National Bank
of Georgia

INFLATION REPORT

May

2013

2009 2010 2011 2012 **2013**

MONETARY POLICY IN GEORGIA

- The aim of the monetary policy is to maintain low and stable inflation and thus promote macroeconomic stability, which in turn is a precondition for robust and sustainable economic growth, low interest rates and decreasing unemployment.

- The CPI inflation target is set at 6% for the years 2013-2014 and 5% from the year 2015. The inflation target of the National Bank of Georgia is planned to decrease gradually to 3% in the long term, parallel to the development of the economy.

- Since monetary policy decisions impact the economy with a certain time lag (4-6 quarters), the formulation of the monetary policy is done according to inflation forecasts in order to hit the target in the medium term. The medium term horizon depends on shocks and exogenous factors that influence the rate of inflation and the aggregate demand.

- The primary tool of the monetary policy is the refinancing rate. The change of the policy rate is transmitted to the economy through market rates, exchange rate and credit activity, thus influencing the aggregate demand. The difference between the actual and the natural level of demand is the main determinant of inflation in the medium term.

- Monetary policy decisions are communicated to the general public via press releases. The vision of the bank with regard to ongoing and expected macroeconomic activity is published in the Inflation Report in the second month of every quarter.

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1. Executive Summary

During the last quarter of 2012, real GDP grew by an annual 2.8%, while overall economic growth in 2012 amounted to 6.1%, despite the slowdown observed in the fourth quarter. According to Geostat's preliminary evaluation of economic activity during the first quarter of 2013, economic growth for the period stands at 2.4%. According to this preliminary estimate, the agricultural sector has made a significant positive contribution to growth, while a reduction in investments and consumption largely caused the slowdown during the last two quarters. The slowdown of growth is distributed more or less evenly among all major sectors, with the construction and service sectors having a relatively larger share.

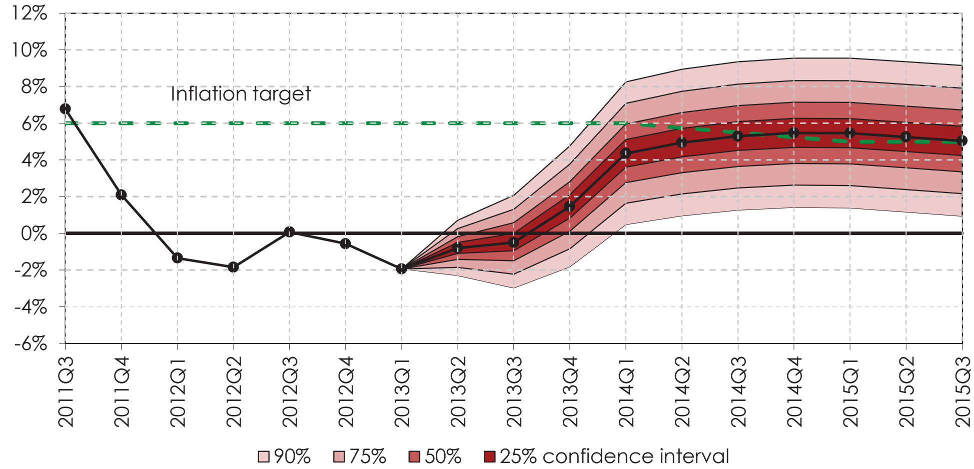
Credit activity in the banking sector has reduced along with the slowdown of economic growth. As of March 2013, the loan portfolio grew by an annual 12%, which is lower than last year's trend indicator. Reduction in credit growth has been uneven in terms of individuals and legal entities, with retail credit growing faster than lending to legal entities, which is explained by a stable demand for retail products on the one hand and the risk aversion of banks on the other.

The loosening of the monetary policy has had a positive impact on the reduction of commercial banks' retail product interest rates. The cost of funds has decreased due to the decline of interest rates on retail deposits and cheaper resources attracted from abroad. However, the transmission of decreased funding costs to private sector credit has been limited, which can be explained by a weakened demand from the business sector and the banks' tempered risk appetite in light of existing risk premiums.

The first quarter of 2013 was characterized by deflation. The average annual growth of the CPI amounted to -1.9% during the first quarter of 2013, while in April it was equal to -1.7%, which is significantly lower than the 6% target figure of the NBG. The deviation of the current inflation rate from its target is mainly due to factors independent of monetary policy. Food prices have decreased compared to the previous year, contributing -1.3 percentage points to the current inflation rate, while the deflation of imported prices accounts for -1 percentage point. The recent decrease in utility prices is another important factor contributing to deflation (-0.4 pps). Shrinking profit markups in retail sales have also contributed towards the general level of prices. The insufficient pressure on consumer prices from the demand side during the first quarter of 2013 should also be noted as having contributed to the undershooting of the inflation target.

According to the NBG's forecasts, the inflation rate is expected to pick up, but it will remain below the 6% target during 2013. Growth in economic activity after the second/third quarter of 2013 is expected to create positive inflationary pressure on consumer prices. The effect of reduced food, energy and utility prices on annual inflation will be maintained until late 2013/early 2014. According to the current forecast, the inflation rate is expected to reach the target level at the end of 2014.

Chart 1.1 Annual Inflation

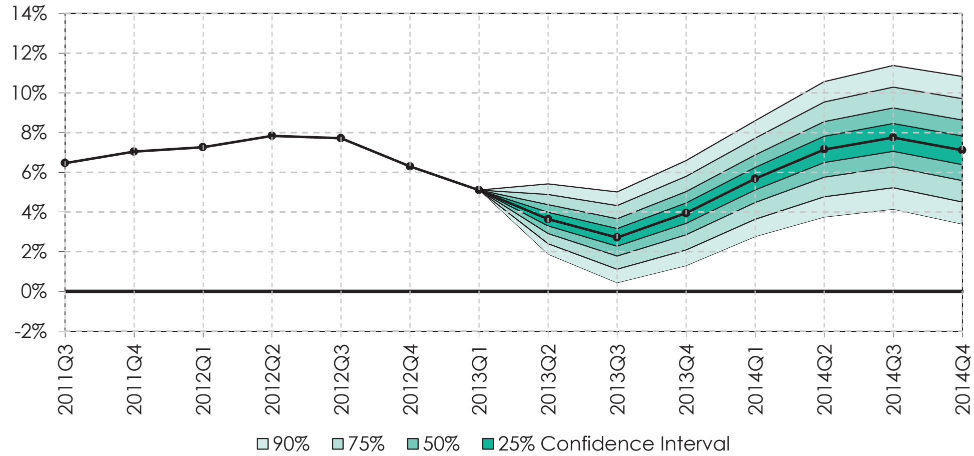


Source: National Bank of Georgia

According to the forecast of the NBG, economic growth will be about 4.0% this year. The main drivers of economic growth will be agriculture and manufacturing industries, with the trade and tourism sectors also expected to make a positive contribution. Similar to the forecast made in February, the current forecast of economic growth figures for 2013–2014 varies considerably and is largely dependent on the growth of business sector confidence and the efficiency of the investment projects that have been announced by the government.

Given the ongoing fiscal consolidation and the slowdown of credit activity, lackluster business activity implies negative risks in terms of economic growth. On the other hand, investment activity planned by the government or a higher than expected growth of net exports will have a positive impact on the forecasted economic growth rate. The macroeconomic trends of trade partners and the international economic environment in general are also important in this regard because the impact of international economic activity is transmitted to the Georgian economy through several channels: the demand for exports, volume of remittances and inflow of foreign investments. The forecasted indicator of economic growth is therefore largely dependent on each of these factors and the respective risks arising from them have to be considered.

Chart 1.2 Real GDP Annual Growth (annual growth during the last four quarters)



Source: National Bank of Georgia

A trend towards recovery in the global economy has been observed in the beginning of 2013, which, according to the International Monetary Fund, is partly due to consistent fiscal and monetary policies. The availability of funding for banks, improvement of business confidence and correction of financial imbalances have contributed to world economic growth. In developed countries economic growth has been relatively uneven. Despite the fact that risks, which were mostly due to the expected budget sequestration in the U.S. and the feared collapse of the eurozone, have receded, growth forecasts for developed countries remain unchanged. Georgia's main trading partners are primarily subject to the risk of a worsening of the economic crisis in the eurozone – according to IMF estimates, the aggregate output of developing economies in Europe will grow by 2.2% in 2013, with the Turkish economy being the main contributor. The economic growth trends of neighboring Ukraine and Russia, where the outlook is less optimistic, are also important. The main problem in the case of Ukraine is reduced domestic demand and high interest rates, while for Russia it is a slowdown in the growth of the oil price.

Taking the current forecasts and results of macroeconomic analysis into account, on 8 May 2013 the Monetary Policy Committee decided to decrease the monetary policy rate by 0.25 percentage points to 4.25%. Loosening the monetary policy reflects the view of the NBG concerning the forecasted inflation rate and other macroeconomic indicators.

2. Forecast of the Macroeconomic Environment

2.1 EXTERNAL SECTOR ASSUMPTIONS

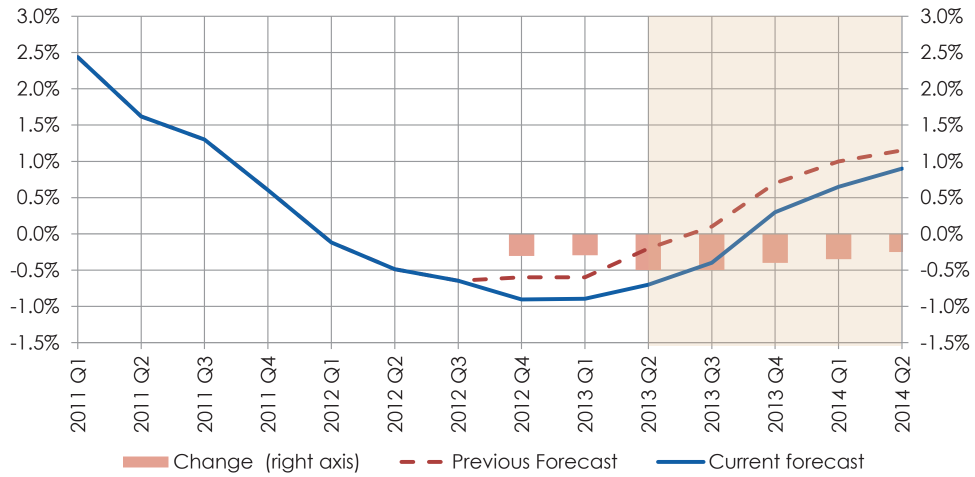
The beginning of 2013 was marked by weak economic activity in developed countries. However, the fiscal cliff in the U.S. and the collapse of the eurozone have been avoided. According to the IMF, consistent monetary and fiscal policies have yielded results – strengthening business confidence and mitigating financial imbalances, thereby putting the world economy on a path to recovery. The economic environment has been much more positive for developing and emerging economies, where a sharp increase in consumption has been observed against the background of moderate unemployment. The IMF estimates that the global economy will grow by 3.3% in 2013 and by 4% in 2014.[1]

‹‹ The global economic recovery is proceeding at an uneven pace: GDP growth in developed countries is still significantly lower than that of emerging and developing countries.

The reduction of yield spreads on government securities indicate that the risks of a sovereign crisis in eurozone periphery countries are gradually receding. However, Italy's political fluctuations and financial sector problems in Cyprus still pose significant dangers for the eurozone economy. Consensus growth forecasts for the eurozone have declined after it posted less than expected GDP growth in the 4th quarter of 2012 (see Chart 2.1). According to current estimates, this decline will continue during the first two quarters of 2013, but the recent tick up in business and consumer confidence indicators provide basis for optimism in terms of a gradual improvement of the situation.

