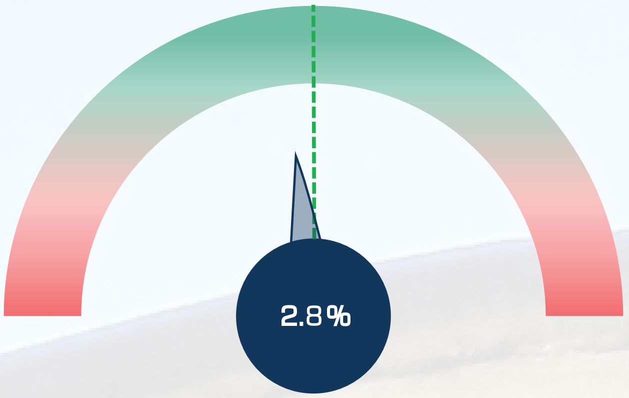
Monetary Policy Report

February

2021

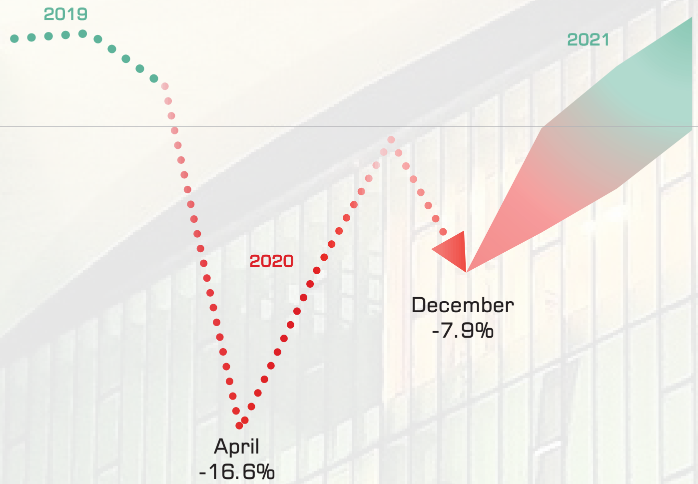
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



2.8%	Inflation has fallen since the beginning of COVID-19-induced economic crisis. Nevertheless, monetary policy is focused on further reducing inflationary risks.

Economic Growth



The renewal of pandemic-related regulations have hindered economic recovery.	-7.9%

Monetary Policy

8.0%

0

8.0%	Monetary policy maintains a tightened stance 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 has ultimately reduced prices and inflation has gradually returned close to the target. However, upward pressure on inflation persists. A prolongation of pandemic-related restrictions creates inflation risks as production costs remain at a high level. Meanwhile, a significant increase in prices on international commodity markets is notable and affects the dynamics of inflation.

Given the present situation, the National Bank of Georgia decided to keep the monetary policy rate unchanged at 8%.

Interest rate changes are reflected on the economy gradually with a time lag of 4-6 quarters. If upward pressure on inflation expectations develop, a tight monetary policy stance may need to be maintained for longer or even tightened further.

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 COVID-19 pandemic has been challenging for both Georgia and the rest of the world. The decline in external demand has severely hit the tourism sector, which was one of the most important sources of economic growth in the pre-pandemic period. Although weak aggregate demand reduces inflation, a faster decline in inflation has been counterbalanced by higher production costs. Partly as a result of the latter, inflation was above the target in 2020. Although the diminishing effect of production costs and output remaining below its potential level are both expected to have downward pressure on inflation, according to the current forecast, inflation will stay above the target throughout 2021. This is due to recent sharp rise of prices on international commodity markets as well as the depreciation of the lari exchange rate observed in previous periods. As prolonged deviation of inflation from the target contains risks for both long-term inflation expectations and price stability, monetary policy will remain tight for a relatively long time. Other things being equal, subsequent reductions in the monetary policy rate – reflecting a decline in inflation expectations – will gradually lead to its neutral level.

Annual inflation, partly due to one-off factors, will temporarily hover above the target.

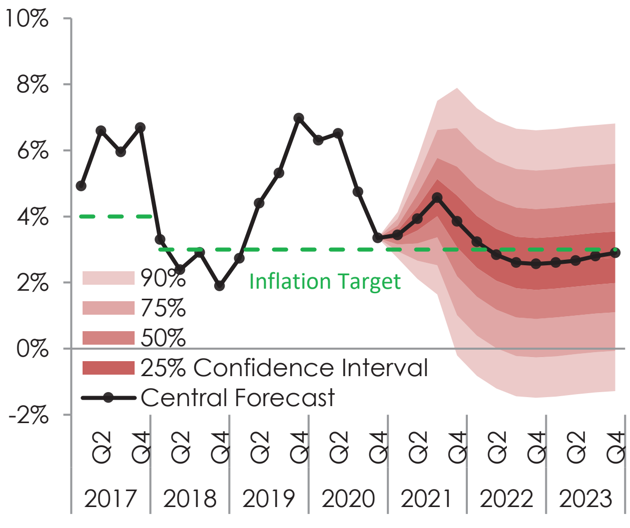


Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia

In 2020, **inflation** was significantly affected by both demand and supply. Reduced aggregate demand pushed consumer prices down, while higher production costs stemming from pandemic-related constraints and the depreciation of the lari exchange rate weighed on inflation, resulting in its hovering above the target (see Figure 1).

According to the **current forecast**, the impact of the above-mentioned factors will gradually wane. However, higher prices of commodities on international markets and the termination of the current government subsidy programs on utilities and bread flour will exert upward, albeit one-off, pressure to push inflation above the target.

Amid the global pandemic, **economic activity** fell sharply in 2020 (see Figure 2), although a further decline was mitigated by relatively strong fiscal stimulus and lending. Given this trend, and the assumption that amid improving epidemiological situation the tourism sector will gradually begin to recover in the second half of the year, a partial recovery of the economy **is expected** in 2021. According to the current forecast of the National Bank of Georgia (NBG), real economic growth in 2021 will be around 4%. In terms of the pace of recovery, the effect of the pandemic-induced reduction in potential output is noteworthy: weakened external demand over time has pushed some firms to leave the market, creating obstacles for economic recovery.

In the previous forecast, it was noted that, in the event of a prolongation of inflationary pressures, the National Bank of Georgia would consider tightening monetary policy or maintaining the existing tightened

Partial recovery of the economy in 2021 is expected given fiscal stimulus measures, sustained lending and the assumption that the epidemiological situation will improve leading to a gradual recovery of the tourism sector in the second half of the year.

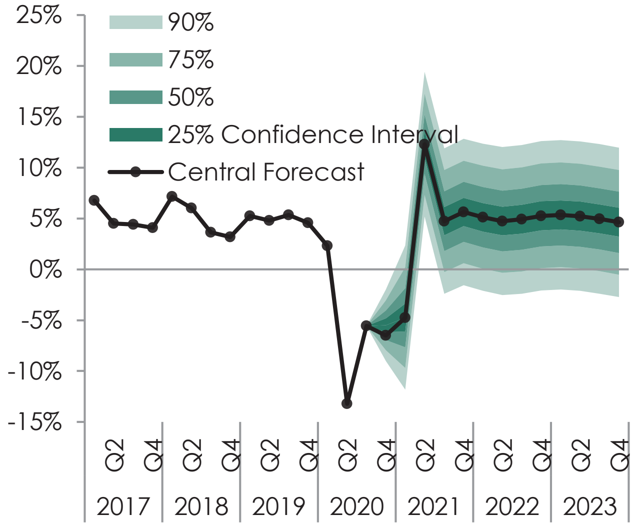


Figure 2. Annual growth forecast of quarterly real GDP

Source: National Bank of Georgia

Amid the prolonged deviation of inflation from the target, the monetary policy rate will remain tight to prevent a rise in long-term inflation expectations.

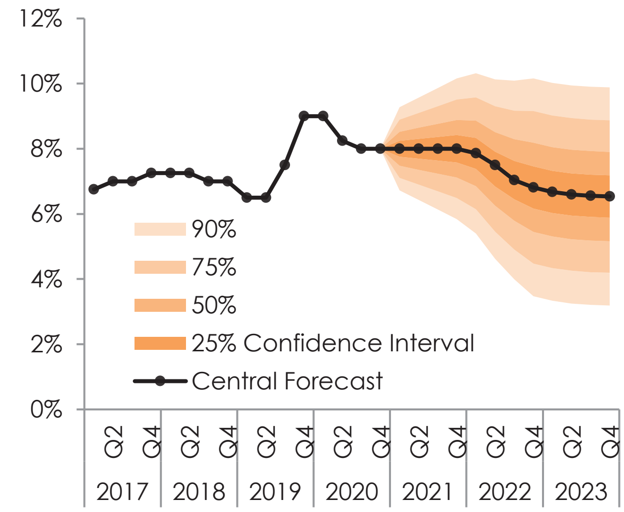


Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

position for a longer period. The reason for this is the threat coming from **elevated inflation expectations**, which is a typical consequence of a prolonged deviation from the target – regardless of the temporary nature of the factors resulting in the upward departure. Such one-off events do not usually affect long-term inflation expectations and, consequently, monetary policy does not respond to them as a separate supply-side factor. However, today, in tandem with other factors, they have **induced a prolonged deviation from the inflation target**. Without an adequate monetary policy stance, this might call into question the possibility of achieving the inflation target and thereby lead to higher inflation expectations. Therefore, it is expected that **monetary policy will maintain a tighter stance in the short term** and that the policy rate will gradually start to decrease to its neutral level only after a decline in inflation expectations.

Finally, 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

In 2020, amid the COVID-19 pandemic, economic growth in Georgia's trading partner countries decreased significantly. As a result, foreign inflows to Georgia, including revenues from exports of goods and services (mainly tourism) and foreign direct investments, substantially reduced. Although imports declined at the same time, the current account deficit continued to widen and, amid a worsening of its stable sources of financing, the GEL exchange rate was under pressure to depreciate. Based on current estimates, the external shock has already been reflected on the exchange rate and the effect of the latter on inflation is gradually being exhausted.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Amid the COVID-19 pandemic, the global economy reduced significantly in 2020. However, economic activity is expected to recover from 2021 with the easing of pandemic-related restrictions and the start of vaccination programs.

