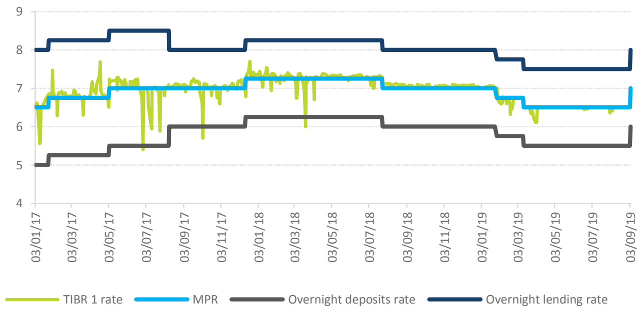
The NBG to tighten further unless the GEL strengthens

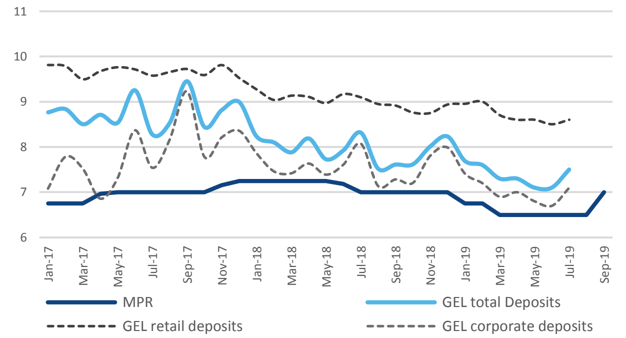
TBC RESEARCH

Monetary policy rate and short-term interbank market rates
(%)



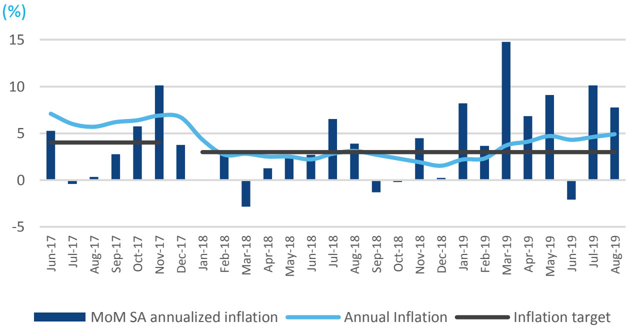
Source: The NBG

Interest rates on GEL deposits (flows) and monetary policy rate
(%)



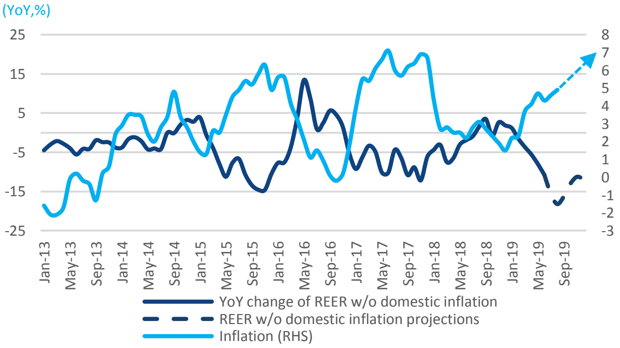
Source: The NBG

Annual and seasonally adjusted monthly annualized Inflation
(%)



Source: The NBG, TBC Research estimates

The GEL REER and Inflation
(YoY,%)



Source: The NBG, TBC Research estimates

NBG moves more decisively as inflation picks up further

On its 4th of September meeting, the Monetary Policy Committee (MPC) of the National Bank of Georgia decided to raise the policy rate by 0.5 PP to 7.0%, a sharpest rate increase since the end of 2015.

As stated by the NBG, along with the one-off factors related to the excise tax increase on tobacco, upward pressure of nominal effective exchange rate depreciation on inflation has been increasing recently, also influencing inflation expectations. In addition, the NBG stressed its decision to further tighten policy until the exchange rate pressures subside – a demonstration of quite strong position on currently undervalued exchange rate. in particular, during the press conference, the governor pointed out the possibility of additional FX interventions if deemed effective and necessary, as well as possibility of carrying out the extraordinary MPC meeting ahead of scheduled one on October 23, to address the GEL undervaluation.

At the same time, an estimated core inflation remains below 3%, indicating that the demand pressures on inflation are weak, according to the NBG.

Also, despite the slowdown in tourism, the central bank expects CA deficit to improve further. As for the GDP growth, the initial indicators are assessed as pointing to a stronger growth.

