Research Report on Georgia

3 April 2020

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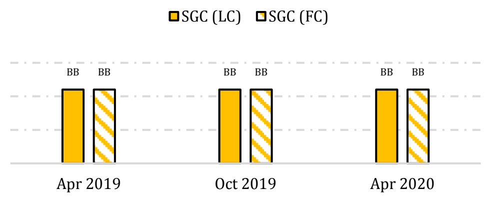
Ratings

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	38	41	45
Real GDP growth, %	4,8	4,7	5,1
Gross gov. debt/GDP, %	45,1	44,9	45,7
Deficit (surplus)/GDP, %	-0,5	-0,9	-2,9
Inflation rate, %	6,7	1,5	7,0
Current Account Balance/GDP, %	-	-	-5,7
External debt, USD bn	-	-	17,8*

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

Default indicator	03.04.2020
10Y Gov Bond Yield, %	9,7**

Source: RAEX-Europe calculations based on data from the IMF, WB, NBG, UN.
* 3Q 2019 ** GEL-denominated bond

Note: All forecasts in the graphs exclude potential effect from the coronavirus pandemic.

Summary

The confirmation of Georgia's ratings at 'BB' mainly reflects solid economic growth, stable public finances supported by a sound fiscal policy, a prudent monetary policy and a sound banking system.

However, the ratings were limited mostly by the weak external position as shown by large trade and current account deficits, high dependence on imports and external funds, as well as high levels of dollarization.

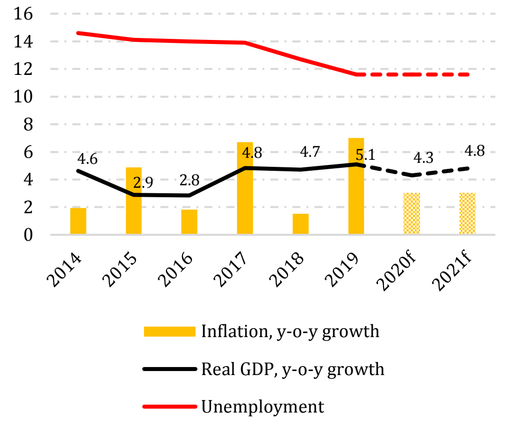
Moreover, we expect the coronavirus crisis to have a direct impact on the economy and public finances as the government has already announced support measures. We could also see an impact on inflation due to the depreciation of GEL and the high level of imports.

Economy remained solid but will be affected by the coronavirus crisis. The economy continued to grow strongly in 2019 recorded a reading of 5,1%, 0,4p.p. higher than the year before supported by the retail and real estate sectors (see graph 1), which grew by 9% and 6% respectively in real terms. In terms of consumption, both private and government spending were steady during the year; however, the latter saw a dip towards the end of the year. Household consumption increased at a rate of 12,8% while government spending grew by 8,7% in 2019. Moreover, strong demand of goods from China in January helped the economy to maintain the pace.

Nevertheless, we expect the economy to lose momentum throughout 2020 as a result of the negative effect from the coronavirus crisis. In addition, the level of unemployment, despite decreasing down to 11,6% in 2019 (see graph 1), is also expected to hike as a result of the coronavirus effect. However, the IMF is already working with the authorities to provide aid under the Extended Fund Facility arrangement. In addition, the World Bank has also committed EUR 45 m to mitigate the economic impact.

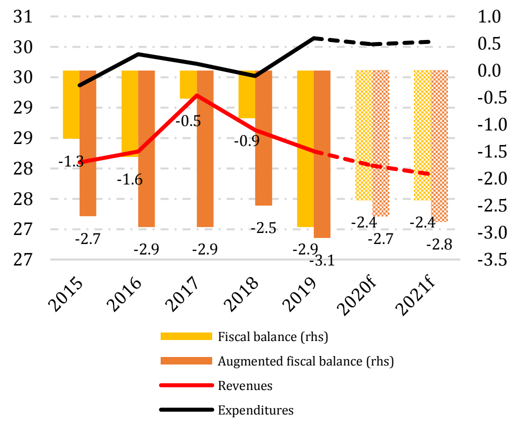
The fiscal position remained stable, however, further spending to mitigate the pandemic will take toll on public finances. According to preliminary figures issued by the Ministry of Finance, the deficit widened up to 2,9% of GDP in 2019 as a result of a rise in capital expenditures (acquisitions of non-financial assets) as well as spending on social benefits. On the revenue side, these increased by 9,2% as a result of improved tax collection. Also, a decrease in the amount of budget lending

Graph 1: Macroeconomic indicators, %



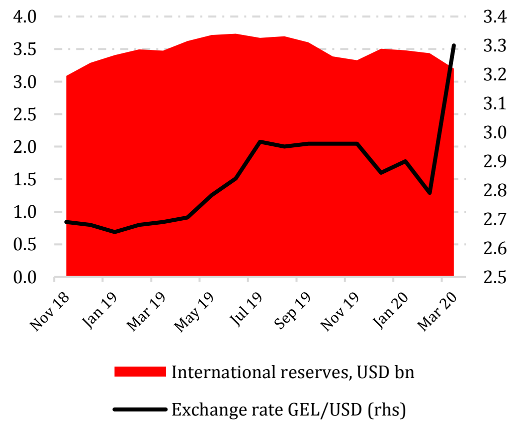
Source: RAEX-Europe calculations based on data from the IMF, Geostat and NBG

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

resulting in an augmented fiscal balance of around 3,1% narrowing the gap from the official deficit (see graph 2).

