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Exchange rate pressure is off. Output growth picks up in October

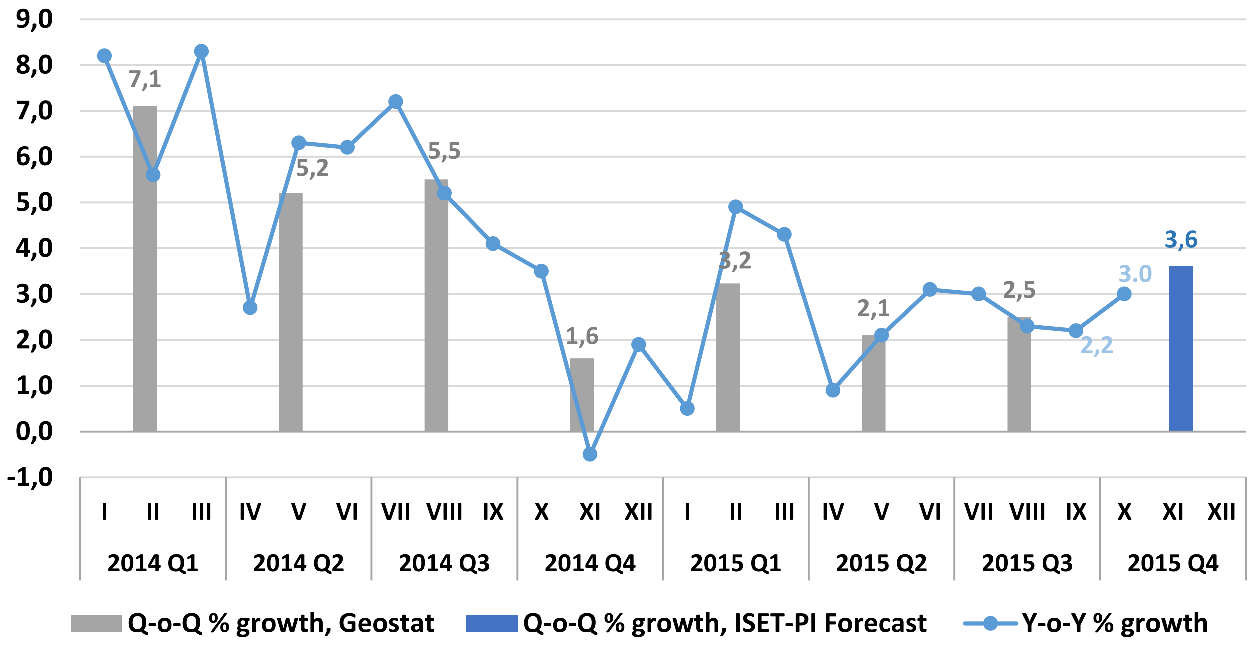
According to recently released statistics, the Georgian economy continued on a stable trajectory of low-single digit growth in September and October. The rapid growth estimates for October show 3% GDP growth, definitely an improvement over the 2.2% growth in September. The estimated average real GDP growth rate in the first ten months of 2015 was 2.8% year on year.

The latest figures point to the strong possibility that Georgia will close out the year with annual real GDP growth above the 2% projected by IMF for 2015.

In the third quarter of 2015, estimated real GDP growth reached 2.5% year on year. This was very close to ISET-PI's third quarter forecast of 2.6%.

At the same time, **ISET-PI's Leading Economic Indicators forecast puts 2015 annual GDP growth at about 3%.**

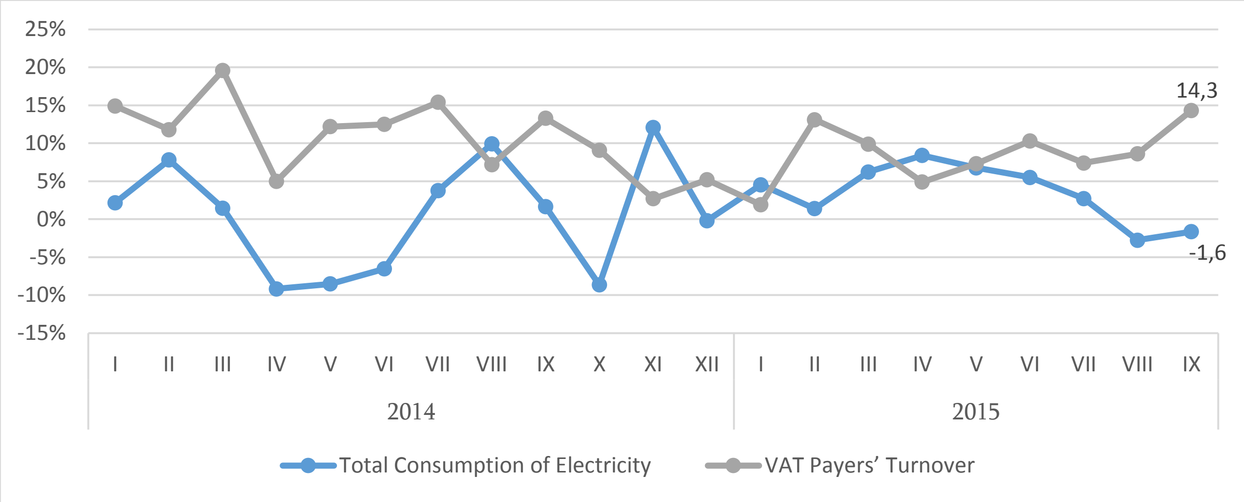
Figure 1: GDP Growth, ISET-PI Forecast, % *Source: GeoStat, ISET-PI*



