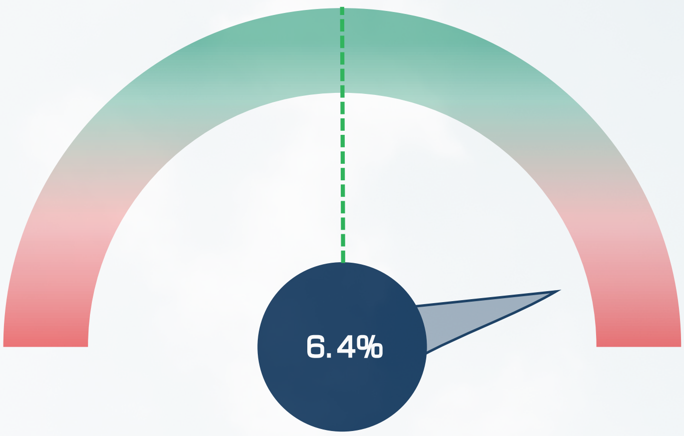
Monetary Policy Report

February

2020

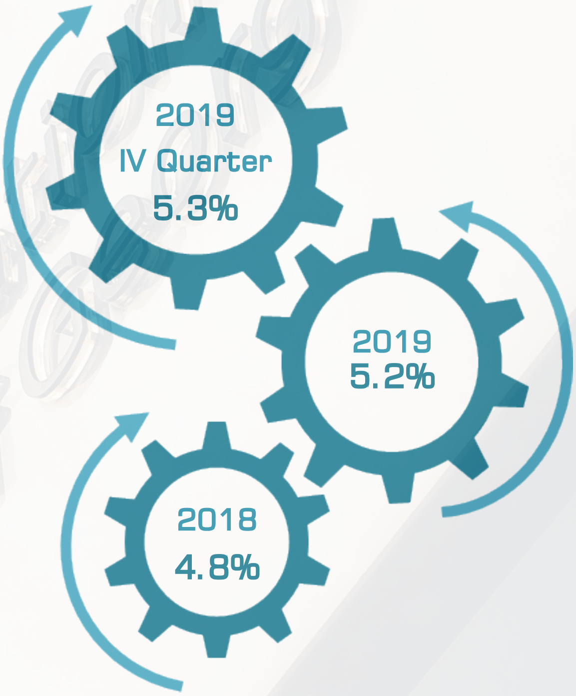
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



6.4%	Inflation is still above the target

Economic Growth



Aggregate demand is strong	5.3%

Monetary Policy

9.0%

0

9.0%	In response to above-target inflation, the NBG tightened monetary policy

MONETARY POLICY DECISION

We have maintained the monetary policy rate at 9.0%.

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

Low and stable inflation supports employment and economic growth.

In the second half of 2019, the depreciation of the lari exchange rate against the US dollar and other major trading partners’ currencies pushed consumer prices up by more than 3%. Although the lari has recently appreciated against the US dollar, prices remain at a high level. Meanwhile, strong aggregate demand also supports increased inflation.

Given the present situation, thus far in 2020 we have kept the monetary policy rate at 9.0%. The increase in the interest rate will reduce the total amount of spending in the country, which will ultimately slow the rise in consumer prices. At the same time, a higher interest rate reduces total lending in GEL, while making savings in GEL more attractive and encouraging investors to use GEL securities. This contributes to an increase in demand for the GEL and an appreciation of the exchange rate.

The interest rate increase will be gradually reflected on the economy with a time lag of 4-6 quarters. According to the forecast, other things being equal, the 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, inflation will return to its target level in about three quarters.

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

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BRIEF OVERVIEW

Inflation had an upward dynamic in 2019. Alongside one-off factors, this growth was mostly related to the higher-than-expected depreciation of the nominal effective exchange rate. In addition to these inflationary factors, according to revised GDP estimates, a recent strengthening of aggregate demand has also made a contribution. As a result of these dynamics, it is expected that monetary policy will remain tight and that it will decline to its neutral level only after inflation expectations sustainably return to the target level of 3%.

While inflation will remain relatively high in the short run, it is expected to fall below the target by the end of 2020 and will approach the 3% target from below in the medium term.

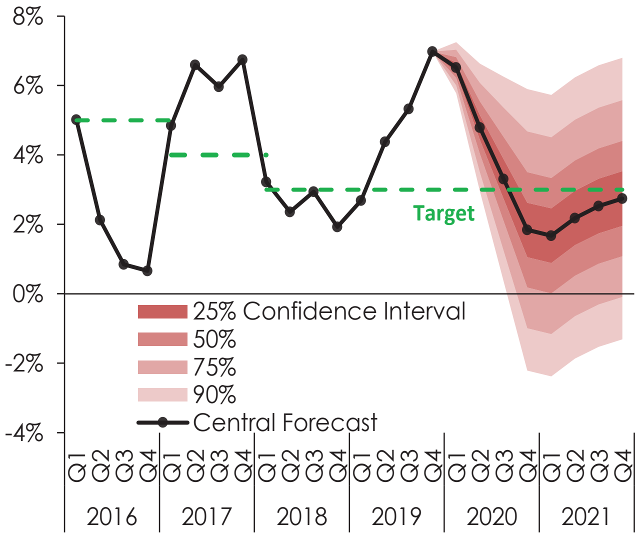

Figure 1. Headline CPI inflation

Source: National Bank of Georgia

The actual level of annual inflation in the fourth quarter of 2019 exceeded the previous forecast by 0.5 percentage points (pp) and averaged 7%. Although the high inflation throughout 2019 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 noteworthy. In addition, revised economic growth data indicate stronger domestic demand. This 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 start approaching the target from below (see Figure 1). The below-target inflation rate at the end of 2020 will be driven by 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.

As noted above, these inflation forecast dynamics are partly driven by the depreciation of the lari nominal effective exchange rate. The latter puts pressure on consumer prices as it increases both import inflation and the intermediate costs of companies burdened with foreign currency credit. In previous periods, the inflationary pressure of the exchange rate was balanced by weak aggregate demand, but this picture has recently changed. Revised estimates suggest that economic activity no longer deviates from its potential level. According to current estimates, the output gap has largely been closed and is expected to become slightly positive (around 0.5%). Recent economic growth has also contributed to this. Annual GDP growth in the third quarter of 2019 was 5.8%, while preliminary estimates suggest that growth in the fourth quarter equaled 5.3%.

Recently, on the back of an improvement in real GDP growth, the forecast was revised upward, increasing the need for maintaining a tight monetary policy stance.

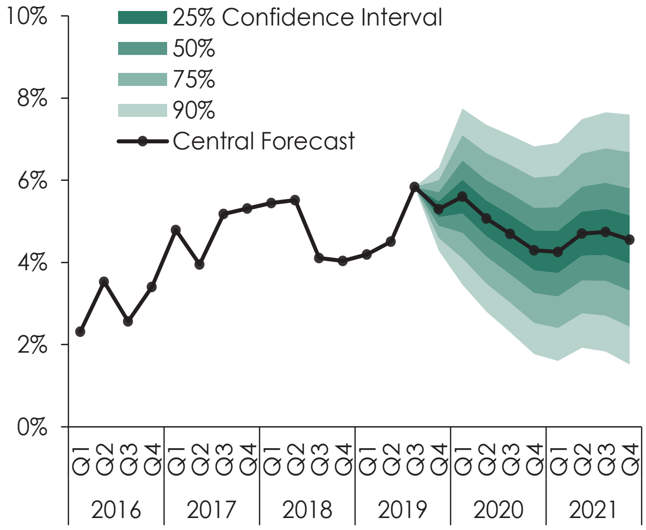

Figure 2. Annual real GDP growth

Source: National Bank of Georgia

In response to higher-than-targeted inflation, the policy rate is expected to remain temporarily high, only declining to its neutral level after a lowering of inflation expectations to the 3% target.

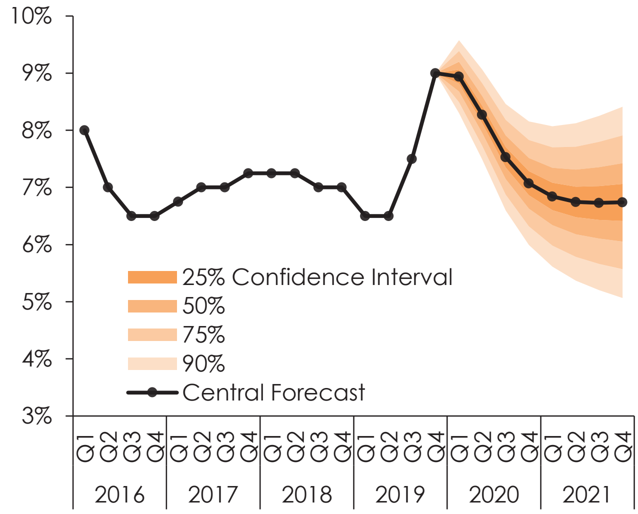

Figure 3. Forecast of the monetary policy rate

Source: National Bank of Georgia

As for future dynamics, the NBG's **forecast of real GDP growth** for 2020 has increased to 5%, rising from 4.5% (see Figure 2). Despite the tight monetary policy (which is itself a response to higher inflation and stronger demand), the factors driving aggregate demand remain strong. Current estimates suggest that, on the back of positive trends in the trade balance, net exports as well as a revival of domestic demand and investment related to fiscal stimulus and credit growth, will all make positive contributions to growth in 2020.

Amid the higher-than-targeted inflation and higher inflation expectations, according to the current macroeconomic forecast, **monetary policy will remain tight** before the policy rate declines to its neutral level. This will only occur after the lowering of inflation expectations down to the target (see Figure 3). The baseline scenario assumes that, despite high levels of uncertainty in the recent period, Georgia's sovereign or currency risk premia 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 6.5%, 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 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

Based on recent estimates, the global macroeconomic environment is expected to improve slightly and thus affect Georgia's exports. Given that in previous periods a competitive exchange rate made a positive contribution in the growth of exports, Georgia's current account deficit improved significantly in 2019. This was accompanied by a growth of local consumption at a moderate pace that contributed to economic growth of 5.2% in 2019, according to preliminary estimates. This was also supported by a relatively high growth of lending, which continued to exceed nominal GDP growth. Despite the recent stabilization of the exchange rate, the depreciation effect in previous periods and increased domestic demand have both weighed on inflation (which currently stands at 6.4%, according to recent data). Domestic and imported inflation have both increased, remaining above the 3% target.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Global economic growth remained weak in the fourth quarter of 2019, which was mostly driven by the deceleration of economic activity in emerging, developing and developed countries. However, growth rates have started to stabilize in Georgia's trading partner countries.

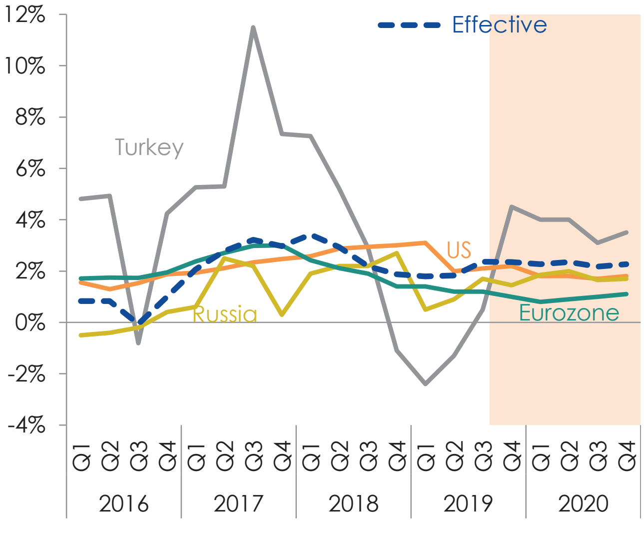

Figure 1.1.1. Real GDP growth of economic partners

Source: Bloomberg; National Bank of Georgia

Weak global activity continued in the last quarter of 2019. According to the IMF's forecast[1], **global economic growth** in 2019 is projected at 2.9%, which is 0.1 percentage point (pp) below its previous forecast.[2] However, by 2020 the growth rate is expected to be a bit higher at 3.3%. This is mostly due to the first phase of a US-China agreement and the reduction of uncertainty surrounding "Brexit". Other crucial drivers include the easing of monetary policy and increasing fiscal stimulus in various countries.

