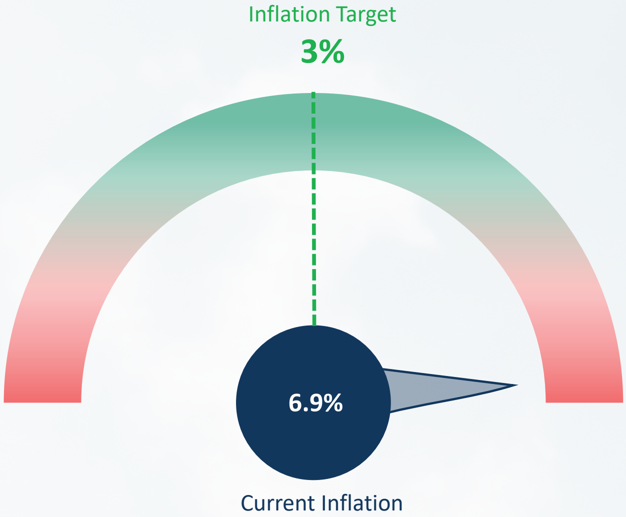
Monetary Policy Report

May

2020

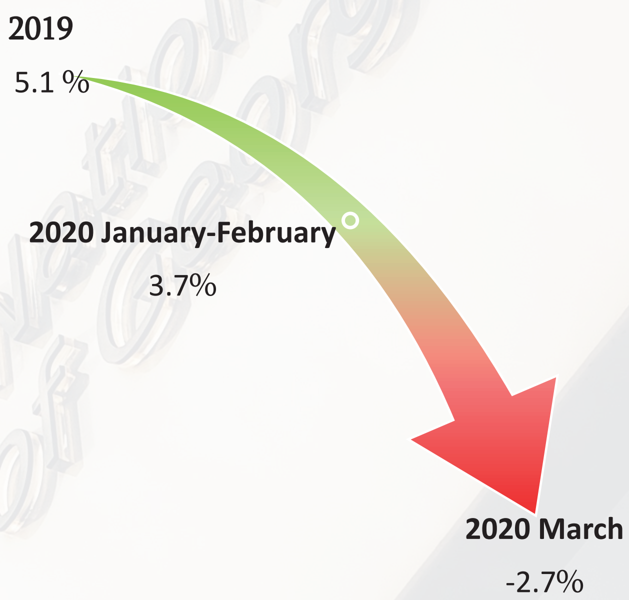
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



6.9%	Current inflation is above the target

Economic Growth



While the COVID-19 pandemic suppress-es economic activity	-2.7%

Monetary Policy

8.5% ↓ 0.5

8.5%	In line with the expected reduction of inflation and to support economic recovery, the NBG has reduced the policy rate

MONETARY POLICY DECISION

We have reduced the monetary policy rate to 8.5%.

Our role is to set the interest rate to affect total spending in the economy and to guide inflation expectations so as to ensure that inflation returns to the target level of 3%.

Low and stable inflation supports employment and economic growth, which are of the utmost importance during challenging times such as those now confronting us as a result of the COVID-19 pandemic. Such difficult circumstances should not reduce the credibility of macroeconomic policy.

The COVID-19 pandemic has hit the global economy and external demand of Georgia hard. Under such circumstances, the lari exchange rate depreciated against both the USD and the currencies of Georgia's main trading partners. Furthermore, the lockdown and national quarantines have increased production costs. Consumer price inflation has thus remained above the target, but this effect is expected to be temporary.

Given the present situation, in April 2020 the NBG decided to reduce the monetary policy rate to 8.5%. This reduced policy rate will support economic recovery and improve access to finance.

Interest rate changes are gradually reflected on the economy with a time lag of 4-6 quarters. According to the forecast, inflation will gradually return to the target level of 3%. This gives us an opportunity to further reduce the monetary policy rate.

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

Due to the restrictions imposed by the authorities to cope with the COVID-19 pandemic, economic activity will face significant challenges in 2020, both in Georgia and the rest of the world. According to the current forecast, which remains uncertain, real GDP growth in Georgia in 2020 will be negative, at around -4%. A sharp drop in aggregate demand, other things being equal, would significantly reduce the rate of inflation. However, in the short term, other things may not be equal. Large capital outflows from developing countries also remain a considerable challenge, which in turn puts pressure on the exchange rate and, consequently, on inflation. In addition, disruptions to the production process (measured labor productivity) and supply chains significantly increase the per-unit costs of firms, which also puts upward pressure on prices. As a result, according to the National Bank of Georgia's forecast, inflation in the short term will remain high, above the target. However, after these short-run disruptions dissipate, inflation will start to fall due to weak demand and, as a result, further monetary policy easing will become possible.

On the back of supply-side disruptions, inflation will remain high in the short term at around 6%; however, once supply-side factors are neutralized, it will fall below the target next year. This reduction in inflation is expected to be driven by weak aggregate demand.

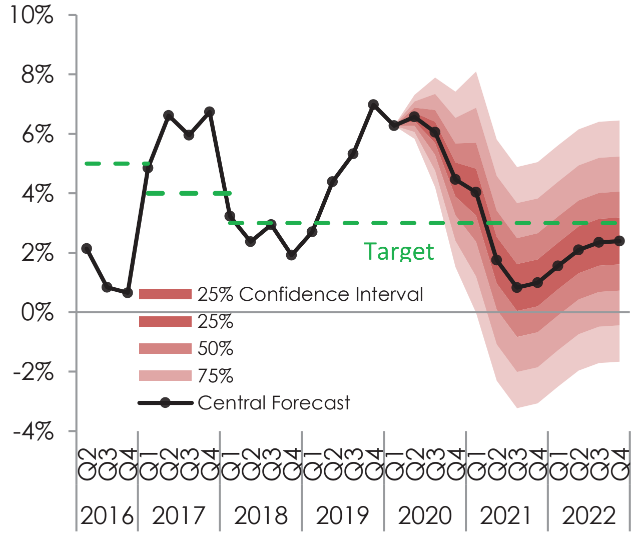

Figure 1. Forecast of headline CPI inflation

Source: National Bank of Georgia

As a result of the COVID-19 pandemic, the world faces a severe and completely unexpected problem. Clearly, the first priority is to protect lives. This has necessitated significant restrictions, which have had unprecedented consequences for economic activity. The goal of economic policy should be to mitigate this negative impact as much as possible. However, as the use of policy instruments is not costless and there is limited room for maneuver, their optimal use depends on macroeconomic forecasts – the accuracy of which is a particular challenge today.

Despite this ongoing uncertainty, the factors that are likely to affect the **future dynamics of inflation** clearly stand out. Although the 6.3% actual annual inflation in the first quarter of 2020 was in line with the previous forecast, it may significantly decline in the future due to a sharp decline in aggregate demand. On the other hand, the supply side has the opposite impact, placing upward pressure on inflation. In particular, the depreciation of the lari exchange rate increases the debt-service costs of firms that have foreign currency liabilities, which, along with imported inflation, pushes consumer prices up. Moreover, the restrictions put forward by the authorities to contain the virus complicates the production process and, on the back of a decline in measured productivity, increases the per-unit costs of products. Disruptions in supply chains have a similar effect.

As the result of these factors, according to the National Bank of Georgia's (NBG) current forecast, inflation will remain above the target level this year. Based on current estimates, supply-side factors will outweigh the effect of weak aggregate demand. However, beyond the short term, weak demand will push inflation temporarily below the target rate (see Figure 1).

After relatively high economic growth in 2017-2019, real GDP will take a significant hit in 2020. The decline in economic activity is primarily expected to be due to external demand (primarily tourism), although domestic demand will also be weak.

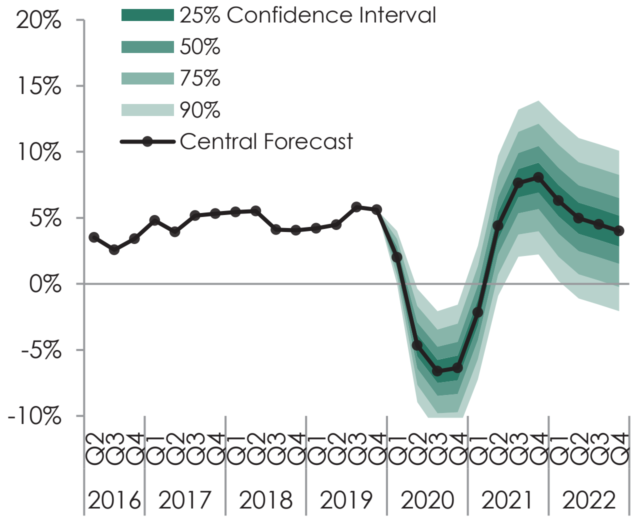

Figure 2. Forecast of annual real GDP growth

Source: National Bank of Georgia

Given the lower inflation forecast in the medium term, a gradual decline in the monetary policy rate is expected, which should also help the recovery of the economy.

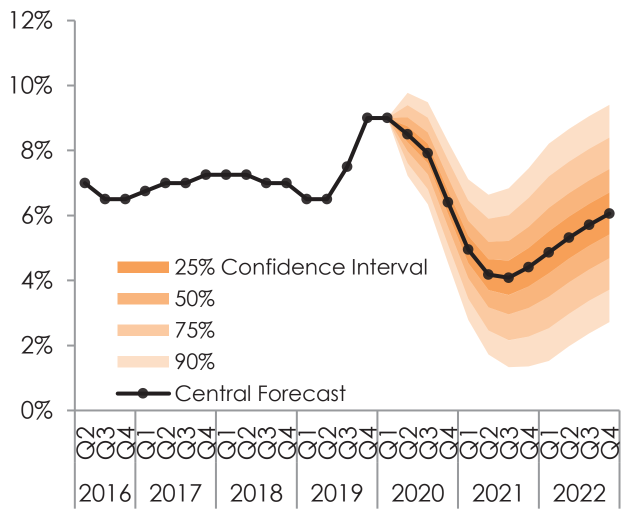

Figure 3. Forecast of the monetary policy rate

Source: National Bank of Georgia

In terms of the expected **future dynamics of economic growth**, which are behind the inflation forecast discussed above, according to the NBG's forecast, real GDP will decrease by 4% in 2020 (see Figure 2). Such a rapid and unprecedentedly large drop in real GDP has not been seen in Georgia since the 1990s. This is expected to be a result of a decline in both external and domestic demand. The tourism sector, which has been one of the most important drivers of economic activity in recent years, has been hit particularly hard. Revenues from exports of goods have reduced, and remittances are also affected. In addition, domestic demand is likely to be weak, especially for the long-term consumption goods and services.

Despite the significant foreign aid received from international financial institutions, which should partially offset the effects of this severe shock, monetary policy still faces a tough trade-off in 2020. On the back of temporary disruptions in the supply potential, higher-than-targeted inflation expectations and an increased sovereign risk premium, tight monetary policy is necessary. On the other hand, a sharp drop in aggregate demand requires a lower monetary policy rate. Because the latter could be more important, according to the current macroeconomic forecast, the monetary policy rate will gradually decrease. Together with the decline in inflation expectations, the policy rate may temporarily fall below the neutral rate (see Figure 3). Based on the current forecast, the neutral interest rate is around 6.5%.

Clearly, if inflationary pressure persists longer than is currently expected, the NBG is ready to maintain a tight monetary policy until inflation returns to its target level. Thus, 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.

BOX 1. EXTRAORDINARY MEASURES OF THE NATIONAL BANK OF GEORGIA REGARDING COVID-19

As part of its mandate, the National Bank of Georgia has taken several important measures to mitigate the impact of COVID-19 on the economy and the financial sector. Extraordinary steps have been taken in different directions, including ensuring an uninterrupted supply of liquidity to various sectors of the economy, the development of a temporary supervisory plan and the expansion of the International Monetary Fund (IMF) program.

