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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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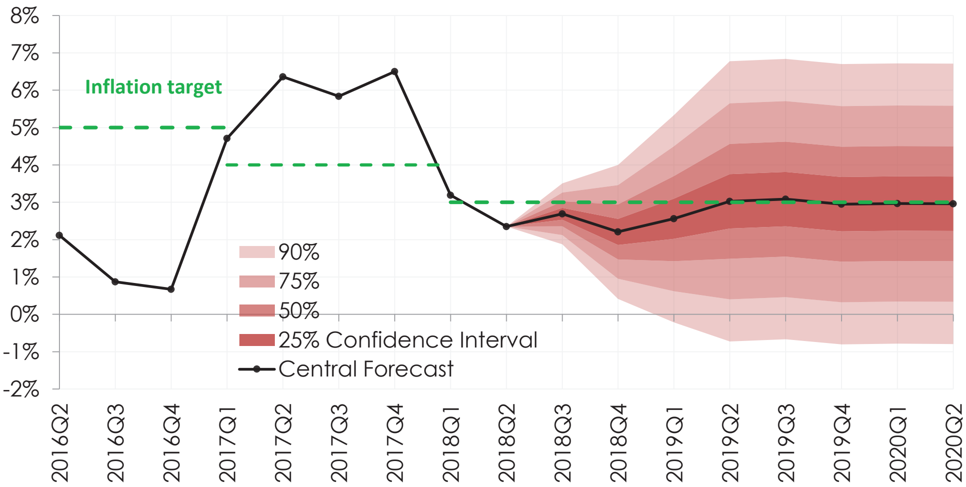
1. Brief Overview

In the second quarter of 2018, **annual inflation** stood lower than expected and equaled 2.4%. This decline was mainly a consequence of the faster-than-expected appreciation of the nominal effective exchange rate, even though domestic demand was stronger than had previously been anticipated. In June, annual inflation was 2.2%, which was close to the NBG's target of 3%.

According to the NBG's forecast, inflation will fluctuate around the target level of 3% in the medium term (see Figure 1.1). The inflation forecast relies on both real economic activity and the nominal effective exchange rate. On the one hand, the improvement in economic activity has lessened the downward pressure on inflation stemming from weaker aggregate demand; on the other hand, the stronger-than-expected appreciation of the nominal effective exchange rate has reduced upward pressure on inflation. Hence, with the appreciation of the real effective exchange rate and improvements in economic activity, inflation is expected to remain around the target.

Figure 1.1 Headline CPI Inflation



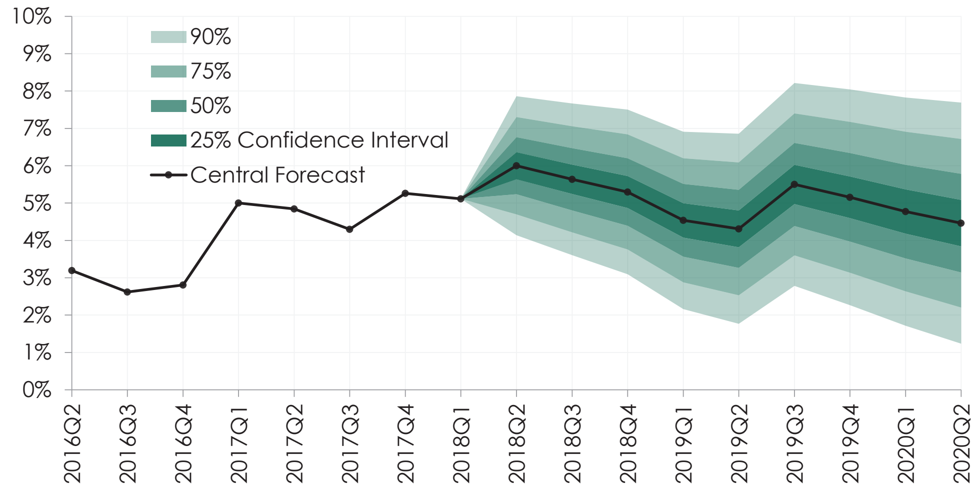
Source: National Bank of Georgia

Real economic growth in 2017 was higher than expected and stood at 5%. This positive trend continued in the first half of 2018, with growth, according to preliminary estimates, reaching 5.7%. The improvement in economic activity was driven by favorable trends in the external sector and the recovery of domestic demand. In particular, remittances and exports of goods and services significantly increased. Moreover, a growth of imports reflects the recovery of domestic demand, which, in turn, was supported by improved consumer and business sentiment and an increase in lending.

The National Bank of Georgia has revised its **economic growth forecast** for 2018 from 4.8% to 5.5% (see Figure 1.2). This revision was motivated by the improvement in both domestic and external demand. According to the forecast, net exports, consumption, and investments will all positively contribute to economic growth over the year. These, in turn, will be supported by foreign inflows, improved business sentiment, credit growth, and the capital spending of the government. Based on the revised assumptions, the output gap is expected to close at a faster pace than had previously been expected, which is in line with the revised forecast of economic growth.

It should be noted that monetary policy cannot aim to fully neutralize temporary factors affecting the inflation rate in the short run. That objective could only be reached through policy changes that might lead to extreme fluctuations in economic growth and employment. The National Bank of Georgia thus tries to strike a balance in its decision making, considering the expected timeframe over which the inflation rate will return to the target level and estimating the possible effects on economic growth.

Figure 1.2 Annual Real GDP Growth

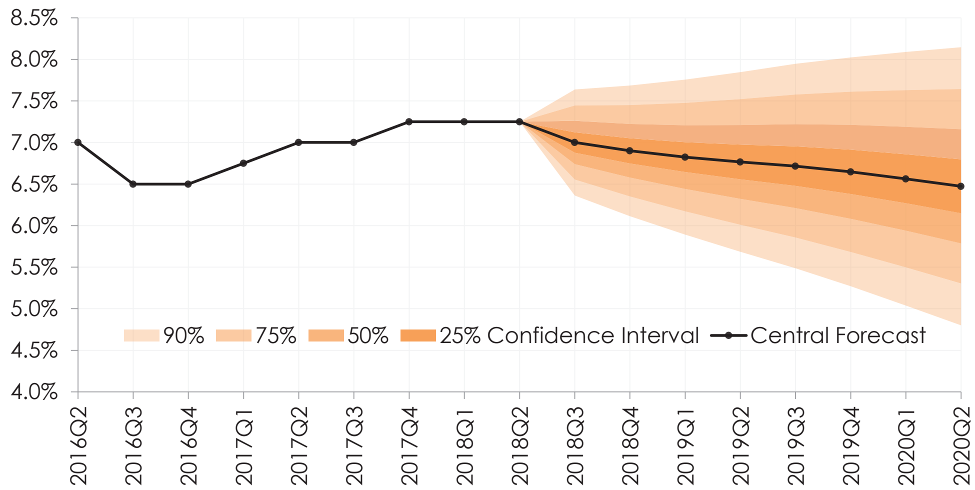


Source: National Bank of Georgia

To curb inflationary expectations, the National Bank of Georgia gradually increased the monetary policy rate from 6.50% to 7.25% over the course of 2017. However, based on the current macroeconomic forecast, following the decline of inflation to its target level of 3%, **the monetary policy rate is expected** to decline to its neutral level in the medium term (see Figure 1.3). Although economic activity has improved at a faster pace than expected, the inflationary risks stemming from the effective exchange rate have declined. As a consequence, the moderately tight monetary policy stance has been slightly loosened. However, in order to soften the risk of demand increasing above the potential level of output, monetary policy rate is expected to decline to its neutral level at a slower pace than previously estimated, only doing so after a 2-year period.

It should be noted that the monetary policy rate forecast is not a commitment to 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

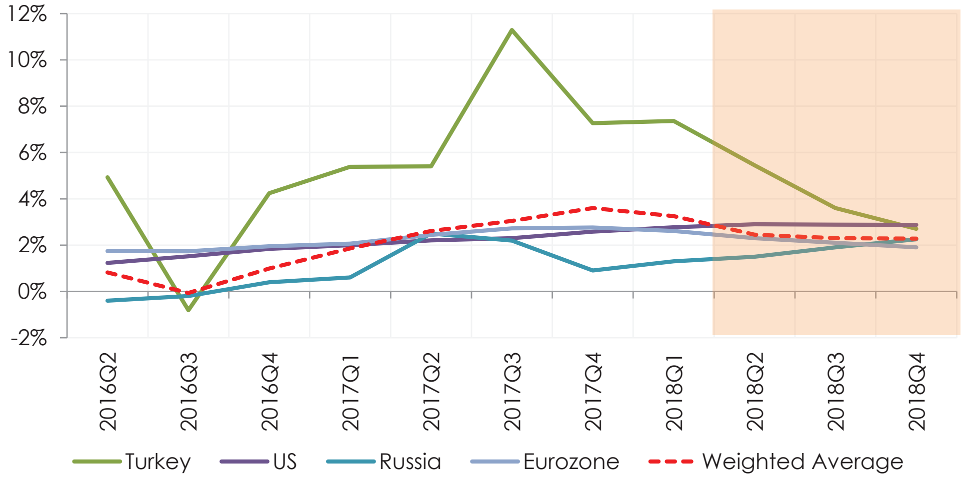
The forecasts are dependent on **exogenous factors and contain risks in both upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth of Georgia's main trading partners, the global trends of the euro and US dollar, and international prices of 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 macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

According to the International Monetary Fund, positive business sentiment, benign financial conditions and, to some extent, an increase in international commodity prices, will drive the estimated 3.9% global growth in 2018.[1] However, compared to previous forecasts, risks to growth projections have soared. In particular, the new, US-initiated "trade war"[2] poses a risk to global economic growth and suggests that, compared to previous forecasts, growth may be less even.[3]

Figure 2.1 Real GDP Growth of Economic Partners



Source: Bloomberg; National Bank of Georgia.

At the beginning of the year, the growth of the **eurozone** slowed as a result of a strengthening of the euro and weaker global demand. Moreover, the election of new governments in Italy and Spain increased political uncertainty and the US-launched "trade war" added threats to the European economy through tariffs on exported steel and aluminum, which could be further extended to car exports. Considering these factors, the IMF has revised its eurozone growth forecast downward, from 2.4% to 2.2%.[4]

Based on consensus estimates[5], economic activity in the **US** has improved, being supported by high investment, tax cuts, and supportive conditions on the labor market. The negative expectations related to the "trade war" with partner countries thus appear to have had a less significant impact on the private sector. Moreover, fiscal stimulus is expected to significantly increase domestic demand while reducing the unemployment rate. As a result, the IMF expects growth of 2.9% for the US economy over 2018[6], which is 0.4 percentage points (pp) higher than in the previous forecast.[7]

Following the growth above its estimated potential level in 2017, **Turkey's** economy

1 *International Monetary Fund. 2018. World Economic Outlook Update. Washington, D.C., July.*

2 *The US has imposed tariffs on a small number of imported commodities; however, these tariffs may also be extended to other imported goods. This move may be followed by counter-tariffs from other countries, resulting in a decline in international trade.*

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

4 *Ibid.*

5 *Consensus estimates are the averages of market analysts' survey.*

6 *International Monetary Fund. 2018. World Economic Outlook Update. Washington, D.C., July.*

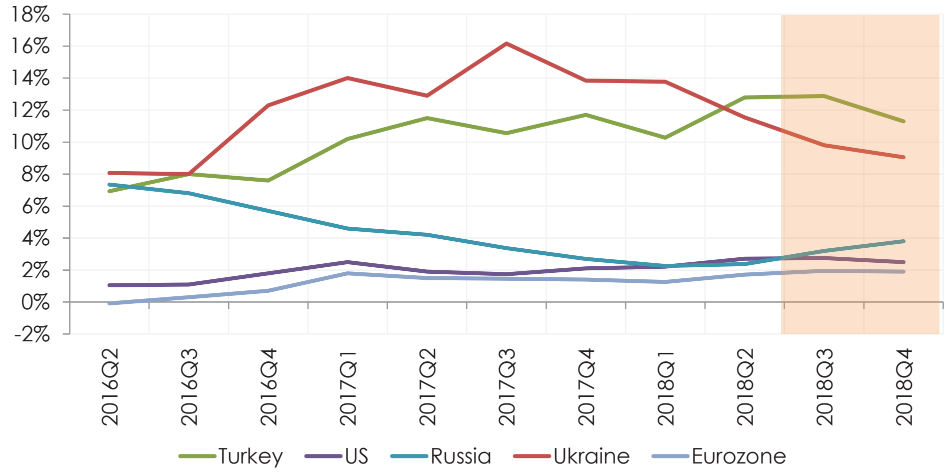
7 *International Monetary Fund. 2018. World Economic Outlook: Cyclical Upswing, Structural Change. Washington, D.C., April.*

faces significant challenges in 2018. In particular, the central bank's independence has weakened, which has led to a sharp depreciation of the Turkish lira since the beginning of the year and an increase in inflation. Economic activity has also weakened following the widening of the current account deficit. However, strong fiscal stimulus remains the main driver of economic growth and supports the growth of private consumption. As a result, economic growth in the first quarter equaled 7.4%. Nonetheless, the World Bank estimates that, given tighter financial conditions[8], an increasing current account deficit and emerging geopolitical threats, Turkey's economy is expected to grow by 4.5% in 2018, while inflation will remain in double-digits.[9]

In the first quarter of 2018, following an increase in industrial output and rising international commodity prices, GDP growth in **Russia** reached 1.3%. Although investments remain low, this economic recovery is expected to persist in the second quarter. According to the World Bank's estimates, given the 1.5% increase in real wages and consumer goods, real GDP growth is expected to be modest over 2018, while inflation is expected to remain low, in the range of 2-4%.

