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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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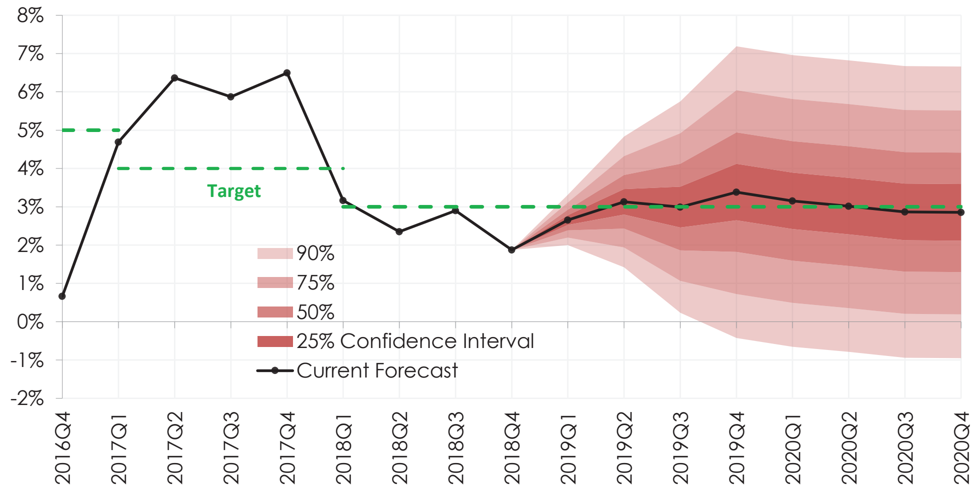
1. Brief Overview

In the fourth quarter of 2018, **annual inflation** was slightly lower than expected at 1.9%. This was mainly a consequence of weak aggregate demand and, to a slightly lesser extent, of the faster-than-expected reduction of oil prices on international markets. These factors outweighed the upward pressure put on inflation from the recent price increase on bread and cereals. As a result, the annual inflation rate in December decreased to 1.5%, before recovering somewhat in January 2019 to stand at 2.2%. Despite this variation, inflation remains close to the National Bank of Georgia's target of 3%.

According to the **NBG's forecast**, inflation will continue to vary around the target level of 3% in the medium term (see Figure 1.1). Despite the downward pressure coming from the still weak aggregate demand on prices, it is forecast that next year this effect will be balanced by imported inflation and intermediate costs of production. These will occur on the back of a somewhat undervalued real effective exchange rate and one-off factors, such as an increase in bread prices. However, once these one-off factors are eliminated, aggregate demand is expected to increase to the potential level of output in the medium term, with inflation still remaining close to the target.

Figure 1.1 Headline CPI inflation

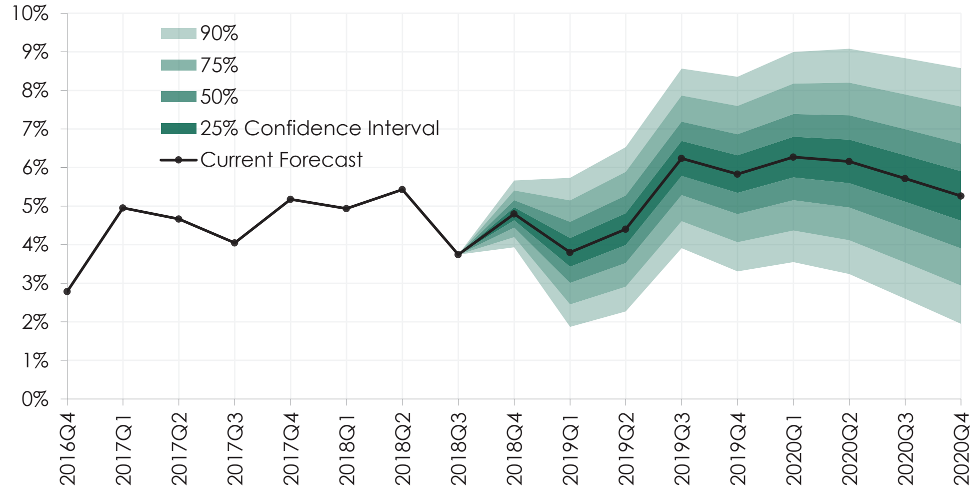


Source: National Bank of Georgia

In 2018, **real GDP growth** was characterized by relatively high levels of variation. While growth in the first half of the year stood at 5.4%, it fell to 4.3% in the second half. This variation was driven by both domestic and external factors. Among the domestic factors, particularly notable was the effect of weakened fiscal stimulus, including from infrastructure projects. As for external factors, in the second half of the year, money transfers and tourism revenues from Turkey and Iran were both reduced as a result of those countries experiencing a deterioration of their economic situations. According to current estimates, real GDP growth in 2018 totaled 4.8%.

The NBG's **forecast of real GDP growth** for 2019 remains unchanged at 5% (see Figure 1.2). Despite higher risks stemming from a softening of economic growth, the baseline scenario expects that the recent slowdown will only be temporary. This view is based on the assumption that the moderate growth of credit activity will continue, and that fiscal stimulus will be of the planned scale. According to the current forecast, net exports, consumption and investments will all positively contribute to real GDP growth. According to the baseline scenario, these will be supported by capital spending of the government and a moderate growth of loans. Recent estimates show that the deviation of aggregate demand from the potential level of output deteriorated somewhat in the second half of 2018, but it is expected that the moderately high economic growth will continue and that the output gap will close within the next two years.

Figure 1.2 Annual real GDP growth



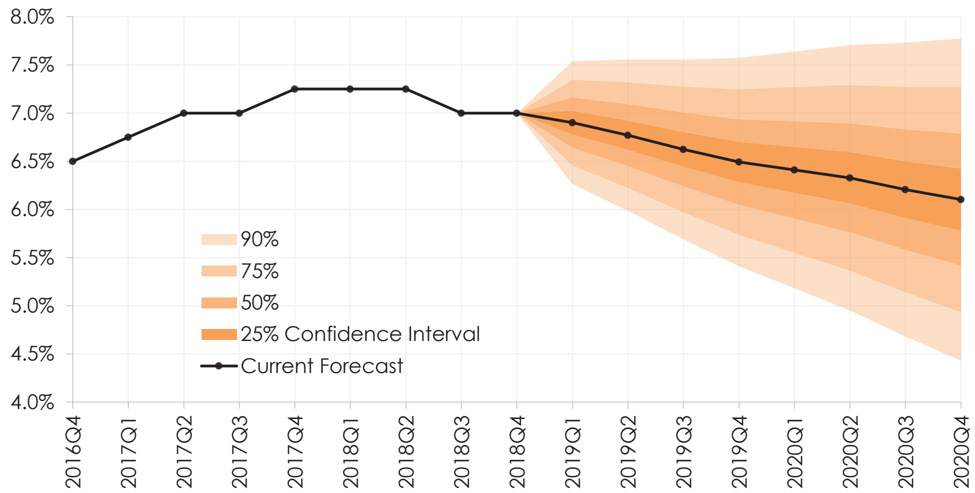
Source: National Bank of Georgia

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.

In the recent period, the NBG has maintained a moderately tight monetary policy in order to neutralize inflationary risks. However, based on the current macroeconomic forecast, following the reduction of inflation to the target level of 3% and its stability around that level, in the medium term the **monetary policy rate is expected** to gradually decline to its neutral level (see Figure 1.3). This marks a continuation of the process of monetary policy normalization that was started in August last year. Despite economic activity remaining weak, the reduction of the monetary policy rate will proceed at a slow pace as a consequence of heightened risks in the region. 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 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 the 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 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.

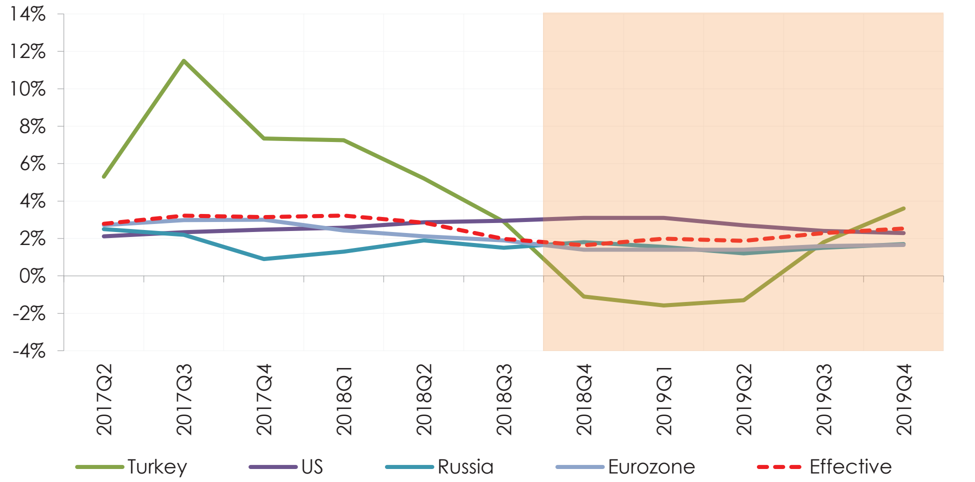
2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

The Georgian economy is experiencing growing influence from the external sector, mainly through export revenues, money transfers and foreign direct investment. According to the IMF's forecast, in the third quarter of 2018, **global economic growth** slowed to 3.7%. A further decline is expected, with the same forecast predicting growth of 3.5% for 2019.[1] This pattern reflects a slowdown in the growth rate of the eurozone and Great Britain and is caused by several factors, including uncertainty regarding Brexit, trade tensions and a decline of export volume, as well as a reduction in private consumption and fixed investment. According to preliminary estimates, drastic changes are not expected for the fourth quarter, only a slight stabilization of the global growth, which should be supported by a new, calmer phase in the "trade-war" and the possibility of an agreement.

In the second half of 2018, economic activity seemed robust and high in the **United States**, with the IMF's forecast for annual GDP growth for that year standing at 2.9%; however, this is expected to fall to 2.5% in 2019, which is lower than previously estimated. Last year was distinctively good for emerging and developing countries; however, in the last quarter, their growth lost momentum and, according to the IMF's forecast, it is expected to be 4.5% in 2019 which is 0.2 percentage points (pp) below the previous forecast of October 2018.[2]

Figure 2.1 Real GDP growth of economic partners



Source: Bloomberg; National Bank of Georgia.

Following the deepening of financial and economic ties with partner countries, Georgia's economy is heavily dependent upon ongoing processes in **Turkey**. Recent developments there have resulted in a decline in trade and other financial inflows to Georgia. The impact of the August 2018 currency crisis has continued to reverberate, and Turkey's economy significantly shrank in the third quarter of the year, which was followed by a deterioration of consumer and business sentiment. A similar trend will continue throughout the fourth quarter, with soft private consumption and fixed investments. Annual inflation declined by 5 pp since September and stood at 20.3% in December – which is still a high rate. According to the World Bank's forecast, these existing challenges will remain throughout the medium term and GDP growth for 2018 has been predicted as being 3.5%[3], with ex-

1 International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, DC, January.

2 International Monetary Fund. 2018. World Economic Outlook: Challenges to Steady Growth. Washington, DC, October.

3 World Bank. 2019. Global Economic Prospects: Darkening Skies. Washington, DC, January.

pectations of it rising by 1.6% in 2019. Inflation is expected to be around 15-16% in 2019.

Positive dynamics continued in the process of the recovery of **Ukraine's** economy. Improved conditions on the labor market significantly encouraged consumer spending, which together with increasing money transfers, caused a boost in domestic demand. However, these strong growth dynamics were partly offset by a marked contraction in exports due to weather-related factors and a challenging external environment. Therefore, the World Bank's growth forecast for Ukraine in 2018 stood at 3.5%, with the economy expected to grow by 2.9% in 2019.[4] Annual inflation was high in December at 9.8%, while it is forecast to be 7.3% in 2019.

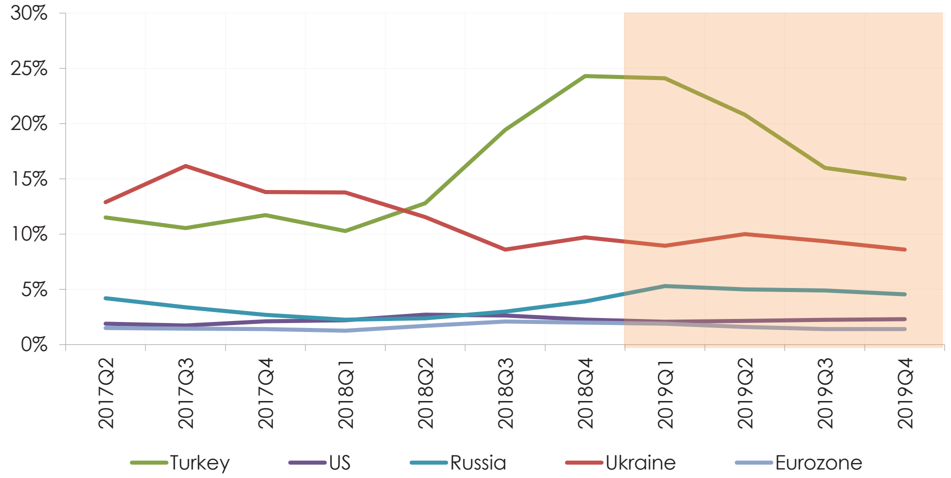
Last year, economic growth in **Russia** stood at 1.5%, which was higher than expected. Despite this upward revision, the recovery still lost steam in the third quarter, as the depreciation of the local currency, deteriorating consumption dynamics on the back of an increased VAT rate, and poor performance by the agricultural sector all weighed on activity. Falling oil prices were also an issue, but these were partly balanced by an agreement between OPEC and Russia about further limiting oil production. Annual inflation increased and stood at 2.9%. On the positive side, the U.S. Treasury announced plans to lift sanctions on several Russian companies. According to the IMF's forecast, Russia's economy is expected to grow by 1.6% in 2019 and inflation will be around 5%.[5]

In the third quarter of 2018, economic growth in **Armenia** was reduced and stood at 2.7%. However, stable money transfers from Russia and loose monetary policy positively contributed to the economy. According to the World Bank, annual growth in 2018 was 5.3% and is expected to reach 4.3% in 2019, while inflation for 2019 is forecast at 4%.[6]

The moderate recovery of **Azerbaijan's** economy continued in the last quarter of 2018. This was caused by solid government spending and accelerated growth in the non-oil sector. Even though Azerbaijan's economy is mostly dependent on the oil sector, the fall in international oil prices was contained by the OPEC-Russia agreement on oil production cuts. According to the World Bank's forecast, economic growth in Azerbaijan stood at 1.1% in 2018 and is expected to be 3.6% in 2019. Annual inflation was 2.3% in December and is forecasted to be 3.3% in 2019.[7]

The loss of momentum in the growth of the **eurozone** was mostly caused by a deterioration in consumer sentiment and a slowdown in the growth of export volume, alongside negative expectations in financial markets caused by Brexit uncertainties. The IMF reduced its projections for the eurozone's real GDP growth in 2018 to 1.8%, while it is expected to fall to 1.6% in 2019.[8]

Figure 2.2 Headline inflation rates of economic partners



Source: Bloomberg; National Bank of Georgia.