‹‹ Despite the reduction of sovereign risks in periphery countries, eurozone growth forecasts remain pessimistic.

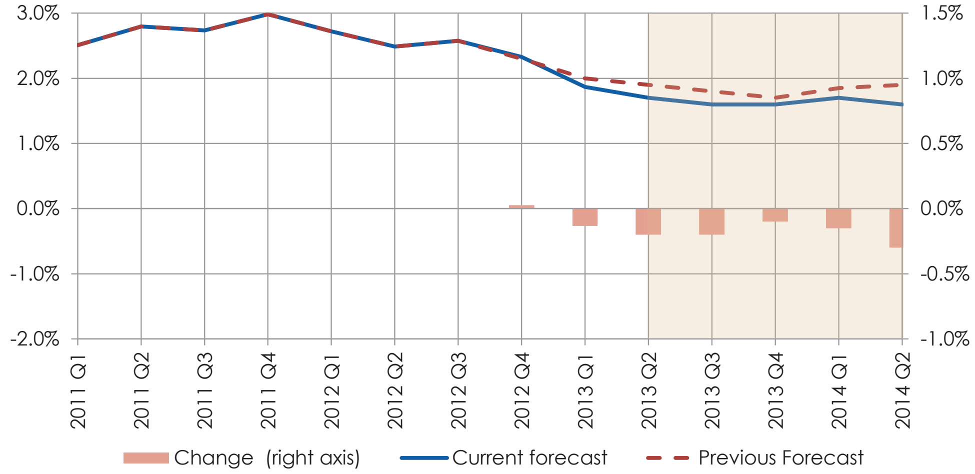
Chart 2.1 Euro Area Real GDP Growth, YoY



Source: Eurostat

1 Source: The IMF, World Economic Outlook (April 2013)

Chart 2.2 Euro Area CPI Inflation, YoY

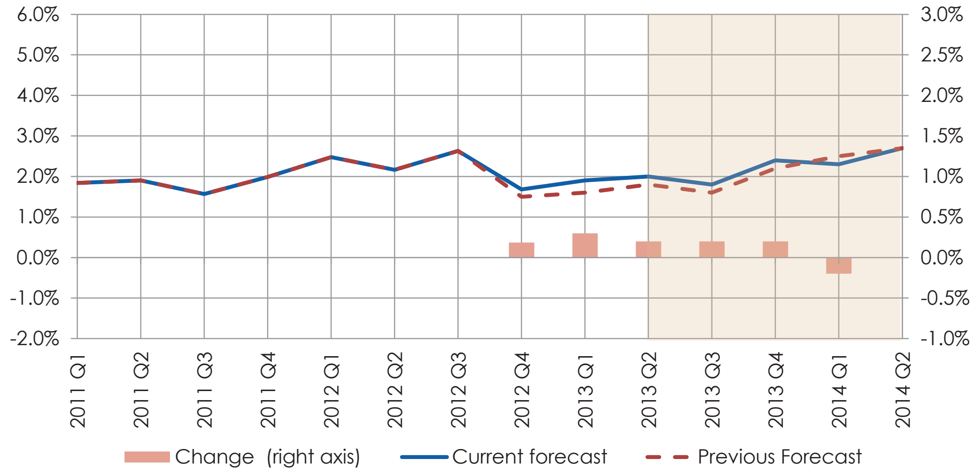


Source: OECD

An unprecedented loosening of monetary policy, the availability of financial resources and enhanced private sector confidence are the key factors that contributed to economic recovery in the U.S. at the end of 2012 and in the first quarter of 2013. The U.S. annual growth rate amounted to 1.7% in the fourth quarter of 2012 and 1.9% in the first quarter of 2013 (see Chart 2.3). Risks have been reduced after the fiscal cliff was avoided at the beginning of the current year, but the implemented budget cuts are still expected to somewhat hamper the growth of economic activity in the future. Despite the fiscal problems, the U.S. Bureau of Economic Analysis forecasts that real GDP growth will reach 2.4% in the fourth quarter of 2013, which is 0.7 percentage points higher than the comparable figure in 2012. The inflation rate is also expected to grow slightly to exceed 2% by the end of the year (see Chart 2.4).

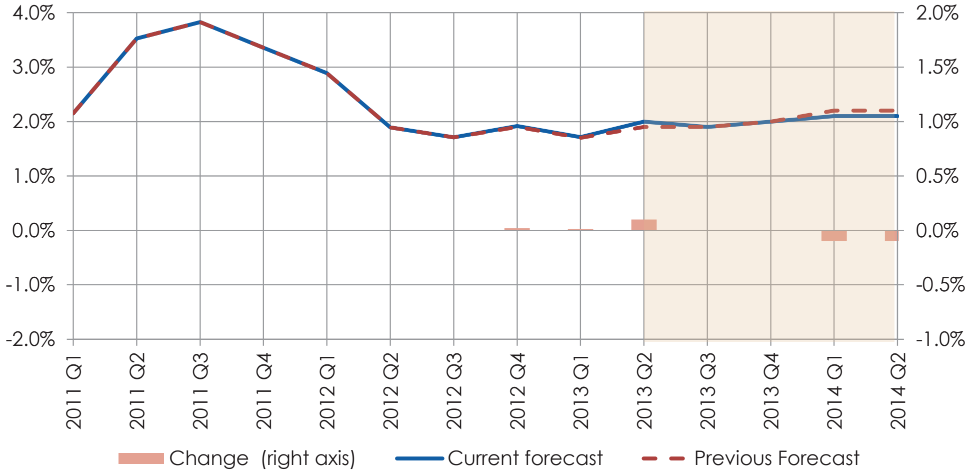
‹‹ An unprecedented loosening of monetary policy, the availability of financial resources and enhanced private sector confidence have supported economic recovery in the U.S.

Chart 2.3 US Real GDP Growth, YoY



Source: OECD

Chart 2.4 US CPI Inflation, YoY



Source: OECD

The deepening of the crisis in eurozone countries has had a negative impact on developing European economies, with a reduction in exports, a decline of capital inflows and shaken confidence weakening economic activity. However, according to IMF estimates, growth will reach 2.2% in 2013, while last year's indicator stood at 1.5%. The Turkish economy is an important contributor to the forecasted growth rate for 2013 and is expected to grow at a rate of 3.5%, mainly due to private consumption and investment. In addition to the trends of some of Europe's emerging economies, the growth trends of neighboring Ukraine and Russia, where the outlook is less optimistic, are also important for Georgia. The main problem in the case of Ukraine is reduced domestic demand, which is due to high interest rates; while for Russia the slowdown in the growth of the oil price is important. The annual inflation forecasts for 2013 for Turkey, Ukraine and Russia are 6.6%, 0.5% and 6.9% respectively.

‹‹ The deepening of the crisis in eurozone countries has had a negative impact on developing European economies, but their GDP growth in 2013 will exceed that of 2012.

Due to a lack of pressure from the demand side, the global inflation rate was hovering at around 3% during last year. Price volatility has been reduced for major trading goods largely due to the stabilization of the global financial situation and gradual recovery, but price increases have been observed for energy and food products. The upward trend stems mainly from supply factors: in the case of oil, it is the tense geopolitical situation in the Middle East, Asia and North Africa; and in the case of food – reduced inventories and increased cost of production factors (mainly fuel and fertilizers). However, according to the forecast, the prices of oil and all major food products (corn, wheat, sugar) will decrease during the year as significant growth of supply is expected in the global market.

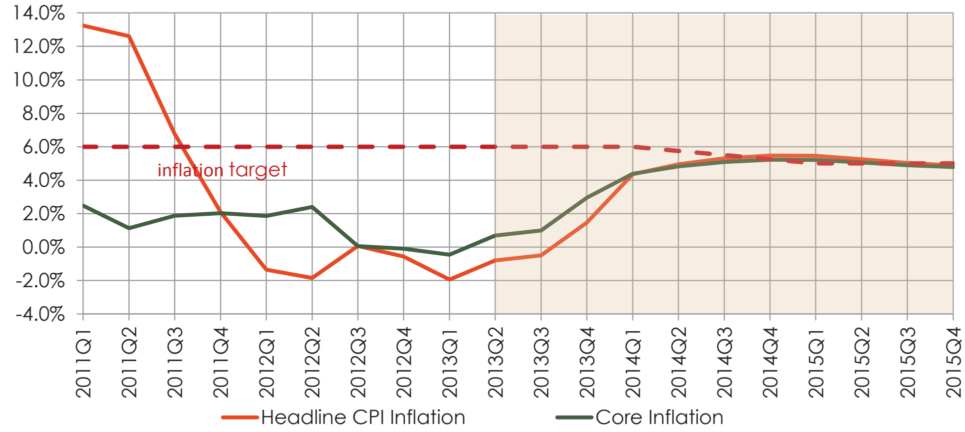
‹‹ Global inflation risks are moderate due to a lack of pressure from the demand side.

In order to promote weakened demand, the world's leading central banks continue to maintain unprecedentedly low monetary policy rates, which leads to greater access to credit facilities. The global forecast points to a definite continuation of loose monetary policy, since inflationary expectations are manageable and the prudential reform of financial institutions is successfully reducing existing imbalances. However, according to the recommendation of the IMF, regulatory institutions should continue to closely monitor the financial stability risks that may arise against the backdrop of expansionary policies.

2.2 BASELINE SCENARIO OF THE MACROECONOMIC FORECAST

Consumer prices continued to decline during the first quarter of 2013 and the annual inflation rate amounted to -1.9% (see Chart 2.5). The undershooting of the NBG's target of 6% was caused by both supply and demand factors. The supply side exerted significant deflationary pressure, with declining prices for food products and fuels. Another important factor that had a deflationary effect was the decrease of utility prices. The tendency to decrease markups continued, which also played an important role in reducing the CPI. There was not enough inflationary pressure from the demand side either, because of weak economic activity during the last two quarters. All this caused a significant decline in domestic prices (see Chart 2.6).

Chart 2.5 Headline and Core CPI Inflation



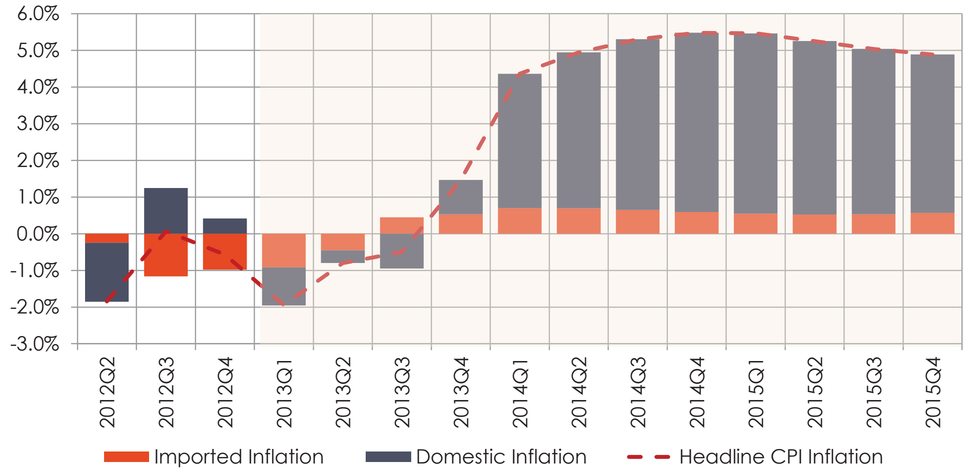
* Core inflation excludes food, energy and utilities ' prices from the basket.

Source: National Bank of Georgia

‹‹ Annual inflation is to remain relatively low during 2013 and is expected to reach the target indicator in the second half of 2014.

