National Bank of Georgia

INFLATION REPORT

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MONETARY POLICY IN GEORGIA

- **The aim of the monetary policy is to maintain low and stable inflation** and thus promote macroeconomic stability, which in turn is a precondition for robust and sustainable economic growth, low interest rates and decreasing unemployment.

- **The long-term CPI inflation target is 3%.** It is planned to gradually decrease the inflation target of the National Bank of Georgia to 3%. The inflation target for 2015-2016 is set at 5%, for 2017 it is 4%, and from 2018 it is 3%.*

- **Since monetary policy decisions impact the economy with a certain time lag (of 4-6 quarters),** in order to hit the target in the medium term the formulation of monetary policy is done according to inflation forecasts. 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 rates 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 National Banks of Georgia's vision with regard to ongoing and expected macroeconomic activity is published in the second month of every quarter in the Inflation Report.

* *A draft resolution "on the Main Directions of the Monetary and Exchange Rate Policy for the Years 2016-2018 ", according to which the inflation target rate will be reduced to 3% in 2018, currently is submitted to the Parliament.*

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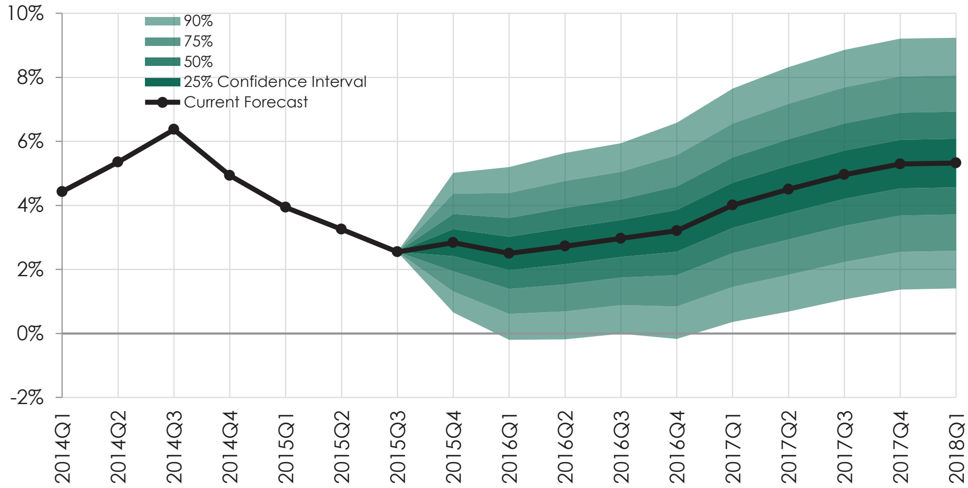
1. Brief Overview

According to preliminary data, **real economic growth** in the third quarter of 2015 was around 2.5% on an annual basis, while the average for the first three quarters of the year was 2.7%. The construction sector made the largest contribution to GDP growth. This was the result not only of private sector investments, but also of government capital expenditures. As was expected, the GDP growth rate remains modest due to external disturbances. Although this was predominantly a consequence of the fall in exports of goods and services, domestic demand has also been weak – reflective of the decline in remittances and the increased debt service burden on foreign currency loans. On the other hand, economic stability has been supported by adjustments in external imbalances that occurred as a consequence of the exchange rate depreciation.

According to the **economic growth forecast** of the National Bank of Georgia, GDP growth in 2015 will remain in the current range up to 3%, and will be 3% in 2016 (see Figure 1.1). The main impediment for economic growth will be the foreign sector. Given the tense economic situation in the region, this sector has a negative influence on exports of goods and services and remittances. As a consequence of stable monetary and fiscal policies, an increase in lending should encourage economic activity.

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

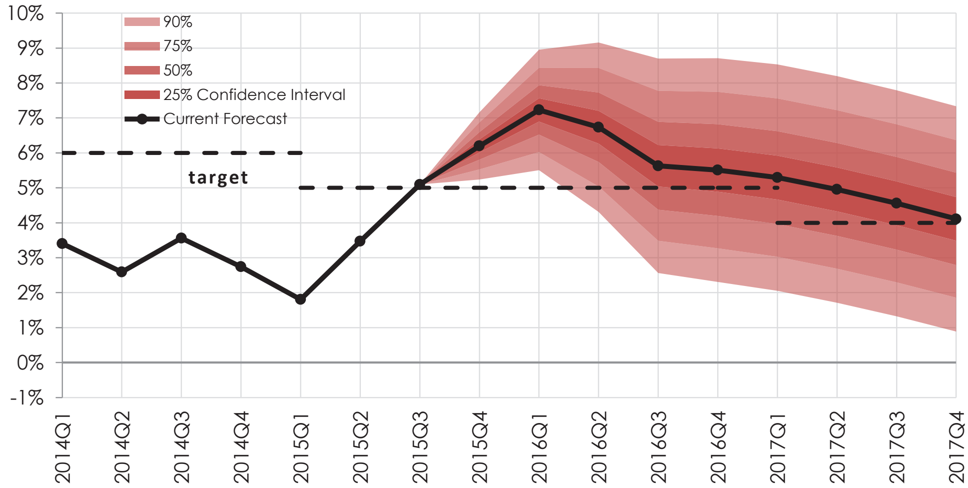


Source: National Bank of Georgia

Inflation in the third quarter of 2015 was higher than expected. The annual change in consumer prices was 5.8% in October and thus stayed in the range of the NBG's 5% inflation target. The main factor contributing to higher inflation was the higher intermediate costs of firms, which was a result of the increased debt service burden on foreign currency loans. In addition, the depreciation of the lari exchange rate 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.

According to the forecast, inflation will increase moderately. It will temporarily overshoot the 5% target before returning to the target rate by the end of 2016 (see Figure 1.2). According to the forecast, the main source of higher inflation will be the supply side – in particular, an exchange rate depreciation-induced rise in debt service costs and higher prices of imported durable goods. Against this, downward pressure on inflation will come from weak demand and low global prices of food and oil.

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. An important assumption made by the forecast is that the negative spillovers from the external sector will not deteriorate further. On the other hand, a greater amount of foreign investments than expected and/or increased private and public infrastructure projects both represent positive risks for the forecast.

At the Monetary Policy Committee meeting of 4 November 2015, it was decided to raise the refinancing rate by 50 basis points to 7.5%. This decision was based on macroeconomic forecasts that suggest the normalization of monetary policy by the National Bank should curb inflationary expectations. Further monetary policy moves will also be gradual. Their pace will depend on the expected dynamics of the inflation rate, the factors influencing it, and economic activity in general.

2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

The unstable economic and geopolitical situation in the region remains an important challenge for the Georgian economy. Despite the relative de-escalation of the armed conflict in Ukraine, the conflict has left Ukraine facing a heavy burden, which is reflected in fiscal difficulties, reduced consumption and lower investment. The conflict has also negatively affected the Russian economy, mainly in the form of economic sanctions that have worsened the investment mood. Meanwhile, falling oil prices on international markets create additional difficulties in terms of export revenues. In Turkey, political risks and volatility in global financial markets threaten economic activity and the country has seen a significant worsening of both consumer and business sentiment. Decreased oil revenues have reduced fiscal revenues in Azerbaijan; however, in 2015 the public sector still remains the main source of economic activity and employment (together with the energy sector). Despite significant annual growth in the first half of 2015, Armenia's economy is still weak amid reduced trade and remittances and a lack of investment from trading partners. A relatively better situation is observed in the euro area, where the uncertainty surrounding Greece is decreasing amid a moderately-paced recovery. In the United States, the unemployment rate continues to fall, while the real estate market is steadily improving. However, the strengthening of the dollar has recently had a negative impact on US net exports. The International Monetary Fund (IMF) estimates that in 2015 global economic growth will total 3.1%, while in 2016 it will reach 3.6%.[1]

Despite some improvements, the economic outlook of Georgia's main regional trading partners remains less than promising. In most countries of the region, national currencies are under pressure from devaluation, which is complemented by high inflation and tighter credit conditions. Under the conditions of external shocks, Georgia, like other countries, still faces weak export revenues and remittances, which, in turn, lead to a decrease in foreign exchange inflows.

In Ukraine, amid a de-escalation of the conflict in the industrialized eastern part of the country, the latest data suggest that economic activity is most likely approaching a turning point. The exchange rate and foreign reserves are stable, while depreciation-induced inflation has started to decrease. Nevertheless, the heavy legacy of the conflict persists in the form of negative sentiments and expectations among consumers and the business sector. Under these circumstances, Ukraine's GDP will have fallen by about 9% in 2015. However, it is expected that planned structural reforms and infrastructure projects will help the country's economic growth become positive in 2016. The IMF predicts that Ukraine will emerge from recession in 2016 and its total output will post 2% growth year on year.[2]

In Russia, foreign direct investment and domestic demand continues to deteriorate amid national currency devaluation and rising inflation. The extended sanctions from the developed world are likely to have an additional negative effect on business sentiment – especially taking into the account the fact that the "import substitution" program announced by the Russian government last year has produced no tangible benefits.[3] The Russian ruble still remains vulnerable to fluctuations in oil prices and US interest rate expectations, while the inflation rate, in spite of a tighter monetary policy, is floating around 16%. The IMF predicts that the Russian economy will contract by 3.8% and 0.6%, in 2015 and 2016 respectively.

The economic downturn in Russia has had a contagious effect on Armenia's economy, which substantially depends on remittances, export demand and investment. However, as a result of the opening of a new copper mine in the second quarter and a significant growth in the agricultural sector, GDP grew by 5.1% year on year. Although the devaluation of the dram at the end of 2014 increased consumer prices, the inflation rate has recently started to decline, and stood at 3.3% in September.

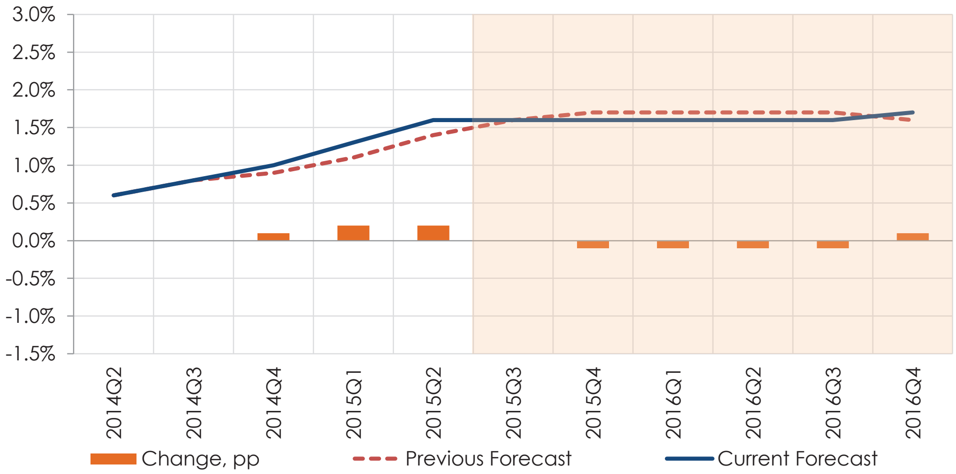
1 *World Economic Outlook (WEO) – October 2015.*
2 *World Economic Outlook (WEO) – October 2015.*
3 *United Nations, World Economic Situation and Prospects, Monthly Briefing, No. 83.*

The IMF estimates that in 2015 Armenia's GDP will grow by 2.5%.[4] Large expenditures during the preparation period for the First European Games sporting event in Baku caused a significant increase in the construction and other non-energy sectors in Azerbaijan. However, falling prices have negatively affected oil export revenues and the current account of Azerbaijan, while a weak manat threatens the stability of the highly dollarized financial system.[5] Annual inflation was 3.6% in September and the IMF's latest forecasts show that Azerbaijan's GDP growth will reach 4% in 2015.[6]

Despite the reduction in oil prices and the depreciation of the lira, Turkey's current account deficit persists against the background of volatile funding sources. Internal political tensions, the complicated situation on the country's southern border and current trends in global financial markets all represent significant impediments to attracting investment – with the situation being exacerbated by a lack of foreign demand for Turkish exports. Although inflation has remained above the target rate (around 7%), the central bank has thus far refrained from further tightening the monetary policy. Amid the parliamentary election-related uncertainty, the IMF expects Turkey's economic growth to be only 3% and 2.9% in 2015 and 2016 respectively.

