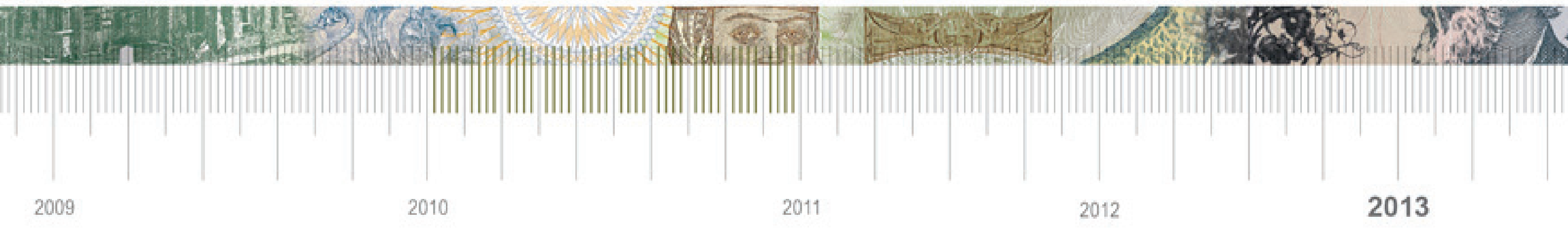
National Bank
of Georgia

INFLATION REPORT

November

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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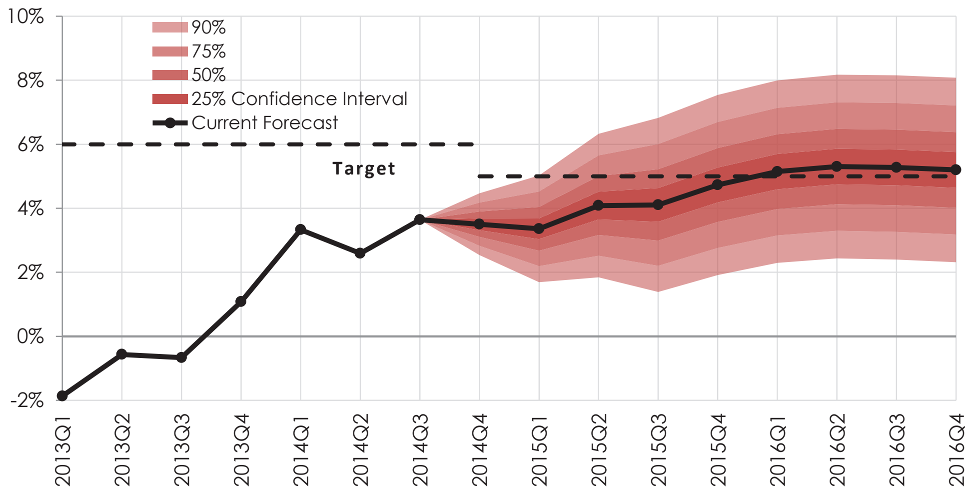
1. BRIEF OVERVIEW

Real GDP increased by 5.5% year-on-year in the third quarter of 2014 according to preliminary estimates. Average year-on-year growth for the first three quarters of 2014 reached 5.9%. Economic growth in the current year has been supported by the growth of domestic demand. In particular, amid expansionary monetary policy and fiscal stimulus measures, lending growth was positively reflected in the growth of consumption and domestic investments. In contrast, net exports made a negative contribution to GDP growth, which was due to the high growth of imports partly coming from the growth of domestic demand. Export growth declined. This was partly caused by an escalation of the Russia-Ukraine conflict, but also reflected the fall in effect of the sharp increase in exports that had followed the opening of the Russian market last year. In addition, stricter regulations on auto transport in Azerbaijan had a negative effect on Georgia's re-export of vehicles.

Inflation posted 3.4% in October 2014 and remained below the National Bank's target rate of 5%. The factors affecting inflation dynamics have also changed to a certain extent. Higher-than-expected depreciation of some trading partner currencies caused the strengthening of the nominal effective exchange rate, which was consequently reflected in import prices. Imported inflation, which was affecting the inflation rate in an upward direction at the beginning of this year, created downward pressure on consumer prices in October. A stronger-than-expected fall in global oil prices had a negative impact on international markets and was also partly reflected in domestic market developments. In contrast, food prices, which contributed to the reduction of the inflation rate in the beginning of the year, have, consistent with the forecast, exerted upward pressure on headline inflation since the second quarter of 2014.

According to the forecast, inflation will remain below the 5% target in the coming quarters. Inflation will average 3.5% in the fourth quarter of 2014. In 2015, following a small reduction in the first quarter due to the base effect, inflation will gradually reach the target. Growth will be supported by local prices, assuming a significant impact of food prices. The transfer of trading partners' inflation will be limited due to the appreciation of the nominal effective exchange rate. The impact of imported inflation will increase, albeit somewhat moderately, in the second quarter of 2015 owing to the transmission of inflation from trading partner countries. The weakening of commodity prices on the international market will negatively affect the inflation rate, which will also be reflected on the domestic market to some extent.

Figure 1.1 Headline CPI Inflation

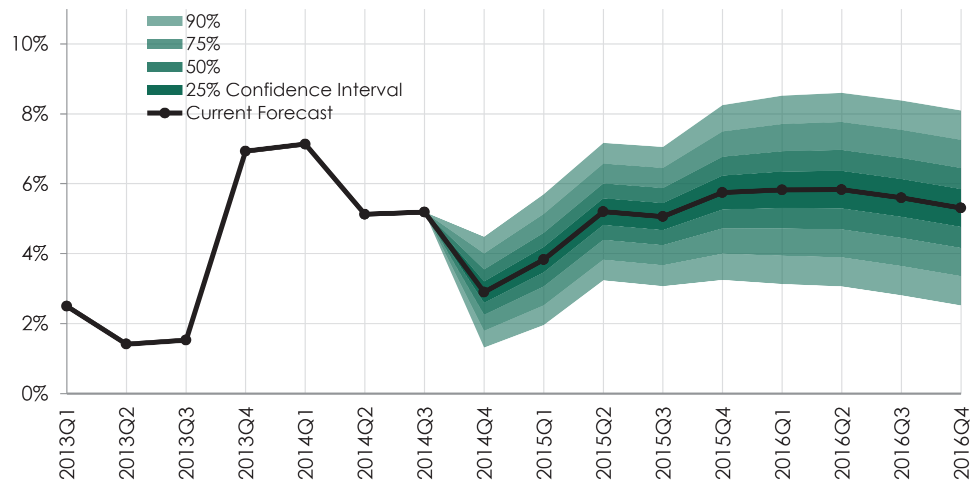


Source: National Bank of Georgia

The inflation forecast is largely dependent on **exogenous factors** affecting the market and contains **risks** in both an upward and downward direction. In particular, if the weakening of trading partner currencies is reversed, the transmission of their inflation onto imported goods will be stronger. Food prices also bear risks as long as they make up an important part of the consumer basket and are dependent on supply factors. If external demand on food increases due to the Russian embargo imposed on European countries, this may be reflected in an increase of food prices in Georgia. The opposite effect on inflation might also be observed if the currencies of trading partners depreciate more than expected and/or the fall of commodity prices on international markets is transferred to local prices more than expected. The realization of such risks may lead to a change in the inflation rate relative to the forecast.

According to the forecast, GDP growth in the fourth quarter will decrease due to the base effect and, subsequently, economic growth in 2014 will average 5%. Real GDP will increase by 5% in 2015 too, which is going to be mainly supported by continued growth in domestic demand. Despite the planned fiscal consolidation measures, the growth in lending will promote investment and consumption growth amid the increase in capital expenditures and expansionary monetary policy. Net exports are expected to make a slightly negative contribution to GDP growth in 2015. The economic slowdown in Georgia's trading partners negatively influences net exports along with the depreciation of their currencies. According to current estimates, the level of economic activity will gradually move closer to its potential, however, the gap will remain negative throughout 2015. Due to foreign risk factors, economic growth is still fragile.

Figure 1.2 Real GDP Annual Growth



Source: National Bank of Georgia

The Monetary Policy Committee decided to keep the refinancing rate unchanged at 4% at their meeting of 19 November 2014. Based on the analysis of current economic developments, forecasts and related risks (including foreign risk factors), the committee considered that there is a need to further maintain an accommodative monetary policy. The committee believes that the exit from the accommodative monetary policy will take place gradually, and its pace will depend on the expected dynamics of the inflation rate and factors affecting it. The main determinant of the monetary policy rate is the objective that medium-term (4-6 quarters) inflation is maintained around the target rate of 5%.

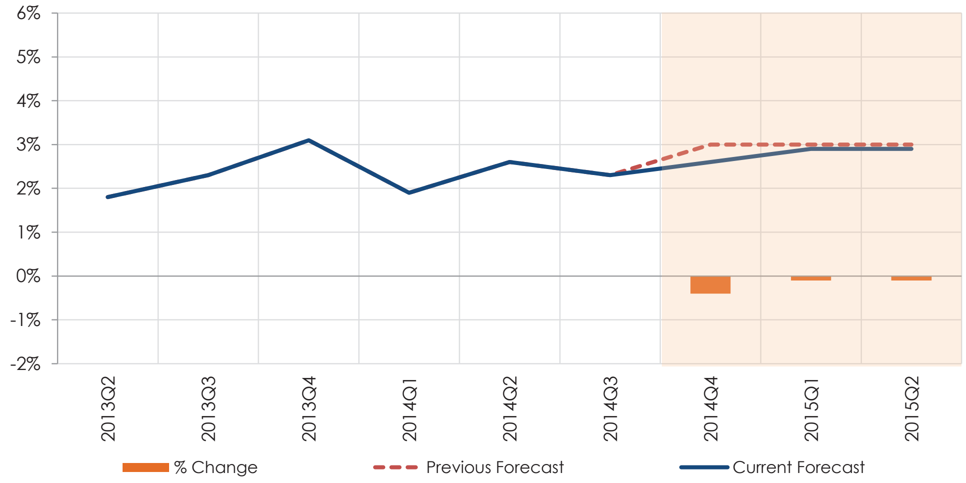
2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

The world economy is still coping with the legacies of the global financial crisis. High private and public debt, as well as high levels of unemployment, remains major challenges for a number of economies worldwide. The recovery process in the eurozone is likely to last longer than was previously anticipated. The outlook for the emerging and developing world has deteriorated somewhat amid the amplified geopolitical crisis in Ukraine and weak demand from developed countries. Better developments are observed in the US, where the recovery process is stable; as reflected in a gradual reduction of the unemployment rate while keeping the inflation rate close to the long-term target. According to International Monetary Fund (IMF) forecasts, the global economy will increase by 3.3% and 3.8% in 2014 and 2015 respectively.[1]

Following a weak first quarter, the US economy grew by 2.6% in the second quarter, while third quarter growth posted 2.4% (see Figure 2.1). There has been a significant increase in consumption and private investments, while the unemployment rate declined to 6.1%. The economic recovery is expected to continue throughout 2015 and will be underpinned by improved labor and real estate markets, the availability of credit and a reduced fiscal burden. The IMF predicts that the US economy will increase by 2.2% in 2014 and that the growth will reach 3.1% in 2015.

Figure 2.1 U.S. Real GDP Annual Growth

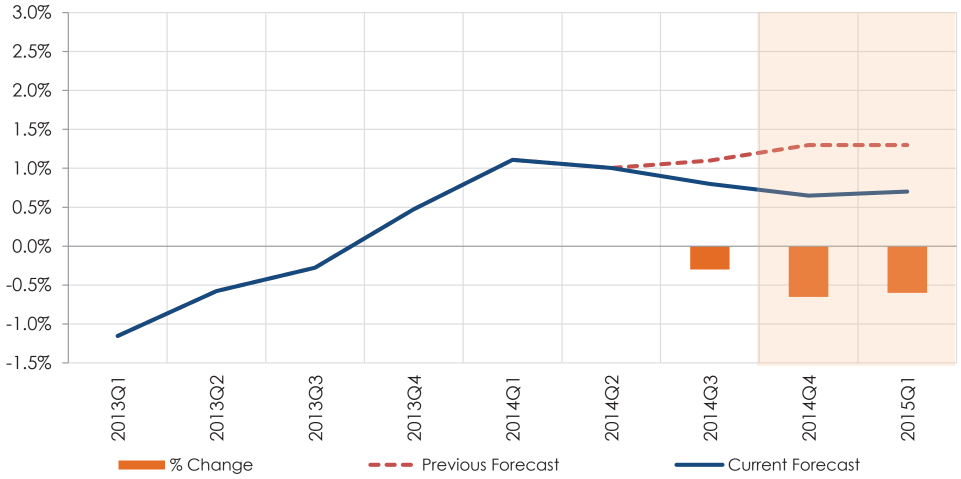


Source: OECD

The economic recovery is still fragile in the euro area. This was confirmed by the significant reduction of investments in the third quarter. As a result, the region's GDP growth during this period was only 0.8% (see Figure 2.2). Unemployment is still high, as is private and public debt. There is also a weak level of growth in productivity and competitiveness. It is noteworthy that the forecasts for economic growth have turned rather uneven among eurozone member countries. According to the International Monetary Fund's assessments, the growth prospects for Germany and Spain are much better than those of France and Italy. Overall, the eurozone economy will increase by 0.8% and 1.3% in the years 2014 and 2015 respectively.

1 *Source: World Economic Outlook (WEO) – October 2014.*

Figure 2.2 Eurozone Real GDP Annual Growth



Source: Eurostat

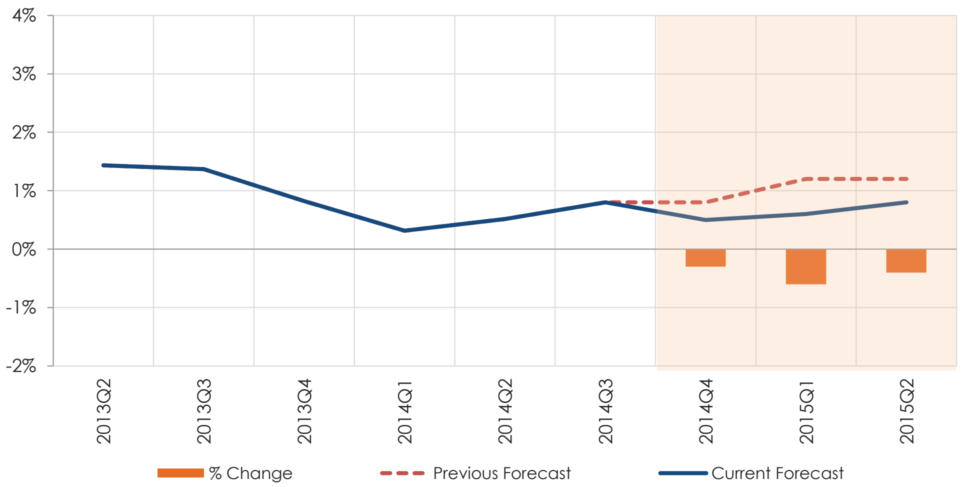
The potential growth rate for the emerging and developing world has recently deteriorated due to the legacy of the financial crisis as well as a lack of structural reforms and a low rate of their implementation. This is compounded by the geopolitical crises in Ukraine and the Middle East, which makes the outlook of these regions even more dismal. A permanent reduction in industrial production and exports has significantly affected economic activity in Ukraine, which has been followed by the devaluation of the national currency and high losses to official reserves. The IMF predicts that the Ukrainian economy will decrease by 6.5% in the current year.

