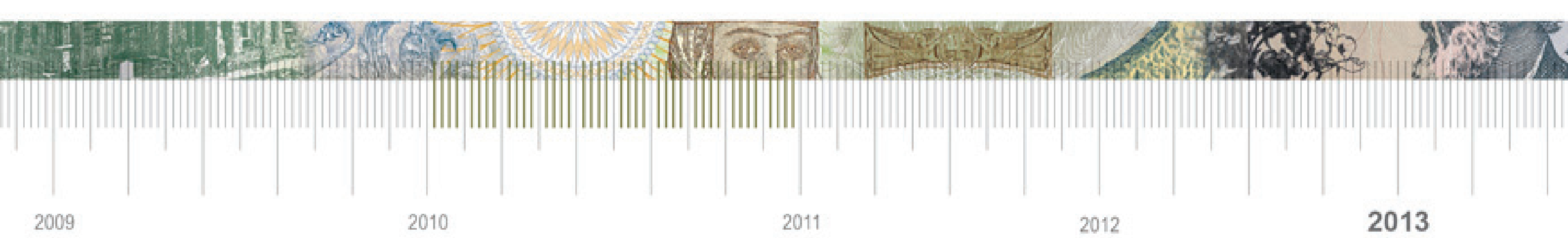
National Bank of Georgia

INFLATION REPORT

February

2015



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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 5% for the year 2015 and 4% from the year 2017**. 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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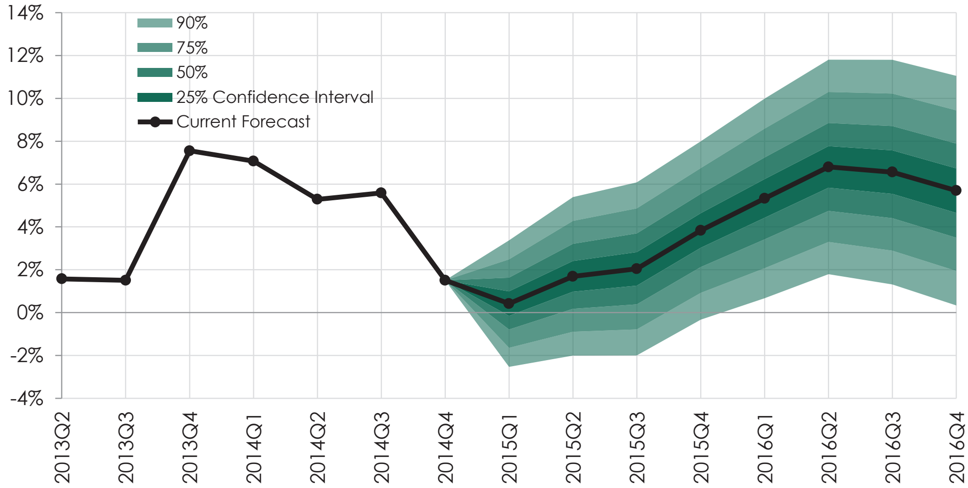
1. BRIEF OVERVIEW

Economic growth in Georgia slowed significantly in the fourth quarter of 2014. The average **annual GDP growth** rate in the first three quarters of the year reached 5.9%, however, according to preliminary data, declined to 1.9% in the fourth quarter, making the average GDP growth for 2014 equal 4.7%. Economic growth in 2014 was supported by the growth of domestic demand. In particular, amid expansionary monetary policy and fiscal stimulus, lending growth was positively reflected in the growth of consumption and domestic investment. In contrast, net exports made a negative contribution to GDP growth. Negative spillovers from the adverse political and economic conditions facing Georgia's trading partners were especially evident in the second half of 2014. The fall in exports and remittances in the fourth quarter of 2014 were more than expected, and were only partly offset by reduced imports due to weakened oil prices.

The economic growth forecast for 2015 has been revised downwards, which reflects the negative influence of worsened economic conditions in the region on the Georgian economy. According to current projections, GDP growth in 2015 will be around 2% and its main impediment will be the foreign sector. Net exports will again make a negative contribution and economic growth will thus be supported by domestic demand. Amid an increase in government capital expenditures and expansionary monetary policy, growth in lending will encourage investment and consumption. Unfavorable spillovers from the foreign sector will be partly offset by lower petrol prices, which represent a positive factor for the current account as well as for the other sectors of the economy.

Figure 1.1 Real GDP Annual Growth

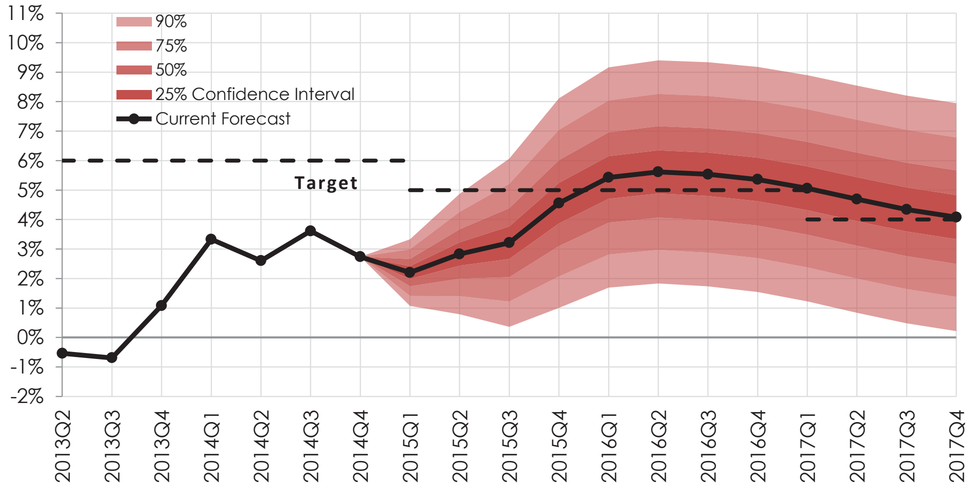


Source: National Bank of Georgia

Annual Inflation was lower than expected and posted 2% by the end of 2014. It stood at 1.4% in January 2015. The main cause of weakened inflation was falling food and energy prices on international markets. Also, even though the lari has depreciated against the US dollar, the nominal effective exchange rate (which takes into account Georgia's main trading partners) has remained strong and translated into low imported inflation. In contrast, the contribution of domestic prices to overall prices has been broadly stable and moderate, which indicates improving, albeit still weak, domestic demand in 2014.

According to the forecast, inflation will remain below the 5% target in the first half of 2015 and will reach it in the second half of the year. The main source of downward pressure is weak global oil prices. Food prices also exhibit a decreasing trend that is expected to continue throughout 2015. The effect of lari depreciation against the US dollar is partly offset by its appreciation against other currencies. Imported prices will thus remain modest, which is reflected in the forecast of headline inflation. According to the forecast, upward pressure on inflation mainly stems from increased input costs.

Figure 1.2 Headline CPI Inflation



Source: National Bank of Georgia

These forecasts are largely dependent on exogenous factors affecting the market and contain **risks in both upward and downward directions**. The main risk to the forecast comes from the foreign sector. In particular, if the adverse conditions in the region are transmitted to the Georgian economy more than expected, this would imply lower economic growth; while, on the other hand, this would strengthen the transmission of high inflation rates from partner countries. An upside factor for GDP growth would be if foreign investment and the large-scale projects planned throughout the year had a greater than expected positive influence on economic activity. Inflation would also be lower than forecast if the transmission of globally falling food and energy prices on overall prices is more than expected, or if imported inflation from partner countries is weaker than is currently anticipated.

The Monetary Policy Committee decided to raise the refinancing rate by 50 basis points to 4.5% at their meeting of 11 February 2015. Based on the analysis of current economic developments, forecasts and related risks, the committee decided that there is a need to tighten monetary policy in order to curb inflationary expectations. The tightening will be gradual and its pace will depend on the expected dynamics of the inflation rate and the factors influencing it. Unless new shocks affecting the economy emerge, the forecast shows that the rate will reach 5% by the end of 2015.

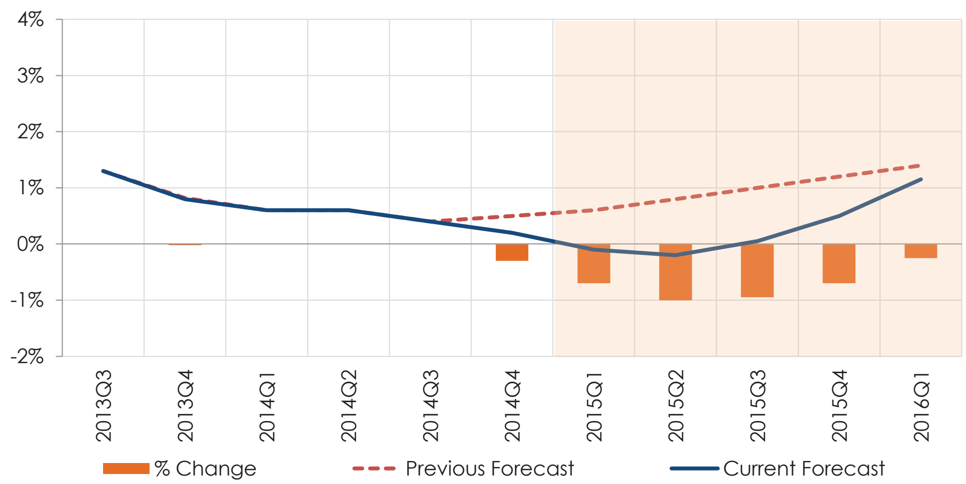
2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

The significant drop in global prices of major commodities, alongside the economic situation in Georgia's trading partners, has had a considerable influence on the Georgian economy. This impact is mainly reflected in weak demand for goods and tourism exports, in falling remittances and declining prices on imported goods. Most developed countries that have some economic ties to Georgia are either struggling to cope with the legacy of the global financial crisis (such as Greece and Italy) or, due to the events of last year, face deteriorated prospects (such as Germany and France). The only exception has been the United States, where the recovery process is gradually becoming irreversible. Meanwhile, the geopolitical conflict between Ukraine and Russia and its economic consequences negatively affect the outlook for Georgia's emerging and developing trading partner countries. Armenia, one such important partner, faces a poor outlook because of its close relations with the troubled Russian economy. Low economic activity in Azerbaijan, meanwhile, has been negatively affected by the global oil price fall, along with some other external factors. Relatively better prospects loom in Turkey, where planned structural reforms and a gradual increase in private consumption are expected to promote growth.

Following a turbulent year for the eurozone economy, two important events, which may have a significant impact on the monetary union's perspective, marked the beginning of 2015. First of all, on 22 January the European Central Bank announced a massive monetary easing program involving bond purchases worth 1.1 trillion euros, thereby increasing the money supply. The aim of this move was to encourage investment and stimulate demand in order to overcome the downward trend in prices (see Figure 2.1) and push inflation closer to the target rate of 2%. Naturally, this move increased volatility in financial markets, as reflected in the depreciation of the euro against the US dollar. This process is also important for the Georgian economy. Growth of domestic demand in the euro area will improve demand on export goods, but, at the same time, a weak euro will have a negative effect on the competitiveness of Georgian exporters. A few days after the European Central Bank's announcement, a left-wing party won the Greek parliamentary elections. This greatly increases the risk that Greece might default on its huge sovereign debt and possibly, sometime later, even leave the currency union. Expectations of such an adverse scenario have recently weakened the euro. According to the forecasts, economic growth in the eurozone will total 1.1-1.2% in 2015 (see Figure 2.2).[1]

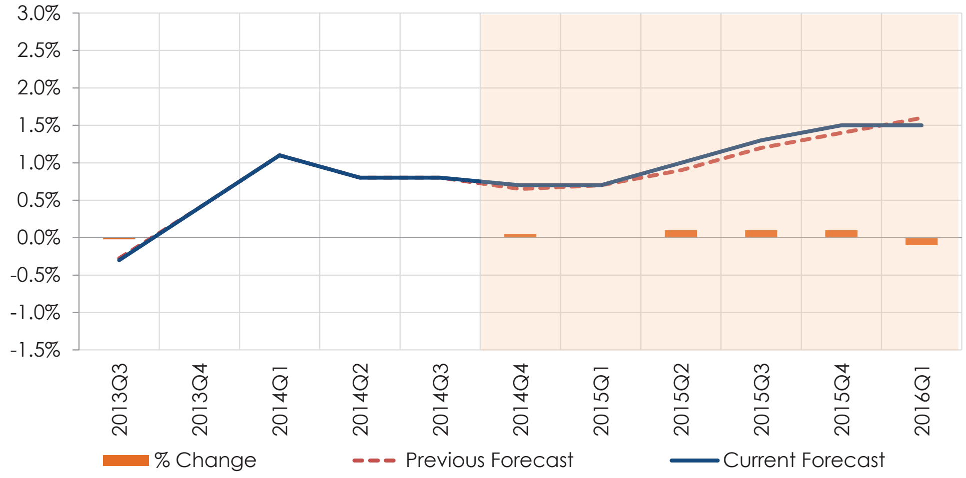
Figure 2.1 Eurozone CPI Annual Inflation



Source: OECD

1 *The estimates are those of the IMF (WEO Update, Jan. 2015) and World Bank (Global Economic Prospects, Jan.*

Figure 2.2 Eurozone Real GDP Annual Growth



Source: Eurostat

The Russia-Ukraine geopolitical crisis has significantly affected both countries. The economic sanctions imposed on Russia in 2014 were followed by a global decline of oil prices, which has been a serious blow to the energy export-oriented economy. The 70% depreciation of the Russian ruble against the US dollar has not compensated the deteriorated terms of trade. Instead, depreciation propelled inflation and reduced real income, which has also been reflected in a significant reduction of demand on exported goods and remittances from Russia to neighboring countries. It is expected that this negative trend will persist in the near future. Under the most optimistic estimates, Russia's GDP will decrease by approximately 3-5% in 2015.[2]

As for Ukraine, the country's economy decreased by about 8% in 2014 and the local currency has depreciated by 85% against the US dollar. Weakened demand and the large-scale depreciation of the hryvnia are negative factors for Georgia's export potential in Ukraine, along with the reduction of remittances and tourism inflows. Considering the start of a new phase of military conflict in the country, it is expected that the crisis will grow into a long recession and Ukraine's GDP will fall 5% in 2015.[3]

The outlook for Armenia, another important trade partner for Georgia, has also deteriorated. This was mainly due to the country's close economic relations with Russia being reflected in a 17% depreciation of the local currency against the US dollar and a reduction of remittances from Russia. According to forecasts, in 2015 the Armenian economy will see trivial growth.[4] This, in turn, may weaken the demand for tourist services and export products from Georgia. Regional difficulties are also affecting Azerbaijan's economy, however, falling global oil prices have had a much more serious impact on this energy exporting country. As a result of the latter factor, Azerbaijan's GDP growth forecast for 2015 has been significantly revised down to 1.5%.[5]

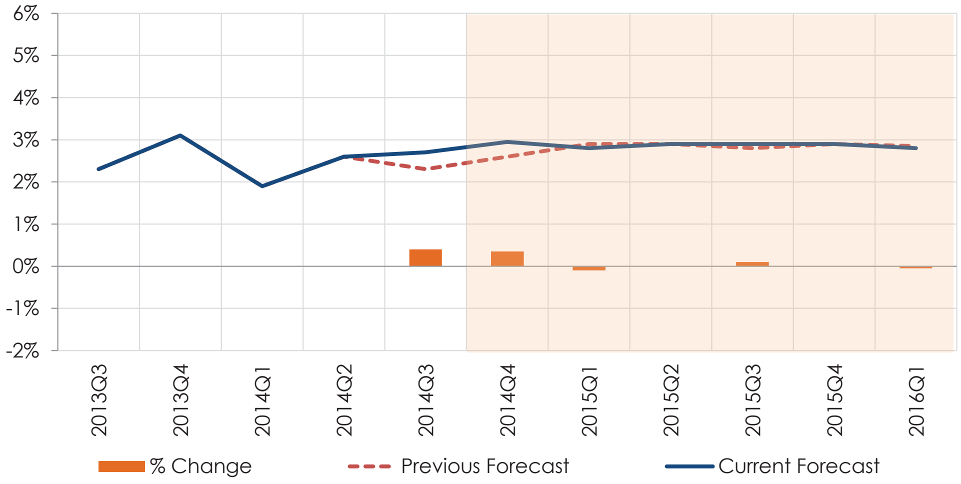
Compared to other economies in the region, a better outlook looms for Turkey, where 2014 was marked with moderate growth. The mitigation of inflation risks, which was a result of the strict monetary policy adopted last year, has allowed for softer credit conditions in January 2015[6], thereby creating a precondition for private consumption growth. In addition, the government plans to launch a major structural labor market liberalization reform. All of these factors are expected to increase domestic demand on goods and services, including on those exported from Georgia. The growth in income should also positively affect remittances transferred from Turkey. According to forecasts, Turkey's GDP growth in 2015 will amount to 3%.[7]

Economic activity and employment in the United States increased significantly in the second half of 2014 (see Figure 2.3). Soft monetary and fiscal policies substantially contributed to this, however, the intensity of the recovery process has increased expectations that the Federal Reserve System will increase the monetary policy rate in

2 The estimates are those of the EBRD (Regional Economic Prospects, Jan. 2015) and IMF (WEO Update, Jan. 2015).
3 EBRD estimate. Regional Economic Prospects, Jan. 2015.
4 EBRD estimate. Regional Economic Prospects, Jan. 2015.
5 EBRD estimate. Regional Economic Prospects, Jan. 2015.
6 The Central Bank of Turkey decreased its monetary policy rate by 50 basis points, down to 7.75%, on 20 January 2015.
7 EBRD estimate. Regional Economic Prospects, Jan. 2015.

