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MONETARY POLICY IN GEORGIA

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

- **The long-term CPI inflation target is 3%.** It is planned to gradually decrease the inflation target of the National Bank of Georgia to that level. The inflation target for 2017 is 4%, and from 2018 is 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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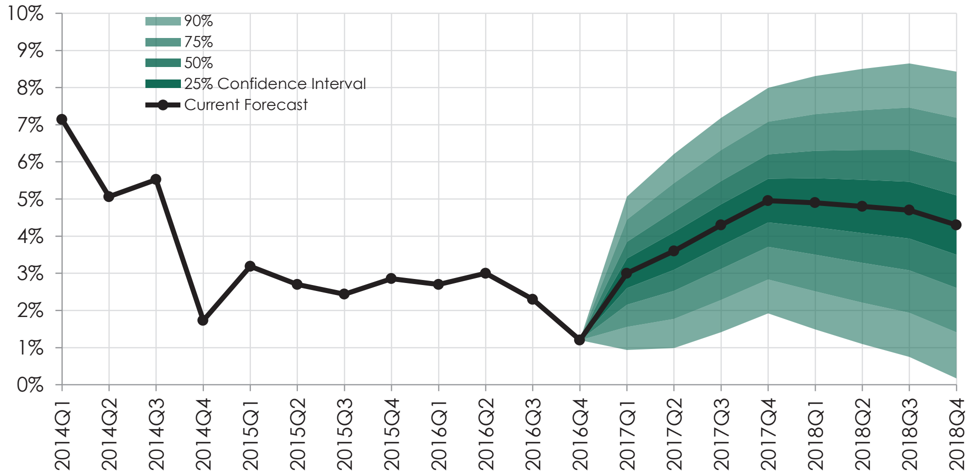
1. Brief Overview

According to preliminary estimates, **real GDP growth** in the fourth quarter of 2016 was lower than expected and amounted to 1.2%. The average annual GDP growth rate in 2016 equalled 2.2%. The increase in business sector confidence and fiscal stimulus resulted in the growth of domestic demand and, in particular, investment, positively contributing to economic growth. However, growth continues to be negatively influenced by the economic conditions of Georgia's trading partners, alongside the general global economic environment. In 2016, although improved, the growth of exports and money transfers remained weak. External factors, in addition to trade channels, have created pressure on exchange rate expectations; however, the exchange rate adjustment has softened the impact of negative external shocks.

The National Bank of Georgia **expects real GDP growth** to be approximately 4% in 2017 (see Figure 1.1). This projection is based on planned fiscal stimulus measures and infrastructure projects that will positively contribute to the confidence of economic agents and foreign investors in Georgia's economic outlook, thereby promoting investments and domestic demand. The National Bank of Georgia assumes that the impact of negative external shocks on the Georgian economy will be softened in 2017. However, as net exports are not expected to increase significantly, these will continue to make a negative contribution to economic growth.

Figure 1.1 Annual Real GDP Growth

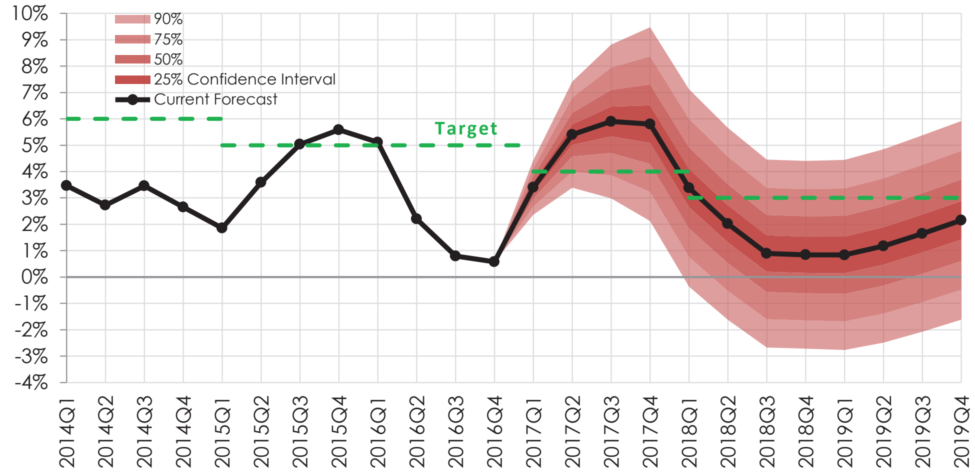


Source: National Bank of Georgia

The annual inflation rate in 2016 was below the NBG's target and in December stood at 1.8%. This was mainly due to weaker aggregate demand, reduced commodity prices on international markets and currency depreciations of trading partners that further reduced imported inflation. Moreover, the sharp decline in inflation during 2016 was caused by the gradual elimination of the effect of the one-time increase in the price level stemming from the exchange rate shock that originated in 2015.

Given the effects of increased excise tax rate and exchange rate depreciation, the National Bank of Georgia **forecasts that inflation** will temporarily increase above its target in 2017. In particular, the global strengthening of the US dollar and the depreciation of the Turkish lira continue to influence the value of the Georgian lari. However, inflationary pressure will be constrained by weak aggregate demand and, provided that the impact on inflationary pressures is temporary, the National Bank expects the inflation rate to reach the target in the medium term. Based on the NBG's estimates, the inflation rate will fall below the target in 2018. Nevertheless, inflation will subsequently gradually increase and reach the target in the medium term (see Figure 1.2).

Figure 1.2 Headline CPI Inflation

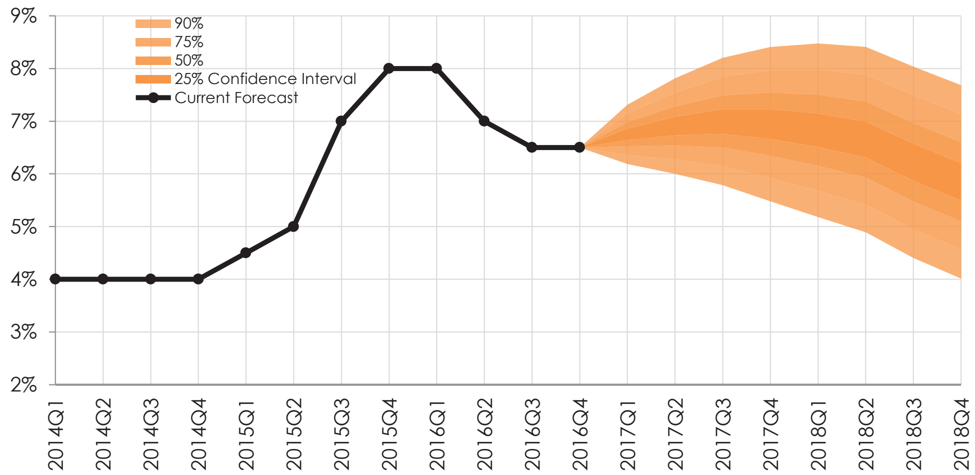


Source: National Bank of Georgia

The forecast is largely dependent on exogenous factors affecting the market and contains **risks in both upward and downward directions**. The main risks continue to stem from the external sector; in particular, from the economic conditions of trading partner countries, the global strength of the US dollar as well as international commodity prices. The current forecast does not expect any significant changes in those factors; however, if economic conditions deteriorate more than is expected, the performance of the economy may be worse than is currently forecast and may lead to a slowdown in real GDP growth and an increase in the inflation rate. However, 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 is currently projected.

To curb inflationary expectations, the National Bank of Georgia expects an increase in the **trajectory of the monetary policy rate** in 2017. However, a gradual normalization of monetary policy should be expected in 2018 (see Figure 1.3). In the medium term, the monetary policy rate will be at its neutral level of approximately 5.5-6%. The forecast assumes that there will be no further pressure on the exchange rate from the foreign sector and, thus, lower inflation and expectations should contribute to the exchange rate strengthening in the medium and long run.

Figure 1.3 Forecast of the Monetary Policy Rate



Source: National Bank of Georgia

The monetary policy rate forecast 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 on economic activity in general.

2. Macroeconomic Forecast

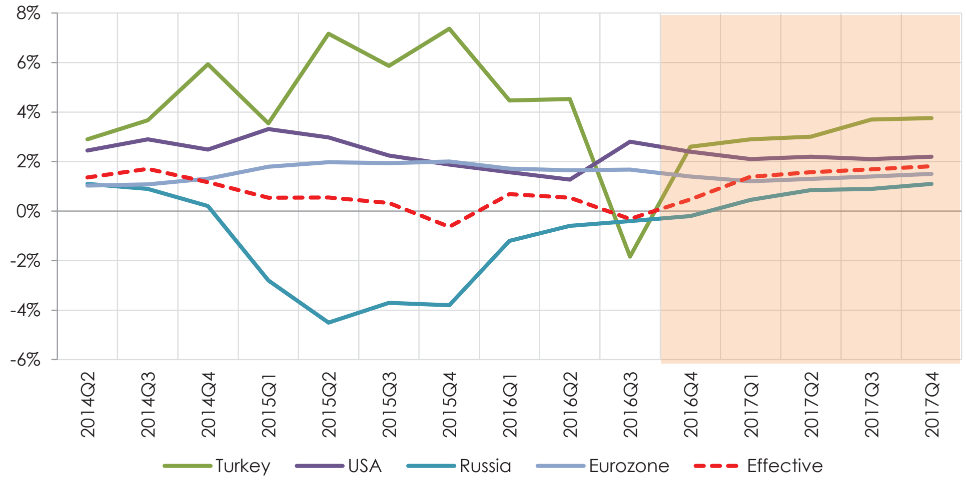
2.1 OVERVIEW OF EXTERNAL FACTORS

In 2016, in the background of growing integration and closer economic ties, the Georgian economy continued to be significantly affected by the economic environment of neighbouring countries through trade, tourism and remittances. The relative de-escalation of the armed conflict in Ukraine has led to the moderate stabilization of the country's economy. In Russia, tighter monetary and fiscal policies ensured that inflation remained on a downward path, while the deal on oil output cuts that was agreed upon by oil-producing countries influenced the situation and the Russian economy entered a phase of gradual stabilization. Meanwhile, in Turkey, deteriorating domestic and geopolitical factors became a major obstacle to economic growth. The situation in the euro area has gradually been improving, albeit at a slow pace. According to IMF estimates, global economic growth in 2016 amounted to 3.1%, while in 2017 it is predicted to reach 3.4%.[1]

In the second half of 2016, **Ukraine** showed signs of economic recovery. Following the stabilization of the geopolitical situation and an improved business environment, industrial production increased alongside consumer demand. Meanwhile, in exchange for obtaining additional financial assistance from the IMF, the Ukrainian government and the Central Bank undertook a number of structural reforms, including steps towards ensuring financial stability. In 2016, Ukraine's GDP increased by 1-1.5%[2] and the inflation rate was approximately 12-13%. Based on IMF estimates, with fiscal stimulus GDP in Ukraine will grow by 2.5% in 2017, while inflation will average 10%.[3]

With the stabilization of oil prices in the global market in the second half of 2016, the economic downturn in **Russia** slowed. Moreover, the impact of fiscal and monetary policy significantly weakened inflation. Despite prolonged sanctions by the EU and the US, Russia's GDP growth forecast for 2017 has improved from -0.8% to -0.6%.[4] As for consumer prices, the Central Bank of Russia predicts that inflation will slow down and reach the 4% target in late 2017.[5]

Figure 2.1 Real GDP Growth of Economic Partners



Source: Bloomberg; National Bank of Georgia.

1 *International Monetary Fund, 2017. World Economic Outlook Update: An Update of the Key WEO Projections. Washington, D.C., January.*

2 *Based on the estimates of the IMF & World Bank.*

3 *International Monetary Fund. 2016. World Economic Outlook: Subdued Demand: Symptoms and Remedies. Washington, D.C., October.*

4 *International Monetary Fund, 2017. World Economic Outlook Update: An Update of the Key WEO Projections. Washington, D.C., January.*

5 *Bank of Russia, 2016. Monetary Policy Report. Moscow, December.*

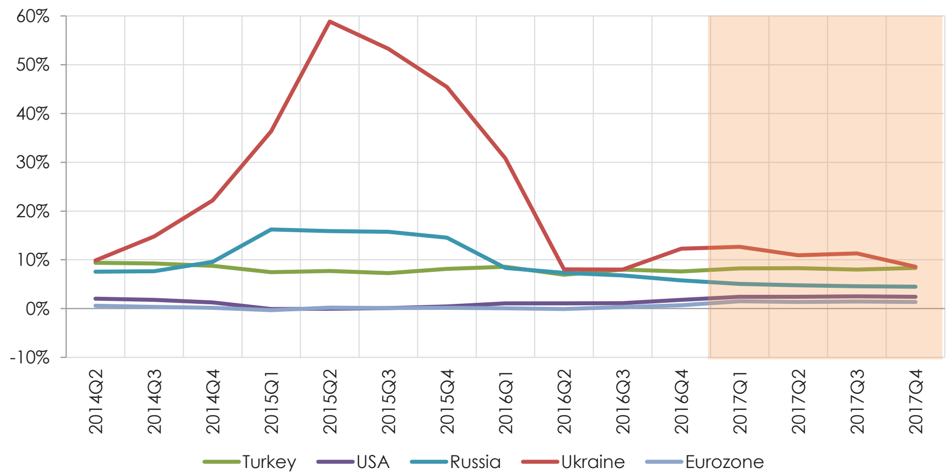
The year 2016 turned out to be challenging for the **Turkish economy**. An attempted military coup, various terrorist attacks, the national currency devaluation and political crises all provoked a significant deterioration of business and consumer confidence. As a result, in the third quarter the country's GDP shrank for the first time since the global financial crisis, despite massive expenditures incurred by the government. The depreciation of the lira against the US dollar at the end of the year created inflationary pressure and the annual inflation rate in December was 8.5%. Amid worsened conditions, the IMF's current GDP growth forecast for 2017 (3.0%[6]) is likely to be revised downward, while the inflation forecast is likely to be revised upwards.

