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MONETARY POLICY IN GEORGIA

- **The aim of the National Bank of Georgia's monetary policy is to maintain low and stable inflation** and thus promote macroeconomic stability, which is a precondition for robust and sustainable economic growth, low interest rates and decreasing unemployment.

- **The long-term CPI inflation target is 3%.** The inflation target was reduced gradually from 6% to its long-term value. It was 4% for 2017, and from 2018 it is 3%.

- **Since monetary policy decisions impact the economy with a certain time lag (4-6 quarters),** the formulation of monetary policy is done according to inflation forecasts in order to hit the target in the medium term. The medium term horizon depends on shocks and exogenous factors that influence the rate of inflation and aggregate demand.

- **The primary tool of monetary policy is the refinancing rate**. The change of the policy rate is transmitted to the economy through market rates, exchange rate and credit activity, thus influencing aggregate demand. The difference between the actual and natural level of demand is the main determinant of inflation in the medium term.

- **Monetary policy decisions are communicated to the general public via press releases.** The vision of the bank with regard to ongoing and expected macroeconomic activity is published in the Monetary Policy Report in the second month of every quarter.

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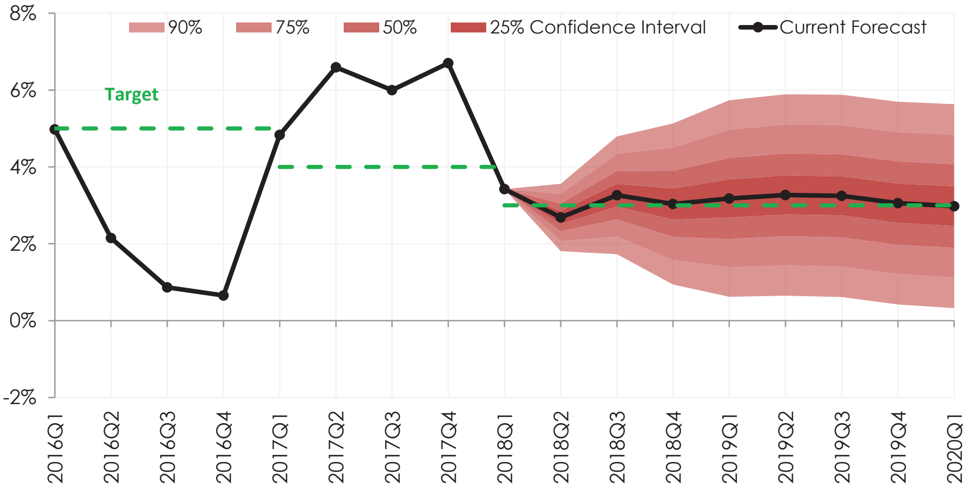
1. Brief Overview

In the first quarter of 2018, as had been expected, **the annual inflation rate** gradually declined and equalled 3.3%. However, in light of the greater-than-expected appreciation of the nominal effective exchange rate and lower oil prices on international markets during that period, the rate of decline was slightly faster than had been previously projected. In April, the inflation rate stood at 2.5%, which was slightly lower than the NBG's target rate of 3%. In contrast, throughout 2017 the inflation rate remained above its target, driven by temporary factors involving an increase of excise taxes and a surge in oil prices on international markets.

According to the National Bank of Georgia's forecast, **inflation** will remain around the target rate of 3% in the medium term (see Figure 1.1). The inflation forecast is mainly dependent on economic activity and the effective exchange rate. In particular, below-potential economic activity exerts downwards pressure on inflation, while the still insufficiently appreciated real effective exchange rate partially neutralizes that pressure. Inflation is expected to remain around the target following an improvement of economic activity and strengthening of the real effective exchange rate.

Figure 1.1 Headline CPI Inflation



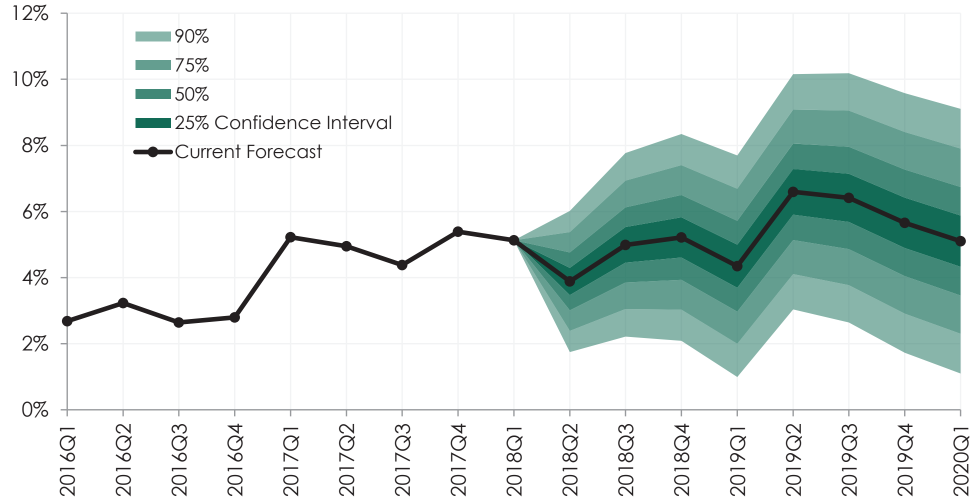
Source: National Bank of Georgia

In 2017, **real GDP growth** was relatively higher than expected and stood at 5%. This favourable trend persisted in the first quarter of 2018, with economic growth standing at 5.2% – higher than previously anticipated. Exports of goods and remittances significantly increased, but imports of goods also grew, reflecting a growth in consumption and investments. In terms of domestic factors, an increase in economic activity was supported by improved consumer and business sentiment together with the growth of credit.

The National Bank of Georgia has revised the **GDP growth forecast** slightly upwards to 4.8% (see Figure 1.2). This upward revision reflects favorable trends in the external sector. Based on the estimates, net exports, consumption and investment are all expected to positively contribute to GDP growth – stemming from a growth of foreign inflows, improvement in business sentiment and government capital spending. However, despite showing some improvement, aggregate demand still lags behind the potential level of output. According to the forecast, this output gap will gradually close over 2018 and 2019.

It should be noted that monetary policy cannot aim to fully neutralize temporary factors affecting the inflation rate in the short run. This objective could only be reached through a severe reduction of economic growth and employment. The National Bank of Georgia thus tries to strike a balance in its decision making, considering the ex-

Figure 1.2 Annual Real GDP Growth

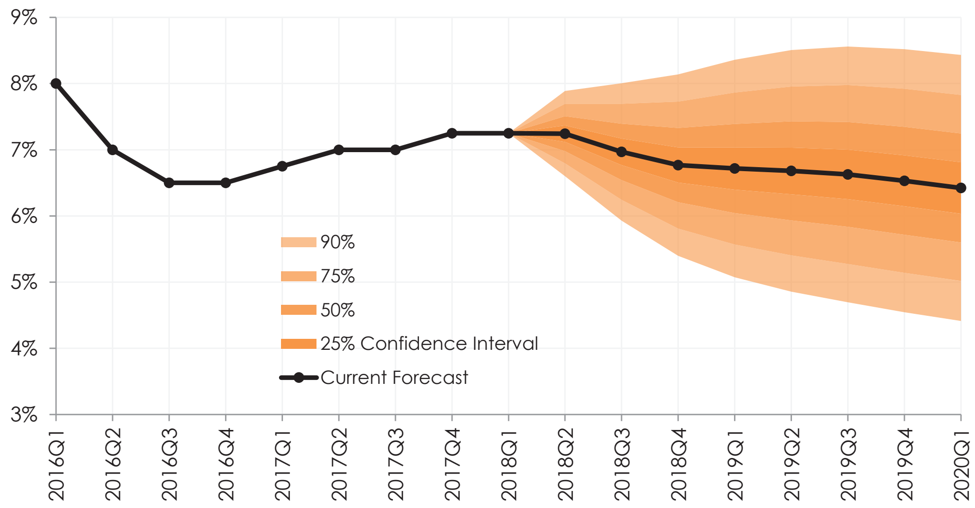


Source: National Bank of Georgia

pected timeframe over which the inflation rate will return to the target level and estimating the possible effects on economic growth.

To curb inflationary expectations, in 2017 the National Bank of Georgia gradually increased the monetary policy rate from 6.50% to 7.25%. However, following the decline of inflation to its target level of 3%, based on the current macroeconomic forecast, the **monetary policy rate is expected** to decline to its neutral level in the medium term (see Figure 1.3). Nevertheless, to further reduce the inflationary risk stemming from the effective exchange rate, the policy rate is currently maintained at a moderately tight level. It should be noted that the monetary policy rate forecast is not a commitment on future decisions made by the National Bank of Georgia. Rather, it is the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected.

Figure 1.3 Forecast of the Monetary Policy Rate



Source: National Bank of Georgia

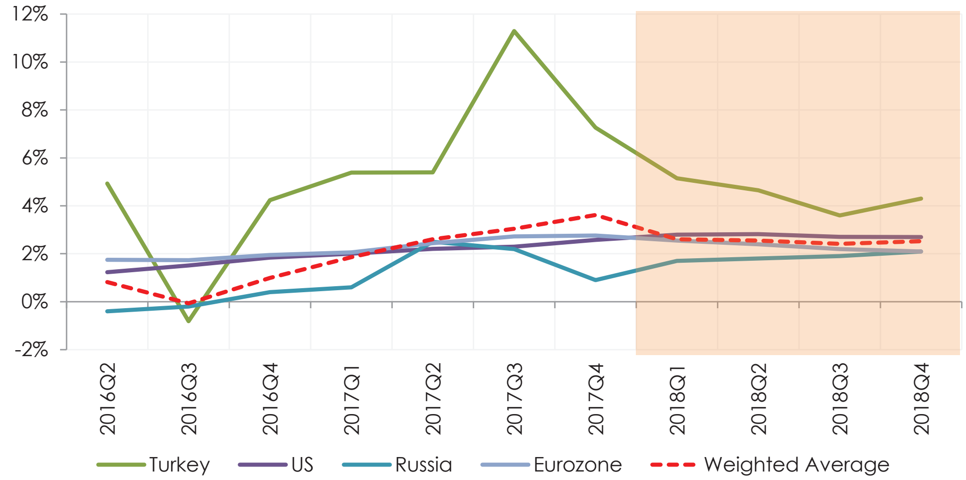
The **forecasts are dependent on exogenous factors and contain risks in both upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth of Georgia's main trading partners, the global trends of the euro and US dollar, and international prices of oil and food. In terms of domestic factors, risks stem from changes in the fiscal deficit, credit activity and business sentiment. Hence, if external and/or domestic factors evolve differently than is currently expected, this may influence the projected paths of macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

Over 2017 the world economy grew by 3.8%. This was driven by the significant increase in international trade and investment indicators among both developed and developing economies. According to the International Monetary Fund (IMF), these positive trends will persist over 2018. Improved business sentiment, supported by benign financial conditions and increased prices on commodities, is expected to lead to global growth of 3.9% in 2018.[1]

Figure 2.1 Real GDP Growth of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Over 2017, the growth of the **eurozone's** economy proved higher than expected and, according to preliminary estimates, this trend has persisted in the first quarter of 2018 – being reflective of a decline of unemployment and improved business sentiment. Moreover, growth in disposable incomes and consumer sentiment were also observed. As a result, the IMF revised the eurozone's growth forecast for 2018 upwards by 0.2 percentage points to 2.4%.[2] However, despite positive dynamics in the real sector, inflation is still below the target rate of 2%. In March, inflation stood at 1.4%. The IMF forecasts that by the end of 2018 annual inflation will average 1.5%.

In the first quarter of 2018, the growth of the **U.S.** economy slowed; however, the macroeconomic outlook remains positive due to increasing wages and declining unemployment. Recent statements from the White House have created certain risks to trade arrangements with international partners, which may in turn limit the effect of fiscal stimulus on economic growth. According to the IMF, compared to the previous forecast[3], the economic growth forecast was revised upwards by 0.2 percentage points to 2.5%, while the inflation forecast remains unchanged at 2.4%.[4]

Relatively high economic activity in **Turkey** over the year has created the risk of overheating. Annual inflation in the country stood at 10%, while following increased domestic demand the current account deficit deepened. The annual economic growth of 7% in 2017 was driven by fiscal stimulus and this has created certain fear among investor cycles. Namely, at the beginning of March, Moody's lowered the sovereign credit rating of Turkey, which may create difficulties for financing the current account

1 *International Monetary Fund. 2018. World Economic Outlook: Cyclical Upswing, Structural Change. Washington, D.C., April.*

2 *International Monetary Fund. 2018. World Economic Outlook Update: Brighter Prospects, Optimistic Markets, Challenges Ahead. Washington, D.C., January.*

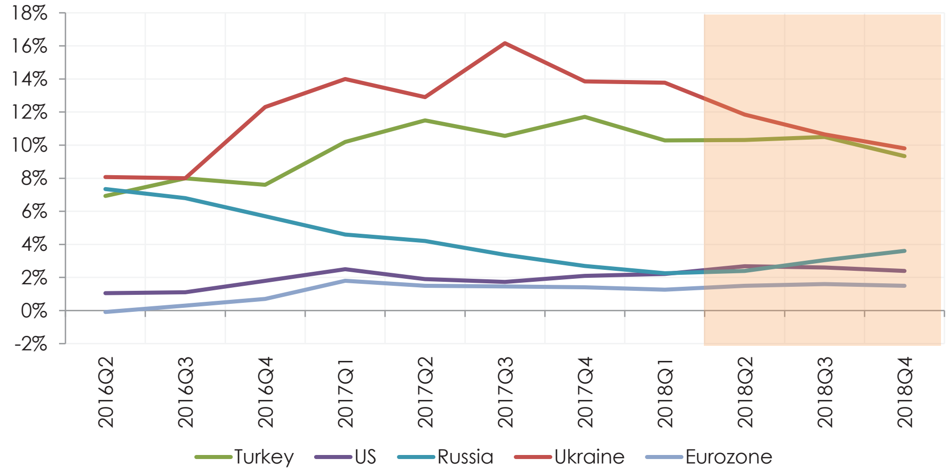
3 *Ibid.*

4 *International Monetary Fund. 2018. World Economic Outlook: Cyclical Upswing, Structural Change. Washington, D.C., April.*

deficit and servicing the foreign debt from foreign inflows in the future. Moreover, the current macroeconomic environment together with the tensions between China and the US have led to a record devaluation of the Turkish lira against the US dollar. According to the IMF forecast, the economic growth of Turkey in 2018 will stand at 4.4%, while CPI inflation will stand at 11.4%.[5]

The recovery of the **Ukrainian** economy has been relatively slow; however, its 2.5% growth in 2017 was higher than expected. That growth was achieved through high government spending and investments. Following the stabilization of the macroeconomic outlook, business sentiment has also improved. Nonetheless, various challenges, such as the low pace of implementing structural reforms, the trade blockade of the industrial regions in the east of the country, and geopolitical risks remain. Considering such risks, the IMF has not revised the country's growth forecast, which remains at 3.2%.[6] Ukraine still has a double-digit inflation rate and, according to the current IMF forecast, the inflation level in Ukraine will remain above 10% over 2018.