Changes in aggregate demand indicators

Meanwhile, VAT payers' turnover, which is one of the important indicators of aggregate demand, has increased quite significantly, by 14.3% year on year in September. **Electricity consumption, however, did not follow VAT dynamics. Total consumption of electricity decreased by 1.6% relative to September 2014.** As we have discussed in earlier publications, this decrease in electricity demand was driven largely by the higher electricity tariffs that was instituted in both the Georgian regions (on 1 August) and in Tbilisi (on 5 September).

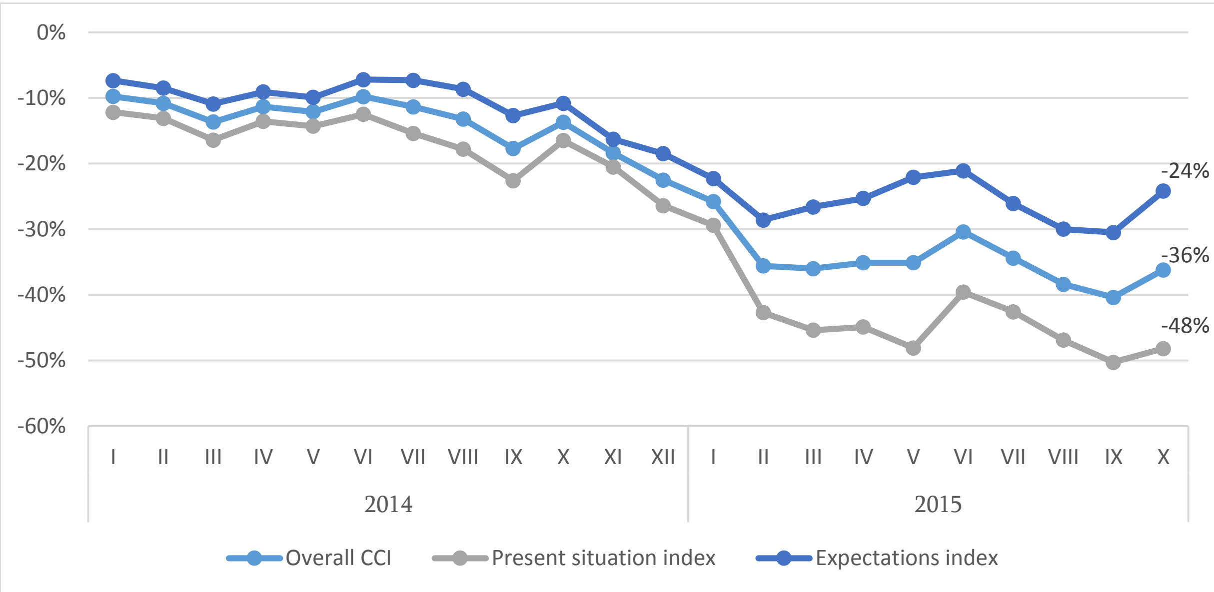
Figure 2: VAT Turnover and Electricity Consumption, Y-o-Y Change, % *Source: Ministry of Energy of Georgia, GeoStat*



In addition, in September the consumer confidence index (CCI) experienced a further drop of 2 points, crossing the -40 points margin to reach yet another historical minimum of -40.4 points. Responses to the question about making major purchases was the primary driver of the decrease. Concerns about the turbulence on the currency exchange market were also reflected in the consumer confidence jitters during the month.

In October, however, the CCI managed to regain its footing – in line with the higher estimated output growth reported by GeoStat.

