

Georgia's liberal trade policy will help to mitigate its external vulnerabilities



Scope
Ratings

The reforms undertaken by the Georgian government aimed at liberalising its foreign trade regime and customs procedure, introducing low import tariffs and simplifying tariff & non-tariff regulations, will foster the economy's resilience to external shocks and mitigate current account vulnerabilities with positive rating implications over the medium term, according to Scope Ratings.

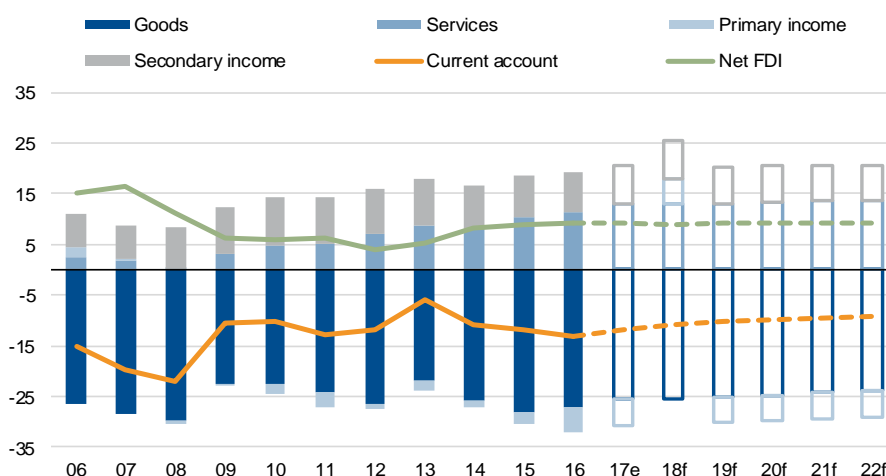
Georgia's commitment to the 2016 EU-Georgia Association Agreement, which introduced a preferential trade regime between EU and Georgia; the Free Trade Agreement (FTA) with China, which took effect on 1 January; agreements with European Free Trade Association (EFTA) countries; as well as an imminent deal with Hong Kong; and trade discussions with India are assessed as credit positive by Scope.

Georgia may further benefit from the launch of the Baku-Tbilisi-Kars railway, connecting it with Azerbaijan and Turkey via freight and passenger links; the construction of the Anaklia Sea Port – a potentially significant trade corridor in Asia; and the likely opening of alternative trade corridors between Georgia and Russia.

Georgia's high current-account (CA) deficit is historically a key credit challenge. Georgia has posted double-digit current account deficits relative to GDP since 2005 (except for 2013) driven by large negative trade balances. As a result, the country has been heavily reliant on external financing reflecting low domestic savings, a narrow export base, import-dependency and the need to secure external funding for investment and development. In Q3 2017, Georgia's net international investment position (IIP) increased to USD -21.5 billion, or -144.4% of GDP¹, from -138% in Q4 2016. These risks are, however, mitigated by foreign direct investments which have financed more than three-quarters of the CA deficits on average since 2013².

It is Scope's view that the successful implementation of and the continued progress on FTAs and strategic projects are leading to a structural shift, reflecting improved investment activities and trade capacities, a broader export base, and access to new export markets. These may collectively lead to an improvement in the assigned rating of Georgia (BB/Stable).

Figure 1: Balance of payments baseline scenario (% of GDP)



Source: IMF, National Bank of Georgia, Scope Ratings GmbH

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Related Research

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¹ <https://www.nbg.gov.ge/index.php?m=340&newsid=3258&lng=eng>

² Data from the National Bank of Georgia: <https://www.nbg.gov.ge/index.php?m=304>, calc. Scope

In its baseline scenario Scope expects a gradual recovery in Georgia's current account balance over the medium-term, driven by a steady recovery in its main trading partners, and benefitting from the recent free trade agreements. Strong FDI inflows due to planned investment projects and a favourable business environment will allow the country to sustain high imports levels.

