Fitch Revises Georgia's Outlook to Stable; Affirms at 'BB-'

Fitch Ratings-London-17 April 2015: Fitch Ratings has revised the Outlook on Georgia's Long-term foreign and local currency Issuer Default Ratings (IDR) to Stable from Positive and affirmed the IDRs at 'BB-'. The issue ratings on Georgia's senior unsecured foreign and local currency bonds have also been affirmed at 'BB-'. The Country Ceiling has been affirmed at 'BB' and the Short-term foreign currency IDR at 'B'.

KEY RATING DRIVERS

The revision of the Outlook to Stable reflects the following key rating drivers and their relative weights:

HIGH

Georgia has experienced multiple external shocks following the lower oil price/sanctions-induced downturn in Russia, which has spilled over to surrounding CIS economies, triggering a wave of trading partner currency devaluations. These developments have had a highly adverse impact on Georgian trade and remittances: exports have fallen sharply, while remittances are down about 25%.

The external sector remains Georgia's main weakness. The Georgian lari has depreciated by about 30% from its 2011-13 levels compared to the US dollar, although the real effective exchange rate has remained relatively stable. The floating of the lari provides a shock absorber and mitigates the decline in foreign-exchange reserves. Nevertheless, the central bank has intervened on six occasions since November 2014, lowering reserves by USD240m to USD2.45bn in March, their lowest level since January 2011. We expect reserves to fall below 2.5 months of import coverage in 2015 and 2016, well below the 'BB' median.

With CIS countries accounting for over half of total exports, Fitch expects exports to fall by 20% in 2015. Despite a decline in imports, we expect the current account deficit (CAD) to widen to about 14% of GDP in 2015 from 9% in 2014. The depreciation will also push net external debt up from 58% of GDP in 2014 to nearly 80% in 2015, far above the 'BB' rating median of 15%.

MEDIUM

Economic growth is expected to slow markedly to 2% in 2015 from 4.8% in 2014, primarily due to spillovers from the regional economic downturn. Lower exports to Russia and other CIS countries, weaker business and consumer sentiment will weigh on the economy. Downside risks remain and will be linked to further developments in the oil price, Russia and other trading partners.

The lari depreciation will reduce Georgia's per capita GDP in US dollar terms from USD3,623 in 2014 to an estimated USD2,923 in 2015, a fall of almost 20%, leaving it over 30% below the 'BB' median. Lower per capita GDP can accentuate vulnerability to shocks and reduce debt tolerance.

Given the economic slowdown and the government's decision to preserve investment and social spending, we forecast the 2015 general government deficit to reach about 3.5% of GDP, with some risks of moderate fiscal slippage. The high share of foreign currency-denominated debt in Georgia (about 80%) means that the depreciation of the lari will push general government debt above 43% of GDP in 2015. Despite the high share of concessional or near-concessional debt, debt dynamics remain vulnerable to further exchange rate developments.

The government has reiterated its determination to maintain its fiscal stimulus, primarily via the continuation of its ambitious investment programme. However, should revenue significantly underperform expectations, we expect the government to adopt corrective measures to maintain fiscal sustainability. As a large share of public investment is financed by international financial institutions (IFIs) and the near-term external redemption schedule is not heavy, liquidity risks should be contained.

Georgian banks do not run major short open current positions, which will limit direct devaluation losses. Foreign currency-deposit outflows (adjusted for exchange-rate changes) have been moderate and banks have significant liquidity cushions, partly because of stringent regulations. The economy is highly dollarised. Nonetheless, with over 60% of banks' loan portfolios US-dollar denominated, the fall of the lari could create asset-quality pressures and a slight decrease in regulatory capital ratios due to asset inflation.

Georgia's 'BB-' IDRs also reflect the following key rating drivers:

Georgia continues to demonstrate a strong commitment to economic and structural reforms, guided by a succession of IMF programmes, including a three-year standby arrangement signed in July 2014. Georgia has also signed an Association Agreement with the EU, which entails a Deep and Comprehensive Free Trade Area. Easier access to EU markets should help to boost Georgia's attractiveness as an investment location over the medium to long term. Georgia's business environment compares favourably with rating peers, as illustrated by the World Bank's ease of doing business indicators.

We expect FDI flows to remain robust, supported by IFIs but also private investors' appetite. Some large-scale infrastructure projects could boost investment over the coming years, notably in the railway, road, energy and sea transport sectors. However, the high import content of investments limits their short-term impact on growth. A recent reform of immigration regulation appears to have created difficulties for businesses, which already face a shortage of skilled labour. Amendments are expected in 2015 to lift these difficulties.

Russia's decision to sign an integration treaty with the breakaway regions of South Ossetia and Abkhazia has sparked some protest from Georgia, the US and the EU, but so far has not derailed the slow and relative normalisation of the bilateral relationship.

RATING SENSITIVITIES

The main factors that could lead to a downgrade are:

- Renewed pressure on reserves and the exchange rate, brought about by a worsening of the downturn affecting trading partners and widening in the CAD.
- A departure from prudent fiscal and monetary policymaking.
- A further deterioration of the domestic or regional political climate.

The main factors that could lead to an upgrade are:

- A revival of strong and sustainable GDP growth combined with fiscal discipline.
- A stabilisation of the net external debt ratio, accompanied by export growth and strong FDI inflows.
- A further and significant reduction in the dollarisation ratio.

KEY ASSUMPTIONS

Fitch does not expect a significant worsening of the economic downturn in Russia and in major trading partners.

Fitch assumes that the government will maintain its medium-term ambition to keep fiscal deficit below 3% of GDP, stabilising the gross general government debt ratio below 40% of GDP.

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Applicable criteria, 'Sovereign Rating Criteria' dated 12 August 2014 and 'Country Ceilings' dated 28 August 2014, are available at www.fitchratings.com.

Additional Disclosure
Solicitation Status