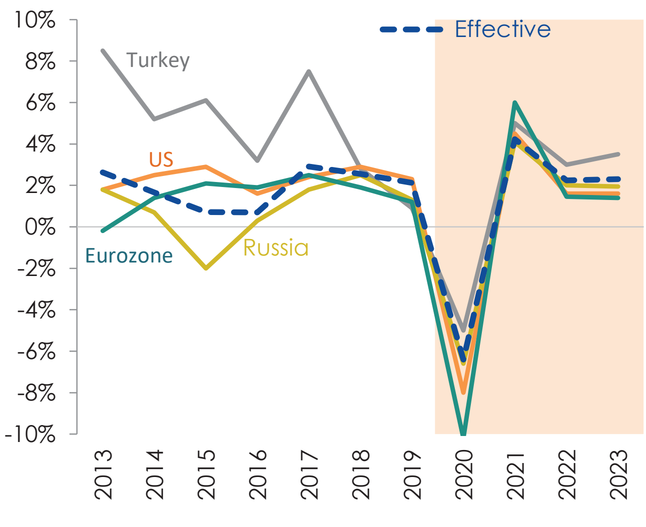


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

The COVID-19 pandemic has led to one of the deepest global recessions in recent decades. Amid restrictions imposed due to the pandemic, economic and business activities have been hampered and supply chains and production process disrupted – leading to the deepest crisis in both developed and developing countries. However, after the second half of the year, with the easing of restrictions, economic activity is expected to slightly recover. In addition, the start of vaccination processes worldwide creates positive expectations about the end of the pandemic. According to the International Monetary Fund's (IMF) forecast[1], the **global economy** in 2020 declined by 3.5%, which is 0.9 percentage points (pp) above the previous forecast.[2] After the virus slows and the vaccination process expands, economic activity should stabilize, and growth in 2021 is projected at 5.5%. For emerging and developing countries, real GDP is forecasted to have fallen by 2.4% in 2020, but growth is expected to recover to 6.3% in 2021.

Together with the easing of pandemic-related restrictions, the growth rate in the **US** slightly stabilized in the second half of 2020. Amid a decline in imports, the external sector recovered slightly. Consumer spending increased and the unemployment rate declined. However, there has been low activity in the manufacturing sector as a result of prolonged restrictions in individual states, and industrial production also fell. Amid monetary and fiscal stimulus, as well as the start of vaccinations, economic activity is expected to recover in 2021. According to the IMF's January forecast, real GDP in the US is expected to have declined by 3.4% in 2020,

1 International Monetary Fund. 2021. World Economic Outlook Update: Policy Support and Vaccines Expected to Lift Activity. Washington, D.C., January.

2 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. Some increase in inflation is expected in the US and eurozone in 2021.

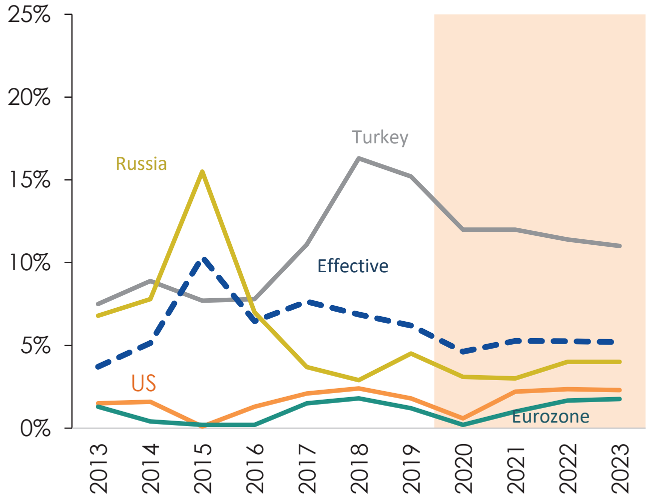


Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

while the growth is projected to be 5.1% in 2021.[3] The inflation rate will be 1.5% in 2020 and 2.8% in 2021.[4]

In the second half of 2020, economic activity slightly improved in the **eurozone**, where activity in the manufacturing and industrial sectors recovered. Meanwhile the start of the vaccination process creates positive expectations for 2021. However, amid the rapid spread of COVID-19 the tourism sector remained suppressed and consumer and business sentiment deteriorated. The volume of exports and investments declined due to reduced demand from trading partners. According to the IMF's January forecast, real GDP in the eurozone is expected to decline by 7.2% in 2020, while the growth is projected to be 4.2% for 2021.[5] The inflation rate will be 0.4% in 2020 and 0.9% in 2021.

In the second half of 2020, economic activity slightly recovered in **Turkey**, where the business climate and manufacturing sector improved and exports slightly increased. However, because of pandemic-related restrictions, both domestic and external demand remained deteriorated. Despite the stabilization of credit growth, consumer spending is low. Inflationary pressure remains high amid the depreciation of the Turkish lira, with annual inflation standing at 14.6% in December. Based on this, the Central Bank of the Republic of Turkey significantly increased the monetary policy rate by the end of the year (6.75 pp). The IMF forecasts that real GDP in Turkey has declined by 5% in 2020 and should increase by 5% in 2021. Inflation is expected to be 11.9% in both 2020 and 2021.[6]

In the second half of 2020, economic activity continued to worsen in **Russia**, which was mostly driven by a deteriorating foreign sector amid pandemic-related restrictions, where the volume of exports and investments declined sharply. The manufacturing sector and consumer spending have also weakened and the unemployment rate increased. Amid a depreciation of the local currency, annual inflation increased and equaled 4.9% in December. According to the IMF's January forecast, real GDP in Russia has declined by 3.6% in 2020, while growth is projected to be 3% in 2021.[7] The inflation rate is expected to be 3.2% in both 2020 and 2021.

3 International Monetary Fund. 2021. World Economic Outlook Update: Policy Support and Vaccines Expected to Lift Activity. Washington, D.C., January.

4 The inflation forecast for Georgia's trading partners is taken from: International Monetary Fund. 2020. World Economic Outlook: A Long and Difficult Ascent. Washington, D.C., October.

5 International Monetary Fund. 2021. World Economic Outlook Update: Policy Support and Vaccines Expected to Lift Activity. Washington, D.C., January.

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

7 International Monetary Fund. 2021. World Economic Outlook Update: Policy Support and Vaccines Expected to Lift Activity. Washington, D.C., January.

In 2020, monetary policy rates were reduced several times in Georgia's main trading partner countries. This was mostly driven by efforts to stimulate economic activity amid the deep recession. The exception to this was Turkey, where the policy rate increased significantly by the end of the year.

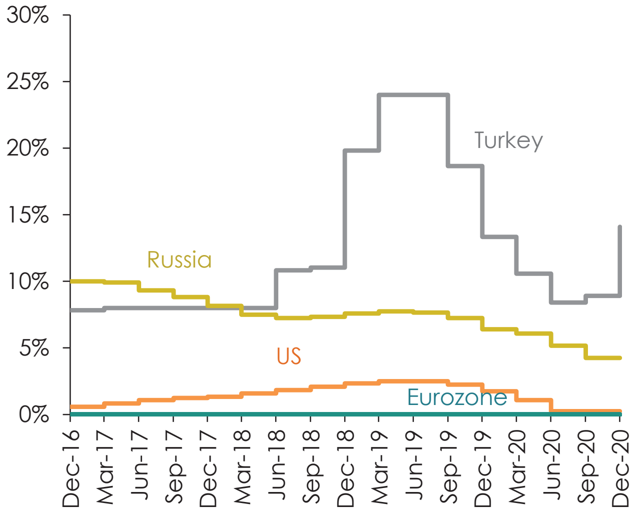


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

In the second half of 2020, weak 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, but consumer spending improved slightly as well as retail sales. Annual inflation also increased and stood at 5% in December. According to the IMF's forecast, Ukraine's real GDP will decline by 7.2% in 2020, while it should grow by 3% in 2021.[8] The inflation rate is expected to be 3.2% in 2020 and 6% in 2021.

In the second half of 2020, growth 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 and the armed conflict with Azerbaijan. Armenia's external sector recently worsened alongside a weakening of the export growth rate and increased imports. Along with high foreign debt, Fitch downgraded the country's credit ranking from BB- to B+. According to the IMF's forecast, real GDP growth in Armenia will decline by 4.5% in 2020, while inflation is expected to be 0.9%.[9] The economic growth and inflation forecasts for 2021 are 3.5% and 2% respectively.

In **Azerbaijan**, economic activity has slowed in both the oil and 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 in Azerbaijan will decline by 4% in 2020, while annual inflation is expected to be 3%.[10] In 2021, economic growth and inflation are projected at 2% and 3.1% respectively.

The **central banks** of Georgia's main trading partners reduced their monetary policy rates several times in 2020 to encourage domestic demand amid the COVID-19 pandemic (see Figure 1.1.3). The only exception to this is Turkey, where the main policy rate increased to 17% in December (from 10.25% in September). The US Federal Reserve has also eased its monetary policy and cut the federal funds rate at 0-0.25%. Meanwhile, the European Central Bank (ECB) has kept its policy rate unchanged at 0%, although the ECB has implemented an extensive quantitative easing program to mitigate the negative effects of the pandemic.

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

In the fourth quarter, registered exports of goods declined by 11.6% annually.

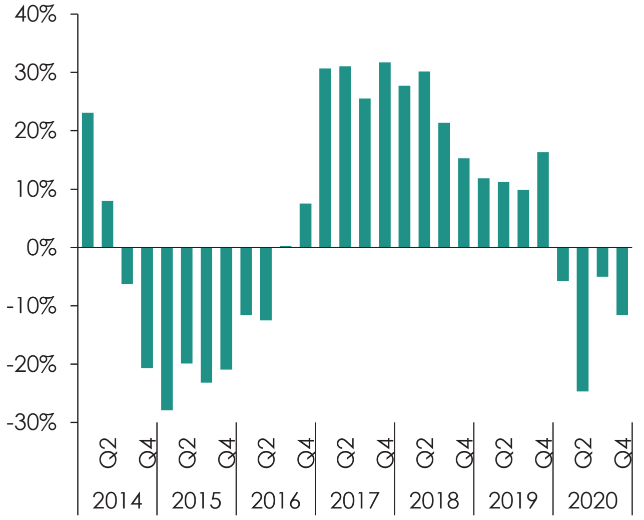


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

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

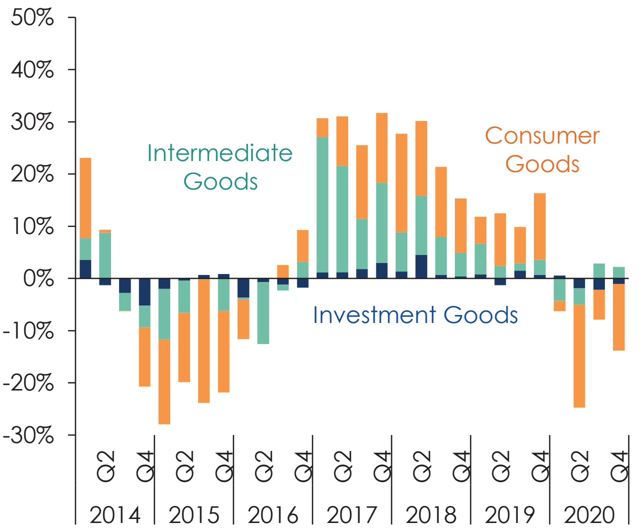


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

External demand continued to decline in the fourth quarter of 2020. Following the declaration of COVID-19 as a pandemic, measures for containing the spread of the virus extended globally, which negatively affected not only internal economic activities and economic growth perspectives, but also international trade and tourism. Against this background, economic activities in Georgia's trade partners decelerated. Alongside restrictions placed on international mobility, these negatively affected demand for exports of goods and services from Georgia, especially for tourism. In light of weaker domestic demand and lower external inflows, imports of goods substantially declined. According to the recent forecast, the current account deficit in 2020 has considerably widened compared to the previous year.