EU-Georgia Association Agreement

Georgia is benefiting from the Association Agreement with the EU, which entered into force in July 2016,³ establishing a common ground for economic integration and political association. As an integral pillar of the agreement, a so-called Deep and Comprehensive Free Trade Area (DCFTA) was established between the two, aimed at increasing mutual market access and facilitating convergence to EU regulatory standards in a wide range of areas, including food safety, public procurement, technical standards and competition policy. The relationship was strengthened in 2017, with the EU's confirmation of a visa-liberalisation agreement for Georgia⁴. Scope notes that Georgia is progressing with the implementation of its commitments under the DCFTA.

Continued commitment under the Association Agreement

Figure 2: EU trade as a share of overall trade turnover (2016), %

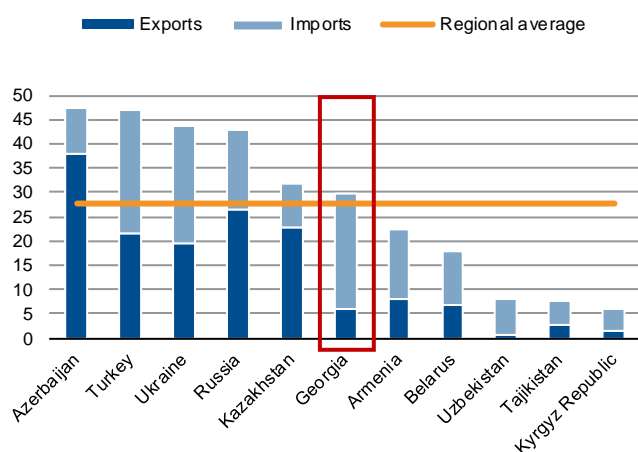
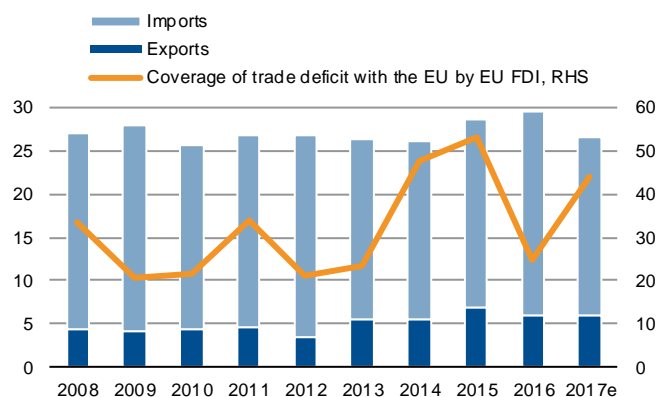


Figure 3: Georgia: Share of EU trade in overall trade turnover and FDI coverage ratio, %



Source: National Statistics Offices, National Central Banks, European Commission, Scope Ratings GmbH

Source: National Statistical Office of Georgia, Scope Ratings GmbH

In 2017, the EU remained Georgia's largest trading partner, with the EU representing 27% of total trade (24% of exports and 28% of imports), although this was slightly lower than in 2016. Total bilateral trade was valued at a steady EUR 2.5 billion in 2017. For the same year, Georgia's exports to the EU increased by over 10% to EUR 0.57 billion, while imports slipped 3% to EUR 1.94 billion. In 2016, Georgia's exports consisted primarily of mineral and vegetable products, and chemicals. Imports comprised mainly of machinery, mineral products, chemicals and transport equipment.⁵

EU's rising assistance to Georgia

The Association Agreement supports structural and institutional reforms in Georgia through technical and financial assistance totalling over EUR100 million annually from EU institutions⁶. Before 2020, the reforms will focus on supporting economic development and market opportunities, strengthening institutional and environmental governance, and

³ https://eeas.europa.eu/delegations/georgia_en/9740/EU/Georgia%20Association%20Agreement

⁴ https://eeas.europa.eu/headquarters/headquarters-homepage/23697/visa-free-travel-comes-effect-georgia_en; <http://www.consilium.europa.eu/en/policies/eastern-partnership/georgia/>

⁵ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng, calc. Scope

⁶ https://eeas.europa.eu/headquarters/headquarters-homepage_en/23634/EU-Georgia%20relations,%20factsheet

