საქართველოს ეროვნული ბანკი
National Bank of Georgia

Monetary Policy Report

May

2017

ISSN 1512-0767

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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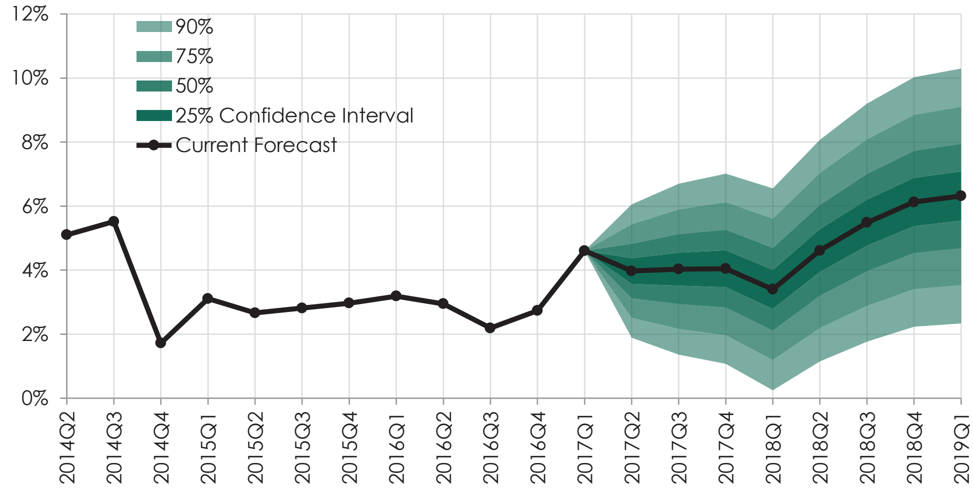
1. Brief Overview

Real GDP growth in the first quarter of 2017 was higher than expected and, according to preliminary estimates, stood at 5%. Aggregate demand improved due to both external and internal factors. The increase in exports of goods and services was significantly higher than expected and improved consumer and business sentiment has led to a rise of foreign direct investments – positively contributing to GDP growth.

The NBG's annual GDP growth forecast for 2017 has not changed and is around 4% (see Figure 1.1). Nevertheless, the level of uncertainty regarding the forecast has decreased. The annual growth will be driven by increased aggregate demand and FDI flows, supported by the planned fiscal stimulus, infrastructure projects and improved business and consumer expectations. In 2017, based on the NBG's estimates, exports are expected to have a small but positive impact on economic growth – this is a significant change as net exports have been exerting downward pressure on GDP growth since 2013, when Georgia was affected by external shocks. Yet, overall growth will continue to be negatively influenced by the global economic outlook and the political and economic conditions experienced by Georgia's trading partners. According to current estimates, output in 2017 will continue to be lower than its potential level; however, this gap is expected to gradually close during 2018 and 2019.

Figure 1.1 Annual Real GDP Growth

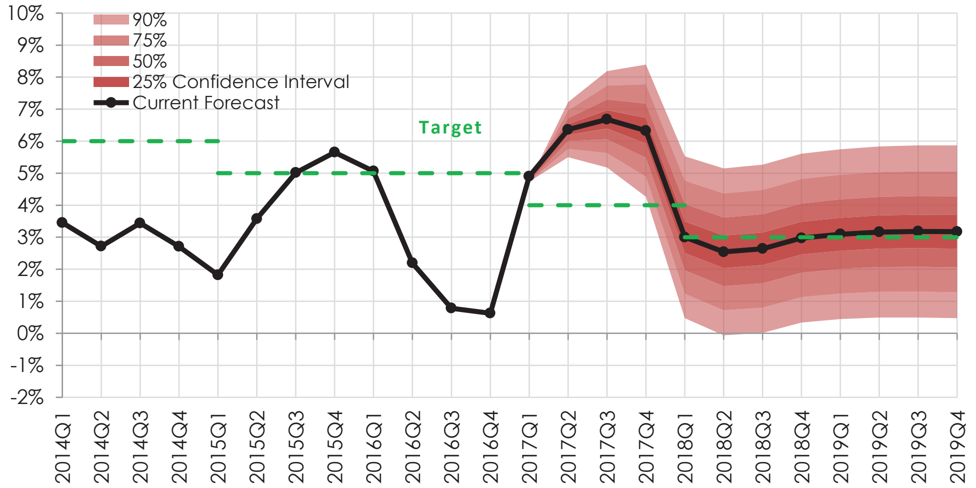


Source: National Bank of Georgia

The annual inflation rate in the first quarter of 2017 was above the target and equaled 5.4% in March. Temporary factors caused the increase in inflation. The rise of excise tax, alongside increased prices of oil and food on international markets, has already been reflected on consumer prices. However, the increase in prices was recently balanced by the relative appreciation of the GEL exchange rate.

Temporary factors will continue to influence the annual inflation rate in 2017. **The NBG thus expects** the annual inflation rate to remain slightly above the target. Nevertheless, with the exhaustion of one-time factors, the inflation rate will decline over the year, hovering around 3% in 2018. Moreover, below-potential aggregate demand will have downward pressure on the inflation rate. In the medium term, the shocks pushing inflation upwards will shorten, thereby maintaining the inflation rate at its target level (see Figure 1.2).

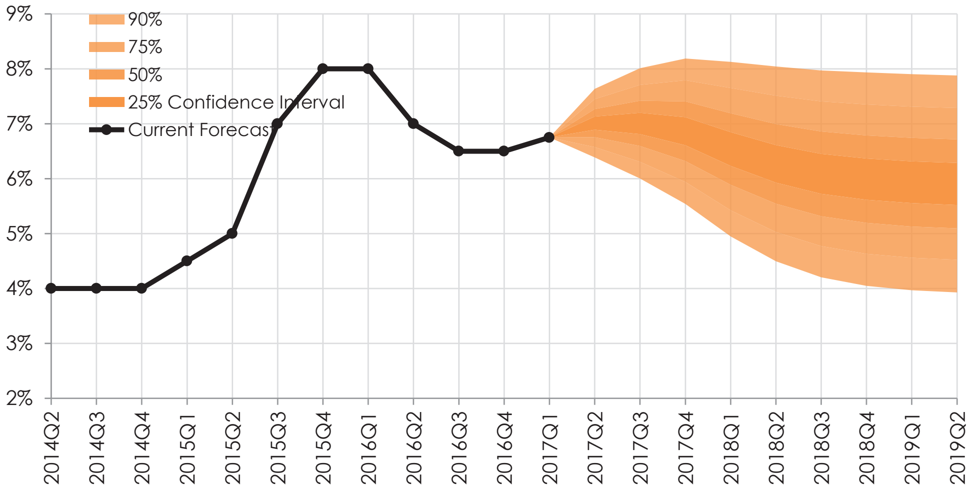
Figure 1.2 Headline CPI Inflation



Source: National Bank of Georgia

It should be noted that the aim of the monetary policy cannot be a full neutralization of temporary factors affecting the inflation rate in the short run. as this objective could be only reached through a dramatic reduction in economic growth and employment. Thus, while forming monetary policy, the National Bank of Georgia tries to be balanced in its decision-making. On the one hand, it considers the expected timeframe over which the inflation rate will return to the target; on the other hand, it estimates its effect on economic growth. To curb inflation expectations, the NBG increased the monetary policy rate to 7.0%. However, according to current macroeconomic forecasts, the NBG expects a decrease in the trajectory of the monetary policy rate to reach its neutral level in the medium term as the temporary factors are exhausted (see Figure 1.3). It should be noted that the monetary policy rate forecast is not a promise on future decisions 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.

Figure 1.3 Forecast of the Monetary Policy Rate



Source: National Bank of Georgia

The forecast is dependent on exogenous factors 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 Georgia's trading partners, the global strength of the US dollar and international oil prices. The baseline forecast does not assume an amplification of external shocks or increased volatility of international commodity prices. Therefore, if external factors and/or international prices evolve differently than expected, they may influence the projected paths of macroeconomic variables and, consequently, future decisions taken by the National Bank of Georgia.

2. Macroeconomic Forecast

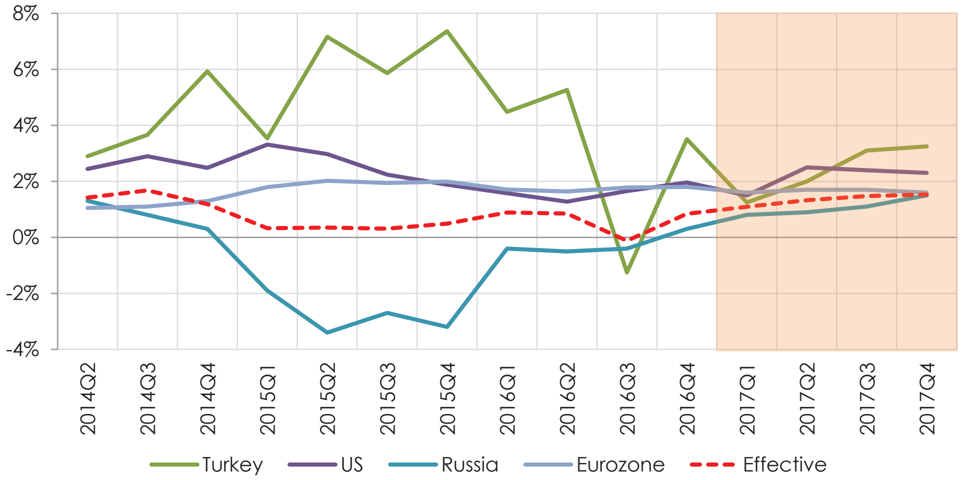
2.1 OVERVIEW OF EXTERNAL FACTORS

At the beginning of 2017, although signs of improvement are apparent, economic activity in the region remained weak. The Georgian economy continued to be significantly affected by the macroeconomic trends of the neighboring countries through trade, tourism and remittances. According to IMF projections, global economic growth for 2017 will stand at 3.5%[1], which is a higher estimate than the previous forecast (January 2017[2]). This change is linked to expectations of a relatively faster economic recovery in developed countries.

Deteriorating geopolitical factors in the Eastern part of **Ukraine** have slowed the economic recovery process and annual industrial output has declined by 5%. However, in April the IMF agreed to provide an additional tranche to Ukraine. This positively influenced business and consumer sentiment and partly neutralized the effects stemming from the decline in industrial output. As a result, the IMF has only slightly decreased its economic growth forecast for Ukraine to 2%.[3]

Meanwhile, **Russia** has remained on the path of gradual economic recovery. In March, the implementation of prudential policy measures, together with the stabilization of international oil prices, increased industrial output and improved the balance of trade. Moreover, the recent appreciation of the ruble muted the inflation rate, which stood at 4.3%. Based on IMF estimates, in 2017 Russia's GDP will grow by 1.4%,[4] which is 0.3 percentage points higher than previously predicted (in January 2017).

Figure 2.1 Real GDP Growth of Economic Partners[5]



Source: Bloomberg; National Bank of Georgia.

At the beginning of 2017, supported by the steady recovery in Russia, economic activity in **Armenia** significantly increased. A growth of remittances and export revenues had a positive impact on consumer confidence. Moreover, to facilitate foreign direct investments, the new government expressed readiness for the implementa-

1 *International Monetary Fund. 2017. World Economic Outlook: Gaining Momentum? Washington, D.C., April.*

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

3 *International Monetary Fund. 2017. World Economic Outlook: Gaining Momentum? Washington, D.C., April.*

4 *ibid.*

5 *Effective growth is the weighted average of the 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.*

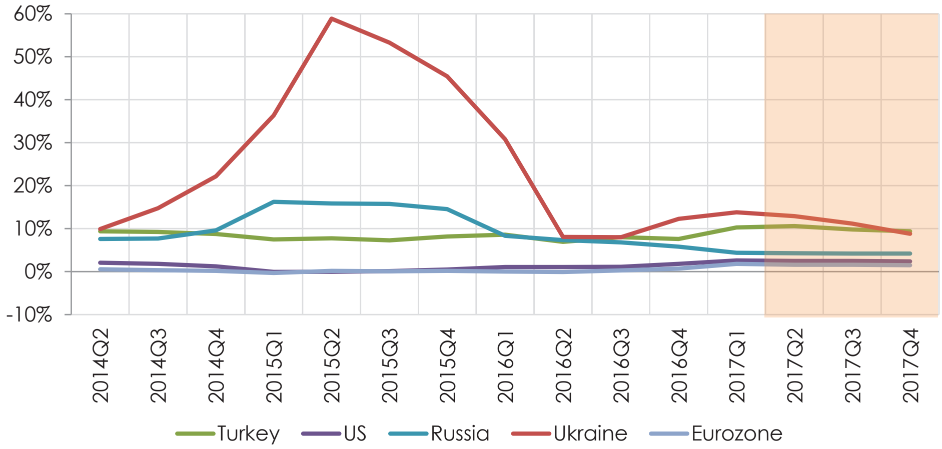
tion of liberalization reforms. Nonetheless, the IMF revised its October 2016[6] real GDP growth forecast down to 2.9%.[7]

As with other countries in the region, **Azerbaijan's** economy has also showed signs of recovery. In parallel with an increased rate of investments, non-oil industry performance significantly improved. Moreover, with the stabilization of oil prices, the decline of the oil industry slowed. However, given the lower-than-projected GDP growth in 2016, the IMF expects -1% growth in Azerbaijan in 2017.[8]

Despite weak growth in the second half of 2016, the countercyclical measures implemented by the government of **Turkey** led to an increase in industrial output and aggregate demand in the beginning of 2017. However, uncertainty in the country's political environment persisted, negatively affecting the expectations of market agents. Due to the sharp devaluation of the Turkish lira, the inflation level surged to a historical high and stood at 11.3% in March. The IMF expects the Turkish economy to grow by 2.5% in 2017, which is a somewhat lower estimate compared to the previous forecast of October 2016.

