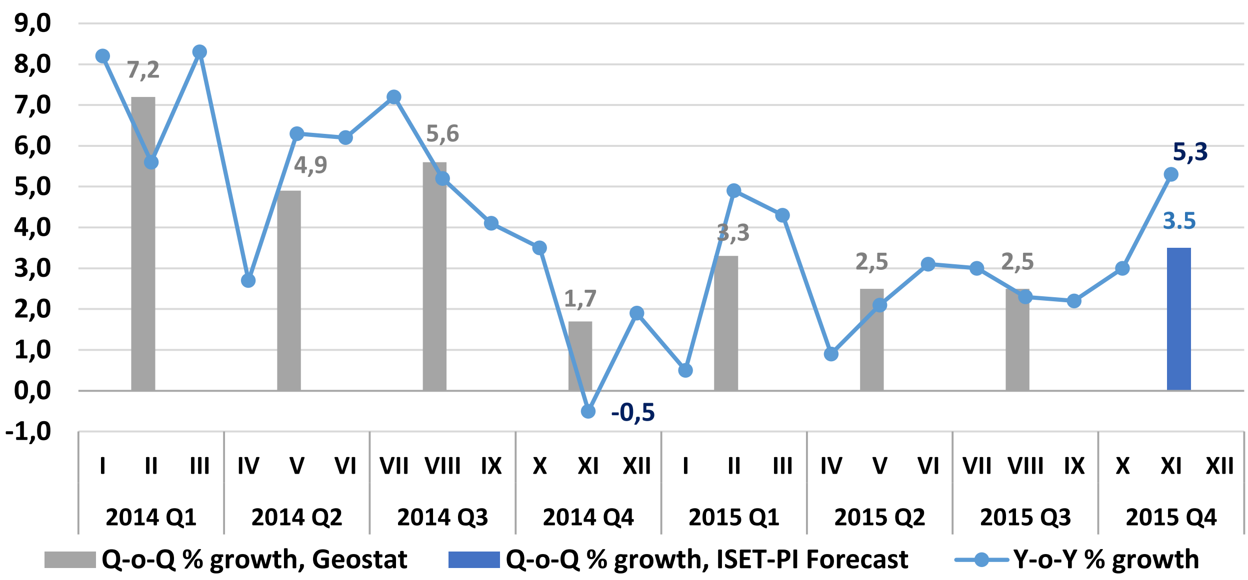
Authors: Yaroslava Babych and Giorgi Mzhavanadze

Saved by Statistics: Growth Rate Jump in November Revives Economic Hopes, but Caution Is in Order

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

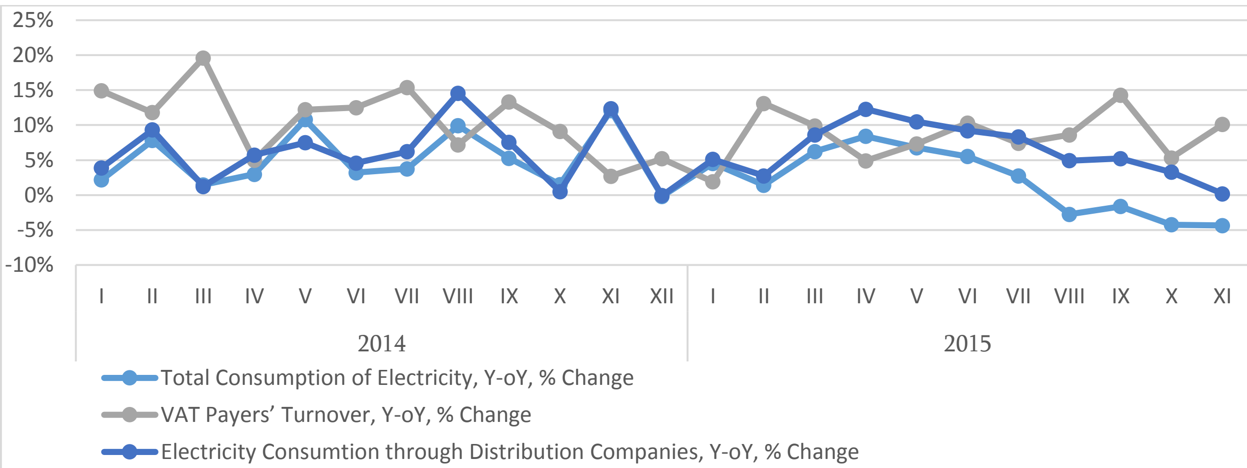


According to the most recent rapid estimates of economic growth by GeoStat, in November 2015 the Georgian economy increased by 5.3% compared to the same month the year before. The 5.3% increase represents the highest growth rate in nearly 15 months. This optimistic outcome should, however, be treated with a degree of caution. As can be seen from Figure 1 above, one of the reasons for the high growth numbers in November 2015 was the fact that November 2014 was a particularly bad month in which GDP declined by 0.5% in year-on-year terms.

Nevertheless, the high growth in November 2015 can be treated as evidence that the overall economy stabilized in the last quarter of the year. We are certainly not observing high swings in GDP, which in itself is a good sign.

For the first eleven months of 2015, the year-on-year growth rate was 3.0% – the same as ISET-PI's Leading Economic Indicators (LEI) annual growth forecast. The LEI prediction for the fourth quarter is still 3.5% (the forecast remained virtually unchanged since the last update).

