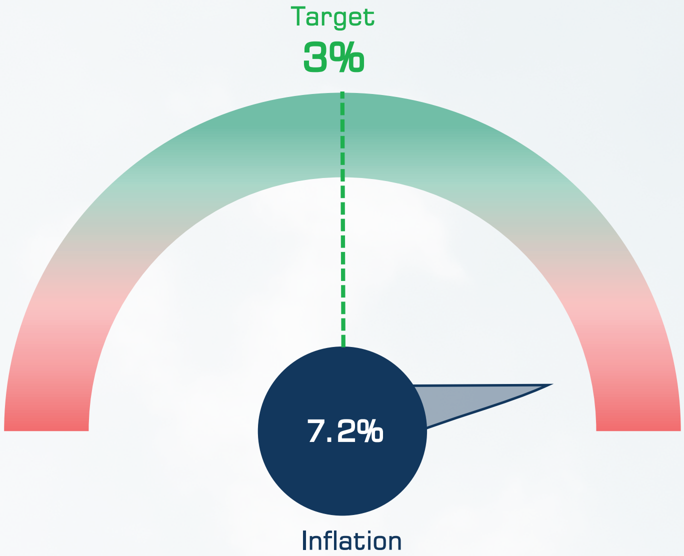
Monetary Policy Report

April

2021

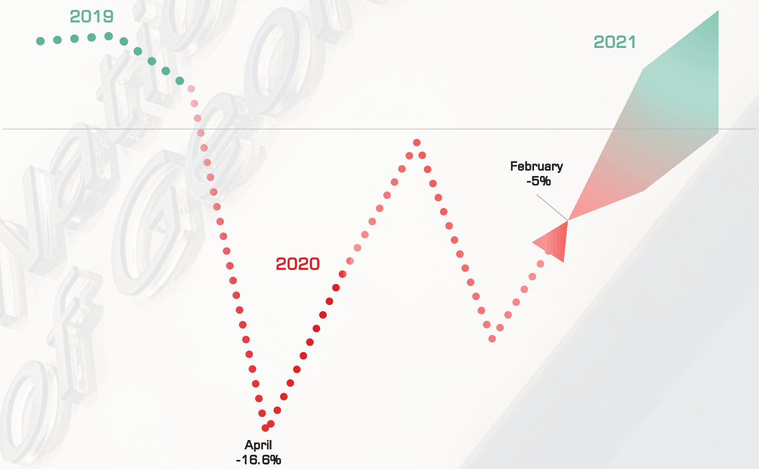
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



7.2%	Inflation stood higher than the target.

Economic Growth



Prolongation of the pandemic reduces the rate of economic recovery.	-5.0%

Monetary Policy

9.5% 1.0

9.5%	In order to curb inflation expectations, the NBG raised the policy rate.

MONETARY POLICY DECISION

We have raised the monetary policy rate to 9.5%.

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.

From the beginning of the year, a trend of price increases has been observed. Elevated food and oil prices on international markets have been transmitted to local market prices. At the same time, a depreciated lari exchange rate further contributes to inflationary pressures. The prolongation of the pandemic is also noteworthy. In order to contain a potential new wave of the virus, it may be necessary to extend restrictions, which will affect prices through higher costs of production. Against the background of these factors, inflation expectations have also increased.

Considering rising inflation expectations and risks, we have tightened monetary policy and increased the monetary policy rate to 9.5%. Although economic activity is still weak, this decision was aimed at reducing inflation, which will help ensure long-term economic growth.

Changes in interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If factors augmenting inflation expectations continue to be identified, it may be necessary to further tighten monetary policy 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

Following the start of the pandemic and the unprecedented economic crisis observed in 2020, some signs of global recovery have emerged since the beginning of 2021. With the availability of effective COVID-19 vaccines and mass immunization programs, current economic activity and expectations have improved in developed countries. However, the situation is less favorable in emerging and developing countries, including in Georgia, where economic activity remained weak at the beginning of the year and inflationary pressures intensified. The latter is mostly due to the upward dynamics of commodity prices on international markets, although the effects of the depreciated GEL exchange rate and higher production costs are also significant. According to the baseline forecast scenario, it is expected that these pressures will ease early next year, and inflation will move closer to the target. In order to ensure this and safeguard the goal of achieving the target, monetary policy will retain a tight stance so that short-term inflation fluctuations do not adversely affect longer-term expectations. According to the same forecast, despite weak external demand, the Georgian economy will grow by 4% in 2021, bolstered by relatively strong domestic demand.