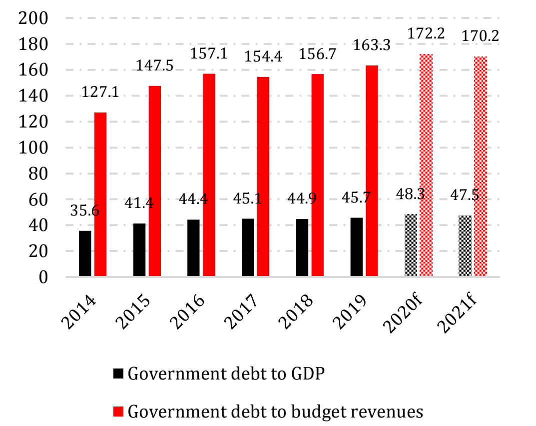
Despite the fiscal discipline shown by the government and having complied with the IMF's objectives, we anticipate public finances to deteriorate in 2020 as a result of government efforts to curve the effects of the coronavirus crisis in the Georgian economy. In fact, the authorities already announced that they will spend around GEL 2 bn, or about 4% of GDP, to support the economy. The government will also introduce measures to postpone taxes and increase VAT refunds to companies engaged in tourism-related activities.

Monetary policy remains tight. The monetary policy from the National Bank of Georgia (NBG) remains sound and effective. However, as a result of one-off effects caused by increases in food, alcohol and tobacco prices, the inflation rate increased substantially and stood at 7% in 2019, 4p.p. above the NBG target of 3%. In order to bring inflation to targeted levels, the NBG has continued to tighten the policy. Back in December 2019, the reference rate was increased by 50b.p. up to 9%. Despite the regulator having stated that the policy will remain tight in spite of the coronavirus effect of the economy, we believe this could rapidly change depending on the course the economy takes as a result of the negative impact.

Despite the NBG's plan to pile up on international reserves to build up buffers, it is now using these to stave off the rapid GEL depreciation resulting from the fall out of the coronavirus pandemic. The NBG has already intervened in the currency market this year, which supported the GEL and halted a continued depreciation since 25 March 2019, and we expect it to continue to do so in case the GEL is further pressure by the current situation. As of the end of February 2020, international reserves stood at USD 3,4 bn, showing a gradual decline over the last two months (see graph 3). However, short-term debt continues to be well covered by the level of reserves which are equivalent to 5x the amount of the obligations. On the other hand, reserves represent about 3 months of imports standing at acceptable levels.

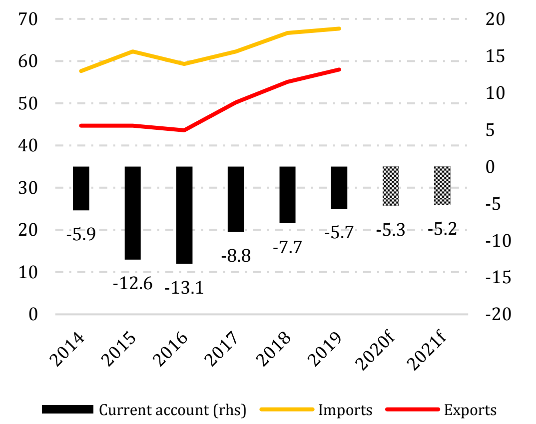
Government debt levels remain stable. Government debt increased slightly in 2019 but remains at acceptable levels. As of the end of 2019, gross government debt as a percentage of GDP and budget revenues stood at 45,7% and 163,3% respectively (see graph 4). Even though we expect debt to remain stable as the government's plan to achieve debt sustainability, the potential high level of financial relief needed to inject to the economy to curve the coronavirus pandemic effect may cause debt to hike further.

Graph 4: Government debt dynamics, %



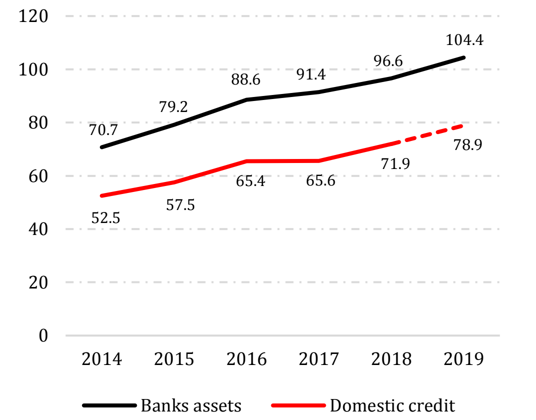
Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 5: External sector indicators, % of GDP



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

Graph 6: Credit to the economy dynamics, % of GDP



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

As of 3Q 2019, the level of short-term debt remained acceptable at 4% of GDP and 8,7% of total debt. Nonetheless, the amount of FX-denominated debt, despite declining, remained high at 79% of the total level of debt as of the end of 2019. In the current atmosphere of uncertainty and potential further currency depreciation, the high level of foreign currency debt could represent a risk for the country. Despite this, the risk is somewhat mitigated by the fact that 91% out of the total external debt is in concessional terms. Moreover, more domestic issuance is expected by the government in the medium term.