4 Ibid.

5 International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, DC, January.

6 World Bank. 2019. Global Economic Prospects: Darkening Skies. Washington, DC, January.

7 Ibid.

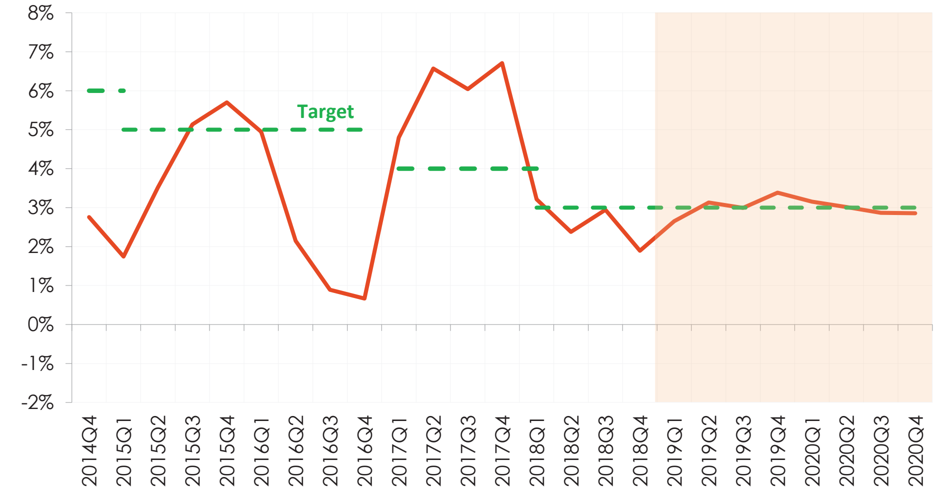
8 International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, DC, January.

In the second half of 2018, in response to the depreciation of their local currencies, the central banks of partner countries (Turkey, Russia and Ukraine) started to tighten their monetary policy. This move was somewhat unexpected for the financial markets. Moreover, the U.S. Federal Reserve increased interest rates once again in 2018, which was justified by inflation expectations and the labor market environment. In addition, according to their current forecast, the federal funds rate will be increased twice next year and will reach 3%.

2.2 MACROECONOMIC FORECAST

In the fourth quarter of 2018, **annual inflation** equaled 1.9% (see Figure 2.3). It stood slightly lower than predicted due to a further slackening of demand and a greater-than-expected fall in imported inflation. However, it should be noted that annual inflation might have hit an even lower mark if one-off factors had not exerted upward pressure on prices. Of the latter, the greatest contributions were made by the January 2018 increase of electricity and water tariffs, and the more recently elevated price on bread and cereals.

Figure 2.3 Headline CPI inflation



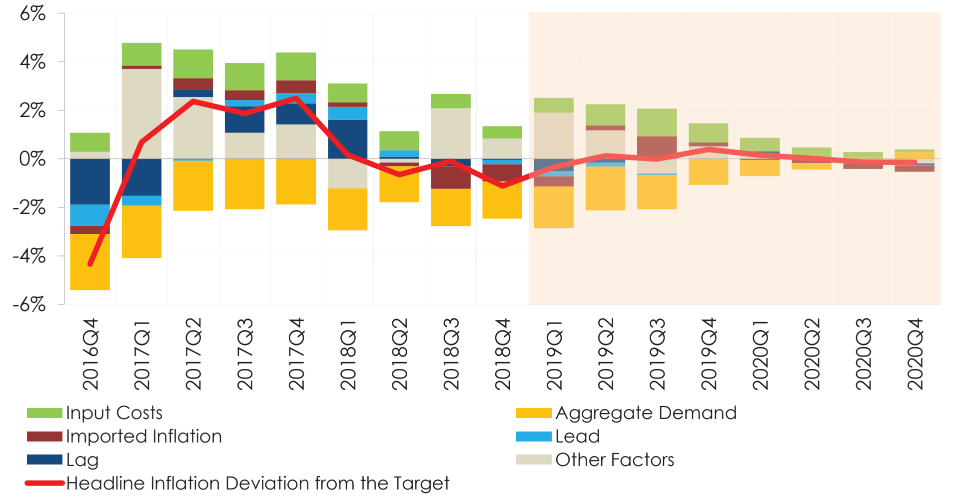
Source: National Bank of Georgia.

According to the current forecast, annual inflation will get closer to the target level in the first half of 2019 and will remain around it over the medium term (see Figure 2.3). As in 2018, this year will again see the influence of temporary effects on consumer prices, with the increased tax on tobacco and heightened price of bread being the most significant of those factors. These effects, as well as the positive impact the depreciating lari effective exchange rate has on input costs, will be partially counterbalanced by sluggish aggregate demand. Over the medium term, a gradual increase of the latter to the potential level of output is expected to help inflation remain close to the target (see Figure 2.4).

The inflation rate might deviate from its projected path if certain less probable but still plausible factors materialize. 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 increased risk premiums for the whole region, including Georgia, which would cause a depreciation of local currencies and, because of increasing payments on foreign currency loans, this 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, regardless of the recent thawing, the ongoing "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 would ultimately make consumer products cheaper.

In 2018, economic activity experienced sizable swings. The first half of the year saw a 5.4% growth in real GDP followed by 3.7% and 4.8% growth in the third and fourth quarters, respectively. This was driven by both domestic and foreign factors. Among

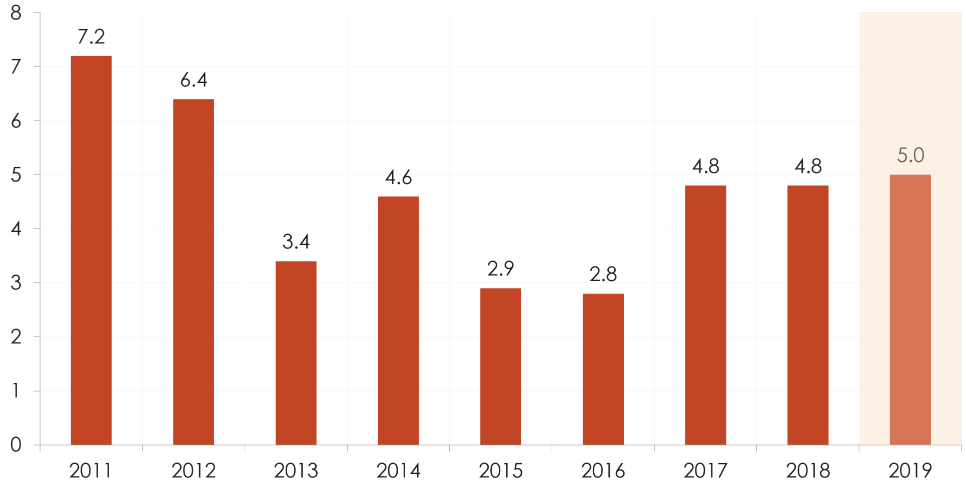
Figure 2.4 Deviation of inflation from the target and its decomposition[9]



Source: National Bank of Georgia.

the domestic factors, a mitigation of fiscal stimulus was notable; while the external factors included a reduction of money transfers and tourist revenues from Turkey and Iran, where unfavorable economic trends were observed.

Figure 2.5 Real GDP growth

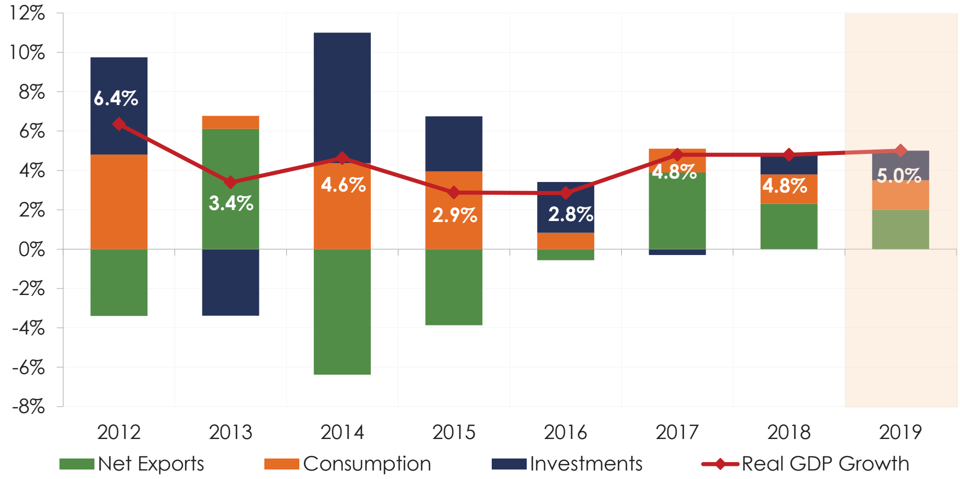


Source: National Bank of Georgia.

According to current estimates, this heightened variation in economic activity will be temporary; however, risks to growth loom large. The NBG maintains the real GDP growth forecast for 2019 at around 5% (see Figure 2.5). The primary driving force of economic growth will still be net exports, but the contributions of consumption and investment will also be sizable, assuming the planned fiscal stimulus occurs and there is a reasonable growth of credit activity (see Figure 2.6).

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

Figure 2.6 Real GDP growth decomposition



Source: National Bank of Georgia

The current forecast of real GDP might deviate from the actual path 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, thereby ensuring that economic activity will be lower than expected. Conversely, if business sentiment improves, then investments and the resulting economic activity will be higher than expected.

In the third quarter of 2018, the **current account balance turned positive for the first time in the history of independent Georgia**, and equaled 11.9 million US dollars (30.1 million lari). Whilst this period of the year has commonly been marked by a fall in the current account deficit, the relatively stronger foreign demand on tourism services provided additional support to this trend in 2018 (it should be noted that the balance of merchandise trade remained negative). According to the short- and medium-term forecasts, the ratio of the current account to GDP will stay in single-digit territory as long as trading partner countries maintain stable economic environments 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 also 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.

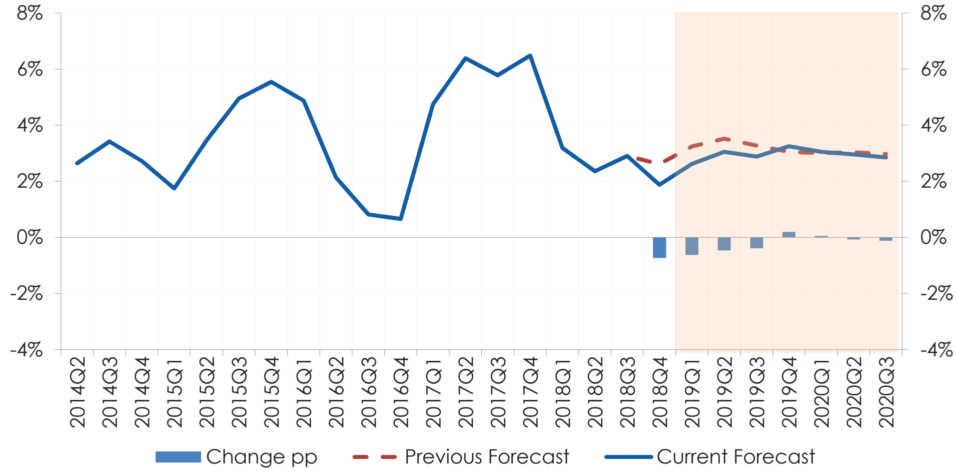
Based on the forecast, in the medium term, the **short-term interest rate will continue its moderate normalization process**. This will occur on the back of inflation hovering around the target level and economic activity remaining below the potential level. As in the previous forecast, a slightly declining monetary policy rate path (as consistent with the current baseline scenario) is the optimal response to the factors mentioned above (see Figure 1.3); however, because of uncertainty in the region, the reduction of the rate will be slower than previously anticipated. The monetary policy rate will return to its neutral level over a two-year period. The neutral policy rate level is estimated to range between 5.5 and 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 path of short-term lari interest rates – upon which long-term rates depend.

