# When Tightening Means Easing

## Monthly Update December 2019

Prepared by TBC Bank Economic Team

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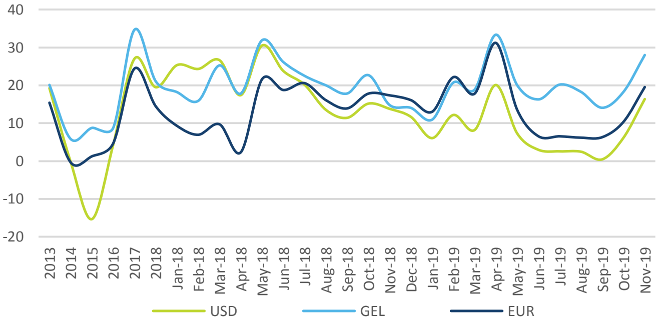
# Contents

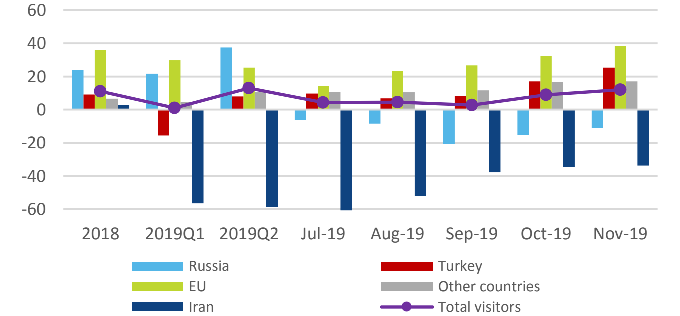
## When Tightening Means Easing

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




*Sources: NBG, GeoStat*

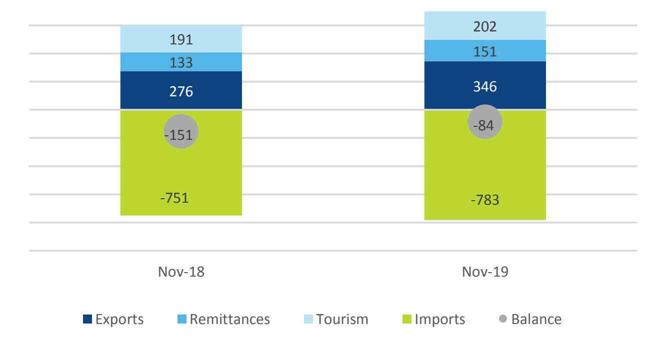
**Growth of international arrivals by countries/regions***
(%, YoY)




*Source: GNTA*

**In 2018 shares of given countries in total tourism inflows were following: Russia: 22.9%; Turkey: 12.4%; EU: 11%; Iran: 7.4%*

**Key components* of the CA balance in Nov. 2019**
(m USD)




*Sources: NBG, GeoStat*

**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.*

External inflows picked up sharply in November, supported by the strong rebound in exports (+25.2% YoY in USD), the continued recovery in tourism receipts (+5.6% YoY in USD) and the steady growth of remittance inflows (+13.3% YoY in USD). Overall, exports, tourism and remittance inflows increased by 16.3% YoY in USD, while growth stood at 19.6% YoY and 28.0% YoY when measured in EUR and GEL, respectively. Concurrently, imports increased only moderately, by 4.2% YoY in USD. As a result, the key components of the CA balance improved in November by an estimated 70 mln. USD.

Alongside the rebound in exports, the tourism industry has begun to recover earlier than expected on the back of strong growth from the EU, Georgia's neighbors, including a recovery from Turkey, as well as growth from Central Asia, Israel and Middle Eastern countries. This increase was sufficient to offset the drop from Russia and Iran, and even to deliver a 10.3% YoY growth of tourists in November, after 7.8% in October and only 1.4% in July-September 2019. In tourism inflows, starting from September 2019, the EU share has continued to surpass Russia, akin to remittances from the beginning of 2018.

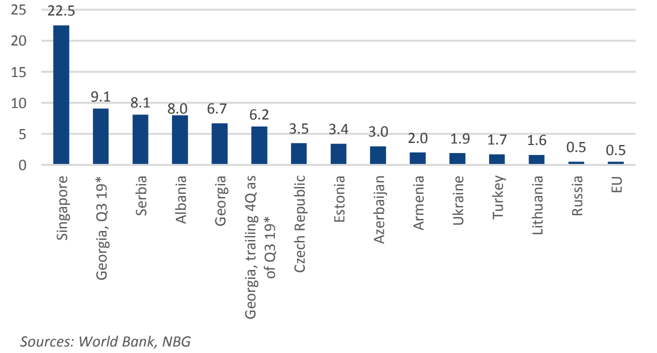
In Q3 2019, FDI inflows posted much stronger growth than expected (+13.7% YoY in USD) and stood at a solid 10.4% of GDP; mostly reflecting higher reinvested earnings, while equity inflows almost halved. Despite lower equity inflows, the level of FDIs, relative to GDP, remains well above the peer economies, even without potential large-scale developments like the Anaklia Deep Sea Port or hydropower projects like the Nenskra HPP.

**FDI inflows by components**

| mln USD | Q1-18 | Q2-18 | Q3-18 | Q4-18 | Q1-19 | Q2-19 | Q3-19 |
|---|---|---|---|---|---|---|---|
| **Total** | **324** | **404** | **367** | **171** | **288** | **204** | **417** |
| of which: | | | | | | | |
| Equity | 141 | 283 | 215 | 164 | 87 | 134 | 119 |
| Reinvestment of earnings | 185 | 104 | 125 | 24 | 106 | 71 | 259 |
| Debt instruments | -2 | 17 | 27 | -17 | 94 | -1 | 40 |

*Source: GeoStat*

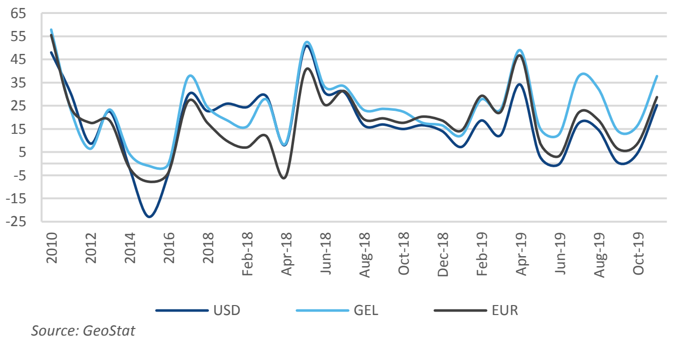
**Net FDI inflows**
(% of GDP, 2018)




