Research Report on Georgia

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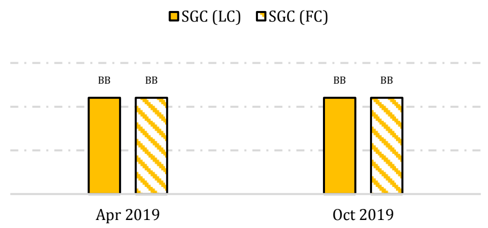
Ratings

Sovereign Government Credit (LC)	BB
Sovereign Government Credit (FC)	BB
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Georgia

Macro indicators	2016	2017	2018
Gross gov. debt, GEL bn	15,1	17,1	18,4
Nominal GDP, GEL bn	34	37,8	41
Real GDP growth, %	2,9	4,8	4,7
Gross gov. debt/GDP, %	44,4	45,1	44,9
Deficit (surplus)/GDP, %	-1,6	-0,5	-0,9
Inflation rate, %	1,8	6,7	1,5
Current Account Balance/GDP, %	-	-	-7,7
External debt, USD bn	-	-	18,2*

Development indicators	2018
Inequality adj. HDI	0,68
GDP per capita, USD th	11,5

Default indicator	04.10.2019
10Y Gov Bond Yield, %	8,5

Source: RAEX-Europe calculations based on data from the IMF, WB, NBG, UN.
* 2Q 2019

Summary

The confirmation of Georgia's 'BB' sovereign government credit ratings reflects the continued high economic growth supported by structural reforms, stable public finances with an acceptable fiscal stance, efficient monetary policy focusing on price stability, as well as a solid and growing banking sector.

However, the country's main downside risk is the high external exposure, which could potentially cause spillover effects in case of external shocks, as the economy remains highly dependent on imports, FDI and remittances as well as elevated financial dollarization.

The stable outlook reflects that in the mid-term perspective we anticipate with a high probability that all underlying factors affecting creditworthiness will behave according to our base forecast scenario.

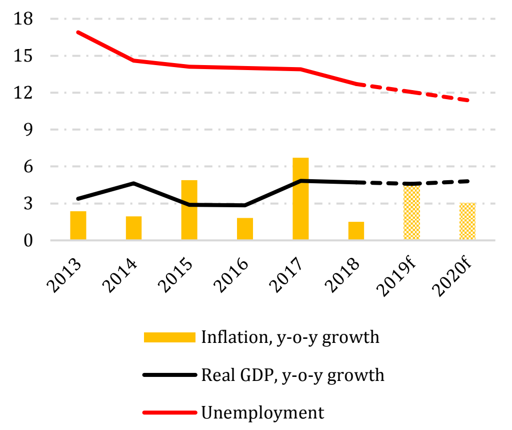
Stable economic growth continues, although high vulnerability to external developments remains. Georgia's economy has demonstrated strong performance with an average growth rate of 4,8% in 2017-2018 (see graph 1), driven by an increase in net exports amid the strong external demand. An important driver of growth in the value-added contribution was from the manufactory and retail trade side, as well as from the hospitality industry. We expect growth to remain high in 2019 at around 4,5%, underpinned by robust exports of goods and strong tourism services, although Russia's continued ban on flights to Georgia may have a negative impact on this segment of the economy. Moreover, the government's planned capital spending in infrastructure projects is also expected to support economic growth.

Nevertheless, in the mid-term, we also see risks of deterioration, as the Georgian economy is largely dependent on external developments and international financial markets. Besides, unemployment remains high and the population's income levels are still weak. In this regard, the success and commitment to structural state reforms, which we mentioned in our previous report[1], will largely determine further development and growing resilience to external shocks.

The fiscal stance is adequate and the authorities commit to the fiscal rule. The official budget deficit slightly widened to 0,9% in 2018 from

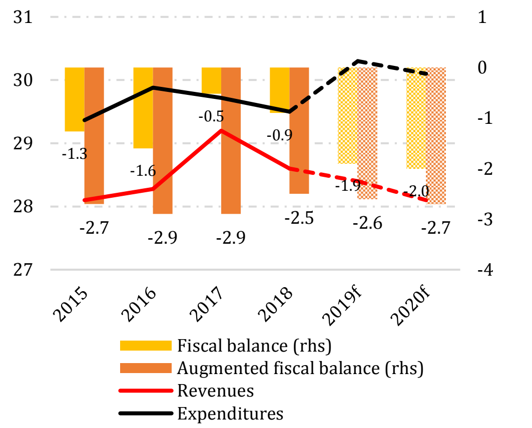
[1] See our previous research report from 5 April 2019: https://raexpert.eu/reports/Research_report_Georgia_05.04.2019.pdf

