National Bank
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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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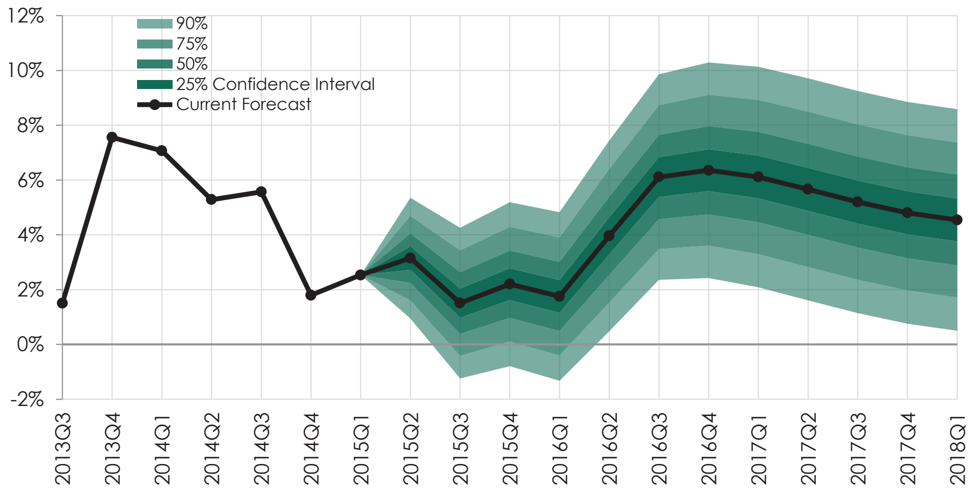
1. BRIEF OVERVIEW

Real economic growth in Georgia remains low in the backdrop of external factors. However, the depreciation of the lari nominal exchange rate has partly offset the negative spillovers from foreign shocks and has contributed to a trade balance adjustment. According to preliminary data, annual GDP growth in the first quarter of 2015 was around 3.2%, representing a decline from 4.8% in 2014. The slowdown in the GDP growth rate is mostly a result of a fall in exports of goods and services. However, domestic demand has also been weak, reflecting the decline in remittances and an increased debt service burden on foreign currency loans. Despite this slowdown, economic growth in the first quarter remained higher than expected – largely due to private sector activity along with a stable monetary policy. Among the different sectors, construction activities made a significant contribution to GDP growth, which reflects investments not only in residential and commercial real estate, but also in infrastructure and the energy sector.

The economic growth forecast for 2015 has not changed since the last report and remains around 2%. The main impediment to economic growth will be the foreign sector. In the backdrop of a tense economic situation in the region, this has a negative influence on the export of goods and services and on remittances. According to the forecast, real GDP growth in 2015 will have the same structure as in 2014. Net exports will again make a negative contribution, while domestic demand will have a positive effect, albeit only a modest one. Lending will encourage investment and consumption due to a stable monetary policy. Also, despite the planned fiscal consolidation measures, an increase in capital expenditures should help economic activity. Unfavorable spillovers from the foreign sector are partly offset by lower oil prices on international markets, which represent a positive factor for both the current account and other sectors of the economy. In addition, the exchange rate depreciation helps the process of adjustment for external imbalances and serves as a foreign shock absorber.

Figure 1.1 Real GDP Annual Growth

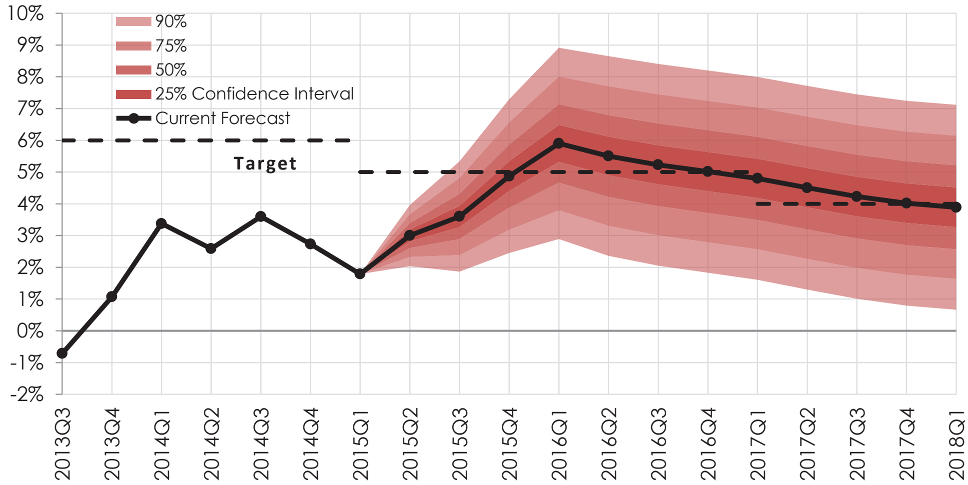


Source: National Bank of Georgia

Annual Inflation in the first quarter was lower than expected. The annual change in consumer prices was 2.5% in April and remained below the inflation target. The effect of nominal exchange rate depreciation on inflation has been offset by weak aggregate demand. Weakened inflation was also a result of falling food and energy prices on international markets.

According to the forecast, inflation will reach the 5% target in the second half of 2015. The main source of downward pressure on inflation will be weak economic activity and low global prices of food and energy. Against these, inflationary pressures come from the supply side. Loan dollarization and the depreciation of the Georgian lari exchange rate against the US dollar, the increased debt service burden on FX loans of firms, and higher prices of imported durable goods all contribute to higher overall inflation. According to the forecast, which takes into account all of the aforementioned effects, inflation in the first quarter of 2016 will slightly overshoot its target before reducing and stabilizing around it.

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 the upward and downward directions**. The main risks to the forecast come from the foreign sector. A possible worsening of the already adverse conditions in the region or a stronger-than-expected transmission of these to the Georgian economy represent the major risks. An important assumption underlying the forecast is that the negative external sector spillovers will not deteriorate further. On the other hand, greater-than-expected foreign investments and large-scale infrastructure projects represent positive risk factors for the forecast.

The Monetary Policy Committee decided to raise the refinancing rate by 50 basis points to 5% at their meeting of 6 May 2015. This decision was based on macroeconomic forecasts, according to which inflation expectations have increased and thus strengthened inflationary risks. In the backdrop of this, the National Bank of Georgia continues exiting from its accommodative monetary policy stance. Despite this increase, one should not expect a contractionary effect from the policy rate because it still remains below the neutral level. At the same time, real interest rates remain low in light of higher inflation expectations. The exit from the loose monetary policy stance will be gradual and its pace will depend on the expected dynamics of the inflation rate, the factors influencing this, and economic activity in general. Unless new shocks that could affect the economy emerge, the forecast implies that the policy rate will reach 5.5% by the end of 2015.

2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

As a small open economy the Georgian economy is sensitive to regional and global challenges. Reduced exports to Georgia's main trading partners, combined with falling remittances and reduced tourism inflows, cause income and domestic demand to decline, and, on the other hand, put pressure on the exchange rate. The grim economic situation in the region has been exacerbated by the global appreciation of the US dollar, which stemmed from the solid recovery of the US economy and the monetary policy pursued by the Federal Reserve. The situation is particularly acute in Ukraine, Russia and Armenia, where further declines in economic activity this year are unavoidable. Falling oil prices have adversely affected Azerbaijan, leading to significantly worsened economic growth prospects. A relatively favorable situation is observed in Turkey, despite the slowdown of economic activity in 2014. The eurozone, which is an important trading partner, still suffers from a lack of private investment due to low expectations and complicated political and economic issues in its peripheral member states.

The economic sanctions imposed on Russia last year, combined with dramatically reduced oil prices, have added to the structural problems in the country's economy, worsened business sentiment and provoked capital flight. The depreciation of the ruble by almost 100% in 2014 exerted inflationary pressure on consumer prices, which rose by 16.9% year on year in March 2015. The current crisis in the Russian economy has resulted in reductions of trade, tourism and remittances inflows to Georgia, and has also had a contagious effect on other countries in the region – including important trading partners such as Armenia and Azerbaijan. According to IMF forecasts, in 2015 the Russian economy will decrease by 3.8%, while the slowdown in 2016 will be 1.1%.[1]

The ongoing military conflict in the industrial eastern regions of Ukraine and its consequences have had a severe impact on the country's economy. Gross output fell by 6.8% in 2014, the local currency significantly depreciated against all major currencies (e.g. the depreciation against the US dollar in March was 113% in year-on-year terms), and consumer price inflation totaled 46%. Amid domestic and foreign challenges, Ukraine's GDP in 2015 will fall by about 5.5%; however, economic activity will stabilize owing to contributions from planned structural reforms and reconstruction projects. The IMF predicts that Ukraine will recover from recession in 2016, boosting output by 2% year on year.

Azerbaijan's positive current account deteriorated significantly at the end of 2014, mainly as a result of the decline in oil export revenues. However, it is worth noting that before the depreciation against the US dollar, the manat had appreciated against its major trading partners' currencies, which significantly impaired competitiveness and reduced non-oil exports. In order to maintain a stable exchange rate with the US dollar, the Central Bank spent a significant share of its foreign currency reserves from November 2014 to February 2015, but was eventually forced to depreciate the manat by 34%. As a result, consumer price inflation increased in February and reached 4% year on year. It is expected that investment, which has been one of the main driving forces of Azerbaijan's economic growth in recent years, will fall in 2015 due to reductions in export revenues. As a result, the IMF estimates that annual GDP growth in 2015 will reach only 0.6%. The forecast for 2016 stands at 2.5%.

Armenia's economic growth gradually slowed in 2013-2014 together with the weakening of the Russian economy, an important trade partner. Falling investment flows from Russia into the construction and mining sectors, as well as sluggish demand on Armenian exports and a sharp decline in remittances last year, resulted in only 3.4% output growth. Due to cuts in foreign exchange inflows, the Armenian dram remains depreciated on a year-on-year basis against most trading partner currencies, despite massive foreign exchange interventions by the Central Bank. Annual inflation posted 5.8% in March, which is slightly beyond the target band. The IMF estimates that amid deteriorating macroeconomic prospects in Russia, the Armenian economy will enter

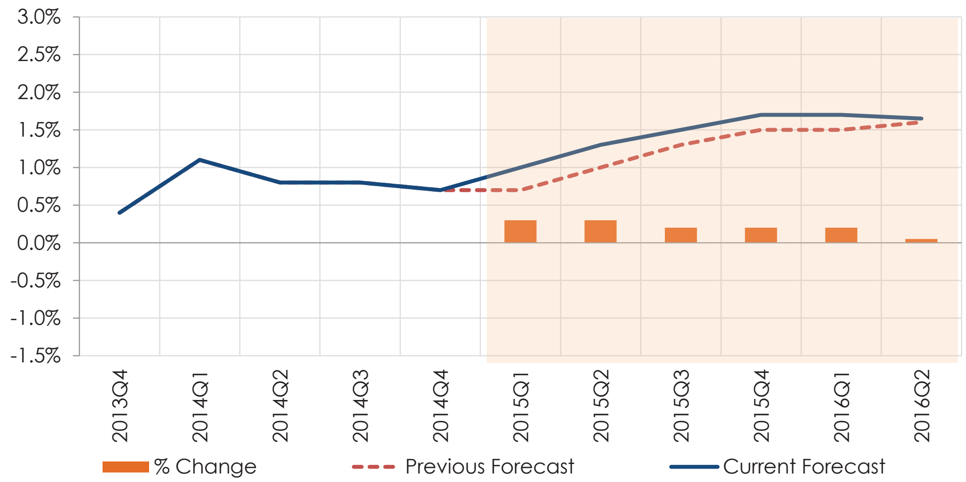
1 *Source: World Economic Outlook (WEO) – April 2015.*

recession in 2015 and GDP will fall by 1%.

Amid the uncertainty of the presidential elections, geopolitical tensions and significant fluctuations in the foreign exchange market, Turkey's economy grew by only 2.9% in 2014. Despite weak foreign and domestic demand, the devaluation of the lira puts high pressure on inflation, which exceeded the 5% target by 2.5 percentage points in February. Total output, the IMF predicts, will grow at the rate of 3.1% in 2015, supported by improved private consumption, an accommodative monetary policy and the low price of imported oil. The GDP growth forecast for 2016 stands at 3.6%.

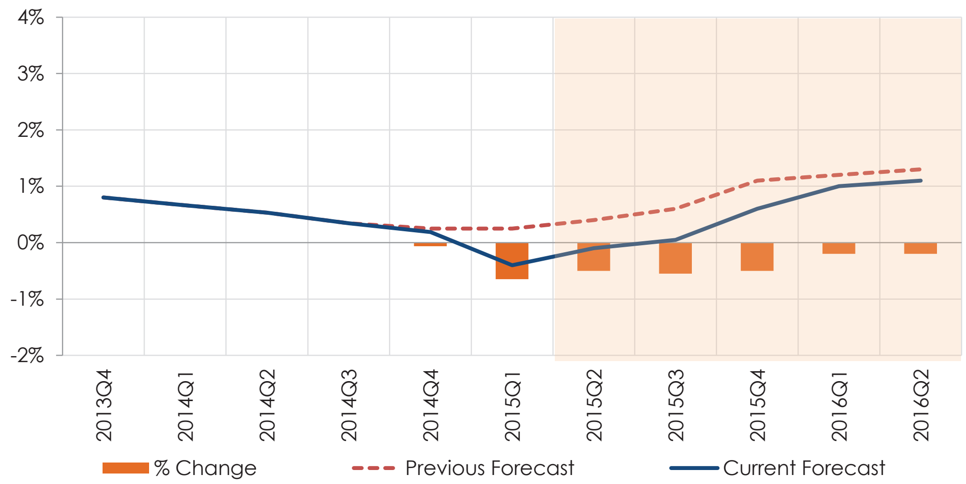
Political and economic difficulties in peripheral eurozone member states, low business sentiment and a lack of private investment have significantly impeded the recovery process in the currency union. However, lower oil prices, the ECB's expansionary monetary policy and the depreciated euro have recently helped lift private consumption and net exports. Inflation turned negative in December 2014; however, owing to monetary stimulus measures, it will become positive again this year, resting slightly above zero. The IMF forecasts that the eurozone economy will grow by 1.5% and 1.6% in 2015 and 2016 respectively.