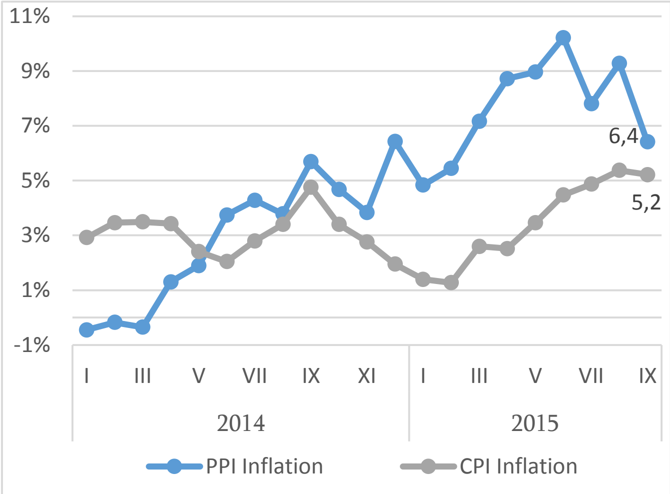
Figure 3: Consumer Confidence Index *Source: ISET-PI*



Producer and consumer prices are climbing, but at a slower pace

In September 2015, the Producer Price Index (PPI) increased by 6.4% year on year, but the rate of the increase slowed down compared to previous months. The slowdown in PPI growth was mainly due to a 1.4% monthly decline in the prices of manufacturing, which in turn was driven by the 4.7% decline in the price for manufacturing metals.

Figure 4: Inflation Rates, Y-o-Y, % *Source: GeoStat*



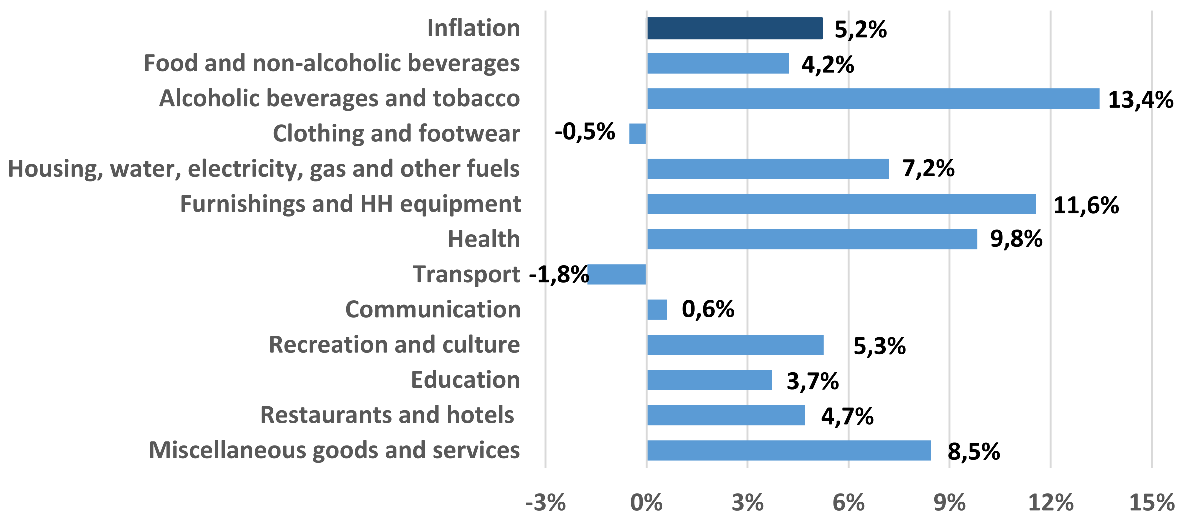
Consumer Price Index (CPI) based inflation reached 5.2% in September 2015, which was still slightly higher than the National Bank's target inflation rate.

According to the National Bank's data, the inflation rate is expected to increase in the last months of 2015 and hit a maximum of 7% in the first quarter of 2016 (NBG Inflation Report, November 2015). This pickup of quarterly inflation in 2016 will be partly due to the so-called "base effect" or "carry-over effect" from the relatively sharp elevation of prices in the last months of 2015.

Even if the price level stays the same from now on, we are guaranteed to have high year on year inflation in the beginning of 2016, as prices are already at a much higher level than they were in the early months of 2015.

To combat future inflation, the NBG continues to tighten monetary policy. It already increased the monetary policy rate by 100 basis points, to 7%, on 23 September, and then further to 7.5% in November.

Figure 5: Inflation Rates by Categories, Y-o-Y, % *Source: GeoStat*



The increase in intermediate costs of production for domestic companies due to higher electricity tariffs and increased costs of servicing USD debts remain important contributors to the overall rise in price levels.

Furthermore, prices for imported goods are increasing due to lari depreciation. In the CPI this is reflected mainly through the furnishings and household equipment (11.6% year on year) and medicines (9.8% year on year) categories. These two categories contributed 0.7 and 0.9 percentage points to overall CPI inflation respectively.

Alcoholic beverages and tobacco traditionally show the highest inflation rate (this stood at 13.4% year on year in 2015). The increase in this category was mainly due to the excise tax imposed in January 2015. This product category had a 0.7 percentage points impact on CPI inflation.