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

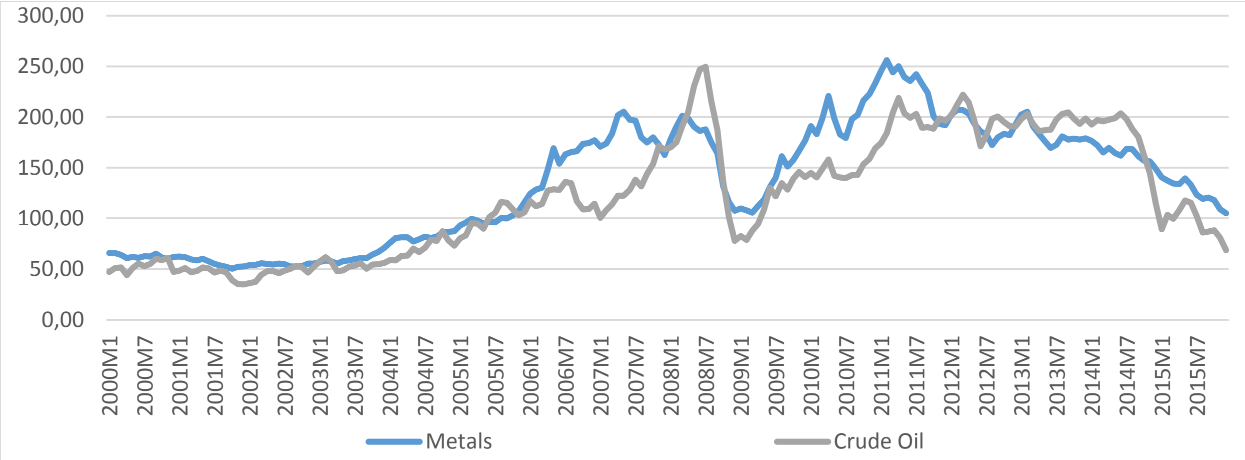


Demand factors affect economic growth in November

Total consumption of electricity, which had been falling for the last three months, declined by 4.4% year on year in November. The continuous decline was primarily driven by the company "Georgian Manganese", one of the largest energy consumers. The electricity consumption of this company alone accounted for 11% of total Georgian electricity consumption in 2014. In November 2015, the company consumed 35.7% less electricity than in the same month of the previous year.

"Georgian Manganese" continues to suffer from the rapidly decreasing metal prices worldwide. *Metal prices are closely linked to the declining prices of energy and recently fell to a 10-year minimum, according to the IMF PMETA index.* Given the trends on the energy markets, expectations about future production volumes at "Georgian Manganese" are not at all promising.

Figure 3: Metals and Crude Oil Price Indices *Source: IMF*



Traditionally a large portion of household electricity usage in November is for heating. However, the electricity consumption through distribution companies shows only a 0.2% growth rate year on year in the reported month. The reason for this could be that households are mindful of the higher electricity tariffs: they are switching from electricity to gas heating (which is cheaper), and use electricity more economically than before.

VAT payers' turnover increased by 10.1% year on year in November, which was reflected in the GDP growth rate. This indicator continues to be a good proxy for rapid estimates of the real GDP annual growth rate, while total electricity consumption now has less correlation with economic growth because of the factors described above.

Overall, we conclude that the demand factors, as represented by VAT payers' turnover, were favorable for Georgia in November. This is despite the tough situation facing primary commodities-exporting enterprises like "Georgian Manganese".

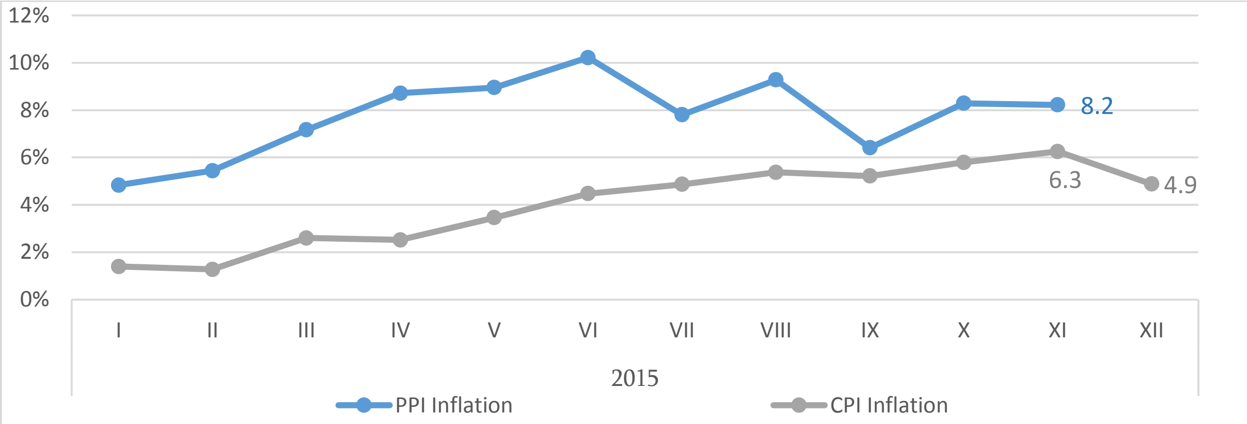
Money and credit markets

The NBG continued the gradual monetary policy tightening that it started in the beginning of the year. The refinancing rate was increased by 50 basis points to 8%. In total, the refinancing rate increased by

400 basis points (4 percentage points) in 2015. The refinancing rate is now at the highest level since June 2011. The NBG aims to reduce annual inflation to its target level of 5%.

