TBC CAPITAL

MAINTAINING STRONG GROWTH

MACRO INSIGHTS

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Content

Summary I/II

On February 28, we published [rapid and delayed resolution scenarios](). While a rapid resolution of the military conflict still seems to be an optimistic assumption, in an economic terms, taking into account a spillover effect on the Georgian economy, the first scenario appears to be more plausible.

On an international level, this implies that even an uneasy peace returns only gradually throughout the year and large number of disagreements remain unsolved. Sanctions imposed on Russia remain harsh, however, there is no complete and effective cut-off of the Russian financial system from SWIFT and the energy exports are not materially disrupted. In this scenario, the Russian economy contracts by around 8% in 2022 and the RUB against the USD is at around 90, while the Ukrainian economy contracts by around 20% and the USD/UAH is at around 30. Brent oil prices remain elevated at around 105$ before declining to around 85$ by the end of the year and the EUR/USD should recover to around 1.12. Important to highlight that after Russia's invasion of Ukraine the growth outlook is not worsened for all countries. In particular, economies highly dependent on energy exports such as Azerbaijan, Kazakhstan, Saudi Arabia are expected to grow even faster.

If that is the baseline, we expect the Georgian economy to grow at around 5.5% in 2022. The outlook is supported by likely very strong pre-war growth momentum at around 7.5% for the full year 2022, the continuous recovery in the tourism inflows especially when the migration impact is considered. Also, the remittances have demonstrated a resilience and we do not project a decline for the full year 2022. On the trade balance side, the growth in real exports would be difficult to achieve, however, due to the higher prices, we still expect the growth at above 20% in the USD terms. Stronger exports of the transportation services is also expected with an additional revenues of around 80 million USD as a result of cargo redirection from the northern route. In imports, higher prices are also a driver, however, to less extent, while the real growth should be marginally positive on the back of still strong economic activity. This looks to be the case even when imports are adjusted for likely lower investment demand due to higher uncertainties. Other than investment component, the credit growth should be still strong. On the fiscal side, we project only slight increase in deficit, financed externally. As for the labor market, we do not expect large adverse impact, however, low real wages still should be a challenge in 2022.

Summary II/II

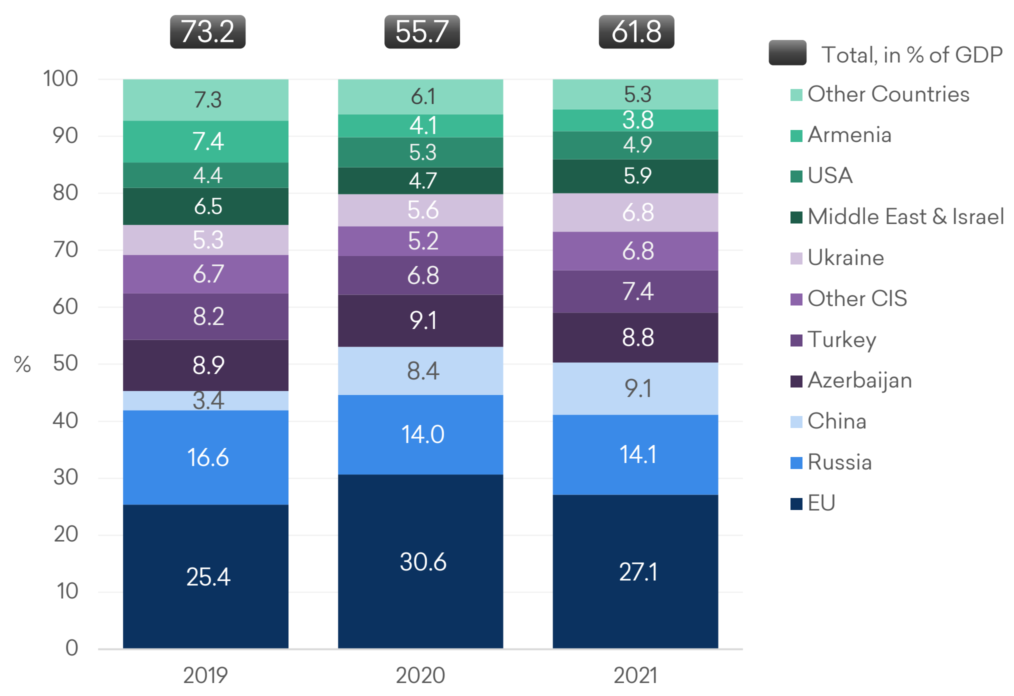
On the GEL side, based on our three pillar approach, we are broadly neutral:

- In particular, unlike the most common believe on the worsening, in the baseline we expect an improvement of the external balance. While the trade deficit will likely widen a bit, though not in percent of GDP, this will be more than compensated by the rebound in the tourism inflows. At the same time, we do not envisage any sizable deterioration from the financial account;
- The second pillar, - the GEL REER assessment seems to be broadly neutral or slightly on the overvaluation side;
- As for the third pillar, a well above target inflation outlook is GEL supportive taking into account tighter monetary policy stance.

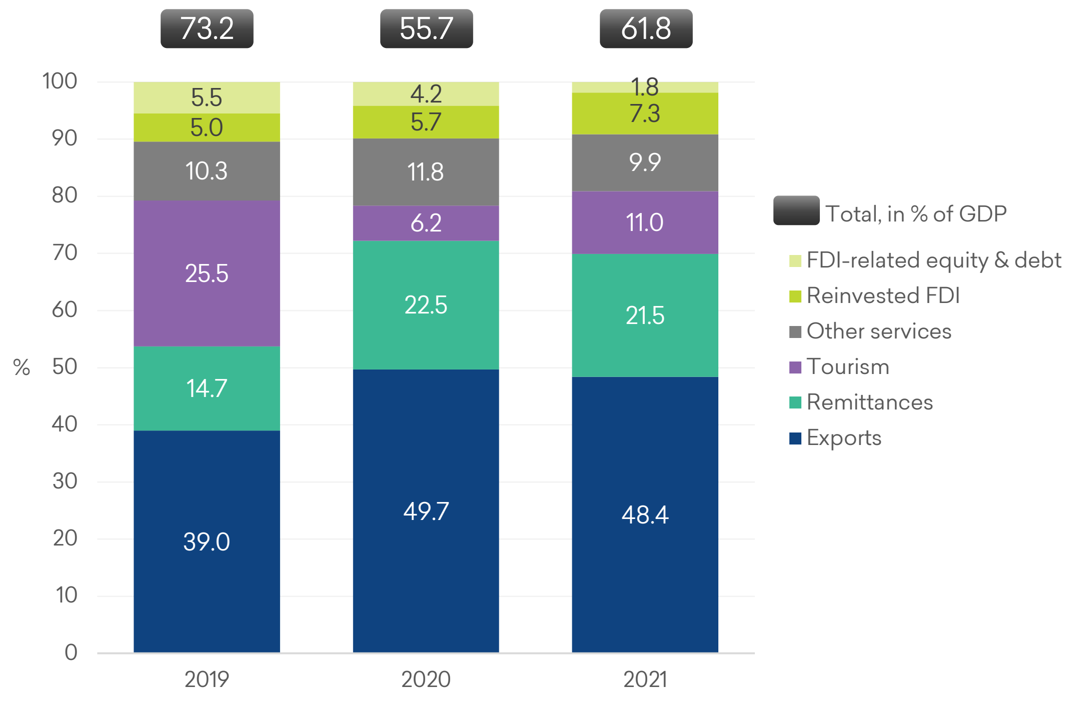
We also once again highlight that based on the relevant international practices and our estimates for Georgia, the depreciation at least may be contractionary, rather than expansionary. This is important from the policy response perspective as the depreciation certainly may lead to lower imports, however, at the expense of slower growth, especially when the shock amplifier impact is taken into account. Therefore, we believe that to a reasonable extent, the GEL relative stability is also a pillar to maintain the high growth momentum.

Share of Ukraine & Russia in 2021 inflows is around 20%, though including more than a half share of re-exports as well as broadly similar size of import component of tourism, remittance and FDI inflows

Structure of external inflows by countries



Structure of inflows by types

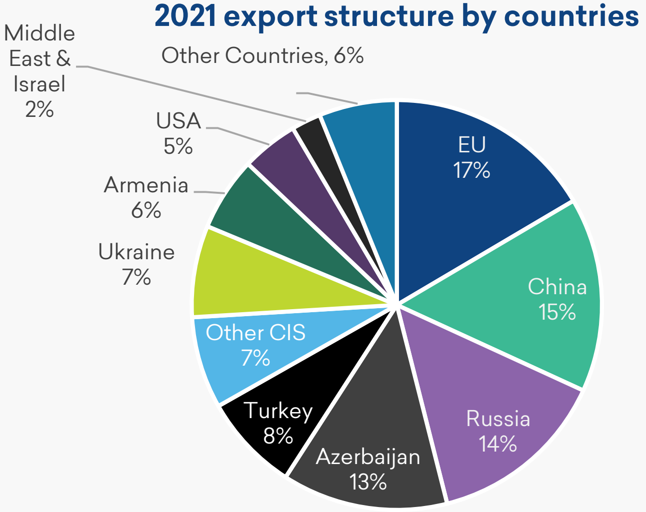


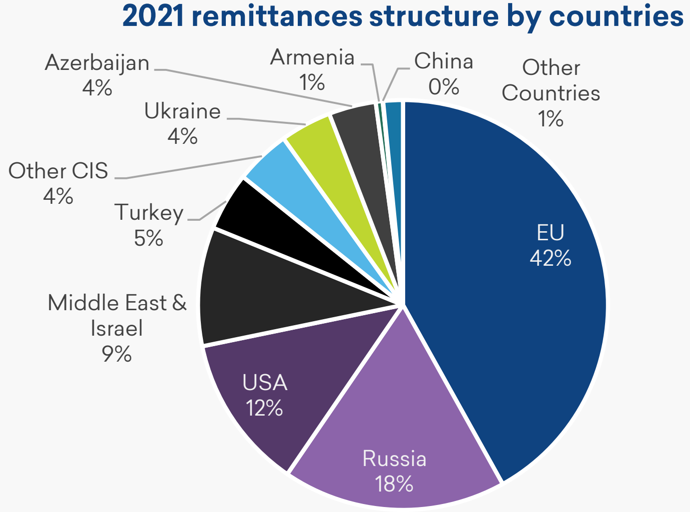
Note: Important to highlight that after Russia's invasion of Ukraine the growth outlook is not worsened for all countries. In particular, countries highly dependent on energy exports such as Azerbaijan, Kazakhstan, Saudi Arabia are expected to grow even faster

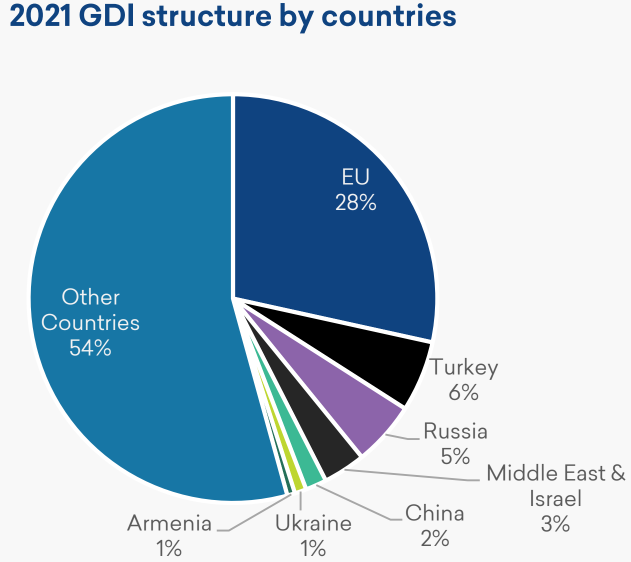
Note: 2020 FDI inflows are adjusted by one-time transaction of transferring of ownership from nonresident to the resident companies, without cash outflow, but still reducing FDI by around 295 m USD.

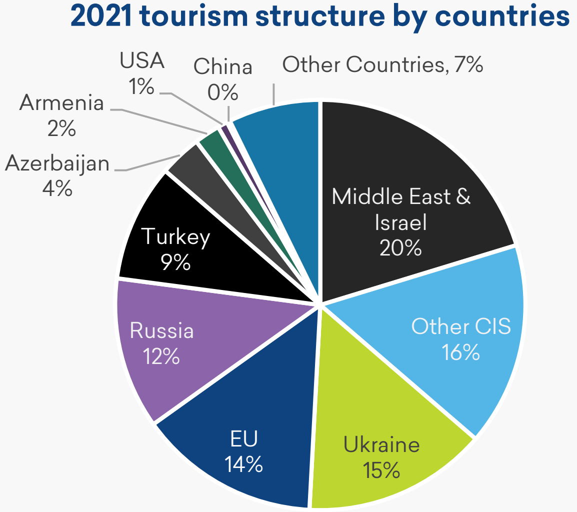
Source: Geostat, NBG, TBC Capital

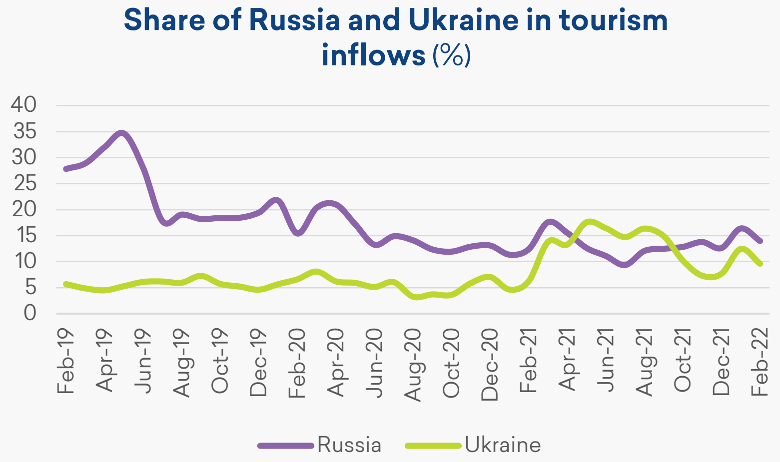
The 20% share is on the back of material exposures in exports, remittances, and tourism, while FDI exposure is low and mainly represents reinvested earnings of already invested FDIs







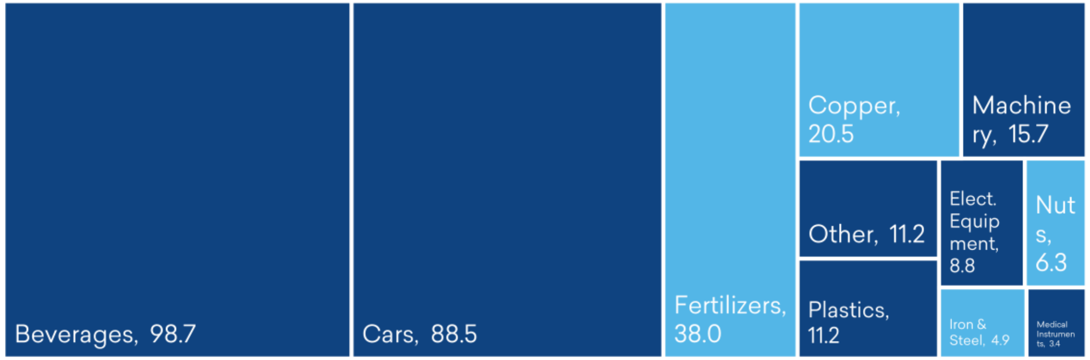




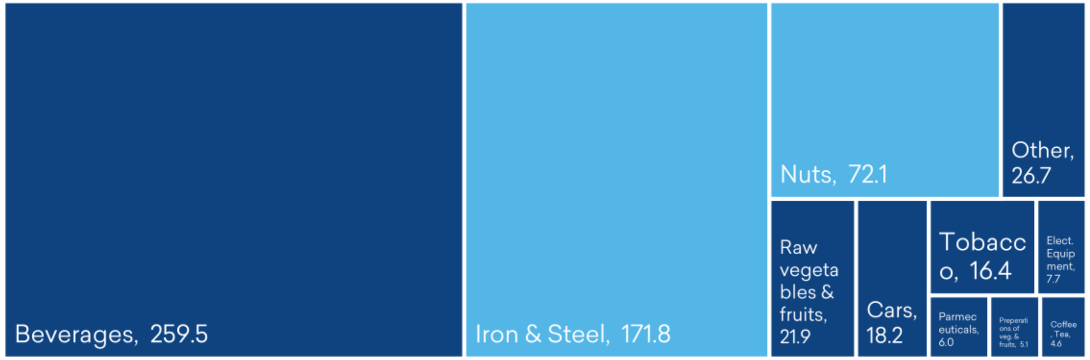
Source: Geostat, NBG, TBC Capital

Destination sensitive exports and commodities

2021 exports to Ukraine by products (million USD, total 307.3)



2021 exports to Russia by products (million USD, total 610.0)