*Sources: World Bank, NBG*

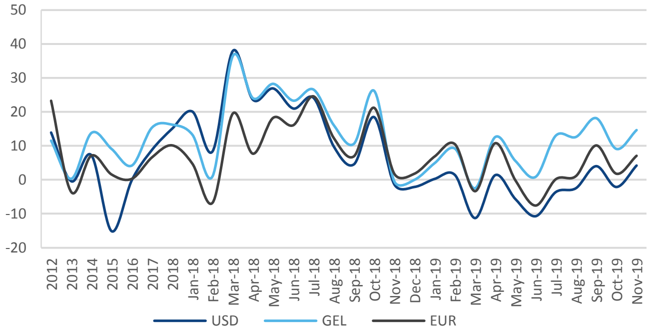
** Gross FDI inflows*

### Growth of exports in different currencies
(%, YoY)



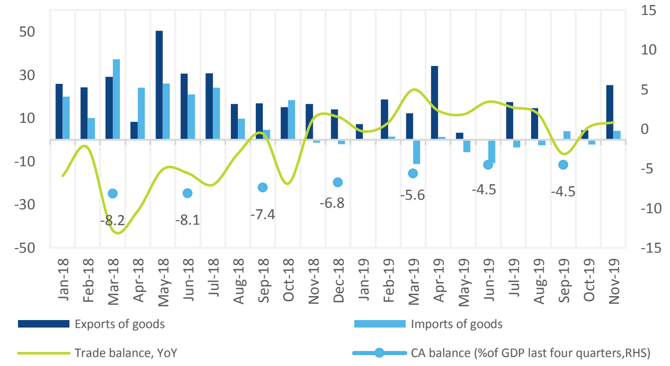

*Source: GeoStat*

### Growth of imports in different currencies
(%, YoY)



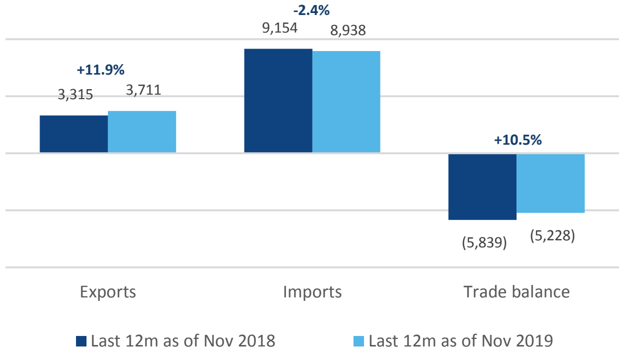

*Source: GeoStat*

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



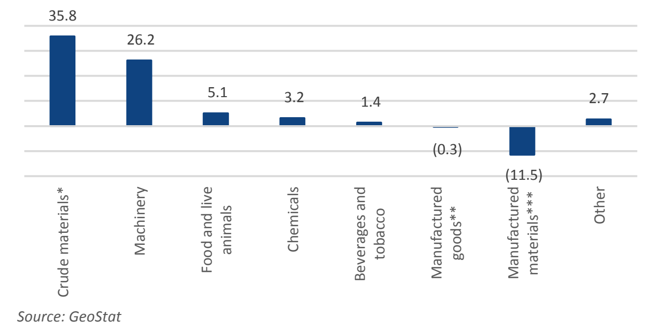

*Sources: GeoStat, NBG*

### Exports, Imports and Trade Balance
(mln USD)




*Source: GeoStat*

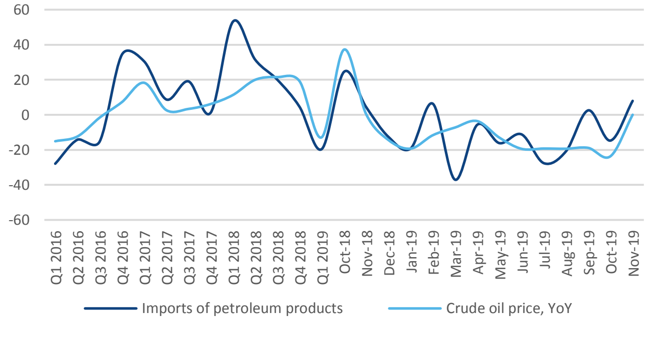
### Exports by goods in November 2019
(SITC classification, mln USD, YoY)




*Source: GeoStat*

** mostly metal ores, ** mostly textile, prefabricated buildings, lighting and heating devices,*
**** mostly metal and rubber manufacture*

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



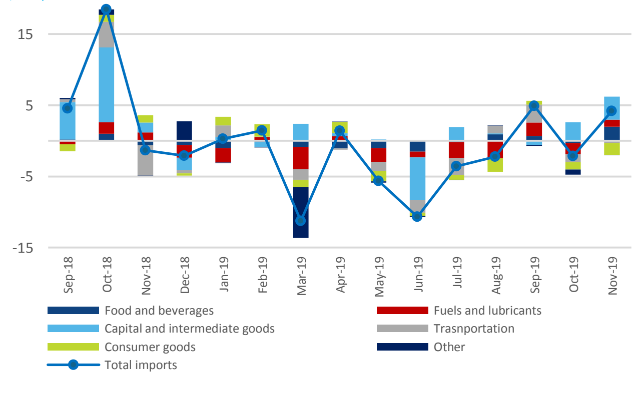

*Sources: GeoStat, St. Louis Fed*

### Exports of goods by regions/countries

| mln USD | Nov-18 | Nov-19 | YoY | YoY % |
|---|---|---|---|---|
| *Total export* | 276.2 | 345.9 | 69.7 | 25.2 |
| | | | | |
| *To EU* | 59.2 | 67.4 | 8.2 | 13.8 |
| *To CIS* | 168.5 | 184.3 | 15.8 | 9.4 |
| *To other countries* | 48.5 | 94.3 | 45.8 | 94.3 |
| | | | | |
| *China* | 8.1 | 46.6 | 38.4 | 471.6 |
| *Armenia* | 26.9 | 43.5 | 16.6 | 61.8 |
| *Kyrgyzstan* | 3.5 | 10.3 | 6.8 | 191.9 |
| *Lithuania* | 2.9 | 8.4 | 5.5 | 187.6 |
| *Turkey* | 10.3 | 15.0 | 4.7 | 45.3 |
| *Switzerland* | 5.1 | 9.8 | 4.7 | 91.4 |
| *Belarus* | 2.5 | 6.0 | 3.4 | 134.8 |
| *Italy* | 2.3 | 5.7 | 3.4 | 148.7 |
| *Russia* | 41.7 | 44.2 | 2.5 | 6.0 |
| *Poland* | 1.0 | 3.5 | 2.5 | 251.7 |
| *Other* | 171.9 | 153.2 | (18.6) | (10.8) |