Figure 2.1 Eurozone Real GDP Annual Growth



Source: OECD

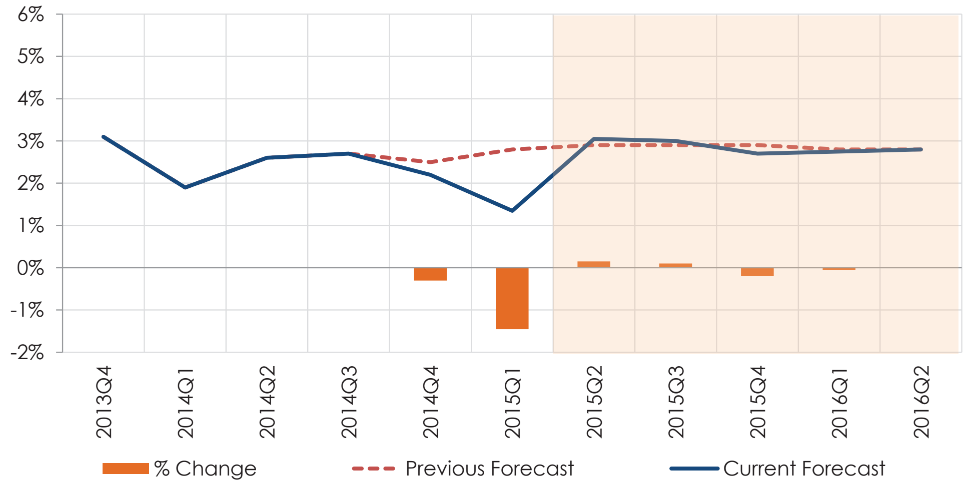
Figure 2.2 Eurozone CPI Annual Inflation



Source: Eurostat

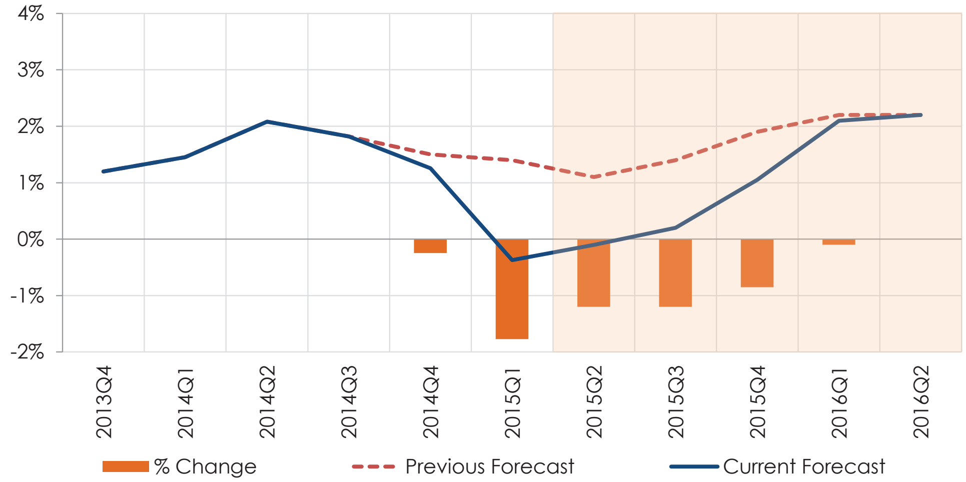
The year 2014 was marked by 2.4% economic growth in the US. Improved consumer confidence, direct investments and low prices of oil have significantly contributed to the increase in activity. Unemployment fell to 5.5%, a decrease of 1.1 percentage point year on year; however, low energy prices and the dollar's global strengthening exerts downward pressure on headline inflation and slows its growth towards the 2% target. This fact gives rise to expectations that policy rates will not be lifted until the third quarter and that they will continue to grow at a slow pace thereafter. Like last year, an unusually harsh winter led to a significant revision of first quarter growth (see Figure 2.3). The IMF predicts that the US economy will increase by 3.1% in 2015 and the forecast for 2016 stands at 3.1%.

Figure 2.3 U.S. Real GDP Annual Growth



Source: OECD

Figure 2.4 U.S. CPI Annual Inflation



Source: OECD

Since the beginning of this year, the monetary policy pursued by the central banks of Georgia's important trade partners have served two main goals: (i) the stimulation of weak economic activity (Turkey and the eurozone), and (ii) the contraction of inflationary pressures caused by local currency devaluation (Armenia, Ukraine and Russia). As noted above, the US Federal Reserve is expected to keep its key policy rate near zero until the third quarter and will then gradually lift rates at a slow pace.

The global strengthening of the US dollar is reflected in the rise of USD LIBOR rate.[2] As of March, the US dollar 3-month LIBOR rate increased by 0.04 percentage points to 0.27%, year on year, and is expected to reach about 1% by the end of this year. The opposite situation is observed with the euro LIBOR rate which has a downward trend, with the 3-month rate equaling 0.02% as of March.

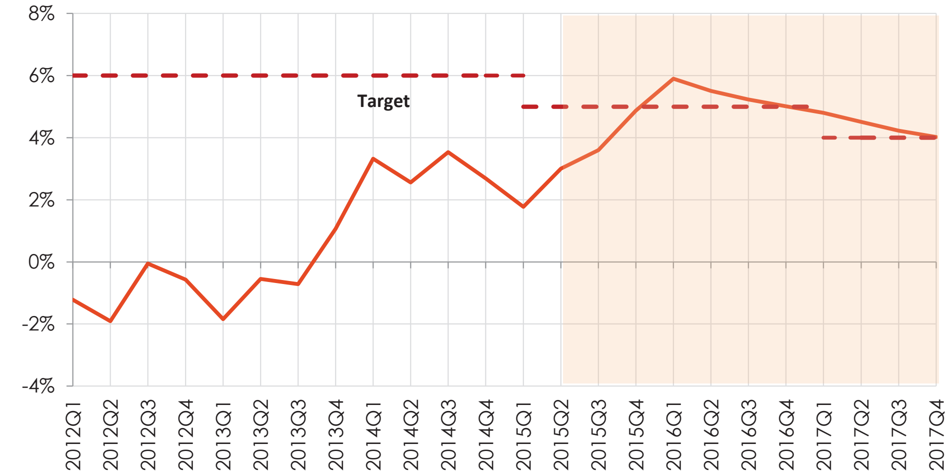
Prices on global commodity markets continue to fall. The IMF estimates that the decline in commodity prices in the first quarter of 2015 averaged approximately 10% year on year. Prices fell on energy, as well as on agricultural products and metals. The reasons behind the reduction include weak demand (mainly in the euro area and China) and excess supply. The forecasts predict that by the end of the year prices on energy and agricultural products will rise, while prices on metals will remain almost unchanged.

2 The USD LIBOR rate is the average interest rate on US dollar-denominated resources borrowed by commercial banks on the London interbank market.

2.2 MACROECONOMIC FORECAST

The annual inflation rate increased moderately throughout the first quarter of 2015, but has still been less than expected. The annual growth of consumer prices in April was 2.5%, while it averaged 1.8% in the first quarter and thus remained below the inflation target of the National Bank of Georgia (see Figure 2.5). The less-than-expected inflation in the first quarter of the current year was mainly driven by weak food and energy prices in global markets. At the same time, the effect of the nominal exchange rate on prices was dampened by weak aggregate demand.

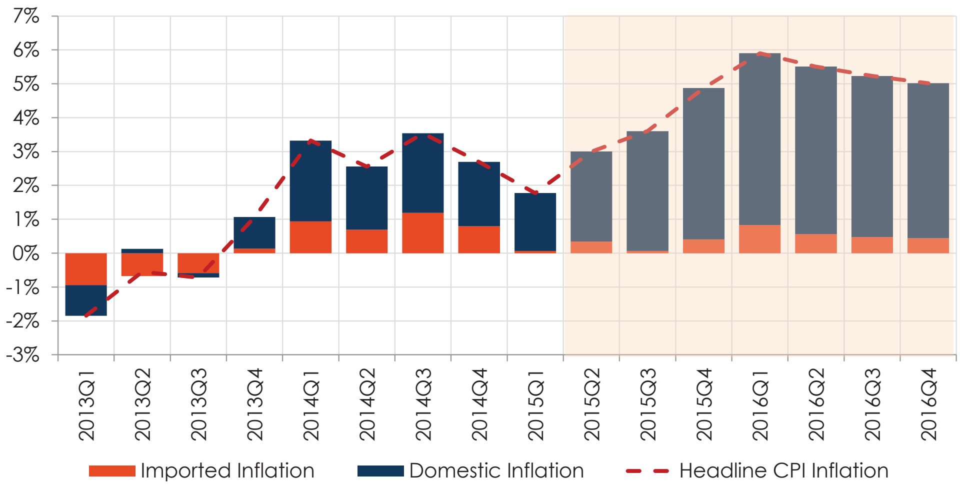
Figure 2.5 Headline Inflation



Source: National Bank of Georgia

According to the **forecast, inflation** in the second quarter of 2015 will be around 3% on average and afterwards will continue moderately increasing towards the target. According to the current forecast, inflation will reach its target of 5% by the end of 2015 (see Figure 2.5).

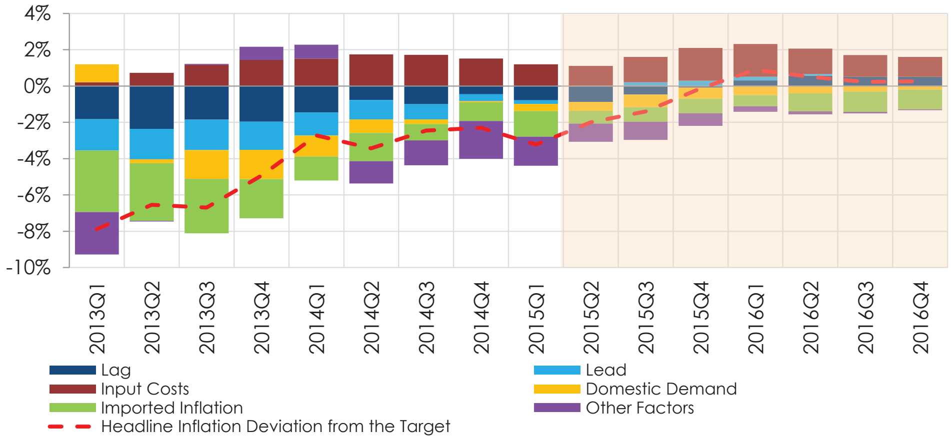
Figure 2.6 Headline Inflation Decomposition



Source: National Bank of Georgia

Until recently the deviation of inflation from the target has mainly been caused by a combination of weak imported inflation (see Figure 2.6), globally declining food and energy prices, and sluggish demand (see Figure 2.7). In the forecast, the main source of higher inflation comes from the supply side. An increase in input costs, due to the dollarization of business loans and the depreciation of the Georgian lari with respect to the US dollar, will place upward pressure on prices. Against this, downward pressure comes from weak demand and low global food and oil prices. Specifically, in light of low economic activity, it is expected that demand in 2015 will be lower than its potential and will thus curb other inflationary pressures. According to the forecast, which takes all of the above mentioned factors into account, inflation in the first quarter of 2016 will slightly overshoot its target before reducing and stabilizing around it.

Figure 2.7 Inflation deviation from target and its decomposition*



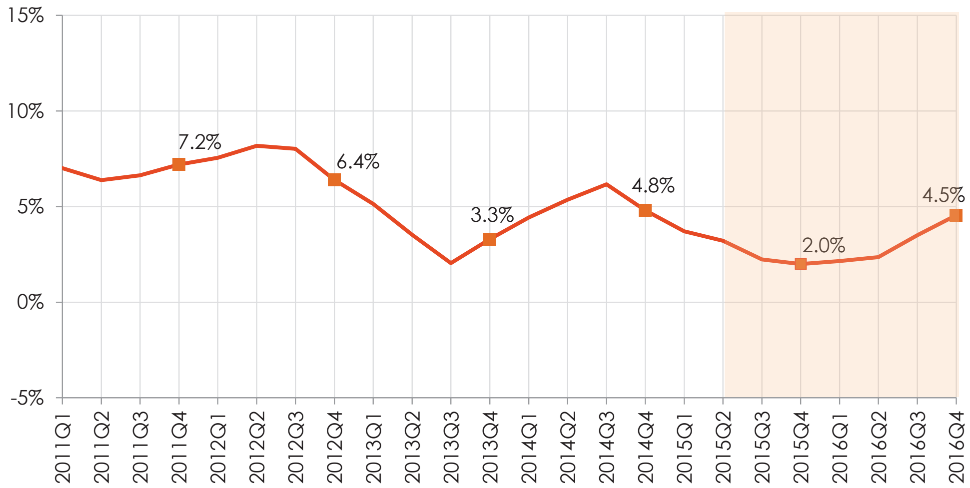
** In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

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, this would strengthen the transmission of the already high inflation rates of those countries. There is also some uncertainty surrounding food and petrol prices, both of which have substantial weight in the consumer basket and are mostly supply-driven. On the other hand, if aggregate demand is weaker than expected, this may cause actual inflation to be lower than current projections.

Real GDP growth in 2014 was consistent with the previous forecasts and equaled 4.8% (see Figure 2.8). Economic activity in 2014 was driven by domestic demand. In particular, in the backdrop of 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 negative contribution to GDP growth in 2014. This was mainly caused by considerably weakened foreign demand, on the one hand, and by the increase in imports due to higher domestic demand, on the other. Weak net exports are reflective of the geopolitical tensions in the region. The strong lari nominal effective exchange rate during that period was another factor in explaining lower net exports. According to current estimates, the deviation of economic activity from its potential level worsened in the fourth quarter of 2014. The output gap is expected to deteriorate further before starting to improve from late 2015.

