March Brings Positive Dynamics in Growth and Consumer Confidence

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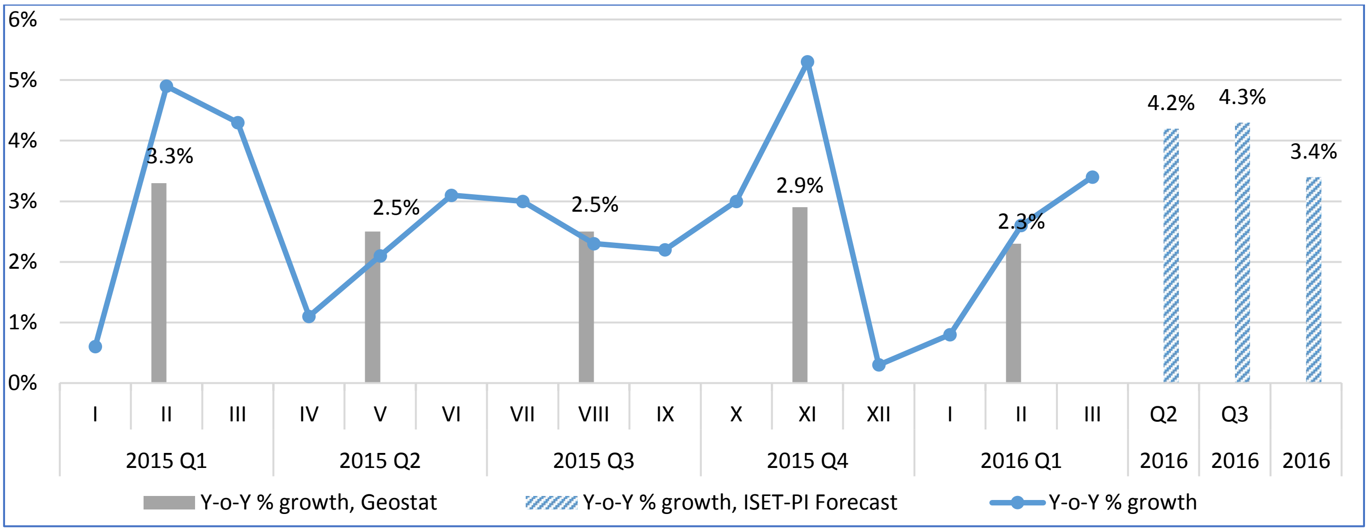
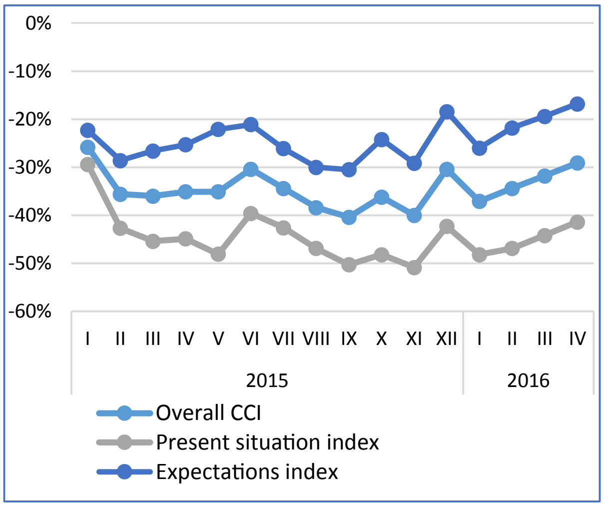
Figure 1: GDP Growth, ISET-PI Forecast, % *Source: GeoStat, ISET-PI*



According to Geostat's rapid estimates, real GDP grew by 3.4% in March, while the growth rate for Q1 stood at 2.3% year over year. The estimated first quarter growth was 0.5 percentage points less than ISET-PI's GDP forecast for the quarter. We have updated our forecast for Q2 based on the new information and lowered it from 5% to 4.2%; at the same time, the Q3 forecast was revised upward to 4.3%.

