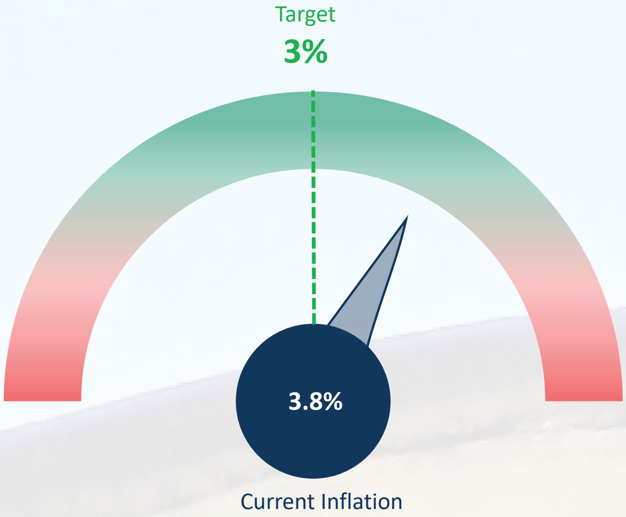
Monetary Policy Report

November

2020

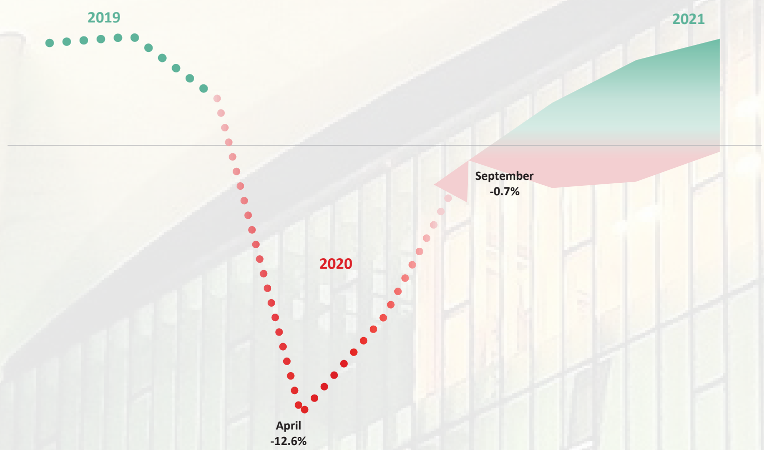
FIRST GEORGIAN
CENTRAL
BANK

Inflation



3.8%	Inflation continues to fall, closing on our 3% target.

Economic Growth



The COVID-19 pandemic has suppressed economic activity, but the economy has recently started to recover.	-0.7%

Monetary Policy

8.0%

0

8.0%	Monetary policy maintains a tightened position to further reduce inflation expectations.

MONETARY POLICY DECISION

We have kept the monetary policy rate unchanged at 8%.

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 pushed consumer prices up. Nevertheless, in line with our projections, weak demand will eventually reduce inflation.

Interest rate changes are reflected on the economy gradually 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. Lower interest rates will support economic activity. In contrast, should upward pressure on inflation expectations develop, a tight monetary policy stance may need to be maintained for a longer period.

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.

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BRIEF OVERVIEW

After facing an unprecedentedly strong recession, Georgia's economy, like that of the rest of the world, has entered a recovery phase. Nevertheless, the recovery process is accompanied by huge uncertainty that is primarily related to the potential duration of the COVID-19 pandemic. The main driver of the recovery has been domestic demand, amid relatively strong lending and fiscal stimulus, while external demand remains quite weak as a result of the effective halt of tourism. Although weak external demand is characterized by less disinflationary pressure than weak domestic demand, such a sizable reduction in aggregate demand still significantly reduces inflation. However, a faster decline in inflation is counterbalanced by higher production costs stemming from the pandemic-related constraints facing firms. According to the current forecast, all else being equal, inflation will remain above the target in 2020. However, inflation is expected to fall below the target next year 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 during 2021.

As expected, on the back of supply-side disruptions, inflation remains relatively 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.

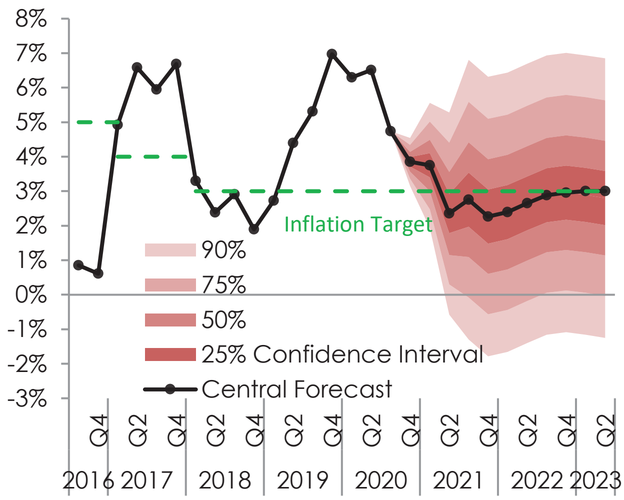

Figure 1. Headline CPI inflation forecast

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. Actual annual inflation in the third quarter of 2020 was 4.8%, as forecast. 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.

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

As for economic activity, according to the NBG's current **forecast, real GDP** will decrease by 5% in 2020, while it is expected to increase by 5% in 2021 (see Figure 2), which means that the current forecast has remained unchanged. Although the real GDP growth forecast for 2020-2021 has remained unchanged, the decomposition of this growth has changed slightly. According to the updated forecast, although some firms may exit the market amid the prolongation of weak external demand, thereby reducing potential GDP, strong lending will strengthen domestic demand. Such changes in the driving forces mean slightly less disinflationary pressure, which is also reflected on the inflation forecast.

After a 5% decline in real GDP, mostly as a result of declining net exports, real GDP growth is expected to be a positive 5% in 2021. The latter is mostly going to be driven by domestic demand – consumption and investments.

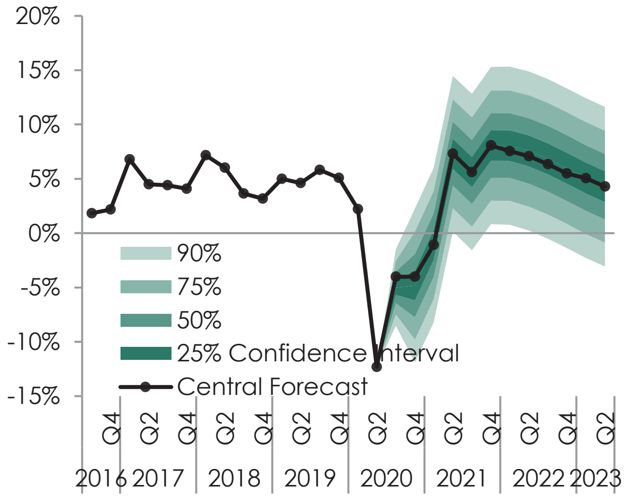

Figure 2. Annual growth forecast of quarterly real GDP

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, rate cuts will be relatively slow initially.

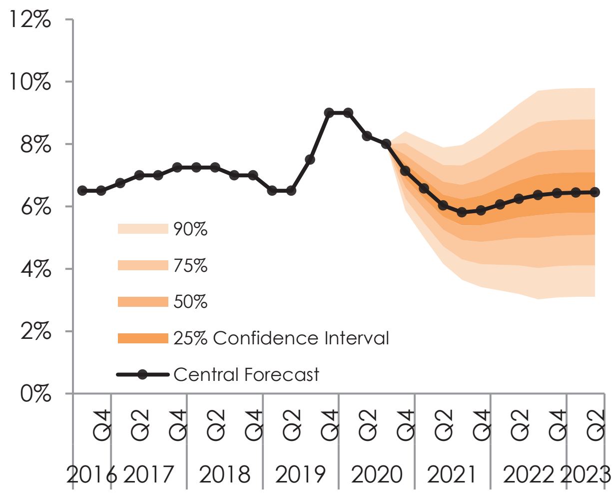

Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

Despite the significant aid received from international financial institutions, which should partially offset the effects of the severe shock caused by the pandemic, 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 prove to 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 for 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 the exchange rate dynamics, with a significant depreciation of the lari observed in the previous period. Thus far, the exchange rate has been one of the reasons for rising inflation; however, further growth of inflation has been limited by the weak economic activity observed in the current crisis.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Amid the COVID-19 pandemic, there will be a significant downturn of the global economy in 2020. However, with the easing of pandemic-related restrictions, economic activity is expected to recover from next year.

