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The Exchange Rates of the Georgian Lari and the Armenian Dram in Comparison, 2014-2015

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The Exchange Rates of the Georgian Lari and the Armenian Dram in Comparison, 2014-2015

Executive Summary

Both Georgia and Armenia have been subject to negative external economic shocks, particularly through remittances and exports, in 2014 and 2015, yet the macroeconomic adjustment of the countries appears to have been different. While the GDP growth of both countries remained relatively stable at around 3% in both years, the exchange rate of the Georgian Lari (GEL) depreciated by a 29% in 2014-2015 compared to 15% for the Armenian Dram (AMD). While the depreciation of the AMD was initially quicker than that of the GEL, the GEL depreciation lasted much longer into 2015.

Comparing the external shocks faced by the economies of Armenia and Georgia, it appears that Armenia was hit earlier, with remittances and FDI clearly dropping off stronger in the end of 2014 than in Georgia. However, Georgia was subject to a much larger and prolonged fall in exports – a 6% of GDP decrease in Georgia compared to 1.7% of GDP in Armenia in 2015. Also, the reaction of imports to reduced income and lower exchange rates appears much quicker in Armenia, partially explaining why the exchange rate may have behaved more stable in 2015.

However, policy responses across the two countries were clearly different. While the National Bank of Georgia (NBG) only very mildly intervened with reserves in the foreign currency market to smooth the depreciation path of the GEL, the Central Bank of Armenia (CBA) performed heavy foreign exchange interventions in 2014, using up 34% of its foreign currency reserves. Furthermore, monetary policy in Armenia was much more contractionary in a short timeframe, with both the refinancing and Lombard rates being sharply increased in late 2014 (by 4 and 11.5 percentage points respectively), compared to only a relative mild and slower adjustment of the GEL policy rate by 4 percentage points throughout 2015.

Although both countries have experienced similar growth rates of GDP in 2014 and 2015, the contractionary monetary policy seems to have contributed to a significant weakening of domestic market and stresses on the financial sector in Armenia, whereas domestic demand and credit in Georgia remained highly resilient in 2015.

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Contents

1 Introduction

The economy of Georgia has been subject to strong external shocks in the past two years. Macroeconomic developments both within the region and on a global scale have impacted the country and required a macroeconomic adjustment. Not Georgia alone was affected, but all economies in the region were subject to similar pressures, albeit of different magnitudes, depending on the specific characteristics of the countries.

Comparing the developments and macroeconomic adjustments of Armenia and Georgia is of particular interest as the countries are direct neighbours, are not mainly resource exporters and both economies are of relatively comparable size. However, exchange rate adjustments in both countries seem to have been different in the wake of the shocks. This paper is intended to shed light on the differences between the magnitudes of external shocks the countries were subject to and on the differences in the macroeconomic adjustment of the economies. The aim of the paper is not to assess the appropriateness of policy responses in Armenia and Georgia, but to contribute to a deeper understanding of how the impact of external shocks on economies can differ and how different policy instruments such as monetary reserves, interest rates or administrative measures may lead to different outcomes.

