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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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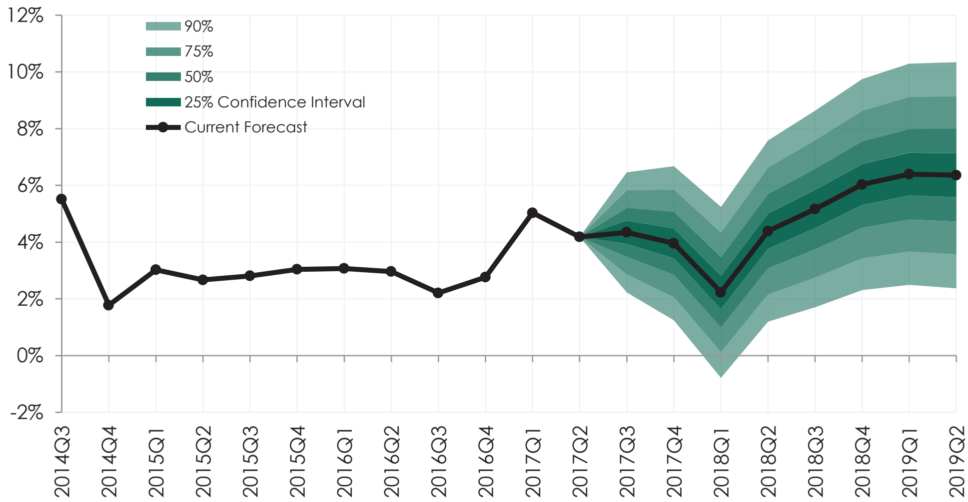
1. Brief Overview

According to preliminary estimates, real GDP growth in the second quarter of 2017 stood at 4.0%. The Georgian economy continues to recover from external shocks, and has seen improvements in both the domestic and external environments. In particular, exports of goods and services, together with money transfers have improved significantly. Moreover, a rise of investments, increased consumption, improved consumer and business sentiment, fiscal stimulus measures and increasing loans have positively contributed to GDP growth.

In 2017, the National Bank of Georgia expects real GDP growth to be 4% (see Figure 1.1). Compared to the previous period, negative risks associated with the forecast have declined as Georgia's main trading partners continue to recover. Thus, if the external environment continues the current trend of improvement, GDP growth may exceed 4% in 2017. Growth will be driven by increasing levels of consumption and investment, supported by the planned fiscal stimulus and improved business expectations. At the same time, the NBG expects net exports to make a positive contribution to GDP growth. Although, according to current estimates, output is still below its potential level, the gap is expected to gradually close during 2018 and 2019.

Figure 1.1 Annual Real GDP Growth



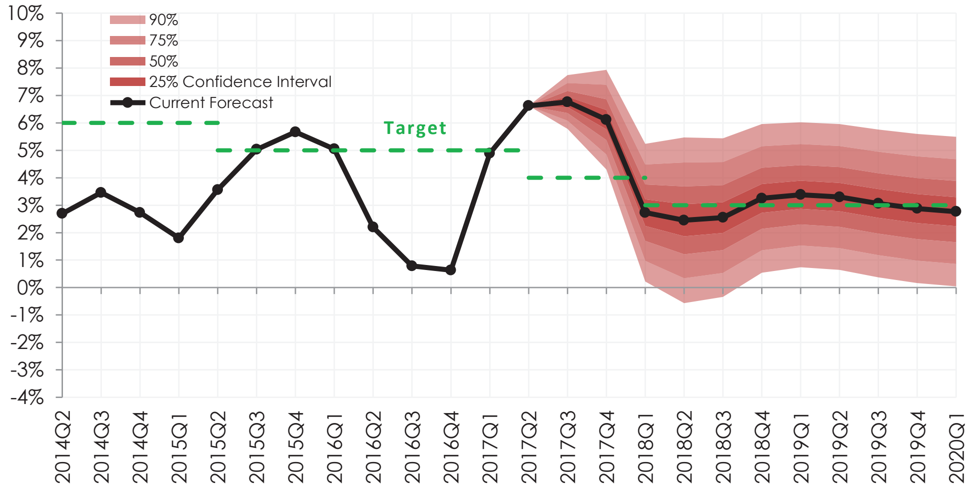
Source: National Bank of Georgia

As was forecast, in the second quarter of 2017 the annual inflation rate increased, equaling 7.1% in June. One-time factors, such as the rise of excise tax, alongside increased prices of oil and food on international markets, have been reflected in consumer prices. The impact of these temporary factors will be maintained until the end of the year.

According to the NBG forecast, when the aforementioned one-time factors get exhausted, the inflation rate will decline and is expected to fall below the target rate of 3% in 2018. Since aggregate demand remains below its potential level, this will also put downward pressure on the inflation rate. In the medium term, the shocks affecting inflation will be eliminated, thereby maintaining inflation at its target level (see Figure 1.2).

It should be noted that the aim of the monetary policy cannot be the full neutralization of temporary factors affecting the inflation rate in the short run. This objective could only be obtained through a severe reduction of economic growth and employment. The National Bank of Georgia thus tries to be balanced in its decision making. It considers the expected timeframe over which the inflation rate will return to the target level, and estimates the likely effect this will have on economic growth. To

Figure 1.2 Headline CPI Inflation

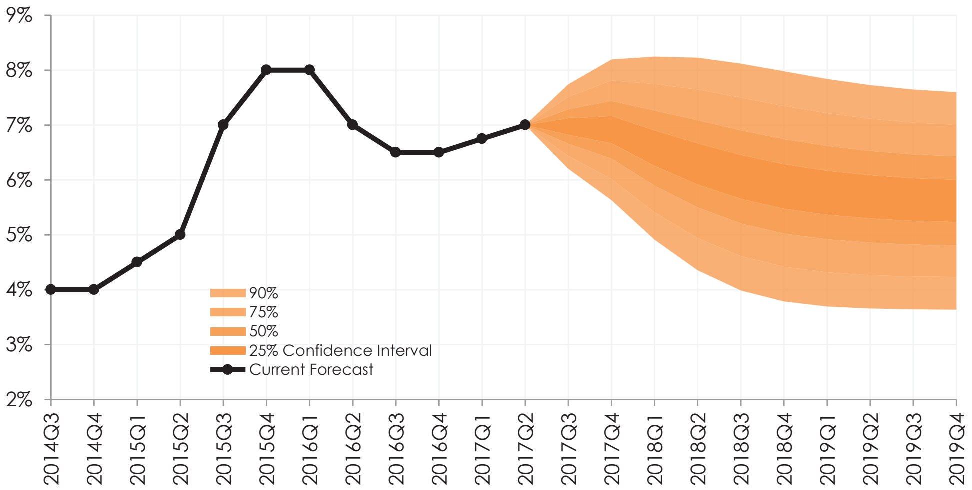


Source: National Bank of Georgia

curb inflation expectations, the NBG increased the monetary policy rate to 7.0% in the second quarter of 2017.

According to current macroeconomic forecasts, other things being equal, with the exhaustion of the temporary factors affecting inflation, the National Bank of Georgia expects a decrease in the trajectory of the monetary policy rate to reach its neutral level in the medium term (see Figure 1.3). It should be noted that the monetary policy rate forecast is not a commitment on future decisions made by the National Bank of Georgia. Rather, it is 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. In terms of external factors, risks are mainly associated with the volatility of the US dollar and euro exchange rates on international markets, the economic growth rate of Georgia's main trading partners, and international prices of oil and food. As for domestic factors, risks stem from fiscal deficit, credit activity and business sentiment. Therefore, if the external and/or domestic factors evolve differently than is currently expected, they may influence the projected paths of macroeconomic variables and, consequently, affect future decisions made by the National Bank of Georgia.

2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

Following the growth of economic activity in developing countries, in the second quarter of 2017 the growth of the global economy improved and international trade increased. Global headline inflation rates are close to the targeted levels. In developing countries, inflation has decreased in the direction of the target rate, while inflation has increased in developed countries. According to current IMF projections, global economic growth for 2017 stands at 3.5%.[1]

At the beginning of 2017, the economic situation in the region improved for both commodity exporting and commodity importing countries. This was supported by the increase in oil prices, improved economic conditions in the EU and better financing conditions in international markets. According to the World Bank forecast[2], the Eastern Europe and Central Asia region is expected to grow by 2.5% in 2017 and by 2.8% in 2018-2019. The current forecast is based on faster economic recovery expectations in Russia and Turkey.

The economic growth in the **eurozone** accelerated. This trend was supported by an increase in global trade and benign financing conditions, which had a positive impact on consumer demand and investment. Moreover, labor market reforms promoted a growth of employment. The annual inflation rate in the second quarter of the year averaged 1.5% and, according to the IMF forecast, economic growth in the eurozone will stand at 1.7% in 2017.[3]

The process of economic recovery in **Turkey** continues to be negatively affected by political uncertainty and a high inflation rate. According to the IMF forecast, in 2017 inflation will post 10% and, assisted by fiscal stimulus and a growth in exports, economic growth will stand at 2.5%.[4] The World Bank's forecast is more optimistic, expecting economic growth of 3.5% in 2017, which is 0.5 percentage points higher than in the previous forecast.[5]

Russia's economy remains on the path of economic recovery, supported by the stabilization of oil prices and an increase in consumer demand and exports. Moreover, the easing of monetary policy and a decrease in inflation towards the target rate of 4% further promoted growth. According to the Russian Central Bank, economic growth in May was 1.5-1.6%.[6] However, the long-term development of the Russian economy will depend on the implementation of structural reforms to increase its flexibility, productivity and labor market.

Economic growth has also picked up in **Ukraine**. The International Monetary Fund expects the growth rate to exceed 2% in 2017.[7] Moreover, the country's currency reserves increased to 17.6 billion USD, and inflation is expected to fall below 10% by the end of the year. The decline of the inflation rate, followed by the stabilization of the local currency allowed the National Bank of Ukraine to ease its monetary policy; however, the implementation of structural reforms remains the critical factor that will shape the long-term sustainable development of the economy.

Azerbaijan's economy has also exhibited signs of recovery in 2017. Stabilization of oil prices, together with the growth of non-oil industries has positively contributed to growth. However, tight monetary and fiscal policies along with a weak banking

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

2 *World Bank Group. 2017. Global Economic Prospects, June 2017: A Fragile Recovery. Washington, D.C.: World Bank.*

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

4 *Ibid.*

5 *World Bank Group. 2017. Global Economic Prospects, June 2017: A Fragile Recovery. Washington, D.C.: World Bank.*

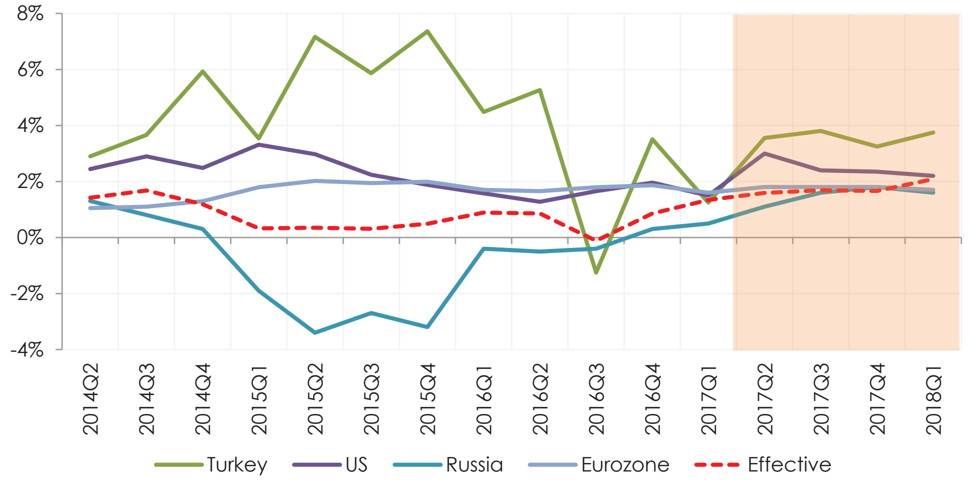
6 *Bank of Russia. 2017. Talking Trends. Macroeconomics and Markets. Moscow, June.*

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

sector have slowed the economic recovery process. According to IMF estimates, inflation in Azerbaijan in 2017 will stand at 10%, while growth will be -1%.[8]