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

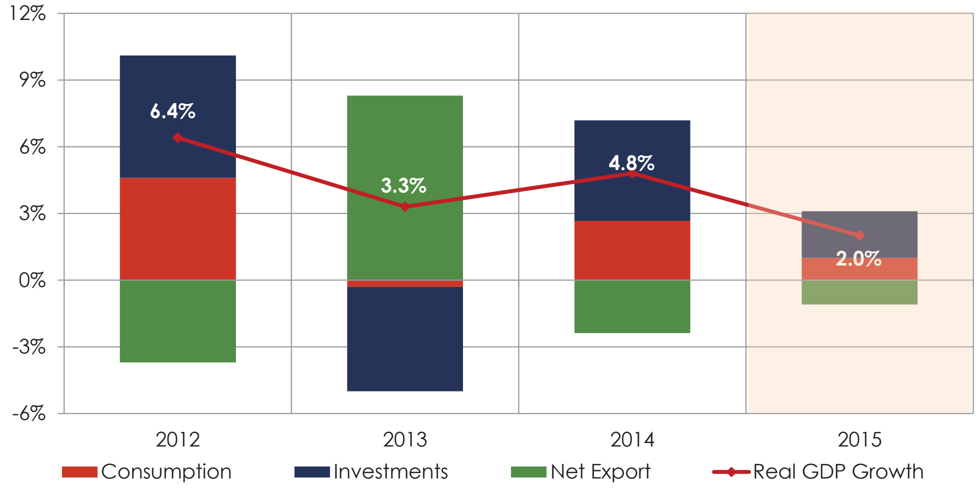


Source: National Bank of Georgia

According to the **GDP forecast**, the growth rate in 2015 is expected to be around 2% (see Figure 2.8), which will be driven by domestic demand. An increase in government capital expenditures, alongside the continued accommodative monetary policy stance, 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 events in 2015 will have a positive impact on economic activity. On the other hand, unfavorable foreign sector trends are 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. These, in turn, are reflected in weak foreign demand for Georgian exports, remittances and international tourism receipts. Such negative foreign sector spillovers are partly offset by reduced petrol prices, which serve as a positive factor for the current account and 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 worsen or are transmitted to Georgia to a greater extent 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 the large-scale 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

The current account deficit, according to preliminary data, increased to 14.9% of GDP in the first quarter of 2015. This deterioration was mainly caused by a 27.7% fall in exports over the same period. This sharp drop of exports started from the fourth quarter of 2014. In addition, there have been decreases in remittances (by 27.3%) and tourism receipts (by 2.9%). As for imports, the annual growth rate, which was still positive in the fourth quarter of last year, became negative in the first quarter 2015 and amounted to -3.3%. It is worth noting that the reduction in imports is moderately intensifying, which shows that, alongside reduced foreign currency inflows, the import adjustment process is active and is contributing to macroeconomic stability.

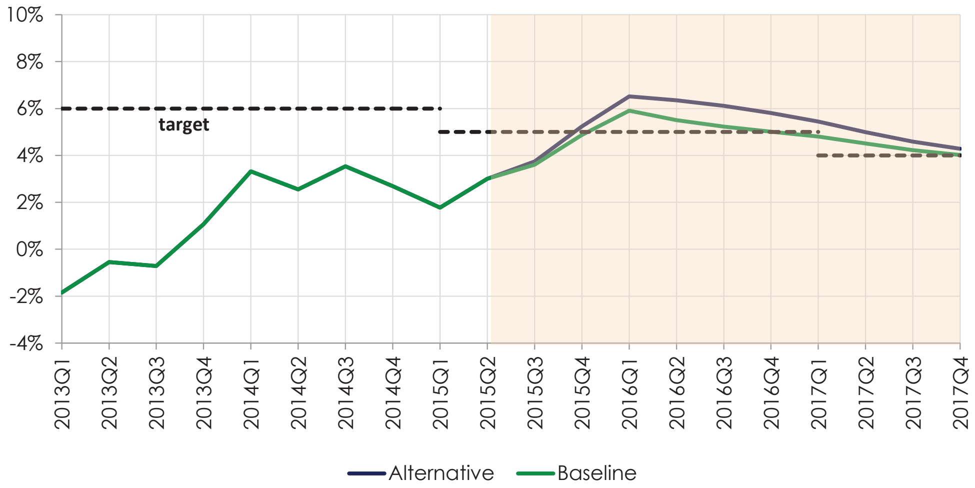
The current account deficit for 2014 worsened to 9.7%, which is 4 percentage points higher than the same figure in the preceding year. According to the current forecast, the current account will deteriorate in 2015 as well, but will start improving steadily in the medium-term.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers the case of a higher realization of foreign shocks. In particular, the scenario assumes that if the economic crisis deepens in the region, the negative effect on exports, remittances, and the nominal effective exchange rate will be stronger than expected. According to this scenario, 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).

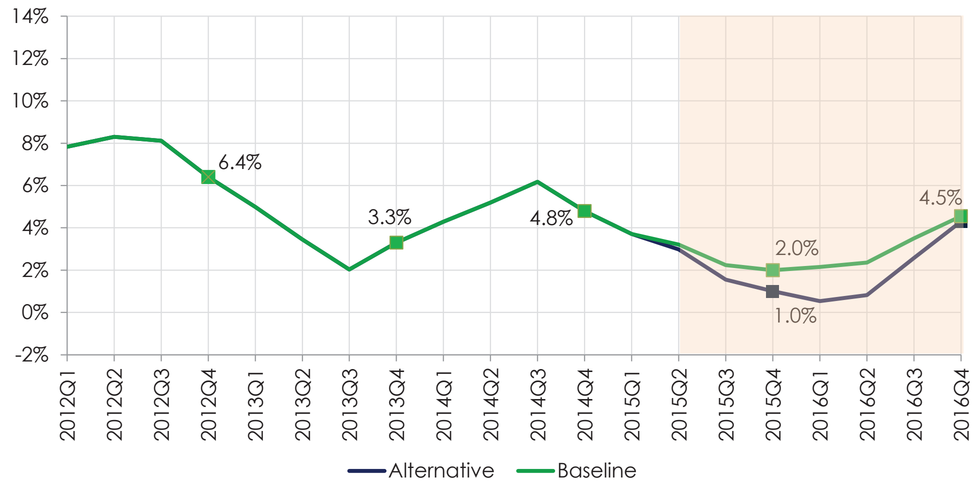
According to the alternative scenario, the inflation rate will increase faster than in the baseline scenario, since the effect of the nominal effective exchange rate on prices dominates the effect of weak demand. However, the inflationary pressure will not be strong. In this alternative forecast, headline inflation in 2016 will be one percentage point higher than in the baseline scenario. In order to influence inflation expectations, the appropriate monetary policy response to this would be to make inflation return 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)

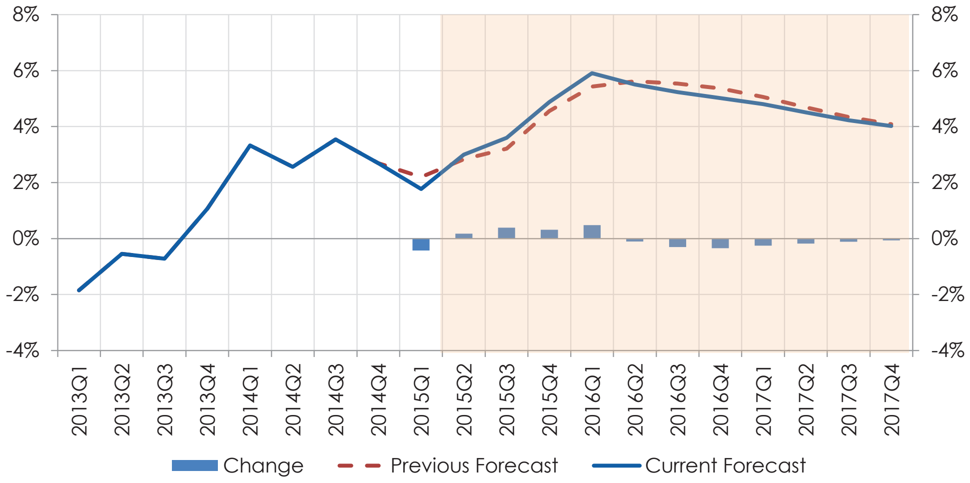


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous forecast, the inflation forecast has been slightly revised upward (see Figure 2.12). This is mainly a reflection of foreign shocks, in particular the change in the nominal effective exchange rate. Weak demand somewhat limits the effect of the exchange rate on prices, which comes partly at the expense of reducing firms' markups. In the presence of foreign shocks, the share of imported inflation in headline inflation is higher than in the previous forecast. As a result, according to the current forecast, inflation will be higher during 2015, but will not exceed the target rate.

Figure 2.12 Change in the Forecast of Headline Inflation



Source: National Bank of Georgia

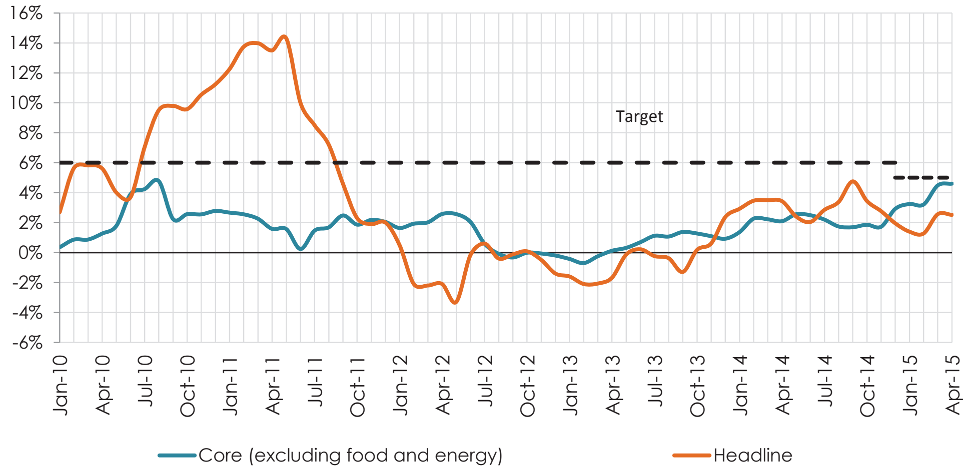
As for economic activity, the GDP growth forecast for 2015 has not changed.

3. Consumer Prices

By the end of the first quarter of 2015, the annual growth rate of the overall price level increased as compared to the previous quarter and totaled 2.6%. During April, the annual inflation indicator declined slightly to 2.5%. The annual inflation rate is thus below the NBG's medium-term target of 5%. In the backdrop of headline inflation, core inflation surged. The recent depreciation of the nominal exchange rate is partly reflected in the prices of some consumer goods. As a result, the annual consumer price level, excluding food and energy, increased to 4.5% in March. By the end of April, core inflation increased further and stood at 4.6% (see Figure 3.1).

« Headline inflation is below the NBG's target level and stood at 2.5% in April 2015.

Figure 3.1 CPI and Core Inflation



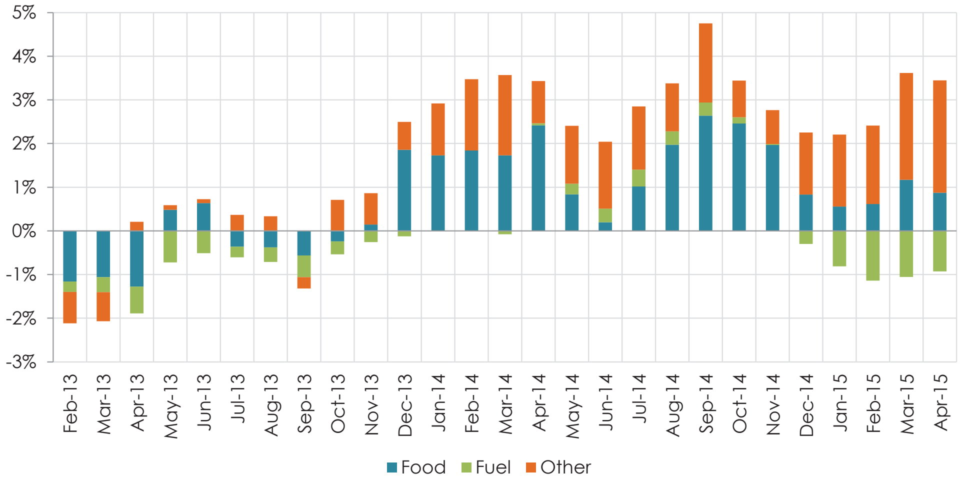
Source: GeoStat and National Bank of Georgia

Against the backdrop of the 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 March 2014 , prices on petrol and diesel had declined by 17-18% on an annual basis, contributing approximately -1.1 percentage points to headline inflation. During April, fuel prices increased slightly and thus the annual rate of decline slowed down somewhat. However, this still puts important pressure on headline inflation. By the end of April, the annual price reduction on petrol and diesel amounted to 15.8%. The impact of reduced fuel prices on the overall inflation indicator decreased to approximately -0.9 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 commodity markets. In addition, due to the economic downturn in Russia and the sharp depreciation of the ruble, the export of fruit and vegetables to the Russian market was restricted. All of this was reflected on domestic food prices. However, the recent exchange rate depreciation against the US dollar put upward pressure on some food products, resulting in increased food prices in the subsequent period. The food inflation rate amounted to 2.8% by the end of April and its impact on headline inflation grew by 0.9 percentage points (see Figure 3.2).

Figure 3.2 Contribution of food inflation in headline inflation

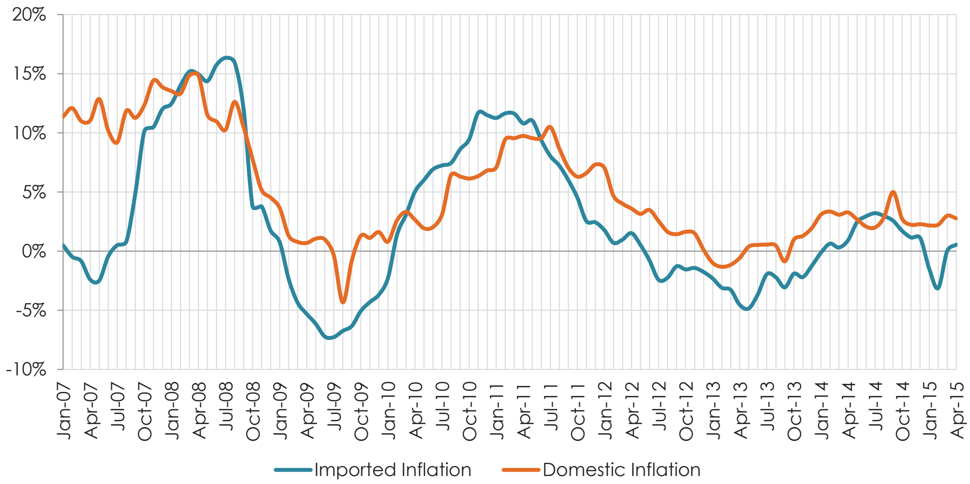


Source: GeoStat and National Bank of Georgia

In terms of exogenous factors, it is worth stressing the influence of imported inflation on the overall price level. By the end of 2014, the significant 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. Moreover, in January and February 2015, prices on imported consumer goods declined on an annual basis. However, the nominal effective exchange rate later started to depreciate and imported inflation again turned positive. The nominal effective exchange rate depreciation puts upward pressure on the durable goods included in the consumer basket. The durable goods category mostly consists of imported goods (motor cars, household appliances, etc.). During April, the prices on durable goods increased by 8.4%, which, in turn, was reflected on the imported inflation indicator. However, the reduction in fuel prices has had a declining effect on overall imported prices. As a result, considering both of these factors, imported inflation increased to 0.5% by the end of April, contributing approximately 0.1 percentage points to headline inflation (see Figure 3.3).