Despite the gloomy global economic outlook and increasing instability on Europe's financial markets, the eurozone economy is showing signs of recovery. The fall in energy prices contributed to the growth in private consumption and a reduction in production costs – particularly in Italy, Spain and Ireland, which largely compensated for the weakened economic activity in Germany. This, in turn, improved consumer and business sentiment indicators. The annual inflation rate turned negative in September, but the main reason for this was the reduction of oil prices. The IMF predicts that the eurozone economy will continue to recover and in 2015 GDP growth will reach 1.5%. The forecast for 2016 stands at 1.6%.[7]

Figure 2.1 Eurozone Real GDP Annual Growth

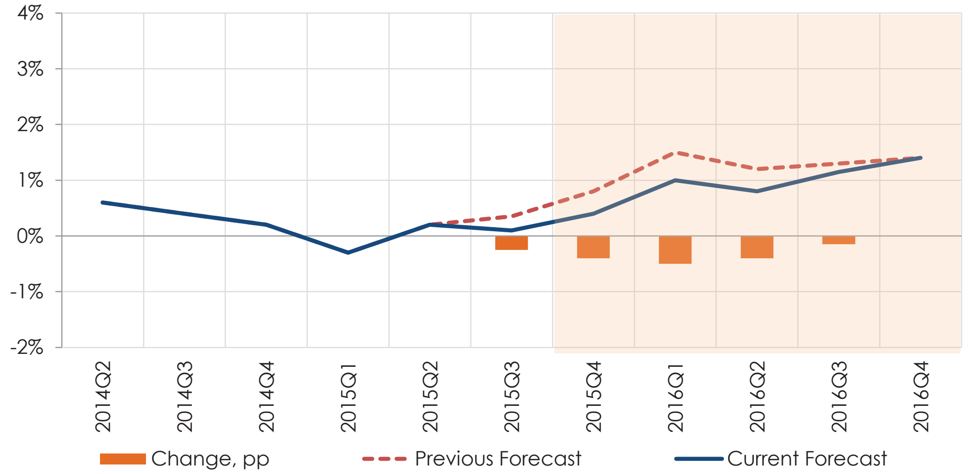


Source: OECD

The economic growth of the US in 2015 will be less than expected due to the weak first quarter resulting from harsh winter weather conditions, disruptions in international traffic and reduced investment in the oil sector. At the same time, the strengthening of the dollar has recently had a negative impact on net exports, which has been supplemented by weakened demand in China. However, many indicators suggest the irreversible recovery of the US economy. In particular, the unemployment rate was 5.1% in the second quarter, a 1 percentage point improvement over the previous year. The real estate market is also significantly improving. The IMF predicts that the US economy will grow by 2.6% in 2015 and by 2.8% in 2016.[8]

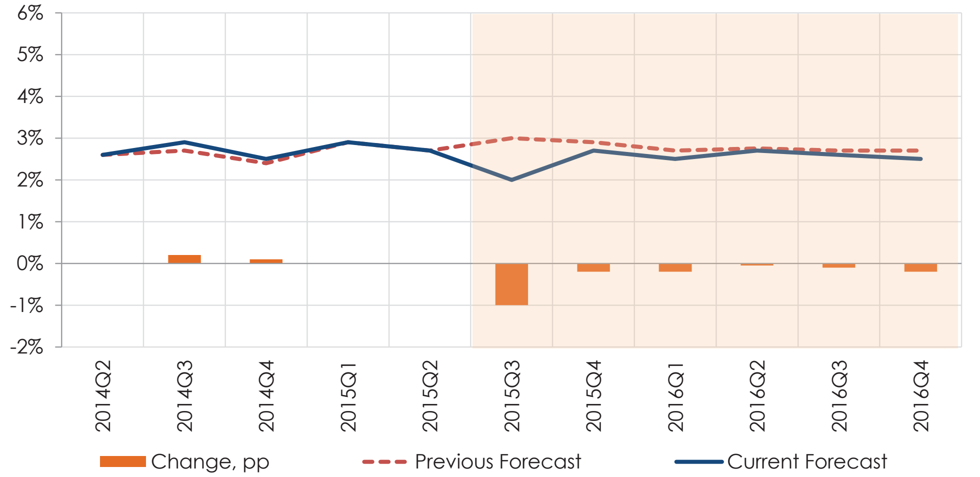
4 *World Economic Outlook (WEO) – October 2015.*
5 *Asian Development Outlook, 2015 Update.*
6 *World Economic Outlook (WEO) – October 2015.*
7 *World Economic Outlook (WEO) – October 2015.*
8 *World Economic Outlook (WEO) – October 2015.*

Figure 2.2 Eurozone CPI Annual Inflation



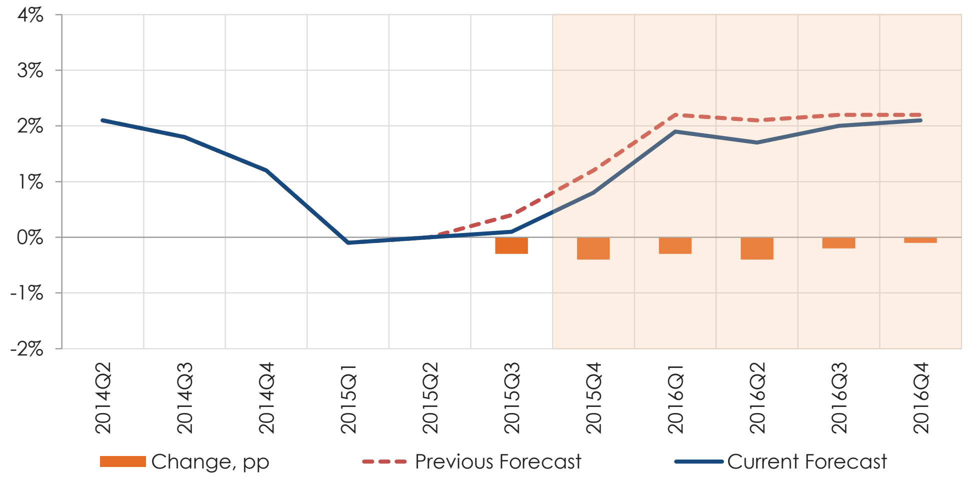
Source: Eurostat

Figure 2.3 U.S. Real GDP Annual Growth



Source: OECD

Figure 2.4 U.S. CPI Annual Inflation



Source: OECD

In terms of monetary policy, the world's leading developed economies maintained an expansionary approach to support economic activity and raise inflation towards the target levels. It is expected that the US Federal Reserve will increase interest rates by the end of the year, albeit at a slow pace, while the European Central Bank is expected to continue its policy of monetary easing. The situation is different in the majority of developing countries, where local currency devaluations have created inflationary pressure and elevated the need for tighter policy.

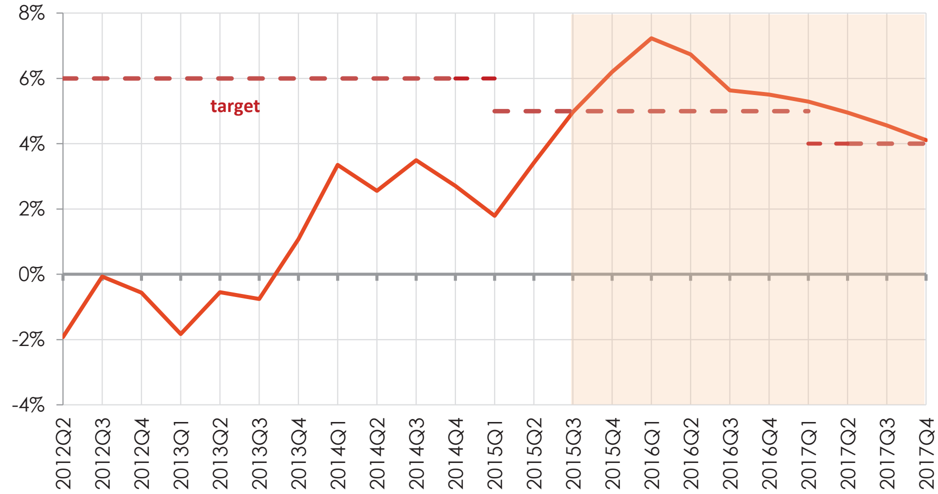
The global strengthening of the dollar is reflected on the USD LIBOR rates.[9] In September, the US dollar's 3-month LIBOR rate remained broadly unchanged at 0.3%, and it is expected to increase to 0.5% by the end of the year. The opposite situation is seen with regard to the euro LIBOR rates. These have exhibited a downward trend and the current 3-month rate is virtually zero.

The recent weakening of economic activity in China (which makes up 30-50% of total demand on commodity markets) has had a significant impact on commodity prices. Since the beginning of 2015, the commodity price index, as calculated by the IMF, fell by 21%. This reflects a drop in prices on all major commodity groups (energy, metals and food). According to current forecasts[10], an oil price hike is less likely because of the possible removal of sanctions on Iran, which will bring this resource-rich player back to the global market. Given the conditions of weak demand and stable supply, metal and agricultural product prices will remain almost unchanged.

2.2 MACROECONOMIC FORECAST

The inflation rate in the third quarter of 2015 was slightly higher than expected. The annual growth of consumer prices reached 5.8% in October – which is within the range of the inflation target set by the National Bank of Georgia (see Figure 2.5). The main factor contributing to higher inflation in the third quarter was higher intermediate costs for firms, which, in turn, was a result of the increased debt service burden on foreign currency loans. In addition, the lari exchange rate depreciation translated into higher prices on imported durable goods, which 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.

Figure 2.5 Headline Inflation



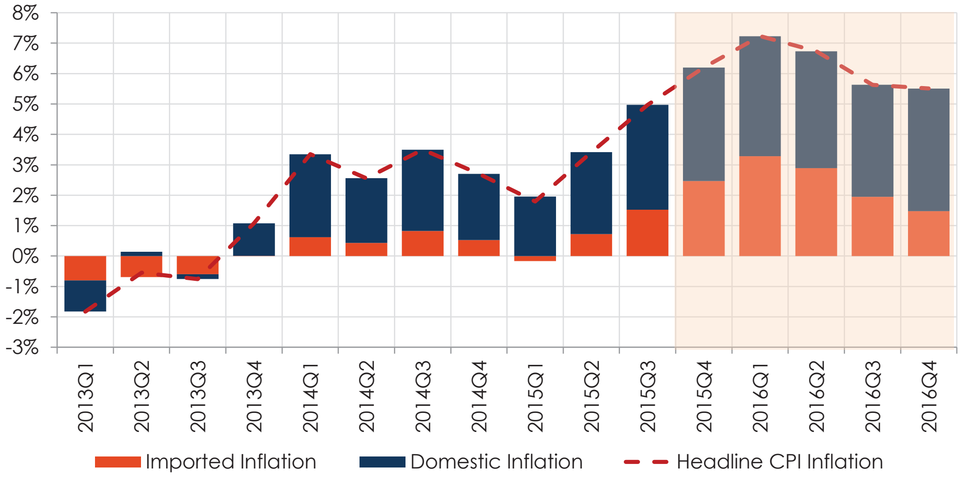
Source: National Bank of Georgia

According to the forecast, over the next period **inflation** will increase moderately and overshoot the 5% target (see Figure 2.5). After this, it will start a downward trend, returning close to the target by the end of 2016. In addition to imported inflation, domestic prices will also partly contribute to the aforementioned dynamics (see Figure 2.6).

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

10 Commodity Price Outlook & Risks, October 2015.

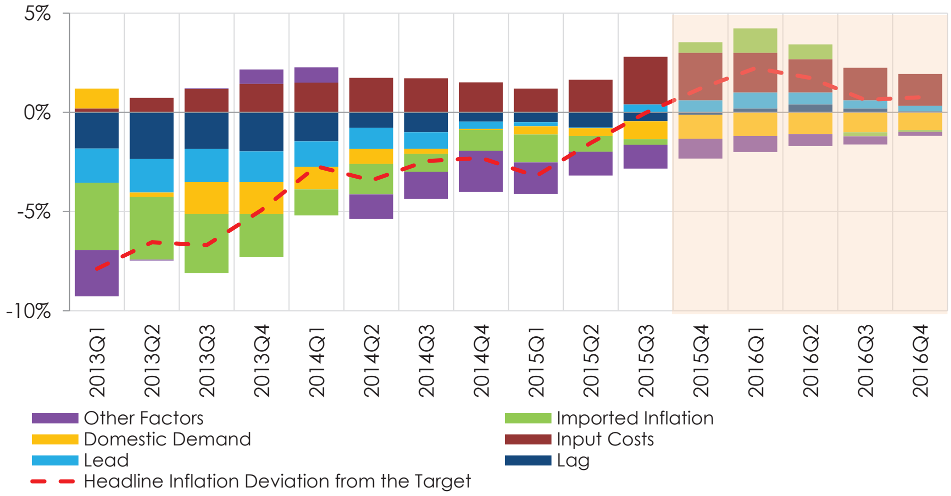
Figure 2.6 Headline Inflation Decomposition



Source: National Bank of Georgia

Until the previous quarter, **the deviation of inflation from the target** had mainly been caused by a combination of weak imported inflation, declining global 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. 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. In addition, a depreciation-induced increase in imported durable goods prices will also contribute to higher annual inflation. Against this, downward pressure on inflation will come from low global food and oil prices and weak demand. Under the backdrop of low economic activity, it is expected that demand in both 2015 and 2016 will be lower than its potential level and will thus curb other inflationary pressures. According to the forecast, which takes all of the above mentioned factors into account, in the first quarter of 2016 inflation will overshoot the target by about two percentage points and will return to the target level by the end of 2016.

