GALT & TAGGART
RESEARCH

Georgian Economy
Private Sector - Growth Driver

Georgia | Economy

November 19, 2014

Georgia's real GDP growth reached 5.9% y/y in 9M14 outperforming regional peers. The private sector has been the main driver of growth so far in 2014, accounting for the bulk of the investment spending, which was up 28.1% in 1Q14 and up 27.6% in 2Q14. The private sector's strong performance has also generated strong tax revenues (2.7ppts above plan) and credit growth of 21% in 9M14. Inflationary pressure remains low with inflation 3.4% in October, well below central bank's target of 6.0%. However, the increased trade deficit, moderate growth of remittances and tourism revenues and weak FDI weigh on Georgia's external balance and may put moderate pressure on lari. As 9M14 budget deficit reached to 1.1% of GDP, there is a room for fiscal expansion to boost growth. We expect 5.0%+ annual GDP growth in 2014 even without planned fiscal stimulus, supported by private sector investments. 2015 draft budget aims at fiscal consolidation with deficit declining to 3.0% of GDP and public debt at a comfortable 35.7% of GDP. Fiscal framework remains prudent with total expenditures below 30% of GDP in 2015. The share of capital spending increases by 1.3ppts y/y since growth of capital spending at 15.0% y/y significantly outpaces 5.9% y/y increase in current spending in 2015 draft budget. Overall, economy remains well diversified, resilient to geopolitical tensions and medium term growth looks sustainable.

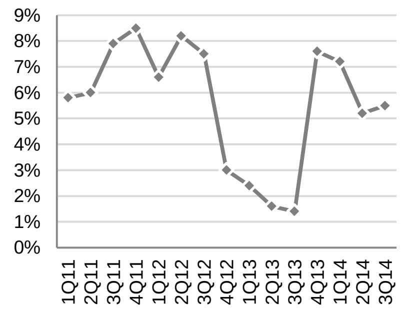
Private sector driving growth in 2014 with investments up 27.6% y/y in 2Q14. Private investments drove the growth in the quarter, accounting for 89.2% of the total investments and up 25.5% y/y in 2Q14. Public investments also increased 49% y/y in 2Q14, although from a lower base. As a result, investments as a share of GDP increased 5.5ppts y/y to 31.4% in 2Q14.

Private consumption continued its upward trend, adding 5.3% y/y in 2Q14 – the biggest hike since 4Q13. Notably, despite resumed consumption and moderate growth of remittances, national savings continued to grow and reached 23.1% of GDP in 2Q14 (+2.2ppts y/y).

The contribution of construction was the highest to 2Q14 growth. Construction increased 17.9% y/y in 2Q14; communications (+10.0%) financial sector (+9.6%), manufacturing (+8.1%) and transport (+6.9%) were the other top performers. Georgia's economic structure remains well diversified, with the two biggest sectors (trade and manufacturing) accounting for just 33.8% of 1H14 GDP, ensuring the economy's flexibility in the face of regional uncertainties.

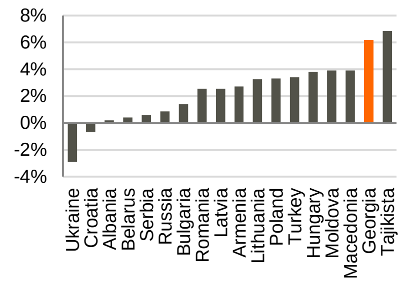
Economic activity remains solid with real GDP growing 5.5% in 3Q14 according to Geostat's preliminary estimates, despite a drop in exports. As a result, 9M14 real GDP growth remains solid at 5.9% y/y, once again marking economy's flexibility and resilience to external shocks.

Figure 1: Real GDP growth



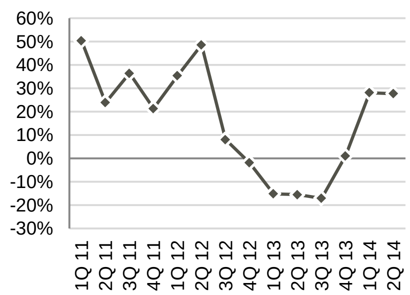
Source: GeoStat

Figure 2: 1H14 real GDP growth vs peers



Source: Relevant statistical offices

Figure 3: Real investment growth



Source: GeoStat, G&T Research

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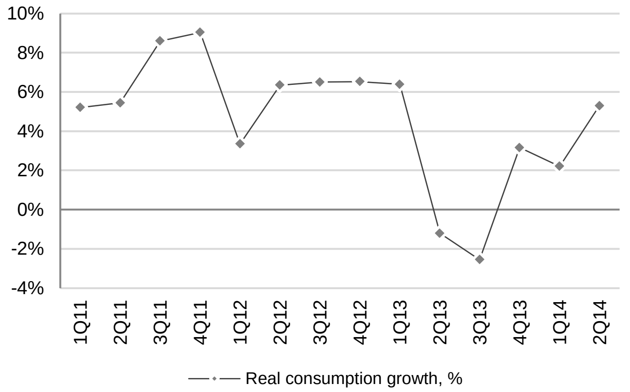
Planned fiscal expansion can also boost growth in 4Q14. As public debt to GDP remains comfortable at 33.1% and the fiscal deficit is at 1.1% of GDP in 9M14 (planned at 3.7% of GDP in 2014), the government can boost growth further through fiscal expansion in the remainder of 2014. We expect that fiscal stimulus will have a moderate impact on lari depreciation if deficit widens above 2.5% of GDP in 2014.

