Research Report on Georgia

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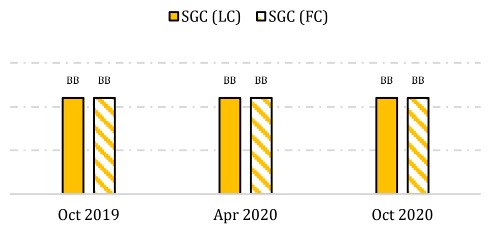
Ratings

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	2017	2018	2019
Gross gov. debt, GEL bn	17	18	21
Nominal GDP, GEL bn	41	45	50
Real GDP growth, %	4,8	4,7	4,6
Gross gov. debt/GDP, %	41,8	41,3	42,7
Deficit (surplus)/GDP, %	-0,5	-0,8	-1,8
Inflation rate, %	6,7	1,5	7,0
Current Account Balance/GDP, %	-	-	-5,1
External debt, USD bn	-	-	5,7

Development indicators	2019
Inequality adj. HDI	0,69
GDP per capita, USD th	12,2

Default indicator	02.10.2020
10Y Gov Bond Yield, %	9,05*

Source: RAEX-Europe calculations based on data from the IMF, WB, NBG, UN.
* GEL-denominated bond

Summary

The confirmation of Georgia's ratings at 'BB' reflects our view that the negative fiscal and economic effect from the pandemic will be short-lived and it will be cushioned by external financing at concessional terms. We also expect the economy to recover in 2021. Moreover, the monetary policy has been adequate, adapting to the current economic situation and stabilizing the level of inflation, while the banking sector metrics remain quite satisfactory under the current circumstances.

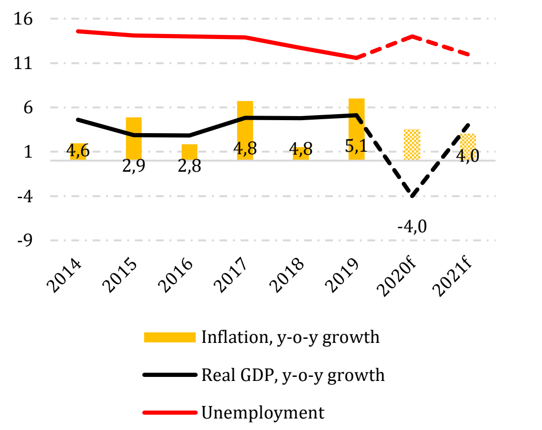
However, the coronavirus crisis has had a direct impact on the economy and has worsened the country's external position. Moreover, the measures implemented by the government combined with the depreciation of the GEL will have a negative impact on the fiscal budget and public debt in 2020.

Economy slide expected in 2020. The economy is expected to contract substantially in 2020 as a result of the negative effect from the coronavirus crisis. After a solid growth of 4,6% in 2019, the economy already recorded a negative growth of -12% y-o-y in 2Q 2020 and of -5% y-o-y in the whole 1H 2020 as a result of reduced domestic consumption due to the lockdown measures imposed, lower external demand translated in less exports and a steep decline in tourism, one of Georgia's main economic activities. Therefore, we anticipate the economy to contract by 4% in 2020. Nevertheless, we also expect a full recovery in 2021 in a scenario where the pandemic eases as expected (see graph 1).

Moreover, the unemployment rate hiked up to 12,2% by 2Q 2020, an increase of around 1p.p. as compared to the end of 2019; also a fallout effect from the crisis. Most of the job losses are concentrated in the hard-hit tourism sector. However, the government has implemented measures to support the unemployed which are equivalent to around 1% of GDP.

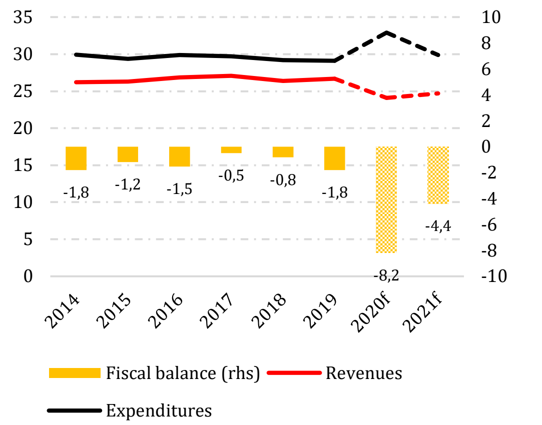
Fiscal policy to remain supportive due to pandemic. The fiscal deficit stood at 1,8% of GDP, while the augmented deficit, which includes budgetary lending, stood at 2% in 2019. The former reading widened as compared to 2018 mainly due to additional capital spending, while the latter shrunk as budget lending decreased. Due to the government's pandemic policy response, we anticipate these metrics to deteriorate further in 2020.