The **US** has enjoyed fast economic growth, promoted by increasing consumer demand and a falling unemployment rate. Furthermore, consumer and business expectations have been further influenced by the expected fiscal stimulus. According to IMF projections, the US economy will grow by 2.3% in 2017.[9] The **eurozone** economy has also gained momentum. This was accompanied by improved consumer and business sentiment, increasing aggregate demand and positive trends in the labor market. However, consumer price inflation in the area has remained below the target of 2%. In March, the annual inflation rate stood at 1.5% and the IMF expects the eurozone to grow by 1.7% during 2017.[10]

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

At the beginning of 2017, given the weakening effect caused by the devaluation of local currencies, falling inflation expectations in some trading regional partners allowed their central banks to reduce monetary policy rates to encourage economic activity. Meanwhile, in developed countries, where growth rates are below their potential and inflation rates are low, accommodative monetary policy expectations remained. In the United States, in the wake of increased inflation and improved expectations of economic activity, the Federal Reserve increased the monetary policy rate in March. Furthermore, according to the minutes of the Federal Open Market Committee, the monetary policy rate in the US is expected to increase twice more in 2017.

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

7 *International Monetary Fund. 2017. World Economic Outlook: Gaining Momentum? Washington, D.C., April.*

8 *ibid.*

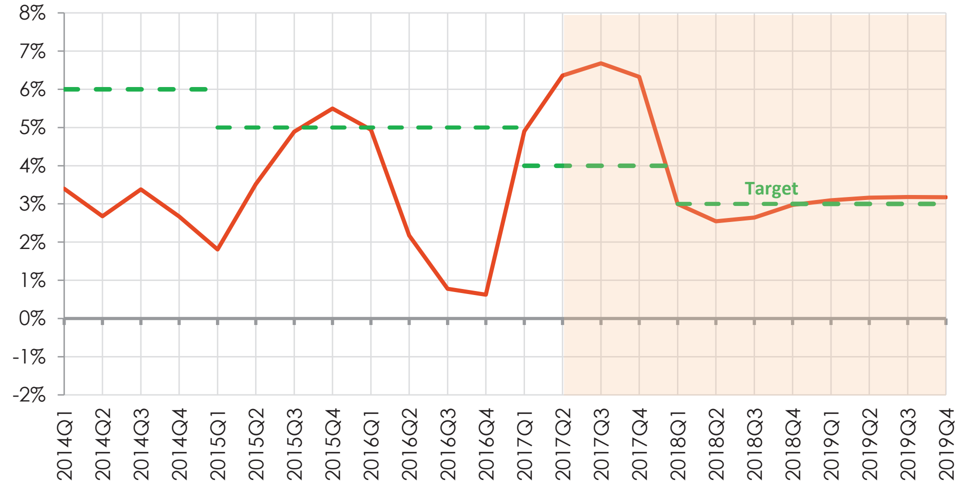
9 *International Monetary Fund. 2017. World Economic Outlook: Gaining Momentum? Washington, D.C., April.*

10 *ibid.*

2.2 MACROECONOMIC FORECAST

In the first quarter of 2017, **the annual inflation rate** was above the target and stood at 4.9%. In March, it was 5.4% (see Figure 2.3). The rate exceeded the target because of temporary factors affecting the supply side. In particular, consumer prices were affected by recent increases in excise tax rates and international food and oil prices.

Figure 2.3 Headline CPI Inflation

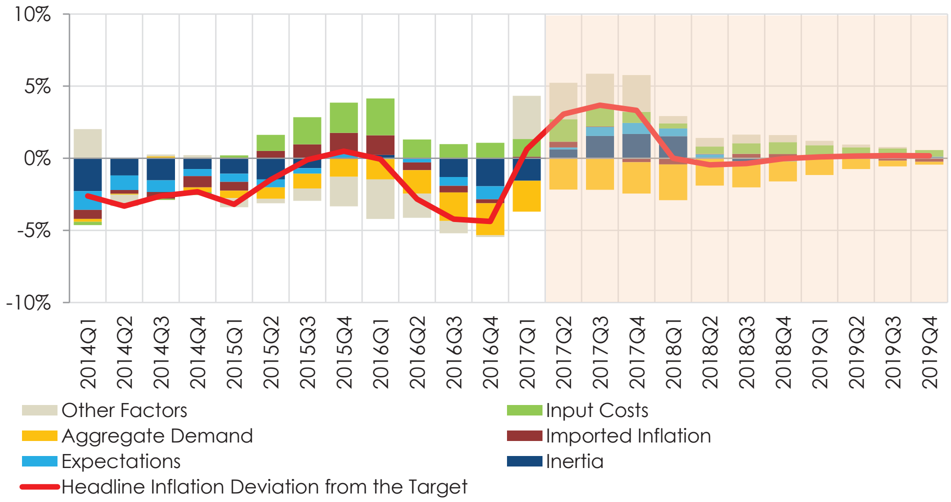


Source: National Bank of Georgia.

In the first half of 2017, the National Bank of Georgia **expects inflation** to increase slightly further and to continue to temporarily remain above the target level. However, with the gradual exhaustion of temporary factors, inflation will start to decrease and will subsequently approach the target rate. Starting from 2018, inflation will stabilize at the long-run target of 3% (see Figure 2.3).

The factors that influenced the **deviation of the inflation rate from its target** level in the first quarter of 2017 will continue to affect inflation over the rest of the year. The above-target inflation is predominantly caused by temporary factors, such as the growth of excise tax rates and international prices on food and oil. In addition, according to the forecast, the increase in inflation in 2017 will be further promoted by the imported inflation rate and a rise of intermediate costs that reflect the growing burden on producers' loans in foreign currency. On the other hand, weak aggregate demand puts downward pressure on the inflation rate. In the medium term, as temporary factors are eliminated and economic output rises to its potential level, the inflation level will stabilize around its target (see Figure 2.4).

Figure 2.4 Inflation Deviation from the Target and its Decomposition[11]



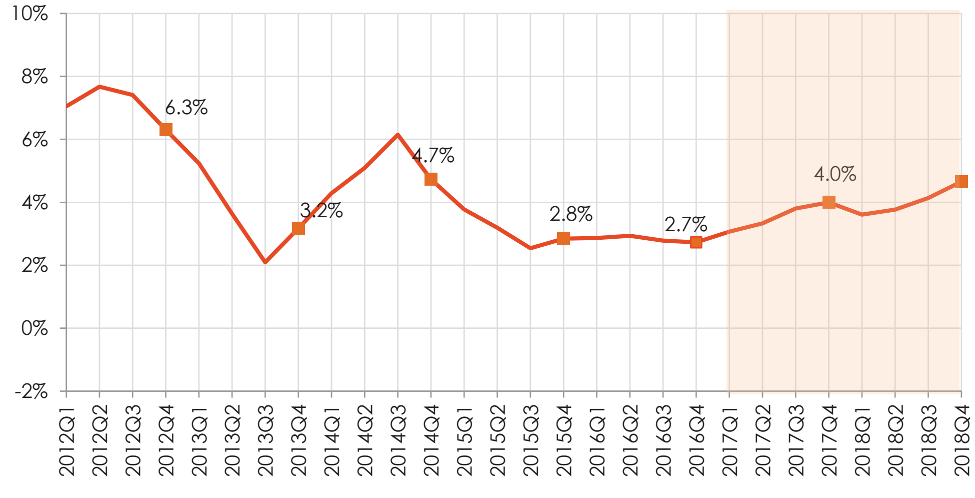
Source: National Bank of Georgia.

11 *In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

There are **risks associated with the inflation forecast** in both directions. Uncertainty remains surrounding international food and oil prices, which have substantial weight in the consumer basket and are mostly supply driven. The baseline forecast scenario does not consider significant changes in those factors; however, if international prices are greater than expected, inflation in Georgia will be higher than forecast. Moreover, if the exchange rates of major trading partners appreciate more than is projected, this will increase the prices on imported goods, further increasing the risk of inflation. Risks are also associated with the euro exchange rate, which will depend on the pace of lifting the European Central Bank's quantitative easing program. 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-than-projected inflation. There is also uncertainty surrounding economic activity. If economic activity is stronger than expected, it will cause inflation to be higher than projected, and vice versa if weaker than anticipated.

Real GDP growth in the fourth quarter of 2016 was lower than expected and amounted to 2.8%. However, based on initial estimates, economic growth in the first quarter of 2017 was 5%, which was higher than anticipated (see Figure 2.5). This growth can be attributed to both the increase in domestic demand and the improvement of the external environment. In particular, fiscal stimulus and an improvement of investor sentiment have both led to the growth of aggregate demand and FDI. Moreover, the improved external environment further promoted an increase in exports of goods and services. Net exports have exerted downward pressure on GDP growth since 2014, when Georgia was affected by external shocks. At that time, the decline in exports could be attributed to lower foreign demand and increased imports. The external balance started to improve from the second quarter of 2015, with the relative depreciation of the GEL exchange rate against the dollar. This currency depreciation both corrected the import balance and softened the adverse shocks on exports. Despite this relative recovery, net exports continued to negatively contribute to GDP growth during 2015 and 2016. However, according to NBG estimates, from 2017 exports are expected to have a positive contribution to economic growth (see Figure 2.6).

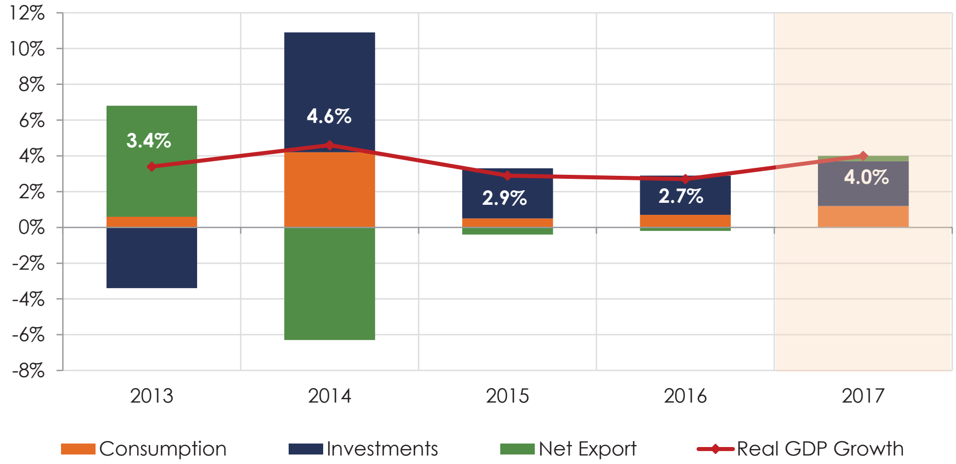
Figure 2.5 Real GDP Growth (Annual Growth of the Last Four Quarters)



Source: National Bank of Georgia.

According to the **GDP forecast**, the growth rate for 2017 is projected to be around 4% (see Figure 2.5). Planned infrastructure projects and fiscal stimulus will support an increase in domestic demand. Moreover, the unfavorable trend in the foreign sector is expected to improve, making a small but positive contribution to GDP growth (see Figure 2.6). Net exports were negatively influenced by the adverse political and economic conditions experienced by Georgia's trading partners. These were reflected in both weak foreign demand for Georgian exports and declining remittances. The negative contribution of net exports was further reinforced by fiscal stimulus and the growth of domestic demand, both of which led to an increase in imports. Nonetheless, such negative spillovers from the foreign sector were partly offset by reduced commodity prices on international markets since 2014 – a positive factor for both the current account and other sectors of the economy – and by the correction of the real effective exchange rate.

Figure 2.6 Real GDP Growth Decomposition[12]



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, economic conditions in Georgia's trading partner countries worsen and/or are transmitted to Georgia to a greater extent than expected, then actual GDP growth will be lower than in the current forecast. Another risk is associated with the dollar and euro exchange rates on international markets, as these directly influence the currencies of the trading partners and, through trade channels and expectations, affect foreign exchange inflows and the GEL 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 in the forecast.

According to preliminary data, the **current account deficit** in 2016 was equal to 13.3% of GDP. The deepening of the deficit can mostly be ascribed to the negative balance of investment revenues[13], whereas the trade balance for goods and services, as well as inflows of remittances, have improved. For the current year, in USD terms, exports of goods increased by 30.3% in the first quarter, while imports grew by 14.4%. Therefore, the negative trade balance widened by 7.6% compared to the same period of last year. In contrast, remittances and revenues from tourism grew by 22% and 23% respectively.

According to the **forecast, in 2017 the current account deficit** will be approximately 12% of GDP. In the medium term, the deficit is expected to decrease – mostly due to increased exports of goods and services, tourism and FDI.

The ultimate goal of the National Bank of Georgia is price stability, which can efficiently be reached through pursuing an inflation-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. In addition, the NBG takes into account output volatility. The NBG's response to supply side shocks should not be overly aggressive to induce high output volatility. Gradual changes in the policy rate are considered optimal for other considerations as well (e.g., in times of uncertainty and for controlling long-term interest rates more effectively). Thus, the inflation forecast itself includes the **interest rate forecast** that takes all of the above mentioned into account.

Figure 1.3 shows the forecasted trajectory of the monetary policy rate that is consistent with the macroeconomic forecast presented above. To curb inflation expectations, the trajectory implies a moderate increase in the policy rate during 2017. However, as shocks will die out in 2018, a gradual reduction in the interest rate should be expected to support output reaching its potential level. An important assumption of forecast is that there will be no further significant pressure on the exchange rate from the foreign sector, thus lower and stable inflation expectations should strengthen the lari exchange rate in the long run.

12 The figure excludes the impact of grant-financed hepatitis C drug imports, unlike in previous Monetary Policy Reports.

13 This is due to the increase in revenues received from direct and other foreign investments as dividends and reinvestments. Although the latter negatively affects the balance of the current account, it is considered as foreign direct investment and thus the balance of payments does not change as a result of such operations.

In the medium term, the National Bank of Georgia will gradually continue monetary policy normalization, which means cutting the policy rate until its medium-run neutral level has been reached. 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.

