



National Bank  
of Georgia

# INFLATION REPORT

---

May

# 2014



## 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 year 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 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 aggregate demand.
- **The primary tool of 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 aggregate demand. The difference between the actual and 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.

## CONTENTS

---

1. BRIEF OVERVIEW .....	5
2. MACROECONOMIC FORECAST .....	7
2.1 EXTERNAL SECTOR OVERVIEW .....	7
2.2 MACROECONOMIC FORECAST .....	9
2.3 ALTERNATIVE FORECAST SCENARIO .....	12
2.4 COMPARISON WITH THE PREVIOUS FORECAST .....	13
3. CONSUMER PRICES .....	14
4. MONETARY POLICY .....	16
5. FINANCIAL MARKET AND TRENDS .....	19
5.1 LOANS .....	19
5.2. INTEREST RATES AND CREDIT CONDITIONS .....	20
5.3. EXCHANGE RATE .....	23
6. DOMESTIC DEMAND .....	24
7. EXTERNAL DEMAND AND BALANCE OF PAYMENTS .....	26
8. OUTPUT AND LABOUR MARKET .....	28
8.1 OUTPUT .....	28
8.2 LABOUR MARKET .....	29

### BOXES

BOX 1 LARIZATION .....	18
BOX 2 ASSESSMENT OF THE STRUCTURE OF TOTAL FINANCIAL SECTOR ASSETS .....	22

### CHARTS

CHART 1.1 ANNUAL INFLATION .....	5
CHART 1.2 REAL GDP ANNUAL GROWTH (ANNUAL GROWTH DURING THE LAST FOUR QUARTERS) .....	6
CHART 2.1 U.S. REAL GDP ANNUAL GROWTH .....	7
CHART 2.2 EUROZONE REAL GDP ANNUAL GROWTH .....	8
CHART 2.3 U.S. CPI ANNUAL INFLATION .....	8
CHART 2.4 EUROZONE CPI ANNUAL INFLATION .....	9
CHART 2.5 HEADLINE AND CORE INFLATION .....	9
CHART 2.6 HEADLINE INFLATION DECOMPOSITION .....	10
CHART 2.7 REAL GDP GROWTH (ANNUAL GROWTH OF LAST FOUR QUARTERS) .....	10
CHART 2.8 COMPONENTS OF REAL GDP .....	11
CHART 2.9 CURRENT ACCOUNT COMPONENTS RATIO TO GDP .....	12

CHART 2.10 CPI INFLATION ACCORDING TO BASELINE AND ALTERNATIVE FORECASTS .....	12
CHART 2.11 REAL GDP GROWTH ACCORDING TO BASELINE AND ALTERNATIVE FORECASTS (ANNUAL GROWTH OF THE LAST FOUR QUARTERS).....	13
CHART 2.12 CHANGE IN FORECAST OF HEADLINE INFLATION .....	13
CHART 3.1 CPI AND CORE INFLATION.....	14
CHART 3.2 CONTRIBUTION OF FOOD INFLATION IN HEADLINE INFLATION .....	14
CHART 3.3 IMPORTED AND DOMESTIC INFLATION .....	15
CHART 4.1 MONETARY POLICY RATE.....	16
CHART 4.2 REFINANCING LOANS.....	17
CHART 4.3 INTERBANK MONEY MARKET .....	17
CHART 4.4 LARIZATION OF LOANS (EXCLUDING EXCHANGE RATE EFFECTS).....	18
CHART 4.5 LARIZATION OF DEPOSITS (EXCLUDING EXCHANGE RATE EFFECTS) .....	18
CHART 5.1 CREDIT PORTFOLIO ANNUAL GROWTH.....	19
CHART 5.2 RETAIL LOANS ANNUAL GROWTH.....	19
CHART 5.3 INTEREST RATES ON GOVERNMENT SECURITIES.....	20
CHART 5.4 SPREAD BETWEEN THE MONETARY POLICY RATE AND YIELD CURVE.....	21
CHART 5.5 AVERAGE INTEREST RATES ON BUSINESS LOANS .....	21
CHART 5.6 AVERAGE INTEREST RATES ON DEPOSITS.....	22
CHART 5.7 STRUCTURE OF THE FINANCIAL SECTOR ASSETS .....	22
CHART 5.8 EFFECTIVE EXCHANGE RATES (JAN 2008 = 100).....	23
CHART 6.1 ANNUAL GROWTH RATE OF CAPITAL FORMATION .....	24
CHART 6.2 REAL GDP AND REAL CONSUMPTION GROWTH .....	25
CHART 6.3 CONSOLIDATED BUDGET DEFICIT (MLN GEL).....	25
CHART 7.1 ANNUAL GROWTH RATE OF EXPORTS .....	26
CHART 7.2 ANNUAL GROWTH RATE OF IMPORTS ACCROSS THE PRODUCT GROUPS.....	27
CHART 8.1 CONTRIBUTION OF SECTORS OF ECONOMY TO REAL GDP GROWTH .....	28
CHART 8.2 LABOR PRODUCTIVITY, AVERAGE MONTHLY SALARY AND UNIT LABOR COST, 2009-2013 Q IV (ANNUAL PERCENTAGE CHANGE) .....	30

## **TABLES**

TABLE 5.1 EFFECTIVE EXCHANGE RATE ANNUAL GROWTH .....	23
TABLE 8.1 INDEX OF VALUE ADDED PRODUCED PER WORKER IN 4TH QUARTER OF 2013 RELATIVE TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR.....	29
TABLE 8.2 INDEX OF AVERAGE MONTHLY NOMINAL WAGE OF EMPLOYEES IN 4TH QUARTER OF 2013 RELATIVE TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR.....	30

## 1. BRIEF OVERVIEW

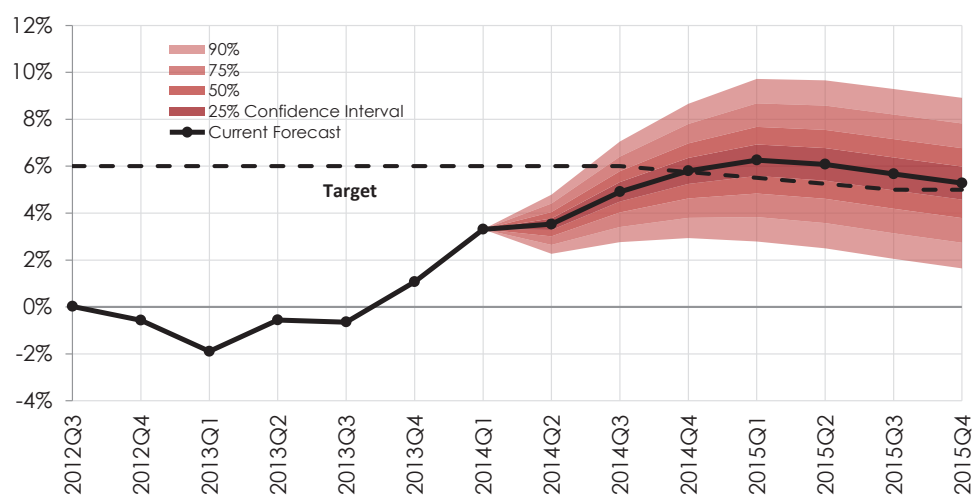
According to preliminary estimates, the Georgian **economy increased** by 7.4% year-on-year in the first quarter of 2014. Despite the high annual growth rate, the recovery in economic activity, which started at the end of 2013, has been only partially sustained as a result of the possible impact of increased regional geopolitical risks on Georgia. According to preliminary estimates, economic growth was reflected in an increase of consumption and investment. A higher than expected growth rate of net exports also contributed to the increase in GDP. In terms of the contributions of the main sectors of the economy, recovery has been more or less homogenous among all major sectors, but the construction, trade and services sectors have made the highest contributions. The growth of the tourism sector has also been sustained.

Along with economic activity, the **inflation rate** increased to 3.4% in April 2014. The increase in inflation is, in part, a result of the elimination of deflationary pressure from the supply side, which was reflected in food prices. Imported prices also made an impact on inflation. Amid relaxed monetary policy and fiscal stimulus measures, an improvement in business sentiment was reflected in aggregate demand, which had a modest effect on consumer prices. Current estimates indicate that demand-side inflationary pressures remain weak.

After the improvement in the fourth quarter of 2013, **banking sector activity** was sustained in the first quarter of 2014. In March, the annual growth rate of the total portfolio posted 17%.<sup>1</sup> This increase was mostly caused by the credit portfolio of GEL denominated loans, which, in turn, was caused by increased demand stemming from the relaxed monetary policy.

The National Bank forecasts that **inflation** will increase moderately and reach the target in the second half of 2014. This forecast is based on the assumption that, amid the soft monetary policy and fiscal stimulus plans, an improvement in economic activity and an increase in aggregate demand will affect prices. Also, with the nominal effective exchange rate being stable, increased inflation in the region will be partly reflected on imported prices in Georgia (see Figure 1.1).

Chart 1.1 Annual Inflation

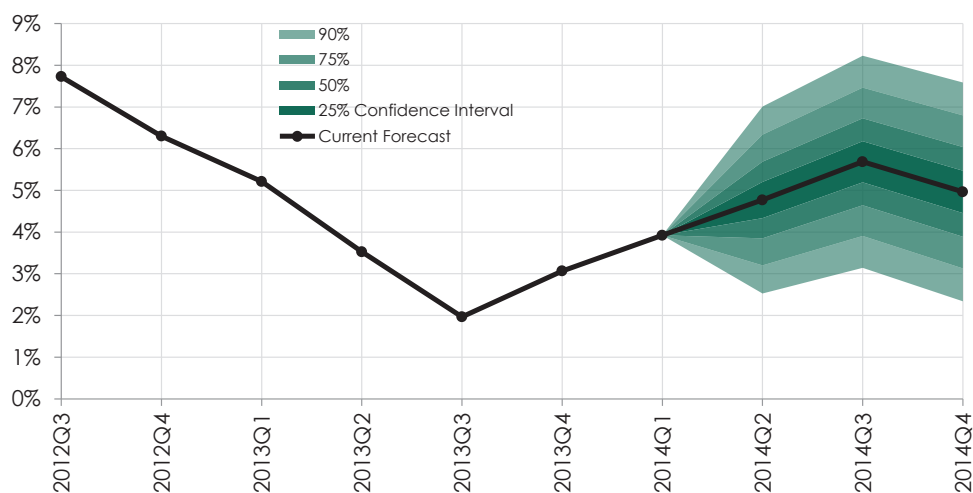


Source: National Bank of Georgia

1 With the exchange rate effect excluded.

According to the forecast of the NBG, **economic growth** for 2014 will be around 5%. The forecast assumes that business sentiment will improve and will be reflected in a growth of domestic investments. Despite the tense geopolitical environment in the region, the forecast assumes that the investment climate will not deteriorate significantly, while the impact on the growth of exports and remittances will be moderate. Internal factors, such as the planned fiscal stimulus measures and soft monetary policy will support economic activity (see Figure 1.2). An increase in consumption and investment will significantly contribute to the projected economic growth for 2014. Despite the positive trend in the trade balance, net exports will have a negative contribution due to high import growth. In terms of sector contributions, GDP growth will be distributed among all major sectors, but the construction, trade and service sectors will be the most important. Compared to 2013, the contribution of the agricultural sector will be modest due to the base effect.

Chart 1.2 Real GDP Annual Growth (Annual Growth During the Last Four Quarters)



Source: National Bank of Georgia

**The projections vary** and largely depend on the different assumptions, that the forecast is based on. As there are risks on both sides, the forecast is partly balanced; however, compared to the previous quarter, amid escalating tensions in the region, external risks have significantly increased. In particular, the reduced economic growth forecasts for trading partner countries, amid increased geopolitical risks and a tapering of monetary stimulus measures in the U.S., elevate risks for the investment climate in the region. In addition to threats to foreign investment, foreign trade and remittances should also be placed under scrutiny while the Russia-Ukraine conflict unfolds. In contrast, the amplification of capital expenditures by the government, the transition to the European free trade regime and the activation of the co-investment fund may be reflected in overall business activity being greater than expected and might induce higher economic growth.

The abovementioned factors also **affect risks for inflation**. In particular, the expected low level of economic activity might be reflected in weak pressure on prices and may effectively delay the process of meeting the inflation target. In contrast, if, amid fiscal stimulus measures, aggregate demand creates more than expected pressure on inflation and inflationary risks in the region are reflected in imported inflation, the inflation rate might increase more than projected.

Based on an analysis of the forecasts and associated risks, on May 7, 2014 the Monetary Policy Committee made a decision to keep the policy rate unchanged at 4%. This decision reflects the macroeconomic forecasts of the National Bank.