Economic activity has increased in **Armenia**. Aggregate demand continues to recover, affected by easy monetary conditions amid a tight fiscal policy. Significant growth was observed in the industrial sector. Nonetheless, despite an increase in demand, the inflation level remains low. The Central Bank of Armenia expects inflation to increase in the direction of the target rate in the second half of 2017, while the IMF expects Armenia to grow by 2.9% in 2017.[9]

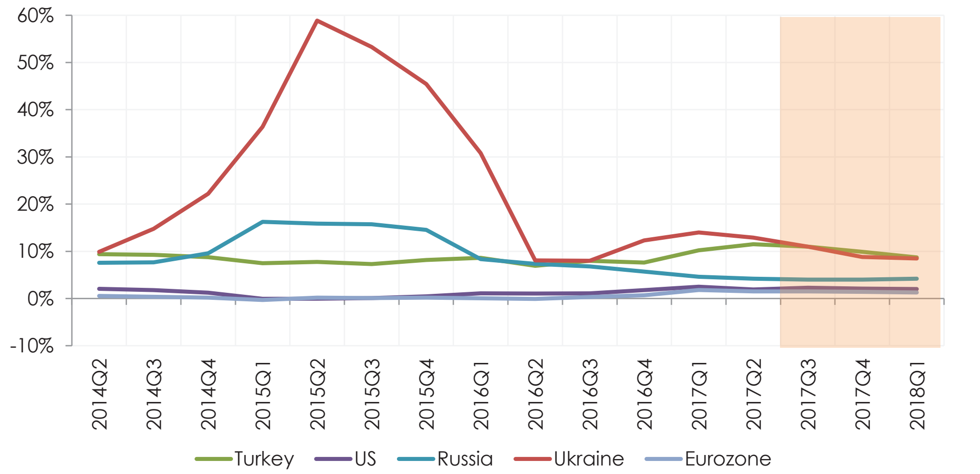
Figure 2.1 Real GDP Growth of Economic Partner Countries



Source: Bloomberg; National Bank of Georgia.

In the first quarter of 2017, as a result of weakened consumer spending and substantially reduced commodity supplies, economic growth in the United States decreased to 0.3%. However, following the relatively weak first quarter, economic growth picked up in the second quarter of the year as a result of improved business and consumer sentiment. Furthermore, benign conditions on the labor market led to the growth of salaries, and recent investments in the energy sector positively contributed to the recovery of economic activity. The International Monetary Fund expects the US economy to grow by 2.3% in 2017.[10]

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

In the first half of 2017, inflation expectations in Georgia's trading partners decreased in parallel with the weakening of depreciation pressure on their local currencies. The

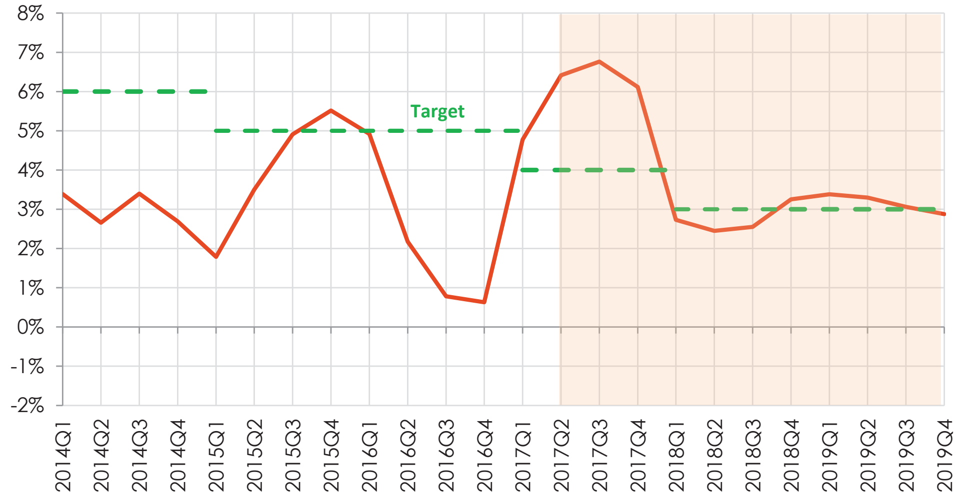
8 *International Monetary Fund. 2017. World Economic Outlook: Gaining Momentum? Washington, D.C., April..*
9 *Ibid.*
10 *Ibid.*

central banks of those countries eased their monetary policies, promoting economic activity. Meanwhile, in developing countries, where output is below the potential level and the trend of consumer price growth is slow, monetary policy easing expectations persisted. The market currently expects the ECB to phase out its quantitative easing program. In the United States, due to expectations of high inflation and employment, the Federal Reserve increased the monetary policy rate to 1.25%. Moreover, according to the minutes of the Federal Open Market Committee, the monetary policy rate in the US is expected to be increased still further this year.

2.2 MACROECONOMIC FORECAST

The annual inflation rate in the second quarter of 2017 increased and stood at 7.1% in June. The average inflation rate in the second quarter was 6.4% (see Figure 2.3). Although inflation is above the National Bank's target, the increase remains in line with the NBG's forecast. The above-target inflation rate is a result of temporary factors affecting the supply side. In particular, consumer prices grew following recent increases in excise tax rates and in international food and oil prices. The impact of these factors will be maintained throughout 2017.

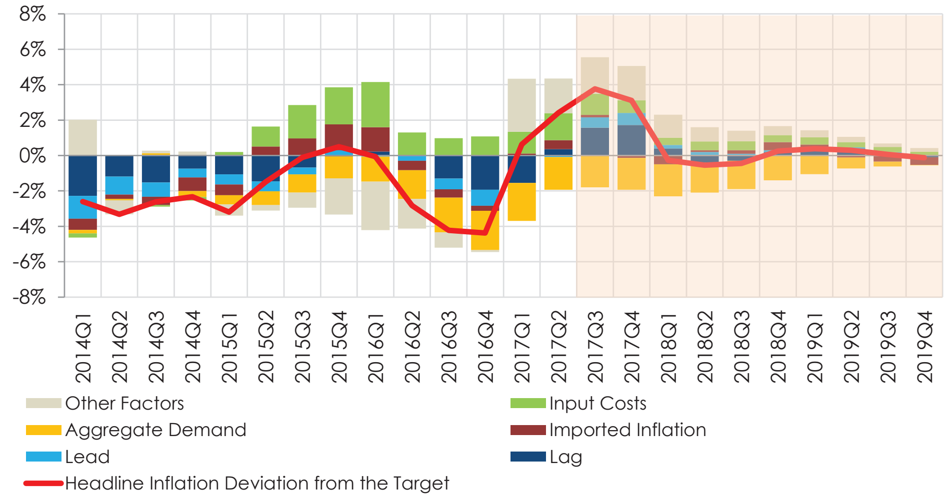
Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

According to the forecast, annual inflation will decrease alongside the gradual exhaustion of temporary factors and will be close to the 3% target in 2018. Aggregate demand will also push inflation downwards because, despite[11] improvements,

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.*

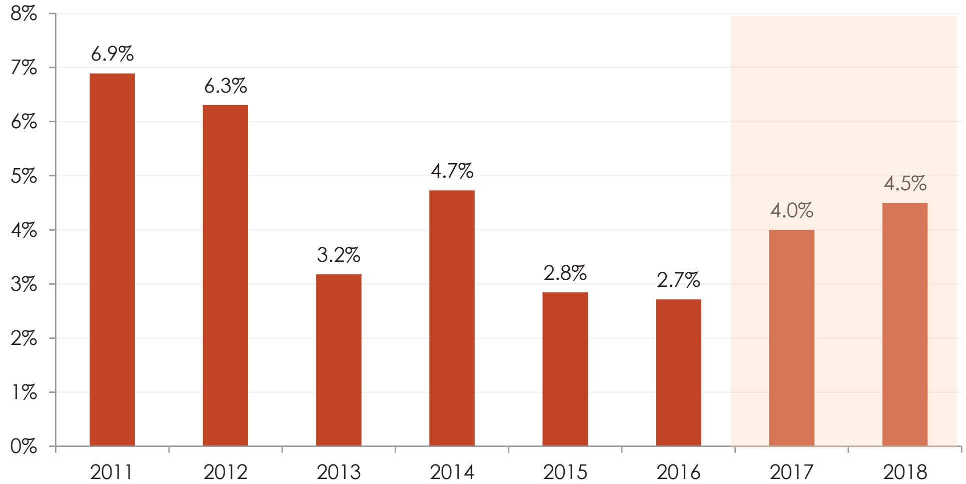
economic activity remains behind its potential level. In the medium term, inflation shocks will shorten and inflation will be maintained within the target range (see Figure 2.3). The target level of inflation is 3% from 2018.

According to the forecast, the above-target inflation rate in the second half of 2017 will be a result of the same factors that led to an increase in the first half of 2017 – in particular, the temporary factors affecting the supply side, such as increased excise taxes and higher prices of commodities on international markets. Moreover, expectations and the hike in import prices on intermediary goods will positively contribute to the increase, while weak aggregate demand will place downward pressure on the inflation rate. In the medium term, with the elimination of the temporary factors affecting the supply side and the gradual growth of the real economy to its potential level, inflation will be guided to the target level (see Figure 2.4).

There are **risks associated with the inflation forecast** in both directions. One risk to the forecast is related to economic activity, which, if stronger than expected, will push inflation upwards and, if weaker than expected, will ensure the inflation level is lower than forecast. Uncertainty remains surrounding international food and oil prices, which have substantial weight in the consumer basket and are mostly supply driven. Although the baseline forecast scenario does not consider significant changes in those factors, if international prices are greater than expected, inflation in Georgia will be above the forecasted rate. Moreover, if the exchange rates of the main trading partners appreciate more than is expected, this will increase the prices of imported goods, further increasing the risk of inflation. Risks are also associated with the euro exchange rate, which will depend on the pace at which the European Central Bank's quantitative easing program is scaled back. Furthermore, any significant changes in the exchange rates of trading partner currencies may lead to changes in the prices of imported goods, thereby affecting the inflation level.

Real GDP growth in the first quarter of 2017 was higher than expected and amounted to 5.1%. Based on preliminary estimates, the economic growth trend has continued in the second quarter of the year and stood at 4.0% (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 in investor sentiment have led to the growth of aggregate demand and foreign direct investment (FDI). Moreover, the improved external environment further promoted an increase in exports of goods and services, leading to GDP growth. Since 2014, when Georgia was first affected by the external shock, net exports made a negative contribution to GDP growth due to lower foreign demand and increased demand for imports. The external balance started to improve from the second quarter of 2015 with the relative depreciation of the GEL exchange rate against the US dollar. According to NBG estimates, from 2017 exports are expected to make a positive contribution to economic growth (see Figure 2.6).

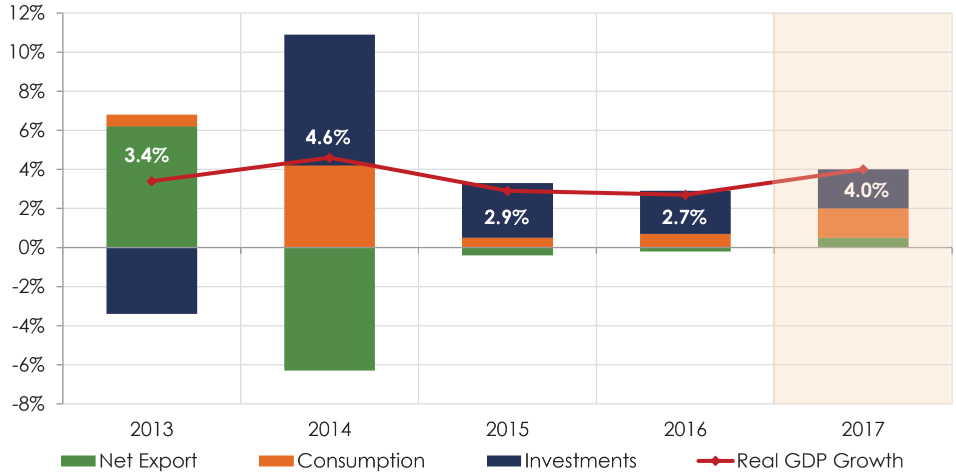
Figure 2.5 Real GDP Annual Growth



Source: National Bank of Georgia.