In the fourth quarter of 2019, the slowdown of the growth rate continued in the **US**, mostly driven by low consumer spending and reduced retail sales, but were also impacted by the presidential impeachment process. As for the US-China trade relationship, the first phase of an agreement was signed in January 2020 and this could have a positive impact on the economy. According to the IMF's forecast, real GDP growth for the US in 2019 was 2.3%, while in 2020 it is expected to be 2%[3]. The inflation rate in 2019 was 1.8% and is forecasted to be 2.3% in 2020.

As for the **eurozone**, amid sluggish consumer spending and business sentiment, growth slowed in the fourth quarter of 2019. However, the reduced uncertainty surrounding "Brexit" is a positive sign. Ac-

1 *International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.*
2 *International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.*
3 *International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.*

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

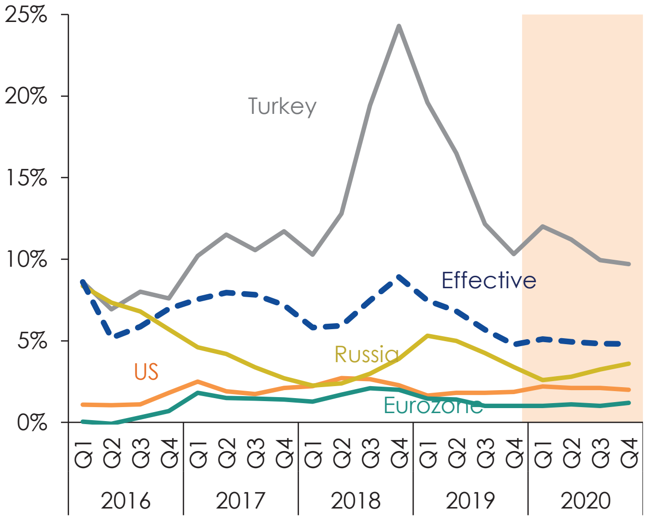

Figure 1.1.2. Headline Inflation rates of economic partners

Source: Bloomberg; National Bank of Georgia

cording to the IMF's forecast, the growth rate for the eurozone in 2019 was 1.2%, while it is projected to be 1.3% in 2020.[4] Annual inflation in 2019 was 1.2% and is expected to be 1.4% in 2020.

In the fourth quarter of 2019, amid an easing of monetary policy, economic activity in **Turkey** slightly recovered. This was mostly due to increased consumer loans and improvements in the manufacturing sector. However, consumer and business sentiment remains low and investment and export volumes are significantly reduced. Inflationary pressure remains high amid the depreciation of the Turkish lira. Annual inflation in December equaled 11.8%. The IMF's real GDP growth forecast for Turkey predicts growth of 0.2% in 2019, while this is projected to be 3% in 2020.[5] Annual inflation in 2019 was 15.5% and is expected to be 12.6% in 2020.

A slight recovery of economic activity was noticed in **Russia**, mostly due to increased fiscal stimulus and an easing of monetary policy. In the fourth quarter of 2019, amid a stable national currency, inflation was low. Annual inflation in December equaled 3%, which was 0.5 pp lower than in the previous month. The IMF's real GDP growth forecast for Russia predicts growth of 1.1% in 2019, while it is projected to be 1.9% in 2020.[6] Annual inflation in 2019 was 4.5% and is expected to be 3.5% in 2020.

Economic activity was high in **Ukraine** in the last quarter of 2019. On the back of higher wages, consumer spending further increased alongside a high level of fixed investments. Amid reforms from both the government and the Central Bank, annual inflation in December stood at 4.2%, which was 1.0 pp below that of the previous month. According to the IMF's forecast, real GDP growth in Ukraine equaled 3% in 2019 and is expected to be 3% in 2020.[7] Annual inflation in 2019 was 7.9% and is forecasted to be 5.9% in 2020.

High growth continued in **Armenia**, which was mostly driven by higher fixed investments and increased consumer spending. Amid higher export volumes, the balance of payments also improved. The IMF's real GDP growth forecast for Armenia was 6% for 2019, while it is projected to be 4.8% in 2020.[8] The annual inflation rate stood at 1.7% in 2019 and is forecasted to be 2.5% in 2020.

At the end of 2019, monetary policy rates declined in both the US and Georgia's trading partner countries.

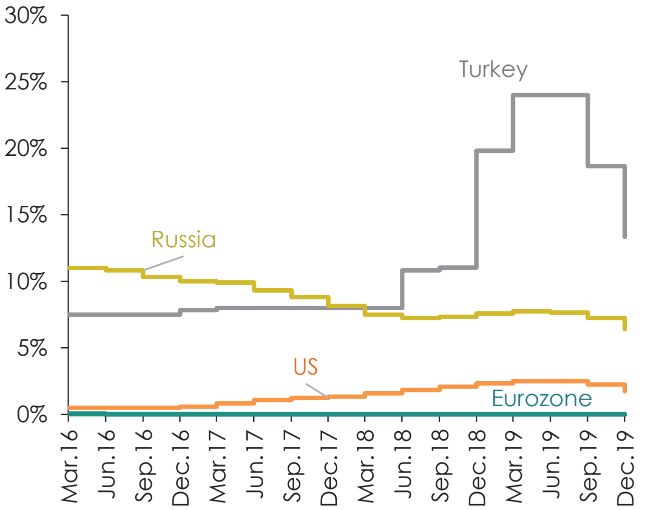

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: Bloomberg; National Bank of Georgia

4 *International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.*
5 *International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.*
6 *International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.*
7 *International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.*
8 *Ibid.*

In **Azerbaijan** a slight slowdown was observed in the oil sector, which has hindered the economic growth process. On the other hand, the non-oil sector was still highly active. The IMF's real GDP growth forecast for Azerbaijan equaled 2.1% in 2019 and is expected to be 2.1% in 2020.[9] Annual inflation was 2.8% in 2019 and is forecasted at 3% for 2020.

The central banks of Georgia's main trading partner countries (Turkey, Russia and Ukraine) have further reduced their monetary policy rates in the last quarter of 2019 to encourage domestic demand (see Figure 1.1.3). The US Federal Reserve has also eased its monetary policy and cut the federal funds rate from 1.75-2.00% to 1.5-1.75%. Meanwhile, the European Central Bank (ECB) has kept its policy rate unchanged at 0%, although it has resumed a quantitative easing program since November 2019.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

Registered exports of goods continue to grow and increased by 15.9% annually in the fourth quarter of 2019.

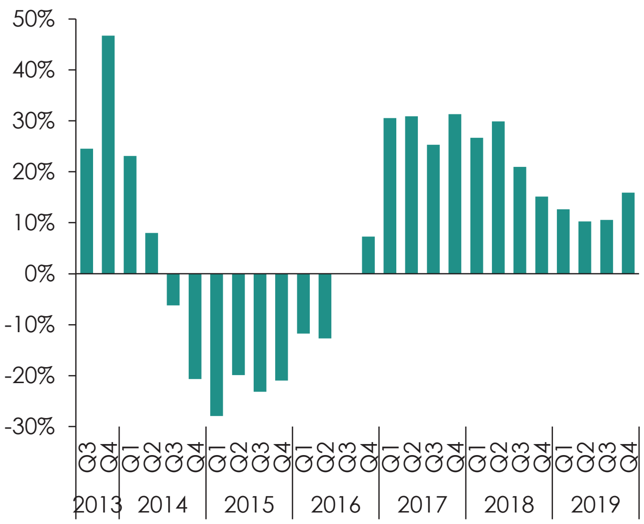

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

External demand continued to grow in the fourth quarter of 2019. Exports of goods increased rapidly. Despite the Russian ban on air travel to Georgia, revenues from international travelers began to increase again and money transfers grew at a higher rate. According to the updated forecast, an improvement of the current account balance is expected throughout 2019.

Registered exports of goods grew by 15.9% annually in the fourth quarter of 2019 (see Figure 1.2.1). The volume of exports increased to Georgia's main trade partner countries, like Armenia and Turkey, and to other regional countries. In the fourth 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 vehicles. Exports to Turkey also grew, mainly due to the increased demand for semi-finished iron products and textiles, while demand for natural grape wines and chemical fertilizers increased in Ukraine. Furthermore, exports to Belarus increased because of higher demand for copper waste and scrap. In contrast, Russian purchases of ferroalloys and medicaments stayed at almost the same level, while exports to Azerbaijan decreased due to lower demand for 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 exports of mineral and chemical fertilizers. Demand for copper ores and concentrates was also high from China.

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

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

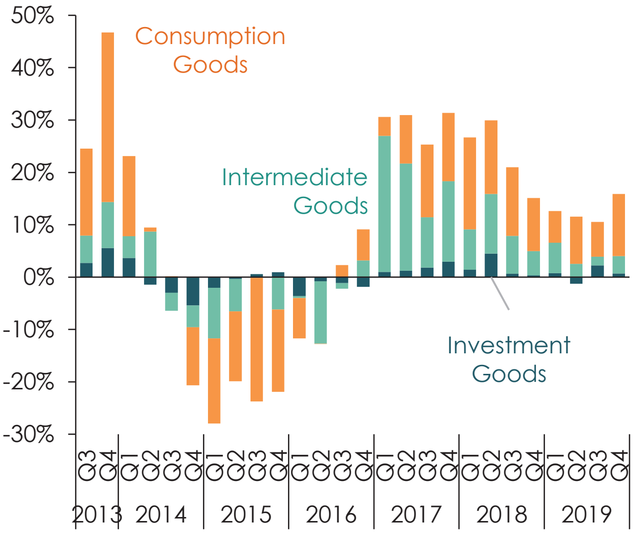

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

The dynamics of revenues from international travelers again showed positive growth.

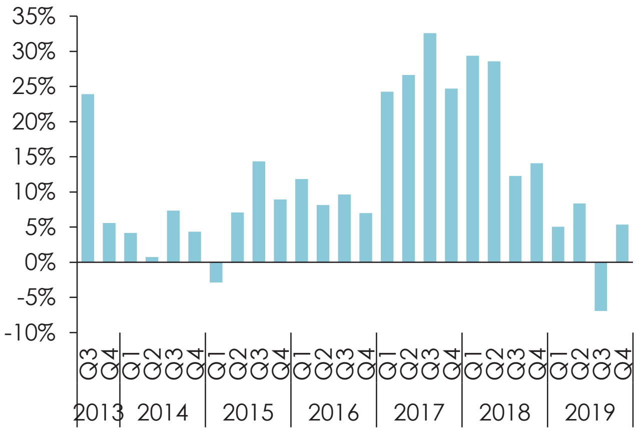

Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

The volume of money transfers has continued rising.

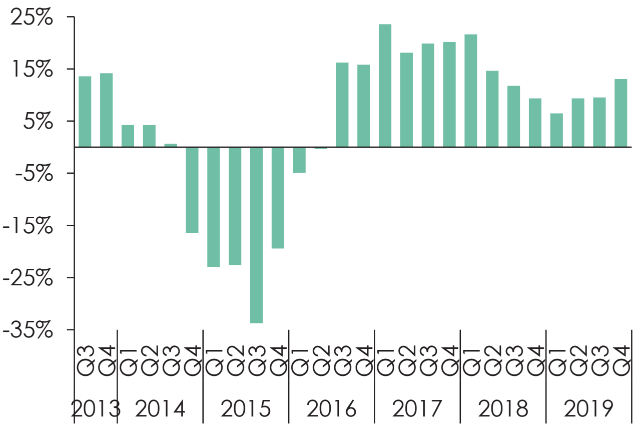

Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

The rise in exports of goods was due to increased demand for consumer and intermediate goods (see Figure 1.2.2). The rise in the volume of re-exports also had a significant impact on the growth of exports. The increase in consumer goods was mainly due to rising exports of motor cars, natural grape wines, medicaments and mineral waters. In terms of 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 groups. The overall increase in exports was mainly due to increased volumes of re-exports, as well as the increased external competitiveness resulting from the exchange rate depreciation.