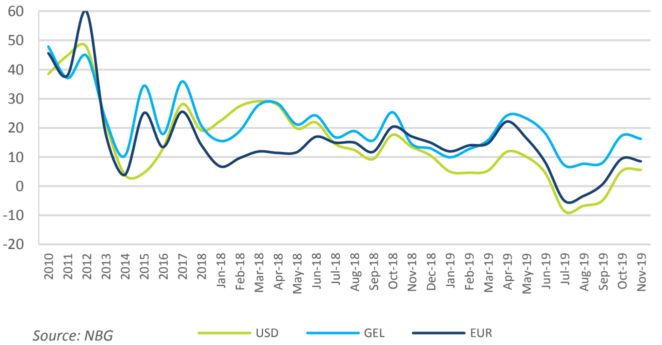
*Source: GeoStat*

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



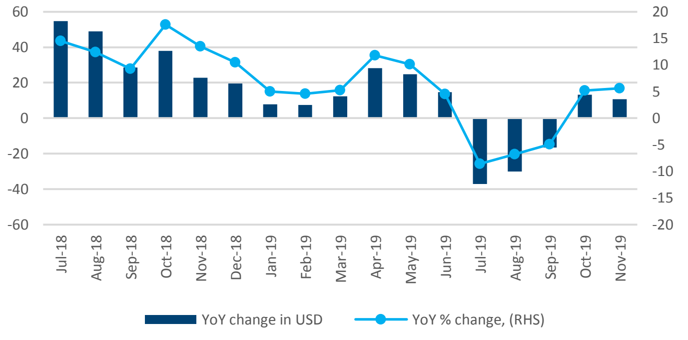

*Source: GeoStat*

### Tourism inflows in different currencies
(%, YoY)



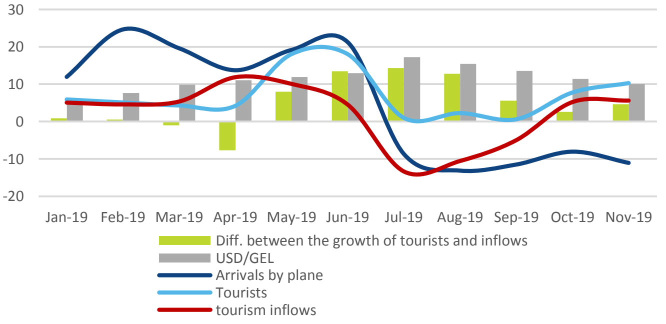

Source: NBG

### YoY growth of tourism inflows



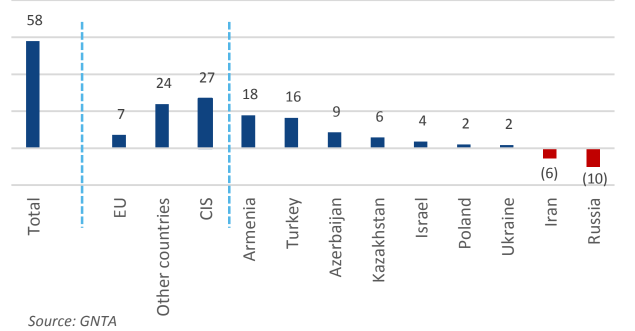

Source: NBG

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



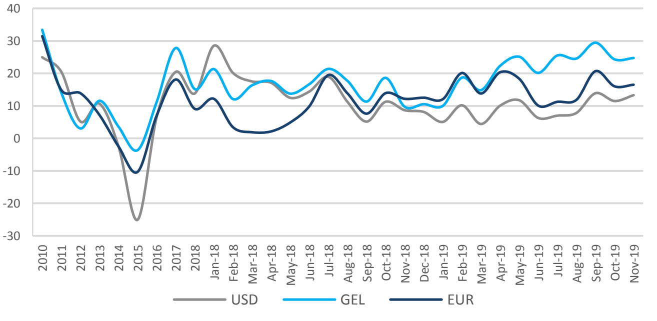

Sources: GNTA, NBG

### Dynamics of visitors by countries/regions in November
(YoY, 1000 persons)



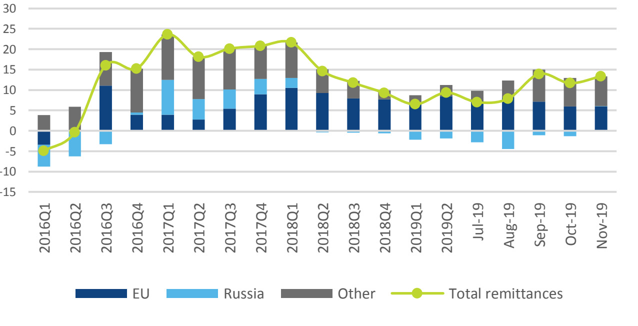

Source: GNTA

### Growth of remittances in different currencies
(%, YoY)



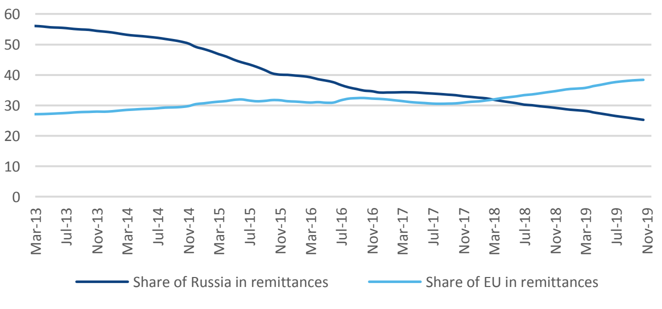

Source: NBG

### Growth of remittances and contribution (PP) of major sources
(%, YoY, in USD)



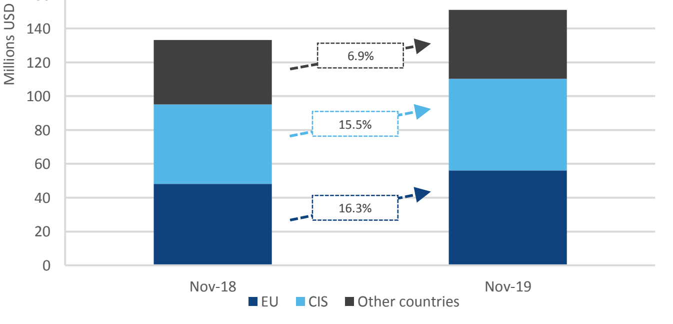

Source: NBG

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




Source: NBG

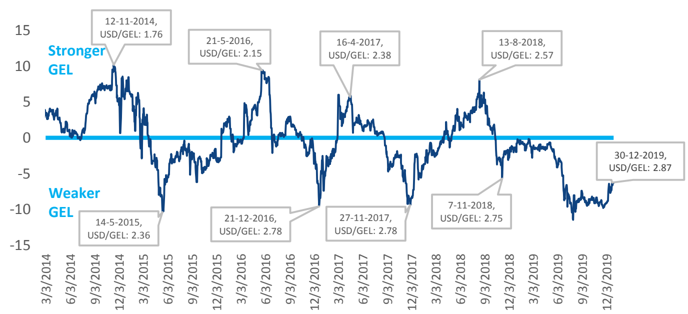
### Remittances by regions




Source: NBG

Following a prolonged period of an undervalued GEL, the domestic currency has started to recover some of its value. Since the beginning of December the GEL REER strengthened by an estimated 3.0% and the USD/GEL exchange rate moved from 2.96 to 2.87. A tighter monetary policy stance in GEL, expressed by a further rate hike in December and the sale of 20 million USD, coupled with the relaxed requirements for FX reserves, and in general NBG's hawkish communication, have delivered initial desirable results. Unlike the trend prior to October, November was the second consecutive month when FX credit growth contribution outpaced that of GEL, implying that the market has already started to react to the tighter monetary policy stance. In particular, with the higher interest rate differential between GEL and FX credit, the depreciation expectations have also likely weakened, at least to some extent. However, the same (switching from FX to GEL) is less evident on the deposit side. Besides exchange rate expectations, GEL deposits are also driven by GEL credit, which is normalizing. Estimated seasonally adjusted monthly growth rates declined from above 3% (annualized 45%) in Q3 to around 1.3% (annualized 16%). This further impacts the dynamics of GEL deposits, alongside changes in governmental deposits in banks. Typically, a change in sentiment on the deposit side takes longer, and the deposits are much less sensitive to the interest rate differential compared to credit. Though, per our judgment, there is still a certain positive tendency on the deposits side; conversions to FX having taken place in earlier months are not, at least, expressly observable.