Liquidity provision

The smooth supply of liquidity to the financial sector is one of the key functions of the central bank. As of today, the financial sector has excessive foreign currency liquidity. At the same time, demand for the national currency has increased. The National Bank of Georgia has effective monetary instruments to ensure that liquidity in the national currency is supplied to the financial sector without restrictions. In the case of foreign currency, international reserves, including reserve liabilities on foreign liabilities (currently 1.4 billion USD), serve as an additional buffer and a source for supplying liquidity.

The COVID-19 pandemic and existing logistical constraints have led to a significant increase in demand for cash from private individuals and companies. To finance the costs of responding to the pandemic, the state budget has mobilized funds from commercial bank accounts to the government account at the National Bank. In addition, the National Bank has withdrawn lari from circulation through foreign exchange interventions. Also, commercial banks and most microfinance organizations have offered lenders a three-month moratorium period, which has reduced their inflows and increased demand for liquidity. Considering the above-mentioned steps, demand for national currency liquidity in the financial system has significantly increased, which is something that needs to be addressed by the central bank using liquidity management instruments.

Microfinance organizations play an important role in providing businesses and individuals financial services in the regions of Georgia. Hence, in addition to standard refinancing loans to support the demand for liquidity, the National Bank will provide GEL liquidity to commercial banks and microfinance organizations through swap operations with a limit of 200-200 million USD (in total 400 million USD). The total amount of the swap will be distributed among the participants of the scheme as well as in proportion to the market share of the financial institution. However, to avoid excessive concentration, a limit of 25% of the total volume will be imposed on each organization, which will increase the availability of resources for small financial institutions. The term for swap operations is set at 1 month, with the right for a monthly renewal for the next year. Under both the current circumstances and after the pandemic ends, when the economy returns to usual, the National Bank will continue to ensure an adequate level of liquidity in the financial system and in the economy as a whole. Thus, the use of monetary policy instruments and buffers accumulated in foreign currency, liquidity will not be a limiting factor for lending, even in the event of a prolongation of the pandemic.

Temporary supervisory plan

Amid the global pandemic, the National Bank of Georgia has developed a temporary supervisory plan that is in full compliance with the recommendations of the International Monetary Fund, the European Central Bank and other leading financial organizations.

It is important to note that the country's banking sector is healthy and has sufficient capital and liquidity buffers that have been gradually accumulated as a result of the consistent supervision of the National Bank. In addition, the volume of non-performing loans (NPLs) in the overall portfolio is low and, in general terms, the banking sector has been characterized by stable profitability in recent years. Importantly, the policies of the National Bank and the government have supported a decline in the dollarization of loans in foreign currency to individuals, which reduces the vulnerability of the population to exchange rate fluctuations. At the same time, as a result of the introduction of a responsible lending framework, citizens are facing the current challenges with lower and more adequate levels of debt.

The National Bank's action plan implies the use of banking sector capital and liquidity buffers during the period of financial stress. Through reducing the existing capital and liquidity requirements, the NBG will allow the banking sector neutralize potential losses and continue normal business operations. According to the supervisory plan, commercial banks will have their capital requirements eased, which would include the abolition of the capital conservation buffer (at 2.5% of risk-weighted assets) and a portion of the Pillar 2 buffer (2/3 of the unhedged credit risk buffer). As a result, capital worth 1.6 billion USD will be released, which could be used to offset potential losses. In total, the banking sector has a capital buffer of 4 billion GEL above the minimum requirements, which can be fully released if needed. The easing of capital requirements by the National Bank may not be used by commercial banks for issuing dividends, stock repurchases, equity investments, management bonuses, or other payments that will reduce a bank's capital.

It is also noteworthy that considering the so-called loan repayment period extension program by commercial banks, the National Bank of Georgia has significantly eased its supervisory requirements so that banks can be as flexible as possible in this process. The National Bank monitors current events and is in constant communication with the financial sector, so if, due to reduced economic activity and difficulties caused by the pandemic, the share of NPLs and credit losses increases more than is expected, the National Bank will launch other instruments and take additional decisive financial measures to ensure financial stability.

The International Monetary Fund Program

Over 1-13 April 2020, the National Bank of Georgia, together with the government authorities, held discussions with the International Monetary Fund. As a result, an agreement was reached at the mission level to successfully complete the sixth review of the current program in Georgia and to increase the total amount of the program in order to limit the economic impact of the COVID-19 pandemic. Increasing funding under the IMF program will help the country implement macroeconomic stabilization measures and, at the same time, accelerate the mobilization of assistance from other international donors.

The agreement reached with the IMF mission envisages an additional increase in funding of about 375 million USD under the program, which will be used for macroeconomic stabilization measures and the socio-economic needs of the economy. Following approval from the Executive Board of the IMF, which is expected in early May, about 200 million USD will be immediately made available to the Georgian budget. The rest of the money will be distributed over the duration of the program.

In addition to funding the increased financial needs resulting from the pandemic, the funds allocated by the IMF will have a positive impact on Georgia's international reserves. It should be noted that the benefits of the NBG's efforts to accumulate international reserves over recent years have been particularly evident in the current situation. Given the extraordinary circumstances currently facing the economy, the reserves will be used for interventions on the foreign exchange market. The flexibility of the exchange rate to deal with shocks will still be relevant. However, at the same time, considering the price stability mandate, foreign exchange interventions will be used to mitigate the excessive fluctuations of the lari and to provide liquidity to the foreign exchange market.

1 CURRENT MACROECONOMIC SITUATION

The COVID-19 pandemic has put the global economy into a sharp recession. An economic downturn is expected in Georgia's trading partner countries, which will negatively be reflected on foreign inflows in Georgia. As a consequence of the restrictions intended to contain the spread of the virus, the tourism sector has been affected the most, but the shock has had significant effects on other sectors as well. The current account is thus expected to worsen this year. This has been reflected on exchange rate dynamics, which had already depreciated significantly in previous periods. The exchange rate has been one of the main reasons for the rise in inflation to date; however, in the climate of the current crisis, any additional increase in inflation will be limited by a weakening of economic activity.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

On the back of the COVID-19 pandemic, the global economy is expected to decline in 2020. In terms of GDP growth, an especially challenging environment is seen in developed countries, where economic activity is projected to deteriorate significantly. Negative growth rates are also expected in Georgia's trading partner countries.

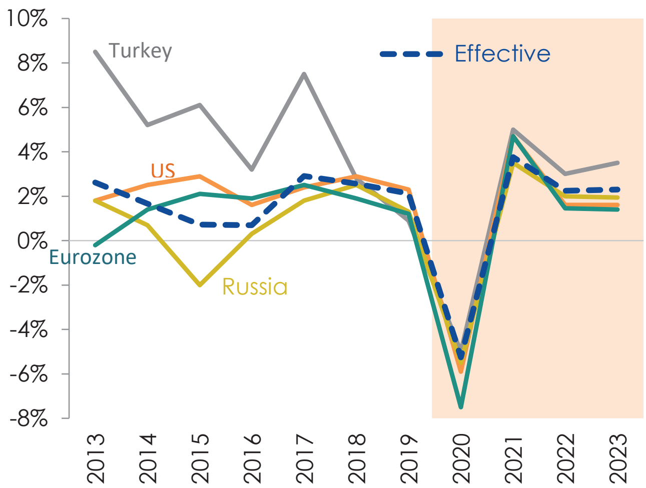

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF; National Bank of Georgia

Early 2020 has turned out to be challenging for the global economy. Due to the COVID-19 (novel coronavirus) pandemic, economic and business activities have been hampered in both developed and developing countries. After states of emergency and quarantines were declared, borders and shops were closed, and most employed people were transferred to remote (distance) working arrangements. The continued pandemic and high degree of uncertainty around it, makes the situation more difficult. According to the International Monetary Fund (IMF), the crisis caused by COVID-19 will be much greater than the previous 2008-09 financial crisis. According to the IMF's April forecast[1], **global economic growth** in 2020 will be -3%, which is 6.3 percentage points (pp) below the previous forecast[2]. After the virus slows, economic activity should stabilize, and growth in 2021 is projected at 5.8%. For emerging and developing countries, the real GDP growth forecast for 2020 is -1%, but this is expected to recover to 6.6% in 2021.[3]

Growth in **the US** slowed in the first quarter of 2020, which was mostly due to a decline in the output of the manufacturing and industrial sectors. Moreover, a sharp drop in oil prices and the rapid spread of COVID-19 throughout the United States has further damaged the already weak manufacturing sector. Consumer and business sentiment have significantly deteriorated after the lockdown of some states. Amid the global pandemic, stock price indices have also

1 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.
2 International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.
3 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.

A stable level of inflation is expected in Georgia's trading partner countries in 2020, with the only exception being Turkey, where the inflation has been well above the target for some time.

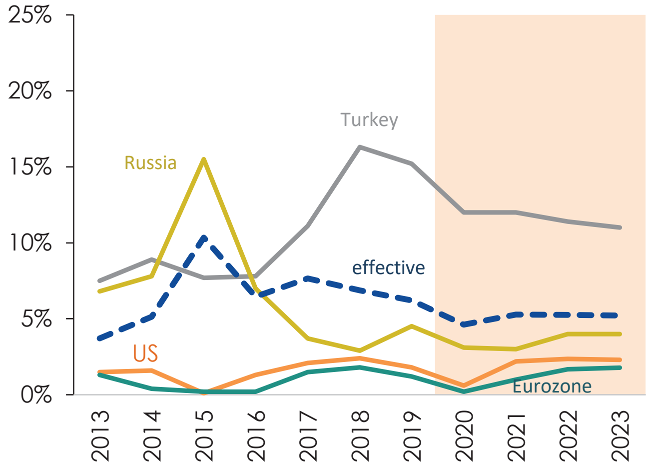

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF; National Bank of Georgia

declined. According to the IMF's forecast[4], real GDP growth in the US will be -5.9% in 2020, which is 7.9 pp lower than previously forecast[5], while growth is projected to be 4.7% in 2021. Annual inflation in 2020 is forecasted at 0.6%, and 2.2% in 2021.

In the **eurozone**, weak economic growth continued in the first quarter of 2020. Amid the COVID-19 pandemic, all eurozone countries were closed, which caused a deterioration in the manufacturing and tourism sectors, and the volume of exports and investments declined due to reduced demand from trading partners. Consumer and business sentiment have also weakened. According to the IMF's forecast[6], real GDP growth for the eurozone will be -7.5% in 2020, which is 8.8 pp below the previous forecast[7], while growth in 2021 is projected at 4.7%. Annual inflation is expected to be 0.2% in 2020, and 1% in 2021.

In the first quarter of 2020, **Turkey's** economic activity recovered slightly. Amid higher consumer loans, consumer spending increased and the production sector improved. In January-February, business sentiment also increased. However, investments declined significantly and, amid a decrease in exports and an increase in imports, the trade balance deteriorated. Furthermore, the global pandemic and declared state of emergency has put additional pressure on the economy. Inflationary pressures remain high amid the depreciation of the Turkish lira. Annual inflation in March equaled 11.9%. According to the IMF's forecast[8], real GDP growth of Turkey in 2020 will be -5, which is 8 pp lower than previously forecasted.[9] Growth in 2021 is projected at 5%, while annual inflation is expected to be 12% in both 2020 and 2021.

In early 2020, economic activity in **Russia** deteriorated, which was mostly driven by the sharp drop in oil prices and a deteriorating foreign sector amid the COVID-19 pandemic, where the volume of exports declined sharply. Due to a weakened oil extraction and refining sector, state infrastructure investments were paused in Russia and the level of unemployment increased. Despite a depreciation in the local currency, annual inflation was low and equaled 2.5% in March.

4 Ibid.

5 International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.

6 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.

7 International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.

8 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.

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

In early 2020, monetary policy rates declined in Georgia's main trading partner countries and in the US. This was mostly driven by moves to stimulate economic activity during the COVID-19 crisis.