Registered exports of goods fell by 11.6% annually in the fourth 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 fourth quarter, the reduction of exports to Armenia made the highest contribution to the overall decline (a -10.3 pp contribution annually), which was mainly a consequence of lower demand for motor cars and motor vehicles for the transport of goods and alcoholic beverages. Meanwhile, exports to Azerbaijan declined mainly in terms of substantially lower levels of exports of motor cars, rods of non-alloy steel and manufactured tobacco. In contrast, exports to Ukraine increased, mainly due to higher sales of motor cars, ferro-alloys, copper scrap and cigarette-cigarillos, while exports to Russia rose due to increased sales of ferro-alloys, mineral waters, various fruits, and cigarette-cigarillos. For European countries, exports to Germany increased in terms of sales of various nuts, 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 scrap, 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, wines of fresh grapes, alcoholic beverages and mineral waters. In terms of intermediate goods, exports of copper ores and concentrates, semi-manufactured gold, ferro-alloys, live bovine and other types of animal groups all saw a substantial rise.

Given the restrictions on international flights and land border closures, the number of international visitors to Georgia continued to decline in the fourth quarter. Overall, the number of international visitors declined by 91.6% annually, inducing a 93.8% fall in revenues from international travelers (see Figure 1.2.3).

Revenues from international travelers remained at a considerably low level.

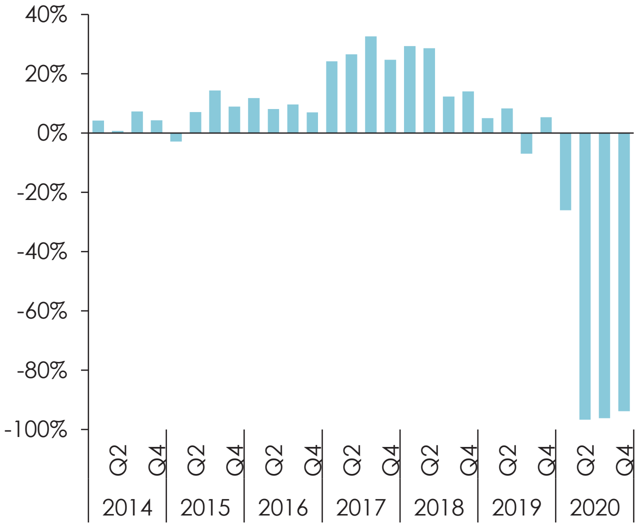


Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

Instant money transfers continued to increase.

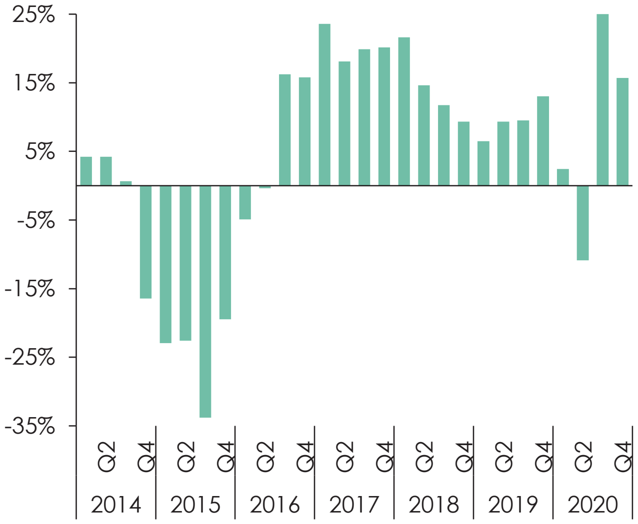


Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

It is expected that until the national borders reopen and international tourism recovers, revenues from international travelers will remain negligible in the beginning of 2021.

In the fourth quarter of 2020, instant money transfers to Georgia increased by 15.7% 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 551.3 million USD in the fourth 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 weaker domestic demand, imports of goods declined, falling by 17.2% annually in the fourth quarter (see Figure 1.2.5). The decline in imports from regional countries was significant, particularly those from Russia, while the decline of imports from the USA, Japan and China also continued. In contrast, imports from Armenia increased because of higher imports of copper, as well as precious metals ores and concentrates for subsequent re-export.

In the fourth quarter of 2020, imports of all types of goods (intermediate, consumer and investment) declined (see Figure 1.2.6). This reduction predominantly stemmed from lower imports of consumer goods – more specifically, from reduced purchases of motor cars, petroleum products and various ready-made clothes. 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 and special purpose motor vehicles.

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

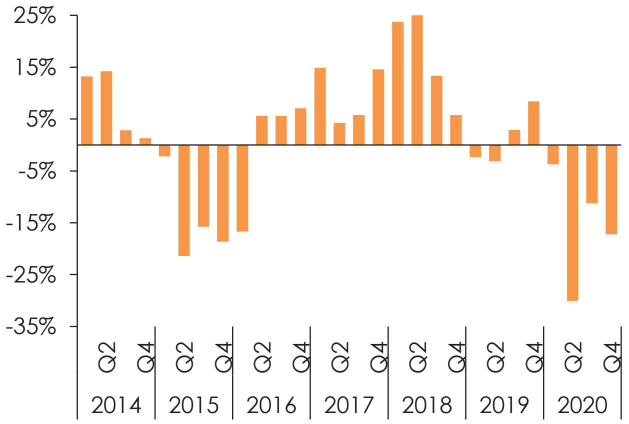


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

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

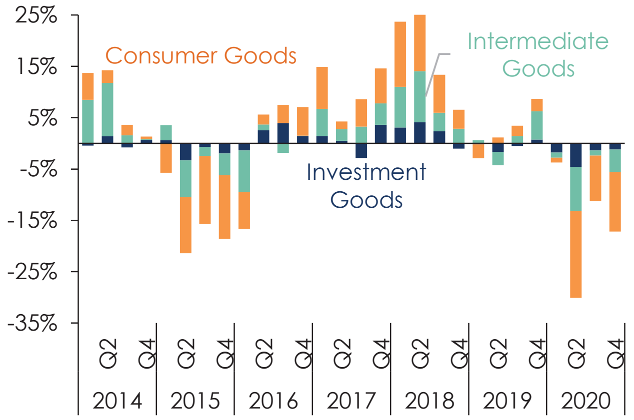
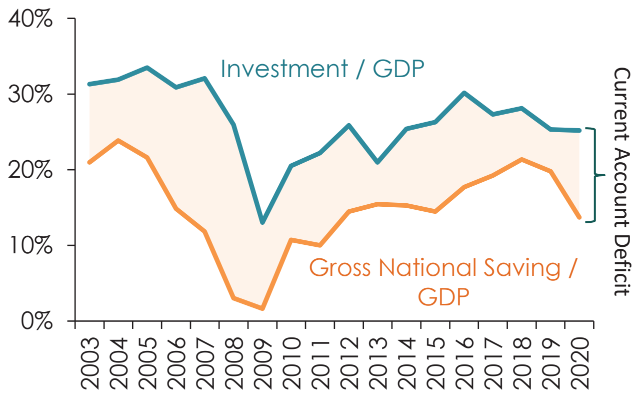


Figure 1.2.6. Annual change in registered imports of goods

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 quarter of 2019 and the first three quarters of 2020.

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

In the third quarter of 2020, in light of decreased exports of goods and services, as well as lower money transfers, the current account deficit increased by 577 million USD and amounted to 560 million USD, which was 13% of quarterly GDP. It is worth noting that in the same quarter of 2019 the current account balance was positive – as it had been in 2018 for the first time since Georgia gained independence. According to preliminary estimates, the current account balance in 2020 has considerably worsened compared to the previous year.

The primary source of financing the current account deficit is foreign direct investments, which decreased by 23.6% annually in the third quarter and reached 302.6 million USD. The largest of these investments went to the finance, energy and manufacturing sectors.

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

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

The sharply negative contribution of net exports to economic growth was somewhat offset by consumption.

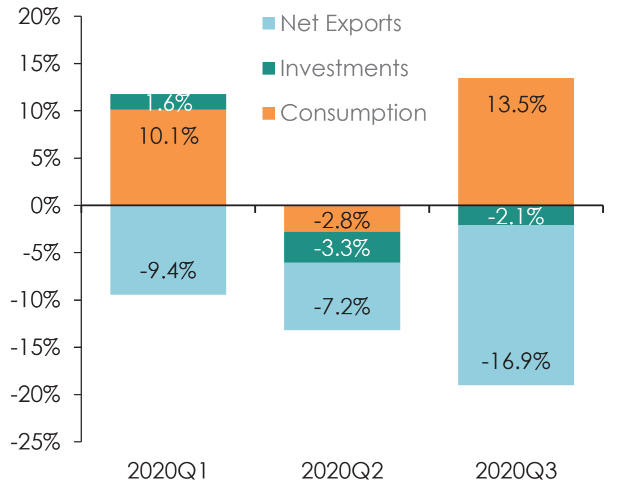


Figure 1.3.1. Real growth of GDP and private consumption

Source: GeoStat; NBG calculations

In the third quarter of 2020, real GDP fell by 5.6% year on year.

Exports of goods and services almost halved. This reduction reflected an 80% drop in exports of services that stemmed from the disruption in tourism revenues. In contrast, imports of goods and services fell by 20%. In sum, net exports contributed 16.9 percentage points (pp) to the economic downturn.

The sharply negative contribution of net exports to economic growth was somewhat (13.5 pp) offset by rising consumption. The boost to consumption can be related to both fiscal stimulus aimed at mitigating the effects of the pandemic and the favorable growth of lending to the economy.

The impact of the crisis on investments was relatively small, making a negative contribution amounting to 2.1 pp (see Figure 1.3.1).

1.3.2 OUTPUT

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

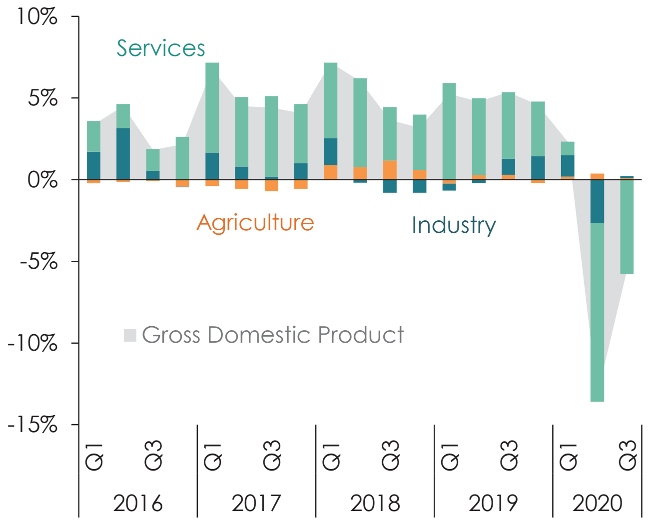


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

As mentioned above, in the third quarter of 2020, real gross domestic product decreased by 5.6% year on year (see Figure 1.3.1). This drop was caused by the sharp decline of services (5.8 pp). Meanwhile, the contributions of agriculture and industry were positive, each amounting to 0.1 pp.

