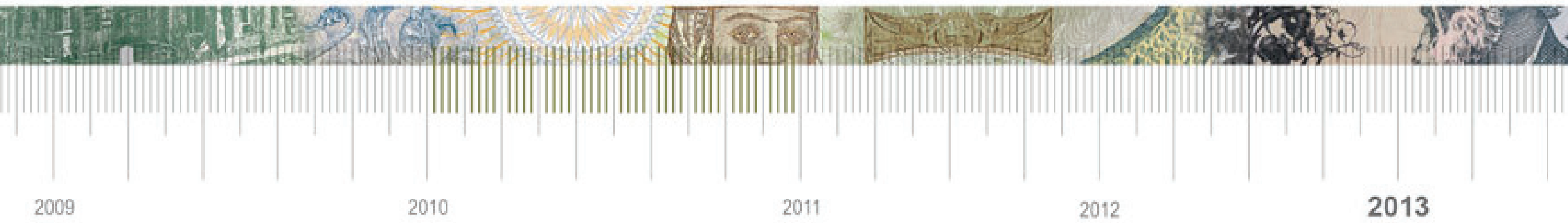
National Bank
of Georgia

INFLATION REPORT

August

2014



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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.

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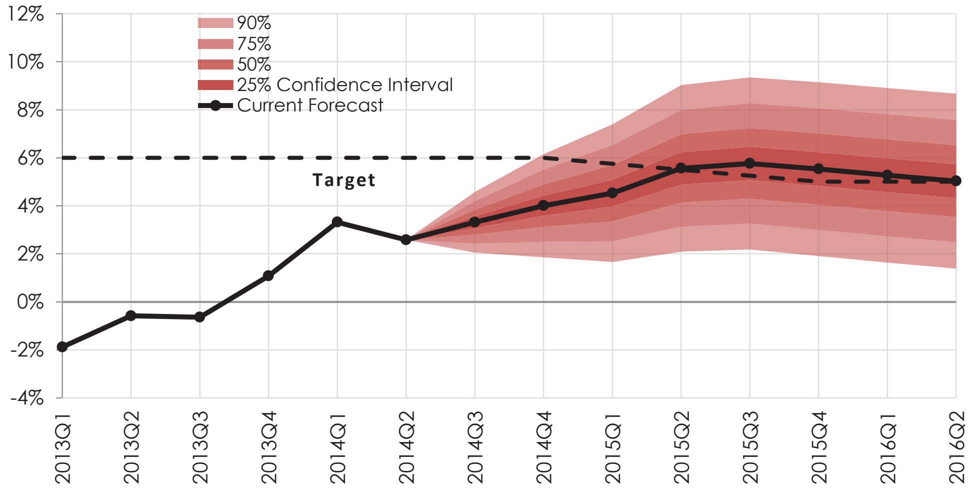
1. BRIEF OVERVIEW

The recovery of economic growth in Georgia has continued moderately in recent quarters. According to preliminary statistics, real GDP increased by 6% year-on-year in the first half of 2014, which was largely in line with the projections. Investment and consumption were the major contributors to GDP growth, along with the fiscal sector, which has been relatively active compared to last year. In terms of economic sectors, the construction, trade and service sectors made a significant contribution. The tourism sector continues its robust increase, albeit at a relatively slower pace. Compared to 2013, the growth rate reflects the significant base effect from last year's level. The output gap has narrowed, but remains negative.

The inflation rate was less than expected, which was mainly determined by supply side factors. The annual inflation rate in July was 2.8%. The decrease of the inflation rate since March was a result of the fall in food prices, which is likely to be temporary. The contribution of import prices increased, although the impact of this was less than expected. The increase of imported inflation reflects higher inflation rates in Georgia's major trading partner countries. The nominal effective exchange rate depreciation from the end of 2013 to the beginning of 2014 was reversed by appreciation since February, which was a result of the depreciation of trading partners' currencies. The import-weighted nominal exchange rate depreciated by a cumulative 4% in the few months before February 2014, and has appreciated by 3% since then. In annual terms, by the second quarter of 2014, the nominal income paid to private and public sector employees increased at a relatively high rate. However, demand-side pressure on inflation is still insufficient, which allows the retention of an accommodative monetary policy stance as the inflation rate falls to its 5% target.[1]

The NBG forecasts that inflation will be around 4% by the end of 2014, reaching the 5% target in the first half of 2015 (see Figure 1.1). In light of the accommodative monetary policy and fiscal stimulus measures, the forecast assumes that increased demand will be reflected in domestic prices. It is also assumed that imported inflation will further increase, because high inflation remains persistent in some of Georgia's trading partner countries. These projections are exposed to risks that influence both directions. In particular, if the currencies of trading partner countries strengthen, it will influence the nominal effective exchange rate by putting additional pressure on import prices. Aggregate demand may also carry upside risk for the inflation forecast if fiscal spending influences the economy to a greater extent than expected. On the

Chart 1.1 Annual Inflation



Source: National Bank of Georgia

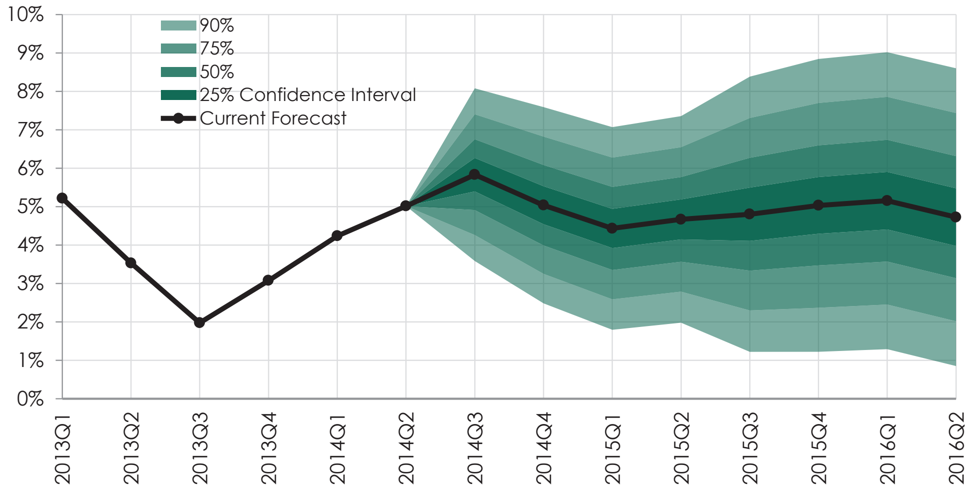
1 *In 2014, the inflation target rate remains at 6%, but it is to be reduced to 5% from 2015. Because monetary policy affects the economy with a time lag, the target rate is assumed to be 5% when forming the monetary policy.*

other hand, a prolonged food price shock may result in lower-than-forecast inflation. Considering the geopolitical situation in the region, a greater than expected deterioration in net external demand will put additional downside pressure on the inflation rate.

The economic growth forecast has not changed from the May Inflation Report and stands at 5% for 2014. Consumption and investment are expected to be major contributors to economic growth, while the contribution of net exports will be modest compared to 2013 – the latter being triggered by the high growth of imports. In terms of sectorial contributions, output growth is expected to be more or less evenly distributed among all major sectors, with the construction, trade and service sectors being relatively more important. The forecast assumes that the foreign investment climate in the country will not significantly deteriorate, despite the escalation of tensions in the region. Tourism revenues and remittances will follow the stable growth trend. As for local factors, it is important that business sentiment improves under the accommodative monetary and fiscal policies, which will be reflected on consumption and investments (see Figure 1.2).

The foreign sector is a major risk factor for economic growth, in particular there are the risks of a worsening investment climate and the possible disruption of trade amid the escalation of tensions in the region. Economic growth has slowed in neighboring trading partner countries and the situation is significantly worse in Ukraine. Because of economic sanctions, Russia also faces a crisis. If the current situation is sustained for a long period of time, there will be significant economic losses in these countries due to the disruption of economic activity, capital flight, increased risk premiums and inflation.

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



Source: National Bank of Georgia

At a meeting held on 13 August 2014, the Monetary Policy Committee took the decision to keep the monetary policy rate unchanged at 4%. This decision was based on an analysis of the current economic situation, macroeconomic forecasts and associated risks. Economic growth in the first half of 2014 was more or less in line with the estimates, despite growth slowing in neighboring trading partner countries. According to the Monetary Policy Committee's evaluations, the current economic growth rate is fragile, while the demand-side inflationary pressure is still unclear. Refinancing rates are set in line with the view that inflation in the medium term will be at the 5% target. Assessments of the current economic situation usually contain uncertainty, which creates the need for gradual and consistent changes in monetary policy.

In light of the current macroeconomic forecasts, the Monetary Policy Committee believes that there is a need for a gradual exit from the accommodative monetary policy. However, this process should not constrain economic activity, insofar as the policy rate remains below its neutral level. If developments in forthcoming periods do not affect the current forecasts and new shocks do not materialize, the monetary policy rate will gradually increase to its neutral level in parallel with the recovery of economic growth and inflationary pressures from aggregate demand. The policy rate is expected to be around 6% by the end of 2015.

In accordance with its mandate, the National Bank uses all possible means to ensure price stability, which is a precondition for low interest rates, high economic growth and low unemployment in the long run.

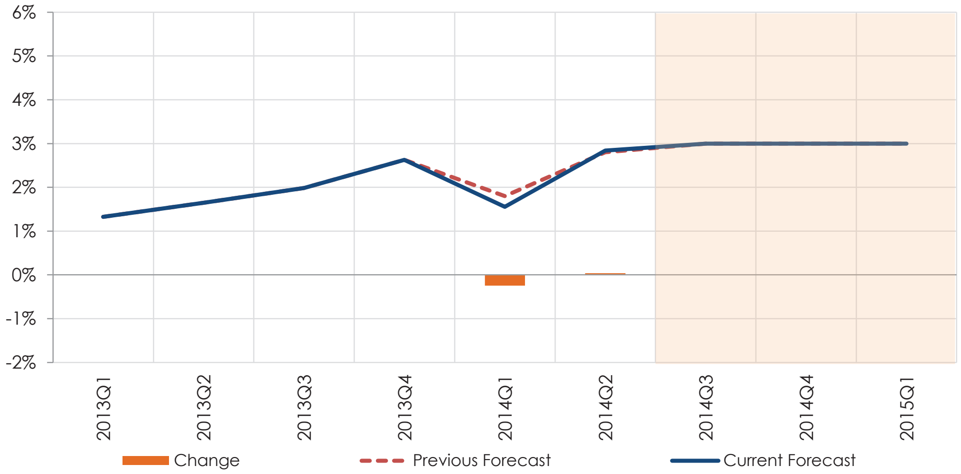
2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

In the first half of 2014, global economic growth slowed down, mainly because of weakened demand in the United States and several major developing countries. Besides demand factors, reduced investment also had an impact on economic activity. The negative effects are expected to only be short term and, by the end of the year, a recovery in global growth is predicted. These optimistic expectations are based on expansionary monetary policies and softened fiscal consolidation. The International Monetary Fund (IMF) estimates that the world economy will grow 3.4% in 2014 and 4% in 2015.[2]

An unusually harsh winter and inventory reduction in the United States resulted in less total output in the first half of 2014 than had been anticipated (see Figure 2.1). Nevertheless, it is expected that the expansionary monetary policy and reduced fiscal burden will help economic activity to recover in the second half of the year. In light of improved labor market and business sentiment, private consumption and business investment will make the largest contribution to economic growth. In addition, there will be strong investments in real estate due to increased demand. The IMF projects that the U.S. economy will grow 1.7% in 2014 and 3% in 2015.

Chart 2.1 U.S. Real GDP Annual Growth

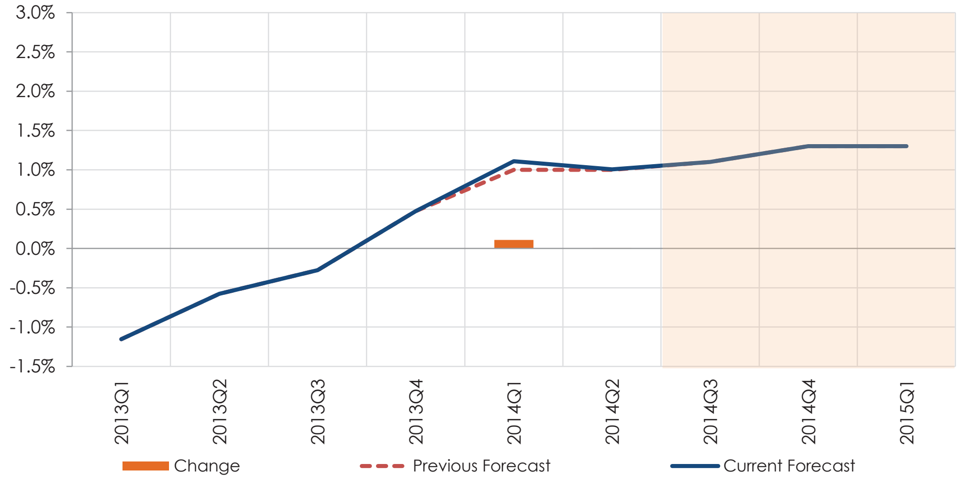


Source: OECD

The eurozone economy is recovering gradually, but this process has been slower than was expected at the beginning of the year. Domestic demand is still weak, a result of high unemployment, high real interest rates, the fiscal burden and poor lending. Consequently, the eurozone region remains heavily dependent on foreign demand and is sensitive to future shocks coming from its trade partners. There are significant barriers from the supply side too. Capital, labor force and production factors are still lower than their potential levels, hindering the growth of productivity and employment. The IMF estimates that the eurozone economy will grow 1.1% in 2014 and 1.5% in 2015 (see Figure 2.2).

