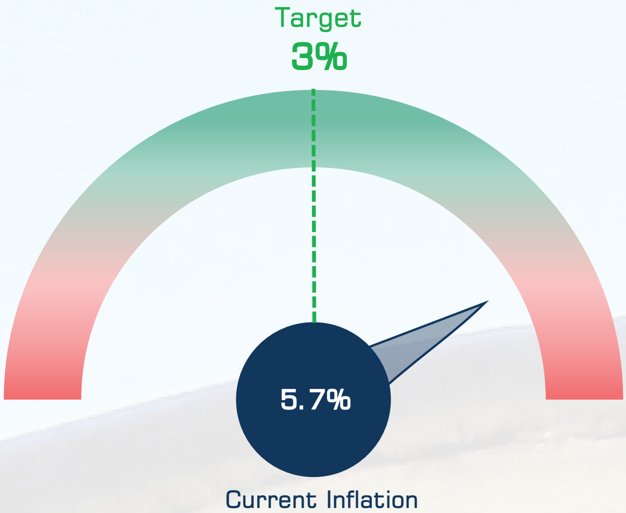
Monetary Policy Report

August

2020

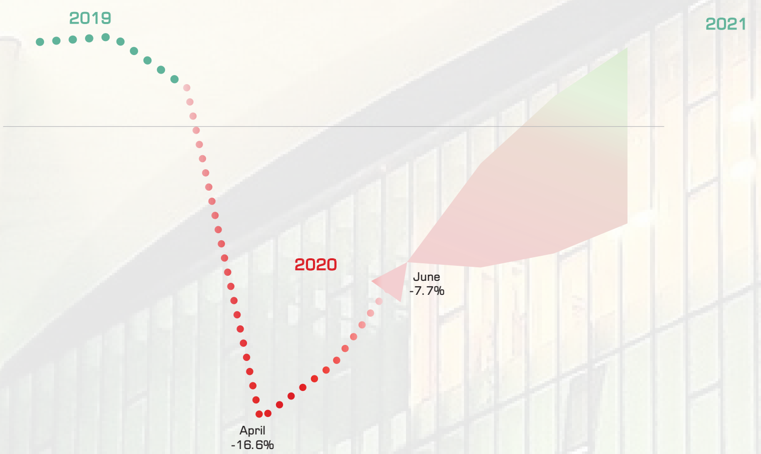
FIRST GEORGIAN CENTRAL BANK

Inflation



5.7%	Inflation continues to fall, but current inflation is still above the target.

Economic Growth



The COVID-19 pandemic has suppressed economic activity, but the economic recovery has already started.	-7.7%

Monetary Policy

8.0% **0.25**

8.0%	In line with the expected reduction of inflation, the NBG has reduced the policy rate.

MONETARY POLICY DECISION

We have reduced the monetary policy rate to 8.0%.

Our role is to set the interest rate to affect total spending in the economy and to guide inflation expectations 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. Difficult circumstances such as these should not reduce the credibility of macroeconomic policy.

The COVID-19 pandemic has hit the global economy hard. The measures taken to contain the pandemic have increased production costs and consumer price inflation has thus remained above the target. This effect is expected to be temporary. Inflation has a decreasing trend as weak demand will push prices down.

Given the present situation, in August 2020, the NBG decided to reduce the monetary policy rate by 25 basis points to 8.0%. 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. Thus, according to the forecast, inflation will gradually return to the target level of 3%. This will give 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.

CONTENTS

ISSN 1512-0767

BRIEF OVERVIEW

Georgia and the global economy has experienced a rapid and unprecedentedly large decline in economic activity. The fact that this downturn has been caused by the COVID-19 pandemic, and not by economic factors, gives hope for a fast recovery of the economy (indeed, signs of this are already visible); however, the current forecast still predicts a significantly negative decline in economic activity. While signs of recovery are observed on domestic demand, external demand projections are weaker (mainly because of tourism). On the back of this, the economic growth forecast now stands at -5%. Such a reduction in aggregate demand will reduce inflation, although weak external demand is characterized by less disinflationary pressure than weak domestic demand. In addition, a faster decline in inflation is hampered by higher production costs (or lower productivity) stemming from pandemic-related constraints. Hence, according to the current forecast, even though it is projected to decline, inflation will remain above the target in 2020. But next year, inflation is expected to fall below the target before subsequently approaching it from below. Due to the current unprecedented degree of uncertainty, the reduction of the monetary policy rate, which reflects the declining inflation forecast, will initially be slower, although it is expected to approach its neutral level from next year.

On the back of supply-side disruptions, inflation will remain high in the short term. However, amid weakening aggregate demand, once the supply-side factors are neutralized, inflation will fall below the target next year.

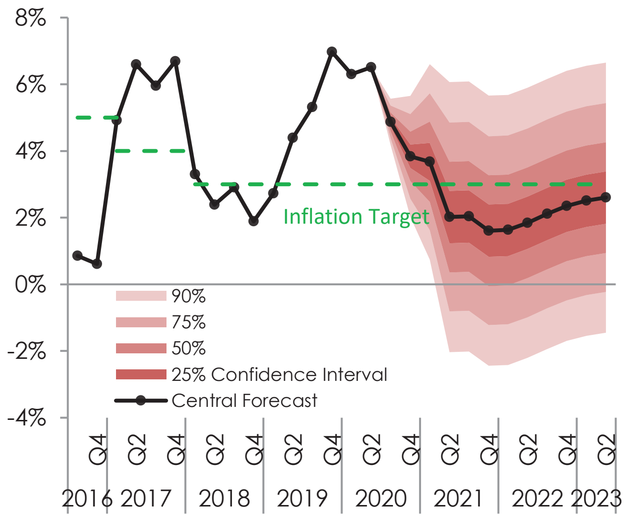


Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia

Although the uncertainty caused by the COVID-19 pandemic makes macroeconomic forecasting particularly challenging, the **recent dynamics of the annual inflation** rate remain in line with the forecast made at the beginning of the pandemic. In particular, actual annual inflation in the second quarter of 2020 was 6.5%. This was the result of two opposing factors balancing each other: reduced aggregate demand pushed inflation down, while COVID-19-related supply-side constraints and increased unit labor costs pushed inflation up.

As a result, according to the National Bank of Georgia's (NBG) **current forecast**, inflation will remain above the target this year. According to current estimates, supply-side factors will outweigh the effect of reduced demand in 2020. However, beyond the short-term horizon, weak demand will push inflation temporarily below the target in the medium term (see Figure 1).

The expected dynamics of economic growth have changed somewhat. While external demand is weaker than previously expected due to delays in the resumption of tourist inflows, domestic demand has been stronger than anticipated. The latter was facilitated by fiscal stimulus and stronger credit activity as well as by better-than-expected remittance dynamics. However, as external demand outweighs these factors, the economic growth forecast has been reduced. According to the NBG's current **forecast, real GDP** will decrease by 5% in 2020 (see Figure 2), instead of by 4% as previously predicted.

Real GDP will take a significant hit in 2020, mostly as a result of declining net exports and lower investment. GDP growth is expected to resume in 2021.

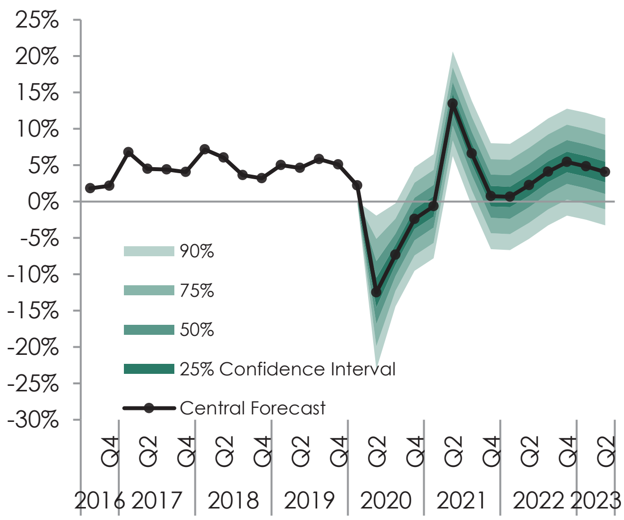


Figure 2. Annual growth forecast of quarterly real GDP

Source: National Bank of Georgia

Given the declining inflation forecast in the medium term, a gradual decline in the monetary policy rate is expected. This should also help the recovery of the economy. However, because of high levels of uncertainty, the rate cuts will be relatively slow in the near term.

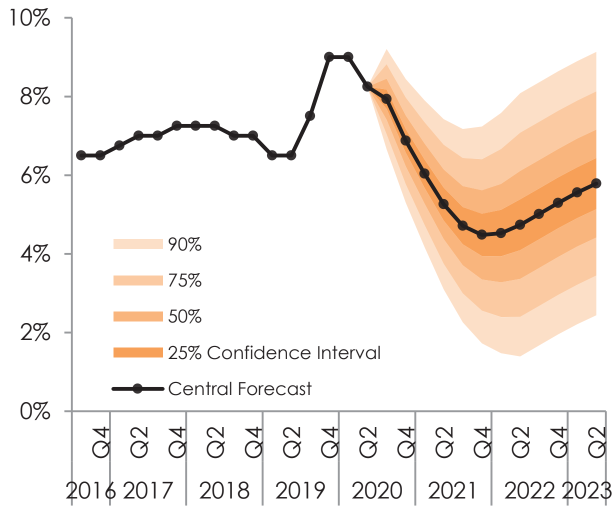


Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

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

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. 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

The COVID-19 pandemic has put the global economy into a severe recession. An economic downturn is expected in Georgia's trading partner countries, which will negatively affect external inflows. Amid health-related restrictions, the tourism sector has received a significant blow; however, the size of that shock is also significant for other sectors of the economy. The current account deficit is thus expected to deteriorate this year. This has already been reflected in exchange rate dynamics, with a significant depreciation observed in the previous period. Thus far, the exchange rate has been one of the reasons for growing inflation; however, further growth of inflation is limited by the weak economic activity observed in the current crisis.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

The COVID-19 pandemic has led to one of the deepest global recessions in recent decades. In the first half of 2020, the mass closure of countries and the lockdown of the global economy had serious consequences for both developed as well as emerging and developing economies. For the first time, negative growth rates are expected in all regions. According to the International Monetary Fund's (IMF) forecast[1], amid the high level of uncertainty surrounding the pandemic, **global economic growth** in 2020 will be -4.9%, which is 1.9 percentage points (pp) below the previous forecast.[2] Once the pandemic slows, growth is projected to be 5.4% in 2021. The pandemic hit developed economies harder than had been expected, with a -8% decline being forecast for 2020, and growth in those countries expected to be 4.8% in 2021.[3] The growth forecast for emerging and developing countries is -3% in 2020, which is 2 pp below the previous forecast[4], and this is expected to recover to 5.9% in 2021.[5]

Amid the COVID-19 pandemic, a significant downturn of the global economy is forecast for 2020. For the first time in decades, negative growth rates are expected in both developed as well as in emerging and developing countries.