In the first quarter of 2018, economic activity in **Ukraine** increased to 3.1%, revealing signs of recovery. This growth was driven by an increase in domestic demand, improvements on the labor market, declining inflation and favorable lending conditions. However, the pace of the implementation of reforms remains slow, worsening the sentiment of international financial institutions and investors. Moreover, the geopolitical threats facing the country remain. The World Bank expects growth of 3.5% in Ukraine over 2018.[10]

Figure 2.2 Headline Inflation Rates of Economic Partners



Source: Bloomberg; National Bank of Georgia.

Following the trend of extensive growth seen in 2017, **Armenia's** GDP grew by 10% in the first quarter of 2018. Latest estimates suggest that this growth has slowed down in the second quarter as a result of lower growth in the industrial sector. Nevertheless, the growth of exports has remained higher than anticipated. Moreover, a significant increase in lending has driven growth of private consumption – all of which has been supported by the stabilization of the political situation following the change in government. According to the World Bank's estimates, given favorable trends in the external sector, Armenia's growth will stand at 4.1% in 2018.[11]

Low commodity prices on international markets over 2015-2016 drove **Azerbaijan** into a severe recession. A subsequent renewal of growth was triggered by increasing activity in the non-oil sector, and growth stood at 0.1% in 2017. This positive trend persisted in the first half of 2018. Moreover, consumer price inflation has fallen significantly from the double-digit inflation observed in 2017 – a decline supported by reduced inflation expectations that followed the steadying macroeconomic outlook. Given the relative increase in commodity prices on international markets, real GDP growth in Azerbaijan is expected to reach 1.8% over 2018.[12]

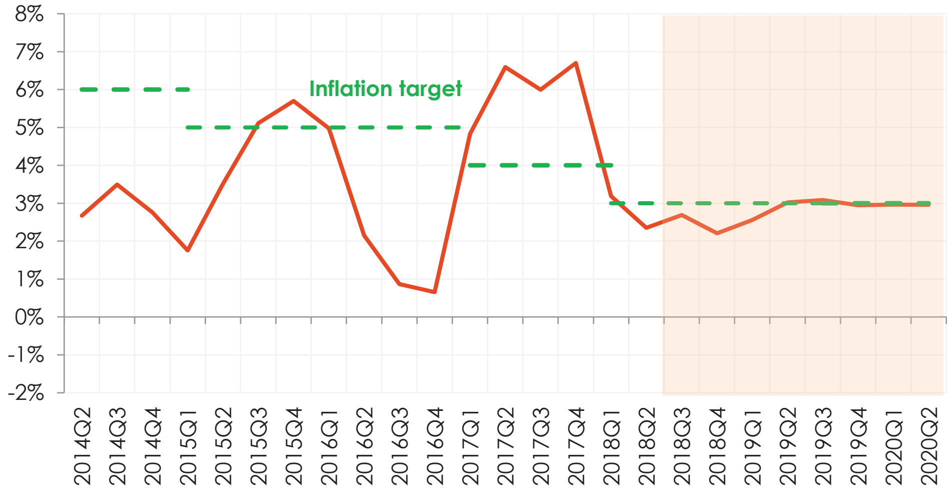
8 *In response to the lira's depreciation and double-digit inflation, the Central Bank of Turkey increased its policy rate in May 2018.*
9 *World Bank. 2018. Global Economic Prospects, June 2018: The Turning of the Tide? Washington, D.C.: World Bank.*
10 *Ibid.*
11 *Ibid.*
12 *Ibid.*

Both the US Federal Reserve and the European Central Bank (ECB) continue to phase out their monetary policy easing programs. In June, the FED increased interest rates, while the ECB reduced the monthly purchase of securities. Some of Georgia's trading partners have reduced their monetary policy rates following a decline in inflation and inflation expectations.

2.2 MACROECONOMIC FORECAST

In the second quarter of 2018, the annual inflation rate was 2.4%, which was slightly lower than previously projected. The higher-than-expected appreciation of the nominal effective exchange rate reduced the pressure from imported inflation and neutralized the impact of the greater-than-expected improvement in domestic demand. Moreover, the stabilization of the inflation around the target since the start of the year lowered inflation expectations compared to last year when inflation overshot the target due to temporary factors.

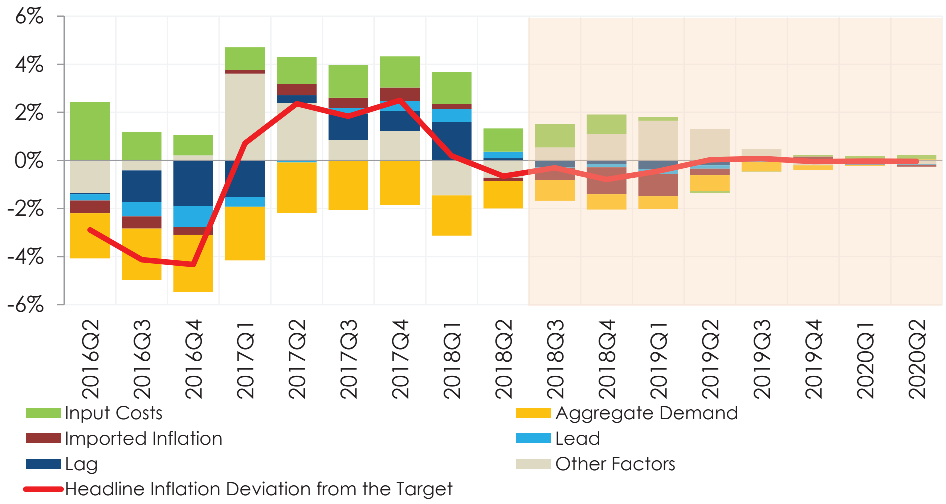
Figure 2.3 Headline CPI Inflation



Source: National Bank of Georgia.

According to the forecast, inflation is expected to fluctuate around the target level in 2018 and over the medium term (see Figure 2.3). Inflation will remain around the target level due to several factors counterbalancing each other. On the one hand, increased tariffs on electricity and water, coupled with increased prices on commodities, will place upward pressure on inflation; on the other hand, the strengthening of

Figure 2.4 Inflation Deviation from the Target and its Decomposition[13]



Source: National Bank of Georgia.

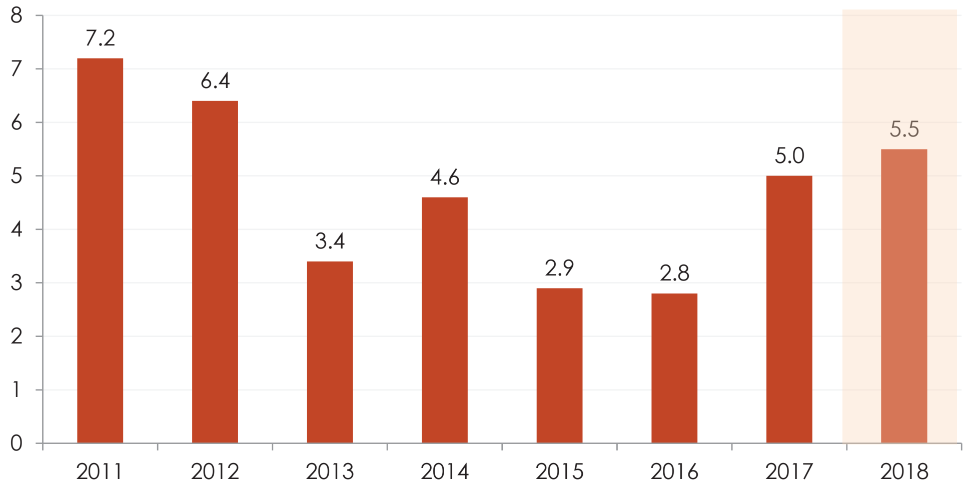
13 *In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.*

the effective exchange rate will put downward pressure on inflation given the below-potential domestic demand. Nevertheless, the output gap is expected to close at a faster pace than previously anticipated, supporting the faster return of inflation to the target level (see Figure 2.4).

A range of less probable, yet still plausible, factors may cause the **inflation rate to deviate** from its projected path. On one hand, a greater-than-expected increase in consumer prices could be driven by a deterioration of geopolitical and economic conditions in the region. A realization of such risks may lead to increased risk premiums for the countries in the region, including Georgia, which would be reflected in a depreciation of regional currencies and upward pressure on inflation. Higher-than-expected inflation could also follow a sharp increase of commodity prices on international markets. On the other hand, consumer prices may be lower than expected if the US dollar depreciates against its main trading partner countries as a result of an escalation of the "trade war". The strengthening of the lari exchange rate under such circumstances would reduce inflation expectations and the loan payments of firms, resulting in lower inflation.

In the first quarter of 2018, **real GDP growth** equaled 5.3%, while growth in the first six months of the year reached 5.7%. This higher-than-expected growth was driven by a significant increase in tourism revenues and exports. Moreover, an 18% growth in remittances, coupled with a rise in lending since the beginning of the year, triggered the recovery of domestic demand.

Figure 2.5 Real GDP Growth



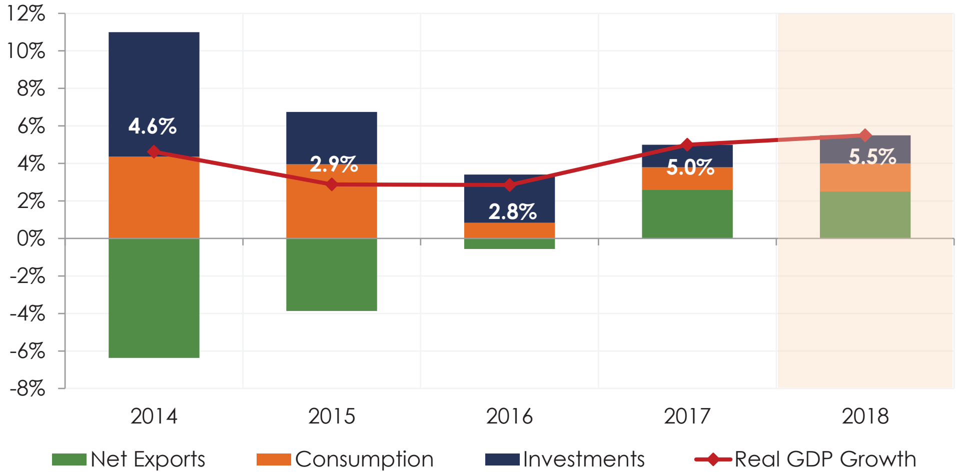
Source: National Bank of Georgia.

According to current estimates, the sharp increase in economic activity observed in the last few months is likely to be temporary, since demand remains below its estimated potential in the short term. However, the recent increase in economic activity has promoted a **revision of the real GDP growth forecast** in an upward direction, moving from 4.8% to 5.5% (see Figure 2.5). This revision was motivated by changes in both the domestic and external macroeconomic outlook. In particular, given the competitiveness of the GEL exchange rate, the growth of 2018 thus far has been driven by rising exports; however, over the year as a whole consumption and investment will also make a significant contribution (see Figure 2.6).

The external macroeconomic outlook is **a major source of risk for the GDP forecast**. Any deterioration of the geopolitical environment will increase sovereign risk premiums in the region, negatively affecting business sentiment and investment. In such conditions, economic growth will be lower than predicted. Other sources of risk for the GDP forecast are the dynamics of the euro and dollar exchange rates on the international market. These are transmitted to Georgia through trade and expectations channels, affecting economic activity and the lari exchange rate. However, if economic activity in Georgia's main trading partners increases faster than previously anticipated, GDP growth will be higher than forecast as a result of the increase in external demand and improved investor sentiment. Moreover, as long as the trends of improved business sentiment and increased lending persist, the output gap will close at a faster pace and GDP growth will be higher than anticipated.

In the first quarter of 2018, the **current account deficit** equaled 11.6%, while in the

Figure 2.6 Real GDP Growth Decomposition



Source: National Bank of Georgia

last four quarters the deficit stood at 9%. The improvement in the current account over the last year followed the increase in external demand. According to short- and medium-term forecasts, the ratio of the current account deficit to GDP will stay in single-digit figures as long as trading partner countries have stable economic environments that support a modest growth trend of exports and other revenues from the external sector.

Inflation forecast targeting is the most efficient framework to reach the ultimate goal of the National Bank of Georgia: price stability. To ensure that inflation reaches the target level in the medium-term, the NBG uses the monetary policy rate. Under the inflation targeting framework, the NBG takes into account aggregate output. Hence, responses to supply side shocks are gradual and balanced in order to avoid high output volatility. In times of uncertainty, gradual changes to the policy rate are considered optimal for efficiently controlling long-term interest rates. The inflation forecast includes the interest rate forecast, which takes each of the above-mentioned factors into account.