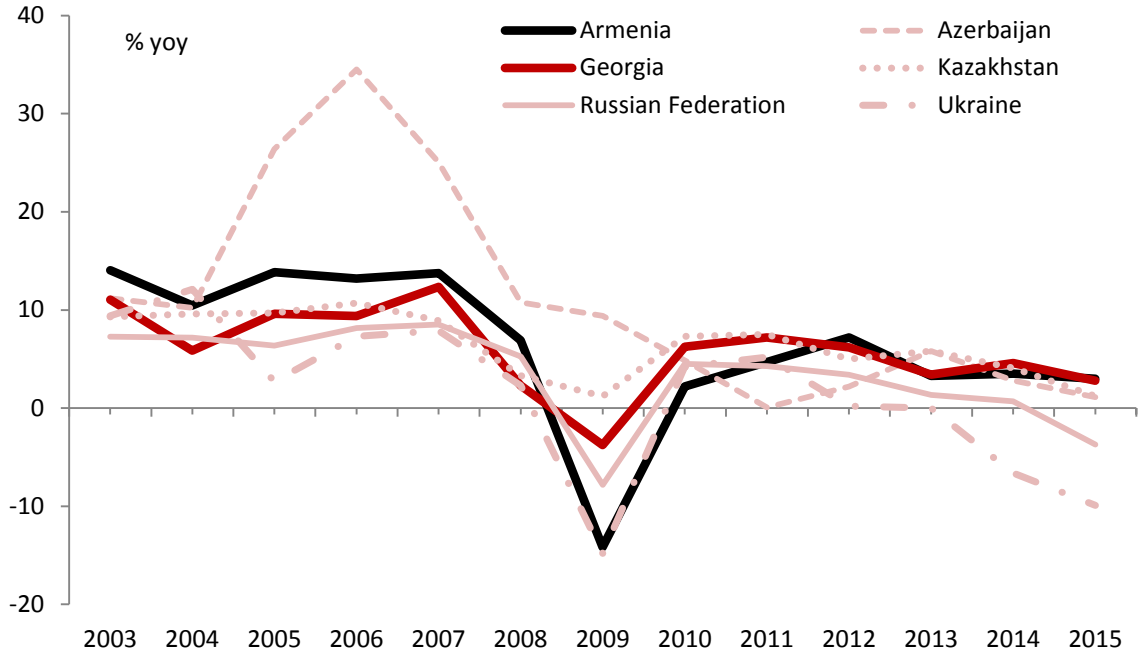
The paper proceeds as follows: In chapter 2, the broad developments of GDP and exchange rates in Georgia and Armenia are compared and the external shocks are summarised. Chapter 3 analyses the magnitude of the external shocks the countries were subject to using a balance of payments approach. In chapter 4 the actions of the two central banks are reviewed and chapter 5 looks at macroeconomic outcomes beyond the GDP response.

2 GDP and Exchange Rate Developments

The period from late 2014 to the end of 2015 saw a global appreciation of the US dollar, principally stemming from the expected normalization of the Federal Reserve's monetary policy in the USA. Additionally, CIS countries and Georgia experienced additional pressure on their currencies. There was a contraction of the Ukrainian economy due to the war with Russia. International sanctions imposed against Russia, capital flight and falling oil prices caused Russia's economic growth to slow in 2014 and contract in 2015. Falling oil prices also had a significantly negative effect on Azerbaijan and Kazakhstan. The spill-over effects from these economies led to weakened regional demand, which had a negative impact on both Georgia and Armenia. In 2015, real GDP growth was at 2.8% in Georgia and at 3% in Armenia, well below potential growth rates for these countries in normal circumstances.

Figure 1

Real GDP growth rates

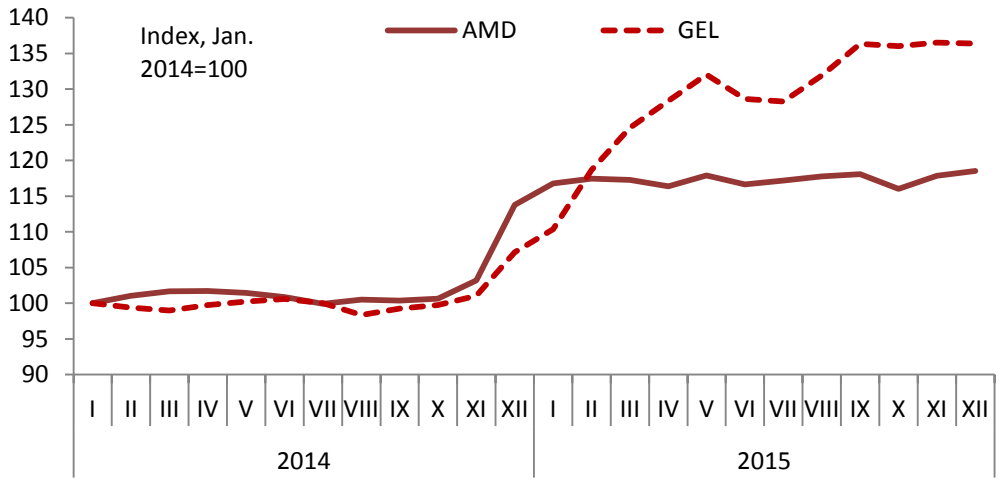


Source: World Bank

Despite the similarity of the external shocks facing them, the Georgian Lari (GEL) and the Armenian Dram (AMD) reacted at different amplitudes. Until November 2014, both currencies had been quite stable against the US dollar for an extended period of time, but in the three months that followed the Dram and Lari depreciated by 16% and 10% respectively. The Dram stabilized in February 2015, while the Lari continued to depreciate until September 2015. As a result, the Dram's year over year depreciation against the US dollar was 15%, compared to 29% for the Lari in 2015.

