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 – 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 NBG to that level. The inflation target for 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 Bank of Georgia's vision with regard to ongoing and expected macroeconomic activity is published in the Inflation Report in the second month of every quarter.

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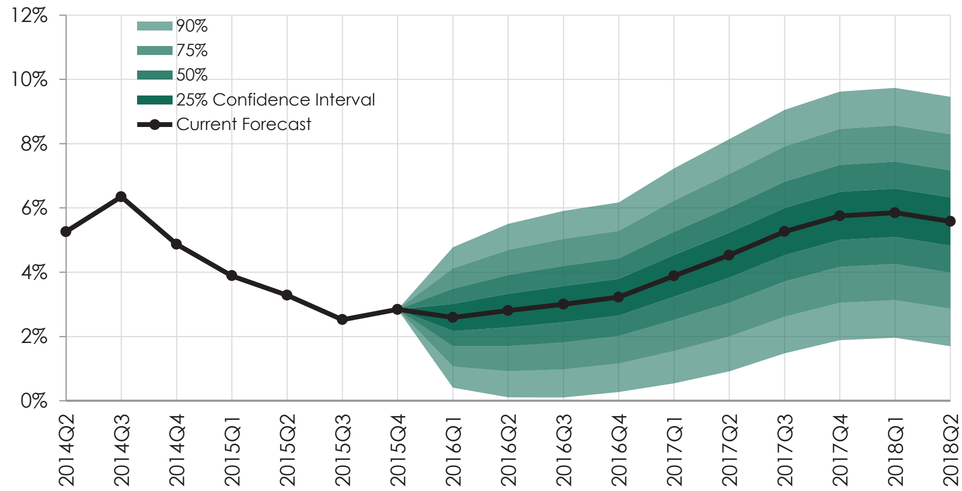
1. Brief Overview

According to preliminary data, **real economic growth** in the fourth quarter of 2015 was 2.9% on an annual basis, while total growth in 2015 amounted to 2.8%. External disturbances had a negative influence on economic growth. Exports and remittances fell, which weakened aggregate demand and induced exchange rate depreciation. This depreciation helped the economy absorb foreign shocks and dampened the effect on the domestic market, however it also increased the debt service burden on foreign currency loans, which weighed negatively on aggregate demand. The effect of the drop in international oil prices had a heterogeneous effect on the Georgian economy. On the one hand, it negatively influenced Georgia's oil-exporting trading partners in the region, with their problems transmitting to the domestic economy through trade and financial channels. However, on the other hand, the direct impact on the Georgian economy was positive, being reflected in lower consumer prices and cost savings on oil imports.

According to the **economic growth forecast** of the National Bank of Georgia, GDP growth in 2016 will be around 3% (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 will likely have a negative influence on exports of goods and services and on remittances. In contrast, given the abatement of external shocks, the use of fiscal stimulus measures and stable monetary policy, the forecast predicts that domestic demand will be the main driver of economic growth. At the same time, in the backdrop of the foreign shock already experienced, lower oil prices will help the real economy and consumers' disposable income.

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

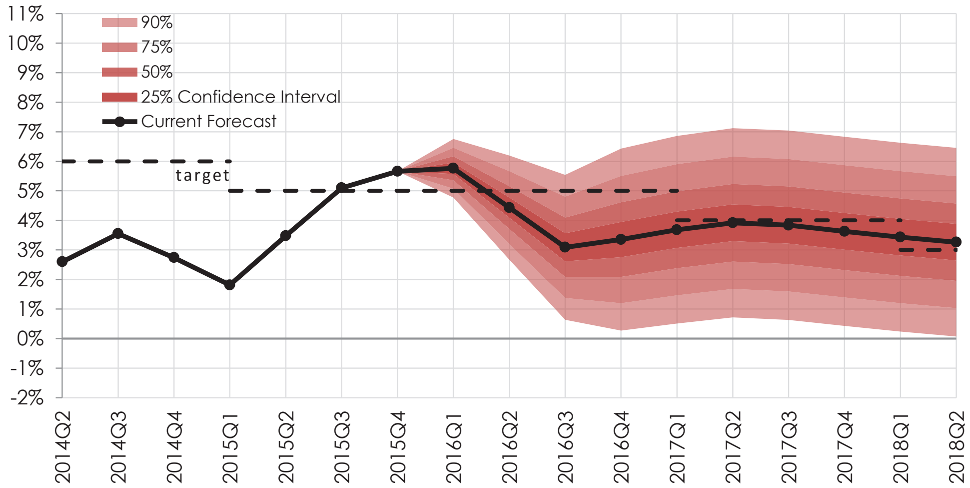


Source: National Bank of Georgia

Annual inflation in January 2016 was 5.6% and thus slightly overshot the NBG's 5% target. However, it should be noted that inflation was lower than expected as a result of the stronger-than-expected decline in international oil prices. The main factor contributing to higher inflation in 2015 was the higher intermediate costs of firms, which were 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 is expected to stay above the 5% target in the first quarter of 2016. It is subsequently expected to start decreasing and remain in the neighborhood of the target level (see Figure 1.2). According to the forecast, the main source of inflation will be the supply side – in particular, increased debt service costs due to the already depreciated lari exchange rate 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 the exogenous factors affecting the market and contain **risks in both upward and downward directions**. The main risks to the forecast still 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 are both positive risks for the forecast.

At the Monetary Policy Committee (MPC) meeting of 3 February 2016, it was decided to keep the refinancing rate unchanged at 8%. Based on an analysis of the current economic situation and macroeconomic forecasts, the MPC considered the current level of monetary policy rate to be appropriate for maintaining inflation around the target in the medium term and supporting economic growth. Further monetary policy moves 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 last three years have been marked by declining economic growth in the region due to the ongoing conflict in eastern Ukraine, the international sanctions imposed on the Russian economy and falling global commodity prices. The economies of Ukraine and Russia were particularly affected, and their problems were transmitted to other countries in the region, including Georgia. The negative impact was reflected in weakened export demand, lower remittances and less foreign direct investment. This situation was exacerbated by Russia's decision to reconsider its trade relations with Turkey and Ukraine at the end of 2015. These circumstances, along with the conflict in Syria, all led to a deterioration of global expectations, which increased depreciation pressure on local currencies and stoked inflation. All this negatively affected consumer and business confidence in 2015. The situation was relatively better in the developed parts of the world as the recovery of the labor market and favorable credit conditions created solid grounds for private consumption and investment growth. However, the Chinese economy's recent slowdown has posed a threat to the potential growth of the world's high-income economies. The World Bank estimates that the global economy grew by 2.4% in 2015, while its forecast for 2016 stands at 2.9%.[1]

The year 2015 was severe for Ukraine's economy: the country's GDP fell by 12%, which was followed by high inflation (40-50% on average). The sharp rise in inflation was caused by the depreciation of the national currency and the correction in utility rates. A significant decline was reported in exports, which was mainly a result of the ongoing conflict in the industrialized eastern part of the country, the interruption of trade with Russia, and the global reduction in prices of metal and agricultural products. It is expected that in 2016 the Ukrainian economy will enter a recovery phase, which will be underpinned by a reduction of tensions in the conflict zone, the launch of infrastructure projects, and financial aid provided through the IMF's stabilization program.

Sharply reduced revenues from oil exports, international sanctions and massive capital outflows all had severe consequences for the Russian economy in 2015. The country's GDP fell by about 4% and, due to the depreciation of the ruble, inflation averaged 15% year on year. Against this background, investment and consumer sentiment significantly deteriorated, which, alongside lower oil prices and international sanctions, have had a negative impact on the outlook. According to IMF estimates, the recession in Russia will continue in 2016 and the country's economy will shrink by 1%. Only in 2017 is economic growth expected to become positive.[2]

In Azerbaijan, the 50% depreciation of the manat at the end of 2015 undermined consumer confidence. The World Bank estimates that the economy of Azerbaijan increased by 2% in 2015, while the forecast for 2016 stands at 0.8%.[3]

For Armenia, the crisis in Russia had a negative impact on economic activity. This was reflected in weakened export demand, lowered remittances and less foreign direct investment. The World Bank estimates that Armenia's economy grew by 2.5% in 2015, while its growth in 2016 will be considerably lower.

The Turkish economy grew by approximately 4.2% during 2015.[4] However, this growth was slowed by various factors, including the migrant problem caused by the Syria conflict; political tensions following the parliamentary elections in June (which ended with a snap election and the victory of the ruling party); and a weakening of exports (following an interruption of trade with Russia and reduced demand for tourism services). The low price of imported crude oil contributed to the improvement in economic activity and the current account; however, amid existing uncertainty the depreciation of the local currency fueled inflation up to 8%. The World Bank's

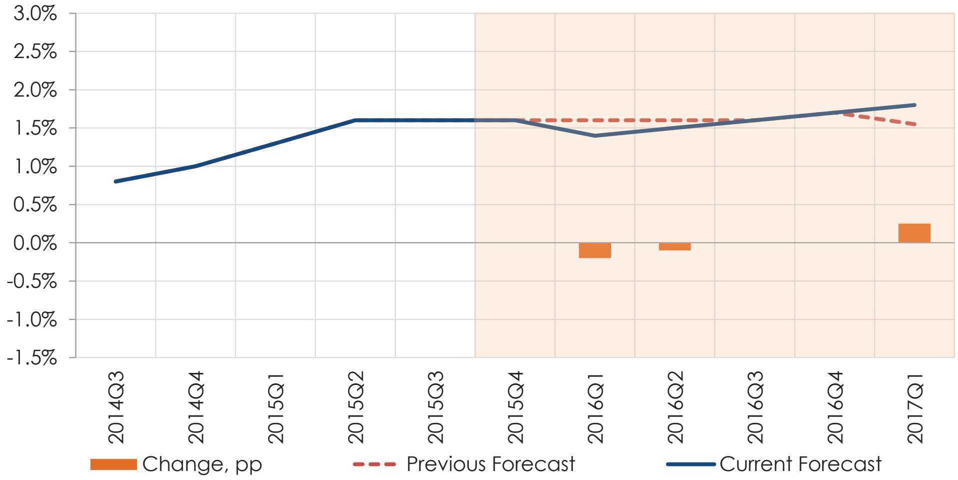
1 *Source: Global Economic Prospects, World Bank, January 2016.*
2 *Source: World Economic Outlook Update, IMF, January 2016.*
3 *Source: Global Economic Prospects, World Bank, January 2016.*
4 *Source: Global Economic Prospects, World Bank, January 2016.*

estimates suggest that Turkey's economic growth will average 3.5% in 2016-2017, conditional on geopolitical stability and stable consumer confidence.[5]

The economy of the eurozone in 2015 was marked by moderate growth (about 1.5%).[6] The positive trend resulted from lower oil prices, favorable credit conditions and, partly, from the depreciation of the euro in the first half of the year. However, it should be noted that in the second half of 2015 the trade-weighted nominal and real effective exchange rate of the euro strengthened (due to the depreciation of trading partner currencies), which led to a weakening of exports and deflationary pressure. The economic growth forecast for 2016-2017 stands at 1.6% and is primarily a consequence of ongoing migration processes. The World Bank estimates that in the short term government spending on the management of migration processes will boost private investment and consumption, while in the medium term migrants are expected to fill shortages in the European labor market (caused by population aging).

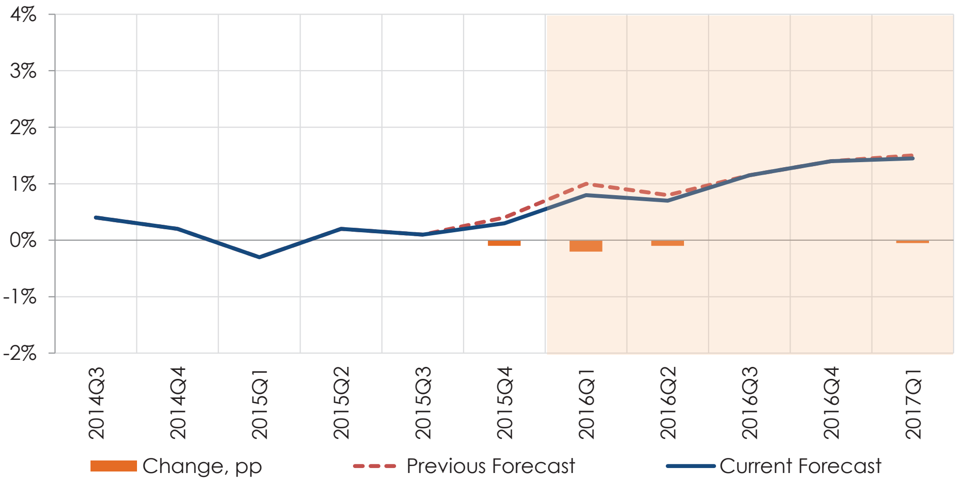
The economic growth of the US in 2015 will be less than expected due to the weak first quarter resulting from harsh winter weather conditions, disruptions in international traffic and reduced investment in the oil sector. At the same time, the strengthening of the dollar has recently had a negative impact 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.[7]

Figure 2.1 Eurozone Real GDP Annual Growth



Source: World Economic Outlook Update, IMF, January 2016; EuroStat

Figure 2.2 Eurozone CPI Annual Inflation

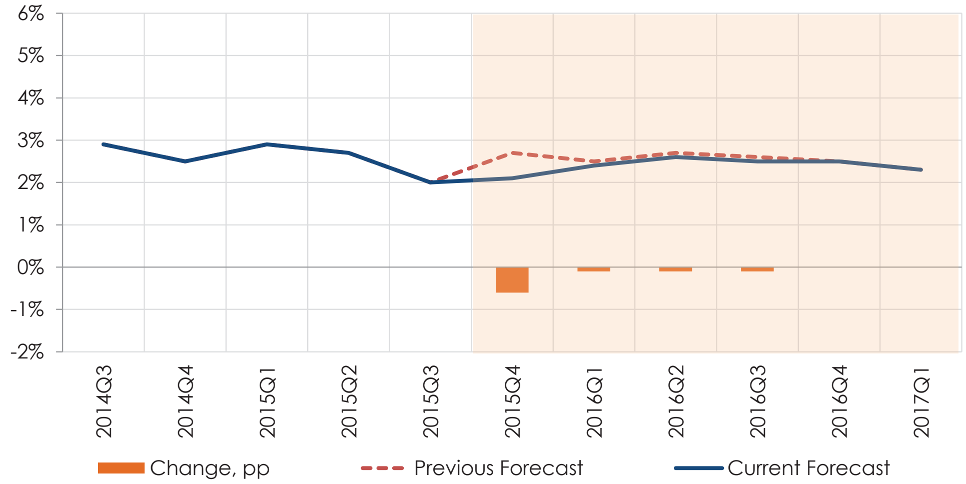


Source: World Economic Outlook Update, IMF, January 2016; EuroStat

5 *Source: Global Economic Prospects, World Bank, January 2016.*
6 *Source: World Economic Outlook Update, IMF, January 2016.*
7 *Source: Global Economic Prospects, World Bank, January 2016.*

