

Monetary Policy Report

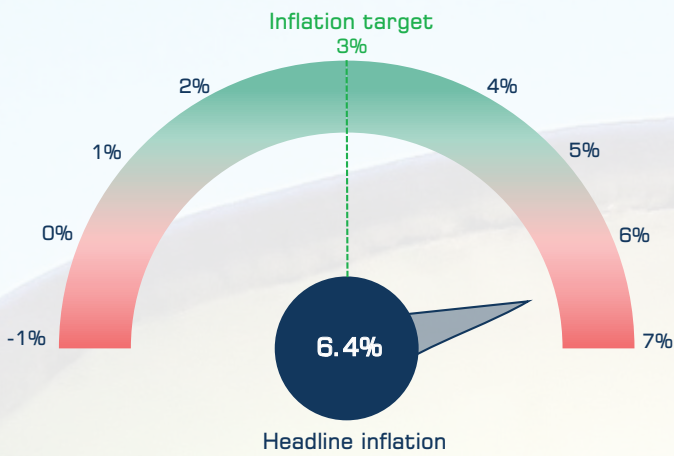
October
2019



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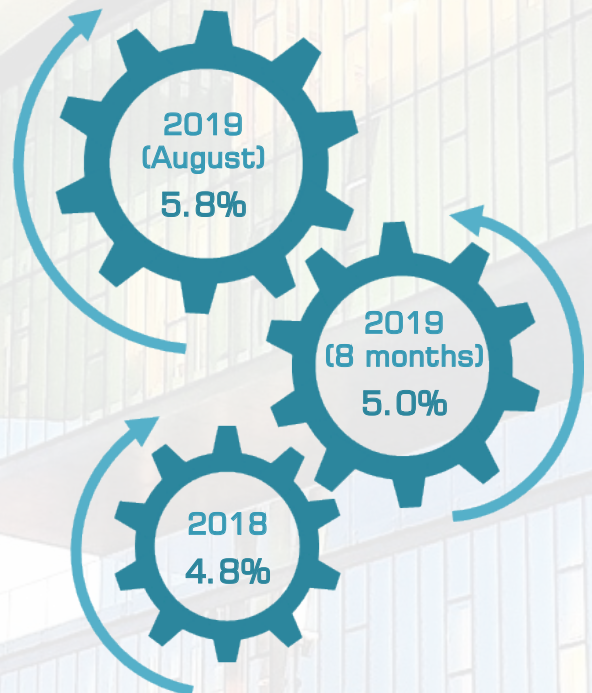
INFLATION



6.4%

Due to the exchange rate depreciation, the inflation rate is above the target

ECONOMIC GROWTH



Economic growth is stable

5.8%

MONETARY POLICY

8.5%

↑
1.0

8.5%

In response to rising inflation, NBG tightened the monetary policy

MONETARY POLICY DECISION

We have increased the monetary policy rate to 8.5%.

Our role is to set interest rate to affect the total spending of the economy thereby ensuring that the inflation (growth rate of prices) returns to the target.

Low and stable inflation supports employment and economic growth.

Recently, nominal exchange rate of GEL significantly depreciated against the US dollar. At the same time, it also weakened against the currencies of the trading partner countries. Along with other factors, depreciation of the nominal exchange rate elevated consumer prices by more than the target of 3%.

Given the present situation, we raised the monetary policy rate twice by 0.5 percentage point (pp) from 6.5% to 7.5%, and then by 1 pp to 8.5%. The increase of interest rate will reduce the amount of total spending in the country, which ultimately will slow down the rise in consumer prices. At the same time, higher interest rate reduces total lending in GEL, while it makes savings in GEL more attractive and encourages investors to use GEL securities. This contributes to an increase in demand for the GEL and appreciation of the exchange rate.

Based on our estimation, the exchange rate is excessively undervalued. According to the forecast, other things equal, increased interest rate will support the appreciation of the GEL effective exchange rate. Total spending will be relatively lower due to the higher interest rate, and as a result, the inflation will return to its target level in about three quarters.

In any case, we will use all instruments at our disposal to ensure the price stability and maintain the purchasing power of the GEL, which means that the rate of overall price increase will return to 3%.

BRIEF OVERVIEW

In the second half of 2019, inflationary pressures emerged that, alongside one-off factors, are mostly related to the higher-than-expected depreciation of the nominal effective exchange rate. The shortfall of economic activity from its potential level was lower than in previous periods. As a result, weak aggregate demand can no longer offset the exchange rate pass-through on inflation. Therefore, in response to rising inflation expectations, monetary policy has been tightened significantly and it is expected that the National Bank of Georgia will continue to maintain a tight policy until inflation expectations return to the target level of 3%.

Inflation, while being sustained at a higher rate in the short run, is expected to fall to a lower-than-target level in the medium term, and to ultimately approach the 3% target from below.

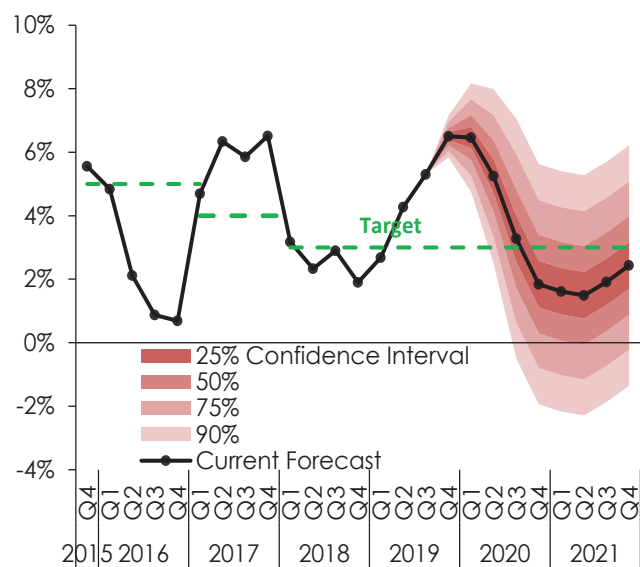


Figure 1. Headline CPI inflation

Source: National Bank of Georgia

In the third quarter of 2019, the annual inflation rate was higher than previously forecast and equaled 5.3% on average. Although this increase in inflation was partly due to higher-than-expected prices on tobacco products and certain components of the food category, the inflationary pressure coming from the greater-than-expected depreciation of the local currency was also strong. The latter factor led to the upward revision of the inflation forecast and to the subsequent monetary policy response.

According to the National Bank of Georgia's (NBG) **forecast, inflation** will remain above the target in the next three quarters. Subsequently, after a gradual decline in the medium term, which will see inflation fall below the target, it will approach the target from below (see Figure 1). The below-target inflation rate at the end of 2020 will be driven by the tightened monetary policy, which is ready to temporarily accommodate lower-than-target inflation in order to ensure that long-run inflation expectations decline back to the target level.

These inflation forecast dynamics are driven both by the recent depreciation of the nominal effective exchange rate and by weak aggregate demand. The first factor, in the short run, puts pressure on consumer prices as it increases both import inflation and the intermediate costs of companies burdened with foreign currency credit. In contrast, the continuation of weak aggregate demand puts downward pressure on prices in the short run. However, in the medium term, improving economic activity along with an appreciation of the effective exchange rate, will ensure that the inflation rate is close to its target.

Annual GDP growth in the second quarter of 2019 was 4.5%, while growth in the third quarter reached 5%, according to preliminary estimates. These indicators are in line with the National Bank of Georgia's previous forecasts. Specifically, despite recent risks, the relatively high economic growth seen in 2019 has largely been driven by increased external demand.

According to the forecast, moderate economic growth at 4.5% will continue in the medium term.

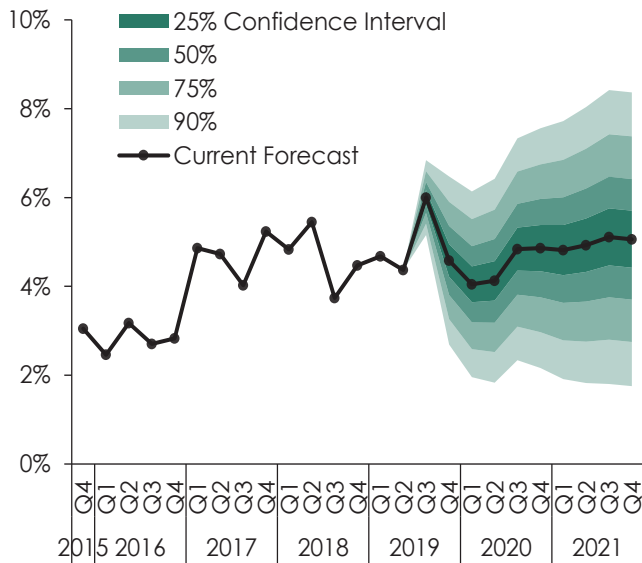


Figure 2. Annual real GDP growth

Source: National Bank of Georgia

In response to higher-than-targeted inflation and higher inflation expectations, the monetary policy rate first rises and is expected to decline to its neutral level only alongside lowering of inflation expectations.

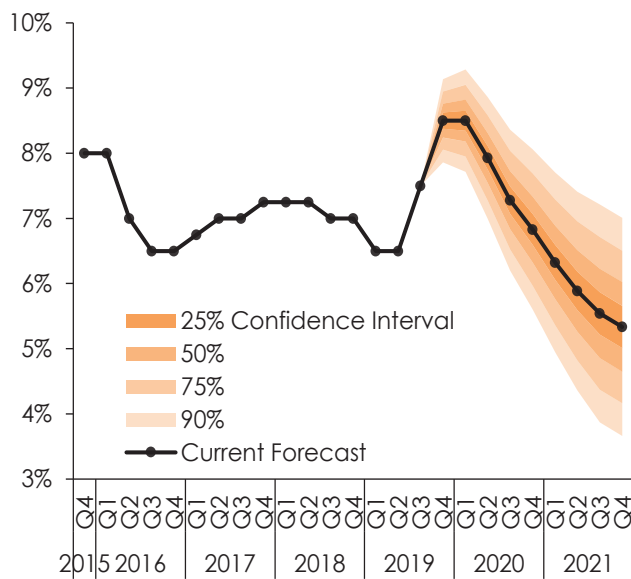


Figure 3. Forecast of the monetary policy rate

Source: National Bank of Georgia

As for future dynamics, the NBG’s **forecast of real GDP** growth for 2019–2020 remains at 4.5% (see Figure 2). Although current indicators raise the likelihood that economic growth in 2019 will exceed 4.5%, the more likely forecast for real GDP growth in the next year is still 4.5%. This is due to two contradictory factors: the tightened monetary policy amid rising inflation is offset by a strong increase in net exports and fiscal stimulus. Indeed, current estimates suggest that, on the back of positive trends in the trade balance, as well as a revival of domestic demand and investment related to fiscal stimulus, net exports will make a significant contribution to growth. Based on the revised estimates, the deviation of economic activity from the potential level (which, according to estimates, is currently around -1%) will widen slightly in the short run. However, it is expected that the output gap will then gradually shrink starting from next year and will close in 2021.

Amid higher-than-targeted inflation and higher inflation expectations, according to the current macroeconomic forecast, **monetary policy will be initially tightened** before declining to its neutral level with the lowering of inflation expectations (see Figure 3). The baseline scenario assumes that, despite high levels of uncertainty in the recent period, Georgia’s risk premium will not increase significantly. However, if the inflationary pressure coming from the exchange rate continues, the National Bank of Georgia is ready to continue tightening policy until inflation returns to its target level. According to the baseline forecast, following an initial increase, the policy rate will decline to its neutral level, which is currently estimated at 6%, in two years.

It should be stressed 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. 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.