Figure 2

National currencies per USD since Jan 2014



Source: National Bank of Georgia, Central Bank of Armenia

There are two possible reasons for the different Lari and dram reactions to the recent depreciation: a) the different extent of the external shocks on the countries' economies; and b) the different reactions of the central banks to those shocks.

3 The External Sector

The main transmission channels through which the recent external shocks affected the local economies and exchange rates were remittances, trade, and foreign direct investment.

Table 1

External sector, changes in key aggregates, 2014 and 2015

	Georgia				Armenia			
	2014		2015		2014		2015	
	USD m	% of GDP	USD m	% of GDP	USD m	% of GDP	USD m	% of GDP
Net Remittances	10.5	0.1%	-339.8	-2.4%	-73.2	-0.6%	-247	-2.3%
FDI	514.2	3.1%	-134	-1.0%	35	0.3%	-218.5	-2.1%
Export	-136.2	-0.8%	-841.1	-6.0%	163	1.4%	-179.2	-1.7%
Import	756.7	4.6%	-1,407.40	-10.0%	102.7	0.9%	-1,110.30	-10.5%

Source: National Bank of Georgia, Central Bank of Armenia,

Remittances

Remittances are a significant component of foreign currency inflow and household consumption for Georgia and Armenia. Net remittances to both countries dropped in November 2014 due to economic problems in Russia – the main source of money transfers to these countries. The debt crisis and restrictions on banking transactions in Greece (which is the second largest source of remittances to Georgia) had an additional negative impact on money transfers to Georgia. In 2014, it resulted in a year over year decline in remittances of USD 10 m (equivalent to 0.1% of GDP) to Georgia and USD 73 m (0.6% of GDP) to Armenia. In 2015, these indicators continued to shrink by 339 USD m (2.4% of GDP) for Georgia and 247 USD m (2.3% of GDP) for Armenia. Overall, losses of foreign currency inflow through remittances channel were similar for both countries.

Foreign direct investment

FDI tends to be relatively stable to external shocks in the short run. Indeed, FDI to Georgia was resilient in 2014 and 2015. Due to long-term infrastructural projects and the IPO of a major Georgian bank on the London Stock Exchange, in 2014, net FDI in Georgia increased by USD 297 m (3.1% of GDP), while it grew by only USD 35 m (0.3% of GDP) in Armenia. In 2015, FDI slightly shrank by USD 134 m (1% of GDP) in Georgia, which is more likely to be a consequence of the large one-off FDI flows in 2014, and by a larger USD 219 m (2.1% of GDP) in Armenia, where the decrease cannot be attributed to a base effect. Overall, losses of foreign currency inflow through FDI channel were higher in the case of Armenia.

Exports

A number of external shocks affected the exports of Georgia and Armenia in 2014 and 2015: Regional demand was falling, the depreciation of the Russian Ruble led to increased competitiveness of

Russian exports and the fall of global commodity prices for Georgia's and Armenia's major exports (copper ores and ferroalloys) all negatively affected both countries' exports. Economic crises and the extreme currency devaluation seen in Azerbaijan and Kazakhstan – major trading partners of Georgia – had an additional negative impact on Georgian exports. At the same time, the negative impact on Armenian exports was smoothed by favourable weather conditions for agricultural production and the opening of a new copper mine. As a result, Georgian exports of goods and services declined by USD 136 m (0.8% of GDP) in 2014 and USD 841 m (6% of GDP) in 2015, while Armenian exports increased by USD 163 m (1.4% of GDP) in 2014 and only fell by USD 179 m (1.7% of GDP) in 2015. It should be noted that these figures are nominal figures in current prices in order to shed light on the pressures on exchange rates. Real decreases of exports were less than this due to the movement of commodity prices and exchange rates. Overall, losses of foreign currency inflow from exports were clearly much more significant in the case of Georgia and outweigh the difference in FDI streams.