Different international and domestic financial institutions have slight variations in their forecasts for Georgia's year-over-year real GDP growth rate in 2016. The ADB and IMF both reduced their forecasts by 0.5%, now predicting 2.5% annual growth. In contrast, EBRD revised its forecast upward to 3.4% (coinciding with the value predicted by the ISET-PI forecast model), while the World Bank annual forecast stood at 3%. The National Bank of Georgia predicted 3% growth earlier in the year, and ISET-PI (in our "middle-of-the-road" scenario forecast) predicted a **3.4% real GDP increase in 2016.**

Figure 2: Consumer Confidence Index *Source: ISET-PI*



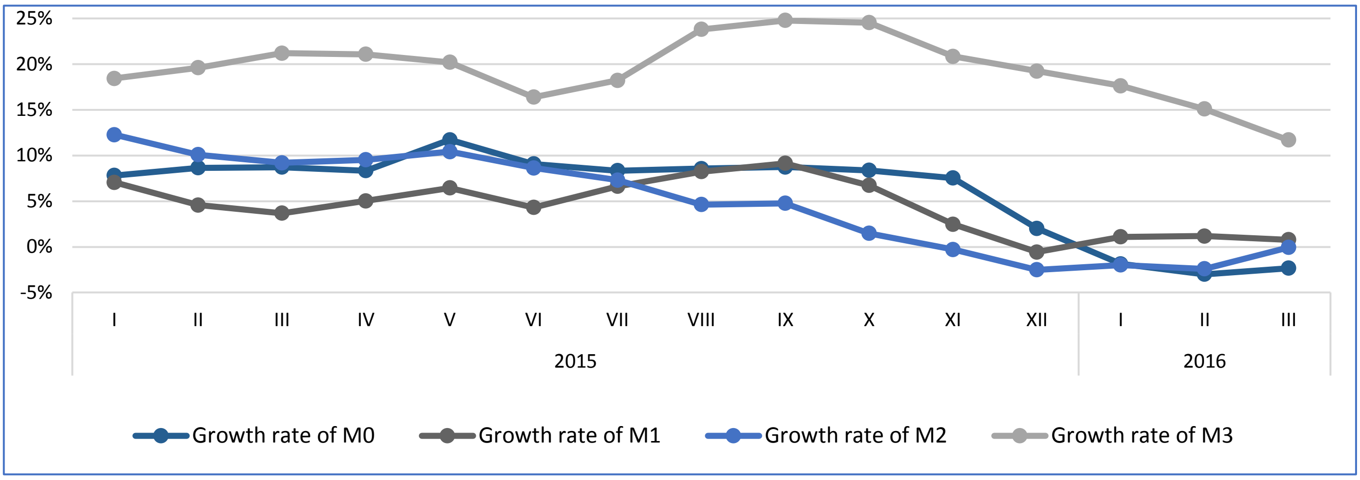
ISET-PI's Consumer Confidence Index gives reason for optimism, showing a **clear positive trend in the beginning of the reported year**. The expectations index reached its maximum point since November 2014.

Money, inflation and exchange rates

The monetary policy tightening, which started in May 2015 through a gradual increase of the monetary policy rate from 4% to 8%, has been largely successful. Since November 2015, the growth rate of M2 money aggregate was negative, which resulted in a **stabilized price level and decreased inflation expectations.**

The **inflation rate was below its target level in the first four months of 2016, reaching 4.6% on average year over year.** This allowed the NBG to decrease the monetary policy rate from 8% to 7.5% in April 2016. With an eye on inflation, the NBG announced that expansionary monetary policy would be continued until the monetary policy rate reaches a "neutral level" of 5%-6%.

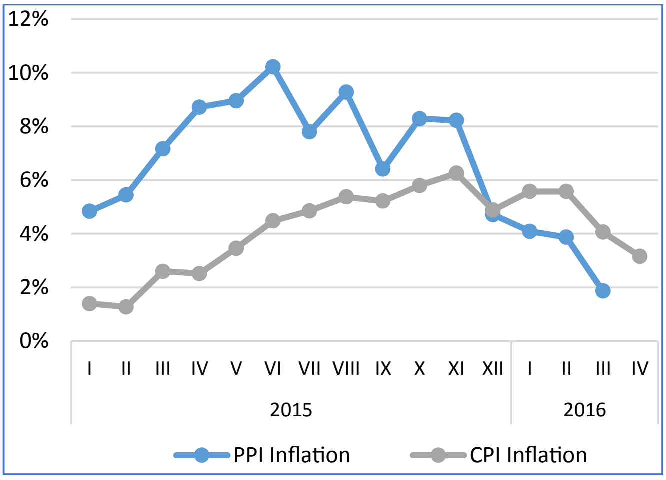
Figure 3: Growth Rates of Money Aggregates, Y-o-Y, % Change *Source: NBG*



According to Geostat, CPI-based year-over-year inflation constituted 4.1% (and -0.3% month over month), while PPI-based year-over-year inflation was 1.9% (-0.9% month over month) in March 2016. Both CPI and PPI prices showed negative monthly dynamics in the first four months of 2016.

