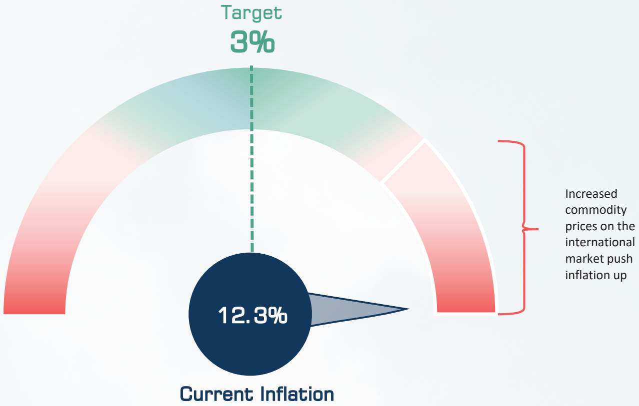
# Monetary Policy Report

October

2021

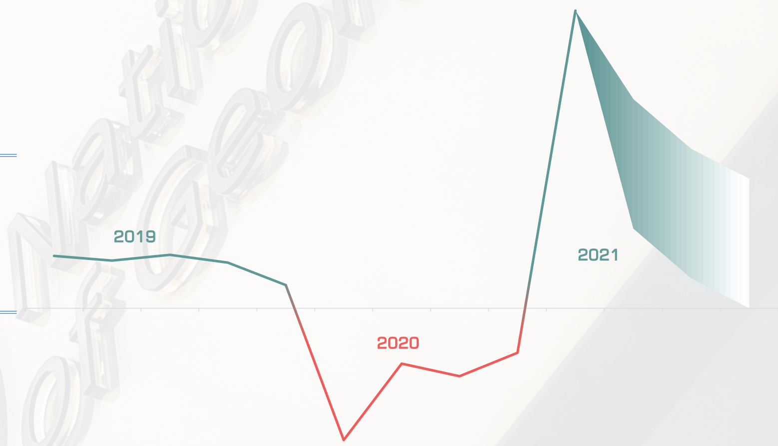
საქართველოს ეროვნული ბანკი
National Bank of Georgia

## Inflation




| | |
|---|---|
| 12.3% | Increased commodity prices on international markets have pushed inflation above the target. |

## Economic Growth




| | |
|---|---|
| After the pandemic-induced recession, the economy has started to recover in 2021. | 10.0% |

## Monetary Policy


| | |
|---|---|
| 10.0% | In order to curb inflation expectations, the NBG has maintained a tightened monetary policy stance. |

# MONETARY POLICY DECISION

**Monetary policy remains tightened as the monetary policy rate has been left unchanged at 10%.**

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

Low and stable inflation supports employment and economic growth, which are of the utmost importance during challenging times such as those now confronting us as a result of the COVID-19 pandemic.

Pandemic-induced supply-side disruptions, rising commodity prices on international markets and elevated costs of global shipping have caused inflation to rise worldwide. The transmission of global inflationary factors to the local market has led to high headline inflation in Georgia. Meanwhile, inflation expectations have also increased. A combination of these factors has led to inflation remaining above the target in 2021.

Considering rising inflation expectations and lingering risks, we have maintained a tightened monetary policy stance and kept the monetary policy rate unchanged at 10.0%. This decision aims to ensure that the current price hike does not aggravate long-run inflation expectations.

Changes in interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If strong domestic demand (which highly depends on fiscal stimulus and credit activities) or other factors further augment inflation expectations, we are ready to further tighten the monetary policy stance or to maintain the current tight position 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

*The challenges caused by the COVID-19 pandemic have been compounded by a significant increase in global consumer price inflation in 2021. The beginning of the recovery process as observed in various economies has been putting upward pressure on prices through strong fiscal stimulus, credit activity and the spending of accumulated savings. On the other hand, especially in developing countries, inflation is driven by supply-side disruptions and a sharp increase of prices on international commodity markets. The latter has had a significant impact on local consumer prices in countries like Georgia, where the dependence on imported food, raw materials, and fuel is high. Consequently, amid unprecedented global inflationary pressure over the last decade, high inflation has also been observed in Georgia and this will remain at an elevated level in the short run. It should be noted that these international factors, by their very nature, are temporary and their effect on inflation should be exhausted in the medium term. However, in the presence of such a strong supply-side shock, there also exist risks of "second round" effects and rising inflation expectations. These could prolong the process of inflation returning to its target and, consequently, impede the goal of price stability over time. In order to reduce this risk, the National Bank of Georgia has decided to maintain its tight monetary policy stance.*

*Inflation has significantly exceeded the target and will remain high in the short run. Together with the exhaustion of one-off factors and the strict monetary policy stance, inflation is forecast to start returning to its target from the second quarter of 2022.*

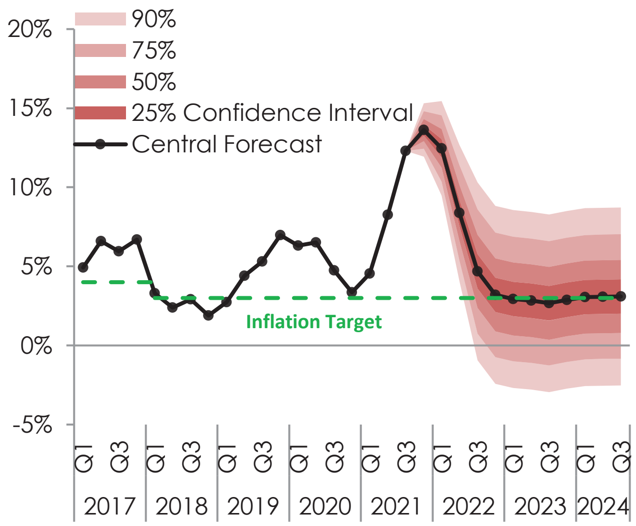


Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia

Recently, the annual inflation rate has significantly exceeded its target (see Figure 1). The reasons for this are mostly factors exogenous to monetary policy, including the high prices of products on international commodity markets and sharp rises in global shipping costs. These have been accompanied by the impact that changes in domestic utility bill prices have had on the inflation rate. In particular, the completion of the government's subsidy program on utilities caused the inflation rate of these services to rise more than the initial reduction and, statistically, led to an increase in the overall inflation rate. On the other hand, the upward revision of utility tariffs in the first half of the year became an additional reason for the increase in inflation. According to the National Bank of Georgia's recent estimates, in total, the above-mentioned factors have contributed about 2/3 of the current inflation (see Box 1). However, by their very nature, these factors are only temporary and their effect on annual inflation will be exhausted.

The baseline forecast scenario is partially based on this fact, but also takes into account factors that may prevent a decline in inflation. Domestic demand has significantly accelerated since the second quarter of the year, meaning that, unlike in previous periods when it was weaker, it can no longer counterbalance the above-mentioned inflationary pressures. In addition, in the presence of strong supply-side shocks, risks of "second round" effects and rising inflation expectations are present. Expectations, in turn, are exacerbated by the fact that inflation has remained above its target for quite a long time. Considering each of

*According to the baseline forecast, real GDP growth will be around 10% in 2021, and 5% in 2022. Growth will be supported by strong credit activity and a gradual recovery of tourism.*

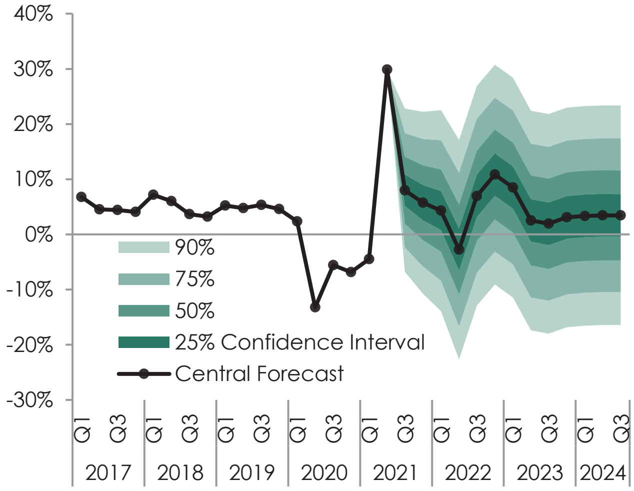


Figure 2. Annual growth forecast of quarterly real GDP

Source: National Bank of Georgia

*Amid strong supply-side shocks, the National Bank of Georgia maintains a tight monetary policy stance to avoid a rise in medium- and long-term inflation expectations.*

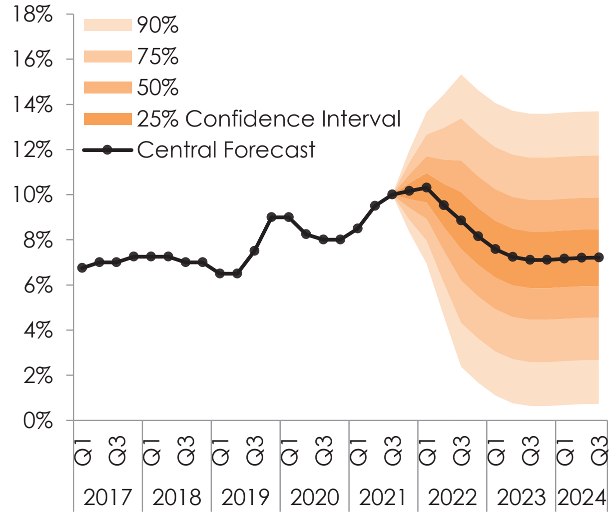


Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

the above-mentioned factors, **inflation is projected to average 9.7% in 2021 before it starts declining towards its target from the second quarter of 2022.**

Strong domestic demand in the current period is mainly driven by strong credit activity, the continuation of fiscal stimulus, and a realization of pent-up demand. As a result, according to the baseline forecast, real GDP growth will be around 10% in 2021 (see Figure 2). This is higher than the previous forecast of 8.5%, which largely reflects the stronger-than-expected impact of pent-up demand. The main driving forces of this growth are final consumption and net exports. The positive contribution of the latter, in turn, is due to a significant increase in exports of goods, which has been accompanied by a partial recovery of the tourism sector. The real GDP growth forecast for 2022 is around 5%, which assumes decent credit activity but only a partial recovery of tourism compared to 2019 levels.

Taking into account the current and expected drivers of inflation, the National Bank of Georgia has left the monetary policy rate unchanged at the high level of 10%. The tight policy stance is aimed to reinforce expectations of a timely return of inflation to its target. Consequently, the exit from the tightened position will take place gradually over the medium term and will only occur in tandem with a normalization of inflation expectations (see Figure 3).

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

*Amid the easing of COVID-19 pandemic-related restrictions, the global economy continues to improve and is expected to grow by 5.9% in 2021. Alongside the commencement of mass vaccination programs, expectations have improved in Georgia's trading partner countries. Meanwhile, commodity prices on international markets continue to rise, which have put some pressure on inflation expectations and central banks have responded by further tightening monetary policy. Amid mass vaccination programs, international tourism has become more active and the revenues received from foreign visitors has started a gradual recovery; money transfers have also increased. As a result, Georgia's current account deficit has slightly improved. According to current estimates, the deficit will be reduced this year, but will remain in the double digits. It should be noted that a significant annual increase in exports of goods was observed in the third quarter of 2021. In addition, the second quarter saw a significant improvement of aggregate demand, where final consumption remained strong. The recent intensification of inflationary pressures is closely related to the upward dynamics of the prices of consumption goods.*

## 1.1 OVERVIEW OF THE GLOBAL ECONOMY

*Along with the easing of pandemic-related restrictions, in the third quarter of 2021 the global economy continued to recover amid mass vaccination programs and unprecedentedly strong fiscal and monetary stimulus.*

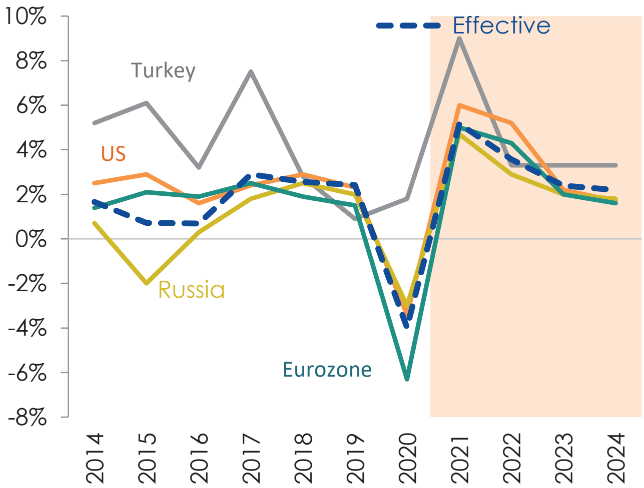


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

In the third quarter of 2021, the global economy continued to recover, albeit at a relatively slower pace than previously expected. Nevertheless, risks associated with the spread of the virus remain high, especially regarding the Delta variant of COVID-19. In a number of countries, various restrictions remain in place that continue to significantly hamper economic activity. However, along with the start of mass vaccination programs and a gradual easing of pandemic-related restrictions, strong fiscal and monetary stimulus measures have increased expectations of a further improvement of economic activity in both developed as well as emerging and developing countries. According to the International Monetary Fund's (IMF) October forecast[1], **global economic growth** will be 5.9% in 2021, which is 0.1 percentage point (pp) below the previous forecast.[2] Meanwhile, growth is projected to be 4.9% in 2022. For emerging and developing countries, real GDP is expected to grow by 6.4% in 2021, and by 5.1% in 2022. Inflation expectations have also increased worldwide, with the expected global inflation rate being 4.3% this year.[3]

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*1 International Monetary Fund. 2021. World Economic Outlook: Recovery during a Pandemic; Health Concerns, Supply Disruptions and Price Pressures. Washington, D.C., October.*

*2 International Monetary Fund. 2021. World Economic Outlook Update: Fault Lines Widen in the Global Recovery. Washington, D.C., July.*

*3 The economic growth and inflation forecasts, including those for Georgia's trade partners, have been taken from the following source: International Monetary Fund. 2021. World Economic Outlook: Recovery during a Pandemic; Health Concerns, Supply Disruptions and Price Pressures. Washington, D.C., October.*

Since the beginning of 2021, the consumer price index has increased sharply in developed as well as in emerging and developing countries. This is mostly due to supply-side disruptions amid the pandemic, as well as the upward dynamics of product prices on international commodity markets. In September, the food price index saw an increase of 32.8%[4] compared to the same period last year, while international oil prices almost doubled. According to the IMF's October forecast, a high inflationary environment will be maintained globally in 2021 and inflation will return to pre-pandemic levels in the second half of 2022.