‹‹ The inflation rate on imported consumer goods increased and stood at 0.5% by the end of April

Figure 3.3 Imported and Domestic Inflation



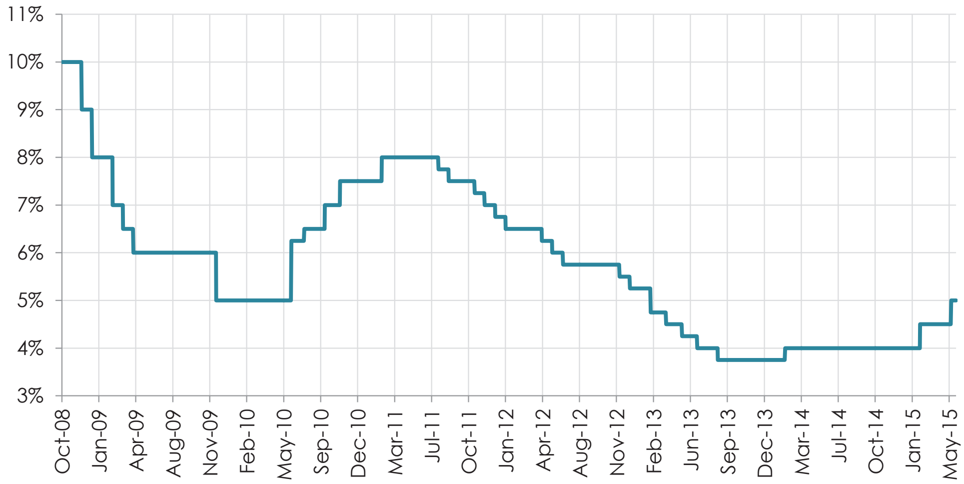
Source: GeoStat and National Bank of Georgia

The realization of geopolitical risks and the subsequent economic downturn in Georgia's main trading partners has been reflected on external demand and has had a negative impact on the Georgian economy. Exports, remittances and tourism revenues all decreased significantly. The factors weakening external and domestic demand thus caused a widening of the negative output gap. That, in turn, put downward pressure on the consumer prices growth rate and prolonged the approach towards the target level.

4. MONETARY POLICY

For one year, starting from February 2014, the National Bank of Georgia kept the monetary policy rate unchanged at 4%. This decision was mainly taken as a result of external shocks. In spring 2014, geopolitical risks became apparent that were followed by worsened economic conditions in Georgia's main trading partner countries. These events were first reflected in lower growth rates of exports and remittances, which were then followed by negative growth rates. These factors reduce both domestic and external demand. By the end of 2014, in line with the existing external imbalances, the lari depreciated against the US dollar. Given the high level of dollarization in the economy, depreciation affects inflation expectations and increases intermediate costs. To reduce inflation risks in this situation, in February 2015 the National Bank of Georgia found it appropriate to tighten the monetary policy and increased the refinancing rate by 25 basis points to 4.5%.

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 5.0 percent.

On 6 May 2015, the Monetary Policy Committee (MPC) of the National Bank of Georgia met and decided to increase the refinancing rate by 50 basis points to 5%. At the same time, the interest rate for standing refinancing loans increased to the policy rate plus 150 basis points. This decision was based on the existing inflation forecast and on a macroeconomic analysis of ongoing events in both Georgia and outside its borders.

After falling in 2012-2013, the inflation rate exhibited a growth trend during 2014. However, it still remains below the NBG's target. Reduced prices in commodity markets and falling oil prices had a significant impact on inflation rate dynamics. These developments were accompanied by weakened external demand. By the end of April 2015, the inflation rate amounted to 2.5%. The impact of the increase in intermediate costs related to servicing foreign currency-denominated debts (due to the GEL depreciation) on inflation was partially balanced by the decrease in fuel prices.

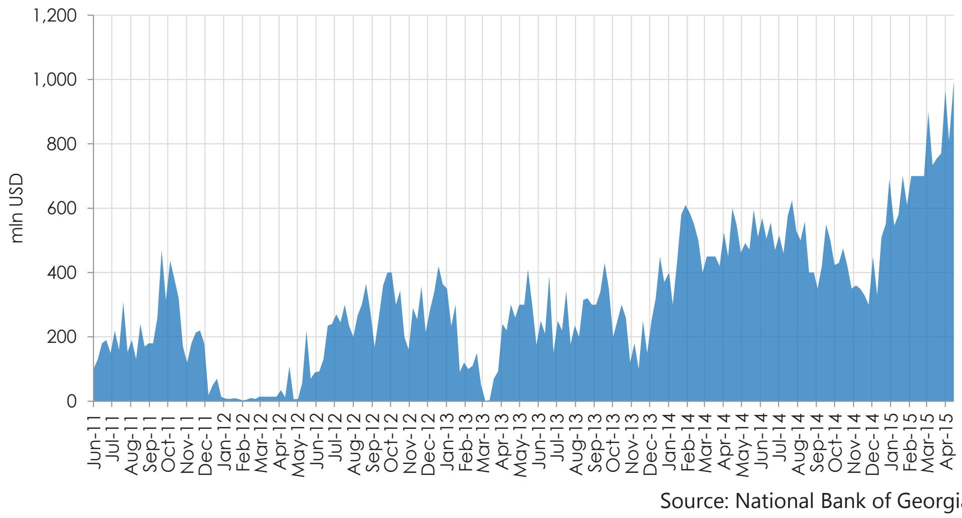
According to current estimations, economic activity in the first quarter of 2015 was higher than expected. Preliminary information suggests real economic growth amounted to 3.2%. Credit activity remained reasonable during the first quarter, but significantly slowed in April. In addition, the expected slowdown in imports during April may indicate a decline in demand; but, at the same time, this encourages local production and ensures economic recovery. Negative trends have been recorded in the external sector as a result of external shocks. Against the background of worsened economic conditions in trading partner countries, a reduction of external demand became apparent from the second quarter of 2014 and this continued to gradually decline towards the end of the year. During the first quarter of 2015, registered exports declined by 28%, while the decrease in imports amounted to 3%. Remittances declined considerably as well – by 23.5% annually in March. During 2014, the growth rate of tourism revenues decreased significantly. However, recent changes in the exchange rate have already started to affect import demand, which, in turn, ensures the adjustment of external imbalance and fosters domestic demand.

According to the NBG's forecasts, inflation will reach its target rate of 5% at the end of 2015. However, risks remain. Predominantly those stemming from a possible deterioration of the economic situation in the region and/or the transfer of external shocks to the Georgian economy at a higher degree. On the other side, greater than expected foreign direct investments realized in the country and/or the acceleration of large infrastructure projects may have a positive effect on inflation dynamics.

Given the aforementioned external shocks and domestic factors, the Monetary Policy Committee considered it necessary to increase the monetary policy rate to 5%. The National Bank of Georgia is thus continuing the process of exiting from its loose monetary policy stance. However, the committee emphasizes that there will be no contractionary effect on the economy. The policy rate remains below the neutral level, and in line with increased inflation expectations real interest rates are low. The tightening will be gradual and its pace will depend on the expected dynamics of the inflation rate, the factors influencing it, and on the general situation in the economy. Unless new shocks potentially affecting the economy emerge, the forecast shows that the rate will gradually reach 5.5% by the end of 2015.

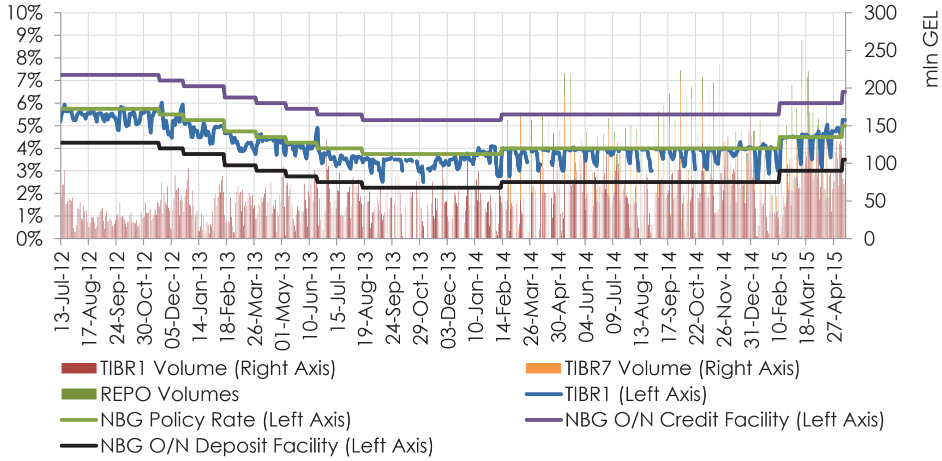
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. Due to seasonal and temporary factors, demand for this instrument is relatively high at this stage as compared to the previous year. This 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

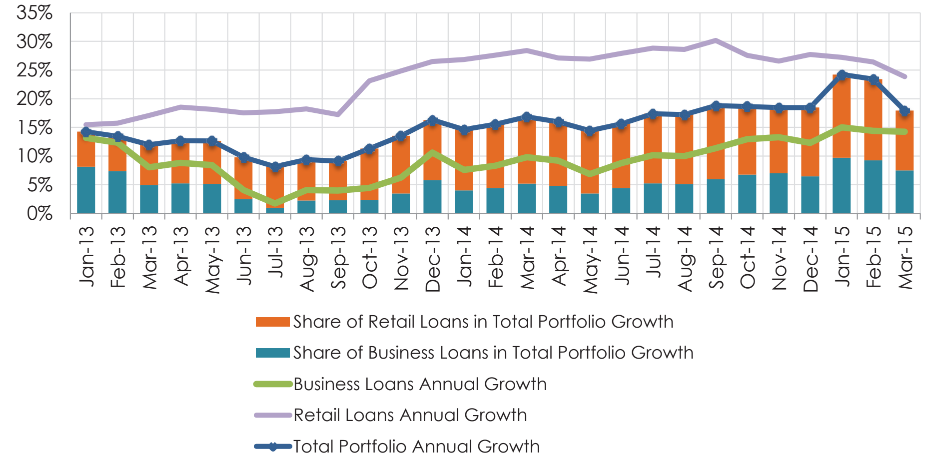
‹‹ Short-term interbank rates are stable and hover around the policy rate.

5. Financial Market and Trends

5.1 LOANS

In the first quarter of 2015, the annual growth rate of the loan portfolio decreased and amounted 18.5%.[3] Compared to previous periods, this growth was more balanced in terms of the growth of loans to legal entities and retail loans. Loans extended to small and medium sized businesses continue to exhibit a stable growth rate and in March the annual growth rate amounted to 12%.[4] Demand was amplified for corporate loans and the annual growth rate for these in March amounted to 17%. It should be noted that compared to December 2014, in March business loans in the national currency with floating interest rates increased by 30%. However, 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



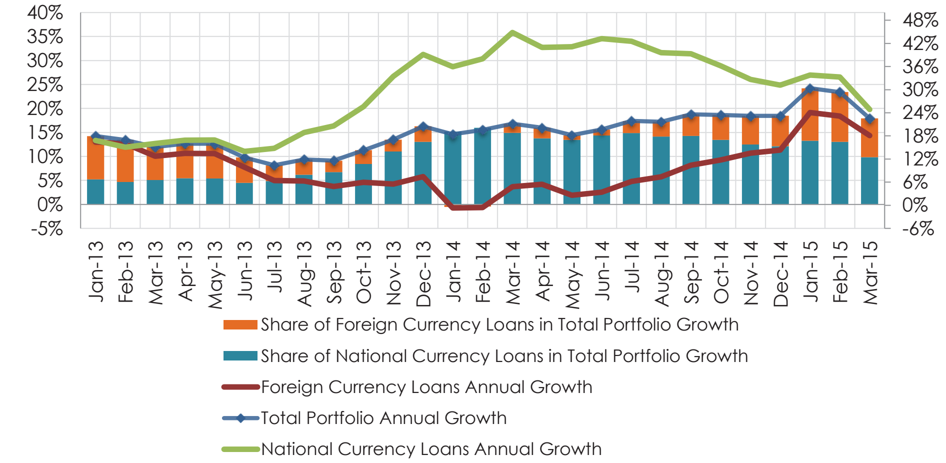
Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was largely caused by an increase in domestic currency loans. In March, the annual growth rate of foreign currency denominated loans increased to 14.4%, while loans in the domestic currency increased by 25%. It should be noted that loan larization decreased to 36% in the first quarter, which largely reflects the effect of exchange rate depreciation.

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

4 *Ibid.*

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

In the first quarter 2015, the stock of retail loans increased by 370 million GEL compared to previous quarter, which was largely caused by currency depreciation. However, without accounting for that effect, the amount of mortgage and consumer loans have not changed; while the stock of installment loans decreased by 35 million GEL. Consumer loans are mainly used to finance imports. In light of the currency depreciation, consumer demand weakened for imported products, which led to a reduction in the growth rate of consumer loans.