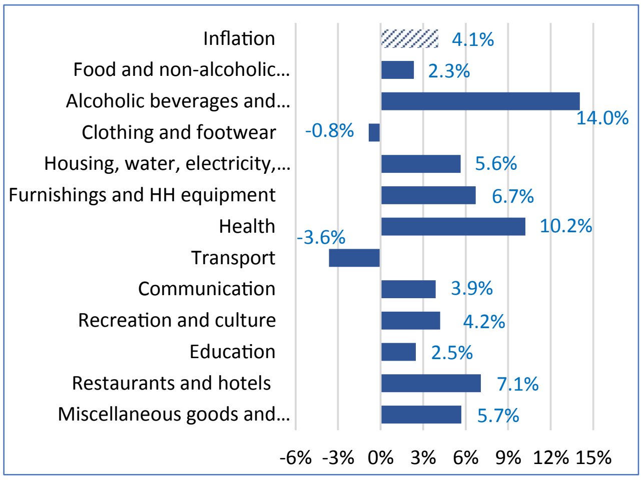
The product categories that contributed the most to consumer inflation were health (10.2%) and alcoholic beverages & tobacco (14%). These two categories together contributed 1.8 percentage points. Transport and clothing & footwear were categoiries that deflated, by -3.6% and -0.8% respectively. CPI-based inflation was even lower in April 2016 (3.2%) and this downward trend may continue in the next months.

Figure 4: Inflation Rate, Y-o-Y, % Change



Source: GeoStat

Figure 5: Inflation Rates by Category, Y-o-Y, % Change

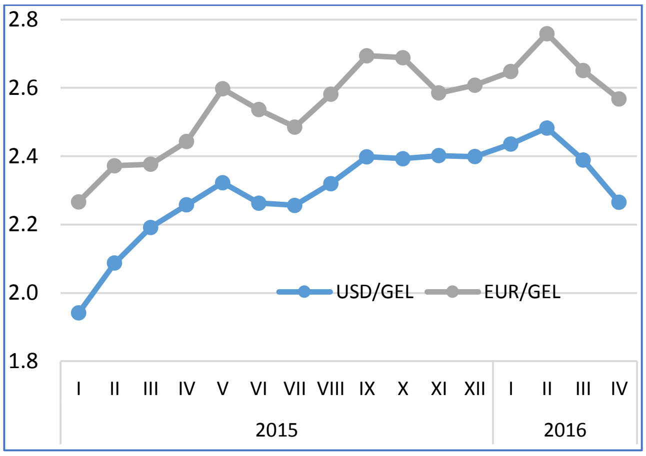


Source: GeoStat

The lari continued to appreciate against foreign currencies in March and April 2016. In nominal terms, the lari gained 3.8% against the US dollar and 3.9% against the euro month over month in March. **Both nominal and real effective exchange rates showed a month-over-month appreciation in March**, at 2.9% and 2.2% respectively. The appreciation would have been even higher without the NBG's interventions.

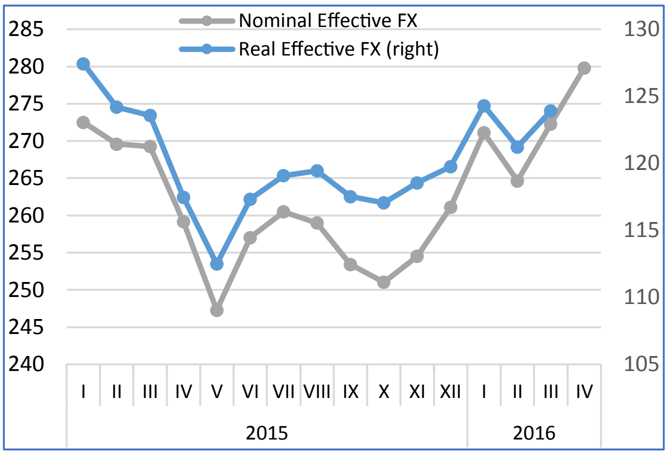
Starting from March 2016, the NBG bought 95 million US dollars on foreign exchange auctions to smooth out the lari appreciation process and build up its foreign currency reserves.

