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Monetary Policy Report

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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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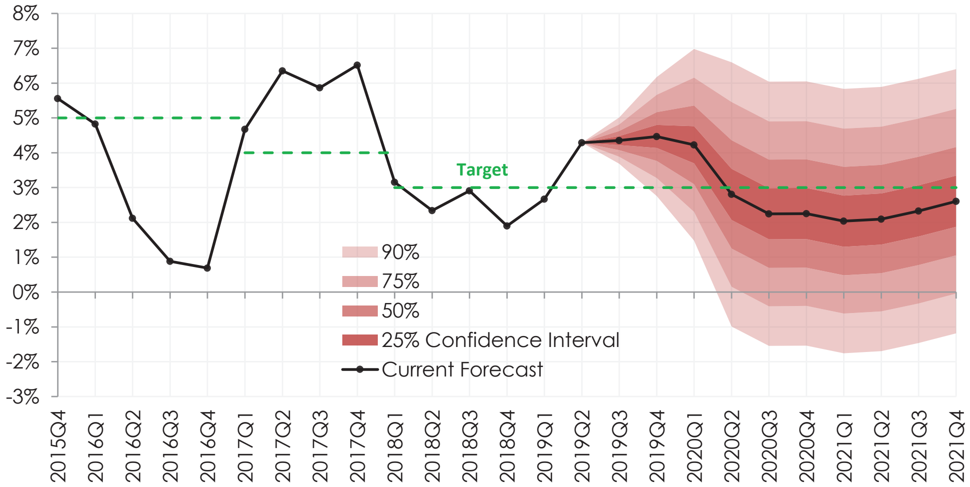
1. Brief Overview

In the second quarter of 2019, the **annual inflation rate**, as expected, stood higher than the target level and equaled 4.4%. However, the increase from the beginning of the year was slightly higher than forecast, as a result of higher-than-expected prices of tobacco products and certain components of the food category. Nevertheless, the upward pressure on inflation from these one-off factors and the intermediate costs of servicing foreign currency loans was, as expected, partly offset by the downward pressure from aggregate demand. As a result, annual inflation in June retreated slightly and stood at 4.3%. Even though this indicator remains higher than the target level of 3%, if the 1.3 percentage points contribution of excise taxes on tobacco products is excluded, inflation is very close to its target.

According to the National Bank of Georgia's **forecast**, following on from the rise of excise taxes on tobacco products and the recent depreciation of the domestic currency, annual inflation will remain higher than the 3% target level in the short run. However, since the currency depreciation reflects expectations of a weakening of external demand, the latter will put downward pressure on inflation, causing inflation to fall below the target in the medium term. Finally, as aggregate demand increases to its potential level, it is expected that annual inflation will reach the 3% target from below by the end of the forecast horizon (see Figure 1.1).

Figure 1.1 Headline CPI inflation

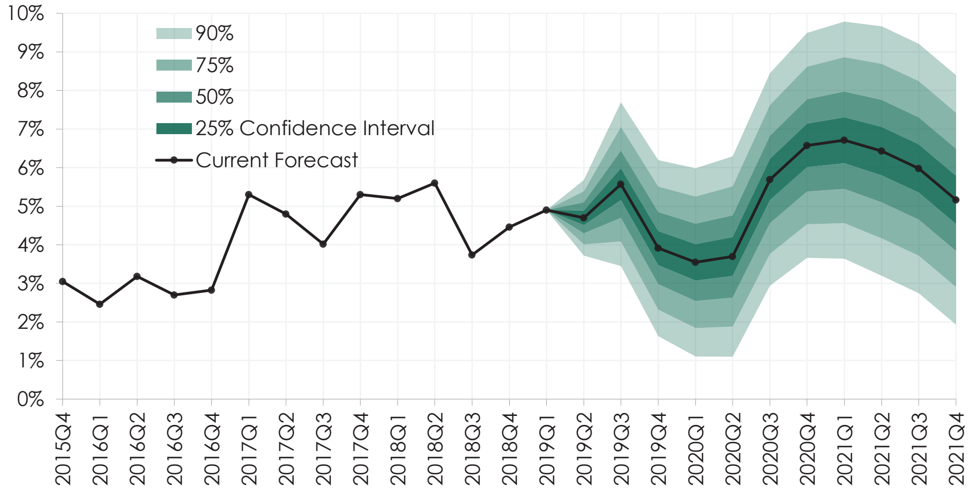


Source: National Bank of Georgia

In the first quarter of 2019, **real GDP growth** was 4.9%, and, according to preliminary data, it stood at 4.9% in the second quarter as well. Despite a recent rise in risks, the relatively high economic growth in the first half of 2019 was mostly driven by stronger external demand. However, notwithstanding an acceleration of fiscal spending and a moderate growth of loans, the growth of consumption and investment have both been weak. Thus, as was the case in the previous Monetary Policy Report, downside risks to real GDP growth remain clearly visible.

Due to external shocks, the NBG has reduced its **real GDP growth forecasts** for 2019 and 2020, which now stand at 4.5% (see Figure 1.2). While the growth of credit and the size of the fiscal deficit carried more risk in the previous quarter, the rise of external sector risks has replaced those issues in the current period. The baseline scenario is based on the assumption that the Russian sanctions on air travel to Georgia will reduce external demand through the travel services by 300 million US dollars. Despite this outcome, according to the forecast, net exports will still contribute positively to GDP growth, albeit more modestly. Net exports continue to make a positive contribution as a result of the important improvement to the current account observed in the first half of 2019. In addition, on the back of moderate credit growth and budget expenditures, consumption and investment will also positively contribute throughout the forecast horizon. According to the revised estimates, the deviation of economic activity from the potential level (which, according to current estimates, is around -1%) will widen slightly in the short run. However, it is expected that the output gap will then improve from next year and will close in 2021.

Figure 1.2 Annual real GDP growth



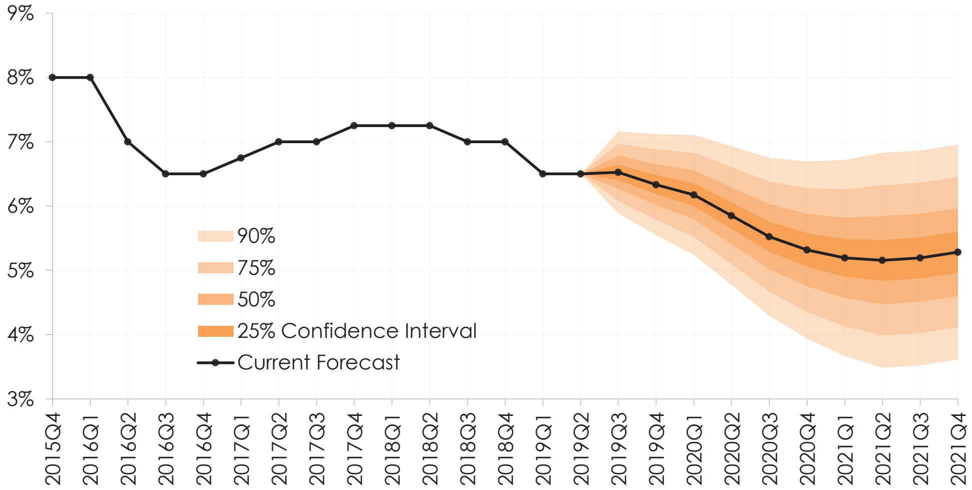
Source: National Bank of Georgia

The main goal of the National Bank of Georgia is price stability, which means inflation remaining close to its target level in the medium term. 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.

Despite the higher-than-targeted inflation, the current macroeconomic forecast envisages a **downward trend for the monetary policy rate** in the medium term (see Figure 1.3). There are several reasons for this prediction. First of all, the baseline scenario assumes that, despite high levels of uncertainty in the recent period, Georgia's risk premium will not increase significantly. In addition, the current nominal effective exchange rate seems to be more undervalued than the size of the current external shock would suggest. Hence, a possible appreciation of the nominal effective exchange rate is expected to exert downward pressure on inflation. Secondly, the expected weakening of external demand next year (and hence of aggregate demand), together with the expiration of one-off factors, will significantly slow down the increase of prices. This expectation is also based on the assumptions that the budget deficit and the growth of credit will not be higher than is currently expected. The optimal monetary policy response to this requires determining the policy rate trajectory that would guarantee inflation being close to the target. According to the baseline forecast, the policy rate will decline to its neutral level, which is currently estimated as 5.5%-6%, after 1-2 years. However, if the upward pressure on inflation stemming from the exchange rate persists, then the Monetary Policy Committee will consider the possibility of tightening monetary policy.

It should be stressed 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 international food and oil prices. 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.

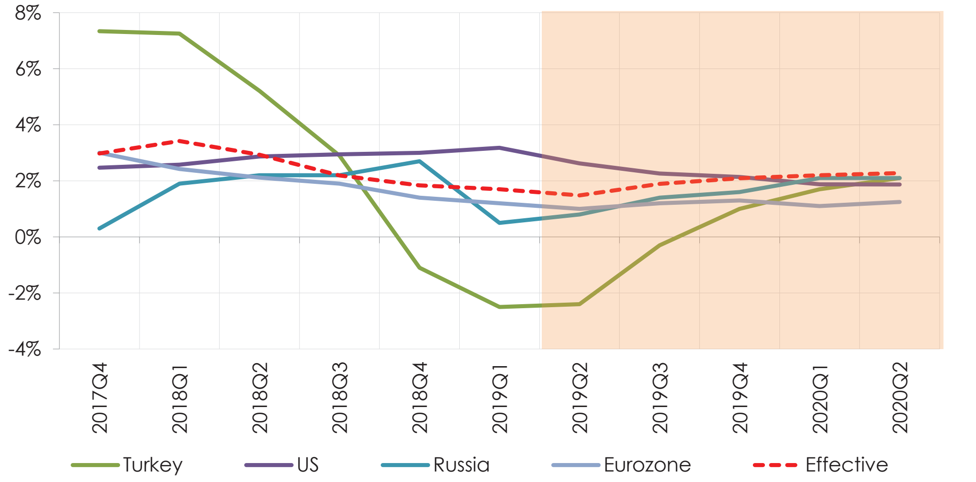
2. Macroeconomic Forecast

2.1 OVERVIEW OF GLOBAL ECONOMY

In the first half of 2019, the global economy was characterized by weak activity. According to the IMF's forecast[1], **global economic growth** in 2019 is projected at 3.2%, which is 0.1 percentage point (pp) below the previous forecast.[2] The slowdown was mostly driven by **emerging and developing countries**, where real GDP growth was lower than expected in the first half of the year. In addition, the slowdown of investment growth and new sanctions related to the US-China "trade war" remain significant challenges. As a result, the IMF reduced the real GDP growth forecast for emerging and developing countries to 4.1%, which is 0.3 pp below the previous forecast. As for the eurozone and Great Britain, volumes of exports and investments have both decreased on the back of a challenging external environment and the uncertainties surrounding "Brexit". However, consumer spending has increased as a result of improved labor market conditions.

In the first half of 2019, a higher growth rate was evident in the **US**, which was mostly encouraged by rising net exports. However, a deceleration in private consumption and investment, together with new trade sanctions remain a significant challenge. Despite the latter, the IMF's real GDP growth forecast for the US in 2019 stand at 2.6%, which is 0.3 pp higher than the previous forecast.

Figure 2.1 Real GDP growth of economic partners



Source: Bloomberg; National Bank of Georgia.

After the sharp slowdown observed last year, the **eurozone's** economy slightly stabilized in the first quarter of 2019. On the back of improved labor conditions, consumer expenditures increased, which were followed by improvements in the production and construction sectors. However, in the face of the challenging external environment, the volume of exports and investments have both declined, which significantly hinders economic growth. It is expected that this trend will continue in the second quarter of 2019. The IMF's real GDP growth forecast for the eurozone in 2019 stands at 1.3%, while inflation is expected to be maintained at around 2%.[3]

Turkey is in a tough economic situation: high inflation, rising unemployment and capital

1 *International Monetary Fund. 2019. World Economic Outlook Update: Still Sluggish Global Growth. Washington, D.C., July.*

2 *International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery.*

Washington, D.C., April.

3 *International Monetary Fund. 2019. World Economic Outlook Update: Still Sluggish Global Growth. Washington, D.C., July.*

outflows have resulted in a significant reduction of the country's economy. Consumer and business sentiment has deteriorated further, which has made aggregate demand even weaker in the wake of the early removal of the Turkish central bank's governor, the political uncertainty around the Istanbul elections and the slowdown of credit growth. Furthermore, Moody's downgraded Turkey's credit rating to the B1 level, owing to increased balance of payment risks. According to the IMF's April forecast, real GDP growth in Turkey will be negative in 2019, being projected at -2.5%.[4] As for inflation, the annual rate decreased by 3 pp in June and stood at 15.7%, while it is forecast to be 17.5% for the year as a whole.

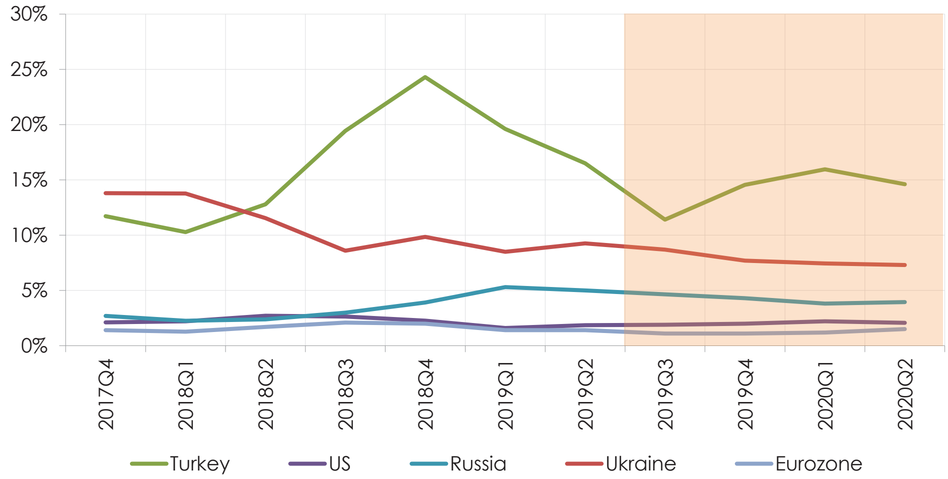
The recovery of the **Russian** economy slowed at the beginning of 2019. Deteriorating consumption dynamics on the back of an increased VAT rate and the depreciation of the local currency slowed economic growth. Due to the challenging external environment and an agreement reached between OPEC and Russia about limiting oil production, export volumes decreased. It is expected that similar dynamics have continued in the second quarter of 2019. According to the IMF's July forecast[5], Russia's real GDP growth will be 1.2% in 2019, which is 0.4 pp below the previous forecast.[6] As for inflation, the annual rate in June was 4.7%, while it is forecast to be 5% for 2019 as a whole.