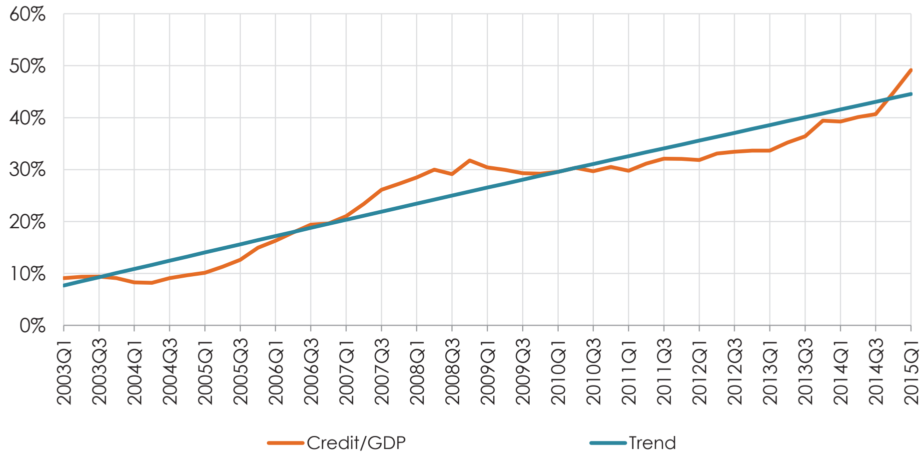
In March, the annual growth rate of the loan portfolio to legal entities amounted to 14.3%, which is 2 percentage points higher than in December. Demand on large business loans improved in the second half of the year. This was mainly caused by easing interest rate conditions and a relative recovery of demand. According to the credit conditions survey, in the first quarter of 2015 banks tightened interest and non-interest rate terms, which were caused by banks' expectations of economic deterioration. An analysis of business loans by sector reveals that the trade, energy, agriculture and construction sectors posted growth in terms of credit, while the volume of outstanding loans disbursed to the manufacturing and transport sectors increased only slightly. According to the credit conditions survey, representatives of the banking sector expect a decline in the growth of the credit portfolio in the next quarter. In terms of currency, demand is expected to be weak on foreign currency loans, while demand for domestic currency loans is expected to grow.

In recent years, the credit to GDP ratio[5] has followed the trend[6] without significant fluctuations. In the first quarter, the credit to GDP ratio increased by 4.3 percentage points compared to previous quarter and amounted to 49.2%. The growth of this ratio was largely caused by currency depreciation. Currently, the credit to GDP ratio is above the trend by 4.6 percentage points.

5 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.

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

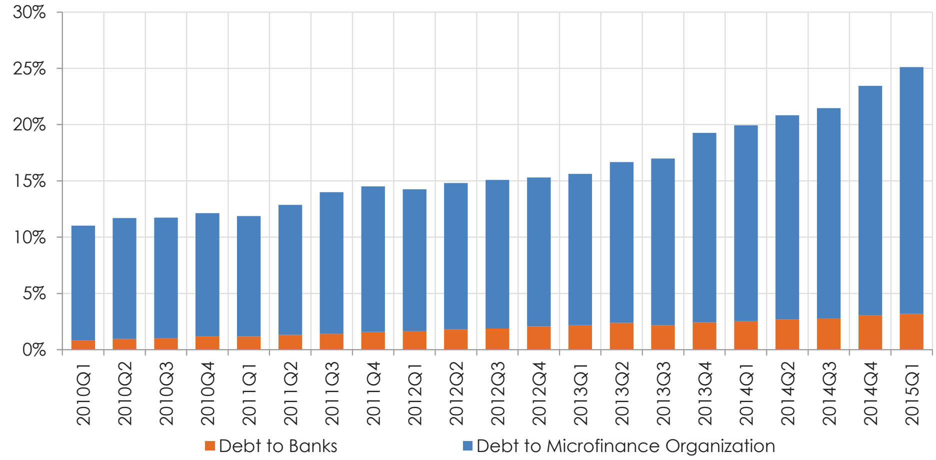
Figure 5.3 Credit to GDP gap



Source: National Bank of Georgia

In the first quarter of 2015, individuals' debt to net national disposable income ratio increased by 4.3 percentage points compared to the previous quarter and amounted to 25%. Debt to commercial banks amounts to 87% of total individuals' debt.

Figure 5.4 Individuals' debt to net national disposable income ratio



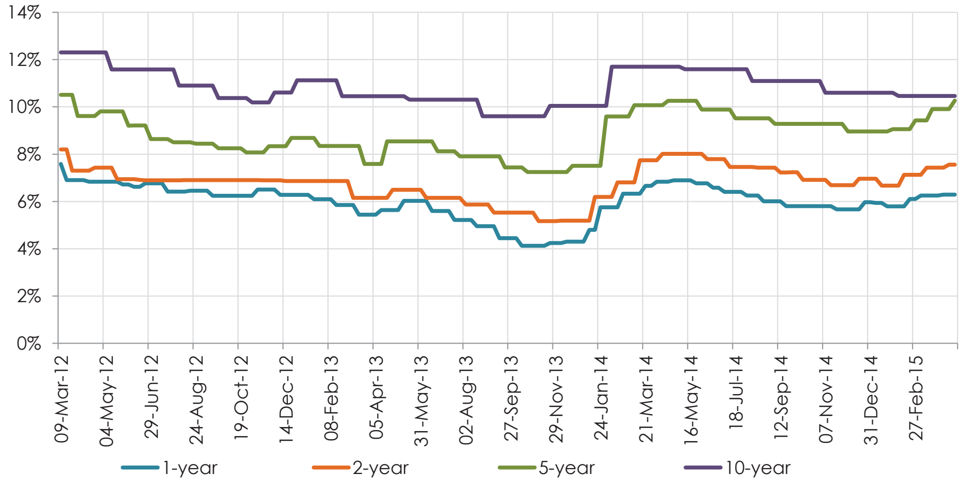
Source: National Bank of Georgia

The share of non-performing loans increased by 0.2 percentage points in the first quarter of 2015, as compared to the previous quarter, and amounted to 7.8%. According to the data from March, the share of non-performing loans in the national currency increased by 0.3 percentage points, compared to December, amounting to 5.9%; while the share of non-performing, foreign currency loans did not change and equals 8.9%. In the first quarter, the amount of loans written off amounted to 29 million GEL, which decreased non-performing loans by 0.2 percentage points.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In May 2015, the monetary policy rate increased to 5%. In the first quarter of 2015, compared to the previous quarter, interest rates increased for government securities with a maturity of less than 5 years, supposedly as a result of a rise in inflationary expectations and the beginning of exiting from the accommodative monetary policy.

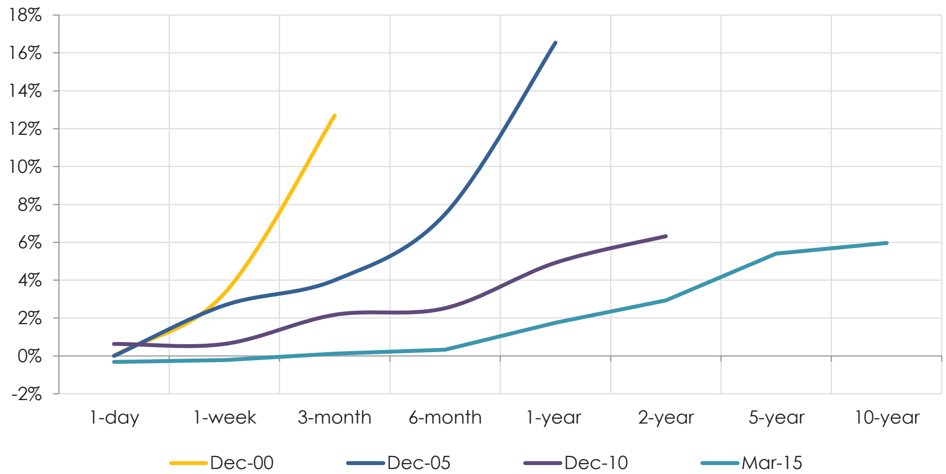
Figure 5.5 Interest Rates on Government Securities



Source: National Bank of Georgia

Inflationary expectations raised belief of an increase in the monetary policy rate and the spread between long-term assets and the monetary policy rate consequently increased. 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.

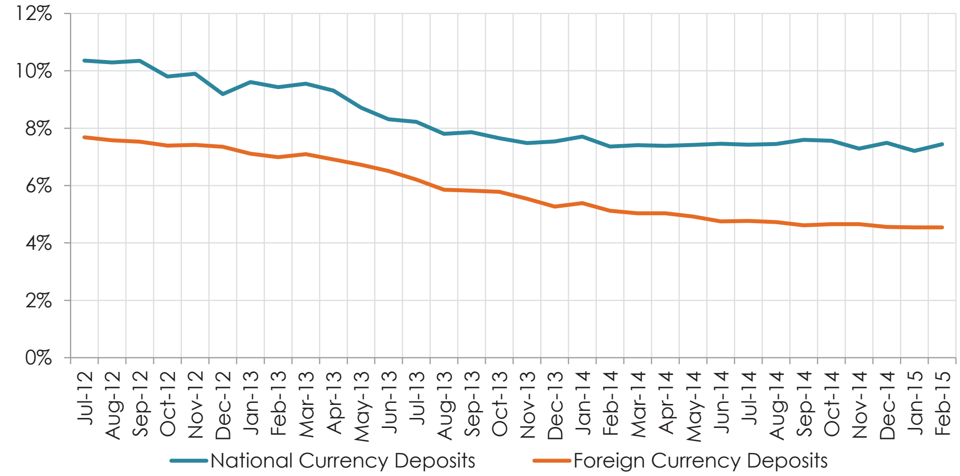
Figure 5.6 Spread between the Monetary Policy Rate and the Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on deposits in both the domestic and foreign currency did not change and amounted to 7.5% and 4.7% respectively. It should be noted that interest rates have risen on certain types of domestic currency deposits, which was caused by an increase in the monetary policy rate and decreased demand for domestic currency deposits. According to the credit conditions survey, in the next quarter the cost of foreign currency deposits is not expected to change, while the interest rate on national currency deposits might rise following the growth of domestic currency loans and weakened demand for domestic currency deposits.

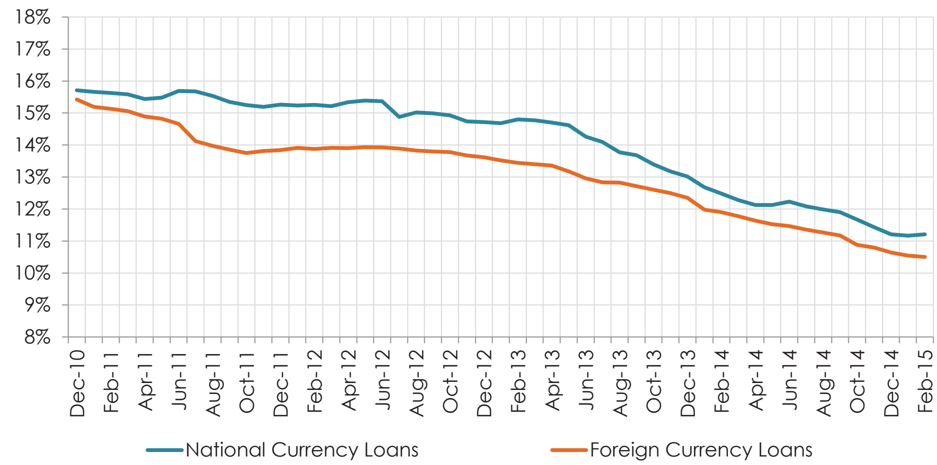
Figure 5.7 Average Interest Rates on Deposits



Source: National Bank of Georgia

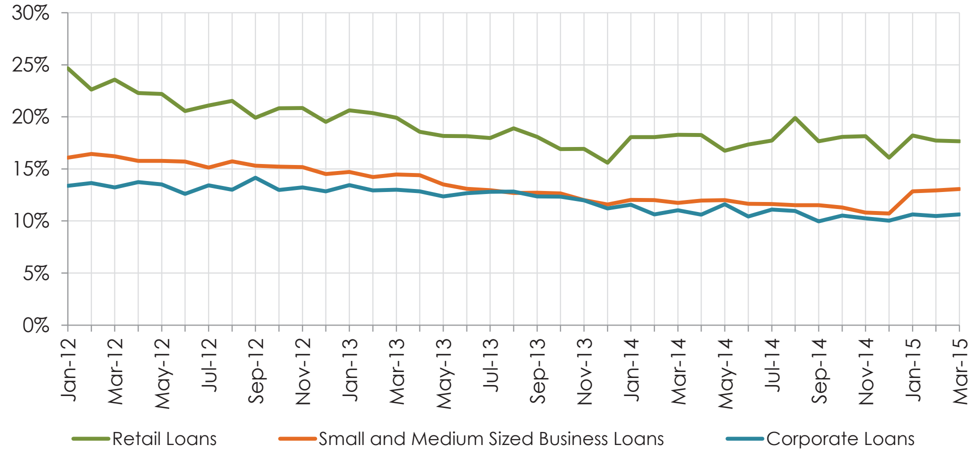
According to the credit conditions survey, in the first quarter of 2015, credit conditions tightened for individuals and legal entities. This tightening was reflected in both interest and non-interest rate conditions. The tightening of supply conditions was caused by economic trends, increased financial costs and the processes of starting to leave the accommodative monetary policy. In March, interest rates on corporate loans increased by 0.6 percentage points, compared to December, and amounted to 10.6%. Interest rates on loans to small and medium business increased by 2.3 percentage points and amounted to 13.1%; while rates on retail borrowings increased by 1.6 percentage points and amounted to 17.7%. Interest rates on business loans in both the domestic and foreign currency did not change significantly. According to the credit conditions survey, non-interest rate conditions are not expected to change in the next quarter, but interest rate conditions might increase.

Figure 5.8 Average Interest Rates on Business Loans



Source: National Bank of Georgia

Figure 5.9 Interest rate on loan flow



Source: National Bank of Georgia

Box 1 Refinancing Loans

Price stability represents the main objective of the National Bank of Georgia. The primary instrument the NBG uses to influence the price dynamics of monetary policy is the short-term interest rate.

From the operational perspective, the stability of short-term interest rates represents the main goal of central banks. Achieving this depends on the effective management of short-term liquidity by commercial banks.

The National Bank of Georgia provides/absorbs liquidity from the interbank market using its refinancing loans and other open market operations. Commercial banks place their excess liquidity in liquid assets, such as securities of the government or the national bank, which can be easily transformed into cash if needed. If there is need for additional cash in the banking system, this can be achieved on the interbank money market or by taking a refinancing loan from the NBG. Due to the many factors affecting commercial banks' demand for liquidity, the interbank money market is characterized by large fluctuations. In order for this fluctuating demand for money not to be translated into fluctuating interest rates, the demand and supply of liquidity must be well balanced. Therefore, the provision of liquidity must be adequate for the factors influencing the demand for money. The central bank can achieve stability on the interbank market by the provision of an adequate volume of refinancing loans. If the central bank cannot guarantee the provision of the volume of refinancing loans adequate for the demand of the interbank market, the demand on GEL liquidity will diminish. This will result in a depressed economy or the depreciation of the domestic currency. An effective refinancing instrument thus supports economic growth and the long-term stability of the exchange rate.