Graph 1: Macroeconomic indicators, %



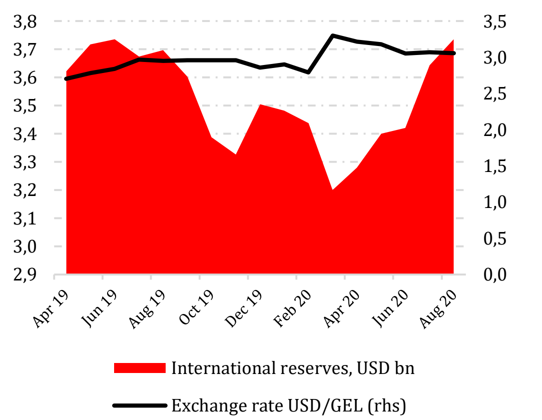
Source: RAEX-Europe calculations based on data from the IMF, Geostat and NBG

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

The authorities have announced different measures at different points in time in 2020 in order to curve the negative impact from the coronavirus crisis in the economy. These measures include income tax waivers, unemployment support to former employees and self-employed, subsidies for interest payments and utilities, healthcare and medical equipment acquisitions, direct help to children and students, among others. The total cost of the plan is estimated to be around GEL 3,4 bn, which is equivalent to around 7% of GDP. Therefore, in 1H 2020, we have already seen an increase in overall expenditures by 16,7% y-o-y. In contrast, depressed private consumption as a result of the lockdown measures and dampened tourism activity, have caused budget revenues to decline by 5% y-o-y over the same period. Thus, we expect the deficit to widen up to 8,2% of GDP (8,5% of GDP for the augmented balance) in 2020 (see graph 2).

Monetary policy remains tight but has accommodated slightly to relieve the economy. The National Bank of Georgia (NBG) continues to manage the monetary policy in an adequate manner. While it still maintains a tight policy, it has also managed to relax the reference rate in order to propel economic activity. The policy rate has gone down from 9% at the beginning of the year down to a current rate of 8%.

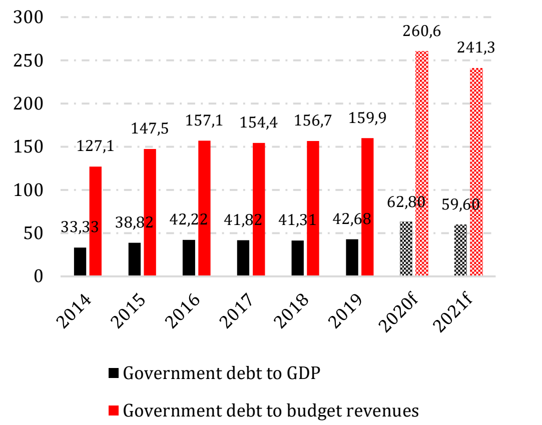
Even with the gradual reduction of the policy rate, the inflation rate has declined consistently in 2020 as a result of lower consumption and tourism activity in the country. Despite the decline, due to the lagging effect of monetary policy in inflation, we still believe the NBG to have enough room to reduce rates even further without an increase in inflationary pressures.

As of August 2020, the y-o-y inflation rate stood at 4,8% as compared to 7% by end-2019, even in spite of the strong depreciation of the GEL. Going forward, we expect the inflation rate to stand at 3,5% by the end of 2020, slightly above the NBG target.

In addition, in order to curve the rapid depreciation of the GEL caused by low tourism, reduced inflows of funds from abroad and instability in its main trading partners, the NBG has already sold around USD 467 m since the beginning of 2020 (see graph 3). If further pressures on the currency were to arise, we anticipate the NBG to continue its controlled interventions in order to avoid a disorderly devaluation.

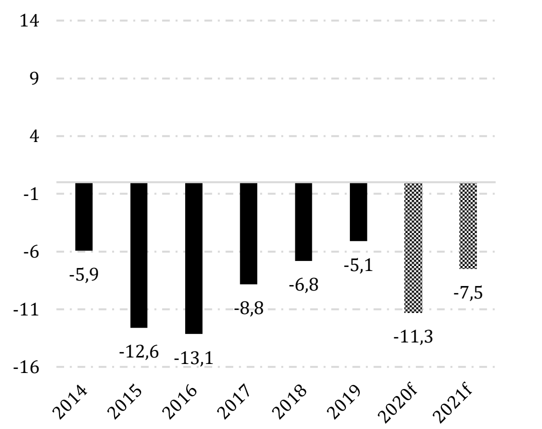
Government debt to hike due to fiscal stimulus and GEL depreciation. Gross government debt remained stable in 2019 posting figures of 42,7% of GDP and 160% of budget revenues. Given the wide range of measures the government has implemented to cushion the economic shock from the pandemic implications, the depreciation of the local currency and the expected depressed nominal GDP in the current year, we anticipate

