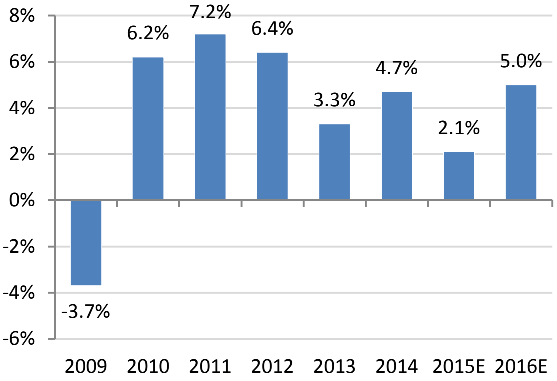
February 26, 2015

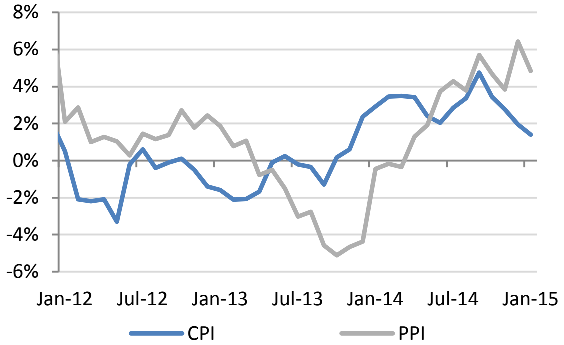
Georgia Macroeconomic Review

Real GDP, chg. yoy



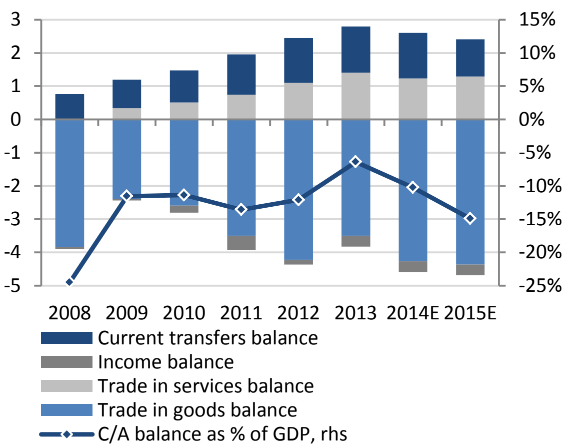
Sources: GeoStat, SP Advisors

CPI and PPI, yoy



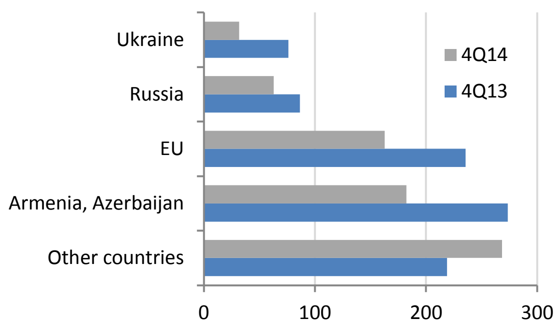
Source: GeoStat

Current account balance, USD bln



Sources: NBG, SP Advisors

Georgian exports by countries in the 4Q, USD mln



Source: GeoStat

The Georgian economy has been facing headwinds since last September and they are likely to persist through 2015. The challenges faced by Russia and Ukraine, Georgia's key trading partners, were the trigger behind the economic slowdown in Georgia, but now structural bottlenecks may prevent an acceleration of growth over the mid-term. We see GDP expanding 2.1% in 2015. A widening C/A shortfall (c. 15% of 2015E GDP) will pressure the local currency – we see the lari depreciating to GEL 2.30/USD by end-2015 from GEL 1.86/USD at end-2014. The NBG will need to sell some reserves to prevent an even stronger depreciation. Fiscal policies should remain prudent with a general government budget gap at a projected 3.0-3.5% of GDP this year and next.

Regional troubles hit Georgian economy

Georgia's economy enjoyed robust growth in 9M14 before a major external shock broke the trend. The sharp depreciation of the local currencies in Russia and Ukraine, Georgia's key trading partners, dampened exports. By our estimates, exports of goods (26% of GDP in 2013) fell some 15-20% yoy in 4Q14 in real terms, weighing down overall economic activity. The 4Q GDP growth rate disappointed at 1.6% yoy, taking the full 2014 number to 4.7%, below our 5.9% projection. Other demand components seem to have held up relatively well through the 4Q.