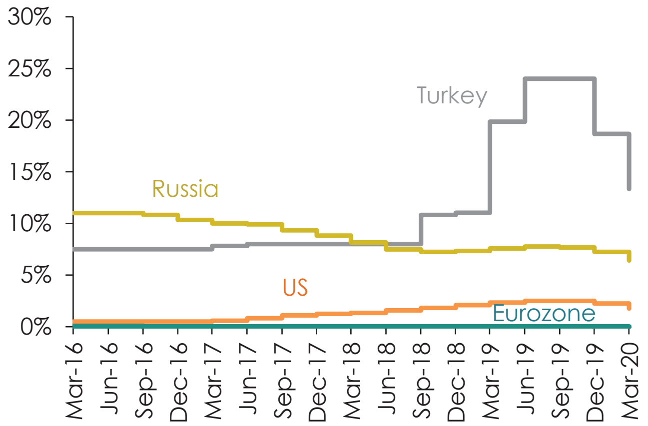

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: National Bank of Georgia

According to the IMF's forecast[10], real GDP growth in Russia will be -5.5% in 2020, which is 7.4 pp lower than previously forecast[11], and growth is projected to be 3.5% in 2021. As for inflation, it is expected to be 3.1% in 2020 and 3% in 2021.

Ukraine's economic activity slowed in the first quarter of 2020, mostly due to the global slowdown in trade and declining investments amid the COVID-19 pandemic. Consumer spending was still high amid higher wages; however, because of the declared state of emergency, this situation is expected to change dramatically. The annual rate of inflation was low, reaching 2.3% in March – a result of the reforms undertaken by the government and the Central Bank. According to the IMF's forecast[12], real GDP growth in Ukraine will be -7.7% in 2020, which is 10.7 pp below the previous forecast[13], and growth is projected to be at 3.6% in 2021. Annual inflation is expected to be 4.5% in 2020 and 7.2% in 2021.

In the first quarter of 2020, a slowdown of growth also occurred in **Armenia**. This was mostly driven by a reduction in investments and export volume amid the COVID-19 pandemic, as well as being a consequence of economic deterioration in Russia. Armenia's external sector recently worsened alongside a weakening of the export growth rate and increased imports. According to the IMF's forecast[14], real GDP growth in Armenia will be -1.5% in 2020, which is 6.3 pp lower than previously forecast[15], and growth is projected to be 4.8% in 2021. Inflation is expected to be 0.8% in 2020 and 2% in 2021.

In **Azerbaijan**, the non-oil sector was still highly active in early 2020. Alongside low interest rates on loans and higher wages, consumer spending and business investments both increased. Moreover, high activity was observed in the agricultural sector. However, because of the declared state of emergency, a deceleration in the growth rate is expected. The external sector has already deteriorated amid a sharp drop in oil prices and the impact of the COVID-19 pandemic. According to the IMF's forecast[16], real GDP growth in Azerbaijan

10 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.
11 International Monetary Fund. 2020. World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? Washington, D.C., January.
12 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.
13 International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.
14 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.
15 International Monetary Fund. 2019. World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers. Washington, D.C., October.
16 International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.

will be -2.2% in 2020, which is 4.3 pp below the previous projection.[17] Growth is expected to be 0.7% in 2021. Annual inflation is expected to be 3.3% in 2020 and 3.2% in 2021.

The central banks of Georgia's main trading partners (Turkey, Russia, Ukraine, Armenia and Azerbaijan) further reduced their monetary policy rates in the first quarter of 2020 to encourage domestic demand amid the COVID-19 pandemic. The US Federal Reserve has also eased its monetary policy and cut the federal funds rate twice this year, from 1.5-1.75% to 0-0.25%. Meanwhile, the European Central Bank has kept its policy rate unchanged at 0%, although it has resumed a quantitative easing program.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

Registered exports of goods declined by 5.9% annually.

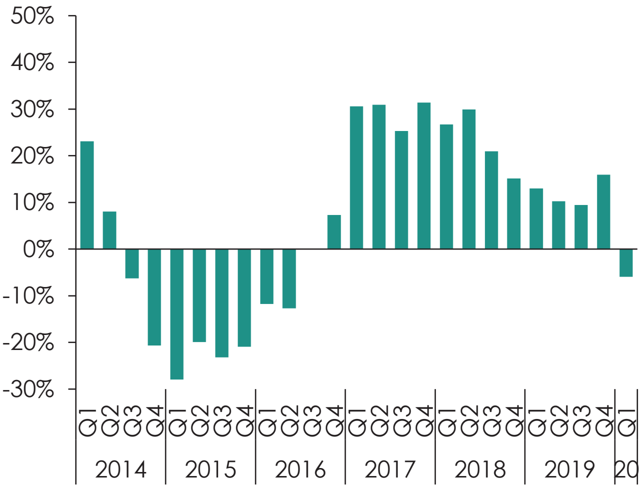

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

External demand decreased in the first quarter of 2020. Following the declaration of novel COVID-19 as a pandemic (by the World Health Organization) and the rapid increase in infection rate, the majority of countries introduced several restrictions that negatively affected not only internal economic activities, but also international trade and tourism. Hence, it is expected that the economic activity in trade partner countries will decline, negatively affecting demand for exports of goods and services from Georgia. Moreover, revenues from international travelers have already begun to decline, while the growth of money transfers has decelerated. Due to weaker domestic demand, imports of goods have also declined. According to the updated forecast, the current account deficit is expected to widen in 2020.

Registered exports of goods fell by 5.9% annually in the first quarter of 2020 (see Figure 1.2.1). The volume of exports to Russia, Armenia and other regional countries substantially declined. In the first quarter of 2020, the reduction of exports to Russia made the highest contribution to this decline (falling by -5.3 pp annually), mainly as a consequence of lower demand for ferro-alloys, natural wines and mineral waters. Exports to Armenia declined mainly in terms of a dramatically lower level of re-exports of motor cars and vehicles. For EU countries, exports to Romania declined due to weaker demand for copper ores and concentrates. The growth in exports to Azerbaijan contributed positively to the overall change, mainly because of higher demand for motor vehicles, cigarettes and chemical fertilizers, while exports to Bulgaria and Spain increased in terms of sales of copper ores and concentrates. Demand for ores and concentrates of copper, as well as for precious metals were also high in China.

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

The decrease in exports of goods was mainly driven by the fall in external demand for both consumer and intermediate goods.

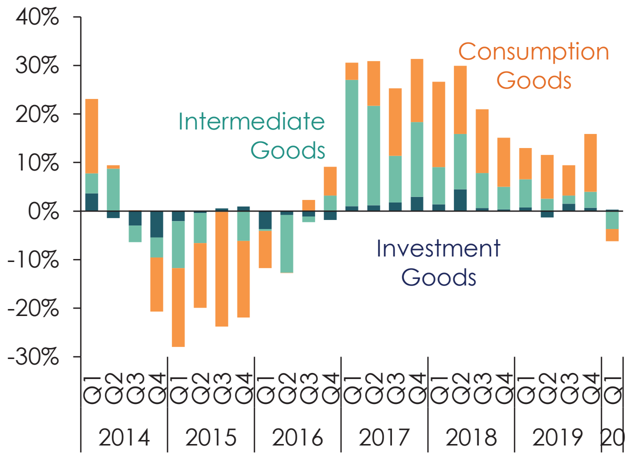

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

The dynamics of revenues from international travelers reverted to a declining trend.

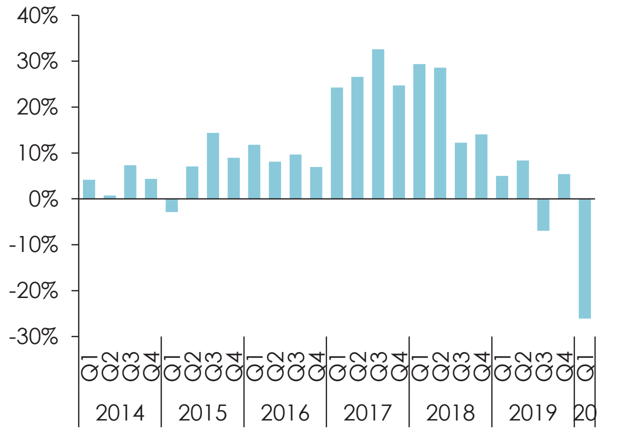

Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

The growth rate of money transfers decelerated.

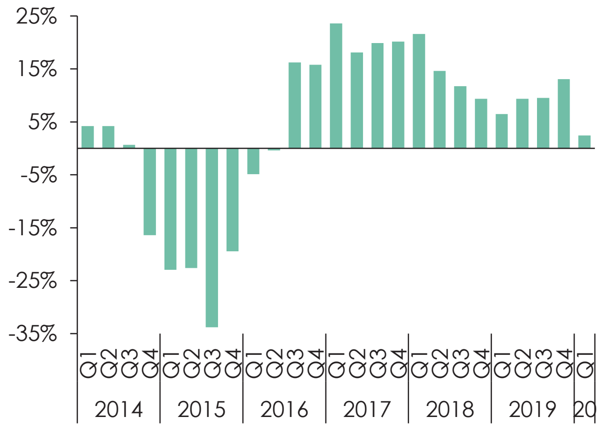

Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

The exports of goods fell mainly due to low demand for consumer and intermediate goods (see Figure 1.2.2), while the decline in consumer goods followed low exports of medicaments, cigarettes, chemical fertilizers, natural grape wines and mineral waters. In terms of intermediate goods, exports of ferro-alloys, semi-finished iron products and pneumatic types of rubber saw a drastic decline. It is worth noting that in recent quarters, re-exports of copper ores and concentrates, as well as of precious metals and motor cars were higher due to increased external demand for those commodities.

In March, following the restrictions on international flights and the closure of the borders of Georgia to contain the spread of the novel coronavirus, the number of international visitors began to decline. Overall, in the first quarter, taking into account the growth in January-February, the number of international visitors decreased by 16.0% annually. A decline is expected over the rest of the year. Against the background of a reduced number of visitors, revenues from international travelers decreased by 26.1% annually (see Figure 1.2.3). It is also worth noting that, similar to the case with the number of international travelers, revenues dropped significantly in March after an increase over January-February. It is expected that revenues from international travelers will continue to decline until the cross-country borders reopen and the international tourism recovers.

At the beginning of 2020, the growth of money transfers to Georgia decelerated, but their volume still increased by 2.4% and amounted 388.8 million USD in the first quarter (see Figure 1.2.4). The largest contributions to total growth came from money transfers from the EU (especially from Italy, Greece and Germany), Ukraine and the USA.

In light of decreased external activities and weaker domestic demand, imports of goods declined in March, after the initial growth in January-February. Overall, in the first quarter of 2020 imports of goods declined by 1.4% annually (see Figure 1.2.5). This reduction was principally driven from Romania (mainly due to a decline in imports of petroleum products) and China (due to imports of iron bars and rods and lamps). The rise in imports from regional countries was significant from Russia (mainly due to electricity imports) and Turkey (mainly due to electricity and motor vehicles for the transport of ten or more persons), while imports from other countries increased because of higher imports of copper ores and concentrates for subsequent re-export.

In the first quarter of 2020, imports of intermediate and consumer goods accounted to 45% and 44% of total imports respectively. It is worth noting that the decline in imports of goods predominantly stemmed from lower imports of intermediate goods (see Figure

At the beginning of 2019, imports of goods declined.

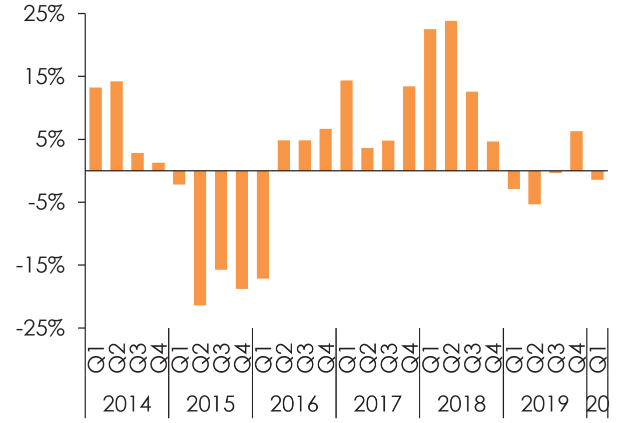

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the first quarter of 2020, imports of consumer goods rose, while imports of intermediate and investment goods declined.

