Monthly Update

July 2019

Prepared by TBC Bank Economic Team

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Key insights: GDP growth outlook reasonably strong, international financing conditions favorable and the GEL to strengthen

In July IMF released updated World Economic Outlook, revising down global growth projections. It mostly reflected worsened outlook for the emerging countries including China, Latin America, Russia and South Africa. At the same time, the outlook for many of Georgia's economic partners remained unchanged and/or was revised upwards. The EU is expected to grow at a same rate in 2019 and slightly stronger in 2020. The outlook for the CIS countries other than Russia was kept unchanged while the projections for the Emerging and Developing Europe was revised upwards for 2019 and downwards in 2020.

Fed's decision to lower target range for the policy rate was broadly expected, but the hawkish tone of the announcement drove the USD stronger. However, the interest rates on the US 10 year treasuries dipped further and dollar retreated back as US-China trade tensions escalated. Lower UST yields increased the appetite for at least some emerging market assets, historically the relevant for Georgia, also evidenced by the correlation between low US treasury yields and higher share of non-resident holdings in the GEL treasury securities. Also, recently TBC Bank has raised 425 million USD in the form of senior and additional tier 1 notes at record low rates.

After the latest IMF projections, the global environment has further somewhat worsened. While the Euro Area latest economic indicators has weakened as the EA is relatively more exposed to exports to China, Brexit developments also weighed on growth outlook, prompting the ECB to indicate further policy easing. As compared to the Fed, the ECB has smaller room for maneuver implying more space for USD to depreciate if the interest rate differential narrows. On the contrary, the USD enjoying the safe haven status may strengthen if the rest of the world would perform much worse. Still, from the medium term perspective, the USD remains overvalued and the chances of it strengthening further are low, in our view. Also, despite currently the US economy performing stronger as compared to the Euro Area, and the rational for the FED rate cut was challenged by some FOMC members and market analysts, the latest Bloomberg surveys indicate a higher recession probability in the United States.

Overall, it may be argued that the probability of further strengthening of the USD is low, however, the negative impact of such scenario would be much larger as compared with the stronger EUR case. Given those considerations, when taking the FX risk with the GEL income stream, at current EUR/USD, the diversification appears to be the optimal choice with likely relatively higher share of the EUR especially for the business borrowers (see more details in TBC Economic Review, insight #3).

On the domestic front, overall solid economic developments were interrupted by the Russian tourism sanctions. Per TBC Research projections (See TBC Economic Review, insight #10) published in May and primarily based on the Q1 data, GDP growth in 2019 was expected at 4.7%. Thereafter, the economic data was somewhat stronger and despite global weakness, the growth would have been revised up to 5%. If the flight ban was not imposed, with strengthening the tourism inflows, the growth would have been revised even well above 5%.

Taking into account tourism sanctions, GDP growth is reassessed to 4.3% for the FY 2019 with stronger growth in 2020. This rests on the updated projections for external sector including tourism growth of around 2.5%*, exports growth of 11% and more moderate, around 6% growth of remittance inflows in the USD terms**. FDI's are projected to weaken by 20% YoY, but still remain at solid 6% of GDP. Growth of imports is also revised downwards to 3.5% as a result of weaker demand as well as stronger FDI related imports reduction in H1 2019. Lower imports is partly offsetting the impact of weaker inflows' growth projection on GDP outlook. As for the credit growth and fiscal, those remain broadly in-line with the initial expectations.

Moving to the exchange rate, we remain bullish on the GEL for the following reasons:

- The further strengthening of the USD worldwide is unlikely;
- NBG bought c. 215 mln USD , 3% of same period GDP, indicating that the inflows were sufficient even for higher growth. While the external sector outlook has weakened, it is still expected to remain balanced with:
    - Tourism inflows close to zero growth rates in coming months;
    - Strong exports growth going forward also supported by recovering exports of hazelnuts with around 2.5 percentage points contribution in USD terms;
    - Remittances also having reasonably strong growth rates;
    - Moderate increase of imports;
    - Favorable financial conditions internationally;
    - Lower but still high levels of FDIs.
- The GEL real effective exchange rate is already heavily undervalued, even more than at the peak in 2015;
- The balance sheet (income) effects arising from the GEL depreciation against the USD are considerable and are negatively impacting domestic demand including imports (see TBC Economic Review, insight #3);
- Weak GEL could lead to some substitution effect as well with time lag, assuming the trade in goods and services is elastic;
- The inflation will pick up further at current exchange rate level and the NBG stated that it will hike rates and use other tools unless the GEL strengthens;
- The NBG international reserves being at a higher level as compared with the short-term targets defined even before the flight ban;
- Some recent conversions of the GEL deposits to FX are unlikely to continue and/or might even somewhat reverse;
- If credit regulations and up to 200 000 GEL ban on FX lending are somewhat softened, this will increase FX supply to the economy and support the exchange rate without excessive risk taking (see TBC Economic Review, insight #8).