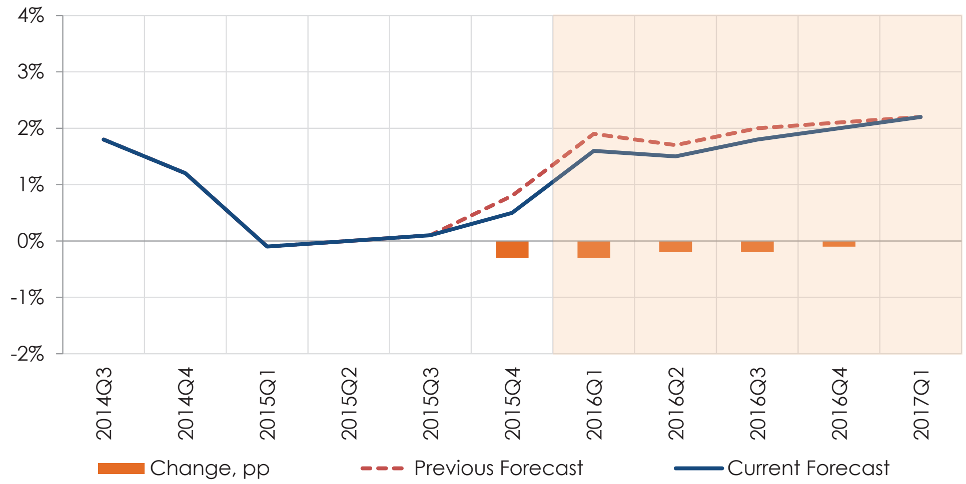
In 2015, the main driving forces behind the growth of the US economy were solid consumer demand and growing investments in non-oil sectors. The economy grew by about 2.5%, which is the highest recorded annual rate since the global financial crisis.[8] Unemployment gradually reduced to 5%, which had a positive impact on disposable income. However, the appreciation of the US dollar and weak global demand negatively affected net exports and reduced inflationary pressure. These factors, alongside the impact of falling oil prices, kept inflation near zero in 2015. The IMF forecasts that, against the background of the recovered labor market, relaxed financial conditions (the Federal Reserve Bank rate is still below the neutral point) and lower oil prices, US economic growth will exceed the potential level to reach 2.7% in 2016.[9]

Figure 2.3 U.S. Real GDP Annual Growth



Source: World Economic Outlook Update, IMF, January 2016; Bloomberg

Figure 2.4 U.S. CPI Annual Inflation



Source: World Economic Outlook Update, IMF, January 2016; Bloomberg

In 2015, those economies with weak economic growth and consumer prices maintained expansionary monetary policies. The European Central Bank further eased its policy at the end of the year on the grounds of low inflation. As for the US, with significantly increasing employment and price growth expectations in mind, the Committee of the Federal Reserve increased the interest rate by 0.25pp at the end of 2015. It is expected that the policy tightening will take a gradual form. The Fed's move immediately affected market rates, with the 3-month USD LIBOR reaching 0.6%. A partly different situation was observed in some developing countries, where high policy rates were maintained to combat inflation fueled by national currency depreciation.

Despite the complicated geopolitical situation in East Asia, the price of oil fell to a record-low level of $30 a barrel by late 2015. In addition, the lifting of international

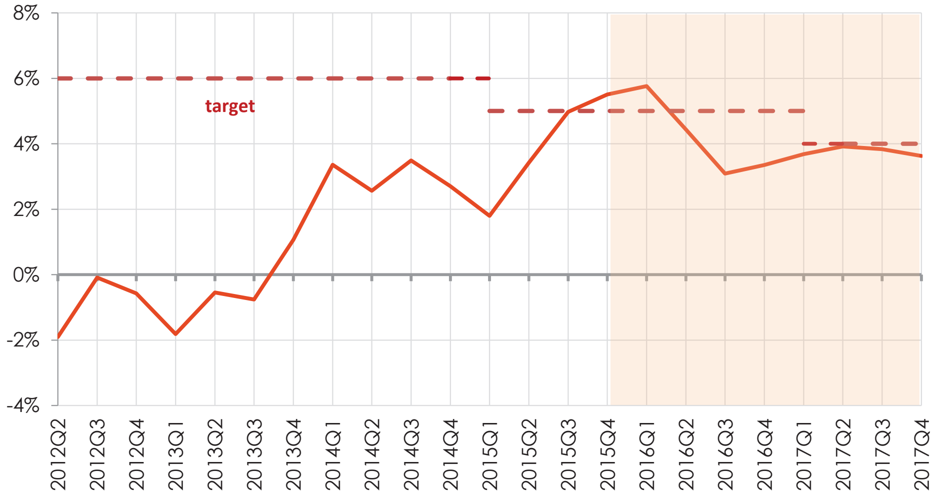
8 *Source: World Economic Outlook Update, IMF, January 2016..*
9 *Source: World Economic Outlook Update, IMF, January 2016.*

sanctions on Iran, one of the world's most oil-rich nations, is likely to have further repercussions on the price. Last year also saw a marked decline of the prices of other commodities: in particular, the IMF-calculated price index of agricultural products decreased by approximately 15%, while the metal price index fell by 20%. According to the forecasts, commodity prices will be stable during 2016.[10]

2.2 MACROECONOMIC FORECAST

The annual inflation rate in January 2016 was 5.6%, which is slightly above the target of the National Bank of Georgia (see Figure 2.5). However, it should be noted that this inflation figure was lower than expected – a result of the lower international price of oil being transmitted to domestic prices. The main factor contributing to higher inflation in 2015 was higher intermediate costs for firms. These, in turn, were 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 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



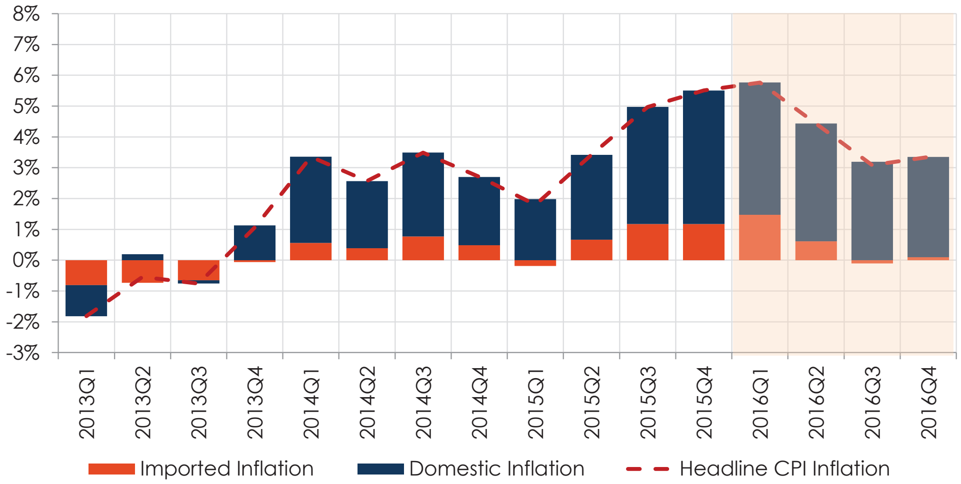
Source: National Bank of Georgia

According to the **forecast, inflation** will slightly increase in the first quarter of 2016 thus temporarily overshooting the 5% target (see Figure 2.5). After this, it will start a downward trend and remain around the target level in the following quarters. According to the projections, domestic prices will have the largest contribution to these dynamics, while the contribution of imported inflation will have been dampened by oil price declines (see Figure 2.6).

Due to various factors contributing to inflation in different directions, in the last quarter of 2015 the **deviation of inflation from the target** was insignificant. In particular, the upward pressure on the price level from a one-time increase in input costs (due to liability dollarization and the depreciated lari exchange rate) along with increased inflation expectations, were dampened by downward pressure on the price level from weak aggregate demand and lower oil prices (see Figure 2.7). According to the forecast, the main source of higher inflation in the first quarter of 2016 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 inflation. In addition, a depreciation-induced increase in the prices of imported durable goods 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 in 2016, as in the previous year, demand 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 slightly overshoot the target before decreasing gradually and stabilizing around the target level in the following quarters.

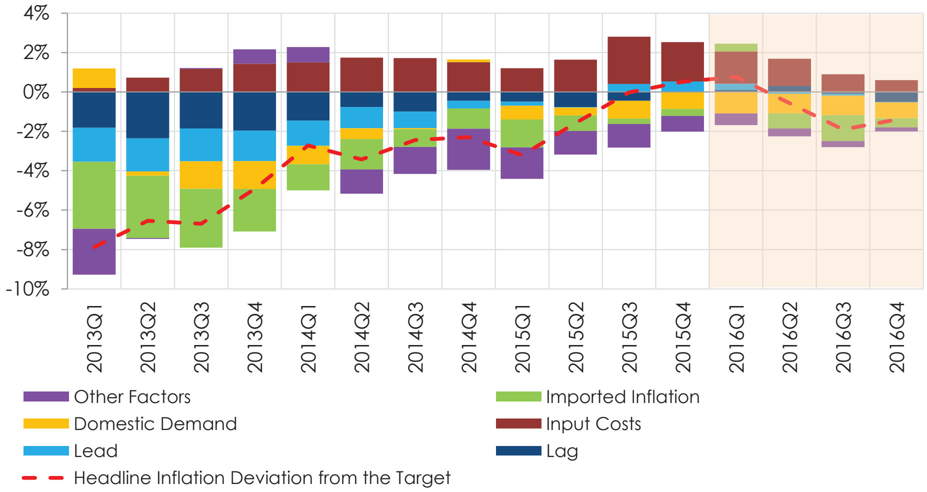
10 Source: Commodity Price Outlook & Risks, IMF, January 2016.

Figure 2.6 Headline Inflation Decomposition



Source: National Bank of Georgia

Figure 2.7 Inflation Deviation From Target And Its Decomposition[11]



Source: National Bank of Georgia

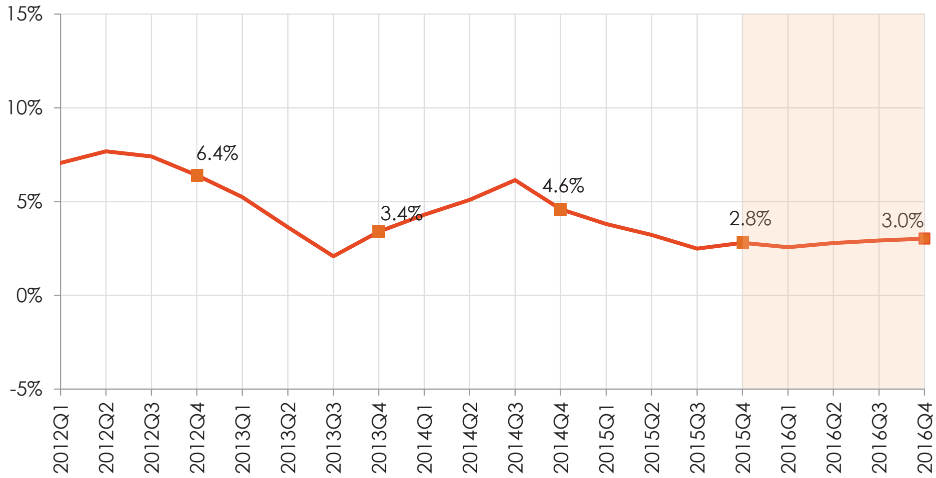
There are **risks associated with the inflation forecast** in both directions. If the depreciation of the currencies of Georgia's main trading partners is reversed, this would strengthen the transmission of the already-high inflation rates of those countries to Georgia, which could contribute to temporarily higher inflation. 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 and/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 it is stronger than expected.

Real GDP growth in the last quarter of 2015 was consistent with the previous forecasts and, according to preliminary data, the growth rate in 2015 amounted 2.8% (see Figure 2.8). Economic activity during this period was driven by domestic demand. In particular, against the backdrop of fiscal stimulus measures and the by-then accommodative monetary policy, 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

11 *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.*

driven by the 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 continue to make a negative contribution to economic growth because of external disturbances. The deviation of economic activity from its potential level worsened in the first half of 2015 and, according to current estimates, the output gap is likely to remain in the same range in 2016.

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

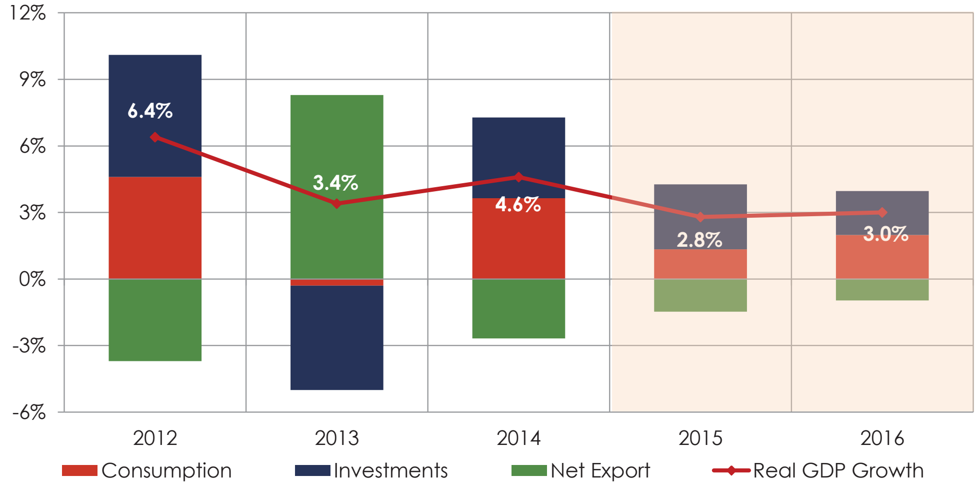


Source: National Bank of Georgia

According to the **GDP forecast**, the growth rate in 2016 is expected to be around 3% (see Figure 2.8). Fiscal stimulus measures, alongside stable monetary policy will support lending. This, in turn, will help investment and consumption growth rates. On the other hand, the unfavorable foreign sector trend is expected to affect net exports, which will continue to make a negative contribution to GDP growth in 2016 (see Figure 2.9). Net exports are negatively influenced by the adverse political and economic conditions in Georgia's trading partners – these are also reflected in weak foreign demand for Georgian exports, as well as in 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 and/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 and/or investment projects have a greater-than-expected positive impact on economic activity or business confidence, then GDP will be higher than forecast.