Looking ahead we expect exports to shrink further in 2015. Household demand is also poised to weaken on a drop in remittances and a likely adjustment in wages in export-oriented industries. The lari's depreciation also adds uncertainty to consumer markets. Meanwhile, healthy bank lending and robust government social spending should prevent a critical slowdown in private demand. Investments may also decelerate from an estimated +15-18% yoy in 2014 on the broader economic uncertainty, but are still likely to be in the low double-digits. All in, we expect GDP growth to slow to 2.1% yoy in 2015 – well below the average of the past decade.

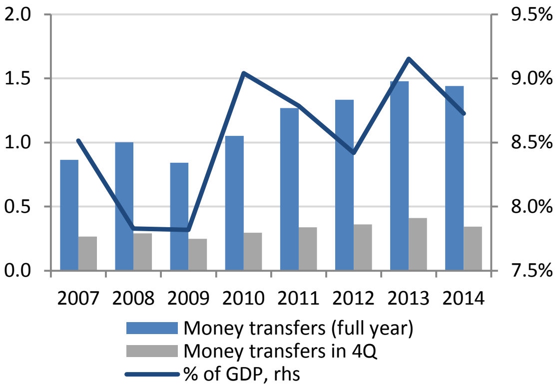
Structural bottlenecks as a constraint to longer-term growth

While the economic slowdown stems first and foremost from external factors, the risks of a low-growth period beyond 2015 are growing. Georgia currently holds decent spots in major economic rankings: #15 in the WB Ease of Doing Business 2015 list (#14 in 2014), #22 in the Heritage Foundation Index of Economic Freedom (#21 in 2014) and #69 in the WEF Global Competitiveness Report (#72 in 2014). However, the comfort of those rankings is misleading; Georgia is in need of a new wave of structural reforms. The stagnation/decline of exports to key EU markets, rapidly decelerating growth in tourism (the problems in Ukraine and Russia offer only a partial explanation), the sluggish implementation of new infrastructure projects, and a re-burgeoning bureaucracy (based on our feedback from local businesses) are all pressing issues. Georgia's pro-active approach in unlocking new growth opportunities and pursuing unconventional reforms rocketed the country up the global rankings in the past. The government now needs to follow the same roadmap. Unless economic policies are reconsidered and the pace of reform picks up, the economy is destined for a mid-term annual growth rate of 4-5% – nothing to scoff at, but far from the rate that a small economy with a low starting point should generate.

Inflation to accelerate to 6.5% by end-2015E

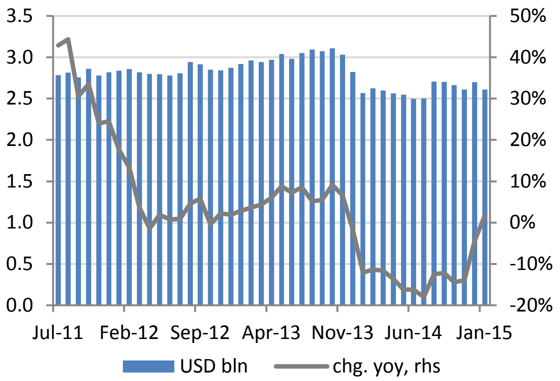
Inflation slowed to 1.4% yoy in January from 2.0% in December thanks to declining prices for transport and clothing. The trend is poised to reverse shortly due to lari weakening and we see consumer prices increasing as import prices rise, while demand-side pressures will remain limited. Overall, we expect inflation to accelerate to 6.5% by the end of the year, above the NBG target of 5%. As a result, we expect the NBG to raise the refinancing rate from the current 4.5% (after the 50 bp increase two weeks ago).