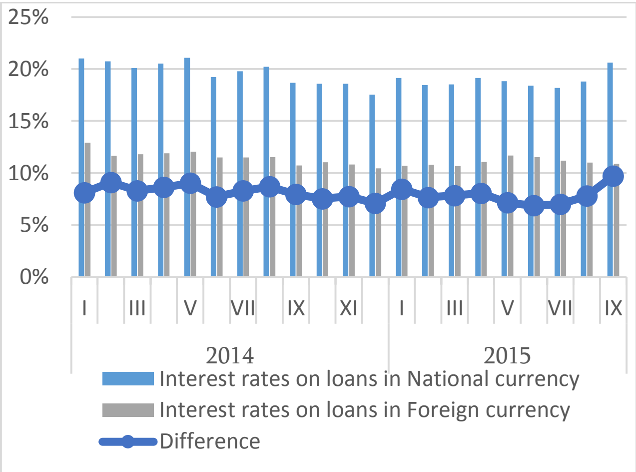
While prices of food and non-alcoholic beverages increased by only 4.2% year on year, this increase had the biggest influence on overall consumer price inflation in September. More precisely, it contributed 1.3 percentage points to the total and was thus responsible for nearly a quarter of the observed inflation rate. The food and beverages product group makes up 30.7% of the total consumer basket. Thus, even small fluctuations in the prices of these goods will have a significant impact on consumer price inflation.

The main factors pushing inflation down in September were once again the decreasing prices of diesel and petrol (-13.6% and -10% respectively).

Financial sector indicators show the effect of monetary tightening

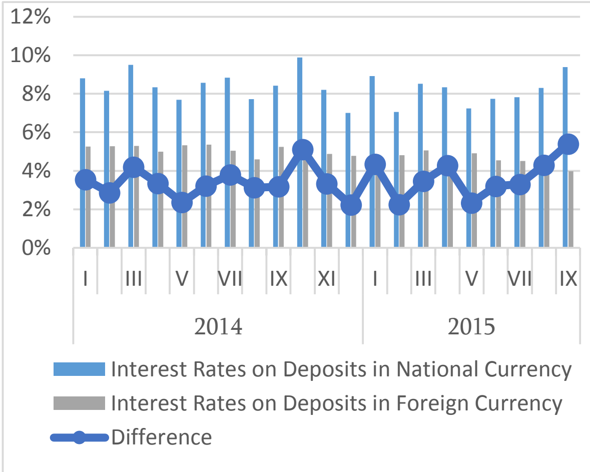
Due to the monetary policy tightening, borrowing and lending in the national currency is becoming more expensive. The higher policy rates affect market interest rates on lari loans and deposits. **The spread between national and foreign currency interest rates on loans (and deposits) continued to increase in September.**

Figure 6: Market Interest Rate on Loans, %



Source: NBG

Figure 7: Market Interest Rate on Deposits, %



Source: NBG

The same dynamic is observed for interest rates on mortgage loans. Borrowing in foreign currency is now becoming cheaper relative to borrowing in lari on the mortgage market.

Yet, the monetary policy changes did not affect spreads on consumer loans. Here, the spread between national and foreign currency interest rates was significantly higher than for mortgage loans, but it has stayed largely unchanged during the last few months of 2015.

Figure 8: Annual Weighted Average Interest Rates on Individuals' Mortgages Loans, Issued During the Reporting Period, % Source: NBG

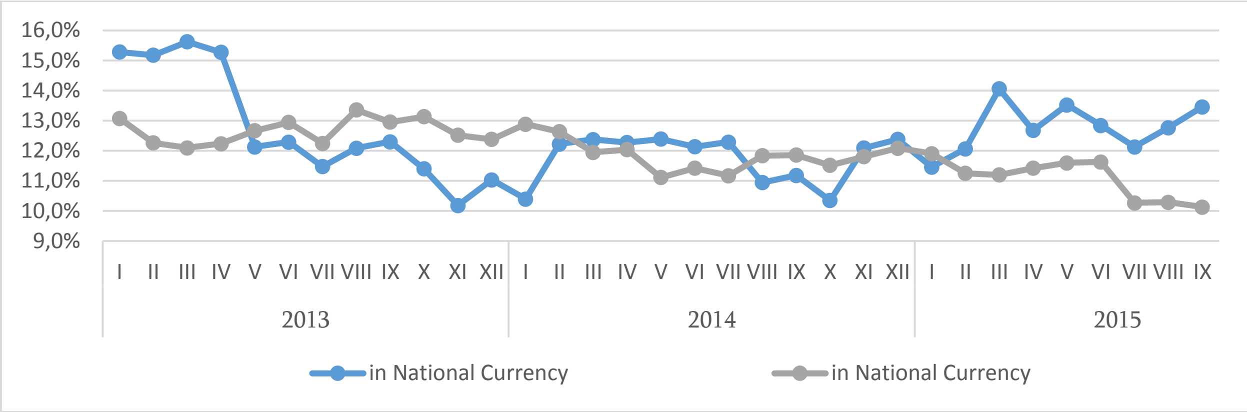
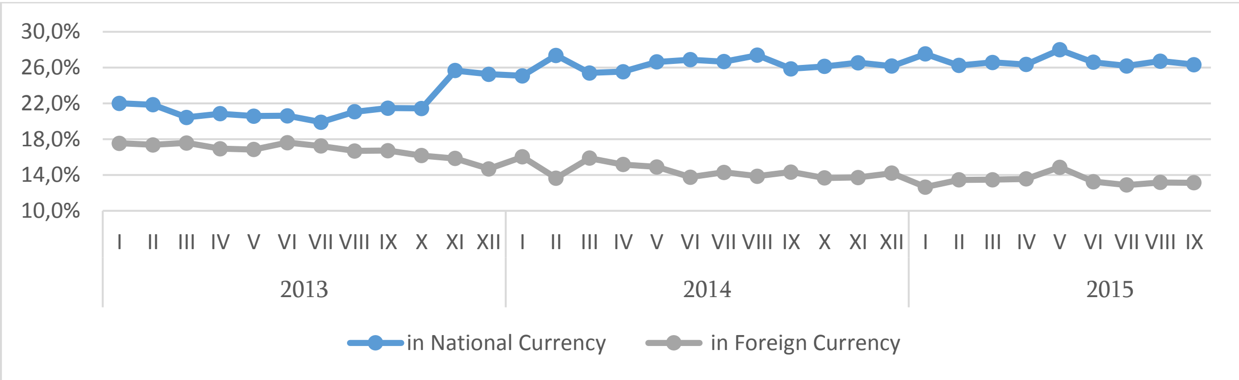