According to the **GDP forecast**, the growth rate in 2017 will be around 4%, and will equal 4.5% in 2018 (see Figure 2.5). However, based on the same forecast, negative risk factors affecting economic growth have declined compared to previous periods and, if the external environment continues the current trend of improvement, GDP growth may exceed 4% in 2017. Planned infrastructure projects and fiscal stimulus will support an increase in domestic demand. Moreover, the situation in the foreign sector has improved, promoting an increase in exports. The NBG thus expects net exports to have a positive contribution to GDP growth in 2017 (see Figure 2.6).

Figure 2.6 Real GDP Growth by Components[12]



Source: National Bank of Georgia

The foreign sector is seen as a major **risk to the GDP forecast**. 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 currently forecast. On the other hand, if the opportunity of free trade with the EU and/or investment projects have a greater-than-expected positive impact on economic activity or business sentiment, then GDP growth will be higher than is forecast.

According to the forecast, in 2017 the **current account deficit** will be approximately 12% of GDP. Based on preliminary data, in the second quarter, exports of goods (in USD terms) increased by 30%, while imports (excluding hepatitis C drug imports) grew by 4%. In addition, in the second quarter, money transfers grew by 18%, while revenues from tourism increased by 28%. The current account deficit is thus likely to have decreased in the second quarter.[13] In the medium-term, the current account deficit is expected to gradually improve as a result of the increase in exports of goods as well as services, including tourism and remittances.

The ultimate goal of the National Bank of Georgia is price stability, which can be reached efficiently through following 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 so aggressive as to induce high output volatility. Gradual changes in the policy rate are considered optimal, both in times of uncertainty and for controlling long-term interest rates more efficiently. The inflation forecast itself thus includes the **interest rate forecast**, which takes all of the above-mentioned issues into account.

Figure 1.3 shows the trajectory of the monetary policy rate, which is consistent with the macroeconomic forecast presented above. All else being equal, with the exhaustion of one-off factors affecting inflation, in the medium term the National Bank of Georgia will gradually continue the process of monetary policy normalization – this implies 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 5-6%. 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.

The falling trajectory of the monetary policy rate reflects the response of the NBG to the decline of the inflation rate in 2018. Furthermore, it is important to mention that the impact of existing external factors has already been reflected in the current

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

13 The current account deficit for the second quarter will be published in September.

exchange rate and therefore low and stable inflation expectations will contribute to a long-term strengthening of the exchange rate.

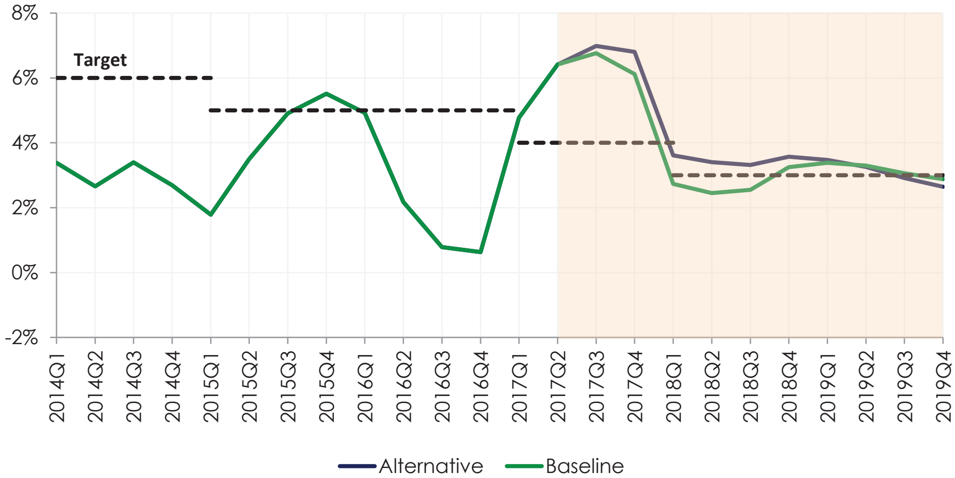
Finally, it should be stated that the forecast of the monetary policy rate is not a promise from the National Bank of Georgia. It is only the expected trajectory of the policy rate; assuming that all the exogenous factors incorporated into the forecast materialize as expected. Despite the inherent uncertainty,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

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a situation in which supply side shocks moderately worsen. 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 US 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 could 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).

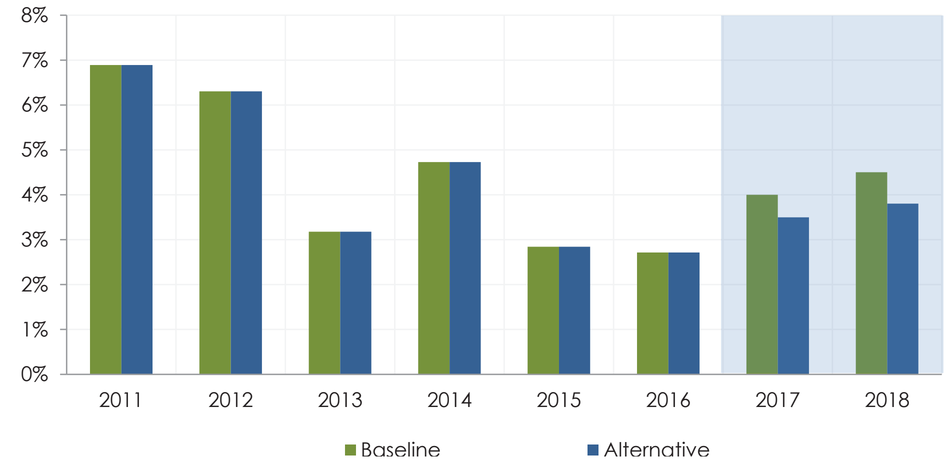
In the alternative scenario, due to negative external shocks, inflation increases at a faster rate than in the baseline scenario. Under such circumstances, the monetary policy provides an appropriate response to neutralize inflationary expectations and reduce inflationary pressures. According to the alternative scenario, inflation in 2017 will, on average, be 0.2 percentage points higher than in the baseline forecast; while in 2018 the average inflation rate will be one percentage point higher than in the baseline scenario (see Figure 2.7). The monetary policy response will ease inflationary expectations and reduce inflationary pressure. As a result, inflation will be close to the 3% target in the medium term.

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)

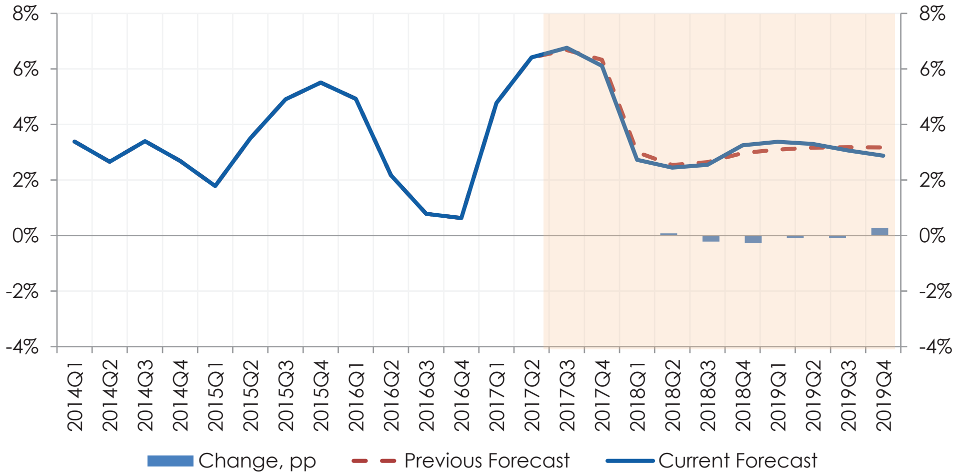


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast for 2017 has not changed (see Figure 2.9). The factors that the forecast was based on have not changed significantly and no new substantial inflationary risks have arisen that would require a revision. The economic growth forecast for 2017 has also remained unchanged, standing at 4%.

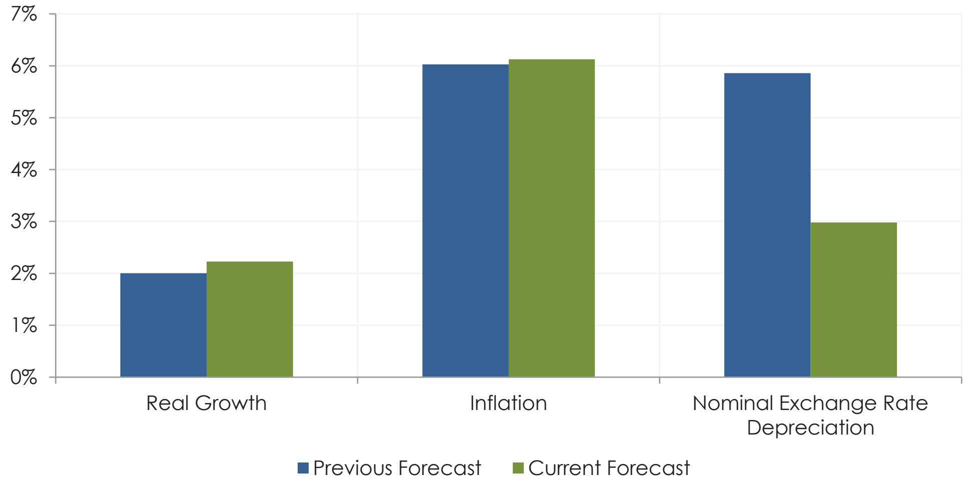
Figure 2.9 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

Assumptions regarding the external sector are particularly important for the macroeconomic forecast. Any renewed assumptions regarding the economic situation of trading partner countries therefore affect changes in the forecast and the associated risks (see Figure 2.10). Assumptions regarding the expected dynamics of trade partner currencies against the US dollar were revised significantly given the global economic situation. In particular, a further strengthening of the US dollar is less likely than in the previous quarter. Changes in assumptions regarding inflation and the economic growth of trading partner countries are insignificant, but have been slightly revised in a positive direction.

Figure 2.10 Changes in External Sector Assumptions for 2017[14]



Source: Bloomberg

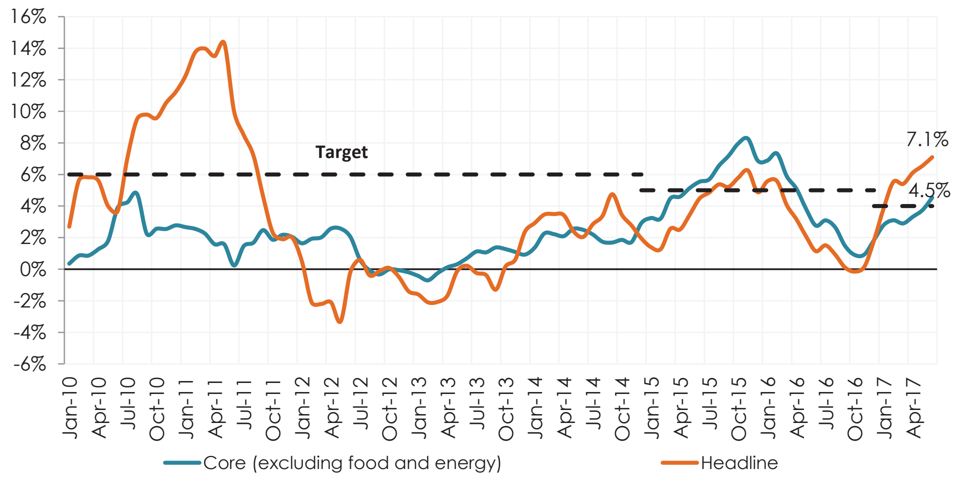
14 The calculations are based on forecasts for the five main trading partners of Georgia.

3. Consumer Prices

Following the forecast, the inflation rate increased in the beginning of 2017. In June, annual inflation stood at 7.1 % and the core inflation rate was 4.5%. The inflation rate in the first half of the year thus exceeded the 4% target for 2017.