In the beginning of 2019, **Ukraine's** economic recovery process slowed for the first time in the last two years. This was primarily a consequence of the low level of activity in the manufacturing sector. However, amid high consumer and business sentiment, the healthy recovery is expected to continue in the second quarter of the year. Furthermore, improved labor conditions, a competitive exchange rate and loose monetary policy are all boosting aggregate demand. However, political instability remains a significant challenge. The IMF's real GDP growth forecast for Ukraine in 2019 is 2.7%.[7] The annual inflation rate in June was 9%, while it is forecast to be 8% for the year as a whole.

Armenia's economic growth in the first quarter of 2019 was solid and stood at 7.1%. This was mostly driven by increased activity in the trade, construction and service sectors. The double-digit growth of wholesale and retail businesses, as well as high levels of activity in the financial services and insurance sectors, all reflect a healthy business environment. However, a reduction in export volume is a challenge. According to the IMF's April forecast, Armenia's real GDP growth will be 4.6% in 2019, while annual inflation is forecast to be 2.1%.[8]

Azerbaijan's economy continues its gradual recovery. This has mostly been driven by a high level of activity in the non-oil sector and increased production of natural gas. In addition, fiscal spending has increased. There was a low level of activity in the oil sector in the first quarter of 2019, and this dynamic will probably continue until the second quarter of the following year as well. The IMF's real GDP growth forecast for Azerbaijan is 3.4%, while

Figure 2.2 Headline inflation rates of economic partners



Source: Bloomberg; National Bank of Georgia.

4 *International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.*

5 *International Monetary Fund. 2019. World Economic Outlook Update: Still Sluggish Global Growth. Washington, D.C., July.*

6 *International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.*

7 *Ibid.*

8 *Ibid.*

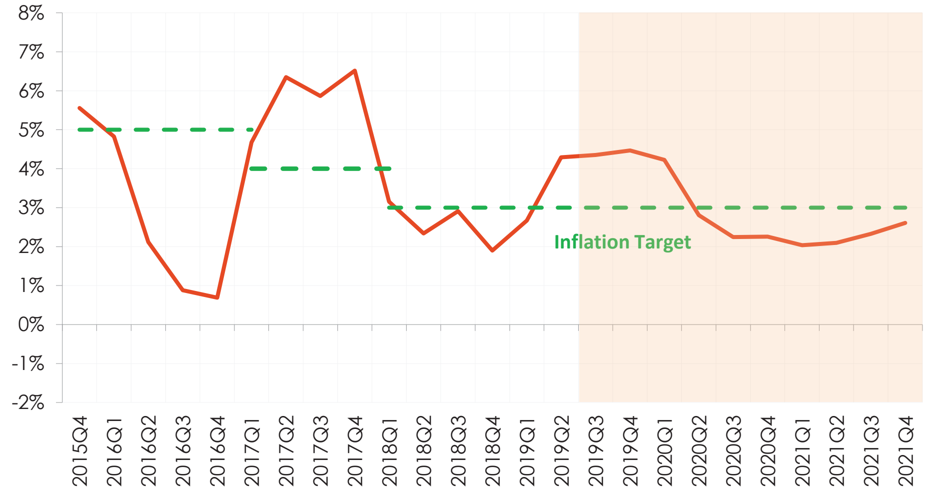
inflation is forecast to be 2.5% in 2019.[9]

The central banks of Georgia's main trading partners kept their monetary policy rates unchanged at relatively low levels. This should help encourage domestic demand in the background of the slowdown of global growth. According to the current forecast, the US Federal Reserve is going to lower the benchmark interest rate by 25 basis points. Meanwhile, the European Central Bank is expected to keep its policy rate unchanged at 0%.

2.2 MACROECONOMIC FORECAST

In the second quarter of 2019, annual headline inflation remained above the target level and averaged 4.4% (see Figure 2.3). This was in accordance with the previous forecast. Inflation pressures were mainly driven by one-off factors, such as the heightened prices on bread at the end of last year and the elevated excise tax on tobacco products from the beginning of this year. These developments were accompanied by hikes in imported prices and intermediate costs, which were both caused by the depreciation of the GEL against the US dollar. In contrast, the still-weak aggregate demand was depressing inflation. Based on the current data for the second quarter of 2019, real GDP fell below its potential by about 1%.

Figure 2.3 Headline CPI inflation



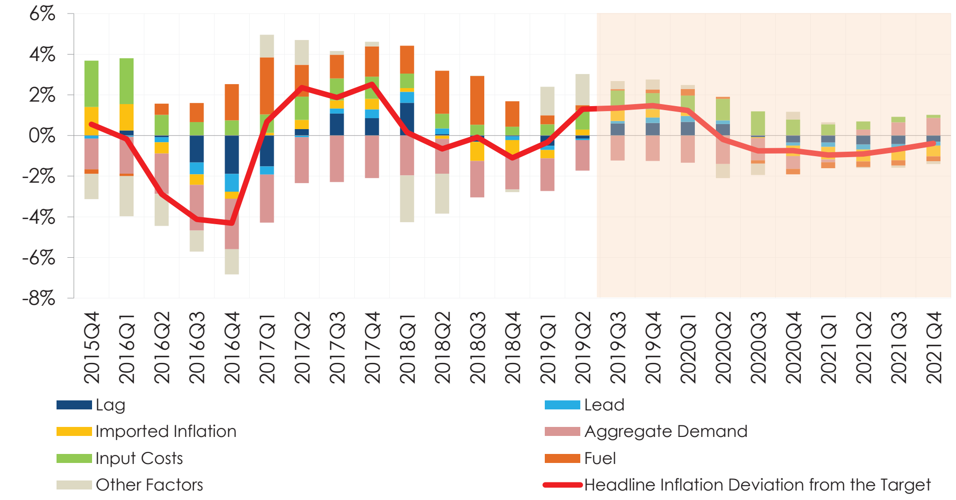
Source: National Bank of Georgia.

As in the previous forecast, **annual inflation is projected to hover above the target level, including the first quarter of next year**. However, in the medium term it will temporarily fall below the target before gradually approaching it once more (see Figure 2.4). The initially increased inflation over the forecast period is a result of an expected fall in external demand. This will first lead to the depreciation of the GEL against the USD and inflationary pressure, and subsequently to a weakening of aggregate demand and a slowdown in inflation.

The inflation rate might deviate from its projected path if certain less probable factors materialize. On the one hand, a deterioration of geopolitical and economic conditions in the region could drive a substantial increase in consumer prices. The realization of such risks might lead to increased risk premiums for the whole region, including Georgia. This would cause a depreciation of local currencies and, because of increasing payments on foreign currency loans and higher imported prices, would drive annual inflation above the predicted level. Another potential cause of upward pressure on inflation could be a sharp increase in international commodity prices (particularly on oil and food). On the other hand, consumer prices could be lower than expected if domestic demand decreases. This would depend on external sector revenues, the size of fiscal stimulus and the growth of credit activity. Despite the recent positive trend, any escalation of the "trade war" between the United States and its major trading partners carries some risk. If this were to cause a global depreciation of the US dollar, the corresponding appreciation of the lari exchange rate could reduce the credit burden of firms and lower inflation expectations, which would ultimately make consumer products cheaper.

9 *Ibid.*

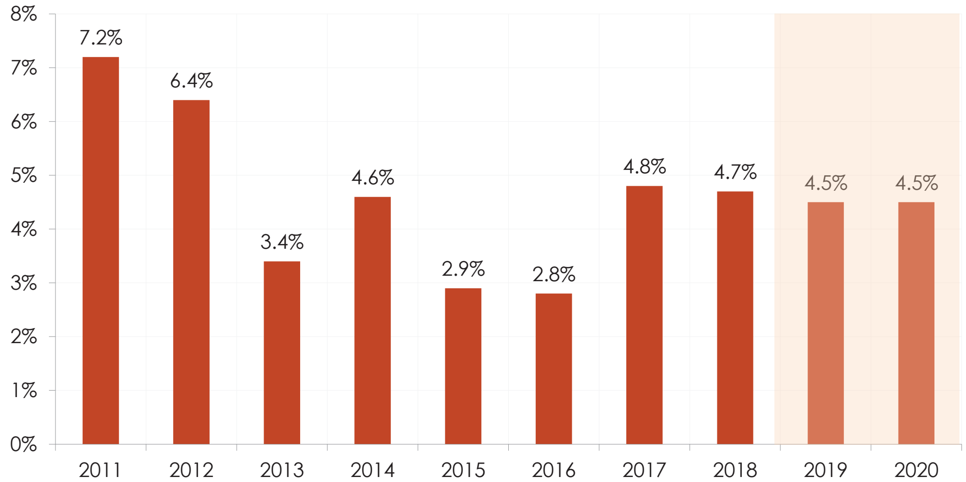
Figure 2.4 Deviation of inflation from the target and its decomposition[10]



Source: National Bank of Georgia.

In the first quarter of 2019, real GDP grew by 4.9% year on year, and annual growth in the second quarter is estimated at 4.9%. This growth was primarily driven by strong external demand, which was reflected in an increase in net exports. Fiscal spending was also solid. However, there was only a relatively modest increase in private consumption, and a decline in investment was noted.

Figure 2.5 Real GDP growth

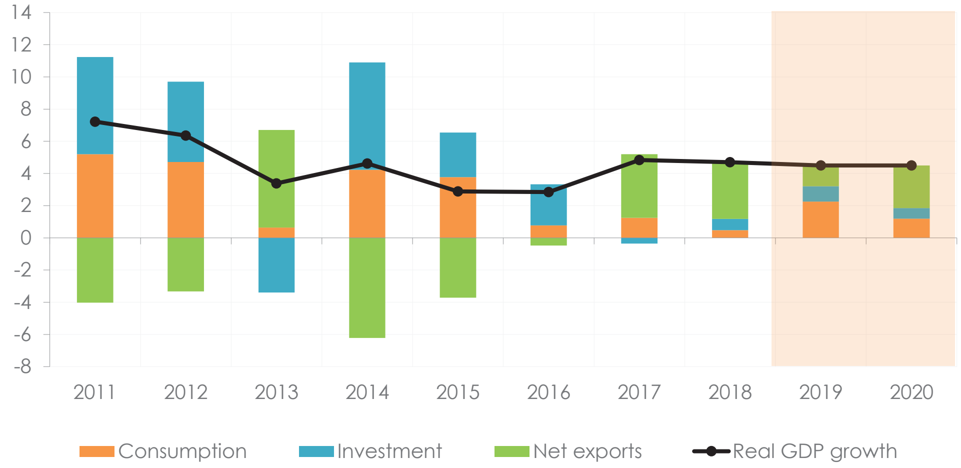


Source: National Bank of Georgia.

Against the backdrop of increased external risks, the National Bank of Georgia has cut its forecast for real GDP growth in 2019 to 4.5% (see Figure 2.5). This revision was prompted by the Russian Federation introducing restrictions on air travel to Georgia. This embargo will induce a decline in export of travel services during the year (see Box 1) and would eventually weaken aggregate demand. Despite elevated uncertainty, net exports are still projected to remain a significant driver of economic activity while a competitive exchange rate is maintained (see Figure 2.6). The assumptions of the forecast also provide for a continuation of fiscal spending, specifically on infrastructure projects, and a moderate growth in the pace of lending. A similar growth of economic activity is expected in 2020, leading to the output gap gradually closing by the beginning of 2021.

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

Figure 2.6 Real GDP growth decomposition



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 downside risks to economic growth. A further deterioration of the geopolitical and economic environment would cause a further decrease in financial inflows, while sovereign risk premiums in the region would increase. This would negatively affect business sentiment and investment, thereby ensuring that economic activity will be lower than expected. Moreover, 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. Conversely, if business sentiment picks up amid improved local and external factors, then investments and the resulting economic activity will be higher than expected.

The **current account deficit** to nominal GDP ratio in 2018 stood at -7.7%, which is the best standing of recent years. This improvement has continued in 2019. According to preliminary data, the figure for the first quarter of the year was -6.2%, which is almost half of the figure recorded during the first quarter of the previous year. Despite a recent increase in risks from the external sector, in the short to medium term the current account deficit is expected to further improve, being supported by a competitive real effective exchange rate and a steady increase in inflows from stable foreign sources.

The ultimate goal of the National Bank of Georgia is price stability and inflation forecast targeting is the most efficient framework to reach this. To ensure that inflation hits the target level in the medium term, the NBG adjusts the monetary policy rate. Under the inflation-targeting framework, the NBG also takes into account aggregate output. Responses to supply-side shocks are gradual and balanced in order to avoid high output volatility. Meanwhile, gradual changes to the policy rate are considered optimal, not only in times of uncertainty but also for efficiently controlling long-term interest rates. The inflation forecast thus includes the interest rate forecast, which takes each of the above-mentioned factors into account.