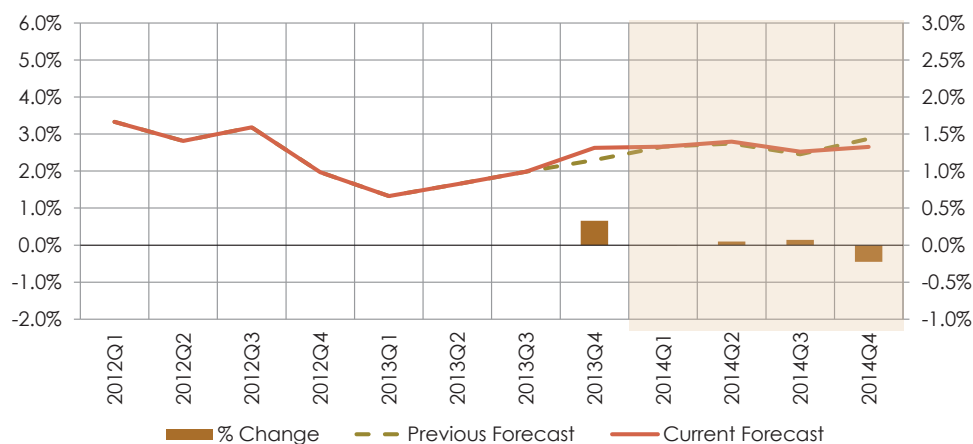
## 2. MACROECONOMIC FORECAST

### 2.1 EXTERNAL SECTOR OVERVIEW

According to current data, global economic growth slightly slowed in early 2014. This was preceded by higher than expected activity in the second half of 2013. The major determinant of economic activity are the developed countries, where monetary policy is subdued and weakened fiscal consolidation creates a favorable environment for growth. The economic outlook for countries with emerging economies is still largely dependent on the developed economies. The process of economic recovery in the latter has had a positive impact on the exports of emerging countries. In contrast, the economic recovery in developed countries creates a high risk of capital flight from developing countries and, therefore, gives rise to the need to tighten monetary policy, which restricts economic growth. The International Monetary Fund (IMF) has predicted that the global economy will grow by 3.6% in 2014 and by 3.9% in 2015.

Among the developed countries, the U.S. has contributed the most to global growth. Aggregate output in the U.S. grew by 1.9% in 2013, mainly due to an increase in domestic demand, exports and inventories. However, recent economic indicators point to a slight slowdown in this trend, mainly associated with unusually deteriorated climatic conditions. Overall, the 2014-2015 forecast is clearly positive, which is a result of moderate fiscal consolidation, subdued monetary policy, an improving real estate sector, and relaxed credit conditions. The IMF has forecast that the U.S. economy will grow by 2.8% in 2014 and by 3% in 2015 (see Figure 2.1).

Chart 2.1 U.S. Real GDP Annual Growth

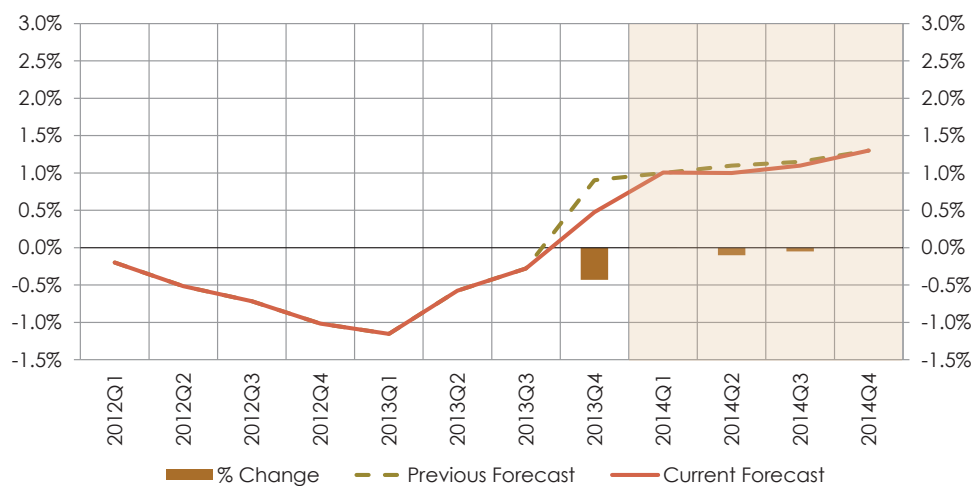


Source: OECD

The eurozone has overcome the recession and has had a positive growth rate since the second quarter of 2013. Several factors indicate the eurozone's economic recovery, with the stabilization of domestic demand and the growth of net exports being the most important of these. Although the eurozone GDP still contracted by 0.5% over the whole year, which was conditioned by high unemployment, tight credit conditions and small investments, the IMF has forecast that the recovery will continue and, in the wake of the 2013 fiscal expenditures, GDP growth will total 1.2% and 1.5% in 2014 and 2015, respectively (see Figure 2.2).

Ukraine's current geopolitical crisis has raised substantial risks in Eastern Europe and the Commonwealth of Independent States (CIS) that may be doubly damaging for the economy of Georgia. First, the threat of reduced exports to Ukraine, together with a worsening economic outlook for the region, is significant. The Russian-Ukrainian conflict is likely to complicate trade relations with both countries and other CIS members. This is accompanied by the fact that in the near future Armenia will join

Chart 2.2 Eurozone Real GDP Annual Growth



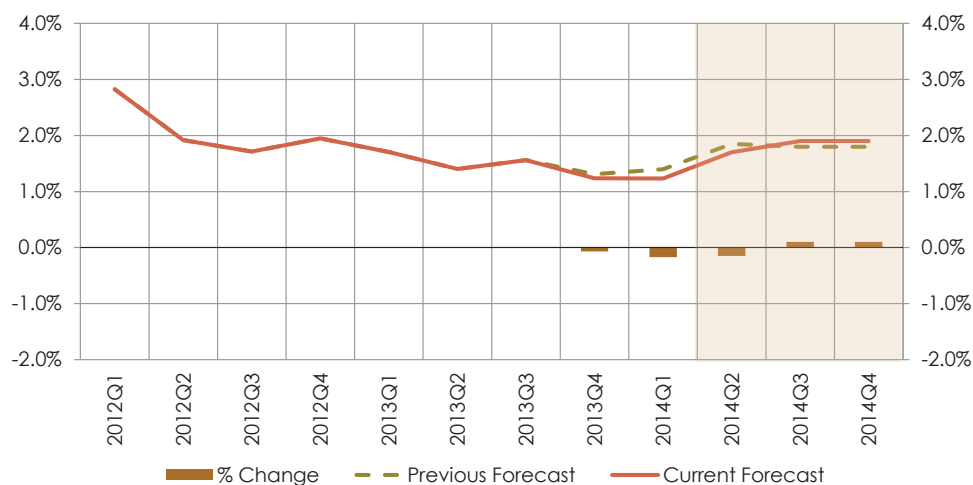
Source: Eurostat

the Eurasian Customs Union (following Kazakhstan and Belarus). It should be noted that due to the current risks, the IMF has lowered the growth forecast for Russia's GDP in 2014 by 1.7 percentage points, to 1.3%, while the 2015 growth forecast was cut by 0.2 percentage points, down to 2.3%. As for Ukraine, the IMF estimates that its economy will be reduced by 5% in 2014, which is a significantly deteriorated figure as compared to the projections made in October 2013.<sup>2</sup>

Turkey's economy increased by 4.3% in 2013 at the expense of amplified private consumption growth. However, some slowdown in this trend is expected owing to the macroprudential policy pursued. Increased interest rates in early 2014, in response to the depreciation of the exchange rate, will make a significant negative contribution to economic growth, the IMF's forecast of which has been reduced from 3.5% to 2.3%. According to the same projections, Turkey's GDP will increase by 3.1% in 2015.

Global prices for major commodity groups in 2013 were characterized by relative stability. There were only moderate fluctuations in energy and grain prices as a result of bad weather. The IMF predicts that prices on energy, metals and food will fall in 2014, which will mainly be caused by increased supply and continued weak demand. Eurozone inflation will equal 0.9% in 2014; however, the forecast for Georgia's neighboring trading partners has been revised upward. Specifically, compared to October 2013, the IMF's forecast of consumer price inflation increased by 0.5 pp to 5.8% for Russia, by 3 pp to 7.8% for Turkey, and by 14 pp to 16% for Ukraine.<sup>3</sup> With this in mind, effective inflation will rise and thus affect Georgia's imported inflation, but this impact will be moderate.

Chart 2.3 U.S. CPI Annual Inflation



Source: OECD

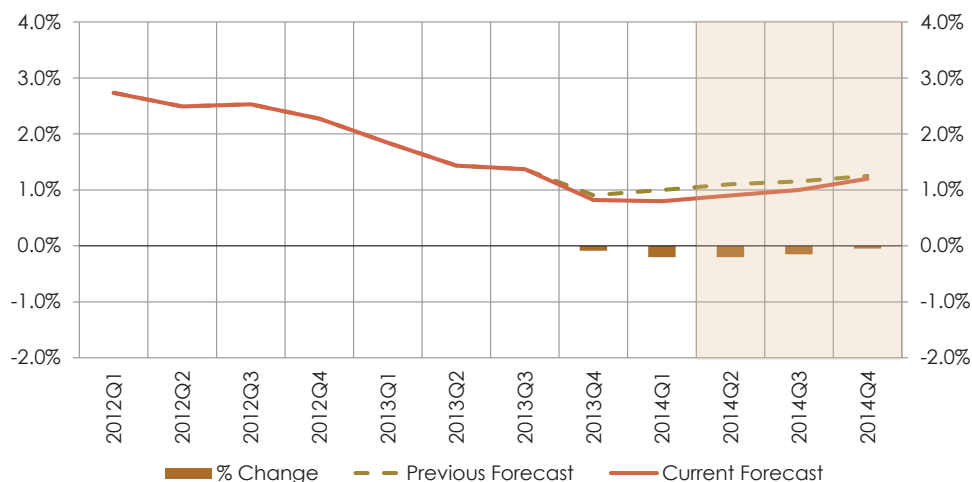
<sup>2</sup> Source: <http://www.imf.org/external/np/sec/pr/2014/pr14189.htm>.

<sup>3</sup> Source: <http://www.imf.org/external/np/sec/pr/2014/pr14189.htm>.



Monetary policy in the U.S. remained largely subdued during 2013. However, an increase in interest rates on Treasury securities has been observed since May 2013 when the Federal Reserve announced a gradual tapering of the monetary stimulus program. However, market expectations indicate that investors do not expect monetary policy rates to rise until the second half of 2015. Amid low inflation expectations in the euro area, it is expected that the relaxed monetary policy, which is a prerequisite for overcoming the recession, will be maintained for a long period. Emerging and developing countries tightened their monetary policies in the second half of 2013 because of the increase in bond interest rates and real signs of economic recovery in developed countries. This step somewhat restricted the unwanted flow of capital, especially in the case of Turkey. Overall, considering global trends, market expectations point to interest rates remaining at a stable level in the medium term.

Chart 2.4 Eurozone CPI Annual Inflation

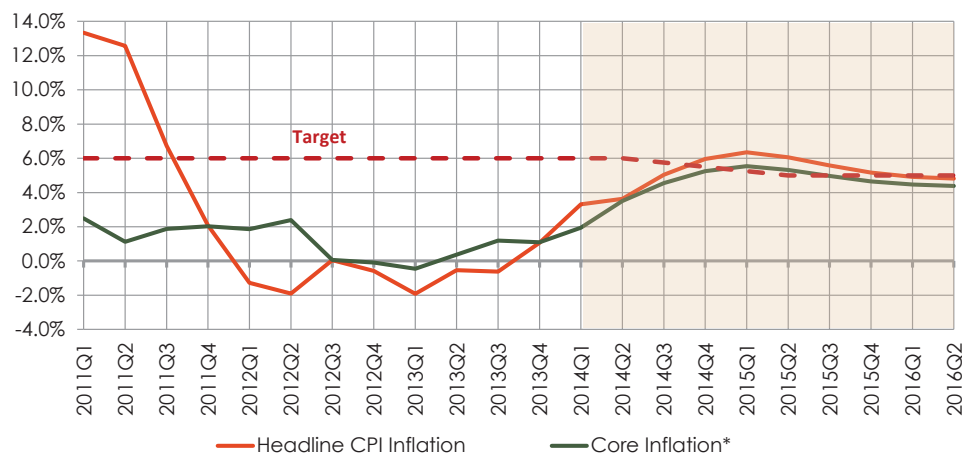


Source: OECD

## 2.2 MACROECONOMIC FORECAST

In the first quarter of 2014, inflation had an increasing trend and the annual inflation rate stood at 3.5% in March. In the same period, core inflation, which implies a change in consumer prices excluding food and energy, stood at 2.2%. Despite the increase of inflation, the annual inflation rate is still below the National Bank of Georgia's target of 6%. This retardation is still partly due to exogenous factors; however, insufficient pressure on consumer prices from the demand side is also an important factor. The increase of inflation in the first quarter was affected by the elimination of the negative base effect that existed in previous quarters. In addition, because of improved economic activity, there has been an increase in domestic prices, although demand-side inflationary pressures have still remained weak.