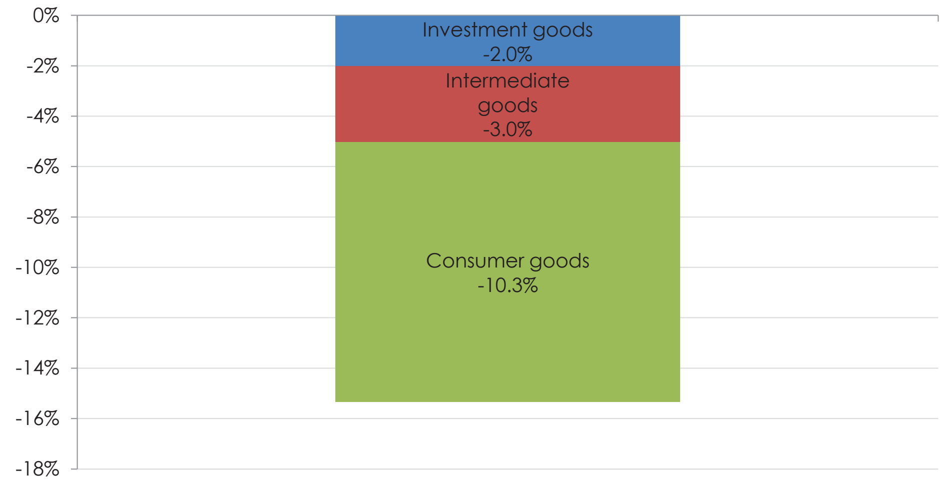
Figure 2.9 Components Of Real GDP Growth



Source: National Bank of Georgia

According to the forecast, the current account deficit in 2015 increased to 11.6% of GDP. Despite this rise in the ratio, which is the result of a drop in US dollar-denominated GDP, the drop in imports has balanced the reduced foreign currency inflows. Exports of goods in the fourth quarter of 2015 decreased by 21.1% annually, while net money transfers from abroad declined by an annual 21.2%. As for imports, in the last quarter of 2015 these dropped by a significant 19% annually (excluding imports of grant-financed hepatitis C medication). In 2015 as a whole, imports fell by an annual 15.3% (excluding hepatitis C medications). The fall in consumption goods imports contributed 10.3 percentage points to the overall drop, while the decline in imports of intermediate and investment goods contributed 3 and 2 percentage points respectively (see Figure 2.10). It is worth noting that the reduction of imports, alongside reduced foreign currency inflows, indicates the functioning of the import adjustment process that contributes to macroeconomic stability.

Figure 2.10 Decomposition of Annual Growth of Imports in 2015



Source: Geostat

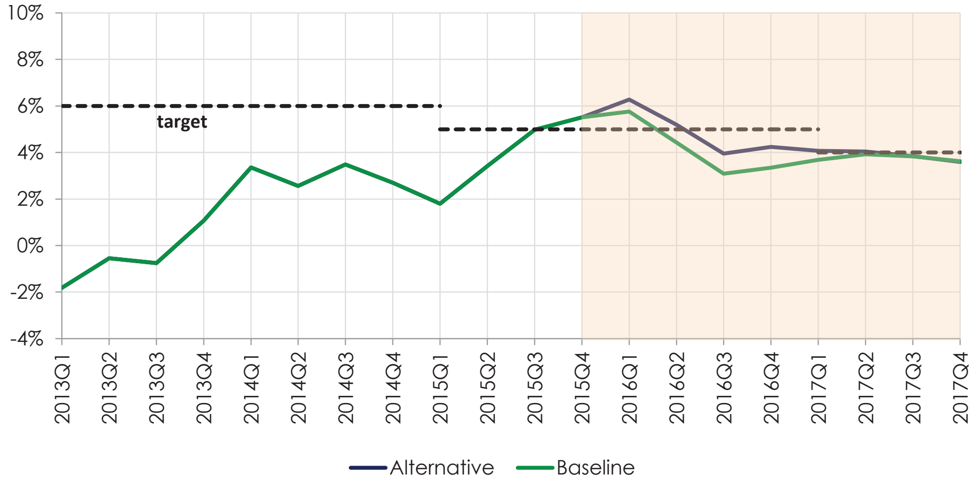
In 2014, the current account deficit worsened to 10.6% of GDP, which was 4.8 percentage points higher than in the preceding year. According to the current forecast, the current account is expected to have slightly worsened in 2015, but it will start improving steadily in the medium term, supported by increased exports of goods and 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.

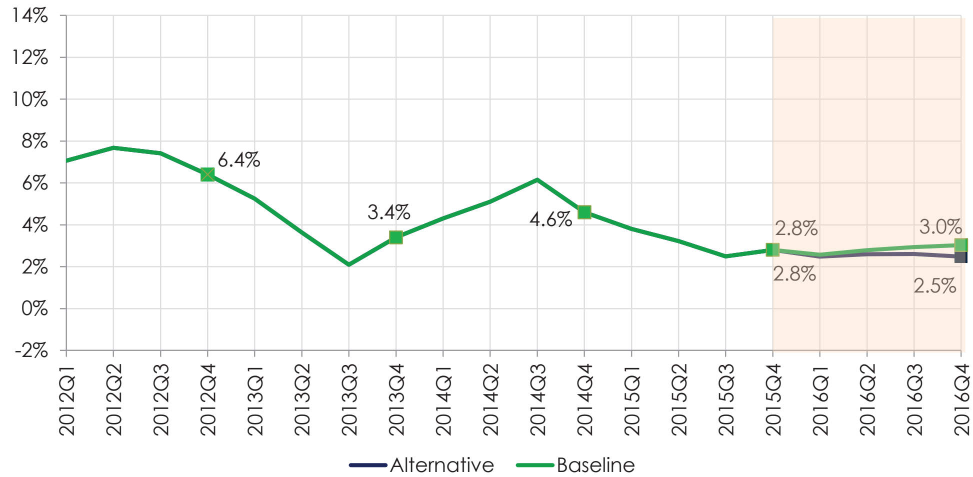
According to the alternative scenario, the inflation rate will increase faster than in the baseline case as the upward pressure from the nominal effective exchange rate will outweigh the downward pressure from weak demand. In order to influence inflation expectations, adopting an appropriate monetary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

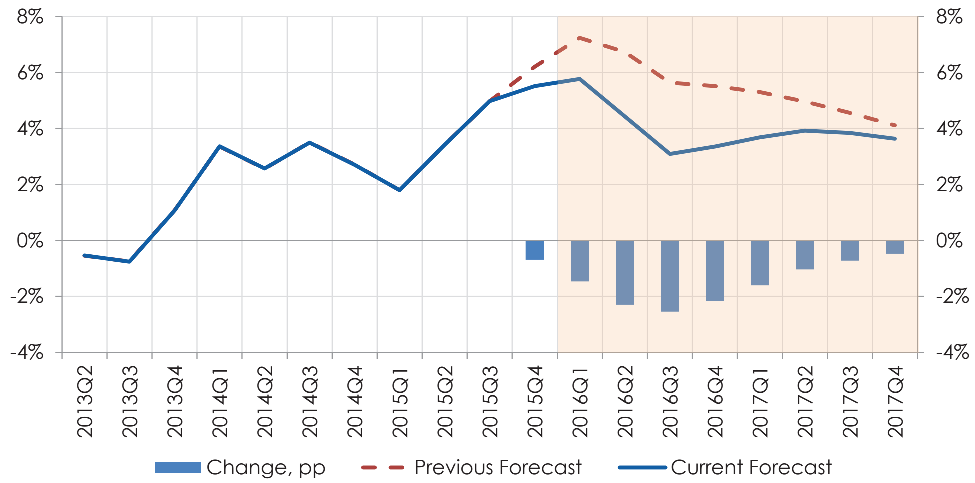


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast for upcoming quarters has been revised downward (see Figure 2.13). This was mainly due to the sharp drop in international oil prices. It is worth noting that this drop, unlike that of 2014, was not accompanied by a significant global appreciation of the US dollar. Moreover, the dependence of the Georgian economy on oil-exporting partners has been somewhat reduced. Based on these facts, the recent fall in oil prices should have a positive impact on Georgia as an oil-importer economy. Inflation is additionally dampened by weak demand, and hence by the lower profit margins of firms. According to the current forecast, the inflation rate in the first quarter of 2016 will be slightly higher than the target; however, it will subsequently start decreasing and then remain around the target level.

Figure 2.13 Change In The Forecast Of Headline Inflation



Source: National Bank of Georgia

As for economic activity, the economic growth forecast for 2016 has not changed (see Figure 2.14). Although the oil price drop frees up resources for Georgian firms and increases the disposable income of Georgian consumers, it will only have a moderate effect on the growth rate, given the difficult conditions in the foreign sector.

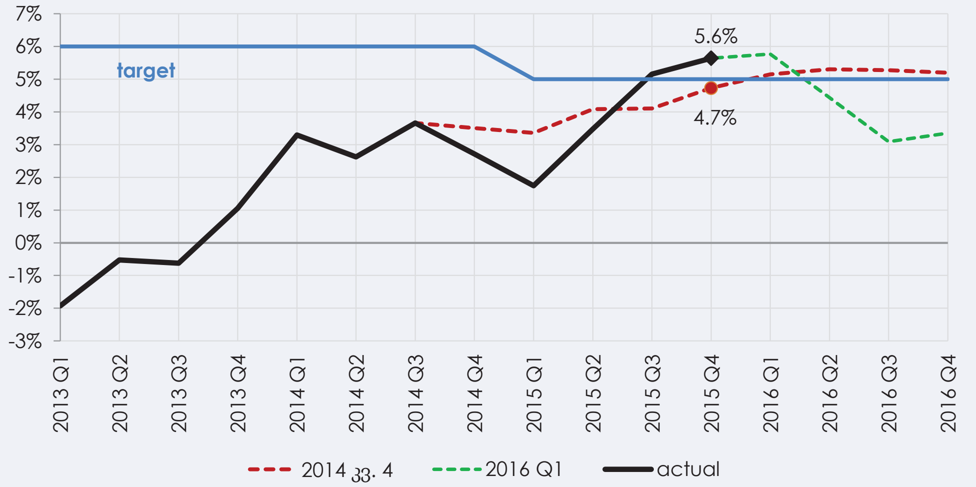
Box 1 Inflation Target Achievement and the Performance of 2015 Forecasts

Since monetary policy changes transmit to the economy only after some time (4-6 quarters), in the medium term the inflation forecast acquires a special role in assessing the adequacy of monetary policy decisions. Thus, in order to evaluate how appropriate the National Bank of Georgia's monetary policy decisions have been for achieving its inflation objective, it is necessary to analyze the forecasts made in previous periods. An inflation forecast can be evaluated as adequate if its deviation from the actual value was caused by exogenous forces that could not be foreseen at the time of making the forecast. We will start our analysis from the inflation report of the fourth quarter of 2014, since earlier forecasts were covered in an analogous section published last year.

According to the forecast published in the November 2014 Inflation Report, inflation was expected to rise from 3.4% (October 2014) to the target value by the end of 2015 (see Figure 2.14).

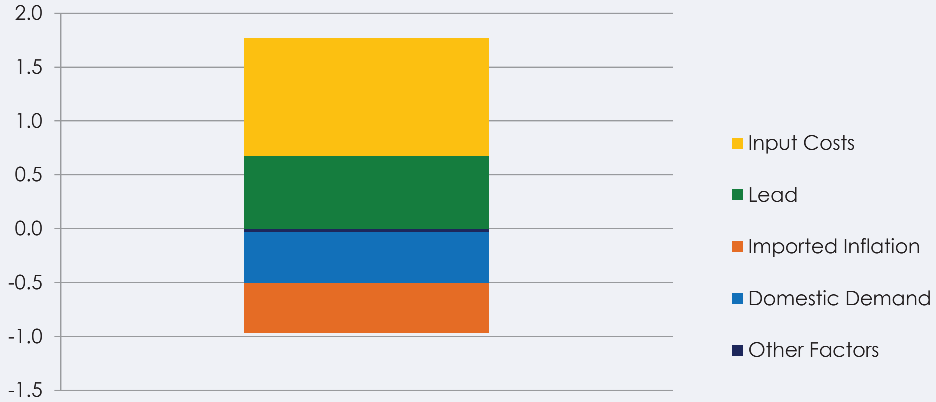
The November 2014 forecast appears to have been largely in line with the actual average figure for 2015. However, it should be noted that a number of different factors that were not incorporated into the baseline forecast scenario of the November 2014 Inflation Report pushed inflation in opposite directions. Weak demand and lower international prices of oil put downward pressure on inflation, while the depreciation of the lari exchange rate against the backdrop of external disturbances and increased inflation expectations put upward pressure on overall prices. The former made actual inflation fall more than expected in the first half of 2015, while the latter made it increase more than projected for the second half of the year (see Figure 2.15).

Figure 2.14 Performance of the Annual Inflation Forecast



Source: National Bank of Georgia

Figure 2.15 Decomposing the Deviation of 2015Q4 Annual Inflation from its Projected Value*



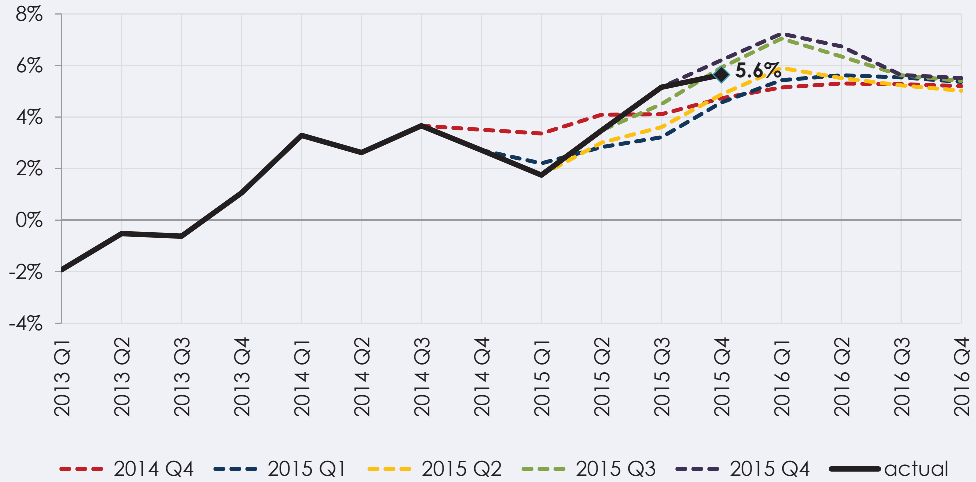
** The actual annual inflation of the fourth quarter of 2015 is compared to the forecast made a year earlier (i.e. in the fourth quarter of 2014).*

Source: National Bank of Georgia

It is worth noting that the alternative forecast scenario published in the November 2014 Inflation Report was even closer to the actual inflation figure. On the one hand, the scenario considered lower-than-baseline foreign demand and, on the other hand, a further global appreciation of the US dollar, implying a corresponding GEL/USD exchange rate change. According to this alternative scenario, annual inflation for the last quarter of 2015 was projected to increase to 5.5%, which essentially coincides with the actual inflation of that period. Therefore, while the monetary policy decisions made in the first half of 2015 (which implied only a gradual exit from the accommodative stance) were more in line with the baseline forecast scenario, the decisions made in the second half of 2015 (which involved a faster exit from the accommodative stance) were following the alternative forecast scenario made in the November 2014 Inflation Report.

The main factors behind the inflation forecast revisions in 2015 were unexpected exogenous disturbances. Therefore, the inflation forecasts made in the last quarter of 2014 and thereafter were not systematically different from the actual values (see Figure 2.16), which indicates the adequacy of the analysis and forecasting methods employed.