In the short run, several key factors determine the volume of the liquidity supply: government operations, cash in circulation, FX interventions, and the securities of the government and central bank.[7] Each of the above mentioned factors influence liquidity in the banking sector. For instance, the emission of securities reduces liquidity, government spending increases liquidity and government revenues (taxes) reduce liquidity. Increasing the volume of cash in circulation decreases the liquidity of the financial system and increases the volume of refinancing loans to fill the gap. All of the above mentioned elements can be characterized by excessive volatility in the short run. For example, during days when the collection of government revenues takes place (VAT, profit tax) liquidity significantly drops and this increases demand for refinancing loans. Budget expenditures are also seasonal and during times of increased expenditures the demand for refinancing decreases. During holidays, especially over New Year and Easter, the cash in circulation sharply rises, which reduces the liquid assets on hand for commercial banks and, consequently, the demand for liquidity provided via refinancing loans increases. On top of these factors, economic growth creates increased demand for cash in circulation in the long run. All other things remaining equal, this trend drives increased demand for liquidity in the financial system.

The effective operation of the refinancing instrument represents a necessary precondition for low interest rates, the long-run stability of the exchange rate, the development of the financial sector and stable long-run economic growth. Insufficient liquidity in the financial sector might lead to a severe crisis. The global financial crisis in 2008 started with a "systemic crisis of liquidity", resulting from the deteriorating quality of assets used as collateral (it was hard to assess the value of these assets).

Refinancing loans are provided in weekly auctions, in which every commercial bank can participate. The number of auction participants differs every week and the commercial banks determine the parameters of the volume of the loan and interest rates in their auction applications. The total volume of loans announced for auction is distributed among banks according to the interest rate they indicate in the auction application. Those who offer higher interest rates obtain refinancing loans first. The NBG forecasts the amount of short-term liquidity demand and supplies the appropriate volumes

7 *Detailed information on the short-term forecasting of liquidity can be found here: https://www.nbg.gov.ge/index.php?m=563*

in the weekly auctions. The forecast of liquidity is based on the above mentioned factors that influence the demand-supply balance of liquidity in the financial system.

In the event that a commercial bank is unable to satisfy its liquidity needs through the refinancing auctions, it can obtain additional refinancing via the standing facilities of the central bank in exchange for appropriate collateral. Standing facilities serve as insurance for commercial banks, raising confidence in the financial system towards refinancing instruments and enabling banks to manage their short-term liquidity more actively and efficiently.

The financial resources attracted by commercial banks will increase alongside the deepening of financial markets, and will automatically increase the financial system's demand for longer-term liquidity. To account for the above mentioned developments, the National Bank of Georgia will employ instruments for longer-term liquidity provision in future.

Since the end of 2014, demand on refinancing loans has increased. This fact is related to the reduction of liquidity in the financial system and is mainly attributed to seasonal and temporary factors. The reduction of liquidity by the end of 2014 was principally caused by the growing amount of cash in circulation. As mentioned above, the cash volume usually grows before the New Year and Easter holidays. In the second half of December, the amount of cash rose by 182 million GEL and this had an effect on the increase of refinancing loans. Additional demand for refinancing loans was fueled by the financial sector's expectations of government operations. In particular, it was expected that public entities' accounts were going to be transferred from commercial banks to a unified account of the state treasury, which would have triggered a liquidity reduction in the banking system by about 300 million GEL and caused a hike of demand for refinancing loans.

In March 2015, the demand for refinancing loans increased again. This happened mainly because of the impending profit tax payment period. In addition, the demand on refinancing loans increased at the beginning of April, before the Easter holiday period, in anticipation of the increased demand for cash.

It is frequently asked whether refinancing loans are directed at currency market speculations, thereby causing excessive fluctuations of the exchange rate. As we mentioned above, refinancing loans are a short-term liquidity tool for the banks (in other words, a bank borrows its own money that has been invested in liquid assets). It is therefore impossible to use them for currency speculations. If we closely watch the dynamics of refinancing loans and the GEL exchange rate we will not find any systematic correlations between them. For example, during a recent increase of refinancing loans the GEL exchange rate can be seen to have appreciated. On 25 December 2014, 550 million GEL of refinancing loans were issued, exceeding the previous week's amount by 40 million GEL, but the GEL nevertheless appreciated against the US dollar rising from 1.8904 to 1.8793. On the other hand, there were other recent cases in which the volume of refinancing loans shrank, but the GEL depreciated. For instance, on 8 January 2015, the amount of refinancing loans fell by 144 million GEL from the previous week, but the GEL depreciated against the US dollar falling from 1.8831 to 1.9086. A similar case happened on 12 March, when the amount of refinancing loans were lower by 166 million GEL than in the previous week, but the GEL depreciated from 2.185 to 2.1908.

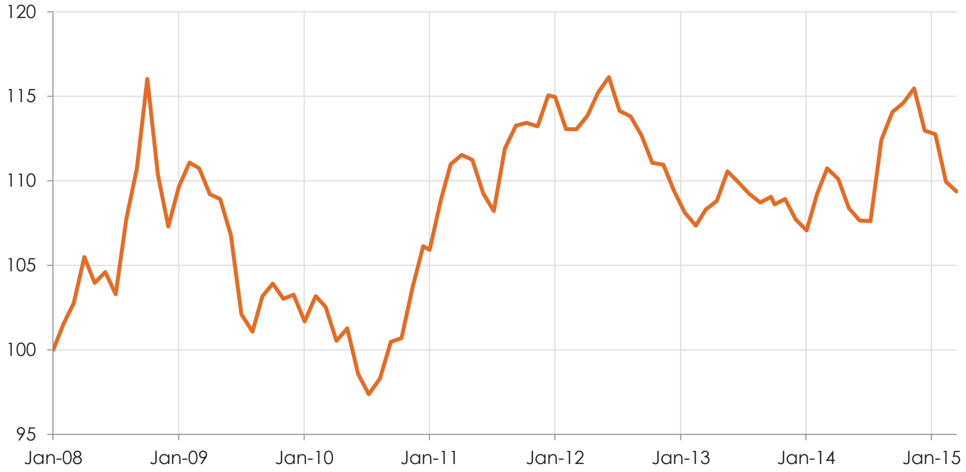
There are thus neither statistical nor economic links between the GEL exchange rate fluctuation and the volume of refinancing loans.

As explained above, refinancing loans are used for liquidity management in the financial sector – thereby addressing one of the key functions of the central bank. This liquidity management tool is used by all central banks that have an independent monetary policy, and the National Bank of Georgia is one such bank. The sophisticated system of liquidity management helps commercial banks to lend long-term loans in GEL. Due to liquidity management improvements made by the National Bank, relatively cheap long-term GEL loans are available today, which was not the case in recent years. Restrictions and/or changes in refinancing loans or other liquidity management tools will thus push the banking sector back to the period when only foreign currency loans were available – this would subsequently increase the currency risks for the population and put pressure on exchange rate devaluation.

5.3. EXCHANGE RATE

In March 2015, the lari depreciated against the USD by 16.3%, compared to December 2014, and averaged 2.19. The lari also depreciated against the euro (2.3%) and Turkish lira (2.7%), with the average rate totaling 2.38 and 0.85 respectively. In contrast, the national currency appreciated against the Ukrainian hryvnia (20.3%) and the Azerbaijani manat (12.6%); however, the lari depreciated against the Russian ruble by 6.2%. The exchange rate averaged 0.97 and 3.65, respectively. As a result, in the above-mentioned period, the nominal effective exchange rate depreciated by 1%, while it strengthened by 4.1% compared to March 2014.

Figure 5.10 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

The real effective exchange rate depreciated by 3.2% in March, compared to December 2014. It appreciated by 1.2% compared to March 2014.

Table 5.1 Effective Exchange Rate Annual Growth

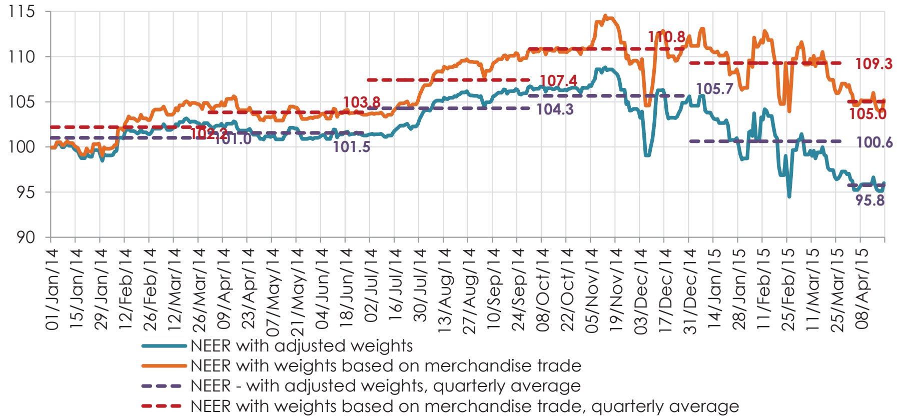
December 2014	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective Exchange Rate	4.1	-1.2	-
Turkey	-7.2	-11.5	-2.5
Eurozone	1.3	3.9	0.8
Ukraine	82.7	28.5	2.1
Armenia	-8.6	-11.3	-0.7
USA	-20.6	-18.5	-1.0
Russia	31.9	15.7	1.3
Azerbaijan	5.8	3.8	0.5
Other	-8.4	-7.0	-1.8

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, gives a slightly different picture.[8] In particular, the adjusted nominal effective exchange rate decreased annually by 1.5% in the first quarter, while it weakened by 4.8% compared to the fourth quarter of the previous year.

8 Calculation of the index for adjusted nominal effective exchange rate includes weights based on trading with only those goods and services (tourism) that are sold in the currency of a partner country. Share in trading with commodity products (oil, copper, wheat, etc.) has been given to the weight of the US dollar, because their pricing is in USD on international commodity markets.

Figure 5.11 Corrected Nominal Effective Exchange Rate



* adjustment of weights made according to trade with commodities and tourism export

Source: National Bank of Georgia

6. Domestic Demand

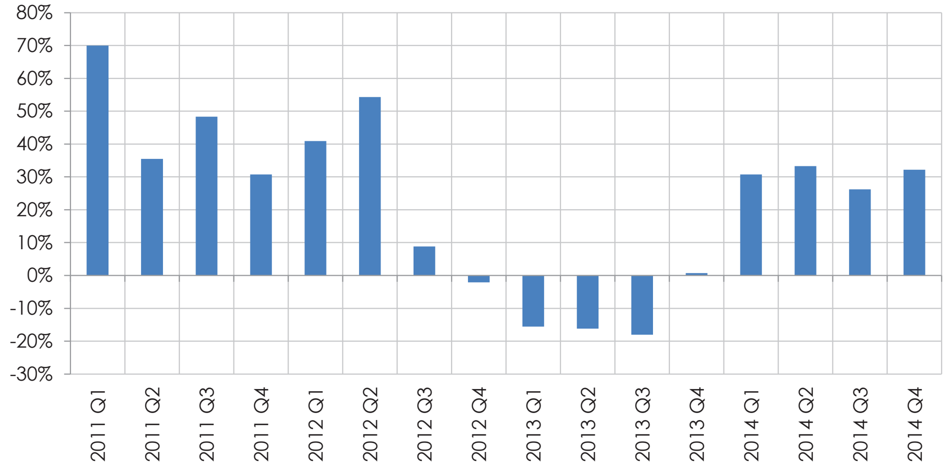
Real GDP growth amounted to 1.8% in the fourth quarter of 2014. The main factors leading towards the decreased growth rate of the economy are the slowing growth of consumption and reduced exports. The negative effect resulting from the reduction in exports was partially compensated by an increase in investments. In overall terms, the economy grew by 4.8% in 2014. According to existing forecasts, investments and consumption are expected to have a positive contribution to GDP growth in the current year, while net exports are expected to contribute negatively.

« Real GDP growth amounted to 1.8 percent in the fourth quarter of 2014.

The growth rate of capital formation was quite high (30.6%) in fourth quarter of 2014, as was the case over the whole year. As a result, as in previous quarters, investments were the main factor driving GDP growth. The high growth rate of capital formation was supported by a large increase in FDI (annual 44%). The high rate of investment growth was also partially caused by the base effect (investments increased by 0.7% annually in fourth quarter of 2013).

« The growth rate of capital formation was quite high (30.6%) in fourth quarter, as was the case over the whole year.

Figure 6.1 Annual Growth Rate of Capital Formation



Source: GeoStat

Exports of goods and services (expressed in US dollars) posted a negative annual growth rate of 13.2% in the fourth quarter, while imports increased by 0.4%. The negative growth rate of exports was determined by a reduction in external demand (from the main trading partner countries). The decrease of external demand was caused by a depreciation of the national currencies of our partner countries against the US dollar and the slowing of economic growth in both our region (Turkey, Armenia) and in the EU. Besides, the Russian-Ukrainian conflict has had an additional negative effect on exports. As a result, the negative contribution to annual GDP growth from net exports increased in the fourth quarter.

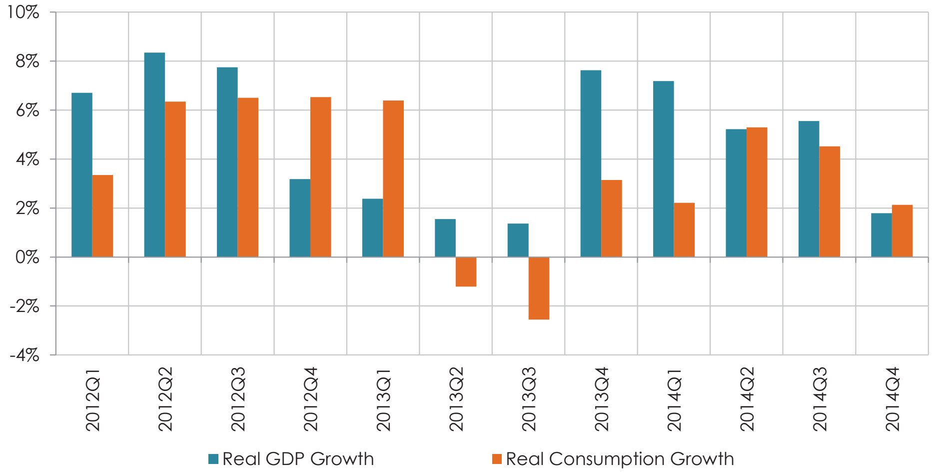
« The negative contribution to annual GDP growth from net exports increased in the fourth quarter.

The growth rate of real private consumption[9] decreased in the last quarter of 2014 and posted 2.1%. Although this figure is smaller than in previous quarters, the seasonally adjusted data does not indicate a weakening of domestic demand. It also should be noted that the high growth observed in the second and third quarters is partially caused by the base effect.

