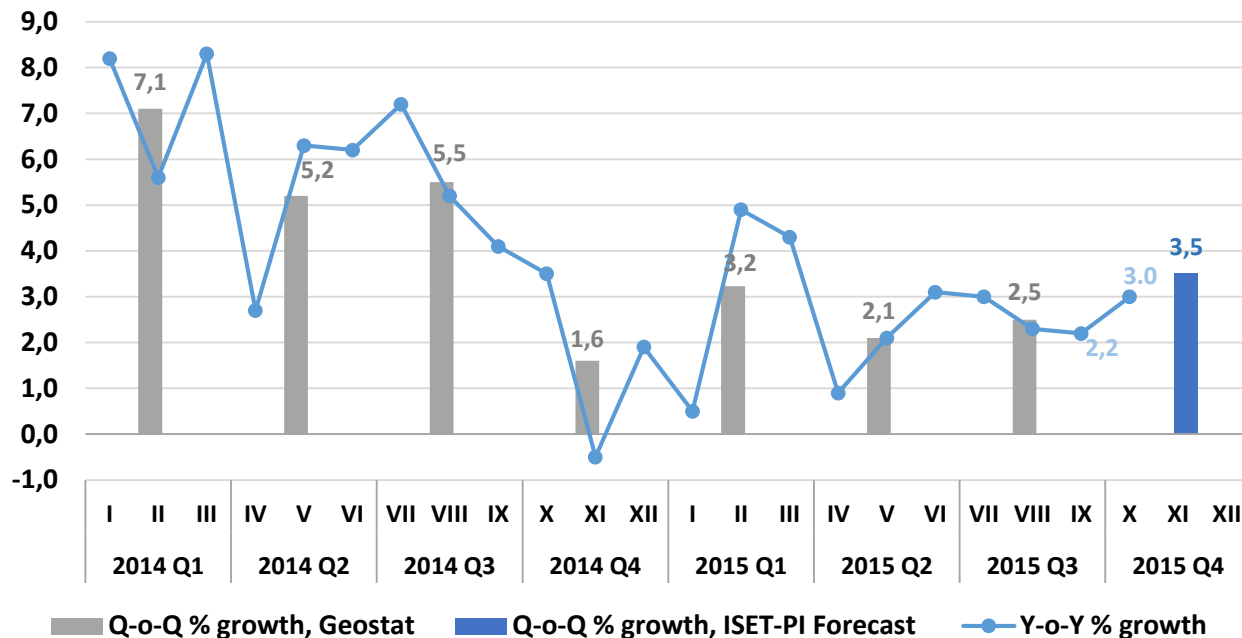


Authors: Yaroslava Babych and Giorgi Mzhavanadze

## The worst may be over, but not for everyone

Figure 1: GDP Growth, ISET-PI Forecast, %

Source: GeoStat, ISET-PI



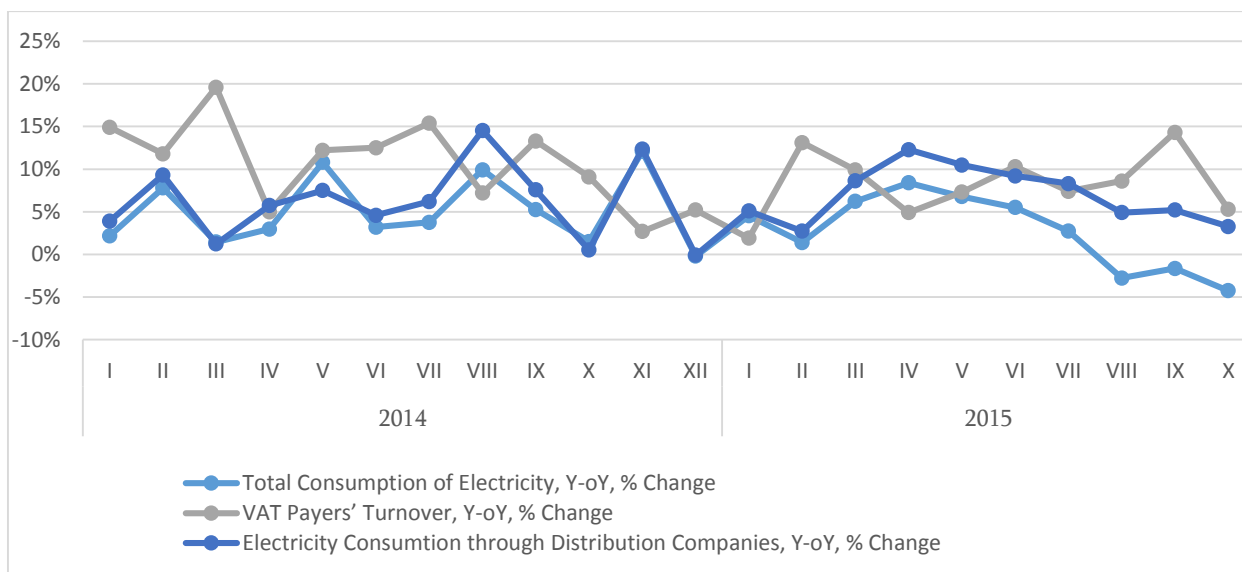
According to the most recent statistics, the Georgian economy is showing signs stabilization in the last quarter of 2015. Economic growth increased to 3% year on year in October – about the same as the estimated average real GDP growth rate (2.8%) for the first ten months of 2015.

ISET-PI’s Leading Economic Indicators forecast still predicts 3.6% growth in the fourth quarter (the forecast remained virtually unchanged since last month’s update), and 2.9% annual GDP growth for 2015.

The Georgian economy is thus showing a degree of resilience to regional economic pressures.

Figure 2: VAT Turnover and Electricity Consumption, Y-o-Y Change, %

Source: Ministry of Energy of Georgia, GeoStat



### Industrial demand for electricity is taking a hit

Total consumption of electricity in October decreased by 4.2% year on year. Although negative growth in demand has been observed since the tariff rates were increased in August, the decline seems to have little to do with households’ and small businesses’ demand for energy. While the data does not allow us to separate household and business consumption, we can see how much electricity was purchased by smaller consumers via distribution companies (such as Telasi), and how much was directly purchased by large industrial enterprises.