1 CURRENT MACROECONOMIC SITUATION

The economic situation in Georgia's trading partner countries has weakened recently and is only expected to stabilize in the coming quarters. However, exports from Georgia have increased significantly and Georgia's current account deficit has improved significantly, largely as a result of a competitive exchange rate being maintained in previous periods. Local consumption has continued to grow at a moderate pace, despite a weakening of investments. As a result, economic growth was within 5% in the first three quarters of 2019. This was also supported by a relatively high growth of lending, which continued to exceed nominal GDP growth. To summarize, as economic activity continues to grow moderately and without mounting downward pressure on inflation, the recent depreciation of the exchange rate has significantly increased annual inflation at the expense of both imported and domestic inflation.

Global economic growth remained weak in the third quarter of 2019, which was mostly driven by the deceleration in the growth rates of emerging and developing countries as well as that of the USA. However, it is expected that growth rates will stabilize by the end of the year.

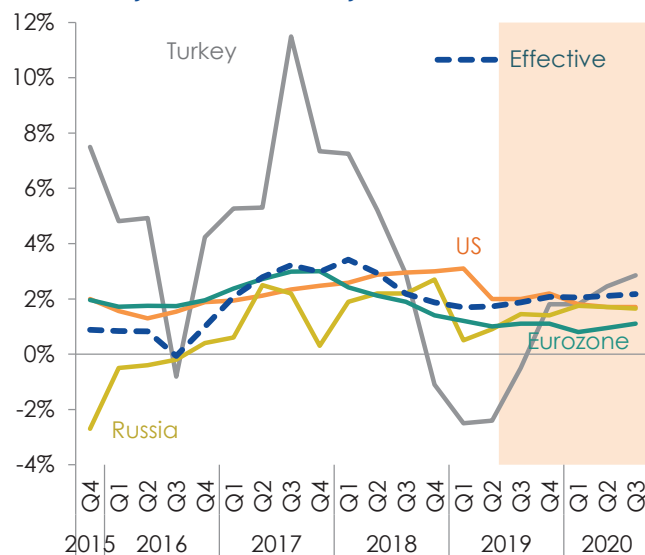


Figure 1.1.1. Real GDP growth of economic partners

Source: Bloomberg; National Bank of Georgia

1.1 OVERVIEW OF THE GLOBAL ECONOMY

In the third quarter of 2019, both developed and developing countries were characterized by weak economic activity. As a result, **global economic growth** in 2019 is projected at 3%¹, which is its lowest level since 2008-09. The deceleration was mostly driven by additional trade tensions related to the US-China "trade war" as well as by uncertainties surrounding Brexit. Economic growth in 2020 is expected to be 3.4%.

Growth remained sluggish in the **US** at the beginning of the third quarter, where business investments and consumer spending declined. The manufacturing sector has also deteriorated. The IMF's real GDP growth forecast² for the US in 2019 is 2.4%, which is 0.2 percentage points (pp) below its previous forecast³.

As for the **eurozone**, exports have declined amid the negative external environment. Consumer spending and investment have also fallen, which hampers economic growth. According to the IMF's forecast, real GDP growth in the eurozone will be 1.2% in 2019.⁴

Turkey remains in a tough economic situation, especially on the back of recent developments that saw a decline in investments, with private consumption and industrial production causing a further reduction of the economy. However, a higher lending volume on

1 International Monetary Fund. 2019. *World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers*. Washington, D.C., October.

2 Ibid.

3 International Monetary Fund. 2019. *World Economic Outlook Update: Still Sluggish Global Growth*. Washington, D.C., July.

4 International Monetary Fund. 2019. *World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers*. Washington, D.C., October.

The level of inflation in Georgia's trading partner countries was stable. The only exception to this is Turkey, where the inflation rate is significantly higher than the target.

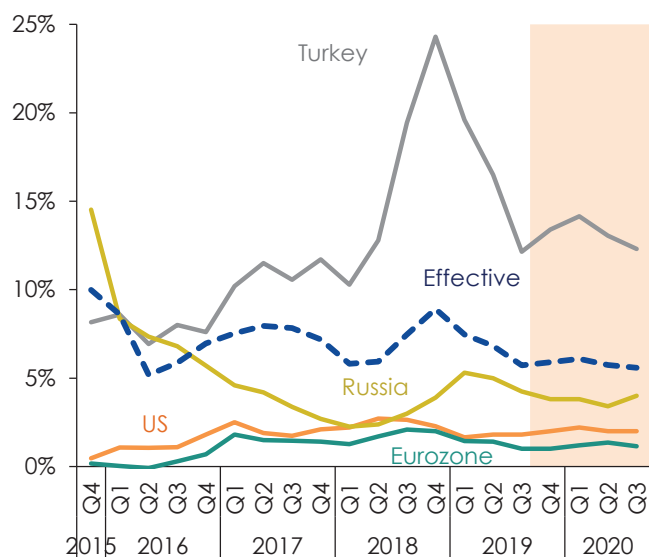


Figure 1.1.2. Headline Inflation rates of economic partners

Source: Bloomberg; National Bank of Georgia

the back of tight monetary policy, as well as positive external factors are helping to start the recovery process of the economy. The IMF's real GDP growth forecast⁵ for Turkey in 2019 is 0.2%, which is significantly higher than April's forecast⁶, while growth in 2020 is projected at 3%. As for inflation, the annual rate in September stood at 9.3%, which is 6 pp below the previous month.

Economic growth in **Russia** slowed notably, which was mostly driven by the decline in the industrial sector, the challenging external environment and a reduction in private consumption. However, on the back of higher fiscal stimulus and tight monetary policy, growth is expected to stabilize. According to the IMF's forecast⁷, real GDP growth in Russia will be 1.1% in 2019, which is 0.1 pp below the previous forecast⁸, while growth in 2020 is projected to be 1.9%. As for inflation, the annual rate in September was 4%, while it is forecasted to be 4.7% across 2019 as a whole.

Ukraine's economy continues to recover. On the back of increased consumer spending and fixed investments, economic activity is high. Furthermore, government reforms have proven crucial. The IMF's real GDP forecast⁹ for Ukraine in 2019 is 3%, which is 0.3 pp higher than the previous forecast¹⁰, and growth is projected to remain at 3% in 2020. Annual inflation is forecasted to be 8.7% over 2019.

Solid economic growth has continued in **Armenia**. This has mostly been driven by increased salaries and consumer spending, together with a steadily rising volume of money transfers. According to the IMF's forecast, real GDP growth in Armenia will be 6%, while annual inflation is projected to be 1.7%.¹¹

As for **Azerbaijan**, a stable growth rate was evident in the beginning of the third quarter, with both oil and non-oil sectors showing high activity. The IMF's real GDP growth forecast for Azerbaijan in 2019 is 2.1%, while the annual inflation rate is forecast at 2.8%.¹²

Monetary policy rates in Georgia's trading partner countries have declined recently.

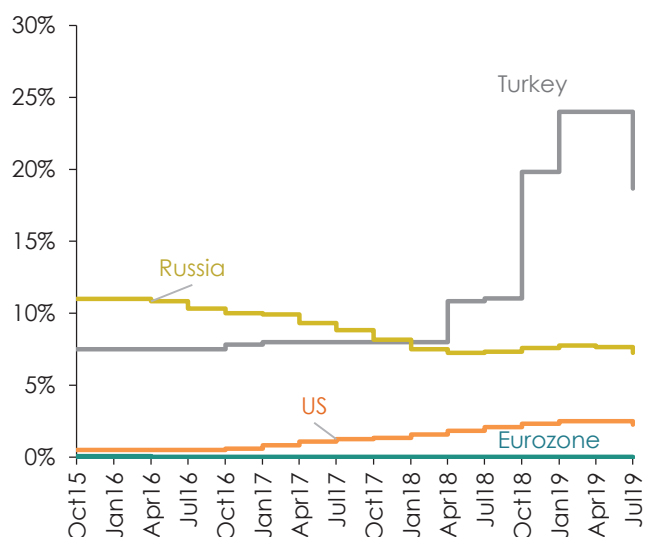


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: Bloomberg; National Bank of Georgia

5 Ibid.
 6 International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.
 7 International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.
 8 International Monetary Fund. 2019. World Economic Outlook Update: Still Sluggish Global Growth. Washington, D.C., July.
 9 International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.
 10 International Monetary Fund. 2019. World Economic Outlook Update: Still Sluggish Global Growth. Washington, D.C., July.
 11 International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.
 12 Ibid.

Alongside the global slowdown, **central banks in Georgia's main trading partner countries** are easing monetary policy to encourage domestic demand (see Figure 1.1.3). The US Federal Reserve has cut the federal funds rate from 2.25% to 2% for the second time this year. Meanwhile, the European Central Bank (ECB) has kept its policy rate unchanged at 0%, although a quantitative easing program has recently been restarted.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

Despite the deceleration of the latest period, registered exports of goods continued to rise, growing by 10.6% annually in the third quarter of 2019.

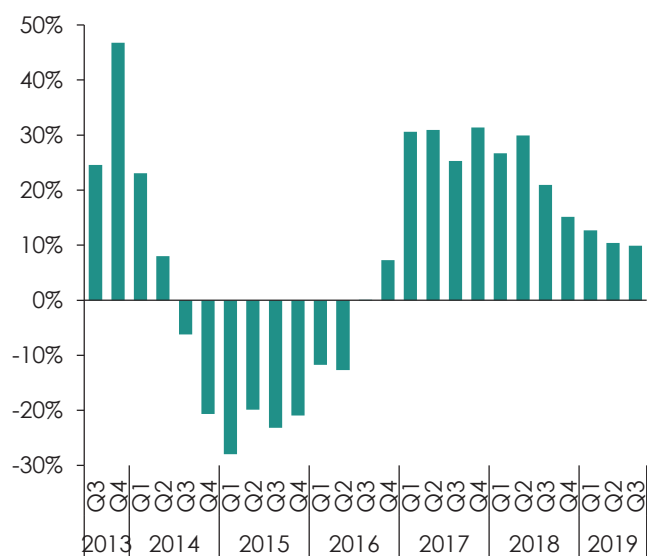


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

The increase in exports of goods was mainly driven by the rise in external demand for consumer and investment goods.

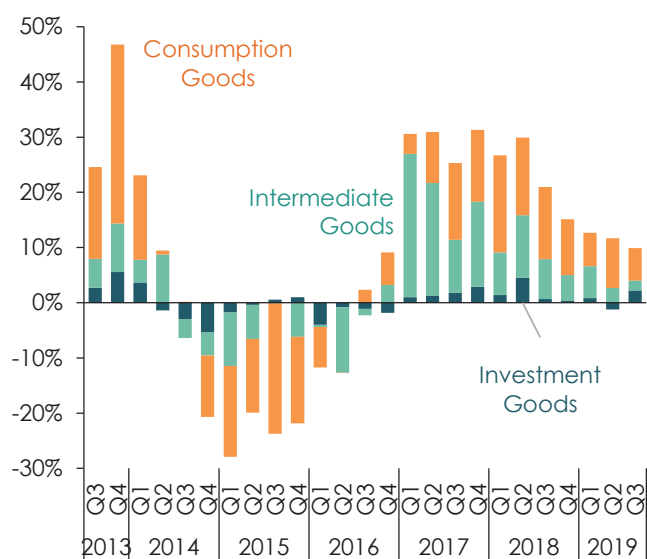


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

Despite heightened risks in the external sector, external demand showed a trend of moderate growth. The Russian ban on air travel to Georgia caused revenues from international travelers to decrease, but exports of goods and services continued to grow alongside rising money transfers. Despite the lower revenues from international travelers, according to the updated forecast, an improvement of the current account balance is expected throughout 2019.

Registered exports of goods grew by 10.6% annually in the third quarter of 2019 (see Figure 1.2.1). The volume of exports increased to Georgia's main trade partner countries – Armenia and Ukraine – as a result of increased external demand that stemmed from the improved economic situations in those countries. In the third quarter of 2019, compared to the same period of the previous year, exports to Armenia grew, mainly in terms of re-exports of motor cars and motor vehicles for the transport for goods, while demand for natural wines and chemical fertilizers increased in Ukraine. In contrast, Russian purchases of ferroalloys and medications decreased, while exports to Azerbaijan stayed at almost the same level due to lower exports of alcoholic beverages and cigarettes. As for EU countries, exports to Romania were high once more because of copper ores and concentrates, while exports to Lithuania increased drastically due to mineral and chemical fertilizers. Demand for copper ores and concentrates was also high from China.