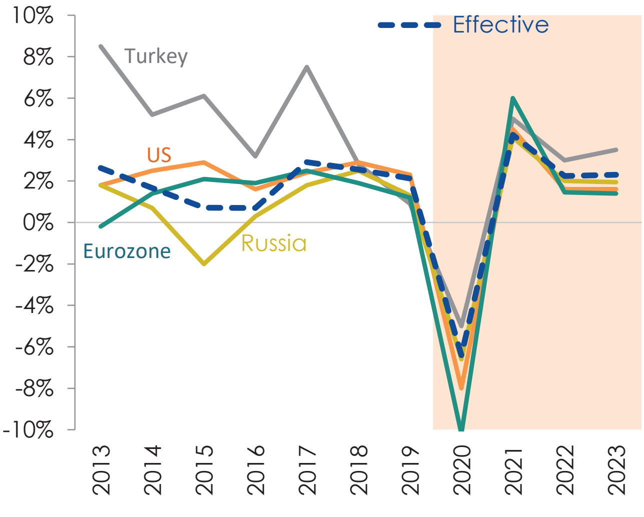


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

In the first half of 2020, amid pandemic-related constraints, economic activity fell to a record low in the **US**. The level of unemployment increased significantly. Private consumption and retail sales declined,

1 *International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.*

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

3 *International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.*

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

5 *International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.*

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

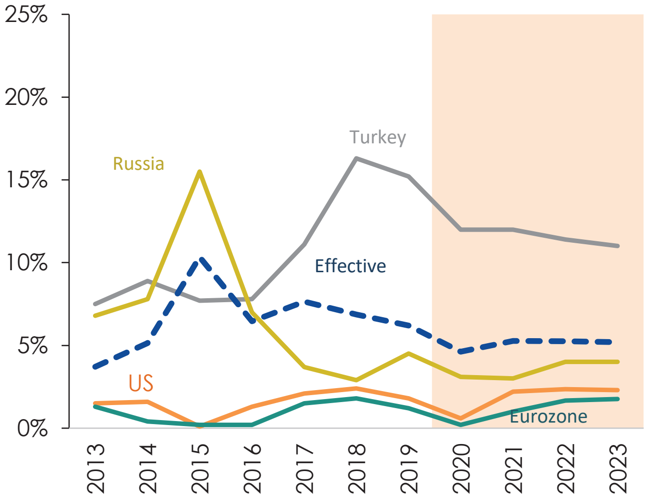


Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

and, with the closure of firms, industrial production deteriorated. Consumer and business sentiment have fallen as a result of the lockdown of individual states. In addition, a sharp drop in oil prices had a negative impact on the investment environment. Despite some recent improvements in economic activity, the IMF forecasts[6] that real GDP growth in the US will be -8% in 2020, which is 2.1 pp lower than the previous forecast[7]. Growth in 2021 is projected to be 4.5%, while inflation will be 0.6% in 2020 and 2.2% in 2021.

The rapid spread of COVID-19 in the **eurozone** led to the closure of both borders and firms. As a result, in the first half of 2020, economic activity fell significantly. The industrial sector and retail sales saw an unprecedented deterioration. The volume of exports and investments also decreased sharply. Consumer and business sentiment are both low. According to the IMF's forecast, real GDP growth in the eurozone for 2020 will be -10.2%, which is 2.7 pp below the previous forecast[8], while growth is projected to be 6% in 2020.[9] The inflation rate will be 0.2% in 2020 and 1% in 2021.

In early 2020, economic recovery was observed in **Turkey**; however, COVID-19 drastically changed that situation. Restrictions imposed due to the pandemic significantly reduced economic activity. The manufacturing sector, together with consumer spending and consumer sentiment, have seen a large deterioration. Business sentiment has fallen to its lowest level since 2009. The volume of exports and investments also decreased. Inflationary pressure is still high, with annual inflation standing at 11.6% in June. The IMF forecasts that real GDP growth in Turkey will be -5% in 2020 and 5% in 2021. Inflation is expected to be 12% in both 2020 and 2021.[10]

The first half of 2020 was especially difficult for **Russia**. Amid the pandemic, the manufacturing sector deteriorated and export volumes continued to fall as a result of the oil price collapse. Furthermore, the volume of investments significantly decreased and the unemployment rate increased. The depreciation of the ruble and disruptions to the supply chain has led to a significant slowdown in the economy. Annual inflation in June was 3.2%. The IMF forecasts that Russia's real GDP growth in 2020 will be -6.6% (1.1 pp below the previous forecast[11]), while growth is projected to

6 *International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.*
7 *International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.*
8 *Ibid.*
9 *International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.*
10 *International Monetary Fund. 2020. World Economic Outlook: The Great Lockdown. Washington, D.C., April.*
11 *Ibid.*

In the first half of 2020, monetary policy rates were reduced several times in Georgia's main trading partner countries and the US. This was mostly driven by efforts to stimulate economic activity during the COVID-19 crisis.

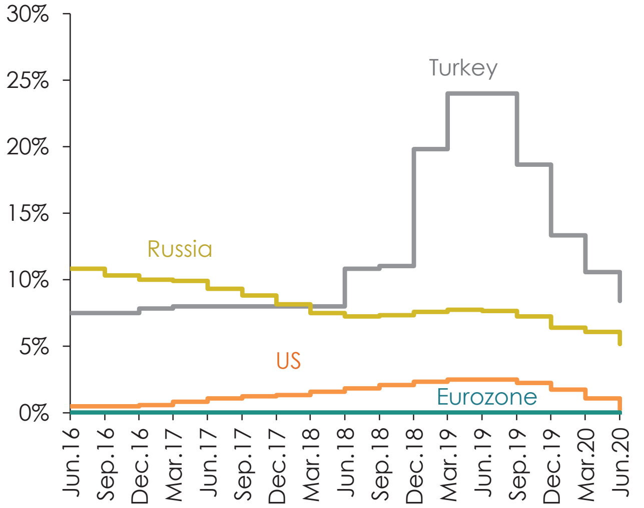


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

be 4.1% in 2021.[12] The inflation rate is expected to be 3.1% in 2020 and 3% in 2021.

Low economic activity was observed in **Ukraine**, where the industrial production and consumer spending saw a significant reduction. Amid COVID-19-related restrictions, the volume of investments and exports also decreased. However, annual inflation was relatively low in June at 2.4%. According to the IMF's forecast, Ukraine's real GDP growth will be -7.7% in 2020 and 3.6% in 2021.[13] Inflation is expected to be 4.5% in 2020 and 7.2% in 2021.

Amid the difficult epidemiological situation, economic activity fell sharply in **Armenia**. Closure of firms caused a decline in production and trade. Consumer and business sentiment deteriorated and remittances from Russia decreased as well. In May, the IMF decided to increase its financial assistance package to Armenia, and, according to their forecast, Armenia's real GDP growth in 2020 will be -1.5%, while inflation is expected to be 0.8%.[14] The economic growth and inflation forecasts for 2021 are 4.8% and 2% respectively.

In **Azerbaijan**, economic activity in the non-oil sector slowed in the second quarter of 2020 due to COVID-19-related restrictions. The foreign sector has deteriorated due to the collapse of oil prices. According to the IMF's forecast, real GDP growth in Azerbaijan will be -2.2% in 2020, while annual inflation is expected to be 3.3%.[15] In 2021, economic growth and inflation are projected at 0.7% and 3.2% respectively.

The **central banks** of Georgia's main trading partners reduced their monetary policy rates significantly 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%, alongside adopting a broader quantitative easing program. Meanwhile, the European Central Bank has kept its policy rate unchanged at 0%, although it has resumed a quantitative easing program.

12 International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.

13 Ibid.

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

15 Ibid.

Registered exports of goods declined by 24.8% annually.

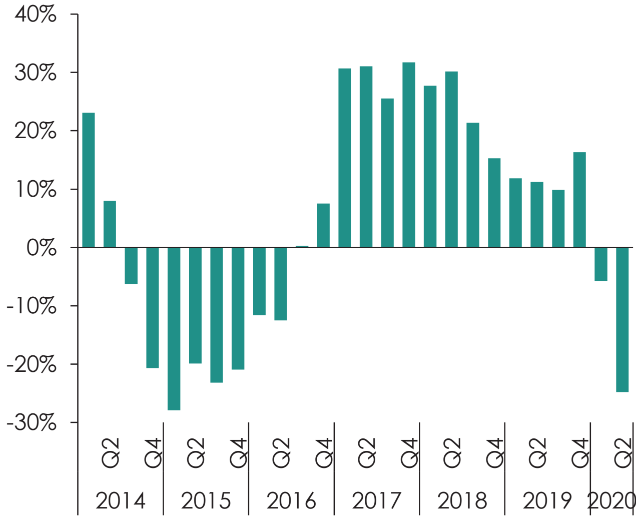


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

External demand declined on all types of export goods: consumption, investment and intermediate goods.

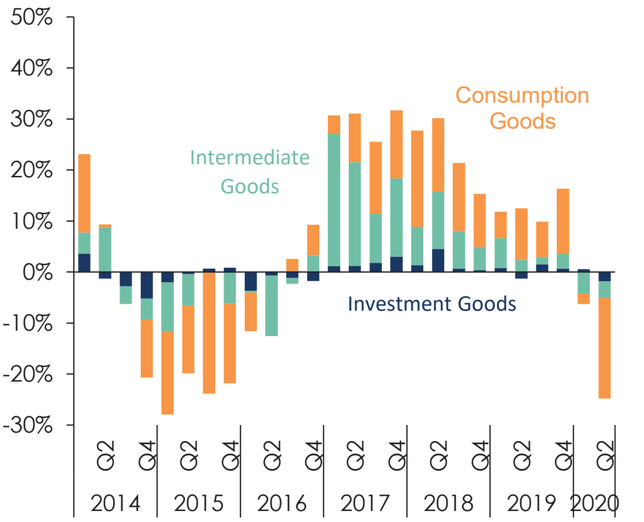


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

External demand continued to decline in the second quarter of 2020. Following the declaration of COVID-19 as a pandemic by the World Health Organization and the rapid increase in the infection rate, the majority of countries introduced a number of restrictions that negatively affected not only internal economic activities, but also international trade and tourism. Hence, as expected, the economic activity in Georgia's trade partners decelerated, thereby negatively affecting demand for exports of goods and services from Georgia. Specifically, revenues from international travelers have fallen significantly. Money transfers to Georgia also fell and, due to weaker domestic demand, imports of goods have substantially declined. According to the recent forecast, the current account deficit is expected to widen in 2020.

Registered exports of goods fell by 24.8% annually in the second quarter of 2020 (see Figure 1.2.1). The volume of exports to Azerbaijan, Armenia and other regional countries substantially declined. In the second quarter of 2020, the reduction of exports to Azerbaijan made the highest contribution to this decline (a -5.3 pp contribution annually), which was mainly a consequence of lower demand for motor cars and motor vehicles for the transport of goods, cigarettes and medicaments; meanwhile, exports to Armenia declined mainly in terms of a dramatically lower level of re-exports of motor cars and vehicles. Exports to Ukraine declined mainly due to lower sales of alcoholic beverages, natural grape wines and chemical fertilizers, while exports to Russia decreased due to lower sales of ferro-alloys and mineral waters. For EU countries, exports to Bulgaria and Spain increased in terms of sales of copper ores and concentrates, while exports to Switzerland increased because of higher demand on semi-manufactured gold. Demand for ores and concentrates of copper, as well as for precious metals, was also high in China.