In the short run, annual inflation will remain above the target, but with the exhaustion of one-off factors and a tighter monetary policy stance, it will return to the target early next year.

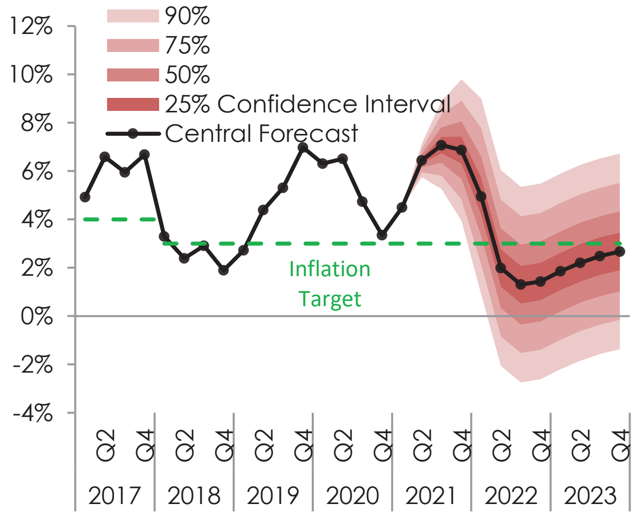

Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia

The COVID-19 pandemic had a significant impact on headline inflation. Last year, amid a sharp decline in foreign inflows, the GEL exchange rate depreciated – and, due to rising imported inflation and higher intermediate costs associated with dollarization, consumer prices were significantly affected. Moreover, due to pandemic-related restrictions, disruptions in supply chains and higher production costs exerted upward pressure on inflation that was only partially offset by weak aggregate demand. In the current period, these factors are still notable, and have been accompanied by the sharply rising commodity prices in international markets eventually being transmitted to local prices. It should be noted that short-term inflation fluctuations have also been driven by a social program implemented by the government. With the subsidy of utility bills, the inflation rate fell at the end of 2020, before rising again following the termination of the program in March 2021.

According to the National Bank of Georgia's baseline forecast, the effects of the above-mentioned factors on consumer prices will persist throughout the year; however, they will gradually fade away in the first half of next year and inflation will approach the target (see Figure 1). Even though weak aggregate demand will still exert downward pressure on prices, **inflation is expected to average 6-6.5% this year**. On the back of this, and given the relatively prolonged upward deviation of inflation from the target, a combination of strong supply-side shocks increase the risk of rising inflation expectations.

COVID-19 pandemic-related restrictions have largely remained strict worldwide, hampering the recovery of the global economy. However, starting from

A gradual recovery of the economy is expected in 2021. Although external demand has remained subdued, relatively strong domestic demand will drive real GDP growth to 4% this year.

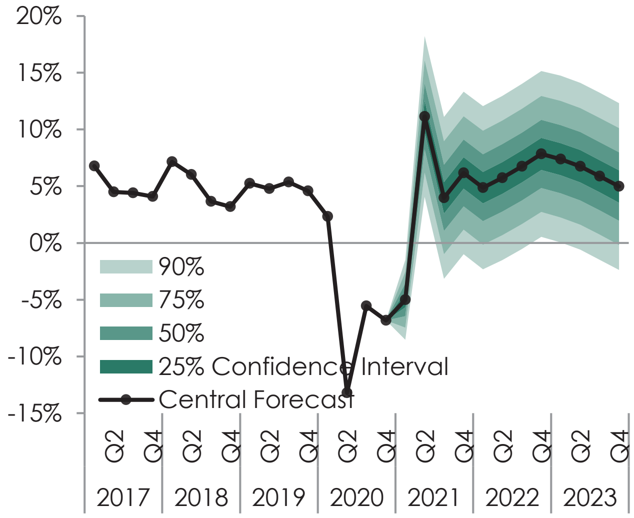

Figure 2. Annual growth forecast of quarterly real GDP

Source: National Bank of Georgia

Monetary policy has been further tightened to avoid the transmission of short-term fluctuations to long-term inflation expectations. After having the desired effect on expectations – reflected in a reversal of the inflation upsurge – the rate will begin to decline and gradually approach its long-term neutral level.

