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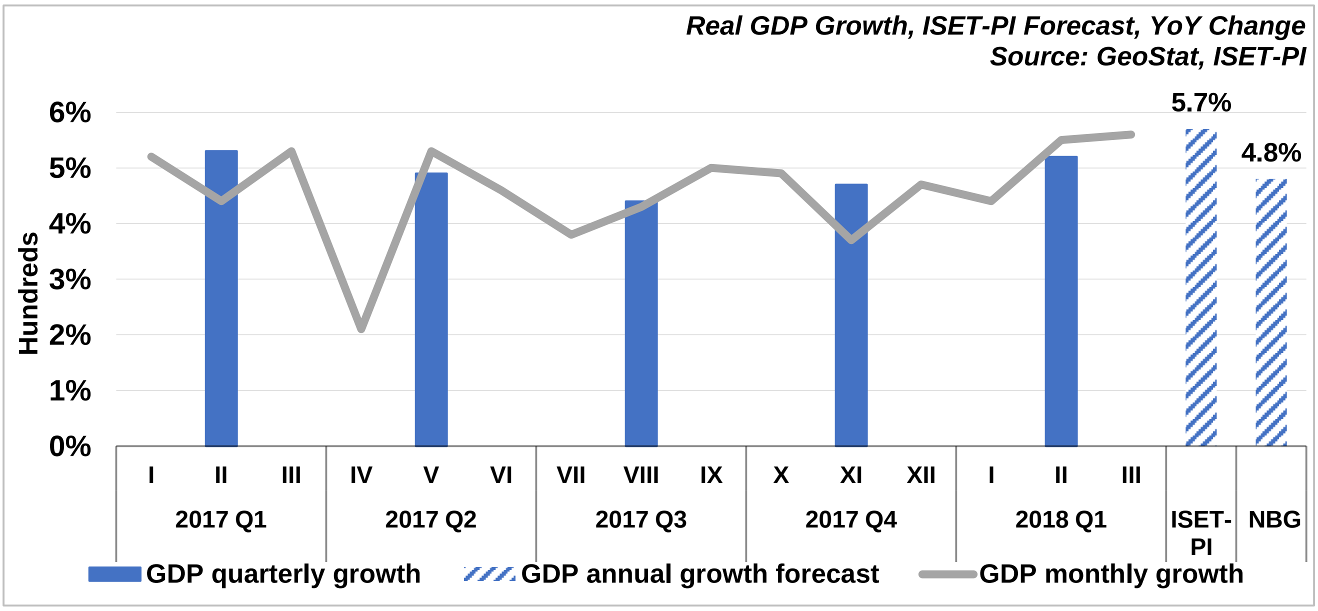
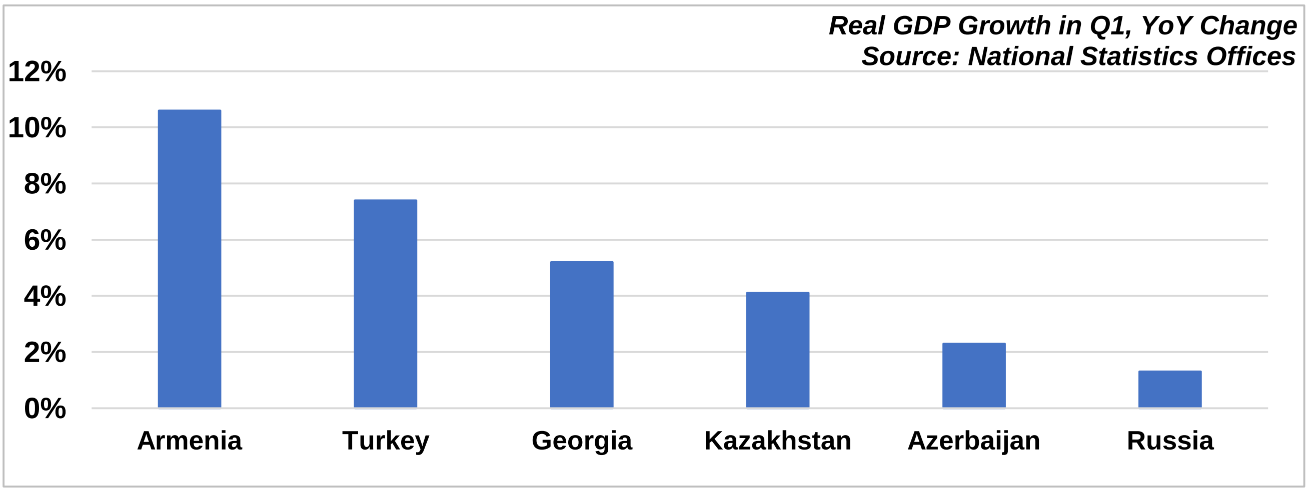
BUSINESS AS USUAL: GEORGIA'S ECONOMY CONTINUES TO EXPAND AT A MODERATELY HIGH RATE.