Chart 2.5 Headline and Core Inflation

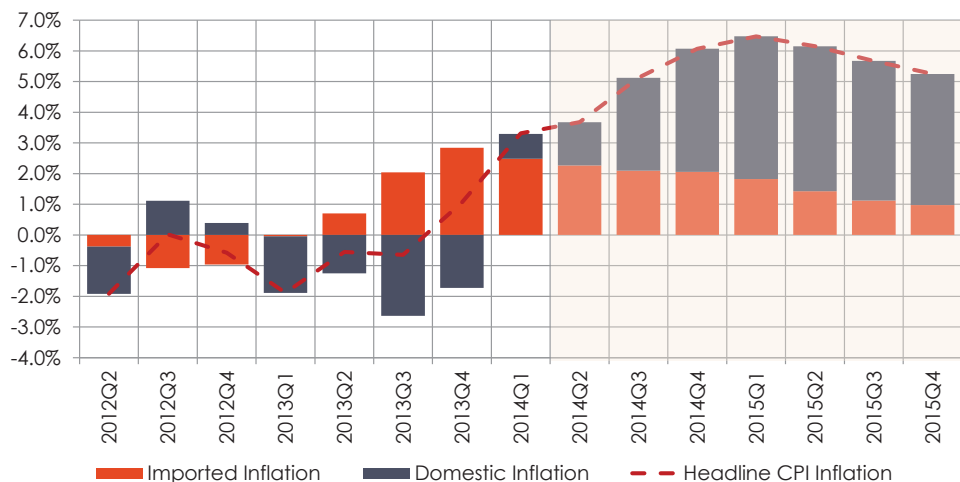


\* Core inflation excludes food, energy and utilities' prices from the basket

Source: National Bank of Georgia

External factors also contributed to inflation in the first quarter of 2014. The depreciation of the GEL against the USD was reflected in deflation of the nominal effective exchange rate, which contributed to an increase in imported inflation (see Figure 2.6).

Chart 2.6 Headline Inflation Decomposition



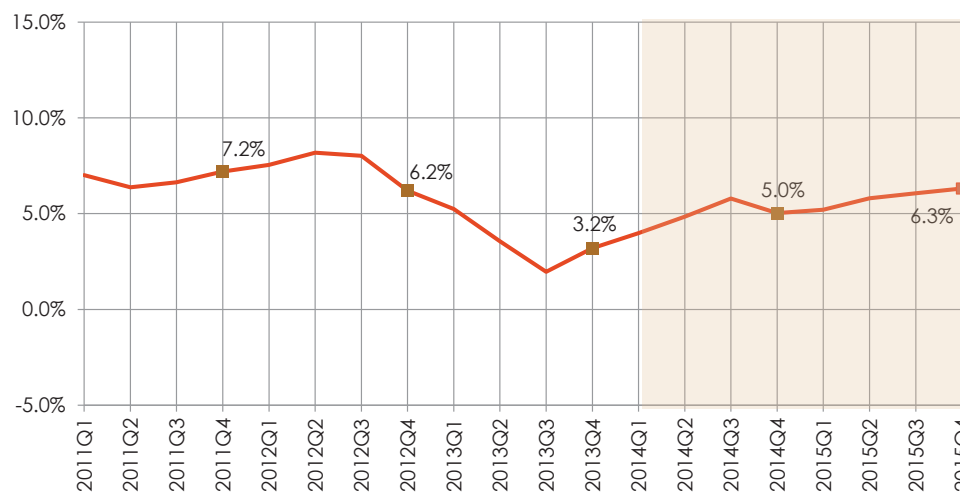
Source: National Bank of Georgia

According to the current forecasts, it is expected that the upward trend of consumer prices will be maintained in 2014 as well. Annual inflation will reach its target in the second half of 2014 (see Figure 2.5).<sup>4</sup> One of the determinants of the increasing trend of prices will be domestic prices, which will be supported by higher demand due to improved business confidence and increased fiscal expenses. Moreover, imported inflation caused by an increase in the effective inflation of trade partners will also contribute significantly.

The major risk factor for the forecast remains in the supply side, namely the seasonality of agricultural crop production. The demand side is also important. The expected growth in economic activity leads to higher domestic prices. Inflationary risks from the foreign sector have also increased. In particular, high inflationary risks in the region may cause a higher than expected increase in imported prices.

According to preliminary data from GeoStat, in the first quarter of 2014 the annual growth rate of economic activity was 7.4% (see Figure 2.7). The economic growth was revealed by the moderate growth of consumption and economic activity. Increased demand also improved activity in the financial sector, which was reflected in the moderate growth in loans in the first quarter.

Chart 2.7 Real GDP Growth (Annual Growth of Last four Quarters)



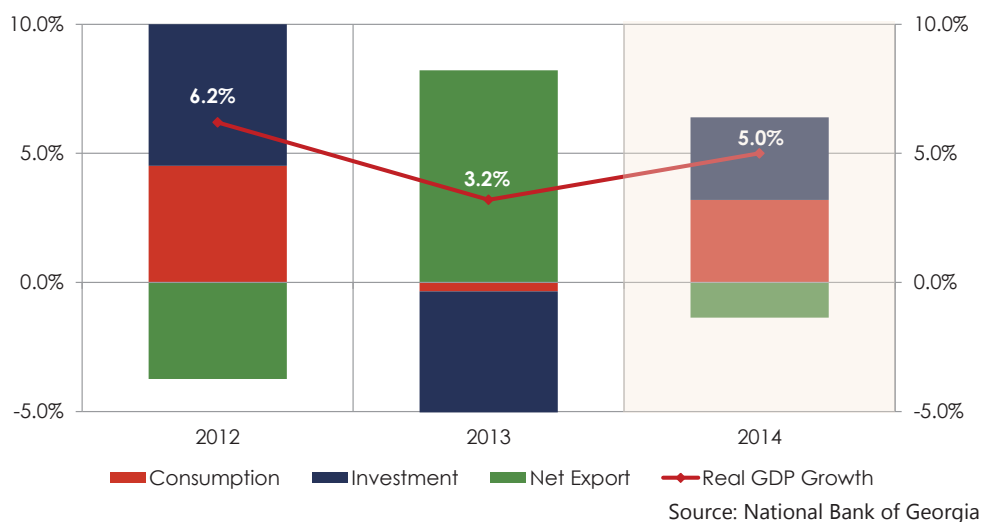
Source: National Bank of Georgia

<sup>4</sup> The inflation target will be reduced to 5% from 2015

According to the current baseline forecast, real GDP growth in 2014 will be around 5% (see Figure 2.7). The forecast is based on strong fiscal stimulus measures and, partly, on the private sector’s recovery. This forecast is balanced by risks existing in both directions.

On the one hand, possible low levels of foreign investment and reduced demand on exports, as caused by global economic activity and increased external risks in the region, may have a negative impact. On the other hand, an expected increase in the activity of government capital expenditures, alongside an improvement in business confidence with the prospect of a free trade regime with Europe, may lead to higher than expected economic activity.

Chart 2.8 Components of Real GDP

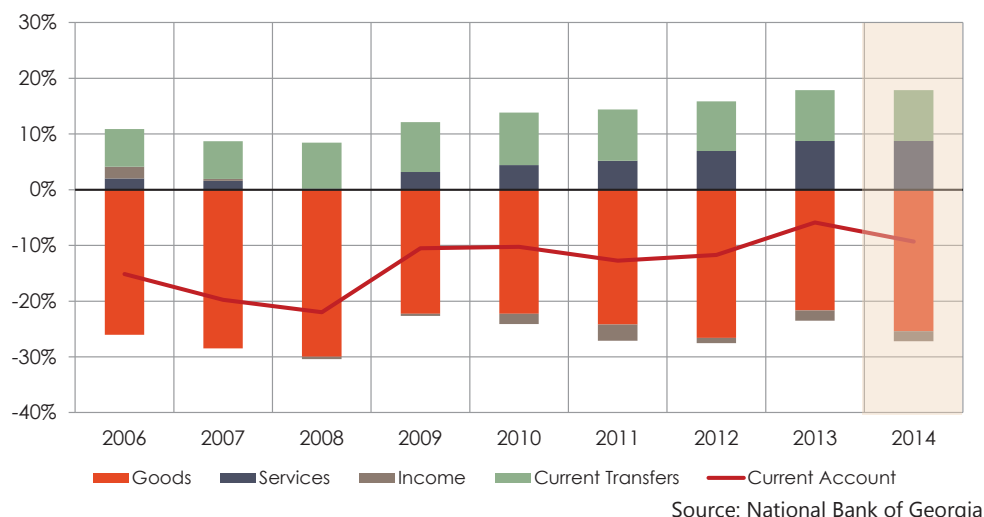


According to the forecast, the contribution of private and government consumption to GDP growth will significantly increase to become one of the major determinants of growth in 2014 (see Figure 2.8). After the high growth of 2013, the contribution of net exports will decrease in 2014.

Due to increased imports, the trade balance in the first quarter of 2014 deteriorated by 30% according to the preliminary data, and the negative trade balance amounted to 550.6 mln USD. The annual growth rate of exports in the first quarter of 2014 was 23.2%, which mainly came from consumer goods. The export of goods largely depends on both the domestic demands of trading partner countries and on global economic growth. The service sector’s (including tourism) potential for growth also contributes to export growth. As was the case in the fourth quarter of 2013, there was an increase in imports in the first quarter of 2014. According to preliminary data, this growth rate was 17%. Consumer goods were still the major determinant of import growth.

The improved trade balance had a positive impact on the current account deficit for 2013, which is an important indicator of macroeconomic imbalances. The current account deficit in 2013 was 5.9% of GDP. The reduction of the current account deficit in 2013 was due to an increase in exports and a decline in the import of investment goods. It is expected that imports of these types of goods will increase in subsequent years with the inflow of foreign capital, which in the short term will have a negative impact on the current account deficit. According to the current forecast, the current account deficit will be within 8.4% of GDP in 2014.

Chart 2.9 Current Account Components Ratio to GDP



### 2.3 ALTERNATIVE FORECAST SCENARIO

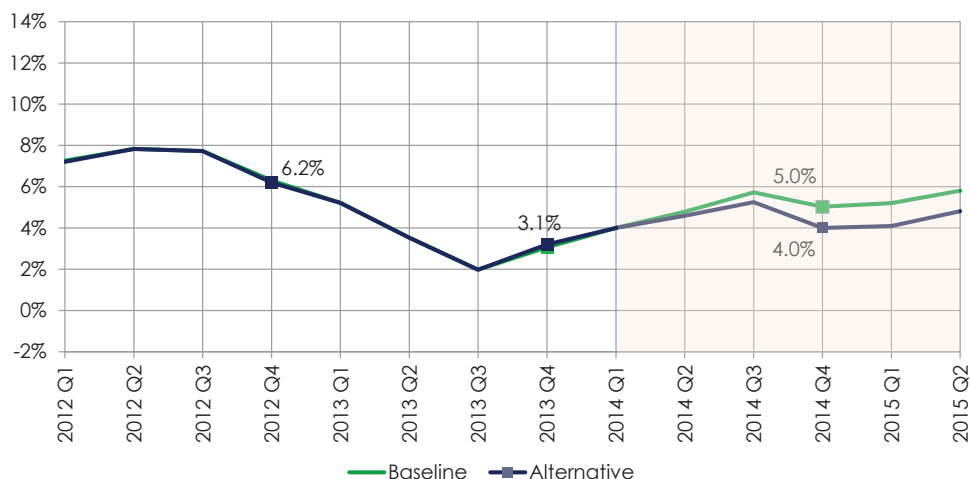
The alternative forecast scenario considers the impact of two main macroeconomic risks affecting the GDP growth and inflation forecasts. Firstly, it takes into account the effects of increased tensions between Ukraine and Russia and thus downwardly revises the economic growth forecasts for Georgia’s main trading partner countries. Secondly, due to higher geopolitical risks and the Federal Reserve exiting its policy of quantitative easing, the currencies of Georgia’s main trading partners may depreciate with respect to the U.S. dollar. This would mean the appreciation of the lari’s nominal effective exchange rate, which, in turn, would translate into lower imported inflation. The alternative forecast scenario gives the quantitative effects of the aforementioned factors on the inflation forecast (see Figure 2.10).

Chart 2.10 CPI Inflation According to Baseline and Alternative Forecasts



Falling economic growth in Georgia’s trading partner countries will have a negative impact on Georgia’s exports, as well as on remittances and investor sentiment. This will become manifested in lower growth relative to the baseline forecast. According to this scenario, GDP growth for 2014 will be around 4% (see Figure 2.11). Subdued economic activity and inflation will be partly accommodated by a slower exit from the easy monetary policy. As a result, the alternative scenario shows that inflation will be around 5% in the second half of 2014 and, after a small additional hike, will stabilize on the 5% inflation target of the National Bank for 2015.

