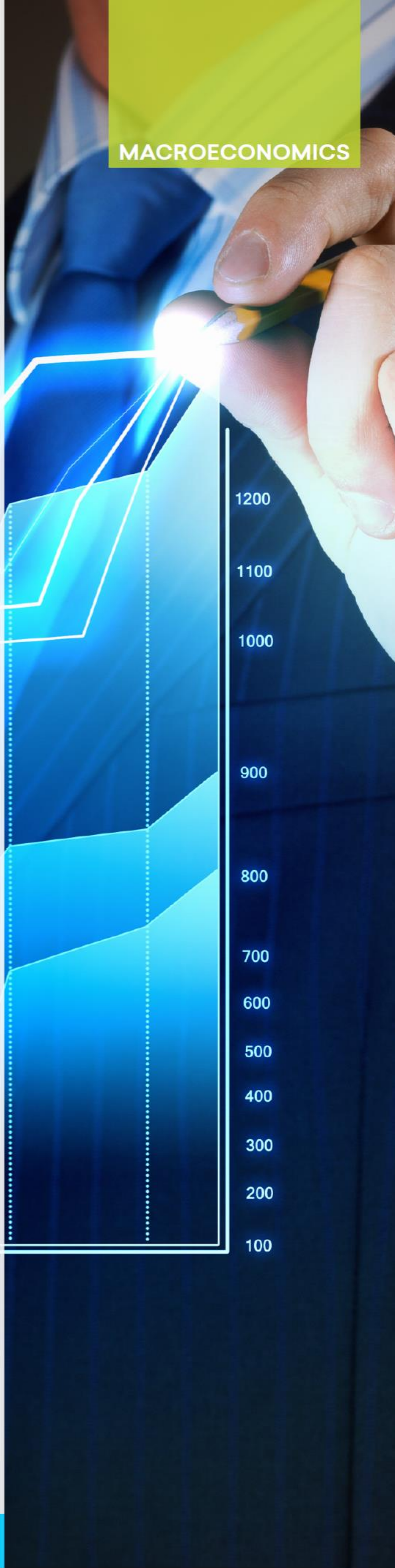

TBC CAPITAL

The additional fuel behind the restart:

THE REVERSAL OF THE SHOCK AMPLIFIER, LOW USD YIELDS AND A STRONGER GEL

THEMATIC INSIGHTS

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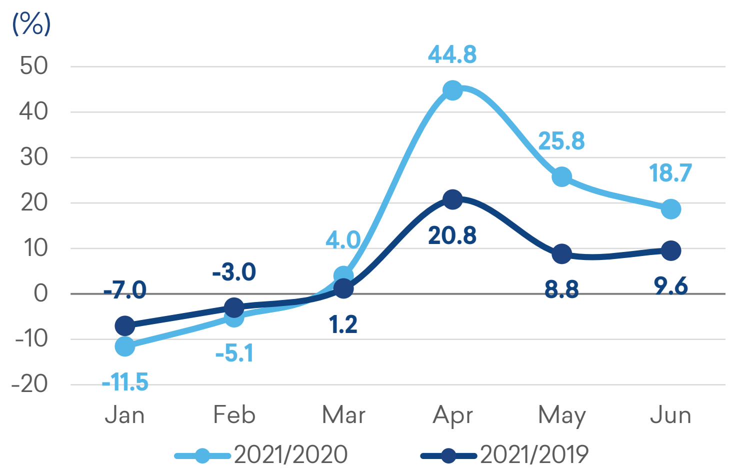
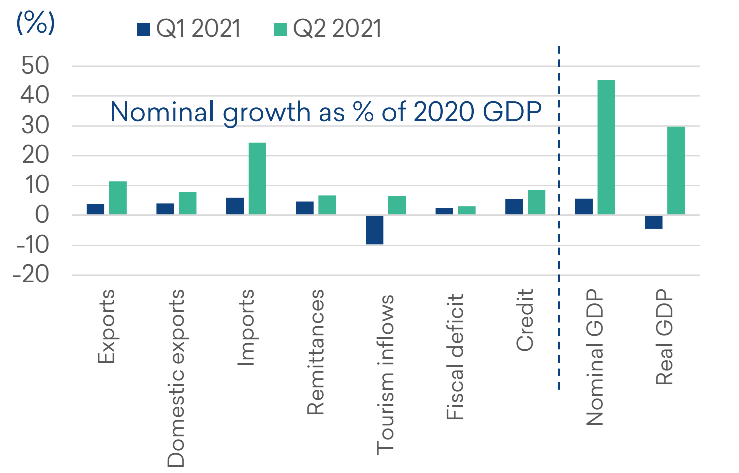
Introduction

