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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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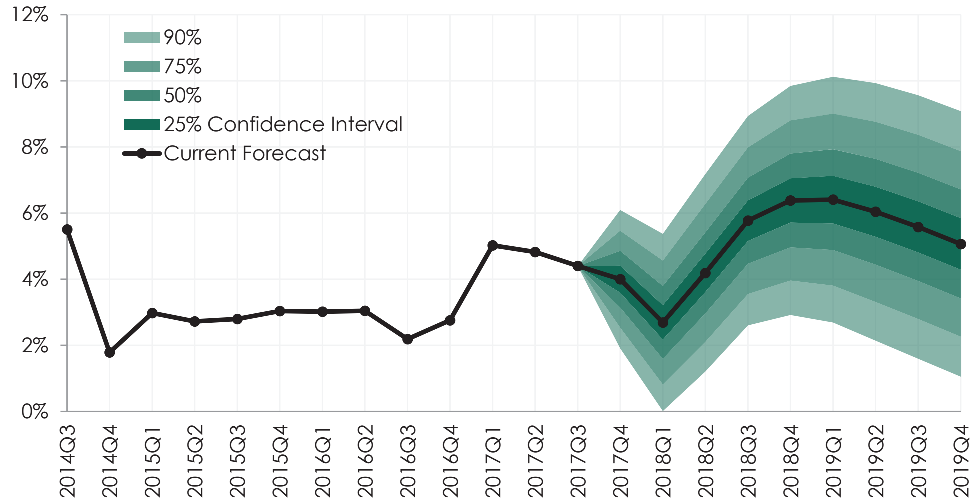
1. Brief Overview

Real GDP growth in 2017 has been higher than expected. According to preliminary estimates, in the third quarter of 2017, real GDP growth was 4.4%, and, based on the data from the first three quarters, real GDP grew annually by 4.7%. The recovery of economic activity has been supported by positive trends in the external sector – in particular, by an increase in remittances and significant improvements in exports of goods and services. Moreover, in terms of domestic factors, high levels of investment and a moderate growth of consumption have positively contributed to GDP growth – all of which is a result of improved business and consumer sentiments and an increase in loans.

Given the external sector developments, the National Bank of Georgia has revised its **GDP growth forecast for 2017** upwards, from 4% to 4.5% (see Figure 1.1). As expectations about economic activity of Georgia's main trading partners in 2018 have not changed significantly, GDP growth for Georgia in 2018 is still projected at around 4.5%. According to the forecast, GDP growth will be driven by increases in net exports, consumption and investments, each supported by rising inflows, planned fiscal stimulus and improving business sentiment. However, according to current estimates, output is still below its potential level. According to the forecast, the output gap is expected to gradually close during 2018 and 2019.

Figure 1.1 Annual Real GDP Growth



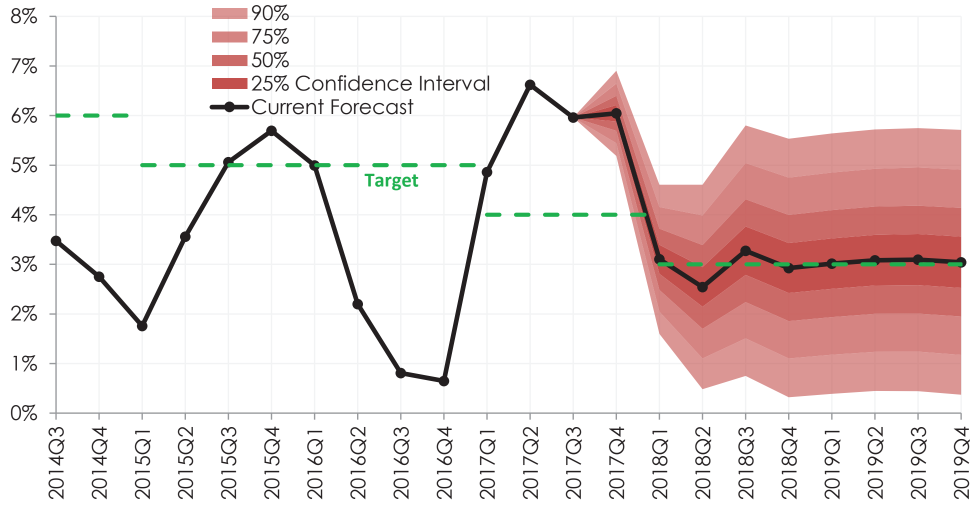
Source: National Bank of Georgia

In the third quarter, **the annual inflation rate** was slightly lower than expected. This was largely the result of a reduction in the contribution of food prices to inflation, which had pushed inflation up in the second quarter. Annual inflation in September stood at 6.2%. From early 2017, one-time factors put upwards pressure on the inflation rate. In particular, the rise of excise taxes, alongside the increased price of oil on international markets, have been reflected in consumer prices. The impact of these temporary factors will be exhausted from the beginning of 2018.

According to the NBG's forecast, with aggregate demand still lagging behind potential output, inflation will decline with the exhaustion of one-time factors and approach its target rate of 3% in 2018. In the medium term, following the neutralization of one-time factors and the increase in aggregate demand to its potential level, inflation will be maintained around the target rate of 3% (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 reached through a severe reduction of economic growth and employment. The National Bank of Georgia thus tries to strike a balance in its decision

Figure 1.2 Headline CPI Inflation

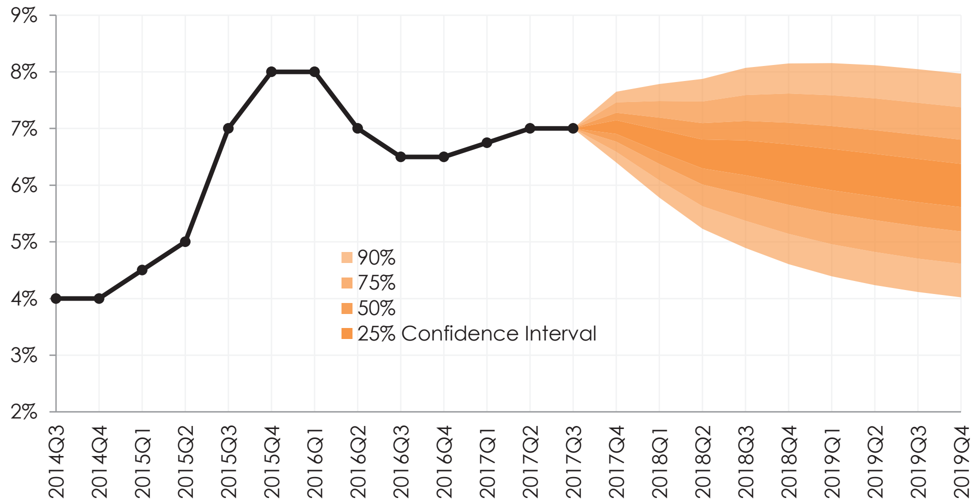


Source: National Bank of Georgia

making. The NBG considers the expected timeframe over which the inflation rate will return to the target level, and estimates the possible effects this will have on economic growth.

To curb inflationary expectations, in the second quarter of 2017, the National Bank of Georgia increased the monetary policy rate to 7.0%. However, according to the current macroeconomic forecast, 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 forecasts **are dependent on exogenous factors and contain risks in both upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth rate of Georgia's main trading partners, the global trends of the euro and US dollar, and the international prices of oil and food. In terms of domestic factors, risks stem from changes in fiscal deficit, credit activity and business sentiment. Hence, if the external and/or domestic factors evolve differently than is currently expected, this may influence the projected paths of macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

In the third quarter of 2017, the higher-than-expected growth of the international economy persisted. This was supported by improving business sentiment and an increase in international trade and investment. Growth was most significant in the eurozone, emerging European markets, Turkey and China. Moreover, global inflation declined following a reduction of prices of certain commodities on international markets. According to current IMF projections, global economic growth for 2017 will be 3.6%[1], which is 0.1 percentage point (pp) higher than the previous forecast.[2]

In the last two quarters, economic growth in the eurozone accelerated. This growth was supported by an increase in both domestic and foreign demand that resulted from benign financing conditions and declining political uncertainty. Despite lower productivity growth and the high debt burden in some eurozone member states, consumer and business sentiments have significantly improved and the unemployment level is at a historic low. According to the IMF forecast, economic growth in the eurozone will stand at 2.1% in 2017, which is 0.2 pp higher than in the previous forecast.[3] Growth in 2018 is expected to stand at 1.9%.

In the first half of the year, fiscal expansion and an increase in exports led to higher-than-expected economic growth in Turkey. As a result, the International Monetary Fund has revised its GDP growth forecast for 2017, increasing it almost twice to 5.1%. The projections for 2018 stand at 3.5%. However, the inflation rate in Turkey is above the target – having been affected by a devaluation of the exchange rate and growing demand. According to the current forecast, inflation in 2017 will increase to 11%.[4]

As a result of massive infrastructural projects and an increase in private consumption, the growth of the Russian economy accelerated in the second and third quarters of 2017. Moreover, a gradual improvement of consumer and business sentiments were supported by the stabilization of the exchange rate and a decline in inflation. After two years of recession, the IMF expects Russia's GDP to grow by 1.8% in 2017; however, in 2018, growth is expected to be moderate (1.5-1.6%) due to lower oil prices and structural constraints in the economy.[5]

The economic recovery in Ukraine has slowed due to a full transport blockade of the separatist-held east of the country since March. This, and the rebel seizure of industrial assets, has constrained the transportation of commercial goods from the east to the west of Ukraine. However, the losses incurred by the blockade of railway lines have been partially compensated by an increase in consumption and massive infrastructural projects. In 2017, according to IMF projections, economic growth in Ukraine will stand at 2.0%, while in 2018, the economy is expected to grow by 3.5%.[6] Nevertheless, inflation in Ukraine remains high and prices of food have significantly increased. In the second half of the year, despite expectations, the inflation level is expected to be above 10% and to stand at 13% in 2017.

As a result of the activation of its non-oil sectors, Azerbaijan has exhibited signs of economic recovery. Private consumption is gradually growing and, after two years of recession, fixed investments have increased. However, a weak banking sector alongside tight monetary and fiscal policies have negatively contributed to GDP growth. According to the current forecast, the country's GDP has declined by 1% in 2017; however, in 2018, Azerbaijan's economy is expected to grow by 1.3%. The inflation level in 2017 is expected to remain high and will stand at 12%.[7]

1 *International Monetary Fund. World Economic Outlook: Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges. Washington, D.C., October 2017.*

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

3 *International Monetary Fund. World Economic Outlook: Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges. Washington, D.C., October 2017.*

4 *Ibid.*

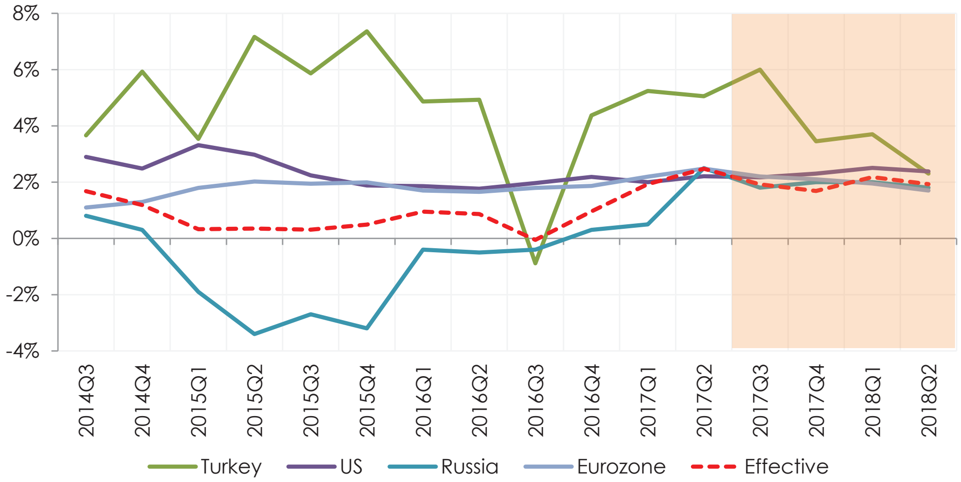
5 *Ibid.*

6 *Ibid.*

7 *Ibid.*

Following Russia's recovery, economic activity in Armenia has improved. This has been driven by increased remittances, investments and trade. Available data suggest that the 3.5% GDP growth in 2017 will be driven by a rise in consumption, industrial output and exports. However, it is predicted that growth will decline to 2.9% in 2018.[8] Following the deflation seen in 2016, the inflation level in 2017 has increased to 1.9%.