According to Geostat's rapid estimates of GDP growth, Georgia's economy continues expanding at a moderately high pace, reaching 5.2% in the first quarter of 2018. GDP growth was mainly driven by an enhanced external environment, improved business confidence, credit expansion and fiscal stimulus. Geostat's Q1 growth figure is higher than the National Bank of Georgia's (NBG) 4.8% projection for annual growth in 2018, but falls behind ISET PI's annual GDP growth forecast of 5.7%



The beginning of 2018 saw robust growth in the wider region, which benefits the Georgian economy. According to the official data, economic growth in the first three months of 2018 in Armenia was as high as 10.6% YoY, while Russian and Azerbaijani economies advanced on average by 1.3% and 2.3% YoY, respectively. Turkey reached 7.4% YoY growth in Q1. These developments in neighboring countries further stimulate the Georgian economy though trade, remittances and tourism channels.



External Sector: Trade, Tourism, Remittances

In the first quarter, the external merchandise trade of Georgia increased by 23.3% YoY, driven by both export and import growth. Total exports surged by 28.4% YoY, and amounted to 740.3 million USD. This growth was driven by higher re-exports of cars to Azerbaijan, re-exports of copper and petroleum to Turkey and the EU countries, and increased export of tobacco products (mainly to Azerbaijan). Exports of wine, mineral water and fertilizers also showed high growth in the reported period.

The main destination markets for Georgian export products in Q1 were Russia (13.3% of total), Turkey (12.6%) and Azerbaijan (10.3%). The top ten destination countries for Georgian exports accounted for 71.4% of total exports, underlining the problem of low export diversification.

Imports amounted to 2,083.4 million USD in Q1 2018, a 21.6% annual increase. This figure was mainly driven by the accelerated import of petroleum (+53.3% YoY) and the nearly quadrupled imports of automatic data processing machines (probably being used for crypto currency mining). The main source markets for Georgian imports in Q1 were Turkey (14.9% of total), Russia (10.2%) and Azerbaijan (9.3%). As a result of growing exports, the negative trade balance deepened by 18.1%, compared to the same period of the previous year.

Both tourism and remittance transfers maintained double-digit growth in the first quarter of 2018, and had a significant positive contribution to estimated GDP growth. The number of international visitors increased by 15.5% YoY, while the change in tourist numbers (visitors who spent 24 hours or more in Georgia) was even higher – a 28.2% increase YoY. International tourism receipts reached 561 million USD in Q1, a 29.1% annual increase. According to the NBG, the volume of total remittances to Georgia amounted to 355 million USD in Q1 2018 – a 22.4% annual increase. All primary source countries for money inflows to Georgia showed a positive growth trend, especially Israel (+62% YoY) and Italy (+41.5% YoY).