Capital flight from Russia was evident even before the conflict with Ukraine; however, this process has become more intensive because of the sanctions imposed against Russia. As a result, economic activity and income in Russia has reduced. This adversely affects the economies of other CIS countries that extensively rely on remittances from and trade with Russia. The outflow of capital puts depreciation pressure on the Russian ruble, which in turn is reflected in consumer prices. The IMF predicts that Russian GDP growth will be 0.8% in 2014 and 1.6% in 2015.

In the wake of boosted public expenditures and investments, the Turkish economy has significantly increased over the last two years, despite the fact that capital flight risks (coming from expectations of an increase of US-based long-term interest) put upward pressure on exchange, inflation and interest rates. According to IMF estimates, it is expected that Turkey's GDP will grow by 3% in 2014 as a result of improved net exports alongside the aforementioned factors. The Turkish GDP growth forecast for 2015 is equal to 3%, which will be a result of the recent monetary easing and growth of private consumption.

The trend of the depreciation of local currencies in important trading partners of

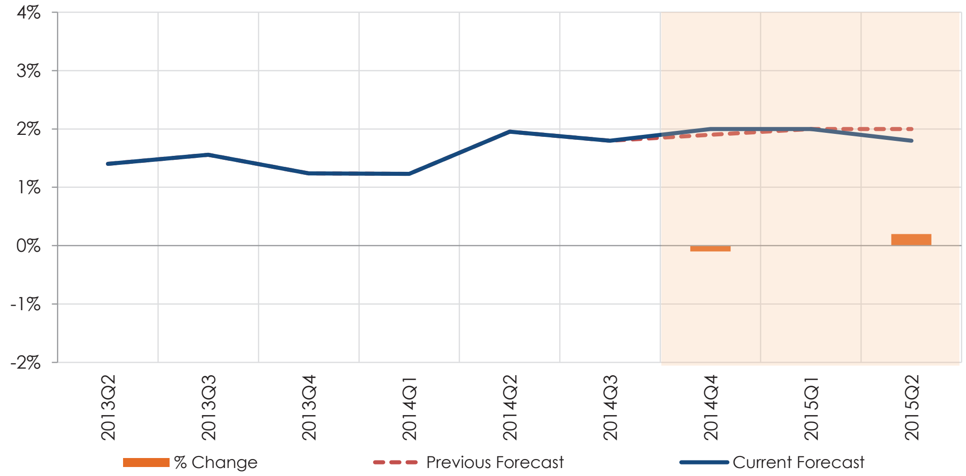
Figure 2.3 U.S. CPI Annual Inflation



Source: OECD

Georgia (Turkey, Ukraine and Russia), creates inflationary pressure on consumer prices, despite the global fall of food and energy prices. It is expected that high inflation rates will persist in these countries in the near future; however, monetary authorities have responded to inflation risks. Because of the significant negative GDP gap, eurozone inflation remains close to zero and, according to current forecasts, in 2014-2015 it will increase less rapidly than previously expected (see Figure 2.3). Inflation is maintained close to the long-term target rate of 2% (see Figure 2.4). Amid an improved outlook for global production, food prices have a declining trend and energy prices are also falling (at the expense of increased supply). The IMF assesses that this trend will continue next year and predicts that oil prices will decline by about 3.3% and that food prices will fall by 8%.

Figure 2.4 Eurozone CPI Annual Inflation



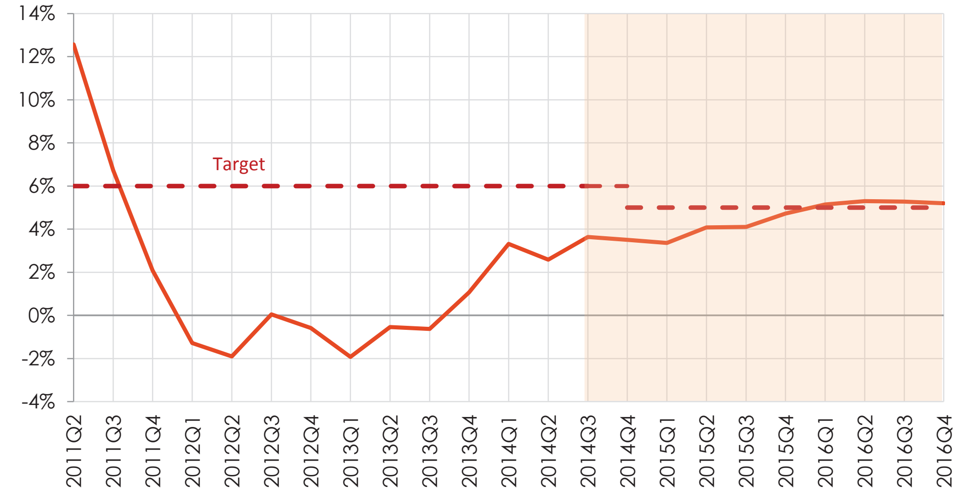
Source: OECD

On a global scale, monetary policy institutions face a range of different challenges. In many emerging and developing countries, high inflation and the growing threat of capital flight necessitates the tightening of monetary policy, while in developed countries (especially in the eurozone) the sluggish recovery process requires the maintenance of an expansionary policy. It is worth pointing to the US, where, amid positive economic indicators, the monetary policy is gradually coming out of an expansionary phase. This was reflected in the Federal Reserve's recent termination of financial asset purchases. It is likely that monetary policy rates in the US will increase from 2015.

2.2 MACROECONOMIC FORECAST

The inflation rate slowed to 3.4% in October 2014 (which was at an average of 3.7% in the third quarter) and is therefore still below the target of the National Bank of Georgia (see Figure 2.5). Factors affecting inflation dynamics have partly reversed as compared to the first half of the year. In particular, food prices, which had placed downward pressure on inflation at the beginning of the year, are now, as was expected, lifting consumer prices up. Also, due to the stronger-than-expected appreciation of the lari nominal effective exchange rate, imported inflation, which previously had a positive contribution, is now weakening overall inflation as compared to the previous forecast. Although imported prices did increase from the beginning of the year, they did so at a slower rate than was expected. Domestic prices had a broadly stable influence on overall prices in 2014, however, the size of their contribution still indicates weak, yet improving, domestic demand (see Figure 2.6).

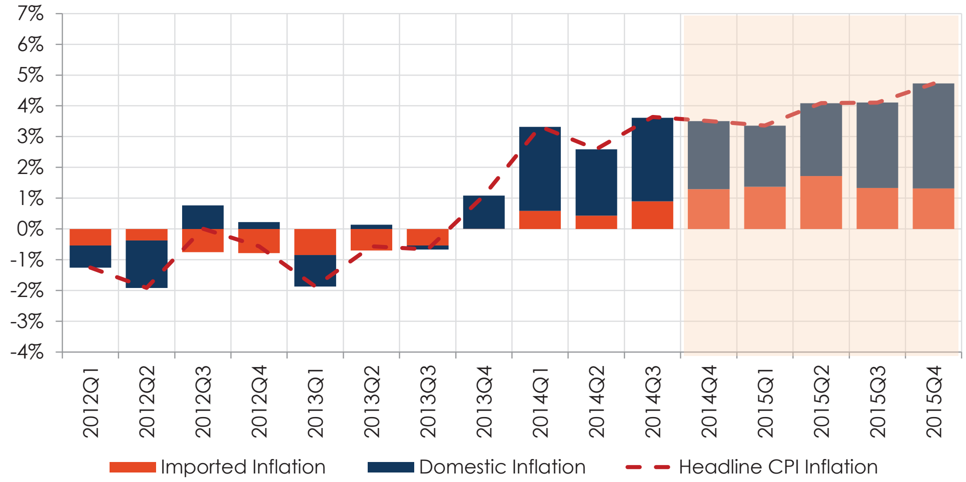
Figure 2.5 Headline Inflation



Source: National Bank of Georgia

According to the **forecast**, inflation in the fourth quarter of 2014 will be around 3.5% and, after a negligible decrease due to the base effect in the first quarter of 2015, it will continue increasing towards the target rate. The current forecast shows that inflation will reach its target of 5% by the end of 2015 (see Figure 2.5). The main driver of overall inflation will be domestic prices, which includes the important contribution made by food prices. The transmission of high inflation rates from Georgia's partner countries will be dampened by the appreciated lari nominal effective exchange rate. Falling food prices on international markets will also exert downward pressure, which will be partly reflected in the domestic market. Therefore, the influence of imported prices on overall inflation will be modest; however, against the backdrop of last year's low value, the base effect will make it have a positive contribution. The size of this contribution will be larger in the second quarter of 2015, which will be a reflection of the increased transmission of the high inflation rates of Georgia's partner countries (see Figure 2.6).

Figure 2.6 Headline Inflation Decomposition



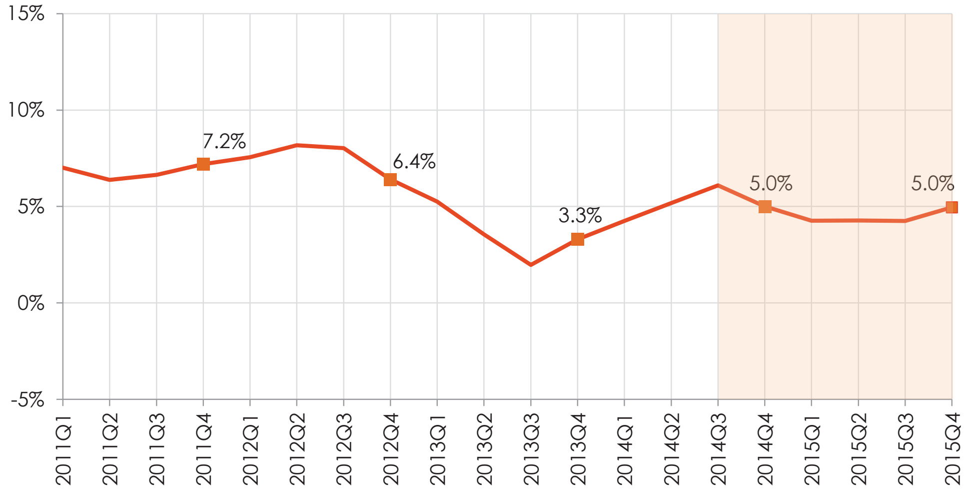
Source: National Bank of Georgia

There are **risks** associated with the forecast in both directions. In particular, if the depreciation of the currencies of Georgia's main trading partner counties, which occurred in late-2013 and the beginning of 2014, is reversed, it would strengthen the transmission of the already high inflation levels of those countries. There is also some uncertainty surrounding food prices, which have a substantial weight in the consumer basket and are mostly supply-driven. However, if there is an increase in foreign demand for food, potentially caused by the Russian embargo, it may also give rise to upward pressure on domestic food prices. On the other hand, if the partner countries' currencies depreciate more than expected and/or the decrease of oil and other commodity prices in international markets gets transmitted into inflation more than forecasted, it may cause actual inflation to be lower than the current projections.

Real GDP growth in 2014 has been consistent with previous forecasts. According to preliminary data, the annual growth rate in the third quarter of 2014 was 5.5%, which corresponds to an average 5.9% annual increase in the first three quarters of the year. Economic activity in the current year was mainly driven by domestic demand. In particular, against the backdrop of an accommodative monetary policy and fiscal stimulus measures, an increase in lending had a positive impact on consumption and domestic investment. After a very strong increase in 2013, net exports had a slightly negative contribution to GDP growth in 2014, which was partly caused by the increase in imports due to higher domestic demand. Weak net exports were also the result of slowed exports, which could be explained by both lower foreign demand due to geopolitical tensions and the already fully exploited Russian market, which was opened last year and caused a one-time jump in exports. In addition, stricter regulations on automobiles in Azerbaijan had a negative effect on vehicle re-exports from Georgia. In the context of weak activity in 2013, the base effect had a positive influence on economic growth in 2014. According to current estimates, economic activity is gradually progressing towards the potential level, however the output gap is still negative and, due to risks from the foreign sector, growth is still fragile.

According to the **GDP forecast**, growth in the fourth quarter of 2014 will slow, mainly due to base effect, which would imply average growth of around 5% in 2014. The growth rate in 2015 is also forecasted to be 5% (see Figure 2.7), which will largely be driven by domestic demand. Despite the fiscal consolidation plans, an increase in government capital expenditures and the accommodative monetary policy will help increase lending, which would lift investment and consumption growth rates. It is expected that net exports will again have a modest negative contribution to GDP growth (see Figure 2.8). Net exports will be negatively influenced by worsened economic growth prospects in trading partner countries, as well as the depreciation of their currencies, which depresses foreign demand further.

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

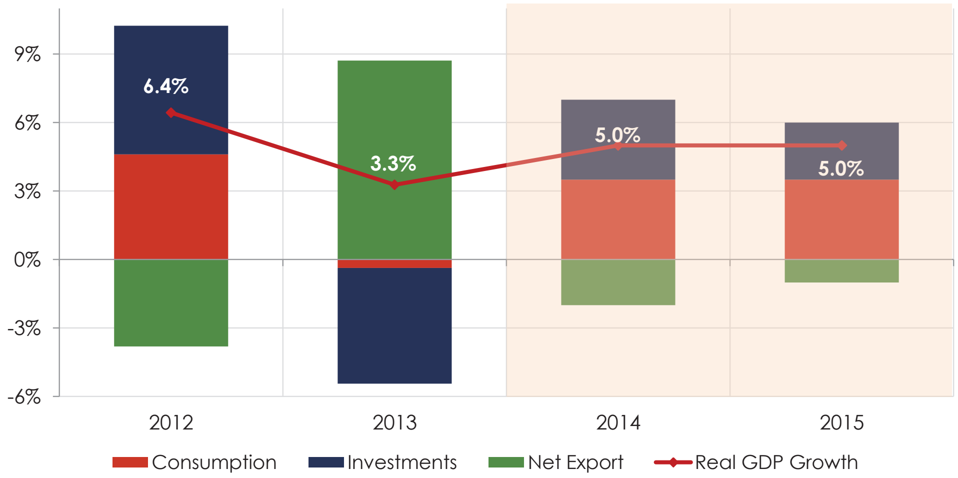


Source: National Bank of Georgia

The trade balance in the third quarter of 2014 deteriorated by 11.5% annually and the negative balance amounted to 19.4% of GDP. In the same period, the annual growth rate of exports, as opposed to the previous quarter, became negative, equaling -6.2%. This is mainly due to the fall in vehicle re-exports. The growth rate of imports, in turn, is still positive; however, at 4.9% it is smaller than in the previous period.

The forecast and preliminary data show that after the rapid improvement of the current account deficit in 2013, it has worsened again, down to 8.5% in 2014 (see Figure 2.9). The forecast for the current account is steadily improving in the medium-term. In addition to the export of goods, this is mainly supported by an increase in the export of services, especially tourism and the higher income received from abroad.