According to the forecast, in the medium-term, the **steady decline of short-term interest rates** towards the neutral level is conditioned on inflation remaining around the target level and on the moderate improvement in economic activity. According to the baseline scenario, the gently declining monetary policy rate path is a response to the factors mentioned above (see Figure 1.3). In particular, although economic activity improved at a faster pace than previously expected, the upside risks stemming from the exchange rate declined. Nonetheless, to avoid the risk of overheating, the monetary policy rate will return to its neutral level over a longer time horizon (over 2 years) than previously anticipated. The neutral policy rate level is estimated to range between 5-6%.

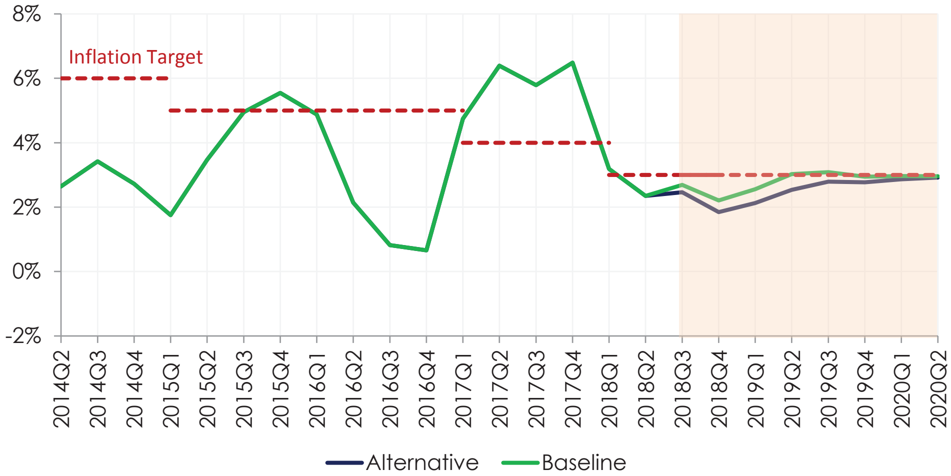
It should be stated that the forecast of the **monetary policy rate is not a promise from the National Bank of Georgia regarding future decisions**. It only reflects the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. 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

In the alternative forecast scenario, domestic demand increases at a slower pace than in the baseline forecast. In 2018, the significant increase in GDP was driven by a combination of both domestic and external demand. The relatively high growth rate of lending is among the factors strengthening domestic demand, with credit activity increasing by approximately 20% YoY in June. Under the alternative forecast scenario, the growth of credit activity declines, reducing domestic demand and causing economic activity to slow. Hence, both GDP growth (see Figure 2.8) and inflation (see Figure 2.7) will be lower than in the baseline scenario.

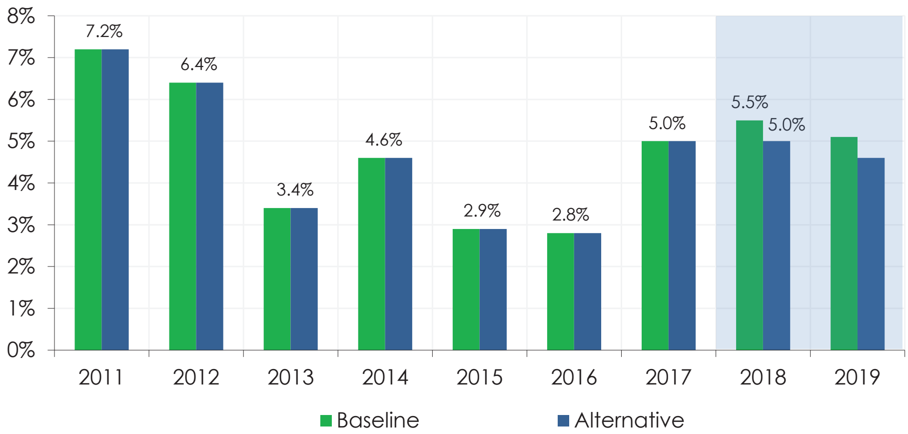
In the alternative scenario, inflation is lower than in the baseline forecast due to weaker demand. According to the alternative scenario, during 2018-2019 inflation will be 0.4 percentage points lower than in the baseline scenario (see Figure 2.7). In response, to promote domestic demand and push inflation towards its target level, the monetary policy trajectory will shift down by 0.4 percentage points (see Figure 2.9). Moreover, lower domestic demand will result in lower economic growth, which will stand at 5% for 2018 (see Figure 2.8). As a result, the easing of monetary policy will drive inflation to the target level of 3% in the medium term.

Figure 2.7 Headline CPI Inflation According to Baseline and Alternative Forecasts



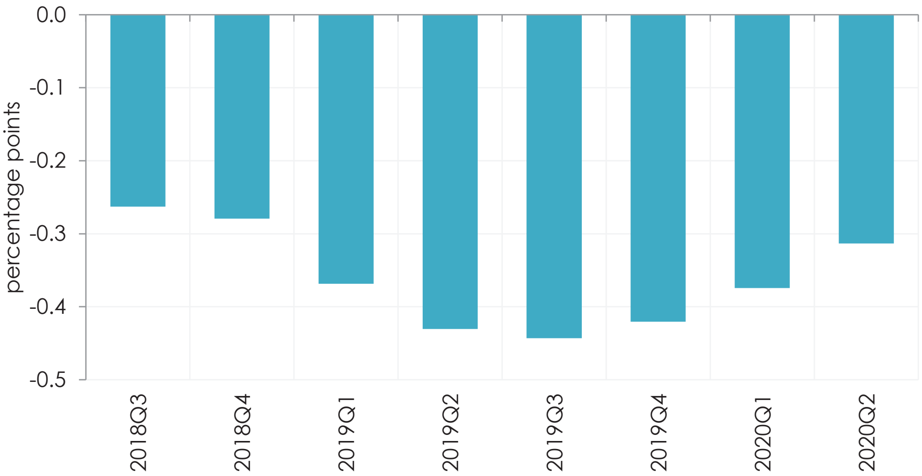
Source: National Bank of Georgia

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

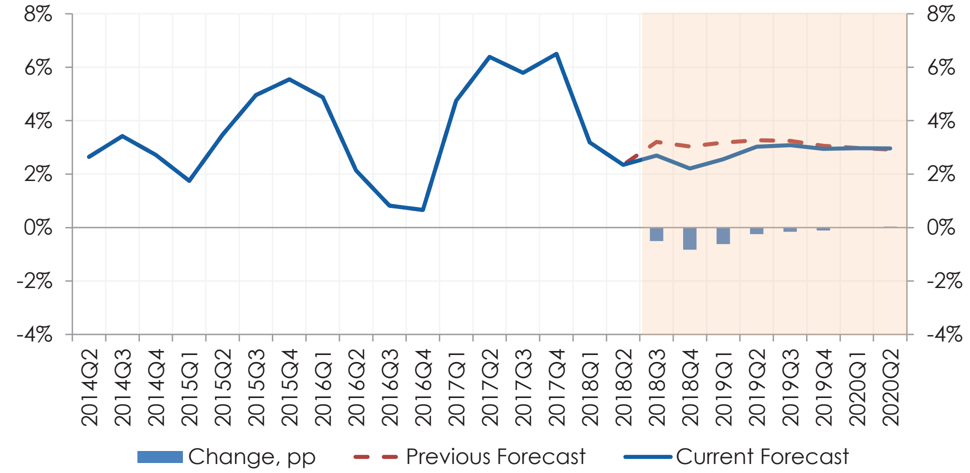


Source: National Bank of Georgia

2.4 COMPARISON WITH THE PREVIOUS FORECAST

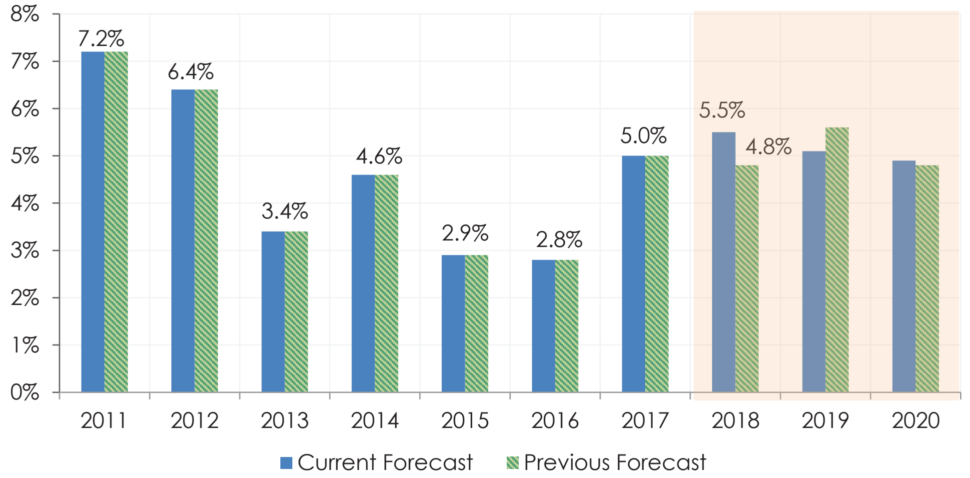
Although aggregate demand was higher than expected, the inflation forecast for 2018 has been revised in a downward direction compared to prediction of the previous quarter (see Figure 2.10). This revision was mainly motivated by a relative strengthening of the nominal effective exchange rate, which partly neutralized the inflationary pressures that stemmed from increasing commodity and oil prices on international markets. It is worth noting that, since the beginning of the year, domestic inflation has fallen following a decline in intermediate costs. According to the revised forecast, given the improvement of domestic demand and the strengthening of the effective exchange rate, inflation is expected to remain around the target level.

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



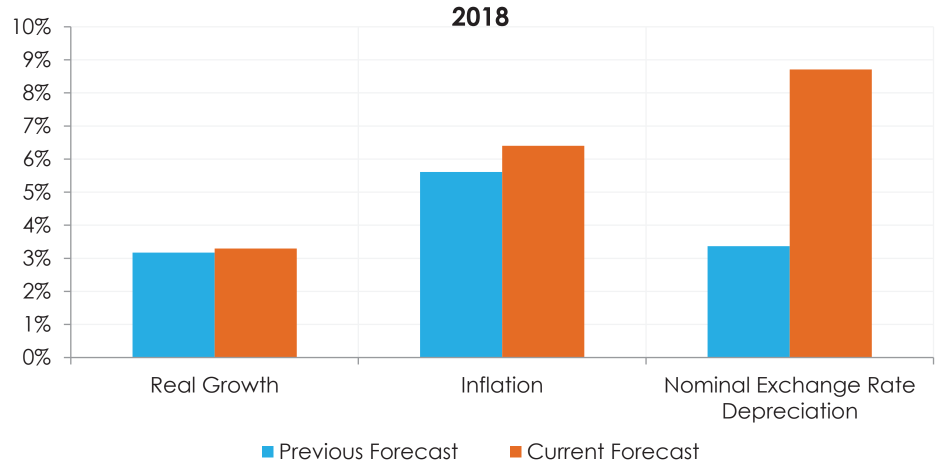
Source: National Bank of Georgia

As for economic activity, compared to the previous quarter, the GDP growth forecast was revised in an upward direction to 5.5% (see Figure 2.11). This revision was motivated by the greater-than-expected recovery of domestic demand, coupled with stronger external demand following the favorable economic conditions observed in Georgia's main trading partner countries. The growth of external demand was reflected in higher exports. As a result, revenues from the export of services (tourism) have increased significantly.

Assumptions regarding economic growth, inflation and the exchange rates of Georgia's main trading partners are particularly important for the macroeconomic forecast as changes in these assumptions affect both forecast itself as well as the associated risks (see Figure 2.12).

Assumptions regarding the external sector were revised slightly upwards in light of the improved economic outlook of Georgia's main trading partners, while expectations about a depreciation of the currencies of those countries grew. This change in assumptions was primarily motivated by rising expectations of a depreciation of the Turkish lira; however, inflation in Turkey remains high, thus depreciation will not have a meaningful effect on the real effective exchange rate. However, it is worth noting that both the Russian ruble and the euro have also slightly depreciated. Assumptions regarding inflation expectations in trading partner countries were also revised upward, mostly due to the expectations of higher inflation in Turkey.

Figure 2.12 Changes in External Sector Assumptions for 2018[14]



Source: Bloomberg

Box 1 The accuracy of the NBG's inflation forecasts

Under the inflation targeting regime, the successful implementation of monetary policy heavily depends on reliable inflation forecasts. Since the transmission of monetary policy to the real economy is gradual, monetary policy instruments can only affect future inflation – a fact that emphasizes the need for policy decisions to be fully consistent with inflation forecasts. However, the accuracy of inflation forecasts remains a challenge, even for countries whose central banks operate under an inflation targeting framework.

