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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%.** The inflation target was reduced gradually from 6% to its long-term value. It was 4% for 2017, and from 2018 it 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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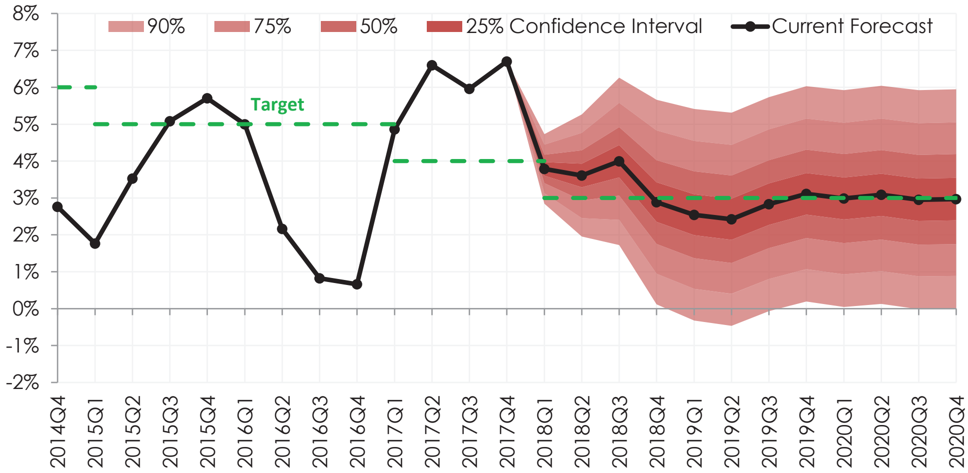
1. Brief Overview

In the fourth quarter of 2017, **the annual inflation rate** totaled 6.7%, which was slightly higher than in the previous forecast. The developments on the international oil market and a notable depreciation of the nominal effective exchange rate has pushed the inflation slightly higher than previously expected. However, in January 2018, the annual inflation rate fell to 4.3%.

Over the course of 2017, temporary factors placed upwards pressure on inflation. However, the impact of these temporary factors generated by the increase of excise taxes, surge in oil prices on international markets and depreciation of nominal effective exchange rate on annual inflation is expected to dissipate over 2018.

According to the National Bank of Georgia's baseline scenario, inflation will gradually decline to the target rate of 3% in the medium term. In the first half of 2018, the inflation rate will be on average 3.5-4%, but from the second half of the year, inflation is expected to continue to decline and stabilize around the target level (see Figure 1.1). The inflation forecast is dependent upon economic activity and the nominal effective exchange rate. Specifically, below-potential aggregate demand exerts downward pressure on inflation, but the effect of this was partially neutralized by the depreciation of the nominal effective exchange rate at the end of 2017. As a result, following an expected strengthening of the nominal effective exchange rate in the medium term, the inflation rate will gradually decline to the target level of 3%.

Figure 1.1 Headline CPI Inflation



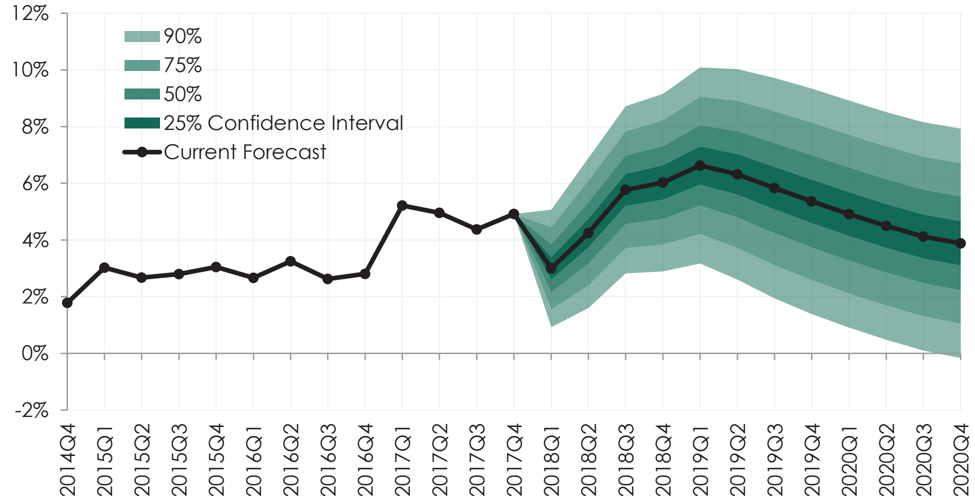
Source: National Bank of Georgia

In 2017, **real GDP growth** was moderately higher than expected. Based on preliminary estimates, annual growth in the fourth quarter stood at 4.7% and in 2017 it equaled 4.8%. Economic activity improved following positive trends in the external sector. In particular, remittances and exports of goods and services both significantly increased. Moreover, growth in 2017 was supported by domestic factors, such as high levels of investment and moderate increases in consumption which in turn was driven by improved business and consumer sentiment and an increase in lending.

According to the NBG's **forecast, real GDP growth** in 2018 is projected to stand at 4.5% (see Figure 1.2). GDP growth will be driven by net exports, consumption and investments, and will be supported by foreign inflows, improved business sentiment and the capital expenditures of the government. However, based on current estimates, despite some improvement, aggregate demand remains below the potential level. Based on the forecast, the output gap will gradually close over 2018-2019.

It should be noted that monetary policy cannot aim to fully neutralize the temporary factors affecting the inflation rate in the short run. This objective could only

Figure 1.2 Annual Real GDP Growth

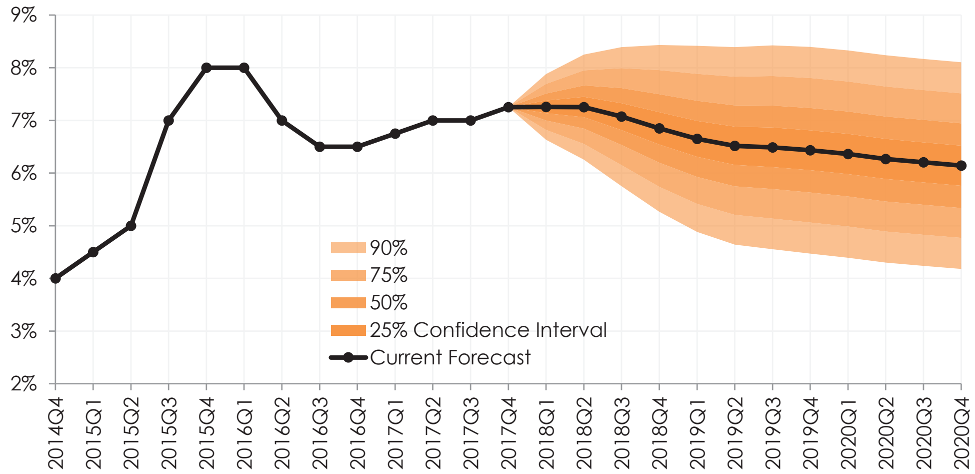


Source: National Bank of Georgia

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 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 contain inflationary expectations, in 2017 the National Bank of Georgia gradually increased the monetary policy rate from 6.50% to 7.25%. According to the current macroeconomic forecast, other things being equal, to curb inflation expectations driven by the depreciation of the nominal effective exchange rate, the National Bank of Georgia **expects monetary policy to remain tightened for some time**. However, following the reduction of inflation to around the target level, the monetary policy rate is expected to decline to 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

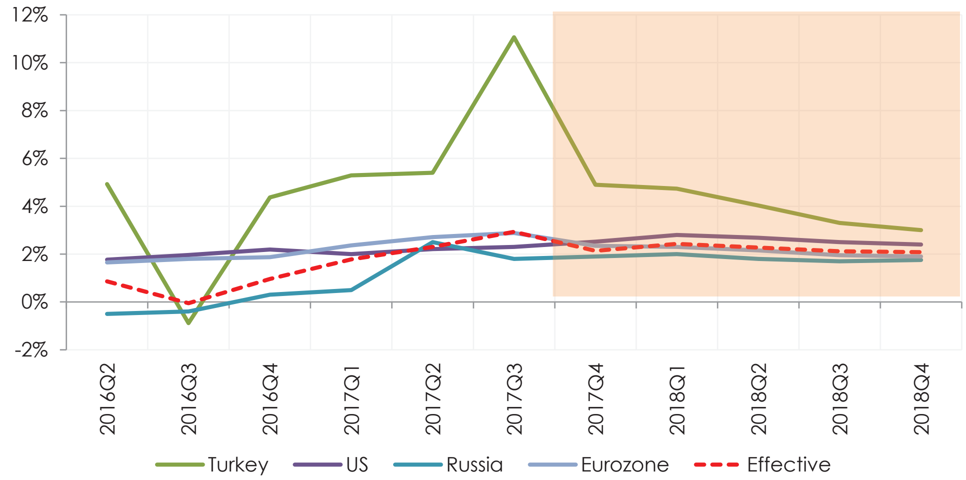
The forecasts are dependent on **exogenous factors and contain risks in both upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth of Georgia's main trading partners, the global trends of the euro and US dollar, and international prices of oil and food. In terms of domestic factors, risks stem from changes in the fiscal deficit, credit activity and business sentiment. Hence, if 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

Following a deepening of financial and economic ties with partner countries, the Georgian economy is experiencing growing influence from the external sector: mainly through export revenues, money transfers and direct foreign investment. In the third quarter of 2017, the **Eurozone** economy hit its fastest growth in a decade, growing by 2.6%. Based on initial estimates, this growth persisted in the fourth quarter and was supported by favorable dynamics in the global economy, improved conditions on the labour market, and benign financing conditions. Moreover, it should be noted that at the end of last year uncertainty regarding Brexit declined, leading to positive expectations in the financial markets regarding the negotiations. According to the World Bank, the Eurozone economy will grow at a moderate rate over 2018[1]. Based on the forecast, growth for 2017 will stand at 2.4%, while in 2018 the Eurozone economy is expected to grow by 2.1%.

Figure 2.1 Real GDP Growth of Economic Partners



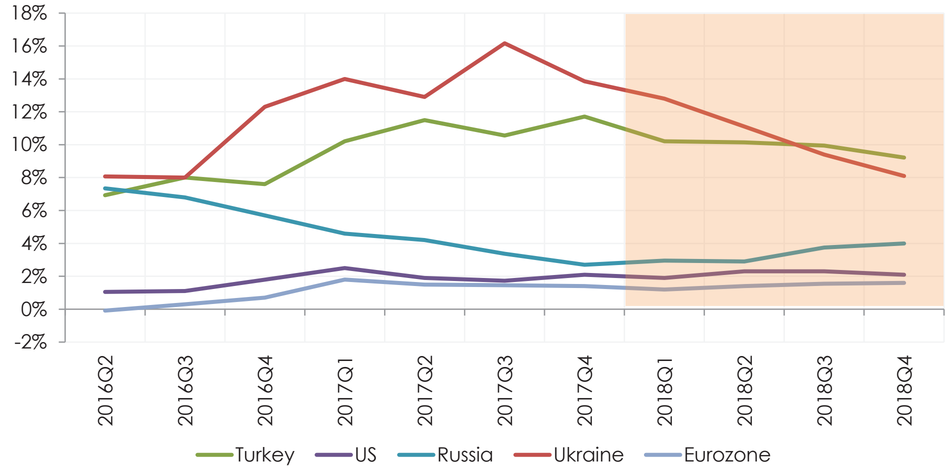
Source: Bloomberg; National Bank of Georgia.

Over 2017, the economic recovery in **Ukraine** was slow due to a full transport blockade of the separatist-held east of the country and a relative deceleration in the implementation of reforms – the latter has constrained the IMF's decision to provide further financial assistance. A decline in agricultural output also restrained growth. According to the World Bank's estimates, economic activity in Ukraine increased by only 2% in 2017[2]. However, with the exhaustion of the effects of the transport blockade, real GDP is expected to grow by 3.5% in 2018. The inflation rate in the country remains high; following the depreciation of the local currency, inflation stood at 15% in 2017.

In 2017, based on initial estimates, the **Turkish economy** grew by a record high of 6.7%.[3] The growth was supported by a number of factors, including fiscal stimulus, an increase in external demand (especially from the Eurozone) and the base effect. However, the current account deficit grew and inflation reached 11%, resulting in worsened investor sentiments and elevated depreciation pressure on the local currency. Relying on the mixed economic conditions shaped by the range of factors, the World Bank expects the Turkish economy to grow by 3.5% in 2018.

1 *Global Economic Prospects, January 2018: Broad-Based Upturn, but for How Long? Advance edition. Washington, DC.*
2 *Ibid.*
3 *Ibid.*

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Over 2017, the **Russian** economy was gradually, but unevenly, recovering from the imposed sanctions and low oil prices on international markets. The recovery was supported by increasing prices, planned fiscal stimulus and a declining current account deficit. Domestic consumer demand was another driver of growth and followed improved conditions on the labour market and record low inflation. Based on the World Bank's estimates, real GDP growth in Russia over 2017-2018 will equal 1.7%.[4]

The ongoing recovery of the Russian economy over 2017 positively contributed to the growth of the **Armenian** economy, mainly through increased remittances and export revenues. The significant growth of Armenia's industrial sector was particularly noteworthy and was driven by increased demand and higher prices on international markets. If the current trend persists, the World Bank expects Armenia to grow by 3.7% on average over 2017-2018.