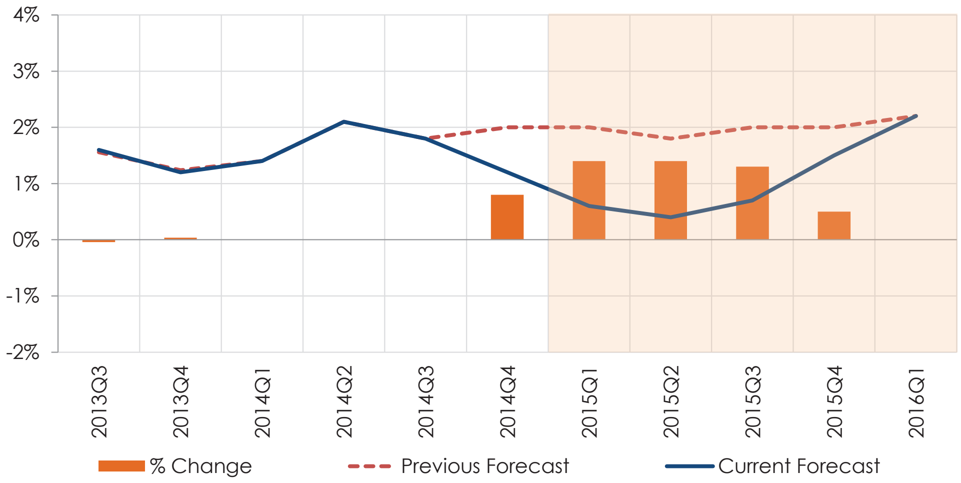
the near future. Meanwhile, weak inflation led by the appreciation of the US dollar and falling oil prices deserves attention (see Figure 2.4). Private consumption will be the driving force behind growth, which, according to current forecasts, is expected to total 3.2-3.6% in 2015.[8]

Figure 2.3 U.S. CPI Annual Inflation



Source: OECD

Figure 2.4 U.S. Real GDP Annual Growth



Source: OECD

The depreciation of local currencies against the US dollar led to inflationary pressures in the region. Significant pressure has been observed on the Ukrainian hryvnia, Russian ruble and Armenian dram. However, the downward trend of major commodity prices has softened inflationary pressure in energy importer countries. The abovementioned trend, combined with falling international prices on food products, exerts a positive influence on imported inflation in Georgia. It is likely that commodity prices will continue to exhibit a downward trend in 2015 due to excess supply expectations.

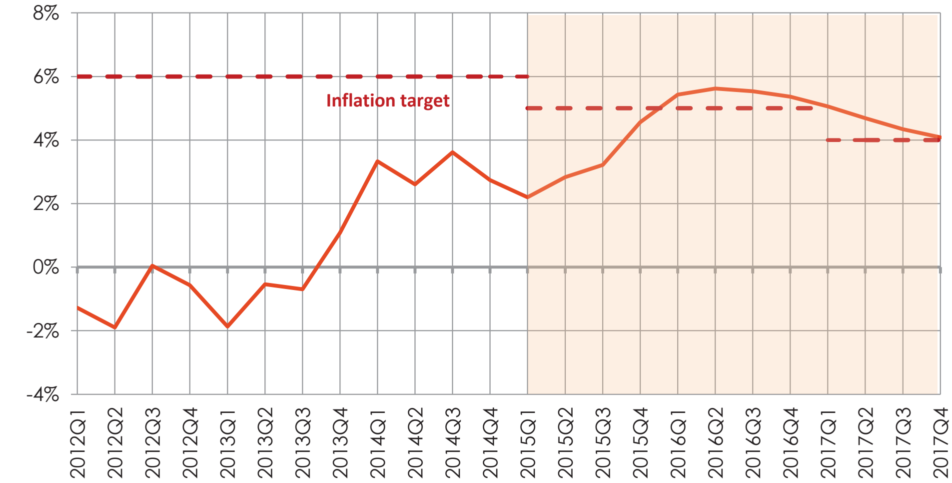
Regional central banks pursued strict monetary policies to deal with inflation risks in 2014. At the end of the year, in Russia and Ukraine the main policy rate reached 17% and 14% respectively. A drastically different situation is observed in the eurozone, where the central bank aims to ease credit conditions and promote demand and investment. While in the United States, an expansionary monetary policy persists in spite of financial market expectations of a growth in interest rates.

8 *IMF (WEO Update, Jan. 2015) and World Bank estimate (Global Economic Prospects, Jan. 2015).*

2.2 MACROECONOMIC FORECAST

The annual inflation rate declined more than expected and stood at **1.4%** in January 2015. It was at 2% in December 2014, which makes the fourth quarter annual inflation average 2.7%. It is thus still below the target of the National Bank of Georgia (see Figure 2.5). The greater-than-expected decline in inflation by the end of 2014 was mainly driven by falling food and energy prices in global markets. At the same time, even though the lari has depreciated against the US dollar, the nominal effective exchange rate (which takes into account exchange rates with respect to the currencies of Georgia's main trading partners) has remained strong, which has translated into low imported inflation. Contrary to imported inflation, the contribution of domestic prices to overall prices was broadly stable and moderate in 2014 (see Figure 2.6), which indicates improving, albeit still weak, domestic demand.

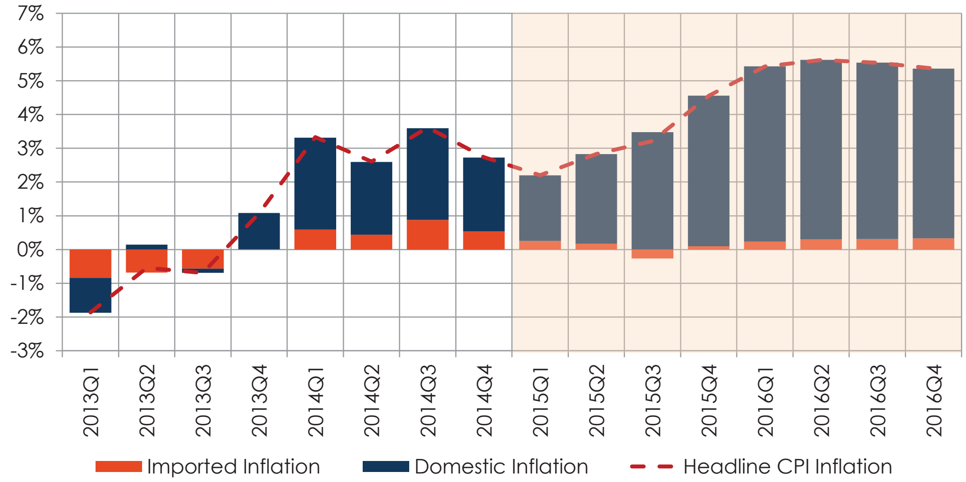
Figure 2.5 Headline Inflation



Source: National Bank of Georgia

According to the **forecast, inflation** in the first quarter of 2015 will be around 2.2% on average and will afterwards continue increasing towards the target rate. The current forecast shows that inflation will reach its target of 5% in the second half of 2015 (see Figure 2.5), which is in line with the previous forecast.

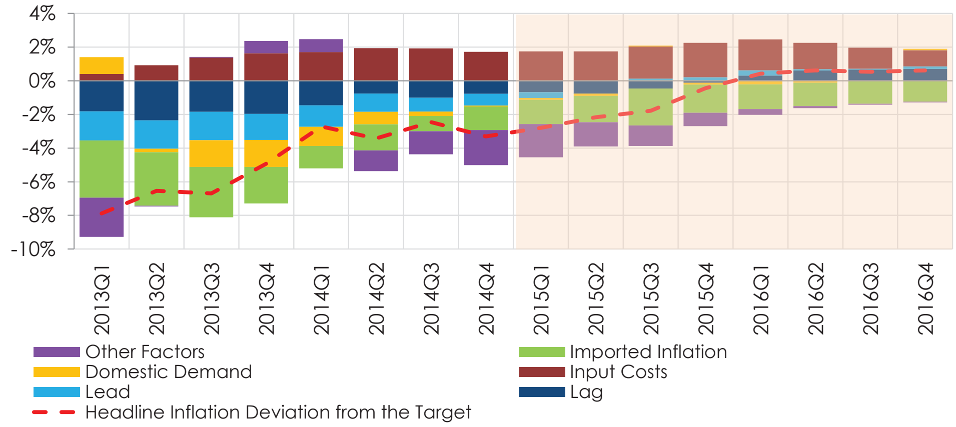
Figure 2.6 Headline Inflation Decomposition



Source: National Bank of Georgia

The deviation of inflation from the target has mainly been caused by a combination of weak imported prices, weak expectations (until recently on the backdrop of previous deflation), inertia in setting prices, as well as other factors, including globally declining food and energy prices (see Figure 2.7). Also, while in the second half of 2013 and the first half of 2014 domestic demand had a downward pressure on prices, it is now relatively neutral and is expected to remain so in 2015. According to the current forecast, the deviation of inflation from the target is expected to die out in the second half of the year. This will be facilitated by neutralizing the effects of weak expectations and other factors, and, on the other hand, by higher input costs. Upward pressure on inflation mainly stems from increased interest costs for firms due to dollarization and a depreciated lari with respect to the US dollar, as well as from higher production costs largely resulting from an increase in natural gas prices for corporate customers. Finally, it is expected that these factors will outplay the long-lasting negative influence of weak imported inflation, which is a result of a strong lari nominal effective exchange rate.

Figure 2.7 Inflation deviation from target and its decomposition*



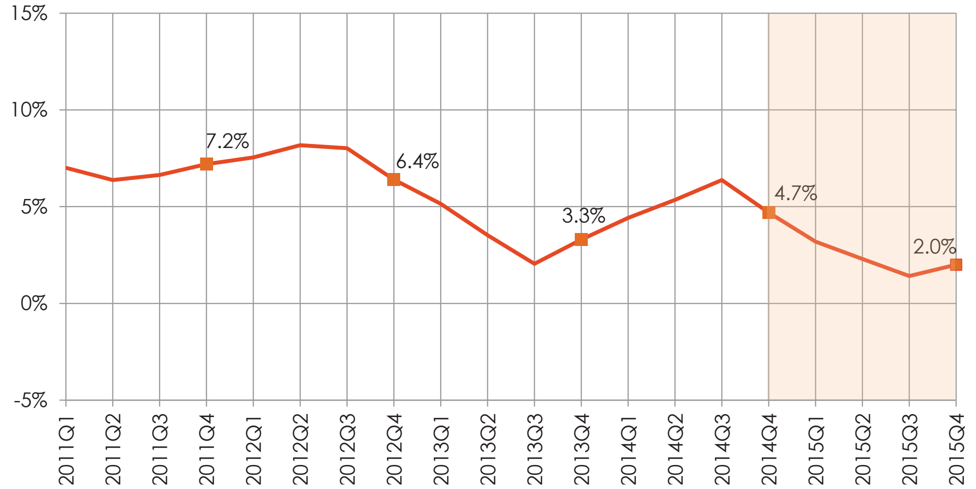
** In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

Source: National Bank of Georgia

There are **risks associated with the inflation forecast** in both directions. In particular, if the depreciation of the currencies of Georgia's main trading partners is reversed, it would strengthen the transmission of the already high inflation rates of those countries. There is also some uncertainty surrounding food prices, which have substantial weight in the consumer basket and are mostly supply-driven. At the same time, if there is an increase in foreign demand for food, potentially caused by the Russian embargo on European products, this may also give rise to upward pressures 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 are transmitted into inflation more than forecasted, it may cause actual inflation to be lower than the current projections.

Real GDP growth in the first three quarters of 2014 was consistent with the previous forecasts. The annual growth rate in the third quarter of 2014 was 5.5%, which corresponds to an average annual growth of 5.9% in the first three quarters (see Figure 2.8). However, according to preliminary data, weak growth in the fourth quarter ensured average annual growth was 4.7%. Economic activity in the last year was driven by domestic demand. In particular, against the backdrop of accommodative monetary policy and fiscal stimulus, an increase in lending had a positive impact on consumption and domestic investment. After a very strong increase in 2013, net exports had a negative contribution to GDP growth in 2014. This was mainly caused by considerably weakened foreign demand, on the one hand, and by the fall in net exports due to higher domestic demand, on the other. Weak net exports could be explained by geopolitical tensions and the already fully exploited Russian market that was opened in 2013 and caused a one-time jump in exports. In addition, the strong lari nominal effective exchange rate is an important factor in explaining lower net exports. In the context of weak activity in 2013, the base effect had a positive influence on economic growth in 2014. According to current estimates, the deviation of economic activity from its potential level has deteriorated in the last quarter and the output gap is expected to start improving from late 2015. Due to the risks stemming from the foreign sector, growth is still fragile.

Figure 2.8 Real GDP Growth (Annual Growth of Last four Quarters)

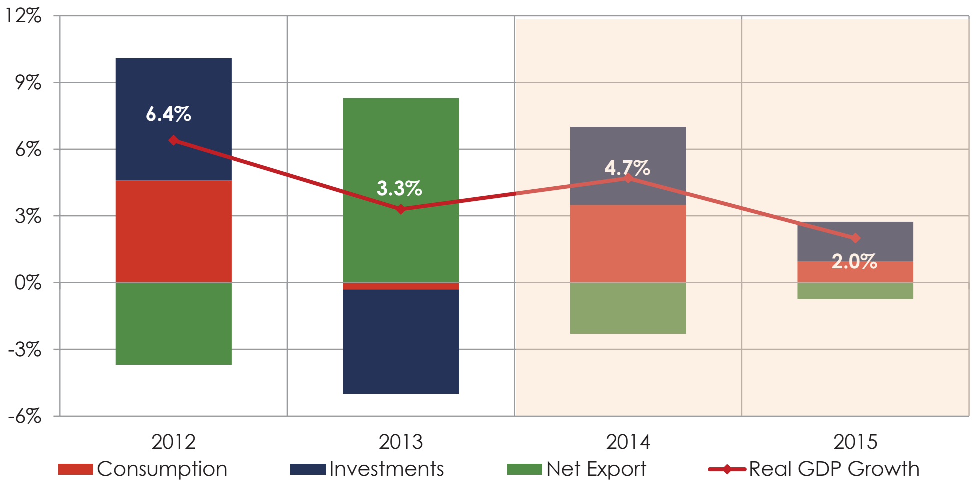


Source: National Bank of Georgia

According to the **GDP forecast**, the growth rate in 2015 is forecasted to be around 2% (see Figure 2.8), which will be driven by domestic demand. An increase in government capital expenditures, alongside accommodative monetary policy, will support lending in 2015. This, in turn, will lift investment and consumption growth rates. It is expected that the Baku-Tbilisi-Ceyhan pipeline project and hosting various international sports events in 2015 will have a positive impact on economic activity. On the other hand, the unfavorable trend in the foreign sector is expected to weaken net exports, which will continue to have a negative contribution to GDP growth in 2015 (see Figure 2.9). Net exports are negatively influenced by adverse political and economic conditions in trading partner countries, which will be reflected in weak foreign demand for Georgian exports, remittances and international tourism receipts. Such negative spillovers from the foreign sector are partly offset by reduced petrol prices, which is a positive factor for the current account as well as for other sectors of the economy.

The foreign sector stands out when analyzing **risks to the GDP forecast**. In particular, against the backdrop of geopolitical tensions, if economic conditions in trading partner countries are worsened and/or are transmitted to Georgia more than expected, then actual GDP growth will be lower than the current forecast. On the other hand, if the free trade prospects with Europe or large investment projects have a greater-than-expected positive impact on economic activity or business confidence, then GDP will be higher than forecast.

Figure 2.9 Components of Real GDP Growth



Source: National Bank of Georgia

According to preliminary data, the **trade balance** deteriorated by 12.1% in 2014. In the same period, the growth rate of exports was negative, equaling -1.6%, which was mainly a result of a fall in re-exports of cars. However, recent months suggest exports of other products have slowed as well, resulting in a 20.5% annual fall in exports in the fourth quarter of 2014. At the same time, the growth rate of imports, although slower than in the previous period, was still positive, amounting to 1.1%. As a result, imports grew by 7.1% in 2014.

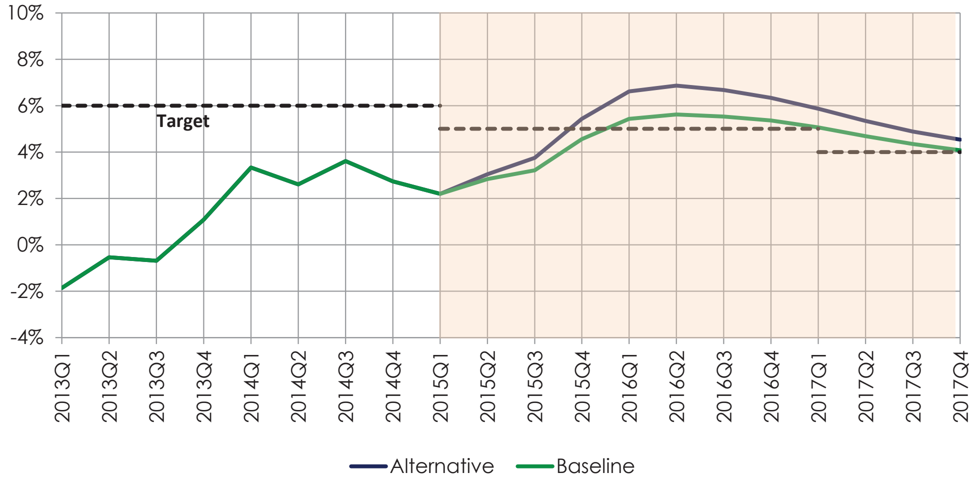
Preliminary data shows that the current account deficit worsened to 9.6% in 2014. The forecast for the current account deficit for 2015 is around 11.5% and is steadily improving in the medium-term. In addition to goods exports, this will mainly be supported by an increase in the export of services, especially tourism, and higher income received from abroad.