Figure 2.16 Performance of Annual Inflation Forecasts (2014Q4 - 2015Q4)



Source: National Bank of Georgia

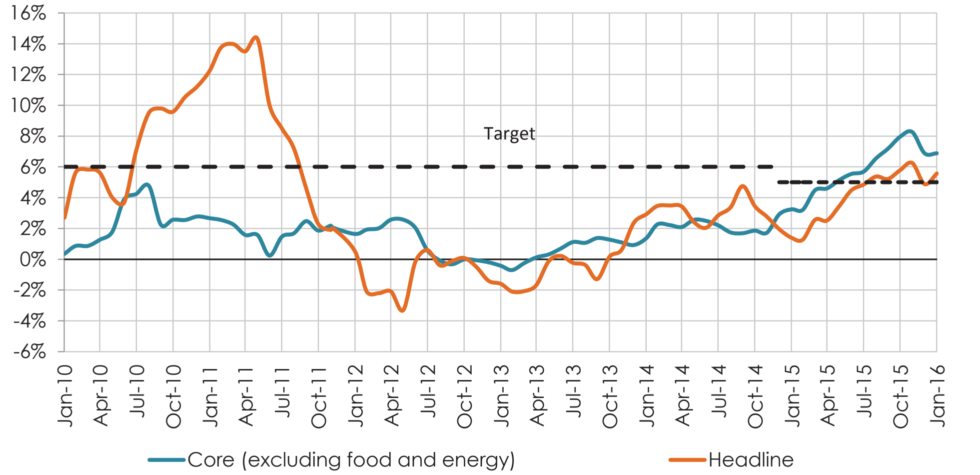
To sum up, according to the forecasts and economic conditions of the time, in the first half of 2015 the NBG started gradually exiting from its accommodative monetary policy stance and increased the refinancing rate from 4% to 5.5%. However, as external disturbances heightened and started to affect the inflation forecast, the NBG decided to exit its accommodative stance faster and, as a result, the refinancing rate was increased in the second half of 2015 from 5.5% to 8%. It can thus be concluded that the monetary policy decisions were made in line with the forecasts.

3. Consumer Prices

By the end 2015, the annual growth rate of the overall price level declined compared to the previous quarter and amounted to 4.9%. During January 2016, the annual inflation rate grew to 5.6% and is thus in compliance with the NBG's medium-term target of 5%. Against the backdrop of growing headline inflation, core inflation is also high. 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, amounted to 6.9% in January (see Figure 3.1).

« Headline inflation is close to the NBG's target level and stood at 5.6% in January 2016.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

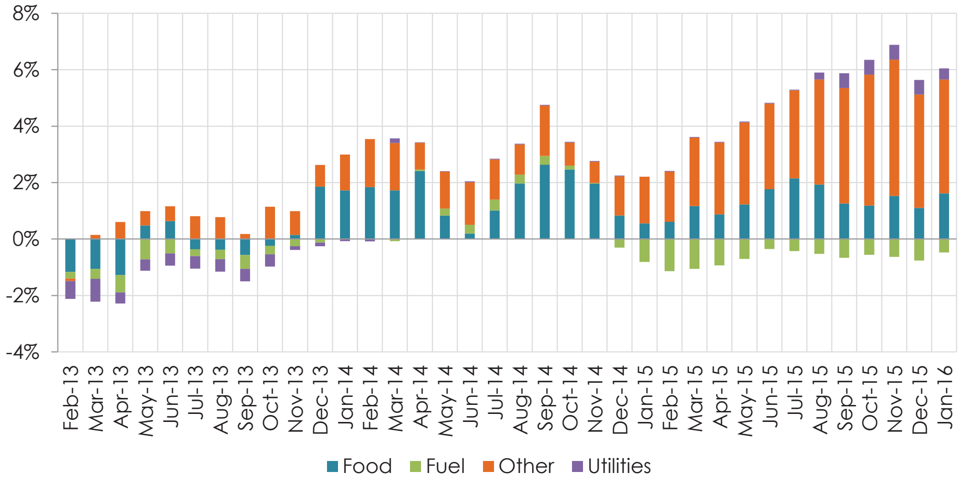
Against the low level of oil prices on international markets, fuel prices have declined in Georgia. Taking into account the high share of oil products in the consumer basket, this drop had a significant impact on the overall price level. By the end of 2015, the rates of decline on diesel and petrol amounted to 14.4% and 13.8% respectively, contributing approximately -0.8 percentage points to headline inflation. The decline of petrol and diesel prices continued during January 2016. In January, oil prices on international markets decreased even further. At the same time, the pressure coming from the nominal effective exchange rate declined as appreciation was observed compared to the last months. As a result, fuel prices had a significant effect during January. Prices of diesel declined by 10.8% and those of petrol by 8.7% annually. The contribution of this decline to headline inflation was approximately -0.5 percentage points (see Figure 3.2).

By the end of 2015 and the start of 2016, the upward pressure on inflation coming from food prices declined. Despite the depreciation of the lari exchange rate against the US dollar, the increase in prices on some food products was lower than expected. This was a result of significant exchange rate depreciations in food exporting trading partner countries. In January, the overall level of food prices increased by 5.1%, with the contribution to headline inflation amounting to 1.6 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 upward pressure on the overall inflation rate. The electricity tariff increased by an annual 27.5% in January; contributing approximately 0.4 percentage points to headline inflation (see Figure 3.2).

« The growth of administrated prices put upward pressure on the inflation rate.

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

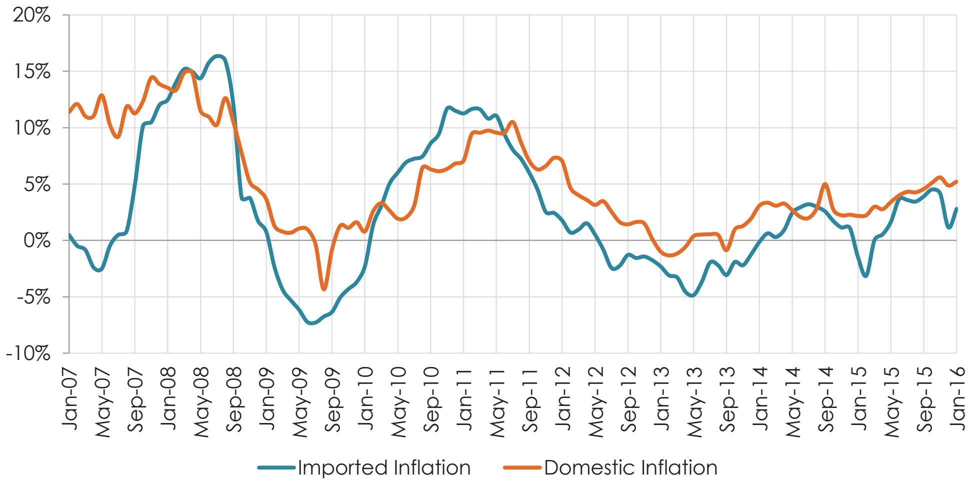


Source: GeoStat and National Bank of Georgia

In terms of supply factors, the influence of imported inflation on the overall price level is worth stressing. Due to the depreciation of the nominal effective exchange rate during the first half of 2015, imported inflation turned positive and exhibited growth. By the end of October, imported inflation had increased to 4.5%. However, in the last two months of 2015, the effective exchange rate started to appreciate as a result of the high depreciation occurring in Georgia's main trading partners. Accordingly, upward pressure on imported inflation weakened. In January, imported inflation declined to 2.8% (see Figure 3.3), contributing approximately 0.6 percentage points to headline inflation.

« The inflation rate on imported consumer goods decreased and stood at 2.8% by the end of January.

Figure 3.3 Imported And Domestic Inflation



Source: GeoStat and National Bank of Georgia

The growth of intermediate costs, another supply side factor that puts upward pressure on inflation, is also worth noting. The higher intermediate costs of firms, which was a result of the increased debt service burden on foreign currency loans, was the main factor contributing to higher inflation in 2015.

The realization of various 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 significantly decreased. The tightening of monetary policy in the second half of 2015 also pushed domestic demand downwards. The factors weakening both external and domestic demand thus caused a widening of the negative output gap. Overall, weak aggregate demand put downward pressure on consumer prices.

« Weak aggregate demand put downward pressure on the inflation rate.

Box 2 Core Inflation

Core inflation is the part of headline inflation that excludes certain types of goods and services. According to the general concept, core inflation is used to help identify the underlying trends in inflation. Core inflation should track the components of the overall price change that are expected to maintain somewhat stable dynamics for a relatively long period of time. Core inflation can thus serve as a useful instrument for near- and medium-term inflation forecasting. Over time, the prices of individual goods and services change along with the underlying trends in the economy that are defined by the dynamics of fundamental factors. At any point in time, some item prices will rise at an above-trend rate, while others will increase at a below-trend rate or even fall. Such differences in the rates of price changes reflect shifts in the relative prices of goods and services, which may be due to changes in relative supply. Core inflation should remain abstract from such relative price changes and isolate the common components in price changes that correspond to the underlying trend in prices in the economy.

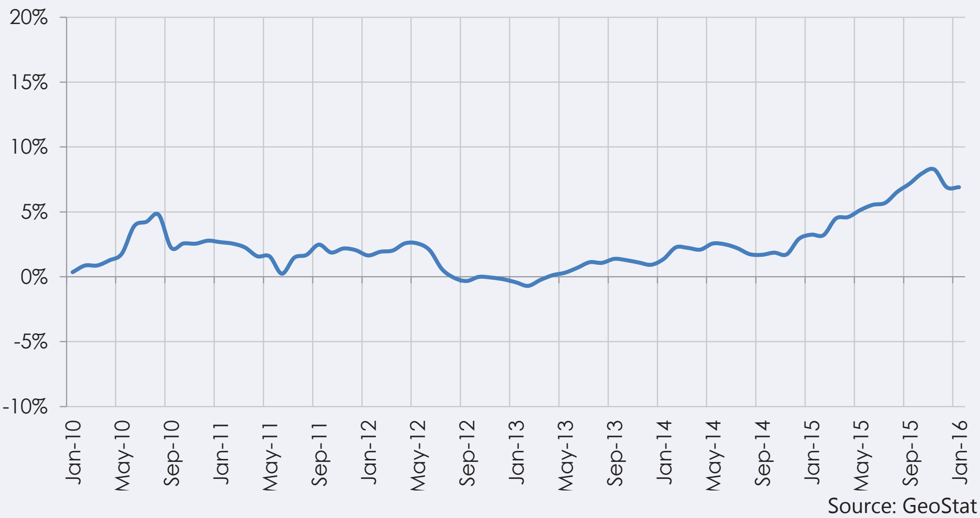
Core inflation serves to measure the particular part of overall price changes that is determined by demand side factors and inflation expectations, but is independent of supply shocks. By this reasoning, core inflation is the measure of price change that is most related to monetary policy, thus making it a useful tool in the process of monetary policy decision making.

National statistics offices and central banks use different methodologies for measuring core inflation. The most common practice is to exclude the same fixed set of items from the consumption basket, even though the price changes on those goods and services are not large during the current period. In other methods, those components experiencing large price changes in just one month are removed from the overall inflation rate that month. In this case, the exclusion of goods and services with the most volatile prices is based on different statistical methods.

Goods and services thought to be subject to large, temporary price changes often related to supply disturbances are excluded while measuring core inflation by the systematic removal of a limited, fixed set of components from overall inflation. In this sense, food and energy products are assumed to be the most volatile components in the consumption basket. Goods and services in these two categories are highly sensitive. To understand why items of food are more sensitive to price changes, consider the regional and global environmental factors that can ravage a year's crops, or seasonality that may induce food supply shock. As a result, food prices and thus the overall inflation rate may experience large fluctuations. Analogously, changes in the prices of energy and energy-related products are strongly tied to international markets and supply shocks may affect the prices of such products. However, although the prices of food and energy goods and services may frequently increase or decrease at rapid rates, those price disturbances may not be related to a change in the economy's overall price level trend. Instead, changes in food and energy prices are often more likely to be related to temporary factors that may later be reversed. In some countries, core inflation is derived by eliminating so-called administrated prices. The reason for adopting this methodology is that those prices are not shaped by market mechanisms, but are subject to various regulations, and thus the distribution of their shifts may not reflect the long-term inflation trend.

The National Statistics Office of Georgia started to calculate and publish core inflation at the end of 2015. To create core inflation, the following groups of goods and services, taken from the range of components explained above, are excluded from the consumption basket: "food and non-alcoholic beverages", "energy" (gasoline, diesel, gas fuel, liquid gas and firewood) and administrated prices (regulated tariffs on water, garbage collection, electricity and natural gas fees). Moreover, some specific tariffs from the category of "transport" (suburban trains, long distance trains, suburban buses, intercity motor transport and intracity taxi tariffs, and air flight fees) are also eliminated from the overall consumption price index. The exclusion of these components is due to the fact that there is a significant correlation between them and energy and administrated prices and fluctuations in these prices are subsequently transmitted to the abovementioned services. As can be seen from Figure 3.4 below, core inflation is characterized by less volatility over time than headline inflation and was in the 0-2% range in 2010-2014. Some increasing trends have been observed starting from 2015. The recent depreciation of the lari nominal exchange rate is partly reflected in the prices of some consumer goods. At the same time, low oil prices on international markets put downward pressure on the overall inflation rate. As a result, core inflation remains above headline inflation.

Figure 3.4 Core Inflation

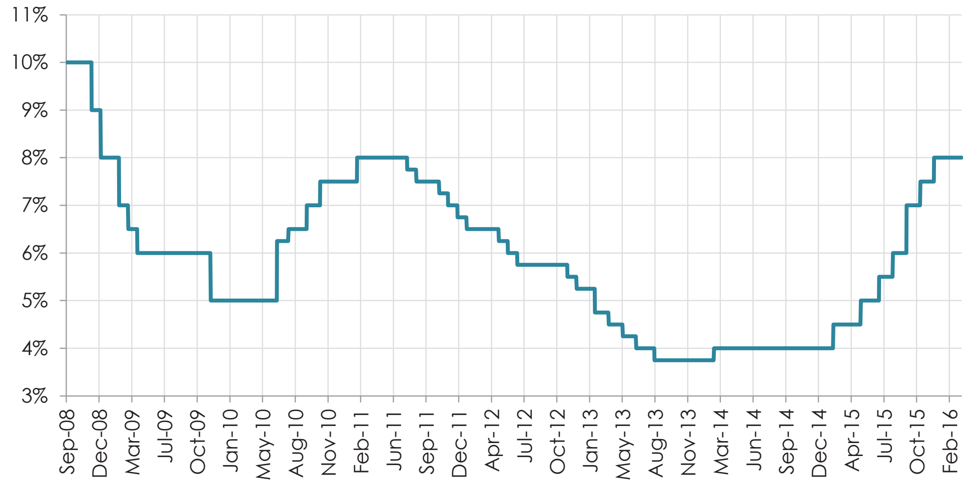


Source: GeoStat

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 lower 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 inflation expectations up. Increased inflation expectations are reflected in 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 its monetary policy. In the period February-September 2015, the Monetary Policy Committee decided to gradually increase the refinancing rate by 4.0 percentage points to 8%. 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

‹‹ During 2015, the Monetary Policy Committee increased the refinancing rate by 4.0 percentage points to 8%.

The last meeting of the National Bank's Monetary Policy Committee (MPC) was held on 3 February 2016. At that meeting the MPC decided to keep the refinancing rate unchanged. The tightening of monetary policy in 2015 is partly reflected on the economy. Interest rates on lari denominated loans increased and, as a result, the growth of the credit portfolio declined. This will further weaken aggregate demand and will push inflation downwards. Thus, unless more shocks take place, at this stage there is no need for additional monetary tightening to contain inflation expectations. Taking both external risks and domestic factors into account, the MPC thus found it appropriate to leave the policy rate unchanged at 8%.