Since the decline of oil prices in 2014, **Azerbaijan** continued the path of recession. Given the weak monetary policy transmission mechanism, the Central Bank of Azerbaijan is unable to constrain inflation expectations. However, positive dynamics were observed in the non-oil sector, and with the stabilization of prices on commodity markets, external balance improved. Based on World Bank estimates, the economy of Azerbaijan declined by 1.4% in 2017, while inflation stood at 13%. However, 0.9% growth is expected in 2018.

A robust recovery of private investments resulted in 2.3% growth in **the United States**. Despite damages incurred by adverse climate conditions, this growth was accompanied by positive dynamics in the energy sector, a weaker dollar and the recovery of external demand. A decline of the unemployment rate and growth of wages further stimulated growth. Although planned legislative changes may influence the growth of the U.S. economy, the World Bank estimates that growth in 2018 will stand at 2.5%.[5]

Over the course of 2017, central banks in Georgia's trading partner countries (where inflationary expectations declined and local currencies depreciated less than expected) eased monetary policy to promote economic recovery. Meanwhile, central banks in developed economies (where output is still lagging behind its potential and consumer prices increased at a slower pace) maintained policy rates at low levels. Notably, in 2018 the European Central Bank (ECB) plans to gradually phase out its quantitative easing program by cutting its monthly asset purchases.

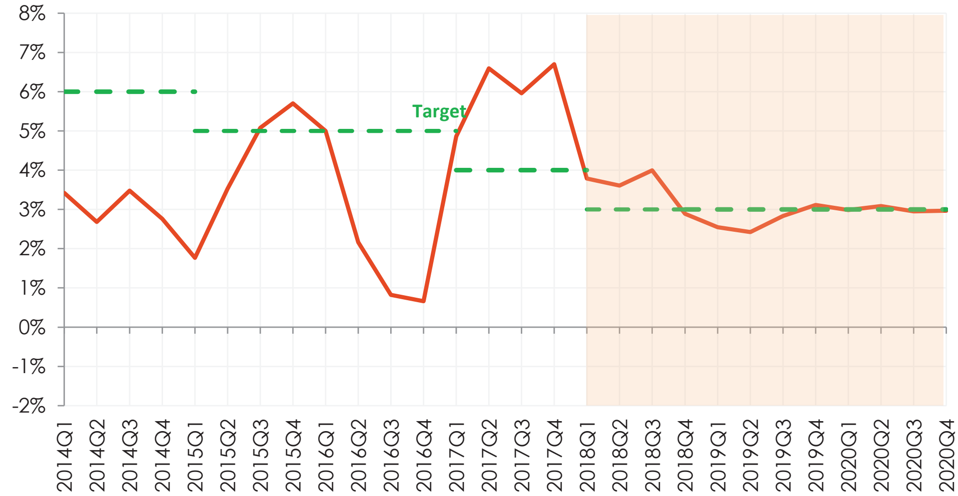
4 *Global Economic Prospects, January 2018: Broad-Based Upturn, but for How Long? Advance edition. Washington, DC.*

5 *Ibid.*

2.2 MACROECONOMIC FORECAST

In December 2017, **the annual inflation rate** totaled 6.7%, which was equal to the average of the fourth quarter (see Figure 2.3). Although an above-target rate had been forecast, the rate in the fourth quarter was slightly higher than predicted due to developments on the international oil market and the notable depreciation of the nominal effective exchange rate. Over 2017, temporary supply-side factors, including the increase of excise taxes and a surge in commodity prices on international markets, put upwards pressure on inflation. The impact of those temporary factors on inflation is expected to dissipate over 2018.

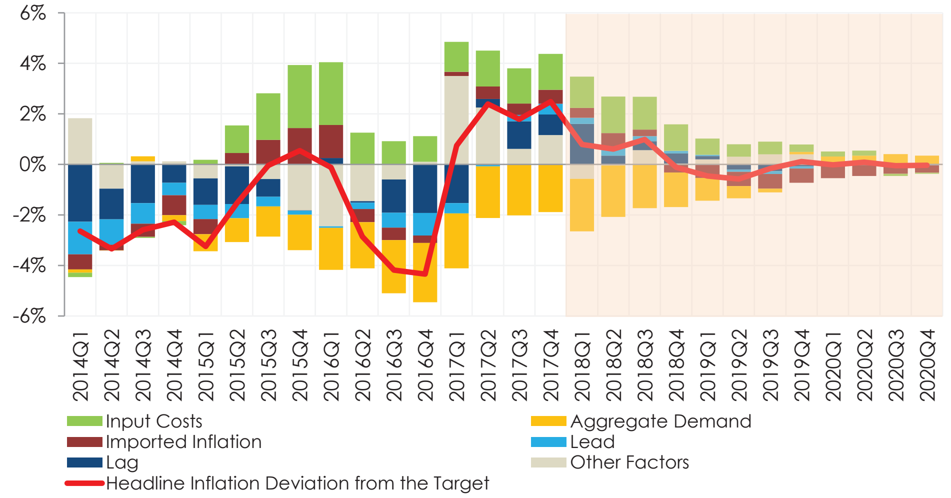
Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

As a result of the increase in consumer tariffs on electricity and water at the beginning of 2018, accompanied by the price dynamics of oil and food on international markets that started in the second half of 2017, **inflation will continue to slightly overshoot the target in the first half of 2018.** However, with the exhaustion of these temporary factors, inflation will continue to decline in the second half of the year to approach the target of 3% (see Figure 2.3).

Figure 2.4 Inflation Deviation from the Target and its Decomposition[6]



Source: National Bank of Georgia.

In addition to the factors mentioned above, **the above-target inflation** in the first half of 2018 will result from imported inflation and increased input costs (see Figure 2.4). The latter will be driven by a price increase on intermediary goods following the de-

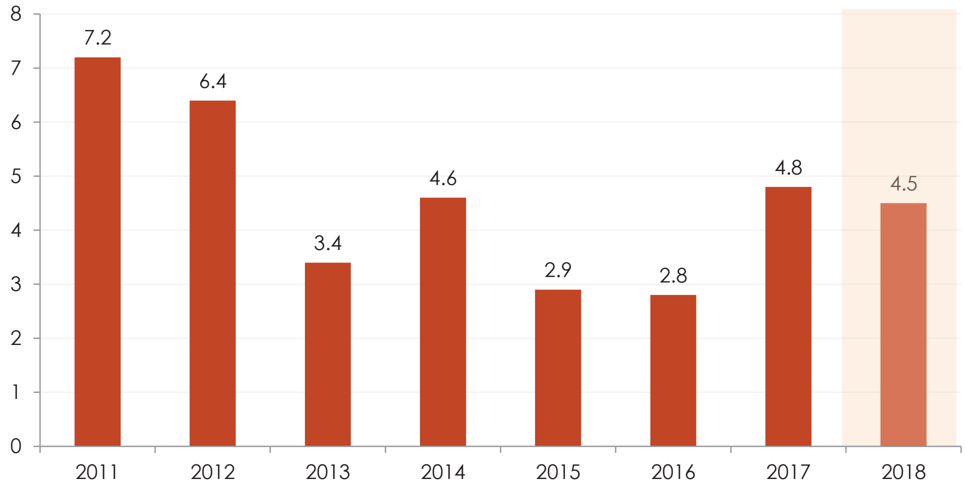
6 *In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

preciation of the real effective exchange rate at the end of 2017. On the other hand, aggregate demand remains below its potential level, exerting downward pressure on inflation. However, the downward pressure on inflation generated by low economic activity will be gradually exhausted. Based on the current forecast, with an increase in economic activity, assisted by the strengthening nominal effective exchange rate and lower imported inflation, inflation will stabilize at around 3% in the medium term.

The inflation forecast is dependent upon developments in both the internal and external economic environment and is therefore associated with several risks. Economic activity is a source of uncertainty for the inflation forecast. If stronger than expected, this will drive inflation upwards; but, if weaker than expected, it will push inflation lower than in the forecast. Uncertainty remains surrounding international food and oil prices, which have substantial weight in the consumer basket and are mostly supply driven. Moreover, risks are associated with the exogenous factors, including exchange rate dynamics in Georgia's main trading partners. In particular, the strength of the Euro is dependent upon the pace of the European Central Bank's withdrawal of its quantitative easing program. However, depreciation of trading partner currencies may lead to drops in the prices of imported goods, which would thereby reduce the inflation level.

According to preliminary estimates, in the fourth quarter, **real GDP growth** stood at 4.7%, and in 2017 it equaled 4.8%. Based on these estimates, economic activity grew more than expected and was driven by improved external demand. In particular, the economic recovery of Georgia's main trading partners, assisted by the relative increase of the competitiveness of the lari exchange rate, significantly promoted exports of goods and services (especially tourism). Moreover, remittances grew more than expected, which in turn increased domestic demand. Investments in the construction sector also positively contributed to growth in 2017.

Figure 2.5 Real GDP Growth



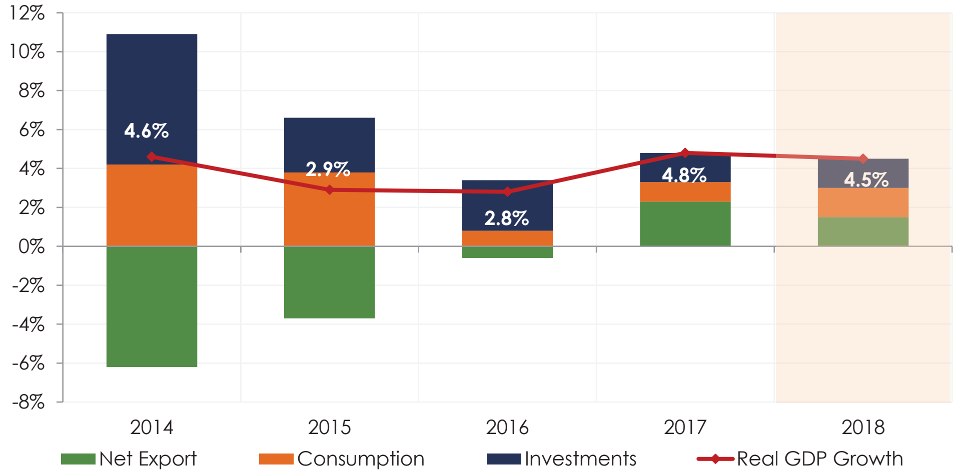
Source: National Bank of Georgia.

The GDP forecast for 2018 has not changed. **GDP growth is expected to stand at 4.5%** (see Figure 2.5). The recovery of the external sector is expected to persist, and net exports will thus continue to make a positive contribution to GDP growth. Moreover, the increase of remittances and lending to the private sector (especially the tourism sector) will foster a growth of investments and consumption (see Figure 2.6). Planned massive infrastructural projects will further drive growth.

The external sector is seen as a major source of risk for the GDP forecast. If, against the backdrop of geopolitical tensions, economic conditions in Georgia's trading partner countries worsen, then actual GDP growth will be lower than in the current forecast. Another risk is associated with the dynamics of the euro and dollar exchange rates on the international market, which are transmitted to Georgia through trade and expectations channels, thereby affecting economic activity. However, if opportunities for free trade with the EU and China, accompanied by intensified investment projects and improved business sentiment, have a greater-than-expected positive impact on economic activity, then GDP growth will be higher than forecast in the medium term.

Following significant improvements in the external sector, **the current account deficit hit a record low** in the third quarter of 2017 and equaled 3% of GDP. In particular,

Figure 2.6 Real GDP Growth Decomposition[11]



Source: National Bank of Georgia

exports of goods increased by 20%, while exports of services grew by 24.3%. Moreover, tourism revenues grew by 19% and remittances increased by 20%. According to the short- and medium-term forecasts, the current account deficit will remain in single digits so long as the economic recovery of Georgia's main trading partners persists, and the trend of increasing exports and other revenues from the external sector continues.

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 gradual and 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 reveals the trajectory of the monetary policy rate, which is consistent with the baseline macroeconomic forecast presented above. According to the forecast, short-term rates are expected to remain at the current level and thereafter to gradually decline to the neutral level. The temporary tightened monetary policy is the NBG's response to rising inflation expectations, while monetary policy easing will be the optimal response to a strengthening of the nominal effective exchange rate and declining inflation. In the long- and medium-term, the monetary policy rate will decline to its natural level, which, according to current estimates, is around 5-6%. Furthermore, it is important to mention that the impact of existing external factors is assumed to have already been reflected in the current exchange rate; hence, low and stable inflation expectations will contribute to a long-term strengthening of the nominal effective exchange rate.