The COVID-19 pandemic started to have a negative effect on the Georgian economy in the first quarter of 2020. The tourism sector suffered the biggest losses, in both Georgia as well as worldwide. 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. A small decrease in the number of foreign visitors to Georgia 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 effectively stopped.

In the third quarter, the restrictions directed at countering the spread of the pandemic were eased. Domestic mobility and tourism activities increased compared to the second quarter, although declined year on year.

With 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 53.1% year on year, making a 2.8 pp negative contribution to the overall economic decline. The transport sector, where the contribution of travel agencies is significant, decreased by 25% (making a 1.4 pp contribution to the decline of GDP).

The impact of the crisis on the industrial and agricultural sectors was smaller. Despite the pandemic, infrastructural projects were actively pursued and activity was maintained in the manufacturing industry, where the share of export-oriented enterprises is high. The mining industry grew by 14.7%, rendering a 0.2 pp contribution to GDP growth. A small increase was also observed in agriculture.

1.4 LABOR MARKET

An increase in unit labor cost is one of the factors behind inflation growth.

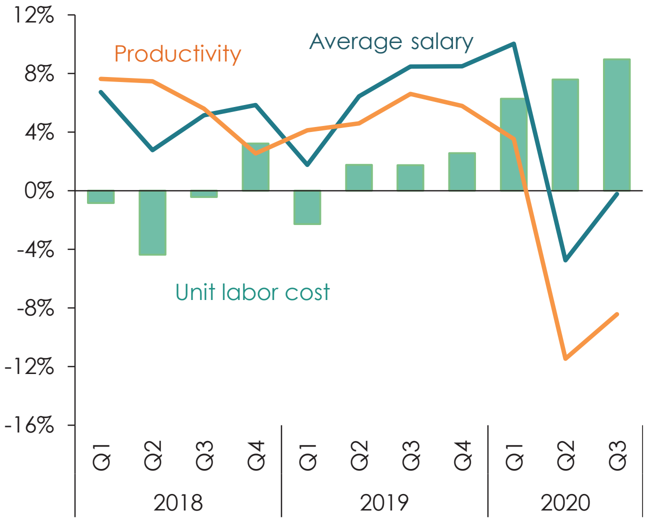


Figure 1.4.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

In the third quarter of 2020, the real value added produced per employee (labor productivity/productivity) in the country's economy decreased by 8.4% annually (see Figure 1.4.1).

At the same time, the salaries of employees averaged 1,240 GEL, which was a 0.2% nominal annual decrease.

Therefore, 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 this increase was the smaller decrease in salaries than in output.

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

1.5 FINANCIAL MARKET AND TRENDS

1.5.1 LOANS

In December, relative to September, the annual loan portfolio growth decreased and stood at 9.1% (excluding the effect of exchange rate fluctuations).

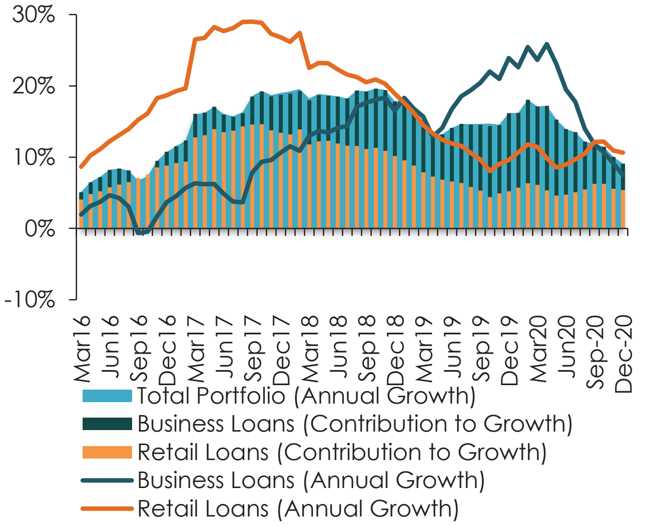


Figure 1.5.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In December, relative to September, the loan portfolio decreased and stood at 9.1% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 1.5 pp and stood at 10.6%, while loans to legal entities decreased by 4.3 pp and equaled 7.5% (see Figure 1.5.1). The growth of business loans was primarily driven by an increase in loans issued to the transport, construction and agriculture sectors. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for business loans and a slight decline in demand for retail loans.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the fourth quarter of 2020 was driven by domestic currency loans (see Figure 1.5.2). In December, the annual growth rate of foreign currency-denominated loans decreased and stood at 1.1%, while the growth rate of loans in the domestic currency increased by 4.1 pp and equaled 19.0%. In the fourth quarter, the loan larization ratio increased slightly and equaled 44.3%. 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.

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

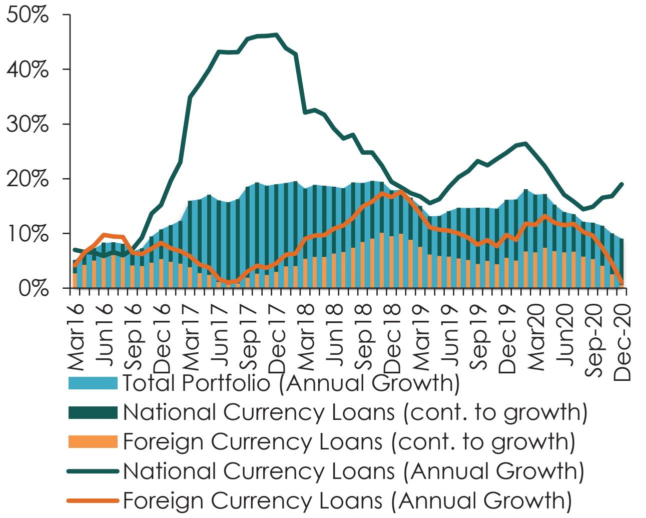


Figure 1.5.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

1.5.2 INTEREST RATES AND CREDIT CONSTRAINTS

In December, the monetary policy rate was 8.0%. In the fourth quarter of 2020, interest rates on government securities did not change significantly as the monetary policy rate remained unchanged (see Figure 1.5.3).

Compared to the previous quarter, the spread between long- and short-term interest rates 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 December, relative to September, interest rates on domestic currency deposits did not change significantly and equaled 9.2%. Meanwhile, interest rates on foreign currency deposits decreased slightly and equaled 2.6%. 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. Representatives of the banking sector expect a slight tightening of credit conditions; however, it is important to note that it is difficult to

As the monetary policy rate remained unchanged, in the fourth quarter of 2020 interest rates on government securities did not change significantly.

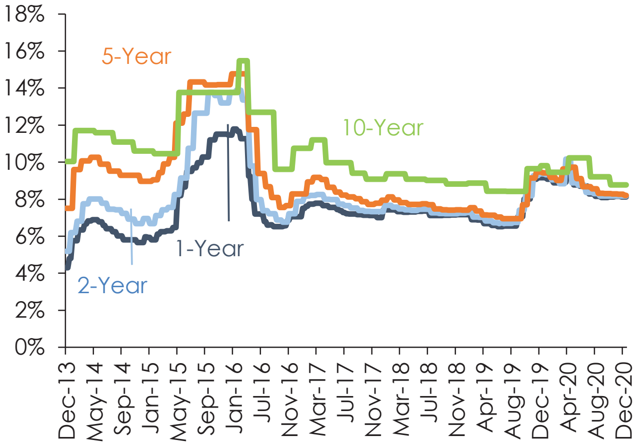


Figure 1.5.3. Interest rates on government securities

Source: National Bank of Georgia

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

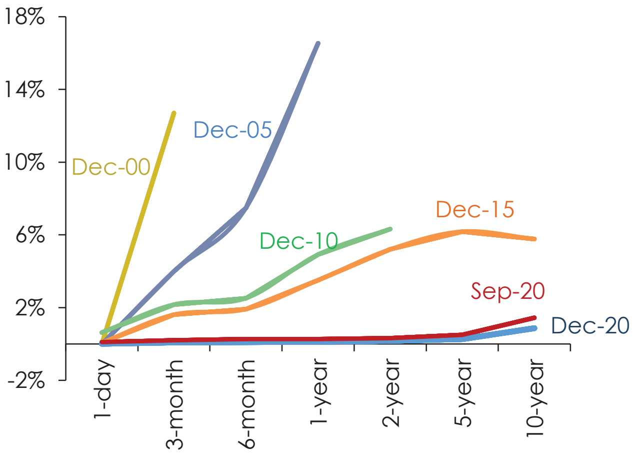


Figure 1.5.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

As of December, relative to September, average interest rates on the stock of legal entities for domestic currency loans decreased slightly, while not changing significantly for foreign currency loans.

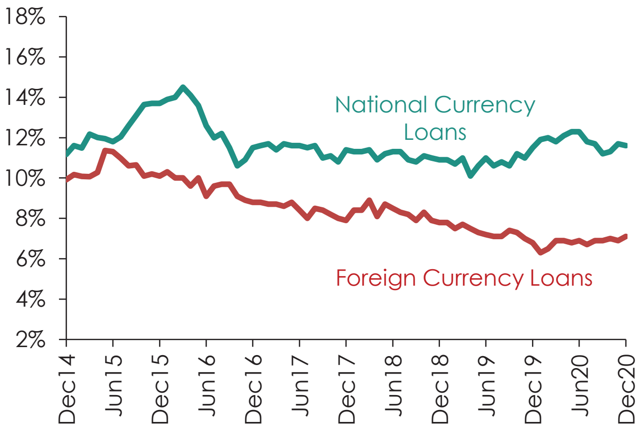


Figure 1.5.5. Average interest rates on business loans

Source: National Bank of Georgia

form expectations due to the ongoing uncertainty caused by the COVID-19 pandemic. In December, relative to September, interest rates on loans for small and medium enterprises (SME) decreased, while increasing slightly for corporate loans. Interest rates on SME loans decreased by 0.6 pp and equaled 10.2%, while interest rates on corporate loans increased by 0.6 pp and stood at 9.7%. Meanwhile, interest rates on retail loans decreased by 0.8 pp and equaled 14.2%.

As of December, average interest rates on the stock of legal entities for domestic currency loans increased slightly and stood at 11.6%, while interest rates for foreign currency loans did not change significantly and equaled 7.1% (see Figure 1.5.5). Representatives of the banking sector expect a slight increase in interest rates for loans in foreign currency.