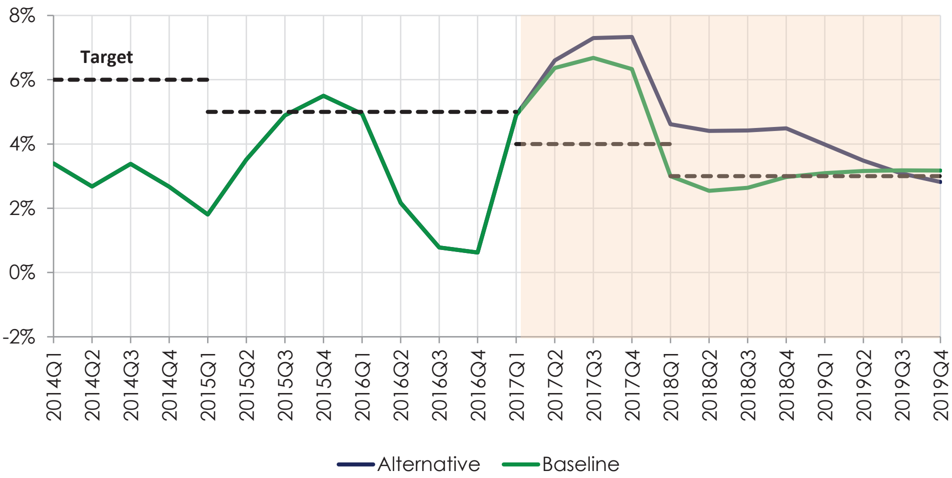
Finally, it should be clearly stated that the **forecast of the monetary policy rate is not a promise from the National Bank of Georgia**. It is only the expected trajectory of the policy rate; assuming that all the exogenous factors incorporated into the forecast materialize as expected. Despite this uncertainty, which is characteristic of any projection, 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 moderately worsens. In particular, the scenario assumes less-than-expected growth in global and regional economic activity, which will have negative effects on the Georgian economy. As a result, net exports and GDP growth will be lower than expected. The alternative scenario also considers an even greater-than-expected appreciation 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. In this scenario, the high current account deficit would require an adjustment of the nominal effective exchange rate, which may become a source of inflation. Under this scenario, because of greater-than-expected pressure from the supply side, the annual inflation rate is higher than in the baseline scenario (see Figure 2.7), while economic growth is lower (see Figure 2.8).

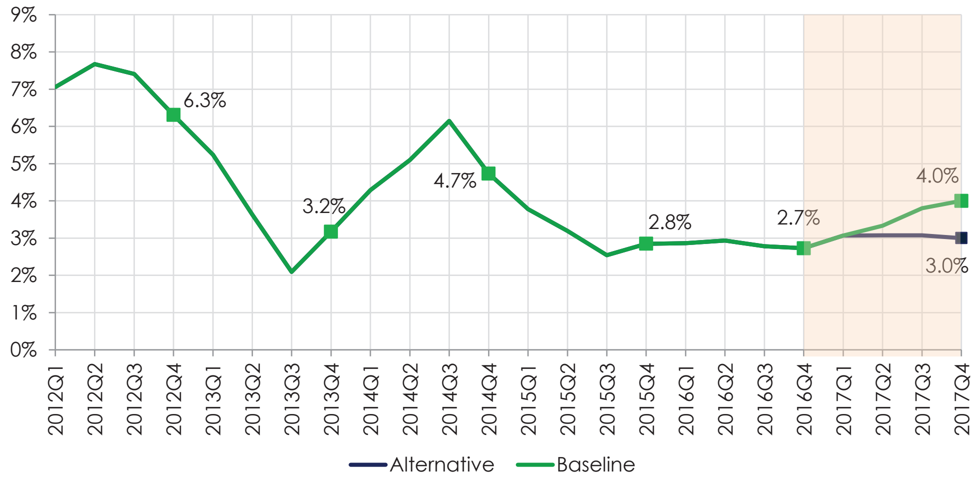
In the alternative scenario, due to negative external shock the inflation level increases at a faster rate than in the baseline scenario. Under such circumstances, monetary policy provides an appropriate response to neutralize inflationary expectations and reduce inflationary pressures. According to the alternative scenario, inflation in 2017 will, on average, be 0.5 percentage points higher than in the baseline forecast; while in 2018 the average inflation rate will be 1-2pp 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)

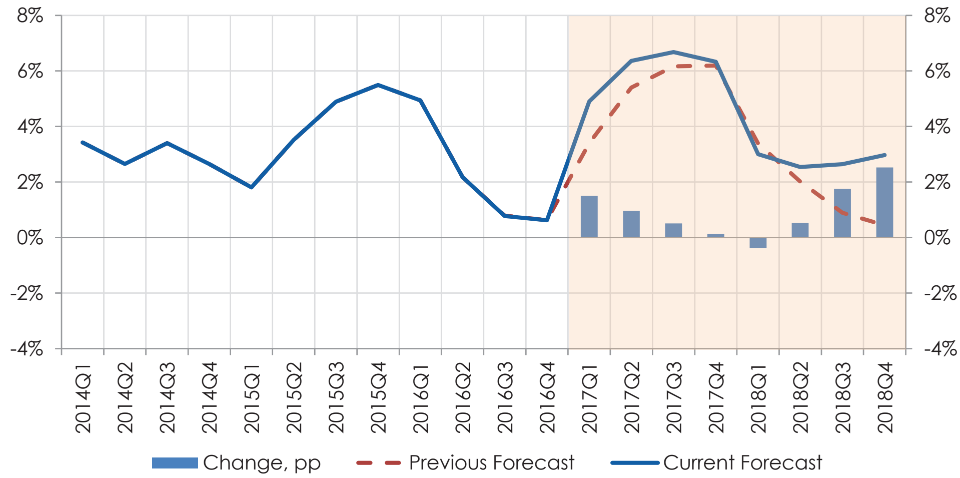


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast for upcoming quarters has been revised upwards due to temporary factors and increased inflation expectations (see Figure 2.9). The temporary factors include the increased excise tax rate, which had a greater influence than projected on consumer prices in the first quarter of 2017. Moreover, increased international prices on food and oil have pushed imported inflation upwards. In addition, with higher-than-expected economic growth in the first quarter of 2017, previous changes in the GEL exchange rate were reflected in consumer prices with a delay.

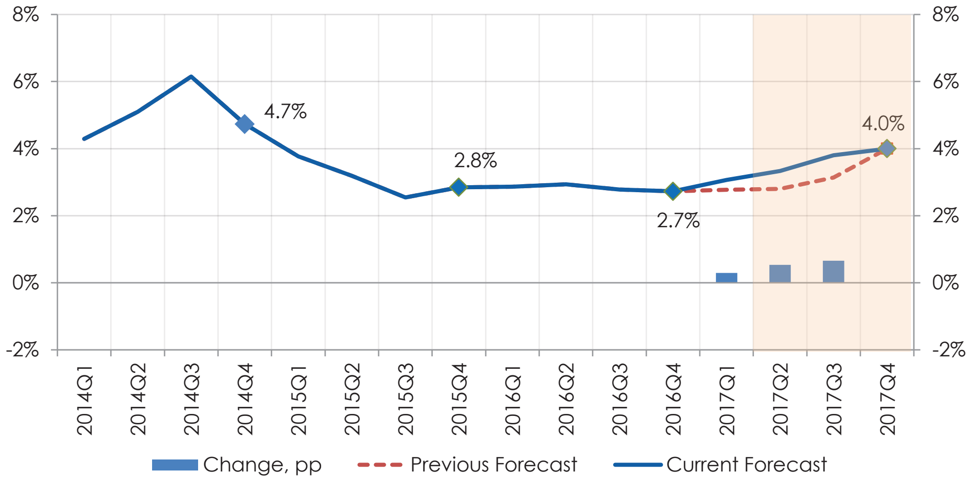
Figure 2.9 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

As for economic activity, the real economic growth forecast for 2017 has not changed (see Figure 2.10). As the key factors that defined growth have not changed, the GDP growth projection for 2017 still stands at 4%.

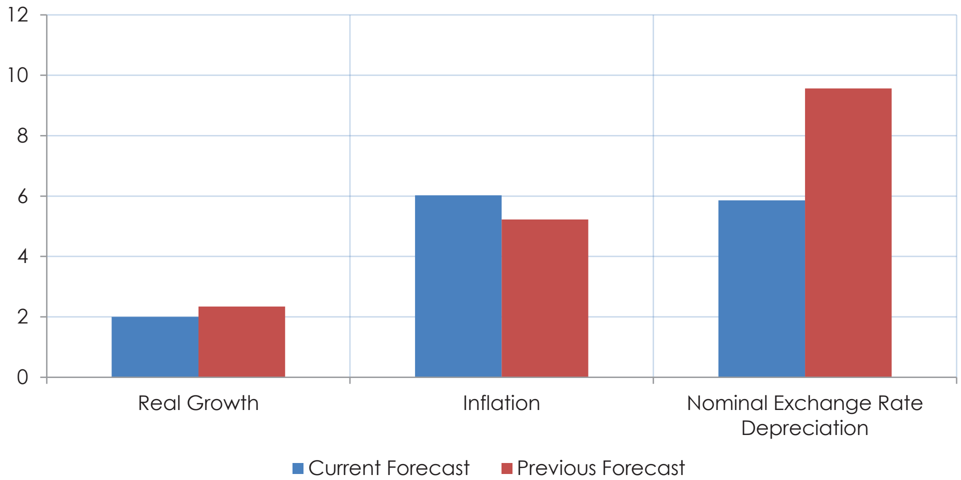
Figure 2.10 Changes in the Forecast of Real GDP Growth (Annual Growth of the Last Four Quarters)



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 improved 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[14]



Source: Bloomberg

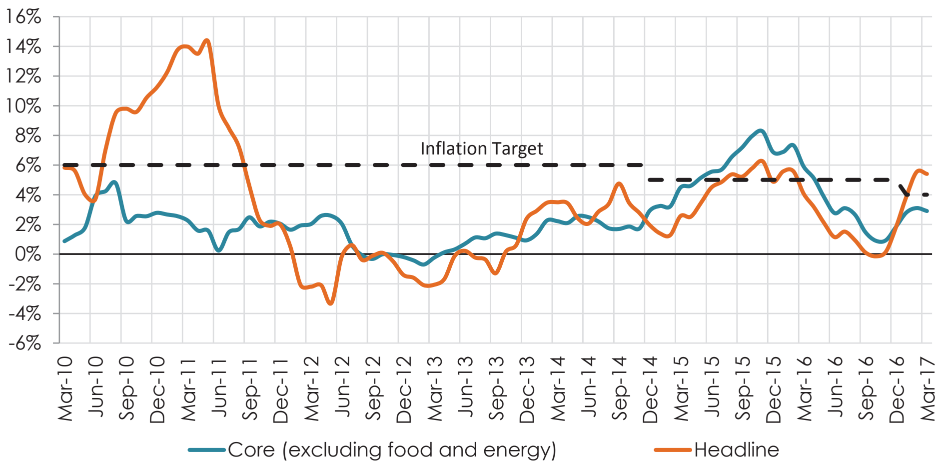
14 *The calculations are based on forecasts of the five main trading partners of Georgia.*

3. Consumer Prices

The inflation rate increased in the beginning of 2017. In March, annual inflation stood at 5.4% and the core inflation rate was 2.9%. As the inflation target for 2017 is set at 4%, the inflation rate in February and March was above this target.

‹‹ Inflation increased in the beginning of the year.

Figure 3.1 CPI And Core Inflation



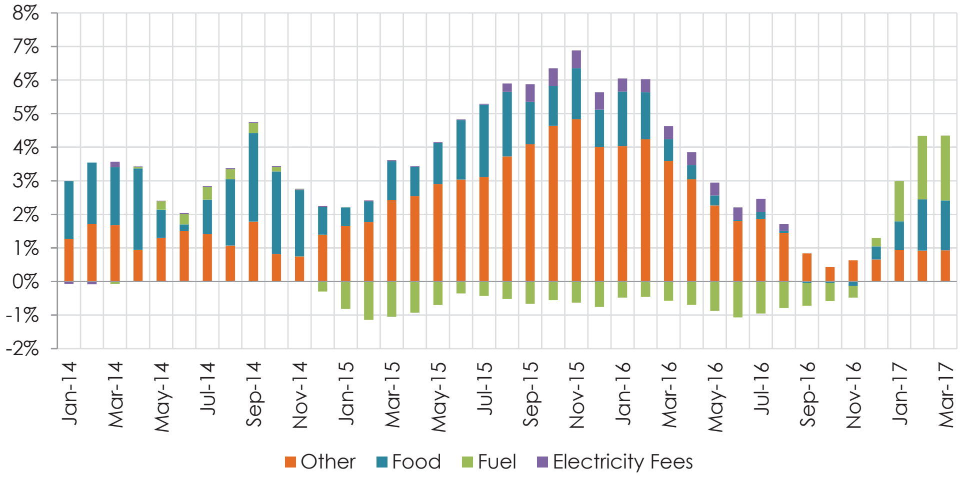
Source: GeoStat

The rise of the inflation rate can be ascribed to increases in the prices of oil and tobacco, which stemmed from increased international prices on oil and a rise in the excise tax rate from the beginning of 2017. From January to March, approximately half of the growth of inflation was attributed to the higher prices of those products. In particular, of the 5.4% inflation in March, the price increase on those products had a 2.9 percentage points (pp) share, while food prices contributed 1.5 pp, and other goods 1 pp (see Figure 3.2).

‹‹ Growth of inflation is mainly related to fuel and tobacco.

In March, from the food group, the price increase was most significant (6%) on meat and meat products; making a 0.4 pp contribution to headline inflation. This can be linked to growing meat exports to trading partner countries. Compared to the previous period, the rising price of sugar on international markets led to an increase in prices on products containing sugar (rising by 13.6%; a 0.3 pp share in the overall inflation rate). Prices also importantly rose on vegetables (by 8.1%; a 0.3 pp share in inflation). On the other hand, prices of apples and potatoes substantially declined, by 26% and 19% respectively.

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



Source: GeoStat and National Bank of Georgia

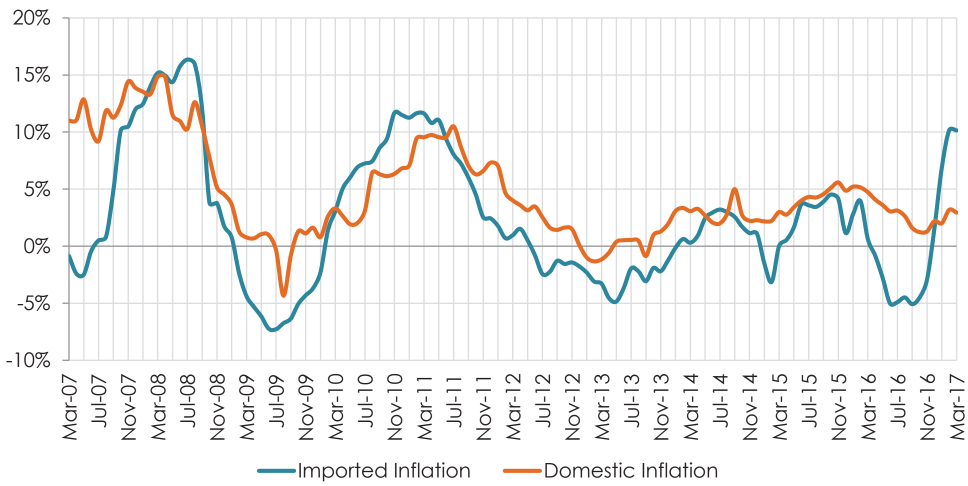
Annual imported inflation stood at 10.1%. This growth can be explained by the increase of prices on fuel and tobacco caused by the rise in excise tax on these products. Rising international prices on oil and sugar also contributed to imported inflation.

