Georgian Economy

Exposure to Turkey Lower than Broadly Believed

Georgia | Economy

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Currency depreciation in Turkey is raising concerns in Georgia, as many analysts believe that there is a direct link between TRY and GEL. While correlation to the currency of its largest trading partner exists, we argue that it is relatively low and significantly smaller than widely believed.

In recent years, TRY has seen far more rapid depreciation trends than GEL. GEL is however impacted in the short term by TRY through the expectations channel. For example, GEL's depreciation from September to November 2017 was largely driven by negative expectations amid TRY depreciation – there was no evidence from the trade, tourism or financial channels to explain the development.

Georgia's exposure (as defined by combination of four channels: exports, tourism, remittances and FDI) to Turkey accounted for only 6.1% of GDP in 2017. Notably, in the 2008-2017 period, exposure to Turkey increased by just 1.9ppts as a share of GDP, while exposure to other countries rose by 20.3ppts.

Georgia is a well-diversified economy and this minimizes the potential negative impact from turbulence in any particular market. This was illustrated in 2015-2016 when growth in Georgia slowed but remained positive at 2.8% as many of its trading partners entered recessions. Furthermore, Georgia 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.

Summing up:

- Given Turkey's economic structure, dependency on short-term portfolio funds flow, and domestic political developments, TRY has been more vulnerable to USD global strengthening than GEL.
- Inflation differential between Turkey (double-digits) and Georgia (low single-digits) justifies 6-8% annual outperformance of GEL against TRY in nominal terms.
- As Georgia enters the busy tourism season, GEL is expected to be stable over the June-September period.
- The ongoing currency crisis in Turkey may cause GEL to depreciate by 2-3% in the short term via the trade channel (to 2.49-2.52 vs US$).
- Pressure from TRY weakness will be offset by positive spillovers from Russia and Azerbaijan's recovery.
- We expect the current account deficit to improve slightly to 8.6% of GDP in 2018 (8.7% in 2017) and believe that the fundamental factors affecting GEL remain favorable. We see GEL's fair value close to 2.4 vs US$.
- We expect year-end GEL weakness, but we think that volatility will be lower compared to previous years.

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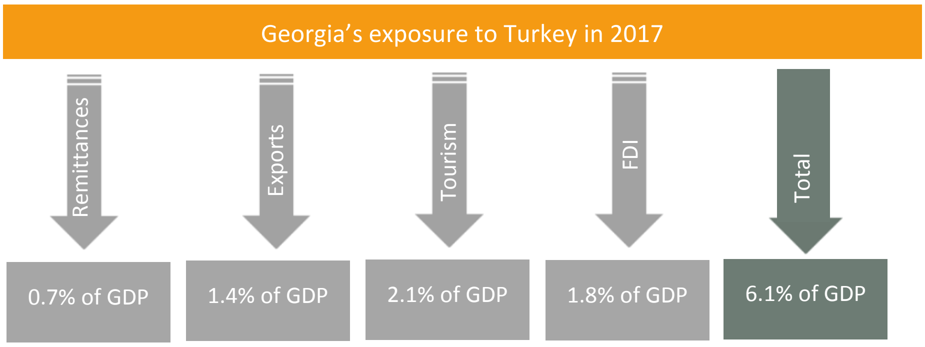
Georgia-Turkey economic links

In 2017, Georgia's exposure to Turkey accounted for 6.1% of GDP through the following channels:

- Remittances from Turkey accounted for 7.9% of total money transfers, or 0.7% of GDP.
- Exports to Turkey accounted for 7.9% of total exports, or 1.4% of GDP.
- Arrivals from Turkey accounted for 16.5% of total arrivals, and receipts from Turkish tourists reached 2.1% of GDP.
- FDI from Turkey accounted for 15.0% of total, or 1.8% of GDP.