Together with the easing of pandemic-related restrictions, the recovery process continued in **the United States** in the third quarter of 2021. In particular, external demand recovered and, along with a declining unemployment rate, labor market conditions improved. Despite the strong base effect, following the mass vaccination campaign, as well as strong fiscal and monetary stimulus, economic activity has been high, and a further improvement is expected. However, the uncertainty around the pandemic and the tense trade relations with China have a negative impact. Moreover, inflation pressure remains high, with the annual inflation rate standing at 5.4% in September. However, the Federal Reserve System has kept the federal funds rate unchanged. According to the IMF's October forecast, real economic growth in the US is expected to be 6% in 2021 and 5.2% in 2022. The inflation forecast for 2021 is 4.3%, while it is expected to be around 3.5% in 2022.

*In the third quarter of 2021, inflation rates have further increased in Georgia's trading partners, including in the US and the eurozone. In Turkey, the inflation rate has recently been significantly higher than the target.*

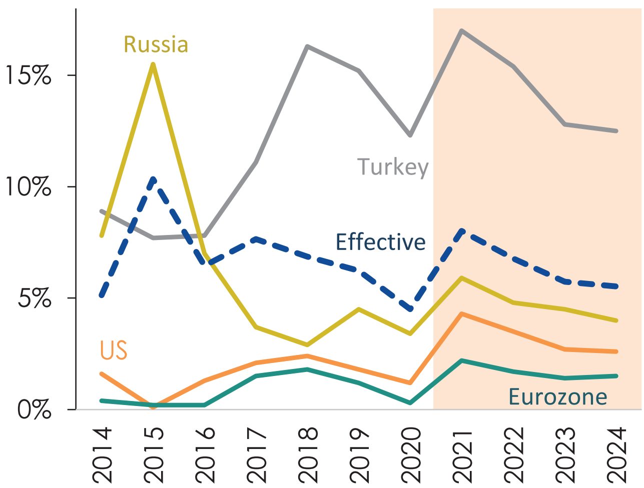



Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

In the third quarter of 2021, amid the easing of pandemic-related restrictions, economic activity continued to improve in the **eurozone**. According to data from July-August, activity in the manufacturing and industrial sectors recovered, with consumer and business sentiment also improving. Alongside the development of the vaccination process, expectations for investments and tourism have also improved. The annual inflation rate increased to 3.4% in September. According to the IMF's October forecast, real economic growth for the eurozone will be 5% in 2021 and 4.3% in 2022. The inflation rate is projected to be 2.2% in 2021 and 1.7% in 2022.

In the third quarter of 2021, rapid improvements in economic activity continued in **Turkey**, where the business climate and manufacturing sector improved, and exports increased. Amid the easing of pandemic-related restrictions, expectations on investments and the tourism sector also improved. However, inflationary pressure remains high amid the depreciation of the Turkish lira, with annual inflation standing at 19.6% in September. According to the IMF, the real GDP forecast for Turkey is 9% in 2021 and 3.3% in 2022. The current inflation forecast for 2021 is 17% and 15.4%

4 *The Food and Agriculture Organization (FAO).*

*In the third quarter of 2021, together with a rise in inflation expectations, some central banks of Georgia's trading partners have further tightened their monetary policy rates.*

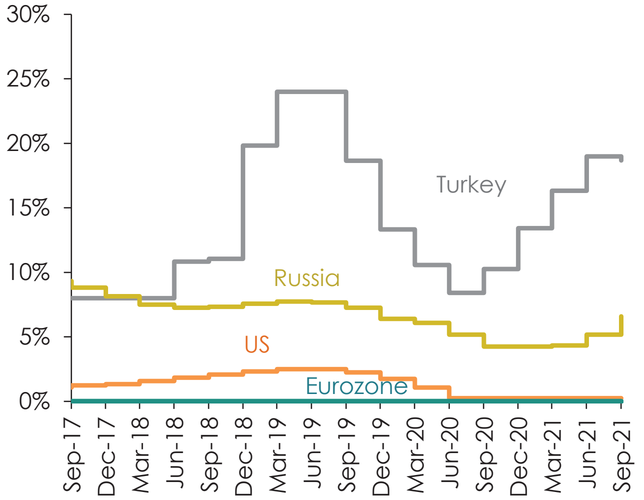



Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

for 2022.

In the third quarter of 2021, similar to the previous period, economic activity continued to improve in **Russia**. This was mostly due to the easing of pandemic-related restrictions and a start of the mass vaccination process. Labor market conditions improved together with the recovery of the manufacturing sector; consumer spending and retail sales also increased, and consumer and business sentiment improved. Along with the increase in global oil prices, the external sector also saw improvements. However, annual inflation increased significantly and equaled 7.4% in September. As a result, the Central Bank of Russia decided to tighten their monetary policy. According to the IMF's October forecast, real economic growth in Russia will be 4.7% in 2021 and 2.9% in 2022. The inflation rate is projected to be 5.9% in 2021 and 4.8% in 2022.

Having been weak in the first half of 2021, in the third quarter economic activity improved slightly in **Ukraine**. The industrial sector improved alongside rising consumer and business sentiment. Consumer spending and retail sales also increased with the easing of pandemic-related restrictions, and there are positive expectations for the trade balance amid improvements in global economic activity. However, annual inflation also increased and stood at 11% in September. According to the IMF, the real GDP growth forecast for Ukraine is 3.5% in 2021 and 3.6% in 2022. Meanwhile inflation is expected to be 9.5% in 2021 and 7.1% in 2022.

The third quarter of 2021 saw the growth rate stabilize in **Armenia**. This was mostly due to the easing of pandemic-related restrictions, which led to a recovery in the manufacturing sector and increased consumer spending. Remittances have also increased. However, the annual rate of inflation remained high and stood at 8.9% in September, leading the Central Bank of Armenia to a further tightening of monetary policy. According to the IMF, the real GDP forecast for Armenia is 6.5% in 2021 and 4.5% in 2022. The inflation rate is projected to be 6.9% in 2021 and is expected to be 5.8% on average in 2022.

In the third quarter of 2021, **Azerbaijan's** economic activity continued to improve in both the oil and non-oil sectors. This was mostly due to the upward dynamics of oil prices on international markets and an improvement of the manufacturing sector. Compared to the previous quarter, oil production and refining increased, which led to a stabilization of the external sector. However, the annual rate of inflation also increased and stood at 8.5% in September. According to the IMF's forecast, real GDP growth in Azerbaijan will be 3% in 2021 and 2.3% in 2022. Inflation is projected to be 4.4% in 2021 and 3.2% in 2022.

In the third quarter of 2021, the central banks of some of Georgia's main trading partners further tightened their monetary policies in response to higher inflation and rising inflation expectations. The US Federal Reserve kept its federal funds rate in the 0-0.25% range, although it is expected that interest rates in the US will start to rise earlier (in 2022) than had been expected last year. Meanwhile, the European Central Bank's interest rate remains unchanged at 0%. However, it should be noted that, amid the pandemic, the broader quantitative easing program in the euro area has been extended until March 2022.

*In light of revived external demand, registered exports of goods increased considerably.*

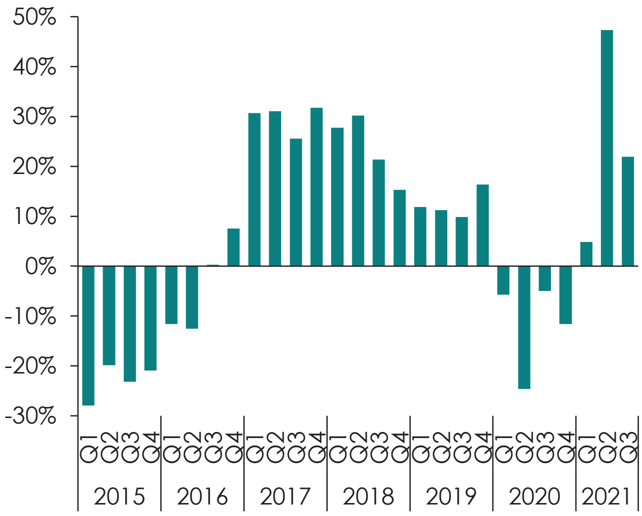



Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

*The rise in exports of goods mainly stemmed from an increase of external demand on consumer and intermediate goods. The contribution of investment goods, like in previous years, was small.*

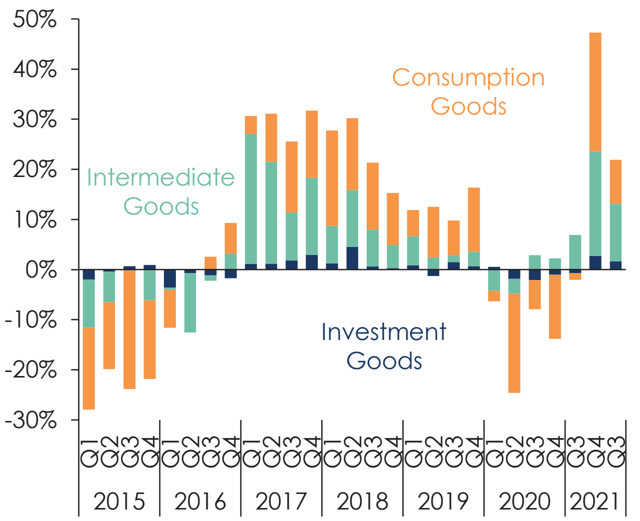



Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

## 1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the third quarter of 2021, external demand on goods increased annually. It is worth mentioning that a modest improvement in external demand is visible compared to the same period in 2019. The acceleration of global vaccination programs against COVID-19 and an easing of restrictions have revived economic activities worldwide – especially in those sectors that had been severally damaged by the pandemic. The gradual reopening of economies and the progressive revival of supply chains have positively affected the turnover of Georgia's external trade. In line with the recovery of domestic demand, imports of goods considerably increased. Thanks to universal vaccination programs, international tourism became active and revenues from international visitors gradually began to rise. Against the background of a partial improvement in global economic activities, instant money transfers also increased. Overall, due to rising external inflows, in the first half of 2021 the current account deficit improved by USD 81 million compared to the same period last year. According to recent estimates, the ratio of current account deficit to GDP will decrease in annual terms, but will still hover around the double-digit level.

In more detail, in the third quarter of 2021, registered exports of goods grew by 21.9% annually (see Figure 1.2.1) and rose by 15.8% compared to the same period in 2019. In particular, the volume of exports to regional countries increased considerably. In the third quarter, the increase of exports to Russia made the highest contribution to overall growth (of 4.7 pp annually), which was mainly a consequence of high demand for ferro-alloys and natural grape wines. Meanwhile, exports to Azerbaijan increased mainly in terms of substantially high levels of exports of motor cars and telephones; while exports to Turkey rose due to increased sales of ferro-alloys and ferrous scrap. To the EU, exports to Italy grew considerably due to high sales of hazelnuts and other nuts. Meanwhile, demand for ores and concentrates of copper was high from China (making a 4.3 pp contribution to the overall export growth).

