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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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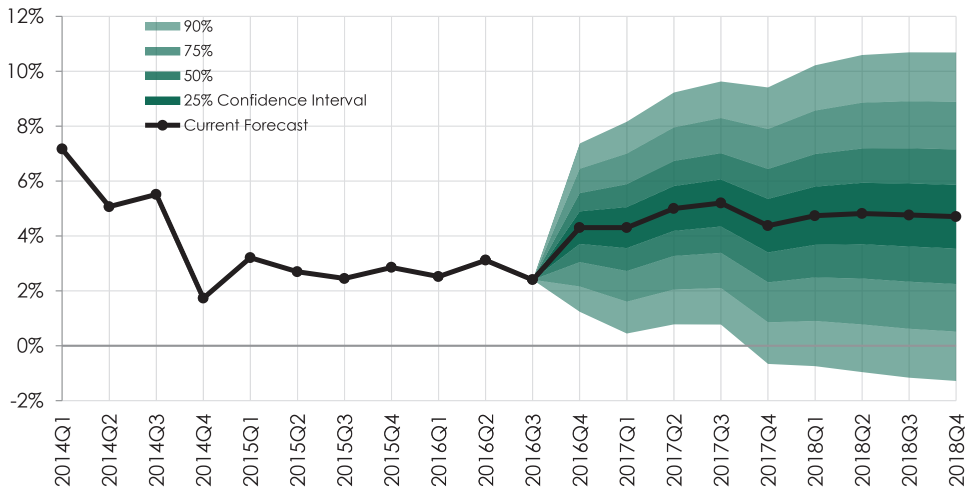
1. Brief Overview

Real GDP posted slightly lower-than-expected growth in the third quarter of 2016 and amounted to 2.2%, according to preliminary estimates. Investments and aggregate consumption made a positive contribution to this growth, while net exports negatively contributed. Economic growth continues to be negatively affected by external shocks stemming from the tough economic conditions facing Georgia's trading partners, along with more general global economic weakness. Investment growth has been mainly supported by the construction sector, which is backed by both private sector and public infrastructure projects.

The **economic growth forecast** of the National Bank of Georgia for 2016 is still around 3.5%, despite the fact that the latest, third quarter, GDP figures imply a higher risk of growth underperformance (see Figure 1.1). According to the same forecast, real economic growth in 2017 is expected to be around 4.5%. This will be supported by fiscal stimulus and the normalization of monetary policy[1], which are expected to support investment and consumption growth rates. Weak demand from Georgia's trading partners is still expected to somewhat negatively affect net exports, which will make a negative contribution to real GDP growth in 2016. Weak exports are expected to continue in 2017 and to be coupled with slightly higher imports. However, the forecast also assumes that conditions in Georgia's trading partners will gradually improve, which will imply higher remittances and a growth of tourism inflows in 2017.

Figure 1.1 Real GDP Growth



Source: National Bank of Georgia

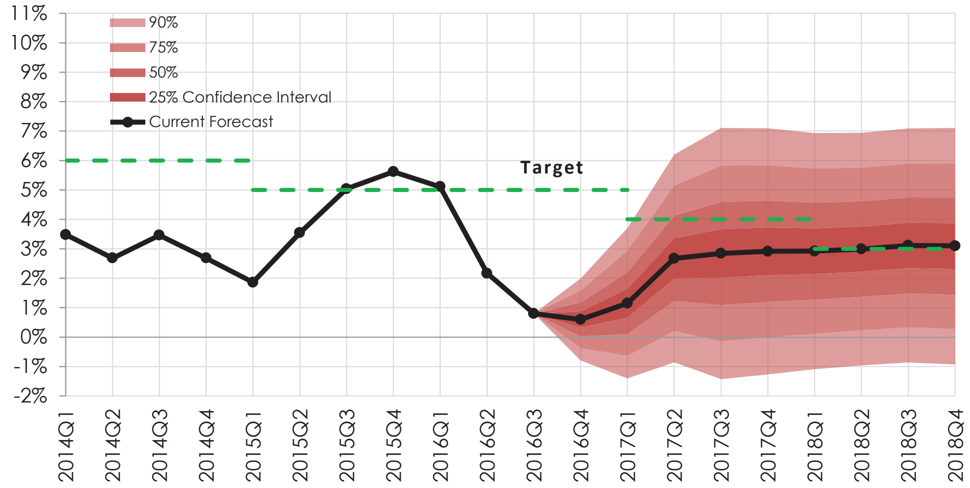
Annual inflation fell in the third quarter of 2016 and reached 0.1% in September. The undershooting of the NBG's inflation target of 5% was mainly due to weak aggregate demand, lower inflation expectations and a stronger-than-expected transmission of earlier drops in international oil and food prices. The abatement of the base effect also contributed to the downward trend of inflation that began this year. The one-time increase in prices that occurred last year, following lari exchange rate depreciation in the presence of the liability dollarization, made some companies pass their increased debt-service burden onto consumer prices. This is gradually being phased out from the annual inflation figure this year.

According to the forecast, inflation in the fourth quarter of 2016 will remain at a low level. However, it will gradually start increasing from the beginning of 2017 and

1 *Monetary policy normalization 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 around 5.5-6%.*

is expected to stabilize around the target in the medium term (see Figure 1.2). The inflation target of the NBG is 3% from 2018 onwards. The main factors that will support an increase in inflation to its target are gradually improving aggregate demand and the elimination of the downward pressures on inflation from international commodity prices.

Figure 1.2 Headline CPI Inflation



Source: National Bank of Georgia

The forecast is largely dependent on exogenous factors affecting the market and contains **risks in both upward and downward directions**. The main risks still stem from the external sector. In particular, 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, due to lower inflows. On the other hand, if the economies of partner countries are strengthened and/or the amount of foreign direct investments are greater than expected due to improved investor sentiment, then the performance of the economy would be better than currently forecast.

At the Monetary Policy Committee (MPC) meeting of 26 October 2016, it was decided to keep the refinancing rate unchanged at 6.50%. Against the backdrop of weak aggregate demand and lower expected inflation, the NBG still deems the gradual normalization of its monetary policy to be necessary; however, taking into account the effect this has on financial markets, this process will proceed only gradually. The forecast assumes that there will be no further pressure on the lari exchange rate from the foreign sector and, thus, lower inflation and expectations should make the lari exchange rate strengthen in the medium and long term.

The forecast of the monetary policy rate is not a promise made by the National Bank of Georgia. Rather, it is only the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. 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

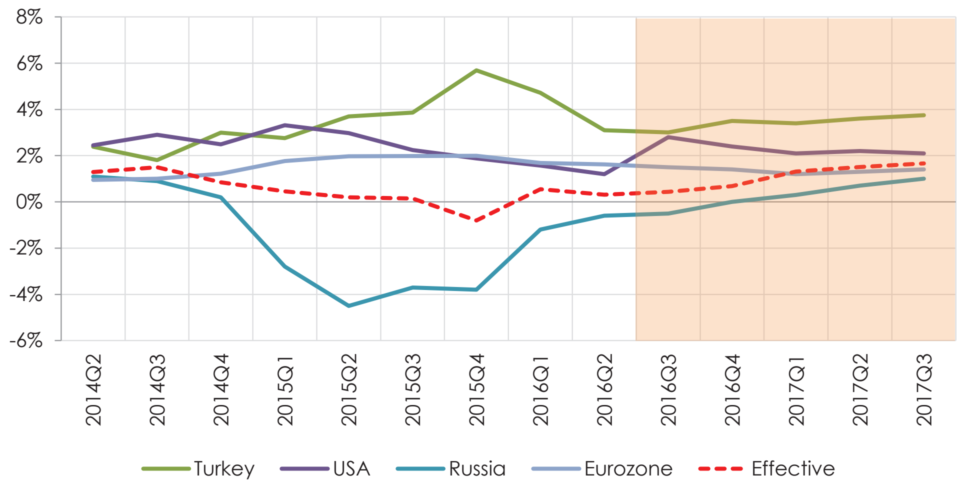
2.1 EXTERNAL SECTOR OVERVIEW

Compared to the second quarter of 2016, the economic situations and outlook of the main partner countries of Georgia have not changed. The situation is still shaky in the region. In the light of Russia's economic recession and the difficult geopolitical situation in Turkey and Syria, trade, investment and remittances are still reduced. Despite the negative impact of the negotiations between the UK and the EU, the US and eurozone economies are gradually improving. The International Monetary Fund (IMF) estimates that global economic growth for 2016 will be maintained at 3.1%, and will be 3.4% for 2017.

Ukraine's real GDP increased 1.4% in the second quarter of 2016, which is the country's best indicator since the fourth quarter of 2013. This was a result of a significant contribution made by private consumption and investment amid a stabilizing geopolitical situation and reduced pressure on consumer prices. In line with expectations, in September the government of Ukraine received an IMF tranche of 1 billion US dollars, which was to support structural reforms. Against this, the IMF's forecast for real GDP growth remained unchanged at 1.5% and 2.5% for 2016 and 2017, respectively. As for annual inflation, for 2016-2017 the projected rate stood at above 10%.

In **Russia**, the severe macro-economic situation, caused by falling oil prices and Western sanctions, continues. However, in recent months the rising price of oil (by about 10 USD a barrel) has been reflected in a slowdown of the economic downturn and some signs of stability have emerged. In the second quarter of 2016, Russia's annual economy shrank by 0.6%, which was the lowest level in the past six quarters. In spite of this, the IMF forecast for Russia's real GDP growth improved and averaged -0.8% in 2016, instead of the -1.2% previously expected. Although the 2017 forecast suggests improving economic activity (1.1%), structural problems and sanctions will continue to significantly undermine economic growth. The annual inflation forecast for 2016 is 7.2%, which is expected to fall to 5% in 2017.

Figure 2.1 Real GDP Growth of Economic Partners[2]



Source: Bloomberg; National Bank of Georgia.

2 Effective growth stands for the weighted average of real GDP growth rates of partner countries (Turkey, the US, Russia, the EU, Ukraine, Armenia and Azerbaijan), where the weights are determined by export revenues and remittances inflows from these countries.

In 2015, the **Turkish** economy grew by 4%, but the growth rate subsequently slowed amid the armed conflict near the country's southern border and internal political strife, including a military coup in July. These circumstances were accompanied by significantly reduced revenues from tourism and exports, which are mainly caused by strained relations with Russia. Meanwhile, credit agencies significantly reduced Turkey's sovereign credit rating. The real GDP growth forecasts for 2016 and 2017 were revised downward by the IMF, and were fixed at 3.3% and 3.0% respectively. According to current forecasts, annual inflation will average 8% in the 2016-2017 period.

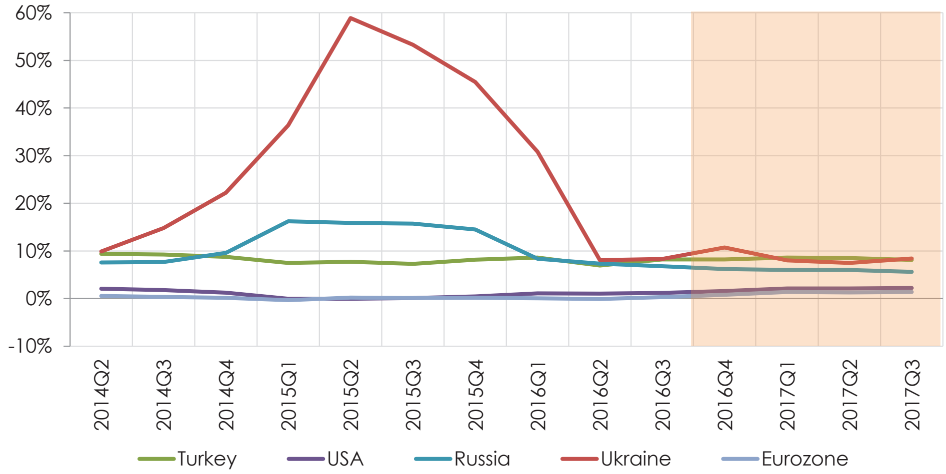
Azerbaijan's economy has seen a significant decline. In the first half of 2016, real GDP decreased by 3.4% year on year. This was a result of a reduction in government investment, credit activity and oil production. In an effort to help neutralize the negative effects, the government recently took several counter-cyclical steps, including measures to improve the social environment and incentivize the non-oil sector. Against the background of reduced revenues, a worsening current account and a budget deficit, the IMF estimates that the economy of Azerbaijan will decrease by 2.4% in 2016, while in 2017 it is expected to grow by only 1.4%.

The significant (4.5%) increase in **Armenia's** real GDP in the first quarter of 2016 was followed by only 1.5% growth in the second quarter of the year. This slowed economic activity was accompanied by political turbulence, which ended in September with the resignation of the country's Prime Minister. It is expected that reduced copper prices and the sluggish Russian economy will be important impediments to the growth of export revenues and remittances, which is why the IMF predicts only moderate growth in 2016-2017, averaging 3.3% year-on-year. According to the same forecast, consumer prices are expected to fall by 0.5% in 2016, while in 2017 inflation will average 2.5%.

Economic growth in the **US** was slower than expected and totaled 1.1% in the second quarter of 2016. This moderate increase was due to a boost in private consumption amid a falling unemployment rate. However, declining capital expenditures in the energy sector and a weakened export sector amid the strong US dollar decelerated investment growth. Against the background of these circumstances, and amid prevailing uncertainty surrounding the presidential election, the IMF significantly revised the US real GDP growth forecast down to 1.6% for 2016, while the forecast for 2017 stands at 2.2% year on year. The same estimates suggest that the annual inflation rate in 2016 and 2017 will average 1.2% and 2.3% respectively.

In contrast to the first quarter of 2016, the **eurozone's** economic growth slowed to 1.2% in the second quarter of the year. However, this remained better than had been expected as a result of improvements in net exports. The consensus estimates suggest that the eurozone economy has continued to recover. In addition, according to current readings, the result of the July referendum on the UK leaving the European Union did not have a significant effect on expectations and economic activity. Low oil prices, moderate fiscal stimulus and an accommodative monetary policy contributed to the IMF forecasting the eurozone's annual economic growth at 1.7% and 1.5% for 2016 and 2017, respectively. The annual inflation rate is forecast at 0.3% and 1.1% for the same years.