‹‹ According to the decision of 3 February, the refinancing rate was kept unchanged. At this stage, there is no need for additional monetary tightening.

The inflation rate in 2015 showed a growing tendency and was approaching the 5% target value set by the National Bank. A rise in inflation due to increased prices stemming from the exchange rate depreciation was restricted by the decrease in global oil and food product prices. However, the impact of oil prices has gradually diminished. The annual growth in consumer prices equaled 5.6% in January. The main factors causing the rise in inflation at the start of 2016 were increased intermediate costs of production, higher prices on certain imported goods and a growth of administrated prices.

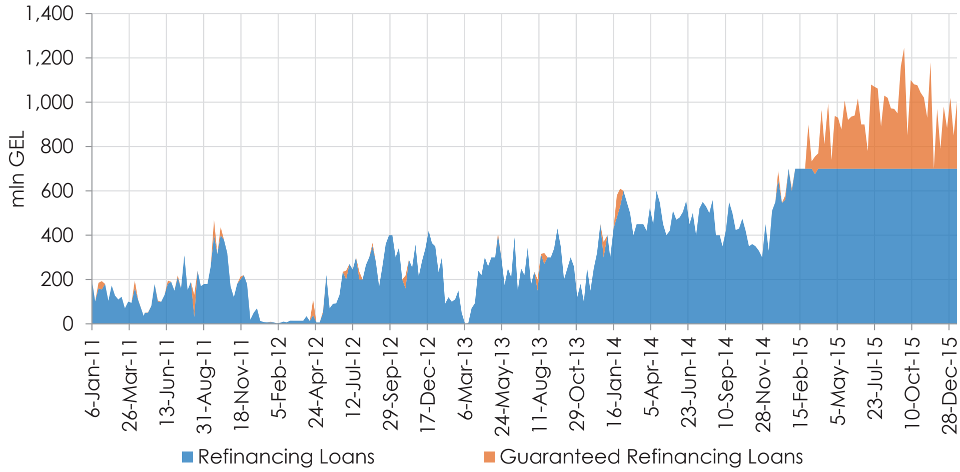
Domestic demand remains weak. According to preliminary information, real GDP growth in 2015 was 2.8%. Credit activity growth has decelerated and the growth rate of the portfolio hovers at around 6% (excluding the exchange rate effect). The significant decline in imports also indicates weakened demand.

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 2%. However, since the second quarter of that year, the rate of export decline slowed in line with the 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 fourth 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). During the last quarter of 2015, remittances had an annual decline of 20%. This was an improvement over the previous quarters of the year and, as a result, the annual decline in remittances in 2015 amounted to 25%. The dynamics in revenues from tourism also improved compared to the previous year, with 8.3% annual growth in 2015.

According to the NBG's existing forecasts, inflation will temporarily slightly overshoot the target of 5% in the beginning of 2016. It will thereafter decline below 5%, although it will remain close to the target. However, both upside and downside risks to the forecast remain. Inflation pressure might stem from expectations of worsened inflation due to the depreciation of the GEL/USD exchange rate, a greater-than-expected growth of intermediate costs, a surge in oil prices and/or higher-than-expected aggregate demand. On the other hand, lower-than-expected aggregate demand and/or further depreciations of exchange rates in Georgia's main trading partners could have a downward effect on inflation dynamics in the short run.

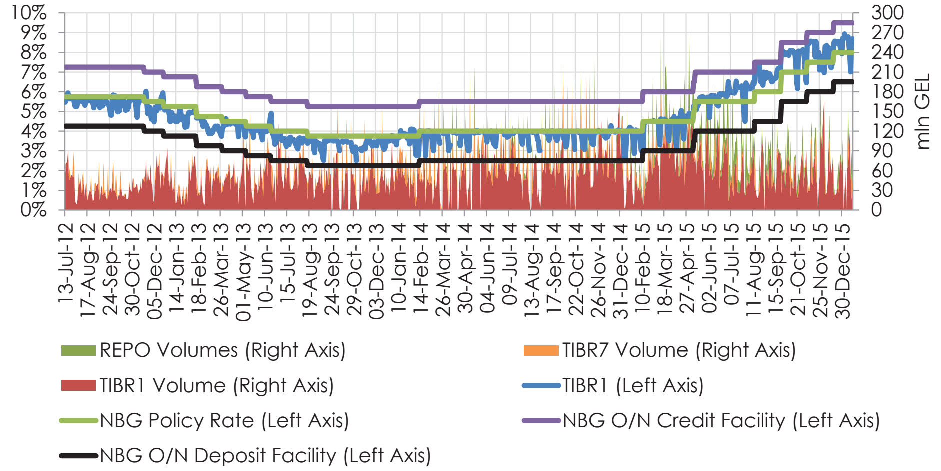
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. 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 the standing facility to get the required liquidity. Interest rates on these instruments are set 150 basis points higher than the policy rate. Interbank short-term interest rates are correspondingly augmented 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.

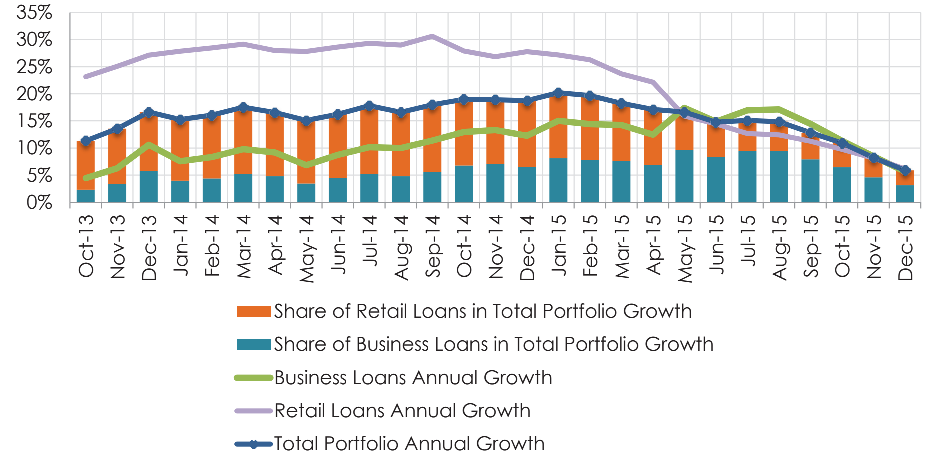
5. Financial Market and Trends

5.1 LOANS

In the fourth quarter of 2015, the annual growth rate of the loan portfolio decreased and, excluding the effect of exchange rate movement, amounted to 5.9% in December. That 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. This caused a decrease of the annual growth rate of lending to individuals compared to the previous quarter. The growth rate of business loans also decreased as a result of lower demand. It should be noted that the volume of business loans in the national currency with a floating interest rate did not change significantly in December and their share in total business loans remained 7%.

« As a result of weak economic activity and exchange rate depreciation demand for imported goods decreased, that caused decrease of 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

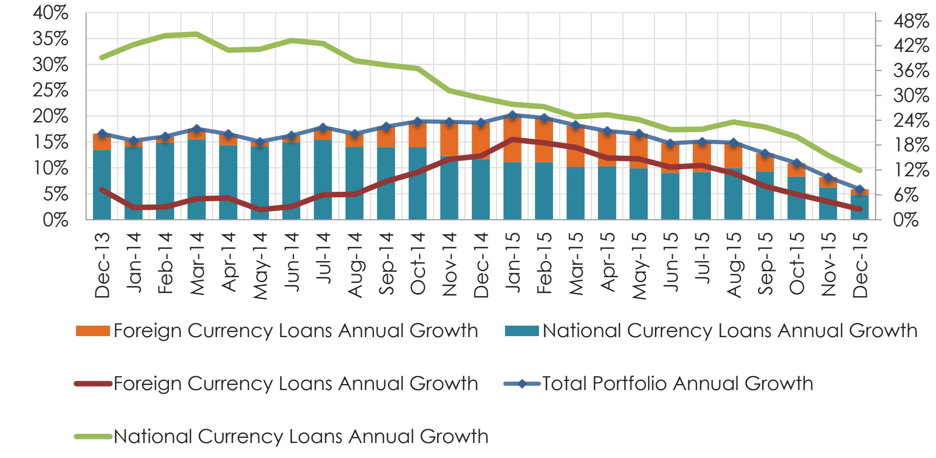


Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was largely caused by an increase in domestic currency loans. In December, the annual growth rate of foreign currency denominated loans decreased to 2%, while domestic currency loans increased by 11.9%. Despite this fact, in the fourth quarter loan larization coefficient decreased to 35.6, which was mainly caused by the exchange rate depreciation.

« The growth of the loan portfolio was largely caused by an increase in domestic currency loans.

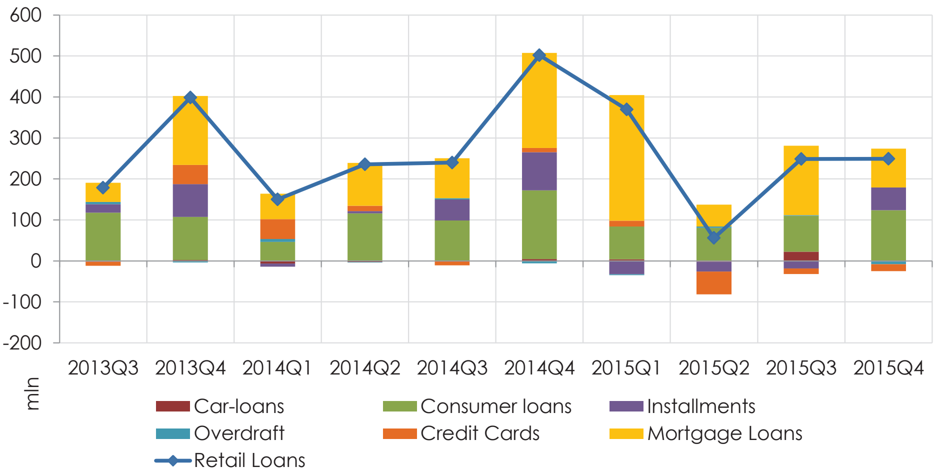
Figure 5.2 Annual Growth Rates Of Domestic And Foreign Currency Loans And Their Contributions To The Growth Of The Loan Portfolio



Source: National Bank of Georgia

In December, the stock of retail loans increased by 250 million GEL compared to September. In terms of loan products, compared to the previous quarter the amount of mortgage and consumer loans increased by 96 mln and 124 million GEL respectively. The volume of instant loans and credit cards increased by 39 million GEL, and was driven by seasonality factors. As these loans are mainly used to finance imports, their slower growth reflects reduced demand for imports and 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 December, the annual growth rate of the loan portfolio to legal entities amounted to 5.7%[12], which is 8.8 percentage points lower than in September. According to the credit conditions survey, in the fourth quarter of 2015 the banks tightened interest and non-interest rate terms in response to expectations of economic deterioration. An analysis of business loans by sector reveals that the energy, agriculture and construction sectors posted growth in terms of credit, while the volume of outstanding loans disbursed to the trade, manufacturing and transport sectors increased only slightly. Representatives of the banking sector do not expect an improvement of demand for business loans in the next quarter.

In recent years, the credit to GDP ratio[13] has followed the trend[14] without significant fluc-

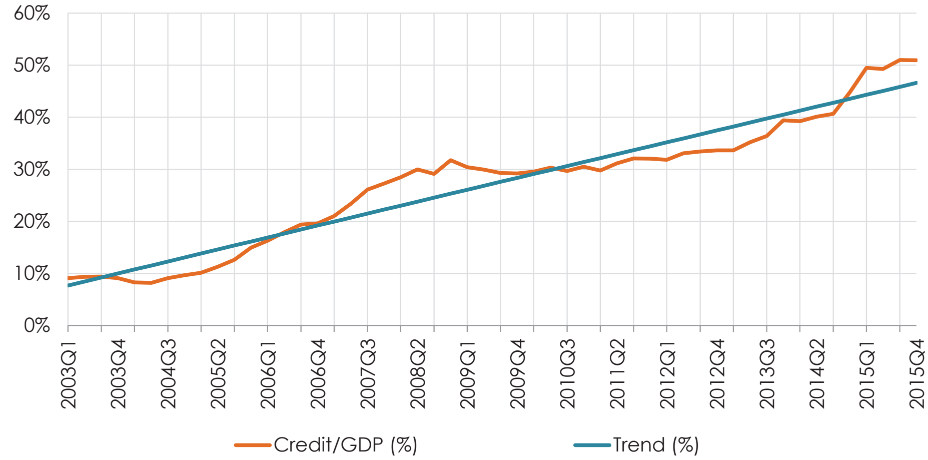
12 Excluding exchange rate effect.

13 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.

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

tuations. However, the ratio increased considerably after the exchange rate depreciation in the first quarter of 2015. In the fourth quarter, the credit to GDP ratio did not change and amounted to 51%. The ratio is currently 4.3 percentage points above the trend.

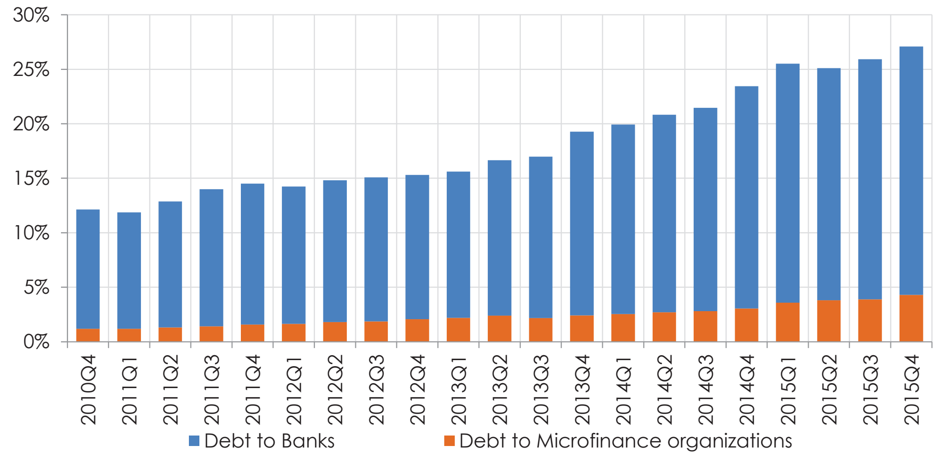
Figure 5.4 Credit To GDP Gap



Source: National Bank of Georgia

In the fourth quarter of 2015, the individuals' loan to net national disposable income ratio increased by 1.1 percentage points compared to the previous quarter and amounted to 27.1%. Debt to commercial banks accounts for 84% of total individuals' loans.