Imports

Imports can be expected to react to lower remittances as well as the ongoing local currency depreciation against the USD and other currencies, but usually the adjustment begins only after some time has passed. As the GEL exchange rate had depreciated less than that of the AMD by late 2014. Georgian imports of goods and services in 2014 continued to increase, by a total of USD 757 m (4.6% of GDP), compared to a smaller increase in Armenian imports by USD 103 m (0.9% of GDP) that was kept small by a fall in imports in the fourth quarter of 2014 which did not yet take place in Georgia. In 2015, imports decreased sharply in both countries, by USD 1.4 bn (10% of GDP) in Georgia and USD 1.1 bn (10.5% of GDP) in Armenia. Overall, Armenian imports showed faster adjustment that lasted in 2015 despite a smaller exchange rate depreciation. This may partly be due to implicit pressures on the private sector to hold back on imports as well as due to the contraction in credit supply effected by monetary policy as will be discussed in the next chapter.

Comparison of external shocks

In sum, particularly through the channel of exports, Georgia experienced a harder, but later shock. Remittances, export and FDI net foreign currency inflow to Georgia decreased by 33 m USD in Q4 2014 and by 69 m USD to Armenia. However, for Georgia the shock lasted longer into 2015 when the reduction in Armenian exports was much milder than in Georgia. In 2015, due to imports adjustment – which is an endogenous variable, determined by domestic income as well as exchange rates – net foreign currency inflow increased to both countries; however an increase was only 92 m USD in Georgia, while it increased by 466 m USD in Armenia. Because of drastic reduction in Georgian exports and slower import adjustment, there was greater and more prolonged pressure on the Georgian Lari than on the Armenian Dram.

4 Central Bank Policy

In order to influence the economic adjustment to external shocks, central banks can either allow the exchange rate to adjust to market pressures or use three policy levers: Foreign exchange interventions in the market, monetary policy tools (i.e. interest rates) and administrative measures (such as capital controls). As the aim of this paper is not to assess policy appropriateness, we here only analyse which, if any, instruments were used.

Despite the fact that both Georgia and Armenia have floating exchange rate regimes and that the aim of both central banks is to hold inflation under the targeted level, data shows that the National Bank of Georgia (NBG) and the Central Bank of Armenia (CBA) responded in different ways to the external pressures.

The CBA reacted immediately to the oil price fall and the Western sanctions against Russia in Jul-September 2014. To sustain the AMD-USD exchange rate, the CBA performed heavy **foreign exchange interventions** between August 2014 and February 2015, using up 34% of foreign currency reserves, while NBG foreign currency reserves remained stable in this period. Between November 2014 and February 2015, CBA performed net sales of USD 145 m, while its Georgian counterpart's net sales were USD 80 m. After that, the adjustment of Armenian imports eased external pressure on dram and the CBA could even partially replenish foreign currency reserves in 2015, while the NBG continue to perform very limited foreign exchange interventions to smooth the depreciation of the Lari.

Monetary policy tools were not used for the exchange rate policy by National Bank of Georgia. The NBG started to gradually increase (from 4% to 8%) the monetary policy interest rate only in May 2015 in order to address inflationary pressure arising from the Lari depreciation and increased electricity prices. Meanwhile, the CBA sharply tightened monetary policy already in late November 2014 (when the dram started to devaluate):

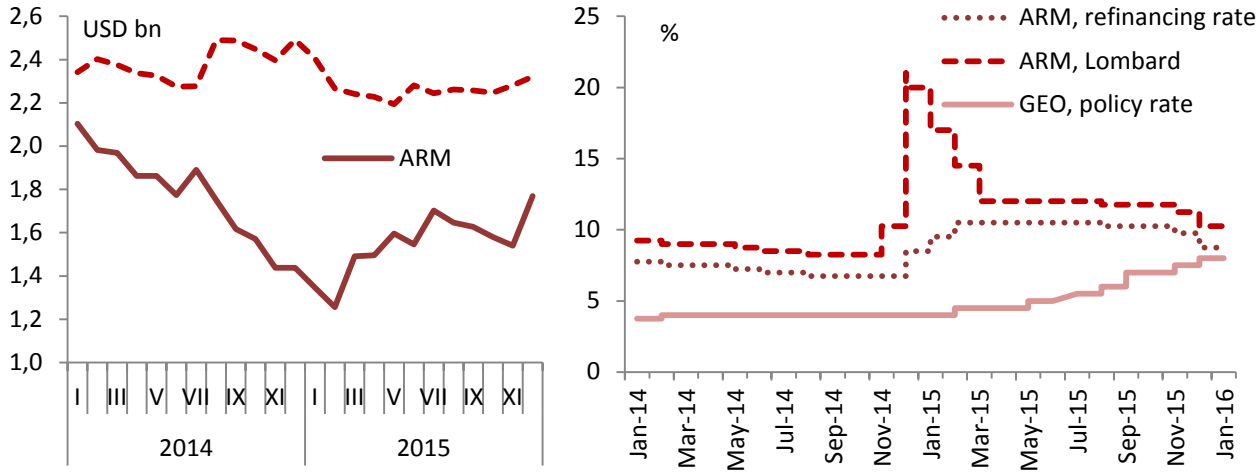
- 24 Nov, 2014, the CBA increased the Lombard repo (short-term dram liquidity instrument) rate from 8.25% to 10.25%;
- 3 Dec, 2014, the CBA increased the Lombard repo rate from 10.25% to 21%;
- 24 Dec, 2014 the CBA increased the refinancing rate from 6.75 to 8.5%.