Recent research by Duncan and Martínez-García (2018)[15] reveals that the accuracy of inflation forecasts can be efficiently measured through a comparison with those made using a random walk model. The authors demonstrate that the inflation forecasts of 14 emerging economies – each of which were made by complex models – appear to be less accurate than forecasts based on a simple random walk model. The authors considered a variant of a random walk model where the expected annual inflation in the following quarter is equal to the average annual inflation rates of the last four quarters:

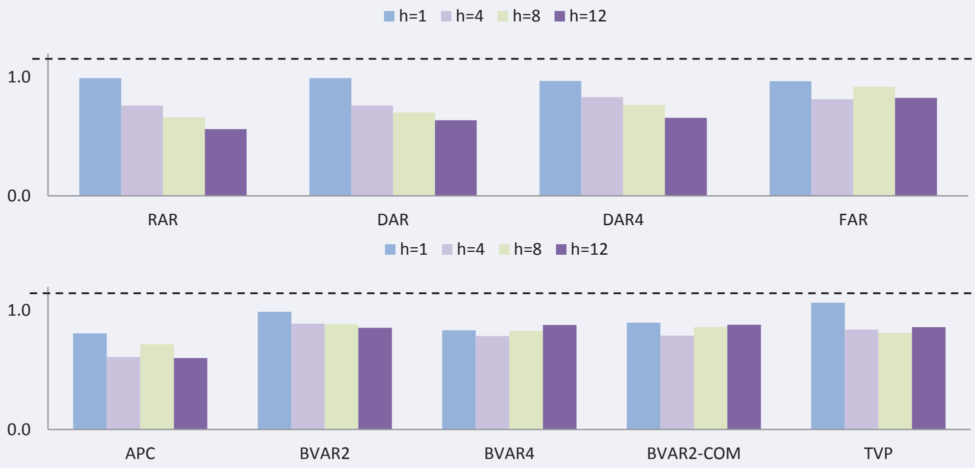
$$E_t(\pi_{t+h}) = \frac{1}{4}\sum_{i=1}^{4} \pi_{t+1-i}$$

Using the historical data of 14 countries, the results from the simple random walk model were compared to the results of different types of alternative and more complex models that were used in practice. It was determined that, in almost all cases, the alternative models were worse at predicting inflation on a horizon of 1, 4, 8 and 12 quarters. Moreover, the differences were more apparent over a longer time horizon (see Figure 2.13).

14 Calculations are based on the forecasts for the five main trading partners of Georgia: (the US, the EU, Turkey, Ukraine and Russia).

15 Duncan, R. & Martínez-García, E. (2018), "New Perspectives on Forecasting Inflation in Emerging Market Economies: An Empirical Assessment", Globalization and Monetary Policy Institute, Working Paper No. 388.

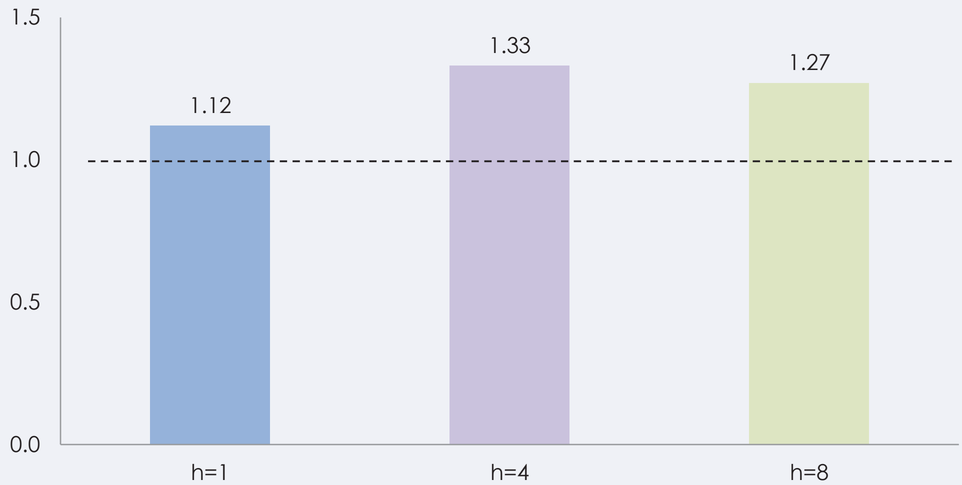
Figure 2.13 Comparison of marginal errors of different models[16]



Source: Duncan and Martínez-García (2018)

In order to assess the accuracy of inflation forecasts in Georgia, the procedure described above was carried out with regard to the National Bank's Forecasting and Policy Analysis System (FPAS). A comparison of the forecast errors of the FPAS with the errors of the random walk model demonstrated that the FPAS's inflation forecasts were more accurate (see Figure 2.14).

Figure 2.14 Comparison of forecast errors of the random walk model to those of the National Bank of Georgia



Source: National Bank of Georgia

It is also important to note that, in contrast to the results of other countries, the relative accuracy of the FPAS rises with an increase of the forecast horizon – adding practical value to the NBG's forecasts in the efficient conduct of monetary policy.

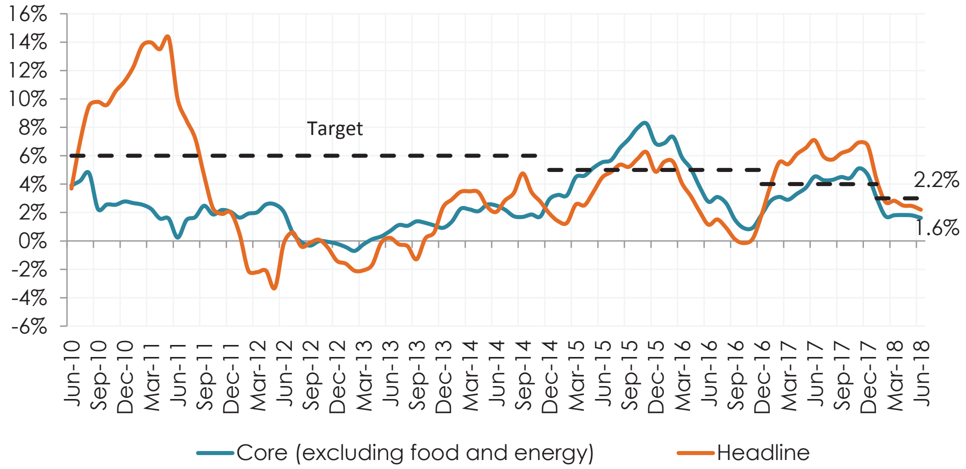
16 *Measurement of forecast errors is made through the root mean square of prediction error (RMSPE). Less than 1 implies that the random walk model prediction error is smaller than that of the alternative model (see Duncan and Martínez-García, 2018).*

3. Consumer Prices

From the beginning of 2018, inflation gradually declined to equal 2.2% in June, which is close to the target of 3%. Meanwhile, core inflation (which excludes volatile food and energy prices) was lower, at 1.6% (see Figure 3.1).

‹‹ Inflation remains around the target level.

Figure 3.1 CPI And Core Inflation



Source: GeoStat

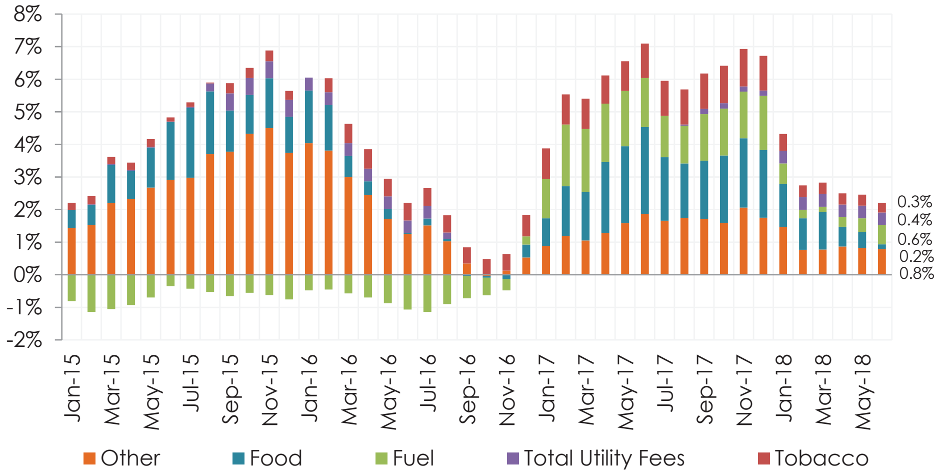
The effects of the temporary supply side factors that had driven inflation above the target in 2017 had mostly expired by the beginning of 2018. However, the increase in tariffs on natural gas since August 2017 and the increase in water and electricity tariffs since January 2018 still exert a meaningful effect on CPI inflation. The contribution of the latter factors on total inflation was 0.4 pp in June.

‹‹ Inflation in the food group has revealed a declining trend since the beginning of the year.

Inflation in the food group has revealed a declining trend since the beginning of the year. In June, inflation in the food group equaled 0.6%, contributing 0.2 percentage points to total inflation. In 2017, inflation in this group was significantly higher, so the decline is mostly a result of the base effect. In June, the most significant increase in prices was observed in vegetable oils and fruits, where prices increased by 4.9% and 4.7% respectively compared to the same period last year; meanwhile, prices on vegetables and products containing sugar fell by 5.4% and 2.7% respectively over the same period.

From other products, the increase in prices on fuel and tobacco significantly contributed to inflation (see Figure 3.2). Although the effect of the temporary increase of prices on these products (that followed an increase in excise taxes) was exhausted last year, prices on these products grew once more and contributed 0.6 and 0.3 percentage points respectively to total inflation in June. The rise in fuel prices followed the increase in oil prices on international markets. Meanwhile, prices in the healthcare group increased by 5.1% (contributing 0.4% to total inflation). In contrast, prices on clothes and shoes fell by 7.7% (contributing -0.3 percentage points to total inflation).

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

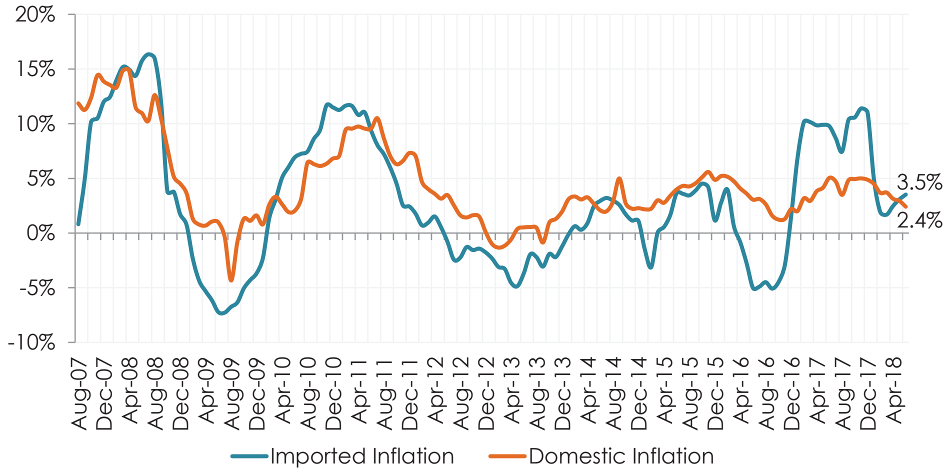


Source: GeoStat

In June, annual inflation on imported and domestically produced goods equaled 3.5% and 2.4% respectively (see Figure 3.3), while inflation on mixed goods saw almost no change.

‹‹ In June, annual inflation on imported and domestically produced goods equalled 3.5% and 2.4% respectively.

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

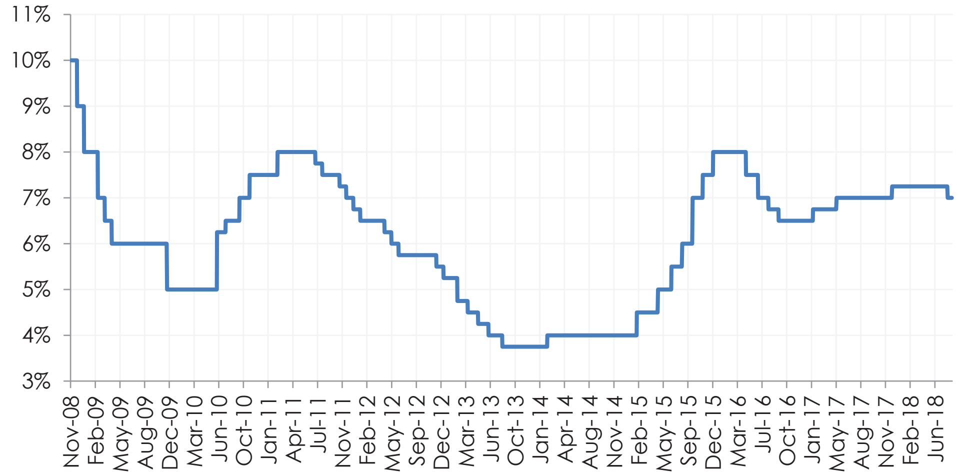


Source: GeoStat and National Bank of Georgia

4. MONETARY POLICY

Considering the upwards risks to the inflation forecast, the NBG maintained a moderately tight monetary policy in 2018. As had previously been anticipated, inflation declined from the start of the year and in June equaled 2.2%, which is close to the target of 3%. According to the baseline scenario, other things being equal, inflation is expected to remain around the target level. According to the NBG's estimates, domestic demand is still lagging behind its potential level, exerting downwards pressure on inflation, while the risks of the transmission of inflation from Georgia's main trading partners fell. Hence, the Monetary Policy Committee deemed it appropriate to maintain a moderately tight monetary policy.