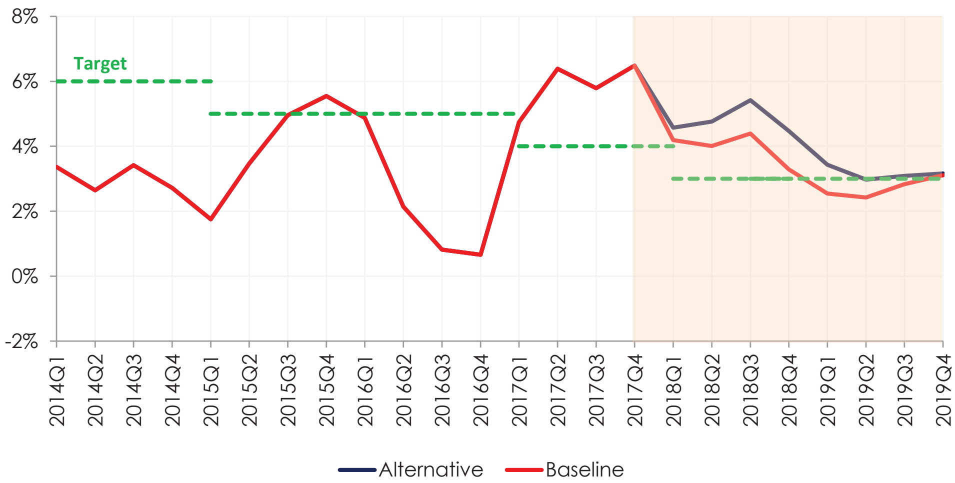
It should be stated that the forecast of the monetary policy rate is not a promise from the National Bank of Georgia regarding future decisions. It only reflects the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. Despite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

2.3 ALTERNATIVE FORECAST SCENARIO

As in previous reports, the alternative forecast scenario considers a situation where Georgia is affected by an external shock. In particular, the scenario considers a faster-than-expected phasing out of the European Central Bank's quantitative easing program, which will lead to the relative appreciation of the euro exchange rate against other currencies. On the other hand, a rise in the yield curve will create capital inflow risks in Eurozone countries, subsequently pushing up risk premiums in developing countries, like Georgia. Hence, 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. As a result, inflation will be relatively higher than in the baseline forecast (see Figure 2.7) and economic growth more restrained (see Figure 2.8). However, compared to the previous report, this alternative forecast scenario considers a less severe external shock because the previous forecast partly materialized and has become the baseline scenario for this quarter.

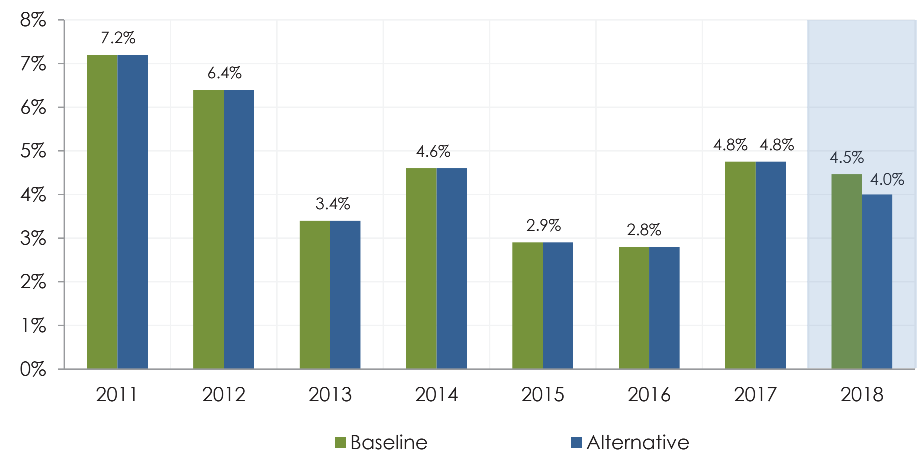
In the alternative scenario, the negative external shock increases inflation at a faster rate than in the baseline scenario. In this scenario, a depreciated nominal effective exchange rate creates inflation pressure and inflation in 2018 is subsequently 0.8 percentage points higher than anticipated in the baseline scenario (see Figure 2.7). Under such circumstances, the monetary policy trajectory in 2018 will increase by 0.7 percentage points compared to the baseline scenario. Due to tightened monetary policy, economic growth is lower in the alternative scenario and equals 4%. However, if this were to occur, the monetary policy response would curb inflationary expectations and reduce inflationary pressure; inflation would thus still 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

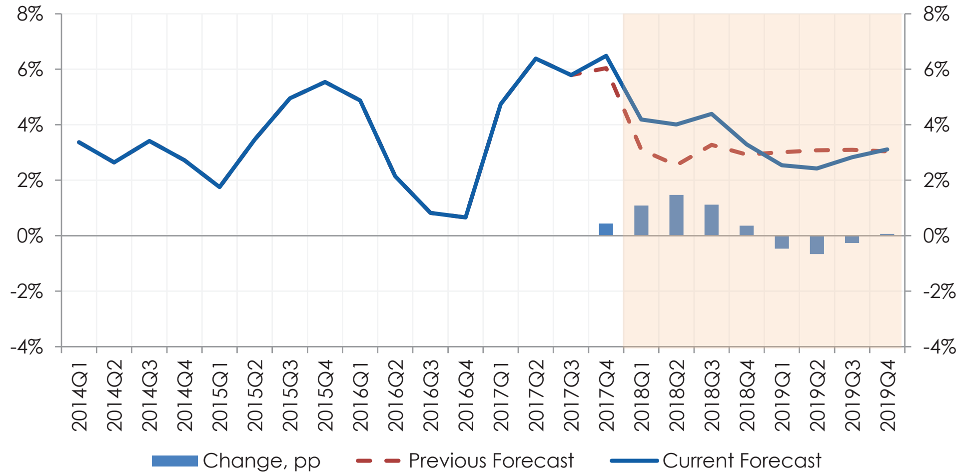


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

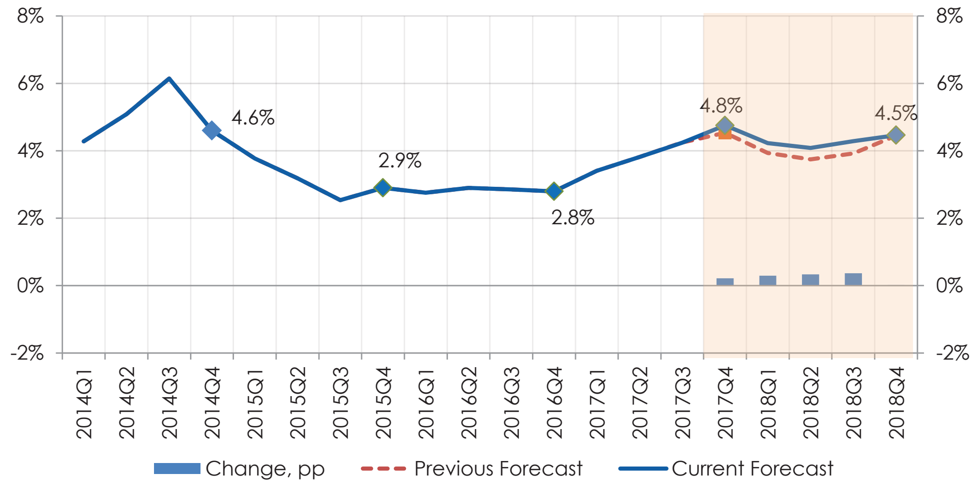
The inflation forecast for 2018 has been revised in an upwards direction (see Figure 2.9). This revision is a result of both the planned increase in tariffs on electricity and water, which will have direct and indirect impacts on the price level, and the depreciation of the nominal effective exchange rate from the second half of 2017, which creates the risk of increased imported inflation from trading partner countries. In addition, oil prices on international markets have an increasing trend and it is expected that fuel prices will make a greater contribution to inflation in 2018. According to the current forecast, inflation in the first half of 2018 will range between 3.5-4%, while approaching the 3% target over the second half of the year.

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)



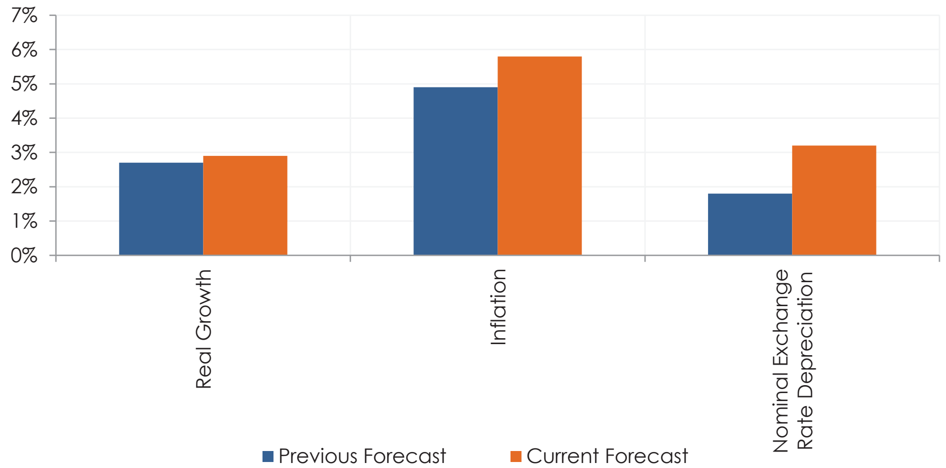
Source: National Bank of Georgia

In terms of economic activity, assumptions regarding the economic variables affecting growth have not changed. The GDP growth forecast was therefore not revised compared to the previous quarter and stands at 4.5% (see Figure 2.10). The economic growth forecasts for Georgia's main trading partner countries have not changed significantly and were thus only slightly increased. Assumptions regarding fiscal stimulus and aggregate demand dynamics have also remained the same.

Assumptions regarding the economic growth, inflation and exchange rates of Georgia's main trading partners are particularly important for the macroeconomic forecast. Thus, any change in these assumptions affects the forecast and its associated risks (see Figure 2.11).

Assumptions regarding the expected depreciation of trading partner currencies against the US dollar have been revised upward. This change was mostly driven by the greater-than-expected depreciation of the Turkish lira, but its transmission to the Georgian real effective exchange rate will be lessened since inflation in Turkey is high. For other trading partner countries, assumptions regarding exchange rate dynamics have not changed significantly. However, inflation expectations have increased following the growth of oil prices on international markets, and economic growth projections were slightly revised in an upward direction.

Figure 2.11 Changes in External Sector Assumptions for 2017-2018[7]



Source: Bloomberg

Box 1 EVALUATION OF INFLATION TARGET FULFILLMENT AND ASSESSMENT OF 2017 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (4-6 quarters). Hence, the inflation forecast is key to monetary policy formation in the medium term. To assess the reliability of monetary policy in achieving its monetary objectives, it is important to analyze the forecasts made in previous periods. The inflation forecast is assessed as having been accurate if any deviations from the forecast were a result of exogenous (independent of monetary policy) factors. In Georgia, as in other small open economies, exogenous shocks are imminent. Exogenous factors can cause actual inflation to deviate from the target level. Monetary policy is a tool to impact aggregate demand and is thus the central bank's response to demand shocks. Central banks do not usually react to exogenous supply-side shocks, as doing so would facilitate economic fluctuations and increase social costs. Consequently, central banks only respond to exogenous shocks when a deviation is so significant that it impacts inflation expectations and influences inflation in the medium or long term.

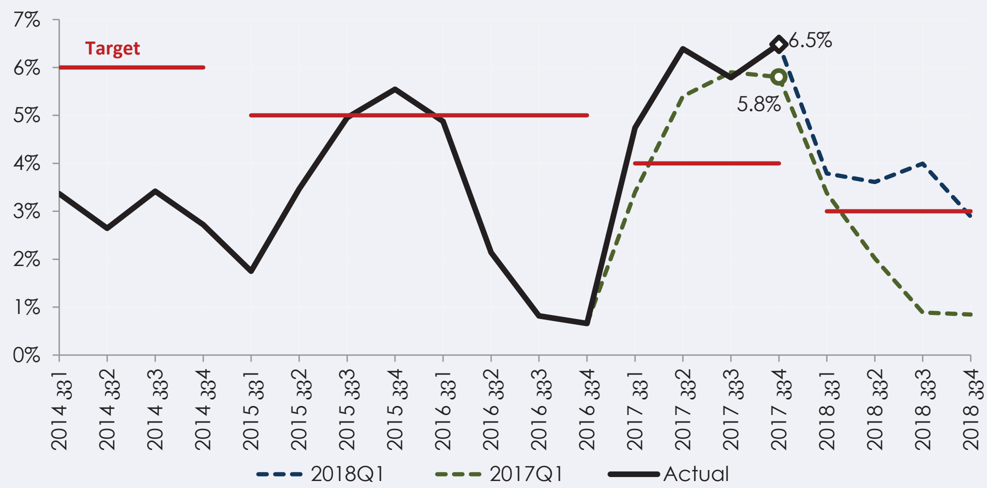
We will start this analysis of the accuracy of the 2017 forecasts from the first quarter. An analysis of the forecasts made in 2016 can be found in a monetary policy report published last year.

The inflation forecast of February 2017 appears accurate since developments in the real economy were in line with the forecast (see Figure 2.12). According to the forecast, inflation was expected to overshoot its target level over the course of 2017.

The reasons for inflation remaining above the target were temporary supply-side shocks – in particular, the increase of excise tax on a certain group of products (oil, tobacco and automobiles), which had a one-off effect on inflation. Since the decision to increase excise tax was made at the end of 2016, this was not considered in the forecast of November 2016, which predicted a lower inflation rate for 2017.