Exports of goods mainly increased due to high demand for consumer and intermediate goods, while

*Revenues from international travelers continued to rise, but are still far below pre-pandemic levels.*

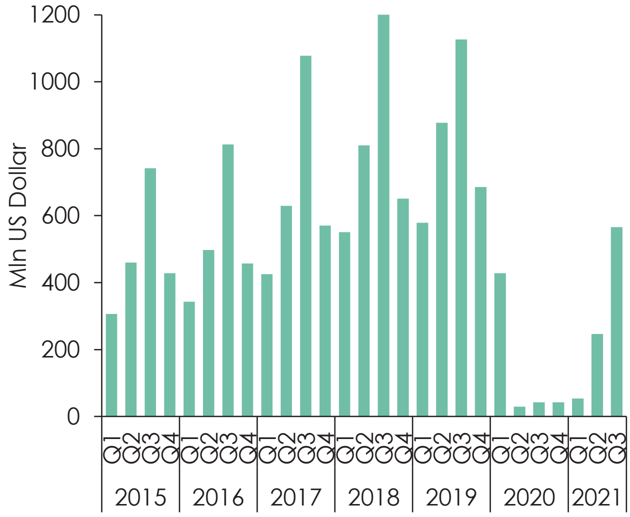



Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

*In the third quarter of 2021, instant money transfers continued to rise, which was partially due to the economic recovery of partner countries.*

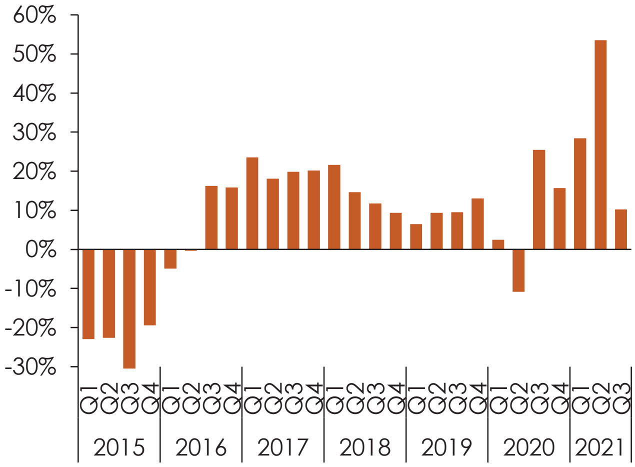



Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

exports of investment goods made only a moderate contribution to the overall growth of exports (see Figure 1.2.2). The increase in consumer goods mainly stemmed from high exports of motor cars. In terms of the rise in exports of intermediate goods, ferro-alloys had the biggest positive contribution; while for exports of investment goods, various construction machines played a leading role in the overall growth.

The lifting of most restrictions on international air and land mobility from June-July, softening of safe travel rules and a gradual acceleration of vaccination programs positively affected the number of international visitors to Georgia. In the third quarter of 2021, the number of international visitors rose by 417.2% annually; however, the total figure was still significantly below the number of visitors observed in the same period in 2019 (down by -73.7%). It is worth noting that, as international tourism was at a standstill for most of 2020, the rise in revenues from international travelers in the third quarter of 2021 is also related to the base effect. The increase of numbers of international visitors induced a rise in revenues from international travelers. In the third quarter, revenues from international travelers increased 13.3 times (see Figure 1.2.3) but remained 49.8% below the level of revenues received in the same period in 2019. Until international tourism begins to approach its pre-pandemic levels, it is expected that the number of visitors and the revenues received from them will remain below the record high level of 2019.

In the third quarter of 2021, instant money transfers to Georgia increased by 10.2% annually and amounted USD 623.1 million (see Figure 1.2.4). Transfers from the EU (especially from Italy and Germany), Kazakhstan, the USA and Russia made the largest contributions to total growth.

Considering the revived economic activities and increased internal demand, as well as the rise of prices of import goods in USD terms, imports of goods rose considerably, increasing by 23.8% annually in the third quarter of 2021 (see Figure 1.2.5), while rising by 9.9% compared to the same period in 2019. The rise in imports from regional countries was significant, particularly those from Turkey and Azerbaijan, meanwhile imports from other regions, including Hong Kong and Indonesia, made the largest contribution to overall growth. In contrast, imports from the USA fell because of lower imports of motors cars for subsequent re-export.

In the third quarter of 2021, imports of consumer and intermediate goods made largest contributions to the overall growth of imports (see Figure 1.2.6). The increase in imports of consumer goods predominantly stemmed from higher purchases of petroleum products, medicaments and telephones, while the rise of imports of intermediate goods was due to higher im-

*In light of strong domestic demand, registered imports of goods increased considerably in the third quarter. The rise of expenses on import goods was also induced by a rise of prices in USD terms.*

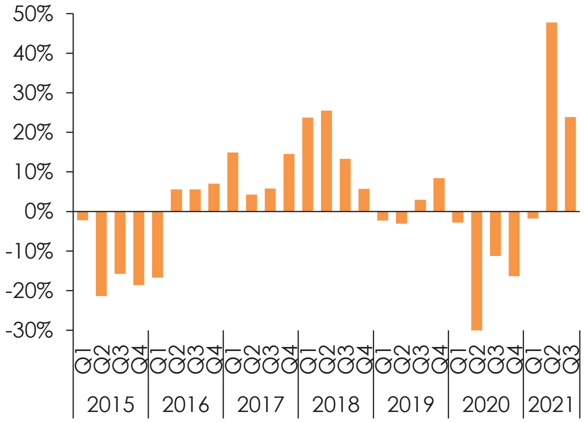



Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

*In the third quarter of 2021, imports of consumer and intermediate goods exhibited the largest rise.*

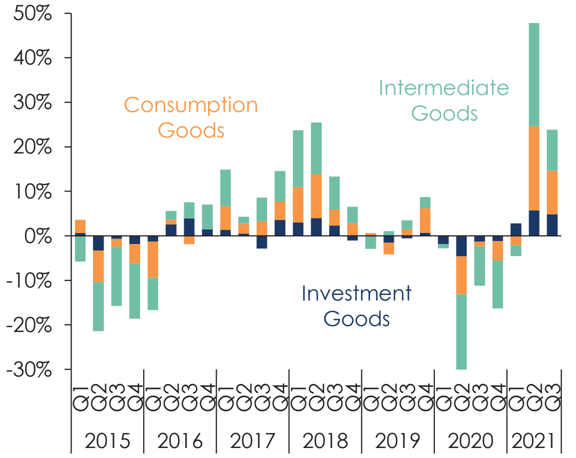
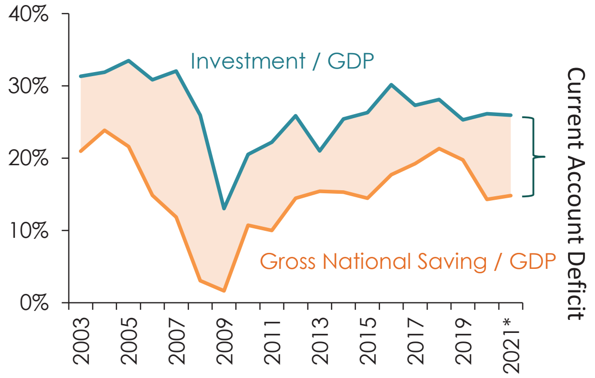



Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

*From the perspective of savings and investments, the improvement of the current account balance in the first half of 2021 was mainly due to a rise in savings.*




* 2021 data contains the joint sum of the last 2 quarters of 2020 and the first 2 quarters of 2021.

Figure 1.2.7. Investments and savings

Source: GeoStat, NBG Calculations

ports of immune serums, as well as copper ores and concentrates. The rise in imports of investment goods stemmed from higher purchases of automatic data processing machines and their units.

In light of increased exports of goods and higher instant money transfers, the current account deficit amounted to USD 381 million in the second quarter of 2021, which was 8.0% of quarterly GDP. This represents an improvement of USD 37 million compared to the same quarter of 2020.

One of the sources of financing the current account deficit is foreign direct investments (FDI), which fell by 2.6% annually and reached USD 234.2 million in the second quarter of 2021. The main reasons for the decline of FDI were the reduction of the amount of equity, the transfer of the ownership of several companies from non-resident to resident units, and the payment of debt. The majority of FDI went to the finance, energy, and manufacturing sectors.

From the perspective of savings and investments, in the first half of 2021, as compared to the same period last year, the improvement of the current account balance, in light of the modest fall in investments, was mainly due to the rise in savings (see Figure 1.2.7).

## 1.3 OVERVIEW OF THE DOMESTIC ECONOMY

### 1.3.1 AGGREGATE DEMAND

*Besides the base effect, the reasons for the high level of economic growth include the continuation of strong fiscal stimulus and credit activity, and deferred demand following previous mobility constraints. This is evidenced by the exceptionally high contribution that consumption has made to economic growth.*

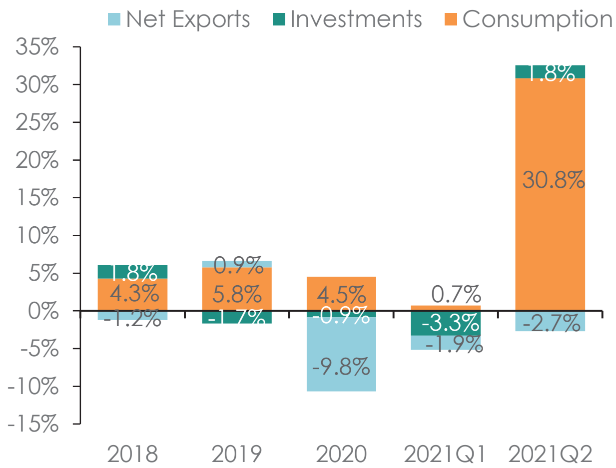



Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat; NBG calculations

In the first quarter of 2021, real GDP grew by 29.9% year on year.

Since the beginning of the second quarter of 2021, restrictions directed at preventing the spread of the pandemic have gradually been eased, significantly changing the economic picture. One reason for the high level of economic growth is obviously the base effect, as severe restrictions were initially imposed in the second quarter of last year, leading to a significant economic downturn in that period. However, it should be noted that the volume of GDP in the second quarter of 2021 actually exceeded the level of the same period in 2019 by 12.7%. Other reasons for the high growth include the activation of pent-up demand accumulated over the months of pandemic-related restrictions, alongside fiscal stimulus and lending. Consumption was the main driver of economic growth in the second quarter, rising by 34.5% and contributing 30.8 pp to the total growth.

The gradual opening of the country's borders was important in terms of the impact on foreign tourism. After a one-year pause, foreign tourists were again able to visit Georgia and their number has been growing since the beginning of the second quarter. This fact has had a particularly positive impact on the tourism-related sectors of the economy. At the same time, foreign demand for Georgian exports increased at a high rate. In total, real exports of goods and services increased by 53.4%. However, increased demand also significantly increased imports of goods and services by 42.8% and, because the total volume of imports exceeded the volume of exports, the contribution of net exports to economic growth was ultimately a negative 2.7 pp.

High growth was also observed in gross capital formation/ investments (a 25.2% increase, making a 1.8 pp contribution to overall growth), which was underpinned by both public and private sector investments (see Figure 1.3.1).

*Most of the growth comes from the services sector, which, along with deferred demand, has been impacted by a partial recovery in tourism.*

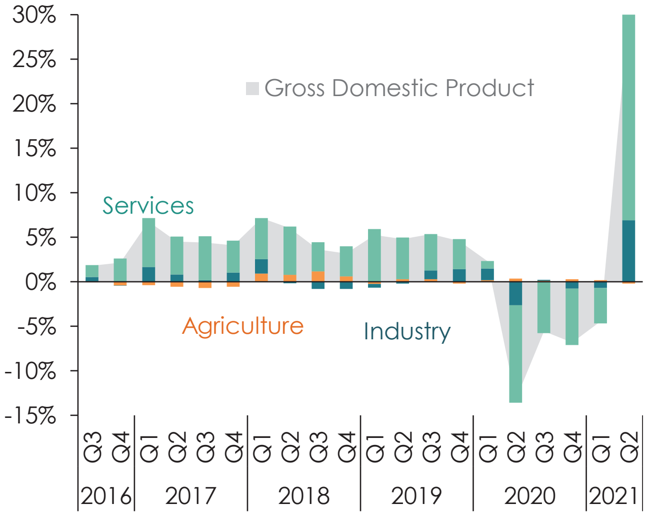



Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

### 1.3.2 OUTPUT

In the first quarter of 2021, the real gross domestic product grew by 29.9% year on year (see Figure 1.3.2). The main driver of that growth, with a contribution of 23.2 pp, was the services sector. The contribution of the industrial sector was 6.9 pp, while agricultural output declined, making a negative contribution of 0.2 pp.

As mentioned in the previous chapter, the main reasons for the high growth in the second quarter of 2021 include the base effect, the activation of demand accumulated over several months of restrictions, fiscal stimulus, lending and the partial recovery of foreign tourist flows into Georgia after a one-year pause. The latter has had a positive impact on the tourism-related businesses that were most affected by the pandemic. Accommodation and catering activities (mainly restaurants and hotels), transport (with a large share of travel agencies), real estate activities, and arts, entertainment and recreation (where foreign participation is high) collectively contributed a total of 10.1 pp to GDP growth. Trade, which is the largest sector of the economy, grew by 53.9%, making a 6.3 pp contribution to overall growth.

In the industrial sector, the 42.3% growth of manufacturing (a 3.7 pp contribution to total growth), where the weight of export manufacturing enterprises is high, and the 36.9% growth of construction (a 2.3 pp contribution) are particularly notable.

