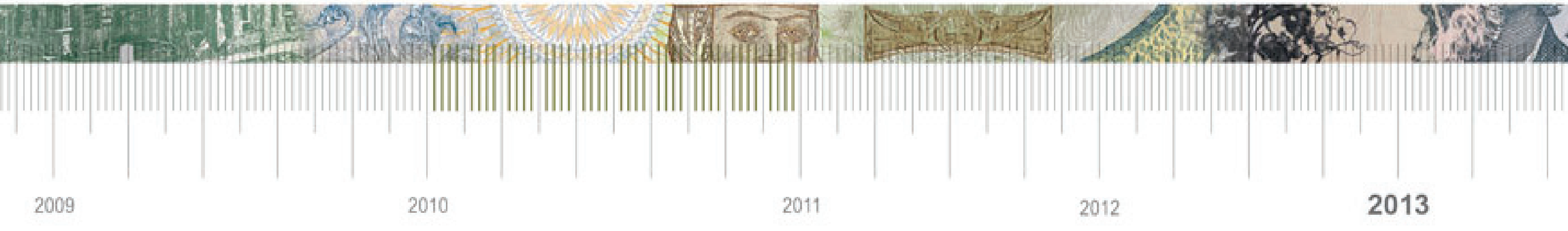
National Bank
of Georgia

INFLATION REPORT

August

2015



ISSN 1512-0767

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.

CONTENTS

TABLES

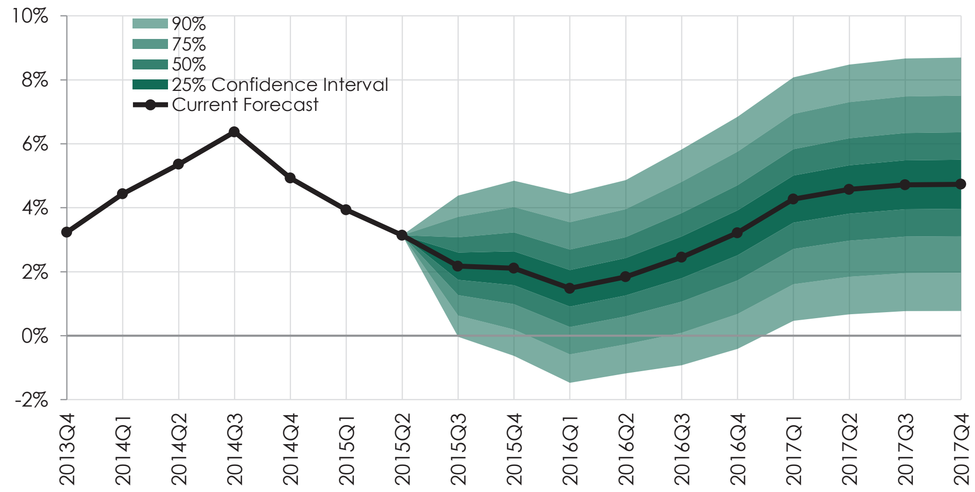
1. BRIEF OVERVIEW

The Georgian economy was under strong pressure from **external shocks** in the second quarter of 2015. In particular, economic activity declined and inflation accelerated, which reflects the temporary upward pressure on inflation from loan dollarization and the lari exchange rate depreciation against the US dollar. The increased debt service burden on foreign currency loans puts pressure on aggregate demand, while also placing upward pressure on prices from the supply side. A positive trend was seen in the process of reducing external imbalances, which was mainly supported by exchange rate depreciation and serves as an absorber of foreign shocks. In terms of structural policy, it is important to actively support economic education, which will be targeted at emphasizing the necessity of foreign exchange hedging and reducing the unnecessary dependence the pricing of goods and services has on the lari exchange rate with the US dollar (particularly in sectors such as real estate and maintenance). Doing so would reduce the vulnerability of the economy to exchange rate fluctuations.

Real economic growth in the second quarter, according to preliminary data, was around 2.1% on an annual basis, while it averaged 2.6% in the first half of 2015. The slowdown in the GDP growth rate was mostly a consequence of a fall in exports of goods and services. However, domestic demand has also been weak, reflecting the decline in remittances and the increased debt service burden on foreign currency loans.

The economic growth forecast for 2015 remains around 2% (see Figure 1.1). The main impediment for economic growth will be the foreign sector, which, given the backdrop of the tense economic situation in the region, has a negative influence on exports of goods and services, remittances and foreign investment inflows. Against this, it is expected that a reduction of imports will offset the fall in foreign demand; thereby reducing the negative contribution of net exports to GDP growth. As a result of stable monetary policy, lending will encourage investment and consumption. While an increase in government capital expenditures should help economic activity. In addition, the depreciated exchange rate helps the adjustment process to external imbalances and increases the competitiveness of domestic producers.

Figure 1.1 Real GDP Annual Growth (Annual Growth of Last Four Quarters)

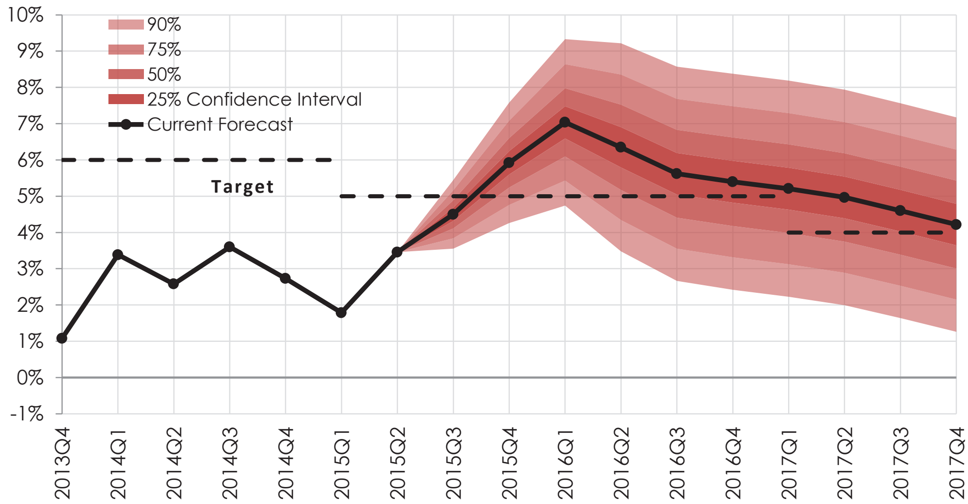


Source: National Bank of Georgia

Annual inflation in the second quarter was higher than expected. The annual change in consumer prices posted 4.9% in July and stayed close to the 5% inflation target of the National Bank of Georgia. The main factor contributing to higher inflation in the second quarter was the higher intermediate costs of firms, which, in turn, was a result of the increased debt service burden on foreign currency loans. In addition, the depreciation of the lari exchange rate has translated into higher prices of imported durable goods, which also contributed to higher consumer prices. On the other hand, the increase in inflation has been dampened by weak aggregate demand and lower food and oil prices on international markets.

According to the forecast, inflation will increase and slightly overshoot the 5% target by the end of 2015 (see Figure 1.2). Both domestic and imported inflation will follow qualitatively similar patterns in the forecast horizon. According to the forecast, the main source of higher inflation will be the supply side. Against this, downward pressure on inflation comes from weak demand and low global prices of food and oil. According to these projections, inflation will peak in the first quarter of 2016 and will then start a downward trend, closing on the target by the end of 2016. It is worth noting that while inflation in the short and medium term is determined by several factors, in the long term it is a monetary phenomenon. Therefore, it is the independent National Bank that serves as the guarantee of price stability in Georgia in the long-term. Price stability, in turn, implies the strengthening of the lari exchange rate in the long-term. Therefore, any move that negatively affects the credibility of the central bank will also affect the foreign exchange market, in both the long and short term.

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 risks to the forecast come from the foreign sector. The possible worsening of the adverse conditions in the region or a stronger-than-expected transmission of these to the Georgian economy represent major risks. An important assumption made by the forecast is that the negative spillovers from the external sector will not deteriorate further. On the other hand, more foreign investments than expected and large-scale infrastructure projects represent positive risks for the forecast.

The Monetary Policy Committee decided to raise the refinancing rate by 50 basis points to 6% at their meeting of 12 August 2015. Based on existing economic conditions, macroeconomic forecasts and related risks, the National Bank of Georgia continues normalizing its monetary policy. Despite the increase of the refinancing rate, one should not expect a contractionary effect from the policy rate, since the normalization is gradual and appropriate to higher inflation expectations. Further monetary policy moves will also be gradual and their pace will depend on the expected dynamics of the inflation rate, the factors influencing it and economic activity in general. Unless new shocks affecting the economy emerge, the forecast implies that the policy rate will reach its neutral level of 6.5% by the end of 2015, and it will be around 7% in 2016.

2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

The geopolitical and economic situation in the region has remained volatile, which has adversely affected the Georgian economy. Ukraine continued to face a range of problems, including the ongoing conflict in the industrial eastern part of the country, fiscal complications and reduced private consumption. The geopolitical crisis has severely affected Russia as well, where the influence of economic sanctions and the falling international price of oil has resulted in the deterioration of business sentiment. This was accompanied by soaring inflation and interest rates, which had a negative impact on private consumption. Reduced revenues from oil and gas sales have also weakened the economic growth of Azerbaijan and Kazakhstan, energy exporter countries in the region. Amid falling remittances and reduced export demand from Russia, aggregate demand decreased in Armenia, which was followed by inflationary pressure coming from currency devaluation. Turkey's economic growth slowed, mainly due to political instability and tough macro prudential measures. Despite the uncertainty associated with Greece, the eurozone economy has clearly showed signs of recovery, accompanied by a positive trend in inflation. After a weak first quarter resulting from harsh climatic conditions, the US economy recently regained momentum, with improvements in employment, construction sector activity and consumer sentiment.

The economic prospects of Georgia's main regional trading partners remain discouraging. The decline of the international price of oil, the armed conflict in eastern Ukraine and the economic sanctions imposed on Russia have all had a negative impact on the economies of the region, including Georgia. Under the conditions of foreign shocks, exports and remittances remain reduced. In addition, tourism revenues are weak, which reduces foreign exchange inflows.

Russia's long standing dependence on its oil and gas reserves has left other sectors of its economy at lower stages of development. The non-oil sectors might have been an alternative source for growth amid falling energy prices. Large-scale annual reductions were observed in Russia's manufacturing and construction sectors, resulting in a significant drop in private income and consumption. The imposed sanctions have elevated capital outflows and negatively affected business sentiment. In addition, Russian consumer confidence is deteriorating, which is a result of inflation following the ruble's depreciation, amongst other factors. Following active intervention from the central bank, price growth weakened slightly to 16% year on year. It is expected that Russia's GDP will decrease by 3.4% in 2015, while only growing by 0.2% in 2016.[1]

The slowdown in Russia has had a contagious effect on the Armenian economy, which heavily depends on remittances and export demand. In the first half of the year, retail sales significantly decreased in Armenia due to falling revenues and soaring inflation (5.5% year on year in June) following the depreciation of the dram. The IMF estimates that in 2015 Armenia's GDP will shrink by 1%.[2]

The extensive financing of an international sporting event (the First European Games) in Azerbaijan boosted the construction and other non-oil sectors, but the reduced price on oil had a negative impact on export revenues and the current account, while the devalued manat threatens the stability of the heavily dollarized financial system.[3] Inflation in May posted 3.4%. According to the IMF's latest forecasts, in 2015 Azerbaijan's GDP growth will reach only 0.6%.[4]

Ukraine's economy is in recession. This is a result of the armed conflict in the industrial eastern part of the country, fiscal complications, and the deterioration of consumer and business sentiment followed by the depreciation of the hryvnia. Un-

1 *World Economic Outlook (WEO) Update, July 2015.*

2 *World Economic Outlook (WEO), April 2015.*

3 *Moody's Global Credit Research, 29 Jun 2015 https://www.moodys.com/research/Moodys-Outlook-changes-to-negative-for-Azerbaijans-banking-system--PR_329088.*

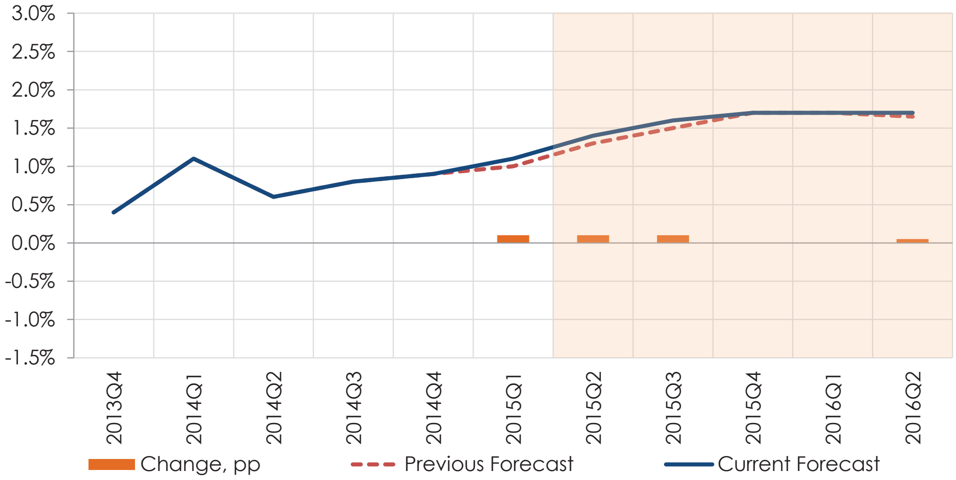
4 *World Economic Outlook (WEO), April 2015.*

der these circumstances, Ukraine's GDP will fall by about 5.5% in 2015; however, economic activity will become relatively stable owing to planned structural reforms and infrastructure projects. The IMF predicts that Ukraine will recover from recession in 2016 with total output growth hitting 2%.[5]

Due to political instability and tough macro prudential measures, Turkey's economic growth slowed, and the weak lira translated into an annual 8% increase in prices. On the other hand, the lira's depreciation contributed to export growth, and high public spending largely compensated for weak private demand. It should also be noted that post-election uncertainty has been damaging business sentiment and uneven capital inflows have complicated current account financing. With this in mind, the World Bank's 2015 GDP growth forecast for Turkey is 3%, while for 2016 it is 3.5%.[6]

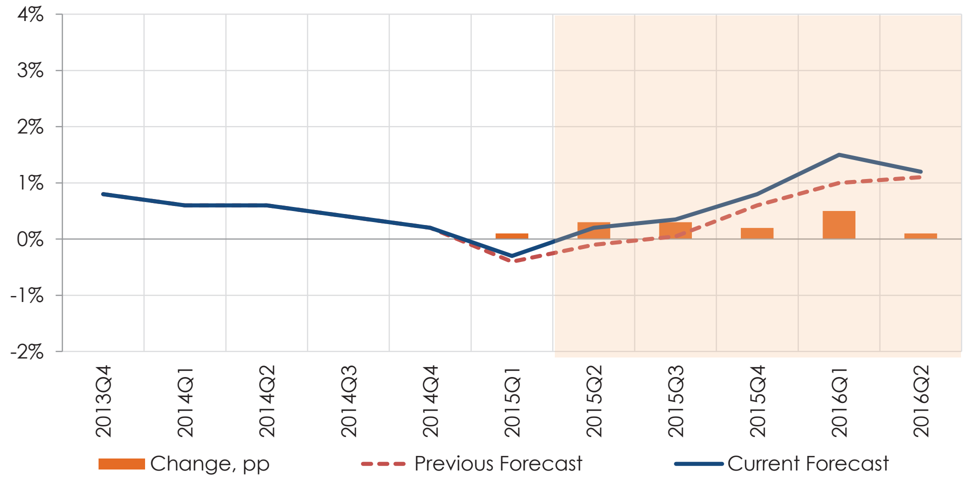
Data from the second quarter suggest that the recovery in the eurozone has continued in spite of the uncertainty surrounding Greece. Consumer and business sentiment is improving, which has been reflected in retail sales and investment growth. As of July, the final agreement between the Greek government and its creditors[7] had not yet been achieved, however, on 22 July the Greek Parliament supported a package of reforms, including the privatization of state assets, optimization of the pension and VAT administration system, and cutting expenditures. This step makes it possible for another three-year aid program to be agreed by the end of August, which will allow the Greek government to repay its existing debt to the European Central Bank and also use the funds for its long-term needs. The success of the agreement is expected to significantly reduce the risk of Greece leaving the eurozone and thus positively affect financial market confidence. The International Monetary Fund expects the eurozone economy to grow by 1.5% and 1.7% in 2015 and 2016 respectively.[8]

Figure 2.1 Eurozone Real GDP Annual Growth



Source: World Economic Outlook (WEO) Update, July 2015. Bloomberg Indices.