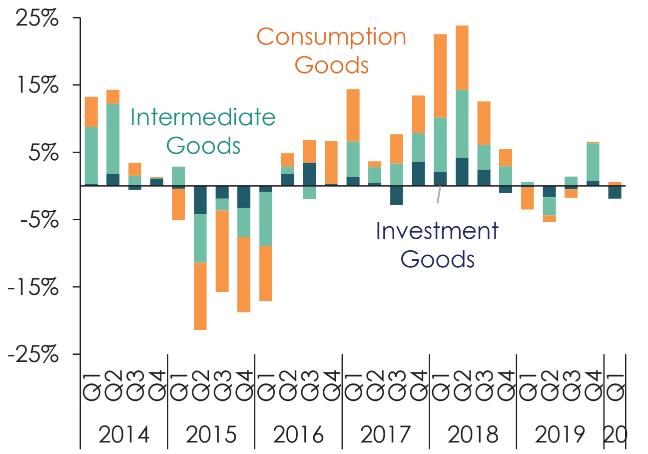

Figure 1.2.6. Annual change in registered imports of goods

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.

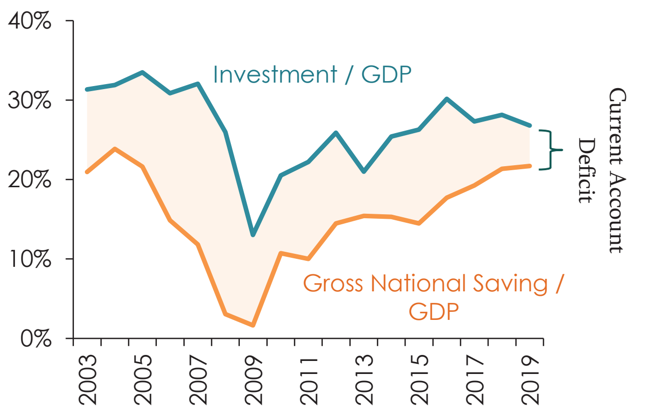

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

1.2.6). The increase in consumer goods was mainly due to increased purchases of motor and vehicle cars, telephones and maize. In terms of intermediate goods, the majority of exports consisted of petroleum gas, electricity and unwrought aluminum. Meanwhile, the decline in imports of investment goods is likely connected with the weakening of current economic activities. In terms of commodity groups, imports of goods have become less diverse compared to the same period last year.

In 2019, the improvement of the current account deficit was significant and amounted to 5.1% of GDP, which is the lowest indicator since Georgia gained independence. Overall, the current account deficit was 901 million USD in 2019. It is worth noting that in the fourth quarter the deficit amounted to 538 million USD and accounted 11.1% of GDP. Against this background, thanks to higher exports of goods and services, rising revenues from international travelers and increased money transfers, the current account deficit continued to decline in 2019.

The primary source of financing the current account deficit is foreign direct investments, which increased by 0.2% annually and reached 1.3 billion USD in 2019. The largest investments went to the finance, energy, and hotels and restaurants sectors.

From the perspective of savings and investments, the improvement of the current account balance in 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 fourth quarter of 2019, GDP grew by 5.1%. The main contributor to that growth was private consumption, with 10.3% real growth.[18]

Investments have risen against the backdrop of strong growth in the construction sector. The growth of investments was ensured by the growth of capital expenditures in both the public and private sectors.

According to preliminary data, in the fourth quarter, net exports contributed negatively to growth due to the accelerated growth of imports.

Private consumption was a main driver of economic growth in the fourth quarter of 2019.

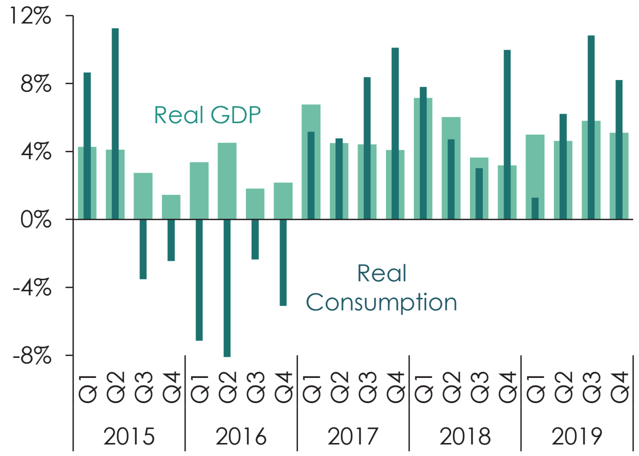

Figure 1.3.1. Real growth of GDP and private consumption

Source: GeoStat; NBG calculations

1.3.2 OUTPUT

In the fourth quarter of 2019, GDP grew by 5.1% compared to the same period of the previous year. This growth was primarily driven by services, which contributed 3.9 percentage points (pp) to the total. The contribution of industry to growth was 1.5 pp, while the contribution of agriculture was negative at -0.3 pp (see Figure 1.3.2).

The ban on air traffic from Russia has had a negative impact on the tourism sector, but this shortfall has been offset by a gradual increase in the number of visitors from other countries. Ultimately, tourism-related industries were still the main drivers of economic growth in the fourth quarter.

There has been a significant increase in real estate transactions, in the output of hotels and restaurants, and in transport, where the participation of non-residents is likely to remain significant. The contribution of these sectors to economic growth was 1.7 pp.

In the fourth quarter, trade, the largest sector of the economy, grew by 12.4%. The hotels and restaurants sector saw high growth (15.2%), whereas the growth rate of construction decreased to 1.4% after having a rather high growth rate in the previous quarter (17.1%).

The agricultural sector shrank by 5.1% in the fourth quarter. In total, agriculture decreased by 1.1% in 2019.

Economic growth in the fourth quarter of 2019 was driven mainly by tourism-related sectors.

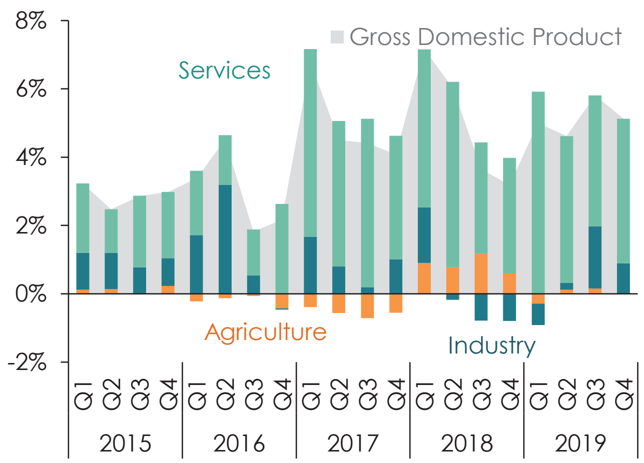

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

18 *The real growth of consumption is calculated using average annual inflation*

1.3.3 LABOR MARKET

The labor market does not create inflationary pressure on prices.

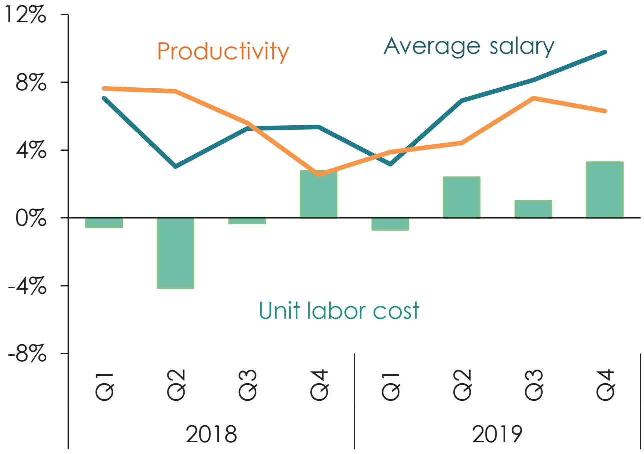

Figure 1.3.3. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

The real added value (labor productivity / productivity) produced per employee in the country's economy increased by 6.3% annually in the fourth quarter of 2019.

In the fourth quarter the highest rate of productivity growth (16.0%) was recorded in the services sector, which was the main driver of economic growth during 2019. In the industrial sector, labor productivity increased by 2.8%, while in agriculture it decreased by 4.1% (see Table 1.3.3.).

In the fourth quarter of 2019, the salaries of employees in the country averaged 1,320 GEL per month, which was a 9.8% nominal increase over the same period in the previous year. The unit labor cost increased by 3.3% annually, which does not create inflationary pressures on prices from the labor market (see Figure 1.3.3).

	Increase in labor productivity
Agriculture and agriculture output by households	-4.1%
Industrial sector	2.8%
Services sector	16.0%
Overall in the economy	6.3%

Table 1.3.3 Annual growth of value added per employee in the fourth quarter of 2019

Source: GeoStat

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.

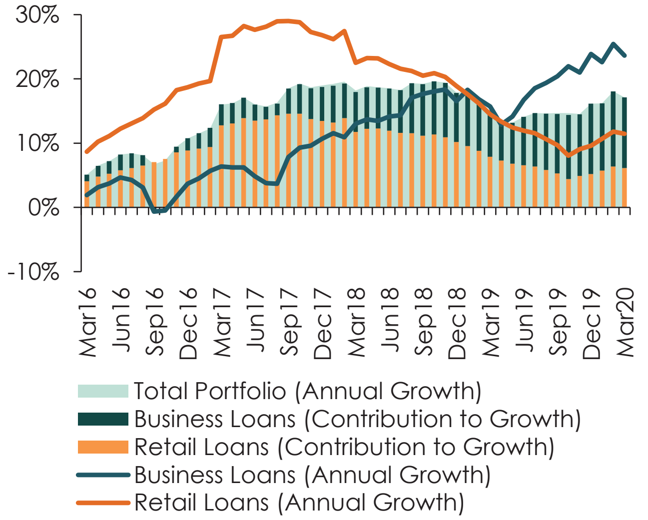

Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In March, relative to December, the loan portfolio increased slightly and stood at 17.1% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 1.8 pp and stood at 11.4%, while loans to legal entities decreased slightly and equaled 23.6% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the energy sector, whereas the increase in credit for the transport, construction, trade, manufacturing and agriculture sectors did not change significantly. According to the credit conditions survey, representatives of the banking sector expect a decrease in demand for business and retail loans.

In terms of currencies, it is important to emphasize that in the first quarter of 2020, the growth of the loan portfolio was mainly driven by an increase in domestic currency loans (see Figure 1.4.2). In March, the annual growth rate of foreign currency denominated loans increased by 1.9 pp and stood at 11.6%, while loans in domestic currency grew by 24.3%. In the first quarter, the loan larization ratio declined slightly and equaled 41.6%. 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 first quarter of 2020, the growth of the loan portfolio was mainly driven by an increase in domestic currency loans.

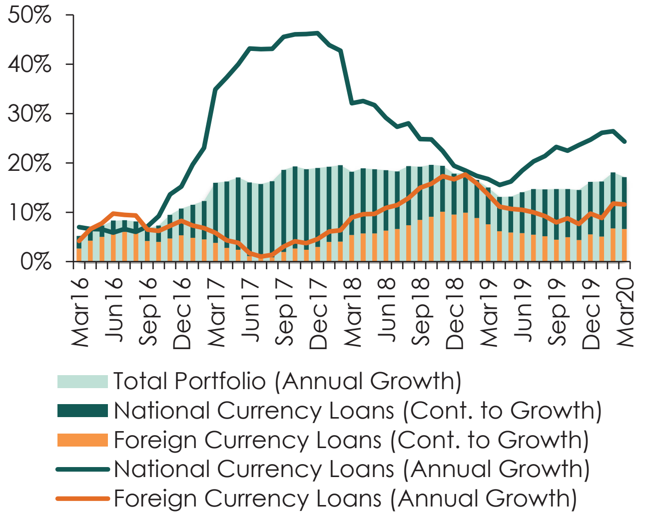

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In March, the monetary policy rate was 8.5%. In the first quarter of 2020, 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 March, relative to December, interest rates on domestic currency deposits increased by 1.2 pp and equaled 9.6%. Meanwhile, interest rates on foreign currency deposits have not changed significantly and equal 2.9%. 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 same survey, interest rates on mortgage loans issued in both domestic and foreign currencies have increased. In terms of credit conditions for legal entities, representatives of the banking sector expect an increase in interest rates in

In the first quarter of 2020, interest rates on government securities increased.