« Following the forecasts, inflation increased in June and stood at 7.1%.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

The rise of inflation is mainly attributed to increases in oil and tobacco prices. These stemmed from the surge of oil prices on international markets and a rise of excise tax on fuel and tobacco products from the beginning of 2017. In particular, of the 7.1% inflation seen in June, the price increase on those products had a 2.6 percentage point (pp) share; food contributed 2.7 pp, while other goods contributed 1.9 pp (see Figure 3.2).

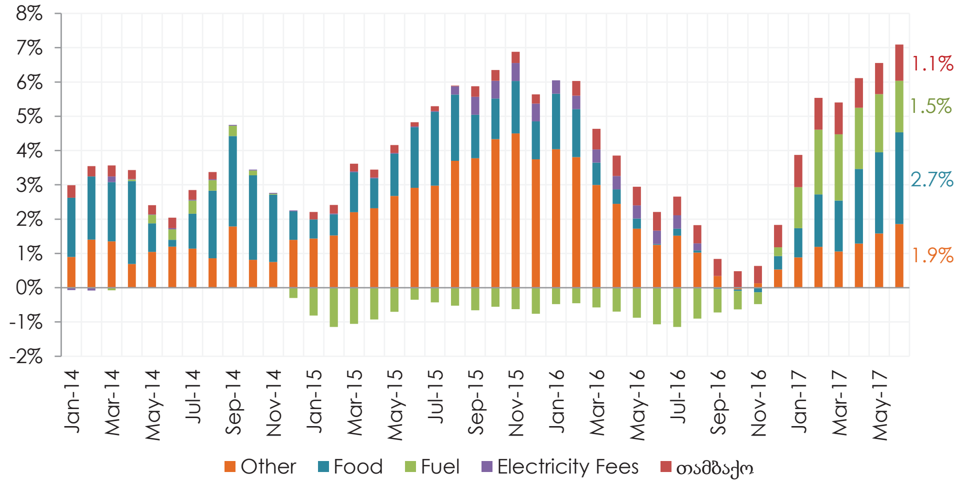
« Of the 7.1% inflation in June, 2.6 pp came from fuel and tobacco products.

In the first half of 2017, the contribution of the food group to total inflation increased and reached 2.7 percentage points at the end of the second quarter. At the beginning of 2016, prices on fruits and vegetables declined and thus the increase of the food group inflation is mainly related to the base effect. Moreover, prices increased on meat and meat products, which can be linked to growing meat exports to trading partners and a reduction of supply to the local market.

« The high contribution of food to total inflation is linked to the base effect.

Compared to previous periods, the price of sugar and products containing sugar on international markets was relatively high (rising by 10.4% and making a 0.2 pp contribution to inflation). Last year, sugar prices surged all over the world due to poor sugarcane harvests in the main producing countries. However, this trend reversed from the beginning of the year and led to the reduction of sugar inflation. Prices have also significantly increased on healthcare products, where annual inflation was 7.4%, contributing 0.6 pp to overall inflation. Medications saw the most significant price increase from this group.

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

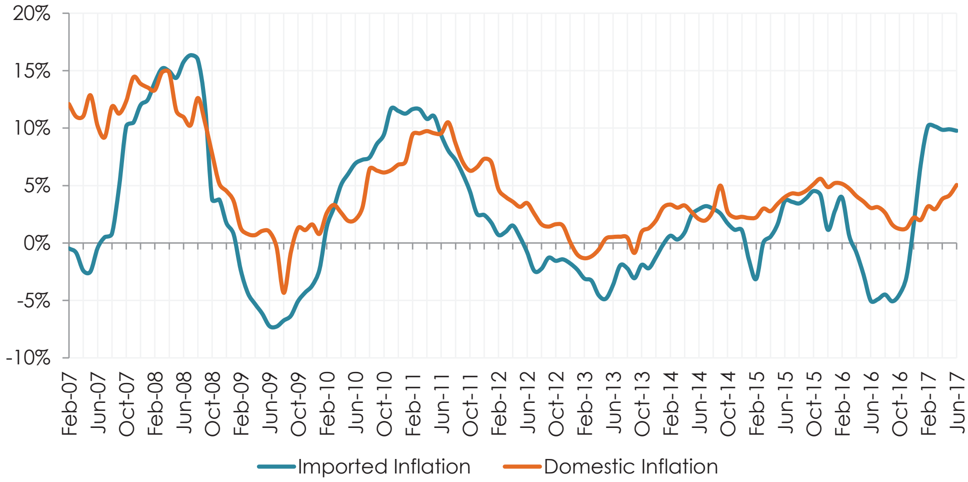


Source: GeoStat and National Bank of Georgia

The increase in inflation can mainly be attributed to rising prices of imported goods. Imported inflation in June stood at 9.8%. The main reason behind this growth was the increase in prices on fuel and tobacco. In June, inflation on locally produced and mixed goods was comparatively lower and stood at 8.7% and 5.1% respectively.

‹‹ Domestic inflation was comparably low, standing at 5.1%.

Figure 3.3 Imported And Domestic Inflation

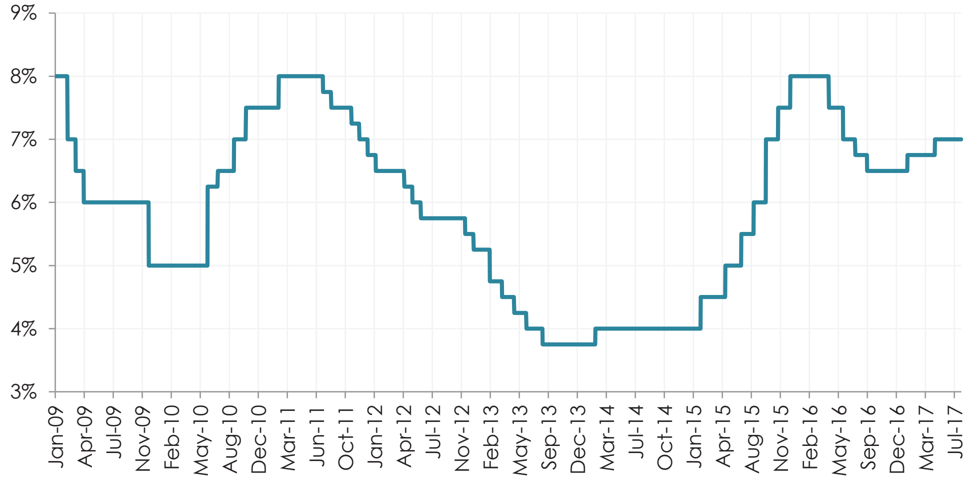


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

In the first half of 2017, following the expansionary monetary policy of the previous year, the National Bank of Georgia started tightening monetary policy. The policy rate increased by 25 basis points, from 6.5% in January to 7% in May 2017. These decisions were promoted by temporary supply side factors, such as the increase in excise tax on certain import commodities, rising prices on international markets and past pressures on the lari exchange rate due to the recent global appreciation of the US dollar. These factors led to increased inflation forecasts and inflation expectations. As a response, in order to curb inflation expectations, the NBG decided to gradually increase the policy rate in January and May.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the NBG's Monetary Policy Committee was on 26 June 2017. During that meeting, the committee decided to keep the refinancing rate unchanged at 7%. This decision was based on the macroeconomic forecast, according to which inflation is expected to remain above the target during 2017. It should be noted that increasing in inflation is temporary and is driven by supply side factors. Recently, the inflation expectations are declining, pushing the inflation downwards. Thus, other things being equal, there is no need for a further tightening of monetary policy.

‹‹ The NBG has kept the policy rate unchanged at 7%.

In June 2017, annual inflation reached 7.1%. From the beginning of the year, the inflation rate has been above its 4% target – this was largely driven by increased excise taxes on certain commodities. In addition, higher intermediate costs and imported inflation supported growth of the inflation rate.

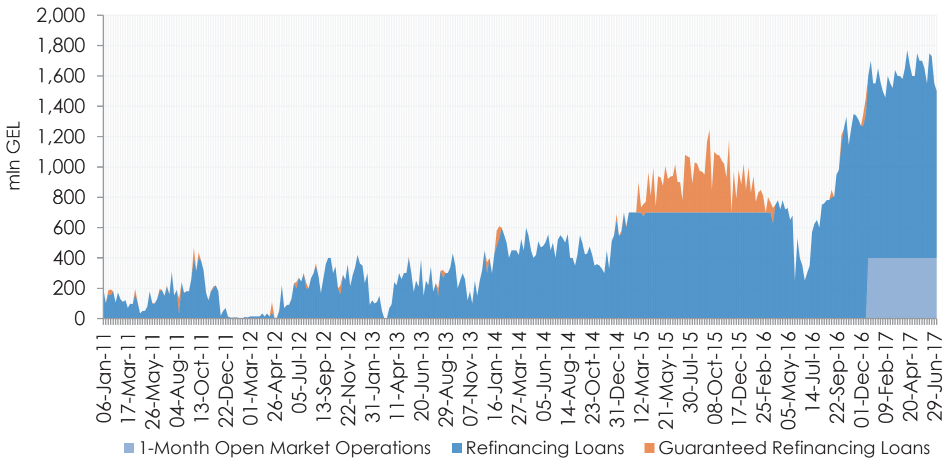
From early 2017, domestic demand improved and economic growth indicators revealed higher than expected growth. Based on preliminary estimates, the economy grew by 5.1% in the first quarter of 2017. Positive trends continued in the external sector and, in parallel with the economic recovery of Georgia's main trading partners, external demand grew, thereby increasing revenues from exports. The positive trend of increased revenues from international visitors, particularly tourists, has also persisted. Tourism revenues increased by 43% in June 2017. Meanwhile, the volume of remittances also continued to grow. During January-May 2017, money transfers grew by 20% annually. The positive dynamics of the external sector have supported consumption and contributed to economic growth. Although enhanced domestic demand encourages imports, domestic demand and overall economic activity currently remain below potential levels and are not creating demand-side inflationary pressures.

According to the current forecasts of the NBG, headline inflation is expected to remain temporarily above its target level, albeit with a decreasing trend. Inflation is expected to approach the target level at the beginning of 2018 as the one-time factors affecting inflation start to be exhausted. According to the forecast, in the absence of additional shocks, the monetary policy rate will gradually decrease to the neutral level (of 5-6%) in the medium term. The risks associated with the inflation forecast are related to higher- or lower-than-expected aggregate demand, the exchange rate volatilities of major trading partner currencies and changes in the prices of consumer goods.

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. Currently, the banking sector operates under the conditions of a liquidity deficit. Commercial banks are thus 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 one-week refinancing loans and one-month open market operations. As a result, interbank money market interest rates move around the monetary policy rate.

‹‹ The interbank money market interest rates move around the monetary policy rate.

Figure 4.2 Liquidity Supply Instruments

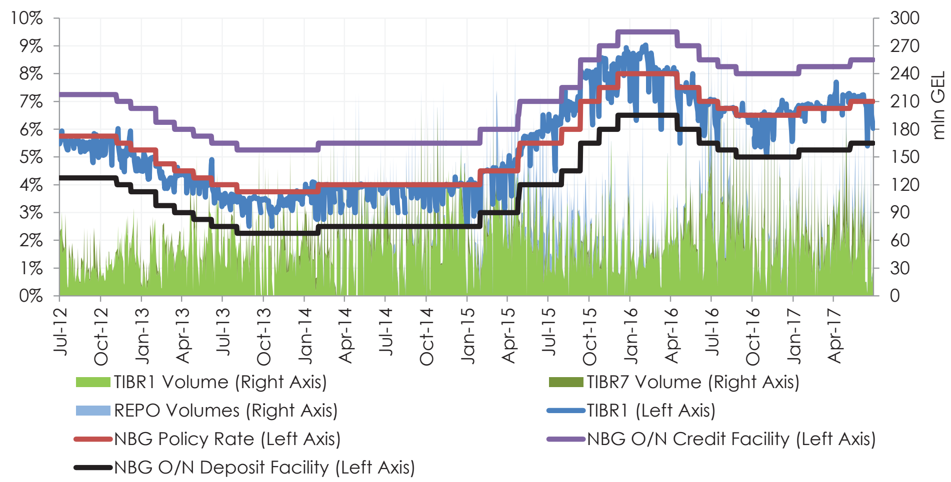


Source: National Bank of Georgia

On 26 July, the Monetary Policy Committee of the National Bank of Georgia decided to reduce the interest rate corridor to 2 percentage points. This decision was made in order to further decrease the volatility of interbank rates and ensure the higher efficiency of the interbank market. According to the amendment, interest rates for overnight loans and deposits of the National Bank are defined as the policy rate +/-1 percentage point, instead of the previous rate of the policy rate +/-1.5 percentage points. This decision will come into force from 10 August 2017.