Graph 4: Government debt dynamics, %



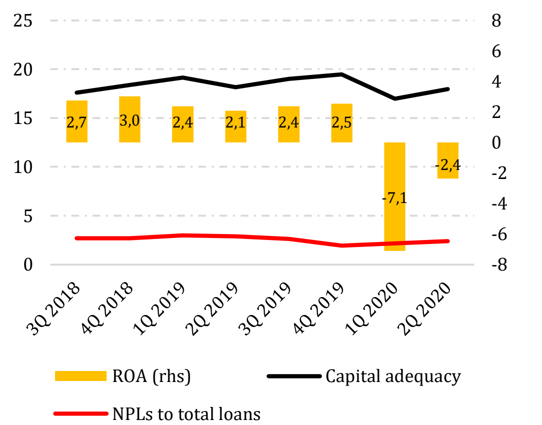
Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 5: Current account, % 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

government debt to GDP to be around 62,8% by end-2020. In fact, we have already seen a hike in the level of debt; as of August 2020, the level of fiscal obligations increased by 24% in absolute terms as compared to end-2019 (see graph 4).

In regard to the structure of the debt, it remains mixed. Short-term debt climbed slightly in 1Q 2020 to about 4,5% of GDP. However, the share of debt denominated in foreign currency remains high at 78% of overall debt. Even though this is mitigated due to the fact that 92% of this debt is owed to bilateral and multilateral creditors at favorable terms, it still carries risk in case the currency depreciation were to continue. The government has also an upcoming maturity of its Eurobond in 2021 for an amount of USD 500 m, which we anticipate will be met as the amount of government deposits is vast.

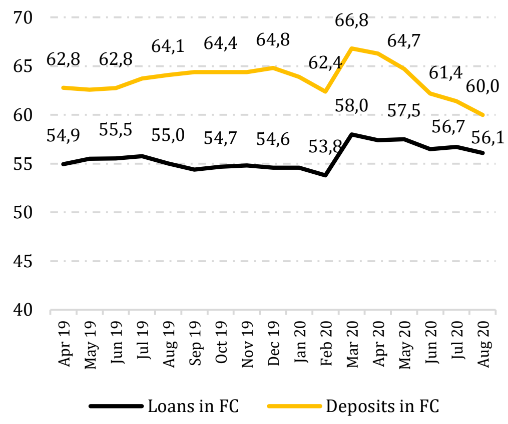
Contingent liabilities stemming from inefficient and unprofitable SOEs, as well as power purchasing agreements (PPAs) attributed to hydropower companies with attached government guarantees and public-private partnerships (PPPs) remain elevated and the risk of materialization is moderately high.

External stance remains weak. Despite showing resilience to external events, the main threat to the stability of the creditworthiness of Georgia remains the exposure to external shocks. In 2019, both the trade of goods and services, as well as the current account deficits decreased slightly to 8,9% and 5,1% respectively. Both indicators are still quite wide and reflect the country's dependence on imports, remittances and foreign investment. In addition, the external debt of the economy was around 107% of GDP in 2019 and the banking sector remains highly dollarized.

Going forward, as mentioned previously, we expect lower inflow of funds into the economy due to the depressed tourism sector and dampened remittances from abroad, as well as a steep decline in exports as the coronavirus crisis has taken a heavy toll on the main trade partners. Thus, we anticipate the current account balance to worsen further down to -11,3% (see graph 5). Finally, due to the same factors mentioned above, we expect the GEL to remain under stress.

Banking sector to face challenges. Even though the banking sector metrics remain acceptable, we already observed a deterioration of the financial soundness indicators as a result of the crisis. As of 2Q 2020, the NPLs to total loans ratio increased slightly up to 2,4%, regulatory capital to risk-weighted assets decreased to 18%, while ROA and ROE stood at -2,4% and -21,7%, marking the first time profitability turned to negative territory since the aftermath of the global financial crisis in 2008 (see graph 6).

Graph 7: Financial dollarization, % of total



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

However, the government support for repayment of bank loans for companies and individuals may help cushion the effect on the quality of assets. In addition, NBG has announced measures to support capital and liquidity in the sector.

Domestic credit and bank assets increased in 2019 standing at 69,8% and 94,4% of GDP respectively; an increase of 3,5p.p. and5,4 p.p. accordingly. However, due to the effect of the coronavirus crisis, we have seen corporate loans increase at its lowest rate since the beginning of 2019 (19% y-o-y as of August 2020), while consumer loans have been increasing at an increasingly fast pace (12,5% y-o-y). Moreover, despite the government and NBG's effort to support credit growth through different measures, we still expect lower credit to GDP in 2020.

The banking sector's concentration remains elevated as the top three banks (TBC Bank, Bank of Georgia and Procredit Bank) account for about 77% of the total banking system's assets, which carries negative effects for the competition level in the country. Finally, the Georgian banking system remains highly dollarized; loans and deposits in FX were equivalent to 56% and 60% of total portfolio as of August 2020 (see graph 7).

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://www.raexpert.eu/reports/Press_release_Georgia_02.10.2020.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.