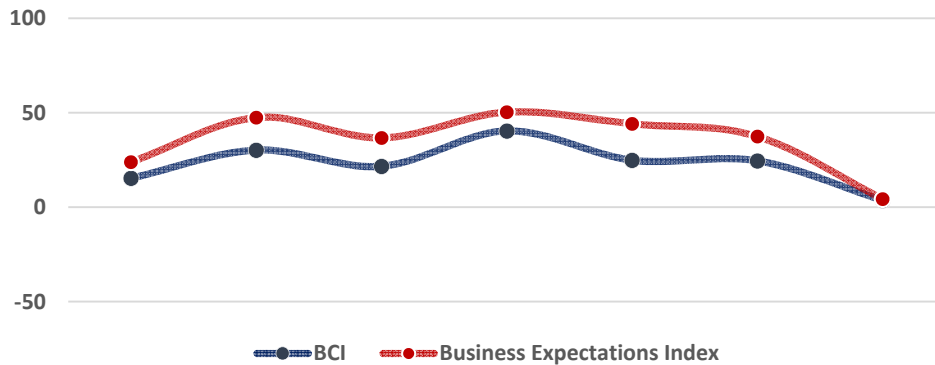


...confidence-inspiring policies will foster and not hamper economic recovery.
— [J.C. Trichet](#)

BUSINESS CONFIDENCE INDEX

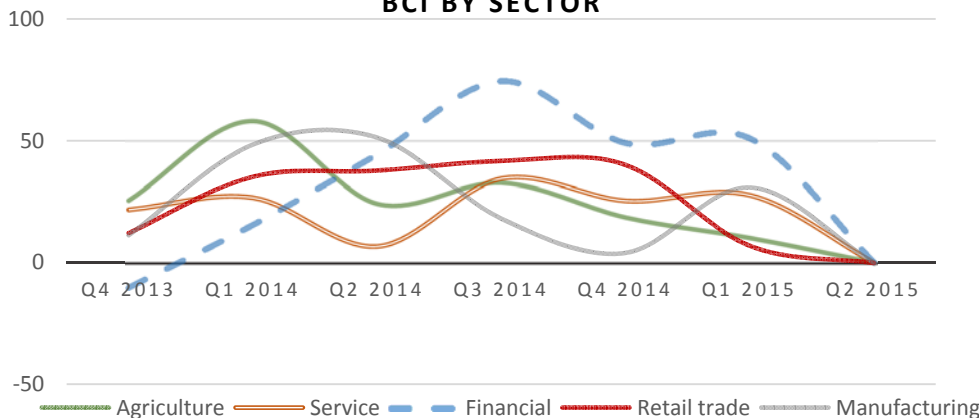


Having been steadily optimistic for most of 2014 and the first quarter of 2015, Georgia’s business confidence has decreased. The business survey is a useful indicator of the immediate economic future and thus a sharp drop in confidence, as observed in the second quarter of 2015, is worrisome.

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 points. This was a significant fall from the 24.5 recorded in the first quarter of the year. The positive number on the index indicates that confidence among businesses is about 3.6 index points more positive than negative or neutral. A confidence index of 100 would indicate that all firms in the sample reported a positive outlook. An index of zero would indicate that the weighted balance of positive and negative views reported by firms is about equal or, alternatively, that all firms reported no change in the current business situation (for more details, see the methodological notes).

The decrease in business confidence is apparent on all levels. It is consistent across all sectors and firm sizes, and affects current performance as well as expectations. 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.

