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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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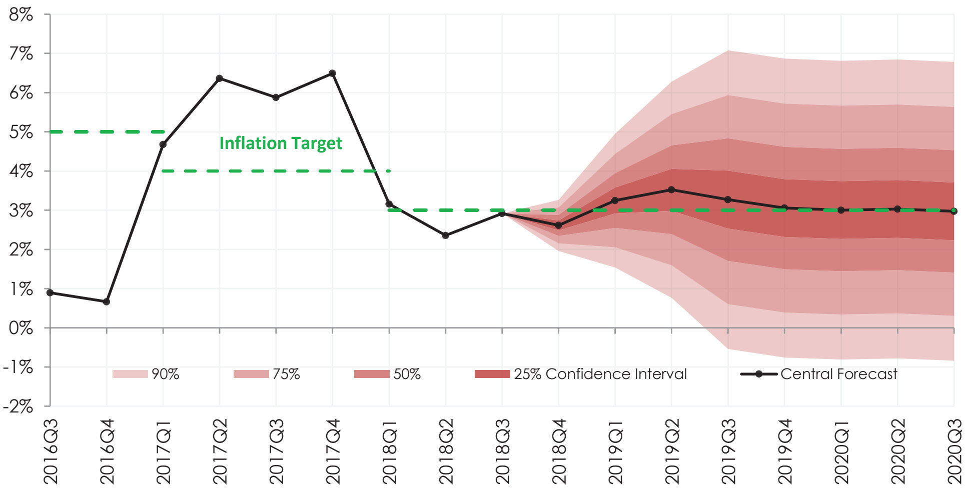
1. Brief Overview

In the third quarter of 2018, **annual inflation** stood slightly higher than previously expected at 2.9%. This was mainly a consequence of higher oil prices on international markets, which itself led to an increase in local prices of petrol and petrol-related products. The latter outweighed the downward pressure coming from low imported inflation and the still weak aggregate demand. Notwithstanding the increase in oil prices, annual inflation, which stood at 2.7% in September, remains close to the 3% target.

According to the National Bank of Georgia's **forecast, inflation** will remain close to the target level of 3% for the remainder of 2018, as well as in the medium term (see Figure 1.1). In the forecast, imported inflation – stemming from the appreciation of the nominal effective exchange rate and continued weak aggregate demand – creates downward pressure on overall inflation; however, over the course of next year this pressure will be balanced by the effect of increased prices on petrol and petrol-related products. Alongside the elimination of these one-time factors in the medium term, aggregate demand is also expected to increase to the potential output level – keeping inflation close to the target.

Figure 1.1 Headline CPI Inflation

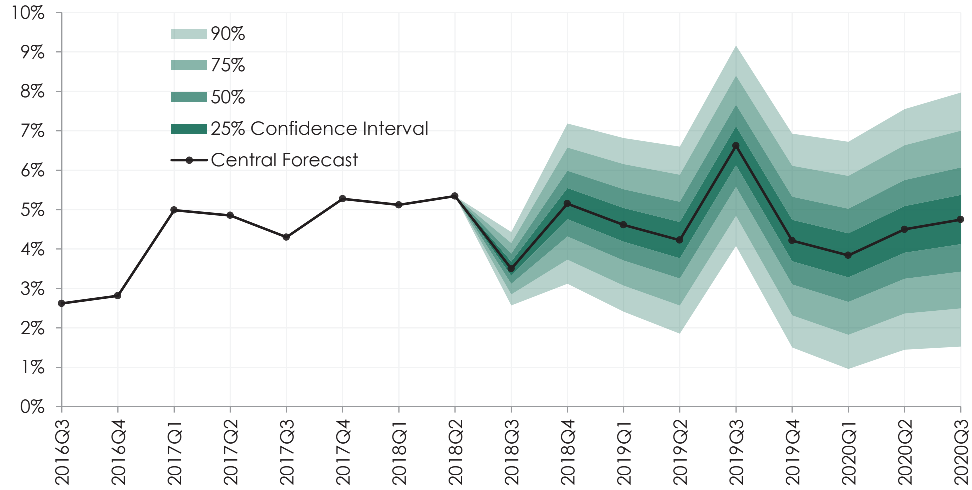


Source: National Bank of Georgia

In the first half of 2018, as in 2017, the annual growth of the **real Gross Domestic Product** (GDP) was slightly higher than previously expected, amounting to 5.4%. The improvement in economic activity was driven by favorable trends in the external sector and the recovery of domestic demand. However, it should be noted that the risk of economic growth slowing has risen in recent months as a consequence of increased uncertainty in the region, especially in Turkey – which has already been reflected in reduced money transfers and tourist revenues from that country – and partly due to weaker fiscal impulse compared to the previous year.

The NBG's **forecast of real GDP growth** for 2018 remains the same as last quarter at 5.5% (see Figure 1.2). Despite the rising risks of economic growth slowing, it is expected that the slowdown observed in recent months will only be temporary. The growth forecast for 2019 has also been maintained at 5%, in line with previous projections. According to the current forecast, net exports, consumption and investments will all positively contribute to real GDP growth over 2018 and 2019. According to the baseline scenario, these will be supported by capital spending of the government and a moderate growth of loans. Aggregate demand is expected to gradually increase towards the potential level of economic activity and the output gap is projected to close within the next two years.

Figure 1.2 Annual Real GDP Growth



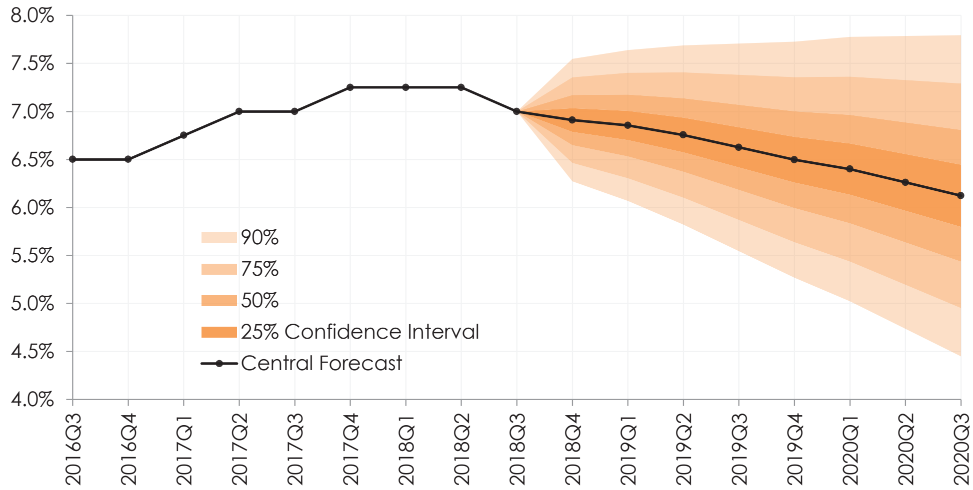
Source: National Bank of Georgia

It should be noted that monetary policy cannot aim to fully neutralize temporary factors affecting the inflation rate in the short run. That objective could only be reached through policy changes, which might lead to extreme fluctuations in economic growth and employment. Therefore, the National Bank of Georgia tries to strike a balance in its decision making, considering the expected timeframe over which the inflation rate will return to the target level and estimating the possible effects on economic growth.

To curb inflationary expectations, over the course of 2017 the NBG gradually increased the monetary policy rate from 6.50% to 7.25%. However, based on the current macroeconomic forecast, following the decline of inflation to its target level of 3%, **the monetary policy rate is expected** to decline to its neutral level in the medium term (see Figure 1.3). Even though economic activity is moderate and imported inflation has decreased because of heightened risks in the region, the reduction of the monetary policy rate will proceed at a slow pace. As a result, the policy rate will only return to its neutral level (of around 5.5-6% as per current estimates) after two years.

It should be noted that the monetary policy rate forecast is not a commitment to 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

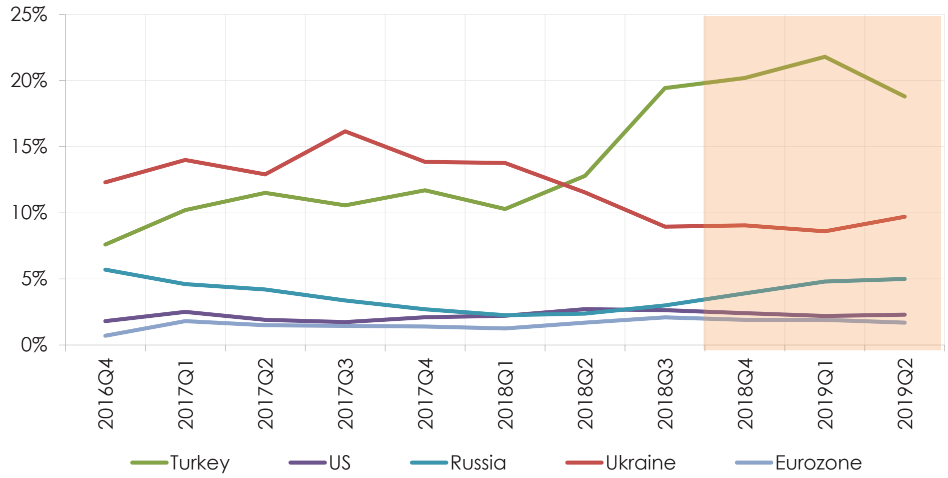
The forecasts depend on **exogenous factors and contain risks both in upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth of Georgia's main trading partners, the global trends of the euro and US dollar, and international prices of oil and food. In terms of domestic factors, risks stem from changes to the fiscal deficit, credit activity and business sentiment. Hence, if external and/or domestic factors evolve differently than is currently expected, this may influence macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

After the robust economic activity of 2017, **global growth** in the second half of 2018 weakened. This trend was most evident in advanced economies, including in the eurozone and the UK; while moderately high growth was maintained in emerging and developing countries. The exception to this was the US economy, where economic activity increased considerably based on strong fiscal stimulus. However, according to the IMF, the current "trade-war" between the US and its trading partners poses a threat for the parties directly involved and for the global economy as a whole.[1] This underpins the change in the IMF's growth forecast for 2018-2019, which now stands at 3.7%, a 0.2 percentage point (pp) reduction from the previous forecast of April 2018.[2]

Figure 2.1 Real GDP Growth of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Georgia's economy is heavily dependent upon macroeconomic trends in its trading partner countries. In particular, recent developments in **Turkey** have resulted in a decline in trade and other financial inflows to Georgia. In the third quarter, Turkey's economic performance fell significantly, which was followed by a deterioration of consumer and business sentiment. Uncertainty around the Central Bank's policy and excessive fiscal stimulus was accompanied by US tariffs on Turkish steel, which led to the sharp depreciation of the Turkish lira (by around 30%) in August, while in September annual inflation surged to 25%. According to the IMF's forecast, the current challenges will continue in the medium term and real GDP growth will decrease to 3.5%, falling by almost 1 pp, while growth in 2019 is expected to equal 0.4%. Meanwhile, the normalization of inflation will take time and, according to the IMF, average inflation over 2018-2019 will be around 15-16%.[3]

Tourist revenues and money transfers also fell from **Russia**, albeit to a lesser extent. This was mostly caused by the depreciation of the ruble, alongside unfavorable trends in the country. Together with the August-September sanctions from the US and the fluctuations of emerging financial markets caused by events in Turkey, the ruble depreciated by 10%. However, the exchange rate stabilized relatively soon afterwards, which was a result of tighter monetary policy and the increase of inter-

1 *International Monetary Fund. World Economic Outlook: Challenges to Steady Growth. Washington, D.C., October 2018.*

2 *International Monetary Fund. World Economic Outlook: Cyclical Upswing, Structural Change. Washington, D.C., April 2018.*

3 *International Monetary Fund. World Economic Outlook: Challenges to Steady Growth. Washington, D.C., October 2018.*

national oil prices. A planned increase in the VAT rate and possible complications in the geopolitical environment render the economic outlook uncertain for Russia. According to the IMF's forecast, average growth in 2018-2019 will equal 1.75%, while inflation will remain close to the target of 4%.[4]

The recovery of **Ukraine's** economy continued in the second half of 2018. Increasing fiscal spending and improved conditions on the labor market significantly encouraged consumer spending. However, according to the IMF's forecast, due to severe geopolitical risks and the uncertainty hovering over structural reforms in the country, economic growth for 2018-2019 will remain low at around 3%. Meanwhile, following the depreciation of the local currency, the inflation forecast is high at around 10%.[5]

Regardless of the reduced fiscal spending observed under the new government, **Armenia's** economy still looks solid – a consequence of stable money transfers from Russia, loose monetary policy and increased lending. The IMF's forecast of real GDP growth for the country in 2018-2019 is around 5%, while for inflation it is close to 4%.[6]

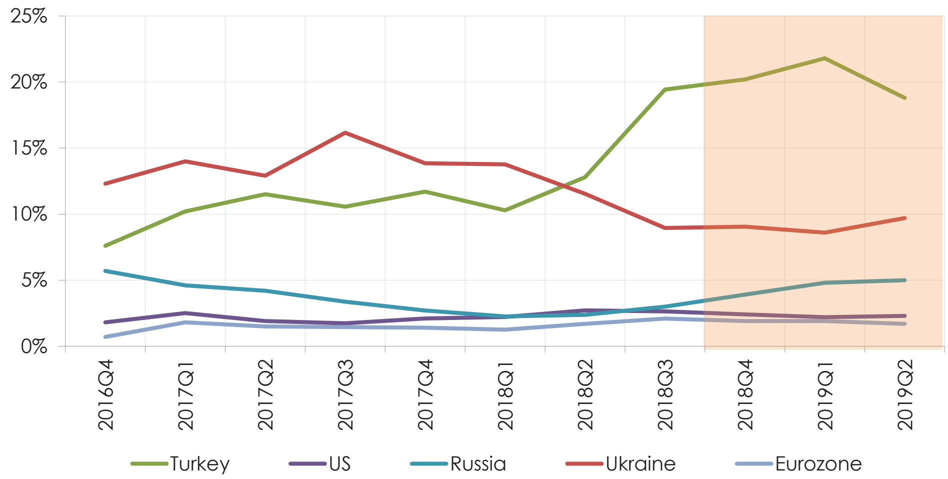
Azerbaijan's economy has been growing moderately and has gradually started to recover following international oil price dynamics. In addition, activity in the non-oil sector has been significant from the beginning of the year. According to the IMF's forecast, on average, real GDP growth in 2018-2019 will equal 3%, while inflation will remain around 3.4%.[7]

According to the current forecast, economic growth in the **eurozone** is slightly sluggish – a consequence of a slowdown in export growth (in line with the global downturn of trade) and increasing international oil prices. In addition, consumer sentiment has declined in recent months, which has had a negative effect on the growth of retail sales in the eurozone. Based on its latest forecast, the IMF reduced its projections of the eurozone's real GDP growth by 0.4 pp, to 2%, while the 2019 forecast remains unchanged at 1.9%.[8]

On the back of fiscal stimulus, the **US** economy is growing at a high rate. However, the recent escalation of the "trade war" is expected to have a negative effect on the economic outlook – as is the rising inflation rate and interest rate hikes by the Federal Reserve (FED). Thus, the IMF has maintained its forecast for real GDP growth for 2018 at 2.9%, while revising the forecast for 2019 to 2.5%.[9]

In response to rising inflation expectations following the depreciation of their local currencies, the central banks of Turkey, Ukraine and Russia have all started to tighten monetary policy. This was somewhat unexpected on the financial markets, which had expected the FED to raise interest rates in September. In addition, following the current forecast, the federal funds rate will increase one more time this year, followed by a further three times next year, thereby rising from the current 2% to 3%.