Figure 9: Annual Weighted Average Interest Rates on Individuals' Consumer Loans, Issued During the Reporting Period, % Source: NBG



The spread between lari and foreign currency interest rates on mortgage loans was 0.5% on average during the last 3 years, while the same spread on consumer loans was 9.8% on average in the same period.

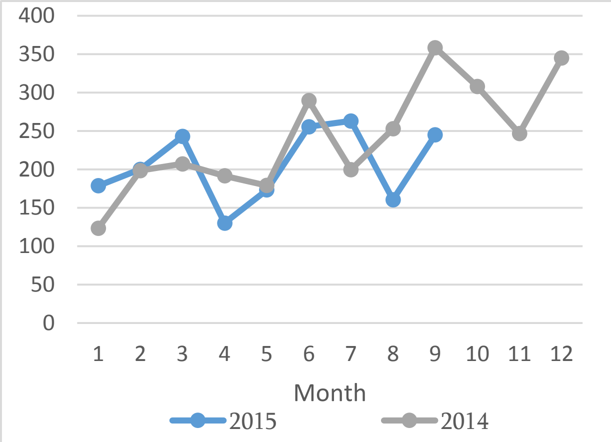
Yet, despite such a huge difference in interest rates, the consumer loans market is dominated by national currency loans.

The share of USD loans in total consumer loans is about 20%, while mortgage loans are 78% dollarized. This means that **the choice of borrowing currency is not a simple linear function of the relative cost of borrowing. The borrowing behavior of individuals may depend on the purpose of the loan, and on how "dollarized" the specific product market is.** For example, the real estate sector remains heavily dollarized relative to the retail sector (most prices are quoted and indexed in dollars), driving up mortgage dollarization rates.

Lari depreciation did not affect the foreign currency borrowing behavior of legal entities until August 2015. After that, we observe a -100 million USD level shift in monthly borrowing.

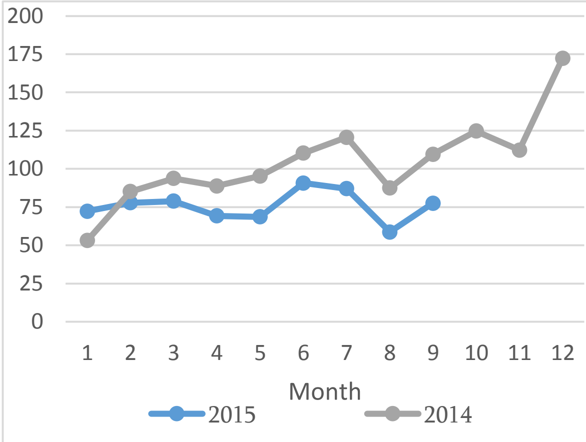
Individuals started borrowing less in dollars from the beginning of the year. In 2015, they borrowed about 20 million USD less than in 2014.