In terms of imported products, the price decrease on shoes and clothing is noteworthy. The appreciation of the lari against the Turkish lira resulted in cheaper shoes and clothing imports from this country.

« Inflation of locally produced and mixed goods was comparatively lower.

In March, inflation on locally produced and mixed goods was comparatively lower and stood at 3.7% and 2.9% respectively.

Figure 3.3 Imported And Domestic Inflation

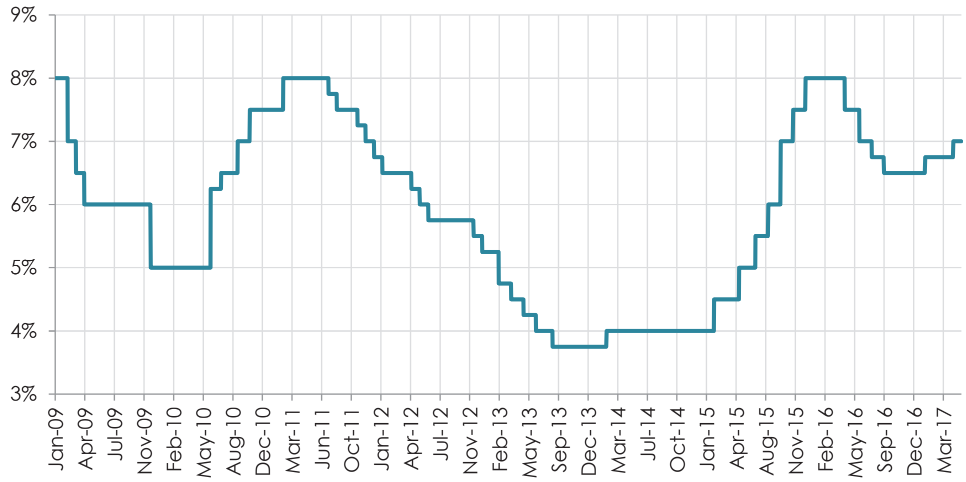


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

At the end of 2016, based on the economic situation at that time, the National Bank of Georgia suspended its monetary policy easing and decided to keep the refinancing rate unchanged at 6.5%. This decision was linked to the improvement of the monetary policy transmission mechanism. Due to the decreased monetary policy rate, by the end of the year loans in GEL were rapidly increasing, which created an additional monetary policy easing effect. There was thus no need for rapid phase-out of the tight monetary policy. Moreover, by the end of a year, global factors started to deteriorate more than expected. In Turkey, a number of geopolitical and political factors led to significant depreciation of the national currency, transmitting the effect through the expectations channel to the lari. In addition, the global strengthening of the dollar further affected the GEL exchange rate. Moreover, the increase in excise tax on certain imported goods from the start of 2017 has led to higher projected inflation and has pushed up inflationary expectations. In order to curb inflation expectations, the NBG thus decided to increase the policy rate to 6.75%, and this was left unchanged in the March 2017 meeting.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the NBG's Monetary Policy Committee was held on 2 May 2017. At that meeting, it was decided to increase the refinancing rate by 25 basis points to 7%.

« According to the NBG's Monetary Policy Committee's decision, the refinancing rate increased by 25 basis points to 7.0%.

This decision was based on the macroeconomic forecast – according to which, due to supply side pressures, inflation was expected to be above its target during 2017. Nonetheless, once the effect of temporary factors affecting inflation are exhausted, the inflation rate is projected to decline at its target level in 2018. Moreover, by increasing the policy rate, the NBG intends to control inflation expectations. Ceteris paribus, no further increase in the policy rate is expected in 2017. Hence, with the elimination of the effects caused by the aforementioned temporary factors, inflation will start to decline and will remain close to the target rate in the medium term. The policy rate in the medium term is expected to gradually decrease to its neutral level.

In March 2017, annual inflation stood at 5.4%. Since the beginning of 2017, inflation has been above its target rate of 4%, which was mainly driven by the rise of excise tax. Increases in intermediate costs and imported inflation have also contributed to the growth of CPI inflation. Factors affecting the demand side of consumer prices are still weak, while economic activity has improved in 2017. Based on preliminary estimates, average economic growth in the first quarter of 2017 was 5.0%.

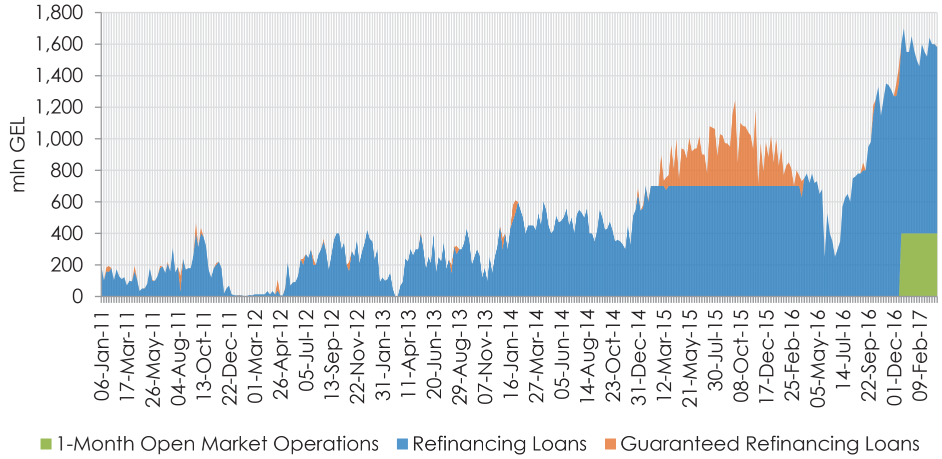
Positive trends are observed in export revenues. Following the economic recovery of

Georgia's main trading partner countries, external demand has increased, resulting in a sharp increase in exports. Imports of goods also continue to grow with the increase of domestic demand. Positive trends can also be observed in the growth of international visitors and tourists. According to preliminary estimates, in the first quarter of 2017, revenues from tourism increased by 23.4% year over year. Meanwhile, the volume of remittances from overseas continues to grow. In the first quarter of 2017, money transfers rose by 22.3% year over year.

According to the current forecasts, inflation is expected to be temporarily above its target level; however, with the exhaustion of one-time factors affecting inflation, the rate is expected to decline to its target in the medium term. Risks associated with the inflation forecast surround a higher-than-expected increase in prices of goods and oil, and a greater-than-expected appreciation of the exchange rates of major trading partner currencies. Moreover, inflation may increase due to a faster increase in aggregate demand than projected.

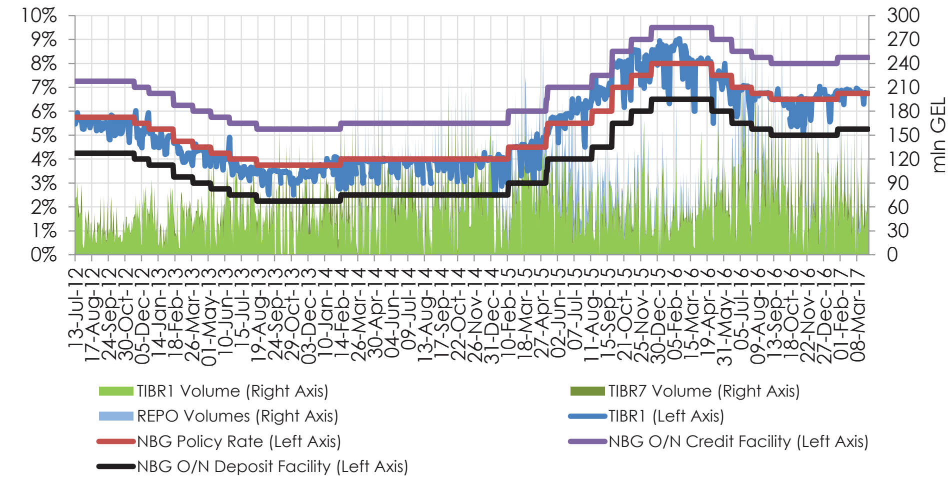
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. With the given level of short-term liquidity in the banking system, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. The NBG provides short-term liquidity to the banking system via refinancing loan auctions without any restrictions. In addition, one-month open market operations are used to provide liquidity to commercial banks where necessary. 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

Figure 4.3 Interbank Money Market



Source: National Bank of Georgia

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

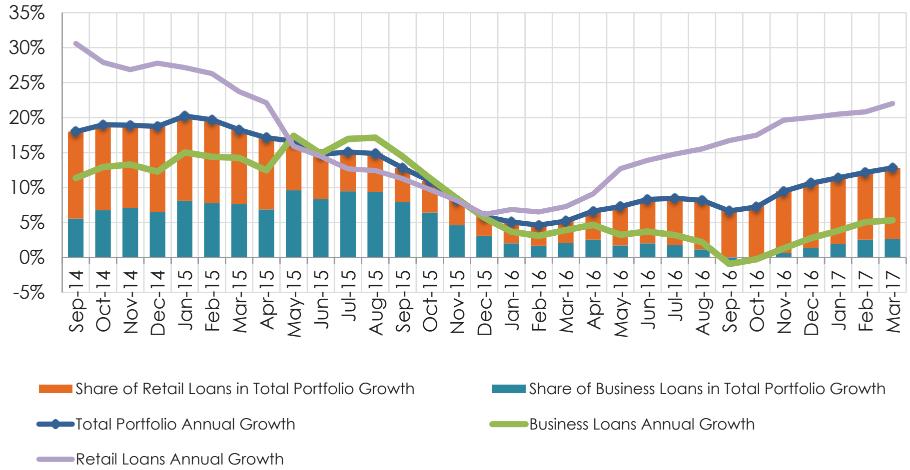
5. Financial Market and Trends

5.1 LOANS

Credit activity improved in the first quarter of 2017. The loan portfolio increased and, excluding the effect of exchange rate movements, amounted to an annual 12.8% in March. This increase can mainly be attributed to the growth of retail loans, but the rate of the growth of business loans has also increased. The NBG expects the annual growth rate of the credit portfolio to be approximately 10-15% in 2017.

« The NBG expects the annual growth rate of the credit portfolio to be approximately 10-15% in 2017.

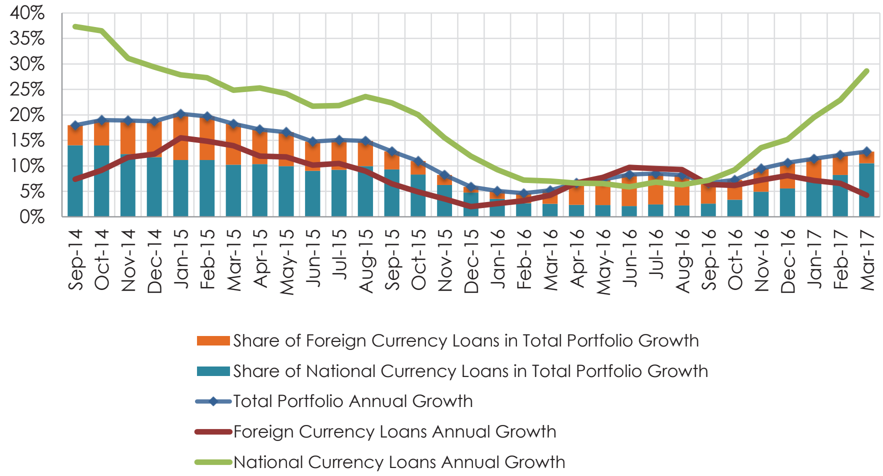
Figure 5.1 Annual Growth Rates Of Retail And Business Loans And Their Contributions To The Growth Of The Loan Portfolio



Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was primarily driven by an increase in domestic currency loans. In March, the annual growth rate of foreign denominated loans was 4.2%, while domestic currency loans grew by 28.6%. It is important to note that the increase in the domestic currency loans can be ascribed to the one-time larization program, under which a loan portfolio worth approximately 80 million USD

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



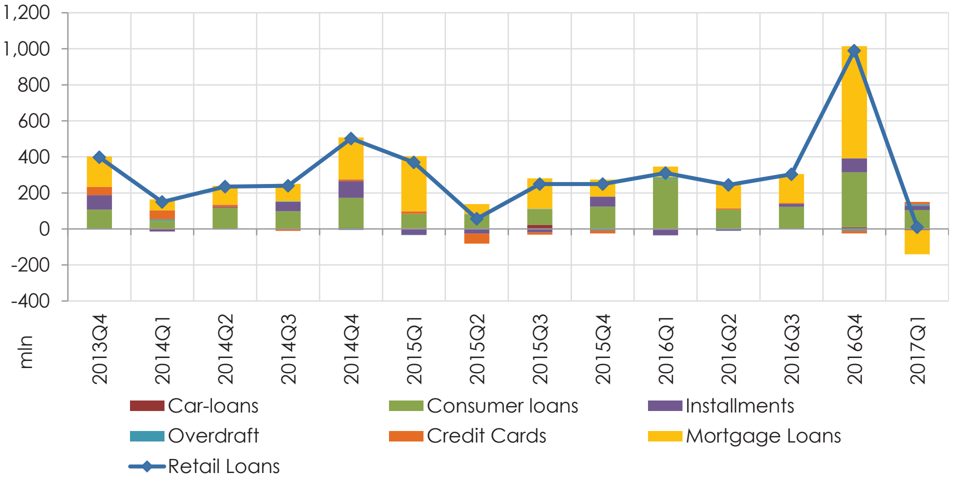
Source: National Bank of Georgia

was converted into GEL. Hence, in the first quarter, the loan larization ratio increased by 2.9 pp and was equal to 39.6%.

