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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%.** The inflation target of the National Bank of Georgia is planned to decrease gradually to 3%. The inflation target for 2016 is set at 5%, for 2017 – at 4%, and from 2018 – at 3%.

- **Since monetary policy decisions impact the economy with a certain time lag (4-6 quarters),** the formulation of monetary policy is done according to inflation forecasts in order to hit the target in the medium term. The medium term horizon depends on shocks and exogenous factors that influence the rate of inflation and aggregate demand.

- **The primary tool of monetary policy is the refinancing rate**. The change of the policy rate is transmitted to the economy through market rates, exchange rate and credit activity, thus influencing aggregate demand. The difference between the actual and natural level of demand is the main determinant of inflation in the medium term.

- **Monetary policy decisions are communicated to the general public via press releases.** The vision of the bank with regard to ongoing and expected macroeconomic activity is published in the Monetary Policy Report in the second month of every quarter.

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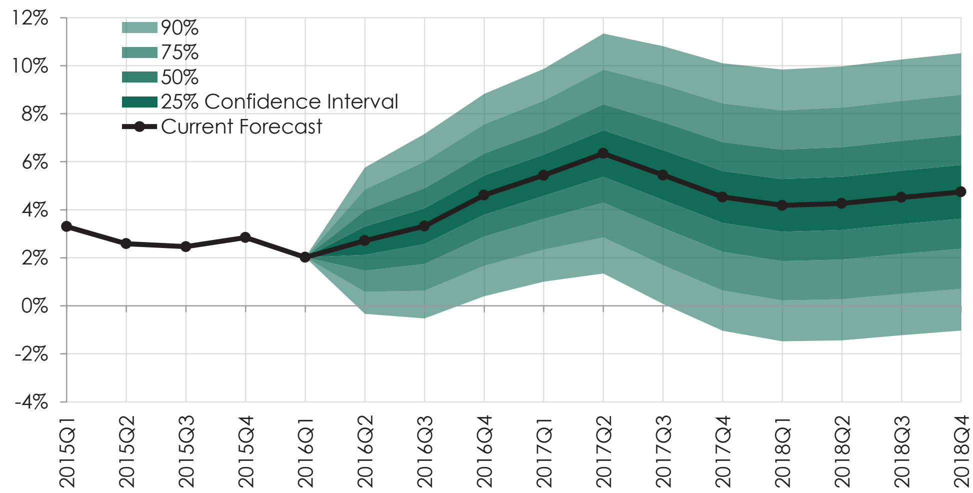
1. Brief Overview

Annual real economic growth in 2015 was 2.8%, while, according to preliminary data, it amounted to 2.3% in the first quarter of 2016. Economic activity in Georgia during this period was driven by domestic demand. Investments increased against the backdrop of fiscal stimulus measures and better investor sentiment, which contributed to higher aggregate demand. However, in broader terms, economic growth remains subdued, primarily due to the headwinds caused by the tough economic conditions facing Georgia's trading partners. In particular, the regional economic recession has visibly been reflected on Georgian exports and remittances, and hence on the domestic economy. The deprecation of the lari that followed external shocks in 2015 increased the debt service burden on foreign currency loans; however, it also helped the economy absorb foreign shocks and dampened the effect on the domestic market. After the depreciation, the economy underwent a process of external adjustment – gradually strengthening exports of goods and services and reducing imports. The drop in international oil prices continues to have a heterogeneous effect on the Georgian economy. On the one hand, it has negatively influenced Georgia's oil-exporting regional trading partners and their problems have been transmitted to the domestic economy through trade and financial channels. On the other hand, the direct impact on the Georgian economy has been positive, being reflected in lower consumer prices and savings on oil imports.

According to the **economic growth forecast** of the National Bank of Georgia, real GDP growth in 2016 will be around 3% (see Figure 1.1). Fiscal stimulus, alongside the normalization of monetary policy, is expected to support lending. This, in turn, will help investment and consumption growth rates. The main impediment for economic growth remains the foreign sector. The unfavorable conditions in Georgia's trading partners are still expected to negatively affect net exports, which will continue to make a negative contribution to real GDP growth in 2016. However, such negative spillovers from the foreign sector are partly offset by reduced petrol prices – a positive factor for the current account and other sectors of the economy – and by the correction of the real effective exchange rate last year.

Figure 1.1 Real GDP Growth



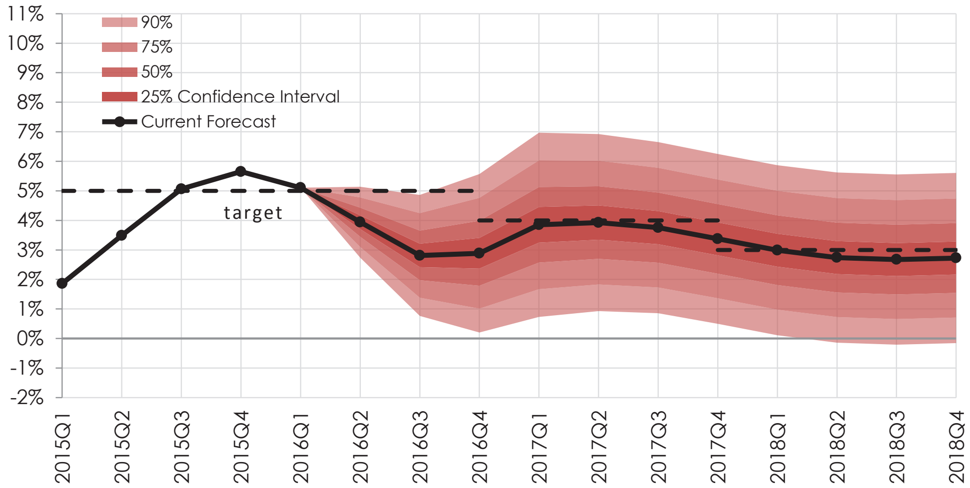
Source: National Bank of Georgia

Annual inflation in the first quarter of 2016 was lower than expected. It reached 4.1% in March 2016 and thus slightly undershot the NBG's target of 5%. The global weakening of the US dollar during that period and the concomitant appreciation of the lari against it reduced inflation expectations, and thereby contributed to the fall of actual inflation. At the same time, inflation was further lowered by the stronger-than-expected transmission of international oil price drops to domestic petrol prices.

In contrast, during 2015 inflation had an increasing trend that was largely driven by the higher intermediate costs of firms resulting from the lari depreciation and the increased debt service burden on foreign currency loans. However, at the same time, the increase in inflation was dampened by weak aggregate demand and lower food and oil prices on international markets.

According to the forecast, **in the following quarters inflation** is expected to fall moderately and remain below the target level before stabilizing around it in the medium term (see Figure 1.2). The inflation target for 2017 is 4% and is 3% from 2018 onwards. Weak aggregate demand and low global food and oil prices are the main factors behind the lower forecasted inflation.

Figure 1.2 Headline CPI Inflation



Source: National Bank of Georgia

The forecast is largely dependent on 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 baseline forecast is that the negative spillovers from the external sector will not deteriorate further. However, if the economic conditions in trading partner countries deteriorate or are transmitted to Georgia more than is expected, then the actual performance of the economy would be worse than the baseline projection. On the other hand, a greater than expected amount of foreign investment and/or increased private and public infrastructure projects both represent positive risks for the forecast.

At the Monetary Policy Committee (MPC) meeting of 27 April 2016, it was decided to lower the refinancing rate by 50 basis points to 7.5%. Based on current projections, inflation is expected to continue its recent downward trend and remain below target in the following quarters. Inflation expectations are stable, while economic activity remains behind its potential. Considering these developments, the NBG deemed the normalization of monetary policy appropriate. This implies gradually cutting the policy rate until its long-run neutral level is reached (see Figure 2.10). According to current estimates, in the long-run the neutral level of the monetary policy rate is 5-6%. Further monetary policy moves will depend on the expected dynamics of the inflation rate, the factors influencing it, and economic activity in general.

The forecast of the monetary policy rate is not a promise made by the National Bank. Rather, it is only the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize just as expected. Despite this uncertainty, which is characteristic of any such forecast, it still offers valuable information regarding the expected trajectory of short-term interest rates, which long-term rates largely depend on.

2. Macroeconomic Forecast

2.1 EXTERNAL SECTOR OVERVIEW

In the first quarter of 2016, global economic activity slightly weakened, in spite of the fact that reduced oil prices have positive effects on energy-importing economies. In addition, the reduction in capital flows and slowing growth of China's economy are exacerbated by increasing geopolitical threats, all of which negatively affect both consumer and business confidence. The International Monetary Fund (IMF) estimates that the global economy grew by 3.1% last year, while growth is projected to average 3.3% in 2016-2017[1].

Ukraine's economy remained in recession in the first quarter of 2016; however, some signs of stabilization have emerged – the most prominent being the adjustment of fiscal and external imbalances. It is also expected that the real devaluation of the national currency will create favorable conditions for Ukraine's exports. Given that the country is continuing its structural reforms, and assuming that further escalation of the conflict is avoided, it is expected that economic growth in 2016 will increase by 1.5%, while in 2017 growth is predicted to reach 2.5%.

The major impediments that led the **Russian** economy into recession lessened slightly in the first quarter of 2016. Consequently, it is expected that the economic recovery will be very slow (mostly occurring in parallel with oil prices). The IMF estimates that in 2015 the country's real GDP shrank by 3.7%, while the decline in 2016 is expected to be 1.8%. Positive growth (of 0.8%) is only predicted in 2018.

In **Turkey**, despite the significant political turmoil and tense security situation, the real GDP grew by 3.8% in 2015. Current estimations indicate that the growth forecast for the current year will be 3.8%; however, inflation will be maintained at a high level and will reach 9.8% this year.

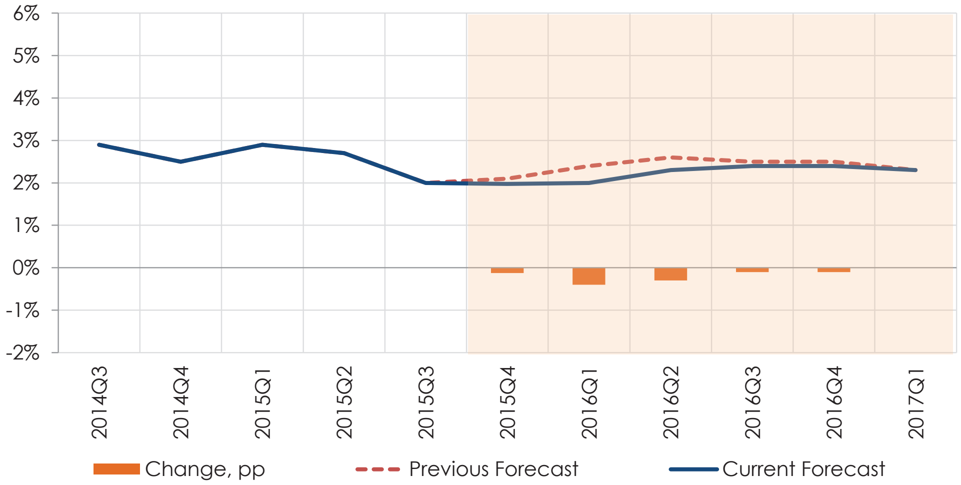
Falling oil prices significantly affected **Azerbaijan's** economy, which grew by only 1.1% last year. The 50% depreciation of the national currency at the end of 2015 strongly undermined consumer and business sentiment. The IMF estimates that the economic problems facing the country will deepen in 2016 and the real GDP will shrink by 3%; annual inflation is expected to be 13%.

Amid the deteriorating situation in the external environment (the depressing Russian economy, in particular) **Armenia's** economy grew by 3% in 2015. This was mainly caused by temporary effects – a good agricultural harvest and the opening of a new copper mine. With the state of the Russian economy in mind, Armenia's GDP growth is expected to be around 2% in 2016, while inflation will fluctuate around 3%[2].

In 2015, the **U.S.** real GDP grew by 2.4%; however, the fourth quarter saw weakening exports, declining private consumption and lower investments in non-oil and non-housing sectors. Nevertheless, labor market indicators improved in March and the unemployment rate decreased to 4.5%. Against the background of slowing growth in trading partner countries and reduced investment in the energy industry, it is expected that the economy will grow at a moderate pace in 2016. U.S. GDP growth will average 2.5% for the years 2016-2017[3].