During the same period, agriculture fell by 2.3%, contributing a negative 0.2 pp to economic growth (see Figure 1.3.2).

## 1.4 FINANCIAL MARKET AND TRENDS

### 1.4.1 LOANS

*In September, the growth of the annual loan portfolio increased and stood at 15.8%, excluding the effect of exchange rate fluctuations.*

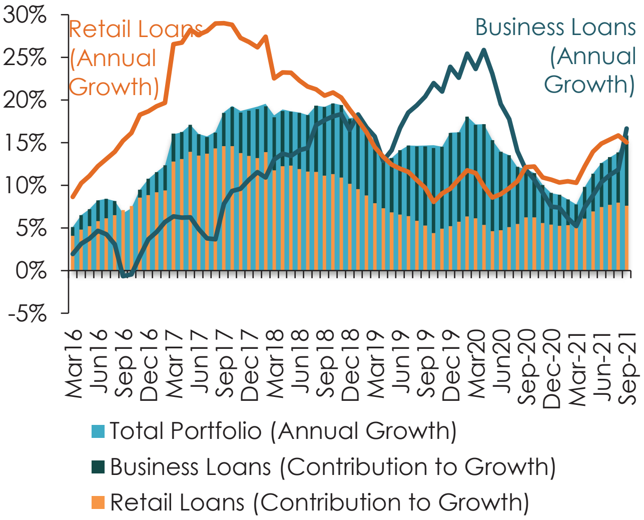



Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In September, relative to June, the growth of the loan portfolio increased and stood at 15.8% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 0.2 pp to stand at 15.0%, while the growth of loans to legal entities increased by 6.3 pp and equaled 16.6% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the agriculture, trade, transport and communications sectors. According to the credit conditions survey, representatives of the banking sector expect an increase in demand for retail and business loans.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the second quarter of 2021 was mainly driven by domestic currency loans (see Figure 1.4.2). In September, the annual growth rate of foreign currency denominated loans increased and stood at 6.8%, while the growth rate of loans in the domestic currency increased by 0.4 pp and equaled 28.1%. In the third quarter, the loan larization ratio increased slightly and stood at 48.3%. It is expected that the larization (de-dollarization) process will continue in the future. Recent changes made to reserve requirements will motivate banks to increase larization, which is a step towards reducing risks to financial stability.

*The growth of the loan portfolio was mainly driven by an increase in domestic currency loans.*

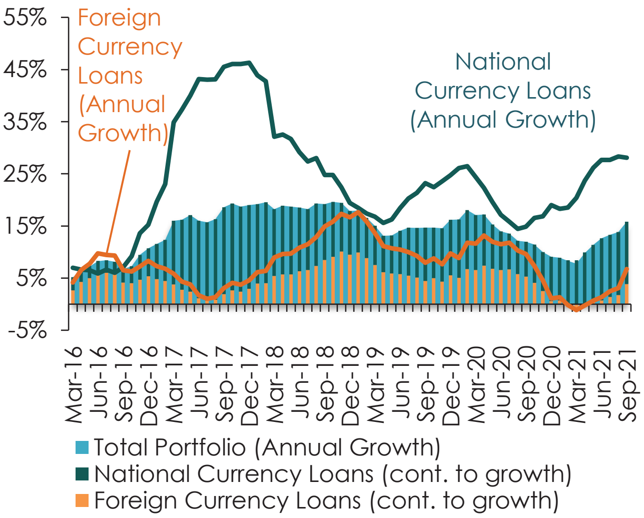



Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

### 1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In September, the monetary policy rate was 10.0%. In the third quarter of 2021, interest rates on government securities increased slightly due to the increase in the monetary policy rate (see Figure 1.4.3).

Compared to the previous quarter, the spread between long- and short-term interest rates decreased slightly. This indicator remains at a low level, which suggests the increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate. Compared to long-term rates, the increase in short-term rates, in part, was a reflection of expectations in the financial market that, in the short term, an increase in the policy rate will cause a lowering of inflation, which will be a prerequisite for a reduction of the policy rate in the future.

In September, relative to June, interest rates on domestic currency deposits increased slightly and equaled 10.0%. Meanwhile, interest rates on foreign currency deposits decreased slightly and equaled 1.9%. According to the credit conditions survey, representatives of the banking sector expect no significant change in the cost of funds in the next quarter.

Furthermore, according to the same survey, interest

*As the monetary policy rate increased, interest rates on government securities rose slightly in the third quarter of 2021; however, that increase was smaller than the monetary policy rate.*

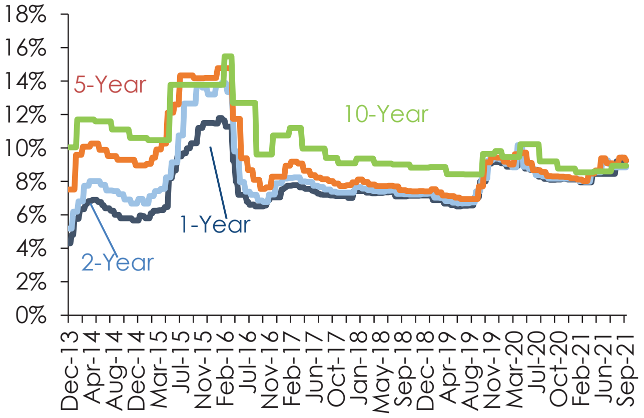



Figure 1.4.3. Interest rates on government securities

Source: National Bank of Georgia

*Compared to the previous quarter, the spread between long- and short-term interest rates remained negative. This is a reflection of expectations of decreasing inflation in the future and, consequently, of a fall in the policy rate.*

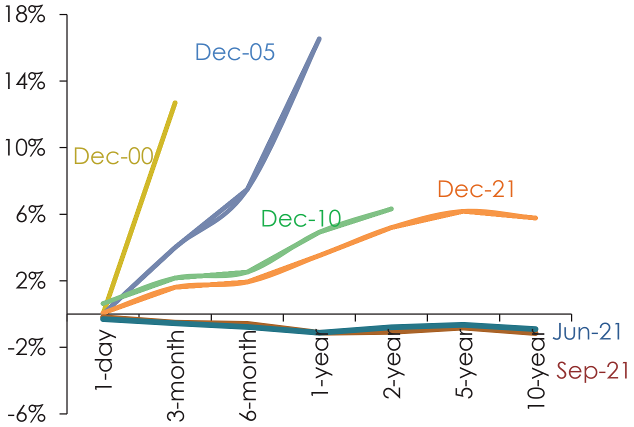



Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

rates on consumer and mortgage loans issued in the domestic currency did not change significantly; meanwhile, interest rates on business loans issued in the domestic currency increased slightly. Although representatives of the banking sector do not expect any significant changes in interest rate conditions, 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 to small and medium enterprises (SMEs) and corporate loans did not change significantly, with the former equaling 10.2% and the latter rising by 0.3 pp to equal 9.8%; meanwhile interest rates on retail loans increased slightly.

As of September, average interest rates for domestic and foreign currency loans on the stock of legal entities did not change significantly. In particular, interest rates for domestic currency loans stood at 12.9%, while those for foreign currency loans equaled 6.5% (see Figure 1.4.5). Representatives of the banking sector do not expect significant changes in interest rates for loans in foreign currency.

*As of September, average interest rates for domestic and foreign currency loans on the stock of legal entities did not change significantly.*

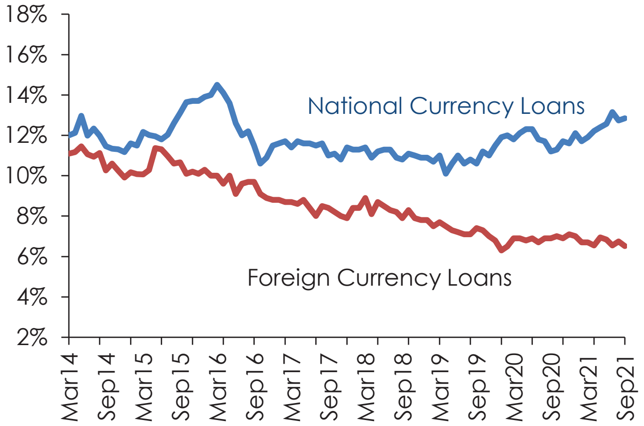



Figure 1.4.5. Average interest rates on business loans

Source: National Bank of Georgia

*The real effective exchange rate appreciated by 6.0% on an annual basis.*

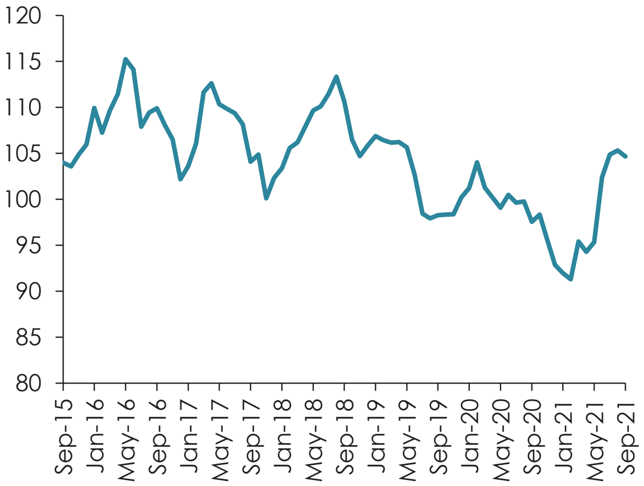



Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

### 1.4.3 EXCHANGE RATE

In the third quarter of 2021, the GEL nominal exchange rate appreciated by 6.2% against the US dollar and by 8.1% against the euro, as compared to the previous quarter. According to average quarterly data, the GEL appreciated against the Russian ruble by 5.2% and against the Turkish lira by 8.1%. Over the same period, the nominal effective exchange rate appreciated by 6.7% on a quarterly and by 1.4% on an annual basis. In terms of the price-adjusted exchange rate, in the third quarter of 2021 the real effective exchange rate appreciated by 7.8% on a quarterly basis and by 6.0% on a year-on-year basis (see Figure 1.4.6).

It should be noted that the real exchange rate appreciated against all trading partner countries aside from Ukraine (see Table 1.4.1).

*The appreciation of the real effective exchange rate is caused by real appreciation against almost all major trading partners.*

| | Change in Nominal Exchange Rate % | Change in Real Exchange Rate % | Contribution to the Change in Real Exchange Rate, pp |
|---|---|---|---|
| **Effective exchange rate** | **1.4** | **6.0** | **6.0** |
| Eurozone | -1.6 | 7.5 | 1.4 |
| Turkey | 17.7 | 10.9 | 1.9 |
| Ukraine | -3.1 | -1.5 | -0.1 |
| Armenia | 0.4 | 3.7 | 0.2 |
| US | -0.6 | 6.0 | 0.4 |
| Russia | -0.9 | 4.2 | 0.6 |
| Azerbaijan | -0.5 | 4.4 | 0.4 |
| China | -7.1 | 3.5 | 0.5 |
| Other | -0.8 | 6.8 | 0.7 |

Table 1.4.1. Effective exchange rates annual growth (third quarter of 2021)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

*Unlike the previous year, sharply increased productivity reduced the unit labor cost, which indicates an absence of inflationary pressure from wages.*

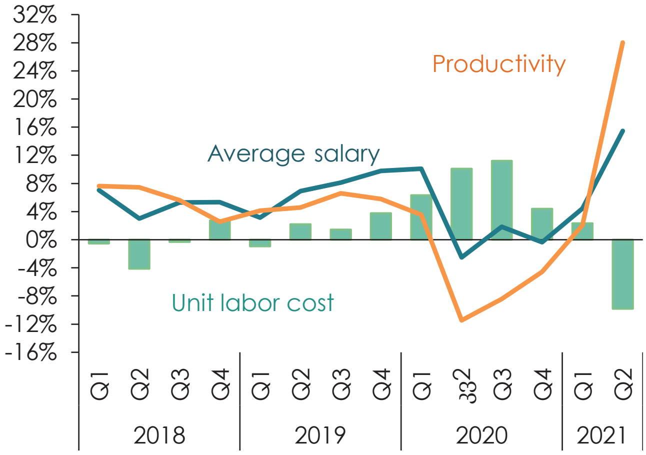



Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

*Inflation equaled 12.3% in September, which was largely due to a sharp rise of prices on oil and consumer goods on world commodity markets and increased international freight costs.*

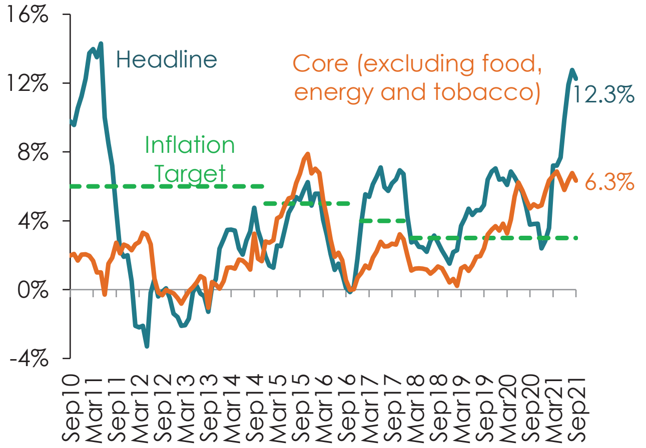



Figure 1.6.1. Headline and core inflation

Source: GeoStat

*Food, fuel and utility bills continue to make a large contribution to inflation.*

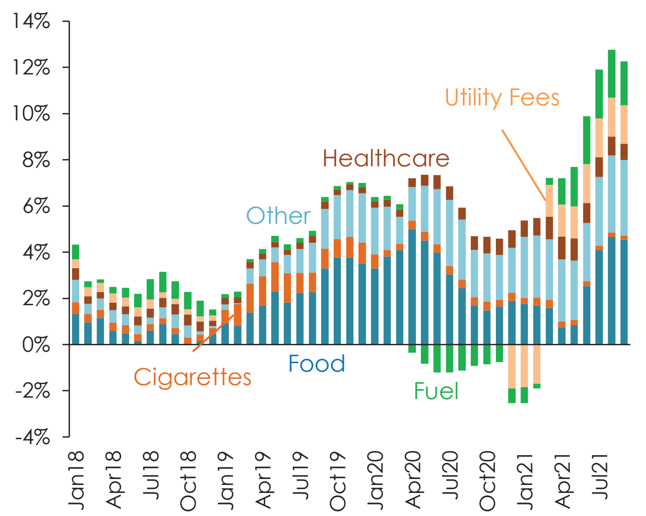



Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

## 1.5 LABOR MARKET

In the second quarter of 2021, the real value added produced per employee (labor productivity/productivity) in the country's economy increased by 28.0% annually (see Figure 1.5.1).