‹‹ In the first quarter, the loan larization ratio increased by 2.9 pp and was equal to 39.6%.

In March, compared to December, the stock of retail loans increased by 42 million GEL. This low growth was mainly caused by seasonal factors and currency appreciation, the latter causing a revaluation of foreign currency loans. In terms of loan products, the amount of mortgage and consumer loans declined by 134 million GEL compared to the previous quarter, while retail loans increased by 105 million GEL. The volume of instant loans and credit cards increased by 38 million GEL. According to the credit conditions survey, representatives of the banking sector are expecting a growth in demand for retail loans in the next quarter.

Figure 5.3 Quarterly Growth Of Retail Loans



Source: National Bank of Georgia

The annual growth rate of the loan portfolio to legal entities amounted to 5.3%[15], which was 2.5 percentage points higher than in December. An analysis of business loans by sector reveals that the increase in credit was driven by the construction, trade, agriculture, and energy sectors, while the increases in credit for the transport and manufacturing sectors were insignificant. Representatives of the banking sector expect an increase in the amount of demand for business loans in the next quarter.

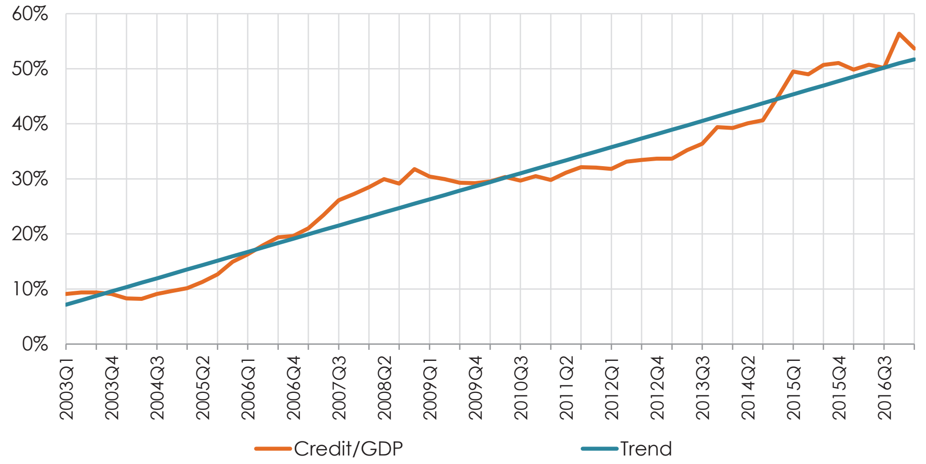
Compared to the previous quarter, the credit to GDP ratio decreased by 2.7 percentage points and amounted to 53.7%. The decline in this ratio was largely caused by the exchange rate effect. The credit to GDP ratio is currently above the trend by two percentage points.[16]

In the first quarter of 2017, compared to the previous quarter, the ratio of individuals' loans to net national disposable income decreased by 0.8 pp and equaled 32.2%. The majority of loans to individuals (86%) come from commercial bank loans.

15 Excluding the exchange rate effect.

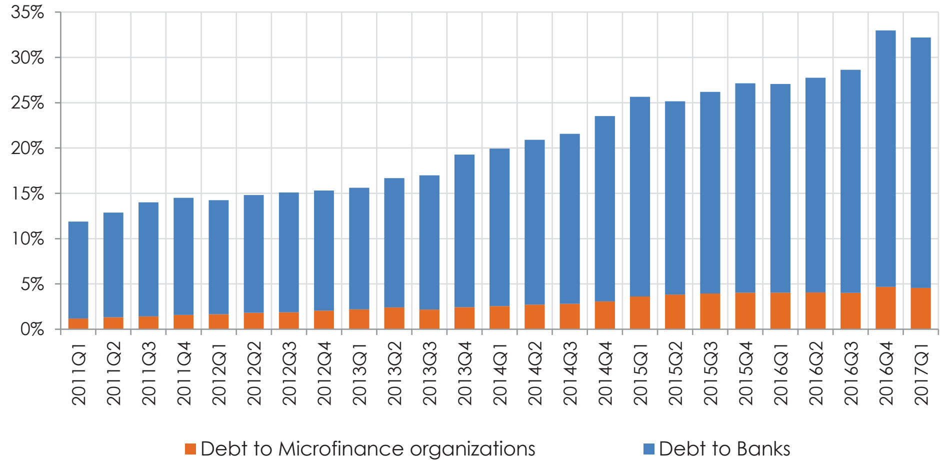
16 An HP filter is used to assess the trend. Based on Basel recommendations, lambda is equal to 400,000.

Figure 5.4 Credit To GDP Gap



Source: National Bank of Georgia

Figure 5.5 Individuals' Debt To Net National Disposable Income Ratio



Source: National Bank of Georgia

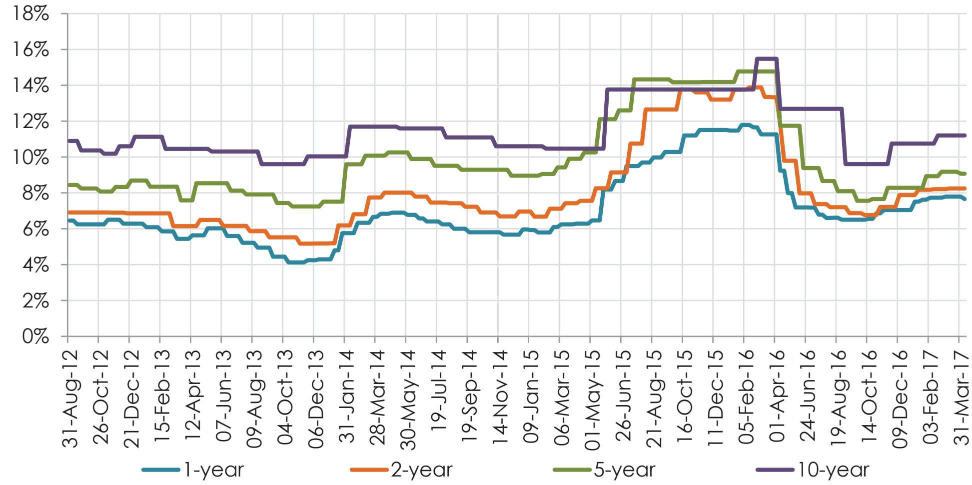
Compared to the previous quarter, the share of non-performing loans decreased by 0.3 percentage points and amounted to 7.4%. This change was mainly due to the amount of loans written off, which amounted to 70 million GEL in the first quarter of 2017. According to the data from March, the share of non-performing loans in the national currency decreased by 0.4 percentage points compared to December and amounted to 5.3%. Meanwhile, the share of non-performing foreign exchange loans dropped by 0.2 percentage points and stood at 8.6%.

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In March 2016, the monetary policy rate was equal to 6.75%. In the first quarter of 2017, interest rates on government securities were characterized by an increasing trend as a result of increased inflationary expectations and tighter monetary policy. However, in March the appreciation of the GEL exchange rate contained this trend (see Figure 5.6).

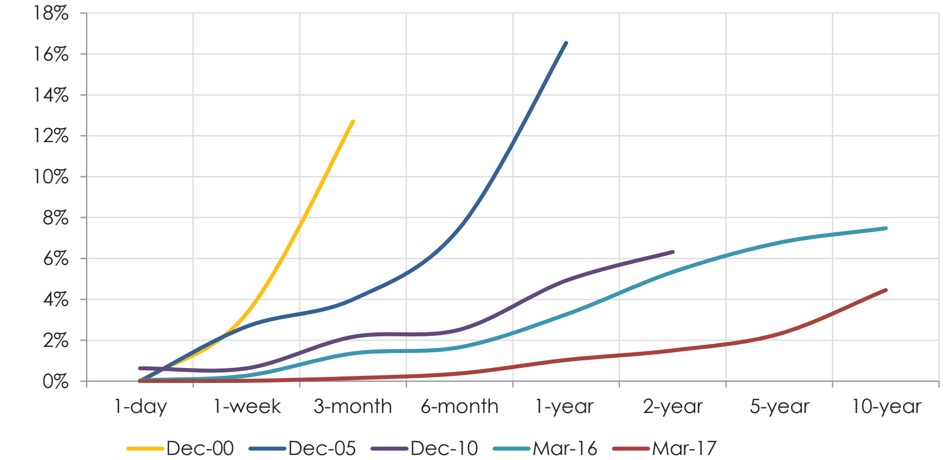
Compared to the previous quarter, the spread between long-term assets and the monetary policy rate decreased due to lower inflationary expectations. It should be noted that the spread has significantly decreased compared to the same period of last year, which implies increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

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

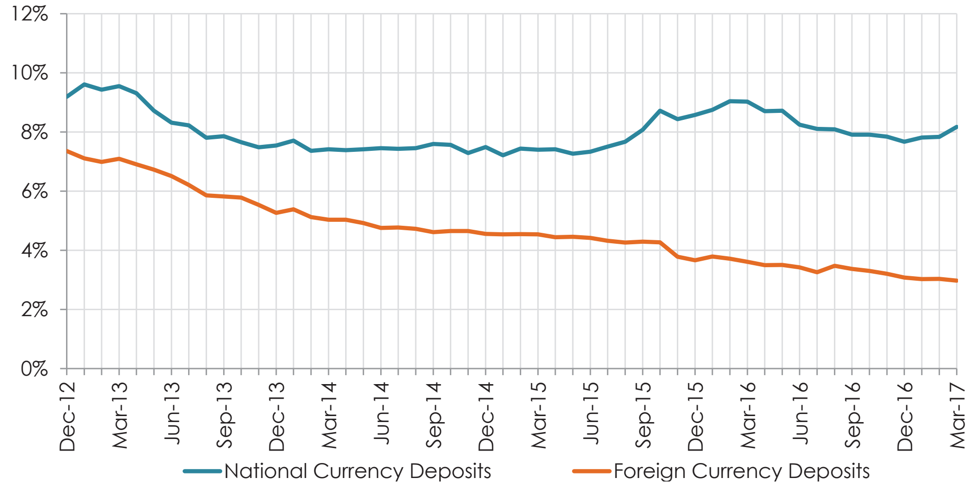


Source: National Bank of Georgia

Compared to the previous quarter, in March the interest rate on domestic currency deposits increased by 0.5 percentage points and amounted to 8.2%, while for foreign exchange deposits interest rates it decreased by 0.1 percentage point and amounted to 3.0%. The rise in interest rates on domestic currency deposits was caused by an increase in the monetary policy rate and an increase in demand for Lari funding. According to the credit conditions survey, the cost of domestic and foreign currency deposits is expected

‹‹ According to the credit conditions survey, the cost of domestic and foreign currency deposits is expected to increase in the next quarter.

Figure 5.8 Average Interest Rates On Deposits



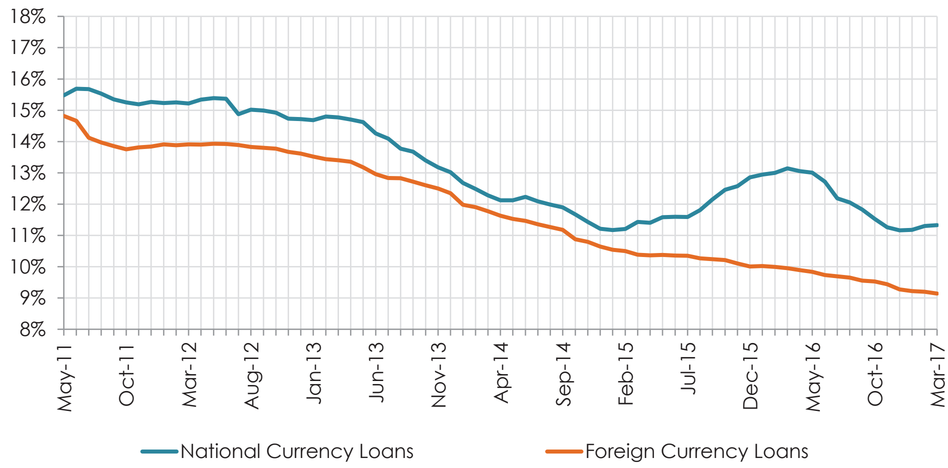
Source: National Bank of Georgia

to increase in the next quarter. The increase in the cost of dollar resources can be attributed to the projected increase in the monetary policy rate by the US Federal Reserve.

According to the same credit conditions survey, in the first quarter of 2017 credit conditions for individuals and legal entities did not change significantly. A minor decrease was observed in interest rates for foreign currency loans, which was caused by a decline in demand for foreign exchange loans. In March, compared to December, interest rates on the flow of SME loans increased by 0.8 pp and equaled 10.7%. For corporate loans, interest rates increased by 0.3 pp and amounted to 10.0%, while interest rates on retail loans increased by 0.7 percentage points and equaled 15.7% (see Figure 5.10). In March, compared to December, the average interest rate on the stock of legal entities' domestic currency loans increased by 0.2 pp, while decreasing by 0.1 pp for foreign currency loans (see Figure 5.9). According to the credit conditions survey, credit supply conditions are not expected to change significantly, while, due to increased competition, the spread between the loan and deposit interest rates will decrease. It should be noted that, in light of international increases in US dollar interest rates, foreign currency loans with low interest rates may appear risky for the domestic financial sector. It is therefore essential that representatives of the banking industry take these risks into account while pricing those loans.