Figure 2.2 Headline Inflation Rates of Economic Partners



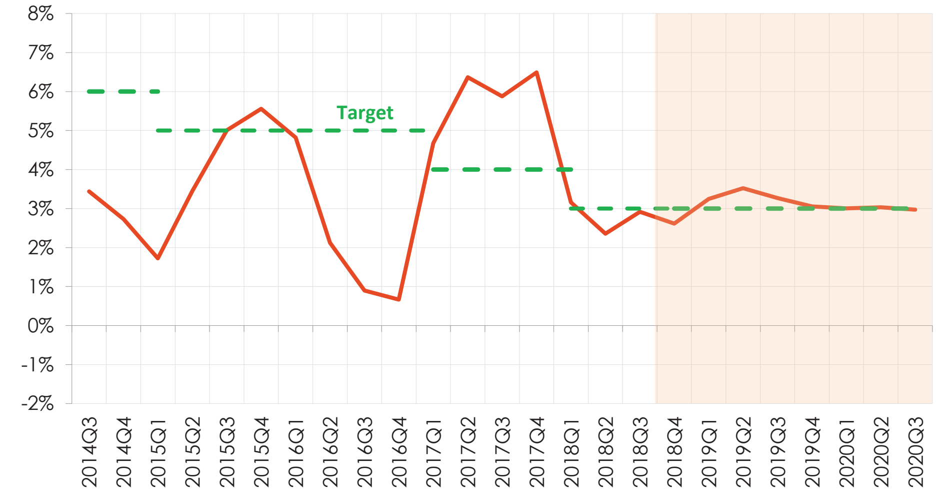
Source: Bloomberg; National Bank of Georgia.

4 *Ibid.*
5 *Ibid.*
6 *Ibid.*
7 *Ibid.*
8 *Ibid.*
9 *Ibid.*

2.2 MACROECONOMIC FORECAST

In the third quarter of 2018, **annual inflation** stood slightly higher than previously predicted and equaled 2.9%. Even though imported inflation – as influenced by the appreciation of the nominal exchange rate – put downward pressure on prices (just like weaker demand), higher oil prices on international markets caused local prices of fuel and fuel-related products to rise.

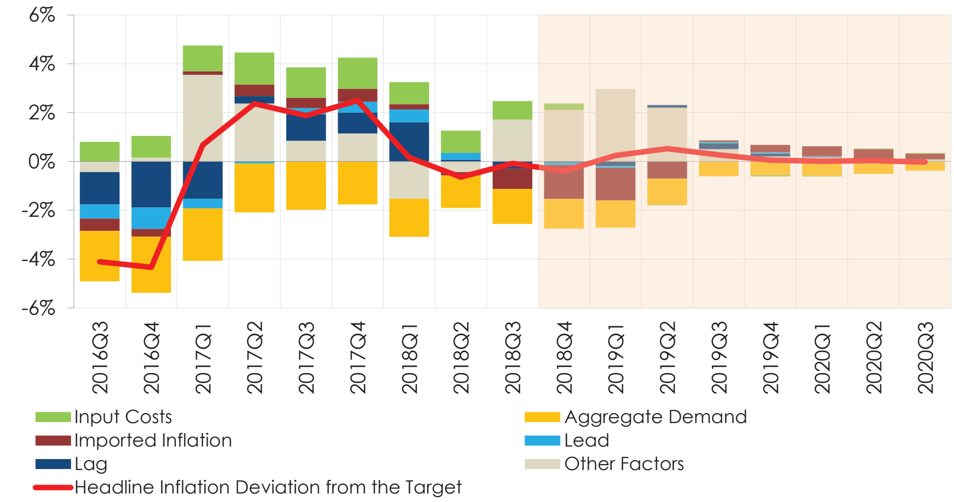
Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

According to the current forecast, annual inflation will remain around the target level of 3% in 2018 and over the medium term (see Figure 2.3). It should be noted that one-time factors will put upward pressure on prices over the next year – in particular, the increased tariffs on electricity and water at the beginning of the year and the recently heightened fuel prices. Nevertheless, lower imported inflation, following the appreciation of the nominal exchange rate, as well as weak aggregate demand will partly balance the effect of those one-time factors. In the medium term, as these factors fade out, aggregate demand is expected to increase to the potential level of output, thereby keeping inflation close to the target (see Figure 2.4).

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



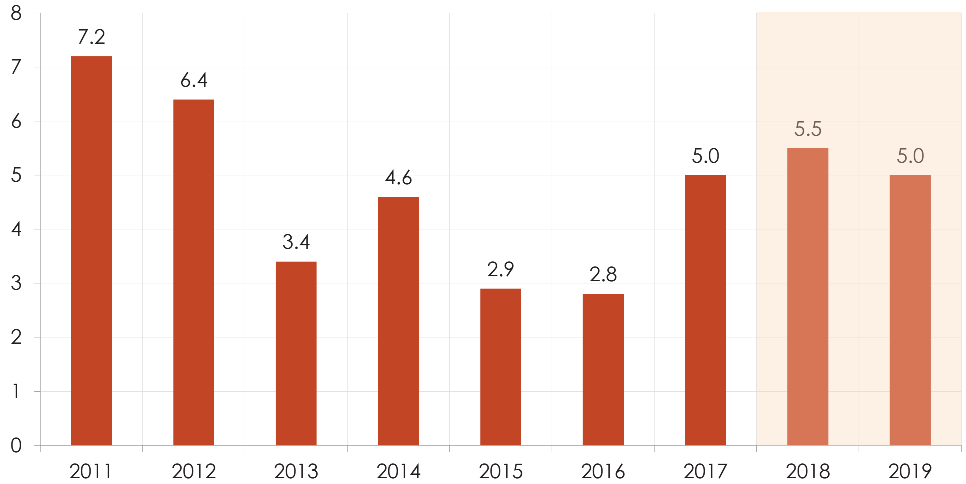
Source: National Bank of Georgia.

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.

A range of less probable but yet still plausible factors may cause the **inflation rate to deviate** from its projected path. On the one hand, a substantial increase in consumer prices could be driven by a deterioration of geopolitical and economic conditions in the region. Realization of such risks may lead to an increase of risk premiums for the whole region, including Georgia, which would cause a depreciation of local currencies and, as a consequence of increasing payments on foreign currency loans, will drive annual inflation above the predicted level. Another potential cause of upward pressure on inflation could be a sharp increase in international commodity prices (oil and food). On the other hand, consumer prices could be lower than expected if domestic demand decreases, which itself would depend on the size of fiscal stimulus and on the growth of credit activity. Furthermore, an escalation of the "trade war" between the US and its main trading partners contains certain risks. If this causes a global depreciation of the US dollar, the corresponding appreciation of the lari exchange rate may reduce the credit burden of firms as well as inflation expectations, which will ultimately make consumer products cheaper.

In the first half of 2018, real GDP growth equaled 5.4%; however, the preliminary estimate for the third quarter is much less at 4%.[11] This unexpectedly low growth was driven by both domestic and foreign factors. Among the domestic factors, the mitigation of fiscal stimulus was notable; while external factors included the reduction of money transfers and tourist revenues from Turkey and Iran, where unfavorable economic trends were observed.

Figure 2.5 Real GDP Growth



Source: National Bank of Georgia.

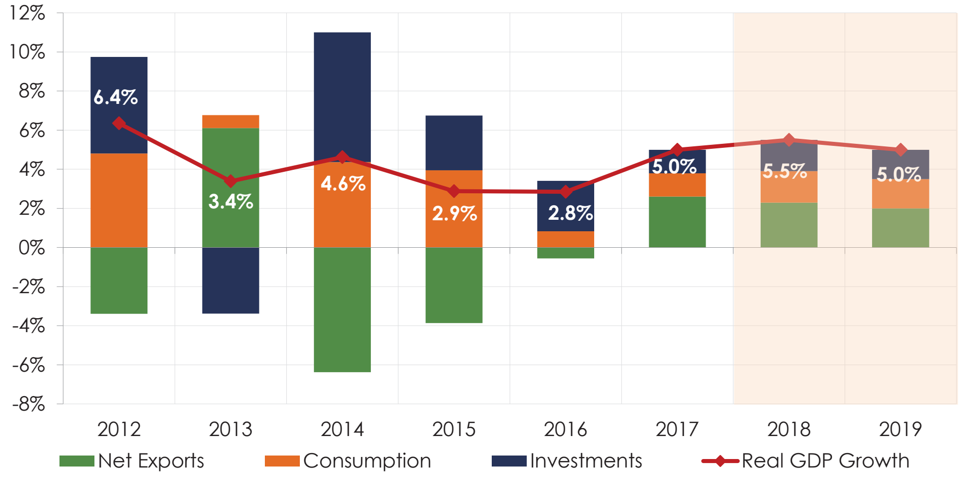
The volatility of economic activity has increased; however, according to current estimates, this is only temporary. Although the NBG has kept the real GDP growth forecast unchanged at 5.5% (Figure 2.5), the risks to the forecast loom large. As for 2019, growth forecast for it has also been maintained at 5%. The primary driving force of economic growth will still be net exports, but the contribution of consumption and investment will also be sizable, assuming the planned fiscal stimulus and a reasonable growth of credit activity.

The current forecast of real GDP might prove inaccurate if some less probable yet still plausible scenarios unfold. In this regard, it is important to mention the risks to economic growth. If fiscal stimulus remains weak or the growth of the credit portfolio is less than expected, then economic activity will grow at a slower rate than predicted. Moreover, any deterioration of the geopolitical environment would increase sovereign risk premiums in the region and lead to a decrease in financial inflows. The latter would negatively affect business sentiment and investment, and therefore ensure that economic activity will be lower than expected. Conversely, if business sentiment improves, then investments and resulting economic activity will be higher than expected.

In the second quarter of 2018, **the current account deficit** equaled 8.8%, while in the last four quarters it stood at 9.2%. This is a slightly lower figure than that of the

11 Preliminary results of the National Statistics Office of Georgia. See: http://geostat.ge/cms/site_images/_files/georgian/economic/ekonomikuri%20zrda_seqtemberi(geo)_2018.pdf

Figure 2.6 Real GDP Growth Decomposition



Source: National Bank of Georgia

previous year, but it shows relative improvement compared to the long-term historical index. This trend was a result of a substantial recovery in external demand. According to the short- and medium-term forecasts, the ratio of current account deficit to GDP will stay in single-digit territory as long as trading partner countries maintain a stable economic environment and the modest growth of exports and other revenues from the external sector persist. This will also be supported by a close-to-equilibrium real effective exchange rate.

Inflation forecast targeting is the most efficient framework to reach the ultimate goal of the National Bank of Georgia: price stability. To ensure that inflation reaches the target level in the medium term, the NBG uses the monetary policy rate. Under the inflation targeting framework, the NBG takes into account aggregate output. Hence, responses to supply side shocks are gradual and balanced in order to avoid high output volatility. In times of uncertainty, gradual changes to the policy rate are considered optimal for efficiently controlling long-term interest rates. The inflation forecast includes the interest rate forecast, which takes each of the above-mentioned factors into account.

Based on the forecast, in the medium term, the short-term interest rate will continue its moderate normalization process on the back of inflation hovering around the target level and economic activity remaining below the potential level. According to the baseline scenario, **a slightly declining monetary policy rate path** is the optimal response to the factors mentioned above (see Figure 1.3); however, the reduction of the rate, as a result of uncertainty in the region, will be slower than previously anticipated. The monetary policy rate will return to its neutral level over a 2-year period. The neutral policy rate level is estimated to range between 5.5-6%.