Based on the aforementioned considerations, we project the USD/GEL at 2.8 or even stronger GEL in the coming months assuming approximately the same level of major trading partners' currencies against the USD and the commodity prices.

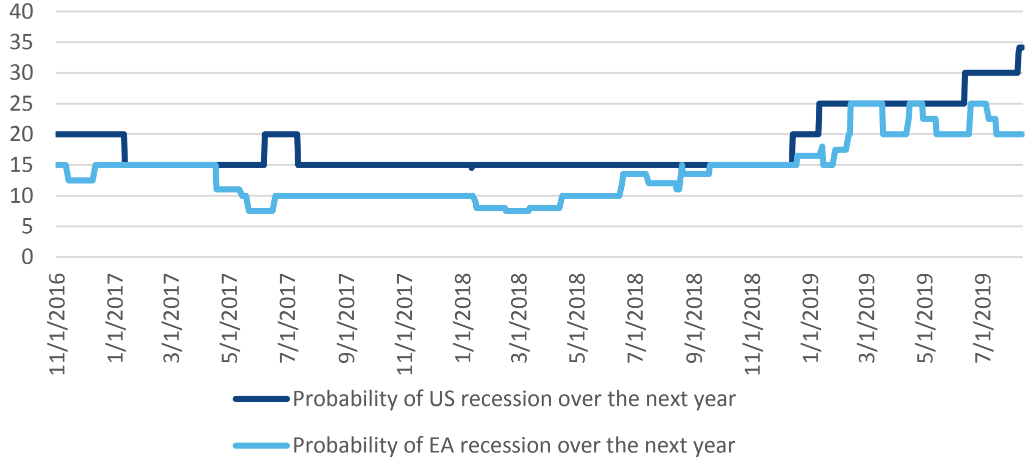
For more information see TBC Research latest Quick Updates published since the previous monthly update.

**There is considerable amount of uncertainty regarding the tourism inflows as latest surveys indicate decline of per visitor spending, even before the introduction of the flight ban, partly to be explained by the GEL depreciation against the USD and lower per visitor spending when measured in USD, leading to the downward revision of Q2 2019 numbers. Therefore, the estimates given in this publication differ from those published in quick updates earlier.*

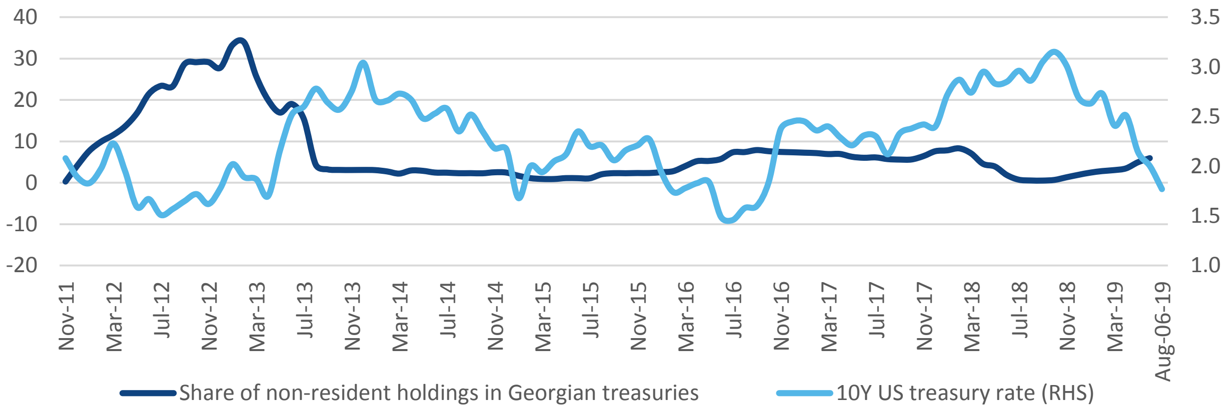
***Data when measured in EUR and GEL better reflects the impact of inflows on GDP growth. This is taken into account in relevant estimations.*