Chart 2.11 Real GDP Growth According to Baseline and Alternative Forecasts (annual growth of the last four quarters)

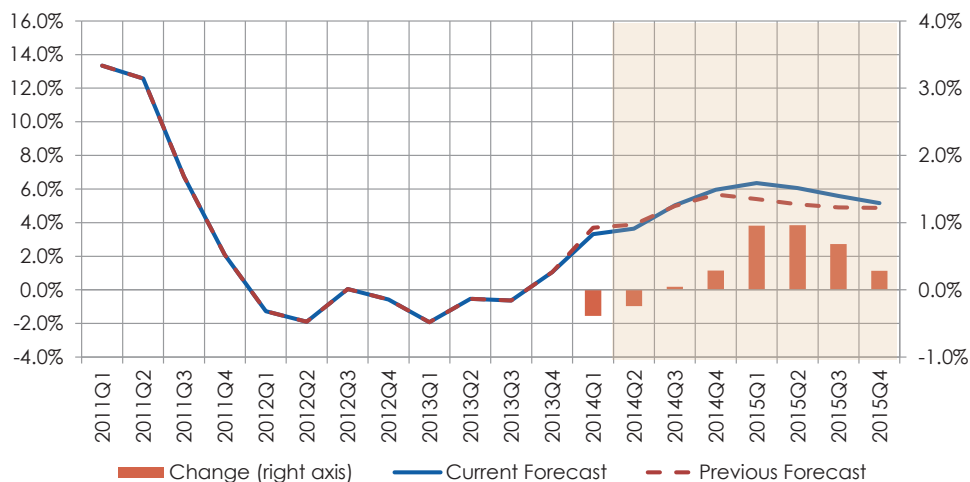


Source: National Bank of Georgia

### 2.4 COMPARISON WITH THE PREVIOUS FORECAST

The economic growth forecast for 2014 has not been changed compared to the previous quarter. In addition, the inflation forecast for 2014 is practically the same, however, this has been revised upwards for 2015. The existing forecast for 2014 is balanced with risks on both sides, while for 2015 upwardly revised inflation forecasts for Georgia’s trading partner countries have dominated the downside risks. This, in turn, is reflected in higher imported and, hence, headline inflation (see Figure 2.12).

Chart 2.12 Change in Forecast of Headline Inflation



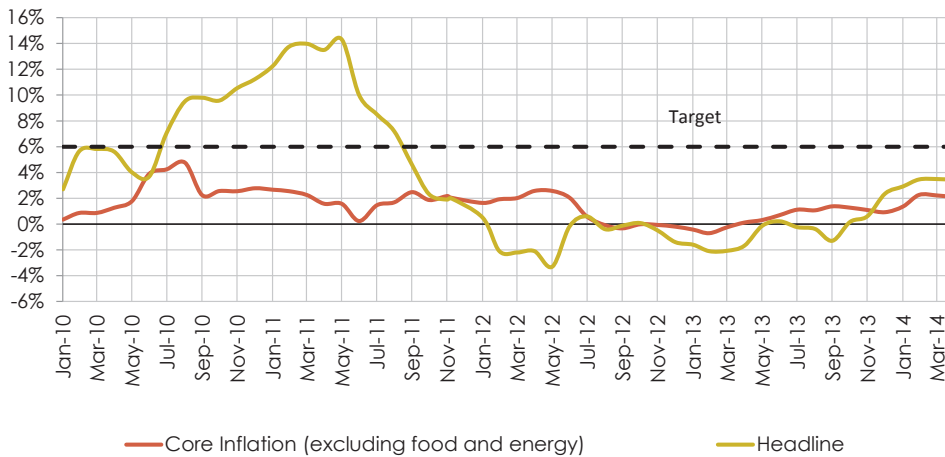
Source: National Bank of Georgia

### 3. CONSUMER PRICES

Annual inflation is gradually approaching the NBG’s medium-term target of 6%.<sup>5</sup> In the backdrop of growing headline inflation, core inflation is gradually increasing. The annual change of the consumer price index excluding food and energy stood at 2.1% by the end of April 2014 (see Figure 3.1).

« Headline inflation is approaching the NBG’s target level and standing at 3.4% in April, 2014.

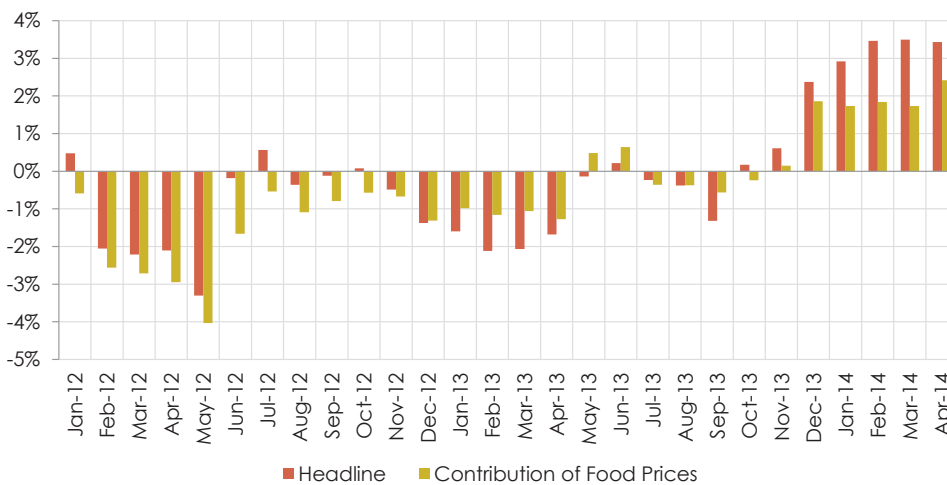
Chart 3.1 CPI and Core Inflation



Source: National Bank of Georgia

Changes in food prices are still important for the dynamics of the development of the consumer price index. From November 2013, the overall price level of food started to rise. During the next couple of months food inflation further increased. The annual price change on food products stood at 6.5% by the end of the first quarter of 2014 and 8.2% by April, contributing approximately 2.4 percentage points to headline inflation (see Figure 3.2).

Chart 3.2 Contribution of food inflation in headline inflation



Source: GeoStat and National Bank of Georgia

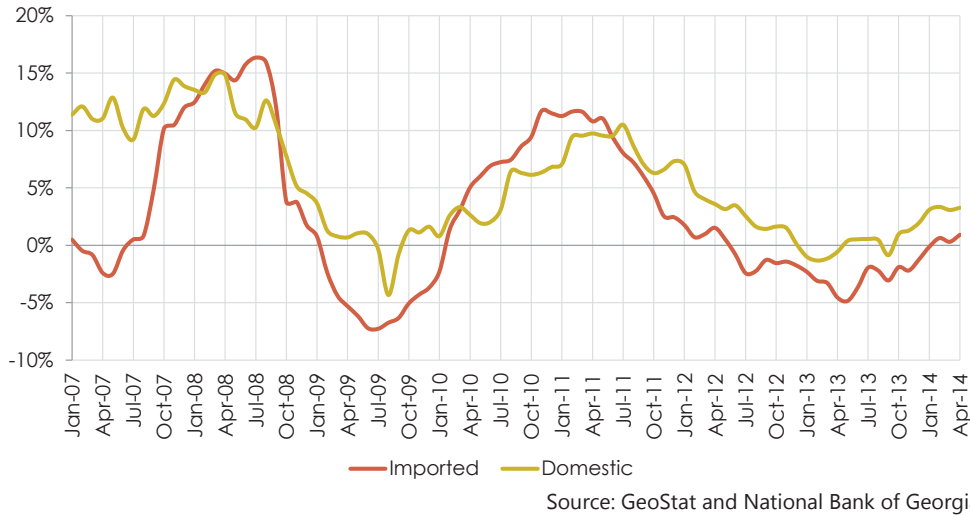
5 The inflation target will decrease to 5% in 2015.

The price cut on utility services implemented during 2012-2013 had a significant negative effect on the overall price level in the country. Electricity tariffs were reduced from the beginning of 2013 and gas tariffs were cut in March. However, this effect gradually faded away, which placed upward pressure on the overall price level.

In terms of supply factors, it is worth noting that the growing deflation on imported goods decreased during the fourth quarter of 2013. Declining prices on imported goods has further lowered since the beginning of 2014. From February, in line with the high inflation rates in Georgia’s main trading partner countries, the change of the overall price level became positive. By the end of April, the annual imported inflation amounted to 0.9%, contributing approximately 0.2 percentage points to headline inflation (see Figure 3.3).

« Inflation rate on imported consumer goods increased and stood at 0.9% by the end of April .

Chart 3.3 Imported and Domestic Inflation



During the last quarter of 2013, the negative impact on overall prices from factors existing on the demand side of the economy declined. Against the backdrop of the soft monetary policy, low interest rates in the economy resulted in a sufficient growth of credit activity. During the first quarter of 2014, the credit growth rate was about 17%.<sup>6</sup> Increased lending to the economy caused domestic demand to rebound, which had a positive impact on consumer prices.

« Aggregate demand also causes inflation rate to increase moderately.

Thus, against the backdrop of loose monetary policy, economic activity has been improving since the fourth quarter of the previous year. The Gross Domestic Product gap remains negative, but, in line with growing aggregate demand, a gradual closing of that gap is expected. This will place inflationary pressure on overall price levels and ensure that inflation rate will approach to the target level.

6 Excluding the exchange rate effect.

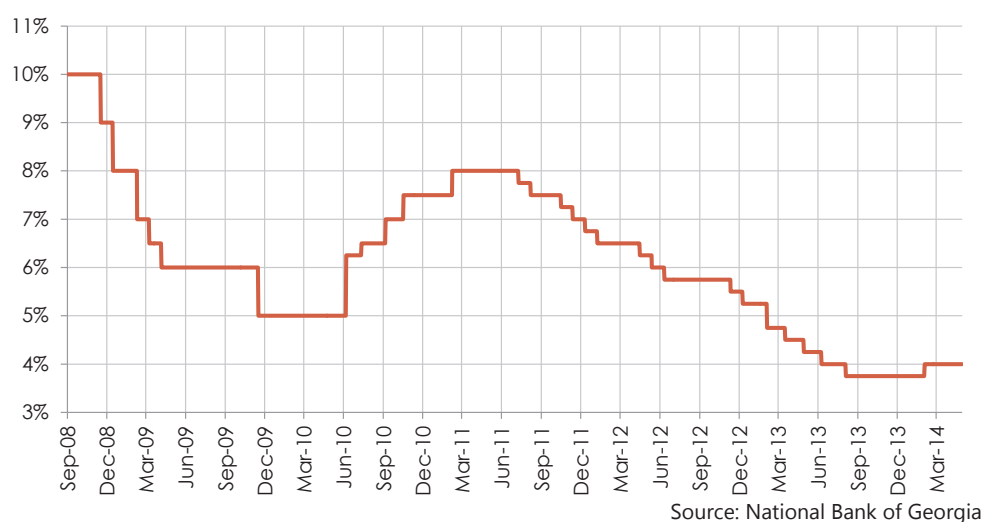
## 4. MONETARY POLICY

Starting from 2014, the National Bank of Georgia started the process of exiting its loose monetary policy stance. As a consequence, the policy rate was increased by 25 basis points to 4% at February's meeting of the Monetary Policy Committee (MPC). Against the background of improved bank credit activity, increased domestic demand and the recovery of economic activity since the second half of 2013, it was expected that the inflation rate would reach its target level by the end of 2014. Furthermore, foreign demand continued to grow. There was thus no need to retain an accommodative monetary policy.

*« Starting from 2014 the National Bank of Georgia started the process of exiting its loose monetary policy stance.*

In spring 2014, geopolitical risks evolved that contained economic uncertainty for the whole region. The deterioration of the economic environment may result in decreased demand for Georgian exports, lowered investor sentiment and reduced remittances from abroad. A materialization of these risks will put downward pressure on foreign demand. However, coupled with the expected recovery of domestic demand and the removal of the base effect, this will support the convergence of the inflation rate with its target level. Taking all of these factors into consideration, the Monetary Policy Committee decided to keep the policy rate unchanged at its meeting in March, although it still believed that there was a need to exit the accommodative monetary policy.

Chart 4.1 Monetary Policy Rate



The last Monetary Policy Committee meeting was held on 7 May and the policy rate was left unchanged. This decision was based on the existing inflation forecasts and on the macroeconomic analysis of ongoing events in both Georgia and outside its borders.

*« The National Bank of Georgia keeps the policy rate unchanged at 4 percent.*

Price developments follow the dynamics forecasted by the NBG. Starting from the fall of 2013, the inflation rate has exhibited a growth trend. It is expected that inflation will reach its target level in the second half of 2014. In April, overall annual CPI inflation stood at 3.4%. This was mainly a result of the removal of the base effect and the growth of import prices. Monthly inflation stood at 0.3%.

According to preliminary estimates, economic growth amounted to 7.4% in the first quarter of 2014. Even though the GDP gap remains negative, this is expected to gradually decline against the backdrop of increased domestic demand – thus putting upward pressure on prices.

Credit activity continues to evolve, further stimulating domestic demand. In March 2014, the growth rate of commercial bank loans stood at 17% (excluding exchange

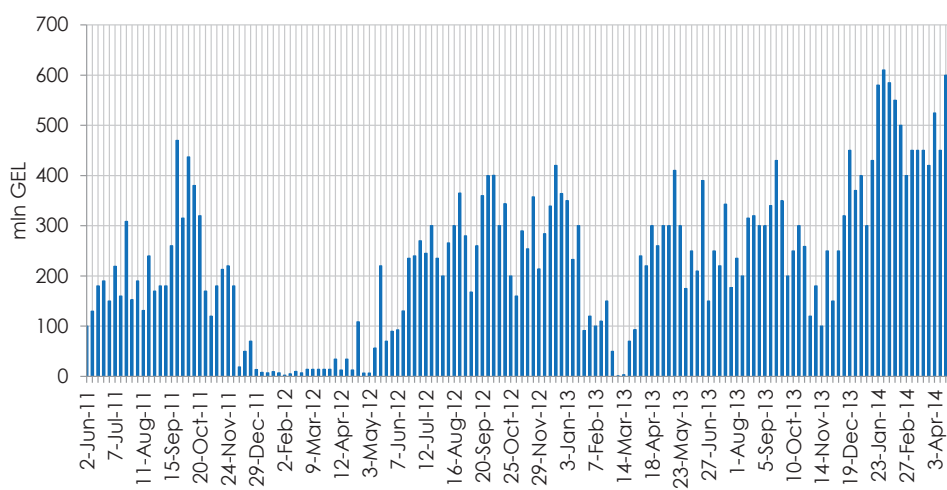


rate effects). The growth of domestic demand is also manifested in external sector data. In March, registered imports grew by 15.9%. Foreign demand has significantly increased as well, with the annual growth rate of imports standing at 23.8% in March. However, some slowdown has been observed in the growth rates of remittance inflows and tourism revenues.