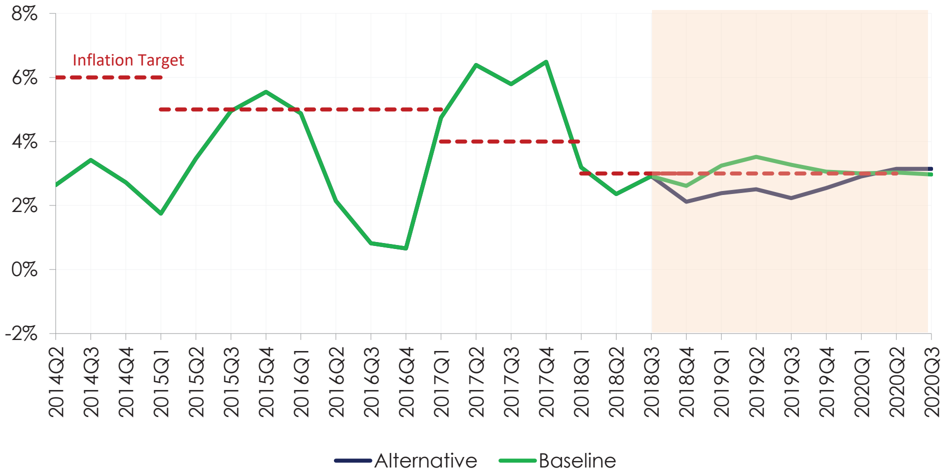
It should be stated that the forecast of the **monetary policy rate is not a promise from the National Bank of Georgia regarding future decisions**. It only reflects the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected.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

2.3 ALTERNATIVE FORECAST SCENARIO

In the alternative forecast scenario, aggregate demand increases at a slower pace than in the baseline forecast. In the first half of 2018, real GDP growth was relatively high. However, in the second half of the year it slowed somewhat as a result of smaller-than-anticipated fiscal stimulus and deteriorated economic conditions in trading partner countries. In particular, economic activity weakened in Turkey, which has had a negative impact on external demand for Georgian products. Under the alternative forecast scenario, the effect of the new regulations on household borrowing are assumed to be higher, with a greater reduction in the growth of credit activity suppressing domestic demand and causing real economic growth to slow. With weaker aggregate demand, inflation also stays at a lower level. Hence, in this scenario, both real GDP growth (see Figure 2.7) and inflation (see Figure 2.8) are lower than in the baseline scenario.

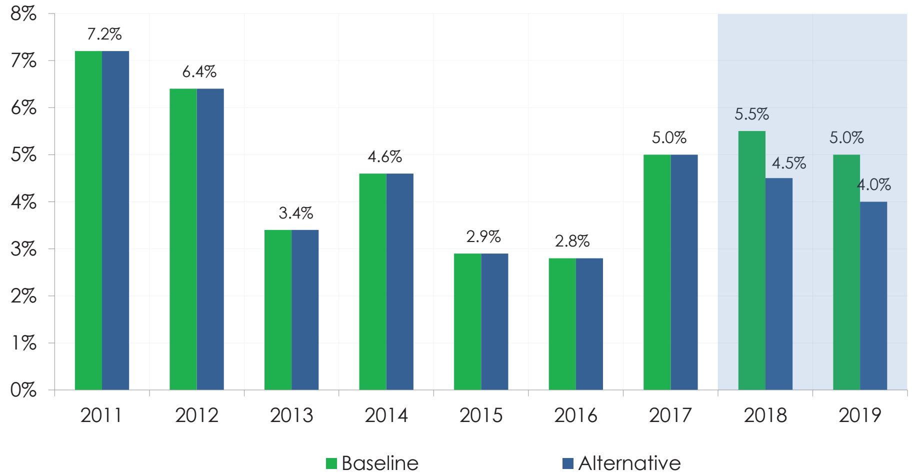
According to the alternative forecast scenario, during 2018-2019, inflation will be 0.8 percentage points lower than in the baseline projection (see Figure 2.7). In response, to support aggregate demand and push inflation back towards its target, the monetary policy trajectory will shift down by 0.6 percentage points (see Figure 2.9). Despite this policy easing, weaker aggregate demand will still result in lower GDP growth, which will stand at 4% for 2019 as opposed to 5% in the baseline scenario (see Figure 2.8). However, the easing of monetary policy will eventually drive inflation to the target level of 3% 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

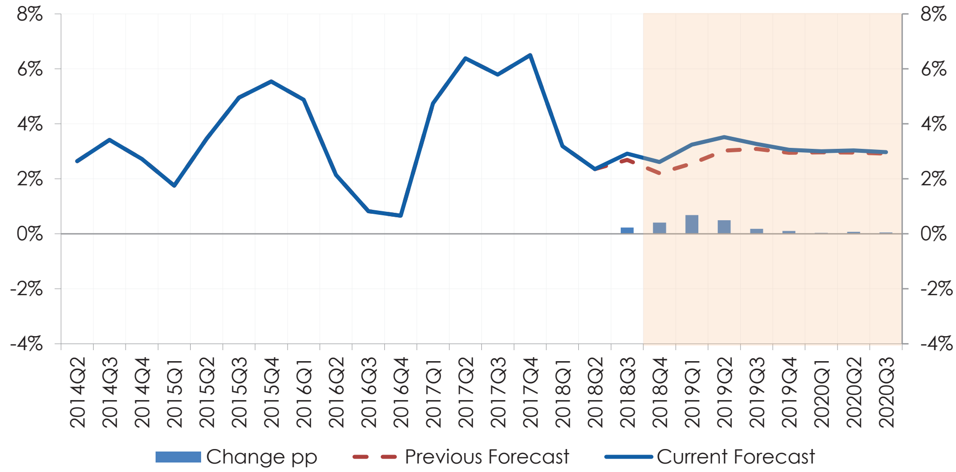
Figure 2.9 The Difference in the Monetary Policy Rate in Alternative and Baseline Scenarios

Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

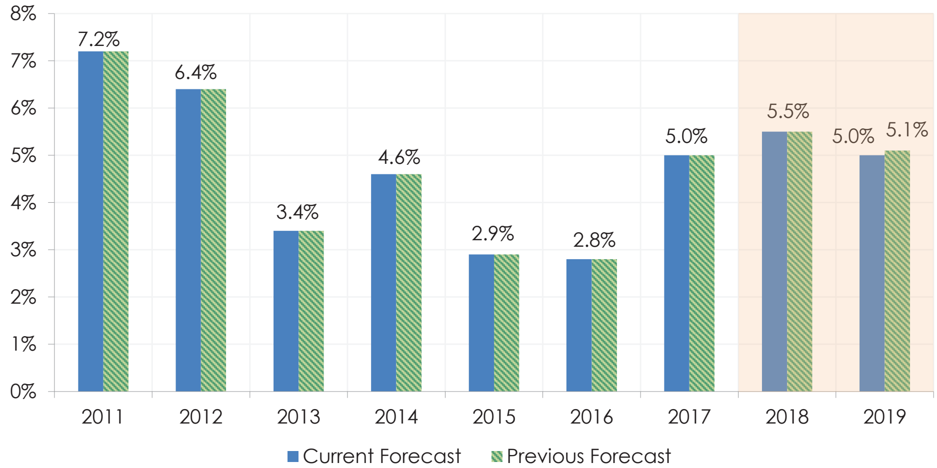
The inflation forecast has been revised slightly upwards compared to the projections of the previous quarter (see Figure 2.10). However, the main factors that the earlier forecast was based on have not changed significantly. The slight upward revision was mainly driven by increased oil prices on international markets and a planned increase in tobacco excise taxes. According to the revised forecast, inflation is expected to remain close to the target level of 3% in both 2018 and in the medium run.

Figure 2.10 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

Figure 2.11 Changes in the Forecast of GDP Growth



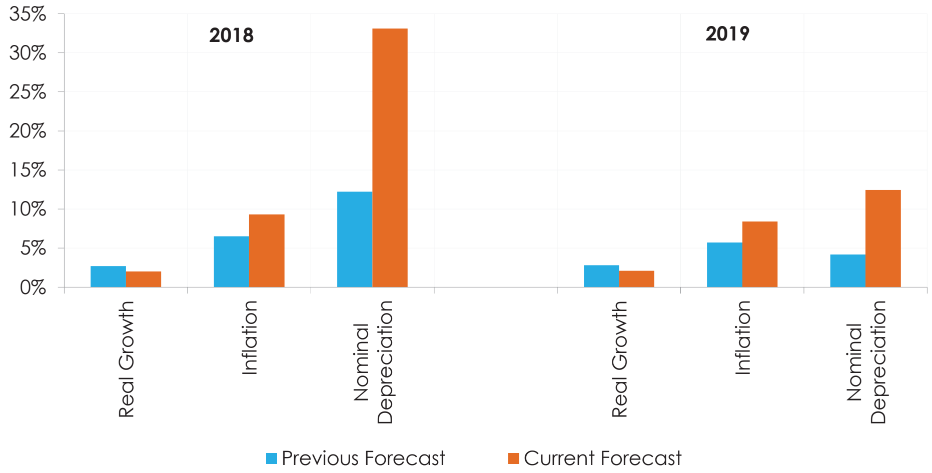
Source: National Bank of Georgia

As for economic activity, the GDP growth forecast has stayed at the same level of 5.5% as in the previous quarter (see Figure 2.11). However, since then, downside risks to economic growth have strengthened. The main risks stem from the external sector: in particular, the weakening of the economic conditions of Georgia's main trading partners and a deterioration of external demand. In recent months, growth rates of tourism revenues, remittances and exports have all slowed – primarily driven by weakened economic conditions in Turkey. Internal factors, like less fiscal stimulus, can also slow down economic growth. If such tendencies continue, economic growth in 2018 might be lower than is currently projected.

Assumptions regarding economic growth, inflation and the exchange rates of Georgia's main trading partners are particularly important for the macroeconomic forecast. Changes in these assumptions affect both the baseline forecast as well as associated risks (see Figure 2.12).

Assumptions regarding the economic growth of Georgia's trading partners were revised slightly downward, mainly due to an expected deterioration of Turkey's economic conditions. Meanwhile, expectations about a depreciation of the currencies of those countries intensified – primarily motivated by rising expectations of a depreciation of the Turkish lira. Since inflation in Turkey also remains high, this helps ensure that the nominal depreciation of the Turkish lira will not have a meaningful effect on the real exchange rate, thereby reducing the risks of transmission to the Georgian economy. However, it is worth noting that the Russian ruble and the euro have also depreciated slightly. Assumptions regarding inflation expectations in trading partner countries have also been revised upward – once more mostly due to the expectations of higher inflation in Turkey.

Figure 2.12 Changes in External Sector Assumptions for 2018-2019[12]



Source: Bloomberg

12 Calculations are based on the forecasts for the five main trading partners of Georgia: (the US, the EU, Turkey, Ukraine and Russia).

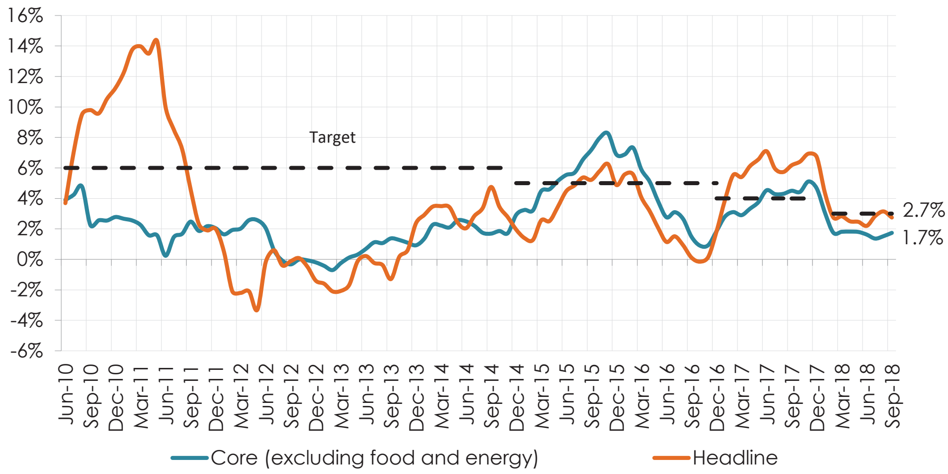
3. Consumer Prices

From early 2018, the temporary effect of increased excise taxes on tobacco and oil products expired. As a consequence, as expected, the annual inflation level gradually declined and inflation remained around the target level of 3% (this target was set from 2018). In September, inflation equaled 2.7%.

« Over the year, inflation remained around the target level.

Meanwhile, core inflation, which excludes volatile food and energy prices, was lower due to higher oil prices and stood at 1.7% (see Figure 3.1).

Figure 3.1 Headline And Core Inflation



Source: GeoStat

As mentioned above, the effect of temporary supply side factors that pushed inflation upwards over the course of 2017 have expired. However, the January 2018 increase of tariffs on electricity and water still exert upward pressure on inflation. The contribution of the latter equaled 0.2% in September.

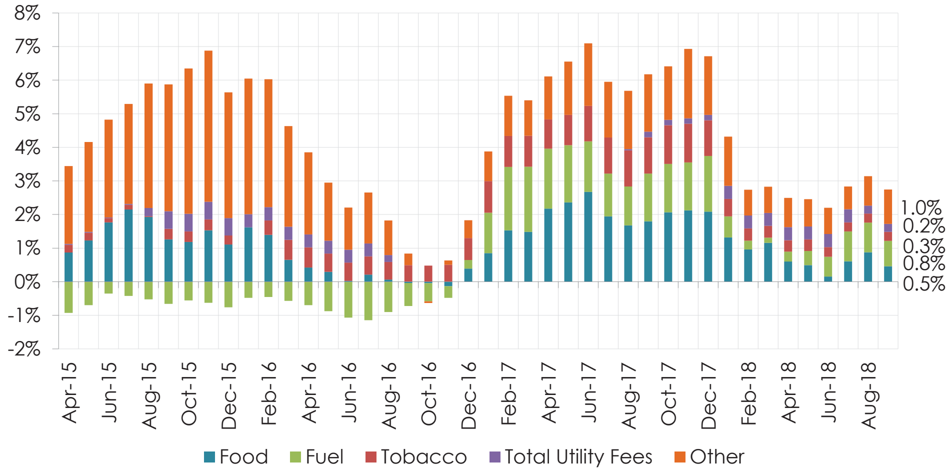
From 2018, food inflation has revealed a declining trend. In September, inflation in the food group stood at 1.7%, contributing 0.5 pp to overall inflation. As food inflation in 2017 was relatively high, the lower inflation from 2018 onwards can also be attributed to the base effect.