Figure 10: USD Loans, Granted to the Legal Entities, Issued During the Reporting Period, Million USD



Source: NBG

Figure 11: USD Loans, Granted to the Individuals, Issued During the Reporting Period, Million USD



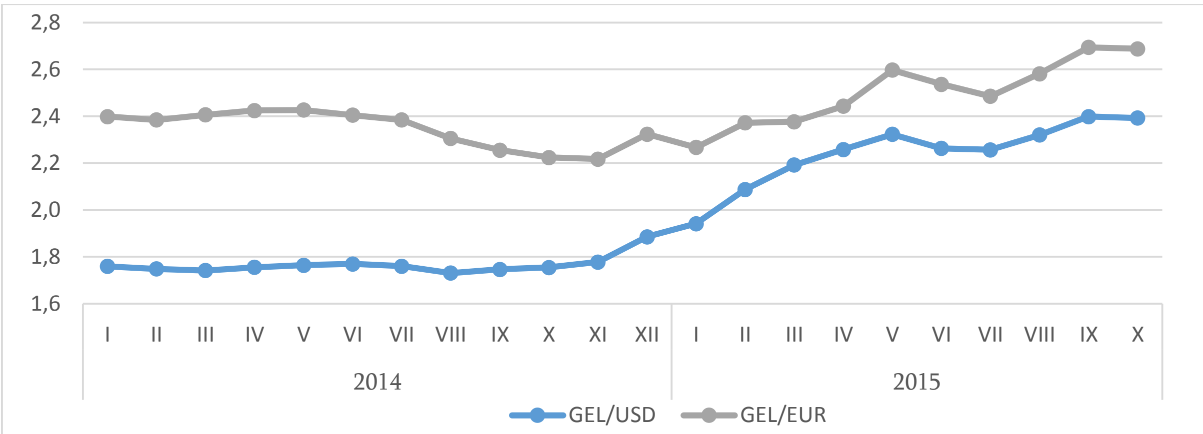
Source: NBG

Exchange rate market pressure is off

In September 2015, the lari hit an absolute minimum against the dollar (2.45 on 22 September), prompting swift intervention from the National Bank on the currency market. Afterwards, the GEL/USD exchange rate stabilized at 2.4. The intervention on the currency market was justified by the belief that all external shocks affecting the level of the nominal exchange rate had already been absorbed and that further depreciation was not expected.

Overall, in September the lari depreciated against the USD by 37.4% year on year. Nominal depreciation against the euro was 19.5% year on year for the reporting month.

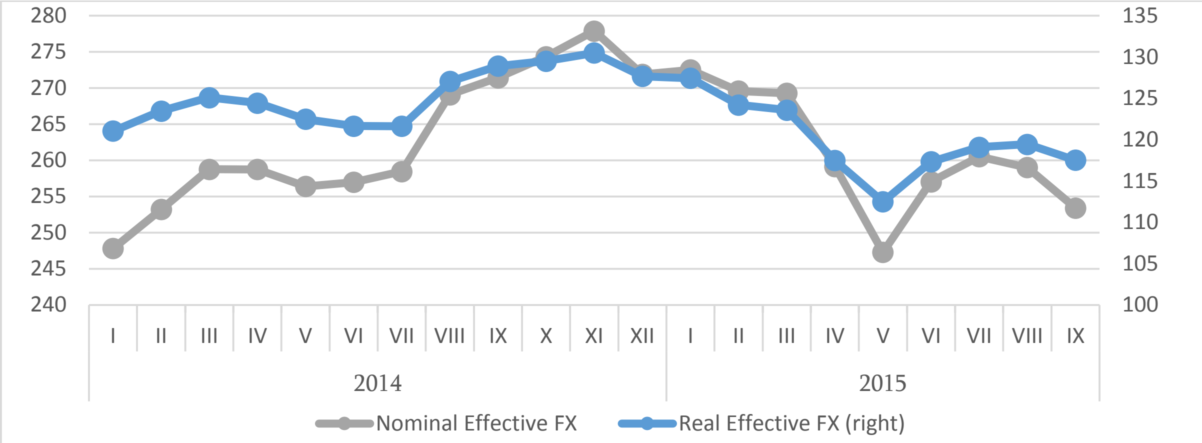
Figure 12: Nominal Exchange Rates *Source: NBG*



In September, the nominal effective exchange rate and real effective exchange rate declined by 2.2% and 1.6% respectively, compared to August.

Year on year, the Georgian lari depreciated by 7% in nominal and by 9% in real terms against partner currencies.

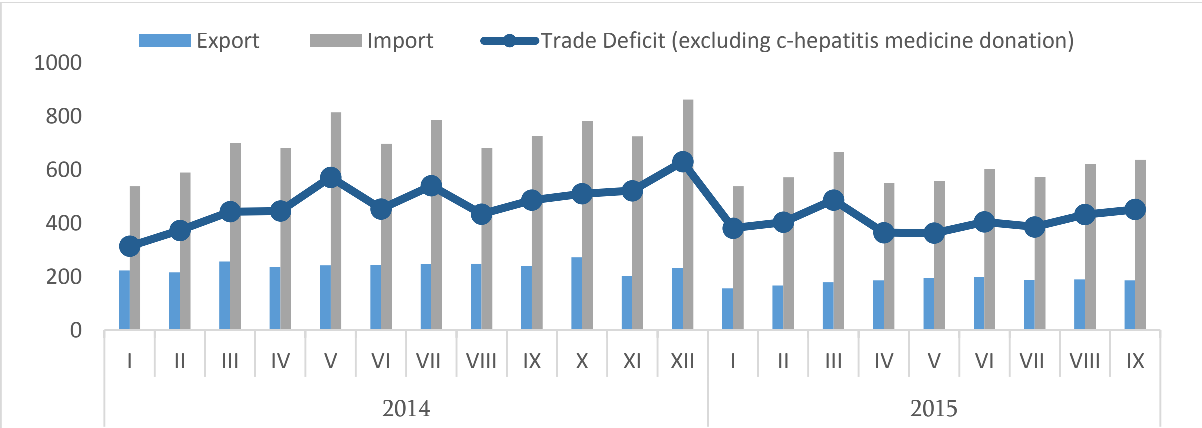
Figure 13: Effective Exchange Rates *Source: NBG*