2.3 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast has been revised slightly downwards compared to the projections of the previous quarter (see Figure 2.7). This slight downward revision was mainly driven by lower-than-expected economic growth in 2018. Domestic demand was weak, which deepened the negative output gap. Inflation in 2018 was thus lower than expected and, consequently, the inflation forecast for 2019 has been slightly reduced. This was also driven by decreased oil prices on international markets. Nevertheless, the size of the revision was not significant and, according to the revised forecast, inflation is expected to remain close to the target level of 3% in both 2019 and in the medium run.

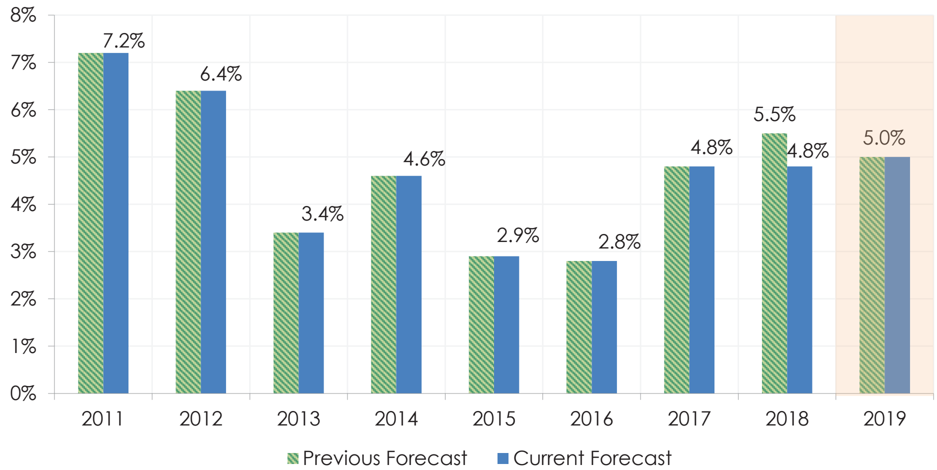
Figure 2.7 Changes in the forecast of headline inflation



Source: National Bank of Georgia

As for economic activity, the real GDP growth forecast for 2019 remains at the same level of 5.0% as in the previous quarter (see Figure 2.8). Economic growth in 2018 was less than projected, but the forecasts for the main contributors to economic growth have remained the same for 2019.

Figure 2.8 Changes in the forecast of GDP growth

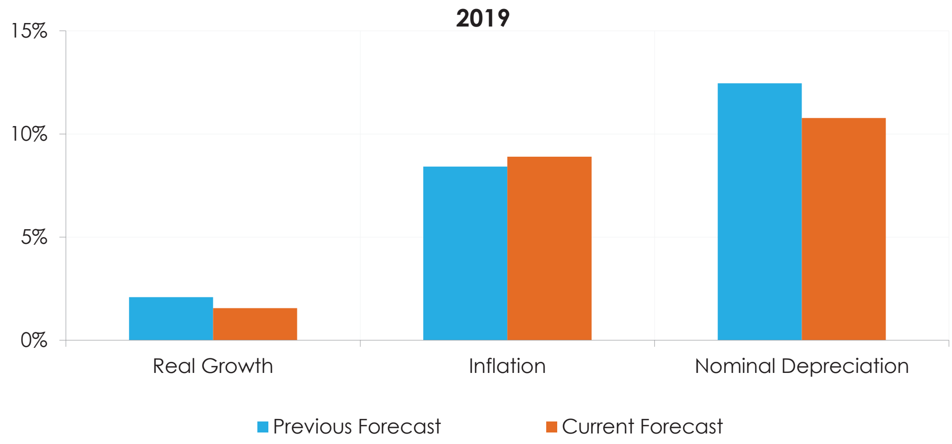


Source: National Bank of Georgia

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 2.9).

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. Moreover, the economic growth forecast for the EU was revised downward.

Figure 2.9 Changes in external sector assumptions for 2019[10]



Source: National Bank of Georgia

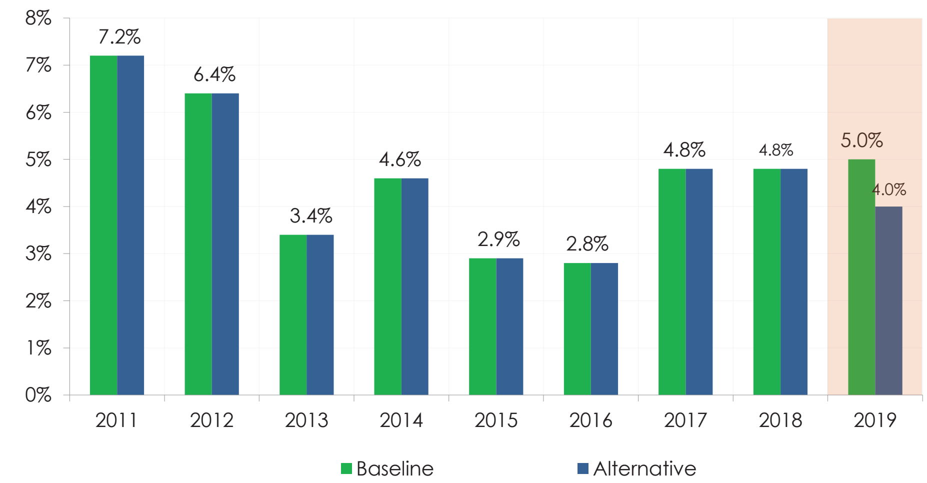
Expectations about a depreciation of the currencies of trading partners declined – primarily a consequence of the depreciation of the Turkish lira being less than previously expected. Meanwhile, assumptions regarding inflation expectations in trading partner countries have been revised upward, once more mostly due to expectations of higher inflation in Turkey. Higher inflation and expectations of lower depreciation in trading partners would positively affect Georgia's competitiveness.

2.4 ALTERNATIVE FORECAST SCENARIO

In the alternative forecast scenario, aggregate demand increases at a slower pace than in the baseline forecast. In 2018, credit growth was strong, and the lending rate increased by approximately 19% YoY. However, as a result of new macroprudential regulations, credit growth is expected to slow in 2019. Under the alternative forecast scenario, the effect of the new regulations on household borrowing is assumed to be higher than in the baseline forecast, with a greater reduction in the growth of credit activity suppressing domestic demand and causing real economic growth to slow. Moreover, fiscal stimulus was less than anticipated in 2018. If such a tendency continues, economic growth in 2019 would be less than forecasted.

Realization of the abovementioned risks would subdue domestic demand compared to the baseline scenario. Accordingly, under the alternative scenario, annual real GDP growth is lower and equals 4% (see Figure 2.10).

Figure 2.10 Real GDP growth according to the baseline and alternative forecasts

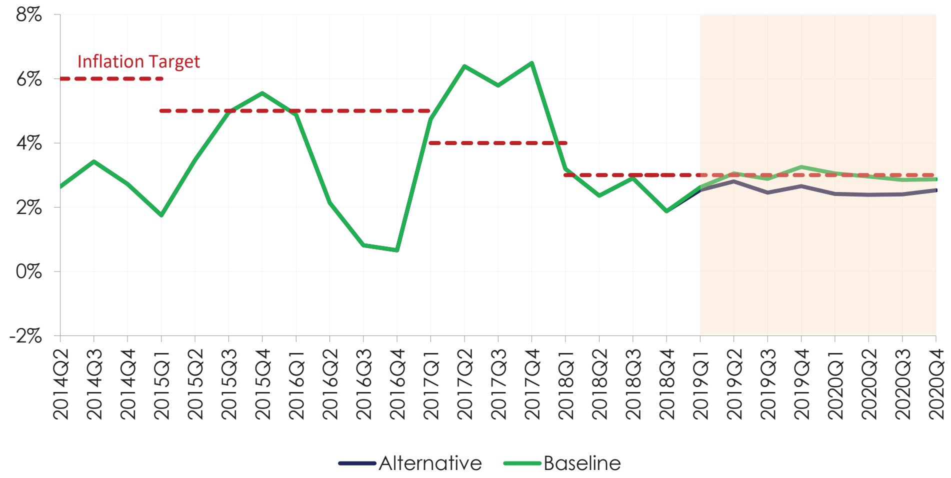


Source: National Bank of Georgia

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

Under the alternative forecast scenario, weak aggregate demand suppresses the growth of consumer prices and the inflation rate is lower than the target level. The scenario builds upon the assumption that, due to weak demand, growth of imports is slow while external conditions do not deteriorate. According to the alternative forecast scenario, over 2019-2020 inflation will be 0.4 percentage points lower than in the baseline projection (see Figure 2.11).

Figure 2.11 Headline CPI inflation according to the baseline and alternative forecasts



Source: National Bank of Georgia

In response, to support aggregate demand and push inflation back towards its target, monetary policy neutralization will occur faster than in the baseline scenario. Under the alternative scenario, the monetary policy trajectory will shift down by 0.6 percentage points compared to the baseline scenario (see Figure 2.12). However, the easing of monetary policy will eventually drive inflation to the target level of 3% in the medium term.

Figure 2.12 The difference in the monetary policy rate in the alternative and baseline scenarios

Source: National Bank of Georgia

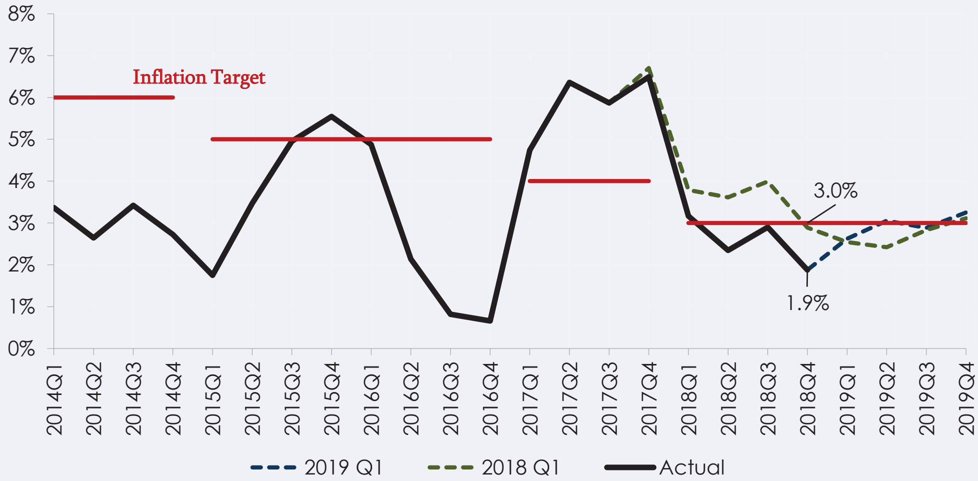
Box 1 Evaluation of Inflation Target Fulfillment and an Assessment of the 2018 Forecasts

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 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 an ever-present threat. Exogenous factors can cause actual inflation to deviate from the target level. Monetary policy is a tool to affect 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 affects inflation expectations and influences inflation in the medium or long term.

We will start this analysis of the accuracy of the 2018 forecasts from the first quarter. An analysis of the forecasts made for 2017 can be found in the corresponding monetary policy report published last year.

The predictions of the inflation forecast made in February 2018 were higher than the reality (see Figure 2.13). Based on that forecast, inflation was expected to remain above the target during the year and reduce to the target level at the end of the year. The reason for inflation remaining above the target was the depreciation of the real effective exchange rate. Since the second half of 2017, the real effective exchange rate had a depreciating trend until the end of that year. Therefore, an increase in imported inflation was predicted. Moreover, the depreciation of the real exchange rate makes intermediate goods more expensive, which pushes inflation up. However, contrary to expectations, the real effective exchange rate started to appreciate in 2018 and the actual inflation rate was thus lower than had been predicted.

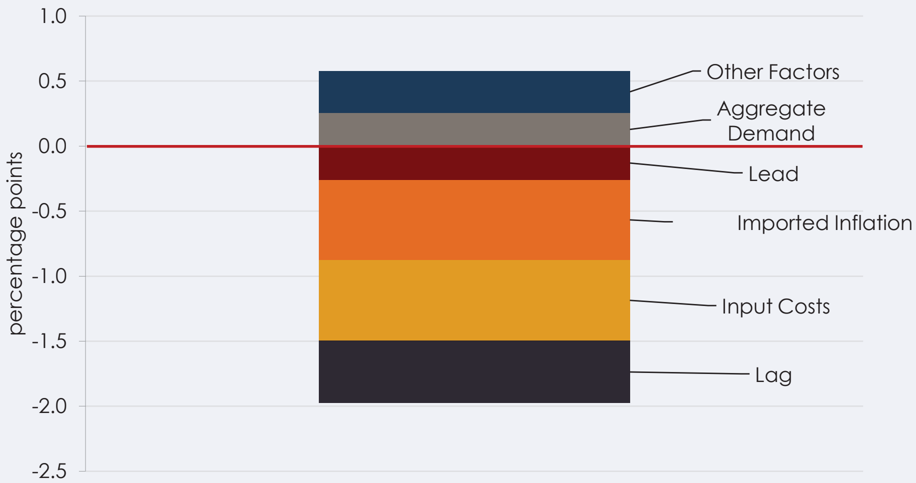
Figure 2.13 Comparison of annual inflation forecasts



Source: National Bank of Georgia

Inflation decompositions reveal that that the lower-than-expected inflation was a result of the relatively lower increase in imported inflation and input costs (see Figure 2.14). Since the beginning of 2018, both the nominal and real effective exchange rates started to appreciate more than had been anticipated. Consequently, the impact of imported goods prices and input costs on inflation (the impact of imported inputs and loan dollarization on prices) was lower than projected. Alongside low inflation, inflationary expectations were also less than expected and their impact on headline inflation was suppressed. On the other hand, the impact of other factors was greater than had been predicted – mainly a consequence of oil price dynamics on the international market.