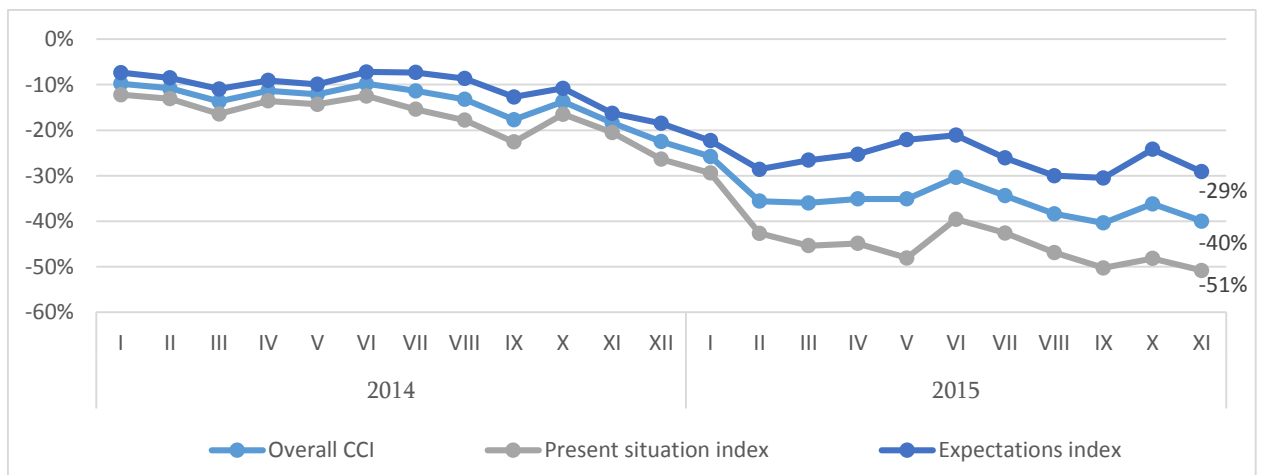
The total electricity consumption decrease was primarily driven by the "Georgian Manganese" company. The company consumed about 134 million kilowatts per hour less electricity in August-October 2015 than it did in the same period in 2014. This represents nearly a 45% reduction from their previous energy consumption levels. **“Georgian Manganese” is particularly suffering from the rapidly decreasing price of metals worldwide.** In November, world metal prices (reference IMF PMETA index) were just slightly (4%) above the “crisis level” of 2008, but still 35% below the historical average between 1980-2004. Currently, the prognosis for world metal prices is not encouraging, and the [company is bracing for tougher times to come.](#)

### Consumer confidence and expectations stabilize at a lower level

In October, the [Consumer Confidence Index](#) data suggested that consumers were sensing the end of the economic turbulence. The index improved by 4.1 points, driven by a strong improvement in expectations. However, the November [Consumer Confidence Index](#) data all but reversed the uptick observed in October. **The CCI, which began to decline about a year ago, now seems to be stabilizing at a lower level.**

Figure 3: Consumer Confidence Index

Source: ISET-PI

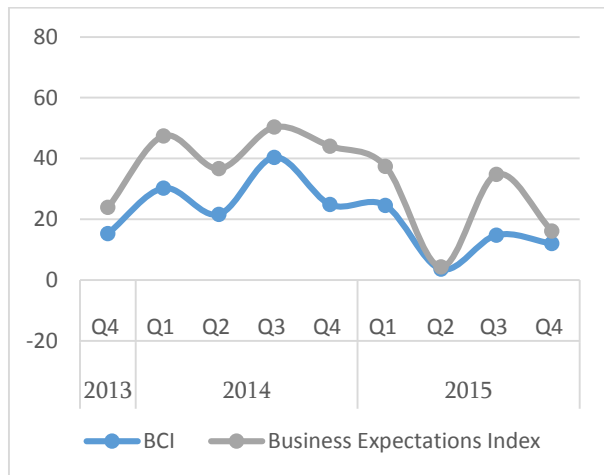


### Business confidence rebounds slightly after the second quarter shock

The Georgian [Business Confidence Index \(BCI\)](#) took a sharp hit in Quarter 2 of 2015, losing more than 20 points on the overall index and about 33 points on the expectations index. Quarter 3, 2015 brought some relief, as expectations soared once again by more than 30 points, while the overall index recovered by 10 points.

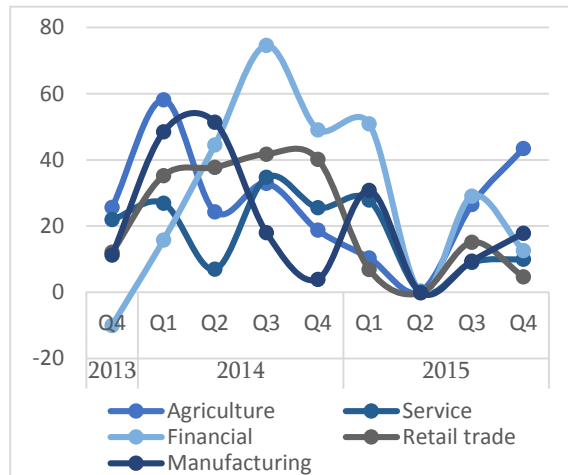
In Quarter 4 survey, however, the business expectations were falling again, although not as much as in the beginning of the year. The overall index decreased by only 2 points, giving hope that the worst may be over, and that the present situation is no longer deteriorating for most businesses. In fact, it is encouraging the BCI rose for the Manufacturing and the Agricultural sectors.