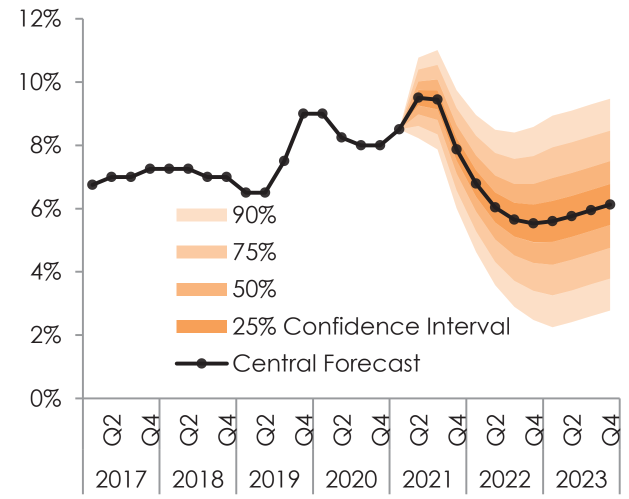

Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

2021, the development and distribution of vaccines has strengthened positive expectations. However, the global supply of vaccines is uneven, which is especially notable in emerging and developing countries – including in Georgia, where the economy shrank by 6.2% in 2020 and economic activity has remained subdued since the beginning of 2021.

The main reason for the economic downturn was external demand, which decreased significantly as a consequence of cross-border travel restrictions. Consequently, exports of goods and services made the largest negative contribution to real GDP growth in 2020 (of 20.9 percentage points). In contrast, domestic demand remained relatively strong, mostly due to sizable fiscal stimulus and credit activity. Based on preliminary indicators, the beginning of 2021 has unfolded in similar manner – domestic demand has been the main driving force of economic activity, which is expected to lead to **economic growth of 4% this year** (see Figure 2).

Although economic activity is still weak, the factors described above create the risk of raising long-term inflation expectations. Therefore, the adequate monetary policy response is to **maintain a tighter stance**. The monetary policy rate has increased in the current period and it is expected that it will remain tight for some time in order to put downward pressure on inflation expectations (see Figure 3). As inflation expectations fall, the rate will gradually decline and approach the long-term neutral level, which, according to current estimates, is around 6.5%.

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, the global economy declined by 3.3%. However, with the availability of effective COVID-19 vaccines and mass immunization programs, expectations in Georgia's main trading partner countries have improved. Meanwhile, the upward dynamics of commodity prices in international markets have put some pressure on inflation expectations and central banks have responded by tightening monetary policy. Amid restrictions on tourism, Georgia's current account deficit remains deteriorated; however, in the first quarter of 2021 an annual increase in exports of goods and services was observed. Last year, despite weak aggregate demand, final consumption was stronger than net exports and investment – a consequence of sizable fiscal stimulus and a fair growth of lending activity. Inflationary pressures have recently intensified significantly due to the depreciated exchange rate and supply-side factors.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Amid the COVID-19 pandemic, the global economy continues to face the deepest crisis of recent decades. Restrictions imposed to counter the pandemic continue to disrupt supply chains and production processes, which hamper economic activity. As a result, both developed and developing countries began this year deep in recession. According to the International Monetary Fund's (IMF) April forecast[1], the global economy declined by 3.3% in 2020. However, with strong fiscal and monetary stimulus implemented in many countries, growth is expected to recover in the second half of the year. In addition, the rollout of mass vaccination programs worldwide creates positive expectations about the end of the pandemic; however, it should be recognized that vaccination is proceeding quite slowly in some countries and uncertainty surrounding it remains high. According to the IMF's April forecast, **global economic growth** will be 6% in 2021, which is 0.8 percentage points (pp) above the previous forecast[2]. Meanwhile, growth is projected to be 4.4% in 2022. For emerging and developing countries, whose economies shrank by 2.2% in 2020, real GDP is expected to grow by 6.7% in 2021, and by 5% in 2022.

Amid the COVID-19 pandemic, the global economy reduced significantly last year. However, economic activity is expected to recover from 2021 following mass vaccination campaigns and unprecedentedly strong fiscal and monetary stimulus.

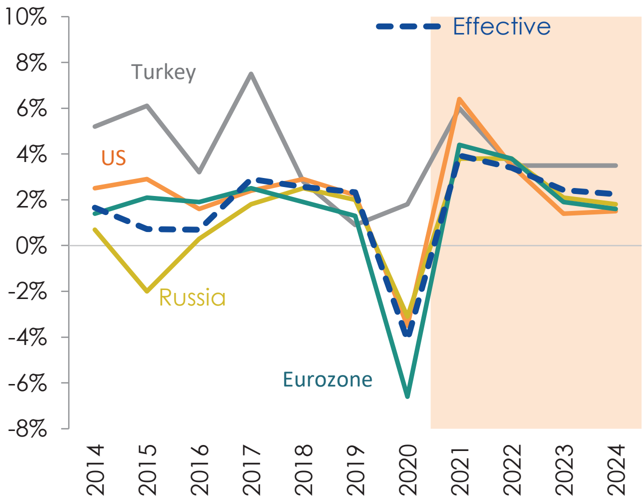

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

Together with the easing of pandemic-related restrictions, the growth rate in the **United States** slightly stabilized in early 2021. In particular, external demand recovered and, along with a declining unemployment rate, consumer spending increased. Follow a mass vaccination campaign, as well as strong fiscal and mon-