The rise in external demand was supported by a higher volume of revenues from international travelers, which increased by 5.4% annually in the fourth quarter of 2019 (see Figure 1.2.3). An even higher rise in the growth of revenues was tempered by lower numbers of visitors from Russia and Iran. All else being equal, revenues from international travelers is expected to increase again in upcoming periods.

The share of long-term visitors (especially tourists) in the structure of revenues from international travelers has increased. In the fourth quarter, the number of international visitors increased by 3.9% annually, the majority of whom (62.5%) were tourists. It should also be noted that the number of visitors to Georgia has not only grown in terms of those arriving for leisure and recreational purposes, but those for business and other professional purposes too. 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 also negatively influenced revenues from international travelers. On the other hand, the number of visitors from the European Union and other regional countries increased.

By the end of 2019, money transfers to Georgia accelerated significantly, increasing by 13.0% annually in the fourth quarter (see Figure 1.2.4). This increase was mainly due to increased transfers from the European Union (notably from Italy and Greece), Central Asia (Kyrgyzstan and Kazakhstan) and Ukraine. It is worth noting that money transfers from Russia have seen a decreasing trend since the second half of 2018 – a pattern that continued in the fourth quarter of 2019, albeit at a slower pace. At the same time, money transfers from Turkey showed growth, unlike in the previous quarters of the year.

Imports of goods declined from the beginning of 2019, but showed a positive annual change in the fourth quarter (see Figure 1.2.5). The rise in imports is likely to stem from the increased flow of FDI and

The beginning of 2019 was characterized by a decline in imports of goods, but this increased annually in the fourth quarter.

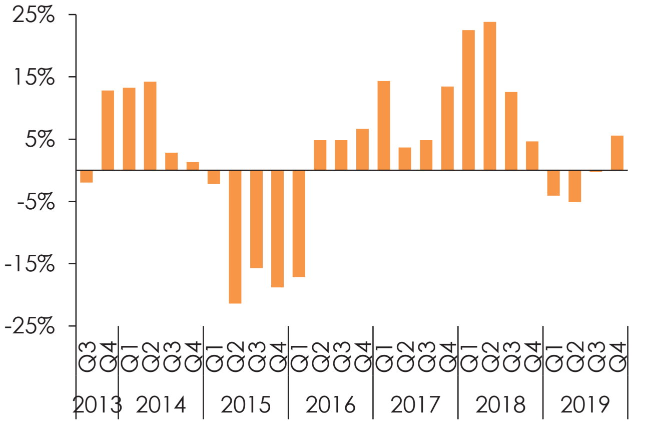

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the fourth quarter of 2019, imports of intermediate and investment goods rose, while imports of consumer goods remained almost the same.

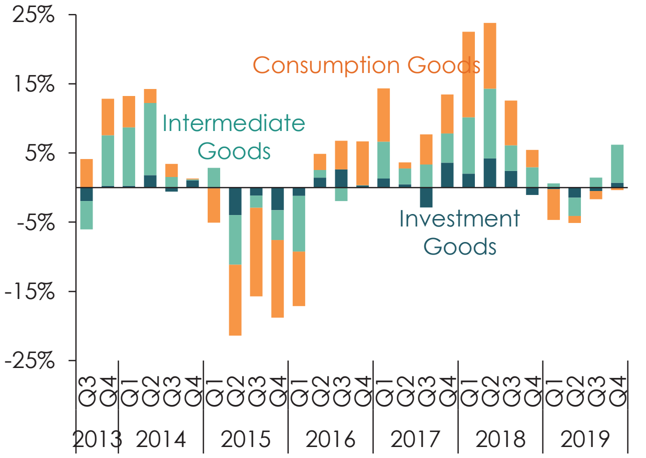

Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

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

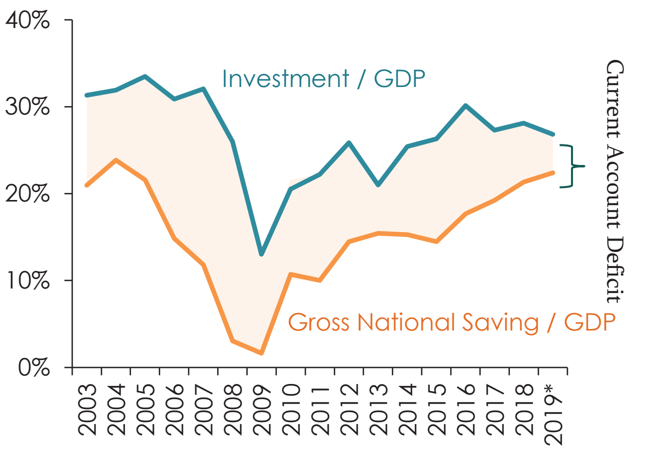

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

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

imports of higher purchase goods that are intended for re-export. Imports increased substantially from regional countries, mainly from Russia (due to imports of electricity) and Turkey (due to motor vehicles suitable for the transport of ten or more persons). Meanwhile, the growth of imports from other countries was mainly due to increased purchases of copper ores and concentrates intended for re-export. It is worth noting that imports of goods continued to decline from several countries, including Turkmenistan (due to a decline in imports of petroleum products), Azerbaijan (due to a fall in petroleum products and electricity imports) and Ukraine (due to a decline in imports of cigarettes); while from the EU, imports declined from France (due to a fall in imports of loading machinery and aircraft vehicles).

In the fourth quarter of 2019, imports of intermediate and consumer goods accounted for 44 and 44% of total imports respectively. It is worth noting that the increase in imports of goods predominantly stemmed from a rise in imports of intermediate goods (see Figure 1.2.6). This increase was largely due to higher purchases of copper ores and concentrates, as well as of several types of petroleum products (such as coke and bitumen). Meanwhile, the fall in imports of consumer goods stemmed from decreased expenses on petroleum goods imports, which was a consequence of lower petroleum prices on global markets. Moreover, in terms of commodity groups, imports of goods became less diverse compared to the same period of 2018.

The improvement of the current account deficit has continued. In the third quarter of the year, the current account balance was positive and reached 127 million USD (0.3% of GDP). A positive current account balance was also reached in the third quarter of 2018, but the 2019 indicator showed a slight improvement. Overall, a considerable decrease of the current account deficit is expected throughout 2019.

The primary source of financing the current account deficit is foreign direct investments, which increased by 13.7% annually and reached 417 million USD. In the third quarter of 2019, investments in the finance sector outweighed the decline of investments in other sectors.

From the perspective of savings and investments, the improvement of the current account balance in the third quarter of 2019 was a result of an increase in savings and a decrease in investments (see Figure 1.2.7).

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the third quarter of 2019, GDP grew by 5.8%. The main contributor to that, with 9.4% real growth[10], was private consumption. The rate of increase of consumption in the public sector was similar to that of the private sector. Investments have risen against the backdrop of strong growth in the construction sector.

Consumption was a driver of economic growth in the third quarter.

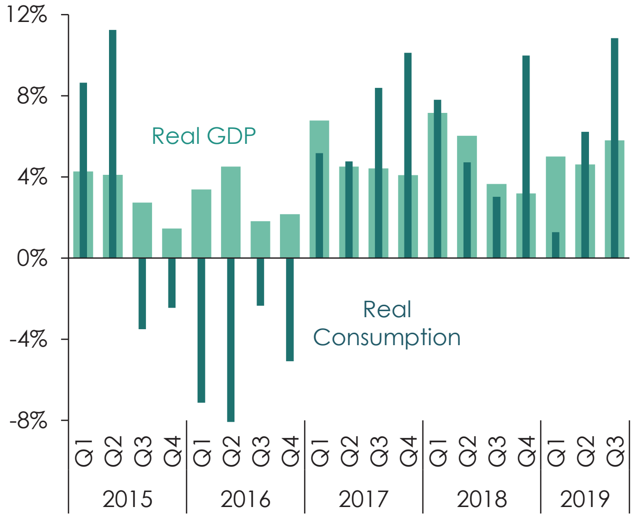

Figure 1.3.1. Real growth of GDP and private consumption

Source: GeoStat; NBG calculations

1.3.2 OUTPUT

In the third quarter of 2019, GDP grew by 5.8% compared to the same period of the previous year. The growth was primarily driven by services, which contributed 3.8 percentage points (pp) to the total. The contribution of industry to the growth was 1.8 pp, while agriculture contributed 0.2 pp (see Figure 1.3.2).

The 9.8% increase in trade, the largest sector of the economy, in the third quarter, indicates strong domestic demand. Trade contributed 1.2 pp to overall growth.

The Russian ban on air travel to Georgia has had a negative impact on the tourism sector, though this loss was gradually compensated by an increase of visitors from other countries. As a result, the tourism-related sectors of the economy increased, albeit not as much as in previous periods. There has also been an increase in real estate operations, where the participation of non-residents is likely to continue to be significant.

Trade and construction significantly contributed to the third quarter growth.

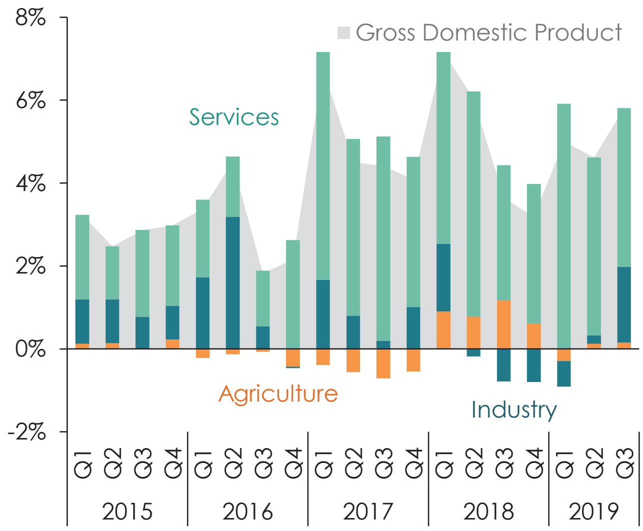

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

One of the main drivers of economic growth in the third quarter was construction (growth of 17.1%, making a 1.3 pp contribution to total growth). Although government-funded infrastructural projects were significantly enhanced, it can be assumed that this increase also affected civil construction.

In the third quarter, agricultural output increased by 2.1%.

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

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In December , the loan portfolio increased slightly and stood at 16.2%, excluding the effect of exchange rate fluctuations.

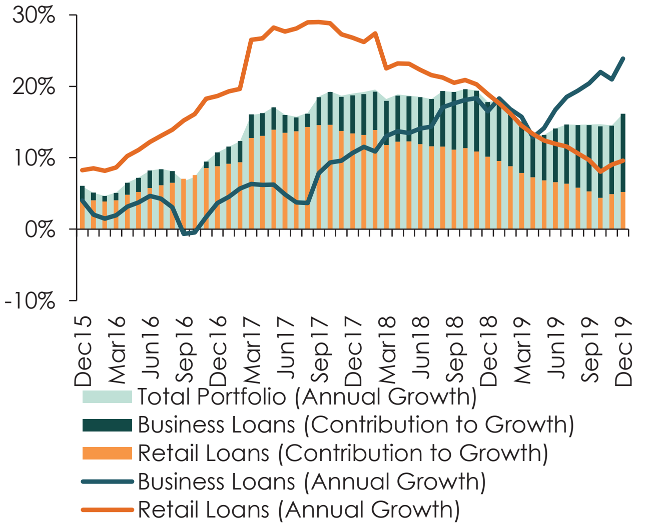

Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In December, relative to September, the loan portfolio increased slightly and stood at 16.2% , (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans declined slightly and stood at 9.6%, while loans to legal entities increased by 3.5 pp and equaled 23.9% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the trade, construction and manufacturing sectors; whereas the increase in credit for the transport, agriculture and energy sectors did not change significantly. According to the credit conditions survey, representatives of the banking sector expect a slight decrease in demand for business loans and an increase in demand for retail loans.