1.5.3 EXCHANGE RATE

In the fourth quarter of 2020, the GEL nominal exchange rate depreciated by 5.4% against the US dollar and by 7.6% against the euro, compared to the previous quarter. The GEL also depreciated against the Russian ruble by 1.9%, but appreciated 3.5% against the Turkish lira. In the same period, the nominal effective exchange rate depreciated by 3.3% on a quarterly basis and by 3.0% on an annual basis. As for the price-adjusted exchange rate, in the fourth quarter of 2020, the real effective exchange rate depreciated by 3.4% on both a quarterly and year-on-year basis (see Figure 1.5.6). It should be noted that the real exchange rate depreciated against almost all trading partner countries, although appreciating 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 depreciates slightly more than the official exchange rate. In the fourth quarter of 2020, the adjusted nominal effective exchange rate depreciated by 3.9% on a quarterly basis and by 4.3% on an annual basis (see Figure 1.5.7). The reason for this is that the lari depreciated more against the US dollar than against other trading partners on average.

The real effective exchange rate remains undervalued (annual depreciation 3.4%).

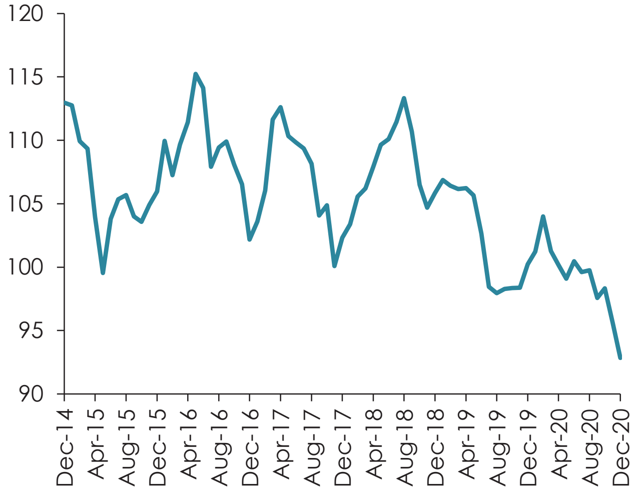


Figure 1.5.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

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

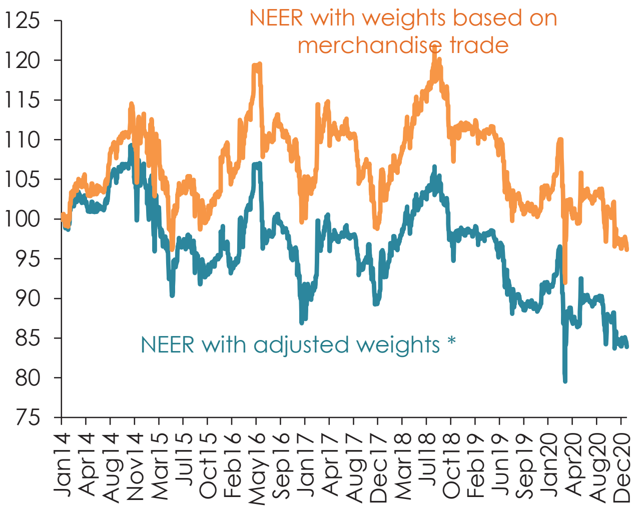


Figure 1.5.7. Corrected nominal effective exchange rate

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	**-3.0**	**-3.4**	**-3.4**
Eurozone	-16.3	-13.3	-2.5
Turkey	22.5	11.6	2.2
Ukraine	5.0	4.5	0.3
Armenia	-5.2	-4.1	-0.3
US	-9.9	-8.1	-0.4
Russia	7.9	6.7	1.0
Azerbaijan	-9.9	-9.1	-1.0
Other	-15.2	-12.7	-2.7

Table 1.5.1. Effective exchange rates annual growth (4th quarter of 2020)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

Inflation has been declining since May. Utility subsidies drastically reduced inflation in December.

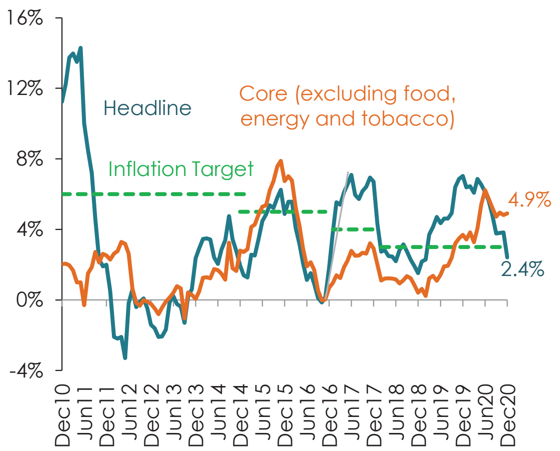


Figure 1.6.1. Headline and core inflation

Source: GeoStat

During the year, inflation was mostly driven by food prices, while fuel prices pushed it down.

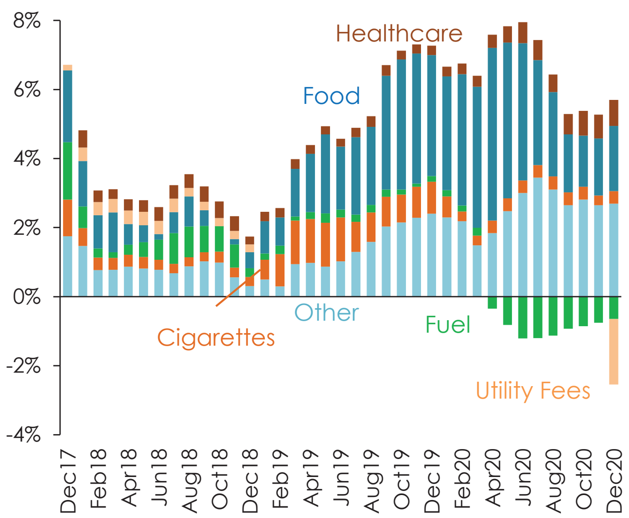


Figure 1.6.2. Food inflation

Source: GeoStat

1.6 CONSUMER PRICES

In early 2020, as we noted in previous reports, the decline in inflation was delayed as a result of the shock caused by the COVID-19 pandemic. In April, annual inflation reached the highest mark of the year at 6.9%. Over the following months, as expected, inflation gradually decreased, falling to 2.4% in December. It should be noted that the sharp decline in inflation in December was caused by the utility subsidies offered to the population, which reduced inflation by 1.9 pp.

Meanwhile, core inflation, which excludes volatile food, energy and cigarette prices, amounted to 4.9% in December. The significant difference between headline and core inflation is largely due to the aforementioned utility subsidies (see Figure 1.6.1).

During the year, food prices pushed inflation upward, while, on the contrary, fuel prices had the biggest impact on the reduction of inflation, the latter stemming from lower oil prices compared to the previous year. The impact of both of these factors largely declined towards the end of the year. In December, food inflation was 6.7%, making a 1.9 pp contribution to inflation, of which oil and cheese alone contributed 0.8 pp. The negative impact of fuel prices on inflation fell to -0.6 pp in December. The year-on-year rise in the prices of healthcare and cigarettes were also noteworthy, making 0.8 pp and 0.4 pp contributions to December inflation, respectively (see Figure 1.6.2).

In December, inflation for imported, domestically produced, and mixed goods was 0.5%, 2.3%, and 3.6% respectively. The relatively low inflation on imported goods can be explained by the reduction of fuel prices (see Figure 1.6.3).

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

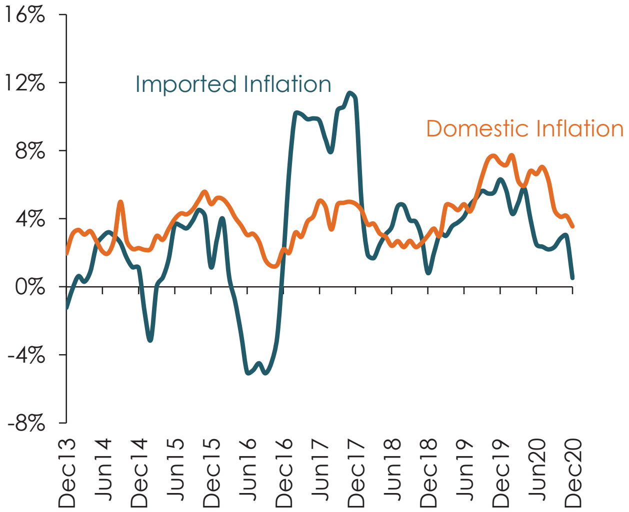


Figure 1.6.3. Contribution of different products to inflation

Source: GeoStat

2 MACROECONOMIC FORECAST

The COVID-19 pandemic hit the Georgian economy hard in 2020, causing a severe drop in real GDP. Although economic activity is expected to recover gradually in 2021, according to current estimates, it will remain below the potential level. Against this backdrop, aggregate demand will linger and have downward pressure on inflation. In contrast, the effects of sharply rising commodity prices on international markets and the depreciation of the lari exchange rate in previous periods will push inflation up. In part, this interplay of factors will be accompanied by the impact of continued high unit labor costs stemming from pandemic-related constraints. As a consequence, inflation will likely temporarily hover above the target. The tight monetary policy stance is thus expected to be maintained for a relatively longer period in order to prevent this deviation from being reflected in long-term inflation expectations.

Given the current situation, the main macroeconomic forecasts are characterized by extraordinary uncertainty. The recent vaccine approvals have raised hopes of a turnaround in the pandemic. However, new waves and new variants of the virus pose concerns for the baseline economic outlook. It is worth mentioning that a vaccine will not stop the pandemic immediately and vaccine coverage is likely to expand only gradually. The alternative scenario considers a realization of those risks. Under this scenario, the process of economic recovery will be slower in 2021 than in the baseline scenario. Inflation will remain above the target for a longer period, while monetary policy will be tighter.

2.1 BASELINE MACROECONOMIC FORECAST

In the last quarter of 2020, annual inflation declined to 3.3%, partly as a result of the effect that temporary subsidies on utilities had on consumer prices in December (see Figure 2.1.1). The sharp reduction of demand resulting from the pandemic has put downward pressure on inflation, but several significant factors have pushed consumer prices in the opposite direction, including increased unit labor costs in the wake of restrictions and the effects of the depreciated lari exchange rate (see Figure 2.1.2).

Headline inflation will temporarily hover above the target.

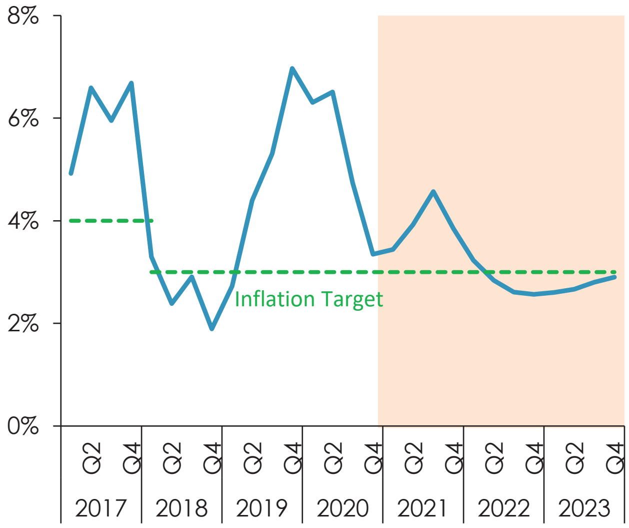


Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

The impact of the aforementioned factors on inflation is expected to be partially maintained in the short term, in tandem with the pressure stemming from recently rising prices on international commodity markets. At the same time, the termination of the current government subsidy programs on utilities and bread flour will put (albeit one-off) upward pressure on consumer prices, leading inflation to temporarily remain above the target. Upon the exhaustion of those one-off factors, the deviation will gradually diminish and inflation will remain close to the target in the medium term, amid an adequate monetary policy response.