Armenia's economy decreased by 2.6% in the third quarter. As a result, it is expected that GDP growth in 2016 averaged significantly less than was previously projected. Economic growth is expected to remain weak in 2017; however, this figure will be dependent on the economic situation in Russia, as these countries have important trade, investment and financial ties. Based on the latest estimates, **Azerbaijan's** GDP declined by 3% in 2016, which was more than expected. However, the recent stabilization of the oil market has given rise to optimism. The World Bank predicts that Azerbaijan's GDP will grow by 1.2% in 2017.[7]

Great Britain's decision to abandon the European Union (Brexit) has not had a significant effect on expectations and economic activity in the **eurozone**. The IMF's 2016 GDP growth rate forecast for the euro area has remained unchanged at 1.7%.[8] The recovery process during the year contributed to an improved situation on the labor market, low inflation and an accommodative monetary policy. However, it should be noted that the results of the US presidential election gave rise to uncertainty in both political and economic terms. Nevertheless, the IMF's latest estimates for the eurozone's economic growth for 2017 have increased to 1.6%.[9]

After a weak first half of 2016, **US** economic activity improved more than expected in the second half of the year; however, this was still accompanied by weak exports and investments. Current uncertainty around the new administration's agenda have made forecasts difficult, but, assuming increased access to fiscal stimulus, the IMF suggests a 2.3% growth in economic activity in 2017, which is 0.1 percentage point higher than the previous forecast.[10]

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

In the second half of 2016, given the weakening effect of the devaluation of local currencies, annual inflation rates lowered in the region, allowing central banks to reduce monetary policy rates and encourage economic activity. Moreover, in developed countries, where growth is below potential levels and inflation rates are low, accommodative monetary policy expectations have remained. Following the December de-

6 *International Monetary Fund. 2016. World Economic Outlook: Subdued Demand: Symptoms and Remedies. Washington, D.C., October.*

7 *World Bank Group. 2017. Global Economic Prospects, January 2017 Weak Investment in Uncertain Times. Washington, D.C.: World Bank.*

8 *International Monetary Fund, 2017. World Economic Outlook Update: An Update of the Key WEO Projections. Washington, D.C., January.*

9 *ibid.*

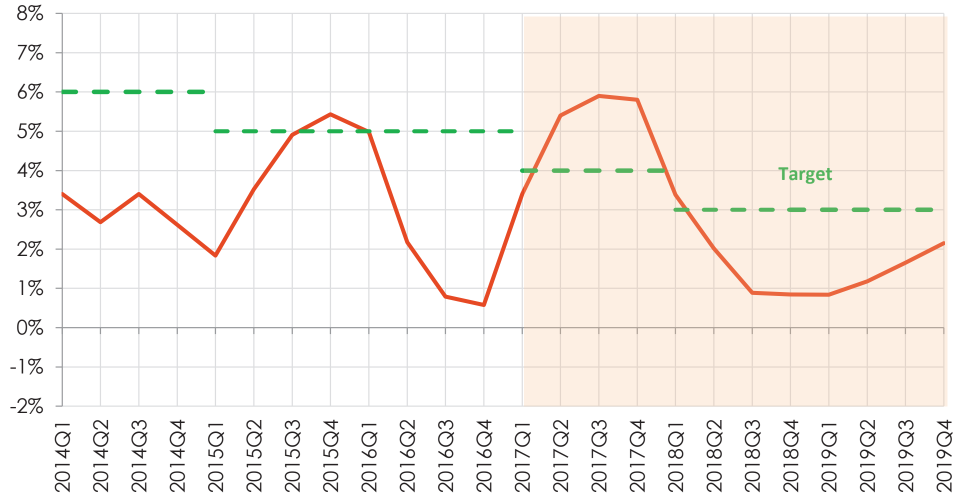
10 *ibid.*

cision by the US Federal Reserve to increase the monetary policy rate, expectations of a more intense tightening increased, with higher expected inflation and economic activity in the background.

2.2 MACROECONOMIC FORECAST

The annual inflation rate in December 2016 was 1.8%, while in the fourth quarter it averaged 0.6%. Inflation was thus below the 5% target of the National Bank of Georgia (see Figure 2.3), which was mainly a consequence of weak aggregate demand, reduced commodity prices on international markets and reduced imported inflation due to currency depreciation of some trading partners. The significant decrease in inflation seen from the beginning of 2016 was partially caused by the gradual elimination of the one-time increase in year-on-year inflation that was driven by higher intermediate costs of firms, resulting from the lari depreciation and increased debt service burden on foreign currency loans.

Figure 2.3 Headline CPI Inflation

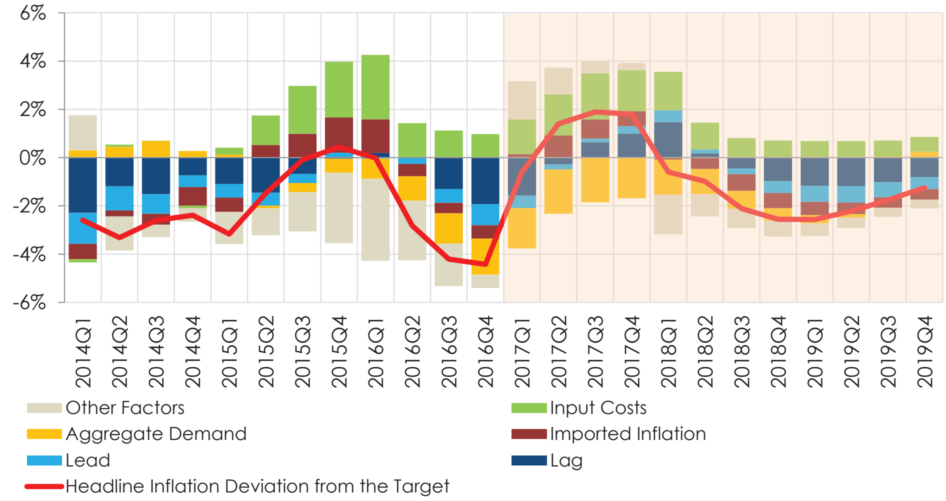


Source: National Bank of Georgia.

In 2017, the **National Bank of Georgia expects** inflation to increase in the first half of the year and to temporarily be above the NBG's 4% target. However, after the gradual elimination of the effects of the increased excise tax rate, inflation will start to decrease and will subsequently approach the target rate from below in the medium term. Starting from 2018, the inflation target rate will be 3%.

The **inflation level** remaining above the target during 2017 will mainly be a result of temporary factors; in particular, the effects of the increased excise tax rate. In addition, the devaluation of the Turkish lira will continue to influence the value of the Georgian lari. Hence, imported inflation through other trading partner countries and an increase in intermediate costs, which largely reflects the increased debt service burden of foreign currency loans, will both have a partial impact on inflation. However, inflationary pressure will be constrained by weak aggregate demand, which is a result of economic activity being lower than its potential level. According to the forecast, lower than potential aggregate demand will cause inflation to decrease below the target level in 2018, in light of the elimination of temporary shocks. In the medium term, however, in line with real economy converging with its potential level, inflation will approach the target level from below (see Figure 2.4).

Figure 2.4 Inflation Deviation from the Target and its Decomposition

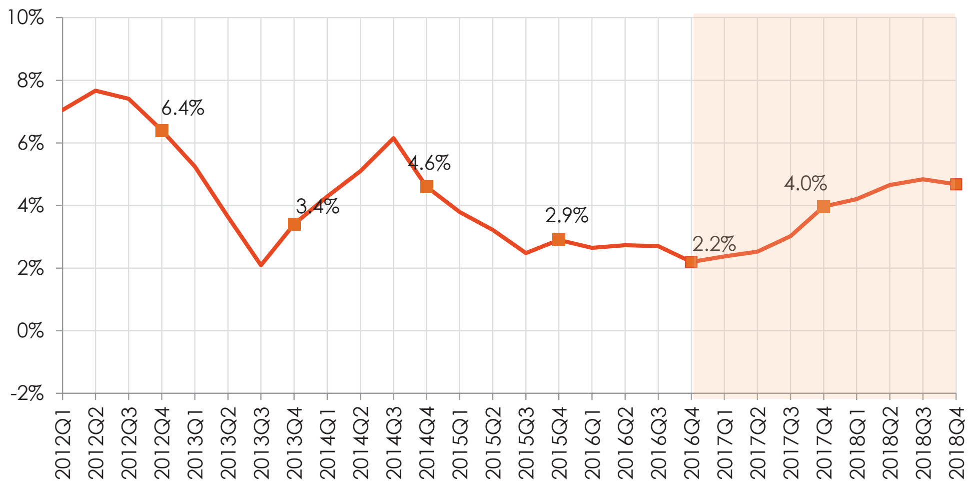


Source: National Bank of Georgia.

There are **risks associated with the inflation forecast** in both directions. There is uncertainty surrounding the economic environment of major trading partners, over the dollar's global strength and concerning international food and oil prices – which have substantial weights in the consumer basket and are mostly supply driven. The baseline forecast scenario does not consider significant changes in those factors; however, if foreign economic conditions deteriorate more than is expected and/or if international prices are greater than expected, this will cause inflation in Georgia to be higher than forecast. On the other hand, lower-than-expected imported inflation from trading partners or a further reduction in oil and food prices will lead to lower inflation than expected. There is also some uncertainty surrounding economic activity, which depends on the amount of fiscal stimulus. If economic activity is stronger than expected it will cause inflation to be higher than forecasted, and vice versa if it is weaker than expected.

Real GDP growth in 2016 was lower than expected. According to preliminary data, growth stood at 1.2% in the fourth quarter and amounted to 2.2% in 2016 as a whole (see Figure 2.5). Economic activity during this period was driven by domestic demand. In particular, the increase in business sector confidence and fiscal stimulus have resulted in the growth of domestic demand and investment, positively contributing to economic growth. In sectoral terms, a significant contribution was made by the construction sector, where, in addition to the weight carried by the Baku-Tbilisi-Ceyhan pipeline project, a number of other private construction and public infrastructure projects were important. However, economic growth continues to be negatively influenced by both the economic conditions of Georgia's trading partners and the global economic environment. In 2016, although improved, the growth of

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

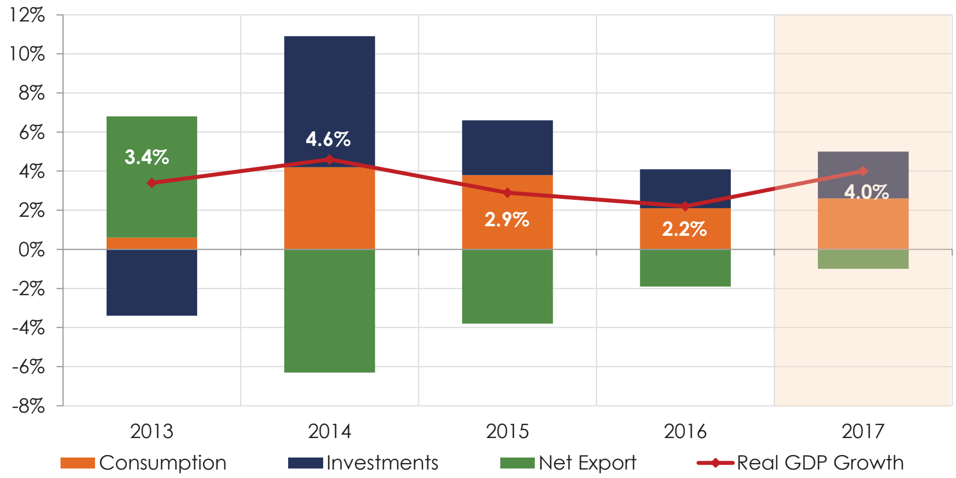


Source: National Bank of Georgia.

exports and money transfers remained weak. Net exports started to decline in 2014, which 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. According to the forecast, although it is expected that net exports will improve compared to previous years, they will continue to make a negative contribution to real GDP growth in 2017 (see Figure 2.6).

According to the **GDP forecast**, the growth rate in 2017 is expected to be around 4% (see Figure 2.5). Activation of planned infrastructure projects and increased fiscal stimulus will support an increase of domestic demand. On the other hand, the unfavorable trend in the foreign sector is expected to affect net exports, which will continue to make a negative contribution to GDP growth, albeit to a lesser extent (see Figure 2.6). Net exports are negatively influenced by the adverse political and economic conditions experienced by Georgia's trading partners. These are reflected in both weak foreign demand for Georgian exports and declining remittances. In addition, the negative contribution of net exports is further reinforced by fiscal stimulus measures and the growth of domestic demand, both of which lead to an increase in imports. However, such negative spillovers from the foreign sector will be 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 last period.

Figure 2.6 Real GDP Growth Decomposition *



* Includes hepatitis C medication imports

Source: National Bank of Georgia

While analyzing **risks to the GDP forecast**, the foreign sector clearly stands out. If, against the backdrop of geopolitical tensions, 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. Another risk is associated with the dollar exchange rate on international markets, as this directly influences the currencies of trading partners and, through trade channels and expectations, influences foreign currency inflows and the lari exchange rate. 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 8.4% of GDP in the third quarter of 2016. Registered exports of goods increased by 7.6% in the fourth quarter, while imports (excluding grant-financed hepatitis C medications) increased by 6.9%. This caused the goods trade balance to deteriorate by an annual 6.6%. However, remittances, which are another important source of financing imports, increased by an annual 16% in the fourth quarter.

According to the **current forecast, the current account deficit** was approximately 12.5% of GDP in 2016, and is expected to amount to approximately 12% in 2017. 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, to date, the most efficient way to obtain this goal is pursuing an inflation forecast targeting regime. For this purpose, the NBG uses its monetary policy rate to ensure that the inflation forecast reaches the target level in the medium term. Hence, each **inflation forecast implies a corresponding interest rate forecast**. Figure 1.3 shows the forecasted trajectory of the monetary policy rate that is consistent with the macroeconomic forecast presented above. The trajectory implies a moderate increase in the policy interest rate during 2017 to constrain inflation expectations. However, as shocks will die out in 2018, a gradual reduction in the policy interest rate should be expected and this will converge to its neutral level in the medium term. According to current estimates, the medium-run neutral level of the monetary policy rate is 5.5-6%. It is worth noting that this level mostly depends on long-run inflation expectations and country risk premiums. Hence, changes to any of these factors will eventually be reflected in the actual monetary policy rate.