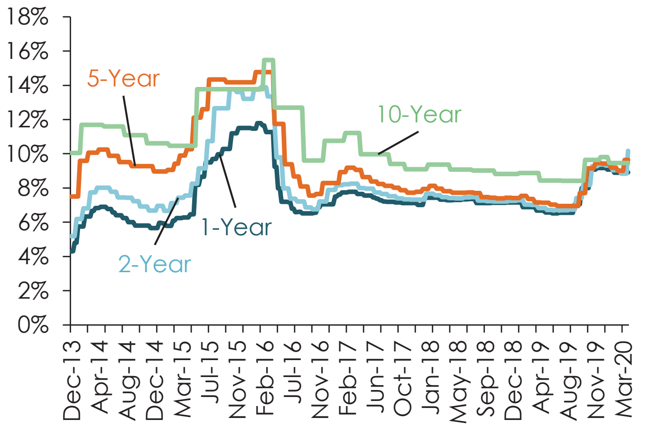

Figure 1.4.3. Interest rates on government securities

Source: National Bank of Georgia

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

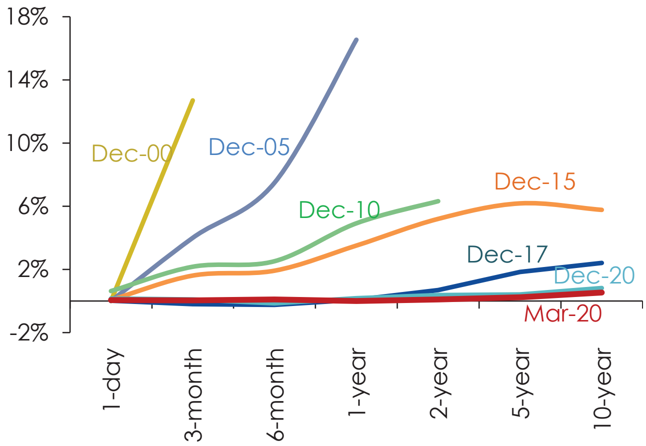

Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

In March 2020, compared to December 2019, average interest rates on the loan stock of legal entities increased slightly for domestic currency loans, while declining slightly for foreign currency loans.

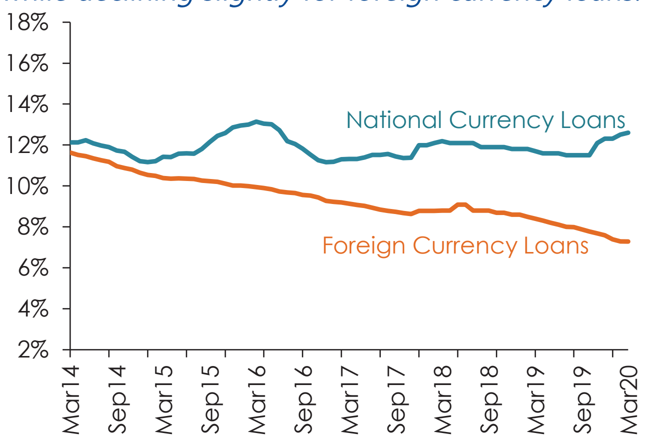

Figure 1.4.5. Average interest rates on business loans

Source: National Bank of Georgia

the next quarter. However, it is important to note that due to the ongoing uncertainty caused by the COVID-19 virus, it is difficult to form expectations. In March 2020, compared to the previous December, interest rates on retail loans have not changed significantly. Meanwhile, interest rates on loans for small and medium enterprises increased by 1.4 pp and stood at 9.8%, while interest rates on corporate loans increased by 1.3 pp and equaled 9.2%.

In March 2020, compared to December 2019, average interest rates on the stock of legal entities increased slightly for domestic currency loans, rising by 0.3 pp, while average interest rates for foreign currency loans declined slightly by 0.3 pp (see Figure 1.4.5.). Representatives of the banking sector expect a slight increase in interest rates for loans in foreign currency.

1.4.3 EXCHANGE RATE

In the first quarter of 2020, the GEL nominal exchange rate appreciated against the US dollar by 0.7% and against the euro by 1.1%, compared to the previous quarter. The GEL appreciated against the Turkish lira and the Russian ruble by 5.8% and by 4.6% respectively. As a result, the nominal effective exchange rate appreciated by 2.7% on a quarterly basis and depreciated by 6.1% on an annual basis.

As for the price-adjusted exchange rate, the real effective exchange rate appreciated by 3.2% on a quarterly basis and depreciated by 4.0% 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 first quarter of 2020, the adjusted nominal effective exchange rate appreciated by 2.4% on a quarterly basis and depreciated by 6.5% on an annual basis (see Figure 1.4.7). This depreciation was partly due to the appreciation of the dollar against the currencies of developing economies during the crisis. However, this was also accompanied by the depreciation of the GEL against the currencies of Georgia's major trading partners. One of the reasons for the latter development is that Georgia's tourism sector was exposed – a sector that is a more important part of the Georgian economy than it is for its trading partners.

The real effective exchange rate remains undervalued (annual depreciation 4.0%).

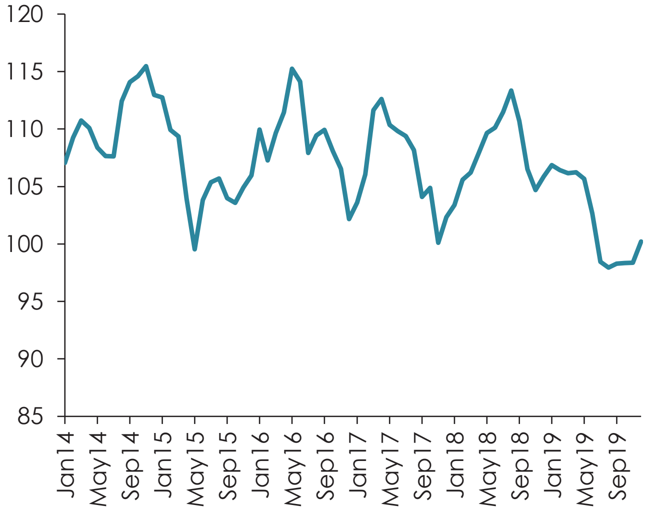

Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

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

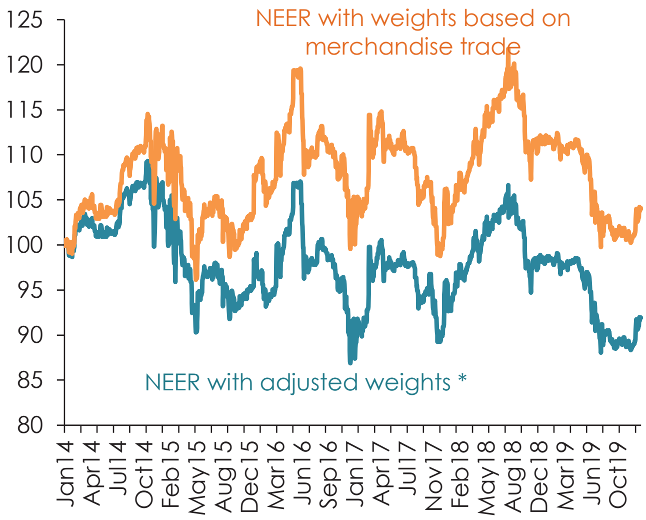

Figure 1.4.7. Corrected nominal effective exchange rate

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.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	-6.1	-4.0	-4.0
Eurozone	-5.9	-1.1	-0.2
Turkey	3.7	-1.7	-0.3
Ukraine	-16.3	-13.4	-0.9
Armenia	-9.7	-3.9	-0.3
US	-8.7	-5.0	-0.3
Russia	-8.2	-4.7	-0.7
Azerbaijan	-8.6	-5.7	-0.6
Other	-5.7	-4.2	-0.7

Table 1.4.1. Effective exchange rates annual growth (1st quarter of 2020)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

1.5 CONSUMER PRICES

Inflation began to decline as expected in early 2020. Annual inflation fell to 6.4% in January and February. However, the subsequent shock caused by the global COVID-19 pandemic affected the trajectory of inflation. The main changes in the inflation trajectory are related to the depreciation of the lari nominal effective exchange rate. As a result, annual inflation fell less than expected in March to 6.1% and rose to 6.9% in April. The future dynamics of price changes will be determined by aggregate demand. This is expected to decline and will promote the reduction of inflation.

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was substantially lower than headline inflation and stood at 3.3% in March.

Due to increased inflation expectations following the depreciation of the GEL nominal effective exchange rate, annual inflation in March decreased less than expected to 6.1%. .

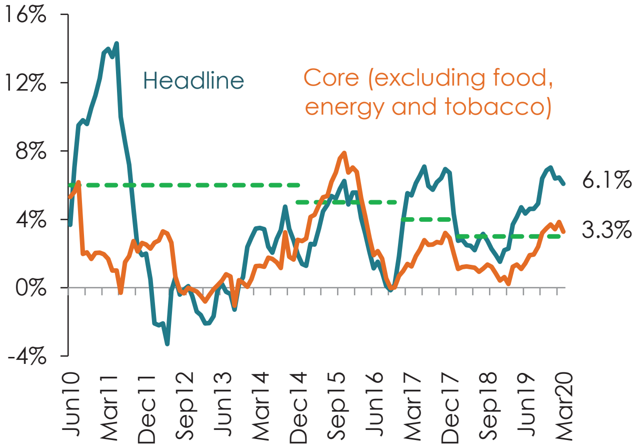

Figure 1.5.1. Headline and core inflation

Source: GeoStat

Despite the depreciation of the lari's nominal effective exchange rate, inflation of locally produced goods in March was higher than that of imported goods (6.2% and 4.9% respectively – see Figure 1.5.2). This fact is explained by the high inflation of food, which, for the most part, is locally produced. Food prices are characterized by high fluctuations – influenced by seasonality, productivity and various other factors. Given the high weight (28.0%) of food in the consumer basket, these fluctuations can significantly affect the overall inflation rate. In March, food inflation was high and amounted to 13.9%. From the 6.1% total inflation, 4.1 pp came from food (Figure 1.5.4), of which cheese, meat, potatoes, and apples made a 1.7 pp contribution.

Higher inflation of domestically produced products is explained by high food inflation.

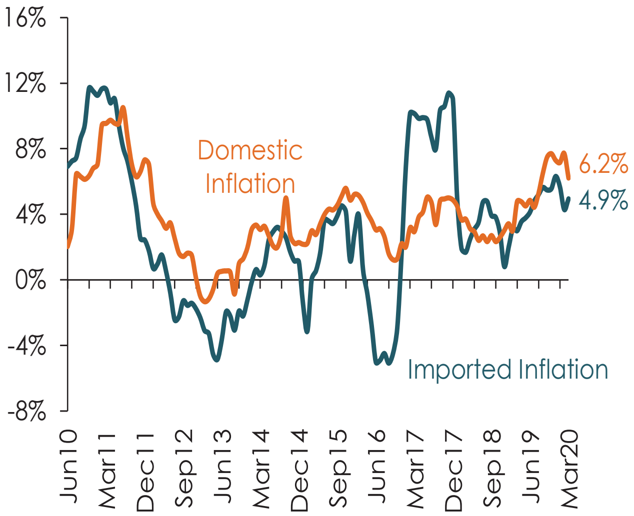

Figure 1.5.2. Food inflation

Source: GeoStat

In March, amid falling oil prices on world markets, gasoline prices fell compared to previous months, but still stood 6.4% higher on a year-on-year basis, contributing 0.2 pp to overall inflation. It should be noted that a decline in oil prices will gradually affect gasoline prices in Georgia and the full effect of this on inflation has yet to be seen.