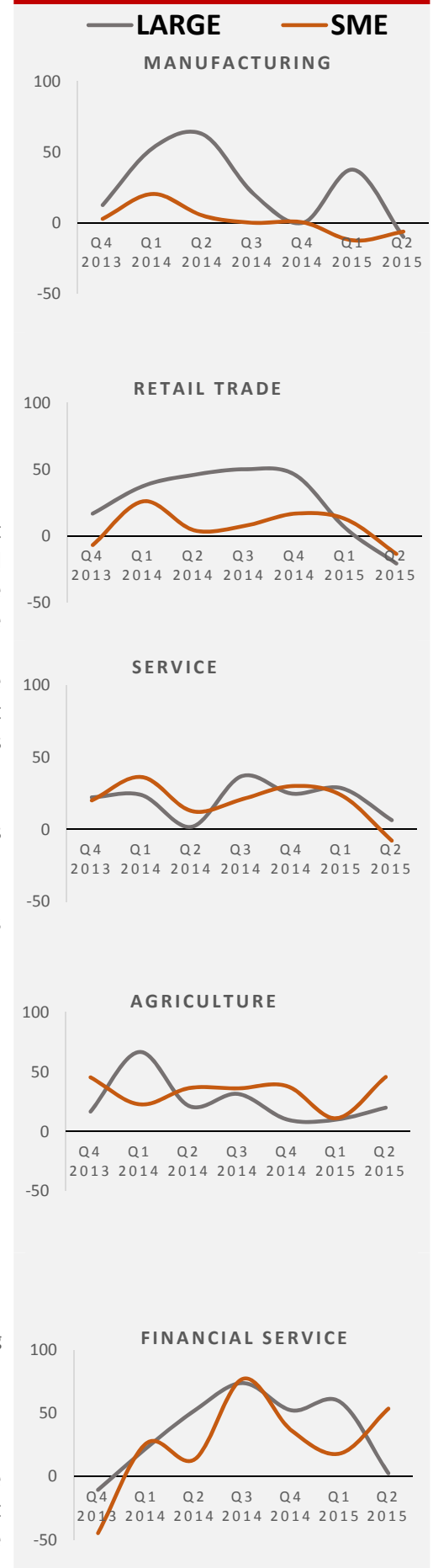
BCI BY SECTOR



The reduction in the confidence index affects all sectors of the economy.

As can be seen from the chart above, the BCI decline is affecting all sectors of the economy. However, one of the more worrisome developments is the fact that financial sector confidence has taken a direct hit – with this sector exhibiting the sharpest drop. 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

Overall business confidence by sector, for large firms and SMEs



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.

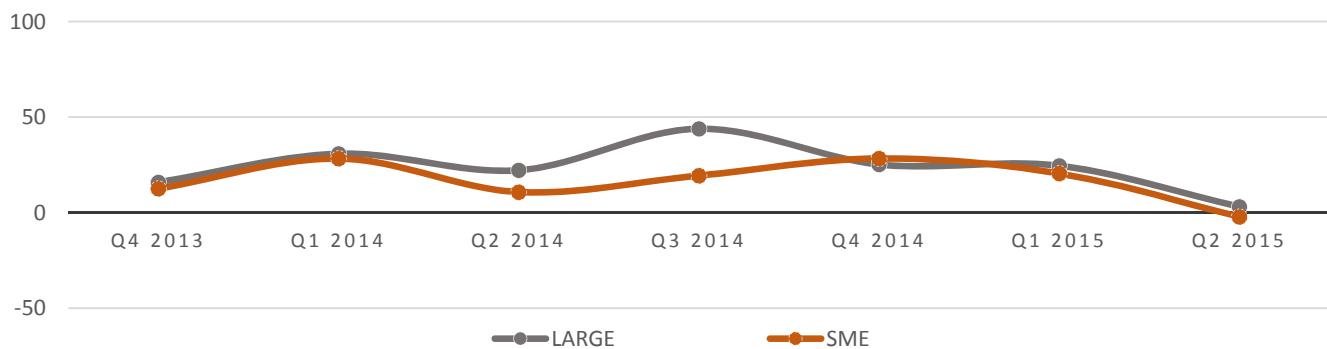
Why might financial institutions worry about the currency depreciation? First and foremost, the loan portfolio of banks is heavily tilted towards foreign currency loans (by more than 60%). Financial firms might be worried about their customers' ability to repay such loans if depreciation continues. Practically 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 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. That sector's outlook has deteriorated to 0 index points, down from 27 points in Q1 2015.