« The growth rate of real private consumption decreased in the last quarter of 2014 and posted 2.1 percent.

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

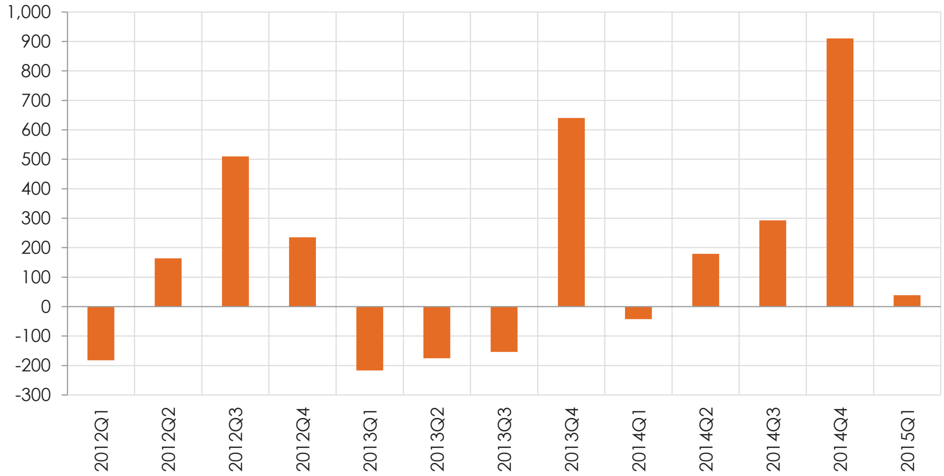
Figure 6.2 Real GDP and Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget surplus posted 12.7 million GEL in the first quarter of 2015. Due to seasonality during the year, the first quarter generally has a budget surplus (rarely a small deficit). In 2015, the consolidated budget has a planned deficit of 980 million GEL. Therefore, the forthcoming quarters of the current year are expected to have a negative budget balance.

Figure 6.3 Consolidated budget deficit (million GEL)



Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

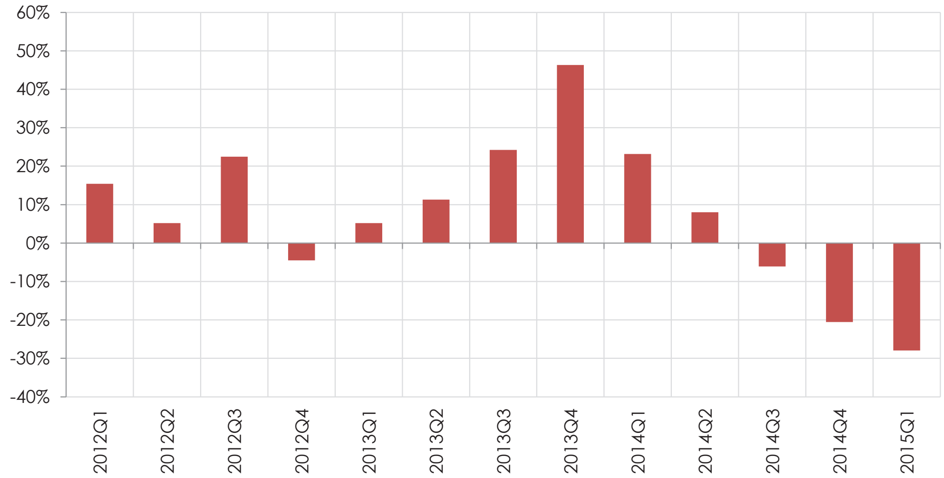
The current account (CA) deficit to GDP ratio increased by 4.3 percentage points over the previous year and reached 13.8% in the fourth quarter of 2014. In absolute terms, the CA deficit widened by 192 million USD to reach 626.7 million USD in the fourth quarter of 2014. According to preliminary estimates, in the first quarter of 2015 the CA deficit to GDP ratio reached 14.9%, which exceeds the same indicator from the previous year by 4.4 percentage points.

‹‹ The current account deficit to GDP ratio increased by 4.3 percentage points over the year earlier and reached 13.8% in the fourth quarter of 2014.

As was the case in previous periods, the trade deficit continued to widen in the first quarter of 2015, which was the main cause of the deepening current account deficit in this period. Alongside the increased trade deficit, transfers from abroad (secondary income) and services export receipts also declined on an annual basis, which further widened the CA deficit.

External demand significantly deteriorated in the first quarter of 2015, which had a negative influence on Georgian exports. Registered exports of goods declined by 28% over the period, or by 194.5 million USD in absolute terms.

Figure 7.1 Annual Growth Rate of Registered Exports of Goods



Source: GeoStat

The change in exports of goods was uneven across different destinations in the first quarter of 2015. Exports to the EU increased by 19.2% year on year, while exports to CIS countries dropped by 55.3% over the same period. Exports declined to other countries by some 2.8%. The most dramatic decline in exports among CIS countries was registered to Azerbaijan (-56%), Armenia (-55%), Russia (-60%), Ukraine (-75%) and Kazakhstan (-59%). The decline of exports of goods to other countries was chiefly driven by falling exports to Turkey (-20%) and the USA (-39%), at the same time exports sharply increased to China (+144%), mainly on the back of re-exports.

An analysis of export growth across different products shows that the export of wines (-67%), other spirits (-59%), mineral waters (-34%) and fertilizers (-47%) had the sharpest year-on-year declines in the first quarter of 2015. At the same time, the re-export of cars also fell sharply (-62%). The decline of exports of the above-mentioned goods was partially balanced by an increase in the exports of nuts (+139%) and medicaments (+84%); re-exports of copper concentrates were also up by 19%.

The main reasons behind declining exports in the first quarter of 2015 were the Russia-Ukraine conflict, the economic slowdown in the region and a sharp depreciation of regional currencies. These regional crises coincided with tightening restrictions on car imports in Armenia and Azerbaijan, which further heightened the negative pressure on Georgian exports. Observing the latest trend of the stabilization of regional currencies, it can be concluded that the rate of export reductions have reached its maximum and, given current developments, the decline of exports is not expected to accelerate any further. On top of that, starting from the second quarter of 2015 the rate of the decline of car re-exports should be lower as a result of the base effect.

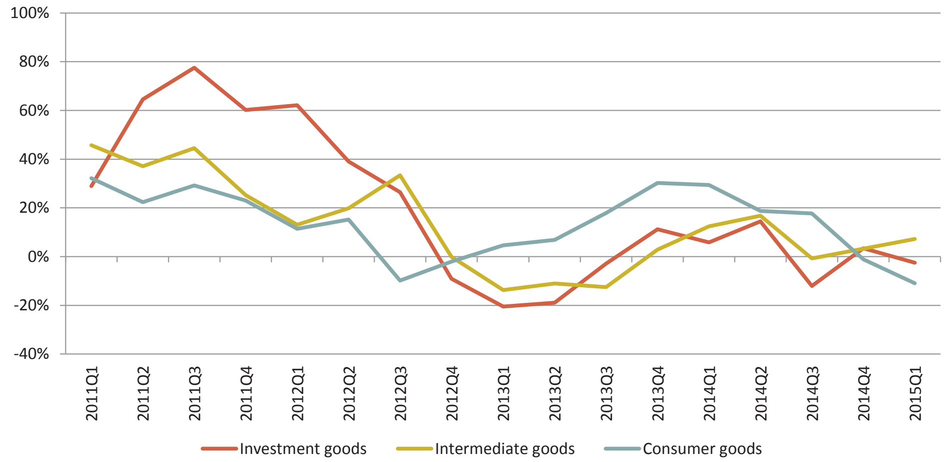
‹‹ The rate of export reduction reached its maximum and, given current developments, the export decline is not expected to accelerate any further.

In the first quarter of 2015, registered imports of goods declined by 3.4% year on year. A 33% decline of imports of petroleum products was the main source behind the total reduction of registered imports of goods. The reduction of imports of miscellaneous electronic equipment also played an important role in the overall reduction of imports. Cars remained the top import product, despite a 3% year-on-year reduction in the first quarter of 2015. Weak internal demand and reduced demand on re-exports creates the conditions for a further reduction of goods imports in the upcoming periods.

‹‹ Weak internal demand and declined demand on re-exports creates the conditions for a further reduction of goods imports in upcoming periods.

The decomposition of imports across different categories of products indicates that the import decline was chiefly driven by consumer goods (-11%). The import of investment goods also fell (by 3%), however the contribution of these types of goods to the overall reduction of imports was minimal. On the other hand, imports of intermediate goods were up by 7% year on year in the first quarter of 2015.

Figure 7.2 Annual Growth Rate of Imports Across the Product Groups

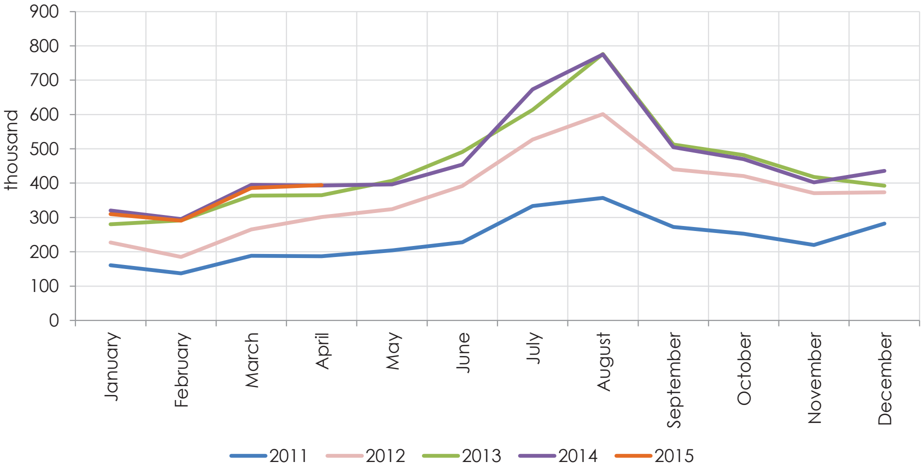


Source: GeoStat

The regional crises negatively affected the amount of remittances coming into Georgia. In the first quarter of 2015, money transfers were reduced by 22.8% on an annual basis to 250 million USD. This decline was mainly a result of a 43.7% annual decline of transfers from Russia, but transfers were also down from Greece (-17.9%), Italy (-9.5%) and Ukraine (-47.1%). Overall money transfers from CIS countries declined by 41.1% and those from EU countries fell by 11.3%. In the first quarter of 2015, money transfers increased from the US and Turkey by 27.7% and 30.5% respectively.

The number of incoming visitors to Georgia declined in the first quarter of 2015 by 2.4% compared to a year earlier. Over the same period, the number of incoming visitors also declined from Turkey (-9.8%), Ukraine (-12.5%) and Russia (-4.5%).

Figure 7.3 Number of incoming visitors to Georgia



Source: GNTA

In the fourth quarter of 2014, the CA deficit was mainly financed by other investments and foreign direct investments (FDI). Inflows of other investments reached 326.7 million USD, which is 181.2 million USD higher than the same indicator from the previous year. Other investments increased mainly due to increased long-term public debt. FDI also played an important role in financing the CA deficit. In the fourth quarter of 2014, FDI in Georgia increased by 49.2% and reached 349.2 million USD.

Box 2 Causes of the Reduction of External Revenues

Recent developments at both the global and regional level have been challenging for the Georgian economy, which, as a small open economy, is quite vulnerable to external shocks. These events created an unfavorable background that adversely affected the economy in terms of a sharp decrease in external revenues. The main reasons behind this are as follows:

- In 2014 and the beginning of 2015, in line with positive economic trends and expectations in the United States, the US dollar began to appreciate. In addition, the announcement made by the Federal Reserve about the decision to complete the tapering that was started in 2013, further strengthened the position of the dollar. As a result of this, most of the world's currencies faced significant depreciation.
- In January 2015, the European Central Bank (ECB) announced the beginning of a quantitative easing program. The ECB will use this program to buy up private, and sovereign bonds each month until at least September 2016. This step put additional pressure on the already depreciated euro.
- At the regional level, geopolitical risks were identified in the first half of 2014. The subsequent realization of those risks put negative pressure on the economic trends in the main trading partner countries. The conflict between Russia and Ukraine and the economic sanctions imposed on the former had a drastic effect on their economies. It is also worth noting that the current crisis in Russia has had a contagious effect on other countries in the region, including Armenia and Azerbaijan – both major trading partners of Georgia.
- The sharp decline in oil prices in international markets last year also negatively affected the economic prospects of Russia and Azerbaijan.

The abovementioned factors led to a significant reduction in goods and services exports – and in Georgian tourism revenues in particular. Moreover, a decline was observed in money transfers, which constitute an important source of income for Georgian citizens.

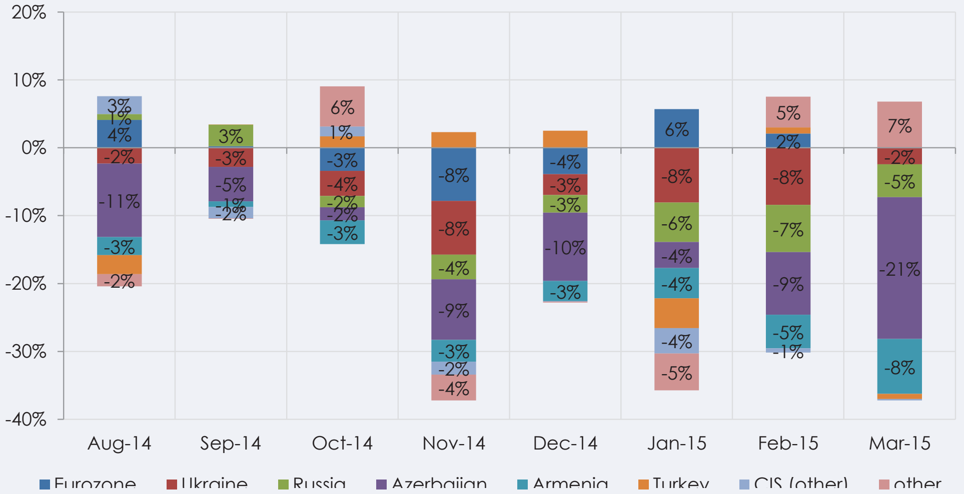
The decline of export revenues started in August 2014 and reached the maximum level of 35% in November. Exports continued to fall over the following months, but did so at a relatively slower pace in the range of 20-30%.