2 *Source: World Economic Update (WEO) - July 2014. Since July 2014, the International Monetary Fund has calculated global economic growth figures with a new methodology, which makes past and current projections incomparable.*

Chart 2.2 Eurozone Real GDP Annual Growth

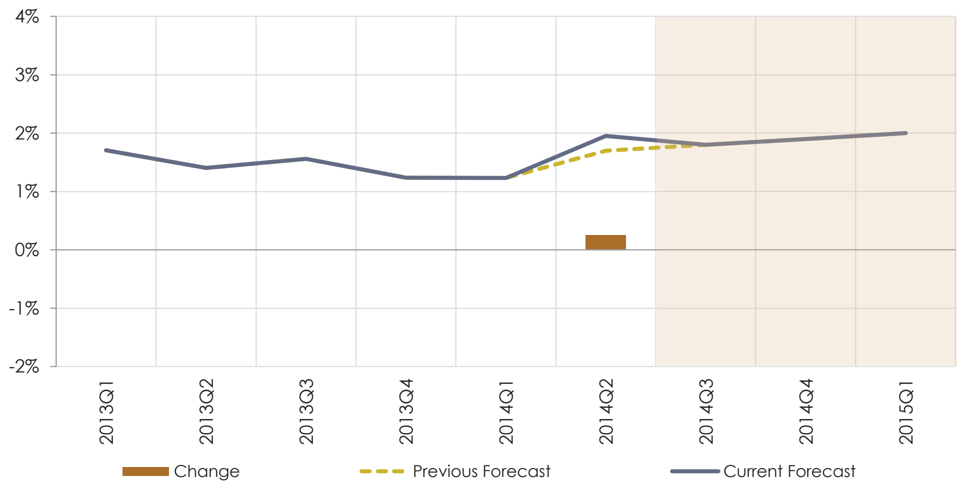


Source: Eurostat

Geopolitical developments in the Middle East and Ukraine have had a significant impact on emerging and developing countries, where the risks to growth have clearly increased. In addition, there are notable risks arising from expectations of a U.S. long-term interest rate hike (which is a result of the probable tapering of unconventional policy by the Federal Reserve). These risks have had a substantial effect on the Turkish economy, leading to currency devaluation, an increase in inflation and monetary tightening. In the medium term, it is expected that real consumption and investment in Turkey will decrease; however, amid exchange rate depreciation, net exports will improve and contribute to a 2.6% increase in total production. The IMF forecasts 3.3% economic growth for Turkey in 2015, along with the normalization of domestic demand.

The geopolitical situation is more severe in Ukraine, where a decrease of GDP by 6.5% is expected in 2014.3 Among the main reasons for this reduction are the interruption of economic activity in the eastern regions of the country, the impossibility of tax collection, high levels of spending on security, and high inflation as a result of currency depreciation and capital flight. The Russian economy is also experiencing a negative impact in the form of capital outflow, accelerating inflation and higher interest rates. However, Russia faces even more significant risks because of further economic sanctions placed on the country's economy. In particular, limited access to long-term foreign capital is one of the hazards that may be faced by the Russian industrial sector. For the natural-resource-based economy of Russia, this means dramatically reduced production, income and employment, which can serve as a pre-

Chart 2.3 U.S. CPI Annual Inflation



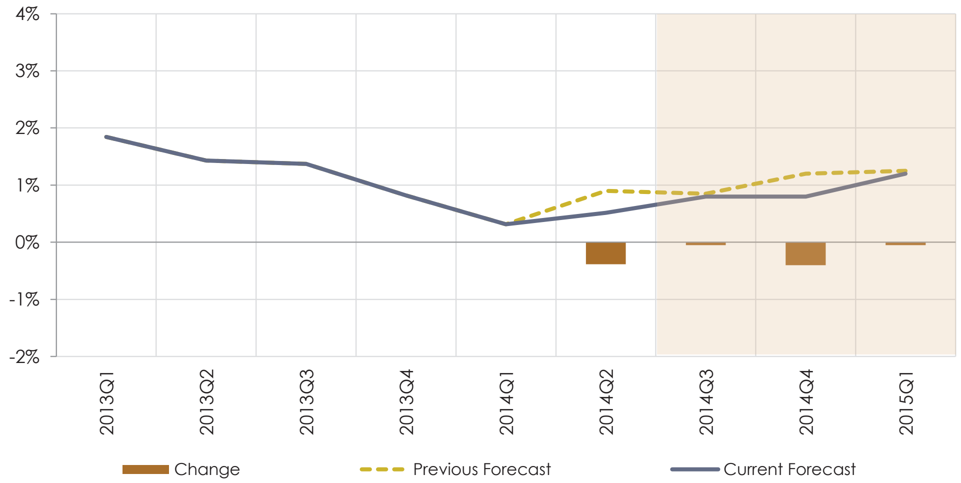
Source: OECD

3 *Source: Press Release, IMF, July 2014 http://www.imf.org/external/np/sec/pr/2014/pr14351.htm*

condition for a lasting economic recession. The IMF predicts the Russian economy to grow only 1% in 2014.

In the first half of 2014, major commodity product prices increased by approximately 0.4%. This rise is due to increased energy prices, which have been influenced by geopolitical developments in the Middle East. In contrast, food prices decreased as a result of positive expectations from the supply side. In terms of price changes at the regional level, the low inflation rate in the eurozone is notable, which is a result of both internal and external factors. The IMF predicts that the eurozone's inflation rate will fall to 1% in 2014, down from 1.5% in 2013 (see Figure 2.3). Much higher rates of inflation are expected in major trading partner countries. Exchange rate depreciation has led to a high growth in prices in Turkey, Russia and Ukraine. According to various projections, inflation in these countries will become relatively stable by the end of the year, reaching 8%, 6% and 18% respectively. In the U.S., inflation remains within reasonable limits. Prices will grow by 1.4% year-on-year by the end of 2014 (see Figure 2.4).

Chart 2.4 Eurozone CPI Annual Inflation



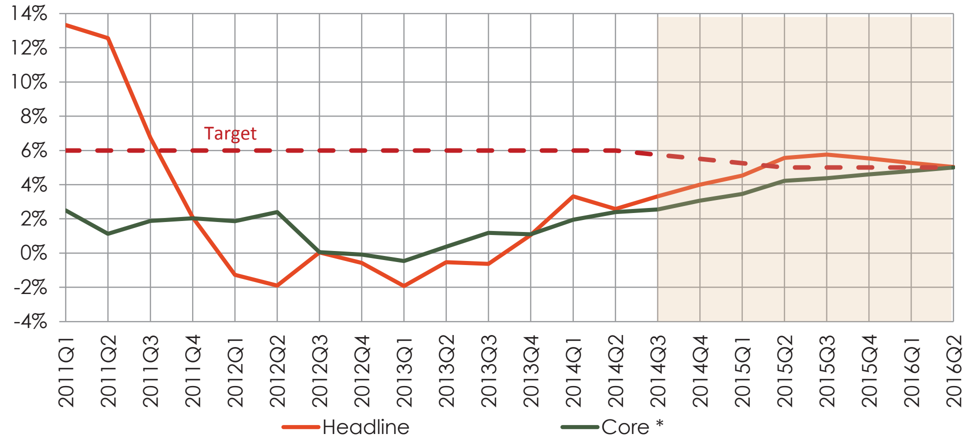
Source: OECD

Because of the passive recovery of economic activity, monetary policy remains largely expansionary in developed countries. This creates an incentive to acquire financial resources at lower cost and profitably invest in emerging and developing countries. In addition, in some developing countries local central banks have raised the policy rate in order to avoid inflationary threats. According to current forecasts, a lack of recovery in economic activity will lead to lasting low interest rates in developed countries in the medium term. The monetary policy in emerging and developing countries is expected to remain relatively strict until inflationary risks fade.

2.2 MACROECONOMIC FORECAST

Inflation has slowed and stood at 2.6% in the second quarter of 2014. However, in the same period, core inflation, which measures changes in consumer prices, excluding food and energy, rose to 2.4% (see Figure 2.5). The annual inflation rate is below the National Bank of Georgia's target. This deceleration is partly due to exogenous factors, of which decreased food prices are the most important. However, insufficient pressure on consumer prices from the demand side, which is a result of economic activity being less than its potential level, is also a significant factor.

Chart 2.5 Headline and Core Inflation

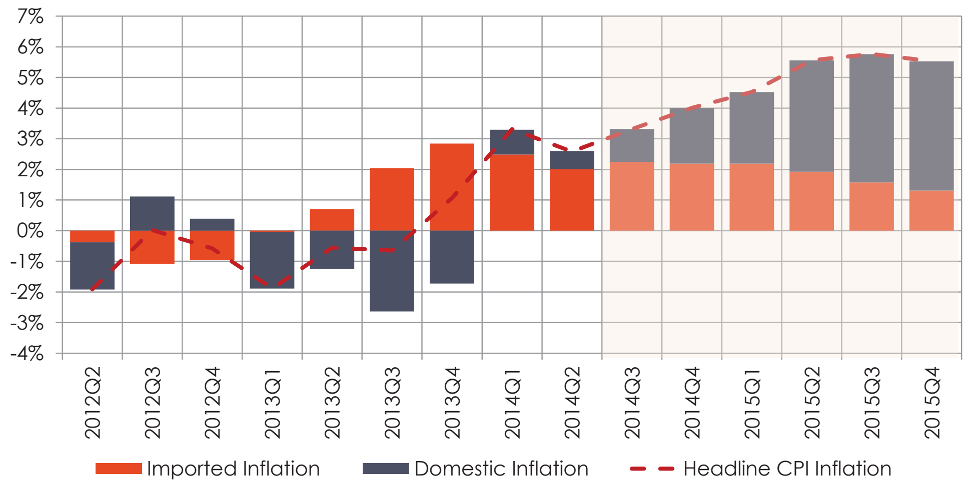


* Core inflation excludes food, energy and utilities ' prices from the basket

Source: National Bank of Georgia

Imported inflation contributed to inflation in the second quarter of 2014, but this contribution was smaller than expected. Even though the lari nominal effective exchange rate depreciated at the end 2013 and beginning of 2014, the subsequent depreciation of trading partner currencies (Turkish Lira, Ukrainian Hryvna, Russian Ruble) has made the lari appreciate again. The increased inflation in partner countries as a result of their depreciated currencies has already been partly reflected in imported inflation in Georgia. This effect is likely to remain important and active in the foreseeable future (see Figure 2.6).

Chart 2.6 Headline Inflation Decomposition



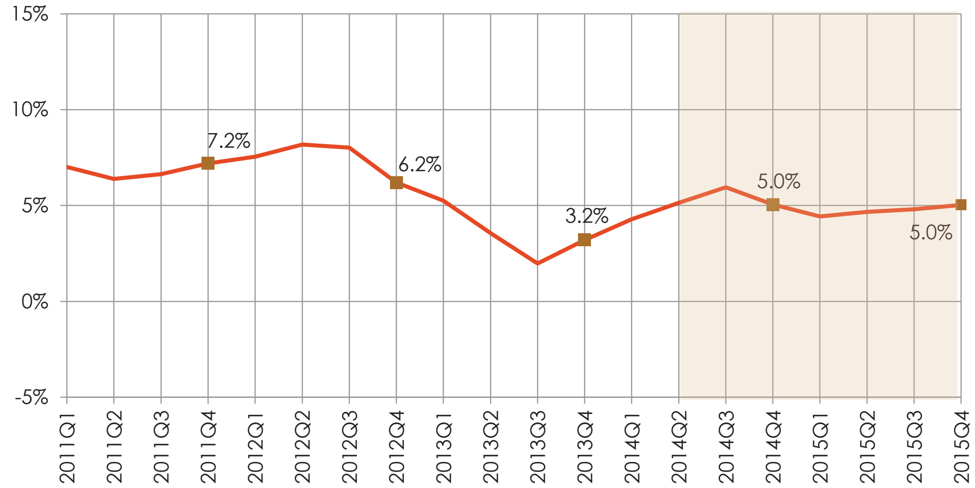
Source: National Bank of Georgia

According to current forecasts, it is expected that the upward trend of consumer prices will resume and be maintained throughout the second half of 2014 and the first half of 2015. As a result, annual inflation will reach its target in the beginning of 2015 (see Figure 2.5).[4] Imported inflation will play a significant role in this increase, but in the medium term the main drivers of annual inflation that will force it to reach the target will be strengthening domestic demand and economic activity (see Figure 2.6). It is worth noting that this forecast is accompanied by risks on both sides. On the one hand, tightened monetary policy in trading partner countries as a response to increased inflation may cause their currencies to appreciate more than expected, which would likely place upward pressure on imported inflation in Georgia. On the other hand, the decreased food prices of the second quarter may persist longer than expected and/or weaker than forecasted domestic demand might place insufficient pressure on inflation.