Figure 2.2 Eurozone CPI Annual Inflation



Source: World Economic Outlook (WEO) Update, July 2015. Bloomberg Indices.

5 *World Economic Outlook (WEO), April 2015.*

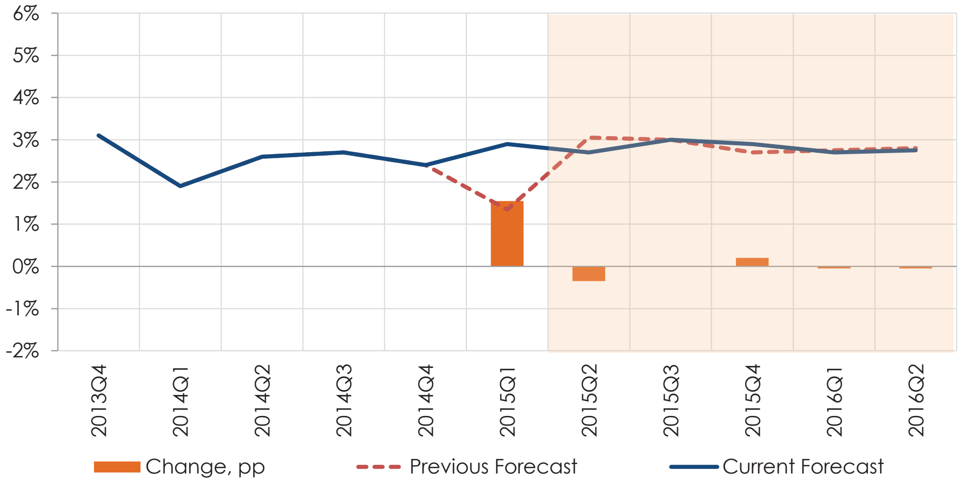
6 *Turkey Regular Economic Note (World Bank Group), July 2015.*

7 *The main creditors include the International Monetary Fund, the European Central Bank and eurozone countries through the European Stability Mechanism (ESM).*

8 *World Economic Outlook (WEO) Update, July 2015.*

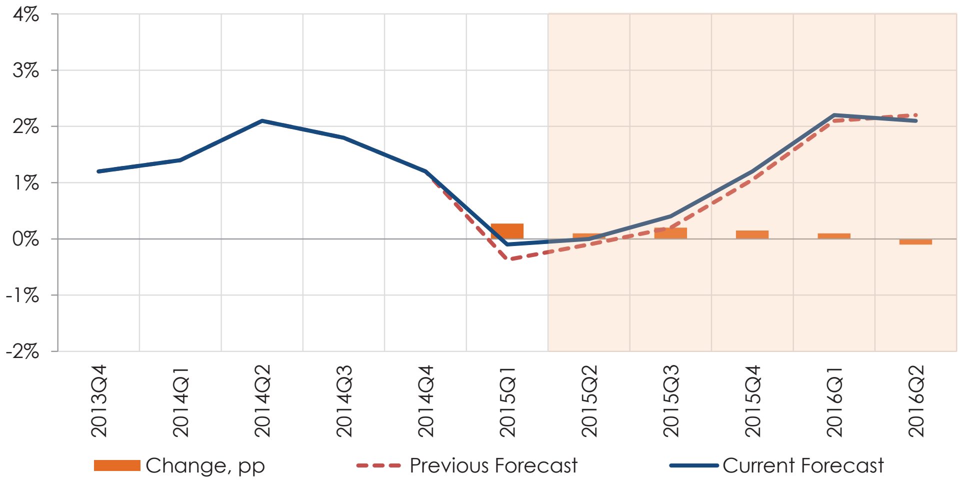
Although the recovery of the US economy seems irreversible, the beginning of 2015 was marked by weak economic activity, as was the case in the previous year. Reduced oil prices cut investments in the energy sector, which was followed by unusually harsh weather conditions and weaker exports (exports fell due to the strengthening of the US dollar, international cargo traffic delays and slower growth in trading partners). Nevertheless, private consumption in the second quarter improved significantly. This was underpinned by solid growth in the real estate and labor markets and favorable credit conditions. It is expected that these circumstances will play a leading role in the growth of economic activity. The International Monetary Fund predicts that the US economy will expand by 2.5% and 3.0% in 2015 and 2016 respectively.[9]

Figure 2.3 U.S. Real GDP Annual Growth



Source: World Economic Outlook (WEO) Update, July 2015. Bloomberg Indices.

Figure 2.4 U.S. CPI Annual Inflation



Source: World Economic Outlook (WEO) Update, July 2015. Bloomberg Indices.

In terms of monetary policy, the world's leading developed economies maintained an expansionary approach to support economic activity and raise inflation close to its target. It is expected that the US Federal Reserve will keep interest rates at zero until the end of the third quarter, before starting to raise them at a moderate pace. The ECB is expected to continue its monetary easing policy. The situation is different in most developing countries, where local currency devaluation puts pressure on inflation and creates the need for tighter policy.

The global strengthening of the US dollar is reflected in rising USD LIBOR rates.[10] In July, the 3-month US dollar LIBOR remained unchanged at 0.3%, but it is expected to reach 1% by the end of the year. The opposite situation is observed with regard to the euro LIBOR rates, which are falling. Currently, the 3-month EUR LIBOR rate is virtually at zero.

9 World Economic Outlook (WEO) Update, July 2015.

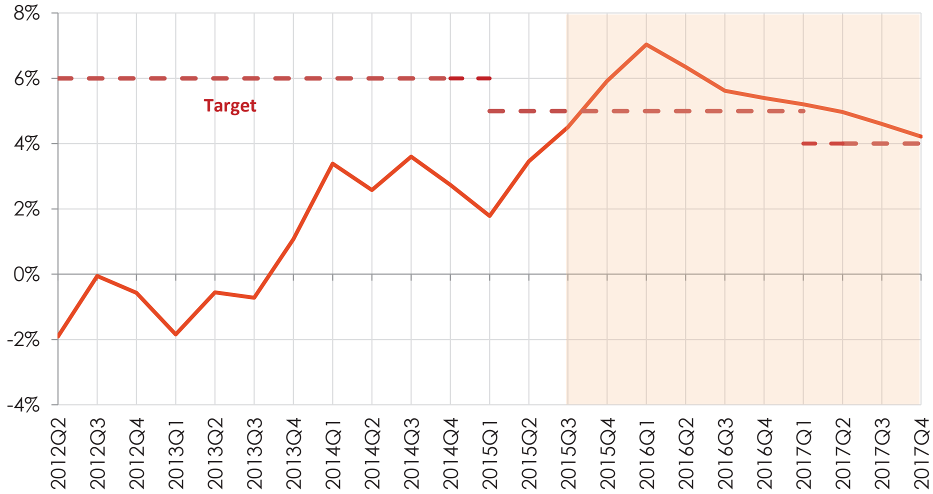
10 The US dollar London Interbank Offered Rate (USD LIBOR) is the average interest rate estimated by leading banks in London that the average leading bank would be charged if borrowing from other banks.

The recent weakening of demand in China and macroeconomic risks surrounding Greece caused commodity prices to hover at lower levels. In the first half of 2015, the commodity price index calculated by the IMF fell by 5.8%, mainly reflecting a decline in prices of food and metals; however, the price of energy in the same period exhibited a growing trend. The current forecast[11] shows that an oil price hike is becoming less likely because of the possible removal of sanctions on Iran, a resource-rich player in the global market. Under weak demand conditions, metal and agricultural product prices will remain almost unchanged.

2.2 MACROECONOMIC FORECAST

The annual inflation rate in the second quarter of 2015 was higher than expected. Annual growth of consumer prices averaged 3.5% in the second quarter, while reaching 4.9% in June – close to the inflation target of the National Bank of Georgia (see Figure 2.5). The main factor contributing to higher inflation in the second quarter of the current year was higher intermediate costs for firms, which, in turn, was a result of the increased debt burden on foreign currency loans. In addition, the lari exchange rate depreciation translated into higher prices of imported durable goods, which also contributed to higher consumer prices. On the other hand, the increase in inflation was dampened by weak aggregate demand and lower food and oil prices on international markets. Dollarization increases the vulnerability of the economy with respect to fluctuations in the GEL/USD exchange rate. Economic stability is threatened not only by dollarization and currency mismatches, but also by the tradition of pricing some goods and services in dollars (as seen in certain sectors of the economy such as construction, maintenance and furniture). It should be noted that the share of imported intermediate goods (and especially the share such goods that are priced in dollars) in the Georgian economy is not sufficiently high to justify pricing in dollars. In this regard, addressing the problem of economic education in small- and medium-sized enterprises is very important and should form part of the government's structural policy.

Figure 2.5 Headline Inflation

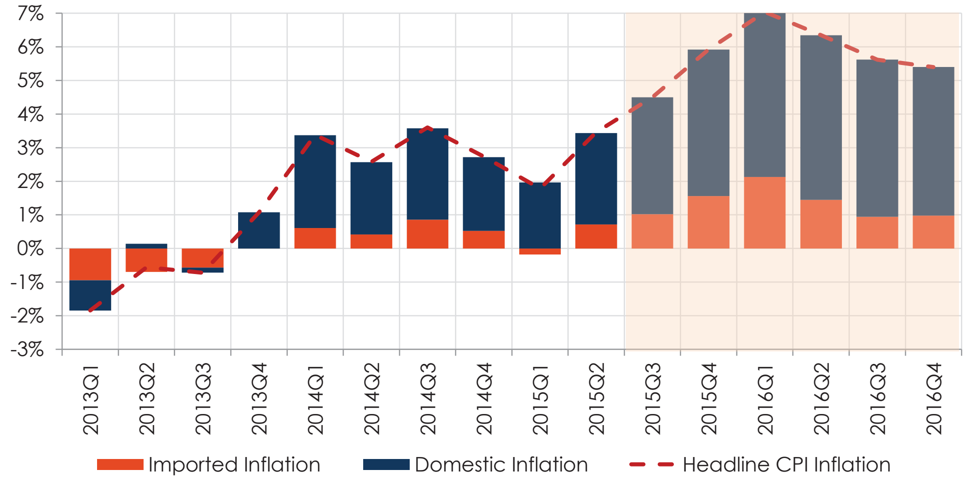


Source: National Bank of Georgia

According to the forecast, inflation in the third quarter of 2015 will stay at its current level, averaging 4.5%, and afterwards it will increase moderately. The current forecast shows that inflation is expected to slightly overshoot the target at the end of 2015 (see Figure 2.5). According to these projections, inflation will peak in the first quarter of 2016 and will then start a downward trend, returning close to the target by the end of 2016. In addition, both domestic and imported inflation have qualitatively similar patterns in the forecast horizon (see Figure 2.6).

11 *Commodity Price Outlook and Risks. IMF Research Department, Commodities Team, July 2015.*

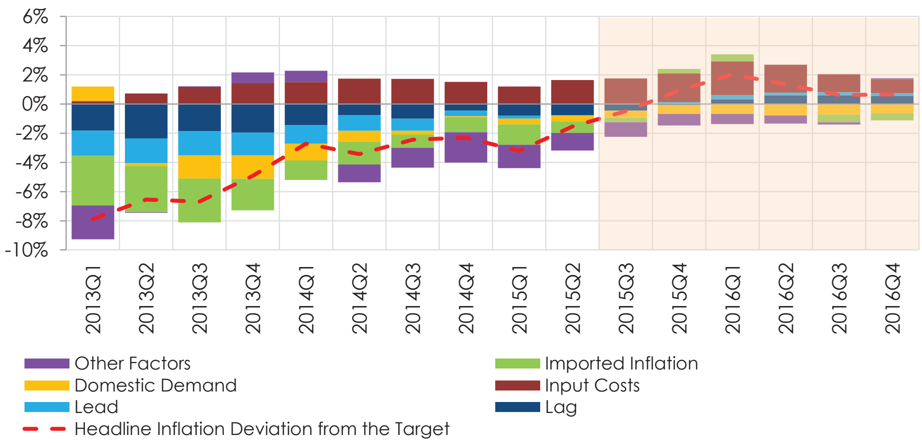
Figure 2.6 Headline Inflation Decomposition



Source: National Bank of Georgia

Until recently, the deviation of inflation from the target had mainly been caused by a combination of weak imported inflation, globally declining food and energy prices, and sluggish demand (see Figure 2.7). However, according to the forecast, the main source of higher inflation in the next two quarters will come from the supply side. Namely, an increase in input costs – stemming from the dollarization of business loans and the already depreciated lari exchange rate against the US dollar – will place upward pressure on prices. Against this, downward pressure on inflation comes from low global prices of food and oil and weak demand. In light of low economic activity, it is expected that demand in both 2015 and 2016 will be lower than potential and will thus curb other inflationary pressures. According to the forecast, which takes all the above mentioned factors into account, inflation in the first quarter of 2016 will overshoot its target by about two percentage points and will then reduce and stabilize around it. It is worth noting that while inflation in the short and medium term is determined by several factors, in the long term it is a monetary phenomenon. Therefore, the independent National Bank serves to guarantee price stability in Georgia in the long term. Such price stability implies strengthening the lari exchange rate in the long term.