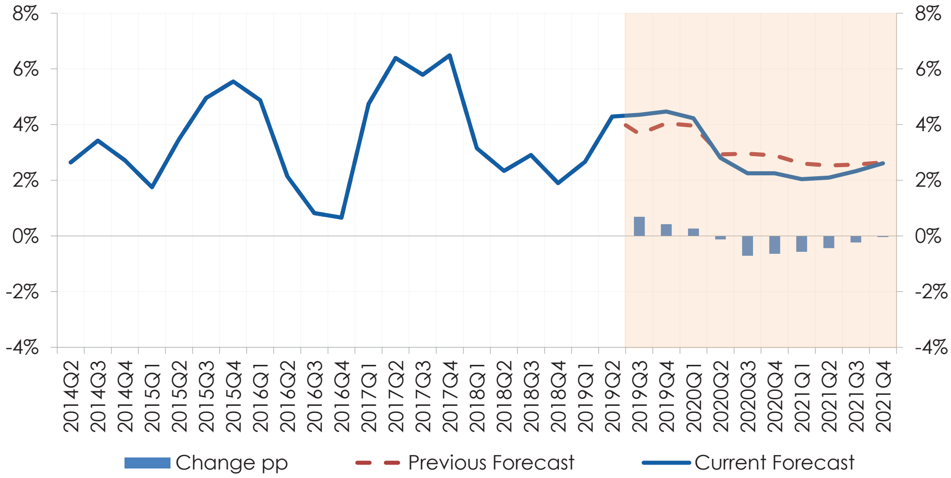
As discussed earlier, the effect of one-off factors and the depreciation of the national currency will increase inflation in the short run; however, weakened aggregate demand, together with the expiration of temporary effects, will subsequently significantly slow the growth of prices. **The optimal monetary policy response** requires determining the policy rate trajectory to ensure proximity to the inflation target in the medium term. In particular, this means maintaining the policy rate at the current level in the short term (which will allow the exchange rate to help the economy cope with the shock), and subsequently reducing it at a slightly faster pace than previously anticipated (see Figure 1.3). According to the current forecast, the policy rate will return to its neutral level, which is estimated at 5.5%-6%, after 1-2 years. It should be noted that the current interest rate forecast is based on the assumption that the country risk premium will not rise significantly.

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. Consequently, if incoming future data presents a different picture from that which has been predicted, then the monetary policy response will be different. 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 short-term inflation forecast has been revised upward compared to the previous projection, while the medium-term forecast has been revised downward (see Figure 2.7). The upward revision of the short-term forecast was mostly driven by the currency depreciation following the Russian flight ban. As previously mentioned, the ban could lower arrivals of Russian tourists, which would cause the current account balance to deteriorate. Ceteris paribus, a widening of the current account deficit would cause the effective exchange rate to depreciate. The response of financial market participants to the news of Russia's flight ban was immediately reflected on the exchange rate. Therefore, compared to the previous forecast, the contribution of imported inflation and intermediate costs to headline inflation have increased. On the other hand, the medium-term inflation forecast has been revised downward, mostly driven by reduced aggregate demand (due to reduced external demand) compared to the previous forecast. According to the revised forecast, inflation in 2019 is expected to remain at around 4.5%, which is higher than the target level. However, in the medium term, headline inflation is predicted to decline and subsequently approach the 3% target from below.

Figure 2.7 Changes in the forecast of headline inflation



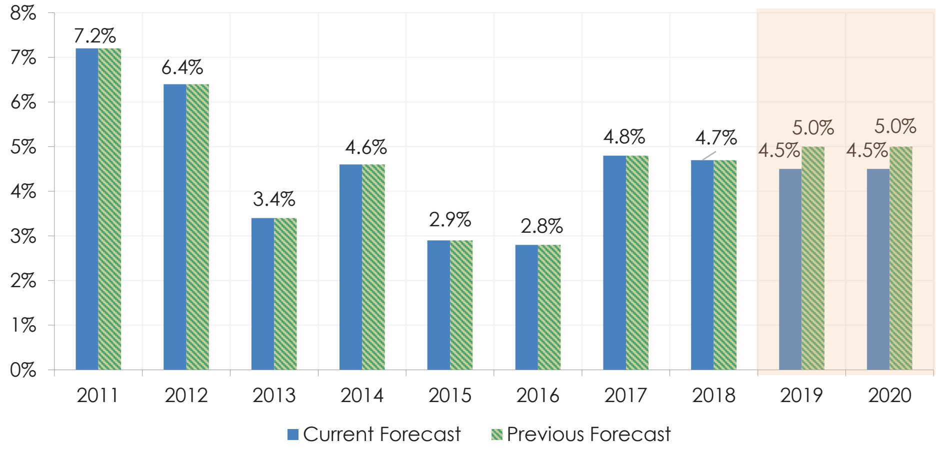
Source: National Bank of Georgia

As for economic activity, the real GDP growth forecast has been revised downward to 4.5% (see Figure 2.8). This revision was mainly driven by the flight ban between Russia and Georgia that would reduce exports of travel services from Russia. In addition, geopolitical tensions somewhat increase the country risk premium, causing a slowdown in investment growth.

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 the baseline forecast as well as associated risks (see Figure 2.9).

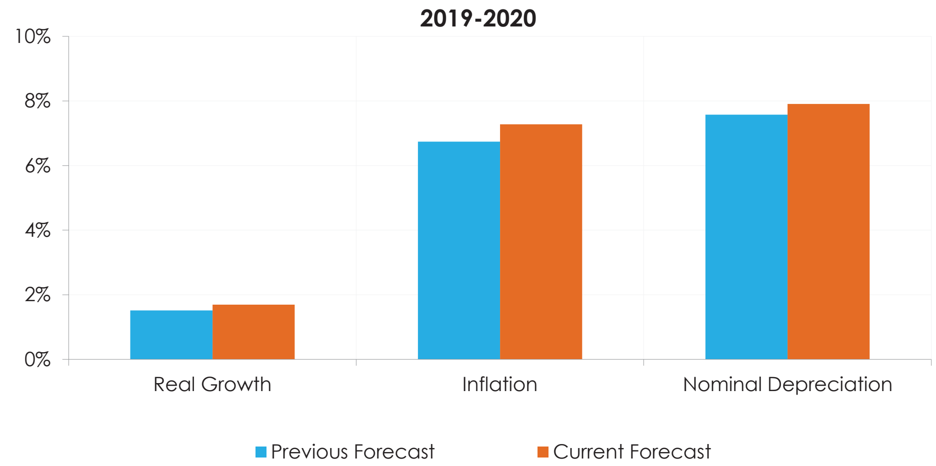
These assumptions for 2019-2020 have changed only slightly. Assumptions regarding the economic growth of all of Georgia's main trading partners were revised upward, mainly driven by the expected economic recovery of Ukraine. Increased economic activities in Georgia's main trading partners will stimulate external demand. Nevertheless, expectations about the size of the depreciation of trading partner currencies slightly increased, primarily as a consequence of an expected depreciation of the Turkish lira against the US dollar. In line with higher economic growth and higher expected depreciation, inflation expectations for Georgia's trading partner countries have been revised upward, which was also largely related to higher inflationary expectations in Turkey.

Figure 2.8 Changes in the forecast of GDP growth



Source: National Bank of Georgia

Figure 2.9 Changes in external sector assumptions for 2019-2020[14]



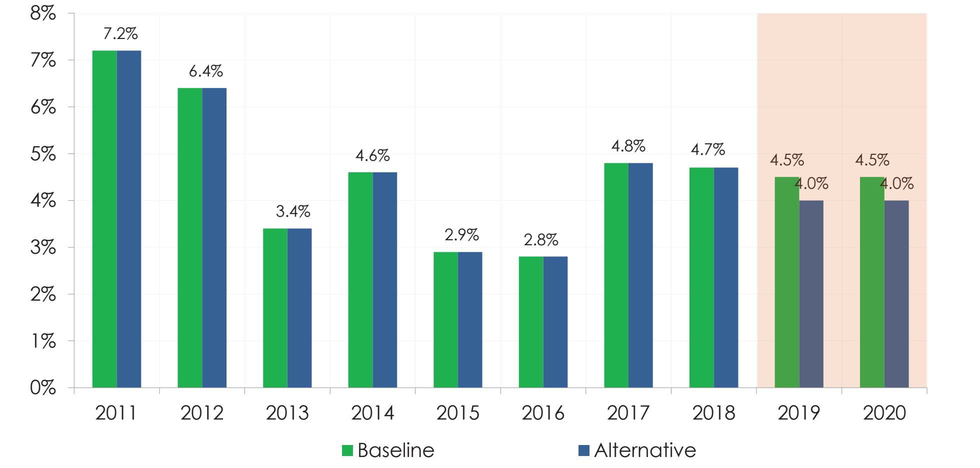
Source: National Bank of Georgia

2.4 ALTERNATIVE FORECAST SCENARIO

In the alternative forecast scenario, external shocks are assumed to be more severe than in the baseline scenario. In the alternative scenario, the impact of the Russian flight ban is stronger, with approximately 500 million USD revenues lost as a result. This scenario assumes a decline of Russian tourist arrivals from both air and land borders. Moreover, in the event of severe geopolitical tensions, exports of goods to Russia would also decline. Therefore, in the alternative scenario the deterioration of net exports is stronger, which causes a greater reduction of aggregate demand than in the baseline scenario.

Realization of the abovementioned risks would reduce external demand compared to the baseline scenario. Accordingly, under the alternative scenario, annual real GDP growth for 2019-2020 is 0.5 pp lower (see Figure 2.10).

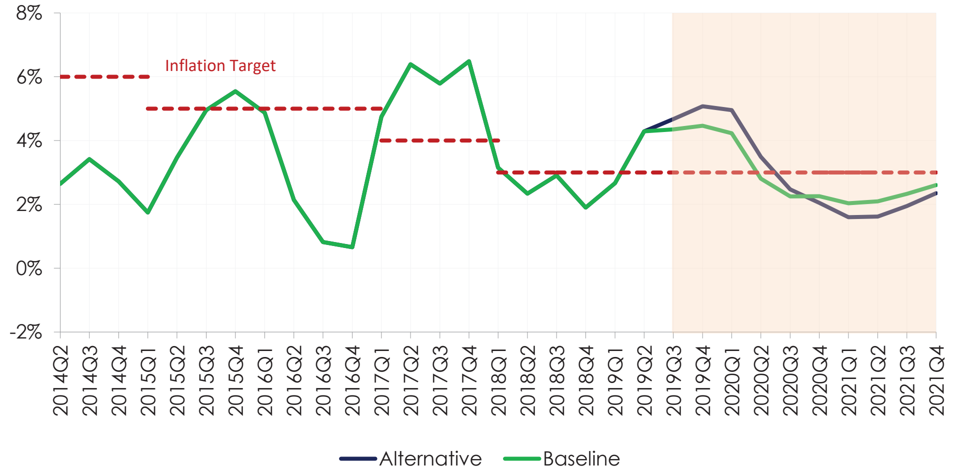
Figure 2.10 Real GDP growth according to the baseline and alternative forecasts



Source: National Bank of Georgia

Under the alternative forecast scenario, weak external demand causes the nominal effective exchange rate to depreciate and increases inflation through the imported inflation and intermediate input costs channels. This effect is partially neutralized in the medium term by subdued aggregate demand. According to the alternative forecast scenario, over 2019-2020 inflation will be 0.4 percentage points higher than in the baseline projection (see Figure 2.11).

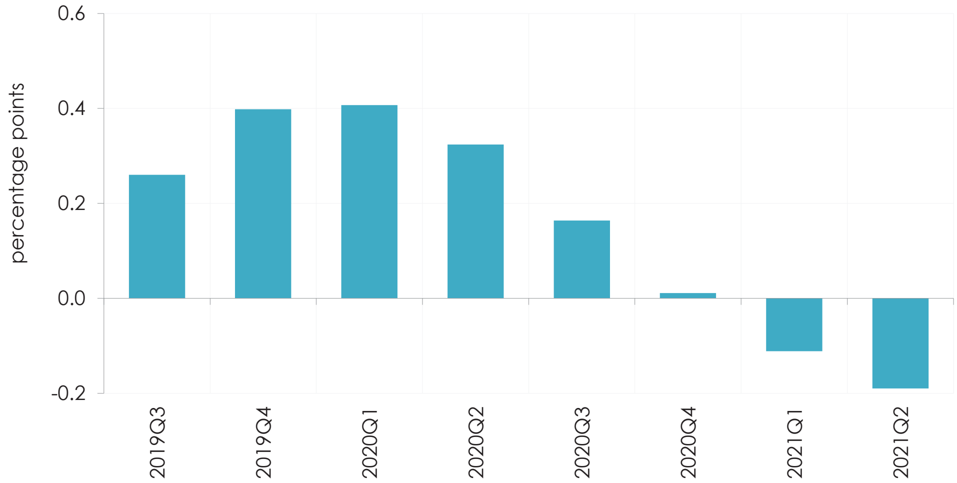
Figure 2.11 Headline CPI inflation according to the baseline and alternative forecasts



Source: National Bank of Georgia

In order to bring inflation back to the target, monetary policy will be tightened in response. Under the alternative scenario, the monetary policy trajectory will shift up by 0.4 percentage points compared to the baseline scenario (see Figure 2.12). This tightening of monetary policy will eventually drive inflation towards 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 The Impact of Russian Sanctions on the Georgian Economy

The Russian authorities banned flights from Russia to Georgia starting from 8 July 2019, and recommended that tour agencies stop selling travel packages to Georgia. The escalation of geopolitical tensions also threaten wine exports to the Russian market. As Russia is one of Georgia's main trading partners, assessing the potential impact of the ban on the Georgian economy and on the corresponding macroeconomic forecasts is crucial.

The major sources of revenues received from Russia come from export of travel services, exports of goods, FDI and remittances. The high level of dependence on Russia is most visible in the travel sector. In 2018, 26% of export of travel services were received from Russia (see Figure 2.13). Arrivals from Russia increased by 29% on an annual basis in the first half of 2019 and accounted for 30% of total travel revenues. Some dependence is also present in terms of remittances. In 2018, money transfers from Russia accounted for 29% of total remittances. However, it should be noted that the share of money transfers from Russia have significantly declined over time, while contributions from other countries have steadily risen. In terms of exports of goods, Russia's share of the total was 13% in 2018. Meanwhile, Russia is not a major source of FDI for Georgia.

The Monetary Policy Report usually provides baseline and alternative scenarios that are based on different assumptions for the Georgian economy. Under these scenarios, the forecasts of major variables like inflation and the monetary policy rate differ. This report concentrates on assumptions regarding the external sector, in particular on the impact of the Russian flight ban.

Baseline scenario

In the baseline scenario, the impact of the flight ban is moderate. On average, an estimated 30% of Russian tourists arrive by air and create 40% of the total exports of travel services received from Russia. Under the baseline scenario, in the second half of 2019 the number of travelers arriving by air will drop significantly. Nevertheless, a small share of Russian tourists still come to Georgia by air through Armenia. On the other hand, Russian arrivals via land borders will continue to moderately increase (as they did in 2018). Based on these assumptions, the potential loss to travel services accounts will be approximately 300 million USD (see Figure 2.14).