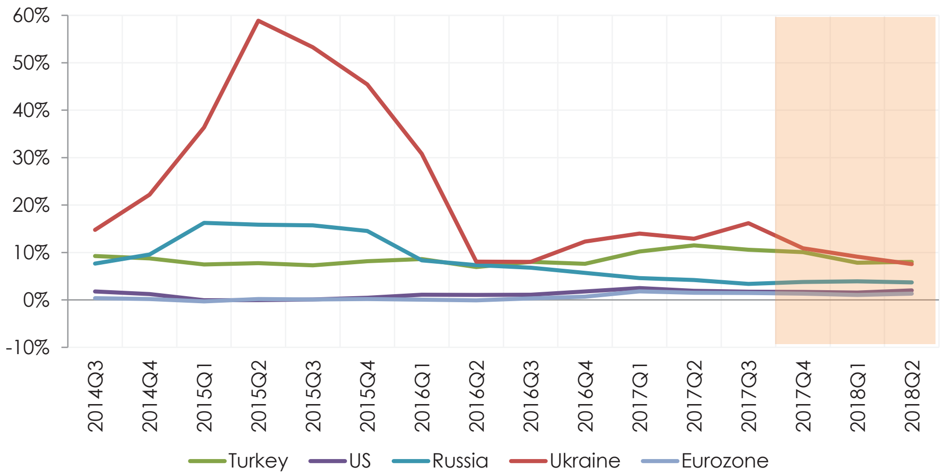
Figure 2.1 Real GDP Growth of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Due to damages incurred by adverse climate conditions, economic growth in the US is expected to slow down. However, investments continue to grow steadily as a result of the recovery of the energy sector. The unemployment rate remains low, and improved conditions on the labor market have resulted in an increase in wages. The IMF has thus increased its GDP growth forecast for the US by 0.1% (to 2.2%), while the inflation rate forecast stands at 2.1%. In 2018, the US economy is expected to grow by 2.3%.[9]

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

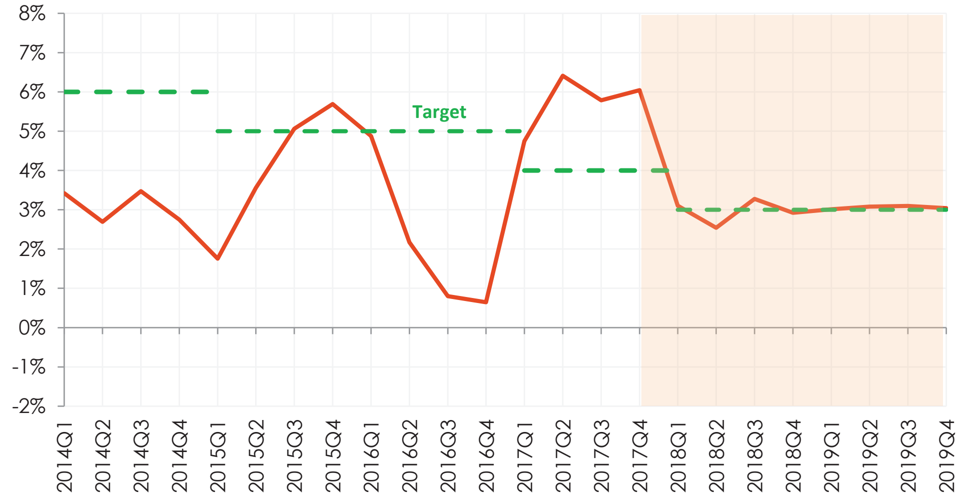
In Georgia's trading partner countries – where inflationary expectations have declined and local currencies saw a lower-than-expected devaluation – central banks eased monetary policy, thereby promoting economic activity in the first three quarters of 2017. Meanwhile, in developed economies, where output is still lagging behind its potential and the growth of consumer prices is slow, central banks have maintained policy rates at low levels. However, markets are now expecting the European Central Bank (ECB) to phase out its quantitative easing program.

8 *Ibid.*
9 *Ibid.*

2.2 MACROECONOMIC FORECAST

Inflation declined to an average of 6% in the third quarter of 2017 and stood at 6.2% in September (see Figure 2.3). The decrease in recent months is associated with a reduction of the contribution of food prices to total inflation (following the temporary increase in the second quarter). During 2017, the inflation level remained above the National Bank's target rate; however, this was in line with the existing forecast. The above-target inflation rate is a result of temporary factors affecting the supply side – in particular, the growth of consumer prices following recent increases in excise tax rates and international oil prices. Starting from 2018, the impact of those temporary factors affecting inflation will be exhausted.

Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

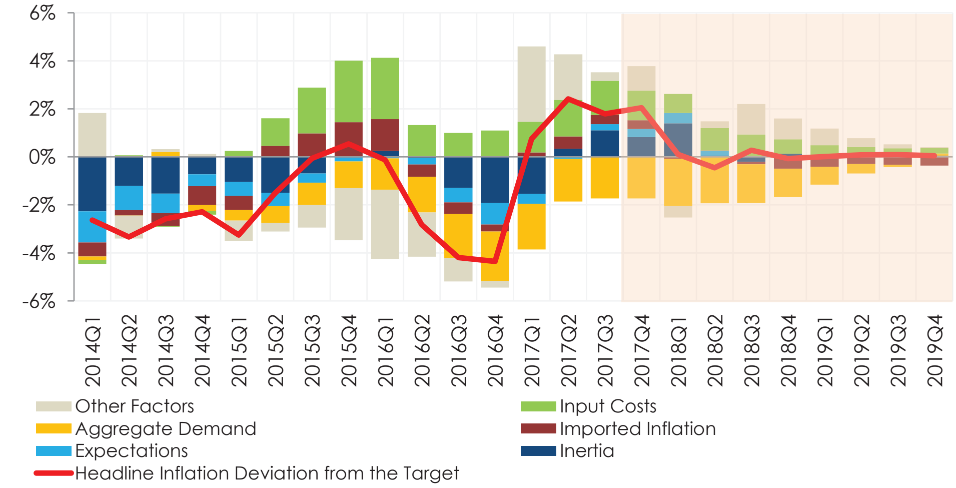
According to the forecast, once the effect of temporary factors affecting inflation are exhausted, annual inflation is projected to decline and reside close to the 3% target level in 2018. Aggregate demand will also put downward pressure on inflation as, despite recent improvements, economic activity remains below its potential level. In the medium term, once economic activity grows to its potential level and inflation shocks are neutralized, inflation will be maintained around the target level, which is 3% from 2018 (see Figure 2.3).

According to the forecast, the above-target inflation rate in the fourth quarter of 2017 will be a result of the same factors that led to its increase in the first half of 2017: temporary factors affecting the supply side, such as increased excise taxes and the higher price of oil on international markets. Expectations and import prices on intermediate goods will also positively contribute to the increase in inflation, while weak aggregate demand will place downward pressure on the inflation rate. In the medium term, with the elimination of temporary factors affecting the supply side and the gradual growth of the real economy toward its potential level, inflation will be guided towards the target level (see Figure 2.4).

The inflation forecast might change in both direction. 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 that 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. The baseline forecast scenario does not consider significant changes in those factors. Moreover, risks are associated with the lari exchange rate against the currencies of Georgia's main trading partners – including the euro, the strength of which will depend on the pace of the European Central Bank's withdrawal from its quantitative easing program. Any significant changes in the exchange rate against trading partner currencies may lead to changes in the prices of imported goods, thereby affecting the inflation level.

Real GDP growth in the second quarter of 2017 was higher than expected and amounted to 4.7%. Based on preliminary estimates, the trend of economic growth has persisted in the third quarter and averaged 4.4% (see Figure 2.5). The gradual recovery of the external sector was a significant contributor to real economic growth. In particular, the economic recovery of trading partners and a competitive real ef-

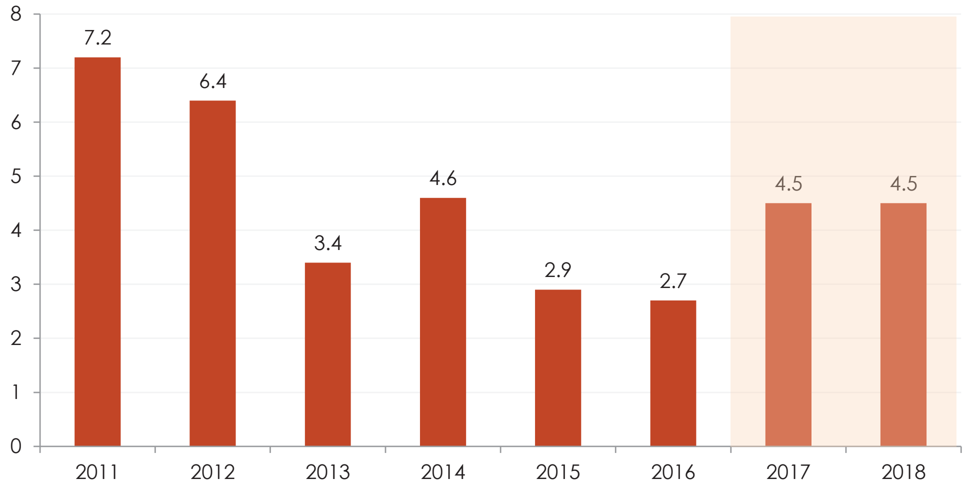
Figure 2.4 Inflation Deviation from the Target and its Decomposition[10]



Source: National Bank of Georgia.

fective exchange rate have promoted exports of goods and services (particularly tourism). In 2014, when Georgia was first affected by the external shock, net exports made a large 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 following the relative depreciation of the GEL exchange rate against the US dollar. According to NBG estimates, from 2017 net exports are expected to make a positive contribution to economic growth (see Figure 2.6).

Figure 2.5 Real GDP Growth



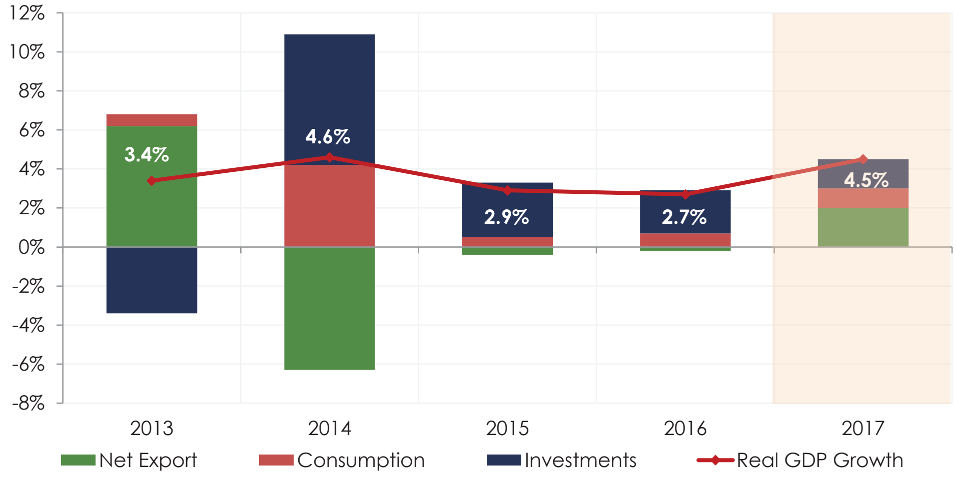
Source: National Bank of Georgia.

According to the forecast, real GDP growth in 2017 will stand at 4.5%, instead of 4%, as projected in the previous quarter. The NBG has revised its forecast mainly as a consequence of improvements in the external sector. If external factors develop as expected, growth will stand at 4.5% in 2018 (see Figure 2.5). Given the improvement of external factors, net exports are expected to make a positive contribution to GDP growth in the medium term. Moreover, in light of planned infrastructural projects, a growth of consumption and investments are both expected to positively influence economic growth (see Figure 2.6).

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 at a greater extent than expected, then actual GDP growth will be lower than currently forecast. On the other hand, if opportunities of free trade with the EU and/or investment projects have a greater-than-

10 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.

Figure 2.6 Real GDP Growth Decomposition[11]



Source: National Bank of Georgia

expected positive impact on economic activity and/or business sentiment, then GDP growth will be higher than forecast in the medium term.[11]

According to the forecast, in 2017 the current account deficit will be approximately 10% of GDP. Based on preliminary data, in the third quarter, exports of goods (in terms of USD) increased by 26%, while imports (excluding hepatitis C drug imports) grew by 7%. In addition, over the same period, money transfers grew by 20%, while revenues from tourism increased by 31%. Thus, the current account deficit is likely to have decreased in the third quarter.[12] This positive trend is largely a result of the improvement of the economic conditions in Georgia's main trading partner countries. If this trend persists in the medium term, the current account deficit is expected to gradually improve as a result of an increase in exports of goods and services (mostly tourism) and other sources of income from abroad.

The ultimate goal of the National Bank of Georgia is price stability, which can be reached efficiently by 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, ensuring that the response to supply side shocks is not 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 thus includes **the interest rate forecast**, which takes each of the above-mentioned factors into account.

Figure 1.3 shows the trajectory of the monetary policy rate, which is consistent with the baseline macroeconomic forecast presented above. All else being equal, with the exhaustion of the one-time factors affecting inflation, in the medium term the National Bank of Georgia is expected to gradually cut the policy rate until its neutral level has been reached (which, according to current estimates, is around 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 NBG's response 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 exchange rate, therefore low and stable inflation expectations will contribute to a long-term strengthening of the nominal effective exchange rate.

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

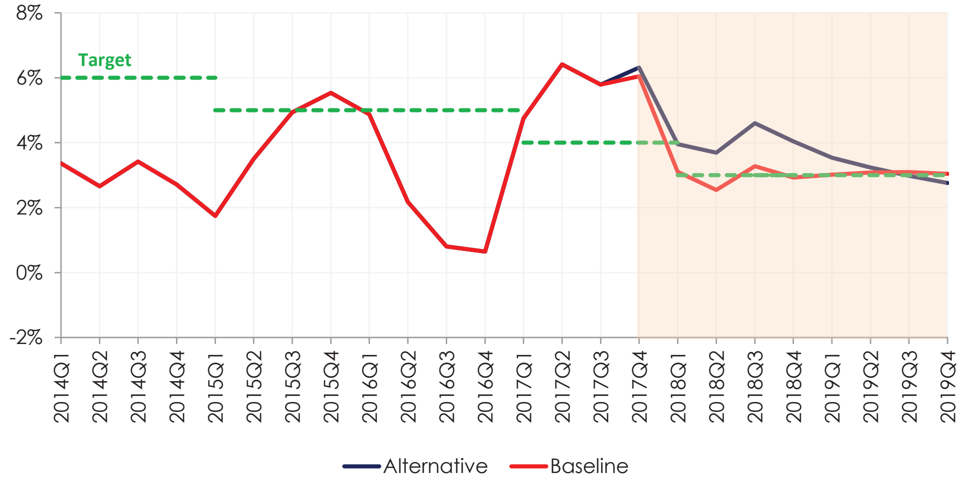
11 *The figure excludes the impact of grant-financed hepatitis C drug imports.*
12 *The current account deficit for the third quarter will be published in December.*

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a situation in which external shocks moderately worsen. In particular, the scenario considers a faster-than-expected phasing out of the European Central Bank's quantitative easing policy. On one hand, this will lead to the strengthening of the euro exchange rate against other currencies. On the other hand, alongside a rise in the yield curve, this will create capital inflow risks to eurozone countries, which will subsequently push risk premiums up in developing countries, including Georgia. In the alternative forecast scenario, a greater-than-expected appreciation of the euro causes an adjustment in the nominal effective exchange rate and creates inflationary pressure. In this scenario, as a result of supply side shocks, inflation will be greater (see Figure 2.7) and economic growth lower compared to the baseline scenario (see Figure 2.8).