External sectors: shifting patterns of regional trade

The **volume of Georgian exports declined by 22.3% in September 2015** compared to the same month of the previous year. Excluding the donation of Hepatitis-C medicine, which contributed 86 million USD to the import balance, **in September 2015 there was a 11.8% drop in imports, and the trade deficit decreased by 7.2% year on year to 451.4 million USD.**

Figure 14: Trade Balance, Million USD *Source: GeoStat*



In regional trade we see a continuation of the trends observed in the past few months. In September 2015, Georgia increased exports to EU countries (8.5% year on year) and decreased exports to CIS and other countries (-40.8% and -11.4% year on year respectively).

Similar dynamics were observed in imports. **Imports from the EU increased by 9.1% in September compared to the same month of the previous year, while imports from CIS countries decreased by 18.2%**.

The main causes of such a drastic reshuffling in regional trade patterns are both the economic problems in our neighboring countries and, importantly, the valuation effect that arises from the dollar denomination of trade statistics.

For example, the same volume of trade in national currencies would automatically translate into a lower trade volume quoted in USD, if the national currencies depreciate against the dollar.

Figure 15: Georgian Exports by Region, Y-o-Y Change, % *Source: GeoStat*

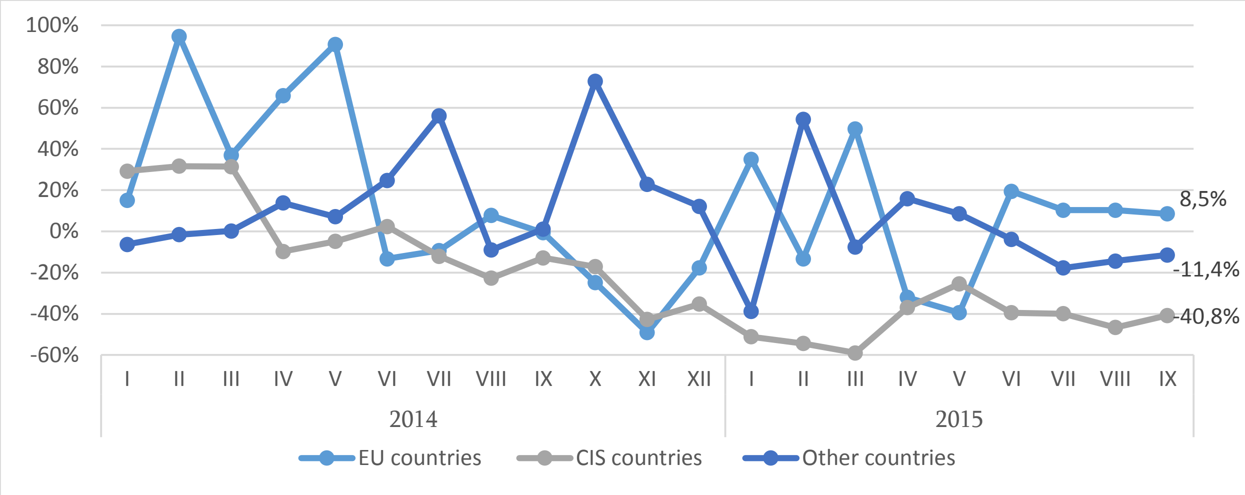
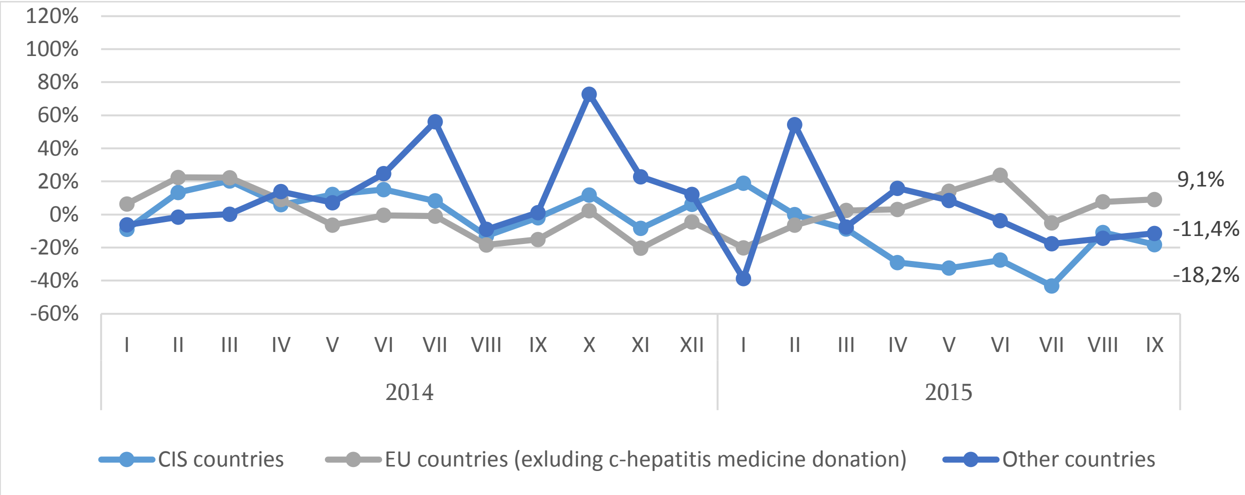