According to preliminary estimates, the contraction of real GDP averaged 6.1% in 2020 (see Figure 2.1.3). This was largely induced by a sharp decline of net exports (including tourism) resulting from diminishing foreign demand. However, the increase of consumption has been noteworthy, owing to the growth

The deviation of inflation from its target is largely driven by the pressure stemming from the recent rise of prices in international commodity markets.

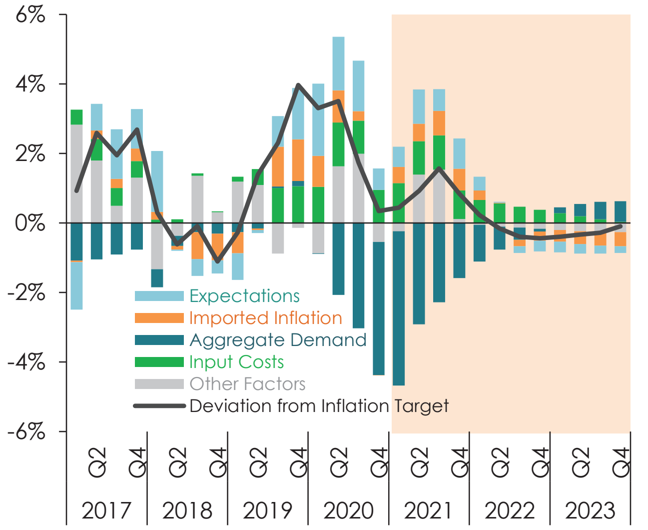


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

Real GDP contraction stood at 6.1% in 2020; however, according to the current forecast, the economy will partially recover and grow by 4% in 2021.

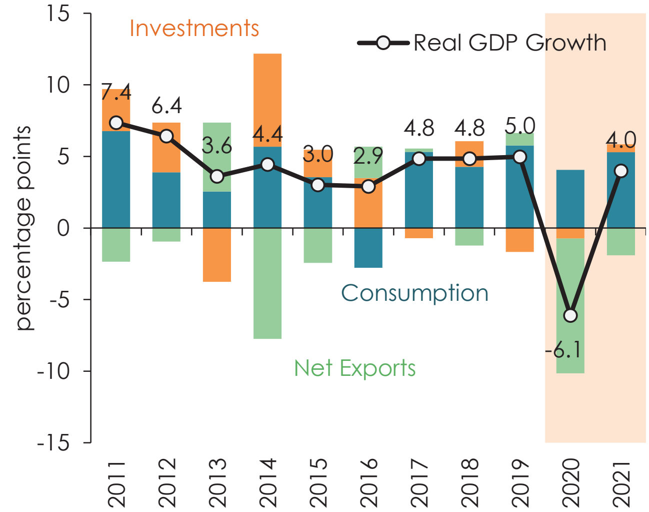


Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

of fiscal stimulus and lending. With the persistence of the latter factors and an expected partial recovery of the tourism sector in the second half of the year, the economy is currently projected to grow by 4% in 2021.

The current forecasts are naturally characterized by great uncertainty. The recovery period and the pace of domestic activity and the tourism sector will essentially be determined by the timely availability and efficiency of the COVID-19 vaccines. Any complications in this regard may become a pre-condition for prolonged restrictions on international mobility, which, in turn, will keep economic activity at a low level and push inflation downward. Moreover, a prolongation of restrictions will force some companies to exit the market and further curtail economic activity. On the contrary, a higher-than-expected upsurge in international commodity prices will put upward pressure on inflation. Furthermore, any worsening of the epidemiological situation in Georgia's trading partners may become an additional reason for a rise in inflation: expectations will deteriorate amid falling demand for exports of goods and remittances, which will be negatively reflected in the country's currency and sovereign risk premia. The latter will put upward pressure on consumer prices through both the channel of imported inflation and higher input costs of companies.

As stated previously, annual inflation was above the target in the previous year and is expected to remain above it throughout 2021, albeit to a smaller extent. These dynamics were largely driven by one-off factors, including a sharp rise of prices on international commodity markets; however, a prolonged deviation from the inflation target underpins the threat of an elevation of long-term inflation expectations and hinders the objective of achieving price stability. Furthermore, uncertainties related to the prolongation of the pandemic may cause expectations to further deteriorate. Given such circumstances, it is optimal to maintain a tightened monetary policy stance for a relatively long time; thereby, the policy rate is expected to stay at the current 8% in the short term. Afterwards, it will decline gradually 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 inflation forecast for the medium term has been revised upward. The trend of increasing commodity prices on international markets has led to the increased inflation outlook. Meanwhile, renewed measures to contain the virus have pushed production costs up for a longer period than previously expected, which will eventually increase inflation.

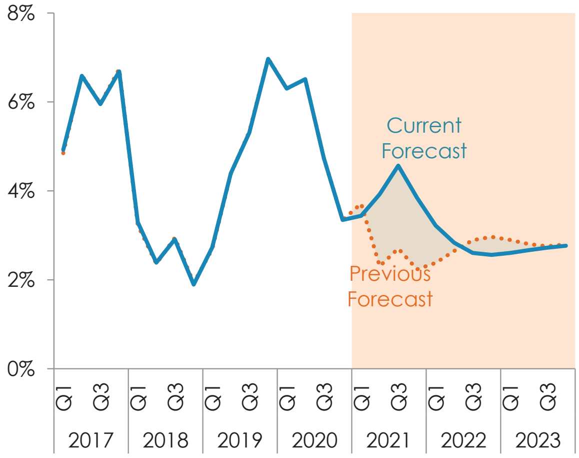


Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The real GDP growth forecast has been revised downward to 4%. The major reason for the downward revision is the prolonged pandemic, which pushes investments down.

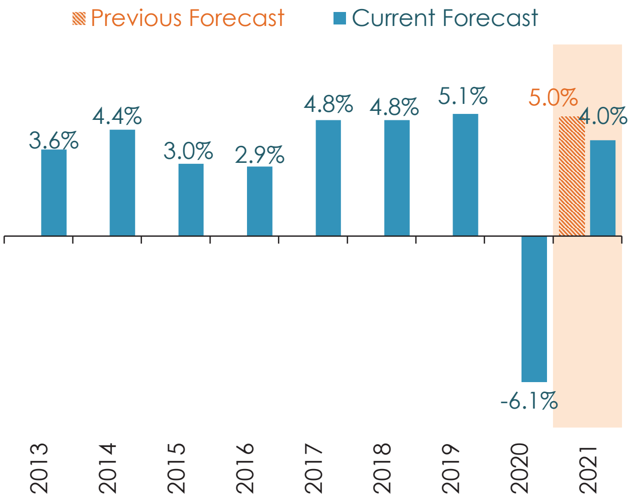


Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). A significant increase in commodity prices on international markets has led to the increased inflation forecast. Increased prices on international markets are eventually transmitted to food and fuel prices in the domestic market. The persistence of high production costs are also notable. Renewed measures to contain the spread of the virus pushes production costs up, which ultimately increases expected inflation. Based on the current epidemiological situation and the new strains of the virus, it is expected that containment measures will be maintained for longer than previously expected. The revised inflation forecast thus considers a higher and longer contribution of increased production costs to inflation. Based on the revised forecast, inflation will start to rise in the second half of 2021. Inflation will then subsequently decline to the 3% target level.

The real GDP growth forecast has been revised downward to 4% (see Figure 2.2.2). The major reason for this downward revision is the prolongation of the pandemic, which pushes investments down. Compared to the previous forecast, fiscal stimulus and credit activities are the major contributors to economic growth. While the external sector remains weak.

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 remain almost the same as in the previous forecast. Although expectations about a depreciation of their currencies have decreased, inflation expectations have increased, which could be linked to a prolonged pandemic. In particular, virus containment measures persist, which increase production costs and ultimately push up prices. Meanwhile, the significant increase in international commodity market prices could lead to higher inflation expectations compared to previous projections.

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

The updated projections regarding the economic stances of Georgia's main trading partners are almost the same as in the previous forecast. Although expectations about a depreciation of their currencies have decreased, inflation expectations have increased.

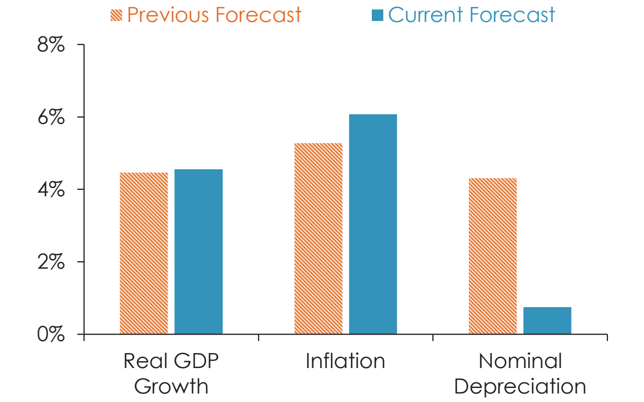


Figure 2.2.3. Changes in the forecast of external assumptions for 2021

Source: Bloomberg

The alternative forecast scenario considers a deeper recession than in the baseline scenario. In particular, a prolonged pandemic causes a greater reduction of external demand and investment. Economic recovery is slower in the alternative scenario and real GDP is expected to grow by only 1% in 2021.

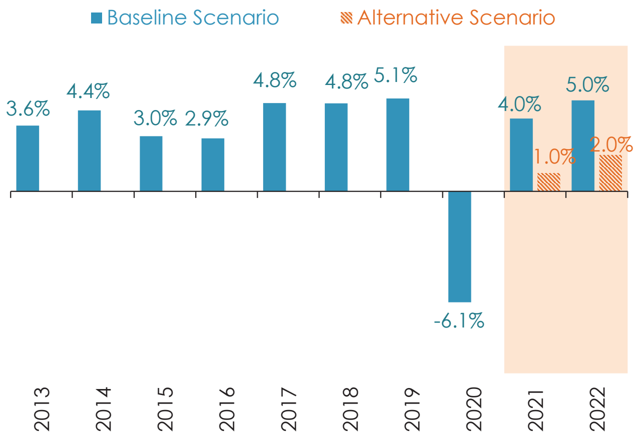


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a more severe economic crisis compared to the baseline scenario. The recent vaccine approvals have raised hopes of a turnaround in the pandemic. However, new waves and new variants of the virus pose concerns to the baseline economic outlook. It is worth mentioning that a vaccine will not stop the pandemic immediately and that the coverage of the vaccine is likely to expand only gradually. Before that, various virus containment measures would need to be retained. 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. 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 in place. Thus, people's willingness to start travelling even after the reopening of borders is uncertain. Prolongation of the COVID-19-induced recession will make developing economies, including Georgia, riskier. The country sovereign risk premium will thus see a hike that will dampen investment and economic activities.