Figure 2.7 Inflation deviation from target and its decomposition*



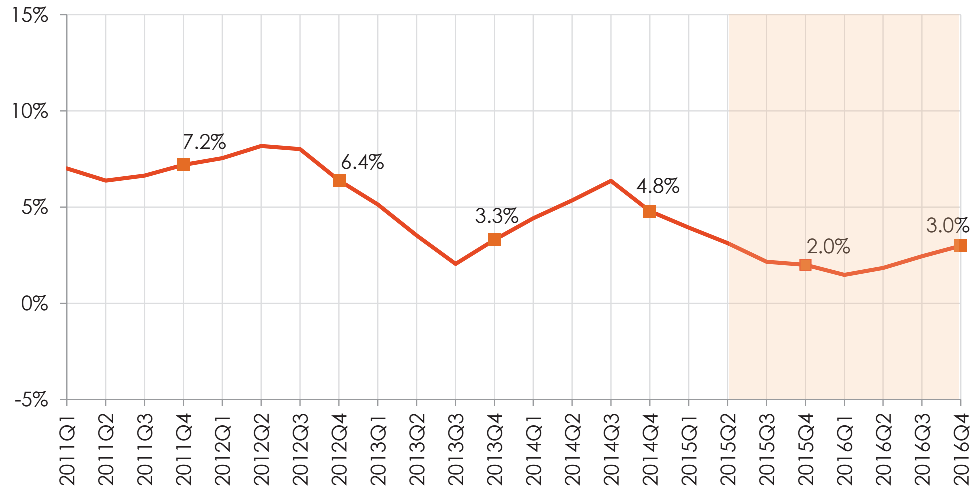
** In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

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, which could contribute to temporarily higher inflation in Georgia. There is also some uncertainty surrounding food and petrol prices, which have substantial weight in the consumer basket and are mostly supply-driven. Possible negative expectations in society about monetary or fiscal policies also represent a risk factor. On the other hand, a greater-than-expected depreciation of Georgia's main trading partners' currencies or a stronger-than-expected transmission of low food and oil prices on international markets into domestic prices may contribute to lower inflation relative to the current forecast. There is also some uncertainty surrounding economic activity, which, if weaker than expected, will cause actual inflation to be lower than current projections, and vice versa if it is stronger than expected.

Real GDP growth in second quarter was consistent with previous forecasts. In the first part of 2015 real GDP grew by 2.6% (see figure 2.8). Economic activity during this period 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. The construction sector also made a strong positive contribution, which was driven by both private sector and government construction projects. After a very strong increase in 2013, net exports made a negative contribution to GDP growth in 2014. This was mainly caused by considerably weakened foreign demand, and, on the other hand, by an increase in imports due to higher domestic demand. This imbalance started to improve in the first quarter of 2015, after the depreciation of the Georgian lari against the US dollar. Reduction in imbalances was mainly driven by accelerated process of import correction and also, to some extent, by softening the negative growth rate of exports. Despite the fact that net exports started to improve from the beginning of the year, these will still make a negative contribution to economic growth because of external disturbances. According to current estimates, the deviation of economic activity from its potential level worsened in the first half of 2015. The output gap is expected to deteriorate further before starting to improve in 2016.

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

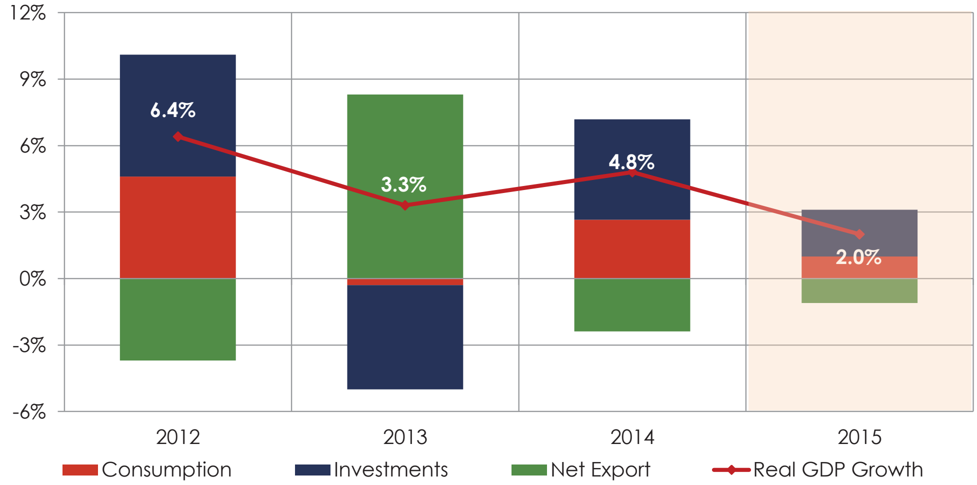


Source: National Bank of Georgia

According to **the GDP forecast**, the growth rate in 2015 is expected to be around 2% (see Figure 2.8). An increase in government capital expenditures, alongside stable monetary policy, will support lending in 2015. This, in turn, will help investment and consumption growth rates. It is expected that the Baku-Tbilisi-Ceyhan pipeline project and Georgia hosting various international 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 affect 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 the adverse political and economic conditions in trading partner countries, which are reflected in weak foreign demand for Georgian exports, as well as declining remittances and international tourism receipts. Such negative spillovers from the foreign sector are partly offset, on the one hand, by reduced petrol prices, which is a positive factor for the current account and other sectors of the economy, and, on the other hand, by real effective exchange rate correction.

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 more than expected, then actual GDP growth will be lower than is currently forecast. On the other hand, if the free trade prospects with Europe or 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

According to the forecast, the **current account deficit**, increased in the second quarter of 2015 relative to the same period last year; however, as a share of GDP it fell compared to the previous quarter and amounted 10.2% of GDP. This deterioration was mainly caused by an annual 20% fall in exports over the same period. The sharp drop of exports started from the fourth quarter of 2014 and was seen in a fall of both car re-exports and other export goods. In addition, remittances declined by 25.6%. As for imports, the annual growth rate, which was still positive in the fourth quarter of last year, became significantly negative in the second quarter of 2015, amounting to -14.3%. It is worth noting that the reduction of imports, alongside reduced foreign currency inflows, indicates that the import adjustment process is activating, which contributes to macroeconomic stability.

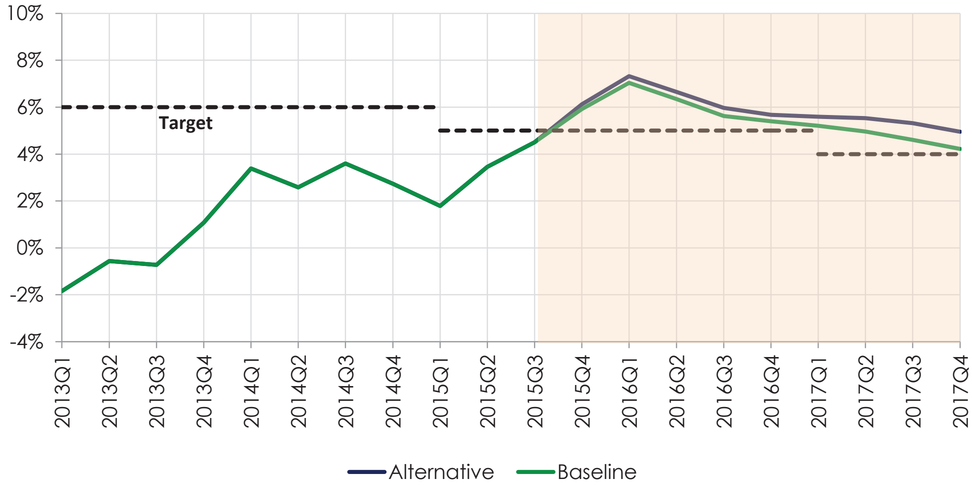
The current account deficit for 2014 worsened to 9.7% of GDP, which is 4 percentage points higher than the preceding year. It is expected that the current account will continue to deteriorate in 2015. However, according to the current forecast, it will start improving steadily in the medium term, supported not only by increased exports of goods, but also of services, including tourism.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers, on the one hand, the case of a higher-than-expected transmission of foreign risk factors to the Georgian economy, and, on the other hand, worsened expectations due to public statements that damage the credibility of the National Bank of Georgia. In particular, the scenario assumes that the significant deterioration in exports and remittances, resulting from the tense economic circumstances in the region, will persist in 2015 and that the effect of this on the nominal effective exchange rate would be higher than expected. According to this scenario, inflation expectations would be higher (see Figure 2.10) and economic growth slower than in the baseline scenario (see Figure 2.11).

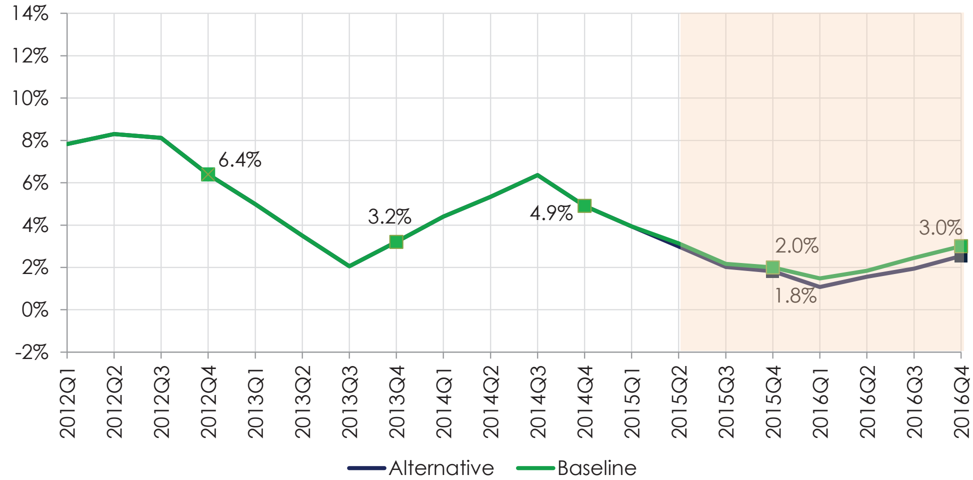
According to the alternative scenario, the inflation rate will increase faster than in the baseline scenario, since the upward pressure from the nominal effective exchange rate will outweigh downward pressure from weak demand. This scenario shows that inflation will be about one percentage point higher than in the baseline scenario. In order to influence inflation expectations, adopting an appropriate monetary policy response 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)

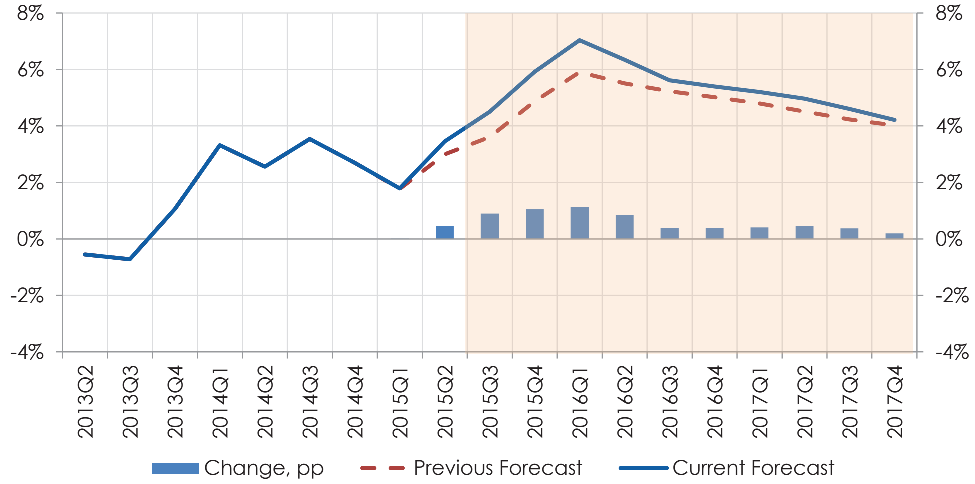


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast has been revised upward as a result of the stronger-than-expected effect of foreign shocks – particularly on the depreciation of the lari nominal effective exchange rate (see Figure 2.12). This upward pressure from the exchange rate has been partly dampened by weak demand, and, hence, by the lower markups of firms. According to the current forecast, in light of foreign shocks the contribution of imported inflation to overall inflation is higher than in the previous forecast. In addition, higher intermediate costs for firms, resulting from loan dollarization and the depreciation of the domestic currency, also contribute to higher prices. As a result, the inflation rate in 2015 will be higher than was predicted in the previous forecast and will slightly overshoot the target by the end of 2015.

Figure 2.12 Change in the Forecast of Headline Inflation



Source: National Bank of Georgia

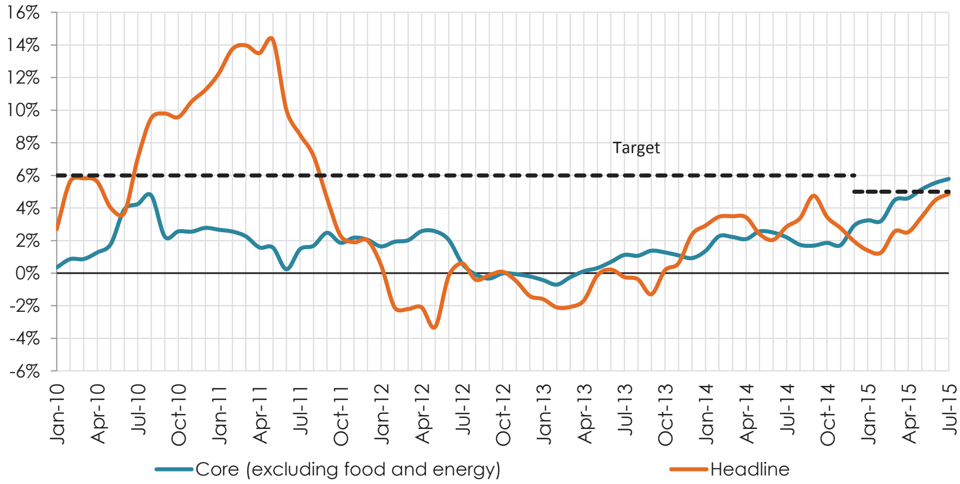
As for economic activity, the GDP growth forecast for 2015 has not changed.

3. Consumer Prices

By the end of the second quarter of 2015, the annual growth rate of the overall price level increased compared to the previous quarter and totaled 4.5%. During July, the annual inflation indicator grew further to 4.9%. The annual inflation rate thus approached the NBG's medium-term target of 5%. Against 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 5.5% in June. By the end of July, core inflation further increased and stood at 5.8% (see Figure 3.1).

‹‹ Headline inflation is close to the NBG's target level and stood at 4.9% in July 2015.

Figure 3.1 CPI and Core Inflation



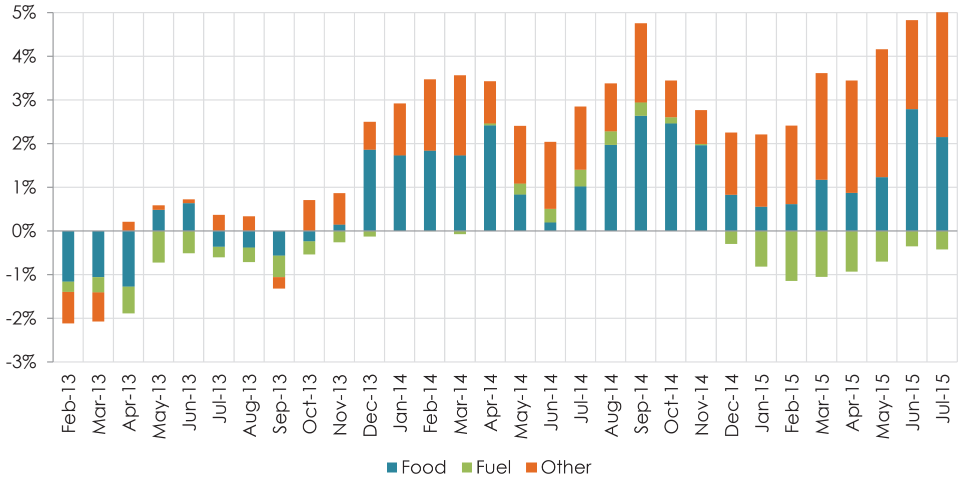
Source: GeoStat and National Bank of Georgia

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. The decline of petrol and diesel prices continued by the end of the second quarter of 2015. However, due to the depreciation of the nominal exchange rate, fuel prices decreased at a slower pace on an annual basis. By the end of July, the rates of decline of petrol and diesel prices amounted to -6.5% and -8.1%, contributing approximately -0.4 percentage points to headline inflation (see Figure 3.2).