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Following the increase of oil prices on international markets and improved consumer sentiment, **Russia's** economy continues the path of recovery. However, structural constraints within the economy and international sanctions remain a challenge. As a result, the IMF has left its forecast unchanged. After record low inflation of 2% in February, consumer prices increased to 2.4% in March. According to the IMF forecast, CPI Inflation in Russia will stand around 2% over 2018.

Based on the latest data, in the first quarter of 2018, economic activity in **Armenia** declined compared to 2017. This decline was a result of the decrease in growth rates of the industrial sector, while growth in the services sector remains high. An increase in lending resulted in the growth of consumption, driving inflation upwards to 3.7% from an average of 1% in 2017. The IMF has increased the economic growth forecast for Armenia by 0.5 percentage points (pp) to 3.4% in 2018, while inflation is expected to stand at 3.5%.[7]

Low oil prices on international markets drove **Azerbaijan** into a severe recession over 2015-2016. However, in 2017, the real GDP growth rate was positive and equalled 0.1%. This growth was driven by increased activity in the non-oil sector. The inflation level also declined from the double-digit rate of last year – a consequence of an improved macroeconomic outlook and lower inflation expectations. The IMF has revised the GDP growth forecast for Armenia upwards from 1.3% to 3%.[8] Based on the same forecast, the inflation forecast for the country was left unchanged at 7%.

Following the decision to gradually phase out its monetary policy easing program, the **U.S. Federal Reserve** increased the policy rate in March, raising expectations of a faster pace of policy normalization within financial markets. The ECB has also started to gradually phase out its quantitative easing program, reducing the monthly pur-

5 *Ibid.*

6 *Ibid.*

7 *Ibid.*

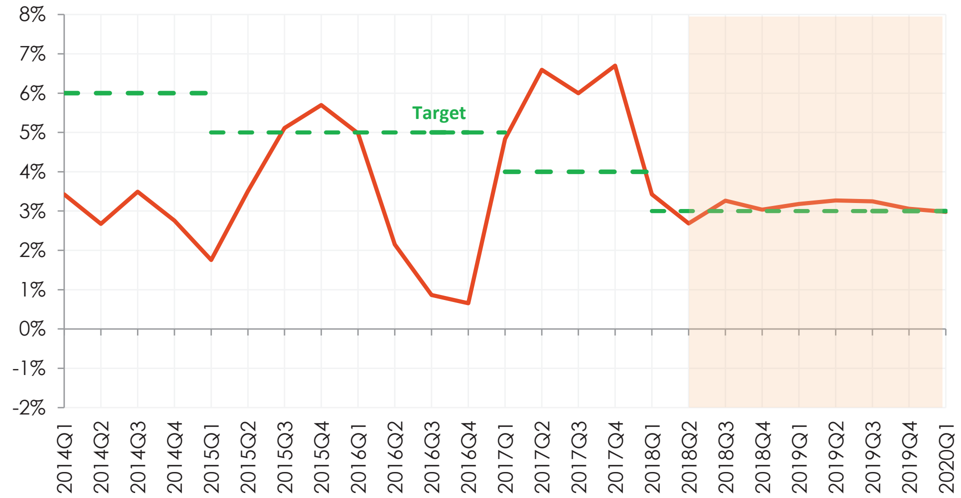
8 *International Monetary Fund. 2017. Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges. Washington, D.C., October; International Monetary Fund. 2018. World Economic Outlook: Cyclical Upswing, Structural Change. Washington, D.C., April.*

chase of government securities in January. Some of Georgia's trading partners have reduced their monetary policy rates, following the decline in inflation and inflation expectations.

2.2 MACROECONOMIC FORECAST

In March 2018, annual inflation equaled 2.8%, while average inflation in the first quarter stood at 3.3%. As the previous forecast indicated, inflation is currently around the target level. However, following a weakening of supply-side factors, inflation fell at a faster pace than was expected. In particular, in February, oil prices were lower and the nominal effective exchange rate was higher than had been expected, reducing imported inflation (on both intermediate and consumer goods).

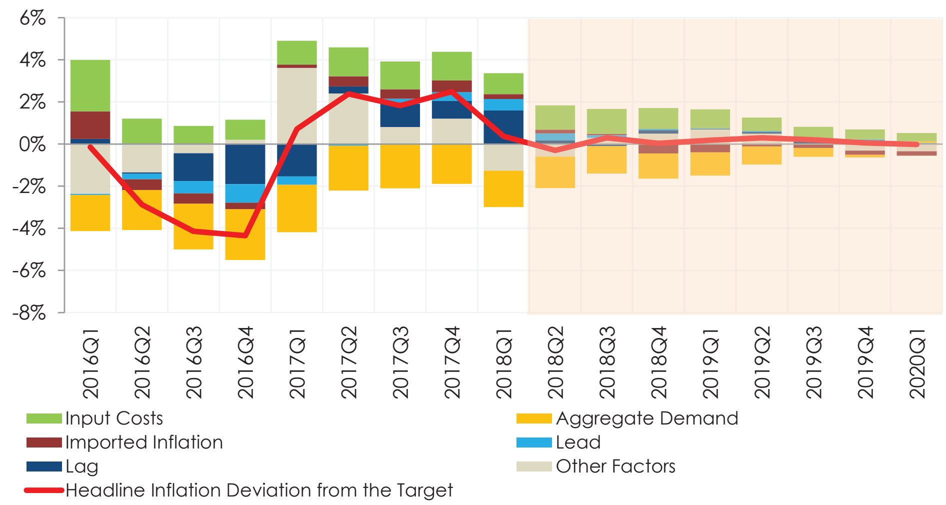
Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

Altough some one-off factors will push inflation upwards, according to the current forecast, **annual inflation is expected to remain around the target level** over 2018 and in the medium (see Figure 2.3). The effects of increased tariffs on water and electricity at the beginning of 2018, together with an increase in natural gas tariffs in the middle of 2017, will both inflate consumer prices compared to the previous year. Nevertheless, both of those effects are expected to be neutralized by weak aggregate demand and a strengthening of the effective exchange rate.

Figure 2.4 Inflation Deviation from the Target and its Decomposition[9]



Source: National Bank of Georgia.

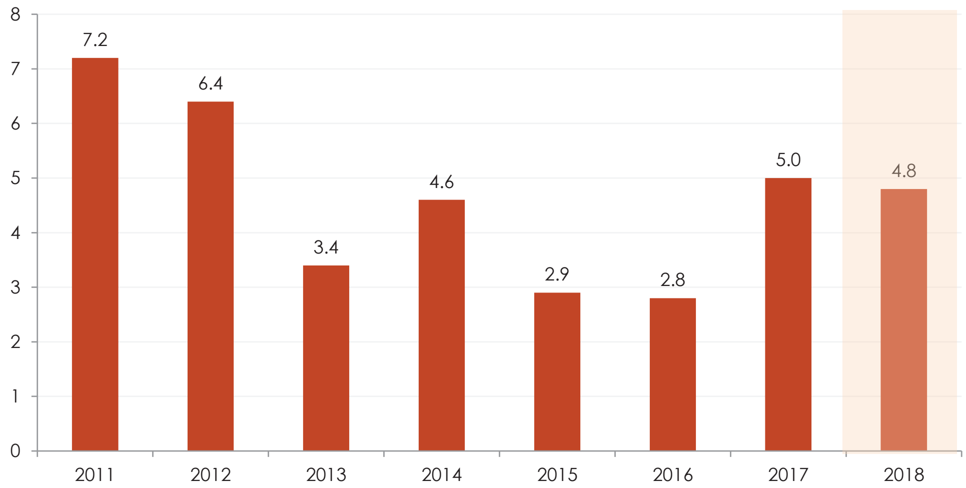
9 *In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

As explained above, the **deviation of annual inflation from the target will be insignificant**. It is important to note that despite the relative appreciation of the lari exchange rate, it is still weak compared to the long-run trend. As a result, prices on intermediate goods are pushing inflation upwards (see Figure 2.4). However, according to the forecast, the effect of the latter, when coupled with pressure stemming from imported inflation, will gradually decline. On the other hand, the expected growth of economic activity towards the potential level (see Figure 1.2) will reduce downward pressure of aggregate demand, effectively decelerating inflation towards the target level of 3%.

A number of less probable but still plausible factors may cause the inflation rate to deviate from its projected level. In particular, if geopolitical factors deteriorate more than expected, inflation may be higher than forecast as such a deterioration would result in an increased risk premium for countries in the region, including Georgia. As a result, the currencies of the region would depreciate more than expected, driving inflation above the forecasted level. Other upward risks to the inflation forecast include a faster-than-expected phasing out of the ECB's monetary policy easing program and a significant increase of oil prices on international markets. On the other hand, inflation may be lower than forecast if the "trade war" escalates, causing the U.S. dollar to depreciate on global markets and leading to a relative appreciation of the lari exchange rate. As a result of the latter, inflation would be lower and prices would decline on imported consumer goods.

In 2017, real GDP growth equaled 5% and, according to preliminary estimates, this rate has persisted in the first quarter of 2018. Indicators were higher than expected as a result of a substantial increase in tourism revenues and exports. Moreover, a sharp 23% increase in money transfers from the beginning of the year has significantly contributed to a rise in domestic consumption. According to estimates, the growth rate of money transfers for 2018 is expected to be 16% on average.

Figure 2.5 Real GDP Growth



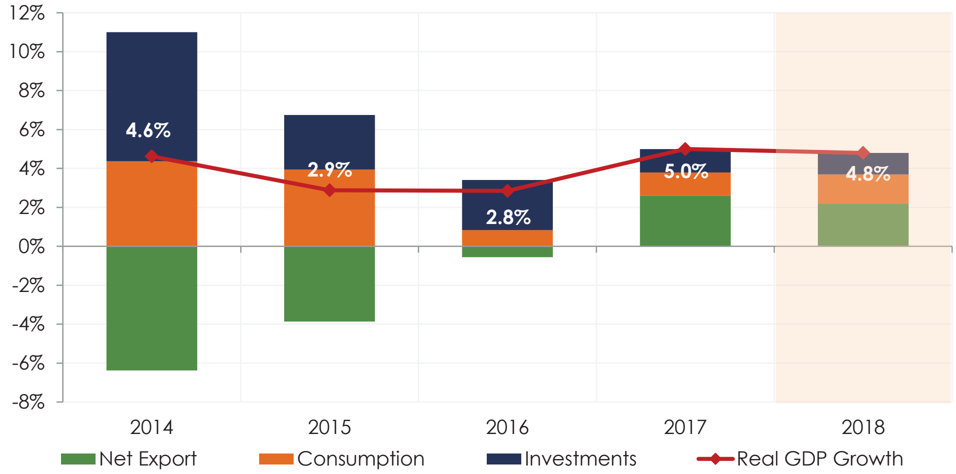
Source: National Bank of Georgia.

The NBG has revised its GDP growth forecast for 2018 to 4.8% (see Figure 2.5). This revision, was motivated by favourable dynamics in the external sector. As in 2017, amid sustained lari competitiveness, net exports are expected to be the main driver of growth in 2018; however, consumption and investments are also expected to make positive contributions to the growth (see Figure 2.6).

The external sector is a **major source of risk for the GDP forecast**. A deterioration of the geopolitical environment will result in an increase of sovereign risk premiums in the region, negatively affecting business sentiment and investment. Hence, the economic growth will be lower than predicted. Another risk is associated with the dynamics of the euro and dollar exchange rates on the international market, which are transmitted to Georgia through trade and expectations channels, and thereby affect economic activity and the lari exchange rate. However, if economic activity in Georgia's main trading partners increases faster than is expected, GDP growth will be higher than is forecast as a result of the increase in external demand and improved investor sentiment.