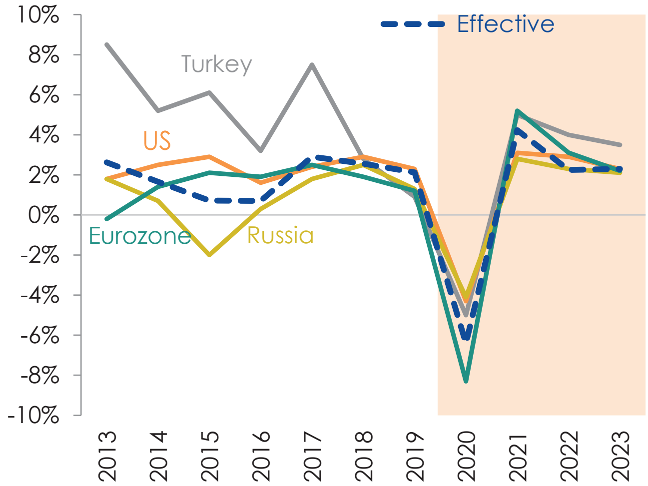

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

The year 2020 has been challenging for the global economy. Amid restrictions imposed due to the COVID-19 pandemic, economic and business activities have been hampered, domestic demand has deteriorated, and supply chains and production process faced disruption. This has led to the deepest recession in both developed and developing countries. Most employed people transferred to remote (distance) working arrangements. However, after the second quarter, with the gradual easing of restrictions, economic activity has slightly recovered. According to the International Monetary Fund's (IMF) forecast[1], **global economic growth** in 2020 will be -4.4%, which is 0.5 percentage points (pp) above the previous forecast.[2] After the spread of the virus slows, economic activity should stabilize, and growth in 2021 is projected at 5.2%. For emerging and developing countries, the real GDP growth forecast for 2020 is -3.3%, but this is expected to recover to 6% in 2021.[3]

After a record decline in economic activity, the growth rate in the **US** slightly stabilized in the third quarter of 2020, mainly due to the easing of pandemic-related restrictions. Amid a decline in imports, the external sector recovered slightly. The unemployment rate also declined. However, there is low activity in the manufacturing sector as a result of prolonged restrictions in individual states, and industrial production has also fallen. In addition, the drop in oil prices had a negative impact on the investment environment. According to the IMF's October forecast, real GDP growth in

1 International Monetary Fund. 2020. World Economic Outlook: A Long and Difficult Ascent. Washington, D.C., October.
2 International Monetary Fund. 2020. World Economic Outlook Update: A Crisis Like No Other, An Uncertain Recovery. Washington, D.C., June.
3 International Monetary Fund. 2020. World Economic Outlook: A Long and Difficult Ascent. Washington, D.C., October.

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

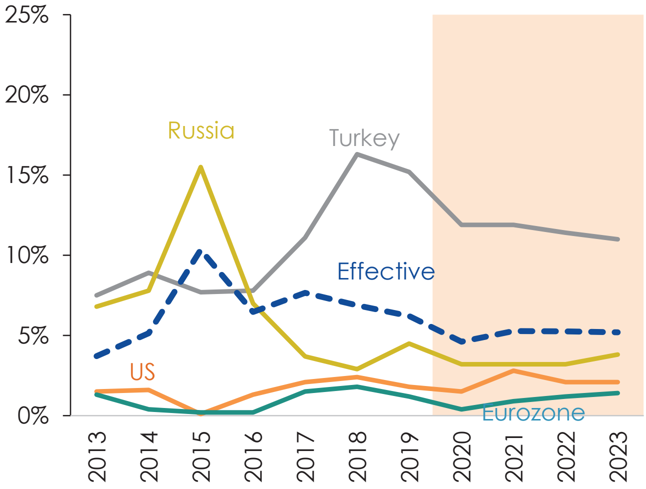

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

the US will be -4.3% in 2020 and 3.1% in 2021. The inflation rate will be 1.5% in 2020 and 2.8% in 2021.[4]

In the third quarter of 2020, weak economic activity continued in the **eurozone**. The rapid spread of COVID-19 led to a significant deterioration in the manufacturing and tourism sectors, and retail sales also fell. The volume of exports and investments declined due to reduced demand from trading partners. Consumer and business sentiment have also weakened. However, growth is expected to recover alongside a lessening of restrictions by the end of the year. According to the IMF's October forecast, real GDP growth in the eurozone will be -8.3% for 2020 and 5.2% for 2021. The inflation rate is expected to be 0.4% in 2020 and 0.9% in 2021.[5]

In the third quarter of 2020, economic activity was low in **Turkey**, mostly because of pandemic-related restrictions leading to a deterioration in both domestic and external demand. The volume of exports and investments decreased. Consumer and business sentiment have also weakened. However, an easing of the restrictions should stabilize the situation. Inflationary pressure remains high, with annual inflation standing at 11.75% in September. The IMF forecasts that real GDP growth in Turkey will be -5% in 2020 and 5% in 2021. Inflation is expected to be 11.9% in both 2020 and 2021.[6]

Economic activity has deteriorated in **Russia** as well. This was mostly driven by the sharp drop in oil prices and a deteriorating foreign sector amid the COVID-19 pandemic, which saw the volume of exports decline sharply. The oil extraction, production and refining sectors have also weakened. Despite a depreciation of the local currency, annual inflation was low and equaled 3.7% in September. According to the IMF's October forecast, real GDP growth in Russia will be -4.1% in 2020 and 2.8% in 2021. The inflation rate is expected to be 3.2% in both 2020 and 2021.[7]

In the third quarter of 2020, low activity was observed in **Ukraine** too, mostly due to the global slowdown in trade amid the COVID-19 pandemic. The volume of investments and exports also decreased. Although consumer spending has improved slightly since July, the situation may get worse due to prolonged restrictions within the country. Annual inflation was relatively low in September at 2.3% – a result of the reforms undertaken by the government and the Central Bank. According to the IMF's forecast, Ukraine's real GDP growth will be -7.2% in 2020 and 3% in 2021. The inflation rate is expected to be 3.2% in 2020 and 6% in 2021.[8]

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4 International Monetary Fund. 2020. World Economic Outlook: A Long and Difficult Ascent. Washington, D.C., October.
5 Ibid.
6 Ibid.
7 Ibid.
8 Ibid.

In 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 amid the deep recession.

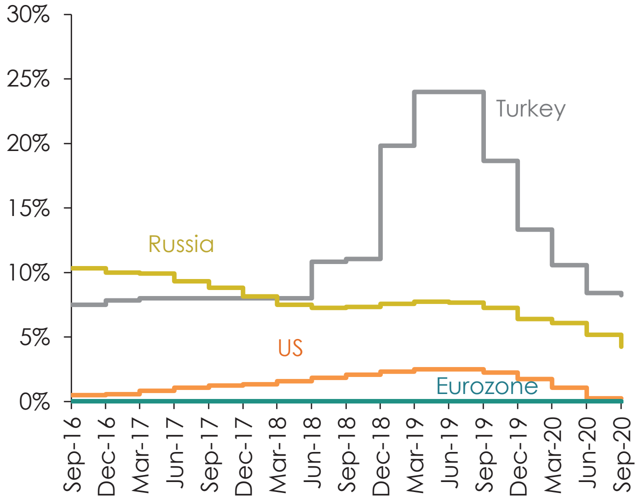


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

In the third quarter of 2020, the growth rate slowed in **Armenia**. This was mostly driven by a reduction in investments, trade and industrial production amid the COVID-19 pandemic, as well as being a consequence of the 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, real GDP growth in Armenia will be -4.5% in 2020, while inflation is expected to be 0.9%. The economic growth and inflation forecasts for 2021 are 3.5% and 2% respectively.[9]

In **Azerbaijan**, economic activity has slowed in both the oil and the non-oil sectors. Amid a collapse in oil prices, oil extraction and production decreased, which led to a deterioration in exports and external demand. According to the IMF's forecast, real GDP growth in Azerbaijan will be -4% in 2020, while annual inflation is expected to be 3%. In 2021, economic growth and inflation are projected at 2% and 3.1% respectively.[10] In addition, the war between Armenia and Azerbaijan, which started on 27 September, is likely to cause significant economic damage for both countries.

The **central banks** of Georgia's main trading partners reduced their monetary policy rates significantly in 2020 to encourage domestic demand amid the COVID-19 pandemic. The US Federal Reserve has eased its monetary policy and cut the federal funds rate 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 amid the COVID-19 pandemic.

9 International Monetary Fund. 2020. World Economic Outlook: A Long and Difficult Ascent. Washington, D.C., October.
10 Ibid.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the third quarter, registered exports of goods declined by 5.0% annually.

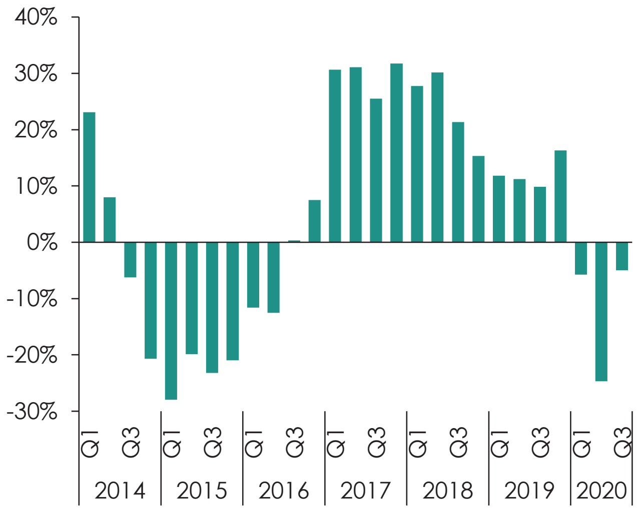


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

The decline in exports of goods stemmed mainly from the decline of external demand on consumer and investment goods.