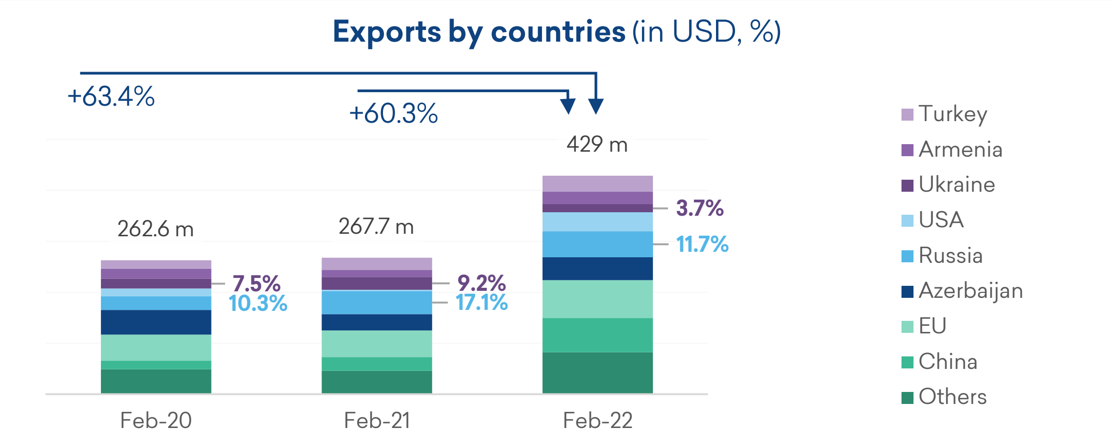


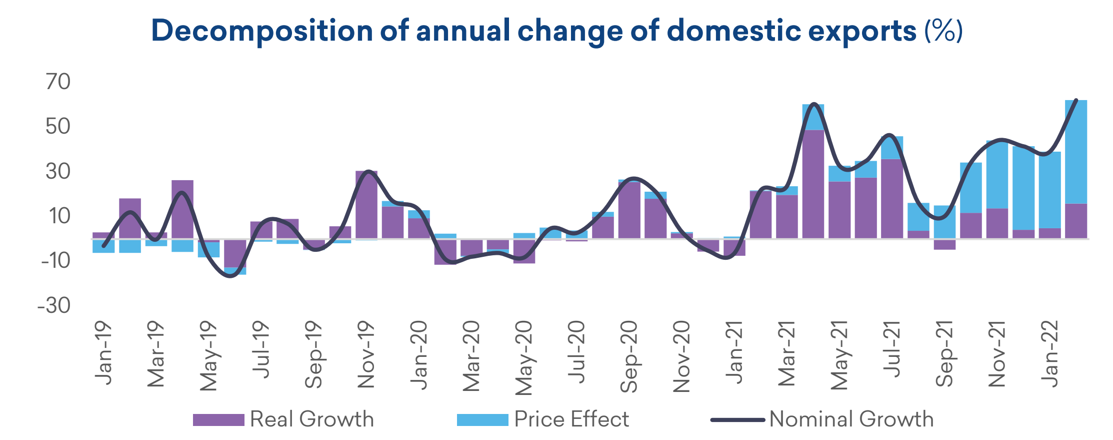
To estimate the impact on Georgian exports

- First, we split exports into destination demand sensitive and commodity categories, prices for the latter predominantly being set on the international markets. Therefore, finding substitute markets being relatively easy
- Second, for the remaining sensitive product we assume on average 55% import share. For example, in traditional export product like wine the import share is around 50%
- For the full year 2022, we assume destination-sensitive exports to Ukraine and Russia to decline by 70% and 50%, respectively

Source: Geostat, TBC Capital

Export prices are the main driver of high growth



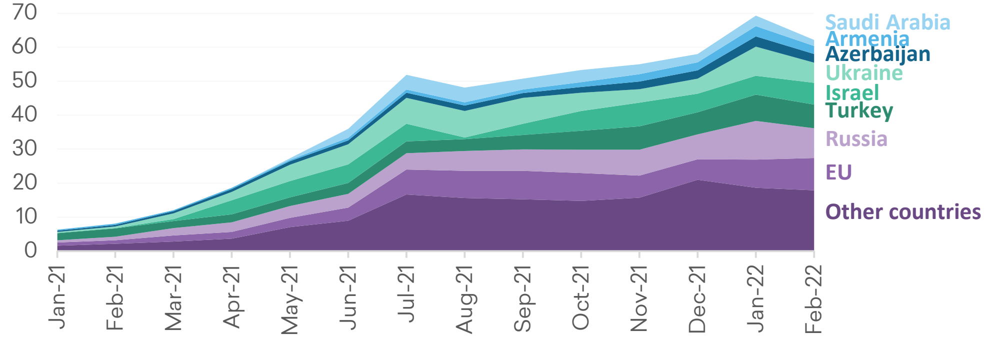


- Important to highlight that pre-war very high growth in exports was not driven by Russia and Ukraine
- In fact, the driver is higher commodity prices
  - See also terms of trade in the GEL drivers section
- For the full year 2022, we expect export of goods to increase by 23.0% in USD terms, fully driven by higher prices, as per our projection, real exports should decrease on the back of much lower demand from Russia and Ukraine
- The estimate is a result of employing two approaches:
  - First, we have projected prices for key export items
  - Second, using historical relationship, we have estimated the real demand for exports based on the latest GDP growth outlooks for Georgia's main export markets
- While technically speaking, real GDP growth is impacted by real exports growth in the first place, we also take into account higher revenues of exporters, which would indirectly support domestic economic activity. However, keeping in mind high presence of non-residents in key export sectors and, therefore, relatively higher of revenue outflows
- Also, we assess the impact of additional export of transportation services due to higher turnover in the southern route to stand at around 80 million USD

Source: Geostat, NBG, TBC Capital

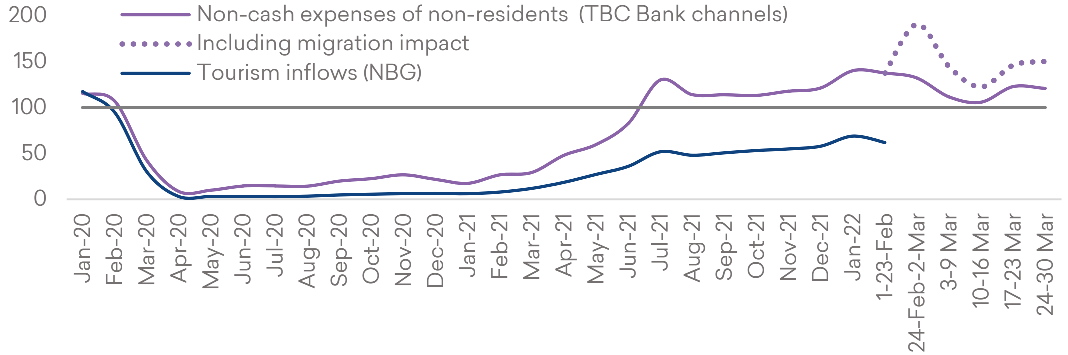
Tourism recovery has slowed, but still YoY rebound should be large, also supported by the migration impact

Tourism inflows by countries
(in USD, total inflows of the same month of 2019=100, %)



Tourism inflows by countries (January 2022 / January 2020)	Growth, %	Contribution to growth, %
Ukraine	30	4
Saudi Arabia	45	2
Israel	-28	-4
Other	-14	-6
Iran	-66	-7
Armenia	-60	-9
EU	-37	-10
Azerbaijan	-76	-20
Turkey	-56	-20
Russia	-56	-29

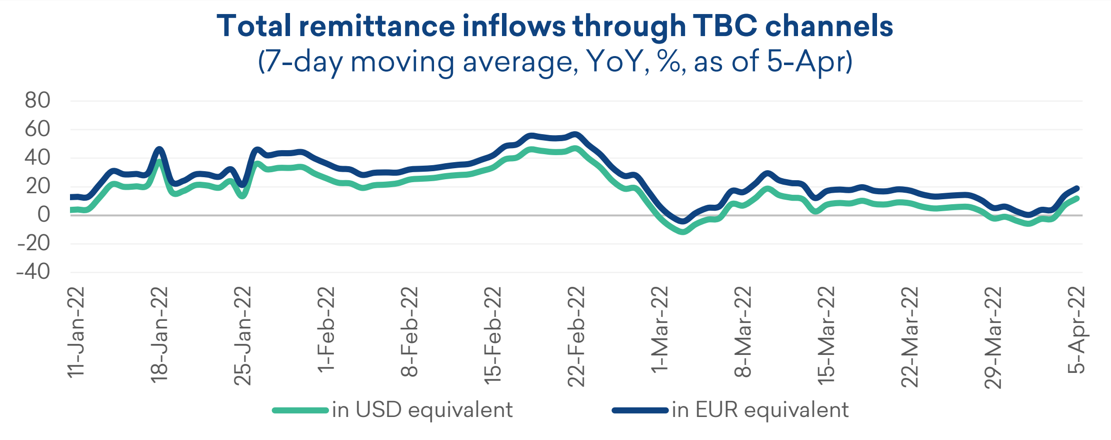
Various estimates of tourism inflows
(In USD, same month of 2019=100)

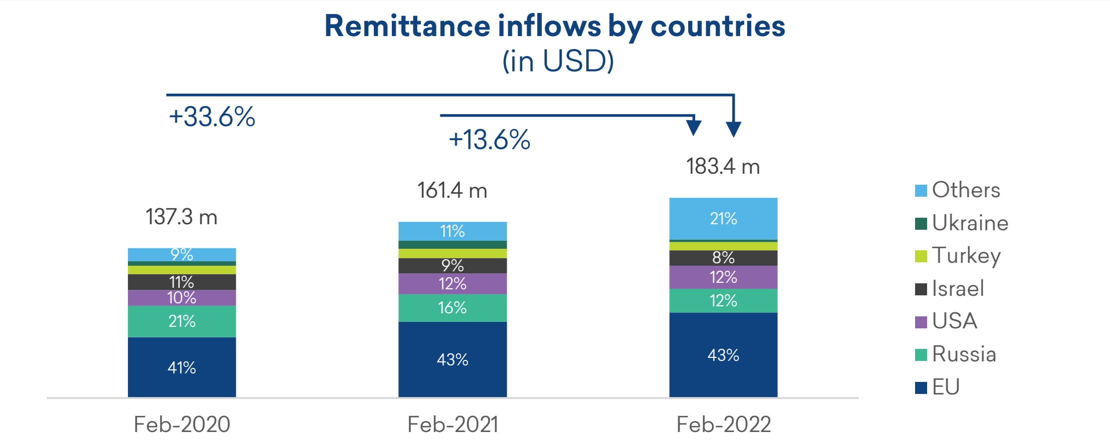


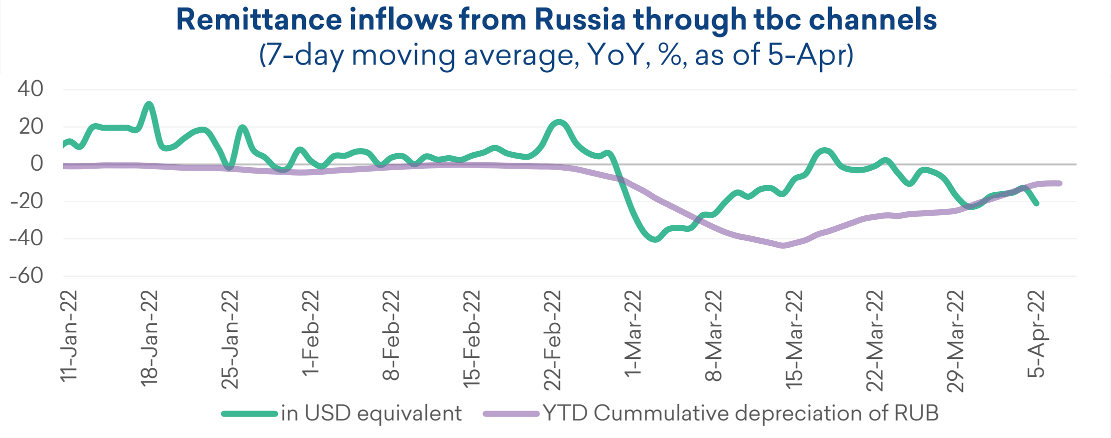
- February-March tourism recovery has slowed
- However, the migration effect from citizens of Russia, Belarus and also to some extent Ukraine should be taken into account
- This is not evident in spending by non-residents via foreign cards as in case of Russia predominantly local cards are acquired
- Also, the closer neighborhood tourism still has to recover. In particular, in January 2022, only Armenia, Azerbaijan and Turkey made around 50% of shortfall in inflows compared with January 2020 as due to the lag in the vaccination closer neighborhood tourism was recovering at a slower pace
- For the full year 2022, we expect around 70% recovery compared with the 2019 level, including the migration effect

Source: Geostat, NBG, TBC Bank, TBC Capital

Remittances demonstrate a resilience





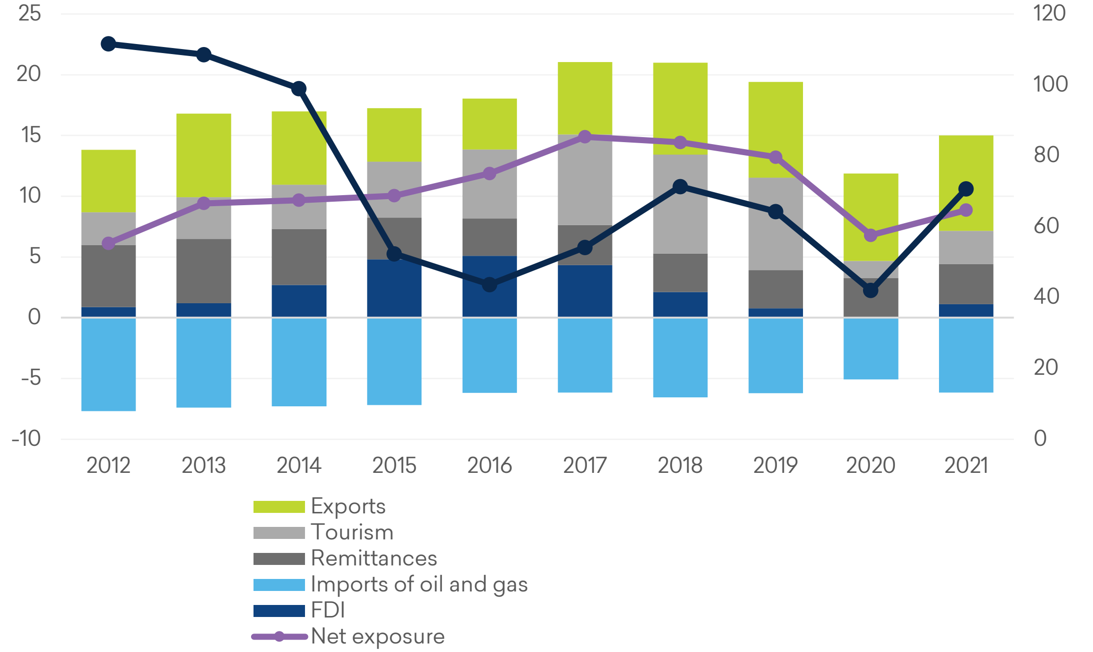


- The resilience is evident even in case of Russia
- Traditionally, the ruble is important driver of dollar value of remittances from Russia
- Going forward, as the impact of recession and higher unemployment is more pronounced, we expect remittance inflows from Russia to decline by 20-25% for the full year 2022, assuming GDP drop at around 8% and the USD/RUB at around 90
- For the full year 2022, we expect total remittances to increase by 1.4%

Source: NBG, TBC Bank, TBC Capital

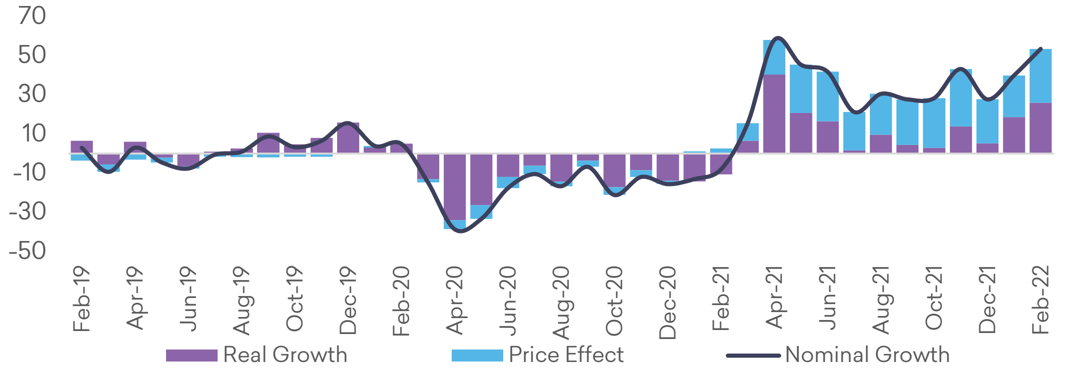
Import growth is also largely dominated by higher prices, though to less extent compared to exports

Imports of oil and gas and receipts from oil exporters and oil price (% of GDP)



Note: Taking into account the different elasticities of currency inflows and imports of petroleum products against oil prices, the country's overall net exposure to oil prices appears to be reasonably balanced. For example, a possible drop in oil prices should have a greater proportional impact on petroleum imports than on tourism or export inflows. The impact also depends on the prices of oil, which is assumed in the state budgets of relevant countries