Figure 4: Business Confidence Index



Source: ISET-PI

Figure 5: Business Confidence Index by Sector



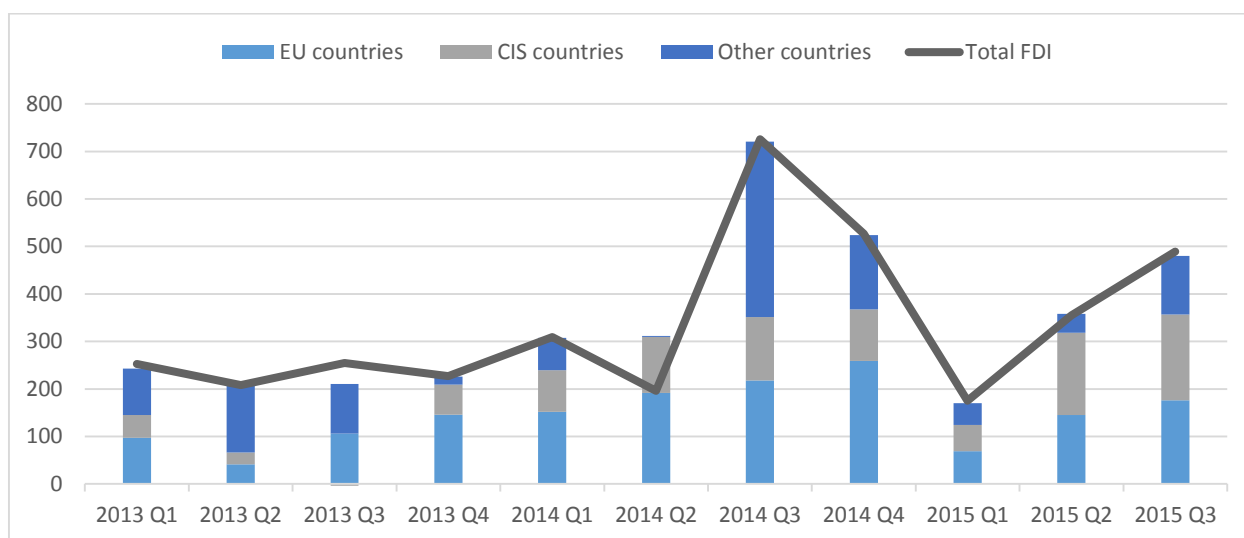
Source: ISET-PI

After the decline in the first quarter, FDI has been increasing throughout the year

So far, 2015 has been marked by slower growth of foreign direct investments in Georgia. This can once again be attributed to the economic slowdown in the wider region, as well as slower growth in European countries. According to GeoStat’s preliminary data, in the first three quarters of 2015 total FDI amounted to 1,019 million USD, which was 17.3% lower than in 2014. The major investor countries in the third quarter were Azerbaijan, the Netherlands, Turkey, the United Kingdom and China.

Figure 5: FDI in Georgia by Country

Source: GeoStat



## Consumer and producer prices continue to rise, but the pace is returning to normal

**Consumer Price Index (CPI) inflation broke a 2-year record in 2015, showing 5.8% year-on-year inflation in October and even higher 6.3% inflation in November.**

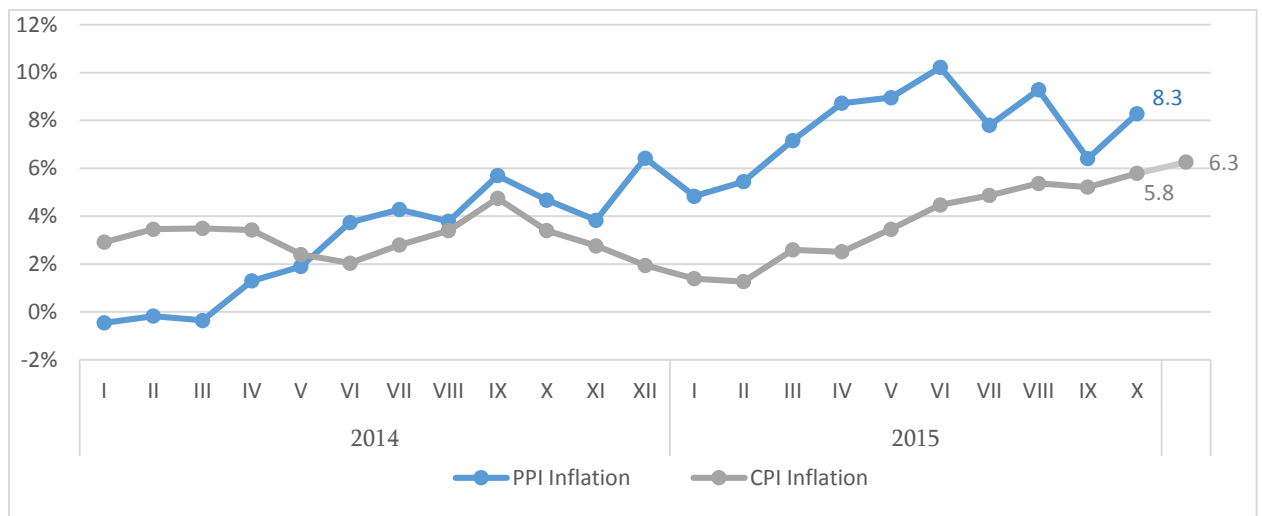
Monetary policy tightening, which started in May 2015 and has gradually continued until now (the NBG increased the monetary policy rate by 0.5 percentage points in November), will work its way through the economy in four to six quarters. In particular, the NBG's inflation report forecasts that in 2016 annual inflation will be higher (about 6%-7%) due to the "base effect" caused by the increased price level at the end of 2015.

The inflation rate is predicted to return to its target level of 5% in the first quarter of 2017. In other words, the NBG estimates that the price shock is largely over, and the price level will continue to rise at a more "normal" pace in 2016.

Despite the evidence of high year-on-year inflation rates, the average annual inflation in January-November 2015 stood below the annual target, at 4.2%. According to the NBG, the consumer price index calculated without food and energy prices (i.e. core inflation) showed an 8% year-on-year growth rate in October 2015. This was 2.2 percentage points higher than CPI based inflation, and was mainly due to increased prices of imported consumer goods.

Figure 6: Inflation Rates, Y-o-Y, %

Source: GeoStat



More precisely, **the increase in core CPI was driven by the higher cost of medicines and furniture.** These prices increased by 11.1% and 13.1% respectively and contributed 1.04 and 0.82 percentage points to total inflation in October.

Likewise, prices on the housing, water, electricity, gas and other fuels category increased significantly (despite the 12.5% and 8.4% year-on-year deflation of diesel and gasoline prices respectively). Alcoholic beverages and tobacco products also became more expensive this year. These two categories combined were responsible for 1.4 percentage points, nearly a quarter, of October's inflation.