The **current account deficit** in the fourth quarter of 2017 stood at 13%. However, fol-

Figure 2.6 Real GDP Growth Decomposition



Source: National Bank of Georgia

lowing significant improvements in the external sector, coupled with the record low deficit of 3% in the third quarter of 2017, the current account deficit for 2017 equalled 8.7%. In both the short and medium term, the current account deficit is expected to remain in single digits, as long as neighboring countries retain stable growth rates, and export and other foreign income flows follow a decent growth path.

The ultimate goal of the National Bank of Georgia is price stability, which can be reached efficiently by following an inflation-targeting regime. For this purpose, the NBG uses its monetary policy rate to ensure that the inflation forecast reaches the target level in the medium term. The NBG also takes into account output volatility, ensuring that the response to supply-side shocks is gradual and not so aggressive as to induce high output volatility. Gradual changes to the policy rate are considered optimal, both in times of uncertainty and for controlling long-term interest rates more efficiently. The inflation forecast thus includes the interest rate forecast, which takes each of the above-mentioned factors into account.

According to the forecast, a gradual decline in short-term rates is expected as long as inflation remains around the target and aggregate demand is below its potential level. According to the baseline scenario, a modestly declining monetary policy rate is the optimal response to falling inflation (see Figure 1.3). The monetary policy rate will thus decrease to its neutral rate (5-6%) in the medium and long term. However, to reduce the risks stemming from the effective exchange rate, monetary policy currently remains relatively tight and its easing is expected to be implemented only gradually.

It should be stated that **the forecast of the monetary policy rate is not a promise from the National Bank of Georgia regarding future decisions**. It only reflects the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. Despite the inherent uncertainty characteristic of any projection, the forecast contains valuable information regarding the expected trajectory of short-term lari interest rates – upon which long-term rates depend.

2.3 ALTERNATIVE FORECAST SCENARIO

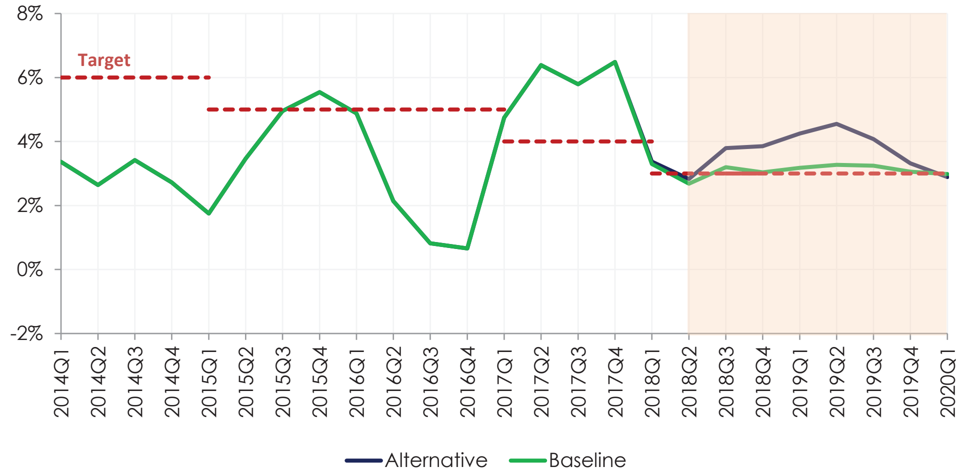
The alternative forecast scenario considers a situation where Georgia is affected by an external shock. Geopolitical risks in the region have recently increased. U.S. sanctions on Russia have led to a depreciation of the Russian ruble and, due to negative expectations, the Turkish lira has continued to depreciate against the U.S. dollar. Any deterioration of those conditions will be transmitted to Georgia's nominal effective exchange rate and will also affect the risk premium rate for countries of the region, thereby decreasing the volume of investment and economic activity. As a result, according to the alternative forecast scenario, annual inflation will be higher than in the baseline scenario due to pressure from the exchange rate (see Figure 2.7), while economic growth will be lower as a result of the increase in the risk premium (see Figure 2.8).

According to the alternative forecast scenario, the depreciation of the exchange rate will affect the inflation rate. Hence, all else being equal, the inflation rate over 2017-2018 will be approximately 0.6% higher than in the baseline scenario (see Figure 2.7).

As a response, in order to reduce inflation expectations, the monetary policy trajectory in 2018-2019 will increase by 0.6 basis points compared to the baseline scenario (see Figure 2.9).

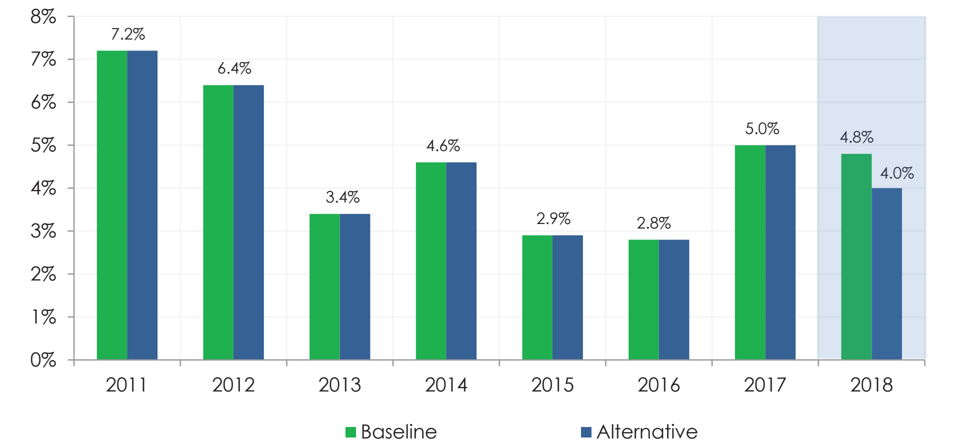
According to the alternative forecast scenario, as a result of relatively tight monetary policy, economic growth in 2018 will be lower than in the baseline scenario and will stand at 4%. Ultimately the monetary policy response will curb inflationary expectations and reduce inflationary pressure. As a result, inflation will be around the target level of 3% in the medium term.

Figure 2.7 Headline CPI Inflation According to Baseline and Alternative Forecasts



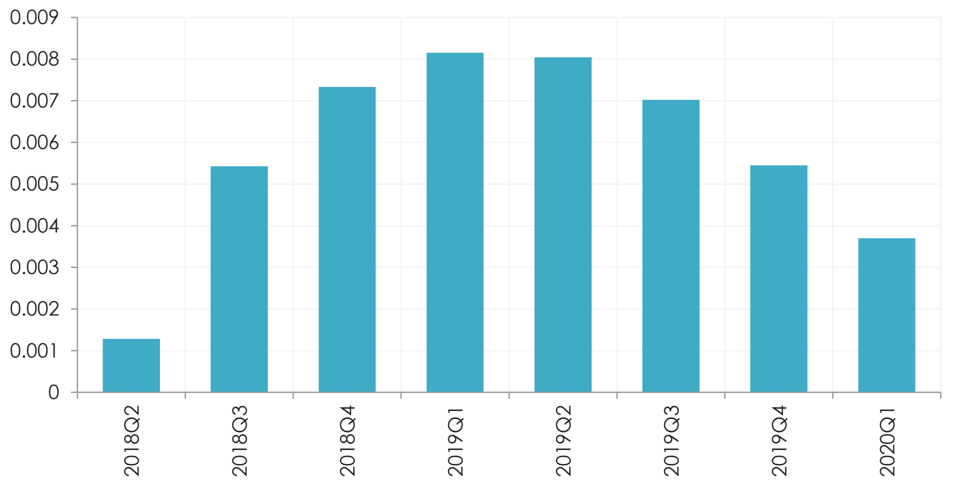
Source: National Bank of Georgia

Figure 2.8 Real GDP Growth According To Baseline And Alternative Forecasts



Source: National Bank of Georgia

Figure 2.9 The difference in the monetary policy rate in alternative and baseline scenarios



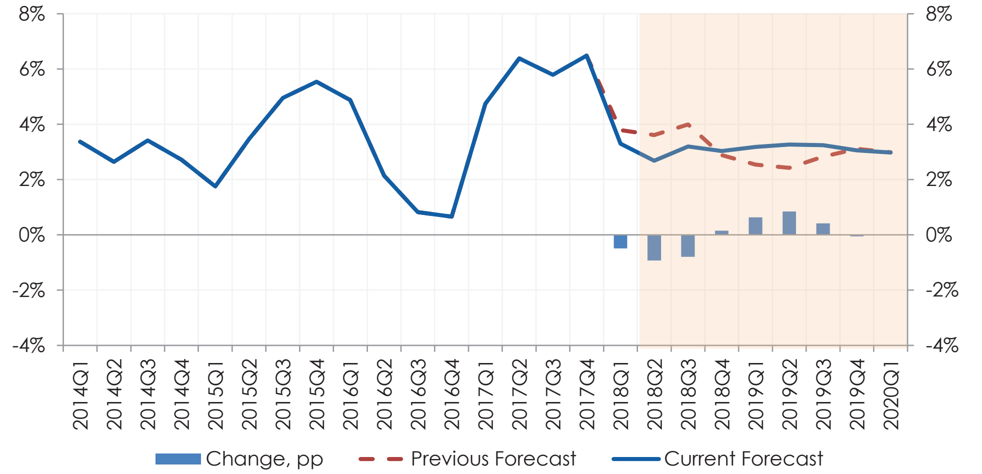
Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous quarter, the inflation forecast for 2018 has been revised downwards (see Figure 2.10). Neutralization of one-off supply-side factors motivated the revision – namely the decline of oil prices on international markets. Moreover, from early 2018, the nominal effective exchange rate appreciated more than expected, decreasing imported inflation. According to the revised forecast, inflation is expected to remain around the target level.

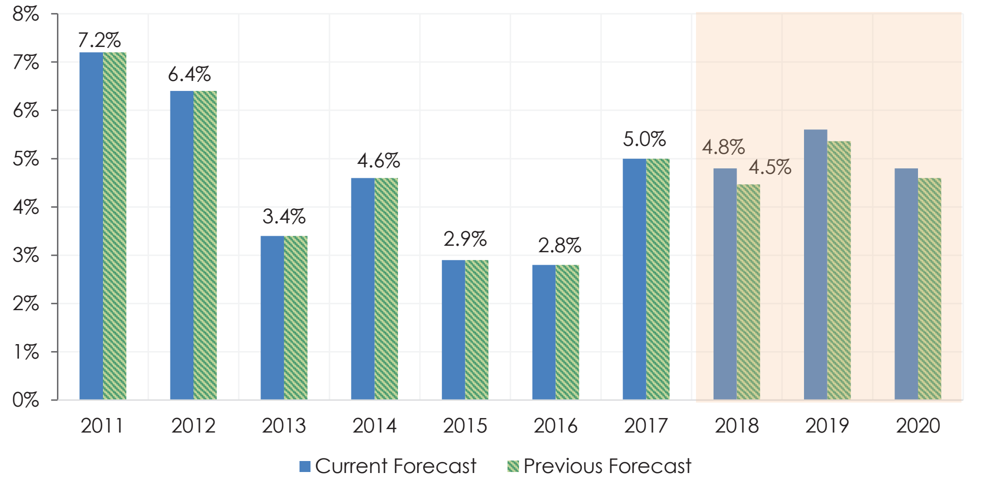
As for economic activity, compared to the previous quarter, the real GDP growth forecast was revised in an upwards direction to 4.8% (see Figure 2.11). This revision is related to the higher economic growth of trading partner countries and an increase in external demand. However, domestic demand has also increased more than expected.

Figure 2.10 Changes in the Forecast of Headline Inflation



Source: National Bank of Georgia

Figure 2.11 Changes in the Forecast of GDP Growth

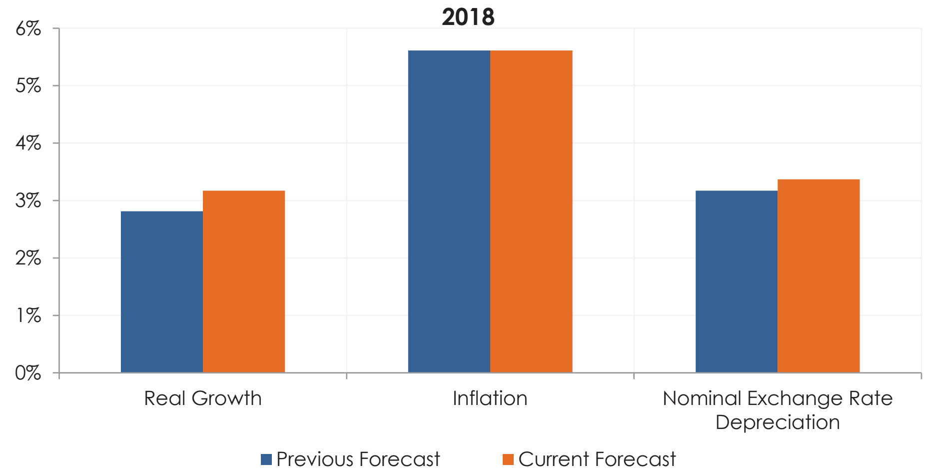


Source: National Bank of Georgia

Assumptions regarding economic growth, inflation and the exchange rates of Georgia's main trading partners are particularly important for the macroeconomic forecast. Any change in these assumptions affects the forecast and its associated risks (see Figure 2.12).