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 the significant deterioration in exports and remittances seen in the fourth quarter of 2014, resulting from stressed economic circumstances in the region, will persist in 2015 and that the US Federal Reserve will continue exiting from its highly accommodative monetary policy. This would have greater negative effects on foreign demand as well as on the nominal effective exchange rate. As a result, high rates of inflation in trading partner countries will be transmitted at greater strength (see Figure 2.10), while economic growth will be slower than in the baseline scenario (see Figure 2.11).

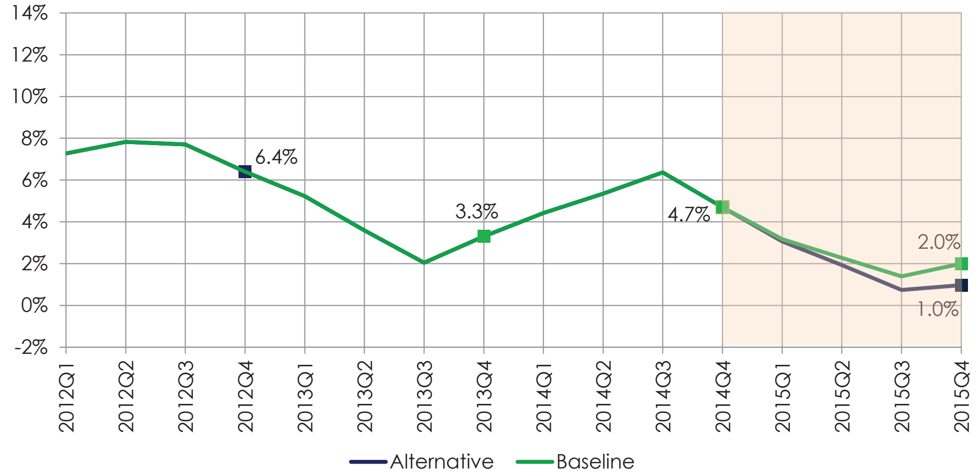
According to this alternative scenario, the inflation rate will increase faster than in the baseline scenario, mainly as a result of higher imported inflation. The scenario shows that inflation hits its target one quarter earlier than in the baseline case and stays temporarily above it in 2016 by 1-2 percentage points. In order to influence inflation expectations, the appropriate response of monetary policy would make inflation go back to its target in the medium-term.

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)

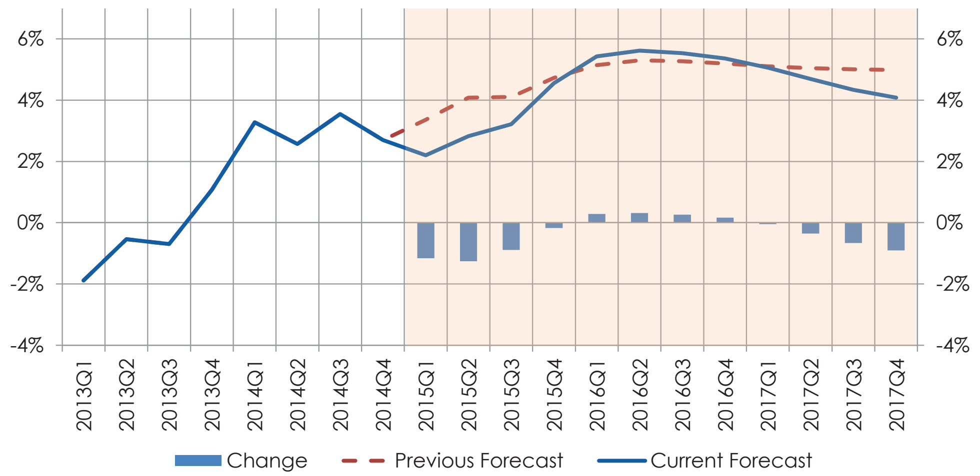


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast has been revised downward (see Figure 2.12). This is mostly the result of a stronger-than-expected depreciation of the currencies of Georgia's trading partners. In particular, the more-than-expected appreciation of the lari nominal effective exchange rate has dampened the effect of high trading partner inflation on domestic consumer prices. Accordingly, the lower-than-expected contribution of imported prices to overall prices is reflected in the current inflation forecast. The current forecast also takes into account lower food and energy prices, which are expected to remain weak in 2015. This fact is also partly reflected in domestic prices. As a result, the inflation rate in 2015 will be lower than was predicted in the previous forecast, but it will still reach its target in the second half of 2015. The new forecast also takes into account the reduction of the inflation target to 4% from 2017 onwards.

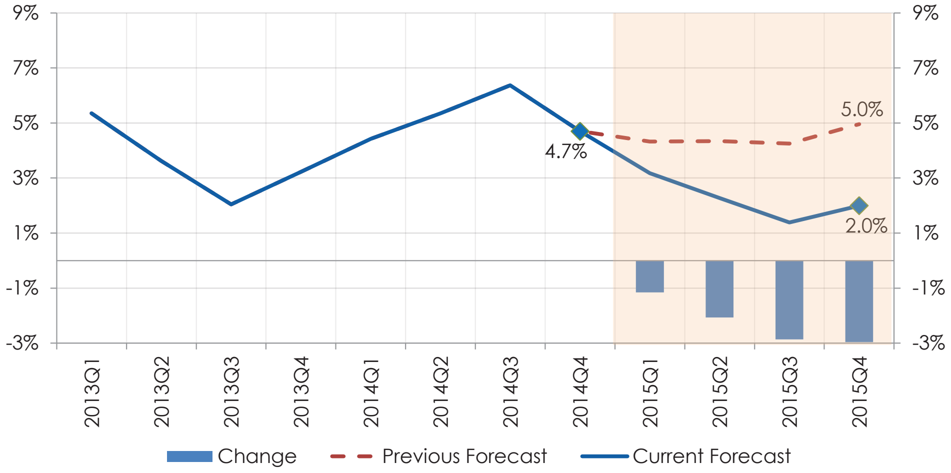
Figure 2.12 Change in the Forecast of Headline Inflation



Source: National Bank of Georgia

The GDP growth forecast has also been revised downwards for 2015 (see Figure 2.13), which is a reflection of significantly weakened foreign demand – a tendency that intensified from the last couple of months of 2014 and is expected to remain an important factor in 2015.

Figure 2.13 Change in the Forecast of GDP Growth



Source: National Bank of Georgia

Box 1 INFLATION TARGET ACHIEVEMENT AND FORECAST PERFORMANCE

In the fourth quarter of 2014, the annual inflation rate was 2.7%, which is below the 5% target level. In order to evaluate how suitable the National Bank of Georgia's monetary policy was for achieving the inflation target, we should analyze the projections from previous periods. Since monetary policy aims to achieve the inflation target in the medium term (of 4-8 quarters), we will start our analysis from the inflation report from the fourth quarter of 2013.[9]

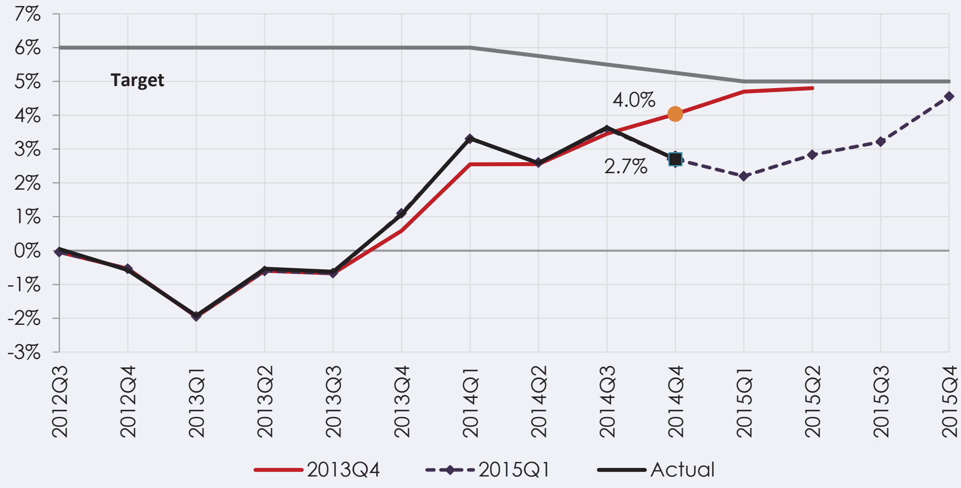
The forecasts for both economic growth and inflation were optimistic at the end of 2013 and the beginning of 2014. It was expected that inflation would reach the target by the end of the year (see Figure 2.14 and Figure 2.15). Accordingly, the National Bank decided to start exiting from its accommodative monetary policy and increased the policy rate in February 2014. However, due to the increase of risks related to these forecasts, as well as the realization of some of those risks, during the second half of the year there was a downside revision of the forecast. The above mentioned risks were mainly related to foreign factors. In particular, Georgia's main trading partner currencies depreciated and, as a result, the nominal effective exchange rate appreciated; economic conditions significantly deteriorated, which resulted in a more-than-expected reduction in foreign demand and remittances; and there was a significant decrease in the price of commodities, especially oil, in the world market. Each of these factors caused a reduction in the inflation forecast for Georgia. As a result, the National Bank decided to temporarily stop the exit from accommodative monetary policy and kept the policy rate unchanged during the second half of the year.

The lower-than-target inflation rate at the end of 2014 is partly in line with the forecast that was presented in the fourth quarter 2013 inflation report (see Figure 2.14). According to that forecast, inflation was expected to increase up to 4% by the end of 2014 and to reach the target at the beginning of 2015. The forecast was based on the assumptions that the deflationary impact from the supply side would vanish and that the positive effect from the aggregate demand side would increase. However, the forecast also contained some risks. In particular, a low level of local investment and reduced business activity could cause an insufficient increase in domestic prices. According to the fourth quarter 2013 baseline forecast, the economic growth projection for 2014 was 5%. The risks of this scenario were related to investor and business sentiment. The economic growth of trade partner countries was also important, as was the global macroeconomic environment, which is reflected on the Georgian economy through remittances and foreign investment.

Actual inflation was below both the 2013 forecasted value (4%) and the fourth quarter 2014 forecasted value (3.5%) (see Figure 2.15). The small revision of forecasted inflation was mainly due to exogenous factors, while the assumptions regarding the fundamental factors on which the 2013 forecast was based remained almost unchanged. There turned out to be only a small difference between the inflation forecast for 2014 presented in the fourth quarter 2013 inflation report and the actual numbers, which indicates an improvement in both forecasting methods and procedures (see Figure 2.15).

9 *Please see the evaluation of previous forecasts in the February 2014 inflation report.*

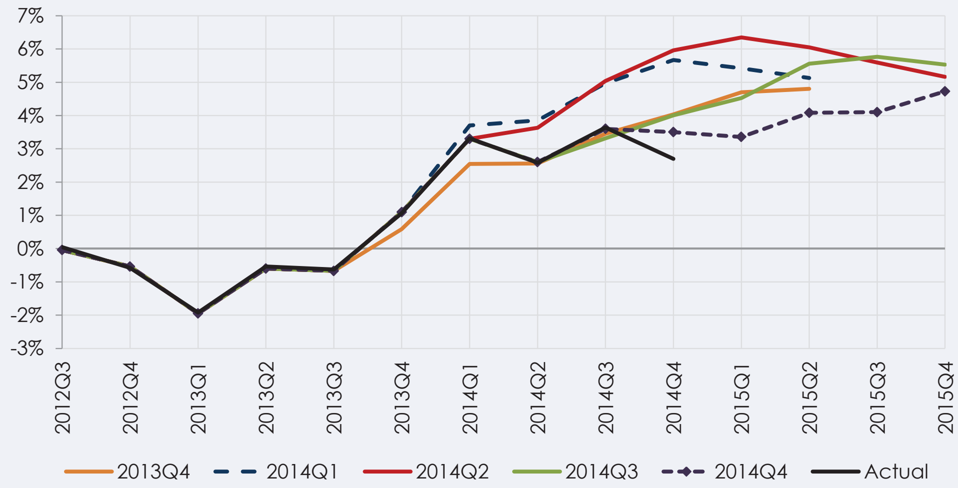
Figure 2.14 Annual inflation



Source: National Bank of Georgia

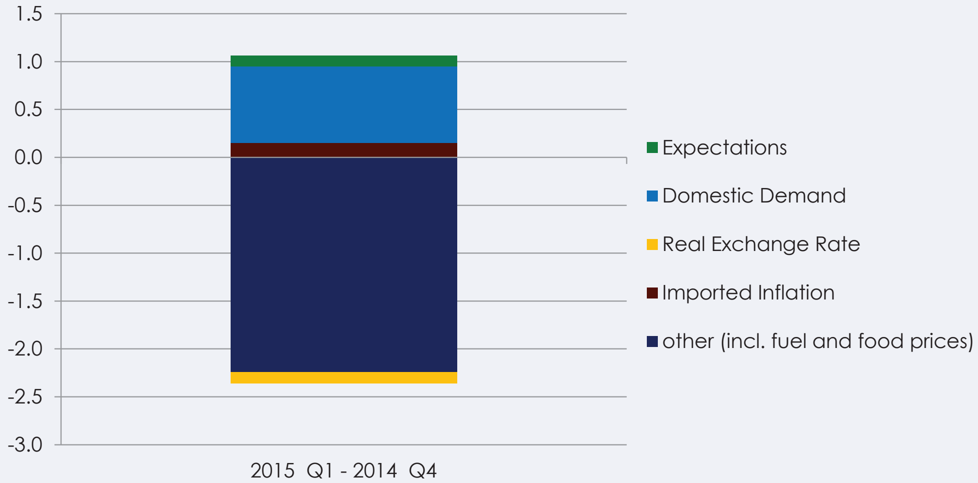
The greater-than-expected decrease in the inflation rate at the end of 2014 was due to supply side shocks (see Figure 2.16). In particular, the significant decrease in oil and commodities prices on the world market caused a greater decrease in the price of these goods in Georgia than was expected. In addition, despite the depreciation of the GEL against the USD, the nominal effective exchange rate (which considers the exchange rate against the currencies of Georgia's main trading partners) stayed strong, which caused a reduction in imported inflation. Unlike imported inflation, the contribution of domestic inflation to headline inflation was reasonable and stable during 2014, which points to a trend of increasing of domestic demand. Parallel to the significant decrease in foreign demand at the end of 2014, the increase in domestic demand became quite prominent.

Figure 2.15 Annual Inflation Forecasts, 2012Q4-2014Q4



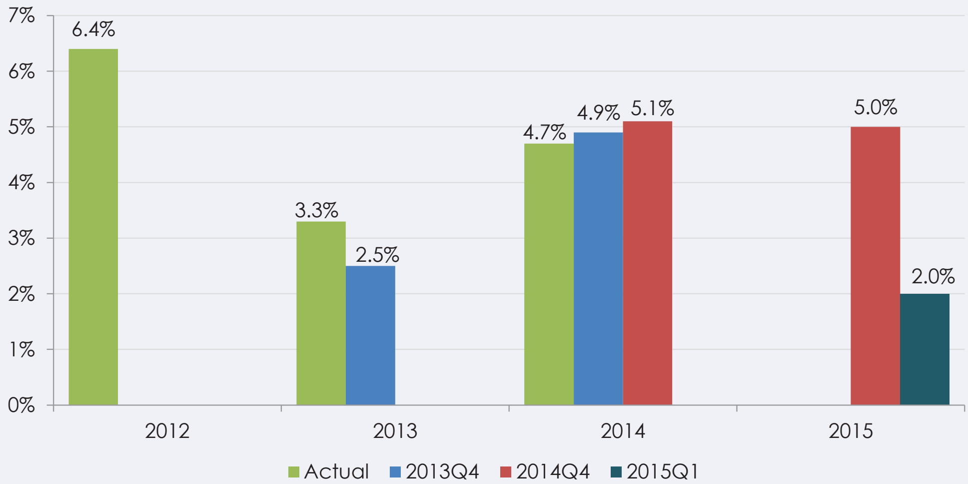
Source: National Bank of Georgia

Figure 2.16 Change in the Forecast, 2015Q1 – 2014Q4



Source: National Bank of Georgia

Figure 2.17 Real GDP



Source: National Bank of Georgia

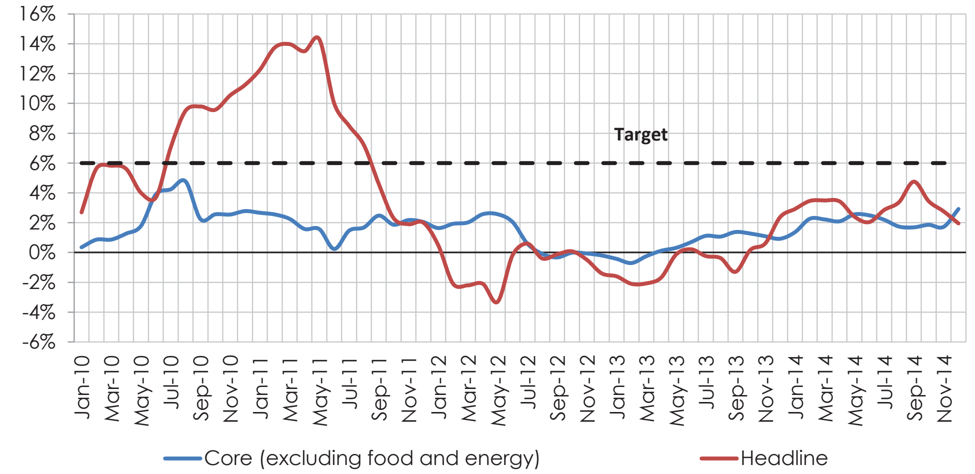
In February 2014, taking into account the inflation forecast and economic situation in Georgia, the National Bank of Georgia decided that there was no further need to retain an accommodative monetary policy and thus increased the policy rate up to 4%. However, in light of the increased risks in Georgia's main partner countries and in the whole region – factors that were also reflected in Georgia's forecast for inflation and GDP, the National Bank subsequently decided to keep the policy rate unchanged. In general, we can conclude that the monetary policy adopted was consistent with the existing forecasts.