Figure 7: Inflation Rates by Category, Y-o-Y, %

Source: GeoStat

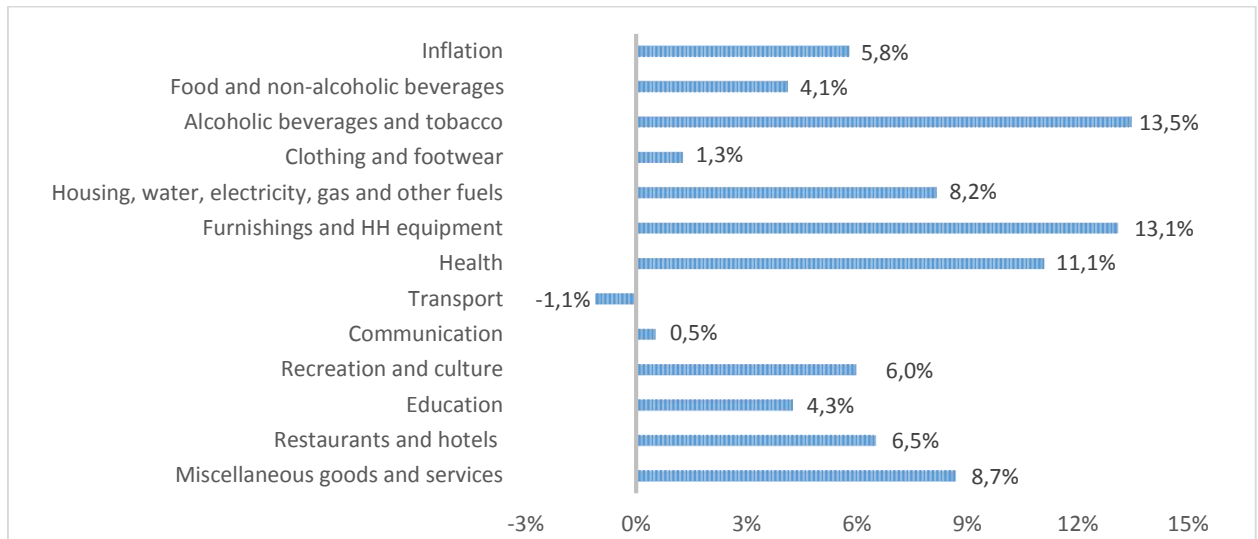
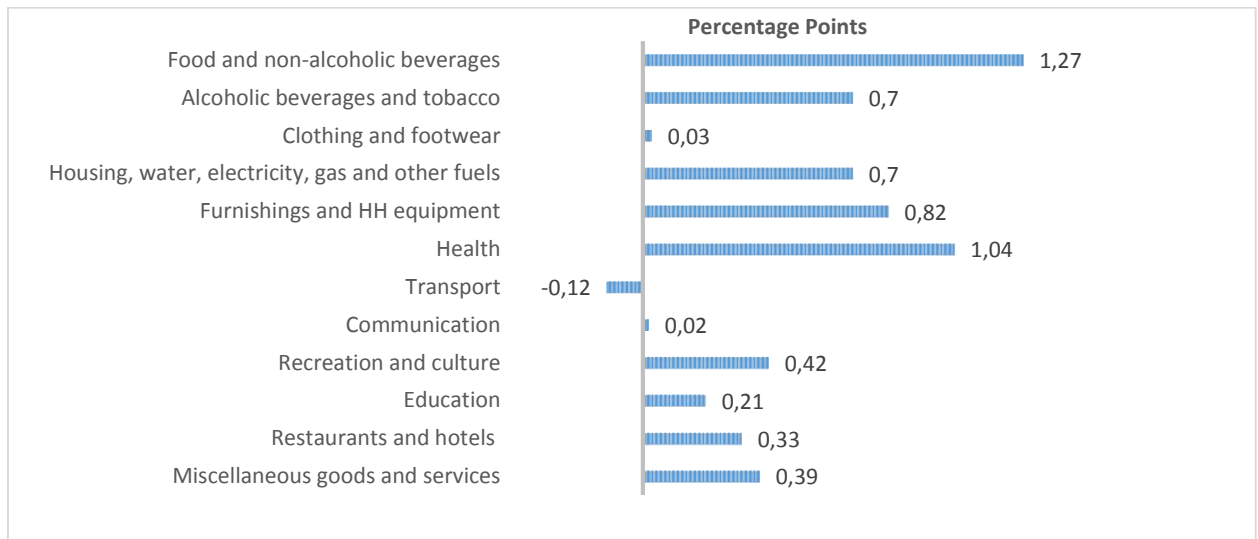


Figure 8: Contribution to Inflation Rate by Category, Percentage Points

Source: GeoStat



### The domestic-foreign interest rate spread is widening

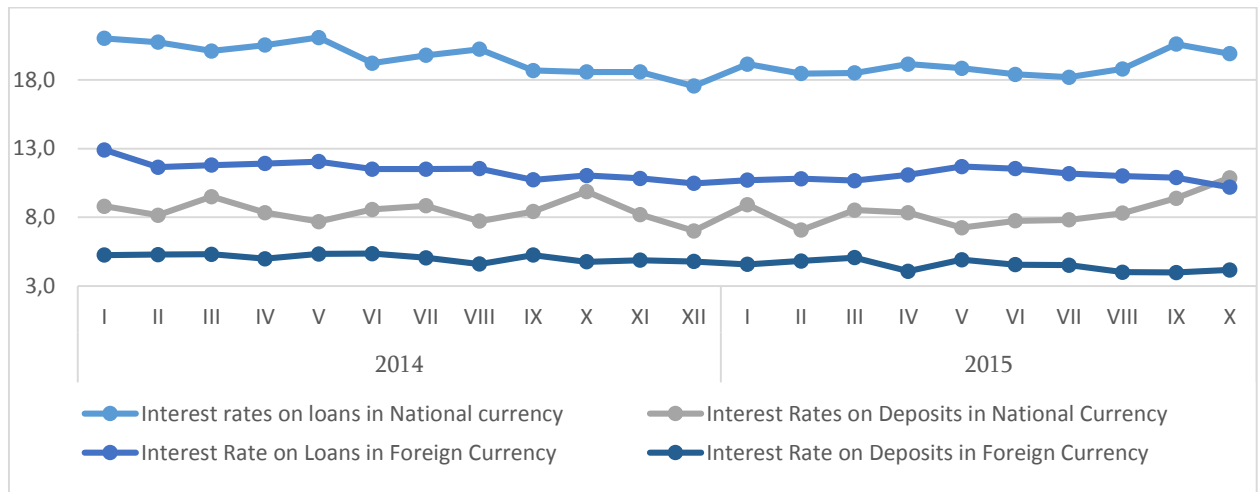
The increase of the NBG’s monetary policy rate predictably caused an increase in the market interest rate on deposits in the national currency. The upward trend started in May 2015. The market interest rate on national currency deposits increased to 10.9% in October (a 1.5 percentage points increase compared to September), and exceeded the market interest rate on loans in foreign currency by 0.7 percentage points.