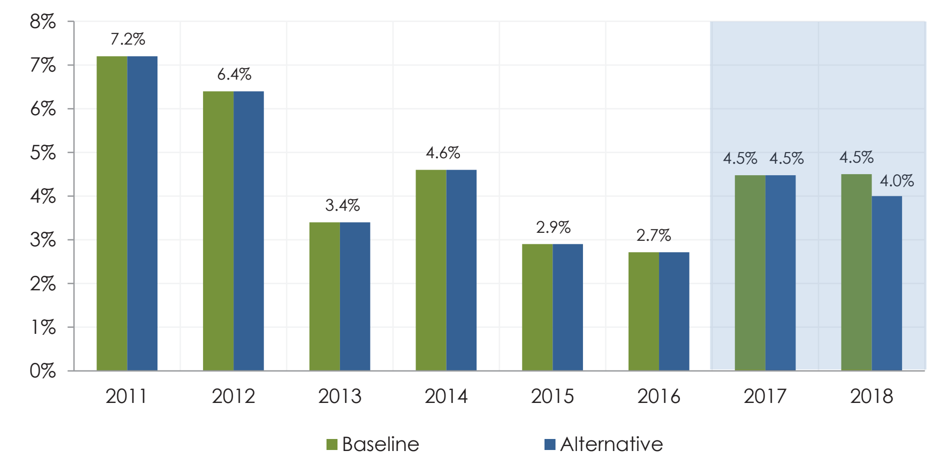
In the alternative scenario, negative external shocks increase inflation at a faster rate than in the baseline scenario. In this scenario, inflation in 2018 will be 1.1 percentage points higher than is anticipated in the baseline scenario (see Figure 2.7). Under such circumstances, the monetary policy trajectory will increase by 1 percentage point compared to the baseline scenario. Should this occur, the monetary policy response would curb inflationary expectations and reduce inflationary pressure. As a result, inflation would 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)



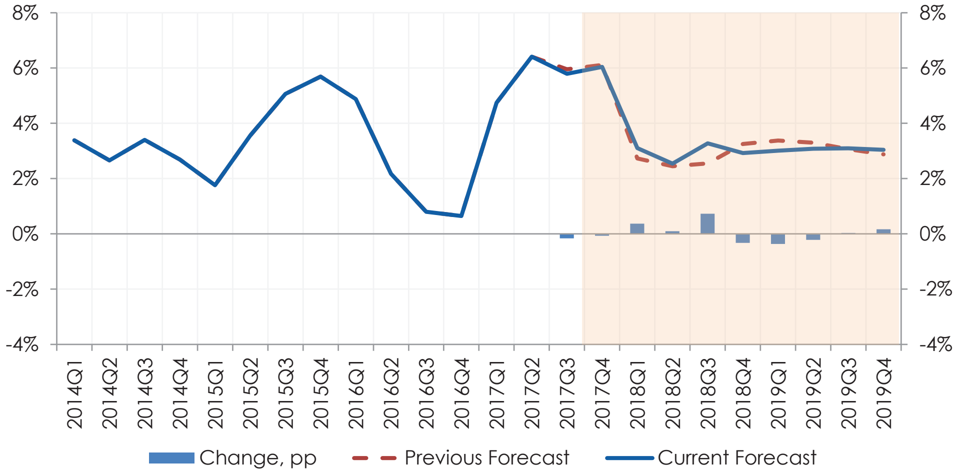
Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast for 2017 has not changed since the last quarter (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. Nor has the inflation forecast for 2018-2019 changed substantially. Even though economic growth in 2017 has improved the pressure of aggregate demand on inflation remains low; thus, in 2018-2019 inflation is expected to be close to the target. It is also noteworthy that the updated inflation forecast for 2018 does not consider an increase in excise tax on tobacco products.

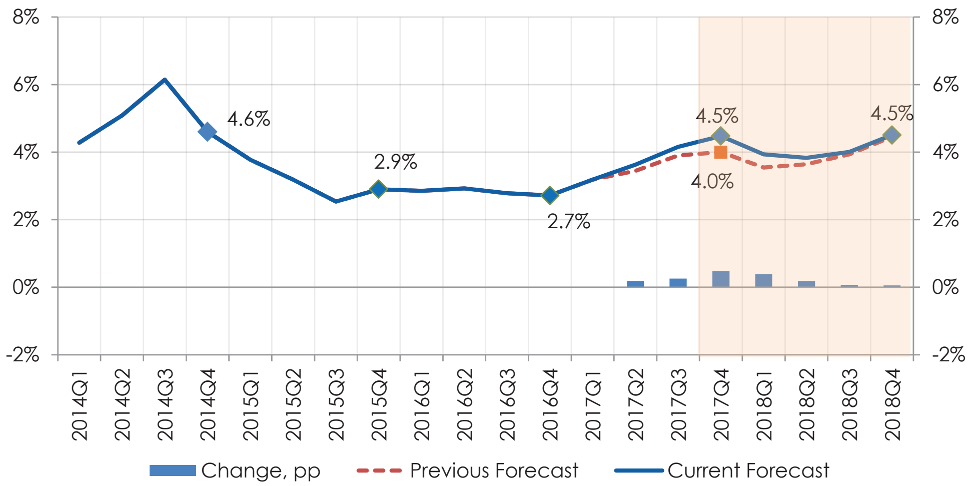
In terms of economic activity, the economic growth forecast for 2017 increased by 0.5 percentage points to 4.5% (see Figure 2.11). This upwards revision was motivated by the faster-than-expected economic recovery of Georgia's main trading partners, resulting in a sharp increase of exports. Moreover, tourism revenues grew as a result of an increasing number of international visitors. In 2018, assuming expectations regarding economic activity in main trading partner countries remain unchanged, economic growth in Georgia will stand at 4.5%.

Figure 2.9 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

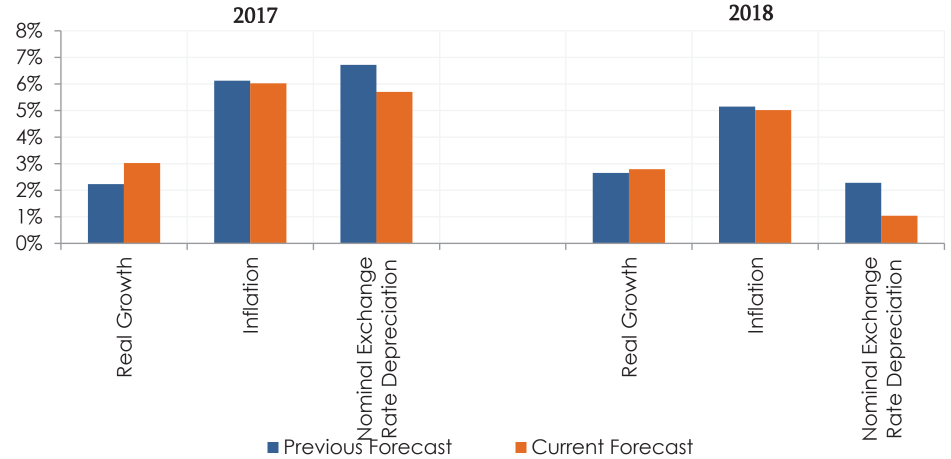
Figure 2.10 Changes in the Forecast of Real GDP Growth (Annual Growth of the Last Four Quarters)



Source: National Bank of Georgia

Assumptions regarding the external sector (on the economic growth, inflation and exchange rates of main trading partner countries) are particularly important for the macroeconomic forecast. Thus, any change in assumptions regarding the economic situation of trading partners affect the forecast and its associated risks (see Figure 2.11). These assumptions have changed significantly. Based on current estimates, the economic growth of trading partners has been higher than expected. This has positively contributed to Georgia's economic growth through an increase in external demand. Moreover, assumptions regarding the expected dynamics of trading partner currencies against the US dollar have also been revised. In particular, a further strengthening of the US dollar is considered less likely than it was in the previous quarter. Changes in assumptions regarding inflation and the economic growth of trading partner countries in 2018 are insignificant, but have been slightly revised in a favorable direction.

Figure 2.11 Changes in External Sector Assumptions for 2017-2018[13]



Source: Bloomberg

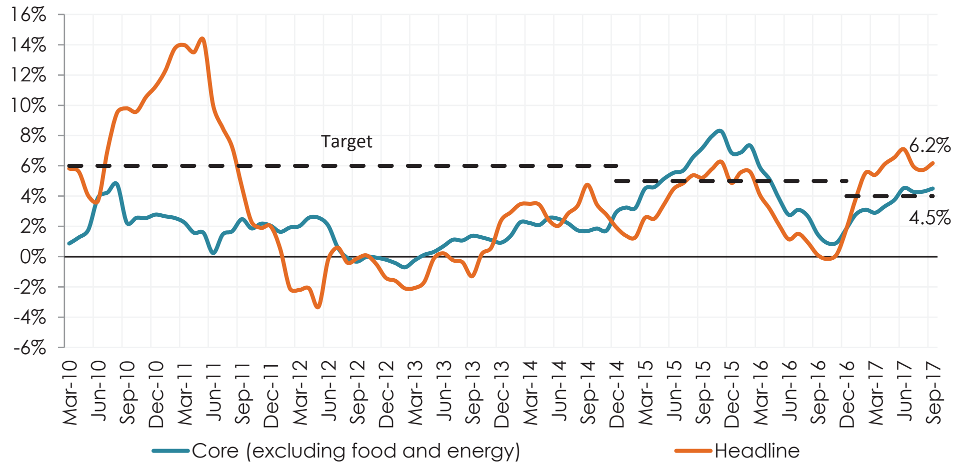
13 *These calculations are based on forecasts for the five main trading partners of Georgia (the USA, the EU, Turkey, Ukraine and Russia).*

3. Consumer Prices

From the beginning of 2017, as was expected, one-time factors caused inflation to exceed its 4% target level, reaching 7.1% in June. However, the growth trend reversed thereafter and inflation declined to 6.2% in September. The rise of inflation at the start of the year can mainly be attributed to increases in oil and tobacco prices, which stemmed from a surge of oil prices on international markets and a rise of excise tax on fuel and tobacco products. Meanwhile, core inflation (which excludes volatile food and energy prices) was lower over the year and stood at 4.5% in September. It is worth noting that tobacco products are included in core inflation and their contribution equaled 2.0 pp. The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation signals a reduction of headline inflation in the future.

« The increase in inflation was a result of one-off factors.

Figure 3.1 CPI And Core Inflation

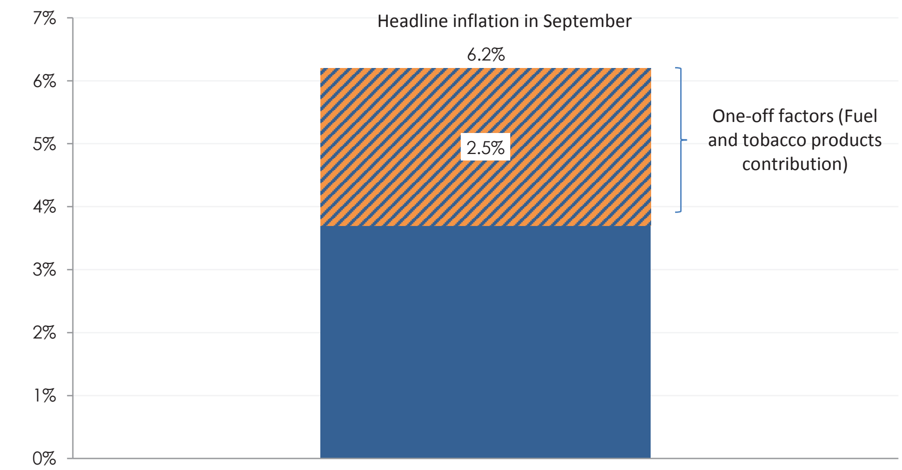


Source: GeoStat

« The contribution of fuel and tobacco products to the 6.2% inflation of September was 2.5 pp.

As mentioned earlier, the rise of inflation was a result of increased prices on tobacco and fuel. Of the 6.2% inflation in September, those two products made a contribution of 2.5 pp. Food contributed 1.8 pp, while the share of other products equaled 1.9 pp (see Figure 3.2).

Figure 3.2 Contribution of fuel and tobacco products to headline inflation

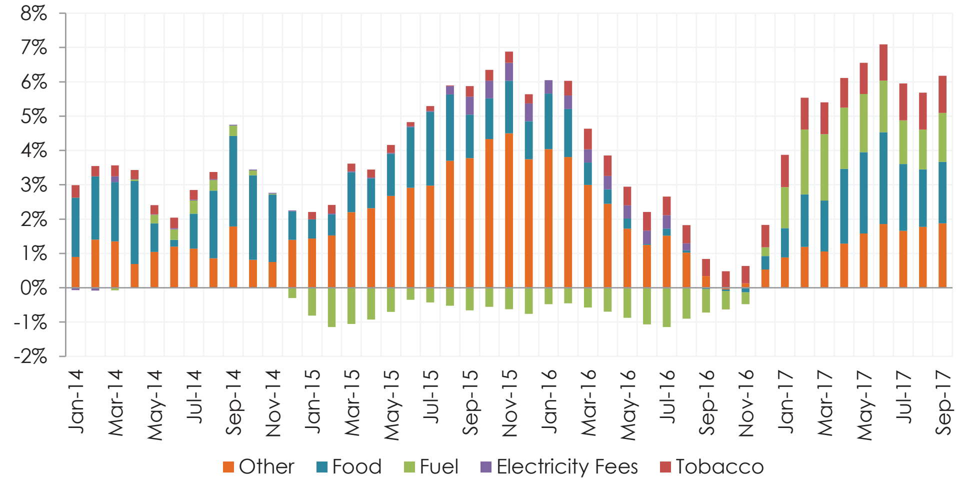


Source: GeoStat and National Bank of Georgia

Over the first two quarters of 2017, the contribution of the food group to total inflation increased from 0.9 pp to 2.7 pp. There are several reasons behind the increase. In 2016, prices on fruit and vegetables were relatively low and thus prices in 2017 mainly increased due to the base effect. The price level on meat products also, which can be attributed to increased exports of meat products, which reduced supply to the local market. During the last two years, because of high prices on sugar on the world market, products containing sugar were becoming more expensive, with their contribution to total inflation fluctuating from 0.3 pp to 0.6 pp. However, following a reduction of global prices, from the beginning of 2017 prices of products containing sugar started to decline, contributing by 0.1 pp to inflation in September. The contribution of the food group to total inflation reached 2.7 pp in June, but subsequently dropped to 1.8 pp in September.