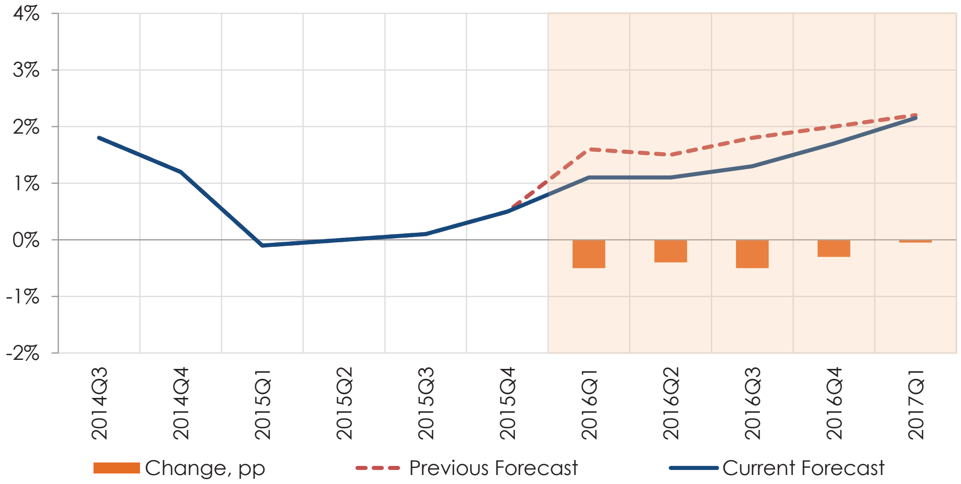
1 *International Monetary Fund (IMF), WEO, April 2016.*
2 *IMF, WEO, April 2016.*
3 *IMF, WEO, April 2016.*

Figure 2.1 U.S. Real GDP Annual Growth



Source: Bloomberg. IMF WEO, April 2016.

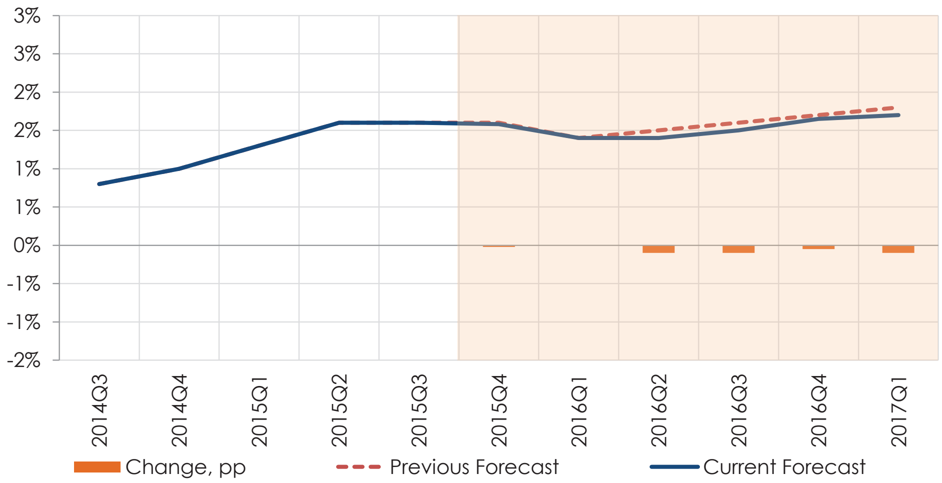
Figure 2.2 U.S. CPI Annual Inflation



Source: Bloomberg. IMF WEO, April 2016.

The recovery of **the eurozone** is still continuing at an uneven pace. Earlier in the year, the Italian economy grew less than was expected, while the opposite situation was observed in Spain. Key issues for the region include high private and public debt, low investments and unemployment, but these are balanced by low energy prices and favorable lending conditions. Economic growth in 2015 is estimated to have been 1.6% and the eurozone economy is expected to grow moderately at an average rate of 1.5% in 2016-2017[4].

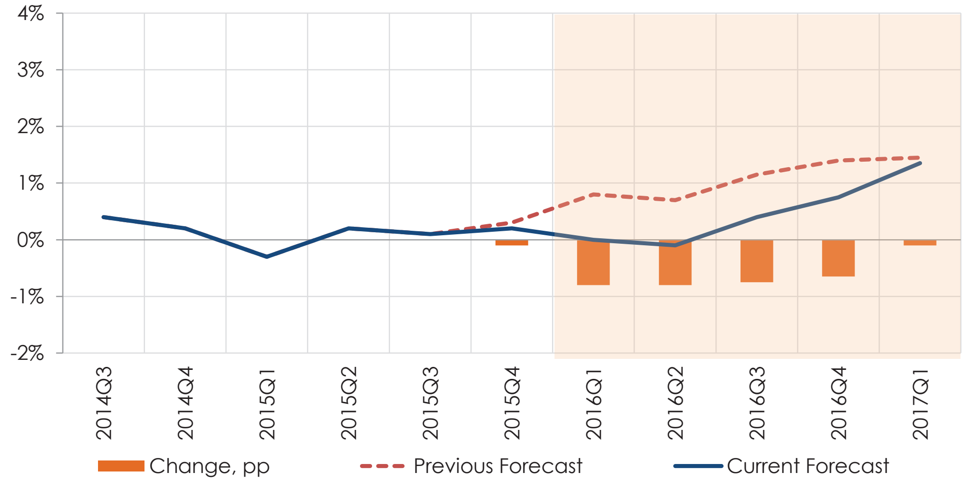
Figure 2.3 Eurozone Real GDP Annual Growth



Source: Bloomberg. IMF WEO, April 2016.

4 *IMF, WEO, April 2016.*

Figure 2.4 Eurozone CPI Annual Inflation



Source: Bloomberg. IMF WEO, April 2016.

Countries with weak economic growth and inflation retained expansionary monetary policies in the first quarter of 2016. From the statements of the U.S. Federal Reserve it became likely that policy tightening would occur more slowly than had been expected. As a result, after its sharp appreciation in international currency markets, the US dollar started to weaken. Under another quantitative easing framework, the European Central Bank announced additional measures in March, which include an expansion of the asset purchase program, long-term refinancing operations and monetary policy rate cuts. A partly different situation was observed in some developing countries, where the monetary policy is set to combat inflation caused by national currency depreciations.

In January 2016, the downward movement of oil prices continued. In February and March, the resource became slightly more expensive in the expectation that the largest oil-producing countries would reach an agreement on a supply cut. However, at the end of April it became clear that such an agreement would be as yet unattainable due to Iran's resistance. The first quarter of 2016 saw slightly increasing prices of other commodity products amid deteriorating weather conditions and relatively stable global demand. According to the forecasts, commodity prices will fluctuate less in 2016[5].

2.2 MACROECONOMIC FORECAST

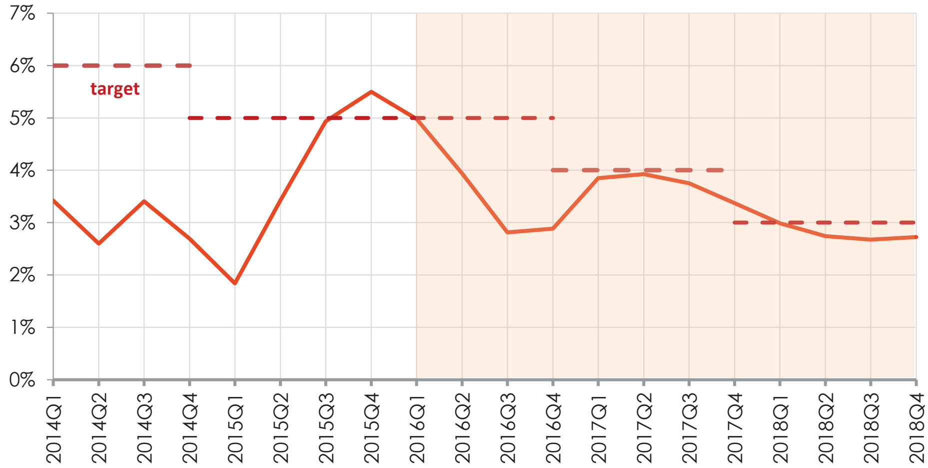
The annual inflation rate in March 2016 was 4.1%, which is slightly below the 5% target of the National Bank of Georgia (see Figure 2.5). It should be noted that the inflation figure was lower than expected – partly a result of reduced inflation expectations stemming from the recent global weakening of the US dollar and, hence, the appreciation of the lari exchange rate against it. At the same time, inflation was further lowered by the stronger-than-expected transmission of international oil price drops into domestic petrol prices. In contrast, in 2015 inflation had an increasing trend that was largely driven by the higher intermediate costs of firms, resulting from the lari depreciation and 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. However, at the same time, 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 fall moderately and remain below the target level in the following quarters. It will subsequently stabilize around the target in the medium term (see Figure 2.5). The inflation target for 2017 is 4%, and is 3% from 2018 onwards.

Due to the various factors pushing inflation in different directions, in the first quarter of 2016 **the deviation of inflation from the target** was negligible. In particular, the upward pressure on inflation from input costs (due to liability dollarization and the depreciated lari exchange rate) and increased imported durable goods prices, were dampened by downward pressure from weak aggregate demand and lower oil prices (see Figure 2.6). According to the forecast, the main sources of lower headline

5 *Commodity Price Outlook & Risks, IMF, April 2016.*

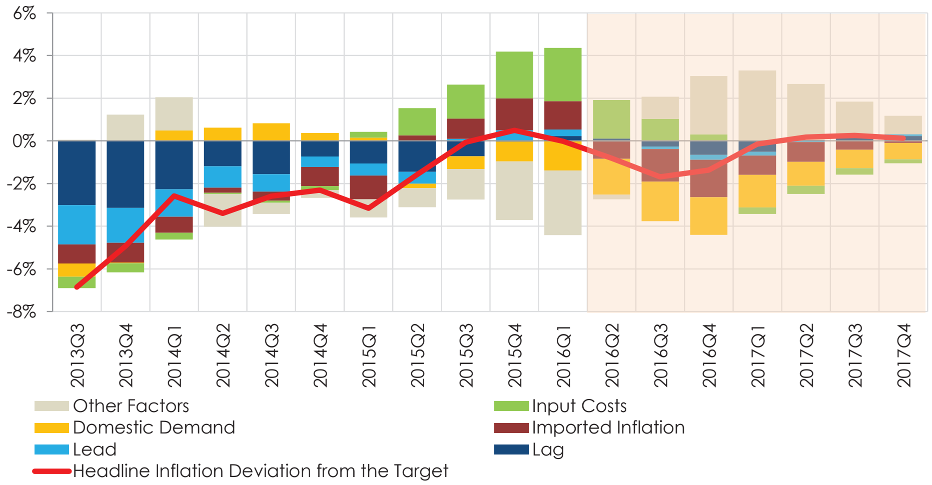
Figure 2.5 Headline Inflation



Source: National Bank of Georgia

inflation in the second and third quarters of 2016 will be weak aggregate demand and the abatement of the base effect stemming from the one-time increase in costs last year due to depreciation. It is expected that in 2016, as in the previous year, demand will be lower than its potential level and will thus put downward pressure on inflation. According to the forecast, which takes all of the above mentioned factors into account, in the second and third quarters of 2016 inflation will be below the target. It will subsequently reach the target, supported by food and oil prices stabilizing at their expected levels in 2017 and by a gradual recovery of aggregate demand.

Figure 2.6 Inflation Deviation From Target And Its Decomposition[6]



Source: National Bank of Georgia

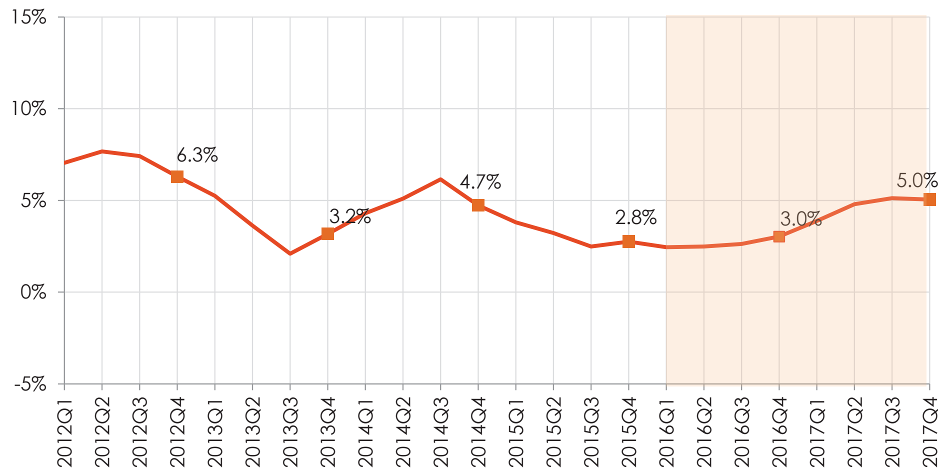
There are **risks associated with the inflation forecast** in both directions. If last year's depreciation of the currencies of Georgia's main trading partners is reversed, this would strengthen the transmission of the already-high inflation rates of those countries to Georgia, which could contribute to temporarily higher imported inflation. There is also some uncertainty surrounding food and petrol prices, both of which have substantial weight in the consumer basket and are mostly supply driven. The baseline forecast assumes that international food and oil prices will broadly stabilize in the neighborhood of current levels in 2016 and 2017. Therefore, if they turn out to be higher than expected, it would imply higher-than-forecasted inflation in Georgia. 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 could 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

6 *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.*

lower than current projections, and vice versa if stronger than expected.

Real GDP growth was consistent with previous forecasts and amounted to 2.8% in 2015, while, according to preliminary data, it stood at 2.3% in the first quarter of 2016 (see Figure 2.7). Economic activity during this period was driven by domestic demand. In particular, investments increased against the backdrop of fiscal stimulus measures and better investor sentiment, which helped aggregate demand. In terms of sectors, a significant contribution was made by the construction sector, where, in addition to the weight carried by the Baku-Tbilisi-Ceyhan pipeline project, other private construction and public infrastructure projects were also important. After a very strong increase in 2013, net exports made a negative contribution to GDP growth in 2014. This was caused by 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 following the depreciation of the Georgian lari against the US dollar. The reduction in imbalances was driven by the process of import correction as well as by a softening of the negative growth rate of exports. Notwithstanding this improvement, net exports are estimated to have made a negative contribution to economic growth because of external disturbances (see Figure 2.8). 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 as well.