Figure 6: Nominal Exchange Rates



Source: NBG

Figure 7: Effective Exchange Rates

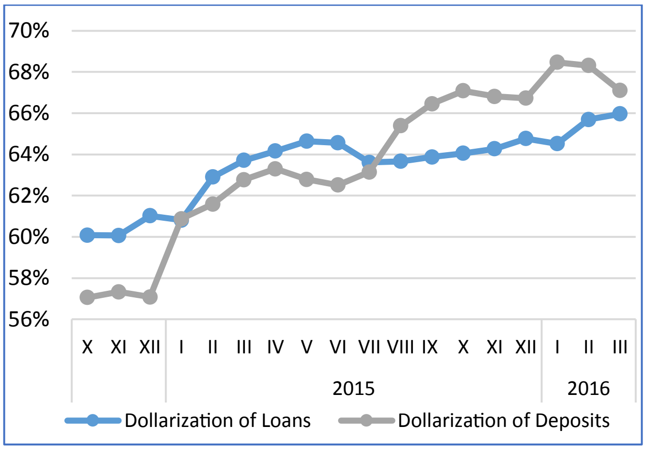


Source: NBG

The NBG reduced the minimum reserve requirement on lari funds from 10% to 7% in April 2016. At the same time, the minimum reserve requirement on attracted foreign currency funds increased from 15% to 20%. Through these changes, the **NBG is attempting to reduce the dollarization rate in the economy,** which stood at 67.1% for deposits and 66% for loans in March 2016.

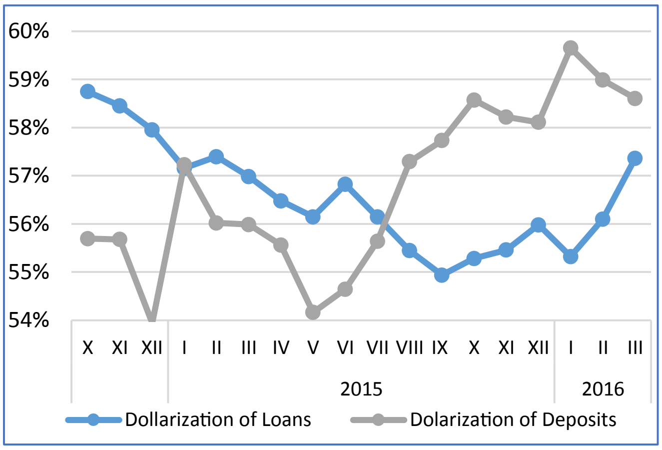
Official statistics, however, overestimate dollarization due to the effect of the lari depreciation in 2015. Adjusted statistics, which control for lari fluctuations against the US dollar, show less dramatic results with 58.6% of deposits and 57.4% of loans dollarized.

Figure 8: Dollarization Rates



Source: NBG

Figure 9: Adjusted Dollarization Rates, 2012 as a Base Year



Source: NBG, ISET-PI

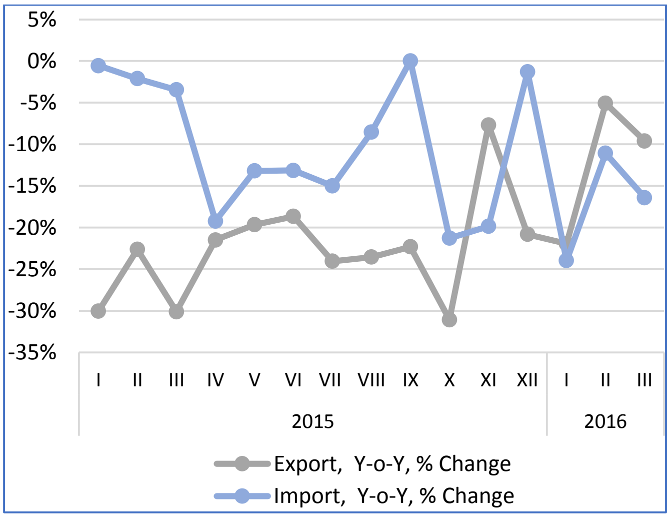
External sector

Georgian exports amounted to 161.9 million USD in March 2016 – a 9.6% year-over-year decline. Most of this decline came from EU countries, which contributed -16 percentage points. Imports to Georgia amounted to 565.8 million USD in the reported month, a 16.4% year-over-year decline. As a result, in March 2016 the trade deficit shrank by 18.9% year over year, and amounted to 403 million USD.

According to our adjusted calculations, exports decreased by 1.4%, while imports decreased by 8.9% and the trade deficit shrank by 11.5% in March 2016 year over year.