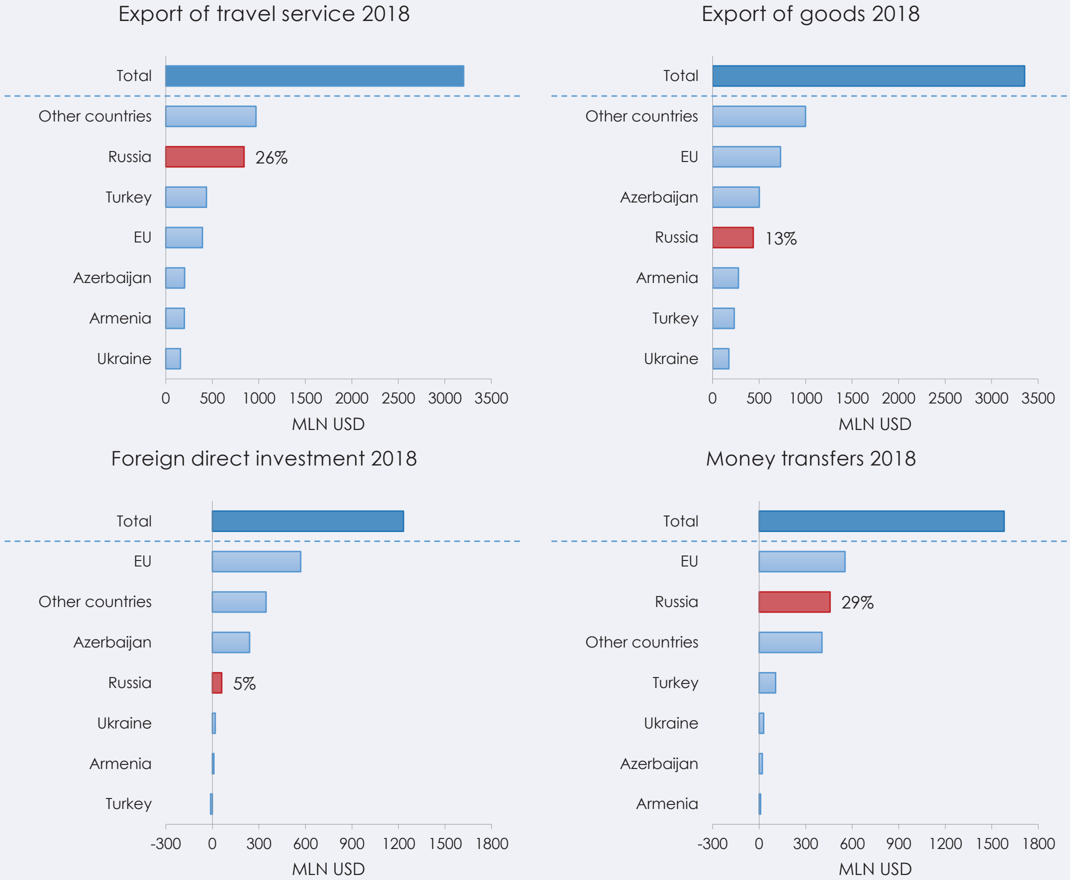
Alternative scenario

Uncertainty surrounding the Russian sanctions is very high. Therefore, in the alternative forecast scenario the external shock is assumed to be more severe than in the baseline. In this scenario, travel inflows via land borders are assumed to drop significantly as well. Overall, reduced travel inflows from Russia could translate to a revenue loss of around 400 million USD (see Figure 2.14). Moreover, escalating geopolitical tensions put exports of goods at risk, especially wine exports. This could incur an additional revenue loss of around 100 million USD. In addition, geopolitical tensions increase the country risk premium and cause a slowdown in investment growth.

The baseline scenario is based on the estimation of a 300 million USD revenue loss, which is 2% of GDP. While the alternative scenario assumes a 500 million USD revenue loss, which is 3.5% of GDP. Nevertheless, the final impact of either scenario on GDP is likely to be relatively small.

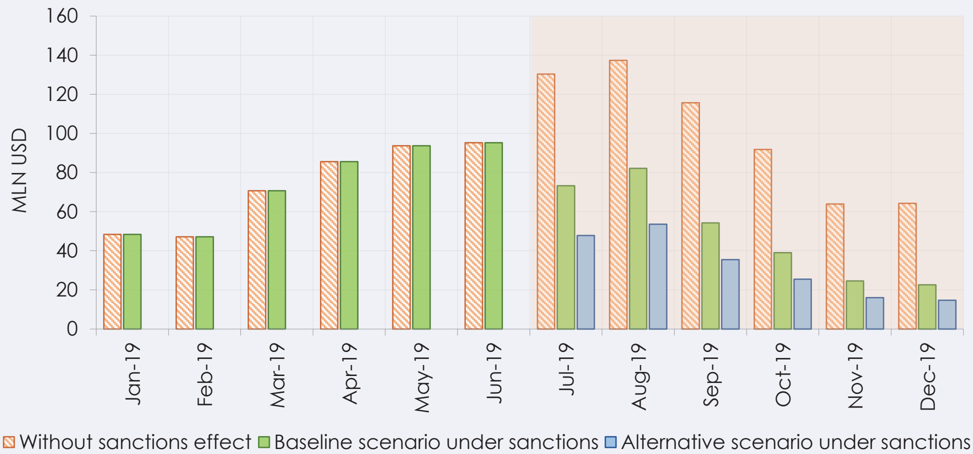
It is worth mentioning that a certain share of revenues is directly spent on buying imported goods. Therefore, a reduction of imports should also be considered when assessing the final impact on the economy. This can be done by estimating the share of imports (excluding re-export and intermediate imported goods, which are used to produce exporting goods) in GDP (or total value added). However, using total imports is not appropriate in this case as a certain share of imported

Figure 2.13 The share of revenues from Russia in BOP items



Source: National Bank of Georgia

Figure 2.14 The forecast of exports of travel services from Russia



Source: GeoStat, National Bank of Georgia

goods are not consumed in the country specifically goods that are directly re-exported or intermediate goods that are imported to produce export goods. For example, in some countries that actively participate in global value chains, the amount of total imports can exceed the amount of GDP. Estimating total import as a share of GDP thus exaggerates import dependence. In such cases, it is appropriate to exclude re-exports and the amount of intermediate imported goods that are used to produce export goods. Based on this approach, the NBG estimates that around 35%-40% of income is spent on buying imported goods. Due to this reason, a decline in imports would partially neutralize the negative effect of the abovementioned shock.

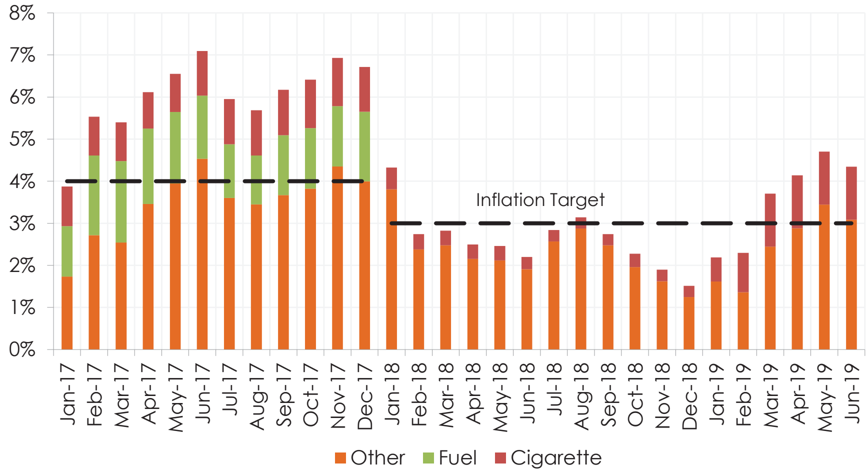
In addition, a drop in imports is also expected due to the recent currency depreciation (indirect effect). As previously mentioned, the flight ban is expected to lower exports of travel services from Russia. This would, other things being equal, cause a deterioration of the current account balance. Ceteris paribus, a widening of the current account deficit causes the depreciation of the effective exchange rate. The responses of financial market participants to this information was immediately reflected on the exchange rate. The exchange rate depreciation makes imported goods more expensive and increases the competitiveness of domestic goods and services. A drop in imports through the exchange rate channel would also partially neutralize the negative impact of Russian sanctions on the Georgian economy.

3. Consumer Prices

Inflation has exceeded the target level since March 2019. In June, inflation equaled 4.3%. The main reason for the increase in inflation was the price increase on cigarettes, which was caused by the rise of excise tax on tobacco products from the beginning of the year. Out of the 4.3% inflation in June, 1.3 pp was related to cigarettes (see Figure 3.1). With the exclusion of cigarettes, inflation is close to the target. It is expected that inflation will near the target after the expiration of this one-off factor.

« Cigarettes have an important share in inflation due to an increase in excise tax.

Figure 3.1 One-off factors affecting inflation



Source: GeoStat, National Bank of Georgia

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was substantially lower than headline inflation and stood at 1.4% in June (see Figure 3.2). The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation signals a reduction of headline inflation in the future.

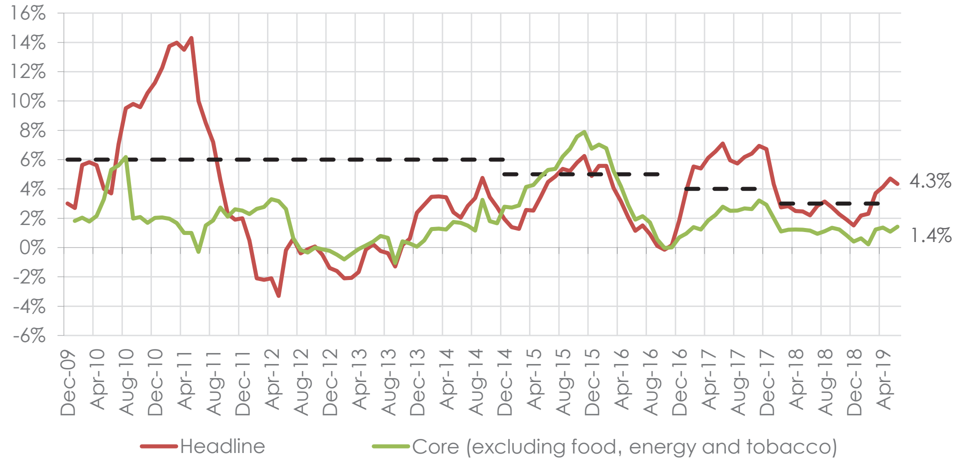
« Core inflation is low, stood at 1.4% in June.

In June, inflation in the food group equaled 6.8%. Due to the substantial weight that food has in the consumer basket (27.3%), its contribution to overall inflation was 1.8 pp (see Figure 3.3). Of this increase, the most significant share came from the price increase of bread observed in December 2018. The latter made a 0.5 pp contribution to inflation in June.

Fuel prices have made a significant contribution to inflation in recent years. In June, gasoline was 5.5% more expensive than in the corresponding period of last year and it made a 0.2 pp contribution to inflation.

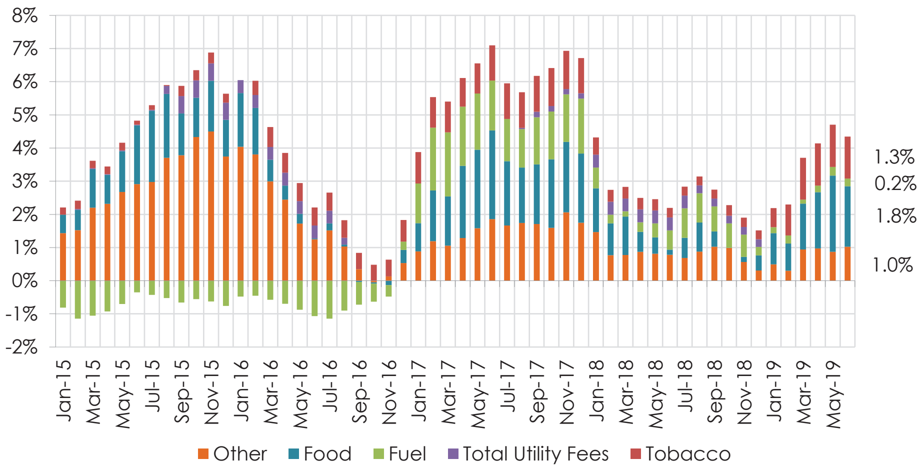
The trend of decreasing prices on shoes and clothes evident in recent years has continued. In June, prices in this group were 6.9% cheaper than in the same period in 2018 and this group made a negative contribution to inflation amounting to 0.3 pp (see Figure 3.3).

Figure 3.2 Headline and core inflation



Source: GeoStat

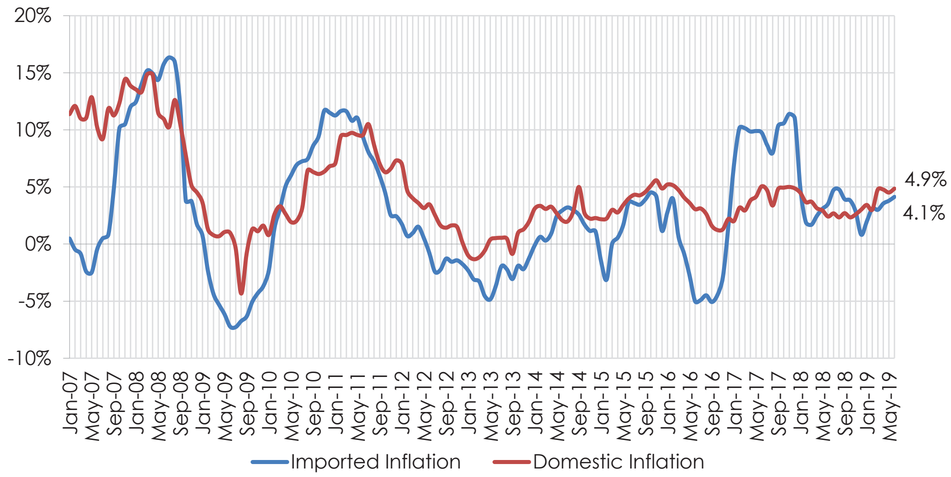
Figure 3.3 Contribution of tobacco, fuel, food and utilities inflation to headline inflation



Source: GeoStat

In June, annual inflation on imported, mixed and domestically produced goods equaled 4.1%, 2.9% and 4.9% respectively (see Figure 3.4).