Challenges associated with the implementation of DCFTA

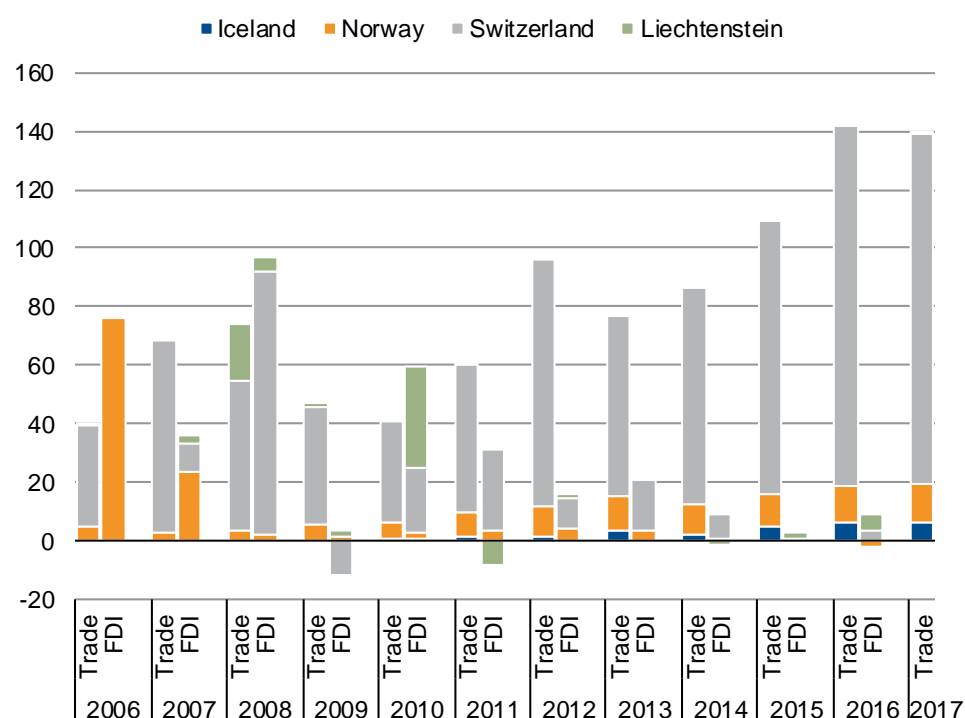
facilitating connectivity and mobility⁷ through financial assistance of EUR 371-453 million. Additional funding could be extended under the “More for More” incentive-based mechanism.

Despite the challenges that Georgia faces from industrial- and labour-market adjustment costs, as well as to retain export competitiveness in Europe, Scope believes that the long-term economic effects of the Association Agreement will be positive for Georgia, leading to more transparent and efficient public institutions, enhanced external sector potential and market access, as well as an improved investment climate and more inclusive growth.

EFTA-Georgia FTA

Georgia may further benefit from the Free Trade Agreement with EFTA states, which came into force on 1 September 2017 for itself, Iceland and Norway, with the ratification process for Liechtenstein and Switzerland pending⁸. Once effective in all countries, the agreement will eliminate all customs duties on imports and exports of industrial products. The FTA also addresses, among other subjects, trade in services, intellectual property rights, competition, sustainable development and government procurement. Moreover, the agreement will create a level playing field for the private sectors of partner markets vis-à-vis the beneficiaries of the EU-Georgia Association Agreement.

Figure 4: Trade turnover with and FDI from EFTA countries, USD mil.



Source: National Statistical Office of Georgia, Scope Ratings GmbH

Trade volumes between the EFTA states and Georgia have been increasing since 2006 at an average annual rate of 21.2%. In 2017, Georgian imports from EFTA members reached USD 67.1 million, less than Georgian exports to EFTA of USD 72.5 million. Pharmaceutical products, electronic equipment and fish were among the key EFTA

⁷ https://eeas.europa.eu/delegations/georgia/35934/eu-and-georgia-adopt-revised-association-agenda_en

⁸ <http://www.efta.int/free-trade/free-trade-agreements/georgia>

Potential benefits from the FTA with EFTA states

Only country in the region having FTAs with the EU and China

exports to Georgia in 2016. Georgian sales to EFTA states mainly consists of precious metals and stones, and vehicles⁹.