Alongside domestic factors, deflation was also caused by external factors. The appreciation of the nominal effective exchange rate and the slowdown in the growth of world prices resulted in a decline of imported inflation. The appreciation of the nominal effective exchange rate was mainly caused by the depreciation of the Turkish lira and the euro.

Chart 2.6 Headline CPI Inflation



Source: National Bank of Georgia

According to the current forecast, consumer prices will go up from the second quarter of 2013, but the inflation rate will continue to remain negative until the third quarter. Annual inflation will reach the target in the second half of 2014 (see Chart 2.5). The trend of declining food prices will be partially maintained in the second quarter. The deflationary effect from reduced markups and from the decline in utility prices in the fourth quarter of 2012 and in the first quarter of 2013 will be maintained until the end of the year. In addition, the absence of inflationary expectations represents a factor impeding rapid price growth. However, the expected pick-up in economic activity by the end of the year will promote a rise of domestic prices and support the convergence of inflation with the target rate (see Chart 2.6). It should be noted that the inflation target will be reduced to 5% in 2015.

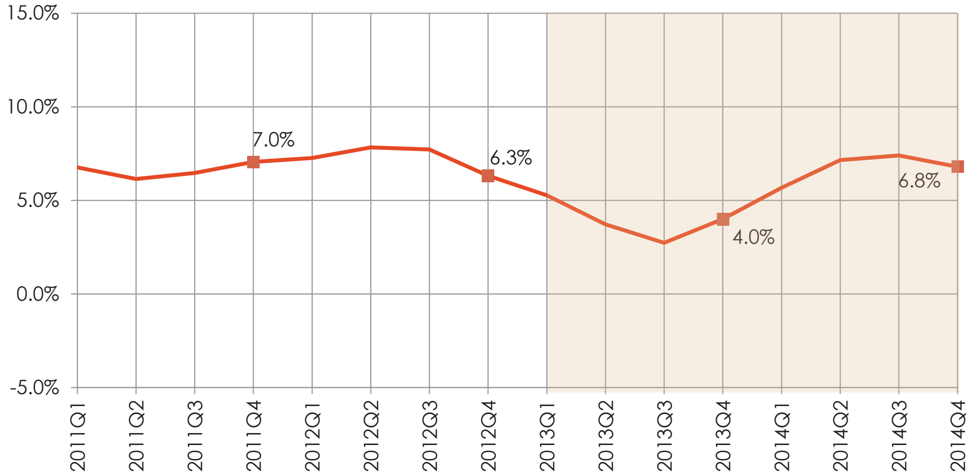
‹‹ Annual inflation rate is going to stay low in 2013 and will reach the target in the second half of 2014.

‹‹ Slowdown of activity in the financial sector was mainly caused by a decrease in demand for loans and partially by the banks choosing to take on less risk.

According to the leading indicators, economic activity remained subdued in the first quarter of 2013 (see Chart 2.7), and the preliminary estimate of annual real GDP growth is 2.4%. The low economic growth during the fourth quarter of 2012 and the first quarter of 2013 is due to various important factors. Consumer confidence remains reduced, which leads to a weakening of domestic demand (see Chart 2.8).

Activity in the financial sector has not improved significantly, which is still caused by low demand for credit and the reduced risk appetites of commercial banks. The weakening of large businesses' and subcontractors' activity is explained by the slowdown in the implementation of public infrastructure projects. However, it should be noted that the foreign trade balance has improved in the first quarter of 2013.

Chart 2.7 Real GDP Growth

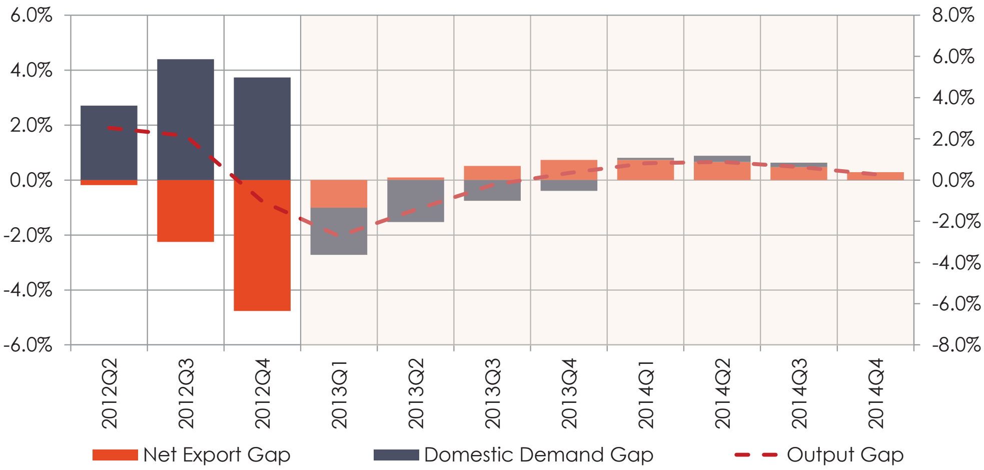


Source: National Bank of Georgia

« Forecast for real GDP growth in 2013 is still positive in spite of low economic growth in the fourth quarter of 2012.

Given the existing slowdown of economic activity, real GDP growth in 2013 is forecasted to amount to 4.0% (see Chart 2.7). The forecast implies that the expected increase in activity in the agriculture and manufacturing sectors will materialize and that the tourism sector will continue to grow. The effect of increased exports due to trade with Russia is also partially taken into account, as this will promote growth of net external demand (see Chart 2.8).

Chart 2.8 Output gap decomposition



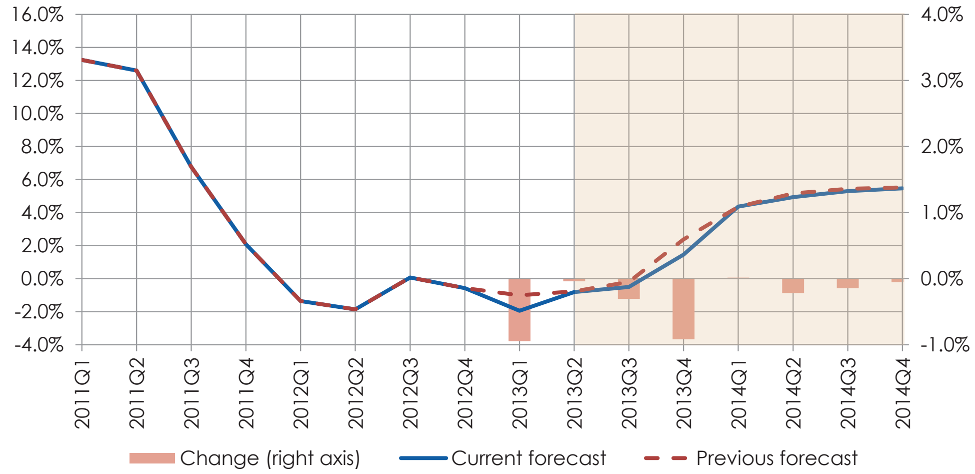
Source: National Bank of Georgia

The current forecast also accounts for a gradual improvement in business confidence amid a reduction of uncertainty. This will encourage investments and promote domestic demand. An expected increase in the implementation of public infrastructure projects is also supposed to have a positive impact on demand.

2.3 COMPARISON WITH PREVIOUS FORECASTS

The current forecast of annual headline inflation has changed slightly compared to the previous forecast (Chart 2.9). The main reason for the revision of the forecast is the persistence of declining demand at the beginning of 2013. According to the preliminary assessment, the subdued economic activity of the fourth quarter of 2012 has continued in the first quarter of 2013, causing intensified deflationary pressure from the demand side and a respective downward revision of the inflation forecast.

Chart 2.9 Headline CPI Inflation

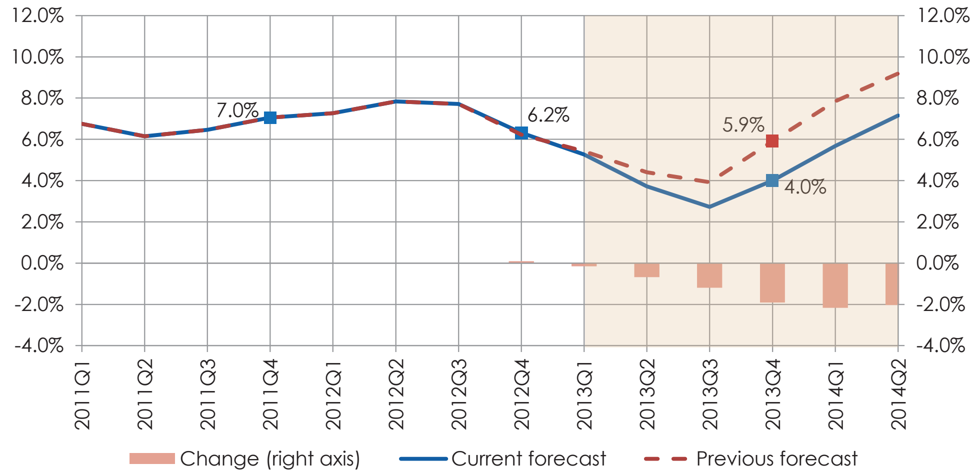


Source: National Bank of Georgia

The current forecast of annual real GDP growth for 2013 has been reduced by 1.9 percentage points (Chart 2.10). The reduction of the growth forecast was caused by the persistence of low levels of demand for longer than expected. The halting of public infrastructure projects and the failure to restore business confidence had a negative impact on domestic demand, which was reflected in economic activity.

« The reduction of the growth forecast was caused by the persistence of low levels of demand for longer than expected.

Chart 2.10 Real GDP Growth



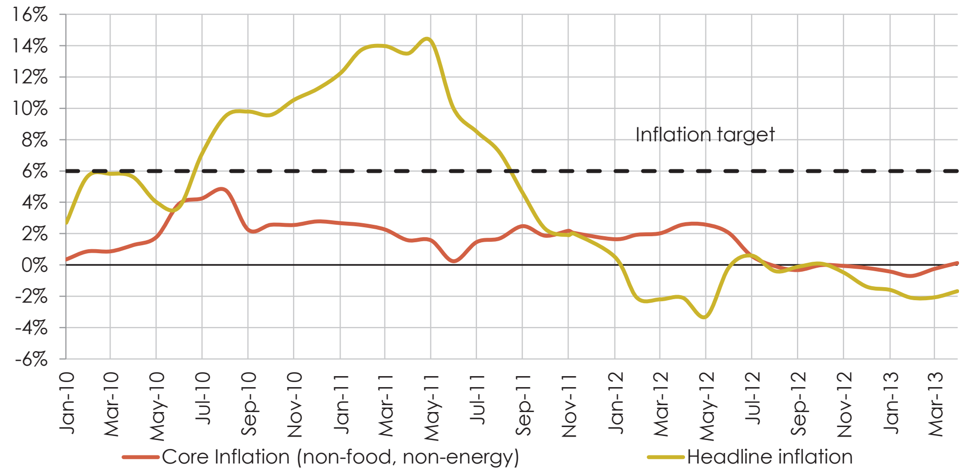
Source: National Bank of Georgia

3. Development of Consumer Prices

According to the National Statistics Office of Georgia, the decline of the overall price level continued during the first quarter of 2013. Consumer prices declined by 0.2% during this period compared to the fourth quarter of 2012. The change of the overall price level declined from -1.4% in the previous quarter to -2.1% by the end of the first quarter of 2013. The decline extended to April 2013, with a slightly higher inflation indicator of -1.7%. As one can see, headline inflation is at a significantly lower level than the NBG's target of 6% in the medium-term. Core inflation (excluding food and energy) has improved slightly and stood at 0.1% by the end of April (see Chart 3.1).