« Over the year, inflation in the food group was relatively low.

« The increase in the prices of oil still has a meaningful effect on inflation.

From other products, the increase in prices on tobacco and oil were still significant. Despite the fact that the effect of the increased excise taxes on those products expired, in September the price increase remained high, making a contribution of 0.3% and 0.8% respectively. The increase of oil prices can be linked to the growth of prices on international markets. Meanwhile, prices in the healthcare group increased sharply by 5.7%, contributing 0.5% to total inflation (see Figure 3.2). In contrast, over the last few years prices on clothes and shoes have exhibited a declining trend.

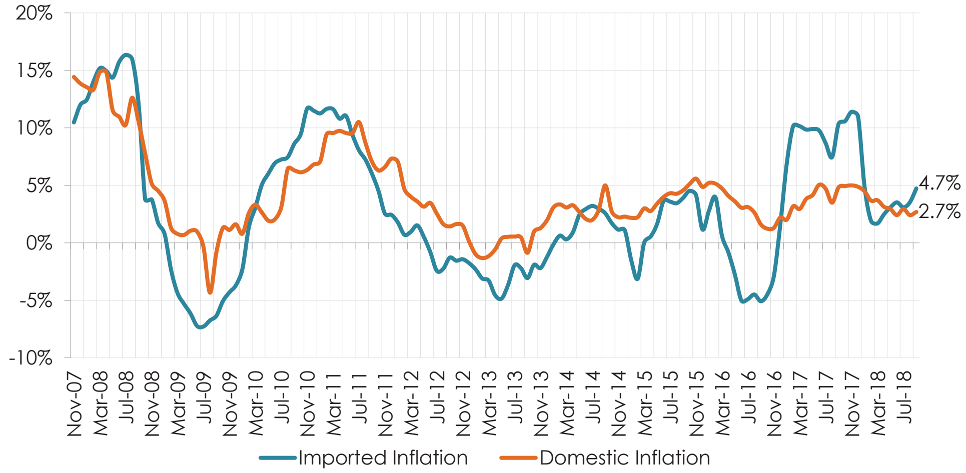
Figure 3.2 Contribution Of Tobacco, Fuel, Food And Utilities Inflation To Headline Inflation



Source: GeoStat

In September, annual inflation on imported and domestically produced goods equaled 4.7% and 2.7% respectively (see Figure 3.3), while inflation on mixed goods equaled 1.5%.

Figure 3.3 Imported and Domestic Inflation



Source: GeoStat and National Bank of Georgia

Box 1 Change in prices of different groups of the consumer basket in 2009-2018

Inflation is the increase of price levels in a country and is measured using the consumer price index. The consumer price index measures the price changes in a consumer basket made up of the goods and services purchased by an average consumer. The consumer basket comprises 305 items, sorted into 12 groups: food, transport, education, healthcare, utilities, entertainment, etc.

The share of food in the consumer basket of Georgia, as in other relatively low-income countries, is high and equals 30%. Therefore, inflation in Georgia is more sensitive to changes in food prices than is the case in high-income countries.

In Georgia, as in other countries, prices in different groups have different trends, with some growing faster than others. For example, prices on food have grown by 49% since 2009. The price increase in the healthcare group has been even higher: the price of a doctor's consultation more than doubled and the average price of medicine increased by 39%. On the other hand, over the same period the price of real estate rent has remained nearly unchanged, while prices on clothing fell by 38%.

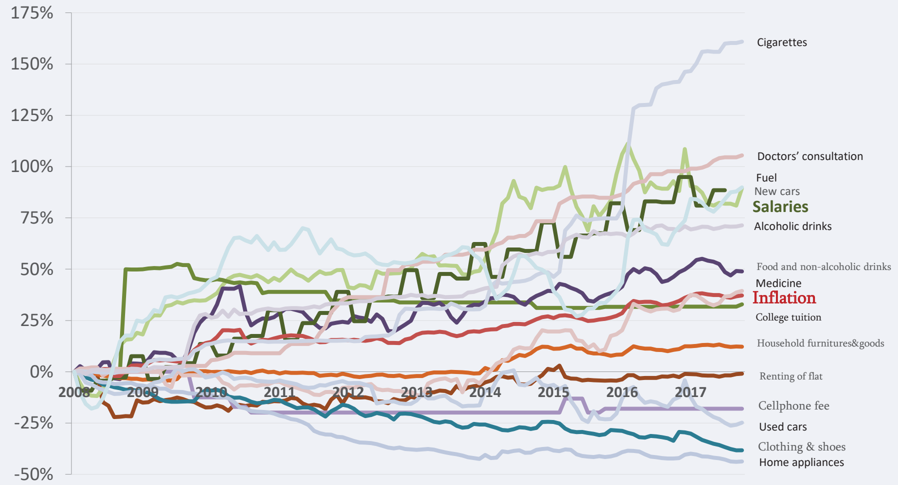
It is noteworthy that along with price increases on certain goods or services, quality rises as well. However, the latter is not captured by consumer basket-based inflation and only price increases are prescribed to inflation. This effect is especially relevant for healthcare, where both service quality, together with prices, have substantially increased.

As mentioned above, inflation is measured by price changes in the consumer basket (or, in other words, by the average price change of the components of the consumer basket). Since 2009, the consumer basket index calculated in such a way grew by 37%, which means that average annual inflation during this period equaled 3.4%. This is the lowest inflation rate in our region. However, inflation perception in the country could be higher, as consumers usually pay more attention towards those goods or services that have seen remarkable price changes – yet this is not unique to Georgia and also affects developed countries.

Inflation is usual for economic growth and salaries grow along with prices. Keeping inflation at a low rate gives the opportunity to maximize the difference between salary and price increases in the medium and long term. The inflation target set by the National Bank of Georgia is 3%, which means that the National Bank implements monetary policy in a way that keeps the overall price level change near 3% in the medium and long term. A 3% level of inflation creates beneficial conditions to maximize the real growth of income (income minus the increase of prices).

It is also interesting to observe how average wage trends have evolved since 2009. The average salary in Georgia is calculated according to employees' salaries. However, a large part of employed people in Georgia are self-employed and official statistics of their income are not available. The average salary of employed people since 2009 has risen by more than 80%. This number is still less than the price increase on certain products, such as cigarettes and doctors' consultations, but is more than inflation on most other products and services. Moreover, it is important to note that salary growth exceeds the overall inflation rate. See Diagram 1 for the comparison of the change of average salary and that of certain groups in the consumer basket.

Figure 3.4 Change of average salary and consumer basket components from 2009 to September 2018

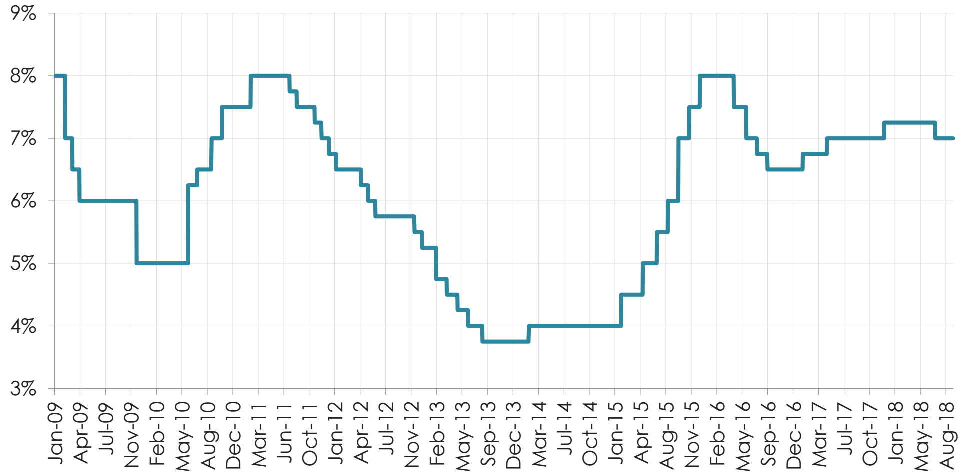


Source: GeoStat

4. MONETARY POLICY

Considering the upwards risks to inflation, the NBG maintained a moderately tight monetary policy in the first half of 2018. However, in June, the Monetary Policy Committee started a gradual exit from the moderately tight policy stance and reduced the policy rate. Nonetheless, according to the revised estimates and considering the increasing macroeconomic risks in the region and volatility of financial markets, monetary policy easing will continue at a slower pace than previously anticipated. Hence, at the Monetary Policy Committee meeting held on 5 September, the decision was made to leave the policy rate unchanged. From the beginning of 2018, following the NBG's forecast, inflation declined to 2.7% – lower than the 3% target.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

A further Monetary Policy Committee meeting held on 24 October 2018 also made a decision to keep the policy rate unchanged at 7%. Recently, the macroeconomic risks stemming from the external sector grew, activating negative expectations and causing increased volatility on foreign exchange markets. Nonetheless, no significant deviation of inflation from the target is expected since lower-than-expected economic activity neutralizes the upwards risks to inflation. According to the NBG's estimates, there is still a necessity for policy normalization – that is, gradual policy easing. However, the speed of normalization will depend on both the pace at which the output gap is closed and the magnitude of the transmission of increased regional macroeconomic risks to the Georgian economy.

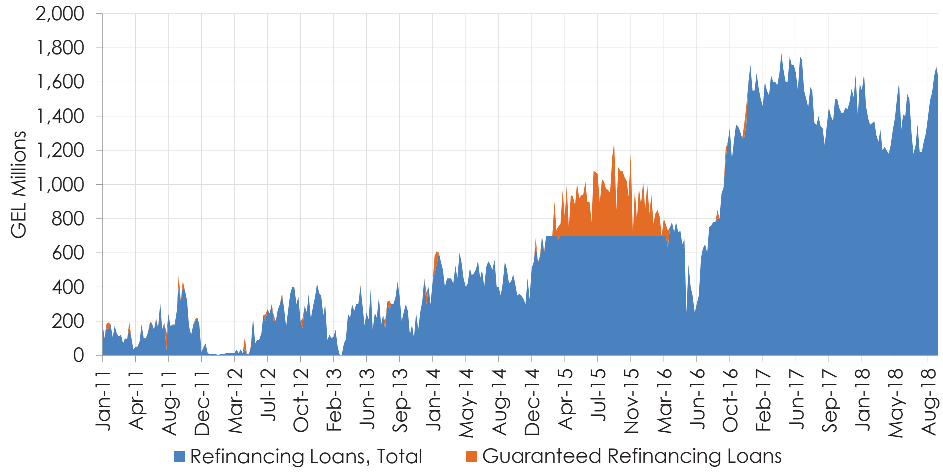
‹‹ The Monetary Policy Committee of the National Bank of Georgia decided to keep the policy rate unchanged at 7%.

According to primary estimates, real GDP growth in the first three quarters of 2018 stood at 4.9%, which reveals weaker-than-expected economic activity – largely stemming from lower-than-planned fiscal stimulus and weaker external demand. The latter followed the increase of macroeconomic volatility. In September, exports grew annually by 17.1%. Tourism revenues also increased however; the growth rate was lower compared to previous periods (9.3%). In September, money transfers increased by 5.6%, while the growth rate of imports stood at 3.3%.

According to the NBG's forecast, annual inflation is expected to remain around the target level over 2018 and in the medium term. It is important to note that temporary factors will push inflation upwards: in particular, the increased tariffs on electricity and water and international prices of oil. However, that increase will be balanced by lower imported inflation following the relative strengthening of the nominal exchange rate and weaker aggregate demand. Nonetheless, several major risks to the inflation forecast remain. Inflation will be lower than expected if the US dollar depreciates on international markets and the US-initiated "trade war" with its major trade partners escalates. Moreover, inflation may be lower than expected if economic activity is weaker than anticipated. Conversely, inflation may be higher than expected if geopolitical and economic conditions in the region deteriorate and prices on international markets grow. Furthermore, inflation may stand higher than expected if the European Central Bank (ECB) phases out its quantitative easing program at a faster pace than anticipated.