Exports of goods fell mainly due to low demand for consumer and intermediate goods (see Figure 1.2.2). The decline in consumer goods mainly followed low exports of motor cars, medicaments, cigarettes, chemical fertilizers, natural grape wines and mineral waters. In terms of intermediate goods, exports of ferro-alloys, centrifuges, prefabricated buildings and pneumatic types of rubber all saw a drastic decline.

Following the restrictions on international flights and the closure of the borders of Georgia in March, as was expected, the number of international visitors to Georgia continued to decline in the second quarter. Overall, in the second quarter, the number of international travelers fell by 94.3% annually. Meanwhile, against the background of a reduced number of visitors, revenues from international travelers fell by 96.7%

Revenues from international travelers continued to decline.

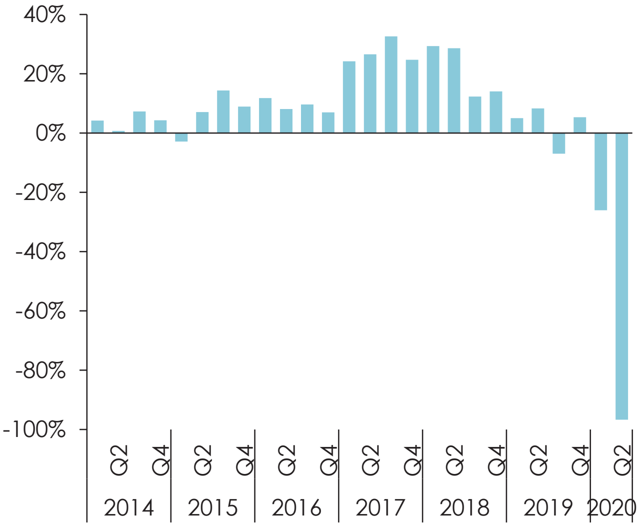


Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

Money transfers increased annually in June, but fell in the second quarter of 2020 annually.

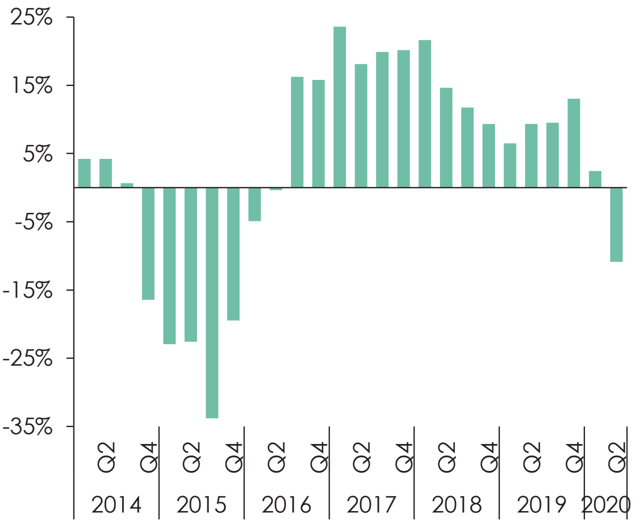


Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

annually (see Figure 1.2.3). It is worth noting that revenues from international travelers are expected to be negligible until the national borders reopen and international tourism recovers.

In the second quarter of 2020, money transfers to Georgia decreased by 10.9% annually (see Figure 1.2.4). It is worth noting that after the decline observed in April and May, money transfers increased by 17.8% annually in June, reaching 380.2 million USD in the second quarter. Once again, the largest contributions to total growth came from money transfers from the EU (especially from Italy, Greece and Germany), Russia and the USA.

In light of decreased external activities and weaker domestic demand, imports of goods declined substantially. In the second quarter, overall imports of goods declined by 32.8% annually (see Figure 1.2.5). The decline in imports from regional countries was significant, particularly those from Turkey, while the decline of imports also continued from the USA and China. In contrast, imports from Armenia increased because of higher imports of copper ores and concentrates for subsequent re-export.

In the second quarter of 2020, imports of all types of goods (intermediate, consumer and investment goods) declined. It is worth noting that the reduction in imports of goods predominantly stemmed from lower imports of consumer goods (see Figure 1.2.6) – more specifically, from reduced purchases of motor cars and vehicles, telephones and petroleum products. In terms of intermediate goods, the majority of the decline came from lower imports of petroleum gas, pneumatic rubber tires, and copper ores and concentrates, while the decline in imports of investment goods was due to lower purchases of large-scale construction machinery.

Imports of goods significantly declined.

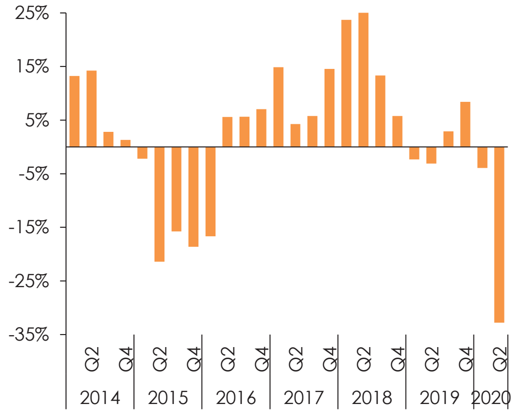


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

Compared to other types of imports, imports of consumer goods substantially declined in the second quarter of 2020.

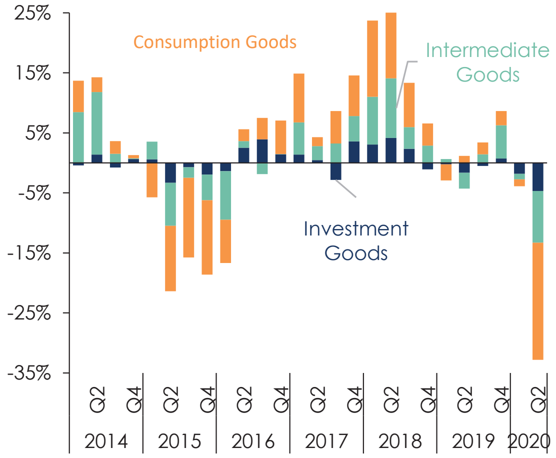
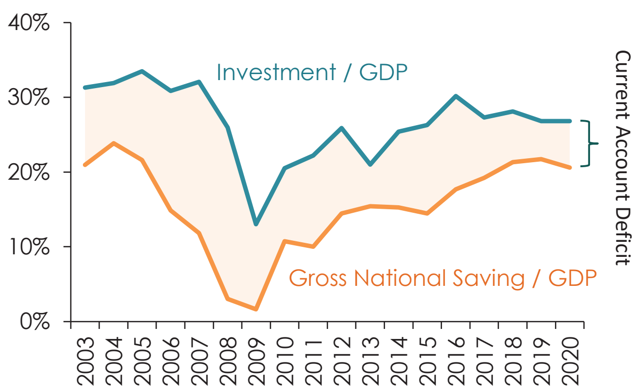


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

From the perspective of savings and investments, the worsening of the current account balance was due to a decline in savings.



* 2020 data contains the joint sum of the last three quarters of 2019 and the first quarter of 2020.

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

In light of decreased exports of goods and services, as well as lower money transfers, the current account deficit amounted to 417 million USD in the first quarter of 2020, which is 11.0% of GDP. This indicator worsened by 5.2 percentage points of GDP (by 192 million USD) compared to the same quarter of 2019. According to preliminary estimates, the widening of the current account deficit in annual terms has continued in the second quarter.

The primary source of financing the current account deficit is foreign direct investments, which decreased by 41.7% annually and reached 165.4 million USD in the first quarter of 2020. The largest of these investments went to the finance, real estate and communication sectors.

In light of the lower rise in investments, the worsening of the current account balance in the first quarter of 2020 was predominantly a result of a decrease in savings (see Figure 1.2.7).

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the first quarter of 2020, GDP grew by 2.2%. Private consumption was the main driver of that growth, making a 9.4 pp contribution.

Net exports contributed negatively to growth (-7.1 pp), which was mainly related to the reduction of the tourism sector as a result of COVID-19 and, consequently, to a decrease in the export of services. The contribution of total capital formation/investment was also negative (at -0.1 pp).

1.3.2 OUTPUT

In the first quarter of 2020, GDP grew by 2.2% compared to the same period of the previous year. This growth was primarily driven by services, which contributed 1.4 percentage points (pp) to total growth. The contribution of industry was 0.8 pp, while the contribution of agriculture was close to zero.

The COVID-19 pandemic started to have a negative effect on the Georgian economy in February. The biggest losses in Georgia, and worldwide, were suffered by the tourism sector. A small decrease in the number of foreign visitors was observed as early as February. In March, after the declaration of a state of emergency and the closing of national borders, the entry of foreign visitors to the country basically stopped.

The tourism industry, which incorporates a number of interrelated fields and covers a large part of the Georgian economy, has been the main driver of economic growth in recent years. According to the available data, at the beginning of the first quarter the tourism industry grew at such a high rate that it overshadowed the subsequent fall in the second half of the quarter. According to the information on the first quarter, a small increase (0.2%) was observed in the provision of accommodation and food supply activities, where the output of hotels and restaurants has the largest share. Real estate activities, where the participation of non-residents is substantial, grew by 1.6%. Based on the information from the first quarter, the contribution of both these sectors to economic growth was 0.2 pp. In comparison, these sectors made a 1.0 pp contribution to economic growth in 2019.

The tourism industry is closely connected to other industries. For example, in the first quarter, the growth of transport, where the contribution of travel agencies is significant, slowed to 4.7% (making a 0.3 pp contribution to overall growth). At the same time, trade, the largest sector of the economy, grew by only 0.2%.

In the first quarter, the crisis had a comparatively lower effect on the construction and manufacturing sectors, which grew by 6.7% and 5.7% respectively, making a corresponding 0.4 pp and 0.5 pp contribution to economic growth. Meanwhile, agriculture grew only slightly (by 0.3%) and its contribution to overall growth was almost zero.

Private consumption was a main driver of economic growth in the first quarter of 2020. The contributions of investments and net exports were negative.

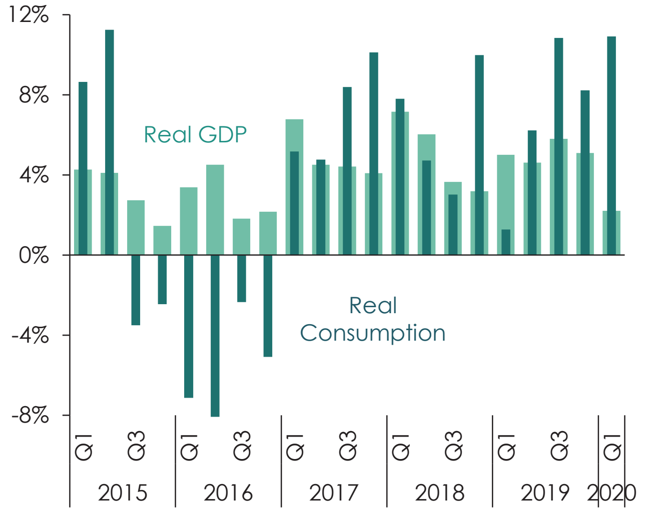


Figure 1.3.1. Real growth of GDP and private consumption

Source: GeoStat; NBG calculations

The tourism sector, which was the main driver of economic growth in recent years, suffered as a result of the COVID-19 pandemic.