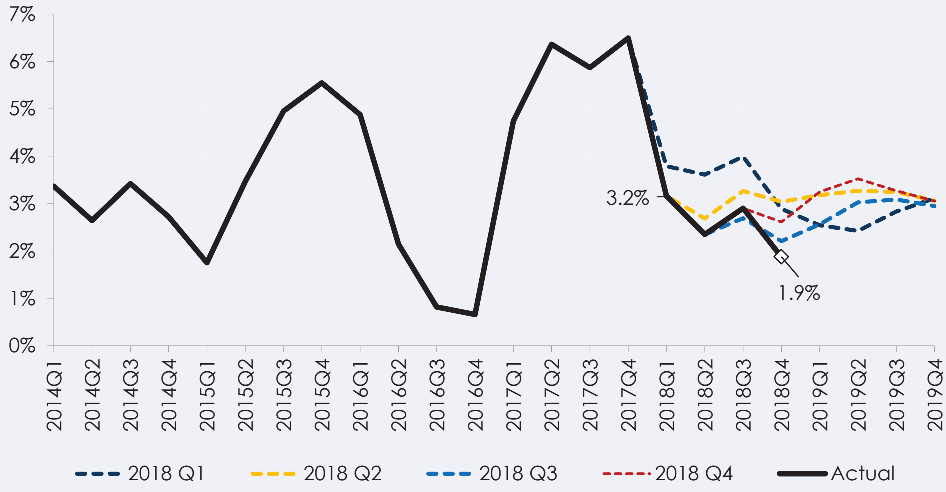
Figure 2.14 Decomposing the deviation of headline inflation from its projected value



Source: National Bank of Georgia

In terms of the quarterly forecasts, the inflation forecast for the second quarter of 2018 was revised downwards. This revision was driven by the neutralization of the impact of supply side factors. As already mentioned, in 2018 the real effective exchange rate appreciated more than had been expected, which reduced imported inflation. Meanwhile, the forecasts for the third and fourth quarters of 2018 were not changed significantly (see Figure 2.15).

Figure 2.15 Performance of headline inflation forecasts (2018Q1 – 2018Q4)



Source: National Bank of Georgia

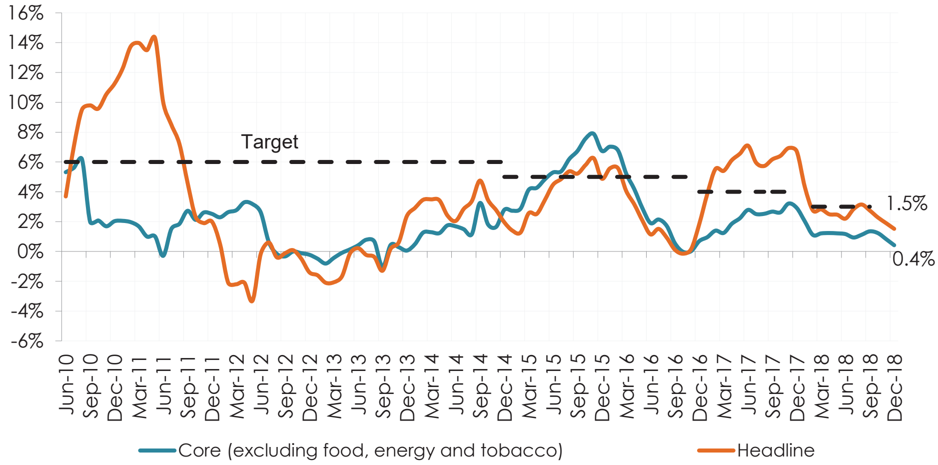
The formation of monetary policy in 2018 can be summarized as follows: according to the forecast, inflation was predicted to fluctuate around the target level, but inflationary risks during the year were high. Macroeconomic risks rose as a consequence of regional developments, causing increased volatility on financial markets. There was the risk that a deterioration of economic conditions in trading partners would push up prices. In response to high inflationary risks, the NBG chose a conservative approach and decided to decelerate the gradual exit from its tight monetary policy stance. Over 2018, the Monetary Policy Committee decided to decrease the policy rate only once, by 25 basis points, and thereafter decided to remain at 7%.

3. Consumer Prices

During 2018, inflation stood close to, but slightly under, the target level of 3%. This was in spite of the substantial increase in tobacco and fuel prices and the growth of water and electricity fees from the beginning of the year. Additionally, in December, there was a hike in bread prices, but inflation nevertheless declined to its lowest point of 1.5%. Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was even lower and stood at 0.4% (see Figure 3.1).

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

Figure 3.1 Headline and core inflation



Source: GeoStat

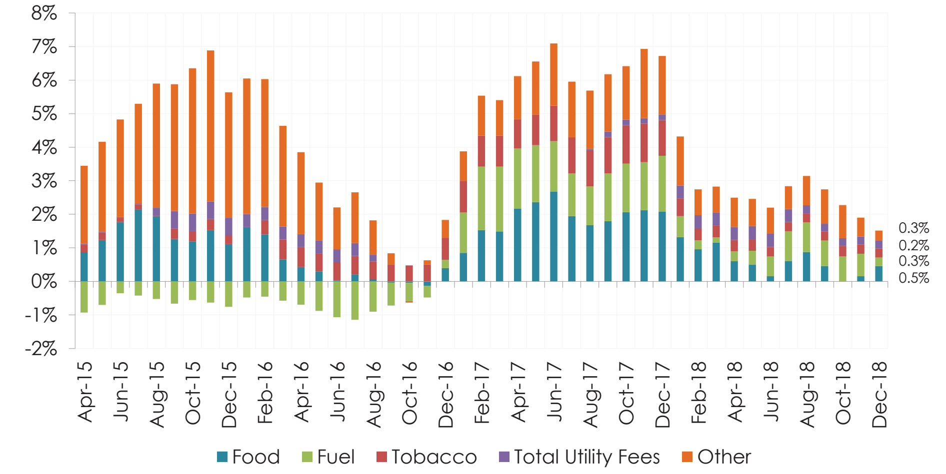
Over 2018, average annual inflation equaled 2.6%. As mentioned above, the rise in prices on fuel and tobacco largely affected the level of headline inflation, making an average annual contribution of 0.5 and 0.3 percentage points respectively (see Figure 3.2). The increase of fuel prices is linked to the growth of oil prices on international markets during the first three quarters of the year. However, by the end of the year, prices on fuel had declined following a substantial decrease of global oil prices. Accordingly, the contribution of fuel to headline inflation shrank to a 0.3 pp impact in December. Throughout 2018, the cumulative average impact of water and electricity fees on inflation equaled 0.2 pp.

‹‹ Increased prices on fuel and oil have a substantial impact on inflation.

In 2018, inflation in the food group was low. The relatively high prices of meat products were balanced by decreased prices on fruit, vegetables and products containing sugar. The price of bread, which has the greatest weight (3.6%) in the consumer basket, grew by 13.3% in comparison to December 2017, contributing 0.5 pp to inflation. The overall increase of food prices was 1.7%, contributing 0.5 pp to inflation.

‹‹ Inflation on food was low at 1.7%.

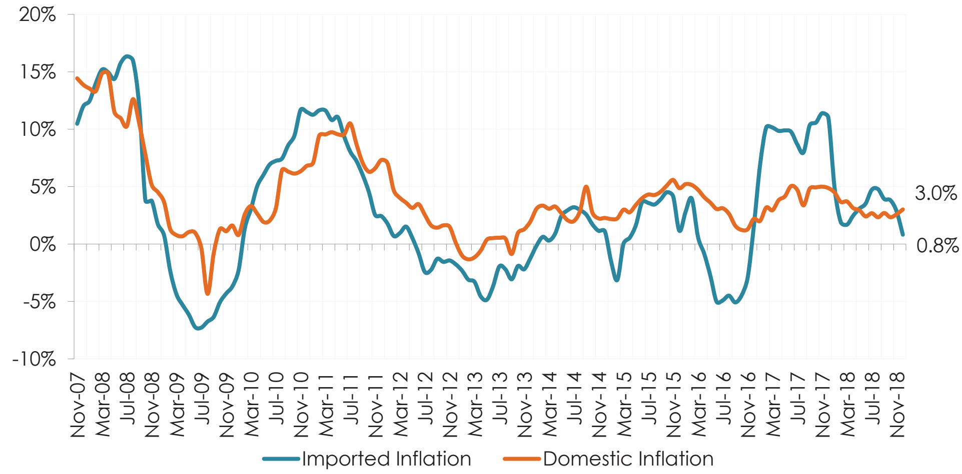
Figure 3.2 Contribution of tobacco, fuel, food and utilities inflation to headline inflation



Source: GeoStat

In December, annual inflation on imported and domestically produced goods equaled 0.8% and 3.0% respectively, while prices on mixed goods declined by 1.7% (see Figure 3.3). Prices in services increased by 1.8% – a low number and indicative of the weak pressure on prices from the supply side.

Figure 3.3 Imported and domestic inflation

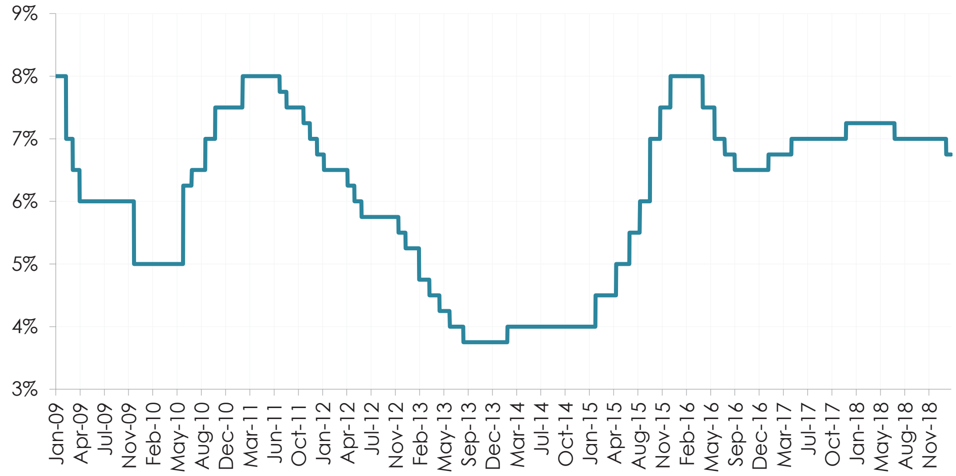


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

From early 2018, as was forecast, inflation declined and remained around the target level of 3%. Hence, as expected, in June, the Monetary Policy Committee started a gradual exit from its relatively tight monetary policy stance and cut the policy rate by 25 basis points. In the second half of 2018, considering the upward risks to inflation stemming from the external sector, the National Bank of Georgia kept the policy rate unchanged. In December, inflation equaled 1.5%.

Figure 4.1 Monetary policy rate



Source: National Bank of Georgia

At the last Monetary Policy Committee meeting, which was held on 30 January 2019, the decision was made to cut the refinancing rate by 25 basis points. Currently, the policy rate stands at 6.75%. According to the forecast, other things being equal, inflation will fluctuate around the target level in the medium term. Along with the reduction of macroeconomic risks stemming from the external sector, upward risks to the inflation forecast have also abated. Considering that inflationary pressure from aggregate demand remains weak, the Monetary Policy Committee deemed it appropriate to cut the policy rate. According to the forecast, the monetary policy rate is expected to be cut further over the year. However, the speed of policy normalization will depend upon a few factors: in particular, the speed at which the output gap is closed and the strength of the transmission of external sector risks to Georgia's economy.

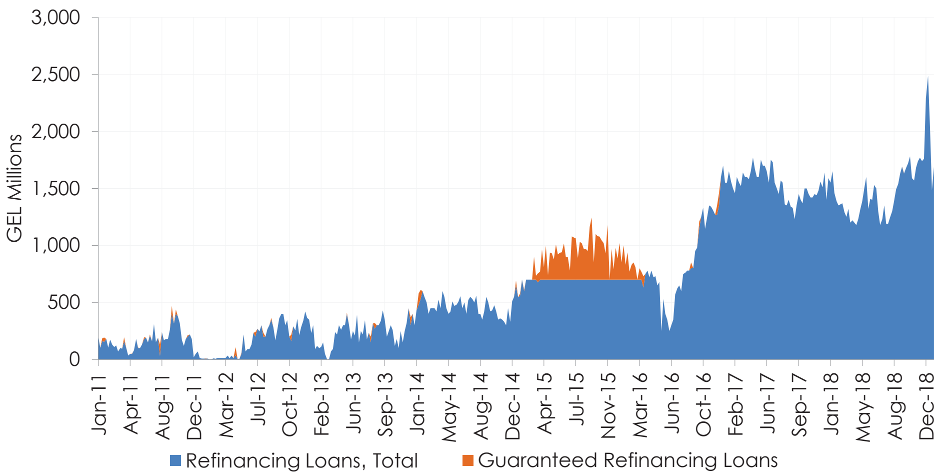
According to preliminary estimates, real economic growth stood at 4.8% in 2018, which reveals weaker-than-expected economic activity – largely stemming from weaker fiscal stimulus and lower demand.

By the end of 2018, as well as over the year as a whole, following an increase in external demand, the external sector made a significant contribution to economic growth. In December, exports grew by 14.0%, while total growth in 2018 was 22.9%. Tourism revenues also increased by 7.2% in December, but the growth rate was relatively low compared to the previous months. Meanwhile, remittances over the same period increased by 9.1%, while over 2018 as a whole the growth of remittances reached 14.3%. It is important to note that from the spring of 2018, imports also exhibited a growth trend; however, by the end of the year the rate of that growth had declined, falling by -2.7% in December. Over 2018 as a whole, imports rose by 14.9%.