The rise in exports of goods was due to an increased demand for consumer and investment goods (see Figure 1.2.2). The rise in the volume of re-exports also had a significant impact. The increase in consumer goods was mainly due to rising exports of motor cars and vehicles for the transport of goods, natural wines and mineral waters. From intermediate goods, exports of copper ores and concentrates showed high growth, while exports of ferroalloys declined. It is worth noting that in recent quarters exports of goods have become less diverse in terms of commodity group. The overall increase in exports was mainly due to increased external competitiveness due to the exchange rate depreciation.

The volume of money transfers continued rising, albeit at a slower pace.

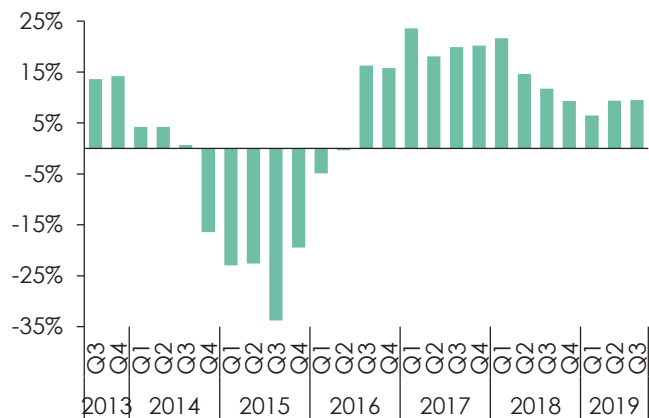


Figure 1.2.3. Annual change in money transfers

Source: National Bank of Georgia

Revenues from international travelers decreased, mainly as a result of a lower number of visitors from Russia.

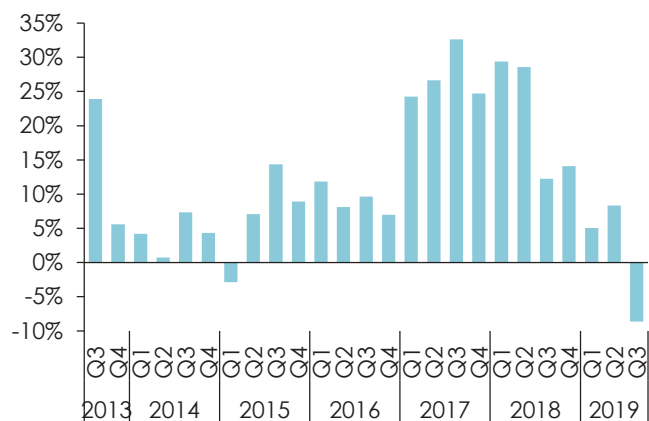


Figure 1.2.4. Annual change in revenues from international travelers

Source: National Bank of Georgia

A decline of imports of goods was visible from the beginning of 2019 and these continued to fall in the third quarter.

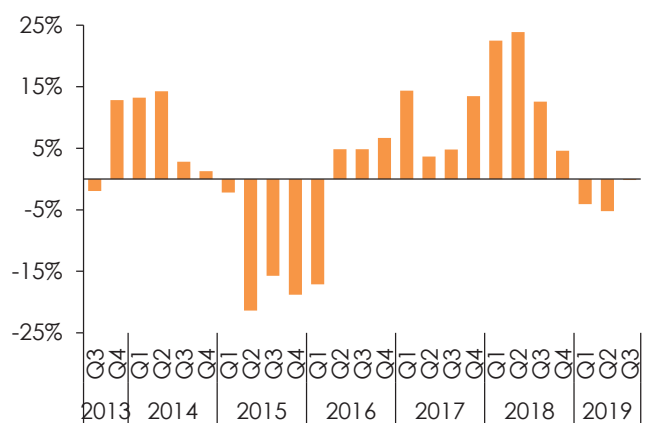


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

From the beginning of 2019, money transfers to Georgia showed an increasing trend, although the growth rate slowed compared to last year. In the third quarter, money transfers to Georgia increased by 9.5% annually (see Figure 1.2.3). Such an increase was mainly due to increased transfers from the European Union (notably from Italy, Greece and Poland) and Ukraine. It is worth noting that money transfers from Russia and Turkey have seen a decreasing trend from the second half of 2018 – a pattern that has continued in the third quarter of 2019. Transfers from those countries thus made a negative contribution (-2.8 pp) to the overall change in money transfers when compared to the same period last year.

The rise in external demand was weakened by a lower volume of revenues from international travelers. In the third quarter of 2019, revenues from international travelers reached 1,106 million USD, which was 8.6% lower than the same period of last year (see Figure 1.2.4). The comparative slowdown of the growth in revenues in the third quarter can be explained by the declining number of visitors from regional countries (mainly Russia, but also from Iran). All else being equal, the decline in revenues from international travelers is expected to cease and then gradually revert to an increasing trend in the second half of 2019.

The share of long-term visitors (especially tourists) in the structure of revenues from international travelers has increased. In the third quarter, the number of international visitors increased by 3.9% annually, the majority of whom (65.7%) were tourists. It should also be noted that the number of visitors to Georgia has grown not only for leisure and recreational purposes, but also for business and other professional purposes. Moreover, the number of repeat visitors who are accompanying or visiting family members or relatives has substantially increased. As was expected, the number of Russian visitors declined as a result of the Russian ban on air travel to Georgia, which negatively influenced revenues from international travelers. On the other hand, the number of visitors from the European Union and other regional countries has increased.

Imports of goods declined from the beginning of 2019 and showed a negative annual change in the third quarter (see Figure 1.2.5). The decline in imports primarily stemmed from the decline of FDI inflows and lower demand on import goods resulting from the exchange rate depreciation. Imports fell substantially from regional countries, including Turkmenistan (due to petroleum products) and Ukraine (due to cigarettes and cigarillos); while from the EU, imports declined from Austria (due to hydroturbines) and France (due to aircraft and hoisting machineries). From other countries, imports substantially declined from China (due to electrical transformers), from Korea (due to automatic data processing machines) and from Brazil (due to copper ores and concentrates).

Imports of intermediate goods rose, imports of consumption goods declined, while imports of investment goods remained the same in the third quarter of 2019.

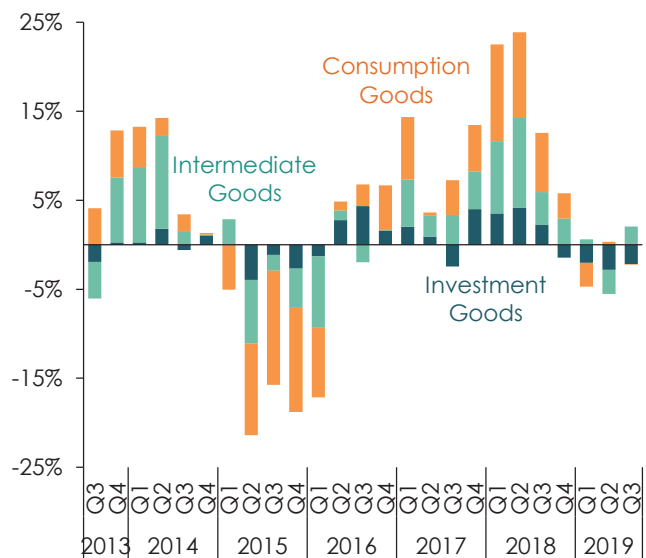


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

From the perspective of savings and investments, the improvement of current account balance is due to the increase in savings and the decrease in investments.

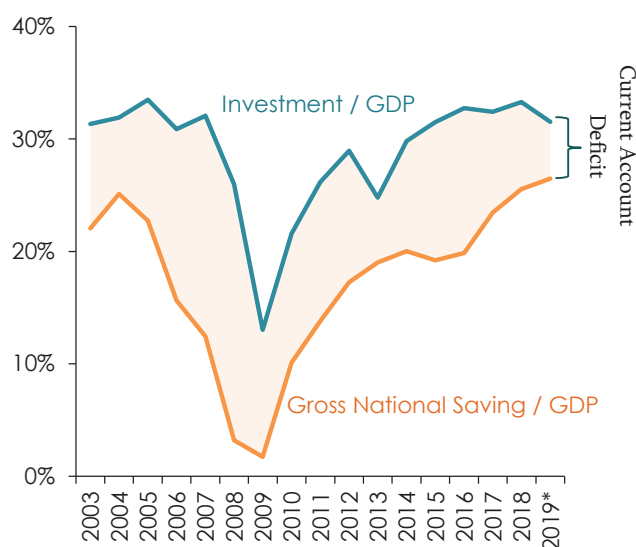


Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

* 2019 data contains the joint sum of the last two quarters of 2018 and the first two quarters of 2019.

In the third quarter of 2019, imports of intermediate and consumer goods accounted for 43% and 44% of total imports respectively. It is worth noting that the decline in imports of goods predominantly stemmed from a fall in consumer goods imports (see Figure 1.2.6). This reduction was largely due to a decline of expenses on petroleum products, which was a result of lower petroleum prices on global markets compared to the previous year. Meanwhile, the fall in imports of investment goods was due to one-off items (like automatic data processing machines and electrical transformers); if those were excluded, there would have been an increase in imports of investment goods. In terms of commodity groups, imports of goods have become less diverse compared to the same period of last year.

In light of the above-mentioned tendencies, a further improvement of the current account deficit is expected, which should positively affect nominal exchange rate dynamics.

The improvement of the current account deficit continued in 2019. In the second half of the year, the current account deficit reached 127 million USD (3.2% of GDP), which was a considerable improvement over the same period of last year.

The primary source of financing the current account deficit is foreign direct investments, which reached 187 million USD. The volume of FDI decreased substantially, by 53.7% annually, in the second half of 2019. It is worth noting that the completion of the final phase of the BP pipeline project and the movement of several enterprises into the possession of Georgian residents both affected the level of FDI.

From the perspective of savings and investments, the improvement of the current account balance was a result of an increase in savings and a decrease in investments (see Figure 1.2.7).

BOX 1. GEORGIA'S SOVEREIGN CREDIT RATING

A country's sovereign credit rating assesses the credibility of the commitments taken by a national government. In other words, credit agencies evaluate the extent to which a country is able to repay its debts according to pre-agreed conditions.

The largest credit agencies in the world are Standard & Poor's, Moody's and Fitch. Their country grading methodologies involve comprehensive economic, financial, institutional assessment, and risks analysis. After conducting their evaluations, the rating agencies publish analytical reports with detailed explanations of the positive and negative factors affecting a country's final rating. In the case of Georgia, the country's rating is reviewed twice a year on average by each agency.

Given the complexity and reputation of the rating agencies, their ratings are the best determinant of a country's macroeconomic position and investment environment and are of great importance to both international and local investors.

A high credit rating with a favorable investment environment enables the country to attract relatively cheap credit resources and vice versa. The higher the risks, the greater the risk premium economic agents need in exchange, which ultimately increases the price of credit resources.

	Grade Description	Moody's	S&P	Fitch
Investment Grade	Highest grade, lowest risk	Aaa	AAA	AAA
	Very high credit grade, very low risks	Aa1	AA+	AA+
		Aa2	AA	AA
		Aa3	AA-	AA-
	High credit grade, low risks	A1	A+	A+
		A2	A	A
		A3	A-	A-
	Good credit rating, moderate risks	Baa1	BBB+	BBB+
		Baa2	BBB	BBB
		Baa3	BBB-	BBB-
Non-investment Grade	Speculative credit grade, substantial risks	Ba1	BB+	BB+
		Ba2 Georgia	BB Georgia	BB Georgia
		Ba3	BB-	BB-
	Highly speculative, high risks	B1	B+	B+
		B2	B	B
		B3	B-	B-
	Real possibility of default	Caa1	CCC+	CCC+
		Caa2	CCC	CCC
		Caa3	CCC-	CCC-
	Very high credit risks, close to default	Ca	CC	CC
Default	C	C	C	

Table 1.2.1 Rating grades

Source: Data of Standard & Poor's, Moody's and Fitch rating agencies

Georgia's sovereign rating was first assessed by Standard & Poor's in 2005. Since 2010, all three rating agencies evaluate Georgia's rating. However, for several years the rating remained unchanged. In 2017, Moody's upgraded its rating to an all-time high of Ba2. This move was followed by a similar assessment from Fitch, and in October 2019 Standard & Poor's also upgraded Georgia's credit rating to BB (see Figure 1.2.8). Important factors that affected the growth in Georgia's ratings were the National Bank's floating exchange rate policy and the accumulation of international reserves that have significantly contributed to external sustainability.