‹‹ Increased prices of some food products following the exchange rate depreciation put upward pressure on inflation.

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. Accordingly, the annual inflation of food and its impact on headline inflation was minimal. 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 5.7% by the end of second quarter and its impact on headline inflation grew to 2.8 percentage points. The influence of depreciation continued in July as well. In spite of the fact that this period was characterized by a low rate of food inflation, the overall level of food prices increased to 7.4% (see Figure 3.2) and its contribution to the headline inflation declined to 2.2 percentage points.

Figure 3.2 Contribution of food and fuel inflation in headline inflation

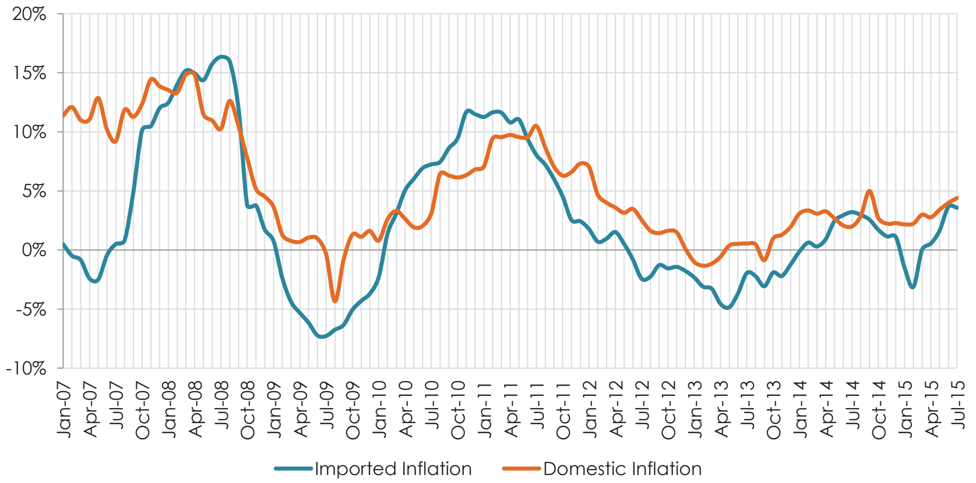


Source: GeoStat and National Bank of Georgia

In terms of exogenous factors, the influence of imported inflation on the overall price level is worth stressing. 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. The inflation rate on imported consumer goods thus slowed. Moreover, in January and February 2015, prices on imported consumer goods declined on an annual basis. However, the nominal effective exchange rate subsequently started to depreciate and imported inflation turned positive and exhibited a growth tendency. By the end of July, imported inflation increased to 3.6%, contributing approximately 0.8 percentage points to headline inflation (see Figure 3.3).

‹‹ The inflation rate on imported consumer goods increased and stood at -3.9% by the end of July.

Figure 3.3 Imported and Domestic Inflation



Source: GeoStat and National Bank of Georgia

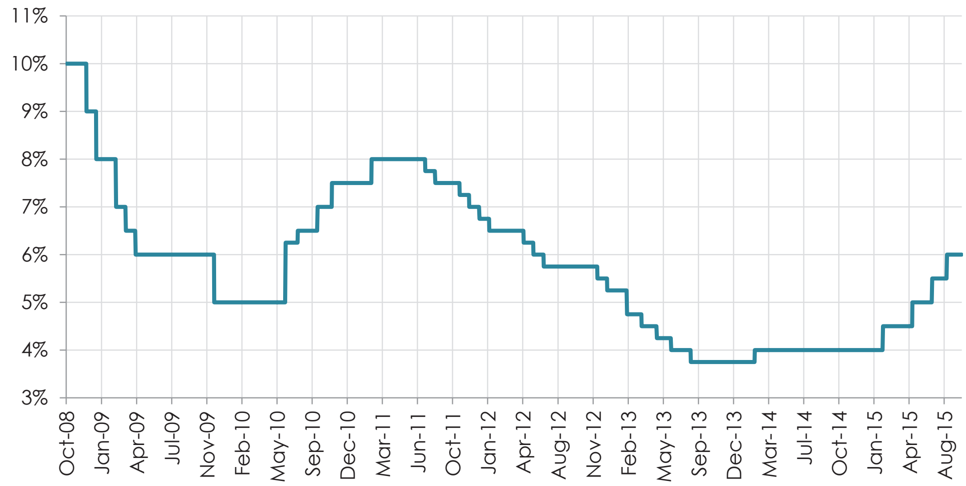
The realization of geopolitical risks and the subsequent economic downturn in Georgia's main trading partners has been reflected on external demand and has had a negative impact on the Georgian economy. Exports, remittances and tourism revenues all decreased significantly. The factors weakening external and domestic demand thus caused a widening of the negative output gap, which, in turn, does not put upward pressure on consumer prices from the demand side.

‹‹ Factors from the aggregate demand side have not put upward pressure on prices.

4. MONETARY POLICY

From the beginning of 2015, the transmission of external shocks to the Georgian economy has strengthened. Worsened economic conditions in Georgia's main trading partner countries were reflected in reduced exports and remittances. These factors reduce both domestic and external demand. In line with 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. At the same time, the pressure on the policy of the National Bank pushes up long-term interest rates, reduces the efficiency of monetary policy transmission and drives up inflation expectations. Increased inflation expectations are reflected on the risks of deviating from the inflation target in the medium term. In order to reduce inflation risks in this situation, the National Bank of Georgia found it appropriate to tighten monetary policy. In the period February-July 2015, the Monetary Policy Committee decided to gradually increase the refinancing rate by 1.5 percentage points to 5.5%. At the same time, the interest rate for standing refinancing loans increased to the policy rate plus 150 basis points.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

‹‹ During the first eight months of 2015 the Monetary Policy Committee increased the policy rate by 2 percentage points to 6%.

The last meeting of the National Bank's Monetary Policy Committee (MPC) was held on 12 August. At that meeting the MPC decided to increase the refinancing rate by 50 basis points to 6%. This decision was based on the existing inflation forecast and on a macroeconomic analysis of ongoing events in both Georgia and outside its borders.

The inflation rate in 2015 is characterized by a growing tendency and is getting close to the 5% target value set by the National Bank. The rise in inflation due to increased prices resulting from the exchange rate depreciation has been limited by the decrease in global oil and food product prices. However, it worth noting that the oil price effect is gradually diminishing. The annual growth in consumer prices equaled 4.9% in July. The main factors causing the rise in inflation were the increase intermediate costs of production due to exchange rate depreciation and higher prices on certain imported goods.

Domestic demand remains weakened. According to preliminary information, real GDP growth in the second quarter was 2.1%, and in the first six months of 2015 average growth amounted to 2.6%. Credit activity growth has decelerated. The growth rate of the portfolio hovers around 14% (excluding the exchange rate effect). The significant decline in imports also indicates weakened demand.

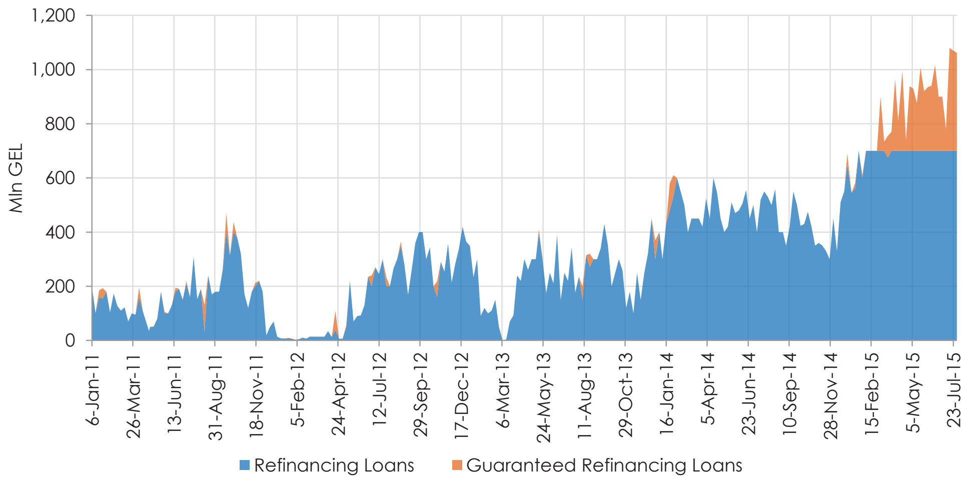
Negative trends have been recorded in the external sector as a result of external shocks. Against the background of worsened economic conditions in Georgia's trading partners, external demand declined significantly. During the first quarter of 2015, registered exports declined by 28%, while imports decreased by 3%. However, in the second quarter, the rate of export decline slowed in line with signs of economic stabilization in the region and depreciation of the domestic currency. The adjustment effect of the exchange rate depreciation is evident, which became reflected in considerably decreased imports. According to second quarter data, exports declined by 20%, while the annual rate of the decline of imports increased to 21% (excluding imports of Hepatitis C treatments provided by a grant). Remittances declined by 20% annually in June, which was a better indicator compared to previous months; however, the dynamics of remittances subsequently deteriorated. This was principally a result of a sharp decline of transfers from Greece due to the negative developments in the country in July. Revenues from tourism improved during the second quarter of 2015 and this tendency persisted into July. Considering the factors explained above, pressure on the exchange rate slowed compared to previous periods.

According to the NBG's existing forecasts, inflation will temporarily overshoot its target value in the beginning of 2016 and will then gradually reduce to the target level. However, upside and downside risks remain. Inflation pressure might stem from a possible surge in oil prices and a greater-than-expected growth of utility prices and intermediate expenses. On the other side, lower-than-expected aggregate demand and exchange rate depreciations in the main trading partner countries may have a downward effect on inflation dynamics in the short run.

Given the aforementioned external shocks and domestic factors, the Monetary Policy Committee considered it necessary to increase the monetary policy rate to 6%.

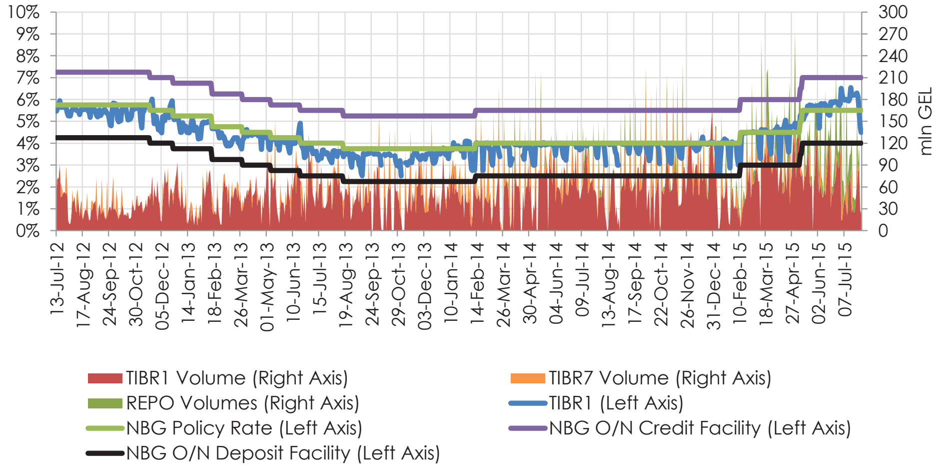
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. As compared to the previous year, demand for this instrument is relatively high at this stage. Taking into account the fact that this increased demand is not sufficiently met via refinancing auctions, the banking sector is forced to use the guaranteed refinancing instrument and/or standing facility to get the required liquidity. Interest rates on these instruments are 150 basis points higher than the policy rate. Interbank short-term interest rates are augmented correspondingly. Currently, short-term interest rates fluctuate above the monetary 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 interest rates increased and hover above the policy rate.

Box 1 The optimal inflation level in Georgia

The National Bank's long-term inflation target is 3%. The National Bank's current inflation target is 5%. As the efficiency of monetary policy increases, the National Bank will gradually decrease its target inflation rate. For 2015-16 the target rate is 5%, and for 2017 the target will be reduced to 4%.

Determining the optimal inflation target depends on many factors. In order to find out what the optimal inflation rate is for economic development at this stage, it is necessary to answer the following questions:

- Why might high inflation be damaging for the economy; why is the National Bank trying to maintain low and stable inflation?
- If high inflation is harmful for the economy, why the does the National Bank not try to keep prices unchanged (in other words, why is the National Bank's inflation target not 0%)?
- Why is inflation in developing countries systematically higher than developed countries; what determines the difference between inflation rates?

What are the negative aspects of high inflation?

High inflation is associated with different types of costs for the public, which ultimately generate welfare losses. A number of economic studies have focused on high inflation losses and we will try to summarize the factors that lead to utility losses below.

- High inflation and investment risk

High and variable inflation inhibits economic growth, which primarily has a negative effect on the volume of domestic and foreign investment. High fluctuations of inflation leads to fluctuations of the real interest rate. Where there is uncertain inflation, investors find it difficult to plan future revenues from their investments, and, consequently, measure its current value, which ultimately reduces the volume of investments. When there is high and volatile inflation, investors are unwilling to implement long-term projects, which ultimately creates a shortage of long-term capital in the country and will have a negative impact on long-term economic growth.

When assessing the macroeconomic environment in the country, credit rating agencies use inflation as an indicator. High and volatile inflation adversely affects the country's credit rating, and thus the country's investment activity and economic growth. As a rule, countries with high credit ratings are characterized by low and stable inflation.

- Price signaling function

Prices of goods and services are important economic indicators. The price level determines consumer choices about what and where to buy. At the same time, prices are signals to producers about what products are in high demand and, therefore, more profitable to produce. Prices thus play an important role in terms of optimal allocation of resources in the economy. During high inflation, it is difficult for firms and consumers to distinguish whether a price increase of an individual product is relative to other products or if prices are rising on all products due to inflationary pressures.

- "Menu changing costs"

During high inflation, economic agents often have to change prices, which entails additional expenses for them. Such kinds of expenses are known as "menu changing costs". Because a price change means certain expenditures for firms, they change their prices less frequently than would have been justified in the course of high inflation. Price and wage rigidity is thus formed, which reduces the real income of firms and employees.

Why should the inflation rate be higher than 0%?

The above reasoning on the costs associated with high inflation, might logically lead to the conclusion that it would be optimal for the economy to keep inflation at zero. However, there are some arguments that favor having low positive inflation.