Figure 3.4 Imported and domestic inflation

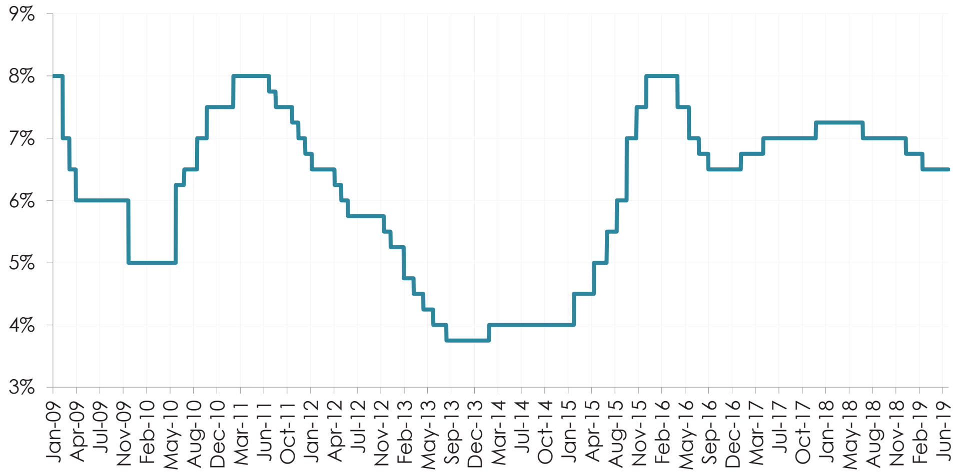


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

At the beginning of 2019, due to one-off factors, particularly the increased excise taxes on tobacco and rising international oil prices, inflation increased and remained above the target. In June, annual inflation totaled 4.3%. It is important to note that the increased excise tax on tobacco made a 1.3 pp contribution to total inflation. Core inflation, which excludes food, energy and tobacco prices, equaled 1.4%, indicating that the increase in the overall inflation rate is only temporary. However, it is noteworthy that aggregate demand is still lagging behind its potential and demand-side inflationary pressure thus remains weak. As a result, after monetary policy easing of January 2019, the NBG has kept its policy rate unchanged.

Figure 4.1 Monetary policy rate



Source: National Bank of Georgia

At the last Monetary Policy Committee meeting of 24 May 2019, the decision was made to keep the refinancing rate unchanged at 6.5%. Although inflationary pressure stemming from the exchange rate depreciation increased against the background of the external shock, in the medium term this pressure will be offset by weakened demand, which still lags behind the potential level of GDP. Moreover, the current nominal effective exchange rate seems to be undervalued to a greater extent than the size of the current shock would suggest. Hence, the possible appreciation of the nominal effective exchange rate is expected to exert downward pressure on inflation. Taking this into consideration, the Monetary Policy Committee deemed appropriate to keep monetary policy unchanged. However, if the upward pressure on inflation stemming from the exchange rate persists, then the committee will consider the possibility of the monetary policy tightening.

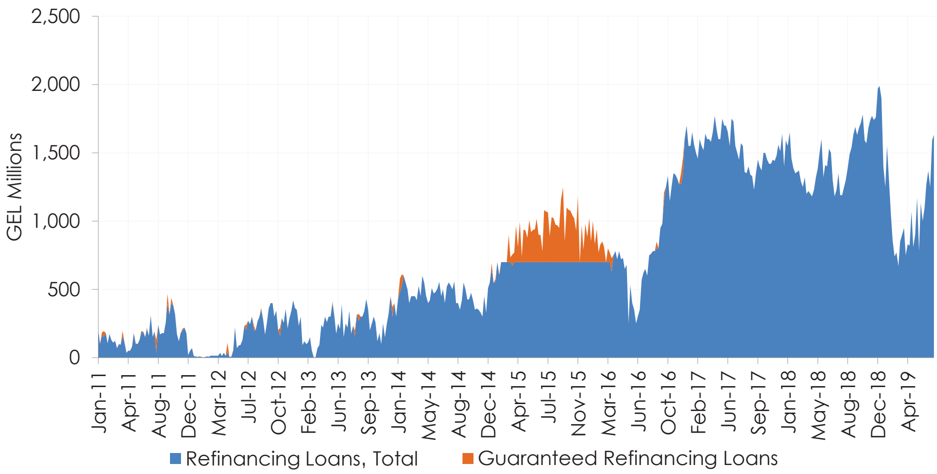
It is important to note that the ratio of the current account deficit to nominal GDP stood at -7.7% in 2018, which is the best indicator of recent years. In addition, preliminary data shows that in the first quarter of 2019 this ratio equaled - 6.2%. In the second quarter of 2019, exports of goods increased annually by 10.3%. Over the same period, revenues from tourism (8%) and remittances (8.2%) also increased moderately. It is noteworthy that, compared to last year, the growth of imports has been negative, with imports of goods declining by 4.6% in the second quarter. The current external sector dynamics indicate an improvement in the current account deficit for 2019.

According to the current forecast, as a result of temporary, one-off factors – specifically the rise of excise taxes on tobacco products at the start of the year and rising oil prices – annual inflation will be above the target level throughout 2019. The effect of these factors will, however, be partly offset by weak aggregate demand. From March 2020, with the exhaustion of these temporary factors, the inflation level will start to decline and will be around the target level in the medium term.

Monetary policy is an instrument to affect aggregate demand and it should be emphasized that central banks do not usually react to exogenous (independent of monetary policy) factors. At the same time, it is important to consider several major risks to the inflation forecast. Inflation will be lower than anticipated if demand is weaker than expected, which will depend on the strength of fiscal stimulus, the growth of lending activity and income from abroad. 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 a deterioration of geopolitical conditions, increased risk premiums in the region (including in Georgia) cause a depreciation of local currencies and thereby increase the debt service burden on foreign exchange loans.

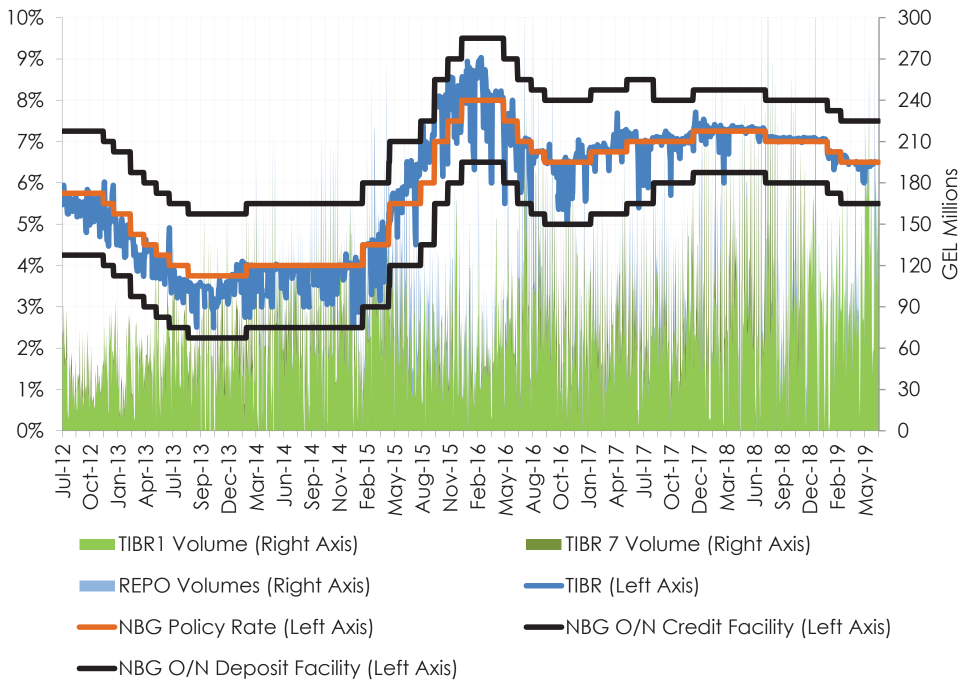
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. To manage short-term liquidity, the 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



Source: National Bank of Georgia

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

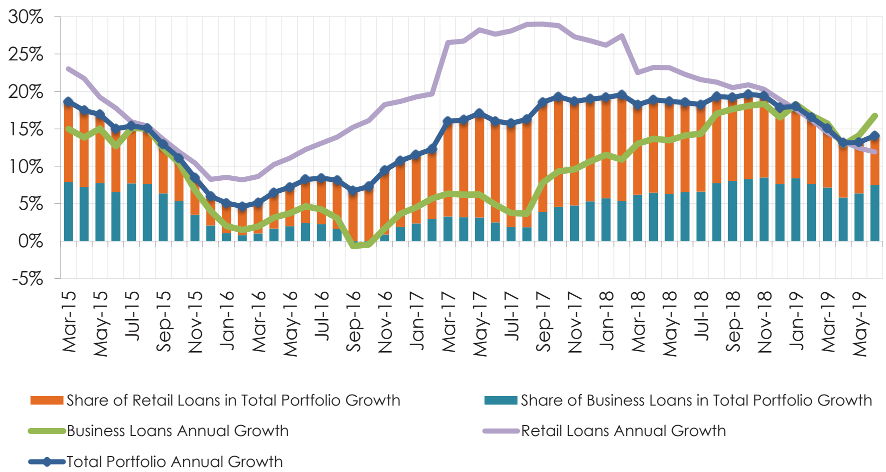
5. Financial Market and Trends

5.1 LOANS

In June 2019, excluding the effect of exchange rate fluctuations, the loan portfolio declined slightly and stood at 14.1%. Relative to March, the growth rate of retail loans in June declined by 2.6 pp and stood at 11.9%, while loans to legal entities increased by 1 pp and equaled 16.7%. The growth of business loans was primarily driven by an increase in loans issued to the trade, energy, construction and transport sectors; whereas the increases in credit for the manufacturing and agriculture sectors were insignificant. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for business loans; whereas no significant change in demand for retail loans is expected.

« According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for business loans and no significant change in demand for retail loans.

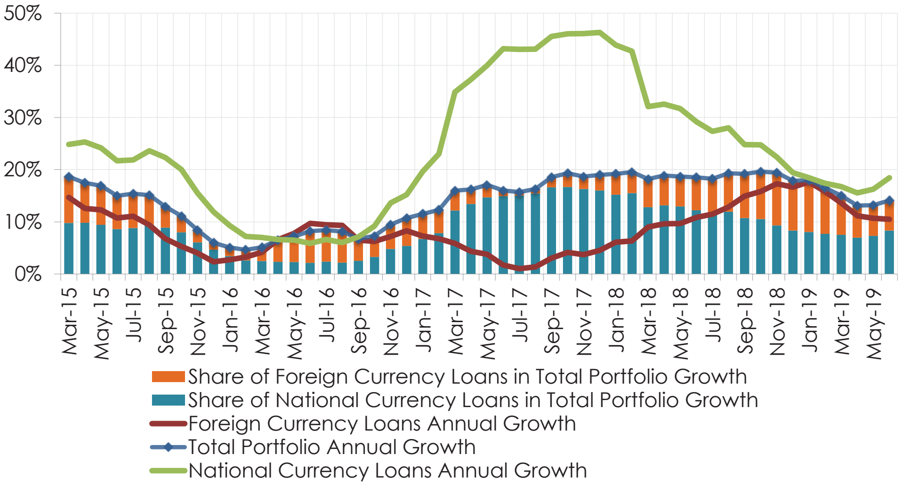
Figure 5.1 Annual growth rates of retail and business loans (excluding the exchange rate effect)



Source: National Bank of Georgia

In terms of currencies, it is important to emphasize that in the second quarter of 2019 the growth of the loan portfolio was mainly driven by an increase in domestic currency loans (see Figure 5.2). In June, the annual growth rate of foreign currency denominated loans was 10.5%, while loans in domestic currency grew by 18.5%. In the second quarter, the loan larization ratio increased by 1.5 pp to equal 43.2%. It is expected that loan larization will increase as a result of the recent enactment of regulations on responsible lending and the prohibition of issuing loans in foreign currency under 200,000 lari.

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

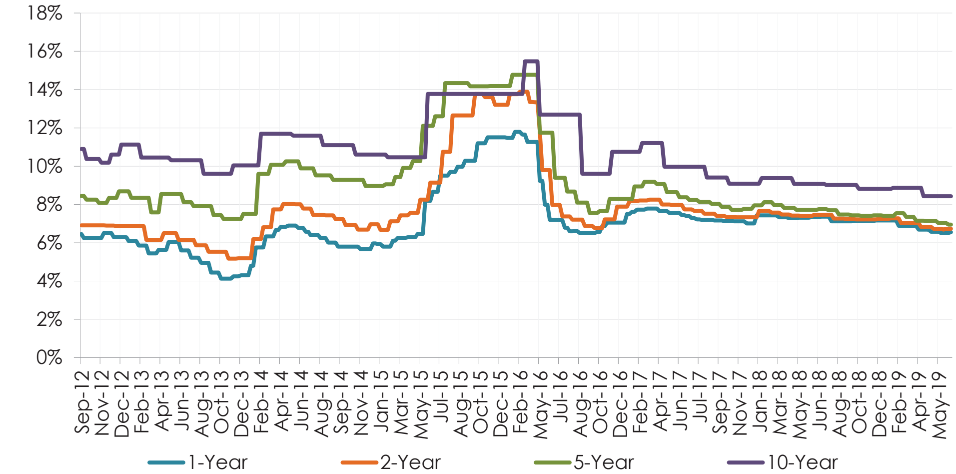


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In June, the monetary policy rate was 6.5%. In the second quarter of 2019, interest rates on government securities revealed a declining trend. This was a result of a reduction of interest rate fluctuations (as well as of maturity premiums) and expectations of a reduction of the monetary policy rate in the medium term (see Figure 5.3).