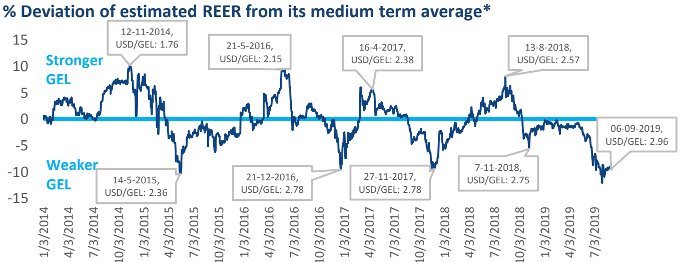
Inflation to reach around 7% unless the GEL strengthens

Inflation stood at 4.9% in August, while a seasonally adjusted monthly annualized inflation came in at 7.8%. As indicated by the seasonally adjusted figures, inflation pressures have been building up since the beginning of the year.

Real effective exchange rate has been substantially undervalued and with significant pass-through on inflation (in the short term around 30-40% of effective exchange rate depreciation is passed on the inflation) it has been the major driver of the price increase. Currently estimated daily GEL REER is around 10% below its medium term average, implying undervaluation comparable to that in 2015, when the economy faced much larger external shock.

Per TBC Research estimates, unless the GEL REER appreciates substantially from its current level, the year-end inflation is expected at around 7%.

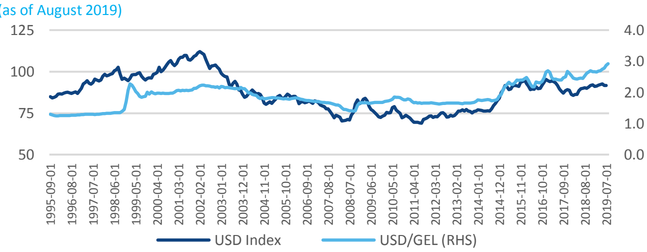
% Deviation of estimated REER from its medium term average*



*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 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.

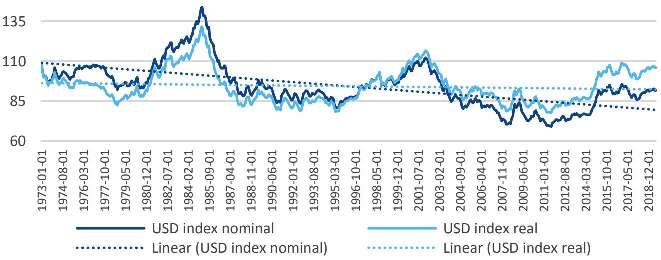
Source: The NBG, TBC Research Estimates

USD index (against major currencies) and USD/GEL exchange rate
(as of August 2019)



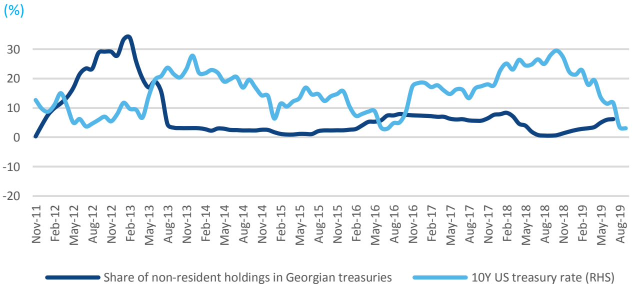
Source: The NBG, St. Louis Fed

Nominal and real USD index against major currencies
(as of Aug. 2019)



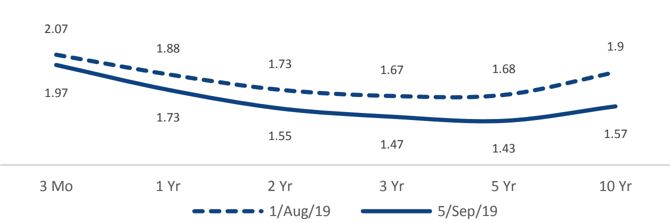
Source: The St. Louis Fed

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



Source: The NBG, St. Louis Fed

USD yield curve
(Constant maturity treasuries, %)



Source: The Fed

The USD has strengthened internationally, explaining only a fraction of the GEL weakness

Global factors have also been affecting the GEL as the USD has strengthened a bit further being at its historic highs. Despite lower yields on US treasuries, especially on those with longer term maturities, USD have been appreciating against major currencies likely reflecting the safe haven premium, as the risks related to the escalating US-China trade war have been denting the optimism on growth in the Euro Area and in some major emerging markets.