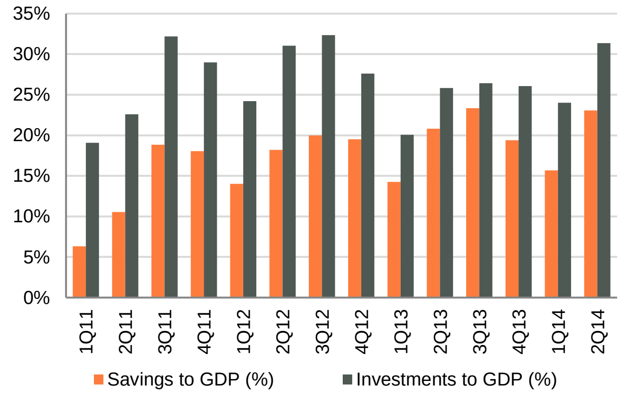
Even without fiscal expansion we expect 5%+ growth in 4Q14, as credit growth remains robust, at +21.8% y/y and investment goods import increased 16.7% y/y in September, tax collection was also strong, +14.2% y/y in 3Q14.

Figure 4: Private consumption real growth



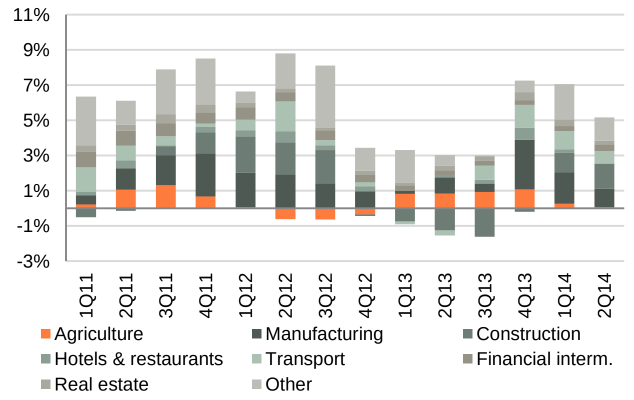
Source: GeoStat, G&T Research

Figure 5: Savings and investments as % of GDP



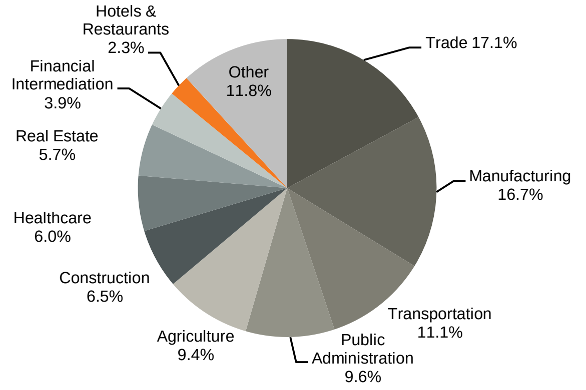
Source: GeoStat, G&T Research

Figure 6: Contributions to real GDP growth by sectors



Source: GeoStat, G&T Research

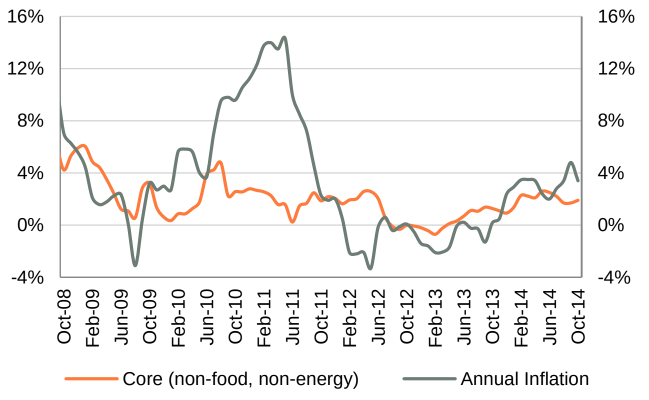
Figure 7: 1H14 GDP structure



Source: GeoStat

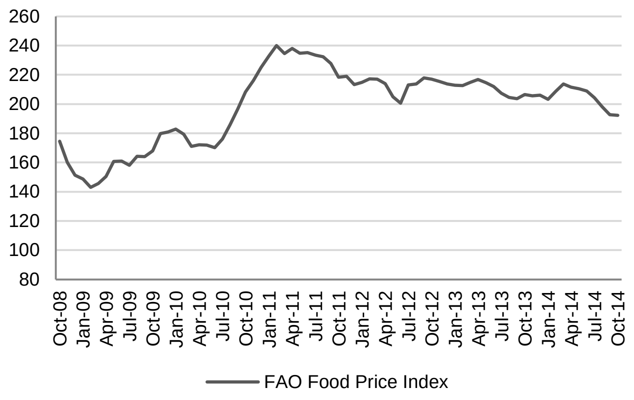
Inflation remains low at 3.4% y/y in October 2014. Price increases in food, beverages, tobacco and healthcare were drivers of inflation in 2014. As world food prices continue to drop and food has the highest weighting within Georgia's consumer basket (30.25%), we expect inflation to remain subdued, enabling the monetary authority to keep the policy rate at the current 4.0%.