Figure 2.8 Components of Real GDP Growth



Source: National Bank of Georgia

Figure 2.9 Current Account Components Ratio to GDP

** According to the 6th edition of the "Balance of Payments and International Investment Position Manual" (PBM6) instead of th e terms "Income" and "Transfers" the terms "Primary income" and "Secondary income" are introduced*

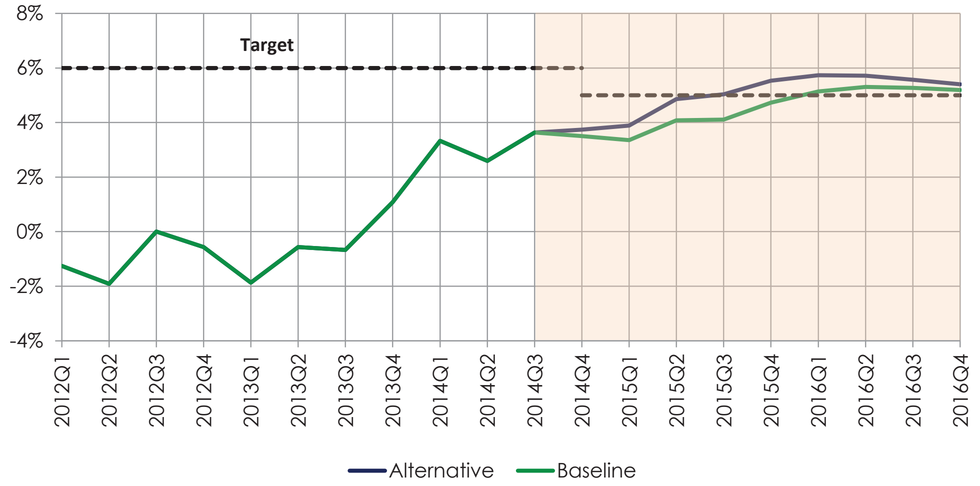
Source: National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers the case of a higher-than-expected transmission of foreign risk factors into inflation and output growth. In particular, the scenario assumes that stressed economic circumstances in the region and the US Federal Reserve's expected exit from its highly accommodative monetary policy will have a greater negative effect on foreign demand and, on the other hand, on the nominal effective exchange rate. As a result, the high levels of inflation in trading partner countries will be transmitted at greater strength.

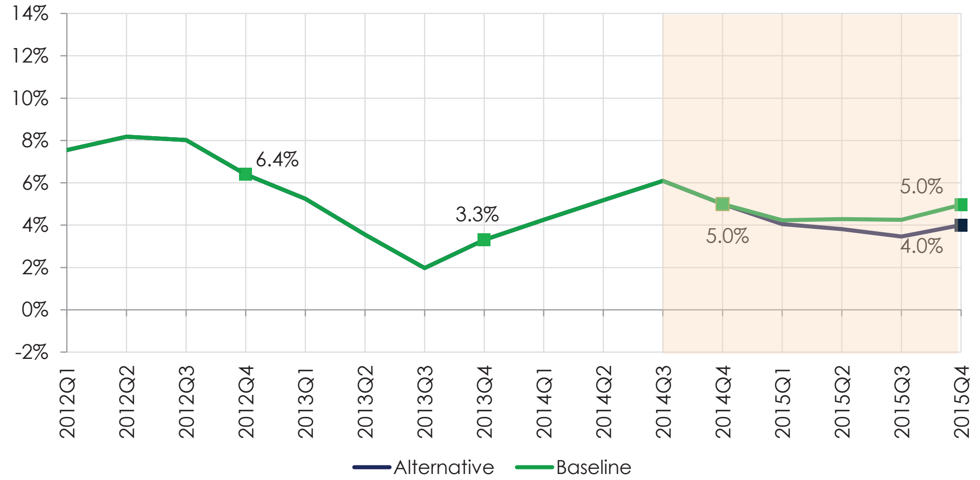
According to this scenario, the inflation rate will reach its target faster than in the baseline scenario, which is mainly facilitated by higher imported inflation. The scenario forecasts that inflation will hit the target in the second quarter of 2015 and stay slightly and temporarily above it until mid-2016. The appropriate response of monetary policy, in order to influence inflation expectations, makes inflation go back to its target in the medium-term (see Figure 2.10).

Figure 2.10 CPI Inflation According to Baseline and Alternative Forecasts



Source: National Bank of Georgia

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

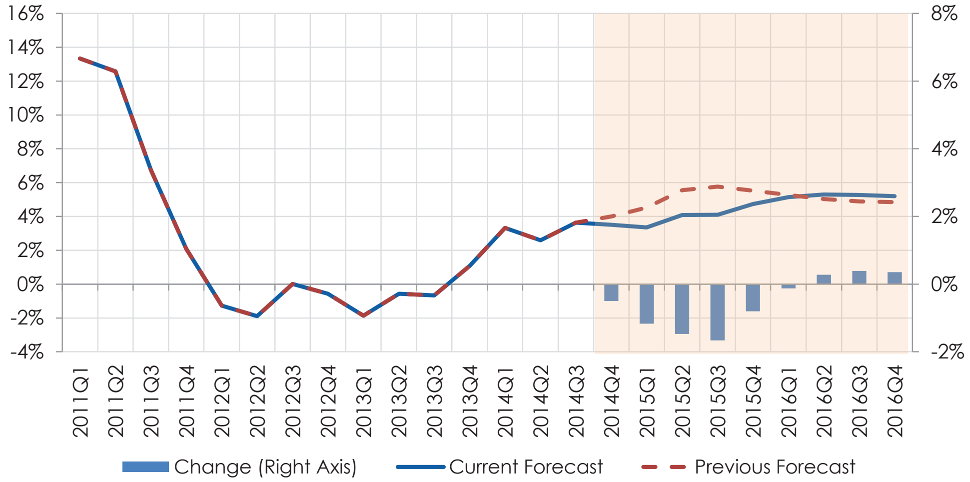


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the forecast of the output growth rate in 2014 has not been changed and remains well in line with the available data. However, the forecast for inflation has been revised downward (see Figure 2.12), which is mostly the result of the stronger-than-expected depreciation of the currencies of Georgia's trading partner countries. In particular, the more-than-expected appreciation of the lari nominal effective exchange rate has dampened the effect the high inflation in those countries has had on domestic consumer prices. As a consequence of lower-than-expected imported inflation, the inflation forecast is reduced until the end of next year. The current forecast also takes into account lower oil prices. These are expected to remain weak in 2015 as well and are partly reflected in domestic prices. As a result, the inflation rate will reach its target by the end of 2015.

Figure 2.12 Change in Forecast of Headline Inflation

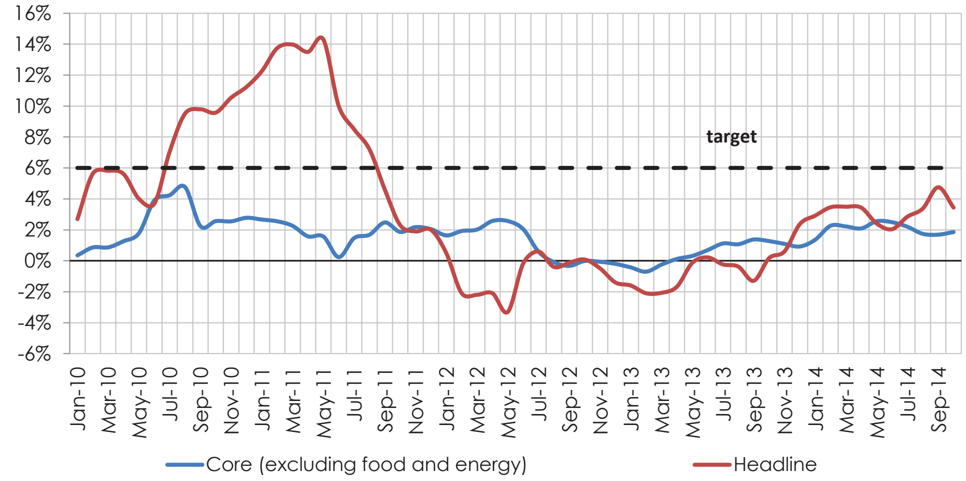


Source: National Bank of Georgia

3. Consumer Prices

Annual inflation stood at 3.4% by the end of October and is thus gradually approaching the NBG's medium-term target of 5%.[2] Under the backdrop of headline inflation, core inflation is gradually increasing. The annual change of the consumer price level, excluding food and energy, stood at 1.9% by the end of October 2014 (see Figure 3.1).

Figure 3.1 CPI and Core Inflation

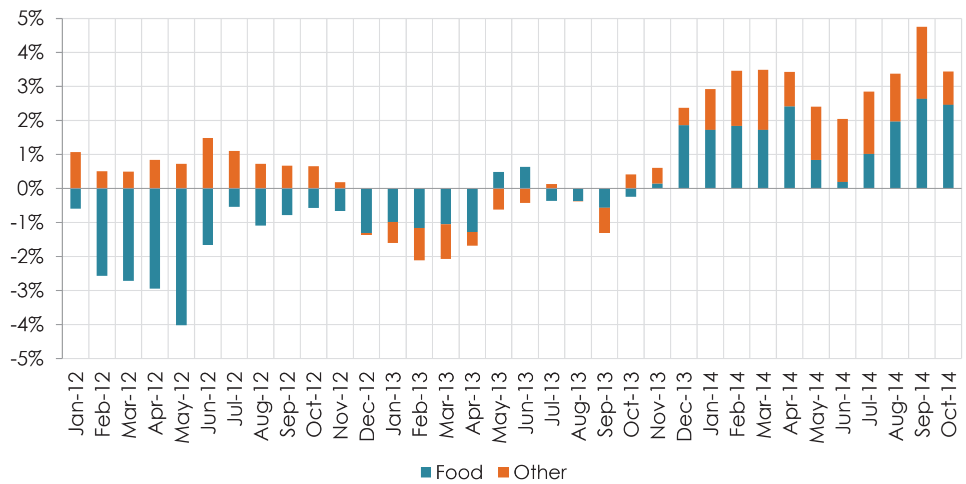


Source: GeoStat and National Bank of Georgia

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 the following months, the annual growth rate of food products significantly declined as a result of both domestic and external factors. In line with these shocks, the food inflation rate declined by 7.6 percentage points in June, as compared to April, and stood

« *Dynamics in inflation were mainly caused by the surge in food prices.*

Figure 3.2 Contribution of food inflation in headline inflation



Source: GeoStat and National Bank of Georgia

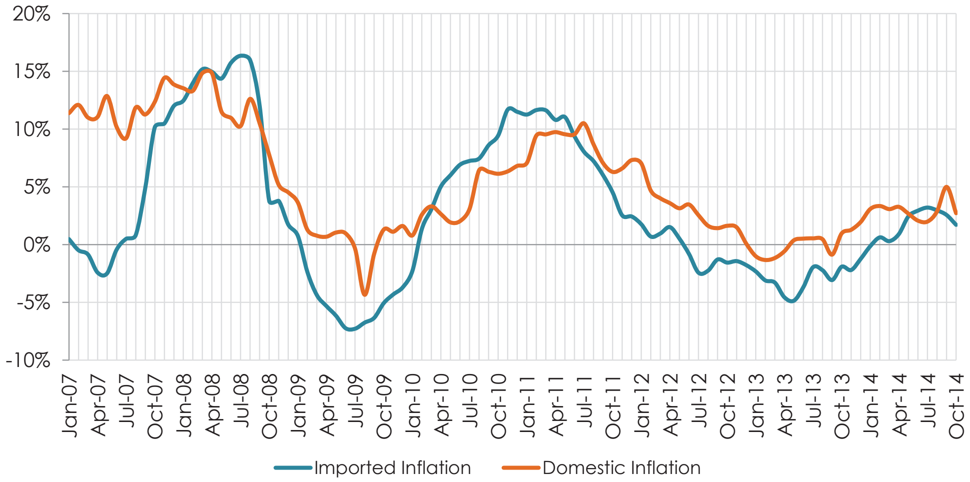
2 *Inflation target is still 6% in 2014, but will decrease to 5% in 2015. Because monetary policy actions have a lagged effect on the economy, the inflation target of 5% is used for the formulation of monetary policy.*

at 0.7%. In subsequent periods, this downward trend was not maintained and the overall price level of food products started to rise again. This was due to increased external demand for fruit and vegetables. The significant increase of exports to the Russian Federation resulted in increased domestic market prices. Consequently, by the end of October the annual change of food prices amounted to 8.5%, contributing approximately 2.5 percentage points to headline inflation (see Figure 3.2).

In terms of exogenous factors, it is worth noting that price changes on imported goods in the consumer basket have an influence on the overall price level in the country. From the beginning of 2014, in line with the high inflation rates in Georgia's main trading partner countries, the change of imported prices became positive and had a growing trend during the first half of the year. However, the subsequent depreciation of the currencies of Georgia's main trading partners caused the appreciation of the lari nominal effective exchange rate. Therefore, the inflation rate on imported consumer goods slowed down. By the end of October, annual imported inflation declined by 1.5 percentage points compared to July, amounting to 1.7% and contributing approximately 0.6 percentage points to headline inflation (see Figure 3.3).

‹‹ Inflation rate on imported consumer goods declined and stood at 1.7% by the end of October.

Figure 3.3 Imported and Domestic Inflation



Source: GeoStat and National Bank of Georgia

During the second quarter of 2014, a number of geopolitical risks were identified that were reflected on external demand. The growth rates of exports, remittances and tourism revenues all declined. Factors weakening external demand thus put downward pressure on the consumer price growth rate and prolonged the approach towards the target level. As for domestic demand in 2014, in the backdrop of expansionary monetary and fiscal policies, its recovery is observable. Lending activity continues to moderately grow in line with increasing investment and domestic consumption. According to preliminary data from the first nine months of 2014, economic growth fits the forecast. The negative output gap is closing, which will place inflationary pressure on price levels and ensure an increase of the inflation rate to the target level.

‹‹ The factors affecting aggregate demand also determine dynamics in the inflation rate.

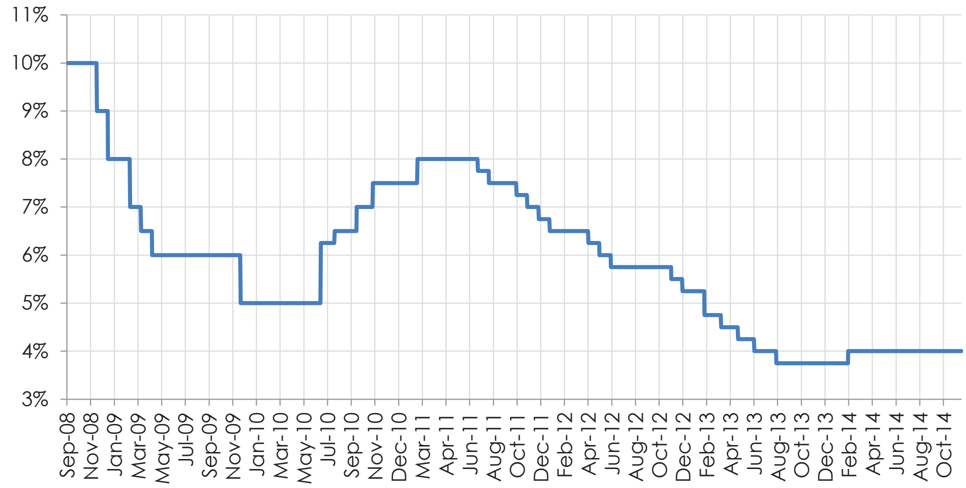
4. MONETARY POLICY

From the start of 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 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, as foreign demand continued to grow, there was no need to retain an accommodative monetary policy.