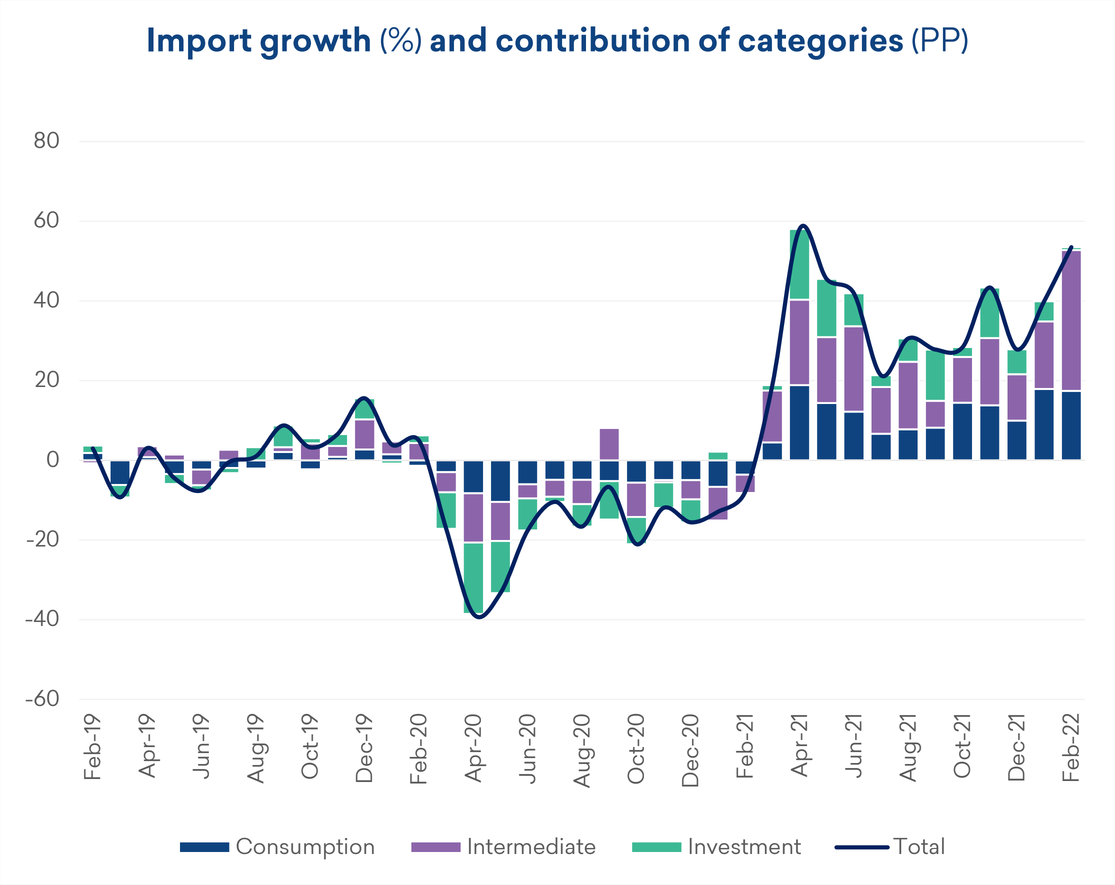
Decomposition of annual change of import (%)

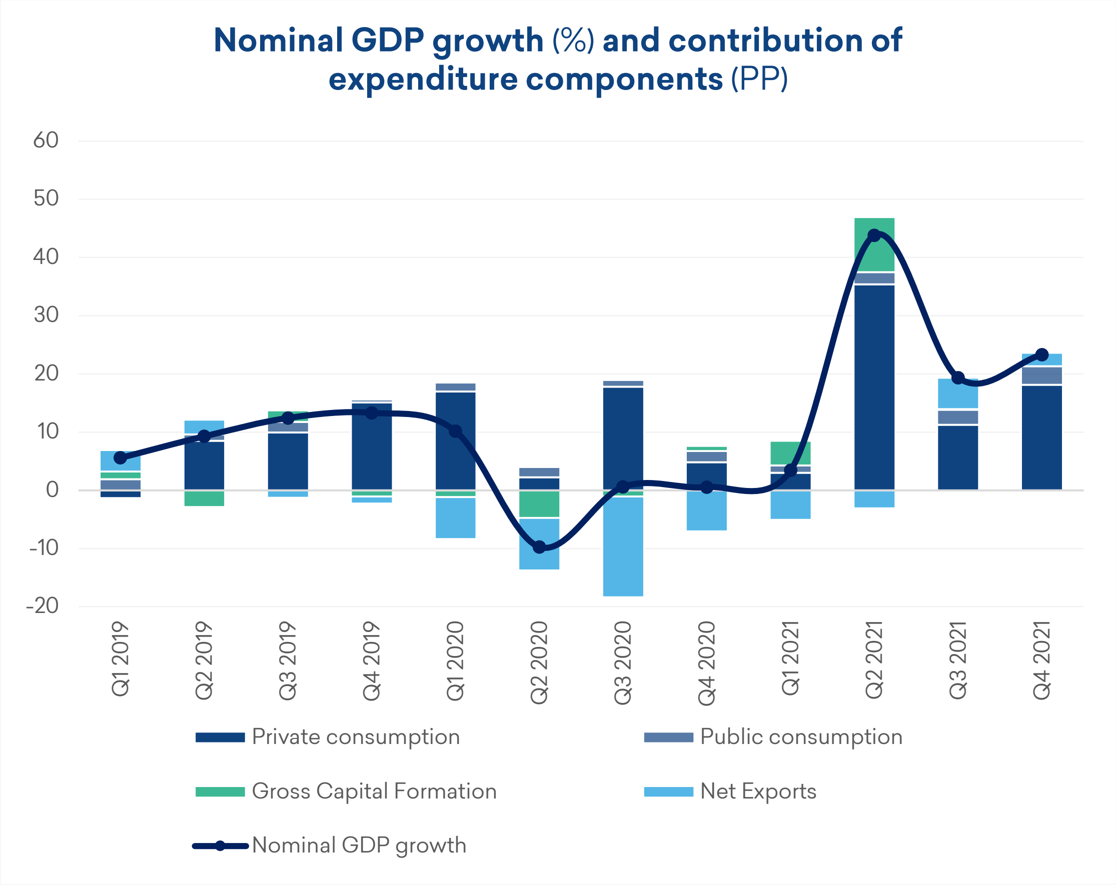


- Going forward, higher oil and other commodity prices, combined with still solid expected real GDP growth, will lead to strong import of goods growth, per our estimates, at 16.5% in USD terms for the full year 2022
- Likewise exports, here we also use product-wise as well as aggregate top-down estimates
- For the net impact of the higher oil prices, we take into account somewhat higher inflows from Georgia's energy exports dependent economic partners
    - See also terms of trade in the GEL drivers section
- We also assume lower demand for investment goods due to high uncertainties. This is important for import outlook as investment goods have the highest share of imports

Source: NBG, TBC Bank, TBC Capital

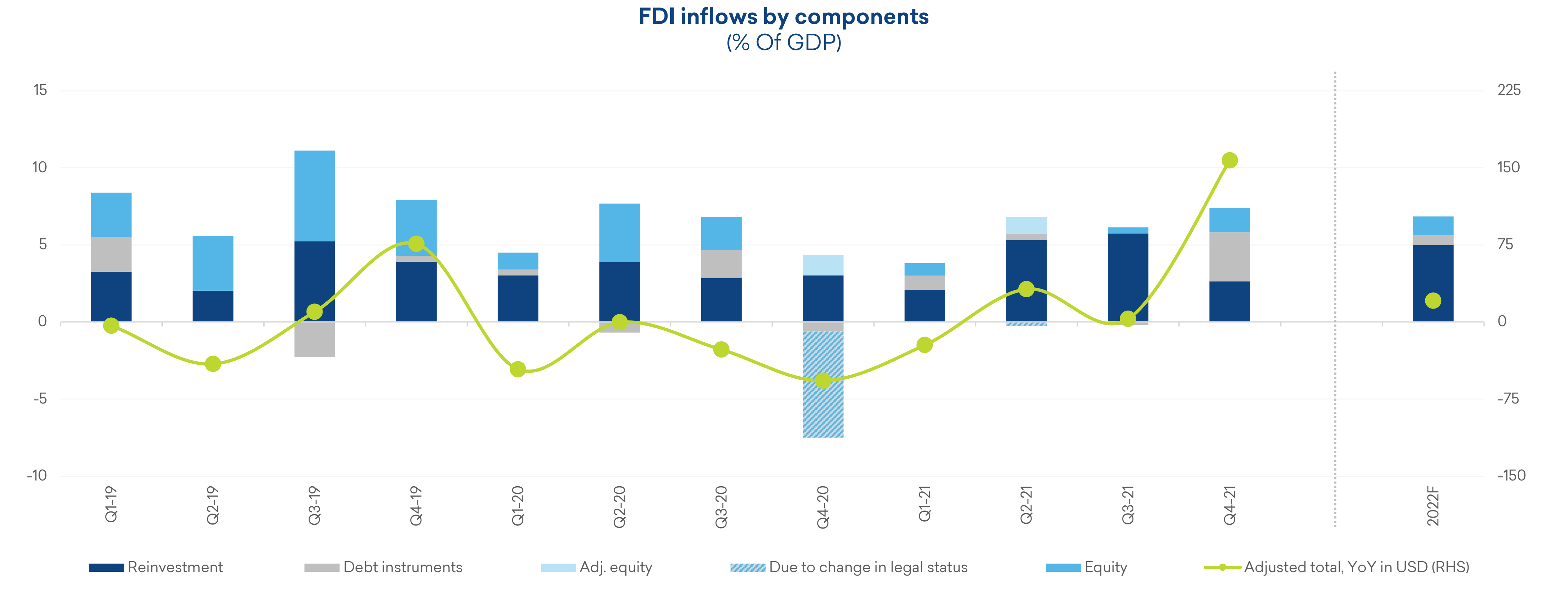
2022 growth will likely be dominated by consumption and net exports, the investment demand likely lagging behind on the back of high uncertainties





Source: Geostat, , TBC Bank, TBC Capital

FDI equity and debt inflows likely to remain flat in 2022, while reinvested earnings are expected to increase further

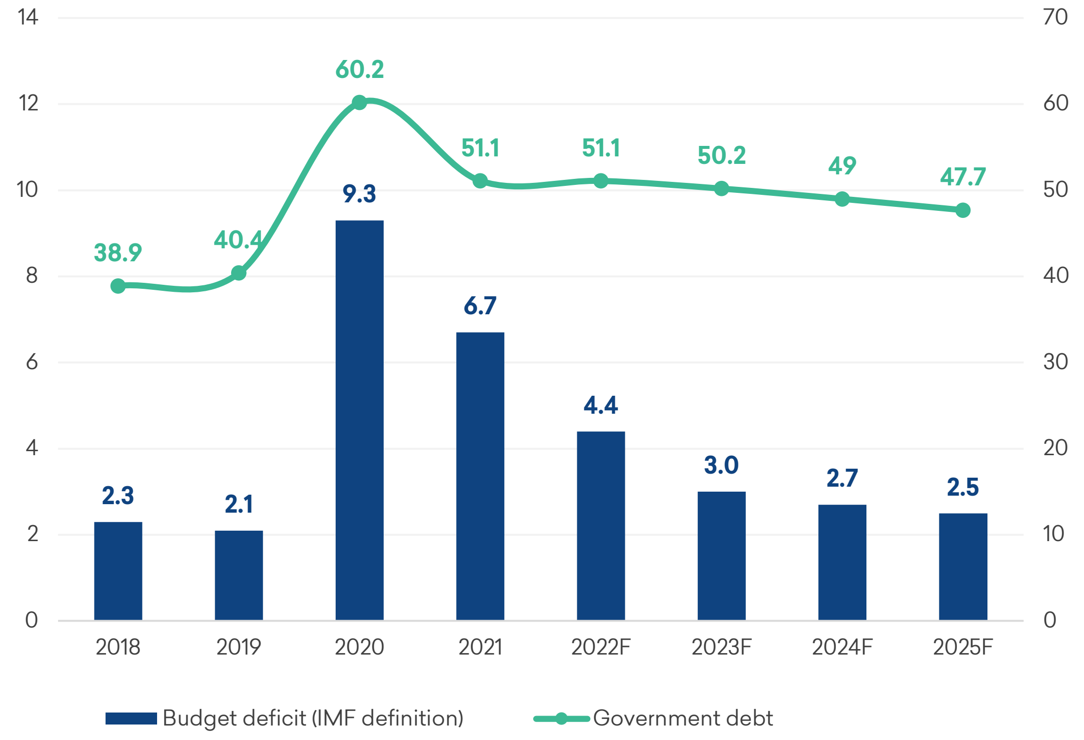


Note: In Q4 2020, the main reason for the decline of FDI was transferring of ownership from nonresident to the resident companies, without cash outflow, but still reducing FDI by around 295 m USD. Adjusted for this component equity investments had a positive value

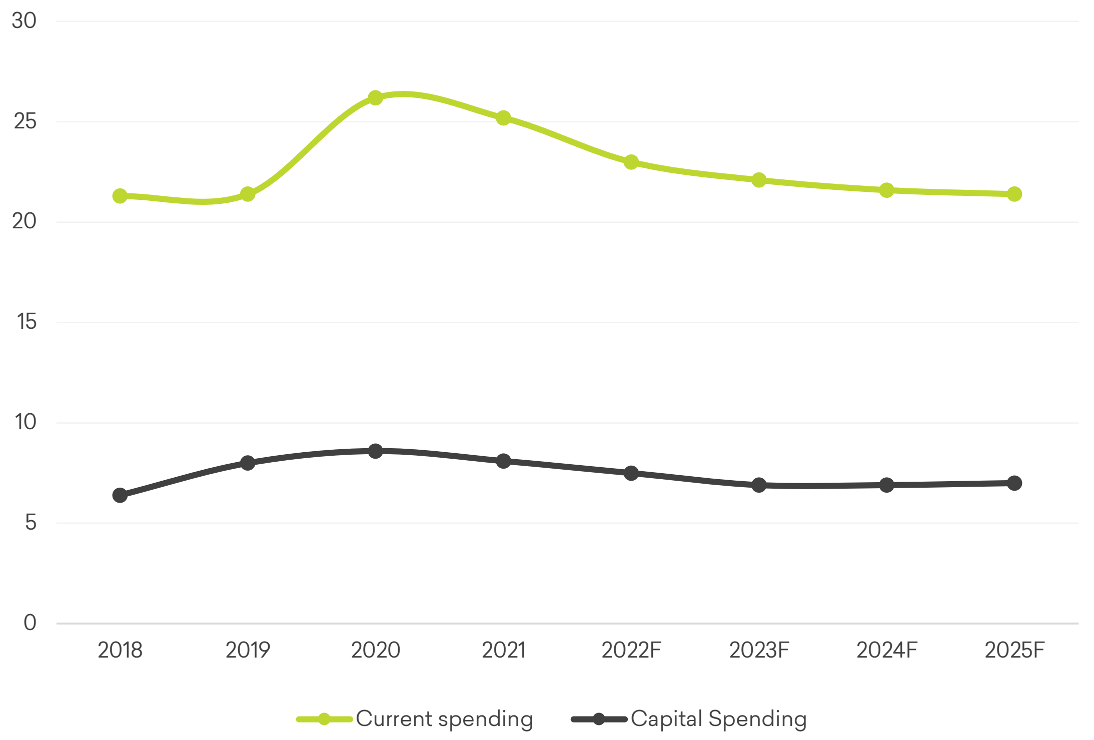
Source: Geostat, TBC Capital

In the baseline, we assume slightly higher deficit in 2022 at around 5.0%, instead of initially planned 4.4%, being predominantly financed externally

Budget deficit and government debt
(% of GDP, as of Dec-21 budget plan)