The healthcare group also contributed to the increase in total inflation. In September, the price level in this group grew by 7.7%, contributing 0.6 pp to overall inflation.

Figure 3.3 Contribution Of Fuel, Food And Utilities Inflation To Headline Inflation

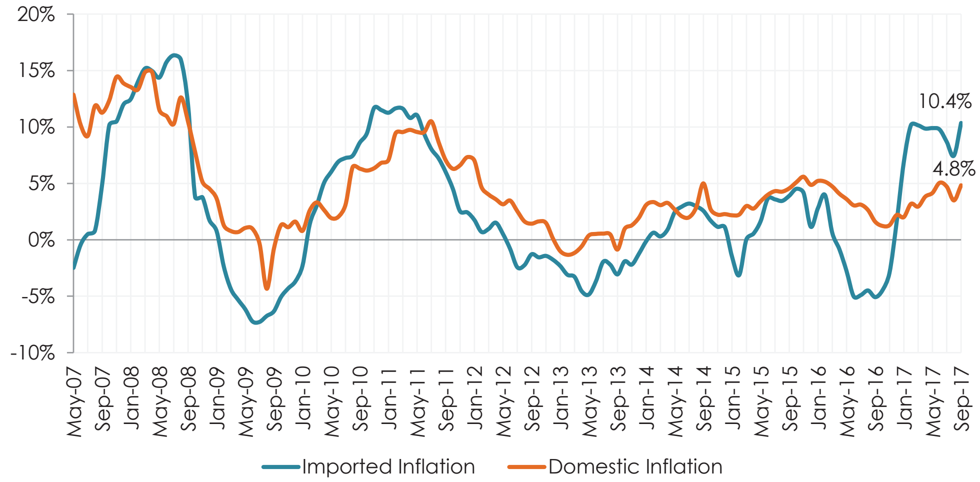


Source: GeoStat and National Bank of Georgia

The increase in inflation can mainly be attributed to increased prices of imported goods, with imported inflation standing at 10.4% in September. The main reason behind this growth was an increase in prices on fuel and tobacco. In September, inflation on mixed and locally produced goods were comparatively lower and stood at 6.3% and 4.8% respectively.

‹‹ Domestic inflation was comparably low, standing at 4.8 pp.

Figure 3.4 Imported And Domestic Inflation



Source: GeoStat and National Bank of Georgia

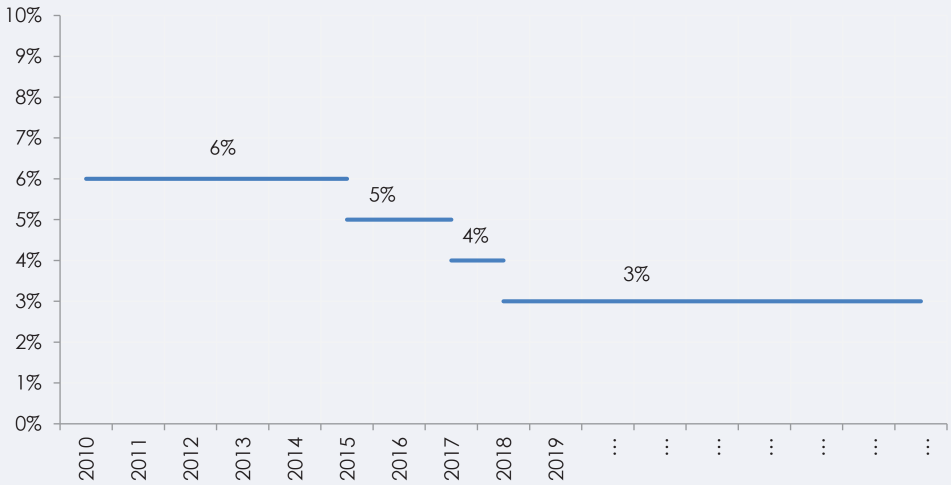
Box 1 Determining the optimal inflation target

From 2018 onwards, the National Bank of Georgia's inflation target will decline to its long-term objective. The NBG has presented its monetary policy objectives to Parliament, stating that inflation target for 2018 is set at 3%. Determining the optimal inflation target is dependent on a number of factors. In theory, not only high inflation harms economic development, but so does zero inflation or deflation as well. In general, developing economies have higher inflation than developed economies. On average, inflation targets in developed countries stand at 1-2%, while in developing countries the target range is usually 2-4%.

The higher level of inflation in developing countries can be explained by higher productivity growth. In countries where productivity in the tradable sector grows faster than in the non-tradable sector, there is a faster increase in wages in the tradable sector, which raises prices in the non-tradable sector and creates inflationary pressure. Thus, greater productivity in the tradable sector compared to the non-tradable sector leads to a higher inflation rate in a country. The weighted average inflation in the tradable sector stands at 2.5% in Georgia's trading partner countries. Based on the assumption of law of one price[14] in the tradable sector, we can thus assume that the weighted average inflation in the tradable sector in Georgia will be around 2.5%.

To determine the optimal inflation target for Georgia, it is important to look at the productivity differentials between the tradable and non-tradable sectors. From 2010 to 2016, the difference in productivity growth for the tradable and non-tradable sectors in Georgia was 1.5%, while the share of non-tradable sector goods in the consumer basket was 30%. Thus, the optimal inflation target for Georgia is 3% (2.5% + 30% * 1.5% = 3%).However, it is important to consider the monetary policy instruments used by the Central Bank to reach its target. The NBG has operated an inflation targeting regime since 2009. When this regime was first started monetary policy instruments to control inflation were limited and thus immediately setting a target rate at 3% would have led to fluctuations on the interbank money market and created unstable interest rates. Hence, the strategy of the NBG was to gradually decrease the inflation target in line with the increasing efficiency of monetary policy tools and the monetary policy transmission mechanism. Over time, the National Bank of Georgia developed the capacity to keep inflation on target and the decision was thus made to decrease the medium-term target to 3% from 2018 onwards.[15]

Figure 3.5 Inflation Target



Source: National Bank of Georgia

Focusing on the medium term is key, as shocks constantly appear and the inflation rate may differ from the target in the short-term. Sometimes inflation will be above the target, and in other times it may fall below the rate. However, with the monetary policy rate set by the National Bank, the inflation rate will be maintained around the target level in the medium term.

In an inflation targeting regime, price stability is achieved with minimal social costs and long-term economic growth is higher and more stable than under other alternative regimes. It should be noted that the inflation target rate of 3% does not imply that the inflation rate will range between 0-3%, but rather that inflation will be maintained around 3% in the medium term.

Setting the inflation target at 3% will lead to declining inflation expectations and will promote macroeconomic stability in general. Moreover, reducing inflation expectations over time is essential for increasing the efficiency of monetary policy, as the costs of policy implementation decline.

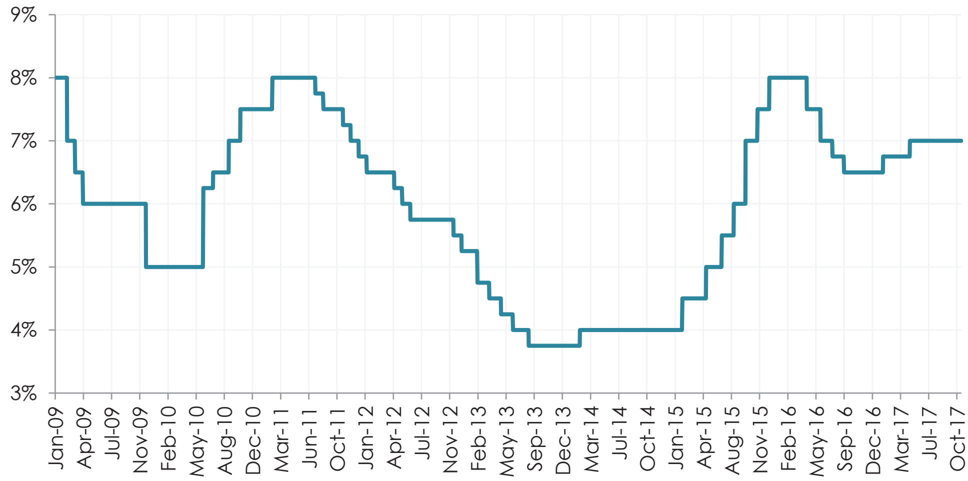
14 The economic principle that the same goods should be sold at the same prices in different locations is the basis for the theory of purchasing power parity.

15 For more details on determining the optimal level of inflation in Georgia, see: Aleksandre Bluashvili, "Optimum Inflation Level in Georgia", Economics and Banking, Vol. 3, No. 3, 2015.

4. MONETARY POLICY

In the first half of 2017, the National Bank of Georgia started tightening monetary policy. The policy rate increased by 25 basis points in January and May, rising from 6.5% to 7%. These decisions were promoted by temporary supply side factors such as the increase in excise tax on certain import commodities and rising prices of oil on international markets. These factors led to an increase in inflation forecasts and expectations. As a response, in order to curb inflation expectations, in January and May the NBG decided to gradually increase the policy rate. This was sufficient response to curb inflation expectation, thus the monetary policy rate was kept unchanged thereafter.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last meeting of the NBG's Monetary Policy Committee was on 25 October 2017. During that meeting, the committee decided to keep the refinancing rate unchanged at 7%. This decision was based on the macroeconomic forecast, which expected the inflation to remain above the target during 2017. It should, however, be noted that the increase in inflation is temporary and is driven by supply side factors. Therefore, other things being equal, there was no need for a further tightening of monetary policy.

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

In September 2017, annual inflation stood at 6.2%. Nevertheless, inflation in the third quarter was slightly below the forecasts. The inflation rate has been above its target since the start of the year, largely driven by increased excise taxes on certain commodities.

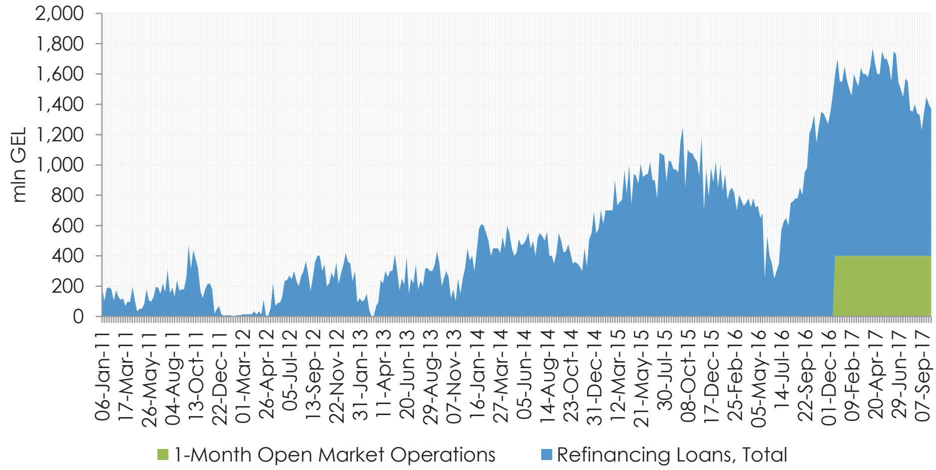
From 2017 onwards, economic activity has improved and the annual growth forecast was increased to 4.5%. Based on preliminary estimates, in first eight months of 2017, economic growth stood at 4.7%. This increase in economic activity was supported by positive dynamics in the external sector that started to evolve at the beginning of the year and continues. It is supported by economic recovery processes observed in the US, the EU and countries in the region. This serves to increase foreign demand and supports the growth of export proceeds. The positive trend of increasing numbers of international visitors, particularly tourists, has also persisted, increasing tourism revenues. In first nine months of 2017, tourism revenues grew by 29%. Meanwhile, the volume of remittances also continued to increase, however it remains below the pre-shock level. During January-September 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, it grows at a slower pace compared to exports, thus supporting the reduction of trade deficit. In addition to economic recovery in trading partner countries, the competitive real exchange rate also encourages external demand.

Despite improved economic activity, domestic demand currently remains below potential levels and is not creating demand-side inflationary pressures.

According to current forecasts, headline inflation is expected to remain temporarily above the target level, albeit with a decreasing trend. Inflation is expected to approach the target level at the beginning of 2018. Accordingly, in the absence of additional shocks, the monetary policy rate will gradually decrease to the neutral level (of 5-6%) in the medium term. Alongside with these forecasts, associated risks should be considered as well that are in both upward and downward directions. Among them are higher- or lower-than-expected aggregate demand, the exchange rate volatilities of major trading partner currencies and changes in the prices of consumer goods.