4 *The inflation target will be reduced to 5% from 2015*

According to preliminary data, the annual GDP growth rate of the second quarter of 2014 was 5.1% (see Figure 2.7). This, in turn, means around 6% annual growth for the first half of 2014. This moderate economic growth was a result of a number of factors, with improved business and consumer confidence, accompanied by a loose monetary and relatively active fiscal policies, resulting in greater consumption and investment. In terms of annual comparison, the growth rate reflects the significant base effect from 2013. The output gap narrowed, but remains negative. Finally, the increase in demand was further supported by financial sector activity, which was manifested in reasonable growth rates of loans in the first and second quarters.

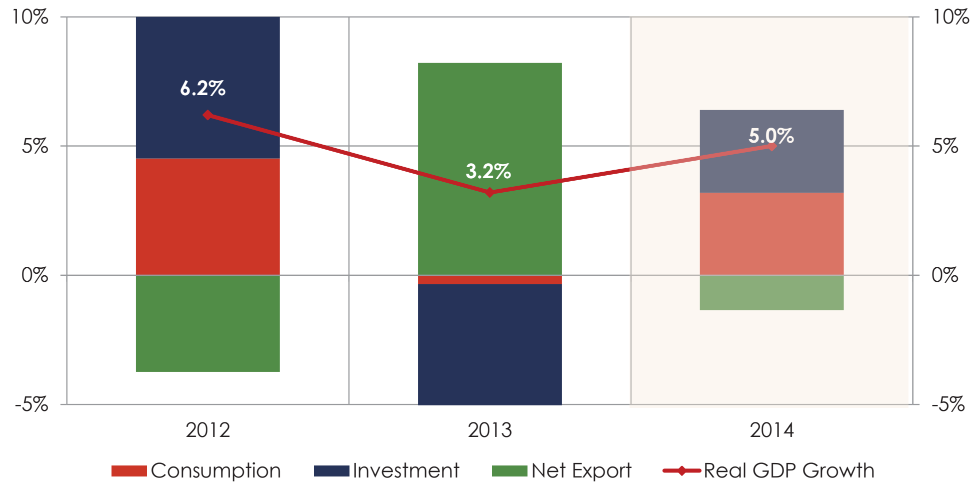
Chart 2.7 Real GDP Growth (Annual Growth of Last four Quarters)



Source: National Bank of Georgia

According to the current baseline forecast, real GDP growth in 2014 will be around 5% (see Figure 2.7). This prediction is based on improving business confidence and strong fiscal stimulus measures. Decreased foreign demand due to the Russia-Ukraine conflict is another important factor for the forecast. The baseline scenario is based on the assumption that the conflict will not have any further negative effect on foreign demand and the investment climate. The forecast is balanced by risks existing in both directions. One significant risk factor is the possible deterioration of foreign demand, which might have a negative impact on both net exports and foreign investment. On the other hand, the activation of government capital expenditures in the second half of the year may have a greater than expected impact on economic activity. In addition, improved business confidence, as a result of the prospect of a free trade regime with Europe, may result in higher investment in relevant sectors and thus in higher economic growth than forecasted.

Chart 2.8 Components of Real GDP



Source: National Bank of Georgia

According to the forecast, the contributions of consumption and investment to GDP growth will significantly increase and become major determinants of growth in 2014 (see Figure 2.8). It is expected that this process will be supported by improved business sentiment, active fiscal policy and increased banking sector activity resulting from the accommodative monetary policy. After the high growth of 2013, the contribution of net exports will decrease in 2014.

Due to increased imports, the trade balance in the second quarter of 2014 deteriorated by 21.2% according to preliminary data, and the negative trade balance amounted to 1471.6 mln USD. The annual growth rate of exports in the second quarter of 2014 was 8%. The export of goods largely depends on both the domestic demand of trading partner countries and on global economic growth. The growth potential of the service sector (including tourism) also contributes to export growth. In the second quarter of 2014, as was the case in the first quarter, there was an increase in imports that, according to preliminary data, amounted to 16.5%.

After a significant reduction of the current account deficit to 5.9% of GDP, which was the result of the high growth rate of exports and subdued imports in 2013, this is expected to rise again to 8.4%. However, this increase is still in line with the long-term decreasing trend of the current account deficit.

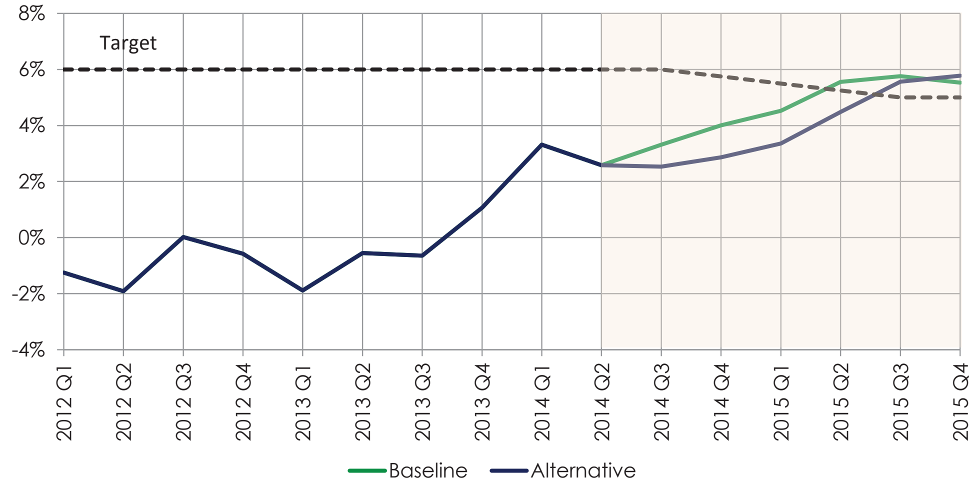
Chart 2.9 Current Account Components Ratio to GDP

Source: National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers the impact of the main macroeconomic risks affecting the inflation and aggregate demand forecasts. It considers the possible further deterioration of foreign demand due to the weak economic activity in trading partner countries resulting from the Russia-Ukraine conflict. The effect of the latter is moderate. However, according to the alternative scenario, overall economic growth will be around 4% in 2014. The same factors will also be reflected in inflation. In addition, the alternative scenario assumes that the positive cost-push shock that materialized in the second quarter, which made food prices decrease, may exhibit more persistence and be eliminated at a slower pace than expected. The alternative forecast scenario gives the quantitative effects of the aforementioned factors on the inflation forecast (see Figure 2.10).

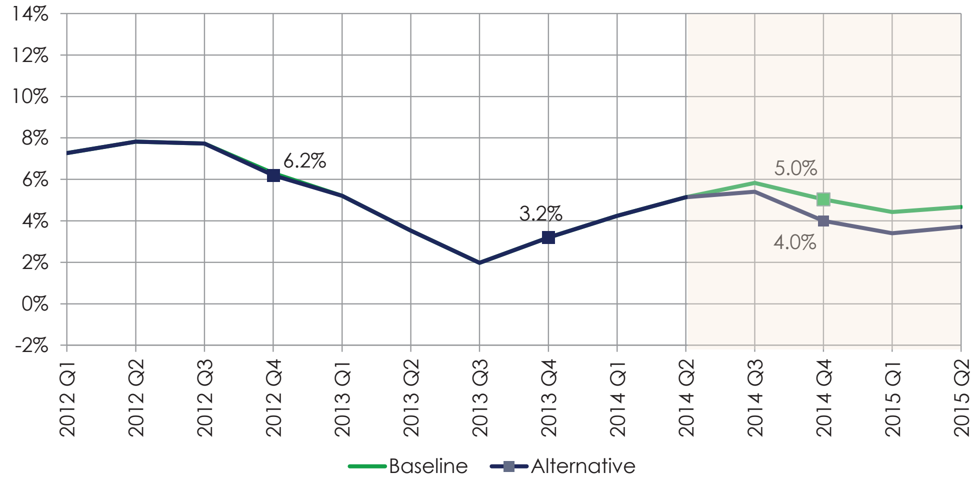
Chart 2.10 CPI Inflation According to Baseline and Alternative Forecasts



Source: National Bank of Georgia

According to this scenario, subdued economic activity (see Figure 2.11) will be partly accommodated by a slower exit from the loose monetary policy, which is quite feasible given that inflation remains below the target. As a result, the alternative scenario shows that inflation will be around 5% in the second half of 2015.

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

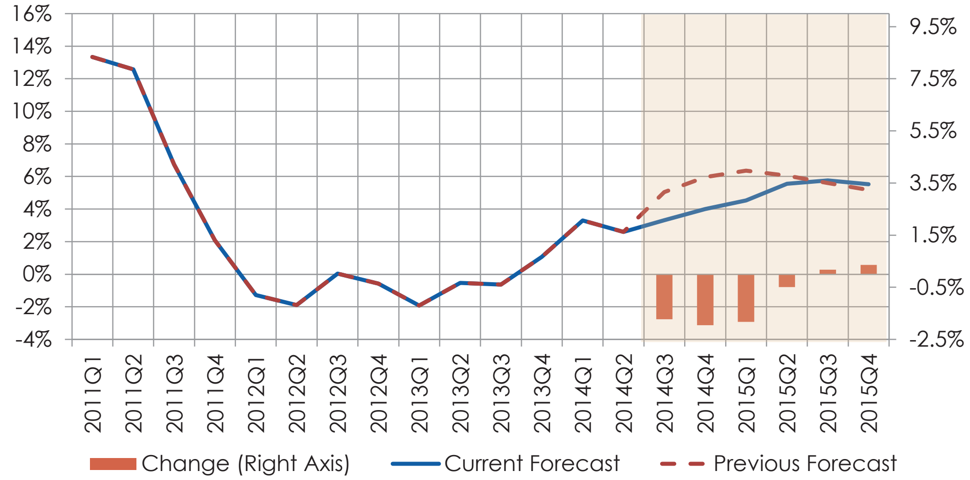


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

The economic growth forecast for 2014 has not changed compared to that of the previous quarter. However, the inflation forecast has been revised downwards and it is predicted that it will reach the target in the first half of 2015. The main reason for this revision is the supply side factors that were reflected in food prices. On the other hand, the weaker-than-expected transmission of nominal effective exchange rate depreciation by the end of 2013 and the beginning of 2014 was another important factor for the inflation forecast. The weak transmission was mainly due to the reversal of the aforementioned depreciation by appreciation starting from February 2014. This was the result of the bilateral appreciation of the lari in relation to the currencies of Georgia's main trading partners.

Chart 2.12 Change in Forecast of Headline Inflation



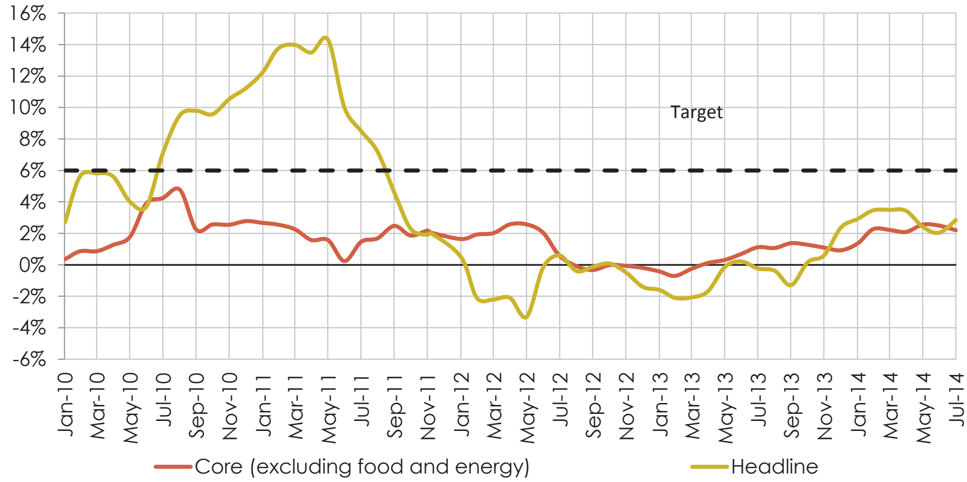
Source: National Bank of Georgia

3. Consumer Prices

The growth rate of the overall price level declined in the second quarter of 2014, standing at an annual 2% by the end of June. In July, the monthly inflation rate amounted to -0.6%. The rate of deflation was even higher in the same period of 2013. By the end of July, the change of annual CPI increased to 2.8%. The annual inflation rate is thus gradually approaching the NBG's medium-term target of 6%.[5] In the backdrop of growing headline inflation, core inflation is gradually increasing. The annual change of the consumer price level, excluding food and energy, stood at 2.2% by the end of July 2014 (see Figure 3.1).

‹‹ Headline inflation is gradually approaching the NBG's target level and standing at 2.8% in July, 2014.