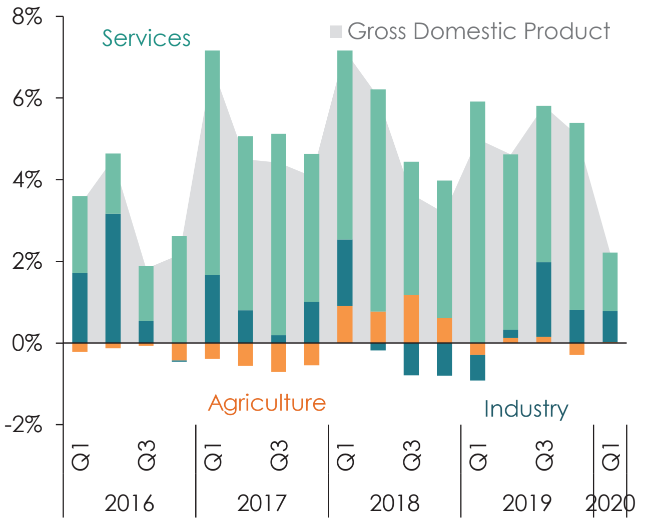


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

1.4 LABOR MARKET

ULC rise by 6.4% at this point can be considered moderate.

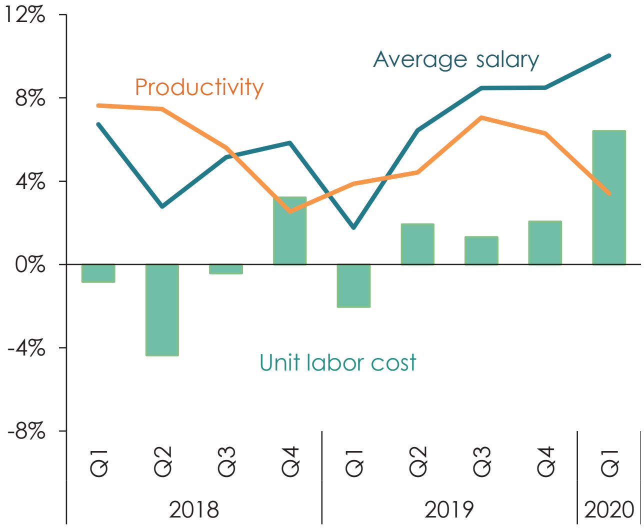


Figure 1.4.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

The real added value (labor productivity/productivity) produced per employee in the country's economy increased by 3.4% annually in the first quarter of 2020 (see Table 1.4.1.).

In the first quarter of 2020 the services sector recorded the highest rate of productivity growth (3.1%), which was also the main driver of economic growth. In the industrial sector, labor productivity increased by 17.0%, while in agriculture it decreased by 0.2%.

In the first quarter of 2020, the salaries of employees in the country averaged 1,424 GEL per month, which was a 10.0% nominal increase over the same period in the previous year.

The unit labor cost rose by 6.4% annually, which is a relatively higher increase compared to recent years (see Figure 1.4.1). The reason for the increase of this indicator is the slowdown in output due to the pandemic, during which time, at least in the initial stage, salaries were generally maintained. The increase in labor costs per unit of output affects prices in an upwards direction; however, at this point this increase can be considered moderate.

	Increase in labor productivity
Agriculture and agriculture output by households	-0.2%
Industrial sector	-17.0%
Services sector	3.1%
Overall in the economy	3.4%

Table 1.4.1 Annual growth of value added per employee in the fourth quarter of 2019

Source: GeoStat

1.5 FINANCIAL MARKET AND TRENDS

1.5.1 LOANS

In June, the loan portfolio decreased and stood at 13.9%, excluding the effect of exchange rate fluctuations.

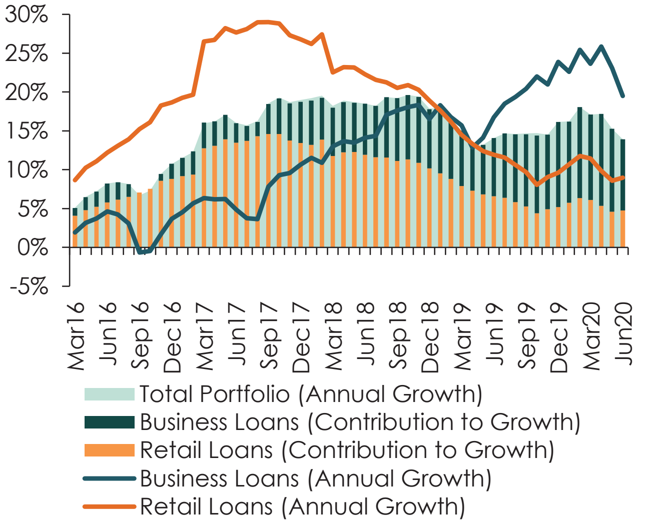


Figure 1.5.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In June, relative to March, the loan portfolio decreased and stood at 13.9% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans decreased by 2.5 pp and stood at 9.0%, loans to legal entities decreased by 4.1 pp and equaled 19.5% (see Figure 1.5.1). The growth of business loans has not changed significantly and there was a slight decrease in credit for the agriculture, transport, construction, trade, manufacturing and energy sectors. According to the credit conditions survey, representatives of the banking sector expect a 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 second quarter of 2020 the growth of the loan portfolio was driven by domestic currency loans, despite the fact that the growth rate of loans issued in local currency decreased (see Figure 1.5.2). In June, the annual growth rate of foreign currency denominated loans decreased slightly and stood at 11.5%, while the growth rate of loans in domestic currency decreased by 7.2 pp and equaled 17.1%. In the second quarter, the loan larization ratio increased slightly and equaled 42.9%. It is expected that the larization (de-dollarization) process will continue in the future. Increased larization is a step towards reducing risks to financial stability.

1.5.2 INTEREST RATES AND CREDIT CONSTRAINTS

In the second quarter of 2020, the growth of the loan portfolio was mainly driven by an increase in domestic currency loans.

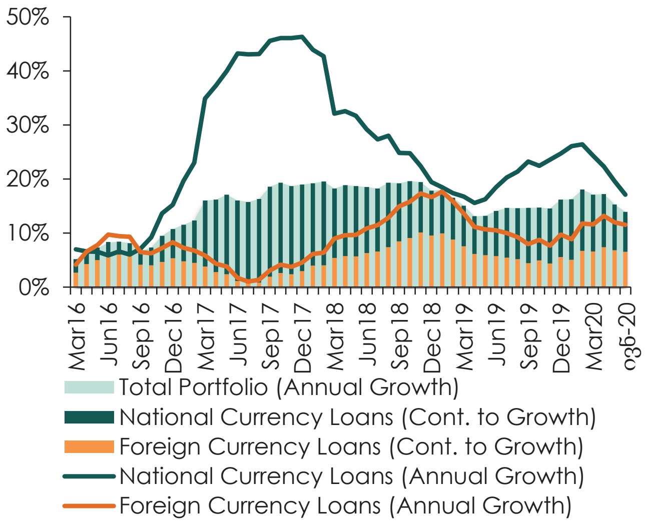


Figure 1.5.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In June, the monetary policy rate was 8.25%. In the second quarter of 2020, interest rates on government securities decreased as a result of a decrease of the monetary policy rate (see Figure 1.5.3).

Compared to the previous quarter, the spread between long- and short-term interest rates slightly increased. 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 June, relative to March, interest rates on domestic currency deposits increased by 0.3 pp and equaled 9.9%. Meanwhile, interest rates on foreign currency deposits did not change significantly and equaled 2.9%. According to the credit conditions survey, representatives of the banking sector do not expect a significant change 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

In the second quarter of 2020, interest rates on government securities decreased.

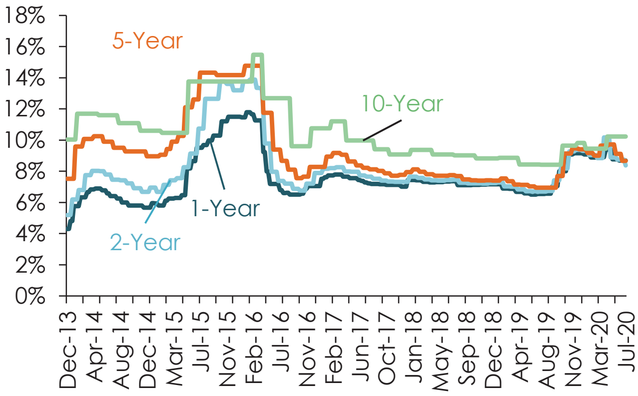


Figure 1.5.3. Interest rates on government securities

Source: National Bank of Georgia

Compared to the previous quarter, the spread between long- and short-term interest rates has increased slightly.

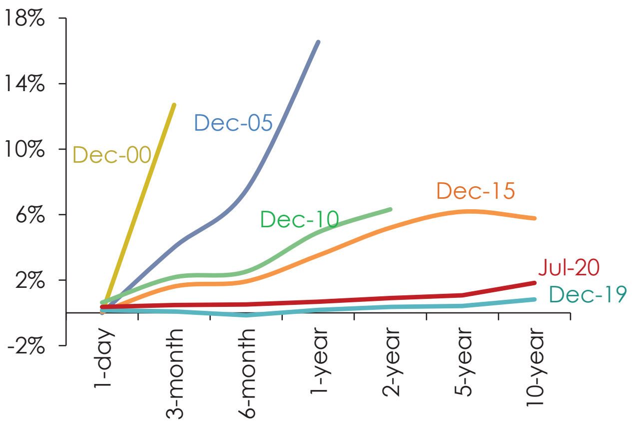


Figure 1.5.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

In June, relative to March, average interest rates on the stock of legal entities decreased slightly for domestic and foreign currency loans.

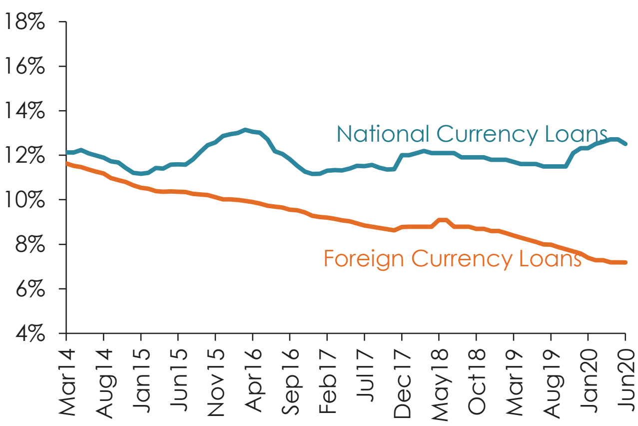


Figure 1.5.5. Average interest rates on business loans

Source: National Bank of Georgia

the banking sector expect a decrease in interest rates in the next quarter. However, it is important to note that it is difficult to form expectations due to the ongoing uncertainty caused by the COVID-19 pandemic. In June, relative to March, interest rates on retail loans increased by 1.5 pp and interest rates on loans for small and medium enterprises increased by 0.3 pp and stood at 10.2%. Meanwhile, interest rates on corporate loans decreased by 0.4 pp and equaled 8.8%.