7 *The estimates are based on forecasts for five main trading partners: the USA, EU, Turkey, Ukraine and Russia.*

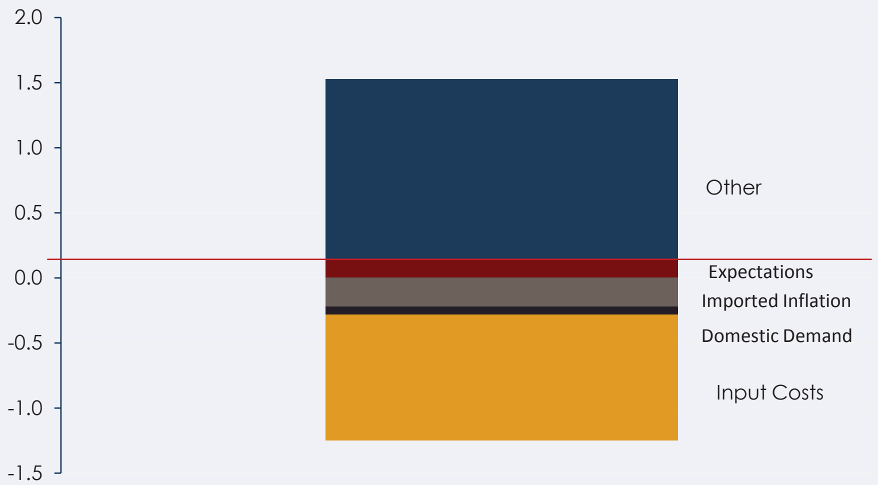
Figure 2.12 Comparison of Annual Inflation Forecasts



Source: National Bank of Georgia

The forecast for 2017 appears to have been largely in line with the actual average figures for the year (see Figure 2.13). Inflation decompositions reveal that that the higher-than-expected inflation was a result of other factors, such as the increase in excise tax and the rise of administrative prices on natural gas, from the second half of the year. On the other hand, the impact of input costs on inflation (the impact of imported inputs and loan dollarization on prices) was lower than projected. In particular, the forecast of February 2017 expected greater exchange rate depreciation than the actual average figures.

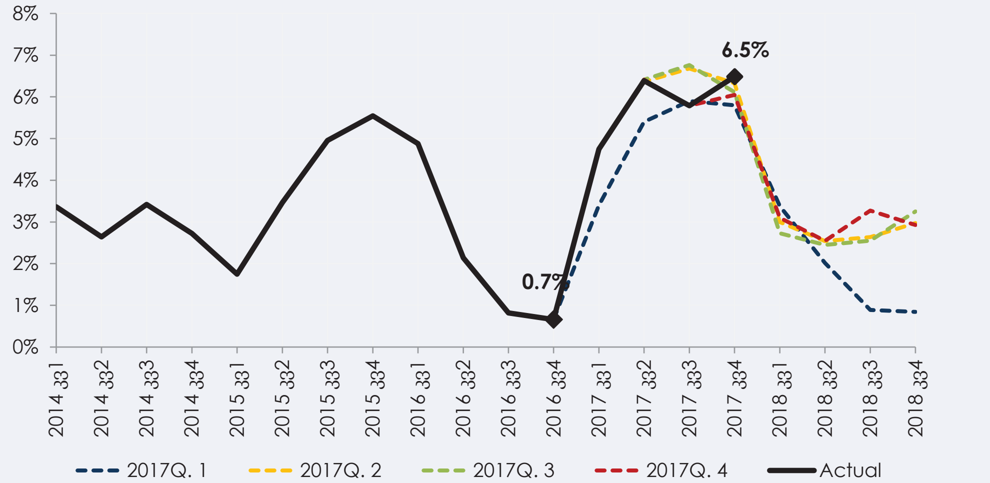
Figure 2.13 Decomposing the Deviation of Headline Inflation From Its Projected Value (Quarterly Average)



Source: National Bank of Georgia

In terms of the quarterly forecasts, the inflation forecast for the second quarter of 2017 was revised upwards. This revision was driven by the greater-than-expected impact of increased food prices on headline inflation. Meanwhile, the forecasts for the third and fourth quarters of 2017 were not changed significantly (see Figure 2.14).

Figure 2.14 Performance of Headline Inflation Forecasts (2017Q1 – 2017Q4)



Source: National Bank of Georgia

The formation of monetary policy in 2017 can be summarized as follows: at the beginning of the year, in order to curb inflationary expectations, the monetary policy rate was increased gradually by 0.5 percentage points to 7%. As explained earlier, inflation overshot the target level over the year mainly due to the increase of excise tax on a particular group of products, which had a temporary effect on inflation. In the following period, the NBG thus kept the policy rate unchanged. However, by the end of the year, the nominal effective exchange rate depreciated more than had been expected and international prices on oil increased. Thus, to limit the pressure of the exchange rate depreciation on the inflation rate, which would influence inflation in 2018, the Monetary Policy Committee decided to increase the policy rate to 7.25%.

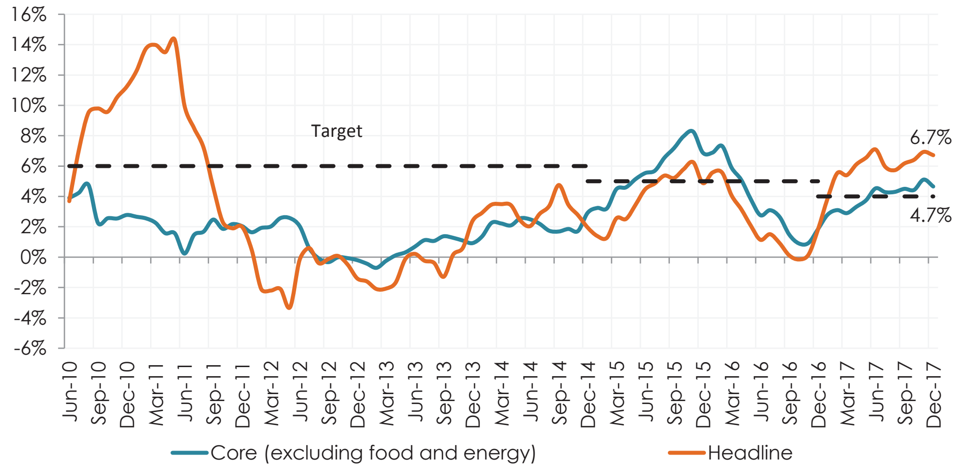
3. Consumer Prices

From the beginning of 2017, temporary supply-side factors pushed inflation above the target level. This was expected. From February onwards, inflation exceeded its 4% target. The increase was driven by the rise of oil and tobacco prices, which stemmed from a surge of oil prices on international markets and a growth of excise tax on fuel and tobacco products. Moreover, from August onwards, an increase in the administrative price of natural gas further pushed inflation above the target. Annual inflation in 2017 totaled 6.7%. Meanwhile, core inflation (which excludes volatile food and energy prices) was lower over the year and stood at 4.7% in December (see Figure 3.1), from which tobacco made a 2.0 percentage points (pp) contribution. 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.

‹‹ Lower core inflation signals a reduction of headline inflation in the future.

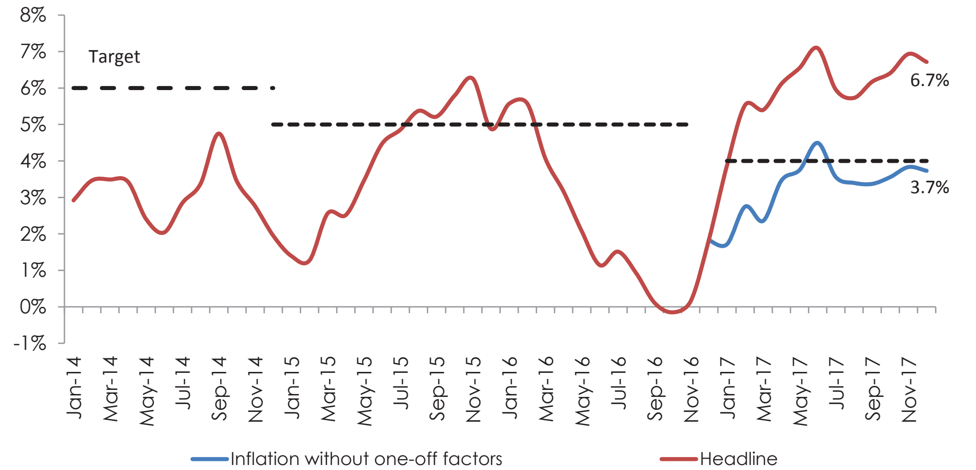
Figure 3.1 CPI And Core Inflation



Source: GeoStat

As mentioned earlier, the rise of inflation was a result of increased prices on tobacco and fuel. The contribution of those two products ranged between 2.1-2.9 pp. From August onwards, the rise of the administrative price of natural gas also contributed

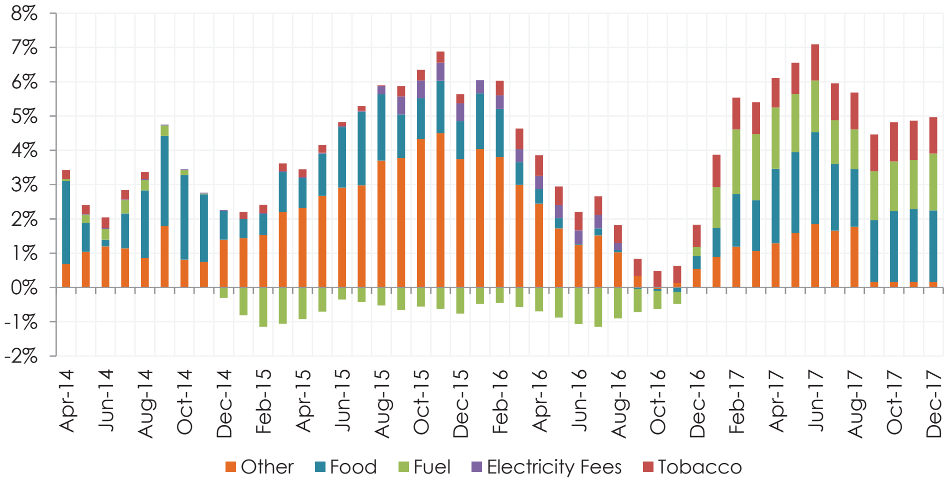
Figure 3.2 The Share of One-off Factors in CPI Inflation



Source: GeoStat

to the increase in inflation. In December, the contribution of temporary supply-side factors (increased prices on natural gas, tobacco and oil) to the 6.7% total inflation equaled 2.9 pp, while the food group added 2.1 pp and other products 1.7 pp (see Figure 3.2).

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



Source: GeoStat and National Bank of Georgia

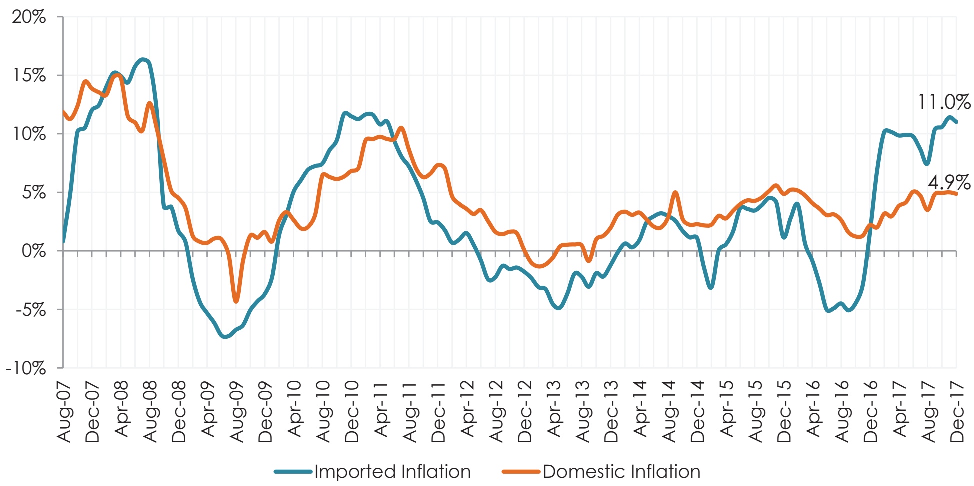
Over the first two quarters of 2017, the contribution of the food group to total inflation increased from 0.9 pp to 2.7 pp. There are several reasons behind the increase. In 2016, prices of fruit and vegetables were relatively low and thus the increase of prices in 2017 was mainly a result of the base effect . The price level on meat products also grew, which can be attributed to increased exports of those products and reduced supply to the local market. During the last two years, increased prices on sugar on the world market ensured a growth of prices on products containing sugar, which added from 0.3-0.6 pp to total inflation. However, following a reduction of global prices, prices of products containing sugar started to decline from the beginning of 2017 and the base effect expired in the fourth quarter. The contribution of the food group to total inflation reached 2.7 pp in June, but subsequently dropped to 2.1 pp in December.

‹‹ High inflation on food group is a result of base effect.

The contribution of the healthcare group to annual inflation was relatively high. In December, prices on this group grew by 8.1%, contributing 0.7 pp to overall inflation.

The overall increase in inflation can mainly be attributed to increased prices of imported goods, with imported inflation standing at 11% in December. The main reason behind this growth was an increase in fuel and tobacco prices. In contrast, inflation on mixed and locally produced goods was comparatively low. Inflation on locally produced goods stood at 4.9% in December.