« Headline inflation in April 2013 is at a significantly lower level than the NBG's target and stands at -1.7 percent.

Chart 3.1 Headline and Core Inflation



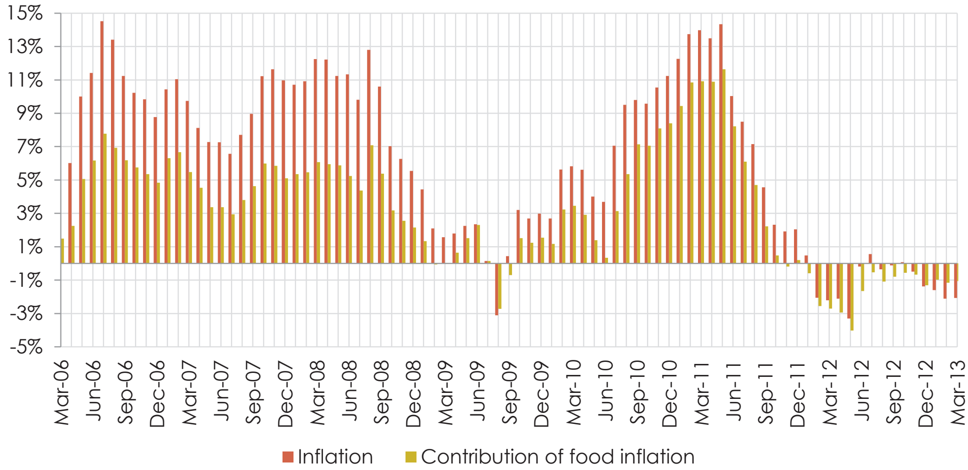
Source: National Bank of Georgia

The decline of the CPI and the significant deviation of headline inflation from the target have been caused by both supply and demand factors.

« The significant deviation of inflation from its target level is largely caused by the base effect from the decline in food prices.

Food prices have experienced significant growth since late 2010-2011 both world-wide and in the region due to poor harvests. This growth was temporary and the trend was expected to reverse with the harvest improving. However, price elasticity is usually lower when prices are declining than when they are increasing. Thus a prolonged trend of increased prices due to a supply shock affects the current levels of the inflation rate. Food products were cheaper by an annual 4.1% in April, contributing approximately -1.3 percentage points to headline inflation (see Chart 3.2).

Chart 3.2 Contribution of food inflation in headline inflation



Source: GeoStat and National Bank of Georgia

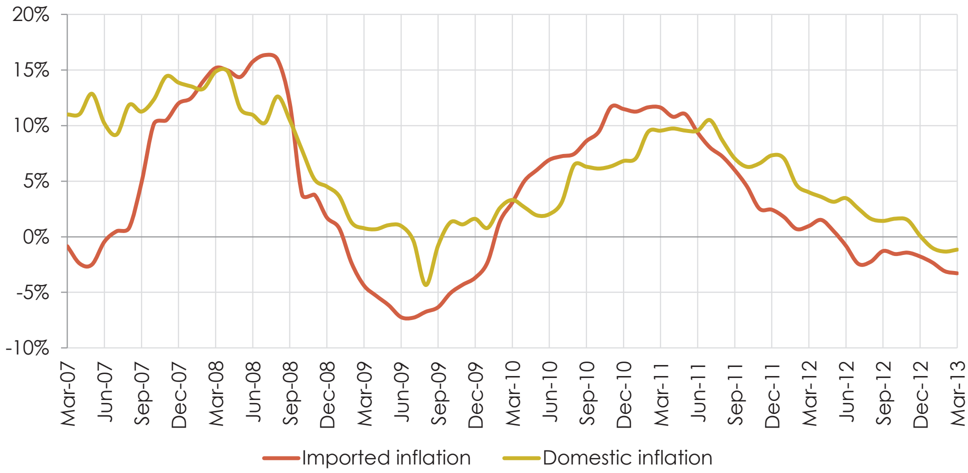
It should be noted that electricity tariffs were reduced at the beginning of the year and gas tariffs were cut in March, amplifying the negative base effect on inflation. The decline of these utility prices has contributed -0.4 percentage points to the annual inflation rate.

« A decline in administered prices creates an important negative base effect on annual inflation.

In terms of supply factors, it is worth noting that last year low inflation rates were prevalent in our main trade partner countries – Azerbaijan, Armenia and Ukraine. The growth in the price of imported goods exhibited a downward trend since June 2011 before switching to deflation by the end of the second quarter of 2012. This trend continued in both the third and fourth quarters of 2012, with the deflation rate further increasing. The annual change in the overall price level for imported goods stood at -4.6% by the end of the first quarter of 2013 and the contribution of imported inflation to headline inflation was equal to -1.0 percentage points (see Chart 3.3).

« Due to the low inflation rates prevalent in our main trade partner countries, imported goods inflation stood at -4.6% by the end of April.

Chart 3.3 Imported and Domestics Inflation



Source: GeoStat and National Bank of Georgia

The reduction of profit margins in different segments of business should also be mentioned as one of the factors influencing inflation. This has been evident since 2011 and is partly due to increased competition. As a result, a decline of prices was obvious for the retail trade, particularly for food, clothing, pharmaceutical and communication products. The reduction of gross profit margins contributed about 0.5 percentage points to headline inflation.

« A Reduction of profit margins for retail sales has lowered the aggregate price level.

As already mentioned above, the low inflation rate has been facilitated by both supply and demand factors. The budget deficit and exchange rate fluctuations are important to consider in terms of demand factors affecting price levels. Significant fiscal consolidation has been implemented over the last three years, bringing the consolidated budget deficit to GDP down by 6.3 percentage points (from 9.2% to 2.9%). The appreciation of the exchange rate during the same period is also noteworthy, since

« Factors weakening aggregate demand have also caused the rate of inflation to deviate from its target.

the nominal effective exchange rate appreciated by approximately 9% over the last three years. These factors acted to weaken demand. Against the backdrop of fiscal tightening and exchange rate appreciation, the NBG has implemented a gradual loosening of monetary policy in order to stimulate demand. Since 2011, the NBG has cut its policy rate by 3.75 percentage points (from 8% to 4.25%).

The loosening of monetary policy during 2011-2012 was in line with the existing forecasts of the time, according to which the inflation rate was supposed to start growing from the second half of 2012 and hit the target by the beginning of 2013. However, election-related uncertainty caused demand for private credit to decrease. In spite of ample liquidity in the banking sector, credit activity has continued to remain slow after the elections. Existing uncertainty has thus hindered the transmission of monetary policy to the real economy; the loose monetary policy did not result in a growth of credit activity, which is supposed to promote aggregate demand and increase inflation to the target level.

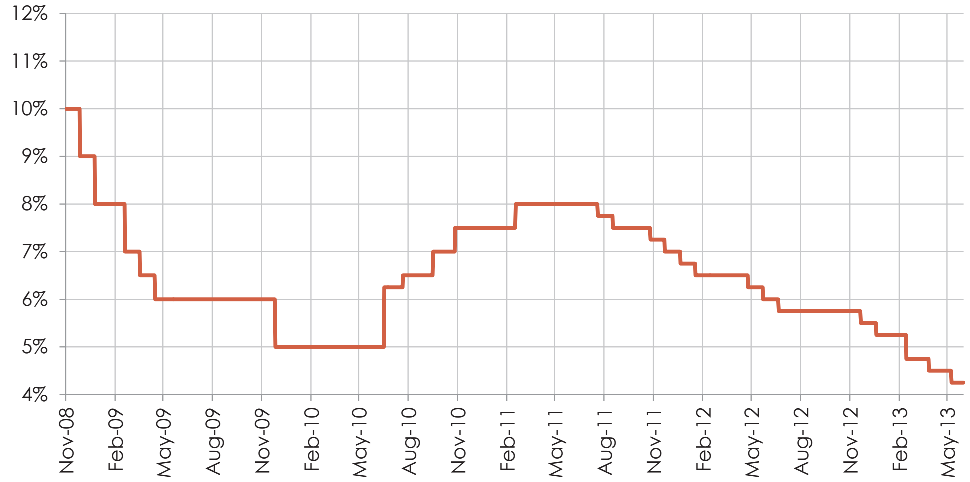
‹‹ *Uncertainty existing in society hindered the transmission of the loose monetary policy to the real economy, thus preventing inflation from rising to its target level.*

4. MONETARY POLICY

The NBG started to loosen its monetary policy from July 2011 and has continued this course in 2013. During February-May the NBG cut the monetary policy rate by 1 percentage point to 4.25%. These decisions were based on the existing forecasts of the time, according to which inflation was to stay below its target level.

« The NBG has continued to loosen its monetary policy.

Chart 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last Monetary Policy Committee meeting was held on 8 May and the policy rate was further cut from 4.5% to 4.25% as a result. This decision was based on the existing inflation forecast and on macroeconomic analysis of ongoing events in both Georgia and outside its borders.

Preliminary estimates point to a relatively low level of economic activity during the first quarter of 2013, which is accompanied by lower than expected inflation. Commercial bank lending activity has also remained moderate due to the decreased demand for credit, which in turn weakens the interest rate channel of monetary policy transmission. Given that the loose monetary policy will be transmitted to the economy with a time lag, it is expected to promote aggregate demand and support the convergence of the inflation rate with its target level.

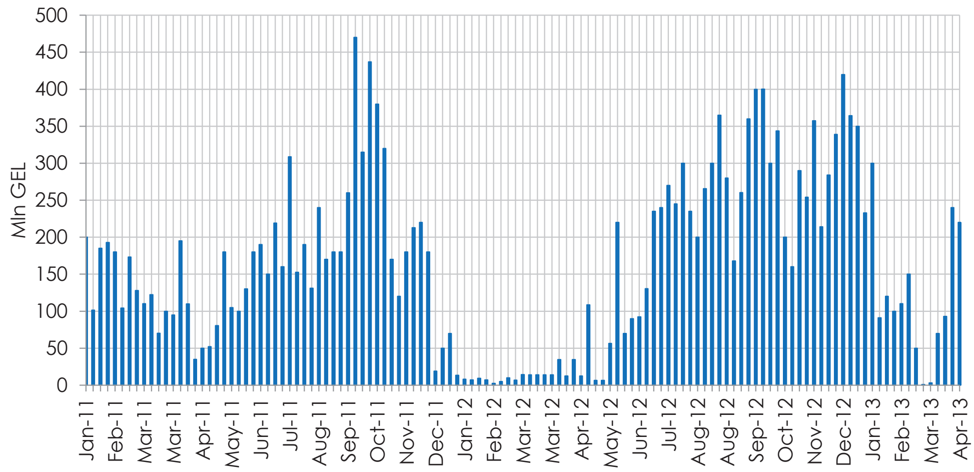
Positive trends have been evident in the external sector, which have encouraged domestic demand to some extent. The growth rate of remittance inflows has increased in the first quarter, standing at 7.6%. In addition, we should note the increase in income from tourism, which stimulates demand. As for the trade balance, it is expected to improve in the first quarter of the current year, mainly due to the decrease in the growth rate of imports, indicating a decrease of domestic demand.

According to current forecasts, economic activity is expected to improve in the second quarter and deflationary pressure is expected to recede. Inflation is estimated to begin increasing in the second quarter, but will remain below the target rate during the current year. The convergence of inflation with its target level is forecasted by the end of 2014. The inflation target is set at 6 percent for 2013-2014 and will be decreased to 5 percent in 2015. The forecasts and factors mentioned above warranted the further loosening of monetary policy, prompting the Monetary Policy Committee to continue this course in its meeting on 8 May.

