Monthly Update

October 2019

Prepared by TBC Bank Economic Team

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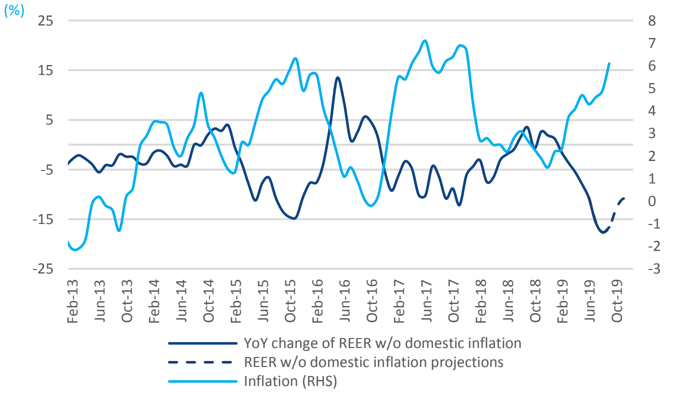
Contents

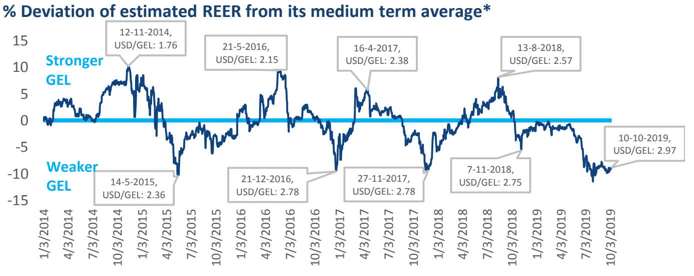
Key insights: The NBG to tighten further; external sector balanced; the growth to slow

REER and Inflation



Sources: The NBG, GeoStat, TBC Research estimates

% Deviation of estimated REER from its medium term average*

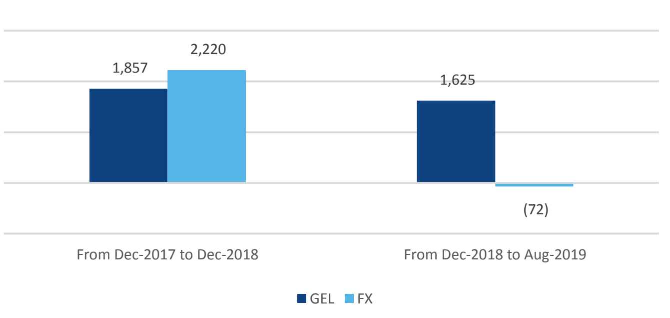


**Real effective exchange rate (REER) represents weighted average exchange rate of GEL against Georgia's major trading partner currencies, adjusted for inflation differential. Daily estimates of REER are calculated by using the nominal effective exchange rate published daily by the National Bank of Georgia and monthly inflation differential between Georgia and its main trading partners. As inflation data for major trading partners and Georgia is published with lag, latest inflation differential represents TBC Research estimates. Latest day exchange rate represents the results of the same day FX trading.*

Sources: The NBG, TBC Research estimates

Growth of loans by currencies

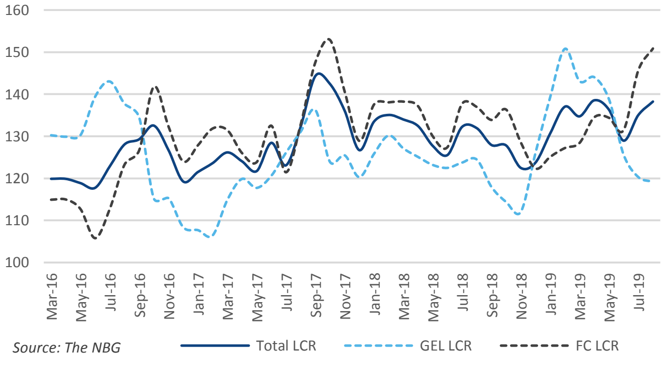
(mln GEL, at constant August 2019 FX rate)



Sources: The NBG, TBC Research estimates

Liquidity coverage ratio of the banking system

(%, as of August)



Source: The NBG

Inflationary pressures have remained high on the macro agenda as headline inflation jumped sharply in September to reach 6.4% YoY – a figure slightly above our expectations. Higher inflation in September was broad based across a number of products, both imported and domestic, indicating that besides direct cost-push pressures stemming from the undervalued exchange rate, higher inflation expectations are also building up. Given the current level of commodity prices and the GEL REER, we have revised our earlier projection of CPI inflation to around 8% for YE 2019 (the previous estimate was around 7%). The GEL REER remains significantly undervalued and, unlike previous depreciation peaks, has remained so for a relatively prolonged time, having even stronger pass-through on prices.

The NBG has continued to deploy more of its tools to address the undervalued exchange rate. After two rate hikes and FX interventions, the NBG amended the reserve requirements for FX funds from 30% to 25%, increased the treatment in the LCR from 75% to 100% and increased the remuneration rate to be much closer to the LIBOR. The intention is to increase the supply of FX loans to the economy, in line with the usage of reserve requirements in a cyclical way. According to the NBG, banks are likely to be left with an estimated 700 million USD of additional FX liquidity what increases available FX even further and should result in lower FX loan and/or deposit yields, higher FX credit and shift in the expectations to some extent. This is a welcome step as the balance between the GEL and the FX credit has shifted too much this year, placing additional pressures on the GEL exchange rate through more savings in FX and more borrowing in GEL**.

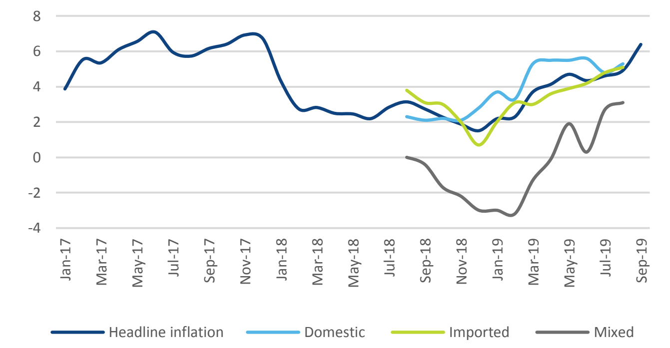
Unless the GEL REER strengthens by around 5%, we expect a further tightening in GEL in the form of an additional 50 basis points rate hike during the NBG's late October MPC meeting, possibly combined with some form of quantitative tightening. Also, a further relaxation of FX lending standards are not ruled out.

Judging from the latest data releases, even if the GEL REER strengthens by a few percentage points, around 7% CPI inflation at the end of the year appears to be unavoidable taking into account the lagged effects of the exchange rate depreciation and the low base effect in October and December. At the same time, addressing second-round effects and medium-term inflation expectations is certainly important. Therefore, we think the NBG will continue to tighten the policy rate until the GEL strengthens and will manage CPI inflation to be closer to the target in the second half of 2020 and thereafter.

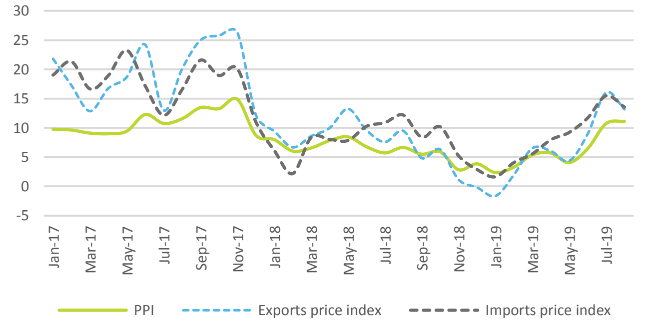
In our baseline scenario, we project the GEL REER to strengthen by around 5%, which given the recent effective exchange rate implies a USD/GEL exchange rate at around 2.8-2.85.