Assumptions regarding economic activity have been revised upward. The expected depreciation of trading partner currencies has also slightly increased. The latter change was mostly driven by the greater-than-expected depreciation of the Turkish lira; however, its transmission to the Georgian real effective exchange rate will be lessened since inflation in Turkey is high. Assumptions regarding inflation dynamics in Georgia's main trade partners have not changed significantly.

Figure 2.12 Changes in External Sector Assumptions for 2018



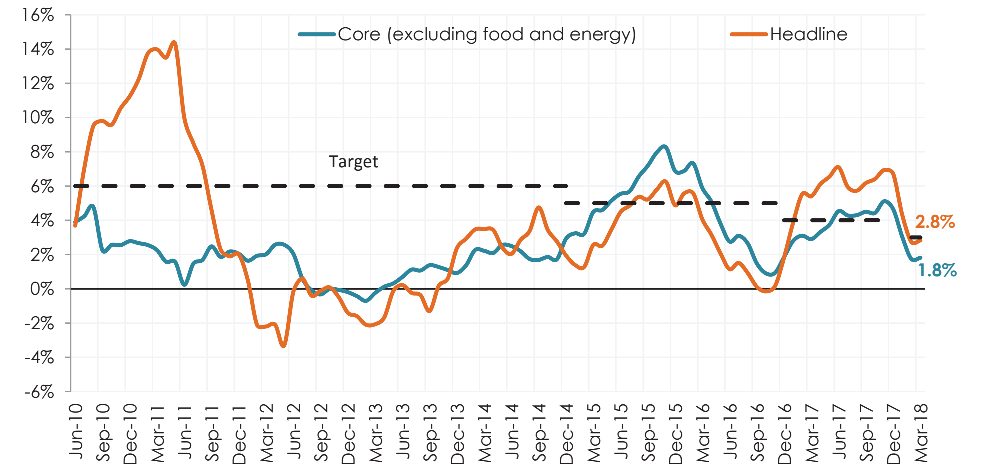
Source: Bloomberg

3. Consumer Prices

Last year, inflation was driven above the target by temporary supply-side factors, such as the rise of the excise taxes on tobacco and oil alongside increased international prices on the latter. Excise taxes on tobacco and oil rose from January last year, resulting in above-target inflation (4%) over the year. However, the effect of those factors was exhausted in January-February 2018 and, as expected, inflation declined. Annual inflation in February and March stood at 2.7% and 2.8% respectively. From 2018 onwards, the inflation target is 3%; inflation thus stood around the target rate. Meanwhile, core inflation (which excludes volatile food and energy prices) was lower than CPI inflation and equaled 1.8% in March (see Figure 3.1).

« With the exhaustion of temporary supply side factors, the inflation has declined to around the target.

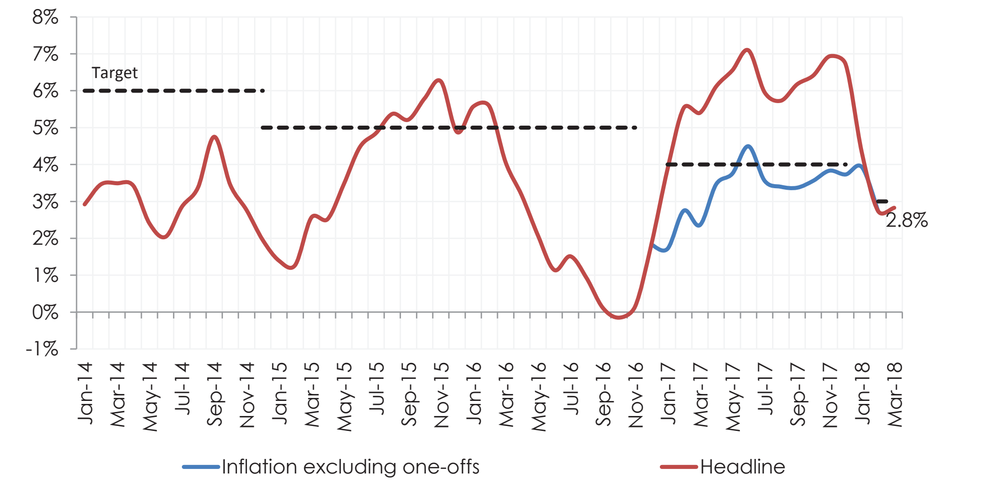
Figure 3.1 CPI And Core Inflation



Source: GeoStat

In the beginning of the year the effect of one-off supply side factors was mainly exhausted. However, the increase in prices on natural gas from August 2017 and on electricity and water from January 2018, still has an upward pressure on inflation. Total contribution of these utilities to the total inflation equalled 0.4 p.p in March. (Figure 3.2).

Figure 3.2 The Share of One-off Factors in CPI Inflation



Source: GeoStat

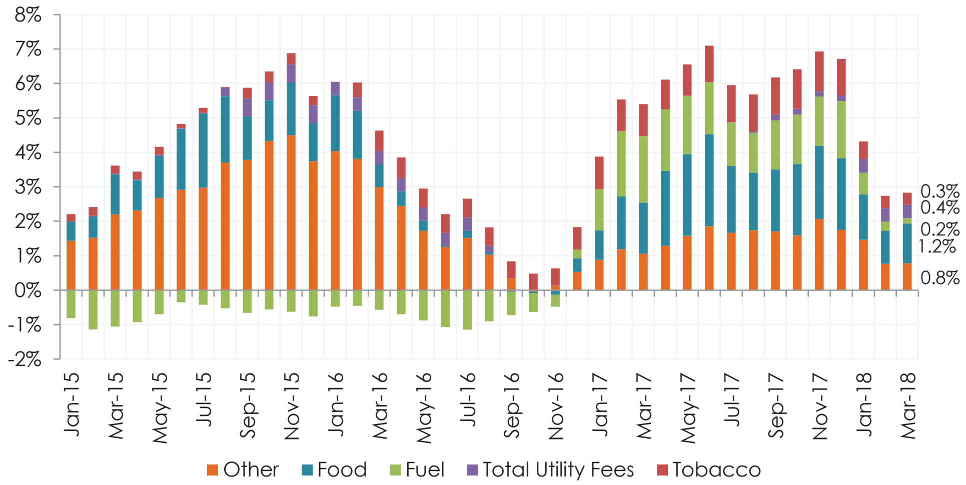
Over 2017, the contribution of the food group to total inflation was high, ranging from 0.8 pp to 2.7 pp. There are two main reasons behind this increase: (i) in 2016, the prices of vegetables, dairy, meat and meat products were relatively low and thus the increase of prices in 2017 was mainly a result of the base effect; (ii) the price increase on meat products can be attributed to increased exports of those products and reduced supply to the local market.

From 2018 onwards, the base effect pushing inflation upwards expired, hence the contribution of the food group to inflation fell. In March, inflation in the food group equalled 4.3% and the contribution declined to 1.2 pp. However, the price increase remained high on fruits, dairy and meat products. The overall contribution of these subcategories to total inflation totaled 0.9 pp .

‹‹ The contribution of the food group to inflation fell.

The contribution of the healthcare group to annual inflation was relatively high. In March, prices on this group grew by 3.7%, contributing 0.3 pp to overall inflation. Moreover, following increased demand from international visitors, prices of hotels and restaurants grew by 5.2% (see Figure 3.3).

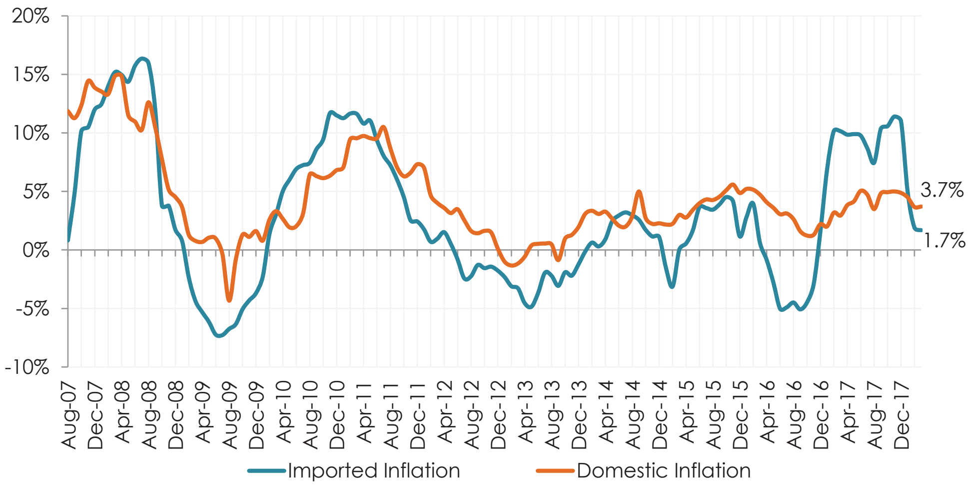
Figure 3.3 Contribution Of Fuel, Food And Utilities Inflation To Headline Inflation



Source: GeoStat and National Bank of Georgia

From 2018, inflation declined, following reduction of prices of imported goods, such as prices on fuel and tobacco . From January onwards, imported inflation significantly declined and equaled 1.7% in March. In contrast, inflation on locally produced goods was less volatile and stood at 3.7% (see Figure 3.4).

Figure 3.4 Imported And Domestic Inflation

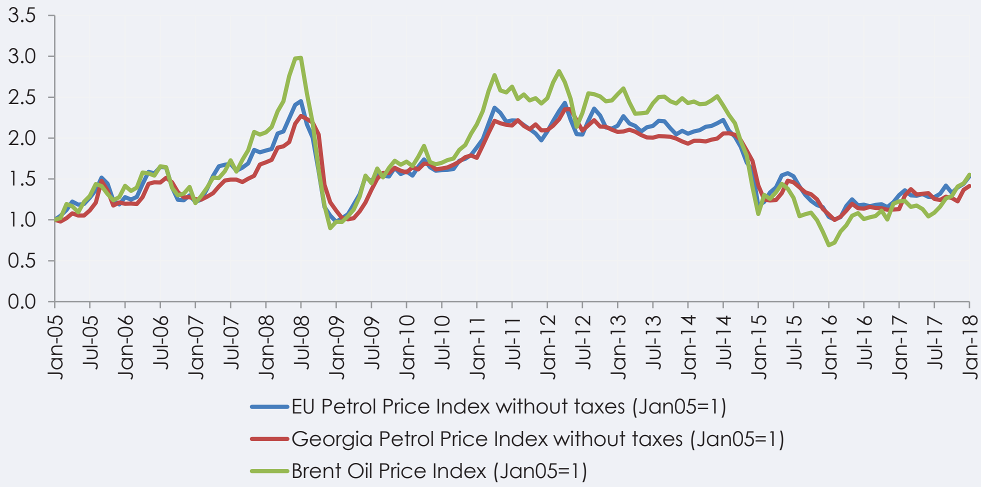


Source: GeoStat and National Bank of Georgia

Box 1 The Impact of Oil Prices in International Market on Petrol Prices in Georgia

Oil prices in Georgia are highly affected by international prices on oil; however, the correlation between oil prices in Georgia and those in Europe is even more significant. If we compare the prices of oil (excluding taxes)[10] in Georgia and Europe, we see a correlation of 95% (see Figure 3.5). Moreover, although international prices of oil determine prices on local markets, the latter prices also rely on other costs, such as refining, transport and administrative costs. Moreover, changes in the price of oil are reflected on petrol prices with a certain time lag. Given this, an empirical analysis of the price transmission mechanism is significant.

Figure 3.5 Price indexes on oil and petrol (US dollars)



Source: Bloomberg, National Bank of Georgia

According to research focused on European countries, changes in the price of oil on international markets are directly transmitted to the price of petrol (excluding taxes) with a certain time lag. For example, the change in price will be transmitted to petrol prices at the same amount after approximately three months; however, in the short term (over one month) an international price increase on oil will result in the price of petrol increasing by only half of the amount that the price of oil increased.[11] Another factor that should be considered is symmetry in the transmission of prices. Increases in prices tend to be transmitted faster, while decreases will be transmitted more slowly. However, research has demonstrated that asymmetry is not significant for European countries. According to Castro et al. (2017), a 10% increase of oil prices on international markets results in an approximate 3.6% increase in the prices of energy products (which include liquid fuel, gasoline and different engine and transmission oils).[12]

The analysis of the market in Georgia (using the methodology from Clerides (2010)) demonstrates that changes in international oil prices are equally reflected on market prices in the long term (excluding the exchange rate and tax effect). However, in the short term (of approximately one month) a change of one dollar in the price of Brent Crude Oil leads to a change of 0.35 USD[13] in Georgia. Based on the same estimates, the long-term balance on markets is achieved by a 40% monthly change in price. Hence, the full transmission of changes in the price of crude oil on international markets takes approximately 3-4 months, which means that if the price of one barrel of Brent Crude Oil declines from 70 USD to 63 USD (by 10%), prices on the local Georgian market will decline by 1.5 U.S. cents (0.04 lari) in 1 month, and by 4.4 cents (0.11 lari) over 3 to 4 months, which is approximately 5% of the retail price in Georgia. Such a decline in the oil price would contribute -0.12 pp to headline inflation.

As we have mentioned, exchange rate factors are not considered in these calculations. Depending on the dynamics, an exchange rate change may strengthen or weaken the above-mentioned impact on oil prices. It is also worth noting that the asymmetry of price transfers to Georgia was statistically insignificant. A change in the Brent Crude Oil price is symmetrically reflected in local petrol prices. However, to detect any asymmetry, a database should include data of a higher frequency (for example, weekly).