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

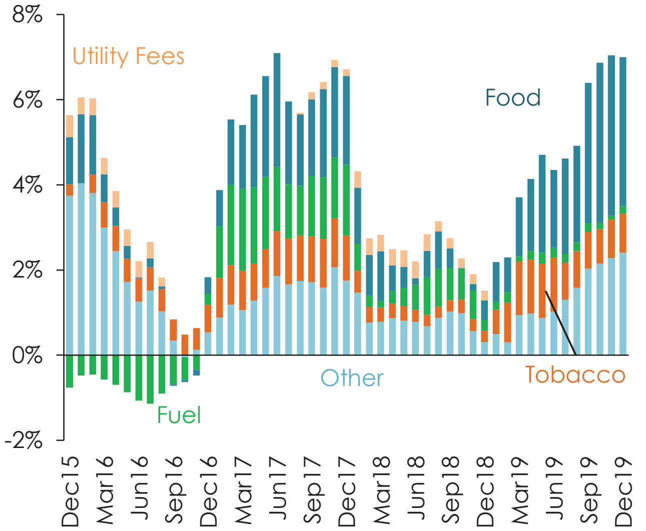

Figure 1.5.3. Contribution of different products to inflation

Source: GeoStat; NBG calculations

BOX 2. THE IMPACT OF COVID-19 ON THE GEORGIAN ECONOMY

The COVID-19 pandemic has hit the global economy hard. Leading economists around the world as well as the International Monetary Fund expect that the global economy will experience a recession deeper than that of the Global Financial Crisis of 2008. There is severe uncertainty about the duration and intensity of the pandemic. Accordingly, precise macroeconomic forecasting is a challenge. The date at which a vaccine and treatment therapies to counter the virus might be developed remains unclear. This makes it harder to project the precise duration of the virus containment policies and travel restrictions. While the final economic impact of COVID-19 may ultimately be similar to that of the Global Financial Crisis, in the case of COVID-19 the underlying situation is more complex – the supply and demand shocks are simultaneous. On one hand, a reduction of domestic demand creates deflationary pressures; while on the other, travel restrictions, the shutdown of firms and supply chain disruptions all increase production costs and shrink the supply side of the economy, which pushes inflation up.

The Monetary Policy Report usually provides baseline and alternative scenarios that are based on different assumptions for the Georgian economy. Under these scenarios, the forecasts of major variables like inflation and the monetary policy rate differ. Those shown here are based on assumptions that differ in terms of the blow that COVID-19 will make to domestic demand.

Baseline Scenario	**Travel is restricted until September**, which will be followed by a gradual recovery phase
Alternative Scenario	Travel is still restricted until September; however, **due to high uncertainty the reduction of domestic demand is deeper than in the baseline scenario**

Baseline scenario

In the baseline scenario, travel is restricted until September in order to contain the spread of the virus. This is followed by a gradual recovery phase. Meanwhile, domestic economic activities are projected to follow a slow recovery path throughout the whole year. The baseline scenario considers similar problems occurring in Georgia's main trading partner countries. For the full picture, it is crucial to identify and separate the economic shocks coming from the demand side and those from the supply side.

Demand shocks

The COVID-19 pandemic and containment measures such as travel restrictions have a particularly acute impact on tourism. In the baseline scenario, tourist inflows and tourism revenues will be paused until September and then will start to gradually increase. The COVID-19 pandemic will also lead to an economic recession in Georgia's main trading partners. Therefore, a drop in external demand will reduce revenues from exports of goods. Meanwhile, remittances are projected to decline as well. In addition, low domestic demand implies a reduction in imports. Despite the latter, when taken together the former factors will widen the current account deficit compared to the previous year.

The national quarantine and lockdown disrupt domestic economic activities. The service sector, which relies on social interactions, is particularly impacted. These circumstances create an unattractive atmosphere for investment and reinvestments. During the lockdown, consumers only buy essential products and services. The baseline scenario considers a gradual exit from the national quarantine and envisages economic activities starting a slow recovery. Meanwhile, strong fiscal stimulus will increase, and capital expenditures will support economic activities to partially neutralize the negative shock.

	2020
Exports of goods	-20.0%
Exports of services	-60.0%
Imports of goods	-25.0%
Imports of services	-60.0%
Remittances	-30.0%
Budget deficit (% GDP)	8.5%
Credit portfolio growth	0.0%

Figure 1.5.1. Assumptions of the baseline scenario

Source: National Bank of Georgia

Supply Shock

The COVID-19 pandemic creates high levels of uncertainty surrounding current global economic conditions, especially in developed countries. Recently, the sovereign risk premia of emerging and developing economies rose by almost 5 pp. The largest capital outflow was recorded from emerging economies to developed countries. Both of these factors create depreciation pressure on local currencies. Currency depreciation, in turn, pushes inflation up through the direct imported and input costs channels.

It is worth mentioning that the lockdown increases production costs. In several sectors distance working is either impossible or raises costs. As a result, unit labor cost will increase. For example, if the labor force continues to go out to work, then workplaces become riskier and that creates upward pressures on wages. However, firms facing lower demand do not have room to increase wages and thus unemployment increases. Meanwhile, due to the current circumstances, transportation costs are also increased. We can distinguish those sectors where unit labor costs are likely to increase. Based on our calculations, the cumulative supply-side shock on inflation will be around 1.5 pp.

In the medium term, lockdowns and quarantines can lead to a temporary fall in productivity and potential GDP growth. Based on our estimates, labor productivity's contribution to potential growth is around 2 pp. It is expected that for the next year the contribution of productivity will decline, which implies lower potential growth. However, in the long run digital technology improvements will push potential growth up.

Alternative scenario

The alternative forecast scenario also considers travel restrictions until September. However, in this scenario, fears about a second wave of the virus are persistent and create higher macroeconomic uncertainty compared to the baseline scenario. A higher level of uncertainty further suppresses domestic demand. The alternative forecast scenario thus considers a more severe shock to domestic demand.

Demand shock

Fear of a second wave of the pandemic creates a higher level of macroeconomic uncertainty. If such fear is persistent, consumers will lower consumption while investors will not have incentives to invest. Uncertainty also increases concerns regarding unemployment, and therefore consumers will start to save more. In the alternative forecast scenario, Georgia gradually exits from a national quarantine. However, in the second half of the year, due to fear of the virus spreading, investment and consumption will be lower than in the baseline scenario. Meanwhile, fiscal stimulus will be strong, which will partially neutralize the negative demand shock.

The assumptions regarding the external sector are the same as in the baseline scenario, while the assumptions about domestic demand are summarized in Figure 1.5.4 below.

The assumptions behind the baseline scenario are summarized below (see Figure 1.5.1).

	2020
Consumption	-20.0%
Exports of services	-60.0%

Figure 1.5.1. Assumptions of the alternative scenario

Source: National Bank of Georgia

Supply shock

Suppressed domestic demand also reduces imports of goods. Therefore, the current account deficit will be smaller as compared to the baseline scenario. Accordingly, the country's sovereign risk premium is lower than in the baseline scenario. The assumptions regarding production costs and potential growth are the same.

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, real GDP will shrink by 4% in 2020. Such a drop in demand puts downward pressure on prices, but in the short term this is offset by complications on the supply side and the exchange rate depreciation. Projected inflation thus remains high in the short term. However, inflation and inflationary expectations will begin to decline under the influence of negative demand shocks. In response, the policy rate will gradually be reduced, which in turn will help the economy recover. The COVID-19 pandemic creates a high level of macroeconomic uncertainty. In particular, the national quarantines and lockdowns create high degrees of uncertainty about the post-crisis recovery of domestic demand. A fear of a second wave of COVID-19 can impact the saving-investment behavior of economic agents. Consumers may reduce consumption, while investors will reduce investment and reinvestment. Therefore, the alternative forecast scenario considers a more severe domestic demand shock. Weaker domestic demand will push inflation down. In the medium term, the monetary policy rate will be reduced more than in the baseline scenario.

2.1 BASELINE MACROECONOMIC FORECAST

Inflation will continue to decline in 2020 and, after undershooting, will return to the target in the medium term.

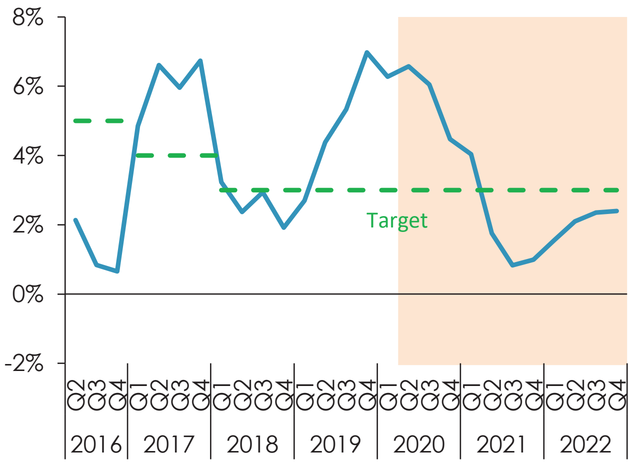

Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

In the first quarter of 2020, headline inflation posted 6.3% (see Figure 2.1.1) – an insignificant departure from the projected level. The increase in consumer prices was mainly due to the nominal lari exchange rate depreciation in previous periods; while aggregate demand, as at the end of last year, had a neutral effect on inflation (see Figure 2.1.2).

Given the state of emergency and other ongoing constraints, sharply-reduced demand will have a significant negative impact on overall inflation over the forecast horizon (see Figure 2.1.2). Lower oil prices on global markets will also depress inflation. However, a sharp decline in consumer prices will be hampered by the depreciation of the exchange rate against the background of elevated uncertainty, and by the increased production costs of companies in the current situation. The latter, in particular, is a result of higher unit labor costs for those firms where remote working processes significantly reduce labor productivity. A depreciated exchange rate further increases companies' other intermediate costs (including those related to dollarized loans) and raises inflationary pressures. Nevertheless, the baseline assumption is that these effects will be temporary. After a reduction in the next year, inflation will remain below target for some time in the medium term, which will be partly due to the moderate and gradual response of monetary policy. The latter is essential for long-term inflation expectations to return to the target level.

Against the background of the pandemic, economic activity will be significantly reduced in 2020. According to the current forecast, the annual decline in real GDP will be in the range of 4%, which will be due to a de-

Sharply reduced demand on the forecast horizon will have a significant negative impact on headline inflation, although complications on the supply side and the depreciation of the exchange rate will put upward pressure on prices.

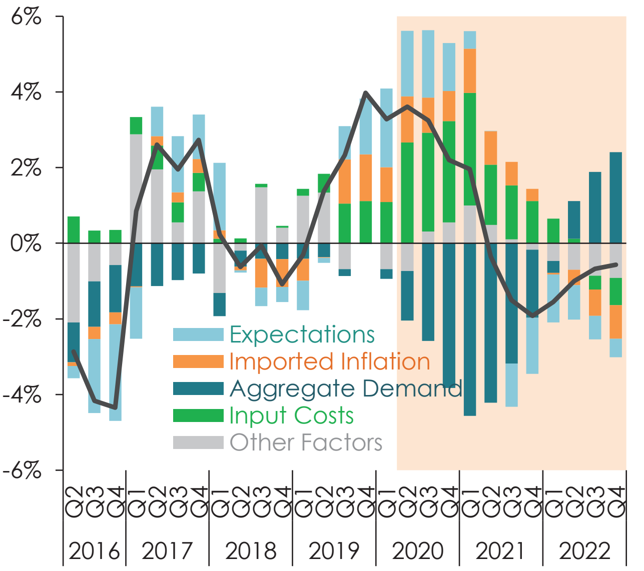

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

According to the current forecast, real GDP will decrease by 4% in 2020 as a result of a drop in both foreign and domestic demand.