Georgia’s high economic growth and relatively high institutional strength are determining factors for its rating assessment. Other factors that have contributed to the increase in rating include the independence of the National Bank, the adequacy of monetary policy, the stability of the banking sector, fiscal sustainability, low levels of corruption, and developed public services.

The weaknesses that are hindering a further improvement of the country’s credit rating include the small size of the economy, low GDP per capita, the high current account deficit, and high levels of dollarization. The latter, which concerns the dollarization of the banking sector, also includes the high level of foreign currency denominated loans in the country’s liabilities, which makes the country vulnerable to currency fluctuations.

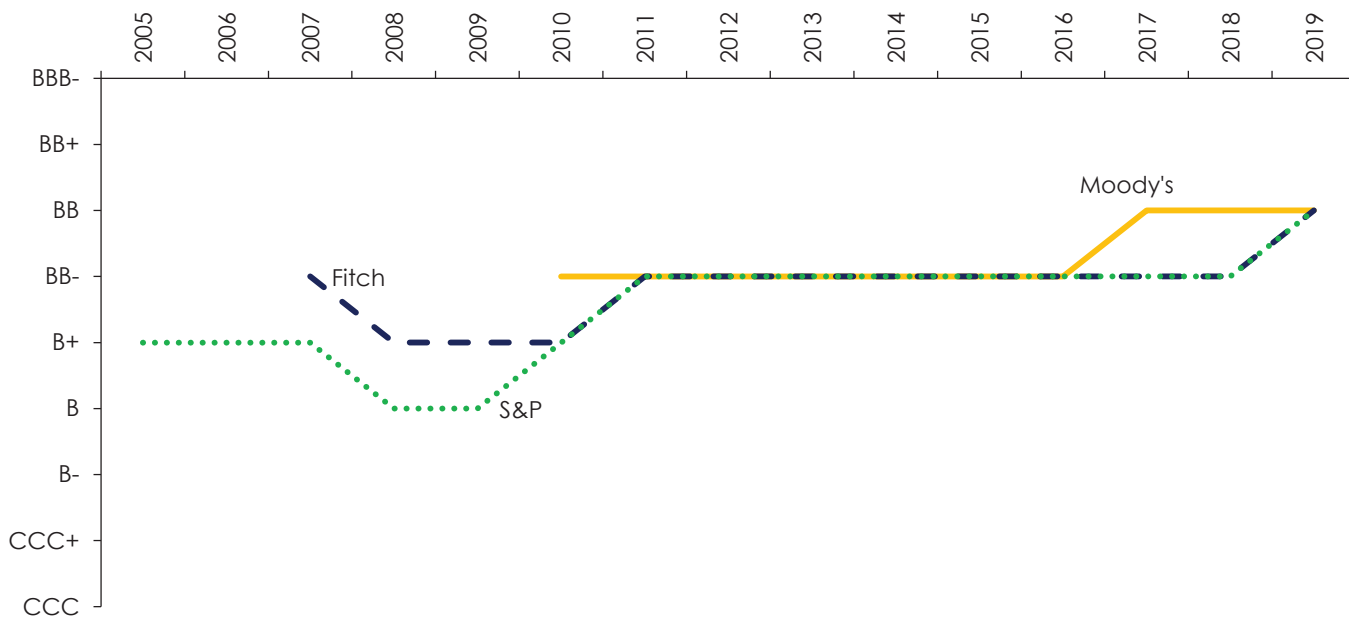


Figure 1.2.8 Georgia’s credit rating history

Source: Data of Standard & Poor’s, Moody’s and Fitch rating agencies

To obtain an investment grade Georgia has must take overcome few challenges. In particular, Georgia needs to maintain macroeconomic stability, which implies sustainable economic growth and a low level of inflation. In addition, it is important to maintain a low budget deficit, improve the current account balance and reduce dollarization. This will reduce external vulnerabilities promote economic sustainability. Reaching the investment grade will raise Georgia’s attractiveness for international investors and increase long-term investment capital inflows into the country.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the second quarter, economic growth and external demand were driven by strong private consumption.

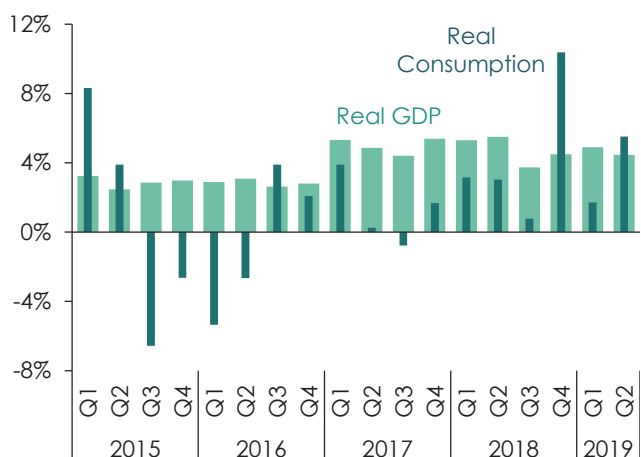


Figure 1.3.1. Real growth of GDP and private consumption

Source: GeoStat; NBG calculations

Growth in the second quarter was driven by the services sector as a consequence of increased inflows of international travelers and activated trade.

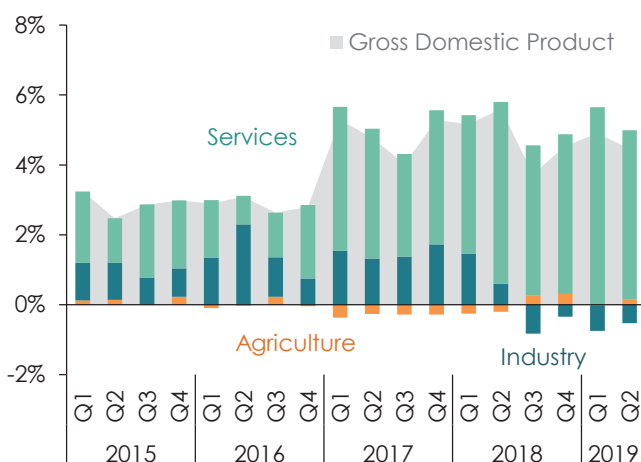


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

Economic growth has primarily been driven by external demand and strong private consumption (see Figure 1.3.1). In the second quarter of 2019, GDP grew by 4.5% in real terms. This growth was mainly driven by net exports and consumption, while the contribution of capital formation/investments was negative. Net exports of goods and services significantly increased. Real growth of household consumption equaled 5.5%.¹³ Meantime, government consumption remained at the same level as in the corresponding period of last year.

The 2.7% reduction of capital formation/investments in nominal terms was due to a decrease of private investments. On the contrary, public investments substantially increased as a consequence of activated infrastructural projects.

1.3.2 OUTPUT

As a sectoral analysis shows, the main driver of economic growth was the service sector. In the second quarter, services contributed 4.8 percentage points (pp) to the total growth of 4.5%. The contribution of agriculture to growth was 0.2 pp, while industry made a negative contribution of -0.5 pp (see Figure 1.3.2).

Services linked to tourism grew the most. Transport made a large contribution, with travel agencies, tour operators and air transport taking a substantial share of that growth. The rise in the output of hotels and restaurants was also significant, as was the participation of foreigners in real estate operations. Each of the abovementioned branches contributed a total of 2.5 pp to the second quarter growth.

Domestic demand showed signs of revival as the growth of trade, the largest branch of the economy, accelerated to 7.4%, contributing 1.0 pp to the total growth.

In the second quarter, construction fell by 4.6%. This was a consequence of a decline in private construction. Although publicly financed infrastructural projects saw high growth (of 55% in nominal terms), the weight of this remained substantially less than that of private constructions.

¹³ The real growth of consumption is calculated using average annual inflation.

Productivity grew by 4.3% in the second quarter of 2019.

	Growth of Productivity
Agriculture	3.6%
Industry	3.3%
Services	4.2%
Overall in the economy	4.3%

Table 1.3.1. Annual growth of value added per employee in the second quarter of 2019

Source: GeoStat

The labor market is not creating inflationary pressure in the economy.

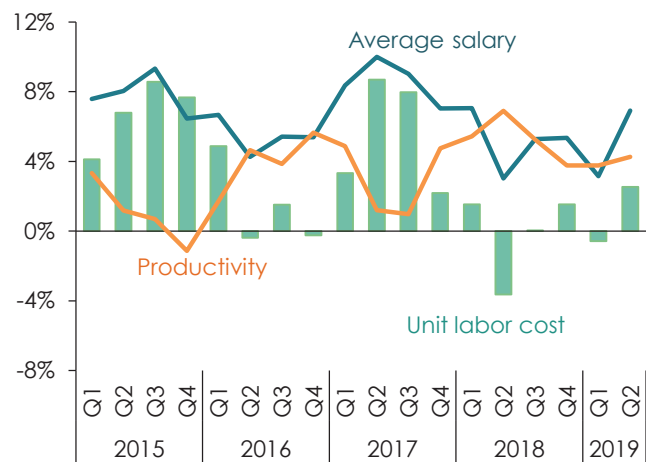


Figure 1.3.3. Labor productivity, average monthly salary and unit labor cost (annual percentage change)

Source: GeoStat; NBG calculations

1.3.3 LABOR MARKET

The growth of productivity has continued. In the second quarter of 2019, labor productivity per worker increased by 4.3% compared to the same period of the previous year. The growth levels of labor productivity in services, agriculture and industry were nearly equal (see Table 1.3.1).

In 2019, the main driver of economic growth has been the service sector. In the second quarter, the output of that sector increased by 7.6%, while the amount of labor employed in the sector grew by 3.3%, which ultimately resulted in a rise of productivity by 4.2%.

The 2.5% output reduction in industry resulted in a 5.6% decrease in employment, thus leading to a 3.3% rise in productivity.

The nominal growth of wages was 6.9% and the average monthly salary equaled 1,180 GEL.

Following the increase in productivity, the unit labor cost grew by 2.5%. Thus, the labor market is not creating inflationary pressure in the economy (see Figure 1.3.3).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In September, the loan portfolio increased slightly and stood at 14.6%, excluding the effect of exchange rate fluctuations.

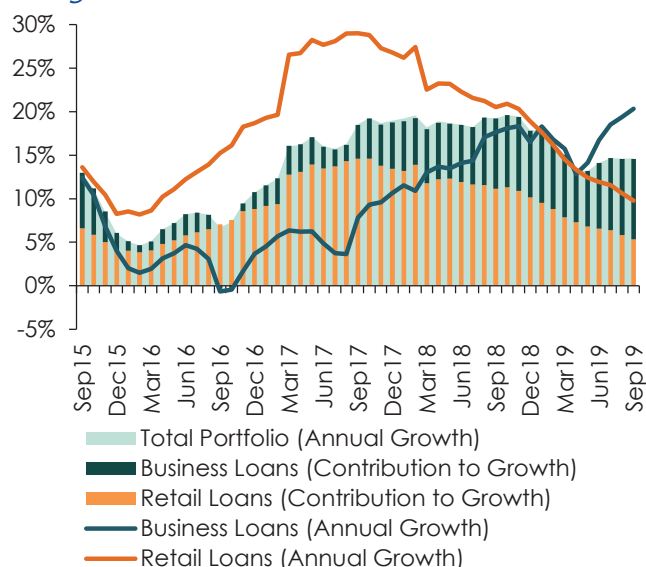


Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In September, relative to June, the loan portfolio increased slightly and stood at 14.6%, excluding the effect of exchange rate fluctuations. During this period, the growth rate of retail loans declined by 2.2 pp and stood at 9.8%, while loans to legal entities increased by 3.6 pp and equaled 20.3% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the trade, energy, construction and manufacturing sectors; whereas the growth of credit in the transport and agriculture sectors decreased slightly. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for retail loans.