1 International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.

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

In 2021, some increase in inflation is expected in Georgia's trading partner countries, including in the US and eurozone. The inflation rate in Turkey has recently been significantly higher than the target.

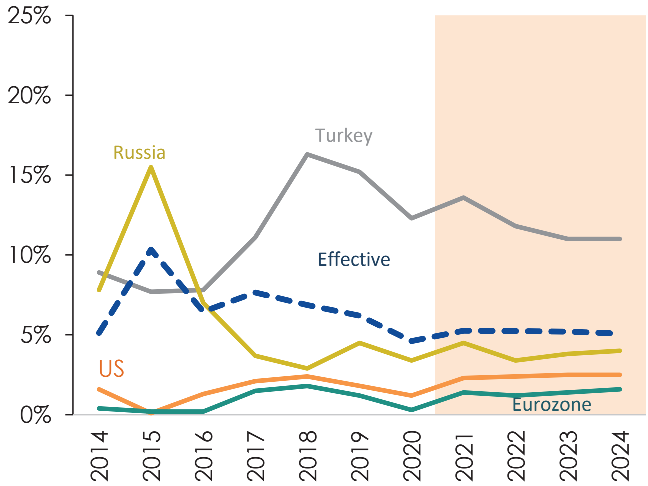

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

etary stimulus, it is expected that the country will return to a 2019 growth rate from the first half of 2021. According to the IMF's April forecast, real economic growth is expected to be 6.4% in 2021 and 3.5% in 2022. It should be noted that the US economy declined by 3.5% in 2020. The inflation forecast for 2021 is 2.3%, while it is expected to be around 2.4% in 2022.

In early 2021, amid the easing of pandemic-related restrictions, economic activity slightly improved in the **eurozone**. Activity in the manufacturing and industrial sectors recovered, and the vaccination rollout has created positive expectations. However, following a rapid resurgence of the spread of COVID-19, a number of European countries had to tighten restrictions in March. The tourism sector thus remained suppressed, and consumer and business sentiment deteriorated. According to the IMF's April forecast, real economic growth for the eurozone will be 4.4% in 2021 and 3.8% in 2022. The eurozone economies declined by 6.6% in 2020. The inflation rate is projected to be 1.4% in 2021 and 1.2% in 2022.

In early 2021, economic activity continued to recover in **Turkey**, where the business climate and manufacturing sector improved and exports slightly increased. Amid higher credit growth, consumer spending also increased. However, because of pandemic-related restrictions, foreign investments declined, and the external sector remains deteriorated. Inflationary pressure remains high amid the depreciation of the Turkish lira, with annual inflation standing at 16.2% in March. Based on this, the Central Bank of the Republic of Turkey further increased the monetary policy rate in early 2021 (by 2.0 pp). According to the IMF, the real GDP forecast for Turkey is 6% in 2021 and 3.5% in 2021. Turkey was one of the few countries that had a positive growth rate in 2020 (of 1.8%). The current inflation forecast for 2021 is 13.6% and 11.8% for 2022.

In early 2021, compared to the end of the previous year, economic activity slightly improved in **Russia**. This was mostly due to the easing of pandemic-related restrictions and a start of the vaccination process. Consumer spending and retail sales increased slightly, and consumer and business sentiment improved. However, the external sector remains unfavorable: both exports and foreign investments have declined. Amid a recent depreciation of the local currency, annual inflation increased and equaled 5.8% in March. According to the IMF's April forecast, real economic growth in Russia will be 3.8% in both 2021 and 2022. In 2020, the country's economy declined by 3.1%. The inflation rate is projected to be 4.5% in 2021, and 3.4% in 2022.

In early 2021, weak economic activity continued in **Ukraine**, mostly due to the global slowdown in trade amid the COVID-19 pandemic. The volume of investments and exports also decreased. However, alongside an easing of pandemic-related restrictions, consumer spending improved slightly, as did retail sales. Annual inflation also increased and stood at 8.5% in March. This situation is complicated by the uncertainty surrounding the escalation of hostilities in eastern Ukraine. According to the IMF, the real GDP growth forecast for Ukraine is 4% in 2021 and 3.4% in 2022. It should be noted that the country's economy declined by 4.2% in 2020. Inflation is expected to be 7.9% in 2021 and 6.8% in 2022.