Realization of the abovementioned risks will slow economic recovery. Due to weak net exports and investment, under the alternative forecast scenario real GDP will only increase by 1% (see Figure 2.3.1). A prolonged pandemic may also lead to a fall in potential GDP growth.

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 increases the sovereign country risk premium, which causes currency depreciation. Production costs increase as producers' debt burdens will be higher. Finally, increased imported inflation and higher input costs create inflationary pressure. Meanwhile, inflation expectations will increase. In the alternative scenario, over 2021-2022, inflation will be 1.1 pp higher than in the baseline scenario.

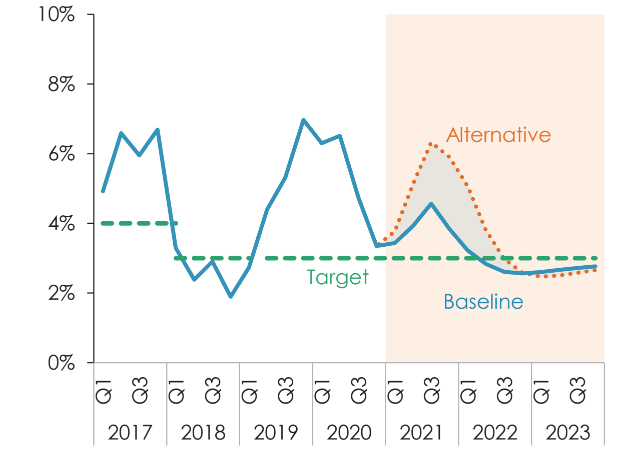


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

In response, the monetary policy stance will be tighter than in the baseline scenario. Under the alternative scenario, over 2021-2022, the monetary policy rate trajectory will shift upwards by 1.6 pp.

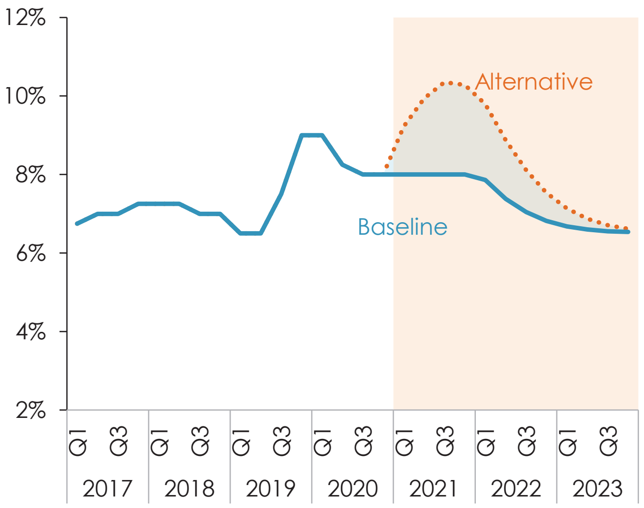


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

demand leads to an increase in the current account deficit, which creates currency depreciation pressure and leads to a higher sovereign country risk premium. Production costs will increase as the currency depreciation will elevate producers' debt burdens. Ultimately, prices will rise as a result of increased direct imported inflation and higher input costs. Accordingly, over 2021-2022 inflation will be 1.1 pp higher than in the baseline projection (see Figure 2.3.2).

In response to these developments, in the alternative forecast scenario, 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.

Under the alternative forecast scenario, the monetary policy rate trajectory will increase by 1.6 pp for 2021-2022 compared to the baseline scenario (Figure 2.3.3). The appropriate monetary policy response will eventually drive inflation towards the target level of 3% in the medium term.

BOX 1. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2020 FORECASTS

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

The predictions made in the February 2020 inflation forecast were lower than the reality (see Figure 2.3.4). Based on that forecast, inflation should have had a decreasing trend in 2020 and was expected to fall to the target level in the third quarter of the year. In reality, the inflation trajectory was similar to the forecast, but the reduction of inflation was delayed compared to the projections. The COVID-19-induced recession was the major reason for high inflation in the second quarter of 2020. In March, various restrictions were imposed to contain the spread of the virus. Real GDP thus dropped drastically. Nevertheless, weak aggregate demand did not reduce prices as the supply-side shocks were stronger. The underlying situation regarding COVID-19 is complex as supply and demand shocks occur simultaneously. On the one hand, a reduction of domestic demand creates deflationary pressures, while on the other, travel restrictions, the shutdown of firms and supply chain disruptions all increase production costs and shrink the supply side of the economy, which pushes inflation up. Meanwhile, an increased risk premium coupled with currency depreciation caused inflationary pressures.

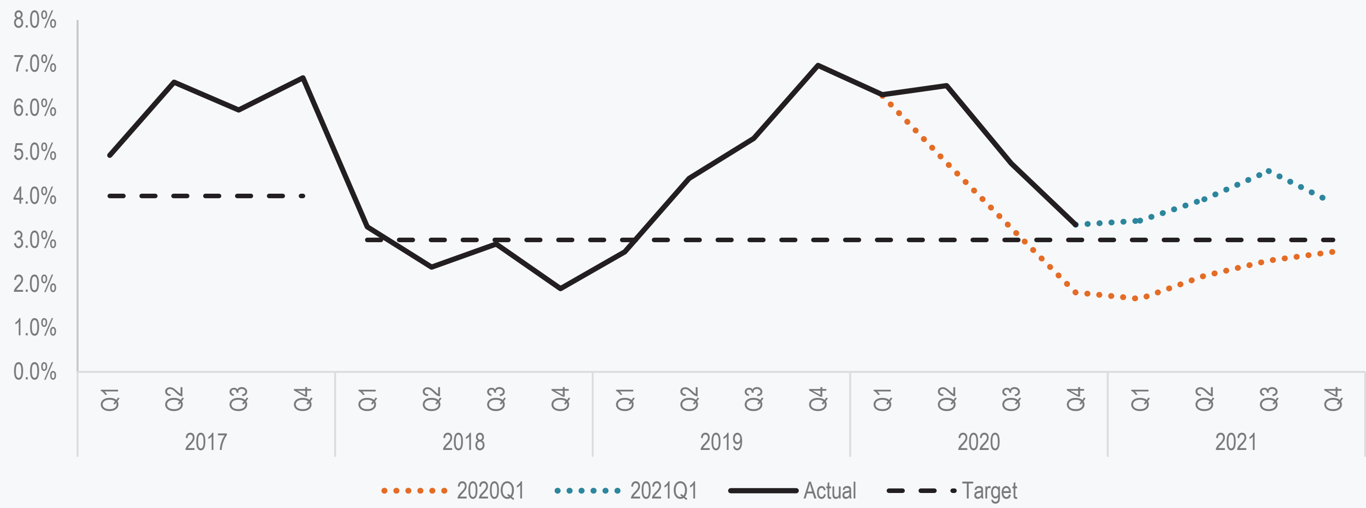


Figure 2.3.4 Comparison of annual inflation forecasts.

Source: National Bank of Georgia

On average, actual inflation in 2020 was 1.8 pp higher than predicted (see Figure 2.3.5). Inflation decompositions reveal that this higher-than-expected inflation was a result of supply-side shock. From March 2020, various containment measures and restrictions were imposed in an effort to restrict the spread of the virus. Those measures increased production costs, especially in the service sector where social distancing is essential. Meanwhile, supply-side disruptions and transportation problems pushed prices up. Those factors outweighed the disinflationary impact from suppressed demand. It is worth noting that the COVID-19-induced recession pushed up the risk premium of developing economies, including Georgia. The currency thus depreciated and, due to the dollarized balance sheets of producers, debt service burdens increased, which ultimately pushed prices up.

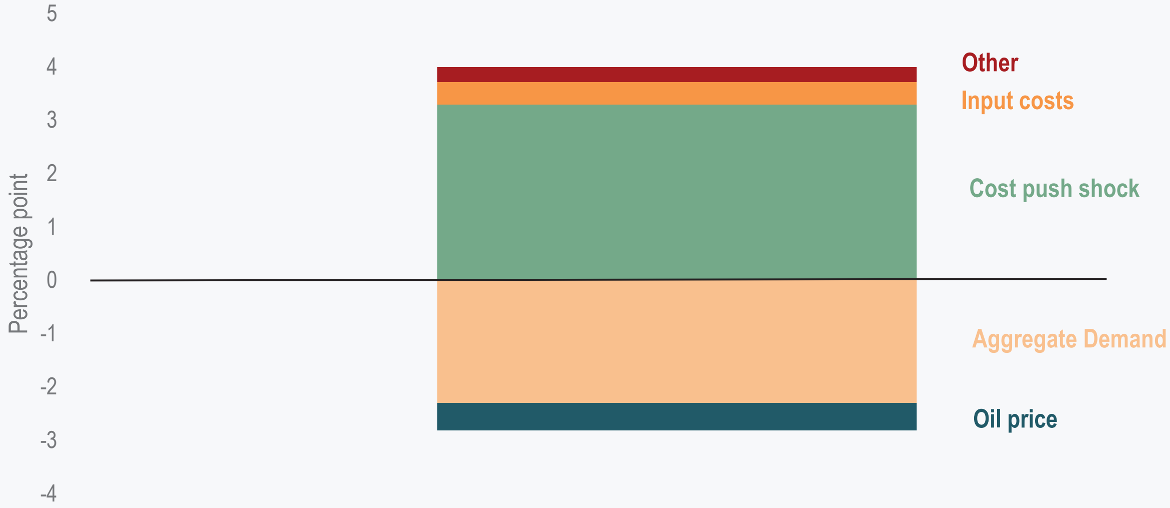


Figure 2.3.5 Decomposing the deviation of headline inflation from its projected value

Source: National Bank of Georgia

In terms of the quarterly inflation forecasts, it was revised upward for the second quarter of 2020 (see Figure 2.3.6). In the third and fourth quarters, the short-term inflation forecasts were revised downward, while the forecast for the medium term increased. The revision of the estimates of potential real GDP has led to an upwards shift in the inflation outlook. The COVID-19 pandemic has continued for longer than had been expected. Containment measures (such as travel restrictions and social distancing) have had a particularly acute impact on tourism and the service sectors. This could probably lead to firms exiting those sectors, thereby lowering the aggregate potential of the economy. In this case, the size of the negative output gap is smaller and the disinflationary impact weaker compared to the previous forecast.