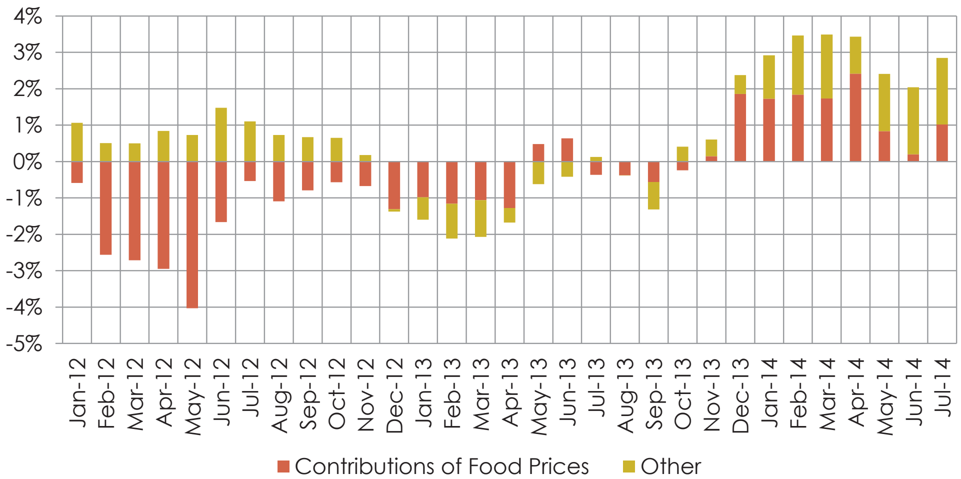
Chart 3.1 CPI and Core Inflation



Source: National Bank of Georgia

Changes in food prices remain important for the dynamics of the consumer price index. The overall price level of food started to rise from November 2013 and the annual price change on food products stood at 8.2% by April 2014. However, in May-June the annual growth rate of food products significantly declined. The monthly decrease in food prices was caused by both domestic and external factors. Food prices are currently experiencing a considerable decline as a result of the rich harvest in the country. Moreover, according to FAOSTAT (the Food and Agriculture Organi-

Chart 3.2 Contribution of food inflation in headline inflation



Source: GeoStat and National Bank of Georgia

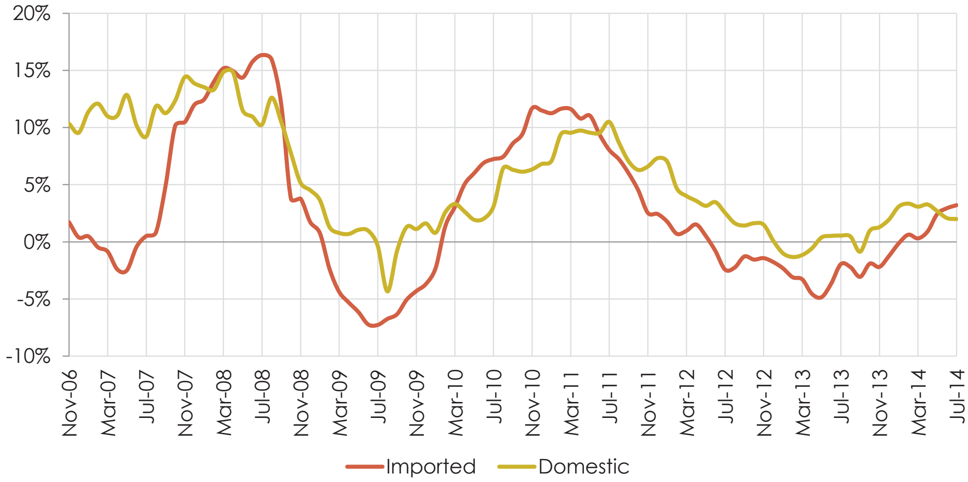
5 *The inflation target will decrease to 5% in 2015.*

zation of the United Nations), during the second quarter of 2014, a decreasing trend was observed in the overall price level of food. In line with these shocks, the food inflation rate declined by 7.6 percentage points in June, as compared to April, and stood at 0.7%. By the end of July, the annual change of food prices slightly increased, amounting to 3.6% and contributing approximately 1 percentage point to headline inflation (see Figure 3.2).

« Inflation rate on imported consumer goods increased and stood at 3.2% by the end of July .

In terms of supply factors, it is worth noting that price changes on imported goods in the consumer basket have an influence on overall price levels in the country. From the beginning of 2014, in line with high inflation rates in Georgia's main trading partners, the change of imported prices became positive. In spite of the depreciation of the Georgian lari at the end of 2013 and the beginning of 2013, the subsequent depreciation of the currencies of Georgia's main trading countries caused the lari to appreciate. By the end of July, annual imported inflation amounted to 3.2%, contributing approximately 0.6 percentage points to headline inflation (see Figure 3.3).

Chart 3.3 Imported and Domestic Inflation



Source: GeoStat and National Bank of Georgia

« The factors weakening the aggregate demand have also partially determine the dynamics in the inflation rate.

During the second quarter of 2014, a number of geopolitical risks were identified, which were reflected on external demand. The growth rates of exports, remittances and tourism revenues all declined. At the same time, a relatively lower growth rate in lending activity was observed, which provided insufficient stimulus for domestic demand. Factors weakening aggregate demand thus put downward pressure on the consumer price growth rate and prolonged the approach towards the target level.

Box 1 Import-weighted Nominal Effective Exchange Rate

As Georgia has a small and open economy, the impact of exchange rates on consumer prices is important. Prices of imported consumption goods and imported intermediate goods used in local production are reflected in general price levels and affect inflation. However, to analyze the influence of the exchange rate on inflation it is important to study the dynamics of the lari exchange rate against not only a particular currency, but to all trading partner currencies in general.

Traditionally, the calculation of the effective exchange rate is accomplished by using the shares of trading partner countries in total trade. This implies that the weight of a particular trading partner is computed from the total volume of imported and exported goods, which is then used for the calculation of the weighted average exchange rate. The traditional effective exchange rate calculation is an important factor for macroeconomic analysis. In addition to being a factor for inflation, it helps characterize the competitiveness of a country.

As the weights of trading partner countries in export and import volumes are heterogeneous, an analysis of the impact of exchange rates on the dynamics of inflation is better carried out via import-weighted exchange rates, which provide a more accurate picture. To this end, a new index (NEERIW) has been constructed to characterize the import-weighted lari exchange rate against trading partner currencies.

Table 3.1 Shares of major commodities in total imports

Product	Share
Oil	15.94%
Wheat	2.44%
Copper	1.45%
Steel	1.06%
Sugar	0.87%
Iron	0.65%
Coal	0.55%
Corn	0.21%
Coffee	0.19%
Aluminum	0.13%
Rice	0.09%
Soya	0.01%

Source: National Bank of Georgia

Table 3.2 Shares of major trading partners in total imports and final weights in the NEERIW index

Country/Region	Share in Total Imports	Final Weight
Eurozone	20.13%	18.15%
Turkey	17.08%	17.32%
Azerbaijan	8.10%	0.00%
Ukraine	7.65%	6.18%
Russia	7.48%	3.53%
China	7.16%	7.46%
Romania	4.10%	0.47%
Japan	4.06%	4.23%
US	3.16%	29.39%
United Arab Emirates	2.34%	2.44%
Armenia	2.31%	1.03%
Iran	1.64%	1.63%
Brazil	1.26%	0.67%
United Kingdom	1.16%	1.20%
Poland	1.13%	1.16%
Czech Republic	0.96%	0.99%
Korea	0.90%	0.93%
Switzerland	0.74%	0.65%
Hong Kong	0.71%	0.74%
India	0.71%	0.71%
Kazakhstan	0.70%	0.17%
Hungary	0.64%	0.67%
Turkmenistan	0.61%	0.03%
Israel	0.40%	0.24%
Other Countries	4.87%	0.00%
Total	100.00%	100.00%

Source: National Bank of Georgia

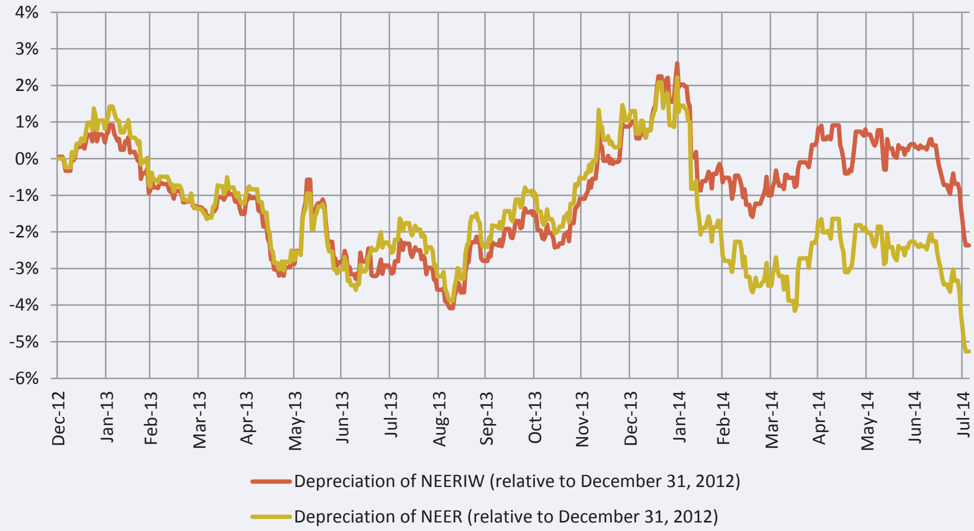
The weight of the bilateral exchange rate in the NEERIW index should correspond to the share of a country's imports in total imports. In the construction of the index import data from 24 major trading partner countries was considered (see the first column in Table 3.2). Imports from these countries account for 95% of total imports. Final weights have been obtained through adjustment of the shares in total imports from certain countries. Firstly, the share of commodities in imports (see Table 3.1) has been fully given in USD. This correction was necessary because the pricing of commodity products takes place in international markets where the reference currency is USD. Secondly, the import shares from the rest of the countries have been distributed proportionately over 24 trading partner countries. The final weights are given in the second column of Table 3.2.

The base period of the NEERIW index is December 31, 2012. Figure 3.4 depicts this index alongside the traditional nominal effective exchange rate (NEER) index. The correlation between the two indices is quite high, although differences do exist in certain periods. A significant difference has been observed since February 2014, when the nominal appreciation became more remarkable in the case of NEER. The reason for this difference lies in the different weight of the Ukrainian currency in the NEERIW and NEER indices – the weight equals 11.5% in the latter index, while on the import-weighted and commodity-adjusted NEERIW index it equals 6.2%.

Chart 3.4 Import-weighted Nominal Effective Exchange Rate NEERIW and Traditional Nominal Effective Exchange Rate NEER

Source: National Bank of Georgia

Chart 3.5 Change in NEER and NEERIW



Source: National Bank of Georgia

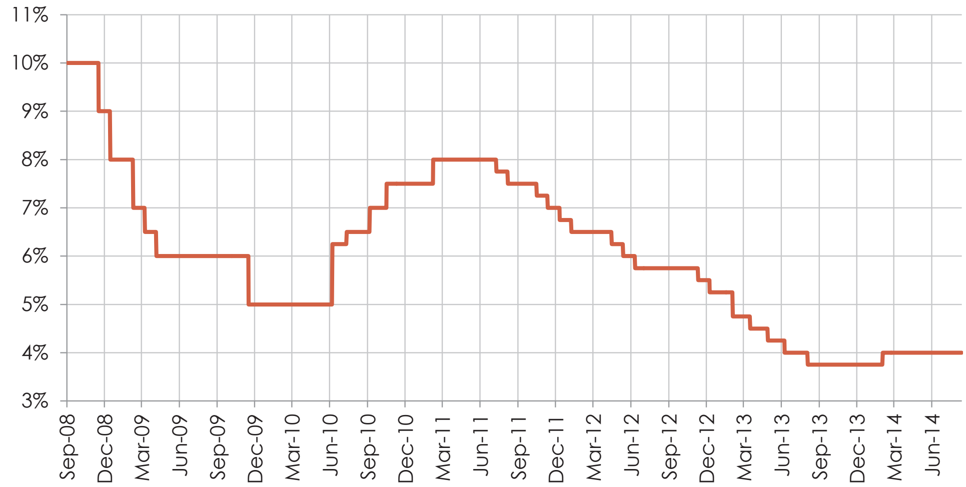
4. MONETARY POLICY

From 2014, the National Bank of Georgia started the process of exiting from its loose monetary policy stance. As a consequence, at February's Monetary Policy Committee (MPC) meeting the policy rate was increased by 25 basis points to 4%. Against the background of 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. It was thus decided that there was no need to continue retaining an accommodative monetary policy.

The increased geopolitical risks in spring 2014 were reflected in lower growth rates of exports and remittances. A low growth of credit activity was also observed, which provided insufficient stimulus for domestic demand. Taking all of these factors into consideration, at its August meeting the Monetary Policy Committee decided to keep the policy rate unchanged. Although it still believed that there was a need to exit the accommodative monetary policy, the speed of this process will depend on aggregate demand and the extent of the revival of economic activity.

It should be taken into account that exiting the accommodative monetary policy will not have a restraining effect on the economy, insofar as the policy rate will remain below the neutral level. So long as new information revealed in forthcoming periods does not affect the current forecasts and no new shocks to the economy evolve, the policy rate, along with the revival of economic growth, will gradually approach its neutral level to reach 6% by the end of 2015.

Chart 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last Monetary Policy Committee meeting was held on 13 August, at which it was decided to leave the policy rate unchanged. This decision was based on the existing inflation forecast and on the macroeconomic analysis of ongoing events in both Georgia and outside its borders.