In terms of currencies, it is important to emphasize that in the third quarter of 2019 the growth of the loan portfolio was mainly driven by an increase in domestic currency loans (see Figure 1.4.2). In September, the annual growth rate of foreign currency denominated loans declined slightly and stood at 7.9%, while loans in the domestic currency grew by 23.2%. In the third quarter, the loan larization ratio increased by 1.6 pp to equal 44.8%. The increased level of larization is a step towards reducing risks to financial stability.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In the third quarter of 2019, the growth of the loan portfolio was mainly driven by an increase in domestic currency loans.

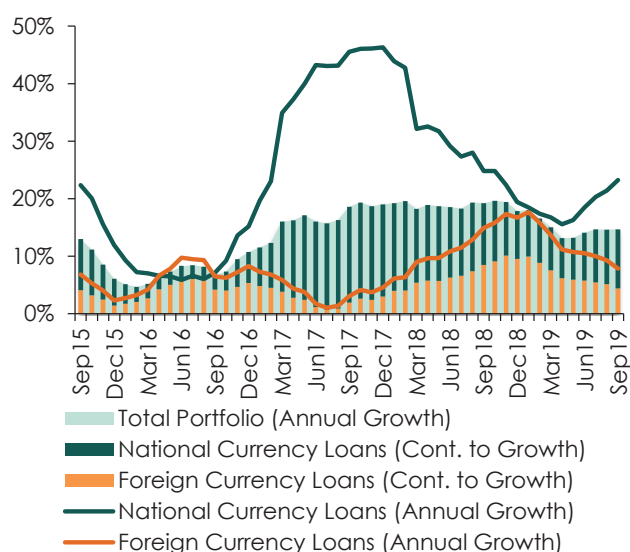


Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In October, the monetary policy rate was 8.5%. In the third quarter of 2019, interest rates on government securities increased as a result of the increase in the monetary policy rate (see Figure 1.4.3).

Compared to the previous quarter, the spread between long- and short-term interest rates has not changed significantly. This indicator remains at a low level, which suggests increased credibility of monetary policy instruments and improved predictability of the monetary policy rate.

In September, relative to June, interest rates on domestic and foreign currency deposits did not change significantly and equaled 7.8% and 3% respectively. According to the credit conditions survey, representatives of the banking sector do not expect an increase in the cost of funds in the next quarter.

Furthermore, according to the survey, interest rates for mortgage loans issued in the domestic currency have increased, while interest rates for mortgage loans issued in foreign currency have slightly decreased. In terms of credit conditions for legal entities, representatives of the banking sector expect a slight decrease of interest rates in the next quarter. In September, compared to June, interest rates on loans issued to small and medium enterprises have not changed significant-

Along with a tightening of monetary policy, interest rates on government securities have increased in the third quarter of 2019.

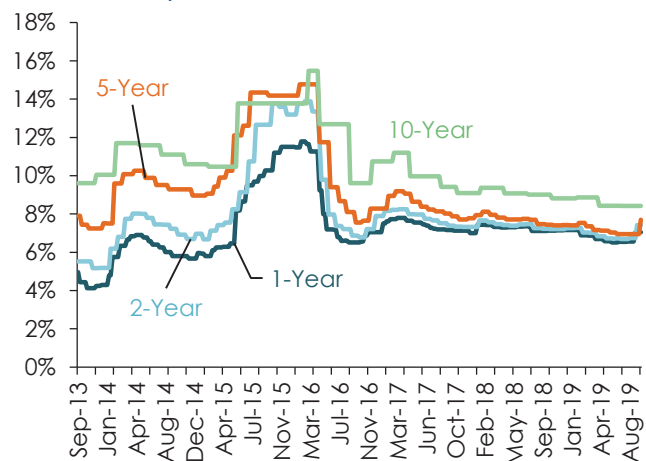


Figure 1.4.3. Interest rates on government securities

Source: National Bank of Georgia

In the third quarter, the spread between long- and short-term interest rates has not changed significantly.

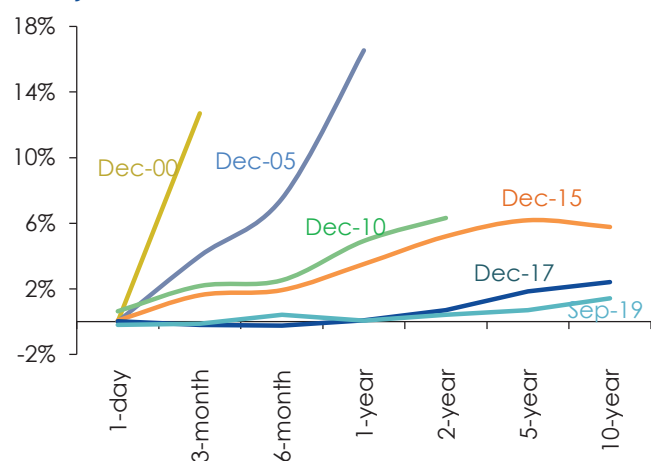


Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

In September, compared to June, average interest rates on the stock of legal entities declined slightly for both foreign and domestic currency loans.

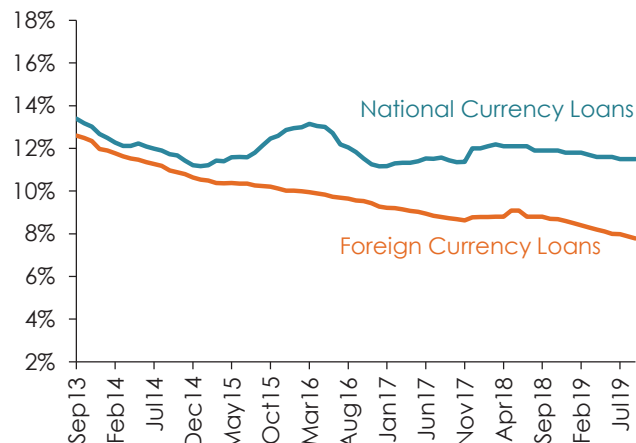


Figure 1.4.5. Average interest rates on business loans

Source: National Bank of Georgia

ly. Interest rates for corporate loans declined by 0.4 pp and stood at 8.5%, while interest rates on retail loans increased by 0.8 pp and equaled 15.4%.

In September, compared to June, average interest rates on the stock of legal entities declined slightly for both foreign and domestic currency loans (see Figure 1.4.5.). Representatives of the banking sector do not expect a significant change in interest rates for loans in foreign and domestic currency.

The magnitude of the real effective exchange rate depreciation during the last period corresponds to the previous period's depreciation when the exchange rate reversed in the other direction.



Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

The nominal effective exchange rate, weighted based on commodity groups and services, depreciated slightly more than the nominal effective exchange rate with official weights.

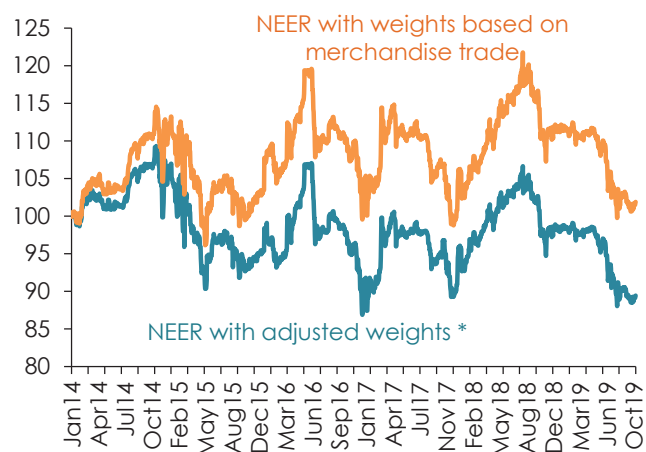


Figure 1.4.7. Corrected nominal effective exchange rate

Source: National Bank of Georgia

* 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.

1.4.3 EXCHANGE RATE

In the third quarter of 2019, the GEL nominal exchange rate depreciated against the US dollar by 6.6% and against the euro by 5.5%, compared to the previous quarter. Meanwhile, the GEL depreciated against the Russian ruble and against the Turkish lira by 6.6% and 10.3% respectively. As a result, the nominal effective exchange rate depreciated by 6.6% on a quarterly basis and by 12.6% on an annual basis. As for the price-adjusted exchange rate, the real effective exchange rate depreciated by 6.3% quarterly and by 12.2% on a year-on-year basis. The depreciation of the effective exchange rate, without a substantial weakening of economic activity, puts pressure on inflation. Historically, after depreciation of that magnitude, the exchange rate usually changes the direction

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture. In the third quarter of 2019, the adjusted nominal effective exchange rate depreciated by 13.0% on an annual basis and by 6.8% on a quarterly basis.

During this period, the exchange rate was negatively affected by the decline in revenues from the tourism sector. However, the perception of risk may have been significant in this regard, as recent tourism data show that the decline in tourism revenues has been lower than expected by the National Bank. At the same time, the reduced level of FDI is also significant. On the other hand, as mentioned above, the exchange rate depreciation has contributed to the elimination of external imbalances. Improving the current account will be one of the most important contributors to the long-term stability of the exchange rate.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	-12.6	-12.2	-12.2
Eurozone	-9.5	-5.6	-1.2
Turkey	-12.5	-18.7	-3.2
Ukraine	-20.1	-22.5	-1.6
Armenia	-14.5	-10.7	-0.7
US	-13.4	-10.4	-0.5
Russia	-14.6	-13.8	-1.9
Azerbaijan	-13.3	-11.3	-1.2
Other	-10.3	-8.1	-1.7

Table 1.4.1. Effective exchange rates annual growth (3rd quarter of 2019)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

Core inflation was substantially lower than headline inflation, which signals a reduction of headline inflation in the future.

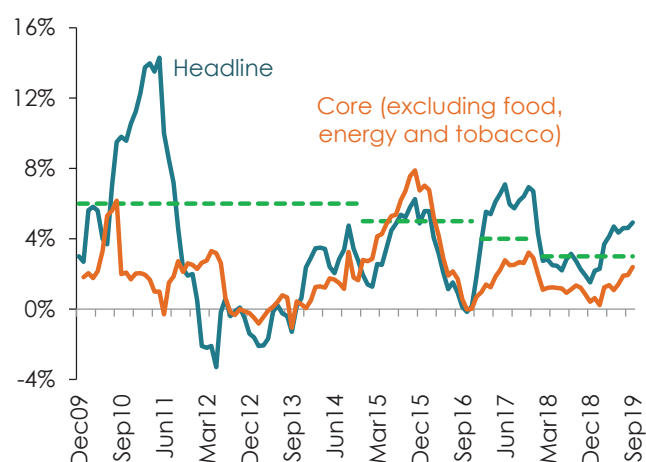


Figure 1.5.1. Headline and core inflation

Source: GeoStat

Due to their large weight (27%) in the consumer basket, volatile food prices significantly affect inflation.