Real GDP growth



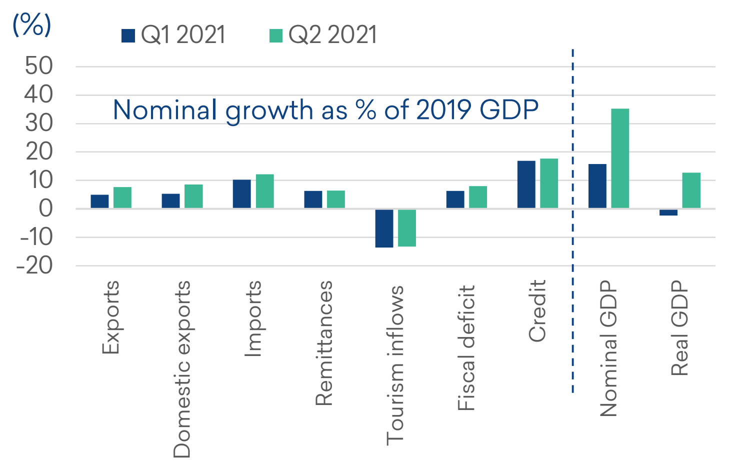
Source: GeoStat

GDP and key macro variables, 2021/2020



Source: GeoStat, NBG, MoF

GDP and key macro variables, 2021/2019



Source: GeoStat, NBG, MoF

The exogenous nature of the COVID-19 shock implies the potential for a quick recovery compared to conventional business cycles. Although the pandemic is still ongoing and the timeframe for a full return to normality is still debatable, the recent restart of the economy, as opposed to a gradual recovery, has confirmed the exogenous nature of the shock (see TBC Capital's earlier publication: Comparing the 2008 and 2020 shocks).

While the observed restart was certainly expected, the Georgian economy has rebounded at a speed exceeding even the most optimistic scenarios. Importantly, the growth is broad based and has been reflected in all sources of inflows, as well as in domestic demand. Despite tourism and re-export related imports still recovering, in June 2021 imports of goods in USD terms already surpassed those of 2019 by 14.2%. According to the preliminary estimates of GeoStat, after dropping by 4.5% in the first quarter of 2021, the economy posted 29.8% YoY growth in the second quarter. While the low base effect from 2020 has certainly played a role, in the second quarter the economy also surpassed the 2019 level by 12.6%.

Together with the exceptional performance of both exports and remittances, higher credit balances, a gradual recovery in tourism inflows and a sizable fiscal stimulus (especially when compared with 2019), we argue that the restart has been further fueled by the recent reversal of the 2020 shock amplifier, record low USD deposit rates and the stronger GEL.

The reversal of the past year's shock amplifier

In 2020, Georgia lost around USD 2.73 billion in tourism inflows, though around 40% of that figure was import expenditure. Furthermore, outbound tourism was also down, saving the economy around USD 477 million. Georgia also saved around USD 260 million on lower oil prices and almost flat petroleum imports coupled with further savings on other import categories due to the lockdowns, lower demand on most durables, and a weaker and more volatile GEL (see The restart and the stronger GEL, below). Furthermore, exports excluding re-exports increased by USD 84 million as Georgia produces very few, if any, cyclical durables. Remittances[1] were also higher by USD 102 million (USD 176 million net). Overall, the current account deficit was USD 1.03 billion higher in 2020 (USD 0.79 billion higher in the four quarters ending in Q1 2021).