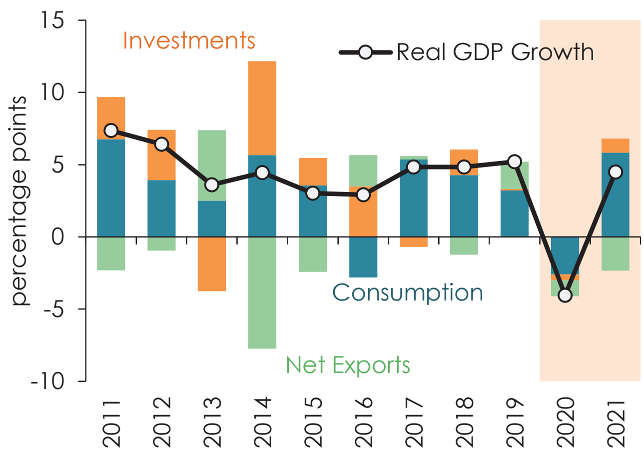

Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

crease in both external and domestic demand. Despite the uncertainty over the duration and scale of the pandemic, it is safe to say that the tourism sector, which has been a leading force of economic activity in recent years, will suffer. Revenues from exports of goods will decrease as well as inflows of remittances and foreign direct investment. At the same time, local demand will decrease (especially for long-term consumer goods and many types of services) and investment will also fall. However, the large-scale fiscal stimulus that has been planned in partnership with international financial institutions will partially offset the effects of the severe shock and will contribute to the rapid recovery of the economy in the post-crisis period. According to the current forecast, real GDP growth in 2021 will be in the range of 4.5%, which will be due to the revival of consumption and investment (see Figure 2.1.3).

Given the magnitude and nature of the current shock, these predictions are naturally accompanied by significant uncertainty. The basic forecast is based on the main assumptions that from the second half of the current year, the majority of the restrictions will no longer be necessary and that economic activity will gradually begin to recover. However, if the global or local spread of the pandemic is greater than currently expected, then the decline of real GDP may be deeper. This may depress projected inflation, but at the same time expectations will worsen, and the accompanying depreciation of the exchange rate will put upward pressure on consumer prices. Ultimately, the dynamics of inflation will be determined by the interaction of these two factors. It is also noteworthy that, within the framework of the baseline scenario's assumptions, the factors positively influencing inflation are temporary, which reduces the need to maintain a tight monetary policy.

It is likely that a sharp drop in the economy will reduce inflationary expectations more than a depreciation of the exchange rate. Consequently, monetary policy has begun to exit from its tightened stance and it is expected that this process will continue in the medium term. However, given the current uncertainty, the rate cut will be gradual as long as a cautious and moderate policy reaction is important to keep long-term expectations anchored. However, the policy rate may remain below the neutral level in the medium term to subsequently approach it from below. It should also be noted that the neutral interest rate, in turn, is a measure based on macroeconomic judgment, and depends in part on the assessment of the potential growth of the economy. The latter is likely to be temporarily reduced on the forecast horizon, which may indicate a downward deviation in the neutral rate assessment. However, the risks associated with an expectation of a deterioration in the balance of payments may have an upward effect on the neutral rate. Thus, the response of monetary policy will also depend on the interrelationship among these factors.

Compared to the previous projection, the inflation forecast has been revised upward. The COVID-19 pandemic severely impacts economic activities and creates deflationary pressures. However, the exchange rate depreciation and an increase in production costs will outweigh deflationary pressures in the short run.

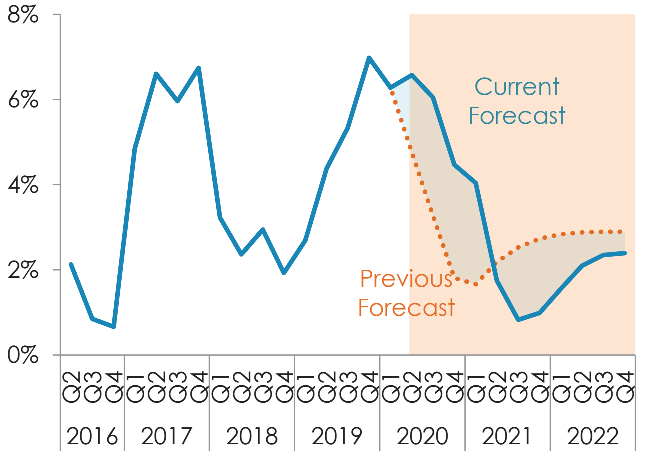

Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The real GDP growth forecast has been revised downward to -4%. The COVID-19 pandemic is severely impacting economic activities though external and domestic shocks. Economic recovery is expected to start in 2021 as the pandemic fades.

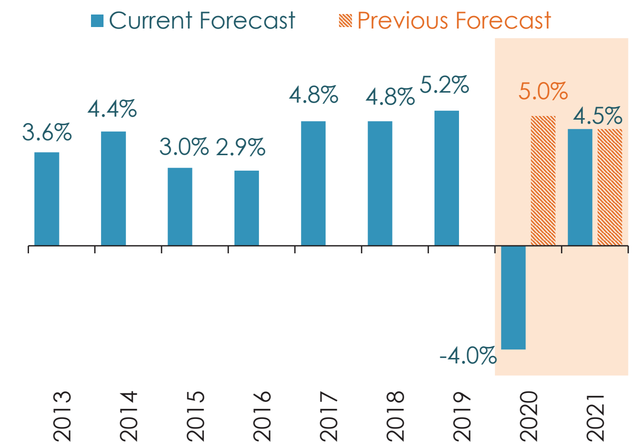

Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

2.2 COMPARISON WITH THE PREVIOUS FORECAST

A new coronavirus pandemic and related containment measures (lockdowns and quarantines) have a severe impact on the global economy. Global economic growth is expected to contract sharply as a consequence. Meanwhile, the NBG's macroeconomic forecasts have been significantly revised. Compared to the previous projection, the short-term inflation forecast has been revised upward, while inflation in the medium term has been lowered (see Figure 2.2.1). The upward revision of the 2020 inflation forecast is mainly driven by the exchange rate depreciation and an increase in unit labor costs. On the one hand, the economic recession will put downside pressure on consumer prices. On the other hand, disruption in supply chains will push inflation upwards, which will outweigh the downside pressures. International and domestic travel restrictions, alongside restrictions in economic activities, are expected to lead to a sharp drop in exports of goods and services. Meanwhile, an increase in the country's sovereign risk premium will lead to currency depreciation. Those factors push inflation up through the imported inflation and input costs channels. It is worth mentioning that social distancing measures either restrict economic activities or raise their cost. Finally, an increase in production costs pushes headline inflation up. According to the revised forecast, inflation is expected to start falling in the second quarter of the year, but will remain above the target level throughout 2020. However, in the medium term, inflation is predicted to fall below the target level and subsequently approach the target from below.

The real GDP forecast has been revised downward to 4% (see Figure 2.2.2). The COVID-19 pandemic and attendant lockdowns around the world have had a particularly acute impact on tourism. Due to the global economic recession, remittances are projected to decline significantly. Meanwhile, the deterioration of the economic situation in Georgia's main trading partners causes a drop in external demand and revenues from exports are expected to decline. The lockdown causes domestic economic disruptions as well. However, compared to the previous forecast, fiscal stimulus has been strengthened and will partially neutralize the economic recession.

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 Georgia's trading partners. Changes in these assumptions will affect both the baseline forecast as well associated risks (see Figure 2.2.3).[19]

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

The COVID-19 pandemic will shrink Georgia's trading partners' growth dramatically. Deflationary pressures coming from the expected recession are projected to be balanced by expected depreciation and inflation expectations have thus only slightly reduced.

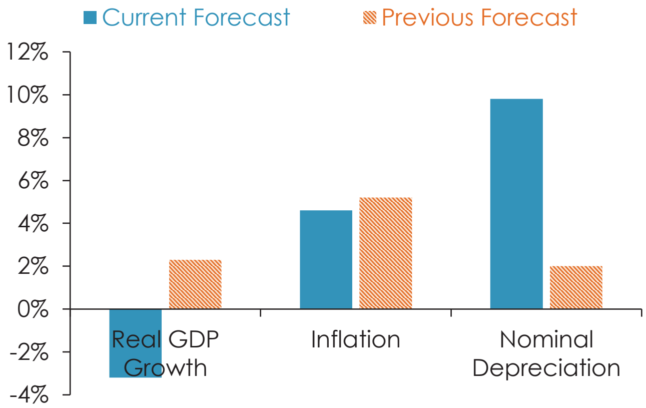

Figure 2.2.3. Changes in the forecast of external assumptions for 2020

Source: Bloomberg

In the alternative scenario, macroeconomic uncertainty causes a greater reduction of domestic demand. In this scenario, real GDP will reduce by 8.5% in 2020. However, the economic recovery in 2021 is projected to be faster.

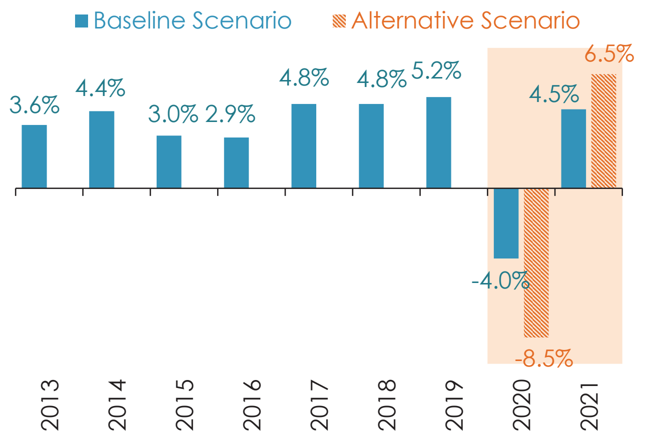

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

Assumptions regarding the economic stance of Georgia's trading partners have changed. Based on the revised forecasts, the COVID-19 pandemic will dramatically shrink trading partners' growth. Expectations about a depreciation of their currencies have increased for 2020. This can be linked to the largest capital outflow from emerging economies towards developed countries ever recorded. Inflation expectations have only slightly reduced. In the forecasts, the impact of weak demand, which may led to lower inflation, is neutralized by expected currency depreciations.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a more severe domestic demand shock compared to the baseline scenario. The assumptions regarding travel restrictions are the same as in the baseline scenario. Travel restrictions are projected to continue until September and will be followed by a gradual recovery phase. However, the alternative scenario considers a sharper drop in consumption and investment. Fears of the second wave of COVID-19 may impact economic agents' saving and investment behavior. Fears about the virus spreading further creates macroeconomic uncertainty, and incentives for both investing and reinvesting would thus be lower. Meanwhile, uncertainty creates fear about unemployment and therefore consumers may try to increase their savings. Realization of these risks will lead to a sharper and more persistent reduction in consumption and investment. The alternative scenario also considers strong fiscal stimulus, which only partially neutralizes the negative shocks.

The economic recession thus widens in the alternative scenario and real GDP decreases by 8.5% in 2020 (see Figure 2.3.1).

A more severe domestic demand shock will intensify downside pressures on prices and headline inflation will be lower than in the baseline scenario. Under the alternative forecast scenario, uncertainty and reduced domestic demand lead to lower imports of goods. The current account deficit will therefore be smaller compared to the baseline scenario and pressures on currency depreciation will be lower. Accordingly, over 2020-2021 inflation will be 0.8 percentage points lower than in the baseline projection (see Figure 2.3.2).

In response to these developments, in the alternative forecast, monetary policy starts to exit from the tightened policy stance faster. In the short term, the monetary policy rate will reduce faster compared to

Weaker domestic demand will push inflation down. Over 2020-2021, inflation will be 0.8 pp lower than in the baseline scenario.