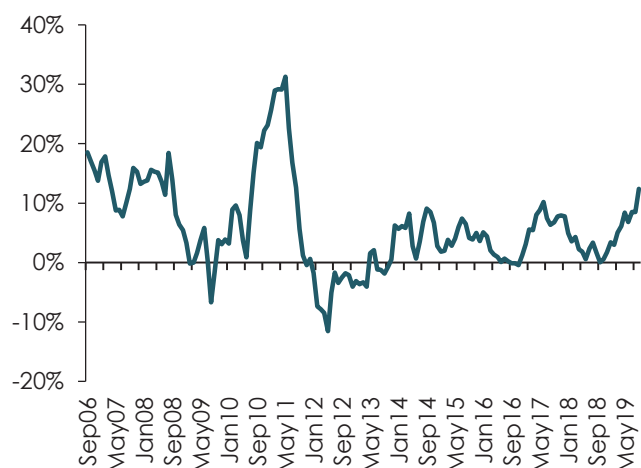


Figure 1.5.2. Food inflation

Source: GeoStat

1.5 CONSUMER PRICES

Inflation has exceeded the target level since March. Food, together with cigarettes, made a significant contribution to the rise in inflation. In September, headline inflation equaled 6.4%.

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was substantially lower than headline inflation and stood at 3.2% in September (see Figure 1.5.1). The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation, in spite of the recent increase, signals a reduction of headline inflation in the future.

Food prices, due to seasonality, productivity and other factors, are highly volatile and, because of the large weight (27.3%) they carry in the consumer basket, significantly affect inflation.

Unlike last year, in the current year food inflation is high (see Figure 1.5.2). Out of the 6.4% overall growth in inflation seen in September, food made a 3.3 pp contribution. An important share of this came from price increases on bread, meat, cheese, potatoes and sugar. This is related to price changes on both local and global markets. In addition, as a consequence of the rise of excise tax on cigarettes from the beginning of the year, tobacco products are substantially more expensive than in the previous year and their contribution to inflation amounted to 0.9 pp.

The rise in inflation is mostly related to food and cigarettes.

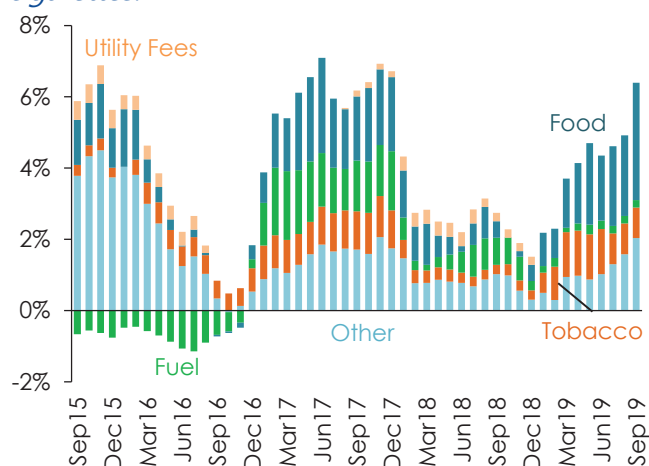


Figure 1.5.3. Contribution of different products to inflation

Source: GeoStat; NBG calculations

The price increase on food was reflected in the rise of domestic inflation. Moreover, price increases on imported food and cigarettes are linked to the depreciation of the nominal effective exchange rate (see Figure 1.5.3).

In September, annual inflation on imported, mixed and domestically produced goods equaled 5.6%, 7.0% and 6.5% respectively (see Figure 1.5.4).

The price increase on food is reflected on the rise of domestic inflation. The price increases on imported food and cigarettes are linked to a depreciation of the nominal effective exchange rate.

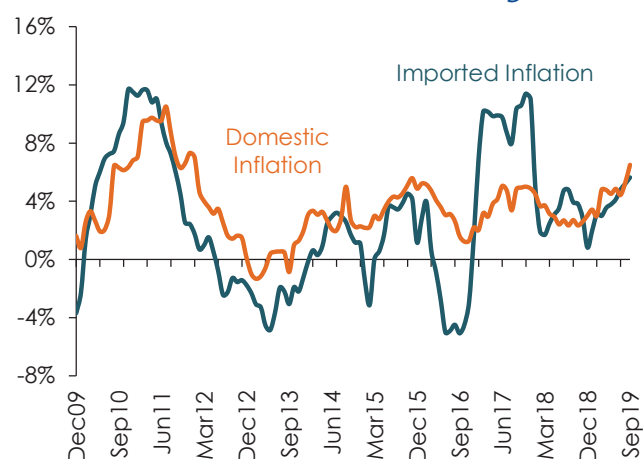


Figure 1.5.4. Imported and domestic inflation

Source: GeoStat; NBG calculations

BOX 2. ESTIMATION OF INFLATION VOLATILITY AT DIFFERENT PERIODS IN GEORGIA

Inflation volatility is one of the key indicators of macroeconomic imbalance, which makes it difficult for economic agents to predict and plan for the future. High levels of uncertainty on future prices distort relative prices and adversely affect production and investment plans. In addition, inflation fluctuations undermine trust in the local currency and encourage economic interactions in foreign currency. The resulting “dollarization” increases vulnerability and challenges macroeconomic stability.

Inflation fluctuations are caused by the volatility of inflation’s long-term trend, as well as by short-term movements around that trend. Short-term inflation movements are caused by exogenous factors, including food, energy and regulated prices. It would be too costly and harmful for the economy to completely offset short-term shocks to inflation. However, in the case of successful monetary policy, when central banks manage to anchor inflation expectations (that results in a lower possibility of short-term shocks being transmitted to long-term inflation dynamics), the volatility of the inflation trend is lower. That said, measuring the volatility of the inflation trend can be used to assess the success of monetary policy in the anchoring of inflation expectations.

Examining variations of the HP (Hodrick Prescott) trend of headline and core inflation can be employed to estimate the volatility of the long-term fundamentals of inflation at different periods. As Figure 1.5.5 shows, the volatility of the trends of headline and core inflation significantly decreased in 2015-2019 relative to previous periods. From 2009 to 2014, the high volatility of the inflation trend can be explained by large supply-side shocks (for instance, the food price shock of 2010-2011), which made it difficult to keep the statistical trend of inflation at a stable level as the inflation-targeting regime had been newly introduced in Georgia at that time.¹⁴ As expected, the volatility of the trend of core inflation is significantly lower than that of headline inflation; core inflation does not include food and energy prices and is thus less sensitive to supply-side shocks. It should also be noted that recently actual inflation has been closer to targeted inflation, which implies improved inflation predictability.

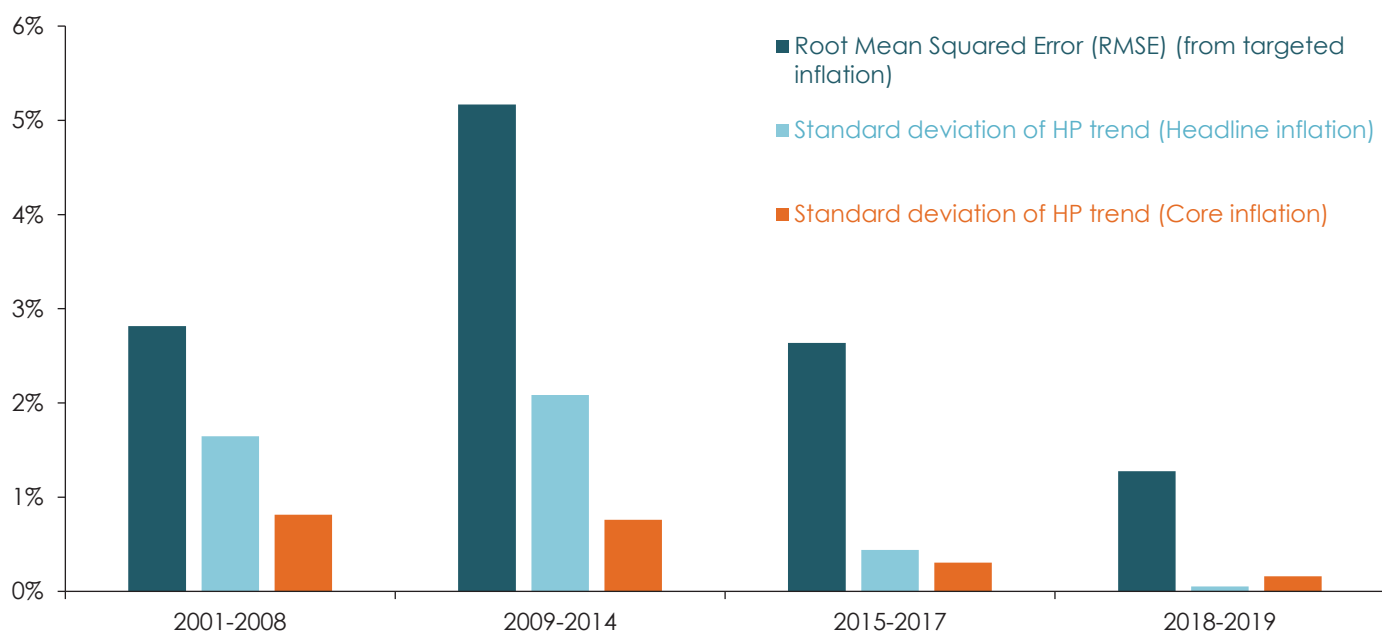


Figure 1.5.5 Inflation volatility at different periods¹⁵

Source: National Bank of Georgia

As Figure 1.5.5 shows, despite short-term fluctuations, recently inflation has more often been closer to its target for a longer time than in previous periods. It is an objective of the central bank to ensure that, after filtering out short-term volatility, inflation is kept close to the target and is predictable. That said, under the inflation-targeting regime, the National Bank of Georgia aims to keep long-term inflation expectations stable and close to the inflation target of 3%.

¹⁴ The inflation-targeting regime was introduced in Georgia in 2009. The inflation target was 6% in 2010-2014, 5% in 2015-2016, 4% in 2017 and has been set at 3% since 2018.

¹⁵ Until 2008, the RMSE is estimated as the volatility of inflation around its mean value.

2 MACROECONOMIC FORECAST

The current forecast is that in the short term, overall annual inflation will stay above the 3% target before falling short of it to ultimately approach the target from below. Upward inflationary pressures will be a result of the current exchange rate depreciation, which will be partially offset by weak aggregate demand. According to current estimates, economic activity will increase by 4.5% in 2019-2020, which will only partially eliminate the negative output gap. In order to keep inflation close to its target in the medium term, it is expected that the policy rate will increase in the short run, and then gradually decrease to the neutral rate at a slower pace than previously projected, in line with the reduction of inflation. This policy rate forecast was a result of a revision of the inflation forecast in the wake of the greater-than-expected depreciation of the GEL, while the forecast of real GDP growth has remained at the same level. The current alternative forecast scenario considers a higher exchange rate depreciation than in the baseline scenario, which would result in a further tightening of monetary policy in response to rising inflation expectations.

In the short term, inflation is expected to be maintained above the target, but will then fall below the target and approach it from below in the medium term.

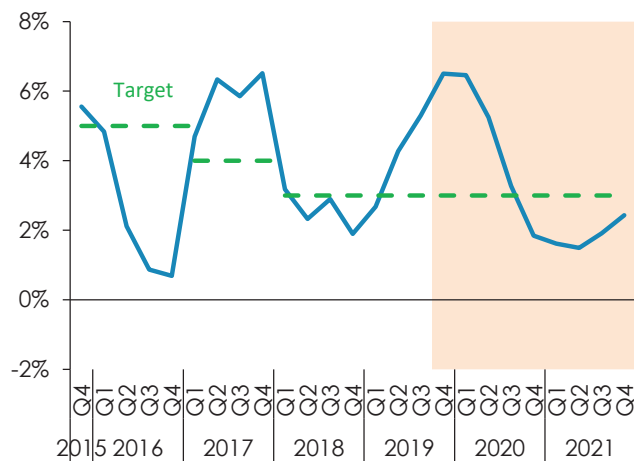


Figure 2.1.1. Headline inflation
Source: National Bank of Georgia

2.1 BASELINE MACROECONOMIC FORECAST

It is projected that overall annual inflation will remain above the target over the next three quarters, and will then go through a gradual decline phase before approaching the target from below in the medium term (see Figure 2.1.1). This will be a result of a tight monetary policy that will temporarily allow for lower-than-target inflation to reduce long-term inflation expectations.