- The risk of deflation

One argument in favor of low inflation is that it keeps the economy away from the deflation zone, and thereby reduces the risk of deflation in the country. Deflation can be more costly to the economy than inflation and avoiding it is important for economic growth. The most famous example of the negative impact of deflation is what happened in Japan in the 1990s, when it could not escape a deflationary spiral. The concept of a deflationary spiral is that when prices start to fall, economic agents postpone consumption in anticipation of further cuts to prices, which leads to a reduction of aggregate demand, which, in turn, causes prices to further reduce.

- The possibility of a negative real interest rate

Firms and individuals make decisions about whether to save or invest according to the real interest rate. The lower this is, the less attractive it is to save. At the same time, a low real interest rate is an additional incentive for firms to invest. Therefore, the National Bank should have the opportunity to influence the real interest rate in order to effect economic activity and price levels. An excessively low inflation target may limit the central bank's possibilities if the nominal rate reaches zero. The further away target inflation is from 0%, the more the central bank will be able to make the real interest rate negative and thus contribute to the promotion of aggregate demand in the economy – which is an additional argument in favor of a positive target inflation rate.

- The margin of error while measuring inflation

Most countries use the consumer price index to measure inflation, which is measured by the prices of goods in the consumer basket. One drawback the consumer price index has is that it does not take into account improvement in the quality of products, which in the end may lead to excessive inflation, compared to real inflation. The flaws caused by improving product quality in the measurement of inflation are higher in countries where the quality of goods and services are improving quickly.

Taking into account the above factors, we can conclude that there is a non-linear relationship between inflation and economic growth, which means that up to some point inflation has a positive impact on GDP growth, but above that point inflation becomes an impediment to economic growth. Empirical studies confirm the existence of such a non-linear relationship; however, it is a complicated problem to precisely determine where the boundary is from where inflation has a negative impact on growth. Various studies indicate that the optimal range of inflation is from between 1% to 8%, depending on the level of a country's development. In addition, the optimal rate of inflation is different between developed and developing countries. The difference in the levels of inflation can mainly be explained by the higher pace of productivity growth in developing countries.

What determines higher levels of inflation in developing countries compared to developed countries?

In developed countries, the average rate of inflation is lower than in developing countries. This can be explained by the higher rate of productivity growth in the latter group. In countries in which the productivity of the tradable sector grows faster, the growth rate of wages is also higher, which ultimately leads to higher inflation. This phenomenon is known as the Balassa-Samuelson effect and it implies that high growth of productivity and wages in the tradable sector of developing countries also leads to a growth of wages and inflation in the non-tradable sector.

In Georgia, between 2005-2009 productivity growth in the tradable sector was 3 percentage points higher than in the non-tradable sector; in 2010-2014 this difference was reduced to 1.5 percentage points, which was caused by a greater decline of productivity growth in the tradable sector than in the non-tradable sector. Reduction of the productivity gap between the two sectors is somewhat reflective of the reduction of pressure on domestic inflation stemming from the Balassa-Samuelson effect.

Given that the share of non-tradable goods in the Georgian consumer basket is in the 30-50% range, and if we assume that labor costs in total expenses have equal shares in both the tradable and non-tradable sectors, we can calculate the optimal inflation range for Georgia, which is in line with the productivity growth rate gap between the tradable and non-tradable sectors. The calculations are given in Table 4.1 below.

Table 4.1 Optimal inflation rate for Georgia

	Inflation of tradable goods in trading partner countries	Share of non-tradable goods in consumer basket	Productivity gap	Optimal inflation level
Inflation (lower limit)	2.5%	30%	1.5	3.0%
Inflation (upper limit)	2.5%	50%	3	4.0%

Source: Authors' calculations

By taking the productivity gap and the inflation of tradable goods in trading partner countries into account, the optimal inflation rate for Georgia is in the range of 3-4%. Determining the inflation target within the above range minimizes unnecessary expenditures of excessively low inflation for the economy. The rate of inflation is in line with the inflation target indicators for economies similar to Georgia. It should be noted that over time, alongside the closure of the productivity level between developed countries and Georgia, the productivity gap and, therefore the optimal rate of inflation, will be reduced.

In determining and achieving the optimal inflation target, the leverage available for the National Bank should also be considered. Consequently, the National Bank's monetary policy strategy is based on the development of instruments and transmission channels alongside the gradual reduction of the target inflation level. Such an approach explains the relatively high target rate of 6% until 2014.

Alongside economic growth and the development of the National Bank's instruments, the optimal level of inflation in Georgia is gradually decreasing. At the same time, the National Bank's capabilities for maintaining an optimal level of inflation are rising. The National Bank's inflation target for 2015-16 has been reduced to 5%, and from 2017 the target rate will decrease to 4%. Given that monetary policy transmission mechanisms are still weak, mainly due to the high dollarization of the economy, these changes are consistent with the findings of this research, according to which the optimal inflation for Georgia in the medium term is between 3-4%.

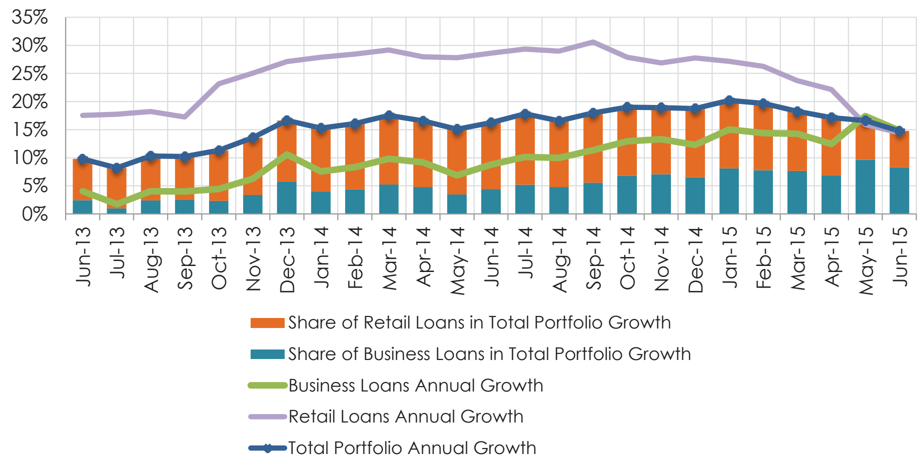
5. Financial Market and Trends

5.1 LOANS

In the second quarter of 2015, the annual growth rate of the loan portfolio decreased. In June, the growth rate, excluding the effect of exchange rate movements, amounted to 18.5%. Compared to previous periods, the growth was more balanced in terms of the growth of loans to legal entities and retail loans. As a result of weak economic activity and exchange rate depreciation, demand for imported goods decreased, which caused a decrease of the annual growth rate of lending to individuals compared to the previous quarter. Business loans continue to exhibit a stable growth rate. It should be noted that compared to March 2015, business loans in the national currency with a floating interest rate increased by 16% in June. However, their share in total business loans remains relatively small (5%).

« As a result of weak economic activity and exchange rate depreciation, demand for imported goods decreased, which caused a decrease of the annual growth rate of lending to individuals compared to the previous quarter.

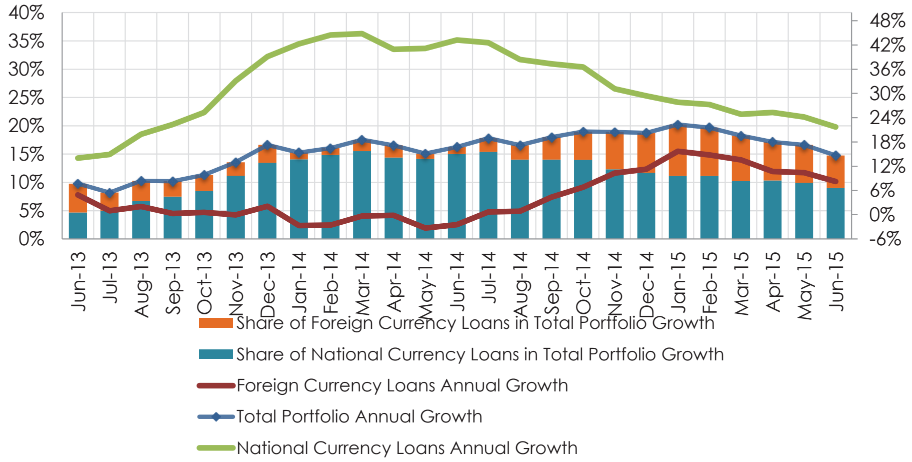
Figure 5.1 Annual growth rates of retail and business loans and their contributions to the growth of the loan portfolio



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 June, the annual growth rate of foreign currency denominated loans increased to 10.2%, while loans in domestic currency increased by 21.7%. In the first quarter, the exchange rate depreciation significantly decreased loan larization. In the second quarter, loan larization increased by 0.8 percentage points over the previous quarter and amounted to 36.5%. It should be noted that the low rate of loan larization is a major contributor to the negative effect of exchange rate movements on the population's welfare. It is important that financial sector larization becomes one of the main goals of the structural reforms undertaken by the state. In particular, in many cases dollarization is caused not only by objective reasons, but also by subjective reasons. One of which is the low level of financial education. For example, an importer who prefers foreign currency loans because the costs have to be made in foreign currency, might not take into account that he/she will be insured against currency fluctuations when the loan currency matches the earnings currency, not the cost currency. A similar situation exists in the case of real estate and development companies. This problem can be partially solved by raising financial literacy and increasing coordination between banks and entrepreneurs, which requires the support of all government agencies. The National Bank considers improving financial education and the promotion of de-dollarization as main priorities and supports them by implementing various policies.

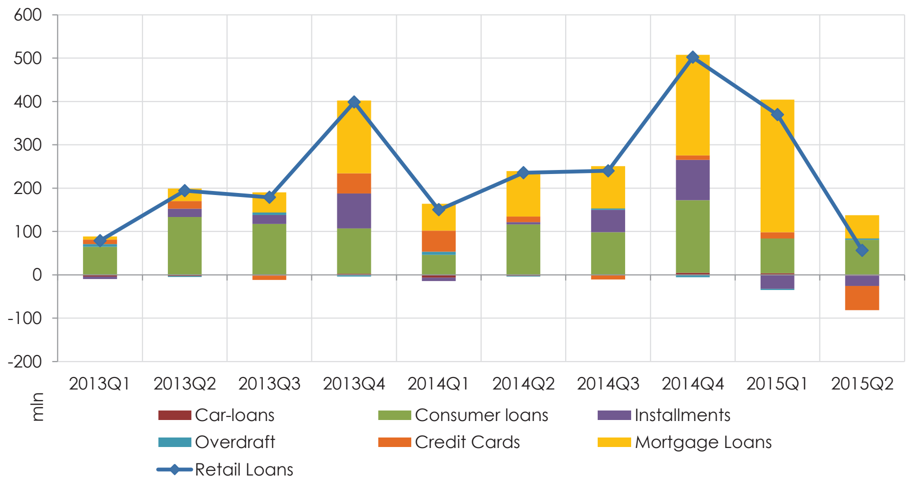
Figure 5.2 Annual growth rates of domestic and foreign currency loans and their contributions to the growth of the loan portfolio



Source: National Bank of Georgia

In June, the stock of retail loans increased by 56 mln GEL compared to March, which is significantly lower compared to the average historical growth rate. The slower growth in lending to individuals was a result of a weakening economic activity and exchange rate depreciation, which were reflected in a reduced demand for imports. In the context of loan products, the amount of mortgage and consumer loans increased by 35 mln and 75 mln GEL, respectively, compared to the previous quarter; while instant loans and credit card volume decreased by 80 mln GEL. These loans are mainly used to finance imports. Therefore, their slower growth reflects reduced demand for imports, and also facilitates a reduction of demand for foreign currency. According to the credit conditions survey, in the next quarter representatives of the banking sector expect an improvement of demand for retail and mortgage loans.

Figure 5.3 Quarterly growth of retail loans

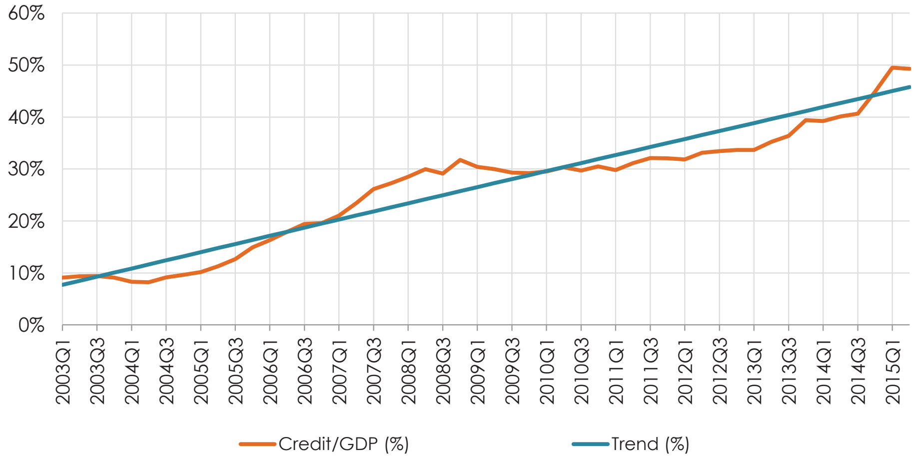


Source: National Bank of Georgia

In June, the annual growth rate of the loan portfolio to legal entities amounted to 14.8%, which was 0.5 percentage points higher than in March. According to the credit conditions survey, in the second quarter of 2015 banks have tightened interest and non-interest rate terms, which were caused by 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. Representatives of the banking sector have positive expectations about loan portfolio growth in the next quarter. 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. Loans denominated in domestic currency are expected to grow and the trade, agriculture and service sectors are expected to intensify .

In recent years, the credit to GDP ratio[12] has followed a trend[13] without significant fluctuations. However, after the exchange rate depreciation of the first quarter, the credit to GDP ratio increased considerably. In the second quarter, the credit to GDP ratio decreased by 0.2 percentage points compared to the previous quarter and amounted to 49.3%. Currently, the ratio is above the trend by 3.5 percentage points.

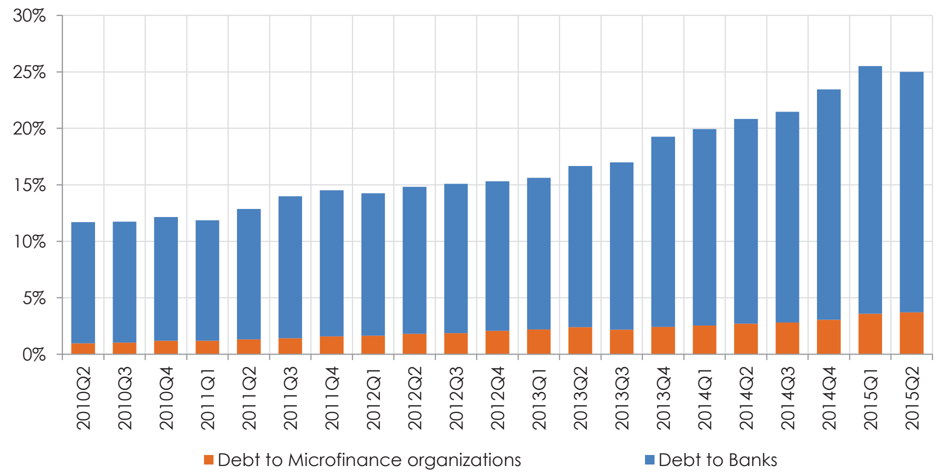
Figure 5.4 Credit to GDP gap



Source: National Bank of Georgia

In the second quarter of 2015, the individuals' debt to net national disposable income ratio increased by 0.5 percentage points compared to the previous quarter and amounted to 25%. Debt to commercial banks accounts for 87% of total individuals' debt.