Figure 4.1 Monetary Policy Rate



Source: National Bank of Georgia

The Monetary Policy Committee of the National Bank of Georgia met on 25 July 2018 and decided to cut the refinancing rate by 25 basis points to 7%. In the first half of the year, following the improvement in economic activity, the output gap was closing at a slightly faster pace than previously anticipated. As a result, the downward pressure on inflation stemming from domestic demand declined. However, the greater-than-anticipated appreciation of the nominal exchange rate reduced inflationary pressure. Moreover, the upward risks to the inflation forecast also weakened. Hence, the Monetary Policy Committee deemed it appropriate to start a gradual exit from the moderately tight monetary policy. However, following the recent modest recovery of domestic demand, the easing of monetary policy will continue at a slower pace than previously expected. Moreover, in order to mitigate potential risks to financial stability in the future, the Monetary Policy Committee decided to increase the reserve requirements on short-term funds (with a remaining maturity of less than one year) attracted in foreign currency from 20% to 25% (see Box 2).

‹‹ The National Bank of Georgia decided to cut the monetary policy rate by 25 basis points to 7%.

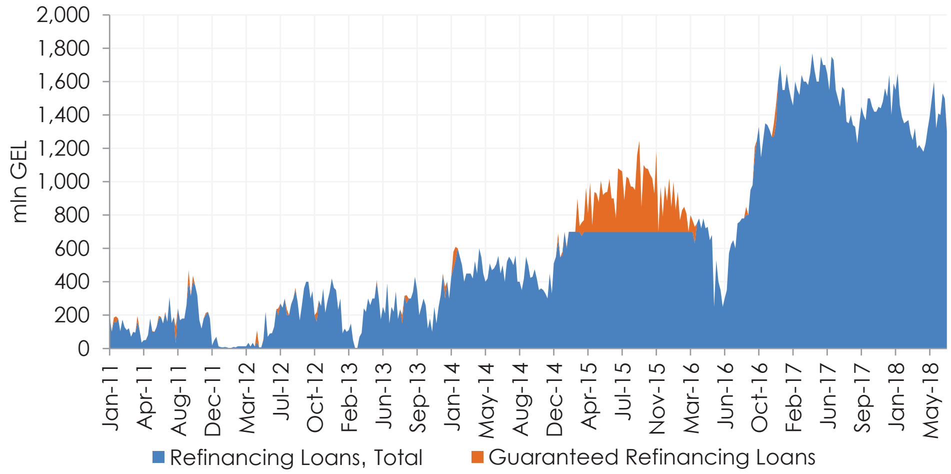
Economic activity increased significantly in the first half of 2018 and, based on preliminary estimates, real GDP growth equaled 5.7% over that period. This was higher than previously anticipated, largely due to external demand being stronger than expected. Meanwhile, the growth in remittances and credit both support an improvement of domestic demand. As a result, the National Bank of Georgia has revised the economic growth forecast upwards from 4.8% to 5.5%.

In the first half of the year, high economic growth was driven by increasing domestic demand and favourable trends in the external sector. In terms of domestic factors, exports of both goods and services and remittances posted high growth rates. In the first half of 2018, exports grew by 28%, while the growth rates of tourism revenues and remittances stood at 24% and 18% respectively. However, increasing domestic demand triggered a growth of imports, which, according to the preliminary estimates, grew annually by 23%.

According to the NBG forecast, annual inflation is expected to remain around the target level over the year. However, there are several major risks to the inflation forecast. Namely, inflation will be lower than expected if the US-initiated “trade war” with its major trade partners escalates, leading to a depreciation of the US dollar on international markets. If this occurs, the lari exchange rate will appreciate, reducing the foreign exchange burden and lowering inflation expectations; consequently, inflation will be lower than in the baseline scenario. Moreover, weaker-than-expected demand will also result in inflation being lower than anticipated (see Section 2.3). Conversely, inflation may be higher than expected if geopolitical conditions deteriorate, thereby increasing risk premiums in the region and depreciating local currencies.

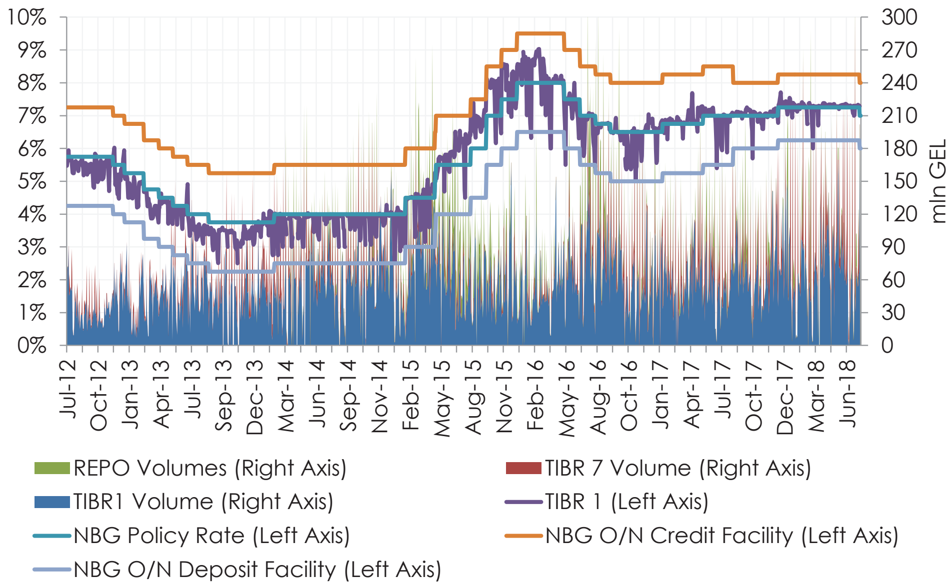
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected in interbank interest rates and to ultimately affect the real economy. The banking sector currently operates under a liquidity deficit. Hence, Commercial banks raise necessary additional 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 vary 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.

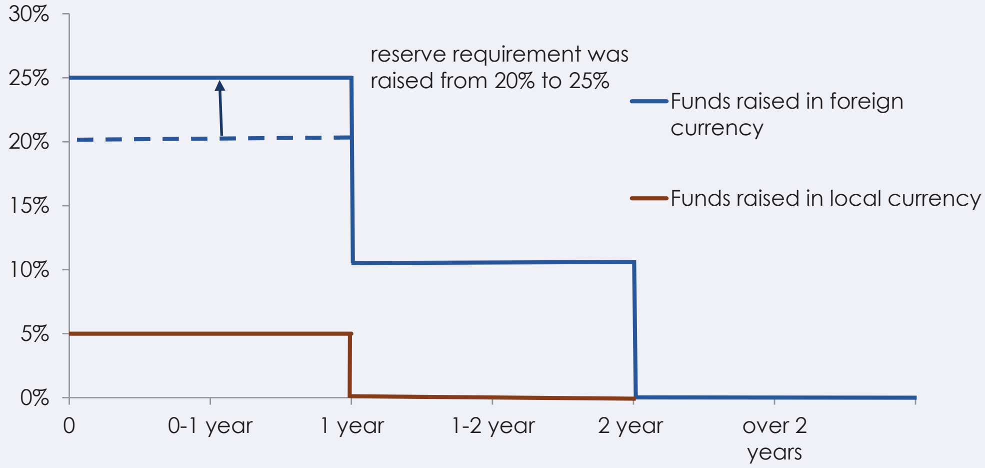
Box 2 Reserve requirements

Reserve requirements are one of the oldest instruments of monetary policy. Reserve requirements used to be employed as an instrument to supply cash. However, since currently monetary policy primarily relies on interest rates, the reserve requirements have now acquired a different purpose. It is important to note that the goal of reserve requirements as a policy instrument differ when applied to national and foreign currency reserve norms. The management of reserve requirements in the national currency is a precondition for the effective implementation of other monetary policy instruments and is an essential component of the monetary policy framework. The purpose of reserve requirements in the national currency and other monetary policy tools is to create an effective liquidity management system for the banking system and to promote the efficiency of the monetary policy transmission mechanism.

Meanwhile, reserve requirements in foreign currency is a tool through which the National Bank can influence interest rates in foreign currency and commercial banks' lending dynamics. For example, raising the reserve requirements increase the costs for banks in attracting foreign currency resources, which in turn results in increased interest rates on foreign currency loans, thereby affecting lending to foreign currency. In addition, reserve requirements for foreign currency play the role of a buffer and are also used for prudential purposes. In particular, in cases of an unexpected rapid outflow of foreign currency, these resources will ensure the availability of liquidity in foreign currency and reduce the risks of a crisis.

At the meeting of the Monetary Policy Committee on 25 July 2018, the decision was made to increase the minimum reserve requirements for foreign currency funds from 20% to 25% (see Figure 4.4). It should be noted that the reserve requirements for funds attracted with a maturity from 1 to 2 years is set at 10%, while the reserve requirements for funds attracted with a maturity more than two years equals 0%.

Figure 4.4 Minimum reserve requirements



Source: National Bank of Georgia

The increase in reserve requirements on foreign currency funds will mitigate risks to financial stability in the future. Given the improved current account in 2017, surplus liquidity in the banking system, coupled with low demand for foreign currency loans, triggered a decline in interest rates for foreign currency loans, thereby increasing the attractiveness of loans in foreign currency. Such dynamics entail future risks to financial stability – these loans carry exchange rate risk and interest rate risk, given the expected increase in interest rates on US and EUR funds. Hence, increasing the reserve requirements for funds attracted in foreign currency was essential for avoiding the accumulation of such risks in the banking system. Moreover, increasing reserve requirements for foreign currency resources supports the NBG's objective of promoting larization (de-dollarization).

The results of the larization measures that have been implemented since the beginning of 2017 are already visible: the dollarization of loans and deposits fell significantly. Moreover, it is worth noting that there has been a decrease in the dollarization of retail loans, which is the segment most significantly affected by exchange rate fluctuations. The NBG's continued support of larization is essential for long-term sustainable growth.

In June, the Monetary Policy Committee also made the decision to cut interest rates earned on required foreign currency reserves. As a result, from 12 June 2018, instead of the US FED rate minus 0.5 percentage points (but no less than 0%), the NBG will pay the interest of the FED rate minus 2 percentage points on required US dollar reserves. Currently, the FED rate stands at 2%, thus the interest rate earned on required dollar reserves is 0%. For euro reserves, the interest earned on required reserves will equal the ECB deposit rate minus 2 percentage points (but no less than -0.6%), instead of the previous deposit rate minus 0.2 percentage points. The ECB deposit rate equals -0.4%, hence the interest earned on EUR required reserves stands at -0.6%. The MPC decision on the changes in interest rates earned on required reserves in foreign currency increase the cost of funding in foreign currency and support the usage of the domestic currency.

5. Financial Market and Trends

5.1 LOANS

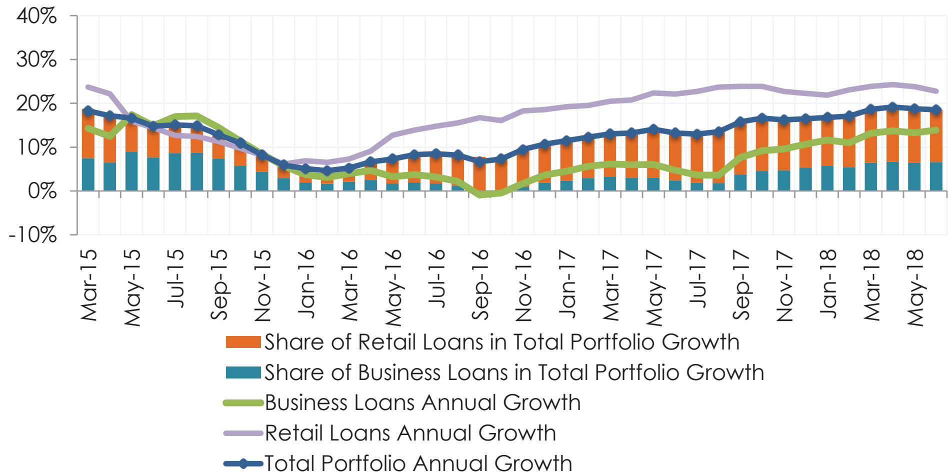
In the second quarter of 2018, credit activity has not changed significantly since the first quarter. In June, excluding the effect of exchange rate fluctuations and the transformation of one microfinance organization into a bank, the loan portfolio increased by 18.5%. While this increase can primarily be attributed to the growth of retail loans, business loans also revealed an increasing trend. In June, relative to March, the growth rate of retail loans declined by 1.2 pp and stood at 22.7%; meanwhile, loans to legal entities increased by 0.7 pp and equaled 13.9%. The growth of the loan portfolio was primarily driven by the increase in the construction, transport, agriculture, manufacturing and trade sectors; whereas increases in credit for the energy sector were insignificant. According to the credit conditions survey, representatives of the banking sector expect an increase in demand for business loans. In particular, growth is expected to be driven by increased demand from both corporate and small- and medium-sized enterprises, while retails loans are expected to decline. These changes in expectations are a result of the NBG's policies.