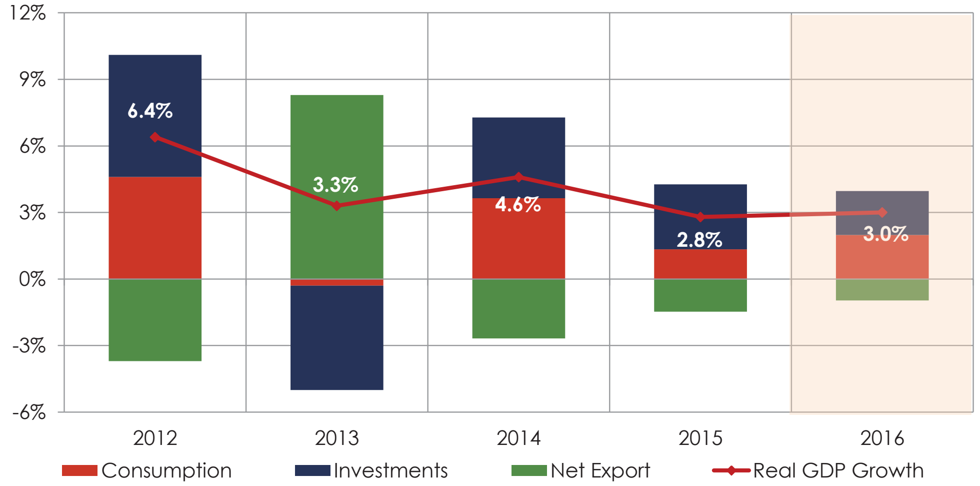
Figure 2.7 Real GDP Growth (Annual Growth Of Last Four Quarters)



Source: National Bank of Georgia

According to the **GDP forecast**, the growth rate in 2016 is expected to be around 3% (see Figure 2.7). Fiscal stimulus measures, alongside a normalization of 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 still expected to affect net exports, which will continue to make a negative contribution to GDP growth in 2016 (see Figure 2.8). Net exports are negatively influenced by the adverse political and economic conditions in Georgia's trading partners. These are reflected in weak foreign demand for Georgian exports, as well as in declining remittances. However, such negative spillovers from the foreign sector are partly offset by reduced petrol prices – a positive factor for both the current account and other sectors of the economy – and by the correction of the real effective exchange rate last year.

Figure 2.8 Components Of Real GDP Growth

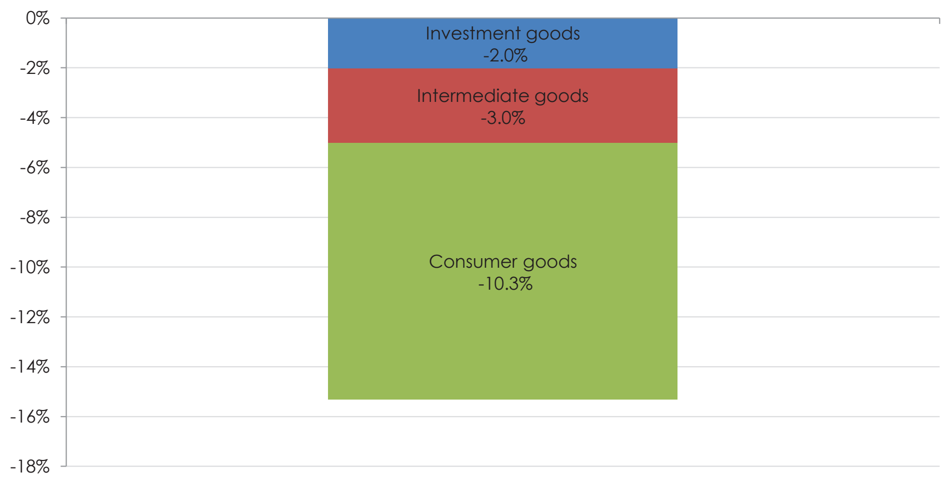


Source: National Bank of Georgia

When analyzing the **risks to the GDP forecast**, the foreign sector clearly stands out. If, against the backdrop of geopolitical tensions, the economic conditions in trading partner countries worsen and/or are transmitted to Georgia to a greater extent than is expected, then actual GDP growth will be lower than currently forecast. If, on the other hand, 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.

In 2015, the **current account deficit** increased to 11.6% of GDP. Despite the rise in the ratio, which was a result of a fall in US dollar-denominated GDP, the drop in imports balanced reduced foreign currency inflows. In 2015, imports (in US dollars) fell by an annual 15.3% (excluding grant-financed hepatitis C medications). The fall in imports of consumption goods 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 2.9). It is worth noting that the reduction of imports, alongside reduced foreign currency inflows, indicates the functioning of the import adjustment process, which contributes to macroeconomic stability.

Figure 2.9 Decomposition of Annual Growth of Imports in 2015

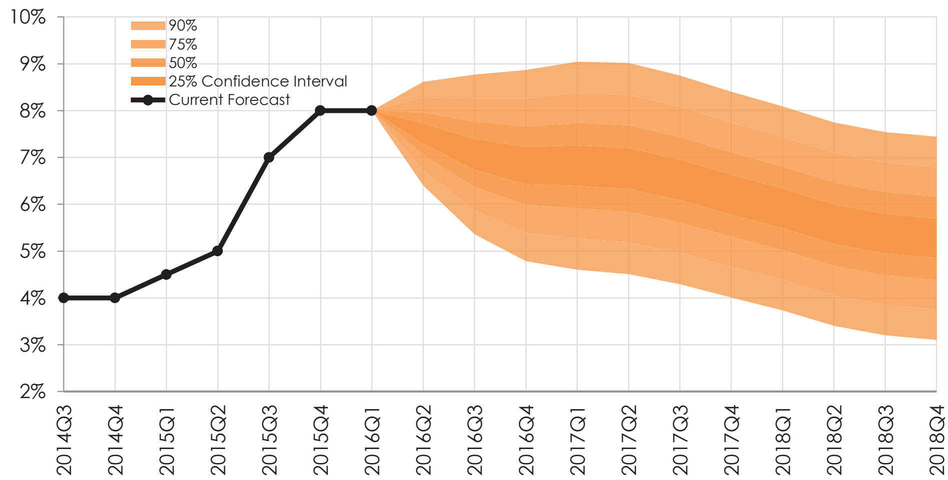


Source: Geostat

The current account deficit in the first quarter of 2016 has moderately improved, according to current estimates. Exports of goods during that period fell by 11.9% annually, while net money transfers from abroad declined by an annual 6.9%. As for imports, these dropped by a significant 16.7% annually in the first quarter (excluding imports of grant-financed hepatitis C medications). According to the current forecast, the current account is expected to recover from worsening in 2015 and improve in the medium term, being supported by increased exports of goods and services, including tourism.

The final goal of the National Bank is price stability and the best possible way of achieving this to date is inflation forecast targeting. For this purpose, the NBG uses its monetary policy rate to ensure that the inflation forecast is at the target level in the medium term. Therefore, each inflation forecast implies a **corresponding interest rate forecast**. The forecasted trajectory of the monetary policy rate, which is consistent with the macroeconomic forecast presented above, shows a gradual reduction in the interest rate in the medium term (see Figure 2.10). There are several factors contributing to this. After significant increases in 2015, inflation expectations stabilized and have started to fall to normal levels again. In addition, the inflation target of the NBG is 3% from 2018 onwards (instead of 5% this year), which, in turn, implies that the neutral nominal rate will follow a similar drop. Considering all of the above mentioned forecasts and estimates, monetary policy normalization is expected to take place in the medium term, which means cutting the policy rate until its long-run neutral level has been reached. According to current estimates, the long-run neutral level of the monetary policy rate is 5-6%.

Figure 2.10 Forecast of the Monetary Policy Rate



Source: National Bank of Georgia

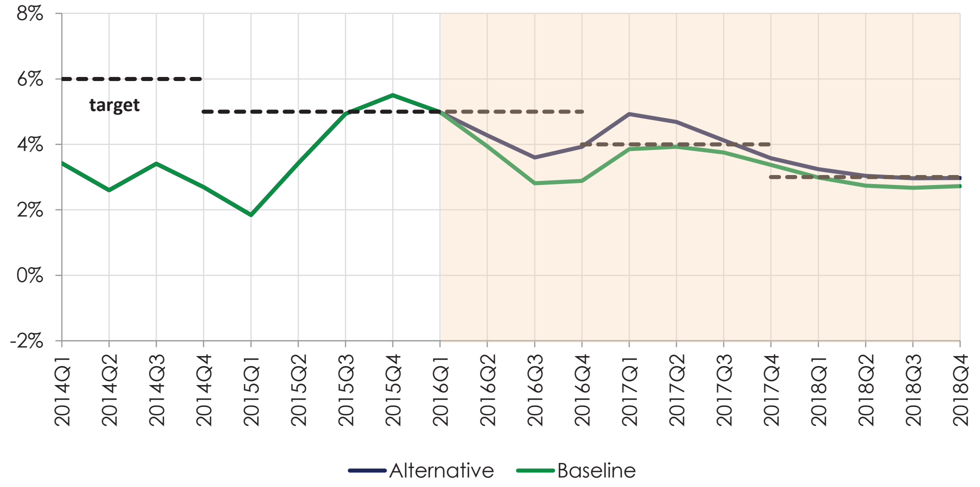
Finally, it should be clearly stated that the forecast of the monetary policy rate is not a promise by the National Bank. It is only an expected trajectory of the policy rate assuming that all the exogenous factors incorporated into the forecast materialize as expected. Despite this uncertainty, which is characteristic of any forecast, it still contains valuable information regarding the expected trajectory of short-term interest rates, which long-term rates largely depend on.

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 adverse geopolitical factors will cause a further deterioration of economic conditions in Georgia's trading partners, which will then be transmitted to the domestic economy. The alternative scenario also assumes the further strengthening of the US dollar exchange rate on a global scale, a fall in international oil prices and capital flow slowdowns in both the region and emerging markets in general. 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.

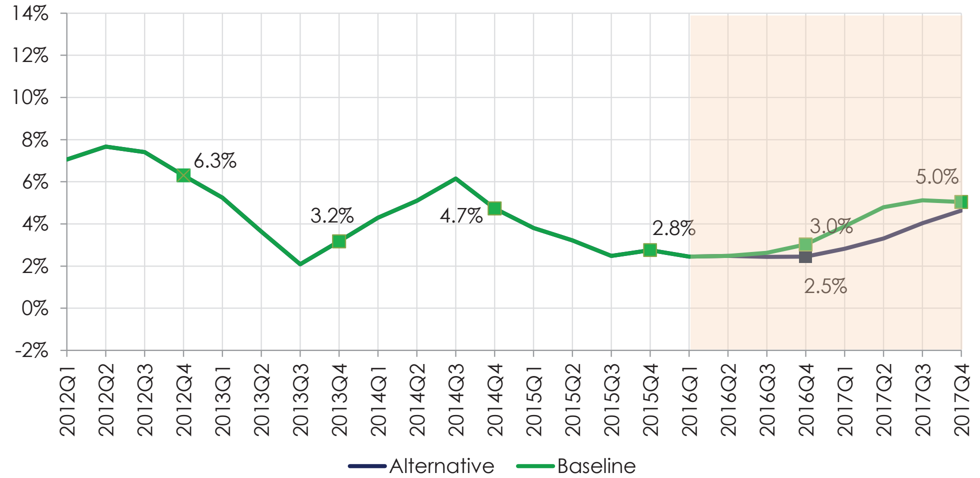
According to the alternative scenario, the inflation rate will increase faster than in the baseline as the upward pressure from the nominal exchange rate will outweigh the downward pressure from weak demand. In order to anchor inflation expectations, adopting an appropriate monetary policy response would partially offset the upward pressure on inflation. As a result, the alternative scenario shows inflation in 2016 as about only 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)

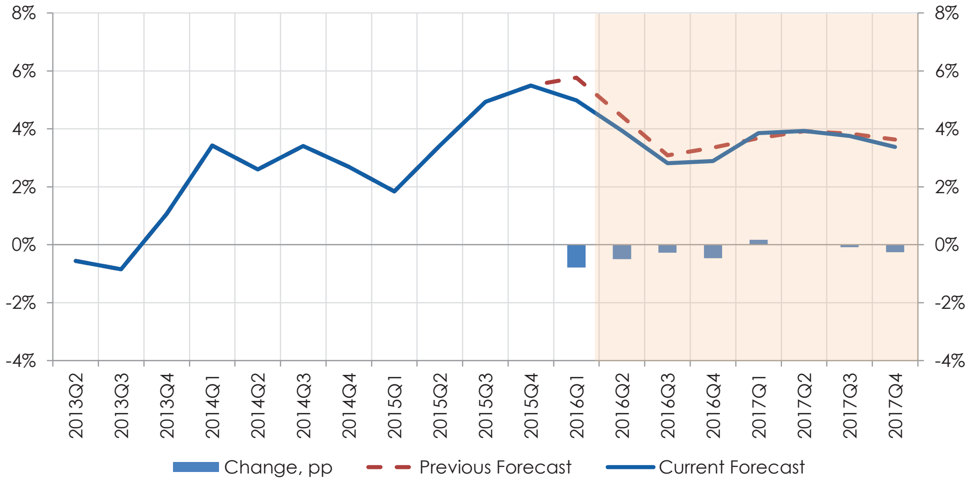


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast for upcoming quarters has been revised slightly downward (see Figure 2.13). This was partly due to the global weakening of the US dollar and, hence, the appreciation of the lari against it in recent months. This reduced inflation expectations and contributed to the fall of actual inflation. Moreover, the drop in international oil prices by the end of the last year was transmitted to headline inflation somewhat more than had been expected. 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 second and third quarters of 2016 will be slightly lower than the target; however, it will subsequently reach near the target in the medium term.