At the same time, gross salaries of employees averaged GEL 1,328, which reflects a nominal annual growth of 15.5%.

Last year, the unit labor cost increased due to a smaller reduction in wages compared to the decrease in output. Against the background of the pandemic, and given the supply constraints and declining output, this acceleration had been expected as a factor contributing to inflation. However, alongside the recovery of the economy, the unit labor cost began to gradually decline from the end of last year. In the second quarter of 2021, given the high economic and productivity growth, the unit labor cost fell sharply by 9.8% compared to the same period of last year. This indicates the absence of inflationary pressures coming from wages (see Figure 1.5.1).

## 1.6 CONSUMER PRICES

Annual inflation rose to 12.3% in September (see Figure 1.6.1). As we explained in previous reports, an important reason for such growth was the extraordinary situation caused by the pandemic, which led to several supply-side factors simultaneously affecting rising inflation.

The increasing inflation in Georgia is closely linked to the rising prices of consumer goods around the world. Indeed, global inflation has been one of the main topics featured in the periodical reports of the International Monetary Fund, the World Bank and other international organizations. One of the most noteworthy developments concerns rising food prices. As a consequence of various pandemic-related delays, poor harvests and increased transportation costs, world food prices have been at a record high for the last ten years. According to the UN Food and Agriculture Organization, in August 2021 food prices on international markets rose by about 33% compared to the same point in 2020.

Rising food prices have particularly affected developing countries, where the weight of food in consumer baskets tend to be high compared to developed countries. The weight of food in the consumer basket of Georgia is also high, comprising 28.9%. As a consequence, changes in food prices have a significant impact on inflation. As such, the increase in global food prices has seen a significant transmission to the local market.

In September, the contribution of food to inflation was 4.5 pp. Among imported foods, the rise in prices of

*Despite the recent strengthening of the GEL exchange rate, the increase in local prices has mainly been due to imported goods. This is a reflection of an increase of USD prices on international markets.*

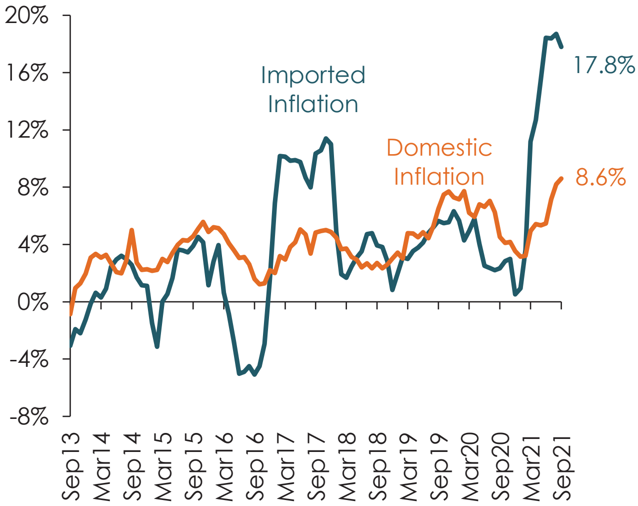



Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

sunflower oil, bread and sugar are particularly notable, making a combined 1.3 pp contribution to inflation. In total, cheese, potatoes, eggs, and chicken made the same contribution to inflation, and these products are generally locally produced.

The impact of the pandemic on locally produced food has mainly been transmitted through the increased intermediate costs of their production.

With the restoration of mobility, demand for oil and fuel prices have increased in international markets. Global oil prices are currently at a three-year high, which has been reflected on fuel prices. In September, the contribution of fuel to annual inflation stood at 1.9 pp.

The contribution of utility bills to inflation was 1.7 pp. This included the inflationary effects of both the actual change in utility bills (0.4 pp) and the impact of the statistical effect of the end of the subsidy program (1.3 pp).

The 9.2% increase in prices in the healthcare group (making a 0.7 pp contribution to inflation) is also significant, where a significant share comes from an increase in the prices of medicine (see Figure 1.6.2).

The fact that the annual inflation of imported and mixed products (17.8% and 14.5%, respectively) continues to be higher than the inflation of domestic products (8.6%), in spite of the approximate 10% appreciation of the nominal effective GEL exchange rate compared to May, indicates that the increase in prices is mainly a consequence of rising prices of products on the world market (see Figure 1.6.3).

Meanwhile, core inflation, which excludes volatile food, energy, and cigarette prices, amounted to 6.3% in September (see Figure 1.6.1). It is worth noting that service inflation was relatively low and stood at 5.2%. An analysis of core inflation is particularly significant as it reflects the long-term trend: lower core inflation signals a reduction of headline inflation in the future.

## BOX 1. EXOGENOUS FACTORS DURING THE PANDEMIC

A comprehensive analysis of the current inflation rate and the dynamics of its forecast are important in determining monetary policy. This process uses existing factual data on the Georgian and world markets, as well as macroeconomic forecasts and estimates. It is important to assess the impact of exogenous factors, which are independent from monetary policy, on inflation. Due to the irregular situation caused by the pandemic, such factors were particularly active worldwide in 2020-2021. Assessing the impact of such factors on inflation has a special role when conducting monetary policy because their impact is temporary and their one-off effect on inflation will thereby fade away. Under such conditions, any monetary policy response to short-term changes is usually counterproductive. At this time, a response occurs only if a shock, despite its temporary nature, reflects on medium- and long-term inflation expectations and produces so-called “second-round effects”. Due to the specifics of the pandemic and its accompanying effect on the economic situation, the National Bank has made this kind of assessment.

According to the National Bank, temporary exogenous factors accounted for around 8-8.5 percentage points of the 12.3% annual inflation observed in September (see Figure 1.6.4). The following components are considered in these calculations:

- Supply-side factors (6.6 pp) - This component comprises several components that have already had a significant impact on price dynamics in Georgia. These include the significant increase in commodity prices on international markets and the increase in global transportation costs:
  - According to the UN Food and Agriculture Organization, in September 2021 food prices on international markets in US dollars increased by 33% compared to the same point in the previous year (this included a rise in prices of meat products by 26%, dairy products by 15%, cereals by 27%, vegetable oils by 61%, and sugar by 52%).[5] In addition, oil prices are at a three-year high and twice as high as they were in September 2020.
  - International transportation and logistics costs form a significant part of the price of imported goods. Any increase in these costs thus increases the final prices of such goods and, consequently, affects the inflation rate. The complications to international transportation observed during the pandemic and the subsequent rise in fuel prices have both dramatically increased the USD cost of global transportation. Freight costs from China to Europe have risen almost five fold and, according to the estimates of OECD, across the world as a whole, the quarterly increase in international transportation costs falls in the range of 30-65% (comparing the first quarter of 2021 to the previous quarter).
  - The rise in agri-food prices has also made a significant contribution to inflation. During the summer, these products are usually cheaper due to seasonal factors. However, in 2021, some such products became significantly more expensive. One of the reasons for this change was the export of certain products that would have been imported in previous years. The latter is likely a reflection of reduced supply/poor yields in export destination countries and is thus a temporary factor.
- The contribution of utility bills to inflation was 1.7 pp. This included the actual change in these bills (of 0.4 pp) and the impact of the statistical effect of the completion of the subsidy program on the inflation rate (1.3 pp).

To return to the inflation outlook, given that the contribution of temporary factors to annual inflation is still being determined, it is expected that when these one-off factors are excluded from the calculation of annual inflation, inflation should begin to significantly decline. This is expected to occur from the second quarter of next year. This process, along with the exhaustion of temporary factors, will be facilitated by tighter monetary policy and fiscal consolidation.

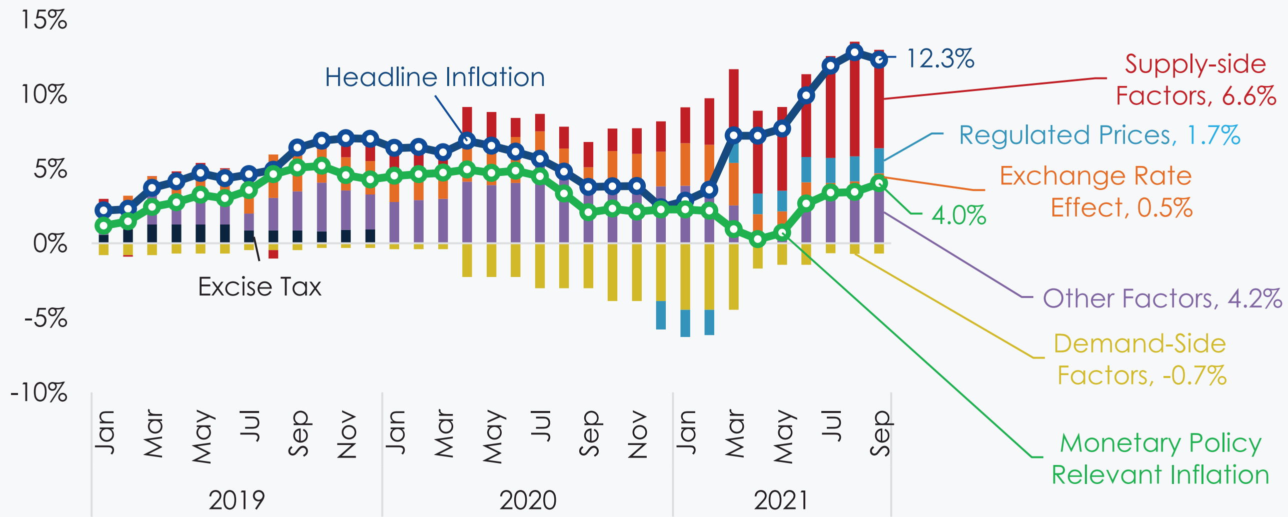



Figure 1.6.4 Estimation of information relevant to monetary policy

Source: IMF; GeoStat; NBG calculations.

