Research Report on Georgia

2 April 2021

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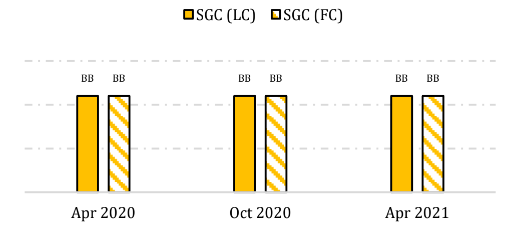
Ratings

Sovereign Government Credit (LC)	BB
Sovereign Government Credit (FC)	BB
Outlook (LC)	Negative
Outlook (FC)	Negative

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Georgia

Macro indicators	2018	2019	2020
Gross gov. debt, GEL bn	18	21	31
Nominal GDP, GEL bn	45	49	49
Real GDP growth, %	4,8	5,0	-6,2
Gross gov. debt/GDP, %	40,0	43,3	62,5
Deficit (surplus)/GDP, %	-0,8	-1,8	-8,8
Inflation rate, %	1,5	7,0	2,4
Current Account Balance/GDP, %	-	-	-9,8
External debt, USD bn	-	-	19,6*

Development indicators	2020
Inequality adj. HDI	0,72
GDP per capita, USD th	15,1

Default indicator	02.04.2020
10Y Gov Bond Yield, %	8,5**

Source: RAEX-Europe calculations based on data from the IMF, WB, NBG, UN.
* 3Q 2020 ** GEL-denominated bond

RAEX-Europe confirmed at 'BB' the ratings of Georgia. The rating outlook changed from stable to negative.

RAEX-Europe confirmed the sovereign government credit ratings (SGC) of Georgia at 'BB' (Sufficient level of creditworthiness of the government) in national currency and at 'BB' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook changed from stable to negative which means that in the mid-term perspective there is a high probability of downgrading the rating score.

Summary

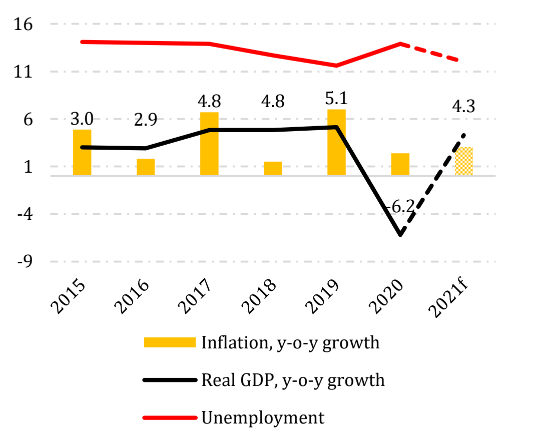
The change in the outlook from stable to negative is mainly a reflection of our view that the hit of the pandemic will last longer than anticipated and will shift the fiscal stance of the government in the mid-term horizon. However, we decided to maintain the ratings at 'BB', as our best-case scenario shows an economic recovery faster than expected in case the pandemic eases substantially in 2Q 2021 and onwards.

In general, we have seen a strong deterioration of the external stance showing the outstanding dependence of the country on external events and international markets. In addition, the monetary policy has been adequate, adapting to the current economic situation and stabilizing the level of inflation, while the banking sector metrics remain quite satisfactory under the current circumstances.

Georgian economy sunk in 2020. The economy shrunk by 6,2% in 2020 due to an overall meager performance, but mainly as a result of a decline in tourism, a key sector for the Georgian economy, due to the COVID-19 pandemic. Moreover, the strong lockdown measures imposed towards the end of 2020 caused lower private consumption, as key parts of the economy were shut down. Moreover, the global effect of the pandemic has reduced the level of exports from Georgia. Nonetheless, we anticipate the real economy to recover slightly in 2021 and to grow at around 4%; however, this will all depend on the development of the pandemic and the effectiveness of the vaccination program (see graph 1).

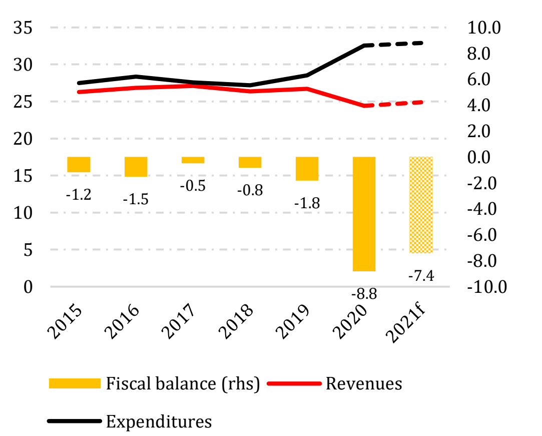
The unemployment rate increased up to 13,9% by 2020, also resulting from the coronavirus crisis. Most of the job losses are concentrated in the hard-hit tourism sector. This was further exacerbated due to the measures imposed towards the end of 2020 when cases spiked. However, we

Graph 1: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the IMF, Geostat and NBG

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 3: Government debt dynamics, %

anticipate this figure to decline in 2021 as restrictions are being lifted and the vaccination campaign has recently started.