As an example, we can summarize how an increase of international oil prices by 10 U.S. cents per liter (a change of 16 USD per barrel) will be transmitted to Georgia and Europe (see Table 3.1). Based on the estimates described above, 35% of the

10 The comparison considers petrol prices excluding the effect of taxes in order to exclude the impact of different levels of tax and excise in different countries.

11 For more information, see: Clerides, S. (2010). Retail fuel price response to oil price shocks in EU countries. Cyprus Economic Policy Review, 4(1), 25-45.

12 For more information, see: Castro, C., Jiménez-Rodríguez, R., Poncela, P., & Senra, E. (2017). A new look at oil price pass-through into inflation: evidence from disaggregated European data. Economia Politica, 34(1), 55-82.

13 An increase in price by 0.10 USD per liter equalls a change of 16 USD per barrel.

change of price will be transmitted to Georgia over the first month, while 50% will be transmitted in Europe. In the longer term (3 months) the full transmission will be complete in both cases. Moreover, the share of gasoline in Georgia's consumer basket is 2.4% while the average share for Europe is 2.8%.

Table 3.1 The impact of oil prices on inflation rates in Georgia and Europe

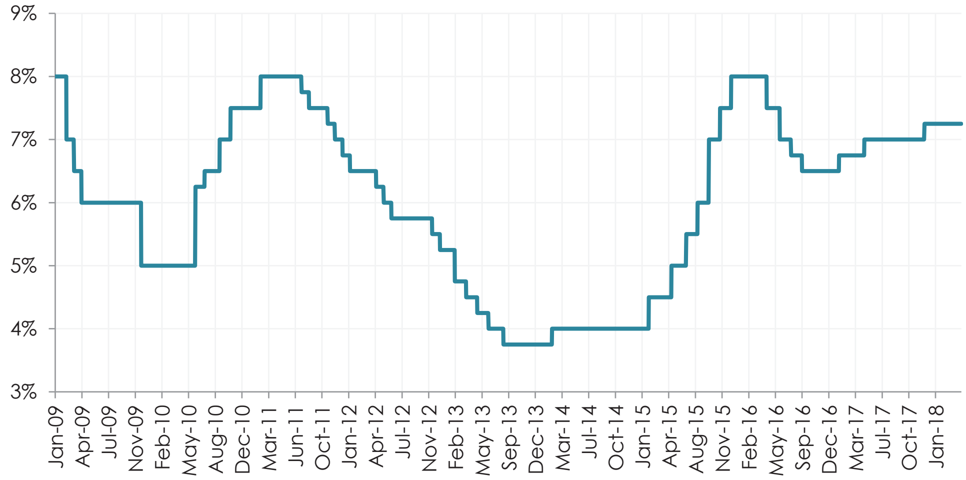
An increase in price by $0.10 per liter ($16 per barrel)	EU	Georgia
The contribution of petrol to inflation in a 1-month period	0.08%	0.09%
The contribution of petrol to inflation in a 1-month period	0.16%	0.25%

The analysis reveals that local petrol prices are closely linked to the international prices of oil. Similar to the situation with EU member states, international oil prices will be fully transmitted to local fuel prices in Georgia; however, doing so takes about three months and in the short term (of 1 month) the change in price transmitted is less than half the amount of the change in oil price.

4. MONETARY POLICY

Currently, the National Bank of Georgia maintains a moderately tight monetary policy. Following the forecast, as temporary factors petered out from the start of 2018, inflation declined and equalled 2.5% in April. It is worth noting that despite the higher-than-expected growth of economic activity in 2017, aggregate demand remains below its potential level, putting downward pressure on inflation. However, the depreciation of the nominal effective exchange rate in autumn 2017 is still pushing inflation upwards. As a response, the Monetary Policy Committee decided to keep the policy rate unchanged at its meetings held in early 2018.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The last Monetary Policy Committee meeting was on 1 May 2018. During the meeting, the committee decided to keep the refinancing rate unchanged at 7.25%. Although aggregate demand remains below the potential level of output, putting downward pressure on inflation, relatively high volatility observed on international financial markets increases risks of a stronger transmission of inflationary pressures from Georgia's main trading partner countries. As a result, the committee deemed it appropriate to maintain a moderately tight monetary policy.

‹‹ The monetary policy committee decided to keep the refinancing rate unchanged at 7.25%.

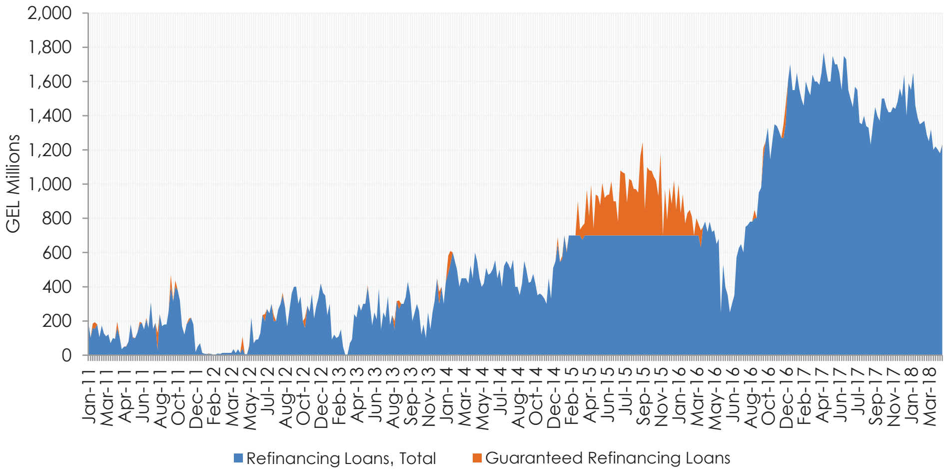
A gradual easing of the policy will be considered once the factors pushing inflation upwards are sufficiently weakened. In April 2018, annual inflation stood at 2.5%. According to the current forecast, other things being equal, inflation will remain close to its target level (of 3%) throughout the year. The growth of economic activity has persisted at the beginning of 2018. Based on preliminary estimates, the economy grew by 5.6% annually in March, while in the first quarter real growth stood at 5.2%.

Positive trends in the external sector persisted at the beginning of 2018. In particular, the first quarter revealed a high growth of exports and tourism revenues. Exports of goods grew by 28.4%, while tourism revenues increased by 28.8%. Remittances continued to grow as well, rising by 22.4% in the first quarter. However, the growth rate of imports is high compared to the previous year. Over the first quarter of 2018, imports increased by 21.6%.

According to the current forecast, in the medium term, inflation is expected to remain around the target level of 3%. However, this forecast is associated with several risks: inflation may be higher than expected if the risk premium in the region increases following a deterioration of geopolitical conditions and a decline in economic activity in the region. An increase in the risk premium will result in the depreciation of local currencies (for details, see section 2.3). Moreover, a faster-than-expected phasing out of the ECB's quantitative easing program and/or an increase of international prices on commodity group products (oil, food) will further push inflation upwards. However, inflation will be lower than expected in the event of a global depreciation of the U.S. dollar following an escalation of the "trade war" with its key trade partners. The latter would result in a strengthening of the lari and, consequently, in a decline of imported consumer products.

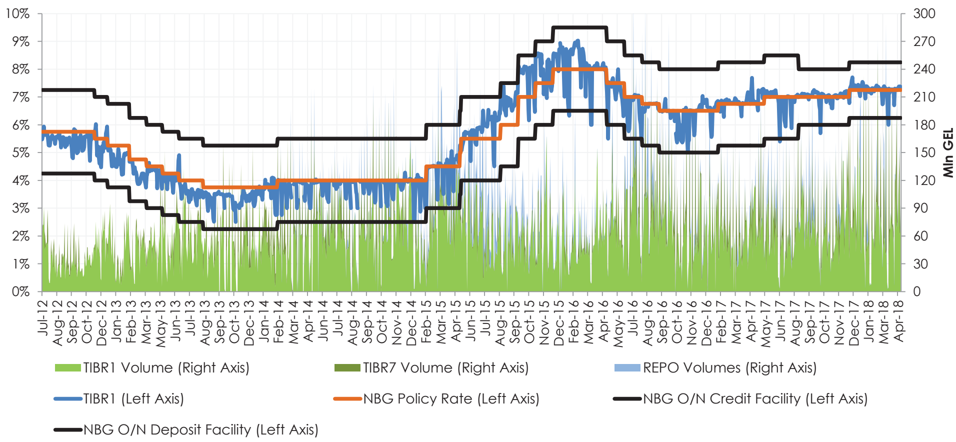
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. Currently, the banking sector operates under the conditions of a liquidity deficit. However, commercial banks are capable of raising necessary additional funds through refinancing loans – the main instrument of the NBG. The National Bank provides short-term liquidity to the banking system via one-week refinancing loans and one-month open market operations. Currently, interbank money market interest rates move around the monetary policy rate.

Figure 4.2 Liquidity Supply Instruments



Source: National Bank of Georgia

Figure 4.3 Interbank Money Market



Source: National Bank of Georgia

‹‹ The interbank money market interest rates move around the monetary policy rate.

Box 2 Open market operations

Price stability is the primary objective of the NBG's monetary policy. Price stability implies a moderate and predictable rate of inflation in the medium term, which is essential for sustainable economic growth.

To ensure price stability, the NBG primarily relies on short-term interest rates as a monetary policy instrument. Interest rates are governed by a liquidity management framework and the stability of short-term interest rates is a precondition for the efficiency of the framework. The liquidity management framework of the National Bank of Georgia includes both liquidity supply and liquidity absorption instruments: open market operations on the primary market[14] (refinancing loans and certificates of deposit), minimum reserve requirements and permanent instruments.

The availability of sufficient resources in the local currency in the banking system and efficient liquidity management are important for encouraging lending in the local currency and promoting de-dollarization. Currently, the Georgian banking system operates under a liquidity deficit. Any additional liquidity is provided to commercial banks through open market operations – refinancing loans. However, central banks in developed countries manage liquidity through open market operations on both the primary and secondary markets.[15] Open market operations on the secondary market are generally conducted using government securities since they are characterized by high liquidity and lower risk.

Open market operations on the secondary market have a number of advantages. In particular, they serve, along with primary market operations, as an indirect tool to control interest rates for efficient liquidity management. Furthermore, the involvement of the National Bank will contribute to the development of the secondary market in Georgia, which is essential for increasing the efficiency of monetary policy.

Liquidity management: Trading with government securities on the secondary market is one of the central bank's instruments for the medium- and long-term management of liquidity and is used in coordination with the main instruments of monetary policy. Unlike primary market operations, which are based on instruments with one-week and one-month maturities, the purchase of securities on the secondary market allows central banks to provide the market with longer-term liquidity, which is essential for the market. Liquidity management is a complex process that involves the assessment of the liquidity needs of the financial sector and forecasting. Afterwards, the central bank determines the tools to be used to address the liquidity needs.

Development of secondary markets. A developed secondary market is an important element for increasing economic activity. In the face of increased liquidity, previously issued bonds and stocks become more attractive financial instruments on the secondary market. The secondary market is an effective platform that connects savers and borrowers who want to invest in non-bank assets. The secondary market will facilitate businesses searching for alternative sources of financing. In addition, an active secondary market and the increased liquidity of securities support the efficient liquidity management of the business sector, which is also reflected in the reduction of risk premiums and interest rates.

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14 The market where newly issued securities are traded.

15 The secondary market is the financial market in which previously issued financial instruments are traded.

5. Financial Market and Trends

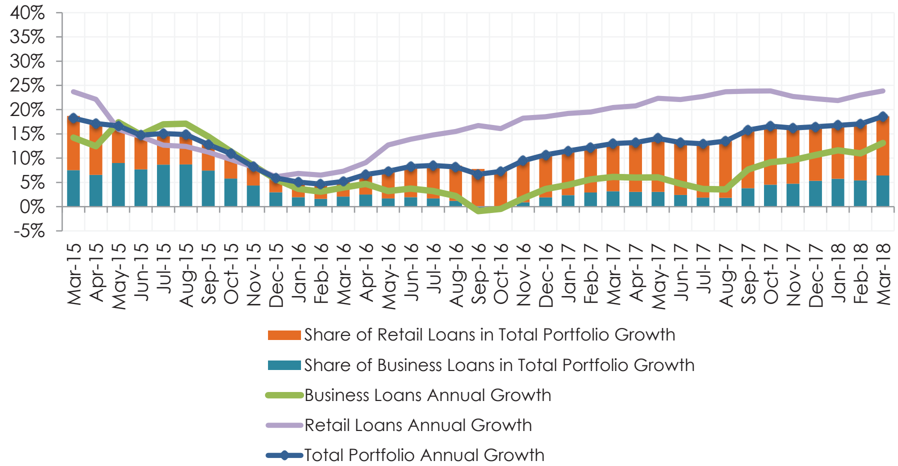
5.1 LOANS

Credit activity improved in the first quarter of 2018. In March, excluding the effect of exchange rate fluctuations and the transformation of one microfinance organization into a bank, the loan portfolio increased by 18.6%. Although this increase can be primarily attributed to the growth of retail loans, business loans have also increased. In March, the growth rate of retail loans increased by 1.7 pp and amounted to 23.9%; meanwhile, loans to legal entities increased by 2.5 pp and equalled 13.2%. The growth of the loan portfolio was primarily driven by an increase in the construction, transport, manufacturing and energy sectors; whereas increases in credit for the trade and agriculture sectors were insignificant.