Given currently stronger USD, we update our earlier projection of the USD/GEL at 2.8 or even stronger GEL to around 2.85 in the coming months assuming approximately the same level of major trading partners' currencies against the USD and the commodity prices. Probably the GEL at this or even stronger level lies within the range of tolerance for the central bank, based on the GEL nominal effective exchange rate impact* on prices. Even if believed in the benefits of the temporary high inflation under the external shock in the Georgian context, the external balance has not worsened that much. This should be true based on the available information even though the BoP data, including FDIs, has not been yet released. In case the external shock is stronger than believed, still the NBG has demonstrated the commitment to the price stability as its primary goal and is highly unlikely to tolerate a sizeable deviation of the inflation from its 3% target**. Strong GDP growth and positive labor market dynamics are also arguments supporting the tighter monetary stance.

Unless the GEL REER strengthens, we expect further tightening. This may take the form of additional rate hikes, FX interventions, stricter collateral requirements to obtain central bank financing (quantitative tightening) being still attractive as compared with the deposit rates. Also, the relaxation of FX lending regulations is an option supporting the exchange rate and growth without excessive risk taking.

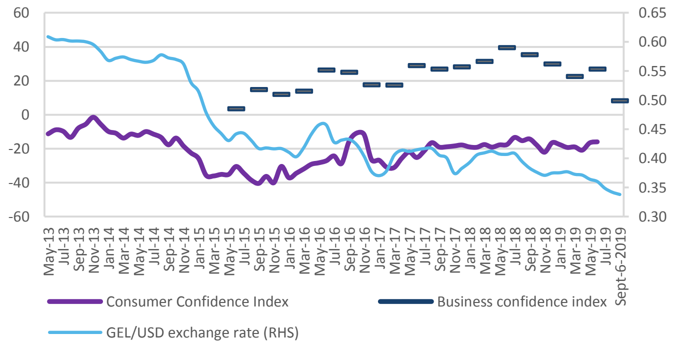
The GEL also supported by the higher interest rate differential

Historically lower UST yields have been supportive of the portfolio inflows to the emerging markets, also evident in case of Georgian government securities. Share of non-resident holdings in Georgian treasuries have been increasing along with the lower 10Y UST yields since the mid-2018. Currently, as interest rate differential between the GEL and USD securities has increased (on the most recent auction, yields on domestic 1Y T-bills increased by 50 BP) along with continued fall in UST yields, portfolio inflows could increase further, supporting the GEL in the short term. Overall, judging from the historical perspective, the USD yield appears to be the most important.

*In a very short term, the difference between REER and NEER is not material.
See TBC Economic Review Insight #9

**Edited as of 09.09.2019 from "persistent and sizeable deviation of the inflation" to "sizeable deviation of the inflation".

Consumer and business sentiments and the USD/GEL



Source: ISET PI, the NBG

Stronger GEL/USD will counteract negative impact of the tighter policy stance on the domestic demand

Currently, GEL lending have been driving the credit growth, in business, including corporate bonds as well as retail segments. Tighter bank margins are also an argument for more expensive GEL credit (see note on credit growth). Tighter monetary stance, especially in case of further rate hikes and employing additional tools, will have adverse impact on the GEL lending and the domestic demand.

On the contrary, if the GEL strengthens against the USD, it will likely counteract the negative impact on the growth through consumer as well as business sentiment channels. This is related to the balance sheet effects (see TBC Economic Review, Insight #3) as well as general perception of the USD/GEL being an indicator of the health of the economy.

Overall the impact on growth of tighter monetary stance shouldn't be strong and there won't be need for further depreciation even if the growth is not affected at all, in our view. This view is supported by the following:

- The GEL is assessed already as more undervalued than explained by the fundamentals and is likely overshooting due to adverse expectations. The expectations may somewhat reverse due to more hawkish NBG stance creating the expectation of a stronger GEL.
- While GDP annual growth estimates are strong, there might be some weakness on a monthly/quarterly basis. Also, some leading indicators like business confidence may point to a weaker growth. This could be an indication, that exchange rate overshooting coupled with the other adverse developments have already impacted the domestic demand more than the external shock would require.
- Tighter GEL conditions and the GEL appreciation should contribute to weaker GEL and stronger FX lending and other sources of external financing, supporting the GEL and the growth at the same time without excessive risk taking (see TBC Economic Review Insight #8).

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