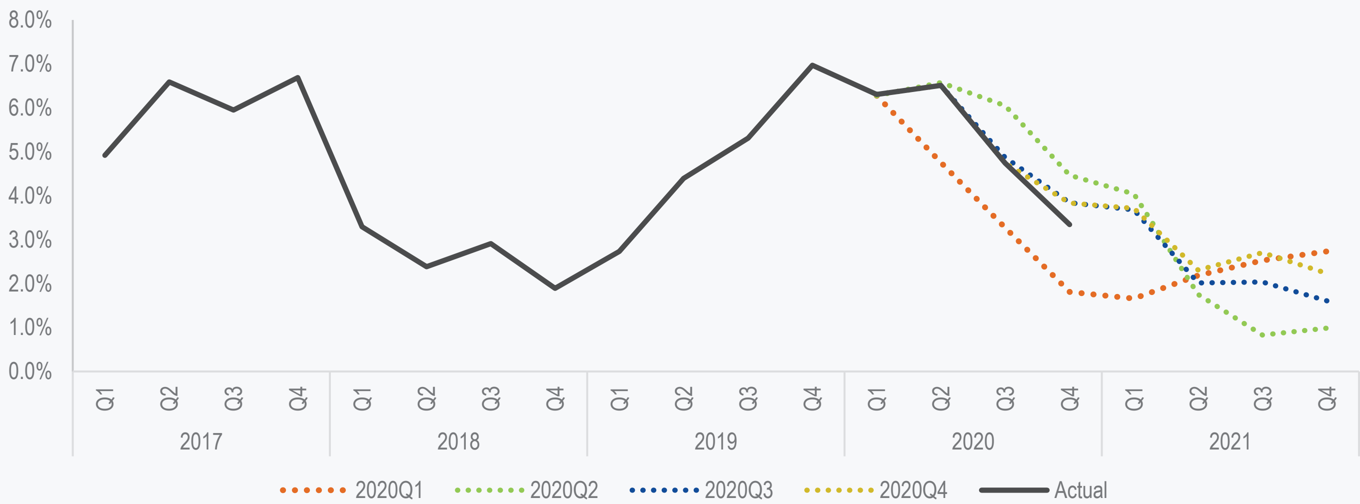


Figure 2.3.6 Performance of headline inflation forecasts (2020Q1-2020Q4)

Source: National Bank of Georgia

The formation of monetary policy in 2020 can be summarized as follows at the beginning of the crisis, the NBG started to exit from its tightened monetary policy to support economic recovery. However, the reduction of the monetary policy rate was very gradual and, since April, was reduced by only 1 pp. The COVID-19-induced recession has proven more complex than other economic crises. Although a reduction of domestic demand creates deflationary pressure, at the beginning of the crisis inflation remained at a high level. The disinflationary effect was outweighed by supply-side shocks. Central banks do not usually react to exogenous supply-side shocks, but in this case the shocks pushed inflationary expectations up. Taking into account inflation risks, the NBG maintained a tightened monetary policy stance. As projected, in the second half of 2020, inflation started to fall and gradually returned close to the target. The deviation from the target and the revision of the inflation forecast was induced by unprecedented and unanticipated shocks. Therefore, monetary policy can be assessed as having been adequate.

3 MONETARY POLICY

Inflation has been declining since May 2020 and even fell below its target level in January 2021. However, it should be noted that this drop is only temporary and is a result of the utility subsidies granted to part of the population. After this effect has elapsed, it is expected that inflation will again be above the target in the spring of 2021. According to the current forecast, other things being equal, inflation will remain around 4% on average in 2021 and will then gradually approach the target level. A significant increase in prices on international commodity markets, which was especially prominent in January 2021, is notable among those factors affecting the dynamics of inflation. Moreover, upward pressure on inflation persists due to rising production costs stemming from a prolongation of pandemic-related restrictions and the depreciated exchange rate. On the other hand, it should be noted that, despite relatively strong domestic demand, aggregate demand remains weak due to the sharp decline in external demand. However, the downward impact of weak aggregate demand on forecasted inflation is weakened by the depreciated nominal effective exchange rate. Considering the abovementioned factors, the need to maintain a tight monetary stance was apparent. The Monetary Policy Committee (MPC) of the National Bank of Georgia met on 3 February 2021 and decided to keep the refinancing rate unchanged at 8.0%. However, the Committee does not rule out the possibility of an increase in the policy rate in the future.

According to the decision made on 3 February 2021, the refinancing rate was kept unchanged at 8.0%.

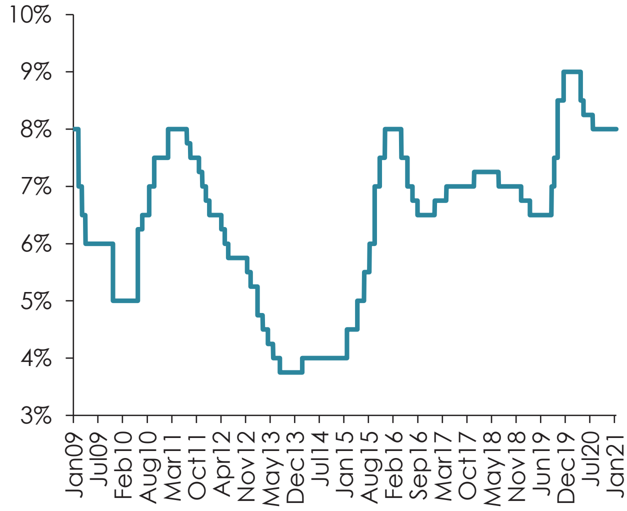


Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

Measures to curb the spread of the pandemic – which led 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 of the demand side, the Monetary Policy Committee began to ease monetary policy, reducing the policy rate by a cumulative 1.0 pp in April-August. However, in later periods, risks related to inflation expectations were still evident and were accompanied by increased volatility in foreign exchange markets and the long-term maintenance of a higher-than-target inflation rate. Potential supply-side risks were also significant, which were associated with an extension of the pandemic and pandemic-related restrictions. Moreover, negative expectations were formed from the worsened geopolitical situation. As a result, the policy rate after August 2020 has remained unchanged.

Annual inflation stood at 2.8% in January 2021. The reduction of inflation over the last two months was related to government subsidies of utility fees and is thus of a temporary nature. Generally, central banks do not react to temporary deviations in inflation due to such exogenous factors and are instead guided by the medium-term inflation forecast. According to the current forecast, other things being equal, inflation will remain around 4% on average in 2021 and will then gradually approach the target. Compared to the previous forecast, a significant increase in prices on international commodity markets is notable among those factors affecting the dynamics of inflation – and this was especially prominent in January. Moreover, the upward pressure on inflation persists due to rising production costs that stem from the prolongation of pandemic-related restrictions and a depreciated exchange rate. The latter, in turn, increases imported inflation and intermediate costs. On the other hand, it should be noted that, despite relatively strong domestic demand, aggregate demand is still weak due to the sharp decline in external demand. However, the downward impact of weak aggregate demand on forecasted inflation is weakened by the depreciation of the nominal effective exchange rate, while the high level of dollarization in the economy fortifies the transmission of exchange rate fluctuations to inflation. In addition, it should be noted that the termination of partial subsidies on interest expenses on mortgage loans has an effect similar to the tightening of monetary policy. The Committee also noted that uncertainty remains high about both the dynamics of the recovery of global economic activity and the growth rate of local lending. Taking into account the abovementioned factors, the need to maintain a tight monetary stance was apparent. However, the Committee does not rule out a potential increase in the policy rate in the future.

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 that could cause its increase.

According to preliminary data, aggregate demand is weak. Based on rapid estimates, economic activity fell by 7.9% year on year in December, while the twelve-month average was -6.1%. After the decline in 2020, a gradual recovery of economic activity is expected in 2021. According to current forecasts, other things being equal, economic growth in 2021 is expected to be around 4% and its main driver is expected to be domestic demand. In contrast, external demand will remain considerably reduced and only marginal growth is projected in 2021. Current indicators suggest that revenues from international travelers has been minimal and, according to preliminary data, decreased by 93% year on year in December. Amid weak aggregate demand and a depreciated exchange rate, imports of goods fell by 18% year on year in December, while exports of goods also fell by 18%.

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 National Bank of Georgia has launched temporary instruments to supply liquidity. To manage short-term liquidity, the banking sector mainly relies on refinancing loans and the interbank money market. Besides standard refinancing loans, the National Bank also provides liquidity support to commercial banks and microfinance organizations through additional "swap" operations. In addition, to facilitate lending to small- and medium-sized businesses, a liquidity support instrument is available. 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.

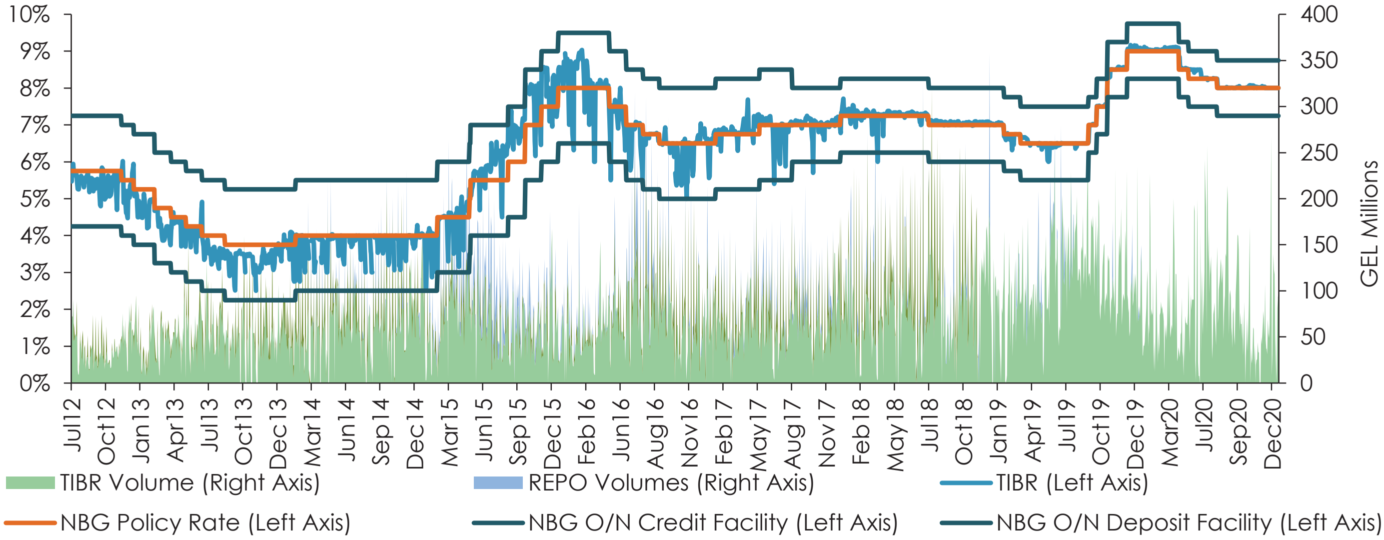


Figure 3.3. Interbank money market

Source: National Bank of Georgia

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