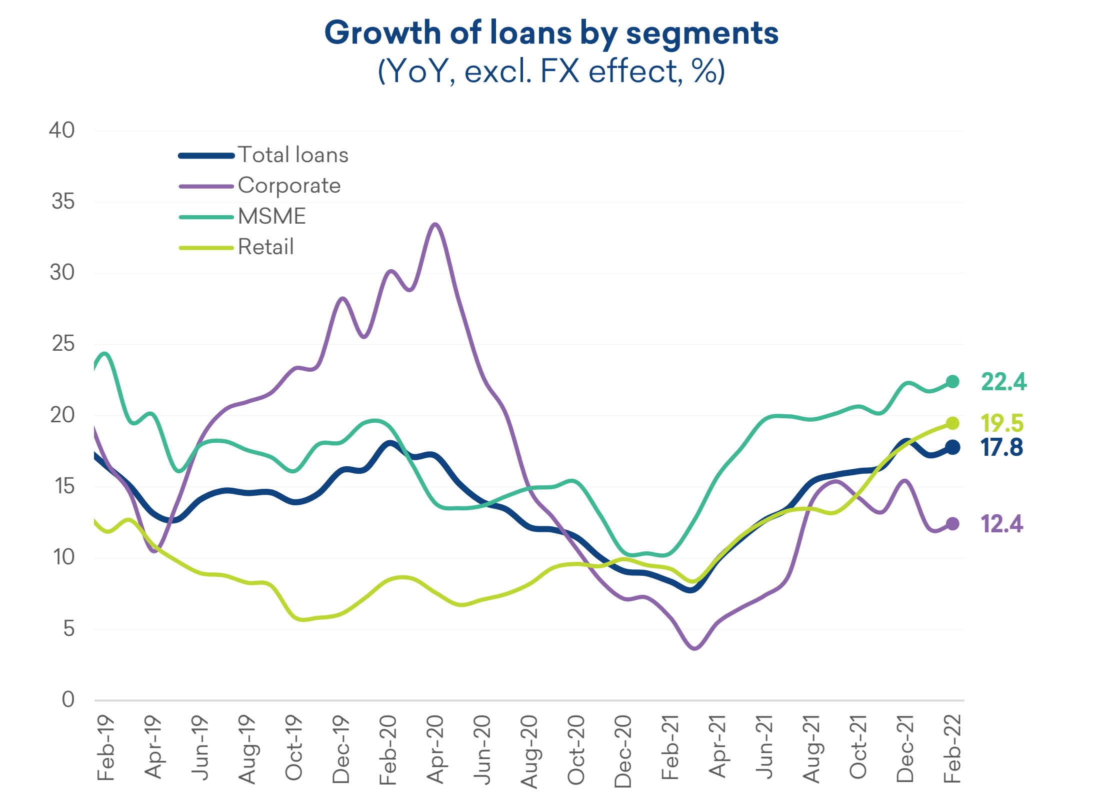


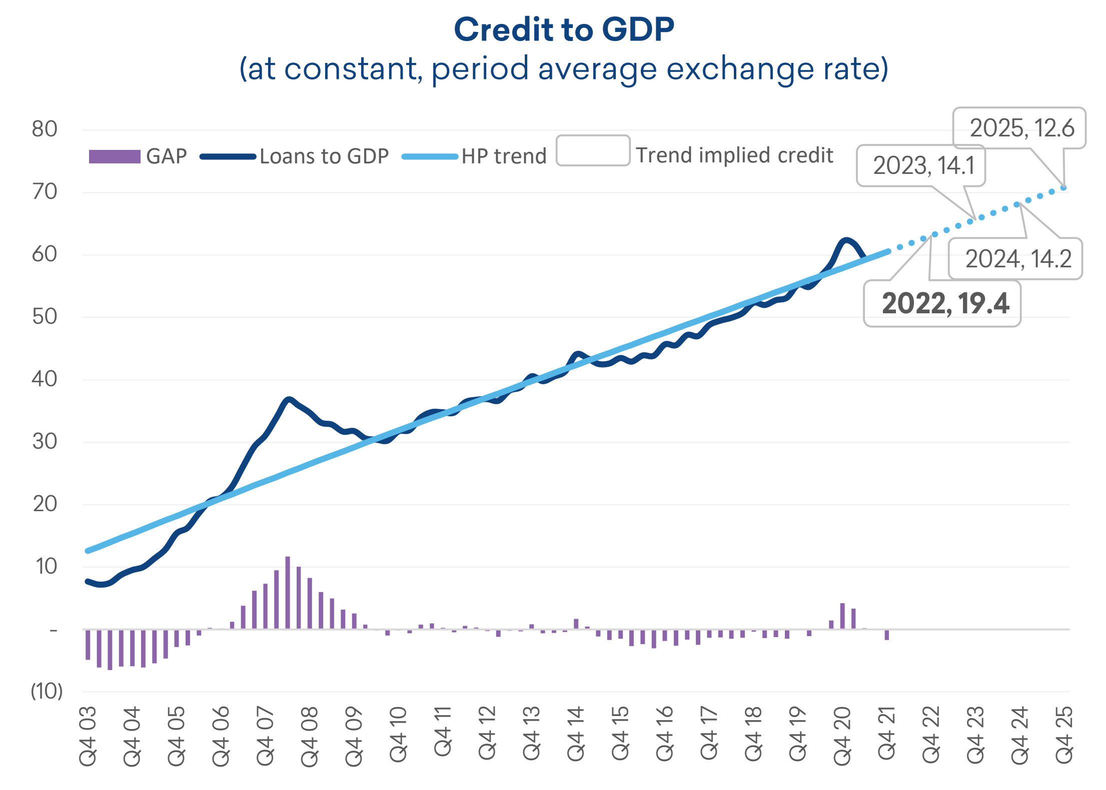
Budget current and capital spending
(% of GDP, as of Dec-21 budget plan)



Source: MoF

2022 end of period credit growth is projected at around 17%





- Assuming nominal GDP growth at around 14.5% in 2022, the trend implied credit growth stands at around 19.4%
- However, taking into account uncertainties likely primarily to be reflected in relatively lower investment demand, we assume credit growth at around 17%, driven by strong inventory demand at higher prices and also strong retail credit

Source: NBG, Goestat, TBC Capital

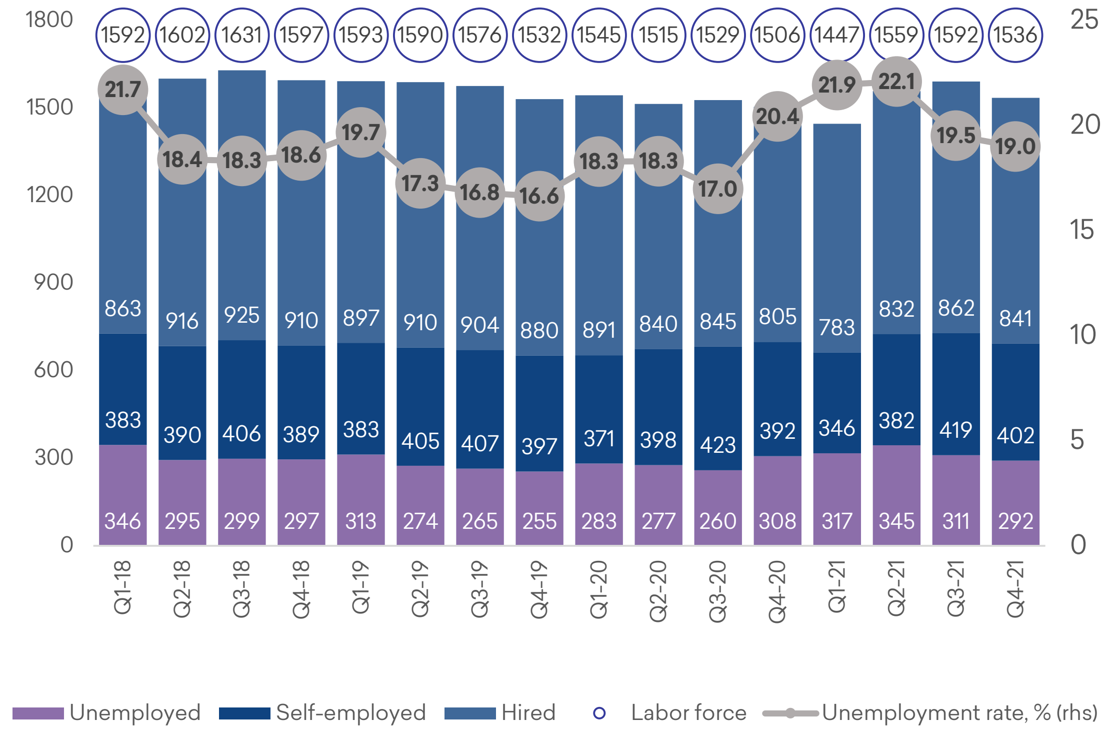
We project 2022 growth at around 5.5%

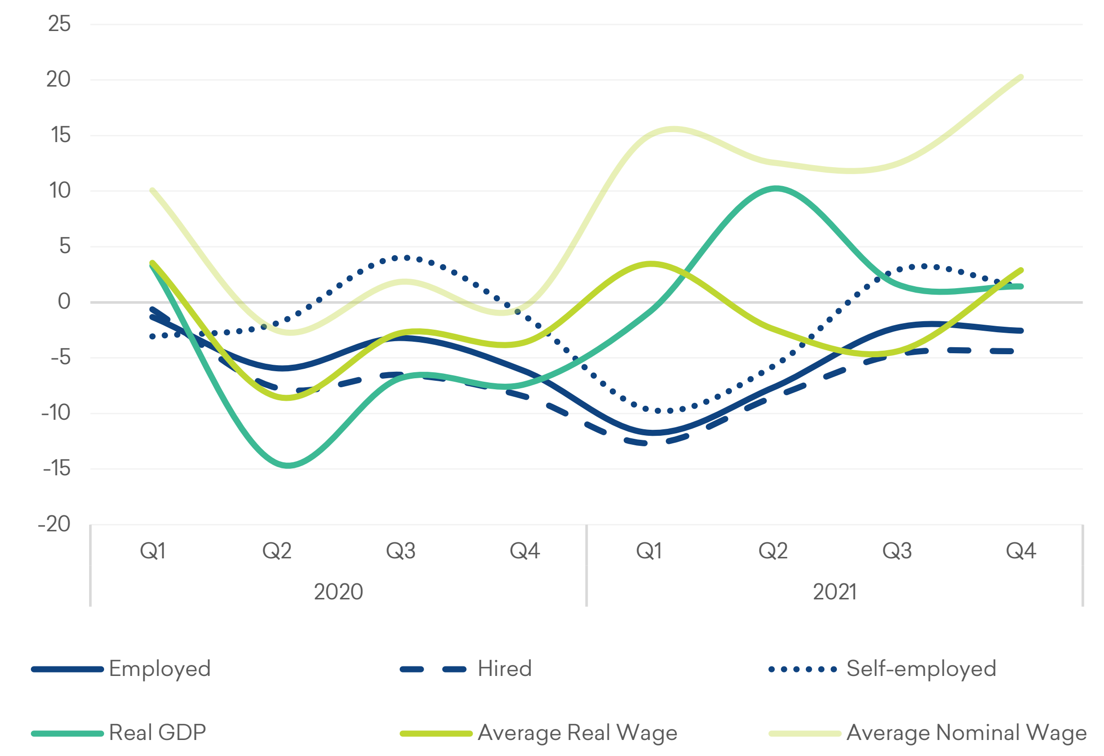
YoY, %	2020 Actual	2021 Actual	2022 Baseline
EXPORTS*	-12.0	+26.5	+23.0
TOURISM (incl. migration impact)*	-83.4	-62.0% vs 2019	-30.0% vs 2019
REMITTANCES*	+5.5	+25.5	+1.4
FDI (incl. reinvested earnings)*	-30.5	+33.0	+20.6%
IMPORT OF GOODS AND SERVICES*	-19.3	+21.5	+16.5
FISCAL DEFICIT**	9.3	6.7	5.0
BANK CREDIT***	+9.1	+18.3	+17.0
GDP GROWTH	**-6.8%**	**+10.4%**	**+5.5%**

*Growth in USD ** Ratio to GDP, as planned by the MoF, IMF methodology ***Year-end
For GDP estimation inflation adjusted period credit growth is used. Also, the calculation is based on the estimation of inflows in real terms in GEL, not in USD. Moreover, various other assumptions are used in terms of the impact of key macroeconomic variables on economic growth

Source: Geostat, NBG, MoF, TBC Capital

In line with expectations, the labor market recovers with a time lag; going forward, we do not expect large adverse impact on the labor market, however, low real wages still should be an issue in 2022



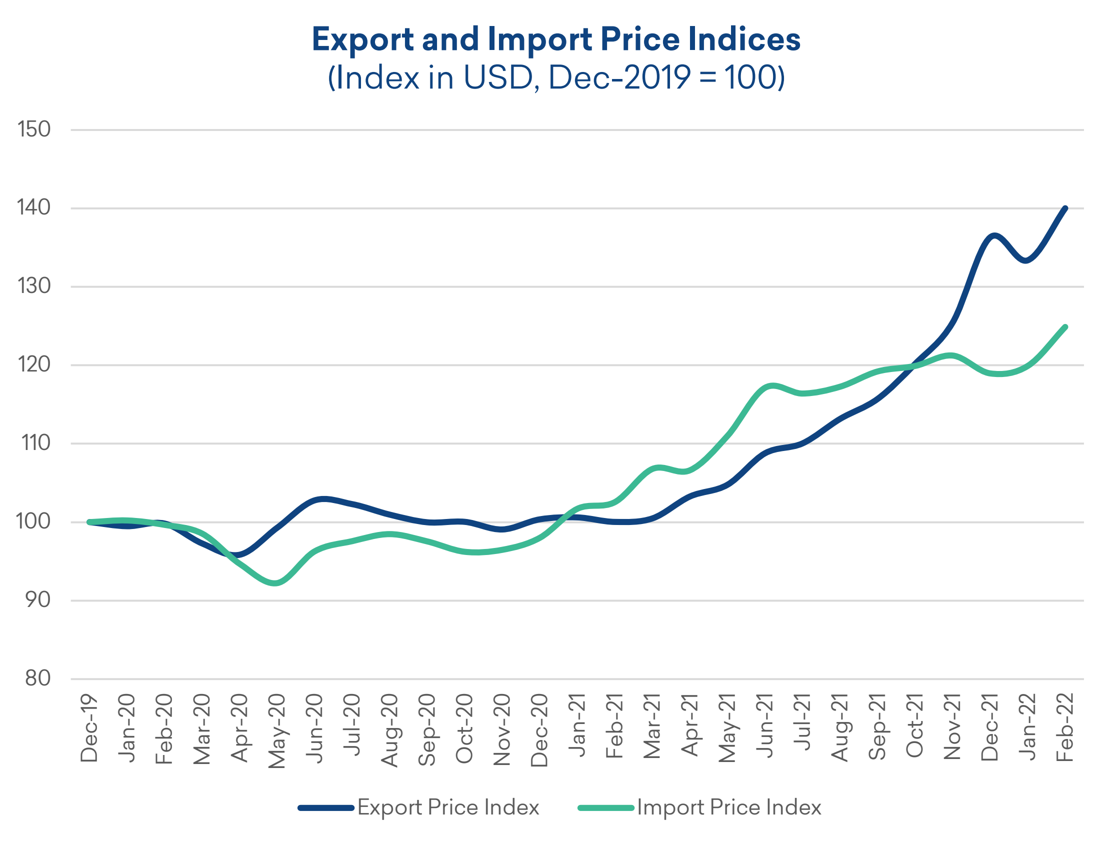


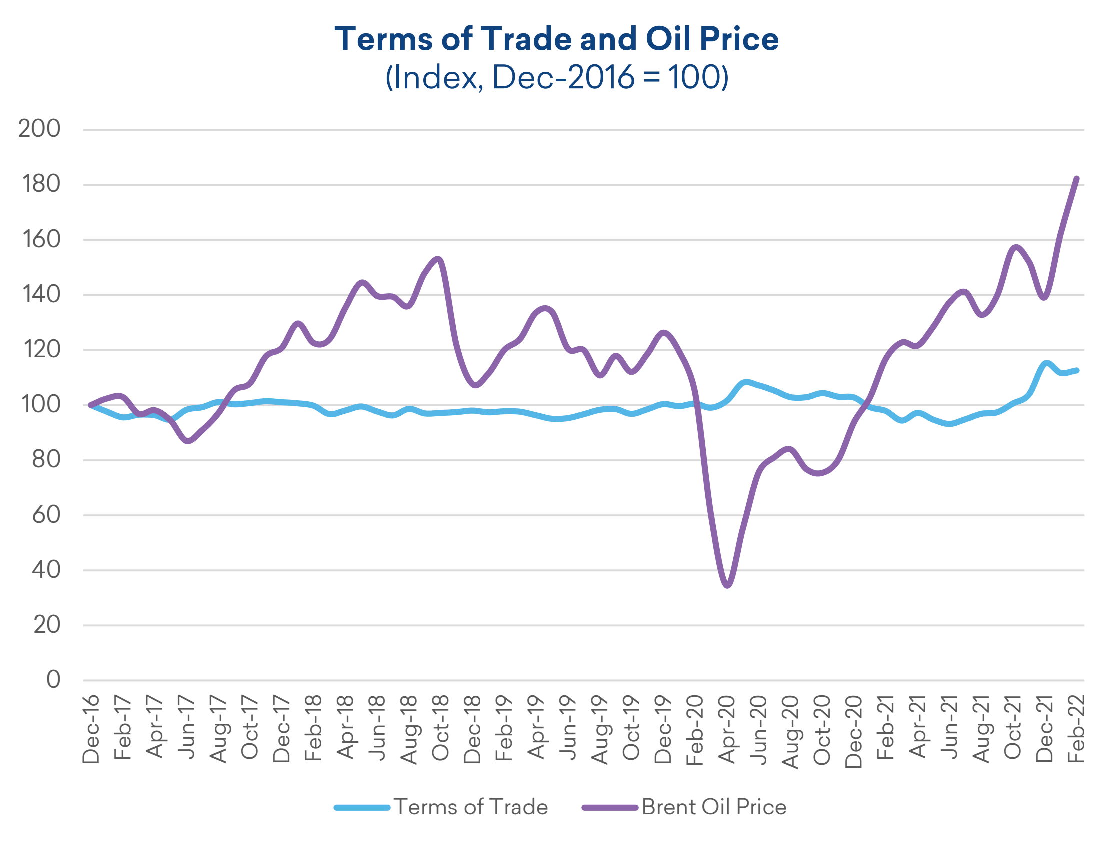
Source: Geostat, NBG, TBC Capital

GEL drivers – the three pillar approach

- **External inflow-outflow balance:** GEL positive projection
- **REER:** the assessment seems to be broadly neutral or slightly on the overvaluation side
- **Inflation:** outlook well above the target and, therefore, GEL positive