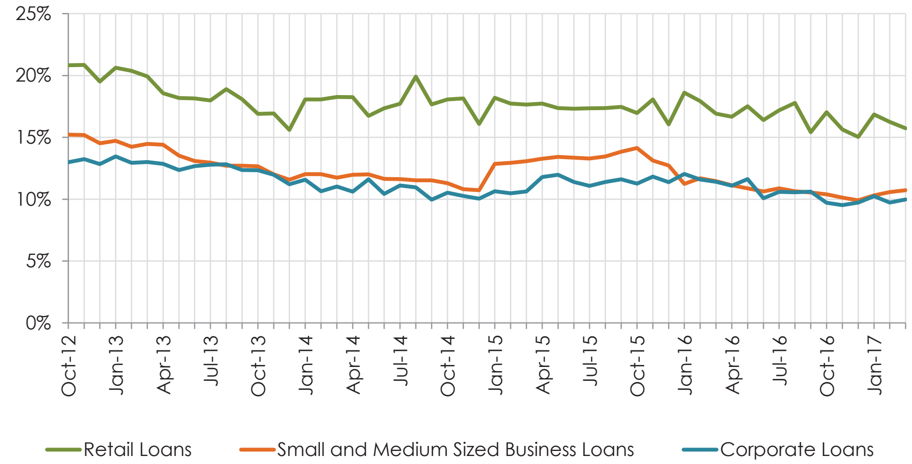
‹‹ According to the credit conditions survey, credit supply conditions are not expected to change significantly, while, due to increased competition, the spread between the loan and deposit interest rates will decrease.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow



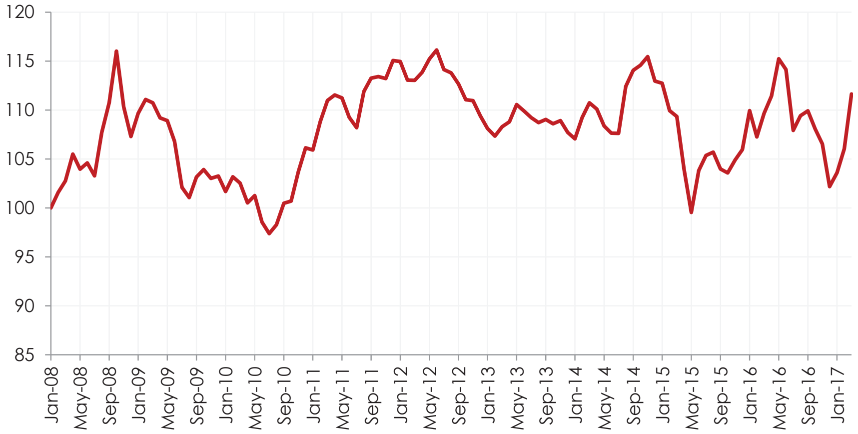
Source: National Bank of Georgia

5.3. EXCHANGE RATE

In the first quarter of 2017, compared to the previous quarter, the GEL exchange rate depreciated against the US dollar by 4.3%, and against the euro by 3.0%, while appreciating against the Turkish lira by 7.3%. In the first quarter, the nominal effective exchange rate depreciated by 0.9% compared to the previous quarter and by 1% on a year-on year basis.

The real effective exchange rate depreciated by 1.7% on a year-on-year basis, while it gained 1.4% in value compared to the previous quarter.

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



Source: National Bank of Georgia

Table 5.1 Effective Exchange Rates Annual Growth[17]

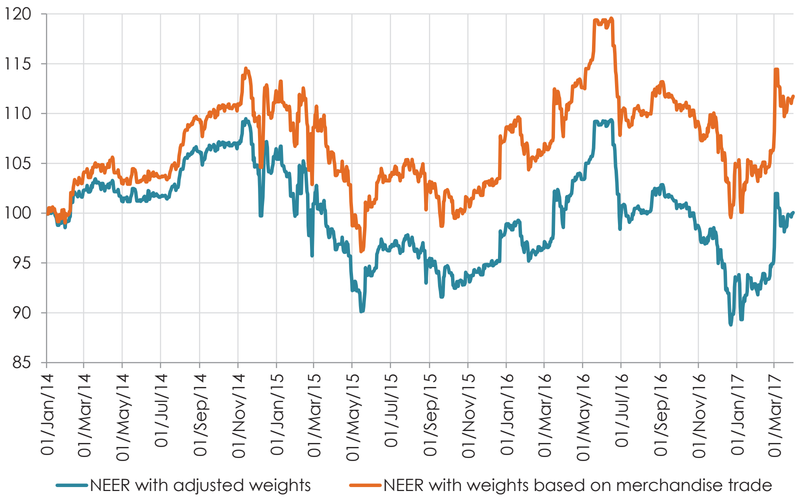
	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate	-1.0	-1.7	-1.7
Eurozone	-3.1	0.0	0.0
Turkey	17.5	11.8	2.5
Ukraine	-0.9	-8.8	-0.6
Armenia	-6.8	-1.9	-0.1
The United States	-6.3	-4.2	-0.2
Russia	-26.2	-26.0	-3.2
Azerbaijan	5.8	-2.0	-0.2
Other	-2.8	0.7	0.0

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, exhibits a slightly different picture. In the first quarter of 2017, the adjusted nominal effective exchange rate depreciated by 0.01% on a year-on-year basis and by 0.2% compared to the previous quarter.

17 *The increase means appreciation.*

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

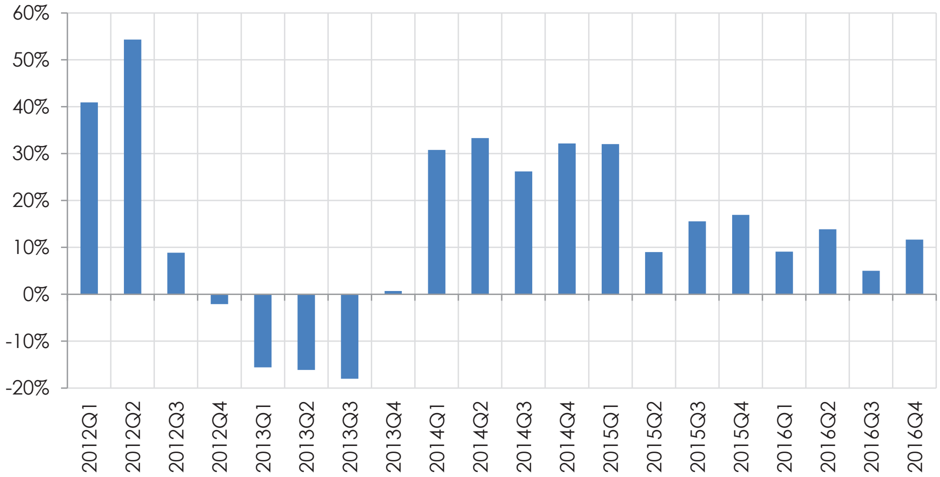
Real GDP growth amounted to 2.8% in the fourth quarter of 2016, while annual growth posted 2.7%. The slow growth can be attributed to lower aggregate demand (despite signs of improvement in the second half of the year). Investments have contributed to economic growth, while net exports put minor downwards pressure on growth. According to the current forecast, investments will continue to be the main driver of growth in 2017.

« Real GDP growth amounted to 2.8% in the fourth quarter of 2016.

The capital formation growth rate increased in the fourth quarter of 2016 and posted 11.7%. Foreign direct investment (FDI) had a significant share in capital formation growth. BP's investment in a new pipeline project again made a significant contribution to the increase in foreign investments. However, government infrastructure projects and domestic investments have also contributed to the rise of investments. In 2016, the investment to GDP ratio amounted to 32%.

« The capital formation growth rate increased in the fourth quarter of 2016 and posted 11.7%.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

In the fourth quarter of 2016, real private consumption growth posted 4.8%. Consumption growth thus made a significant contribution to GDP growth. Although the increased rate of consumption reflects a recovery of domestic demand, it is still considered weak. The rise of retail loans also supported the growth of private consumption.

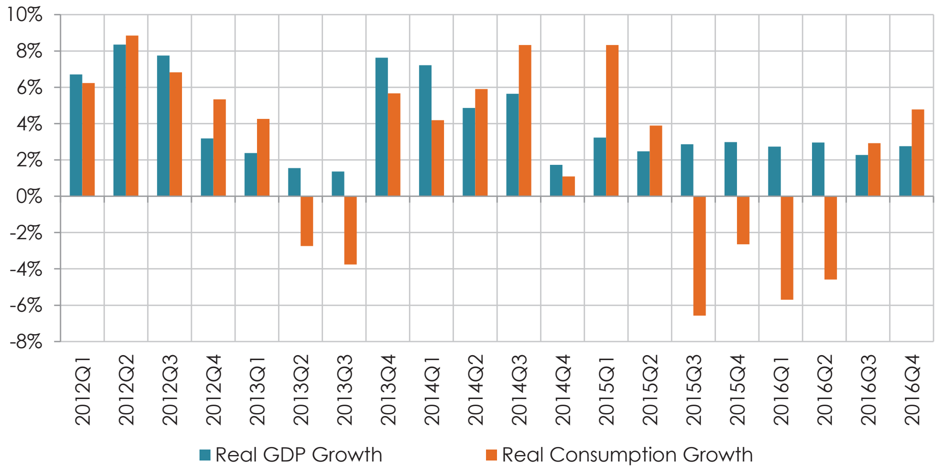
« In the fourth quarter of 2016, real private consumption growth posted 4.8%.

Following a long decline that started in the second quarter of 2014, a positive trend was observed in the nominal growth of exports in the first quarter of 2016. According to the NBG's estimates, although real exports started to increase in the first quarter of 2016, the effect of reduced prices on the goods exported was more significant, thus causing a decline of nominal exports. By the fourth quarter of 2016, nominal as well as real exports improved and this trend continued in the first quarter of 2017, revealing the recovery of external demand. In the fourth quarter of 2016, imports grew by 7%. Unlike in previous quarters, when the growth of imports was mostly attributed to increased imports of investment goods, the fourth quarter growth was due to increased imports of consumer goods.

« Exports growth rates accelerates as a result of improved external demand.

The consolidated budget surplus for the first quarter of 2017 amounted to 178 million GEL. Due to seasonality, the first quarter generally has either a budget surplus or the smallest deficit among quarters. The planned consolidated budget deficit for 2017 is 4.1% of GDP. This planned deficit should contribute to increased public consumption and investments.

Figure 6.2 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

Box 1 Potential output estimation using alternative approaches

Following the 2008-09 global financial crisis, economic growth in both the developing world and advanced economies remains below pre-crisis levels. The deceleration of growth was particularly pronounced in transition economies. Podpiera et al. (2017) demonstrate that average growth during 2009-2015 in Central, Eastern, and Southeastern European Countries (CESEE) was 4.2 percentage points less than the same measure through 2000-2008.[18] Georgia, which belongs to the CESEE region in terms of its geographical location and trade links, is no exception. The average annual GDP growth rate in Georgia after the crisis (2009-2015) was 3.1 percentage points less than the average pre-crisis (2000-2008) growth.

Given the overall slowdown of growth in the region, it is reasonable to ask to what extent such an abrupt deceleration was caused by structural versus cyclical factors. The answer to this question will have a significant bearing on the mix and sequence of macroeconomic policies and structural reforms enacted to recover the economies of the CESEE region.

In order to disentangle the trend and cycle in overall economic growth, one has to estimate potential growth – the theoretical concept referring to the long-term growth rate of the economy attained under the optimal level of capacity utilization, generating no inflationary/deflationary pressures. Accordingly, the difference between actual and potential growth is ascribed to a cycle characterized by short-term volatility. It should be noted that separating the structural and cyclical components of growth is not easy and largely depends on the definition of unobservable potential output and its estimation approach. Moreover, as Blanchard (2015) claimed, prolonged recessions can adversely affect the capacity of the economy, and thus cyclical factors can effectively turn into structural ones. In the case of transition economies, the estimation of potential growth is further complicated by structural changes, deepening financial systems and the limited availability of reliable data.

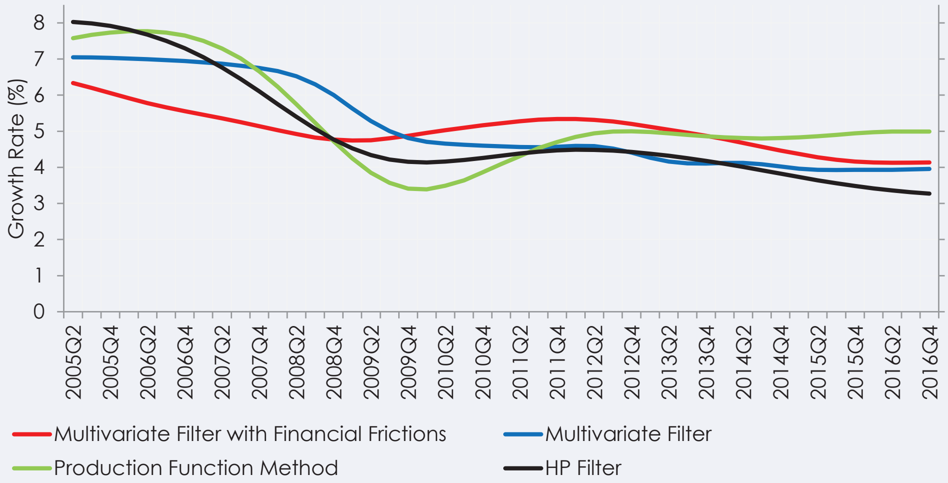
Given the above-mentioned constraints distinctive to transition economies, it is advised to estimate potential growth as the average outcome of multiple approaches, rather than using one method alone. By combining different methods, one can obtain a more reliable estimate that benefits from richness of specification as well as the greater depth of information sets. As in Podpiera et al. (2017), we employ the following three alternative approaches to estimate potential growth in Georgia:

1. The Multivariate Filter defines potential output as the natural level of output under flexible prices in the absence of inflationary pressures. The filter is based on the structural economic linkages between output, inflation, and the unemployment rate described by the Phillips Curve and Okun's Law.
2. The Multivariate Filter with Financial Frictions takes into account credit growth and real estate price dynamics together with structural economic relationships to reveal possible interlinkages between financial and real economic variables. The estimate of potential output obtained by this approach is also referred to as the sustainable level of output since it is neutral to real economic and financial cycles at the same time.
3. The Production Function Approach focuses on the supply side of the economy. It estimates potential output based on factors of production such as capital stock, labor and total factor productivity (TFP).

18 Podpiera, J., Raei, F., & Stepanyan, A. 2017. A Fresh Look at Potential Output in Central, Eastern, and Southeastern European Countries. IMF Working Paper WP/17/37.

The estimation results are displayed in Figure 6.3, which presents the time series of estimated potential growth rates based on the three approaches. As a comparison, the figure also includes the univariate HP filter outcome.