Figure 2.7 Inflation Deviation From Target And Its Decomposition



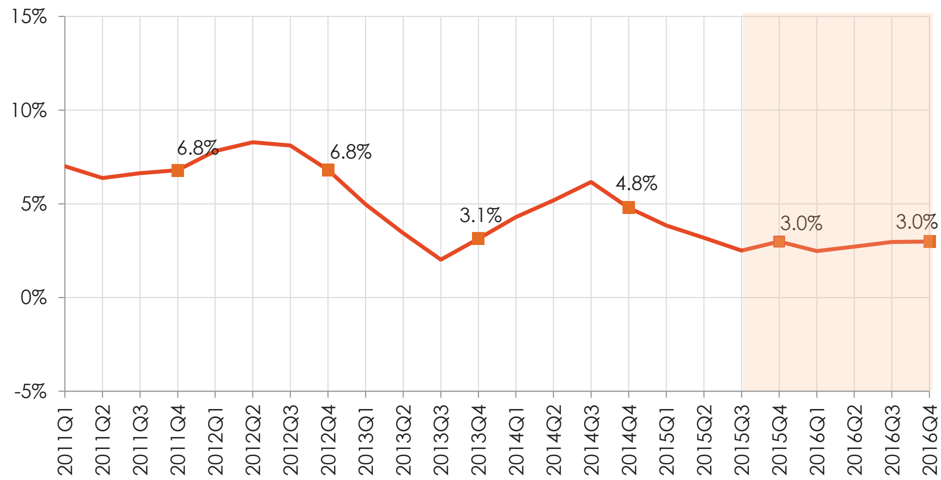
Source: National Bank of Georgia

There are **risks associated with the inflation forecast** in both directions. 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. This 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. On the other hand, a greater-than-expected depreciation of the currencies of Georgia's main trading partners or a stronger-than-expected transmission of low food and oil prices on international markets into domestic prices may contribute to lower inflation than is currently forecast. There is also some uncertainty surrounding economic activity. If this is weaker than expected, it will cause actual inflation to be lower than current projections, and vice versa if stronger than expected.

Real GDP growth in third quarter was consistent with previous forecasts and, according to preliminary data, averaged 2.7% in the first three quarters of 2015 (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 measures, an increase in lending had a positive impact on consumption and domestic investment. The construction sector also made a strong positive contribution – 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 both considerably weakened foreign demand and an increase in imports due to higher domestic demand. This imbalance started to improve in the second quarter of 2015, after the depreciation of the Georgian lari against the US dollar. The reduction in imbalances was mainly driven by an accelerated process of import correction, but also, to some extent, by a softening of 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 and the output gap is expected to remain in the same range in 2016 as well.

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

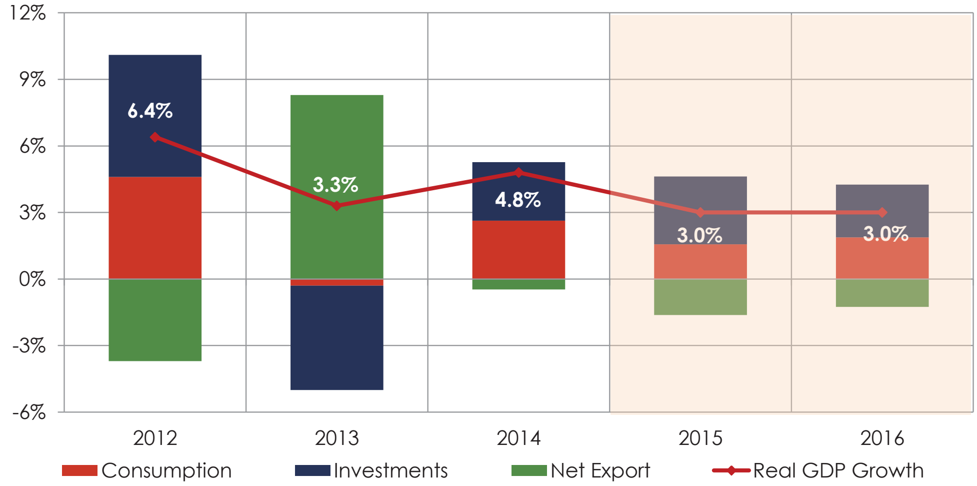


Source: National Bank of Georgia

According to the **GDP forecast**, the growth rate in 2015 is expected to be up to 3%, while it will be around 3% in 2016 (see Figure 2.8). An increase in government capital expenditures, alongside a stable monetary policy, will support lending. This, in turn, will help investment and consumption growth rates. On the other hand, the unfavorable trend in the foreign sector is expected to affect net exports, which will continue to make a negative contribution to GDP growth in 2015 and partly in 2016 (see Figure 2.9). Net exports are negatively influenced by the adverse political and economic conditions in Georgia's trading partners, which are also reflected in weak foreign demand for Georgian exports, as well as declining remittances and international tourism receipts. However, such negative spillovers from the foreign sector are partly offset by reduced petrol prices, which is a positive factor for the current account and other sectors of the economy, and by real effective exchange rate correction.

When analyzing **risks to the GDP forecast**, the foreign sector clearly stands out. In particular, if the economic conditions in trading partner countries worsen against the backdrop of geopolitical tensions or are transmitted to Georgia to a greater extent 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 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 decreased substantially in the third quarter of 2015 and amounted 3.2% of GDP. As a result, the current account deficit-to-GDP ratio was at an average of 9% in the first three quarters of 2015. This improvement was mainly caused by a correction of the real effective exchange rate. The drop in imports balanced the reduced foreign currency inflows. Exports of goods in the third quarter decreased by 23.2% annually. In addition, net money transfers from abroad declined by an annual 36.4%. As for imports, the annual growth rate, which was still positive in the fourth quarter of 2014, became significantly negative in the second and third quarters of 2015, amounting to -21.7% and -16.3% respectively (excluding imports of grant-financed Hepatitis C medication). In the first nine months of 2015, imports fell by an annual 14% (excluding Hepatitis C medications), with the fall in consumption goods imports contributing 10 percentage points to this, while the decline in imports of intermediate and investment goods only contributed 2 percentage points each (see Figure 2.10). It is worth noting that the reduction of imports, alongside reduced foreign currency inflows, indicates the activation of the import adjustment process that contributes to macroeconomic stability.

Figure 2.10 Annual Growth Of Imports In The First Nine Months Of 2015

Source: National Bank of Georgia

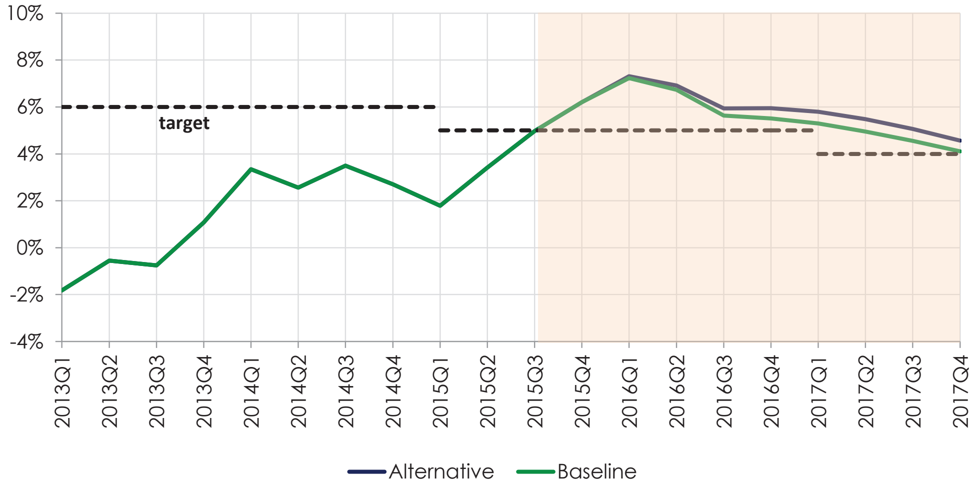
In 2014, the current account deficit worsened to 10.6% of GDP, which is 4.8 percentage points higher than in the preceding year. According to the current forecast, it is expected that the current account will improve slightly in 2015 and will continue improving steadily in the medium term – supported not only by increased exports of goods, but also of services, including tourism.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers the case of a higher-than-expected transmission of foreign risk factors to the Georgian economy. The scenario assumes that the effect of deteriorated external economic conditions on both the nominal effective exchange rate and the real Georgian economy will be higher than expected. According to this scenario, inflation will be slightly higher (see Figure 2.11) and economic growth slower (see Figure 2.12) than in the baseline scenario.

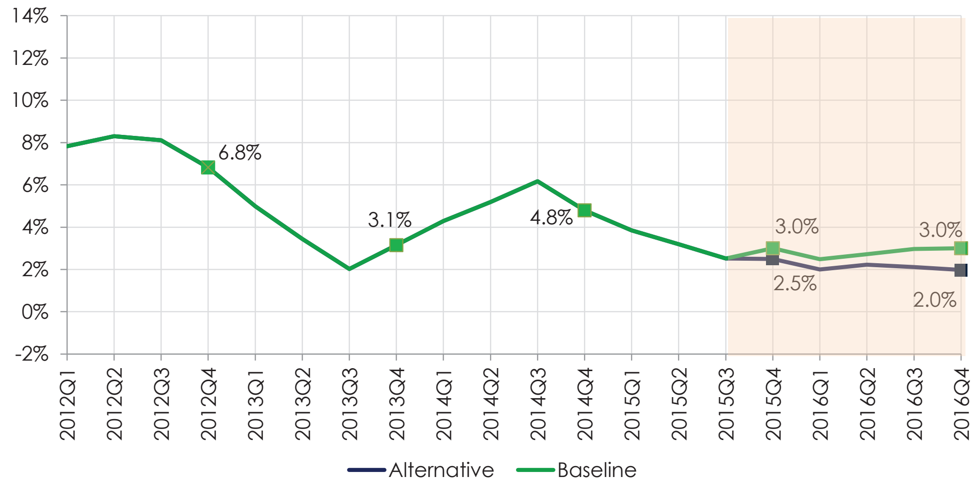
According to the alternative scenario, the inflation rate will increase faster than in the baseline scenario because the upward pressure from the nominal effective exchange rate would outweigh downward pressure from weak demand. In order to influence inflation expectations, adopting an appropriate monetary policy response would make inflation go back to its target in the medium term. As a result, the scenario shows that inflation would only be about half a percentage point higher than in the baseline scenario.

Figure 2.11 CPI Inflation According To Baseline And Alternative Forecasts



Source: National Bank of Georgia

Figure 2.12 Real GDP Growth According To Baseline And Alternative Forecasts (Annual Growth Of The Last Four Quarters)

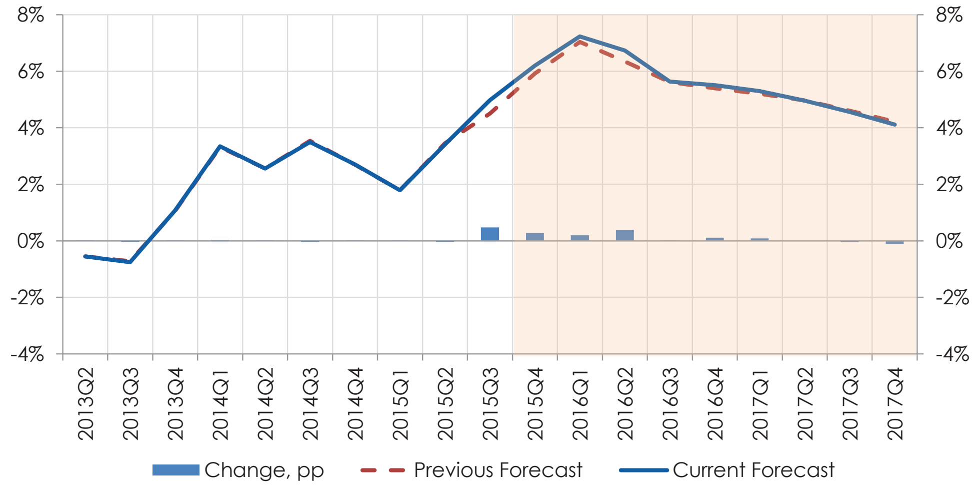


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast has been revised slightly 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 2.13). This upward pressure from the exchange rate has been partially dampened by weak demand, and hence by the lower profits of firms. According to the current forecast, in light of foreign shocks the contribution of imported inflation to overall inflation will be higher than previously forecast. As a result, the inflation rate by the end of 2015 and in the first half of 2016 will be slightly higher than was predicted in the previous forecast; however, it will still reach its target by the end of 2016.