Figure 8: Inflation dynamics in Georgia



Source: GeoStat, NBG

Figure 9: FAO food price index

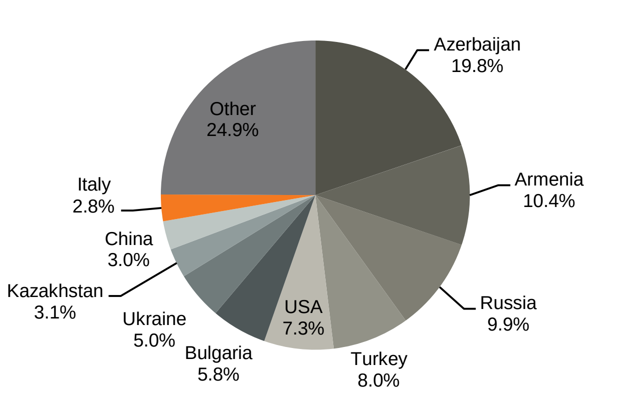


Source: FAO

Foreign Trade

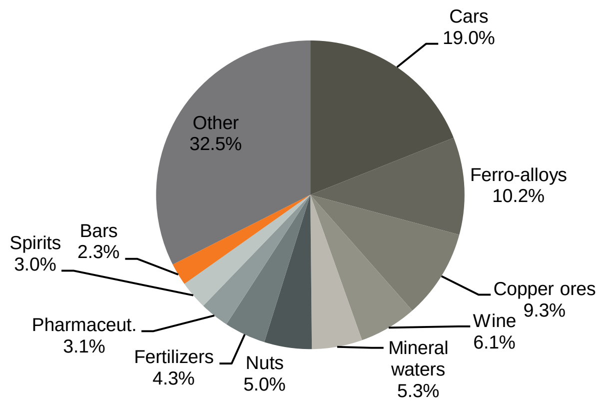
21% of exports were directed to the EU, 52% to CIS and 27% to other countries in 9M14. While exports to Russia increased considerably, its share still remains 7.9ppts below of 2005 level (pre-embargo) at 9.9% of total exports (1.7% of GDP in 1H14). Therefore, any possible deceleration of exports to Russia will have limited costs for Georgia.

Figure 10: Export structure by country, 9M14



Source: GeoStat

Figure 11: Export structure by product, 9M14

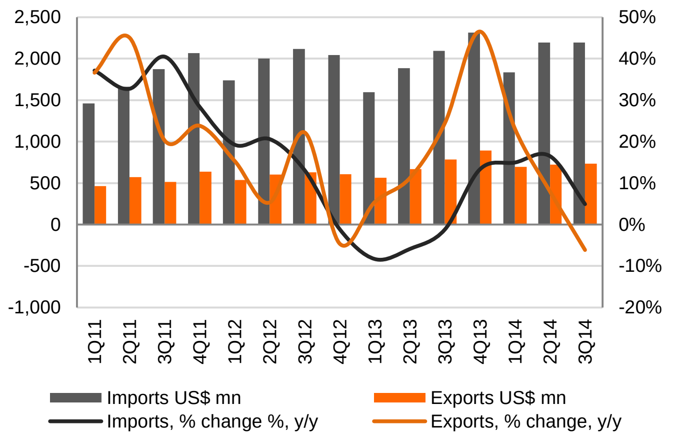


Source: GeoStat

Exports growth remains well above zero in 9M14 despite a negative impact from CIS export markets (Azeri and Ukrainian). As exports dropped to Ukraine and Azerbaijan (restrictions on used car imports), total exports decreased 6.2% y/y in 3Q14. However, 9M14 export growth was still positive +6.7% y/y, on the back of strong growth for the following commodity exports: ferro-alloys (+19.7% y/y), copper (+108.7% y/y), wine (+75.8% y/y), mineral water (+56.2% y/y), nuts (+30.0% y/y), and pharmaceuticals (+72.3% y/y).