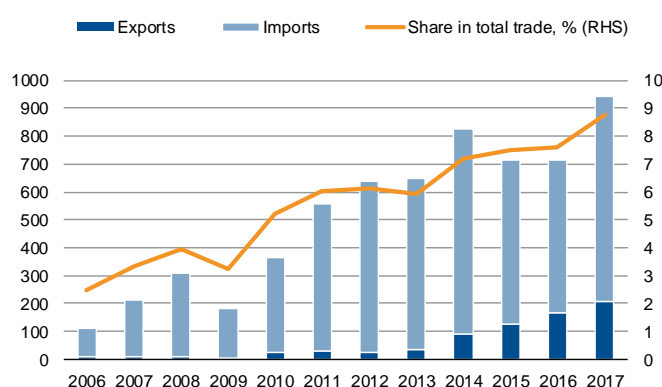
In the first three quarters of 2017, FDI inflows from EFTA states had already almost tripled from that over 2016 due to strong growth in Swiss FDI. Scope expects the positive performance in trade and FDI flows between EFTA and Georgia to continue over the medium term, supported by the expected conclusion of the agreements in Liechtenstein and Switzerland in the near future.

China-Georgia Free Trade Agreement

Scope views positively the FTA between Georgia and China, which took effect on 1 January 2018¹⁰, making Georgia the only country in the region to have similar arrangements with both China and the EU. The FTA means that tariffs on 96.5% of Chinese exports to Georgia have been eliminated, while 91% of Georgian exports to China have become tariff-free, with an additional 3% within the next five years. Alongside trade in goods, the agreement also covers trade in services, intellectual property rights, competition, electronic commerce and the environment.

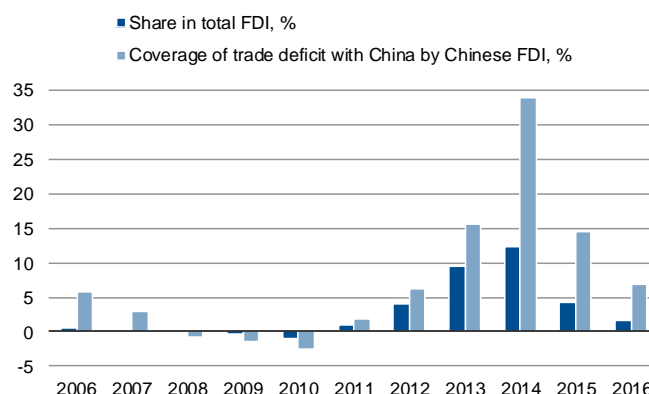
China has become a key trading partner for Georgia (3rd largest after Turkey and Russia, not taking the EU as a unit into account), steadily increasing its share of overall Georgian trade since 2006. In 2017, China accounted for more than 9% of Georgian imports, a notable increase from the previous year. For exports, China's contribution remained almost unchanged at 8%. Georgian exports to China is dominated by copper ore and concentrates, accounting for almost 82% of the total in 2017. About 13.4% came from wine and cars. The import structure is much more diversified with the top four groups – aircraft (one-off import), flat-rolled iron and non-alloy steel products, automatic data-processing machines and pneumatic tyres making up less than 20% of the total.¹¹

Figure 5: Trade turnover with China, USD mil.



Source: National Statistical Office of Georgia, Scope Ratings GmbH

Figure 6: FDI from China



Source: National Statistical Office of Georgia, Scope Ratings GmbH

Chinese FDI in Georgia has notably increased over the last seven years peaking in 2014 at USD218 million (12.4% of total), driven by investments in the construction and real estate sectors. Figures for the first three quarters of 2017 show a continued strong performance.