Figure 5.3 Interest rates on government securities

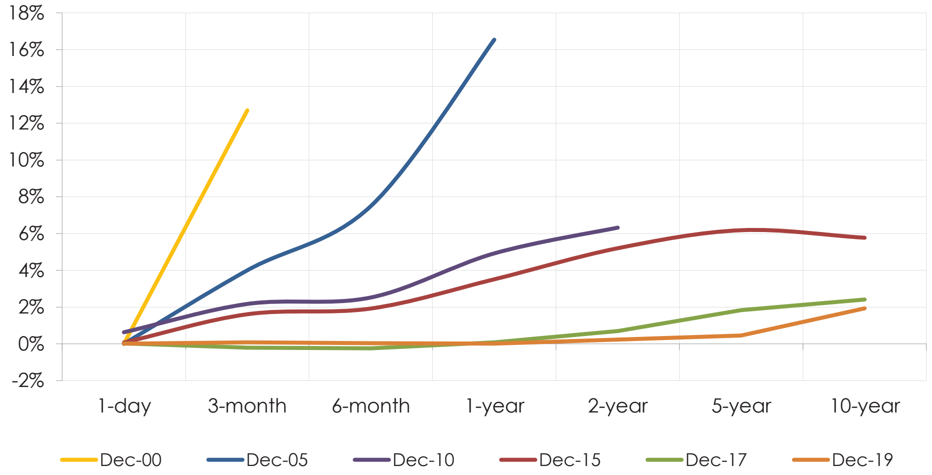


Source: National Bank of Georgia

Compared to the previous quarter, the spread between long- and short-term interest rates has not changed significantly (see Figure 5.4). This indicator remains at a low level, which suggests increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate.

« The spread between long- and short-term interest rates has not changed significantly.

Figure 5.4 Spread between the monetary policy rate and the yield curve

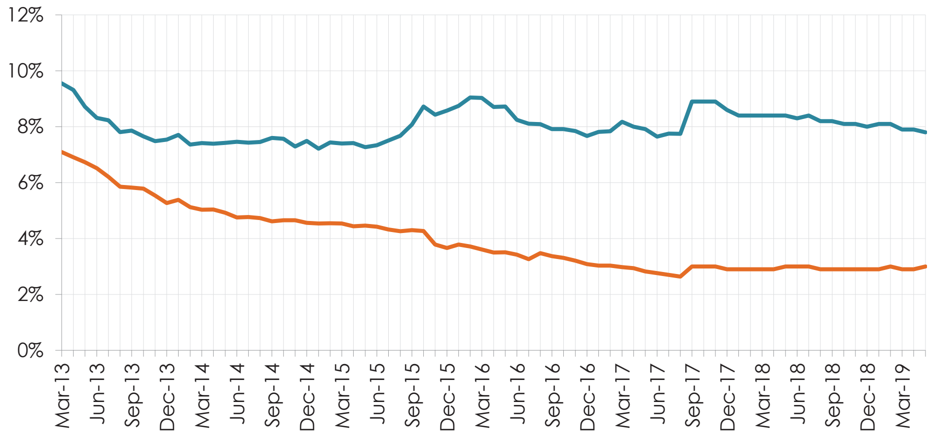


Source: National Bank of Georgia

In June, relative to March, interest rates on domestic and foreign currency deposits did not change significantly and equaled 7.8% and 3% respectively. According to the credit conditions survey, representatives of the banking sector expect a slight increase in the cost of funds in the next quarter due to increased costs of liquidity and capital.

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

Figure 5.5 Average interest rates on deposits

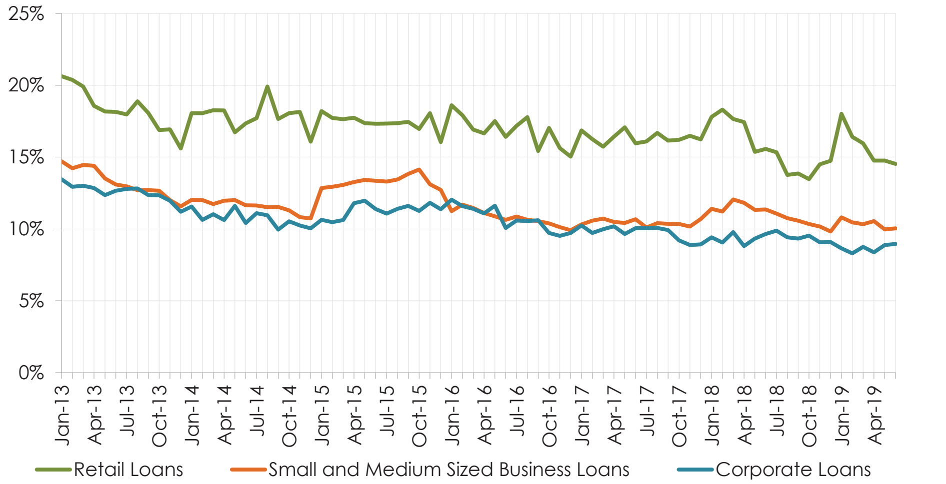


Source: National Bank of Georgia

According to the credit condition survey, margins have slightly decreased for variable interest rate mortgage loans issued in the domestic currency, while interest rates for mortgage loans issued in foreign currency have increased slightly. Representatives of the banking sector expect a slight easing of non-interest rate conditions for mortgage loans issued in domestic currency. In terms of credit conditions for legal entities, representatives of the banking sector expect a slight increase in interest rates for fixed interest rate loans in the next quarter. In June, compared to March, interest rates on loans issued to small and medium enterprises decreased by 0.3 pp and equaled 10%. Interest rates for corporate loans did not change significantly and stood at 9%, while interest rates on retail loans declined by 1.5 pp and equaled 14.5% (see Figure 5.6). In June, compared to March, average interest rates on the stock of legal entities declined slightly for foreign currency loans, while these did not change significantly for loans in the domestic currency (see Figure 5.7). Representatives of the banking sector expect a slight decrease in interest rates on fixed interest rate loans in foreign currency and a reduction of margins on variable interest rate loans in the domestic currency.

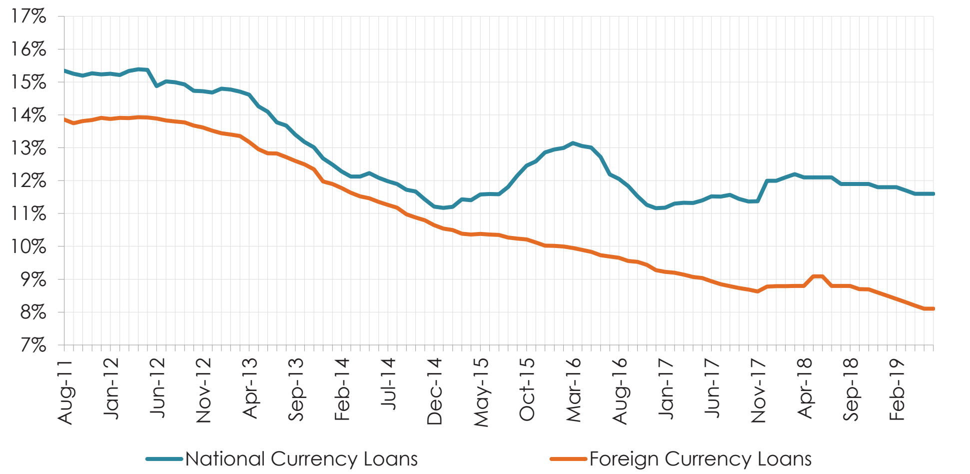
‹‹ Representatives of the banking sector expect a slight easing of non-interest rate conditions for mortgage loans issued in domestic currency.

Figure 5.6 Interest rate on loan flow



Source: National Bank of Georgia

Figure 5.7 Average interest rates on business loans



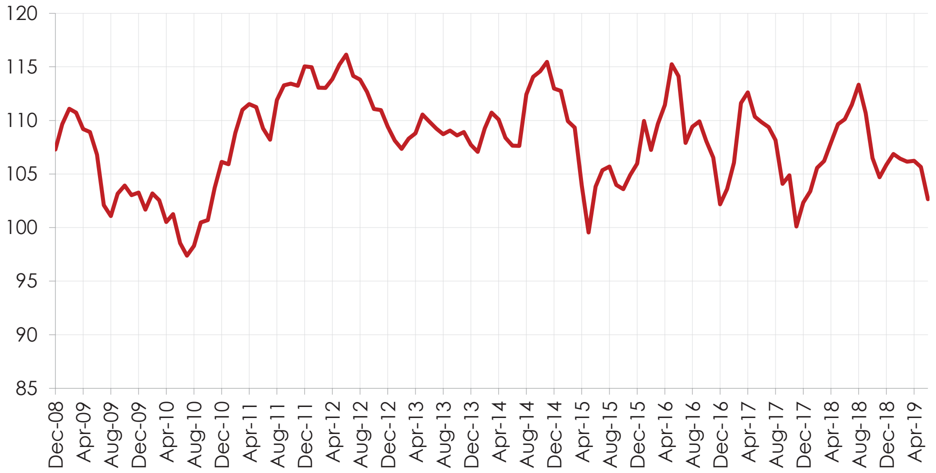
Source: National Bank of Georgia

5.3. EXCHANGE RATE

In the second quarter of 2019, the GEL nominal effective exchange rate depreciated against the US dollar by 2.7% and against the euro by 1.5% compared to the previous quarter. Meanwhile, the GEL depreciated against the Russian ruble by 5.0% and appreciated against the Turkish lira by 6.1%. As a result, the nominal effective exchange rate depreciated by 1.2% on a quarterly basis and by 2.6% on an annual basis. As for the price-adjusted exchange rate, the real effective exchange rate depreciated by 1.5% quarterly and by 4.0% on a year-on-year basis.

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture. In the second quarter of 2019, the adjusted nominal effective exchange rate depreciated by 4.1% on an annual basis and by 1.1% on a quarterly basis.

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



Source: National Bank of Georgia

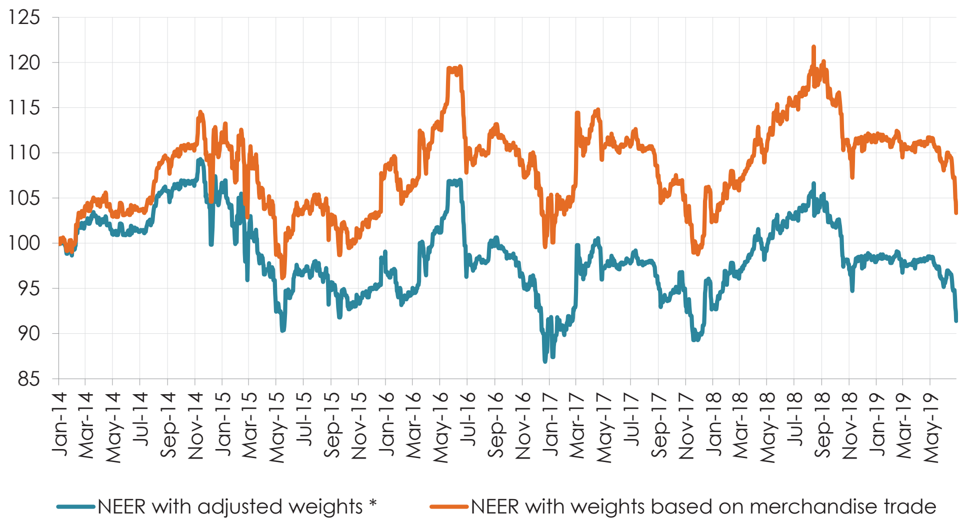
Table 5.1 Effective exchange rates annual growth (2nd quarter of 2019)

	Change of Nominal Exchange Rate, %	Change of Real Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	-2.6	-4.0	-4.0
Eurozone	-5.2	-2.3	-0.5
Turkey	20.2	6.4	1.1
Ukraine	-9.5	-13.4	-0.9
Armenia	-11.0	-9.1	-0.6
The United States	-10.7	-8.4	-0.4
Russia	-6.8	-7.3	-1.0
Azerbaijan	-10.4	-9.2	-1.0
Other	-4.7	-3.2	-0.6

* 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

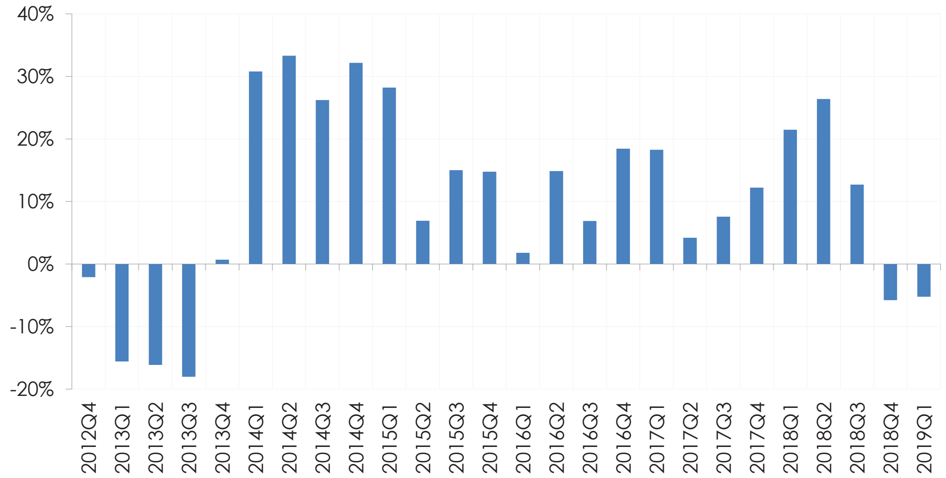
6. Aggregate Demand

In the first quarter of 2019, GDP grew by 4.9% in real terms. This growth was mainly driven by net exports. The contribution of consumption was comparatively less, while the contribution of capital formation was negative.

Growth in the first quarter was primarily driven by strong external demand. Exports of goods and services significantly increased. On the contrary, in the same period, there were signs of a certain weakening of demand. Real growth of household consumption equaled 1.7%[11], which was importantly below the GDP growth rate (see Figure 6.1). Government consumption was more active in comparison with private consumption, with public and private consumption accounting for 13.4% and 4.5% of nominal growth respectively.

‹‹ In the first quarter the growth was driven by net exports.