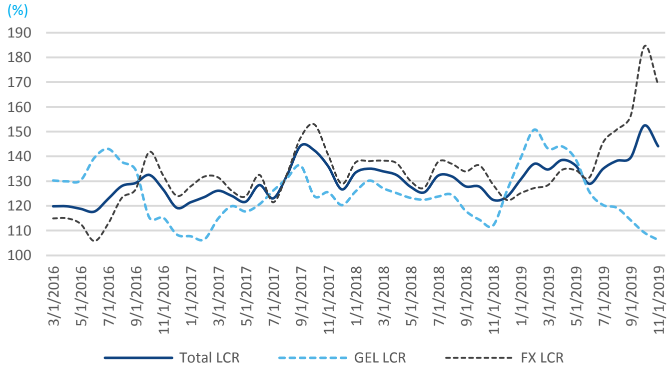
**% Deviation of estimated REER from its medium term average***




*Source: NBG*

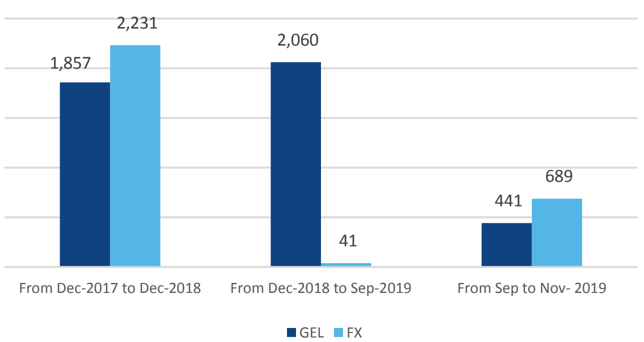
**Real effective exchange rate (REER) represents weighted average exchange rate of GEL against Georgia's major trading partner currencies, adjusted for inflation differential. Daily estimates of REER are calculated by using the nominal effective exchange rate published daily by the National Bank of Georgia 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.*

**Liquidity coverage ratio of the banking system**
(%)



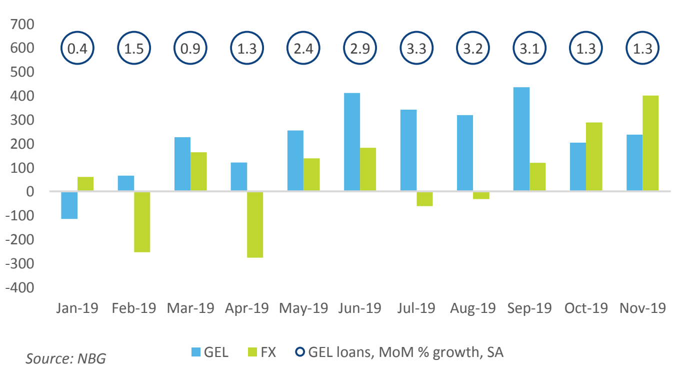

*Source: NBG*

**Growth of loans by currencies**
(mln GEL, at constant Nov. 2019 FX rate)



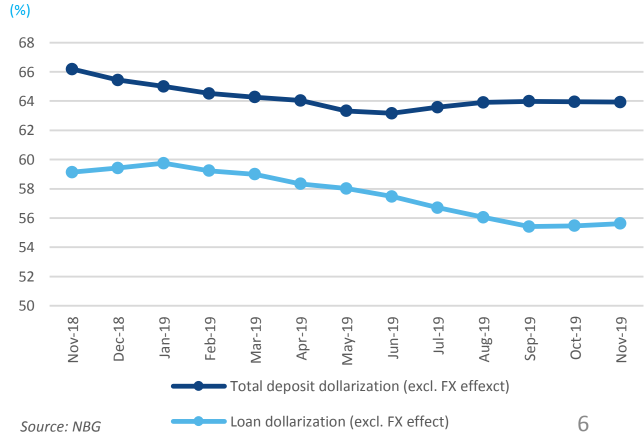

*Source: NBG*

**Monthly loan growth by currencies and monthly seasonally adjusted growth of GEL loans**
(mln GEL, at constant Nov. 2019 FX rate)



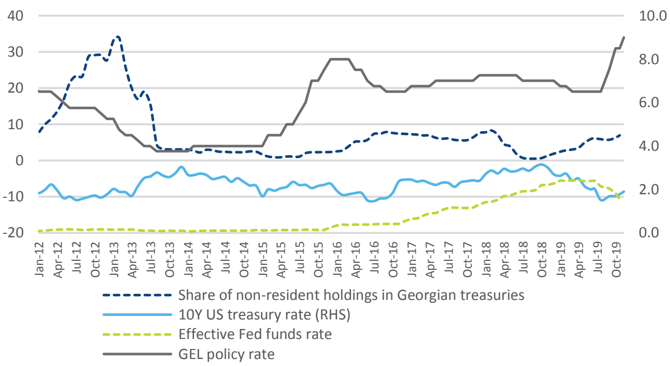

*Source: NBG*

**Dollarization of loans and deposits**
(%)




*Source: NBG*

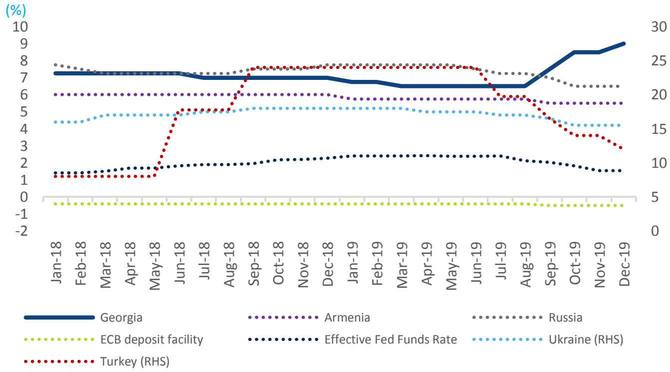
**10 Y US treasury rates and share of non-residents in Georgia's GEL treasury security holdings**
(%, as of December 2019)




*Sources: St. Louis Fed, NBG*

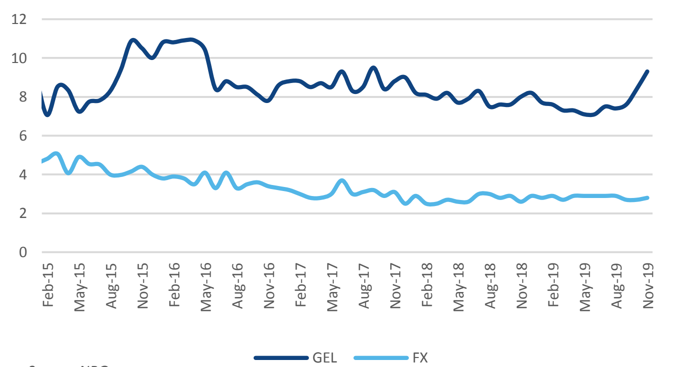
As for the interest rate differential internationally, where a ten-year USD yield plays a key role, further widening the one has yielded a somewhat greater appetite towards the GEL, as in November, compared to September 2019, the proportion of non-resident holdings of total government securities increased from 5.7% to 7.0%. GEL securities are also attractive based on declining rates in many emerging market central banks, including those in Georgia's immediate neighborhood.