Georgia's rising importance as a trade and production corridor

In Scope's assessment, the FTA will have a positive effect on Georgia's economic growth

⁹ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng, calc. Scope

¹⁰ <http://emerging-europe.com/in-brief/china-georgia-fta-takes-effect/>

¹¹ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng & <http://www.geostat.ge/index.php?action=news&lang=eng&npid=1245>, calc. Scope

Talks for potential FTAs underway

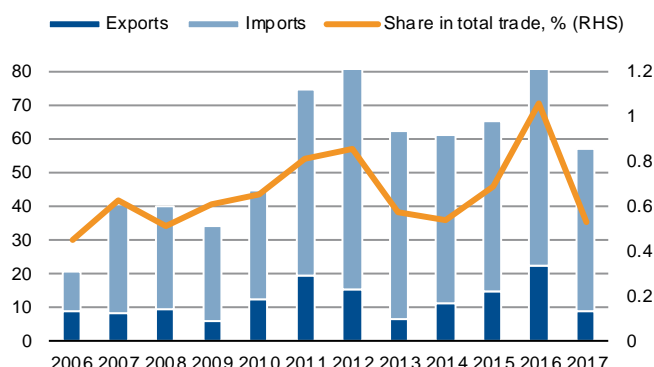
over the medium- to long-term through the facilitation of investment and expansion of export potential. Exports will benefit from the liberalisation of tariffs by China. Georgia's free trade regime with the EU and its role as a production and trade corridor will also provide an enhanced investment perspective for China.

Potential Free Trade Agreements

Potential Free Trade Agreements with Hong Kong¹² and India¹³ can also provide long-term economic benefits for Georgia, according to Scope. Among other areas, the FTA with Hong Kong would likely cover trade in goods and services, investment, customs facilitation procedures and dispute-settlement mechanisms.

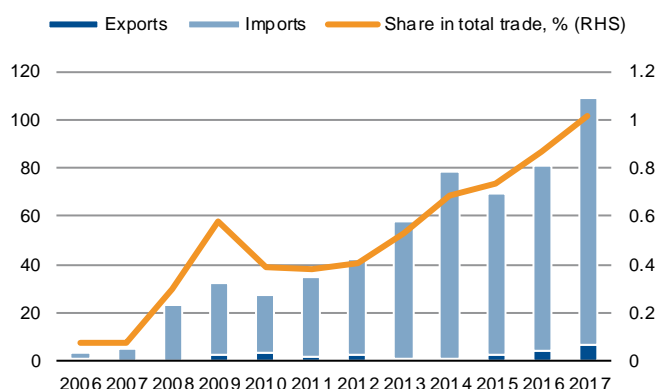
Georgia's bilateral trade volumes with both India and Hong Kong have significantly increased over the last ten years. For that period, the average annual growth rate in bilateral trade was 8.7% with India, and 59.5% with Hong Kong – although that was from a low base. In 2017, Georgia's trade turnover with India and Hong Kong amounted to USD 56.7 million and USD 108.9 million respectively. In 2016, Georgia's key exports to India and Hong Kong were fertilisers, metals, and beverages, while Georgia imported primarily pharmaceutical products, electronic equipment and machinery from India and Hong Kong. Georgia has posted a negative trade balance with both countries since 2005¹⁴.

Figure 7: Trade turnover with India, USD mil.



Source: National Statistical Office of Georgia, Scope Ratings GmbH

Figure 8: Trade turnover with Hong Kong, USD mil.



Source: National Statistical Office of Georgia, Scope Ratings GmbH

In Scope's view, the potential ratification of FTAs with India and Hong Kong will provide Georgia with increased opportunities for export diversification by making full use of its comparative advantages. Furthermore, Georgia can benefit from improved investment activities, currently at a low level (FDI from India and Hong Kong has accounted for less than 1% of the total volume over the past few years), supported by Georgia's strengthening participation in international value chains.