Figure 2.13 Change In The Forecast Of Headline Inflation



Source: National Bank of Georgia

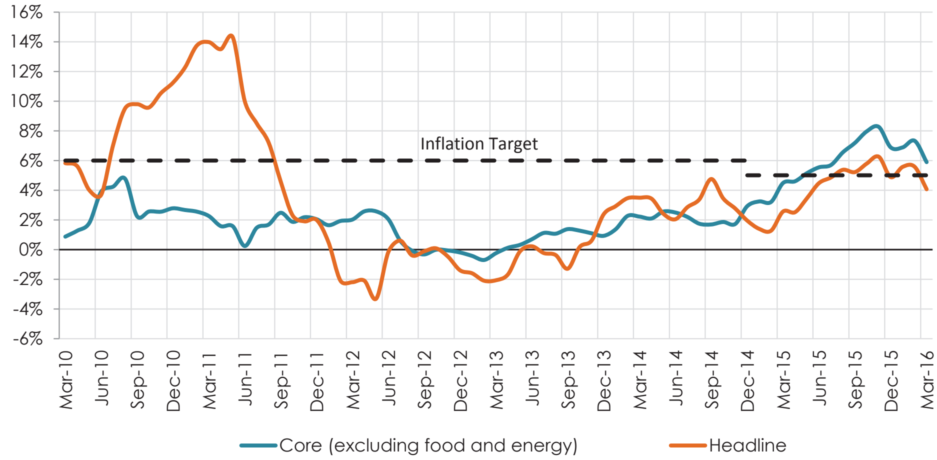
As for economic activity, the growth forecast for 2016 has not changed. As the main factors relevant for economic growth are not significantly different, the expected growth of the real economy in 2016 is 3%.

3. Consumer Prices

Compared to the previous quarter, by the end of the first quarter of 2016 the headline inflation rate declined and amounted to 4.1%, which was below the NBG's target of 5% for 2016. Against the backdrop of reducing headline inflation, core inflation[7] is also decreasing. However, it remains higher than headline inflation and stands at 6% (see Figure 3.1). The lower headline inflation was determined by the decline of oil prices in international markets.

« Headline inflation is below the NBG's target level and stood at 4.1% in March 2016.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

In terms of the supply side factors that put upward pressure on inflation, it is worth noting the growth of intermediate costs. 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. However, the exchange rate appreciation observed over the last period had a positive effect on intermediate costs and upward pressure on inflation lowered as a result.

« The growth of intermediate costs puts upward pressure on inflation.

As was mentioned above, the low level of oil prices on international markets have seen fuel prices decline 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 the first quarter of 2016, the rates of decline on diesel and petrol amounted to 15.3% and 9.6% respectively, contributing approximately -0.6 percentage points to headline inflation (see Figure 3.2).

« Decline in oil prices puts downward pressure on inflation.

By the end of first quarter of 2016, the upward pressure on inflation coming from food prices further declined. In line with the appreciation of the nominal effective exchange rate, the increase in prices for some food products was lower than expected – a result of the significant exchange rate depreciation in food exporting trading partner countries. In March, the y-o-y growth rate of the overall level of food declined to 2.2%, making a 1.0 percentage point contribution to headline inflation (see Figure 3.2).

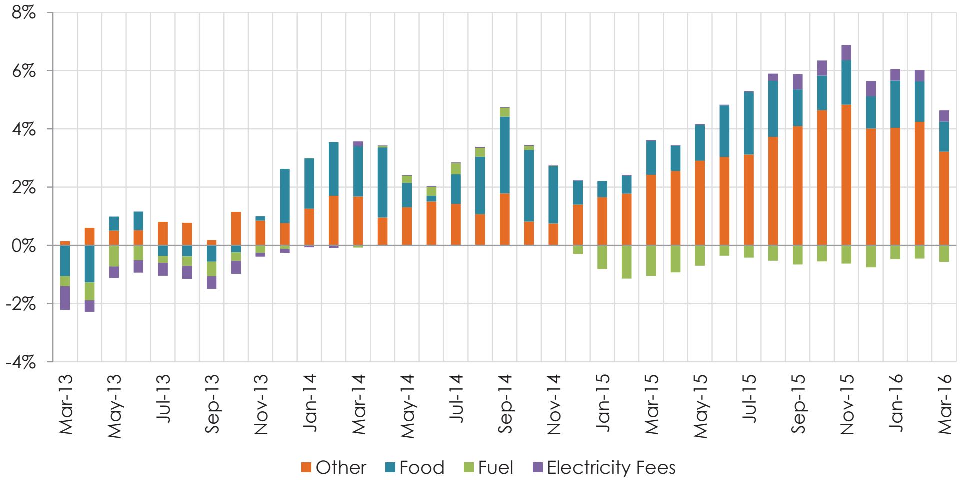
An important factor contributing to the reduced inflation rate is the base effect. Excise taxes on alcoholic beverages increased in March 2015. At the same time, the exchange rate depreciation caused a rise in prices of durable consumer goods and of household appliances in particular. As a result, in March 2015 the inflation rate increased sharply. Annual inflation thus decreased in March 2016 after the exhaustion of the base effect.

7 Core inflation is the y-o-y change of the consumer price index calculated without food and energy products.

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 March; contributing approximately 0.4 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

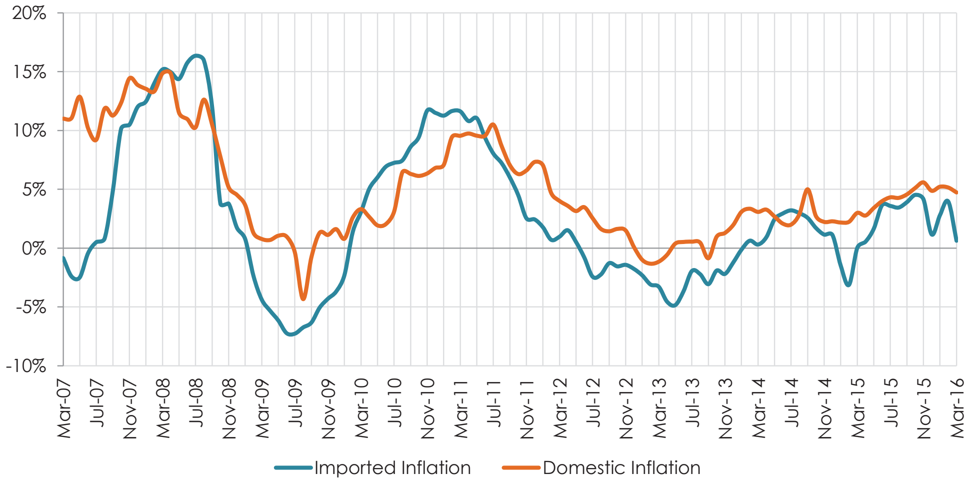


Source: GeoStat and National Bank of Georgia

In terms of supply factors, it is worth stressing the influence of imported inflation on the overall price level. Dynamics in fuel prices have a significant effect on the imported inflation rate indicator. However, the depreciation of the nominal effective exchange rate also put considerable pressure on inflation during 2015. As a result of this depreciation, the influence of imported product prices on the overall price level turned positive. However, in the last two months of 2015, the effective exchange rate started to appreciate as a result of the high depreciation taking place in Georgia's main trading partner countries. Accordingly, upward pressure on imported inflation weakened. In March, imported inflation declined to 0.6% (see Figure 3.3), contributing approximately 0.1 percentage point to headline inflation.

« The inflation rate on imported consumer goods decreased and stood at 0.6% by the end of March.

Figure 3.3 Imported And Domestic Inflation



Source: GeoStat and National Bank of Georgia

The lower external demand stemming from the economic downturn in main trading partner countries has been negatively reflected on the economy of Georgia. Decreased export revenues and remittances have put downward pressure on domestic demand, which has additionally been curbed by tight monetary policy. The factors weakening external and domestic demand thus caused a widening of the negative output gap which, in turn, puts downward pressure on the inflation rate.

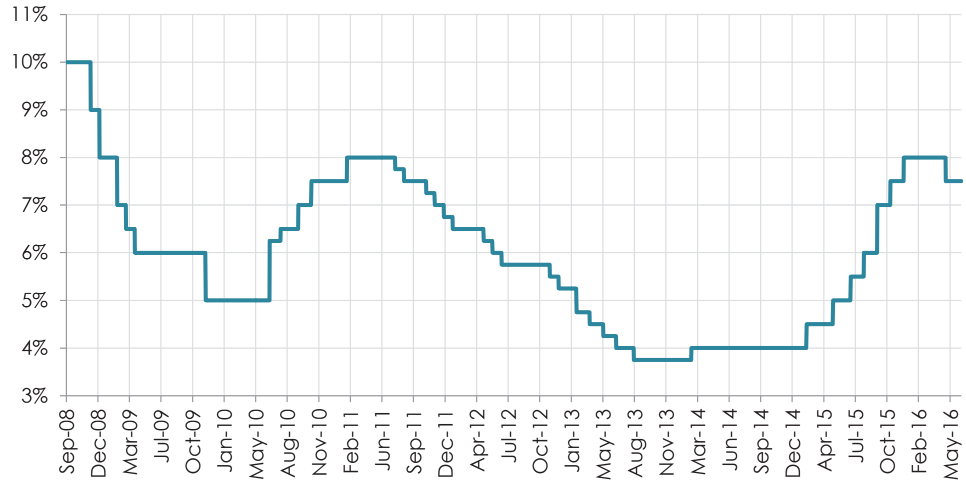
« Factors determining aggregate demand put downward pressure on the inflation rate.

4. MONETARY POLICY

The transmission of external shocks to the Georgian economy was strong in 2015. The worsened economic conditions in Georgia's main trading partners were reflected in reduced exports and remittances, which reduced 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. Taking into account the fact that the share of final imported products in the consumption basket is quite high and that intermediate goods are important in domestic production, increased imported inflation is a significant factor. At the same time, given the high level of dollarization in the economy, the depreciation of the lari against the US dollar puts upward pressure on intermediate costs. Each of these factors drove up inflation expectations. The increased expectations are reflected on the risks of deviating from the inflation target in the medium term. Given this situation, the National Bank of Georgia found it appropriate to tighten monetary policy in order to reduce inflation risks. During 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.

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

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The tightening of monetary policy in 2015 was partly reflected on the economy. Interest rates on lari denominated loans increased and, as a result, the growth of the credit portfolio declined. This had the effect of weakening aggregate demand and pushing inflation downwards. Thus, in the absence of further shocks, at that stage there was no need for additional monetary tightening to contain inflation expectations. Accordingly, taking into account both external risks and domestic factors, in the Monetary Policy Committee (MPC) meetings held in February and March 2016, it was found appropriate to leave the policy rate unchanged at 8.0%.

The last meeting of the National Bank's MPC was held on 27April. At that meeting it was decided to reduce the refinancing rate by 50 basis points to 7.5%.

« According to the decision made on 27 April, the refinancing rate was reduced to 7.5%.

The inflation rate in 2015 had a growing tendency and was 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 was restricted by the decrease in global oil and commodity prices. The main factors causing the rise in inflation were increased intermediate costs of production, higher prices on certain imported goods and a growth of administrated prices. By the end of first quarter of 2016, both headline and core (excluding food and energy products) inflation measures declined.

The y-o-y inflation rate amounted to 4.1% in March. The upward pressure on prices stemming from intermediate costs and specific imported goods was reduced due to the appreciation of the nominal effective exchange rate.

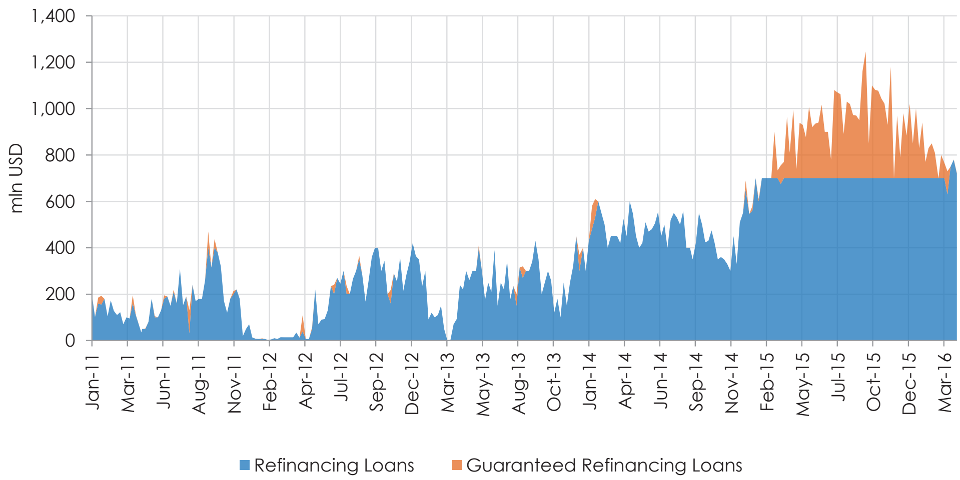
Domestic demand remains weak. According to preliminary information, real GDP growth in the first quarter of 2016 was 2%. Credit activity growth has decelerated and the growth rate of the portfolio hovers at around 6% (excluding the exchange rate effect). The significant decline in imports also indicates weakened demand.