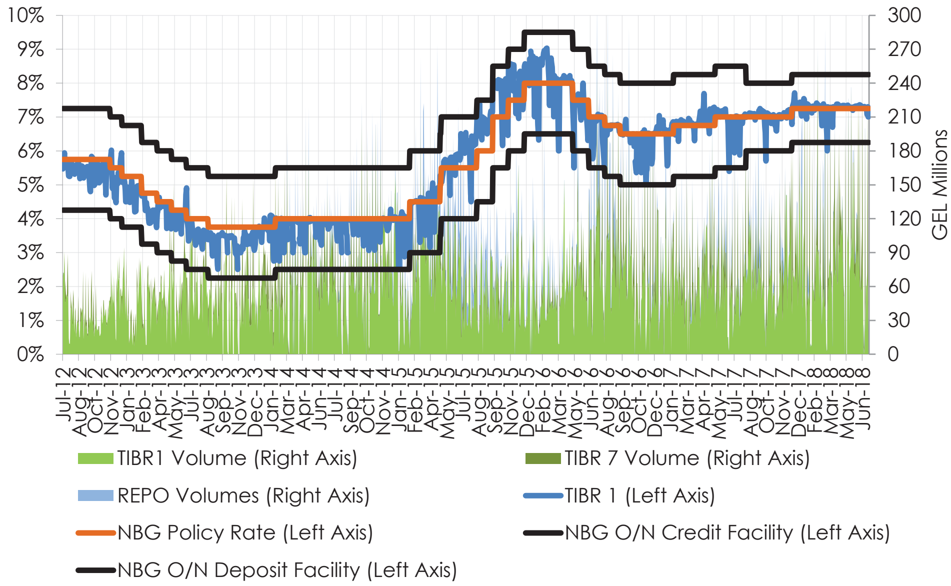
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. The banking sector currently operates under a liquidity deficit. Hence, commercial banks raise necessary additional funds through refinancing loans – the main instrument of the NBG. The National Bank provides short-term liquidity to the banking system via one-week refinancing loans and one-month open market operations. Currently, interbank money market interest rates vary 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

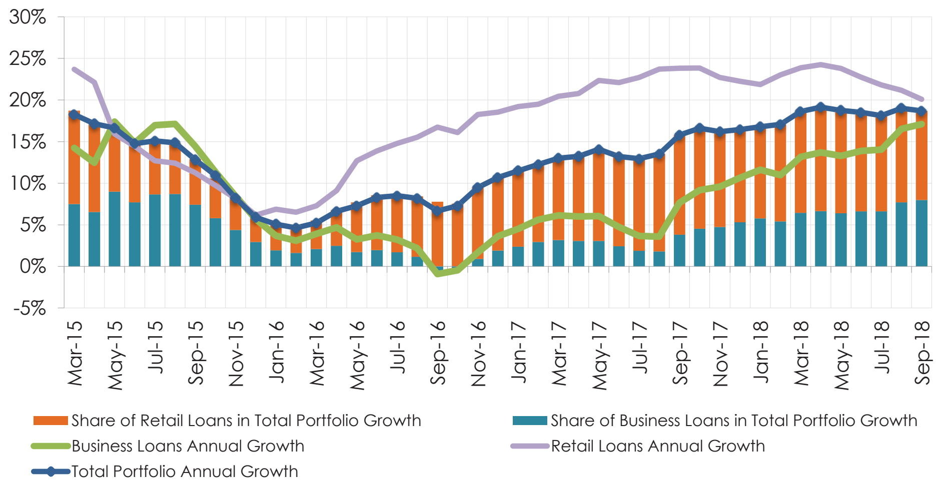
5.1 LOANS

In the third quarter of 2018, credit activity did not change significantly over the previous quarter. In September, excluding the effect of exchange rate fluctuations and the transformation of one microfinance organization into a bank, the loan portfolio increased by 18.7%. While this increase can primarily be attributed to the growth of retail loans, business loans also revealed an increasing trend. In September, relative to June, the growth rate of retail loans declined by 2.7 pp and stood at 20.1%; meanwhile, loans to legal entities increased by 3.2 pp and equaled 17.1% (see Figure 5.1). The growth of the loan portfolio was primarily driven by the increase in the trade, construction, transport, agriculture, and manufacturing sectors; whereas increases in credit for the energy sector were insignificant. According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans. In particular, growth is expected to be driven by increased demand from both corporate and small- and medium-sized enterprises, while retails loans are expected to decline. These changes in expectations are a result of the NBG's policies.

‹‹ Representatives of the banking sector expect an increase in demand for business loans, while, 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, the National Bank of Georgia has published a working draft law on standards for retail loans. This was discussed and developed in coordination with market participants and afterwards is expected to enter into force. In order to avoid an extensive growth of retail loans over the transition period, the number of such loans was limited to 25% of a bank's supervisory capital. According to the draft law, establishing maximum limits for the payments to income (PTI) and loan to value (LTV) coefficients are planned. In addition, from 1 September, a legislative initiative of the Parliament of Georgia entered into force that aims at cutting the maximum effective interest rate limit to 50%, which will also facilitate a decrease in the amount of high-risk financial products on the market.

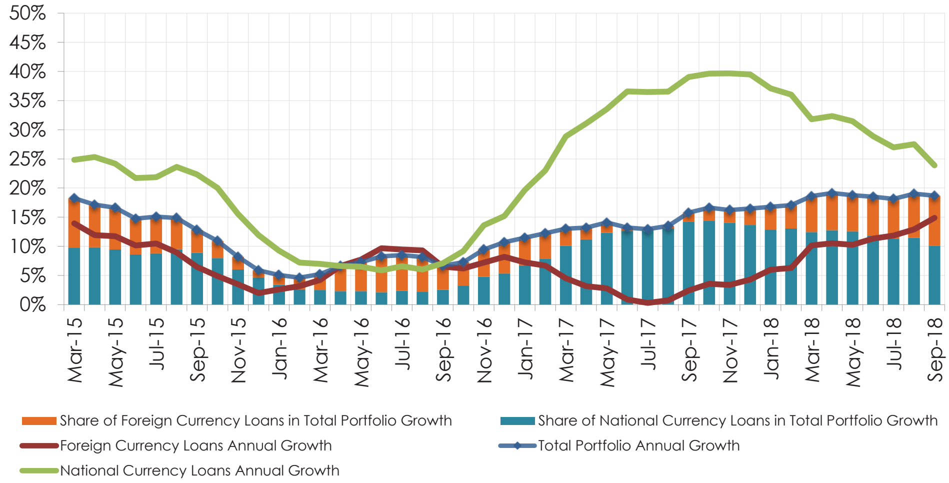
Figure 5.1 Annual Growth Rates Of Retail And Business Loans (Excluding the Exchange Rate Effect)



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 September, the annual growth rate of foreign currency denominated loans was 14.9%, while loans in domestic currency grew by 23.9%. It is important to note that the increase in domestic currency loans can be partly ascribed to the larization measures initiated by the NBG. In the third quarter, the loan larization ratio increased by 0.1 pp and equaled 42.9%.

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

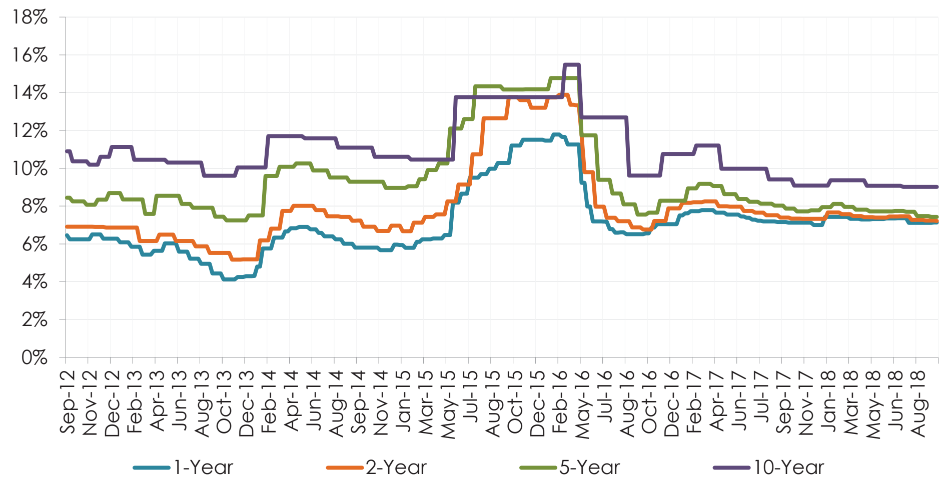


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In September, the monetary policy rate stood at 7%. In the third quarter of 2018, interest rates on government securities revealed a declining trend as a result of lower liquidity risk and expectations of an easing of monetary policy in the medium term (see Figure 5.3).

Figure 5.3 Interest Rates On Government Securities

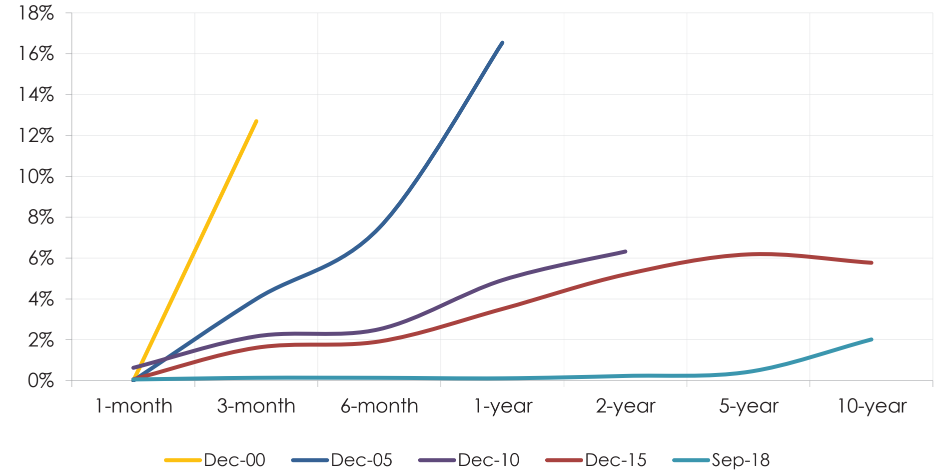


Source: National Bank of Georgia

Compared to the previous quarter, the spread between long- and short-term interest rates declined due to expectations of an easing of monetary policy in the medium term. It should be noted that the significant decline of this spread, as compared to the same period of last year, suggests the increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

‹‹ The spread between long- and short-term interest rates declined.

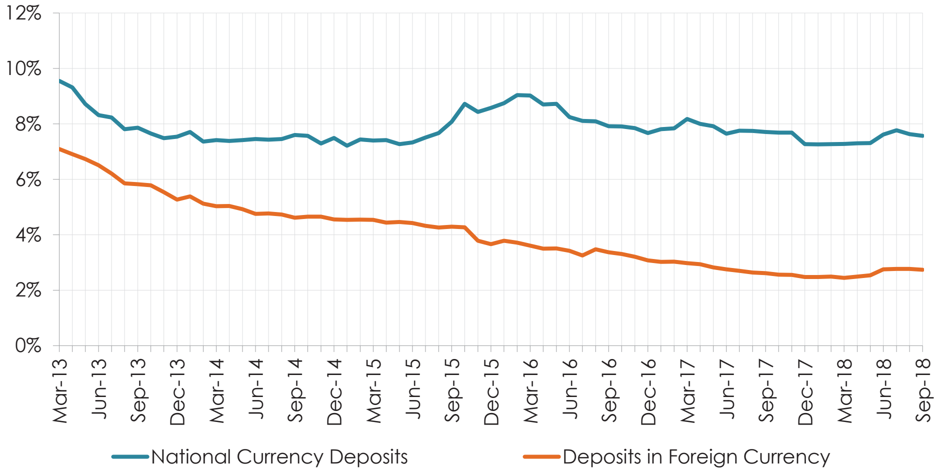
Figure 5.4 Spread Between The Monetary Policy Rate And The Yield Curve



Source: National Bank of Georgia

In September, relative to June, interest rates on domestic currency deposits did not change and stood at 7.6%. Meanwhile, interest rates on foreign currency deposits equaled 2.7% (see Figure 5.5). Representatives of the banking sector expect an increase in interest rates for deposits in both domestic and foreign currency in the next quarter; following the growth of the LIBOR for foreign currency deposits, regulatory changes and an increase in interest rates for domestic currency deposits.

Figure 5.5 Average Interest Rates On Deposits



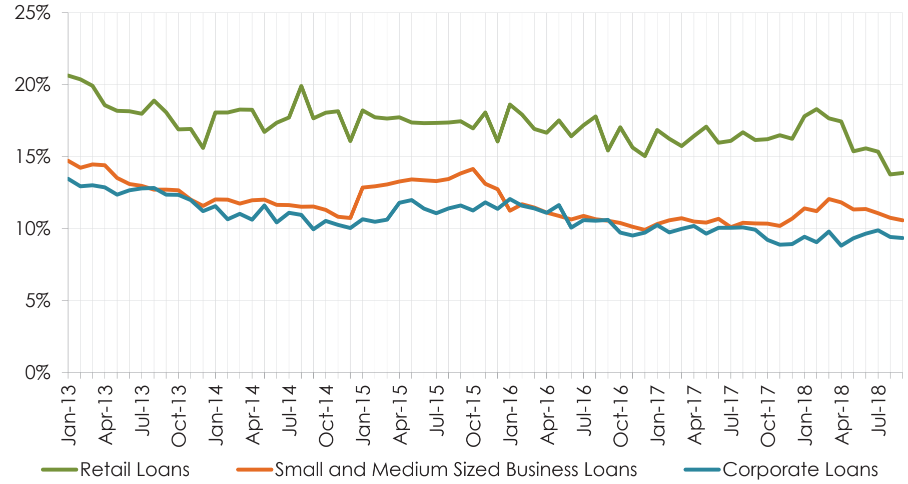
Source: National Bank of Georgia

In the third quarter of 2018, according to the same credit conditions survey, interest conditions for mortgages in foreign currency and legal entities have become more lenient. According to the same survey, non-interest conditions for individual lending have become notably stricter. Representatives of the banking sector claim that the reason behind this tightening is the regulatory requirement of the NBG that limits the number of loans issued without a proof of income to 25% of a bank's supervisory capital. The representatives expect a significant tightening of non-interest conditions in the next quarter due to restrictions on lending without analyzing a borrower's solvency based on the PTA and LTV coefficients.

In September, compared to June, interest rates on loans issued to small and medium enterprises declined by 0.8 pp and equaled 10.6%. For corporate loans, interest rates have not changed significantly and stand at 9.3%, while interest rates on retail loans fell by 1.7 pp and equaled 13.9% (see Figure 5.6). Over the same period, the average interest rate on the stock of legal entities declined in both domestic and foreign currency loans by 0.2 pp and 0.3 respectively (see Figure 5.7). According to the credit conditions survey, representatives of the banking sector expect a slight increase of interest on fixed interest loans in domestic currency following the increased popularity of such loans.

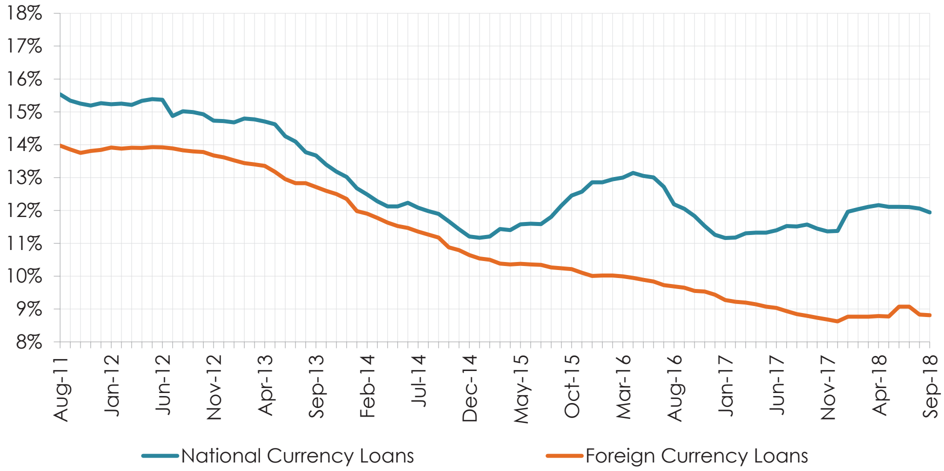
« According to the credit conditions survey, representatives of the banking sector expect a slight increase of interest on fixed interest loans in domestic currency following the growth of interest in such loans.