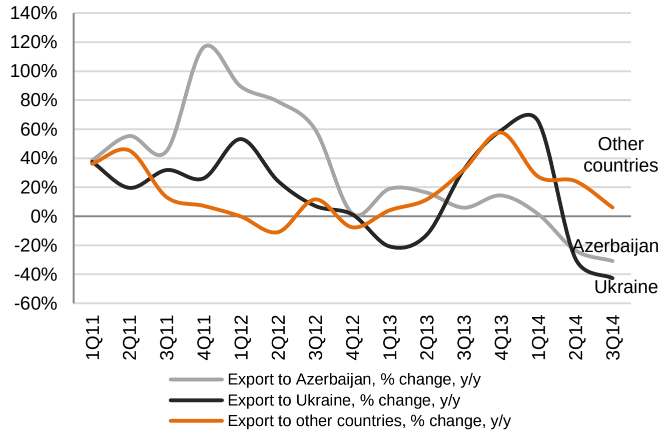
There is a positive sign that car re-exports will resume, as car imports grew 37.7% y/y in September. This may indicate that Georgian car exporters are gradually adjusting to Azerbaijan's (the biggest market for car re-exports) new regulations for car imports, effective since April 2014, in our view.

Figure 12: Foreign trade



Source: GeoStat

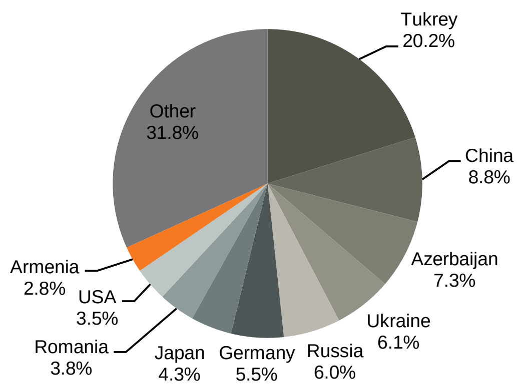
Figure 13: Exports to Azerbaijan and Ukraine



Source: GeoStat

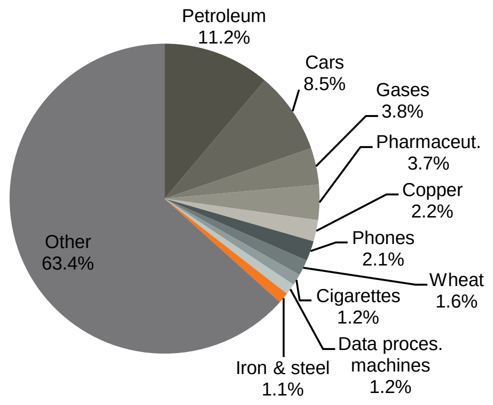
Alongside the economic recovery, imports grew 11.7% y/y in 9M14; however, import growth slowed in August/September mainly due to falling oil prices. Petroleum is the major imported commodity representing 11.2% of imports in 9M14, benefiting Georgia from lower oil import bill (exact impact is yet uncertain, we expect benefit of US$ 120-150mn in 2014 at this point).

Figure 14: Import structure by country, 9M14



Source: GeoStat

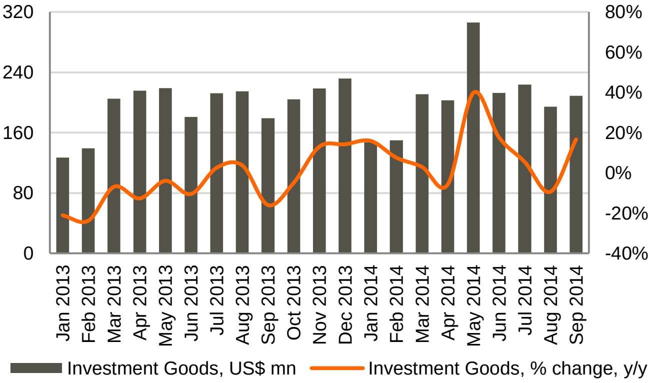
Figure 15: Import structure by product, 9M14



Source: GeoStat

Investment goods import picked up again at 16.7% y/y in September, after a little slowdown in July/August, which is a good sign for economic robustness. In 9M14, investment goods imports increased 10% y/y.

Figure 16: Investment goods import



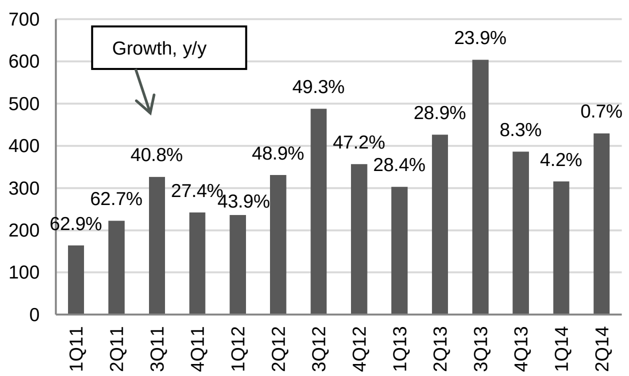
Source: GeoStat

Tourism

Tourism revenues increased moderately by 2.2% in 1H14, as receipts increased by just 0.7% in 2Q14 – 3.5ppts lower than 1Q14. In 1H14, tourism generated US$ 745.2mn. We expect moderate growth of tourism revenues for the remainder of the year, as 9M14 growth in international arrivals was at 2.1% y/y. We forecast 7.1% growth (to 6mn) in arrivals for 2015. NBG intervened in the FX market in August and purchased US$ 120mn on the back of tourism inflows.