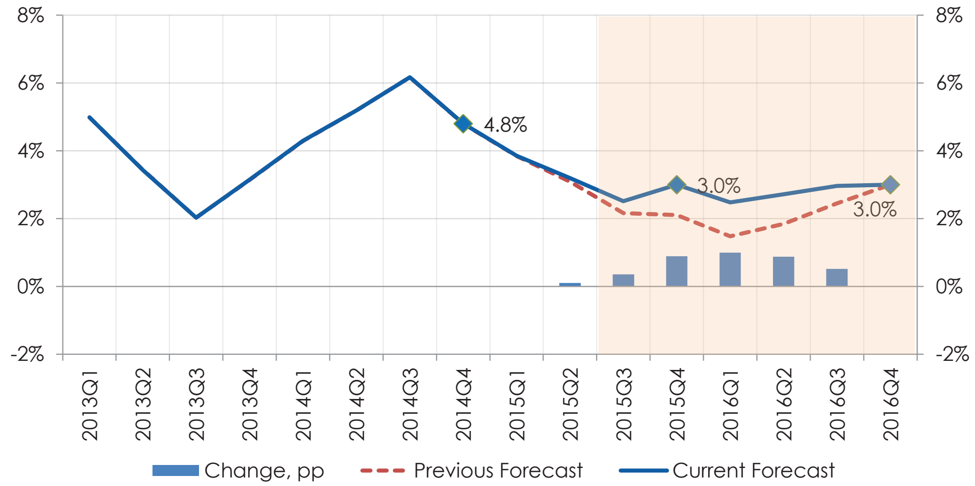
Figure 2.13 Change In The Forecast Of Headline Inflation



Source: National Bank of Georgia

As for economic activity, taking into account the information from the first three quarters of 2015, the GDP growth forecast for 2015 has been revised upward from 2% to 3%. The economic growth forecast for 2016 has not changed (see Figure 2.14).

Figure 2.14 Change In The Forecast Of GDP Growth (Annual Growth Of The Last Four Quarters)



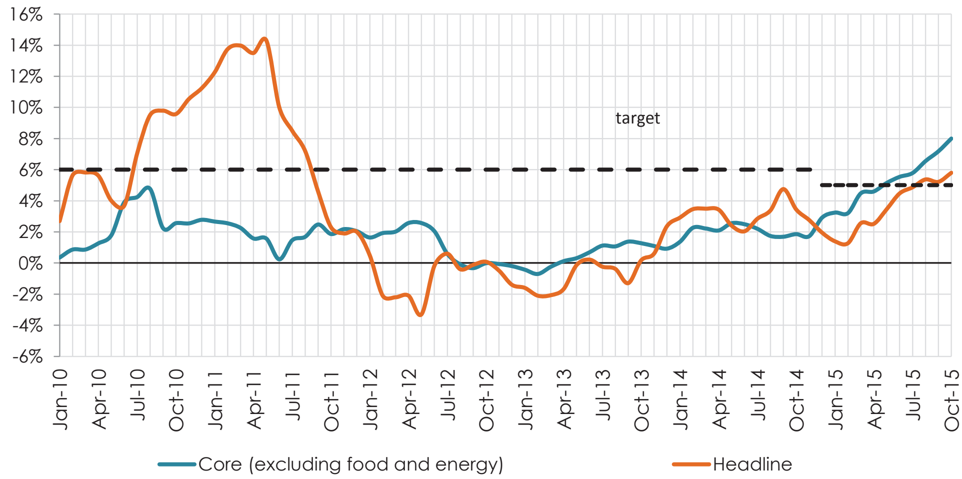
Source: National Bank of Georgia

3. Consumer Prices

By the end of the third quarter of 2015, the annual growth rate of the overall price level increased compared to the previous quarter and amounted to 5.2%. During October, the annual inflation rate grew further to 5.8%. The annual inflation rate is thus in compliance with the NBG's medium-term target of 5%. Against the backdrop of headline inflation, core inflation surged. The recent depreciation of the lari 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 7.2% in September. By the end of October, core inflation further increased and stood at 8% (see Figure 3.1).

‹‹ Headline inflation is close to the NBG's target level and stood at 5.8% in October 2015.

Figure 3.1 CPI And Core Inflation



Source: GeoStat and National Bank of Georgia

Against the low level of oil prices on international markets, fuel prices have 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 during the third quarter of 2015 and into October. 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 October, the rates of decline on petrol and diesel amounted to -8.4% and -12.5% respectively, contributing approximately -0.6 percentage points to headline inflation (see Figure 3.2).

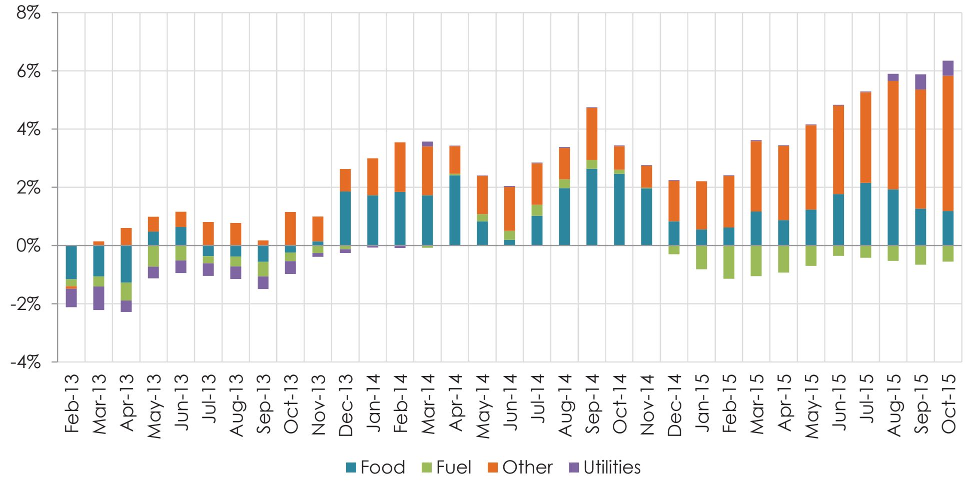
‹‹ Following the exchange rate depreciation, increased prices of some food products put upward pressure on inflation.

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 depreciation of the lari against the US dollar put upward pressure on some food products, resulting in increased food prices in the subsequent period. The effects of depreciation continued in October as well, and the overall level of food prices increased to 4.1%, with the contribution to headline inflation amounting to 1.3 percentage points (see Figure 3.2).

The growth of administrated utility prices – in particular the gradual increase of electricity tariffs that took place in August and September 2015 – put additional upward pressure on the overall inflation rate. The electricity tariff increased by an annual 27.5% in October; contributing approximately 0.5 percentage points to headline inflation (see Figure 3.2).

‹‹ The growth of administrated prices puts upward pressure on the inflation rate.

Figure 3.2 Contribution Of Fuel, Food And Utilities Inflation To Headline Inflation

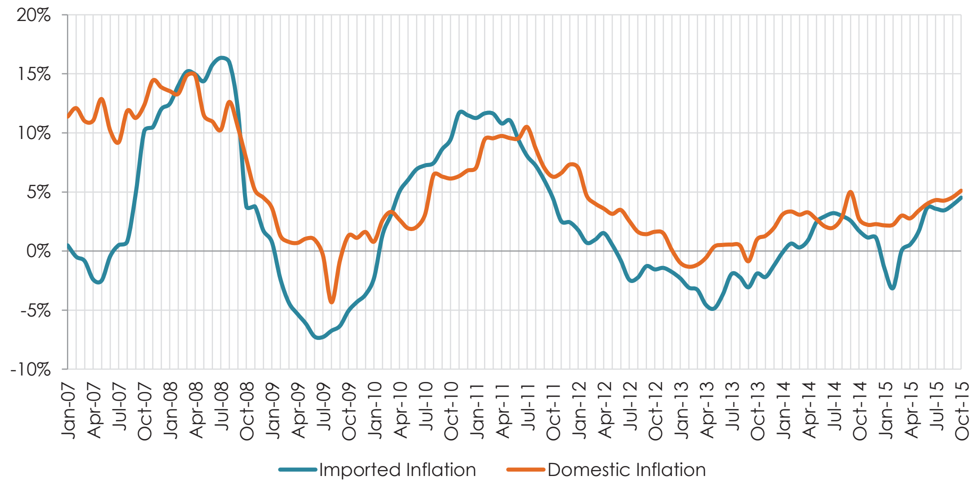


Source: GeoStat and National Bank of Georgia

In terms of exogenous factors, the influence of imported inflation on the overall price level is worth stressing. Due to the nominal effective exchange rate depreciation, imported inflation turned positive and exhibited growth. By the end of October, imported inflation increased to 4.5% (see Figure 3.3), contributing approximately 0.9 percentage points to headline inflation.

« The inflation rate on imported consumer goods increased and stood at 4.5% by the end of October.

Figure 3.3 Imported And Domestic Inflation



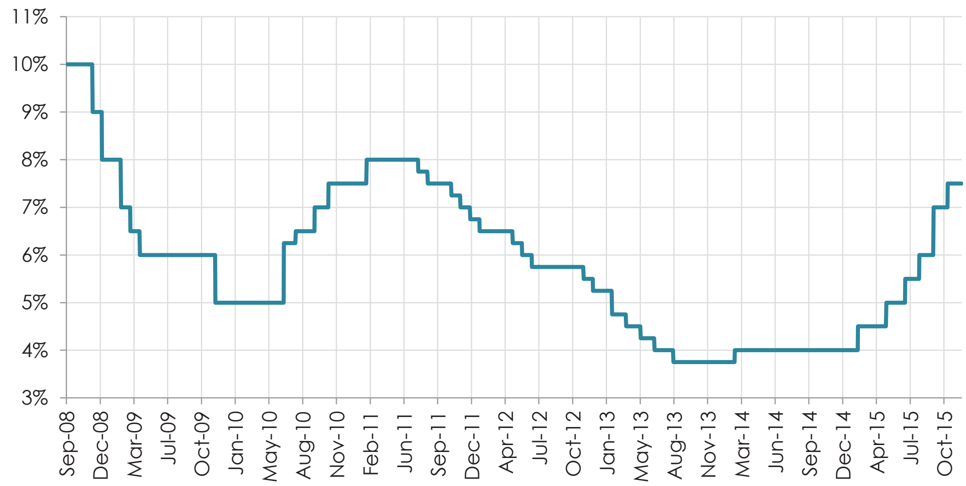
Source: GeoStat and National Bank of Georgia

The realization of geopolitical risks and the subsequent economic downturn in Georgia's main trading partners has been reflected on external demand. This has had a negative impact on the Georgian economy as export revenues and remittances decreased significantly. The factors weakening external and domestic demand thus caused a widening of the negative output gap. Overall, weak aggregate demand put downward pressure on consumer prices.

4. MONETARY POLICY

The transmission of external shocks to the Georgian economy strengthened from the beginning of 2015. The worsened economic conditions in Georgia's main trading partners were reflected in reduced exports and remittances. These factors reduce both domestic and external demand. The nominal exchange rate depreciated in line with existing external imbalances, and the pressure on the inflation rate through the imports channel increased. At the same time, given the high level of dollarization in the economy, depreciation against the US dollar put upward pressure on intermediate costs. Each of these factors drove up inflation expectations. Increased inflation expectations are reflected on the risks of deviating from the inflation target in the medium term. Given this situation, in order to reduce inflation risks the National Bank of Georgia found it appropriate to tighten monetary policy. In the period February-September 2015, the Monetary Policy Committee decided to gradually increase the refinancing rate by 3 percentage points to 7%. At the same time, the interest rate for standing refinancing loans was increased to the policy rate plus 150 basis points.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the National Bank's Monetary Policy Committee (MPC) was held on 4 November. At the meeting the MPC decided to increase the refinancing rate by 50 basis points to 7.5%. This decision was based on the existing inflation forecast and on a macroeconomic analysis of ongoing events in both Georgia and outside its borders. According to this forecast, the National Bank of Georgia continued its monetary policy tightening in response to increased inflation expectations. Further monetary policy changes will depend on the inflation forecast, the factors affecting it and on the general state of the economy.

‹‹ On 4 November, the Monetary Policy Committee decided to increase the refinancing rate by 50 basis points to 7.5%.

The inflation rate in 2015 has 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 stemming from the exchange rate depreciation has been restricted 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 5.8% in October. The main factors causing the rise in inflation were increased intermediate costs of production resulting from exchange rate depreciation, higher prices on certain imported goods and a growth of administrated prices.

Domestic demand remains weak. According to preliminary information, real GDP growth in the third quarter of 2015 was 2.5%, and the average growth over the first nine months of the year amounted to 2.7%. Credit activity growth has decelerated and the growth rate of the portfolio hovers at around 12.8% (excluding the exchange rate effect). The significant decline in imports also indicates weakened demand.

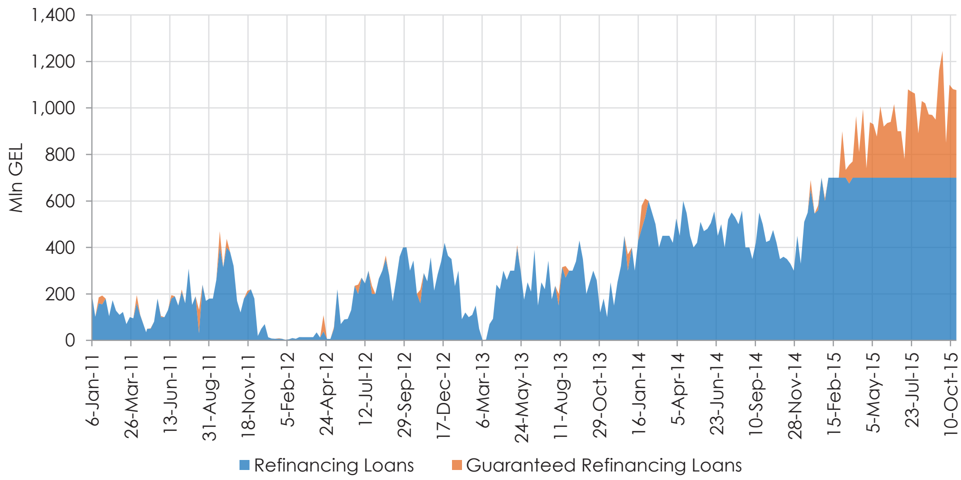
The transmission of negative external shocks to the Georgian economy has been strong since the beginning of 2015. Against the background of worsened economic conditions in Georgia's trading partners, external demand declined significantly. During the first quarter of 2015, registered exports fell by 28%, while imports decreased by 3%. However, in the second and third quarters, the rate of export decline slowed in line with nominal effective exchange rate depreciation. In addition, the adjustment effect of the exchange rate depreciation became evident, and was reflected in considerably decreased imports. According to second and third quarter data, exports declined by 21%, while the annual rate of the decline of imports increased to 19% (excluding the imports of Hepatitis C treatments that were provided by a grant). In the period July-September, remittances declined by 34% annually – a worsened indicator compared to previous months. The deterioration of remittances was principally a result of a sharp decline of transfers from Greece that stemmed from negative developments in that country during this period. Meanwhile, revenues from tourism improved during the second and third quarters of 2015 and this tendency persisted in October.