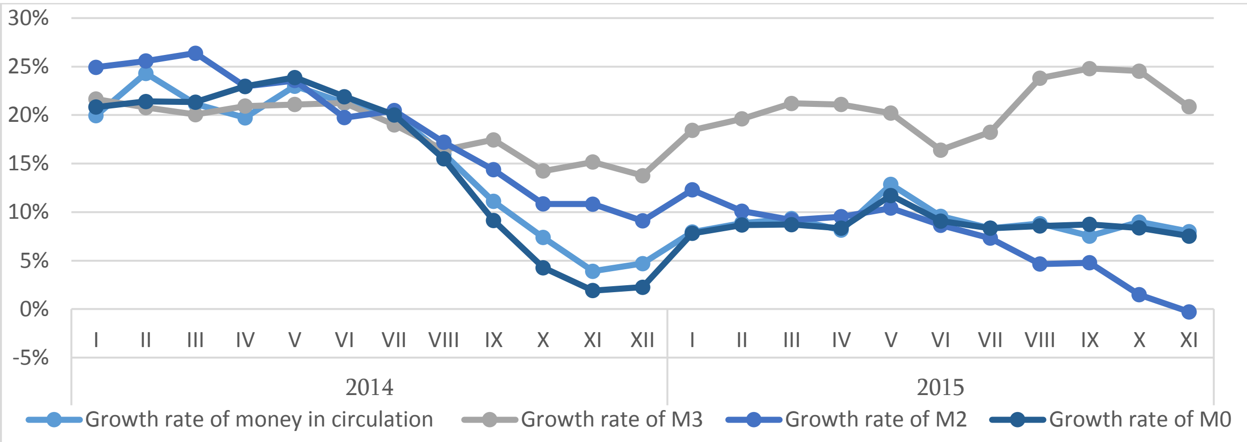
In December 2015, the first results of such a policy were already visible: CPI-based inflation dropped to 4.9%, after reaching the high point of 6.3% in the previous month.

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



The NBG's monetary policy had an effect on money aggregates, with their growth rates slowing in the last months of the year (especially the annual growth rate of M2, which was -0.3% in December 2015).

Figure 5: Growth Rates of Money Aggregates *Source: NBG*



Prices will continue to rise at a more "normal" pace in 2016

The NBG annual report predicts that the inflation rate will be 5-7% in 2016, and will return to its target level of 5% only in the first quarter of 2017.

The high inflation of 2016 will largely be driven by the "carry over" effect from the sharp rise of prices at the end of 2015. *In other words, the NBG estimates that the price shock is largely over, and that price levels will continue to rise at a more "normal" pace in 2016.* At the same time, the fact that December's statistics reflect slower price growth shows that the NBG may have actually over-predicted future inflation – monetary instruments may have become more efficient.

The decomposition of the relatively high CPI in November shows that the 6.3% increase in consumer prices was driven by higher prices on food and non-alcoholic beverages, which contributed 1.58 percentage points to total inflation in that month.

The cost of medicines and furniture (as was the case throughout 2015) showed some of the biggest increases of 11.5% and 12.9% respectively, and contributed 1.09 and 0.81 percentage points to total inflation in November.

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

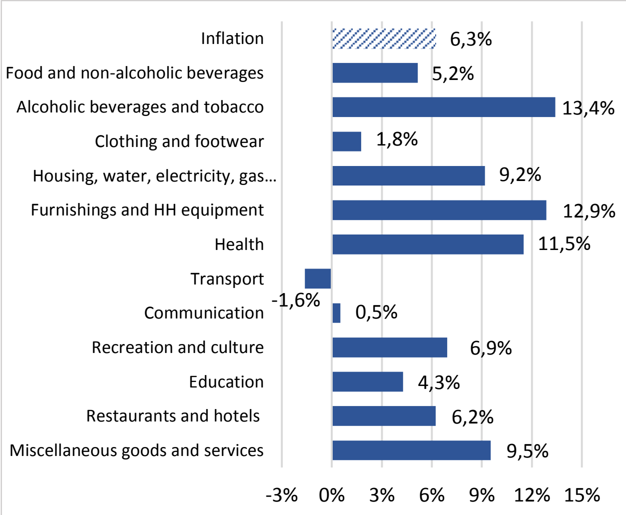
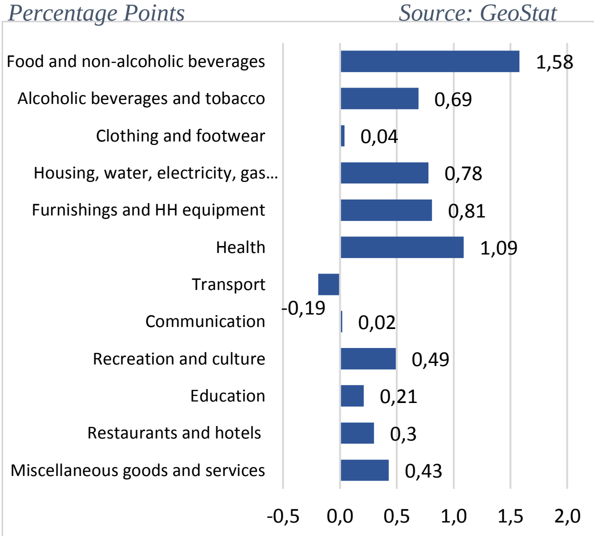