3. Consumer Prices

The annual growth rate of the overall price level decreased by the end of 2014 as compared to the previous quarter, totaling 2%. This decline has continued in 2015 as well and the inflation indicator fell to 1.4% in January. The annual inflation rate is thus below the NBG's medium-term target of 5%. Against the backdrop of headline inflation, core inflation is gradually increasing. The annual change of the consumer price level, excluding food and energy, stood at 3.2% by the end of January (see Figure 3.1).

« Headline inflation is below the NBG's target level and stood at 1.4% in January 2015.

Figure 3.1 CPI and Core Inflation



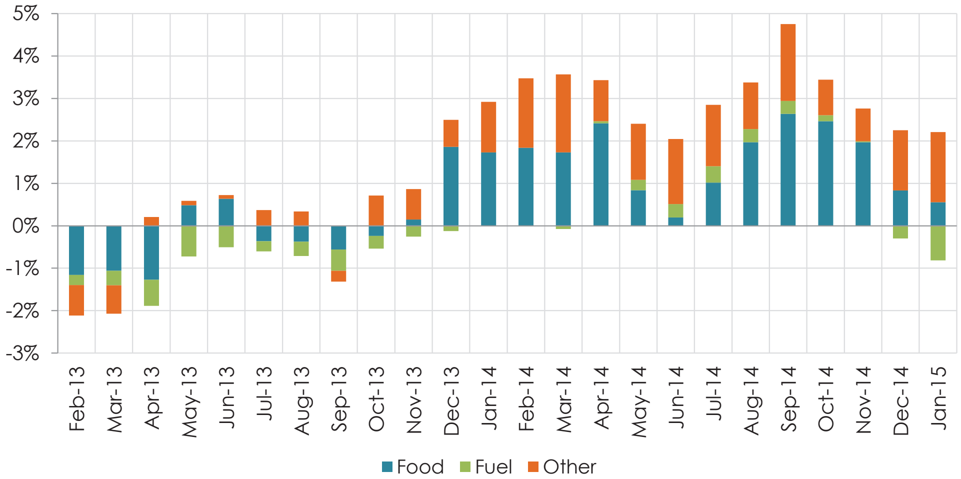
Source: GeoStat and National Bank of Georgia

Against the backdrop of a sharp fall in oil prices on international markets, fuel prices declined in Georgia. Taking into account the high share of oil products in the consumer basket, this drop had a significant impact on the overall price level. By the end of 2014, prices on petrol and diesel had declined by 5-6% on an annual basis, contributing approximately -0.3 percentage points to headline inflation. This decline increased during January 2015. Petrol prices decreased by 13.8% and diesel prices fell by 14% as compared to January 2014. The impact of reduced fuel prices on the overall inflation indicator thus increased, amounting to approximately -0.8 percentage points (see Figure 3.2).

« The inflation dynamics were mainly caused by the drop of fuel prices and changes in food prices.

Changes in food prices remain important for the dynamics of the consumer price index. By the end of 2014 and the beginning of 2015, a significant downward trend was observed on international commodities markets. In addition, the export of fruits and vegetables to the Russian Federation was restricted. All of this was reflected on domestic food prices. In line with these shocks, the annual food inflation rate declined to 2.7% in December, contributing approximately 0.8 percentage points to headline inflation. Despite the recent exchange rate depreciation against the US dollar, as a result of the abovementioned factors, food prices decreased further in the following period. The food inflation rate declined to 1.8% by the end of January and its impact on headline inflation reduced by 0.6 percentage points (see Figure 3.2).

Figure 3.2 Contribution of food inflation in headline inflation

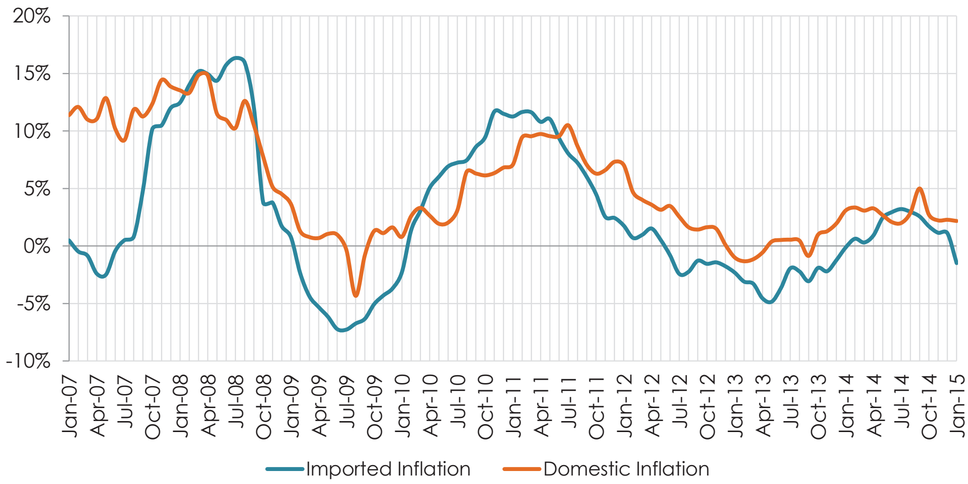


Source: GeoStat and National Bank of Georgia

In terms of exogenous 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 and displayed a growing trend during the first half of the year. However, the subsequent significant depreciation of the currencies of Georgia's main trading partners caused the appreciation of the lari nominal effective exchange rate. As a result, the inflation rate on imported consumer goods slowed down. By the end of the year, annual imported inflation had declined by 2.1 percentage points compared to July, amounting to 1.1% and contributing approximately 0.2 percentage points to headline inflation. In January 2015, prices on imported consumer goods declined on an annual basis. The deflation rate amounted to -1.5% in this period, contributing approximately -0.3 percentage points to headline inflation (see Figure 3.3).

« The inflation rate on imported consumer goods declined and stood at -1.5% by the end of January.

Figure 3.3 Imported and Domestic Inflation



Source: GeoStat and National Bank of Georgia

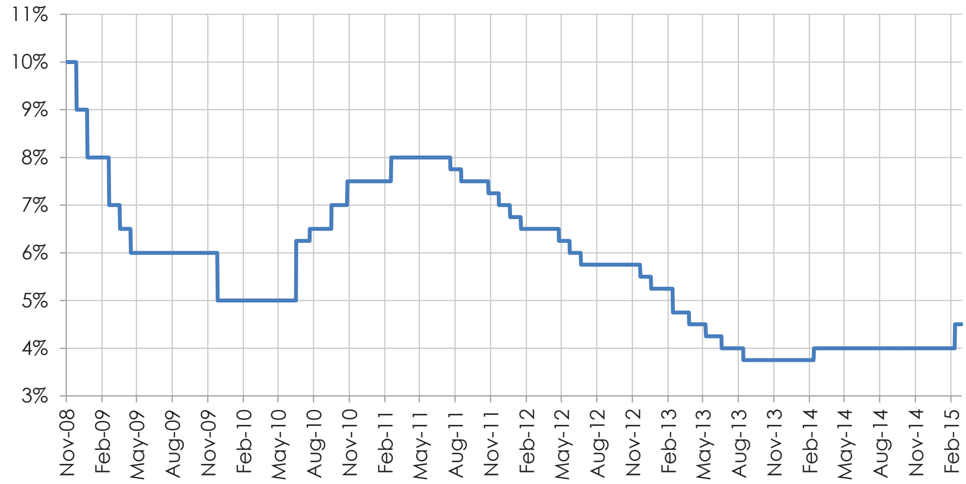
During the second quarter of 2014, a number of geopolitical risks were identified that were negatively reflected on external demand. Exports and remittances declined, and the growth rate of tourism revenues decreased significantly. Factors weakening external demand thus caused the widening of the negative output gap. That, in turn, put downward pressure on the growth rate of consumer prices and prolonged the approach towards the target level. As for domestic demand, against the backdrop of expansionary monetary policy and in line with increasing investment and domestic consumption, lending activity continued moderate growth.

« The factors affecting aggregate demand also determine inflation rate dynamics.

4. MONETARY POLICY

From February 2014, the National Bank of Georgia started the process of exiting its loose monetary policy stance and the policy rate was increased by 25 basis points to 4%. According to the forecasts of that time, given the revival process of the local economy and positive trends in external demand, the inflation rate was expected to grow gradually. However, in the following period external risks evolved and, largely as a result of these, the monetary policy remained unchanged. From spring 2014, in particular, geopolitical risks became apparent and were followed by worsened economic conditions in Georgia's main trading partner countries. These events were reflected in lower growth rates of exports and remittances, followed by negative growth rates. These factors reduced both domestic and external demand. Furthermore, against the background of slower economic growth in partner countries, demand did not put reasonable pressure on prices. A trend of price reduction was observed on global commodity markets as well. Given all these developments, inflation remained below the target rate during this period.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

‹‹ The National Bank of Georgia increased the policy rate by 50 basis points to 4.5%.

The last Monetary Policy Committee meeting was held on 11 February 2015. At that meeting, the decision was made to tighten monetary policy. 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 inflation rate had exhibited a growth trend since fall 2013, but this trend reversed from September 2014 owing to the decrease of prices on commodity markets and the oil price drop. These developments were accompanied by weakened external demand.

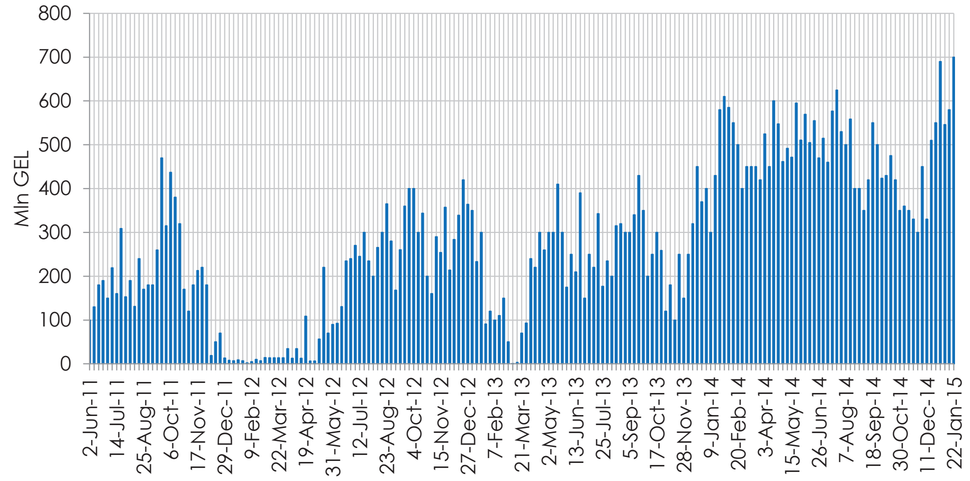
At this stage, risks mainly stem from the external sector. Against the background of worsened economic conditions in trading partner countries, from the fourth quarter of 2014 a trend of reduced external demand became apparent and this declined further toward the end of the year. In November, registered exports declined by 34.9% and by 20.3% in December. Remittances declined significantly as well – by 24.9% annually in December. The growth of tourism revenues also decreased significantly in 2014. Alongside the drop in oil prices, these factors each put downward pressure on inflation. It is expected that the negative impact of the external sector on inflation will be sustained during consecutive periods. Given the worsened external conditions, the lari exchange rate depreciated considerably in November - January. It is thus appropriate to tighten monetary policy in order to avoid the excessive growth of prices and to maintain inflation within the target level.

In terms of domestic demand and economic activity, credit activity remained reasonable. The annual credit growth of commercial banks amounted to 23.7% in December (excluding the exchange rate effect). The recovery of domestic demand is also evident from the increase in imports.

According to the NBG's forecasts, inflation will reach its target rate of 5% at the end of 2015. However, risks, mainly stemming from external developments, remain. Given the external risks and domestic developments, the Monetary Policy Committee thus considered it appropriate to increase the policy rate to 4.5%.

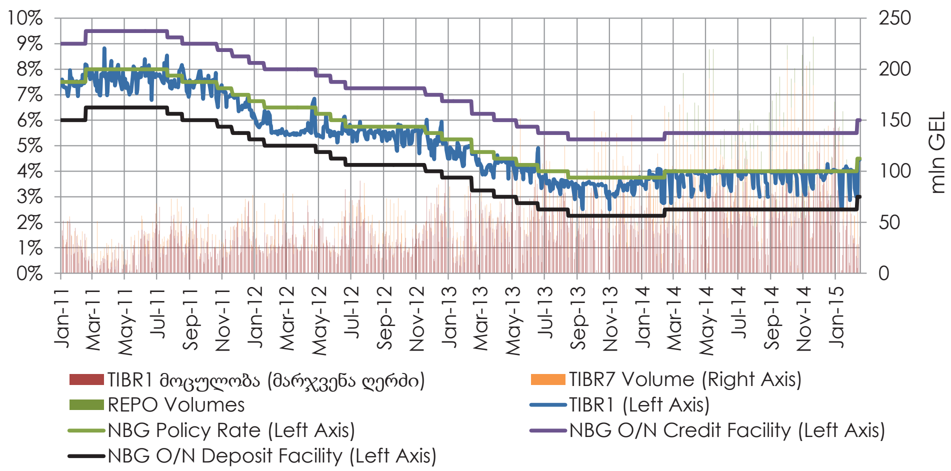
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and, ultimately, to affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising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

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.

Box 2 REASONS BEHIND EXCHANGE RATE FLUCTUATIONS

Since 2009, the monetary policy of the National Bank of Georgia has relied on an inflation targeting regime. This framework implies the announcement of the inflation target in advance and monetary policy is implemented in a manner that aims to meet the target in the medium term. This regime is the optimal choice for small and open economies, like Georgia, that do not have an optimum currency area.

A successful inflation targeting regime requires a flexible exchange rate. Georgia thus has a floating exchange rate regime. The exchange rate is determined on the FX market and depends on the supply and demand of the currency, which are affected by economic fundamentals as well as temporary events. The described regime implies the NBG making occasional interventions on the FX market by means of FX auctions. These auctions are announced in the event of high temporary capital inflows or outflows that can cause excessive short-term fluctuations of the exchange rate; to fill the international reserves; or to balance the government's external operations. Intervention is thus acceptable in occasions where temporary events causing a large one-time exchange rate fluctuation are apparent.

Under this regime, the exchange rate is characterized by short-term fluctuations, but stability in the long run. It depends on both domestic economic developments and foreign trends. It is interesting to analyze the events that caused the lari exchange rate to depreciate in November and December 2014.

In 2014, the US dollar started to appreciate as a result of positive economic trends and expectations in the US. This was coupled with the FED hinting towards the possibility of monetary policy normalization. In October, it was finally decided to terminate the quantitative easing that had been started in 2008. This further strengthened the US dollar. As a consequence of these events, world currencies began to significantly depreciate against the US dollar from the beginning of the year. However, these processes were not reflected on the lari exchange rate until later (towards the end of the year) as a result of moderate foreign currency inflows during the first three quarters of 2014. The high FDI inflows of the third quarter should, in particular, be highlighted. These amounted to 507.5 mln USD, twice that of 2013. In addition, tourism revenues were high due to the summer tourism season, which also had an appreciating impact on the lari exchange rate and outweighed the depreciation pressure.

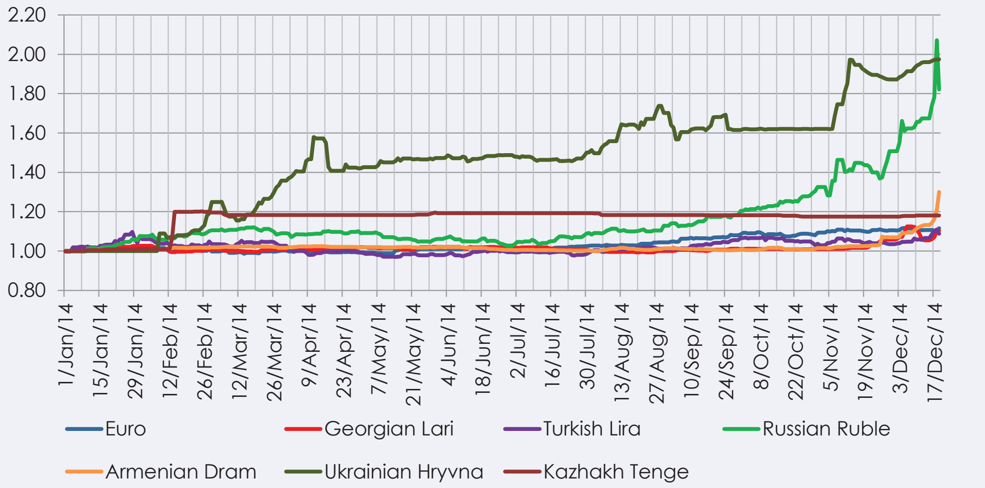
Table 4.1 below illustrates the depreciation of the world's leading currencies against the US dollar in the period January-October 2014. As can be seen, compared to other currencies, the lari remained more or less stable from the beginning of the year. The depreciation pressure on the lari became stronger in the last two months of 2014.