A sharp drop in sales to Azerbaijan, Armenia, Ukraine and Russia made the greatest contribution to the decline of export revenues in Georgia.

External sales to Azerbaijan have been characterized by a decreasing trend since April 2014. The reason for this was new Azerbaijani regulations concerning the import of vehicles. In addition, the significantly lower oil prices on international markets has negatively affected Azerbaijan's import capacity. As a result, the re-export of vehicles in Azerbaijan decreased by almost 70% annually by the end of the first quarter of 2015, while the reduction in total exports amounted to 56%. A decline in the re-exports of motor vehicles resulted in a decrease of total export revenues from Armenia as well. Re-exports of cars and trucks to Armenia worsened by 80% annually by the end of the first quarter of 2015. The decline in total exports to Armenia totaled 55%. As noted above, the contraction of exports to Ukraine was also very important. The ongoing military conflict in the country's industrial eastern parts has had a severe impact on the Ukrainian economy. Real output dropped by 6.8%, while the local currency depreciated significantly against all major trading partners. Accordingly, exports to Ukraine fell at a high pace throughout 2014. Reducing trends were observed for almost all export products and the rate of decline reached 30% over the year. A further sharp reduction was observed over the first three months of 2015, with sales to Ukraine dropping by 70% on average and totaling only 4 million USD in March. As for the Russian market, a decline of exports in natural wines, mineral waters and agricultural products was recorded – all of which had exhibited significant growth in previous periods. According to the data, the annual decline of exports amounted to 60% by the end of first quarter of 2015, making a significant contribution to the reduction of total export revenues of Georgia.

Regional economic and political events were thus fully reflected on Georgia's exports. However, as the revenues from all main export markets have hit bottom, it is very unlikely that there will be any further decline.

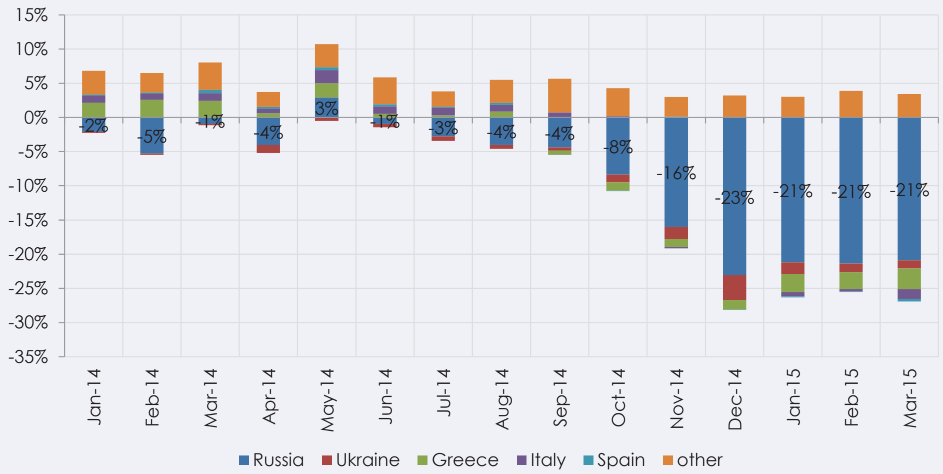
Figure 7.4 Annual export growth rate by destination country



Source: Geostat

The reduction of money transfers started in October 2014, but the growth rate had already slowed to 0.5% during the summer of that year. In November-December, a significant contraction took place that continued over the first quarter of 2015, when money transfers decreased by 22% on average. The main reason for this downturn was a sharp decline of remittances from Russia, the largest source country. Russia's share of total money transfers, which exceeded 50% in recent years, has been reduced to 35%. Transfers from Russia decreased gradually over 2014 and the annual loss in money transfers from Russia amounted to 11.5%. During the last months of 2014 and the beginning of 2015, the rate of decline increased further and exceeded 40%, which contributed more than 20% to the overall reduction in total remittances inflow. At the same time, money transfers from Ukraine fell at an even greater pace. The funds coming from Ukraine decreased by 32% in 2014 and in the last months of the year the rate of reduction reached 60%. Since the beginning of 2015, the reduction of remittances from Ukraine has slowed down to an average rate of 45%

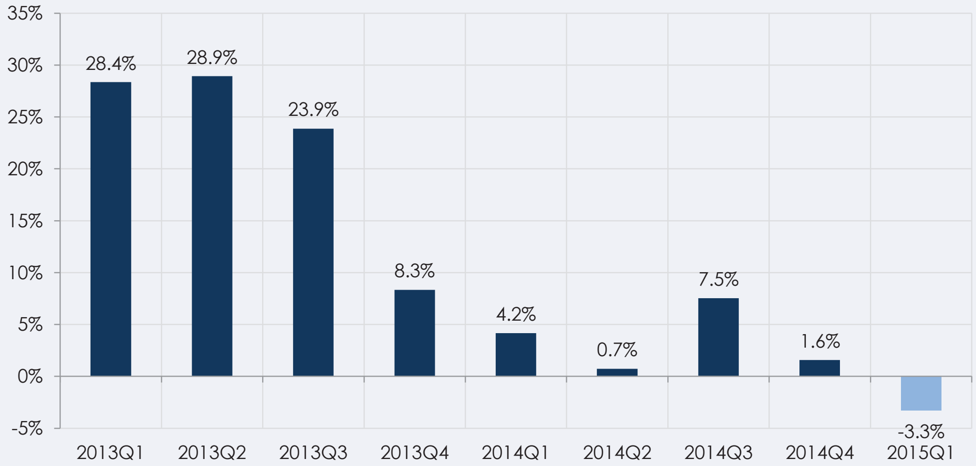
Figure 7.5 Money transfers annual growth rate by country



Source: National Bank of Georgia

As for Europe, money transfers did not decline until late autumn. However, after that point remittances from countries such as Greece, Italy and Spain, which have the largest share in this segment, started to fall. This pattern has continued in 2015. However, against an overall decline, the dynamics of remittances from the United States and Turkey have been characterized by a significant increasing trend.

Figure 7.6 Tourism revenues, annual growth rate



Source: National Bank of Georgia

The analysis provided above shows that the negative impact of external shocks was fully reflected on the Georgian economy through different channels. In the absence of additional shocks, a further decline in revenues is not expected.

8. Output and Labour Market

8.1 OUTPUT

In the fourth quarter of 2014, GDP growth significantly slowed to 1.8%. In 2014, GDP grew by 4.8% in total. The slowing of growth in the fourth quarter was mainly related to worsened external factors, weakened external demand due to the deterioration of the economic situation in Georgia's main trading partners and the base effect (GDP growth was 7.6% in the fourth quarter of 2013).

Services made the largest contribution to growth (2%). Agriculture contributed 0.2% and the industrial sector made a negative (-0.4%) contribution.

‹‹ Growth was mainly a result of the services sector.

In the fourth quarter of 2014, the additional momentum provided by the National Bank's loose monetary policy over the year was mostly picked up by the services sector. The volume of lending for real estate purchases and refurbishments from the banks especially hiked in the fourth quarter. That was clearly beneficial for the real estate sector, which grew by 13.7% and contributed 0.7% to total GDP growth – more than any other branch of the economy. Trade, which is the largest branch, significantly slowed to grow by 1.8%, contributing 0.3% to total growth. The financial intermediation sector grew by 8.7% and made a 0.2% contribution to total growth. Due to the deceleration of imports and declining numbers of foreign visitors, transport rose only by 0.4% and the output of hotels and restaurants increased by 6.5% (making a 0.1% contribution to total growth).

‹‹ The reduction of economic growth is mainly related to the industrial branches.

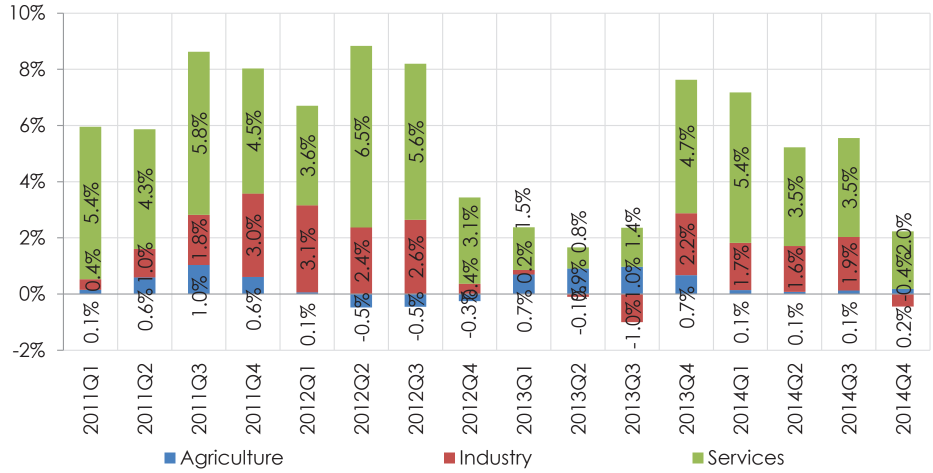
The reduction of economic growth is mainly related to the industrial branches. After several years of sharply rising, which was a result of increased demand from existing external markets, as well as penetration into new markets, manufacturing declined substantially. Despite contracted exports, production of mineral waters, soft drinks and alcoholic beverages have not diminished. However, the manufacture of electrical, optical and transport equipment and the manufacture of machinery all dramatically declined (a nominal reduction of 34%). The manufacture of basic metals and fabricated metal products also declined by a nominal 6.7%. Largely as a result of the reduction of these fields, total manufacturing declined by 6.7% and contributed negatively (-0.6%) to GDP growth. After high growth throughout the year, the growth also of the construction sector also slowed (which had 3.1% growth, making a 0.2% contribution to total growth). Both the public and private construction sectors have shown nearly equal degrees of deceleration.

Agriculture grew by a modest 1.5% in 2014. Plant and livestock production made a nearly equal contribution to that growth. However, it should be noted that even years are less productive and 2014 was the first year since 1998 that agriculture grew.

‹‹ Economic activity slightly recovered in the second half of the first quarter.

The negative tendencies that emerged in the fourth quarter of 2014 as a result of difficult external conditions continued in the first quarter of 2015. However, economic activity slightly recovered in the second half of the first quarter. According to preliminary estimates, first quarter growth will be 2.5%.

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 decreased in the fourth quarter of 2014 as compared to the previous quarter. Labor force productivity declined by 0.4% in year-on-year terms, which is 2.5 percentage points lower than in the previous quarter. During this period, labor efficiency increased in the agriculture sector. According to the data, the annual growth rate of real value added per employee in the agriculture sector amounted to 3.3%, which is 4.6 percentage points more than in the previous quarter. Unlike the second quarter, labor productivity in the industrial sectors decreased, amounting to an annual 9.3%. As for the service sector, the real value added per employee declined, but did so at a slower pace.

« Labor productivity declined by 0.4% during the fourth quarter of 2014. This decrease can be largely attributed to the industrial sector.

Table 8.1 Index of Value Added Produced per Worker in 4th 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	103.3
Industrial sectors	90.7
Service sector	99.2
Overall in the economy	99.6

Source: GeoStat and National Bank of Georgia

As the sectorial breakdown of the economy shows, labor productivity in manufacturing declined with the annual growth rate reaching 6.6%. At the same time, an annual drop of 9.6% was observed in the construction sector. It is worth noting that labor productivity decreased by 3.6% in the trade sector. On the contrary, an increase was exhibited in the hotels and restaurants and financial intermediation sectors.

« Labor productivity in manufacturing declined. The same was observed in the trade sector.

The annual growth rate of the nominal salaries of employees amounted to 8.5% during the fourth quarter of 2014, which is 2.1 percentage points more than in the previous quarter. According to the latest data, the average monthly nominal salary stood at 950 GEL.

« The nominal salaries of employees increased by 8.5% on an annual basis.

In terms of sector analysis, an annual growth of salaries was evident in the mining and quarrying, construction, trade and manufacturing sectors. However, average salaries decreased in the agriculture sector during the fourth quarter of 2014.

Table 8.2 Index of Average Monthly Nominal Wage of Employees in 4th quarter of 2014 Relative to the Corresponding Period of the Previous Year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	96.3
Fishing	70.1
Mining and quarrying	110.6
Manufacturing	103.4
Production and distribution of electricity, gas and water	110.7
Construction	114.7
Wholesale and retail trade; repair of motor vehicles and personal and household goods	106.8
Hotels and restaurants	113.1
Transport and communications	104.7
Financial intermediation	101.9
Real estate, renting and business activities	114.8

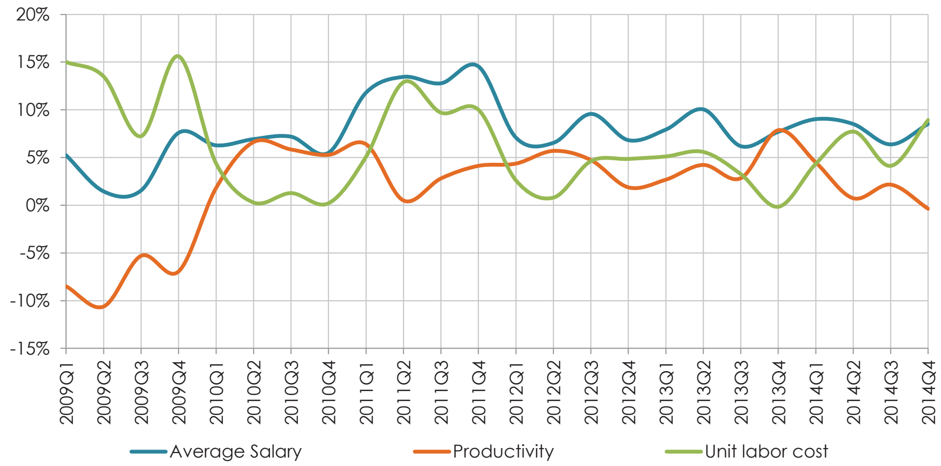
	Average nominal wage (growth index)
Public administration	114.3
Education	106.8
Healthcare and social work	109.1
Other community, social and personal service activities	105.2
Overall in the economy	108.5

Source: GeoStat

To sum up , against the backdrop of declining labor productivity, the annual growth rate of unit labor cost[10] (personnel expense per production unit) increased and stood at 8.9% by the end of the fourth quarter of 2014 (see Figure 8.2). Despite this surge, the growth rate of unit labor cost is not high enough to reflect a risk of a significant rise in inflation.

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

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



Source: GeoStat and National Bank of Georgia

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

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