According to the NBG's existing forecasts, inflation will temporarily overshoot its target in the beginning of 2016 and will then gradually return to the target level. However, upside and downside risks to the forecast remain. Inflation pressure might stem from expectations of worsened inflation, second round effects of increased utility prices, a greater-than-expected growth of intermediate costs, a surge in oil prices and/or higher-than-expected aggregate demand. On the other side, lower-than-expected aggregate demand and/or exchange rate depreciations in Georgia's 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 NBG's Monetary Policy Committee considered it necessary to increase the monetary policy rate by 50 basis points.

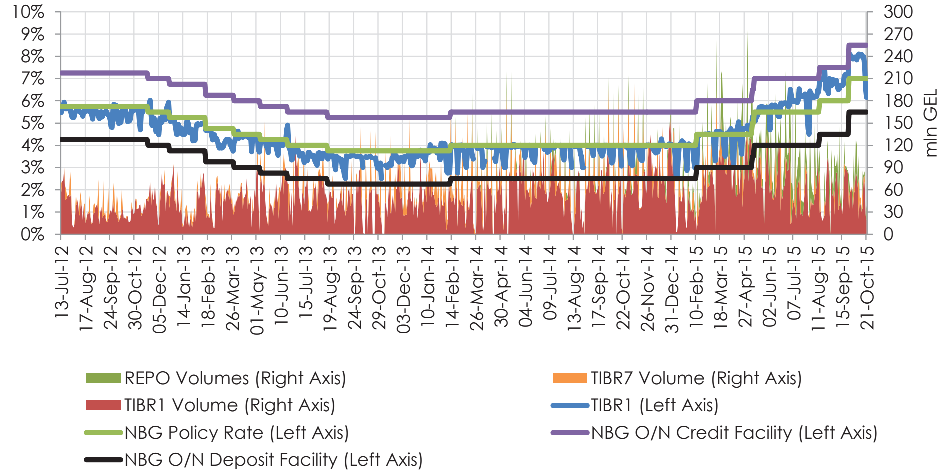
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising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

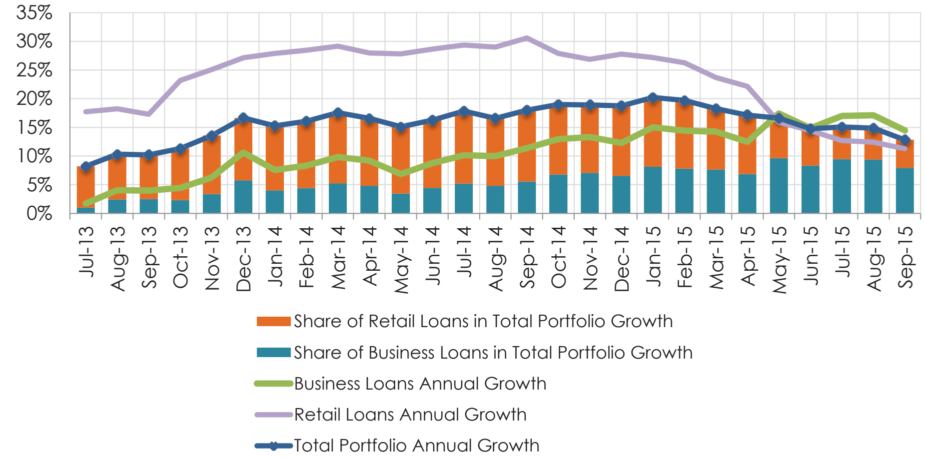
5. Financial Market and Trends

5.1 LOANS

In the third quarter of 2015, the annual growth rate of the loan portfolio decreased and in September, excluding the effect of exchange rate movement, amounted to 12.8%. The growth was 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 in September 2015 business loans in the national currency with a floating interest rate increased by 17% compared to June. However, the share of such loans in total business loans remains relatively small (7%).

« 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.

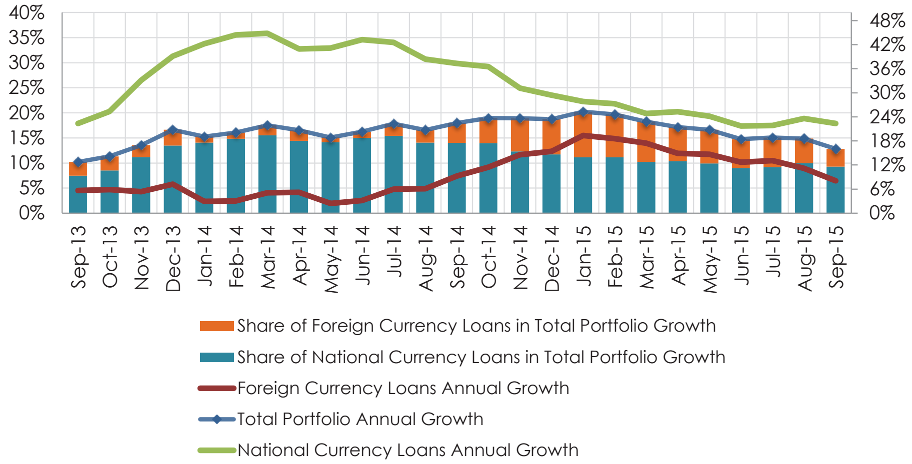
Figure 5.1 Annual Growth Rates Of Retail And Business Loans And Their Contributions To The Growth Of The Loan Portfolio



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 September, the annual growth rate of foreign currency denominated loans decreased to 6.5%, while domestic currency loans increased by 22.3%.

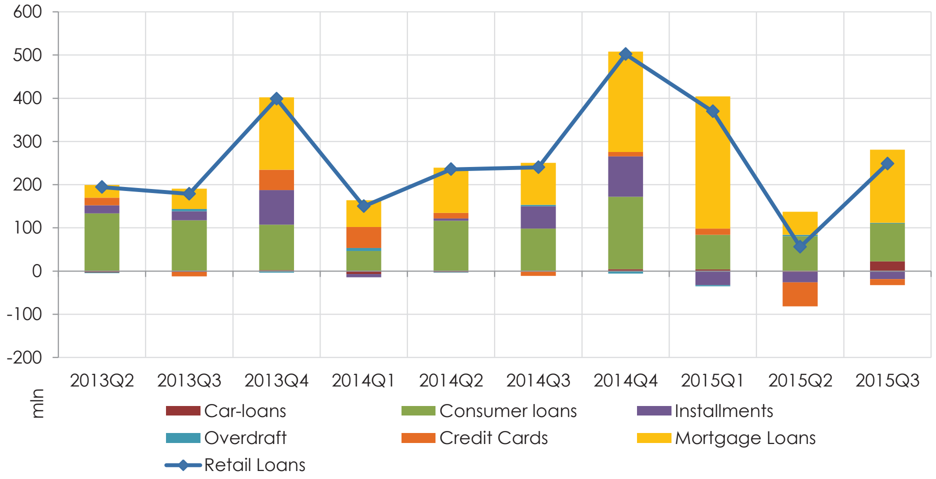
Figure 5.2 Annual Growth Rates Of Domestic And Foreign Currency Loans And Their Contributions To The Growth Of The Loan Portfolio



Source: National Bank of Georgia

In September, the stock of retail loans increased by 250 mln GEL compared to June, which was largely caused by the exchange rate depreciation. The growth of loans to individuals, excluding the effect of exchange rate movement, amounted to 95 mln GEL. In terms of loan products, compared to the previous quarter, the amount of mortgage and consumer loans increased by 57 mln and 52 mln GEL respectively, excluding the effect of exchange rate movement. In the context of currencies, the growth of mortgage loans was mainly driven by foreign currency loans (17 mln USD and 20 mln GEL); while the growth of consumer loans was caused by domestic currency loans (60 mln GEL). The volume of instant loans and credit cards decreased by 30 mln GEL. As these loans are mainly used to finance imports, their slower growth reflects reduced demand for imports and, on the other hand, facilitates a reduction of demand for foreign currency. According to the credit conditions survey, representatives of the banking sector do not expect an improvement of demand for retail loans in the next quarter.

Figure 5.3 Quarterly Growth Of Retail Loans



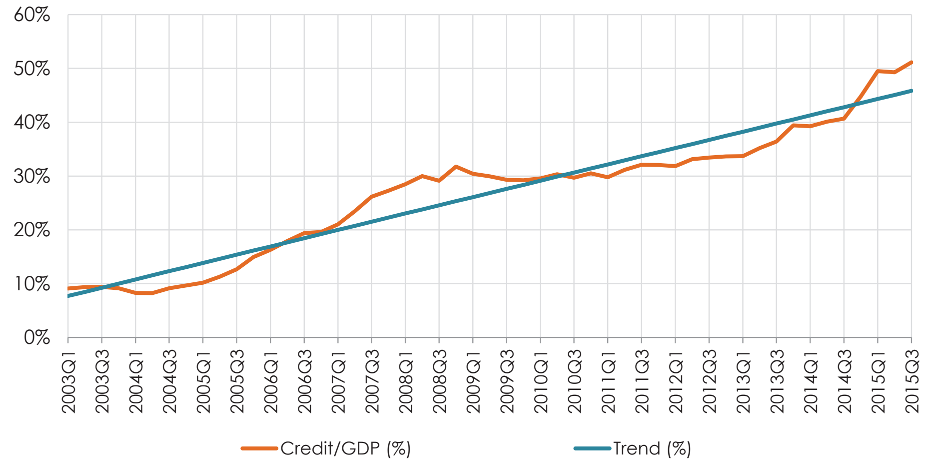
Source: National Bank of Georgia

In September, the annual growth rate of the loan portfolio to legal entities amounted to 14.5%, which is 0.3 percentage points lower than in June. According to the credit conditions survey, in the third quarter of 2015 banks tightened their interest and non-interest rate terms in response to their expectations of economic deterioration. An analysis of business loans by sector reveals that the trade, manufacturing, agriculture and construction sectors all posted growth in terms of credit, while the volume of outstanding loans disbursed to the energy and transport sectors increased only slightly. Representatives of the banking sector have positive expectations about loan portfolio growth in the next quarter. In terms of currency, demand is expected to be weak on foreign currency loans, while demand for domestic currency loans is expected to grow. In the context of sectors, the trade sector is expected to intensify.

In recent years, the credit to GDP ratio[11] has followed a trend[12] without significant fluctuations. However, the ratio increased considerably after the exchange rate depreciation in the first quarter of 2015. In the third quarter, the credit to GDP ratio increased by 1.9 percentage points compared to the previous quarter and amounted to 51.1%. The credit to GDP ratio is currently above the trend by 5.3 percentage points.

‹‹ Representatives of banking sector expect that loans denominated in the domestic currency to grow and that the trade sector will intensify.

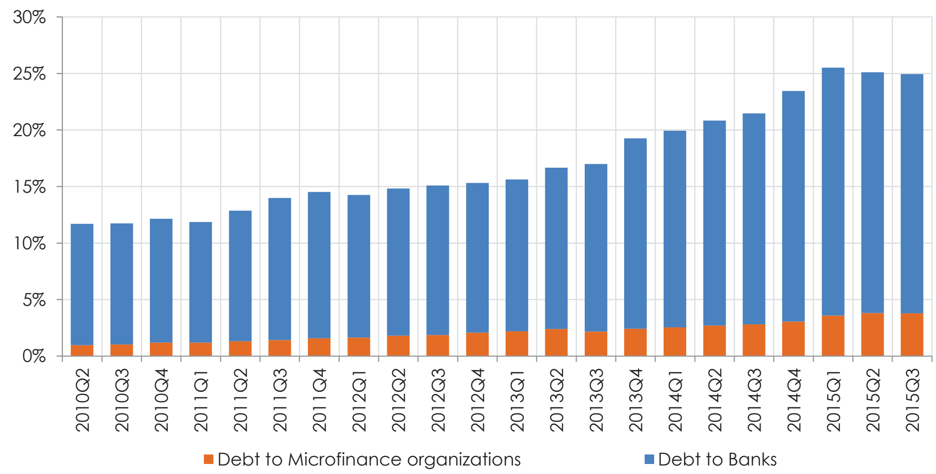
Figure 5.4 Credit To GDP Gap



Source: National Bank of Georgia

In the third quarter of 2015, the individuals' loans to net national disposable income ratio decreased by 0.1 percentage points compared to the previous quarter and amounted to 25%. Debt to commercial banks accounts for 85% of total individuals' loans.

