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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

Main Economic Indicators of Georgia

Macro indicators	2016	2017	2018
Gross gov. debt, GEL bn	15	17	18
Nominal GDP, GEL bn	34	38	42
Real GDP growth, %	2,8	5,0	4,7
Gross gov. debt/GDP, %	44,4	44,9	43,9
Deficit (surplus)/GDP, %	-1,6	-0,5	-1,2
Inflation rate, %	1,8	6,7	1,5
Current Account Balance/GDP, %	-	-	-8,0
External debt, USD bn	-	-	17,2**

Development indicators	2018
Inequality adj. HDI	0,68
GDP per capita, USD th	11,6

Default indicator	05.04.2019
10Y Gov Bond Yield, %	8,2*

Source: RAEX-Europe calculations based on data from the IMF, WB, NBG, UN, Cbonds.
* LC bond with maturity in 2028
** 3Q 2018

Summary

The 'BB' sovereign government credit ratings assigned to Georgia reflect solid public finances with controlled budget balances and public debt, efficient monetary policy, sound banking system metrics and lingering solid macroeconomic growth with low levels of inflation.

However, it also reflects the economy's external vulnerabilities as a result of its wide open economy, high levels of dollarization, substantial dependence on imports, FDI and remittances as well as elevated levels of external public and private debt.

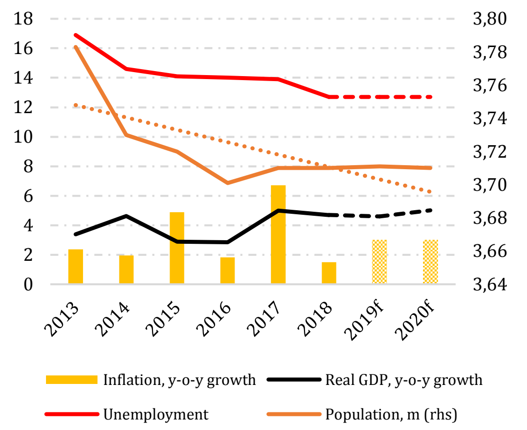
The stable outlook reflects that in the mid-term perspective we anticipate with a high probability that all underlying factors affecting creditworthiness will behave according to our base forecast scenario.

Economy growing steadily. The real economy grew by 4,7% in 2018 as the manufacturing and retail sectors grew strongly; despite the construction sector having contracted on a y-o-y basis as a result of delays in infrastructure projects, it performed better in 4Q 2018. Moreover, consumer demand was also solid on the back of a low inflation environment. Finally, exports of goods grew by 23% y-o-y and tourism was also a strong driver of growth as the hostelry sector increased by 9,4% y-o-y in real terms. However, unemployment levels in the country remained high at 12,7% as of the end of 2018 and demographic dynamics are unfavorable (see graph 1).

In order to realize the economic potential of the country, the government has implemented a number of structural reforms in regard to business law, education and pension, among others. We believe that if the reforms are well-implemented, these will contribute to increase skilled labor, improve economic diversification and boost growth and participation from private companies.

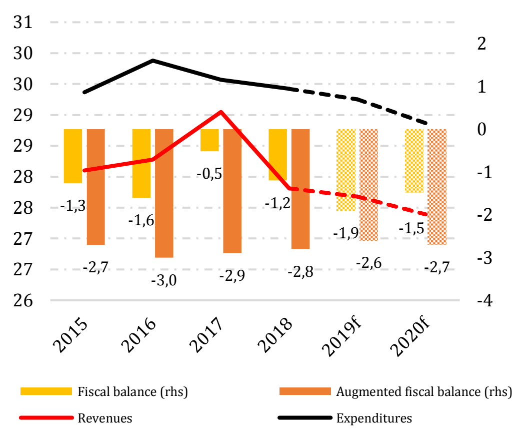
In regard to the pension reform, a new funded savings-based pension system was introduced which makes it obligatory for people under 40 and employed to participate, while participation of self-employed is optional. This reform is a positive step towards reverting the low savings level of the Georgian economy and to use these funds for productive investments which will contribute to realize the economy's growth potential. However, in a country with high levels of inequality as well as unemployment and a