Inflation dynamics on the forecast horizon are mainly determined by two factors: the depreciation of the nominal effective exchange rate over previous periods and weak aggregate demand. The former, in the short run, pushes consumer prices upward as long as the costs of importing of products continue to increase. On the other hand, the intermediate costs for companies with foreign currency debt obligations will also rise (which will eventually be reflected in higher selling prices, see Figure 2.1.2). As for the still-weak demand, in the short run this will exert downward pressure on prices, while in the medium term a recovery in economic activity will ensure inflation gradually nears the inflation target.

Weak aggregate demand is reflected in the moderate growth rate of real GDP projected for 2019-2020. Current estimates suggest that, driven by positive trends in the trade balance, net exports will make a significant contribution to growth (see Figure 2.1.3). Specifically, it is expected that given the nominal exchange rate depreciation over previous periods, export earnings will continue to maintain high growth rates, with imports changing only moderately. However, the assumptions of the forecast also provide for the continuation of both lending and fiscal spending at a

High inflation fluctuations are caused by both exchange rate depreciation effects and weak aggregate demand.

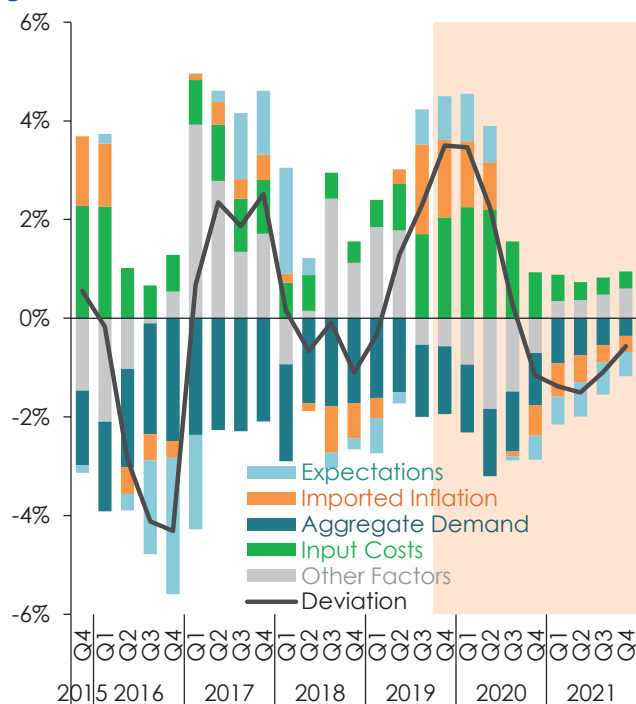


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

Net exports will be the driving force behind the growth in economic activity, though the potential for GDP growth remains.

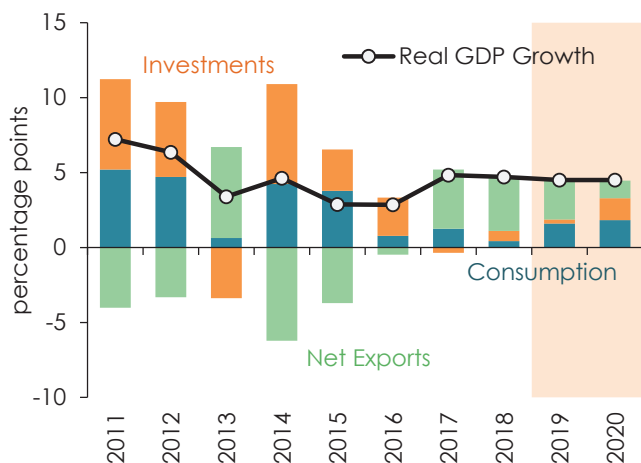


Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

moderate pace, the latter mostly being on infrastructure projects. Against this background, the output gap will only be phased out by the beginning of 2021.

The current forecast of real GDP might deviate from the actual path if some less probable, albeit still plausible, scenarios unfold. In this regard, it is important to mention the downside risks to economic growth. A further deterioration of the geopolitical or economic environment would cause a further decrease in financial inflows, while sovereign risk premiums in the region would increase. This would negatively affect consumption, business sentiment and investment. Moreover, if fiscal stimulus remains weak or the growth of the credit portfolio is less than expected, then economic activity will grow at a slower rate than predicted. Conversely, if the balance of payments improves more than is expected, given an improvement in external factors and a competitive exchange rate, then the growth of economic activity will be more than projected.

As mentioned above, the depreciation of the nominal effective exchange rate creates significant pressure on inflation. According to estimates, the impact is so strong that it has raised inflation expectations and requires an adequate monetary policy response in order to bring inflation to its target in the medium-term horizon. Consequently, based on current information, it is expected that the policy rate will continue to rise until the exchange rate pressure is eliminated. After that point, the rate will gradually begin to normalize and will return to a neutral level, estimated to be 6%, after a two-year period.

The inflation forecast has been revised upward due to currency depreciation.

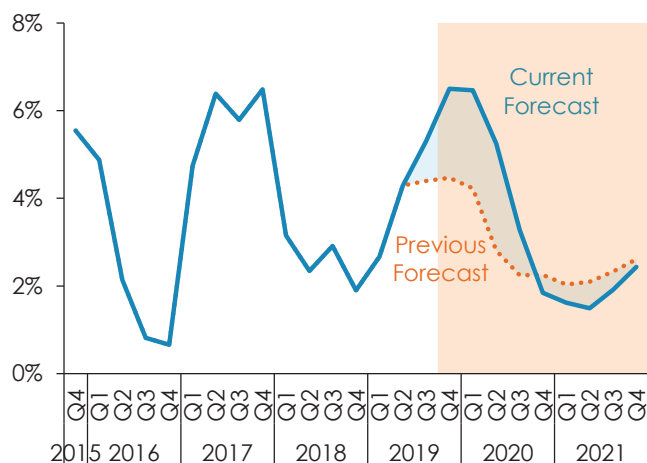


Figure 2.2.1. Changes in the forecast of headline inflation
Source: National Bank of Georgia

The real GDP forecast for 2019-2020 remains at the 4.5% level as tightened monetary policy will neutralize fiscal stimulus.

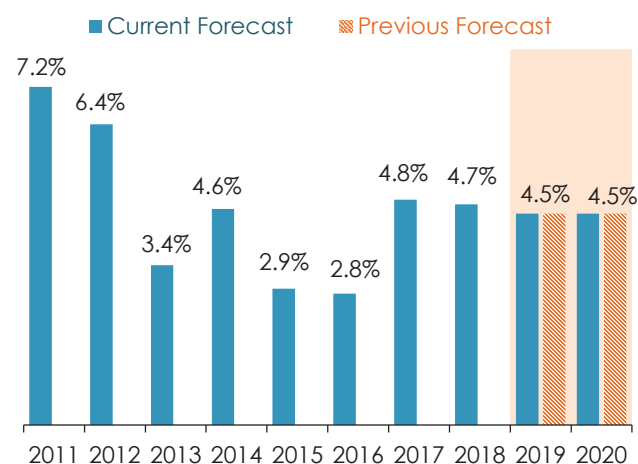


Figure 2.2.2. Changes in the forecast of real GDP
Source: National Bank of Georgia

Expectations about a depreciation of trading partner currencies have reduced for 2019-2020. Accordingly, inflationary expectations have also fallen.

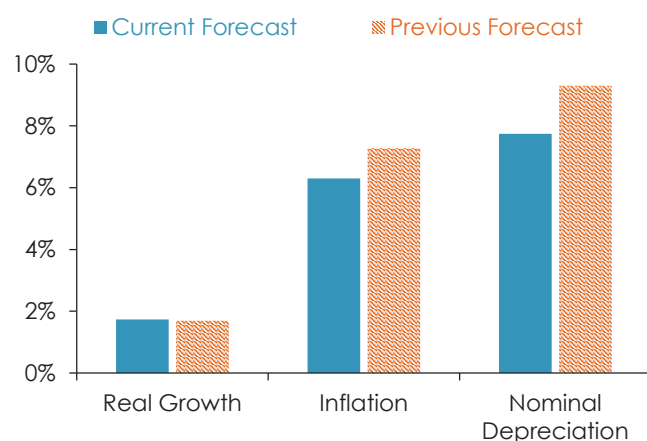


Figure 2.2.3. Changes in the forecast of external assumptions
Source: Bloomberg

2.2 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous projection, the inflation forecast has been revised upward (see Figure 2.2.1). The upward revision of the short-term forecast was mainly driven by the greater-than-expected currency depreciation. Both nominal and real effective exchange rates significantly depreciated and have remained at that level for a prolonged period of time. The exchange rate depreciation makes imported goods more expensive and pushes inflation up. Meanwhile, the depreciation vis-a-vis the US dollar increases the debt burden for unhedged borrowers. As a response, producers increase prices. Due to these factors, the contribution of imported inflation and intermediate costs to headline inflation have increased. On the other hand, the medium-term inflation forecast has been revised downward as a tightened monetary policy will reduce aggregate demand. According to the revised forecast, inflation is expected to remain at 6.5% in the first quarter of 2020, which is higher than the target level. However, inflation is then predicted to start to decline in the second quarter of the year.

Nevertheless, the real GDP growth forecast for 2019-2020 remains at 4.5% – the same prediction as in the previous quarter (see Figure 2.2.2). On the one hand, tightened monetary policy will cause economic activity to slow, but, on the other hand, fiscal stimulus will boost economic growth. Ultimately, a tightened monetary policy will neutralize fiscal stimulus and economic growth will be approximately the same as previously predicted. As for the short-term real GDP forecast, this also remains at the 4.5% level. Nonetheless, the probability of higher economic growth in the short run has increased. The current account balance has improved significantly, which creates the possibility of boosting real GDP through the net exports channel.

Georgia is a small, open economy and trading partners' economic stances have a significant impact on the country. The aforementioned macroeconomic forecasts thus strongly depend on assumptions regarding the economic growth, inflation and exchange rates of trading partner countries. Changes in these assumptions will affect both the baseline forecast as well as associated risks (see Figure 2.2.3).¹⁶

Assumptions regarding the economic stances of Georgia's trading partners have slightly changed. Expectations about a depreciation of their currencies have declined for 2019-2020 as a consequence of an expected weakening of the USD against other currencies. As a result, inflationary expectations for Georgia's trading partners have been revised downward.

¹⁶ Calculations are based on the forecasts for the five main trading partners of Georgia: the US, the EU, Turkey, Ukraine and Russia.

The alternative forecast scenario considers a sharper decline in foreign direct investments compared to the baseline scenario. Accordingly, under the alternative scenario, annual real GDP growth for 2019-2020 will be around 4.0%.

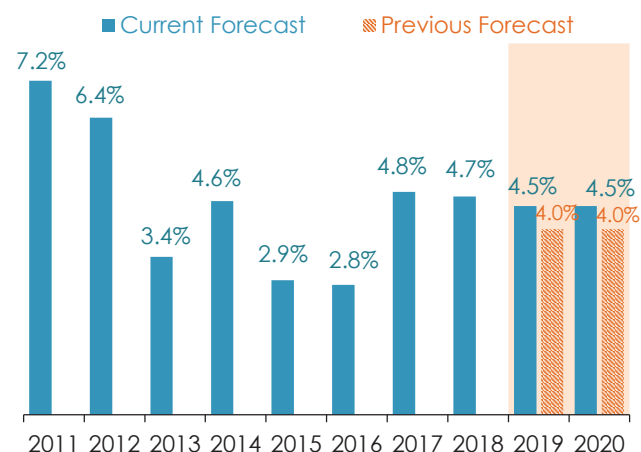


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

A rising risk premium and deposit dollarization will cause exchange rate depreciation. A depreciated currency would push inflation up and over 2019-2020 inflation will be 1.0 percentage point higher than in the baseline projection.