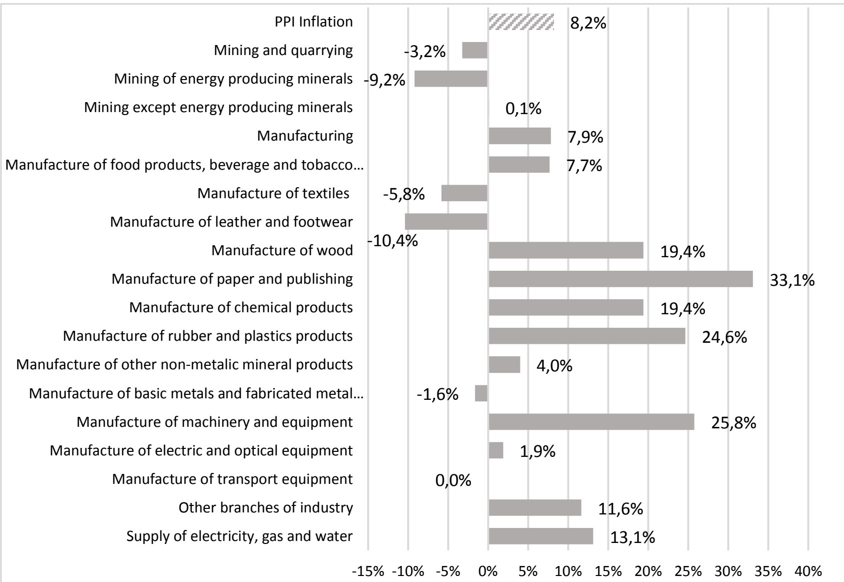
Figure 7: Contribution to Inflation Rate by Category, Percentage Points Source: GeoStat



Transport was the only category for which inflation was negative, at -1.6% year on year. This decline contributed only -0.19 percentage points to total inflation. Likewise, prices in the "housing, water, electricity, gas and other fuels" category increased significantly – mainly because of the new electricity tariffs and the 14.7% increase in the price of gasoline (although, as the NBG reports, world diesel and gasoline prices decreased in 2015 by 12.5% and 10.3% respectively).

Prices of alcoholic beverages and tobacco products traditionally increase more dramatically than other categories, and showed a 13.4% increase year on year in November. The alcoholic beverages and housing expenses categories combined were responsible for 1.47 percentage points, or nearly a quarter, of November's inflation.

Figure 8: PPI Inflation Rates by Category, Y-o-Y, % *Source: GeoStat*



The Producer Price Index in November shows 8.2% price growth year on year. The biggest contributors to this increase were prices of manufactured food products, beverages and tobacco products, the manufacture of chemical products, and the manufacture of paper and publishing.

These categories combined were responsible for 5.15 percentage points of November's PPI inflation.

Despite the evidence of high year-on-year inflation rates, average annual inflation in 2015 remained below the annual target, at 4%.

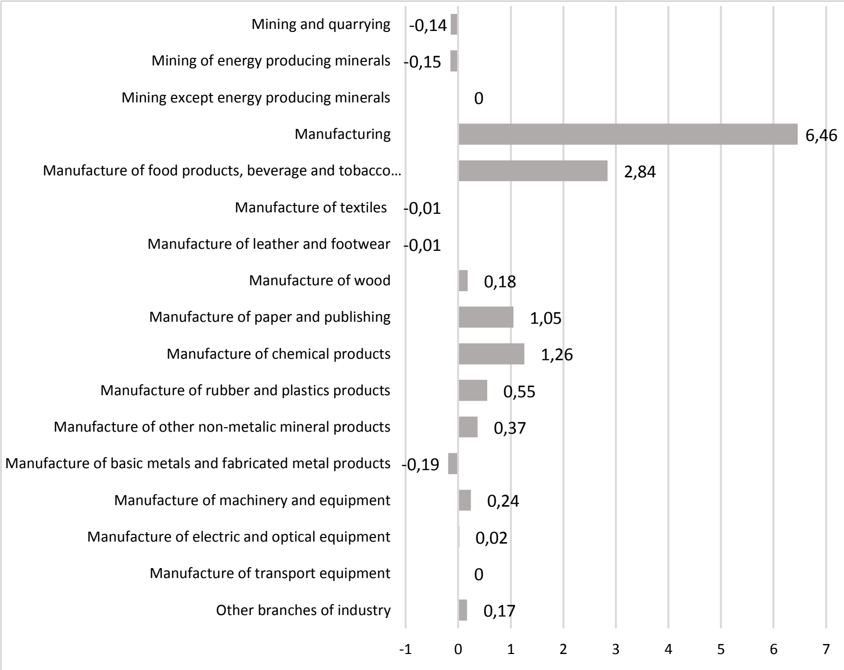


Figure 9: Contribution to PPI Inflation Rate by Category, Percentage Points

From these statistics we can conclude that the NBG successfully dealt with the huge pressure on prices stemming from external shocks and managed to stabilize inflation at the target rate. Going forward, this builds credibility for the Georgian central bank, and can have significant positive long-term effects on the country's economic performance.

Credit markets see a rising gap between foreign and domestic lending rates

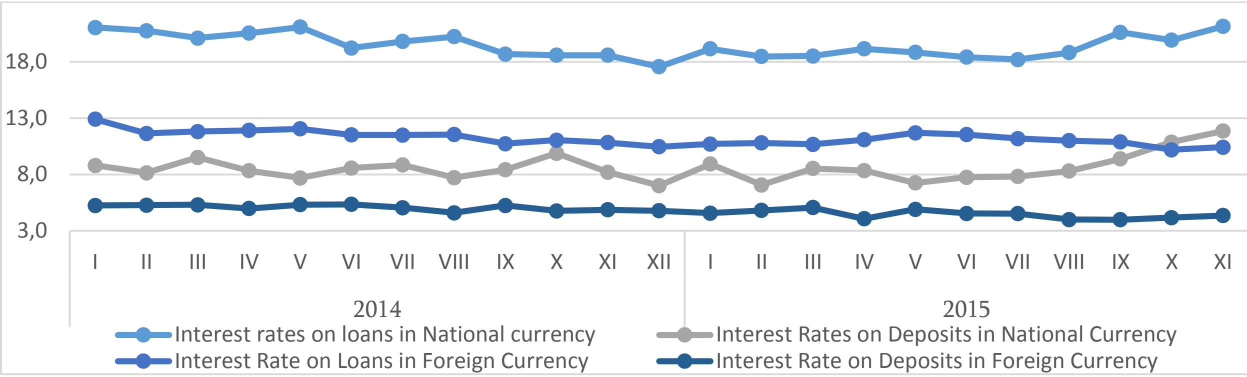
As a result of the NBG's tight monetary policy, the market interest rate on deposits in the national currency continued to increase. The market interest rate on national currency deposits increased to 11.9% in November (a one percentage point increase compared to October) and was the highest level since March 2013.