Figure 5.5 Individuals' debt to net national disposable income ratio



Source: National Bank of Georgia

Compared to the previous quarter, the share of non-performing loans increased by 0.5 percentage points in the second quarter of 2015, and amounted to 8.3%. According to the data from June, the share of non-performing loans in the national currency decreased by 1 percentage point, compared to March, amounting to 4.9%; while the share of non-performing, foreign currency loans increased by 1.5 percentage points and equaled 10.4%. In the second quarter, the amount of loans written off amounted to 74 million GEL, which decreased non-performing loans by 0.6 percentage points.

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 global financial crisis.

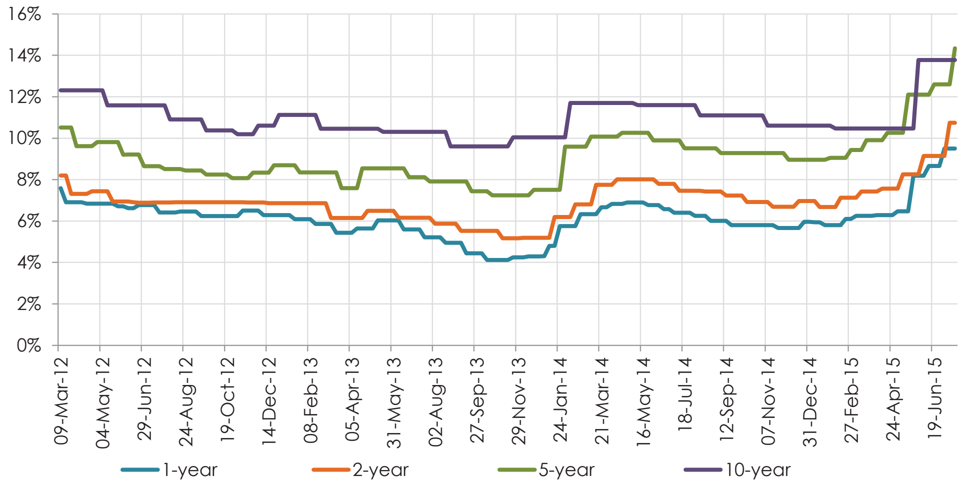
13 An HP filter is used to assess the trend and, based on the Basel recommendations, lambda is equal to 400,000.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In August 2015, the monetary policy rate increased to 6%. In the second quarter of 2015, compared to the previous quarter, interest rates increased for government securities of all maturities, supposedly as a result of an increase in liquidity risk followed by pressure on the National Bank's policy . In addition, the increase of interest rates was caused by a rise in inflationary expectations and a tightening of monetary policy. For banking sector representatives, the risk that the National Bank might be forced to restrict the use of securities as collateral for monetary operations has increased. It should be noted that this risk is actually very low, due to the fact that central banks around the world (with very few exceptions) conduct monetary policy by managing short-term liquidity to the banking system, which is carried out by the use of government securities in monetary operations. Accordingly, the functioning of monetary policy in any prospect makes the liquidity risk of government securities minimal. Despite the likelihood being small, the risk of wrong policies still exists as a result of the current levels of economic development and financial education, which was reflected in interest rates.

« The rise of interest rates on government securities was a result of an increase in liquidity risk followed by pressure on the National Bank's policy.

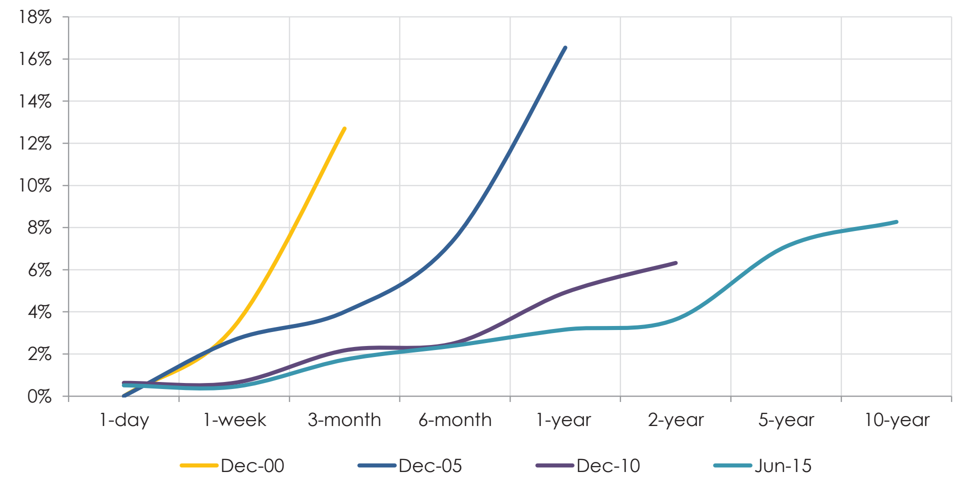
Figure 5.6 Interest Rates on Government Securities



Source: National Bank of Georgia

In addition to liquidity risk, the spread between long-term assets and the monetary policy rate has increased, because inflationary expectations raised belief of an increase in the monetary policy rate. The National Bank's monetary policy agenda was to reduce liquidity risk, which was reflected in the interest rate reduction of long-term assets and a decreased price of credit resources. This, in turn, promoted internal investments and economic growth. Consequently, increased liquidity risk as a result of pressure on the National Bank will have a negative impact on the country's economic development.

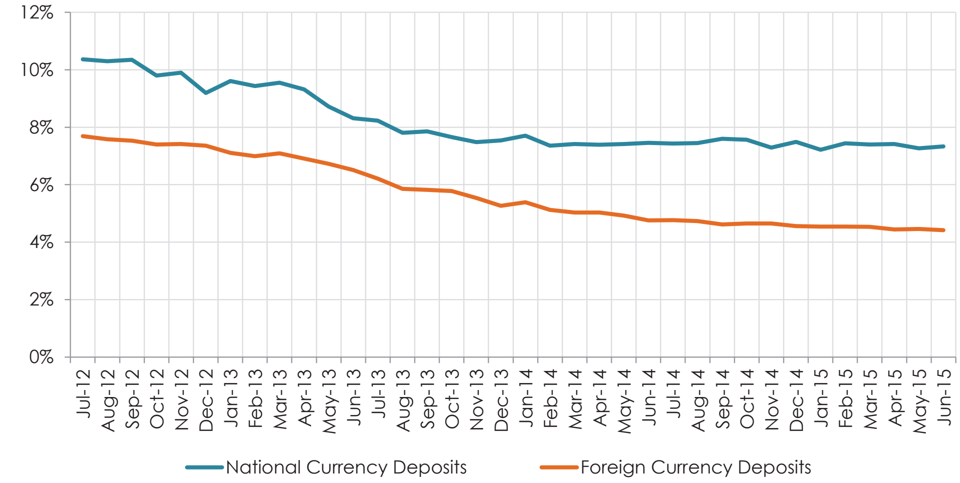
Figure 5.7 Spread between the Monetary Policy Rate and the Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on deposits in both the domestic and foreign currency decreased by 0.1 percentage points, 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 lowered demand for domestic currency deposits. According to the credit conditions survey, the cost of foreign currency deposits is not expected to change in the next quarter, while the interest rate on national currency deposits might rise following the growth of domestic currency loans and weakened demand for domestic currency deposits . It should be noted that increased demand for domestic currency loans and foreign currency deposits creates a currency mismatch risk for banks.

Figure 5.8 Average Interest Rates on Deposits

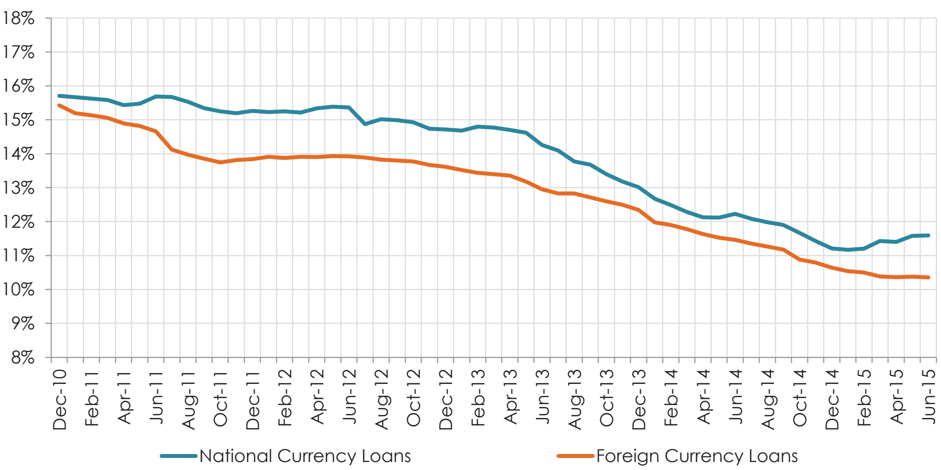


Source: National Bank of Georgia

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.

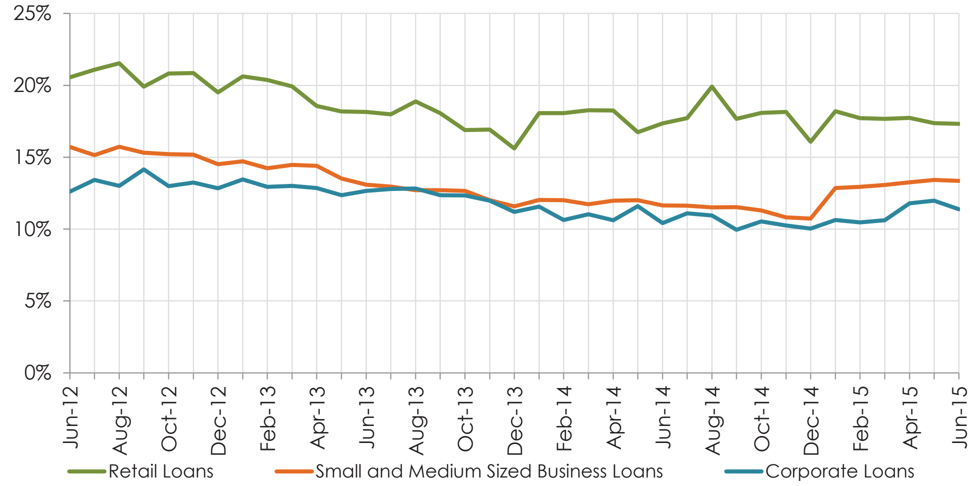
‹‹ Tn the next quarter, bank representatives expect interest rates on national currency deposits to rise.

Figure 5.9 Average Interest Rates on Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest rate on loan flow



Source: National Bank of Georgia

Box 2 Dynamics of money market interest rates

In 2015, interest rates on the National Bank's certificates of deposit and treasury financial papers have sharply increased, especially during the last three months. Several factors determine the level of money market interest rates. First of all, there is the monetary policy rate, by which the central bank tries to manage the short-term interest rate on the money market. In the event of an increase in the monetary policy rate, money market interest rates are expected to rise, and vice versa. In addition, long-term rates depend on expected changes to the monetary policy rate. If the market expects that the monetary policy rate will increase in future, this will be reflected in a rise of long-term rates, and vice versa. Expectations of exchange rate depreciation also affect interest rates. If the market expects the exchange rate to depreciate, this will be translated into increased interest rates. The level of money market interest rates also depends on the liquidity of financial assets – the ability of an asset to be quickly converted into cash at any time. A rise in asset liquidity risk accordingly increases the interest rate on the money market.

It is interesting to consider the impact of each factor on the growth of interest rates. In 2015, the National Bank increased its monetary policy rate by 2 percentage points from 4% to 6%. Accordingly, the growth of the monetary policy rate contributed to the increase of money market interest rates. At the same time, as the press release following the last Monetary Policy Committee meeting pointed out, the policy rate will gradually increase to 6.5% by the end of 2015. There is thus the expectation of a further increase of the market's short-term interest rate, which, in turn, leads to an increase in long-term rates.

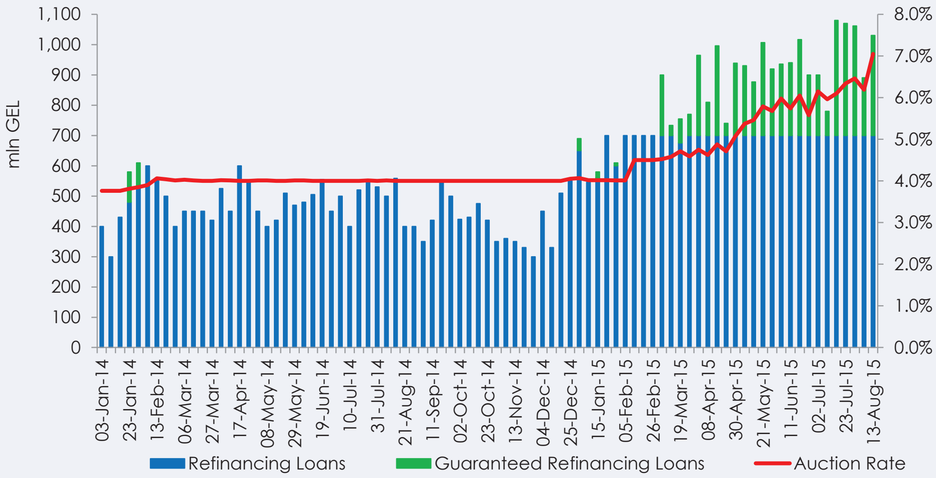
However, if we look at long-term interest rate dynamics, we can see that interest rates have increased by about 3.5-4 percentage points since the beginning of the year. Such a rise in interest rates cannot be explained by only a 1.5 percentage point increase in the policy rate and expectations of future growth by another percentage point. It is clear that the recent rise in interest rates is additionally related to the growth of expectations of exchange rate changes and/or liquidity risk.

In this regard, it is interesting to explain recent developments related to the National Bank's liquidity management instruments. In particular, due to the depreciation of exchange rates in the first half of the year, unjustified criticism of the National Bank's policy and its instruments began. Refinancing loans came under special attack, as if they were the reason behind the depreciation of the exchange rate. As a result, market expectations formed about a future restriction (or suspension) of refinancing loans. Accordingly, the risk of future limits on the liquidity supply appeared in the market, which was immediately reflected in an increase in interest rates. The demand of high rates from commercial banks could stem from increased risks on the restriction of liquidity supply in the future.

Commercial banks' demand for refinancing loans has substantially increased in recent periods. Despite this, since April, due to increased political pressure the National Bank has supplied only 700 million GEL through its auctions. Commercial banks are thus forced to use guaranteed refinancing loans at a relatively high rate (the policy rate plus 1 percentage point) to fill the gap. As a result, the average interest rate on refinancing loans increased significantly.