According to the NBG's forecast, annual inflation is expected to remain around the target level in the first half of 2019 and in the medium term. It is important to note that temporary factors will push inflation upwards: in particular, the increased excise tax on tobacco and the rising price of bread products. However, such temporary inflationary pressure, together with increased intermediate costs following the depreciation of the nominal exchange rate, will be largely offset by weaker demand. Nonetheless, several major risks to the inflation forecast remain. Inflation will be lower than anticipated if demand is weaker than expected, which will depend on the strength of fiscal stimulus and the growth of lending activity. Conversely, inflation may be higher than expected if geopolitical and economic conditions in the region deteriorate or if prices on international markets grow. Inflation may also be greater than expected if, following the deterioration of geopolitical conditions, increased risk premiums in the region (including Georgia) cause a depreciation of local currencies and thereby increase the debt service burden on foreign exchange loans.

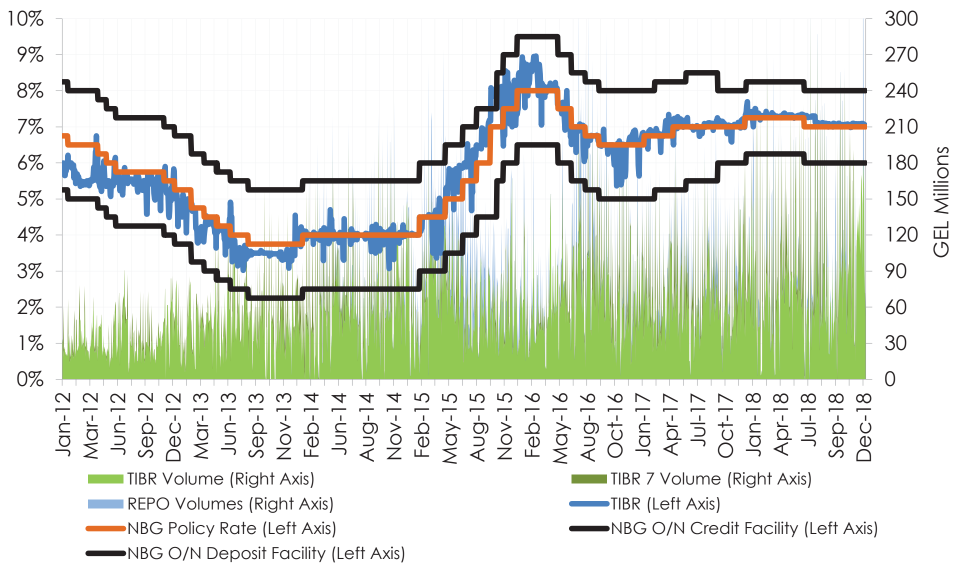
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. To manage short-term liquidity, the banking sector mainly relies on refinancing loans and the interbank money market. 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



* TIBR calculation is approximation until 2013

Source: National Bank of Georgia

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

Box 2 Foreign Exchange Option Auctions

The country's international reserves are a form of protection against shocks and make an important contribution to maintaining macroeconomic stability. One of the sources for maintaining these reserves are the foreign currency interventions made by the National Bank of Georgia. The NBG only intervenes when it is affordable to do so, when foreign currency acquisition does not create excessive volatility on the market, and when it does not change the existing exchange rate trajectory. It is noteworthy that foreign currency acquisitions by the NBG do not influence the exchange rate in the medium or long term.

Since 2017, the NBG has only intervened to buy foreign currency in order to fill its international reserves. According to the most recent internationally accepted IMF methodology (ARA metrics), Georgia's international reserves are behind the desired level for an economy of its size. Therefore, the NBG's aim is to gradually approximate its reserves to the target level. By the end of 2018, the international reserves of the NBG in terms of the ARA metrics stood at 94%, while for an economy of the size of Georgia the recommended level is in the 100-150% range.

When there is a need for foreign currency interventions, it is important to implement rule-based, transparent operations in order to provide the market with appropriate information. At the same time, it is necessary to minimize the influence of such interventions on the exchange rate and ensure the market's needs are met. Taking these issues into consideration, from 2019, the National Bank of Georgia introduced a new instrument, FX options, which gives a holder the right (but not the obligation) to exchange currency in a predetermined timeframe.

Over the year, the National Bank of Georgia will offer the market one-month options with the right to purchase 50 million lari. However, this amount can be adjusted based upon changes on the market. The options will give owners a right to acquire GEL (in exchange for USD or EUR) within the predetermined timeframe and bind the NBG with the liability to sell GEL to the options' holders.

The strike price of the auction is the official exchange rate of the day when an option is exercised, i.e. the average exchange rate of the previous day. This ensures that the international reserves are filled automatically only when the lari exchange rate has a tendency to strengthen. At the same time, a holder is able to use an option only when the lari exchange rate is stronger than the previous 20-day average. This restriction prevents the filling of reserves during periods of short-term volatility in the exchange rate.

The filling of international reserves is important for macro-financial stability. As international experience and academic research show, the existence of adequate reserves diminishes a country's risks and lowers the possibility of crises. Maintaining an adequate level of reserves is especially important for countries similar to Georgia: those with highly dollarized, small and open economies.

The NBG will monitor developments on the market and, depending on FX liquidity conditions, may increase or decrease the volume of FX options.

5. Financial Market and Trends

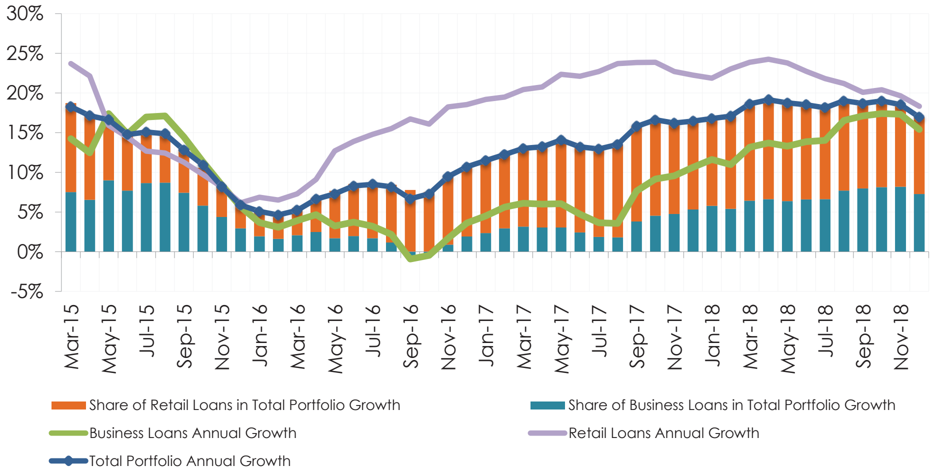
5.1 LOANS

In the fourth quarter of 2018, credit activity declined slightly compared to the previous quarter. In December, excluding the effect of exchange rate fluctuations and the transformation of one microfinance organization into a bank, the loan portfolio increased by 17%. This increase can primarily be attributed to the growth of retail loans. In December, relative to September, the growth rate of retail loans declined by 1.8 pp and stood at 18.3%; while loans to legal entities decreased by 1.7 pp and equaled 15.4%. The growth of the loan portfolio was primarily driven by the increase in the trade, transport, manufacturing and energy sectors; whereas increases in credit for the construction and agriculture sectors were insignificant. According to the credit conditions survey, representatives of the banking sector expect a decrease in demand for retail and business loans. These changes in expectations are a result of the NBG's policies.

« According to the credit condition survey, a representatives of the banking sector expect a decrease in demand for retail and business loans.

To promote sustainable credit activity and improve lending conditions, the National Bank of Georgia has published a law on standards for retail loans, which came into force on 1 January 2019. According to the law, maximum limits for the payments-to-income (PTI) and loan-to-value (LTV) coefficients were established. In addition, from September 2018, a legislative initiative of the Parliament of Georgia was 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. In addition, according to amendments in the Civil Code, loans of up to 200,000 lari are to be issued only in the local currency, except when, as a result of issuing bank credit, the total liabilities of the borrower are higher than 200,000 lari from the same lender.

Figure 5.1 Annual growth rates of retail and business loans (excluding the exchange rate effect)

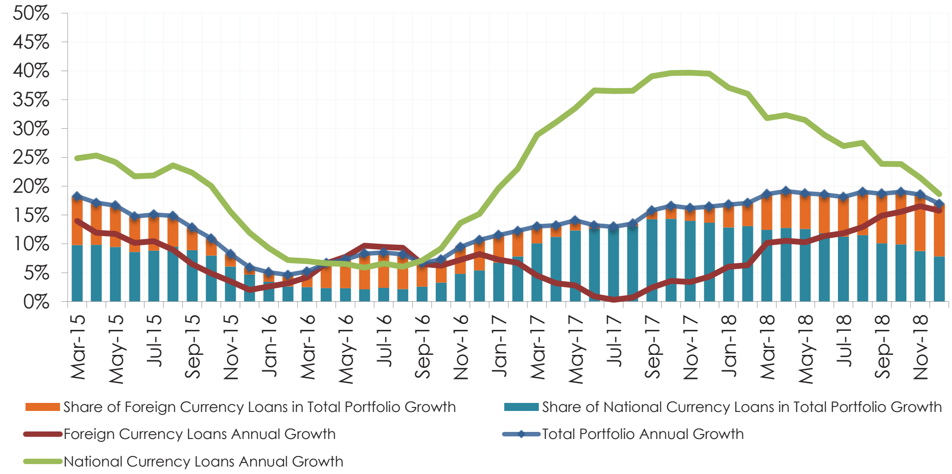


Source: National Bank of Georgia

It is important to note that during 2018 the share of foreign currency loans in the loan portfolio increased (see Figure 5.2). In December, the annual growth rate of foreign currency denominated loans was 15.7%, while loans in domestic currency grew by 18.6%. In the fourth quarter, the loan larization ratio decreased by 1.1 pp and equaled 41.7%. It is expected that loan larization will increase as a result of the regulations on responsible lending and the prohibition from issuing loans in foreign currency under 200,000 lari.

« During 2018, the share of foreign currency loans in the loan portfolio increased.

Figure 5.2 Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

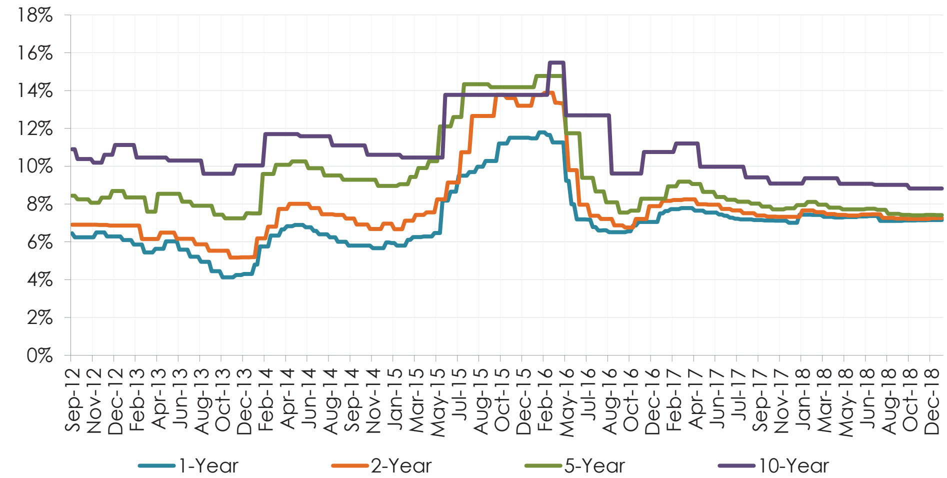


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In the fourth quarter of 2018, interest rates on government securities revealed a declining trend. This was a result of a decrease in interest rate fluctuations (as well as maturity premiums) and expectations of an easing of monetary policy in the medium term (see Figure 5.3).

Figure 5.3 Interest rates on government securities

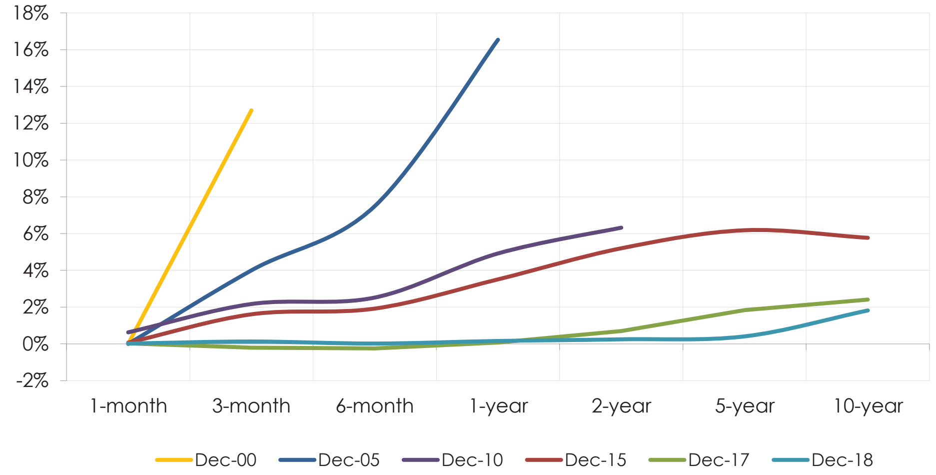


Source: National Bank of Georgia

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 decline of this spread, as compared to the same period last year, suggests the increased credibility of monetary policy instruments and the 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

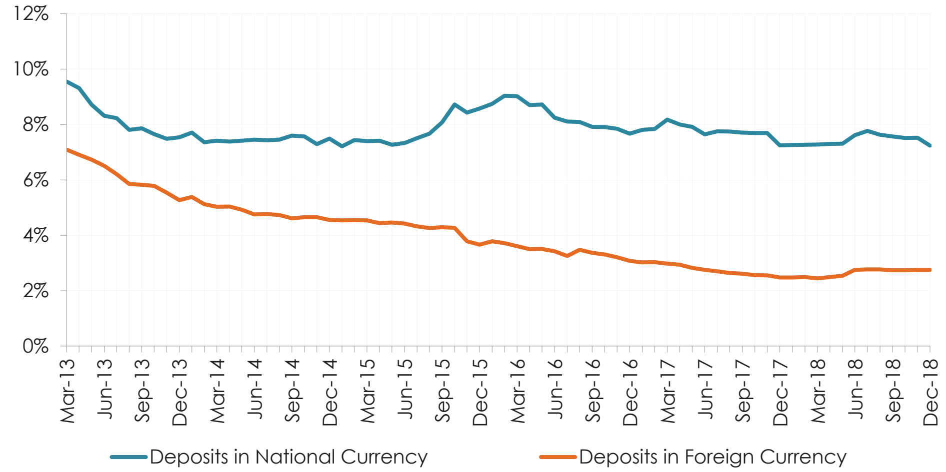


Source: National Bank of Georgia

In December, relative to September, interest rates on foreign currency deposits did not change significantly and stood at 2.7%. Meanwhile, interest rates on domestic currency deposits decreased by 0.3 pp and equaled 7.3%. According to the credit condition survey, following the changes in regulatory requirements and an increase in interest rates for domestic currency deposits, representatives of the banking sector expect a slight increase in cost for domestic and foreign currency funds in the next quarter.