According to the existing forecasts of the NBG, it is expected that the inflation rate will reach the target in the second half of 2014. Considering that this forecast is balanced by risks from both sides, the MPC considered it appropriate to leave the policy rate unchanged at 4%.

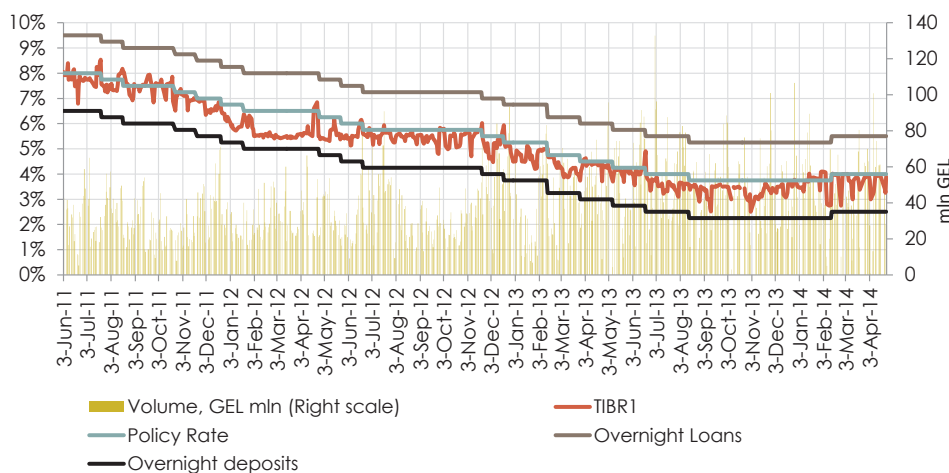
In order to ensure the efficiency of monetary policy, it is important for the changes in the monetary policy rate to be reflected on interbank interest rates and ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. At this stage, demand for this instrument is high, which improves the transmission of changes made to the policy rate to interbank interest rates. Short-term interbank rates are stable and hover around the policy rate.

Chart 4.2 Refinancing Loans



Source: National Bank of Georgia

Chart 4.3 Interbank Money Market



Source: National Bank of Georgia

## Box 1 LARIZATION

Under the inflation targeting regime, the one-week refinancing rate represents the main policy instrument. Changes in the policy rate are transmitted to the aggregated demand and, ultimately, to inflation through monetary policy transmission channels. Dollarization represents one of the factors impeding the efficiency of monetary policy. It weakens the monetary transmission mechanism and is associated with higher social costs. Dollarization implies that a certain portion of the population prefers using foreign currency as a medium of exchange, for their savings or other purposes. However, foreign currency interest rates are out of the NBG's control.

Georgia represents a small open dollarized economy. Promoting the use of domestic currency and thereby increasing the larization level represents a high priority goal for the NBG. The dollarization problem in the country evolved as a result of past economic and political instability and its reduction represents a long-term objective. Over the past years the NBG has undertaken various measures to overcome this problem and enhance trust in the domestic currency. Changes were undertaken with respect to the NBG's instruments and regulations. The NBG also aimed at increasing public awareness. Furthermore, improvements in the transparency and predictability of the NBG's policy were also emphasized (detailed information about the NBG's actions can be found in the annual reports).

The reforms undertaken by the NBG have significantly enhanced the development of GEL financial markets and the financial sector, thus promoting the growth of larization. In March 2014, the larization of loans and deposits stood at 39.4% and 44.2% respectively. It is also significant that a growth trend can be observed. Excluding exchange rate effects, in March 2013 the same measures amounted to 31.9% and 37.8% respectively.

The growth of individual loans in the domestic currency significantly contributed to the improvement of the loan larization measurement. In March 2014, the individual larization level reached 60% – its historic maximum. This rate has increased by 10 percentage points on an annual basis. The increased availability of GEL resources and the popularization of GEL loans with floating interest rates significantly contributed to these developments.

From the outlook of the larization of deposits, a significant improvement in the larization rate of term deposits must be noted: this measure improved from 17.5% to 23.6% during the past year (excluding exchange rate effects).

The NBG will continue implementing further measures to support the growth of the larization level in future.

Chart 4.4 Larization of Loans (excluding exchange rate effects)

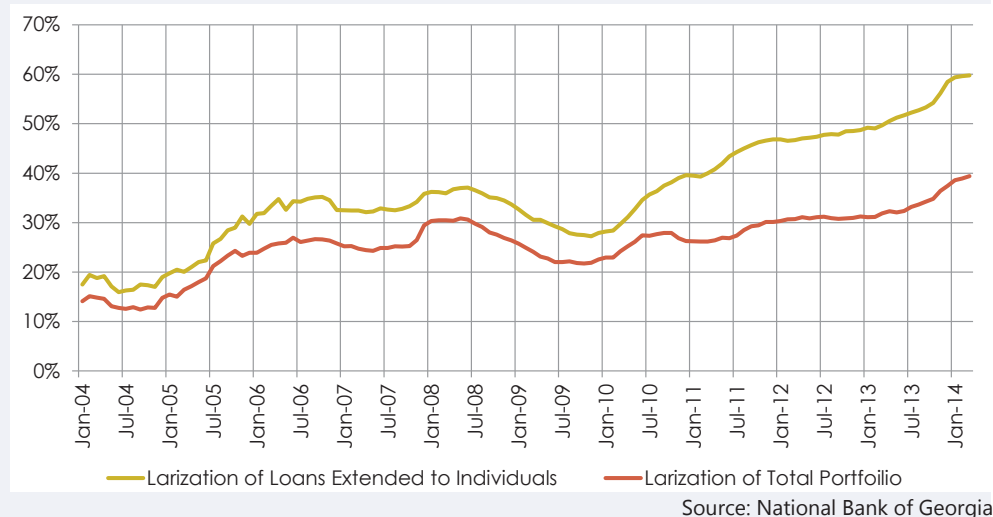
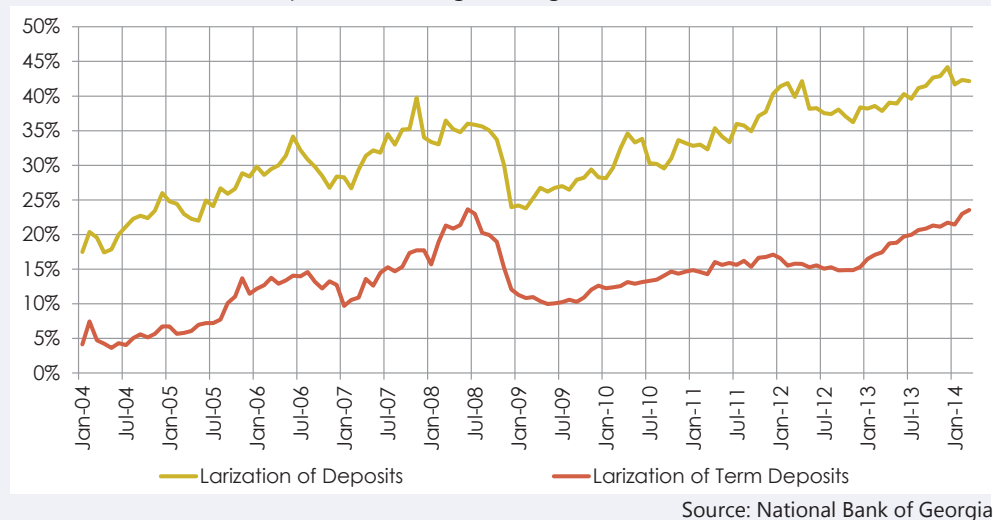


Chart 4.5 Larization of Deposits (excluding exchange rate effects)



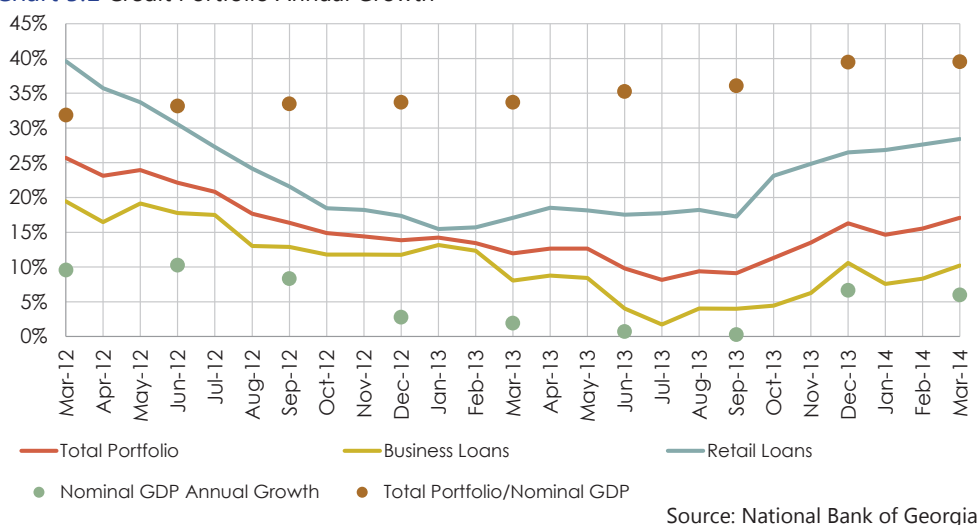
## 5. FINANCIAL MARKET AND TRENDS

### 5.1 LOANS

In March 2014, the annual growth rate of the loan portfolio increased by 0.8 percentage points compared to December 2013 and amounted 17%.<sup>7</sup> Credit growth was largely caused by an increase in demand for retail loans. In the first quarter the private sector was less active as compared to the previous quarter, which was due to a decrease of fiscal stimulus measures and the growth of foreign risks. In the context of currencies, the growth of the loan portfolio was largely caused by an increase in domestic currency loans, which, in turn, was due to an increase of loans with floating interest rates.

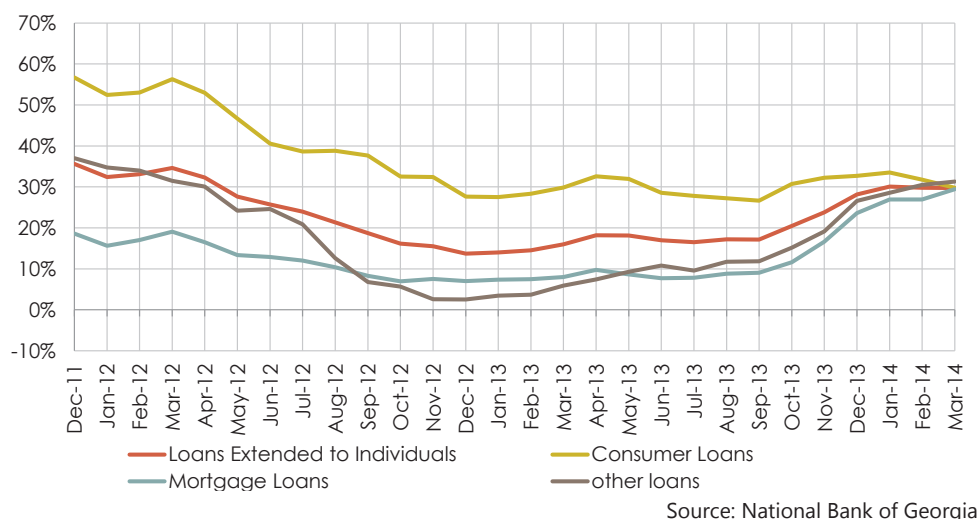
« The growth of the loan portfolio was largely caused by increase in domestic currency loans, which in turn was due to an increase in GEL loans with floating interest rate, given the loose monetary policy.

Chart 5.1 Credit Portfolio Annual Growth



After a less active beginning of the year, the annual growth of the loan portfolio picked up in March 2014, while the credit to nominal GDP ratio declined by 0.4 percentage points compared to the previous quarter and amounted 39.5% (see Chart 5.1). Retail loans, which predominantly include consumer and mortgage loans, continue to exhibit

Chart 5.2 Retail Loans Annual Growth



<sup>7</sup> The growth rate does not account for the effect of exchange rate movement on the loan portfolio.

a high growth rate. This is largely due to a decline in interest rates and the base effect. In March the annual growth rate of consumer loans amounted 29.7%, while the growth rate of mortgage loans increased to 29.4%.