In terms of currencies, it is important to emphasize that in the fourth 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 December, the annual growth rate of foreign currency denominated loans increased by 1.8 pp and stood at 9.7%, while loans in domestic currency grew by 24.7%. In the fourth quarter, the loan larization ratio declined slightly and equaled 44.6%. This slight decrease notwithstanding, it is expected that the process of larization will continue in the future. Increased larization is a step towards reducing the risks to financial stability.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

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

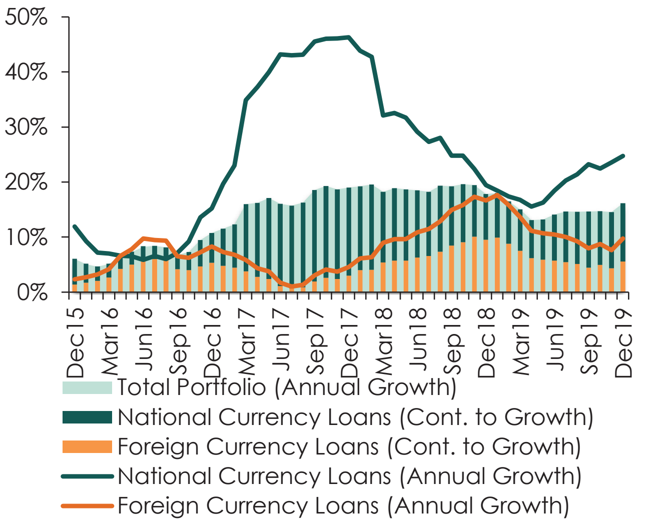

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In December, the monetary policy rate was 9%. In the fourth quarter of 2019, interest rates on government securities increased. This was a result of an increase of 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 the improved predictability of the monetary policy rate.

In December, relative to September, interest rates on domestic currency deposits increased by 0.6 pp and equaled 8.4% and 3% respectively. Meanwhile, interest rates on foreign currency deposits have not changed significantly and equal 2.8%. According to the credit conditions survey, representatives of the banking sector expect a slight increase in the cost of funds in the next quarter.

Furthermore, according to the survey, interest rates on mortgage loans issued in the domestic currency have increased, while interest rates on mortgage loans issued in foreign currency have slightly decreased. In

In the fourth quarter of 2019, interest rates on government securities increased.

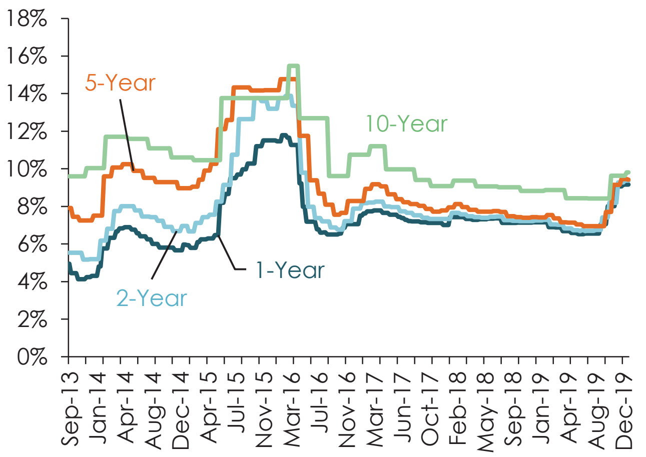

Figure 1.4.3. Interest rates on government securities

Source: National Bank of Georgia

Compared to the previous quarter, the spread between long- and short-term interest rates has not changed significantly.

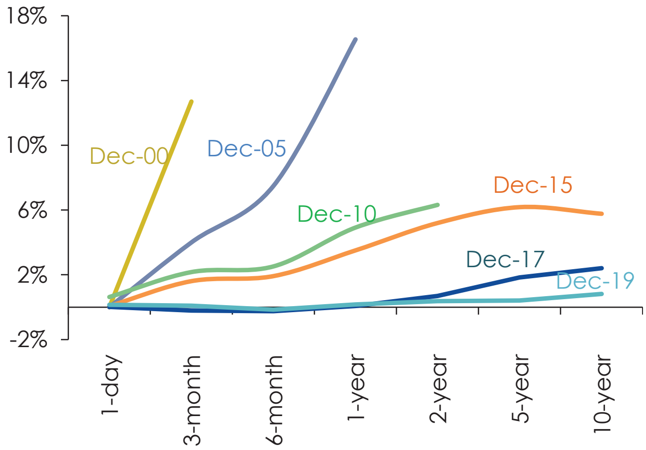

Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

In December, compared to September, average interest rates on the loan stock of legal entities increased slightly for domestic currency loans, while declining slightly for foreign currency loans.

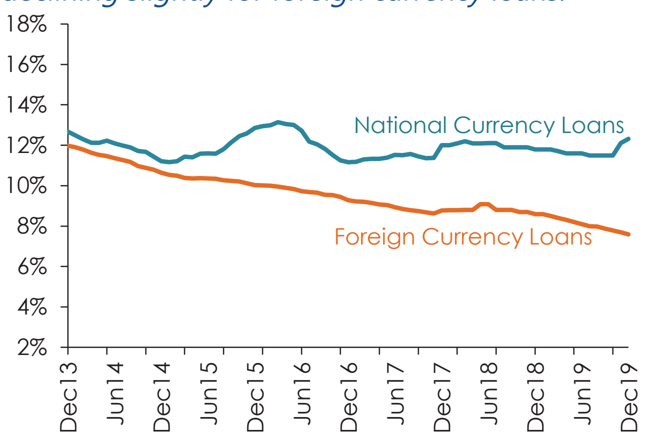

Figure 1.4.5. Average interest rates on business loans

Source: National Bank of Georgia

terms of credit conditions for legal entities, representatives of the banking sector expect a slight increase in interest rates in the next quarter. In December, compared to September, interest rates on loans issued to the corporate sector have not changed significantly. Meanwhile, interest rates on loans for small and medium enterprises declined by 1.5 pp and stood at 8.5%. Interest rates on retail loans decreased by 0.8 pp and equaled 14.9%.

In December, compared to September, average interest rates on the stock of legal entities increased slightly for domestic currency loans, rising by 0.8 pp, while average interest rates for foreign currency loans declined slightly (see Figure 1.4.5.). Representatives of the banking sector do not expect a significant change in interest rates for loans in foreign currency.

The real effective exchange rate remains undervalued (annual depreciation 6.3%).

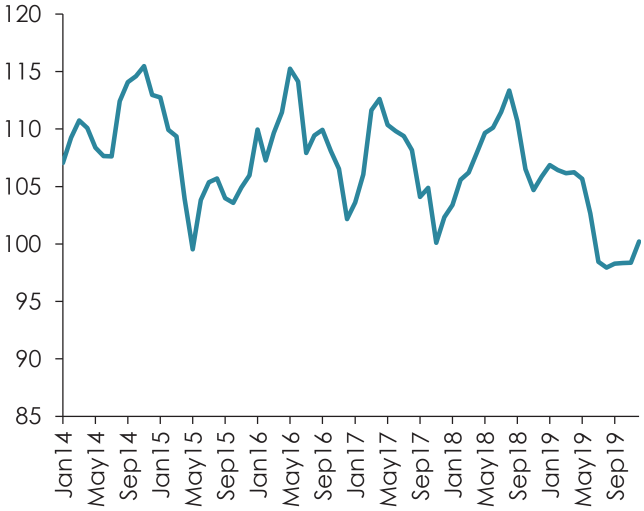

Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

The nominal effective exchange rate with official weights and weighted (based on commodity groups and services) depreciated on a quarterly and annual basis.

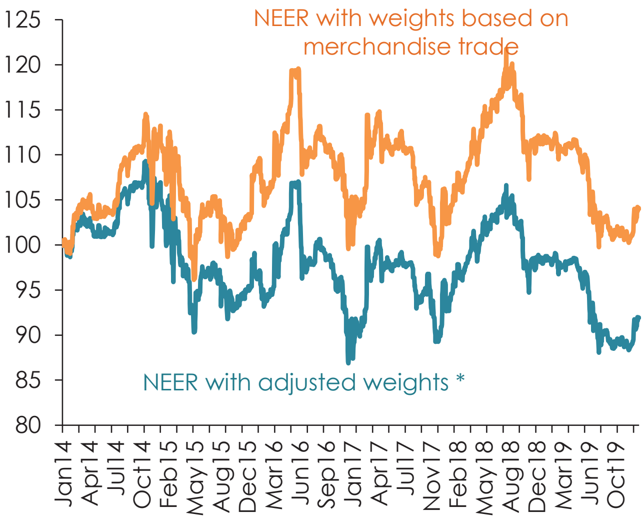

Figure 1.4.7. Corrected nominal effective exchange rate

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 fourth quarter of 2019, the GEL nominal exchange rate depreciated against the US dollar by 0.9% and against the euro by 0.4%, compared to the previous quarter. Meanwhile, the GEL appreciated against the Turkish lira by 1.1% and depreciated by 2.3% against the Russian ruble. As a result, the nominal effective exchange rate depreciated by 0.8% on a quarterly basis and by 9.0% on an annual basis.

As for the price-adjusted exchange rate, the real effective exchange rate appreciated by 0.8% quarterly and depreciated by 6.3% on a year-on-year basis (see Figure 1.4.6). It should be noted that the real exchange rate depreciated against all major trading partner countries (see Table 1.4.1).

When adjusted for commodity groups and services, the nominal effective exchange rate reveals the same picture as the official one. In the fourth quarter of 2019, the adjusted nominal effective exchange rate depreciated by 0.8% on a quarterly basis and by 9.1% on an annual basis (see Figure 1.4.7). Therefore, the depreciation of the GEL against the US dollar in the previous year did not relate to the appreciation of the US dollar globally, but to the depreciation of the GEL against the currencies of Georgia's trading partners.

The significant increase in exports due to the weak exchange rate continued to help reduce the current account deficit. It should also be noted that the growth of tourism and foreign direct investment in the previous quarter have positively affected the exchange rate dynamics. The tightening of monetary policy was a further important factor for the appreciation 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	-9.0	-6.3	-6.3
Eurozone	-6.4	-0.8	-0.2
Turkey	-4.6	-7.4	-1.3
Ukraine	-21.2	-19.8	-1.4
Armenia	-10.7	-5.2	-0.3
US	-9.2	-4.8	-0.3
Russia	-13.1	-10.1	-1.4
Azerbaijan	-9.0	-5.1	-0.6
Other	-7.1	-4.2	-0.9

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

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

BOX 1. THE RELATIONSHIP BETWEEN INFLATION AND THE EXCHANGE RATE (EXAMPLES OF 2018 AND 2019)

Annual inflation reached 7.0% at the end of 2019. According to the explanation of the National Bank of Georgia, inflation was mainly driven by the exchange rate depreciation in the last period on top of the significant upward pressure stemming from the increase in excise tax on tobacco. The local currency depreciation was channeled to inflation through its effect on the prices of imported consumption goods. Liability dollarization also puts pressure on inflation. As aggregate demand has improved, it could no longer offset the upward pressure on inflation. As a result, the NBG began tightening its monetary policy stance to bring inflation down to the 3% target in the medium run.

The GEL bilateral exchange rate against the USD depreciated in 2018 as well, but inflation did not change significantly at that time – as a result, the monetary policy reaction was accordingly muted. The question, then, is whether there is a third factor that explains the muted pass-through of the exchange rate depreciation to inflation that occurred in 2018, but not in 2019? One of the possible explanations for this could be the dynamics of the nominal effective exchange rate (NEER), which measures the GEL exchange rate against a basket of trade partners` currencies. When the exchange rate does not change against a trade partner`s currency, it is highly probable that the price of imported goods from that country will not alter either.

Therefore, there are two main channels for the exchange rate pass-through to inflation: the price of imported goods, and the dollarized debt service burden. The first channel works through the GEL nominal effective exchange rate, while the second depends on the GEL/USD exchange rate. Consequently, when the lari is depreciated against all currencies, then inflation is driven by both of these channels. However, when GEL depreciates only against the USD, then the pass-through to inflation is limited, as the first channel is not in effect.