Figure 2.2 Headline Inflation in Economic Partners



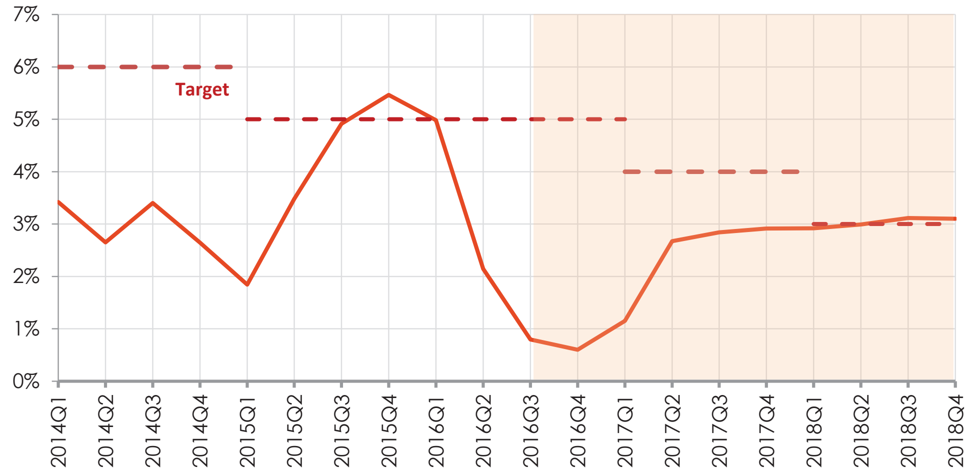
Source: Bloomberg; National Bank of Georgia.

In parallel with the weakening effect of local currency devaluations, annual inflation rates subsided in the countries of the region. This has allowed some central banks to start reducing monetary policy rates in order to encourage economic activity. Meanwhile, in developed countries markets have maintained expansionary monetary policy expectations amid low inflation and weak demand.

2.2 MACROECONOMIC FORECAST

The annual inflation rate in September 2016 declined as expected and amounted to 0.1%. Inflation is thus below the 5% target of the National Bank of Georgia (see Figure 2.3). This is mainly a consequence of weak aggregate demand, lower inflation expectations and a stronger-than-expected transmission of earlier drops in international commodity prices. In addition, the sharp drop in the year-on-year inflation figure seen from the beginning of 2016 has been supported by the gradual elimination of the one-time increase in firms' intermediate costs, and hence prices, that were seen last year (which had been brought about by a combination of the depreciation of the lari exchange rate and foreign currency loans of companies).

Figure 2.3 Headline Inflation



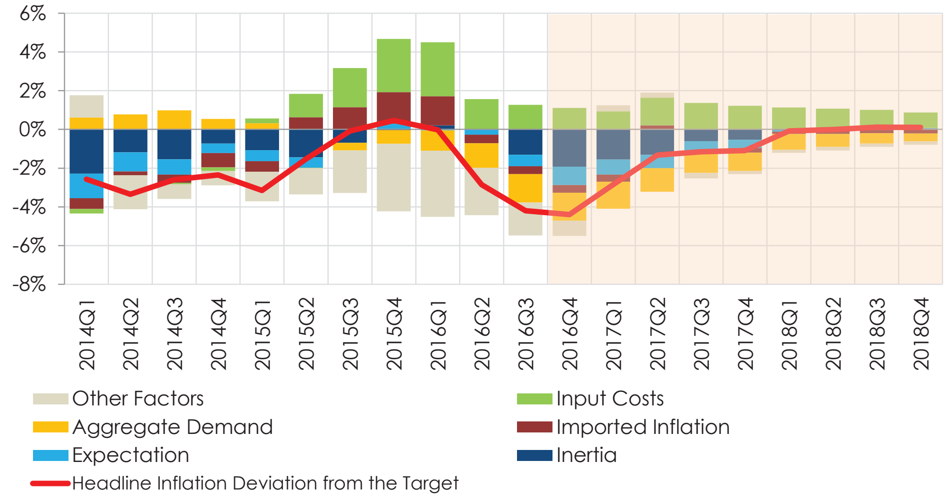
Source: National Bank of Georgia.

According to the **forecast, inflation** is expected to fall moderately in the fourth quarter of 2016; however, this will subsequently move towards the target and stabilize around it from the second half of 2017 (see Figure 2.3). The inflation target for 2018 onwards will fall to its long-run level of 3%.

The below-target inflation level in upcoming quarters will result from both weak aggregate demand (relative to the economy's potential) and lowered inflation expectations (see Figure 2.4). However, the level will subsequently move towards the target, supported by a gradual recovery of aggregate demand and higher commodity prices relative to the beginning of 2016. According to the forecast, which takes all of the above-mentioned factors into account, based on current information, inflation will remain below the target in the following quarters, before gradually approaching it in the second half of 2017.

There are **risks associated with the inflation forecast** in both directions. There is 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 not increase sharply. Therefore, if it turns out that they have increased more than expected, it would imply higher-than-forecasted inflation in Georgia. In addition, if last year's depreciation of the currencies of Georgia's main trading partners is reversed, this would strengthen the transmission of the inflation rates of those countries to Georgia, which could contribute to temporarily higher imported inflation. 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, which in turn depends on the

Figure 2.4 Inflation Deviation from the Target and its Decomposition[3]

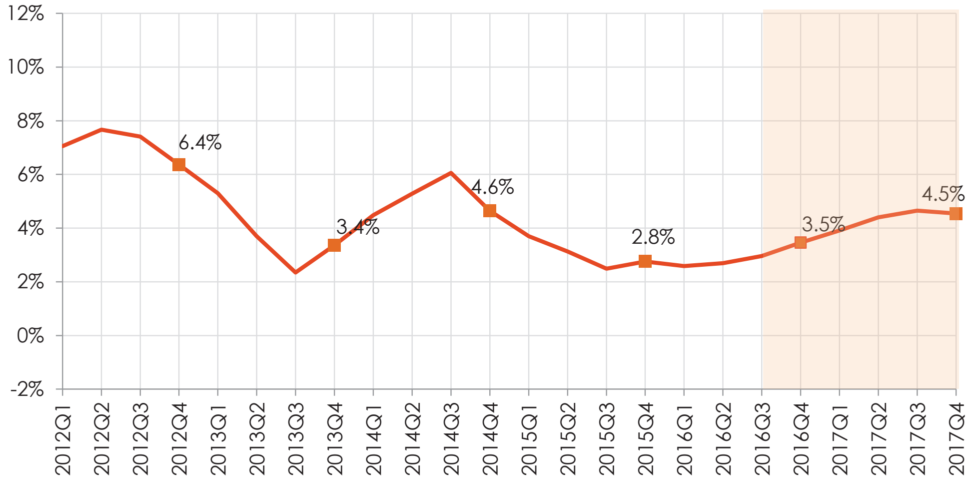


Source: National Bank of Georgia.

amount of fiscal stimulus. If this is weaker than expected, it will cause actual inflation to be lower than current projections, and vice versa if stronger than expected.

Real GDP growth was consistent with previous forecasts and amounted to 3% in the second quarter of 2016. According to preliminary data, this stood at 2.2% in the third quarter (see Figure 2.5). 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 sectoral terms, a significant contribution was made by the construction sector, where, in addition to the notable Baku-Tbilisi-Ceyhan pipeline project, other private construction and public infrastructure projects were 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 and by a softening of the negative growth rate of exports. Notwithstanding this improvement, as was expected, net exports still made a negative contribution to GDP growth in 2015 (see Figure 2.6) and, according to the forecast, the same will be true for 2016, albeit to a lesser extent. The negative contribution made by net exports is projected to decrease even further in 2017.

Figure 2.5 Real GDP Growth (Annual Growth of the Last Four Quarters)

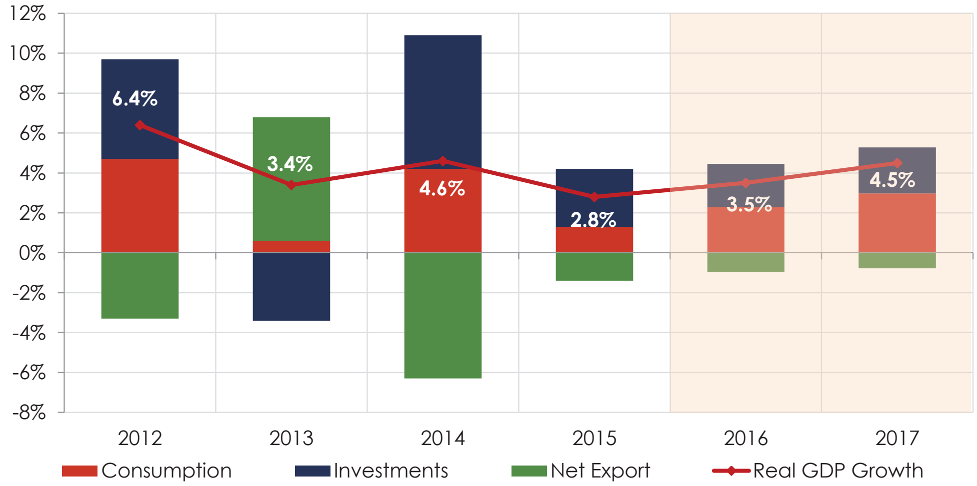


Source: National Bank of Georgia.

3 *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.*

According to the **GDP forecast**, the growth rate in 2016 is projected to be around 3.5%, while it is expected to be around 4.5% in 2017 (see Figure 2.5). Increased fiscal stimulus, 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 2016-2017 (see Figure 2.6). Net exports are negatively influenced by the adverse political and economic conditions facing Georgia's trading partners. These are reflected in both weak foreign demand for Georgian exports and declining remittances. In addition, the negative contribution from net exports is further strengthened by fiscal stimulus and higher consumption. However, such negative spillovers are partly offset by reduced commodity prices on international markets – a positive factor for both the current account and other sectors of the economy – and by the correction of the real effective exchange rate in the last period.

Figure 2.6 Real GDP Growth Decomposition



Source: National Bank of Georgia

When analyzing **risks to the GDP forecast**, the foreign sector clearly stands out. If, against the backdrop of geopolitical tensions, the economic conditions in Georgia's 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.

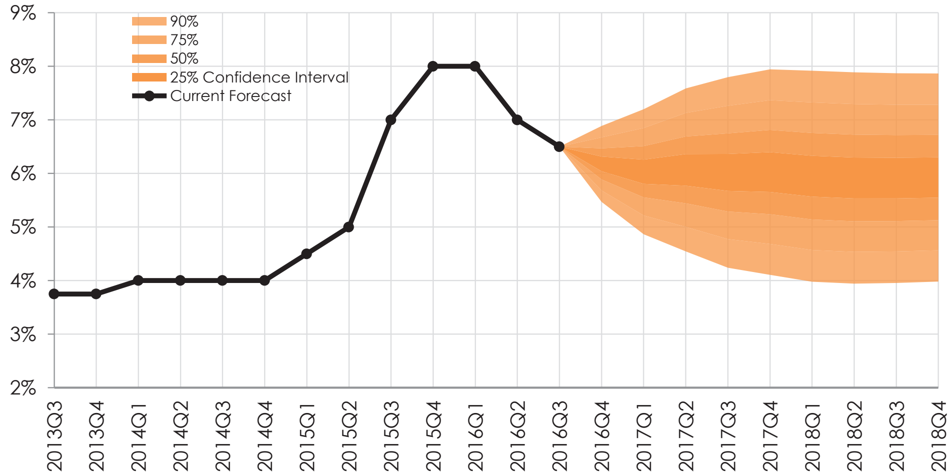
According to preliminary data, the **current account deficit** was 13.3% of GDP in the second quarter of 2016, while it was 14.1% of GDP a quarter earlier. As for registered exports of goods, in the third quarter of 2016 exports (in USD) increased by 0.9%, while imports (excluding grant-financed hepatitis C medications) increased by 3.4%. This caused the goods trade balance to deteriorate by an annual 4.4%. However, money transfers, which are another important source of financing imports, increased by an annual 14.6% in the third quarter.

According to the current forecast, the current account deficit is expected to improve to around 12.5% of GDP in 2016. This improvement is expected to continue in the medium-term, being supported by increased exports of goods and services, including tourism.

The ultimate goal of the National Bank is price stability and the most efficient way of achieving this to date has been 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**. Figure 2.7 shows the forecasted trajectory of the monetary policy rate that is consistent with the macroeconomic forecast presented above. The trajectory implies a gradual reduction in the policy interest rate in the medium term as external shocks gradually die out. This forecast of the policy rate is mainly implied by lower inflation expectations and weak aggregate demand; however, the assumption of there being no further pressure on the exchange rate from the foreign sector is also important. Hence, lower inflation and its expectations should strengthen the lari exchange rate in the medium and long run.

This process of monetary policy normalization 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 5.5-6%. It is worth noting that this level is mostly dependent on long-run inflation expectations and risk premiums. Hence, changes in any of these factors will eventually be reflected in the actual monetary policy rate.

Figure 2.7 Forecast of the Monetary Policy Rate



Source: National Bank of Georgia

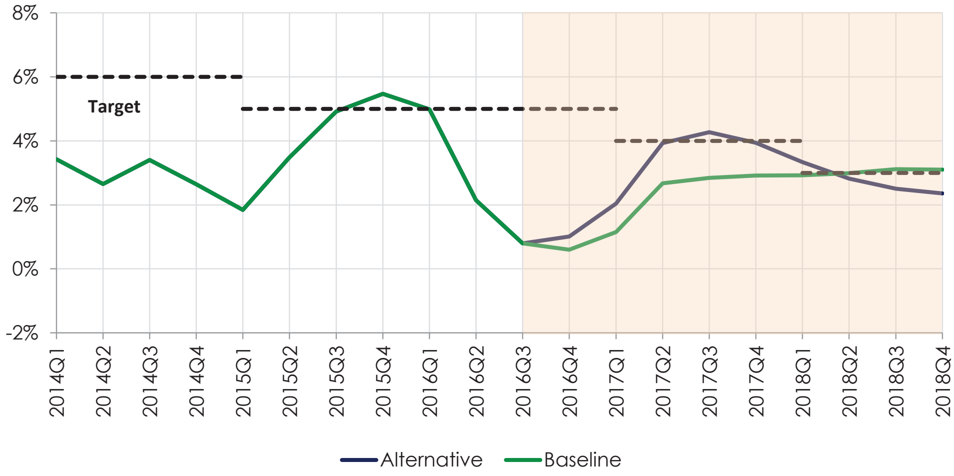
Finally, it should be clearly stated that the **forecast of the monetary policy rate is not a promise by the National Bank of Georgia**. It is only the expected trajectory of the policy rate, assuming that all the exogenous factors incorporated into the forecast materialize as expected. Despite this 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 a situation in which there is an aggravation of supply shocks. In particular, the scenario considers a case in which the economic situation in the EU worsens and in which global economic activity deteriorates further. In such a scenario, negative effects will be transmitted to the Georgian economy more than expected and, consequently, net exports and GDP will be lower than expected. The alternative scenario also assumes a greater than expected appreciation of the dollar against the currencies of Georgia's main trading partners. As a result, the alternative scenario envisages the negative impact of external factors on the GEL exchange rate. Under this scenario, because of greater than expected pressure from the supply side, the annual inflation rate will be higher than in the baseline scenario (see Figure 2.8), while economic growth will be lower (see Figure 2.9).