« The NBG maintains policy rate unchanged at 4%.

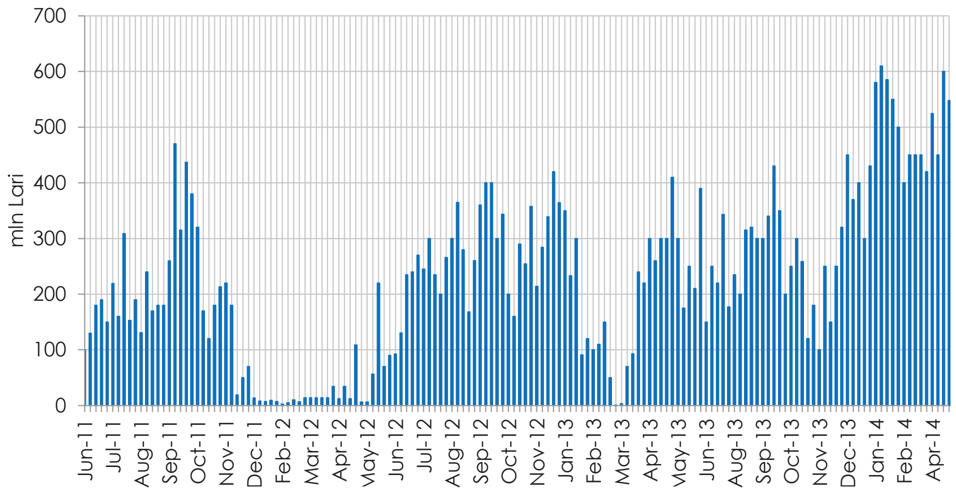
The inflation rate exhibited a growth trend since fall 2013, but annual inflation decreased in May-June 2014. In July 2014, annual CPI inflation stood at 2.8%, which was mainly a result of the reduction of seasonal products. At the end of 2013 and the beginning of 2014, the lari nominal effective exchange rate was depreciating, which was supposed to put upward pressure on inflation in subsequent periods. However, in the period that followed, the currencies of Georgia's trading partners (namely the Turkish lira, Ukrainian hryvnia and Russian ruble) started to depreciate, inter alia against the lari, thus causing the lari nominal effective exchange rate to appreciate. As a consequence, the exchange rate pass-through to inflation was negligible.

According to the preliminary assessment of economic activity, economic growth was close to the expected rate, amounting to 5.1% in the second quarter of 2014. This growth was mostly driven by domestic demand. External demand still remains weak, as indicated by the low goods export figures in July. Given the present situation in the region, external demand still remains a risk factor. In the event of a further decrease in demand, both economic growth and inflation will be pushed down. Although the GDP gap remains negative, an expected increase in domestic demand from the second half of 2015 will support the closure of the gap, placing upward stimuli on prices.

According to the NBG forecasts, given the expected recovery of domestic demand, inflation will gradually reach 4% by the end of 2014 and its target rate of 5% in the first half of 2015. The Monetary Policy Committee thus considered desirable leave the policy rate at 4%. Although the NBG still considers exiting the accommodative monetary policy to be necessary, existing forecasts indicate that this will be a longer process than initially envisaged.

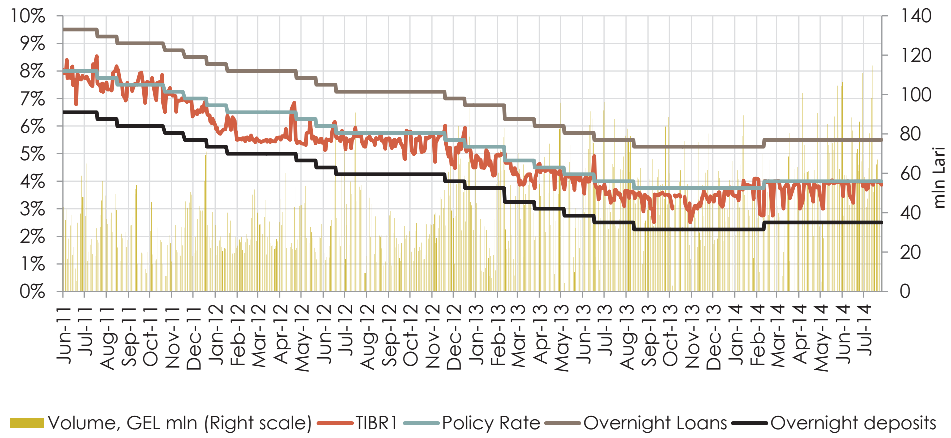
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising 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 policy rate changes 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

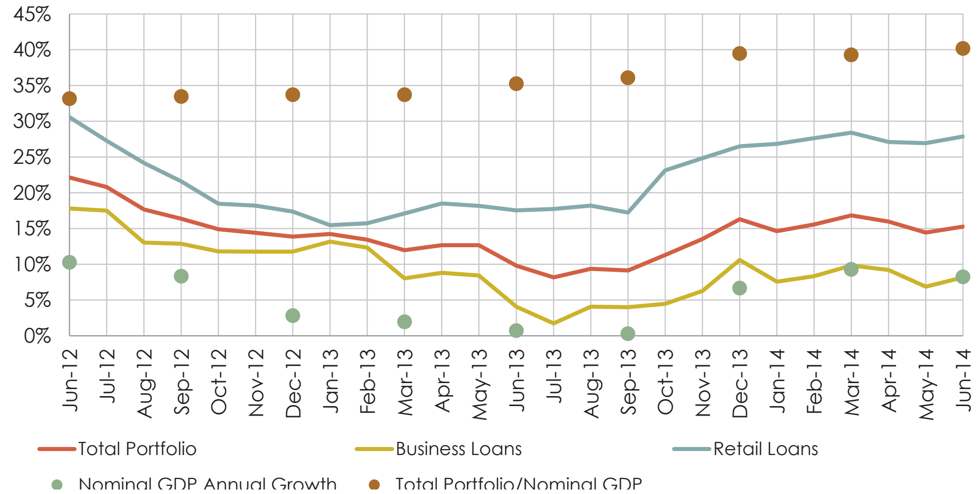
5. Financial Market and Trends

5.1 LOANS

In June 2014, the annual growth rate of the loan portfolio decreased by 0.8 percentage points compared to March and amounted 15%.[6] Credit growth was largely caused by an increase in demand for small- and medium-sized business loans, while retail loans continued to exhibit a high growth rate. In the terms 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. It should be noted that in June, as compared to the same period of the previous year, loan larization increased by 6 percentage points and amounted to 40%.

« Credit growth was largely caused by an increase in demand for small and medium sized business loans, while retail loans continue to exhibit a high growth rate.

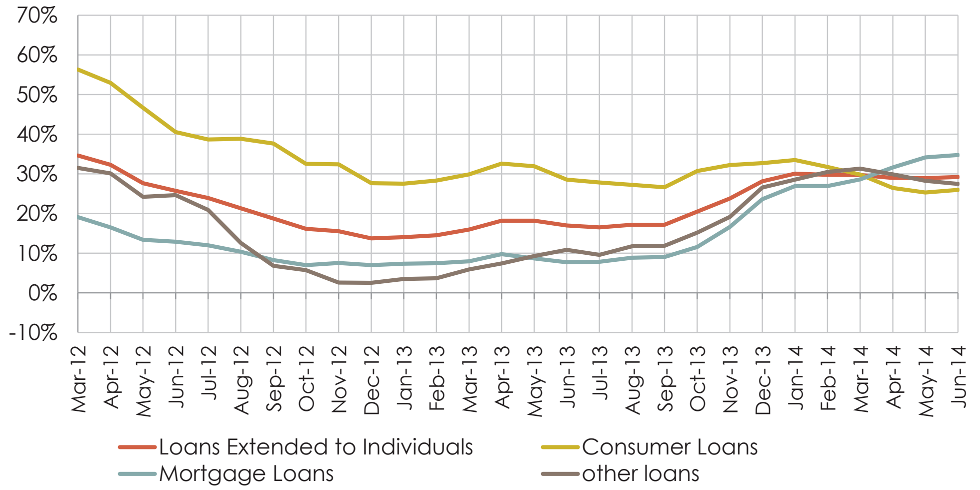
Chart 5.1 Credit Portfolio Annual Growth



Source: National Bank of Georgia

The credit to nominal GDP ratio increased by 0.9 percentage points in the second quarter of 2014 compared to previous quarter, amounting to 40.2% (see Figure 5.1). Retail loans, which predominantly include consumer and mortgage loans, continue to exhibit a high growth rate. In June, the annual growth rate of consumer loans amounted to 26%, while the growth rate of mortgage loans increased to 34.8%.

Chart 5.2 Retail Loans Annual Growth



Source: National Bank of Georgia

6 *The growth rate does not account for the effect of exchange rate movement on the loan portfolio.*

In June 2014, the annual growth rate of the loan portfolio to legal entities amounted to 8.1%, which is 0.7 percentage points lower than in March. Demand on large business loans did not change after the decrease in the previous quarter, which was a result of 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.

« 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. In June, loans to the agricultural sector grew by 200%, 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 remained unchanged in the second quarter of 2014, standing at 7.3%. According to the data from June, the share of non-performing loans in the national currency increased by 0.4 percentage points compared to March, amounting to 5.4%, while the share of non-performing foreign currency loans decreased by 0.2 percentage points and amounted to 8.7%. In the second quarter of 2014, the number of loans written off amounted to 72.4 million GEL, which is twice the amount of the previous quarter.

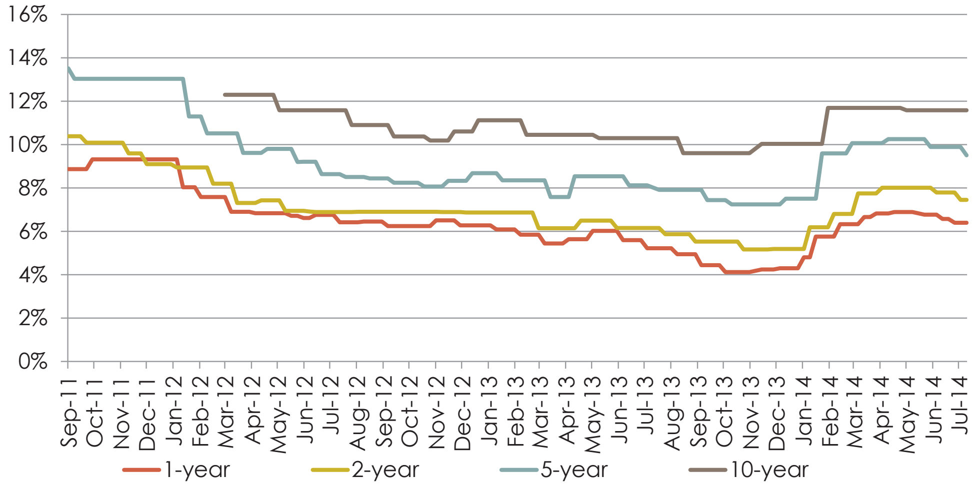
« The share of non-performing loans decreased in foreign currency, but increased slightly in national currency, as compared to the previous quarter.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In line with macroeconomic forecasts, the monetary policy rate did not change in June 2014 and stands at 4%. Changes in monetary policy are transmitted to the real economy with a time lag. However, the easing of monetary policy reduced interest rates. Interest rates on short and long term government securities had an increasing trend in the first quarter, but decreased slightly in the second quarter (see Figure 5.1). As compared to December 2013, in June 2014 interest rates on short and long term government securities increased – supposedly as a result of a rise in inflationary expectations.

« The interest rate on deposits and loans decreased, while rate on government securities increased – supposedly due to a rise in inflationary expectations.