External demand also remains subdued in the first quarter of 2016; however, after exchange rate correction both services and goods export dynamics exhibit positive developments. During the first three months of the year, registered exports fell by 13%, while imports decreased by 17% (excluding one-offs). Remittances statistics improved as well. During the first quarter, remittances declined by 5% y-o-y, which is a superior indicator compared to previous periods. As for tourism revenues, the dynamics significantly improved and in the first quarter of 2016 the annual growth of tourism revenues totaled almost 16%.

According to the current NBG forecast, annual inflation will decrease at a moderate rate in the coming quarters, temporarily keeping below the current 5% target value before reaching the target by the end of the year. However, both upside and downside risks to the forecast remain. Negative risks might arise from aggravation of external shocks. In particular, a greater-than-expected appreciation of the US dollar and a further weakening of the economies in the region due to lower-than expected oil prices and/or capital outflows. On the other side, a faster-than-expected reduction of external shocks and a sharp recovery of aggregate demand resulting from accelerated investment may have a positive effect on inflation dynamics.

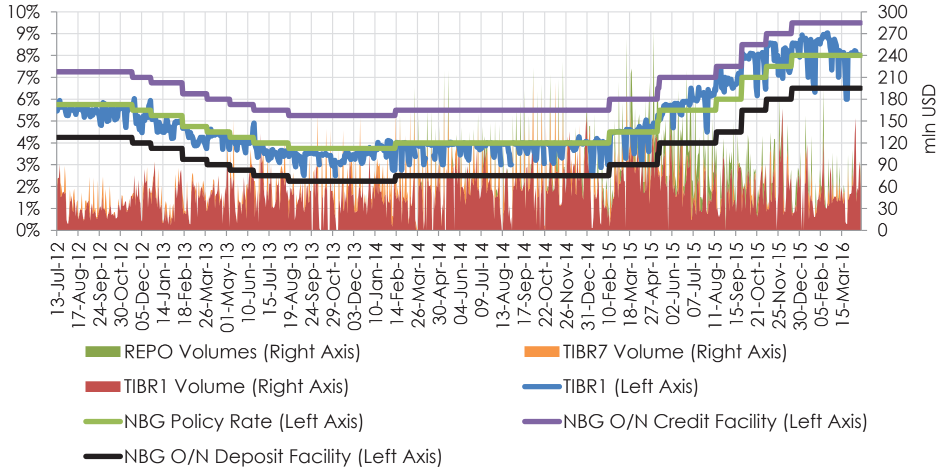
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. Recently, the NBG has provided short-term liquidity to the banking system via refinancing loan auctions without any restrictions. The banking sector is thus not forced to use the guaranteed refinancing instrument and/or standing facility to get the required liquidity. As a result, interbank short-term interest rates declined and currently fluctuate around 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

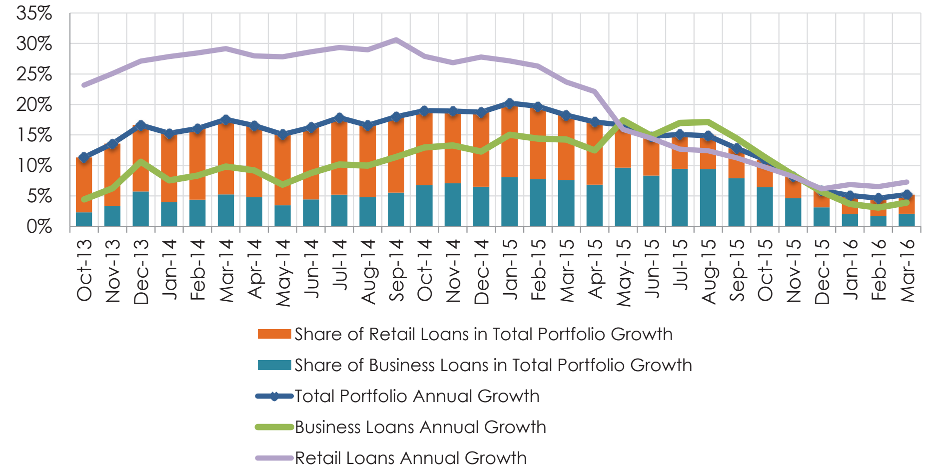
« Short-term interest rates hover around the policy rate.

5. Financial Market and Trends

5.1 LOANS

In the first quarter of 2016, the annual growth rate of the loan portfolio decreased and, excluding the effect of exchange rate movement, amounted to 5.2% in March. The growth was balanced in terms of the growth of loans to legal entities and retail loans. Compared to the previous quarter, the annual growth rate of lending to individuals increased slightly, however the growth rate of business loans decreased as a result of weak economic activity. The volume of business loans in the national currency with a floating interest rate did not change significantly in March and their share in total business loans remained 7%.

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

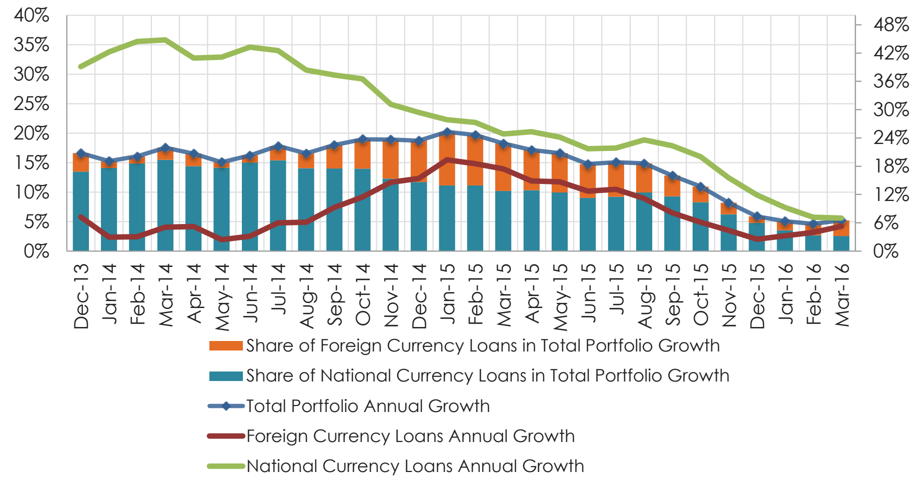


Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was largely caused by an increase in domestic currency loans. In March, the annual growth rate of foreign currency denominated loans increased by 4.2%, while domestic currency loans increased by 7%. In the first quarter of 2016, the loan larization coefficient decreased by 0.5 percentage points and amounted to 35.1%.

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

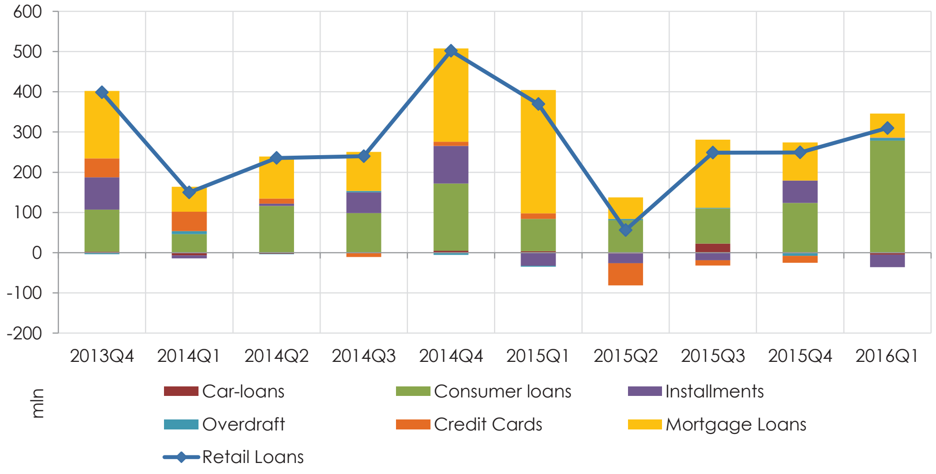
Figure 5.2 Annual Growth Rates Of Domestic And Foreign Currency Loans And Their Contributions To The Growth Of The Loan Portfolio



Source: National Bank of Georgia

In March, the stock of retail loans increased by 310 million GEL compared to December. In terms of loan products, the amount of mortgage and consumer loans increased by 59 million and 278 million GEL respectively over the previous quarter. The volume of instant loans and credit cards decreased by 27 million GEL. As the latter 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 expect an improvement of demand for retail loans in the next quarter.

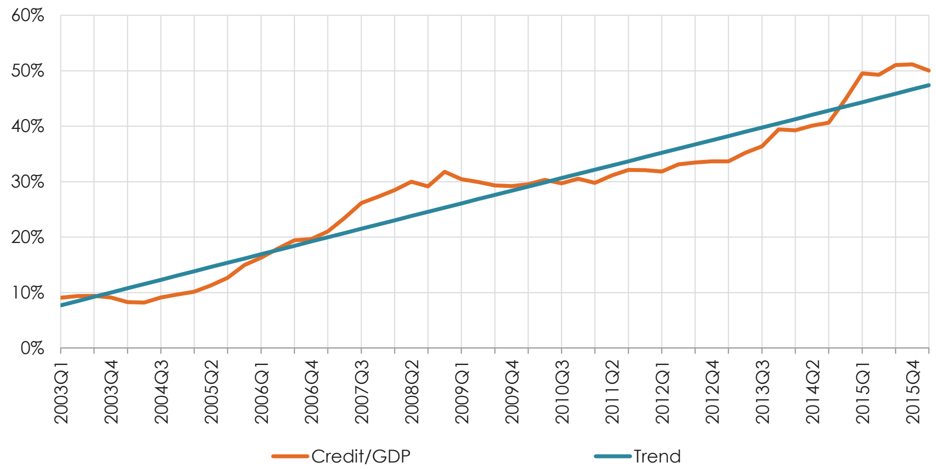
Figure 5.3 Quarterly Growth Of Retail Loans



Source: National Bank of Georgia

In March, the annual growth rate of the loan portfolio to legal entities amounted to 3.9%[8], which was 2 percentage points lower than in December. 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 in demand for business loans in the next quarter. Compared to the previous quarter, the credit to GDP ratio[9] decreased by 1.1 percentage point and amounted to 50%. The credit to GDP ratio is currently above the trend[10] by 2.6 percentage points.

Figure 5.4 Credit To GDP Gap



Source: National Bank of Georgia

8 Excluding the exchange rate effect.

9 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.

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

In the first quarter of 2016, the individuals' loans to net national disposable income ratio did not change compared to the previous quarter and amounted to 27%. Debts to commercial banks accounted for 84% of total individuals' loans.

Figure 5.5 Individuals' Debt To Net National Disposable Income Ratio

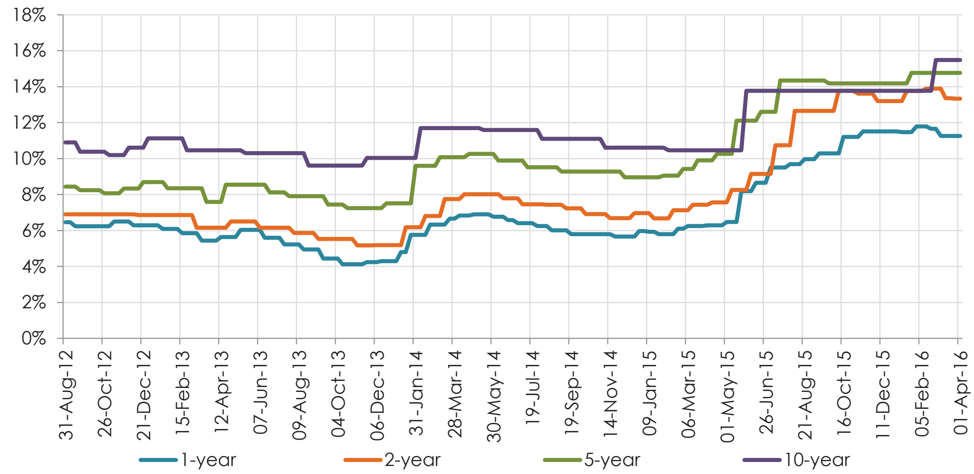
Source: National Bank of Georgia

Compared to the previous quarter, the share of non-performing loans increased by 0.5 percentage points in the first quarter of 2016 and amounted to 9%. According to the data from March, the share of non-performing loans in the national currency increased by 0.4 percentage points compared to December, amounting to 5.6%. The share of non-performing foreign currency loans increased by 0.6 percentage points and equaled 9.3%. The amount of loans written off in the first quarter amounted to 50 million GEL, which caused the share of non-performing loans to decrease by 0.3 percentage points.