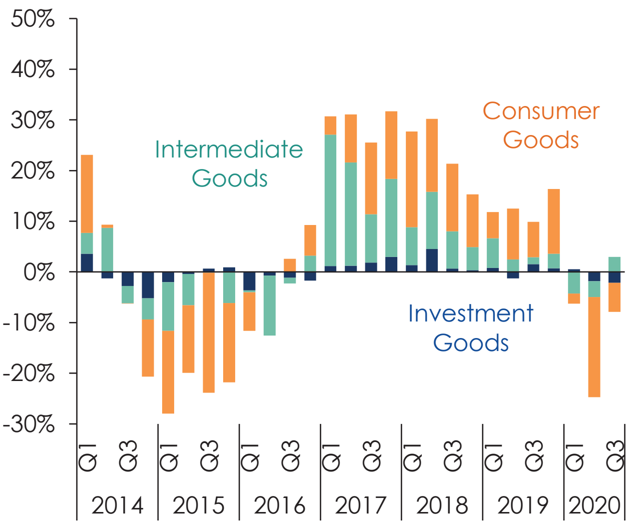


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

External demand continued to decline in the third 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 continued to maintain restrictions that negatively affected not only internal economic activities and economic growth perspectives, but also international trade and tourism. Hence, as expected, economic activity in Georgia's trade partners decelerated, which, from autumn, was accompanied by military clashes between Armenia and Azerbaijan. This all negatively affected demand for exports of goods and services, especially tourism, from Georgia. In contrast, the growth of money transfers accelerated and showed a significant increase in the third quarter. In light of weaker domestic demand and lower external inflows, 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 5.0% annually in the third quarter of 2020 (see Figure 1.2.1). The volume of exports to Armenia, Azerbaijan and other countries in the region substantially declined. In the third quarter, the reduction of exports to Armenia made the highest contribution to the overall decline (a -6.9 pp contribution annually), which was mainly a consequence of lower demand for motor cars and motor vehicles for the transport of goods, machinery and alcoholic beverages. Meanwhile, exports to Azerbaijan declined mainly in terms of substantially lower levels of exports of motor cars, bulldozers and cigarettes. In contrast, exports to Ukraine increased mainly due to higher sales of motor cars, alcoholic beverages, natural grape wines and chemical fertilizers, while exports to Russia rose due to increased sales of ferro-alloys, mineral waters, various fruits and medicaments. For European countries, exports to Bulgaria 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 from China.

Exports of goods fell mainly due to low demand for consumer and investment goods, while exports of intermediate goods increased (see Figure 1.2.2). The decline in consumer goods stemmed mainly from 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 substantial rise.

Following the restrictions on international flights and the closure of the borders of Georgia, the number of international visitors continued to decline in the

Revenues from international travelers continued to decline.

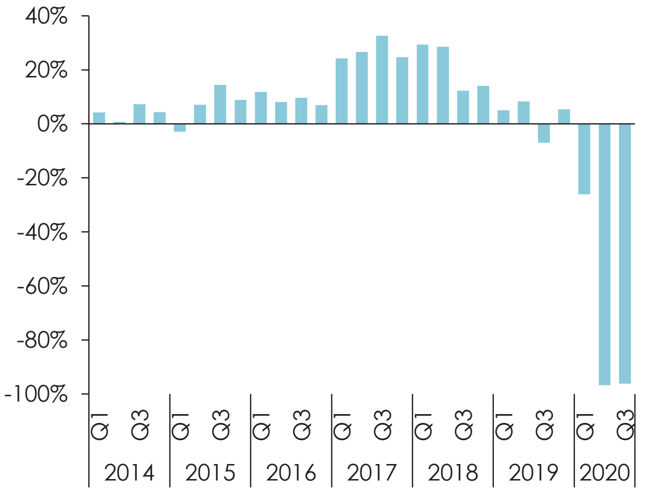


Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

Money transfers increased significantly.

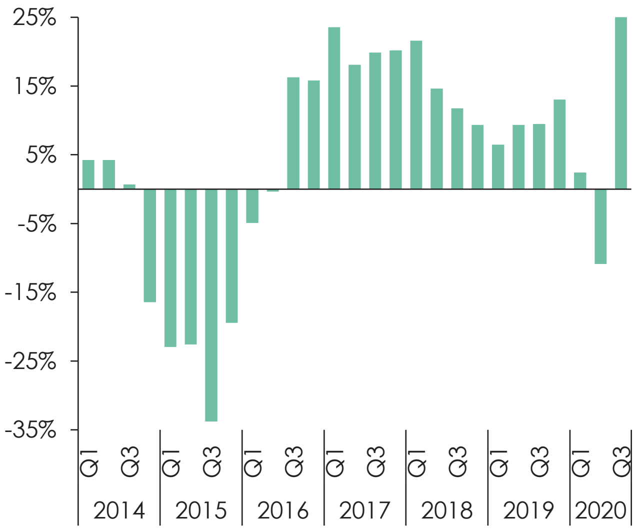


Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

In the third quarter, registered imports of goods continued to decline.

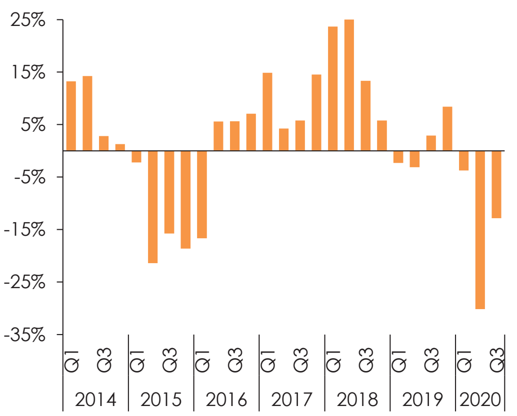


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

third quarter, falling by 94.9% annually. Meanwhile, against the background of the reduced number of visitors, revenues from international travelers fell by 96.2% annually (see Figure 1.2.3). Revenues from international travelers are expected to be negligible until the national borders reopen and international tourism recovers, which is likely to happen from next year.

In the third quarter of 2020, money transfers to Georgia increased by 25.5% annually (see Figure 1.2.4). It is worth noting that after the decline observed in April and May, money transfers increased from mid-summer and amounted 565.7 million USD in the third quarter. Once again, transfers from the EU (especially from Italy, Greece and Germany), Ukraine and the USA made the largest contributions to total growth.

Considering decreased external activities and weaker domestic demand, imports of goods declined, falling by 12.8% annually in the third quarter (see Figure 1.2.5). The decline in imports from regional countries was significant, particularly those from Turkey, while the decline from the USA, Germany and China also continued. In contrast, imports from Armenia increased because of higher imports of copper ores and concentrates for subsequent re-export.

In the third quarter of 2020, imports of all types of goods (intermediate, consumer and investment goods) declined (see Figure 1.2.6). This reduction predominantly stemmed from lower imports of consumer goods – 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.

In the second quarter of 2020, in light of decreased exports of goods and services, as well as lower money transfers, the current account deficit increased by 167 million USD and amounted to 337 million USD, which was 9.4% of quarterly GDP. This was a rise of 5.5 percentage points compared to the same indicator from the second quarter of 2019. After the worsening of the current account in 2020, it is likely that the current account deficit will start to decline in 2021.

The primary source of financing the current account deficit is foreign direct investments, which increased by 0.5% annually in the second quarter and reached 237.8 million USD. The largest of these investments went to the finance, energy and construction sectors.

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

In the third quarter of 2020, imports of consumer goods exhibited the largest decline.

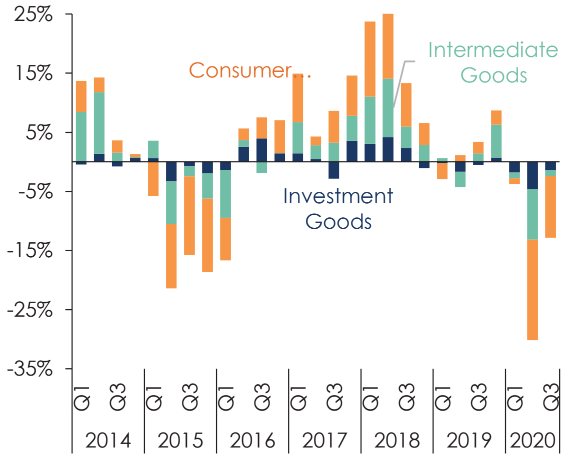
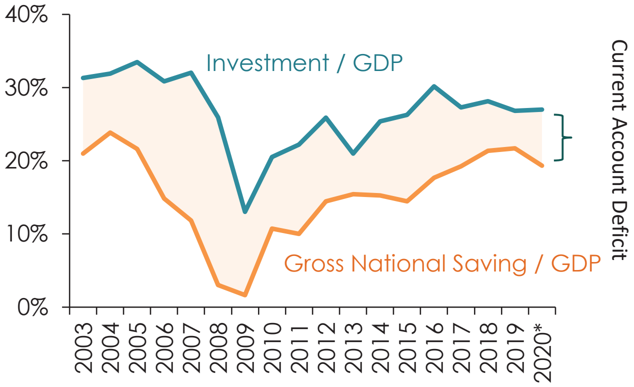


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

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



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

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the second quarter of 2020, real GDP fell by 12.3%. As the COVID-19 pandemic has primarily affected tourism-related industries, the largest decline was observed in the service sector, with net exports making a -7.8 percentage points (pp) contribution.

The contribution of consumption and gross capital formation/investment to the economic downturn was relatively small at -2.9 pp and -1.6 pp, respectively

Net exports made the largest contribution to the GDP decline.

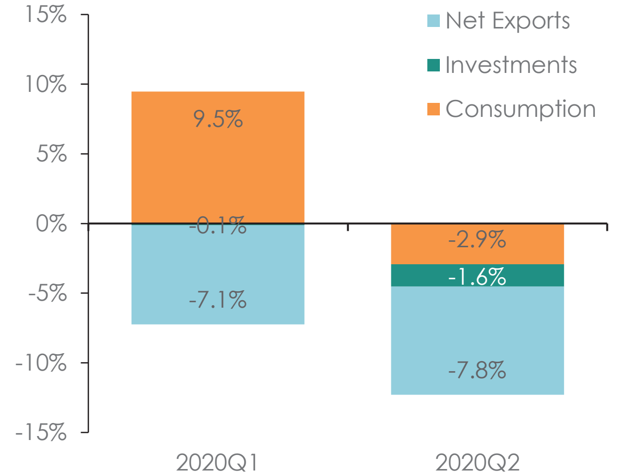


Figure 1.3.1. Contributions to GDP growth by category of use

Source: GeoStat.