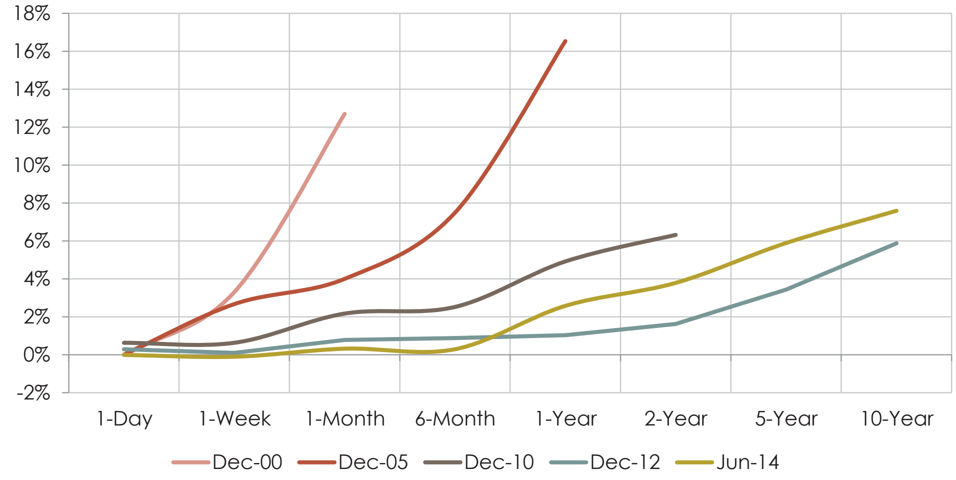
Chart 5.3 Interest Rates on Government Securities



Source: National Bank of Georgia

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 reflects a declining trend. The National Bank of Georgia's monetary policy agenda reduces liquidity and interest rate risks. Additionally, 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

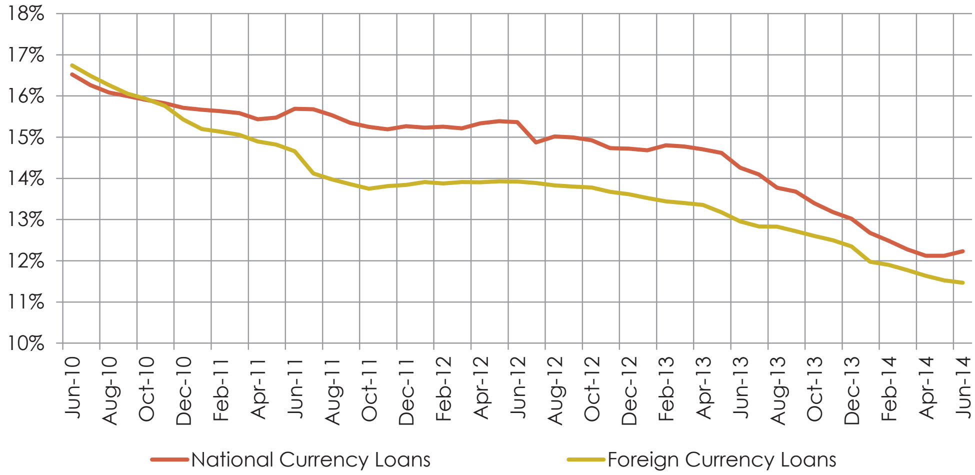


Source: National Bank of Georgia

Because of increased competition among banks and the eased monetary policy, interest rates on loans to both business and retail sectors have declined. In June 2014, as compared to March, interest rates on business loans in the domestic currency have declined by 0.1 percentage points, amounting to 12.2%. For foreign currency business loans, the interest rate declined by 0.3 percentage points, amounting to 11.5%.

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

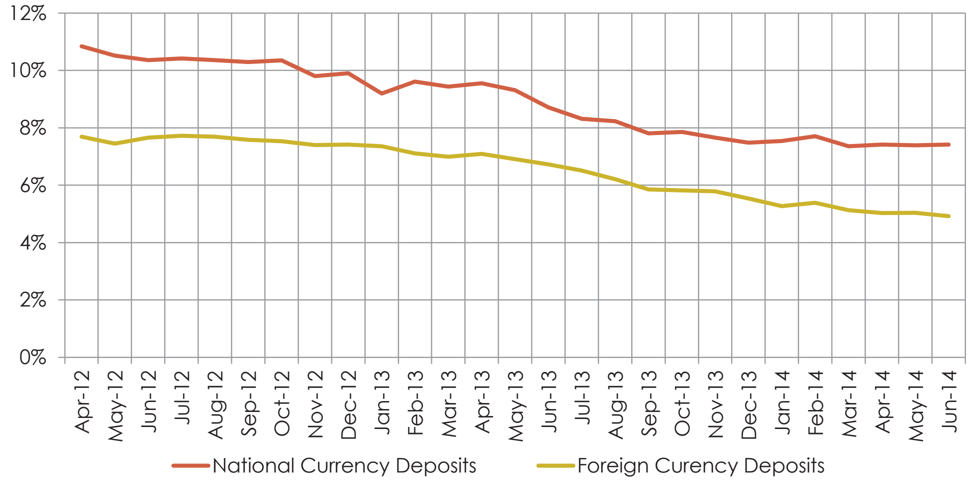
Chart 5.5 Average Interest Rates on Business Loans



Source: National Bank of Georgia

The reduction of interest rates has continued on foreign currency deposits. Compared to the previous quarter, interest rates on foreign currency deposits have declined by 0.2 percentage points, amounting to 4.9%. The interest rate for domestic currency deposits remained unchanged, standing at 7.4%. The decline of 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 a result of the accumulated excess liquidity of banks.

Chart 5.6 Average Interest Rates on Deposits

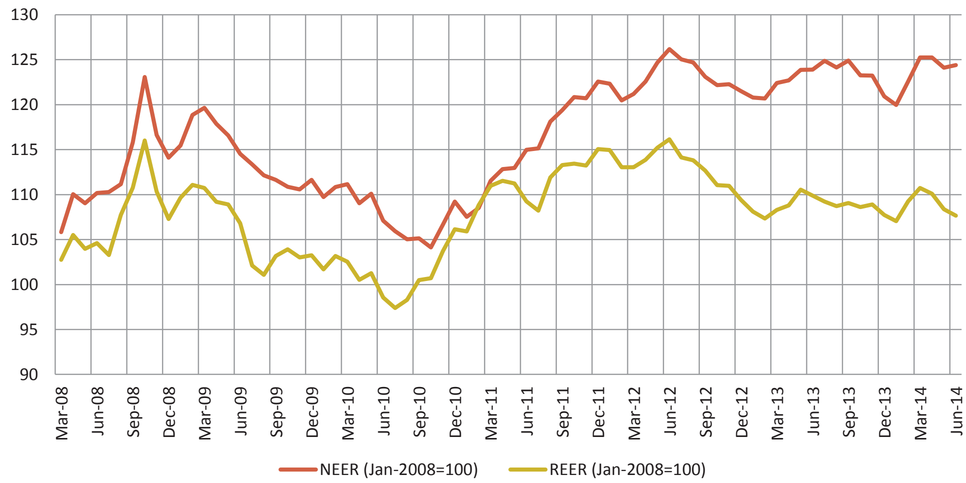


Source: National Bank of Georgia

5.3. EXCHANGE RATE

In June 2014, the nominal effective exchange rate appreciated against the Ukrainian hryvnia and the euro compared to March, but depreciated against the dollar, the Russian ruble and Turkish lira. As a result, in June, the overall nominal effective exchange rate depreciated by 0.7% compared to March, but appreciated by 0.4% compared to the corresponding period of the previous year.

Chart 5.7 Effective Exchange Rates (Jan 2008 = 100)



Source: National Bank of Georgia

In June 2014, the real effective exchange depreciated by 2.8% compared to March, and by 2% compared to the corresponding period of the previous year. In June 2014, the lari real effective exchange rate appreciated significantly against the Ukrainian hryvnia.

Table 5.1 Effective Exchange Rate Annual Growth

June 2014	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	0.4	-2.0	-2.0
Turkey	4.5	-2.3	-0.5
EU	-9.2	-8.1	-1.3
Ukraine	38.2	26.0	3.0
Armenia	-6.8	-6.6	-0.4
USA	-6.4	-6.4	-0.4
Russia	-0.2	-5.6	-0.5
Azerbaijan	-6.4	-5.5	-1.0
other	-5.7	-5.0	-1.1

Source: National Bank of Georgia

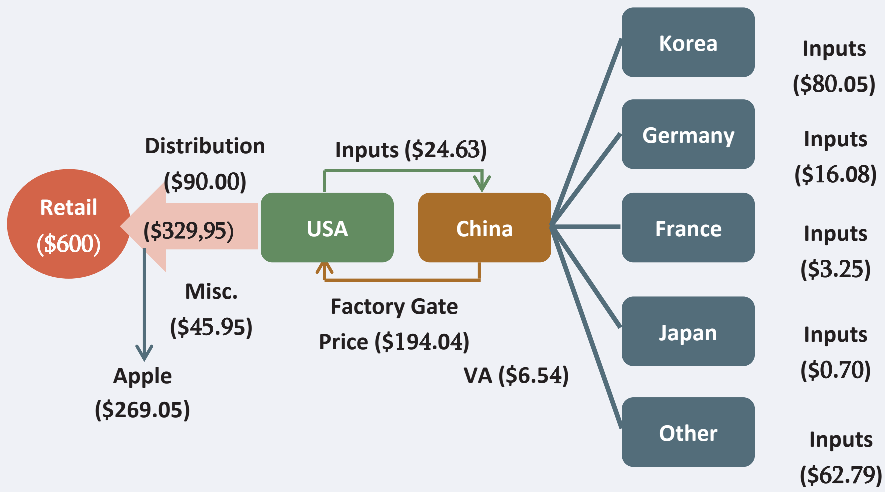
Box 2 Real Effective Exchange Rate and Productivity

The real effective exchange rate index (REER) represents the weighted average exchange rate of the domestic currency against the basket of main trading partners' currencies, adjusted for the effect of inflation in these countries. According to the standard REER calculation, the consumer price index (CPI) is used as an indicator for prices. The weights of partner countries are determined based on their share in the total trade turnover of Georgia.

The REER is an important indicator for the assessment of productivity changes. According to the Balassa-Samuelson hypothesis, appreciation of the real exchange rate shows that a country's productivity has grown faster than the productivity of its partner countries. However, for the REER to be a good estimator of productivity growth in local production, the price index and export value used for REER calculations need to reflect the prices of local inputs and the value of domestically produced goods.

Along with changes in international trade structure, the REER calculated using the standard methodology reflects changes in domestic productivity to a lesser extent. In parallel to the growth of global trade, more countries have become part of the global value chain, meaning that stages of production are distributed among a number of different countries. For instance, as Figure 5.8 shows, iPhones – which are assembled in China – have a high input share from the U.S., Korea, Germany and other countries. Only a small proportion of the value added (assembly) is produced in China. As a consequence, the change in the final price of an iPhone might not reflect changes in the local input prices of China at all. Therefore, the link from prices of local inputs to final price is broken. Nowadays, intermediate products account for two thirds of global trade turnover. Thus, the standard REER does not correctly reflect changes in the productivity of local production.

Chart 5.8 Share of Different Countries in the Gross Value of an iPhone



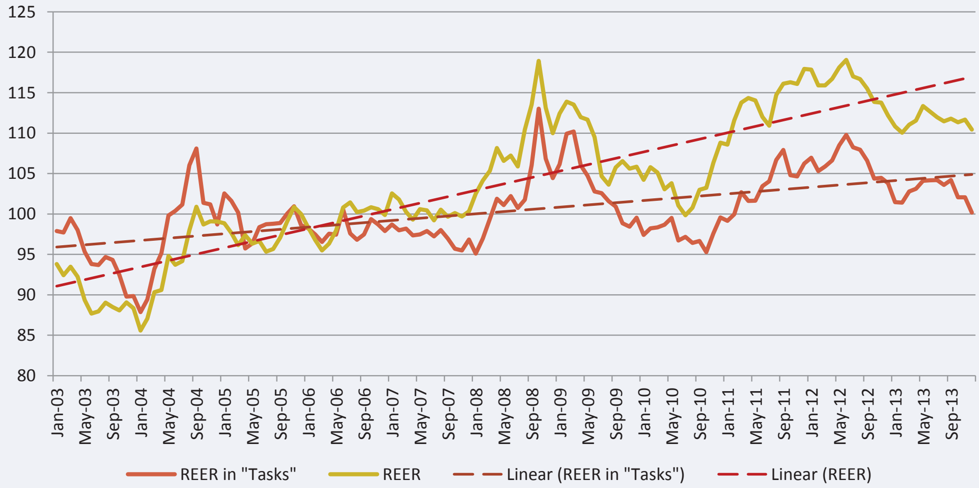
Source: "Global Value Chains: Preliminary Evidence and Policy Issues", Organization for Economic Co-operation and Development, DSTI/IND (2011) 3, Paris, 2011

To better reflect developments in the global value chain and international trade, the REER in "Tasks" (Bayoumi, Saito, and Turunen, IMF, 2013) has been introduced as an alternative methodology. Unlike the standard REER, this takes into account trade with local value added rather than the final value of trade. In addition, the GDP deflator is used in calculations of the REER in "Tasks" instead of the CPI. Using the GDP deflator has several advantages over the CPI:

- The GDP deflator better reflects changes in prices of local inputs, while the CPI does this to a lesser extent.
- The CPI does not take into account the prices of exported goods, while the GDP deflator covers this.

The difference between the REER and REER in "Tasks" is considerable in Georgia, mainly due to the usage of the CPI rather than the GDP deflator.

Chart 5.9 Standard REER and REER in "Tasks"



Source: National Bank of Georgia

Figure 5.9 displays the REER calculated with two different methodologies and their linear trends. As can be seen, the exchange rate index calculated with the alternative REER in "Tasks" methodology is appreciating less. The standard REER appreciated by 3% from 2003, while the REER in "Tasks" appreciated by 1% during the same period.

The alternative REER shows a lower growth of local production productivity than the standard REER. This difference is caused by the fact that the CPI has been higher than the GDP deflator in Georgia, mainly due to imported inflation. Consequently, although the standard REER appreciated more, this appreciation was not related to the growth of local production productivity, as the REER in "Tasks" trend indicates.

The main advantage of the REER in "Tasks" methodology is that it better reflects the competitiveness of locally produced goods compared to those of trading partner countries. However, the data used for the calculation of the REER in "Tasks" is available on a quarterly basis and can thus only be updated once every three months. Furthermore, accurate data on the trade value added is not available, so the index is based on approximated data. Despite problems with data availability, the REER in "Tasks" contains additional information about changes in the productivity of local production. Examining the REER in "Tasks" alongside the standard REER will thus give a more complete picture.