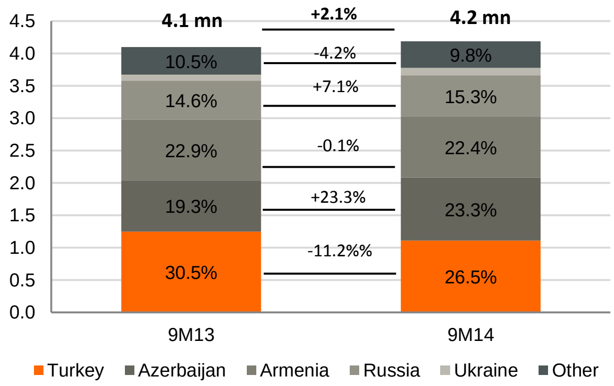
Drop in Turkish arrivals of -11.2% in 9M14 was the main reason behind the lower growth of tourism arrivals at 2.1% in 9M14. Despite this decline, Turkey is still the top country by international arrivals (26.5% of total). Arrivals from Azerbaijan, the country with the second most visitors, increased significantly, +23.3% in 9M14, which was more than sufficient to mitigate the drop in Turkish visitors. Russia, another top country by visitors, saw an increase of 7.1% y/y and its share reached 15.3% of the total in 9M14.

Figure17: Tourism revenues, US$ mn and growth y/y



Source: NBG

Figure 18: International arrivals, mn

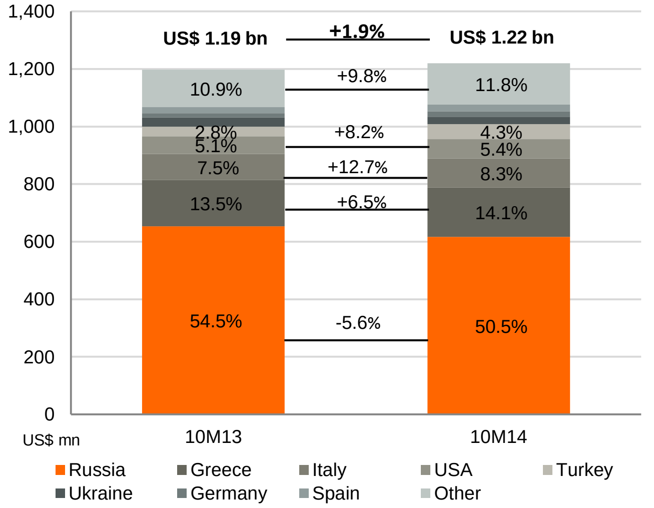


Source: GNTA

Remittances

Despite money transfers from Russia decreasing 5.6% y/y in 10M14, total transfers grew 1.9% y/y in 10M14. Russia continues to account for the half of Georgia's remittances (50.5% in 10M14 vs 54.5% of total in 10M13). In 10M14, remittances increased significantly from Turkey +54.9%, and money inflows from the other traditional donor countries also grew: Greece (+6.5%), Italy (12.7%) and USA (+8.2%). Though growth is sluggish, we anticipate that remittances will be resilient (net transfers will be at 9% of GDP in 2014).

Figure 19: Remittances 10M14 vs 10M13



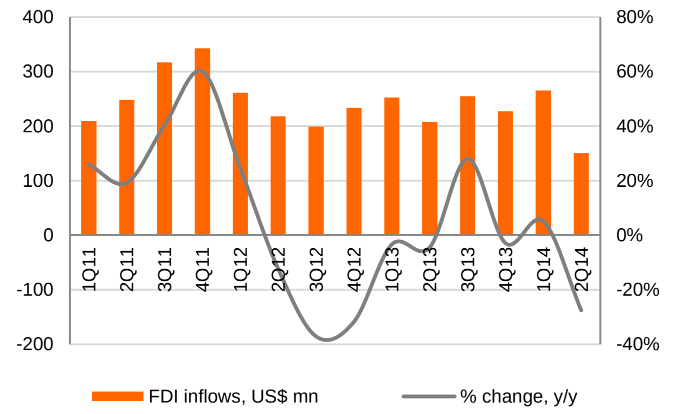
Source: NBG

FDI

In 2Q14, FDI was weak (-27.6% y/y) and external funding was secured by an increase in portfolio investments in the banking sector. The transport and communications sector was the largest FDI recipient in 1H14 with 34.9% of net inflows, followed by the manufacturing sector (25.1%) and energy (13.7%).

Netherlands topped the list of investors with US$ 174.8mn (42% of net inflows), followed by Azerbaijan (US$ 123.4mn, 29.7% of net inflows) in 1H14. While Russia's share was 9.2% of net FDI inflows in 1H14, its share in net cumulative FDI remained limited during 2012-1H14 at 2.7%.