The charts of the month

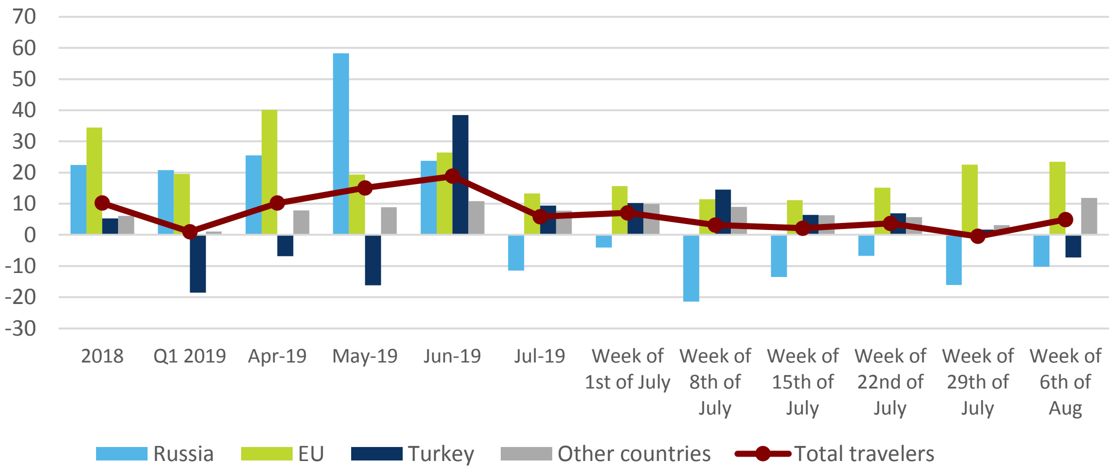
Probability of recession in the US and the Euro Area
(% of forecasters expecting recession over the next year)



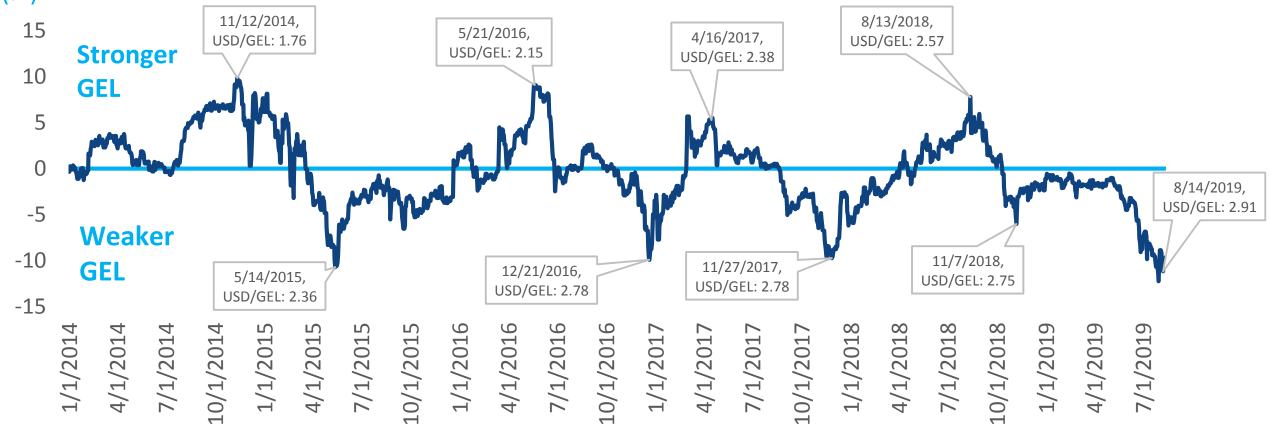
10 Y US treasury rates and share of non-residents in Georgia's GEL treasury security holdings
(%)



Growth of international arrivals by countries/regions
(YoY, %)



Deviation of estimated GEL REER from its medium term average*
(%)



**Real effective exchange rate (REER) represents weighted average exchange rate of GEL against Georgia's major trading partner currencies, adjusted for inflation differential. Increase of REER means appreciation. REER below average indicates that the USD/GEL exchange rate might be undervalued and vice versa. Daily estimates of REER are calculated by using nominal effective exchange rate published daily by the National Bank of Georgia and monthly inflation differential. As Inflation data for major trading partners and Georgia is published with lag, latest inflation differential represent the estimates of the TBC Bank Economic team.*
Latest day exchange rate represents the results of the same day FX trading.

Sources: Bloomberg Surveys, NBG, MIA, St. Louis FED, TBC Research estimates

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