For illustrative purposes, we can look at the last two episodes of the depreciation of the lari against the USD: from May 2018 to May 2019, when the GEL/USD depreciated by 11.9% and from June 2019 to October 2019 when the lari depreciated by an additional 8%. At the same time, the NEER depreciated by 2.4% in the first period, while falling by 8.5% from June to October 2019. Figure 1.7. summarizes the above-mentioned inflation and exchange rate dynamics.

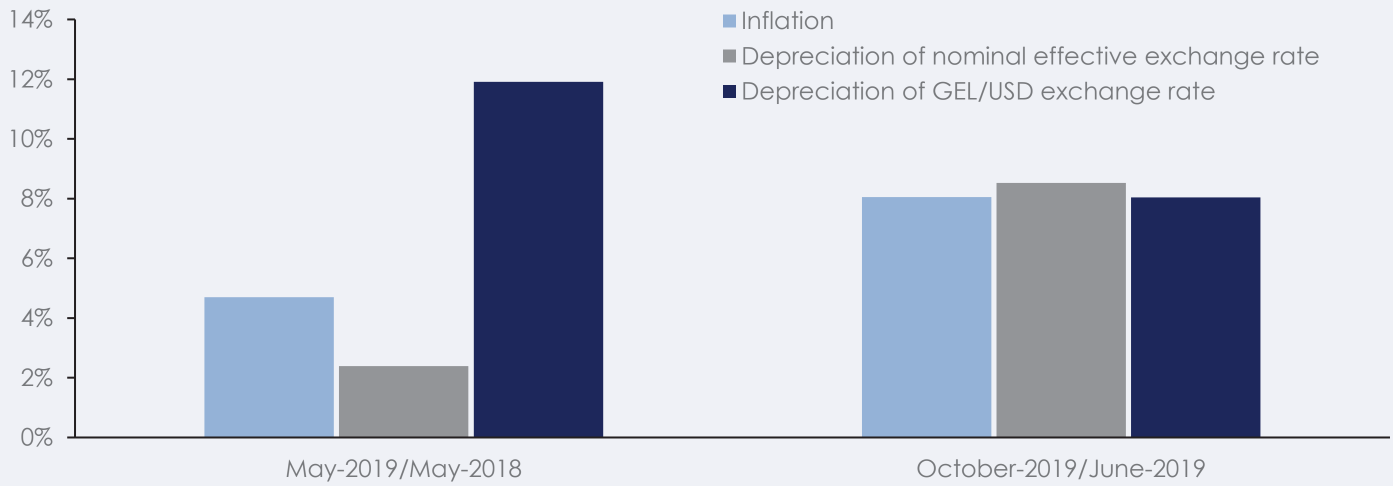

Figure 1.4.8 Inflation and depreciation of the GEL/USD and Nominal Effective Exchange Rates over May 2019 to May 2018 and October 2019 to June 2019 .

Source: National Bank of Georgia

As the figure shows, the exchange rate pass-through to inflation increased in the second period of GEL/USD depreciation, while the depreciation was larger in the first period. This dynamic could be explained by the following factors:

- Firstly, the depreciation of the nominal and real effective exchange rates was muted in the first episode of GEL/USD depreciation, and the pass-through to inflation was thus limited accordingly. In that period, the lari depreciated against the USD alongside a depreciation of trade partners` currencies (for example, the depreciation of the Turkish lira). In contrast to this, the depreciation in the second period was related to idiosyncratic factors (shocks only to the domestic economy). This induced the depreciation of the lari with respect to all currencies, and the pass-through to inflation was thus accelerated.
- In the second period, the higher pass-through of exchange rate depreciation could be related to the non-linearity of the channel: the larger the deviation of the exchange rate from the equilibrium, the faster and larger the adjustment of inflation that is necessary to return to the equilibrium.
- As was mentioned above, weak aggregate demand could not offset the upward pressure on inflation coming from the exchange rate depreciation, while the pass-through is stronger in the case of a positive output gap (a positive gap became visible at the end of 2019).

1.5 CONSUMER PRICES

Inflation was on the rise since early 2019. It exceeded the target in March and reached its highest level of 7% at the end of the year. The increase in inflation at the beginning of the year was mainly due to the increase in excise tax on cigarettes. In the second half of the year, pressure on prices came from the depreciation of the nominal effective exchange rate. Overall, food and cigarettes made the most important contributions to inflation.

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was substantially lower than headline inflation and stood at 3.7% in December. An analysis of core inflation is significant as it reflects the long-term trend.

Food prices are characterized by high fluctuations –influenced by seasonality, productivity and various other factors – which, due to their high weight (27.3%) in the consumer basket, significantly affect the overall inflation rate.

Core inflation was significantly lower than overall inflation in December, signaling a decline in overall inflation in the future.

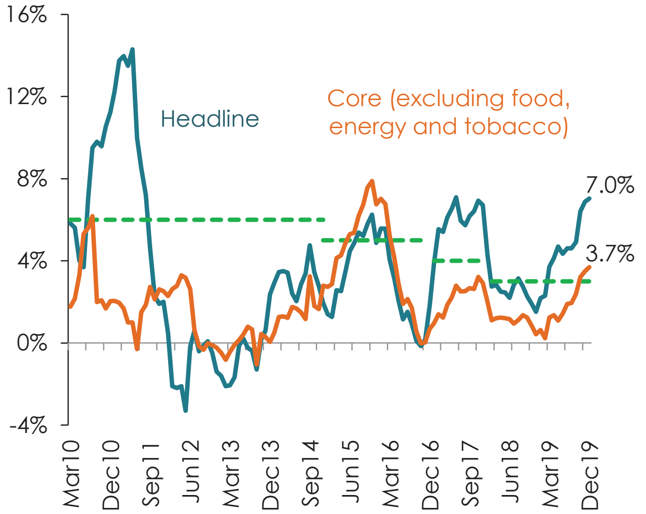

Figure 1.5.1. Headline and core inflation

Source: GeoStat

Food prices are highly volatile and, due to their high weight in the consumer basket, have a significant impact on inflation.

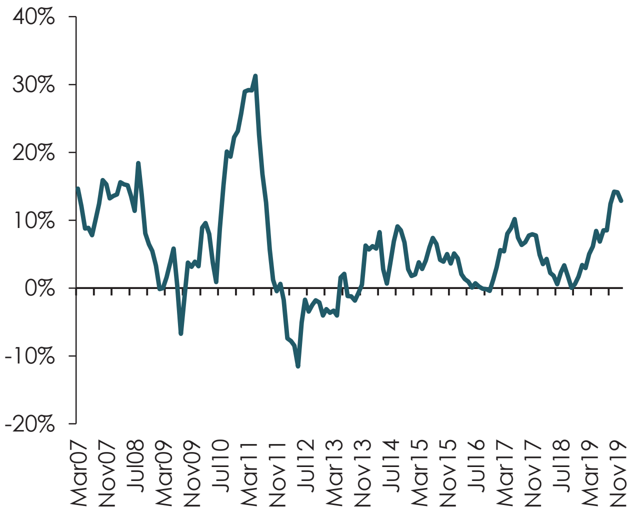

Figure 1.5.2. Food inflation

Source: GeoStat

The rise of inflation is largely attributable to rising food and cigarette prices.

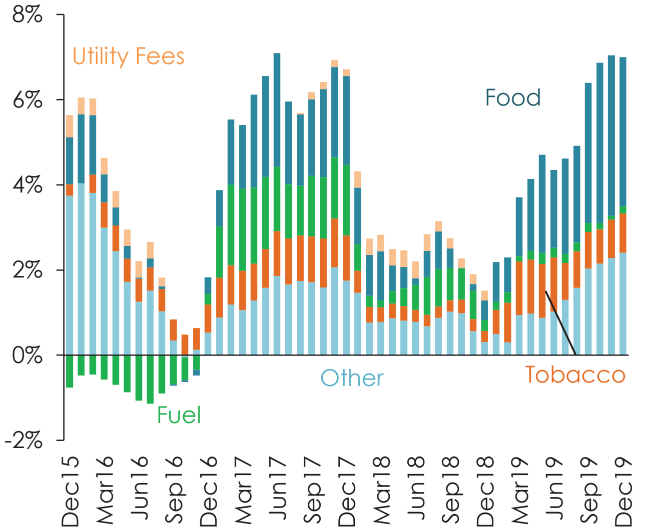

Figure 1.5.3. Contribution of different products to inflation

Source: GeoStat; NBG calculations

The rise of food prices has been reflected on the prices of domestic goods. The rise in prices of imported goods, except cigarettes, is linked to the depreciation of the GEL's nominal effective exchange rate.

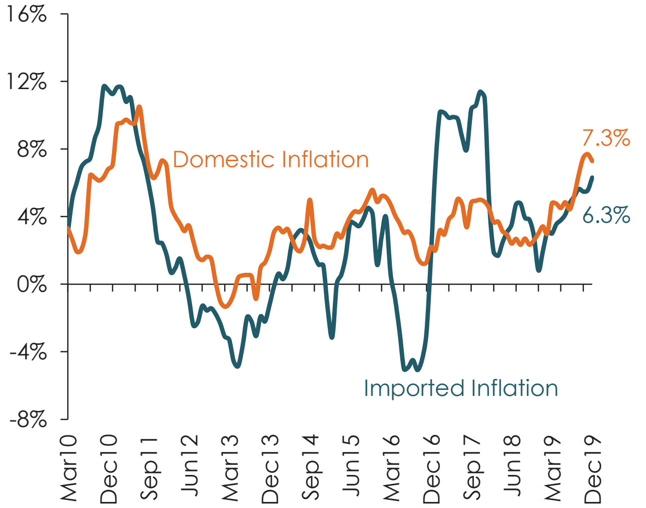

Figure 1.5.4. Imported and domestic inflation

Source: GeoStat; NBG calculations

Food inflation was high in 2019, unlike in the previous year. Food contributed 3.5 pp to December's 7% inflation. A significant portion of food inflation came from a rise of cheese, meat, apple and potato prices.

Since the beginning of the year, there was a significant rise of cigarette prices due to an increase in the excise tax rate. This made a 0.9 pp contribution to annual inflation in December.

The rise of food prices was reflected on the prices of domestic goods. Besides cigarettes, the rise in prices of imported goods is linked to the depreciation of the GEL's nominal effective exchange rate.

In December, the annual inflation of imported and domestically produced goods stood at 6.3% and 7.3% respectively. Meanwhile, prices of mixed goods increased by 6.9% (see Figure 1.5.4).

2 MACROECONOMIC FORECAST

The year 2019 was marked by both high inflation and strong economic activity. According to current forecasts, inflation will gradually decrease in the first half of 2020 to land close to the target of 3% in the second half of the year. Estimates suggest that, by the end of 2019, the gap between GDP and its potential level closed. As a result of intensifying domestic demand, the economy is projected to grow by 5% in 2020. Against this background, the inflation forecast has been revised slightly upward, while monetary policy is expected to maintain a more tightened stance before subsequently beginning to gradually normalize alongside a lowering of inflation expectations. As higher-than-expected demand has become a risk to the baseline growth forecast, the alternative forecast scenario considers a realization of this risk. Under the latter scenario, given the high growth rate of lending and strong fiscal stimulus, real GDP growth will be higher than in the baseline projection, which will increase inflation. In this case, the monetary policy response will be a rate hike (of 1 pp above the baseline scenario), which will ensure that inflation returns to the target over the medium term.

2.1 BASELINE MACROECONOMIC FORECAST

In 2020, inflation will start to decline and will return to the target in the medium term.