In March, the annual growth rate of the loan portfolio to legal entities amounted to 9.8%, which is 0.8 percentage points lower than in December 2013. In the first quarter of 2014 business expectations have worsened due to increased domestic and foreign risks. However, according to the credit conditions survey, it is expected that demand for business loans will pick up in the current quarter.

An analysis of business loans by sector reveals that the transport, energy, agriculture and trade sectors posted growth in terms of credit, while the volume of outstanding loans disbursed to the construction and manufacturing sectors increased only slightly. The continued high growth of loans to the agricultural sector was mainly due to the state assistance program. In March, loans to the agricultural sector grew by 180%, but it should be noted that agricultural sector loans make up only a small proportion of the total loan portfolio (1.5% of loans to legal entities).

The share of non-performing loans decreased by 0.2 percentage points in the first quarter of 2014 as compared to the previous quarter and stood at 7.3%. According to the data from March, the share of non-performing loans in the national currency increased by 0.1 percentage points compared to December, amounting to 5%, while the share of non-performing foreign currency loans decreased by 0.2 percentage points and amounted to 8.8%. In the first quarter the number of loans written off amounted to 34.2 million GEL, which is 56.7% less than in the previous quarter.

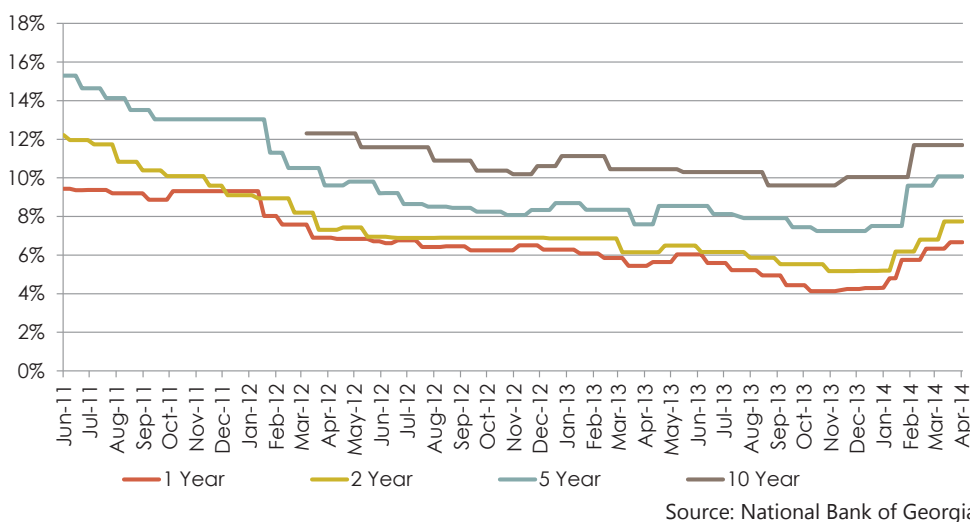
« According to the credit conditions survey, it is expected that demand for business loans will pick up in the current quarter.

« The share of non-performing loans decreased in foreign currency, but increased slightly in national currency, as compared to the previous quarter.

## 5.2. INTEREST RATES AND CREDIT CONDITIONS

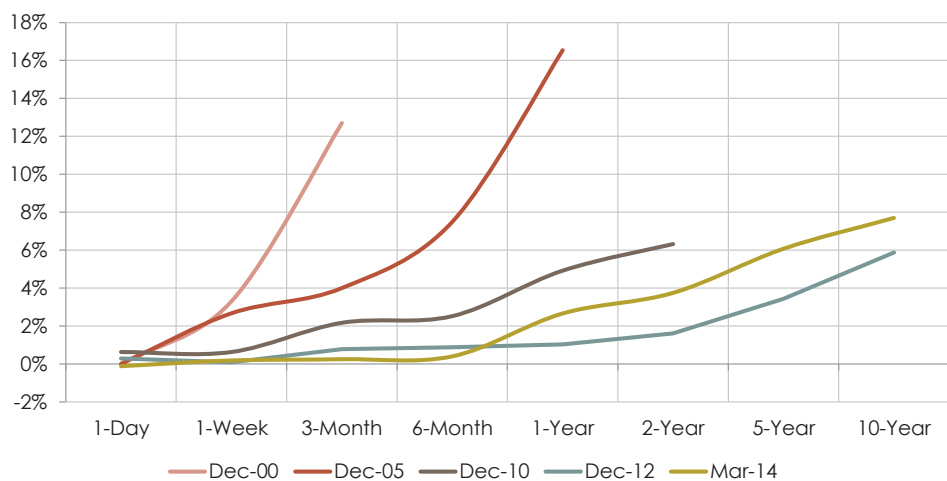
In March 2014, in line with macroeconomic forecasts, the monetary policy rate did not change and stands at 4%. Changes in monetary policy are transmitted to the real economy with a time lag. However, the easing of the monetary policy reduced interest rates. In the first quarter of 2014, the interest rate on loans and deposits decreased, while rates on short and long term government securities increased – supposedly as a result of a rise in inflationary expectations.

Chart 5.3 Interest Rates on Government Securities



It should be noted that the spread between long-term assets and the monetary policy rate has increased. However, the slope of the yield curve displays a declining trend. The National Bank’s monetary policy agenda reduces liquidity and interest rate risks. Additionally, the improvement of the interbank market reduces the liquidity risk of securities. These tendencies should reduce the price of long-term assets and thus promote internal investments and economic growth.

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

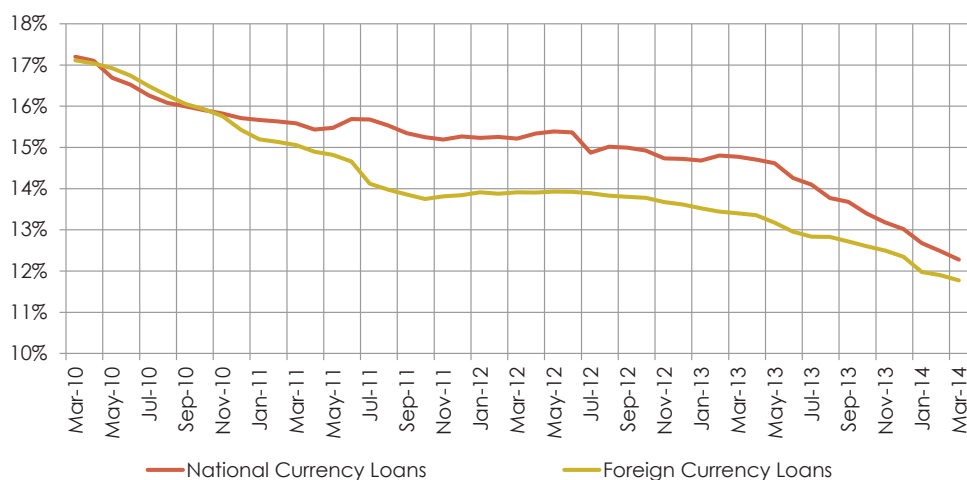


Source: National Bank of Georgia

Because of increased competition among banks and the eased monetary policy, interest rates on loans have declined to both business and retail sectors. In March 2014, as compared to December 2013, interest rates on business loans in the domestic currency have declined by 0.7 percentage points, amounting to 12.3%, while for foreign currency business loans the interest rate declined by 0.6 percentage points, amounting to 11.8%.

« Interest rates continue to decrease on loans to both corporate and retail segments.

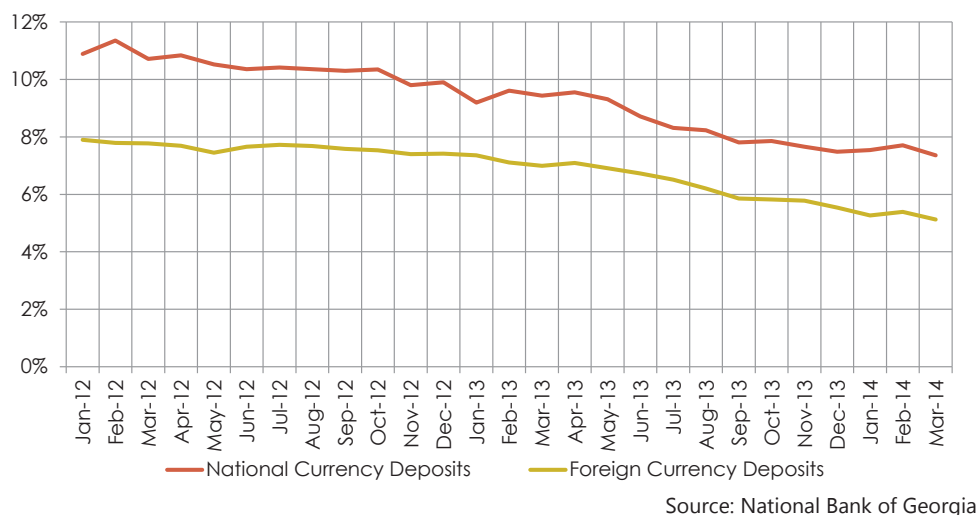
Chart 5.5 Average Interest Rates on Business Loans



Source: National Bank of Georgia

The reduction of interest rates continues on deposits in both the domestic and foreign currencies. Compared to the previous quarter, the interest rate on deposits in the domestic currency has declined by 0.1 percentage points, amounting to 7.4%, while the interest rate for foreign currency deposits decreased by 0.4 percentage points, amounting to 5.1%. The decline in interest rates is partly a result of monetary policy easing. In addition, the contributions of both fundamental and other factors are significant. Fundamental factors include: risk premium reductions, macroeconomic stability, the growth of savings and the improvement of banking sector efficiency. The reduction of deposit rates was also due to the accumulated excess liquidity of banks.

Chart 5.6 Average Interest Rates on Deposits



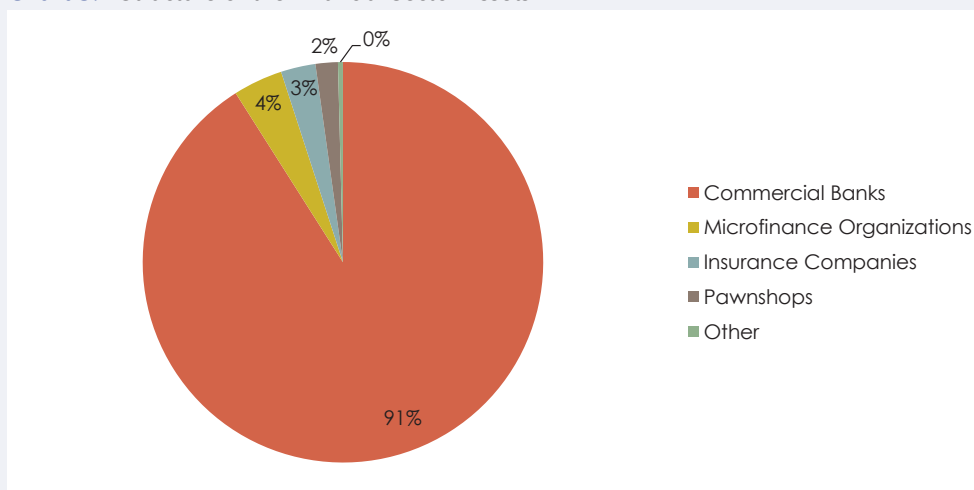
## BOX 2 ASSESSMENT OF THE STRUCTURE OF TOTAL FINANCIAL SECTOR ASSETS

Deriving from the goal of maintaining financial stability, it is crucial to have a comprehensive picture concerning the volume and distribution of financial sector assets across different financial institutions. The National Bank of Georgia regularly collects information regarding the asset structure of key financial market players. However, the assets of pawnshops, which play quite a significant role in issuing funds for households, were previously missing from the coverage. With this in mind GeoStat conducted a survey of pawnshop assets at the end of 2013.

The above mentioned survey revealed that the total assets of pawnshops in 2013 constituted 340 mln GEL, of which 91.5% are loans, 4% comes from the cash in pawnshops, and the remainder of pawnshop assets are redistributed among assets placed in banks and other types of assets.

As a result of the pawnshop assets survey the structure of the total financial sector assets became more complete. In 2013, the total amount of financial sector assets reached 19 bln GEL, out of which 91% are banking sector assets, with pawnshops accounting for 1.8% of the total assets (see Chart 5.7). The financial sector assets to GDP ratio, which is one of the most common measurements of financial sector development, reached 71%. Banking sector assets over GDP reached 64.4%. Despite the continuous growth of the financial sector assets to GDP ratio, in this indicator Georgia still lags behind the majority of Central and Eastern European countries. In some countries, the financial sector assets to GDP ratio is higher than 100% (for example, in the Czech Republic, Latvia, Estonia, and Hungary).