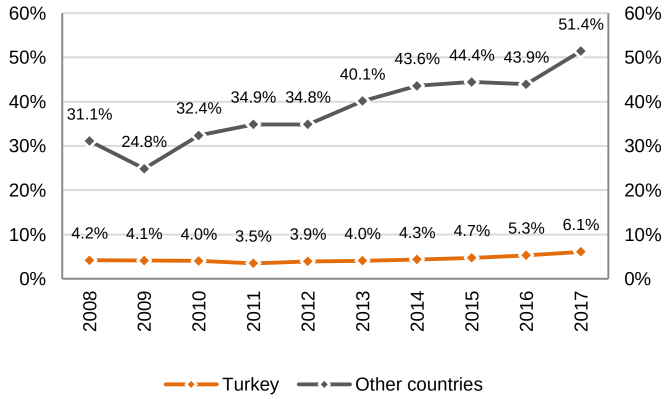
Figure 1: Georgia's exposure to Turkey in 2017



Source: NBG, GeoStat, GNTA, G&T Research

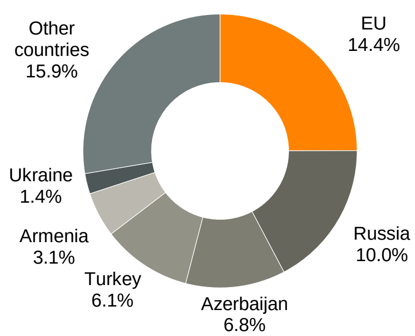
From 2008 to 2017, exposure to Turkey increased by just 1.9ppts to 6.1% of GDP, while exposure to other countries rose by 20.3ppts to 51.4%. Improved economic links with the EU, China and other countries (Iran in terms of tourism) help Georgia to weather any turbulence in its partner countries relatively well. This was illustrated in 2015-2016 when growth in Georgia slowed but remained positive at 2.8% as many of its trading partners entered recessions. Then, growth accelerated to 5.0% in 2017 when regional economies recovered.

Figure 2: Georgia's exposure to partner countries via exports, remittance, FDI and tourism (% of GDP)



Source: NBG, GeoStat, GNTA, G&T Research

Figure 3: Georgia's exposure to partner countries via exports, remittance, FDI and tourism (% of GDP), 2017

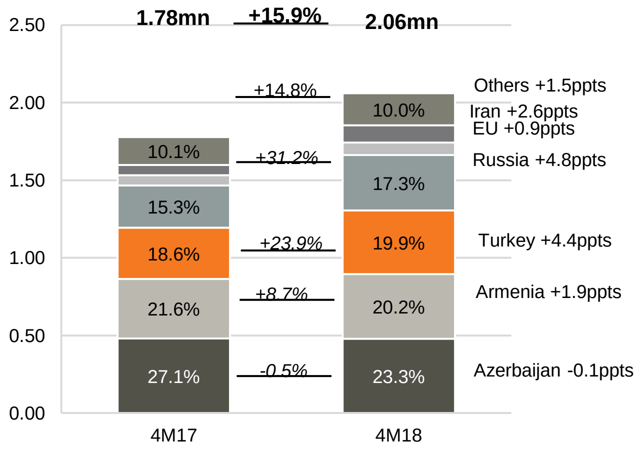


Source: NBG, GeoStat, GNTA, G&T Research
Note: BP-related FDI excluded from Azerbaijan and included in EU

Tourism is the largest exposure to Turkey and accounted for 2.1% of GDP in 2017. Temporary travel restrictions (related to the failed coup) introduced by the Turkish government in 2016 as well as renovation works on the Turkish side of the Georgia-Turkey customs check-point have been weighing on Turkish arrivals since June 2016. However, Turkish arrivals rebounded strongly in 2H17, decreasing by just 0.8% y/y in 2017 and accounting for 16.5% of total arrivals.

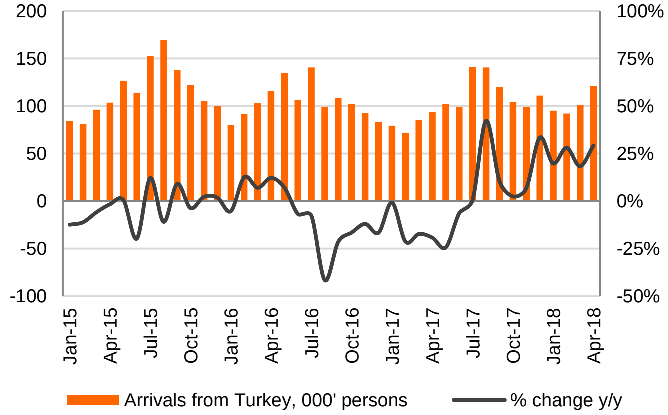
Arrivals from Turkey increased 23.9% y/y in 4M18, and we expect arrivals to grow. Georgia is a neighboring and relatively affordable country for Turkish visitors. They do not need visa or international passport (which is expensive in Turkey) to travel to Georgia and can access it by car. Among other attractions, Georgia offers gambling to Turkish visitors, which has limited alternatives in the region. Overall, we do not expect economic developments in Turkey to have a negative impact on the number of Turkish visitors.