In the reported month, the "strange gap" between the market interest rate on deposits in lari and on loans in foreign currency increased to 1.5 percentage points. As we noted in the previous report, the situation seems strange as it points to the possibility of arbitrage between the two markets. However, we are not yet likely to see investors rushing to borrow in USD and then buying and depositing lari for a profit - mainly because of transactions costs.

However, the rising lari deposit rates point to one simple conclusion: people are still interested in borrowing in lari (as lari loans offer a lower currency risk than those in dollars), but are unwilling to save in lari. This is why rates on national currency deposits are rising.

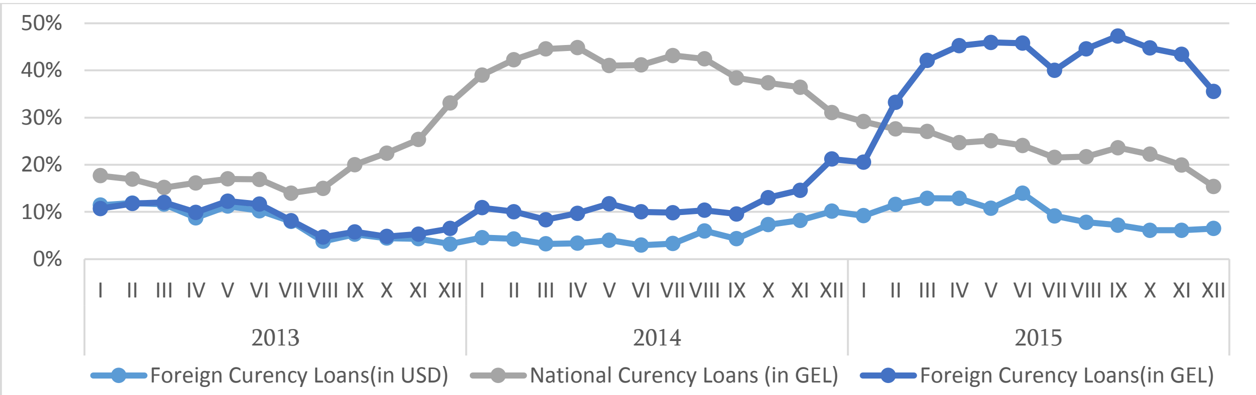
Market interest rates on national currency loans increased by 1.2 percentage points in November compared to the previous month and stood at 21.1%, while market interest rates on foreign currency loans did not change significantly. *The spread between domestic and foreign currency lending rates reached a historical maximum of 10.7 percentage points.*

Figure 10: Market Interest Rates, % *Source: NBG*



Total loans (stocks) granted by commercial banks did not change much in December compared to the previous month, and amounted to 15.9 billion GEL, which was 27.7% higher than in the previous year. *The largest 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 17.7 percentage points to the increase in the December stock of total loans. *The real increase in total loans*[1] *was about 10%, from which 6.0 percentage points came from the increase in lari borrowing.*

Figure 11: Loans, Y-o-Y, % Change *Source: NBG*



The real increase in total deposits in December was about 8.1% year on year

Total deposits of enterprises and households in commercial banks amounted to 15.2 billion GEL, which was 27% higher than in December last year. Here, the valuation effect contributed 23.5 percentage points and the real increase in deposits is estimated to have been 8.1% year on year.

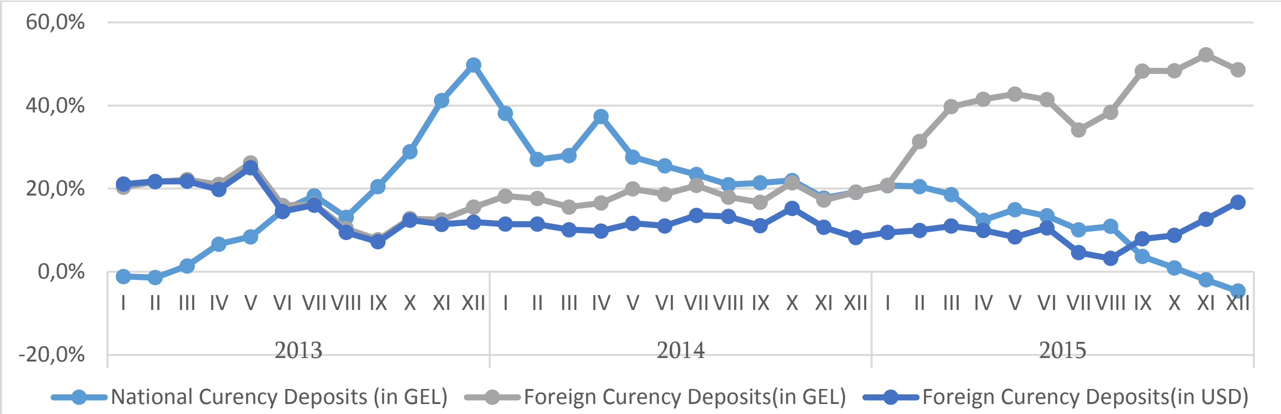
Of the 8.1% real increase, 10 percentage points were due to the increase in dollar deposits.[2] Despite the increase of market interest rates on deposits in the national currency, lari deposits *decreased by 4.6%* year on year in December.