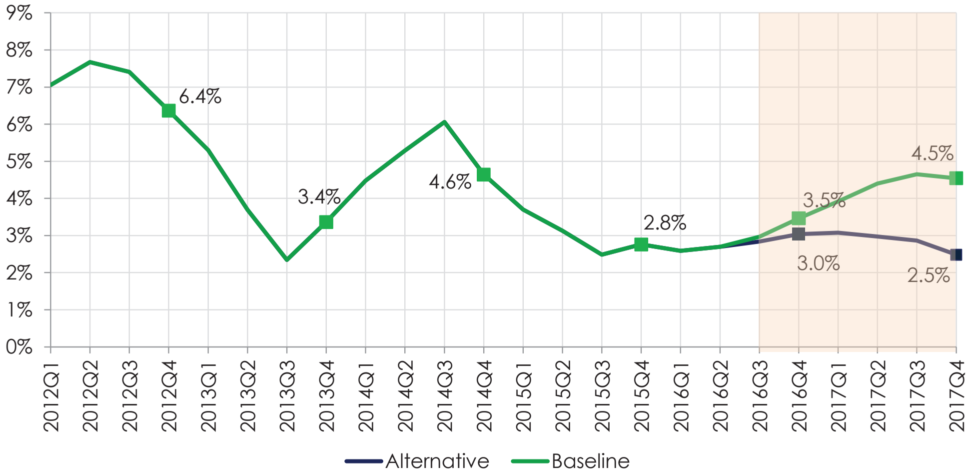
In this scenario, inflation increases at a faster rate than in the baseline scenario as a result of the negative external shock. On this basis, the monetary policy provides an appropriate response to neutralize inflationary expectations and reduce inflationary pressures. According to the alternative scenario, inflation in 2017 will be on average one percentage point higher compared to the baseline scenario (see Figure 2.8).

Figure 2.8 CPI Inflation According to Baseline and Alternative Forecasts



Source: National Bank of Georgia

Figure 2.9 Real GDP Growth According To Baseline And Alternative Forecasts (Annual Growth Of The Last Four Quarters)



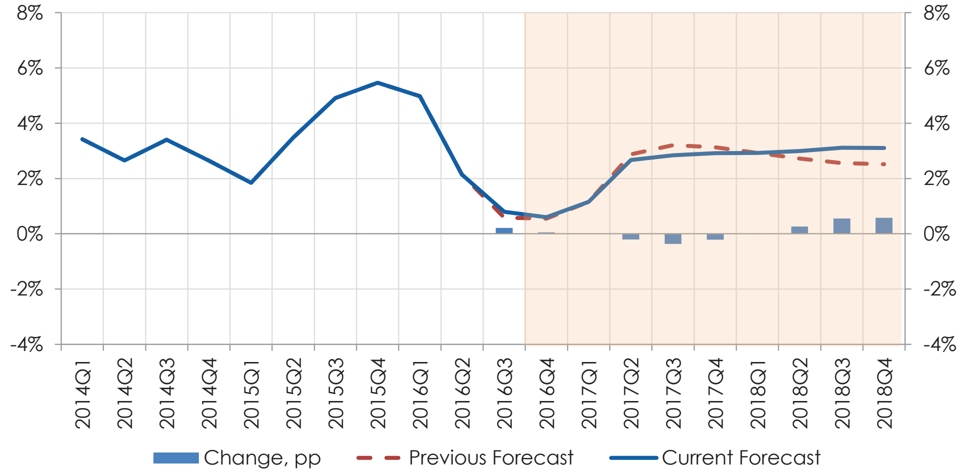
Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter's forecast, the inflation forecast for upcoming quarters has been revised downwards (see Figure 2.10) – essentially due to weak demand and reduced inflationary expectations. As a result, according to the current forecast, the inflation rate in the next quarters will temporarily lie below the target before returning to the target level by the end of 2017.

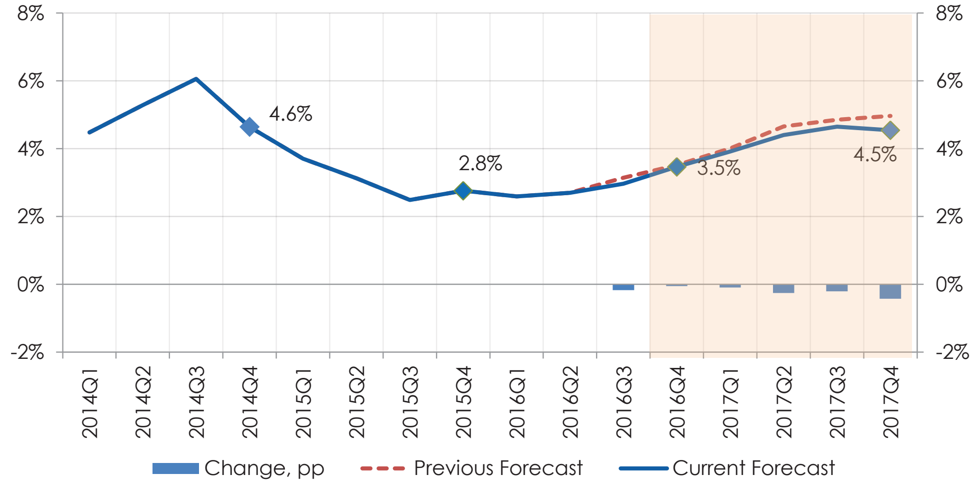
As for economic activity, the real economic growth forecast for 2016 has remained unchanged, while being revised downwards for 2017 (see Figure 2.11). As the main factors determining the forecast for 2016 remain the same, expected economic growth is still 3.5%. However, the lower estimated growth of the budget deficit than was expected in the previous period and the prolonged negative contribution of net exports to GDP caused a slight reduction in the expected economic growth for 2017, which now stands at 4.5%.

Figure 2.10 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

Figure 2.11 Changes in the Forecast of Real GDP Growth (Annual Growth of the Last Four Quarters)



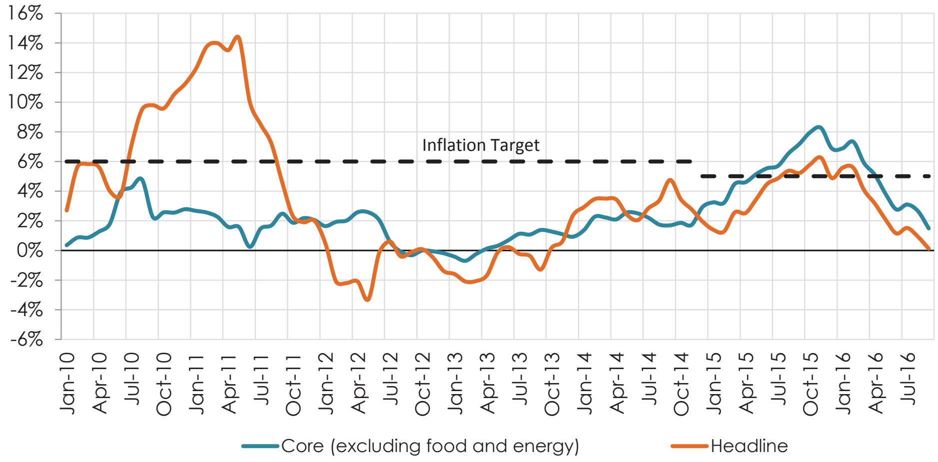
Source: National Bank of Georgia

3. Consumer Prices

In 2016, inflation has a downward trend. Headline inflation fell to 0.1% in September. Inflation is thus below the National Bank's 5% target. Core inflation[4] also decreased to 1.5% (see Figure 3.1). The lower level of headline inflation, compared to core inflation, is a consequence of the reduction of fuel prices.

« This year, inflation has a downward trend.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

Several factors ensured the reduction of inflation. Last year, the contribution of electricity fee's made to total inflation was between 0.4-0.5% percentage points. However, in September 2016 the impact of rising electricity prices eventually expired as a result of the base effect. In addition, since the beginning of the year, the contribution of food inflation to total inflation declined and was finally exhausted in September. In addition, the current low level of food inflation is related to the reduction of food prices on the world market.

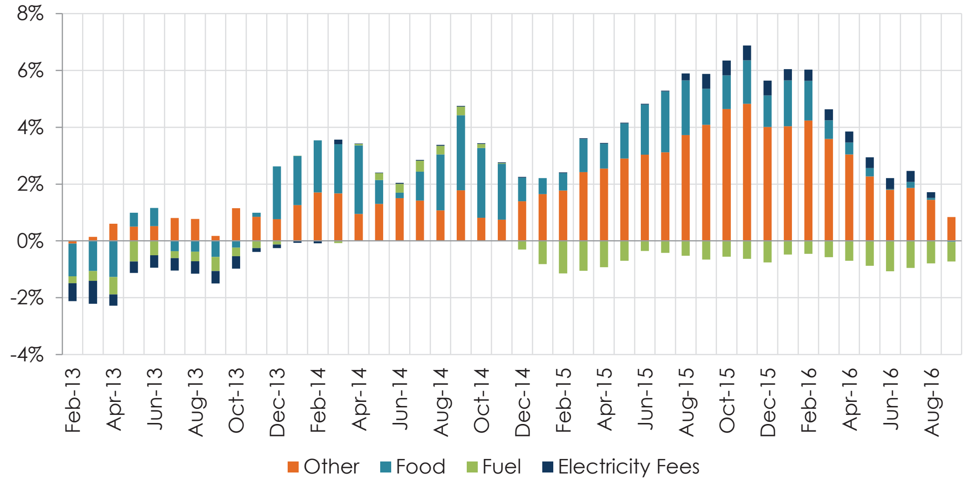
« Expiry of the base effect has largely contributed to a reduction of inflation.

Declining fuel prices are still pushing inflation downward, but the expiration of this trend is being observed. In September, the negative contribution of fuel inflation to total inflation amounted to -0.7 percentage points. On the one hand, this can be explained by the base effect, and on the other by the recent increase of oil prices on the world market.

In addition, it is noteworthy that last year's increase of excise taxes on alcoholic beverages and the price increase on durable goods (particularly home appliances) due to exchange rate depreciation, had a significant influence on prices and led to a sharp increase of inflation in 2015. With the expiration of this effect in the current year, annual inflation declined.

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

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

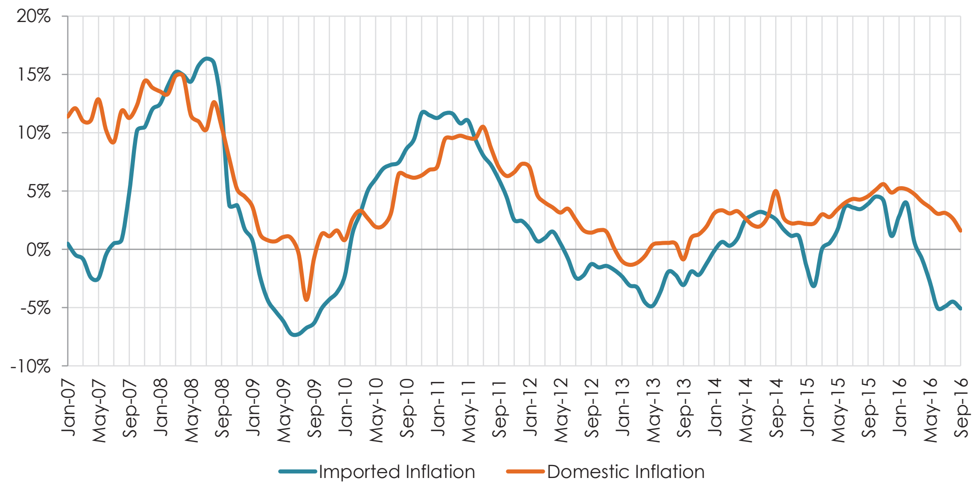


Source: GeoStat and National Bank of Georgia

By the end of the third quarter, imported inflation stood at -5.1% and its negative contribution to total inflation amounted to -1.2 percentage points. Here, the decrease of fuel prices had the most important share (-0.7 percentage points). The annual appreciation of the lari nominal effective exchange rate is also significant. Despite the depreciation of the nominal effective exchange rate in the third quarter in comparison with the previous quarter, on an annual basis it has remained significantly appreciated.

‹‹ Appreciation of the NEER contributed to a reduction of imported inflation.

Figure 3.3 Imported And Domestic Inflation



Source: GeoStat and National Bank of Georgia

External shocks had an important effect on the reduction of foreign demand. At the same time, domestic demand remains weak. This can be explained, on the one hand, by tightened monetary policy and, on the other, by augmenting the debt service burden for US dollar borrowers, thus reducing their disposable income. Weak demand is an important factor for reducing inflation and, in this case, it can be considered one of the main causes of low inflation.

‹‹ Weak demand remains one of the main causes of low inflation.