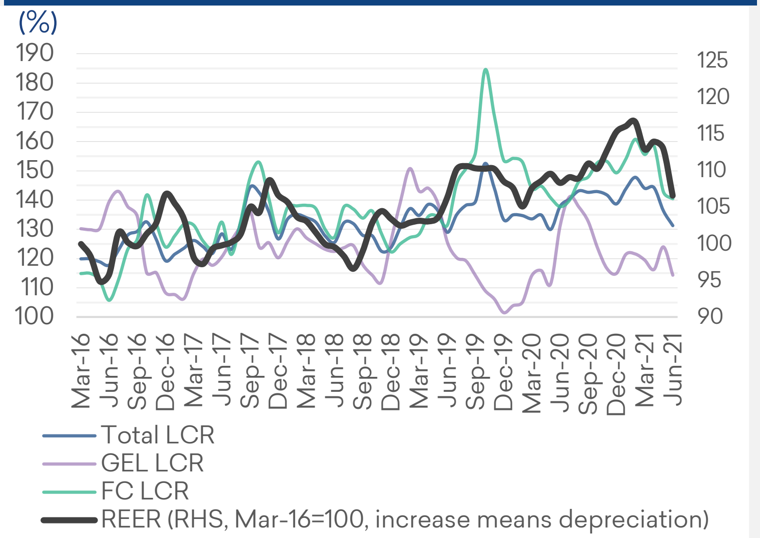
As for FDI, inflows were down by USD 694 million, of which equity saw the greatest decline of USD 682 million, with reinvested earnings also experiencing a minor fall equaling USD 74 million; meanwhile, debt instrument investment actually expanded by USD 62 million. Importantly, about USD 295 million of equity decline in Q4 2020 was a result of a one-off transaction only related to a change in ownership, and therefore not resulting in USD outflow.

On the other hand, FDI from Georgia to the rest of the world also decreased by USD 259 million, meaning that net FDI has fallen by USD 435 million (USD 391 million in the four quarters ending in Q1 2021) or, if the one-off transaction is excluded, by around 140 million (USD 96 million in the four quarters ending in Q1 2021). In total, in 2020 the net loss in inflows arising from the worsened current account deficit and lower FDI equaled around USD 1.17 billion (USD 0.89 billion in the four quarters ending in Q1 2021).

The estimated loss was well compensated by the government's external borrowing, which saw a net increase of USD 1.40 billion, of which around 1.11 billion was utilized by the government and around 0.92 billion was sold by the central bank[2] (1.59 billion, 1.33 billion and 0.98 billion in the four quarters ending in Q1 2021, respectively).

At the same time, due to elevated depreciation expectations, as in 2019, there was an additional significant loss, estimated to be around USD 470 million (USD 564 million in the four quarters ending in Q1 2021)[3], arising from both a higher propensity to save in FX and a higher propensity to borrow in GEL. This shock amplifier was reflected in higher FX liquidity in the banking system (as well as a weaker financial account of the balance of payments[4]) as a significant part of inflows were accumulated on bank deposits from the liability side and their correspondent accounts abroad from the asset side, thereby leading to additional pressures on the exchange rate and the growth.