***For example, if the remittance inflow is accumulated at banks' correspondent accounts and/or the NBG reserves, that in a way equals a remittance shock, unlike the case when an inflow is lent in FX and/or is converted into a GEL deposit and then lent in GEL. This appears to be especially important when the external sector is clearly balanced, but is still not as strong as it was in the beginning of the year and expectations are at least somewhat tilted towards a weaker GEL.*

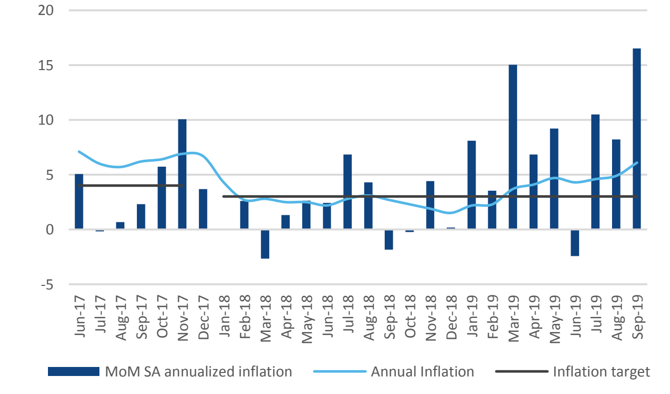
Headline inflation and inflation by types of goods/services
(%, YoY)



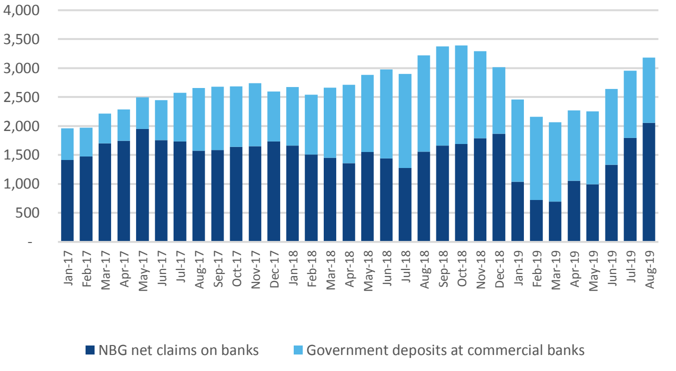
PPI, exports and imports prices
(%, YoY)



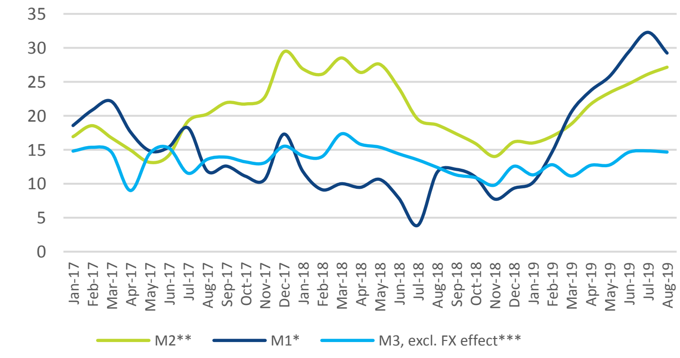
Annual and seasonally adjusted monthly annualized Inflation
(%,YoY)



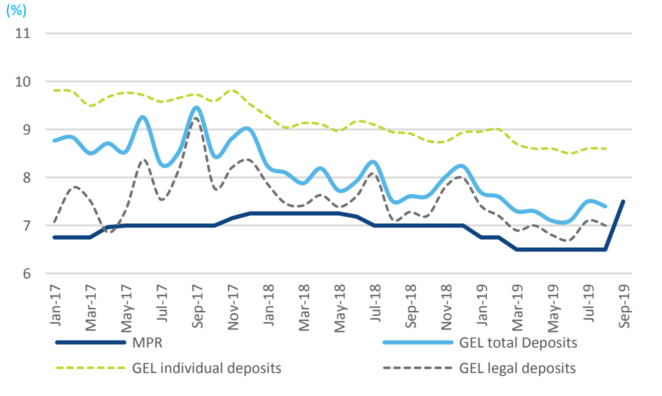
Govt. deposits in banks and financing from the NBG
(1000 GEL)



Growth of GEL monetary aggregates
(%, YoY, as of August)

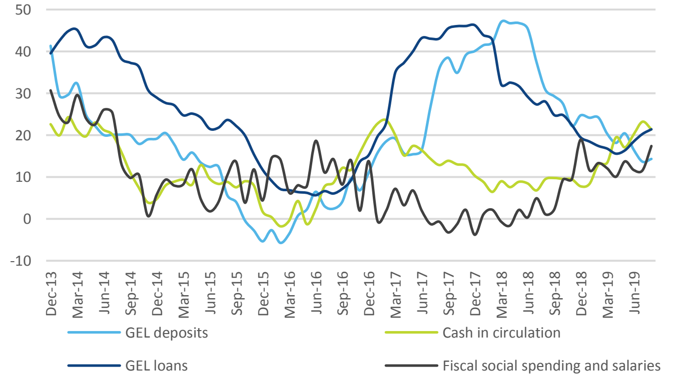


Interest rates on GEL deposits (flows) and monetary policy rate
(%)

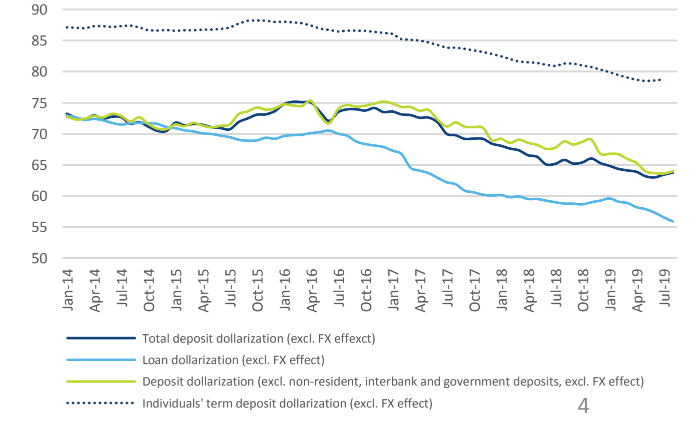


**M1 includes currency in circulation, resident demand NC deposits and excludes banking and government sector deposits at commercial banks. ** M2 includes M1 and resident term NC deposits. ***M3 includes M2 and FX deposits*

GEL loans, deposits, cash and budget social spending and salaries
(%, YoY, as of August)

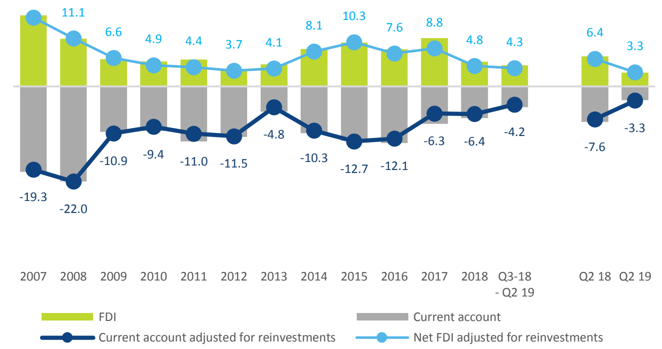


Dollarization of loans and deposits
(%, as of August)



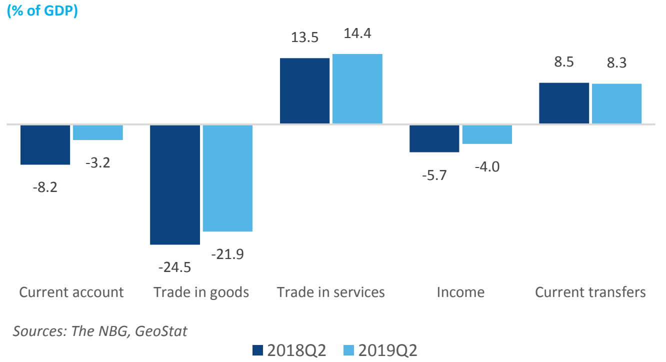
Sources: The NBG, GeoStat, MOF, TBC Research estimates