5 Source: Food and Agriculture Organization of the United Nations. https://www.fao.org/worldfoodsituation/foodprices-index/en/

# 2 MACROECONOMIC FORECAST

*In the short run, inflation will remain significantly higher than target. High inflation is mostly driven by supply-side exogenous factors, which will only shift inflation up temporarily. In particular global inflation has been pushed up by pandemic-induced supply-side disruptions, rising commodity prices on the international market due to demand-supply imbalances, and international transportation disruptions. Georgia was no exception to this trend and global inflationary factors were thereby transmitted to the local market, which led to high inflation. Real GDP is expected to grow by 10% in 2021 and by 5% in 2021. Private demand is a major driver of economic activities. Higher-than-expected domestic demand has closed the output gap and demand cannot neutralize inflationary pressures. The alternative forecast scenario considers higher domestic demand compared to the baseline scenario. In particular, consumer and business sentiment will improve owing to the easing of pandemic-related containment measures and a reduction of uncertainties about the vaccination program contributing to higher-than-expected credit activity. As a result, inflationary pressures stemming from domestic demand will increase significantly, leading to a gradual tightening of monetary policy and, subsequently, the maintenance of such a stance for a relatively long term.*

## 2.1 BASELINE MACROECONOMIC FORECAST

*In the short term, inflation will remain above the target. From the second quarter of 2022, inflation will start to decline back to the target level.*

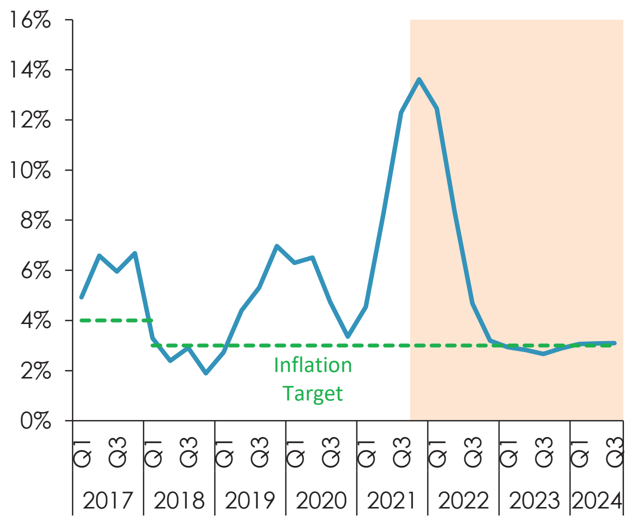



Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

Based on the baseline scenario, inflation will be significantly higher than the target during 2021 and the first half of 2022 (see Figure 2.1.1). High inflation is mostly driven by exogenous supply-side, pandemic-induced shocks. Rising commodity prices on international markets resulting from demand-supply imbalances have pushed up prices of oil, sugar, cereal, and sunflower oil. Georgia was no exception to this trend and these global inflationary factors were transmitted to the local market. It is expected that prices of oil and food will remain at a high level throughout this year. High commodity prices push up the short-term inflation outlook. Moreover, pandemic-induced supply-side and transportation disruptions increase producers' costs and push up global inflation. Meanwhile, an increase in local regulated prices creates additional inflation pressures. These factors will have a temporary impact on consumer prices, similar to the base effect following the government subsidies on utilities.[6] In addition, inflation remaining over the target for a prolonged period has increased short-term inflation expectations and poses a risk of second-round effects. From the second quarter of 2022, upon the exhaustion of these factors, and in tandem with the tightened monetary policy stance, inflation will start to decline and then approach the target in the medium term.

*6 In particular, at the end of 2021 and the onset of 2022, annual headline inflation will see a further increase due to the base effect. At the end of 2020 and beginning of 2021, the government subsidy program on utilities caused a temporary reduction of inflation by 1.85 pp on average.*

*The deviation of inflation from the target is largely driven by the upsurge of prices on international commodity markets, increased global shipping costs and increased short-term inflation expectations.*

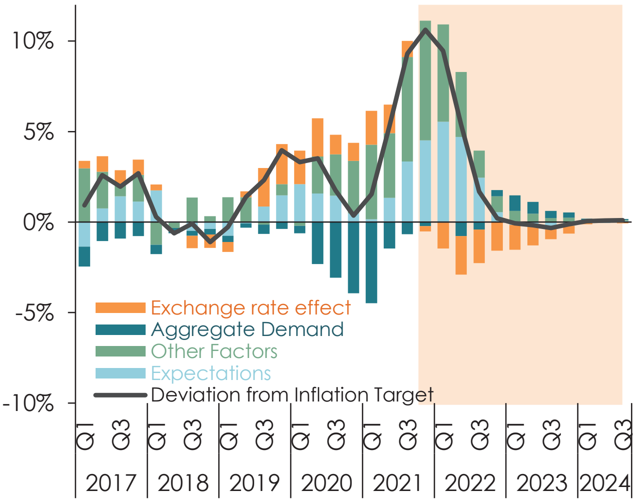



Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

*Real GDP will grow by 10% in 2021 on behalf of domestic demand driven by fiscal stimulus and credit activities. In 2022, the economy is expected to grow by 5%.*

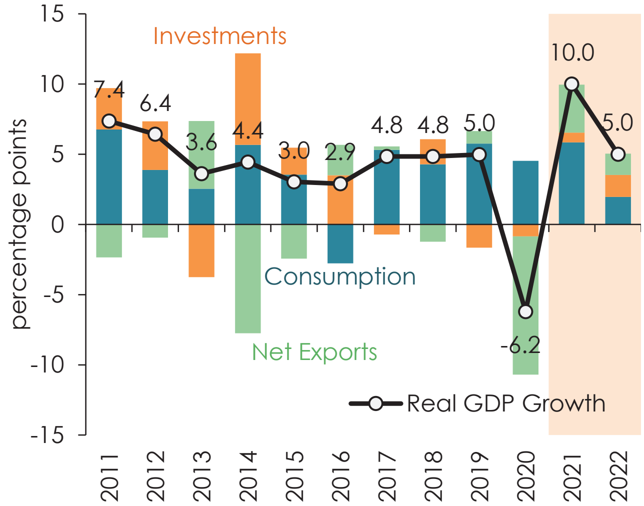



Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

In the short run, exogenous shocks lead to inflation hovering above the target (see "Other Factors" in Figure 2.1.2). Such exogenous factors will only have a temporary impact on inflation and thus inflation will start to decline in the second quarter of 2022. The fact that inflation has been above the target for a prolonged period has elevated short-term inflation expectations. Meanwhile, higher-than-expected domestic demand has closed the output gap and demand cannot neutralize inflationary pressures. However, the recent appreciation of the exchange rate will help push inflation down through the direct import and input costs channels.

In response to increased inflation, a tight monetary policy will be maintained throughout 2021. It is noteworthy that inflationary pressures stemming from increased prices on international markets represent an additional supply-side shock. Other things being equal, central banks do not usually respond to supply-side shocks, as doing so creates additional economic fluctuations. However, in the current stance, the strong supply-side shock elevates inflation expectations and creates so-called "second-round" effects. Moreover, in the wake of various shocks, inflation has deviated from the 3% target for a long period. This factor further amplifies long-term inflation expectations. The NBG will thus maintain monetary policy at a moderately tight stance to eradicate additional inflationary pressures. Afterwards, this stance will gradually decline in line with a curbing of inflation expectations before approaching the neutral level, which is currently estimated at 6.5%, in the medium term.

The economic outlook has improved. Based on the updated forecast, real GDP is expected to grow by 10% in 2021, which is 1.5 pp higher than in the previous forecast. The economic growth forecast for 2022 has also been revised upwards to 5% (see Figure 2.1.3). Private consumption will continue to be the major driver of that economic growth, which will be further encouraged by fiscal stimulus, credit activities and the release of pent-up demand during the year. The slow recovery of the tourism sector will also have a positive impact on economic activities. After the lockdown, tourism started to recover and positively contributes to economic growth. However, tourism still remains significantly lower than 2019 level. Revenues from exports of goods will moderately increase in 2021 alongside the gradual economic recovery of Georgia's trading partners. Meanwhile, increased prices of imported goods will reduce real imports of goods and thus net exports will make a positive contribution to real GDP growth.

### 2.1.1 BASELINE FORECAST SCENARIO RISKS

*Pandemic-induced risks remain high, which could cause a deviation from the baseline macroeconomic forecasts. Those risks are mostly inflationary and monetary policy will thus be hawkish in order to maintain price stability.*

| Macroeconomic Forecast Risks | Impact on Inflation |
|---|---|
| Strong domestic demand | ↑ |
| Prolongation of the pandemic | ↑ |
| Slow vaccination process in Georgia | ↑ |
| Rising commodity prices on international markets | ↑ |
| Rising global shipping costs | ↑ |
| Tightening monetary conditions in developing countries | ↑ |
| Earlier-than-expected cessation of the pandemic | ↓ |
| Low Risk | High Risk |
| ↑ | Upward Pressure on Inflation |
| → | Same Level of Inflation |
| ↓ | Downward Pressure on Inflation |

Table 2.1.1 Baseline Macroeconomic Forecast Risks.

Macroeconomic forecasts are characterized by a high degree of uncertainty. It has been over a year since COVID-19 was declared a pandemic and the spread of the virus remains a challenge. The global vaccination process is ongoing, but it has been uneven across developed and developing economies. This amplifies the risks of the virus further mutating. Moreover, the effectiveness of existing vaccines against new virus variants are unclear. New variants could thus further fuel the spread and intensity of the pandemic, which would lead to its prolongation. A prolongation of the pandemic would further disturb the supply side and cause a pullback of economic activities, especially in the service sector. This would deepen the external shock for Georgia as tourism is a major component of the current account balance. The slower-than-expected recovery of the tourism sector will cause the current account balance to deteriorate, which will create depreciation pressures. Eventually, this will intensify inflationary pressures through the channels of direct imported inflation and increased input costs.

Meanwhile, strong domestic demand poses inflationary pressures. Since April, economic activities have been recovering at a high speed. This is partially an impact of the base effect, as in the second quarter of 2020 the economy faced an unprecedented decline in economic activities. However, recent economic activities are substantially higher than even 2019 levels, and this gives us a strong signal that the economy is recovering. Meanwhile, the potential level of GDP is still subdued, as the recovery of tourism is slow. Under such circumstances, the higher-than-expected domestic demand will be inflationary.

The vaccination process contains some risks at the local level as well. A slower-than-expected vaccination process in Georgia will hinder the economic recovery. Moreover, new waves of infections would dampen tourist inflows. A realization of this risk would widen the current account deficit and push up the country risk premium, which will create depreciation pressures. Eventually, this will intensify inflationary pressures through the channels of direct imported inflation and increased input costs due to high dollarization.

External factors like rising commodity prices on international markets also pose risks to the macroeconomic forecast. Increased international prices have already been transmitted to the local market, but if this tendency persists, inflationary risks will be further amplified. Moreover, increasing shipping costs further impact inflation. If shipping expenditures continue to grow, this will further push up prices.

In contrast, the termination of the pandemic

*An upsurge of commodity prices on international markets and temporary rises of food prices on the local market have driven the increased inflation outlook.*

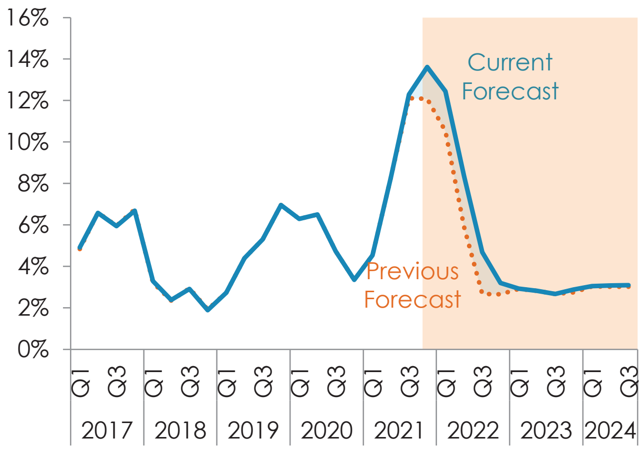



Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

*The real GDP growth forecasts have been revised upward to 10% in 2021 and 5% in 2022. Higher-than-expected pent-up demand and credit activities have driven these upward projections of the economic outlook.*

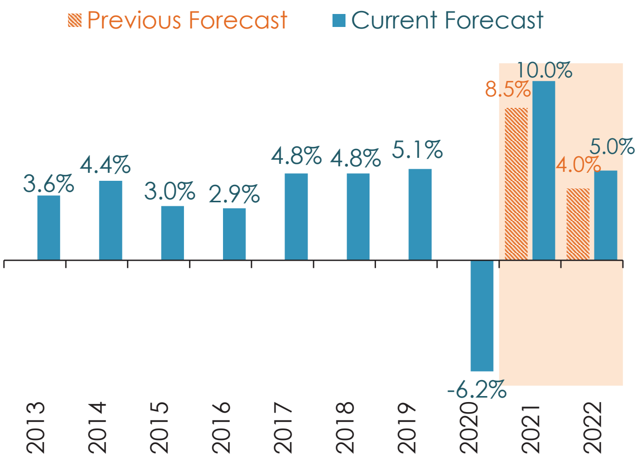



Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

*According to the updated projections, increased prices on the international market put upward pressure on trading partners' inflation expectations.*

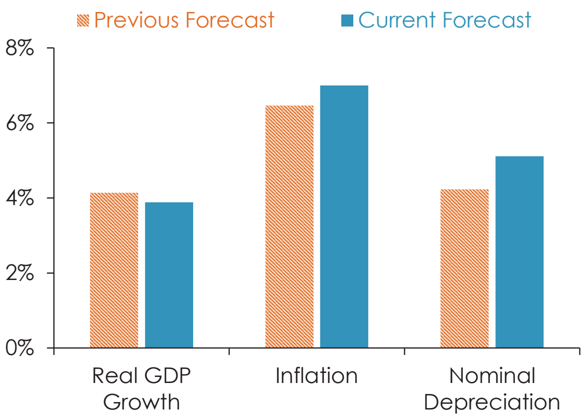



Figure 2.2.3. Changes in the forecast of external assumptions for 2021 Q4 - 2022 Q4

Source: Bloomberg

earlier than expected would lead to a deviation from the baseline forecast scenario in a positive direction, hastening the economic recovery. However, inflation would be lower compared to the baseline scenario amid a relaxation of regulations, the recovery of tourism, and improvements to the current account balance. In such a case, the intensified inflationary pressures stemming from the depreciated GEL exchange rate and increased production costs would be exhausted. However, the realization of this positive shock seems less likely given the current perspective and the assessments of reputable international institutions.