Banking sector liquidity coverage ratio (LCR) and GEL REER

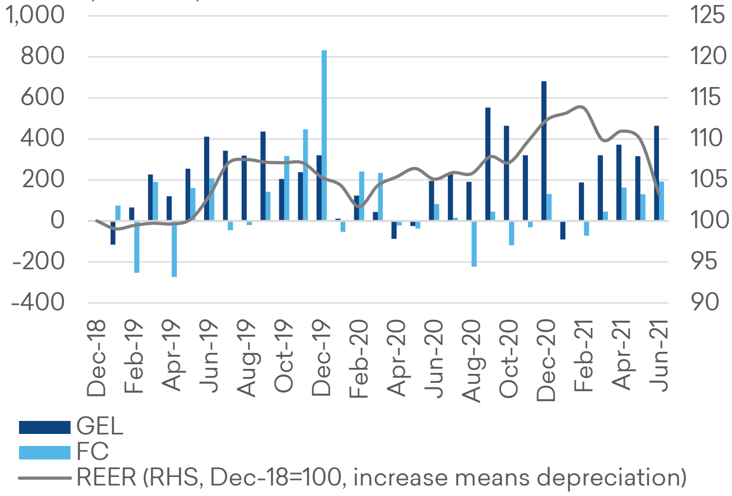


Source: NBG

1. Adjusted for higher remittances through digital channels as a result of the closed borders.
2. The National Bank's net sales of FX totaling USD 916 million in 2020 were financed by the government's external borrowings.
3. Assuming that without the shock amplifier the FX LCR would be down to around 125%, which is not an optimistic assumption as in a business-as-usual situation the banking system operates with an even lower FX LCR. A reduction of 10 percentage points of the FX LCR is estimated at around USD 188 million.
4. According to BoP, in 2020, banks' currency and deposits on the assets side increased by USD 169 million (by USD 591 million in the four quarters ending in Q1 2021 as there was sizable pre-pandemic decrease in Q1 2020 and also sizable increase in Q1 2021).

Credit growth by currencies and the GEL REER

(MoM, m GEL, excl. FX effect)



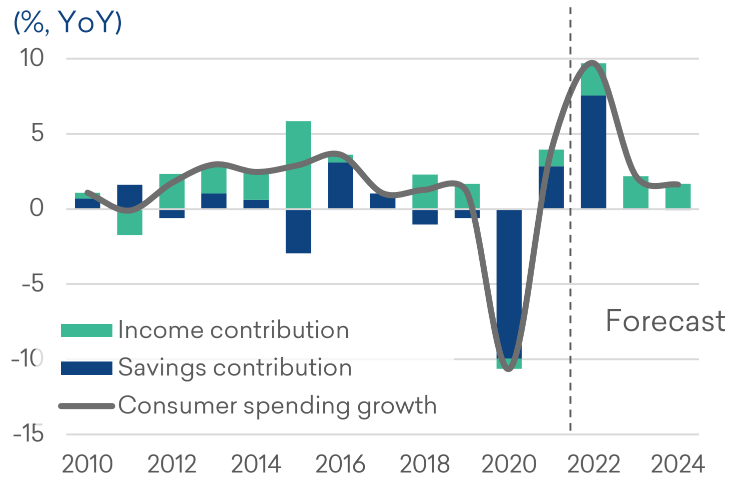
Source: NBG, TBC Capital calculations

While in 2020 this effect amplified the shock, in 2021 it has bolstered the growth. Despite the fact that some of the excess FC liquidity was repaid by banks, a significant part of it has been channeled back to the FX market and the economy in the form of FC loans[5], and, more importantly, it is likely that the largest share has been consumed in the form of dissaving, being further incentivized by record-low USD deposit yields.

5. The FX credit growth funded from a decrease of banks' correspondent accounts abroad is, in terms of the effects on the exchange rate, equivalent to FX inflows. It is also important to highlight that Georgia operates in three rather than one currency. A tightening of the GEL thus does not necessarily mean a contractionary impact on the economy. For example, besides a stronger GEL leading to improved consumer and business confidence, when thinking of the credit pass-through channel, a more expensive GEL and cheaper FX in relative terms leads to lower GEL credit and more FX credit.