1.3.2 OUTPUT

The largest negative contribution to the 12.3% decline of GDP was made by the services sector (-9.8 pp). The industrial sectors contributed by a negative 2.8 pp, while the contribution of agriculture was positive at 0.3 pp.

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 closure of national borders, the entry of foreign visitors to the country basically stopped.

The pandemic primarily affected tourism-related services, which have been a major driver of economic growth in recent years.

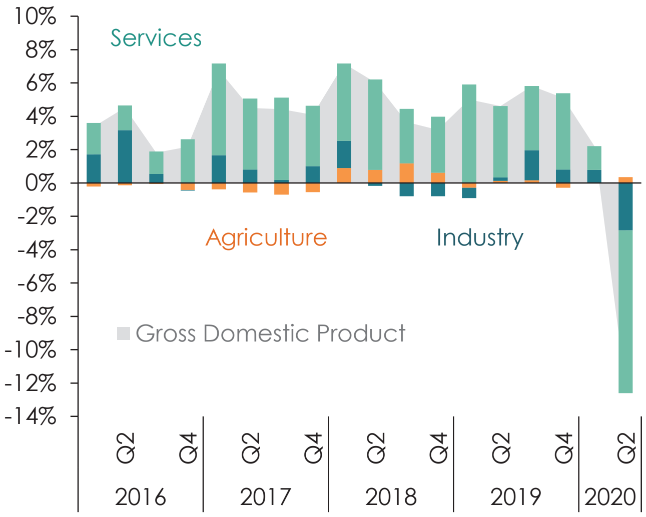


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

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. In the second quarter, amid almost no foreign visitors, the most significant decline was observed in accommodation and catering activities, with the largest share coming from hotels and restaurants. The output of this sector decreased by 40% compared to the corresponding period of the previous year, making a 1.7 pp negative contribution to the overall economic decline. The transport sector, where the contribution of travel agencies is significant, decreased by 22.6% (a -1.3 pp contribution to the decline of GDP). The largest sector of the economy, trade, decreased by 13.2% (making a -1.7 pp contribution to the GDP decline).

In the industrial sector, the most remarkable decline and negative contributions to GDP growth were observed in construction and manufacturing, which fell by 24.5% (1.7 pp) and 12.1% (1.0 pp), respectively. To some extent the decline in manufacturing can be attributed to the decline in foreign demand and lower exports of goods.

The pandemic had less of an impact on agriculture, which grew by 4.7%.

1.4 LABOR MARKET

A 9.0% increase in unit labor cost affects prices in an upward direction.

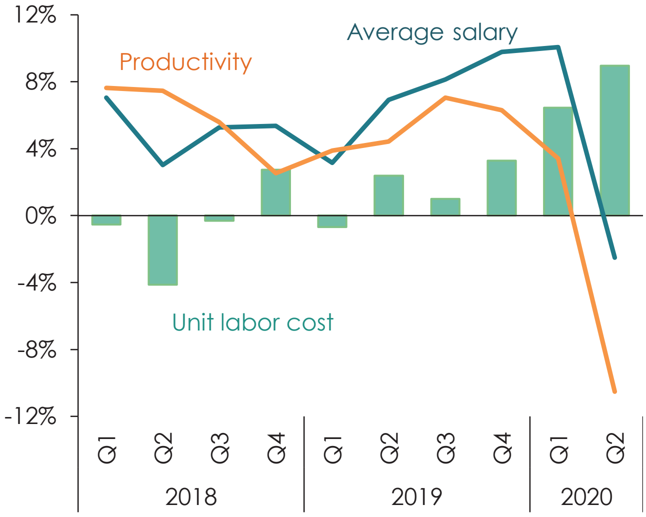


Figure 1.4.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat; NBG calculations.

Amid a 12.3% slowdown of the economy in the second quarter of 2020, the number of employees fell by 1.9% year on year. As a result, the real value added produced per employee (labor productivity/productivity) in the country's economy decreased by 10.5% annually.

In the second quarter of 2020, the salaries of employees averaged 1,150 GEL, which was a 2.5% nominal annual decrease.

The unit labor cost rose by 9.0% annually, which was 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. An increase of unit labor cost affects prices in an upward direction. However, in the face of the pandemic, given the supply constraints and declining output, this increase was expected. In subsequent periods, the recovery from the economic downturn will push unit labor cost in a downward direction.

1.5 FINANCIAL MARKET AND TRENDS

1.5.1 LOANS

In September, the loan portfolio decreased and stood at 12.0%, excluding the effect of exchange rate fluctuations.

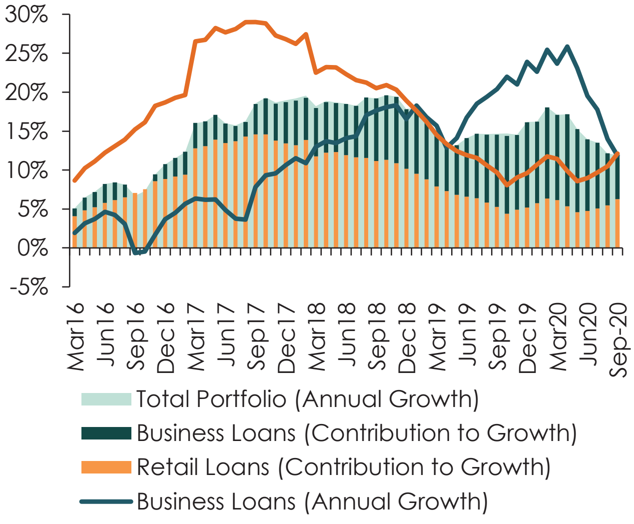


Figure 1.5.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In September, relative to June, the loan portfolio decreased and stood at 12.0% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 3.1 pp and stood at 12.1%, while loans to legal entities decreased by 7.7 pp and equaled 11.8% (see Figure 1.5.1). The growth of business loans was primarily driven by an increase in loans issued to the trade, agriculture, construction and manufacturing sectors, whereas loans issued to the energy sector decreased. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for business and retail loans.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the third quarter of 2020 was driven by domestic currency loans (see Figure 1.5.2). In September, the annual growth rate of foreign currency-denominated loans decreased and stood at 9.6%, while the growth rate of loans in the domestic currency decreased by 2.3 pp and equaled 14.8%. In the third quarter, the loan larization ratio did not change significantly and equaled 42.5%. 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 third quarter of 2020, the growth of the loan portfolio was mainly driven by an increase in domestic currency loans.

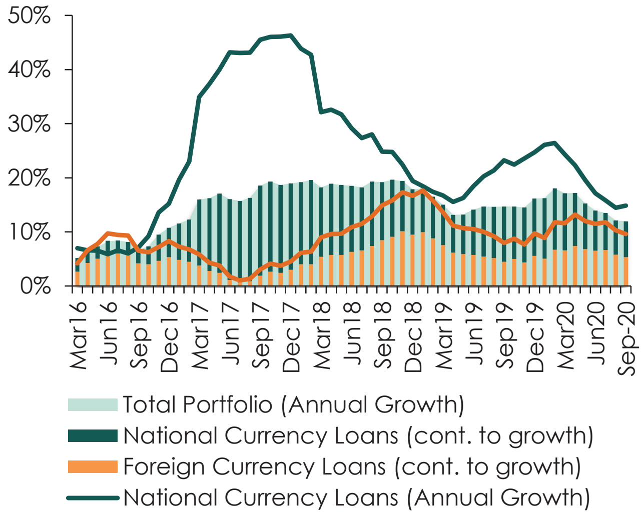


Figure 1.5.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In September, the monetary policy rate was 8.0%. In the third quarter of 2020, interest rates on government securities fell as a result of the 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 decreased. 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 September, relative to June, interest rates on domestic currency deposits decreased by 0.7 pp and equaled 9.2%. Meanwhile, interest rates on foreign currency deposits decreased slightly and equaled 2.8%. 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 and consumer loans have not changed significantly. In terms of credit conditions for legal entities, representatives of the banking sector do not expect a significant change in the next quar-

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

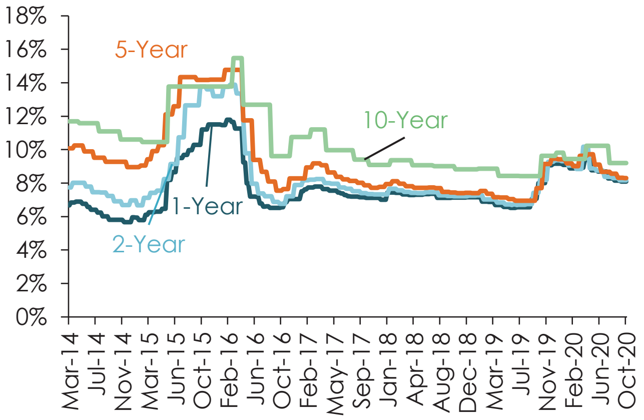


Figure 1.5.3. Interest rates on government securities

Source: National Bank of Georgia

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

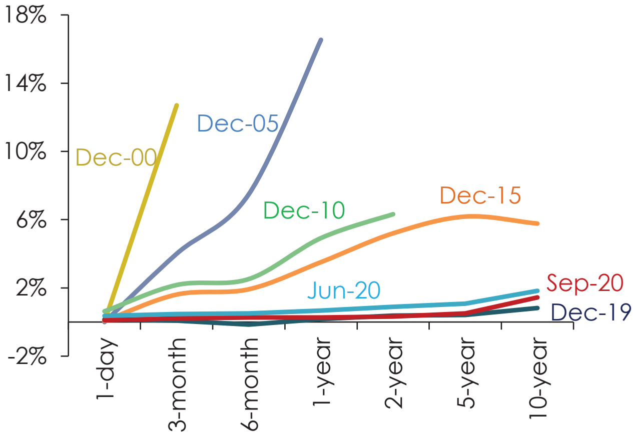


Figure 1.5.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

As of September, relative to June, average interest rates on the stock of legal entities for domestic and foreign currency loans have not changed significantly.