Current account deficit and FDI
(% of GDP)



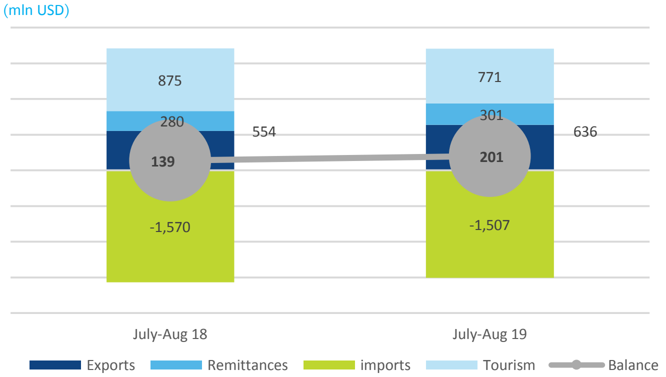
Sources: The NBG, GeoStat

Current account components
(% of GDP)



Sources: The NBG, GeoStat

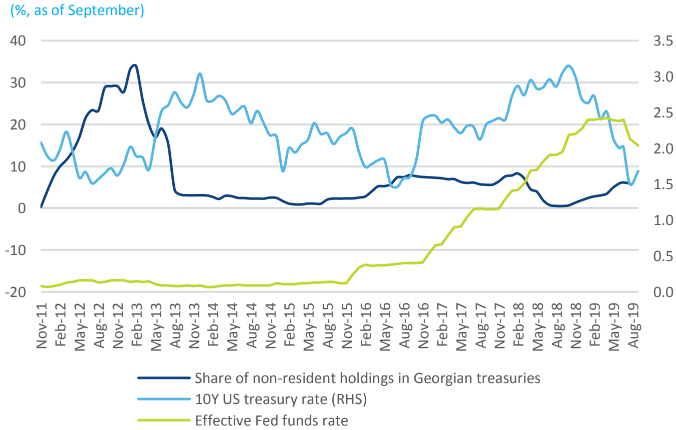
Key components* of the CA balance
(mln USD)



**Given components of the CA balance differ from the actual figures in the current account to be published later. Also, some significant components of the CA balance, like income account is not included. Therefore, the actual dynamics of the CA balance can be different from what is shown in the chart. Nevertheless, these components represent a good proxy.*

Source: The NBG

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



Sources: St. Louis Fed, NBG

In Q2 2019, the CA deficit-to-GDP ratio declined sharply to 3.2%, as opposed to 8.2% of the same figure a year ago. The bulk of the improvement reflected a reduction in the trade deficit, while higher services exports and an improved income account also contributed positively. Overall, the long-standing correlation between the level of FDI and the CA deficit seems to be driving a significant part of the change in the CA balance.

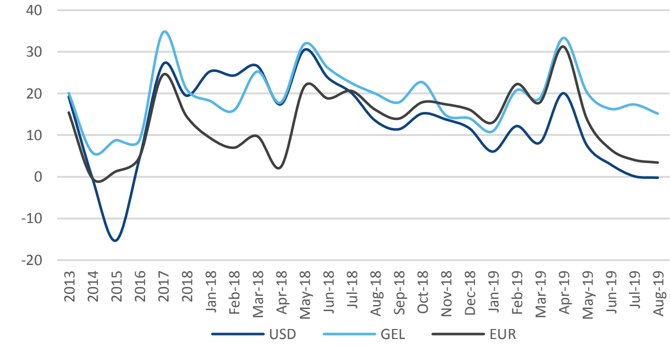
Despite Russia's flight ban and the consequent reduction in tourism inflows, the external sector remained balanced in July-Aug 2019. According to the initial estimates of the central bank, the reduction of tourism inflows amounted to around 100 million USD over the same period, which was well offset by an improved balance of trade in goods as well as by increasing remittance inflows. The decline of inflows is also partially explained by the GEL depreciation as tourists appear to spend less in USD terms when the GEL is weaker.

Given the seasonality of tourism receipts, it can be argued that the impact of sanctions will likely be lower as the high season is nearing an end. Also, the decline from Iran should be moderate in coming months as the base effect comes into play. On the other hand, the declining inflows from these countries is increasingly being offset by higher number of visitors from the EU and Middle East, who usually spend more per trip. In addition, the chances of Russia's flight ban being lifted has increased substantially taking into account recent statements made by high-level Russian officials.

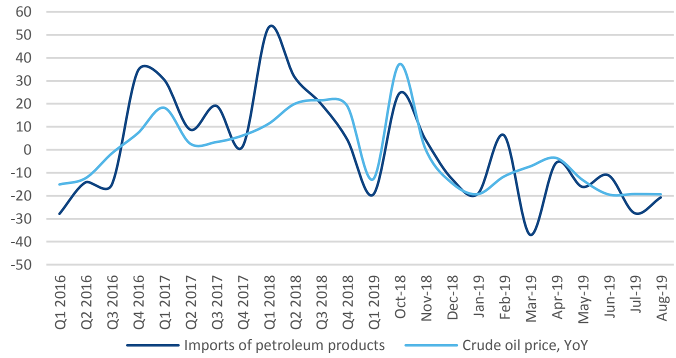
Although the global outlook has worsened since the previous monthly update, on the positive side, the signs of recovery in the Turkish economy have become even stronger. Recently, the IMF sharply increased its projected growth for Turkey from -2.5% to a positive 0.25% for 2019. Additionally, growth in Russia has somewhat strengthened.

International financing conditions remain favorable as interest rates in USD continue to decline. At the same time, despite some signals of a weakening US economy, the dollar maintains a strong position, which can mostly be attributed to its safe haven status. The increasing interest rate differential between GEL and USD rates, along with a sharply undervalued GEL creates attractive opportunities for investors with the USD as a functional currency to benefit from both channels. Historically, the share of non-residents in Georgian treasuries has been strongly correlated with USD long-term yields.

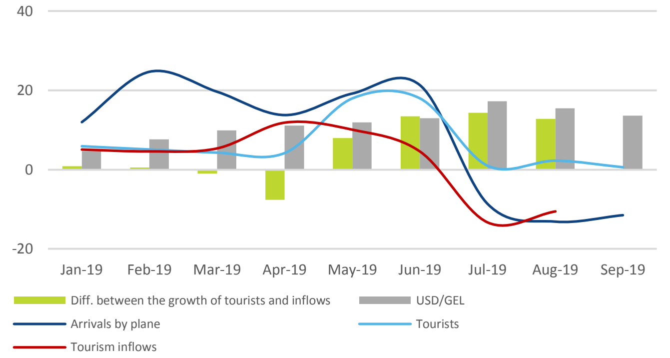
Exports, tourism and remittance inflows in USD, GEL and EUR
(%,YoY)



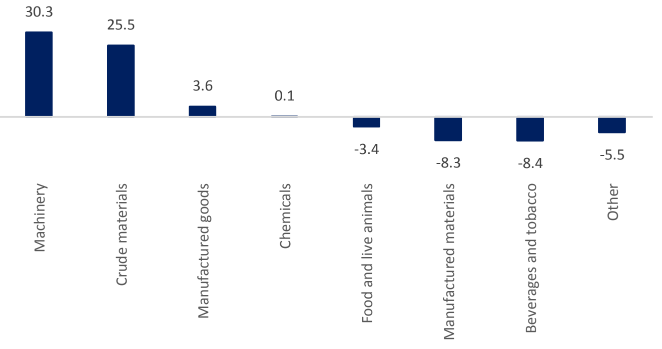
Growth of petroleum products imports in Georgia and oil prices
(%, YoY in USD)