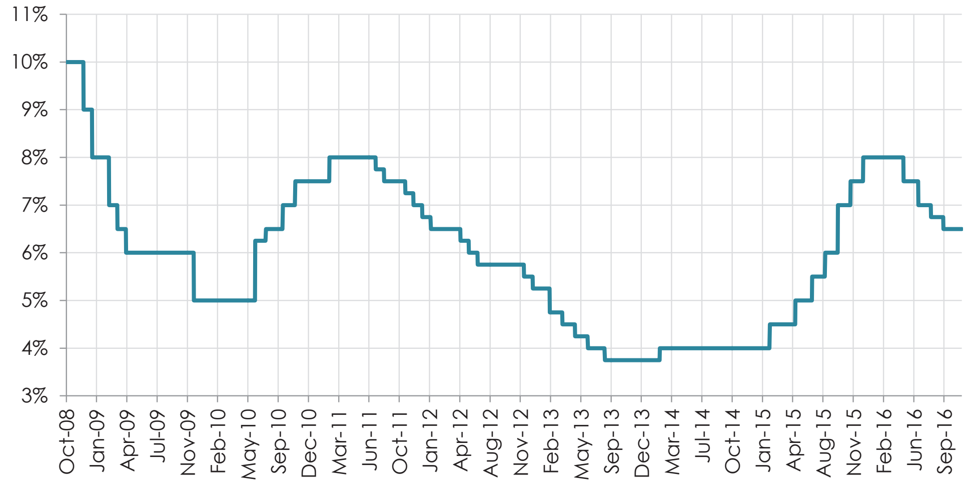
4. MONETARY POLICY

In 2016, the National Bank of Georgia started gradual phasing out of the tight monetary policy. At the beginning of the year, in meetings held in February and March, the Monetary Policy Committee (MPC) found it appropriate to leave the policy rate unchanged at 8%, since at that stage there was no need for additional monetary tightening to contain inflation. Alongside lower inflation expectations, the National Bank of Georgia started a gradual reduction of the refinancing rate and, from April, the policy rate was gradually reduced by 150 basis points to 6%.

The annual CPI dropped to 0.1% in September. This drop was due to weak aggregate demand, a decrease in expectations and falling commodity prices on world markets. At the same time, the significant decrease in inflation seen since the beginning of the year was largely caused by the base effect.

After the first quarter of 2016, headline and core inflation (excluding food and energy) had a decreasing trend and it remains below the target level. According to current NBG forecasts, the annual inflation rate in the next quarters will temporarily lie below the target before reaching the target by the end of 2017.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the National Bank's MPC was held on 26 October. At that meeting it was decided to keep the monetary policy rate unchanged at 6.5%. According to the macroeconomic forecast, and in line with weak aggregate demand and lower inflation expectations, the National Bank of Georgia continues to gradually phase out the tight monetary policy. Ceteris paribus, based on current macroeconomic forecasts, the monetary policy rate can be expected to be decreased to 6% in the coming two quarters. The reduction of the policy rate implemented during 2016 has not been completely passed on to the economy. Furthermore, the increase in confidence in monetary policy instruments has caused improvement in the monetary policy transmission mechanism, which creates an additional monetary policy easing effect. At this stage, the National Bank of Georgia thus deemed it appropriate to keep the policy rate unchanged.

‹‹ The National Bank of Georgia continues gradually phasing out the tight monetary policy.

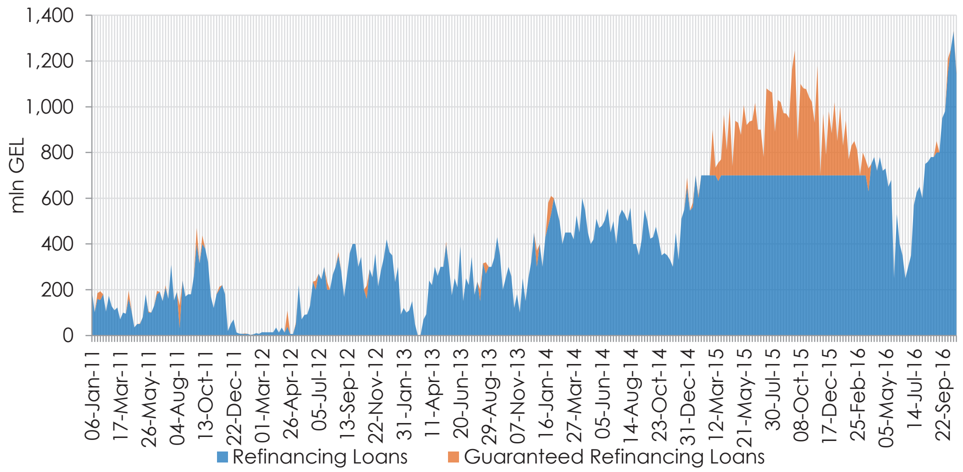
‹‹ According to the NBG's Monetary Policy Committee's decision, the monetary policy rate was kept unchanged.

The impact of external shocks on the Georgian economy has weakened. The economic recovery processes observed in various trading partner countries positively affects the Georgian economy. External demand improved in the third quarter of 2016. The decreasing trend of registered exports of goods slowed and has almost closed to zero, while the import of goods (excluding hepatitis C medications) increased by 4%.

Alongside increased tourism inflows, tourism revenues continue to grow. Based on preliminary data, in the third quarter of 2016 tourism revenues increased by 10.2%. In the first half of 2016, money transfers had a decreasing trend, but this subsequently exhibited a positive growth rate. In the third quarter of 2016 the volume of money transfers increased by 16% year-over-year, mostly money inflows from EU countries, contributed to growth.

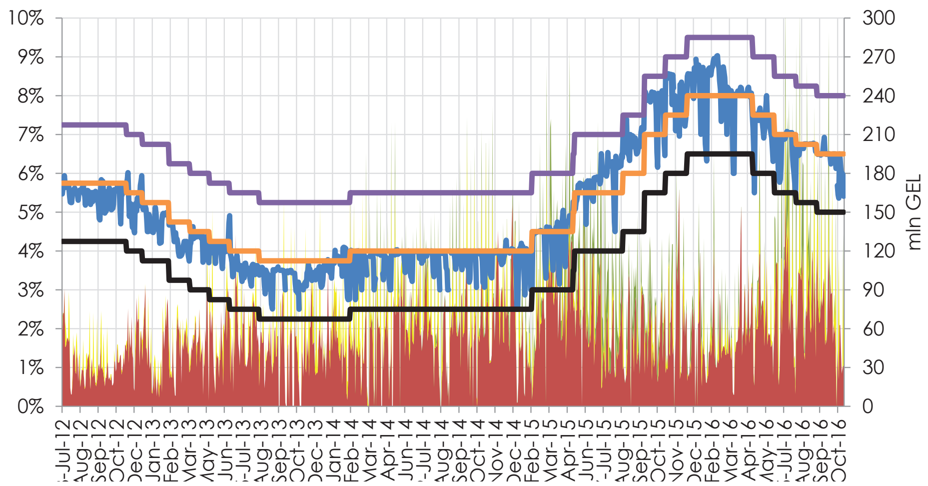
In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising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

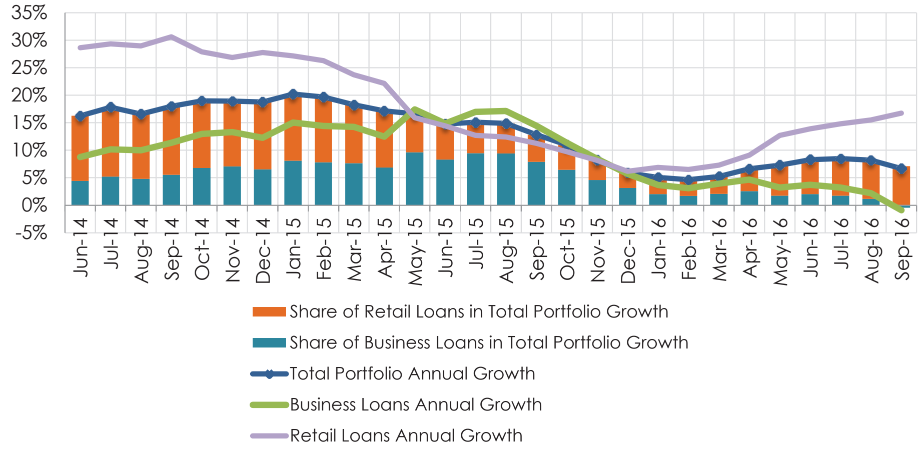
« Short-term interest rates fluctuates around the policy rate.

5. Financial Market and Trends

5.1 LOANS

In the third quarter of 2016, the annual growth rate of the loan portfolio decreased and, excluding the effect of exchange rate movement, amounted to 6.7% in September. The growth was mainly caused by the growth of retail loans, whereas the growth rate of business loans decreased. The volume of business loans in the national currency with a floating interest rate did not significantly change in September, and their share of total business loans remained at 7%. It is expected that the annual growth rate of the loan portfolio will be 5-10% by the end of the year.

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

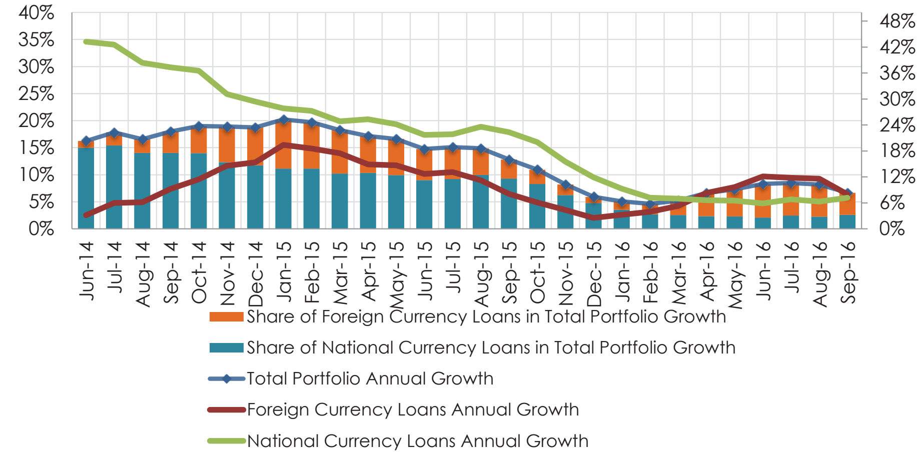


Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was largely caused by an increase in foreign currency loans. However, in September the annual growth rate of foreign currency denominated loans decreased to 6.4%, while domestic currency loans

‹‹ An increase in leverage in foreign currency makes the financial sector more vulnerable to currency shocks and increases financial stability risks.

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

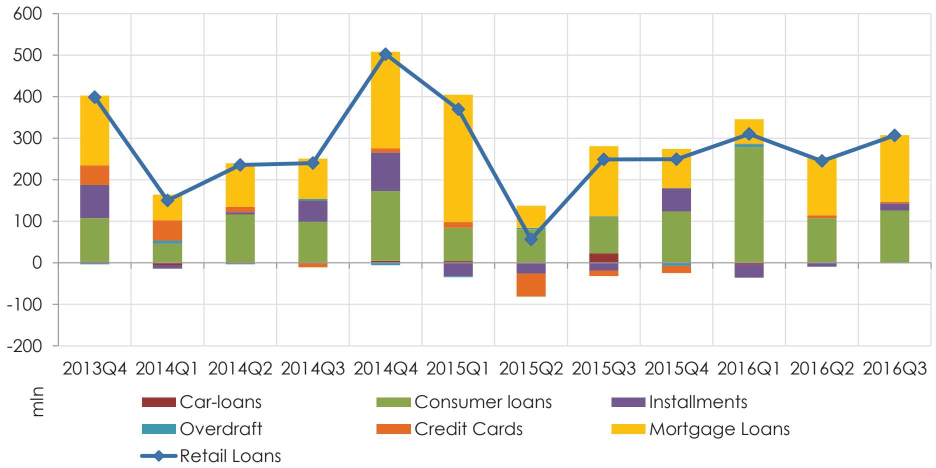


Source: National Bank of Georgia

increased by 7.2%. It should be noted that an increase in leverage in foreign currency makes the financial sector more vulnerable to currency shocks and increases financial stability risks. In the third quarter of 2016, the loan larization coefficient increased by 1.8 percentage points and amounted to 36.7%. De-dollarization is one of the priorities of the National Bank of Georgia. It should be noted that the larization of the financial sector will contribute to the appreciation of the exchange rate trend in the long run by decreasing the demand for foreign currency required for payments of foreign currency loans.

In September, the stock of retail loans increased by 306 million GEL compared to June. In terms of loan products, the amount of mortgage and consumer loans increased by 160 million and 125 million GEL respectively over the previous quarter. The volume of instant loans and credit cards, which had been decreasing during the last four quarters, increased by 21 million GEL. According to the credit conditions survey, representatives of the banking sector expect an improvement in demand for retail loans in the next quarter.

Figure 5.3 Quarterly Growth Of Retail Loans

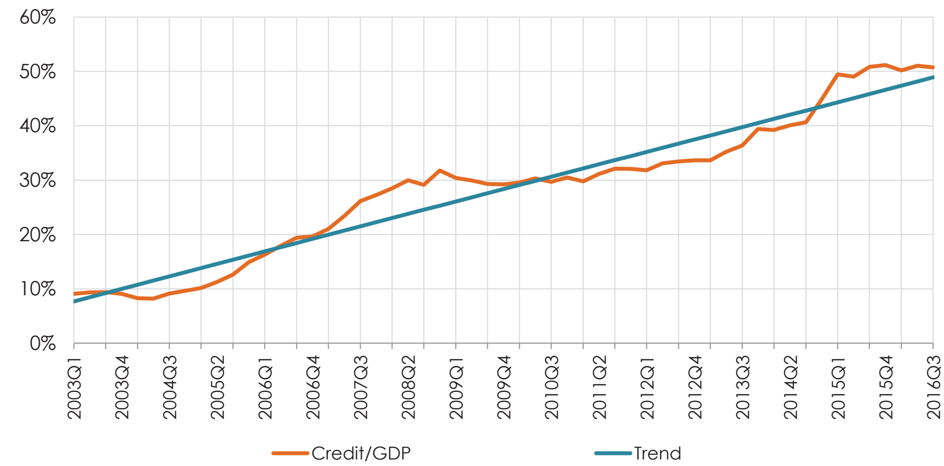


Source: National Bank of Georgia

In September, the annual growth rate of the loan portfolio to legal entities amounted to -0.9%[5], which was 4.7 percentage points lower than in June. An analysis of business loans by sector reveals that the energy, trade, agriculture and construction sectors posted slight growth in terms of credit, while the volume of outstanding loans disbursed to the manufacturing and transport sectors decreased. Representatives of the banking sector expect an improvement in demand for business loans in the next quarter.

« Representatives of the banking sector expect an improvement in demand for business loans in the next quarter.