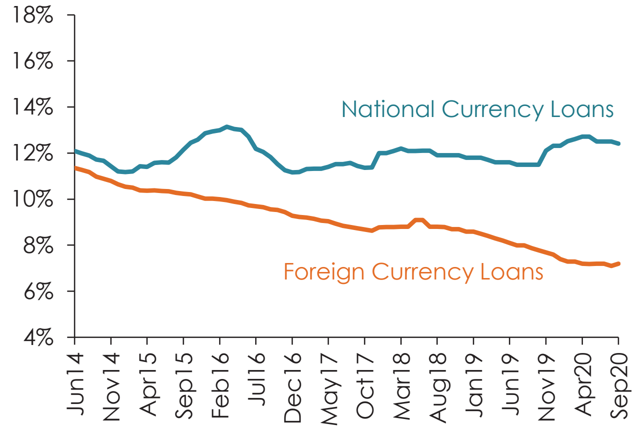


Figure 1.5.5. Average interest rates on business loans

Source: National Bank of Georgia

ter. 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 September, relative to June, interest rates on loans for small and medium enterprises (SME) and corporate loans increased slightly. Interest rates on SME loans increased by 0.6 pp and equaled 10.8%, while interest rates on corporate loans increased by 0.4 pp and stood at 9.2%. Meanwhile, interest rates on retail loans decreased by 0.9 pp and equaled 15.0%.

As of September, average interest rates on the stock of legal entities for both domestic and foreign currency loans have not changed significantly since June (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

The real effective exchange rate remains undervalued (annual appreciation 0.8%).

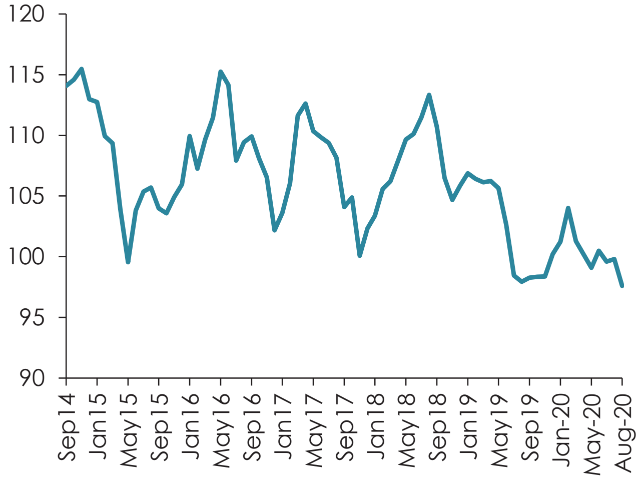


Figure 1.5.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

In the third quarter of 2020, the GEL nominal exchange rate appreciated against the US dollar by 1.1% compared to the previous quarter, but depreciated against the euro by 5.0%. The GEL appreciated against the Turkish lira and the Russian ruble by 5.8% and by 2.8% respectively. In the same period, the nominal effective exchange rate appreciated by 0.7% on a quarterly basis and depreciated by 0.2% on an annual basis. As for the price-adjusted exchange rate, in the third quarter of 2020 the real effective exchange rate depreciated by 0.9% on a quarterly basis and appreciated by 0.8% on a year-on-year basis (see Figure 1.5.6). It should be noted that while the real exchange rate depreciated against some trading partner countries, it appreciated against the currencies of Russia, Turkey and Ukraine (see Table 1.5.1). When adjusted for commodity groups and services, the nominal effective exchange rate reveals slightly different dynamics than the official rate. In the third quarter of 2020, the adjusted nominal effective exchange rate appreciated by 1.0% on a quarterly basis and depreciated by 1.2% on an annual basis (see Figure 1.5.7).

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

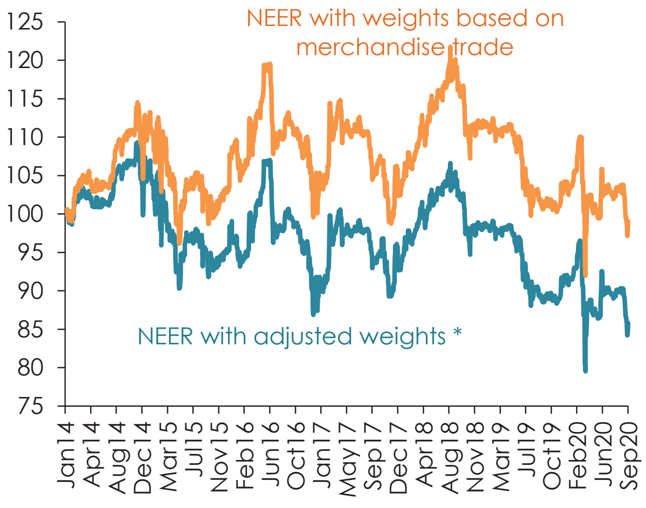


Figure 1.5.7. Corrected nominal effective exchange rate

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	0.0	0.8	0.8
Eurozone	-10.3	-6.1	-1.1
Turkey	19.6	12.1	2.3
Ukraine	3.0	5.3	0.4
Armenia	-4.0	-1.0	-0.1
US	-5.9	-2.6	-0.1
Russia	7.4	8.6	1.3
Azerbaijan	-5.9	-3.9	-0.4
Other	-8.0	-6.5	-1.4

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

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

Core inflation exceeds headline inflation due to the depreciation of the lari nominal effective exchange rate and the rise in product prices resulting from pandemic-related constraints.

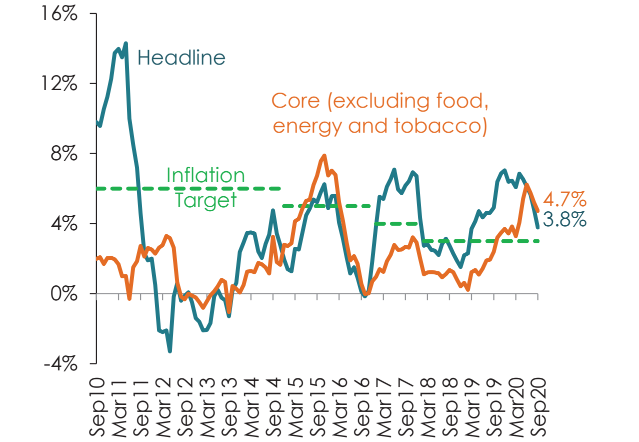


Figure 1.6.1. Headline and core inflation

Source: GeoStat

Along with the reduction of headline inflation, food inflation is also declining.

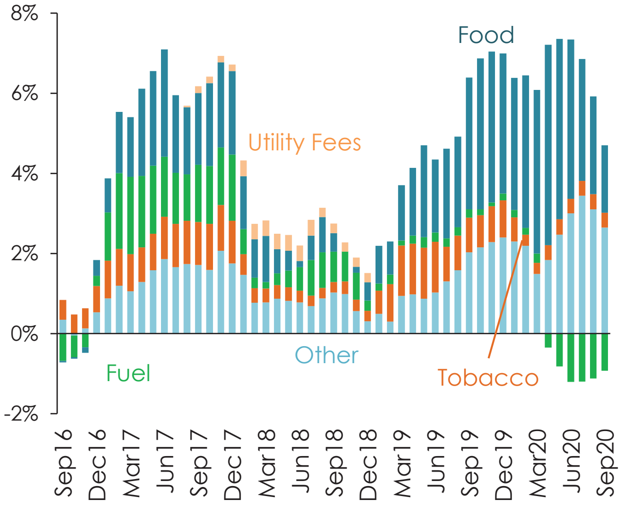


Figure 1.6.2. Contribution of different products to inflation

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 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 and lower fuel prices due to lower oil prices on the world market put downward pressure on inflation.

As a result of these factors, the decline in inflation was slower than had been expected before the pandemic. Inflation fell to 3.8% in September. Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, has exceeded headline inflation since June; however, this also has a downward trend, falling to 4.7% in September. 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.

In the spring, at the start of the pandemic, world oil prices fell sharply. Along with the passage of the first wave of the pandemic, oil prices began to recover, although still remaining significantly lower than in the previous year. Since April, fuel prices in Georgia have affected prices in a downward direction. Despite rising in September, gasoline, diesel and gas prices reduced annual inflation by 0.9 percentage points in September.

Together with the decline in headline inflation, since May a downward trend has also been observed in food inflation, which fell by 6.1% in September. 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

Low inflation on imported goods is explained by the annual decline in fuel prices.

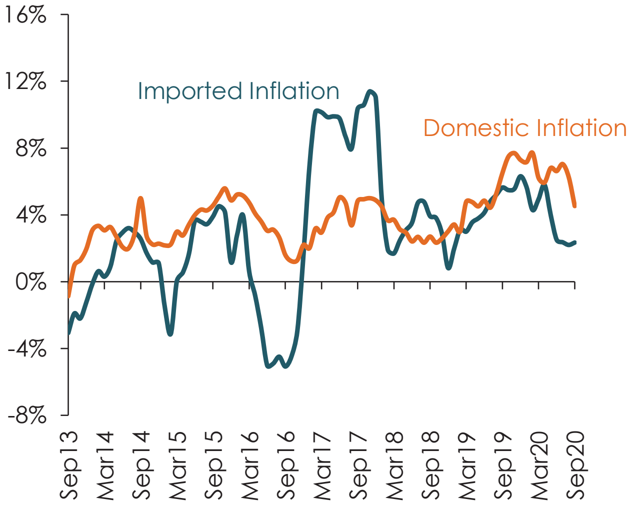


Figure 1.6.3. Imported and Domestic inflation

Source: GeoStat

overall inflation rate. Of the 3.8% total inflation, 1.7 pp came from food (see Figure 1.6.2).