Figure 3.4 Imported And Domestic Inflation

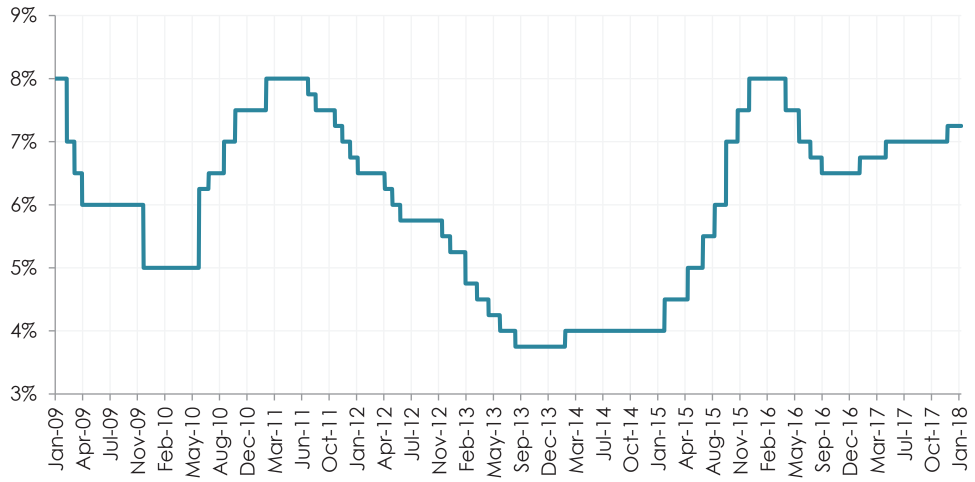


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

Over 2017, the National Bank of Georgia maintained a moderately tightened monetary policy. The above-target inflation observed from the beginning of the year, which was due to temporary supply-side factors, promoted the formation of inflation expectations. In particular, the increase in excise tax on certain import commodities and rising oil prices on international markets pushed the inflation rate above the target. To curb inflation expectations, the National Bank of Georgia increased the policy rate in January and May by 0.25 percentage points to 7.0%, which was a sufficient policy response at the time. However, by October-November the nominal effective exchange rate notably depreciated, thus increasing the inflation pressure relative to the previous forecast. Moreover, the greater-than-expected improvement in economic activity decreased downside pressure on inflation from the demand-side. Thus, a further monetary policy response was required in order to reduce inflation in the medium term. As a response, the Monetary Policy Committee decided to increase the policy rate by 25 basis points to 7.25%.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The Last Monetary Policy Committee meeting was on 31st of January 2018. During the meeting, the committee decided to keep the refinancing rate unchanged at 7.25%. Although the nominal effective exchange rate has started to appreciate, the effect of the recent depreciation on inflation persists. Despite higher-than-expected GDP growth in 2017, aggregate demand remains below its potential, placing downward pressure on inflation. Thus, there is no need for a further tightening of monetary policy at this time. The future decisions of the committee will depend upon the pace at which those factors placing upward pressure on inflation are neutralized. Based on the current forecast, the annual inflation rate will start to decline in the first few months of 2018 and on average will be close to the target level of 3%. Other things being equal, inflation will remain around the target in 2018.

« The NBG decided to keep the refinancing rate unchanged at 7.25%.

In December 2017, annual inflation stood at 6.7%. The inflation rate was above the target since the start of the year. This was primarily driven by temporary supply-side factors that made a contribution equal to 2.9%. In January 2018, with the partial exhaustion of the temporary supply-side factors, the inflation rate declined to 4.3%, as had been expected.

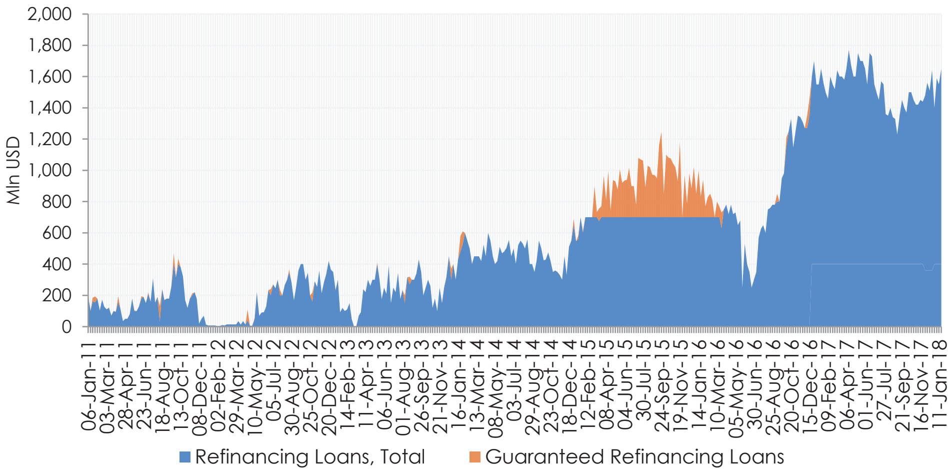
During 2018, the inflation rate will be affected by several exogenous factors, but to lesser degree than in the previous year. Particularly, an increase of administrative prices on electricity and water, and the continued increase of international prices of oil (which started in 2017), will affect the inflation indicator in 2018. Other things being equal, the contribution of these factors to inflation will equal 0.3 and 0.5 percentage points respectively.

Based on preliminary estimates, in the fourth quarter of 2017, real GDP growth totaled 4.7%, while annual growth was 4.8%. The growth of economic activity was supported by positive dynamics in the external sector: remittances and exports of both goods and services (especially tourism) have significantly increased. Tourism revenues in the fourth quarter of 2017 grew by 19.2%, while in 2017 as a whole, tourism revenues increased by 27%. These positive trends in the external sector are expected to significantly improve the current account deficit.

According to the current forecast, in the medium term, headline inflation is expected to remain around the target level. However, the forecast is associated with several risks. It could be influenced upward by a sharp increase of oil and food prices on international markets and a faster-than-expected phasing out of the European Central Bank's quantitative easing program that may lead to the relative appreciation of the euro exchange rate against other currencies. On the other hand, inflation may be lower than forecast if the currencies of some trading partners depreciate more than expected, thereby easing the pressure of imported inflation.

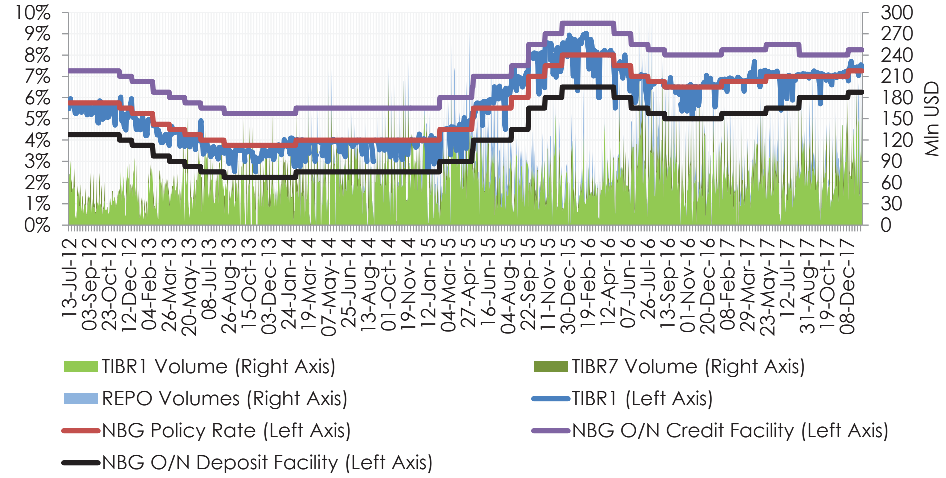
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. Currently, the banking sector operates under the conditions of a liquidity deficit. However, commercial banks are 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 in 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

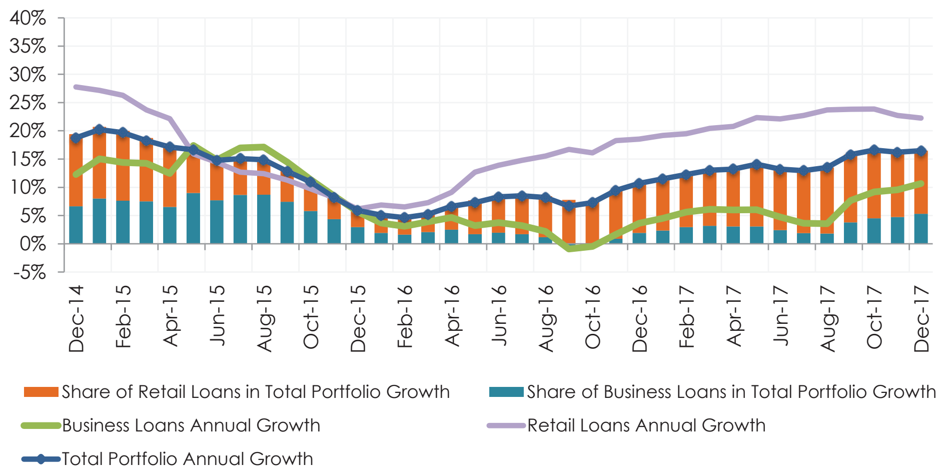
5.1 LOANS

Credit activity improved in the fourth quarter of 2017. In December, excluding the effect of exchange rate fluctuations and the transformation of one microfinance organization into a bank, the loan portfolio increased by 16.5%. This increase can mainly be attributed to the growth of retail loans, but business loans have also seen growth. In December, the growth rate of retail loans slowed by 1.6 pp and amounted 22.2%; meanwhile, loans to legal entities increased by 3 pp and equaled 10.7%. The growth of the loan portfolio was primarily driven by an increase in the construction, transport, agriculture, manufacturing and energy sectors; whereas increases in credit for the trade and agriculture sectors were insignificant.

« According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans in the next quarter. Whereas, following the NBG's policies, the market for retail loans is expected to decline in relative terms.

According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans in the next quarter . In particular, growth is expected to be driven by increased demand from both corporate and small- and medium-size enterprises. In contrast, following the NBG's policies, the market for retail loans is expected to decline in relative terms. To promote sustainable credit activity and improve lending conditions, in 2017 the National Bank of Georgia introduced macroprudential instruments such as the payment-to-income (PTI) and loan-to-value (LTV) ratios. Following best international practice and EU directives, the NBG will continue to implement instruments to protect consumer rights and will extend these to all loan issuers.

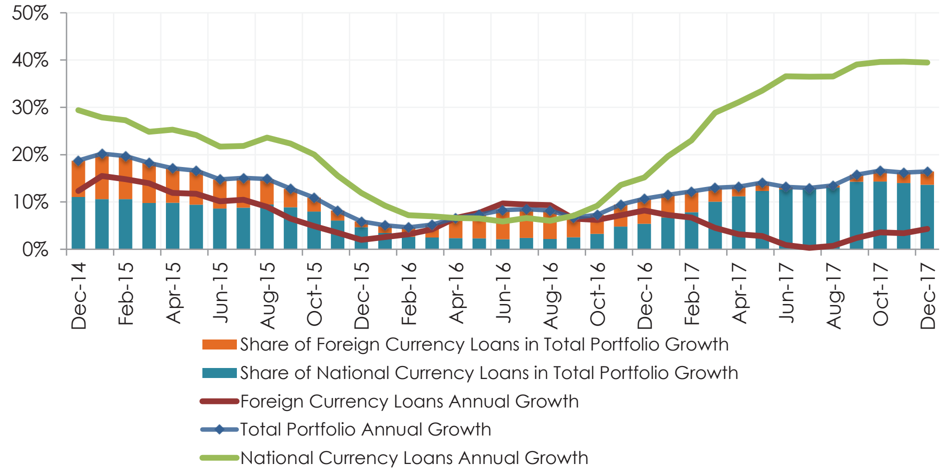
Figure 5.1 Annual Growth Rates Of Retail And Business Loans (Excluding the Exchange Rate Effect)



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 December, the annual growth rate of foreign denominated loans was 4.3%, while loans in the domestic currency grew by 39.5%. It is important to note that the increase in domestic currency loans can be ascribed to the larization measures and a one-time loan conversion program, under which a loan portfolio worth approximately 80 million USD was converted into GEL. Hence, in the fourth quarter, the loan larization ratio declined by 1.1 pp and equaled 41.9%.

Figure 5.2 Annual Growth Rates Of Domestic And Foreign Currency Loans (Excluding the Exchange Rate Effect)

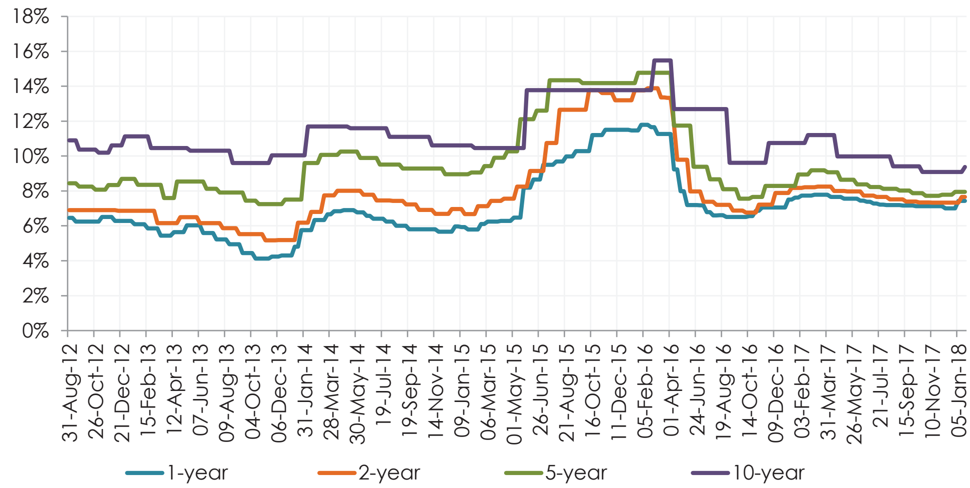


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In December, the monetary policy rate was equal to 7.25%. Starting from late 2017, interest rates on government securities increased as a result of increasing inflation expectations and monetary policy tightening (see Figure 5.3).