Money transfers to Georgia, USD bln



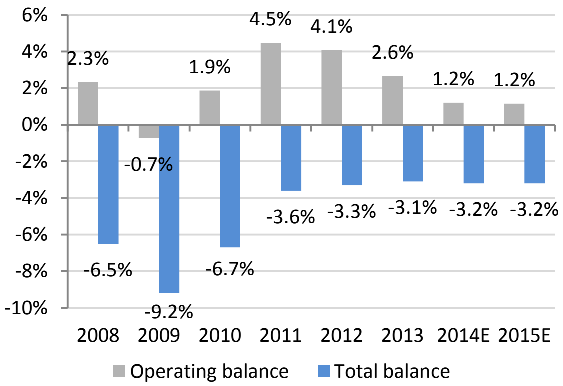
Sources: GeoStat, SP Advisors

NBG gross reserves



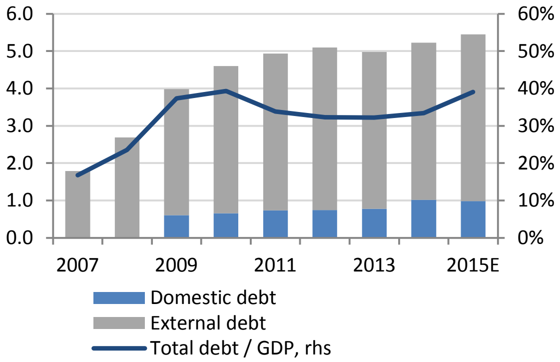
Source: GeoStat

General budget balance, % of GDP



Sources: Finance Ministry, SP Advisors

Public debt, USD bln



Sources: NBG, SP Advisors

Russia, Ukraine troubles are the key source of C/A risks in 2015

Georgia's external accounts deteriorated in 4Q14 as Russia's ruble and Ukraine's hryvnia tumbled and domestic demand weakened. We identify two direct implications of the weaker regional currencies for Georgia:

(i) A decline in goods exports as Georgian fruits, mineral waters, wines – the key exports to Russia and Ukraine (the two countries accounted for 15% of total exports in 2013) – have become less affordable. Exports declined 58% yoy to Ukraine and 27% to Russia in the 4Q. Tourism is also seeing a decline – arrivals from both Ukraine and Russia were down some 2-5% yoy in 4Q.

(ii) A material decline of Georgian migrant incomes in Russia. Remittances amount to 8-9% of Georgia's GDP and Russia has traditionally accounted for 50-55% of the total volume. Money transfers from Russia fell 30% yoy in 4Q14 and 47% yoy in January.

Apart from the Russia and Ukraine jitters, Georgian companies are also facing difficulties with exports to the EU (-31% yoy in 4Q), a problem the government needs address immediately by reinforcing structural reforms and implementing export promotion best practices.

We now see Georgia's C/A deficit widening to 15% of GDP in 2015 from an estimated 10.2% in 2014. Decomposing the incremental C/A gap of 4.8%, we see roughly a 4pp contribution from the deterioration of the external trade deficit (to 20.4% of GDP) and a 0.8pp increase due to a decline in net migrant remittances. The wider C/A gap (relative to GDP) is also due to a contraction in the FX equivalent of economic output – we project Georgia's 2015 GDP at USD 14.5 bln (vs. USD 16.5 bln in 2014E) – a direct effect of the lari depreciation. Assuming the Russian and Ukrainian economies stabilize and Georgia starts to reap the benefits of the EU DCFTA, we expect the C/A gap to narrow to 12% of GDP in 2016.

Lari to face depreciation pressures in 1H15, NBG reserves will decline

The lari will remain under pressure over the next few months as external accounts deteriorate. The current external imbalances and related FX market shortages are being alleviated through the depreciation of the lari (-17% vs. USD YTD) and the NBG's market interventions (in February the NBG sold USD 120 mln in FX). We think the 2015E C/A gap of 15% of GDP (USD 2.2 bln) is unlikely to be fully offset with FDI and new borrowings. Under our calculations, Georgia's external funding gap (the combined balance of the C/A and F/A) will total up to USD 0.6 bln, which will be covered from NBG reserves. Georgia does not have a sizable IMF disbursement scheduled for 2015 to replenish reserves under the current program. We therefore see NBG reserves decreasing 21% yoy to USD 2.1 bln – the equivalent of 2.8 months of 2015E imports. Unless the situation in external markets improves materially through 2015, Georgia may need to seek sizable new funding from IFIs.