‹‹ The Monetary Policy Committee decided to reduce the interest rate corridor to 2 percentage points.

Figure 4.3 Interbank Money Market



Source: National Bank of Georgia

Box 1 International Monetary Fund program

In April 2017, the Board of Executive Directors of the International Monetary Fund (IMF) approved Georgia's Extended Fund Facility (EFF) program for 210.4 million SDR (approximately 285.3 million USD and 100% of the country's quota).

The first tranche of the program was set at 30 million SDR (about 40.7 million USD), to be made available as soon as the program was approved. The remaining amount will be distributed during the course of the program and will be available in six equal tranches – provided every six months, subject to positive reviews from the IMF.

Program goals. The aim of the program is to support the country in attaining high and inclusive grow by encouraging structural reforms. It supports **structural reforms** in the direction of increasing efficiency in sectors such as education, road infrastructure and public governance. These measures, in turn, will encourage national savings, private investments and increase competitiveness.

The IMF's new program also supports **fiscal consolidation** in the medium term and directs expenditure towards capital investments. This is important for maintaining the state debt at adequate levels and for overcoming infrastructural challenges.

The program will also encourage **bilateral and multilateral donor funding** for infrastructural investments and will improve the international reserves of the country during the course of the program.

Overall, the program will promote the implementation of structural reforms, strengthen financial stability, reduce vulnerability to external risks, increase fiscal reliability, and enhance infrastructural investments. These factors, in turn, will reduce macroeconomic challenges and improve the business environment, both of which are important prerequisites for the sustainable growth of the private sector.

Filling up the reserves. Over time, and in parallel with the implementation of the abovementioned reforms, the need for expanding the international reserve buffer is expected to decrease. However, due to the current level of economic development and the macroeconomic situation in the country, it is important to increase the level of international reserves. The IMF's new program will allow the NBG to fill international reserves to the recommended level through increased currency inflows, without creating pressure on the exchange rate. Moreover, it is expected that this program will be a catalyst for facilitating budget support funding from other sources, such as the European Union, the Asian Development Bank and the World Bank.

Program Monitoring. The program will be monitored by reviews occurring every six months. In addition, this entails the constant monitoring of performance criteria (PC) and contains an inflation consultation clause, indicator targets and structural benchmarks.

- Quantitative criteria (PC) include a ceiling on state budget deficits; floors on net international reserves; a ceiling on the deficit of the Partnership Fund and net borrowings; a criteria for foreign liabilities and state guarantees, as well as a defined target indicator for primary expenditure on the budget.
- From the monetary perspective, the program contains an inflation consultation clause. This implies the monitoring of 12-month inflation through dual consultation bands. These borders are determined as the inflation forecast +/-2 percentage points and should be in line with the target of the National Bank.
- Structural benchmarks aim at strengthening financial regulations, supervisory and crisis management frameworks according to the IMF recommendations over the short term. Moreover, they support the creation of directives for public private partnerships, budget financing, and for laying the foundations for pension and capital market reforms.

The inflation consultation clause and the net international reserves criteria for the National Bank of Georgia are given in the table below.

Table 4.1 The inflation consultation targets and the net international reserves criteria for the National Bank of Georgia

The inflation consultation targets for 2017-2018				
	June 2017	December 2017	June 2018	December 2018
Central point	6 %	5 %	3 %	3 %
Inner band	8/4 %	7/3 %	5/1 %	5/1 %
Outer band	9/3 %	8/2 %	6/0 %	6/0 %
Net international reserve quantitative criteria				
	June 2017		December 2017	
Floor on net international reserves (end of period, mln USD)	1,210		1,350	

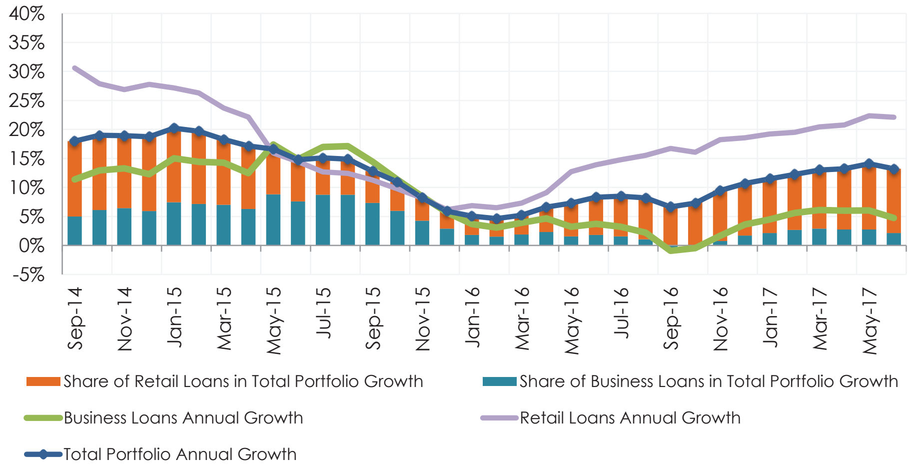
Source: International Monetary Fund

5. Financial Market and Trends

5.1 LOANS

Credit activity improved in the second quarter of 2017. Excluding the effect of exchange rate movement, the loan portfolio increased by 13.2% in June.[15] This increase can mainly be attributed to the growth of retail loans, but the growth rate of business loans also increased.

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

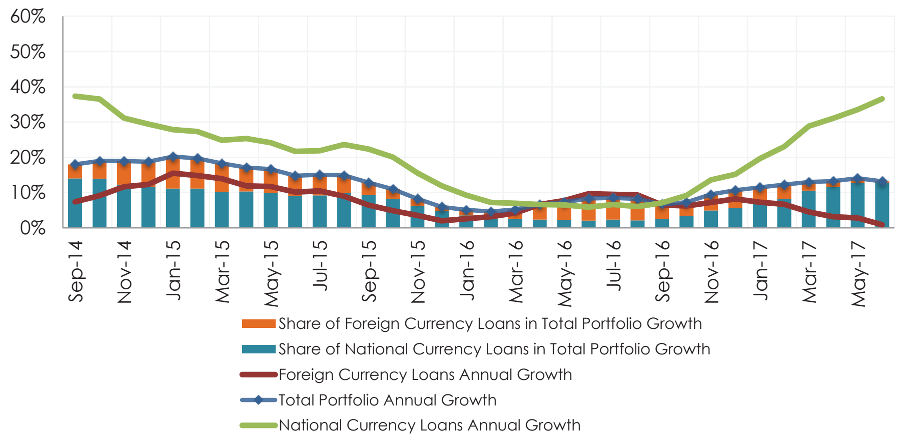


Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was primarily driven by an increase in domestic currency loans. In June, the annual growth rate of foreign denominated loans was 0.9%, while domestic currency loans grew by 36.6%. It is important to note that the increase in domestic currency loans can be ascribed to a one-time larization program, under which a loan portfolio worth approximately 80 million USD was converted into GEL. Hence, in the second quarter, the loan larization ratio increased by 1.9 pp and was equal to 41.0%.

‹‹ In the second quarter, the larization of loans increased by 2 pp and totaled 41%.

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

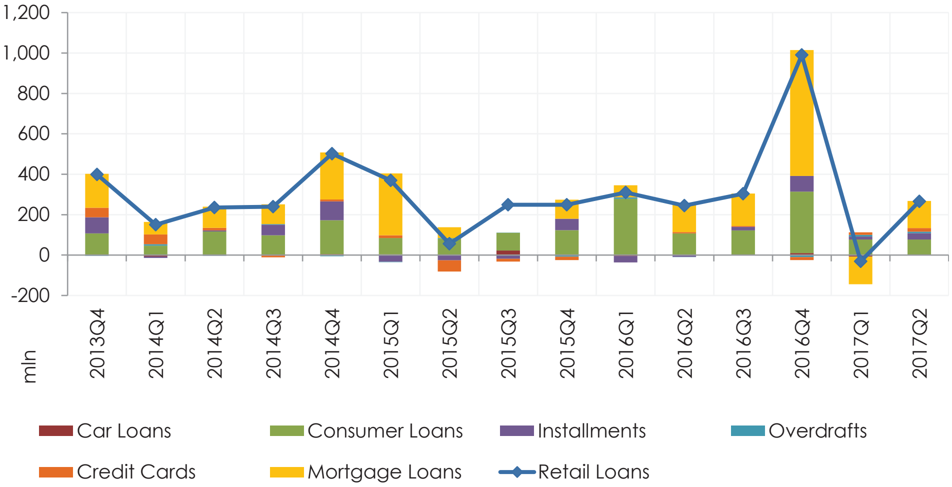


Source: National Bank of Georgia

15 *Excluding the effect of transforming one microfinance organisation into a bank.*

In June, compared to March, the stock of retail loans increased by 265.2 million GEL.[16] In terms of loan products, the amount of mortgage loans increased by 134 million GEL, while consumer loans increased by 77.4 million GEL. The volume of instant loans and credit cards increased by 48.9 million GEL. According to the credit conditions survey, representatives of the banking sector are not expecting a significant 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 4.7%[17], which was 1.4 percentage points lower than in March. An analysis of business loans by sector reveals that the increase in credit was driven by the construction, trade, agriculture and energy sectors; meanwhile, the increases in credit for the transport and manufacturing sectors were insignificant. Representatives of the banking sector expect an increase in demand for business loans in the next quarter.

Compared to the previous quarter, the credit to GDP ratio[18] increased by 1.6 percentage points and amounted to 55%.[19] As a result, the credit to GDP ratio is currently above the trend by 2.5 percentage points.[20]

In the second quarter of 2017, compared to the previous quarter, the ratio of individuals' loans to net national disposable income increased by 1 pp and equaled 31.9%. The majority of loans to individuals (92%) are commercial bank loans.

16 Excluding the effect of transforming one microfinance organisation into a bank.

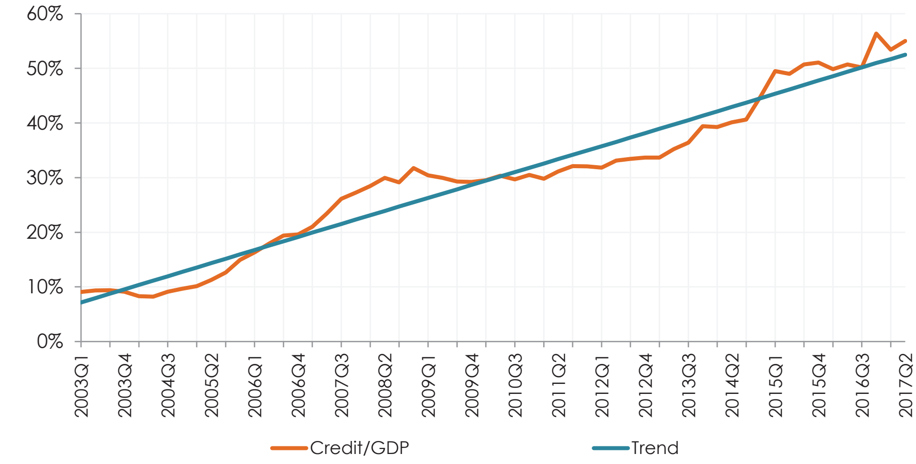
17 Excluding the exchange rate effect.

18 The credit to GDP gap was presented by the Basel Committee as the starting point for capital buffer accumulation. Compared to other measurements, the credit to GDP gap is seen as the best way to assess an expected crisis. Loans include loans issued by commercial banks and exclude interbank and government loans.