‹‹ Representatives of the banking sector expect an increase in demand for business loans while, 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, the National Bank of Georgia has published a working draft law on standards for retail loans. This was discussed and developed in coordination with market participants and is expected to enter into force from 2019. In order to avoid an extensive growth of retail loans over the transition period, the number of such loans was limited to 25% of a bank's supervisory capital. According to the draft law, establishing maximum limits for payments to income (PTI) and loan to value (LTV) coefficients are planned, and these will be extended to the non-banking sector. In addition, the Parliament of Georgia will consider a legislative initiative aimed at cutting the maximum effective interest rate limit to 50%, which will also facilitate a decrease in the amount of high-risk financial products on the market.

‹‹ From 1 January 2019, a legislative initiative on retail loans will enter into force, which will promote sustainable credit activity and improve lending conditions.

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

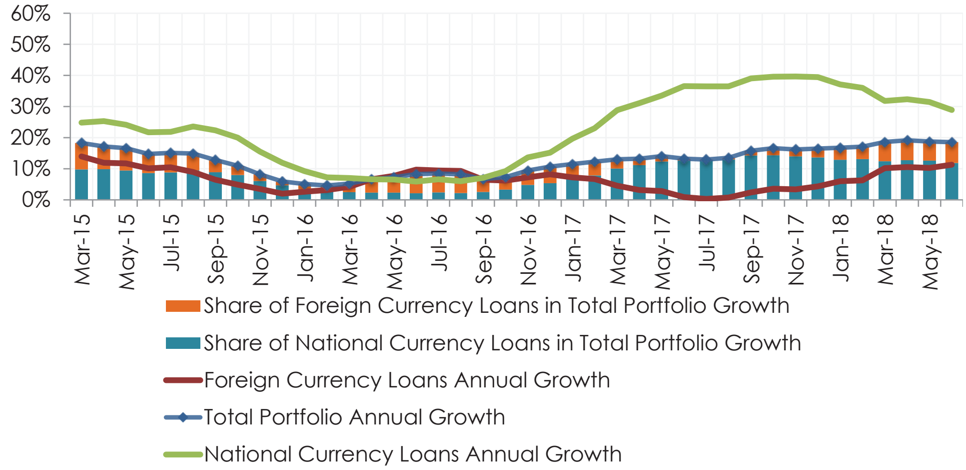


Source: National Bank of Georgia

In terms of currencies, the growth of the loan portfolio was once more driven by an increase in domestic currency loans. In June, the annual growth rate of foreign denominated loans was 11.3%, while loans in domestic currency grew by 28.9%. 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 second quarter, the loan larization ratio increased by 0.7 pp and equaled 44.1%.

‹‹ In the second quarter, the loan larization ratio increased by 0.7 pp and equaled 44.1%.

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

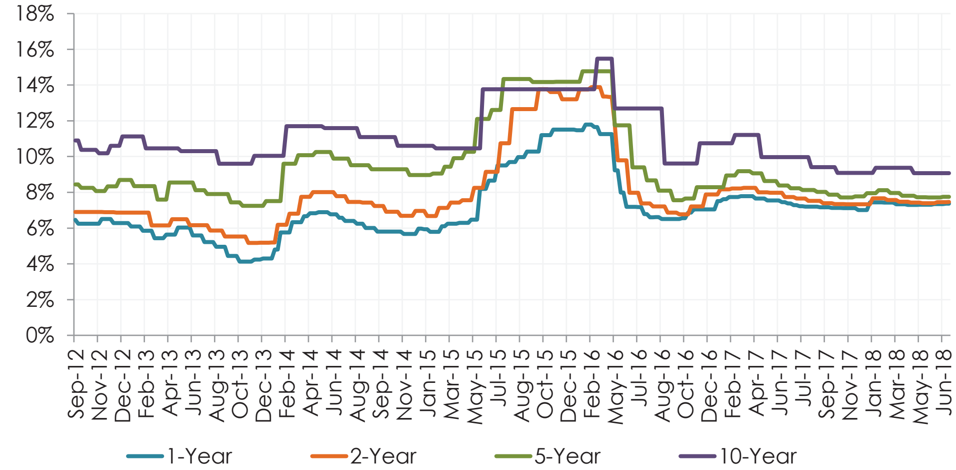


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In June, the monetary policy rate was lowered to 7%. In the second quarter of 2018, interest rates on government securities revealed a declining trend as a result of lower liquidity risk and expectations of an easing of monetary policy in the medium term (see Figure 5.3).

Figure 5.3 Interest Rates On Government Securities

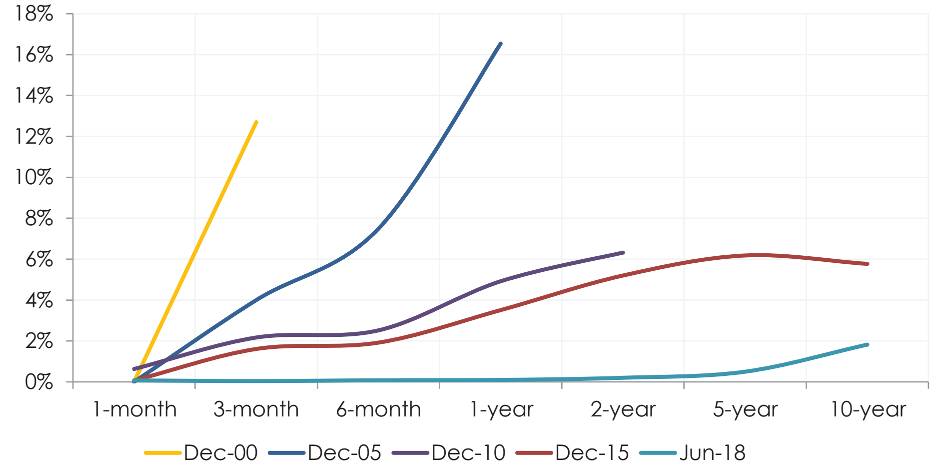


Source: National Bank of Georgia

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

‹‹ The spread between long- and short-term interest rates declined.

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

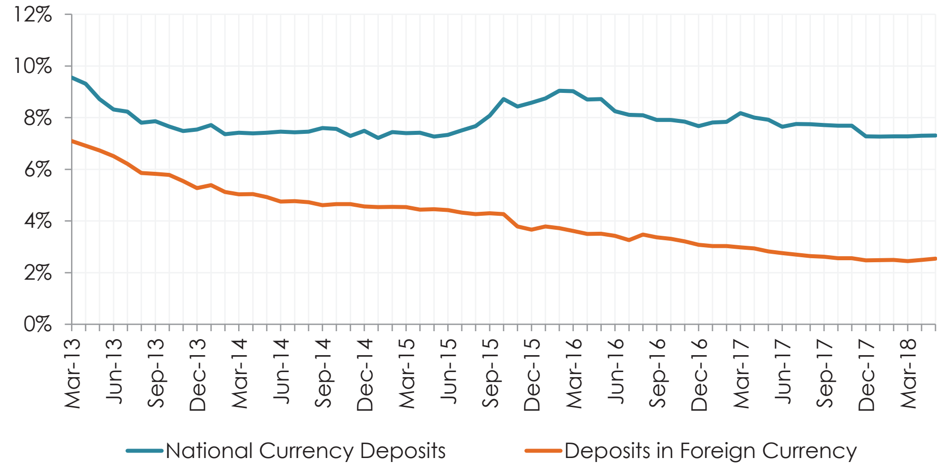


Source: National Bank of Georgia

In June, relative to March, interest rates on domestic currency deposits did not change and stood at 7.3%. Meanwhile, interest rates on foreign currency deposits increased by 0.1 percentage point and equaled 2.5%. 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 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.

Figure 5.5 Average Interest Rates On Deposits



Source: National Bank of Georgia

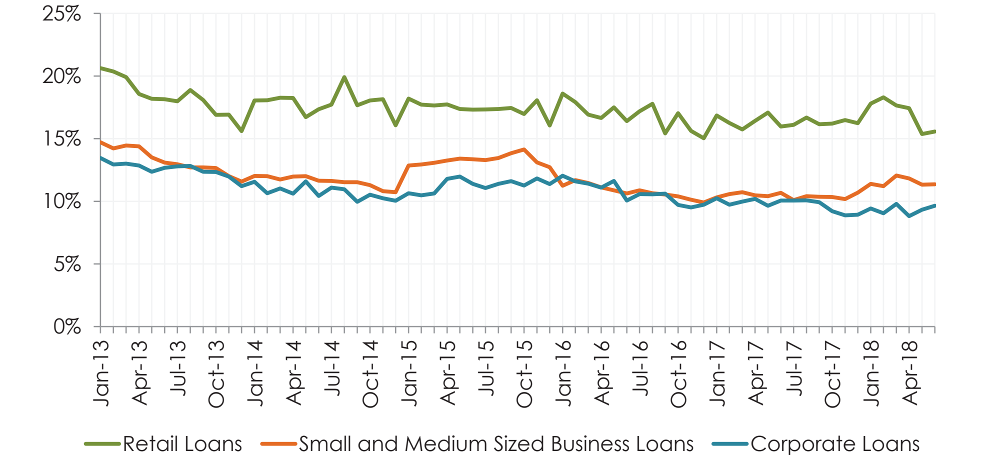
In the second quarter of 2018, according to the same credit conditions survey, interest conditions for individuals and legal entities have not changed significantly. However, driven by an expected increase in the LIBOR, interest rates and lending margins slightly increased for loans with fixed rates issued in foreign currency. Moreover, non-interest terms for retail lending, namely the demand for collateral, were eased. In addition, amendments to regulatory requirements have increased the cost of foreign currency liquidity.

The tightening of credit supply conditions was partially balanced by economic trends. According to the credit conditions survey, non-interest conditions for lending to individuals were significantly tightened. This tightening primarily affected consumer loans, with mortgages also partially affected.

In June, compared to March, interest rates on loans issued to small and medium enterprises declined by 0.7 pp and equaled 11.4%. For corporate loans, interest rates declined by 0.1 pp and amounted to 9.7%, while interest rates on retail loans fell by 2.1 pp and equaled 15.6% (see Figure 5.6). Over the same period, the average interest rate on the stock of legal entities' domestic currency loans declined by 0.1 pp, while average interest rates for foreign currency increased by 0.1 pp (see Figure 5.7). According to the credit conditions survey, credit supply conditions are expected to become relatively stricter for loans issued to legal entities at a fixed rate in a foreign currency, while conditions are not expected to change for retail loans.

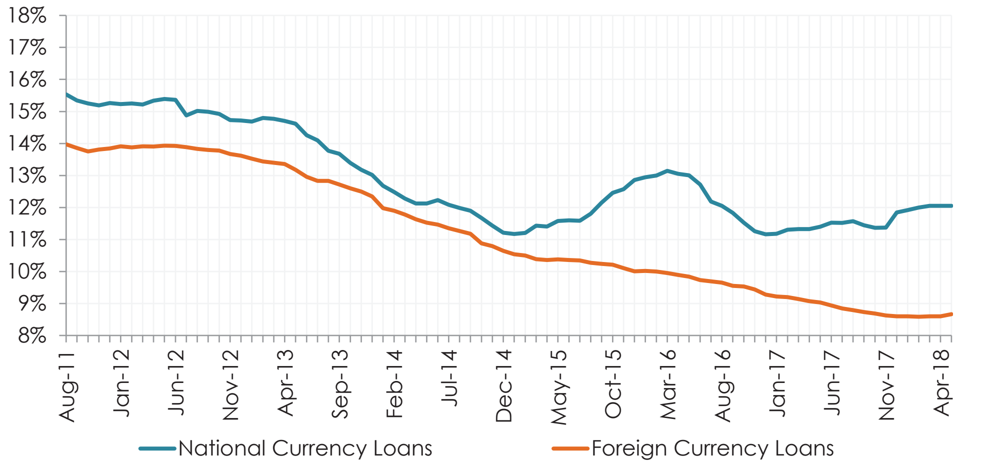
‹‹ Credit supply conditions for corporate and retail loans have not changed significantly, while non-interest conditions for retail loans became stricter.

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

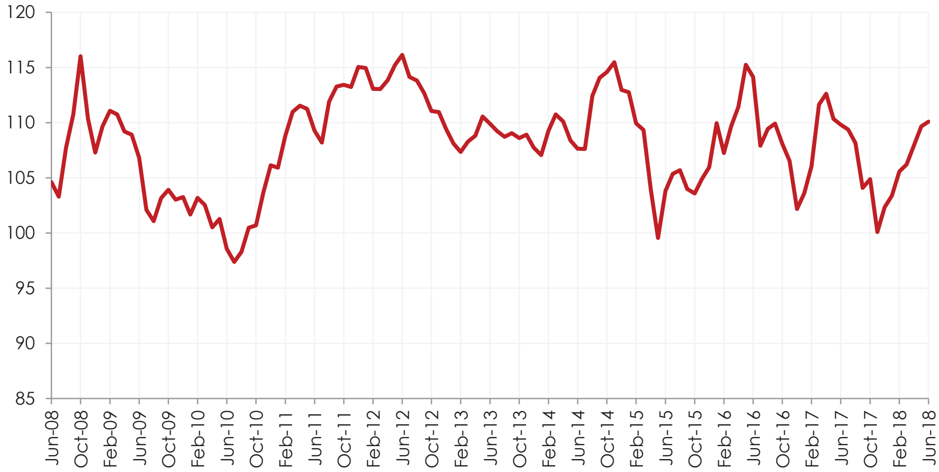
In the second quarter of 2018, compared to the previous quarter, the GEL nominal effective exchange rate appreciated against the US dollar by 1.6%, and by 4.4% against the euro. The GEL also appreciated against the Russian ruble and Turkish lira by 9.5% and 13.8% respectively. The nominal effective exchange rate appreciated by 6.1% on a quarterly basis and by 0.7% on an annual basis.