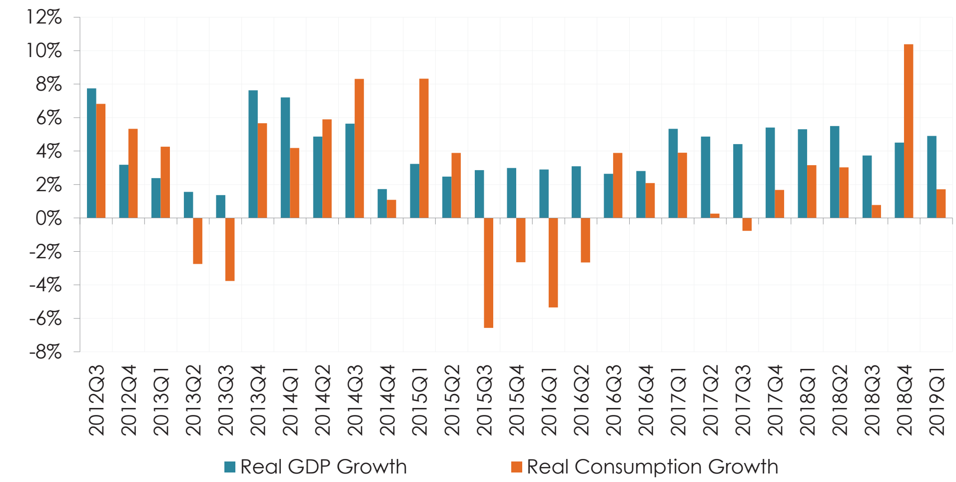
Figure 6.1 Annual growth rate of capital formation



Source: GeoStat

After strong growth in the first three quarters of 2018, the volume of investments/capital formation fell in the fourth quarter of 2018 and again in the first quarter of 2019 (see Figure 6.2). In the first quarter, investments shrank by 5.2% in nominal terms. Both capital formation and inventories declined. As a result, investments negatively contributed to economic growth.

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

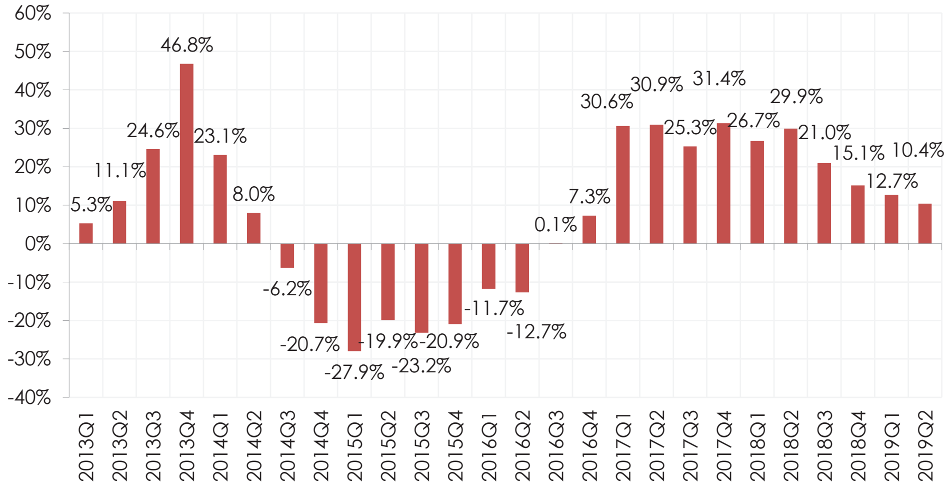
In the first half of 2019, the positive trends in the external sector continued. However, at the end of the second quarter, risks coming from external sector heightened. Because of the Russian ban on air travel to Georgia, the probability of a reduction in the growth of export of travel services increased. Despite the fact that this boycott has not yet been reflected in external sector data, the shaping of negative factors, which impact the current account, was instantly transferred to exchange rate movements. As usual, exchange rate movements give the possibility to quickly correct external imbalances and thus soften the negative effect caused by a shock to the economy. According to the updated forecast, the current account deficit is expected to be lower throughout 2019.

« The current account improved significantly in the first half of 2019.

The second quarter was active in terms of higher revenues from exports, increased money transfers and higher export of travel services. Registered exports of goods grew by 10.4% annually (see Figure 7.1), which mostly stemmed from increased exports of consumer and intermediate goods. From consumer goods, exports of motor cars, medicaments and mineral waters increased significantly. While exports of copper ores, centrifuges and prefabricated buildings increased significantly in terms of intermediate goods. In contrast, exports of cigarettes, alcoholic beverages, ferroalloys, fertilizers and hazelnuts/nuts were all considerably lower.

« In the second quarter of 2019, registered exports of goods increased by 10% annually.

Figure 7.1 Annual change in registered exports of goods



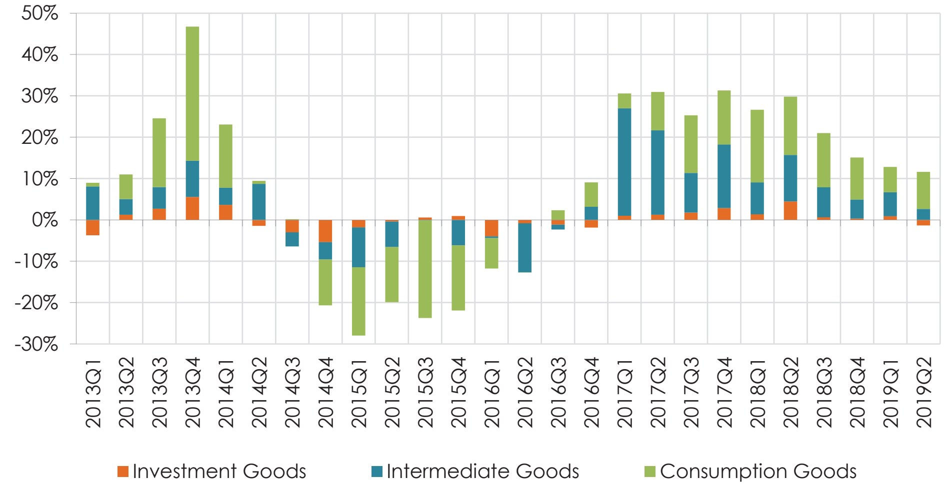
Source: GeoStat

The volume of exports to Georgia's main trading partners, namely to Russia, Armenia and Ukraine, substantially increased as a result of increased external demand stemming from the improved economic situations in those countries. Compared to the same period of the previous year, exports were significantly higher to Russia (ferroalloys, natural wines and alcoholic beverages), Armenia (motor cars and electricity) and EU countries, especially to Romania and Bulgaria (copper ores and concentrates). Trade was also higher to other regional countries, particularly to Turkmenistan and Uzbekistan. In contrast, exports declined to China (copper ores and concentrates) and Turkey (ferroalloys and electricity).

Exports of goods mainly increased due to increased demand for consumer and intermediate goods (see Figure 7.2). In the second quarter of 2019, exports of consumer goods grew by 20.3% annually, chiefly because of higher exports of motor cars, natural wines, mineral waters and medicaments. Exports of textile products 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 in recent quarters. The overall increase in exports was mainly due to higher levels of re-exports and increased external competitiveness due to the exchange rate depreciation.

« Growth in exports was due to both consumer and intermediate goods.

Figure 7.2 Annual change in registered exports of goods by category

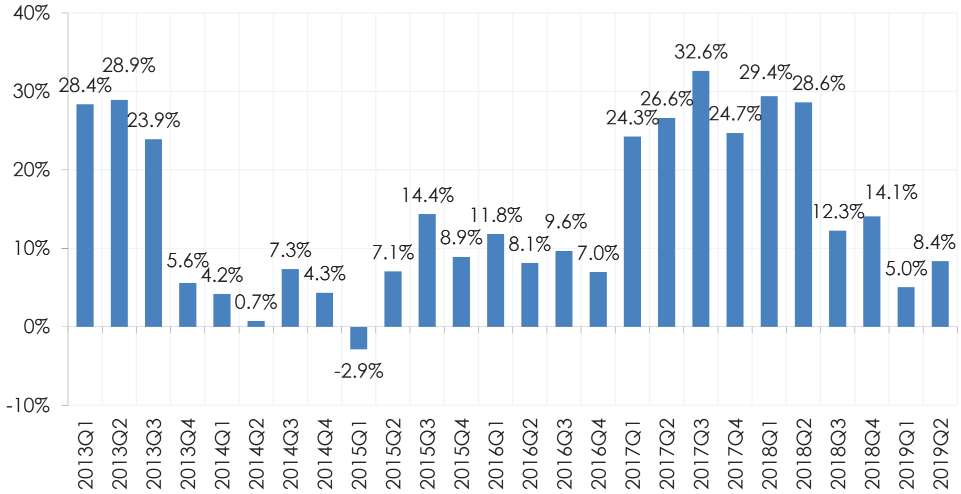


Source: National Bank of Georgia

An increase of external demand was also clearly visible in terms of higher exports of services, especially of tourism. In the second quarter of 2019, export of travel services reached 878 million USD, which is 8.4% more than the same period of last year (see Figure 7.3). The comparative slowdown of growth in export of travel services in the first half of 2019 can be explained by a decline in the number of visitors from regional countries (mainly Turkey, but also Iran). All else being equal, the increase in export of travel services is expected to be moderate in the second half of 2019.

‹‹ In the second quarter of 2019, export of travel services increased by 8% annually.

Figure 7.3 Annual change in export of travel services

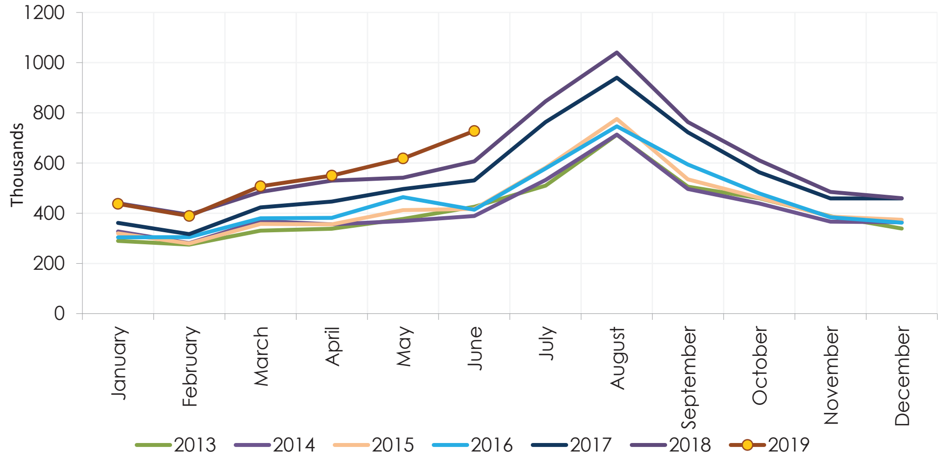


Source: National Bank of Georgia

The rise in export of travel services was a result of an increasing number of international visitors, especially tourists.[12] During the last two years, the number of visitors to Georgia has grown not only for leisure and recreational reasons, but also for business and professional purposes. Moreover, the number of repeat visitors who are accompanying or visiting family members or relatives has also substantially increased. In the second quarter of 2019, the number of foreign visitors entering Georgia grew by 13.0% (see Figure 7.4), the majority of whom (65.7%) were tourists. Travelers from Armenia and Russia made the most significant contribution to this growth, in terms of both the number of arrivals and the revenues received from tourism. Tourist inflows from Turkey and Armenia contributed moderately to the overall growth of visitors. At the same time, there was a substantial increase in the number of visitors from Kazakhstan and EU countries, especially from Germany. However, it is worth noting that the number of Russian visitors might decline as a result of the Russian ban on air travel to Georgia. This might contribute negatively to the overall growth in export of travel services in the future.

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

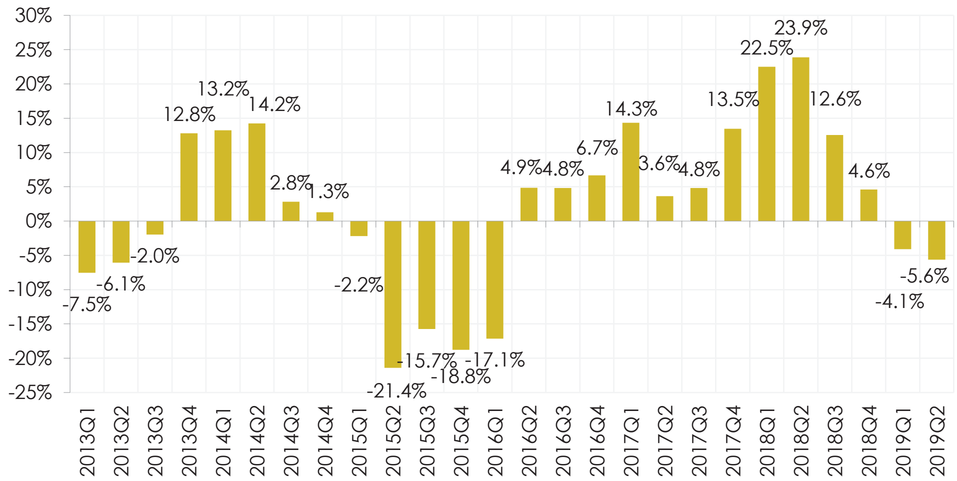


Source: GNTA

From the beginning of the 2019, imports of goods began to fall, with the annual decline amounting to 5.6% in the second quarter (see Figure 7.5). The decline in imports stemmed from the lower growth of inflows of foreign direct investments and lower demand on import goods because of the exchange rate depreciation. It is worth noting that imports declined from both regional countries and the EU. From regional countries, imports fell substantially from Turkmenistan (due to petroleum products) and Ukraine (due to cigarettes and cigarillos); while from the EU, imports declined from Greece (due to petroleum and petroleum products) and the Netherlands (due to air turbines). From other countries, imports substantially declined from China (due to automatic data processing machines and air turbines) and from Japan (due to motorcars).

« In the second quarter, imports of goods declined by 5.6% annually.