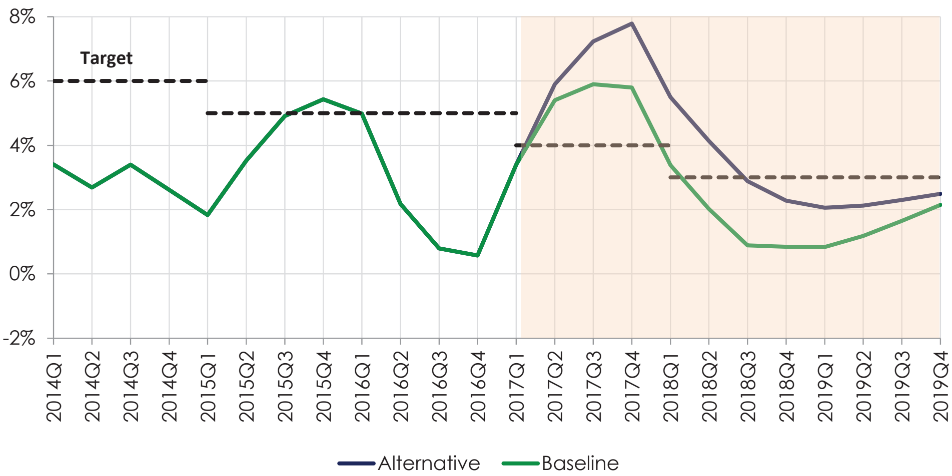
Finally, it should be clearly stated that **the forecast of the monetary policy rate is not a promise from the National Bank of Georgia**. It is only the expected trajectory of the policy rate; assuming that all the exogenous factors incorporated into the forecast materialize as expected. Despite this 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 the negative external shock worsens moderately. In particular, the scenario assumes that the existing geopolitical conditions in the region will weaken economic conditions in Georgia's trading partner countries and that these negative effects will be transmitted to the domestic economy, affecting net exports and the GDP growth forecast. The alternative scenario also considers an even greater than expected strengthening of the dollar exchange rate in international markets, which would affect the value of trading partner currencies. 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 2.7), while economic growth will be lower (see Figure 2.8).

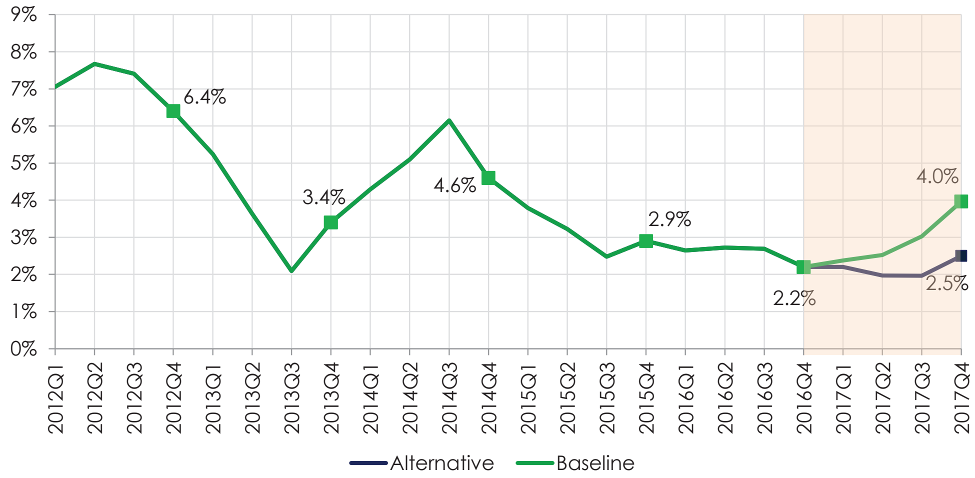
In this scenario, inflation increases at a faster rate than in the baseline scenario as a result of the negative external shock. Under such circumstances, monetary policy provides an appropriate response to neutralize inflationary expectations and reduce inflationary pressures. According to the alternative scenario, inflation in 2017 will, on average, be 1 percentage point higher than in the baseline scenario (see Figure 2.7).

Figure 2.7 Headline CPI Inflation According to Baseline and Alternative Forecasts



Source: National Bank of Georgia

Figure 2.8 Real GDP Growth According To Baseline And Alternative Forecasts (Annual Growth Of The Last Four Quarters)

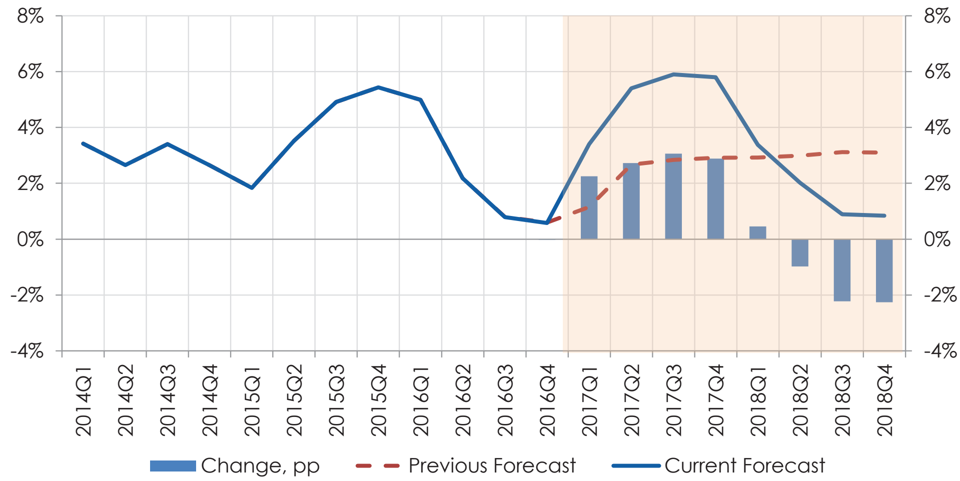


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast for upcoming quarters has been revised upwards, essentially due to temporary factors and increased inflationary expectations (see Figure 2.9). In particular, temporary factors include the effects of increased excise tax rate and the fact that the depreciation of the Turkish lira influenced the value of the Georgian lari. As a result of the latter, imported inflation from other trading partner countries and the increased burden of servicing foreign currency loans will have a partial impact on the growth of inflation. Therefore, the National Bank expects the inflation to overshoot the target in 2017, but to remain around it in the medium term. Specifically, provided that the impact of inflationary pressure in 2017 will be temporary, it is expected that inflation will return to the target rate (set at 3%) in 2018.

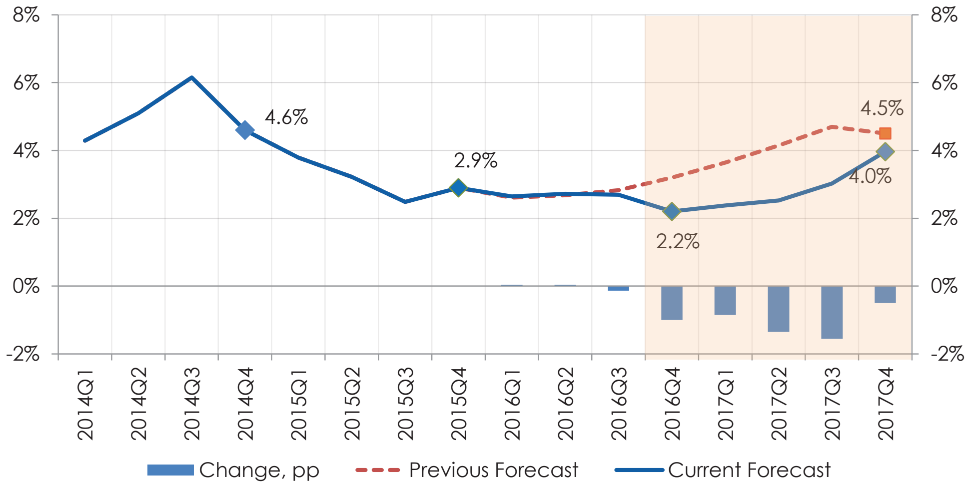
Figure 2.9 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

As for economic activity, the real economic growth forecast for 2016 has been revised downwards (see Figure 2.10). However, the lower-than-expected growth of the budget deficit and the prolonged negative contribution of net exports to GDP has caused a slight reduction in the expected economic growth for 2017, which now stands at 4%.

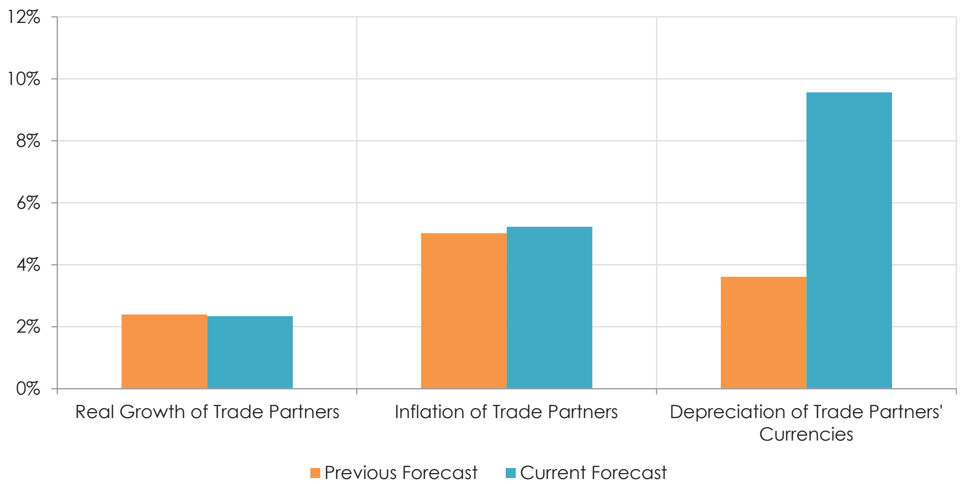
Figure 2.10 Changes in the Forecast of Real GDP Growth (Annual Growth of the Last Four Quarters)



Source: National Bank of Georgia

Assumptions regarding the external sector are particularly important for the macroeconomic forecast because trading partners' economic growth, inflation and exchange rate volatility has a direct effect on Georgia's economic performance. Changes in assumptions regarding the external sector can thus significantly affect the forecast's results (see Figure 2.11). Assumptions regarding the expected dynamics of trade partner countries' currencies against the dollar were revised significantly considering the global economic situation, and have increased compared to the previous quarter. Meanwhile, assumptions on economic growth and inflation in Georgia's trading partners have not changed significantly.

Figure 2.11 Changes in External Sector Assumptions for 2017



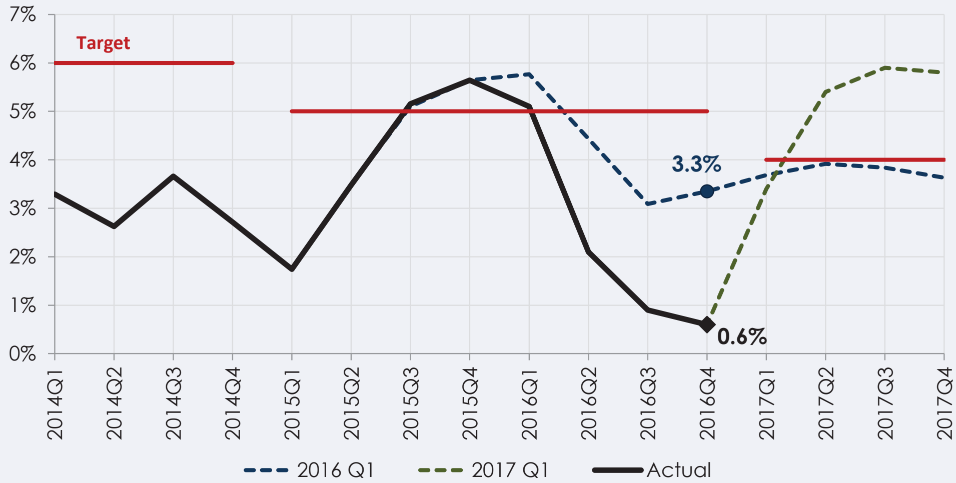
Source: Bloomberg

Box 1 Inflation Target Achievement and Assessment of 2016 Forecasts

As monetary policy changes only transmit to the economy after some time (of 4-6 quarters), in the medium term the inflation forecast acquires a special role in assessing the adequacy of monetary policy decisions. Thus, to evaluate the reliability of monetary policy in achieving its inflation objective, it is necessary to analyse the forecasts made in previous periods. The inflation forecast can be assessed as being adequate if its deviation from the actual value was caused by exogenous forces that could not have been foreseen at the time of making the forecast. We will start this analysis from the inflation report of the first quarter of 2016 (earlier forecasts were covered in an analogous section published last year).

According to the forecast published in the February 2016 Inflation Report, inflation was expected to gradually decrease in 2016 before rising to the target level by the second quarter of 2017 (see Figure 2.12).

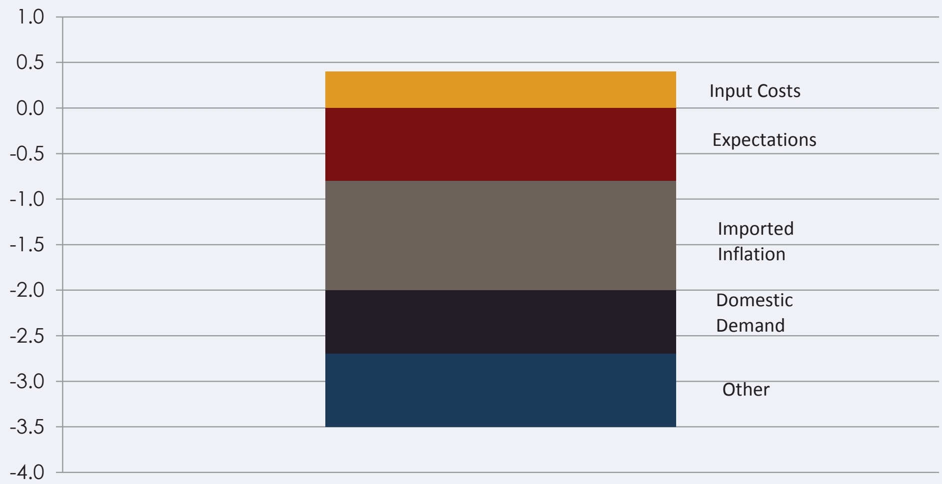
Figure 2.12 Performance of the Headline Inflation Forecast



Source: National Bank of Georgia

The February 2016 forecast appears to have been largely in line with the actual average figures for 2016. However, it should be noted that exogenous factors caused a deviation from the baseline forecast scenario, pushing inflation down even further. In particular, weaker-than-expected demand during 2016, caused by higher transmission of external shocks, put downward pressure on inflation. Moreover, the main reasons why inflation fell below the level forecast in early 2016 were lower than expected imported inflation due to the currency depreciation of trading partners, reduced oil and commodity prices on international markets, and reduced inflation expectations at the beginning of the year. These factors contributed to a lower inflation level in 2016 than was projected (see Figure 2.13).