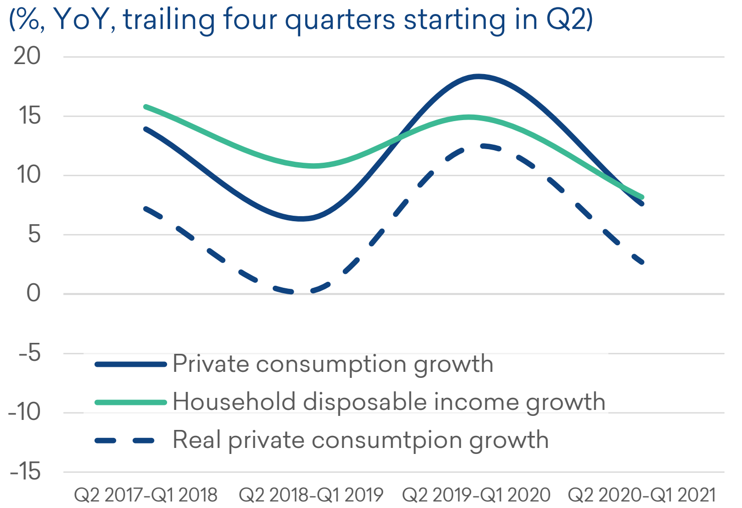
The restart and pent-up demand with record low USD deposit yields

UK: Contributors to consumption growth



Source: Oxford Economics, Haver Analytics

Household consumption and disposable income growth



Source: GeoStat, TBC Capital calculations

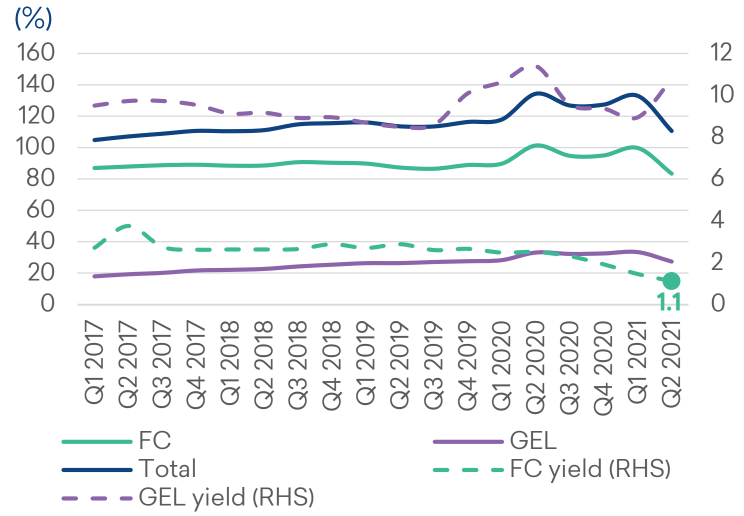
During the pandemic, in advanced economies household disposable incomes appeared to be resilient – coming on the back of government transfers and the fact that expenditure, rather than income, was most affected for higher income groups. Grace periods on loan repayments also led to higher disposable income levels. This led to excessive pandemic-related savings, which, when dissaved, supported the restart[6].

In Georgia, somewhat similar trend is observable, though with important differences. In particular, overall household disposable income demonstrated resilience. In the Georgian context, together with the government transfers, remittances played an important role, as did the grace period offered on loan repayments; however, the household savings rate only went up slightly, resulting in relatively resilient household consumption as well[7]. The main differences seen between Georgia and advanced economies, in terms of relatively lower savings and stronger consumption, can be attributed to the higher share of high net worth individuals in the latter economies and the higher share of essentials in consumption expenditures in Georgia.

Nevertheless, when looking at household deposits in banks, which predominantly reflect the savings of a relatively affluent segment of the population, pandemic-related excessive savings and subsequent dissaving volumes appear to be strong.

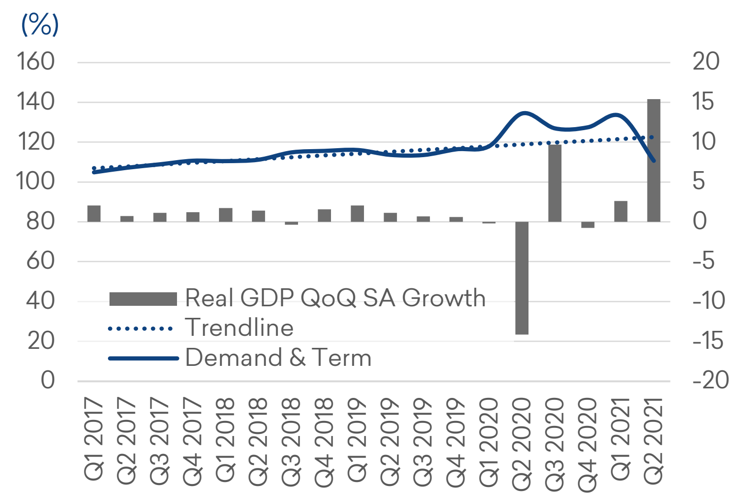
6. See ECB - The Implications of Savings Accumulated During the Pandemic for the Global Economic Outlook; Goldman Sachs - Pent-Up Savings and Post-Pandemic Spending.
7. There are no official estimates on the household savings rate in Georgia. The conclusion is derived from the fact that the estimated household disposable income growth was somewhat higher than the growth of household consumption.