Figure 7.5 Annual change in registered imports of goods



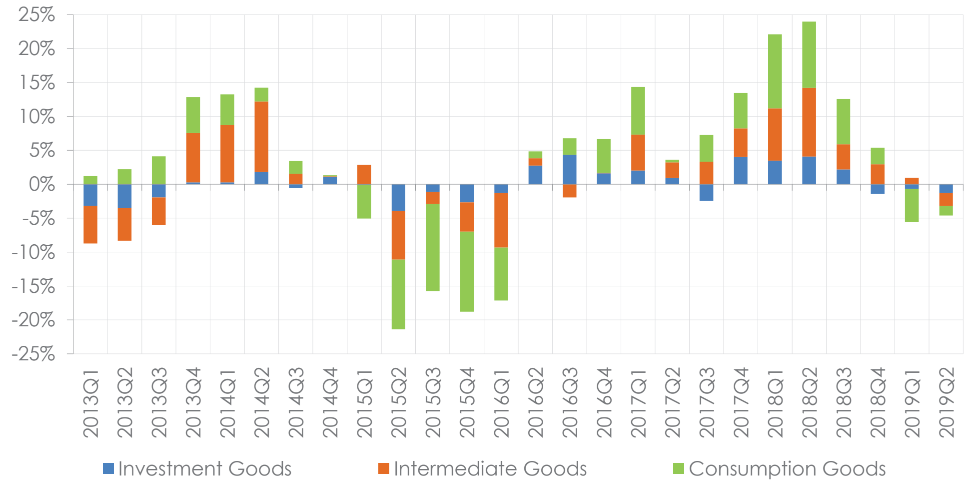
Source: GeoStat

In the second quarter of 2019, imports of intermediate and consumer goods accounted for 41% and 44% of total imports respectively. It is worth noting that the decline in imports of goods predominantly stemmed from the decrease in intermediate goods, which fell by 4.6%, making a -1.9 percentage points contribution to the overall change in imports (see Figure 7.6). This reduction was due to a decline in one-off items that were imported last year (specifically, air turbines and turbo-propellers). Imports of consumer goods also decreased, falling by 3.3% annually. This reduction was due to the decline of imports of petroleum products (the latter being a result of lower petroleum prices on global markets). Imports of investment goods declined by 8.4% annually (making a -1.3 percentage points change in overall imports). The overall fall in imports of investment goods was due to one-off items (like automatic data processing machines and electrical transformers); if those were excluded, there would have been an increase in investment goods imports.

« The decline in imports of goods was due to lower imports of both intermediate and consumer goods.

It is also worth noting that, in terms of commodity groups, imports of goods have become less diverse compared to the same period of last year.

Figure 7.6 Annual change in registered imports by category of goods

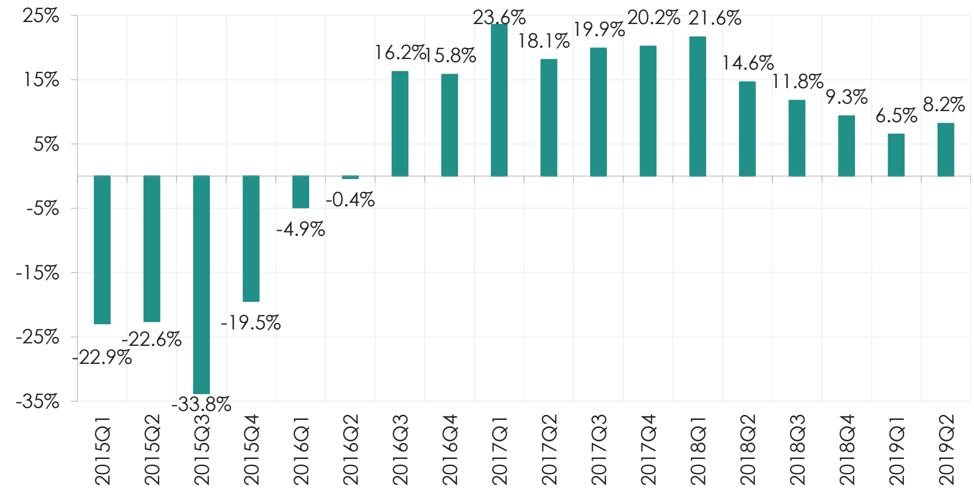


Source: GeoStat

Money transfers to Georgia once more showed an increasing trend, although the growth rate has slowed. In the first quarter of 2019, money transfers to Georgia increased by 6.5% annually (see Figure 7.7). This was mainly driven by increased transfers from the European Union (notably from Italy, Greece and Poland) and the USA. In contrast, money transfers from Russia and Turkey showed a decreasing trend from the second half of the year, which continued into the first quarter of 2019. Transfers from Russia and Turkey thus negatively contributed to the overall change in money transfers compared to the same period last year.

‹‹ In the first quarter of 2019, the volume of money transfers to Georgia increased by 6.5% annually.

Figure 7.7 Annual change in remittances



Source: National Bank of Georgia

In the first half of 2019, money transfers to Georgia showed an increasing trend, although the growth rate slowed compared to last year. In the second quarter of 2019, money transfers to Georgia increased by 9.3% annually (see Figure 7.7). This was mainly driven by increased transfers from the European Union (notably from Italy, Greece and Poland) and the USA. In contrast, money transfers from Russia and Turkey saw a decreasing trend from the second half of 2018, which has continued into the first quarter of 2019. Transfers from Russia and Turkey thus made a negative contribution to the overall change in money transfers when compared to the same period last year.

‹‹ In the second quarter of 2019, the volume of money transfers to Georgia increased by 9% annually.

Thanks to the growth of exports of goods and services, rising money transfers to Georgia and a reduction in imports, the current account deficit amounted to 227 million USD in the first quarter of 2019, which is 6.2% of GDP. The deficit was 5.7 percentage points lower than the same period last year (by 207 million USD).

‹‹ In the first quarter of 2019, the current account deficit amounted to 6.2% of GDP

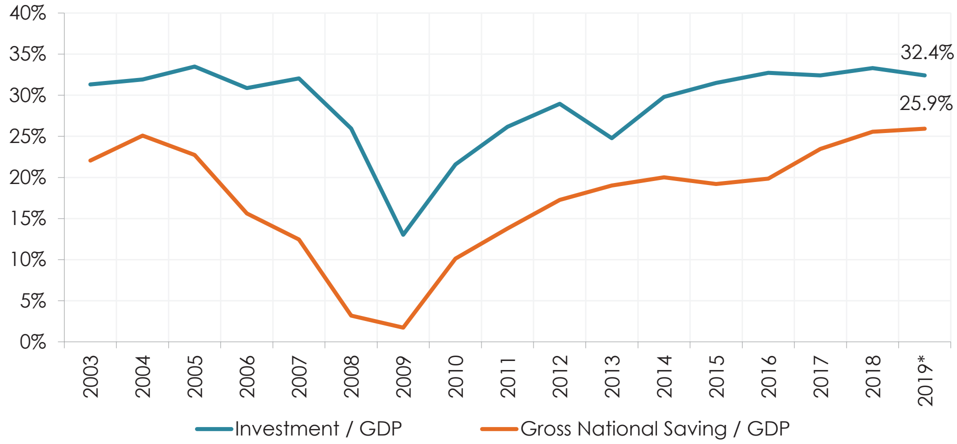
Like the previous year, the current account balance has improved significantly. This improvement was due to trade in services, especially export of travel services, and secondary income such as the increase of personal transfers from abroad. Moreover, the balance of trade in goods improved substantially, which stemmed from both the growth of exports and the decline of imports of goods. According to preliminary data, the current account deficit has further narrowed in the second quarter of 2019.

Foreign direct investments (FDI) remain the primary source of financing the current account. In the first quarter of 2019, the volume of foreign direct investments declined by 6.3% annually and equaled 281 million USD. It is worth noting that the completion of the final phase of the BP pipeline project and the movement of several enterprises into the possession of Georgian residents both affected the level of FDI registered. In the first quarter of 2019, the largest part of FDI went to the finance, transport, and hotels and restaurants sectors, which received 15% (43 million USD), 10% (29 million USD) and 9% (25 million USD) of total FDI respectively.

An analysis of investments and savings reveals that the improvement of the current account in the first quarter of 2019 stemmed from a higher increase in savings rather than in investments. Compared to 2018, the ratio of investments to GDP decreased by 0.9 pp to reach 32.4%, while the ratio of savings to GDP grew by 0.4 pp to 25.9% (see Figure 7.8).

‹‹ The narrowing of the current account deficit was mainly driven by the growth of savings.

Figure 7.8 Investments and savings



* 2019 data contains the joint sum of the last three quarters of 2018 and the first quarter of 2019.

Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

8.1 OUTPUT

In the first quarter of 2019, GDP grew by 4.9% compared to the same period of last year. The growth was primarily driven by services, which contributed 5.7 percentage points (pp) to the total. The contribution of agriculture to growth was close to zero, while industry made a negative contribution of -0.7 pp

As was the case in previous periods, the increased number of foreign visitors to Georgia was the main source of economic growth. Participation of foreigners is important for real estate operations, where growth in the first quarter surged to 11.1%, contributing 0.6 pp to overall GDP growth. Transport made a large contribution to the growth of the first quarter of 2019, which leaped by 12.8% to make a contribution of 0.9 pp. A substantial 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 participation of foreigners is also important for the output of hotels and restaurants, which grew by 13.1%, contributing 0.3 pp to total growth.

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

Trade, which is the largest branch of the economy, grew by 6.7% in the first quarter of 2019, contributing 1.0 pp to overall GDP growth. This growth was predominantly a result of retail trade, which rose by 15% in nominal terms. On the contrary, wholesale trade increased by only 1%. In terms of other services, communication grew by 12.3%, contributing 0.2 pp to the total.

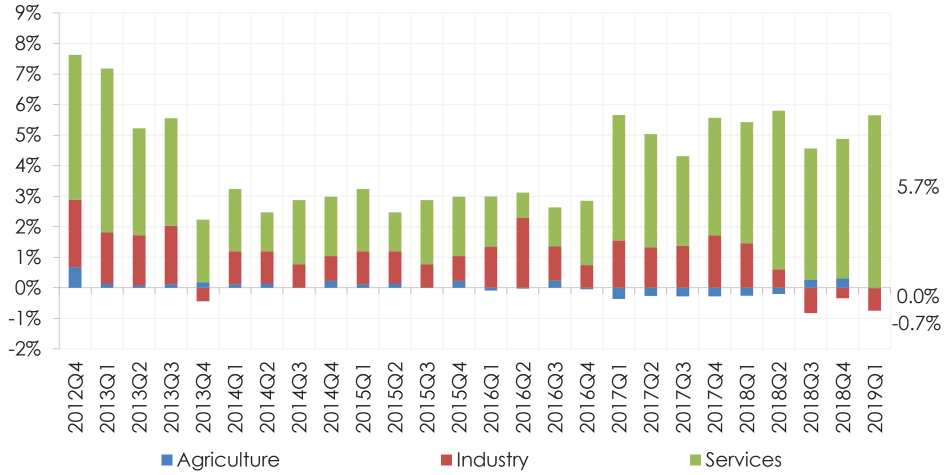
A number of infrastructural projects financed by the government were activated in the first quarter; the nominal growth of such projects was 32% over the corresponding period of last year. However, over the same period, private construction was in decline and overall construction output thus decreased by 9.6%, contributing a negative -0.7 pp to overall growth.

‹‹ Construction decreased, in spite of the activation of infrastructural projects.

In the first quarter, agricultural output declined by 0.3% and its contribution to total economic growth was thus close to zero.

‹‹ The contribution of construction to GDP growth remains negative.

Figure 8.1 Contribution of sectors of economy to real GDP growth



Source: GeoStat.

8.2 LABOR MARKET

In the first quarter of 2019, labor productivity per worker increased by 3.8% compared to the same period of the previous year. Labor productivity increased due to the agricultural sector, where productivity rose by 4.6%; in contrast, productivity fell in the industrial and services sectors by 6.2% and 0.6% respectively (see Table 8.1).

‹‹ Labor productivity increased by 3.8% due to the agricultural sector.

The rise in productivity in the first quarter mainly came from agriculture. The output of the agricultural sector decreased by 0.3%, while the amount of labor employed in the sector declined by nearly 5%, which ultimately resulted in a rise of productivity.

Labor productivity fell in the services sector. The increased number of foreign visitors to Georgia was still the main source of economic growth in the first quarter. The output of the tourist industry surged, and therefore that of services grew by 8.3% in total. However, the volume of labor employed in the sector increased more than the output, thus resulting in a decline in productivity of 0.6%.

The reduction of labor productivity in the industrial sector is linked to construction. The number of people employed in the construction sector increased by 15% compared to the previous year, while output declined by 9.6%. Although a number of infrastructural projects were activated in the first quarter, the output of private construction was in decline. The labor productivity per worker in construction decreased by 21.6%. On the contrary, labor productivity increased in manufacturing by 4%.

« Productivity decreased in services and construction.

Table 8.1 Annual growth of value added per employee in the second quarter of 2019

	Increase in labor productivity
Agriculture and agriculture output by households	18.6%
Industrial sector	-9.6%
Services sector	-5.4%
Overall in the economy	**3.8%**

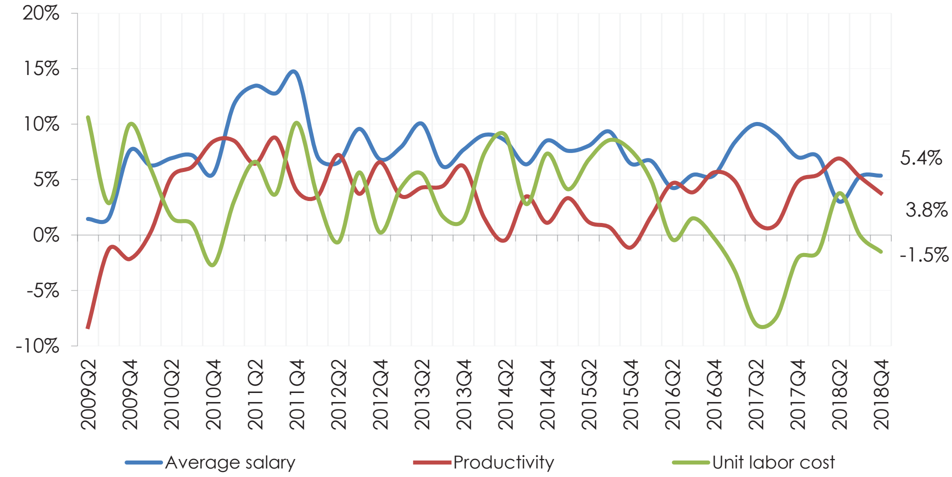
Source: GeoStat

In the first quarter of 2019, the average annual nominal growth of wages was 3.2%. According to GeoStat estimates, the average monthly salary in the economy was 1,093 GEL. In the first quarter of 2019, the unit labor cost grew by 0.6% annually (see Figure 8.2). Thus, the labor market has not created inflationary pressure in the economy.

« Average salaries grew by 3.2% annually.

« Unit labor cost rose by 0.6%.

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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