According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans in the next quarter. In particular, growth is expected to be driven by increased demand from both corporate and small- and medium-sized enterprises.   In contrast, following the NBG's policies, the market for retail loans is expected to decline in relative terms. To promote sustainable credit activity and improve lending conditions, in 2017 the National Bank of Georgia increased the capital requirements for loans on low credit standards. Following best international practice and EU directives, the NBG will continue to implement instruments to protect consumer rights and will extend these to all loan issuers from 1 January 2019.

« According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans in the next quarter. In contrast, following the NBG's policies, the market for retail loans is expected to decline in relative terms.

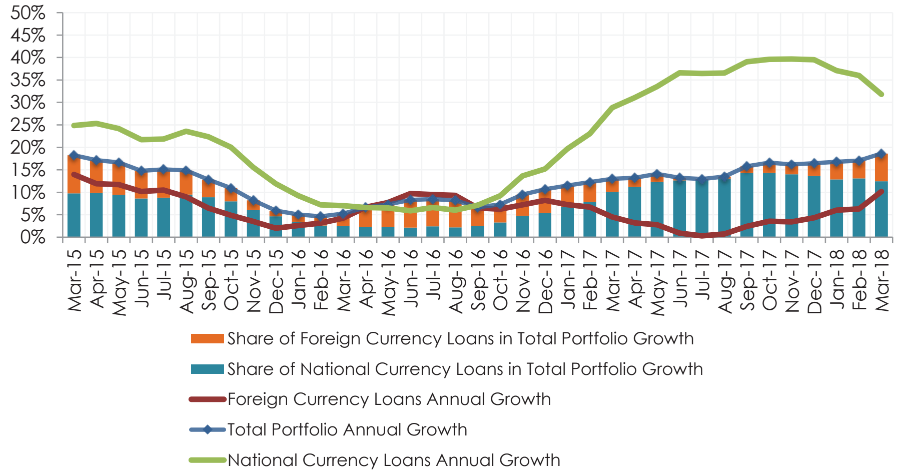
Figure 5.1 Annual Growth Rates Of Retail And Business Loans (Excluding the Exchange Rate Effect)



Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was again driven by an increase in domestic currency loans. In March, the annual growth rate of foreign denominated loans was 10.2%, while loans in the domestic currency grew by 31.8%. It is important to note that the increase in domestic currency loans can be ascribed to the larization measures initiated by the NBG. In the first quarter, the loan larization ratio declined by 1 pp and equaled 42%.

Figure 5.2 Annual Growth Rates Of Domestic And Foreign Currency Loans (Excluding the Exchange Rate Effect)

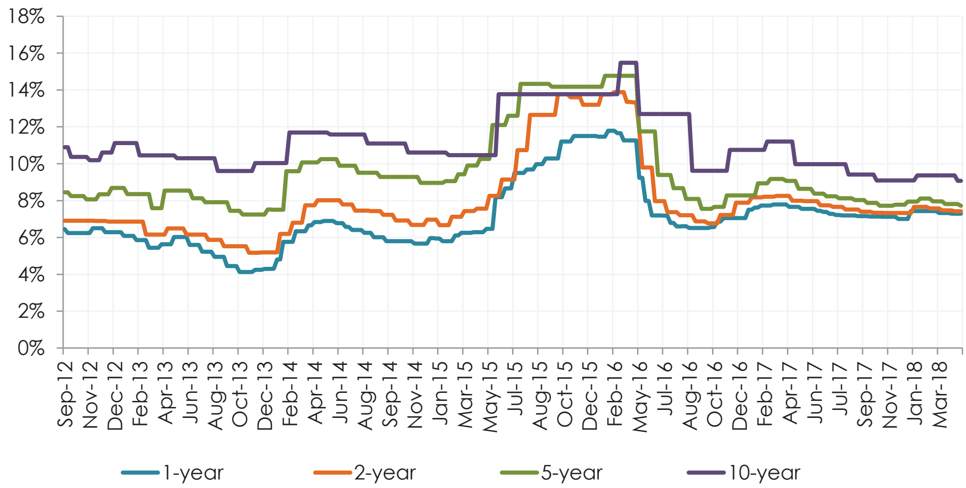


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In April, the monetary policy rate was equal to 7.25%. In the first quarter of 2018, interest rates on government securities declined as a result of lower liquidity risk and expectations of monetary policy easing in the medium term (see Figure 5.3).

Figure 5.3 Interest Rates On Government Securities

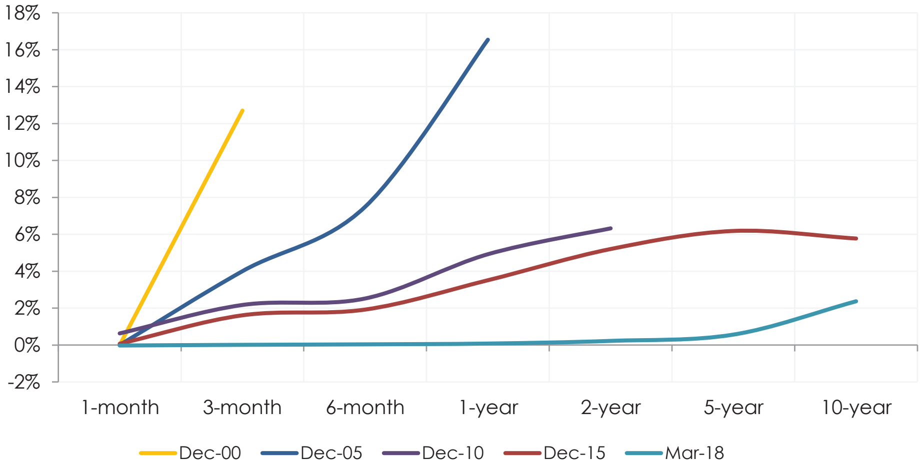


Source: National Bank of Georgia

Compared to the previous quarter, the spread between long- and short-term interest rates declined due to expectations of monetary policy easing in the medium term. It should be noted that this spread has significantly declined compared to the same period of last year, which suggests increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

‹‹ The spread between long- and short-term interest rates has significantly declined compared to the same period of last year, which suggests increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

Figure 5.4 Spread Between The Monetary Policy Rate And The Yield Curve

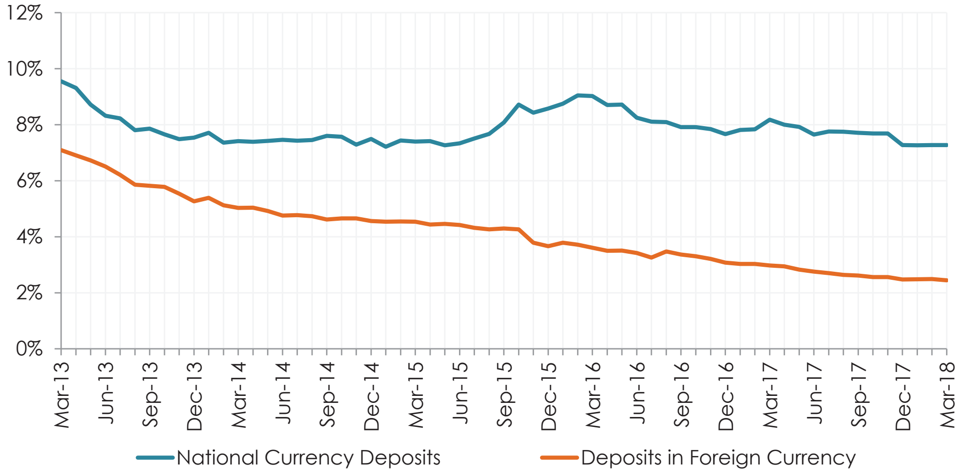


Source: National Bank of Georgia

In March, interest rates on domestic and foreign currency deposits did not change and stood at 7.3% and 2.4% respectively. Representatives of the banking sector do not expect a significant increase in interest rates for deposits in domestic currency in the next quarter; however, interest rates on deposits in USD may increase following the growth of the LIBOR.

« Representatives of banking sector do not expect a significant increase in interest rates for deposits in domestic currency in the next quarter; however, interest rates on deposits in USD may increase following the growth of the LIBOR.

Figure 5.5 Average Interest Rates On Deposits



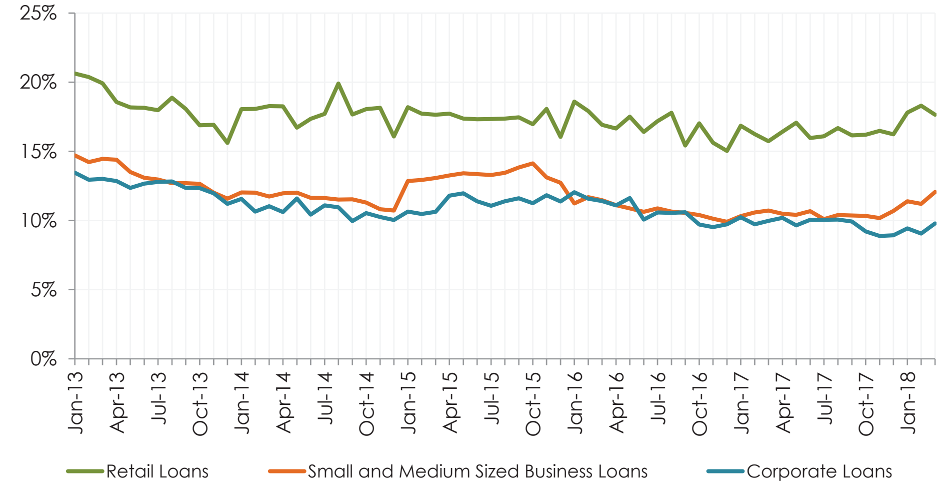
Source: National Bank of Georgia

In the first quarter of 2018, according to the same credit conditions survey, interest conditions for individuals and legal entities became slightly stricter. The stricter credit conditions were caused by the expected increase in the cost of foreign currency funds, which was partly balanced by broader economic trends and competition.

In addition, interest rates and lending margins increased for retail loans and mortgages issued in domestic currency, which were driven by a rise in the cost of funding and a tightening of regulatory standards. Non-interest terms for retail lending, namely the demand for collateral, were eased.

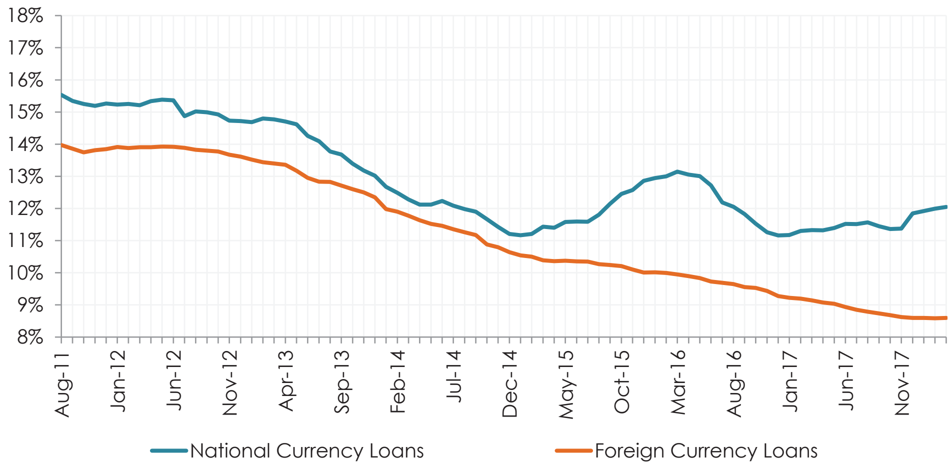
In March, loans issued to small and medium enterprises grew by 1.4 pp compared to December and equaled 12.1%. For corporate loans, interest rates grew by 0.9 pp and amounted to 9.8%, while interest rates on retail loans increased by 1.4 pp and equaled 17.7% (see Figure 5.6). Over the same period, the average interest rate on the stock of legal entities' domestic currency loans increased by 0.2 pp, while average interest rates for foreign currency loans remained unchanged (see Figure 5.7). According to the credit conditions survey, credit supply conditions are expected to become stricter for loans issued to legal entities, while conditions are not expected to change for retail loans.

Figure 5.6 Interest Rate On Loan Flow



Source: National Bank of Georgia

Figure 5.7 Average Interest Rates On Business Loans



Source: National Bank of Georgia

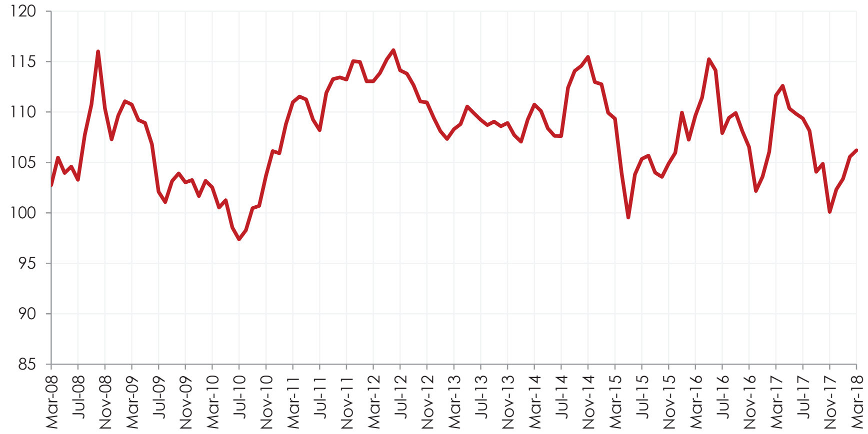
5.3. EXCHANGE RATE

In the first quarter of 2018, the GEL nominal effective exchange rate appreciated against the US dollar by 4.2% compared to the previous quarter, and by 0.04% against the euro. The GEL also appreciated against the Russian ruble and Turkish lira by 1.6% and 4.5% respectively. The nominal effective exchange rate appreciated by 2.4% on a quarterly basis and depreciated by 0.7% year on year.