In addition to the interest rate instrument, the NBG is considering additional measures in order to stimulate economic activity. The supply of long term lari denominated resources is one such potential measure being discussed. The availability of long-term funds denominated in the domestic currency on the market will promote the disbursement of loans in lari and will thus help stimulate demand. In addition, the long-term supply of lari will encourage higher larization levels and improve the overall efficiency of monetary policy.

In order to ensure the efficiency of monetary policy, it is important for the changes in the monetary policy rate to be reflected in the interbank interest rates, and ultimately affect the real economy. In February, excess liquidity was accumulated in the banking system, which was mainly due to an increase in government spending (financing of the agricultural sector and funding for victims of a natural disaster in the Kakheti region). This was accompanied by a slowdown of credit activity, resulting in banks having to keep the excess liquidity. As a result, demand for the NBG refinancing loans has decreased and the monetary policy transmission mechanism has weakened. In response, the NBG planned increased issuance of certificates of deposit (CDs) from March. According to the existing plan, the stock of CDs in circulation will increase by 120 million GEL.

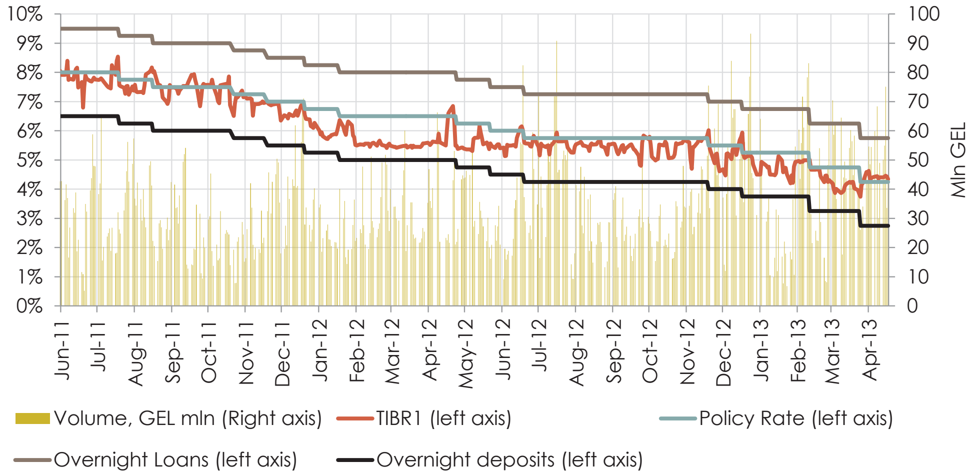
Chart 4.2 Refinancing Loans



Source: National Bank of Georgia

The demand for refinancing loans increased again as a result of the sterilization of excess liquidity in the banking system, improving the transmission of monetary policy to interbank market rates. Short-term interbank interest rates have been stable and hover around the monetary policy rate.

Chart 4.3 Interbank Money Market



Source: National Bank of Georgia

« Interbank money market rates hover around monetary policy rate.

The NBG collateral base

In recent years, the NBG has implemented major reforms in order to increase the efficiency of monetary policy. As a result of these measures, the NBG's influence on short-term money market rates has significantly improved, with these rates fluctuating around the monetary policy rate. However, spreads between long-term interest rates and the policy rate remain high, with the scarcity of long term lari resources on the market being one of the main causes of this. In order to overcome this problem and improve the efficiency of monetary policy, one of the main objectives of the NBG is to ensure the supply of long term lari resources to the market and to promote the larization of the economy. To this end, in 2012, the NBG expanded its list of assets acceptable as collateral for monetary operations. The NBG has loosened the criteria for loan assets that can be used as collateral by commercial banks to get a refinancing loan from the NBG by decreasing the haircut[2], increasing the loan-to-value ratio limit and canceling the minimum limit of a portfolio to be used as collateral. Currently, the list of acceptable collateral includes securities issued and unconditionally guaranteed by the NBG and the Georgian government, international bank guarantees and the commercial bank's loan assets. It is important to take into account that for the purposes of monetary operations the NBG only accepts assets denominated in lari.

The changes mentioned above allow commercial banks to obtain additional funds from the NBG via its refinancing instrument by using their own loan assets as collateral and utilizing these funds to disburse loans denominated in the domestic currency. However, it should be noted that the NBG's refinancing loans have a maturity of a week and the minimum interest rate on these loans equals the monetary policy rate determined by the NBG's Monetary Policy Committee. The Committee usually meets eight times a year and makes its decisions based on current and expected economic developments and on observations of the financial markets. The inflation forecast is also taken into account when formulating monetary policy, since the results of the policy are transmitted to the real economy with a time lag. If the projected rate of inflation exceeds its target level, the NBG will increase the interest rate in order to limit a future increase of price levels. In the opposite case, when aggregate demand is low and the projected inflation rate is less than its target level, the NBG will reduce interest rates.

Thus, changes of the monetary policy rate are reflected in the bank's interest expense when taking a refinancing loan. If the bank uses these funds to disburse fixed rate loans, it is exposed to interest rate risk and therefore banks incorporate the compensation for this risk in the interest rates on loans. In the case of floating rate loans, the interest rate risk is shifted to consumers, but the interest rate is lower than in the case of a fixed rate loan. Thus, in the case of long-term loans, floating rate products typically have a lower interest rate than fixed rate products, given that the yield curve is upward sloping.

The commercial bank defines which variable interest rate to use as a reference rate for the floating rate product and also incorporates its own spread. In the case of floating rate products financed by the NBG's refinancing instrument, the NBG's policy rate is the clear choice for the reference rate. In this case, the loan interest rate is defined as the NBG's policy rate plus the bank's spread. As mentioned above, the reference rate may be changed by the NBG, but the spread usually remains unchanged until the repayment of the loan.

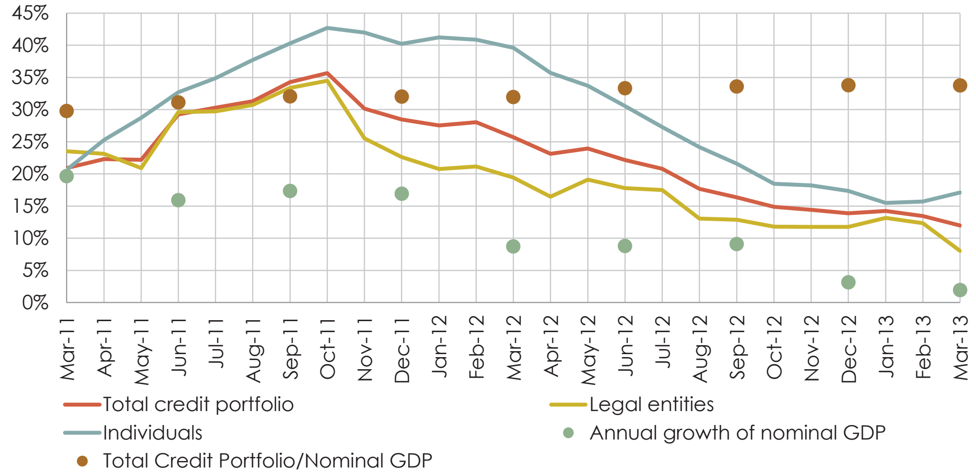
2 The difference between the loan amount and the market value of the collateral asset.

5. Financial Market and Trends

5.1 LOANS

The decline of credit activity continued during the first quarter of 2013. According to the credit conditions survey, demand (adjusted for seasonal factors) is weakened and recovery is uneven in terms of retail and corporate segments (see Chart 5.1).

Chart 5.1 Annual Growth Rate of Loan Portfolio



Source: National Bank of Georgia

Annual growth of the loan portfolio was down to 12% in March 2013 and the credit to nominal GDP ratio remained unchanged in the first quarter of 2013, standing at 33.8% (see Chart 5.1). It should be noted that preliminary data indicates a slight recovery of credit activity in April. Retail loans – which predominantly include consumer and mortgage loans – exhibit relatively higher growth rates, while loans to legal entities are characterized by a sharp slowdown of growth. The agriculture, trade and transport sectors have posted growth in terms of credit, while the volume of outstanding loans disbursed to the energy, construction and manufacturing sectors has declined. The reduction of demand for business loans partially stems from decreased government spending on infrastructure projects. The banks have also tightened assessment standards, becoming more conservative due to slower economic activity.

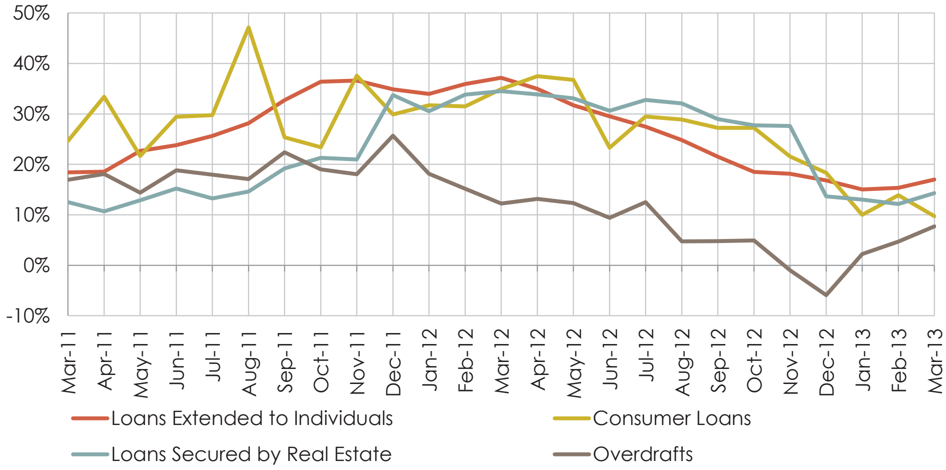
‹‹ According to the credit conditions survey, the slowdown of credit activity is attributable to a decline in demand.

The annual growth of retail loans amounted to 17% during the first quarter of 2013 (see Chart 5.2). This increase was largely due to the growth of loans denominated in the national currency. The growth rate of consumer loans has significantly reduced, while the volume of payroll loans and overdrafts have increased.

The share of non-performing loans increased by 0.3 percentage points in the first quarter of 2013 as compared to the previous quarter to stand at 9.5%. According to data from March, the share of non-performing loans was slightly higher for foreign currency denominated loans compared to the lari portfolio, 9.7% and 9.3% respectively.

‹‹ The share of non-performing loans increased by 0.3 percentage points in the first quarter of 2013 as compared to the previous quarter to stand at 9.5%.

Chart 5.2 Annual Growth of Loans Extended to Individuals



Source: National Bank of Georgia

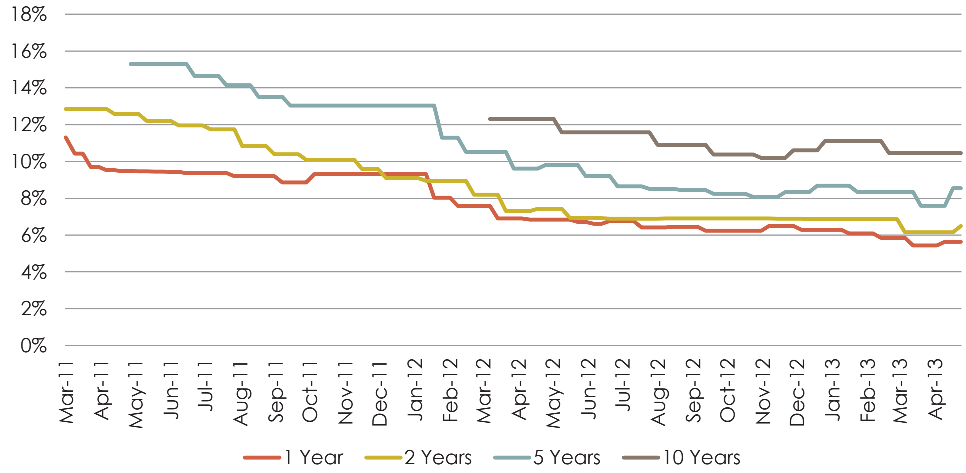
5.2. INTEREST RATES AND CREDIT CONDITIONS

The NBG has cut its policy rate by 1.0 percentage point down to 4.25% during 2013 based on the inflation forecast and analysis of the macroeconomic environment. Since changes in monetary policy are transmitted to the real economy with a time lag, the loosening of the monetary policy has not been fully reflected yet. However, changes made in previous quarters have been partially reflected through decreased interest rates.