Rating implication of Georgia's liberal trade policy

Georgia (BB/Stable)'s long-term creditworthiness will benefit from the government's liberal trade policy if underpinned by the continued implementation of commitments stemming from the recently signed trade and association agreements and strategic projects, according to Scope. Specifically, it could affect positively Scope's assessment of

Gradual recovery in the external economic environment

¹² <https://www.tid.gov.hk/english/ita/fta/index.html>; <http://www.3dcftas.eu/publications/other/georgia-china-fta-side-effect-eu-georgia-dcfta>

¹³ <https://economictimes.indiatimes.com/news/economy/foreign-trade/india-georgia-begin-free-trade-agreement-talks/articleshow/58131302.cms>

¹⁴ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng, calc. Scope

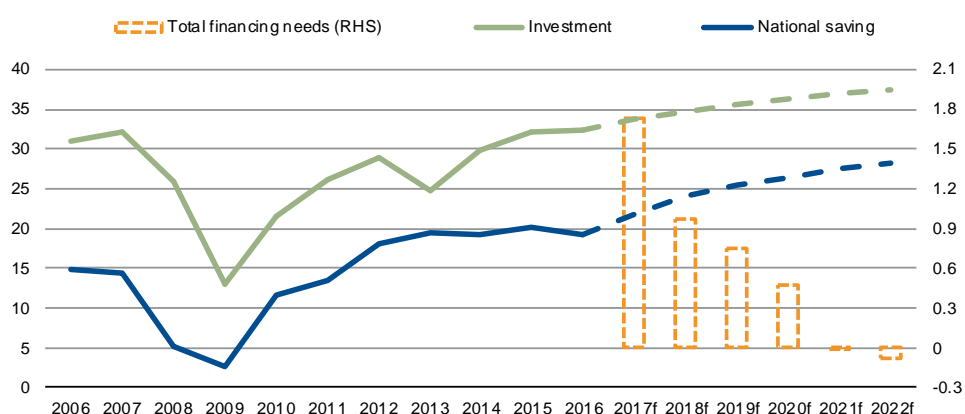
Georgia's 'External Economic Risk' category, with additional potential positive implications for the "Domestic Economic Risk" category (Please see box 1).

Box 1: Potential impact of Georgia's liberal trade policy on Scope's risk assessment¹⁵

External Economic Risk		
Subcategory	Current assessment	Potential assessment
Current account vulnerabilities	"Very high"	"High"
Vulnerability to short-term shocks	"Strongly vulnerable"	"Vulnerable"

In its recent rating action, Scope pointed out the vulnerabilities in Georgia's external economic sustainability as a key rating constraint: current account vulnerabilities, external debt sustainability and the ability to absorb short-term shocks were assigned a very weak assessment relative to its peers¹⁶. It is Scope's view that Georgia's small-open economy with limited market size is susceptible to external shocks and reliant on external financing. Supported by the liberalisation of trade conditions, improving investment climate and the structural and institutional reform agenda (including assisted by EU financial and technical assistance under the Association Agreement), however, Scope expects a gradual recovery in the external economic environment for Georgia, leading to a better resilience against external shocks and decreasing financing needs.

Figure 9: Investment-Saving balance and gross external requirements (% of GDP)



Source: IMF, Scope Ratings GmbH

Scope anticipates that savings, currently at a modest level relative to GDP, will increase to approximately 28% of GDP over the next five years, driven by rising per capita income levels and planned pension reforms via a pension accumulation scheme. Strong performance in investment will be driven by planned infrastructure projects and FTA-driven import-intensive FDI inflows. Georgia's access to new markets and integration into global value chains may contribute to the expansion of its export potential and export diversification in terms of products being exported alongside destination markets. Were there to be a significant improvement in Scope's risk assessment for Georgia, this could contribute to an upgrade in the assigned rating, all else being equal.

¹⁵ For further details on Scope's current risk assessment for Georgia, please see: "Georgia Rating Report", 30 June 2017

¹⁶ Peer comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals

I. Appendix I. Strategic projects and regional “trade corridors”

Anaklia Deep See Port

Scope believes that the Anaklia Deep See Port, which is scheduled to open its first phase in 2021, alongside the planned Free Industrial Zone, will enhance Georgia's export potential and the country's ability to act as a production and transit hub between China and Europe. Developed by a US-Georgian joint consortium at a cost of USD 2.5bn, the project may attract new FDI from China, with one Chinese investor¹⁷ already on board.