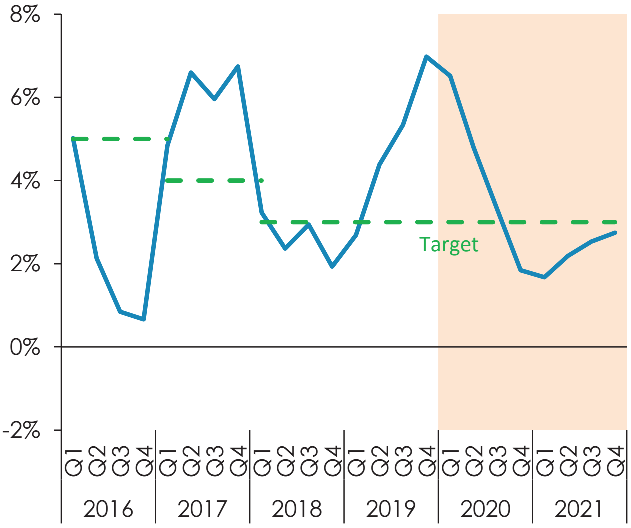

Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

Headline inflation was marked by increasing dynamics during 2019 (see Figure 2.1.1). In the first half of the year, consumer prices were mainly driven by one-off factors, while in the second half of 2019 the effect of the exchange rate depreciation also emerged (see Figure 2.1.2). Eventually, in the 4th quarter, inflation was slightly higher than forecast at 7.0%. While previous estimates suggested that the above-mentioned factors would have been largely counterbalanced by weak aggregate demand, an analysis based on updated data[11] shows that the negative contribution of demand has been relatively small in recent times.

It is noteworthy that, according to current estimates, the gap between actual and potential GDP had been fully eliminated by the end of 2019 (for the first time since the crisis of 2008-2009). Therefore, according to the current forecast, demand-driven inflationary pressures may rise (see Figure 2.1.2). As a result, inflation will be slightly higher than previously projected; however, falling imported inflation and lower input costs – which initially ballooned due to the exchange rate depreciation in previous periods – will see headline inflation begin to decline in 2020, temporarily falling below the target level, before eventually hitting it in the medium term. Amid intensifying aggregate demand, the appreciation of the exchange rate has become even more important for reducing inflation. This will be accommodated by a tightened monetary policy

11 Data updates are based on the new methodology of the system of national accounts adopted by the National Statistics Office of Georgia. For more detail, see: https://www.geostat.ge/en/single-news/1708/geostat-introduced-a-new-methodology-system-of-national-accounts-sna-2008

Over the forecast horizon, aggregate demand will put upward pressure on inflation. Meanwhile, in the short run, the pressure caused by the previous exchange rate depreciation will gradually decline..

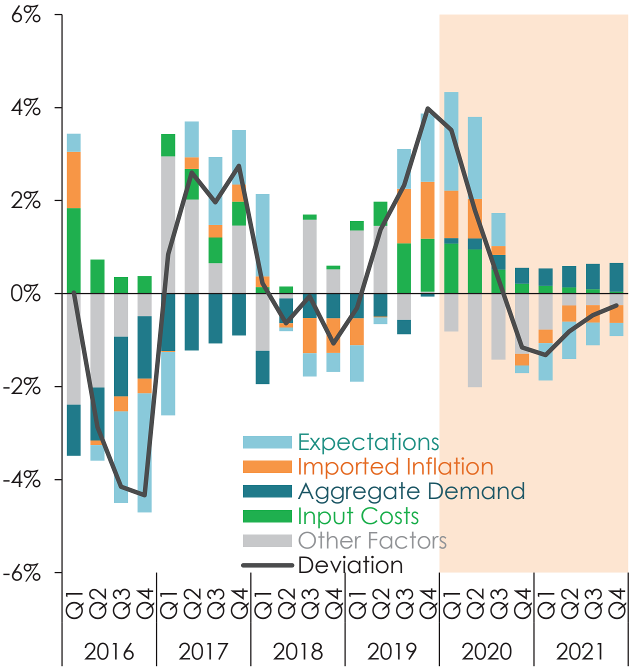

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

The current forecasts are that real GDP will grow by 5.0% in 2020. Consumption will make a considerable contribution to this growth.

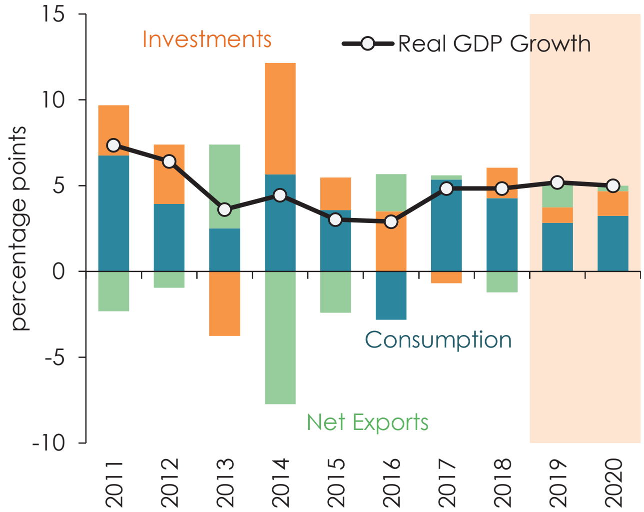

Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

that will temporarily allow lower-than-target inflation in order to decrease long-term inflation expectations.

The economy was characterized by high activity in 2019, with real GDP growth having been estimated at 5.2%. It should be noted that by the end of the year the National Statistics Office of Georgia, based on a new methodology for the National Accounts System, increased the overall level of GDP and other National Accounts aggregates. Among other factors, this increase was partly attributable to improved estimates of the scale of the unobserved economy, which in turn influenced the estimation of the output gap. In previous forecasts the latter remained small, albeit negative, in the short run; however, the updated data already clearly indicate that the gap has been eliminated. High economic activity, in turn, was driven by high credit activity and strong fiscal stimulus, including in infrastructure projects. According to current estimates, these factors are expected to persist in 2020 and will outweigh the effect of the tightened monetary policy on aggregate demand. As a result, the National Bank of Georgia has revised the forecast for real GDP growth for 2020 from 4.5% to 5.0%, although net exports will make a relatively small, albeit still positive, contribution to growth (see Figure 2.1.3).

In an unlikely, albeit still possible scenario, the actual GDP trajectory may differ from what is forecast. Given the recent trend, risks associated with factors positively affecting economic growth have become more noteworthy. If the fiscal stimulus and credit portfolio growth is greater than expected, or the balance of payments is better than expected, amid improving external factors and a competitive exchange rate, then economic activity will increase more than is currently projected. This will put additional pressure on the inflation rate. In contrast, in the event of an escalation of the geopolitical and economic situation in the region, cash inflows will fall, and sovereign risk premia will increase. This, in turn, will have a negative impact on consumption, business sentiment and investment, and economic activity will grow less than is projected.

As noted above, an additional inflationary risk has arisen in the wake of the elimination of the output gap. As a result, there is a need for an adequate monetary policy response, not only to address the depreciation of the nominal effective exchange rate, but also the pressures arising from aggregate demand in order to offset inflationary expectations and to bring inflation close to the target over the medium term. With this in mind, monetary policy is expected to remain tighter – compared to the previous forecast – in the short run. This will be followed by a gradual normalization in tandem with lowering inflation expectations. It is currently estimated that the neutral policy rate is 6.5% and, other things being equal, the actual policy rate will approach this in two years.

Compared to the previous projection, the inflation forecast has been revised slightly upward.

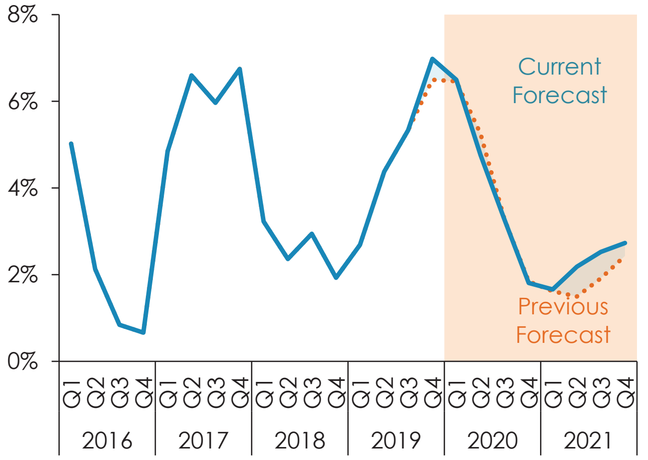

Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The real GDP forecast for 2020 has been revised upward to 5%. The impact of tightened monetary policy will be outweighed by positive factors boosting economic growth.

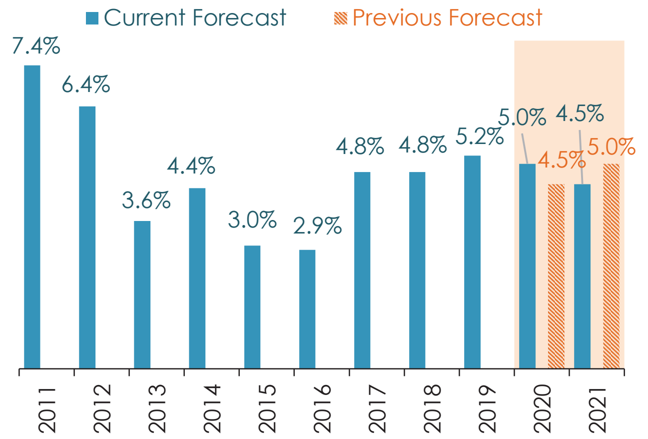

Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

Expectations about a depreciation of trading partner currencies have reduced for 2020. Inflationary expectations have thus also fallen. Meanwhile, expectations about economic growth have slightly increased.

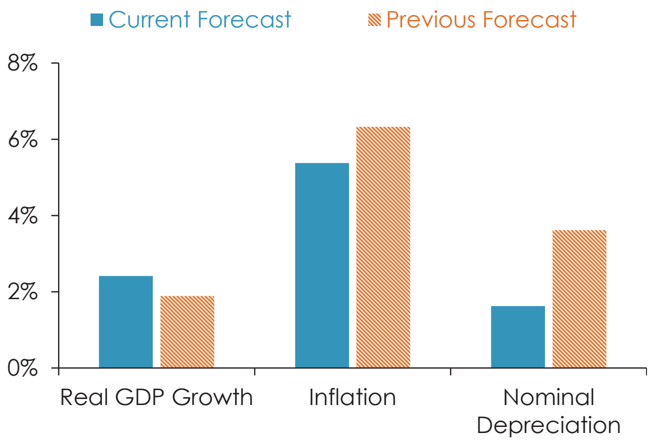

Figure 2.2.3. Changes in the forecast of external assumptions for 2020

Source: Bloomberg

2.2 COMPARISON WITH THE PREVIOUS FORECAST

Compared to the previous projection, the inflation forecast has been revised slightly upward (see Figure 2.2.1). The upward revision of the short-term forecast was mainly driven by the improved GDP forecast. Based on current estimates, the impact of tightened monetary policy on aggregate demand will be outweighed by positive factors that will push demand up. Meanwhile, based on the revised GDP time series, the negative output gap has closed. This means that the inflationary pressures coming from the exchange rate depreciation were not neutralized by weak demand. According to the revised forecast, inflation is expected to start falling in the second quarter of the year and will be around the target level in the second half of 2020. In the medium term, inflation is predicted to decline below the target level and then close on the target from below.

Nevertheless, the real GDP growth forecast for 2020 has been revised upward to 5% (see Figure 2.2.2). The impact of tightened monetary policy on aggregate demand will be outweighed by positive factors that will push economic growth up. On the one hand, strong fiscal stimulus will boost economic growth. On the other hand, introducing regulations on responsible lending for individuals and tightened monetary policy have slowed credit growth. However, the current credit growth rate (16.2%, excluding the exchange rate effect) coupled with the change in the credit portfolio structure (an increase in the contribution of business loans) still significantly stimulate economic activity. Meanwhile, it is predicted that net exports will positively contribute to real GDP growth in 2020.