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In April 2016, the monetary policy rate decreased to 7.5%. In the first quarter of 2016, interest rates on government securities stabilized compared to the previous quarter and this was mainly a result of the decrease in liquidity risk and inflationary expectations.

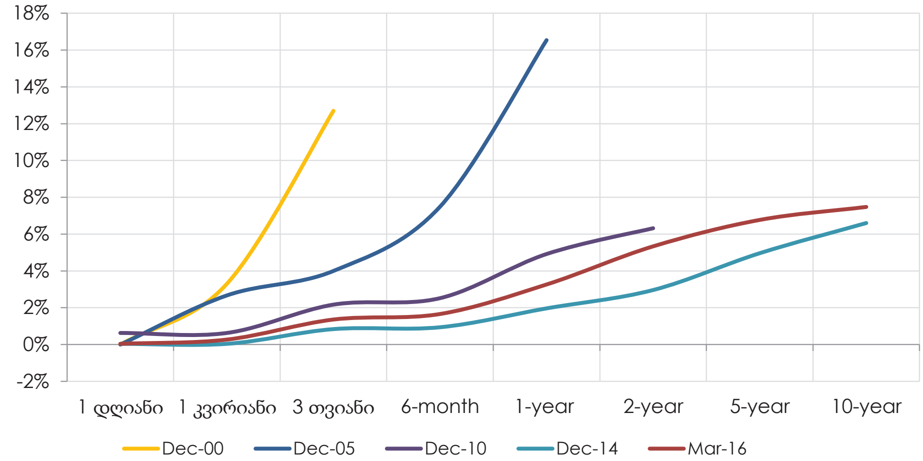
Figure 5.6 Interest Rates On Government Securities



Source: National Bank of Georgia

The spread between long-term assets and the monetary policy rate decreased because lower inflationary expectations reduced belief of an increase in the monetary policy rate.

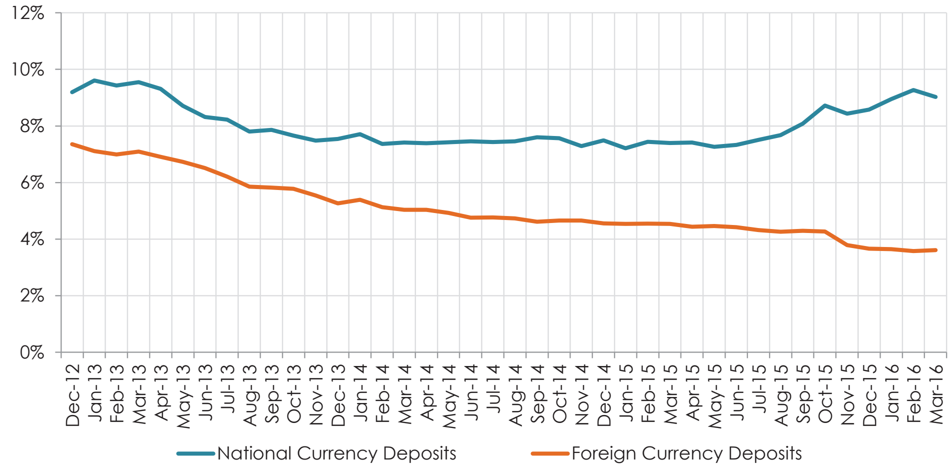
Figure 5.7 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits increased by 0.4 percentage points and amounted to 9%, while for foreign currency deposits the interest rate decreased by 0.1 percentage point and amounted to 3.6%. The rise in interest rates was caused by an increase in the monetary policy rate and lower 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.

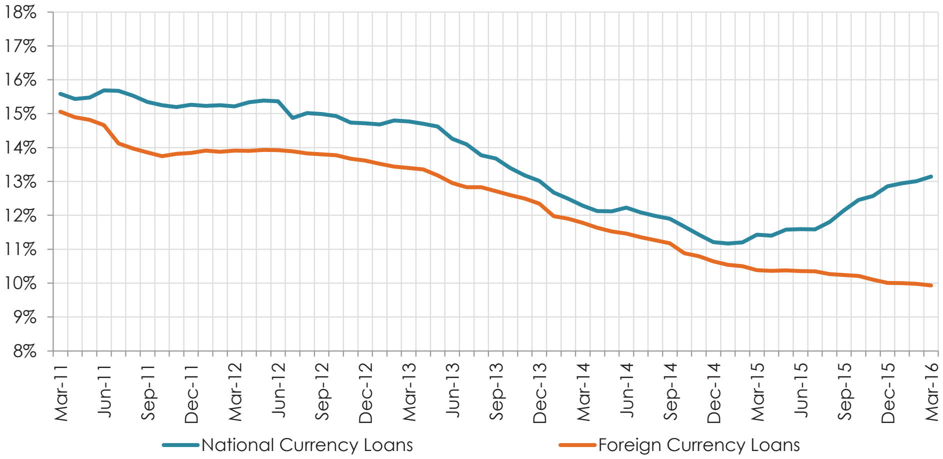
Figure 5.8 Average Interest Rates On Deposits



Source: National Bank of Georgia

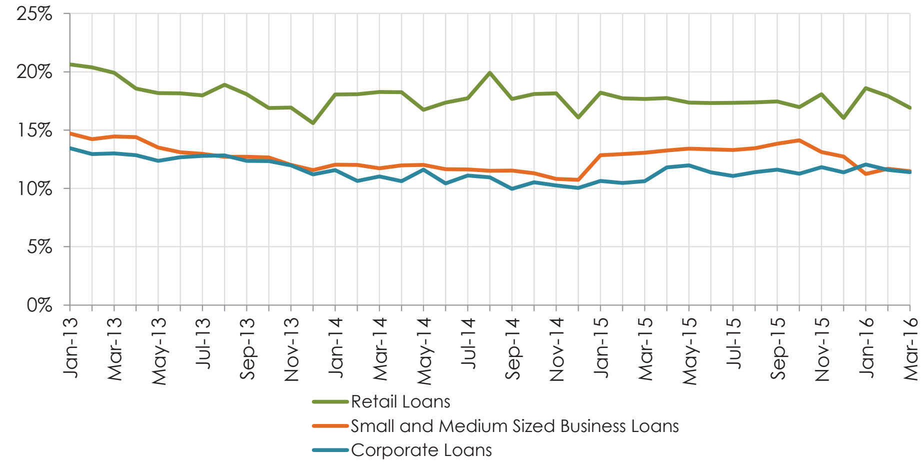
According to the credit conditions survey, in the first quarter of 2016 credit conditions softened for individuals and legal entities. This was mainly reflected on interest rate conditions for foreign currency loans. The softening of supply conditions was caused by general economic trends, decreased financial costs, increased competition and high liquidity. In March, interest rates on the flow of corporate loans did not change compared to December and amounted to 11.4%. Interest rates on loans to small and medium business decreased by 1.3 percentage point and amounted to 11.5%, while rates on retail borrowings increased by 0.9 percentage points and amounted to 16.9%. In the context of currencies, interest rates on business loans in the domestic currency increased by 0.3 percentage points, while interest rates for foreign currency deposits declined by 0.1 percentage point. According to the credit conditions survey, credit conditions are expected to soften in the next quarter.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow

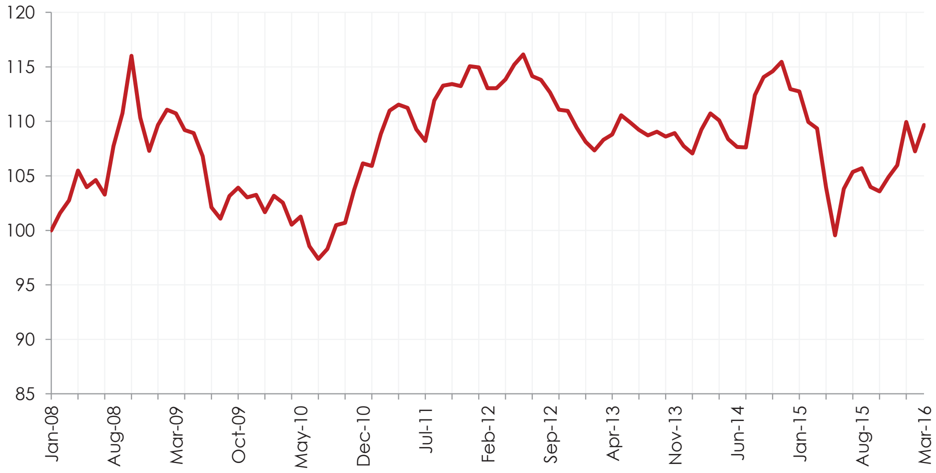


Source: National Bank of Georgia

5.3. EXCHANGE RATE

The lari exchange rate depreciated against the US dollar in the first quarter of 2016 by 1.6% compared to the previous quarter, and the exchange rate was 2.44 on average. The GEL depreciated slightly against the euro (by 2.2%) and the Turkish lira (by 0.3%), while strengthening against the Russian ruble, Ukrainian hryvnia and Azerbaijani manat by 10.3%, 9.2% and 30.6% respectively. As a result, during the first quarter of 2016 the nominal effective exchange rate appreciated by 5.4% compared to the previous quarter and depreciated by 4.1% on a year-on-year basis. The real effective exchange rate appreciated by 4% compared to the previous quarter while year-on-year depreciation totaled 1.6%.

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



Source: National Bank of Georgia

As Table 5.1 shows, in March 2016 the real exchange rate appreciated on a year-on-year basis against the Russian ruble and the Azerbaijani manat.

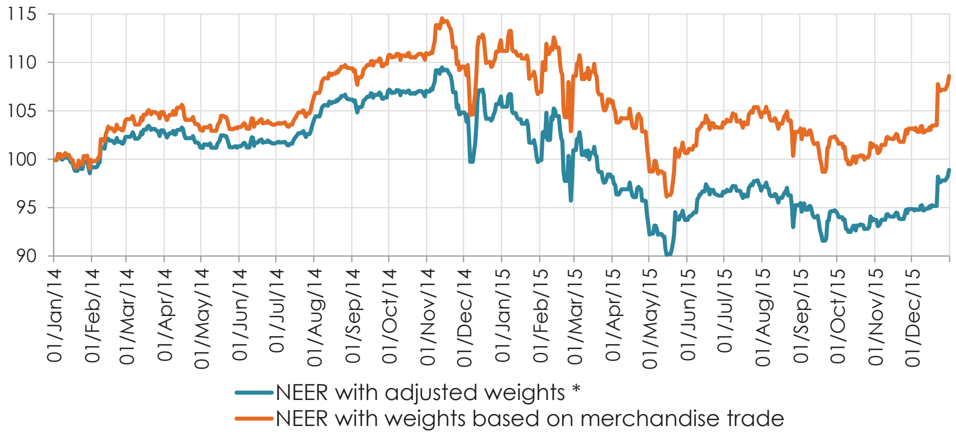
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate
Effective exchange rate*	1.1	0.3	0.3
Eurozone	-10.4	-6.7	-1.6
Turkey	2.4	-0.8	-0.2
Ukraine	6.6	-8.3	-0.6
Armenia	-6.3	-0.6	0.0
The United States	-8.3	-5.4	-0.3
Russia	7.2	3.9	0.4
Azerbaijan	41.9	35.4	4.1
Other	-7.8	-4.9	-1.6

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, paints a slightly different picture. The adjusted nominal effective exchange rate in the first quarter fell by 3.8% year on year, but appreciated by 3.7% compared to the previous quarter.

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., increase - appreciation, 31 Dec. 2013 = 100.

Source: National Bank of Georgia

6. Aggregate Demand

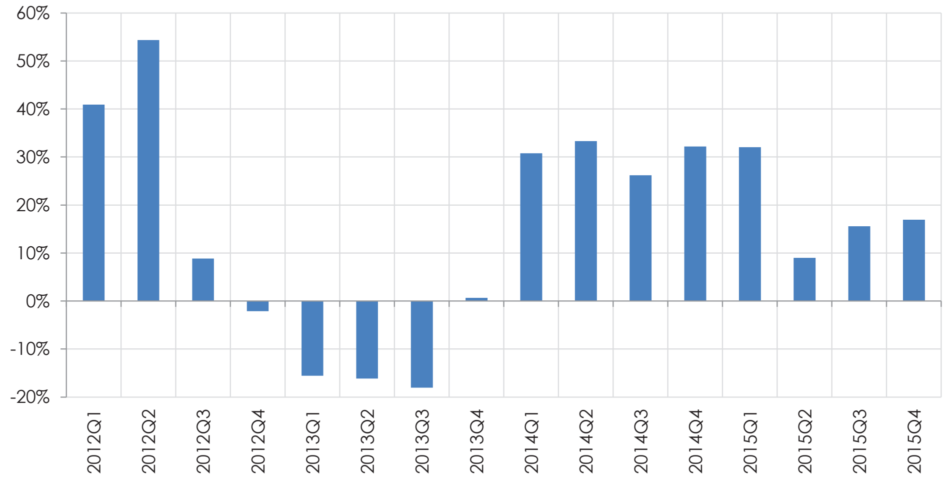
Real GDP growth amounted to 2.9% in the fourth quarter of 2015, while overall GDP growth in 2015 posted 2.8%. The decline in the growth rate of the economy was mostly caused by reduced external demand. Investments were the main driving force behind economic growth in 2015, while, according to current forecasts, in 2016 investments and consumption are expected to be the main determinants of economic growth.