Figure 2.13 Decomposing the Deviation of 2016Q4 Headline Inflation from its Projected Value

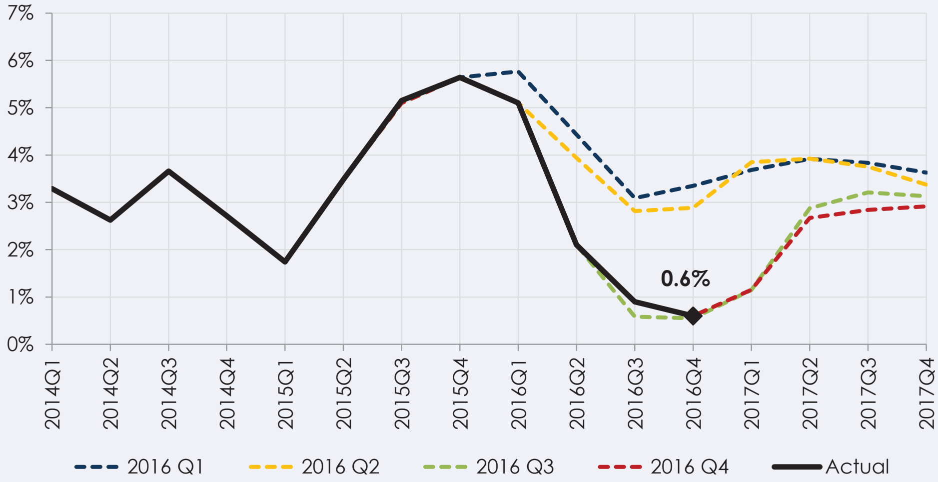


Source: National Bank of Georgia

Since the beginning of 2016, the forecasted rate of inflation was continuously revised downwards, largely due to the realization of the above mentioned exogenous shocks. In the third and fourth quarters of 2016, the inflation forecasts were only slightly different from the actual data (see Figure 2.14).

Monetary policy formation in 2016 can be summarized as follows: based on the inflation forecast and the current economic situation, in April 2016 the National Bank decided to gradually start phasing out the tight monetary policy and reduced the monetary policy rate by 50 basis points. The process of exiting from the tight monetary policy stance, which meant a gradual reduction of the refinancing rate to the neutral level in the medium term, continued in the following months and, during the first three quarters of 2016, the refinance rate decreased from 8% to 6.5%. Nevertheless, as external disturbances heightened and started to affect the inflation and GDP growth forecasts, the NBG subsequently made the decision to keep the refinance rate unchanged. It can thus be concluded that the monetary policy decisions were made in line with the forecasts.

Figure 2.14 Performance of Headline Inflation Forecasts (2016Q1 – 2016Q4)



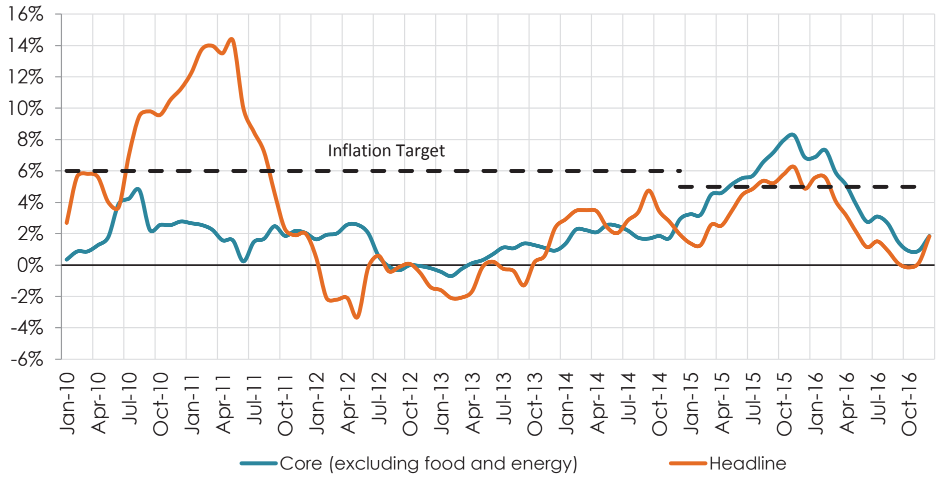
Source: National Bank of Georgia

3. Consumer Prices

In 2016, inflation was below the target level. After the deflation observed in November, inflation moved upward and both core and CPI inflation reached 1.8%.

« Annual inflation is under the target level.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

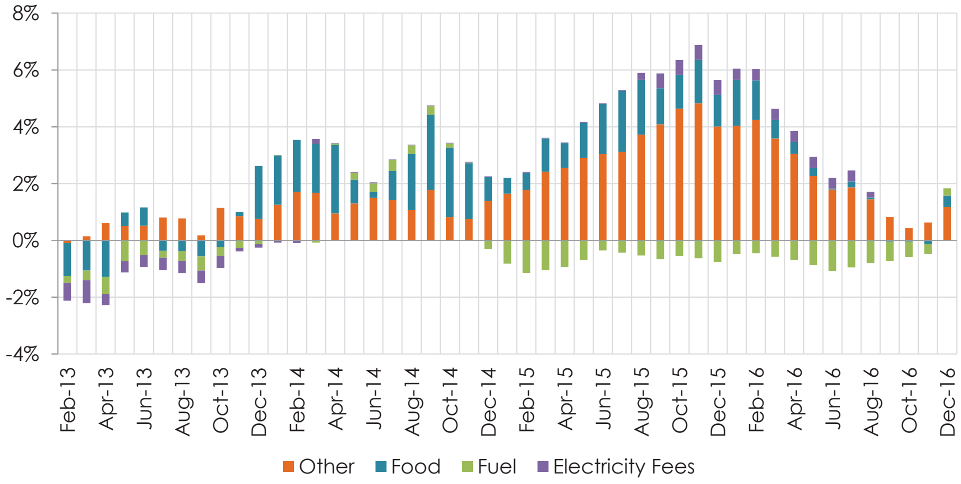
The increase in inflation was caused by various factors, of which fuel prices were the most important. Throughout the year, fuel prices were pushing inflation downward. However, from July this factor started to expire. In December, rising oil prices in the world market made fuel prices increase and these ultimately contributed 0.3 percentage points (pp) to total inflation.

« Of the factors causing inflation to rise in December, the change in the trend of fuel prices was the most important.

Due to the increased excise tax, the "Alcoholic beverages and tobacco" group made the highest contribution to inflation in 2016. In December, expectations of an excise increase on tobacco in 2017 pushed prices up further. This group's inflation finally reached 13.8%, making a 0.8 pp contribution to the total.

The contribution of food prices to overall inflation in the second half of 2016 was close to zero. The increase in sugar prices on the world market was compensated for by decreased prices on other products. In particular, the prices of the "milk, cheese & egg" group gradually decreased until December, when the prices of this group rose by 0.6%. Overall, the contribution of food prices to annual inflation in December was 0.4 pp.

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

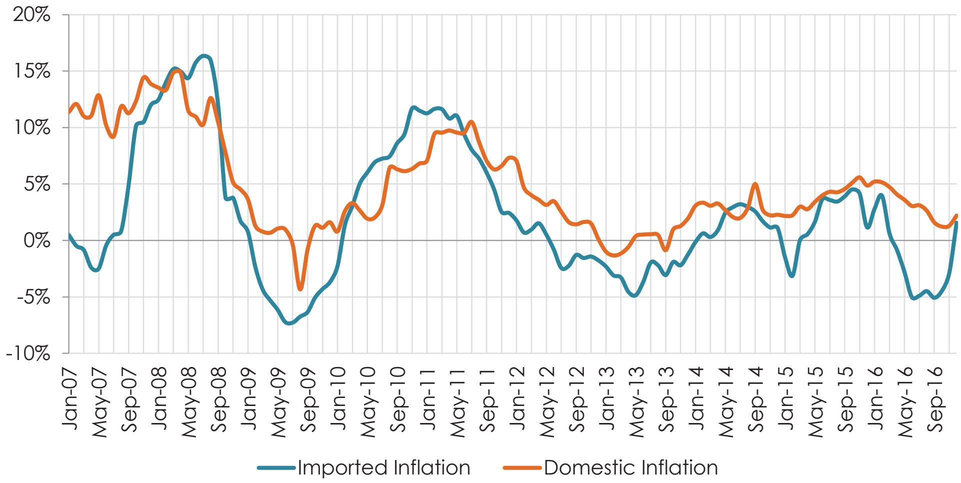


Source: GeoStat and National Bank of Georgia

By the end of the fourth quarter, annual imported inflation stood at 1.6% and its total contribution to inflation amounted to 0.3 pp, while in the previous month it was negative, at -0.7 pp. The increase of fuel prices was the main cause of this change. Although the nominal effective exchange rate (NEER) of the GEL had appreciated since the start of the year, it depreciated in December, which had an impact on inflation growth.

Inflation on locally produced goods was 2.2%, making a 1.3% contribution to overall inflation. Inflation on mixed goods stood at 0.7%, making a 0.1 pp contribution to the total.

Figure 3.3 Imported And Domestic Inflation

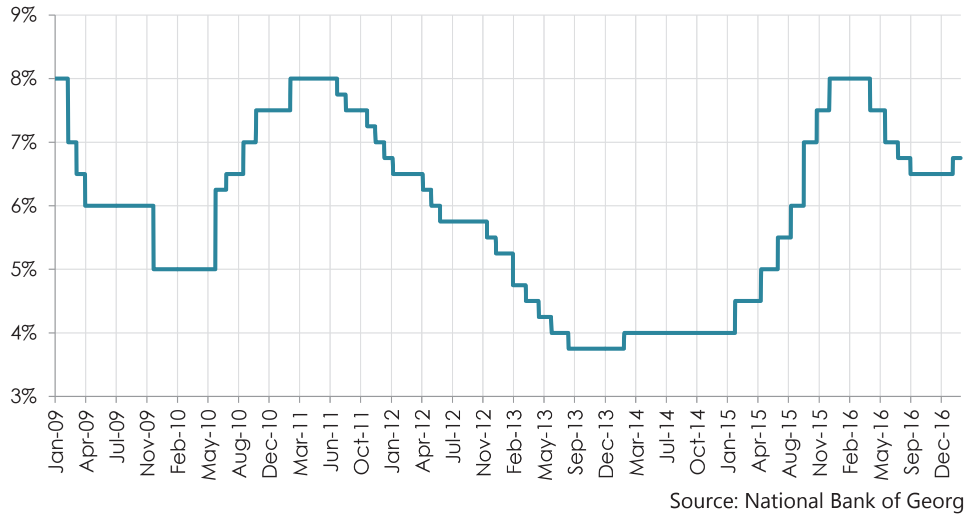


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

In 2016, the National Bank of Georgia started gradually phasing out its tight monetary policy. Since the beginning of 2016, inflation had a decreasing trend and was lower than the target level. Inflation fell due to weak aggregate demand, a decrease in expectations and falling commodity prices on world markets. At the same time, the significant decline in inflation since the beginning of the year was also caused by the base effect. Alongside lower inflation expectations, in 2016 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 6.5%. Consequently, interest rates on national currency loans decreased and loans in GEL increased that provides significant stimulus for demand. Furthermore, an increase in confidence in monetary policy instruments caused an improvement in the monetary policy transmission mechanism, which resulted in an additional monetary policy easing effect. Therefore, at the end of 2016 the Monetary Policy Committee (MPC) found it appropriate to leave the policy rate unchanged at 6.5% as there was no need to rapidly phase out the tight monetary policy at that stage.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the National Bank's MPC was held on 25 January 2017. At the meeting, it was decided to increase the refinancing rate by 25 basis points to 6.75%.

« According to the NBG's Monetary Policy Committee's decision, the refinancing rate increased by 25 basis points to 6.75%.

Monetary policy decisions are based on the macroeconomic forecast. According to this, inflation is expected to be above the target rate for most of 2017 while demand side pressure on prices is weak. The forecast suggests that the temporary increase in inflation is a result of one-off events, the increase in excise taxes and exchange rate developments. It is worth mentioning that the increase in excise taxes will raise prices temporarily and will only have a short-run impact on the level of inflation. Moreover, the later developments with the exchange rate were mainly driven by the depreciation of the Turkish lira in the second half of 2016 and the global strengthening of the US dollar. Under such circumstances, the NBG found it appropriate to increase the refinancing rate by 25 basis points in order to contain increased inflation expectations. Based on the macroeconomic forecast, the NBG will gradually increase the monetary policy rate to 7% over the next two quarters. Ceteris paribus, in the medium term the policy rate will gradually return to its neutral rate as factors affecting inflation are exhausted.

In December 2016, the annual inflation rate was 1.8%. Since the first quarter of 2016, headline and core inflation rates (excluding food and energy) had a decreasing rate and were lower than the target level. The decline of inflation was driven by weak aggregate demand, a decrease in expectations and falling commodity prices on world markets. The significant decline in inflation since the beginning of the year was also caused by the base effect.

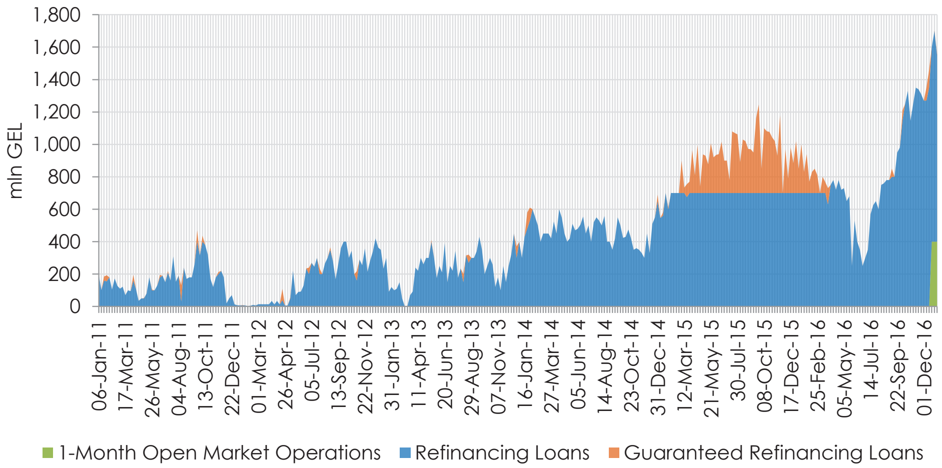
Domestic demand remains weak. Based on preliminary information, average economic growth equaled 2.2% in 2016.