Terms of trade – export prices largely compensate higher import prices



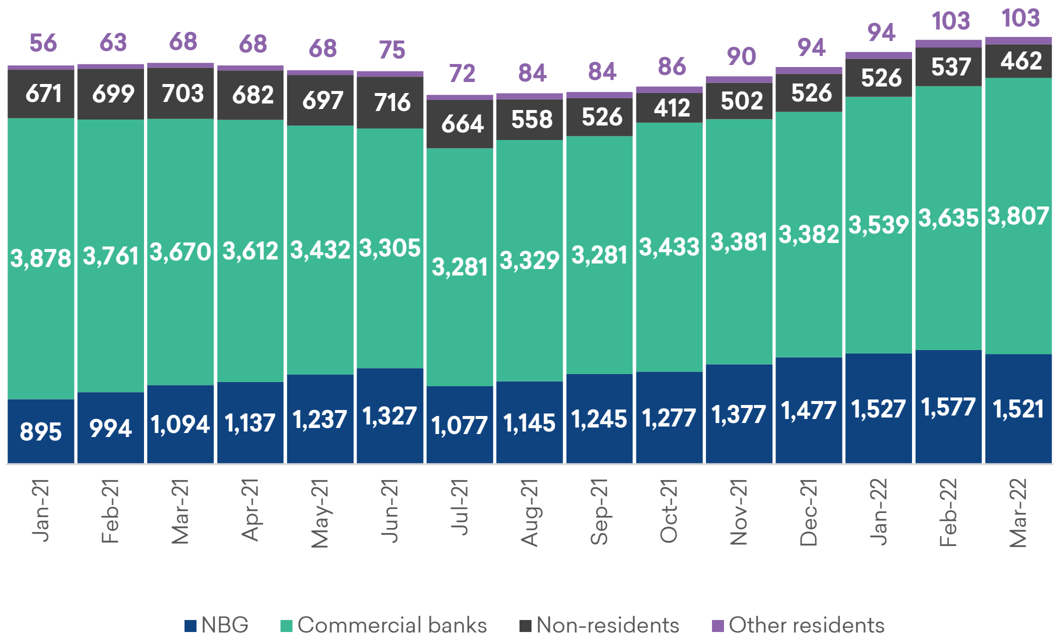


- Higher oil prices will not necessarily lead to deterioration of terms of trade

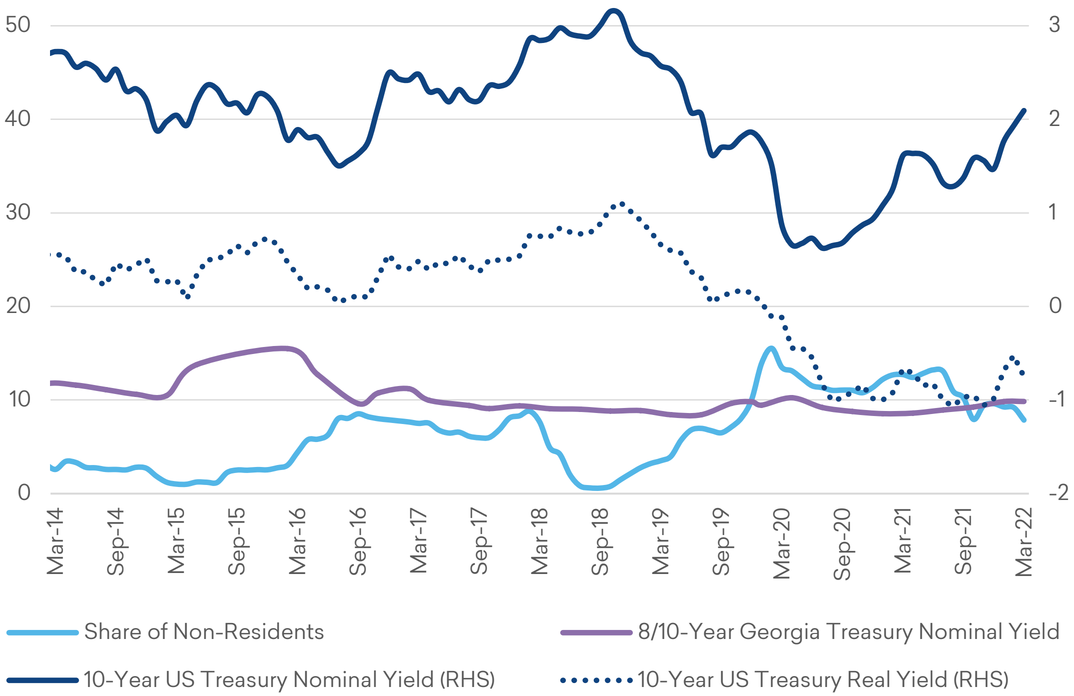
Source: Geostat, Bloomberg

In March, non-resident holdings of GEL securities went down by around 75 million GEL; going forward, we expect the holdings to recover somewhat

Treasury securities by holder
(End of period, million GEL)

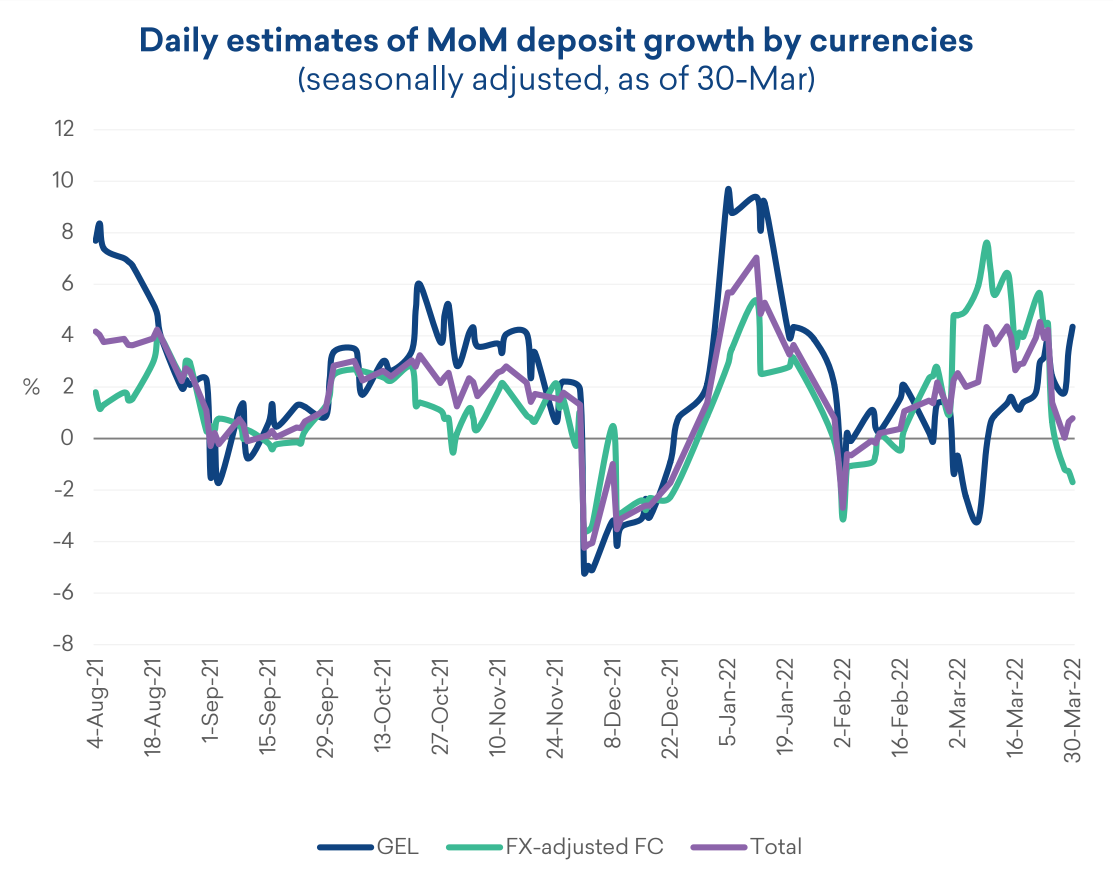


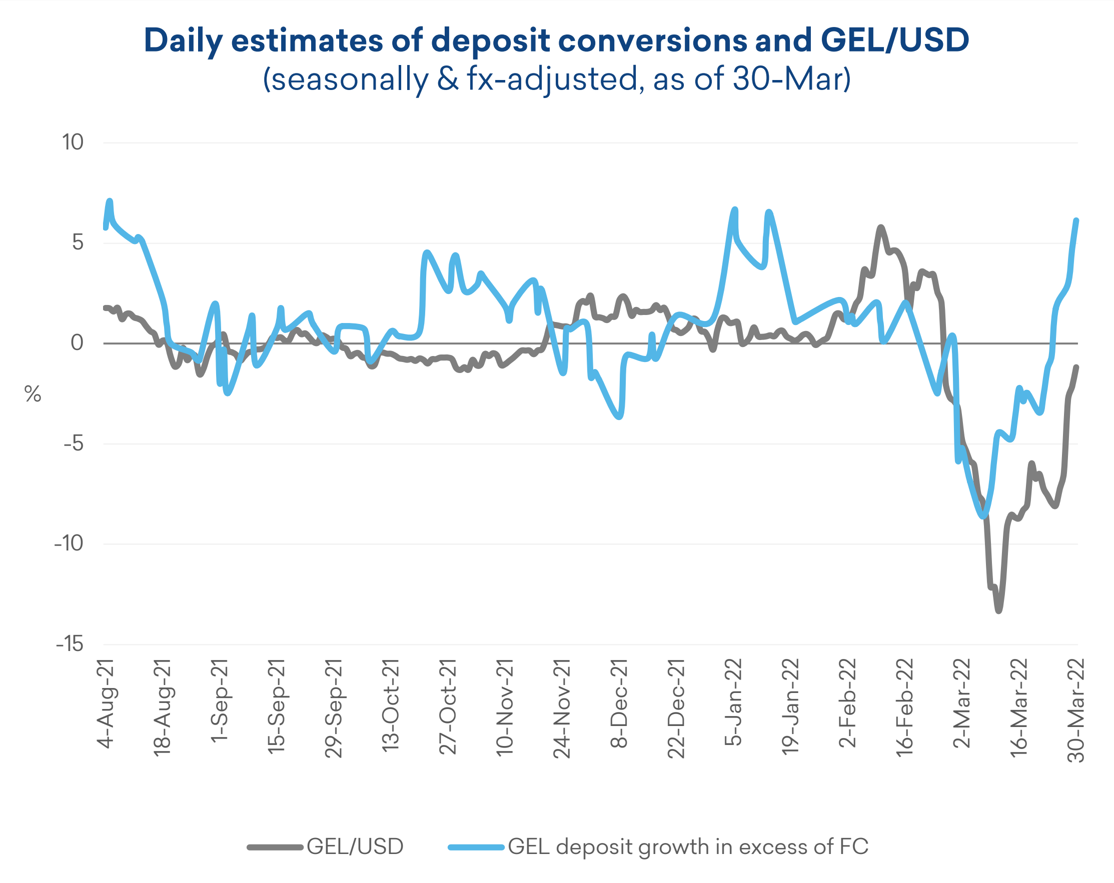
Share of treasury securities held by non-residents and 10Y treasury yields for US and Georgia (%)



Source: NBG, FRED

Recently, the sentiments on the deposit side had a significant impact on the GEL; going forward, assuming broadly stable GEL, we project relatively higher growth of GEL deposits

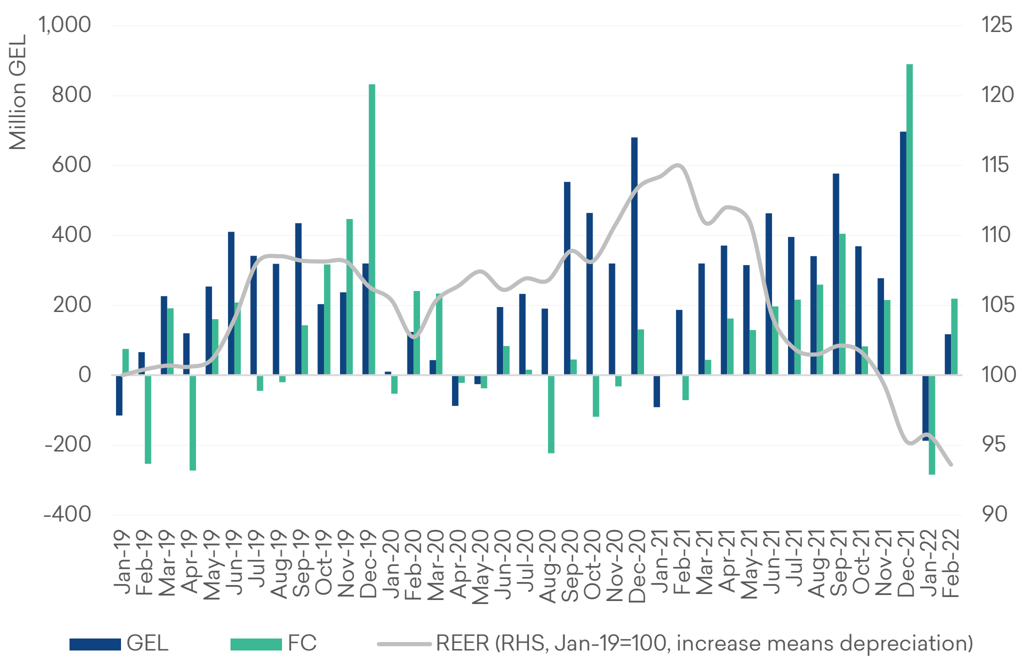




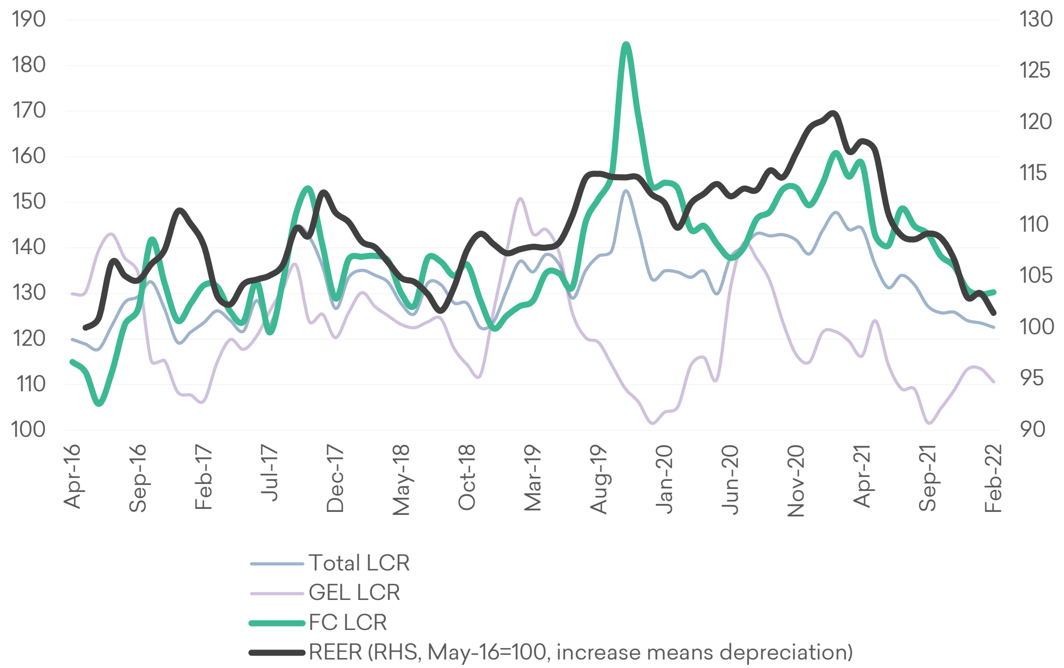
Source: NBG, TBC Capital

Continuing adjustment to back to normal of the banking system FC liquidity will further support the GEL

Growth of portfolio by currencies
(mom, excl. FX effect) **and CPI-based GEL REER**