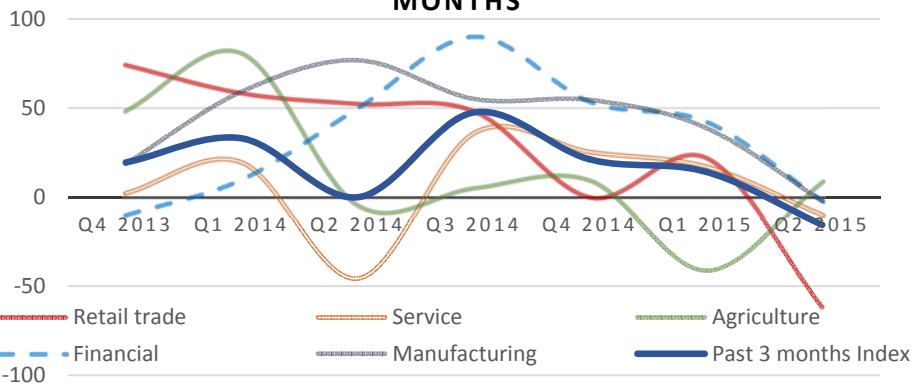
BCI: LARGE VS. SME



It can also be seen that business confidence in the second quarter of 2015 decreased for large companies as well as SMEs. Declining consumer confidence was a problem for firms of all sizes and the depreciation of the GEL harms both large and small domestic non-exporting firms that tend to import most of their intermediate inputs (or objects for resale) from abroad (e.g. manufacturing, agriculture, construction and retail businesses).

It should be noted that the BCI results presented here may be overestimated as the survey only covers businesses currently operating on the market; not those that have already exited the industry. Firms still in operation are more likely to have a positive rather than a negative outlook. Data showing a simultaneous decline in the number of firms entering the market would support this view.

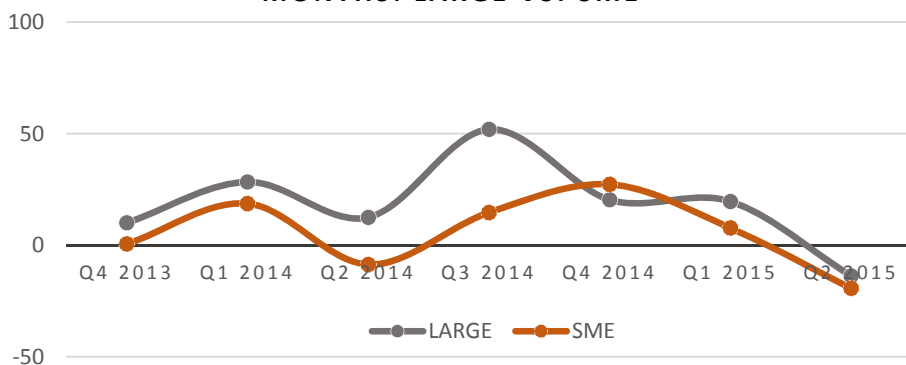
SALES/PRODUCTION/TURNOVER FOR PAST 3 MONTHS



In the Q2 2015 reporting period, the sales (production or turnover) of the 168 firms surveyed decreased by 29 index points, from 14.1 to -15.6. This indicator describes the current activities of the businesses.

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). All other sectors have reported that their average production/turnover/sales have declined. The drop for retailers, particularly large retailers, has been particularly dramatic.

SALES/PRODUCTION/TURNOVER FOR PAST 3 MONTHS: LARGE VS. SME

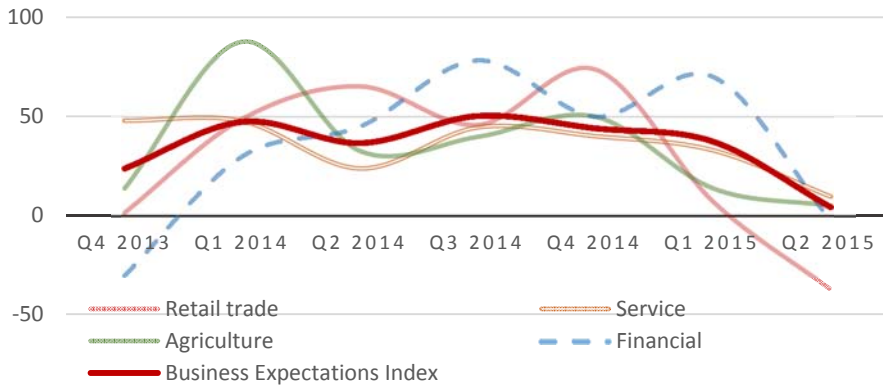


Analyzing the data in terms of business size, it is evident that 2015 got off to a rough start for both large firms and SMEs. Over the first three months of 2015, the private sector in Georgia has fared worse in terms of sales (turnover) than it did during the same period in 2014.

Sales/production/turnover for past 3 months by sector, for large and SME firms



EXPECTATIONS INDEX BY SECTOR



The expectations index declined by 33 index points for all companies. This reduction was driven by all sectors, but a particularly high decline was observed in the financial and retail sectors.