A positive tendency was observed in export developments. In the fourth quarter of 2016, as a result of improved external demand, the decreasing trend of registered exports of goods changed to a positive growth rate. However, registered imports of goods also increased, which worsened the trade balance. A positive tendency remains in terms of international visitors to Georgia, especially tourist[11] arrivals. Alongside increased tourist inflows, tourism revenues continue to rise. Based on preliminary data, in the fourth quarter of 2016 tourism revenues increased by 12.7% year over year, while total growth in 2016 was 11.9% year over year. Since the second half of 2016, remittances inflows had an increasing trend and the volume of money transfers increased by 6.6% in 2016. It should be noted that the structure of transfers has become more diversified and the share of money transfers from EU countries, the US, Israel and Turkey in total remittances all increased.

According to the NBG's current forecasts, inflation is expected to temporarily be above the target level. After the impact of one-off factors is exhausted, inflation will start to decline and in the medium term will remain below the target level. However, both upside and downside risks to the forecast remain. Negative risks might arise from the 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. On the other hand, if aggregate demand improves slowly at a lower rate than expected, the inflation rate will be lower than projected.

In order to ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in 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. Moreover, in December 2016 the NBG introduced a new monetary policy instrument – one-month open market operations. Through these policy instruments the NBG supplies short-term liquidity to the country's banking system when needed. As a result, interbank short-term interest rates fluctuate around the monetary policy rate.

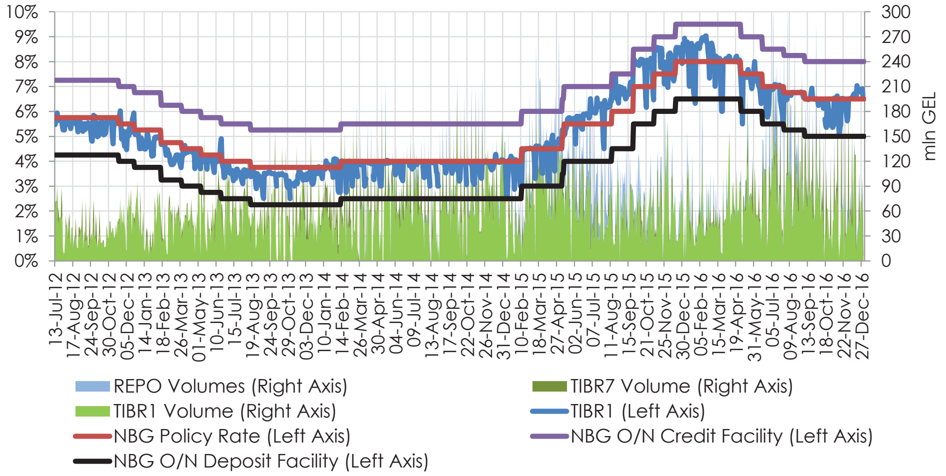
Figure 4.2 Liquidity Supply Instruments



Source: National Bank of Georgia

11 *Tourists are defined as international visitors who stayed in Georgia for 24 hours or more.*

Figure 4.3 Interbank Money Market



Source: National Bank of Georgia

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

Box 2 One-Month Open Market Operations

In December 2016, the National Bank of Georgia introduced a new monetary policy instrument: one-month open market operations. Through this policy instrument, the National Bank of Georgia supplies short-term liquidity to the country's banking system when needed.

The main objective of the National Bank of Georgia is to maintain price stability. In order to achieve this objective, the National Bank of Georgia uses a monetary policy framework with the primary instrument - policy rate. The monetary policy rate impacts interest rates on loans and deposits, which ultimately impact price dynamics. Accordingly, from the operational perspective, the stability of short-term interest rates represents the main goal of the NBG, and this will be achieved by efficient liquidity management.

Under the inflation targeting regime, open market operations are used to indirectly achieve price stability, which is the major goal of all central banks. Similar to other open market operations, the goal of one-month open market operations is to manage short-term interest rates on the interbank money market by providing liquidity to the banking sector and/or absorbing excess liquidity.

One-month open market operations will engage small banks that do not have enough resources to forecast their short-run liquidity with high precision. Therefore, managing liquidity with one-month open market instruments will be more convenient for such banks. One-month open market operations will thus improve financial sector liquidity management and increase the efficiency of the monetary policy transmission mechanism.

One-month open market operations are provided in monthly auctions that every commercial bank can participate in. The liquidity forecast group estimates liquidity deficits in the banking system and, based on these estimates, announces an auction for the specific amount of money. The total volume announced for auction is distributed among banks according to the interest rate they indicate in their auction applications, with those who offer higher interest rates obtain first. NBG certificates of deposit, government securities, local currency denominated bonds issued by international financial institutions, local currency denominated bonds issued by resident and non-resident legal entities, and commercial banks' own credit assets in the national currency can all be used as collateral.

The introduction of one-month open market operations is in line with the International Monetary Fund's recommendations and international best practices. In autumn 2016, meetings between the National Bank of Georgia and the technical assistance mission of the International Monetary Fund were held. The technical assistance mission recommended that, in order to improve structural liquidity, the NBG could introduce long-term instruments that would instill further confidence. They recommended that it would be useful to start with one-month operations.

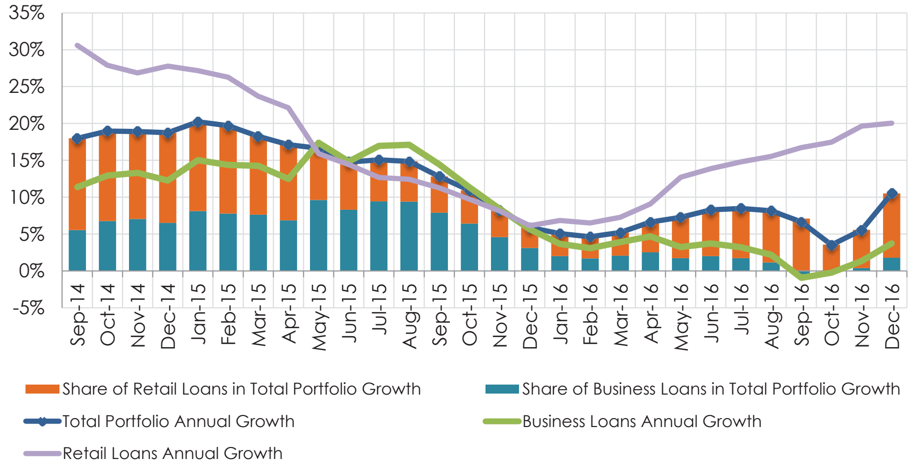
Similar instruments are widely used by other central banks. For example, in its main refinancing operations the European Central Bank uses longer-term (three-month) refinancing operations. The major monetary instrument of the Czech National Bank is two-week repo operations, but the bank also uses three-month repo tenders as a supplementary monetary instrument. The National Bank of Serbia manages financial sector liquidity with main operations and longer-term operations that are implemented in standard auctions. Meanwhile, the Swiss National Bank uses open market operations in order to absorb excess liquidity or/and supply liquidity. Repo auctions are conducted by either volume or interest rate and the maturity varies from one day to several months.

5. Financial Market and Trends

5.1 LOANS

In the fourth quarter of 2016, the annual growth rate of the loan portfolio increased and, excluding the effect of exchange rate movement, amounted to 10.5% in December. The increase was mainly caused by the growth of retail loans, but the growth rate of business loans also increased. The volume of business loans in the national currency with a floating interest rate did not significantly change in December, and their share in total business loans remained at 5%. It is expected that the annual growth rate of the loan portfolio will be approximately 10% in 2017.

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

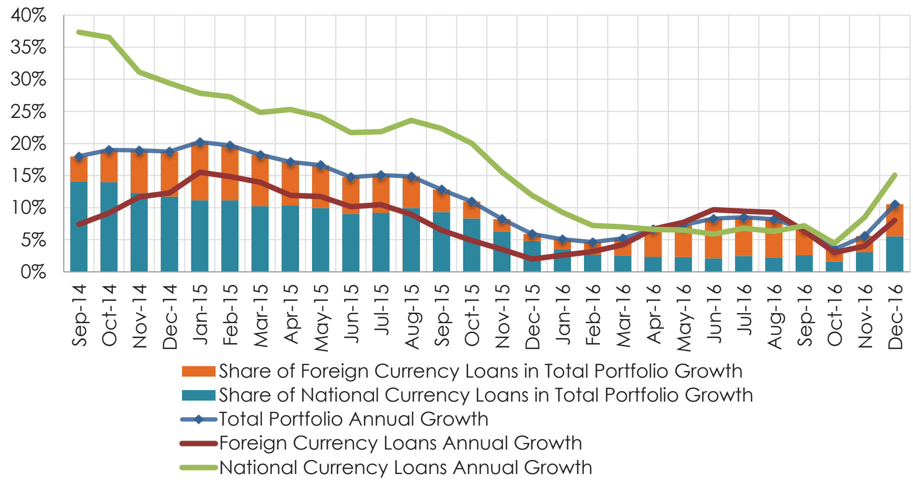


Source: National Bank of Georgia

In the context of currencies, the growth of the loan portfolio was primarily caused by an increase in national currency loans. In December, the annual growth rate of foreign currency denominated loans was 8%, while domestic currency loans rose by 15.1%. It is

« 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

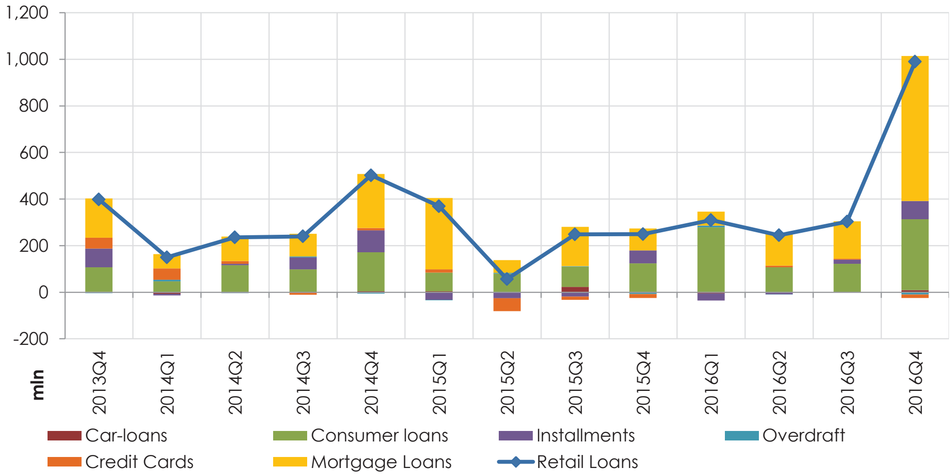


Source: National Bank of Georgia

important to note that an increase in leverage in foreign currency makes the financial sector more vulnerable to currency shocks and increases financial stability risks.

In December, the stock of retail loans increased by 990 million GEL compared to September. Although this was partially caused by seasonal factors and currency depreciation, the growth of loans was still high without accounting for those effects. In terms of loan products, the amount of mortgage and consumer loans increased by 623 million and 304 million GEL respectively over the previous quarter. The volume of instant loans and credit cards increased by 64 million GEL. According to the credit conditions survey, representatives of the banking sector are not expecting significant changes in demand for retail loans in the next quarter.

Figure 5.3 Quarterly Growth Of Retail Loans



Source: National Bank of Georgia

In December, the annual growth rate of the loan portfolio to legal entities amounted to 3.7%[12], which was 4.6 percentage points higher than in September. An analysis of business loans by sector reveals that the energy, trade, agriculture and construction sectors each posted growth in terms of credit, while the volume of outstanding loans disbursed to the manufacturing and transport sectors increased slightly. Representatives of the banking sector do not expect an improvement in demand for business loans in the next quarter.

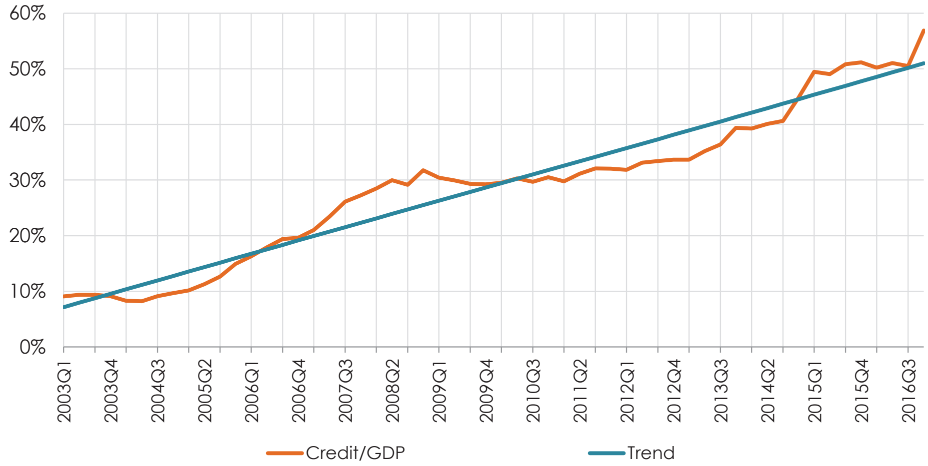
Compared to the previous quarter, the credit to GDP ratio[13] increased by 6.4 percentage points and amounted to 56.9%. The growth of this ratio was largely caused by currency depreciation. The credit to GDP ratio is currently above the trend by 5.9 percentage points.[14]

12 Excluding the exchange rate effect.

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

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

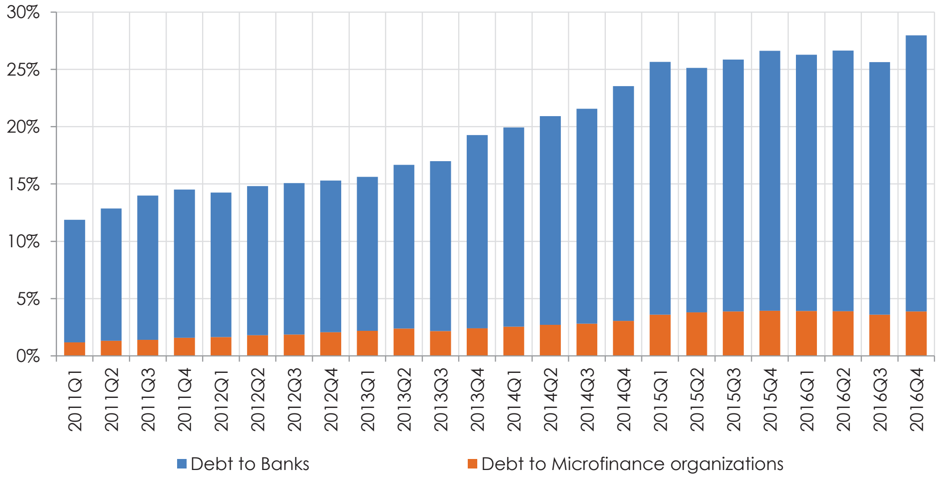
Figure 5.4 Credit To GDP Gap



Source: National Bank of Georgia

In the fourth quarter of 2016, the individuals' loans to net national disposable income ratio increased by 2.3 percentage points compared to the previous quarter and amounted to 28%. Debt to commercial banks accounted for 86% 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 0.4 percentage points and amounted to 7.7%. This change was mainly due to the amount of loans written off, which amounted to 77 million GEL. According to the data from December, the share of non-performing loans in the national currency decreased by 0.2 percentage points compared to September and amounted to 5.7%. Meanwhile, the share of non-performing foreign exchange loans decreased by 0.5 percentage points and equalled 8.8%.