In spring 2014, increased geopolitical risks became reflected in lower growth rates of both exports and remittances. A slow growth of credit activity was also observed, which provided insufficient stimulus for domestic demand. Despite the fact that economic growth was more or less in line with the forecasts, in light of the external risks, it remained an important risk factor. Against the background of slower economic growth in Georgia's partner countries, demand did not put reasonable pressure on prices. Taking all these factors into consideration, the Monetary Policy Committee decided to keep the policy rate unchanged at its subsequent meetings. However, it still believes that there is a need to exit the accommodative monetary policy. The speed of this process depends on the extent of the revival of economic activity and aggregate demand. The process of exiting the loose monetary policy stance will depend on the extent of the revival of economic activity and aggregate demand. External developments will be also important.

« The process of exiting the loose monetary policy stance will depend on the extent of the revival of economic activity and aggregate demand. External developments will be also important.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

« The NBG keeps the policy rate unchanged at 4%.

The last Monetary Policy Committee meeting was held on 19 November and the policy rate was left unchanged. This decision was based on the existing inflation forecast and on the macroeconomic analysis of ongoing events in both Georgia and internationally.

The inflation rate has exhibited a growth trend since fall 2013. In October 2014, the consumer price level grew by 3.4% annually, mainly as a result of the increased prices of seasonal products. As compared to the previous month, price level growth was 0.3%.

According to the preliminary assessment of economic activity, economic growth amounted to 5.5% in the third quarter of 2014. The growth rates observed during the first three quarters of 2014 are consistent with the forecasts. The output gap is negative, but has a decreasing trend. In 2014, domestic demand has strengthened, which will support the closure of the gap and thus have an upward stimuli on prices.

Importantly, credit activity keeps growing and the growth of business loans is apparent. In September, the growth rate of loans (excluding the exchange rate effect) amounted to 18.4%.

As for the external sector, preliminary information shows an annual increase in registered imports by 8.5%. The recovery of domestic demand is also evident from this dynamic. From the second quarter, external demand has been weakening and in October registered exports declined by 5.2% on annual terms. The growth rates of remittances and tourism revenues have declined as well. These factors have been significantly influenced by political developments in the region.

Given the increased economic activity – stimulated by the growth of investments, higher local demand and improved business activity – it is expected that the inflation rate will grow gradually in the following quarters. According to the NBG's forecasts, the inflation rate will reach its target level of 5% at the end of 2015. However, risks, mainly stemming from external developments, remain.

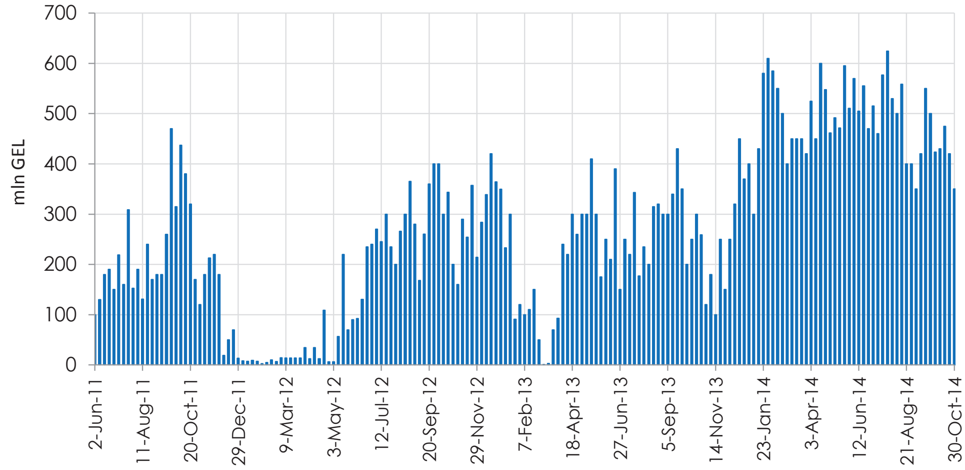
The expected rate of inflation could have a downward impact from the slower-than-expected economic growth of the eurozone and the prolongation of the geopolitical crises in Ukraine and the Middle East. Materialization of these risks would be reflected in lower external demand. The decline of prices on global markets should be mentioned among the risks that might put downward pressure on inflation. On the other hand, the risks that would put upward pressure on inflation include the faster than expected recovery of the US economy and the maintenance of solid growth in Turkey. The preservation of high inflation in partner countries should also be considered.

The inflation forecast was revised downward as new information had been released since the previous MPC meeting. This information mostly related to processes taking place in the region and within trade partner countries. Considering both the external risks and domestic conditions, in order to meet the inflation target the committee decided to keep the policy rate unchanged at 4%. A gradual exit of the accommodative monetary policy is still necessary. Unless new shocks affecting the economy emerge, the revised forecasts indicate that the main policy rate will gradually increase and reach 5.5% (instead of 6% as given by the previous forecast) by the end of 2015.

‹‹ Unless new shocks affecting the economy emerge, the monetary policy rate is expected to increase gradually to 5.5% by the end of 2015.

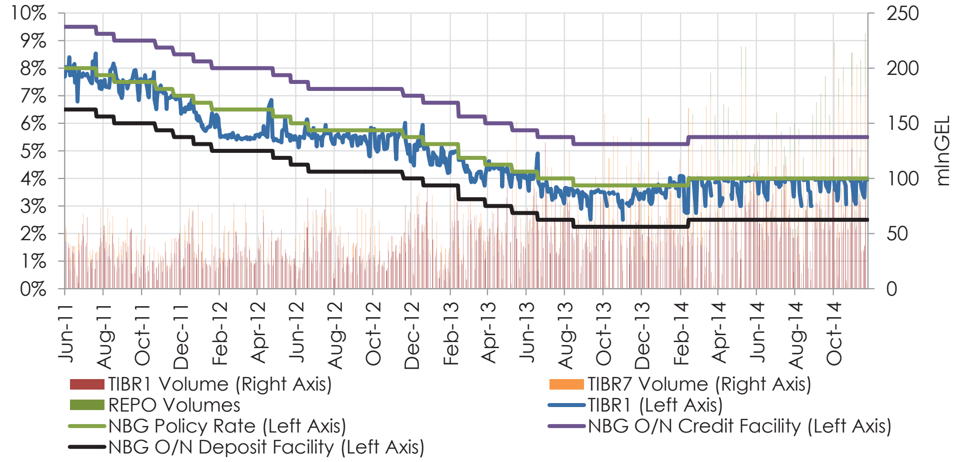
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising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

Figure 4.2 Refinancing Loans



Source: National Bank of Georgia

Figure 4.3 Interbank Money Market



Source: National Bank of Georgia

‹‹ Short-term interbank rates are stable and hover around the policy rate.

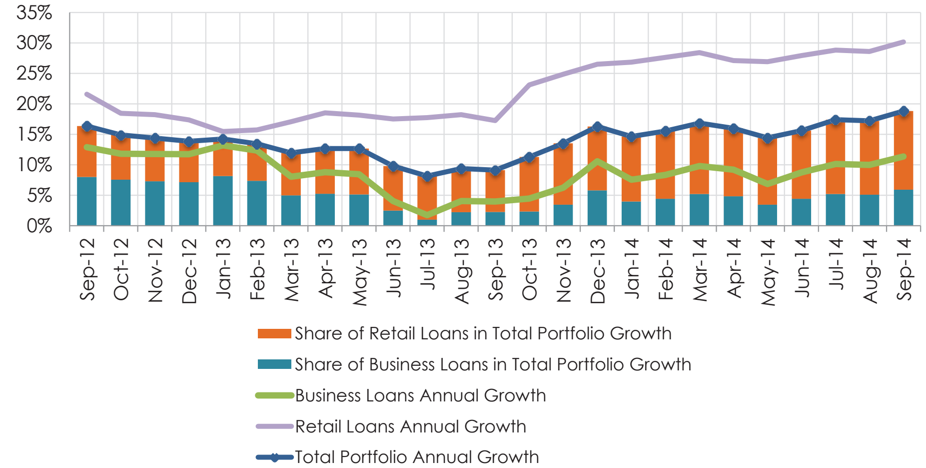
5. Financial Market and Trends

5.1 LOANS

In September 2014, the annual growth rate of the loan portfolio increased by 2.4 percentage points compared to June and amounted to 18.4%.[3] Easing of interest rate conditions contributed to increased demand for loans, which caused higher credit growth. According to the data, demand increased for both retail as well as business loans. In the third quarter, the annualized growth rate of retail loans amounted to 25%. Loans extended to small and medium sized businesses continue to exhibit a stable growth rate, which annualized in the third quarter amounted to 16%. It should be noted that during the year demand for corporate loans was weak, but in September demand was amplified and the annualized growth rate in the third quarter amounted to 12%.

« 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.

Figure 5.1 Annual growth rates of retail and business loans and their contributions to the growth of the loan portfolio

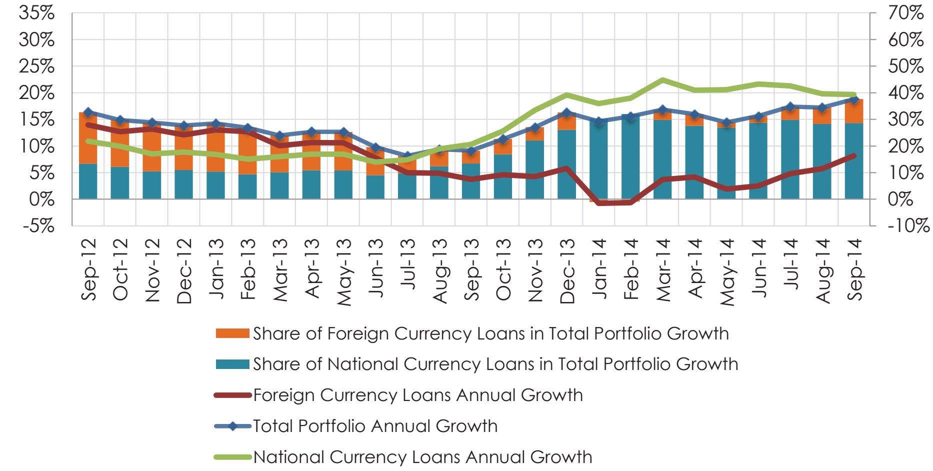


Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was largely caused by an increase in loans in the domestic currency, but foreign currency loans still increased notably compared to the previous quarter. In the third quarter, the annualized growth rate of foreign currency denominated loans increased by 14%, while loans in the domestic currency increased by 22%. Following the growth of domestic currency lending in the previous quarters, in September the annual growth rate of the domestic currency loan portfolio amounted to 40%, while the same rate for foreign currency loans equaled 7.6%. It should be noted that loan larization increased to 40.5% in the third quarter. This contributes to a reduction of systemic risks in the banking sector.

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

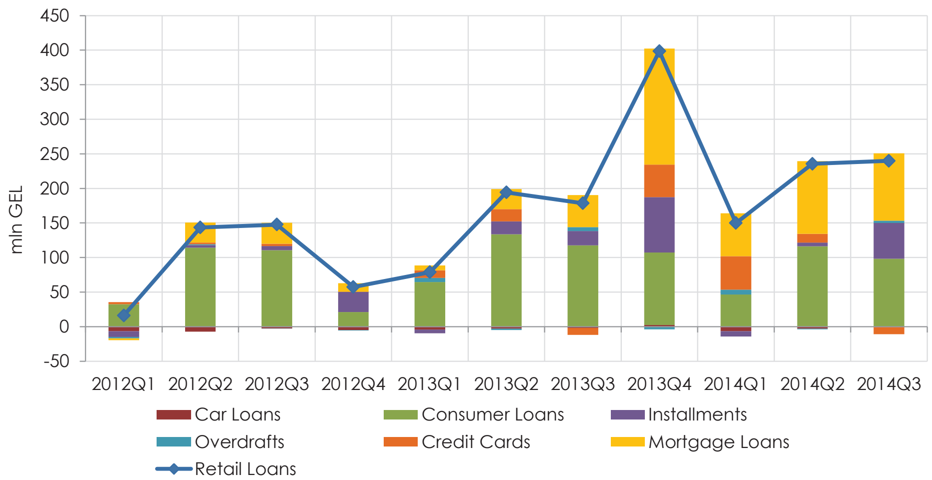
Figure 5.2 Annual growth rates of domestic and foreign currency loans and their contributions to the growth of the loan portfolio



Source: National Bank of Georgia

Retail loans, which predominantly include consumer and mortgage loans, continue to exhibit high growth rates. In the third quarter, the stock of retail loans increased by 240 million GEL compared to the previous quarter. Mortgage and consumer loans increased by 98 and 99 million GEL respectively. It should also be noted that the stock of installment loans increased by 50 million GEL compared to the previous quarter and annual growth amounted to 90%. Debt on credit cards decreased by 10 million GEL.

Figure 5.3 Quarterly growth of retail loans



Source: National Bank of Georgia

In September, the annual growth rate of the loan portfolio to legal entities amounted to 11.4%, which is 2.6 percentage points higher than in June. Demand on large business loans improved after having decreased at the beginning of the year. This was mainly caused by an easing of interest rates and the relative recovery of demand. Demand on small and medium sized businesses also improved. An analysis of business loans by sector reveals that the trade, energy, agriculture and manufacturing sectors posted growth in terms of credit, while the volume of outstanding loans disbursed to the construction and transport sectors increased only slightly. According to the credit conditions survey, representatives of the banking sector expect the growth rate of the loan portfolio to be maintained in the next quarter. Additionally, they expect retail loans to grow, mainly due to mortgage and consumer loans, while small and medium sized businesses should cause the growth of business loans to pick up as well.

In recent years, the credit to GDP ratio[4] has followed the trend[5] without significant fluc-

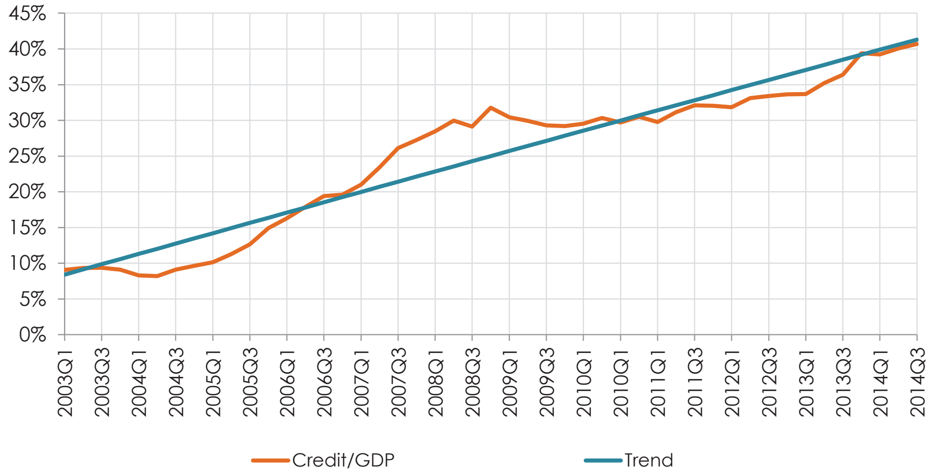
4 *The credit to GDP ratio was proposed by the Basel Committee in order to accumulate a capital buffer. Compared to other measures, the credit to GDP gap performed better in forecasting the crisis.*

5 *The HP filter is used to assess the trend and, based on Basel recommendations, lambda is equal to 400,000.*

tuations. In the third quarter, the credit to GDP ratio amounted to 40.5% and is slightly below the trend, indicating that there is no threat of a bubble forming at this point.