Figure 5.4 Credit To GDP Gap



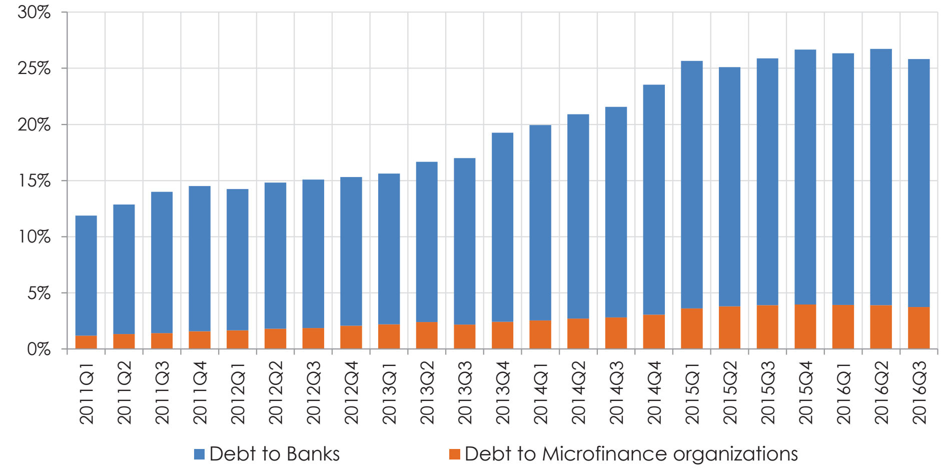
Source: National Bank of Georgia

5 *Excluding the exchange rate effect.*

Compared to the previous quarter, the credit to GDP ratio[6] decreased by 0.3 percentage points and amounted to 50.8%. The credit to GDP ratio is currently above the trend[7] by 1.9 percentage points.

In the third quarter of 2016, the individuals' loans to net national disposable income ratio decreased by 0.9 percentage points compared to the previous quarter and amounted to 25.8%. Debt to commercial banks accounted for 85% 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 decreased by 0.1 percentage point in the third quarter of 2016 and amounted to 8%. According to the data from September, the share of non-performing loans in the national currency increased by 0.1 percentage point compared to June, amounting to 5.9%. Meanwhile, the share of non-performing foreign currency loans decreased by 0.1 percentage point and equaled 9.4%. The amount of loans written off in the third quarter amounted to 63 million GEL, which caused the share of non-performing loans to decrease by 0.4 percentage points

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

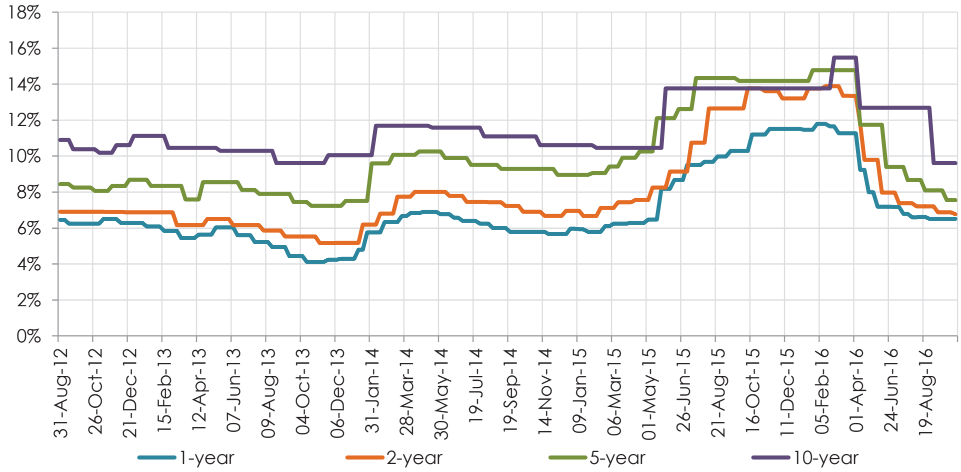
In October 2016, the monetary policy rate equaled 6.5%. In the third quarter of 2016, interest rates on government securities continued to decrease. This trend, together with a decrease in the policy rate, was a result of both a decrease in liquidity risk, which was mainly due to a recovery of belief in monetary instruments, and a decrease of interest rate risk, which was caused by the publication of the policy rate trajectory by the National Bank.

The spread between long-term assets and the monetary policy rate decreased because of lower inflationary expectations; meanwhile, the publication of the policy rate trajectory by the National Bank increased belief in a decrease of the monetary policy rate.

6 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.

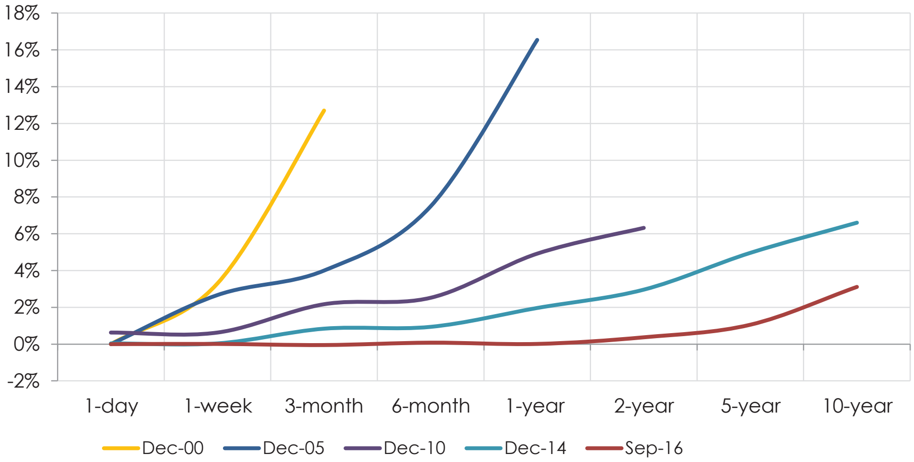
7 An HP filter is used to assess the trend. Based on Basel recommendations, lambda is equal to 400,000.

Figure 5.6 Interest Rates On Government Securities



Source: National Bank of Georgia

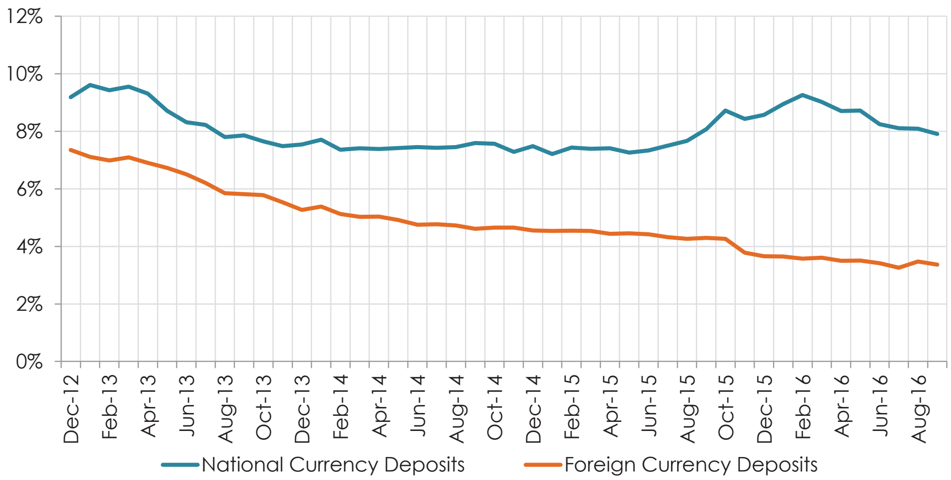
Figure 5.7 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits decreased by 0.3 percentage points and amounted to 7.9%, while for foreign currency deposits the interest rate decreased by 0.1 percentage point and amounted to 3.4%. The fall in interest rates on domestic currency deposits was caused by a decrease in the monetary policy rate. According to the credit conditions survey, the cost of domestic currency deposits is expected to decrease in the next quarter.

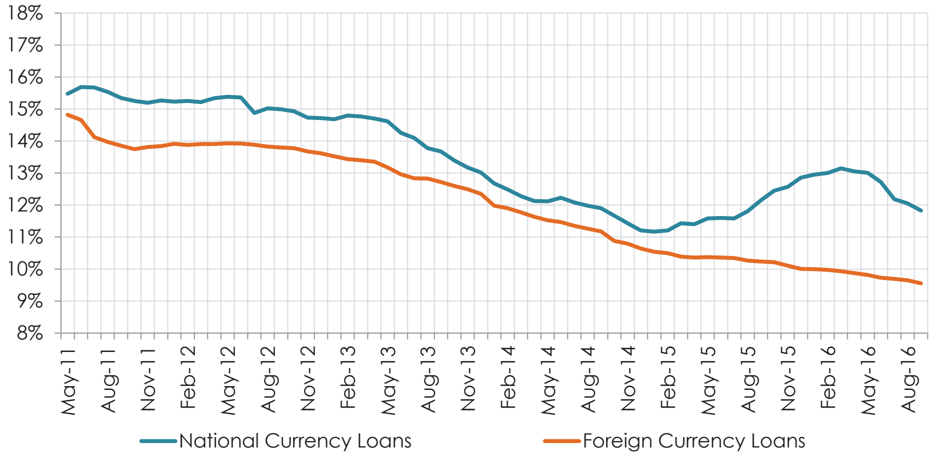
Figure 5.8 Average Interest Rates On Deposits



Source: National Bank of Georgia

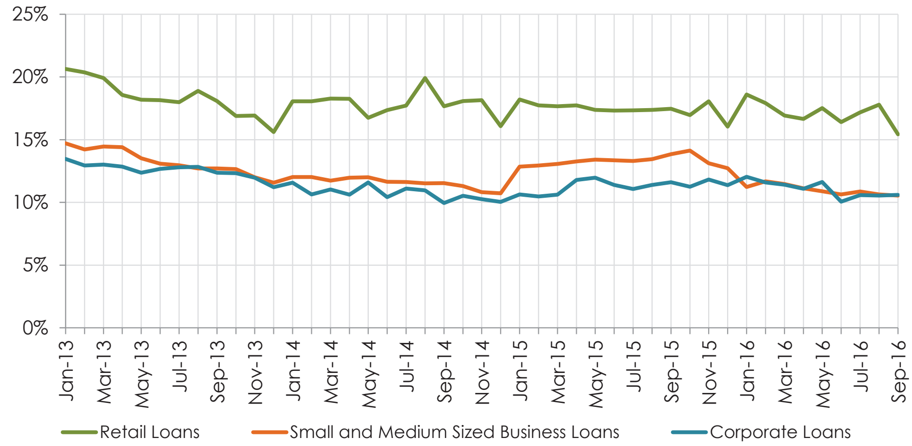
According to the credit conditions survey, in the third quarter of 2016 credit conditions slightly softened for both individuals and legal entities. The softening of supply conditions was caused by general economic trends, decreased financial costs and increased competition. Of the changes in non-interest conditions, the change in maturity conditions has to be highlighted. The softening has mainly been reflected on the interest rates of domestic currency loans, but interest rates on foreign currency loans continue to decrease because of reduced demand for long-term foreign currency loans resulting from increased currency risk. In September, interest rates on the flow of corporate loans increased by 0.5 percentage points compared to June and amounted to 10.6%. Interest rates on loans to small and medium businesses decreased by 0.1 percentage point and amounted to 10.5%, while rates on retail borrowings decreased by 1 percentage point and amounted to 15.4%. In the context of currencies, interest rates on business loans in the domestic currency decreased by 0.9 percentage points, while interest rates on foreign currency loans declined by 0.3 percentage points. According to the credit conditions survey, credit conditions are expected to soften in the next quarte r. It should be noted that foreign currency loans with low interest rates can appear risky for the financial sector and it is therefore essential that representatives of the banking sector take these threats into account while pricing those loans. If the US interest rate increases globally, commercial banks might face difficulties in refinancing their funds at acceptable interest rates.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow



Source: National Bank of Georgia

Box 1 Monetary Policy Rate Path

The NBG's inflation targeting regime requires transparency of monetary policy and active communication with the public. These features help economic agents to have proper expectations regarding the execution of monetary policy and improve the effectiveness of monetary policy in general.

In order to improve communication with the public and increase transparency, since August 2014 the NBG has been announcing possible future monetary policy decisions in press releases. This is an important step to influence expectations and therefore to maintain control over long-run rates. Possible future decisions are based on certain assumptions, and this does not mean that the NBG will make the exact same decisions in future. Possible future decisions should be understood as being the optimal policy reaction based on the information available at a given period of time and in the absence of any other shocks. Correspondingly, if new shocks appear, the optimal monetary policy reaction may change.

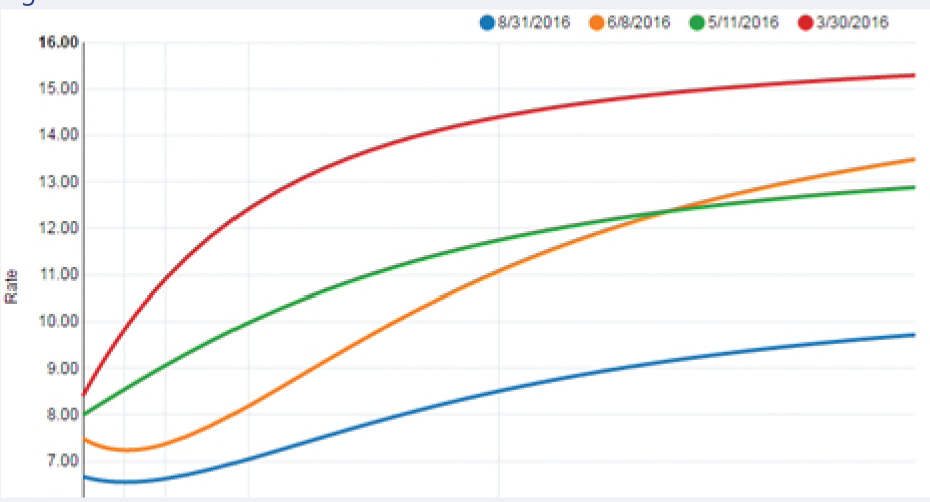
In May 2016, the NBG moved to a new phase of its monetary policy communication and started publishing the probable monetary policy rate path in a monetary policy report (see Figure 2.7). The probable monetary policy rate path will help both financial and non-financial sectors to form proper expectations. Increased transparency and proper expectations promote a smaller spread between the policy rate and interest rates and enable better control of long-term interest rates.

Interest rates on securities have had a downward trend in general in 2016. Since the end of March, the spread between interest rates and the policy rate reduced significantly. This can be explained by a gradual decrease of the policy rate (starting from April 2016) and by the reduced risk for banks to access liquidity (from March 2016 it became clear that the NBG would supply the necessary amount of liquidity to the market). Publishing the possible policy rate path also had a contribution to the reduction of spreads as through these it became clear that the NBG would continue to decrease the policy rate.