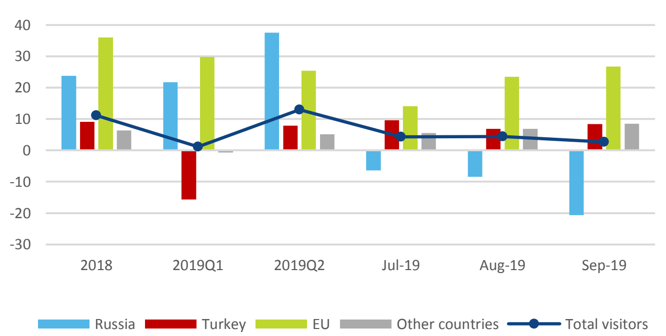
Tourists, arrivals by plane, tourism inflows and the USD/GEL
(%, YoY)



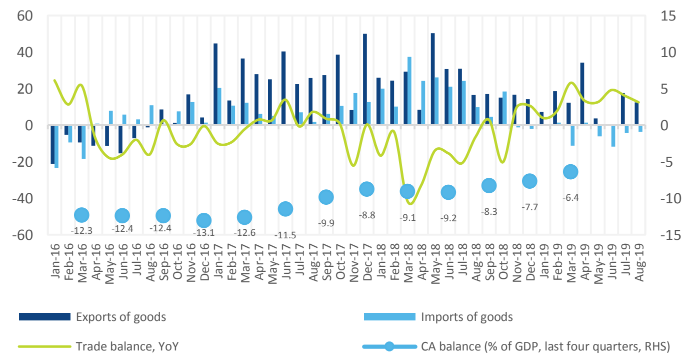
Exports by goods in August 2019
(SITC classification, mln USD, YoY)



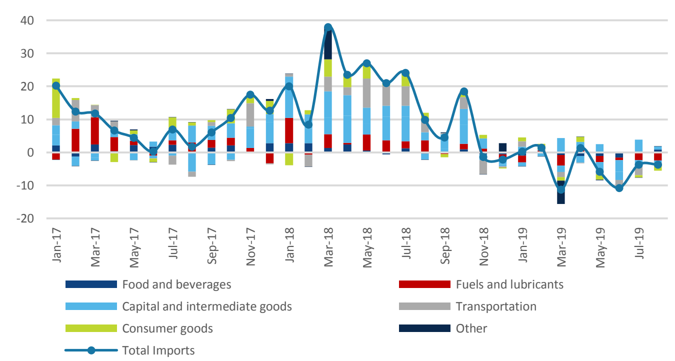
Growth of international arrivals by countries
(%, YoY)



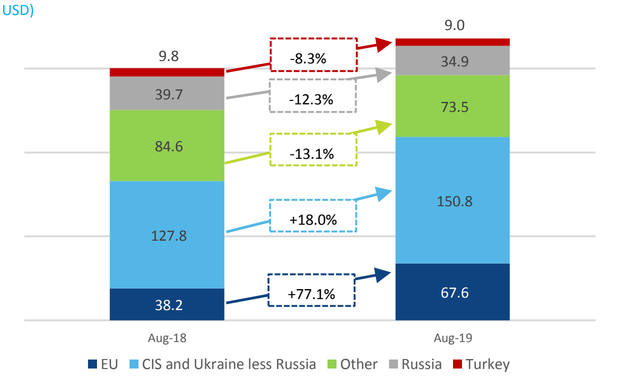
Exports, imports and trade balance in USD, CA deficit to GDP
(%,YoY)



Growth of imports in USD and contribution (in PP) of product groups
(%, YoY)



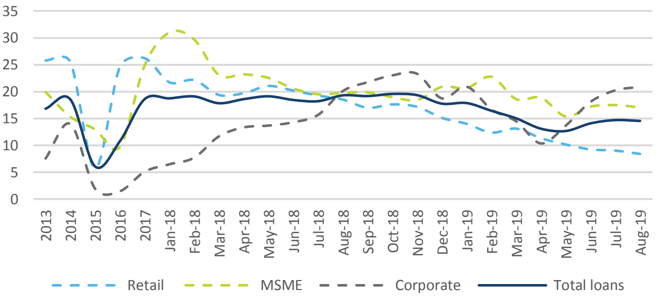
Exports of good by regions
(mln USD)



Sources: GeoStat, The NBG, GNTA

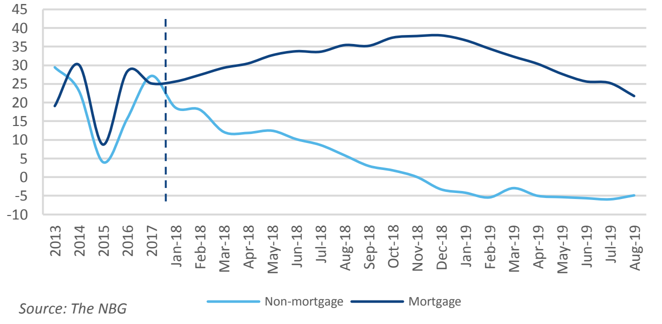
The countercyclical buffer at 0%; housing credit growth has slowed even before the tightening in GEL

Growth of loans by segments
(%,YoY, excl. FX effect)



Source: The NBG

Growth of retail loans by segments
(%, YoY excl. FX effect)



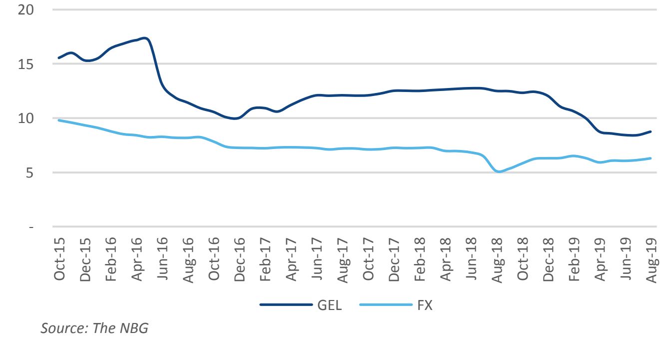
Source: The NBG

Seasonally adjusted annualized growth rates* (%)

	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	8m 2019
Retail	3.6	4.4	-0.8	4.1	12.2	6.2	5.1	6.5	5.1
Retail as sum of mortgage and non-mortgage	2.8	3.8	-0.2	4.9	10.0	5.8	3.7	5.8	4.5
Mortgage	9.3	10.3	7.6	14.4	15.8	14.1	9.4	5.1	10.7
GEL	25.7	65.3	90.6	167.8	198.4	138.2	157.1	99.2	110.5
FX	5.2	-1.7	-9.5	-13.3	-17.7	-14.8	-24.6	-22.6	-12.9
Non-mortgage	-5.4	-4.4	-10.0	-7.2	2.5	-5.3	-3.9	6.7	-3.5
GEL	-0.3	-4.4	-8.0	-6.4	8.6	-4.2	2.3	12.1	-0.3
FX	-28.9	-4.9	-20.5	-12.1	-26.2	-11.0	-31.5	-18.7	-19.7

Sources: The NBG, TBC Research estimates
** Seasonal adjustment is carried out by two methods: 1. Using ARIMA x-12 method using e-views software and 2. manual adjustment based on historical data. Both approaches yielded broadly similar results. Figures given in the table represent the average of these two methods.*

Interest rates on mortgage loans (flows)
(%)



Source: The NBG

During its September Financial Stability Committee meeting, the NBG left the countercyclical buffer unchanged at 0%. The regulator also published the "Financial Stability Report" and the "Macro-prudential Policy Strategy". According to the NBG, the resilience of the banking system remains high. Although there are a number of challenges that need to be addressed further, the message was consistent overall with the NBG's earlier communications.