Figure 5.5 Individuals' Debt To Net National Disposable Income Ratio



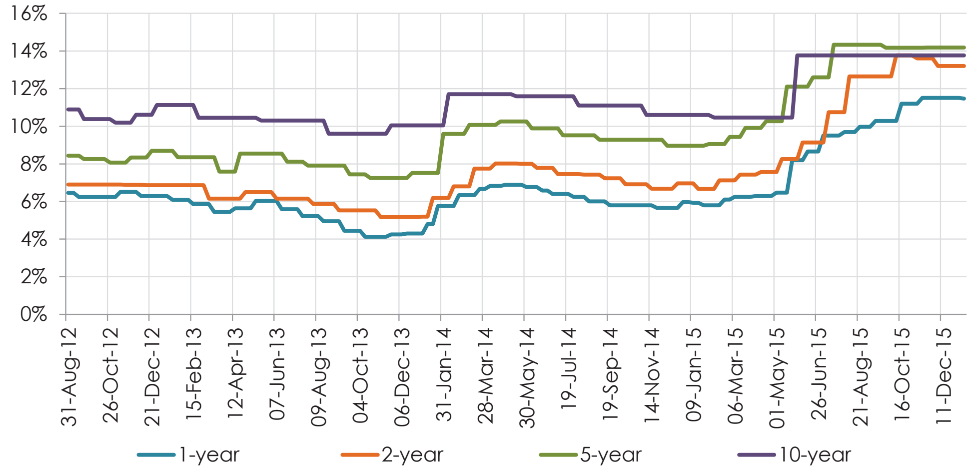
Source: National Bank of Georgia

The share of non-performing loans decreased by 0.2 percentage points in the fourth quarter of 2015, compared to the previous quarter, and amounted to 7.6%. According to the data from December, the share of non-performing loans in the national currency increased by 0.2 percentage points compared to September, amounting to 5.2%. The share of non-performing foreign currency loans decreased by 0.6 percentage points and equaled 8.7%. The amount of loans written off in the fourth quarter amounted to 58 million GEL, which caused the share of non-performing loans to decrease by 0.4 percentage points.

5.2. INTEREST RATES AND CREDIT CONDITIONS

In December 2015, the monetary policy rate increased to 8%. In the fourth quarter of 2015, interest rates on government securities stabilized compared to the previous quarter. This was a result of lower pressure against the National Bank's policy and a decrease in inflationary expectations.

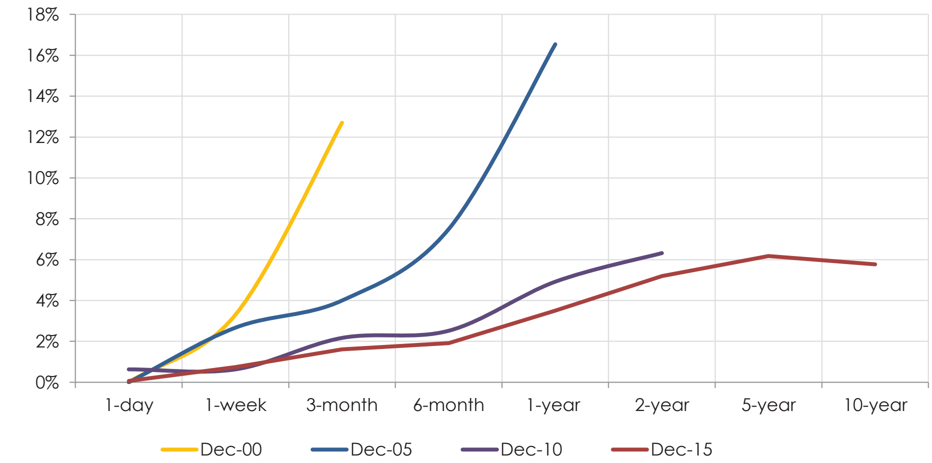
Figure 5.6 Interest Rates On Government Securities



Source: National Bank of Georgia

The spread between long-term assets and the monetary policy rate has decreased – a result of diminishing pressure against the National Bank's policy and lower inflationary expectations decreasing expectations of an increase in the monetary policy rate. The National Bank's monetary policy agenda promoted a reduction of interest rates on long-term assets and decreased the price of credit resources. This, in turn, promoted internal investments and economic growth.

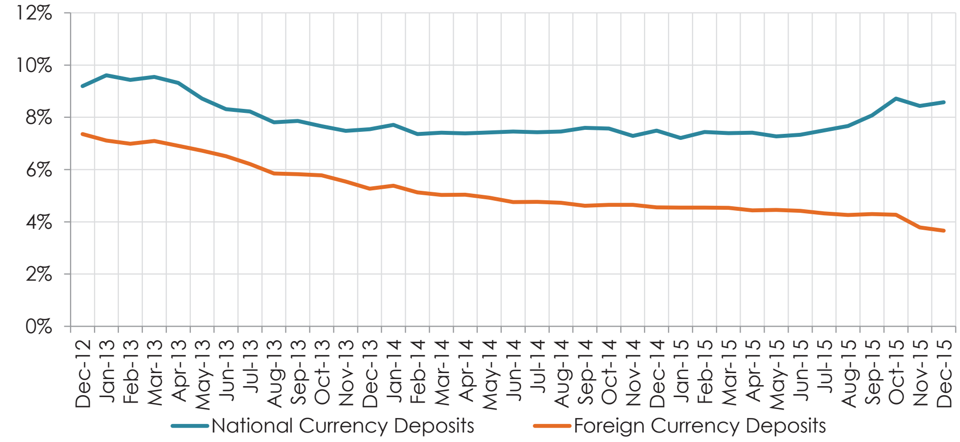
Figure 5.7 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits increased by 0.5 percentage points and amounted to 8.6%, while the interest rate for foreign currency deposits decreased by 0.6 percentage points and amounted to 3.7%. The rise in interest rates 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 domestic and foreign currency deposits is not expected to change in the next quarter.

Figure 5.8 Average Interest Rates On Deposits

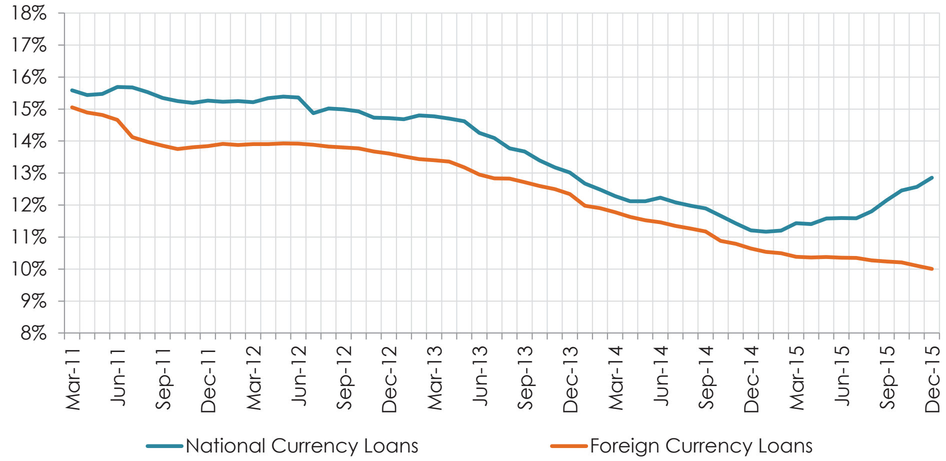


Source: National Bank of Georgia

According to the credit conditions survey, in the fourth quarter of 2015 credit conditions tightened for individuals and legal entities. 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 a tightening of monetary policy. In December, interest rates on the flow of corporate loans decreased by 0.2 percentage points compared to September and amounted to 11.4%. Interest rates on loans to small and medium business decreased by 1.1 percentage points and amounted to 12.7%, while rates on retail borrowings decreased by 1.4 percentage points and amounted to 16%. In the context of currencies, interest rates on business loans in the domestic currency increased by 0.7 percentage points, while interest rates for foreign currency deposits declined by 0.2 percentage points. 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.

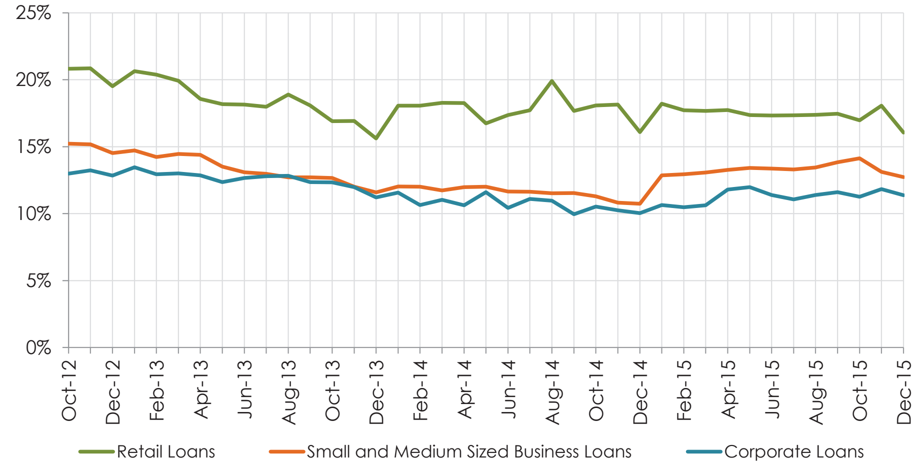
‹‹ Interest rate conditions on domestic currency loans might increase.

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 3 SebStat - A new statistical information system

SebStat, a new statistical information system for the National Bank of Georgia, was put into action following of the NBG's President's decree of November 2015. SebStat is a completely innovative statistical business process model that has fundamentally changed the statistical environment in the Georgian banking sector. In order to ensure the high quality of data, SebStat has been operating together with Excel-based reporting since 2014. The main advantage of the SebStat is that commercial banks are now able to submit their data to the NBG through web-based technologies, instead of Excel-based questionnaires.

SebStat is an information system that guarantees the standardization and optimization of the NBG's statistical business process through the harmonization of statistical terms, categories and concepts. Commercial banks' data for reporting are strictly structured in a standard way, which ensures high quality, the automation of validation and processing procedures, and a reduction of the reporting burden.

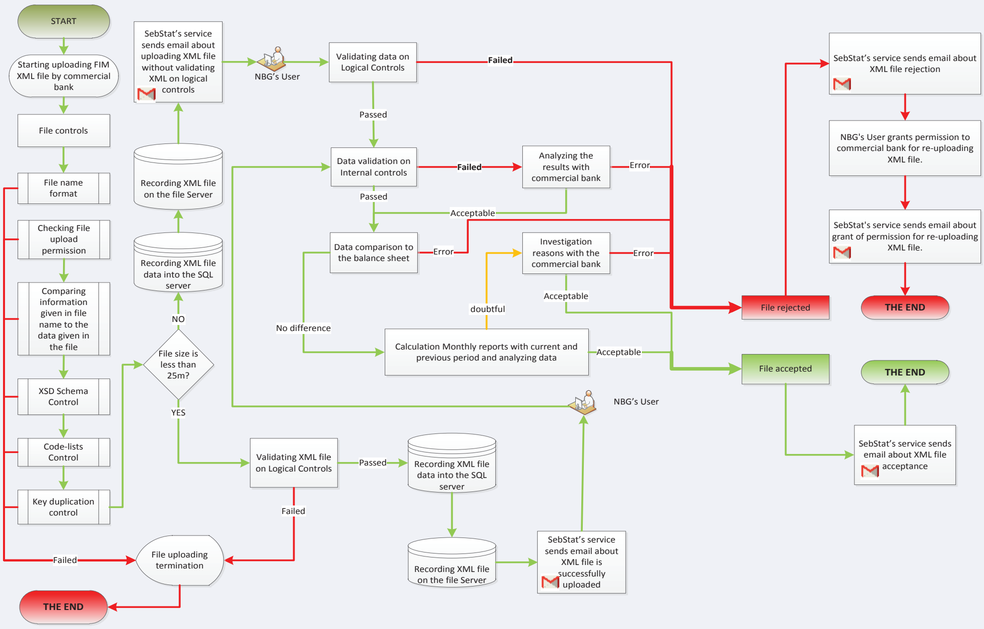
SebStat is a transparent system, which means that its methodology, usage guide and practical handbooks, consistency schemes and procedures to ensure high data quality, and reporting rules are all published on the website and are available to any interested user via the following link: https://www.nbg.gov.ge/index.php?m=634

SebStat is a harmonized system that ensures its consistency with the modern international standards established by macroeconomic statistical systems (the System of National Account, the Balance of Payments, the Monetary and Financial Statistics and the Government Financial Statistics).

SebStat is a flexible system. Any institutional or structural changes in the banking system can be immediately reflected in SebStat without any extra time or cost, and it can be extended by adding new family groups at minimal cost.

The main advantage of SebStat as a new statistical concept is that it not only allows an extension of the required data coverage, but also increases the quality of the data reported by the commercial banks. High data quality is ensured by both the procedures applied in commercial banks and the comprehensive validation schemes of the National Bank of Georgia. One such procedure (FIM family XML file validation) is illustrated below.

Figure 5.11 FIM family XML file validation procedure



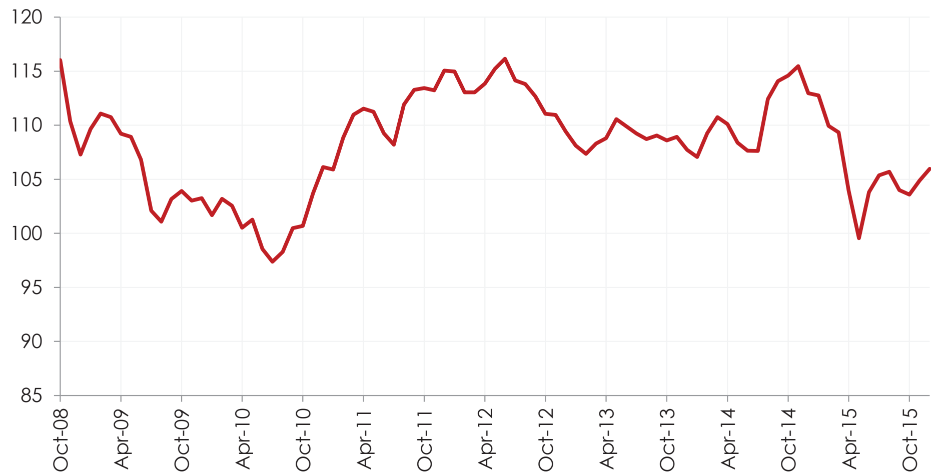
Source: National Bank of Georgia

During the current year, the National Bank of Georgia is going to provide step-by-step updated statistical information to users.

5.3. EXCHANGE RATE

In the fourth quarter of 2015, the GEL depreciated by 3.1% against the USD compared to the previous quarter (the exchange rate was 2.4 on average). The GEL also depreciated against the euro (by 1.6%) and the Turkish lira (by 1%), while strengthening against the Russian ruble, the Ukrainian hryvnia and the Azerbaijani manat by 1.5%, 2.4% and 0.5% respectively. As a result, at the end of the fourth quarter of 2015, the nominal effective exchange rate appreciated by 3% compared to the previous quarter. The real effective exchange rate appreciated by 1.9% compared to September. Year-on-year depreciation totaled 6.2%.

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



Source: National Bank of Georgia

As Table 5.1 shows, the nominal exchange rate in December 2015 appreciated on a year-on-year basis against the Turkish lira, the Ukrainian hryvnia and the Azerbaijani manat.