6. Domestic Demand

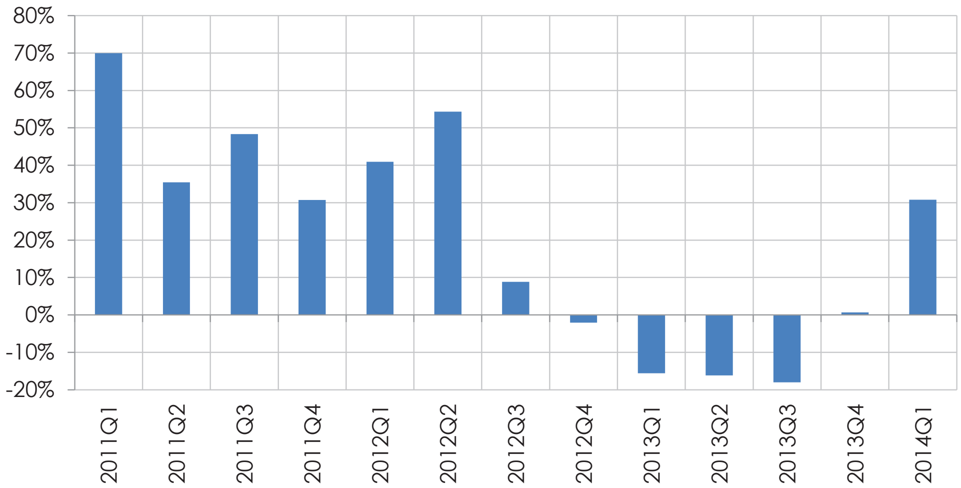
Real GDP growth amounted to 7.1% in the first quarter of 2014. Private consumption and investments are expected to be the main driving forces of GDP growth in 2014, unlike the previous year where net exports was the main contributor. The growth rates of consumption (both public and private) and imports experienced a dramatic fall in 2013 as a result of weak domestic demand, while exports significantly increased. Because domestic demand has exhibited signs of recovery since the end of 2013, both imports and consumption are expected to show high rates of growth. On the other hand, the growth rate of exports is expected to decline due to the political crisis in Ukraine. As a result, net exports should make a small negative contribution to economic growth (see Figure 2.8).

‹‹ Real GDP growth amounted to 7.1% in the first quarter of 2014.

‹‹ Private consumption and investments are expected to be the main driving force of GDP growth in 2014.

In the first quarter of 2014 comparably high level of private and government sector investments relative to the first quarter of the previous year has made significant contribution to GDP growth that partially is caused by base effect (In the first quarter of 2013 capital formation declined by 15.6 percent).

Chart 6.1 Annual Growth Rate of Capital Formation



Source: GeoStat

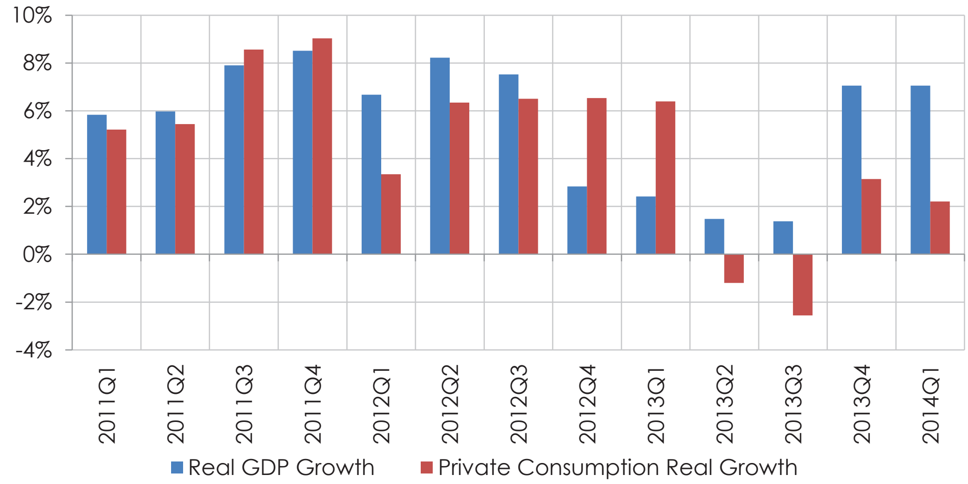
In first quarter of 2014, exports of goods and services increased by 7.4% year-on-year, and imports increased by 12.2%. As a result, net exports negatively contributed to GDP growth in the first quarter and are expected to continue to make a negative contribution to the growth of the economy in forthcoming quarters.

‹‹ Net exports contributed negatively to GDP of first quarter.

The real growth of private consumption[7] decreased slightly in first quarter of 2014 and posted 2.2% growth compared to the previous period. Consumption increased in the public sector as well. Private consumption is expected to have a high rate of growth in the next quarters. One of the reasons for such expectations could be the decline of interest rates on consumer loans. Low interest rates stimulate increased demand. Because of its higher growth rate, private consumption should be one of the main determinants of GDP growth.

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

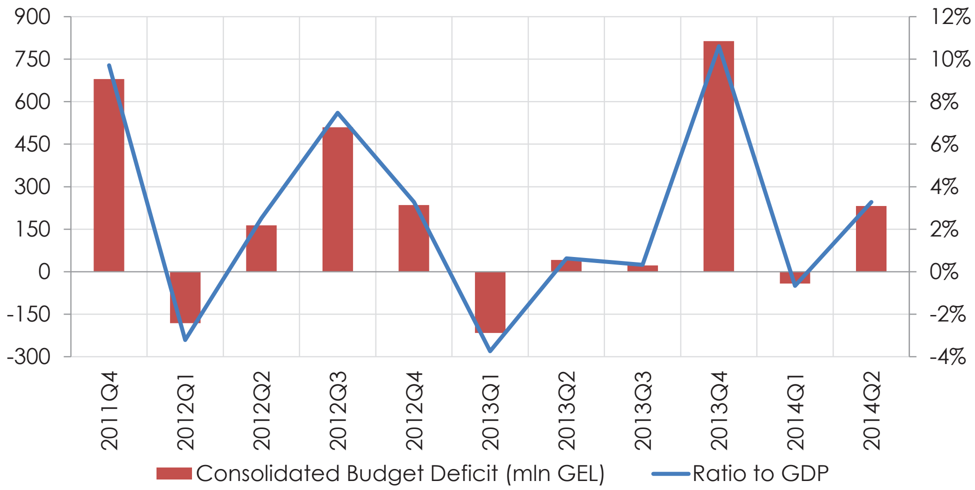
Chart 6.2 Real GDP and Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget deficit posted 179.5 mln GEL in the first half of 2014. Taking seasonal patterns into consideration, a budget surplus is observed in the first quarter, followed by a deficit in the remaining quarters (with the highest deficit in the fourth quarter), along with a rise in budget expenditures. The consolidated budget deficit in the first quarter of 2014 was much smaller than in the first quarter of 2013. Furthermore, the budget deficit in the second quarter posted 222 mln GEL, which is much higher than the deficit in the same period of the previous year. A deficit of approximately 1.1 bln GEL is planned for the consolidated budget of 2014. The last two quarters of 2014 are thus expected to have a negative budget deficit. However, unlike the previous year, the annual budget deficit of 2014 should be more equally distributed among the quarters, which should enable domestic demand to avoid significant fluctuations.

Chart 6.3 Consolidated Budget Deficit (mln GEL)



Source: Ministry of Finance of Georgia

7. External Demand and Balance of Payments

In the first quarter of 2014, the ratio of the current account (CA) deficit to GDP was 9.9%, which is a 3.7 percentage point improvement compared to the analogous indicator of 2013. In absolute terms, as compared to the first quarter of 2013, the CA deficit increased by 142.3 mln USD to 356.2 mln USD. The deepening of the CA deficit was mainly driven by the rapid increase in the import of goods, which, in turn, was caused by the recovery of domestic demand.

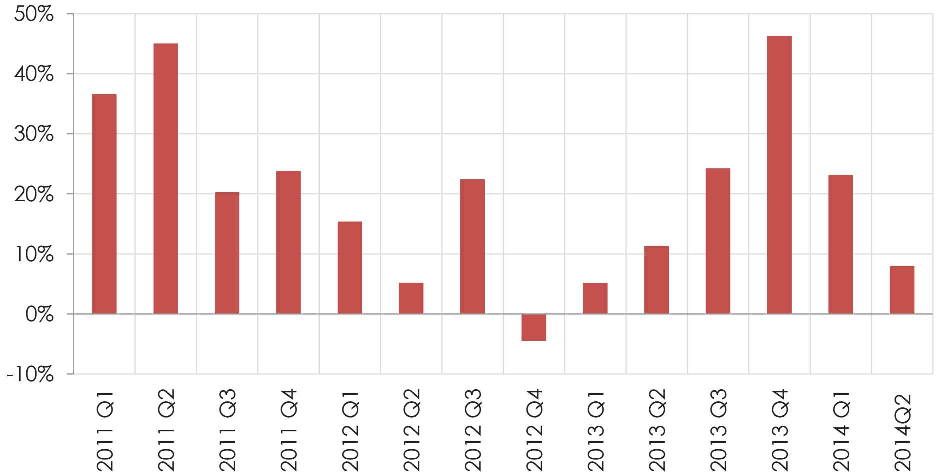
« In the first quarter of 2014 the ration of the current account (CA) deficit to GDP was at 9.9%, that is a 3.7 percentage point improvement compared to the analogous indicator of 2013.

According to the existing forecast, by the end of 2014 the CA deficit to GDP will reach 8.4%, 2.5 percentage points higher than in 2013.

In the first quarter of 2014, the CA deficit deepened due to worsened trade and service account balances. Compared with the same period in 2013, the trade deficit deepened by 97.3 mln USD. The service account deficit increased by 30.5 mln USD, mainly due to the growth of imports of transportation services. The primary income account balance was slightly lower (-13.6 mln USD), while the decrease in secondary income was negligible (-0.9 mln USD).

According to preliminary data, in the second quarter of 2014, as in the first quarter, the CA deficit ratio to GDP will be maintained at around 10%. In the second quarter, registered exports of goods increased by 7.9% year-on-year. This is a lower growth rate than in previous quarters. The reduction of export growth was mainly associated with decreased re-exports of cars. Excluding this, the growth of exports amounted to 18.9% in the second quarter of 2014.

Chart 7.1 Annual Growth Rate of Registered Exports of Goods



Source: National Bank of Georgia

« In the second quarter of 2014 exports of wine (88.3%) and mineral waters (32.9%) recorded rapid growth and belongs to the top 5 of exported products.

In the second quarter of 2014, exports of wine (88.3%) and mineral waters (32.9%) recorded rapid growth and both belong to the list of the top five exported products. During the same period, exports of ferro-alloys increased by 47%, coming in at second place in the list of top exports. The re-export of cars decreased by 22.8% in the second quarter of 2014, mainly due to new regulations introduced on Azerbaijan's markets. Despite this reduction, cars still occupy first place in the list of exported products.

In the second quarter of 2014, exports to EU countries were up by 37%, but exports to CIS countries decreased by 4%. The reduction of exports to the CIS market was mainly caused by a drop in exports to Ukraine (-29%), Kazakhstan (-28%), and Belarus (-22%). Overall, exports to CIS countries accounted for 50.9% of total exports in the second quarter of 2014. The share of EU exports was 21.4% and other exports

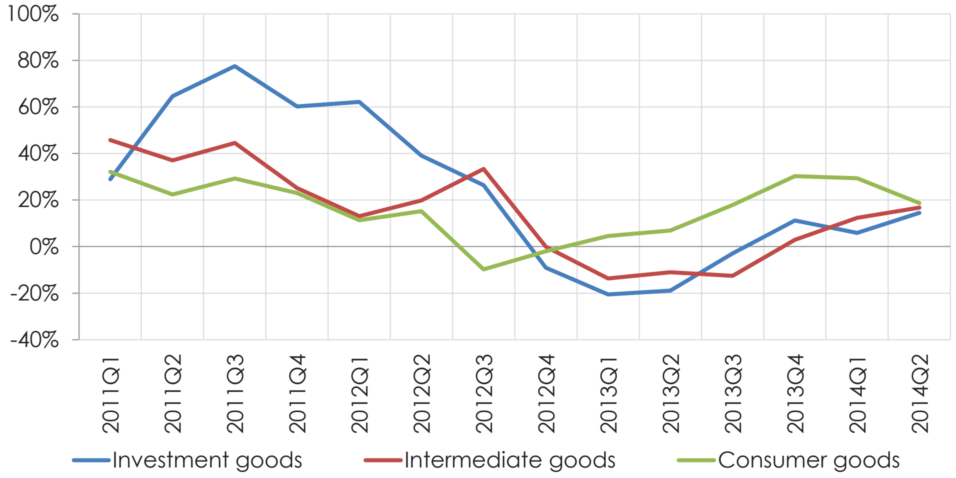
« In the second quarter of 2014, exports to EU countries were up by 37%, but exports to CIS countries decreased by 4%.

accounted for 27.8%.

In the second quarter of 2014, registered imports of goods increased by 15.7%. Growth was observed for both consumption as well as for intermediary and investment goods.

‹‹ Growth was observed for both consumption as well as for intermediary and investment goods.