Graph 1: Macroeconomic indicators, %



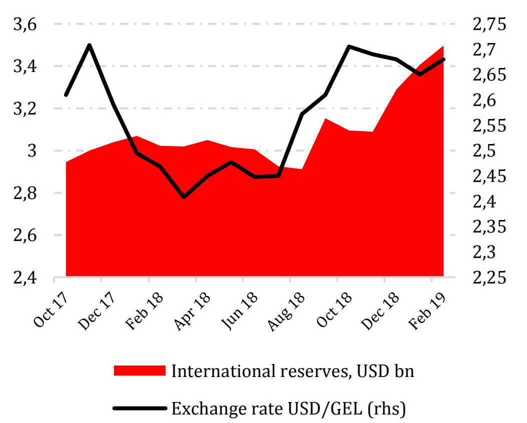
Source: RAEX-Europe calculations based on data from the IMF, Geostat and NBG

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

still undeveloped capital markets, the amount of actual savings the reform will bring is questionable.

Going forward, we anticipate growth to remain stable, however with downside risks as the economy's exposure to external factors is substantial, which, combined with potential lower external demand and slowdown in partner countries, could stall economic growth.

Fiscal stance is solid. The country's fiscal deficit stood at 1,2% of GDP; despite this, the augmented balance calculated by the IMF, which includes budget lending, stood slightly wider at around 2,8% of GDP (see graph 2). The balanced result was mostly propelled by a 7,8% nominal increase in tax income while the current expenses grew marginally and social expenditures increased by 5,3% nominally.

The quality of the fiscal policy is favorable. Both fiscal balance metrics (official and augmented) have remained consistently within the 3% threshold. Additionally, government debt has remained stable and below 60% of GDP. Both metrics, debt and fiscal balance, have complied with the fiscal rule, which will be revamped in order to expand transparency of the government debt. The rule will also contain under the debt ceiling potential contingent liabilities, which are substantial.

Current fiscal objectives have a strong aim on carrying out structural reforms as well as to create a credit guarantee fund to finance SMEs. While both plans will most certainly spur economic growth, the government shall continue to look, at the same time, to achieve fiscal consolidation and debt sustainability.

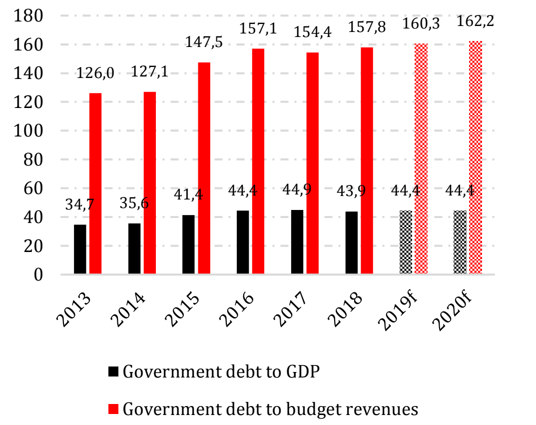
We anticipate fiscal discipline to continue as the government follows the consolidation path. We also expect the government to use its current fiscal space to continue the ambitious reform schedule and to increase social spending.

Sound monetary policy. We consider the policy of the National Bank of Georgia (NBG) to be prudent with a strong commitment to price stability. Additionally, the NBG has in place a floating exchange rate and a solid reserve build-up plan, two important tools to absorb potential external shocks (see graph 3). Given international reserve buffers being insufficient, the NBG has implemented a strategy to build up reserves based on put options. These instruments are useful to avoid negative signaling effects when central banks use open market operations. Instead, they gather currency when the exchange rate is weak. In addition, and despite high dollarization levels, the transmission mechanism of the monetary policy has been effective as move in the reference rate has translated favorably to the local currency interest rates. Thus, monetary policy management is assessed as acceptable.