Household saving deposits to quarterly GDP with respective yields



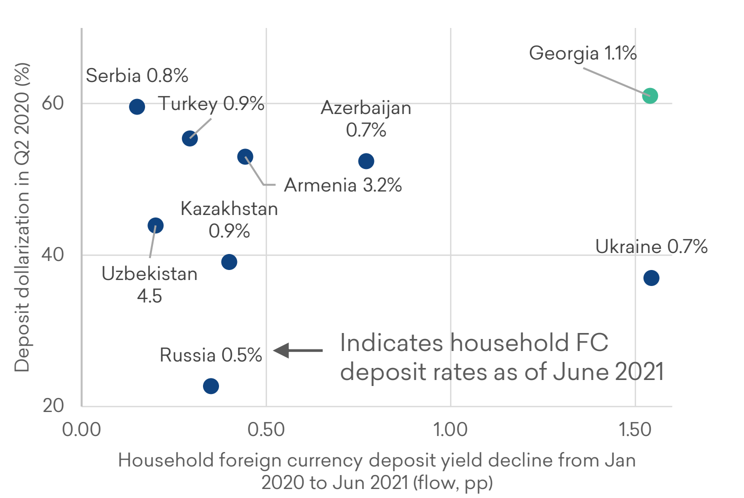
Source: NBG, TBC Capital calculations

Household saving deposits to quarterly GDP and QoQ GDP growth



Source: NBG, GeoStat, TBC Capital estimates

Yield change on foreign currency deposits and dollarization



Source: Respective Central Banks

In particular, the demand and term deposit to quarterly GDP ratio[8] went up significantly during the pandemic and reversed to well below its trend level in the second quarter of 2021, notably being driven by both the stronger GDP and much slower household savings growth[9], with only around 1/5 contribution of similar deposits of non-residents.

In total, in the second quarter of 2021, the ratio of household demand and term deposits to quarterly GDP decreased by 11.9 percentage points compared with the pre-pandemic trend, whereas the contraction equaled 22.3 pp when compared to the first quarter. This leads to the conclusion that the recent marginal propensity to save has decreased, which was likely led by the record-low rates on foreign currency deposits. As of June 2021 77% of household term deposits are in FX. It is thus arguable that savings are impacted more by the FX deposit yield than by the GEL deposit yield, with the latter still, only so far in our view, being less preferable in spite of the record high interest rate differential and the recent strengthening of the GEL.

Banking sector liquidity in FX remains high, international financial conditions for the banks are favorable and FX deposit rates fell even lower in July - we thus expect dissaving to continue at least throughout 2021, further boosting the restart.

It is important to note that lower FX deposit yields are evidenced in similar economies. However, the impact in Georgia is likely the strongest given that the rate decline to close-to-zero was one of the most pronounced and that the country has the highest deposit dollarization rate.