Figure 6.3 Assessment of Georgia's potential growth using alternative methodology (2005-2016)

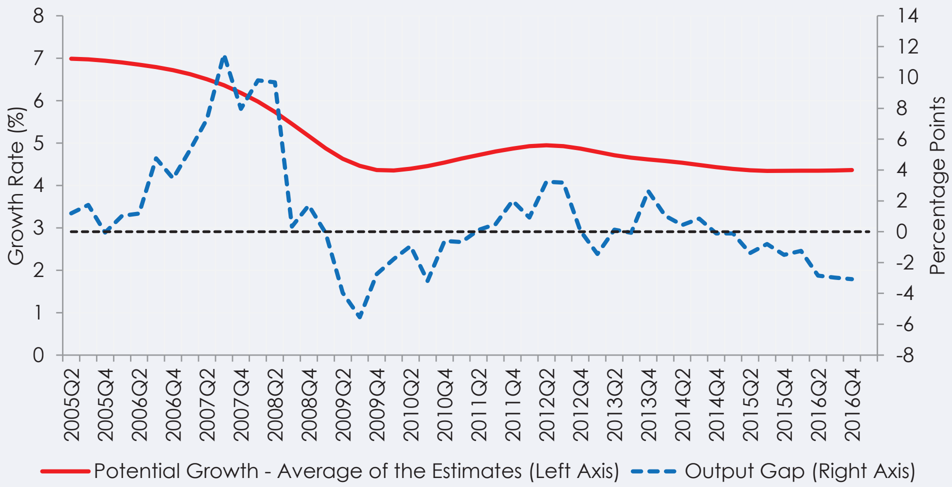


Source: Authors' calculations

As can be seen from the figure, despite quantitative differences, the potential growth rate estimated using standard the Multivariate Filter, Production Function Approach, and HP filter exhibit similar trajectories. These approaches all indicate an abrupt slowdown in potential growth before the crisis. Relatively distinct dynamics of potential growth are provided by using the Multivariate Filter with Financial Frictions since it takes into account not only economic but also business cycles. This method indicates a notably lower potential growth rate before the crisis compared to the other approaches. The story is reversed after the crisis. The source of this discrepancy was the financial cycle: in the pre-crisis period, the above-the-trend growth rates of bank credit and real estate prices created additional pressures on demand and indicated that sustainable economic growth had to be lower than suggested by results obtained using approaches concentrating solely on the real cycle. The situation was reversed in the post-crisis period when credit growth dropped below its trend.

The potential growth rate obtained by averaging the outcomes of the discussed approaches, as well as the deviation of output from its potential level (output gap) is presented in Figure 6.4.

Figure 6.4 Potential growth and the GDP gap (2005-2016)



Source: Authors' calculations

According to the average of the estimates, in the post-crisis period (2009-2015) the potential growth rate in Georgia decelerated by 1.8 percentage points compared to the pre-crisis (2000-2008) level. This result is consistent with the findings of Podpiera et al. (2017), who claim the difference to be 2 percentage points. In addition, the Production Function Approach revealed that in Georgia and the whole CESEE region the potential growth slowdown was largely due to the drop in total factor productivity and, to some extent, slower capital accumulation. According to Podpiera et al. (2017), in the post-crisis period, the reduction in total factor productivity in the CESEE region was brought about by external factors, such as slower potential growth in major trading partners (the EU), decreased trade flows and weakened global supply chains.

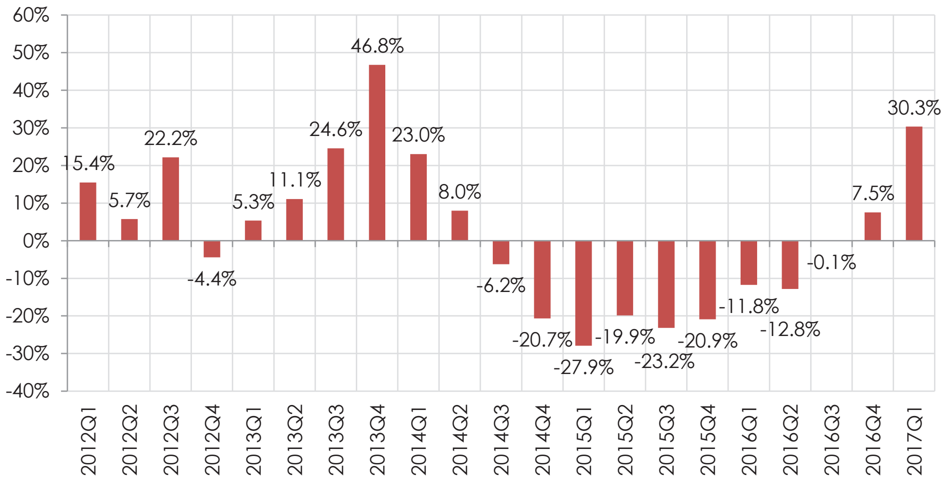
7. External Demand and Balance of Payments

In line with the economic recovery in various main trading partners, external demand has increased and positively contributed to the dynamics of exports. In the first quarter of 2017, registered exports of goods increased by 30.3% year over year. Exports of goods grew to both EU and CIS countries. The increase in external demand from Russia has positively contributed to the growth of export revenues. From CIS countries, the growth of export revenues was also significant from Azerbaijan, Ukraine and Armenia.

« In line with the economic recovery in various main trading partners, external demand has improved and registered exports of goods increased by 30.3% year over year in the first quarter of 2017.

In terms of exports by product category, in the first quarter of 2017 the most significant increase was observed in the exports of ferroalloys. Export revenues also rose in the wine, alcoholic beverages and medicaments categories. An increase in re-exports of copper ores and concentrates also played a significant role in export growth.

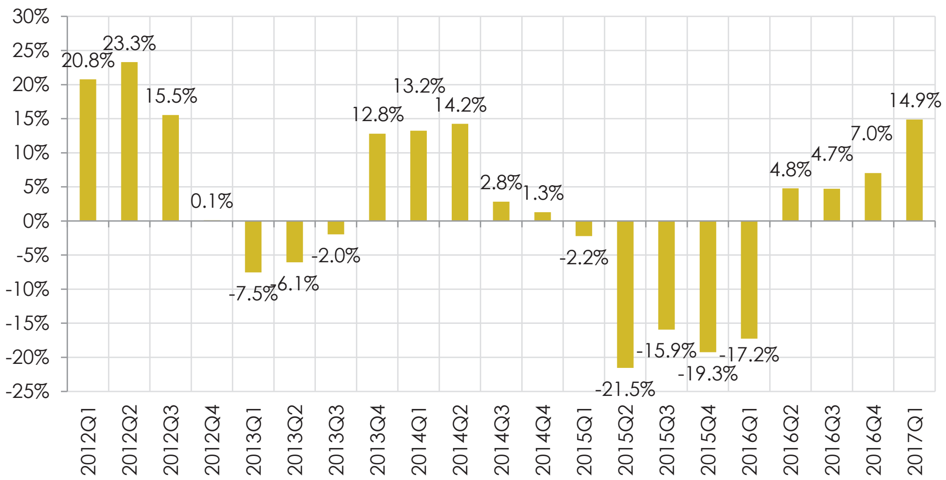
Figure 7.1 Annual Change Of Registered Exports Of Goods



Source: GeoStat

In the first quarter of 2017, registered imports of goods increased by 14.9% year over year. Imports of goods grew from both CIS and EU countries.

Figure 7.2 Annual Change Of Registered Imports Of Goods[15]

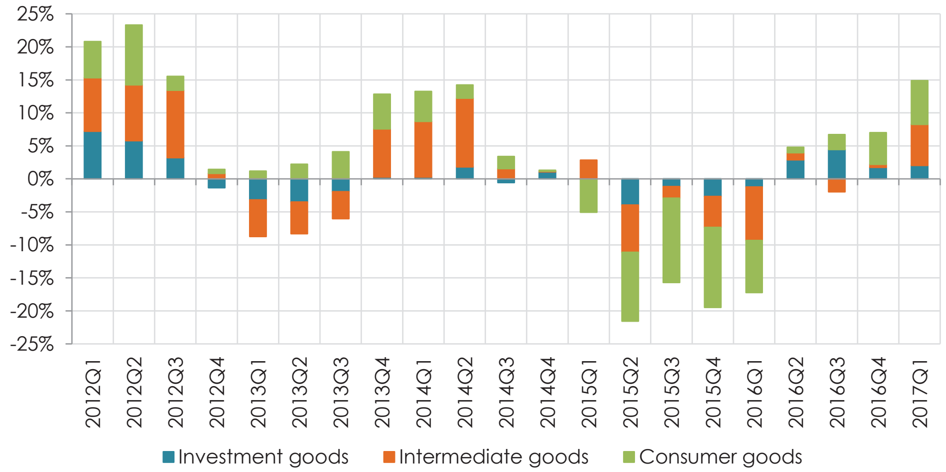


Source: GeoStat

An analysis of registered imports by category reveals that the growth can mainly be attributed to increased demand for intermediate and consumer goods. In the first quarter of 2017, imports of intermediate goods increased by 13.7% year over year, contributing 6.2 percentage points to the growth of imports. A growth trend is also observed in imports of consumer goods, reflecting the increase in domestic demand. In the first quarter of 2017, purchases of consumer goods contributed 6.6 percentage points to the increase of aggregate imports. Imports of investment goods have grown in parallel with the increase in foreign direct investments.

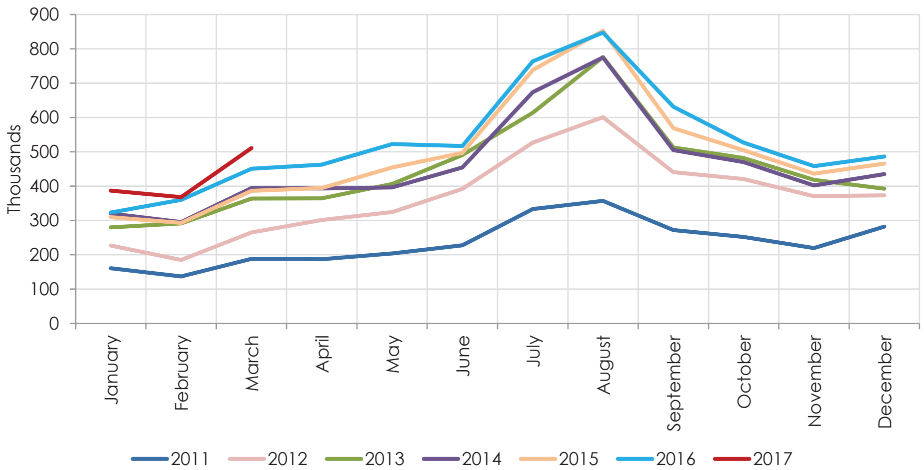
‹‹ In the first quarter of 2017 imports of goods increased, mostly due to increased demand for intermediate and consumer goods.

Figure 7.3 Annual Change Of Registered Imports By Category Of Goods



Source: GeoStat

Figure 7.4 Number of International Visitors to Georgia



Source: GNTA

Inflows of international visitors, especially tourist arrivals, have continued to grow. In the first quarter of 2017, the number of foreign visitors who entered Georgia increased by 11.4% year over year. A total of 40.6% of all international visitors crossing the border were tourists, which is an increase of 25.7% compared to the same period of last year. Most of the visits from neighboring countries were observed from Azerbaijan, Armenia and Russia. Arrivals from those countries made a significant positive contribution to the growth of international visitors. Meanwhile, the number of visitors from Turkey is declining. A significant increase in the amounts of foreign visitors from Iran and India has also been observed. Given the increasing number of international visitors, preliminary information suggests that in the first quarter of 2017 tourism revenues grew by 23.4% year over year and amounted to 435 million USD.

‹‹ In the first quarter of 2017 tourism revenues rose by 23.4% year over year.

In the first quarter of 2017, remittances increased by 22.3% year over year, mostly as a result of the growth of money transfers from Russia. Money inflows from the EU also grew, with transfers from Greece and Italy being the main drivers of that

‹‹ In the first quarter of 2017, remittances increased by 22.3 % year over year.

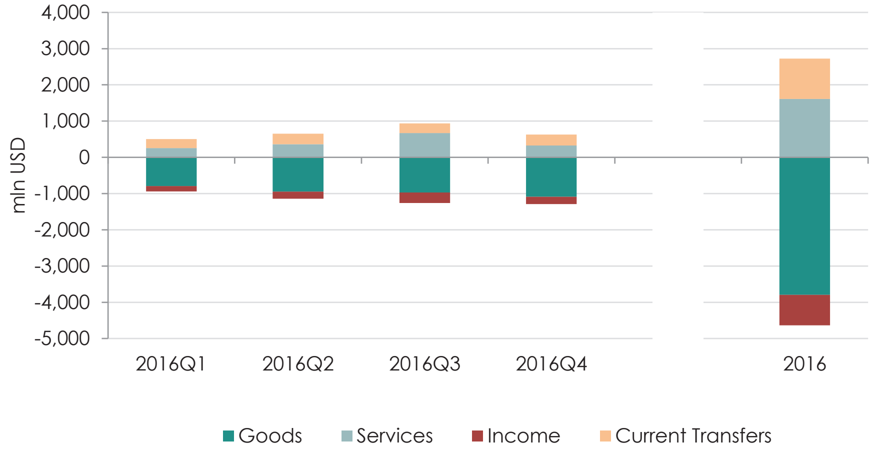
increase. Increased money transfers were also seen from the USA, Israel and Turkey.

In 2016, the current account deficit increased by 229.2 million USD compared to the same period of the previous year and amounted 13.3% of GDP. In 2016, the trade deficit of goods improved compared to the previous year and therefore its negative impact on the current account balance was mitigated. On the other hand, an improvement in the balance of services, especially the increase in tourism, positively impacted the current account balance. Moreover, inflows of remittances increased. The overall growth of the current account deficit in 2016 was a result of the enlarged negative income balance of investments, stemming from to the increase in profits of direct investor enterprises. The increase of reinvested income and dividends placed downward pressure on the current account balance. However, it is worth noting that the growth of reinvested income is part of the financial account and therefore does not cause capital outflow or create additional demand for foreign currency.

« In 2016, the current account deficit increased by 229.2 million USD compared to the same period of the previous year and amounted 13.3% of GDP.

« In 2016, the increase of negative income balance of investments caused current account balance to deteriorate.