Liquidity coverage ratio (%) **and CPI-based GEL REER**

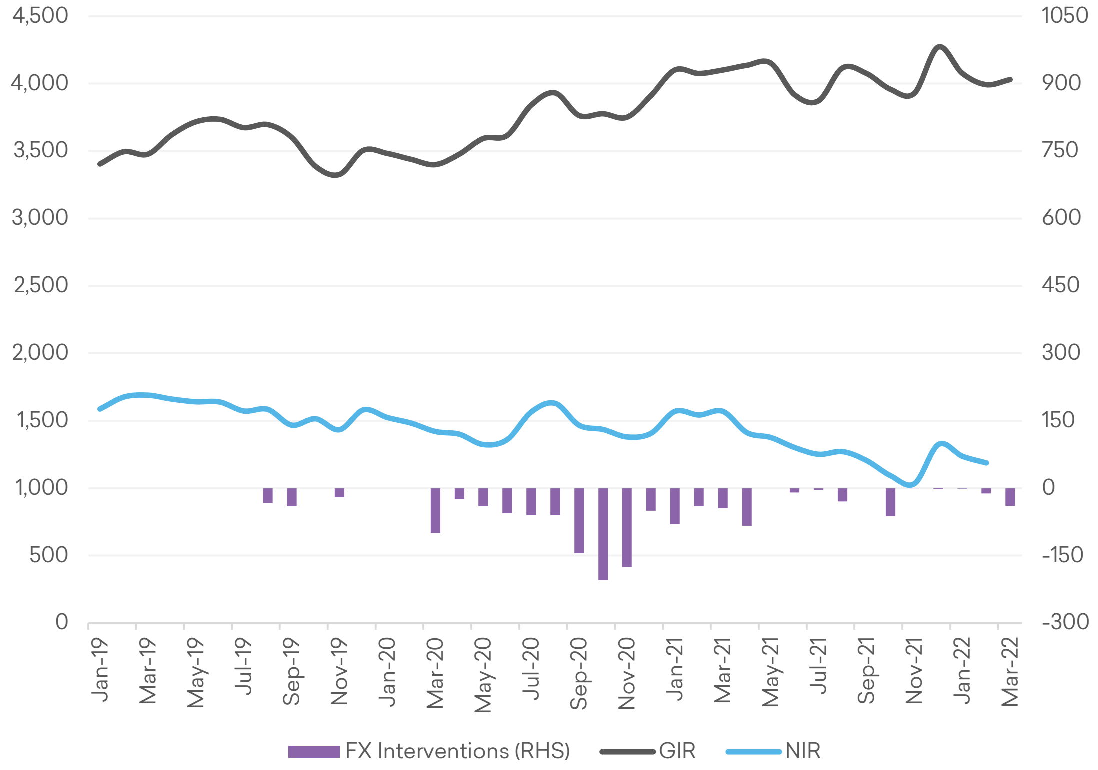


- Important pre-condition for normalization of FC liquidity is absence of strong depreciation expectations; otherwise, the shock will be amplified once again
- In the baseline we assume the increase in credit larization, though only moderately
- For the impact of FC liquidity on the GEL see the “shock amplifier” section of Thematic Insights: The Additional Fuel Behind the Restart

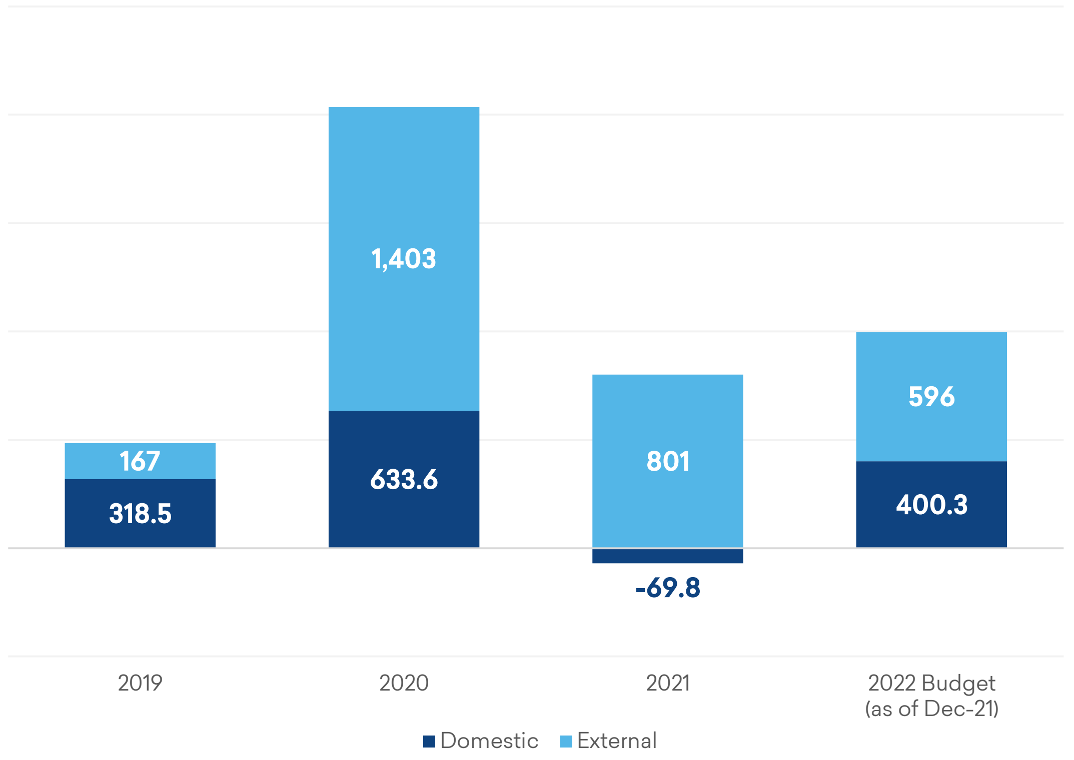
Source: NBG, TBC Capital

Although not in our baseline, if needed, there is a room for NBG FX interventions and additional government external borrowings

NBG gross and net international reserves and FX interventions (Million USD)



Net change in government debt (Million USD)



Source: NBG, MoF, TBC Capital

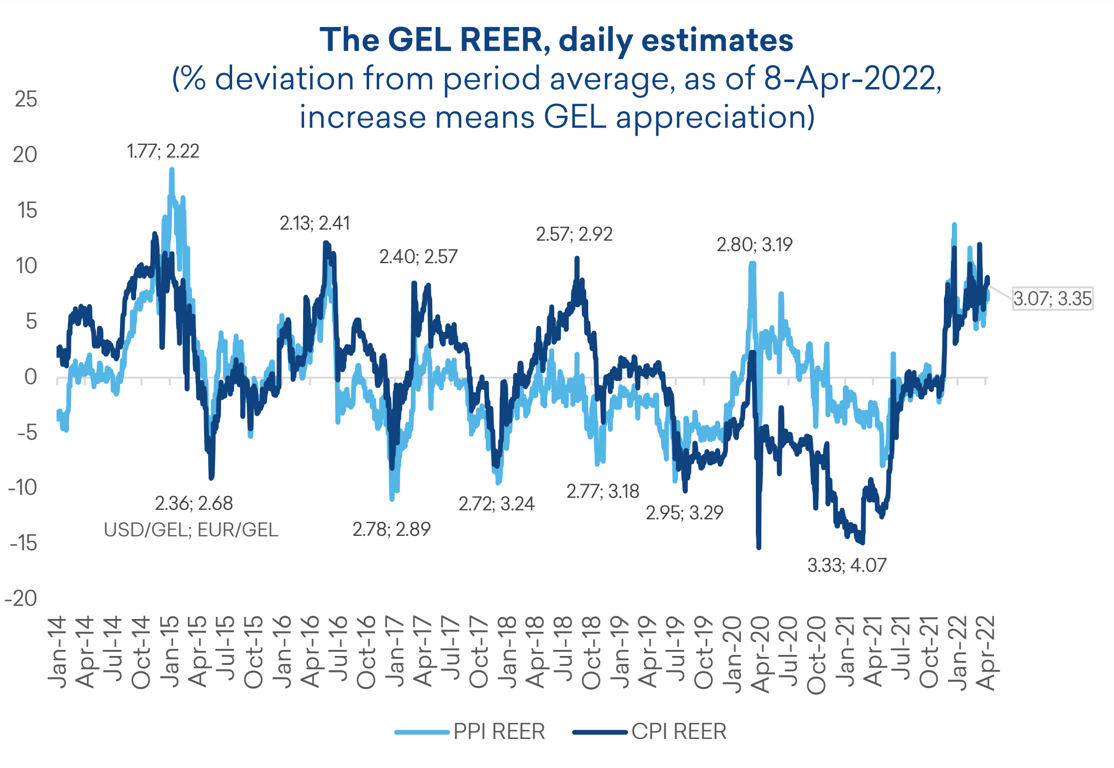
2022 baseline inflow-outflow balance is GEL supportive

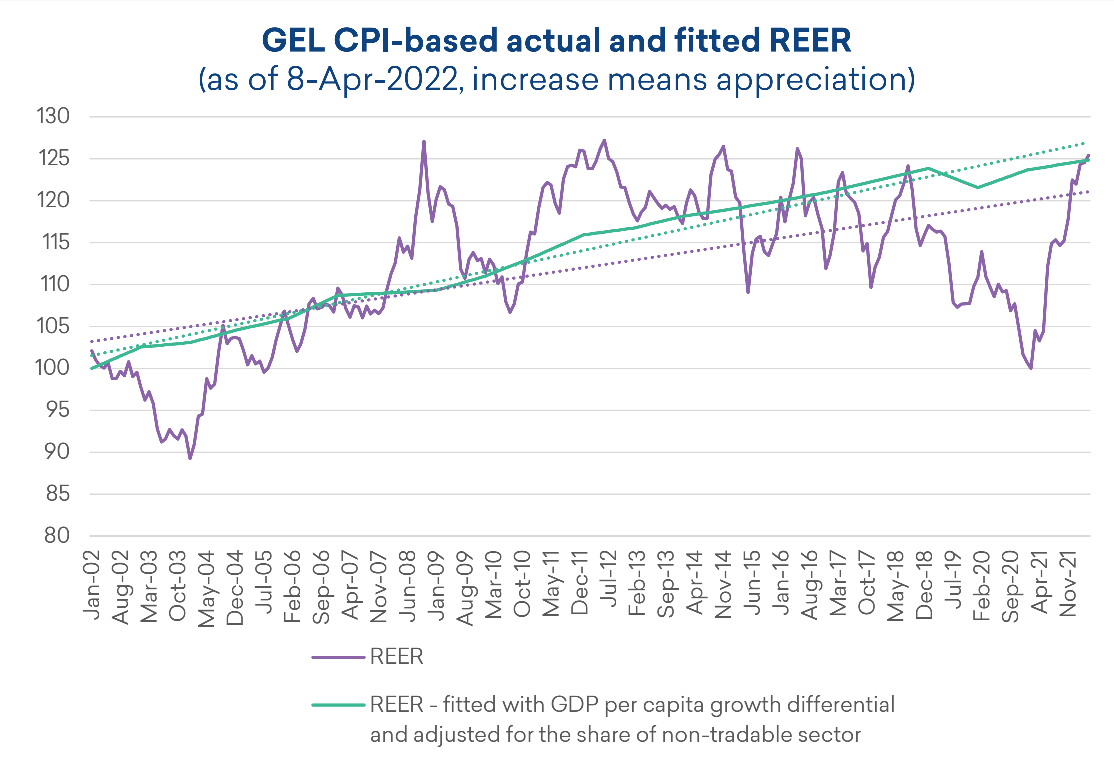
Selected items of balance of payments						
in USD billion	2017	2018	2019	2020	2021	2022 F
Export of goods	3.63	4.45	4.99	4.37	5.57	6.85
Net tourism (incl. migration impact)	2.24	2.70	2.61	0.36	1.06	1.94
Net remittances	1.45	1.63	1.73	1.91	2.42	2.45
Import of goods	7.43	8.56	8.72	7.54	9.33	10.87
Net	*-0.11*	*0.21*	*0.62*	*-0.90*	*-0.28*	*0.37*
Investment income	-1.42	-1.38	-1.58	-1.22	-1.57	-1.80
CA incl. other items	-1.31	-1.19	-0.96	-1.96	-1.84	-1.35
CA incl. other items in % of GDP	-8.0	-6.8	-5.5	-12.4	-9.8	-6.5
Net FDI, *out of which:*	1.71	0.97	1.05	0.55	0.83	1.01
Equity and FDI-related debt	1.35	0.81	0.65	0.31	0.36	0.36
Reinvested earnings	0.36	0.15	0.40	0.24	0.47	0.65
Government	0.45	0.29	0.47	1.53	1.29	0.60
Banks, external borrowings	0.18	0.02	0.18	0.02	0.12	0.10
Banks, FC holdings*	-0.14	0.31	-0.16	-0.17	0.15	0.15
Other private sector borrowings	-0.24	0.26	-0.12	0.15	-0.10	0.10
Pension fund*	0.0	0.0	0.0	0.0	0.0	-0.12
Gross international reserves*	-0.24	-0.28	-0.20	-0.31	-0.45	-0.38
Net	*1.72*	*1.57*	*1.22*	*1.78*	*1.83*	*1.46*
Other items	*-0.41*	*-0.38*	*-0.26*	*0.19*	*0.00*	*-0.12*

- In this table, we summarize the major GEL drivers from foreign currency inflow-outflow perspective in the form of analytical presentation of balance of payments
- While uncertainties are high and it is difficult to be precise on each item, we still believe that the outlook largely reflects the assumptions of our scenario

Source: Geostat, NBG, MoF, TBC Capital

From the GEL REER perspective, the assessment seems to be broadly neutral or slightly on the overvaluation side

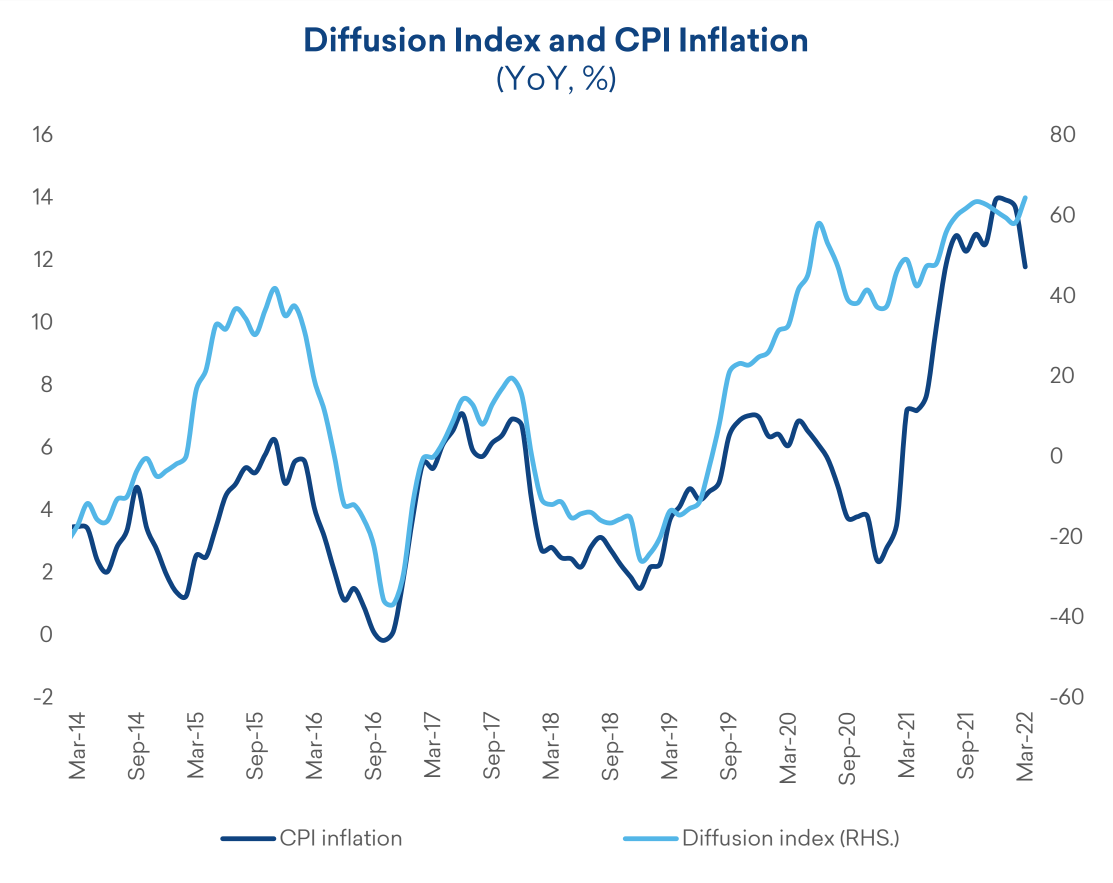


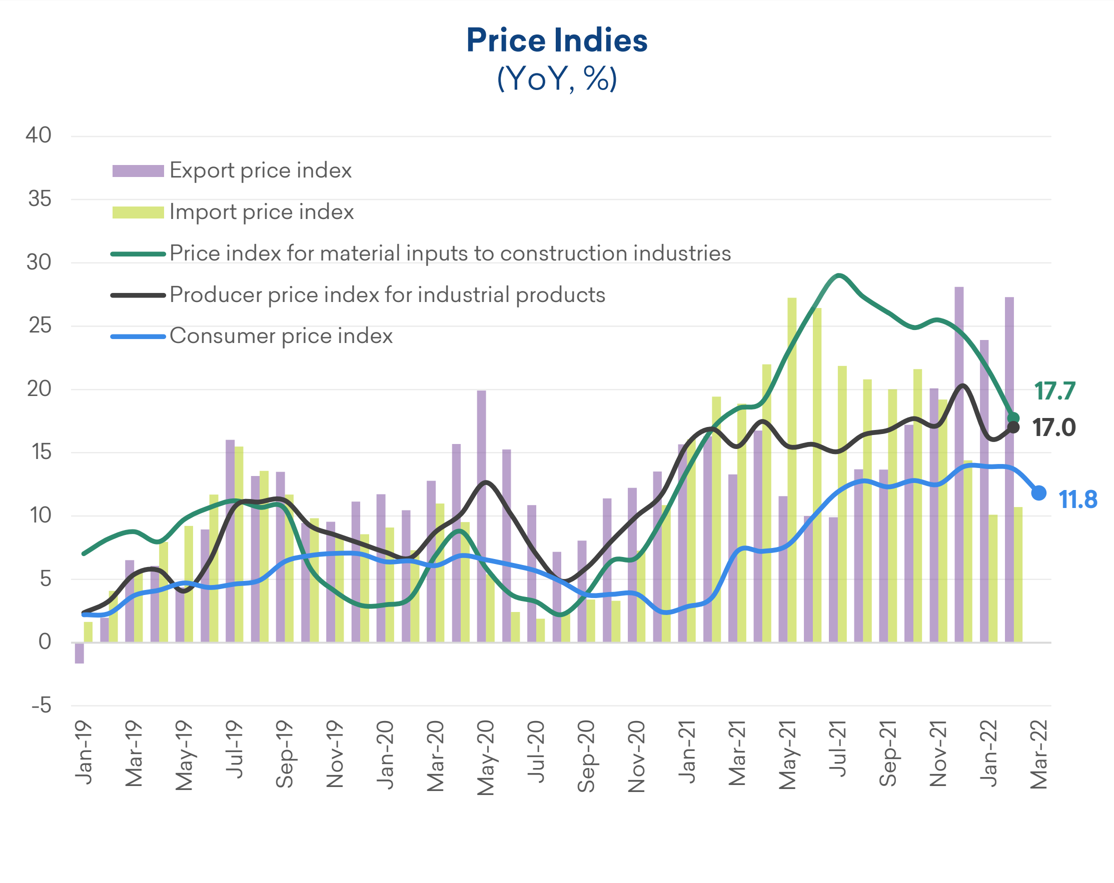


- The deviation from the period average is a simple measure of the GEL REER pillar. The GEL long-term trend is also important to consider, though besides other constraints, the large deviation in the short-term is also an issue
- Theoretically, the GEL REER with the time-lag should impact the inflow-outflow balance and the growth. In case of Georgia, at least strong relationship may be debatable (see slide #33). However, from the expectations perspective, significant movement in Georgia's economic partners' currencies not always, but often has an impact on the GEL