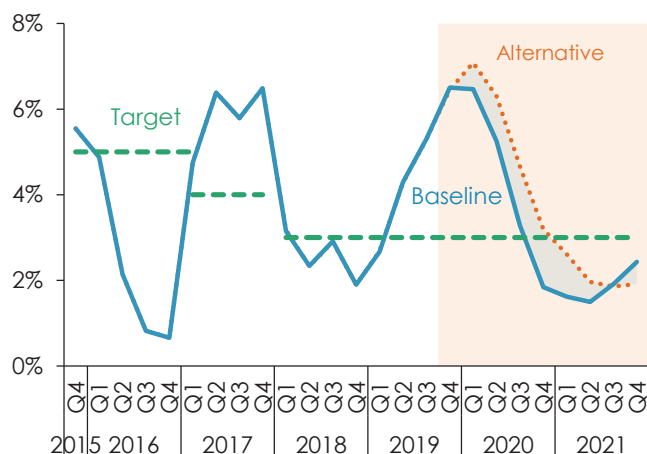


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

However, in terms of economic activity, no significant change is expected. Finally, in line with these updated expectations, no significant change in external demand is expected.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a sharper decline in foreign direct investments compared to the baseline scenario. As already mentioned, in the baseline scenario, FDI is predicted to be around 5-7% of GDP. In the alternative scenario, FDI is smaller, which will have a negative impact on economic activities. Meanwhile, a decline in FDI would be followed by an increase of the country risk premium, which can push up deposit dollarization.

A realization of the abovementioned risks would slow economic growth compared to the baseline scenario. Accordingly, under the alternative scenario, annual real GDP growth will be around 4.0% (see Figure 2.3.1).

A decline in FDI with an increased risk premium and deposit dollarization will cause the nominal effective exchange rate to depreciate. A depreciated currency would push inflation up through the channels of imported and intermediate input costs. This effect will be partially neutralized in the medium term by subdued aggregate demand. According to the alternative forecast scenario, over 2019-2020 inflation will be 1.0 percentage point higher than in the baseline projection (see Figure 2.3.2).

In order to bring inflation back to the target, monetary policy will be tightened in response. Under the alternative scenario, the monetary policy trajectory will rise by 1.0 percentage point compared to the baseline scenario (see Figure 2.3.3). However, in the medium term, alongside weak aggregate demand, the policy rate will start to decline. Tightened monetary policy in the short term will eventually drive inflation towards the target level of 3% in the medium term.

In order to bring inflation back to the target, monetary policy will be tightened. Under the alternative scenario, the monetary policy trajectory will shift up by 1.0 percentage point compared to the baseline scenario.

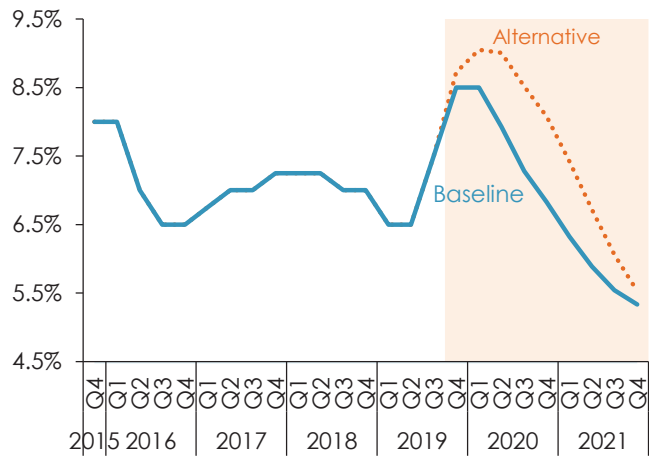


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

3 MONETARY POLICY

To neutralize the inflationary pressure stemming from the exchange rate depreciation, in September, the Monetary Policy Committee deemed it appropriate to start policy tightening. It is important to note that the GEL exchange rate remains undervalued, supporting the activation of inflation expectations and pushing inflation upward. Hence, at a meeting on 23 October, the decision was made to increase the refinancing rate by one percentage point to 8.5%. The NBG will continue to monitor developments in the economy and on financial markets and will use all means and instruments at its disposal to ensure price stability

In response to the increased pass through of the depreciated nominal exchange rate to inflation, the National Bank of Georgia started to tighten monetary policy. In particular, on 4 September and during a subsequent extraordinary meeting of 25 September, the NBG increased the policy rate by 0.5% to 7.5%.

According to the decision made on 23 October 2019, the refinancing rate was increased by 1 percentage point to 8.5%.

It is important to note that the GEL nominal effective exchange rate remains undervalued, exerting upward pressure on inflation. Meanwhile, inflationary pressure is only partially offset by aggregate demand-side factors as based on preliminary estimates, economic activity will be enhanced compared to previous periods. Hence, on 23 October, the Monetary Policy Committee decided to increase the refinancing rate by one percentage point. Future decisions of the committee will depend upon the speed at which the exchange rate pressure stemming from the exchange rate depreciation is neutralized. However, despite the risks stemming from the external sector, external inflows continue to grow at a modest rate, contributing to the growth of economic activity. At the same time, it is important to note that economic activity still lags behind its potential level, and thus demand-side pressure on inflation remains weak. According to the NBG's forecasts, as discussed in the forecasts section of this report, assuming other conditions being equal, inflation is expected to remain above the target this year, before starting to decline from March 2020 and then closing on the target from below in the medium term.

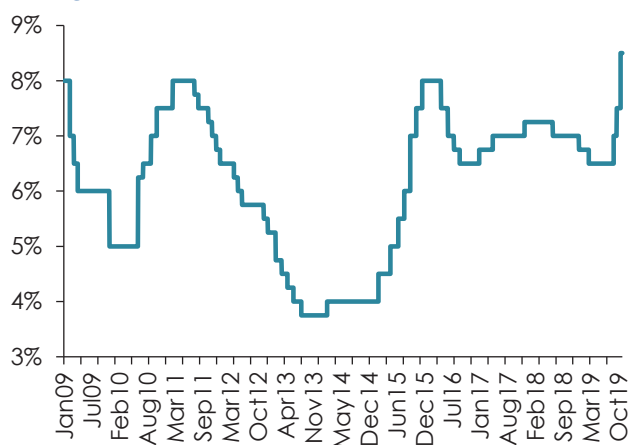


Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

It is worth noting that monetary policy is an instrument to affect aggregate demand and central banks do not usually react to exogenous (independent of monetary policy) factors. At the same time, it is important to consider several major risks to the inflation forecast. Inflation will be lower than anticipated if demand is weaker than expected, which will depend on

According to the decision made on 25 September 2019, the reserve requirements for foreign currency funds were reduced to 25%.

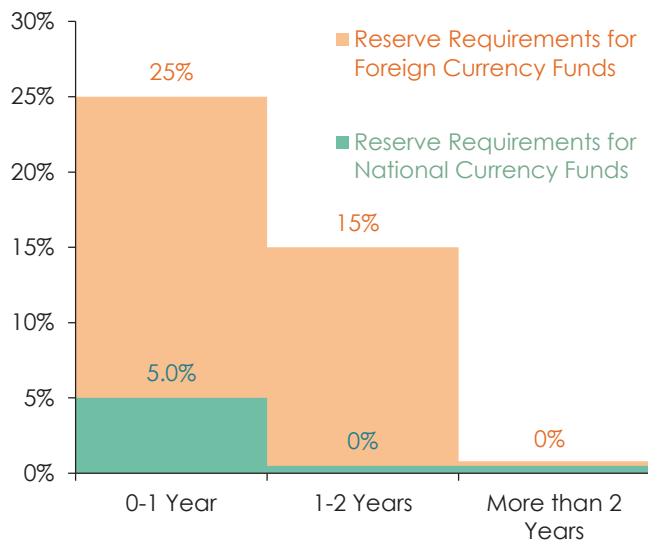


Figure 3.2. Reserve requirements
Source: National Bank of Georgia

the strength of fiscal stimulus and the growth of lending activity. Conversely, inflation may be higher than expected if risk premiums in the region increase following a deterioration of geopolitical and economic conditions, or if prices on international markets grow.

In addition, to mobilize additional foreign currency liquidity in the banking system, on 25 September 2019, on an extraordinary meeting of the Monetary Policy Committee the decision was made to reduce the reserve requirements for foreign currency-denominated funds to 25%. This move will enable banks to supply more foreign currency to the market and will encourage the accumulation of foreign currency resources from international markets. The supply of foreign currency on the market will increase, thereby weakening exchange rate pressure due to the demand on foreign currency resources.

To ensure the efficiency of monetary policy, it is important that changes in the monetary policy rate are reflected on interbank interest rates and ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. To manage short-term liquidity, the banking sector mainly relies on refinancing loans and on the interbank money market. The National Bank provides short-term liquidity to the banking system via one-week refinancing loans and one-month open market operations. In order to further reduce interest rate volatility and boost the efficiency of the interbank market, on 4 September 2019 the National Bank's overnight lending and deposit rates were set at a policy rate of +/-0.75 percentage points, instead of the previous rate of +/-1 percentage point. Interbank money market interest rates thus vary around the monetary policy rate.

Interbank money market rates vary around the monetary policy rate.

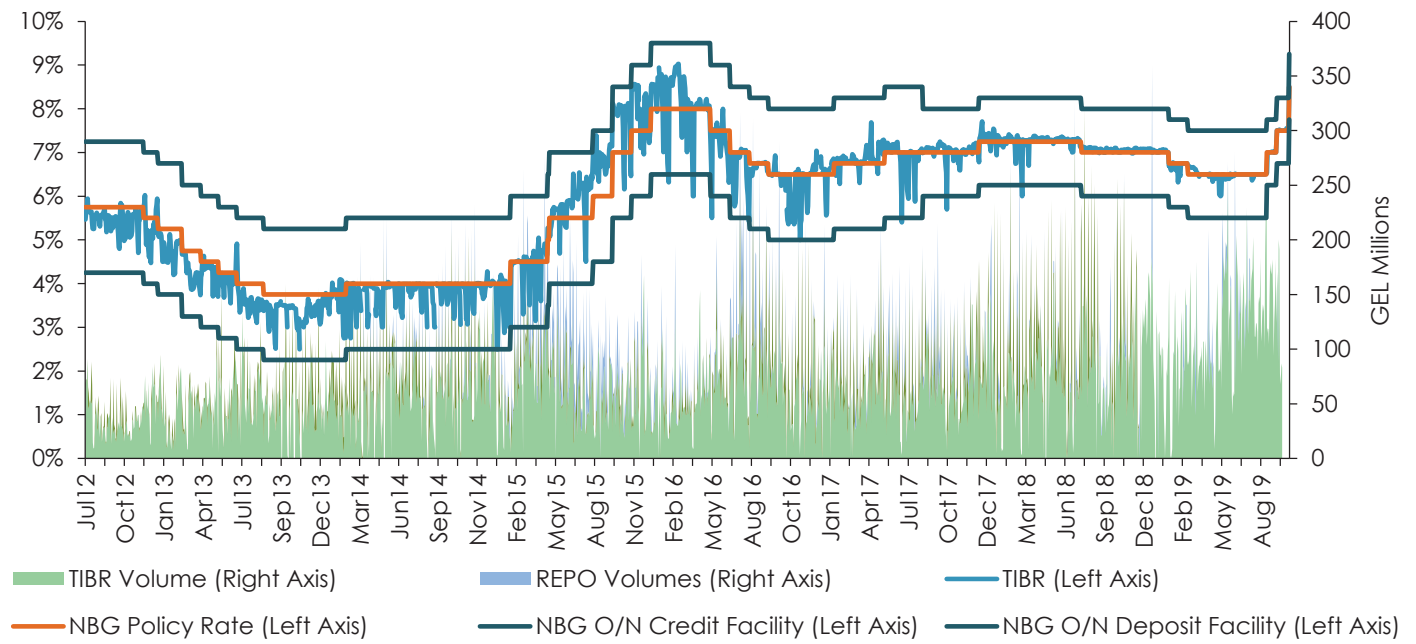


Figure 3.3. Interbank money market

Source: National Bank of Georgia

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