Figure 20: FDI inflows

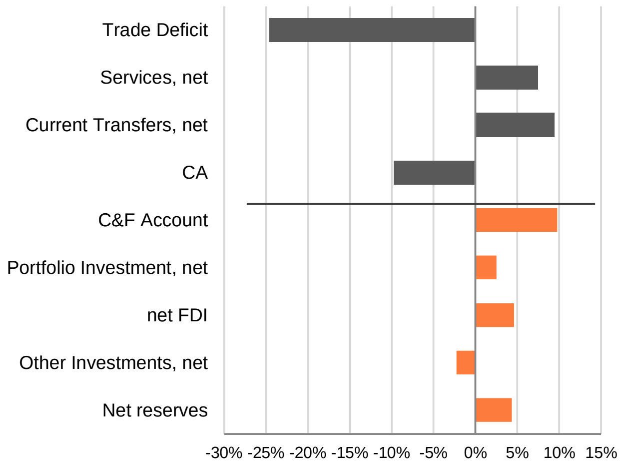


Source: Geostat

Current Account

Current account deficit is supposed to widen driven by weak external environment and resumed imports. The 1H14 trade deficit reached to 24.6% of GDP as merchandise import grew 13.5% y/y. Net services and net transfers were enough to finance 68.6% of trade deficit. As a result, 1H14 current account deficit reached 9.8% of GDP. Net FDI (4.6% of GDP) and net portfolio investments (2.5% of GDP) were enough to finance 72.5% of CA deficit. As tourism receipts and exports come under pressure we estimate that current account deficit will widen to 8-9% in 2014.

Figure 21: Current account balance 1H14 (% of GDP)

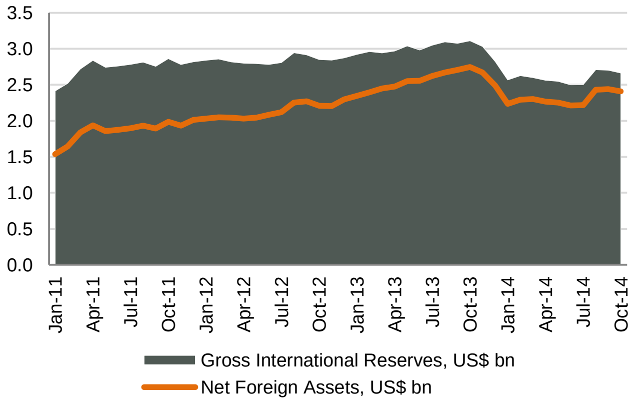


Source: NBG, GeoStat

International Reserves

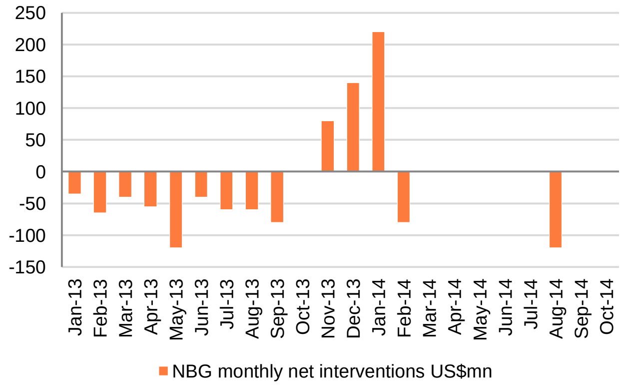
Gross foreign reserves stood at US$ 2.7bn as of end-October 2014, sufficient to finance 3.0 months of merchandise and services imports. As FDI was weak, NBG managed to build reserves in August only, with a purchase of US$ 120mn, on the back of tourism inflows. We expect gross reserves to be maintained at US$ 2.7bn at end-2014. With envisaged fiscal tightening helping to reduce the current account deficit and the significant decrease in public external debt repayments in 2015, we expect NBG reserves to increase to US$ 3bn at the end of 2015.

Figure 22: NBG foreign reserves



Source: NBG

Figure 23: NBG FX interventions

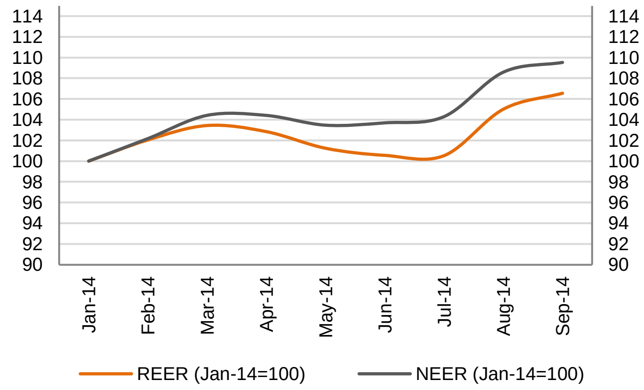


Source: NBG

Exchange rate

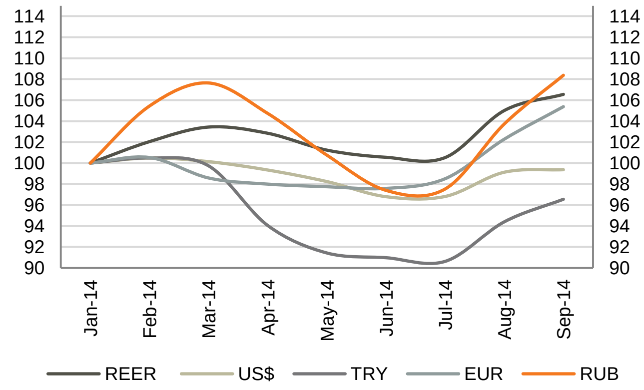
Lari has remained resilient in 2014, weakening only by 1.6% to US$. Weaker currencies in Russia and Ukraine and later in the eurozone led to the strengthening of Georgia's nominal and real effective exchange rates (+9.5% and +6.6% in September). With weak external environment and current account deficit supposed to widen, lari may come under moderate pressure. We acknowledge that lari depreciation is desired to adjust imbalances and support Georgia's external competitiveness, despite its still-high dollarization.