In the first quarter of 2018, the real effective exchange rate appreciated quarterly by 2.6%, and depreciated by 1.9% on a year-on-year basis (see Figure 5.8).

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture. In particular, in the first quarter of 2018, the adjusted nominal effective exchange rate appreciated by 1.2% year on year, and by 3.0% compared to the previous quarter (see Figure 5.9).

Figure 5.8 Real Effective Exchange Rate (Jan 2008=100)



Source: National Bank of Georgia

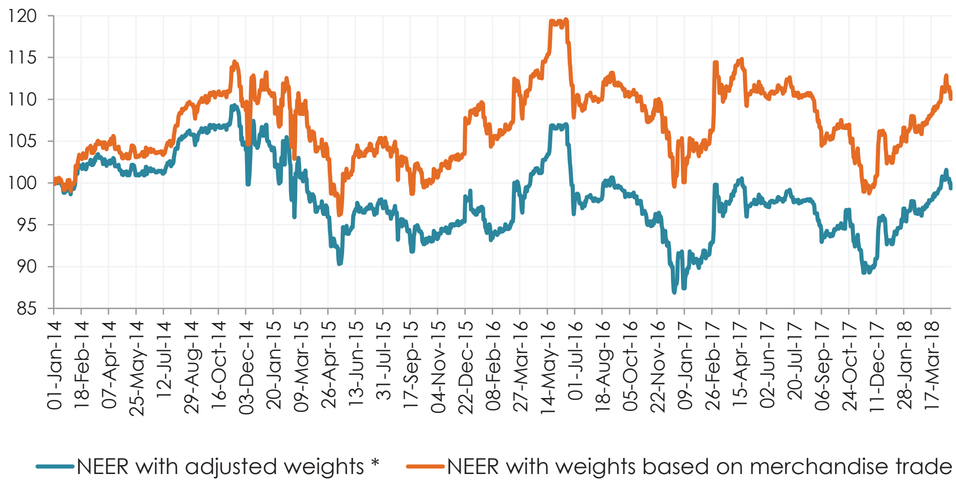
Table 5.1 Effective Exchange Rates Annual Growth

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	-0.7	-1.9	-1.9
Eurozone	-9.3	-7.5	-1.6
Turkey	8.1	1.3	0.2
Ukraine	5.4	-4.2	-0.3
Armenia	3.9	3.9	0.2
The United States	4.7	5.8	0.3
Russia	0.0	0.0	0.0
Azerbaijan	-1.0	-1.7	-0.2
Other	-5.7	-4.6	-0.6

* The growth implies appreciation

Source: National Bank of Georgia

Figure 5.9 Corrected Nominal Effective Exchange Rate



* Calculation of the index for the adjusted nominal effective exchange rate includes weights based on trading with only those goods and services (tourism) that are sold in the currency of a partner country. Increase = appreciation, 31 Dec. 2013 = 100.

Source: National Bank of Georgia

6. Aggregate Demand

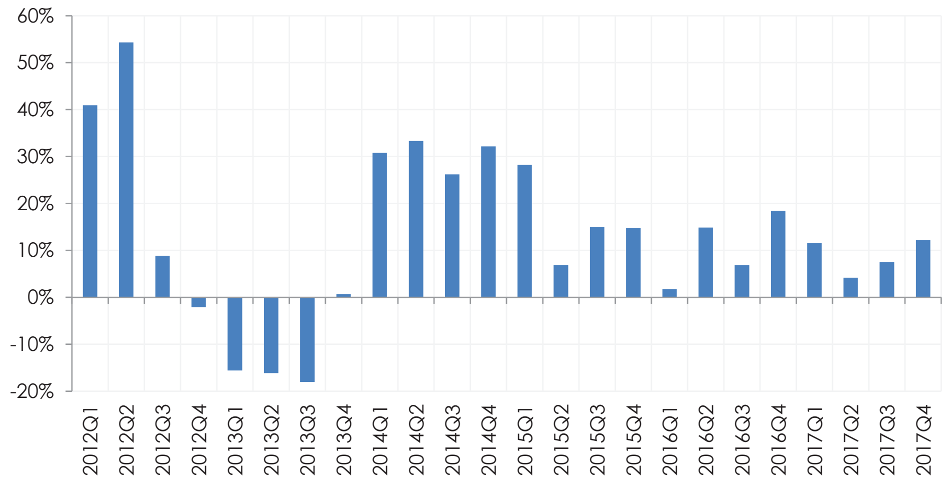
In the fourth quarter of 2017, real GDP growth equalled 5.4%, while 2017 as a whole saw growth of 5.0%. In the fourth quarter of 2017 (as in 2017 overall) the rise in net exports that followed an increase of external demand made the most significant contribution to that growth. Meanwhile, internal demand remains weak – although it has started to increase. According to the forecast, net exports, consumption and investments are all expected to contribute to economic growth in 2018.

‹‹ In the fourth quarter of 2017 real GDP growth equaled 5.4%.

The growth rate of capital formation increased in the fourth quarter of 2017, posting 12.2% growth (see Figure 6.1). Capital formation was supported by increased foreign direct investments, local government spending and private investment. The growth of investments was supported by the growth of capital formation and the increase in inventories.

‹‹ The growth rate of capital formation increased in the fourth quarter of 2017 posting 12.2% growth.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

In the fourth quarter of 2017, the annual growth rate for private consumption[16] increased and totaled 2.4%. Despite that growth, aggregate demand remains weak. The increase of private consumption was driven by a rise in consumer loans, as well as by the growth of disposable income through revenues from remittances and tourism. Moreover, compared to previous quarters, in the last quarter of 2017, government consumption grew significantly.

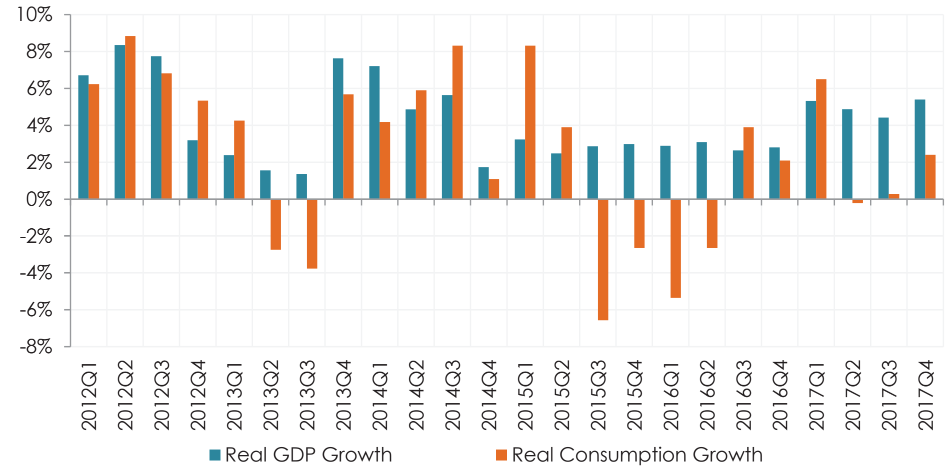
‹‹ In the third quarter of 2017, the annual growth rate for private consumption was positive and totaled 0.3%.

Foreign demand continued to recover in the fourth quarter of 2017 and this was reflected in the improvement of the net export balance. As a result, in the fourth quarter of the year (as in the second and third quarters), net exports remained the main driver of economic growth. In the fourth quarter of 2017, exports maintained high growth, despite the continued growth of prices for export goods. At the same time, it is noteworthy that, compared to the previous two quarters, the real growth rate of exports declined; however, according to preliminary data, this remained high in the first quarter of 2018. In the fourth quarter of 2017, as in previous quarters, the increase in the price index for imported goods neutralized the annual nominal increase in imports. According to preliminary data, this trend persisted in the first quarter of 2018.

‹‹ In the fourth quarter, net exports were the main driver of economic growth.

16 *The growth is calculated considering the average inflation level.*

Figure 6.2 Real GDP And Real Consumption Growth



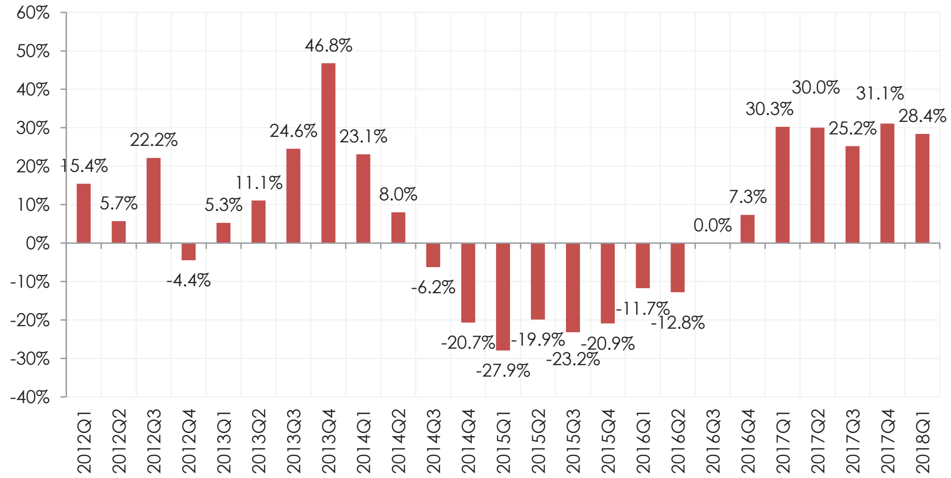
Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

The economic recovery of Georgia's main trading partners persisted throughout 2017 and continued in the first quarter of 2018. This made a positive contribution to the growth of exports. Along with intensified economic activities abroad, registered exports from Georgia increased by 28.4% annually (see Figure 7.1). Exports of intermediate and consumer goods – especially of wines and mineral waters, as well as re-exports of cars, oil products, copper ores and cigarettes – made the most significant contributions to the overall growth.

‹‹ In the first quarter of 2018, registered exports of goods increased by 28.4% annually.

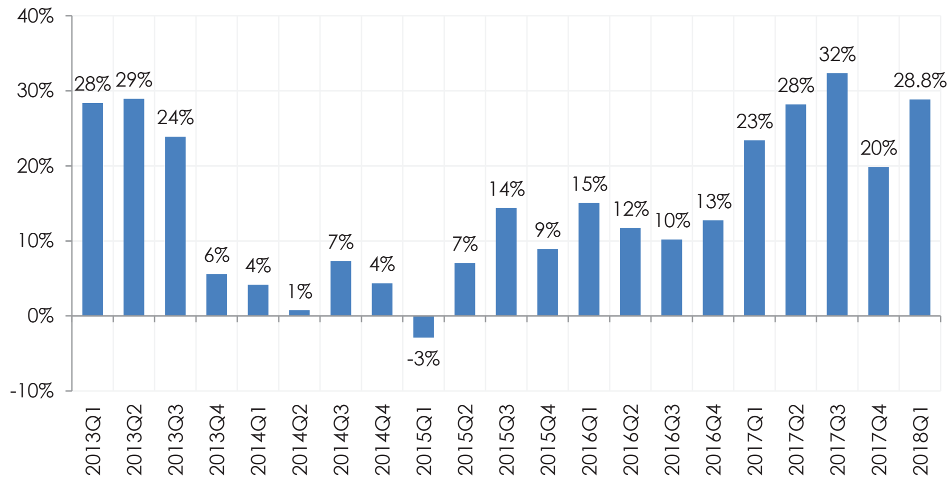
Figure 7.1 Annual Change in Registered Exports Of Goods



Source: GeoStat

The volume of exports from Georgia significantly increased as a result of the economic recovery of major trading partner countries. In the first quarter of 2018, compared to the same period of the previous year, exports to Azerbaijan and Turkey grew by 145% and 71% respectively. In terms of CIS countries, exports also significantly increased to Armenia (83%), Kazakhstan (87%) and Ukraine (84%). Moreover, it is important to note that the volume of exports to the U.S. grew by 18%.

Figure 7.2 Annual Change in Revenues from Tourism



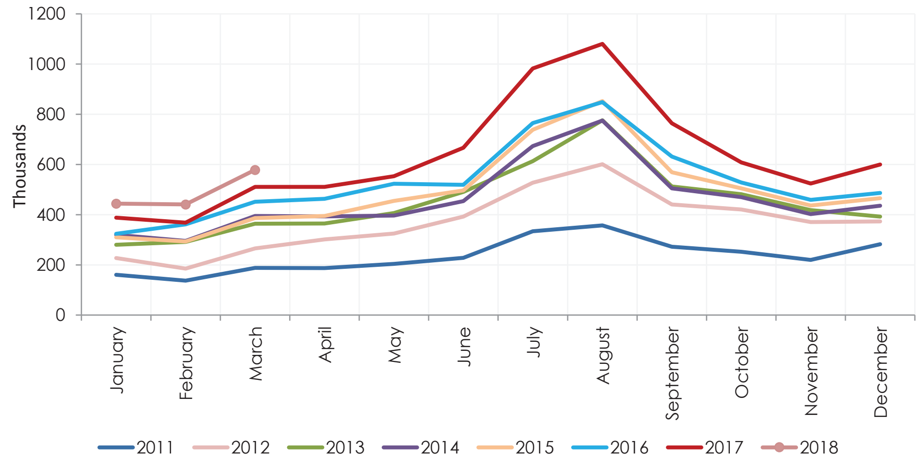
Source: National Bank of Georgia

The improvement of external demand was reflected not only in the growth of exports of goods but also of services, especially tourism. Revenues from tourism increased at high rates throughout 2017, and this trend persisted in the first quarter of 2018 with revenues amounting to 560 million USD, which was 28.8% higher than in the same period last year (see Figure 7.2).