« The loosening of monetary policy during previous quarters has been partially reflected through decreased interest rates.

Yields on government securities exhibited a declining trend during the year. Compared to December 2012, yields on both short and long term government securities decreased by the end of April 2013.

Chart 5.3 Interest Rates on Government Securities

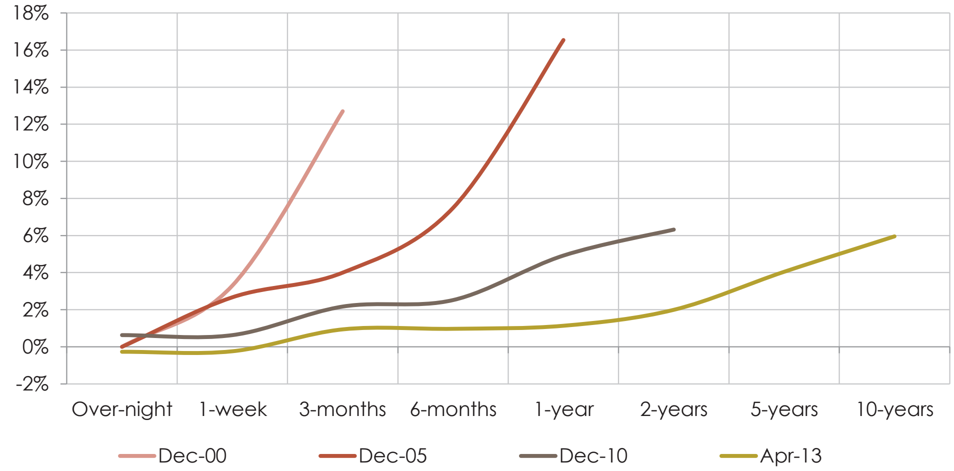


Source: National Bank of Georgia

It is significant that the slope of the yield curve has decreased over time. This implies a decline of the spread between long-term assets and the monetary policy rate. This trend can be explained by the decline of liquidity and interest rate risks; moderate changes in the NBG's refinancing rate and the predictable nature of monetary policy have decreased expectations of sharp short-term interest rates changes. The development of the interbank market has also decreased liquidity risks. Since long-term interest rates are formed in line with inflation expectations, the decline of spreads for long-term assets points towards the stabilization of the financial sector and lowered inflation expectations.

« Moderate changes in the NBG's refinancing rate and the predictable nature of monetary policy have decreased expectations of sharp short-term interest rates changes

Chart 5.4 Spread between the Monetary Policy Rate and the Yield Curve

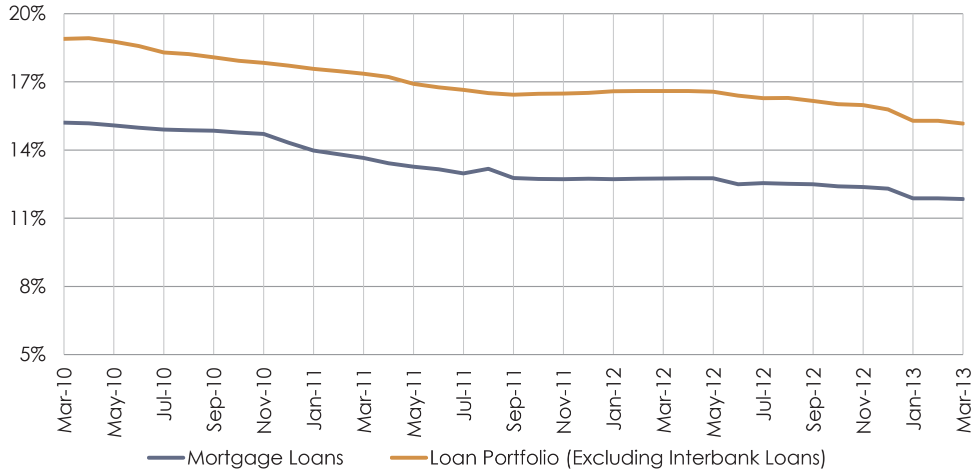


Source: National Bank of Georgia

There have been no significant changes in credit conditions during the first quarter of 2013. Weakened demand and excess supply has promoted competition, which is evident in pricing policies. Interest rates have continued to decline in both retail and corporate segments during the period. Changes in interest rates stem from a variety of factors, but competition and market activity are the main determinants in the short-term. Competition among banks, especially for affluent clients, will facilitate further reductions of market interest rates.

« Interest rates have continued to decline in both retail and corporate segments.

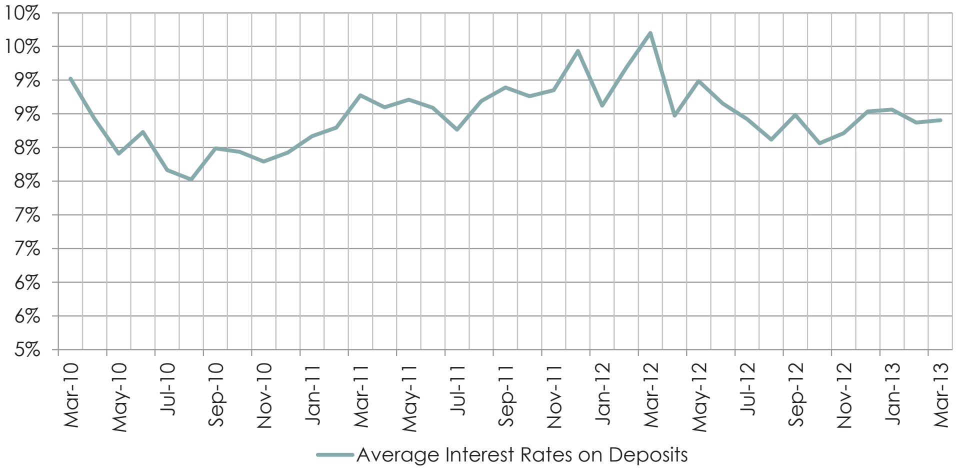
Chart 5.5 Average Interest Rates on Loans



Source: National Bank of Georgia

Interest rates have also declined on deposits. In addition to fundamental macroeconomic factors, this decline was partially caused by accumulated liquidity, weak demand for credits and an increased supply of deposits from both individuals and legal entities. This increase, in turn, indicates that companies refrain from making investments and prefer to deposit funds. It should also be noted that several banks increased rates on deposits, thereby influencing the aggregate indicator and somewhat obscuring the overall declining trend.

Chart 5.6 Average Interest Rates on Deposits

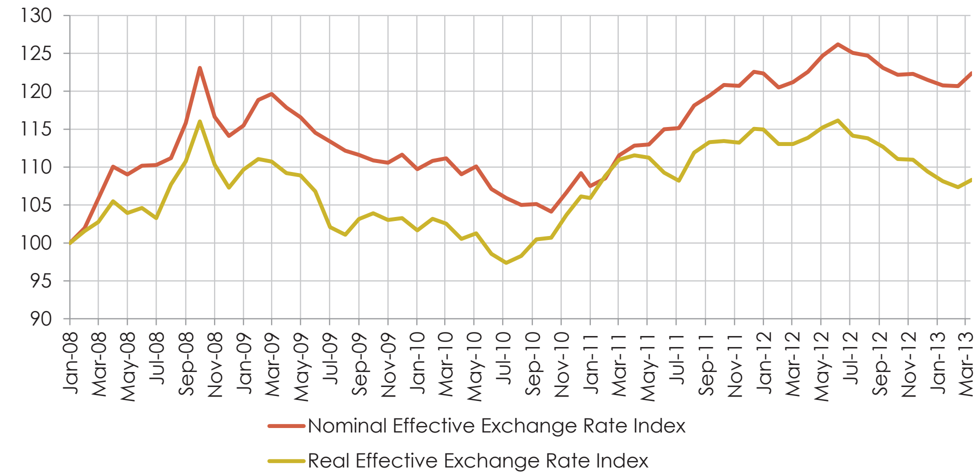


Source: National Bank of Georgia

5.3. EXCHANGE RATE

The GEL exchange rate to the U.S. dollar was stable during the first quarter of 2013 and has depreciated by 1.7% against the euro. The GEL exchange rate also depreciated by a slight 0.4% against the Turkish lira during the same period. As a result, the GEL nominal effective exchange rate has not changed in annual terms and has depreciated slightly, by 0.6%, in quarter-on-quarter terms during the first quarter of 2013.

Chart 5.7 Effective Exchange Rates (Jan 2008 = 100)



Source: National Bank of Georgia

During the first quarter, the GEL real effective exchange rate continued to depreciate, which was largely caused by a lower inflation rate compared to those of Georgia's trade partners. The real effective exchange rate depreciated by an annual 4.2%. In real terms, the GEL has depreciated against all trade partners, except Armenia.

Turkey and Azerbaijan have contributed the greatest share in terms of the depreciation of the GEL real effective exchange rate.

Table 5.1 YoY change of effective exchange rate (March 2013)

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	1.0	-4.2	-4.2
Turkey	0.9	-7.9	-1.8
Eurozone	1.5	-2.2	-0.4
Ukraine	-0.2	-1.5	-0.2
Armenia	6.0	0.4	0.0
USA	-0.3	-3.8	-0.3
Russia	4.5	-4.3	-0.3
Azerbaijan	-0.5	-4.0	-0.7
Others	2.1	-4.2	-0.6

Source: National Bank of Georgia

Futures Contracts

The NBG introduced trading with futures contracts to its international reserves management process in March 2013.

A futures contract is a financial agreement that increases the efficiency of managing the portfolio of international reserves and enables profitable opportunities to be taken advantage of, while simultaneously hedging the international reserves portfolio from interest rate risks. These factors have led the world's central banks to actively use futures contracts to manage international reserves.

When trading futures contracts, the parties agree to buy or sell a standard asset at a specified time in the future and at a price agreed in advance. Interest rate and government securities futures are the most widely used futures contracts. Both of these are traded on the Chicago Mercantile Exchange, which is the largest market for U.S. dollar denominated financial contracts. At this stage, the NBG has started to use U.S. dollar denominated futures to manage the international reserves portfolio, but plans to start trading with euro denominated futures contracts later on.

The gradual expansion of the list of financial instruments used in the process of managing the portfolio of international reserves was made possible as a result of cooperation with the World Bank over recent years. Several important projects have been implemented with World Bank assistance since 2009: the introduction of a modern international reserves management system, the strategic allocation of international reserves, and an improvement of international reserve management practices.

5.4. DOMESTIC DEMAND

Real GDP growth amounted to 2.8% in the fourth quarter of 2012, with a decline in investments being the main determinant of the reduced growth. Capital formation had been driving economic growth in the first half of that year, but the growth rate of investments dropped sharply in the second half of 2012. Given the decline of capital in the third quarter, high real GDP growth in that quarter was supported by a high growth rate of export income (the real growth of private consumption had been changing only slightly). By the fourth quarter, the growth rate of exports dropped significantly and, together with a reduction of investments, this resulted in a slowdown of economic growth. Overall, the Georgian economy grew by 6.1% in 2012.

« Real GDP growth amounted to 2.8% in the fourth quarter of 2012.