Figure 4: International arrivals to Georgia, 4M18



Source: GNTA

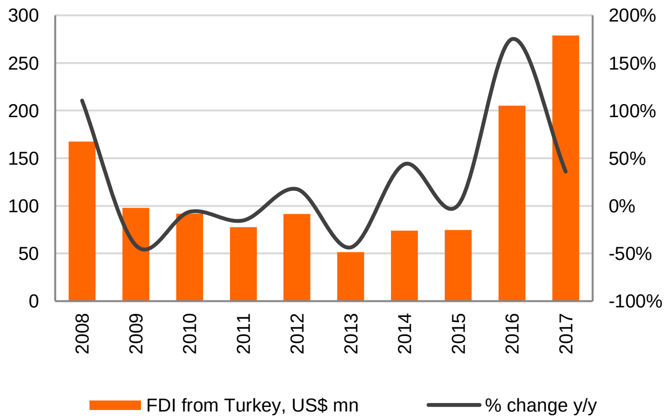
Figure 5: International arrivals from Turkey



Source: GNTA

FDI from Turkey continues to grow strongly. Investment from Turkey increased by 36% y/y in 2017 and accounted for 15% of the total (or 1.8% of GDP), continuing the 2014-2016 trend. This highlights that policy uncertainty in Turkey, combined with Georgia's business-friendly environment, is resulting in capital moving from Turkey to Georgia. Turkish investments are mainly directed toward the energy, manufacturing, hospitality and transport sectors.

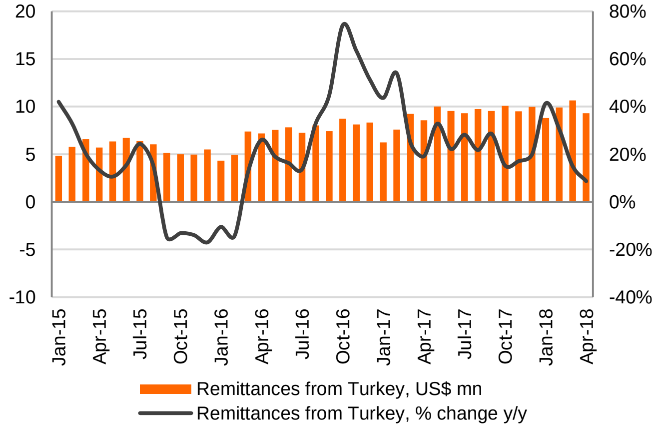
Figure 6: FDI from Turkey



Source: GeoStat

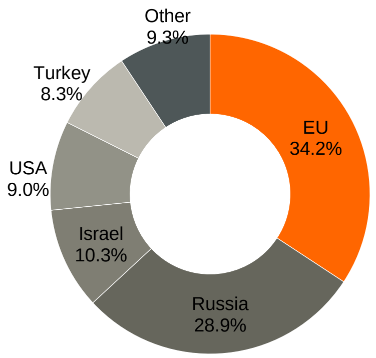
Remittances from Turkey grew by 36% y/y in 2017 (7.9% of the total or 0.7% of GDP), and Turkey's share of total remittances has been increasing in recent years.

Figure 7: Remittances from Turkey



Source: NBG

Figure 8: Money transfers by country, 1Q18



Source: NBG

Banking sector links to Turkey are limited. Two Turkish banks have subsidiaries operating in Georgia, but these accounted for just 0.8% of total banking sector assets in Georgia as of April 2018.

Goods trade with Turkey

Turkey is Georgia's largest trading partner. It is traditionally a top source of imports and was Georgia's third-largest export market in 2017.