**Monetary policy rate in Georgia, policy rates in neighborhood and major advanced economies**
(%)



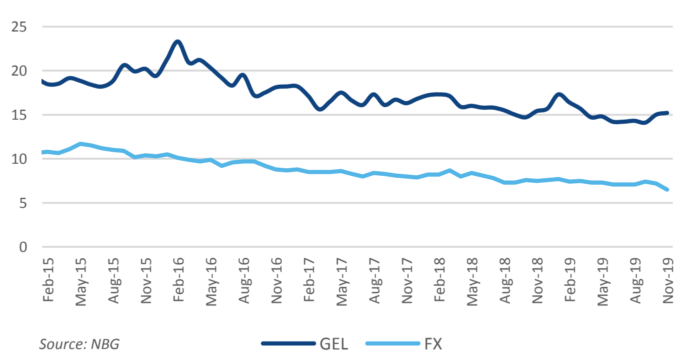

*Source: Respective central banks*

**Interest rates on deposits by currencies**
(%)



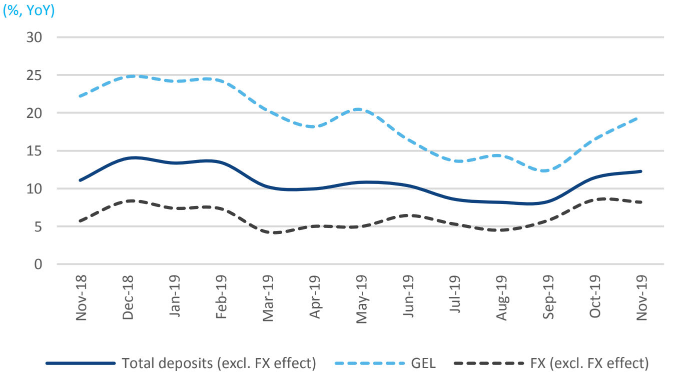

*Source: NBG*

**Interest rates on loans by currencies**
(%)



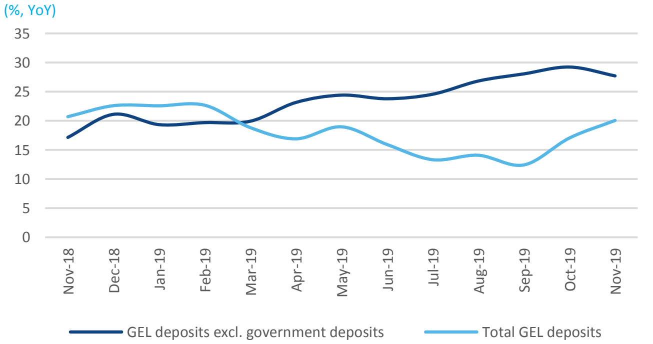

*Source: NBG*

**Growth of deposits by currencies**
(%, YoY)



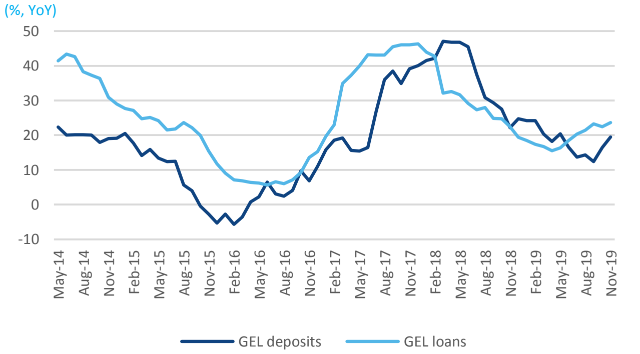

*Source: NBG*

**Growth of GEL deposits**
(%, YoY)



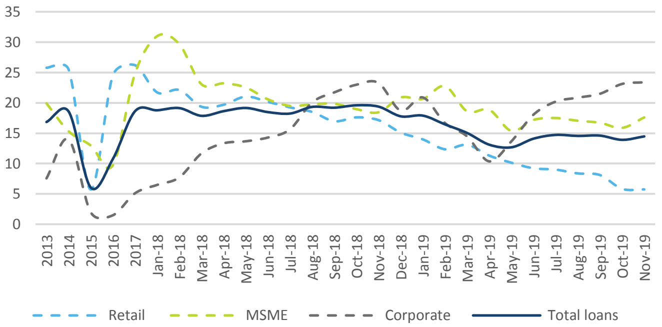

*Source: NBG*

**Growth of GEL loans and deposits**
(%, YoY)



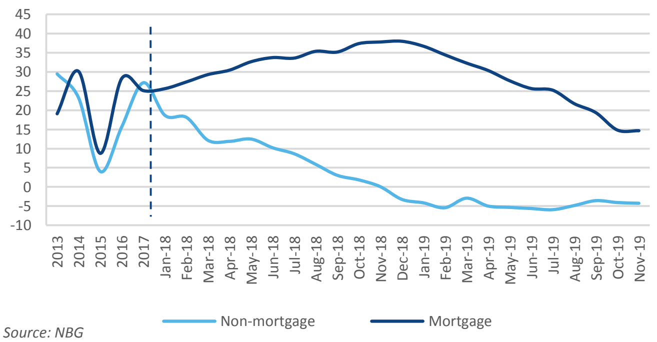

*Source: NBG*

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



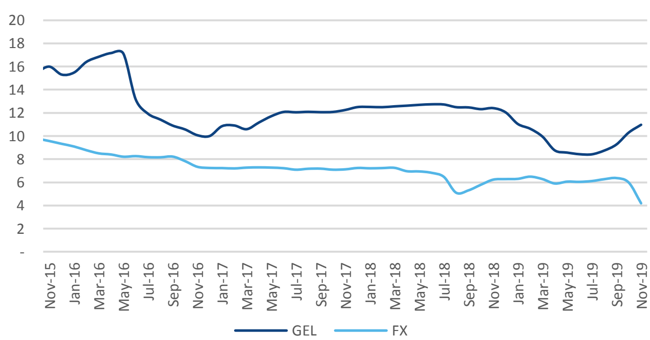

*Source: NBG*

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




*Source: NBG*

**Interest rates on mortgage loans (flows)**
(%)




*Source: NBG*

Aside from the recent high growth of FX credit, overall credit growth has also strengthened. This is in line with our expectations, as the system operates in three currencies and a tighter stance in GEL does not necessarily lead to lower overall credit growth.

Business lending continues to grow well above our expectations, especially on the corporate side. Furthermore, November retail credit has strengthened substantially on the back of the FX recovery. Moreover, it is likely that real estate developers' internal installments portfolio is much larger than expected.

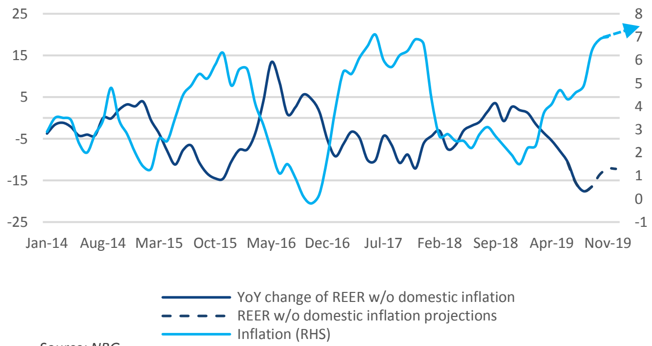
**Seasonally adjusted annualized growth rates* (%)**