Since the beginning of 2021, the growth rate in **Armenia** has continued to deteriorate. This was mostly driven by a reduction in investments, trade and industrial production amid the pandemic-related restrictions. The country's trade balance recently worsened. Business sentiment has deteriorated after the armed conflict with Azerbaijan, and has been exacerbated by a politically unstable environment. Since the beginning of the year, the annual rate of inflation and inflation expectations have increased significantly. The Central Bank of Armenia thus decided to increase the monetary policy rate. According to the IMF, the real GDP forecast for Armenia is 1% in 2021 and 3.5% in 2022. The country's real economy declined by 7.6% in 2020. The inflation rate is projected to be 3.9% in 2021 and is expected to be 3.2% on average in 2022.

In early 2021, **Azerbaijan's** economic activity in the non-oil sector continued to deteriorate, while activity in the oil sector has slightly recovered. Compared to the end of last year, oil production and refining improved, leading to foreign inflows also somewhat stabilizing. However, the annual inflation rate has increased. According to the IMF's forecast, real GDP growth in Azerbaijan will be 2.3% in 2021 and 1.7% in 2022. In 2020, the country's economy declined by 4.3%. Inflation is projected to be 3.5% in 2021 and 3.2% in 2022.

In an effort to encourage domestic demand, the central banks of Georgia's main trading partners maintained a loose monetary policy environment in early 2021. However, in recent months, policy rates were increased slightly in several countries (see Figure 1.1.3). The only exception to this was Turkey, where the policy rate was high (at 17%) and increased further in March to 19%. The US Federal Reserve has kept the federal funds rate in the 0-0.25% range, while the European Central Bank's interest rate remains unchanged at 0%. At the same time, it should be noted that, amid the pandemic, the broader quantitative easing program in the euro area has been extended until March 2022. Quantitative easing is continuing in the US as well.

In the first quarter of 2021, Georgia's trading partners maintained an easing monetary policy environment. This was mostly driven by efforts to stimulate economic activity amid the deep recession. Turkey was an exception to this – where, due to high inflationary pressures, the monetary policy rate increased once again at the beginning of the year.

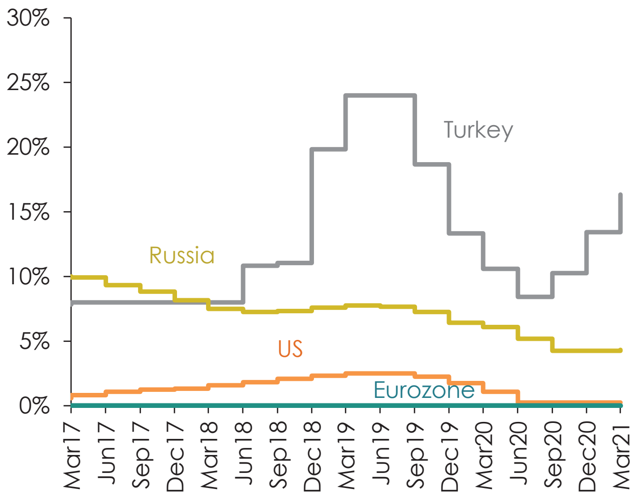

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the first quarter of 2021, compared to the same quarter of 2020, there was increased external demand on goods. In light of the COVID-19 pandemic, the internal economic activities of countries are still at low levels; however, the beginning of global vaccination programs has improved business sentiment. International trade and tourism still function under restrictions. The prolongation of the pandemic and the existing restrictions on international mobility have negatively affected the revival of tourism. In light of weak aggregate demand and lower external inflows, imports of goods decreased in the first quarter, though grew in March. In 2020, the current account deficit[3] increased considerably compared to the previous year and amounted to 12.4% of GDP.

In the first quarter, registered exports of goods increased by 5.2% annually.