Georgia is a small open economy and its 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 partners. Changes in these assumptions will affect both the baseline forecast as well associated risks (see Figure 2.2.3).[12]

Assumptions regarding the economic stances of Georgia's trading partners have slightly changed. Expectations about a depreciation of their currencies have declined for 2020 because of an expected weakening of the USD against other currencies. As a result, inflationary expectations for Georgia's trading partners have been revised downward. Meanwhile, expectations in terms of economic activity have slightly improved. In line with these updated expectations, a slight improvement of Georgian competitiveness is expected.

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

The alternative forecast scenario considers stronger domestic demand compared to the baseline scenario. Accordingly, under the alternative forecast, annual real GDP growth for 2020 will be 6%.

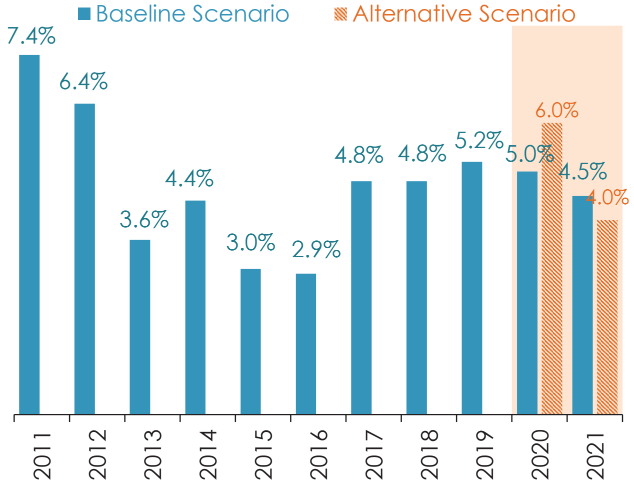

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

Stronger economic growth will push inflation up. Over 2020-2021, inflation will be 0.5 pp higher compared to the baseline scenario.

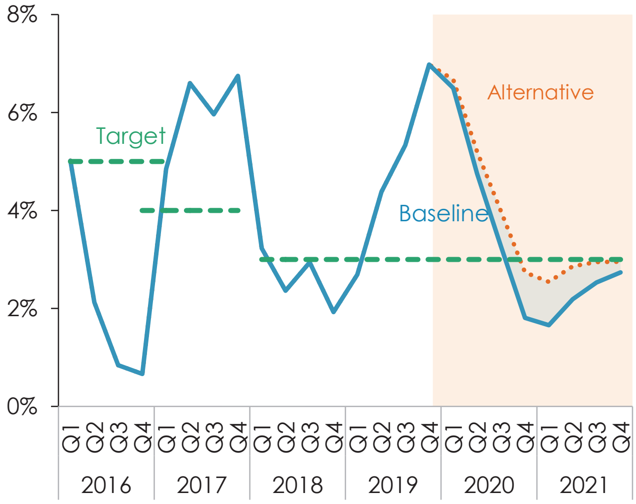

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers stronger domestic demand compared to the baseline scenario. Greater-than-expected credit growth could boost economic activity. Introducing new macroprudential instruments slowed credit growth in 2019. Nevertheless, the credit portfolio increased by approximately 16.2% during the year (excluding the exchange rate impact), which was higher than the increase of aggregate nominal income in the economy. It is worth mentioning that the credit portfolio has recovered and its structure has changed. In particular, business loans started to increase and had a stronger impact on domestic demand. Meanwhile, in 2019, capital expenditures in the fiscal sector increased. Stronger fiscal stimulus would also have a positive impact on economic growth.

Realization of the abovementioned risks will boost economic growth. Accordingly, under the alternative forecast scenario, annual real GDP is higher than in the baseline and equals 6% (see Figure 2.3.1).

As has already been mentioned, based on our estimates, the negative output gap has closed. In the alternative forecast scenario, higher real GDP growth will open a positive output gap and will create inflationary pressures. Accordingly, over 2020-2021 inflation will be 0.5 percentage points higher than in the baseline projection (see Figure 2.3.2).

In order to bring inflation back to the target, in response monetary policy will be tightened and maintained at that level for a longer period. It is worth noting that the alternative forecast scenario considers strong domestic demand, while external demand remains the same as in baseline scenario. Under such circumstances, stronger domestic demand will worsen the current account balance. Based on our estimates, a revenue increase of 1 lari will increase imports by 0.35-0.40 lari[13]. A widening of the current account deficit increases the country risk premium and creates depreciation pressure on the currency. Hence, a more active policy reaction is needed when domestic demand creates inflationary pressure.

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 neutralizing demand-side pressure on inflation, 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.

13 National Bank of Georgia, Monetary Policy Report, July 2019.

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.

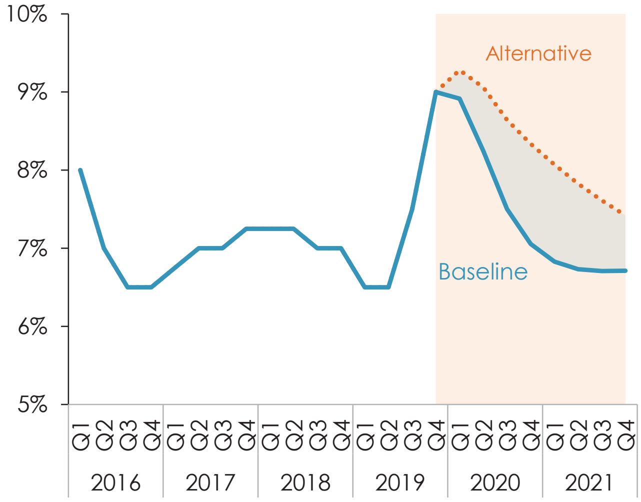

Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

BOX 2. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2019 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters). Hence, the inflation forecast is key to monetary policy formation in the medium term. To assess the reliability of monetary policy in achieving its monetary objectives, it is important to analyze the forecasts made in previous periods. The inflation forecast is assessed as having been accurate if any deviations from the forecast were a result of exogenous (independent of monetary policy) factors. In Georgia, as in other small open economies, exogenous shocks are an ever-present threat. Exogenous factors can cause actual inflation to deviate from the target level. Monetary policy is a tool to affect aggregate demand and is thus the central bank's response to demand shocks. Central banks do not usually react to exogenous supply-side shocks, as doing so would lead to economic fluctuations and increase social costs. Consequently, central banks only respond to exogenous shocks when a deviation is so significant that it affects inflation expectations and influences inflation in the medium or long term. We will start this analysis of the accuracy of the 2019 forecasts from the first quarter. An analysis of the forecasts made for 2018 can be found in the corresponding monetary policy report published last year.

The predictions of the inflation forecast made in February 2019 were lower than the reality (see Figure 2.3.4). Based on that forecast, inflation was expected to remain around the target during the year. In reality, inflation started to increase in the second quarter of 2019 and has remained above the target level since then. The reason for the greater-than-expected inflation was the depreciation of the exchange rate. Russia's flight ban increased economic uncertainty in Georgia and both the real and nominal effective exchange rates started to depreciate, which pushed imported inflation up. Meanwhile, economic uncertainty created higher inflationary expectations. A revised estimation of the GDP gap shows a different picture than had been predicted. GeoStat has published a revised GDP time series that shows that the output gap changed upward. It indicates that the negative output gap was not neutralizing inflationary pressures, as we had predicted it would at the beginning of the year.

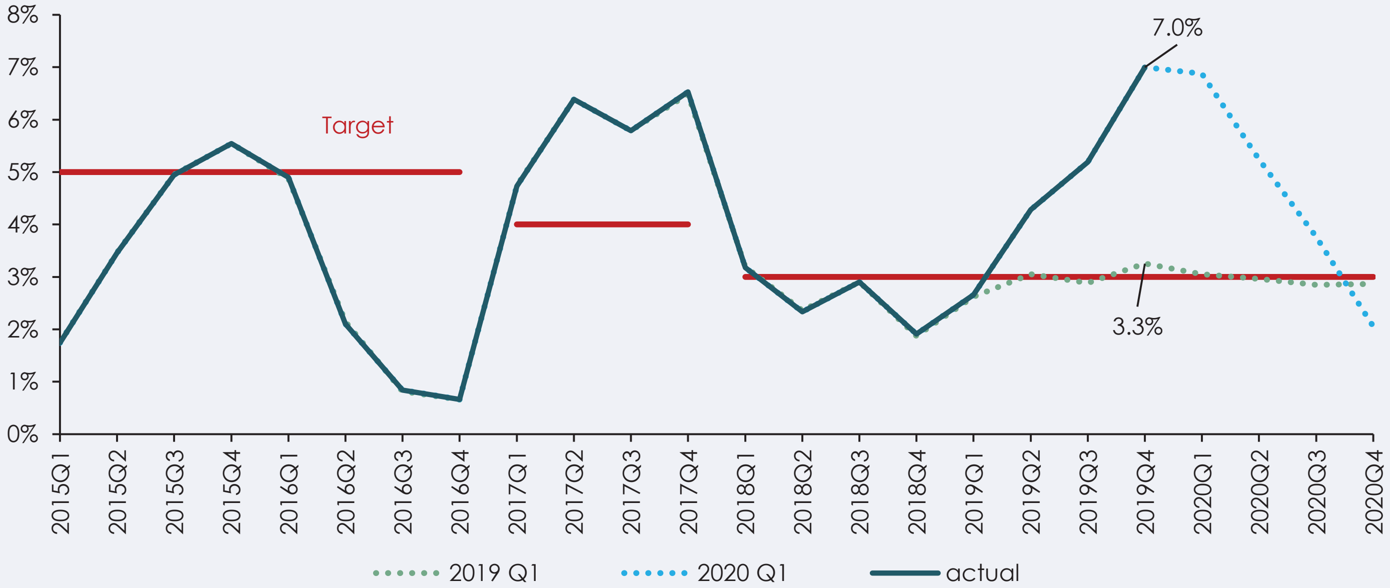

Figure 2.3.4. Comparison of annual inflation forecasts.

Source: National Bank of Georgia

On average, actual inflation in 2019 was 1.8 pp higher than predicted. Inflation decompositions reveal that the higher-than-expected inflation was a result of aggregate demand and expectations (see Figure 2.3.5). The relatively higher contribution of aggregate demand is a result of the revision of historical GDP data. At the end of 2019, in line with the new methodology (SNA 2008), revised historical data for GDP were published. These were significantly higher for the last two years compared to the previous data series. Accordingly, the revised estimates of the output gap, which use the new GDP data series, differ from previous estimates. The size of the negative output gap for 2019 shrank and the data show that the output gap closed at the end of the year. Hence, aggregate demand was not neutralizing inflationary pressures as we predicted at the beginning of the year. Meanwhile, Russia's flight ban created economic uncertainty, which was followed by the exchange rate depreciation and increased inflationary expectations. Accordingly, imported inflation was higher than expected.