Chart 7.2 Annual Growth Rate of Imports Accross the Product Groups



Source: National Bank of Georgia

In the second quarter of 2014, registered imports of goods from EU countries increased by 11%, while decreasing by 3% from CIS countries. Imports from other countries increased by 28%.

The number of foreign visitors to Georgia slightly decreased in the second quarter of 2014, but tourism inflows increased by 2.5%. This decline is mainly due to the decreasing number of Turkish visitors and a temporary road closure because of the landslide at the Larsi customs point. While the number of visitors from Turkey decreased, they increased from Ukraine, Russia and other Eastern European countries, causing the total number of tourism revenues to grow.

In the first half of 2014, the total number of foreign visitors amounted to 2.24 mln people, up by 2.1% compared to the same period in 2013.

Money transfers continued to play an important role in financing the current account deficit. In the second quarter of 2014, the amount of money transferred from abroad as remittances increased by 4.2% to 373.7 mln USD. The Ukrainian crisis was reflected on money transfers from CIS countries. Remittances from Ukraine decreased by 27.7%, as was the case with those from Russia, which were down by 1.4%. Total CIS remittances declined by 1.2%. Money transfers from the EU increased by 10.2%, which were mainly driven by Greece, Italy and Germany.

Foreign direct investments (FDI) increased by 19.4% to 272.7 mln USD in the first quarter of 2014. The finance, manufacturing, and hotels and restaurants sectors were the main contributors to this growth. The FDI received by these sectors in the first quarter of 2014 accounted for 34%, 18%, and 17% of total FDI, respectively.

The external debt service is an important item of the financial account for 2014. In the first half of the year, Georgia paid 152.1 mln USD of an IMF loan, out of which the Ministry of Finance had a 65.9% share and the remaining 34.1% was paid by the National Bank of Georgia.

Box 3 Compilation of the Balance of Payments with a New Methodology

The National Bank of Georgia has switched to a new methodology for the compilation of external sector statistics. Starting from the first quarter of 2014, balance of payments (BOP) and international investment position statistics are compiled according to the sixth edition of the IMF's "Balance of Payments and International Investment Position Manual" (BPM6), which was released in 2009. The 2014 data will be presented according to both the 1993 fifth edition (BPM5) "Balance of Payments manual" and the 2009 sixth edition (BPM6) "Balance of Payments and International Investment Position Manual". As of 2015, data will only be presented in BPM6 format. Historical data from the year 2000 was also recalculated according to the new methodology and this will also be presented in two formats in 2014.

In 2009, the IMF revised BPM5 in line with global economic and financial developments and considering the analytical needs and experience accumulated by the people working on BOP methodology. While the overall framework of the fifth edition (BPM5) remained unchanged, it needed to incorporate numerous elaborations, clarifications, and updates in the methodology. Furthermore, the BOP manual was simultaneously reviewed by the UN statistical commission to obtain a high level of correspondence with SNA (The System of National Accounts, which was last released in 2008). BMP6 also provides considerably more detailed guidance on the international investment position and much greater discussion of revaluations, other volume changes and their impact on the value of assets and liabilities.

Since August 2012, the IMF presents BOP and IIP (International Investment Position) statistics only according to the sixth edition in the IFS (International Financial Statistics) database and BOP yearbook.

The major changes between the fifth and sixth editions of the BOP manual are:

1. Accounting principles

- Transactions with a plus sign indicate an increase of assets or liabilities, and a minus sign indicates a decrease of assets or liabilities. According to the fifth edition, an increase of assets was presented with a minus sign and a decrease of assets with a plus sign.
- Changes in financial assets and liabilities due to a change of residence of individuals are treated as other changes in the volume of assets (reclassifications), rather than as transactions. Consequently, capital transfers due to migration will not be reflected in the BOP (also, transactions connected to migration will not be reflected in the current account and financial account).

2. Institutional sectors

- Institutional sectors were amended to be consistent with SNA. The "Monetary authorities" sector was substituted with "Central bank", and instead of the term "Banking sector," the term "deposit-taking corporations except central bank" is used.
- Other sectors were divided into two separate subsectors: "Other financial corporations" and "Nonfinancial corporations, households and nonprofit institutions serving households (NPISHs)".

3. Classification of financial assets and liabilities

- Special drawing rights (SDRs) allocation represents a liability for the recipient.
- In BPM6 debt arrears remain in the outstanding amount of the debt instrument. In BPM5 it was recorded as a new debt instrument under other investments, accumulation of arrears.

4. Current account

- "Goods for processing owned by others" and "Repairs on goods" are recorded under services. In BPM5 these items were recorded under goods if the goods were returned to the initial owner, otherwise they were recorded as "Miscellaneous business, professional and technical services".
- "Repairs on goods" have been renamed in "Maintenance and repair services". Unlike BPM5, this item is now included under services, rather than goods.
- Interest accrued on debt instruments is divided in two parts: "Financial intermediation services indirectly measured (FISIM)" and "Pure income".
- Instead of the terms "Income" and "Transfers", the terms "Primary income" and "Secondary income" are introduced.
- Income from reserve assets is separated from other investment income and is recorded as a separate item.

8. Output and Labour Market

8.1 OUTPUT

The process of economic revitalization that emerged in the last quarter of 2013 was extended in the first quarter of 2014. GDP growth constituted 7.1% over the same period of the previous year. The growth breaks down as follows: services 4.8%, industry 2% and agriculture 0.2%.

‹‹ Economic revitalization process was extended in the first quarter of 2014.

After a robust increase in the previous year, agriculture rose by 2.7%, due to crop production (+20.8%), while livestock production dwindled (-6.6%). Since 1998, every even year has been low yielding, causing an output drop of agriculture. However, 2014 can be excluded from this pattern, mainly because of the activities of the Georgian Rural Development Fund.

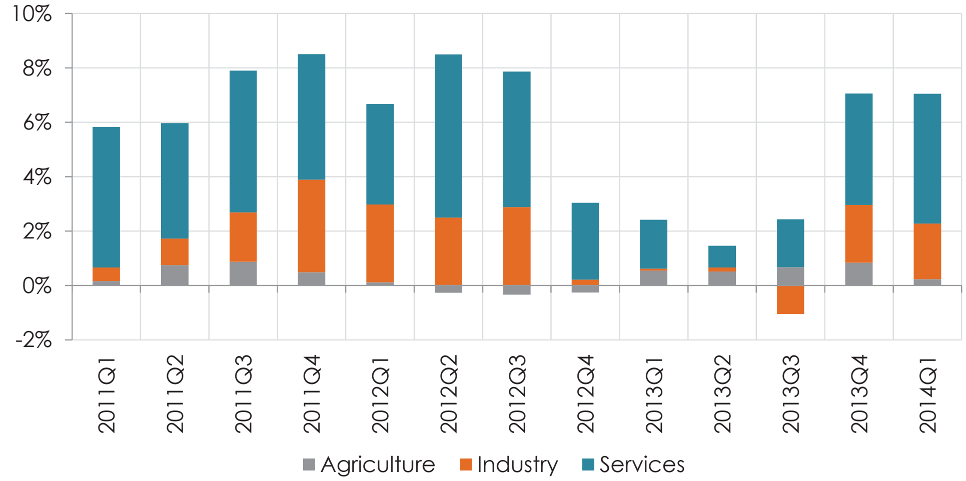
From the industrial sector, the production of mineral water and non-alcoholic beverages (+55.3%) and alcoholic drinks (+69.1%) saw considerable growth due to external demand and a rise in exports. Mining has contracted for a third consecutive quarter, presently standing at a reduction of 11.2%. The decrease in gold mining can explain this reduction, with there being a dramatic reduction of unwrought and semi-manufactured gold exports (-50.4%). Construction rose in the first quarter (+14%) due to both private (+9.9%) and increased governmental spending on infrastructural projects (+24.9%).

The trade sector, the largest part of the services sector, saw remarkable growth (+11.1%). The rise of consumption (+6.4%), underpinned by the National Bank's softened monetary policy and a consequent easing of credit accessibility, largely contributed to the intensification of trade. The rise of trade can also be explained by the surge in car trading, which was preceded and related to the change of trade conditions with Azerbaijan. The transport sector has significantly increased (+9.2%), in line with the growth of imports and the number of visitors. Due to the activation of the real estate market and simplified accessibility to credit, real estate and renting operations have substantially risen (+10.1%). The overall improvement of economic conditions had a positive impact on taxes in real terms (+6.8%).

According to preliminary assessments, GDP growth in the second quarter of 2014 slowed to 5.1%. This can be explained by a reduction of external demand.

‹‹ GDP growth in the second quarter of 2014 slowed down to 5.1 %.

Chart 8.1 Contribution of Sectors of Economy to Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

The growth rate of labor productivity declined in the first quarter of 2014 as compared to the previous quarter. According to Geostat, the productivity of the labor force increased by 4.3% in year-on-year terms during the first quarter, which is 3.2 percentage points less than in the fourth quarter of 2013. During this period, the annual rate of labor efficiency growth significantly decreased in the agriculture sector. According to the data, the annual growth rate of real value added per employee in the agriculture sector amounted to 2%, which is 11 percentage points less than the previous quarter. Labor productivity in industrial sectors increased, but the growth rate slowed. As for the service sector, the real value added per employee in services grew by 3.2% on an annual basis.

« Labor productivity increased by 4.3% during the first quarter of 2014. This increase can be largely attributed to industrial sectors.

Table 8.1 Index of Value Added Produced per Worker in 1st Quarter of 2014 Relative to the Corresponding Period of the Previous Year

	Real value added per employee (growth index)
Agriculture and processing of agriculture products by households	101.9
Industrial sectors	110.8
Service sector	103.2
Overall in the economy	104.3

Source: GeoStat and National Bank of Georgia

As a sectoral breakdown of the economy shows, labor productivity in manufacturing increased, with the annual growth rate reaching 15%. Unlike the previous quarter, an annual 2.5% growth in construction was observed. As was the case in the preceding quarters, labor productivity significantly increased in the hotels and restaurants sector and stood at 37.4%.

« The labor productivity in manufacturing continues to grow.

The annual growth rate of nominal salaries of employees increased during the first quarter of 2014, with the average monthly nominal salary standing at 796 GEL, according to the latest data from Geostat. The growth of the average salary amounted to 9% during that period, which is 1.3 percentage points higher than in the previous quarter.

« The annual growth rate of the nominal salaries of employees has increased.

In terms of sector analysis, an increase in the annual growth rate of salaries is evident in the agriculture, construction, financial intermediation and public administration sectors. However, average salaries decreased in the mining and quarrying sector during the first quarter of 2014.

Table 8.2 Index of Average Monthly Nominal Wage of Employs in 1st quarter of 2014 Relative to the Corresponding Period of the Previous Year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	121.2
Fishing	118.4
Mining and quarrying	97.0
Manufacturing	108.1
Production and distribution of electricity, gas and water	105.2
Construction	116.1
Wholesale and retail trade; repair of motor vehicles and personal and household good	104.3
Hotels and restaurants	105.4
Transport and communications	109.4

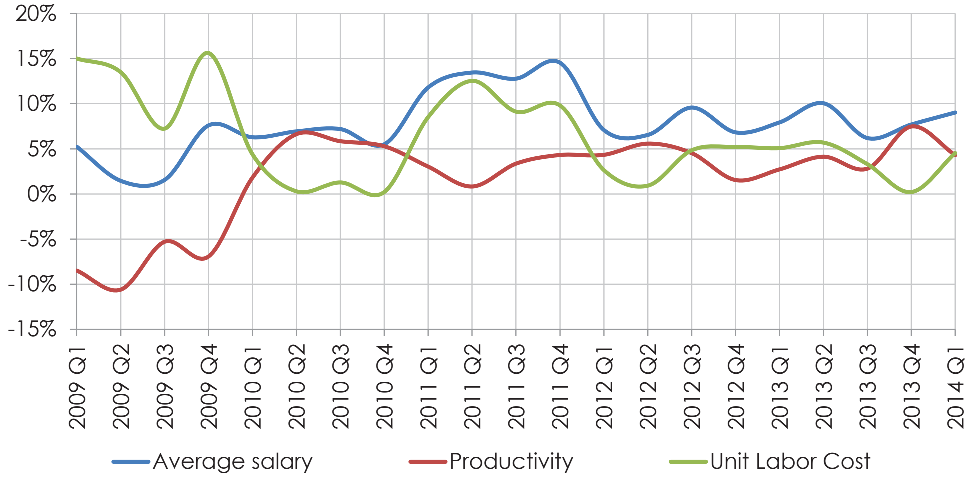
	Average nominal wage (growth index)
Financial intermediation	109.9
Real estate, renting and business activities	105.1
Public administration	110.3
Education	107.5
Healthcare and social work	105.0
Other community, social and personal service activities	113.3
Overall in the economy	104.3

Source: GeoStat

To sum up, against the backdrop of a declining annual growth rate of labor productivity, the annual growth rate of unit labor cost[8] (personnel expense per production unit) increased and stood at 0.2% by the end of the first quarter of 2014 (see Figure 8.2). However, it remains at a low level, which indicates that there is no upward price pressure from the labor market.

‹‹ The annual growth rate of unit labor cost slightly increased.

Chart 8.2 Labor Productivity, Average Monthly Salary and Unit Labor Cost, 2009-2014 Q I (Annual Percentage Change)



Source: GeoStat and National Bank of Georgia

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

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