Inflationary pressures have continued to ease as the inflation rate stood at 1,5% y-o-y remaining below the NBG's 3% target, which caused the NBG to cut the reference rate by 0,25p.p. back in January 2019 and by another 0,25p.p. in March 2019 down to 6,5%. Moreover, in order to avoid possible future financial stability risks, the NBG also increased the minimum reserve requirements for FX-denominated funds by 5p.p.

Going forward, we expect the policy to loosen further and inflation levels to stay balanced as price volatility has persisted in previous years.

Graph 4: Government debt dynamics, %

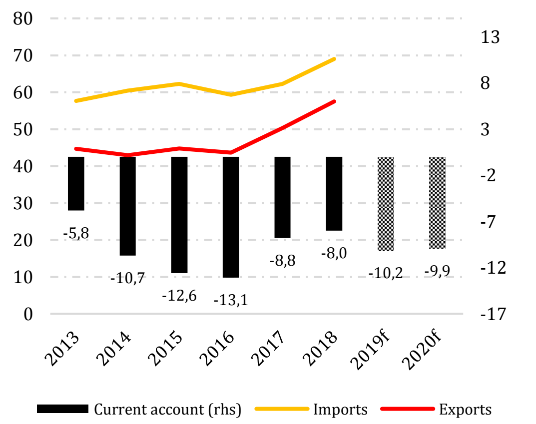


Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Government debt set to remain consistent. Gross government debt has remained fairly constant and at moderate levels. As of the end of 2018, it stood at 43,9% of GDP and 157,8% of budget revenues (see graph 4). In terms of structure, government debt presents mixed results. Maturity-wise, the structure is appropriate as short-term obligations were as low as 8% of total government debt and 3,6% of GDP as of 3Q 2018 and is covered by international reserves by 5x. Nevertheless, external FX-denominated debt was 81,7% of total debt as of the end of 2018; despite this, only 9,5% is from a Eurobond issue while the rest of the counterparties are sovereigns and international institutions which have provided funds mostly in concessional terms. Going forward, we expect government debt metrics to remain stable as the government has solid plans to consolidate public finances.

Nevertheless, the risk of materialization of contingent liabilities in Georgia is latent. These types of liabilities are mainly related to debt from inefficient and unprofitable SOEs, existing power purchasing agreements (PPAs) with hydropower companies which have attached government guarantees as well as public-private partnerships (PPPs). Continent liabilities from SOEs are estimated at around 20% of GDP. However, the new fiscal rule is planned to include contingent liabilities under the debt ceiling and to provide transparency in this regard. This should provide clearer signals for the market and show real debt levels of the government.

Graph 5: External sector indicators, % of GDP

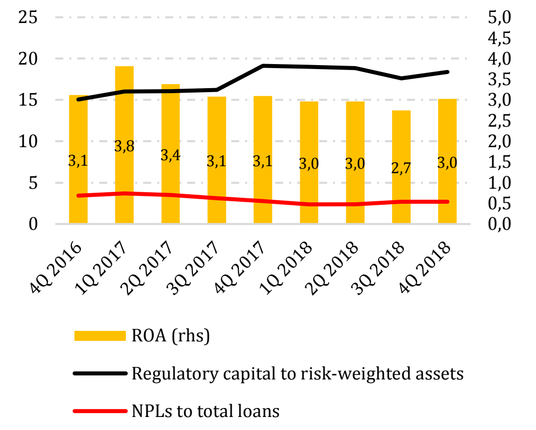


Source: RAEX-Europe calculations based on data from the IMF and NBG

External factors are the key risk for Georgia. The external exposure of the Georgian economy is considered the main threat to the stability of the economy and public finances. The country depends highly on external developments as its financial system is highly dollarized, it has high FX-denominated debt and relies heavily on imports, FDI inflows and remittances. However, it has recently remained resilient to external shocks, including spill-over effects from Turkey.