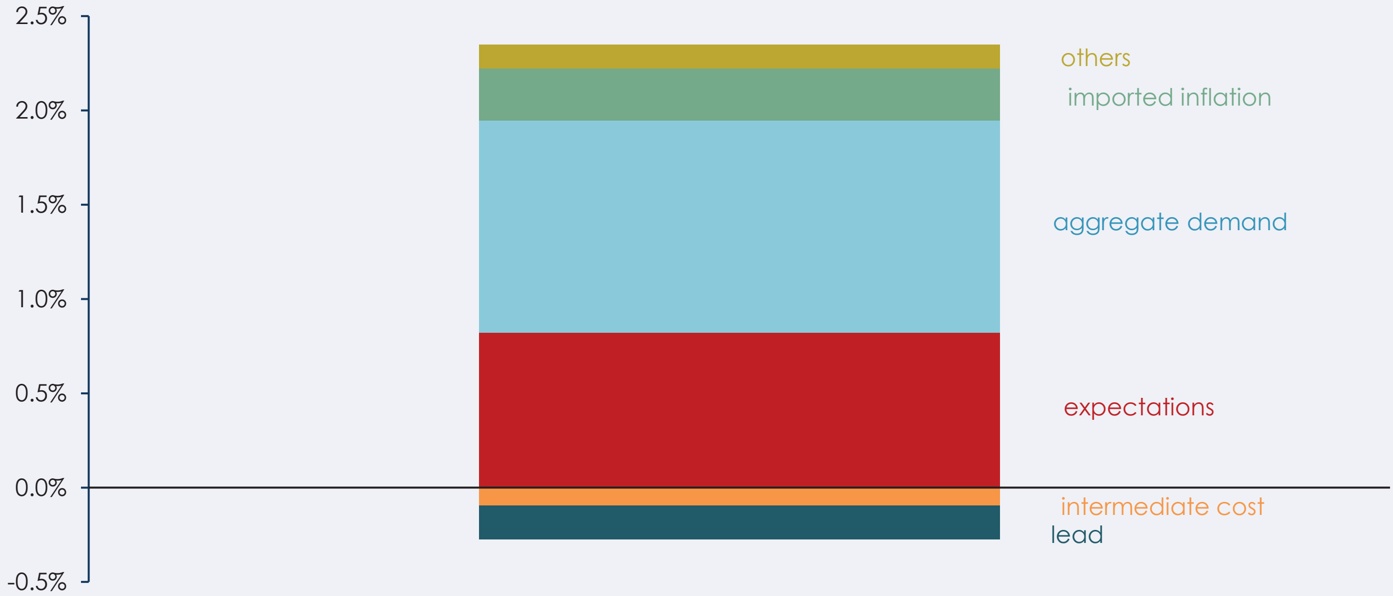

Figure 2.3.5. Decomposing the deviation of headline inflation from its projected value.

Source: National Bank of Georgia

In terms of the quarterly inflation forecasts, these were revised upwards for each quarter of 2019 (see Figure 2.3.6). These revisions were driven by the sharp exchange rate depreciation that started in July 2019 and which was maintained at that level for longer than we expected. The exchange rate depreciation pushed inflation up and the inflation forecast was revised in each quarter.

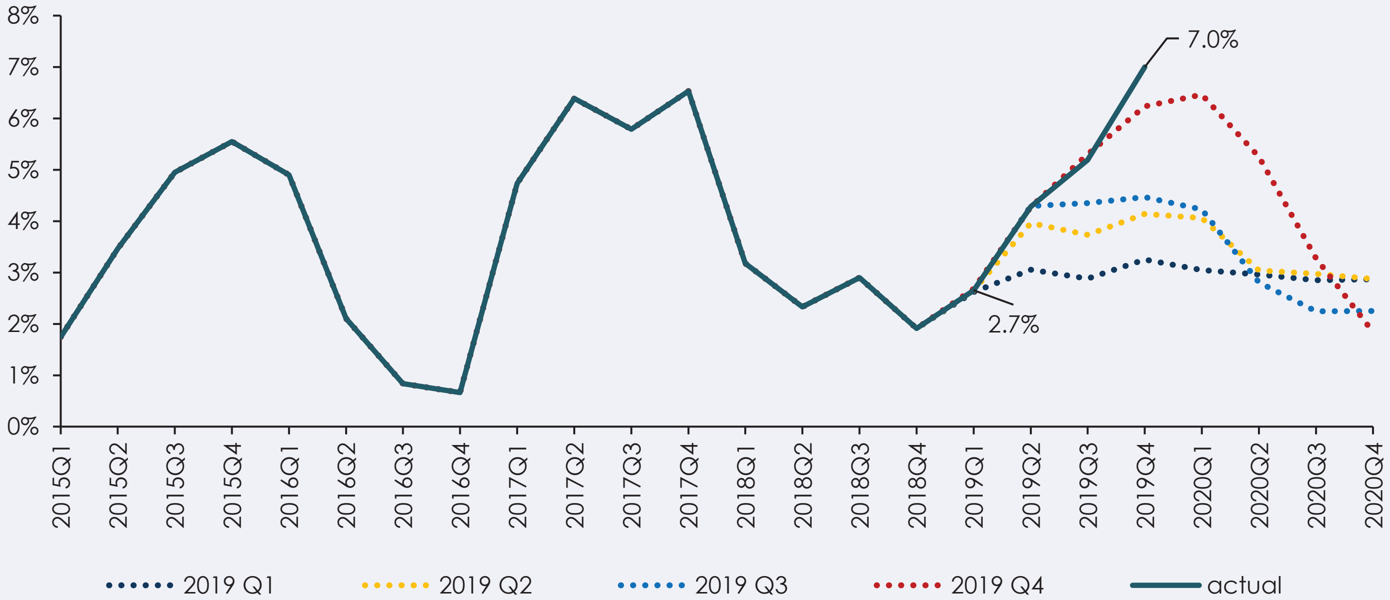

Figure 2.3.6. Performance of headline inflation forecasts (2019 Q1 -2019 Q4).

Source: National Bank of Georgia

The formation of monetary policy in 2018 can be summarized as follows: at the beginning of the year, the inflation forecast was around the target level and inflationary risks were low. Accordingly, the NBG continued its gradual exit from the tight monetary policy stance. However, in July Russia's flight ban increased uncertainty and caused inflationary risks to rise. Due to this unanticipated external shock, the lari exchange rate depreciated against both the US dollar and trading partner currencies. The exchange rate remained depreciated for a longer time than anticipated. As a result, imported inflation and an increase in input costs pushed inflation up. Meanwhile, in line with macroeconomic uncertainty, inflationary expectations started to rise. Under such circumstances, the NBG started to tighten the monetary policy rate. In the second half of the year, the monetary policy rate was increased by 2.5 pp. However, as changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters), it is expected that inflation will decline and will be around the target level in the second half of 2020. The NBG will maintain a tightened monetary policy stance until inflationary risks recede.

3 MONETARY POLICY

To neutralize the inflationary pressure stemming from the exchange rate depreciation, in September 2019 ,the Monetary Policy Committee started a gradual tightening of the monetary policy stance, raising it from 7% to 9%. On 29 January 2020, the MPC made the decision to keep the refinancing rate unchanged. In December, the nominal effective exchange rate strengthened slightly, which reduced pressure on inflation. However, it is important to note that over 2019, the economic growth accelerated, and lending was robust. If these dynamics create additional inflationary pressure, the tight monetary policy stance may need to be maintained for a longer period. The NBG will continue to monitor developments in the economy and will use all means and instruments at its disposal to ensure price stability.

According to the decision made on 29 January 2020, the refinancing rate was kept unchanged at 9%.

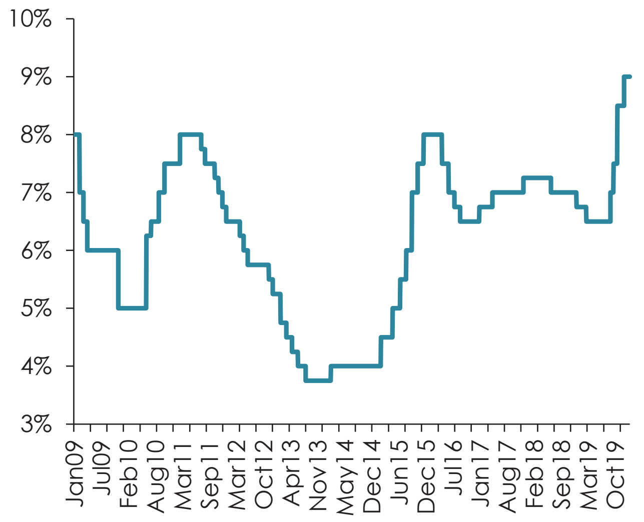

Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

In the beginning of 2019, the increase in inflation was triggered by one-off factors, such as the rise in excise tax on cigarettes and the growth of oil prices on international markets. However, in the second half of the year, a significant depreciation of the nominal effective exchange rate increased the pass-through on inflation, boosting inflation expectations. At the same time, following higher-than-expected economic activity, the downward pressure on inflation coming from the demand side weakened. In response, from September 2019 the National Bank began tightening monetary policy, a move aimed at neutralizing the inflationary pressures stemming from the exchange rate depreciation. As a result, the refinancing rate was increased from 7% to 8.5% in September-October 2019 and to 9% in December.

On 29 January 2020, the Monetary Policy Committee decided to keep the refinancing rate unchanged. In December, the nominal effective exchange rate strengthened slightly, which reduced pressure on inflation. However, the nominal effective exchange rate remains undervalued. In recent periods, economic growth has accelerated, and lending is robust. If these dynamics create additional inflationary pressure, the tight monetary policy stance may need to be maintained for a longer period.

In December 2019, annual inflation equaled 7%, while in January 2020, inflation fell to 6.4%. According to the NBG's forecast, other things being equal, inflation will start to decline from the beginning of the year and will approach the target by the end of the year. This will be ensured by the monetary policy, which will remain tight until medium-term inflation expectations decline to the 3% target.

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 risks to the inflation forecast. It is noteworthy that strong demand is seen as an upward risk to the inflation forecast, which will depend on both fiscal stimulus and credit growth. In addition, it is important to consider higher-than-expected external demand. If, amid external factors and a competitive exchange rate, economic activity rises more than is currently projected, this will create additional pressure on inflation. Meanwhile, inflation may be lower if aggregate demand is weaker due to external factors. In particular, an increase in the currency risk premium or a deterioration of geopolitical conditions in the region may result in a decline in cash flow.

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. Interbank money market interest rates thus vary around the monetary policy rate.

Interbank money market rates vary around the monetary policy rate.

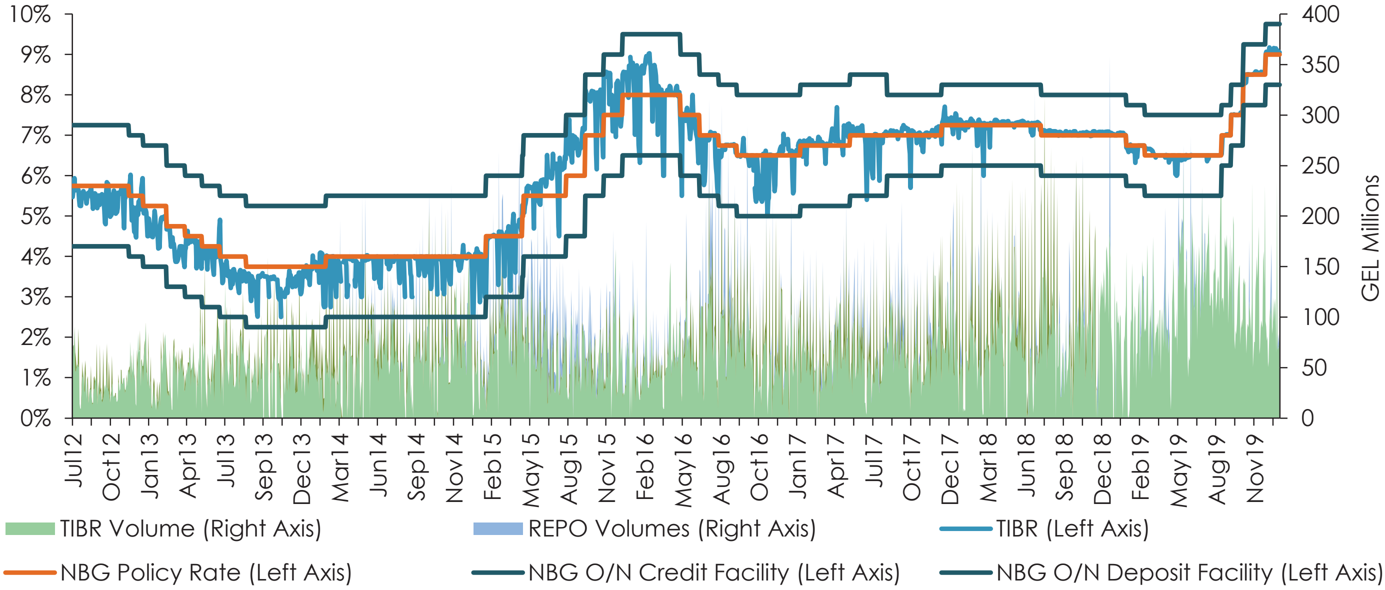

Figure 3.3. Interbank money market

Source: National Bank of Georgia

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