Figure 5.3 Interest Rates On Government Securities

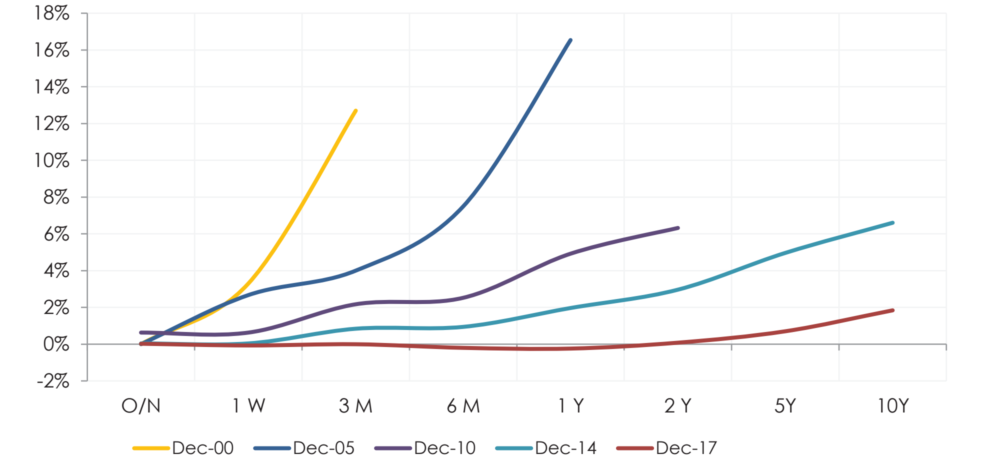


Source: National Bank of Georgia

Compared to the previous quarter, the spread between long-term and short-term interest rates declined due to expectations of monetary policy easing in the medium term. 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.

‹‹ Compared to the previous quarter, the spread between long-term and short-term interest rates declined, which suggests increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

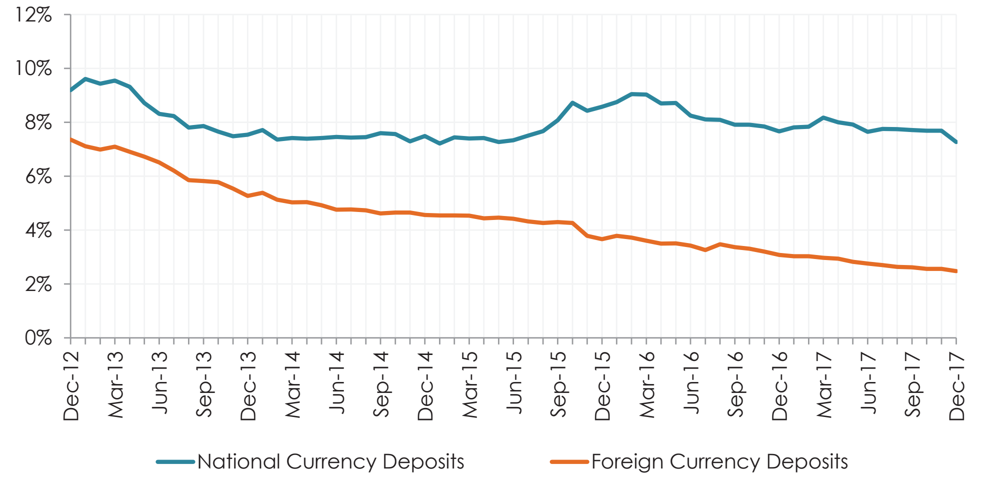
Figure 5.4 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

Compared to the previous quarter, the interest rate on domestic currency deposits declined by 0.4 pp to 7.3%; meanwhile, interest rates for foreign exchange deposits decreased by 0.1 pp and amounted to 2.5%. According to the credit conditions survey, in the fourth quarter of 2017, the decline of interest rates on domestic currency deposits can be explained by the change in the structure of deposits – in particular, by the increase in the share of current and demand deposits. The decline of interest rates on USD deposits is a result of excess liquidity, which could be related to an increase in exchange rate risk following the decline in demand for loans in USD.Representatives of banking sector do not expect a significant increase in interest rates for deposits in domestic currency in the next quarter; however, interest rates on deposits in USD may increase following the growth of the LIBOR[8].

Figure 5.5 Average Interest Rates On Deposits

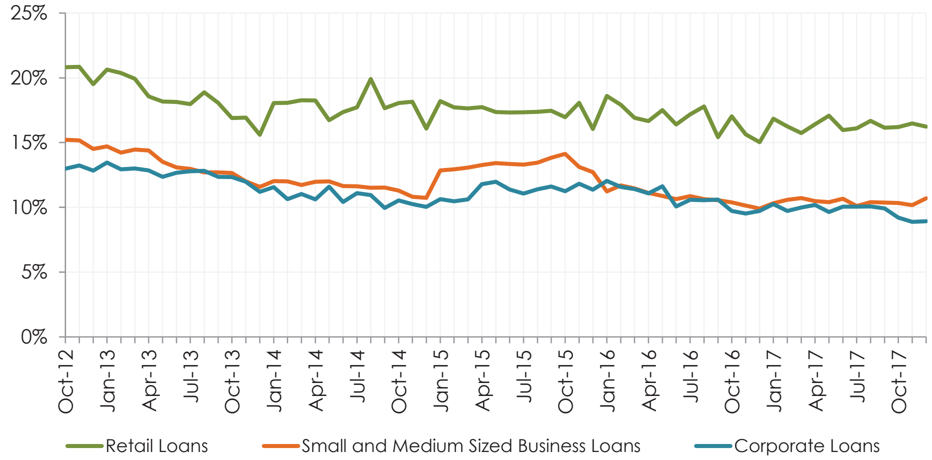


Source: National Bank of Georgia

In the fourth quarter of 2017, according to the same credit conditions survey, non-interest conditions for individuals and legal entities did not change, whereas interest conditions became stricter. Stricter credit conditions were observed for loans issued in both the domestic and foreign currency. Moreover, the change in credit supply conditions was mostly driven by broader economic trends, competition and the quality of credit portfolio. In December, compared to September, loans issued for small and medium enterprises grew by 0.3 pp and equaled 10.7%. For corporate loans, interest rates decreased by 1 pp and amounted to 8.9%, while interest rates on retail loans increased by 0.1 pp and equaled 16.2% (see Figure 5.6). In December, compared to September, the average interest rate on the stock of legal entities' domestic currency loans declined 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 are expected to become stricter.

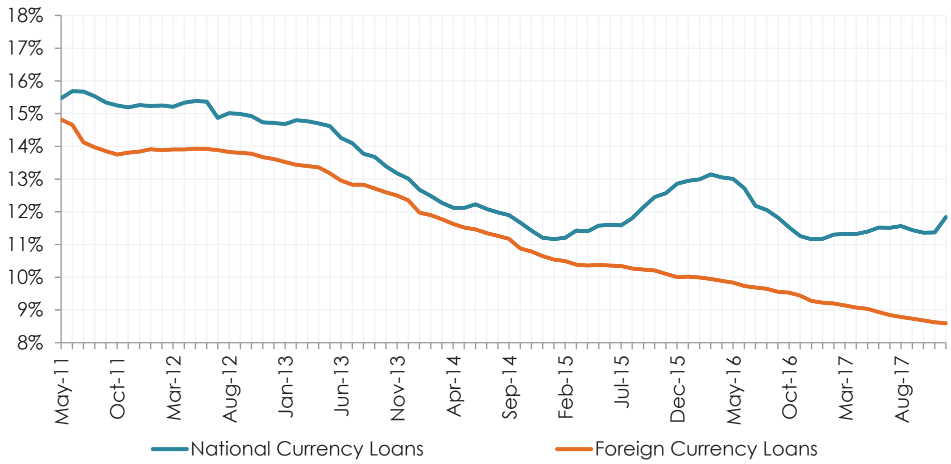
8 *LIBOR – the London Interbank Offered Rate.*

Figure 5.6 Interest Rate On Loan Flow



Source: National Bank of Georgia

Figure 5.7 Average Interest Rates On Business Loans



Source: National Bank of Georgia

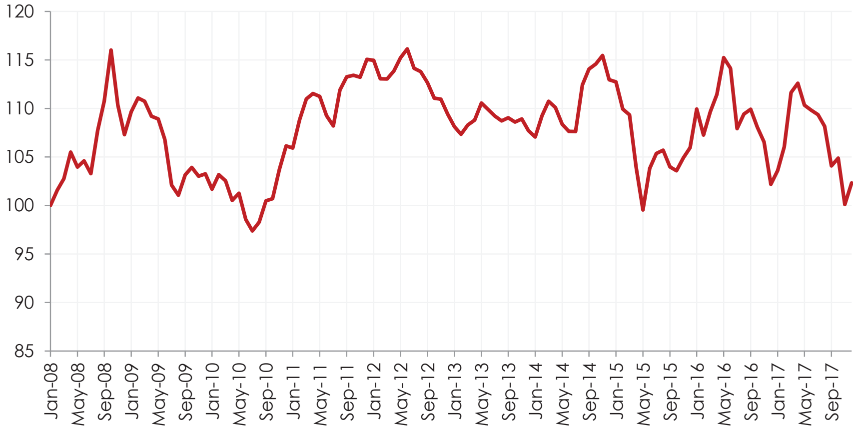
5.3. EXCHANGE RATE

In the fourth quarter of 2017, the GEL nominal effective exchange rate depreciated against the US dollar by 7.1%, and against the euro by 7.4% compared to the previous quarter. The GEL also depreciated against the Russian ruble by 8.0%, while appreciating by 1.0% against the Turkish lira. The nominal effective exchange rate depreciated by 5% quarterly, and by 3.9% on a year-on-year basis.

In the fourth quarter of 2017, the real effective exchange rate depreciated quarterly by 4.4%, and by 3.0% on a year-on-year basis.

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture (see Figure 5.2). In the fourth quarter of 2017, the adjusted nominal effective exchange rate depreciated by 5.2% year on year, and by 3.5% compared to the previous quarter.

Figure 5.8 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

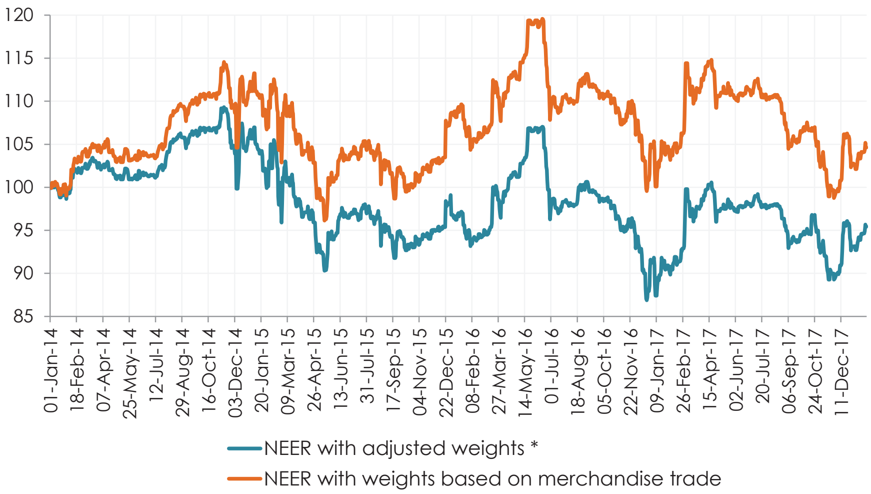
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	-3.9	-3.0	-3.0
Eurozone	-11.9	-7.3	-1.8
Turkey	11.4	5.9	1.2
Ukraine	0.0	-6.4	-0.4
Armenia	-3.1	1.4	0.1
The United States	-3.9	0.4	0.0
Russia	-11.1	-7.5	-0.9
Azerbaijan	-4.6	-7.8	-0.7
Other	-7.2	-2.7	-0.5

* 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

Box 2 FX Policy reform in Georgia

The main goal of macroeconomic policy is to achieve high and sustainable long-term growth. In order to support long-term growth in small, open economies monetary and FX policies operate in two main directions: (i) a flexible exchange rate to absorb external shocks to keep stable employment and income streams for households in the local currency; and (ii) low and stable inflation to keep the purchasing power of savings and future income streams in the local currency.

The National Bank of Georgia has implemented a number of measures to improve the frameworks of its monetary and foreign exchange policies. This short note focuses on reforms made to FX policy, which mostly occurred since 2009. The results of these changes were evident during the external shock of 2014-2015 when Georgia moved to greater exchange rate flexibility. If the reforms had not taken place in previous years, the NBG would not have had sufficient instruments available to choose the best response to this shock.