Figure 5.5 Individuals' Debt To Net National Disposable Income Ratio



Source: National Bank of Georgia

The share of non-performing loans decreased by 0.6 percentage points in the third quarter of 2015, as compared to the previous quarter, and amounted to 7.6%. According to the data from September, the share of non-performing loans in the national currency increased by 0.1 percentage point compared to June, amounting to 5%. The share of non-performing, foreign currency loans decreased by 1 percentage point and equaled 9.3%. In the third quarter, the amount of loans written off amounted to 79 million GEL, which caused non-performing loans to decrease by 0.5 percentage points.

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

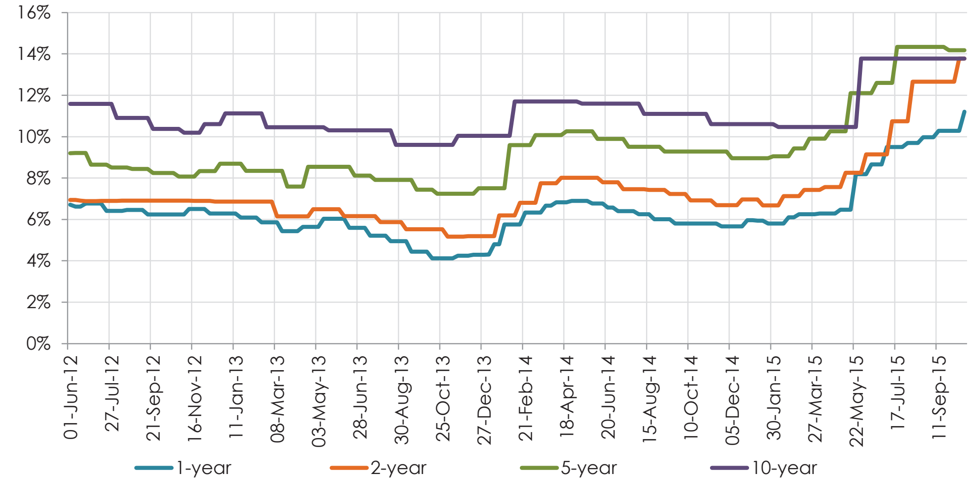
12 An HP filter is used to assess the trend and, based on Basel recommendations, lambda is equal to 400,000.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In November 2015, the monetary policy rate increased to 7.5%. Over the third quarter of 2015, interest rates increased for government securities of all maturities. Rates for short-term maturities rose because of an increase in inflationary expectations and a tightening of monetary policy, while rates for medium- and long-term maturities supposedly did so as a result of an increase in liquidity risk followed by pressure against the National Bank's policy .

« Interest rates increased for government securities of all maturities; for short-term maturities because of an increase in inflationary expectations and a tightening of monetary policy, while for medium- and long-term maturities it was supposedly a result of an increase in liquidity risk followed by pressure against the National Bank's policy.

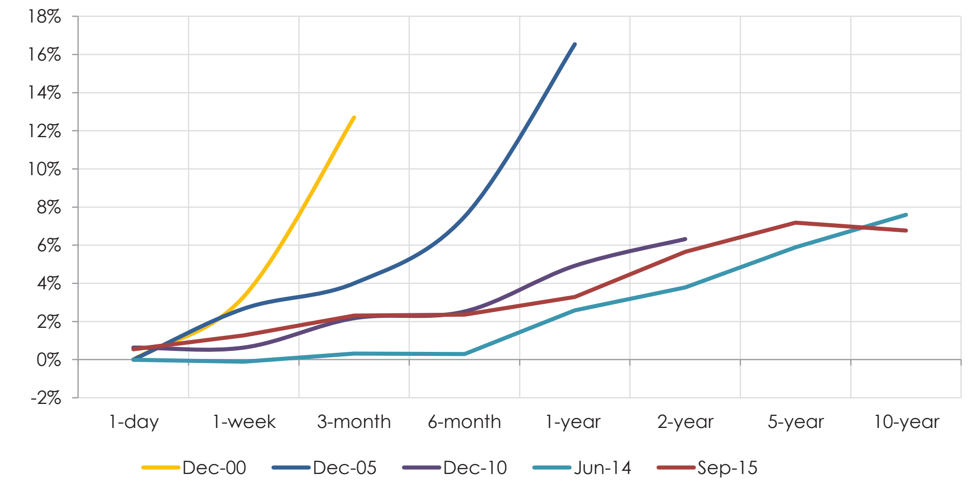
Figure 5.6 Interest Rates On Government Securities



Source: National Bank of Georgia

In addition to liquidity risk, the spread between long-term assets and the monetary policy rate has increased. Inflationary expectations caused anticipation 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



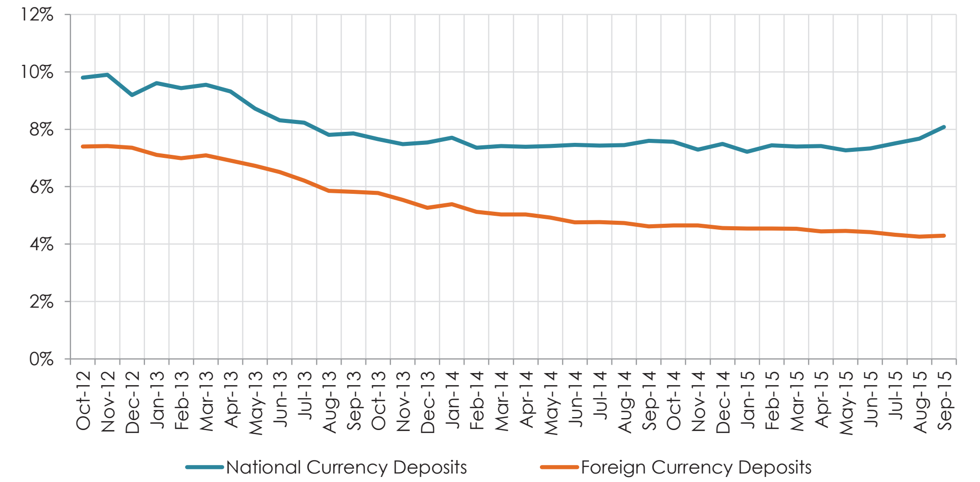
Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits increased by 0.6 percentage points and amounted to 8.1%, while for foreign currency deposits the interest rate decreased by 0.1 percentage point and amounted to 4.7%. The interest rate rise was caused by an increase in the monetary policy rate and decreased 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

« In the next quarter, bank representatives expect a rise in the interest rate on national currency deposits.

the growth of domestic currency loans, an increase in the monetary policy rate and weakened demand for domestic currency deposits .

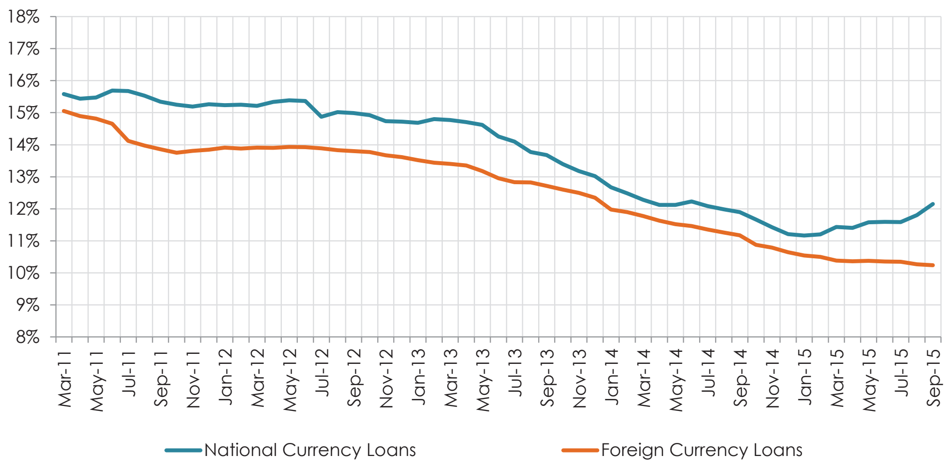
Figure 5.8 Average Interest Rates On Deposits



Source: National Bank of Georgia

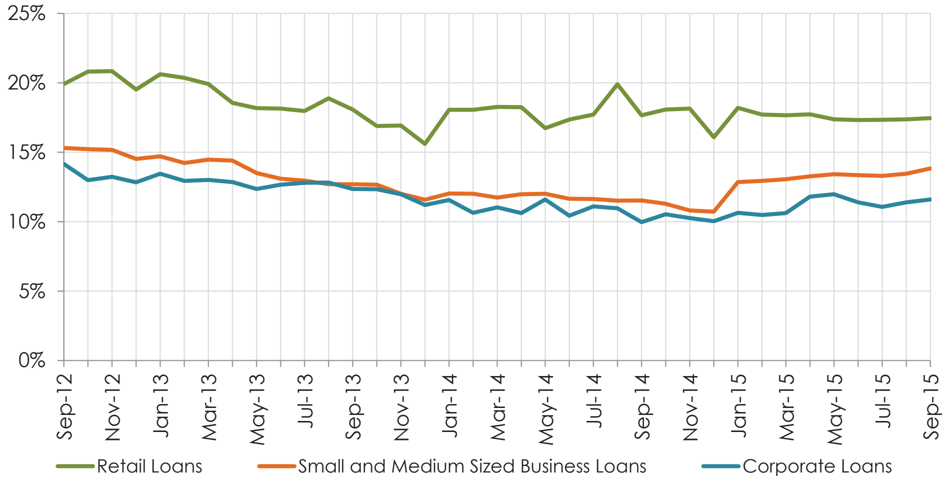
According to the credit conditions survey, credit conditions tightened for individuals and legal entities in the third quarter of 2015. This was reflected in both interest and non-interest rate conditions. The tightening of supply conditions was caused by general economic trends, increased financial costs, decreased attitudes to risk and the tightening of monetary policy. In September, interest rates on the flow of corporate loans increased by 0.2 percentage points, compared to June, and amounted to 11.6%. Interest rates on loans to small and medium business increased by 0.5 percentage points and amounted to 13.8%, while rates on retail borrowings increased by 0.1 percentage point and amounted to 17.5%. In the context of currencies, interest rates on business loans in the domestic currency increased by 0.2 percentage points, while for foreign currency deposits interest rates declined by 0.1 percentage point. According to the credit conditions survey, non-interest rate conditions are not expected to change in the next quarter, but interest rate conditions might increase.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow



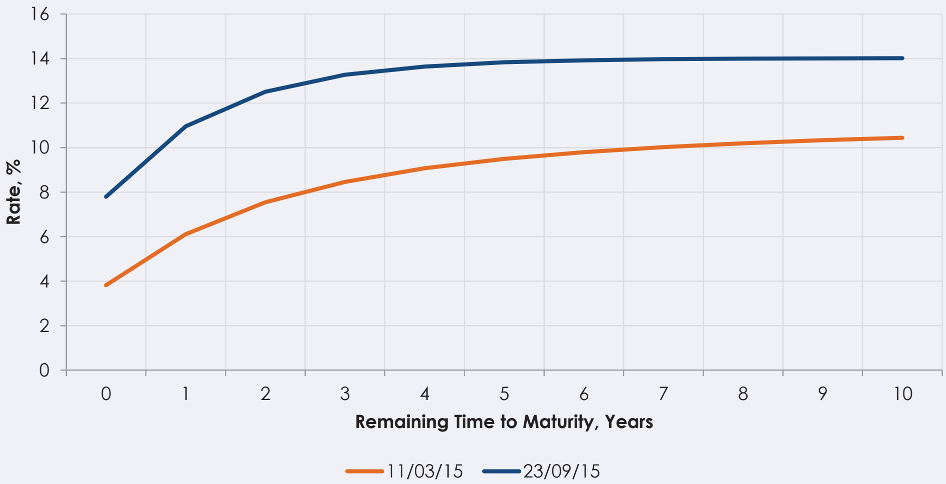
Source: National Bank of Georgia

Box 1 Indicative Yield Curve of the Georgian Lari

From November 2015, the National Bank of Georgia started publishing Indicative Yield Curve of the Georgian Lari. The yield curve methodology was developed in cooperation with foreign experts and takes into account specifics of local capital markets.

Indicative Yield Curve of the Georgian Lari displays yields on following risk-free securities: bills, notes and bonds issued by the Ministry of Finance of Georgia and certificates of deposits issued by the National Bank of Georgia.

Figure 5.11 The Indicative Yield Curve Of The Georgian Lari



Source: National Bank of Georgia

A risk-free yield curve is an important tool in developed financial markets. It displays the minimal level of return that is required by investors for investing in risk free assets and takes into account many factors like, inflation expectations, possible rate changes, etc. For example, when long term yields go up, it could mean that inflation expectations are raising and investors demand higher yield to compensate for a loss of buying power in the future.