Chart 5.8 Annual Growth Rate of Capital Formation

Source: GeoStat

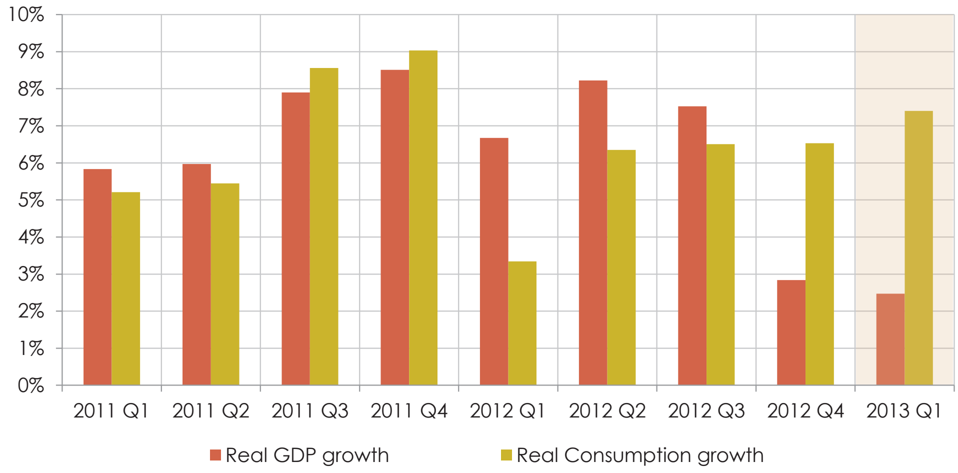
Although capital formation posted a negative growth rate of -2.1 percent during the fourth quarter of 2012, investment was still the main driver of GDP growth in that year. Capital formation is expected to decline by an annual 4.8 percent in the first quarter of 2013, leaving the forecast of the real growth rate low. The reduction of investments has been caused by low activity in the private sector and a decline of government expenditures on infrastructural projects. According to existing forecasts, investments will resume growth at a higher rate from the second half of 2013.

« Net exports have been the main determinants of GDP growth in the first quarter of 2013.

The export of goods and services increased by an annual 6.5 percent and imports by 0.7 percent in the fourth quarter of 2012, with net exports having made a positive contribution to annual GDP growth during the period. According to preliminary information, imports declined by an annual 4.0 percent during the first quarter of 2013 and the annual growth rate of exports amounts to 8.9 percent. As a result, net exports have been the main determinants of GDP growth in the first quarter of 2013.

The annual real growth rate of private consumption[3] did not change compared to the fourth quarter of 2012, standing at 6.5%. The real growth rate of private consumption was mostly stable during 2012.

Chart 5.9 Real GDP and Real Consumption Growth

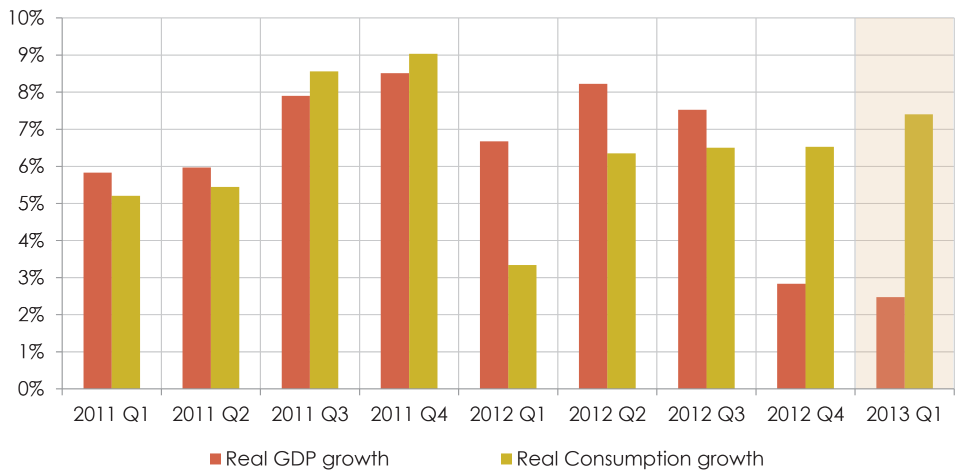


Source: GeoStat and National Bank of Georgia

Consolidated budget expenditures slightly declined during the first quarter of 2013 when compared to the previous year. Social and payroll expenditures have increased significantly, while capital expenditures and goods and services have declined. The reduction of these types of expenditures is reflected in both government investments and consumption, which will probably be one of the factors causing first quarter growth to slowdown. Expenditures on public infrastructure projects are expected to pick up in the next quarters and to promote investment growth, because, according to the existing budget, expenditures on infrastructure during 2013 should be maintained at approximately the same level as they were in 2012.

‹‹ Expenditures on public infrastructure projects are expected to pick up in the next quarters and promote investment growth.

Chart 5.10 Expenditure Structure of the Consolidated Budget



Source: Ministry of Finance of Georgia

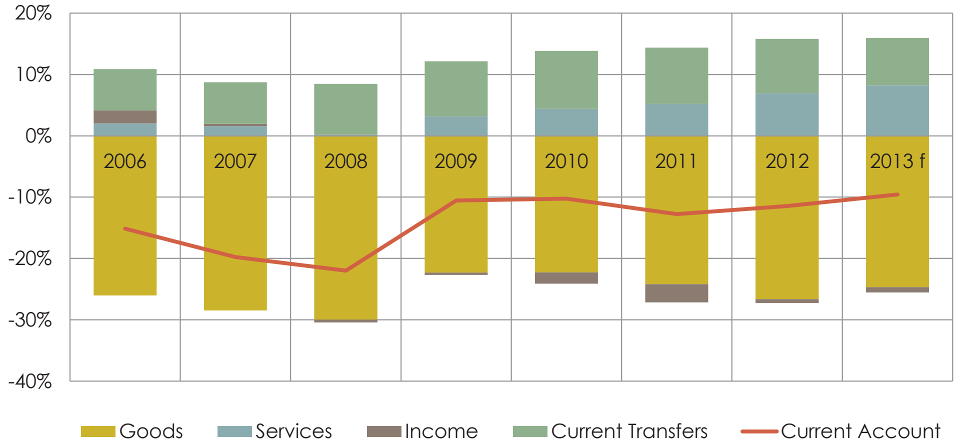
3 The real growth of consumption is calculated using average annual inflation.

6. External Demand and Balance of Payments

In 2012 the current account deficit to GDP ratio improved by 1.3 percentage points and stood at 11.5%. The current account deficit amounted to 1.81 billion U.S. dollars by the end of 2012, which was lower than the 2011 indicator by 25.8 million U.S. dollars. The improvement of the current account deficit was caused by an improvement of the trade balance and the growth of service sector income (mostly from the tourism sector). Remittances have also contributed significantly to financing the trade deficit during the fourth quarter of 2012. The improvement of the trade deficit has continued in 2013 and the current account deficit to GDP is also expected to continue declining during the year.

‹‹ In 2012 the current account deficit to GDP ratio improved by 1.3 percentage points and stood at 11.5%.

Chart 6.1 Ratio of Current Account to GDP



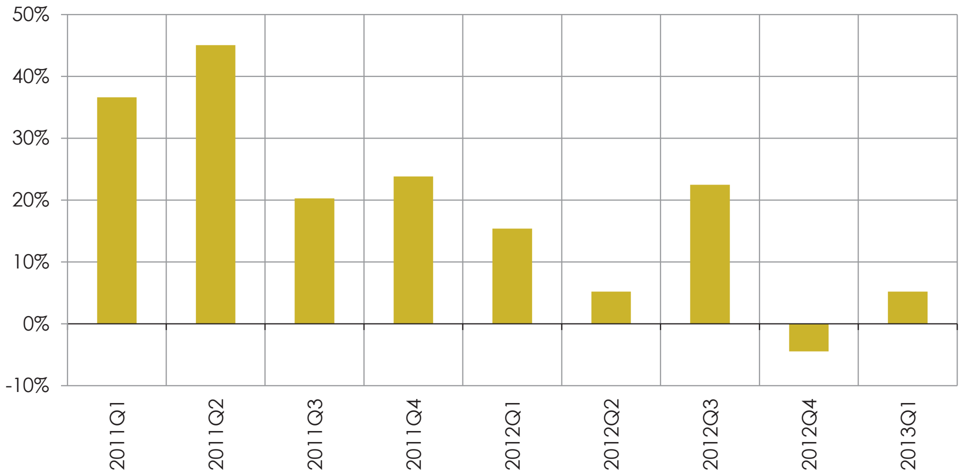
Source: National Bank of Georgia

The export of locally produced products exhibited annual growth during the first quarter of 2013, positively influencing long-term potential growth. Exports decreased by 4.5% during the last quarter of 2012, but have resumed growing since the beginning of 2013. The growth rate amounted to 5.2% during the first quarter, supporting an improvement of the trade balance. The export of fertilizers increased by 94.6% per annum during the first three months of 2013, the export of mineral water by 35.6%, and of wine by 34%.

‹‹ The export of products produced in Georgia exhibited annual growth during the first quarter of 2013, positively influencing long-term potential growth.

The breakdown of export growth by destination regions indicates that the volume of exports to the EU declined by 7.7% during the first quarter of 2013. This may be due to the prolonged economic crisis in some EU countries. Georgian exports increased by 22.7% to CIS countries, supporting the overall growth of exports in the first quarter.

Chart 6.2 Annual Growth Rate of Export

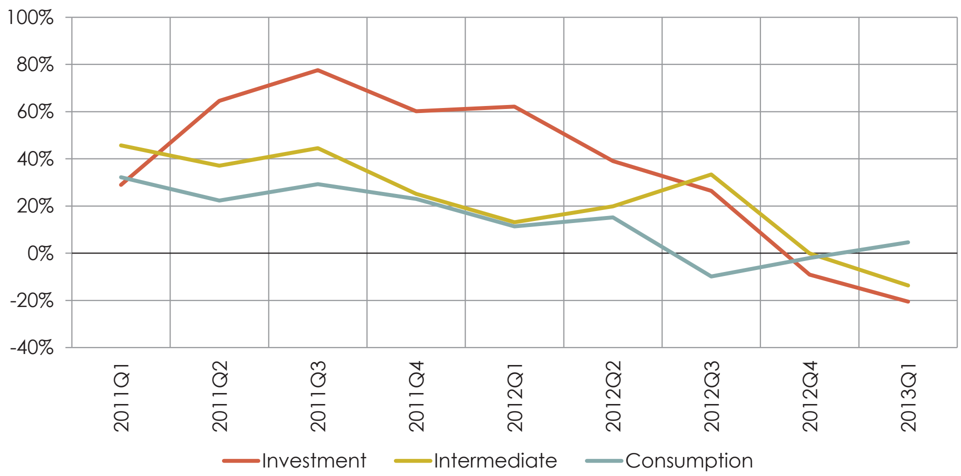


Source: National Bank of Georgia

Imports declined by 2.3% in the fourth quarter of 2012 and were further reduced in the first quarter of 2013 (imports declined by an annual 6.9% during that period). The decline of imports indicates that aggregate demand has weakened. The import of investment goods declined by an annual 20.5% and that of intermediate goods by 13.7%, while the import of consumption goods increased by 4.6% in the first quarter of 2013. The growth of consumer goods imports was mainly due to an increase in automobile imports, as well as the significant growth of the import of pharmaceuticals. The decline of investment and intermediate goods imports points towards a slowdown of business activity in the country.

‹‹ Imports declined by 2.3% in the fourth quarter of 2012 and were further reduced in the first quarter of 2013 (imports declined by an annual 6.9% during that period). The decline of imports indicates that aggregate demand has weakened.