If the attack on refinancing loans continues and the risk of limiting the supply of liquidity to the market increases further, it will naturally lead to an even greater surge in market interest rates.

Figure 5.11 Amount of Refinancing Loans and Interest Rates



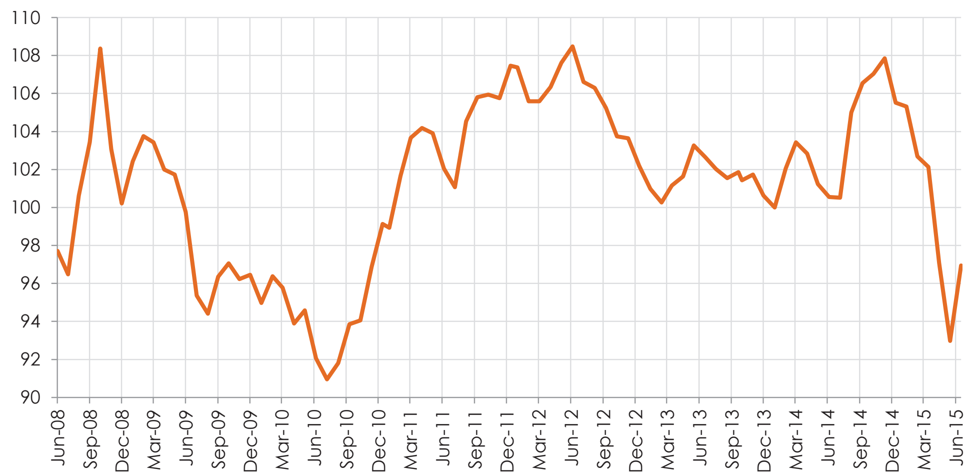
Source: National Bank of Georgia

5.3. EXCHANGE RATE

In June 2015, the Georgian lari depreciated against the US dollar by 3.3%, as compared to March, and averaged 2.26 GEL/USD. The lari also depreciated against the euro (6.7%), the Russian ruble (13.6%) and the Ukrainian hryvnia (10.7%); while appreciation was observed against the Turkish lira (0.8%). The nominal effective exchange rate devalued by 4.5% over the same period; however, it remained unchanged compared to June 2014.

The real effective exchange rate in June was 5.1% lower than in March 2015, and 3.6% lower than in June 2014.

Figure 5.12 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

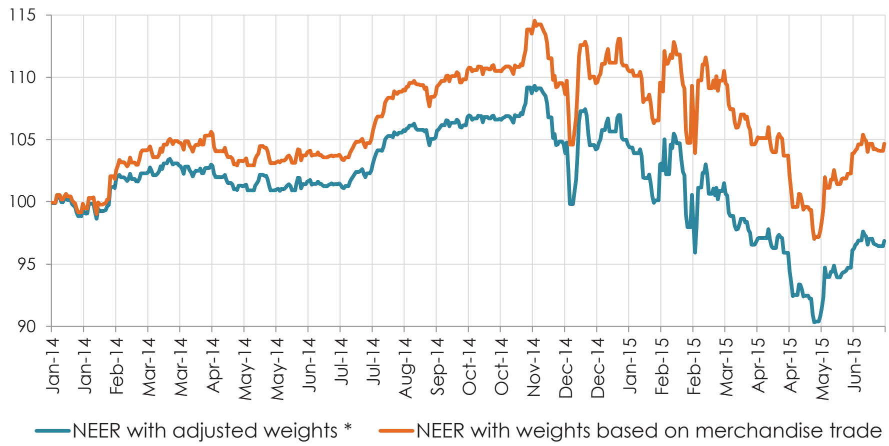
Table 5.1 Effective Exchange Rate Annual Growth

June 2015	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective exchange rate	0.0	-3.6	-3.6
Euro area	-5.2	-1.2	-0.2
Turkey	-0.4	-2.9	-0.6
Ukraine	40.2	-7.0	-0.6
Armenia	-9.9	-10.8	-0.6
The United States	-21.8	-18.4	-0.9
Russia	24.2	12.5	1.2
Azerbaijan	4.1	4.2	0.6
Other	-13.8	-10.7	-2.4

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, gives a slightly different picture.[14] In particular, in June the adjusted nominal effective exchange rate decreased by 5.2% annually, while it weakened by 4% compared to March 2015.

Figure 5.13 Adjusted Nominal Effective Exchange Rate



Source: National Bank of Georgia

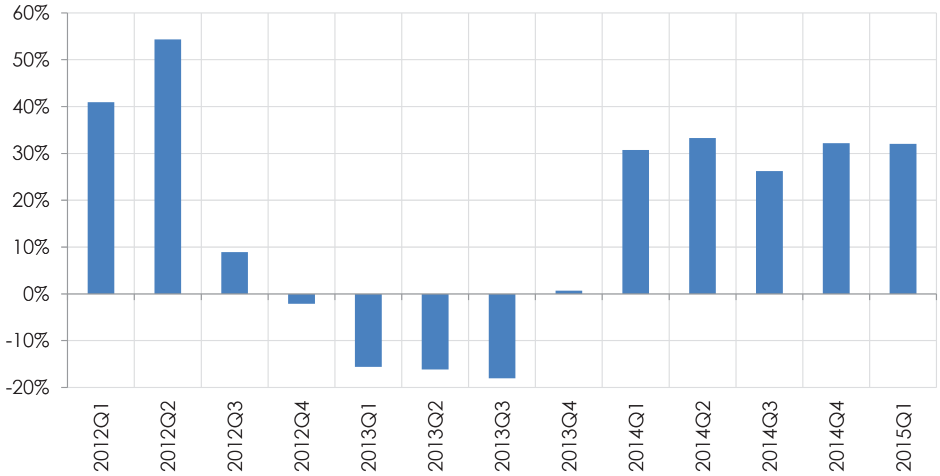
14 Calculation of the index for the adjusted nominal effective exchange rate includes weights based on trading with only those goods and services (tourism) that are sold in the currency of a partner country. The share in trading with commodity products (oil, copper, wheat, etc.) has been given to the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

6. Domestic Demand

Real GDP growth amounted to 3.2% in the first quarter of 2015. The main factor of economic growth is an increase of investments. The contribution of consumption was also important, but net exports contributed negatively to GDP growth. The main driver of growth in 2015 is expected to be investments, while the growth rate of demand and external trade are falling. The expected weakening of domestic demand in 2015 will cause a decrease of imports.

The growth rate of capital formation was high (32.1%) in the first quarter of 2015. The high growth rate of investments was essential for GDP growth. Despite the decline of FDI inflow in the first quarter in comparison with the same period of the previous year, high growth was provided by domestic investments (especially in construction). According to the existing forecast, capital formation will be the main driver of GDP growth during rest of the year.

Figure 6.1 Annual Growth Rate of Capital Formation



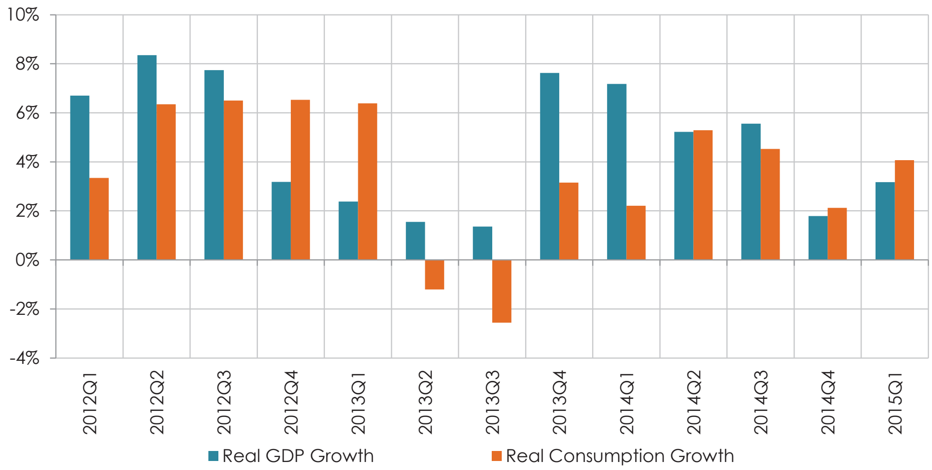
Source: GeoStat

In the first quarter, exports of goods and services (in terms of US dollars) plummeted by 16.5%, while imports contracted by 5.5%. As a result, net exports had a negative contribution to the first quarter GDP growth (the trade deficit widened). Preliminary assumptions expect net exports to contribute positively to GDP growth.

In the first quarter of 2015, private consumption rose by annual 4.1% in real terms,[15] which is higher than the corresponding figure of the previous quarter. The increase of public consumption was also significant. The growth rate of private consumption is expected to be low over the next quarters, which is related to a decrease of consumption activity (due to the devaluation of the lari, imports have noticeably shrunk). The latter is indicated by the substantial decrease in the consumer loan growth rate in the second quarter.

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

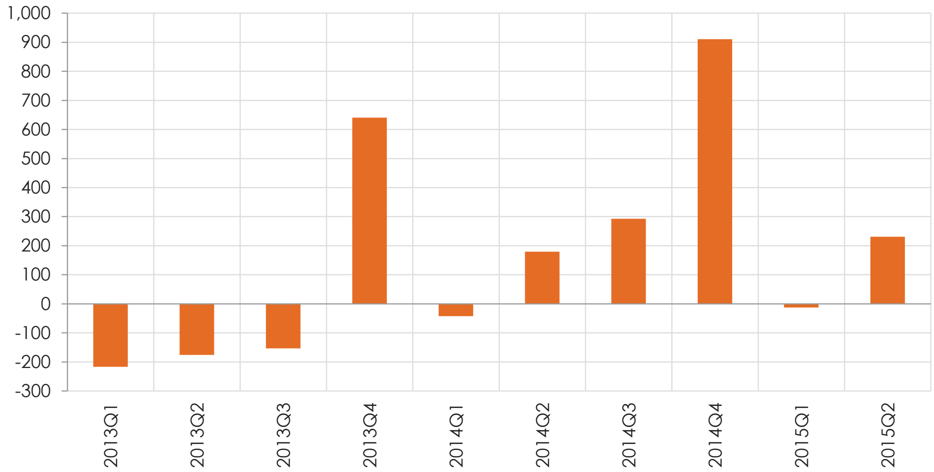
Figure 6.2 Real GDP and Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget deficit in the first half of 2015 was 230.7 million GEL. Due to seasonal factors the first quarter budget is usually in surplus, with the following quarters in deficit (the largest deficit takes place in the fourth quarter). In the first quarter of 2015, the consolidated budget surplus was low, while the deficit in the second quarter amounted to 243.4 million GEL. As the planned consolidated budget deficit in 2015 is 933 million GEL, in the second half of the year the budget deficit will thus rise and promote demand.

Figure 6.3 Consolidated budget deficit (million GEL)



Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

Against the background of external shocks and following diminished export revenues, the current account (CA) deficit to GDP ratio increased by 3.9 percentage points over the previous year and reached 14.1% in the first quarter of 2015. In absolute terms, the CA deficit widened by 99 million USD to reach 626.7 million USD. According to preliminary estimates, in the second quarter of 2015 the CA deficit to GDP ratio improved to 10.3%, which exceeds the same indicator from the previous year by 0.8 percentage points.

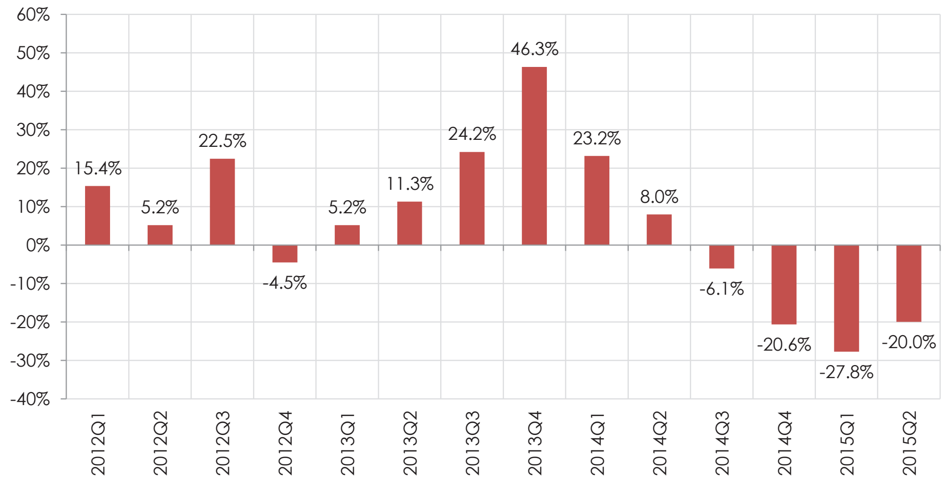
‹‹ The current account deficit to GDP ratio increased by 3.9 percentage points over the previous year and reached 14.1% in the first quarter of 2015.

According to preliminary data, in line with the nominal exchange rate depreciation, the trade deficit improved in the second quarter of 2015, which was the main cause of the deterioration of the current account deficit slowing down in this period. Unlike the improved trade deficit, transfers from abroad (secondary income) and exports of services receipts declined on an annual basis, which widened the CA deficit.

‹‹ During the second quarter of 2015, according to the preliminary data, the trade deficit improved and, as a result, the CA deterioration slowed.

External demand significantly deteriorated in 2015, which had a negative influence on Georgian exports. Registered exports of goods declined by 28% over the period. However, the rate of decline rate slowed, as was expected. The data shows that the annual reduction of registered exports of goods receipts improved to -20%.

Figure 7.1 Annual Growth Rate of Registered Exports of Goods



Source: GeoStat

The change in the exports of goods was uneven in terms of destination region. Against the background of an unstable economic situation, and after the growth in previous quarters, exports to the EU declined significantly, by 20% year on year. The decline of export receipts is related to the reduction of sales to main markets such as Bulgaria (-5.1%), Spain (-38.7%) and Italy (-27.9%). Improvements were seen in exports to CIS countries, with the reduction rate declining from 55.3% to 34.2% over the same period. Among the CIS countries, the most substantial improvement was registered in Russia (from -60% to -34.7%), Armenia (from -55% to -19.7%) and Ukraine (from -75% to -48%). At the same, a dramatic increase was observable in the case of Uzbekistan (93.5%). Exports in this direction have been growing quite rapidly in recent months. Exports to other countries increased by some 6.6%, and was chiefly driven by expanding exports to Turkey (9.1%), Canada (63.8%) and China (51.2%); in contrast, exports to the USA sharply reduced (-54.4%).

An analysis of exports across different product groups shows that the year-on-year reduction rates of exports of mineral waters (-39%), wine (-35%) and other spirits (-17%) were lower compared to the previous quarter. There was also a considerable decrease in the annual reduction rate of the export of fertilizers (-7%). In contrast, the re-export of cars fell sharply (-62%). Deep drops were observed in exports of ferroalloys (-31.6%) and iron or non-alloy steel products (-78%). The decline of exports of these goods was partially balanced by an increase in exports of nuts (246%) and medicaments (60%).