This situation seems strange, as it points to the possibility of arbitrage between the two markets. This would certainly be the case if there were no transaction costs associated with borrowing in foreign currency. As it is, however, we are not likely to see home-grown investors rushing to borrow in USD, and then buying and depositing lari for a profit.

Market interest rates on both national and foreign currency loans decreased slightly (by 0.7 percentage points in October compared to the previous month) and stood at 19.9% and 10.2% respectively. **The spread between domestic and foreign currency lending rates has traditionally been high, but has recently begun to widen further.**

Figure 9: Market Interest Rates, %

Source: NBG

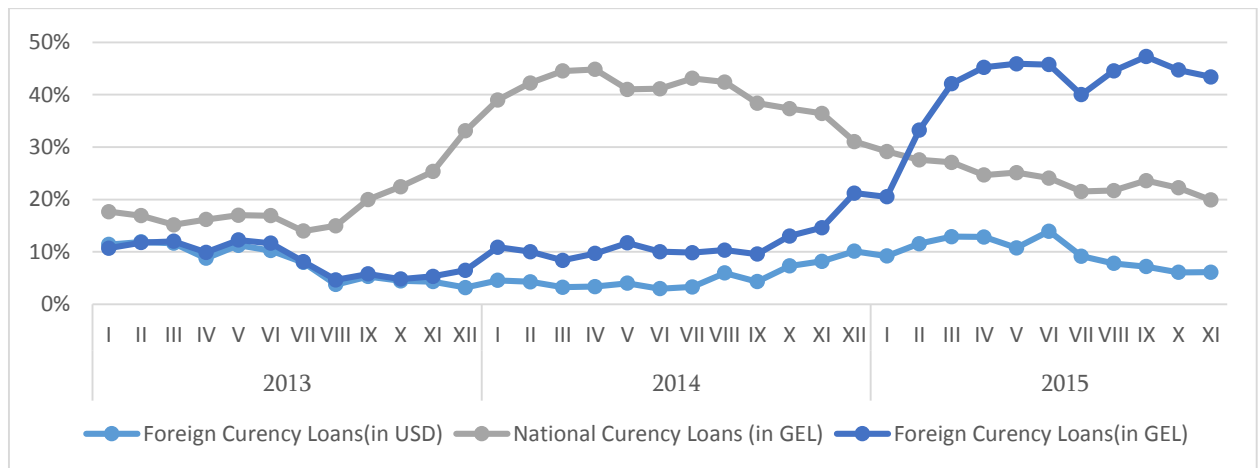


Total loans (stocks) granted by commercial banks amounted to 15.9 billion GEL in November 2015, which was 34% higher than the previous year. Part of this increase was due to the “valuation effect” associated with depreciation and the “inflated” lari price of dollar loans. We estimate that the valuation effect contributed 22.4 percentage points to the increase in the November stock of total loans.

The real increase in loans<sup>1</sup> was about 11.6%, from which 7.9 percentage points came from an increase in lari borrowing. Both lari and dollar borrowing continued to increase in 2015, but did so at a slower pace (see Figure 10 below).

Figure 10: Loans, Y-o-Y, % Change

Source: NBG



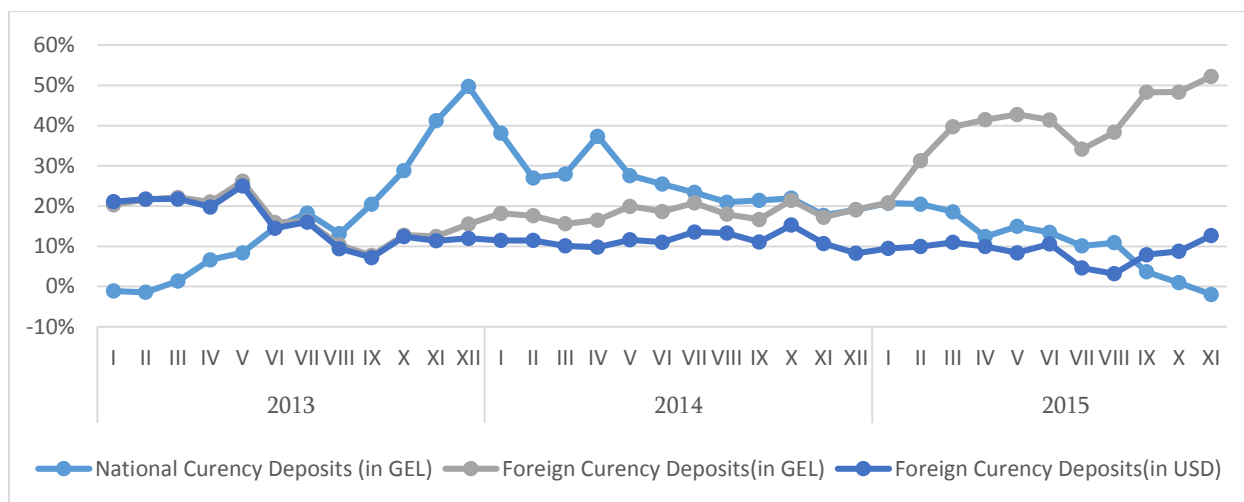
Total deposits of enterprises and households in commercial banks amounted to 14.9 billion GEL, 30.2% higher than in November last year. Here, the valuation effect contributed 23.5 percentage points and the real increase in deposits is estimated to have been 6.7% year on year.

<sup>1</sup> This is the sum of the growth rate in lari loans and the growth rate of foreign currency (dollar) loans in USD terms.

Of the 6.7% real increase, 7.5 percentage points were due to the increase in dollar deposits<sup>2</sup>. The **lari** was actually losing credibility among savers, as lari deposits decreased by 2.0% year on year in **November** (see Figure 11 below).