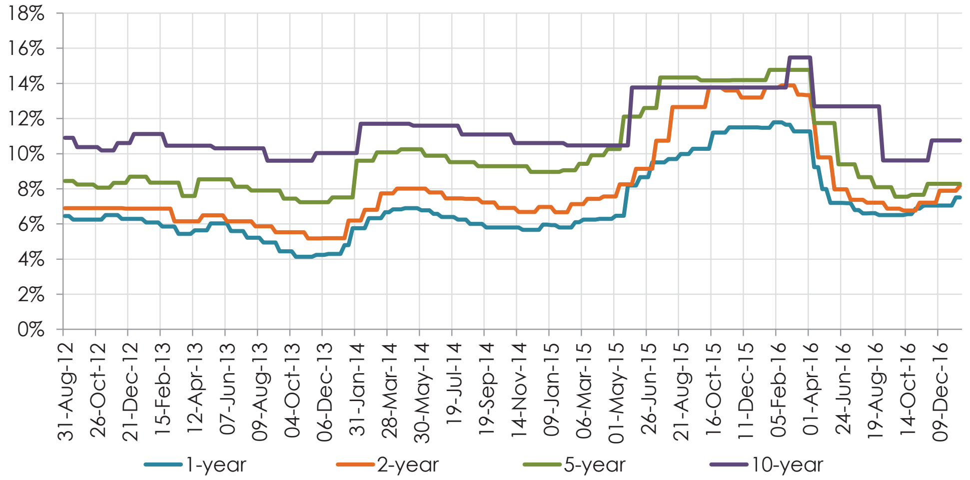
‹‹ Compared to the previous quarter, the share of non-performing loans decreased by 0.4 percentage points and amounted to 7.7%.

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In January 2016, the monetary policy rate amounted to 6.75%. After three-quarters of gradually falling, in the fourth quarter of 2016 interest rates on government securities increased. The main reasons behind the fall during the first three quarters were a decline in the monetary policy rate, a decrease in liquidity and interest rate risks. However, the slight increase in the fourth quarter was due to a rise in inflationary expectations caused by exchange rate depreciation (see Figure 5.6).

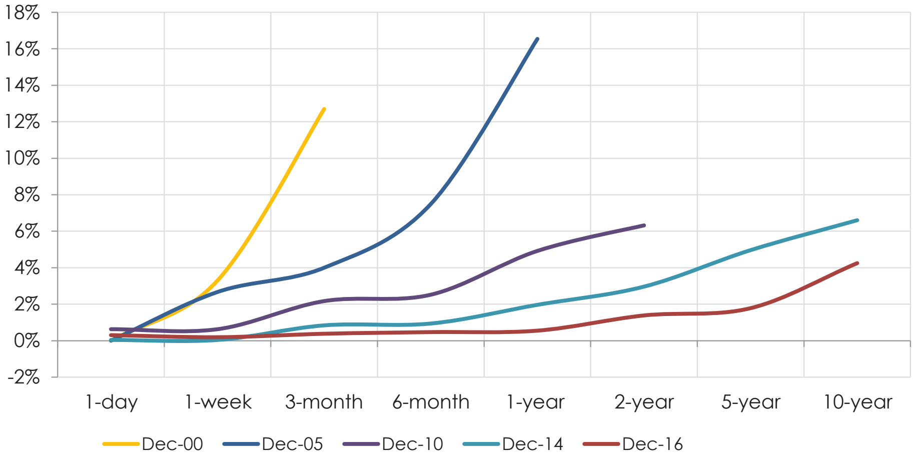
Compared to the previous quarter, the spread between long-term assets and the monetary policy rate increased due to belief in monetary policy tightening. However, it should

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

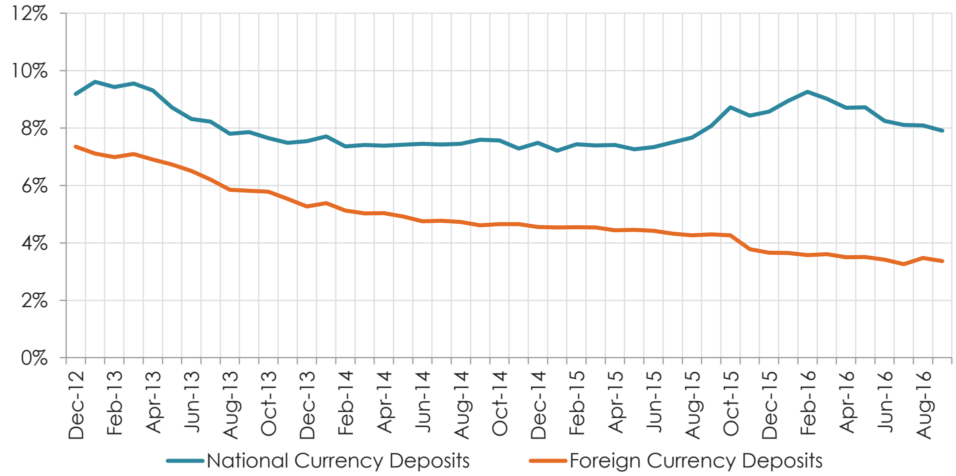


Source: National Bank of Georgia

be noted that the spread decreased compared to the same period of the last year, which implies increased reliability in monetary policy instruments and improved forecasting of the monetary policy rate.

Compared to the previous quarter, the interest rate on domestic currency deposits decreased by 0.2 percentage points and amounted to 7.7%. For foreign currency deposits,

Figure 5.8 Average Interest Rates On Deposits



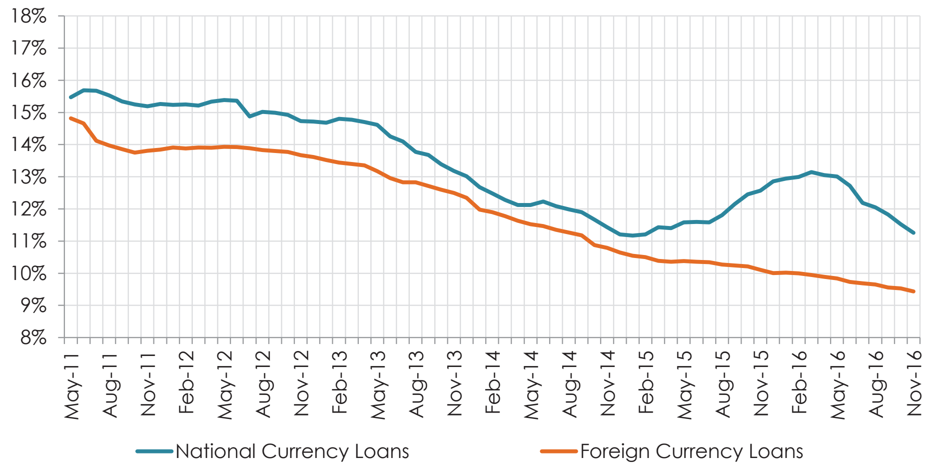
Source: National Bank of Georgia

the interest rate decreased by 0.3 percentage points and amounted to 3.1%. The fall in interest rates on domestic currency deposits was caused by a decline in the monetary policy rate. According to the credit conditions survey, the cost of domestic currency deposits is expected to increase slightly in the next quarter.

According to the credit conditions survey, credit conditions slightly softened for both individuals and legal entities in the fourth quarter of 2016. The softening of supply conditions was caused by general economic trends and increased competition, whereas non-interest conditions did not change significantly. The softening has mainly been reflected in the interest rates of domestic currency mortgage loans. Interest rates on foreign currency loans continued to decrease, because of reduced demand for long-term loans resulting from increased currency risk. In December, interest rates on the flow of corporate loans decreased by 0.9 percentage points compared to September and amounted to 9.7%. Interest rates on loans to small and medium businesses declined by 0.6 percentage points and amounted to 9.7%, while rates on retail borrowings decreased by 0.4 percentage points and amounted to 15%.

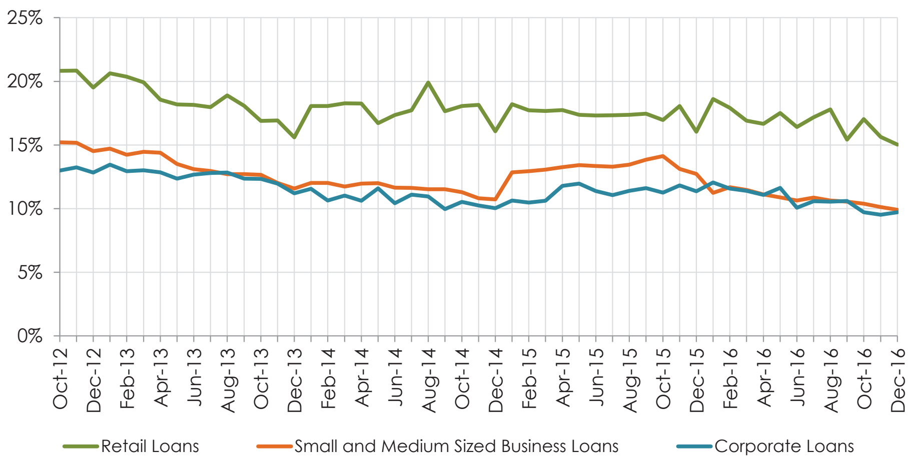
In the context of currencies, interest rates on business loans in the domestic currency decreased by 0.7 percentage points, while interest rates on foreign exchange loans declined by 0.3 percentage points (see Figure 5.9). According to the credit conditions survey, lending conditions are expected to soften in the next quarter. 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.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow



Source: National Bank of Georgia

Box 3 Program on the Larization of Loans

On 11 January 2017, in order to ease the increased debt service burden caused by the exchange rate fluctuation, the government of Georgia approved a subsidized, one-time program on the voluntary conversion of US dollar-denominated bank loans of individuals into lari loans. The program started on 17 January and will continue for two months.

In total, approximately 27,000 loans have been identified as falling under the program's eligibility (approximately 400 million US dollars of the total loan portfolio). The subsidy will not cover individuals whose annual income exceeds 100,000 GEL. Moreover, the program does not imply additional costs for commercial banks and is voluntary for both clients and commercial banks. The government provides a subsidy of 0.20 GEL for every US dollar converted; the exchange rate for loan conversion will be defined as the official exchange rate at the date of conversion minus the subsidized 0.20 GEL. Moreover, the National Bank will implement supportive monetary policy instruments, some of which were specifically designed for this program.

When making the decision about conversion, clients should consider the exchange rate risk as well as the conditions of the loan offered in both currencies. The subsidy will not be granted to individuals whose annual income in 2015 exceeded 100,000 GEL. The National Bank of Georgia offers a loan calculator (available at https://www.nbg.gov.ge/index.php?m=653) that will help clients to compare the conditions of a loan in both currencies.

Conversion of loans will not change the money base in the economy, but will affect the structure of the assets. Banks will have more loans in GEL and less in US dollars. Other things being equal, a bank's foreign exchange liabilities will exceed its foreign assets, while its assets in GEL will exceed its GEL liabilities. As a result, the bank will have an open FX position. To correct these imbalances, commercial banks will be given the opportunity to buy needed US dollars from the NBG to close the FX position and avoid foreign exchange risks. Most importantly, this process will be carried out so that the market will not increase demand for US dollars. Nevertheless, the program will decrease the National Bank's foreign currency reserves. The exchange rate for loan conversions will be the official exchange rate at the conversion date minus 0.20 GEL. The difference between the exchange rates will be reimbursed from the state budget.

Increased demand for GEL to buy foreign currency may lead to adverse fluctuations in interest rates. The National Bank will thus provide additional GEL liquidity to commercial banks and use purchased US dollars or converted loan portfolios as collateral. Only standard loans will qualify as collateral. Using this collateral, commercial banks will be able to borrow twice a week during the period of the program and once a month thereafter for a period of two years. Moreover, a 20% haircut will be applied to the collateral. The volume of loans provided with special monetary policy instruments will be limited to the amount of the converted loans for each commercial bank.

Based on an amendment to the civil code, starting from 15 January 2017, individuals will only be able to borrow amounts up to 100,000 GEL in the national currency. The amendment will increase demand for the national currency, especially in microfinance organizations (MFOs). Usually microfinance organizations accommodate demand for local currency either through their own funds or through borrowing from commercial banks. In the transitory period for the legal amendments the NBG will take this issue into account and, in order not to cause an increased cost of funds for microfinance organizations, commercial banks will be obliged to provide part of the refinancing loans to these microfinance organizations. However, the volume to these loans issued using special monetary policy instruments will be limited to 450 million GEL. There is a limit set for each microfinance organization according to its share of the US dominated loan portfolio. Commercial banks will receive 1/12 of this limit every month from the National Bank, using US dollars as collateral. Subsequently, commercial banks will re-lend the amount to the microfinance organizations. According to the existing schedule, debt will initially increase before starting to decrease in a year. The loans issued using this instrument will be completely covered in two years' time. The amount will be provided to the commercial banks selected by the individual MFO. Larger MFOs can select two banks, while others can choose only one bank. During the year, MFOs will be allowed to switch banks.

In addition, it is planned to support the conversion of loans issued by pawnshops through commercial banks. The National Bank will provide GEL resources to commercial banks that have a portfolio of these loans, using US dollar collateral. The volume of the loans is limited to 258 million, and the total debt increase is limited to 1/8 a month. After eight months, the debt will start decreasing, and will be fully covered in sixteen months.

At the same time, the National Bank will continue using standard monetary policy instruments that will provide liquidity to the banking system. Standard and special monetary policy tools are used for the effective implementation of monetary policy by ensuring short-term interest rates close to the policy rate, and promoting the process of de-dollarization.