In 2009, the NBG made three main changes to its FX operations. The NBG

1. improved infrastructure for the interbank FX market;
2. improved mechanisms for the determination of the FX reference rate; and
3. switched from price-based to volume-based FX interventions.

Until 2009, interbank FX market trades were conducted during a limited time interval (of less than an hour) on the Tbilisi Interbank Exchange based on auction principles. Over this period, interventions from the NBG were common (occurring 17 times out of 22 working days per month in 2008). During the trade session, the NBG decided the volume of interventions needed to keep the exchange rate stable. The FX rates that were set during the sessions were announced as a reference rate by the NBG.

Since 2009, the interbank FX market has been based on bilateral trading and has moved to the Bloomberg platform. The new platform has a number of advantages: it extends trading hours to 24/7, participation is unlimited, and there are no additional fees other than the annual terminal fee. The system is a modern, reliable electronic platform, through which banks conduct FX transactions in a simple and riskless way. No NBG authorization is needed to subscribe to this platform.

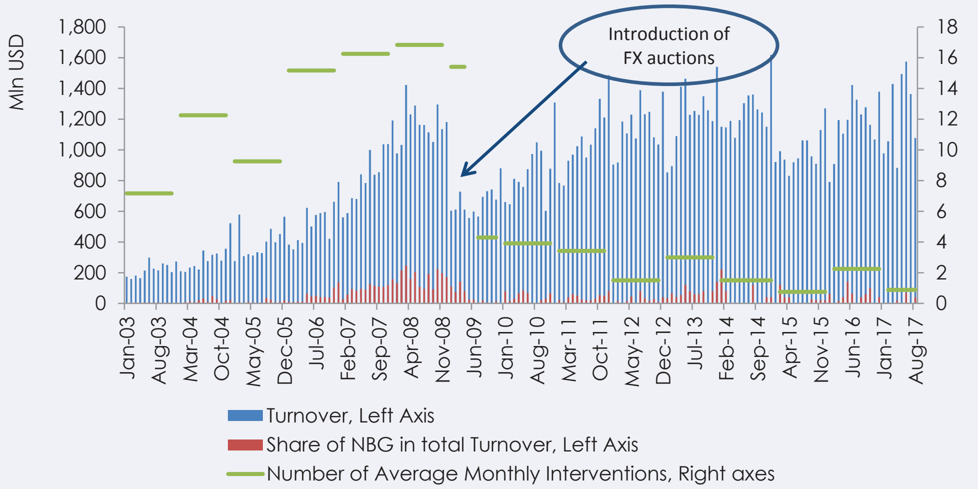
The new infrastructure, on which more than 95% of interbank FX deals are conducted, gives the NBG the opportunity to monitor interbank FX market operations in real time and allows the calculation of the reference rate, which reflects ongoing market dynamics. The reference rate is calculated based on interbank trade during the past 24 hours. The cut off time is 16:30 and the reference rate is published on the NBG's website at around 17:00.

The reference rate is calculated when the cumulative volume of transactions in the system exceeds 1.5 mln USD. If this does not occur, the NBG takes into consideration transactions from the previous period. The current threshold of 1.5 mln USD was introduced in 2018, before then the NBG calculated the reference rate based on a threshold of 3.0 mln USD. The official exchange rate will now be closer to the market exchange rate at times when market turnover is less than 3.0 mln USD.

In 2009, the NBG switched from price-based to volume-based FX interventions. Interventions are now conducted through the Bloomberg auction system. This was the most important of the FX policy reforms. In contrast to the former intervention mechanism, FX auctions today are based on market principles.

The introduction of FX auctions increased exchange rate flexibility and short-term fluctuations became unpredictable. As a result, speculative pressure on the foreign exchange market decreased, and the need for NBG interventions subsided. Following the implementation of the auctions in 2009, the number of NBG interventions decreased from an average of 17 per month to just 4 per month (see Figure 5.9). In 2017, there was fewer than one intervention per month on average

Figure 5.10 FX Market Turnover And NBG Interventions



Source: National Bank of Georgia

6. Aggregate Demand

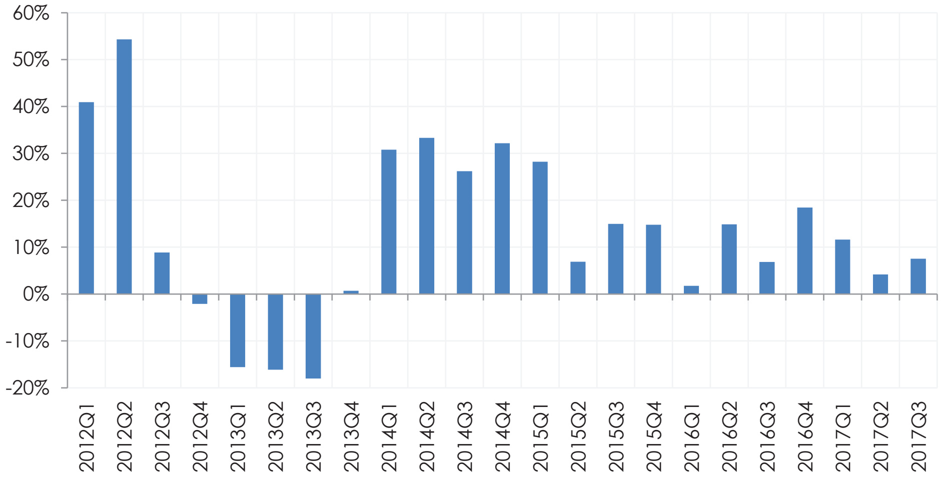
In the third quarter of 2017, real GDP growth amounted to 4.4%. Following the increase of external demand, the growth of net exports made the largest contribution to that growth. Meanwhile, internal demand remains weak. According to preliminary estimates, the growth of exports was maintained in the fourth quarter, and net exports are expected to remain an essential driver of economic growth.

‹‹ In the third quarter of 2017, real GDP growth amounted to 4.4%.

The capital formation growth rate increased, posting 7.6% growth in the third quarter of 2017 (see Figure 6.1). Capital formation was supported by increased foreign direct investments (mostly in the construction sector) and by local government and private investment.

‹‹ The capital formation growth rate increased, standing at 7.6% h in the third quarter of 2017.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

In the third quarter of 2017, the annual growth rate for private consumption was positive and totaled 0.3% (see Figure 6.2). Low growth indicates weak aggregate demand, while government expenditure increased in relative terms over the same period.

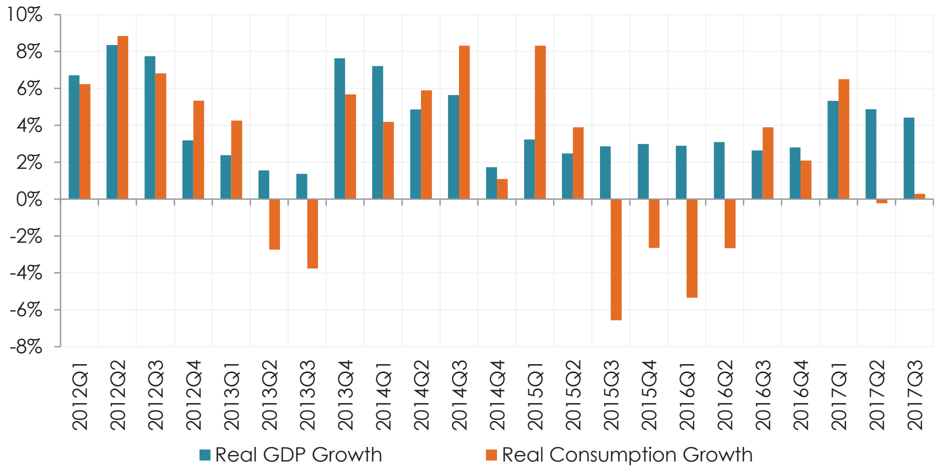
‹‹ In the third quarter of 2017, the annual growth rate for private consumption was positive and totaled 0.3%.

Following the growth of external demand, net exports have improved. In the third quarter of 2017, the growth of exports persisted, albeit at a slower rate than in the second quarter. Based on preliminary estimates, the growth of exports in the fourth quarter has remained high, despite an increase of the price index. Net exports are thus expected to have made a positive contribution to the GDP growth of the last quarter of 2017.

‹‹ In the third quarter of 2017, the growth of exports persisted.

Over the same period, the price index on imports has significantly increased. Therefore, despite the nominal increase in imports, real growth was low. Based on preliminary estimates, the nominal growth of imports was restrained by the increase in the price index on imported goods, as had also been the case in the third quarter.

Figure 6.2 Real GDP And Real Consumption Growth



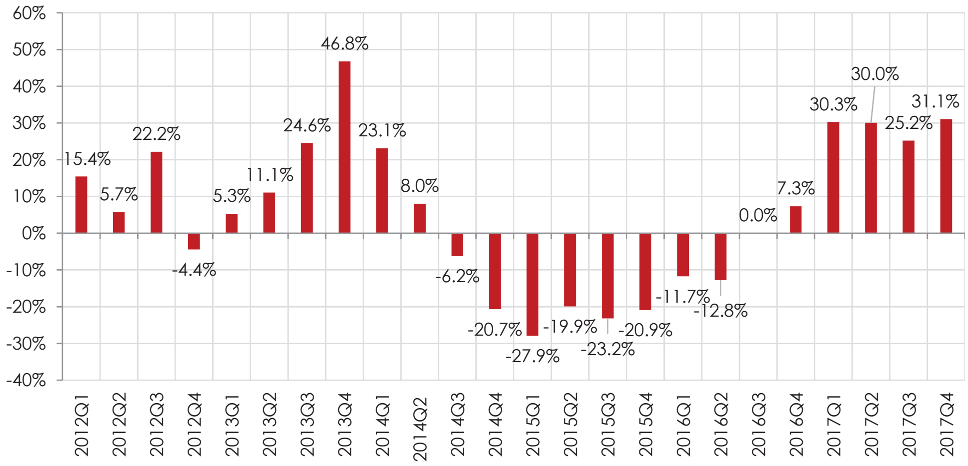
Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

Over 2017, Georgia's exports increased following the steady economic recovery of main trading partner countries. In light of increased external economic activity, in the fourth quarter of 2017 net exports increased by 31.1% annually (see Figure 7.1). Exports of intermediate and consumer goods – especially of ferroalloys, wines, cigarettes and cars – made the largest contribution to the growth.

‹‹ In the fourth quarter of 2017 net exports increased by 31.1% annually.

Figure 7.1 Annual Change in Registered Exports Of Goods

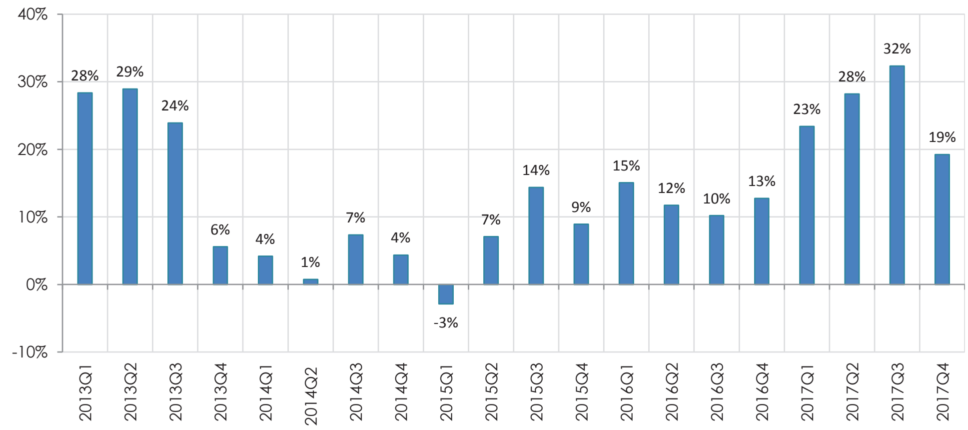


Source: GeoStat

The volume of exports increased significantly as a result of the economic recovery of the main trading partner countries. Compared to the same period last year, the volume of exports to Russia and Turkey increased on average by 63% and 65% respectively. Among CIS countries, exports grew to Azerbaijan, Armenia and Ukraine. The volume of exports also increased to China and the USA. 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 had been increasing at high rates throughout the year and the trend continued in the fourth quarter, where quarterly revenues from tourism amounted to 575 million USD, which was 19.2% higher than in the same period last year (see Figure 7.2).

‹‹ In the fourth quarter, tourism revenues stood at 575 million USD, which was 19.2% higher than in the same period last year.