## 2.2 COMPARISON WITH THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). The upsurge of commodity prices on international markets has led to an increased inflation outlook. Meanwhile, increased local food prices have pushed inflation up. Higher-than-expected aggregate demand has also led to upward revision of the inflation outlook. The output gap is almost closed, and demand cannot neutralize inflationary pressures. As in the previous forecast, inflation is projected to start to decline from the second quarter of 2022 and will gradually return back to its target level.

The real GDP growth forecast for 2021 has been revised upward to 10% (see Figure 2.2.2). A higher-than-expected upsurge in domestic economic activities has led to an upward revision of the economic outlook. On the other hand, the imported inflation outlook has increased, meaning that the nominal growth of imported goods will be slower, which will positively impact real GDP growth. Real GDP is expected to increase by 5% in 2022. According to the updated forecasts, tourism will be a major contributor to economic growth in 2022.

Georgia is a small open economy, and the economic stances of its trading partners thus have a significant impact. Macroeconomic forecasts thereby strongly depend on assumptions regarding the economic growth, inflation and exchange rates of Georgia's trading partners. Changes in any of these assumptions will affect the baseline forecast as well as associated risks (see Figure 2.2.3).[7]

According to the updated projections for 2021Q4-2022Q4, estimates of the pace of the economic recovery of Georgia's main trading partners have not been changed. Meanwhile, the expected depreciation of trading partner currencies have been revised upward. Lower expectations about trading partners' currencies, together with rising prices on international markets, will eventually put upward pressure on inflation expectations.

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

## 2.3 ALTERNATIVE FORECAST SCENARIO

*According to the alternative scenario, domestic demand will significantly increase, resulting in a higher economic growth rate compared to the baseline scenario. In particular, real GDP growth is expected to be 11.5% in 2021 and 6.5% in 2022.*

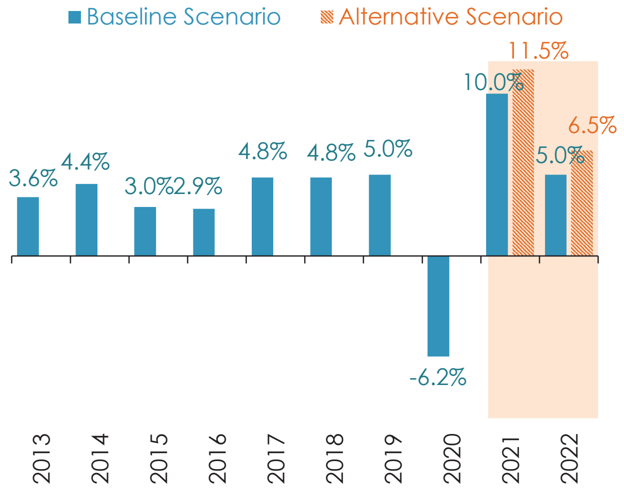



Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

*According to the alternative scenario, inflation in 2022 will increase by 4.3 pp compared to the baseline scenario as a result of a significant activation of domestic demand.*

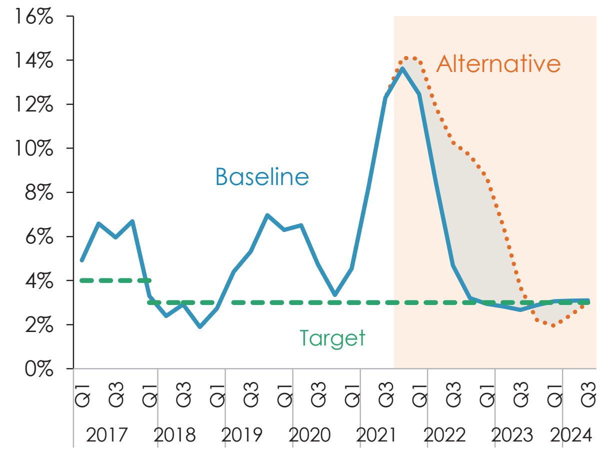



Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

The alternative forecast scenario considers higher domestic demand in 2021-2022 compared to the baseline scenario. The easing of containment measures against the pandemic and a reduction of uncertainties surrounding the vaccination program will unleash pent-up demand. Furthermore, business confidence and the investment environment will improve amid a stabilization of the epidemiological situation. This, in turn, will positively be reflected on credit activity, leading to higher-than-expected economic growth.

Against this background, under the alternative scenario, real GDP will grow by around 11.5% in 2021 and by 6.5% in 2022 (see Figure 2.3.1), despite the relevant monetary policy reaction.

According to this scenario, growing domestic demand will boost imports of goods, worsening the current account balance. The latter will put additional pressure on the country's risk premium and exchange rate. It is noteworthy that the alternative scenario considers the same assumptions about tourism as the baseline scenario. Consequently, net external demand in the service sector will remain at the same level as in the baseline. Hence, inflationary pressures stemming from strong domestic demand will be significantly amplified. In particular, inflation in 2022 will be 4.3 pp higher than in the baseline scenario (see Figure 2.3.2).

Under the aforementioned scenario, monetary policy will gradually be tightened in the wake of updated data, which, in turn, refer to the intensified inflationary pressures.  Such a contractionary position will remain for a relatively long period. Under the alternative forecast scenario, the monetary policy rate trajectory, on average, will see a hike of 3.1 pp in 2022 compared to the baseline scenario (see Figure 2.3.3). However, alongside a neutralization of domestic demand-side pressure on inflation, the policy rate will start to decline in the medium term. The appropriate monetary policy response will eventually drive inflation towards the target level of 3%, albeit with a moderate time lag compared to the baseline scenario.

*In response to increased inflationary pressures, the monetary policy stance will gradually be tightened. Such a relatively contractionary position will remain for a longer period compared to the baseline scenario. Under the alternative scenario, the monetary policy rate trajectory will shift up by 3.1 pp in 2022.*

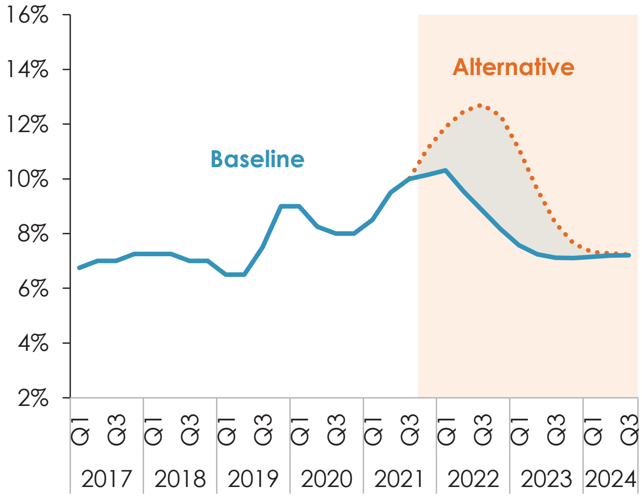



Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

## BOX 2. SURVEY OF MACROECONOMIC FORECASTS

In the fourth quarter of 2021, the National Bank of Georgia (NBG) launched a survey of macroeconomic forecasts that aims to depict a vivid picture of market expectations across several horizons, ranging from the current year to the longer term. This practice has long been established in developed countries and allows central banks to better evaluate risks associated with price stability.

At this stage, the survey seeks forecasts of three major macroeconomic variables: inflation, real GDP growth and the monetary policy rate. Representatives of financial markets currently take part in this survey. The aggregate results are presented in the quarterly monetary policy report under the “Forecasts of Financial Market Participants” section. Box plots are used for data visualization.

In general, a box plot allows for the observation of the distribution of incrementally ascending data. For example, Figure 2.3.4 shows a box plot of inflation forecasts for 2021, the bottom line of which represents the minimum of the projections made by market participants (9%), while the top line corresponds to the maximum value (12.5%). The middle line of the colored part of the box, which is equal to 9.5%, represents the median of the projections. The first half of the ascending data is less than the median, while the second half exceeds it. The average value is denoted by the symbol x and stands at 10%. The horizontal line between the minimum and median displays the 1$^{st}$ quartile, which equals 9.3% and outstrips one-fourth of the increasingly sorted data. The upper line between the maximum value and the median indicates the 3$^{rd}$ quartile and equals 10.6%. This latter only falls behind the highest one-fourth of the data. Typically, the closer the quartiles are to the median and the farther from the minimum and maximum, the greater the concentration of data in the vicinity of the median, which, in turn, indicates more adjacent market expectations. In addition, the box plot displays the variability of the data by the range and interquartile range. The first shows the distance between the maximum and minimum values, and the second represents the distance between the third and first quartiles. All else being equal, the larger the measurements, the more heterogeneous and distant the data are from each other.

*The median of the 2021 inflation forecasts stands at 9.5%, while the average stands at – 10% and the range equals 3.5 pp.*

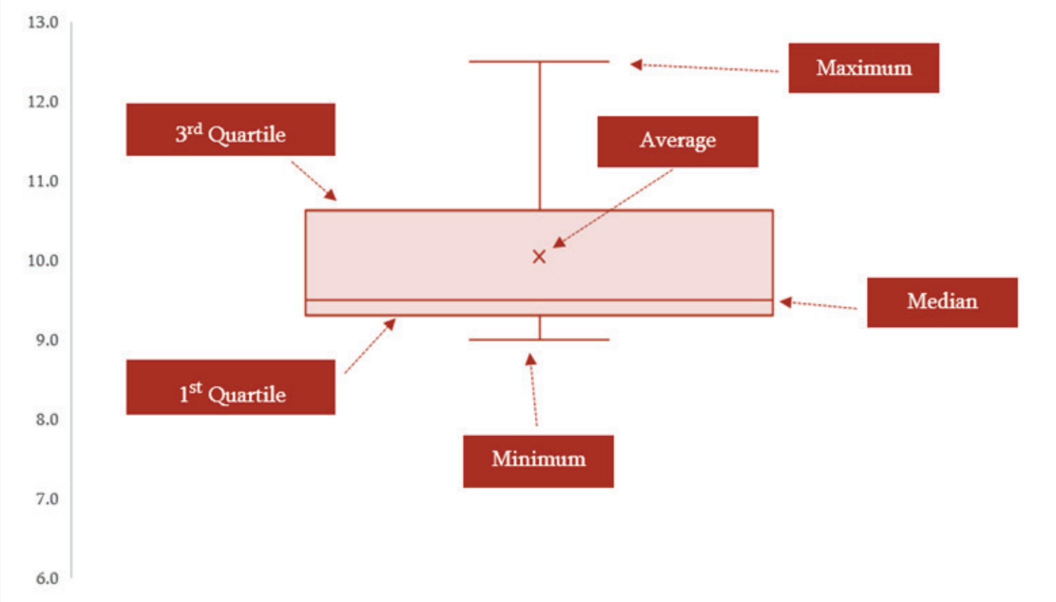



Figure 2.3.4. Box plot of 2021 inflation forecasts made by market participants

Source: National Bank of Georgia

## 2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the fourth quarter of 2021, 10 organizations participated in the macroeconomic forecasts survey. The results revealed that financial market participants project, on average, 10% annual consumer price inflation in Georgia in 2021, with a median of 9.5%. Financial market participants expect a gradual convergence of inflation to its target in the medium term. In particular, the average inflation forecast for 2022 stands at 6% and the median at 5.8%. For 2023, average inflation expectations decrease to 3.9%, and the median to 4% (see Figure 2.4.1). Long-term market expectations are therefore in the vicinity of the inflation target.

In 2021, amid high inflation expectations, market expectations regarding the monetary policy rate fluctuate around its current level. The average forecast is 9.6%, while the median rate is 9.5%. Expectations about the policy rate start to decline in the wake of reducing inflation expectations. In particular, the average and median forecasts for the policy rates fall to 8.7% in 2022 and expectations continue to decline for 2023 to gradually approach the current neutral level. The mean and median rates for 2023 stand at 7.6% (see Figure 2.4.2).

Regarding real GDP growth, market expectations are roughly in line with the NBG's baseline macroeconomic forecasts. The average forecast amounts to 10.3% and the median to 10.1%. The range of market expectations about economic growth in 2021 is notably quite wide and equals 6.2 percentage points. This

*According to the financial market expectations, inflation will gradually converge to its target.*

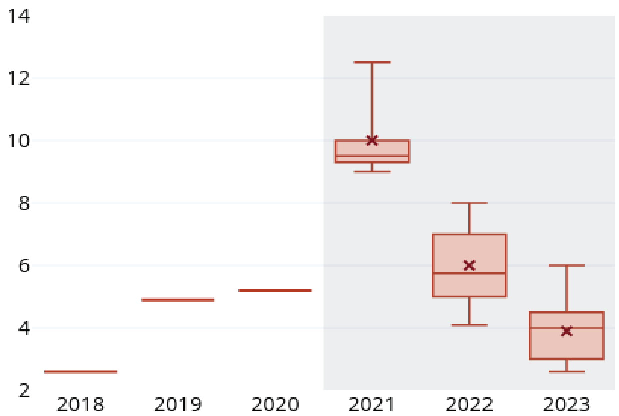



Figure 2.4.1. Actual average inflation (2018-2020) and the distribution of market participants' forecasts (2021-2023)

Source: National Bank of Georgia.