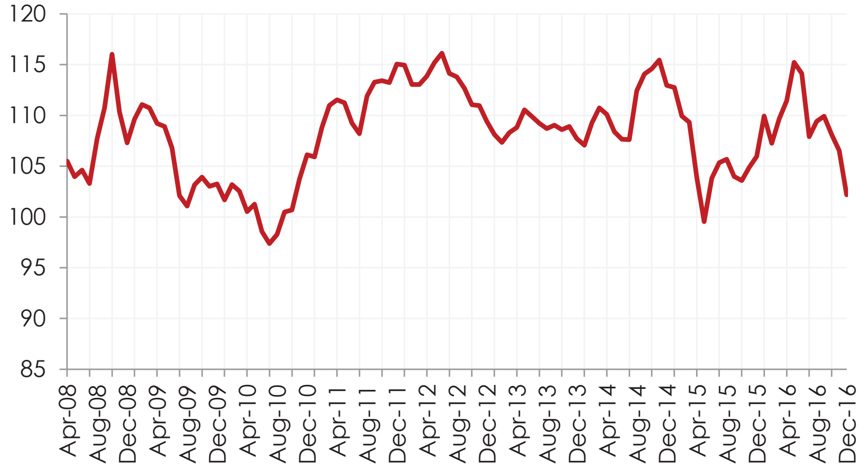
Based on preliminary data, the demand for money in 2017 will increase to 300-400 million GEL. This growth is mostly attributed to the increased volume of currency in circulation. The growth in demand for money will be met using monetary policy instruments, including the refinancing rate, purchase of foreign assets, and government bonds, open market operations and special instruments promoting the larization process. The latter will not affect the money supply, provided that the increased circulation of the national currency is compensated by selling foreign assets and reducing liquidity on the market using standard monetary policy instruments.

5.3. EXCHANGE RATE

In the fourth quarter of 2016, the lari exchange rate slightly depreciated against the US dollar by 7.5%, with the exchange rate averaging 2.5. The GEL also depreciated against the euro (by 3.8%), the Azerbaijani manat (by 1.5%), Ukrainian hryvnia (by 5.2%) and the Russian ruble (by 10.2%), but appreciated against Turkish lira by 3%. As a result, during the fourth quarter of 2016 the nominal effective exchange rate depreciated by 2.9% compared to the previous quarter, while it gained 5.4% in value on a year-on-year basis.

The real effective exchange rate depreciated by 3.2% compared to the third quarter, while the year-on-year appreciation totalled 0.7%.

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



Source: National Bank of Georgia

As Table 5.1 shows, in the fourth quarter of 2016 the real exchange rate appreciated on a year-on-year basis against Turkey and Azerbaijan.

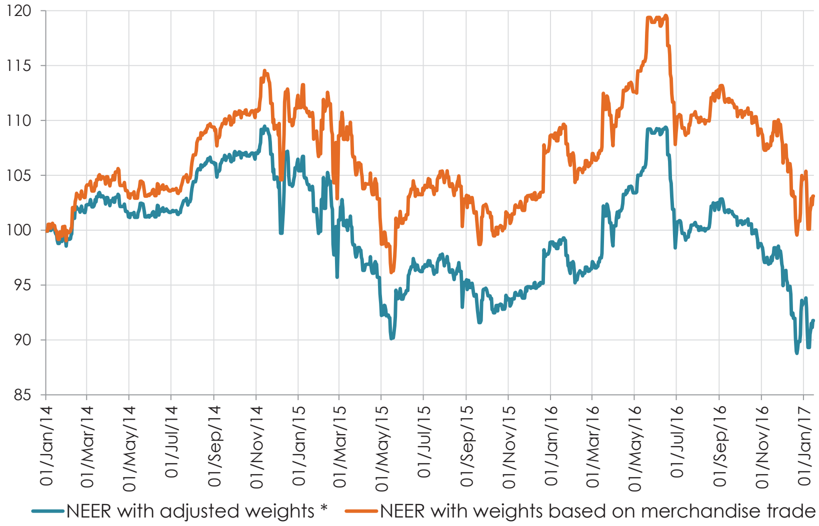
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate	5.4	0.7	0.7
Eurozone	-2.4	-2.5	-0.6
Turkey	8.5	1.5	0.3
Ukraine	9.1	-2.2	-0.2
Armenia	-3.4	-2.0	-0.1
The United States	-3.7	-4.9	-0.2
Russia	-7.8	-12.3	-1.2
Azerbaijan	57.7	31.6	3.7
Other	-1.8	-2.4	-0.9

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, paints a slightly different picture. In the fourth quarter, the adjusted nominal effective exchange rate appreciated by 2.6% year on year, while its value decreased by 4% compared to the previous quarter.

Figure 5.12 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

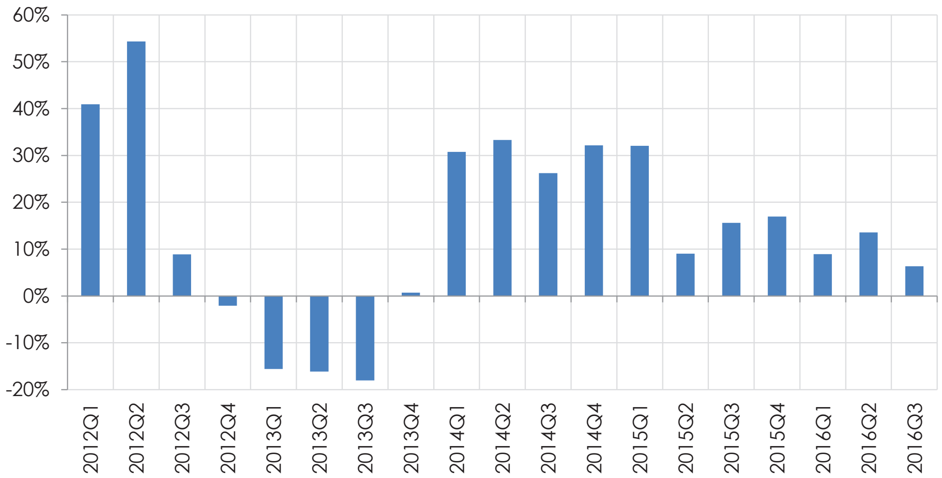
Real GDP growth amounted to 2.3% in the third quarter of 2016, with a rise in investments being the primary determinant of that growth. In contrast, weakened internal and external demand was responsible for the low growth rate of the economy. According to the current forecast, the GDP growth rate is expected to remain low in the fourth quarter.

‹‹ Real GDP growth amounted to 2.3% in the third quarter of 2016.

The capital formation growth rate decreased in the third quarter of 2016 and posted 6.3%. Foreign direct investment (FDI) had a significant share in capital formation growth. BP's investment in a new pipeline project made the most significant contribution to the increase of foreign investments, whereas government infrastructure projects contributed to the rise of domestic investments.

‹‹ The capital formation growth rate decreased in the third quarter of 2016 and posted 6.3%.

Figure 6.1 Annual Growth Rate Of Capital Formation



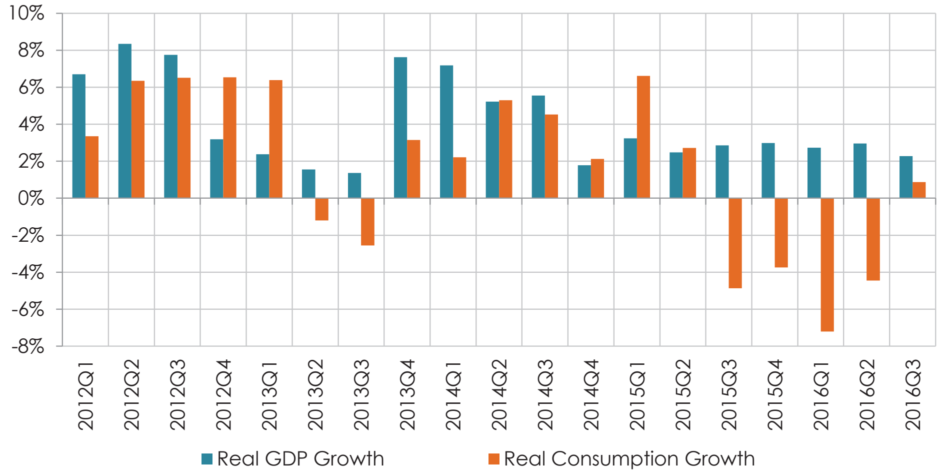
Source: GeoStat

Since the third quarter of 2015, the real consumption growth rate has been negative. In the third quarter of 2016, the private consumption growth rate became positive and amounted to 0.9%, making a positive contribution to real GDP growth. In the current forecast, the rise of private consumption is expected to remain positive in the fourth quarter of 2016. The government consumption growth rate (excluding hepatitis C drugs) remained high, as was the case in the second quarter.

‹‹ In the third quarter of 2016, the private consumption growth rate became positive and amounted to 0.9%.

External demand remained weak in the third quarter of 2016. The net exports balance worsened by 5.9%, which was due to a decrease in exports and an increase in imports. However, some positive trends can be noticed. Exports posted slight positive nominal growth in annual terms in the third quarter, despite the decrease of prices on exported goods. According to preliminary data, exports posted positive annual growth in both nominal and real terms in the fourth quarter. Imports increased annually by 4.1% in the third quarter of 2016, with investment goods being the main driver of that growth. Intermediary goods contributed negatively to the growth of imports. It should be noted that the annual level of imports of consumer goods increased. According to preliminary data, imports will continue growing in the fourth quarter of 2016 and consumer goods are expected to be the main contributor to that growth. The rise in the share of consumer goods indicates the increased growth of consumption in the fourth quarter.

Figure 6.2 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

The consolidated budget deficit for 2016 was planned to amount to 3% of GDP, whereas the actual deficit amounted to 1.3 billion GEL (4% of forecasted GDP). The increased budget deficit contributed to the increased consumption of the public sector and increased domestic investments in the second half of the year. The overall consolidated budget deficit for 2017 is planned to be approximately 1,488 billion GEL, which is 4.1% of forecasted GDP.

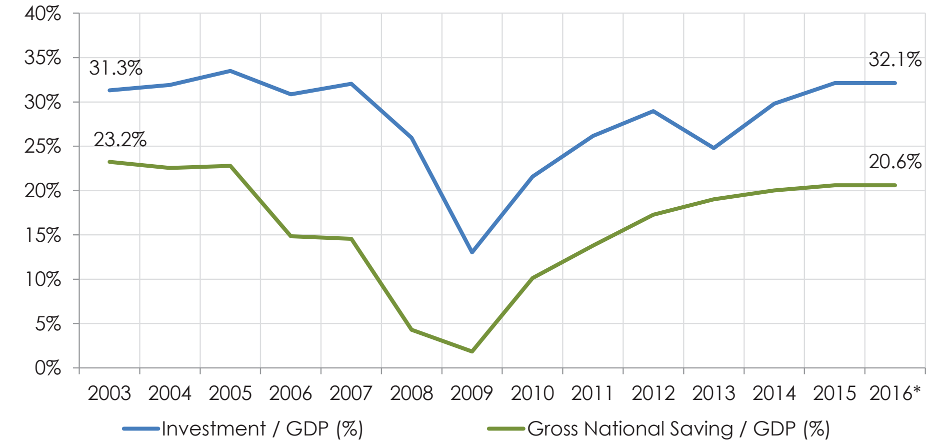
7. External Demand and Balance of Payments

In the fourth quarter of 2016, the rate of registered exports of goods increased by 7.5%. The improvement of exports was mainly caused by the base effect. At the same time, registered imports of goods (excluding C hepatitis medicaments) increased by 6.8%, which caused the trade deficit to deepen. Overall, in 2016 exports and imports of goods decreased by 4.1% and 0.7% year-over-year respectively.

‹‹ In the fourth quarter of 2016, the rate of registered exports of goods increased by 7.5%.

It is important to analyze the balance of payments in terms of investments and savings. Based on the data of the first three-quarters of 2016, the amount of investments and savings both increased. As a result, the difference between total investments and total savings did not change significantly compared to the previous year. The current account deficit was thus maintained at almost the same level.

Figure 7.1 Savings and Investments

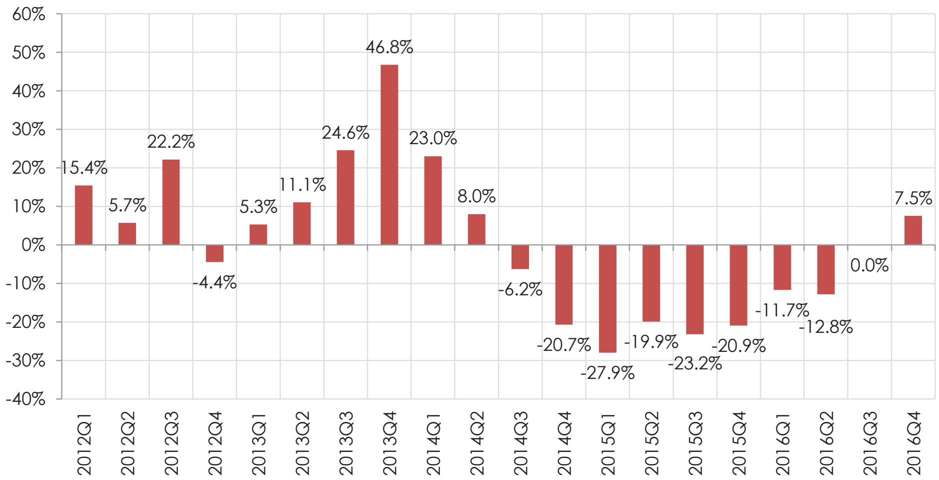


*2016 is based on the data of the first three quarters

Source: GeoStat

In the fourth quarter of 2016, registered exports of goods increased to both CIS and EU countries by 16.3% and 3.6% respectively. Exports to the CIS mainly increased due to growing demand from Azerbaijan, Russia and Ukraine. Meanwhile, Bulgaria, Ger-

Figure 7.2 Annual Change Of Registered Exports Of Goods



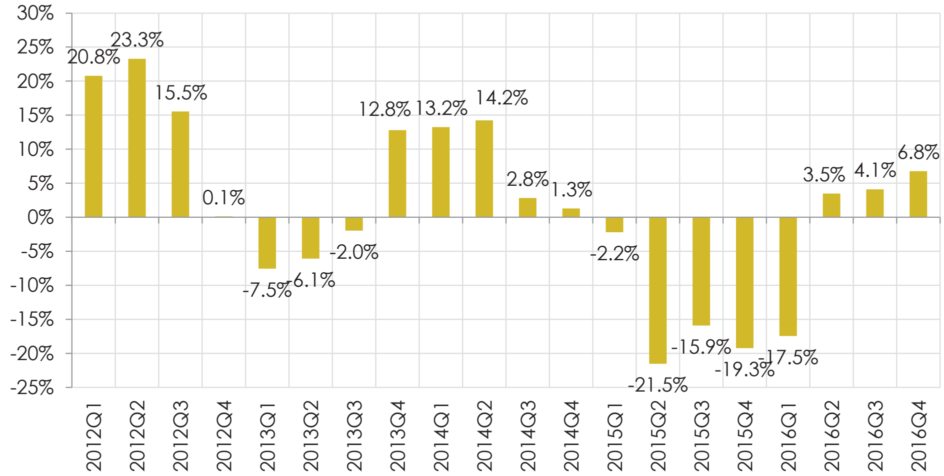
Source: GeoStat

many and Spain were major contributors to the growth in exports to EU countries. It should be noted that exports to Turkey decreased in light of the current situation facing the country. In terms of other major trading partners, exports to China also declined.