Figure 7.5 The current account balance by components



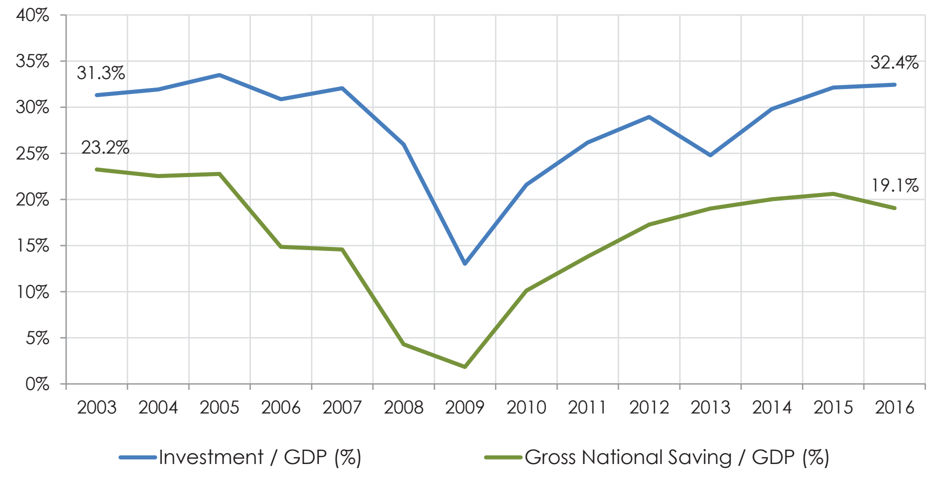
Source: The National Bank of Georgia

Foreign direct investments (FDI) are the main source of financing the current account deficit. Based on Geostat data, in the fourth quarter of 2016, FDI in Georgia amounted to 330.3 million USD. Overall, the amount of foreign direct investments in 2016 increased by 5.2% and equaled 1,645 million USD. In the fourth quarter of 2016, transport was the largest recipient sector of FDI, with 130.9 million USD. The energy (62.9 million USD), construction (57.9 million USD) and hotels and restaurants (44.8 million USD) sectors were also significant recipients of FDI.

« Foreign direct investment are the main source of financing the current account balance.

It is important to analyze the balance of payments in terms of investments and savings. In 2016, the volume of investments increased, while the amount of savings declined as a result of consumption growth. Hence, the difference between total investments and total savings deepened, resulting in an increase in the current account deficit.

Figure 7.6 Savings and Investments



Source: GeoStat and the National Bank of Georgia's calculations

Box 2 Assessing reserve adequacy

The use of official international reserves is the main instrument to insure against external shocks. The global financial crisis demonstrated the importance of holding adequate amounts of international reserves. It is important to note that reserve buffers help to decrease the probability of a crisis, but they cannot prevent one from occurring. Neither can reserves aim to control the exchange rate during external shocks as the involvement of the Central Bank in the foreign exchange market is associated with negative externalities. For small, open economies with high dollarization levels, like Georgia, international reserves are a liquidity buffer that balance short-term, temporary liquidity needs.

It is also important to note that with the growth of reserves its marginal benefits diminishes, While reserves have been important in both preventing crises and mitigating their impact, they are costly (at both the national and global level) and are subject to diminishing returns. It is thus essential that reserves are maintained at an optimal level.

There are several approaches used to assess reserve adequacy. Traditional metrics, based on simple rules of thumb such as import coverage, full coverage of short-term debts, and reserves as a ratio of broad money certainly have relevance and are widely used to assess the adequate level of reserves.[19] It is generally assumed that international reserves should be sufficient to cover three months of imports. For Georgia, at the end of 2016 the international reserves covered 3.7 months of the imports forecast for 2017.

However, the global financial crisis demonstrated that assessing reserve adequacy based on various traditional metrics was not enough and more sophisticated models were needed. During the crisis, pressure on the balance of the payments came from various sources. Based on the experience of several countries, the International Monetary Fund thus developed a methodology to assess the optimal amount of reserves.[20] The method assesses four principal components

- **Export revenues** – which reflect potential losses in the case of a decline in foreign demand or a worsening of the terms of trade.
- **Broad money** – to capture potential risks associated with capital outflows.
- **Short-term debt** – which reflects risks associated with the rollover of debt.
- **Other portfolio liabilities** – which reflect risks related to other portfolio outflows.

Each of these components have a certain weight for assessing the adequacy of reserves and a weighted index is subsequently measured according to general risks. In the floating exchange rate regime, the weight of each of the risky components and the final indicator is presented as follows:

ARA = 5% * exports + 5% * Broad money + 30% * Short-term debt + 15% * other portfolio liabilities[21]

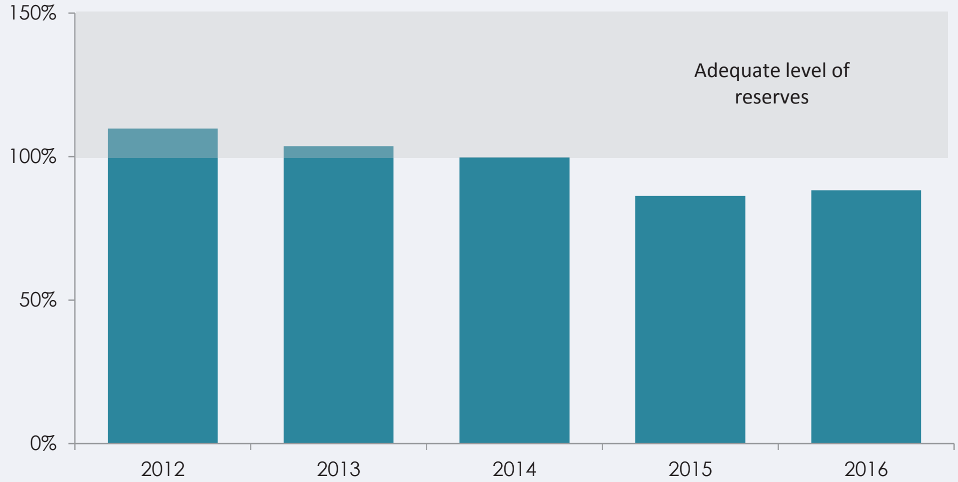
It is assumed that the reserve level should vary within 100-150% of the weighted index.

19 *International Monetary Fund. 2011. "Assessing Reserve Adequacy".*
20 *International Monetary Fund. 2016. "Guidance Note on the Assessment of Reserve Adequacy and Related Considerations".*
21 *International Monetary Fund. 2016. "Guidance Note on the Assessment of Reserve Adequacy and Related Considerations".*

Compared to the other methodologies used for the assessment of the adequacy of reserves, this approach is more complex and reflects risks associated with the balance of payments. Furthermore, it considers risks arising from increased foreign liabilities as a result of capital inflows and, hence, indirectly reflects the impact of global external factors.

The adequate level of international reserves for Georgia are presented in Figure 7.7. Using the International Monetary Fund's methodology, for the past two years the international reserves for Georgia were lower than the adequate level. In 2016, the reserves were at 88% of the optimal level. The lower level of reserves in recent years has been associated with the decline of official international reserves. However, it is worth noting that in 2016 the volume of reserves increased compared with 2015 and the reserve adequacy level slightly improved.

Figure 7.7 Official international reserves and the level of the reserve adequacy



Source: The National Bank of Georgia's calculations

8. Output and labor market

8.1 OUTPUT

Compared to the same period of the previous year, in the fourth quarter of 2016 GDP rose by 2.8%, while in 2016 as a whole it amounted 2.7%. With 1.8 percentage points (pp) the service sector made the largest contribution to overall growth. Industries contributed with 0.8 pp and the agriculture sector's contribution was close to the 0.1 percentage point.

From the industrial sector, manufacturing increased by 6.7%, contributing 0.6 percentage points to overall growth. This growth was a result of an increase in external demand; leading to an increase in the production of export goods (namely oil product materials, metallic products and alcoholic beverages). Significant growth was observed in the output and distribution of gas, water and electricity (growth by 10.5%, contributing by 0.3 percentage points to the overall GDP growth). The construction sector increased by 0.7%, contributing 0.1 percentage point to the GDP growth, but it is worth noting that in the last two-quarters the pace of growth in this sector declined.

‹‹ Improvements in external demand had positive impact on the growth of manufacturing sector.

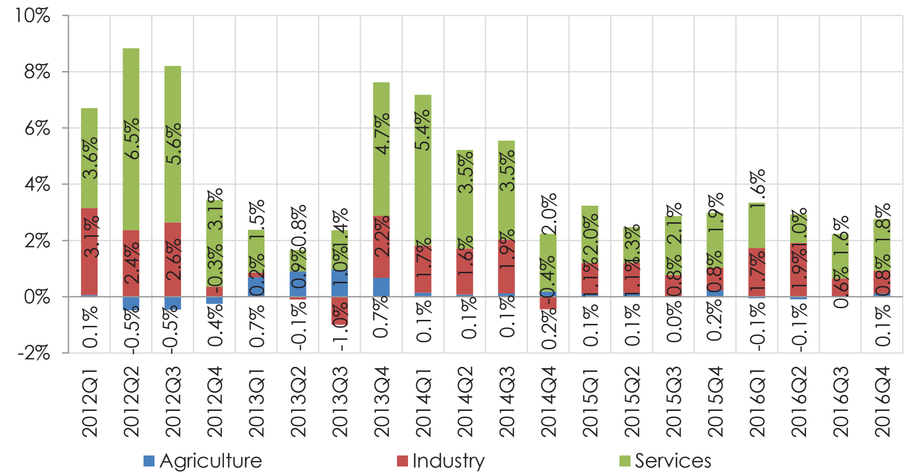
The recovery of the service sector made the most significant contribution to the overall GDP growth (1.8 pp). Together with increased tourism inflows, the hotels and restaurants sector has grown (growth of 5%; and a 0.1 pp share in GDP growth). The largest sector, trade, has also grown by 2.5% compared to the same quarter of previous year,, contributing 0.4 pp to GDP growth. It is also worth noting that due to the recovery of private construction and revival in sale transactions,, real estate, renting and business activities have increased by 6.7%; contributing 0.4 pp to GDP growth. The process is also supported by the growth of retail loans; leading to a 9% increase in financial sector output, adding 0.3 pp to overall economic growth.

‹‹ In light of increased tourist inflows, the output of hotels and restaurants is increasing at a higher rate.

Growth was observed in the output of the transport sector; which grew by 4.3% and added 0.2 pp to overall economic growth. This growth can mainly be attributed to the increase in railway and maritime transportation output.

The output of the agriculture sector played the least significant role in GDP growth, growing by 1.6% and contributing 0.1 pp to GDP growth.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

8.2 LABOR MARKET

In the fourth quarter of 2016, the real value added produced per worker (labor productivity) increased by 2.2% compared to the corresponding period of the previous year. During this period, labor productivity in the agriculture and industrial sectors grew by 1.4% and 2.3% respectively, but decreased in the services sector by 1.4%.

In the industrial sector, employment increased by 1.7% and the value added per worker also rose and stands at 3.7%. The most remarkable real value added growth

(6.7%) in this sector was seen in manufacturing.

« Labor productivity increased by 2.2%, mainly due to trade and manufacturing.

Compared to previous periods, labor productivity in the agriculture sector did not change significantly. Employment grew by 0.3%, while real growth was equal to 1.6%. Labor productivity thus increased by 1.4%.

In trade, the largest sector of the economy, labor productivity increased by 5.1%, yet overall labor productivity in the services sector declined by 1.4%. The main reason behind this drop is the decrease of labor productivity in hotels and restaurants, which fell by 27%. Employment in this sector increased by 45%, while the growth only equaled 5%. However, it should be noted that previous periods saw a significant increase of the labor productivity indicator in hotels and restaurants. The volatility of labor productivity in this sector can be linked to seasonal factors and the growth of tourism inflows.

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

	Labor productivity growth, %
Agriculture and fishery	1.4%
Industrial sectors	2.3%
Service sector	-1.4%
Overall in the economy	**2.2%**

Source: GeoStat and National Bank of Georgia

The growth rate of the nominal salaries of employees in the fourth quarter of 2016 amounted to 5.4%. According to the latest data from Geostat, the average monthly nominal salary stands at 1,066 GEL.

« Salaries for employees increased by 5.4% annually.

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

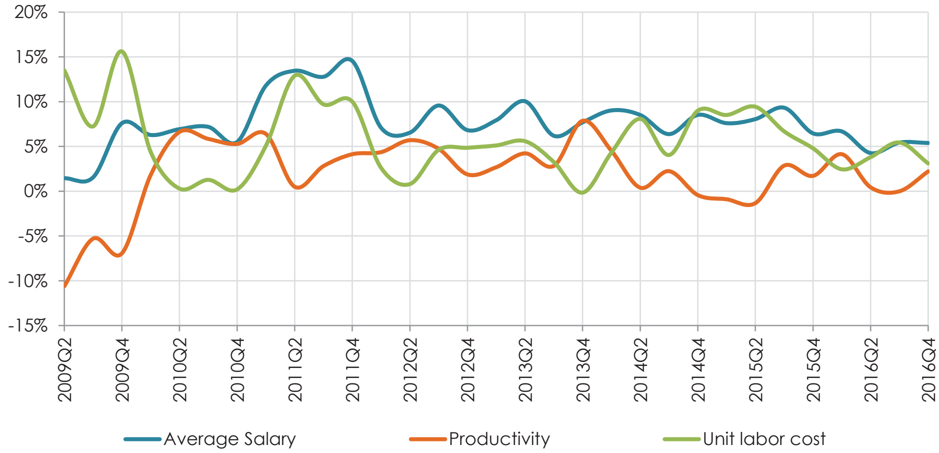
	Growth of nominal wage, %
Agriculture, hunting and forestry	-4.5%
Fishing	37.8%
Mining and quarrying	3.5%
Manufacturing	1.2%
Production and distribution of electricity, gas and water	7.3%
Construction	8.0%
Wholesale and retail trade; repair of motor vehicles and personal and household goods	11.4%
Hotels and restaurants	38.3%
Transport and communications	4.9%
Financial intermediation	30.7%
Real estate, renting and business activities	10.2%
Public administration	-16.4%
Education	8.9%
Healthcare and social work	12.1%
Other community, social and personal service activities	-3.4%
Overall in the economy	**5.4%**

Source: National Bank of Georgia

In the fourth quarter of 2016, the annual growth rate of unit labor cost increased by 3.1 %, which will not create inflationary pressure from the labor market.

‹‹ Unit labour cost increased by 3.1%.

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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