Figure 5.11 presents the lari yield curve, which represents the relationship between interest rates and remaining maturity. The NBG started publishing the lari yield curve in November 2015. This shows the yield on riskless securities (government Treasury notes and the NBG's certificates of deposit – CDs) on the Georgian money market. The yield curve is an important feature of developed markets. It shows what minimal yield is acceptable for investors when making riskless investments and takes into account many factors such as inflation expectations and the expected change in interest rates. As can be seen in Figure 5.11, spreads on long-term rates have decreased significantly. In the last week of August 2016 (the blue line on the figure), interest rates on 2-, 5- and 10-year securities decreased by 6.2, 5.2 and 5.9 percentage points respectively, compared to the peak level at the end of March 2016 (the red line on the figure). Meanwhile, the policy rate decreased by only 1.5 percentage point. Short-term rates came very close to the policy rate. By comparing the green and yellow lines on the diagram, one can notice that one month after (since June 8) publishing the probable policy rate path, the short-term part of the yield became inverted and this trend has been maintained since then (the blue line on the figure). The yield on 3- and 6-month CDs are lower than the rates on TIBR1 and TIBR7.[8] The latter indicates that the future decrease of interest rates have been transmitted into expectations, since the probable policy rate path is being published.

By publishing the monetary policy rate path, the NBG has obtained an additional instrument to influence expectations. Control of expectations enables higher effectiveness of the monetary policy transmission mechanism. In addition, more transparency increases the trust of the financial sector in monetary policy and monetary operations and decreases risk appetite, which is reflected in the spread reduction.

Figure 5.11 Lari Yield Curve



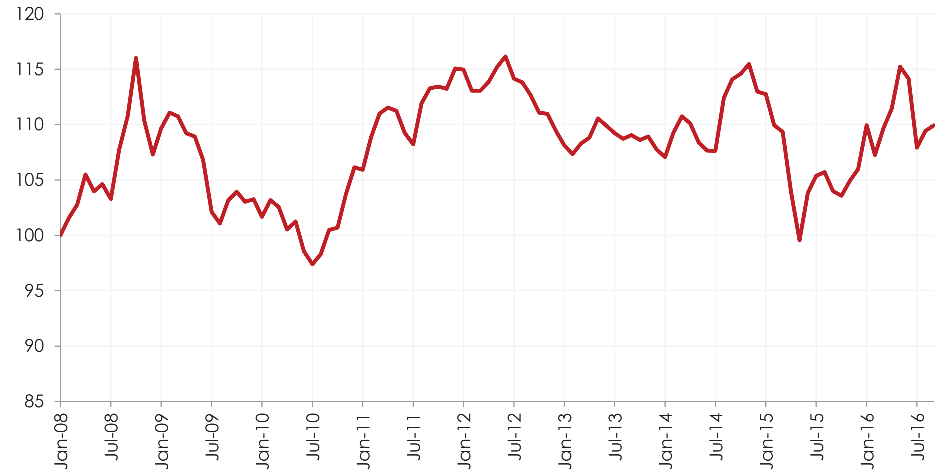
Source: National Bank of Georgia

8 *The Tbilisi interbank market rates for deals on 1 and 7 days.*

5.3. EXCHANGE RATE

In the third quarter of 2016, the lari exchange rate appreciated slightly against the US dollar by 0.3%, with the exchange rate averaging 2.32. The GEL appreciated slightly against the euro (by 0.9%), the Turkish lira (by 2.3%) and the Azerbaijani manat (by 1.9%), but depreciated against the Ukrainian hryvnia and the Russian ruble by 4.5% and 4.7% respectively. As a result, during the third quarter of 2016 the nominal effective exchange rate depreciated by 3.4% compared to the previous quarter and rose by 7.7% on a year on year basis. The real effective exchange rate depreciated by 4.3% while the year on year appreciation totaled 3.9%.

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



Source: National Bank of Georgia

As Table 5.1 shows, in the third quarter of 2016 the real exchange rate appreciated on a year on year basis against the Eurozone, Ukraine, Armenia and Azerbaijan.

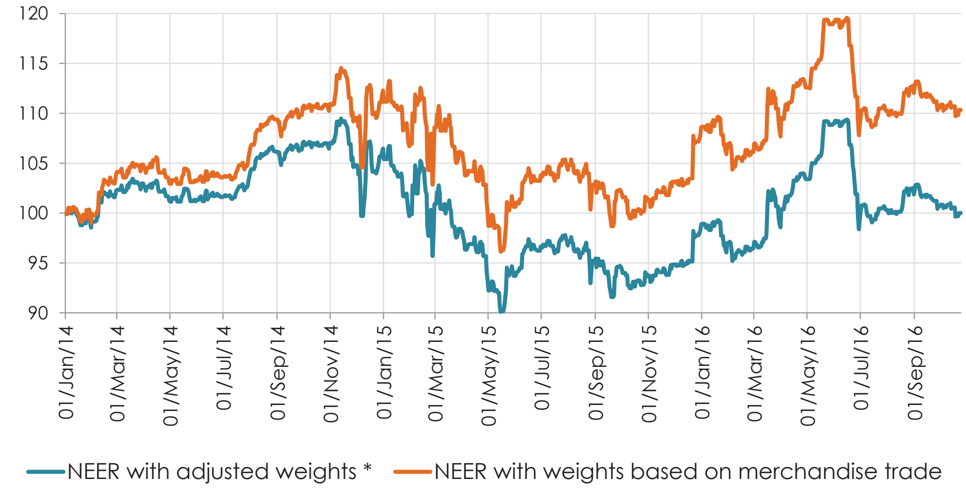
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate	7.7	3.9	3.9
Eurozone	-0.3	0.3	0.1
Turkey	4.1	-2.9	-0.6
Ukraine	17.5	9.7	0.7
Armenia	-0.4	2.1	0.1
The United States	0.1	-0.2	0.0
Russia	2.7	-3.1	-0.3
Azerbaijan	55.0	38.9	4.5
Other	-0.2	-0.1	-0.6

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, paints a slightly different picture. In the third quarter, the adjusted nominal effective exchange rate appreciated by 5.2% year on year and by 5.3% 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

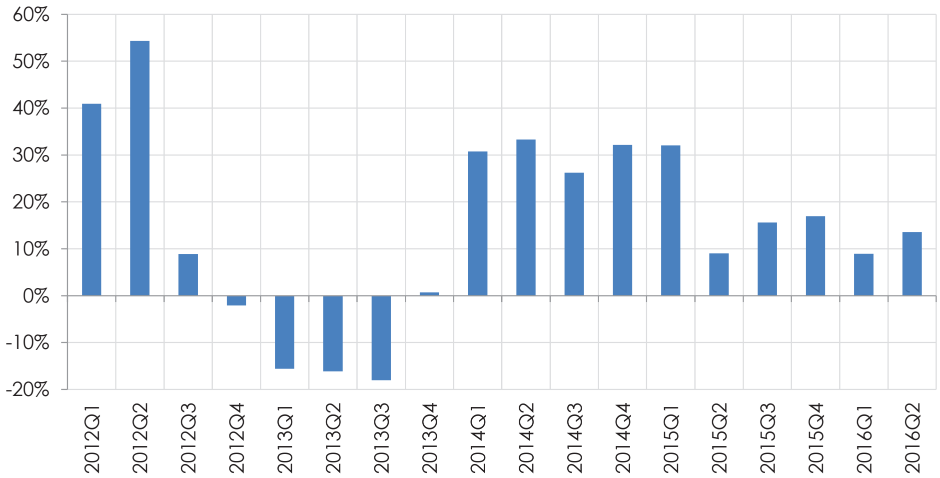
Real GDP growth amounted to 3% in the second quarter of 2016 , with a rise in investments being the main determinant of economic growth. Weakened internal and external demand was responsible for the low growth rate of the economy. According to the current forecast, investments will continue to be the main driving force of GDP growth.

‹‹ Real GDP growth amounted to 3% in the second quarter of 2016.

The capital formation growth rate increased in second quarter of 2016 and posted 13.6%. The higher growth rate of investments played a decisive role in GDP growth. Alongside domestic investments, FDI also had a share in capital formation growth. BP's investment in a new pipeline project made the most important contribution to the growth of foreign investments, whereas government infrastructure projects contributed to the rise of domestic investments.

‹‹ The capital formation growth rate increased in second quarter of 2016 and posted 13.6%.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

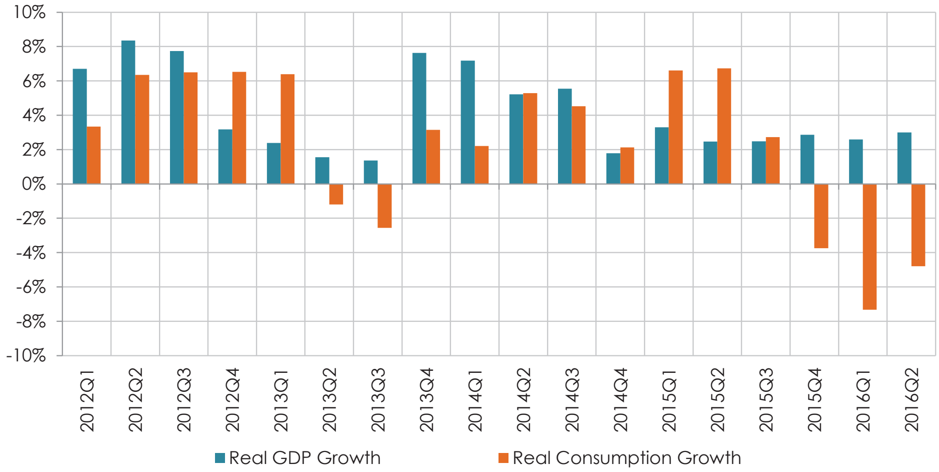
Weakening internal demand in the second quarter was reflected in consumption. Real growth of private consumption[9] remained negative in the second quarter of 2016 and posted -4.8%. However, the annual rate of decline was much less than it was in the first quarter.

External demand remains weak, although some positive trends can be noticed. The net exports balance worsened by 13.7% on annual terms in second quarter, which was due to a decrease in exports and an increase in imports.[10] The real change in external trade is interesting: exports posted positive real growth in annual terms in second quarter, which means that the negative annual nominal growth is a result of decreased prices on exported goods. According to preliminary data, exports posted positive annual growth in both nominal and real terms in third quarter. Imports increased annually in the second quarter of 2016 (in both nominal and real terms). Investment goods contributed most to the growth of imports, while consumer goods made a negative contribution because of the real negative growth rate of consumption. According to preliminary data, imports increased slightly in the third quarter of 2016, thanks to the growth in investment goods.

The consolidated budget deficit posted 810.1 mln GEL in the first three quarters of 2016. The deficit of the third quarter posted 326.5 mln GEL. The overall consolidated budget deficit for 2016 is planned to be approximately 1,035 mln GEL and this should be more equally distributed among quarters compared to the previous year.

9 *The real growth of consumption is calculated using average annual inflation.*
10 *Here, one-off factors (hepatitis C medicaments) are excluded from imports.*

Figure 6.2 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

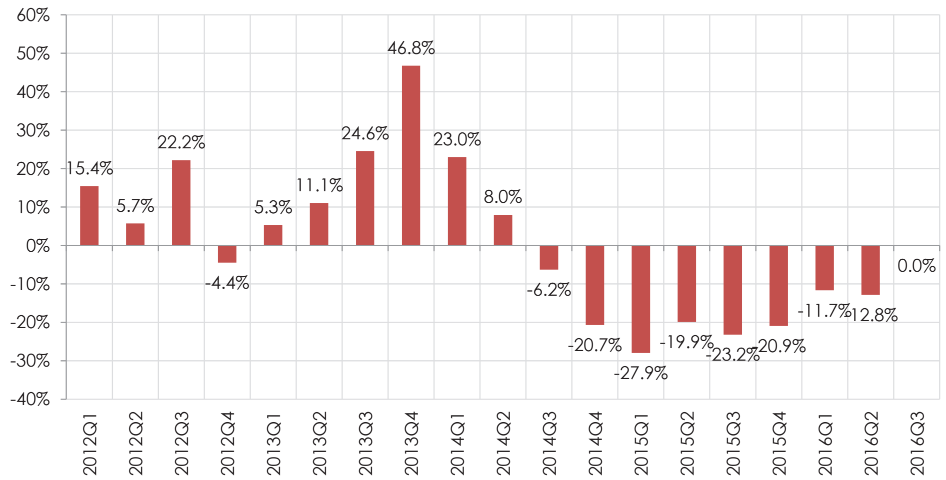
In the third quarter of 2016, the decreasing rate of registered exports of goods slowed and then increased by 8.3% in September. The improvement of exports was mainly caused by the base effect and economic recovery in various trading partner countries: the recovery of Ukrainian economic processes during 2016 improved Georgian exports; furthermore, IMF projections show that although the economic growth of Russia remains negative in 2016, it has improved compared to the previous year, which has an upward impact on Georgian exports. In contrast, the deteriorated economic situation in Azerbaijan has been reflected negatively on Georgian exports.

‹‹ In the third quarter of 2016, the decreasing rate of registered exports of goods slowed and increased by 8.3% in September. The improvement of exports was mainly caused by the base effect and economic recovery in various trading partner countries.

Exports with EU countries have been characterized by an increasing trend and Germany and Italy have been major contributors to that growth.

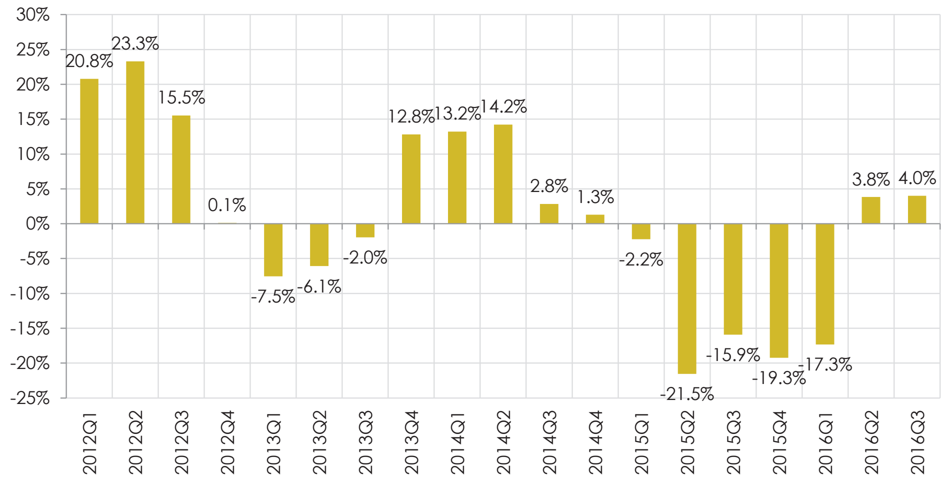
An increase in re-exports of copper and motor cars had a positive impact on exports. In addition, Canada and EU countries increased demand for Georgian nuts, which made a positive contribution to export growth.