This serves as evidence that depositors still remain very nervous about saving in lari. This could cause a further increase in the dollarization rate of deposits and put additional pressure on the exchange rate.

[1] This is the sum of the growth rate in lari loans and the growth rate of foreign currency (dollar) loans in USD terms.

[2] Once again, this number is calculated using the growth rate of dollar deposits in USD terms.

Figure 12: Deposits, Y-o-Y, % Change *Source: NBG*

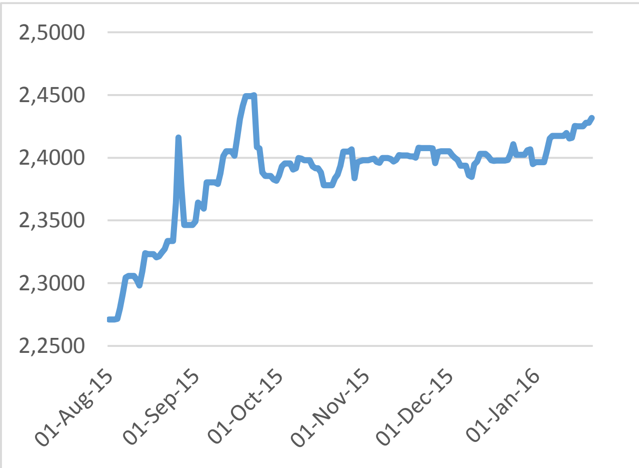


Falling commodity prices worldwide put pressure on the Georgian currency

In the last four months of 2015, the USD/GEL monthly average exchange rate was quite stable, changing in the interval of 2.39-2.4. The EUR/GEL exchange rate decreased by 3.8% month on month and constituted 2.59 lari per euro in November. On average, the Georgian lari depreciated against the dollar by 28.5% in 2015.

Overall, the NBG correctly handled the situation on the currency markets, managing to keep foreign exchange reserves at acceptable levels. In retrospect, those countries that tried to "save" their exchange rate experienced both sharp depreciation and foreign reserve losses (one recent example of this is the Azerbaijani manat, which fell 50% against the dollar on 21 December 2015).

Figure 13: USD/GEL Official Daily Exchange Rate



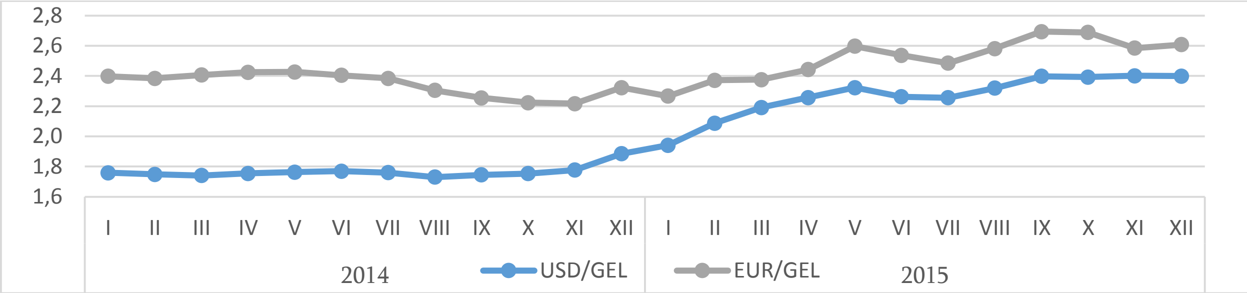
Source: NBG

Since the beginning of January 2016, we have already seen some further depreciation of the GEL against the USD (by 1.46%). This bout of depreciation was driven mainly by the declining price of commodities exported by Georgia, in particular metals prices.

The price of copper, for example, fell sharply in January, in line with other commodities and the price of oil, putting additional depreciation pressure on the lari.

The NBG has been continuously intervening on the foreign exchange market since September 2015, selling about 20 million USD every month to smooth the path of depreciation. Future trends in the USD/GEL exchange rate will continue to depend on external factors, such as oil prices on world markets, the economic situation in Russia and the region, and the remittances flow from Russia and Greece.

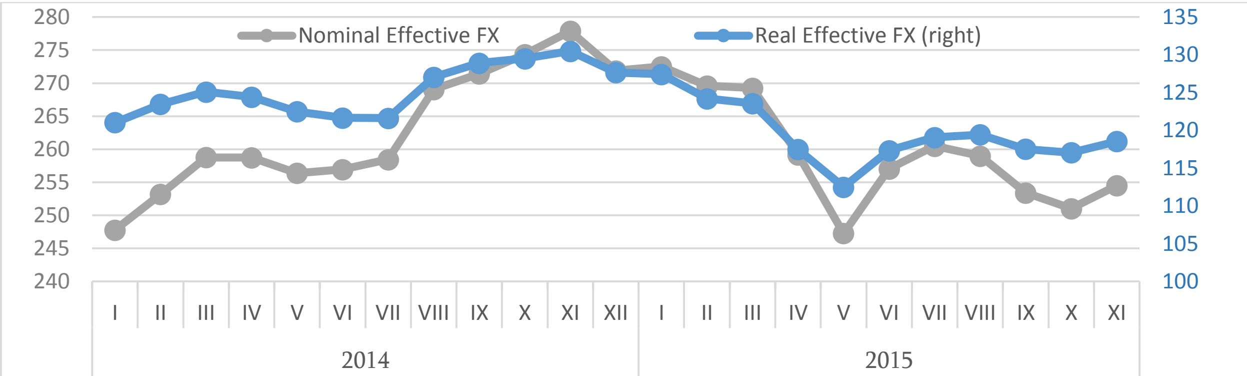
Figure 14: Nominal Exchange Rates Source: NBG



In November, the Georgian lari continued the dynamic of previous months and depreciated year on year in both nominal and real terms by 8.4% and 9.2% respectively. This means that Georgia's main trading partners had higher annual inflation rates, which made Georgian export goods relatively cheaper.