19 This increase reflects the effect of transforming a microfinance organization into a bank.

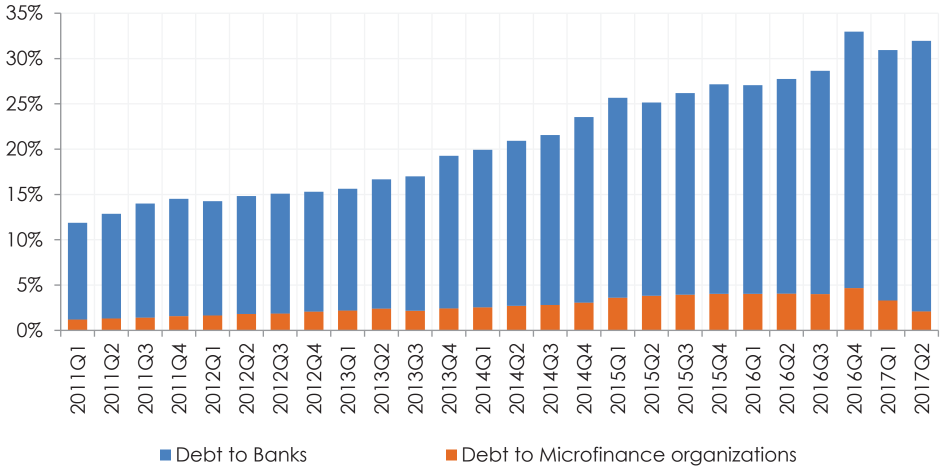
20 An HP filter is used to assess the trend. Based on Basel recommendations, lambda is equal to 400,000.

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

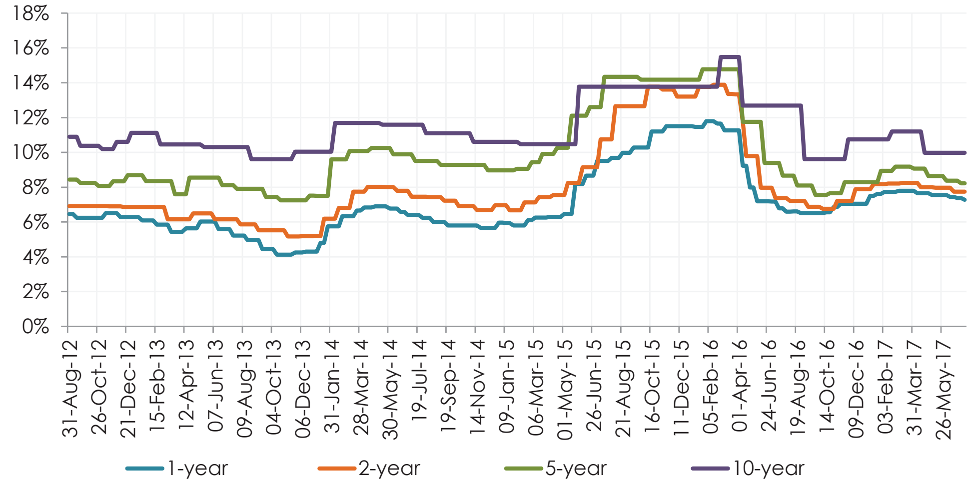
Compared to the previous quarter, the share of non-performing loans decreased by 0.1 percentage point and amounted to 6.9%. This change was mainly due to the amount of loans written off, which amounted to 75 million GEL in the second quarter of 2017. According to the data from June, the share of non-performing loans in the national currency decreased by 0.1 percentage point compared to March and amounted to 4.8%. Meanwhile, the share of non-performing foreign exchange loans dropped by 0.1 percentage point and stood at 8.5%.

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In June, the monetary policy rate was equal to 7%. In the second quarter of 2017, interest rates on government securities were characterized by a decreasing trend. The latter was as a result of the decline of liquidity risk and expectations of an easing of monetary policy in the medium term (see Figure 5.6).

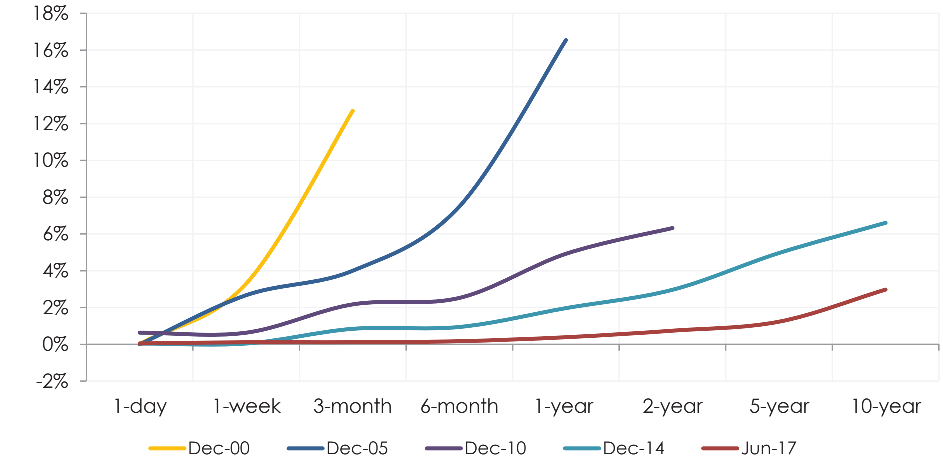
Compared to the previous quarter, the spread between long-term assets and the monetary policy rate decreased due to expectations of monetary policy easing. It should be noted that the spread has significantly declined compared to the same period of last year, which suggests increased credibility of monetary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

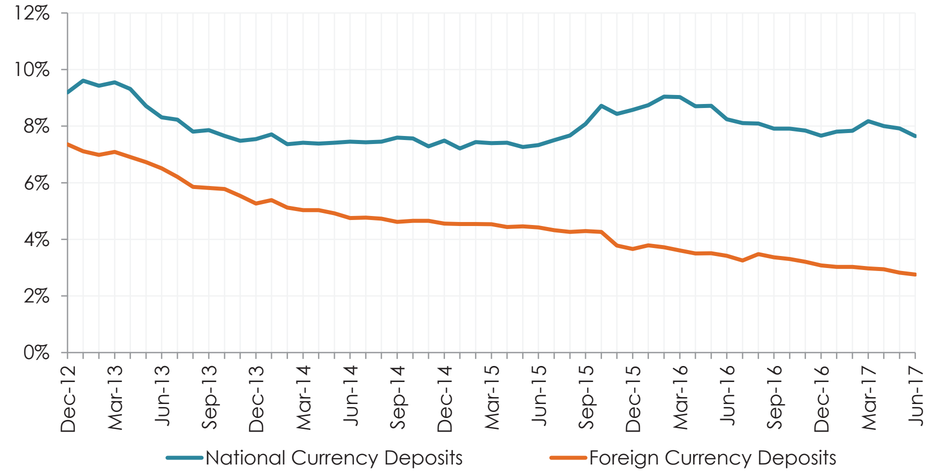


Source: National Bank of Georgia

Compared to the previous month, the interest rate on domestic currency deposits did not change significantly in June and stood at 7.9%, whereas interest rates decreased by 0.1 percentage point for foreign exchange deposits and amounted to 2.8%. According to the credit conditions survey, representatives of the banking sector expect an increase in the costs of domestic and foreign currency funding. The increased cost of funding will be driven by changes in deposit interest rates, liquidity costs, interest rates on international markets and regulatory norms.

‹‹ According to the credit conditions survey, representatives of the banking sector expect increase in the cost of domestic and foreign currency funding.

Figure 5.8 Average Interest Rates On Deposits

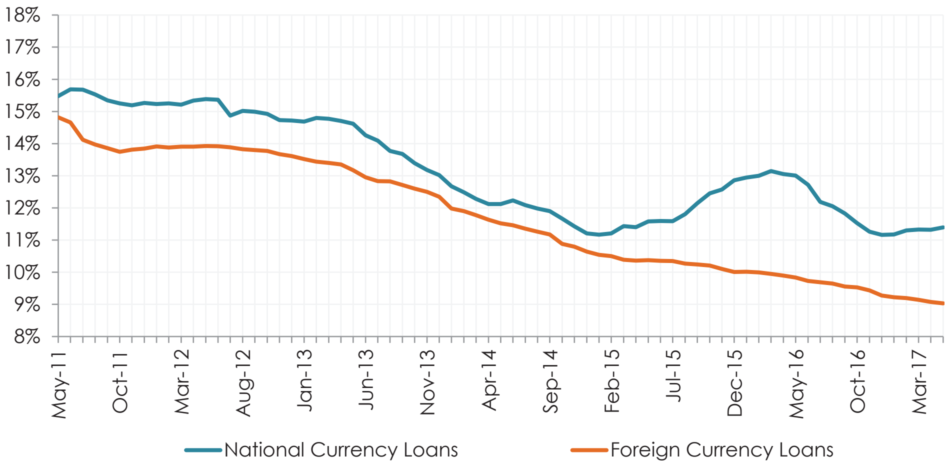


Source: National Bank of Georgia

According to the same credit conditions survey, in the second quarter of 2017, credit conditions for individuals and legal entities were slightly stricter. Stricter credit conditions were observed on consumer loans; in addition, the margin on variable interest rate loans issued in GEL slightly increased. Meanwhile, non-interest conditions for business loans in foreign currency were eased as a result of the decline in demand. In June, compared to March, interest rates on SME loans declined by 0.1 pp and equaled 10.7%. For corporate loans, interest rates increased by 0.1 pp and amounted to 9.6%. Interest rates on retail loans also increased by 0.3 percentage points in June and equaled 16% (see Figure 5.10). In June, compared to March, the average interest rate on the stock of legal entities' domestic currency loans increased by 0.1 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; however, due to increased competition, the spread between loan and deposit interest rates will decrease. It should be noted that, in light of the international increase 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 sector take these risks into account when pricing those loans.

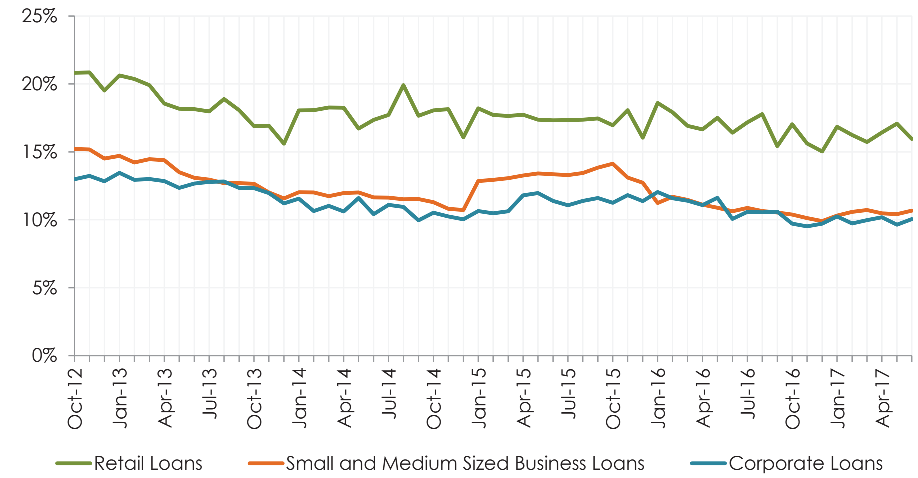
« According to the credit conditions survey, credit supply conditions are not expected to change significantly, while, due to increased competition, the spread between the loan and deposit interest rates will decrease.

Figure 5.9 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.10 Interest Rate On Loan Flow

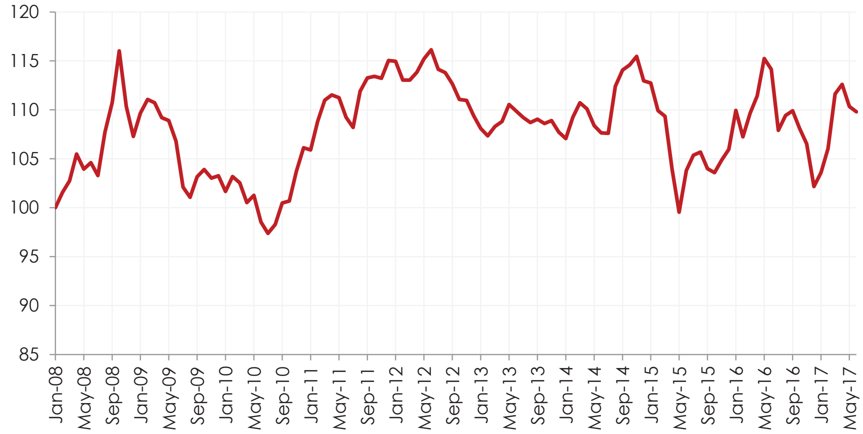


Source: National Bank of Georgia

5.3. EXCHANGE RATE

In the second quarter of 2017, compared to the previous quarter, the GEL exchange rate appreciated against the US dollar by 7.1%, and against the euro by 4.2%. The GEL exchange rate also appreciated against the Turkish lira by 4.2%. In the second quarter, the quarterly nominal effective exchange rate appreciated by 4.6% and depreciated by 2.8% on a year-on-year basis. The real effective exchange rate appreciated by 3.6%, but depreciated on a year-on-year basis by 2.4%.