« Representatives of the banking sector expect a slight increase in cost for domestic and foreign currency funds.

Figure 5.5 Average interest rates on deposits



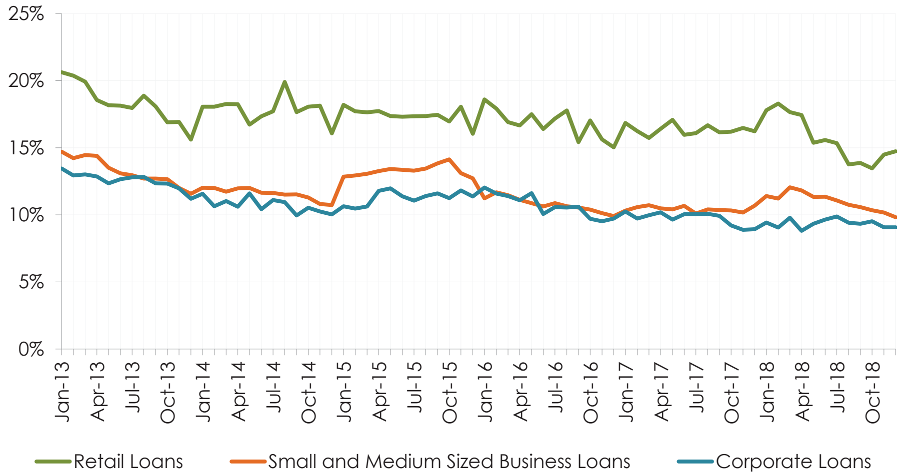
Source: National Bank of Georgia

According to the credit condition survey, non-interest conditions for individual and corporate lending have not changed significantly. Due to restrictions on lending without first analyzing a borrower's solvency based on the PTI and LTV coefficients, representatives of the banking sector expect a tightening of non-interest conditions for individual lending in the next quarter.

In December, compared to September, interest rates on loans issued to small and medium enterprises declined by 0.7 pp to equal 9.8%. Interest rates for corporate loans did not change significantly and stood at 9.1%, while interest rates on retail loans rose by 0.9 pp to equal 14.7% (see Figure 5.6). In December, compared to September, the average interest rates on the stock of legal entities declined in both domestic and foreign currency loans by 0.1 pp (see Figure 5.7). Representatives of the banking sector expect a slight increase of interest on fixed interest loans in foreign currency following the increased cost of funds.

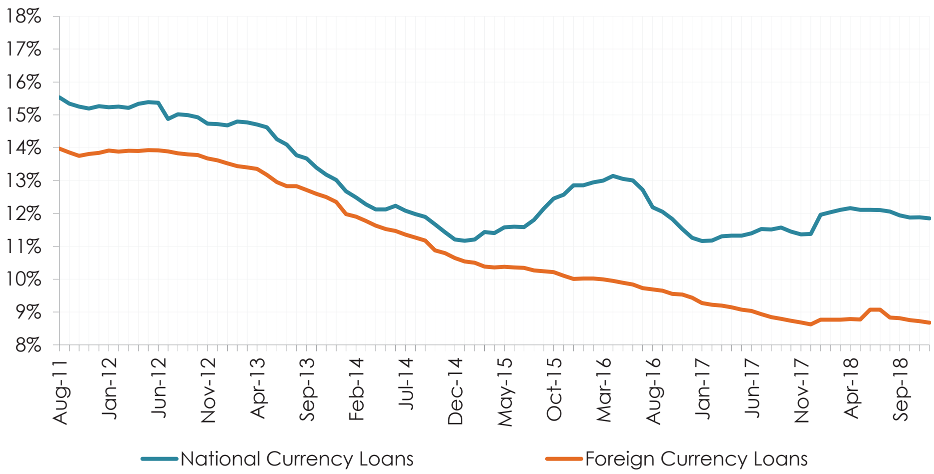
« The representatives of the banking sector expect a tightening of non-interest conditions for individual lending.

Figure 5.6 Interest rate on loan flow



Source: National Bank of Georgia

Figure 5.7 Average interest rates on business loans



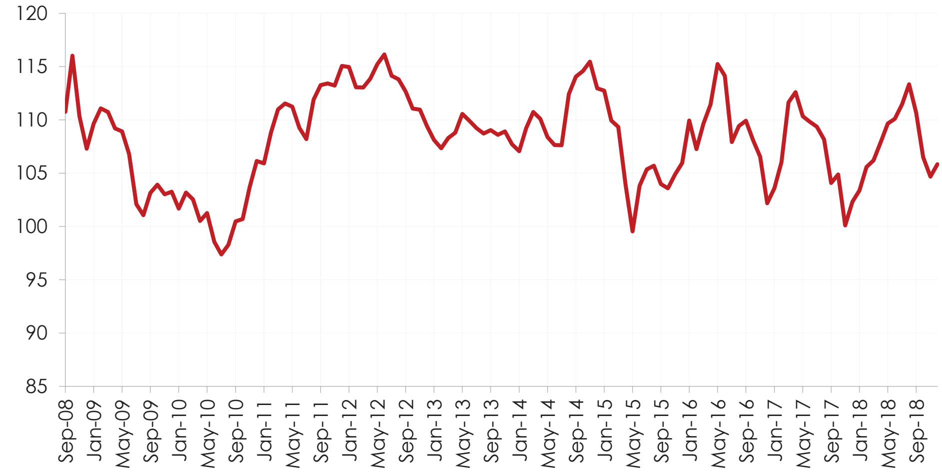
Source: National Bank of Georgia

5.3. EXCHANGE RATE

In the fourth quarter of 2018, the GEL nominal effective exchange rate depreciated against the US dollar by 5.7% and against the euro by 3.8% compared to the previous quarter. Meanwhile, the GEL depreciated against the Russian ruble and Turkish lira by 4.2% and 7% respectively. As a result, the nominal effective exchange rate depreciated by 4.7% on a quarterly basis and appreciated by 8% on an annual basis. In the fourth quarter of 2018, the real effective exchange rate depreciated by 5.5% on a quarterly basis, and appreciated by 3.2% on a year-on-year basis (see Figure 5.1).

When adjusted for commodity groups and services, where the US dollar exchange rate has a relatively high weight, the nominal effective exchange rate reveals a slightly different picture. In the fourth quarter of 2018, the adjusted nominal effective exchange rate appreciated by 5.4% on a year-on-year basis, and depreciated by 5% compared to the previous quarter. These adjusted weights take into account the higher share of the GEL/US dollar exchange rate. Accordingly, the lower appreciation of the adjusted effective exchange rate reflects the depreciation of the currencies of Georgia's major trading partners against the US dollar.

Figure 5.8 Real effective exchange rate (Jan 2008=100)



Source: National Bank of Georgia

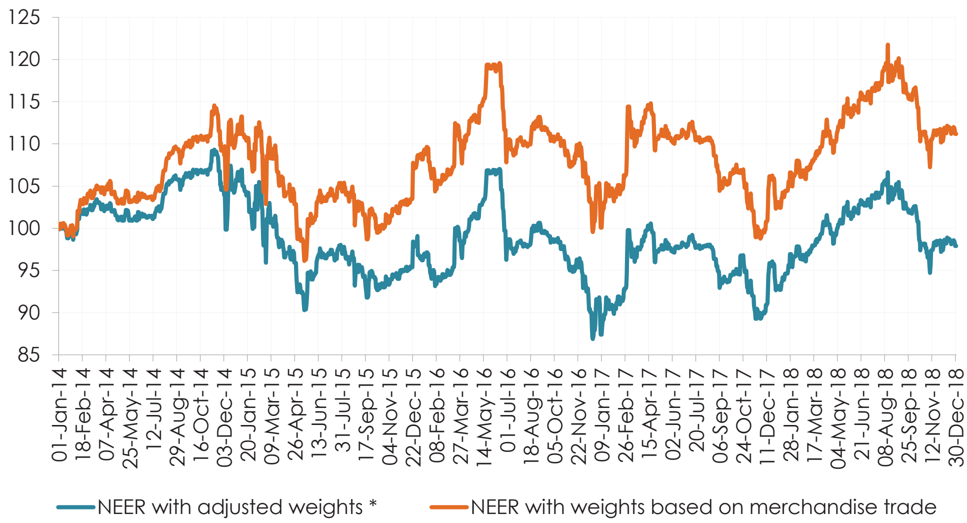
Table 5.1 Effective exchange rates annual growth (4th quarter 2018)

	Change of Nominal Exchange Rate, %	Change of Real Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	8.0	3.4	3.4
Eurozone	1.8	1.8	0.4
Turkey	35.1	14.0	2.7
Ukraine	-1.2	-8.7	-0.6
Armenia	-1.8	-2.1	-0.1
The United States	-2.1	-2.5	-0.1
Russia	12.6	9.6	1.4
Azerbaijan	-2.2	-2.4	-0.2
Other	2.4	1.9	0.1

* 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 3 BI - Modern Platform for Data Visualization and Analysis

It is gradually becoming apparent that given the rapid changes in the volume, flow and use of information in the modern world, existing communication methods are not adequate for meeting future needs. The world uses information at an ever-increasing rate in a range of applications and there is an ever-growing need for faster decision making. An increasingly important problem for communication is the mass flow of unclassified information.

The most effective method to resolve these issues is the automation of data collection, sorting and dissemination. In order to advance its communication with data users, the National Bank of Georgia has developed a modern platform for data visualization and analysis, the so-called Business Intelligence (BI) platform. BI is good for visualizing and analyzing bulk data of different types and formats.

By implementing the BI platform, the National Bank of Georgia took a step forward to improving its communication with users. This step was preceded by the implementation of "Sebstat" – an innovative statistical business process aligned with international standards. Sebstat is an information system for the collection, quality control and processing of information from financial institutions, and the BI interactive dashboards are based on Sebstat data. BI enables the gradual replacement of the Excel statistical tables that are published on the National Bank of Georgia's website with automatically updated, interactive analytical information.

There are many potential benefits of the use of BI: it is a powerful tool that can accelerate decision making, improve quality, optimize internal working processes, improve operational effectiveness, and aid in the identification of trends.

BI covers a wide range of instruments, applications and methodologies that enable us to collect information from both internal and external systems, prepare them for analysis, and create dashboards and visualizations of data. Doing so ensures the availability of analytical results for stakeholders and ordinary employees who can use them in their everyday activities.

The new platform enables the government, businesses and academics to receive information about financial sector activity in a fast and effective manner via automatically updated interactive dashboards prepared by the NBG.

By implementing BI, the National Bank of Georgia has created a platform that gives the banking sector the opportunity to receive necessary information for the evaluation and improvement of their own business performance and for making corresponding analysis. It is also worth mentioning that the successful implementation of this ambitious project was based on detailed data provided by the banking sector.

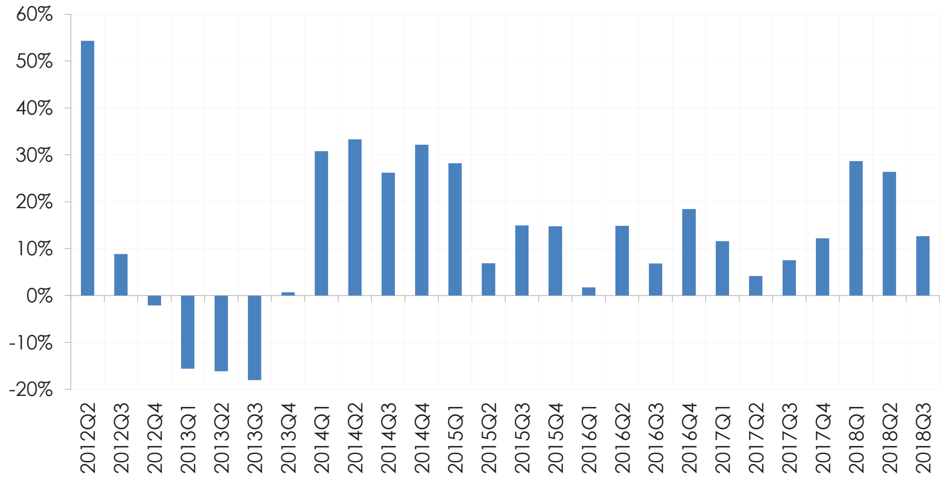
As a first step, reports about loans and deposits have been published on the NBG's website. New dashboards will be periodically added, including those about money transfers and monetary surveys. It is planned that throughout the year the reports published in Excel format will gradually be replaced by interactive dashboards. This will enable users of the NBG's statistics to obtain more information and more detailed data.