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

Figure 5.4 Credit to GDP gap

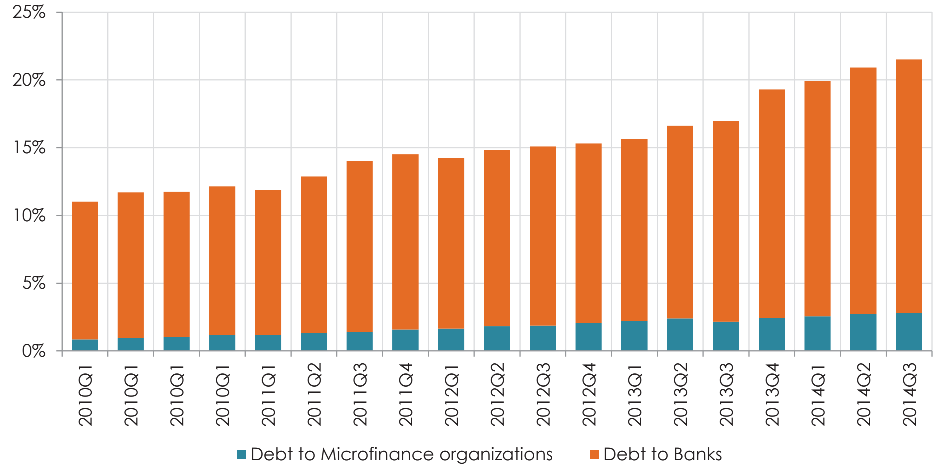


Source: National Bank of Georgia

Individuals' debt to net national disposable income ratio increased, but the debt service ratio did not change significantly in the second quarter, amounting to 17.6%. Debt to commercial banks counts for 87% of total debt.

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

Figure 5.5 Average Interest Rates on Deposits



Source: National Bank of Georgia

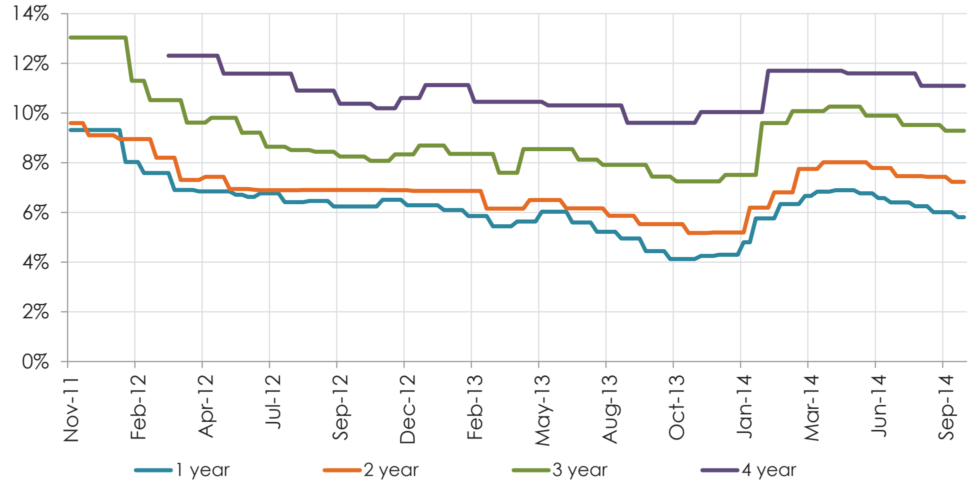
The share of non-performing loans increased by 1.7 percentage points in the third quarter of 2014, as compared to the previous quarter, and amounted to 9%. According to the data from September, the share of non-performing loans in the national currency increased by 0.1 percentage points compared to June, amounting to 5.4%. The share of non-performing foreign currency loans increased by 2.7 percentage points and amounted to 11.3%. In the third quarter, the amount of loans written off amounted to 46.1 million GEL.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In September 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 monetary policy reduced interest rates on loan and deposit stocks. The interest rate on short- and long-term government securities increased in the first quarter, but had a declining trend after the second quarter (see Figure 5.1). Compared to December 2013, in September 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.

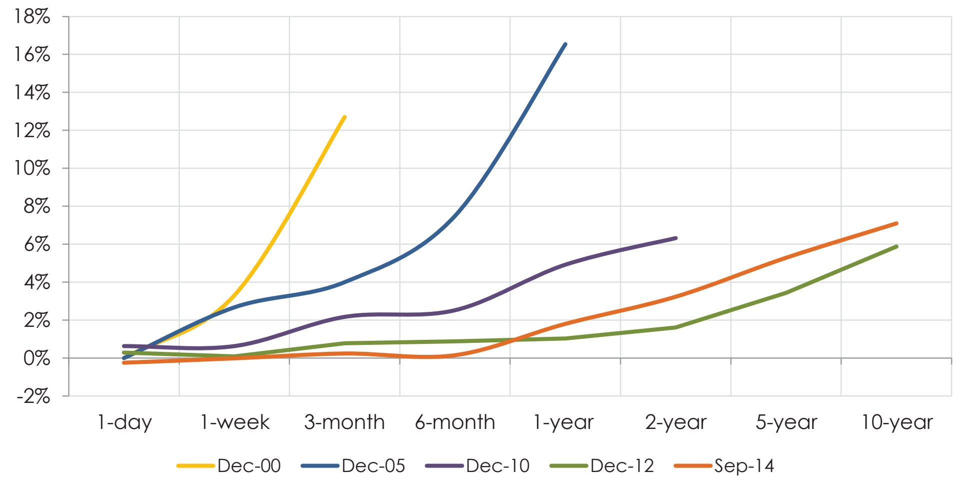
Figure 5.6 Interest Rates on Government Securities



Source: National Bank of Georgia

Inflationary expectations raised belief of an increase in the monetary policy rate and consequently 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 risk. 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.

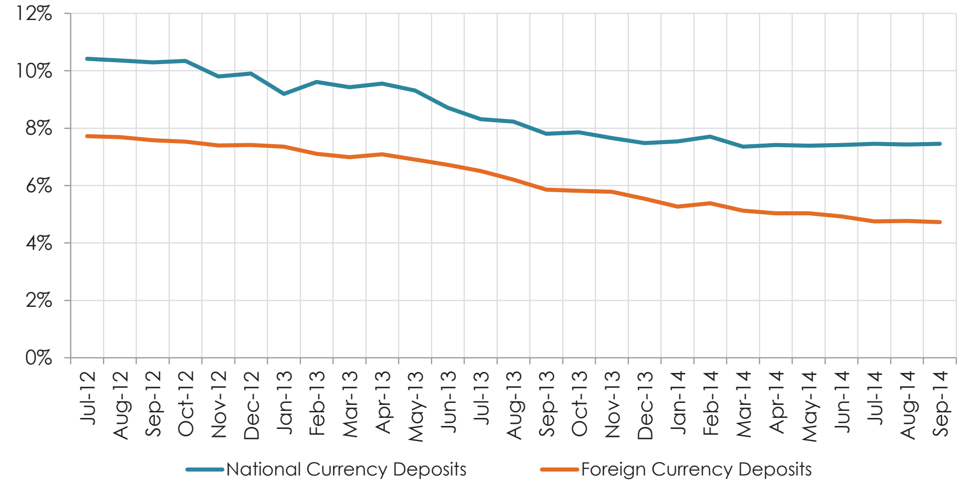
Figure 5.7 Spread between the Monetary Policy Rate and the Yield Curve



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 liquidityAccording to the credit conditions survey, in the next quarter FX funding costs are not expected to change, while the interest rate on national currency deposits might raise following the growth of domestic currency loans.

Figure 5.8 Average Interest Rates on Deposits

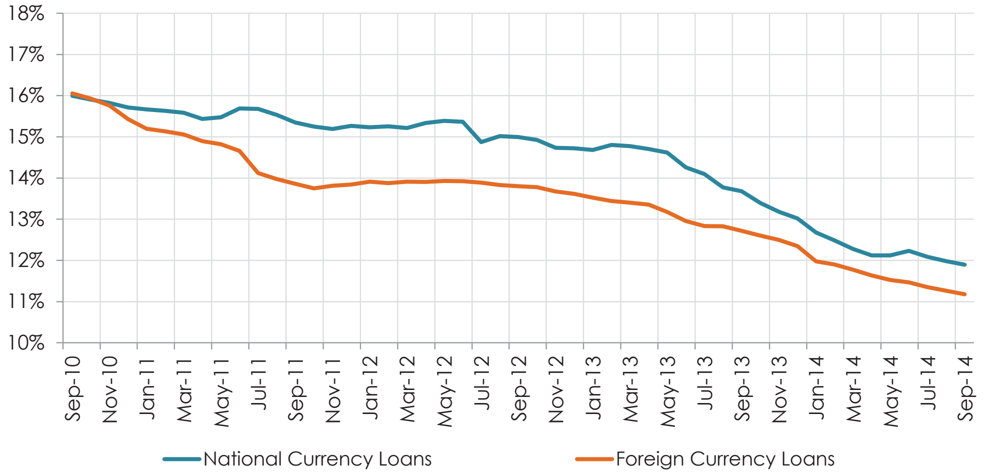


Source: National Bank of Georgia

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

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.

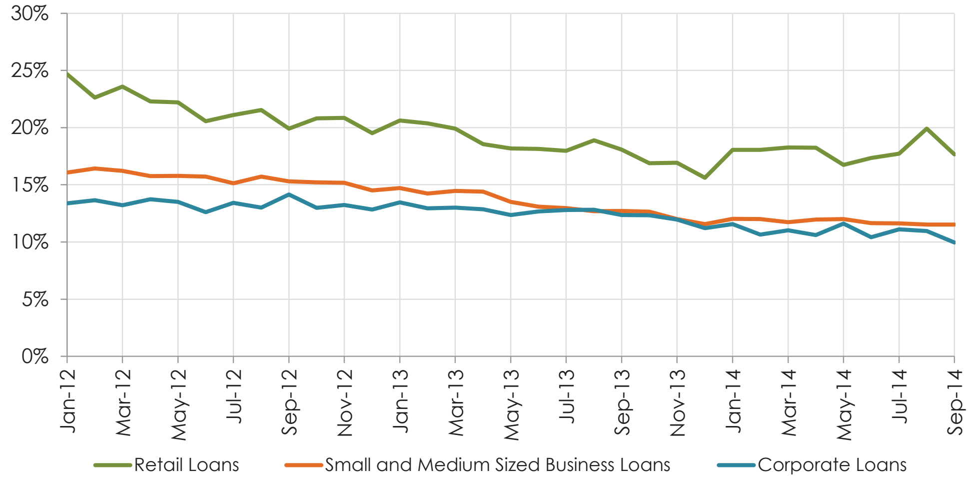
Figure 5.9 Average Interest Rates on Business Loans



Source: National Bank of Georgia

Interest rates on the flow of business and retail loans are characterized by a declining trend. In September, rates on corporate loans decreased by 0.5 percentage points compared to June and amounted to 10%. In addition, interest rates on loans to small and medium businesses declined by 0.2 percentage points and amounted to 11.5%, while rates on retail borrowing did not change and stood at 17.7%.

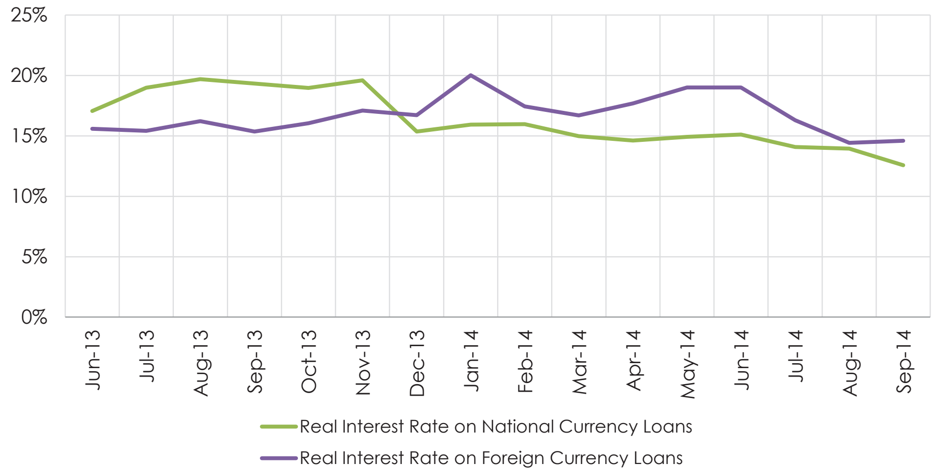
Figure 5.10 Interest rate on loan flow



Source: National Bank of Georgia

It should be noted that the real interest rate on loans is significantly different from the nominal rate. As of September 2014, the real interest rate on loans issued one year ago in foreign currency is 2 percentage points higher compared to that on domestic currency loans. This indicates that the exchange rate risk makes loans in the domestic currency more attractive than foreign currency loans.

Figure 5.11 Real interest rate on loan flow*



Source: National Bank of Georgia

* To calculate the real interest rate, the nominal interest rate is adjusted for inflation after one year. In the case of the foreign currency interest rate, it is also adjusted for the exchange rate after one year.

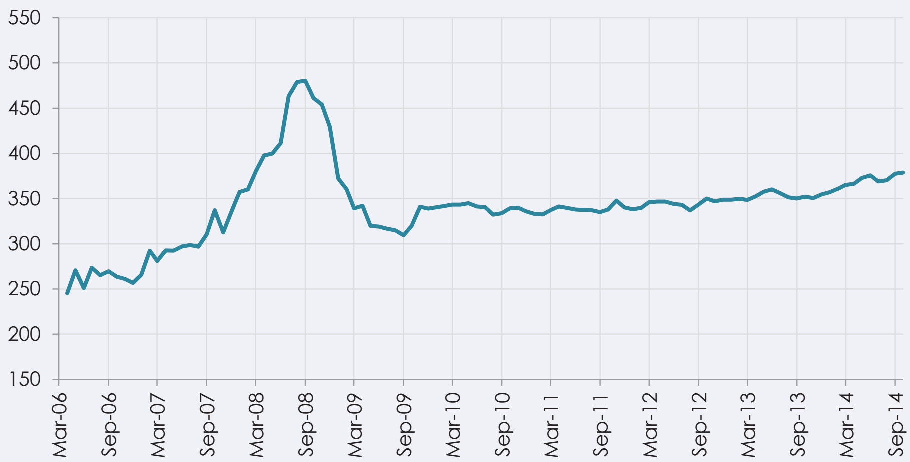
Box 1 Trends in the Real Estate Market

The aim of this box is to provide an overview of real estate market developments in the macroeconomic outlook and to present several analytical indicators. The economic recovery of the real estate market following the 2008 crises exhibited a stable growth rate that led to increased confidence in the real estate sector. In addition, growth of incomes, easing credit conditions and risk reduction all amplified supply and demand. Long term confidence in the real estate market relies on the expectation of the stable growth of the sector, which, in turn, depends on fundamental factors such as demographic trends, economic growth, and the convergence of prices to those of developed countries.