At the same time, we observe that month-to-month effective exchange rates appreciated in November. Compared to October, the appreciation was 1.3% for the real effective exchange rate and 1.4% for the nominal effective exchange rate.

Figure 15: Effective Exchange Rates



External trade sector trends in November mirror the GDP growth recovery

Georgian exports amounted to 187 million USD in November 2015, which represents a 7.7% decline relative to November last year. In comparison, exports declined by 24.4% on average in the previous months of 2015.

November export statistics largely mirror the GDP growth recovery trend - the figures look better than the average, in part because November 2014 was a "bad month" for exports (export volume stood at 202.5 million USD, a 35% reduction compared to November 2013).

Most of the decline, as expected, came from CIS countries, which exhibited a 43% decline of exports year on year (which contributed -22.7 percentage points). Exports to EU countries increased by 52%, and those to other countries by 16% year on year, which contributed 10.5 and 4.4 percentage points respectively.

Imports to Georgia amounted to 579.2 million USD in November 2015, which was 20% lower than in November of the previous year. Imports from CIS countries increased by 2.8% year on year (contributing 0.7 percentage points), while imports from the EU and other countries decreased by

16.1% and 34% respectively. As a result, in November the trade deficit declined by 24.8% year on year, and totaled 392 million USD.

Figure 16: Trade Balance, million USD *Source: GeoStat*

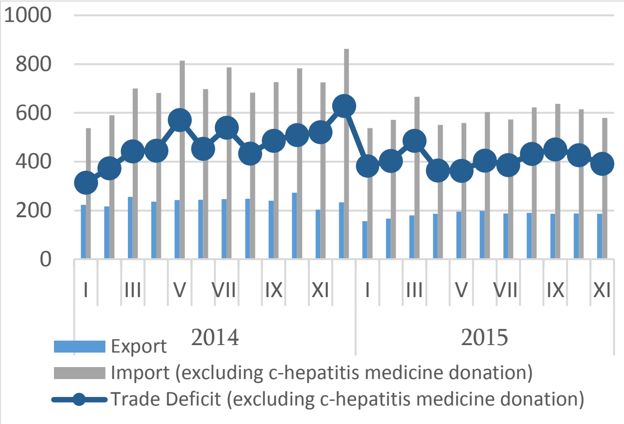
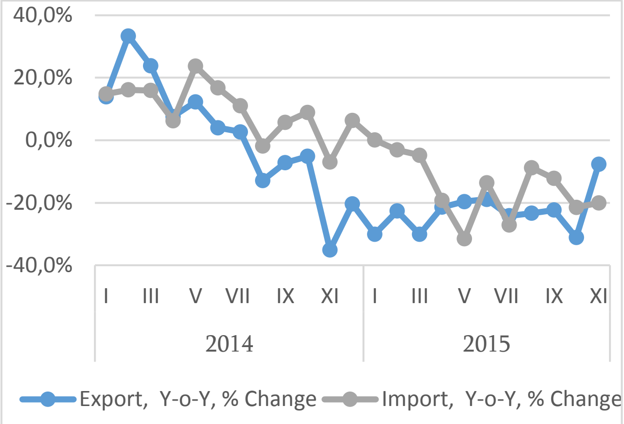


Figure 17: Trade, Y-o-Y, % Change *Source: GeoStat*

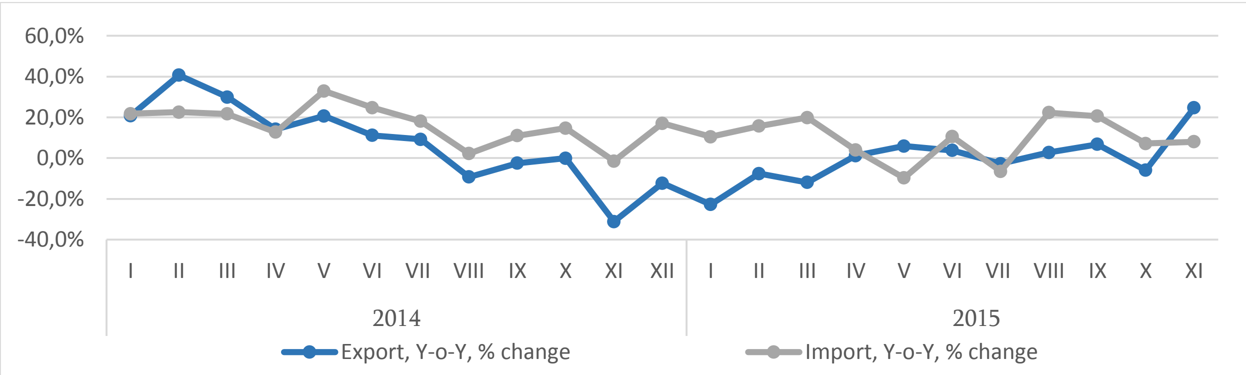


It is also important to consider the valuation effect in trade sector dynamics. GeoStat follows the established practice of converting all trade statistics into US dollars. As a result, sharp fluctuations in the USD/GEL exchange rate distort the information about the real flow of goods and services.