Fiscal policies relatively prudent despite a hike in social spending

Georgia's fiscal policies have remained fairly prudent – we estimate general government tax collection remained flat yoy at 24.8% of GDP (up 9% in nominal terms). The key concern as far as fiscal policy is concerned is a material decline in operating budget surplus (excluding capital spending) to 1.2% of GDP (vs. 2.6% in 2014). The overall balance, though, has likely stayed close to 3.2% in 2014, which means a decrease in government capital spending. Georgia's public debt is projected to grow to 39% of GDP by end-2015 (vs. 33% in 2014) as the lari depreciation inflates FX-denominated liabilities.

Macro Data and Projections

	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
Economic activity									
Real GDP, yoy	2.6%	-3.7%	6.2%	7.2%	6.4%	3.3%	4.7%	2.1%	5.0%
Nominal GDP, GEL bln	19.1	18.0	20.7	24.3	26.2	26.8	29.1	32.0	35.6
chg. yoy	12%	-6%	15%	17%	7%	3%	9%	10%	11%
Nominal GDP, USD bln	12.8	10.8	11.6	14.4	15.8	16.1	16.5	14.5	15.5
chg. yoy	26%	-16%	8%	24%	10%	2%	2%	-12%	6%
GDP per capita, USD	2,921	2,455	2,614	3,220	3,529	3,597	3,676	3,238	3,448
chg. yoy	26%	-16%	6%	23%	10%	2%	2%	-12%	6%
CPI, eop	5.5%	3.0%	11.2%	2.0%	-1.4%	2.4%	2.0%	6.5%	5.0%
External accounts									
Current account balance, USD bln	-3.1	-1.2	-1.3	-2.0	-1.9	-1.0	-1.7	-2.2	-1.9
% of GDP	-24.5%	-11.5%	-11.4%	-13.6%	-12.1%	-6.4%	-10.2%	-15.0%	-12.2%
Merchandise trade balance, USD bln	-3.8	-2.4	-2.6	-3.5	-4.2	-3.5	-4.0	-4.3	-4.4
Service trade balance, USD bln	0.0	0.3	0.5	0.7	1.1	1.4	1.2	1.3	1.6
Trade balance, USD bln	-3.8	-2.1	-2.1	-2.7	-3.1	-2.1	-2.7	-3.0	-2.7
% of GDP	-29.8%	-19.1%	-17.8%	-19.0%	-19.7%	-12.9%	-16.6%	-20.4%	-17.7%
Foreign direct investment (inward), USD bln	1.6	0.7	0.8	1.0	0.9	1.0	1.2	0.9	1.3
% of GDP	12.2%	6.1%	7.0%	7.3%	5.8%	6.3%	7.0%	6.2%	8.4%
Capital and financial account balance, USD bln	2.3	1.3	1.2	2.4	2.1	1.2	1.7	1.6	1.8
NBG gross international reserves, USD bln	1.5	2.1	2.3	2.8	2.9	2.8	2.7	2.1	2.0
Exchange rates									
GEL/USD, eop	1.67	1.69	1.77	1.67	1.66	1.74	1.86	2.30	2.25
GEL/USD, avg	1.49	1.67	1.78	1.69	1.65	1.66	1.77	2.20	2.30
Fiscal indicators									
General budget balance, % of GDP	-6.5%	-9.2%	-6.7%	-3.6%	-2.9%	-3.1%	-3.2%	-3.2%	-3.2%
Central government debt, USD bln	3.2	4.0	4.6	5.3	5.1	5.0	5.2	5.4	5.9
as % of GDP	25%	37%	39%	37%	32%	32%	33%	39%	37%
Banking sector									
Bank deposits, GEL bln	3.84	4.17	5.82	7.35	8.2	10.3	12.4	16.3	19.0
chg. yoy	10%	9%	39%	26%	12%	25%	21%	31%	17%
% of GDP	20%	23%	28%	30%	31%	38%	43%	51%	53%
Bank loans, GEL bln	6.06	5.25	6.33	7.80	8.4	10.1	12.5	16.2	19.1
chg. yoy	31%	-13%	20%	23%	12%	21%	23%	30%	18%
% of GDP	32%	29%	31%	32%	32%	38%	43%	51%	54%
Loan-to-deposit ratio	158%	126%	109%	106%	102%	98%	100%	100%	101%

Sources: GeoStat, NBG, Ministry of Finance, SP Advisors

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