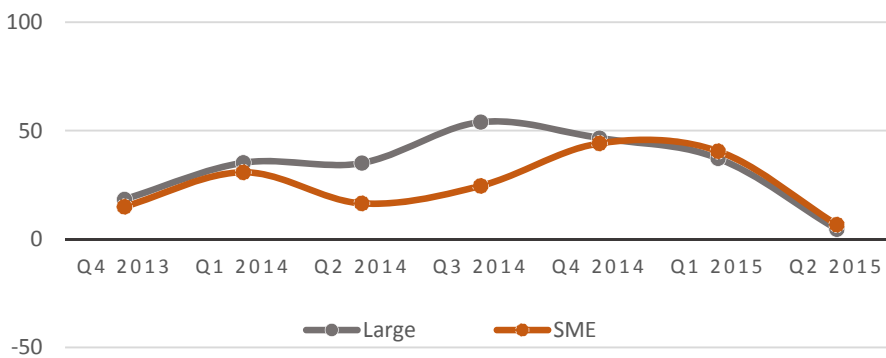
As mentioned earlier, retailers were among the first to feel the effect of the drastic deterioration of consumer confidence. In addition, political wrangling over the financial sector's role in the currency depreciation and worries about asset quality may dampen the future expectations of banks and insurance firms.

Looking at the agricultural sector, SMEs' expectations about the future have actually increased. This optimistic outlook could be attributed to different government agro programs, e.g. planting material (seedlings) and production support that targets the smallholder rural population and aims to improve their socio-economic status.

Small- and medium-size farms are positive about the near future, while large businesses do not expect any improvements. Moreover, 25% more large companies think that their production/sales will deteriorate.

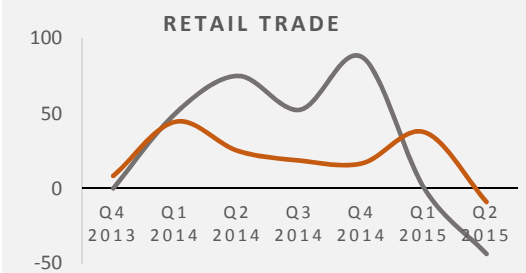
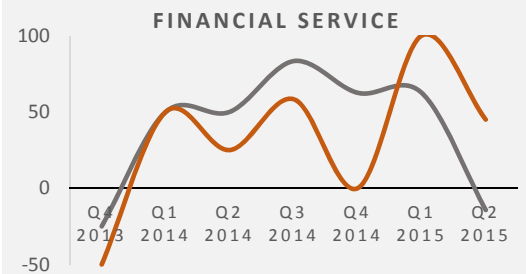
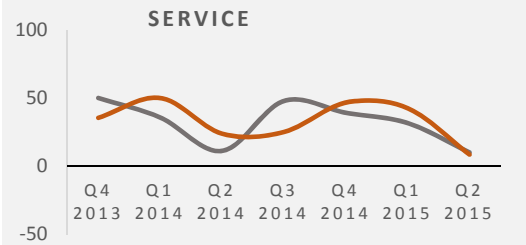
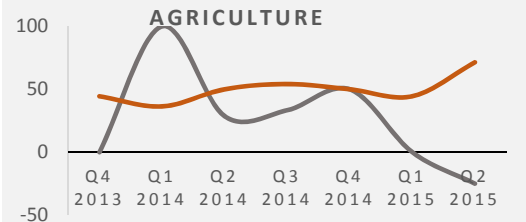
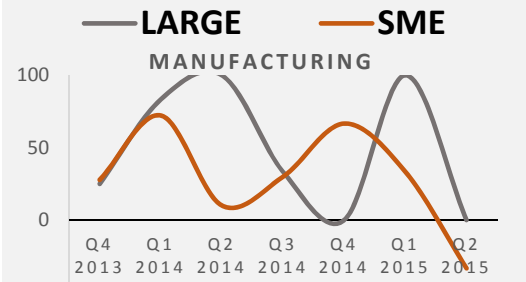
There could be several factors behind the lower expectations of large companies in the agricultural sector. The first factor that comes to mind is once again the recent depreciation of the GEL, which increased the cost of imported fertilizers and other inputs. Another issue could be the expected changes resulting from the draft law on agricultural land ownership, which may severely limit foreign ownership of agricultural land.