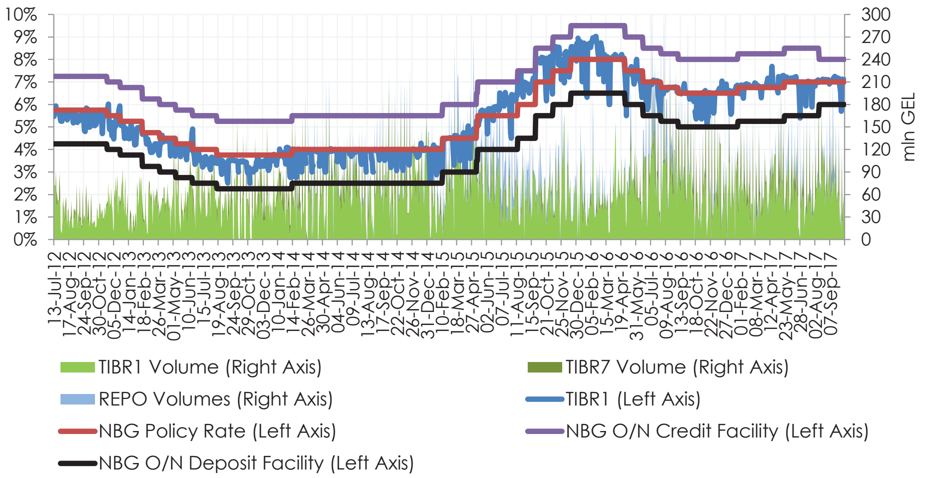
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. Currently, the banking sector operates under the conditions of a liquidity deficit. However, commercial banks are 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 one-week refinancing loans and one-month open market operations. To further decrease the volatility of interbank rates and ensure higher efficiency of the interbank market, from 10 August 2017, interest rates for overnight loans and deposits of the National Bank were defined as the policy rate +/-1 percentage point, instead of the previous rate of the policy rate +/-1.5 percentage points. As a result, interbank money market interest rates move 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

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

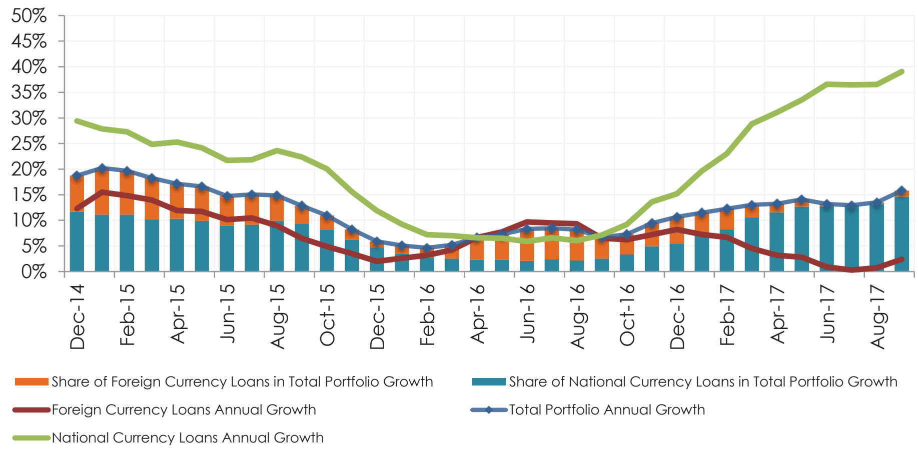
5. FINANCIAL MARKET AND TRENDS

5.1 LOANS

Credit activity improved in the third quarter of 2017. Excluding the effect of exchange rate movement and the transformation of one microfinance organization into bank, the loan portfolio increased by 15.8% in September.[16] This increase can mainly be attributed to the growth of retail loans, but the growth rate of business loans also increased. In September, the growth rate of retail loans increased by 1.7 pp and amounted 23.8%, while the growth rate of loans to legal entities increased by 2.9 pp and equaled 7.6%. The growth of the loan portfolio was primarily driven by an increase in the construction, trade, agriculture and energy sectors; meanwhile, the increases in credit for the transport and manufacturing sectors were insignificant. According to the credit conditions survey, representatives of the banking sector expect an increase in demand for both retail and business loans in the next quarter.

« According to the credit conditions survey, representatives of the banking sector expect an increase in demand for both retail and business loans in the next quarter.

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



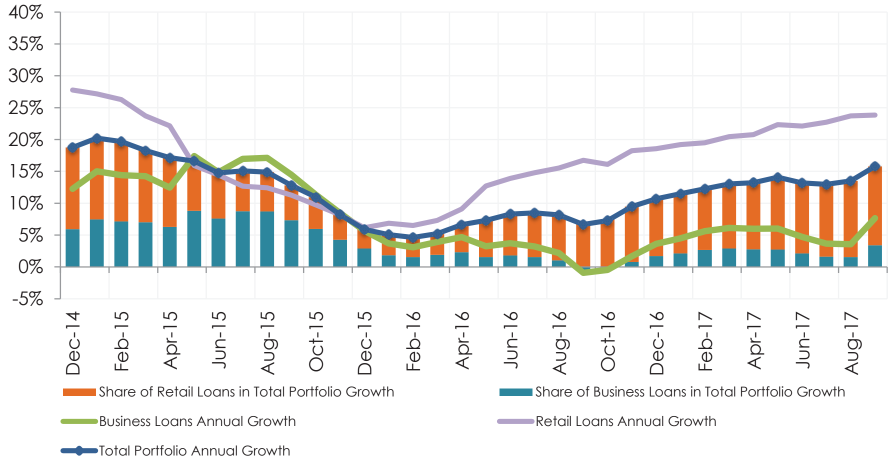
Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was again driven by an increase in domestic currency loans. In September, the annual growth rate of foreign denominated loans was 2.5%, while domestic currency loans grew by 39%. 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 third quarter, the loan larization ratio increased by 2 pp and equaled 42.3%.

« In the third quarter, the loan larization ratio increased by 2 pp and was equal to 42.3%.

16 *Excluding the exchange rate effect.*

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

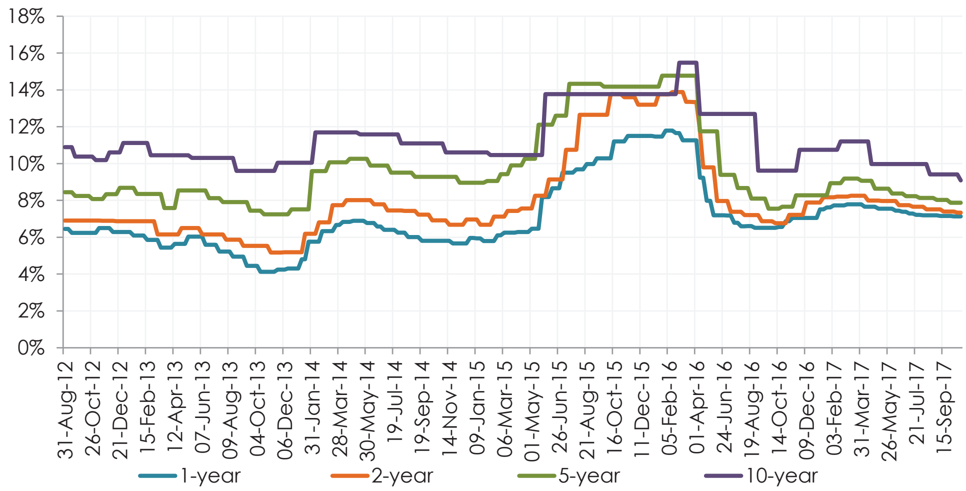


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In October, the monetary policy rate was equal to 7%. In the third quarter of 2017, interest rates on government securities declined as a result of lower liquidity risk and expectations of monetary policy easing in the medium term (see Figure 5.3).

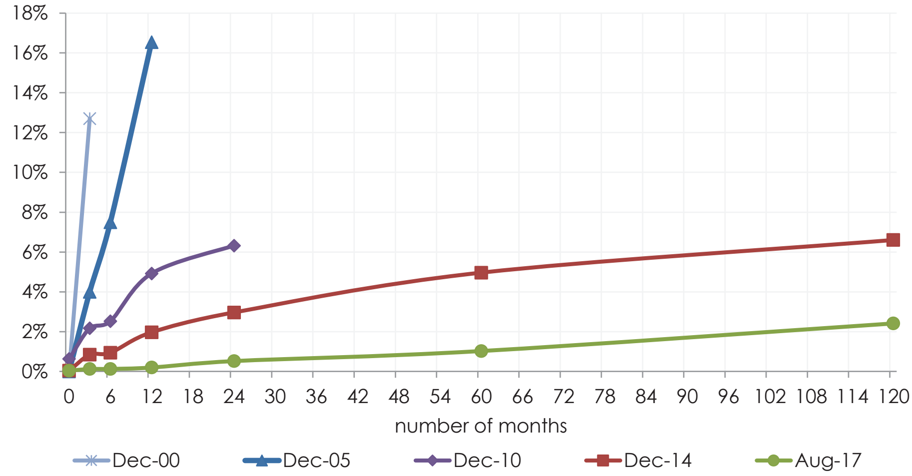
Figure 5.3 Interest Rates On Government Securities



Source: National Bank of Georgia

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.

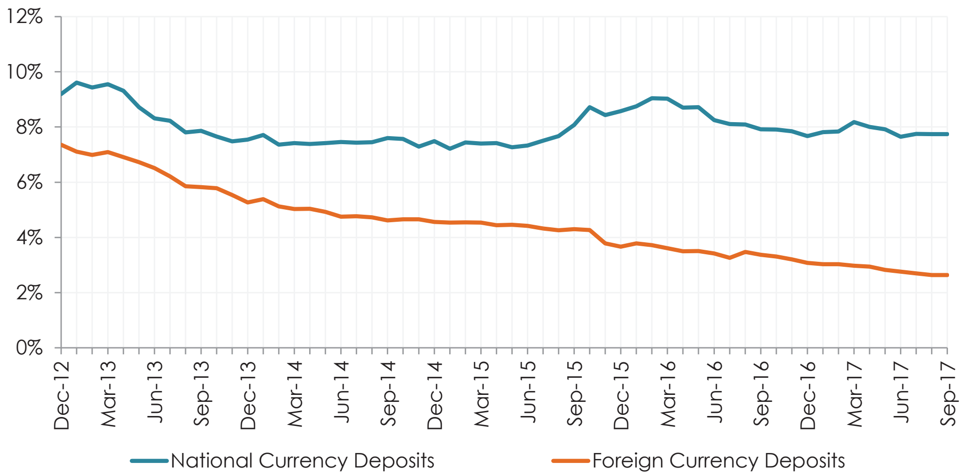
Figure 5.4 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits has increased by 0.1 pp to 7.8%, whereas for foreign exchange deposits interest rates decreased by 0.1 percentage point and amounted to 2.6%. The growth of interest rates on deposits in domestic currency can be explained by increasing demand for loans in domestic currency, while the decline of interest rates on USD deposits is a result of excess liquidity. The latter could be related to an increase in exchange rate risk following a decline of demand for loans in USD. According to the credit conditions survey, representatives of the bankng sector expect a decrease in the cost of domestic currency funding in the next quarter.

Figure 5.5 Average Interest Rates On Deposits

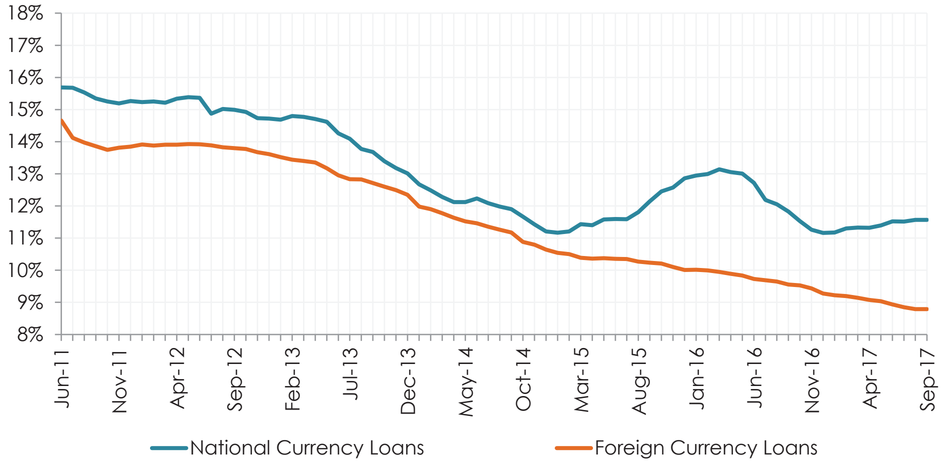


Source: National Bank of Georgia

According to the same credit conditions survey, in the third quarter of 2017, credit conditions for individuals and legal entities were slightly softer. Lower interest rates were observed on consumer loans; while the margin on corporate loans issued in GEL slightly declined. Moreover, credit supply conditions for mortgages and retail loans issued in USD have not changed significantly. In September, compared to June, loans issued for small and medium enterprises declined by 0.3 pp and equaled 10.4%.

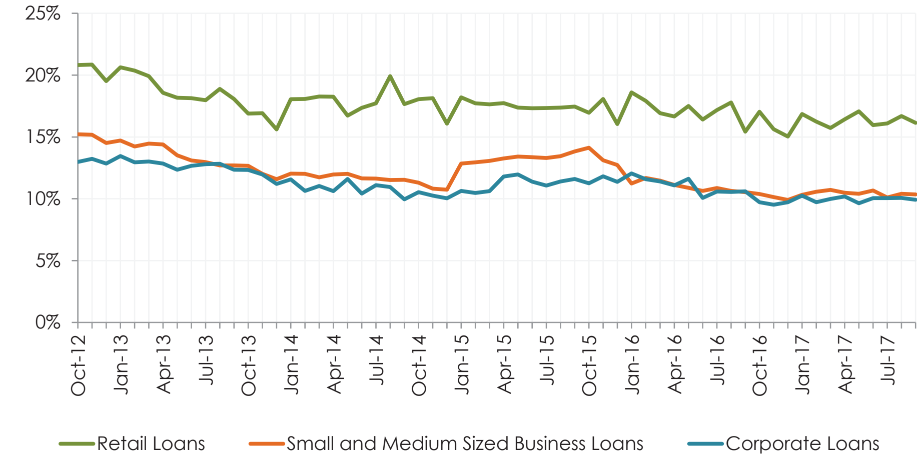
For corporate loans, interest rates deceased by 0.1 pp and amounted to 9.9%, while interest rates on retail loans increased by 0.2 percentage points in June and equaled 16.1% (see Figure 5.6). In September, compared to June, the average interest rate on the stock of legal entities' domestic currency loans increased by 0.1 pp, while decreasing by 0.2 pp for foreign currency loans (see Figure 5.7). According to the credit conditions survey, credit supply conditions for legal entities are expected to improve, while credit conditions for retail loans are expected to become stricter.

Figure 5.6 Average Interest Rates On Business Loans



Source: National Bank of Georgia

Figure 5.7 Interest Rate On Loan Flow



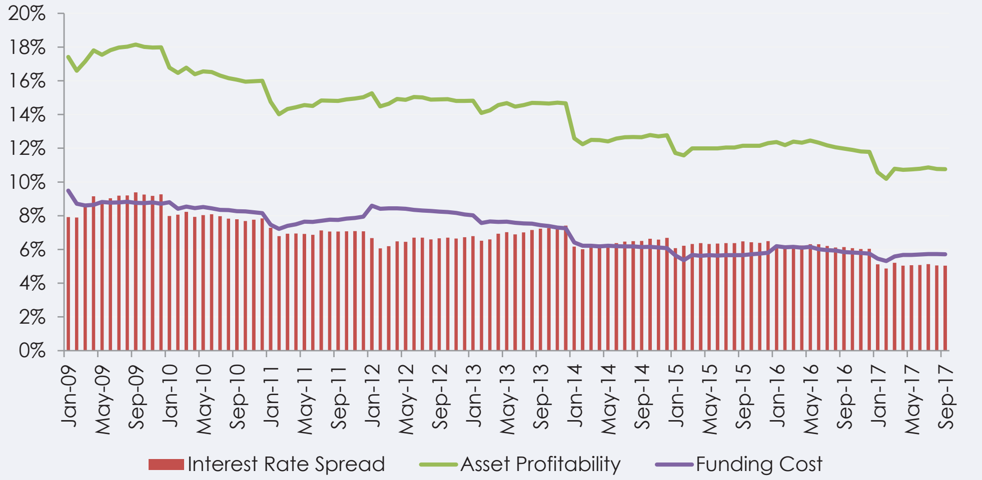
Source: National Bank of Georgia

Box 2 Net interest rate spread

Interest rate spreads have been characterized by a decreasing trend, resulting from macroeconomic stability, decreasing credit risks and increasing efficiency of the financial system (including economies of scale). Over the last eight years, the interest rate spread has declined by 3 percentage points and stands at 6% as of 2017. Changes in the loan portfolio have a significant impact on the interest rate spread. In particular, in 2017 the share of retail loans increased in the total loan portfolio (see Figure 5.9), which caused an increase in the average interest rates on loans and affected the interest rate spread.