Credit growth in August came in at 14.6% YoY, adjusted for the FX effect, which was broadly unchanged from the previous month. This mostly reflects higher business lending; meanwhile, retail lending continued to decelerate. Annual growth in the retail segment stood at 8.4% YoY and corporate lending increased by a solid 20.9% YoY with MSME loans expanding by 17.1% YoY.

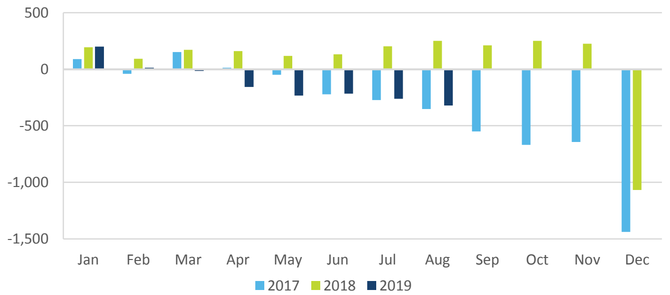
We expect business credit to normalize after the cyclical pick up in 2018. The GEL depreciation, worsened business confidence and slower expected growth going forward are also important to consider alongside the relaxed reserve requirements in FX.

Amid elevated FX volatility and increasing interest rates on GEL lending, retail lending, especially mortgages, decelerated – as suggested by the seasonally adjusted annualized growth rates in August. Over the same period, the growth of non-mortgage lending was stronger compared to previous periods, likely implying that the non-mortgage portfolio is starting to bottom out following the declining tendency since the introduction of lending regulations in May 2018 and January 2019.

Going forward, mortgage lending is at risk of slowing further as the monetary stance in GEL is expected to be further tightened and the regulations in FX are restrictive. At the same time, even without the tightening in GEL, higher GEL mortgage rates were expected at some point as bank margins came under increasing pressure. The probability of relaxing regulations in FX lending has increased substantially and there are certain ways to do so without excessive risk taking (see TBC Economic Review: Insight #8, p.35). If deemed appropriate, this is a very efficient tool to increase FX lending.

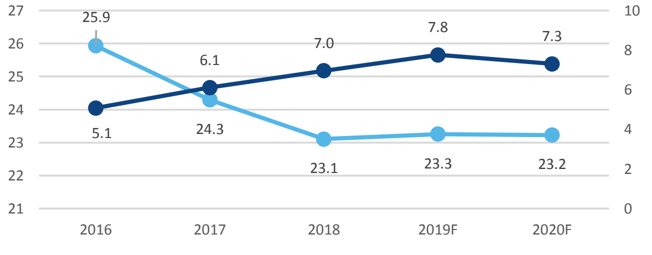
Fiscal more socially oriented in 2020, however balanced from the macro perspective; GDP growth is expected to slow

Consolidated budget balance
(mln GEL, cumulative)



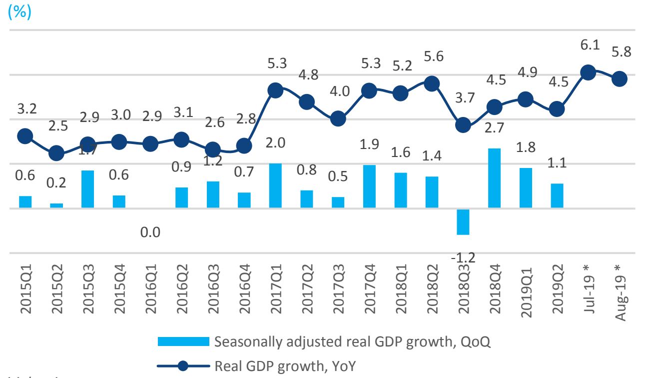
Sources: MOF, TBC Research estimates

Budget spending by types
(% of GDP)



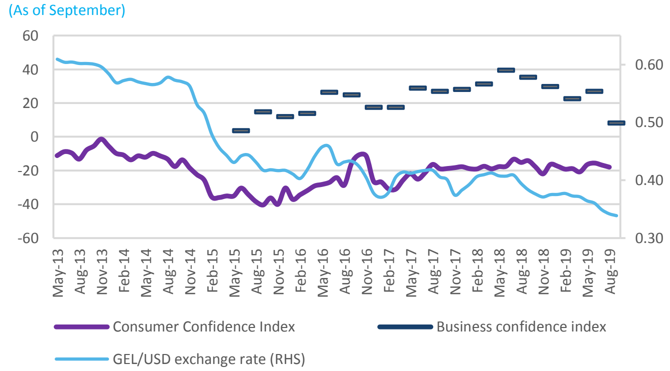
Source: MOF

Annual and seasonally adjusted quarterly real GDP growth
(%)



*Initial estimates
Sources: GeoStat, TBC Research estimates

Consumer and business sentiments and GEL/USD
(As of September)

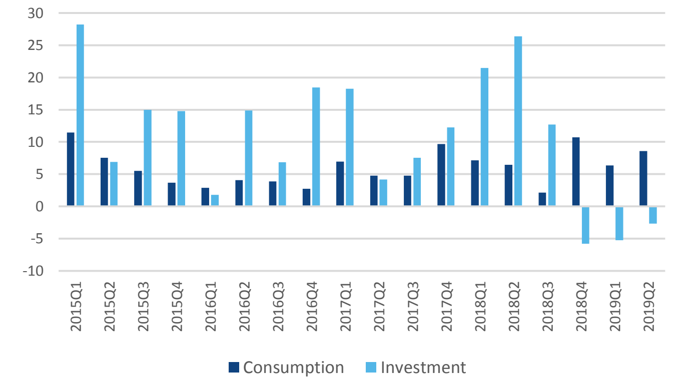


Sources: ISET-PI, The NBG

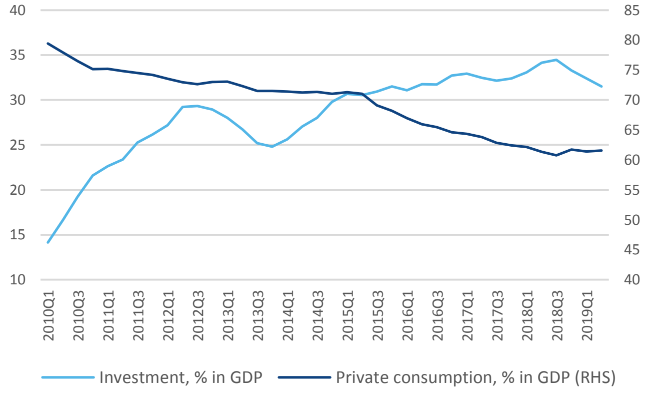
Budget spending remained supportive of growth in August. Unlike the previous year, fiscal expenditures continue to be more balanced and expansionary. The 2020 draft budget is certainly more socially oriented; however, it remains sustainable from a macro perspective when taking into account planned capital and current expenditures, and the deficit of around 3% in percent of GDP. At the same time, the 5% growth projection for next year may be optimistic.

In August, GDP growth stood at 5.8% primarily thanks to the low base effect. If Q3 2019 growth YoY is 5.5%, the GDP QoQ growth in Q3 on a seasonally adjusted basis would be close to zero, indicating a further decline in the growth rate. Together with a weaker external sector and domestic tensions, a weaker GEL against the USD has played a role – at least in the short term, a stronger USD against the GEL appears to be contractionary rather than expansionary. Assuming inflows, fiscal and credit have approximately the same dynamics compared with the latest developments and the GEL strengthens against the USD by around 5%, annual growth in Q4 should stand at around 3%, now also reflecting high base effect unlike Q3. For the full year 2019 and 2020, we project around 4.4% and 4.2%, respectively with low growth in the first half and close to or above 5% in the second half of 2020. The downside risks are related to a greater-than-expected worsening of the international/regional environment, a global strengthening of the USD, uncertainties related to the election year, credit slowing at an even higher pace and a further weakening of the GEL. At the same time, there are strong upsides related to the likely lifting of the flight ban, the more active path of large projects such as the Anaklia Deep Sea Port and HPPs, the rebound of the EUR, an even further strengthening of the GEL/USD exchange rate and a stronger growth of FX credit, especially on the retail side.