The official aim of the CBA's contractionary monetary policy was to release pressure on inflation expectations; however, alongside active interventions in the exchange market, the Dram stabilized in Feb 2015.

Overall, CBA actively used both monetary and exchange rate policy to stabilize the dram, while NBG use only foreign currency interventions in order to smooth lari depreciation. Administrative measures were not officially used by Georgia or Armenia.

Figure 4

Foreign currency reserves of central banks and monetary policy interest rates



Source: National Bank of Georgia, Central Bank of Armenia

In total, different extent of external shocks and central bank policies, both explain the difference in the currencies depreciation. Weakening economic conditions in the region hit Armenia slightly more than Georgia in late 2014; however, hard contractionary monetary policy and intensive foreign currency interventions of the CBA alongside a faster adjustment of imports stabilized the AMD in 2015. The Georgian economy was subject to a more prolonged and larger external shock in 2015, mainly because of a dramatic reduction in exports. As a result, the GEL depreciated more and for a longer phase than the AMD.

5 Economic effects of different adjustment processes

Monetary policy responses of the respective Central Banks kept CPI-inflation under the targets of 4% in Georgia and 3.7% in Armenia in 2015. However, financial intermediation in Armenia was hit much harder due to increased cost of lending and decreased credibility of households. Total loans to the economy decreased by 3.8% in 2015, while they increased in Georgia by 5.5% in the same year. Despite the fact that the GEL devaluated more than AMD and dollarization of loans is high in both countries, the share of non-performing loans (NPL) in total loans remained stable in Georgia, while it increased by 2.2 % of loans in Armenia in 2015. Possible explanations related to the shocks and policy responses described here are: a) Armenian borrowers and their credibility appeared to be more dependent on remittances, b) Georgian banks offered loan restructuring, c) Georgian borrowers took new loans from microfinance organizations and Lombards in order to serve their debts in commercial banks (which may delay the impact on NPL in Georgia).

Overall, the depreciation of the GEL and AMD against the USD has contributed to the absorption of external shocks and had positive effects on the current account balance of both countries by leading to a reduction of imports. Depreciation caused real incomes (revenues in local currencies corrected by CPI) from remittances and exports to fall less dramatically. In the case of the GEL, the 28.5% depreciation reduced real income losses from external sources to almost zero and significantly increased revenues from tourism. Household consumption and fixed capital formation measured at current prices (in GEL) increased by 8.9% and 17.2% respectively in 2015. Considering the low rate of

inflation, this is a very positive development of private domestic demand and investments in particular. The 14.9% depreciation of the AMD seems to have absorbed external shocks only partially; alongside with the CBA's policy tightening it contributed to a decline in household consumption and gross capital formation measured at current prices (in AMD) by 2.3% and 2.9% respectively in 2015. In real terms, the decrease in these indicators was even higher. Domestic demand as a source of future growth in Armenia thus has developed far less positively through the last 2 years.

It is important to stress that these economic effects cannot be solely attributed to the policy choices described in this paper. As we have shown, the magnitudes of external shocks differed in the two countries, also, the effectiveness of policy instruments, particularly in monetary policy, depends hugely on specific characteristics of financial systems and can thus differ vastly across two otherwise similar countries. However, as a tentative conclusion, notwithstanding similar GDP growth (2.8% in Georgia and 3% in Armenia in 2015), it appears in effect that the policy choices made in Georgia, while allowing a larger depreciation of the Lari, have had less negative longer-term impacts on economic growth than the choices made in Armenia.

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