Table 4.1 Depreciation against the US dollar during January-October 2014

	% Change, October 2014-December 2013
Ukrainian Hryvnia	62.0%
Russian Ruble	32.6%
Kazakh Tenge	17.5%
Kyrgyz Som	16.5%
Hungarian Forint	13.5%
Moldavian Lei	12.9%
Belorussian Ruble	12.6%
Polish Zloty	11.2%
Euro	9.2%
Israeli Shekel	8.8%
Uzbekistan Sum	8.3%
Romanian Lei	8.2%
Tajik Somon	4.8%
Turkish Lira	3.7%
British Pound	3.0%
Armenian Dram	1.5%
Georgian Lari	**1.0%**

Source: National Bank of Georgia

Figure 4.4 Exchange rate dynamics against the US dollar (Index, 1 January 2014 = 1)

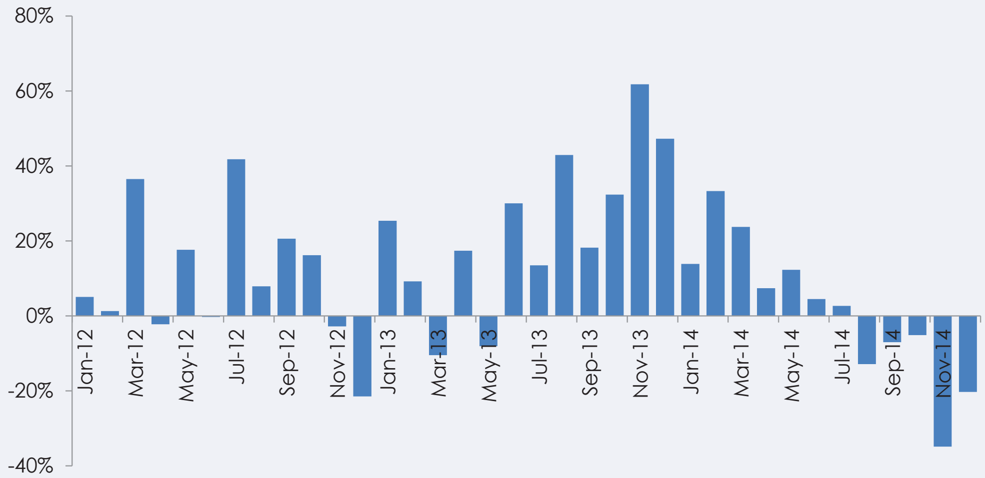


Source: National Bank of Georgia

From an economic viewpoint, the bilateral exchange rate of the lari against the US dollar is not the only important indicator – the exchange rate against the currencies of other trading partners is also significant. The nominal effective exchange rate and the real effective exchange rate are used for these purposes. The former shows the nominal exchange rate of the lari against the main trading partner currencies, weighted by trade turnover shares. The real effective exchange rate accounts for the effect of inflation as well. On 31 December 2013, the official exchange rate of the lari against the US dollar stood at 1.8636 and depreciated by 7.3% in annual terms. However, in the same period, the nominal effective exchange rate appreciated by 8.8%. This indicates that the lari maintained its strength against the currencies of other trading partners. The real exchange rate appreciated as well.

In addition to the appreciation of the US dollar on world markets, the lari-USD exchange rate dynamic was influenced by economic developments in trading partner countries. The oil price drops on world markets were, in particular, negatively reflected on the economic growth of Russia and Azerbaijan, thus reducing external demand for Georgia. It is also worth noting that the Russia-Ukraine conflict has additionally weakened exports. As a result, Georgia is experiencing a deepening trade deficit, a reduction of remittance inflows and a decreased number of visitors. The export growth rate started to decline from the beginning of 2014 and turned negative from August. At the same time, imports continued to grow. This trend was driven by the appreciation of the lari (nominal exchange rate) against the trading partner currencies. The trade deficit considerably worsened in November-December, mainly driven by the Russia-Ukraine conflict. In the fourth quarter of 2014, exports to Russia decreased by 67% and to Ukraine by 84%.[10] This eventually created depreciation pressure on the exchange rate.

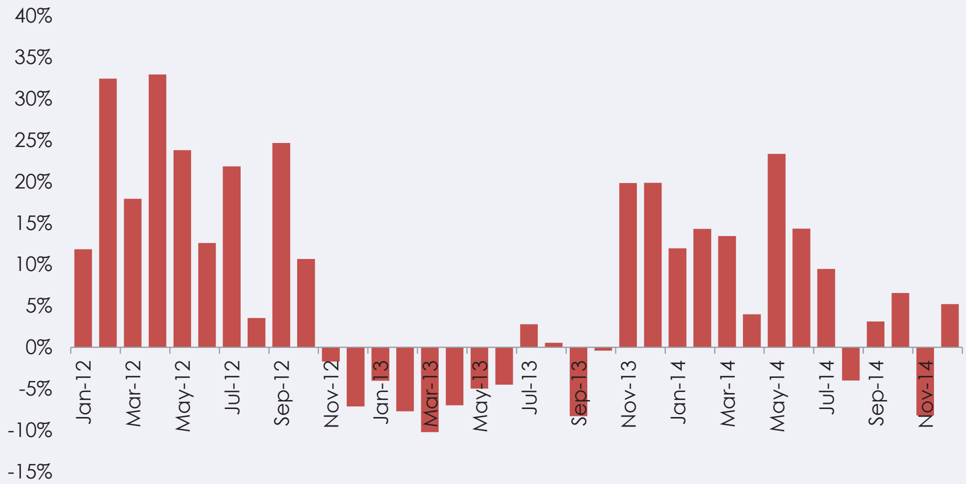
Figure 4.5 Annual growth of exports



Source: Geostat

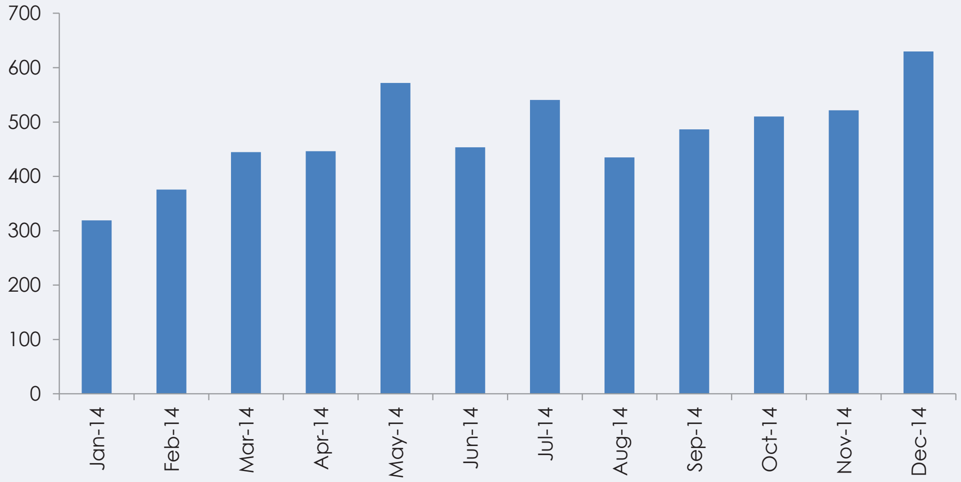
10 *Both figures indicate exports of registered goods.*

Figure 4.6 Annual growth of imports



Source: GeoStat

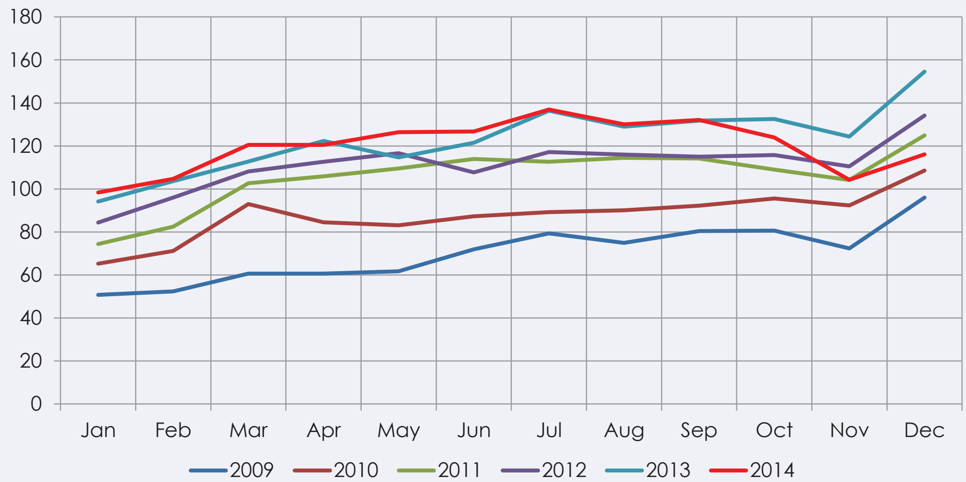
Figure 4.7 Trade deficit (million USD)



Source: GeoStat

The reduction of remittance inflows also considerably contributed to the exchange rate depreciation at the end of 2014. Compared to 2013, the growth rate of remittance inflows was significantly reduced from the beginning of 2014, and turned negative in the fourth quarter. In November-December, the growth rate amounted to -21%, with Russia being the main contributor to the reduction (-37%). Remittances also dropped significantly from Ukraine (-61%).

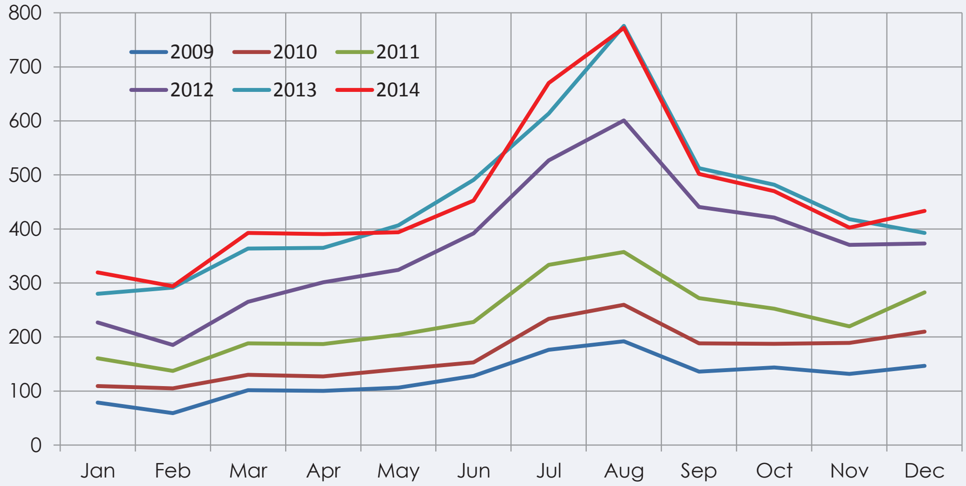
Figure 4.8 Dynamics of Remittances, million USD



Source: National Bank of Georgia

After the growth observed in recent years, the number of visitors to Georgia also declined. Consequently, the growth of tourism revenues have considerably decreased. These developments also had a depreciation impact on the lari exchange rate.

Figure 4.9 Dynamics of visitors to Georgia, thousand people



Source: Ministry of Internal Affairs

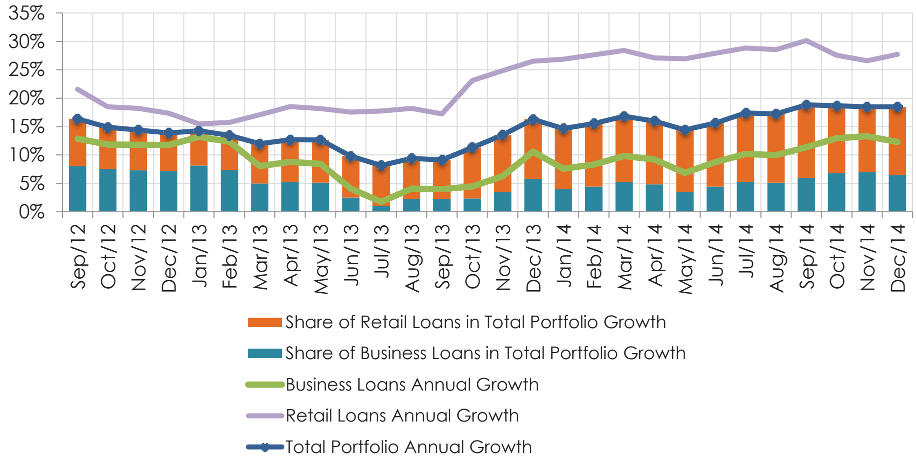
The given analysis shows that during 2014 exchange rate dynamics were significantly shaped by external developments. The use of FX interventions by the National Bank of Georgia is not desirable under such conditions. However, if the exchange rate depreciation translates into higher inflation forecasts, the National Bank of Georgia will use its diverse monetary policy tools to keep inflation on target.

5. Financial Market and Trends

5.1 LOANS

In December 2014, the annual growth rate of the loan portfolio decreased by 0.3 percentage points compared to September and amounted 18.5%.[11] The easing of interest rate conditions contributed to increased demand for loans, which caused higher credit growth. It was mainly the growth of retail loans that contributed to the increase of the loan portfolio. Loans extended to small and medium sized businesses continue to exhibit a stable growth rate and in the fourth quarter the annual growth rate amounted to 12%. Demand was amplified for corporate loans and the annual growth rate for these amounted to 14% in the fourth quarter. It should be noted that in December business loans in the national currency with floating interest rates increased by 20% since September, but their share in total business loans remains relatively small (5%).

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

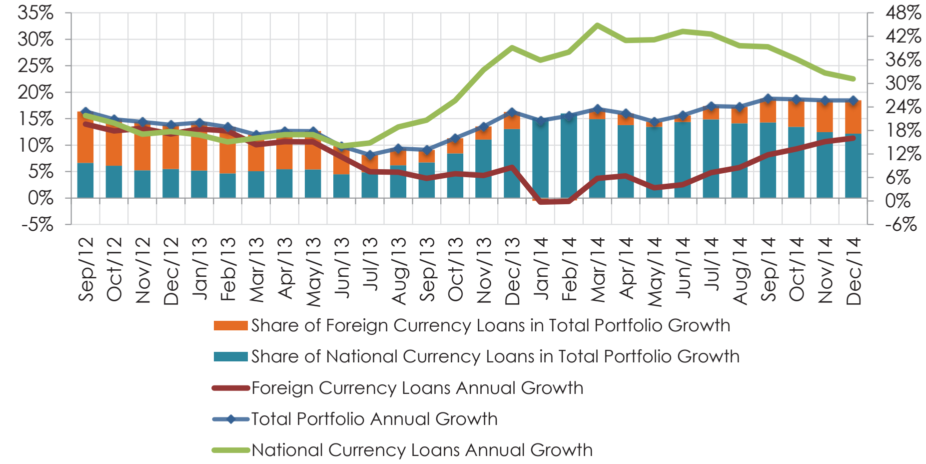


Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was largely caused by an increase in domestic currency loans, however, foreign currency loans notably increased compared to the previous quarter. In the fourth quarter, the annual growth rate of foreign currency denominated loans increased by 12%, while loans in the domestic currency increased by 30%. It should be noted that loan larization increased to 41% in the fourth quarter. This increase contributes to the reduction of systemic risks in the banking sector.

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

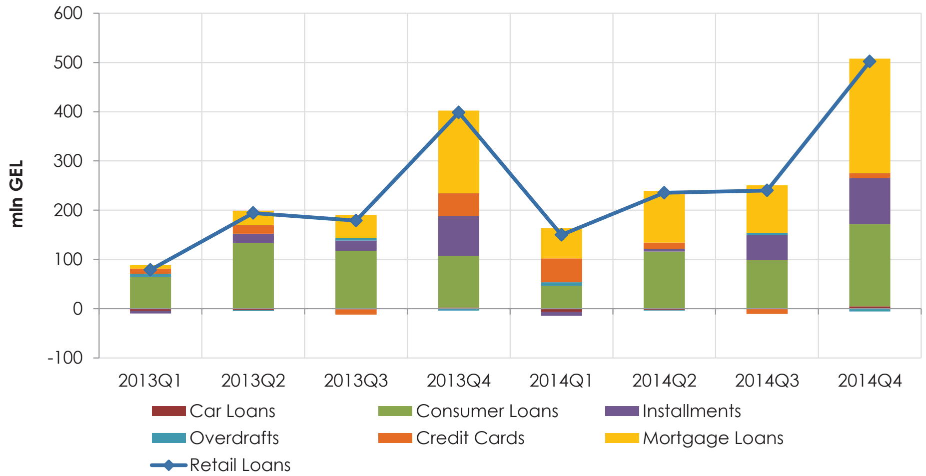
Figure 5.2 Annual growth rates of domestic and foreign currency loans and their contributions to the growth of the loan portfolio



Source: National Bank of Georgia

Retail loans, which predominantly include consumer and mortgage loans, continue to exhibit a high growth rate. In the fourth quarter, the stock of retail loans increased by 502 mln GEL compared to the previous quarter. Although this was partially caused by seasonal factors and currency depreciation, without accounting for those effects, the growth of retail loans was still high. Mortgage and consumer loans increased by 232 and 168 mln GEL respectively. It should also be noted that the stock of installment loans increased by 93 mln GEL compared to the previous quarter.