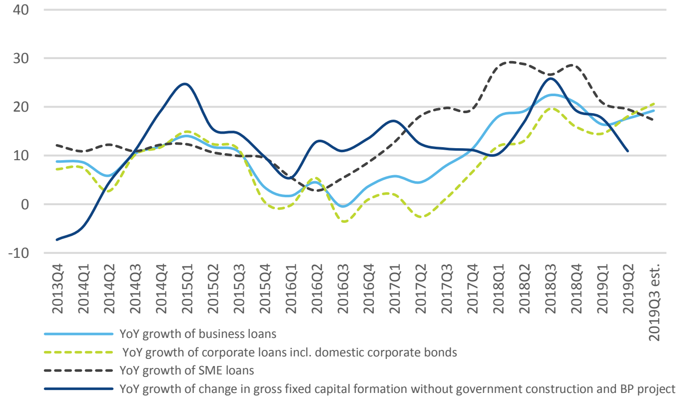
Aggregate consumption and investment
(%, nominal, YoY)



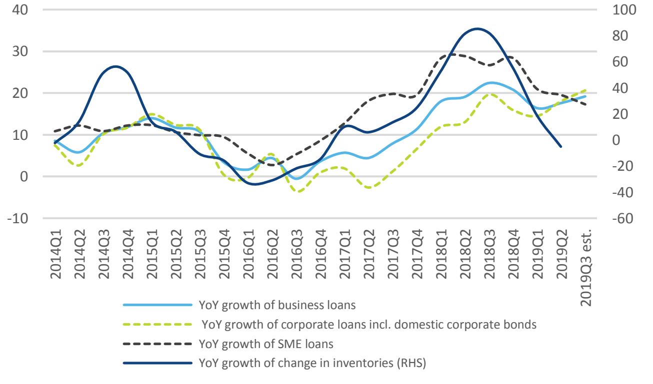
Private consumption and investment
(last four quarters, % of GDP)



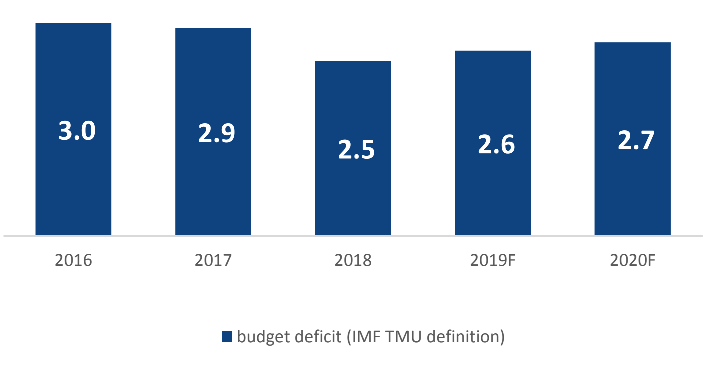
Business lending and gross fixed capital formation
(%, YoY)



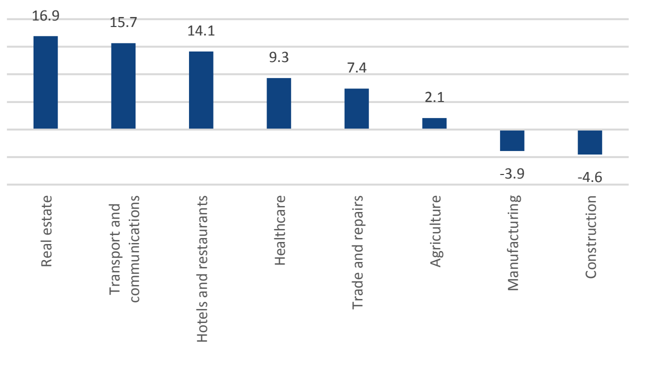
Business lending and inventories
(%, YoY)



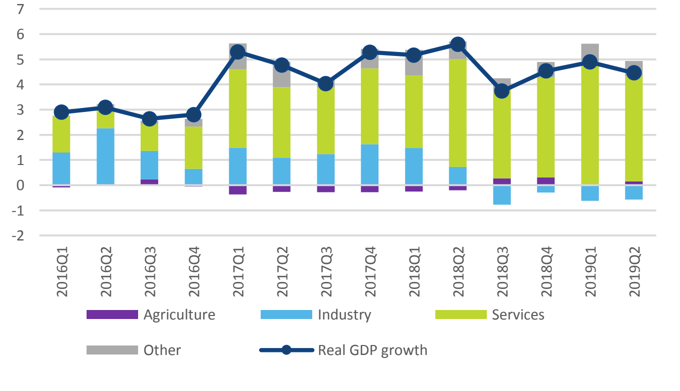
Budget deficit
(% of GDP)



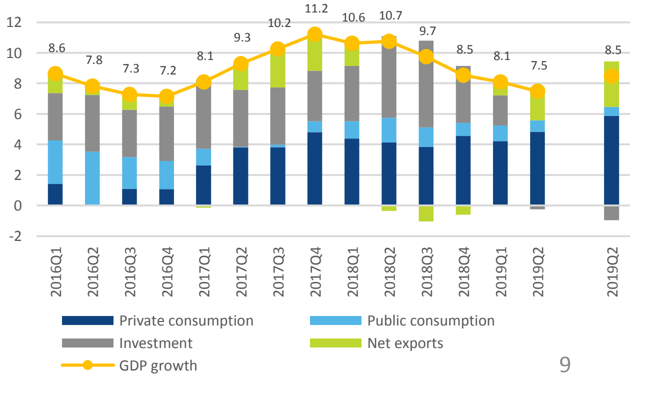
Growth of value added by sectors
(%, YoY, Q2 2019)



Contribution of different sectors to real GDP growth
(%, YoY)

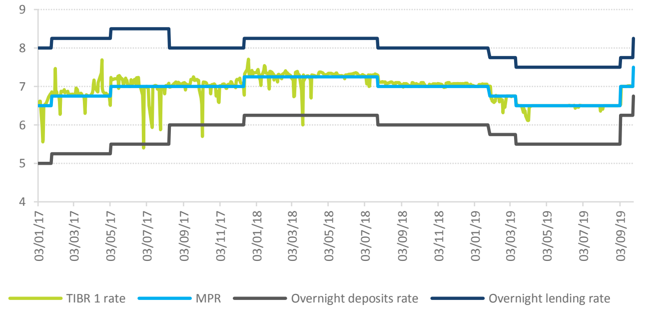


Contribution to nominal growth
(Last 4 quarters, %, YoY)



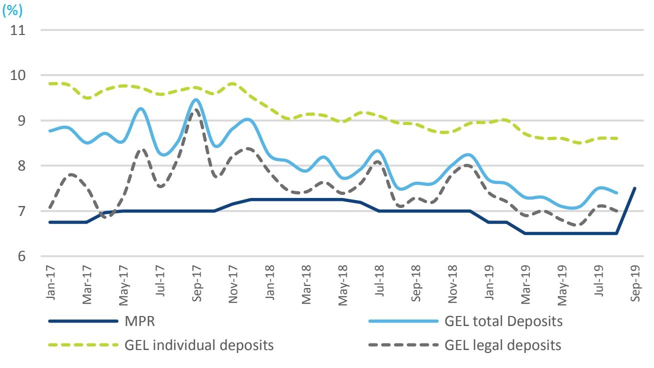
Sources: GeoStat, The NBG, MOF, TBC Research estimates