Table 5.1 Effective Exchange Rates Annual Growth

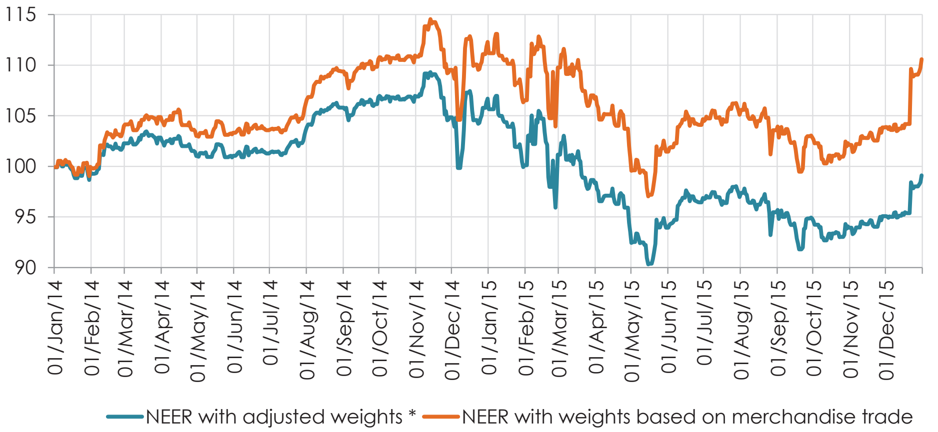
	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective exchange rate*	-4.0	-6.2	-6.2
Eurozone	-10.9	-6.8	-1.4
Turkey	0.2	-3.4	-0.7
Ukraine	18.4	-13.4	-1.1
Armenia	-17.9	-13.8	-0.8
The United States	-21.4	-18.2	-0.9
Russia	-0.2	-7.4	-0.7
Azerbaijan	16.8	13.8	2.0
Other	-16.7	-13.3	-2.6

** Increase of the index corresponds to appreciation.*

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, paints a slightly different picture. In particular, the adjusted nominal effective exchange rate in December fell by 8% year on year, but appreciated by 2% compared to September 2015.

Figure 5.13 Corrected Nominal Effective Exchange Rate



* 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.

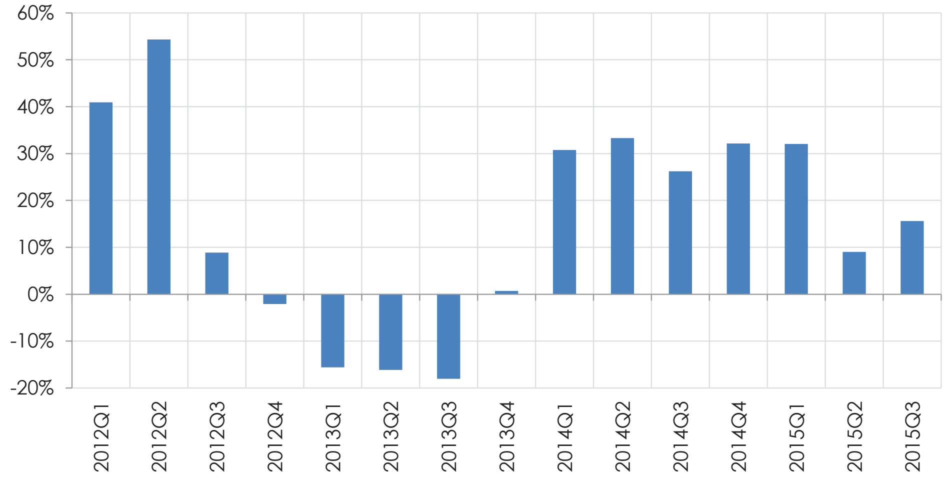
Source: National Bank of Georgia

6. Domestic Demand

Real GDP growth amounted to 2.5% in the third quarter of 2015; with the growth in consumption being the main determinant of the overall growth (an important contribution was also made by investments). Exports declined due to weakened external demand. According to preliminary estimates, the growth rate of the economy increased in the fourth quarter. Relatively higher economic growth was also caused by the base effect.[15]

‹‹ Real GDP growth amounted to 2.5% in the third quarter of 2015.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

Capital formation growth rate increased in the third quarter of 2015 and posted 15.6%. A significant contribution to the growth of capital formation was made by BP's investments into a new pipeline project. The higher growth rate of investments is also a result of an increase in credits to the corporate sector by commercial banks.

‹‹ Capital formation growth rate increased in the third quarter of 2015 and posted 15.6%.

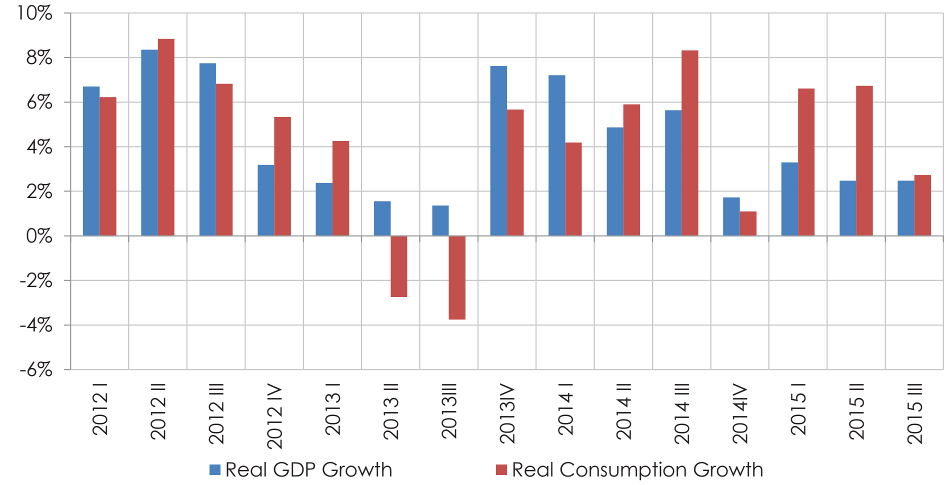
In the third quarter of 2015, exports and imports of goods and services decreased by an annual 8% and 3% in real terms, respectively. As a result, net exports contributed negatively to the GDP growth of the third quarter (though did so much less than in the first half of the year). The decline in exports stemmed from external shocks caused by reduced demand in partner countries. The decline of imports stemmed from reduced demand, which may be caused by the substitution effect following the depreciation of the lari exchange rate. Another reason could be the decrease of the disposable income of individuals and legal entities following lowered exports and money transfers, and the increased debt service on foreign currency loans.

Real growth of private consumption[16] posted 2.7% growth in third quarter of 2015. The decline of consumption growth was caused by weakened of growth of disposable income and by the tightening of the monetary policy of the NBG. The tighter monetary policy resulted in a slowdown in the growth of loans (especially consumer loans).

‹‹ Real growth of private consumption posted 2.7% growth in third quarter of 2015.

15 *Growth rate of economy posted only 1.7% in fourth quarter of 2014.*
16 *The real growth of consumption is calculated using average annual inflation.*

Figure 6.2 Real GDP And Real Consumption Growth

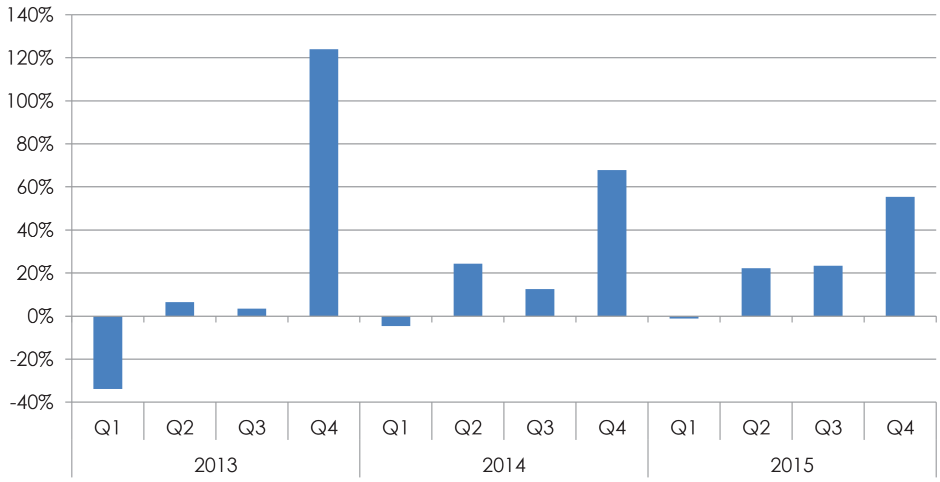


Source: GeoStat and National Bank of Georgia

The consolidated budget deficit posted 1.14 bln GEL (3.6% of the GDP forecast) in 2015. Taking seasonal patterns into consideration, the deficit in the fourth quarter was the highest (634.6 mln GEL), although the annual budget deficit in 2015 was much more equally distributed among quarters than in the previous year. The higher budget deficit in the last quarter of 2015 stimulated an increase of internal demand. The consolidated budget deficit is planned to post around 1.04 bln GEL in 2016, which is around 3% of the GDP forecast.

« The consolidated budget deficit posted 1.14 bln GEL (3.6% of the GDP forecast) in 2015.

Figure 6.3 Consolidated Budget Deficit (Million GEL)



Source: Ministry of Finance of Georgia

7. External Demand and Balance of Payments

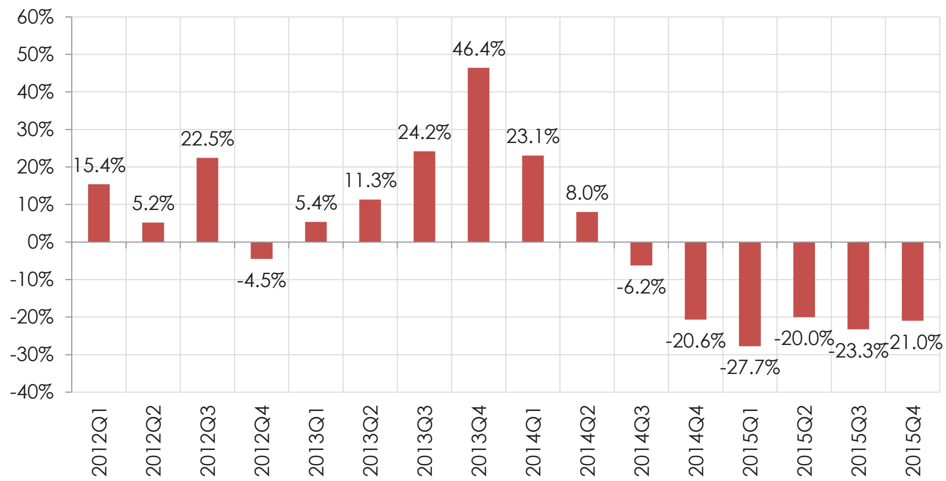
During the third quarter of 2015, export revenues diminished against the background of external shocks. However, the adjustment effect of the exchange rate depreciation was evident and resulted in a significant decline in imports. Despite this, the current account (CA) deficit deteriorated by 4.6% year on year (12 million USD in absolute terms) and amounted to 7.9% of GDP. According to preliminary estimates, in the fourth quarter of 2015 the trade deficit will improve significantly and will be the main cause of the lowering of the current account deficit. The CA deficit to GDP ratio will improve to 14%, which falls behind the same indicator from the previous year by 1.3 percentage points. Increased receipts from exports of services will also encourage an improvement of the CA deficit. As a whole, in accordance with current projections, the CA deficit amounted to 11.6% of GDP in 2015.

« The current account deficit to GDP ratio amounted to 7.9% in the third quarter of 2015.

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. That decline was expected to slow during the following periods, but did not do so due to additional unfavorable developments in trading partner countries. The decrease of oil prices in international markets further worsened external demand on Georgian goods and services from the Russian Federation, Azerbaijan and Kazakhstan. As a result, according to fourth quarter data, the annual decline in registered goods exports revenues lessened to 21% (see Figure 7.1). In total, exports fell by 23% during 2015 compared to the previous year.

« Exports declined 21% in the fourth quarter of 2015.

Figure 7.1 Annual Change Of Registered Exports Of Goods



Source: GeoStat

The change in exports of goods was uneven in terms of destination region. During the fourth quarter of 2015, exports to the EU increased by 8% year on year. Exports to CIS countries worsened, with the rate falling by 38% over the same period. A decline of export receipts was evident from other countries as well (falling by 16.7%). Among the EU, the most substantial growth was registered in Germany (50%), Lithuania (26%) and Bulgaria (24%). In the CIS countries, exports declined to Azerbaijan (-65%), Kazakhstan (-45%) and Armenia (-42%). At the same, a large increase was observed in exports to Turkmenistan and Uzbekistan, with exports to the latter growing quite rapidly in recent months. The decline of exports to other countries was chiefly driven by diminishing sales to the USA (-66%) and Turkey (-39%); in contrast, the sharp growth of exports to China (49%) and Switzerland (267%) is worth noting.

« Exports to the EU increased by 8% year on year while exports to CIS countries fell by 38% over the fourth quarter of 2015.

In terms of product categories, during the fourth quarter of 2015, the year-on-year reduction of export rates were high for natural wines (-40%), other spirits (-32%) and mineral waters (-9%). There was also a considerable decrease in sales of nuts

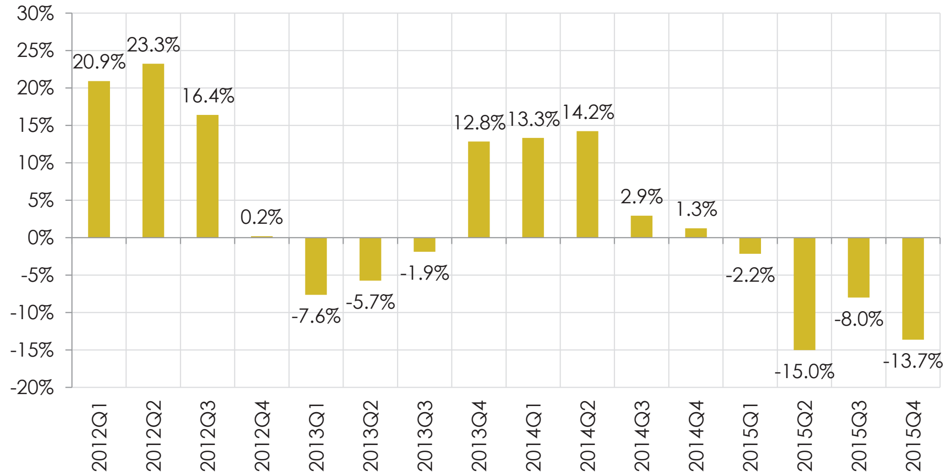
(-18%). Deep drops were observed in the re-export of cars (-65%), exports of fertilizers (-54%) and iron or non-alloy steel products (-46%). The decline of exports of these goods was partially balanced by an increase in re-exports of copper concentrates (80%) and medicaments (68%), and exports of gold (41%) and cyanides (53%).

Against the unfavorable developments in the countries of the region in the fourth quarter of 2015, there was decline of exports still at a high rates. However, recent developments in the diversification of Georgian exports will contribute to improve this situation.