Fiscal policy to remain supportive to mitigate pandemic effects. The fiscal deficit widened substantially to around 8,8% of GDP in 2020 (see graph 2). This was chiefly caused by the strong anti-crisis spending by the government in healthcare, as well as support for businesses and households. Moreover, the augmented deficit, which includes budgetary lending, is expected to have stood at around 9% in 2020.

We anticipate the metric to remain negative in 2021 as a result of further spending to cushion the effect of the pandemic, as expenditures are estimated to be around 2% of GDP. Moreover, as a natural effect of lockdown measures and weak external demand and tourism, fiscal revenues are expected to remain depressed. Thus, we expect the deficit to remain wide at around 7,4% of GDP in 2021, while the augmented deficit to be at 7,5% of GDP.

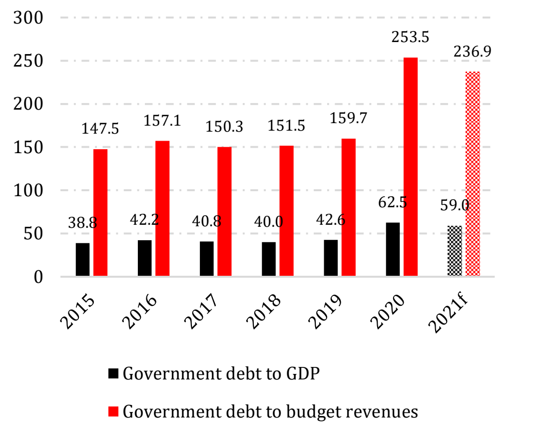
Monetary policy tightened. The National Bank of Georgia (NBG) continues to manage the monetary policy in an adequate manner targeting inflation stability. As a consequence of inflationary pressures resulting from the depreciation of the exchange rate, higher production costs, and higher commodity prices (mainly oil and food), the NBG decided to hike the reference rate by 50 b.p. up to 8,50% back in 17 March 2021.

Contrary to our initial belief, the NBG could not hold the rate low any longer to support the economy. This is a reflection of the outstanding dependency of Georgia on external factors and the difficulty the regulator is facing in managing monetary policy in a highly dollarized economy.

The y-o-y inflation rate stood at 2,4% in 2020 but has since increased up to 3,6% as of February 2021. We anticipate the rate to be at around 3% by year-end 2021. Moreover, in order to curve the rapid depreciation of the GEL caused by low tourism, reduced inflows of funds from abroad, and instability in its main trading partners, the NBG has sold around USD 1,2 bn of FX in 2020 and 2021.

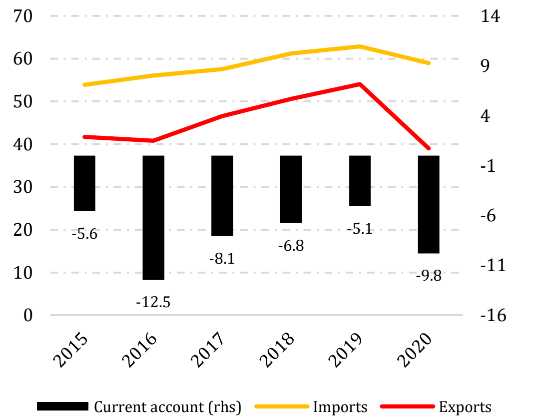
Finally, the NBG has implemented measures, such as FX swap lines with banks and MFIs to support liquidity. Also, the regulator has established tools to support financing for SMEs in order to smoothen the impact of the pandemic.

Government debt increased as a result of fiscal stimulus and currency depreciation. Gross government debt hiked substantially in 2020 posting figures of 62,5% of GDP and 253,5% of budget revenues, as we anticipated in our latest review (see graph 3). This is a consequence of the measures



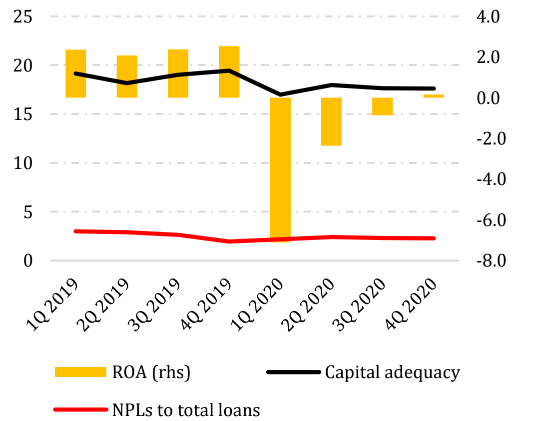
Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of Georgia

Graph 4: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and NBG

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the NBG and WB

Graph 6: Financial dollarization, % of total

established by the authorities to curve the negative effect of the pandemic on the Georgian economy, the depreciation of the local currency (80% of debt is denominated in foreign currency), and the depressed nominal GDP.