Credit Growth

Credit activity showed a significant improvement in the first quarter of 2018. Domestic credit to the private sector grew by 19.9% YoY (25.5% after excluding the exchange rate effect). The growth of the loan portfolio was primarily driven by a significant increase in national currency loans (+41.7% YoY), which accounted for 19.2 percentage points (pp) of growth in total domestic credit to the private sector. The stock of loans granted in foreign currency saw relatively moderate growth at 1.4%. The fact that domestic currency loans increased significantly faster than foreign currency loans can be explained by the introduction of new regulations which prohibit issuing loans up to 100,000 GEL in foreign currencies. Not surprisingly, dollarization rates of loans fell by 5 pp YoY to 55%. However, it is worth mentioning, that total non-bank deposits also became less dollarized and reached 62.9%. The latter could be explained by the stabilization of lari nominal interest rate against the dollar, which boosted public trust in the national currency.

Rapidly growing credit to the private sector positively contributes to short-term growth by stimulating private consumption. The worry is that in Georgia's case domestic credit growth significantly exceeds the rate of GDP growth, and borrowed money is quite often spent on purchasing imported goods and services. This might have negative consequences in the long-run by further increasing household indebtedness. To help prevent potential lending disruptions, NBG introduced additional buffers for systemically important banks. Moreover, a capital buffer was introduced to limit excessive credit growth, which leads to the build-up of systemic risks. Starting on May 7th, NBG introduced a new regulation according to which commercial banks cannot grant retail loans without full analysis of customer solvency. In particular, the total amount of such loans shall not exceed 25% of the bank's supervisory capital.

The banking sector remained sound in Q1 2018. Profitability of commercial banks stayed high, with a return on equity (ROE) and return on assets (ROA) at 22.6% (5 pp lower YoY) and 3% (0.8 pp lower YoY), respectively. In addition, the non-performing loans (NPL) indicator was reduced by 1.3 pp YoY, to 2.4 % of the total loan portfolio.

Government Budget

Despite a significantly increased net acquisition of non-financial assets, the consolidated government budget was in surplus in Q1 2018. Tax collection increased by 3.1% YoY, reflecting positive economic development. VAT mobilization (+10.8% YoY) was the main driver of growth, while revenues from excise and profit taxes declined by 9.1% and 7.8% YoY, respectively. Excise tax collection dropped due to low revenues from tobacco products (by 50 million GEL YoY), which could be explained by lower tobacco consumption, substitution of filtered cigarettes by non-filtered ones (which carry lower excise tax rates), and/or possibly an increased volume of contraband. Considering the strong performance of the economy, lower profit tax revenues could suggest that the Corporate Income Tax (CIT) reform gave businesses the incentive to reinvest their profits. As for the expenditure side, current spending was flat in the reporting quarter. A decrease in compensation to employers and other payment categories was balanced by higher spending on purchases of goods/services and interest payments. In addition, the Georgian Government started to accelerate capital spending from the beginning of this year – net acquisition of non-financial assets more than doubled in Q1 2018.

Inflation and Monetary Policy

The inflation rate continued to fluctuate around the targeted level as the exchange rate stabilized. In nominal terms, the lari appreciated for five consecutive months against the US dollar. However, nominal and real effective exchange rates depreciated slightly by 0.6% and 1.8% YoY, respectively. Overall, annual inflation in Q1 2018 was 3.3% - in line with the 3% NBG target. The annual inflation rate was mainly influenced by price changes in food and non-alcoholic beverages (+4% YoY), alcoholic beverages and tobacco (+8.3%), and transport (+3.7%).

The Monetary Policy Committee of NBG met three times this year. Each time, the NBG decided to maintain a moderately tight monetary policy rate of 7.25%. This decision was explained by the fact that “the nominal effective exchange rate still pushes inflation upwards”. On other hand, despite higher-than-expected economic growth, the aggregate demand is still remains below its potential level, pulling inflation downwards. Yet, at this moment, the external sector factors are dominant.