Figure 7.1 Annual Change Of Registered Exports Of Goods



Source: GeoStat

Figure 7.2 Annual Change Of Registered Imports Of Goods[11]



Source: GeoStat

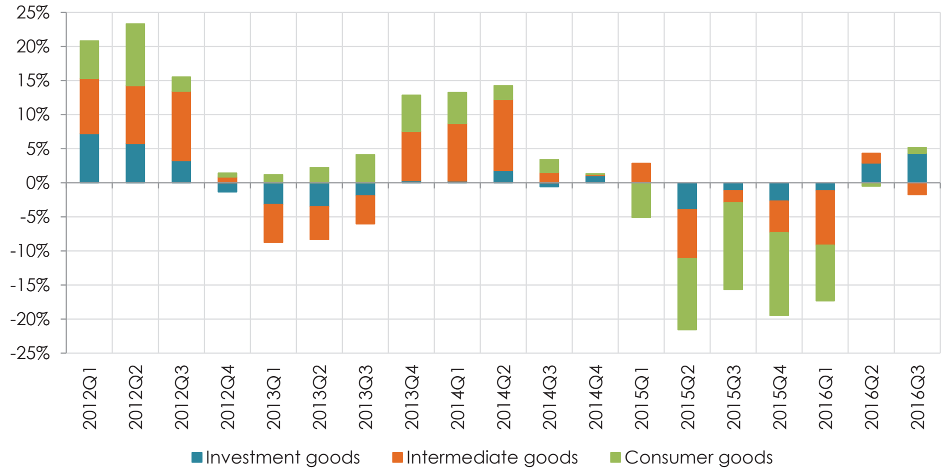
11 *Excluding imports of hepatitis C medicaments.*

It is worth noting that the decreasing trend of imports has stopped and imports have started to increase. In the third quarter of 2016, registered imports of goods (excluding hepatitis C medicaments) increased by 4%. The enlarged volume of foreign direct investments provided significant stimulus for imports of investment goods.

« In the third quarter of 2016, imports of goods increased, mostly due to enlarged volume of foreign direct investment.

In the third quarter of 2016, imports of investment goods contributed 4.4 percentage points to the increase in aggregate imports. Because of weak domestic demand, from the first quarter of 2015 imports of consumption goods had a decreasing trend that was negatively reflected on the volume of aggregate imports. However, in the third quarter of 2016 imports of consumption goods increased and made a positive contribution to growth.

Figure 7.3 Annual Change Of Registered Imports By Category Of Goods[12]



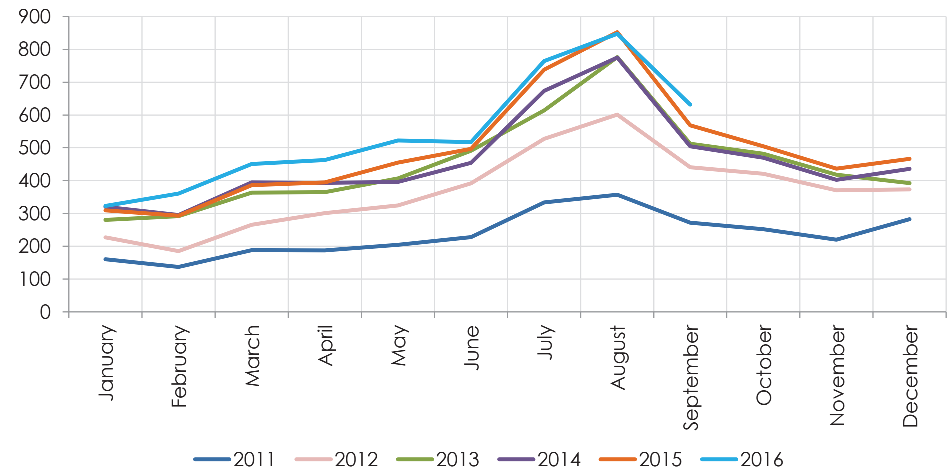
Source: GeoStat

Inflows of international visitors,[13] especially tourist arrivals , have continued to grow. In the third quarter of 2016, the number of international visitors who entered Georgia increased by 3.9% year over year. The major contributor to this growth was tourist inflows. In the third quarter of 2016, tourists comprised 51.1% of overall arrivals – an increase of 20.8% year over year. Visa liberalization with Iran has had a particularly positive effect on Georgian tourism. In the third quarter of the current year, international arrivals from Iran increased by 583% year over year. Arrivals from neighboring countries Azerbaijan, Russia and Ukraine and also from Israel have increased significantly. However, from May the number of visitors from Turkey fell. In the third quarter of 2016, tourism revenues rose by 10.2 % year over year in line with the increasing number of international visitors.

« In the third quarter of 2016, the number of international visitors who entered Georgia increased annually by 3.9% year on year.

« In the third quarter of 2016, tourism revenues rose by 10.2% year over year in line with the increasing number of international visitors.

Figure 7.4 Number Of Incoming Visitors To Georgia



Source: GNTA

12 *Excluding imports of hepatitis C medicaments.*
13 *International visitors who stayed in Georgia for 24 hours or more.*

In the third quarter of 2016, money transfers from abroad increased by 16% percent year over year. Greece was the main source of this increase. It is worth noting that in the same period of the previous year remittances from Greece had fallen sharply as a result of temporary restrictions on foreign currency transactions. The drivers of increased money transfers to Georgia were the USA, Israel, Turkey and Italy. Remittances from Russia have continued to decline, but at a lower rate. The decreased money transfers from Russia were compensated by increased money inflows from EU countries. In the third quarter of 2016, money transfers from Russia decreased by 7.4% year over year, while money inflows from EU countries increased by 44.5% compared to the same period of the previous year.

‹‹ In the third quarter of 2016, money transfers to Georgia increased by 16% year-over-year, mostly due to increased money inflows from EU countries.

In the second quarter of 2016 , the current account deficit increased by 199.6 mln USD compared to the same period of the previous year, and amounted to 13.4% of GDP. The decline of exports and the growth of imports caused the trade balance to deteriorate, which negatively affected the current account. At the same time, the increase of reinvested income placed downward pressure on the current account balance. However, it is worth noting that the latter transaction is part of the financial account and therefore does not cause capital outflow or create additional demand for foreign currency. Meanwhile, an increase of the balance of services had a positive impact on the current account balance.

‹‹ In the second quarter of 2016, the increase of reinvested income caused the current account balance to deteriorate.

Foreign Direct Investments (FDI) are the main source of financing the current account deficit. In the second quarter, FDI in Georgia amounted to 445.3 mln USD. Transport and communications was the largest recipient sector of FDI with 174.7 mln USD (39.2% of total FDI), but compared to the same period of the previous year the amount this sector received declined. The financial (59.8 mln USD) and energy (45.7 mln USD) sectors were other significant recipients of FDI.

Box 2 External Debt DSA for Georgia

Debt Stability Analysis (DSA) analyses debt dynamics for the next 20 years. The baseline scenario is created by assumptions of key macro variables related to the debt burden. Several additional shock scenarios are also analyzed to check the sustainability of debt in times of macroeconomic challenges. The purpose of DSA is to reveal possible risks for debt sustainability.

Three indicators are used to analyze external and government debt sustainability. Each has a threshold value, which if exceeded indicates risks for DSA.

- For External DSA:
  - NPV[14] of external debt stock to GDP (threshold 60%);
  - NPV of external debt stock to exports (threshold 200%);
  - External debt service to exports (threshold 25%).
- For Government DSA:
  - NPV of government debt stock to GDP (threshold 60%);
  - NPV of government debt stock to budget revenues (threshold 300%);
  - Government debt service to budget revenues (threshold 35%).

The baseline scenario holds the following main assumptions:

- Long-term GDP real growth is 4%;
- CPI inflation in the long term is 3%;
- Equilibrium long-term CA deficit is 6% of GDP;
- Long-term consolidated budget deficit is 2% of GDP;
- A total of 60% of the budget deficit is financed by foreign debt;
- The GEL/USD exchange rate remains constant at 2.4 (current rate).

Shock scenarios, compared to the baseline:

- One-time shocks (in 2017):
  - GDP real growth shock (-8 percentage points[15]);

14 *Net Present Value: today's value received by summing up future discounted flows.*
15 *Numbers represent deviation from the baseline scenario data in case of shock.*

– Exports growth shock (-3 percentage points);
– Budget deficit shock (+3 percentage points) and gradual (not immediate) reversion to baseline scenario level;
– Shocks in current transfers and net FDI (+3 percentage points of GDP ratio);
– Exchange rate shock (GEL/USD exchange rate has 20% depreciation);
– Combo shock: a combination of other shocks (a smaller magnitude of each).

- Permanent shocks (starting from 2017):

– GDP real growth shock (-0.6 percentage points);
– Exports growth shock (-0.6 percentage points);
– Budget deficit shock (+0.2 percentage points)
– Shocks in current transfers and net FDI (both -0.8 percentage points of GDP ratio);
– Exchange rate shock (GEL/USD exchange rate has 1% depreciation every year);
– Interest rate shock on new debt (+2 percentage points);
– Combo shock: a combination of other shocks (a smaller magnitude of each).

The results of the external DSA are presented in Tables 7.1 and 7.2.

Baseline scenario results: stock indicators[16] have a downward slope. The debt to GDP indicator is initially well above the threshold line and needs the whole projection period to reach the threshold, while the debt to exports indicator is below the threshold. The debt service indicator is decreasing initially, but it starts increasing after 2020, unlike the debt stock ratios. The reason behind this is that a significant part of government external debt consists of concessional loans. As the DSA follows a conservative approach, the government is assumed to take new external debt on commercial terms, like the private sector (and correspondingly does not enjoy long grace periods and pays more interest). Furthermore, according to the conservative approach, new private sector debt is assumed to have a shorter maturity than the current debt stock (15 years instead of 20 years), which results in higher amortization payments than there would have been otherwise. As a result, over time the greater the share that new borrowing (taken in the projection period) takes of total debt, the higher the debt service burden will get. However, it should be noted that close to the end of the projection period, the debt service to exports ratio loses the upward trend.

Temporary shocks (see Table 7.1): in the post-shock period both debt stock indicators follow a downward path, as in the baseline scenario. Within the whole projection period, the debt to exports indicator stays below the threshold. While it is encouraging to see the debt to GDP indicator decreasing in the post-shock period (in all cases), it should be noted that even the baseline scenario needs the whole projection period to reach the threshold line and the shock scenarios thus cause the indicator to take more time. As for the debt service indicator, in two shock scenarios (exchange rate and GDP growth shocks) the indicator increases but subsequently stabilizes below the threshold level. In the case of transfers and investment shock, the indicator temporary exceeds the threshold level and then falls below the threshold within the projection period. The exports and combo shock scenarios make the indicator breach the threshold line and continue an upward path. A sharp increase of the debt service burden in the shock scenarios could be due to the much shorter maturity of additional debt borrowed in the case of shock.

Permanent shocks (see Table 7.2): unsurprisingly, sooner or later permanent shocks have a cumulative effect and cause a significant deviation of indicators from the baseline scenario. In most of cases, after some time the indicators breach the threshold and continue to increase. Only in the interest rate and exchange rate shock scenarios do the indicators stay on a non-increasing path.

As can be seen, two out of three indicators stay within the threshold under the baseline scenario. Although the third one (the NPV of debt to GDP ratio) is too high, it has a downward trend. Several shock scenarios cause a breach of the debt service burden threshold and in most cases the debt to exports ratio stays within the limits. Based on these, the risk of external debt distress can be assessed as moderate.

Table 7.1 External debt - One-time shocks

		2015	2020	2025	2030	2035
Baseline Scenario	NPV Debt / GDP	**84,0%**[17]	**80,7%**	**71,2%**	**65,2%**	**61,0%**
	NPV Debt / Exp.	187,6%	170,7%	147,2%	128,9%	121,9%
	Debt service / Exp.	20,0%	17,0%	18,3%	18,3%	17,6%
Exports growth rate shock (-3 percentage points)	NPV Debt / GDP	**84,0%**	**88,1%**	**84,3%**	**83,7%**	**84,7%**
	NPV Debt / Exp.	187,6%	194,7%	178.7%	169,7%	173,5%
	Debt service / Exp.	20,0%	20,9%	**26,9%**	**29,4%**	**30,8%**

16 NPV of debt stock ratio to GDP.
17 Bolded numbers are higher than the threshold.

		2015	2020	2025	2030	2035
GDP real growth rate shock (-8 percentage points)	NPV Debt / GDP	**84,0%**	**89,0%**	**79,4%**	**74,2%**	**71,2%**
	NPV Debt / Exp.	187,6%	188,4%	164,0%	146,7%	142,1%
	Debt service / Exp.	20,0%	19,4%	21,2%	21,8%	21,7%
Current transfer and FDI shock (-3 percentage points)	NPV Debt / GDP	**84,0%**	**92,1%**	**81,8%**	**75,1%**	**70,5%**
	NPV Debt / Exp.	187,6%	194,9%	168,9%	148,5%	140,7%
	Debt service / Exp.	20,0%	24,0%	**25,6%**	24,4%	22,6%
Exchange rate 20% depreciation	NPV Debt / GDP	**84,0%**	**100,3%**	**90,4%**	**85,2%**	**82,4%**
	NPV Debt / Exp.	187,6%	172,2%	151,6%	136,6%	133,4%
	Debt service / Exp.	20,0%	17,2%	19,4%	20,4%	20,5%
Combo (One-time)	NPV Debt / GDP	**84,0%**	**96,5%**	**92,1%**	**91,5%**	**92,6%**
	NPV Debt / Exp.	187,6%	199.8%	186,0%	176,8%	180,8%
	Debt service / Exp.	20,0%	23,6%	**29,2%**	**31,5%**	**32,7%**