Adjusted trade statistics paint a more optimistic picture than that suggested by the official data

According to our adjusted calculations, Georgian exports increased by 24.7%, while imports increased by 8% in November 2015 year on year. The adjusted trade deficit increased by 1.5 % year on year in this period.

Figure 18: Trade, Y-o-Y, % Change (2012 as a base year)

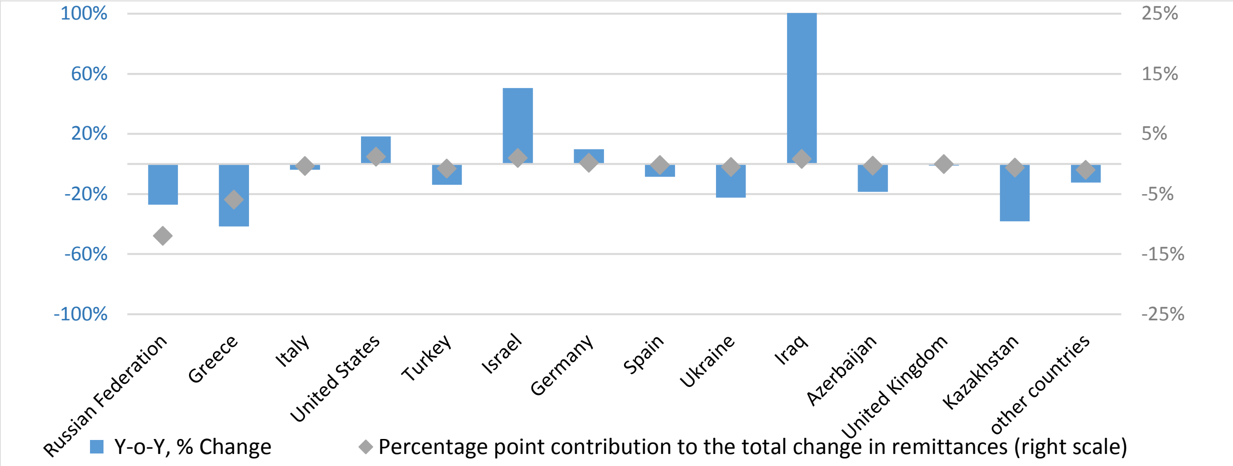


Remittances show some signs of recovery from a slump

According to GeoStat statistics, remittances inflows to Georgia constituted 85.2 million USD in November, which is a 18.3% decrease compared to the same month of 2014. Russia and Greece statistically showed signs of recovery. Their contribution to the total year-on-year decline were -11.9 and -5.9 percentage points respectively (about two times less than in the previous month).

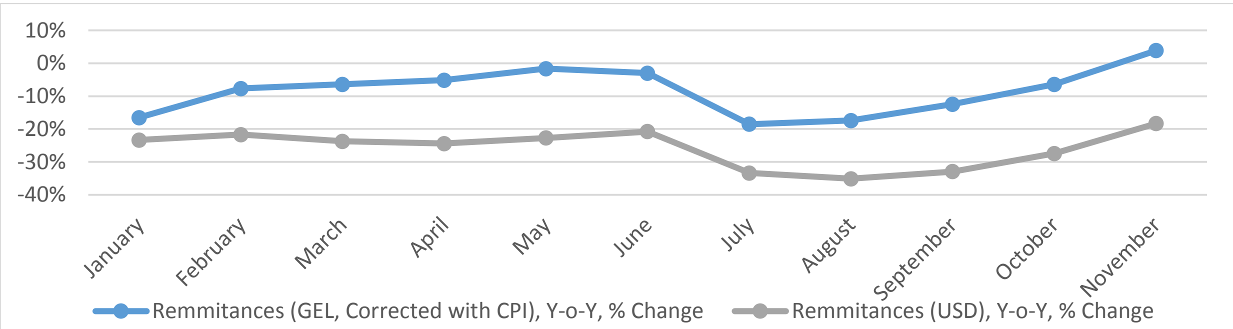
Again, we must remember that November 2014 was the starting point of a sharp currency devaluation in Russia, which influenced the dollar value of money transfers from this country. On the other hand, the remittances increase from the USA, Israel, Germany and other countries was quite high, contributing 7.5 percentage points to the total year on year growth rate of remittances.

Figure 19: Remittances by Country, November 2015 Compared to November 2014, % Change, *Source: NBG*



Adjusted statistics for remittances[3] show that Georgian beneficiaries of money transfers from abroad could buy 3.9% more goods and services in November 2015 than in the same month of the previous year.

Figure 20: Remittances, Y-o-Y Change, % *Source: NBG, GeoStat, ISET-PI*



Government budget update

In November, the common budget was in deficit by -70.5 million USD, which constitutes a 36.7% improvement year on year.

Government's total revenues increased by 10.2% year on year (5% month to month) and amounted to 702.6 million USD (647.5 million USD were revenues from taxes) in the reporting month. This increase was driven by 18.5%, 4.8% and 8.9% increases in income, value added, and excise tax revenues respectively. Their contribution to the total change in tax revenues were 5.1, 2.3 and 2.0 percentage points respectively.

The government's total expenditures amounted to 660.2 million GEL and showed hardly any change year on year (and only a 6.0% month-on-month change) in November.

[3] Since most of the remittances received from abroad support consumption expenditure of Georgian households, we can calculate how the change in inflows affected the purchasing power of remittances in lari terms. To see this, we convert the remittance volumes into lari and then deflate them by the CPI. Figure 19 shows the results.

While the amount of expenditures did not change, the structure of expenditures did – social benefits expenditures increased by 8.5%, while other payments components decreased by 21.2% year on year.

Figure 21: Common Budget, million GEL *Source: Ministry of Finance of Georgia*