| | Jan-19 | Feb-19 | Mar-19 | Apr-19 | May-19 | Jun-19 | Jul-19 | Aug-19 | Sep-19 | Oct-19 | Nov-19 | 11m 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Retail | 3.6 | 4.4 | -0.8 | 4.1 | 12.2 | 6.2 | 5.1 | 6.5 | 4.9 | 5.4 | 7.4 | 5.3 |
| Retail as sum of mortgage and non-mortgage | 2.8 | 3.7 | -0.2 | 4.9 | 9.9 | 5.7 | 3.6 | 5.6 | 4.4 | 5.4 | 10.1 | 5.0 |
| Mortgage | 9.3 | 10.2 | 7.5 | 14.2 | 15.5 | 13.9 | 9.2 | 4.9 | 4.1 | 13.0 | 21.0 | 11.1 |
| GEL | 25.7 | 65.3 | 90.6 | 167.7 | 198.3 | 138.2 | 157.0 | 99.2 | 81.3 | 59.3 | 43.5 | 95.5 |
| FX | 5.2 | -1.7 | -9.4 | -13.3 | -17.7 | -14.8 | -24.6 | -22.6 | -21.5 | -6.2 | 10.0 | -11.2 |
| Non-mortgage | -5.4 | -4.4 | -10.0 | -7.2 | 2.5 | -5.3 | -3.9 | 6.7 | 4.7 | -5.0 | -5.1 | -3.1 |
| GEL | -0.3 | -4.4 | -8.0 | -6.4 | 8.6 | -4.2 | 2.3 | 12.1 | 7.9 | -1.8 | -10.1 | -0.6 |
| FX | -28.9 | -4.9 | -20.5 | -12.1 | -26.2 | -11.0 | -31.5 | -18.7 | -11.9 | -21.3 | 29.7 | -15.6 |

*Sources: NBG, TBC Research estimates*

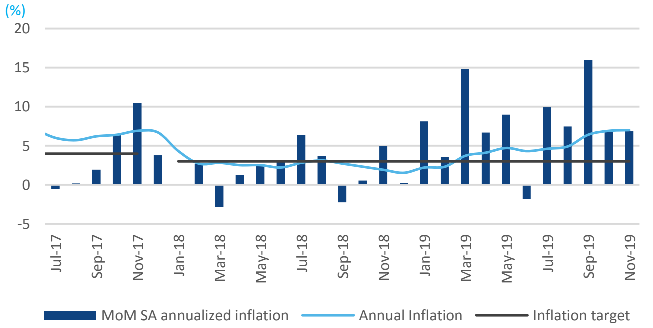
** Seasonal adjustment is carried out by two methods: 1. using ARIMA x-12 method using eviews software and 2. manual adjustment based on historical data. Both approaches yielded broadly similar results. Figures given in the table represent the average of these two methods.*

**The GEL REER and Inflation**
(%, YoY)



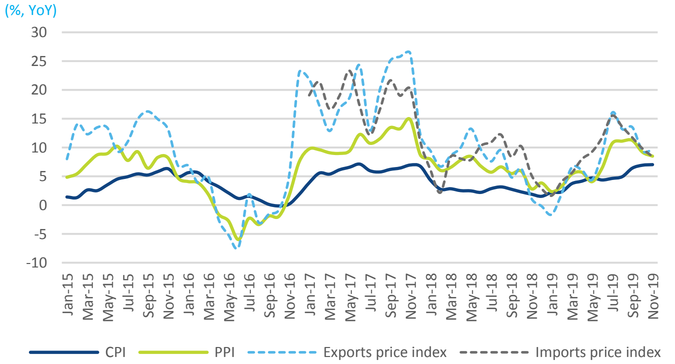

*Source: NBG*

**Annual and seasonally adjusted monthly annualized Inflation**
(%)



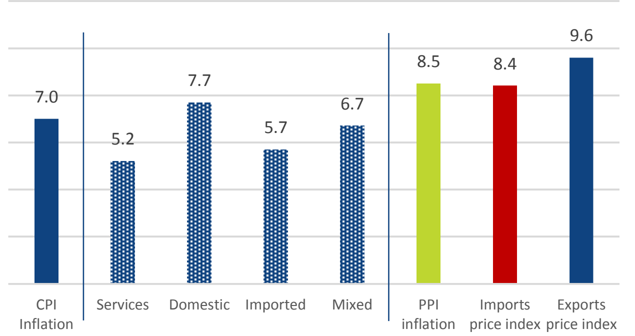

*Sources: NBG, TBC Research estimates*

**Various measures of prices**
(%, YoY)




*Source: GeoStat*

**Different measures of price growth in November**
(%, YoY)

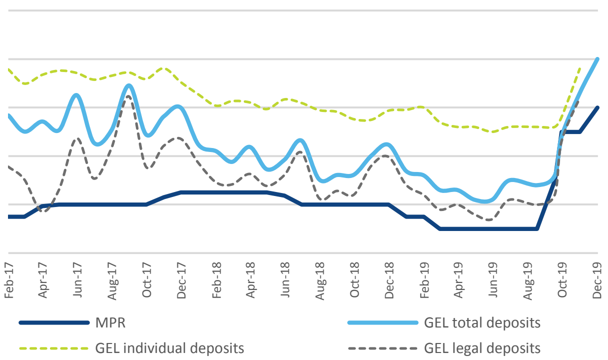



*Sources: GeoStat, NBG*

Inflation reached 7% YoY in November, close to expectations, thus indicating that at least some pass-through from the weak GEL into consumer prices is still under way. While annual inflation increased by only 0.1 percentage points, primarily due to the base effect, as estimated though, the monthly seasonally adjusted annualized inflation in November was still high at around 7%. Moreover, nominal wages also increased with higher inflation in Q3 2019. The wage growth amounted to 8.1% YoY in Q3, with compensation in the business sector increasing by around 11% and the public sector by 2.2%. Consequently, unit labor costs (measured as nominal wage per real output per worker) have likely increased, indicating wage pressures on inflation in Q3 2019. The annual inflation for December should increase further to around 7.5% on the back of some pass-through from the exchange rate and, unlike in November, the low base effect a year ago.

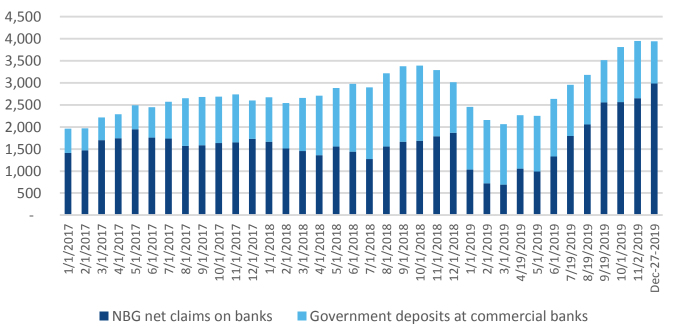
At the same time, the first signs of moderating inflation are already evident in the PPI figures, which often serve as a leading indicator for CPI inflation. The annual change in PPI came in at 8.5% in November 2019, down from the approximate 11% YoY increase in Q3 2019. Alongside lower PPI inflation, export and import price inflation also moderated to 9.6% and 8.4% YoY in November, compared to the peak growth of around 16% in July 2019. Similarly, the TBC Research model, which appears to forecast inflation highly accurately, indicates that the pressure on CPI inflation, arising from the weak GEL, will dissipate in the coming months, while the base effect is also supported by recent GEL appreciation. Though inflation is to return to its target in the second half of 2020, the real effective GEL exchange rate should strengthen further from its current level. Assuming commodity prices remain at their current levels and the exchange rates of the major trading partners against the USD are broadly stable, the GEL REER appreciation required to bring inflation to the target would be equivalent for the USD/GEL exchange rate to be around the 2.75 level. Likely somewhat stronger EUR in 2020 is an upside.