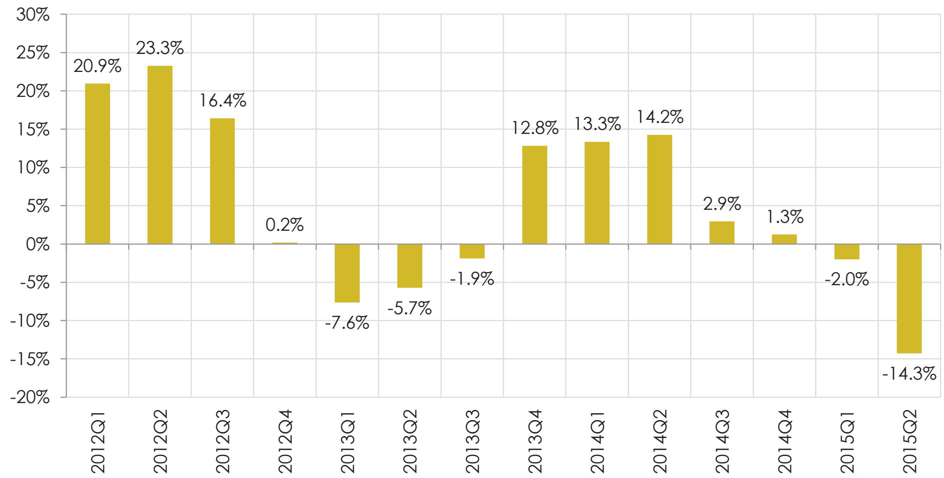
Against the background of the stabilization of regional economies and the depreciation of the domestic currency, the rate of exports reduction has lowered and, given current developments, in the absence of additional shocks, this process is expected to continue further. On top of that, during the remainder of 2015, the rate of decline of car re-exports should be lower as a result of the base effect.

‹‹ The rate of export reduction diminished and, in the absence of additional shocks, this process is expected to continue further.

In the second quarter of 2015, registered imports of goods declined by 14.3% year on year, which is 12.3 percentage points less than the previous quarter's indicator. This decline is even higher, amounting to 21%, when it is considered that Hepatitis C treatments, which were provided by a grant, were imported during this period. The decline of imports of petroleum products remained the most significant source behind the total reduction of registered imports of goods. The import of petroleum products is maintained at a reduced level because of lower oil prices in international markets. In addition, from the second quarter, the adjustment effect of the exchange rate depreciation is clearly evident. This is confirmed by the fact that, unlike the previous quarter, almost all imported products declined. There was a considerable decrease in imports of durable consumption goods. In particular, a sharp drop was observed in purchases of various types of electrical appliances, construction equipment and materials. Cutbacks in imports of food products also contributed significantly to the reduction of total imports.

‹‹ The annual reduction rate of registered imports increased to 21% in the second quarter of 2015 (excluding the import of Hepatitis C treatments provided by a grant). Weak internal demand and falling demand on re-exports creates conditions for a further reduction of goods imports in upcoming periods.

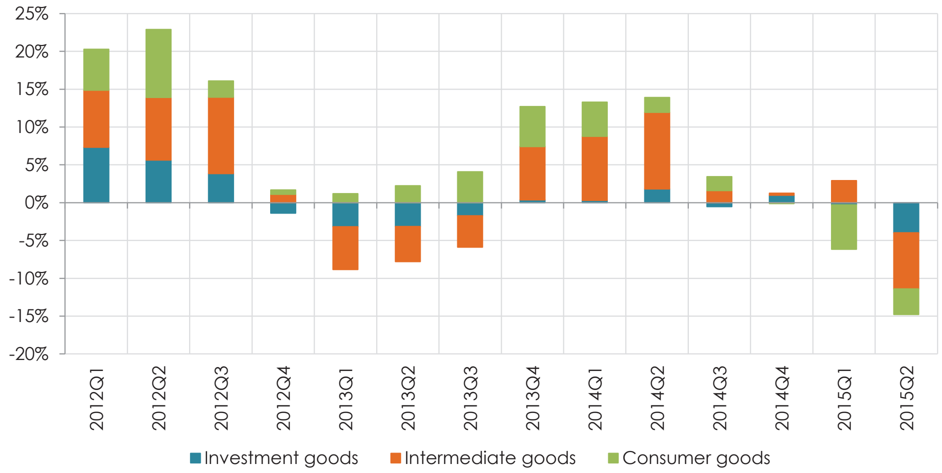
Figure 7.2 Annual Growth Rate of Registered Imports of Goods



Source: GeoStat

The decomposition of imports across different categories of products indicates that the import decline was chiefly driven by a 19.3% reduction of imports of intermediate goods, which contributed -7.4 percentage points to the total decrease. The fall of imports of investment goods was even higher (-29%), however the contribution of these types of goods to the overall reduction of imports was less (-4 percentage points). Consumer goods imports decreased as well, but at a somewhat lower rate of 8% year on year, contributing -3.4 percentage points to the overall reduction of the second quarter of 2015.

Figure 7.3 Annual Change of Registered Imports by Broad Economic Categories

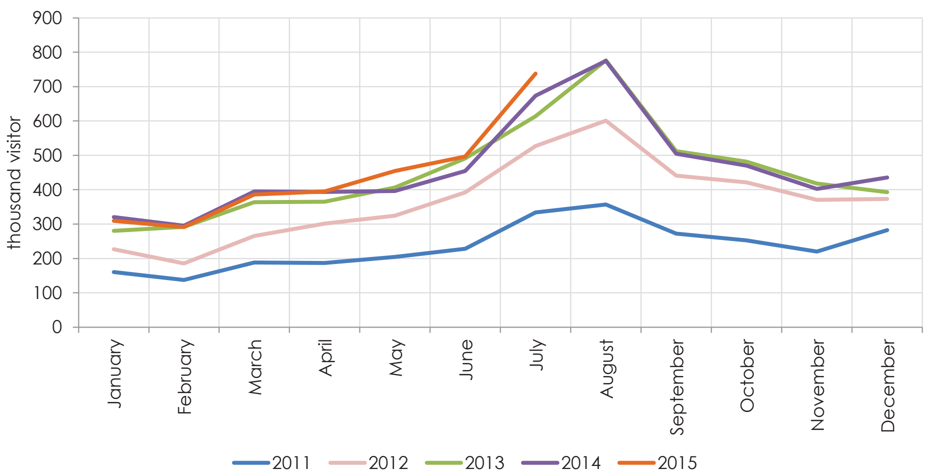


Source: GeoStat.

The European and regional crises negatively affected the amount of remittances coming into Georgia. In the second quarter of 2015, money transfers were reduced by 22.6% on an annual basis to 289 million USD. This decline was mainly a result of a 39% annual decline of transfers from Russia, but transfers were also down from Europe. The most dramatic decline in transfers among Europe were registered from Greece (-21%) and Italy (-15%). During the second quarter, the sharp decline of remittances from Ukraine continued. Overall money transfers from CIS countries declined by 36.7% and those from EU countries fell by 14.9%. Conversely, an increasing tendency was observable from the USA and Turkey, from where money transfers increased by 25.4% and 13.1% respectively.

The number of incoming visitors to Georgia increased in the second quarter of 2015 by 8.2% compared to the previous year. This increase was mainly a result of the sharp growth (43.6%) of the number of foreign transit passengers. However, unlike in the previous periods, growth was also observed in incoming tourists (3.1%).[16] It should be noted that the high growth of visitors was largely a result of the fact that in the May-June period of last year the Lars border checkpoint did not function because of a natural disaster and thus entry into the country for Russian and Armenian citizens was limited. Because of this, the highest growth of visitors came from Russia (29.1%) and Armenia (20.2%). The number of visitors from Europe also increased by 3.7% year on year. In contrast, the number of visitors from Ukraine (-9.2%) and Turkey (-7.8%) fell.

Figure 7.4 Number of incoming visitors to Georgia



Source: GNTA

16 The inflow of foreign nationals crossing the Georgian state border for a period of more than 24 hours.

the first quarter of 2015, the CA deficit was mainly financed by other investments and foreign direct investments (FDI). Inflows of other investments reached 204.8 million USD, which is significantly higher than the same indicator from the previous year. These investments mainly increased due to increased long-term private sector debt. FDI also played an important role in financing the CA deficit. Nevertheless, in the first quarter of 2015, FDI in Georgia declined by 35.4% to 175.5 million USD.

8. Output and Labour Market

8.1 OUTPUT

In the first quarter of 2015, GDP grew by 3.2% in comparison with the same period of the previous year. Services made the largest contribution to growth (1.9%), the industrial sector contributed 0.9% and agriculture made a 0.3% contribution.

« In the first quarter of 2015, services made the largest contribution to growth.

« Trade, the largest branch of the economy, shrunk by 2.5% in the first quarter.

Trade , the largest branch of the economy and one of the main drivers of growth in recent years, shrunk by 2.5% in the first quarter of 2015 (making a -0.4% contribution to total growth). An important part of tradable products comes from imported goods. In the first ten months of 2014, imports of consumable goods rose by 16% in comparison with the same period of the previous year – and this period was thus marked by a high growth rate in trade. However, between November 2014 and March 2015 imports of consumable goods plummeted by 10.5%. This indicates reduced demand on consumable goods since the end of 2014, which later translated into a decline of trade output.

Transport saw the highest growth in the services sector (growing 8.4% and making a 0.5% contribution to GDP growth). This was an outcome of intensified activity from pipeline and railway transports, travel bureaus and tourist agencies. The output of restaurants and hotels also significantly increased (growth of 8.9%, making a 0.2% contribution to GDP growth). The rise in output of travel bureaus, tourist agencies, hotels and restaurants against the contracting number of foreign visitors (-2.4%), can be explained by the activation of internal tourism. Due to continued activity in the real estate market, the output of this branch increased by 5.2%, contributing 0.3% to GDP growth. Community, social and personal service activities, which principally consists of mass media and gambling output, have shown significant growth of 8.3% (making a 0.3% contribution to GDP growth). The financial intermediation sector continued its high growth rate (growing by 8.9% and making a 0.2% contribution to GDP growth).

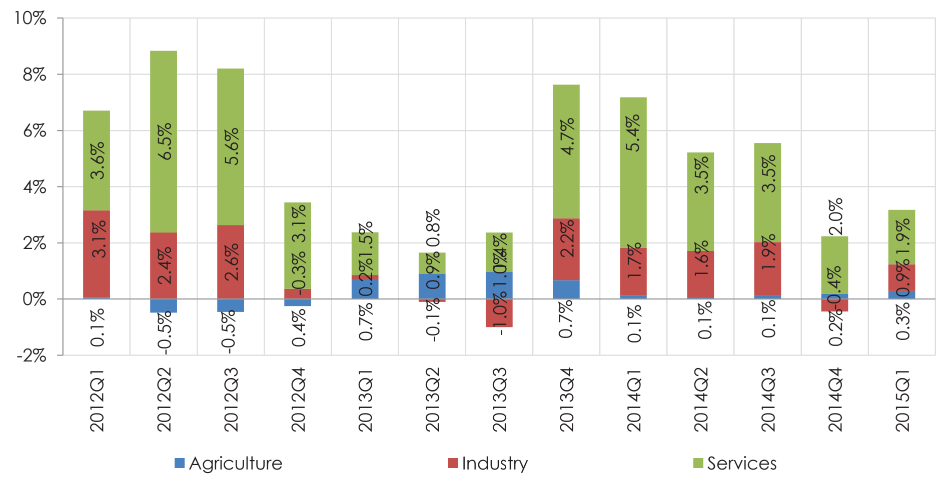
Construction saw the largest increase in the industrial sector (with 17.2% growth, making a 1.1% contribution to GDP growth). This growth was underpinned by the general construction of buildings and civil engineering works, which predominantly belong to the private sector. High growth was maintained in the construction of motorways, roads, airfields and sport facilities, which are related to infrastructural projects implemented by the government. Mining and quarrying surged, growing by 22.9% (making a 0.2% contribution to GDP). After falling last year, much of this increase is related to the recommencement of work on mines. Manufacturing suffered a severe decline of 5.2% (making a -0.5% contribution to GDP). This decline resulted from a reduction of external demand – with the output of alcoholic drinks being most affected.

Agriculture grew by 3.9%, contributing 0.3% to GDP growth.

The economic slowdown process spread to the second quarter as well. According to preliminary data, GDP growth in the second quarter was at 2.1%.

« The economic slowdown process spread to second quarter.

Figure 8.1 Contribution of Sectors of Economy to Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

The number of persons employed in the business sector of the economy increased by 10% in year-on-year terms during the first quarter of 2015, which is 7 percentage points higher than in the previous quarter. During this period, employment increased in the agriculture sector (14%). Employment in the industrial spheres of the business sector grew by 9.3%. The number of employees in manufacturing decreased by 4%, which stands in contrast with the considerable 30.8% growth in the construction sector. The number of persons employed in services increased by 10.2%, with particularly notable growth observed in the hotels and restaurants and trade sectors.

« During the first quarter of 2015, employment in the business sector increased by 10%. High growth rates were observed in the construction and hotels and restaurants sectors.

Table 8.1 Growth of Employment in the Business Sector in the 1st Quarter of 2015 Relative to the Corresponding Period of the Previous Year

	Employment growth, %
Agriculture and fishery	14.4
Industrial sectors	9.3
Service sector	10.2
Overall in the business sector	10.0

Source: GeoStat and National Bank of Georgia

Against the background of increased employment , during the first quarter of 2015 the annual growth rate of labor productivity declined to 1.7%, which is 4.3 percentage points less than in the previous quarter. As a sectoral breakdown shows, labor productivity in manufacturing increased with the annual growth rate reaching 3.5%. At the same time, an annual rise of 9.6% was observed in the construction sector. Relatively lower growth rates (of around 1%) were observed on average in the service sector. It is worth noting that labor productivity only decreased in agriculture, with an annual drop of 5.8%.

« During the 1st quarter of 2015, labor productivity in the business sector increased by 1.7% in year-on-year terms.

The annual growth rate of the nominal salaries of employees in the business sector amounted to 9.3% during the first quarter of 2015, which is 0.2 percentage points more than in the previous quarter. According to the latest data, the average monthly nominal salary in the business sector of the economy stood at 852 GEL. In terms of sector analysis, an annual growth of salaries was evident in all spheres. Particularly high rates of growth were observed in real estate, renting and business activities, healthcare and social work, and education.

« The nominal salaries of employees in the business sector increased by 9.3% on an annual basis.

Table 8.2 Index of Average Monthly Nominal Wage of Employees in the business sector in the first quarter of 2015 Relative to the Corresponding Period of the Previous Year

	Average nominal wage (growth index)
Agriculture, hunting and forestry	110.5
Fishing	152.3
Manufacturing	106.4
Construction	111.4
Wholesale and retail trade; repair of motor vehicles and personal and household good	101.2
Hotels and restaurants	110.5
Transport and communications	103.1
Real estate, renting and business activities	122.1
Education	120.9
Healthcare and social work	123.7

	Average nominal wage (growth index)
Other community, social and personal service activities	101.1
Overall in the business sector	109.3

Source: GeoStat

To sum up , against the backdrop of increasing wages in the business sector, the personnel labor cost[17] per unit of production increased in year-on-year terms and stood at 7.5% by the end of the first quarter of 2015.

‹‹ The personnel cost increased by 7.5% in year-on-year terms.

17 *The same as salary expenditures as a share of business sector output.*

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

2005 2006 2007 2008