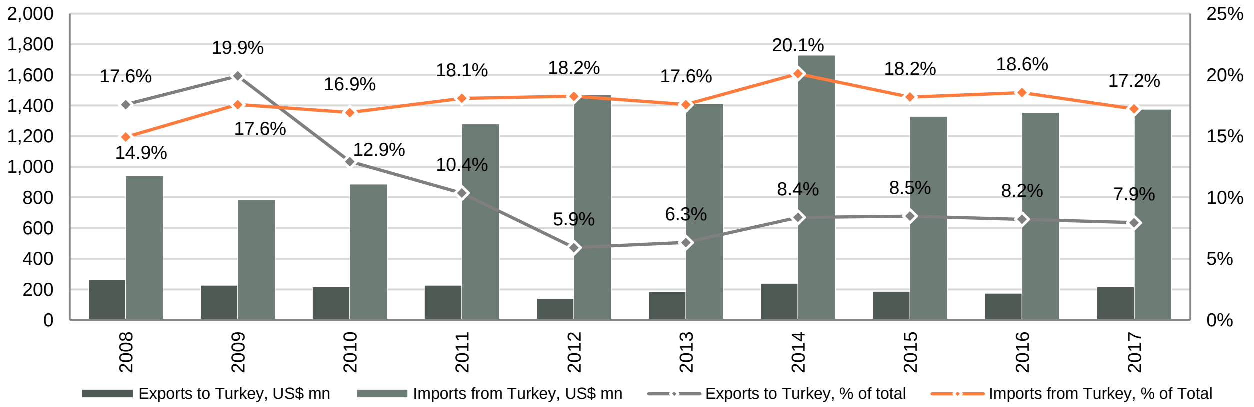
The major concern when TRY depreciates is that cheap imports from Turkey could flood the Georgian market, widening the trade deficit and adversely affecting GEL. The trade balance with Turkey improved by 1.9% y/y in 2017 despite the GEL's real appreciation against the TRY, as exports to Turkey rose by 24.7% y/y while imports increased 1.6% y/y. Moreover, the major adjustment in Georgia's imports in the wake of GEL depreciation in 2015 came on the back of a 23.2% y/y reduction in imports from Turkey.

Share of exports directed to Turkey dropped significantly in 2012-2017 as other markets gained (e.g. 17.6% of the total went to Turkey in 2008 vs 7.9% in 2017). The low volume of Georgian commodity exports that go to Turkey and their low share of GDP demonstrate that Georgia's dependence on the market is limited. The growing number of free trade deals is another positive in terms of diversifying export markets. Moreover, the markets where Georgia exports agricultural products (nuts, fruits, etc.) and wine are more important (e.g. EU, Russia and China), and as these products are more competitive, local value added is high and there is room for further growth.

In 4M18:

- Turkey's share in Georgia's total exports is 10.8% (third-largest market), exports up 36% y/y
- Turkey's share in Georgia's total imports is 15.7% (largest market), imports up 18% y/y
- Trade deficit with Turkey up 13% y/y

Figure 9: Trade with Turkey



Source: GeoStat

Georgia's exports to Turkey, US$ mn		
	2016	**2017**
T-shirts	37	43
Iron and Steel	12	27
Ferro-alloys	12	25
Electricity	13	12
Bars and rods	12	12
Other products	87	99
Total exports to Turkey	174	217
Georgia's total exports	**2,113**	**2,728**

Source: GeoStat

Georgia's imports from Turkey, US$ mn		
	2016	**2017**
Pharmaceuticals	51	68
Tubes and pipes	41	46
Structures of iron	57	38
Sanitary commodities	35	32
Cars	11	30
Other products	1,159	1,159
Total imports from Turkey	1,354	1,375
Georgia's total imports	**7,295**	**7,983**

Source: GeoStat

GEL and TRY

USD appreciation put pressure on both TRY and GEL in 2014-2016 through different channels.

This was especially the case for TRY due to (1) the structure of Turkey's external financing, (2) concerns related with domestic political developments (referendum on constitutional reforms in 2016, and (3) most recently President Erdogan's objection to increases in interest rates.