Increased external demand for Georgian ferroalloys, spirituous beverages and wines had a positive impact on exports. An increase of re-exports of motor cars also positively contributed to growth. It is worth noting that the product diversification of exports improved in 2016.

In the fourth quarter of 2016, registered imports of goods (excluding C hepatitis medicaments) increased by 6.8%. Imports of goods increased from both CIS and EU countries.

Figure 7.3 Annual Change Of Registered Imports Of Goods[15]

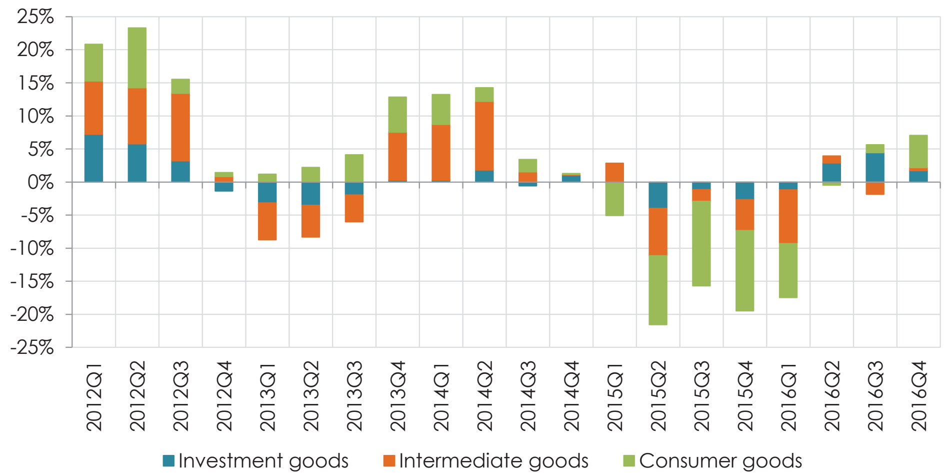


Source: GeoStat

The growth of imports in the fourth quarter of 2016 can mainly be attributed to increased demand for consumer goods. During this period, imports of consumer goods rose by 11.2% and contributed 4.8 percentage points to the increase of aggregate imports. Amongst consumer goods, the sharp increase in purchases of petroleum and petroleum oils was significant. An increase of demand for motor cars also contributed to the growth of imports. The increased volume of foreign direct investments continued to provide stimulus for imports of investment goods, but did so at a lower rate. In the fourth quarter of 2016, an increase in imports of investment goods contributed 1.7 percentage points to the increase of aggregate imports. Purchases of intermediate goods made a small positive contribution to overall growth.

« The growth of imports in the fourth quarter of 2016 can mainly be attributed to increased demand for consumer goods.

Figure 7.4 Annual Change Of Registered Imports By Category Of Goods



Source: GeoStat

15 *Excluding imports of hepatitis C medicaments.*

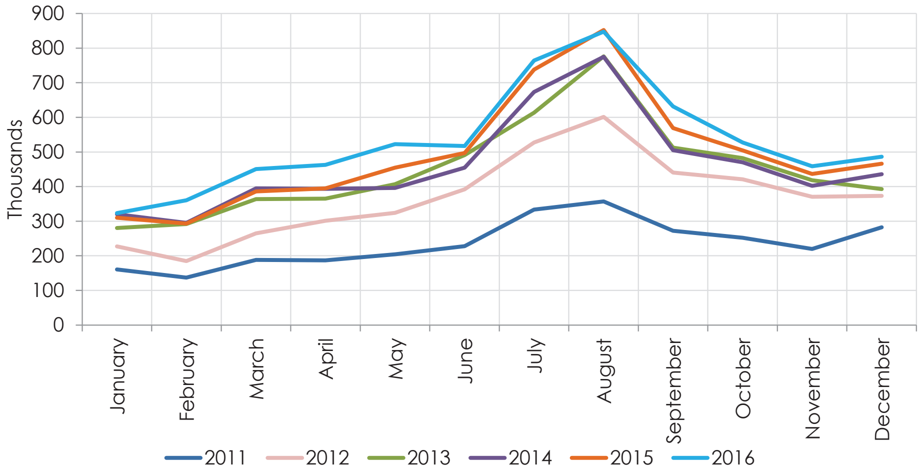
Inflows of international visitors, especially tourist arrivals, have continued to grow. In the fourth quarter of 2016, the number of foreign visitors who entered Georgia increased by 4.6% year over year. Tourist inflows were a major contributor to this growth, increasing by 16.9% year over year. Arrivals from neighbouring countries Azerbaijan, Russia, Ukraine and Armenia positively contributed to the growth of international visitors. The number of international visitors from Iran, Kazakhstan, India and China all increased significantly. However, international arrivals from Turkey continued to decline.

« In the fourth quarter of 2016, the number of international visitors who entered Georgia increased by 4.6%, while tourist arrivals increased by 16.9% year over year.

In line with the increasing number of international visitors, preliminary information suggests that tourism revenues rose by 12.7% year over year in the fourth quarter, and by 11.9% overall in 2016.

« In line with the increasing number of international visitors, based on preliminary information, in the fourth quarter of 2016 tourism revenues rose by 12.7% year over year, and by 11.9% in 2016.

Figure 7.5 Number of International Visitors to Georgia



Source: GNTA

In the fourth quarter of 2016, money transfers from abroad increased by 15.2% year over year and amounted to 319.2 million USD. Money inflows from the EU grew by 13%, with transfers from Greece and Italy being the main sources of the increase. Additional drivers of increased money transfers to Georgia were the USA, Israel and Turkey. The decreasing trend of money transfers from Russia changed in the fourth quarter of 2016 when they rose by 1.6%. On the aggregate level, money transfers to Georgia increased by 6.6% year over year in 2016. The structure of remittances in 2016 was more diversified than in the previous year. The share of money transfers from EU countries (32%), the USA (11.1%), Turkey (7.6%) and Israel (5.3%) in total remittances increased, while the share from Russia (34.3%) decreased compared to the previous year.

« In the fourth quarter of 2016, money transfers from abroad increased by 15.2% year over year.

« The structure of remittances in 2016 was more diversified than in the previous year.

Based on current forecasts, in 2016 the current account deficit increased by 95.4 million USD compared to the same period of the previous year and amounted to 12.5% of GDP. In the second half of 2016, the negative impact of the trade deficit was mitigated by the increase in exports of goods. An improvement in the balance of services, especially the increase in tourism, also positively impacted the current account balance. At the same time, an increase of reinvested income and dividends placed downward pressure on the current account balance. However, it is worth noting that the increase of reinvested income is part of the financial account and therefore does not cause capital outflow or create additional demand for foreign currency.

Foreign direct investments (FDI) are the main source of financing the current account deficit. Based on Geostat data, in the third quarter of 2016 FDI in Georgia amounted to 463.3 million USD, which is 19.9 million USD less than the same period of the previous year. Transport was the largest recipient sector of FDI, with 168 million USD. The financial (51.1 million USD) and construction (69.3 million USD) sectors were also significant recipients of FDI.

« Foreign direct investments (FDI) are the main source of financing the current account deficit.

8. Output and labor market

8.1 OUTPUT

Compared to the same period of the previous year, in the third quarter of 2016, GDP rose by 2.3%. At 1.6 percentage points (pp), the service sector made the largest contribution to overall growth. The industrial sector contributed 0.6 pp and the agriculture sector's contribution was close to the zero mark.

In the third quarter, the trade sector increased by 3.6% and made the largest contribution to overall growth at 0.5 percentage points. It should be noted that this growth was mainly due to the activation of retail trade, which indicates a certain activation of demand. The activity of real estate operations has remained high. This sector's contribution to overall growth has been one of the most significant during the last few years. Real estate operations grew by 7.5%, making a 0.4 pp contribution to overall growth. The increased flow of visitors entering the country contributed to the growth of restaurants and hotels (13.4%, contributing 0.3 pp to overall growth). Growth was also traditionally high in the financial activity sector (9.8%, contributing 0.3 pp to overall growth).

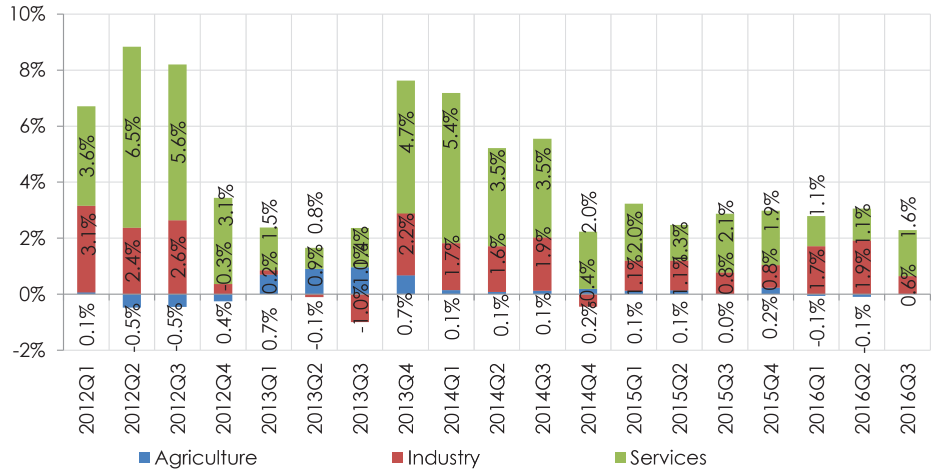
‹‹ In the third quarter trade made the largest contribution to growth.

Compared with previous periods, there was a decline of growth in the industrial sectors. This decline was mainly due to the base effect and the reduction of growth in construction and mining industries. Compared to the remarkable growth these industries saw in the same period last year, in this quarter the increase was relatively low, amounting to 2.4% and 4.7% respectively. A 1.4% increase was observed in manufacturing. A significant share of manufacturing output comes from products that are traditionally considered to be export products and thus augmented foreign demand on certain products was positively reflected on the output of the sector in the third quarter.

‹‹ Growth of industrial sector declined.

The agriculture sector declined by 0.1%, thus its negative contribution to GDP growth was close to the zero mark.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

In the third quarter of 2016, the real value added produced per worker (labour productivity) increased by 0.1%. During this period, labour productivity in the agriculture and industrial sectors declined by 3.6% and 6.4% respectively, but increased in the services sector by 3.6%.

‹‹ Productivity has increased due to services.

The increase in overall productivity was thus largely due to the services sector. Within this sector, the productivity increase in trade was the most notable, where the real growth of output was 3.6% while the number of employees fell by 13,000 (by 6%). Ultimately, the productivity of trade grew by 10%. Meanwhile, a significant growth of labour productivity was also observed in financial activity and hotel and restaurant businesses by 6% and 5% respectively.

The primary cause of productivity reduction in the industrial sector was the 16% productivity decline in construction. Although the real growth of construction in the third quarter of 2016 amounted to 2.4% compared to the same period last year, the number of employees in the sector increased by 20,000 (by 22%) and thus the productivity decreased. It should be noted that the time gap between the growth of employees and the added value created by them is usually longer in the construction sector than in other industries. The productivity level in construction is thus likely to increase over the next quarters.

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

	Labor productivity growth, %
Agriculture and fishery	-3.6%
Industrial sectors	-6.4%
Service sector	3.6%
Overall in the economy	**0.1%**

Source: GeoStat and National Bank of Georgia

The growth rate of the nominal salaries of employees in the third quarter of 2016 amounted to 5.4%. According to the latest data from Geostat, the average monthly nominal salary stands at 981 GEL.

« Salaries for employees increased by 5.4% annually.

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

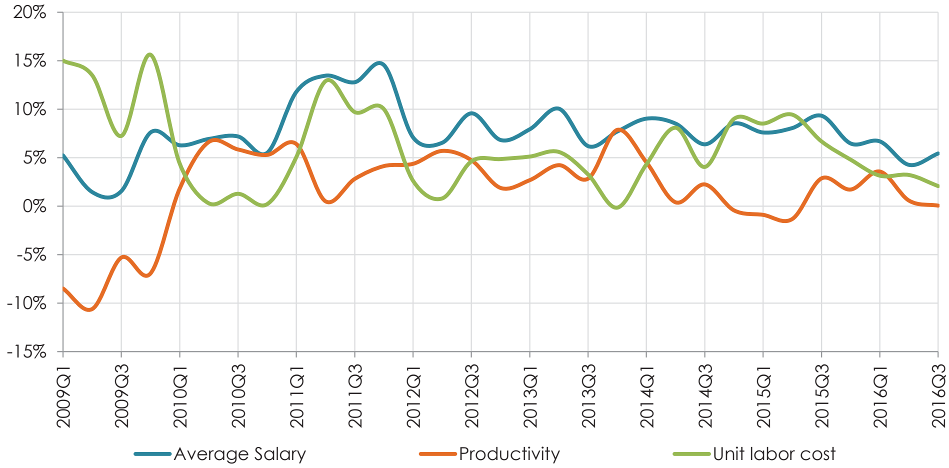
	Growth of nominal wage, %
Agriculture, hunting and forestry	-0.2%
Fishing	106.6%
Mining and quarrying	4.4%
Manufacturing	1.7%
Production and distribution of electricity, gas and water	2.1%
Construction	3.4%
Wholesale and retail trade; repair of motor vehicles and personal and household goods	9.9%
Hotels and restaurants	23.6%
Transport and communications	1.9%
Financial intermediation	7.6%
Real estate, renting and business activities	2.5%
Public administration	3.7%
Education	11.2%
Healthcare and social work	8.1%
Other community, social and personal service activities	0.4%
Overall in the economy	**5.4%**

Source: National Bank of Georgia

In the third quarter of 2016, the annual growth rate of unit labour cost increased by 2.1%, which does not create inflationary pressure from the labour market.

‹‹ Unit labor cost grew by 2.1%.

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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