Chart 6.3 Annual Growth Rate of Imports by Groups of Goods



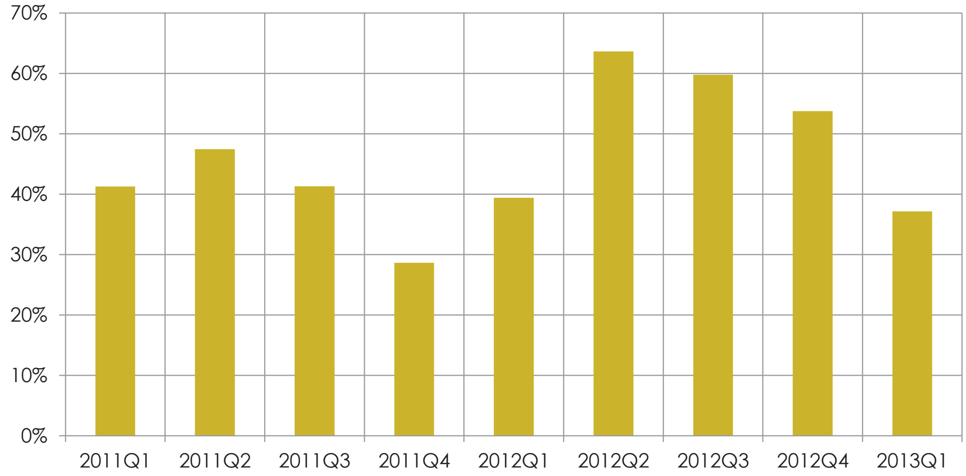
Source: National Bank of Georgia

Receipts from foreign trade in services have continued to grow and positively influence the current account deficit, posting 28% growth in the last quarter of 2012. The positive trend in services trade is expected to continue in 2013 owing to the growth of income from tourism.

Receipts from the tourism sector amounted to 1.41 billion U.S. dollars during 2012, outperforming 2011 by 47.8%. This trend was maintained during the first quarter of 2013 as well, with income growing by an annual 23.9%. According to the National Tourism Administration of Georgia, the number of visitors increased by 37% in January-March 2013, compared to the first quarter of 2012.

‹‹ The growth rate of tourism receipts is still high in 2013, despite the fact that it has declined compared to the previous year.

Chart 6.4 Annual Growth Rate of Number of Non-resident Visitors to Georgia



Source: National Bank of Georgia

The inflow of remittances increased by 6.6% during the fourth quarter of 2012 and has continued to grow in 2013 (the annual growth rate during the first three months of 2013 amounted to 7.6%). The volume of remittances from CIS countries increased by an annual 9.4% during the first quarter of 2013, while those from the EU countries by 6.9%. In the first case, the increase was mainly due to growing remittances from Russia, while in the second case, from Greece (with 15.7% annual growth).

« *The inflow of remittances increased by 6.6% during the fourth quarter of 2012 and has continued to grow in 2013 (the annual growth rate during the first three months of 2013 amounted to 7.6%).*

7. Aggregate Output and Labour Market

7.1 OUTPUT

Annual real GDP growth amounted to 6.1 percent in 2012. The growth in the first three quarters of that year amounted to 6.7, 8.2 and 7.5 percent respectively, while in the fourth quarter it dropped to 2.8 percent.

The slowdown of economic growth during the fourth quarter of 2012 was related to post-election uncertainty and, as a result, to a decline in economic activity, which was also indicated by reduced lending. The flow of credit has been hindered by the caution of both banks and the business sector with respect to increased risks. During the last quarter of 2012, the volume of loans to legal entities declined by 15.2 percent compared with the same period of the previous year.

‹‹ The slowdown of economic growth during the fourth quarter of 2012 was related to post-election uncertainty and to the consequent decline of economic activity.

The most significant decline affecting economic growth was posted by the agriculture and construction sectors. The output of these sectors declined by 3.9 and 2.5 percent respectively in the fourth quarter with their contribution to GDP growth amounting to -0.3 and -0.2 percent.

Compared to other sectors, government participation in the construction sector is especially crucial. In previous periods, high government spending on infrastructure led to the high growth of the construction sector. This type of government expenditure was significantly reduced during the fourth quarter of 2012, which is reflected in growth indicator of the construction sector.

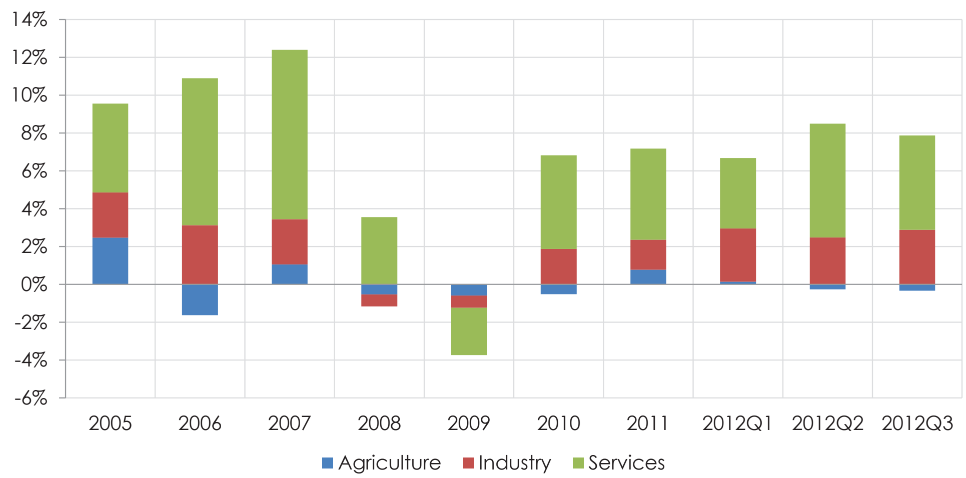
The high growth trend of the number of foreign visitors to Georgia was sustained during 2012 and reached 4.4 million, which is equivalent to an increase of 56 percent compared to 2011. This fact influenced the hotels and restaurants and the transport sectors most, which posted 11.8 and 5.9 percent growth respectively during 2012.

‹‹ The high growth trend of the number of foreign visitors was sustained during 2012 and reached 4.4 million, which is equivalent to an increase of 56 percent compared to 2011.

The economic slowdown that started in the fourth quarter of 2012 continued in the first quarter of 2013, with economic activity still low in almost all sectors. According to preliminary estimates, GDP growth stands at 2.4 percent in the first quarter.

The main factors supporting economic growth in the first quarter of 2013 were tourism revenues and the financing of agricultural activities by government investment funds. Agriculture stimulus measures will contribute significantly to the growth of the agriculture and households sectors' output in 2013. At the same time, the number of foreign visitors to Georgia has increased by 37.2 percent (930 thousand), which should be positively reflected in the rate of economic growth.

Chart 7.1 Shares of the Main Sectors of the Economy in Real GDP Growth Rate 2011-2013 Q I



Source: GeoStat and National Bank of Georgia

‹‹ In the post-crisis period the biggest contributions to economic growth were made by trade, tourism, manufacturing and construction sectors.

7.2 LABOR MARKET

Growth rate of labor productivity declined in the fourth quarter of 2012. According to GeoStat, the productivity of the labor force increased by 1.5% in year-on-year terms during the fourth quarter, which is 3.0 percentage points less than it had been in the previous quarter. The increase of productivity can be largely attributed to the industrial sectors, but the rate of growth has significantly declined. Productivity has not grown in the agriculture sector over the last several years and actually started to decline in 2012. In the fourth quarter, the rate of decline of productivity in the agriculture sector decreased compared to the previous quarter and stood at 3.6%. The growth rate of productivity in the service sector increased similarly to previous periods, but did so at a slower pace. The real value added per employee in services increased by 1.7% compared to the fourth quarter of 2011.

‹‹ Labor productivity increased by just 1.5 percent during the fourth quarter of 2012. The increase of productivity can be largely attributed to the industrial sectors.

Table 7.1 Index of valued added produced per worker in 4th quarter of 2012 relative to the corresponding period of the previous year

	Real value added per employee (growth index)
Agriculture and processing of agricultural products by households	96.4
Industrial sectors	101.4
Service sectors	101.7
Overall in the economy	101.5

Source: National Bank of Georgia

The annual growth rate of the nominal salaries of employees declined during the fourth quarter of 2012, with the average monthly nominal salary standing at 812 GEL, according to the latest data from GeoStat. The growth of the average salary amounted to 6.8% during the fourth quarter of 2012, which is 2.8 percentage points less than it was in the previous quarter.

In terms of sector analysis, a slowdown in the annual growth rate of salaries is evident in the manufacturing, construction, transport and healthcare sectors. Salaries declined on an annual basis in the hotels and restaurants and trade sectors during the fourth quarter of 2012.

Table 7.2 Index of average monthly nominal wage of employs in 4th quarter of 2011 relative to the corresponding period of the previous year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	157.5
Fishing	78.3
Mining and quarrying	86.9
Manufacturing	107.1
Production and distribution of electricity, gas and water	106.4
Construction	106
Wholesale and retail trade; repair of motor vehicles and personal and household goods	92.9
Hotels and restaurants	88.5
Transport and communication	108.8
Financial intermediation	104.3
Real estate, renting and business activities	106.5
Public administration	108.9

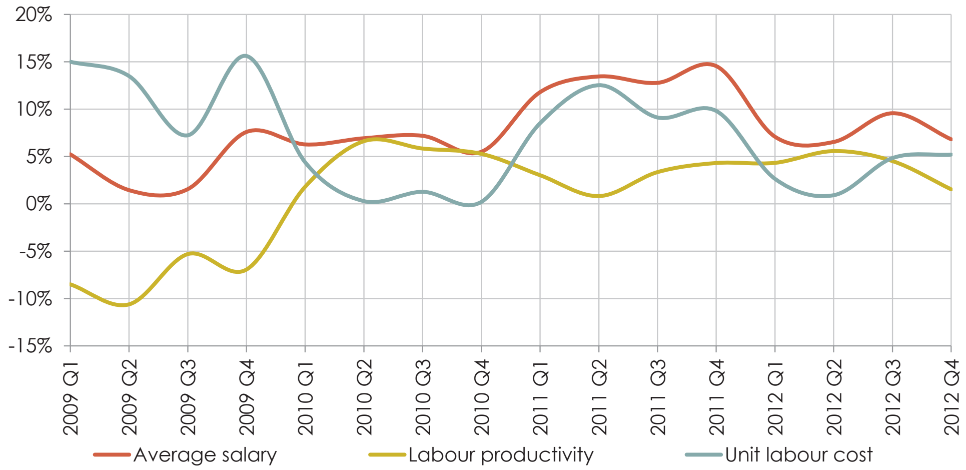
	Average nominal wage (growth index)
Education	109.6
Health and social work	113.1
Other community, social and personal service activities	111.7
Total	106.8

Source: GeoStat

The annual growth rate of employee's average salaries declined during the fourth quarter of 2012. At the same time, the growth rate of employee labor productivity decreased at a higher pace. As a result, the annual growth rate of unit labor cost[4] (personnel expense per production unit) has increased and stood at 5.2 percent by the end of 2012.

« The unit labor cost has increased only slightly and cannot create inflationary pressure.

Chart 7.2 Labor Productivity, Average Monthly Salary and Unit Labor Cost, 2009-2012 Q IV (annual percentage change)



Source: GeoStat and National Bank of Georgia

Overall, due to the higher growth of salaries as compared to labor productivity, the unit labor cost increased during the fourth quarter of 2012. However, this remains at a low level, which indicates that there is no upward price pressure from the labor market.

4 The same as salary expenditures as a share of aggregate real value added (GDP).

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