Figure 5.3 Quarterly growth of retail loans



Source: National Bank of Georgia

In December, the annual growth rate of the loan portfolio to legal entities amounted to 12.3%, which is 0.8 percentage points lower than in September. Demand on large business loans improved after the decrease in the beginning of the year. This was mainly caused by the easing of interest rates and the relative recovery of demand. Also, demand for small- and medium-sized business loans 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 retail loans to grow in the next quarter, mainly as a result of mortgage and consumer loans, while small- and medium-sized businesses should increase the growth of business loans.

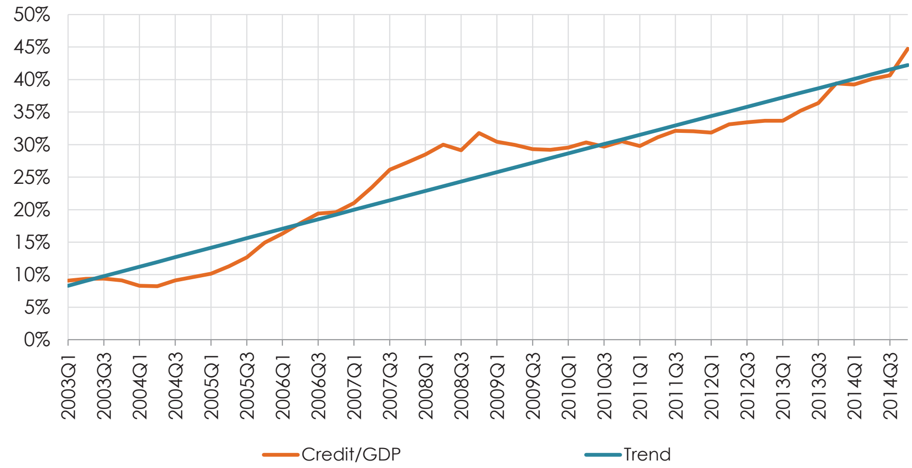
In recent years, the credit to GDP ratio[12] has followed the trend[13] without significant fluc-

12 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.

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

tuations. In the fourth quarter, the credit to GDP ratio increased by 4.1 percentage points compared to the previous quarter and amounted to 44.7%. The growth of this ratio was largely caused by currency depreciation. The credit to GDP ratio is currently above the trend by 2.5 percentage points.

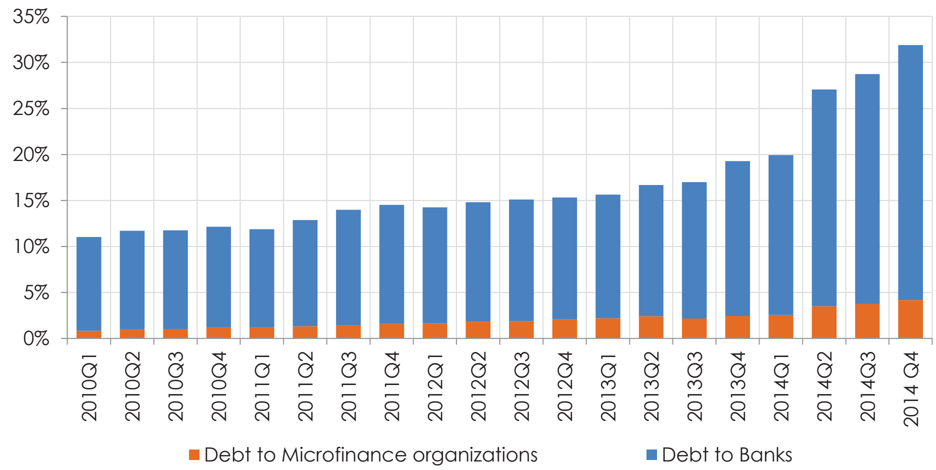
Figure 5.4 Credit to GDP gap



Source: National Bank of Georgia

In the fourth quarter, the individuals' debt to net national disposable income ratio increased by 3 percentage points compared to the previous quarter and amounted to 17.6%. Debt to commercial banks amounts to 87% of total individuals' debt.

Figure 5.5 Individuals' debt to net national disposable income ratio



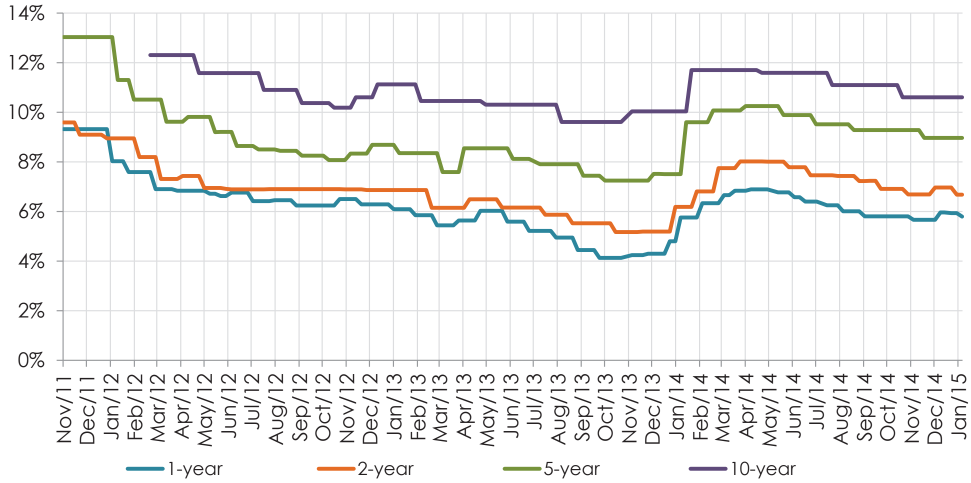
Source: National Bank of Georgia

The share of non-performing loans decreased by 1.4 percentage points in the fourth quarter of 2014 as compared to the previous quarter and amounted 7.6%. According to the data from December, the share of non-performing loans in the national currency increased by 0.2 percentage points compared to September, amounting to 5.6%; while the share of non-performing foreign currency loans decreased by 2.4 percentage points and amounted to 8.9%. In the fourth quarter, the amount of loans written off amounted to 35 million GEL, which decreased non-performing loans by 0.3 percentage points.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In February 2015, in line with macroeconomic forecasts, the monetary policy rate increased by 0.5 percentage points and amounted 4.5%. The interest rate on short and long term government securities increased in the first quarter of 2014, but after the second quarter they exhibited a declining trend (see Figure 5.6). In December 2014, rates on short and long term government securities increased compared to December 2013 – supposedly as a result of a rise in inflationary expectations.

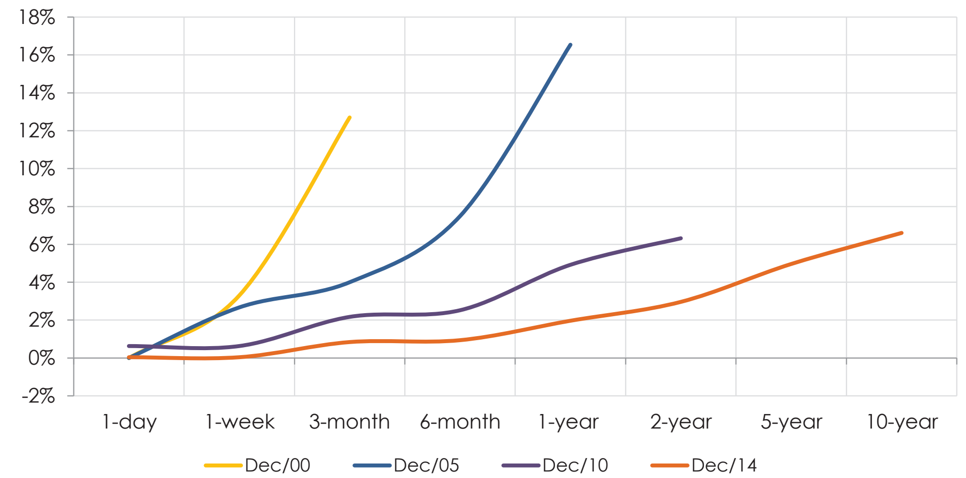
Figure 5.6 Interest Rates on Government Securities



Source: National Bank of Georgia

Inflationary expectations raised belief in an increase in the monetary policy rate and, consequently, the spread between long-term assets and the monetary policy rate 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, thus promoting internal investments and economic growth.

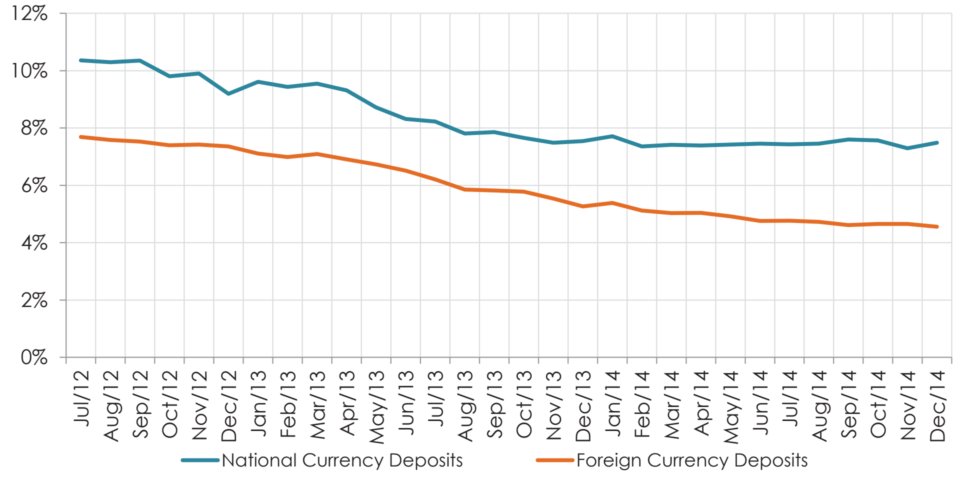
Figure 5.7 Spread between the Monetary Policy Rate and the Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, interest rates on both domestic and foreign currency deposits have declined by 0.1 percentage points, amounting to 7.5% and 4.7% respectively. This decline in interest rates is a result of fundamental factors, including: risk premium reductions, macroeconomic stability, the growth of savings and the improvement of banking sector efficiency. The reduction of deposit rates was also due to the accumulated excess liquidity of banks. According to the credit conditions survey, costs on foreign currency are not expected to change in the next quarter, while interest rates on national currency deposits might rise following the growth of domestic currency loans.

Figure 5.8 Average Interest Rates on Deposits

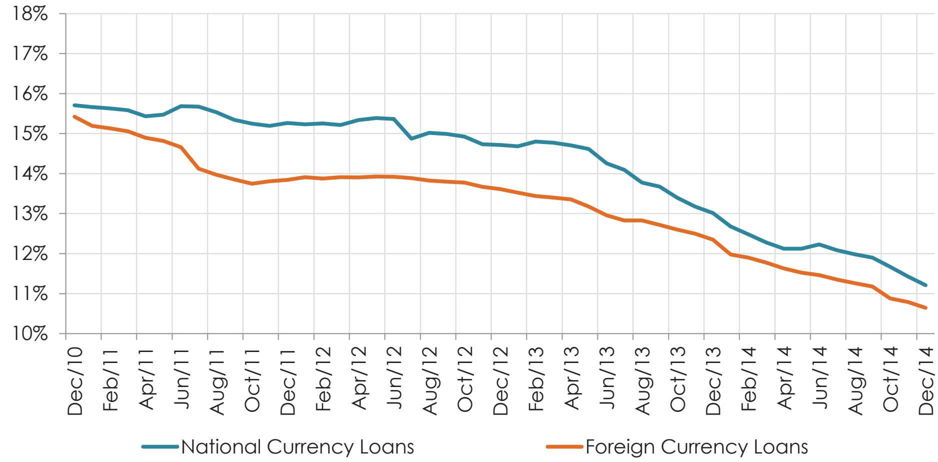


Source: National Bank of Georgia

According to the credit conditions survey, credit conditions for business loans have eased since 2013. This is a result of increased competition among banks, increased risk taking, weak economic activity and low demand . In December 2014, interest rates on business loans in the domestic and foreign currency declined by 0.7 and 0.6 percentage points as compared to September, amounting to 11.2% and 10.6% respectively. According to the survey, interest rate conditions might continue to be eased for both domestic and foreign currency loans in the next quarter.

‹‹ Interest rate conditions might continue to be eased due to increased competition among banks, increased risk taking, weak economic activity and low demand.

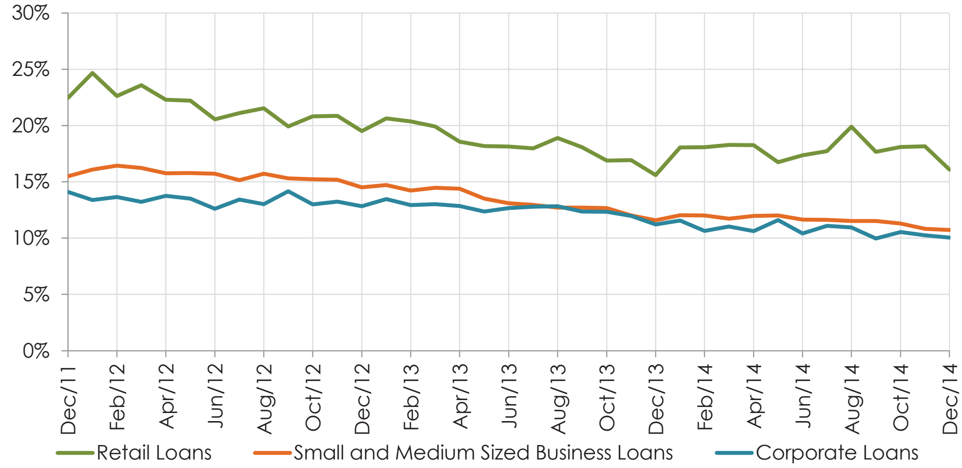
Figure 5.9 Average Interest Rates on Business Loans



Source: National Bank of Georgia

Interest rates on both business and retail loans are characterized by a declining trend. In December, rates on loans to small and medium businesses decreased by 0.8 percentage points compared to September and amounted to 10.7%. Interest rates on corporate loans did not change and stood at 11.5%, while rates on retail loans decreased by 1.6 percentage points and amounted to 16.1%.

Figure 5.10 Interest rate on loan flow



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%.

5.3. EXCHANGE RATE

In the fourth quarter of 2014, the lari exchange rate against the US dollar dropped by 3.5%, and averaged 1.81 GEL/USD. At the same time, the lari continued strengthening against the euro (2.6%). The lari also appreciated against the Turkish lira, Russian ruble and Ukrainian hryvna by 1.1%, 19.9% and 9.3%, respectively. As a result, the nominal effective exchange rate in the fourth quarter of 2014 appreciated by 3.2%, while the average rate was strengthened by 8.6% compared to the corresponding period of the previous year.

The real exchange rate declined by 2.2% in December, but was strengthened by 2.7% over the fourth quarter. Year-on-year appreciation totaled 5.5%.

Figure 5.11 Real Effective Exchange Rate (Jan 2008=100)

Source: National Bank of Georgia

Real appreciation of the lari has taken place against the currencies of Georgia's trade partners such as Ukraine, Russia and the eurozone states.

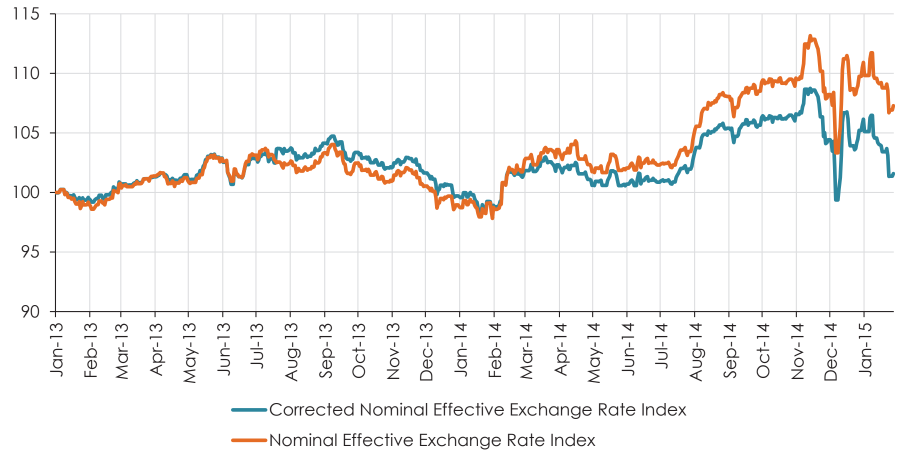
Table 5.1 Effective Exchange Rate Annual Growth

December 2014	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	8.8	4.9	4.9
Turkey	0.8	-5.0	-1.1
Eurozone	1.0	2.7	0.4
Ukraine	76.9	44.4	5.1
Armenia	3.3	0.7	0.0
USA	-9.1	-8.0	-0.5
Russia	51.7	38.9	3.2
Azerbaijan	-9.1	-7.2	-1.3
Other	1.4	1.8	-1.1

Source: National Bank of Georgia

The nominal effective exchange rate, corrected in relation to commodities and services, is slightly different from the traditional exchange rate. In particular, the corrected nominal effective exchange rate was strengthened by only 3.7% in the fourth quarter of 2014, and by 1.7% compared to the third quarter.