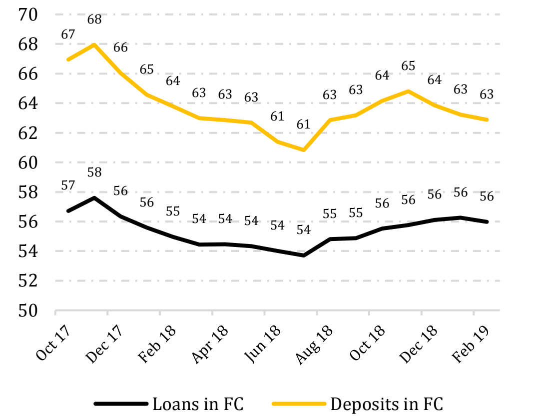
The current account deficit narrowed down to 8% of GDP but remains quite wide as imports were 69% of GDP in 2018; nonetheless, remittances

Graph 6: Financial soundness indicators, %



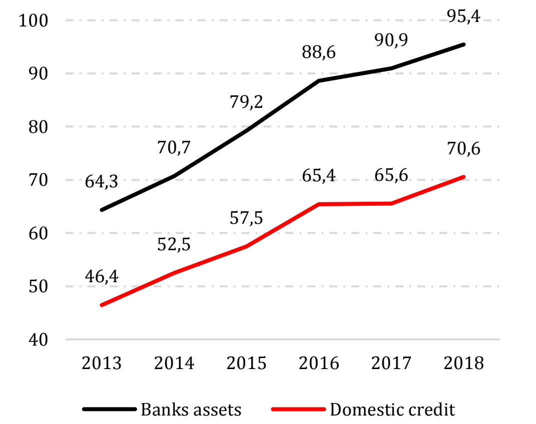
Source: RAEX-Europe calculations based on data from the NBG and WB

Graph 7: Financial dollarization, % of total



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

Graph 8: Credit to the economy dynamics, % of GDP



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

inflows favored a decline in the deficit (see graph 5). The current account is also mainly financed by FDI, which, generally, has been strong and consistent, but declined by around 5p.p. in 2018 down to about 7% of GDP mainly due to lower flows from Azerbaijan. Despite this, exports grew robustly in 2018 as they increased by 23% by year-end backed by strong demand from trade partners.

We expect external metrics to remain stable in the mid-term perspective in the back of balanced external demand and domestic import consumption. However, high external debt and wide deficits will continue to pose a risk for the economy and the government's fiscal sustainability.

Banking system is solid. The top-3 banks in Georgia account for around 77% of all banking system assets, negatively affecting competitiveness, and 90% of the sector is foreign-owned. Nevertheless, the system is quite sound as the NPLs to total loans ratio posted a figure of 2,7% while capital adequacy ratio was 18,4% in 2018. Furthermore, liquidity has been consistent and favorable while profitability was stable and solid with ROA at 3% and ROE as high as 23% in 2018 (see graph 6).

Financial dollarization in the country is quite high; FX-denominated loans and deposits were equivalent to 56% and 62,9% of total portfolio as of February 2019 (see graph 7). Despite the high level of dollarized consumer loans, prudential regulation introduced by the NBG, alongside an increased stability in the exchange rate, is expected to quantify and contain potential rise in NPLs against the income-payment currency mismatch[1]. Nevertheless, the share of household mortgage loans denominated in FX (17% of the total loan portfolio), could augment the level of NPLs as there is the aforementioned mismatch between household currency income (GEL) and the loan repayment currency (USD) could be difficult to overcome in case there is a strong currency depreciation.

The level of credit to the economy is adequate. Bank assets to GDP stood at 95,5% and domestic credit to GDP at about 70,6% in 2018. Moreover, both figures have been consistently increasing. Nevertheless, growth in credit, especially household credit, has been hiking faster than expected (see graph 8). Thus, measures have been put in place in order to curve excessive credit growth; for instance, the maximum effective interest rate was cut from 100% to 50% in order to avoid predatory lending and banks are now more restricted to issue loans to counterparties who cannot show adequate solvency. Even though the measures will curve too-high growth, these could stall economic output.

[1] The *risk-based capital buffer* introduced back in 2017 was established to reduce risk in these types of transactions as banks have to calculate risk based on Loan-to-Value and Payment-to-Income Ratios. Most importantly, these requirements are higher for FX-denominated loans.

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_05.04.2019.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.