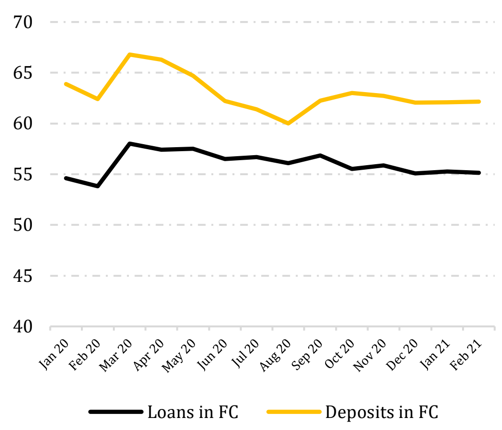
The debt structure of the government remains practically unchanged. Short-term debt was about 3% of GDP in 2020. However, as previously mentioned, the share of debt denominated in the foreign currency remains high at 80% of overall debt. Despite this being mitigated by the fact that 71% of the overall public debt is owed to bilateral and multilateral creditors at favorable terms, it still carries risk in case the currency depreciation was to continue. The government has also an upcoming maturity of its Eurobond in 2021 for an amount of USD 500 m, which we anticipate will be met as the amount of government deposits is vast.

Contingent liabilities stemming from inefficient and unprofitable SOEs, as well as power purchasing agreements (PPAs) attributed to hydropower companies with attached government guarantees and public-private partnerships (PPPs) remain elevated and the risk of materialization is moderately high.

External stance remains weak and vulnerable. As previously mentioned, Georgia's economy is highly dependent on external factors and this has been confirmed in 2020 as the whole economy took a massive hit resulting from GEL-depreciation, a decline in exports, high commodity prices, and elevated dollarization. In 2020, both the trade of goods and services, as well as the current account deficits deteriorated substantially to 19,9% and 9,8% respectively. These indicators confirm what we have previously observed, the country's increased dependence on imports, remittances and foreign investment. In addition, the external debt of the economy hiked up to around 130% of GDP in 2020 and the banking sector remains highly dollarized.

Even though we expect better performance going forward, we do not expect external metrics to recover in the mid-term perspective. Given the lingering effect of the pandemic on the travel industry, we anticipate the tourism sector to remain depressed, remittances will remain subdued and exports will continue to stay low (see graph 4).

Banking sector remains resilient. We have observed mixed banking metrics in 2020, however, they have remained at overall adequate levels taking into account the current situation. By the end of 2020, the NPLs to total loans ratio stood at 2,3%, regulatory capital to risk-weighted assets decreased to 17,6%, while ROA and ROE stood at 0,2% and 1,4% (see graph 5). As mentioned in our previous review, the NBG has implemented measures to support capital and liquidity.



Source: RAEX-Europe calculations based on data from the NBG

On the positive side, we have seen domestic credit and bank assets increasing in a steady manner. In 2020, we anticipate domestic credit to have stood at around 82% of GDP and banks' assets at 115% of GDP.

The banking sector's concentration remains elevated as the top three banks (TBC Bank, Bank of Georgia, and Procredit Bank) account for about 77% of the total banking system's assets, which carries negative effects for the competition level in the country. Finally, the Georgian banking system remains highly dollarized; loans and deposits in FX were equivalent to 55,1% and 62,2% of the total portfolio as of February 2021 (see graph 6).

Stress factors:

- Financial dollarization remains high in Georgia; loans and deposits in FX were equivalent to 55,1% and 62,2% of total portfolio as of February 2021 (moderately weak stress-factor);
- Political risk stemming from the unresolved conflict of South Ossetia and Abkhazia with Russia (moderately weak stress-factor).

The following developments could lead to an upgrade:

- Decrease of external exposure by reducing FX-denominated debt, advancing de-dollarization measures, increasing national savings, buffering-up international reserves and further developing productive sectors of the economy in order to reduce reliance on imports;
- A substantial reduction in the amount of contingent liabilities which would reduce the overall government debt level.

The following developments could lead to a downgrade:

- Strong negative impact from the coronavirus crisis, which would negatively affect the exchange rate causing asset deterioration in the financial system and reduction in international reserves as well as economic volatility;
- Deterioration of the fiscal position by widening the fiscal deficit and increasing government debt including contingent liabilities' materialization as a result of additional spending needs due to the coronavirus crisis

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None.

Next scheduled rating publication: 1 October 2021. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2021

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
02.10.2020	Scheduled review of both types of ratings for the country	BB	BB	Stable	Stable
03.04.2020	Scheduledreview of both types of ratings for the country	BB	BB	Stable	Stable
04.10.2019	Scheduled review of both types of ratings for the country	BB	BB	Stable	Stable
05.04.2019	First assignment of both types of ratings for the country	BB	BB	Stable	Stable

Minute's summary

The rating committee for Georgia was held on 31 March 2021. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from April 2019). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, World Federation of Exchanges, World Economic Forum, Doing Business, United Nations, National Bank of Georgia, National Statistics Office Georgia, Ministry of Finance of Georgia, Georgian Stock Exchange, Cbonds.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

The SGC ratings have been endorsed in accordance with the CRA Regulation. The SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

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Risk warning

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

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