In September, inflation for imported, domestically produced, and mixed goods was 2.3%, 4.5%, and 3.7%, respectively. The relatively low inflation of imported goods can be explained by the reduction of fuel prices. If fuel were excluded from this calculation, the inflation of imported goods would stand at 7.5%.

2 MACROECONOMIC FORECAST

Amid declining external demand and unprecedented restrictions on domestic economic activity, the COVID-19 pandemic will lead to a 5% decline in real GDP in 2020. However, the recovery process that started in the second half of the year is expected to continue in 2021, putting economic growth within 5%. On the forecast horizon, headline inflation is expected to remain close to the target due to a counterbalancing of factors acting in opposite directions: sharply reduced demand will continue to exert significant negative pressure on consumer prices, while increased unit labor costs and the effects of the depreciated exchange rate will put upwards pressure on inflation. Against this background, a cautious monetary policy stance will be maintained, which will be reflected in a gradual and moderate reduction of the interest rate.
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, cross-border mobility will likely be limited for a longer period. Meanwhile, regional tension creates risk to the economic outlook. 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 the process of economic recovery in 2021 will be slower than in the baseline scenario. The aggravation of external shocks raises the country's risk premium and creates currency depreciation pressures. Subsequently, the debt burdens of producers increase, which pushes prices up. In this alternative scenario, inflation will remain above the target for a longer period, while monetary policy will be tighter.

2.1 BASELINE MACROECONOMIC FORECAST

Headline inflation on the forecast horizon will largely remain close to the target.

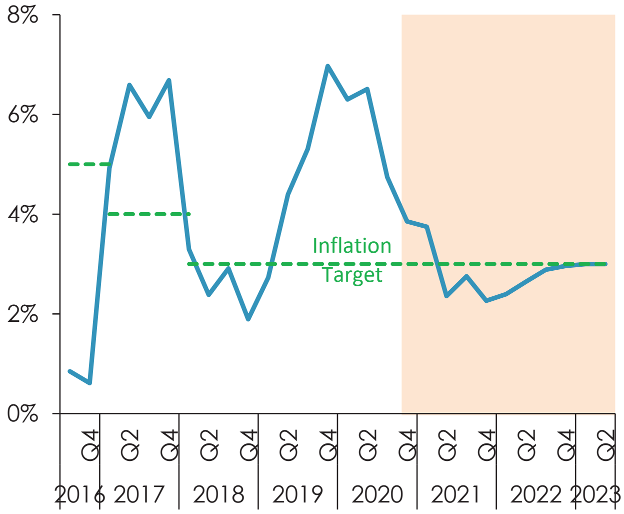


Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

In the third quarter of 2020, headline inflation continued to decline in line with the previous forecast and stood at 4.8% year on year (see Figure 2.1.1). The sharply weakened economic activity continued to put significant downward pressure on consumer prices, partly offsetting the effects of the depreciation of the lari exchange rate and rising unit labor costs that were observed in the previous period. As was expected, the latter increased in the first half of the year due to restrictions related to the efforts to contain the pandemic (see Figure 1.4.1). This has pushed some companies towards price increases.

Despite weak demand, the continuation of restrictions will see input costs continue to make a significant contribution to the deviation of inflation from the target (see Figure 2.1.2). As a result, according to the current forecast, inflation will remain above the target for the next two quarters. After that, in the wake of the weakening effect of input costs, inflation will temporarily fall below the target and eventually approach it from below. A gradual and moderate monetary policy response will also help ensure that long-term inflation expectations fall below the target.

After a sharp drop in aggregate demand in the first half of the year, the economy showed signs of recovery in the third quarter. Real GDP fell by only 3.8% year on year in the third quarter, amid growth in fiscal

Reducing the deviation from the inflation target is conditioned by balancing factors that act in opposite directions.

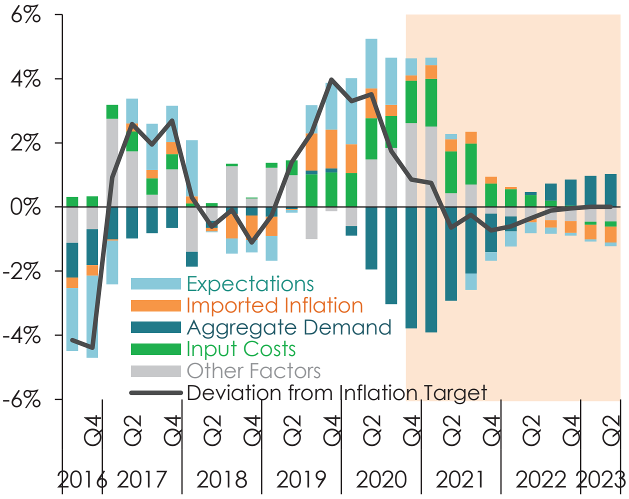


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

The decline in real GDP this year is 5%, however, according to the current forecast, economic activity next year will equal 2019 levels.

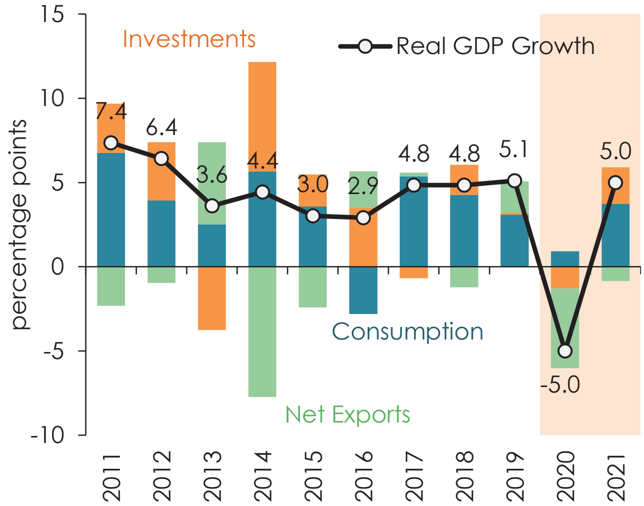


Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

stimulus, domestic tourism activity, lending, and remittances. According to the current forecast, the decline in real GDP by 2020 is expected to be within 5% (see Figure 2.1.3). As for the components of GDP, the decline is mainly a result of lower net exports, while consumption will make a slightly positive contribution – partly due to its strong growth observed in the first quarter of the year.

The current forecast sees the economy grow by 5% in 2021, even though the foreign tourism sector, which has been severely affected by the pandemic, will only begin to recover gradually with the reopening of borders and the lifting of restrictions. Against the background of maintaining credit activity, consumption and investment will make a positive contribution to real GDP growth.

The current forecasts are naturally accompanied by great uncertainty. A deterioration of the situation related to the spread of the virus or concerning the development and availability of a vaccine may have a strong impact on the dynamics of macroeconomic variables during the forecast period. On the one hand, a growing spread of the virus within the country and the introduction of restrictive measures will further curtail economic activity, which will put downward pressure on inflation and only partially offset the effects of increased spending as a result of tighter regulations. On the other hand, a long delay in the availability of a vaccine would lead to the prolongation of restrictions, which in turn will push some companies towards liquidation and further reduce economic activity. Conversely, a worsening of the epidemiological situation in Georgia's trading partners or a worsening of the geopolitical situation in the region may lead to rising inflation: expectations for exports of goods and declining remittances will worsen expectations, which will negatively affect the country's currency and sovereign risk premia. The latter will put upward pressure on consumer prices through the channels of imported inflation and companies' higher input costs.

In the face of projected inflation and growing uncertainty, monetary policy will maintain a cautious and moderate approach. It is expected that the policy rate will continue to be lowered, but at a slower pace than previously predicted. In the medium term, given the dynamics of inflation expectations, the rate may even fall below its neutral level, which is currently estimated at 6.5%.

Compared to the previous projection, the inflation forecast has been revised slightly upward as a result of a revision of the estimates of potential real GDP. The COVID-19 pandemic is expected to continue longer than previously expected, which will shift potential real GDP down. Consequently, the size of the negative output gap and the disinflationary impact have been reduced.

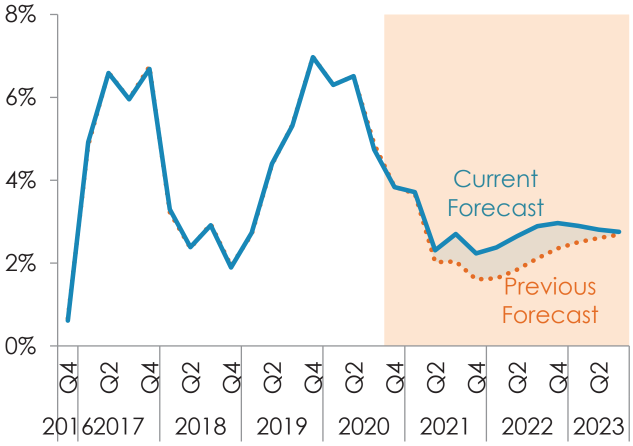


Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The projection of economic growth is the same as in the previous forecast. Real GDP will decline by 5% in 2020 and economic recovery is expected to start in 2021.