In June, relative to March, average interest rates on the stock of legal entities decreased slightly for both domestic and foreign currency loans (see Figure 1.5.5). Representatives of the banking sector expect no significant change in interest rates for loans in foreign currency.

1.5.3 EXCHANGE RATE

In the second quarter of 2020, the GEL nominal exchange rate depreciated against the US dollar by 7.3% and against the euro by 7.1%, compared to the previous quarter. The GEL slightly appreciated against the Turkish lira and against the Russian ruble by 4.7% and 1.8% respectively. As a result, over the same period, the nominal effective exchange rate depreciated by 2.6% on a quarterly basis and by 7.4% on an annual basis.

In the second quarter of 2020, the real effective exchange rate depreciated by 2.2% on a quarterly basis and by 4.7% on a year-on-year basis (see Figure 1.5.6).

When adjusted for commodity groups and services, the nominal effective exchange rate depreciated slightly more than the official exchange rate. In the second quarter of 2020, the adjusted nominal effective exchange rate depreciated by 3.7% on a quarterly basis and by 8.9% on an annual basis (see Figure 1.5.7). This depreciation was due to the appreciation of the US dollar against the currencies of developing economies during the crisis.

The real effective exchange rate remains undervalued (annual depreciation of 4.7%).

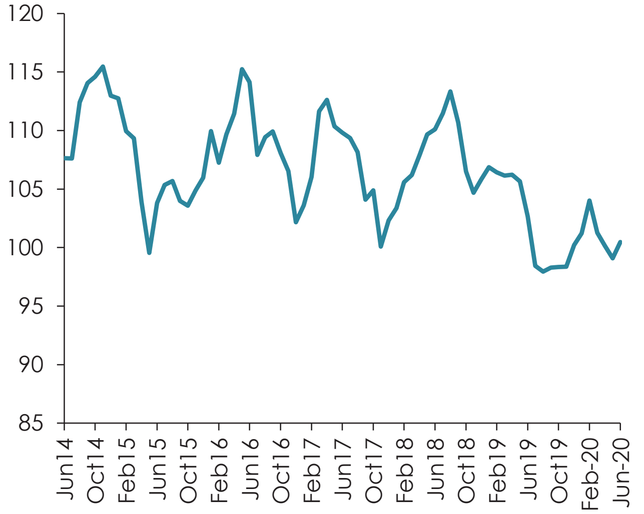


Figure 1.5.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

The nominal effective exchange rate (based on commodity groups and services) depreciated slightly more than the official one.

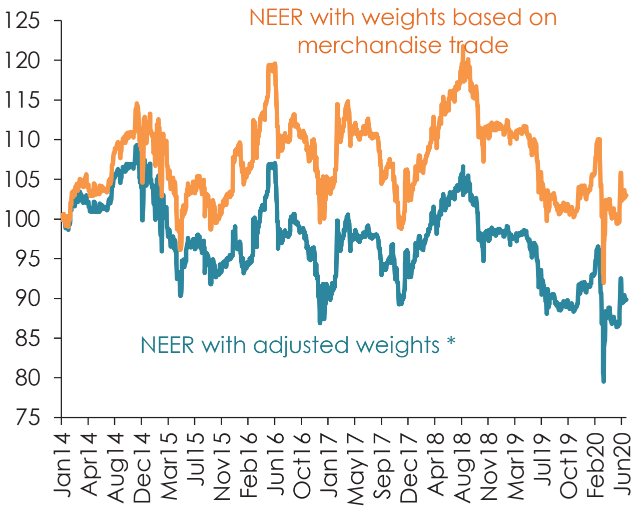


Figure 1.5.7. Corrected nominal effective exchange rate

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	-7.4	-4.7	-4.7
Eurozone	-10.9	-5.3	-1.0
Turkey	2.1	-2.6	-0.5
Ukraine	-11.4	-7.6	-0.5
Armenia	-12.0	-7.4	-0.5
US	-12.7	-7.3	-0.4
Russia	-2.0	1.2	0.2
Azerbaijan	-12.6	-9.6	-1.0
Other	-9.3	-5.7	-0.9

Table 1.5.1. Effective exchange rates annual growth (3rd quarter of 2020)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

Due to the depreciation of the lari nominal effective exchange rate and the rise in product prices as a result of pandemic-related constraints, core inflation exceeded headline inflation in June-July.

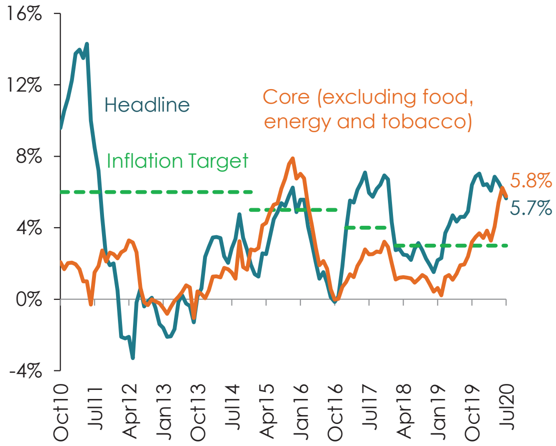


Figure 1.6.1. Headline and core inflation

Source: GeoStat

A large share of inflation is related to food.

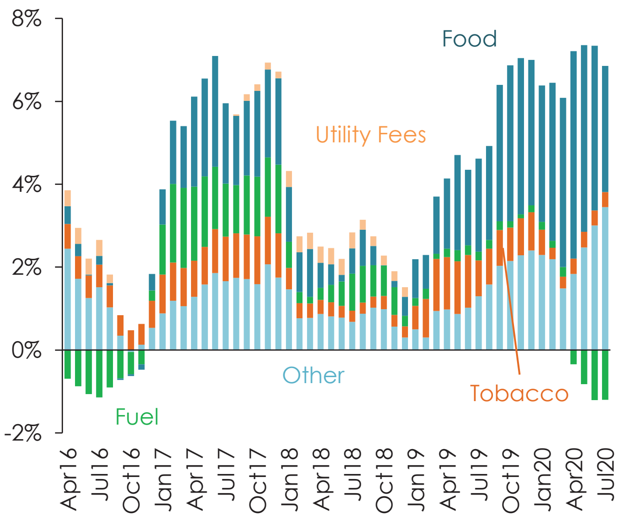


Figure 1.6.2. Food inflation

Source: GeoStat

1.6 CONSUMER PRICES

As was expected, at the beginning of the year inflation started to decline. However, the subsequent shock caused by the global COVID-19 pandemic affected the trajectory of inflation. The main changes were mostly related to the depreciation of the lari nominal effective exchange rate and increased production costs as a result of pandemic-related constraints. On the other hand, reduced aggregate demand pushed inflation down.

As a result of these factors, the expected decline in inflation was delayed, but a downward trend was observed in May-July. Annual inflation fell to 5.7% in July. Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, exceeded headline inflation in June-July for the first time in the last four years. Core inflation reached 6.2% in June, before falling to 5.8% in July. The increase in core inflation is related to the depreciation of the lari nominal effective exchange rate and a rise in the prices of products stemming from an increase in the operating costs of firms as a result of pandemic-related constraints.

Amid falling oil prices on world markets, gasoline prices fell significantly. The decline of gasoline, diesel and gas prices in July made a 1.2 pp contribution to the overall decline in inflation.

Compared to previous months, food inflation decreased, but remained high. In July, food inflation amounted to 11.4%. 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. Of the 5.7% total inflation, 3.0 pp came from food (see Figure 1.6.2), of which cheese, meat and apples made a 1.1 pp contribution.

In July, inflation for imported, domestically produced, and mixed goods was 2.4%, 6.2%, and 7.0%, re-

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

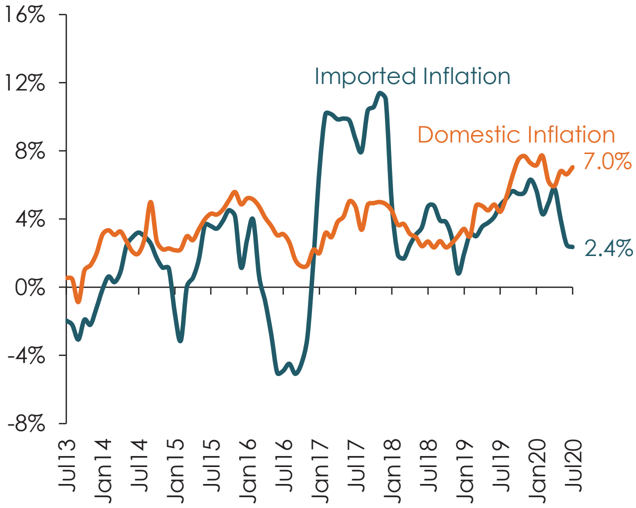


Figure 1.6.3. Contribution of different products to inflation

Source: GeoStat

spectively. The relatively low inflation of imported goods can be explained by the reduction of fuel prices. If fuel is excluded, the inflation of imported goods was 9.0%.

BOX 1. THE IMPACT OF COVID-19 ON THE GEORGIAN ECONOMY AND FORECAST ASSUMPTIONS

The COVID-19 pandemic hit the global economy hard and caused a deep recession in the second quarter of 2020. The degree of uncertainty about the path of the pandemic remains high. Tourism has suffered a deep contraction, reflecting restricted cross-border mobility. Based on the current circumstances, various international organizations, including the International Monetary Fund (IMF), have lowered their global economic growth projections.

The Monetary Policy Report usually provides baseline and alternative scenarios that are based on different assumptions for the Georgian economy. These scenarios differ in their forecasts of major variables, including inflation and the monetary policy rate. Those shown here are based on assumptions that differ in terms of the impact that COVID-19 will have on domestic demand.

Baseline scenario

The baseline scenario assumes that a vaccine will become available at the beginning of 2021. Meanwhile, mobility across international borders will be restored and virus containment measures will be lessened.

Demand side

External demand shock

The COVID-19 pandemic and containment measures (such as travel restrictions) have had a particularly acute impact on tourism. The baseline scenario assumes that flights will resume for a few months in 2020 for a select group of countries that have the epidemiological situation well under control. It assumes that in 2021 restrictions will gradually be lifted and travel activities will start to increase. Based on the updated assumptions, the recovery is projected to be more gradual than previously forecast (see Table 1.6.1).

The COVID-19 pandemic has also led to an economic recession in Georgia's main trading partners. Suppressed external demand thus reduces revenues from exports of goods. However, exports of goods have already started to recover. Compared to April-May, early signs of a recovery have been observed. In the baseline scenario, this recovery of exports of goods will continue.