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



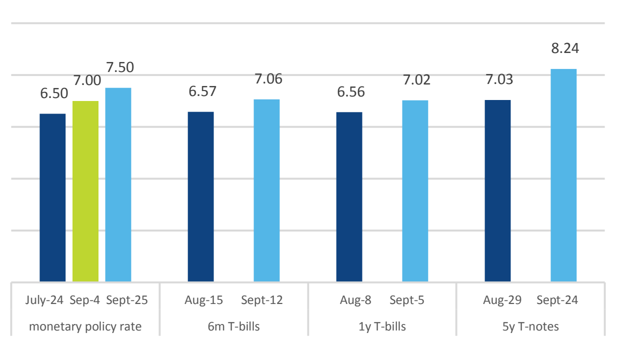
Source: The NBG

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



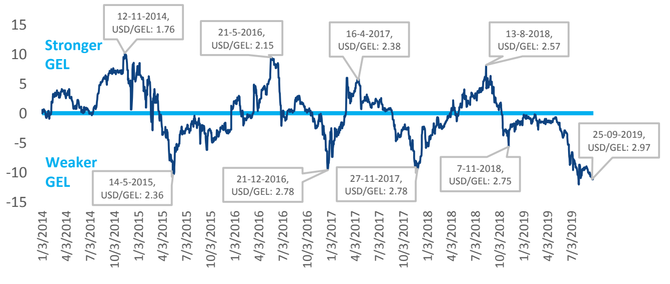
Source: The NBG

Interest rates on treasury securities and monetary policy rate
(%)



Source: The NBG

% 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. Daily estimates of REER are calculated by using the nominal effective exchange rate published daily by the National Bank of Georgia and monthly inflation differential between Georgia and its main trading partners. As inflation data for major trading partners and Georgia is published with lag, latest inflation differential represents TBC Research estimates.*
Latest day exchange rate represents the results of the same day FX trading.

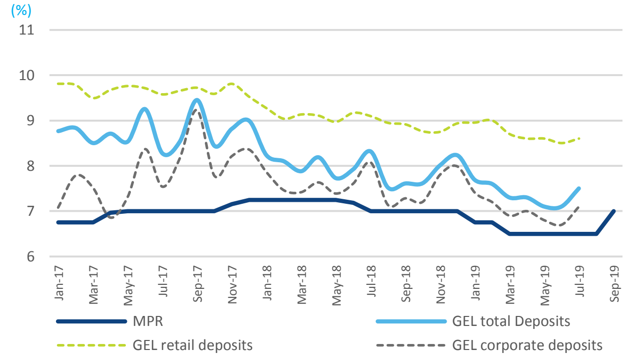
Source: The NBG, TBC Research Estimates

The NBG, during today's extraordinary Monetary Policy Committee meeting raised the policy rate by 50 basis points to 7.5%. The move was well expected as the GEL remains strongly undervalued with high pass-through on the inflation (see TBC Research earlier note on the scheduled MPC meeting).

According to the NBG, all means and instruments will be used to ensure the price stability. Also, the assessment of the external sector dynamics is positive, what together with the tighter monetary stance, contributes to the GEL appreciation through the expectations channel.

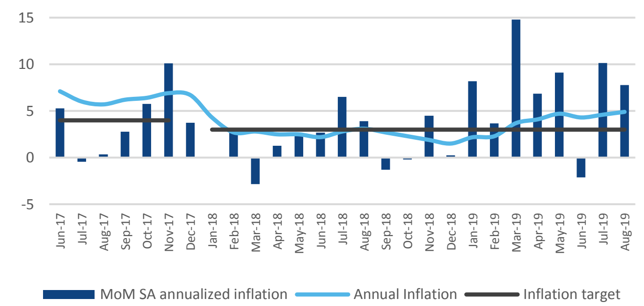
Unless the GEL strengthens, we expect another, probably 50 basis points rate hike during October 23 MPC meeting as well as the usage of other tools.

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



Source: The NBG

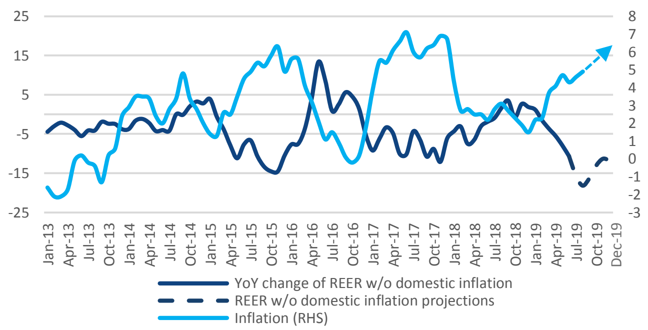
Annual and seasonally adjusted monthly annualized Inflation



Source: The NBG, TBC Research estimates

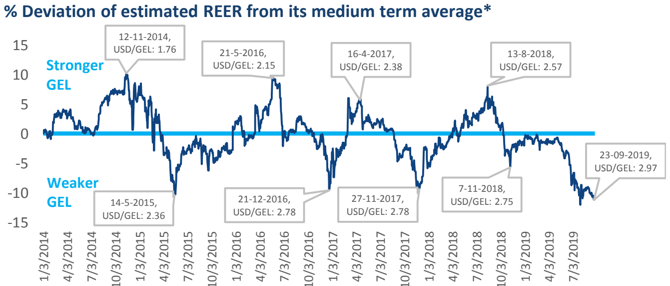
The GEL REER and Inflation

(YoY,%, projection based on August 2019 data)



Source: The NBG, TBC Research estimates

% 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

The NBG announced last Friday it will hold an extraordinary meeting of the Monetary Policy Committee on 25th of September, delivering on its promise to act further unless the exchange rate pressures on inflation subside (see latest monthly update, note on the monetary policy and inflation).

Recently published more detailed information on the price dynamics in August reveal that together with the pick-up in overall inflation rate, it is broad-based across the increasing number of goods and services, potentially impacting the expectations as well. Importantly, prices went up on imported as well as on domestic products, the latter increasing at even somewhat higher rate*. As for the producer price index, often seen as a leading indicator for consumer price dynamics, it went up by 11.1% YoY. Exports and imports prices also increased at solid rates by 13.2% YoY and 13.6% YoY, respectively. At current level of GEL REER and the commodity prices, we maintain our earlier projection of CPI inflation reaching around 7% by the end-2019.

We expect an additional 0.5 PP rate hike and do not rule out the FX interventions to follow. While in the medium term the reserve accumulation stays as a priority, in the short term the central bank may even sell reserves more actively as the existing level already exceeds the target set by the IMF program earlier in Spring, when the external sector was stronger, by around 80 mln USD, per our estimates. Also, some form of quantitative tightening may be used as a policy tool. These measures should do the trick to reverse currently sizeable GEL REER weakness.

Reasonably strong external sector is also an argument for the stronger GEL. At the same time, even if the external sector is weaker than believed, still the NBG has demonstrated the commitment to the price stability as its primary goal and, in our view, will tighten sufficiently, using the range of available tools, to counteract the inflation pressures.

See more in TBC Research previous and upcoming publications.

** See NBG's Monthly Macroeconomic Review pp 5.*

Remittances up by 11.8% YoY in EUR

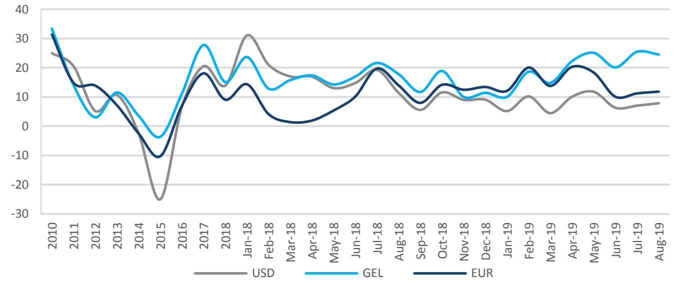
Remittance inflows increased by 7.8% YoY in August 2019 in USD terms, somewhat improved growth compared to previous two months. When expressed in EUR and GEL terms, the annual growth rates stood at higher 11.8% and 24.5%, respectively.