6. Aggregate Demand

In the third quarter of 2018, GDP grew by 3.7% in real terms. This growth was driven by net exports, which maintained high annual growth rates in both nominal and real terms. In third quarter of 2018, the export-import balance of goods and services substantially improved, amounting to the historic low of a negative 138 million GEL.

The growth rate of gross capital formation slowed down in comparison with previous quarters, mainly due to the reduction of construction output, but still remained high at 12.4%. In the third quarter, construction's output declined by 9.2% – a decline linked to both the slowdown of certain publicly funded infrastructural projects and private construction.

Figure 6.1 Annual growth rate of capital formation

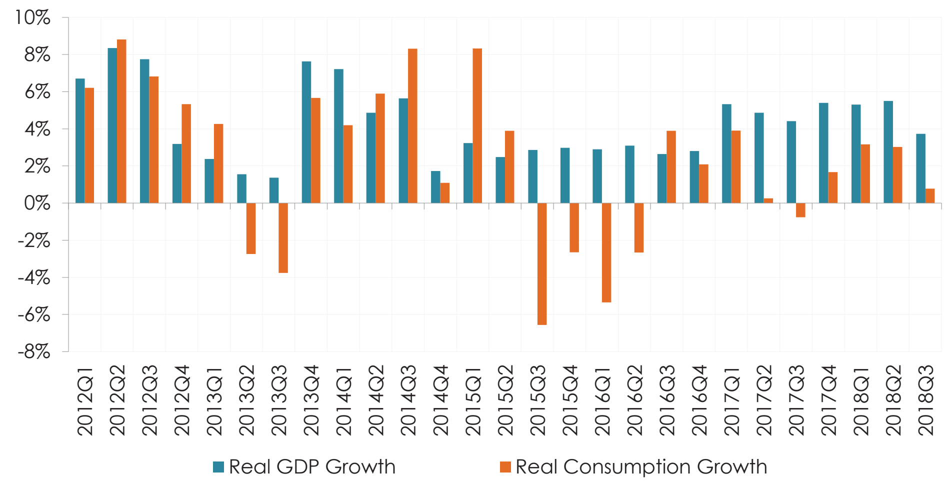


Source: GeoStat

After comparatively high growth in recent quarters, in the third quarter of 2018, real growth of final consumption decelerated to 0.8%.[11] This number is far behind the GDP growth rate and is a sign of weak domestic demand.

‹‹ Weakened growth of final consumption is a sign of weak domestic demand.

Figure 6.2 Real GDP and real consumption growth



Source: GeoStat and National Bank of Georgia

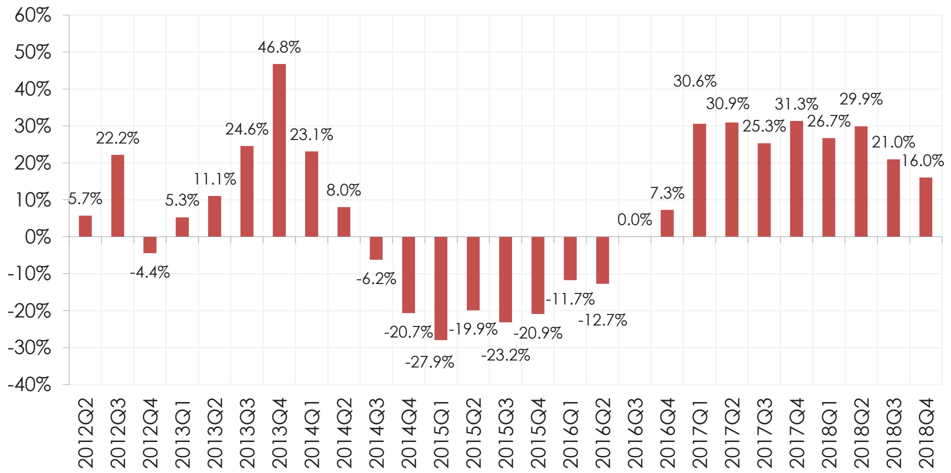
11 *The real growth of consumption is calculated using average annual inflation.*

7. External Demand and Balance of Payments

The year 2018 was notable in terms of external activity; however, from the second half of the year, there was some decrease in the growth of external demand, mainly due to existing economic difficulties in the region (notably in Turkey). In the fourth quarter of 2018, registered exports of goods grew by 16.0% annually (see Figure 7.1). That growth mostly stemmed from increased exports of intermediate goods, while exports of consumer goods revealed modest growth. High growth rates were also notable for exports of ferroalloys, natural wines and waters. Compared to the same period of the previous year, re-exports of motor cars, cigarettes, copper ores and concentrates also became much more active.

« In the fourth quarter of 2018, registered exports of goods increased by 16 % annually.

Figure 7.1 Annual change in registered exports of goods

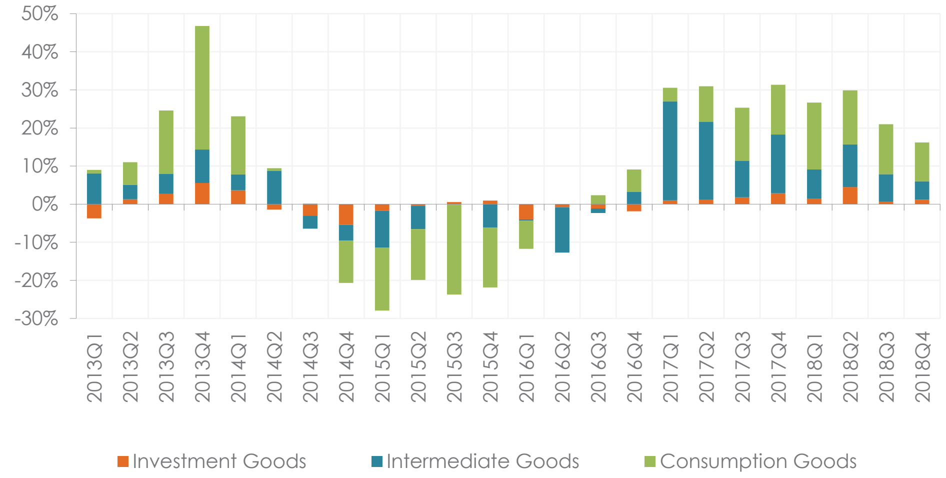


Source: GeoStat

The volume of exports to Georgia's main trading partners significantly increased, except for Turkey, as a result of increased external demand due to the improved economic situations in those countries. Compared to the same period of the previous year, exports were significantly higher to Azerbaijan, Armenia and EU countries. Trade was also higher to other CIS countries, particularly to Kazakhstan and Uzbekistan.

The increase of goods exports was mainly due to higher demand on consumer and intermediate goods. In the fourth quarter of 2018, exports of consumer goods increased by 20% annually, mainly because of higher exports of motor cars, natural wines, bottled waters and cigarettes. Exports of ferroalloys and copper ores and concentrates also considerably increased. It is worth noting that exports of goods in terms of commodity group have become less diverse during the last quarters. The overall increase in exports is mainly due to higher levels of re-exports during the year.

Figure 7.2 Annual change in registered exports of goods by category

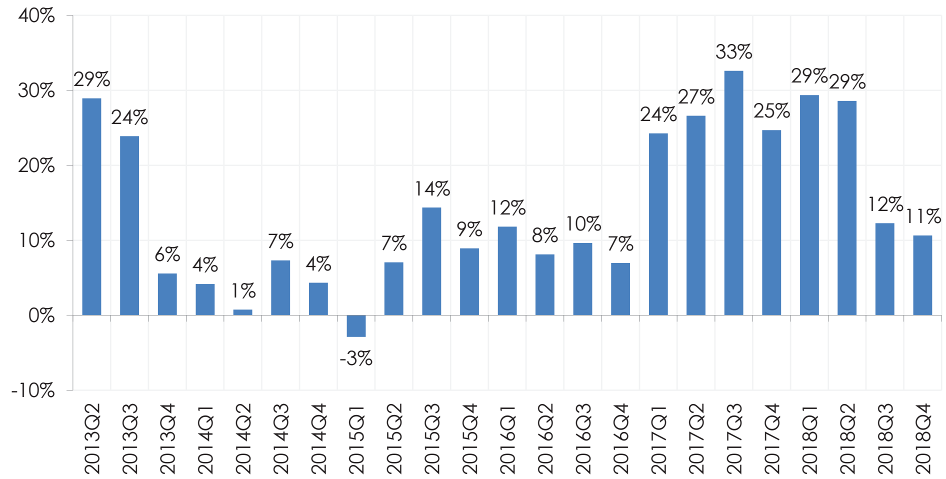


Source: National Bank of Georgia

The increase of external demand also affected exports of services, especially tourism. In 2018, revenues from tourism increased at a high rate, especially from regional countries. In the fourth quarter of 2018, revenues from tourism reached 631 million USD, which is an 11% increase over the same period in 2017 (see Figure 7.3).

« In the fourth quarter of 2018, revenues from tourism increased by 11% and reached 631 million USD.

Figure 7.3 Annual change in revenues from tourism

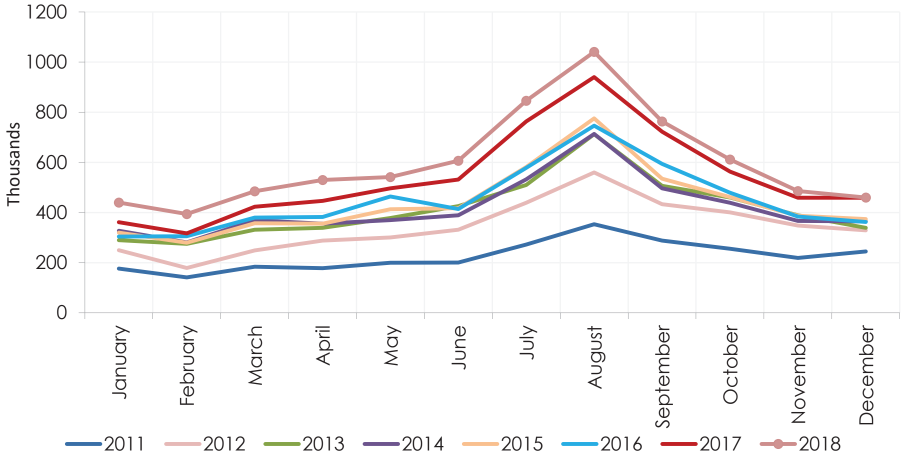


Source: National Bank of Georgia

The rise in revenues from tourism was a result of the increasing number of international visitors, especially tourists.[12] In the fourth quarter of 2018, the number of foreign visitors entering Georgia grew by 5.1% (see Figure 7.4), the majority of whom (69%) were tourists. Travelers from Azerbaijan and Russia made the most significant contribution to this growth, in terms of both the number of arrivals and the revenues from tourism. On the other hand, tourist inflows from Turkey and Armenia contributed negatively to the overall growth of visitors and revenues from tourists from those countries also declined. At the same time, there was a substantial increase in the number of visitors from Israel and EU countries, especially from Germany.

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

Figure 7.4 Number of international visitors to Georgia

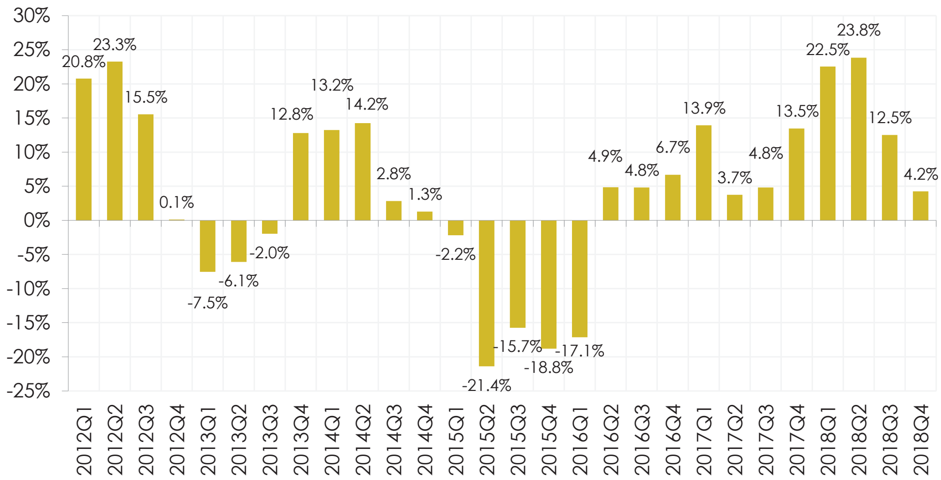


Source: GNTA

At the beginning of 2018, imports of goods showed high growth rates, although this slowed towards the end of the year. In the fourth quarter, the growth rate of imports of goods declined to 4 .2% (see Figure 7.5). It is worth noting that imports increased from CIS countries as well as from the EU. On the other hand, imports were lower from Turkey and China. The decline in imports partially stemmed from lower expenses on petroleum gases and oils, which was due to the decrease of petroleum prices on global markets. It is worth noting that although increased demand for intermediate and consumer goods led to the growth of overall imports, imports of investment goods declined in light of low foreign direct investments.

‹‹ In the fourth quarter of 2018, the growth rate of imports declined.