Domestic demand shock

The epidemiological situation in Georgia has recently been stable and risks of virus transmission are minimal. Based on these circumstances, domestic demand is more robust than was previously predicted. The updated assumptions consider domestic demand making a higher contribution to economic recovery than previously anticipated. Remittances show a positive tendency, which pushes domestic demand up. In June, remittances increased by 17.8% compared to the previous year. Meanwhile, although credit activities will be weaker compared to the previous year, the updated forecast considers growth of credit portfolio of around 5%.

The assumptions behind the baseline scenario are summarized below (see Figure 1.6.1).

	2020	2020
	Previous assumptios	Updated assumptions
Exports of goods	-20.0%	-16.0%
Exports of services	-60.0%	-83.0%
Imports of goods	-25.0%	-23.0%
Imports of services	-60.0%	-77.0%
Remittances	-30.0%	-10.0%
Credit portfolio growth	0.0%	5.0%

Table 1.6.1. Assumptions of the baseline scenario

Source: National Bank of Georgia

Supply side

The recession related to COVID-19 is more complex than other economic crises as supply and demand shocks are simultaneous. On one hand, a reduction of domestic demand creates deflationary pressure. However, this effect is outweighed by supply-side shocks. Productivity shocks and increased production costs push prices up. After the national lockdown, various containment measures and restrictions were imposed. Those measures increase production costs, especially in the service sector where social distancing is essential. A detailed analysis of current headline inflation allows for greater understanding of the decomposition of the shocks to inflation. Based on the NBG's core macroeconomic model, in the second quarter of 2020, weak demand pushed prices down by 2-2.5 pp (see Figure 1.6.4). However, this effect was outweighed by the supply-side shock. An increase in production costs caused headline inflation to rise by 3 pp. It is expected that this effect will continue for the whole year.

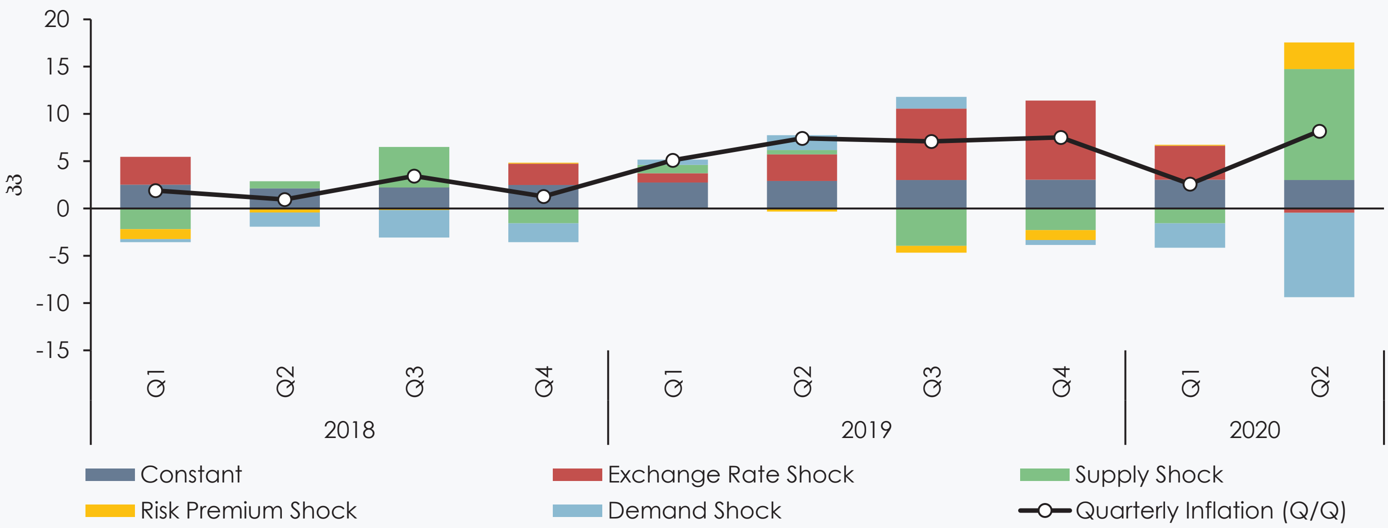


Figure 1.6.4. Decomposition of shocks to quarterly inflation

Source: National Bank of Georgia

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

Alternative scenario

The alternative forecast considers a scenario in which travel activities will resume in the second half of 2021, while the containment of a second wave will be harder in 2020.

Demand shock

In the alternative forecast scenario, travel activities will continue to be restricted in 2021 and the recovery of tourism will thus be more gradual. In this case, global economic growth will be lower than is currently projected for 2021. Weaker external demand will further worsen for exports of Georgian goods.

Supply shock

In the alternative forecast scenario, the COVID-19 pandemic reduces long-run economic potential. Meanwhile, more severe external shocks increase the country’s sovereign risk premium. The assumptions regarding production costs are the same as in the baseline scenario.

2 MACROECONOMIC FORECAST

Amid restrictions on foreign tourist visits until the end of this year and a continuation of restrictions within the country, it is expected that the decline of real GDP in 2020 will be 5%. Sharply reduced demand will continue to have a significant negative impact on projected inflation, which will only be partially offset by the effects of the exchange rate depreciation in previous periods and regulatory costs. The response of monetary policy to lower inflation expectations, even in the face of higher-than-targeted inflation, will be moderate and gradual. Given the current situation, the main macroeconomic forecasts are characterized by extraordinary uncertainty. If the development of a vaccine against COVID-19 is delayed beyond 2021 and is coupled with countries facing difficulties in managing the epidemiological situation, cross-border mobility will likely be limited for a longer period. The alternative forecast scenario considers a realization of these risks. According to the alternative scenario, a protracted pandemic exacerbates the external shock and deepens the economic recession for the remainder of 2020, while in 2021 the process of economic recovery will be slower than in the baseline scenario. Due to the aggravation of external shocks and the subsequent exchange rate depreciation, inflation will remain above the target for a longer period, while monetary policy will be tighter

2.1 BASELINE MACROECONOMIC FORECAST

Inflation will decrease in 2020 and, after temporarily falling below the target, will subsequently return to the target in the medium term.

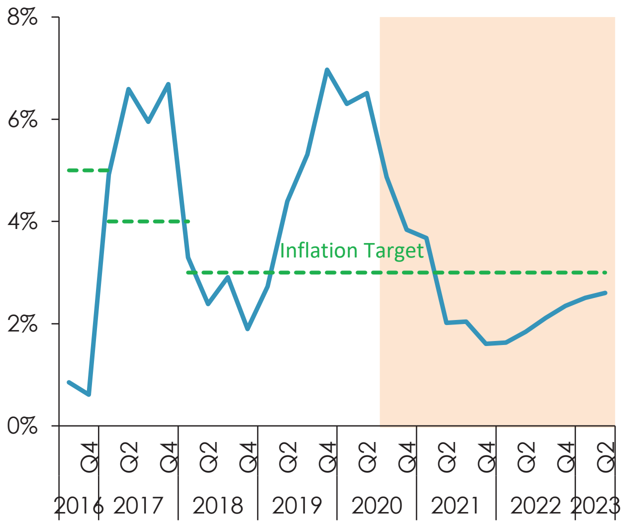


Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

In the second quarter of 2020, annual inflation was 6.5% (see Figure 2.1.1), which coincides with the previous forecast. As expected, the sharp reduction of demand had a strong negative impact on consumer prices, which was partially offset by increased imported inflation and higher intermediate costs resulting from the depreciation of the lari exchange rate (see Figure 2.1.2). It is noteworthy that the share of regulatory costs imposed on companies as part of the pandemic response measures increased in the decomposition of the deviation of inflation from the target. Although these costs are temporary, in the current context they are driving up prices in the services sector particularly.

According to the current forecast, the impact of the above-mentioned factors on prices will persist over the next year; although the headline inflation rate will continue to gradually decline to the target level. After that, inflation will temporarily fall short of the target and will then approach it from below in the medium term. This will partly be due to the moderate and gradual response of monetary policy. The latter is essential for ensuring that long-term inflation expectations return to the target level.

Although there have recently been some signs of recovery in economic activity, the decline in aggregate demand in the second quarter was much higher than expected and was accompanied by deteriorating expectations for the tourism sector. In particular, due to the uncertainty surrounding a possible prolongation of the pandemic, it is expected that tourism from abroad will be severely limited until next year and

Sharply reduced demand on the forecast horizon will put significant negative pressure on headline inflation; however, supply-side disruptions and the annually depreciated exchange rate will put upward pressure on prices.

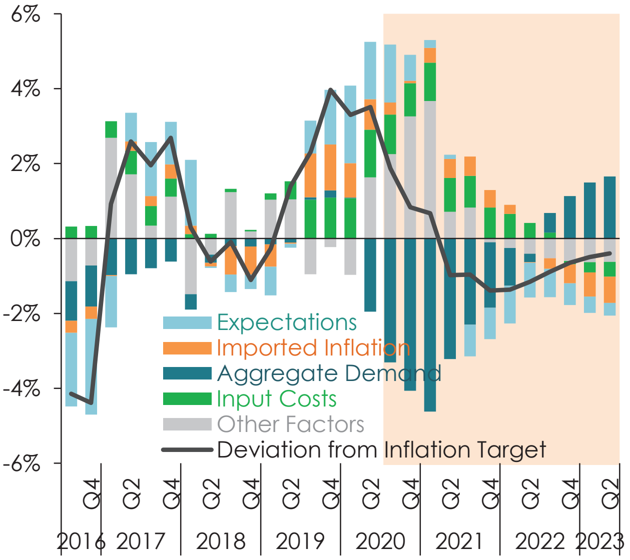


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

According to the current forecast, real GDP will fall by 5% in 2020 because of a slump in both external and domestic demand.

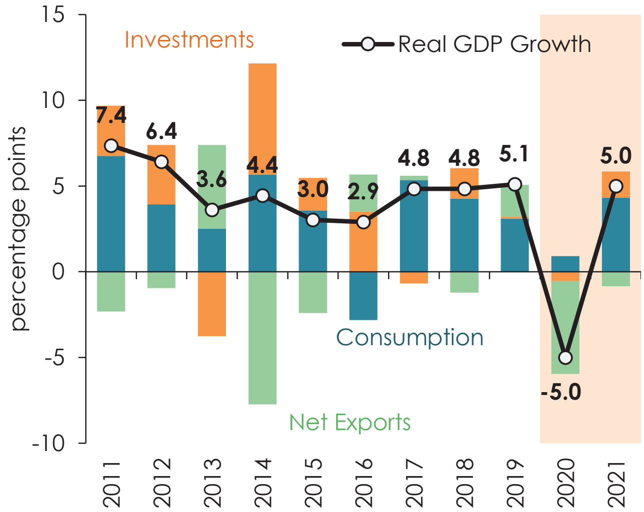


Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

only a small part of that loss will be offset by domestic tourism. Against the background of fiscal stimulus and continued credit activity, the decline in real GDP is expected to be 5% (see Figure 2.1.3). The drop in demand will mainly be due to declining net exports and lower investment. Consumption will also weaken over the year, but because it grew significantly in the first quarter, its contribution will be slightly positive on an annual basis. In 2021, economic activity will increase by 5%, owing mainly to the recovery of consumption and investment.