Source: NBG, Geostat, corresponding statistics offices, World Bank, TBC Capital

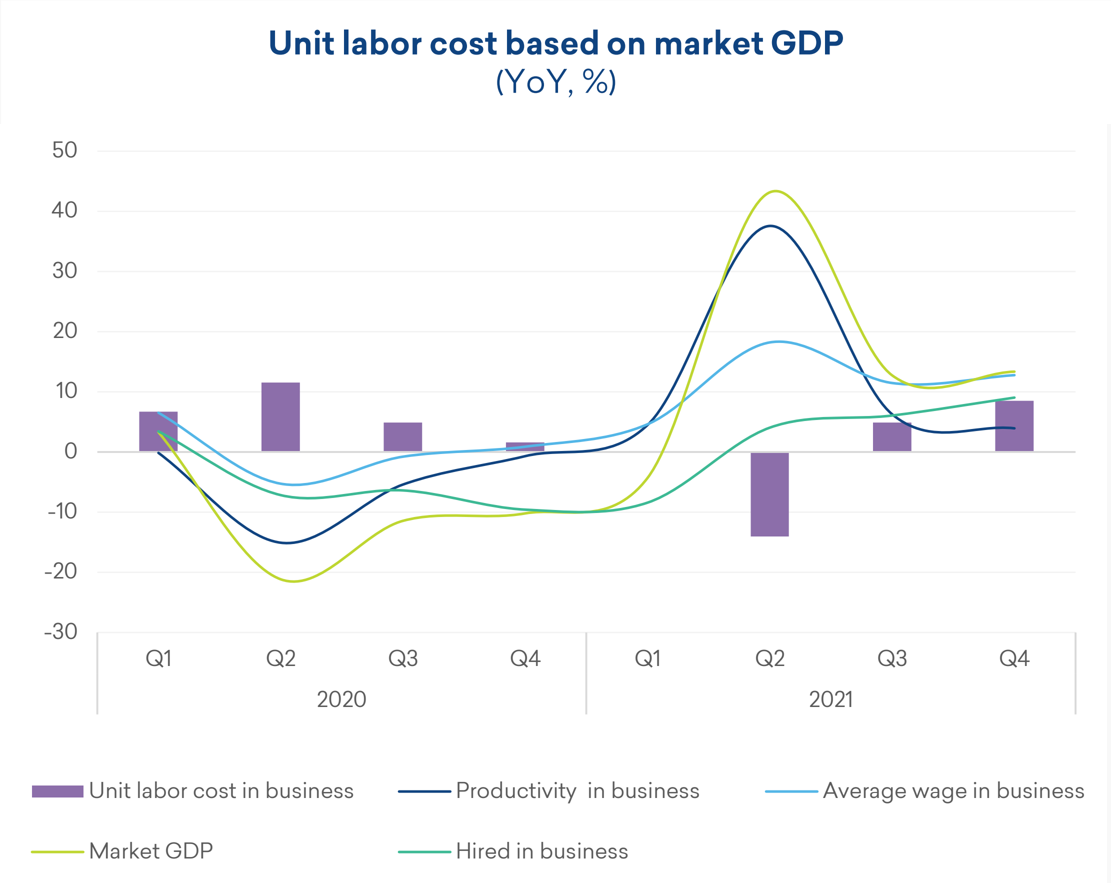
Producer Price Index is expected to stay elevated as well as import prices should pick up; Diffusion Index also adds to higher inflation perception; YoY CPI is down only on the back of low base effect (see next slides)

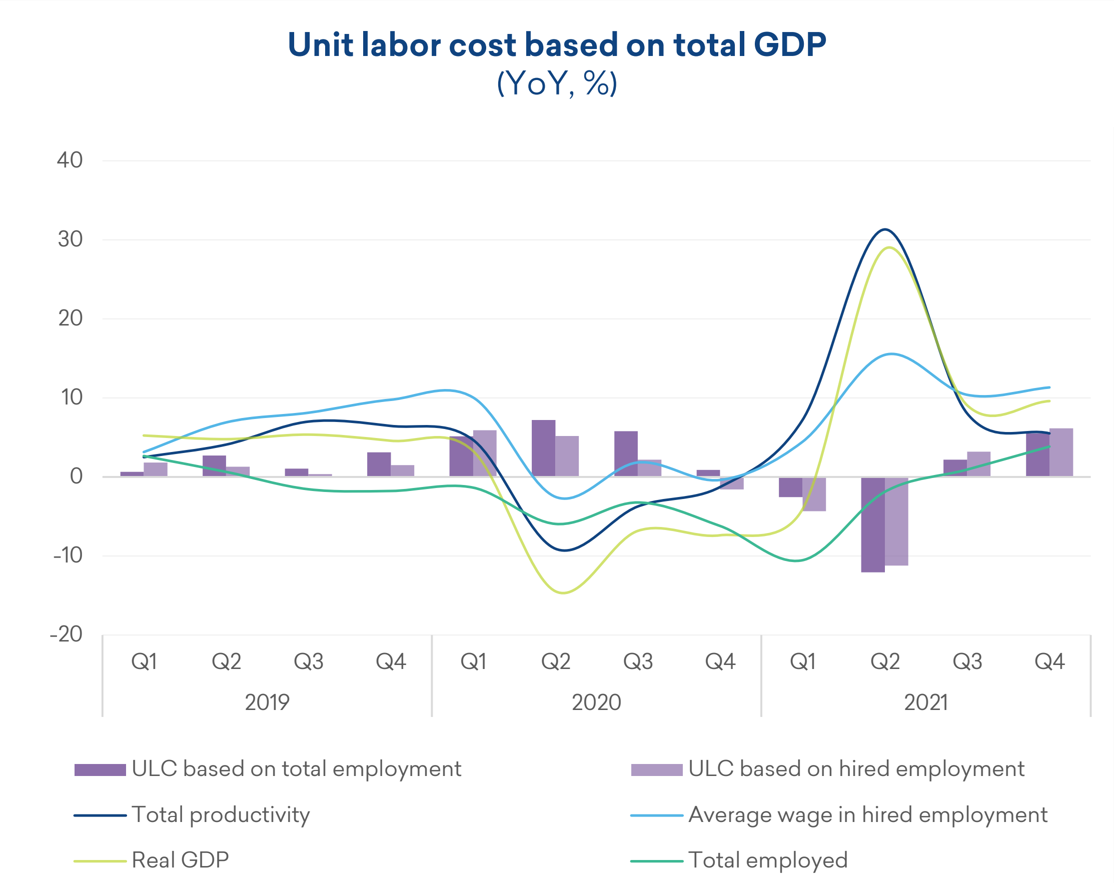




Source: Geostat, TBC Capital

Recently, higher unit labor costs also add to inflation pressures

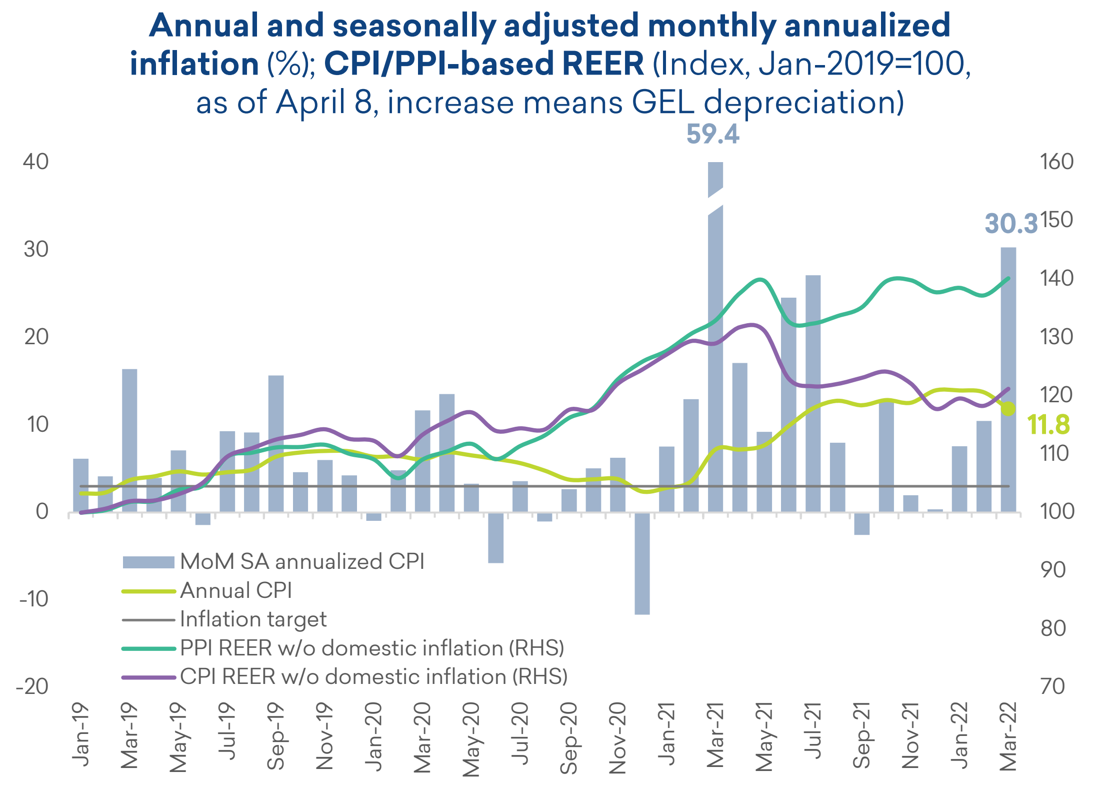


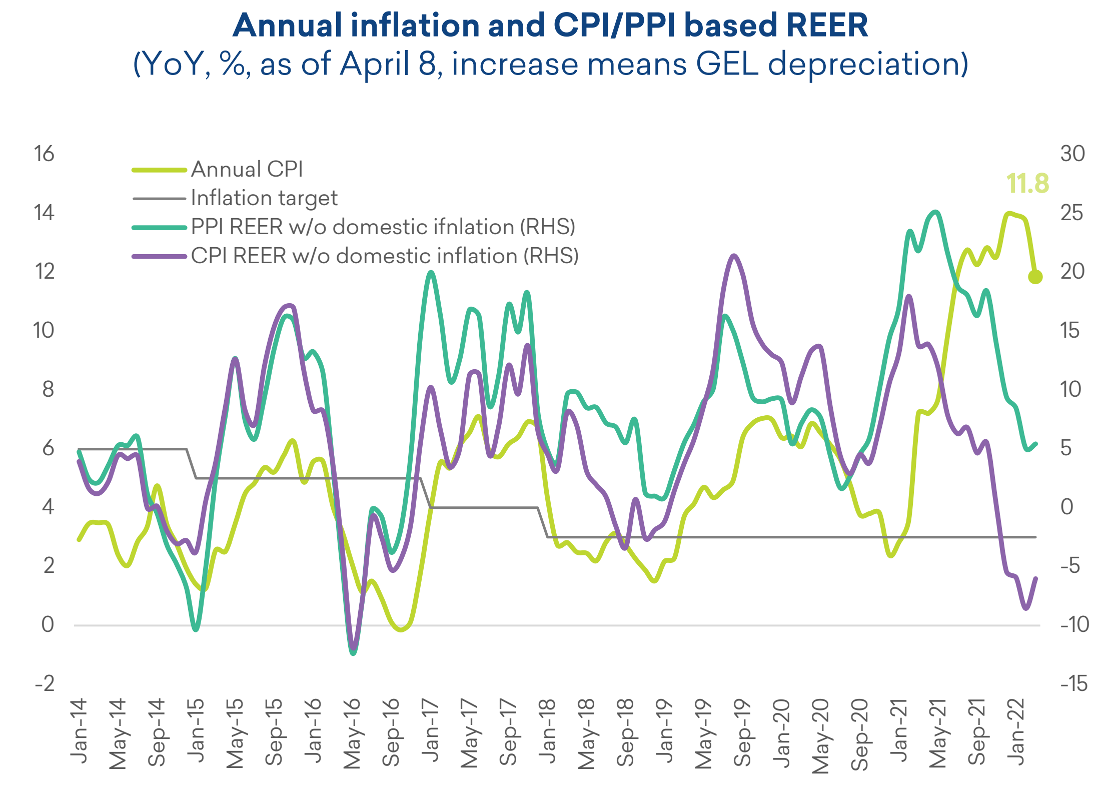


Note: Unit labor costs are measured as an increase in nominal average wages adjusted for the real per capita output

Source: Geostat, TBC Capital

In the baseline scenario, we expect 2022 YE inflation at around 8%, with monthly inflation rates to moderate in the second half of the year