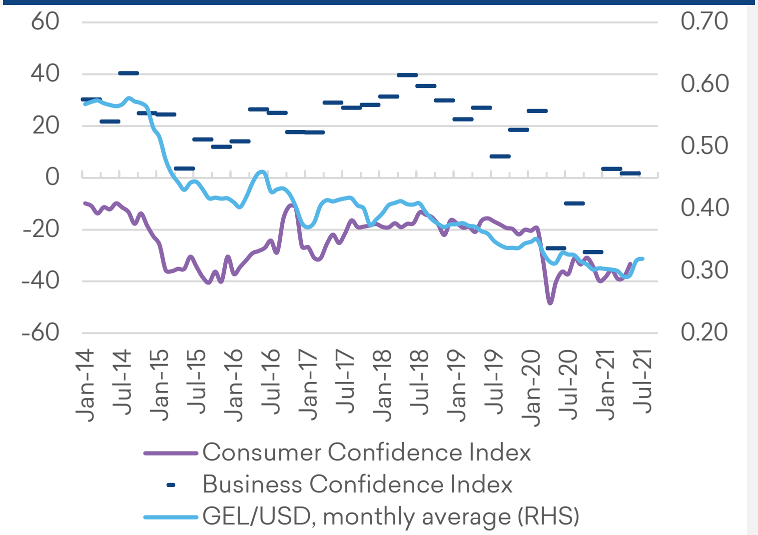
8. The deposit-to-GDP ratio is important as higher GDP growth also leads to higher deposit growth.
9. The increase in household saving deposits in the pandemic period was not due to the pandemic-related higher digitalization of the economy. In fact, initially deposits even decreased somewhat as some households preferred to hold additional cash to face the uncertain environment. Furthermore, even if the higher digitalization throughout the pandemic made some contribution, there is no reason to believe that the trend has reversed in Q2 2021.

The restart and the stronger GEL

The rebound in inflows and FX credit, coupled with high GEL interest rates and low FX rates, led to the recent significant appreciation of the GEL, against both the USD and EUR, as well as in real effective terms. In our view, this trend has further fueled the restart. A stronger GEL is one of the indicators of improved consumer and business confidence and stronger growth. Based on a VAR model[10; 11], 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.

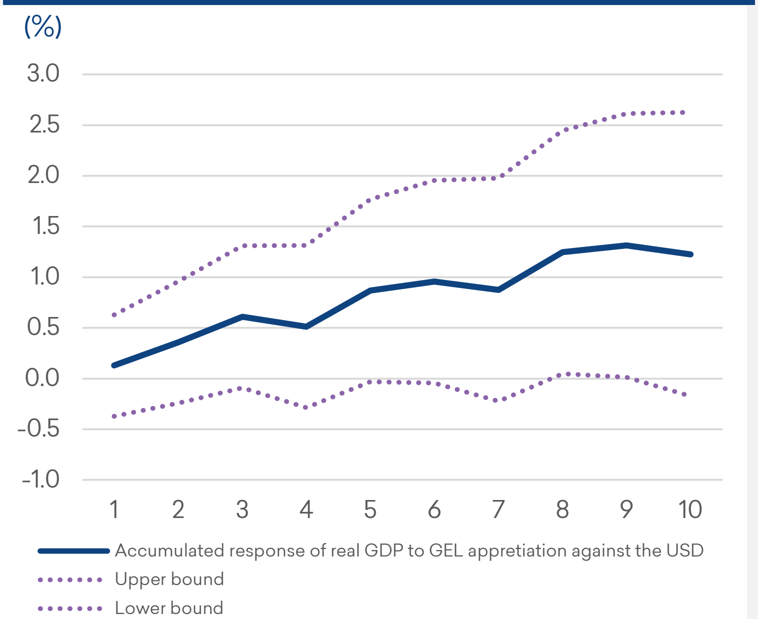
Appreciation of the GEL towards the USD causes real GDP to increase (from the financial/income effect), while appreciation of the REER initially leads to an counterintuitive increase of real GDP with a negative impact (from the trade/substitution effect) only observed after five periods. However, the 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.