Figure 11: Deposits, Y-o-Y, % Change

Source: NBG

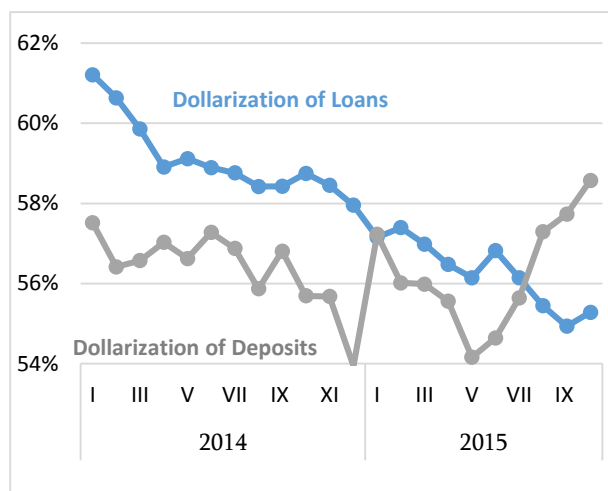
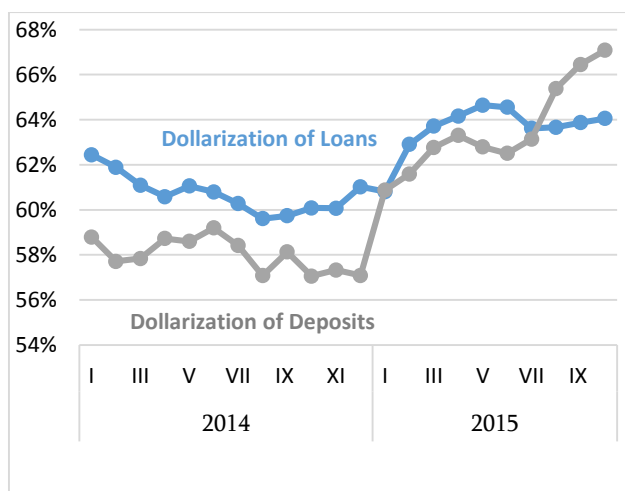


The official dollarization rate of deposits and loans increased in 2015 compared to 2014, but again this was driven mainly by the valuation effect of the lari depreciation against the dollar. According to the official statistics of the NBG, 67% of deposits and 64.1% of loans are dollarized. However, **if 2012 is taken as a base year for the GEL/USD exchange rate, the calculation of dollarization gives different results: only 58.6% of deposits and 55.3% of loans are dollarized.**

The dollarization of loans is showing a clearly decreasing trend. Obviously, the depreciation of the **lari precipitated this process, as borrowing in dollars is now more strongly associated with currency risk.** In contrast, dollarization of deposits has exhibited an increasing trend in the last six months. This was in part driven by the fact that households are now trying to hedge against inflation (and against possible future depreciations of the lari) by saving in dollars.

Figure 12: Dollarization Rates

Figure 13: Dollarization Rates (2012 as a Base Year)



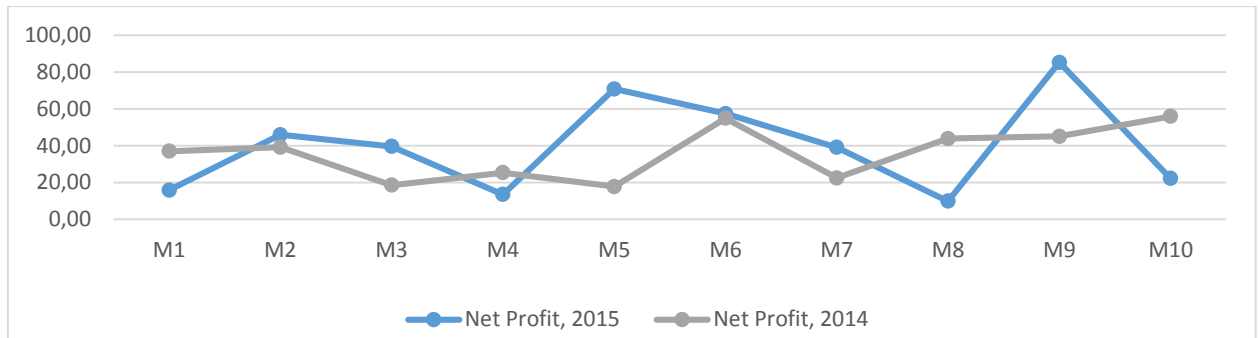
Source: NBG

Source: NBG, ISET-PI

<sup>2</sup> Once again, this number is calculated using the growth rate of dollar deposits in USD terms.

The profits of commercial banks were largely unaffected by the exchange rate depreciation and low real GDP growth in 2015. Net profits increased by 11% in January-October 2015 compared to the same period in the previous year and amounted to 399 million GEL. This may be due to the fact that in January banks acted quickly to prevent defaults by offering loan restructuring terms to their most affected clients.

Figure 14: Commercial Banks Net Profit, Million GEL

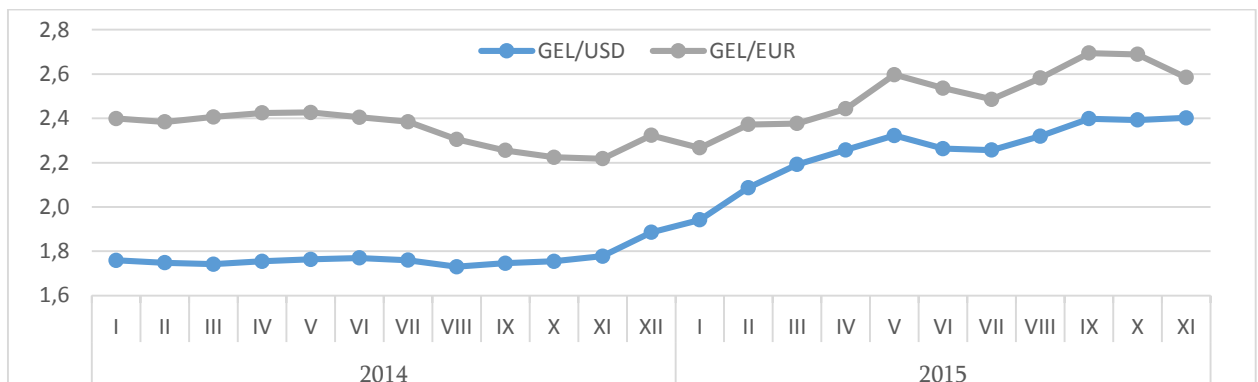


Source: GeoStat

In October, the GEL/USD monthly average exchange rate was 2.4, which was practically the same as in the previous two months. The lari also appreciated against the euro in this period, as the dollar strengthened against the euro on the global market.