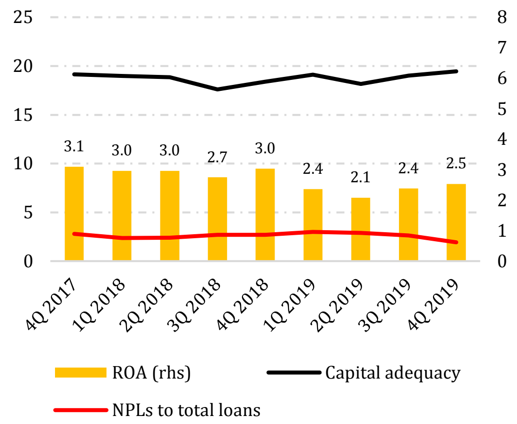
The contingent liabilities of the government arising from inefficient and unprofitable SOEs, as well as power purchasing agreements (PPAs) attributed to hydropower companies with attached government guarantees and public-private partnerships (PPPs) remain elevated and the risk of materialization is moderately high. We still consider that including contingent liabilities under the debt ceiling, according to the fiscal rule, will provide transparency and show real debt levels of the government.

The external exposure remains high and we expect it to deteriorate as a result of the coronavirus impact. The Georgian economy has shown substantial resilience to external shocks; however, the country's external imbalances pose the main threat to its creditworthiness. Both the trade of goods and services, as well as the current account deficits decreased slightly to 10% of GDP and 5,7% of GDP respectively in 2019 (see graph 5). Despite the decline, both remain relatively wide reflecting the economy's dependence on imports, a remittances and foreign investments. Moreover, the level of external debt in the economy remained at 113% of GDP as of 3Q 2019 and financial dollarization remains high.

FDI net inflow is expected to have remained stable and solid in 2019 at around 6% of GDP, mostly supported by the financial and energy sectors. However, it has been declining for the past two years as a result of some projects being finalized. As a consequence of the substantial external exposure we expect the FDI could decline amidst the coronavirus crisis. Moreover, the high dependence on imports alongside the GEL deprecation may exert further inflationary pressures.

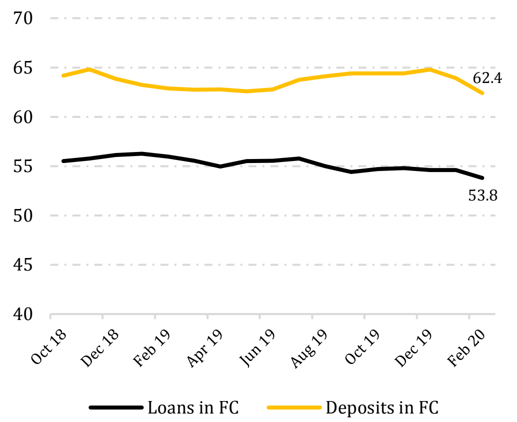
The banking is sound and has already. Financing in the economy has hiked consistently over the past years. In 2019, banks' assets to GDP posted a figure of 104,4% while we forecast domestic credit to have finished the year at around 79% of GDP (see graph 6). The increase in lending has been dominated by loans to enterprises and individual entrepreneurs, suggesting that funds are being canalized towards the

Graph 7: Financial soundness indicators, %



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

Graph 8: Financial dollarization, % of total



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

productive sector of the economy. As of February 2020, the share of corporate and individual entrepreneur loans was 55,1%, while that of individual loans stood at 44,9%. In addition, we saw the level of growth in mortgages decline since August 2019.

In general, the banking sector remains strong. As of the end of 2019, the NPLs to total loans ratio decreased down to 1,9%, the ratio of regulatory capital to risk-weighted assets was 19,5%, while, despite slightly declining, profitability indicators remain positive posting a ROA of 2,5% and ROE of 20,3% (see graph 7). Moreover, amidst the coronavirus crisis, the government has indicated that banks will restructure loans of businesses, which may confront repayment issues, while household loans will obtain a 3-month grace period to repay debt. Furthermore, the NBG already announced measures to support liquidity and relax capitalization requirements, while on-site inspections have been temporarily suspended.

However, concentration is still high 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. As mentioned before, financial dollarization continues to be elevated; as of February 2020, FX-denominated loans and deposits were equivalent to 54% and 62% of total portfolio (see graph 8).

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_03.04.2020.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.