In the second quarter of 2018, the real effective exchange rate appreciated by 4.0% on a quarterly basis, and depreciated by 1.5% on a year-on-year basis.

‹‹ In the second quarter of 2018, the real effective exchange rate appreciated by 4.0% on a quarterly basis, and depreciated by 1.5% on a year-on-year basis.

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture. In particular, in the second quarter of 2018, the adjusted nominal effective exchange rate appreciated by 0.8% on a year-on-year basis, 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

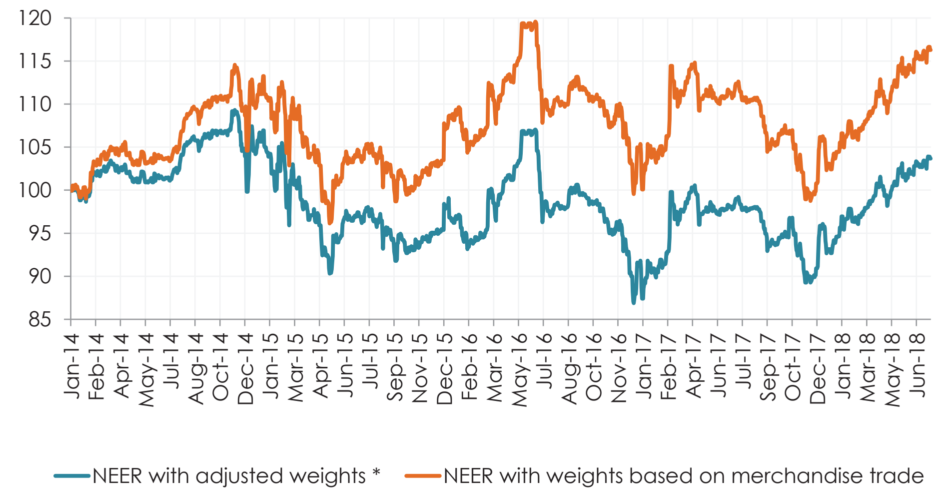
Table 5.1 Effective Exchange Rates Annual Growth (2nd quarter of 2018)

	Change of Nominal Effective Exchange Rate, %	Change of Real Effective Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	0.7	-1.5	-1.5
Eurozone	-9.0	-8.4	-1.8
Turkey	20.5	9.3	1.8
Ukraine	-2.2	-10.2	-0.7
Armenia	-1.3	-0.5	0.0
The United States	-1.1	-1.4	-0.1
Russia	7.0	7.0	1.0
Azerbaijan	-0.7	-0.5	-0.1
Other	-8.4	-8.0	-1.6

* The growth implies appreciation of lari

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

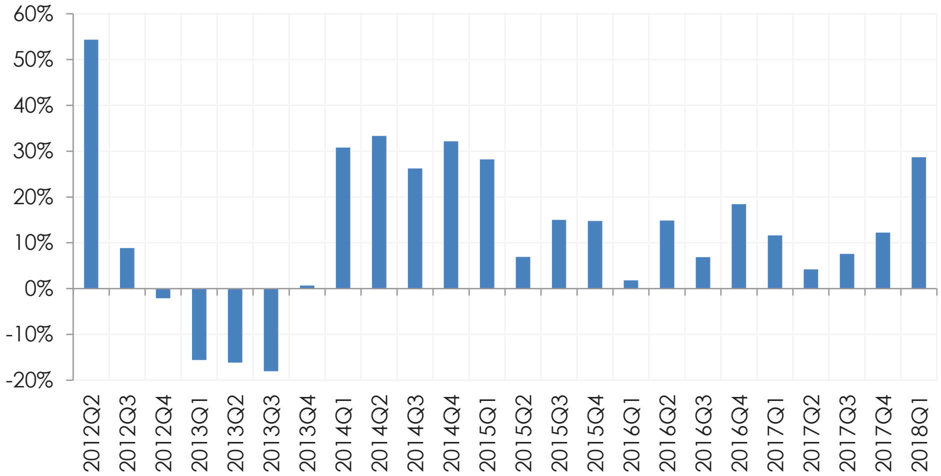
6. Aggregate Demand

In the first quarter of 2018, real GDP growth equaled 5.3%. The increase in investments was the main driver of that growth, but the contribution of net exports was also significant. The contribution of consumption to GDP growth was relatively modest. According to the baseline scenario, the economic growth rate in 2018 will be higher than it was 2017. Over the same period, the growth rate of capital formation reached 28.7%. The growth in investment was triggered by both capital formation and the increase in inventories – with much of the latter being associated with the base effect, since a decline in inventories was observed in the first quarter of 2017.

« In the first quarter of 2018, real GDP growth equaled 5.3%.

« Over the same period, the growth rate of capital formation reached 28.7%.

Figure 6.1 Annual Growth Rate Of Capital Formation



Source: GeoStat

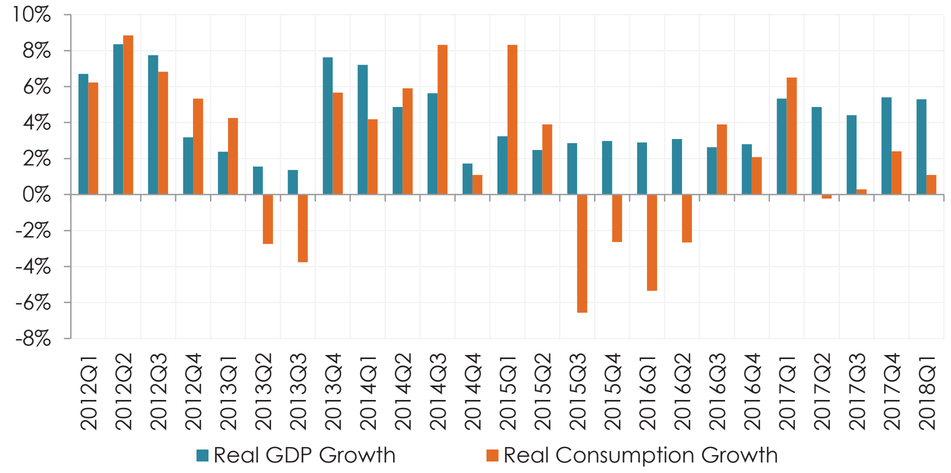
In the first quarter of 2018, the annual growth rate for private consumption[17] posted 1.1%. This increase followed the growth in disposable income, which in turn stemmed from increases in lending, remittances and revenues from tourism. Despite revealing an increasing trend, aggregate demand continues to remain below its estimated potential level. In the first quarter, government consumption increased at a significant pace, which is associated with the base effect (as the first three quarters of 2017 saw a negative growth rate of government consumption).

« In the first quarter of 2018, the annual growth rate for private consumption posted 1.1%.

Meanwhile, external demand has continued to recover. In the first quarter of 2018, the annual nominal growth of exports declined, but annual real growth rate of exports increased. As a result, contribution of net exports to GDP growth remains positive. Imports growth rate compared to previous quarters increased mostly following increased demand for consumer goods and improvements in economic activity. Although the price level on imported goods declined annually compared to the previous quarter, the real growth rate of imports still remains low and insignificant. According to preliminary data, the real growth of imports has remained low in the second quarter of 2018, while exports grew at a relatively high rate.

17 *The real growth of consumption is calculated considering average annual inflation.*

Figure 6.2 Real GDP And Real Consumption Growth



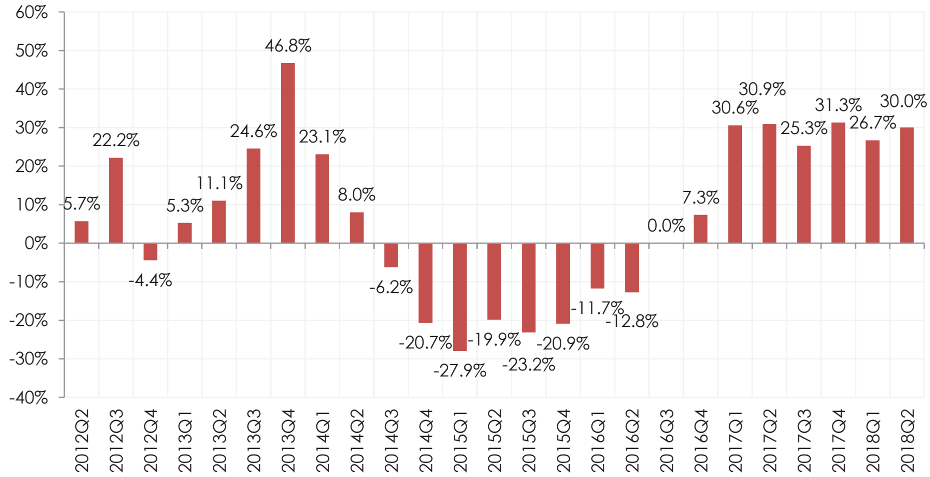
Source: GeoStat and National Bank of Georgia

7. External Demand and Balance of Payments

The improvement of economic activity in Georgia's main trading partners has supported the growth of exports. Given the increase in external demand, exports of goods grew annually by 30% in the second quarter of the year (see Figure 7.1). Exports of intermediate and consumer goods – especially of wines and mineral waters, copper ores as well as re-exports of cars – made the most significant contributions to the overall growth.

‹‹ In the second quarter, registered exports of goods increased annually by 30%.

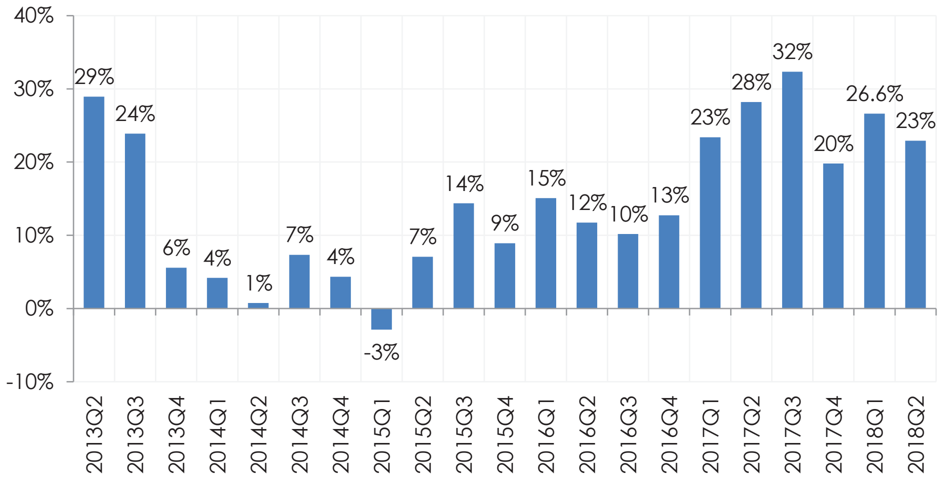
Figure 7.1 Annual Change in Registered Exports Of Goods



Source: GeoStat

The volume of exports has increased significantly following the economic recovery of Georgia's major trading partners. In the second quarter of 2018, exports to Azerbaijan and Turkey grew by 154% and 8% respectively, compared to the same period of last year. Exports have also seen an increasing trend to other CIS countries, particularly to Turkmenistan (403%), Tajikistan (233%) and Kyrgyzstan (127%). Moreover, it is important to note that the volume of exports to the US grew by 109%; whereas, exports to China slightly declined (8%).

Figure 7.2 Annual Change in Revenues from Tourism



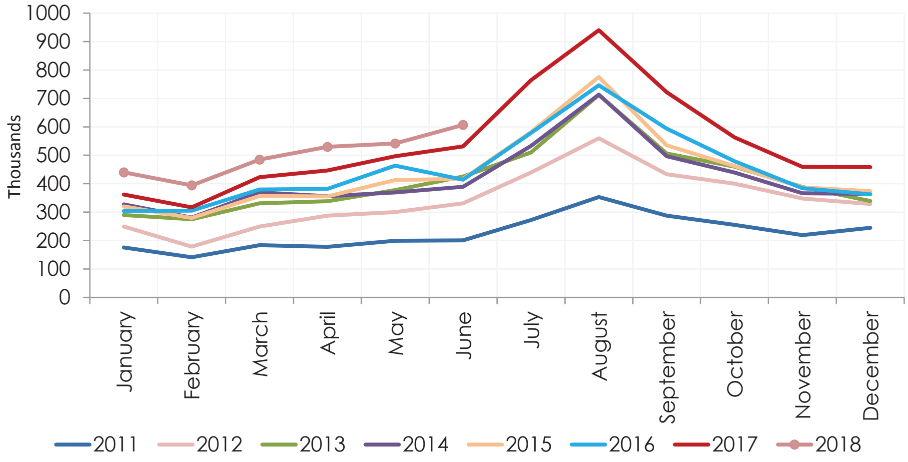
Source: National Bank of Georgia

The recovery 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 the first half of 2018. In the second quarter of 2018, revenues reached 810 million USD, which is a 23% increase over the same period last year (see Figure 7.2).