EXPECTATIONS INDEX: LARGE VS. SME

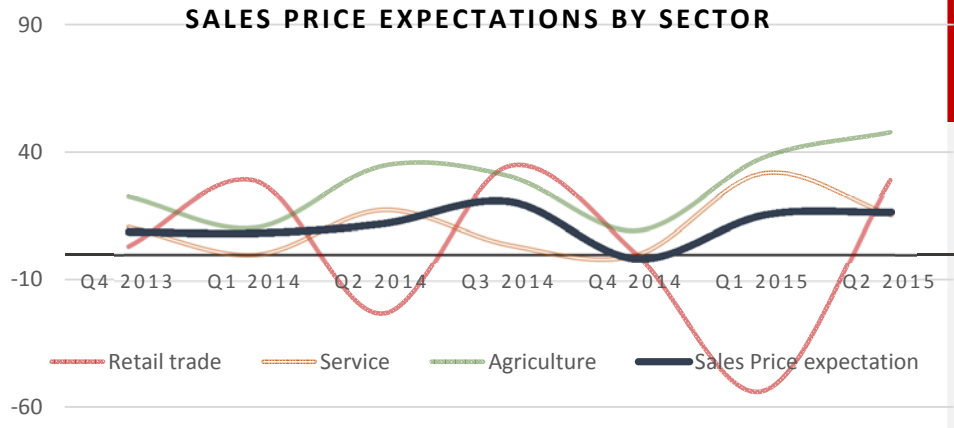


The second quarter expectations for large companies and SMEs are about the same, both being close to 0 points. The expectations of SMEs had been consistently improving since Q2 2014, but the growth dynamics have since reversed to reach the minimum level in Q2 2015.

Expectations index by sector, for large and SME firms



Expectations index by sector, for large and SME firms



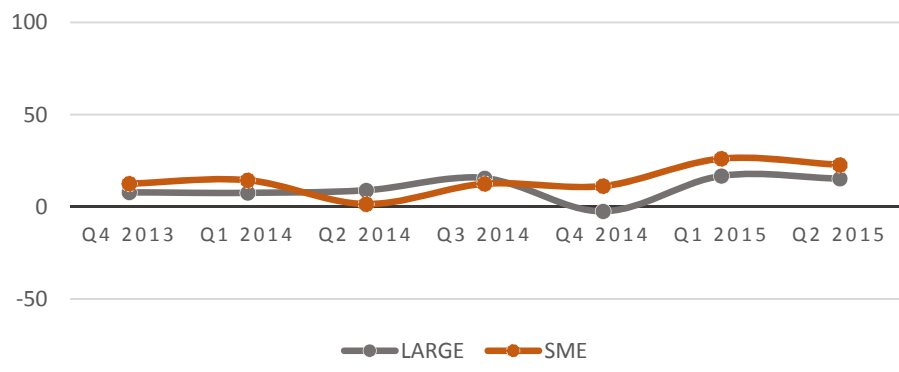
Sales price expectations increased only very slightly over the last quarter, rising from 15 (Q1 2015) to 16 (Q2 2015) index points.

There are several factors that can affect price expectations. On the one hand, decreased consumer demand would have pulled price expectations down. On the other hand, if the costs of doing business are increasing, this would push prices up (the supply effect). If both are at play simultaneously, the overall effect on prices is ambiguous.

In our case, the low consumer confidence would have dampened price expectations, while the GEL depreciation and import price increases would have pushed costs up. As a result, we can see that the changes in price expectations are rather mild.

Inflationary pressure in the Georgian economy remains low, with consumer price inflation in April standing at 2.5%, which is well below the central bank's target of 5%. Producer prices, however, have risen at a faster pace.