Figure 5.12 Corrected Nominal Effective Exchange Rate



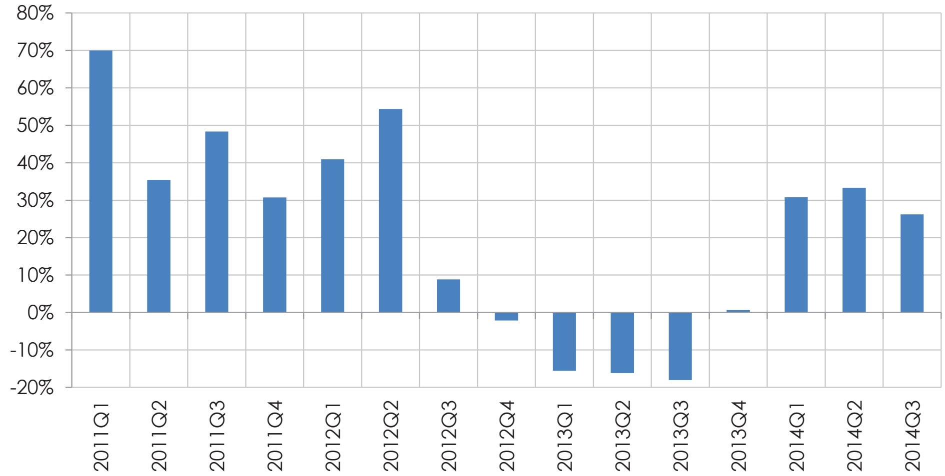
Source: National Bank of Georgia

6. Domestic Demand

Real GDP growth amounted to 5.6% in the third quarter of 2014. As was the case in the two previous quarters, growth in investments was the main determinant of growth (consumption made an important contribution as well). According to preliminary estimates, the growth rate of the economy declined in the fourth quarter, which is caused by the weakening of external demand (reduced exports) and the base effect.

« Real GDP growth amounted to 5.6% in the third quarter of 2014.

Figure 6.1 Annual Growth Rate of Capital Formation



Source: GeoStat

The high growth rate of capital formation continued in the third quarter of 2014. As a result, the high growth rate of investments played a key role in GDP growth in the third quarter. Such a high rate of growth was partially caused by the base effect (capital formation contracted by 18% in the third quarter of 2013).

« The high growth rate of capital formation continued in the third quarter of 2014.

Exports of goods and services increased by an annual 0.5% and imports increased by 10% in the third quarter of 2014. As a result (as in previous quarters), net exports contributed negatively to GDP growth in the third quarter. According to preliminary results, the growth rate of exports was negative during the last quarter of 2014, which was caused by decreased external demand (mainly from Russia and Ukraine). As a result, net exports are again expected to make a negative contribution to the growth of the economy.

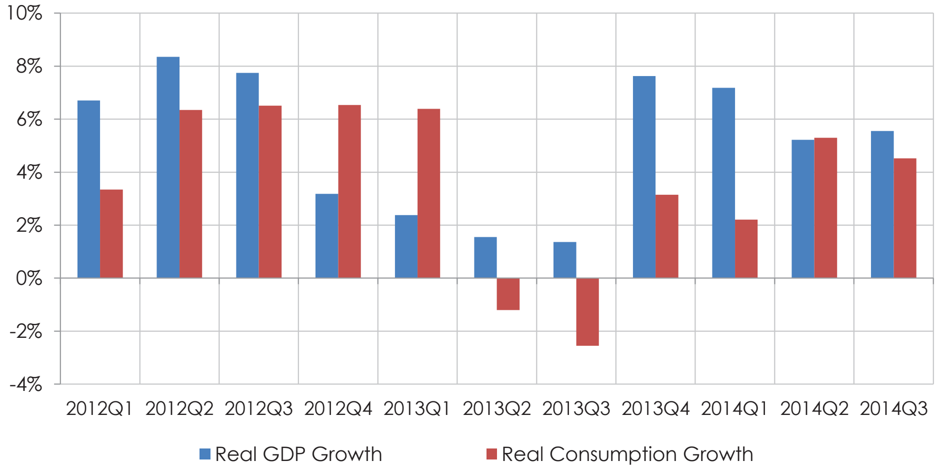
« Net exports contributed negatively to GDP growth in the third quarter.

Real growth of private consumption[14] posted 5.3% growth in the second quarter of 2014. The growth rate of consumption was much higher in the second and third quarters than it was in the first quarter. In the first half of 2014, interest rates on loans had the tendency to decline, which resulted in a high growth rate for consumer and mortgage loans. The growing amount of loans stimulated an increase of demand. According to preliminary results, public consumption increased significantly in the fourth quarter. Unlike in previous quarters, this should enable total consumption to be the main determinant of GDP growth.

« Real growth of private consumption posted 5.3% growth in the second quarter of 2014.

14 *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 3.2% of GDP in 2014. Taking into consideration seasonal patterns, the deficit in the fourth quarter was the highest of the year, although the annual budget deficit for 2014 was much more equally distributed among the quarters than it was in 2013. The higher budget deficit in the last quarter of 2014 stimulated an increase of internal demand. The consolidated budget deficit is expected to post around 980 mln GEL (around 3% of the GDP forecast). According to the plan, capital expenditures are expected to increase more than the other components of budget expenditure. Higher capital expenditures will support the growth of capital formation.

« The consolidated budget deficit posted 3.2% of GDP in 2014

7. External Demand and Balance of Payments

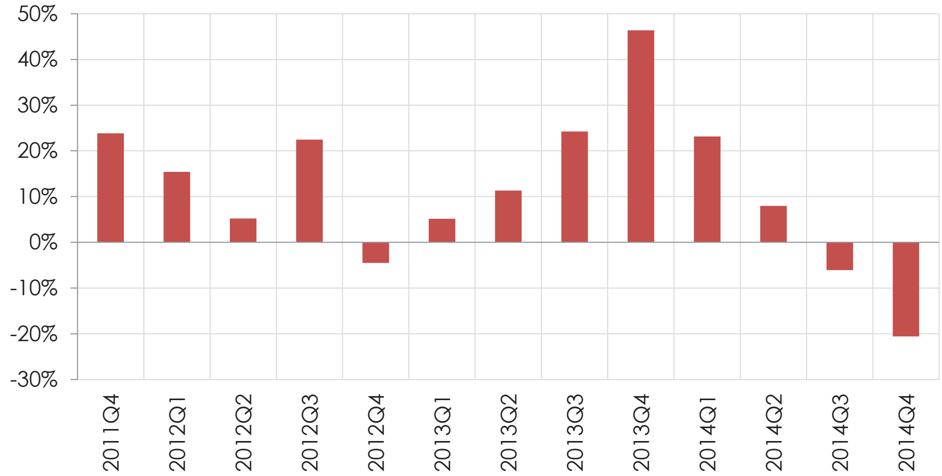
In the fourth quarter of 2014, according to preliminary data, the current account (CA) deficit to GDP ratio reached 13.3%, which is 3.8 percentage points above the same indicator of the previous year. In absolute terms, the CA deficit amounted to 606 mln USD in the fourth quarter of 2014. Based on initial statistics, the CA deficit to GDP ratio amounted to 9.6% in 2014, which is 3.8 percentage points above the same indicator in 2013.

« The CA deficit to GDP ratio in 2014 amounted to 9.6%, 3.8 percentage points above the same indicator in 2013.

The deepening of the CA deficit in 2014 was mainly the result of the deteriorating balance in goods trade. Unfavorable developments in the main markets for Georgian exports significantly contributed to the widening negative gap in the trade in goods balance. In the fourth quarter of 2014, registered exports of goods declined by 20.5% year on year. Over the period, exports to CIS countries continued to decline, mainly due to the instability in Ukraine, but also as a result of the appreciating Lari nominal effective exchange rate, which worsened the competitiveness of Georgian products in their main export destinations. On top of that, new regulations imposed by Armenia and Azerbaijan on imports of automobiles damaged the re-export of cars to these countries. Due to the above mentioned obstacles, exports to Russia were down by 27.4% year on year in the fourth quarter of 2014, exports to Ukraine declined by 58.2%, and exports to Armenia and Azerbaijan declined by 34.6% and 31.1% respectively on an annual basis. Overall registered exports of goods dropped by 31.8% to CIS countries. At the same time, exports to the EU were down by 30.8%, but exports to other countries increased by 28.9% as a result of increased exports to the USA, Turkey and China.

« In the fourth quarter of 2014, registered exports of goods declined by 20.5% year on year

Figure 7.1 Annual Growth Rate of Registered Exports of Goods



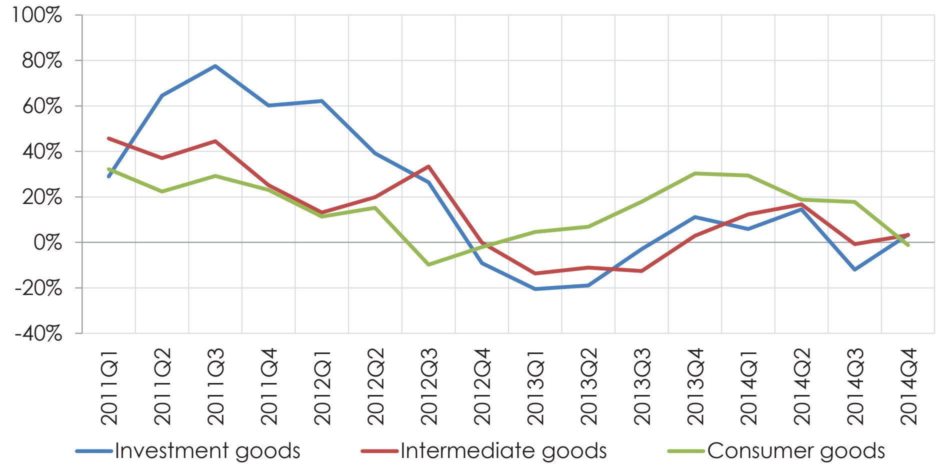
Source: GeoStat

In the fourth quarter of 2014, exports of almost all main export products declined. The reduction was substantial for exports of agricultural products. Compared to the previous year, there was a significant decline in exports of hazelnuts (-10%), wines (-6%), mineral waters (-31%), spirits (-19%), and citrus (-39%). Over the same period, re-exports of cars drastically declined from 192 mln USD to 109 mln USD (-43%).

In the fourth quarter of 2014, registered imports of goods increased by 1.1% year on year and totaled 2.4 bln USD. Overall registered imports of goods in 2014 amounted to 8.6 bln USD, which is 7.1% above the imports of 2013. In the fourth quarter of 2014, imports grew mainly as a result of the growth of intermediate (+3.2%) and investment (+3.4%) goods. In the same period, the growth of consumption goods imports was negative (-1.2%).

« In the fourth quarter of 2014, imports grew mainly as a result of the growth of intermediate (+3.2%) and investment (+3.4%) goods. In the same period, the growth of consumption goods imports was negative (-1.2%).

Figure 7.2 Annual Growth Rate of Imports Accross the Product Groups



Source: GeoStat

In the fourth quarter of 2014, imports of petroleum products declined by 64.2 mln USD, a -22.4% reduction year on year. This reduction mainly reflects the declining oil prices on global markets. Of the total reduction, the price effect accounts for -23.5% as the volume of petroleum imports actually increased by 1.4%. Taking into account the downward trend of oil prices, a further decline in petroleum imports is expected in upcoming periods. Along with petroleum imports, car imports also saw a decline, mainly due to the reduced demand on the re-export of cars. Imports of automobiles were down by 5.6%, while imports of trucks declined by 15.9%.

The Russia-Ukraine conflict and the ruble crisis negatively affected remittances to Georgia throughout 2014. During the first half of 2014, declining money transfers from Russia and Ukraine were balanced by increasing remittances from Greece, Turkey, Italy and the USA. In the fourth quarter of 2014, the annual growth rate of remittances became negative, including from Greece, which translated into a 16.2% annual reduction of total remittances. Over the same period, money transfers declined drastically from Russia (-29.8%), Ukraine (-55.9%) and Greece (-9.6%). The reduction of money transfers was only partially compensated by increased remittances from Turkey (+54.0%), the USA (+14.9%), Israel (+33.4%) and Germany (+30.7%). Overall money transfers from abroad declined by 16.3% in the fourth quarter of 2014.

During the fourth quarter of 2014, tourism inflows increased by 1.7% annually, a modest growth rate compared to the rates of previous periods. Over the same period, the number of incoming visitors increased by 1%.

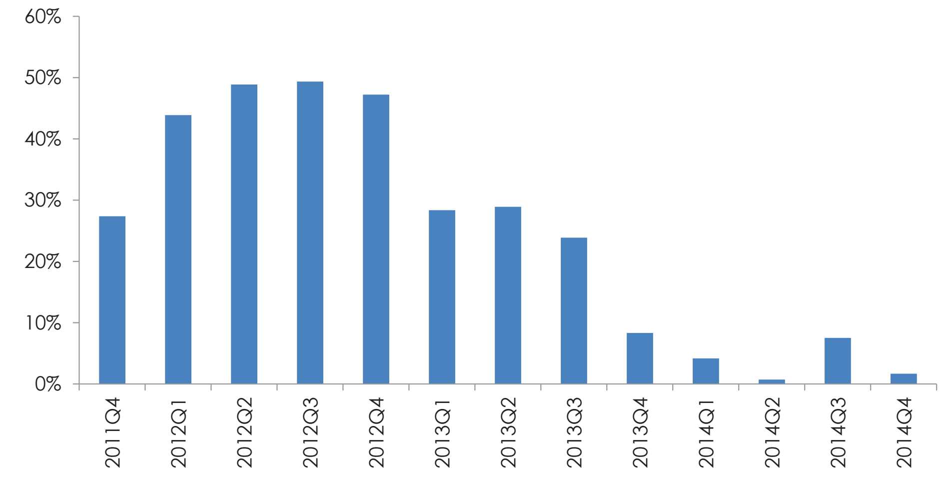
« In the 4th quarter of 2014, imports of petroleum products declined by 64.2 mln USD, a -22.4% reduction year on year that reflected the declining crude oil prices on global markets.

« The Russia-Ukraine conflict and ruble crisis negatively affected remittances to Georgia throughout 2014.

« In the fourth quarter of 2014, money transfers from abroad declined by 16.3%.

« During the fourth quarter of 2014, tourism inflows increased by 1.7% annually, a modest growth rate compared to the rates of previous periods.

Figure 7.3 Annual Growth rate of tourism receipts

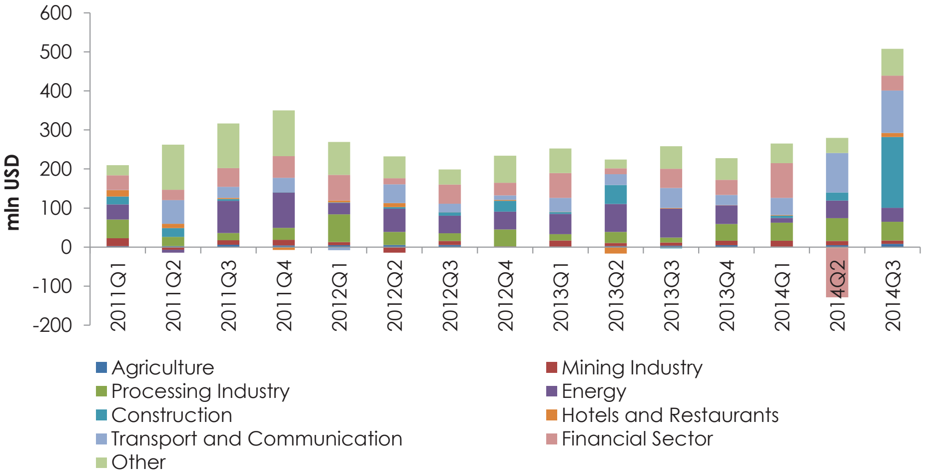


Source: National Bank of Georgia

During the fourth quarter of 2014, the number of visitors increased from Armenia (+8.7%) and Azerbaijan (+7.7%), while Georgia hosted fewer visitors from Turkey (-6.3%) and Ukraine (-10.5%) compared to the same period last year. The number of incoming visitors from Russia remained the same. The Russia-Ukraine conflict and the worsening economic situation in the region is likely to have a negative influence on the number of incoming visitors to Georgia.

In 2014, foreign direct investments (FDI) increased by 27.6% annually and totaled 1.2 bln USD, representing the main source of CA deficit financing. FDI growth was especially notable during the third quarter of 2014, when the Chinese invested in large scale constructions related to the Youth Olympics to be held in Tbilisi. At the same time, FDI sharply increased in the agriculture (+107.6%), processing (+168%) and transport and communication (+122%) sectors.

Figure 7.4 Breakdown of Foreign Direct Investments across different sectors



Source: GeoStat

Portfolio investments also played a significant part in financing the current account deficit. Throughout 2014, portfolio investments of 235.9 mln USD entered the country, the main part of which comprised investments raised on foreign stock markets by the banking sector.