« In the first quarter of 2018, revenues from tourism amounted to 560 million USD, which was 28.8% higher than in the same period last year.

Inflows of international visitors, especially tourists[17], continued to grow. In the first quarter of 2018, the number of foreign visitors who entered Georgia increased by 16% (see Figure 7.3), of which 45% were tourists. Travelers from neighboring countries (Armenia, Turkey and Russia) made a significant contribution to that growth, while tourist inflows from Azerbaijan declined. Moreover, there was a substantial increase in the number of visitors from Iran, Israel and India.

Figure 7.3 Number of International Visitors to Georgia

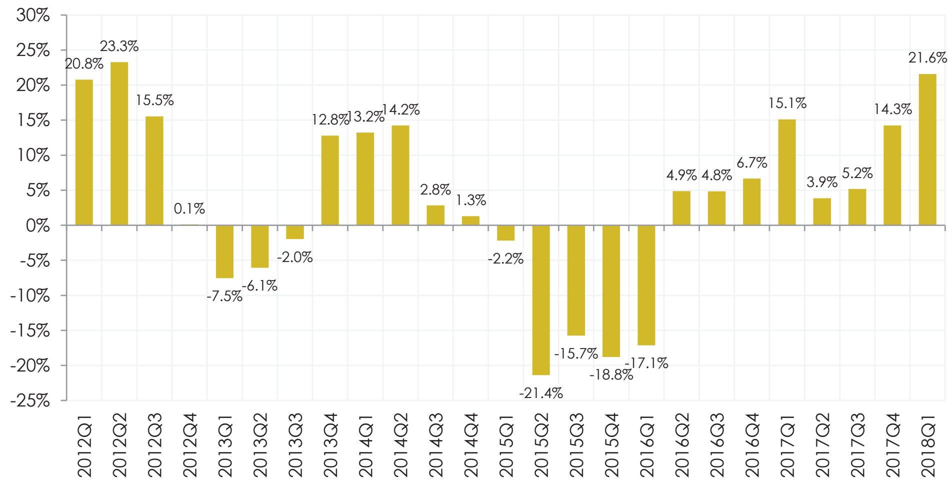


Source: GNTA

In the first quarter of 2018, following the growth of domestic demand, registered imports of goods increased by 21 .6% (see Figure 7.4). It should be noted that imports increased from both CIS and EU countries.

« In the first quarter of 2018, registered imports of goods increased by 21.6%

Figure 7.4 Annual Change in Registered Imports Of Goods



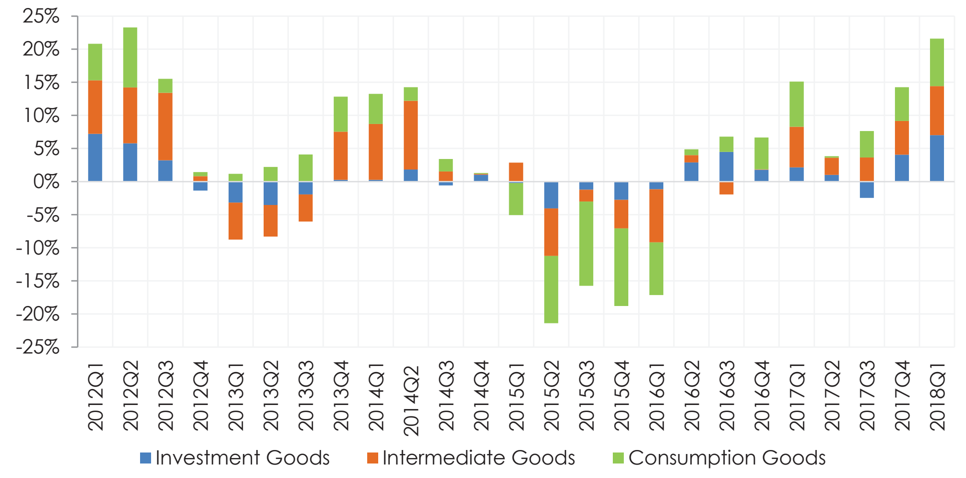
Source: GeoStat

In the first quarter of 2018 , the growth in imports of intermediate and consumer goods continued. In particular, imports of intermediate goods increased by 16.6%, contributing 7.4 percentage points to the overall growth of imports. Imports of consumer goods grew by 17.3%, adding 7.2 percentage points to total imports. Moreover, imports of investment goods, driven by increased Foreign Direct Investment (FDI), also increased, contributing 7 percentage points to the total growth of imports (see Figure 7.5).

« In the fourth quarter, the increase in imports was driven by the growing demand for imports of intermediate and consumer goods.

17 Defined as foreign visitors who crossed the Georgian border and remained in the country for 24 hours or more.

Figure 7.5 Annual Change in Registered Imports By Category Of Goods

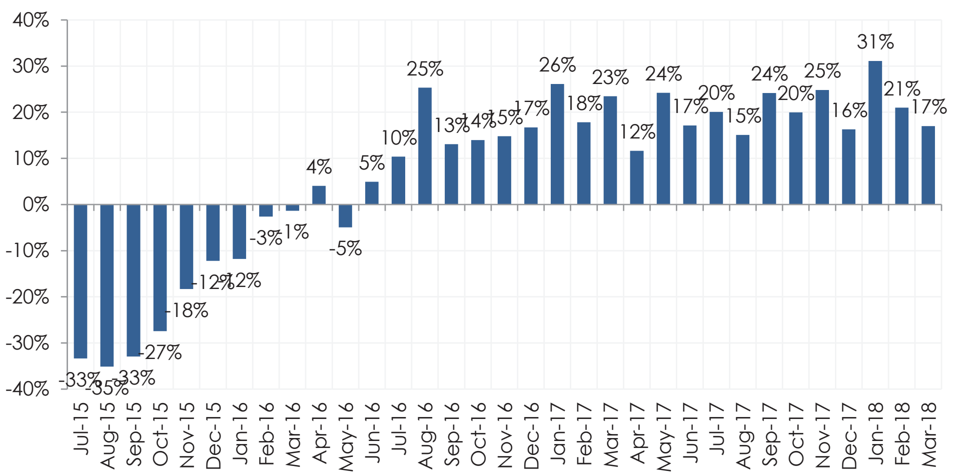


Source: GeoStat

Remittances to Georgia also revealed an increasing trend. In the first quarter of 2018, the volume of money transfers to Georgia increased by 22.4% (see Figure 7.6), which was mainly driven by increased transfers from Russia and the European Union (notably Greece and Italy). The increase in remittances can also be attributed to a substantial increase in money transfers from Israel and Turkey. Moreover, the volume of remittances from the U.S. and Ukraine also slightly increased.

‹‹ In the first quarter of 2018, the volume of money transfers to Georgia increased by 22%.

Figure 7.6 Annual Change in Remittances



Source: National Bank of Georgia

The current account deficit improved and was supported by the increase in net exports, rising remittances and the relatively low growth of imports. In 2017, the current account substantially improved and amounted to 8.7% of GDP. In the fourth quarter of 2017, the current account deficit, compared to the same period of the previous year, improved by 125 million USD and reached 13% of GDP. The increase in exports of goods and services, particularly tourism, positively affected the current account balance. In the fourth quarter of 2017, the investment income balance also improved.

‹‹ In 2017, the current account deficit substantially improved and amounted to 8.7% of GDP.

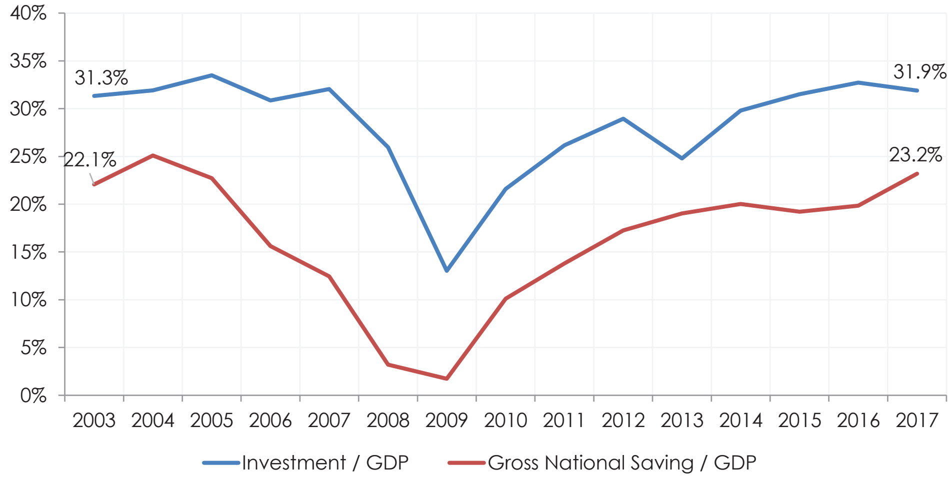
Foreign direct investments remain the primary source of financing the current account deficit. In the fourth quarter of 2017, FDI in Georgia amounted to 497 million USD. The financial sector was the largest recipient of FDI, receiving 30% (149 mln USD). The energy (95 mln USD) and transport (73 mln USD) sectors were also significant recipients of FDI, receiving 19% and 15% of total FDI respectively.

‹‹ Foreign direct investments remain the primary source of financing the current account deficit.

An analysis of investments and savings reveals that the improvement of the current account deficit was driven both by a decrease in investments and an increase in savings. Compared to 2016, the ratio of investments to GDP declined by 0.8 pp and reached 31.9%, while the ratio of savings to GDP grew by 3.3 pp to 23.2% (see Figure 7.7).

‹‹ The improvement of the current account deficit was driven both by a decrease in investment and an increase in savings.

Figure 7.7 Investments and Savings



Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

In the fourth quarter of 2017, GDP grew by 5.4%. The service sector made the most significant contribution to overall growth, contributing 4 pp. Industries added 1.5 pp and the agriculture sector's contribution was negative, standing at -0.2 pp (see Figure 8.1)

« The growth of the trade sector made a substantial contribution to growth.

The growth of the trade sector made a substantial contribution to growth in the fourth quarter of 2017. The annual growth of trade totaled 6.9%, contributing 1 pp to the overall growth – indicating the relative recovery of economic activity and domestic demand. Economic growth was supported by the increased inflow of international visitors. Rising numbers of tourists directly affected the output of the service sector, particularly of hotels and restaurants, transport, and real estate operations. The contribution of those sectors to economic growth equalled 1.1 pp. Meanwhile, the output of the financial sector also significantly increased (growing by 15.4% and making a 0.5 pp contribution to growth).

« Economic growth is supported by the increased inflow of international visitors.

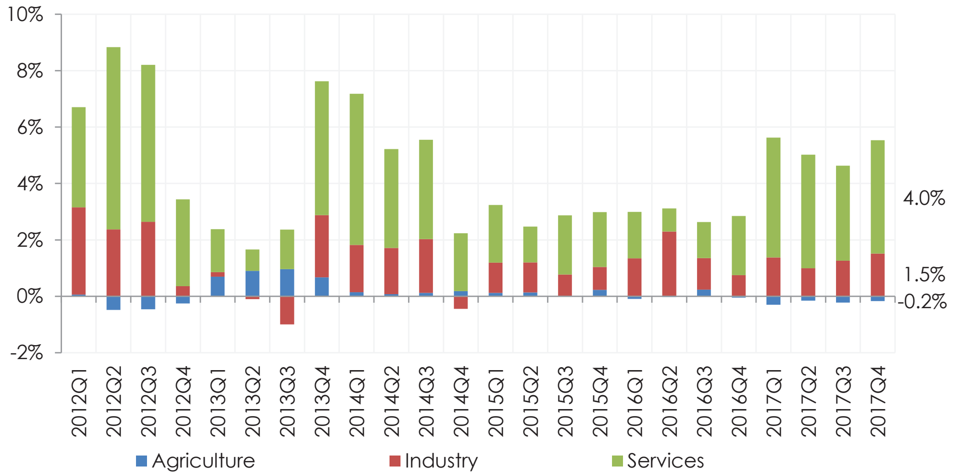
The growth of manufacturing was the most significant among industries. This sector grew by 9.4%, contributing 0.8 pp to the overall growth . This growth can be attributed to the increased production of beverages, metals and metal crafts – all driven by increasing exports. As in previous periods, construction made a significant contribution to economic growth. Construction activity increased in both public and private sectors. In the fourth quarter of 2017, construction grew by 9.5%, adding 0.7 pp to total growth .

« Recovery of foreign demand supported the growth of manufacturing.

« The growth of construction persisted.

The output of the agriculture sector declined over 2017. In the fourth quarter, the sector fell by 2.5% annually, making a negative contribution of -0.2 pp to total growth. The decline of agricultural output can be also attributed to problems caused by the brown marmorated stink bug, which has caused a sharp decline in the production of nuts.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat.

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