According to the available data of the National Bank of Georgia,[6] the average price index for residential space has been stable in recent years. However, during 2014 the real estate market accelerated and in September the annual growth of prices for residential space amounted to 7.5%. The increase in the price index was caused by increased demand and a rise in prices of construction materials, the latter rising by 4.8% in September compared to the same period in 2013. However, it should be noted that current prices for residential space are still considerably lower than they were in 2008. The stability of real estate prices indicates that prices are not being raised speculatively and there is no threat of the development of a price bubble at this point.

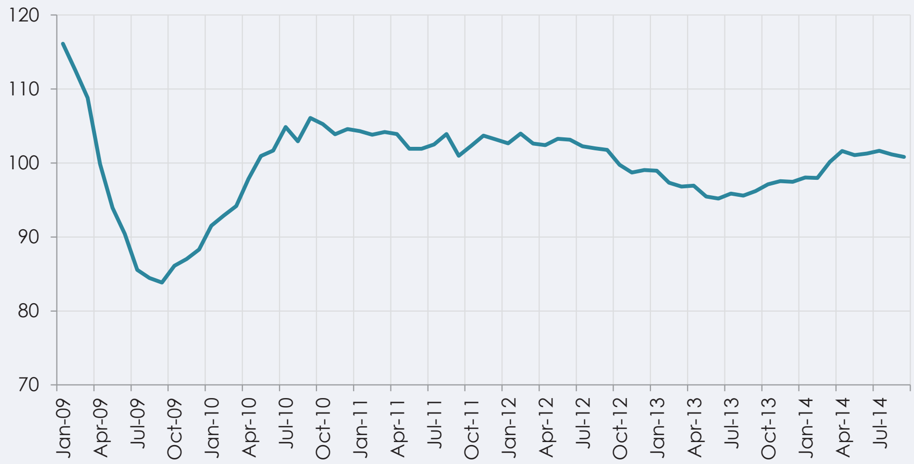
‹‹ According to the available data of the National Bank of Georgia, the average price index for residential space has been stable in recent years, but during this year the real estate market accelerated and in September the annual growth of prices for residential space amounted to 7.5%.

Figure 5.12 Real Estate Price Index



Source: National Bank of Georgia

Figure 5.13 Price index of construction materials



Source: Geostat

6 The source of data is newspaper advertisements with regard to supply prices on apartments for rent, newly finished apartment structures, and land parcels in the Saburtalo and Varketili districts of Tbilisi.

The construction sector plays an important role in economic growth. In the first six months of 2014, the construction sector's share in GDP was 7.4%, while its contribution to GDP growth amounted to 1.2 percentage points. If the recent trend is preserved, it is expected that by the end of 2014 its share in GDP will increase further.

« The construction sector plays an important role in economic growth.

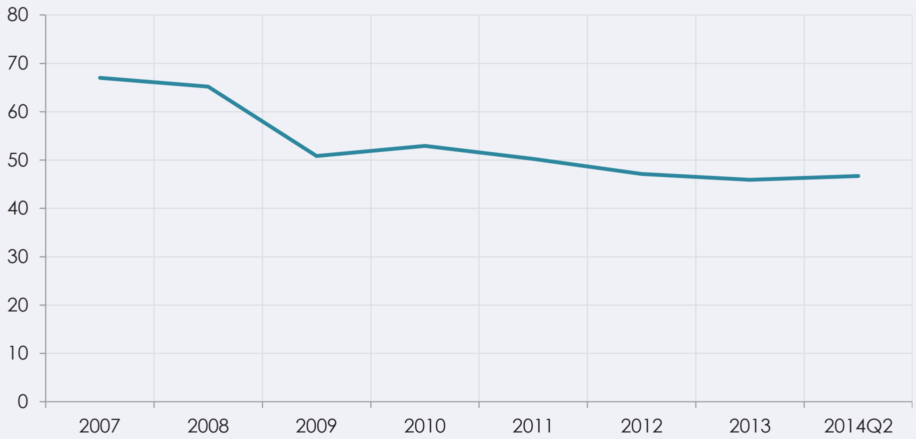
The stability of the real estate market has attracted the interest of foreign companies. In the first six months of 2014, foreign direct investment in the real estate sector increased by 43% compared to the same period of the previous year. In addition, foreign nationals' interest in purchasing real estate has also increased.

« The stability of the real estate market increased foreign companies' interest in the Georgian market.

High economic growth in recent years has contributed to a significant increase in households' income, which led to a decline in the house price to income ratio. This ratio has had a declining trend over the last two years. Accordingly, following the growth of income, the demand for real estate is expected to rise.

« High economic growth in recent years has contributed to a significant increase in household income, which led to a decline in house price to income ratio.

Figure 5.14 Housing price to average wage ratio

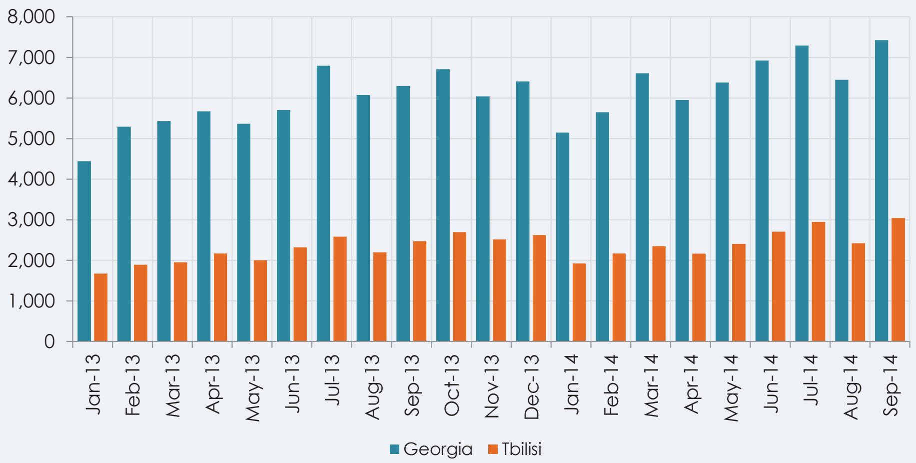


Source: National Bank of Georgiaand Geostat

Improved access to mortgage loans has considerably increased demand for real estate. The softening of interest and non-interest conditions for mortgage loans in 2014 encouraged the growth of demand. In September, the mortgage loan portfolio increased by 32% annually, while the number of transactions in the secondary real estate market increased by 18%.

« Improved access to mortgage loans has considerably increased demand for real estate.

Figure 5.15 Number of transactions in the secondary real estate market



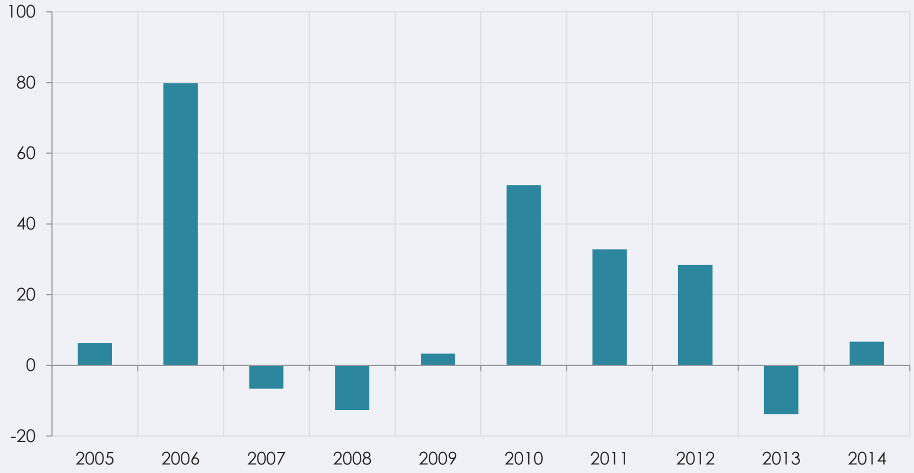
Source: Ministry of Justice of Georgia, Public Registry

The increase in the supply of real estate is relatively offset by population growth, which prevents the accumulation of unsold real estate and price reductions in the future. In the last five years the population increased by 100,000 people, while the construction of 4,300 residential buildings was completed (8 million square meters). Additionally, the size of families has followed a declining trend, which is also reflected in the growth of demand for real estate. According to the most recent data, the average household size in Georgia is 3.6 people, which is 0.4 points lower than the

« The increase in supply of real estate is relatively offset by population growth.

corresponding figure for 2002. It should be noted that in Europe the average family size is 2.5.

Figure 5.16 Change in Population

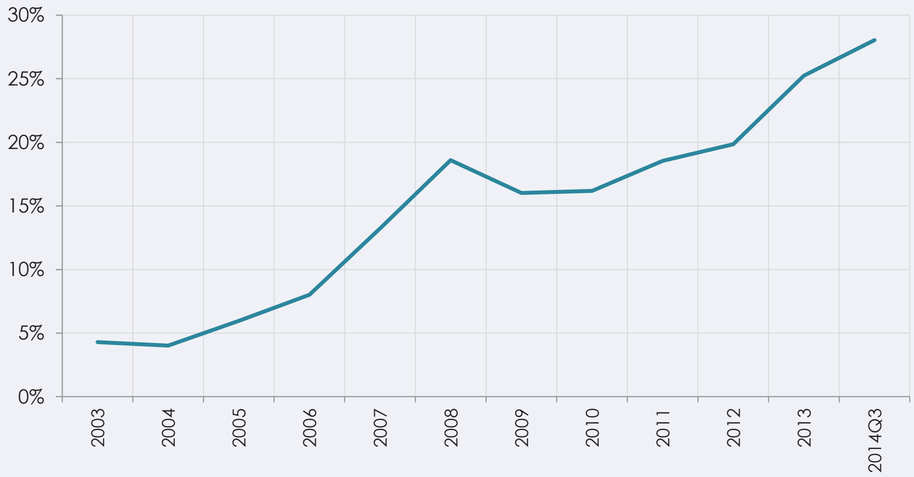


Source: Geostat

The ratio of household debt to annual income has increased, mainly because of an increase in mortgage loans. However, the debt service burden does not significantly exceed that of other countries. In the second quarter of 2014, the debt service ratio [household debt service (principal plus interest) / Income] for Georgia amounted to 17.6%.

« The ratio of household debt to annual income has increased, mainly because of an increase in mortgage loans.

Figure 5.17 Household debt to annual income ratio



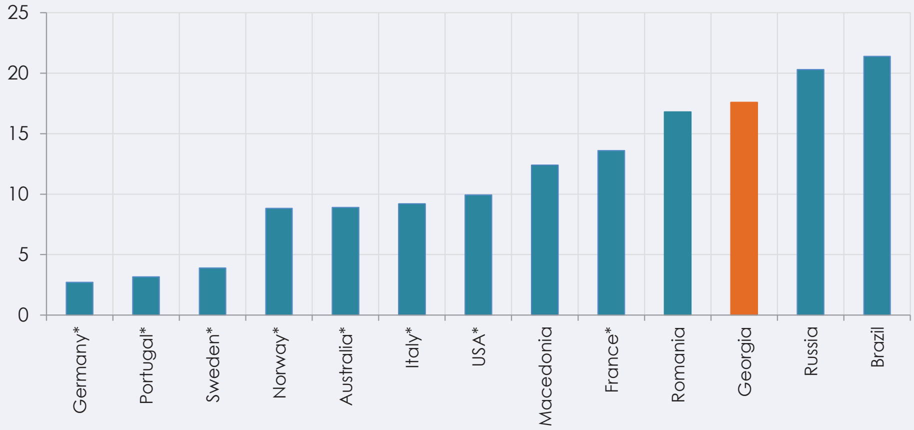
Source: National Bank of Georgia, Geostat

Like the demand side, the supply side of real estate has also been amplified. This is reflected in the growth of completed constructions and in the number of construction permits and loans issued. In September 2014, loans extended to the construction sector grew by 13% annually, while the number of completed constructions in 2014 is forecasted to increase by 7.4%[7] compared to 2013. In recent years, the speed of construction has also increased. Of the construction permits issued in 2006-2014 a total of 25% have been finished, while the corresponding figure for 2003-2010 equaled 17%.[8] In addition, it should be noted that in recent years a significantly increased number of building permits have been issued. Assuming that it takes, on average, four years to complete construction, a significant rise of finished buildings is expected in the coming years.

7 To forecast the completed constructions in 2014, the data for the first six months of the year has been multiplied by 2.

8 "Review of real estate market in Georgia". GREMIC, 2011.

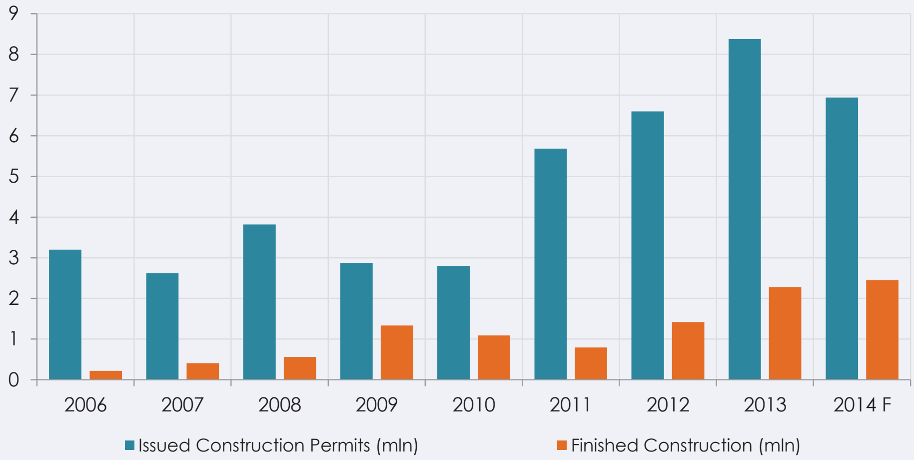
Figure 5.18 Debt service ratio*



*For countries with * debt service coefficient includes only interest payments.*

Source: International Monetary Fund

Figure 5.19 Construction permits and completed constructions

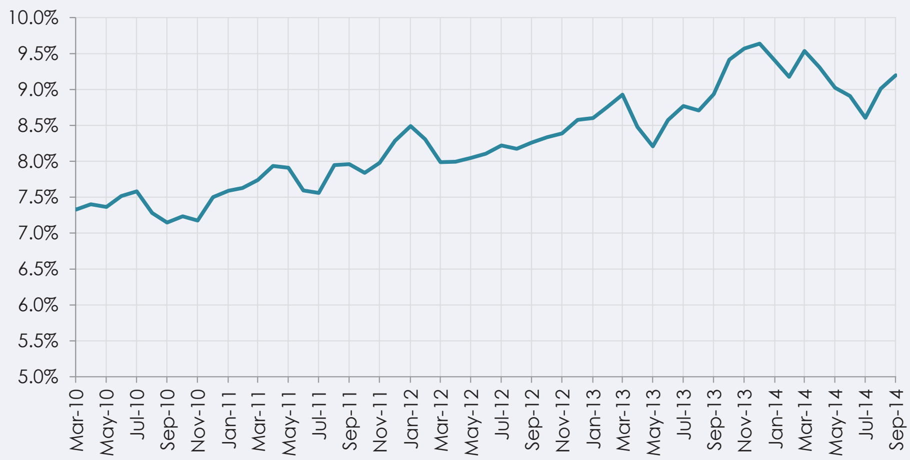


Source: Geostat

In September 2014, the rate of capitalization amounted to 9.2%, which is 0.3 percentage points higher than in the corresponding period of the previous year. The capitalization rate determines the profitability of investments in the real estate sector. It should be noted that the highest capitalization rate was achieved in December 2013 (9.6%) and after that it has had a declining trend. Due to the fact that investments in real estate represent an alternative to investment in financial assets, a rise in the capitalization index increases economic agents' willingness to purchase real estate property, serving as a prerequisite for attracting investments in the real estate sector.