Figure 24: NEER and REER



Source: NBG

Figure 25: REER, selected currencies



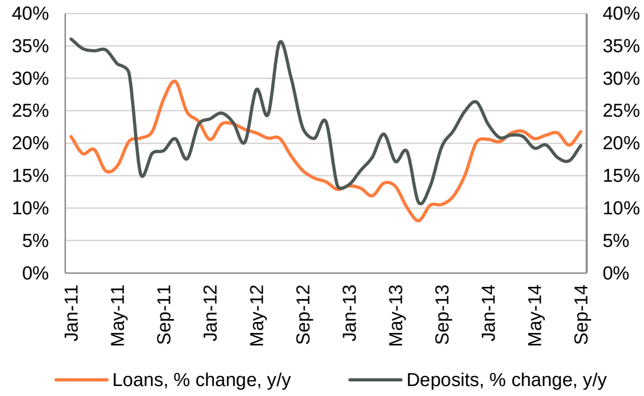
Source: NBG

Banking sector

Robust growth in loans and deposits in 2014. Accommodative monetary policy and strengthened consumer confidence has prompted loan growth of above 20% in 9M14, reaching 21.8% y/y in September, with retail lending growth outperforming corporate lending growth. Deposits grew at 19.6% in September 2014.

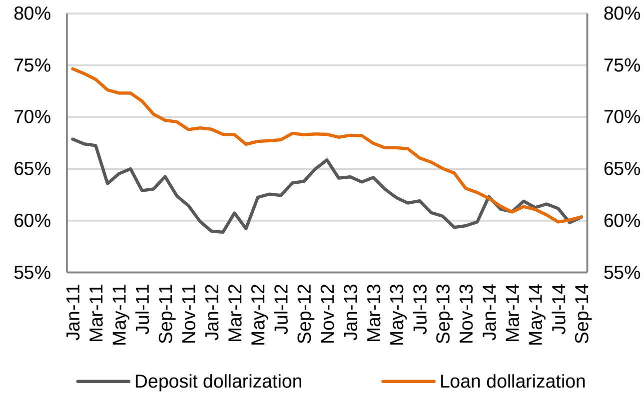
Dollarization of loans is on the decline and dollarization of deposits has stabilized. Loan dollarization dropped 2.3ppts to 60.4% in September 2014 from end-2013. Deposit dollarization has stabilized since the currency depreciation at end-2013 and reached 60.3% in September.

Figure 26: Total loans and deposits



Source: NBG

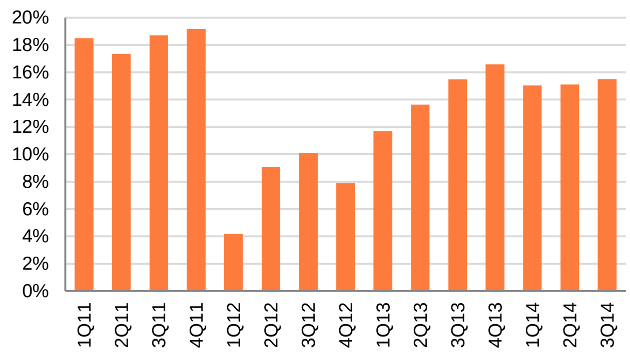
Figure 27: Dollarization of loans and deposits



Source: NBG

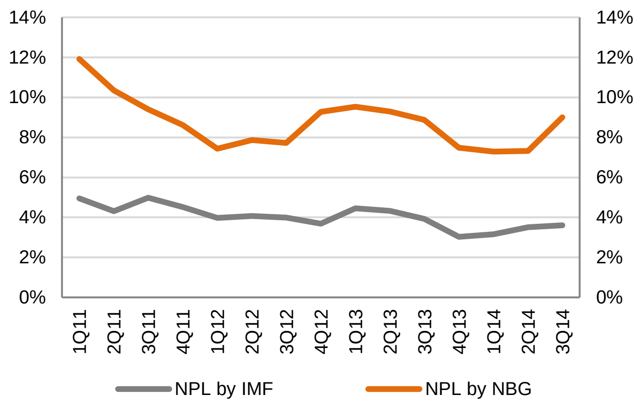
Banking sector profitability remains stable and NPLs are contained. Banking sector ROE reached 15.5% in 3Q14, unchanged y/y. NPLs stood at 9.0% in 3Q14 according to the NBG's more conservative standards and at 3.6% according to the standard 90-day-overdue definition.

