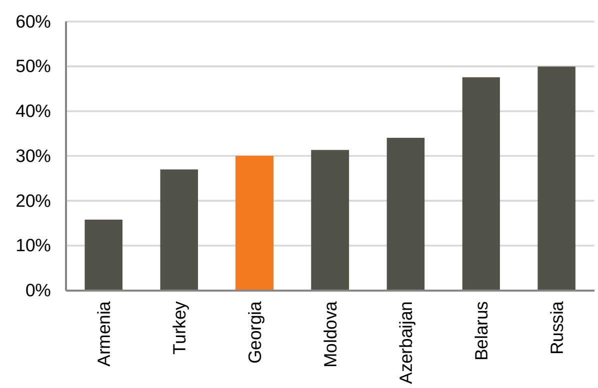
Figure 18: Reserve loss, % change



Source: IMF

Note: During May 2014 – May 2015, Armenian reserves excluding US$ 500mn Eurobond, issued in March 2015

Figure 19: Currency depreciation against the USD, %

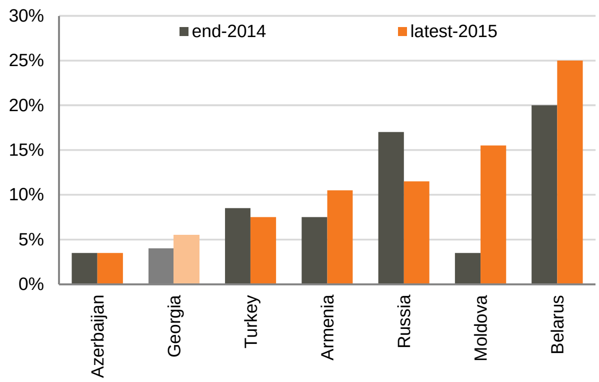


Source: Bloomberg

Note: During May 2014 – May 2015, eop

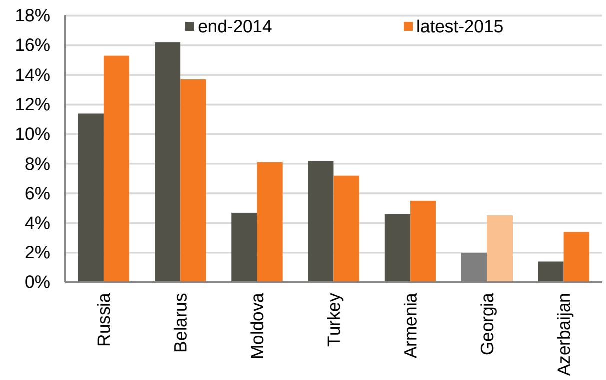
Regional economies faced inflationary pressures, prompting monetary tightening. Despite currency depreciation, inflation remained low in Georgia at the beginning of 2015, enabling the NBG to keep its policy rate low, creating a policy buffer. However, depreciation fueled inflationary pressures in regional economies; this was accompanied by monetary tightening which also hurt growth.

Figure 20: Monetary policy rates



Source: Central banks of relevant countries

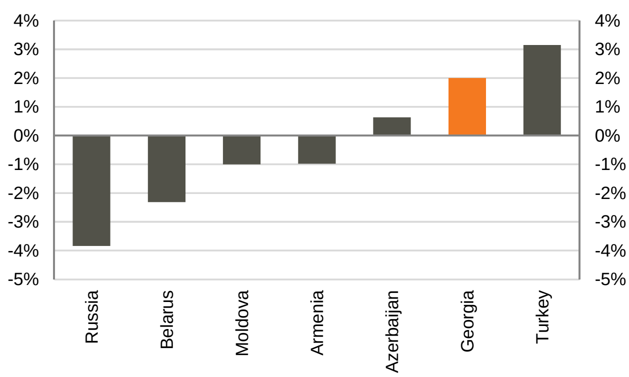
Figure 21: Inflation (consumer prices)



Source: Official statistics of relevant countries

Greater exchange rate flexibility and prudent policies have helped Georgia stand out among regional economies. The Georgian economy absorbed most of the external shocks through the exchange rate channel, easing the pressure on the real economy. This helped Georgia maintain a better growth outlook compared to other regional economies.

Figure 22: Real GDP growth projection, 2015



Source: IMF

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