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



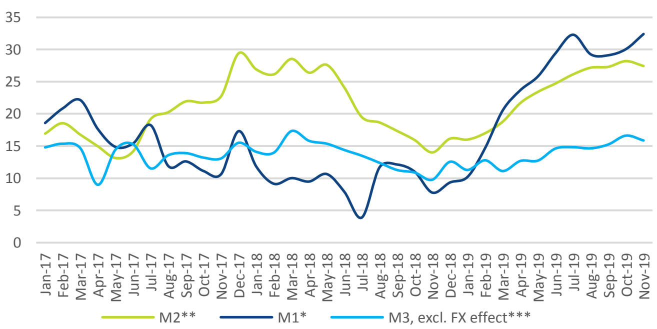

*Source: NBG*
** Initial estimates for December deposit rates*

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




*Sources: NBG, MOF, TBC research estimates*

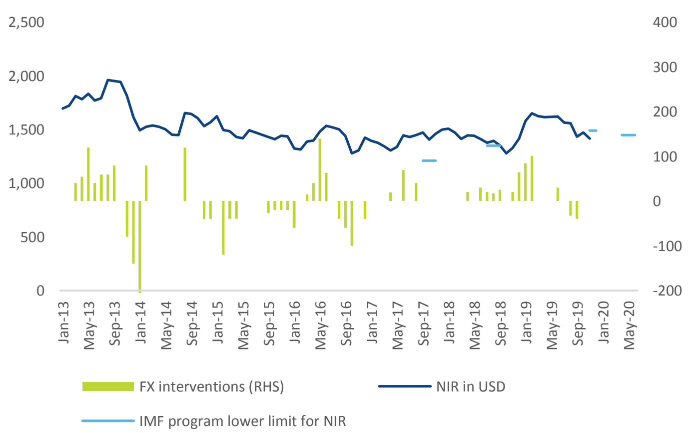
**Growth of GEL monetary aggregates**
(%, YoY, as of November)




*Sources: NBG, TBC Research estimates*

**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.*

**Net international reserve of NBG and FX interventions**
(mln USD)



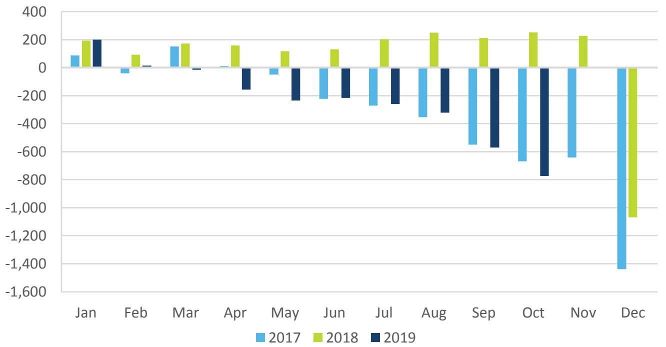

*Sources: NBG, TBC Research estimates*

In the baseline scenario, taking into account the stronger external sector, more focus on FX credit, the high GEL/FX interest rate differential and the fact that the GEL tightening is not yet fully transmitted, we expect the GEL to strengthen further. Therefore, we do not foresee additional tightening of the GEL, however, that is not to rule out further FX easing. While in our view aggressive rate cuts are unlikely, we still expect the NBG policy rate to decrease to 8% in 2020, which may be coupled with certain possible policy moves on the quantitative side if required, especially taking into account the GEL policy rate still remains below deposit rates, despite the rate hikes.

In addition, 2020 may be more active, relatively, on the intervention side. In this respect, we view the wording in the latest IMF staff report on FX interventions to be addressing excess volatility as somewhat supporting possible interventions, if deemed necessary. Considering the availability of reserves, the end of 2019 net international reserves (NIR) target was set at 1.490 million USD by the IMF, and this mark has already been met by the NBG, as per IMF estimates. Furthermore, an end of June 2020 NIR target was set at a lower 1.450 million USD, with no need for the central bank to buy reserves, from an IMF benchmark perspective. Concurrently, if the GEL effective exchange rate strengthens substantially, over that required to bring inflation back on target by the end of 2020, the NBG will likely intervene on the FX market from the buying side, thus building reserves and creating room to possibly "lean against the wind". In fact, in the baseline scenario, with a stronger external sector, a tight GEL and relaxed FX, we expect the NBG to buy reserves in 2020. Our estimates for exports, tourism, remittances and FDI inflows exceeds that of imports of goods and services, even without taking into account an additional debt financing increasing broadly in line with GDP growth and unlike 9 months of 2019, stronger FX credit.

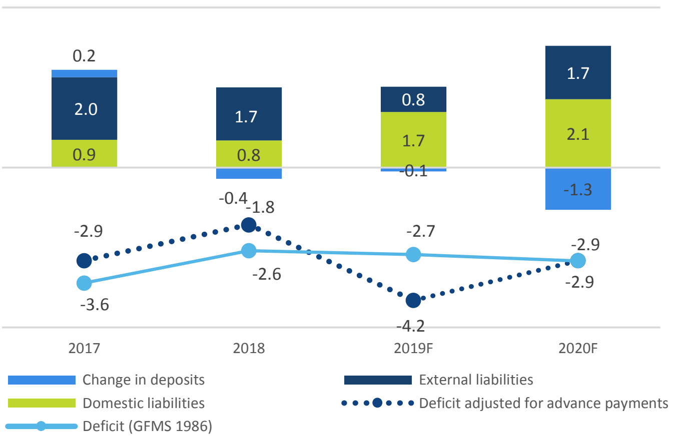
A weaker than expected external sector, a higher fiscal deficit financed domestically, and election related uncertainties would be a downside. In any case, we think it highly unlikely the NBG will tolerate the above target inflation for the second consecutive year, and consequently we bet on an even more hawkish stance if the GEL effective exchange rate fails to follow its assumed trajectory. As for the larization, we expect it to remain a priority, however, much more dependent on the progress on the liability side.

**Consolidated budget balance**
(mln GEL, cumulative)



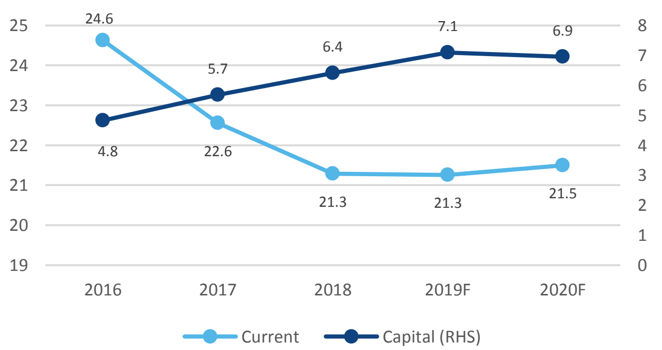

*Sources: MOF, TBC Research estimates*

**Budget deficit and sources of deficit financing***




*Sources: MOF, TBC Research estimates*
**Actual performance often differs from projected figures. Based on revised GDP figures.*

**Budget spending by categories***
(% of GDP)




*Source: MOF*
**Based on revised GDP figures.*

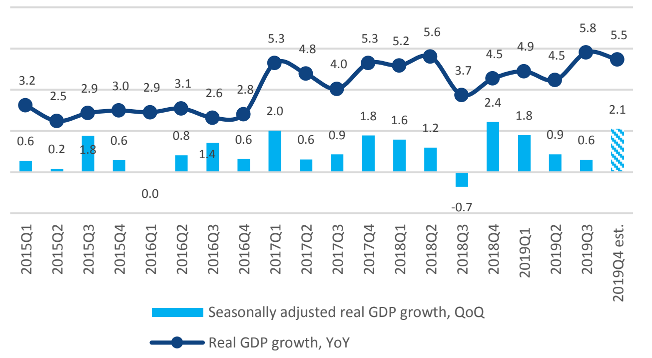
Fiscal stimulus remained strong in October with the budget deficit amounting to an estimated 200 mln. GEL (around 5% of monthly GDP). The fiscal stimulus appears to be even more sizeable than initially expected. The higher fiscal stimulus was mostly channeled through infrastructural projects, as indicated by the sharp growth (3.2x YoY) of capital spending in October. Unlike the previous year when late December advanced payments were at a record high and positively impacted 2019 growth, from strong fiscal spending, it appears that this year advanced payments will be relatively limited.