In 2014-2016, GEL was mostly affected by reduced goods exports and remittances as Georgia's partner countries' currencies depreciated and economies contracted. However, tourism remained resilient and sector revenues continued to grow. To absorb external shocks, the central bank let GEL depreciate by 28.5% in 2015 and imports adjusted (the loss from reduced exports and remittances was US$1.0bn, while the savings from reduced imports was US$1.3bn in 2015). Thus, macroeconomic stability was secured. As a result, economic growth slowed but remained positive, while many Georgia's partners moved into recession.

	2010	2011	2012	2013	2014	2015	2016	2017	24-May-17	24-May-18
End of period										
GEL/US$	1.77	1.67	1.66	1.74	1.86	2.39	2.65	2.59	2.41	2.45
TRY/US$	1.55	1.91	1.79	2.14	2.32	2.91	3.53	3.77	3.57	4.85
(+depreciation/-appreciation)										
GEL/US$		-5.8%	-0.8%	4.8%	7.3%	28.5%	10.5%	-2.1%	12.5%	1.4%
TRY/US$		23.2%	-6.4%	19.3%	8.4%	25.5%	21.3%	6.9%	19.4%	35.9%

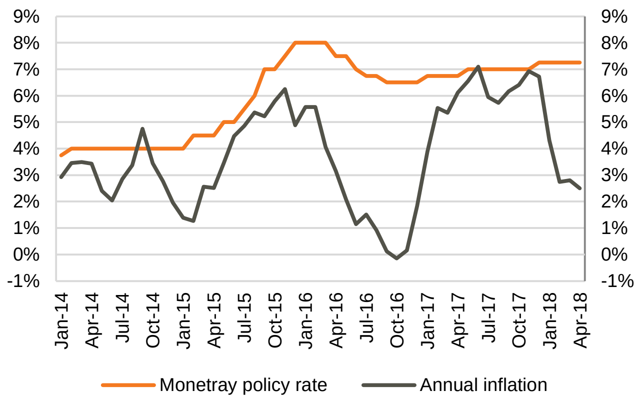
Source: NBG

Georgia and Turkey, both running chronic current account deficits, have different sources for their funding.

In Turkey, the current account deficit has been financed through "hot money", which makes TRY far more vulnerable to global FX developments. Plus, political factors have been dominating economic factors recently, and there was strong political pressure on the central bank not to increase its policy rate, doing what was necessary in response of increased inflation.

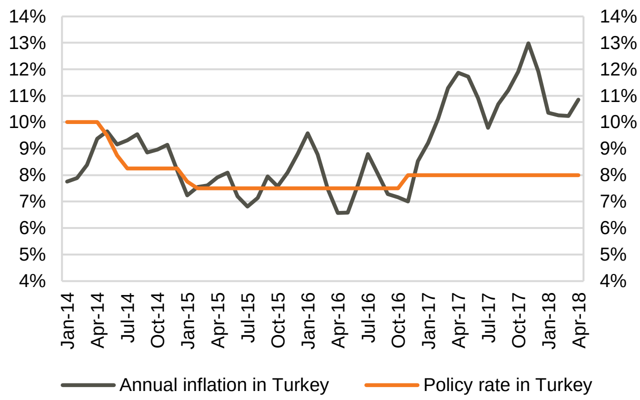
Contrary to Turkey, Georgia's current account deficit is financed mainly through FDI, which is not immediately sensitive to global volatility in FX markets. Moreover, FDI flows have boosted economic growth and export potential, which is a key difference: deficit is neither a threat to the health of the economy, nor the precursor of a currency crash, as it has proven to be in many other emerging markets. Plus, the Georgian central bank is pursuing prudent measures, tightening policy when needed as part of a commitment to price stability. So, given pressure on the Turkish central bank to implement prudent policies and raise the policy rate, TRY has been depreciating far more rapidly than GEL.