Box 3 ESTIMATION OF THE OPTIMAL LEVEL OF INTERNATIONAL RESERVES

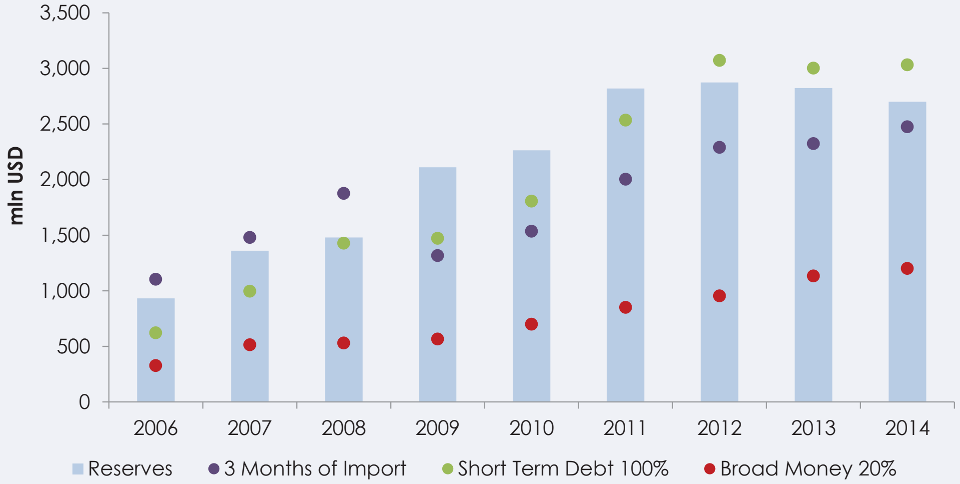
Reserve adequacy

Gross reserves have increased dramatically over the last decades. All regions experienced large increases, although emerging markets have contributed the most. It is worth noting that growth has resumed since the global financial crisis and has even done so at an accelerated pace. However, there is little consensus on what constitutes an adequate level of reserves. Traditional metrics continue to be widely used. These have the attraction of being intuitive, simple and transparent.

- Import cover – This is often seen as a measure of the number of months imports could be sustained should all inflows (such as export revenues and external financing) cease. The measure has traditionally been based on months of prospective imports, with three months' coverage used as a benchmark.
- Short-term debt – The "Greenspan-Guidotti" rule of 100% cover of short-term debt proposes that a country's reserves should be sufficient to completely serve its short-term liabilities for one year.
- Broad money – Given that many recent capital account crises have been accompanied by outflows of deposits from the country, this metric is usually intended to capture this risk. It seeks to measure the reserve holdings that would be sufficient to avoid a crisis in times of capital outflow. According to internationally recognized standards, 20% is usually quoted as the upper end of the range.

According to the traditional metrics discussed above, Georgia possesses international reserves within the adequacy ranges. The indicator of broad money is above the recommended measure. Previously the import coverage metric indicator was below the limit of three months, amounting to 2.6 months on average. However, against the backdrop of a sharp accumulation of reserves and a significant decline in imports, the import coverage ratio exceeded the standard to total 4.8 months in 2009. In the following periods, in line with a relatively high growth in imports, the reserve coverage declined, but still exceeds the internationally established limit. According to the latest data from 2014, Georgia has sufficient reserve holdings available to finance its imports for a period of 3.3 months. As for the Greenspan-Guidotti indicator, this dipped below the recommended limit over the last three years and amounted to 85% by the end of 2014 (see Figure 7.5).

Figure 7.5 International Reserves in Georgia vs. Traditional Metrics of Reserve Adequacy



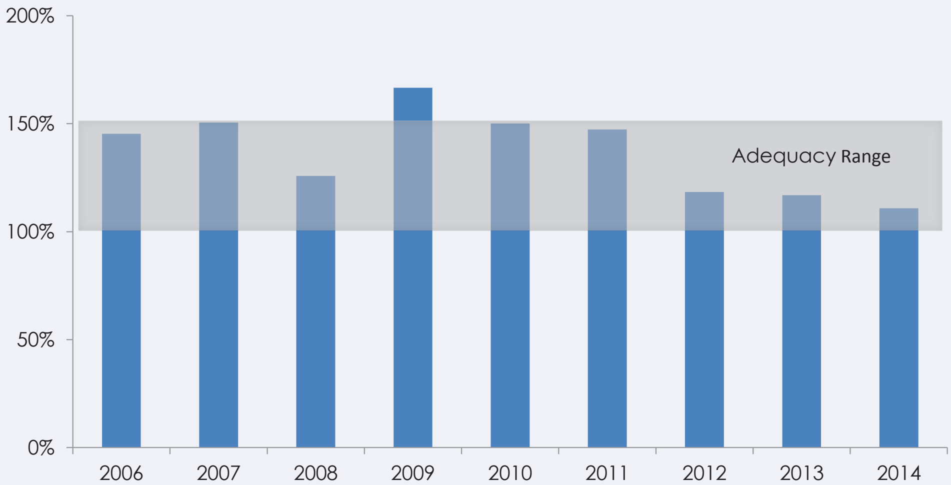
Source: National Bank of Georgia

While assessing international reserve adequacy, a range of analytical approaches are use in addition to the traditional metrics. On the basis of an analysis of past crises, a single weighted indicator (ARA – Assessing Reserve Adequacy) is proposed by the IMF. This focuses on four specific sources of risks: export earnings (X); separate external liability stocks – short-term debt, with remaining maturity (STD); medium- and long-term debt and equity liabilities (OL); and broad money (M2). In the first stage, the relative riskiness of different potential drains on reserves is estimated based primarily on observed distributions of outflows from each source during periods of exchange market pressure, and a “risk-weighted liability stock” is constructed. In the second stage, the desired proportion of this liability stock that should be held in liquid reserves can then be gauged based on the experience of past crises. Moreover, the methodology allows the addition of some specific sources of risks, taking into account individual country factors that have a negative impact on the current account during a crisis. Remittances (RMT) could be considered one such factor for Georgia. After an estimation of relative weights, we have the possibility to derive a composite risk-weighted liability stock:

$$ARA=0.3STD+0.1OL+0.05M2+0.05X+0.05RMT$$

Against the backdrop of past crises and using some degree of judgment, coverage in the region of 100-150% of the metric might be regarded as adequate for a typical country. Despite the fact that the above mentioned composite metric estimated for Georgia declined approximately 30 percentage points during the period 2012-2013, it is consistent with the standard and remains in the 100-150% range, amounting to 111% by the end of 2014 (see Figure 7.6).

Figure 7.6 International Reserves in Georgia vs. Composite Metric of Reserve Adequacy



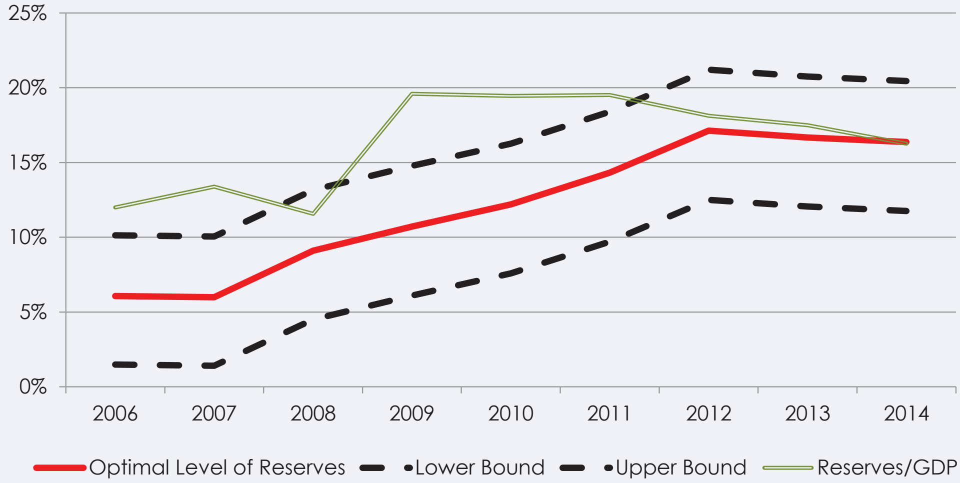
Source: National Bank of Georgia

The Optimal Level of Reserves

During the past few years, a number of models for solving the optimization problem have been developed to derive the optimal level of reserves. The model below features a representative small open economy, which is vulnerable to episodes of sudden stops in capital flows. The role of policymakers (the government) in this model is to insure the private sector against the shock of a sudden stop. It is assumed that the government can smooth domestic consumption by entering a "reserves insurance contract" during periods of economic growth to hedge against risk and manage welfare in times of crises. Pro-cyclical reserve accumulation is associated with certain costs, namely with the opportunity cost of holding reserves. Therefore, some degree of risk aversion it is necessary to determine the long-term welfare-maximizing level of international reserves. The model yields a closed form expression of the optimal level of reserves. In an intuitive way it depends on the probability and the scale of a sudden stop (how large the fall in capital inflow is); potential losses in output and consumption, which reduce welfare in the economy; and the opportunity cost of holding the reserves. In addition, the model stresses the importance of the degree of risk aversion in the economy.

The optimal level of international reserves for Georgia, as estimated using the model described above, is presented in Figure 7.7. Georgia's international reserve holdings have recently decreased after a period of having been significantly above the optimal level. The country paid off a large amount of its debt to the IMF during 2012-2014. As a result, Georgia's international reserve holdings diminished. In addition, the optimal level of reserves increased as a result of the relatively high growth of short-term liabilities (in the period 2010-2014 reserves increased by 6% on average, while the growth rate of short-term liabilities exceeded 18%). The ratio of the optimal level of reserves to the Gross Domestic Product amounted to 16.4% by the end of 2014 (for the same period, the current international level over GDP stood at 16.3%).

Figure 7.7 International Reserves in Georgia and their optimal level (as a share of GDP)



Source: National Bank of Georgia

To sum up, using both traditional and broader-based metrics for Georgia indicates that the level of the country's reserves is in line with all internationally recognized standards. Moreover, Georgia currently holds reserves that correspond to its optimal level.

8. Output and Labour Market

8.1 OUTPUT

In the third quarter of 2014, GDP rose by 5.6% in comparison with the same period of the previous year. The largest contribution to the growth was made by services, at 3.5%. The industrial sector contributed 1.9% and agriculture 0.1%.

« The largest contribution to the growth was made by services.

In industry, investments usually take comparably longer to translate into output than with services, where the process tends to be much shorter. Under the conditions of cheap credit in the third quarter of 2014, which was a result of loose monetary policy and sharp competition among the banks, services exhibited the most growth. Trade, the largest branch of the services sector, increased by 5.5%, contributing 0.8% to GDP growth. In spite of the contraction of car re-exports by 38.4%, car imports increased by 13.8%. Therefore retail trade, including the trade of motor vehicles and motorcycles, grew by 11% in nominal terms. In the same period, total imports and the number of international travelers increased by 2.9% and 2.2% respectively. As a consequence, transport also rose by 6.5%, contributing 0.4% to GDP growth. The high pace of stock extension of loans for real estate purchases had a substantial impact on real estate and renting activities (6.5% and 0.3%). In the same period, in line with the wide expansion of the banking system credit portfolio, financial intermediation output had a large rise (12.8% and 0.3%).

In the third quarter of 2014, the construction sector was the biggest contributor to GDP growth from industry. It rose by 17.8%, contributing 1% to GDP growth. The construction of motorways, roads, airfields and sport facilities, where the public sector share is essential, grew by 49.7% in nominal terms. Favorable conditions in the real estate market promoted the private sector towards the general construction of buildings and civil engineering works (22% of nominal growth). The high growth of the construction sector was also provided by a low base (during the corresponding period of the previous year construction fell by 16.4%). Manufacturing also increased significantly (6.6% growth and making a 0.6% contribution to GDP growth). This was mainly driven by the production of mineral waters and soft drinks (53.8% of nominal growth), the manufacture of alcoholic beverages (25% of nominal growth) and other food products (38.9% of nominal growth). The considerable growth of mining and quarrying (11.4%) is also noteworthy.

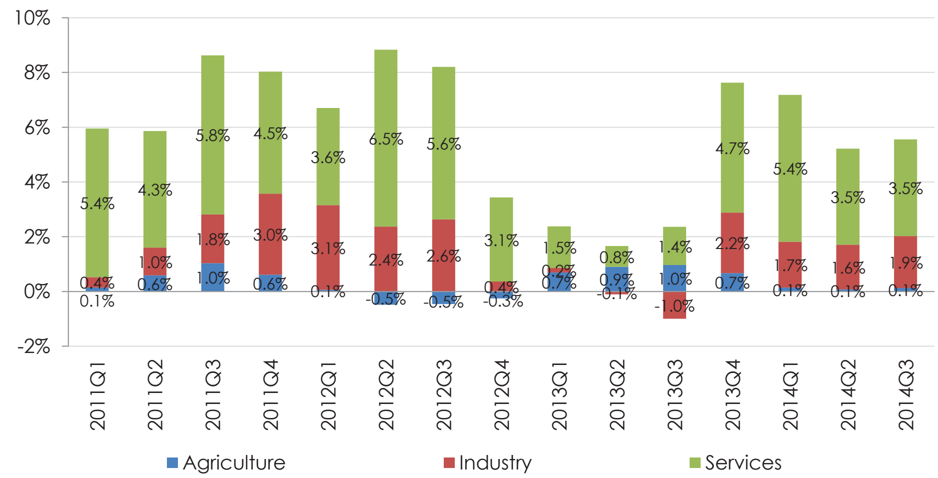
« In the third quarter, the construction grew by 17.8%.

The agriculture only grew by a modest 1.4%, contributing 0.1% to total GDP growth. On the other hand, it should be noted that even years are less productive and 2014 was the first year since 1998 that agriculture has not been in decline.

« The agriculture only grew by a modest 1.4%.

GDP growth slowed in the fourth quarter of 2014, mainly affected by external factors. As preliminary data shows, quarterly growth was at 1.6% and annual growth was 4.7%.

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 increased in the third quarter of 2014 as compared to the previous quarter. The productivity of the labor force increased by 2.8% in year-on-year terms during the third quarter, which is 1.6 percentage points higher than in the previous quarter. During this period, labor efficiency declined in the agriculture sector. According to the data, the annual growth rate of real value added per employee in the agriculture sector amounted to -1.3%, which is 1.4 percentage points more than in the previous quarter. Unlike the second quarter, labor productivity in the industrial sectors increased, amounting to an annual 1.7%. As for the service sector, the real value added per employee grew by 2.2% on an annual basis.

« Labor productivity increased by 2.8% during the third quarter of 2014. This increase can be largely attributed to the services and industry sectors

Table 8.1 Index of Value Added Produced per Worker in 3rd 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	98.7
Industrial sectors	101.7
Service sector	102.2
Overall in the economy	102.8

Source: GeoStat and National Bank of Georgia

As a breakdown of the economy by sector shows, labor productivity in manufacturing increased with the annual growth rate reaching 1%. At the same time, annual growth of 5.1% was observed in the construction sector. As was the case in preceding quarters, labor productivity increased in the hotels and restaurants and trade sectors.

The annual growth rate of nominal salaries of employees amounted to 6.4% during the third quarter of 2014, which is 2.1 percentage points less than in the previous quarter. According to the latest data from Geostat, the average monthly nominal salary stood at 851 GEL.

« According to Geostat, the nominal salaries of employees increased by 6.4% on an annual basis.

In terms of sector analysis, an annual growth of salaries is evident in the mining and quarrying, construction, trade and manufacturing sectors. However, average salaries in public administration decreased during the third quarter of 2014.

Table 8.2 Index of Average Monthly Nominal Wage of Employees in 3rd quarter of 2014 Relative to the Corresponding Period of the Previous Year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	109.0
Fishing	106.0
Mining and quarrying	137.6
Manufacturing	109.9
Production and distribution of electricity, gas and water	110.9
Construction	114.8
Wholesale and retail trade; repair of motor vehicles and personal and household goods	111.0
Hotels and restaurants	105.9
Transport and communications	102.1
Financial intermediation	107.5
Real estate, renting and business activities	101.2

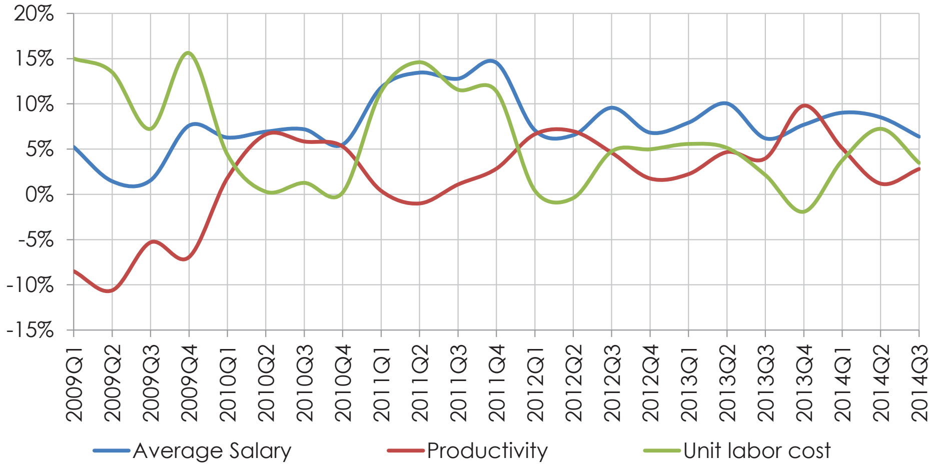
	Average nominal wage (growth index)
Public administration	94.7
Education	109.4
Healthcare and social work	107.6
Other community, social and personal service activities	100.1
Overall in the economy	106.4

Source: GeoStat

To sum up , against the backdrop of increasing labor productivity, the annual growth rate of unit labor cost[15] (personnel expense per production unit) declined and stood at 3.5% by the end of the third quarter of 2014 (see Figure 8.2). This indicates the absence of inflationary pressure from the labor market.

‹‹ *The annual growth rate of unit labor cost declined.*

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



Source: GeoStat and National Bank of Georgia

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

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