The updated version of the 2020 budget pinpoints the fiscal deficit at 2.9%*. Despite further orientation towards social spending, overall, the budget remains balanced from a macro perspective, with capital and current spending at 6.9% and 21.5% of GDP, respectively. As for financing the deficit, it is expected that domestic and external financing will both be much higher; with net issuance of domestic debt at 2.1% of GDP compared to 1.7% in 2019, while external borrowing is also projected to rise from 0.8% of GDP in 2019 to 1.7% in 2020. At the same time, debt financing will be partly used to build up a buffer in the form of deposits in the National Bank, with a total expected amount of 700 mln. GEL (or 1.3% GDP). According to the MoF, the primary reason for the creation of the buffer is the 500mln. USD Eurobond maturing in 2021, though it has not yet been decided whether the Eurobond will be repaid or refinanced.

The lower than projected external financing of the deficit in 2020, particularly coupled with the same or higher level of domestic debt issuance, and not the accumulation of a buffer from the NBG, poses a risk to the GEL as a significant part of IFIs' related project financing directly enters the FX market in the form of FX inflows. Additionally, external financing converted into GEL at the NBG accrues international reserves and enables the central bank to intervene on the FX market.

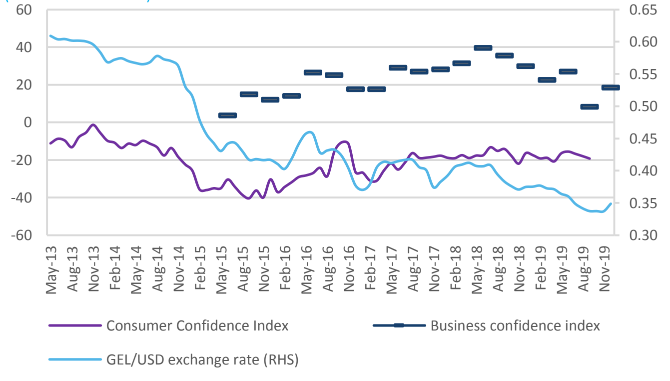
** Based on GFSM 1986, per IMF methodology deficit is projected at 2.5% vs 2.4% in 2019*

**Annual and seasonally adjusted quarterly real GDP growth**
(%)



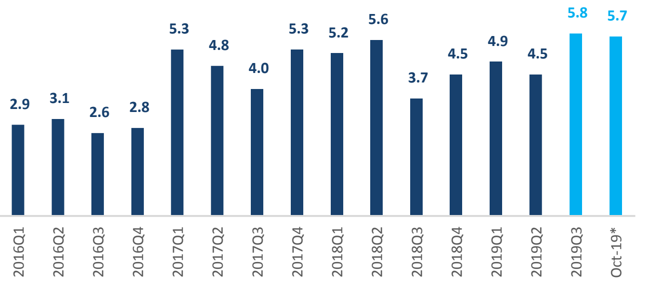
*Sources: GeoStat, TBC Research estimates*

**Consumer and business sentiments and GEL/USD**
(as of December 2019)



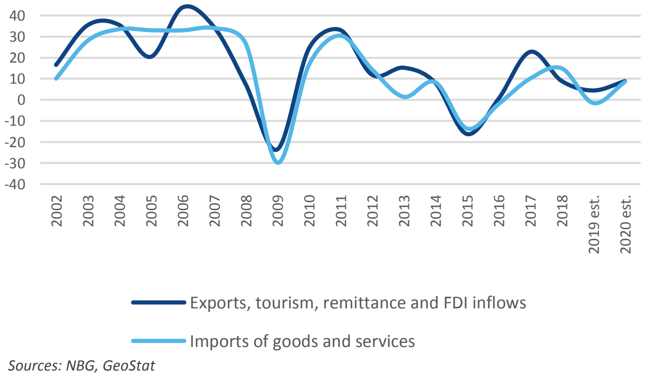
*Source: ISET-PI*

**Real GDP growth**
(%)



*Source: GeoStat*
**Initial estimate*

**Growth of inflows and imports of goods and services**
(%, YoY)



*Sources: NBG, GeoStat*

After the slowdown in Q3, with an estimated quarterly seasonally adjusted growth of 0.6%, on the back of a stronger external sector, credit and fiscal stimulus, growth appears to have recovered far sooner than anticipated. Traditionally, a stable and appreciating GEL against the USD has also seemingly led to strong consumer and business confidence. If YoY GDP increases by around 5.5% in Q4 2019, this would equal, approximately, a very strong 2.1% seasonally adjusted QoQ growth and overall 2019 growth of 5.2%.

Based on initial estimates in October and November, Q4 2019 growth should be strong. October growth stood at 5.7% while the initial indicators pinpoint even stronger expansion in November. External inflows were much stronger in November and despite higher interest rates in GEL, lending also accelerated, assuming budget spending broadly similar to previous month, fiscal will also remain strong.

2019 is a year of fiscal stimulus, taking into account the size of the deficit adjusted for advance payments and large capital spending with high multiplier. This was balancing for the weakness in tourism industry. While in 2020, the fiscal expansionary effect is expected to be much more moderate, according to the budget project, the external sector contribution should be stronger due to increased tourism inflows as the decline from Russia and Iran dissipates, inflows from Turkey should strengthen, at least to some extent, and the drop in FDI inflows is no longer assumed. Based on the TBC research GDP growth model using inflows, fiscal, credit and imports as inputs, 2020 GDP growth should stand at around 5.0%. Although, considering election related uncertainties, in the baseline scenario we project around 4.5% growth (see table on the next page).

| *YoY % growth, unless otherwise indicated* | 2018 | 2019 F. | 2020 F. |
|---|---|---|---|
| Exports, tourism and remittance inflows (in USD) | 19.4 | 6.8 | 9.2 |
| *Exports* | *22.6* | *10.0* | *8.0* |
| *Tourism* | *18.4* | *0.5* | *10.0* |
| *Remittances* | *14.8* | *9.4* | *10.5* |
| FDI (in USD) | -36.9 | -15.0 | 5.2 |
| | | | |
| Credit (period average, FX adjusted) | 17.9 | 13.6 | 13.0 |
| Fiscal deficit* (% of GDP) | -1.8 | -4.2 | -2.9 |
| Imports of goods and services (in USD) | 15.0 | -1.5 | 8.5 |
| | | | |
| Real GDP growth | 4.8 | 5.2 | 5.0 |
| Nominal GDP growth | 9.4 | 11.0 | 9.7 |
| GDP deflator (period average) | 4.4 | 5.5 | 4.4 |
| | | | |
| Real GDP growth adjusted for election related uncertainties | | | 4.5 |

*Sources: MOF, NBG, GeoStat, TBC Research estimates*
**GFSM 1986, Adjusted for advance payments.*

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