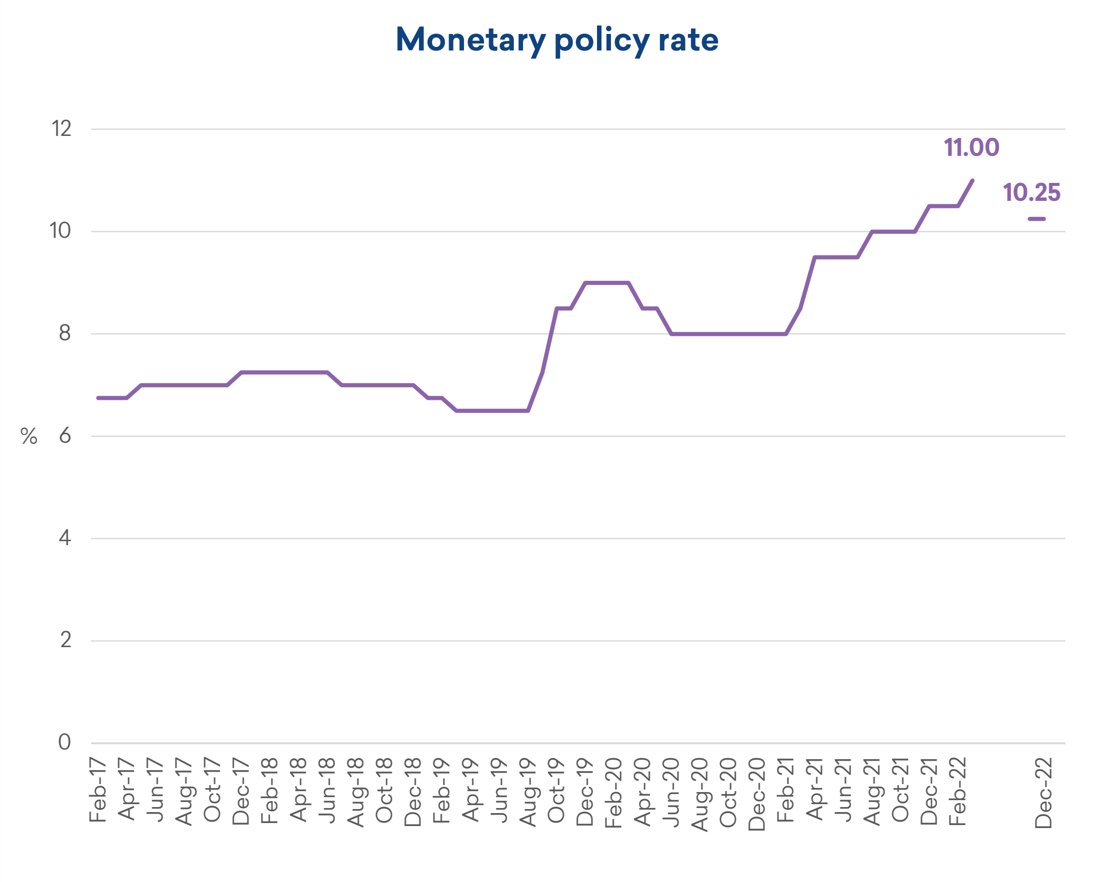


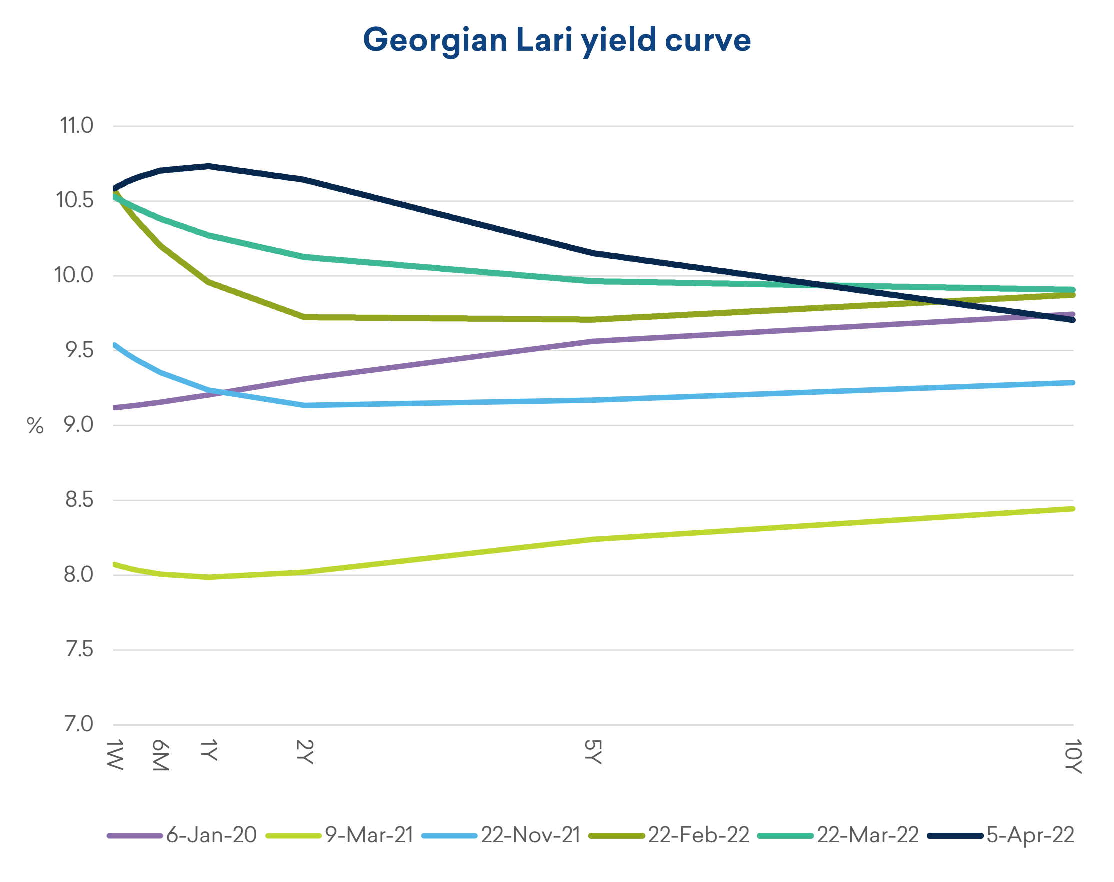


- Recently high commodity prices and the effect of subsidies led to less pronounced relationship of the GEL REER without domestic inflation and CPI inflation in Georgia. This is more evident in case of CPI based, rather than PPI based REER
- In the baseline scenario, we assume the GEL REER at broadly the same level throughout the year, oil prices to decline gradually to around Brent 85 USD and other commodity prices to have approximately the same pace, GDP growth in Georgia at 5.5 percent and policy rate to decrease to 10.25 percent by the end of the year. We also assume imports of some goods from Russia and Ukraine to be substituted by relatively more expensive markets

Source: Geostat, NBG, TBC Capital

We still expect some rate cuts by the end of the year; at least, further rate hikes seem unlikely; the GEL yield curve remains inverted

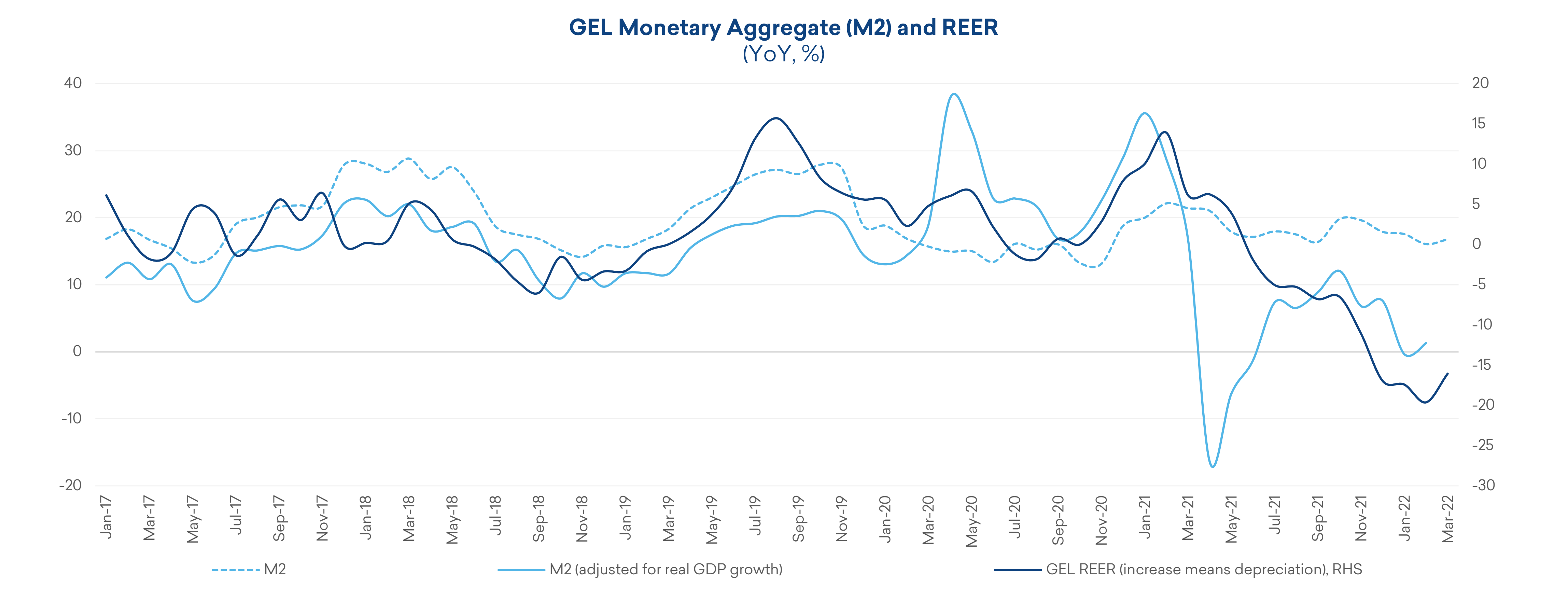




Note: see the yield curve methodology at the following link

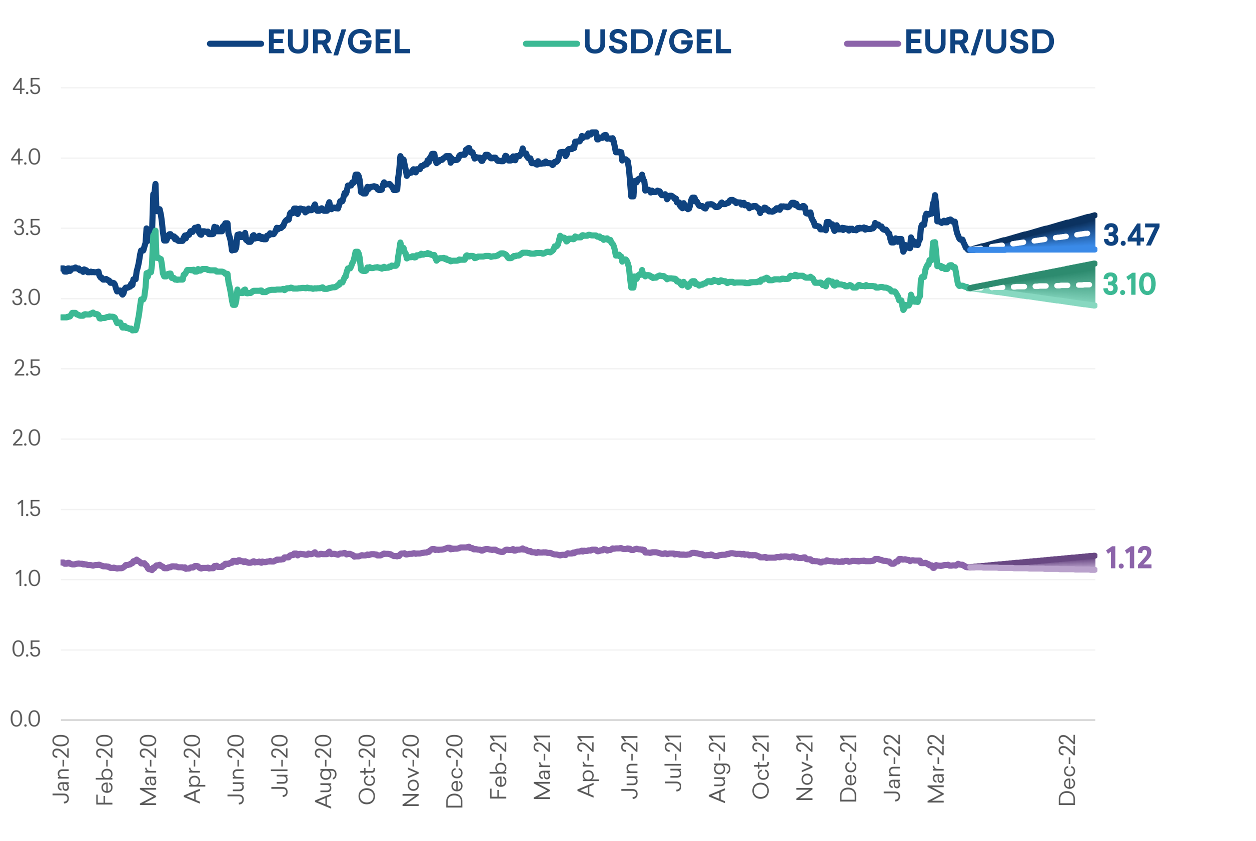
Source: NBG, TBC Capital

As a result of tight monetary policy, the GEL supply remains low



Source: NBG, TBC Capital

We remain broadly neutral on the GEL



Factors pushing GEL towards depreciation:

- War in Ukraine
- Slightly stronger GEL REER
- Local deposit conversions
- Weak Euro, Ruble and Lira
- Fed's stronger than expected rate hikes
- Resurgence of the pandemic

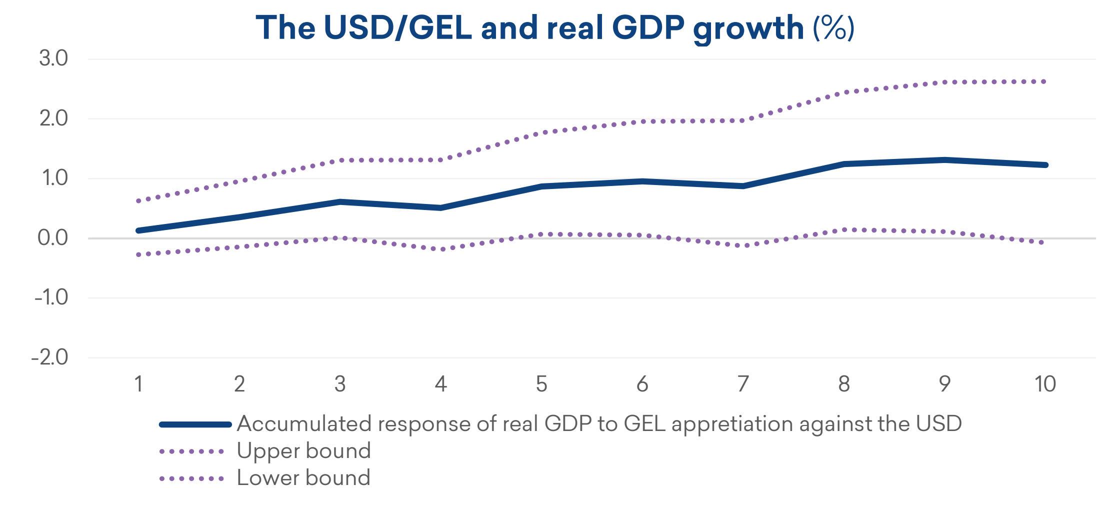
Factors pushing GEL towards appreciation

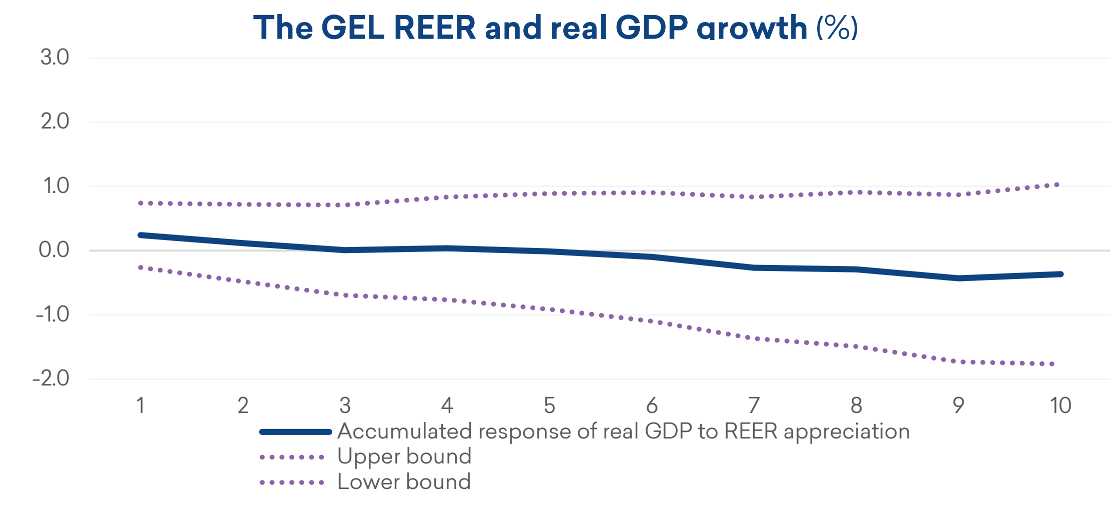
- Tourism recovery
- Still high government external borrowings
- Well above target inflation outlook
- Local deposit conversions
- Historically high GEL/USD differential
- Increased FX credit
- Still somewhat excess FC liquidity of the banking sector
- Weakening of US dollar
- GEL REER long-term appreciation trend

- From our three pillar analysis, the outlook of net inflows and inflation is GEL supportive, however, the GEL REER likely indicates to its same or somewhat weaker level
- The uncertainties remain high, especially likely on the RUB side, however supportive arguments do exist

Source: NBG, TBC Capital

The GEL and the growth





A stronger GEL is one of the indicators of improved consumer and business confidence and stronger growth. Based on a VAR model*, we find very little (if any) evidence of a weak GEL supporting growth through the export expansion and import substitution effect. In particular, the model is constructed to reveal the balance between the trade and financial effects of the GEL real effective exchange rate (REER) and the GEL nominal exchange rate to USD for the Georgian economy. The model consists of the real GDP, the GEL nominal exchange rate towards the USD, the REER, and control variables such as commodity prices and foreign demand.

Appreciation of the GEL towards the USD causes real GDP to increase (from the financial/income effect), while appreciation of the REER initially leads to an counterintuitive increase of real GDP with a negative impact (from the trade/substitution effect) only observed after five periods. However, the latter effect does not seem to be significant, unlike the effect of the USD/GEL. While further study into this matter is necessary for more accurate results, the findings appear to be valid when taking into account the characteristics of the Georgian economy.

This is important from the policy response perspective as the depreciation certainly may lead to lower imports, however, at the expense of slower growth.

*The approach is based on the autoregressive distributed lag (ARDL) model from the BIS 86th annual report, Box III.B: Exchange Rates: Stabilizing or Destabilizing.

Source: NBG, BIS, Bloomberg, TBC Capital

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