Publishing of Indicative Yield Curve of the Georgian Lari is an important step for the development of Georgian capital markets. The indicative yield curve would make it easier to price newly issued Government Securities. It will also simplify pricing of spread securities of different maturities. In this case, investors would add a credit spread on the top of the yield for a specific maturity and the level of spread would depend on the creditworthiness of the issuer company.

The yield curve would also simplify calculations of forward yield curves, which indicates forward yield expectations and could be used for pricing of forward contracts.

A risk-free yield curve and derived yields are indispensable part of various pricing models. Widely used Capital Assets Pricing Model is based on risk free yields and by using it, investors can easily estimate expected returns of different investments having various risk levels.

The Indicative Yield Curve of Georgian Lari covers securities with time to maturity of up to 10 years and also covers historical period starting from 2013. The yield curve is available on the NBG web-site and its web-app supports the download of historical data and comparison of yield curves for different dates.

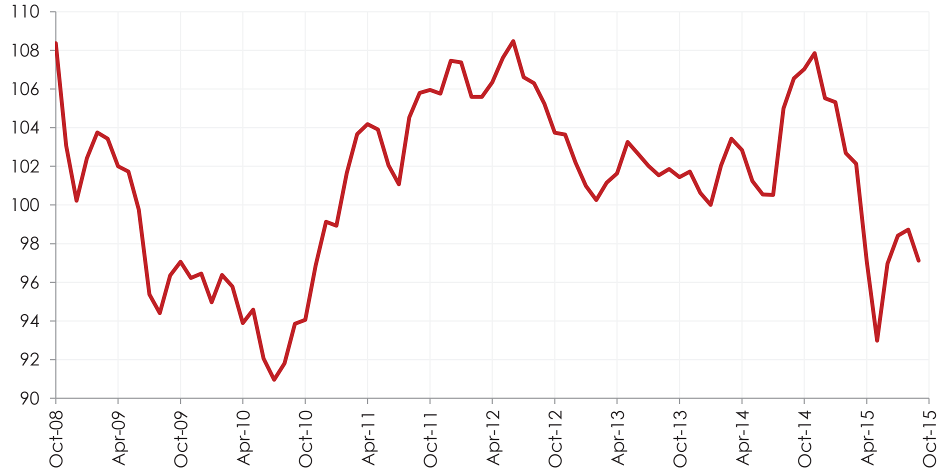
The indicative yield curve of Georgian lari can be viewed at the following link: https://www.nbg.gov.ge/index.php?m=643

5.3. EXCHANGE RATE

In September 2015, the GEL depreciated against the USD by 6% compared to June, and the exchange rate was 2.4 on average. The GEL also depreciated against the euro (by 6.2%) and the Ukrainian hryvnia (by 3.3%), while strengthening against the Russian ruble (by 13.3%) and the Turkish lira (by 5.1%). The nominal effective exchange rate fell by 1.4% over the same period, and declined by 6.6% compared to September 2014.

The real effective exchange rate appreciated by 0.2% in September compared to June, but depreciated 8.8% compared to the same period in the previous year (see Figure 5.12).

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



Source: National Bank of Georgia

As Table 5.1 shows, the real exchange rate in September 2015 depreciated on a year-on-year basis against the currencies of all major trading partners, except for the Russian ruble.

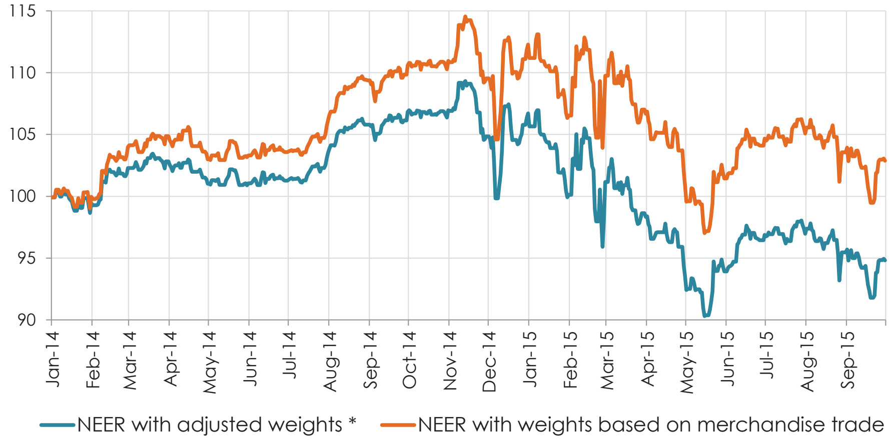
Table 5.1 Annual Change In Effective Exchange Rates (September 2014 - September 2015)

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective exchange rate	-6.6	-8.8	-8.8
Eurozone	-16.3	-11.9	-2.5
Turkey	-0.7	-3.2	-0.6
Ukraine	21.3	-16.0	-1.3
Armenia	-14.7	-13.1	-0.7
The United States	-27.2	-23.4	-1.2
Russia	28.3	16.7	1.5
Azerbaijan	-3.1	-1.5	-0.2
Other	-20.9	-17.5	-3.8

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, paints a slightly different picture.[13] In particular, the adjusted nominal effective exchange rate in September fell by 2% compared to June this year and depreciated by 11% year on year.

Figure 5.13 Corrected Nominal Effective Exchange Rate



Source: National Bank of Georgia

13 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 of trading with commodity products (oil, copper, wheat, etc.) has been given to the weight of the US dollar, because their pricing is in that currency on international commodity markets.

6. Domestic Demand

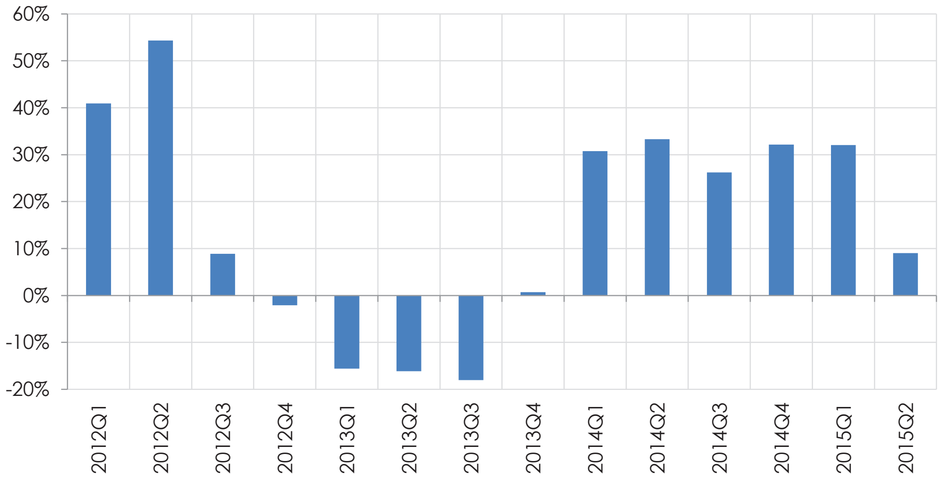
Real GDP growth amounted to 2.5% in the second quarter of 2015. Unlike the first quarter, consumption was the main determinant of economic growth. The growth rate of investments (which used to be the main factor of GDP growth) decreased in the second quarter. Exports showed a negative growth rate, but the growth of private consumption balanced the decline in exports and the slowed growth rate of investments. According to current estimates, private consumption will remain the main factor of economic growth in the second half of the year.

« Real GDP growth amounted to 2.5% in the second quarter of 2015.

The capital formation growth rate significantly diminished in second quarter of 2015 and posted only 9%. Investments were growing at a high rate in the second quarter of 2014 and after the base effect faded away, a slowdown of the growth rate should not come as a surprise. The slowdown of capital formation was also partially caused by a decline in the annual growth rate of credit to enterprises from commercial banks. Commercial banks' credit to enterprises continued to decline in the third quarter, which may result in a further decrease of the capital formation growth rate.

« The capital formation growth rate significantly diminished in second quarter of 2015 and posted only 9%.

Figure 6.1 Annual Growth Rate Of Capital Formation



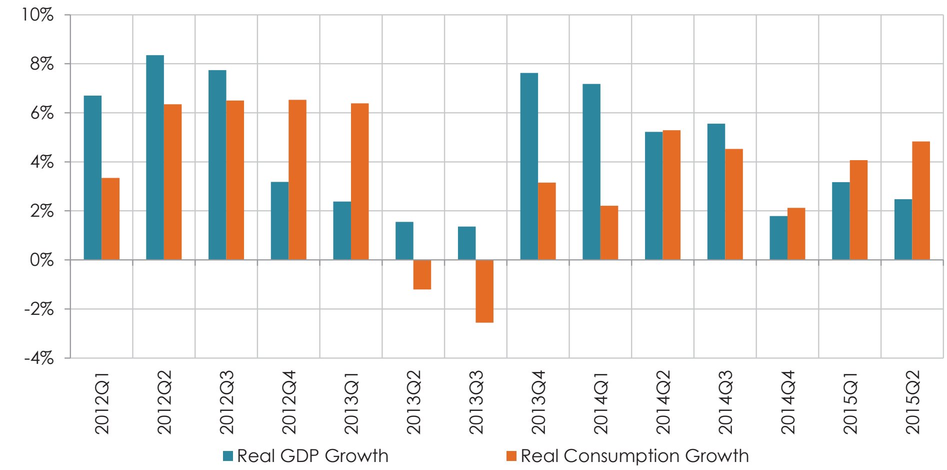
Source: GeoStat

Both exports and imports of goods and services declined in second quarter of 2015. As a result, net exports again contributed negatively to GDP growth, though did so much less than in the previous quarter. The decline of exports stems from the external shock caused by decreased demand in partner countries. The decline of imports is related to the reduced demand for imports caused by the depreciation of the lari. According to the current forecasts, both exports and imports are expected to continue to decline in the third and fourth quarters of 2015.

Real growth of private consumption[14] slightly increased in the second quarter of 2015 relative to the first quarter and posted 4.8%. Public consumption posted negative real growth. Because of the higher growth rate of private consumption, overall consumption was the main contributor to GDP growth in the second quarter.

14 The real growth of consumption is calculated using average annual inflation. A GDP deflator is used in second quarter of 2015 as this parameter better reflects the effect caused by the depreciation of the lari on consumption.

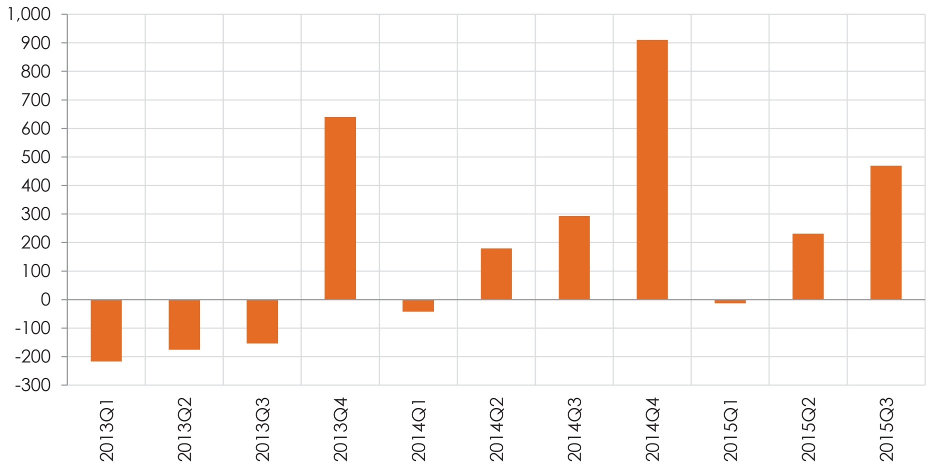
Figure 6.2 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget deficit posted 498.9 mln GEL in the first three quarters of 2015. The deficit of the third quarter posted 268.2 mln GEL. As the consolidated budget deficit for 2015 is planned to total approximately 845 mln GEL, the last quarter of 2015 is thus expected to have a much larger budget deficit than the previous quarters (which complies with the seasonal pattern of the budget). In 2015, the annual budget deficit should be comparably more equally distributed among quarters, compared to 2014.