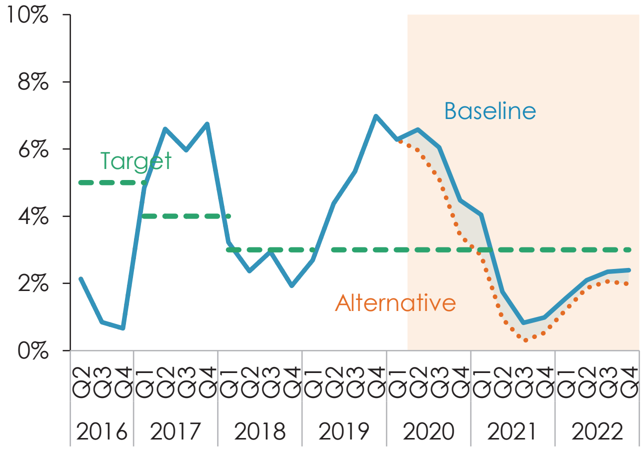

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

In response, the NBG will start a faster exit from the tight monetary policy. Under the alternative scenario, the monetary policy rate trajectory will shift down by 1.6 pp.

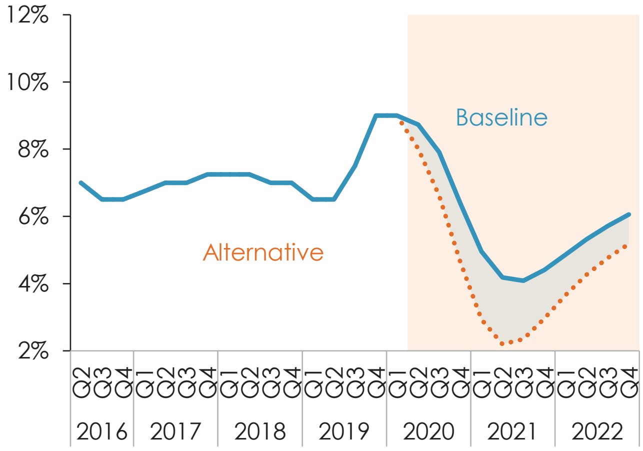

Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

the baseline scenario. In the medium term, the monetary policy stance will be loosened as the policy rate will drop below the neutral policy rate.

Under the alternative forecast scenario, the monetary policy rate trajectory will reduce by 1.6 pp compared to the baseline scenario (see Figure 2.3.3). The appropriate monetary policy response will eventually drive inflation towards the target level of 3% in the medium term.

3 MONETARY POLICY

Amid the COVID-19 pandemic and the sharp drop in oil prices on world commodity markets, economic uncertainty has significantly increased. Factors affecting inflation in both directions have been identified. It should be noted that the decline in aggregate demand is reflected on the inflation rate with a certain time lag, whereas supply factors have a faster impact on inflation. Against the background of the pandemic, supply factors caused by logistical constraints will delay the decline of inflation in the coming months. However, given the expected weakness of the demand side, the Monetary Policy Committee deemed it appropriate to start a gradual exit from its tight monetary policy stance and to reduce the refinancing rate by 50 basis points to 8.5%. The NBG will continue to monitor developments in the economy and will use all means and instruments at its disposal to ensure price stability.

In the second half of last year, following the depreciation of the nominal effective exchange rate, the inflation rate increased. As a result, the need for a monetary policy response was evident. From September 2019, the refinancing rate was gradually increased from 6.5% to 9.0%. According to the NBG forecast, it was expected that, under equal conditions, inflation would decline in 2020 to gradually return to the target level. The forecast implied maintaining a tight monetary policy stance for some period. However, amid the COVID-19 pandemic and the sharp drop in oil prices on world commodity markets, economic uncertainty has significantly increased. Factors affecting inflation have been identified in both directions and the annual inflation rate in March totaled 6.1%. It should be noted that the reduction in aggregate demand will be transmitted to the inflation rate with a certain time lag, while supply-side factors will affect inflation more rapidly. Supply factors caused by logistical constraints will delay the decline in inflation over the coming months; however, a sharp decline in external and domestic demand resulting from the pandemic will create downward pressure on inflation over the course of the year. Given the expected reduction in demand, there is no need to maintain such a tightened policy stance. Hence, the Monetary Policy Committee started a gradual exit from the tightened policy and reduced the policy rate by 0.5 percentage points.

According to the decision made on 29 April 2020, the refinancing rate was reduced to 8.5%.

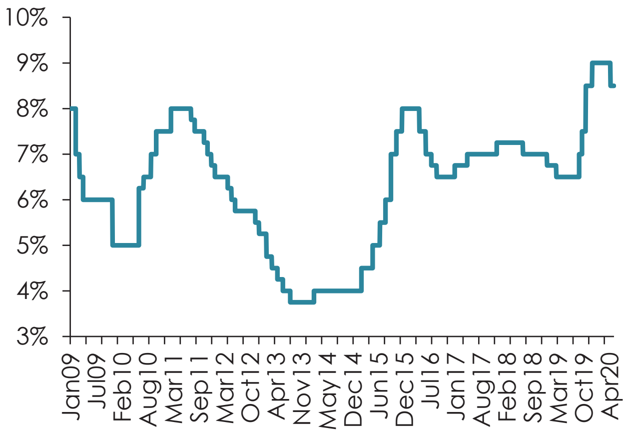

Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

Despite the rate cut, monetary policy remains tight, ensuring a return of inflation to the target level in the medium term. The Monetary Policy Committee will exit this tight monetary policy stance gradually and further steps will depend on how quickly inflation expectations recede.

In terms of the supply side factors, delays in production and supply chains affect companies' costs and, consequently, prices. However, assuming that the strict restrictions imposed by the spread of COVID-19 prove to be temporary, the latter will only have a temporary effect, hence a monetary policy reaction to this type of shock would be counterproductive. At the same time, the sharp decline of oil prices on international markets are reflected on the gradual decline in gasoline prices in Georgia, exerting downwards pressure in inflation.

In addition, the expected financial assistance from international financial organization will support the elimination of shock impact on economic growth and inflation.

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. If either the global or local spread of the pandemic is more severe than is currently expected, the real GDP decline may be deeper. This will exert downward pressure on the inflation forecasts; however, at the same time expectations will worsen, and the accompanying depreciation of the exchange rate will put pressure on consumer prices. Ultimately, the dynamics of inflation will be determined by the interaction of these two factors.

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. Against the backdrop of the COVID-19 pandemic and the attendant restrictions, demand for liquidity has increased (see Box 1). To manage short-term liquidity, the banking sector mainly relies on refinancing loans and the interbank money market. In addition to standard refinancing loans, the National Bank also provides liquidity support to commercial banks and microfinance organizations through additional "swap" operations. The National Bank provides the required amount of short-term liquidity to ensure that interest rates in the interbank money market vary around the policy rate.

Interbank money market rates vary around the monetary policy rate.

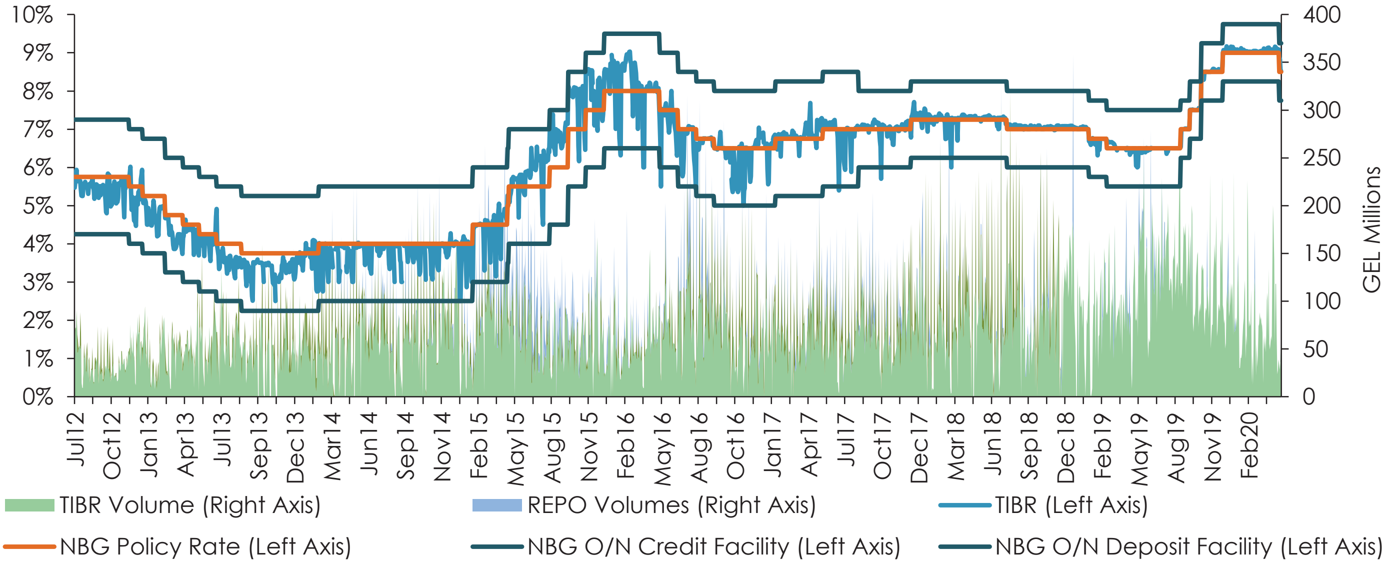

Figure 3.3. Interbank money market

Source: National Bank of Georgia

BOX 3. BLOOMBERG'S BMATCH PLATFORM AND THE NATIONAL BANK'S FOREIGN EXCHANGE INTERVENTIONS

In addition to the existing Bloomberg trading system platform, from February 2020 a new foreign exchange trading system – BMatch – was introduced. BMatch is Bloomberg's foreign exchange trading platform that is based on the principle of automatic "matching" of transactions. Market participants will place foreign currency buying and selling applications on the BMatch platform, and if the exchange rates between the buyer and seller of the currency coincide, then the currency transactions between the parties will be concluded automatically.

At the first stage, only commercial banks will participate in the BMatch platform. Companies are expected to participate at a later stage and will be able to access the BMatch platform in two ways: directly, by installing a Bloomberg terminal, and indirectly through a commercial bank. If a company has a terminal, the company will be able to use the BMatch platform to enter into transactions for the purchase or sale of currency. If a company does not have direct access, then it can apply to buy or sell foreign currency on the BMatch platform through a commercial bank. In such cases, the commercial bank will be required to process the companies' applications on the BMatch platform separately from its own applications, which means that the company's application will be managed by the customer service structure and will be technically executed using a separate terminal from the treasury. Moreover, the BMatch platform allows the National Bank to more actively intervene in the foreign exchange market, thereby facilitating a competitive pricing process in the market. The National Bank has the opportunity to register new applications within the system (with the desired volume and rate) and to satisfy existing applications.

Reducing excess volatility is especially relevant as volatility has risen significantly under the current conditions of increased uncertainty. Despite more active participation in the foreign exchange market, the National Bank maintains a floating exchange rate policy and the flexibility of the exchange rate will still be important when dealing with shocks.

In addition to interventions on the BMatch platform, the National Bank will, if necessary, resort to the FX auction mechanism of interventions. As is known, a large part of the assistance received from international donors is reflected in the foreign exchange reserves of the National Bank and has not entered the foreign exchange market. As a result, we have a negative external balance in the private sector and the public sector has a positive balance. The National Bank will thus hold currency auctions to partially balance these differences. The use of international reserves is currently possible as the National Bank made concerted efforts to accumulate international reserves over recent years. At the same time, the loss of reserves will be offset to some extent by donor-funded resources. Overall, it is expected that by the end of the year the reserve level will be close to the lower limit of the International Monetary Fund's benchmark for reserve adequacy (ARA metric).

2 Sanapiro Str., Tbilisi 0114, Georgia

Tel.: (995 32) 240 6480; Fax: (995 32) 240 6571; Hot line: (995 32) 240 6406

E-mail: info@nbg.ge; www.nbg.ge

საქართველოს ეროვნული ბანკი
National Bank of Georgia