Chart 5.7 Structure of the Financial Sector Assets

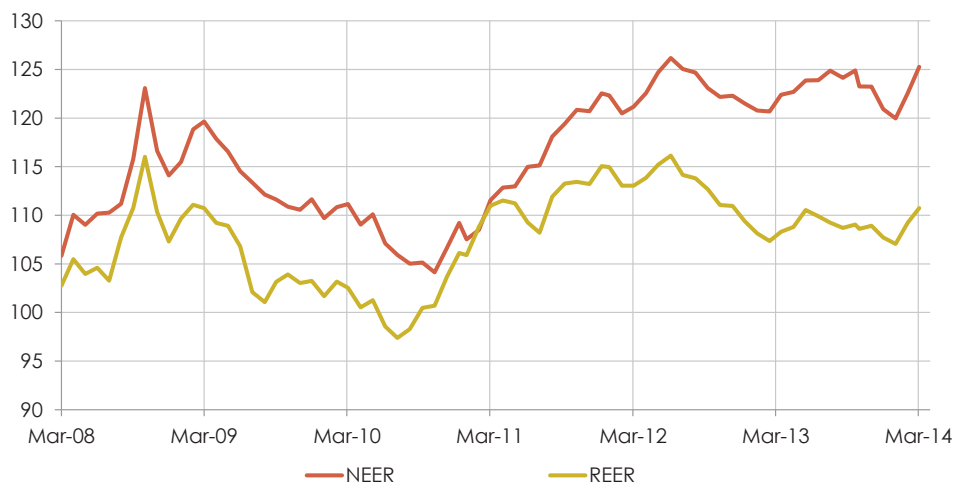


Source: National Bank of Georgia

## 5.3. EXCHANGE RATE

In the first quarter of 2014, the GEL to U.S. dollar exchange rate depreciated by 3.8%. During the same period, the GEL exchange rate depreciated against the euro by 4.5% and appreciated against the Turkish lira by 5.2%. The GEL also appreciated against the Ukrainian hryvnia and against the Russian ruble. As a result, in the first quarter of 2014 the GEL nominal effective exchange rate appreciated by 3.6% in quarter-on-quarter terms and appreciated by 2.3% in annual terms.

Chart 5.8 Effective Exchange Rates (Jan 2008 = 100)



Source: National Bank of Georgia

The real effective exchange rate appreciated slightly, by 2.8%, in quarter-on-quarter terms and by 2.2% in annual terms. The GEL real exchange rate appreciated against the currencies of Georgia's trade partners, including Turkey, Ukraine and Russia. The main contributors to the depreciation of the real effective exchange rate were the Eurozone countries.

Table 5.1 Effective Exchange Rate Annual Growth

March 2014	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	2.3	2.2	2.2
Turkey	16.8	11.5	2.5
EU	-10.6	-8.2	-1.3
Ukraine	17.7	17.7	2.0
Armenia	-4.6	-4.9	-0.3
USA	-4.7	-2.9	-0.2
Russia	12.0	8.4	0.7
Azerbaijan	-4.8	-3.2	-0.6
other	-4.9	-2.7	-0.7

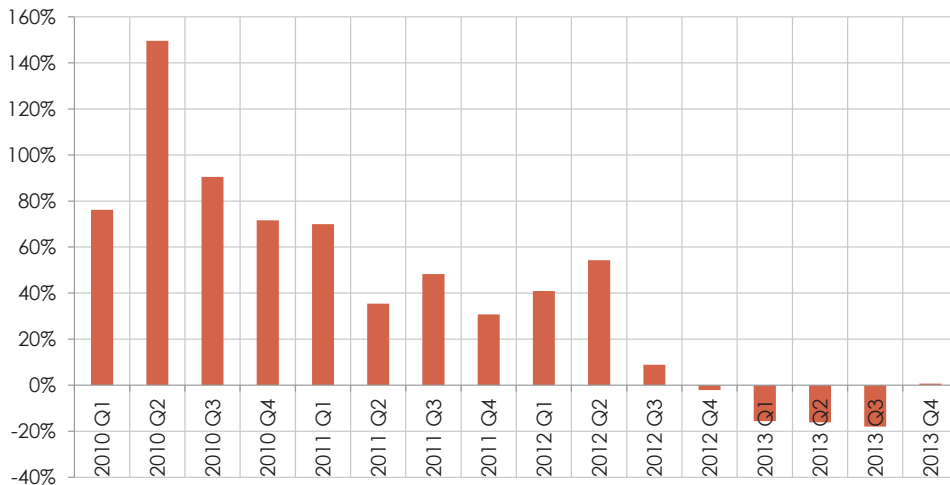
Source: National Bank of Georgia

## 6. DOMESTIC DEMAND

Real GDP growth amounted to 7.1% in the fourth quarter of 2013, with an increase in consumption being the main determinant of economic growth. During the first three quarters of the year, net exports were the main contributor to GDP growth. In the last quarter of the year, imports significantly increased, which lowered the contribution of net exports. The latter was compensated by the growth of investments and private consumption. Overall, GDP grew by 3.2% in 2013. The capital formation growth rate became positive in the fourth quarter of 2013, posting 0.7%.

« Real GDP growth amounted to 7.1% in the fourth quarter of 2013.

Chart 6.1 Annual Growth Rate of Capital Formation



Source: GeoStat

The export of goods and services increased by an annual 28.5%, while imports increased by 17.5% in the last quarter of 2013. As a result, the contribution of net exports to GDP growth was positive, though much less than in previous quarters. It should be noted that net exports were the main factor for GDP growth in 2013. Imports are expected to increase significantly in 2014, which could be a reason for the negative contribution net exports made to the growth of the economy.

« Net exports made a positive contribution to annual GDP growth in the fourth quarter.

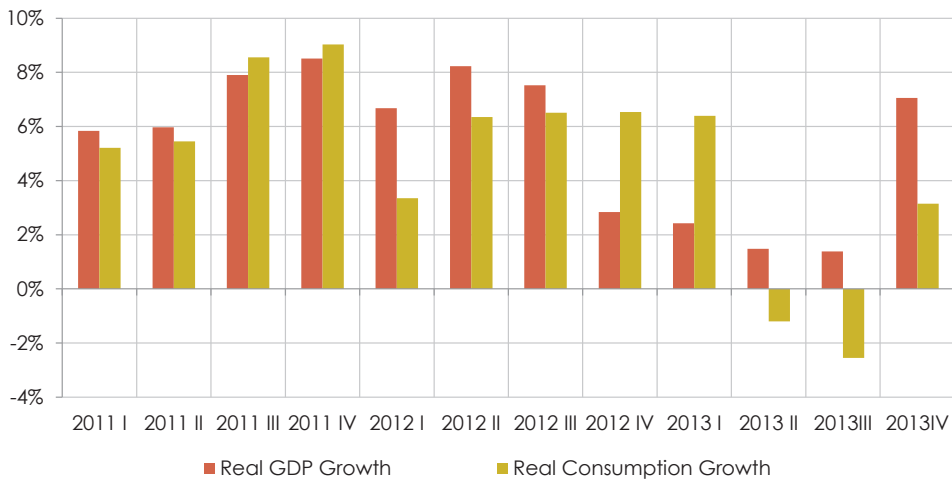
The growth rate of real private consumption<sup>8</sup> became positive in the fourth quarter of 2013, posting 3.2%. Consumption has increased in the government sector as well. The growth rate of real private consumption is expected to increase in 2014, which will support GDP growth.

« The growth rate of real private consumption became positive in the fourth quarter of 2013, posting 3.2%.

<sup>8</sup> The real growth of consumption is calculated using average annual inflation.



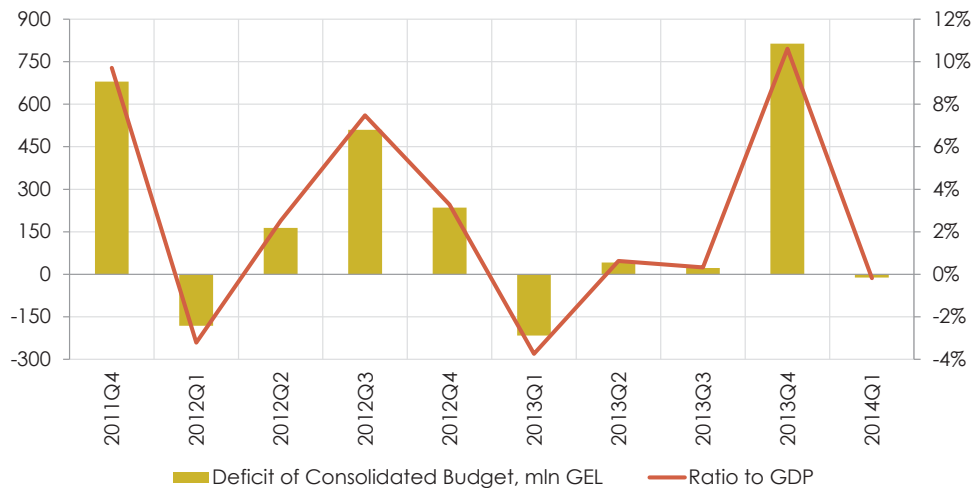
Chart 6.2 Real GDP and Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget deficit posted 814.3 mln GEL in last quarter of 2013, which is almost 3.5 times higher than the same measure in the previous year. The higher deficit was due to an increase of social welfare and capital expenditures. The data from the first quarter of 2014 does not indicate fiscal expansion. Budget revenues are slightly higher than expenditures (for comparison: the consolidated budget surplus posted 216.7 mln GEL in the first quarter of 2013). In 2014, the consolidated budget is planned to have a deficit of approximately 1 bln GEL. Therefore, the forthcoming quarters of the current year are expected to have a negative budget deficit, which should increase consumption and investments in the government sector.

Chart 6.3 Consolidated Budget Deficit (mln GEL)



Source: Ministry of Finance of Georgia

## 7. EXTERNAL DEMAND AND BALANCE OF PAYMENTS

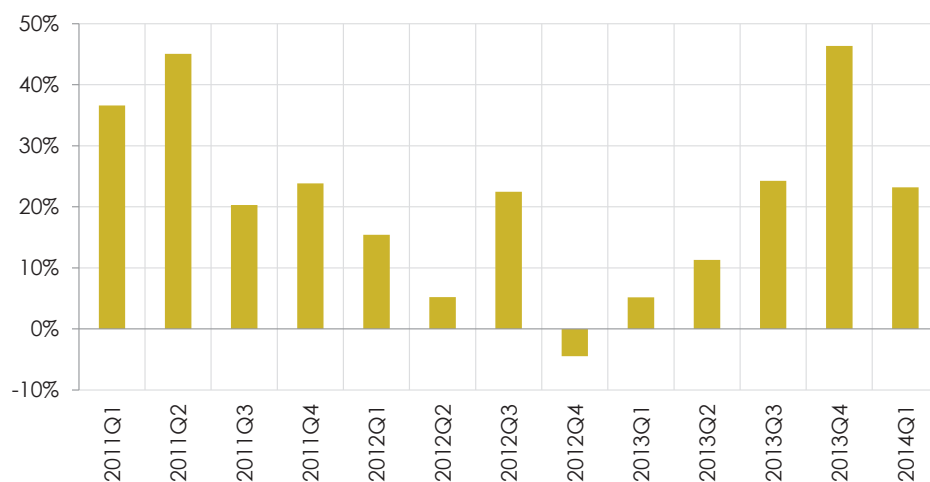
The ratio of the current account (CA) deficit to GDP sharply improved during 2013. By the end of 2013, the CA deficit to GDP ratio was at 5.9%, which is a 5.8 percentage point improvement compared to the analogous indicator of 2012. In absolute terms, as compared to the previous year, the CA deficit improved by 903.1 mln USD and went down to 950.9 mln USD. The decline in the CA deficit was chiefly driven by a shrinkage in the growth rate of imported goods as well as by a sharp growth of exports of goods and services. The CA deficit development throughout 2013 was uneven. While it declined during the first three quarters of 2013, during the fourth quarter the CA deficit shot up to 8.6% of GDP – a result of positive developments in domestic demand and, consequently, a high growth of imports. Based on the existing forecasts, the CA deficit to GDP ratio is expected to reach 8.4% in 2014; the deficit will be worsened mainly due to growing domestic demand and the volume of imports.

« In 2013 the current account (CA) deficit to GDP ratio improved sizably compared to the previous year and stood at 5.9%, which is 5.8 percentage points less than the same indicator in 2012.

The annual growth rate of goods exports in 2013 was pronounced, and this tendency continued during the first quarter of 2014. Exports of goods grew by 23.1% year-on-year in the first quarter of 2014. Growing exports of wine and mineral waters, as well as the re-export of copper ores and cars, most significantly contributed to the overall growth of exports. In the first three months of 2014, wine exports increased 2.5 times in year-on-year terms and the export of mineral waters also experienced significant growth. The Russian market accounts for a big chunk of the growth of exports in the above mentioned commodities. Car re-exports increased by 9% during the first quarter of 2014, however, it is worth mentioning that share of car re-exports in total exports declined by 3 percentage points, from 25% to 22%.

« Exports of goods grew by 23.1% year-on-year in the first quarter of 2014.

Chart 7.1 Annual Growth Rate of Exports



Source: National Bank of Georgia

In the first quarter of 2014, registered exports of goods to EU countries were up by 44.9% year-on-year. Exports to CIS countries were up by 31.1% in the same period. EU countries accounted for 20% of total Georgian exports, whereas 56% of total exports were sent to CIS countries. Starting from the third quarter of 2013, the Russian Federation took third place (after Azerbaijan and Armenia) in the list of destinations for Georgian exports, the volume of Georgian exports to the Russian market exceeding that of the traditional export markets of Turkey, the USA and Ukraine.