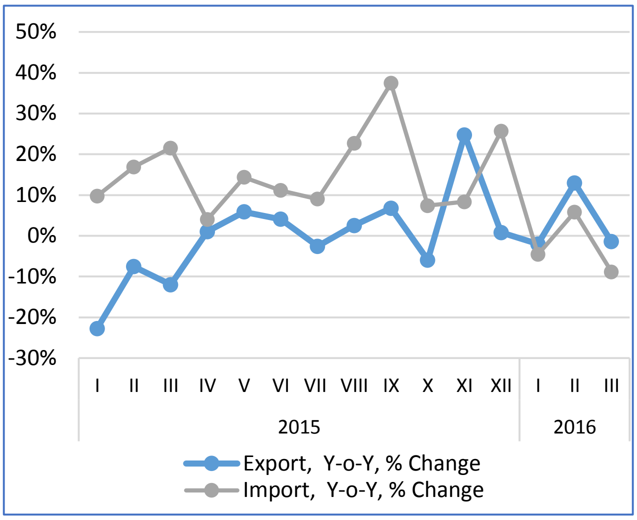
In Q1, exports decreased by 11.9% year over year, while CPI-adjusted incomes from exports (in lari terms) showed a 3.2% increase. The increase highlights the positive effect of lari depreciation for Georgian exporters, particularly in the low commodity price situation.

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



Source: GeoStat

Figure 11: Adjusted Trade, Y-o-Y, % Change



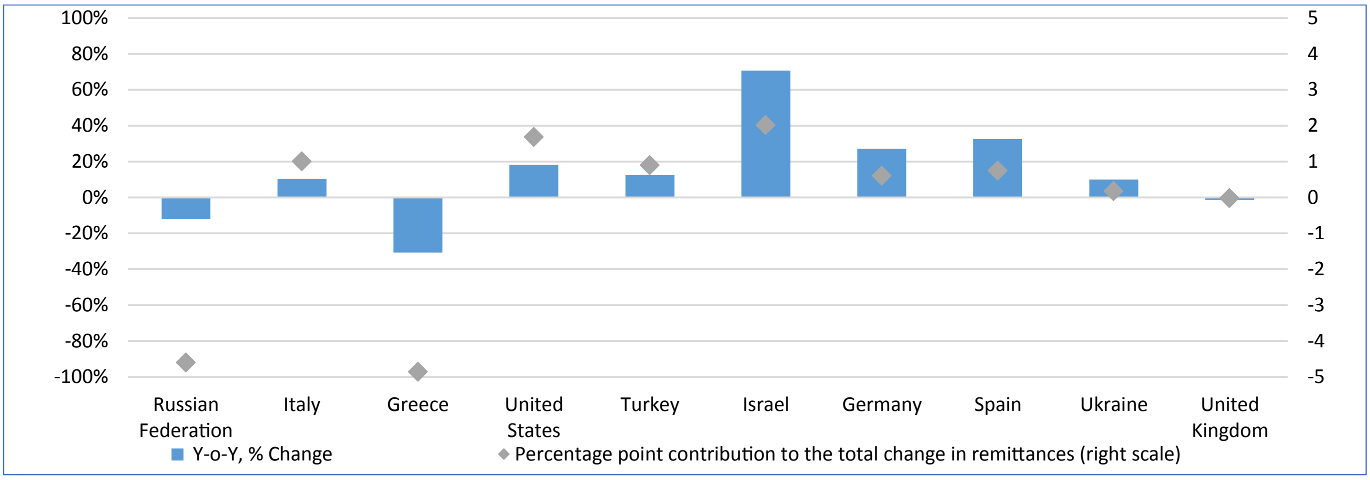
Source: GeoStat, ISET-PI

Remittance transfers

Remittances inflows to Georgia amounted to 90.7 million USD in March, which is a 1.3% decrease year over year. The decline in transfers was once again driven by a decrease in money inflows from Russia (-12.2%) and Greece (-30.7%). However, this was partially balanced by the increased money inflows from Israel (+70.6%), the United States (+18.2%), Italy (10.3%), Turkey (12.5%) and Spain (+32.4).

In Q1 2016, total remittances (in USD terms) decreased by 4.9% year over year. However, if we look at **remittances incomes in CPI-adjusted lari terms, the inflows showed a 7.8% year-over-year increase.**

Figure 14: Remittances by Country, Y-o-Y, % Change *Source: NBG*



In March 2016, the common budget was in surplus by 220.9 million USD, a 11.3% year-over-year increase. Income from taxes increased by 9.7% year over year and amounted to 1,006 million USD in the reporting month, while expenditures increased by 7.8% to 730.2 million USD.

In Q1 2016, the common budget surplus decreased by 60% year over year, primarily a result of a 12.7% increase in government expenditures, while the income of the common budget increased by only 6.3%. General government debt stock totaled 13,162 billion lari, a 14% year-over-year increase. From this amount, 21% was domestic debt, while the remaining 79% was foreign debt.

Figure 15: General Budget, million GEL *Source: MoF*