Graph 1: Macroeconomic indicators, %



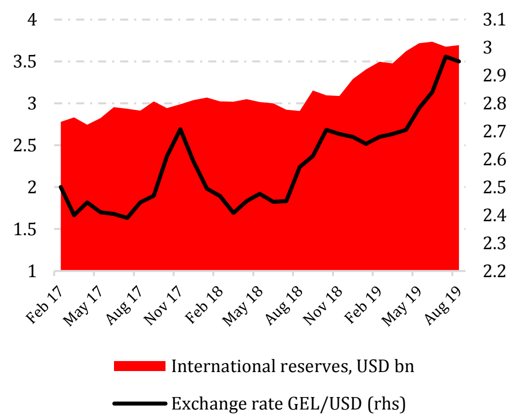
Source: RAEX-Europe calculations based on data from the IMF, Geostat and NBG

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 3: International reserves and FX rate



Source: RAEX-Europe calculations based on data from the NBG

0,5% in 2017, which was a consequence of the tax reforms. Tax revenues were higher than expected and non-tax sources were also expanding, whereas the budget expenditures were in line with the plan. At the same time, greater capital spending and budgetary lending were reflected in the augmented deficit, which stood at 2,5% of GDP in 2018 (see graph 2). Nonetheless, both fiscal balance metrics (official and augmented) remain consistent within the 3% threshold and along with the government debt below 60% of GDP in order to comply with the fiscal rule.

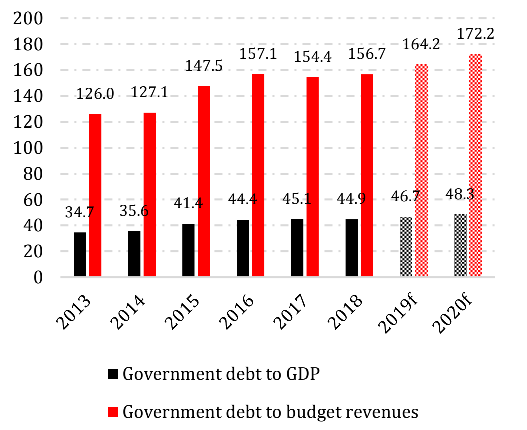
We continue to assess the quality of fiscal policy as satisfactory, taking into account the government's commitment towards fiscal sustainability and consolidation. At the same time, we also expect moderate augmented deficits as the government has a strong aim on carrying out structural reforms, which need increased capital spending that already has been recorded in 7M 2019 as the purchases of nonfinancial assets grew by 58% y-o-y and tax income also increased by 10%.

Monetary policy focuses on price stability. The monetary policy of the National Bank of Georgia (NBG) is committed to maintaining price stability with a target inflation level below 3%. Annual inflation weakened to 1,5% compared to 2017; however, it increased to 4,9% in August 2019 as a result of the rise in food, alcohol and tobacco prices, as well as the depreciation of the national currency. Accordingly, the NBG first relaxed the policy, reducing the refinancing rate by 50b.p. to 6,5% in March 2019. However, with increased inflation and inflationary expectations, the regulator raised the rate twice in September 2019 by 100b.p. to 7,5%. In the medium term, given that the current inflationary spike was largely the result of a one-off increase in excise taxes, we continue to anticipate the NBG to make the necessary adjustments in the monetary policy in order to sustain price stability.

The NBG pursues further accumulation of international reserves while maintaining a floating exchange rate, which will allow to collect buffers in order to mitigate any potential external shocks. The reserves have gradually expanded by 12,4% during 2019 to USD 3,7 bn as of August 2019 (see graph 3) mostly via the FX put options' mechanism, which ensures that international reserves are filled automatically only when the GEL exchange rate tends to strengthen. Thus, in January-May 2019, the NBG purchased USD 186 m in the foreign exchange market, of which USD 51 m was via put options.

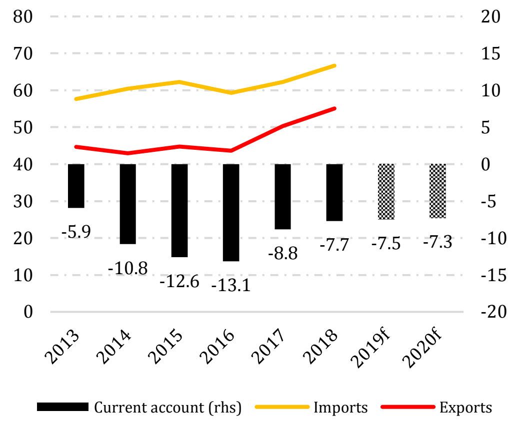
Government debt set to remain consistent. The public debt burden remains at a moderate level of 44,9% of GDP and 156,7% of budget revenues at the end of 2018. This confirms the government's commitment to the strategy to maintain debt stability (see graph 4). Regarding

Graph 4: Government debt dynamics, %



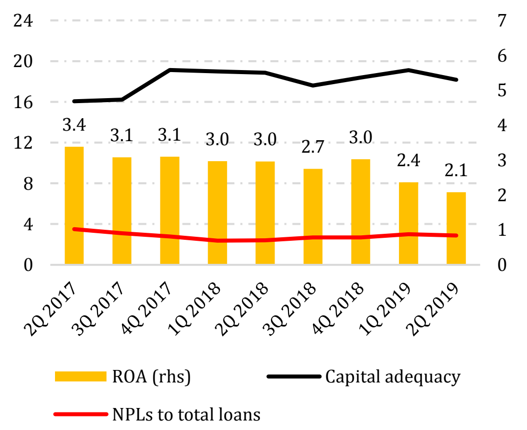
Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 5: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and NBG

Graph 6: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the NBG and WB

maturity, the structure of debt is favorable with short-term debt at only 3,7% of GDP and 8,6% of total debt as of 1Q 2019 and is covered by international reserves by 6x. The cost of debt servicing is also advantageous, as more than 90% of the portfolio comprises multilateral and bilateral agreements with preferential interest rates.