Table 7.2 External debt - Permanent shocks

		2015	2020	2025	2030	2035
Baseline Scenario	NPV Debt / GDP	**84,0%**[18]	**80,7%**	**71,2%**	**65,2%**	**61,0%**
	NPV Debt / Exp.	187,6%	170,7%	147,2%	128,9%	121,9%
	Debt service / Exp.	20,0%	17,0%	18,3%	18,3%	17,6%
Exports growth rate shock (-0.6 percentage points)	NPV Debt / GDP	**84,0%**	**83,1%**	**82,2%**	**91,2%**	**107,7%**
	NPV Debt / Exp.	187,6%	179,7%	178,4%	194,7%	**238,8%**
	Debt service / Exp.	20,0%	18,1%	24,9%	**33,8%**	**45,3%**
GDP real growth rate shock (-0.6 percentage points)	NPV Debt / GDP	**84,0%**	**83,4%**	**78,6%**	**79,0%**	**83,3%**
	NPV Debt / Exp.	187,6%	172,5%	154,2%	144,1%	149,0%
	Debt service / Exp.	20,0%	17,3%	20,0%	22,2%	24,3%
Current transfer and FDI shock (-0.8 percentage points)	NPV Debt / GDP	**84,0%**	**86,9%**	**84,7%**	**85,7%**	**88,3%**
	NPV Debt / Exp.	187,6%	183,9%	175,0%	169,4%	176,2%
	Debt service / Exp.	20,0%	19,7%	**26,1%**	**29,6%**	**31,8%**
Exchange rate 1% depreciation	NPV Debt / GDP	**84,0%**	**84,1%**	**78,7%**	**77,2%**	**78,2%**
	NPV Debt / Exp.	187,6%	171,2%	148,9%	133,1%	129,7%
	Debt service / Exp.	20,0%	17,0%	18,7%	19,4%	19,5%
Int. rate shock Permanent 2 percentage points	NPV Debt / GDP	**84,0%**	**81,4%**	**72,7%**	**67,4%**	**64,1%**
	NPV Debt / Exp.	187,6%	172,3%	150,1%	133,3%	127,9%
	Debt service / Exp.	20,0%	17,0%	18,7%	19,4%	19,5%
Combo (Permanent)	NPV Debt / GDP	**84,0%**	**90,1%**	**98,9%**	**118,9%**	**149,1%**
	NPV Debt / Exp.	187,6%	186,0%	193,6%	**216,2%**	**265,8%**
	Debt service / Exp.	20,0%	19,5%	**29,5%**	**40,4%**	**53,0%**

The results of the government DSA are presented in Tables 7.3 and 7.4.

In the baseline scenario, debt stock indicators have a slightly upward trend, but these are far from the threshold level. The debt service indicator also stays below the threshold; however, the trend is clearly upward for the whole period. The majority of government external debt consists of concessional loans. As the DSA is based on a conservative approach, new debt is assumed to be taken on commercial terms and thus interest payments increase significantly.

18 Bolded numbers are higher than the threshold.

In the case of temporary shocks, debt stock indicators remain below the threshold without having an upward trend. As for permanent shocks, the indicators remain below the threshold for the projection period, but unlike the case of temporary shocks, the indicators have an upward trend. Debt service indicators have an upward trend in all shock scenarios, and in the case of permanent shocks (excluding the exchange rate permanent shock) these breach the threshold level.

As can be seen, debt stock indicators remain below the threshold and these stabilize (do not have an upward trend) in the case of the baseline and temporary shocks scenarios. The debt service indicator obtains an upward trend and in the case of permanent shocks, the threshold is breached. Based on these facts, the risk of external debt distress can be assessed as moderate.

Table 7.3 Government debt - One-time shocks

		2015	2020	2025	2030	2035
Baseline Scenario	NPV Debt / GDP	25,1%	29,0%	30,0%	30,9%	31,6%
	NPV Debt / Rev.	89,9%	120,1%	130,6%	134,3%	137,5%
	Debt service / Rev.	8,0%	13,7%	19,9%	22,4%	23,7%
Budget primary deficit shock (+3 percentage points)	NPV Debt / GDP	25,1%	34,4%	34,9%	35,2%	35,6%
	NPV Debt / Rev.	89,9%	142,5%	151.6%	153,2%	154,6%
	Debt service / Rev.	8,0%	17,0%	24,5%	**26,3%**[19]	**27,7%**
GDP Real Growth Rate Shock (-8 percentage points)	NPV Debt / GDP	25,1%	**37,1%**	**37,4%**	**37,6%**	**37,9%**
	NPV Debt / Rev.	89,9%	154,0%	162,6%	163,5%	164,6%
	Debt service / Rev.	8,0%	18,5%	**26,2%**	**28,1%**	**29,5%**
Exchange Rate 20% depreciation	NPV Debt / GDP	25,1%	32,4%	34,0%	35,9%	38,2%
	NPV Debt / Rev.	89,9%	134,4%	147,8%	156,3%	166,2%
	Debt service / Rev.	8,0%	16,2%	**25,2%**	**30,6%**	**34,9%**
Combo (One-time)	NPV Debt / GDP	25,1%	41,5%	41,5%	41,7%	42,1%
	NPV Debt / Rev.	89,9%	172.2%	180,5%	181,4%	183,1%
	Debt service / Rev.	8,0%	20,3%	**29,4%**	**31,3%**	**33,3%**

Table 7.4 Government debt - Permanent shocks

		2015	2020	2025	2030	2035
Baseline Scenario	NPV Debt / GDP	25,1%	29,0%	30,0%	30,9%	31,6%
	NPV Debt / Rev.	89,9%	120,1%	130,6%	134,3%	137,5%
	Debt service / Rev.	8,0%	13,7%	19,9%	22,4%	23,7%
Budget primary deficit at 2.3% of GDP	NPV Debt / GDP	25,1%	32,9%	40,4%	48,4%	56,2%
	NPV Debt / Rev.	89,9%	136,6%	175.7%	210,5%	244,6%
	Debt service / Rev.	8,0%	15,3%	**26,1%**[20]	**35,1%**	**42,9%**
GDP real growth rate shock (-0.6 percentage points)	NPV Debt / GDP	25,1%	30,5%	35,4%	42,4%	51,4%
	NPV Debt / Rev.	89,9%	126,4%	154,0%	184,3%	223,4%
	Debt service / Rev.	8,0%	14,3%	22,9%	**30,1%**	**37,9%**
Exchange rate 1% depreciation	NPV Debt / GDP	25,1%	29,7%	32,1%	34,7%	37,9%
	NPV Debt / Rev.	89,9%	123,3%	139,4%	150,7%	164,6%
	Debt service / Rev.	8,0%	14,2%	21,9%	**26,8%**	**31,6%**
Combo (Permanent)	NPV Debt / GDP	25,1%	32,5%	39,9%	48,3%	57,1%
	NPV Debt / Rev.	89,9%	135.0%	173,7%	**210,2%**	**248,3%**
	Debt service / Rev.	8,0%	15,1%	**25,5%**	**34,6%**	**42,9%**

19 Bolded numbers are higher than the threshold.
20 Bolded numbers are higher than the threshold.

8. Output and labor market

8.1 OUTPUT

In the second quarter of 2016, GDP rose by 3% in comparison with the same period of the previous year. At 1.8 percentage points (pp), the industrial sector made the largest contribution to overall growth. The service sector contributed 1 pp and agriculture 0.2 pp.

The construction sector continued to be the main driver of growth in the second quarter of 2016, both in the industrial sector and the whole economy. Compared with the same period of last year, the construction sector increased by 12.8% and made the largest contribution to overall growth at 0.9 percentage points. The high growth in construction remains a consequence of the construction of the new gas pipeline. After a long decline, which was mainly caused by weakened foreign demand on exports, 8.3% growth was observed in manufacturing. A significant share of manufacturing output comes from products that are traditionally considered export products. In the second quarter, restored foreign demand on certain products was positively reflected on the output of the sector. Manufacturing's contribution to overall growth amounted to 0.7 percentage points. High growth also continued in the mining industry (24%, contributing 0.2 pp to overall growth).

« The new gas pipeline construction is still a major contributor to economic growth.

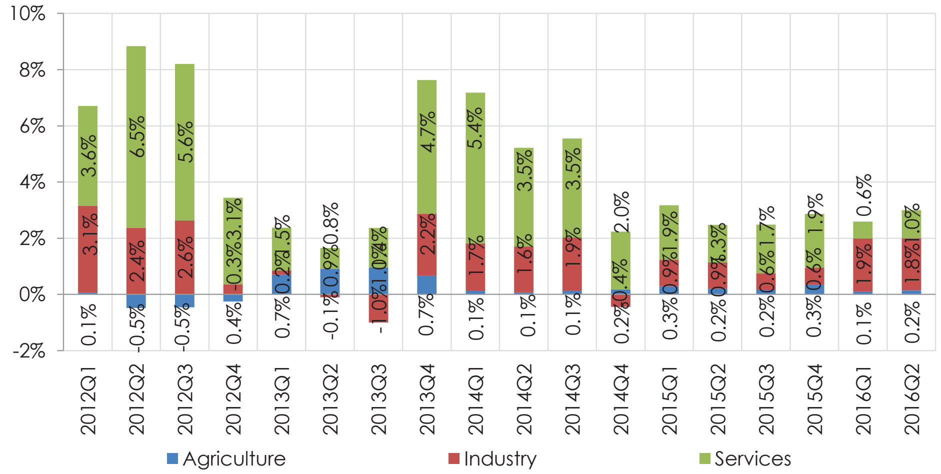
From services, the output of real estate operations was high due to both high activity in housing construction as well as in buying and selling in the real estate market. The contribution of the output of real estate operations in overall growth remains significant and stands at 0.2 pp. The increased flow of visitors entering the country has largely contributed to the growth of restaurants and hotels (10.8%, contributing 0.2 pp to overall growth). Growth was also high in financial activity (9.4%, contributing 0.3 pp to overall growth). Amid weak domestic demand, trade, the largest sector of the economy, decreased by 2.8%. Its negative contribution to GDP growth dropped to 0.4 pp. Transport also saw a significant reduction (-5.8%, with a -0.4 pp contribution to overall growth). A decline was observed in most areas of the transport sector, excluding the air and other land, sea and coastal water transport categories.

« The high contribution manufacturing has made to economic growth is remarkable.

In the second quarter, modest growth (1.7%) was observed in agriculture.

« Trade is declining due to weak domestic demand.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

In the second quarter of 2016, the growth of labor productivity decreased. The real added value per employee created in the country's economy increased by 0.6% compared to the same period of last year. During this period, labor productivity in agriculture and services increased by 0.3% and 1.4% respectively, while falling by 3.4% in the industrial sector. The main cause of productivity reduction in the industrial sector was the 11% productivity decline in construction. Although real growth of construction amounted to 12.8% in the second quarter of 2016 compared to the same period of last year, over the same period the number of employees in the sector increased by 23,000, or by 27%. Productivity thus decreased. It should be noted that the time gap between the growth of employees and the value added by them is usually longer in the construction sector than in other sectors of the economy. Accordingly, productivity in construction will likely increase over the next quarters.

« Decline of productivity growth is linked to the decline of productivity in construction.

From other sectors, a high growth in productivity (17%) was still notable in hotels and restaurants; whereas productivity in the transport sector dropped by almost 9%.

Table 8.1 Annual Growth of Real Value Added Produced per Worker in the Second Quarter of 2016

	Labor productivity growth, %
Agriculture and fishery	0.3%
Industrial sectors	-3.4%
Service sector	1.4%
Overall in the economy	**0.6%**

Source: GeoStat and National Bank of Georgia

The annual growth rate of the nominal salaries of employees amounted to 4.3% during the second quarter of 2016, with the average monthly nominal salary standing at 974 GEL, according to the latest data from Geostat.

« The nominal salaries of employees increased by 4.3% y-o-y.

Table 8.2 Annual Growth of Average Monthly Nominal Wage of Employees in the Second Quarter of 2016

	Growth of nominal wage, %
Agriculture, hunting and forestry	-11.4%
Fishing	69.7%
Mining and quarrying	3.8%
Manufacturing	1.8%
Production and distribution of electricity, gas and water	13.3%
Construction	4.6%
Wholesale and retail trade; repair of motor vehicles and personal and household goods	9.0%
Hotels and restaurants	16.7%
Transport and communications	0.4%
Financial intermediation	0.5%
Real estate, renting and business activities	-6.2%
Public administration	3.6%

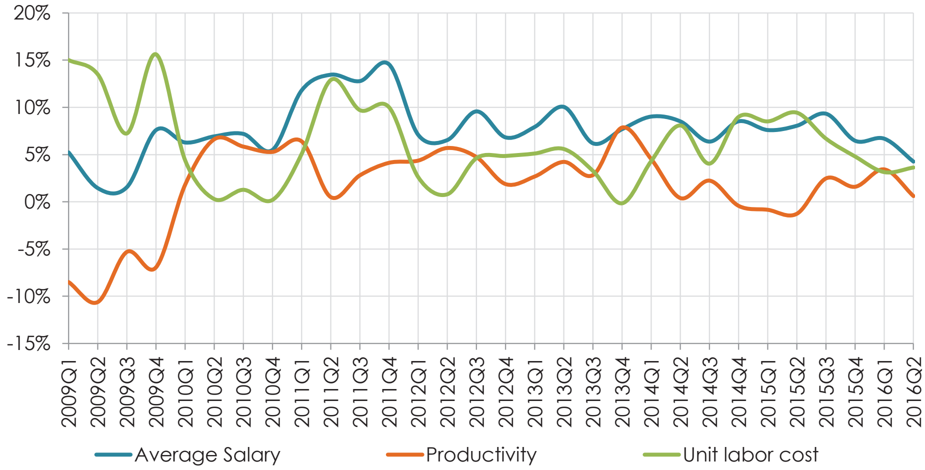
	Growth of nominal wage, %
Education	14.5%
Healthcare and social work	8.4%
Other community, social and personal service activities	3.5%
Overall in the economy	**4.3%**

Source: National Bank of Georgia

In the second quarter of 2016, the annual growth rate of unit labor cost increased and stood at 3.6%. This will not lead to inflationary pressure from the labor market.

« The annual growth rate of unit labor cost is low.

Figure 8.2 Labor Productivity, Average Monthly Salary and Unit Labor Cost (Annual Percentage Change)



Source: GeoStat and National Bank of Georgia

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