In the fourth quarter of 2015, registered imports of goods declined by 13.7% year on year (see Figure 7.2). This decline is even higher, amounting to 19.1%, when the hepatitis C treatments, which were provided by a grant and imported during this period, are excluded.[17] The decline of petroleum product imports continued to have a significant impact on the total reduction of registered imports of goods. Due to the additional reduction of oil prices on international markets, the level of petroleum product imports was maintained at a low level. Moreover, the adjustment effect of the exchange rate depreciation was clearly evident from the second quarter. There was a significant decline of almost all imported products, particularly in imports of durable consumption goods. The drop was especially sharp in purchases of various types of electrical appliances, construction equipment and materials. Cutbacks in imports of food products also contributed considerably to the reduction of total imports. In total, imports, excluding one-offs, decreased by 15.3% during 2015 as compared to the previous year.

‹‹ The annual reduction rate of registered imports amounted to 19.1% in the third quarter of 2015 (excluding one-offs).

Figure 7.2 Annual Change Of Registered Imports Of Goods



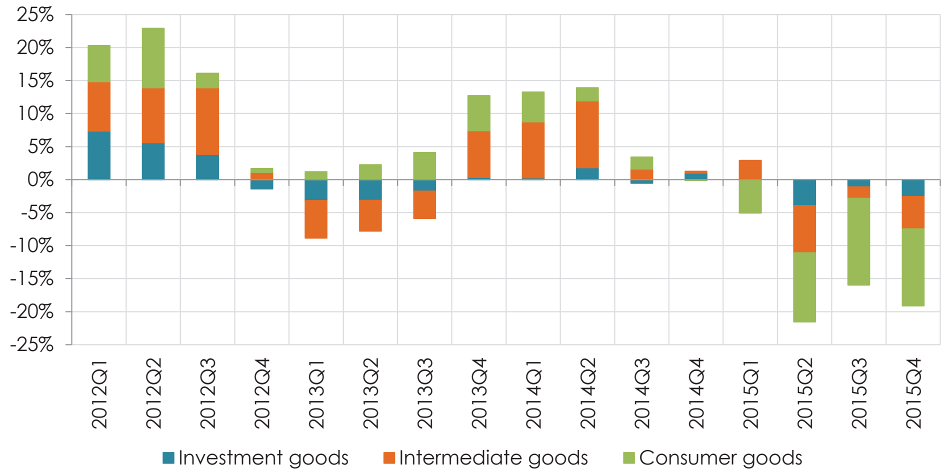
Source: GeoStat

‹‹ 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.

The decomposition of imports across different categories of products indicates that the decline of imports was chiefly driven by a 25% reduction of imports of consumer goods, which contributed -11.7 percentage points to the total decrease. The fall of imports of investment goods was 19.4%; intermediate goods imports decreased at the somewhat lower rate of 12.2% year on year, contributing -4.9 percentage points to the overall reduction of the fourth quarter of 2015. As was noted above, total imports declined by an annual 15.3% in 2015. This was mostly driven by the reduction of imports of consumption goods, which contributed -10.3 percentage points to the overall decrease (see Figure 2.10).

17 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[19]



Source: GeoStat

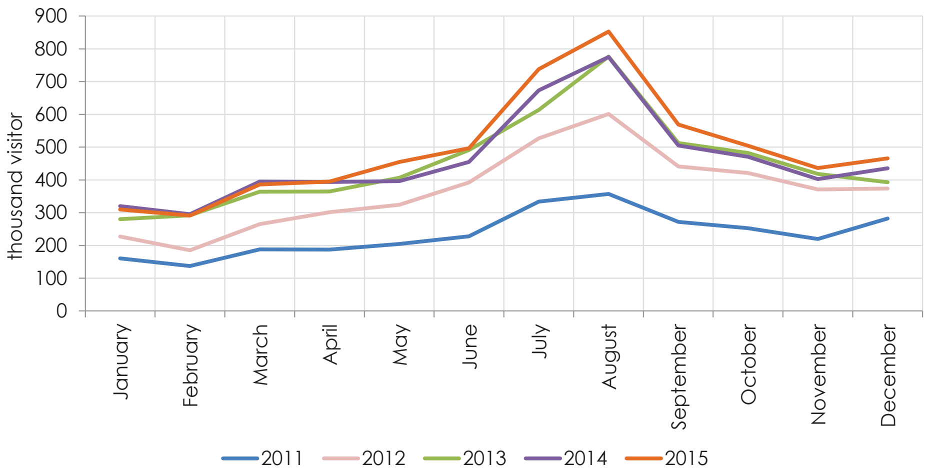
The ongoing regional and European crises have negatively affected the amount of remittances coming into Georgia. In the fourth quarter of 2015, money transfers were reduced to 277 million USD, down by 19.5% on an annual basis; however, this was an improvement over the previous quarter's indicator, which stood at 33%. This tendency was observed from both CIS countries and the EU. The year-on-year reduction of funds coming from Russia improved from 43% to 29% and also slowed in the case of Greece (from -84% to -46%) and Italy (from -14% to -2%). Funds transferred from Germany increased by 10% year on year. Overall money transfers from CIS countries declined by 29% and those from EU countries fell by 21%. Unlike the growth during previous periods, money transfers from Turkey also declined. Conversely, an increasing tendency persists from Israel and the USA, with money transfers from those countries rising by 45% and 19% respectively. In total, during 2015 money transfers fell by 25% compared to the previous year.

« In the fourth quarter of 2015, annual reduction of money transfers slowed down.

The number of incoming visitors to Georgia increased in the fourth quarter of 2015 by 7.5% compared to the year earlier. Contrary to the previous periods, the sharp growth in the number of foreign transit passengers declined and amounted to 10.9%. Growth was also observed in the number of incoming tourists (4.4%).[19] As the breakdown of visitors by country shows, the highest growth rates from leading directions were recorded from Russia (12.2%) and Azerbaijan (10.1%). The number of visitors from Ukraine and Armenia also increased (by 6.3% and 3.9% respectively). Unlike in previous quarters, the number of Turkish visitors declined year on year

« The number of incoming visitors to Georgia increased by 7.5% year on year during the fourth quarter of 2015.

Figure 7.4 Number Of Incoming Visitors To Georgia



Source: GNTA

18 Excluding hepatitis C treatments import.

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

(-0.2%). In the fourth quarter of 2015, the number of visitors from Europe was 4.1% less than in the same period in 2014. In total, during 2015 the sum of incoming visitors grew by 7% annually. The number of foreign transit passengers increased by 25.7%, whereas the growth rates of tourists and other visitors were relatively modest, amounting to 2.2% and 2.1% respectively.

In the third quarter of 2015, the CA deficit was mainly financed by foreign direct investments (FDI). Inflows of foreign direct investments reached 518.1 million USD, of which 45% were investments realized in the transport sector related to the construction of the South Caucasus Pipeline. Annual growth was also recorded in investments in the construction and manufacturing sectors.

8. Output and labor market

8.1 OUTPUT

In the third quarter of 2015, GDP rose by 2.5% in comparison with the same period of the previous year. At 1.7 percentage point, the services sector made the largest contribution to the overall growth. The industrial sector contributed 0.6 p.p and agriculture 0.2 p.p.

Trade, the biggest branch of the economy, was the largest contributor (0.3 p.p) to the growth in services. After a 0.6% decline in the first half of the year, in the third quarter trade rose by 2.1 %. The remarkable growth of real estate activities and financial intermediation seen in the second quarter continued into the third, with both sectors making a 0.3 p.p contribution to GDP growth. In the third quarter, the outcomes of the National Bank's monetary policy tightening were not fully reflected on the real estate market. The stock of loans for real estate purchases had been rising, including in the third quarter, and that propped up activity on the market. As a result, real estate, rental and related business activities, where the share of real estate agencies' turnover is the largest, increased by 6.1%. High credit activity was maintained, widening the credit portfolio of the banks. Consequently, the output of the financial intermediation sector rose by 9.3%. It is noteworthy that after the high increase (6.8%) in the first half of the year, the output of the transport sector declined. The increase in the number of visitors (10.5%) fostered increased turnover for travel agencies and tour operators by a nominal 26%. Growth was relatively low for air and pipeline transport, cargo handling and storage and other supporting transport activities (a nominal 8% in total). However, the decrease in railway and other land and sea transport (a nominal 3% in total), which can be related to the plummeting imports of goods, finally caused a real reduction of transport output by 1%.

« In the third quarter, the main drivers of growth were the construction, trade, real estate and financial intermediation sectors.

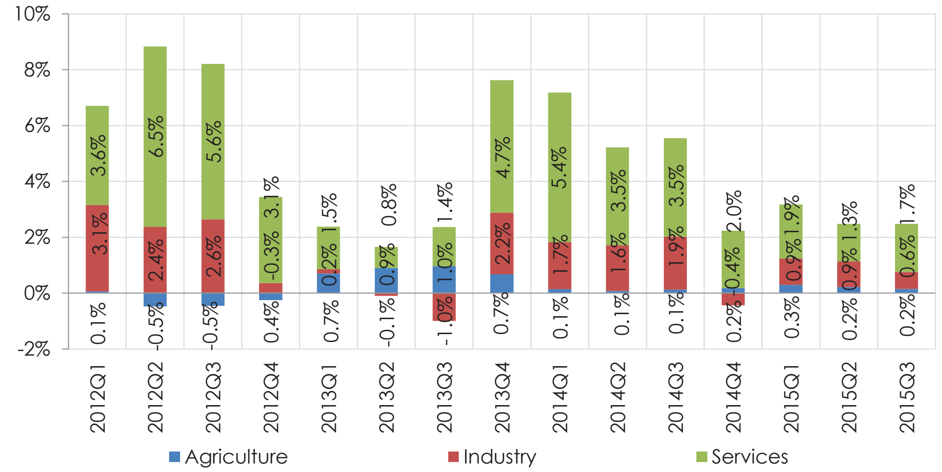
From the industrial sector, the growth of construction in the third quarter remained high. Both private sector housing and public sector infrastructure projects were active. As a result, construction saw a 15.4% increase and made a 0.9 p.p contribution to GDP growth.

The large increase in the mining industry seen in the first half of the year continued, with the sector growing by 24.1% in the third quarter (a 0.2 p.p contribution to GDP growth). Weak foreign demand made manufacturing decline further (a decline of 6.7%, making a -0.6 p.p contribution to GDP growth). The manufacturing sector significantly shrank due to reduced foreign demand: production of alcoholic beverages decreased by 25% in nominal terms, mineral water and soft drink production fell by 21%, metallurgical and finished steel production were down by 10%, and machinery, electronics, transport equipment and other manufacturing production fell by 10%.

In the third quarter, the growth of agriculture further slowed to 1.9%, contributing only 0.2 p.p to GDP growth.

« In the third quarter, growth of agriculture slowed even more.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

After declining in the previous quarter, the real value added produced per worker increased by 2.5% in the fourth quarter of 2015 in year-on-year terms. During this period, the annual rate of labor productivity in the agriculture sector amounted to 6%, which is 4 percentage points higher than the rate in the previous quarter. Unlike in preceding periods, labor productivity in the industrial sectors slightly declined, falling by 0.5%. The real value added per employee also decreased in the service sector, albeit at a somewhat lower pace.

« Labor productivity increased by 2.5% during the third quarter of 2015. This increase can be largely attributed to the agriculture sector.

Table 8.1 Annual Growth of Real Value Added Produced per Worker in the Third Quarter of 2015

	Labor productivity growth, %
Agriculture and fishery	6.0%
Industrial sectors	-0.5%
Service sector	-1.0%
Overall in the economy	**2.5%**

Source: GeoStat and National Bank of Georgia

As a sectoral breakdown of the economy shows, labor productivity in manufacturing declined, falling by 7.9% year on year. On the contrary, a 15.7% annual growth rate was recorded in construction. It is worth noting that labor productivity decreased by 3.1% in the trade sector. There was also a reduction in the hotel and restaurant and financial intermediation sectors.

« Labor productivity declined in manufacturing, while growth was observed in construction.

The annual growth rate of the nominal salaries of employees amounted to 9.3% during the third quarter of 2015, with the average monthly nominal salary standing at 930 GEL, according to the latest data from Geostat. The growth rate was 1.3 percentage points higher than in the previous quarter.

In terms of sector analysis, salaries increased at high rates in the construction, public administration, hotels and restaurants, healthcare and agriculture sectors. Average salaries decreased in the mining and quarrying and trade sectors during the third quarter of 2015.

« Nominal salaries of employees increased by 9.3% on average in the third quarter of 2015.

Table 8.2 Annual Growth of Average Monthly Nominal Wage of Employees in the Third Quarter of 2015

	Growth of nominal wage, %
Agriculture, hunting and forestry	10.3%
Fishing	-6.7%
Mining and quarrying	-8.0%
Manufacturing	5.2%
Production and distribution of electricity, gas and water	6.3%
Construction	20.0%
Wholesale and retail trade; repair of motor vehicles and personal and household goods	-1.7%
Hotels and restaurants	15.4%
Transport and communications	10.6%
Financial intermediation	8.3%
Real estate, renting and business activities	11.1%
Public administration	18.3%

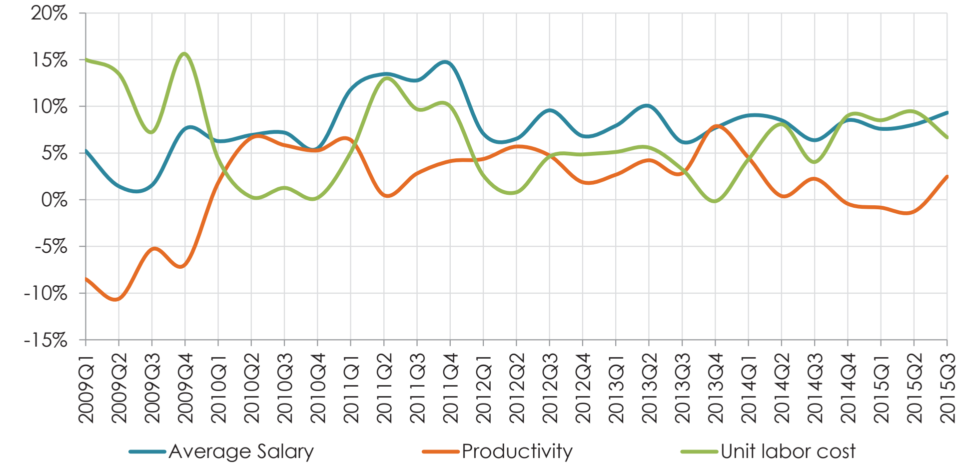
	Growth of nominal wage, %
Education	6.9%
Healthcare and social work	15.3%
Other community, social and personal service activities	14.9%
Overall in the economy	**9.3%**

Source: National Bank of Georgia

To sum up, against the backdrop of a year-on-year increase of labor productivity, the annual growth rate of unit labor cost[20] (personnel expense per production unit) declined and stood at 6.7% by the end of the third quarter of 2015, indicating a reduction in inflationary pressure from the labor market (see Figure 8.2).

« The annual growth rate of unit labor cost declined.

Figure 8.2 Labor Productivity, Average Monthly Salary and Unit Labor Cost, 2009-2015 Q III (Annual Percentage Change)



Source: GeoStat and National Bank of Georgia

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

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