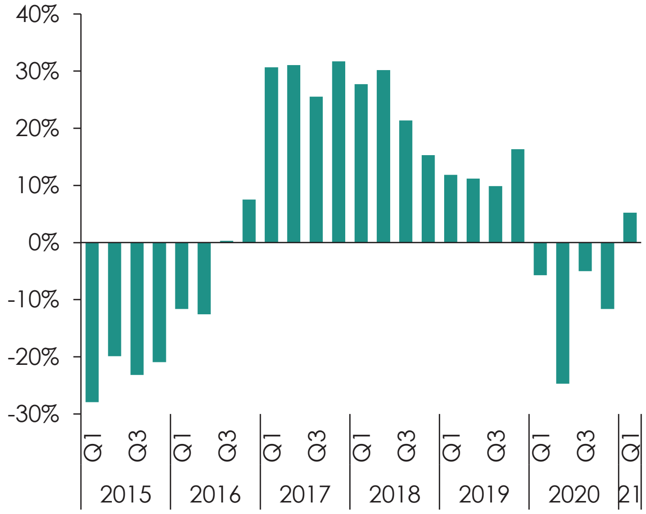

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

Registered exports of goods grew by 5.2% annually in the first quarter of 2021 (see Figure 1.2.1). The volume of exports to Turkey and Russia, as well as to other regional countries increased. In the first quarter, the increase of exports to Turkey made the highest contribution to overall growth (of 2.8 pp annually), which was mainly a consequence of high demand for ferrous waste and scrap, as well as for clothes. Meanwhile, exports to Russia increased mainly in terms of substantially high levels of exports of ferro-alloys, mineral waters, various fruits, and cigarette-cigarillos; while exports to Ukraine rose due to increased sales of automatic data processing machines, copper scrap and alcoholic beverages. In contrast, exports to Azerbaijan and Armenia fell, mainly due to lower sales of motor cars and motor vehicles for the transport of goods. For European countries, exports to Germany increased in terms of sales of various nuts and walnuts, while exports to Lithuania increased because of higher demand on precious metal scrap and chemical fertilizers. Demand for ores and concentrates of copper, as well as for precious metals scrap, was also high from China.

The rise in exports of goods mainly stemmed from the increase of external demand on intermediate goods.

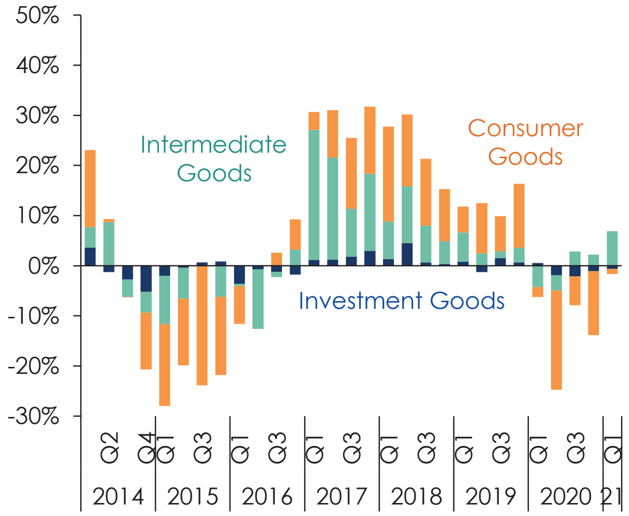

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

Exports of goods grew mainly due to high demand for intermediate goods, while exports of consumer and investment goods decreased (see Figure 1.2.2). The increase in intermediate goods stemmed mainly from high exports of ferro-alloys, precious and black metal scraps, copper ores and concentrates. In terms of the decline in exports of consumer goods, motor cars had the biggest negative contribution; while for exports of investment goods, various aircraft parts showed the largest decline.

Given the restrictions on international air and land mobility, the number of international visitors to Georgia was quite small in the first quarter of the year. The number of international visitors declined by 88.4%

3 *According to BPM6.*

Revenues from international travelers remained at a considerably low level.

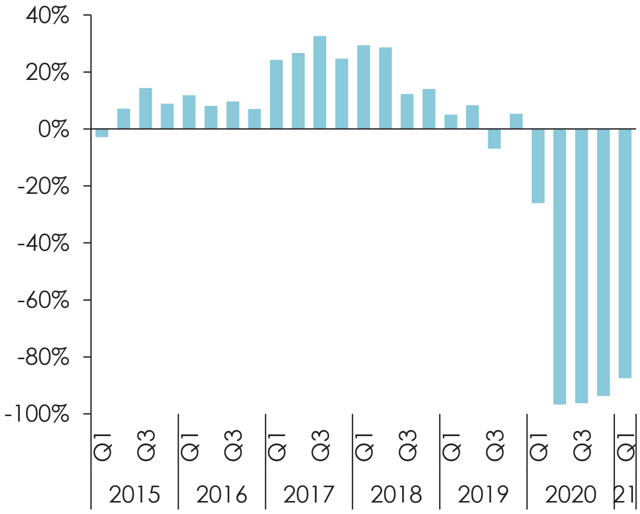

Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

In the first quarter of 2021, instant money transfers increased considerably.