Figure 6.3 Consolidated Budget Deficit (Million GEL)



Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

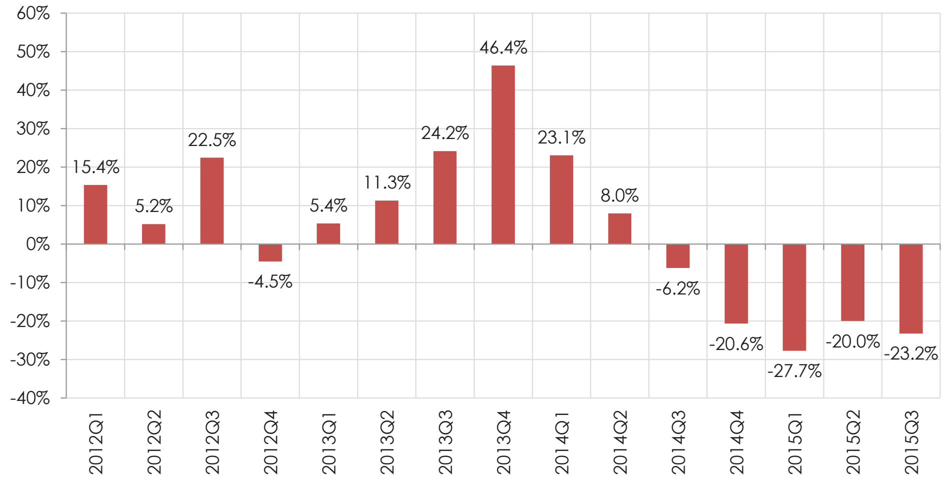
During the second quarter of 2015, export revenues diminished against the background of external shocks. However, the adjustment effect of the exchange rate depreciation was evident, which resulted in a significant decline in imports. The current account (CA) deficit to GDP ratio thus improved by 16.6% (70 million USD in absolute terms). The current account deficit amounted to 10.4% of GDP. According to preliminary estimates, in the third quarter of 2015 the CA deficit to GDP ratio has improved considerably to 3.2%, which falls behind the same indicator from the previous year by 3.1 percentage points.

‹‹ The current account deficit to GDP ratio declined by 0.03 percentage points over the previous year and amounted to 10.4% in the second quarter of 2015.

According to preliminary data, in line with the nominal exchange rate depreciation, the trade deficit will improve significantly in remaining period of 2015, and will be the main cause of a lowering of the current account deficit. Increased receipts from exports of services will also encourage an improvement of the CA deficit.

External demand significantly deteriorated in 2015, which had a negative influence on Georgian exports. Registered exports of goods declined by 28% over the first quarter of the year. However, as was expected, the rate of decline slowed during the following months. Third quarter data shows that the annual rate of reduction of receipts of registered goods exports improved to 23%.

Figure 7.1 Annual Growth Rate Of Registered Exports Of Goods



Source: GeoStat

The change in exports of goods was uneven in terms of destination region. During the third quarter of 2015, after declining in previous periods, exports to the EU increased by 10% year on year. Exports to CIS countries worsened, with the rate falling from 34.2% to 42.3% over the same period. Among the CIS countries, the most substantial deterioration was registered in Russia (falling from -35% to -47%), Armenia (from -20% to -35%) and Ukraine (from -48% to -53%). At the same, a dramatic increase was observed in the case of Turkmenistan and Uzbekistan – with exports to the latter growing quite rapidly in recent months. A decline of export receipts was evident from other countries as well (falling by 14.7%). The decline of exports to other countries was chiefly driven by diminishing sales to Turkey (-40%), the USA (-34%) and China (-6.4%); in contrast, exports to Canada sharply increased (by 30.7%).

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

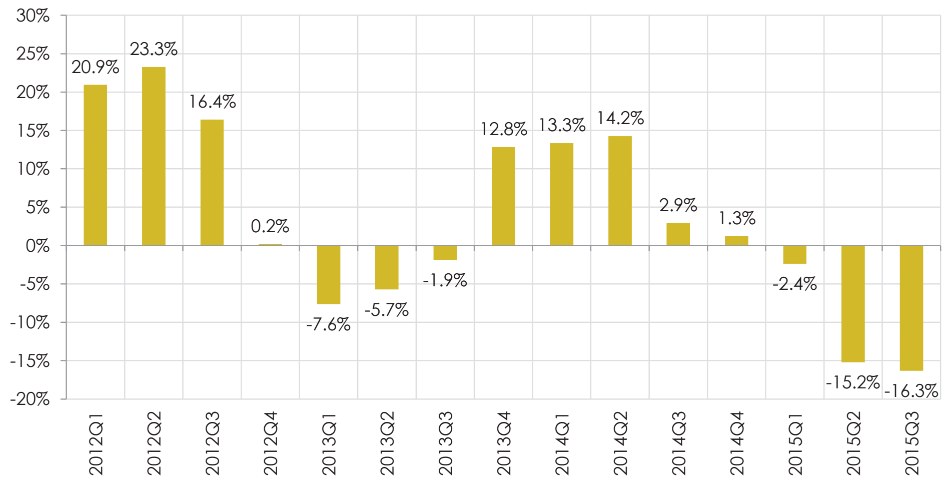
In line with declining exports to CIS countries, sales of products that have traditionally characterized this market also decreased. During the third quarter of 2015, compared to the previous quarter, the year-on-year reduction of export rates were higher for mineral waters (-63%), wine (-43%) and other spirits (-14%). There was also a considerable decrease in sales of nuts (-49%). Deep drops were observed in the re-export of cars (-62%) and exports of iron or non-alloy steel products (-48%) as well. The decline of exports of these goods was partially balanced by an increase in exports of fertilizers (101%), gold (45%) and medicaments (17%).

Against the background of the stabilization of regional economies and the depreciation of the nominal effective exchange rate, the rate of the reduction of exports has slowed. Given current developments and in the absence of additional shocks, this process is expected to continue. Furthermore, for the remainder of 2015, the rate of decline of car re-exports should be lower as a result of the base effect.

In the third quarter of 2015, registered imports of goods declined by 8.3% year on year. This decline is even higher, amounting to 16.3%, when the Hepatitis C treatments, which were provided by a grant and imported during this period, are excluded.[15] The decline of petroleum product imports – a result of lower prices on international markets – remained the most significant source behind the total reduction of registered imports of goods. In addition, the adjustment effect of the exchange rate depreciation was clearly evident from the second quarter. This was confirmed by the fact that, unlike in the previous quarter, there was a decline of almost all imported products. There was a considerable decrease in imports of durable consumption goods and a particularly 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 amounted to 16.3% in the third quarter of 2015 (excluding the import of Hepatitis C treatments).

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 decline of imports was chiefly driven by a 27% reduction of imports of consumer goods, which contributed -13.1 percentage points to the total decrease. The fall of imports of investment goods was relatively modest (-9%), and intermediate goods imports decreased at a somewhat lower rate of -5.2% year on year, contributing -2.1 percentage points to the overall reduction of the second quarter of 2015. During the first nine months of 2015, overall imports declined by an annual 14%. Out of this, consumer goods contributed 10 percentage points, and intermediate and investment goods contributed 2 percentage points each.

‹‹ In line with weak domestic demand and falling re-exports, it is expected that the significant reduction rates in imports will continue in upcoming periods as well.

The European and regional crises negatively affected the amount of remittances coming into Georgia. In the third quarter of 2015, money transfers were reduced by 34% on an annual basis to 264 million USD. This amount lagged behind the previous quarter's indicator, which was mainly a result of a sharp decline (-83%) of transfers from Greece. Transfers were down from elsewhere in Europe too, with the annual rate from Italy down by 14%. Falling transfers from Russia also had a significant impact on the overall decline in remittances. The amount of funds coming from Russia has decreased by 43% year on year. The sharp fall of remittances from Ukraine also continued in the third quarter. Overall money transfers from CIS countries declined by 41.2% and those from EU countries fell by 42.3%. Conversely, an increasing tendency was observed from the USA and Turkey, with money transfers increasing by 17.4% and 7% respectively.

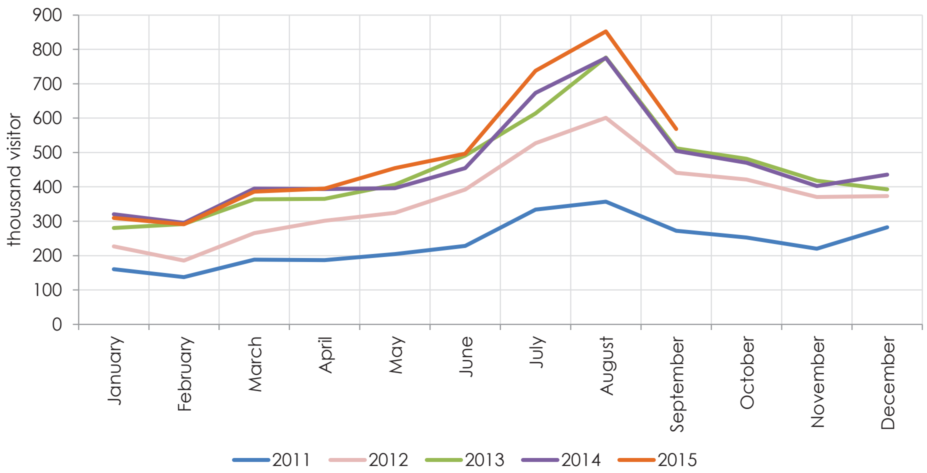
15 Hepatitis C treatments are provided to Georgia as a grant and thus do not affect the current account.

Figure 7.3 Annual Change Of Registered Imports By Category Of Goods

Source: GeoStat

The number of incoming visitors to Georgia increased in the third quarter of 2015 by 10.5% compared to the previous year. This increase was mainly a result of the sharp growth (30.4%) of the number of foreign transit passengers. Growth was also observed in the number of incoming tourists (5.1%).[16] As a breakdown of visitors by country shows, the highest growth rates from leading directions were recorded from Armenia (15.6%) and Russia (14.3%). Unlike in previous periods, the number of visitors from Ukraine and Turkey also increased (by 5.5% and 1.5% respectively). During the third quarter, the number of visitors from Europe was 6.1% greater than the same period in the previous year.

Figure 7.4 Number Of Incoming Visitors To Georgia



Source: GNTA

In the second quarter of 2015, the CA deficit was mainly financed by foreign direct investments (FDI). Inflows of foreign direct investments reached 354.7 million USD, which is nearly twice as high as the same indicator from the previous year. This sharp increase was mainly due to investments realized in transport sector related to the construction of the South Caucasus Pipeline. Such investments accounted for 58% of the total FDI inflow in the economy. Annual growth was also recorded in investments in the hotels and restaurants sector.

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

8. Output

> ‹‹ *In the second quarter, construction and transport were the main drivers of growth.*

In the second quarter of 2015, GDP rose by 2.5% in comparison with the same period of the previous year. At 1.3%, the services sector made the largest contribution to the overall growth. The industrial sector contributed 0.9% and agriculture 0.2%.

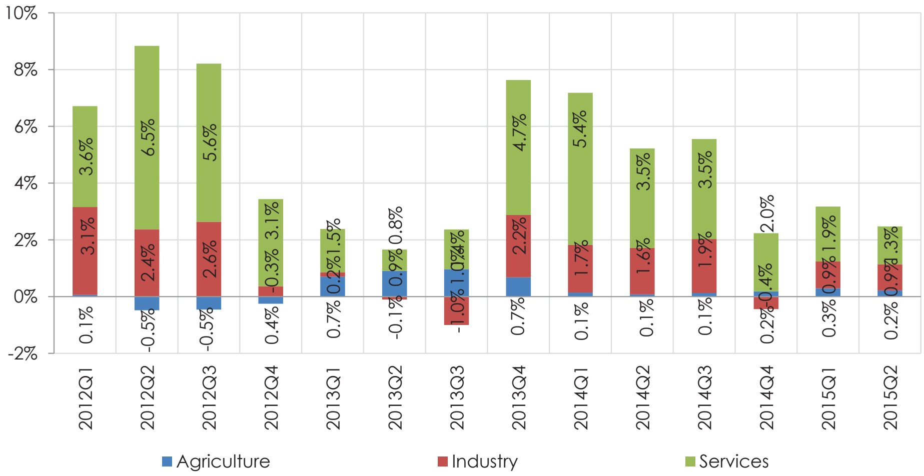
Transport was the largest contributor to the growth from services (growing 5.9% and making a 0.4% contribution to GDP growth). The growth of the transport sector was underpinned by tourism. In the second quarter, the number of visitors to the country rose by 8.2%. This fact became positively reflected on the activities of travel agencies and tour operators, whose nominal output was augmented by 40%. The output of railways, pipelines, air transport, cargo handling and storage, and other activities supporting transport were also increased. The increased output of hotels and restaurants (7.3%) can also be linked to the enhanced flow of foreign visitors. The free floating lari exchange rate regime has largely contributed to maintaining Georgia's competitiveness on the international tourist market.

In the second quarter, the stock of credits for real estate purchases was still growing. This can explain the rise of real estate, renting and business activities output by 5.9% (making a 0.3% contribution to GDP growth) – in which the largest share comes from the turnover of real estate agencies. The growth of the financial intermediation sector was high at 10.6% (making a 0.3% contribution to GDP growth), and consumers' activity has been largely revived. After a fall in the first quarter, trade (the largest branch of the economy) rose by 0.8% in the second quarter.

Construction maintained its high pace of growth at 14.5% (a 0.9% contribution to GDP growth) due to both the private and public sectors. Residential construction and infrastructural projects by the government were intensively underway. As a result of the opening of new mines, the output of the mining industry is rapidly rising for the third consecutive quarter (showing 12.7% growth in the second quarter, making a 0.1% contribution to GDP growth). Given the reduction of external demand and plummeting exports, the manufacturing sector continued falling (a -3.2% reduction making a -0.3% negative contribution to GDP growth). The sharpest drop in manufacturing came from the production of alcoholic drinks, where output fell by a nominal 28%.

The growth in agriculture is unexpectedly low in the current year. After a 3.9% increase in the first quarter, this slowed to 2.6% in the second quarter, contributing only 0.2% to GDP growth.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

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