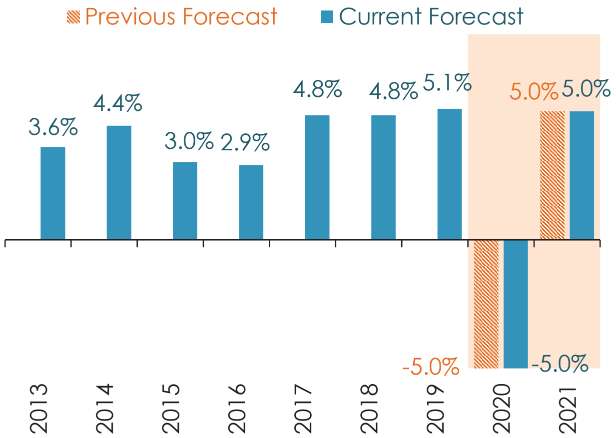


Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised slightly upward (see Figure 2.2.1). In the wake of the COVID-19 pandemic, supply-side disruptions and interruptions in transportation and logistics pushed prices up. However, as expected, this effect was only temporary, and inflation subsequently started to fall. Based on the updated forecast, weak demand will outweigh the supply-side effects and inflation will continue to fall back to the target. In the medium term, inflation is predicted to fall below the target level and subsequently approach the target from below. However, the undershooting of inflation in the medium term is projected to be smaller than previously forecast. The revision of the estimates of potential real GDP has led to an upwards shift in the inflation outlook. The COVID-19 pandemic is expected to continue for longer than previously expected. Containment measures (such as travel restrictions and voluntary social distancing) have a particularly acute impact on tourism and the service sectors. This could probably lead to firms exiting those sectors. Thus, the aggregate potential of the economy will decline. In this case, the size of the negative output gap is smaller, and the disinflationary impact is weaker compared to the previous forecast.

The economic outlook for the medium term has remained the same. The real GDP growth projections for 2020 and 2021 are the same as in the previous forecast (see Figure 2.2.2). As the COVID-19 pandemic has intensified and cross-border mobility continues to be restricted, a greater contraction in tourism revenues is expected compared to the previous forecast. In contrast, there are positive signs from credit activities, which will help encourage domestic economic activities. The updated projections thus show an increase in domestic demand. However, because these factors neutralize each other, the economic growth projection has remained the same as in the previous forecast.

Georgia is a small open economy and the economic stances of its trading partners thus have a significant impact on the country. The macroeconomic forecasts 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).[11]

The updated projections regarding the economic stances of Georgia's main trading partners are almost the same as in the previous forecast. Expectations about a depreciation of their currencies have increased significantly. This could be linked to expectations of a prolonged pandemic, which creates risks of capital outflow from developing economies to developed ones. Capital outflows create currency depreciation pressures and expectations of currency depreciations increase inflation expectations.

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

Projections of the economic stances of Georgia's main trading partners for 2021 have remained the same as in the previous forecast, but expectations of a depreciation of their currencies have increased, pushing inflation expectations up.

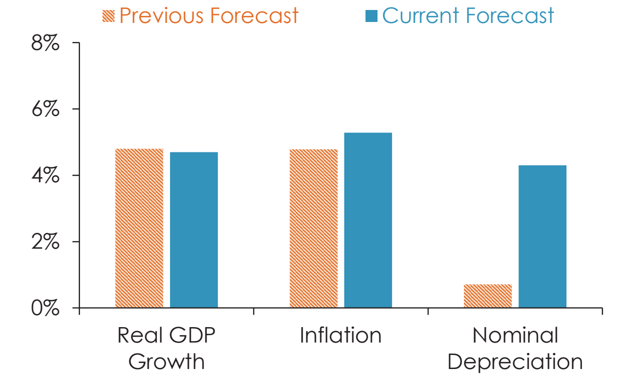


Figure 2.2.3. Changes in the forecast of external assumptions for 2021

Source: Bloomberg

The alternative forecast scenario considers a deeper recession than in the baseline scenario. In particular, a prolonged pandemic and regional tensions cause a greater reduction of external demand. In the alternative scenario, real GDP falls by -5.5% in 2020 and the economic recovery in 2021 is slower than in the baseline.

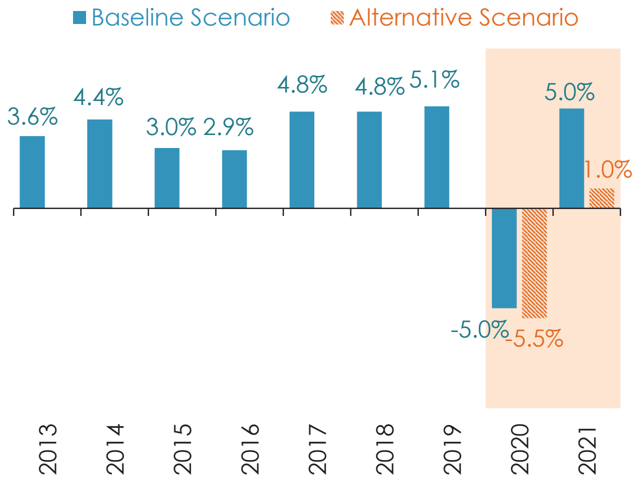


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

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. Although vaccine trials have progressed to the point where some of them have reached the final testing phase, should those trials be rejected and an effective vaccine is thus not made available soon, the economic crisis will become more severe. In this situation, travel will be restricted for longer than in the baseline scenario and the external shock will be more severe. Meanwhile, the speed at which tourism will recover remains uncertain. It is worth mentioning that a vaccine will not stop the pandemic immediately and the vaccine coverage is likely to expand only gradually. People tend to reduce their mobility because they fear contracting the virus. Based on the analysis of different countries, a rise of COVID-19 infections lowers mobility, even without lockdowns. Thus, people's willingness to start travelling even after the reopening of borders is uncertain. Meanwhile, regional tension creates risks for the economic outlook. Recently, Armenia and Azerbaijan reached an agreement to attempt to defuse their ongoing conflict, but any further escalation of regional tension will make the region riskier for investors.

The economic recession widens in the alternative scenario and real GDP decreases by 5.5% in 2020. Deteriorated net exports slow the economic recovery in 2021 compared to the baseline scenario and real GDP increases by only 1.0% (see Figure 2.3.1).

Inflation increases in the alternative forecast scenario. 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

In the alternative scenario, a prolonged pandemic and intensified regional tensions increase the currency and sovereign risk premia, which causes currency depreciation. Production costs increase as producers' debt burdens will be higher. Finally, increased imported inflation and higher input costs create inflationary pressures. Over 2020-2021, inflation will be 2.0 pp higher than in the baseline scenario.

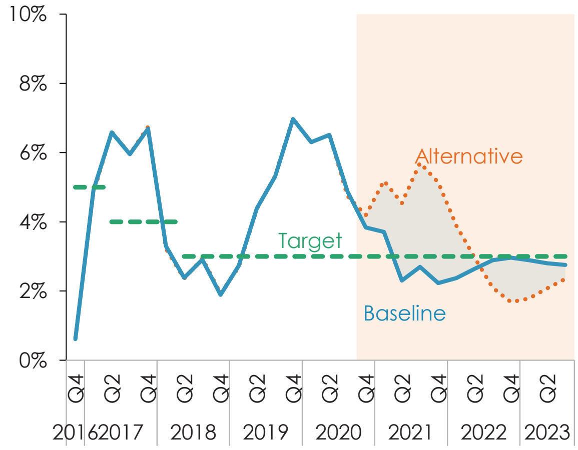


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

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 2.5 pp.

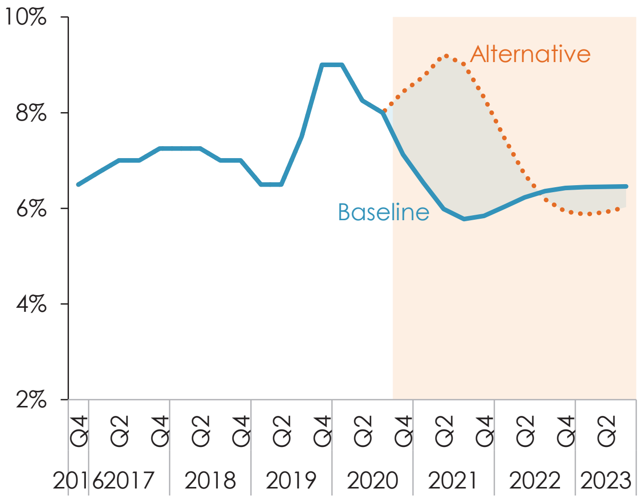


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

demand leads to an increase in the current account deficit, which creates currency depreciation pressure. Prices will rise as a result of increased direct imported inflation and higher input costs. Accordingly, over 2020-2021 inflation will be 2.0 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 2.5 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

Inflation has had a declining trend since May. Other things being equal, it is expected that this trend will continue and that inflation will remain close to the target level in 2021. The declining inflation dynamic has been driven by weak aggregate demand and this impact is expected to persist. However, it should be taken into account that there is significant uncertainty associated with the spread of the virus and the increase in geopolitical risks. Accordingly, on 28 October the Monetary Policy Committee decided to keep the refinancing rate unchanged.

Measures to curb the spread of the pandemic – leading to increased supply-side costs for some goods and services, and the depreciation of the exchange rate – resulted in an increase in the inflation rate in spring. However, since May, inflation has had a decreasing trend. Given these dynamics and the expected weakness on the demand side, the Monetary Policy Committee began to ease the monetary policy, reducing the policy rate by a cumulative 1.0 pp in April-September.