Figure 15: Nominal Exchange Rates

Source: NBG

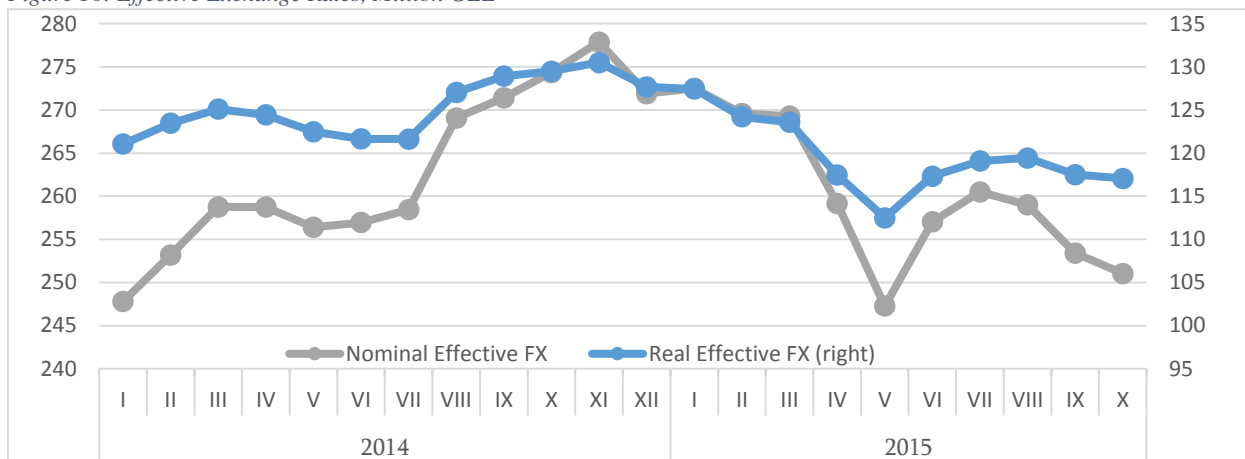


In October, the Georgian lari depreciated year on year in both nominal and real terms by 8.5% and 9.6% respectively. This means that the lari lost value against its main trading partners' currencies and that the inflation rate in Georgia's trading partners was slightly higher than in Georgia (making Georgian export goods cheaper).

In theory, depreciation should positively affect Georgia's export values in the long run. However, the reduction in regional demand (mainly in Russia), along with the fact that Georgian exports that are not denominated in US dollars would lose value after being converted into USD, can significantly dampen the overall export value.



Figure 16: Effective Exchange Rates, Million GEL



Georgian exports amounted to 187.7 million USD in October 2015, which is a 31.1% decline compared to October last year. Most of the decline came from CIS countries (which contributed -20.8 percentage points). The increase of exports to EU countries contributed just 1 percentage point.

Imports to Georgia amounted to 614.8 million USD in October 2015, which is 21.4% lower than October of the previous year. Declining imports from CIS countries contributed -5.3 percentage points, while declining imports from the EU lowered import growth by 5.5 percentage points. As a result, in October the trade deficit declined by 16.3% year on year, and amounted to 427.1 million USD.

Figure 17: Trade Balance, million USD

Source: GeoStat

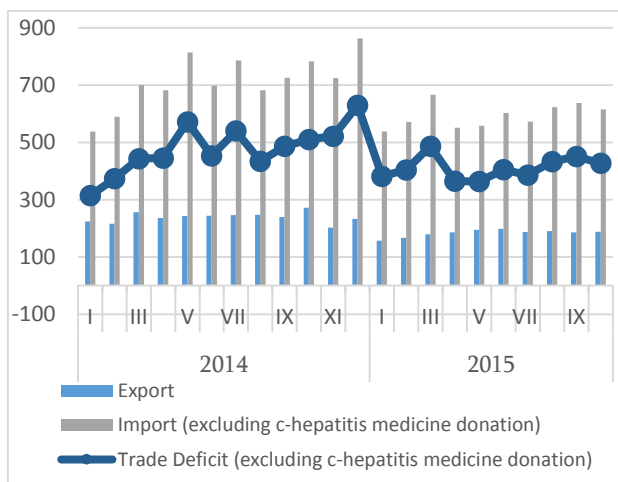
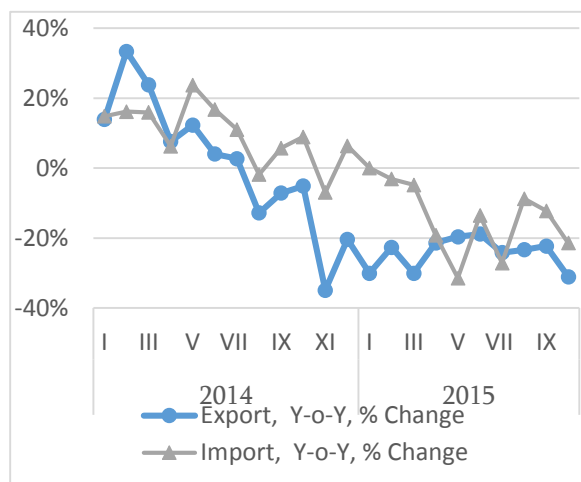


Figure 18: Trade, Y-o-Y, % Change

Source: GeoStat



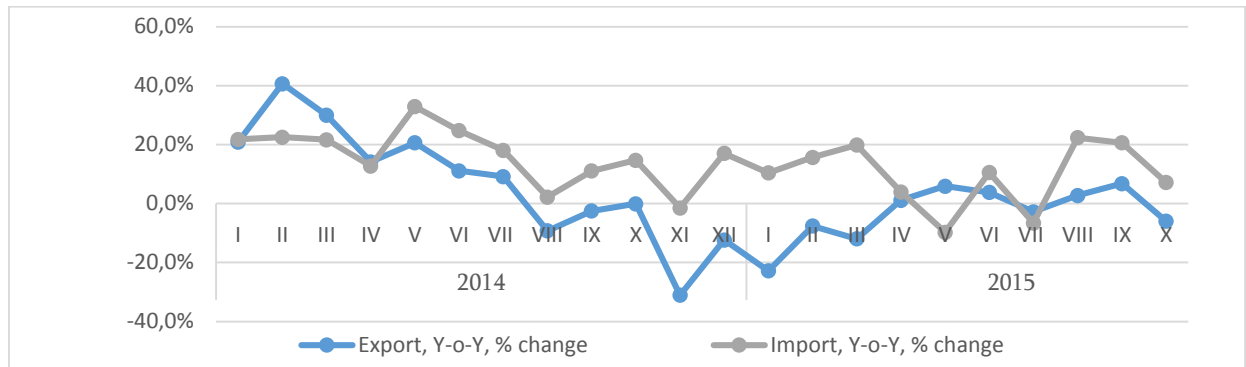
Valuation effect in the trade sector – can we trust what we see?