‹‹ In the second quarter of 2018, revenues from tourism increased by 23% and reached 810 million USD.

The increase in tourism revenues followed an increasing number of international visitors to Georgia.[18] In the second quarter of 2018, the number of foreign visitors who entered Georgia grew by 14% (see Figure 7.3), of which 65% were tourists. Travelers from Azerbaijan, Turkey and Russia made the most significant contribution to that growth, while tourist inflows from Armenia declined. Tourism inflows from Ukraine stayed at the same level. Moreover, there was a substantial increase in the number of visitors from Iran and Israel.

Figure 7.3 Number of International Visitors to Georgia

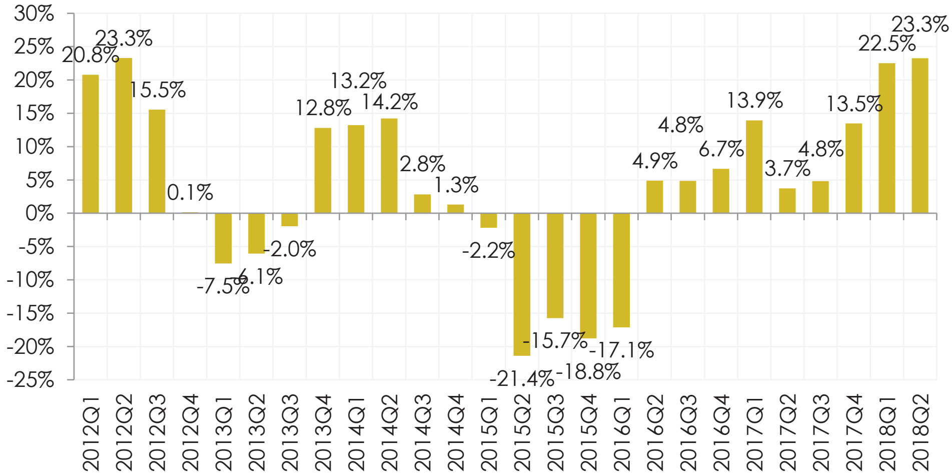


Source: GNTA

In the second quarter of 2018, following the growth in domestic demand, registered imports of goods increased by 23.3% (see Figure 7.4). This growth was driven by increased demand for intermediate and consumer goods. It should be noted that imports increased from CIS countries and fell from the EU. The growth in imports was driven by the increased demand for intermediate and consumer goods.

‹‹ In the second quarter of 2018, registered imports of goods increased by 23.3%.

Figure 7.4 Annual Change in Registered Imports Of Goods



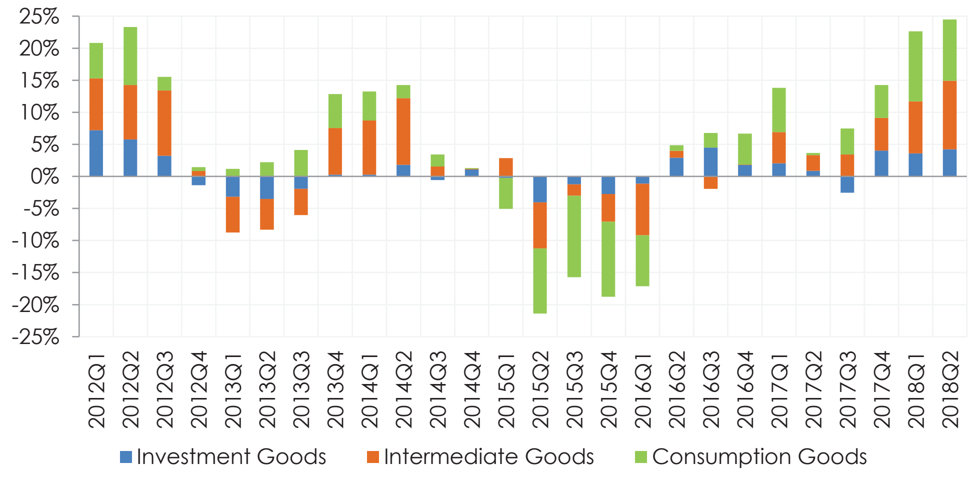
Source: GeoStat

‹‹ In the second quarter of 2018, the growth in imports was driven by the increased demand for intermediate and consumer goods.

In the second quarter of 2018, imports of intermediate goods increased by 24%, adding 10.0 percentage points to the overall growth of imports. Meanwhile, imports of consumer goods grew by 21%, adding 9.0 percentage points to total imports. Moreover, although FDI fell, imports of investment goods increased.

18 *Tourist is a visitor who remained in a country for more than 24 hours.*

Figure 7.5 Annual Change in Registered Imports By Category Of Goods

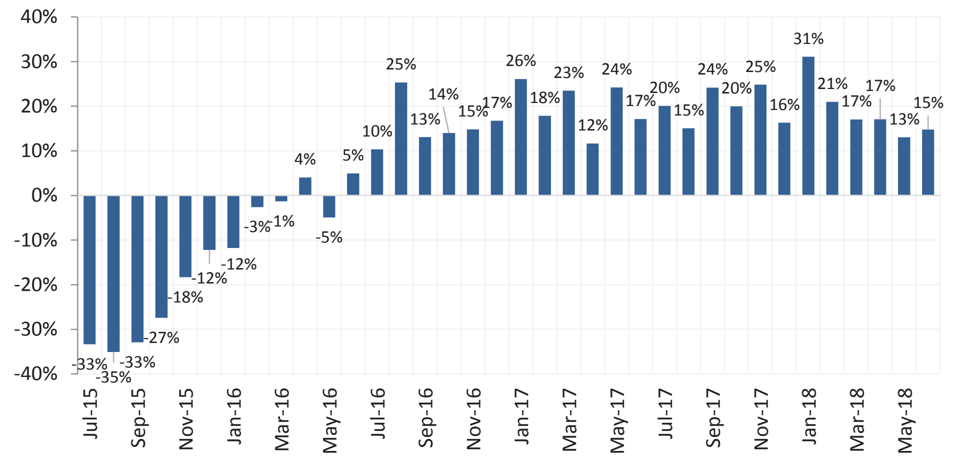


Source: GeoStat

Remittances to Georgia also revealed an increasing trend in the first half of 2018. In the second quarter, the volume of money transfers increased by 14.8% (see Figure 7.6), which was mainly driven by increased transfers from the European Union (notably from Greece and Italy). The overall growth in remittances can also be attributed to the increasing volume of money transfers from Israel and the USA, while remittances coming from Russia declined.

« In the second quarter, the volume of money transfers to Georgia increased by 14.8%.

Figure 7.6 Annual Change in Remittances



Source: National Bank of Georgia

Although the exports and remittances, posted high growth rates, the increase in imports and a negative income balance triggered a widening of the current account deficit to 11.6% of GDP in the first quarter of 2018. For comparison, it is worth noting that the current account deficit in the same period last year stood at 11.4% of GDP. The income balance on the current account is the major source of the widening of deficit – the increasing revenues of investor firms over 2016-2017 consequently led to increasing dividends and reinvested income. The latter dynamic has persisted in 2018.

Foreign direct investments (FDI) remain the primary source of financing the current account deficit. In the first quarter of 2018, the volume of foreign direct investments equaled 279 million USD. It is, however, important to note that the BP pipeline construction project, which has played a significant role in the growth in FDI over the last few years, is entering its closing phase. The financial sector was the largest recipient of FDI, receiving 40% of the total volume (111 million USD), a significant portion of which was reinvestment. The construction (69 million USD) and transport (56 million USD) sectors were also significant recipients of FDI, receiving 25% and 20% of total FDI respectively.

An analysis of investments and savings reveals that the current account deficit in the

« In the first quarter of 2018, the current account deficit equaled 11.6%.

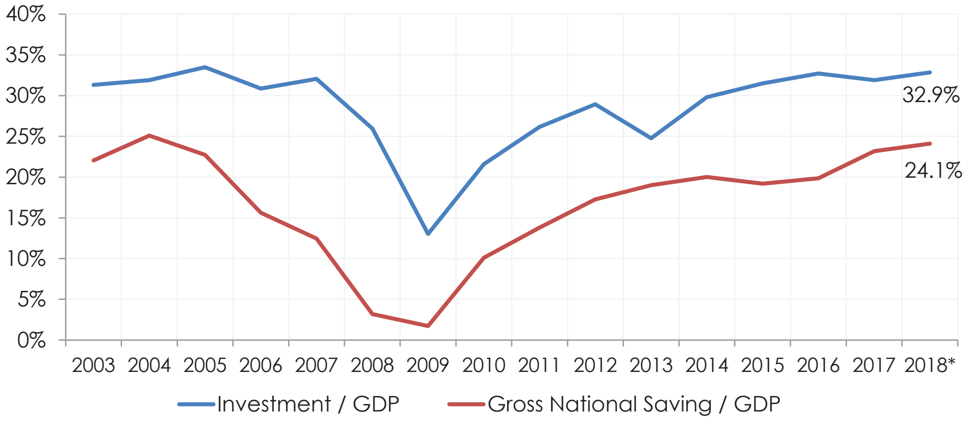
« The widening of the current account deficit was driven by the negative income balance and an increase in imports.

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

first half of 2018 remained unchanged. In 2018, relative to 2017, the ratio of investments to GDP increased by 1.0 pp to reach 32.9%, while the ratio of savings to GDP grew by 0.9 pp to 24.1% (see Figure 7.7).

‹‹ *The widening of the current account deficit followed the slower pace of investment growth.*

Figure 7.7 Investments and Savings



*2018 data contains the last three quarters of 2017 and the first quarter of 2018.

Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

In the first quarter of 2018, GDP growth reached 5.3%. The services sector made the most significant contribution to overall growth, contributing 4 pp. Industries added 1.5 pp, while the agriculture sector's contribution was negative, standing at -0.2 pp.

From the services sector, trade and real estate operations made the most significant contribution to overall GDP growth, increasing by 13.4% and 5.1% respectively, each contributing by 0.7 pp to the total growth. From 2017 onwards, the trade sector gradually increased, signaling a recovery in domestic demand. It is also important to note that the inflow of international visitors is an important trigger for GDP growth in a variety of directions. In the first quarter of 2018, these favorable dynamics were reflected in real estate operations, where the foreign contribution is significant. Moreover, the inflow of international visitors directly affects the output of restaurants and hotels, where growth equaled 10.9%, contributing 0.3 pp to the total growth. Over the same period, the growth in the financial (growth of 9.1%, adding 0.4 pp to the overall growth) and electricity and natural gas production/ distribution sectors (growth of 10%, contributing 0.3 pp to growth) was were also significant.

‹‹ Trade and real estate operations made the most substantial contributions to overall GDP growth.

‹‹ The increased flow of foreign visitors makes an important contribution to GDP growth.

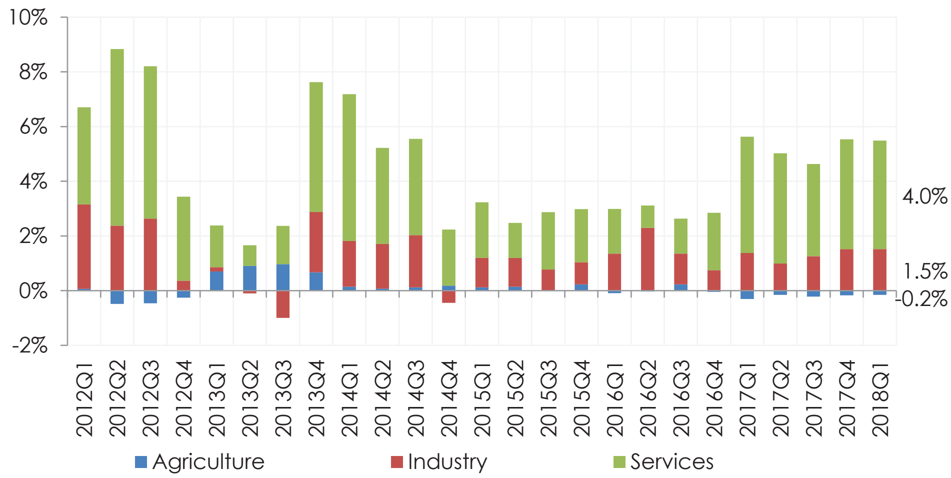
From the industrial sector, the growth of construction was the most significant. Construction activity increased in both public and private sectors, growing by 8.7% in the first quarter and adding 0.6 pp to the overall growth. There was also significant growth in manufacturing, which rose by 6.6%, adding 0.5 pp contribution to the overall growth. This growth in manufacturing can be attributed to increased production of beverages, metals and metal crafts – all of which were driven by increasing external demand.

‹‹ High growth has been maintained in the construction sector.

‹‹ The increase in external demand has been reflected in the growth of manufacturing.

The output of the agriculture sector fell once more in the first quarter of 2018. The sector declined by 1.9% annually, making a negative contribution of -0.2 pp to the total growth.

Figure 8.1 Contribution Of Sectors Of Economy To Real GDP Growth



Source: GeoStat.

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