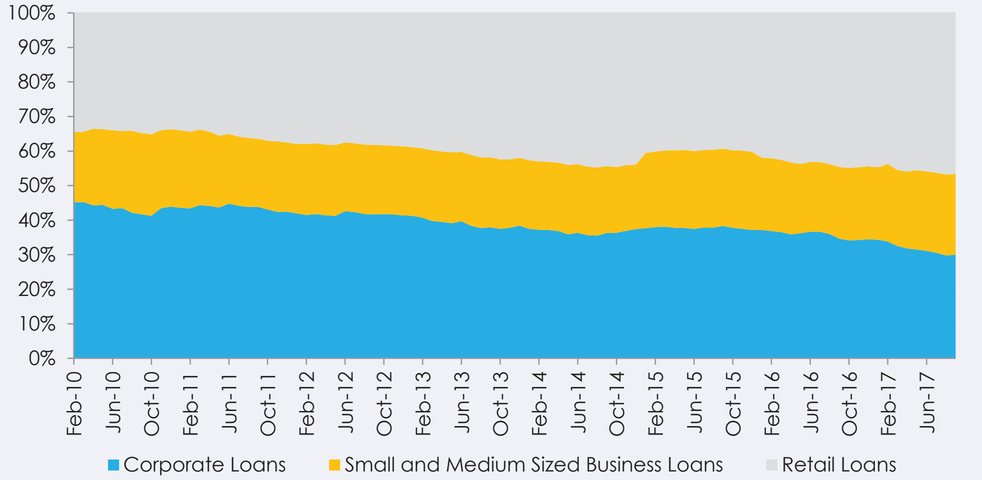
To exclude the impact of the change in the credit portfolio on the interest rate spread, we can analyze the dynamics of the spread on business loans, which are key for economic growth. Over the last 10 years, there has been a sharp decrease in interest rates on loans issued to legal entities in domestic currency (see Figure 5.10). The same trend has also been observed for other types of loans. Interest rates on loans issued in foreign currency have also been declining (see Figure 5.11), albeit at a relatively slower pace compared to the interest rates on loans issued in GEL. In the case of domestic currency loans, the reduction of the interest rate spread was driven by the improved monetary framework. In particular, the development of the operational monetary framework has been reflected in a decline of interest rate fluctuations on domestic currency loans, greater stability and an improvement of liquidity management.

Figure 5.8 Interest rate spread[17]



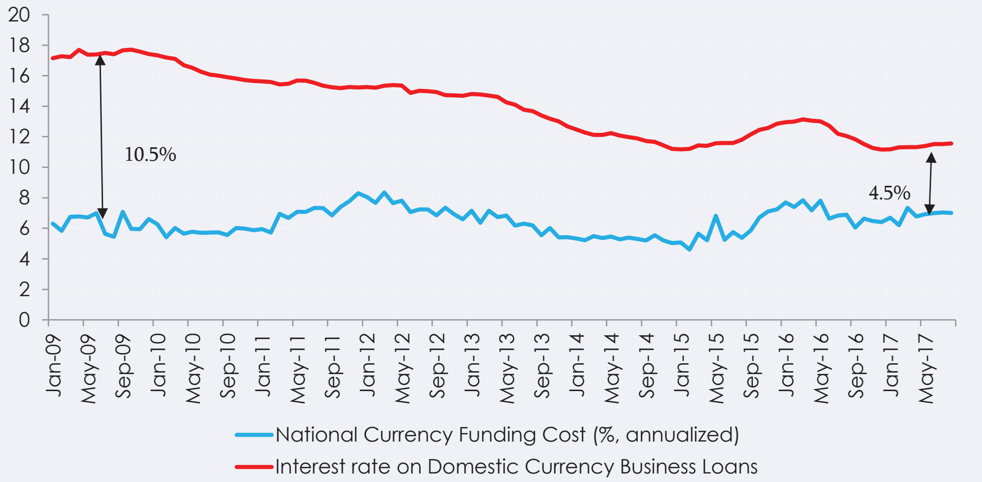
Source: National Bank of Georgia

Figure 5.9 Structure of the loan portfolio



Source: National Bank of Georgia

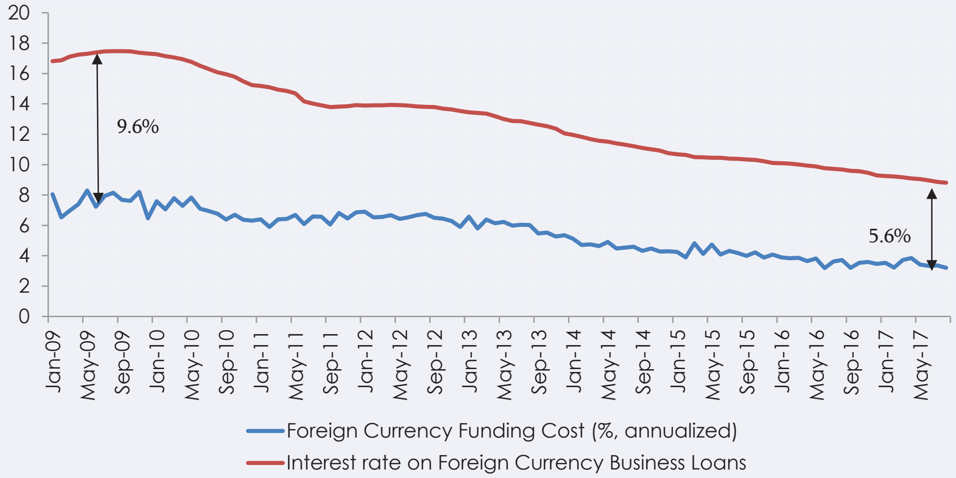
Figure 5.10 Interest Rate Spread on GEL



Source: National Bank of Georgia

17 *Asset profitability = Annualized interest income / Interest earning assets*
Funding Cost = Annualized interest expense / Interest bearing liabilities
Interest rate spread = Asset profitability - Funding cost.

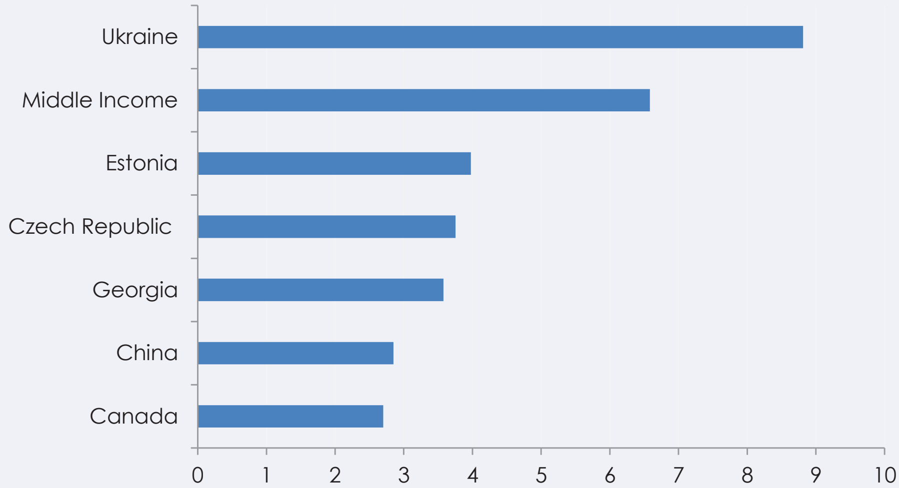
Figure 5.11 Interest Rate Spread on USD



Source: National Bank of Georgia

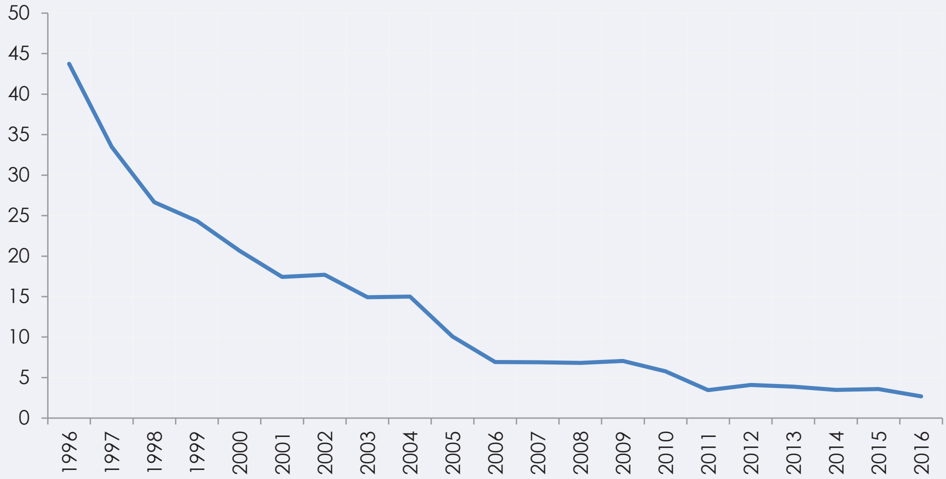
The decrease in interest rates has put downward pressure on the interest rate spread. In particular, since the maturity of liabilities is less than the maturity of assets, the value of funds will decrease sooner than loans. Thus, when interest rates are stabilized, the spreads will be reduced further. However, it should be noted that the existing spreads for foreign currency might be low considering existing global economic trends, foreign currency risks and possible credit losses. According to World Bank data, Georgia falls in the category of countries with the lowest interest rate spreads (see Figure 5.12). Countries are ranked in five main groups (<4.61; 4.61-8.81; 8.81-14.24; 14.24-21.61; >21.61), and Georgia is in the first group.

Figure 5.12 Interest Rate Spread in Different Countries



Source: World Bank

Figure 5.13 Interest Rate Spread in Georgia based on data from the World Bank



Source: World Bank

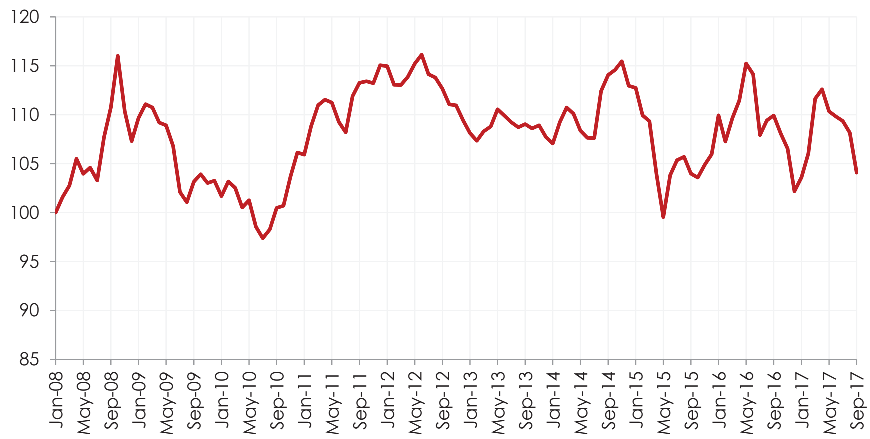
5.3. EXCHANGE RATE

In the third quarter of 2017, the GEL depreciated against the US dollar by 0.1%, and against the euro by 7.0% compared to the previous quarter. The GEL also depreciated against the Turkish lira by 2.0%. The nominal effective exchange rate depreciated quarterly by 2.4%, and by 1.8% on a year-on-year basis.

In the third quarter of 2017, the real effective exchange rate depreciated quarterly by 3.4%, and by 1.7% on a year-on-year basis.

When adjusted for commodity groups and services, the nominal effective exchange rate presents a slightly different picture. In the third quarter of 2017, the adjusted nominal effective exchange rate depreciated by 2.2% year on year, but appreciated by 1.6% compared to the previous quarter.