*The monetary policy rate (MPR) is expected to fall in the wake of descending inflation expectations, reaching its neutral level (currently evaluated at 6.5%) in the medium term. However, MPR expectations are characterized by high variability.*

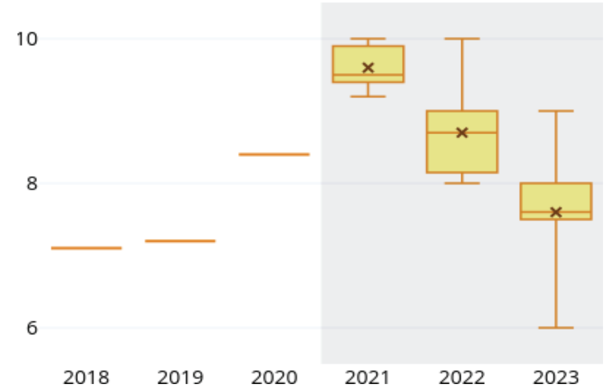



Figure 2.4.2. Actual monetary policy rate (2018-2020) and the distribution of market participants' forecasts (2021-2023)

Source: National Bank of Georgia.

*Market expectations about real GDP growth are roughly in line with the NBG's baseline macroeconomic forecasts.*

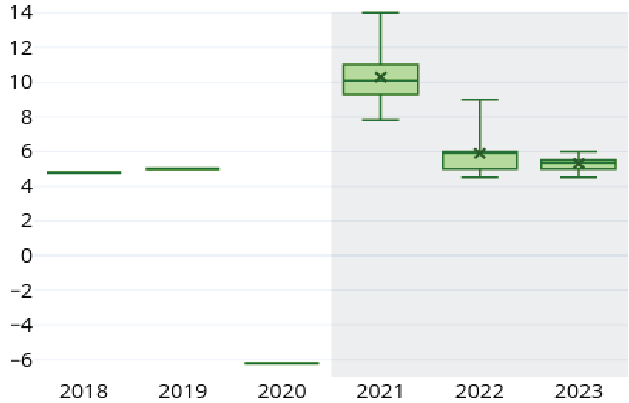



Figure 2.4.3. Actual real GDP growth (2018-2020) and the distribution of market participants' forecasts (2021-2023)

Source: National Bank of Georgia.

is reflective of elevated uncertainties. The average economic growth forecast for 2022 stands at 5.9%, while the median rate is 6%. In 2023, real GDP is anticipated to grow on average by 5.3%, while the median rate is set at 5.4% (see Figure 2.4.3).

# 3 MONETARY POLICY

*Annual inflation stood at 12.3% in September. Recently, high inflation has become a significant challenge for Georgia as well as for other developing and developed countries. The driving forces of high inflation are still mainly one-off factors that are independent from monetary policy. Particularly noteworthy are the significant increases in USD prices of food items and a rise in oil prices on international markets, which have recently accelerated even further. The rapid growth of international transportation costs have also increased inflationary pressure. As for aggregate demand, fiscal stimulus remains, while the lending rate has increased. The increased contribution of foreign currency loans to the increase of lending, against the backdrop of increased GEL funding costs, are also worth noting. According to the current forecast, inflation will remain at a high level for the rest of the year and, under other conditions remaining equal, will significantly decrease from the spring of 2022. Given that the contribution of temporary factors will continue to be a driving force for inflation, and considering that the monetary policy stance is already tight, the Monetary Policy Committee thus decided to keep the policy rate unchanged at 10%.*

*On 27 October, given that temporary factors will continue to be a driving force for inflation and considering that the monetary policy stance is already tight, the Monetary Policy Committee decided to keep the policy rate unchanged at 10%.*

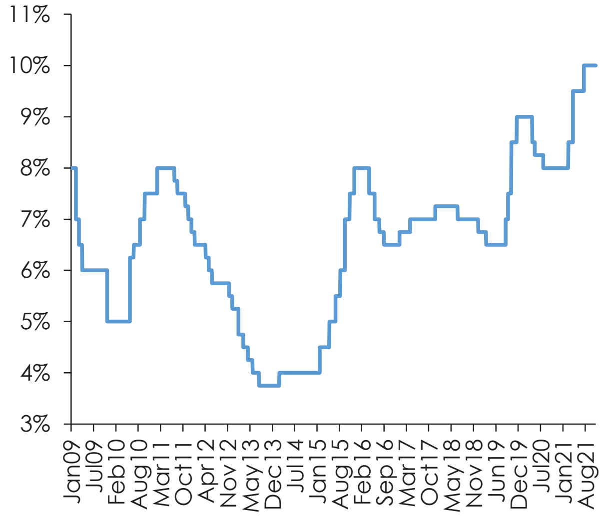



Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

Risks towards inflation growth have been identified since the beginning of the year. These are mainly due to the acceleration of price growth dynamics on international commodity markets. Prices for oil products and some food groups have risen significantly. In addition, international transportation costs have increased, which put additional pressure on prices of imported products. From April, aggregate demand started to activate to a greater extent than had been expected. Against the background of still strong fiscal stimulus, the moderate but accelerated rate of lending also had some effect on inflationary processes. In light of these factors, and in order to curb inflation expectations, between the beginning of the year and August, the Monetary Policy Committee thus increased the interest rate by 2 pp to 10%, subsequently leaving this unchanged at the September session.

The world economy has faced many challenges due to the pandemic. One important factor in this regard concerns the accelerated pace of price increases, which remains a recent concern in both developed and developing countries. Increased inflation is also a challenge for Georgia. Annual inflation stood at 12.3% in September. This high level of inflation is mainly due to one-off factors that became evident globally in 2020-2021. According to preliminary estimates, these exogenous factors have made a contribution of about 8 percentage points to headline inflation. In this regard, the significant increases in USD prices of food items and a rise in oil prices on international markets, which have recently accelerated even further, are particularly noteworthy. The rapid growth of international transportation costs have also added to the pressure.

*The dollarization of deposits and loans continues to decline. This is largely a result of larization measures, including macroprudential instruments. The recent changes to reserve requirements will also contribute to this trend.*

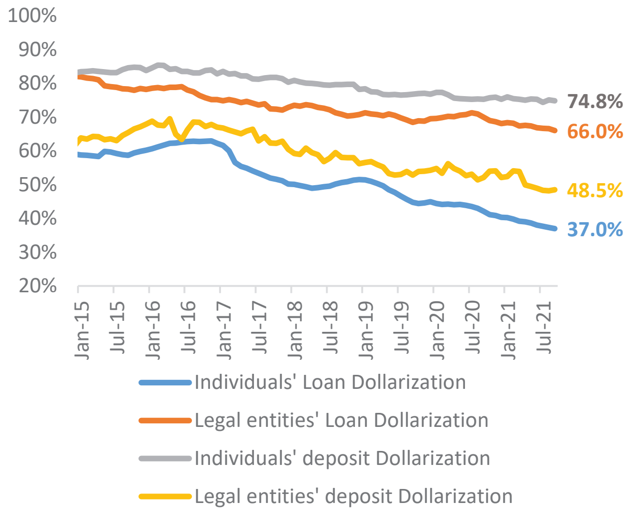



Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: National Bank of Georgia

As for aggregate demand, according to the updated forecast, a real GDP growth of 10% is expected in 2021, which is mainly due to still sizeable fiscal stimulus, pent-up demand and a high growth rate of lending. The latter has recently increased, with the increased contribution of foreign currency loans against the backdrop of increased GEL funding costs being particularly noteworthy. Although strong credit activity is a boost to current economic activity, it also hinders the reduction of inflation.

Inflation will remain high for the rest of the year. In December 2021 and January-February 2022, the base effect from the utility fee subsidy program of the previous year will have an additional upward impact on annual inflation. According to the current forecast, other things being equal, inflation will decline starting from spring 2022. Along with the fading-out of temporary factors, this will be facilitated by tight monetary policy and fiscal consolidation. Given that the contribution of temporary factors to inflation will continue to be a driving force and, considering that the monetary policy stance is already tight, the Monetary Policy Committee decided to keep the policy rate at the current 10% level. Nevertheless, in the face of strong supply-side shocks, the threat of an acceleration of inflation expectations continues to be relevant. In addition, inflationary risks persist and their materialization may warrant a further tightening of monetary policy.

A gradual re-opening of the economy has also had a positive effect on Georgia's foreign trade turnover. According to preliminary data, exports of goods in January-September increased by 24% annually and are about 9% higher compared to the same period in 2019. Revenues from international travelers increased by 73% year on year in the first nine months of the year, though still representing a decline of 66% compared to the same period in 2019. Imports also increased against the backdrop of higher domestic demand, rising by 22% in January-September, reflecting growth of about 3% compared to 2019.

High dollarization remains a challenge for the country and, in addition to limiting the effectiveness of monetary policy, also carries risks to financial stability. In addition, it hinders the improvement of credit ratings and, consequently, impacts investment and employment. Thus, the NBG is constantly analyzing its dynamics. The dollarization of loans is gradually decreasing, which reduces currency and related credit risks to individual borrowers. The dollarization of total loans has decreased by 2.8 pp from the beginning of the year (excluding the exchange rate effect) and stood at 51.4% at the end of September. The dynamics of the dollarization of deposits continued in 2021, which was facilitated by the high differential between the interest rates on GEL and foreign currency deposits. The dollarization of deposits of individuals and legal entities decreased by 1.8 pp from the beginning of the year to September and stood at

64.4% (excluding the exchange rate effect). In order to encourage the de-dollarization of deposits, from 6 July an amendment came into force that directed minimum reserve requirements for foreign currency funds to be determined individually for each commercial bank according to their deposit dollarization. This reduces the reserve requirements for banks with deposit dollarization rates of 40-70%.

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. When necessary, commercial banks generally obtain additional liquidity through refinancing loans, which is the main instrument of the NBG. In addition, the NBG provides liquidity support through temporary instruments, such as swap operations and a liquidity supply instrument to facilitate lending to small- and medium-sized businesses. It should be noted that these temporary instruments are also made available to microfinance organizations through banks. 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.*

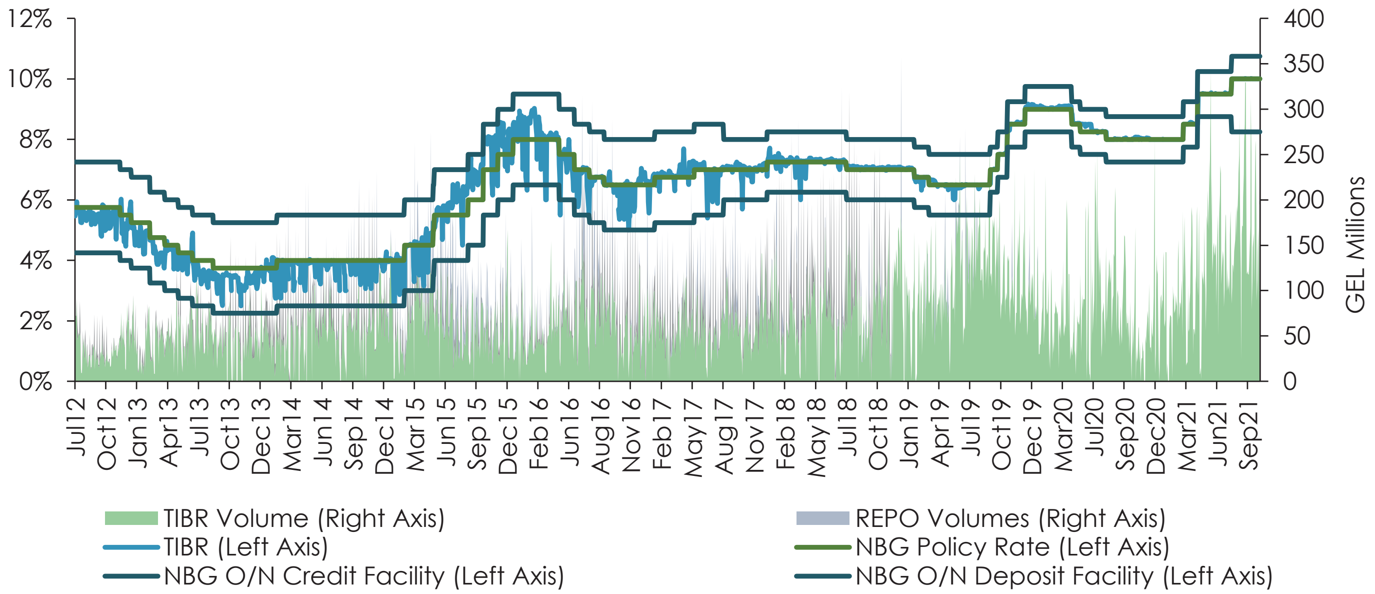



Figure 3.3. Interbank money market

Source: National Bank of Georgia

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