The increase was mostly driven by the inflows from the EU (+24.3% YoY in USD) on the back of traditional source countries like Italy (+25.6% YoY in USD) and Greece (+16.9% YoY in USD). Among the other EU countries, remittances from Poland (+69.1% YoY in USD), Germany (+28.9% YoY in USD) and France (+44.5% YoY in USD) also increased significantly.

As expected, somewhat similar to the tourism dynamics, remittance inflows started to recover from Turkey, following the declining tendency over the last 12 months. The improvement is likely to continue thanks to the low base effect and signs of recovery in Turkey. Also, the growth continued from other major countries of origin, such as Israel (+8.1% YoY) and the USA (+1.5% YoY).

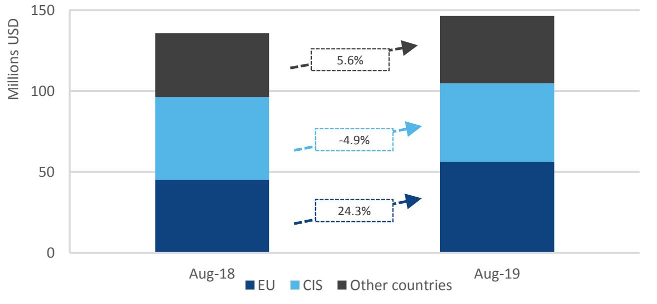
At the same time, remittance inflows from the CIS went down by -4.9% YoY in USD terms, mostly due to the declining trend from Russia (-14.5% YoY in USD).

Growth of remittances in different currencies
(YoY, %)



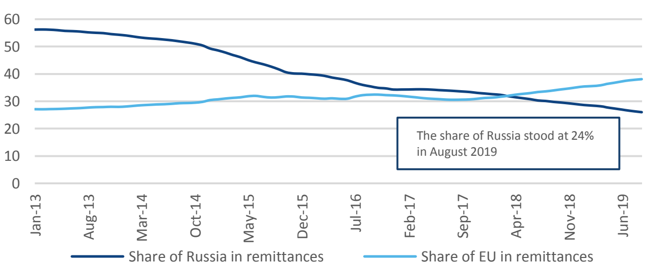
Source: The NBG

Remittances by regions



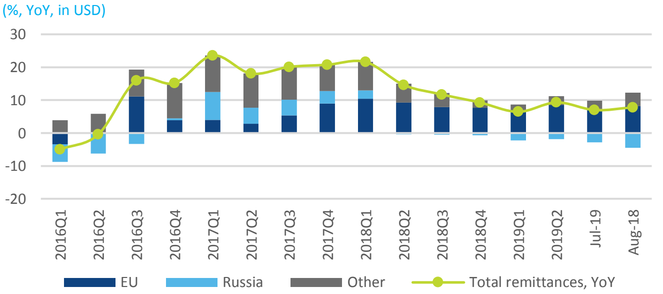
Source: The NBG

Share of EU and Russia in remittance inflows
(%, trailing 12 months)



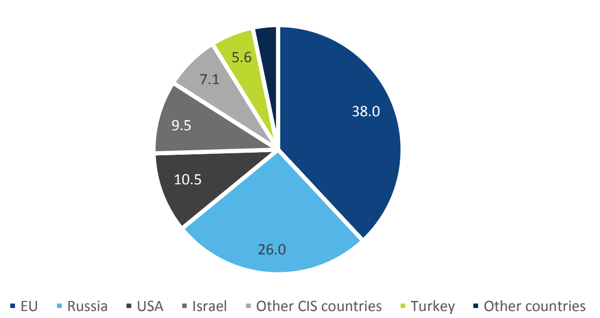
Source: The NBG

Growth of remittances and contributions (PP) from major sources
(%, YoY, in USD)



Source: The NBG

Share of different countries in remittance inflows
(%, trailing 12 months as of August 2019)



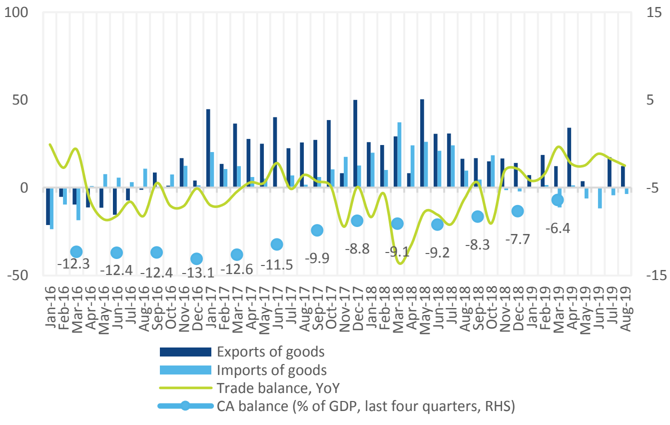
Source: The NBG

Growth of remittance inflows and contribution (PP) of different countries/regions
(%, YoY in USD)

Countries	YoY over the last 12 m as of August 2019	Contr. to growth over the last 12 m as of August 2019	YoY in August 2019	Contr. to growth in August 2019
EU	22.4	94.1	24.3	102.9
Russia	-6.7	-25.1	-14.5	-56.7
USA	13.8	17.2	1.5	2.1
Israel	6.8	8.2	8.1	9.8
Other CIS countires	37.4	26.2	37.0	33.1
Turkey	-19.4	-18.2	9.2	6.3
Other countries	-5.4	-2.5	6.1	2.5
Total	8.0	100.0	7.8	100.0

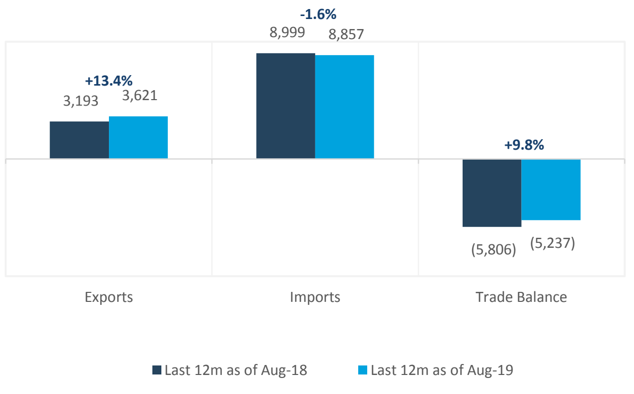
Source: The NBG

Exports, imports and trade balance in USD, CA deficit to GDP
(%, YoY)



Source: Geostat, The NBG

Exports, imports and trade balance
(mln USD)



Source: Geostat

According to the initial estimates of Geostat, trade deficit decreased further in August by 12.5% YoY in USD terms, spanning the 10th consecutive months of improvement since November 2018. Continued improvement of the trade balance supports the view that the external sector is reasonably strong (see September monthly update).

Exports of goods went up by 12.4% YoY in USD terms (+16.5% in EUR and +29.7% in GEL) or by 34 mln USD in absolute terms. Over the trailing 12 months ending in August 2019 exports growth amounted to 13.4% YoY in USD terms (+19.2% in EUR and +23.6% in GEL).

Over the same period, imports declined moderately by 3.7% YoY (-0.1% in EUR and +11.2% in GEL) or by 28 mln USD in absolute terms. Over the last 12 months as of August imports was down by 1.6% YoY in USD terms (+3.4% YoY in EUR and +7.1% YoY in GEL), contributing to a sizeable improvement of the trade balance.

Detailed trade data will be available by 19th of September.

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