Figure 10: Monetary policy rate and inflation in Georgia



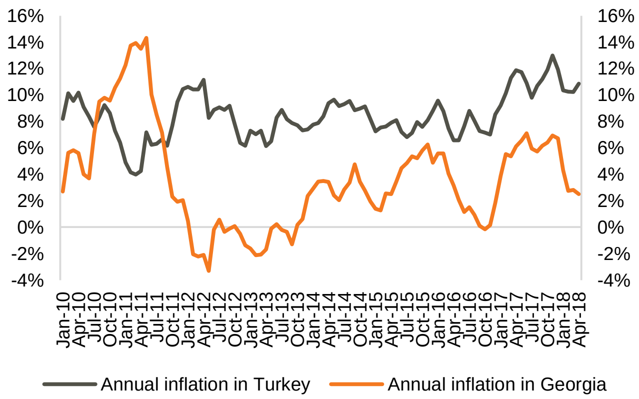
Source: NBG, GeoStat

Figure 11: Monetary policy rate and inflation in Turkey



Source: Turkstat, Central Bank of Turkey

Figure 12: Inflation: Turkey and Georgia



Source: GeoStat, Turkstat

Generally, GEL is more stable during summer due to tourism and weaker in 4Q as seasonal imports increase (New Year related, energy imports) and tourist arrivals slow. Year-end GEL weakness was seen in 2014-2017, but different factors explain these episodes of depreciation, including negative expectations established over years, global factors (e.g. Trump's election in 2016) as well as expectations arising from TRY and RUB movements.

GEL is however impacted in the short term by TRY through the expectations channel. For example, GEL's depreciation from September to November 2017 was largely driven by negative expectations amid TRY depreciation and despite Georgia's current account deficit being at an all-time low in 3Q17 and in 2017 overall.

Based on our model-based estimates regarding the trade channel with Turkey:

- 10% depreciation of TRY vs US$ causes GEL to depreciate by 1.2% vs US$ in the short term (up to one year)

However, the abovementioned link has the potential to weaken/intensify given losses/benefits from other channels with Turkey (remittances, tourism and FDI).

If we assume current developments in Turkey continue, we would expect GEL to appreciate vs TRY by 24% in real terms from May 2018 to December 2018. This would widen the trade deficit with Turkey and likely pressure GEL. Our calculations are based on the following assumptions for May-December 2018:

- Inflation in Georgia at 3%
- Inflation in Turkey at 12%
- TRY vs US$ at 4.9

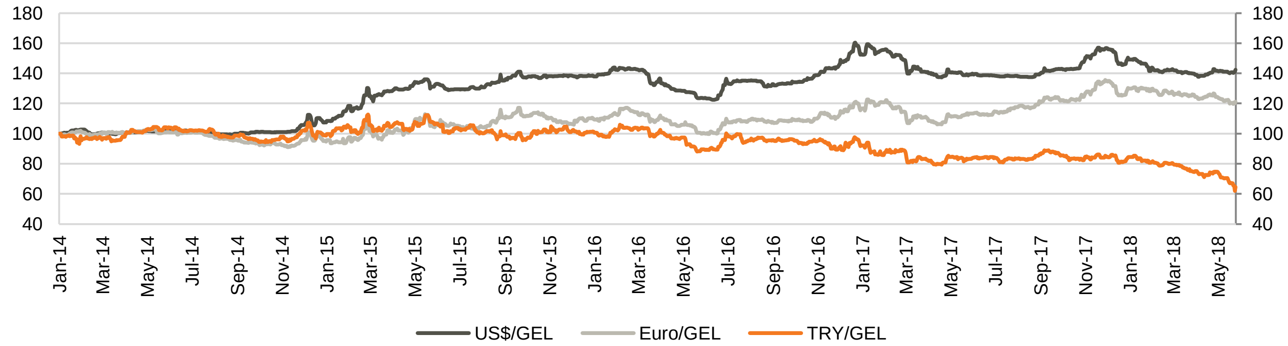
Notably, the same pace of GEL's real appreciation against TRY was seen in 2011 (24%), and there was no effect on GEL/US$ despite a wider trade deficit (+56% y/y) with Turkey.

GEL has been appreciating since December 2017. The appreciation strengthened at the beginning of April, with GEL moving below 2.4 vs US$. The NBG purchased US$20mn to limit further appreciation. The GEL depreciated slightly from mid-April to move into the range of 2.43-2.47 against the US$. This can be explained by the deteriorated trade balance in March-April as well as negative expectations from TRY and RUB depreciations. However, macroeconomic factors supporting the FX rate remain favorable, and considering that Georgia is entering the busy tourism season, we expect the GEL to be close to 2.4 in the medium term despite volatility in major trading partners' currencies. We also expect reduced year-end volatility in FX and expect GEL vs US$ in the range of 2.5-2.6 in 4Q18.