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

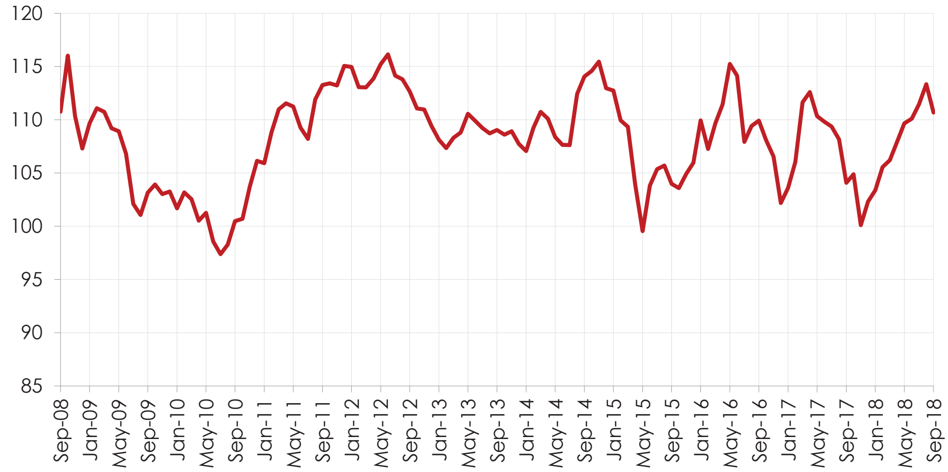
5.3. EXCHANGE RATE

In the third quarter of 2018, the GEL nominal effective exchange rate depreciated against the US dollar by 3.5% and by 0.8% against the euro, compared to the previous quarter. Meanwhile, the GEL appreciated against the Russian ruble and Turkish lira by 2.4% and 19.1% respectively. As a result, the nominal effective exchange rate appreciated by 4.1% on a quarterly basis and by 7.4% on an annual basis.

In the third quarter of 2018, the real effective exchange rate appreciated by 2.4% on a quarterly basis, and by 4.3% on a year-on-year basis (see Figure 5.8). As can be seen from Figure 5.1, the real effective exchange rate appreciation was mainly driven by the lari's significant appreciation against the Turkish lira.

When adjusted for commodity groups and services, where the US dollar exchange rate has a relatively higher weight, the nominal effective exchange rate reveals a slightly different picture. In the third quarter of 2018, the adjusted nominal effective exchange rate appreciated by 5.2% on a year-on-year basis, and by 3.5% compared to the previous quarter.

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



Source: National Bank of Georgia

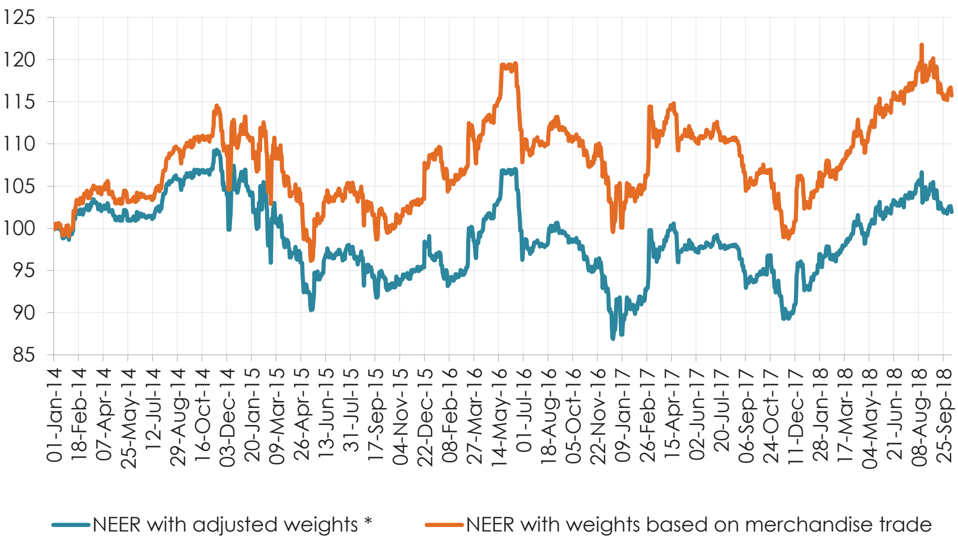
Table 5.1 Effective Exchange Rates Annual Growth (3rd quarter of 2018)

	Change of Nominal Exchange Rate, %	Change of Real Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	7.4	4.3	4.3
Eurozone	-3.3	-2.5	-0.5
Turkey	52.9	31.6	6.0
Ukraine	1.0	-4.6	-0.3
Armenia	-3.5	-3.6	-0.2
The United States	-4.3	-4.0	-0.2
Russia	6.3	6.2	0.9
Azerbaijan	-4.3	-3.4	-0.4
Other	-2.6	-2.2	-1.0

* The growth implies appreciation of lari

Source: National Bank of Georgia

Figure 5.9 Corrected Nominal Effective Exchange Rate



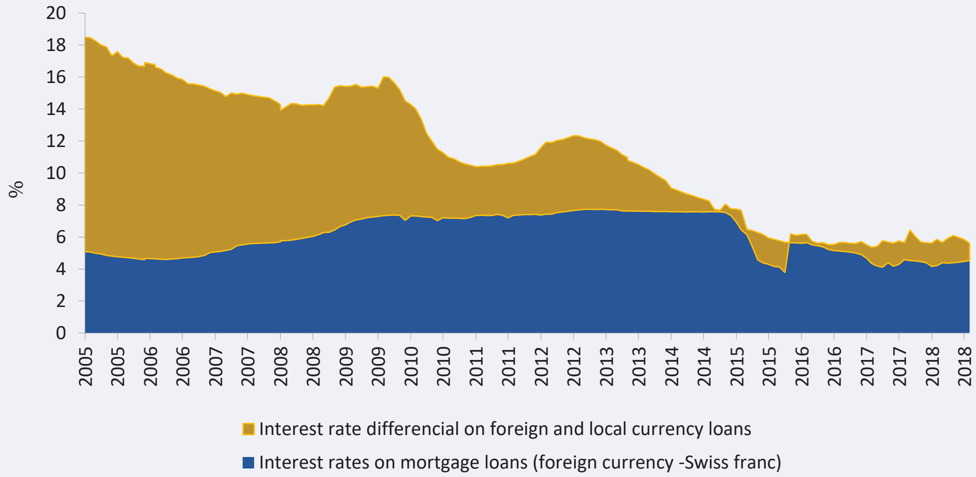
* Calculation of the index for the adjusted nominal effective exchange rate includes weights based on trading with only those goods and services (tourism) that are sold in the currency of a partner country. Increase = appreciation. 31 Dec. 2013 = 100.

Source: National Bank of Georgia

Box 2 The problem of foreign currency indebtedness in Hungary

Since the mid-2000s, households' foreign currency (FX) indebtedness in Hungary has increased sharply. Even though FX risk was initially transferred to households by FX loans, banks subsequently found themselves exposed to (currency-induced) credit risk after the sharp depreciation of the local currency in 2008. Accumulation of FX debt, especially by households, was encouraged by the interest rate differential between foreign and local currency loans[13] (see Figure 5.10) as well as by excessively optimistic expectations regarding FX risks.[14] From the supply side, limited funding in local currency for banks further incentivized lending in foreign currency.

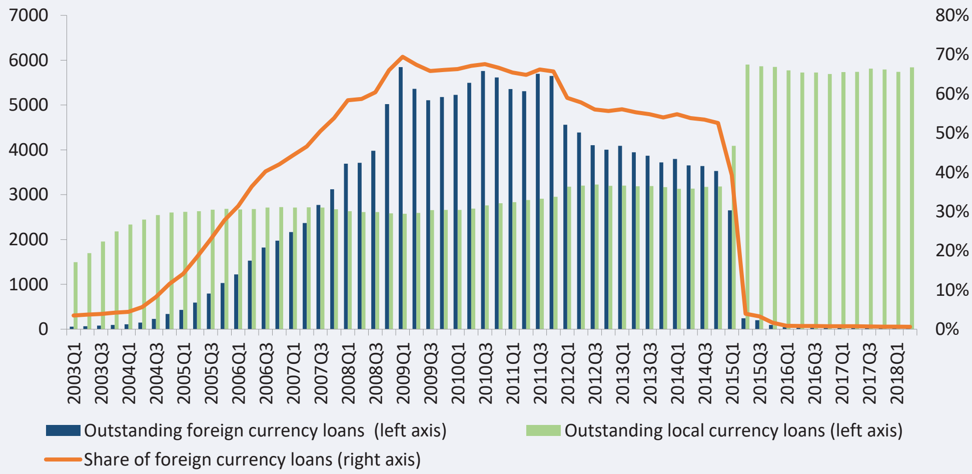
Figure 5.10 Interest rates on foreign- and local-currency mortgage loans in Hungary



Source: National Bank of Georgia

The Global Financial Crisis of 2008, exacerbated by the then-apparent need to deleverage in FX, triggered a sharp depreciation of the local currency. From October 2008 to March 2009, the Hungarian forint depreciated by 24% and 34% against the euro and Swiss franc, respectively.[15] By 2008, the share of FX loans had increased to 70% of households' total liabilities (see Figure 5.11), while the ratio of private sector FX loans to GDP reached 30%. In the years that followed, along with the depreciation of the forint, this ratio jumped further to 50%.

Figure 5.11 Households' outstanding loans in foreign and local currencies (billion Hungarian forints)



Source: National Bank of Georgia

13 *European Central Bank, Financial Stability Review, June 2010. https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart201006en_05.pdf?401f431d6e51dfbb4dd2b362b0a671f3*

14 *Buszko, M. & Krupa, D. (2015) "Foreign currency loans in Poland and Hungary – a comparative analysis". Procedia Economics and Finance, 30, 124-136. https://core.ac.uk/download/pdf/82710803.pdf*

15 *The depreciation against the Swiss franc was 66% by 2011.*

It should be mentioned that the size of household debt itself in Hungary was not particularly large compared to similar countries before the crisis. However, the high share of FX in total loans was the main source of vulnerability.[16] As a result of the considerable depreciation, the share of non-performing loans reached 8% in 2009 and exceeded 16% in 2013.

The Government of Hungary had to implement a range of measures to deal with the issue of the excessive debt burden. One aspect of the new regulations was intended to address problems related to the outstanding loans, while another part was supposed to prevent a further buildup of indebtedness in FX. On a broader level, the purpose was to achieve a sustainable lending practice in the future. The fiscal cost of taking those extraordinary measures in response to existing vulnerabilities was quite significant. However, the financial sector did not have to bear a significant part of that cost and this prevented a further decline in lending.

In 2014, the government implemented a program of foreign currency debt conversion into the local currency. To keep the commercial banks' FX position closed, the central bank had to sell up to 10 billion euros on the FX market.[17] As a result of this conversion, credit risk associated with FX lending declined significantly. This consequently helped reduce the country risk premium and improve the efficiency of the monetary policy transmission mechanism. In addition, after the conversion of outstanding Swiss franc loans into the local currency, the financial system was in a much better position to withstand a further significant appreciation of the Swiss franc in 2015. The ratio of FX loans to GDP was 14.7% in the first quarter of 2018 (while it was more than 30% in 2010).[18]

In 2014, Hungary was one of the first emerging market economies to implement regulations putting limits on loan-to-value (LTV) and payment-to-income (PTI) ratios (see Tables 5.2 and 5.3). These limits have been in force since 1 January 2015.

Table 5.2 Loan-to-value requirements (LTV) in Hungary

LTV	Local currency (HUF)	Euro	Other currencies
Mortgage loans	80%	50%	35%
Car loans	75%	45%	30%

Source: Palicz, A. Szakács, J. and Zsigó, M. (2018) "Experiences of Debt Cap Regulations in Hungarian Retail Lending Péter Fáykiss". Financial and Economic Review, Vol. 17 Issue 1., pp. 34–61.

Table 5.3 Payment-to-income requirements (PTI) in Hungary

PTI	Local currency (HUF)	Euro	Other currencies
Net monthly income < HUF 400,000[19]	50%	25%	10%
Net monthly income > HUF 400,000	60%	30%	15%

Source: Palicz, A. Szakács, J. and Zsigó, M. (2018) "Experiences of Debt Cap Regulations in Hungarian Retail Lending Péter Fáykiss". Financial and Economic Review, Vol. 17 Issue 1., pp. 34–61.

Despite those regulations, real estate prices in Hungary have been increasing robustly, while credit activity has also started to recover since 2016 as a consequence of reduced risks. Economic growth from 2008 to 2010 was negative, but this was a reflection of the Global Financial Crisis rather than these regulations, which were only implemented in 2010. Since 2014, after adopting the LTV and PTI limits, economic growth has been higher than in previous periods, amounting to around 4%.

16 Economic Analysis from European Commission`s Directorate General for Economic and Financial Affairs, Country Focus, July 2013. http://ec.europa.eu/economy_finance/publications/country_focus/2013/pdf/cf_vol10_issue5_en.pdf

17 Favorable economic conditions made the implementation of this plan possible. The international reserves were two times more than the short-term debt of the country at that time.