Figure 28: ROE



Source: NBG

Figure 29: NPLs



Source: NBG

Fiscal framework

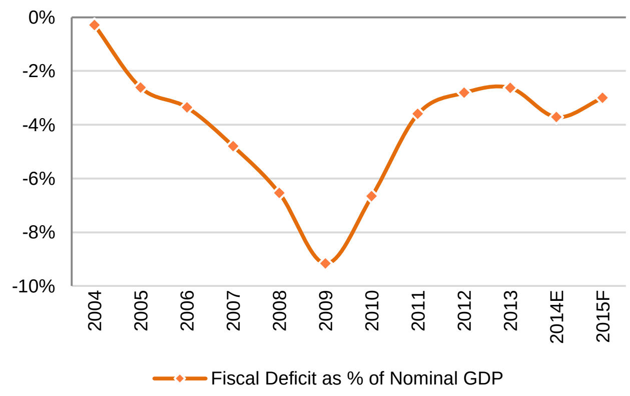
Fiscal deficit reached 1.1% of GDP in 9M14 and 2014 deficit is planned at 3.7% of GDP. We expect that fiscal stimulus will have moderate impact on lari depreciation if deficit widens above 2.5% of GDP in 2014.

Capital spending still needs to catch up with the target. As of 9M14, capital expenditure reached 72% of its planned amount. As a result, public debt to GDP ratio remains low at 33.1% of GDP.

Tax revenues were strong in 9M14. Consolidated budget revenues exceeded the estimate by 1.5ppts thanks to the private sector.

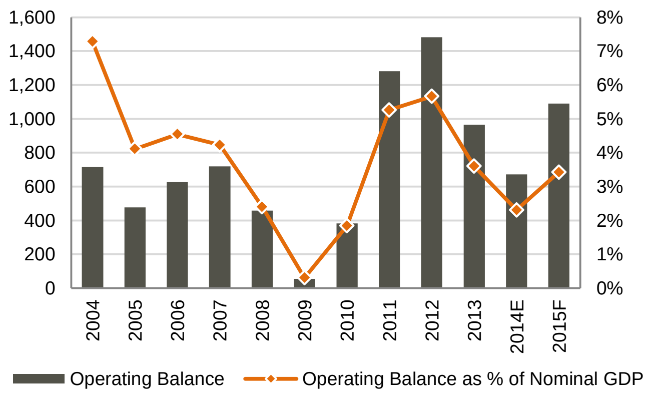
According to a draft 2015 budget (second version – parliament will approve in December 2015), fiscal tightening will continue and 2015 fiscal deficit is planned at 3.0% of GDP with an aim to decrease it to 2.0% of GDP by 2018.

Figure 30: Fiscal deficit



Source: MOF

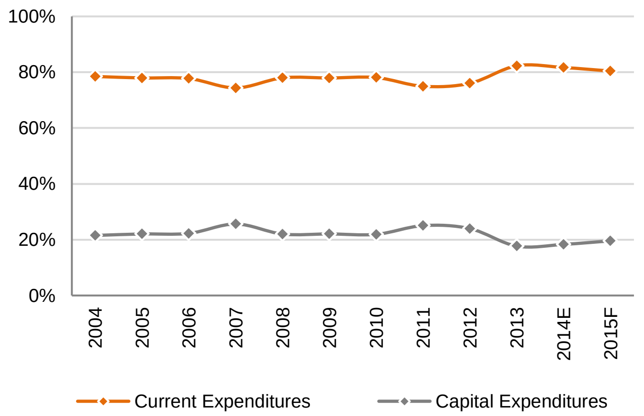
Figure 31: Operating balance to GDP



Source: MOF, GeoStat

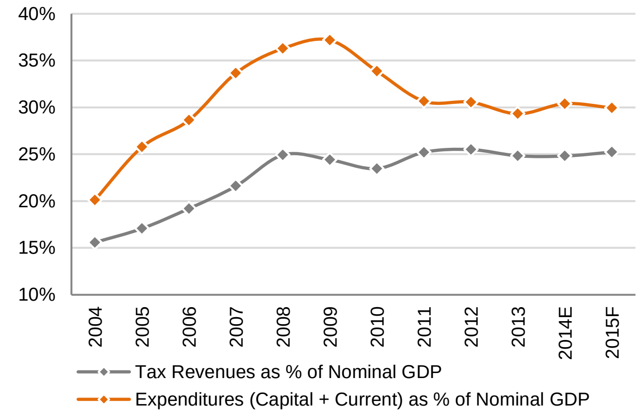
Fiscal framework remains prudent with total expenditures below 30% of GDP in 2015. Notably, the share of capital spending increases by 1.3ppts y/y since growth of capital spending at 15.0% y/y significantly outpaces increase in current spending (+5.6% y/y) in 2015 draft budget.

Figure 32: Share of current and capital expenditures



Source: MOF

Figure 33: Tax revenues and expenditures to GDP



Source: MOF, GeoStat

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