Summing up:

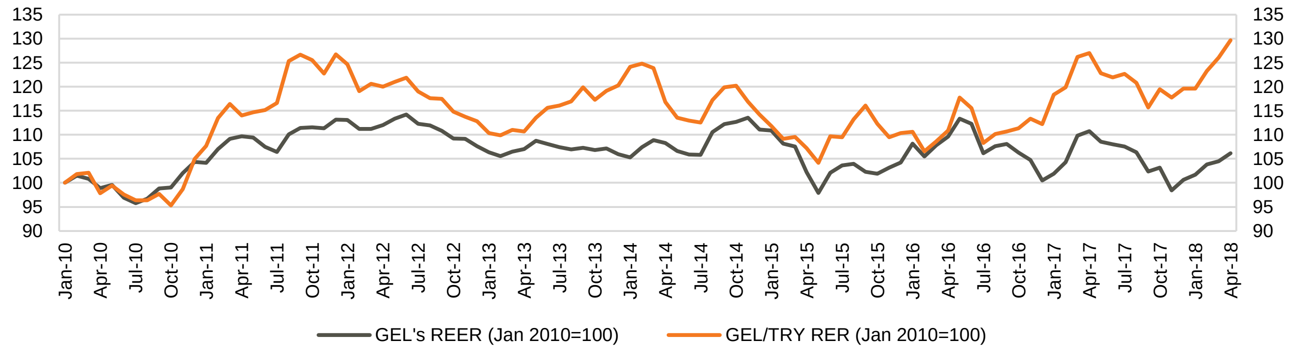
- Current GEL weakness is related to negative expectations given TRY depreciation.
- As Georgia enters the busy tourism season, GEL is set to be stable over June-September.
- The ongoing currency crisis in Turkey may cause GEL to depreciate by 2-3% in the short term via the trade channel (to 2.49-2.52 vs US$)
- Pressure form TRY weakness will be offset by positive spillovers from Russia and Azerbaijan's recoveries.
- We expect the current account deficit to improve slightly to 8.6% of GDP in 2018 (8.7% in 2017) and believe that fundamental factors affecting GEL remain favorable. We see GEL's fair value at close to 2.4 vs US$.
- We expect year-end GEL weakness, but we think that volatility will be lower compared to previous years.

Figure 13: FX



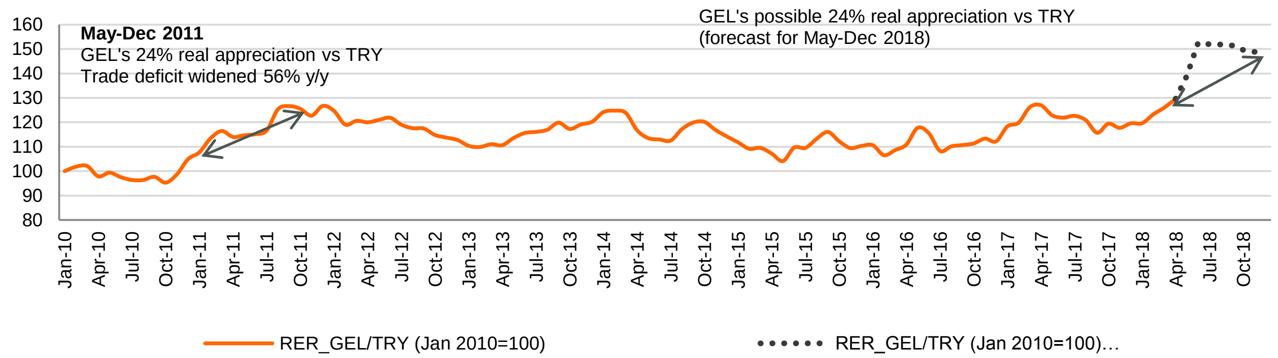
Source: NBG

Figure 14: GEL's real exchange rate vs TRY and GEL's real effective exchange rate (weighted for 10 major trade partners, including Euro zone)



Source: NBG
Note: Index growth means GEL's appreciation and decline means GEL's depreciation

Figure 15: GEL's real exchange rate vs TRY



Source: NBG, G&T Research

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