Figure 16: Georgian Imports by Region, Y-o-Y Change, % *Source: GeoStat*

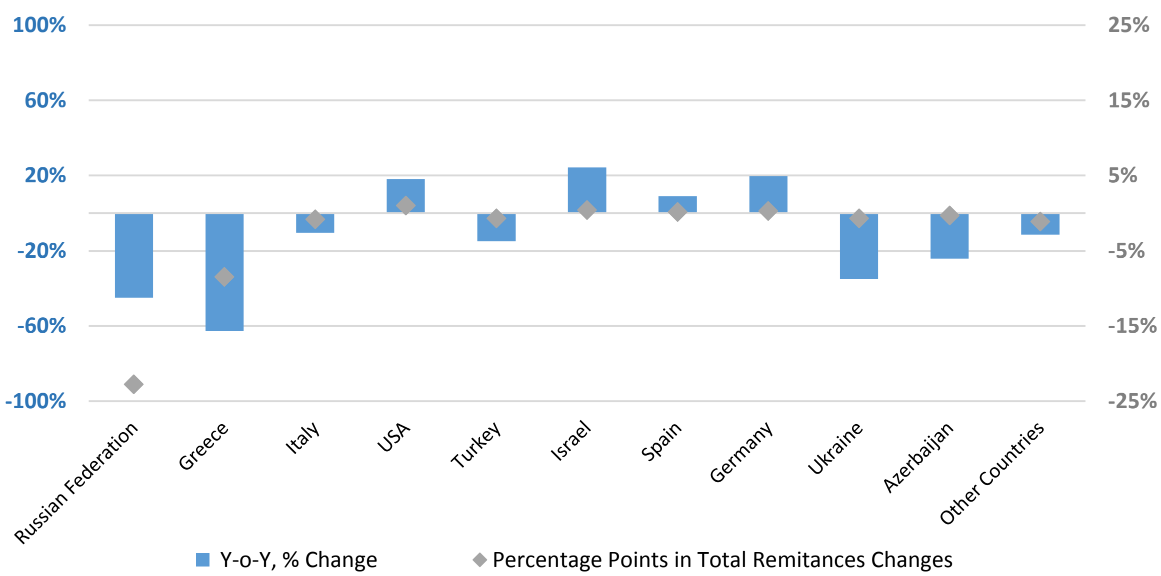


Remittances: other countries only very slowly chipping away at Russia's share

Remittances from abroad decreased by 32.9% in September year on year and amounted to 88.6 million USD. A 45% year on year decline of remittances from Russia contributed as much as -22.7 percentage points to the total change, while a 62% year on year decline in remittances from Greece contributed only -8.5 percentage points to the total.

Remittances increased quite significantly from the USA (+18.2%), Israel (+24.3%) and Germany (+19.8%). However, these countries hold such a small share in the overall remittances volumes, that the impact of the increase was almost negligible.

Figure 17: Remittances by Country, Y-o-Y Change, % *Source: NBG*



Government budget in surplus, as both revenues and expenditures rise

In September 2015, government expenditure increased by 13.9% compared to the same month of the previous year and amounted to 881.8 million USD.

Total expenditure increased mainly due to a 11.7% increase in the compensation of employees, a 14.6% increase in social benefits and an 14.6% increase in purchases of goods and services.

Government revenues increased by 16% year on year in the reporting month. Profit tax was the biggest contributor, increasing by 20.1% year on year, while income and excise taxes increased by 6% and 12% respectively. Overall, the government budget in September 2015 posted a surplus of 46.8 million GEL.

Figure 18: Common Budget, in million GEL *Source: Ministry of Finance of Georgia*