‹‹ In September 2014, the rate of capitalization, which determines the profitability of investments in the real estate sector, amounted 9.2%. That is 0.3 percentage points higher than in the corresponding period of the previous year.

Figure 5.20 Real Estate Capitalization Rate (rent price to house price ratio)



Source: National Bank of Georgia

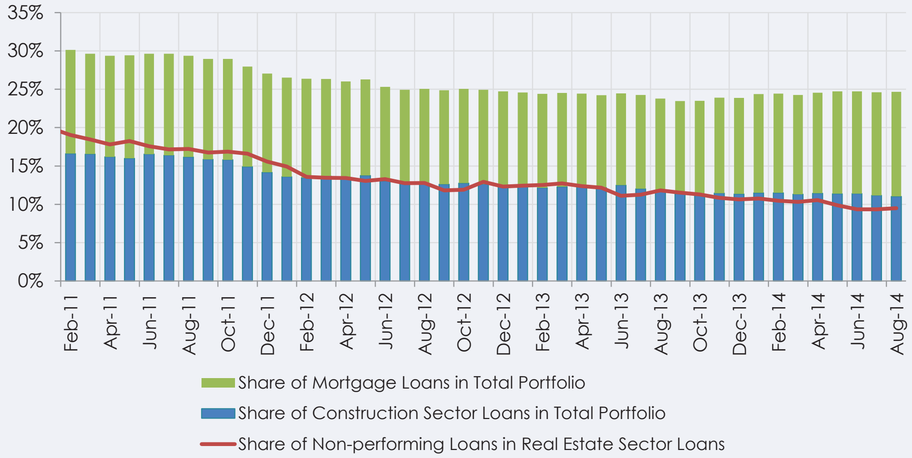
Loans extended to the real estate sector comprise a large share (25%) of the banking sector's portfolio (see Figure 5.2). However, the share of loans in the real estate sector has decreased by 5 percentage points compared to 2011, which makes the banking sector less vulnerable to fluctuations in the real estate market. It should be noted that real estate sector loans include those to the construction sector as well as mortgage loans.

« *Loans Extended to the real estate sector comprise a large share in the banking sector's portfolio (25%).*

The declining trend of non-performing loans in the real estate sector indicates lower risks. The financial crisis of 2008 significantly increased the share of non-performing loans, but since 2009 a declining trend has been visible. In August 2014, the share of non-performing loans in the real estate sector amounted to 9%, which is 3 percentage points lower than in the corresponding period of the previous year. It should be noted that the share of non-performing loans significantly differs for mortgage loans (2.5%) and loans to the construction sector (18.1%), but both indicators have a declining trend.

« *The declining trend of non-performing loans in the real estate sector indicates lower risks in this sector.*

Figure 5.21 Share of loans to the construction sector and mortgage loans in total portfolio



Source: National Bank of Georgia

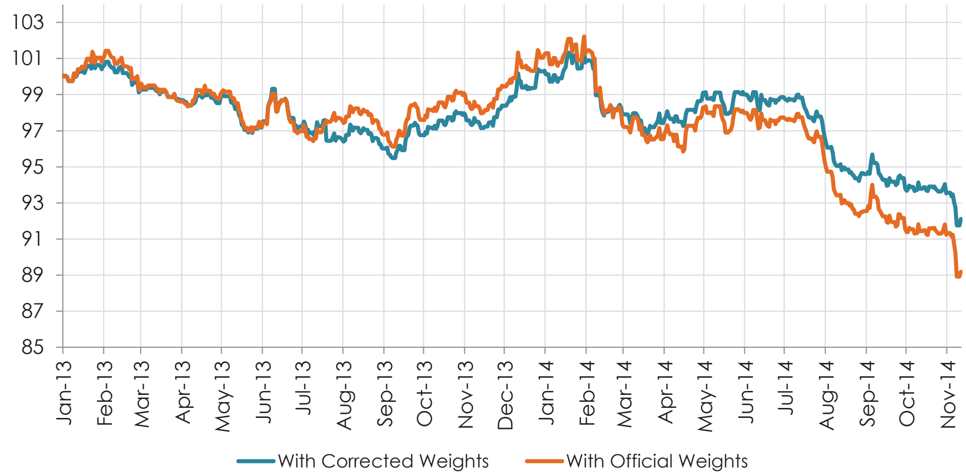
To sum up, at this point, the amplification of the real estate market is not caused by speculative expectations. The main factors contributing to the growth of the real estate market are the increase in incomes, eased accessibility of loans, demographic factors, risk reduction and a rise in profitability. At this time, the formation of a price bubble is not expected and, in line with macroeconomic stability, a fall in real estate prices is less likely.

5.3. EXCHANGE RATE

In the third quarter of 2014, the GEL appreciated slightly against the USD, by 1% and averaged 1.745 lari per dollar. During the same period, the GEL continued appreciating against the euro and in September it increased by 4.3% compared to June. The GEL against the Turkish lira appreciated by 3.2%, and against the Russian ruble and the Ukrainian hryvnia by 4.1% and 7.8% respectively.

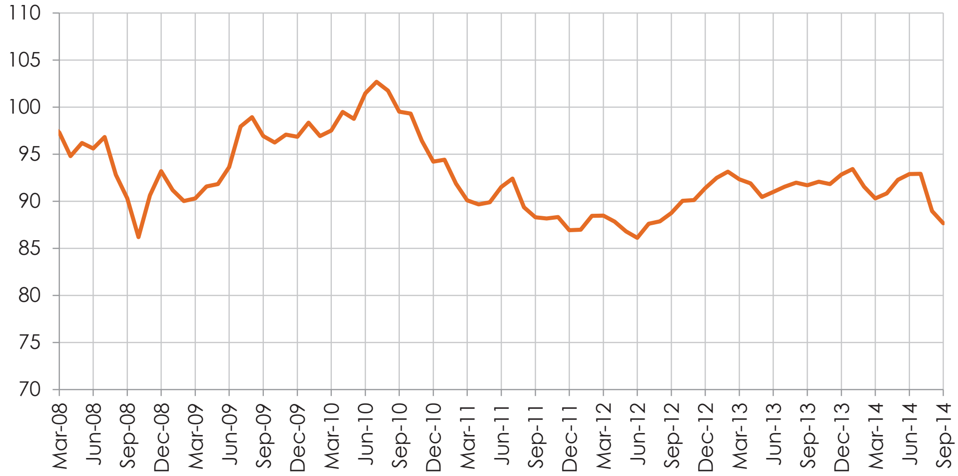
Unlike the previous period, the real effective exchange rate appreciated by 2.5% in quarter-on-quarter terms and by 2.2% in annual terms.

Figure 5.22 Nominal Exchange Rates (Jan 2013=100)



Source: National Bank of Georgia

Figure 5.23 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

The real exchange rate appreciated against the currencies of Georgia's major trade partners, including Ukraine, Russia and Eurozone countries.

Table 5.1 Effective Exchange Rate Annual Growth

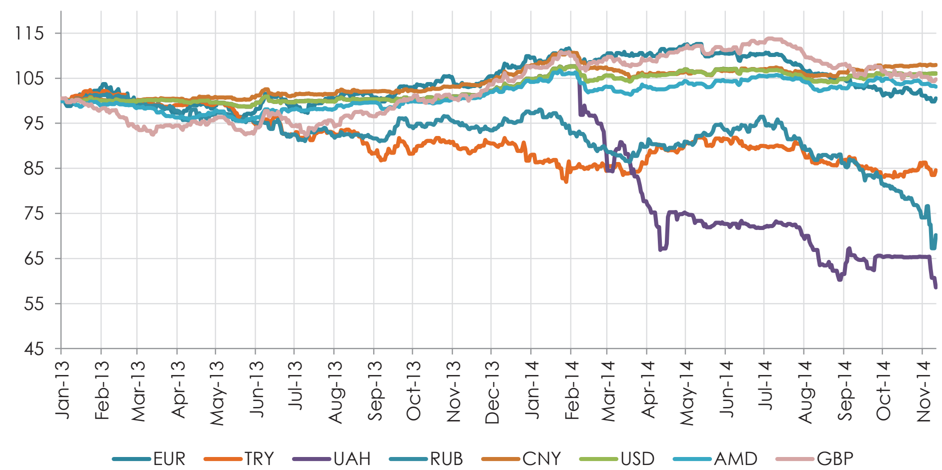
September 2014	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	5.2	4.6	4.6
Turkey	3.9	0.0	0.0
EU	-1.7	2.5	0.4
Ukraine	55.2	38.3	4.4
Armenia	-4.7	-1.6	-0.1
USA	-4.8	-1.9	-0.1
Russia	10.5	7.1	0.6
Azerbaijan	-4.8	-2.5	-0.4
Other	0.2	3.0	-0.2

Source: National Bank of Georgia

The nominal effective exchange rate adjusted by commodities and services weights showed slightly different dynamics. It appreciated by only 0.6% in annual terms and by 2.7% in quarter-on-quarter terms.

According to the new methodology for calculating the weights of the nominal effective exchange rate, commodities trade volume is not included as these are considered homogenous goods whose prices are determined in global markets. Oil, wheat, sugar, rice, soya, coffee, copper, steel, gold, aluminum and iron are included as commodities. Commodities account for 23.6% of exports and 6.5% of imports respectively.

Figure 5.24 Nominal Effective Exchange Rate



Source: National Bank of Georgia

The nominal effective exchange rate with corrected weights are less dependent on the dynamics of the Russian ruble and Ukrainian hryvnia. Consequently, it exhibited less appreciation compared to the effective exchange rate with official weights.

6. Domestic Demand

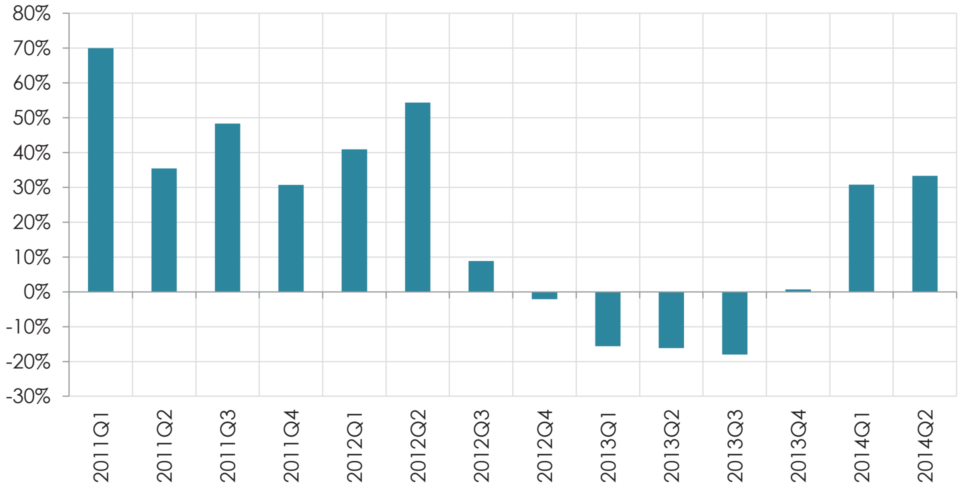
Real GDP growth amounted to 5.2% in the second quarter of 2014, with growth in investments being the main determinant of overall growth (as in the previous quarter). After the significant fall in investments in the previous year, domestic investments have shown an impressive rate of growth. Private consumption is expected to be the main driving force of GDP growth in the second half of 2014. As domestic demand has showed signs of recovery since the end of 2013, imports and consumption are expected to show high rates of growth in the third and fourth quarters of 2014. On the other hand, the growth rate of exports is expected to decline. As a result, net exports should have a negative contribution to economic growth.

« Real GDP growth amounted to 5.2% in the second quarter of 2014.

The capital formation growth rate was still quite high in second quarter of 2014 and the high growth rate of investments played a key role in GDP growth. Such a high rate of growth was partially caused by the base effect (capital formation contracted by 16.1% in the second quarter of 2013).

« Capital formation growth rate was still quite high in the second quarter of 2014.

Figure 6.1 Annual Growth Rate of Capital Formation



Source: GeoStat

Exports of goods and services increased by an annual 4.7% in the second quarter of 2014 and imports increased by 10.6%. As a result, net exports contributed negatively to the GDP growth of the second quarter. Net exports are expected to have a negative contribution to the growth of the economy in the next quarters as well.

« Net exports contributed negatively to the GDP growth of the second quarter.

Real growth of private consumption[9] has increased in the second quarter of 2014 and posted 5.3% growth compared to the previous period. Consumption has 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 an increase of demand. Because of the higher growth rate, private consumption should be the main determinant of GDP growth.

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

Figure 6.2 Real GDP and Real Consumption Growth

Source: GeoStat and National Bank of Georgia

The consolidated budget deficit posted 293.1 million GEL in the first three quarters of 2014. Taking into consideration seasonal patterns, a budget surplus is observed in the first quarter, followed by a deficit in the remaining quarters (the highest deficit is in the fourth quarter), along with a rise in budget expenditures. The consolidated budget deficit in the first quarter of 2014 was small. The budget deficit posted 222 million GEL in the second quarter, which is much higher than the deficit in the corresponding period of the previous year. In the third quarter, the deficit posted 113.6 million GEL. In 2014, it is planned that the consolidated deficit will be approximately 1 billion GEL. Therefore, the last quarter of 2014 is expected to have a much larger negative budget deficit than the previous quarters. However, unlike the previous year, in 2014 the annual budget deficit should be comparably more equally distributed among quarters.

Figure 6.3 Consolidated Budget Deficit (mln GEL)

Source: Ministry of Finance of Georgia

7. External Demand and Balance of Payments

In the second quarter of 2014, the current account deficit to GDP ratio reached 9.2%, which is 3.1 percentage points higher than the same indicator in the previous year. In absolute terms, the current account (CA) deficit increased by 185.9 million USD over the same period and amounted to 379 million USD. According to preliminary statistics, the CA deficit was at 2.8% relative to GDP in the third quarter of 2014. In this period, the CA deficit narrowed, mainly due to the seasonal growth of tourism inflows in the country. In line with the latest available forecast, the CA deficit to GDP ratio will be 8.5% by the end of 2014, this figure is 2.8 percentage points higher than the same indicator from last year.

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The level of registered exports of goods declined by 6.1% year-on-year to 735 million USD in the third quarter of 2014. The decline of exports predominantly reflects the declining re-export of cars to Azerbaijan. The adverse developments in Ukraine are also a drag for Georgian exports, with registered goods exports to Ukraine declining by 42.7% annually during the third quarter of 2014. It is probable that continued instability in Ukraine will negatively influence Georgian exports in following periods as well.