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



Source: National Bank of Georgia

Table 5.1 Effective Exchange Rates Annual Growth[21]

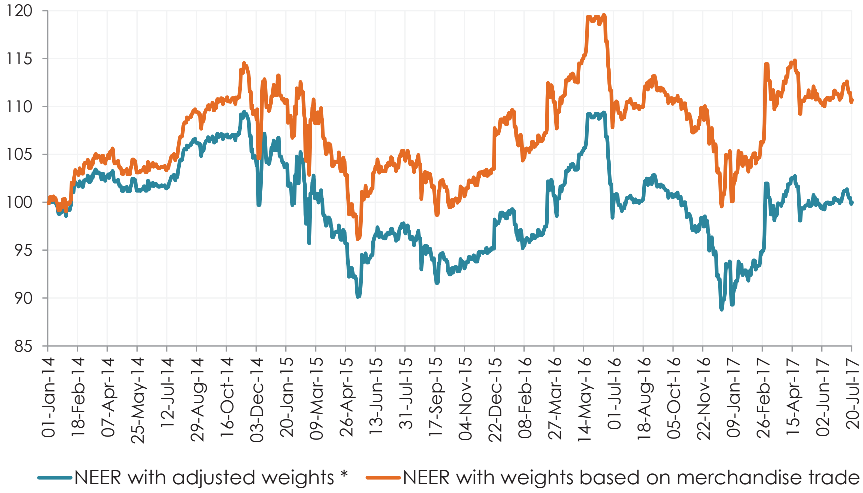
	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate	**-4.8**	**-3.8**	**-3.8**
Eurozone	-9.2	-4.0	-1.0
Turkey	9.3	5.5	1.2
Ukraine	-5.0	-12.0	-0.8
Armenia	-8.6	-3.2	-0.2
The United States	-9.3	-4.4	-0.2
Russia	-19.7	-17.6	-2.1
Azerbaijan	0.8	-5.4	-0.5
Other	-6.8	-1.6	-0.2

Source: National Bank of Georgia

The nominal effective exchange rate, adjusted for commodity groups and services, exhibits a slightly different picture. In the second quarter of 2017, the adjusted nominal effective exchange rate depreciated by 4.8% year on year and appreciated by 5.4% compared to the previous quarter.

21 *The second quarter, compared to the same period last year.*

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

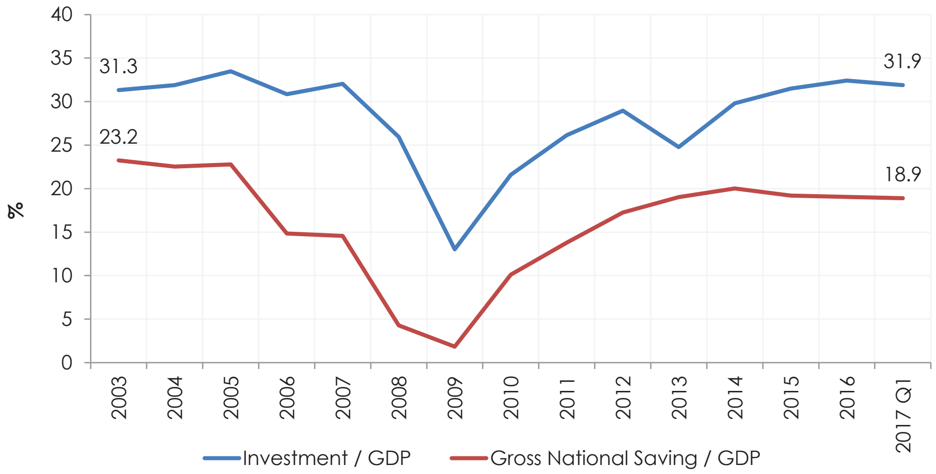
Real GDP growth amounted 5.1% in the first quarter of 2017. An increase in private consumption made the largest contribution to GDP growth (the main factor in the previous year was investment). Growth was also driven by an improvement in both internal and external demand.

« Real GDP growth amounted to 5.1% in the first quarter of 2017.

The capital formation growth rate declined in the first quarter of 2017 and stood at 4.1% following an increase in direct investment (FDI). The investment to GDP ratio in the first quarter of 2017 amounted to 32% (see Figure 6.1). This figure is relatively high for Georgia, promoting long-term economic growth through the accumulation of capital. It should be noted that fixed capital formation helps maintain fast economic growth. Meanwhile, the slowdown in investment growth resulted from the negative indicator for the change in inventories.

« The investment to GDP ratio in the first quarter of 2017 amounted to 32%, which is a satisfactory level for Georgia.

Figure 6.1 Savings and Investments to GDP ratio



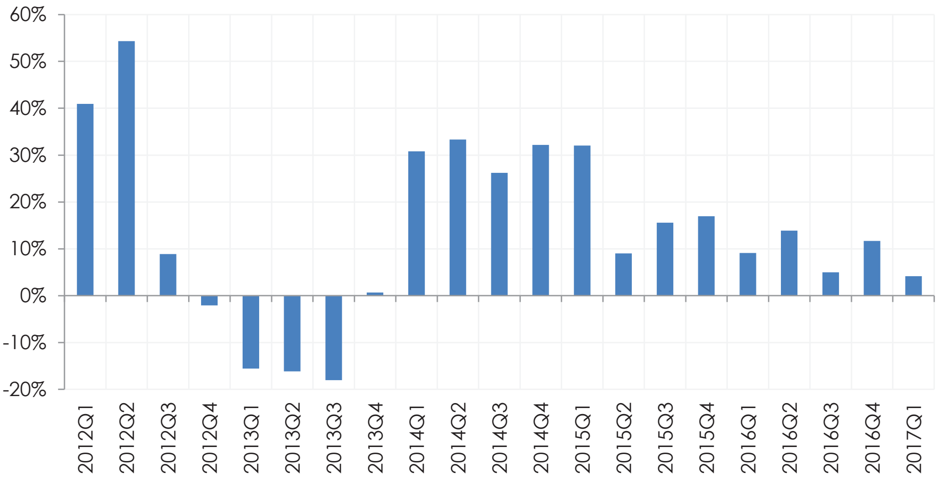
Source: GeoStat and the National Bank of Georgia's calculations

In the first quarter of 2017, the increase in internal demand was reflected on consumption. The private consumption annual growth rate[22] increased compared to previous quarters and posted 6.6%, ensuring that private consumption was the main driver of growth in the first quarter of 2017. The growth in consumption was supported by an increase in disposable income that was driven by an improving external sector, followed by an increase in exports (e.g. tourism) and cash transfers. On the other hand, an increase in consumption was supported by the growth of credits issued by commercial banks. Unlike private consumption, government consumption declined. According to preliminary data, the increasing trend of loans provided by commercial banks seen during the second quarter will continue, supporting the growth of demand.

« The private consumption annual growth rate increased compared to previous quarters and posted 6.6%.

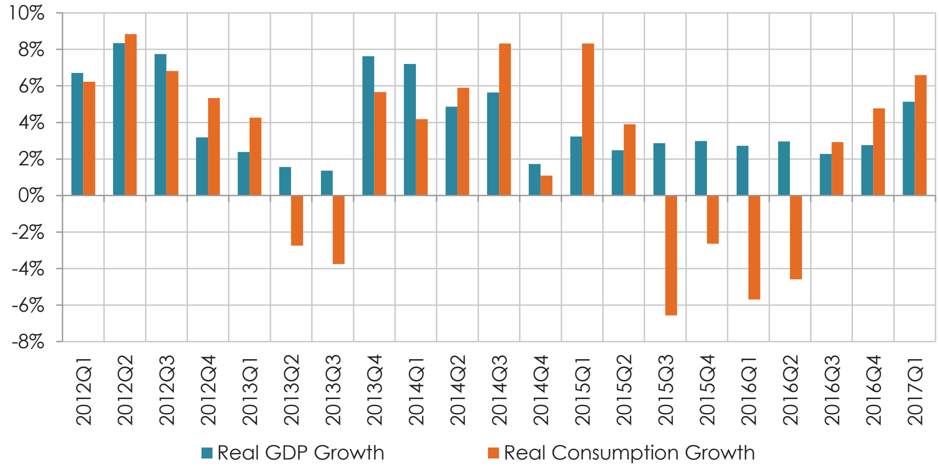
22 *Real growth of consumption is calculated considering average annual inflation.*

Figure 6.2 Annual Growth Rate Of Capital Formation



Source: GeoStat

Figure 6.3 Real GDP And Real Consumption Growth



Source: GeoStat and National Bank of Georgia

Following improvements in external demand, in the first quarter of 2017 exports increased significantly in both nominal and real values. Despite the increase in the price index of exported goods, according to preliminary data, the real growth rate of exports remained high in the second quarter. Net exports are expected to make a positive contribution to GDP growth in 2017. According to preliminary estimates, increased demand has led to an increase in imports of consumer goods. However, the growth rate of imports was relatively low in the second quarter. The rise of intermediary goods imports made the largest contribution to growth, while imports of consumer goods have not grown significantly. The low growth of the latter can be partially explained by the increased excise tax rate on certain consumer goods. The current trend of the lower growth of imports and increasing level of exports supported the reduction of the trade deficit in the second quarter.

In the first half of 2017, the consolidated budget deficit was 222.7 million GEL, which is 2.2 times lower than the same period last year. The relatively low budget deficit in the first half of 2017 was a result of higher tax revenues in the first quarter. The planned consolidated budget deficit for 2017 is 4.1% of GDP.

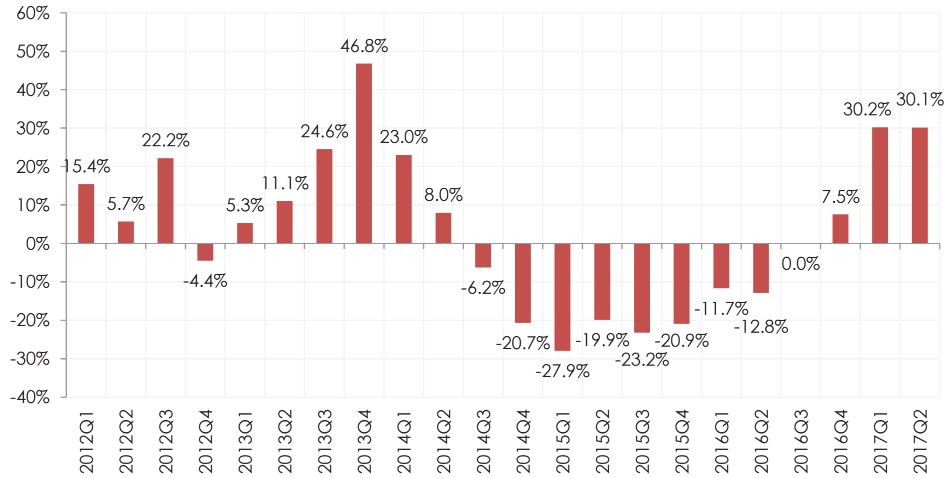
7. External Demand and Balance of Payments

Following the economic recovery observed in Georgia's main trading partner countries, demand for Georgian exports grew. In the second quarter of 2017, registered exports of goods increased annually by 30.1%. However, the structure of exports did not change significantly. In the second quarter of 2017, exports of intermediate and consumer goods made the largest contribution to growth – specifically exports of ferroalloys, wines, and copper ores and concentrates.

‹‹ In the second quarter of 2017, registered exports of goods increased annually by 30.1%.

The geographic destinations of exports are also important to consider. Following the economic recovery of Russia and Turkey, the volume of exports to both countries grew, rising by 5% and 17% respectively compared to the first quarter of 2017. Exports also increased to China and Iran. In the second quarter of 2017, compared to the first quarter, exports to China increased by 40% on average, while exports to Iran grew by 16% on average.