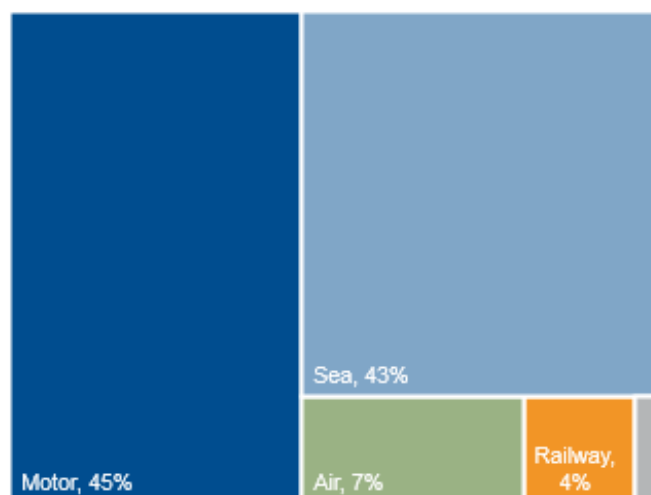
Baku–Tbilisi–Kars

According to Scope, Georgia will benefit from the new trade route connecting it to Azerbaijan and Turkey via rail links with an annual capacity of 5 million tonnes of cargo¹⁸, which is set to increase after the construction of a parallel track in the upcoming years. Financed by Turkey and Azerbaijan, both of which have free trade agreements with Georgia and account for 23% of its total trade and almost half of FDI¹⁹, the line will allow Georgia to increase its trade capacity and facilitate access to new export markets.

Russia-Georgia “trade corridors”

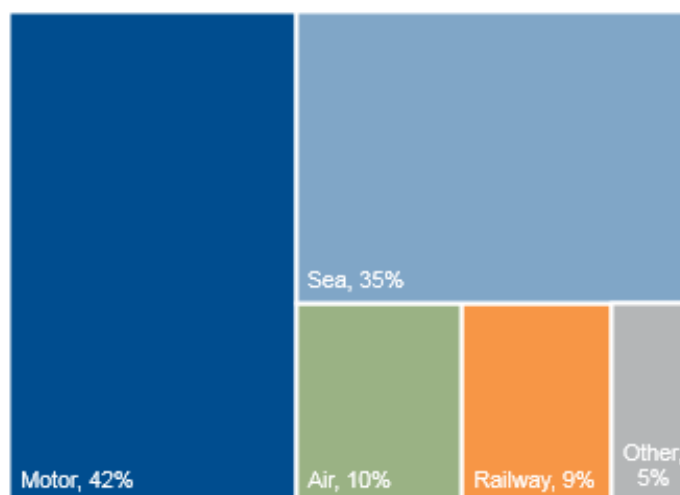
In December 2017, Georgia concluded a contract with a Swiss testing and inspection company²⁰ to monitor cargo movement through three “trade corridors” between Georgia and Russia, two of which go through Abkhazia and South Ossetia. The deal is part of the agreement between Georgia and Russia on third-party trade monitoring. Scope believes Russia may soon sign a similar agreement with the Swiss company, enabling implementation of the Georgia-Russia agreement, opening alternative trade corridors between the two countries. In 2017, Russia was Georgia's second largest trading partner, accounting for 11.1% of total trade. Georgian exports were mainly beverages and ferro-alloys, while it imported chiefly petroleum and petroleum products, as well as wheat²¹.

Figure 10: Exports of Georgia by Mode of Transport



Source: National Statistical Office of Georgia, Scope Ratings GmbH

Figure 11: Imports of Georgia by Mode of Transport



Source: National Statistical Office of Georgia, Scope Ratings GmbH

¹⁷ <http://www.anakliadevelopment.com/news-press-releases/ZPMC-becomes-Anaklia-Development-Constoriums-partner>

¹⁸ <https://www.bloomberg.com/news/articles/2017-10-30/azerbaijan-to-open-railway-planned-as-new-europe-china-corridor>

¹⁹ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng, calc. Scope

²⁰ <http://mfa.gov.ge/News/sagareo-saqmeta-saministros-ganckhadeba-shveicarul.aspx?CatID=5>

²¹ Data from the National Statistics Office of Georgia: http://geostat.ge/index.php?action=page&p_id=1145&lang=eng, calc. Scope



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