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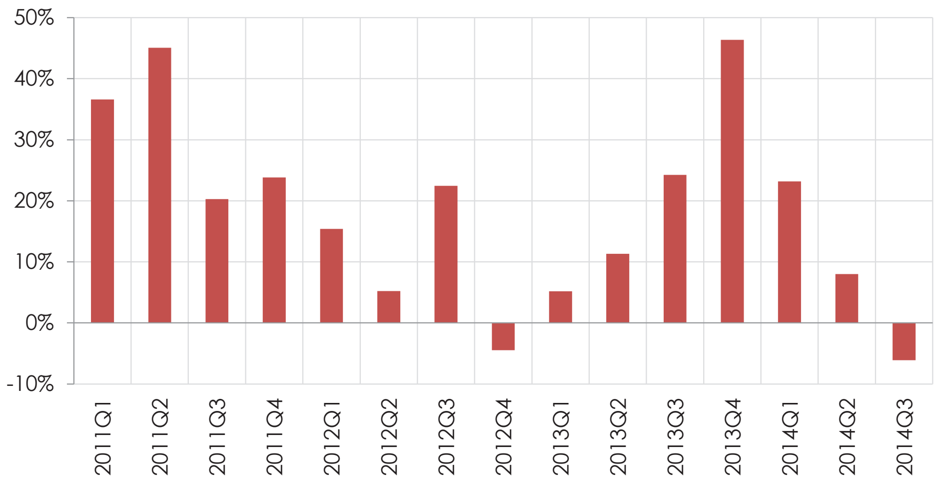
Registered exports of goods to Russia continue a robust growth. During the third quarter of 2014, exports to Russia increased by 26.8% on an annual basis and reached 78.1 million USD. Exports to Russia accounted for 10.6% of the total registered exports of goods. Russia is among the largest destinations for Georgian exports, sharing 2nd/3rd place with Armenia, while Azerbaijan still remains the largest market for Georgian goods, with 18.5% of total exports. It is worth mentioning the sharp growth of exports to China (324.7% year-on-year), mainly due to the re-export of copper from Armenia.

A breakdown of export growth across different regions suggests that registered exports of goods declined by 16% year-on-year to CIS countries in the third quarter of 2014, while over the same period exports to EU countries increased only slightly by 0.2%. Exports to the rest of the world increased by 12% on an annual basis, mainly reflecting the growth of exports to China, USA and Turkey.

Figure 7.1 Annual Growth Rate of Registered Exports of Goods

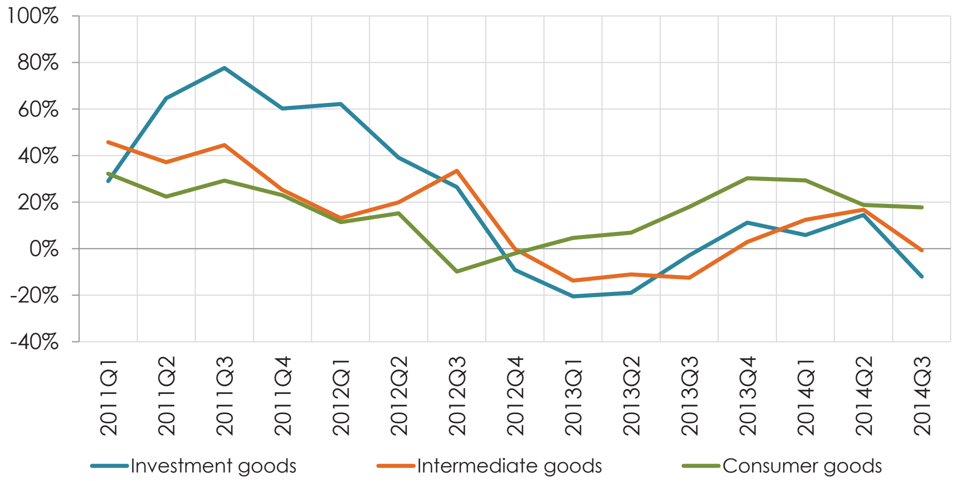


Source: National Bank of Georgia

Despite the sluggish economic growth of Georgia's main trading partners, demand on traditional export commodities remains stable: exports of hazelnuts, wine and mineral waters increased by 41%, 45% and 12% respectively during the third quarter of 2014.

Registered imports of goods increased by 5.4%, and amounted to 2,203 million USD during the third quarter of 2014. Growth was chiefly driven by growing imports of consumer goods (17.8%). At the same time, imports of intermediate and investment goods were down by 0.8% and 12% respectively.

Figure 7.2 Annual Growth Rate of Imports Accross the Product Groups



Source: National Bank of Georgia

In the third quarter of 2014, imports of goods reduced from both CIS (-14%) and EU (-2%) countries. The reduction of imports from these regions was outweighed by increasing imports of goods from Turkey (28.4%), China (41.0%) and Japan (67.2%), resulting in the overall growth of imports in this period. Total trade with China significantly raised during the third quarter of 2014 and, as a result, China moved up to the top three trading partner countries outpacing some traditional trade partners such as Russia.

‹‹ Total trade with China significantly raised during the third quarter of 2014 and, as a result, China moved up to the top three trading partner countries.

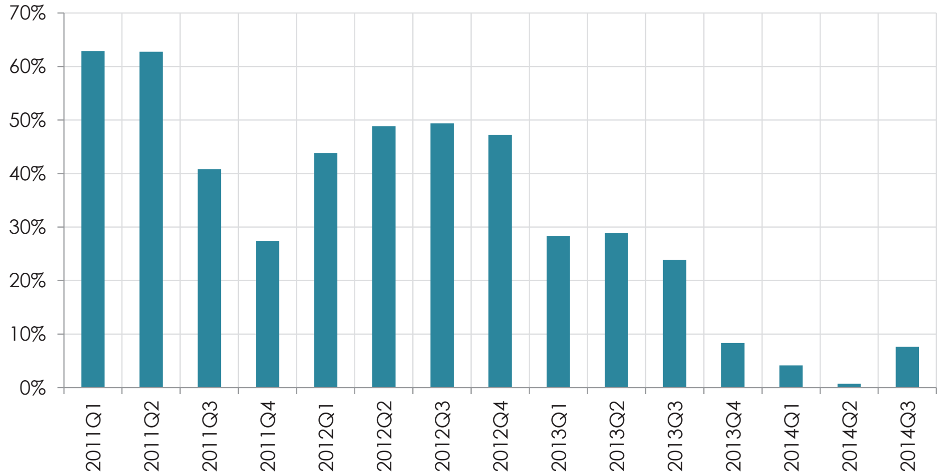
Money transfers increased by 0.5% year-on-year in the third quarter of 2014, in absolute terms increasing to USD 399.1 million in this period. The weakening of the growth rate of money transfers was related to decreasing transfers from Russia (-6.6%) and Ukraine (-23.9%). Sluggish economic growth in Ukraine and Russia negatively affects the growth rates of money transfers to Georgia and this effect is expected to continue in coming periods.

‹‹ Sluggish economic growth in Ukraine and Russia negatively affects the growth rates of money transfers to Georgia and this effect is expected to continue in coming periods.

Overall, in the third quarter of 2014, transfers from CIS countries declined by 5.7%. At the same time, transfers increased by 6.8% from EU countries. The growth of transfers from the USA (13%) and Turkey (43%) have been solid, which chiefly determined the growth of total money transfers.

Tourism inflows maintain a significant positive impact on the CA deficit. As of the third quarter of 2014, the number of incoming tourists increased by 2.2% on an annual basis and reached almost 2 million people.

Figure 7.3 Annual Growth rate of tourism receipts



Source: National Bank of Georgia

8. Output and Labour Market

8.1 OUTPUT

In the second quarter of 2014, GDP rose by 5.2% in comparison with the same period of the previous year. This growth breaks down as follows: services increased by 3.6%, industry by 1.5% and agriculture by 0.1%.

« In the second quarter of 2014, GDP rose by 5.2%.

Second quarter growth in the trade sector, which is the largest branch of services, was still high (6%), but was considerably lower than in the first quarter (12.8%). The reason for the decline was the slowing of the trade in cars (nominal growth in the first quarter was 11.6% and 9% in the second quarter). In particular, due to trade conditions changes with Azerbaijan, exports to that country were dramatically diminished (by 36%). The output of restaurants and hotels increased by 4.5%. The largest contribution of transport growth (6.9%) came from railway transport (with a nominal growth of 15.5%). Increased credit activity largely contributed to a rise in the financial sector (9.6%) As for the real estate market, growth is maintained on rent and real estate operations (2%).

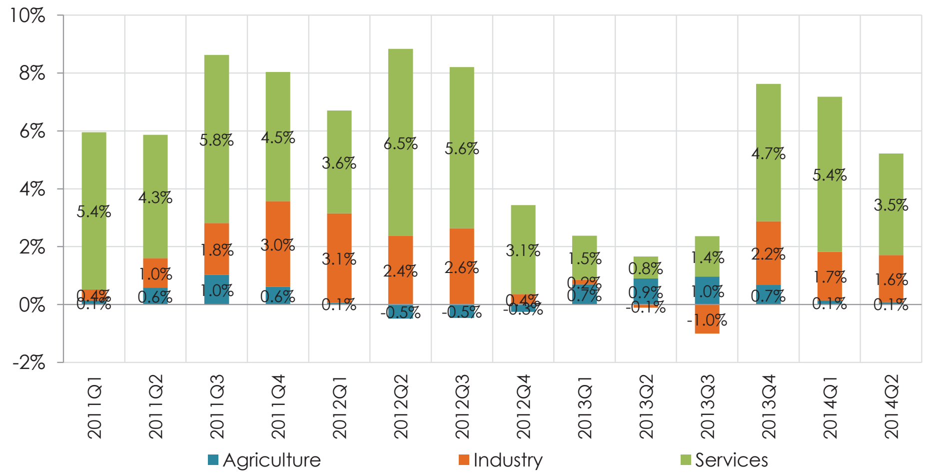
The largest share of industry growth came from construction, affected by both the private and public sectors. After relatively low activity throughout the previous year, work on infrastructural projects intensified from the start of 2014. The value added from the construction of motorways, roads, airfields and sport facilities in nominal terms increased by 30% and 67% in the first and second quarters respectively. The general construction of buildings and civil engineering works, where the biggest share is from the private sector, increased by 16% in nominal terms. Increased credit to the construction sector and a rise in the volume and cheapness of credit for real estate purchases largely contributed to the rise in private construction. Overall, the construction sector grew by 17.9% in real terms in the second quarter of 2014.

« Construction sector grew by 17.9%.

From the industry sector, high growth is maintained in the manufacture of alcoholic beverages (with a nominal growth of 44%) and mineral waters and soft drinks (a nominal growth of 32%). Such large growth was provided by high levels of external demand and a growth of exports. The manufacture of electrical and transport equipment and machinery saw a significant decline (of 40% in nominal terms). However, the fall in mining (4.1%) continued.

Agricultural output slightly increased in the second quarter. Crop production has grown by 0.6% and livestock production by 1.1%. Overall, agriculture's real growth was 0.9%.

Figure 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 second quarter of 2014 as compared to the previous quarter. The productivity of the labor force increased by 0.7% in year-on-year terms during the second quarter, which is 3.6 percentage points less than in the first quarter. During this period, the annual growth rate of labor efficiency 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 3.5%, which is 5 percentage points less than the previous quarter. Labor productivity in the industrial sectors also decreased. The growth rate declined by 13.6 percentage points, equaling -2.8%. As for the service sector, the real value added per employee grew by 3% on an annual basis.

« Labor productivity increased by 0.7% during the second quarter of 2014. This increase can be largely attributed to the services sector.

Table 8.1 Index of Value Added Produced per Worker in 2nd 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	96.6
Industrial sectors	97.3
Service sector	103.0
Overall in the economy	100.7

Source: GeoStat and National Bank of Georgia

As the sectoral breakdown of the economy shows, labor productivity in manufacturing increased, with the annual growth rate reaching 3.5%. At the same time, an annual decline of 11.3% was observed in construction. As was the case in the preceding quarters, labor productivity increased in the hotels and restaurants and trade sectors.

« The labor productivity in manufacturing continues to grow, but at a slower pace.

The annual growth rate of the nominal salaries of employees amounted to 8.5% during the second quarter of 2014, which is 0.5 percentage points less than the previous quarter. The average monthly nominal salary stood at 864 GEL, according to the latest data from Geostat.

« According to Geostat, the nominal salaries of employees increased by 8.5% on an annual basis.

In terms of sector analysis, an annual growth of salaries is evident in the agriculture, hotels and restaurants, and manufacturing sectors. However, average salaries in the fishing sector decreased during the second quarter of 2014.

Table 8.2 Index of Average Monthly Nominal Wage of Employees in 2nd quarter of 2014 Relative to the Corresponding Period of the Previous Year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	120.3
Fishing	93.5
Mining and quarrying	115.7
Manufacturing	110.2
Production and distribution of electricity, gas and water	105.1
Construction	105.2
Wholesale and retail trade; repair of motor vehicles and personal and household goods	108.7
Hotels and restaurants	110.4
Transport and communications	107.9

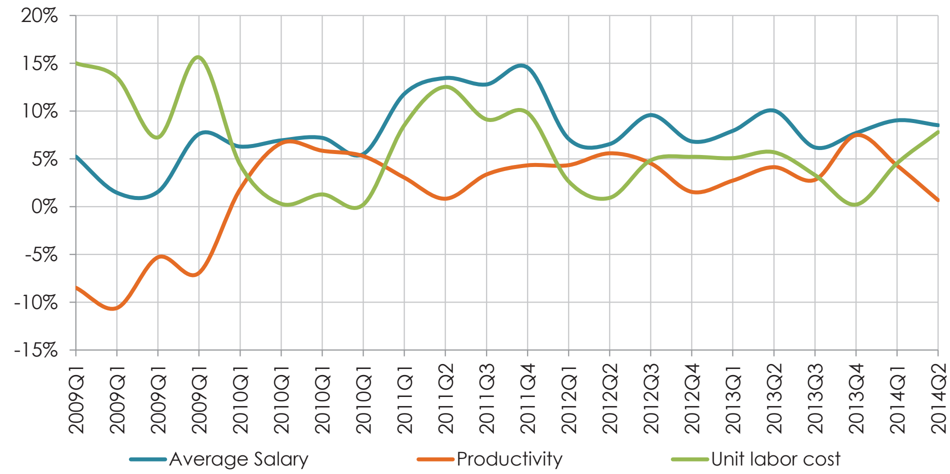
	Average nominal wage (growth index)
Financial intermediation	102.7
Real estate, renting and business activities	103.3
Public administration	109.1
Education	108.9
Healthcare and social work	108.8
Other community, social and personal service activities	107.6
Overall in the economy	108.5

Source: GeoStat

To sum up, against the backdrop of the declining annual growth rate of labor productivity, the annual growth rate of unit labor cost (personnel expense per production unit) increased and stood at 7.8% by the end of the second quarter of 2014 (see Figure 8.2). In spite of the increasing trend of unit labor cost growth, this still remains at a low level, which does not create significant upward price pressure from the labor market.

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

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



Source: GeoStat and National Bank of Georgia

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