Nevertheless, given the weak national currency, an elevated share of FX-denominated government debt at 81% of the total portfolio presents a substantial risk to public finances. To mitigate possible negative effects, the government aims to increase the issue of domestic bonds with a longer maturity, which will make them more attractive for foreign investors. In turn, this will serve to create a GEL-denominated government bond yield curve which will help in the development of local capital markets and will stimulate corporate bond issuance.

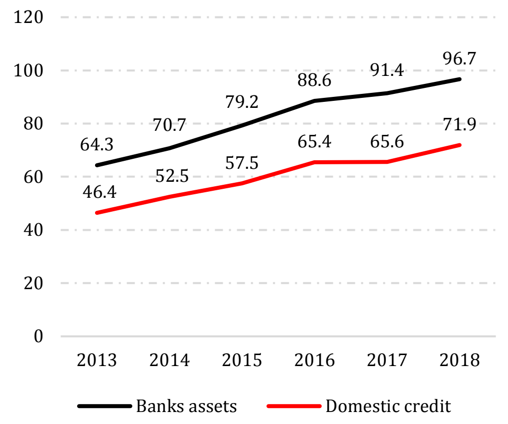
The hidden risks for public finances come from the potential materialization of contingent liabilities related to inefficient and unprofitable SOEs, as well as power purchasing agreements (PPA) attributed to hydropower companies with attached government guarantees as well as public-private partnerships (PPP). We anticipate that including contingent liabilities under the debt ceiling, according to the fiscal rule, will provide transparency and show real debt levels of the government.

External exposure remains the main negative factor. As noted in our previous report, excessive financial dollarization, import dominance and high reliance on remittances and foreign investment expose the economy to external risks, which in turn is a major negative factor for the creditworthiness.

The current account deficit narrowed to 7,7% of GDP in 2018 due to the expansion of merchandized exports by 23%, and lower import growth. Going forward, the current account deficit is expected to decline to 7,5% of GDP in 2019, mostly on the back of further import slowdown, while FDI inflows are projected to increase and support the financing of the deficit. In the medium term, the gross structural reforms aimed at diversifying the economy can foster the strengthening of exports.

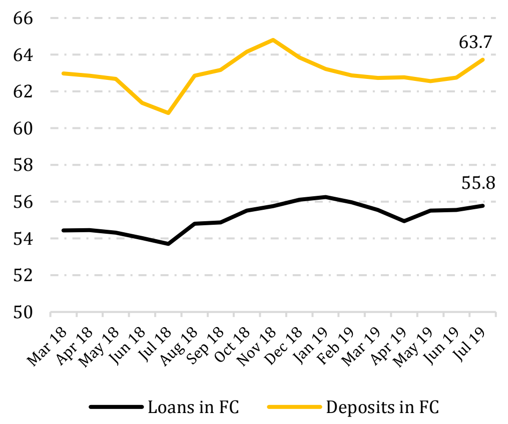
The banking system's stance is solid while the credit policy is tightening. The banking sector is solid maintaining adequate capital and liquidity buffers. The capital adequacy ratio was 18,2% while the NPLs to total loans ratio remained subdued at 2,9% as of 2Q 2019 (see graph 6). Profitability is gradually decreasing, however, remaining favorable with ROA and ROE at 2,1% and 16,2% as of 2Q 2019. Along with that, we emphasize the heightened risk of concentration as the top three banks

Graph 7: Credit to the economy dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the NBG

Graph 8: Financial dollarization, % of total



Source: RAEX-Europe calculations based on data from the NBG

account for about 77% of the total banking system's assets, which weakens the competition in the banking sector.

The role of the banking sector as the main source of financing to the economy and population is increasing which is confirmed by the long-term positive dynamic of bank's assets and domestic credit to GDP, which stood at 96,7% and 71,9% in 2018, respectively (see graph 7). Nevertheless, there are certain concerns in regard to the excess of consumer credit and population's income growth, which may lead to the deterioration of the quality of the loans in the future. Furthermore, financial dollarization remains elevated, FX denomination is retaining its share of 55,8% in deposits and 63,7% in the loan portfolio as of July 2019 (see graph 8). To intensify de-dollarization, the regulator introduced the tightening changes for consumer and FX lending, including a double increase in the floor of minimum FX loans up to GEL 200 000. We anticipate the effect to be seen in the overall slowdown of credit growth due to a reduction in the FX loans to households and corporates.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Georgia_04.10.2019.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.