18 MNB (Central Bank of Hungary), Trends in Lending, August 2018. http://www.mnb.hu/en/publications/reports/trends-in-lending/trends-in-lending-august-2018

19 The threshold is approximately 1,235 euro – twice the average monthly income in Hungary. In 2018, a new amendment was introduced for reducing households' exposure to interest rate risk. According to the new rule, further differentiation of PTI limits were applicable: in the case of the first (lower) income bracket, the PTI limits on domestic currency mortgages with a fixed interest rate period of shorter than 5 years / from 5 to 10 years / more than 10 years are 25% / 35% / 50%, respectively; while in the case of the second (higher) income bracket the PTI limits are 30% / 40% / 60%, respectively. Differentiated limits were applied for FX lending too.

6. Aggregate Demand

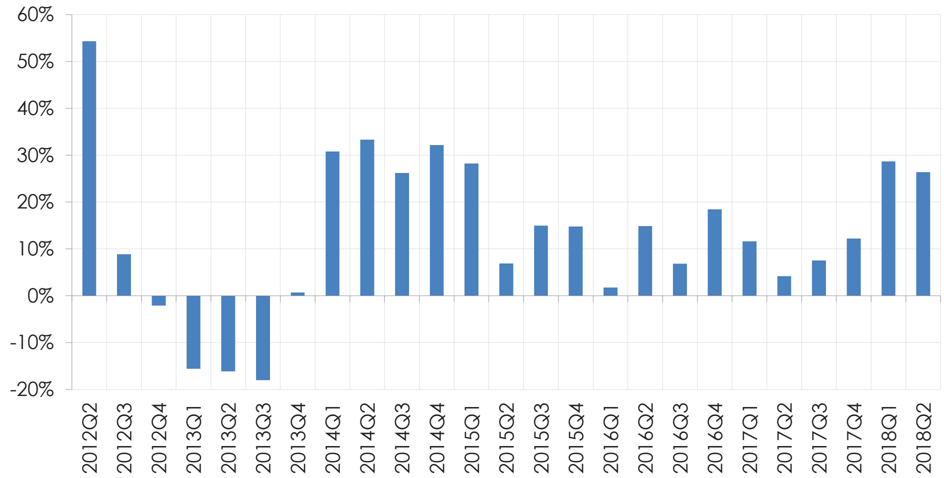
Real GDP growth amounted to 5% in the second quarter of 2018. Investments and consumption were the main determinants of the growth, while the contribution of net exports was rather modest.

« Real GDP growth amounted to 5% in the second quarter of 2018.

Capital formation maintained a high rate of growth in second quarter of 2018 (26.4%). The high growth rate of investments stemmed primarily from the private sector, amid delays in government infrastructure projects. The rise of investments is supported by a growth of savings.

« Capital formation maintained a high rate of growth in the second quarter of 2018.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

The real growth rate of private consumption[20] posted 3% in the second quarter of 2018. This growth was partially enhanced by the increase in consumer loans. However, according to preliminary results, the growth rate of those loans declined in the third quarter, which is going to have a negative effect on the growth of private consumption.

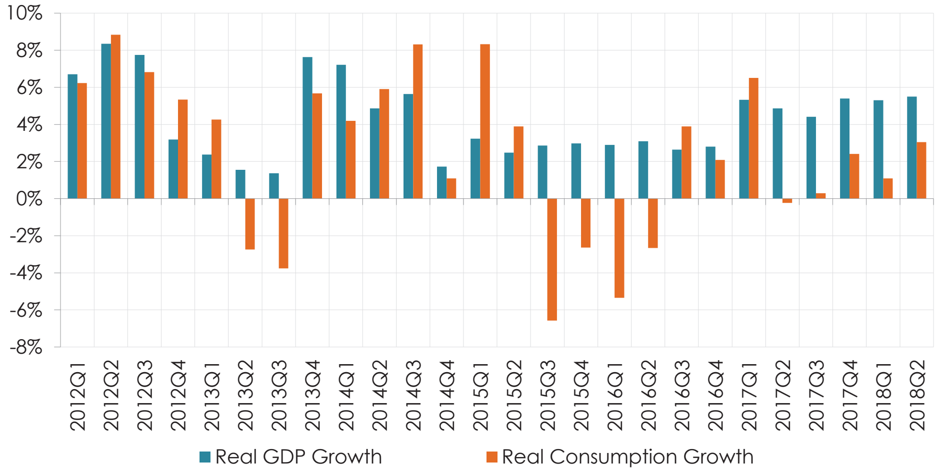
« Real growth of private consumption posted 3% in the second quarter of 2018.

External demand has continued to recover, which has been reflected in growing exports. Exports maintained high annual growth rates in both nominal and real terms in second quarter of 2018 (despite an increase in the price of exporting goods). According to preliminary data, the positive growth dynamics of exports have continued in third quarter of 2018, in both nominal and real terms. The real annual growth rate of imports remained very low in second quarter of 2018, which stemmed from weak domestic demand. According to preliminary data, imports have continued to exhibit low real growth in the third quarter. As a result, net exports are expected to make a significant positive contribution to GDP growth in upcoming quarters.

« Exports maintained high annual growth rates in both nominal and real terms in the second quarter of 2018.

20 *The real growth of consumption is calculated using average annual inflation.*

Figure 6.2 Real GDP And Real Consumption Growth



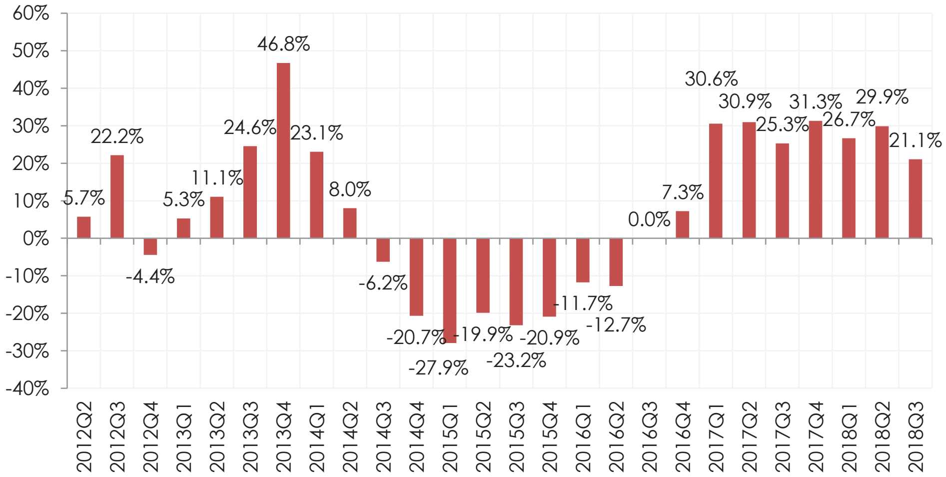
Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

Despite the external volatilities and increased risks observed during the last period, positive trends in the external sector persisted. However, some decrease in the growth rate of external demand was notable following the macroeconomic developments in Turkey. In the third quarter of 2018, registered exports of goods grew annually by 21.1% (see Figure 7.1). That growth was primarily driven by increasing exports of intermediate goods, while the export of consumer goods revealed modest growth. High growth rates were also notable for exports of motor cars, petroleum oils, copper ores, wine and mineral waters, and cigarettes.

‹‹ In the third quarter of 2018, registered exports of goods increased by 21.1% annually.

Figure 7.1 Annual Change in Registered Exports Of Goods



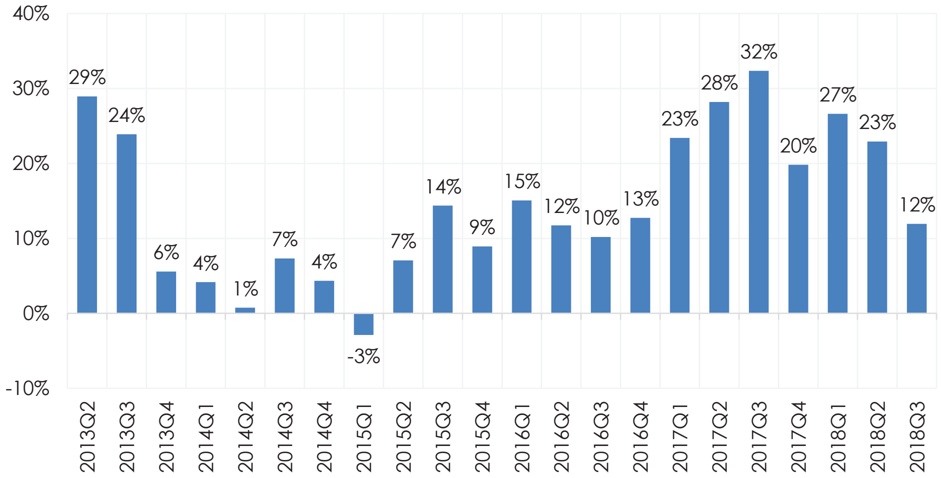
Source: GeoStat

The volume of exports increased significantly in the third quarter of 2018 – a result of increased demand from regional countries, except Turkey. Compared to the same period last year, exports to Azerbaijan and Russia grew annually by 61% and 22% respectively, while exports to Turkey fell by 15%. Trade also intensified with other CIS countries. On the other hand, exports to European countries moderately fell due to decreased re-exports of oil products and copper ores to Malta and Romania.

‹‹ In the third quarter of 2018, revenues from tourism increased by 12% and reached 1.2 billion USD.

The recovery of external demand also affected the export of services, especially tourism. Revenues from tourism increased at high rates throughout the first half of 2018. In the third quarter of 2018, revenues from tourism reached 1.2 billion USD, which is a 12 % increase compared to the same period last year (see Figure 7.2).

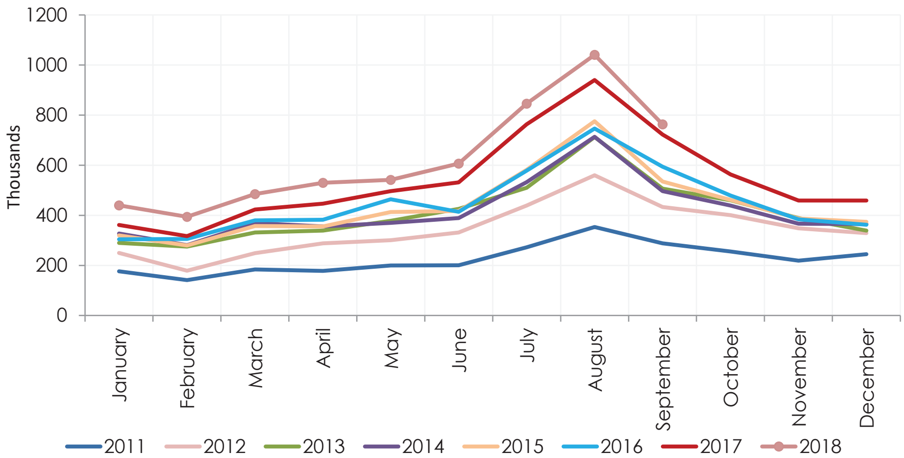
Figure 7.2 Annual Change in Revenues from Tourism



Source: National Bank of Georgia

The increase in revenues from tourism was a result of the increasing number of international visitors to Georgia.[21] In the third quarter of 2018, the number of foreign visitors entering Georgia grew by 9.2% (see Figure 7.3), of which 69% were tourists. Travelers from Azerbaijan and Russia made the most significant contribution to this growth, while tourist inflows from Armenia declined. Although the number of Turkish visitors made a positive contribution to the overall growth of visitors to Georgia and revenues from tourism increased moderately, the growth rate of those revenues from Turkey fell substantially in the third quarter. At the same time, there was a substantial decline in the number of visitors from Iran and Saudi Arabia.

Figure 7.3 Number of International Visitors to Georgia



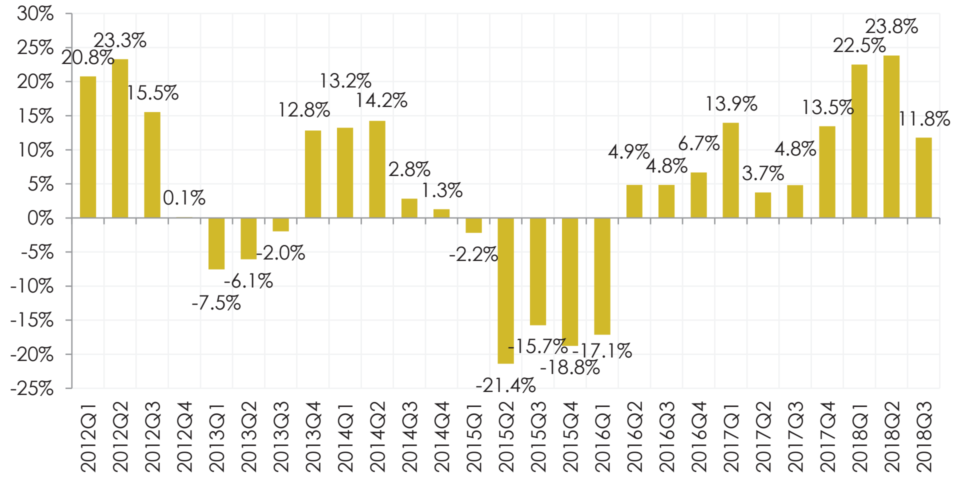
Source: GNTA

In the third quarter of 2018, in light of the increased growth of exports in goods and services , registered imports of goods also increased, rising by 11.8% annually (see Figure 7.4). It is worth noting that imports increased from CIS countries as well as from the EU. The growth stemmed from the increased demand for intermediate and consumer goods.

‹‹ In the third quarter of 2018, registered imports of goods increased by 11.8% annually.