GEL/USD and business and consumer confidence indices



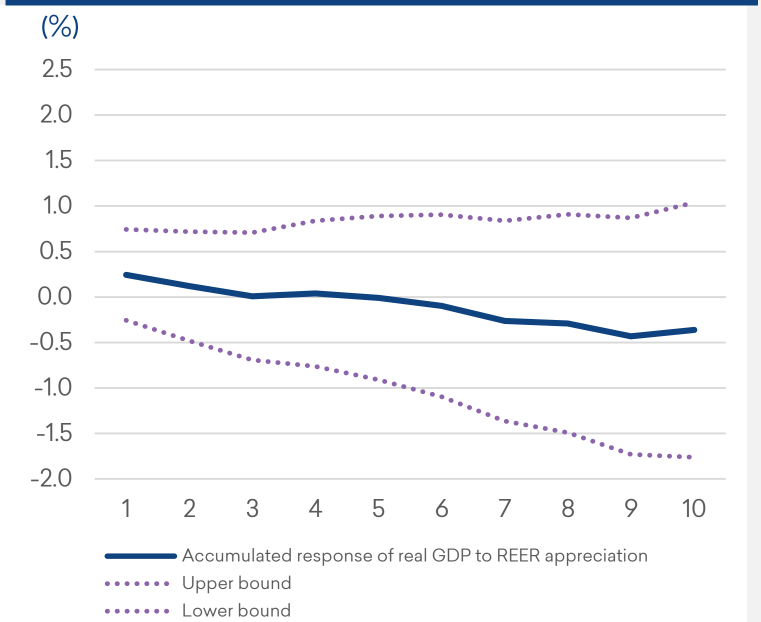
Source: ISET-PI, NBG

The USD/GEL and real GDP growth



Source: TBC Capital, BIS, NBG, GeoStat, FRED

The GEL REER and real GDP growth



Source: TBC Capital, BIS, NBG, GeoStat, FRED

10. Special thanks to Luka Lazviashvili for his valuable contribution.
11. 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.

Implications for the outlook

Exact estimates regarding the aforementioned drivers of growth and their duration are difficult to calculate, though it appears that their contribution to the 2021 restart of the economy has been sizable. As for the duration, we expect the reversal of so-called shock amplifier to be fully materialized in 2021, while it seems that the record-low FX deposit rates will continue to be in place for at least the next year, as will the impact of the USD/GEL exchange rate and the increasing role of the EUR/GEL rate.

Since our previous growth outlook for 2021 and 2022 (of around 10.5% and 6.5% respectively), the pandemic has intensified, especially in Georgia. To date, there have been more than 466,000 confirmed COVID cases in the country (representing 12.5% of the total population), with cases spiking rapidly and resulting in more than 100 new daily cases per 100,000 inhabitants. As of now, 12.8% of the total population has received at least one dose of a vaccine, while 5.6% of the population are fully vaccinated – meaning that, in combination with a 2.5x estimate of the true number of recovered people, around 40% of the population have some level of immunity. At the same time, the proven efficiency of vaccines and their high availability in Georgia with a recent per day vaccination rate of 0.54% of the population is a promising development.

It should also be noted that a temporary slowdown of growth in Q3 2021 was already envisaged in our previous outlook. The further reinforcement of measures by the Georgian Government on August 12, are still light to lead to a sizable quarterly drop in the third quarter.

Therefore, we leave our outlook for 2021 broadly unchanged at 10.5% likely with more upsides than downsides, keeping in mind that GeoStat's initial estimates of GDP growth have recently been subject to a downward revision. In case the initial estimate of Q2 2021 year-on-year growth is revised downwards by 4 PP (from 29.8% to 25.8%), the Q2 quarter-on-quarter seasonally-adjusted (Q-o-Q SA) growth would stand at 14.0%. Thereafter, even after a sizable 6.5% Q-o-Q SA drop in Q3 2021 and recovery of 3.2% Q-o-Q SA in Q4 2021, the annual growth for the full year 2021 would stand at around 10.5%. As for the 6.5% growth outlook for 2022, the more or less temporary nature of the factors contributing to this year's exceptional growth suggest a slower growth rate in 2022; however, the continuation of record-low FX deposit yields and the expected full recovery from the pandemic in 2022 should also be taken into account.

As for the GEL, the aforementioned additional drivers of the restart, especially, the reversal of shock amplifier and low USD yields are the GEL positive.

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