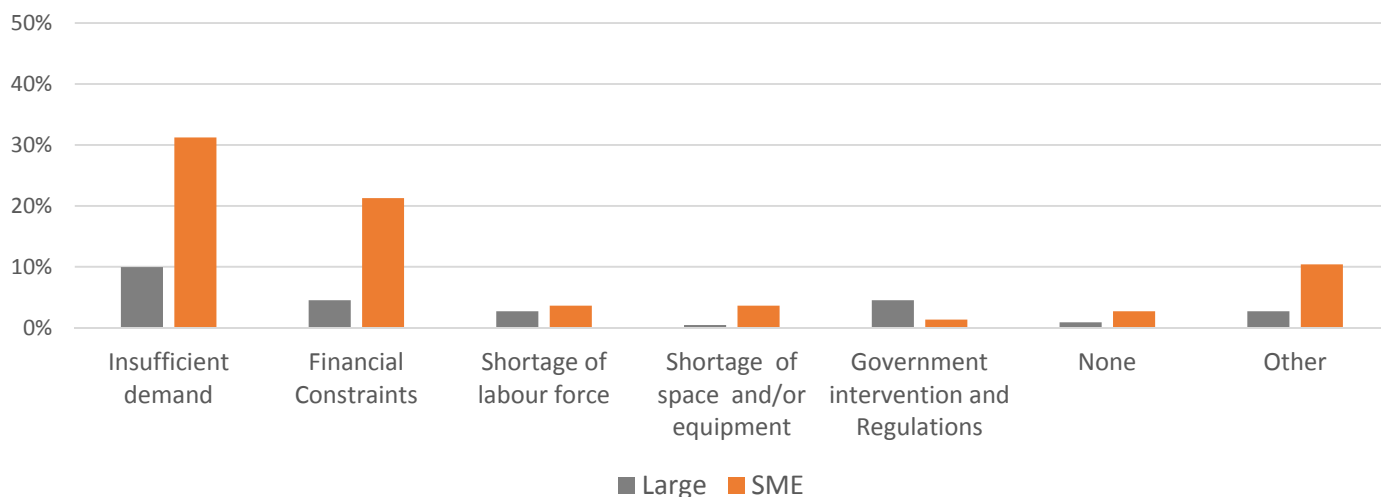
PRICE EXPECTATIONS: LARGE VS. SME



The overall price outlook for both large firms and SMEs remains stable and positive. Given the business community's expectations, an increase in inflationary pressure should be expected in the near future.



What are main factors limiting your business activities?



As in the previous quarter, we find that the most limiting factor for doing business was *insufficient demand*. A total of 10% 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 31% 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.

SAMPLE SIZE BY SECTOR (see methodology)

Q2 2015	Sector	Firm Size		Total
		Large	SME	
	Construction	2	8	10
	Financial Service	7	10	17
	Manufacturing Industry	5	6	11
	Retail Trade	8	22	20
	Service	20	59	79
	Agriculture	4	7	11
	Other	4	6	10
	Total	50	118	168

Interviews were conducted during 2-25 April 2015.

*Methodology

The ISET Policy Institute, working in partnership with the International Chamber of Commerce in Georgia (ICC), has implemented the Business Confidence Survey since December 2013 and publishes the Business Confidence Index (BCI) on a quarterly basis.

Business confidence for Georgia is measured by seven sector-specific indices focusing on: 1) services, 2) retail trade, 3) agriculture, 4) manufacturing industry, 5) financial service 6) construction and 7) other sectors. For each sector, confidence is measured through a simple survey instrument targeted at top business executives.

Answers obtained from the surveys are aggregated in the form of “balances”. Balances are constructed as the difference between the percentage of respondents giving positive and negative replies.

Using this method, a Confidence Index of +100 would indicate that all survey respondents were much more confident about future prospects, while -100 would indicate that all survey respondents were much less confident about future prospects.

VARIABLE	SCORE
Positive	+1
Neutral	0
Negative	-1

The methodology for compiling the indices is based on the Joint Harmonised EU Programme of Business and Consumer Surveys.

DEFINITIONS

- The **Business Confidence Index** is calculated as a weighted average of the balances induced from all the answers about production/sales/turnover, competition, order books, volume of stock, demand evaluation, operation costs, profit, employment, and sales price setting.
- The **expectations index** is calculated based on two questions: production/sales/turnover for the next three months and employment plans for the next three months.
- A **large¹ firm** is one with a yearly average of over 100 people employed or a yearly average turnover exceeding 1.5 million GEL.
- **Small firms** are those with an average of fewer than 20 people employed over a year and an annual average turnover of less than 0.5 million GEL.
- **Medium firms** are those that are neither large nor small.

¹ The size of the company is defined accordingly to the Main Indicators' Calculation Methodology of Business Statistics (http://geostat.ge/cms/site_images/files/georgian/methodology/business/BS%20metodologia.pdf)