21 *A tourist is a visitor who remained in the country for more than 24 hours.*

Figure 7.4 Annual Change in Registered Imports Of Goods

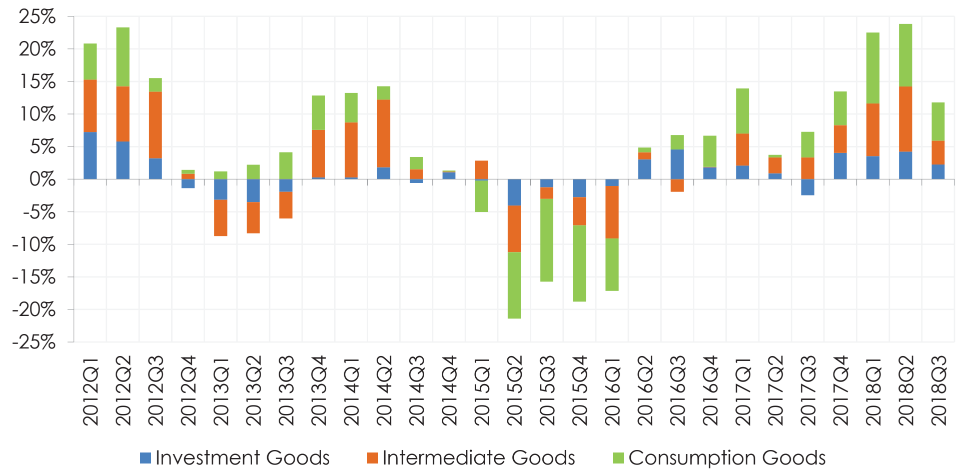


Source: GeoStat

In the third quarter of 2018, imports of intermediate and consumer goods accounted for 41% and 44% of total imports respectively. During this period, imports of intermediate goods increased by 9%, contributing 3.7 percentage points (pp) to the total growth of imports, while imports of consumer goods grew by 14%, adding 5.9 pp to total imports (see Figure 7.6). Moreover, compared to the same period of the previous year, imports of goods were actively diversified. Furthermore, in line with increased foreign direct investments, imports of investment goods also increased.

‹‹ In the third quarter of 2018, the growth in registered import of goods was mainly driven by the higher demand for intermediate and consumer goods.

Figure 7.5 Annual Change in Registered Imports By Category Of Goods

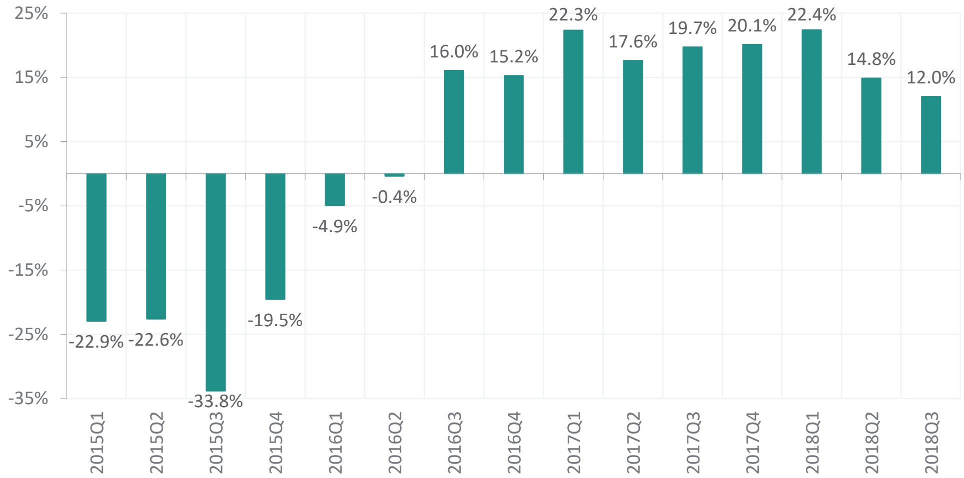


Source: GeoStat

Money transfers to Georgia in the third quarter of 2018 increased by 12% (see Figure 7.6), which was mainly driven by increased transfers from the European Union (notably from Greece and Italy). The overall growth in remittances also benefited from an increased volume of money transfers from Israel and the USA. In contrast, money transfers from Russia and Turkey showed a decreasing trend from the beginning of the year, and their contribution to overall growth in the third quarter was negative compared to the same period last year.

‹‹ In the third quarter of 2018, the volume of money transfers to Georgia increased by 12% annually.

Figure 7.6 Annual Change in Remittances



Source: National Bank of Georgia

Despite high growth rates in exports of goods and services, as well as a rise in money transfers, the current account deficit slightly widened and amounted to 8.9% of GDP in the second quarter of 2018. For comparison, the deficit in the same period of last year stood at 8.3% of GDP. The current account balance was negatively affected by the income account deficit, which has been worsening since 2016 due to increasing dividends and reinvested income. Such tendency is visible in 2018 as well.

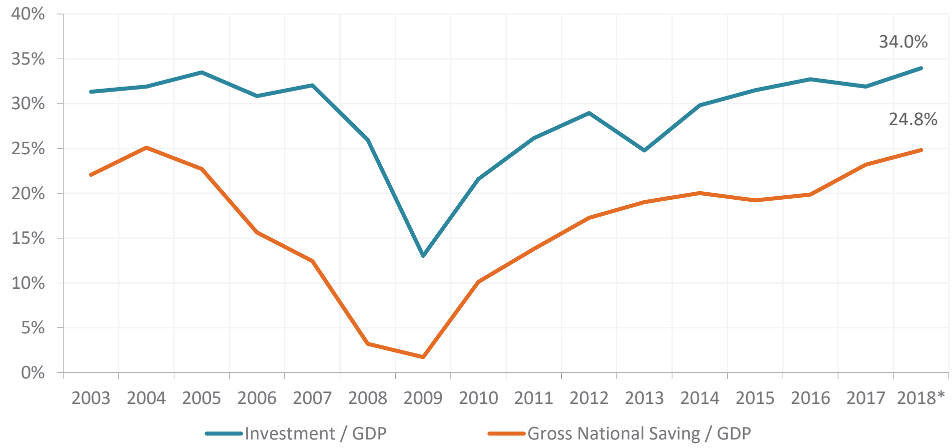
Foreign direct investments (FDI) remain the primary source of financing the current account deficit. In the second quarter of 2018, the volume of foreign direct investments equaled 389 million USD. The energy sector was the largest recipient of FDI, receiving 40% of the total volume (109 million USD), a significant portion of which was reinvestment. The transport (65 million USD) and finance (64 million USD) sectors were also significant recipients of FDI, receiving 17% and 16% of total FDI respectively. An analysis of investments and savings reveals that the widening of the current account deficit stemmed from the higher increase in investments rather than in savings. In 2018, compared to 2017, the ratio of investments to GDP increased by 2.1 pp to reach 34.0%, while the ratio of savings to GDP grew by 1.6 pp to 24.8% (see Figure 7.7).

‹‹ In the second quarter of 2018, the current account deficit amounted to 8.9% of GDP.

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

‹‹ The widening of the current account deficit is mainly driven by the growth of investments.

Figure 7.7 Investments and Savings



** 2018 data contains the joint sum of the last two quarters of 2017 and the first two quarters of 2018.*

Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

8.1 OUTPUT

In the second quarter of 2018, GDP grew by 5.5% compared to the same period last year. The growth was driven by the services sector, which contributed 5.4 percentage points. The contribution of the industrial sectors equaled 0.4%, while the agriculture sector had a negative contribution to growth, standing at -0.3%.

‹‹ From the services sector, trade made the most significant contribution to growth.

From the services sector, trade made the most significant contribution to growth, standing at 10.5% and contributing 1.5 pp to overall growth. The significant increase in the trade sector over the last two years reveals an improvement in aggregate demand. The inflow of international visitors has positively contributed to GDP growth, which was further reflected in the growth of real estate operations. In the second quarter of 2018, real estate operations increased by 13.8%, contributing 0.8 pp to overall growth.

‹‹ Construction output has declined for the first time since 2014.

The participation of foreigners is also important for the output of hotels and restaurants, where growth was lower than in previous periods at 4.5%. The increase in transport by 8% (contributing 0.5 pp to growth), a large proportion of which is linked to the operations of travel bureaus and tourist agents, and the increase in air traffic, is also associated with the increased inflows of visitors. The 22% growth of the financial sector is also noteworthy (contributing 0.8 pp to overall growth).

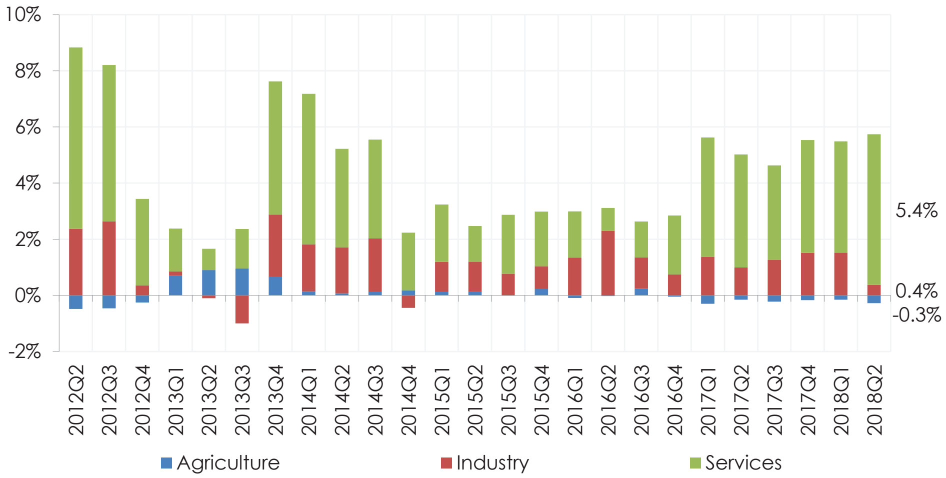
‹‹ The increase in external demand positively contributes to the growth of manufacturing output.

The industrial sectors saw a noteworthy decline in output. From 2014 onwards, construction had high growth rates and was seen as one of the main drivers of economic growth. However, in the second quarter of 2018 construction output declined by 7.1% annually, contributing -0.6 pp to overall growth. This decline may be linked to the slowdown in the construction of infrastructural projects. From other industrial sectors, manufacturing revealed significant growth of 8.5% in the second quarter of 2018, contributing 0.8 pp to the overall growth. The growth in manufacturing can be attributed to the increased production of beverages, metals and metal crafts – all of which are driven by increasing external demand.

‹‹ The output of the agriculture sector fell again.

The output of the agriculture sector fell once again in the second quarter of 2018. The sector declined by 3.3% annually, making a negative contribution of -0.3 pp to total growth.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat.

8.2 LABOR MARKET

In the second quarter of 2018, the labor productivity per worker increased by 6.9% compared to the previous year. In the same period, labor productivity in the services and agriculture sectors increased by 9% and 8.3% respectively, while productivity decreased by 11.1% in the industrial sectors (see Table 8.1).

‹‹ In the second quarter the labour productivity increased by 6.9%.

In the second quarter, the growth of GDP was mainly driven by the services sector, where the growth of the trade sector was particularly notable. The increase of international visitors supported the growth of the restaurants and hotels, real estate operations and transport sectors. The overall increase in productivity in services was 9%.

Although the output of the agriculture sector has declined by 3.3%, productivity per worker increased by 8.3%. The reason behind this was the decline in the amount of labor employed in the sector, which followed the population decline in rural regions.

Labor productivity in the industrial sector declined by 11.1%, which follows the 34% increase in employment in the construction sector compared to the previous year. The output in construction also declined by 7.1%, which might be linked to the slowdown of some infrastructural projects. However, it is important to note that the reporting period between the growth of the number of workers employed in construction and the value added per labor is longer than in other sectors of the economy. We could thus assume that the productivity of labor in the construction sector will increase in the next reporting periods. Conversely, the increase in output and thereby the increase in utilization levels in manufacturing may be linked to the increased productivity that followed the increased output of exported goods. The output of manufacturing increased by 6.7%, while the labor employed in the sector only grew by 1.1%. As a result, productivity increased by 5.5%.

Table 8.1 Annual growth of value added per employee in the second quarter of 2018

	Increase in labor productivity
Agriculture and agriculture output by households	8.3%
Industrial sector	-11.1%
Services sector	9.0%
Overall in the economy	**6.9%**

Source: GeoStat

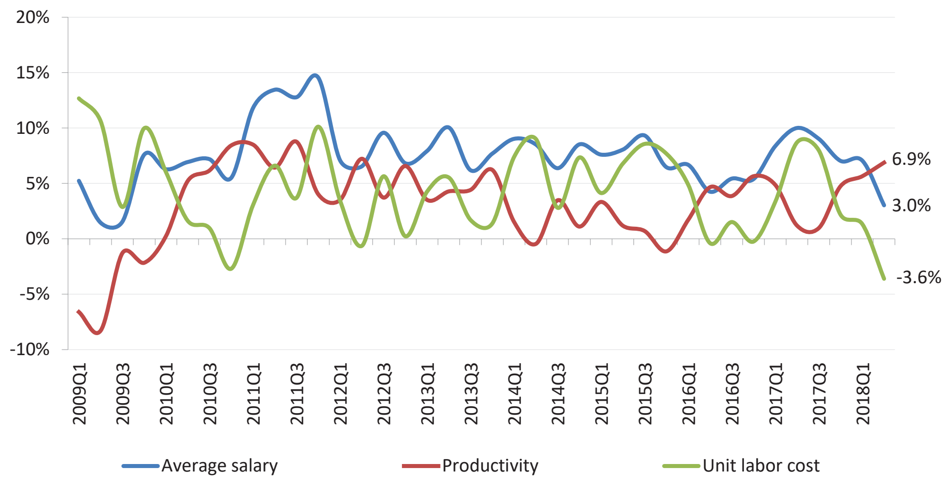
In the second quarter of 2018, the average annual growth of wages equaled 3%. According to GeoStat estimates, the average monthly salary in the economy was 1,104 GEL.

« The average annual growth of wages equaled 3%.

In the second quarter of 2018, the unit labor costdeclined by 3.6% (see Figure 8.2). Thus, the labor market does not create inflationary pressure in the economy.

« Unit labor cost declined by 3.6%.

Figure 8.2 Labor productivity, average monthly salary, unit labor cost (annual percentage change)



Source: GeoStat and National Bank of Georgia

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