The valuation effect is high in the trade sector. This is because GeoStat follows the established practice of converting all trade statistics into US dollars. As a result, fluctuations in the GEL/USD exchange rate directly and immediately affect trade statistics. However, since a good portion of Georgia’s trade is not conducted in US dollars, but in the currencies of the partner countries or in lari, the valuation effect can significantly distort trade statistics.

One way to deal with the valuation effect is to re-calculate the trade data using an exchange rate from a chosen base year (for example, 2012). Adjusting trade statistics in this way gives us results that are much less dramatic than those suggested by the official data.

According to our adjusted calculations, imports increased by 7.2%, while exports decreased by 6% and the trade deficit worsened by 14.2% in October 2015 year on year (see Figure 19 below).

Figure 19: Trade, Y-o-Y, % Change (2012 as a base year)

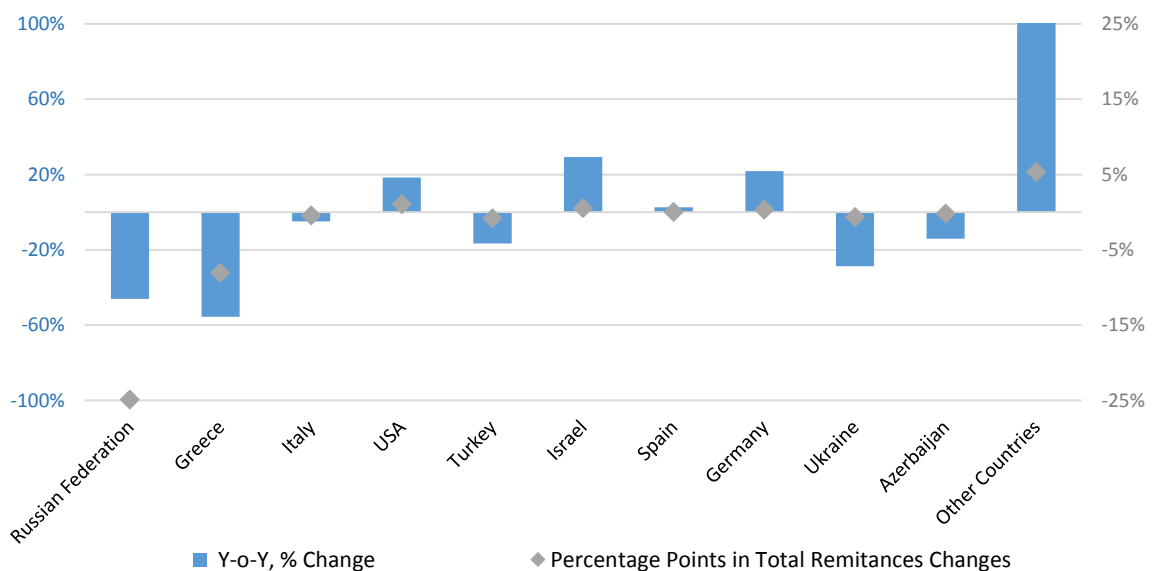


### The purchasing power of households receiving remittances declined by 9.5% in 2015

Remittances inflows to Georgia did not show any significant change in October relative to the previous month. In October, the total inflow of remittances decreased by 27.4% year on year, and amounted to 89.9 million USD. Remittances from Russia and Greece have not yet recovered and their contribution to the total year-on-year decline were -24.8 and -8.0 percentage points respectively. In October remittances increased from the USA, Israel, Germany and other countries, but the total value of these remittances was quite low.

Figure 18: Remittances by Country, October 2015 Compared to October 2014, % Change,

Source: NBG



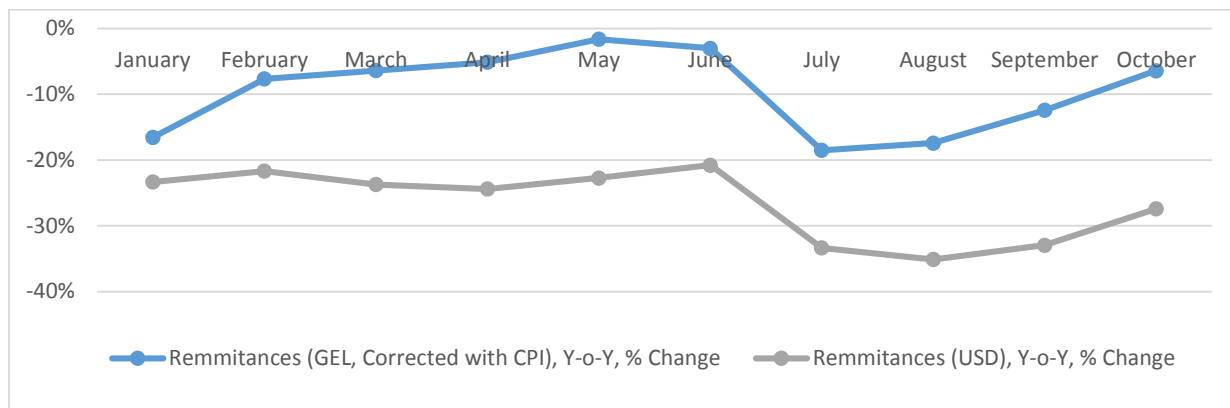
Since most of the remittances received from abroad go to supporting consumption expenditure of Georgian households, we can calculate how the change in the inflows affected the purchasing power of remittances in lari terms. In other words, by how much Georgian citizens are worse off from the decline in remittance transfers.

To see this, we convert the remittance volumes into lari and then deflate them by the CPI. Figure 19 below shows the results. **On average, in 2015 remittance beneficiaries could buy 9.5% less goods and**

services than in 2014 (according to GeoStat statistics, remittances declined by 26.8% in January-October 2015 compared to the same period in 2014).

Figure 19: Remittances, Y-o-Y Change, %

Source: NBG, GeoStat, ISET-PI



### Government budget update

In October, the common budget was in deficit by 139.9 million USD. This is about the same amount as in October 2014 (138.9 million USD). Income from taxes increased by 6.8% year on year in the reporting month. This increase was driven by 10.6% and 8.9% increases in income tax and VAT revenue respectively. Their contribution to the total change in tax revenues were 3.1 and 4.5 percentage points respectively.

Government total expenditures in October increased by 2.7% annually. Of this, increases in compensation to employees and in interest payments accounted for 1.75 and 1.68 percentage points respectively.

Figure 20: Common Budget, million GEL

Source: Ministry of Finance of Georgia