Due to the adverse political and economic developments in Ukraine, the negative risks for Georgian exports were increased on that market. Although the high growth of exports to the Ukrainian market that took place in 2013 continued in the first quarter of 2014, export growth was reversed in March with volumes reduced by 33.3% in

« Ongoing events in Ukraine increases risks for Georgian exports to Ukrainian Market.

year-on-year terms. Wine and other alcoholic drinks, nuts and ferro-alloy exports to Ukraine's market saw the largest decline during March 2014.

Amid heightened domestic demand, goods imports were up by 17% year-on-year during the first quarter of 2014. The growth of consumption goods imports was a main driver for the growth of total imports. These types of imports increased by 29.3% annually during the first quarter of 2014 and accounted for 45.8% of total imports. Imports of intermediate goods increased by 12.4%, accounting for 41.6% of total imports. The growth rate for imports of investment goods was lower. In the first quarter of 2014, investment goods imports grew by 5.9%, standing at a 12.6% share of total imports.

« Amid heightened domestic demand, goods imports were up by 17% year-on-year during the first quarter of 2014.

Chart 7.2 Annual Growth Rate of Imports Across the Product Groups



Source: National Bank of Georgia

In the first quarter of 2014, the import of goods from EU countries increased by 9.2%, imports from CIS countries expanded by 21.3%, and imports from other countries increased by 19.3%. The import of petroleum products, the most imported commodity, was up by 9% year-on-year and constituted 10% of total imports. The import of cars holds second place in the list of most imported commodities. Car imports increased by 5.6% in the first quarter of 2014 and accounted for 8.2% of total imports.

Tourism inflows reached 326.8 mln USD in the first quarter of 2014, which is 7.9% higher than the previous year. Despite the decreased rate of growth, the contribution of tourism inflows is crucial for the improvement of the CA deficit.

The number of foreign visitors increased by 7.6% in the first three months of 2014, although it has to be mentioned that the growth rate of visitors is lower as compared to the figures of previous years – a decline mainly due to the decreasing number of Turkish visitors. The number of visitors from Russia sharply increased (41% annually) as did as the number from Ukraine (51% annually), at the same time the number of visitors from neighboring Armenia and Azerbaijan also increased.

During the first quarter of 2014 323.6 mln USD was transferred to Georgia from abroad as remittances, that represents a 4.2% increase compared to the first quarter of 2013. Money transfers decreased from CIS countries, mainly due to the decrease of transfers from Russia by 5.1% in year-on-year terms. Transfers from Ukraine were also down by 6.2%. Taking into account the crisis in Ukraine, the risk of lessening money transfers from both Ukraine and Russia is significant. If this risk is materialized, declining money transfers will negatively influence the CA deficit.

Money transfers from EU countries increased by 14% year-on-year, which were chiefly driven by increasing transfers from Greece (17.9%) and Italy (12.1%).

As for Foreign Direct Investments (FDI), in 2013 FDI in Georgia increased by 10.8% compared to the previous year. In absolute terms FDI inflows were slightly above 1 bln USD. FDI played the biggest role in financing the CA deficit during 2013. If analyzed in terms of sector, the energy and finance sectors were the biggest recipients of FDI, accounting for 21.7% and 18.6% of total FDI, respectively.

« The number of foreign visitors increased by 7.6% in the first quarter of 2014. Lower growth rate as compared to the figures of previous years, is due to decreasing number of Turkish visitors.

« Taking into account the crisis in Ukraine, the risk of lessening money transfers from both Ukraine and Russia is significant.

## 8. OUTPUT AND LABOUR MARKET

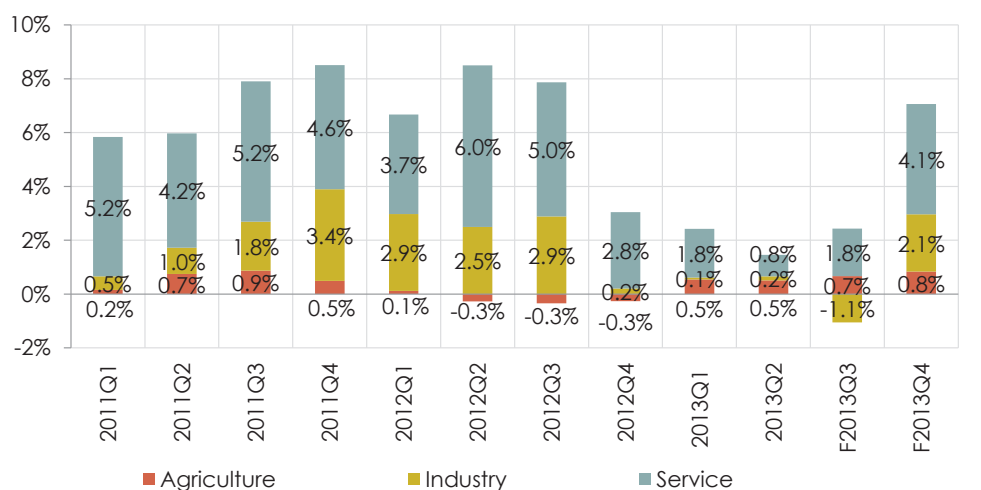
### 8.1 OUTPUT

In the fourth quarter of 2013 GDP increased by 7.1% in comparison with the fourth quarter of 2012. The total annual growth of GDP in 2013 was 3.2%. After three quarters of bleak growth, the last quarter of the year was marked by a significant rise of economic activity, which was mostly related to the end of the uncertainty that had followed the election period.

Contributions to the 7.1% growth of GDP are divided as follows: services, 4.1%; industry, 2.1%; and agriculture, 0.8%.

« Contributions to the 7.1% growth of GDP are divided as follows: services, 4.1%; industry, 2.1%; and agriculture, 0.8%.

Chart 8.1 Contribution of Sectors of Economy to Real GDP Growth



Source: GeoStat, National Bank of Georgia

In terms of services, the trade (with a +1.1% contribution to total growth and +7.4% growth in the fourth quarter of 2013) and transport sectors (a +0.8% contribution to total growth and +14.7% growth in the fourth quarter) were most substantial; and from industry, the manufacturing sector (+1.7% of total growth and +20.6% in the fourth quarter).

The fourth quarter growth of the trade sector (+7.4%), which is the largest sector of the economy, outpaced the growth of the previous three quarters (+6.8%, +3.1%, and +1.5%, respectively). This fact can be viewed in relation with the improvement of the Consumer Confidence Index.<sup>9</sup> The softened monetary policy of the National Bank of Georgia provided additional momentum for trade growth, resulting in easier accessibility to credit.

The growth of the transport sector is a result of increased foreign trade turnover (+22%), augmented by the added value of the gas and oil pipelines crossing Georgian territory (+17%), and the increased activity of foreign visitors (+11%).

The growth of manufacturing is mostly linked to the rise of the manufacturing of alcoholic beverages (+81%); other food products (+42%); mineral waters and soft drinks (+41%); and machinery, electrical and transport equipment (+36%). This is related to the increased export of production from these groups.

The significant growth of the agriculture sector (+12%) can also be explained by the rise in the export of agricultural products and by a favorable harvest.

<sup>9</sup> ISET research: Describes the general attitude of consumers towards the current and expected economic situation, which is directly related to their consumption behaviour.

The shrunken output of the construction sector (the contribution to total growth was -0.3% and growth in the fourth quarter of 2013 was -3.2%) can still be explained by the reduction of government financing of infrastructural projects. However, the fall in the fourth quarter was less than in the previous three quarters (-9.0%, -14.1%, and -16.9%, respectively).

Alongside increased economic activity, real estate and renting activities also increased (the contribution to total growth was +0.5% and growth in the fourth quarter of 2013 was +10.8%). The high growth of agriculture had a positive impact on the processing of products by households (a +0.4% contribution to total growth and a +14.5% increase in the fourth quarter).

The economic revival that started in the last quarter of 2013 continued in the first quarter of 2014. According to preliminary data, growth in the first quarter of 2014 was 7.4%.

« According to preliminary data, growth in the first quarter of 2014 was 7.4%.

## 8.2 LABOR MARKET

The growth rate of labor productivity increased in the fourth quarter of 2013 as compared to the previous quarter. According to GeoStat, the productivity of the labor force increased by 7.5% in year-on-year terms during the fourth quarter of 2013, which is 4.7 percentage points more than it had been in the same quarter of 2012. During that period the annual rate of labor efficiency growth has significantly improved in the agriculture sector. According to the data, in the fourth quarter of 2013 the real value added per employee in the agriculture sector increased by 12.9% as compared to the same period of the previous year. After declining in the previous quarter, labor productivity in the industrial sectors increased, with the growth rate being sufficiently high, exceeding 18%. Labor productivity in the service sector increased as well. The real value added per employee in services grew by 6.4% compared to the fourth quarter of 2012.

« Labor productivity increased by 7.5% during the fourth quarter of 2013. This increase can be largely attributed to industrial sectors.

**Table 8.1** Index of Value Added Produced per Worker in 4th Quarter of 2013 Relative to the Corresponding Period of the Previous Year

	Real value added per employee (growth index)
Agriculture and processing of agriculture products by households	112.9
Industrial sectors	118.3
Service sector	106.4
Overall in the economy	107.5

Source: GeoStat and National Bank of Georgia

As the sectoral breakdown of the economy shows, unlike the previous quarter, labor productivity increased in the manufacturing sector with an annual growth rate exceeding 25%. In contrast, an annual drop was observed in the construction sector. As was the case in the preceding quarters, labor productivity significantly decreased in the financial intermediation sector.

« Labor productivity in manufacturing has increased significantly.

The annual growth rate of the nominal salaries of employees increased during the fourth quarter of 2013, with the average nominal monthly salary standing at 876 GEL according to the latest data from GeoStat. The growth of the average salary amounted to 7.7% during that period, which is 1.5 percentage points higher than in the previous quarter. In terms of sector analysis, an increase in the annual growth rate of salaries is evident in the fishing; mining and quarrying; education; and hotels and restaurants sectors. It worth noting that the decline of nominal salaries did not continue in agriculture. In contrast, during the fourth quarter, average salaries diminished in the financial intermediation and real estate, renting and business activities sectors.

« The annual growth rate of the nominal salaries of employees increased during the fourth quarter.

Table 8.2 Index of Average Monthly Nominal Wage of Employers in 4th quarter of 2013 Relative to the Corresponding Period of the Previous Year

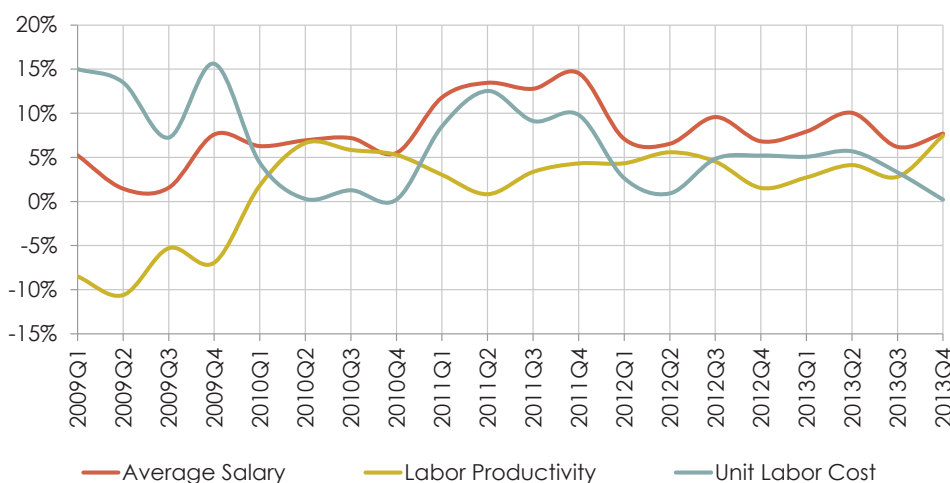
	Average nominal wage (growth index)
Agriculture, hunting and forestry	102.7
Fishing	229.5
Mining and quarrying	121.2
Manufacturing	113.5
Production and distribution of electricity, gas and water	104.6
Construction	106.3
Wholesale and retail trade; repair of motor vehicles and personal and household good	112.0
Hotels and restaurants	117.7
Transport and communications	115.6
Financial intermediation	99.5
Real estate, renting and business activities	93.1
Public administration	102.2
Education	120.3
Healthcare and social work	111.7
Other community, social and personal service activities	105.3
Overall in the economy	107.7

Source: GeoStat

To sum up, against the backdrop of a significant increase in the annual growth rate of employees' average salaries and labor productivity, the annual growth rate of unit labor cost<sup>10</sup> (personnel expense per production unit) decreased and stood at 0.2% by the end of the fourth quarter of 2013 (see Figure 8.2). This indicates the absence of inflationary pressure from the labor market.

« The annual growth rate of unit labor cost remains nearly unchanged.

Chart 8.2 Labor Productivity, Average Monthly Salary and Unit Labor Cost, 2009-2013 Q IV (Annual Percentage Change)



Source: GeoStat and National Bank of Georgia

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

2, Sanapiro Str., Tbilisi 0114, Georgia  
Tel.: (995 32) 240 6480; Fax: (995 32) 240 6571; Hot line: (995 32) 240 6406  
E-mail: [Info@nbg.ge](mailto:Info@nbg.ge); [www.nbg.ge](http://www.nbg.ge)