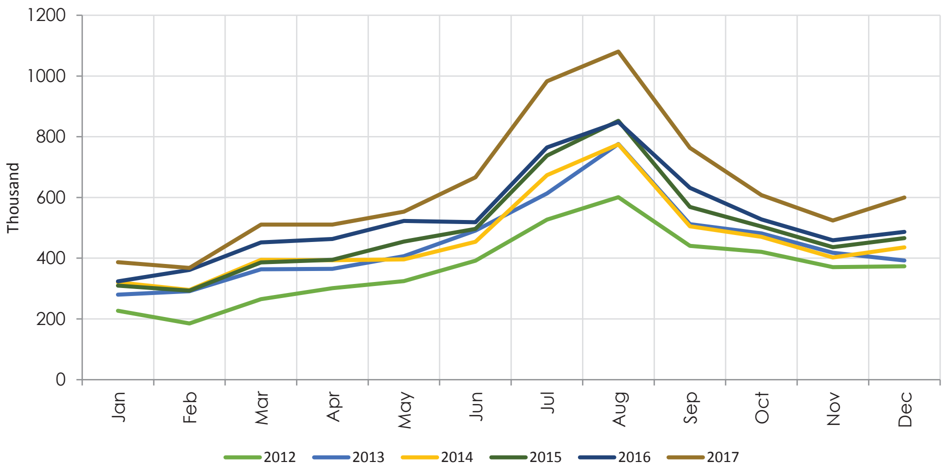
Figure 7.2 Annual Change in Revenues from Tourism



Source: National Bank of Georgia

Inflows of international visitors, especially tourist[9] arrivals, continued to grow. In the fourth quarter of 2017, the number of foreign visitors who entered Georgia increased by 18% (see Figure 7.3), of which 40% were tourists. Travelers from neighboring countries (Azerbaijan, Armenia, Turkey and Russia) made a significant contribution to that growth. In addition, there was a substantial increase in the number of visitors from Iran, Israel and India.

Figure 7.3 Number of International Visitors to Georgia

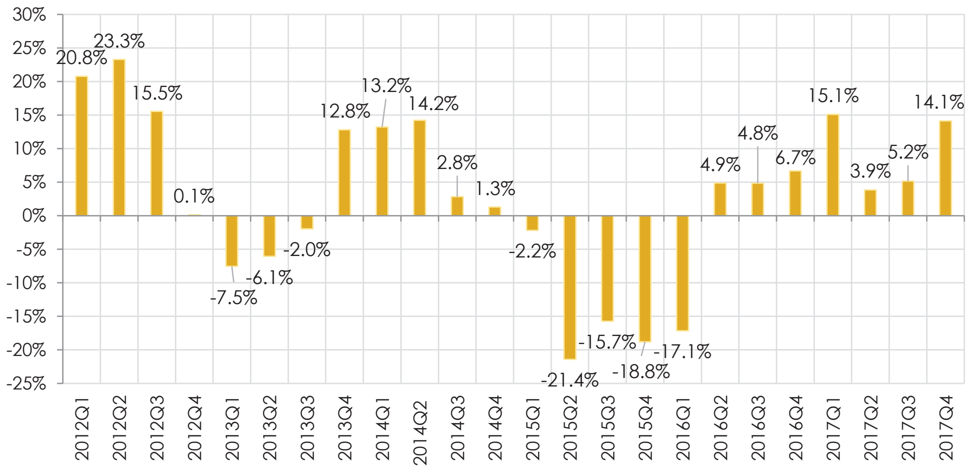


Source: GNTA

Compared to the growth of exports in goods and services, imports increased at a relatively slower pace – rising by only 14.1% in the fourth quarter of 2017 (see Figure 7.4). Imports of goods grew from CIS countries, but declined from EU countries. The growth of imports can be attributed to increased demand for intermediate and consumer goods.

‹‹ In the fourth quarter of 2017, registered imports grew by 14.1% annually.

Figure 7.4 Annual Change in Registered Imports Of Goods



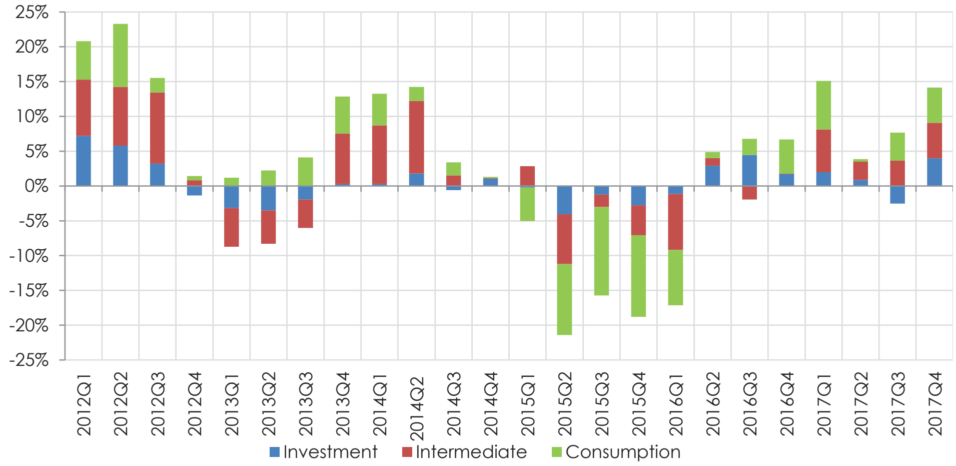
Source: GeoStat

In the fourth quarter, imports of intermediate and consumer goods accounted for 40% and 44% of total imports respectively. Imports of intermediate goods increased by 12.5%, contributing 5.1% to the total growth of imports, while imports of consumer goods grew by 11.1%, adding 5.1% to total imports (see Figure 7.5). Moreover, with the increase in Foreign Direct Investment (FDI), imports of investment goods also increased.

‹‹ In the fourth quarter, the increase in imports was driven by the growing demand for imports of intermediate and consumer goods.

9 *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

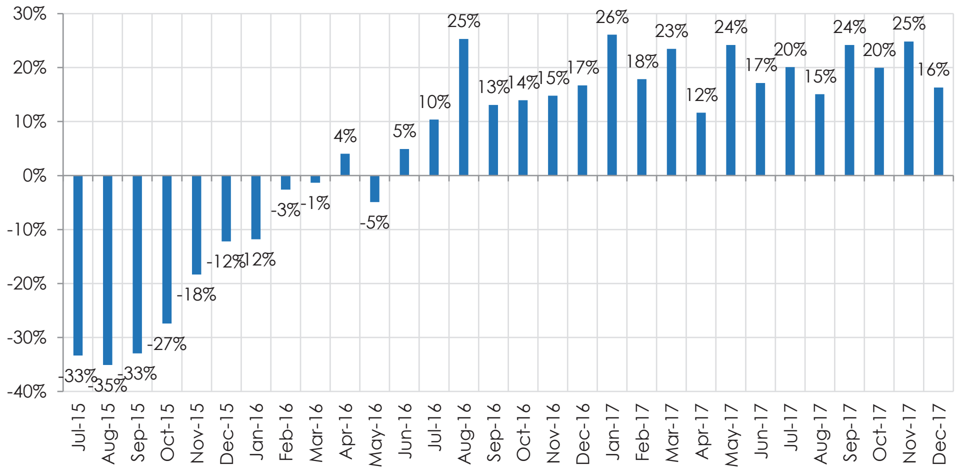


Source: GeoStat

Remittances to Georgia also revealed an increasing trend. In the fourth quarter of 2017, the volume of money transfers to Georgia increased by 20.1% (see Figure 7.6), which was mainly driven by increased transfers from Russia and the European Union (notably Greece and Italy). The substantial increase in money transfers from Israel and Turkey are particularly noteworthy, and the volume of remittances from the U.S. and Ukraine also slightly increased.

« In the fourth quarter of 2017, the volume of money transfers to Georgia increased by 20.1%.

Figure 7.6 Annual Change in Remittances



Source: National Bank of Georgia

The current account has improved, supported by the increase in net exports, rising remittances and the relatively low growth of imports. The current account deficit substantially improved in the first three quarters of 2017 and amounted to 7.1% of GDP, compared to 11.2% in 2016. However, the income account deficit of the current account has deepened since 2016 – a result of the increased profits of direct investor enterprises (reflected in the growth of both dividends and reinvested income). This trend persisted in 2017. Thus, improvements in the current account deficit were moderately hindered by the negative investment income account.

« In the third quarter of 2017, the growth of negative investment income account persisted.

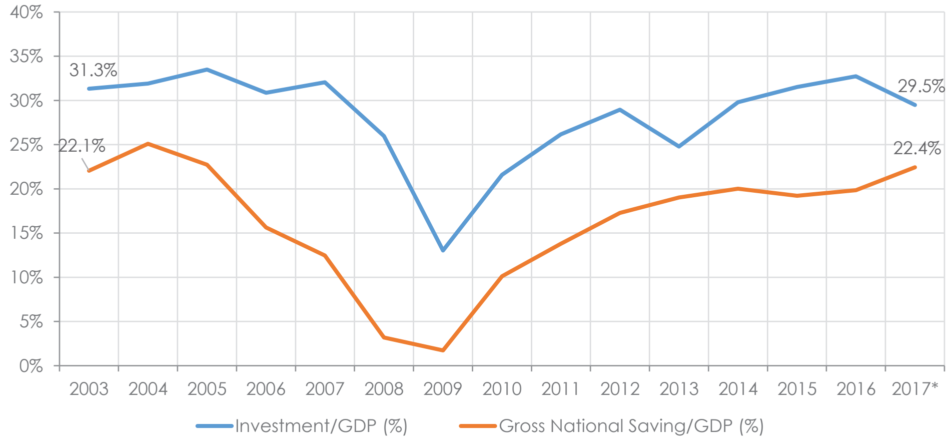
Foreign direct investments remain the primary source of financing the current account deficit. In the third quarter of 2017, FDI in Georgia amounted to 594 million USD. The transport sector continues to be the largest recipient sector of FDI, receiving 164 million USD (28%). The construction and energy sectors were also significant recipients of FDI, receiving 20% (116 million USD) and 12% (72 million USD) respectively.

« Foreign direct investments remain the primary source of financing the current account deficit.

An analysis of investments and savings reveals that the improvement of the current account deficit was driven by both a decrease in investment and an increase in savings. The ratio of investments to GDP declined by 3.2 pp and reached 29.5%, while the ratio of savings to GDP grew by 2.6 pp to 22.4 % (see Figure 7.7).

« The improvement of the current account deficit was driven both by a decrease in investment and an increase in savings.

Figure 7.7 Investments and Savings



* data contains first three quarters of year 2017.

Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

In the third quarter of 2017, GDP grew by 4.4%. The service sector made the most significant contribution to overall growth, contributing 3.4 pp. Industries added 1.3 pp and the agriculture sector's contribution was negative at -0.2 pp (see Figure 8.1).

The growth of the trade sector made a substantial contribution to the improved economic activity . In the third quarter, the annual growth of trade totaled 9.6%, contributing 1.4 pp to the overall growth – indicating the relative recovery of economic activity and domestic demand. Economic growth was supported by the increased inflow of international visitors. Rising numbers of tourists directly affected the output of the service sector, particularly of hotels and restaurants, transport, and real estate operations.

‹‹ The growth of the trade sector made a substantial contribution to the improved economic activity.

‹‹ The output growth was supported by the increased inflow of international visitors.

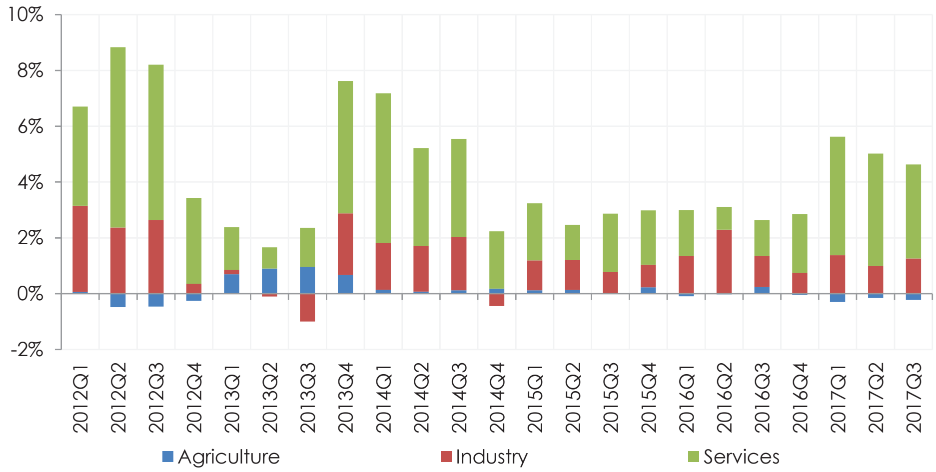
Real estate operations increased by 6.3% (a 0.4 pp contribution to overall growth). This growth was a result of intensive construction activities, which were assisted by rising demand from foreign citizens in the third quarter of 2017. Meanwhile, the hotels and restaurants sector grew by 12.6% (a 0.3 pp contribution to total growth). The growth of the transport sector was also significant (except for railways). As a whole, the transport sector grew by 3.8% in the third quarter of 2017 and contributed 0.3 pp to the overall growth.

In 2017, significant growth was also seen in the communications sector. Although slowing from the pace of the first half of the year, the growth in the third quarter remained high, standing at 4.8%. Meanwhile, the growth of the financial sector remained characteristically steady, standing at 7.2%. Construction made the most significant contribution to economic growth from the industrial sector. In addition to the extensive gas pipeline project, construction activity also increased in both public and private sectors. In total, construction grew by 9.3%, contributing 0.4 pp to total growth.

‹‹ The growth of construction persisted .

The output of the agriculture sector declined. In the third quarter, the sector fell by 2.8% annually, making a negative contribution of -0.2 pp to total growth.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat.

2, Sanapiro Str., Tbilisi 0114, Georgia

Tel.: (995 32) 240 6480; Fax: (995 32) 240 6571; Hot line: (995 32) 240 6406

E-mail: info@nbg.ge; www.nbg.ge