The current forecasts are naturally accompanied by huge uncertainty. A deterioration of the epidemiological situation could have a strong impact on the dynamics of macroeconomic variables during the forecast period. In particular, a second wave of the virus within the country or the reintroduction of restrictive measures will further reduce economic activity. This will put downward pressure on inflation, which will be partially offset by the effects of increased costs as a result of tighter regulations. Conversely, a worsening of the epidemiological situation in Georgia's trading partner countries could lead to rising inflation: expectations will deteriorate amid declining export revenues and lower remittances, which will negatively affect the country's sovereign risk premium and cause a devaluation of the lari exchange rate. The latter will put upward pressure on consumer prices through the channels of imported inflation and companies' intermediate costs.

In the face of acute uncertainty, it is important for monetary policy responses to be cautious and moderate in order to avoid the loss of welfare that often results from sharp policy rate changes made in times of crisis. Consequently, in the wake of declining inflation expectations, it is expected that there will be only a gradual exit from the tightened monetary policy. However, the policy rate may remain below the neutral level in the medium term and will eventually approach it from below. It should also be noted that the neutral interest rate is a value based on macroeconomic judgment that depends, in part, on an assessment of the potential growth of the economy. The latter is highly likely to temporarily decrease over the forecast horizon, which may indicate a downward deviation in the assessment of the neutral rate. In contrast, risks associated with expectations of a deterioration in the balance of payments may have an upward effect on the neutral rate. The response of monetary policy will thus also depend on the interrelationship among these factors.

The inflation outlook and the factors that affect prices are almost the same as the previous projection.

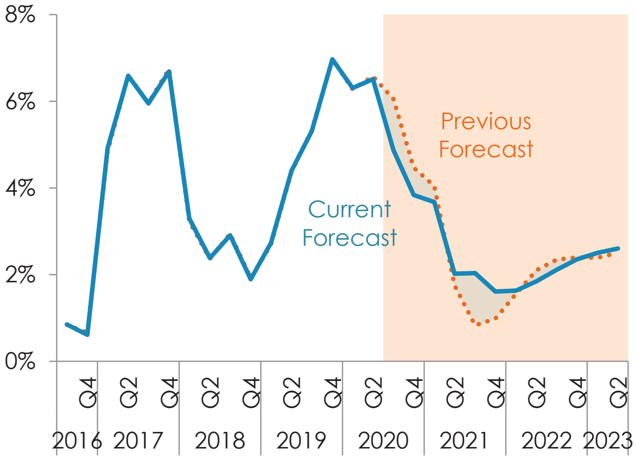


Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The real GDP growth forecast has been revised downward to -5%. Cross-border mobility is still restricted, which intensifies the external demand shock. Economic recovery is expected to start in 2021 as the pandemic fades.

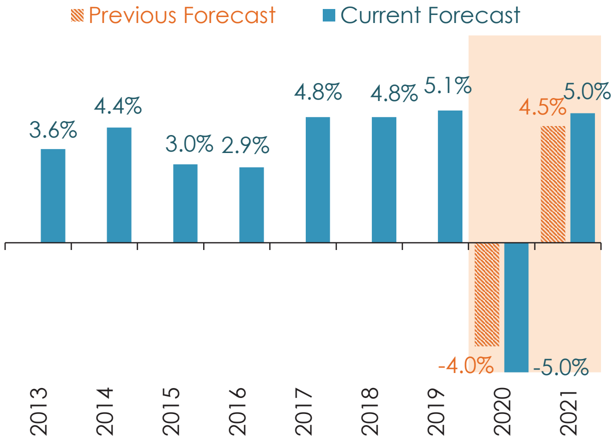


Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The updated inflation forecast has changed only slightly. Compared to the previous projection, the short-term inflation forecast has been revised slightly downward, while the forecast for the medium term has increased (see Figure 2.2.1). As expected, in the medium term, increased production costs increase prices. Nevertheless, lower-than-expected economic activities cause a downward revision. According to the revised forecast, inflation is expected to continue falling in 2020. 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 5% (see Figure 2.2.2). The COVID-19 pandemic has intensified in a number of countries and the date at which a vaccine and/or treatment therapies to counter the virus might be developed remains unclear. Cross-border mobility is expected to remain restricted until a vaccine becomes available. Therefore, compared to the previous forecast, a greater contraction in tourism revenues is expected. This will have the effect of deepening the projected economic recession. In contrast, credit activities will support the domestic economy and fiscal stimulus 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).

Assumptions regarding the economic stances of Georgia's trading partners have changed. According to the revised forecasts, the COVID-19 pandemic will dramatically shrink the growth of trading partners. Expectations about a depreciation of their currencies have slightly decreased for 2020. Nevertheless, inflation expectations have only slightly reduced. This can be linked to upward cost-push pressure from supply-side interruptions. In line with the reopening of the economy, various virus containment regulations have been imposed that have pushed production costs up. Therefore, an economic crisis like the COVID-19 pandemic is expected that would not be deflationary.

The COVID-19 pandemic will cause the growth of Georgia's trading partners to shrink dramatically. Expectations about a depreciation of their currencies have slightly decreased for 2020. Nevertheless, inflation expectations have only slightly reduced.

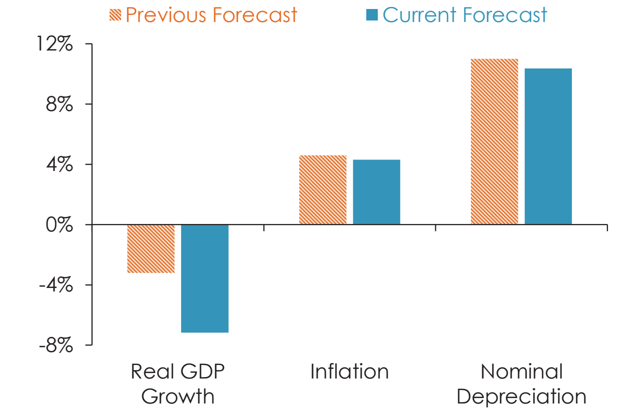


Figure 2.2.3. Changes in the forecast of external assumptions for 2020

Source: Bloomberg

The alternative scenario considers a deeper recession than in the baseline scenario. In the alternative scenario, COVID-19 causes a greater reduction of external demand, a reduction of real GDP by 6.5% in 2020, and slower economic recovery in 2021.

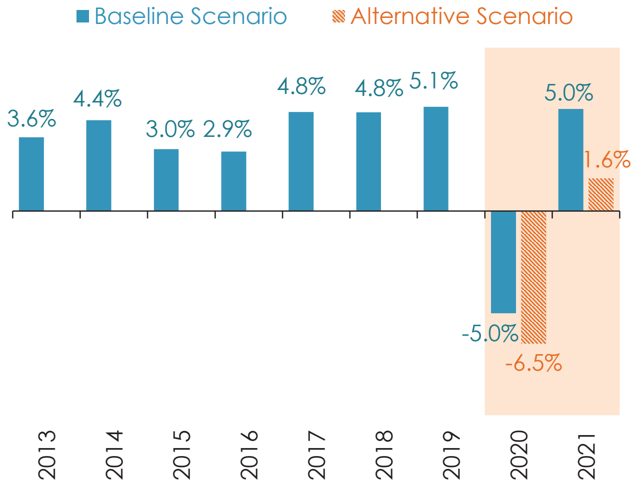


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a more severe economic crisis compared to the baseline scenario. The date at which a vaccine or 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. The alternative scenario assumes that an effective vaccine will be available later in 2021. Travel will be restricted longer than in the baseline scenario and the external shock will thus be more severe. Meanwhile, a second wave of COVID-19 and further measures needed to contain the spread of the virus will jeopardize economic recovery. A second outbreak would require the reintroduction of at least some containment measures. However, if it becomes harder to contain the spread of the virus, there is a possibility that the containment measures will need to be stricter. Realization of these risks will lead to a sharper and more persistent reduction of external demand. 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 6.5% in 2020 (see Figure 2.3.1). The recovery is also slower than in the baseline scenario and real GDP increases by only 1.6% in 2021.

A more severe external demand shock will intensify upside pressures on prices and headline inflation will be higher than in the baseline scenario. Although suppressed aggregate demand pushes inflation down, under the alternative forecast scenario weaker external domestic demand leads to an increase in the current account deficit, which creates currency depreciation pressure. Prices will rise as a result of direct imported inflation and increased input costs. Accordingly, over

Weaker external demand and currency depreciation will push inflation up. Over 2020-2021, inflation will be 1.3 pp higher than in the baseline scenario.

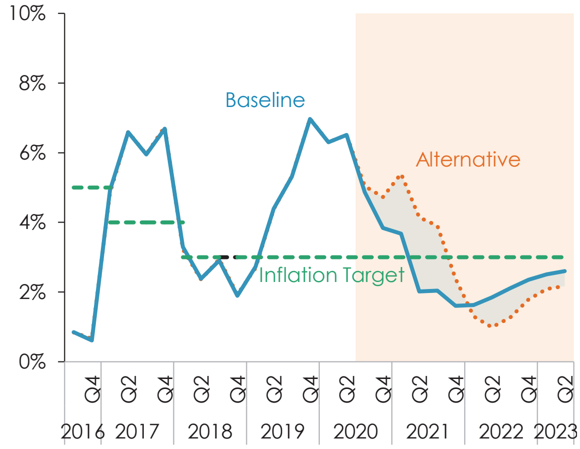


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

In response, the monetary policy stance will be tighter than in the baseline scenario. Under the alternative scenario, the monetary policy rate trajectory will shift up by 1.2 pp.

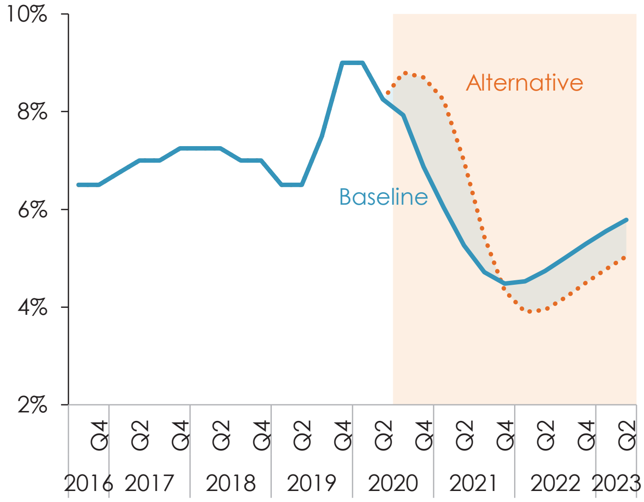


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

2020-2021 inflation will be 1.3 percentage points higher than in the baseline projection (see Figure 2.3.2).