According to the decision made on 28 October 2020, the refinancing rate was kept unchanged at 8.0%.

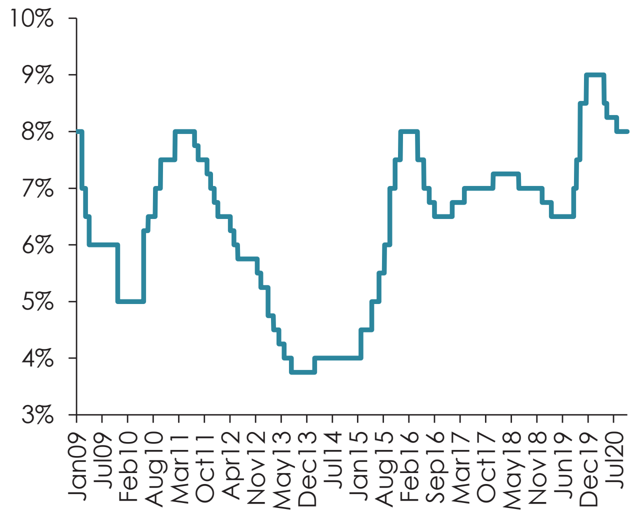


Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

The inflation dynamics in recent months are in line with the forecasts of the NBG. Annual inflation continues to decline, reaching 3.8% in September and October. According to the current forecast, other things being equal, annual inflation will continue to have a declining trend and will remain close to the target level in 2021. The declining dynamics of inflation are driven by weak aggregate demand and it is expected that this impact will persist. The decrease in external demand is especially noteworthy. The Monetary Policy Committee also took into account the uncertainty surrounding the acceleration of the virus and the increase in geopolitical risks. Given these factors, the Monetary Policy Committee decided to keep the refinancing rate unchanged at 8.0% at its meeting of 28 October 2020. According to current estimates, the pace of the gradual exit from the tight monetary policy stance (normalization) will depend on inflation expectations and the dynamics of economic activity.

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. Meanwhile, it is important to consider risks to the inflation forecast. A more severe economic crisis due to a prolonged pandemic is considered among those risks to the inflation forecast. Upside risks to inflation include a greater-than-expected decline in external demand. Additionally, regional tensions may lead to an increase in the risk premium and create additional pressure on inflation. Downside risks to 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 light of the COVID-19 pandemic, it is important not to increase liquidity risks in the financial sector. In response, the NBG 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 NBG also provides liquidity support to commercial banks and microfinance organizations through swap operations. Moreover, to facilitate lending to small- and medium-sized businesses, the liquidity support instrument is available. The NBG provides the required amount of short-term liquidity to ensure that interest rates on the interbank money market vary around the policy rate.

Interbank money market rates vary around the monetary policy rate.

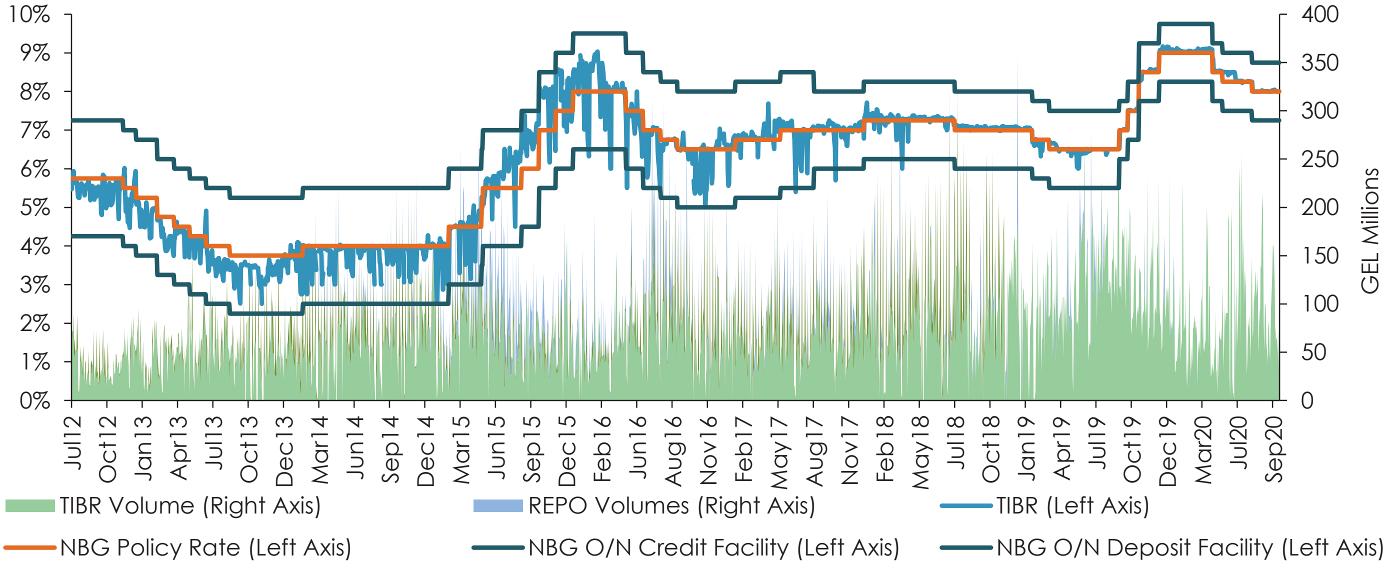


Figure 3.3. Interbank money market

Source: National Bank of Georgia

BOX 1. THE GLOBAL ECONOMIC OUTLOOK UNDER THE PANDEMIC[12]

The coronavirus pandemic is an unprecedented challenge for the world. At this time, all governments face the challenges of stopping the spread of the virus and caring for the infected, whilst at the same time seeking to stimulate the economy, to use reasonable restrictions to mitigate the crisis and to quickly restore growth.

The closure of borders at the initial stage of the pandemic virtually halted international tourism. Maximum restrictions on movement drove fuel consumption to a minimum level, filled the world's oil reservoirs and turned oil prices negative for some time. Tourism-dependent and oil-exporting countries have thus been hardest hit by the pandemic.

Government anti-crisis fiscal measures include reducing private sector losses, maintaining jobs, expanding social assistance, offering credit guarantees, and taking other supportive steps for the economy. Central banks, where possible, gradually reduced policy rates to stimulate weakening demand. These measures have reduced the number of bankruptcies and slowed down the growth of unemployment to some extent. However, if the crisis continues, many millions around the world will still be at risk of losing their jobs.

Overall, developed countries have been able to appeal for more funding, where needed, in comparison with debt-laden developing countries, for whom attracting funds is relatively difficult. Nevertheless, the International Monetary Fund (IMF) has rapidly increased funding for its member states and, together with the World Bank, has called on lenders to postpone debt repayments for low-income countries and to maximally soften the claims.

The pandemic is exacerbating socio-economic problems around the world. Pandemic conditions increase poverty and inequality. This year, an additional 90 million people will be added to the number of the extremely poor (those earning less than 1.9 USD a day). Among many other problems, the closure of schools and working at restricted hours during the pandemic have posed significant challenges for human capital development.

Along with the development of the pandemic and the measures to overcome it, the debts of countries are growing – and these debts will have to be served in the conditions of a worsened economy and lower tax revenues. Consequently, it is often difficult to lend to countries while maintaining their debt at a sustainable level that they will be able to service in the future. In such a situation, it is even more important to use resources to create long-term sources of value-added, to increase productivity and to help those who need it most.

In October, the International Monetary Fund forecast that the world economy would decrease by 4.4% in 2020. This is better than the projections of June (-5.2%). The reason for the improvement in the forecast was that, after the lockdowns in the second and third quarters of the year, the economic data were better than expected in developed countries and China.

According to the baseline scenario, social distancing will continue in 2021, however, with the distribution of a vaccine and improved treatment, these restrictions will gradually be phased out. By the end of 2022, the spread of COVID-19 will be reduced to a minimum. According to the same forecast, in 2021 the world economy will grow by 5.2% (5.4% as forecast in June), and will thus exceed the 2019 level by 0.6%. In the years following 2021, growth will slow to 3.5% in the medium term. The change in the forecasts are due, on the one hand, to the lower economic downturns projected for 2020, which are related to better-than-expected economic results after the lockdown, and, on the other hand, to the relatively low growth projected in 2021, which reflects the expectation of a longer pandemic and the base effect.

In 2020, the 8.3% economic decline in the Eurozone will be more severe than the world's average, but remains a better outcome than the -10.2% forecast made in June. However, a bigger drop is expected from the countries of southern Europe, which are more dependent on tourism. In 2021, amid the expected recovery, the Eurozone economy is expected to grow by 5.2%, representing a downwards revision of the 6.0% growth that was previously forecast.

12 *This follows the International Monetary Fund's World Economic Outlook for October 2020: https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020 .*

The GDPs of developing European countries are expected to fall by 4.6% in 2020 and to grow by 3.9% in 2021 (the June forecast predicted a 5.8% decline and a 4.2% increase respectively). The GDPs of the Middle East and Central Asia will decrease by 4.1% in 2020 and increase by 3.0% in 2021 (a 4.5% decrease and a 3.5% increase, respectively, had been predicted in June).

It should be understood that this forecast carries significant risks. Much will depend on how quickly the pandemic is contained. On the one hand, work on coronavirus vaccines are progressing at an accelerated pace, with some already in the final stages of testing, and the treatment of the virus and cooperation between countries on medical issues have both improved. On the other hand, delays in the release of a vaccine or new waves of the virus could lead to new restrictions and closures, which would further aggravate conditions.

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