Figure 5.14 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

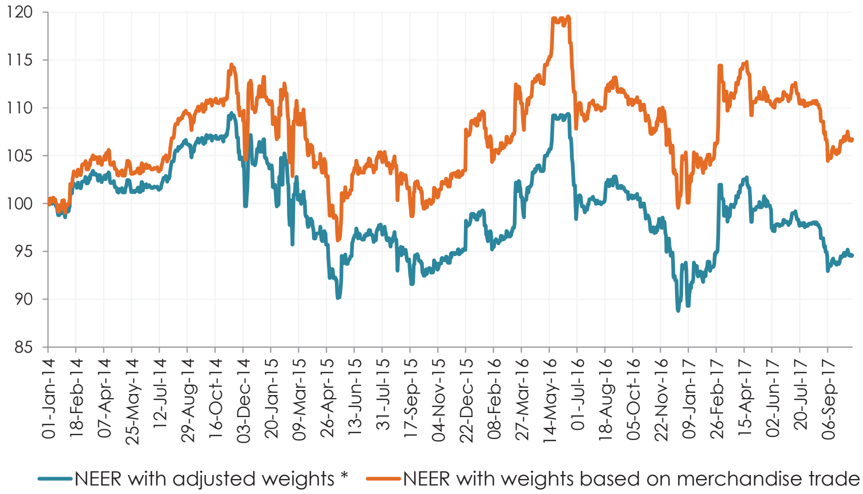
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	-1.8	-1.7	-1.7
Eurozone	-8.7	-4.7	-1.2
Turkey	13.9	9.1	1.9
Ukraine	-2.1	-10.7	-0.7
Armenia	-3.4	1.4	0.1
The United States	-4.1	-0.3	0.0
Russia	-12.4	-10.2	-1.2
Azerbaijan	0.5	-6.4	-0.6
Other	-4.0	0.3	0.0

* The growth implies appreciation

Source: National Bank of Georgia

Figure 5.15 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

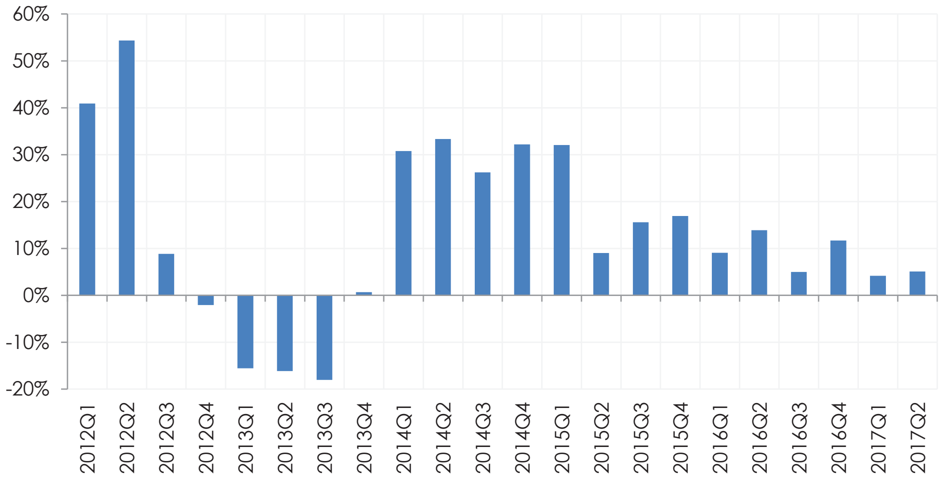
In the second quarter of 2017, real GDP growth amounted to 4.7%. Following the increase of external demand, the growth of net exports made the largest contribution to GDP growth. However, aggregate demand remains weak and the growth rate of investments is low, which was expected due to the high investment to GDP ratio (see Figure 7.7). According to preliminary estimates, the growth of exports will be maintained in the second half of the year, and net exports are expected to be an important factor in economic growth.

« In the second quarter of 2017, real GDP growth amounted 4.7%.

In the second quarter of 2017, the capital formation growth rate increased and stood at 5.1%. Despite the low growth of investments, the investments to GDP ratio was equal to 29.3% in the first half of the year. This figure is relatively high for Georgia, and promotes long-term economic growth through the accumulation of capital. Unlike the first quarter, when the low growth rate of investments was due to a decrease in inventories, the low growth of the second quarter was a result of the slowdown in gross fixed capital formation.

« In the second quarter of 2017, the capital formation growth rate increased and stood at 5.1%.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

In the second quarter, the annual growth rate for private consumption was negative (despite nominal growth) and posted -0.6%, indicating that aggregate demand remains weak.[18] As was the case with private consumption, government consumption also declined in the second quarter.

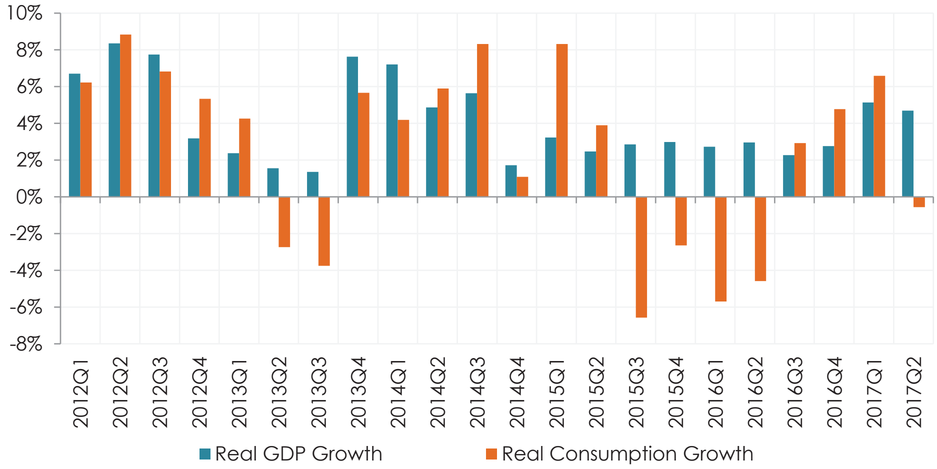
In the second quarter of 2017, following the growth of external demand, net exports have improved. In the second quarter, the growth of exports persisted in spite of an increase in the export price index. Based on preliminary estimates, the growth of exports in the third quarter is expected to be high, in both real and nominal terms. As was the case in the second quarter, net exports are expected to have a positive contribution to GDP growth in the following quarters.

« In the second quarter, the growth of exports persisted in spite of an increase in the export price index.

In the second quarter of 2017, the annual growth rate of imports (both nominal and real) decreased significantly. The real growth rate for imports of consumer goods turned negative, following the decline in real consumption. According to preliminary data, in the third quarter, an increase in imports of intermediate and consumer goods have made the largest contributions to the growth of imports, while the contribution of investment goods was negative.

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

Figure 6.2 Real GDP And Real Consumption Growth



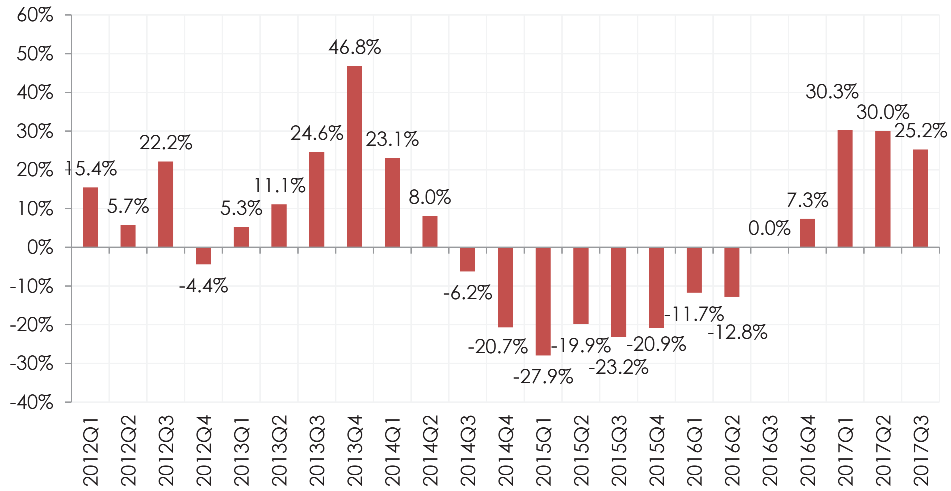
Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

Demand for Georgian exports has grown following the economic recovery of Georgia's main trading partner countries. In the third quarter of 2017, registered exports of goods increased by 25.2% annually. Exports of intermediate and consumer goods – especially exports of ferroalloys, wines and cars – made the largest contribution to the growth.

« In the third quarter of 2017, registered exports of goods increased by 25.2% annually.

Figure 7.1 Annual Change in Registered Exports Of Goods



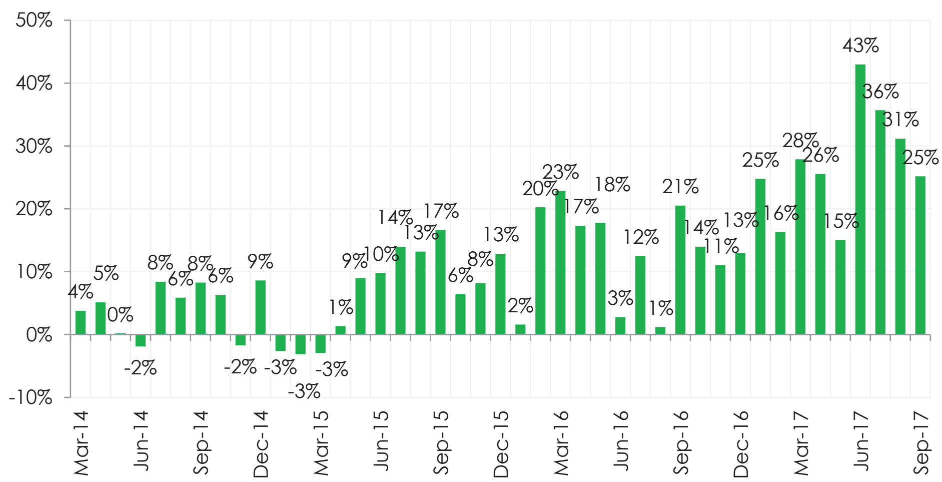
Source: GeoStat

The volume of exports increased significantly following economic recovery and the growth of demand in the eurozone, Russia and Turkey. Compared to the same period last year, exports to Russia increased by 82% and those to Turkey rose by 25%. Among CIS countries, exports grew to Azerbaijan, Armenia and Ukraine, while exports to China declined moderately.

The improvement of external demand was reflected not only in the growth of exports of goods, but also of services, especially tourism. Revenues from tourism have been increasing at high rates throughout the year and the trend continued in the third quarter. In the second quarter of 2017, revenues from tourism amounted to 1,070 million USD , which was 30.9% higher than in the same period last year.

« In the second quarter of 2017, revenues from tourism grew by 30.9% and amounted more than 1 billion USD.

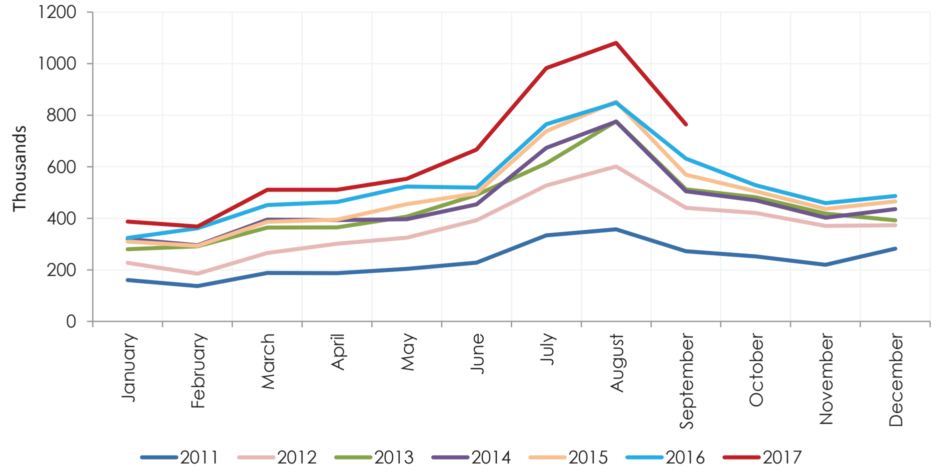
Figure 7.2 Annual Change in Revenues from Tourism



Source: National Bank of Georgia

Inflows of international visitors, especially tourist[19] arrivals, continued to grow. In the third quarter of 2017, the number of foreign visitors who entered Georgia increased by 26%. Moreover, in August alone, the number of visitors entering the country exceeded one million, of which 53% were tourists. Travelers from neighboring countries (Azerbaijan, Armenia and Russia) made a significant contribution to the growth of visitors in Georgia. In addition, there is has been a substantial increase in the number of visitors from Turkey, Iran, Israel and Saudi Arabia.

Figure 7.3 Number of International Visitors to Georgia

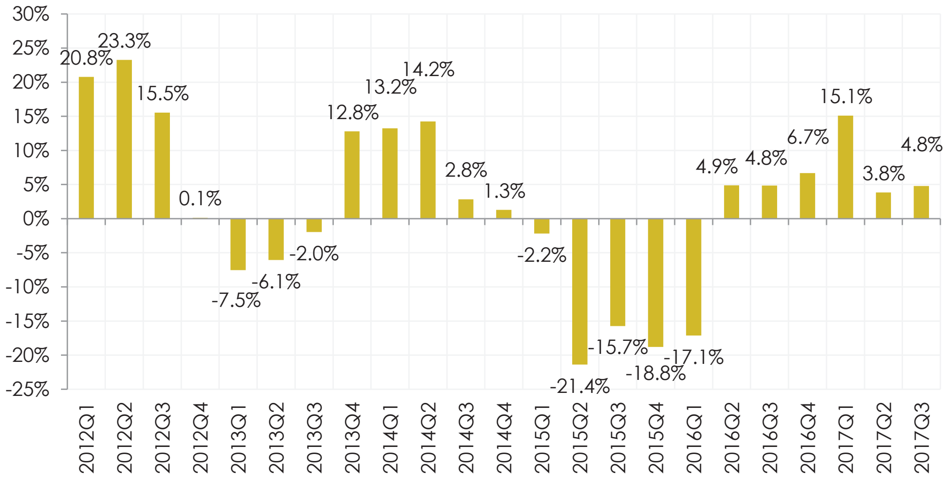


Source: GNTA

In light of the high growth of exports in goods and services, imports increased at a relatively slower pace – rising by only 4.8% in the third quarter of 2017. Imports of goods grew from both CIS and EU countries. The growth of imports can be attributed to increased demand for intermediate and consumer goods.

‹‹ In the third quarter of 2017, imports grew by 4.8%.

Figure 7.4 Annual Change in Registered Imports Of Goods



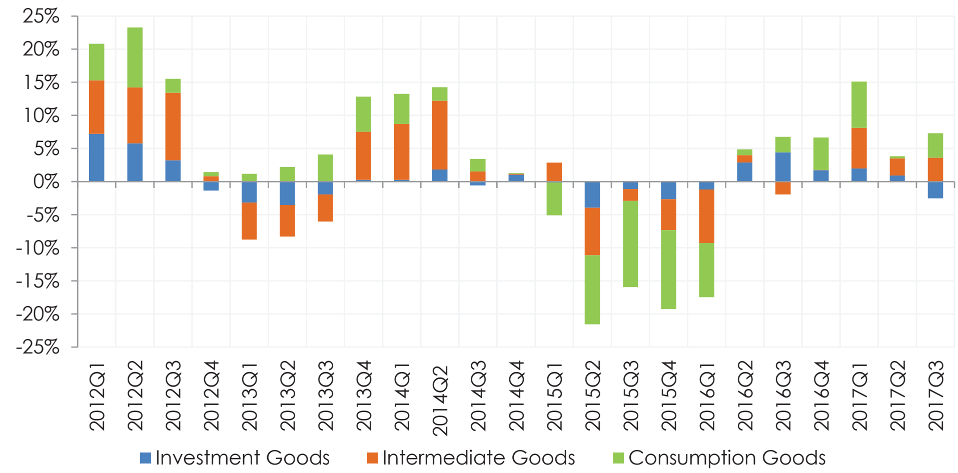
Source: GeoStat

In the third quarter, imports of intermediate and consumer goods separately accounted for 43% of total imports. Imports of intermediate goods increased by 8.9%, contributing 3.6% to the total growth of imports, while imports of consumer goods contributed 3.7%. On the other hand, in line with the lower level of foreign direct investment, imports of investment goods declined.