« Real GDP growth amounted to 2.9% in the fourth quarter of 2015.

The capital formation growth rate remained high in the fourth quarter of 2015 and posted 16.9%. FDI inflows and local domestic investments both made a significant contribution to the growth of investments. BP investments into a new pipeline project was the most important contributor to the growth of foreign investments. The high growth of capital formation was also due to government infrastructure projects. During the first, second and third quarters of 2015 commercial bank credits to the corporate sector posted very high growth rates that supported the realization of infrastructure projects.

« The capital formation growth rate remained high in the fourth quarter of 2015 and posted 16.9%.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

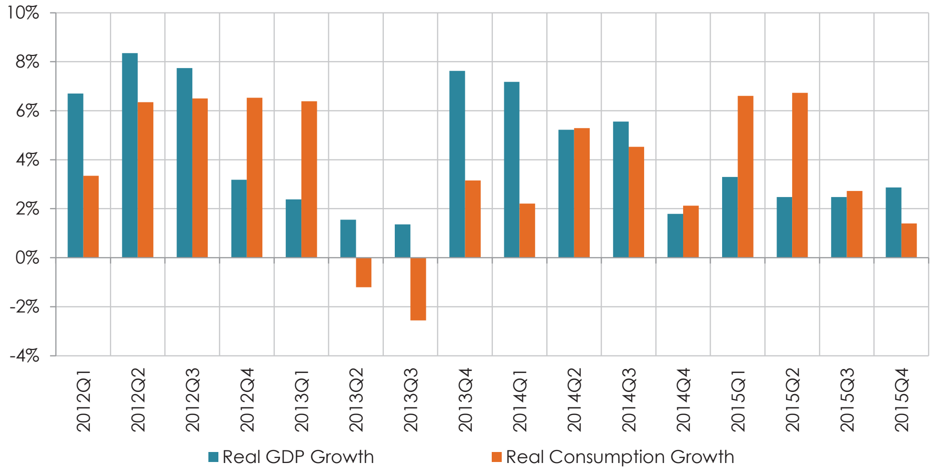
The net exports balance improved in the last quarter of 2015 on an annual basis. The decrease in the decline rate of exports and decreased imports contributed to improve the balance of foreign trade. It is also interesting to analyze the real changes in foreign trade. Since the second of quarter of 2015, the negative growth rate of exports has been declining. As real exports decreased insignificantly in the fourth quarter of 2015, the nominal decline of exports was a result of the decreased prices of exported goods. As in previous quarters, the decline in exports stemmed from external shocks caused by reduced demand in Georgia's trading partners. The real reduction rate of imports is gradually increasing. The decline of imports stemmed from reduced demand, which may have been caused by the substitution effect following the depreciation of the lari exchange rate. Another reason for the decline could be the decrease of the disposable income of individuals and legal entities following falling exports, reduced money transfers, and the increased debt service on foreign currency loans. According to preliminary data, in the first quarter of 2016 the real growth of exports posted a positive growth rate, while the negative growth rate of imports increased. As a result, net exports should positively contribute to GDP growth.

The growth rate of real private consumption[11] decreased in the last quarter of 2015

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

and posted 1.4%. The decline of consumption was caused by the weakened growth of disposable incomes. The latter stemmed from the increased debt service on foreign currency loans following the GEL depreciation. Consumer loans posted insignificant annual growth in the fourth quarter. Furthermore, due to seasonal patterns, budget expenditures on consumption were higher in the fourth quarter compared to the rest of the year, which also contributed to total consumption growth in the fourth quarter.

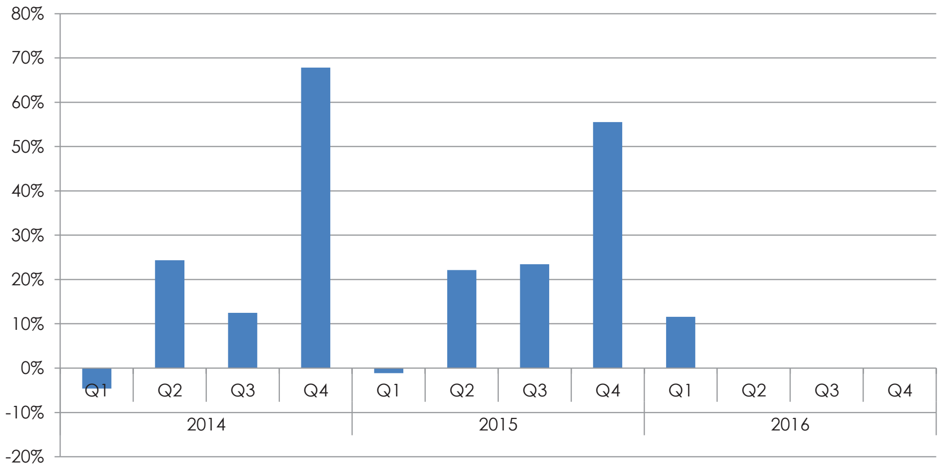
Figure 6.2 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

Compared to the previous year, the consolidated budget deficit to GDP ratio is planned to decrease in 2016 (a 3% deficit in 2016 versus a 3.7% deficit in 2015). The consolidated budget deficit posted 119.9 million GEL in first quarter of 2016. Due to seasonality, the first quarter generally has a budget surplus, or the smallest deficit among quarters. thereforethe forthcoming quarters of the current year are thus expected to have a negative balance.

Figure 6.3 Distribution of Consolidated Budget Deficit Among Quarters



Source: Ministry of Finance of Georgia

Box 1 Impact of foreign shocks on the current account balance

The Georgian economy faced strong external shocks during 2015. Several factors contributed to the reduction of external demand. Throughout 2015 there were expectations in the international market that the U.S. Federal Reserve would increase its policy rate (this finally happened in December 2015). These expectations significantly strengthened the position of the US dollar against other currencies. Against the backdrop of geopolitical tensions and the global economic slowdown the national currencies of Georgia's trading partners started to depreciate. It is worth noting that, as a result of the accommodative monetary policy pursued by the European Central Bank, the euro depreciated even further. As a result of the abovementioned factors the Georgian economy was losing its competitiveness: the demand for imports was increasing, while the external demand for Georgian exports was falling. The decline in oil prices weakened the economies of oil exporting countries and further reduced the demand for Georgian exports from countries such as Russia, Azerbaijan and Kazakhstan. It is also worth noting that the current crisis in Russia has a contagious effect on other countries in the region, including major trading partners Armenia and Azerbaijan. The deterioration of the economic situation in Russia and Greece significantly diminished the inflow of remittances to Georgia, which affected the inflow of foreign currency. These circumstances made the depreciation of the lari inevitable. The depreciation of the exchange rate in 2015 had a corrective effect on the current account balance, causing a reduction of imports and, on the other hand, an increase in revenues from tourism and, to a lesser extent, a contraction of goods exports.

The decline of registered export revenues started in August 2014 and reached the maximum level of 35% in November. Exports continued to fall over the following months, but did so at a relatively slower pace in line with the nominal effective exchange rate depreciation. In total, export revenues declined by 23% y-o-y in 2015 and amounted to approximately 944 million USD. Remittances decreased significantly as well. Throughout the year, from month to month the annual rate of decline of funds received from abroad exceeded 20% and, as a result, money and other private transfers received from alternative sources decreased by 23%. As a result, the current account lost the influx of almost 499 million USD. As for the income from tourism, negative trends developed during the start of 2015, but the exchange rate depreciation had a positive effect on the tourism sector and a positive dynamic was observed in the second half of the year. The eventual 8.3% y-o-y increase in tourism revenues, which equaled around 149 million USD, compensated for the sharp decrease in revenues and balanced the trade deficit to some extent. Overall, in 2015 the shortage in the current account in terms of foreign currency inflows amounted to 1.3 billion USD (see Table 6.1).

The nominal exchange rate depreciation made it possible to balance the above mentioned losses by the decline in demand for imports. Before the depreciation, the demand for imports was high, but that deteriorated amid diminished export revenues. The growth rate of imports gradually declined and became negative in the beginning of 2015. Starting from the second quarter, the y-o-y reduction of imports increased significantly. Due to the exchange rate depreciation, the demand for imported goods declined at a continually increasing rate. It should also be noted that, in addition to the effect of the exchange rate adjustment, the reduction of oil and other commodity prices on international markets had a significant impact on the decline of import costs. Being influenced by these two effects, overall imports decreased by 16% in 2015. That enabled a 1.38 billion USD decrease in expenses of imports compared to the previous year. In addition to trade with goods, imports of services also decreased, resulting in a supplementary reduction in the outflow of foreign currency from the economy (see Table 6.1). Thus, in 2015 the drop in goods and services imports made it possible to eliminate the significant imbalance generated as a result of the sharp decline in revenues and, moreover, allowed improvement of the current account deficit.

Table 6.1 Correction of the Current Account

	2014	Change in 2015	
		%	Mln USD
Total losses in revenues			-1,293
Goods Exports	4,073	-23%	-952
Remittances	2,136	-23%	-489
Tourism	1,787	8%	149
G&S imports	-10,074	-14%	1,420
Goods Imports	-8,354	-16%	1,377
Other	325	-5%	-15
Difference			112

Source: National Bank of Georgia

7. External Demand and Balance of Payments

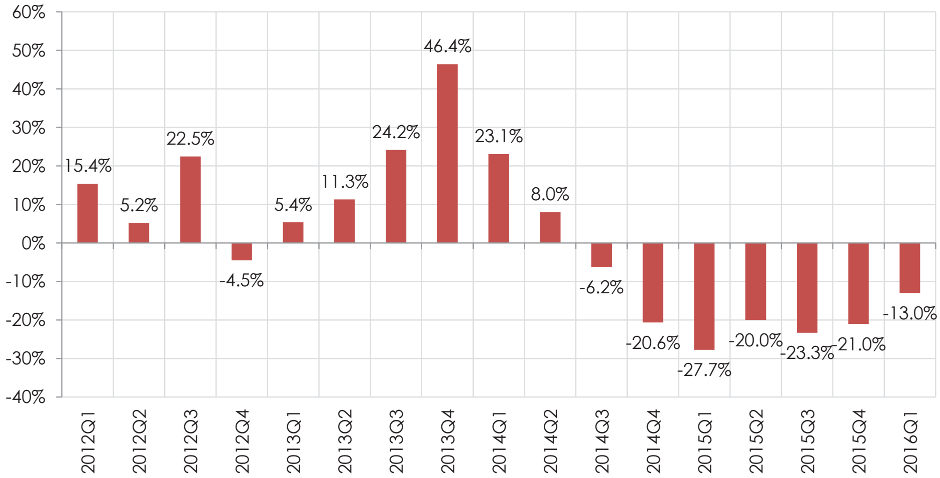
In the beginning of 2016, foreign demand continued to decline as a result of the complicated economic situation in the region and the reduction of Georgia's exports was thus sustained. As a result of the base effect, exports in the first quarter decreased less than in the same period of last year, falling by 13% and totaling 443 million USD. The decrease mainly came from exports of ferroalloys (-44%), nuts (-36%), and vehicle re-exports (-35%). Mineral water exports also fell once more (-15%).

‹‹ The pace of export decline decreases.

A positive trend was observed in natural wine exports. Compared with the first quarter of the previous year, exports of these products increased by 24%. Meanwhile, exports of raw or semi-processed gold increased by 40%.

Georgia's goods exports are still poorly diversified. The change in volume of a particular product's export may be significantly affected by country statistics. Exports to EU countries decreased by 34%, and the main reason for this was the reduction of nut exports. The 26% drop of exports to CIS countries was generally related to the reduction of vehicle re-exports. While due to the decrease in exports of ferroalloys, exports to the U.S. declined by 47%. Conversely, the main cause of doubled exports to China (105%) was an increase of copper ore and concentrates exports.