In response to these developments, in the alternative forecast, monetary policy will be tighter than under the baseline scenario. In the short term, the NBG's monetary policy will be contractionary so as to maintain price stability, while in the medium term the NBG will start to exit from the tightened policy stance more slowly than in the baseline scenario. In the medium term, the monetary policy stance will be loosened as the policy rate drops below the neutral policy rate.

Under the alternative forecast scenario, the monetary policy rate trajectory will increase by 1.2 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

The decline in external and domestic demand in the wake of the COVID-19 pandemic is still evident. Given the current and expected weakness on the demand side, the Monetary Policy Committee continues to ease the policy stance. However, monetary policy remains tight to guarantee a gradual reduction of inflation to its target level.
Inflation continued to decline in July, and, under other equal conditions, is expected to continue to exhibit a declining trend. According to the revised forecast of the National Bank of Georgia, the economy is expected to shrink by 5% in 2020, which will also affect the inflation forecast. However, if inflation remains above the target level over an extended period, risks in terms of inflation expectations should be taken into account. The Monetary Policy Committee has thus continued the gradual exit from the tightened policy stance at a slower pace, deciding to reduce the refinancing rate by 0.25 pp on 5 August.

According to the decision made on 5 August 2020, the refinancing rate was reduced by 0.25 pp points to 8.0%.

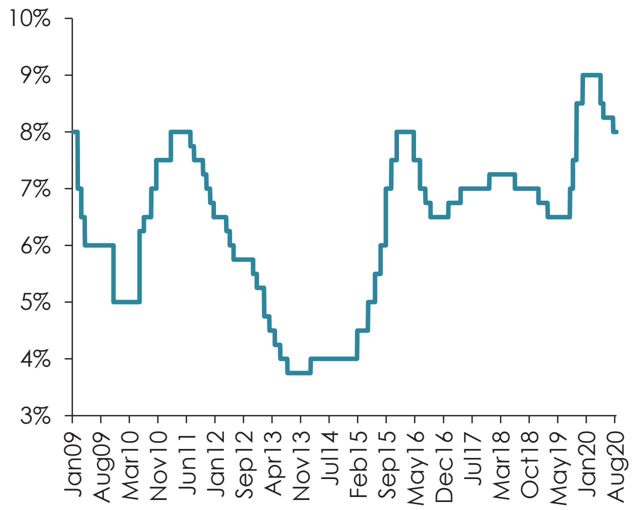


Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

Measures to curb the spread of the pandemic and attendant rising costs in the delivery of some goods and services have led to an increase in the inflation rate; meanwhile, supply factors resulting from logistical constraints delayed the expected decline in inflation over April-May. However, it is expected that these factors will have only a temporary impact on inflation. A sharp decline in external and domestic demand is expected to create a downward pressure on inflation over the year. This impact will last longer, ultimately leading to a reduction in the inflation forecast. It should be noted that in both May and June inflation revealed a declining trend. Annual inflation stood at 6.1% in June, while monthly inflation was declining. Given these dynamics and the expected weakness on the demand side, the Monetary Policy Committee began easing monetary policy, reducing the policy rate by 0.5 pp in April and by a further 0.25 pp in June to 8.25%.

As expected, inflation continued to decline in July, reaching 5.7%, while prices fell by 0.5% on a monthly basis. According to the NBG's forecasts, other things being equal, inflation will continue to decline over the rest of the year, falling below the target level in the first half of 2021 and then approaching it from below. The decline in inflation will be driven by weak aggregate demand. According to the revised forecast of the NBG, the economy is expected to shrink by 5% in 2020, exerting downward pressure on the inflation forecast. The revision of the economic growth forecast reflects a larger-than-expected decline in both global economic activity and external demand than was evident in the early stages of the pandemic. At the same time, the risks of inflation expectations should also be considered as the inflation rate has remained above the target over a protracted period. Thus, at a meeting on 5 August 2020, the Monetary Policy Committee decided to reduce the refinancing rate by 0.25 pp to 8.0% and thus continue to exit from the tightened policy at a slower pace.

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 a greater-than-expected reduction in external demand is considered a risk to the inflation forecast, which can be reflected in a decline in tourism revenues, remittances and revenues from exports of goods. In addition, a higher-than-expected depreciation of the nominal effective exchange rate and the dynamics of international oil prices should also be taken into account. In particular, as a result of the measures taken in connection with a possible second wave of COVID-19, along with a deterioration of external factors, the risk premium will increase and create additional pressure on the inflation rate. Risks in terms of declining inflation include a greater-than-expected decline in aggregate demand, which in turn will depend on the duration of the pandemic.

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. At the same time, in the light of the COVID-19 pandemic, it is important not to increase liquidity risks in the financial sector. In response, the National Bank of Georgia has launched temporary instruments to supply liquidity. 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. Moreover, from 1 June 2020, the NBG launched a liquidity supply tool to facilitate lending to small- and medium-sized businesses, which allows commercial banks to receive liquidity support from the National Bank in exchange for pledging a loan portfolio. Meanwhile, microfinance organizations, with the support of the National Bank, will be able to attract loan resources from commercial banks within the size of the loan portfolio meeting the criteria set by the National Bank. The new liquidity management mechanism will operate with the possibility of monthly updates until the end of 2023 (with a decreasing schedule from 2022), while the price is determined by the one-month interbank money market index (TIBR1M). The NBG 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.

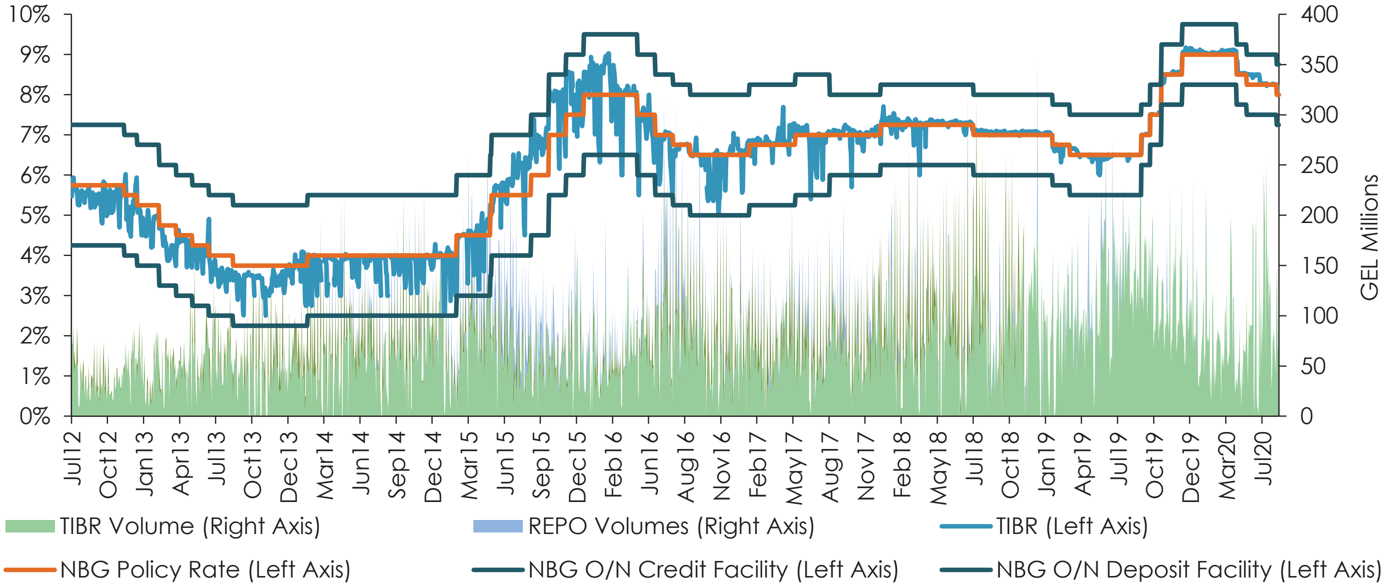


Figure 3.3. Interbank money market

Source: National Bank of Georgia

BOX 2. FURTHER STEPS TO REFORM THE EXCHANGE MARKET

One of the tasks of the National Bank is to promote the efficient functioning of the foreign exchange market by taking timely and necessary measures. One such initiative is a reform aimed at enhancing liquidity, improving transparency and increasing competition in the foreign exchange (FX) market, making it easier for non-bank participants to access the interbank FX market.

The first component of this reform is the implementation of the principles of the FX Global Code, which was created in 2017 with the participation of major central banks. A commitment of compliance with the terms of the FX Global Code is acknowledged by the Bank for International Settlements (BIS), the central banks of 47 countries, as well as more than 1,000 financial institutions and companies – including the central banks and leading banking institutions of the US, UK, Europe, Japan, Canada and Australia.

At the initiative of the National Bank of Georgia and with the support of the United States Agency for International Development (USAID), international experts conducted trainings for Georgian foreign exchange market participants. The experts also helped develop a new regulation regarding rules of conduct for FX market participants, which are based on the core requirements and principles of the FX Global Code.

Both the FX Global Code and the rules of conduct aim to increase transparency and competition, serving to establish fair and unbiased conditions for market participants and better protect the interests of their customers.

Naturally, the introduction of new approaches needs to be accompanied by relevant infrastructural changes. Therefore, the second component of the reform is the launch of the new Bloomberg trading platform – Bmatch. The Bmatch platform has been operating successfully in more than 20 countries around the world since 2016 and it provides automatic matching and execution of matching orders. Prior to a trade, the identity of the BID/ASK provider is anonymous, which ensures confidentiality and impartiality. At the same time, counterparty risks in the system are managed through the limits set by the participants, and the execution of concluded transactions is done in accordance with the rules of the National Bank.

Importantly, with the implementation of new rules, the platform will become accessible to a wider range of participants. Both banks and companies can trade in the system. Companies can subscribe to the Bloomberg terminal themselves and trade FX directly, or they have the option of placing orders with the help of a commercial bank. As a result, companies will no longer be tied to one bank and will be able to trade with the whole banking community or companies that offer them the best price. This ensures greater market concentration, more liquidity and favorable prices. In accordance with international best practice, banks will be required to publish transparent terms and conditions on their websites, describing their full range of FX market services, including fees and other relevant terms. They are expected to process and execute orders in the best interests of the clients and to protect their privacy. In order to maintain high standards of operations in the foreign exchange market, banks must also adopt appropriate organizational structures and have suitable IT infrastructure.

Nowadays, when a company wants to convert a currency, it applies to its service bank, or to several banks at the same time, to get an offer regarding the exchange rate before agreeing to the transaction. As a result, the main volume of the trade comes from transactions between the bank and its client. With the introduction of the Bmatch platform and its new regulations, this situation will change. Instead of trading with its bank, the company will have the opportunity to instruct its servicing bank to apply on the Bmatch platform. Such applications will be met by other applications, as initiated by the other participants in the system, including companies, microfinance organizations and banks. As a result, the new trade platform will have a multitude of small and large applications, and trades will be made between more parties at the best exchange rate available on the market at the time.

The rules of conduct for FX market participants and the new platform will come into force on 1 October 2020. Until then, banks will have time to develop the relevant infrastructure, and companies will be able to sign service contracts with one or more banks.

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