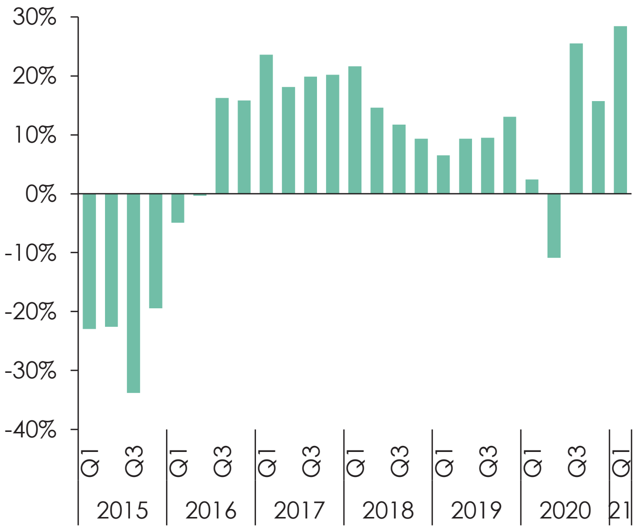

Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

annually, inducing an 87.5% fall in revenues from international travelers (see Figure 1.2.3). Until national borders reopen and international tourism recovers, it is expected that the number of international travelers, and the revenues generated from them, will remain low in the first half of 2021.

In the first quarter of 2021, instant money transfers to Georgia increased by 24.8% annually (see Figure 1.2.4). Once again, transfers from the EU (especially from Italy, Greece and Germany), the USA and Azerbaijan made the largest contributions to total growth.

Considering weaker aggregate demand, imports of goods declined by 2.4% annually in the first quarter of 2021, but showed annual growth in March (see Figure 1.2.5). The decline in imports from regional countries was significant, particularly those from Azerbaijan, meanwhile the decline of imports from Japan and Brazil exhibited the largest negative contributions to the imports change. 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 first quarter of 2021, imports of consumer and intermediate goods declined, while imports of investment goods increased (see Figure 1.2.6). The reduction in imports of intermediate goods predominantly stemmed from lower imports of motor cars, petroleum products and frozen poultry meat products, while the reduction of intermediate goods imports was due to lower imports of parts for typing machines, glazed tiles and parts of iron and steel structures. The rise in imports of investment goods stemmed from higher purchases of extracting/boring machinery, motor vehicles for the transport of goods and motor vehicles for the transport of ten or more persons.

In 2020, in light of decreased exports of goods and services, especially tourism, the current account deficit increased by 1,005 million USD and amounted to 1,965 million USD, which was 12.4% of annual GDP. The current account deficit is expected to be high in 2021, as revenues from tourism are quite low during the current year.

The primary source of financing the current account deficit is foreign direct investments, which fell by 52.9% annually and reached 616.9 million USD. The main reason for the decline of FDI is the transfer of ownership of several companies from non-resident to resident units, which reduced the value of FDI by 340.5 million USD. The majority of FDI went to the finance, mining and real estate sectors.

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

In the first quarter, registered imports of goods continued to decline; however, these grew annually in March.

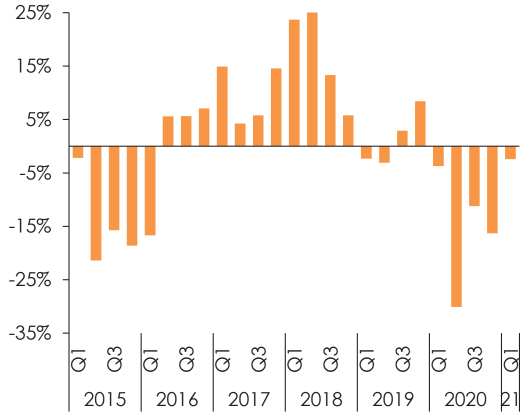

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the first quarter of 2021, imports of consumer goods exhibited the largest decline, while imports of investment goods increased.