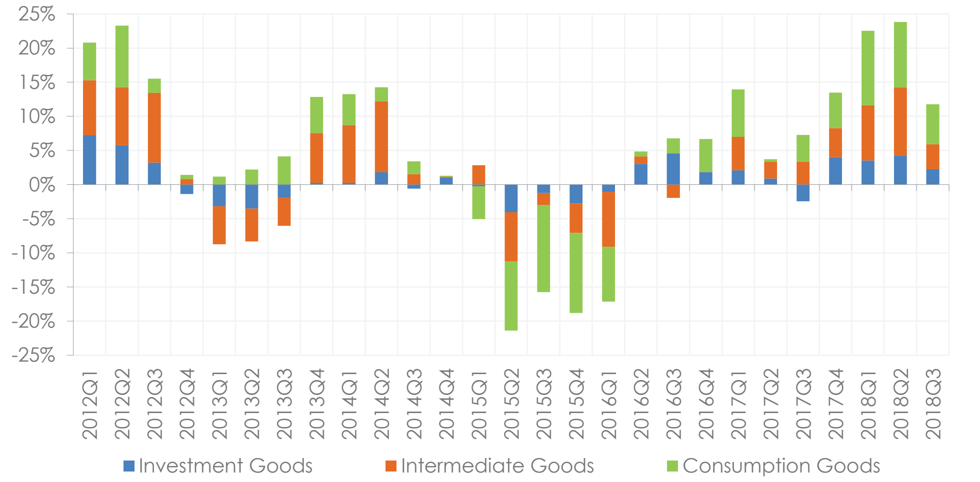
Figure 7.5 Annual change in registered imports of goods



Source: GeoStat

In the fourth quarter of 2018, imports of intermediate and consumer goods accounted for 41% and 45% of total imports respectively. During this period, imports of intermediate goods increased by 7.4%, while imports of consumer goods grew by 5.2% (see Figure 7.6). Moreover, compared to the same period of the previous year, the categories of goods imported were much more diverse.

Figure 7.6 Annual change in registered imports by category of goods

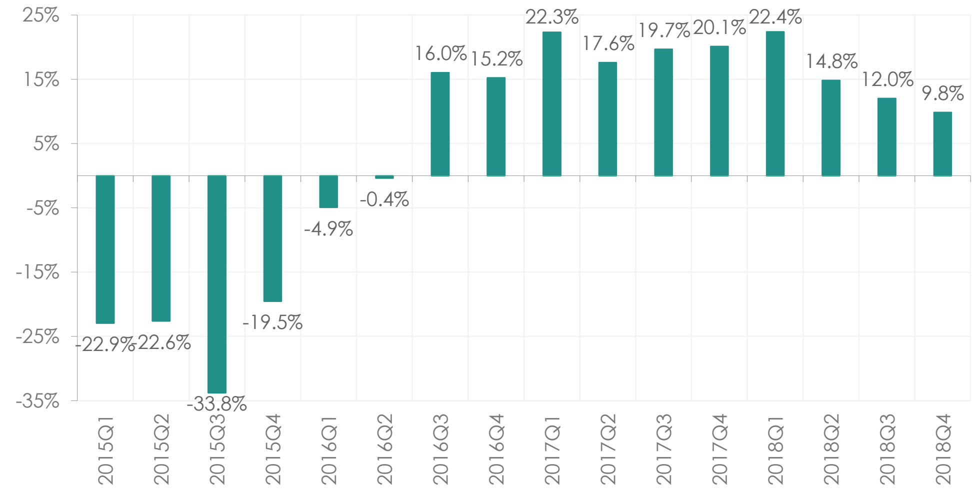


Source: GeoStat

Money transfers to Georgia showed high growth in the fourth quarter of 2018, increasing by 9.8% (see Figure 7.7). This was mainly driven by increased transfers from the European Union (notably from Greece, Italy and Poland) and the USA. In contrast, money transfers from Russia and Turkey showed a decreasing trend from the second half of the year, and their contribution to the overall growth in the fourth quarter was negative compared to the same period last year.

« In the fourth quarter of 2018, the volume of money transfers to Georgia increased by 9.8% annually.

Figure 7.7 Annual change in remittances



Source: National Bank of Georgia

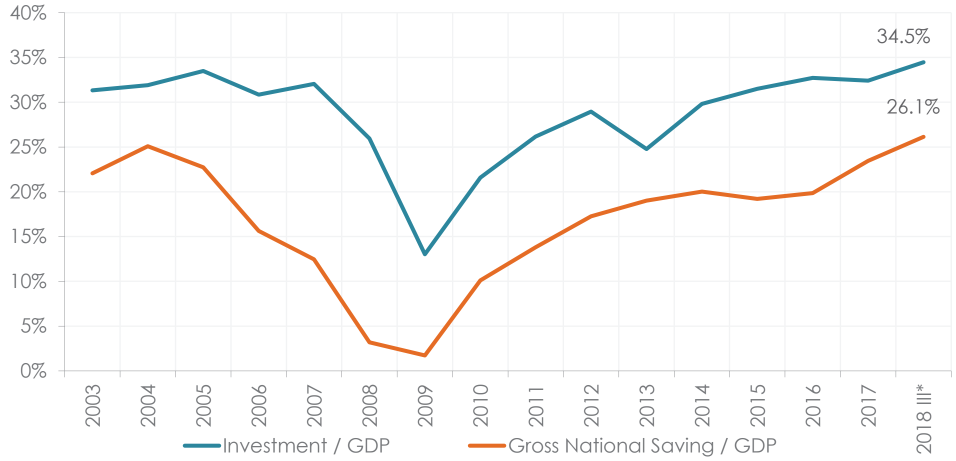
Thanks to the high growth of exports of goods and services, rising money transfers to Georgia and a modest growth in imports, the current account balance became positive and amounted 0.3% of GDP in the third quarter of 2018. This was the first time that the current account balance had been positive, amounting to 11.9 million USD. For comparison, during the same period in the previous year, the current account deficit was 124.9 million USD, amounting to 3.1% of GDP. The current account balance was positively affected by the trade in services – particularly by revenues coming from tourism and current transfers.

« In the third quarter of 2018, the current account balance was positive and amounted 0.3% of GDP.

Foreign direct investments (FDI) remain the primary source of financing the current account. In the third quarter of 2018, the volume of foreign direct investments declined by 48% annually and equaled 322.6 million USD. It is worth noting that the completion of the BP pipeline and several enterprises moving to the possession of Georgian residents both affected the level of FDI. The largest part of FDI went to the manufacturing (56 million USD), energy (46 million USD) and transport (46 million USD) sectors, each receiving 18%, 14% and 14% of total FDI respectively.

An analysis of investments and savings reveals that the improvement of the current account in the third quarter of 2018 stemmed from a higher increase in savings rather than in investments. In 2018, compared to 2017, the ratio of investments to GDP increased by 2.1 pp to reach 34.5%, while the ratio of savings to GDP grew by 2.7 pp to 26.1% (see Figure 7.8).

Figure 7.8 Investments and savings



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

Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

8.1 OUTPUT

In the third quarter of 2018, GDP grew by 3.7% compared to the same period of last year. The growth was primarily driven by services, which contributed 4.3 percentage points (pp). The contribution of agriculture was 0.3 pp, while industry made a negative contribution to growth of -0.8 pp.

The increased number of foreign visitors was the main source of economic growth. Participation of foreigners is important for real estate operations, where growth in the third quarter surged to 13.4%, contributing 0.8 pp to overall GDP growth. Foreigners' participation is also important for the output of hotels and restaurants, which grew by 7.4%, contributing 0.2 pp to total growth. The largest contribution to the third quarter growth came from transport, which surged by 16.2% and made a contribution of 1.2 pp. The largest share of that growth came from travel agencies, tour operators and air transport – all of which further underlines the significance of the enlargement of the tourism industry.

‹‹ The increased number of foreign visitors is the main source of economic growth.

During the last several quarters, trade, which is the largest branch of the economy, grew rapidly, indicating a certain revival of domestic demand. However, the growth of this sector in the third quarter slowed to 2.4% and made a lower, 0.4 pp, contribution to overall growth. Retail trade decelerated the most. As preliminary data show, retail trade grew by only 1.2% in nominal terms. In the meantime, inflation in the third quarter averaged 2.9%, we can thus suppose that the real output of retail trade declined. A reduction of retail trade is a sign of weakening domestic demand.

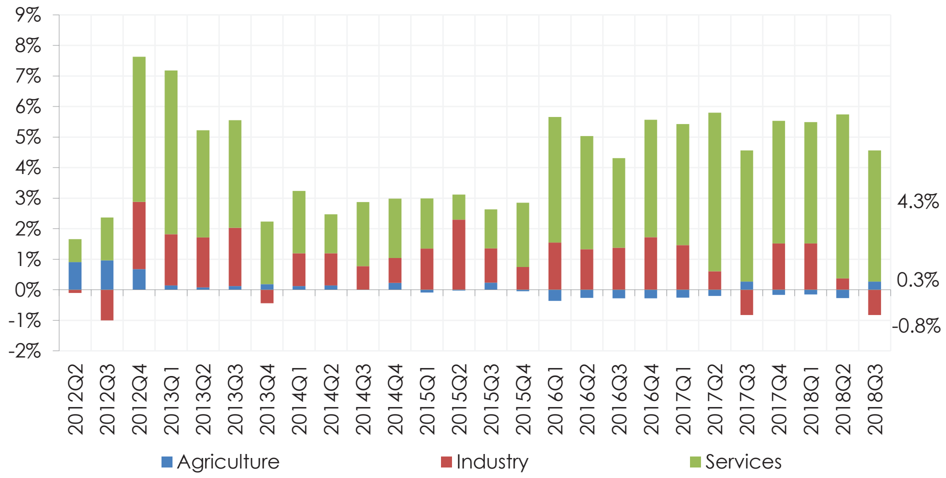
‹‹ Growth in trade is slowed down due to weakened domestic demand.

From industry, the construction sector saw a noteworthy decline. In the third quarter, construction's output fell by 9.2%, contributing -0.8 pp to overall growth. This decline was linked to both a slowdown of certain publicly funded infrastructural projects as well as private constructions.

‹‹ Construction declined by 9.2%.

After its steady decline since 2017, in the third quarter agriculture grew by 3.8% and contributed 0.3 pp to overall GDP growth.

Figure 8.1 Contribution of sectors of economy to real GDP growth



Source: GeoStat.

8.2 LABOR MARKET

In the third quarter of 2018, labor productivity per worker increased by 5.2% compared to the same period of the previous year. In the same period, labor productivity in the agriculture and services sectors increased by 19.1% and 4% respectively, while productivity decreased by 12.2% in the industrial sector (see Table 8.1). In the third quarter, the growth of GDP and productivity was mainly driven by the services and agriculture sectors. The increase of international visitors supported the growth of the restaurants and hotels, real estate operations and transport sectors. The overall increase in labor productivity in services was 4%.

‹‹ Labor productivity grew by 5.2% due to agriculture and services.

The output of the agriculture sector increased by 3.8%, while the amount of labor employed in the sector declined by nearly 13%. Labor productivity per worker thus increased by 19.1%.

Labor productivity in the industrial sector declined by 12.2%, which follows the 22% increase in employment in the construction sector compared to the previous year, while the output declined by 9.2%. Consequently, the labor productivity per worker in construction decreased by 25%. This decline can be linked to the slowdown of both certain publicly funded infrastructural projects and private constructions. 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 for other sectors of the economy. We can thus assume that the productivity of labor in the construction sector will increase in the next reporting period. Meanwhile, productivity slightly decreased in the manufacturing sector by 0.6%, where output increased by 0.1%, while the labor employed grew by 0.8%.

‹‹ A reduction of the productivity in industry is related to a slowdown in construction.

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

	Increase in labor productivity
Agriculture and agriculture output by households	19.1%
Industrial sector	-12.2%
Services sector	4.0%
Overall in the economy	**5.2%**

Source: GeoStat

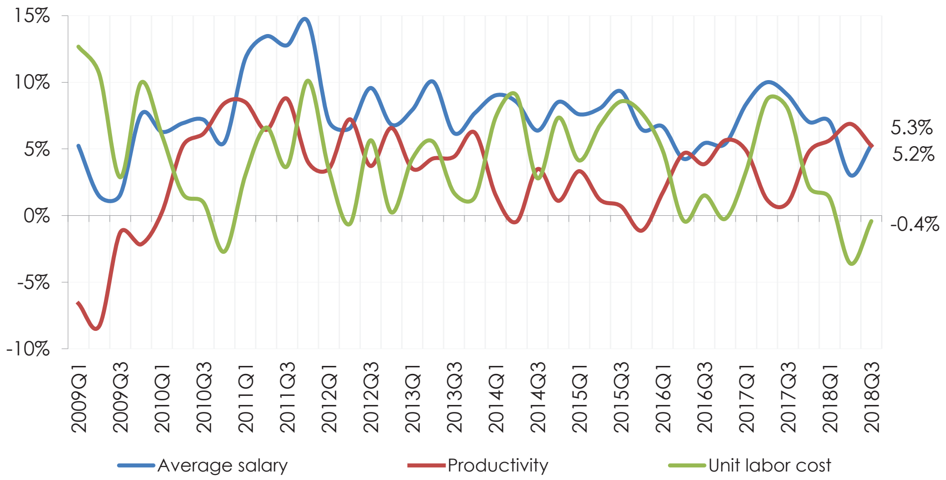
In the third quarter of 2018, the average annual growth of wages equaled 5.3%. According to GeoStat estimates, the average monthly salary in the economy was 1,126 GEL.

‹‹ The average annual growth of wages equaled 5.3%.

In the third quarter of 2018, the unit labor cost declined by 0.4% (see Figure 8.2). Thus, the labor market has not created inflationary pressure in the economy.

‹‹ The labor market does not create inflationary pressure in the economy.

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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