‹‹ The growth of imports in the third quarter of 2017, was a result of increasing demand for consumer and intermediate goods.

19 Tourists are defined as foreign citizens who crossed the Georgian border and remained in the country for 24 hours or more.

Figure 7.5 Annual Change in Registered Imports By Category Of Goods

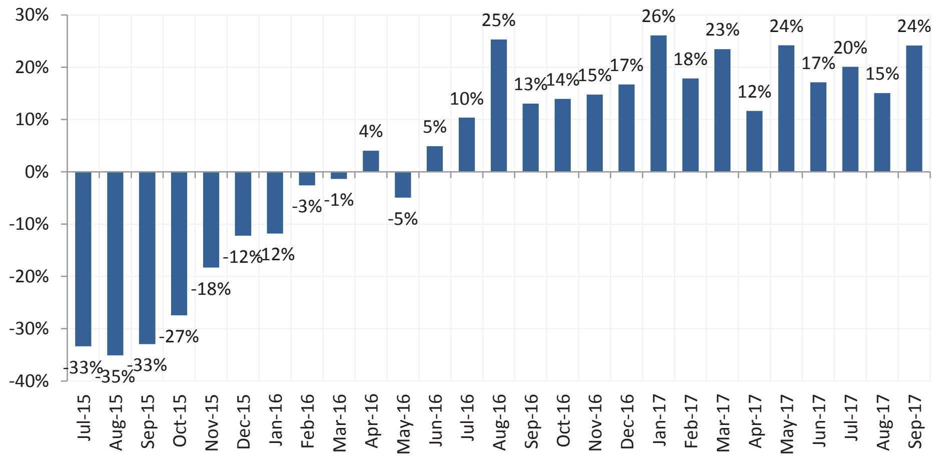


Source: GeoStat

Remittances to Georgia have seen an increasing trend. In the third quarter of 2017, the volume of money transferred to Georgia increased by 19.7%, which was mainly driven by increased transfers from Russia and the European Union (particularly Greece and Italy). The substantial increase in money transfers was also driven by money received from Israel and Turkey. Moreover, the volume of remittances from the US and Ukraine also slightly increased.

« In the third quarter of 2017, the volume of remittances to Georgia increased by 20%.

Figure 7.6 Annual Change in Remittances



Source: National Bank of Georgia

The current account deficit has decreased, driven by increases in net exports, remittances and the relatively low growth of imports. The current account deficit substantially improved from 12.6% in the first half 2016 to 9.4% in the first half of 2017. However, the income account deficit of the current account has deepened since 2016, stemming from increased profits of direct investor enterprises (which has been reflected in the growth of both dividend and reinvested income).Thus, improvements in current account deficit was moderately hindered by the negative investment income account.

« In the first half of 2017, current account deficit has improved substantially.

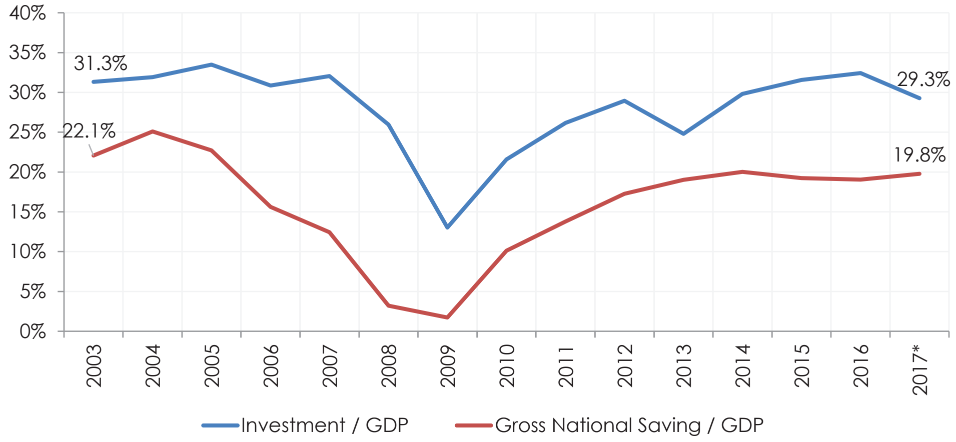
Foreign direct investments (FDI) remain the main source of financing the current account deficit. In the second quarter of 2017 , FDI in Georgia amounted to 347 million USD. The transport sector continues to be the largest recipient sector of FDI, receiving 127 million USD (37%). The construction (70 million USD), and hotels and restaurants (29 million USD) sectors were also significant recipients of FDI.

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

In the first half of 2017, the improvement of the current account deficit was driven mostly by a decrease in investment and an increase in savings. The ratio of investments to GDP decreased by 2.7 percentage points and reached 29.3%, while the ratio of savings to GDP grew by 0.7 percentage points to 19.8%.

« Improvement of current account deficit was driven by a decrease in investment and an increase in savings.

Figure 7.7 Investments and Savings



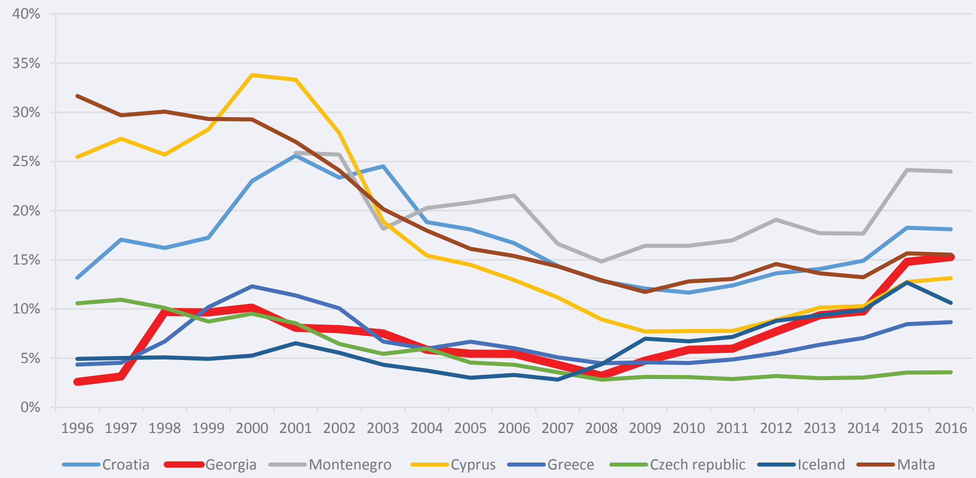
* data contains first two quarters of year 2017

Source: GeoStat and the National Bank of Georgia

Box 3 Tourism revenues in Georgia and other countries

In recent years, Georgia's tourism revenues have exhibited a strong growth trend. From 2010 to 2015, tourism revenues grew by 25.6% on average. In 2016, tourism revenues increased by 11.9% and the tourism revenues to GDP ratio was equal to 15.1%; while in the first nine months of 2017, tourism revenues grew by 29%.

Figure 7.8 Tourism Revenues to Nominal GDP by Country (1996-2016)



Source: World Bank

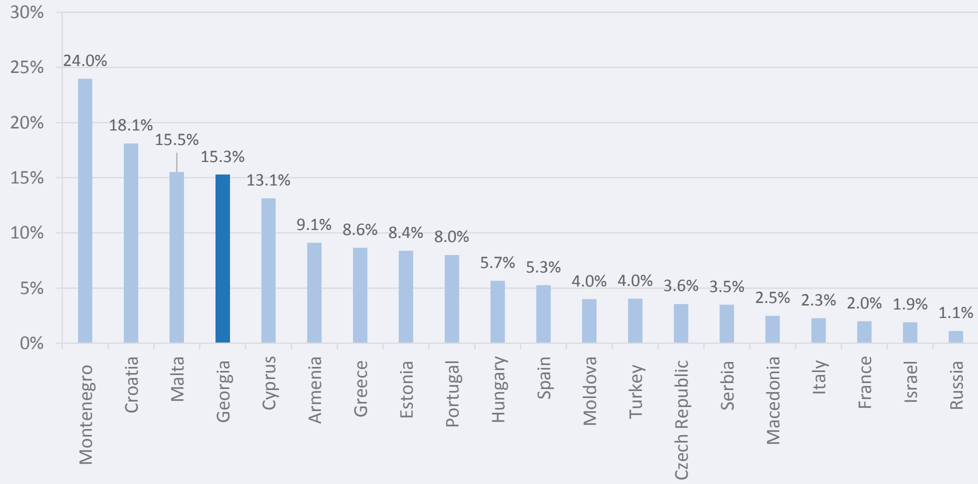
In countries like Georgia, where the 1990s were characterized by political instability, the ratio of tourism revenues to GDP range from 18-23%. For example, in Croatia, the tourism revenues to GDP ratio was high in 2016 and stood at 18.1%. In Montenegro, where tourism is one of the drivers of GDP growth, the tourism revenues to GDP ratio stood at 23.9% in 2016. The tourism revenues to GDP ratio is also increasing in Iceland, where the ratio was 12.7% and 10.6% in 2015 and 2016 respectively.

In EU member countries, tourism revenues to GDP ratios tend to be comparatively low. Despite the increase of tourism revenues in developed economies, the share of tourism revenues to GDP is declining. For example, in Cyprus the tourism revenues to GDP ratio was highest in 2000 and equaled 33%. However, over the years the ratio has declined, reaching 12.1% in 2016. Similarly, the ratio was high in Malta standing at 29% in 2000, but fell to 15.5% by 2016. For Greece the ratio has increased to 8.6% in recent years, while in the Czech Republic the tourism revenues to GDP ratio equals 6.9%.

Considering current growth rates, as in Croatia, the tourism revenues to GDP ratio in Georgia may be close to 18% in 2017. The experience of other countries indicates that the high growth of tourism revenues is likely to be maintained in the coming years. If we assume that the tourism revenues to GDP ratio in Georgia like in Montenegro, will rise to 25%

by 2020, this would mean that tourism revenues will grow at an average annual rate of 20% per year over the next three years. Whereas, if we assume that the ratio for Georgia will increase, as in Cyprus, up to 25% by 2022, this would mean that tourist revenues will grow at an average annual rate of 23% for the next five years.

Figure 7.9 Tourism Revenues to Nominal GDP in Different Countries (2016)



Source: World Bank

8. Output and labor market

In the second quarter of 2017, GDP grew by 4.7%. The service sector made the largest contribution to overall growth, contributing 3.6 percentage points (pp). Industries contributed 1.3 pp and the agriculture sector's contribution was negative at -0.2 pp.

The inflow of international visitors has made a significant contribution to current economic growth. The increased number of tourists has directly affected the performance of service sector, particularly hotels and restaurants, transport, real estate operations and communications.

‹‹ Tourism growth largely contributed to the output of hotels and restaurants, transport, real estate operations and communications.

The hotels and restaurants sector grew by 12.9% (a 0.3 pp contribution to total growth). The growth of the transport sector was also significant, with air transport showing a nominal increase of 37% and supporting transport activity growing by a nominal 29%. Taken as a whole, the transport sector grew by 7% in the second quarter of 2017 and contributed 0.4 pp to the overall growth.

Real estate operations increased by 7.2% (a contribution of 0.4 pp to overall growth), which was a result of intensive construction activities, supposedly driven also by demand from foreign citizens. In 2017, growth was also significant in the communications sector. Although slowing from the first quarter, it remained high at 4.8% in the second quarter. Trade, the largest sector of economy, grew by 3.5% (a 0.5 pp contribution to total growth) – a development that can be linked to the revival of economic activity. The growth of the financial sector remained high, standing at 6.8%.

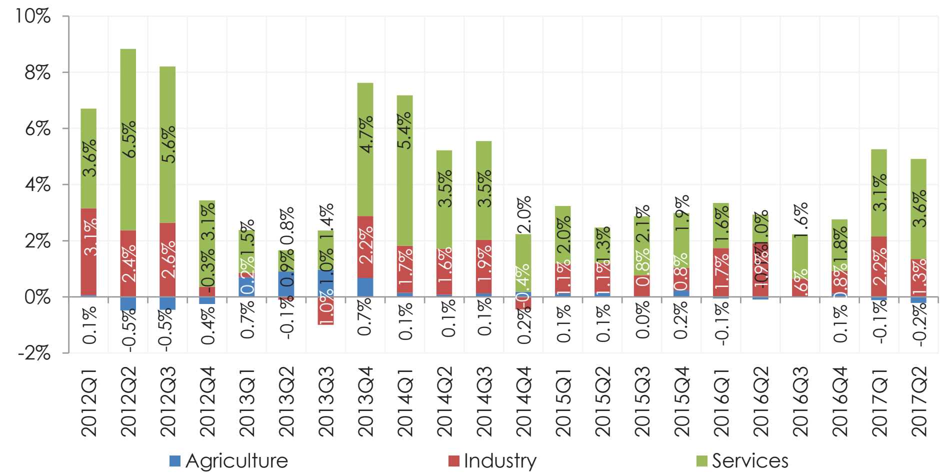
From the industrial sector, construction once more made the most significant contribution to overall economic growth. Apart from the extensive gas pipeline project, construction activity increased in both public and private sectors. In total, construction grew by 16.4%, contributing 1.2 pp to total growth.

‹‹ Construction made the most significant contribution to economic growth.

In the first half of 2017, the output of the agriculture sector declined. Compared to the first quarter, the annual growth of the sector fell by 2.4% in the second quarter, making a negative contribution of -0.2 pp to the overall total.

‹‹ In the first half of 2017, the output of the agriculture sector declined.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat.

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