Figure 7.1 Annual Change Of Registered Exports Of Goods

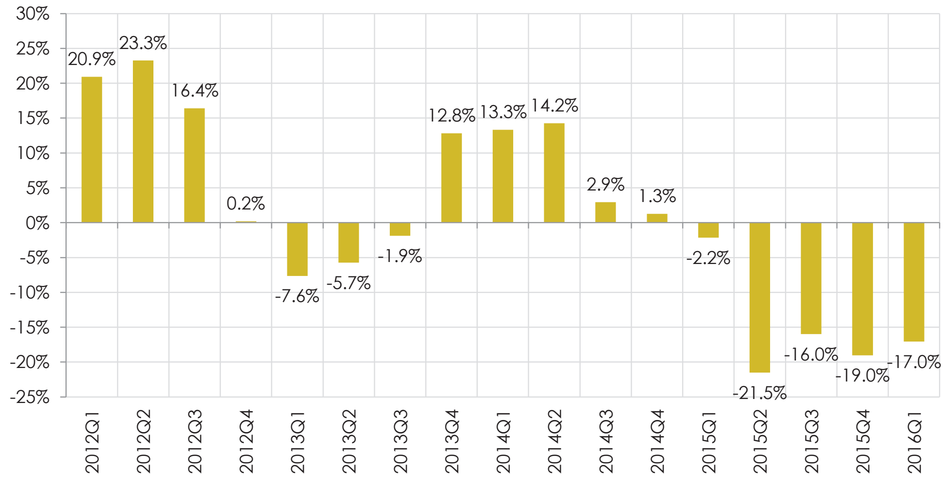


Source: GeoStat

Alongside the reduction of exports, imports also further declined. Since the second quarter of 2015, significant reductions were observed on almost all imported products. In the first quarter of 2016, imports of goods decreased by 5.7% compared with the same period last year; however, if hepatitis C treatments[12] are excluded, imports decreased by 17%. The most significant decrease stemmed from the imports of cars (by -32% or -46 million USD). This was primarily explained by the decrease in vehicle re-exports. Imports of oil and oil products also decreased (by -28% or -37 million USD) compared with the same period of last year. An additional decline of oil subsequently led to a further reduction of imports. The decline in gas imports (by -19% or -28 million USD) can be explained by the decline of local producers' consumption.

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

Figure 7.2 Annual Change Of Registered Imports Of Goods[13]



Source: GeoStat

The depreciation of the lari reduced demand on imports, which was reflected in the annual decline of imports . It should be noted that the decline in imports was largely due to the decline in consumer goods imports. The National Bank's tightened monetary policy also contributed to the reduction of consumer goods imports by leading to the slowing of consumer loans. In the first quarter of 2016, the share of consumer goods imports in the annual reduction of overall imports was -8.3%, intermediate goods imports had a -7.4% share, and investment goods a -1.2% share.

‹‹ The depreciation of the lari reduced demand on imports.

Figure 7.3 Annual Change Of Registered Imports By Category Of Goods

Source: GeoStat

Due to the complicated economic situation in the region the inflow of remittances to Georgia in 2015 fell by 25% compared to the previous year. The downward trend continued in the first quarter of 2016, but then decreased to 4.9% as a result of the base effect. The Russian Federation still tops the country list by amount of remittances, but it is noteworthy that in recent years the share of this country has constantly been decreasing, while the share of EU countries has been increasing. In 2012, the share of remittances from Russia was 56%, and 29% came from the EU and Turkey 29%; in 2015, 40% came from Russia and 38% from the EU and Turkey; and in the first three months of 2016, the share of Russia was 32%, while 42% came from the EU and Turkey.

‹‹ In the first quarter more money remittances came from the EU than from Russia.

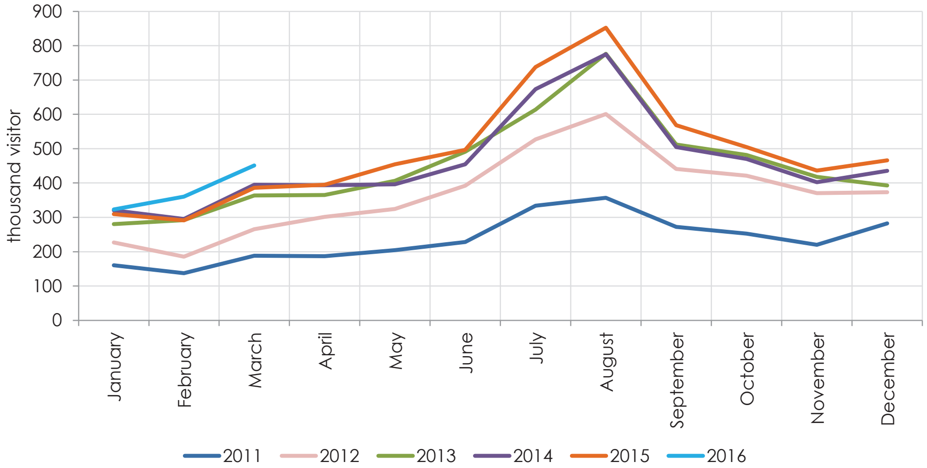
In the first quarter of 2016, the number of visitors entering the country increased by 15%. The increase mainly came from visitors from Azerbaijan, Russia and Turkey. The share of neighboring countries in total number of visitors was 88.2% – a figure that has remained relatively stable, ranging from 86-88% in 2010-2015.

13 *Excluding imports of hepatitis C treatments.*

In the first quarter of the year, the number of foreign citizens who crossed the state border and remained in the country for more than 24 hours increased by 16%. These statistics are important, because this group includes tourists.

In order to assess Georgia's popularity as a tourist destination, statistics regarding visitors from non-neighbor countries are important. In the first quarter, the number of visitors from Iran increased 4.5 times (by 13,500), which was linked to the introduction of visa-free travel for the citizens of that country. Flows also increased from the European Union (4%), the U.S. (11%) and Ukraine (20%).

Figure 7.4 Number Of Incoming Visitors To Georgia



Source: GNTA

In 2015, the current account deficit was reduced by 103 million USD in comparison to the previous year and equaled 1,644 million USD. In spite of the reduction, the current account deficit to GDP ratio increased by 1.2 percentage point and reached 11.8%. The main sources of financing the deficit are foreign direct investments, which reached 1,347 million USD. Out of this sum, 44% was in the field of transport and communications. The majority of FDI in this field were directed at the gas pipeline project crossing Georgia. A total of 14% of FDI went to the finance sector and 10% to the construction sector. On the other hand, imports are an important component of FDI and, as a result, the high current account deficit is partially due to the inflow of foreign direct investment.

‹‹ FDI is the main funding source of financing the current account deficit.

8. Output and labor market

8.1 OUTPUT

In the fourth quarter of 2015, GDP rose by 2.9%, while in 2015 it grew by 2.8%. At 1.9 percentage point (p.p.), the service sector made the largest contribution to overall growth. The industrial sector contributed 0.6 p.p. and agriculture 0.3 p.p.

« In the fourth quarter, GDP grew by 2.9%, mainly due to services.

The most important contribution from the service sector came from operations in real estate, renting and business services, which grew by 8.5% in the fourth quarter, making a 0.4 p.p. contribution to GDP growth. In the last few years, this field, which largely consists of output of real estate agencies, has observed high growth. This fact is linked to the high level of activity in the housing sector and hence the expansion of the real estate market. A significant increase was observed in community, social and personal services, which includes the news media and entertainment industry (which saw growth of 8.9% and made a 0.3 p.p. contribution to overall GDP growth). The growth in financial activities was traditionally high (growth of 8.4%, making a 0.3 p.p. contribution to GDP growth). The increased flow of visitors had a positive impact and is expected to give significant momentum to the growth of restaurants and hotels (growth of 8.8%, making a 0.2 p.p. contribution to GDP growth). The reduction of trade, the largest sector of economy by 1.8%, is noteworthy. In 2013-2014, trade was increasing by 5-6% per year, while in 2015 the sector decreased by 0.3%.

« The growth of services was provided by construction and real estate operations.

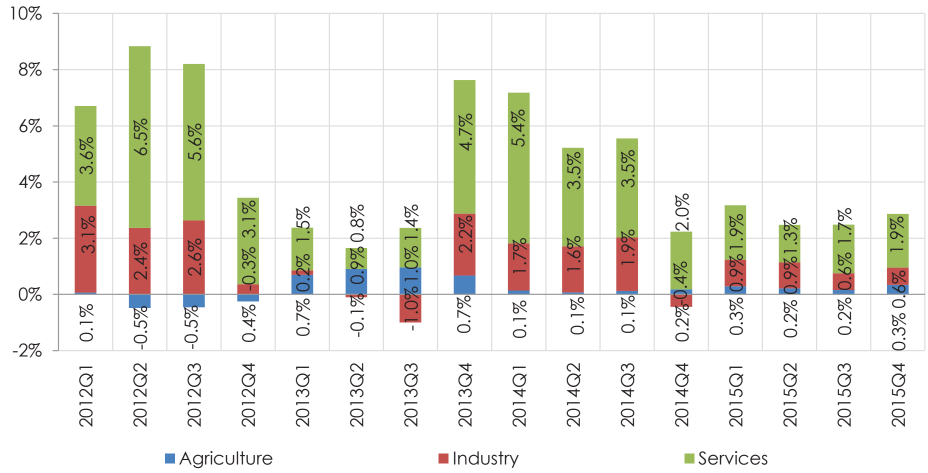
In terms of industry, in the fourth quarter of 2015 the highest growth (12.2%) was in construction, contributing 0.7 p.p. to the total growth. The most important share in construction came from the construction of the new gas pipeline, although activities were also high in both government-funded infrastructure projects and private constructions. Mainly due to an increase in gold extractions, the growth of the mining industry was 23.5% and its contribution to GDP growth was 0.2 p.p. In the wake of weak foreign demand, the output of manufacturing, where the share of export production is high, was below the previous year's level by 4.6%. Meanwhile, manufacturing had the most negative contribution to GDP growth (-0.4 p.p.).

« In the fourth quarter, manufacturing contributed negatively to growth.

In the last quarter, the growth of agriculture increased to 4.1% and the sector's contribution to GDP growth equaled 0.3 p.p.

« The growth of agriculture increased.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

In the fourth quarter of 2015, the growth rate of real value added produced per worker decreased and amounted to 1.6% y-o-y. During this period, labor productivity in the agriculture sector increased by 4.1%, which was 2 percentage points lower than in the previous quarter. The declining rate of labor productivity in the industrial sectors reduced by 4 percentage points to 4.3%. Against the backdrop of diminished exports, that decline was predictable. As for the services sector, after a reduction in the previous quarter, the real value added per employee increased in the fourth quarter of 2015 by 2.2%.

« Labor productivity growth declined to 1.6% during the fourth quarter of 2015. This decline can be largely attributed to the industrial sector.

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

	Labor productivity growth, %
Agriculture and fishery	4.1%
Industrial sectors	-4.3%
Service sector	2.2%
Overall in the economy	**1.6%**

Source: GeoStat and National Bank of Georgia

As a sectoral breakdown of the economy shows, labor productivity in manufacturing declined, falling by 7.5% year on year. On the contrary, a 7.1% annual growth rate was recorded in construction. It is worth noting that labor productivity decreased by 4% in the trade sector. There was also a reduction in the hotel and restaurant, and business and financial intermediation sectors.

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

The annual growth rate of the nominal salaries of employees amounted to 6.5% during the fourth quarter of 2015, with the average monthly nominal salary standing at 1,012 GEL, according to the latest data from Geostat. The growth rate was 2.9 percentage points higher than in the previous quarter.

In terms of sector analysis, high increases of salaries were evident in agriculture, fishery, mining and quarrying, construction and real estate, renting and business activities. Average salaries only decreased in the production and distribution of electricity, gas and water.

« The nominal salaries of employees increased by 6.5% on average in the fourth quarter of 2015.

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

	Growth of nominal wage, %
Agriculture, hunting and forestry	25.7%
Fishing	66.2%
Mining and quarrying	15.4%
Manufacturing	6.2%
Production and distribution of electricity, gas and water	-1.9%
Construction	13.5%
Wholesale and retail trade; repair of motor vehicles and personal and household goods	0.0%
Hotels and restaurants	7.5%
Transport and communications	1.1%
Financial intermediation	7.0%
Real estate, renting and business activities	14.2%
Public administration	6.6%

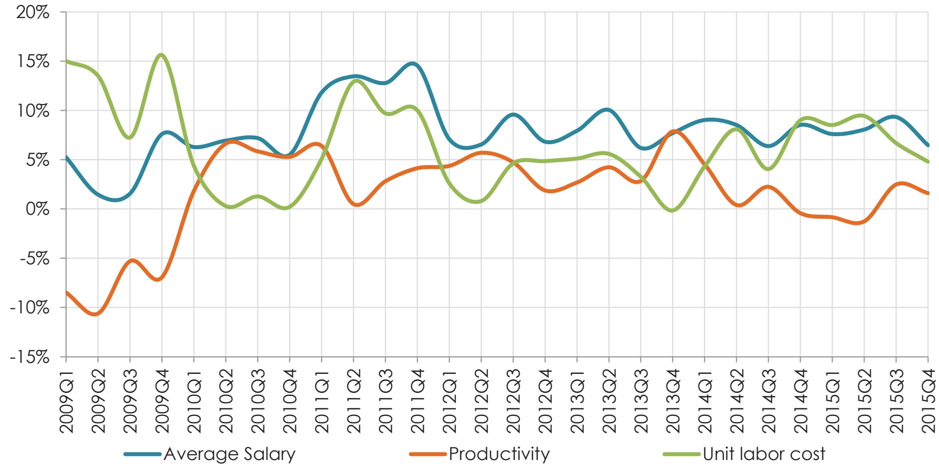
	Growth of nominal wage, %
Education	6.7%
Healthcare and social work	7.9%
Other community, social and personal service activities	16.4%
Overall in the economy	**6.5%**

Source: National Bank of Georgia

To sum up , against the backdrop of a year-on-year decline of labor productivity and average salaries, the annual growth rate of unit labor cost[14] (personnel expense per production unit) decreased and stood at 4.8% by the end of the fourth quarter of 2015, indicating the absence of 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, 2009-2015Q4 (Annual Percentage Change)



Source: GeoStat and National Bank of Georgia

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

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