Figure 7.1 Annual Change Of Registered Exports Of Goods



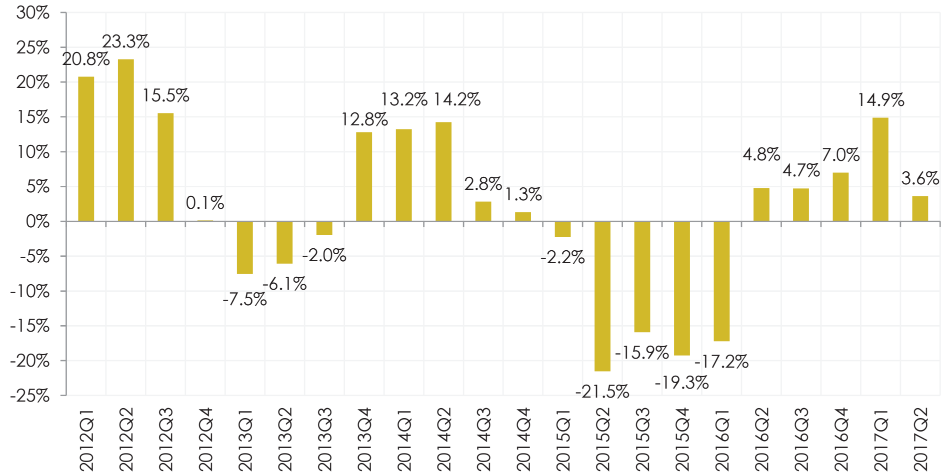
Source: GeoStat

In the first quarter of 2017, registered imports of goods increased by 3.6%. Imports of goods grew from both CIS and EU countries. An analysis of registered imports by category reveals that the growth can be attributed to increased demand for intermediate and consumer goods. In the second quarter of 2017, imports of intermediate and consumer goods were equal to 41% and 43% of total imports respectively. As for the structure of imports according to separate commodity groups, imports of oil and oil products increased significantly by 7.0% in the second quarter of 2017. The overall increase in imports was also driven by increased demand for telephone equipment and motor cars.

‹‹ Registered imports of goods increased by 3.6%.

‹‹ The growth of imports can be attributed to increased demand for intermediate and consumer goods.

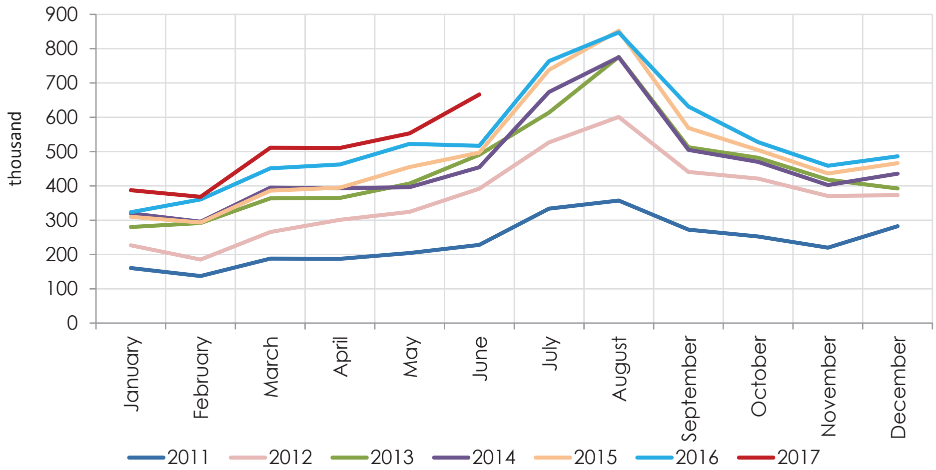
Figure 7.2 Annual Change Of Registered Imports Of Goods



Source: GeoStat

Inflows of international visitors, especially tourist arrivals, have continued to grow. In the second quarter of 2017, the number of foreign visitors who entered Georgia increased by 29%. The 64% rise in the number of tourists entering the country via air was significant as this group, on average, tend to spend more in the country. Annual tourism revenues grew by 43% in June.

Figure 7.3 Number of International Visitors to Georgia



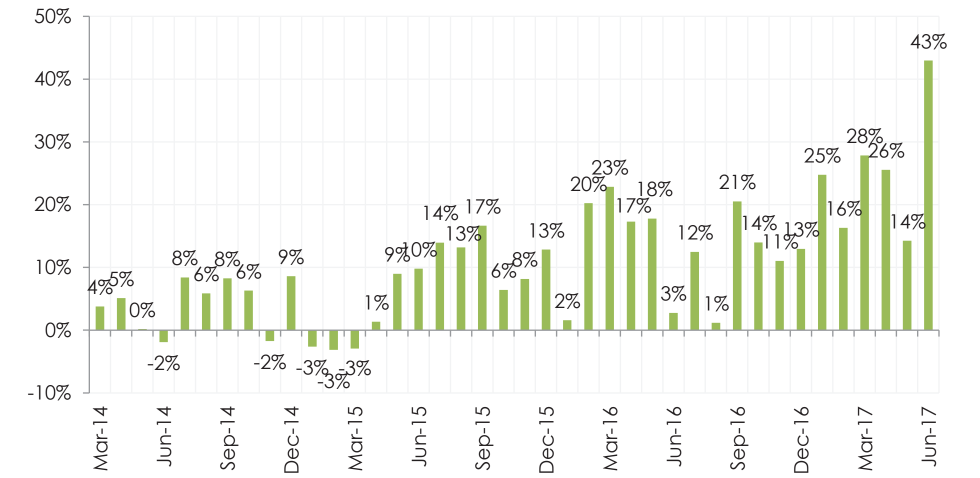
Source: GNTA

In the second quarter of 2017, the growth of tourism revenues grew and amounted to 657.6 million USD, which was 28% higher than in the same period last year.

In the second quarter of 2017, remittances increased by 17.6%, mostly as a result of the growth of money transfers from Russia and Israel. Money inflows from the EU also grew, with transfers from Greece, Italy and Spain being the main drivers. A growth of remittances was also observed from the US and Turkey.

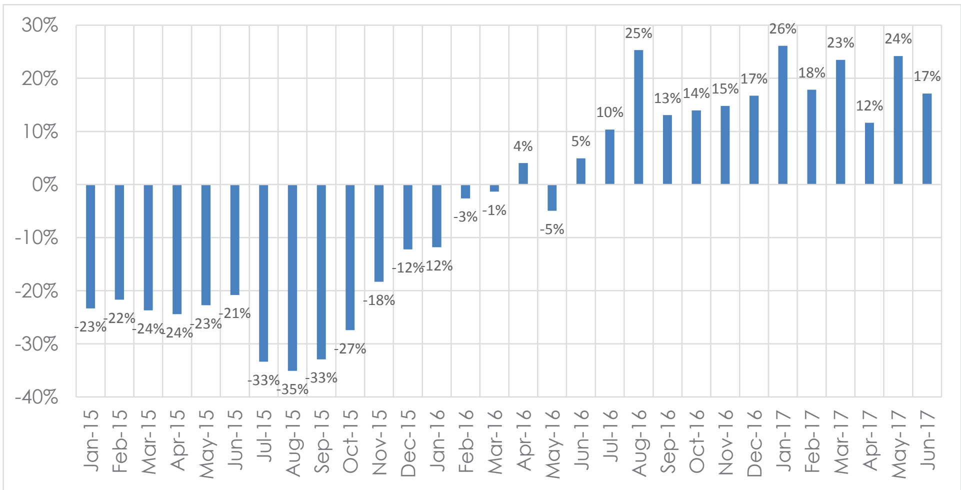
‹‹ In the second quarter of 2017, remittances increased by 17.6%.

Figure 7.4 Annual Change in Tourism Revenues



Source: GeoStat

Figure 7.5 Annual Change in Remittances



Source: The National Bank of Georgia

In the first quarter of 2017, the current account deficit improved compared to the same period of last year and amounted 11.8% of GDP. In 2016, balances on current transfers and trade of goods and services increased, thus positively contributing to the improvement of the current account balance. However, the income account deficit of the current account deepened, stemming from an increase in profits of direct investor enterprises that was reflected in the growth of both dividend and reinvested income. In the first quarter of 2017, the negative balance on income continued to grow.

‹‹ The current account deficit improved to 11.8% of GDP in the first quarter of 2017.

‹‹ In the first quarter of 2017, the negative balance on income continued to grow.

As was the case in 2016, foreign direct investments (FDI) remain the main source of financing the current account deficit. In the first quarter of 2017, FDI in Georgia amounted to 403 million USD. The transport and telecommunications sector continues to be the largest recipient sector of FDI, with 141.1 million USD. The real estate (80.3 million USD), financial (79.6 million USD) and hotels and restaurants (16 million USD) sectors were also significant recipients of FDI.

‹‹ In 2017, foreign direct investments (FDI) remain the main source of financing the current account deficit.

8. Output

Compared to the same period of the previous year, in the first quarter of 2017 GDP rose by 5.1%. At 3.1 percentage points (pp), the service sector made the largest contribution to overall growth. Industries contributed 2.2 pp and the agriculture sector's contribution was negative at -0.1 pp.

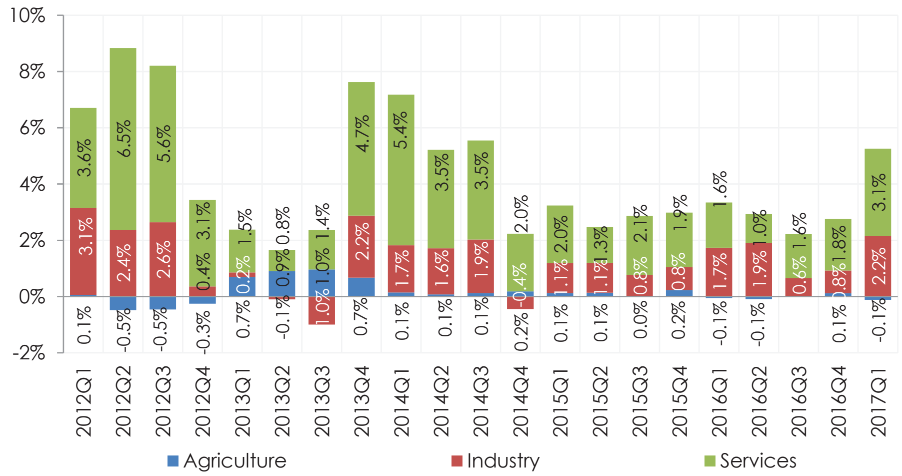
From the services sector, transport increased by 5.2%, contributing 0.4 percentage points to overall growth. In contrast to the decrease of land and rail transport, significant growth was observed in pipeline transportation and supporting transport activities, which contributed to the overall growth of the transport sector. Significant growth was observed in the telecommunications and financial sectors, which increased by 11.5% and 6.8% respectively. Following the increased volume of loans issued by commercial banks for real estate purchases and housing construction, the output of real estate operations increased by 6.3%.

« Services grew significanly, but trade rose by only 0.9%.

The other utilities, social and personal services sector increased by 7.9%, where gambling made the most significant contribution. Healthcare and social services grew by 5.6%. The contribution of each of the above sectors was equal to 0.3 pp. Nonetheless, despite the high growth of the services sector, trade, which is the largest sector, increased by only 0.9%.

From the industrial sector, and as was the case in previous years, construction made the most significant contribution to economic growth. Alongside the gas pipeline project, construction activity has increased in both the public and private sectors. In total, construction grew by 21.6%, contributing 1.4 pp to overall growth. Following the rise in external demand, an increase in manufacturing was observed, leading to growth in the production of export goods, especially metallic products and alcoholic beverages, which saw a nominal increase of 91% and 55% respectively.

Figure 8.1 Contribution Of Each Sector Of Economy To Real GDP Growth



Source: GeoStat, National Bank of Georgia

Despite a 33% nominal increase in animal husbandry, a decline in different directions of crop production reduced agriculture output by 1.5% in the first quarter of the year, contributing negatively (by -0.1 pp) to overall GDP growth.

« The output of agriculture has decreased.

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