

ISET Business Confidence Index is at All Time Low, and Points to Growing Pessimism among Entrepreneurs

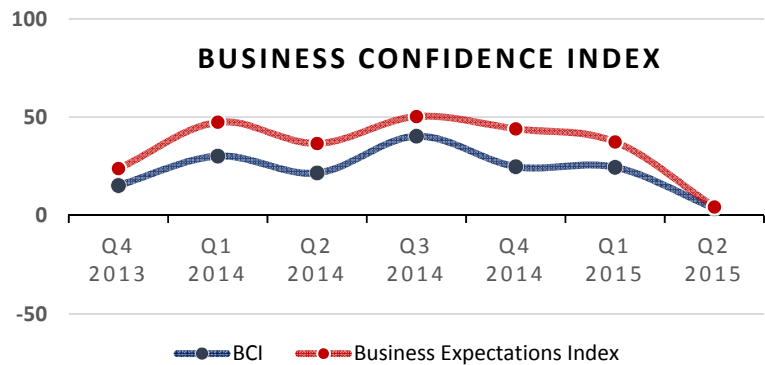
...confidence-inspiring policies will foster and not hamper economic recovery.

– J.C. Trichet

After been steadily optimistic for most of 2014 and in the first quarter of 2015, Georgia’s business confidence has deteriorated.

In the second quarter of 2015, the Business Confidence Index fell to its lowest point since Q4 2013, registering 3.6 on a scale of [-100; 100] points. This was a significant fall from the 24.5 recorded in the first quarter of the year.

Deteriorating business confidence is apparent on all levels. It is consistent across all sectors and firm sizes, and affects current performance as well as expectations of the future.

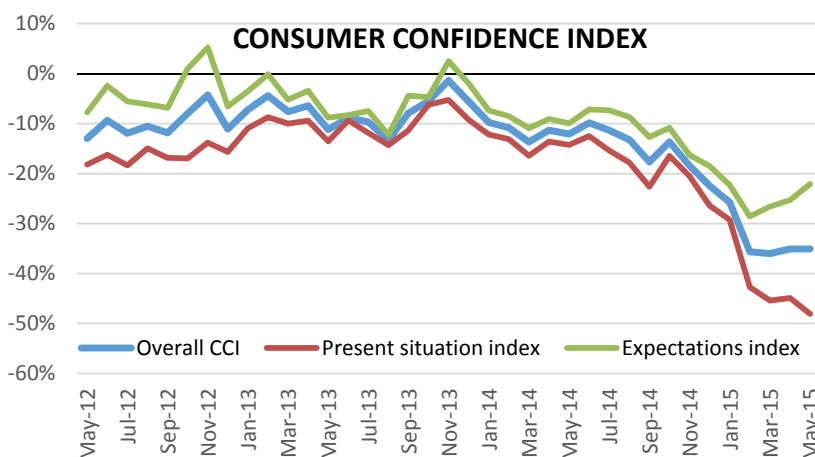


The fall reflects concerns surrounding the depreciation of the Georgian lari, which contributes to the weakening of consumer confidence and an increase in business costs.

The BCI decline is affecting all sectors of the economy. However, one of the more alarming developments is the fact that **financial sector** confidence has taken a direct hit – exhibiting the sharpest decline. The financial sector outlook plummeted from 50.9 index points in the first quarter of 2015 to 0.1 points in the second quarter. At least in part this decline can be attributed to the 30% depreciation of the local currency and to the accompanying political wrangling over financial firms’ activities on the FX market.

Why might financial institutions worry about the currency depreciation? First and foremost, the loan portfolio of banks is heavily tilted towards foreign currency loans (about 65%). Financial firms might be worried about their customers’ ability to repay such loans if depreciation continues. Practically all industries, aside from exporters, are vulnerable to exchange rate fluctuations.

On the other hand, exchange rate instability can, at least initially, be a symptom of a problem rather than the problem itself. When troubles start in the real sectors of the economy (resulting in a decrease of exports and a reduction in foreign investments), this will affect the exchange rate. These exchange rate fluctuations will, in turn, affect the real economy across sectors.



The sharp decline in **retail sector** business confidence started much earlier than the fall in other sectors. The retail sector is the first link in the production chain and is the first to react to changes in consumer confidence. The **manufacturing** and other sectors react to demand side pressure with some lag. Dwindling **consumer confidence** has heavily impacted the **services sector** – the outlook for this sector deteriorated to 0 index points, down from 27 points in Q1 2015.

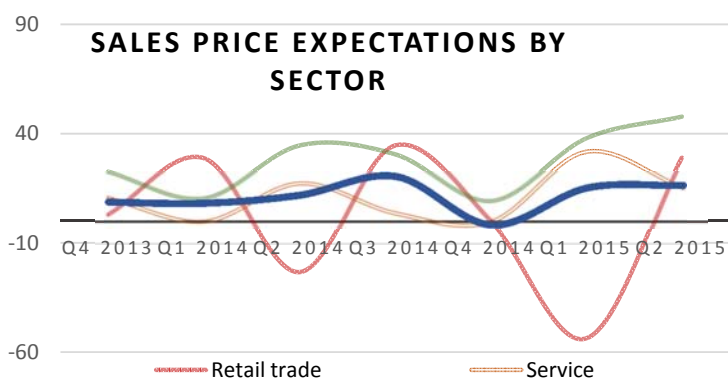
Declining consumer confidence was a problem for firms of all sizes and the depreciation of the GEL harms both large and small non-exporting domestic firms that tend to import most of their intermediate inputs (or objects for resale) from abroad (e.g. manufacturing, agriculture, construction and retail businesses).

Also, firms were less upbeat about their product sales for last three months. The sales confidence indicator describes well the current state of business activities for the firms. In the Q2 2015 reporting period, the sales confidence for the 168 firms surveyed declined and turned to negative; 15.6% more companies reported that their average sales have deteriorated rather than increased or remained unchanged.

This reduction was driven by the retail trade, financial, service and manufacturing sectors. Only the agricultural sector showed positive performance over the past three months (which was not unexpected since the cultivation season coincides with this period).

Sales price expectations increased only very slightly over the last quarter, rising from 15 (Q1 2015) to 16 (Q2 2015) index points.

The GEL depreciation and consequently increase in import prices pushed costs of doing business up. Therefore the firms are expected to increase prices, but the consumers' behavior partially offsets the inflationary pressure. Low consumers' confidence dampens the price expectations. As a result, we can see that the changes in price expectations are rather mild. Given the sluggish sales, apparently firms are taking the part of the increased costs on their shoulders and as a result they cut their profit margins, instead of increasing price expectations.



The most limiting factor for doing business in Georgia is *insufficient demand*. A total of 38% of large companies reported a shortage of demand as the main obstacle. SMEs found it particularly hard to operate with unstable demand on the market, with this index standing at 42% for SMEs in the second quarter of 2015.

SMEs typically have more trouble attracting financial resources than larger companies and this pattern has been preserved in this quarter. On the other hand, government intervention has proven to be a greater problem for large enterprises.