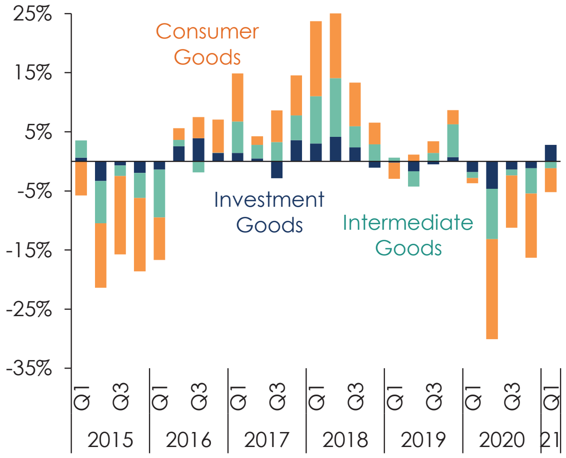

Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

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

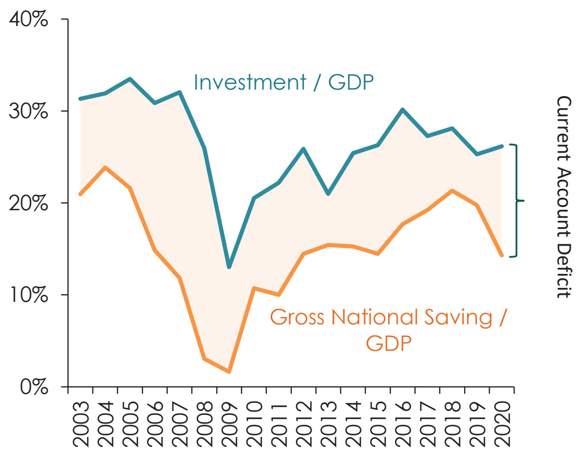

Figure 1.2.7. Investments and savings

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).

BOX 1. THE IMPORTANCE OF TOURISM FOR THE GEORGIAN ECONOMY

The COVID-19 pandemic has led to an unprecedented global economic crisis, which was first expressed in terms of a reduction of international mobility and related economic activities. Before the pandemic, outlays in tourism (both inbound and domestic) accounted for more than 10% of global GDP.[4] This share was even larger in tourism-dependent countries. The effects of the pandemic turned out to be severe for small open economies that were dependent on tourism. Such countries, where international tourism was an important source of both foreign exchange earnings and general income, became exposed to fiscal pressure and increased external imbalances. Georgia is among these countries. Up until 2020, the increasing revenues received from tourism were an important factor for financing the current account deficit and supporting economic activities.

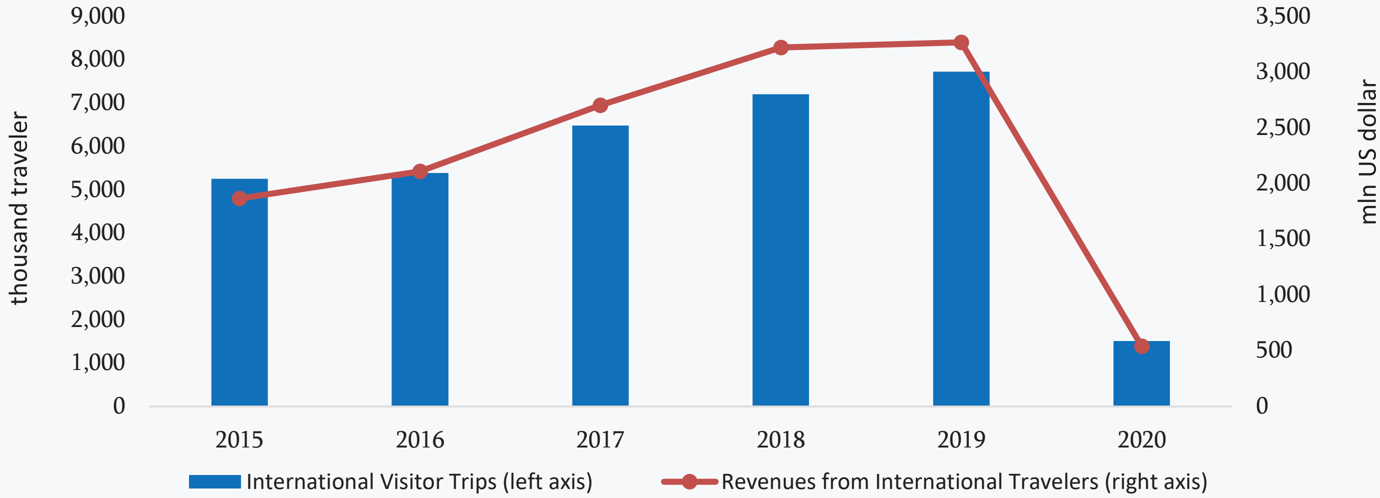

Figure 1.2.8 International visitor trips and revenues from international travelers.

Source: NBG and Georgian National Tourism Administration

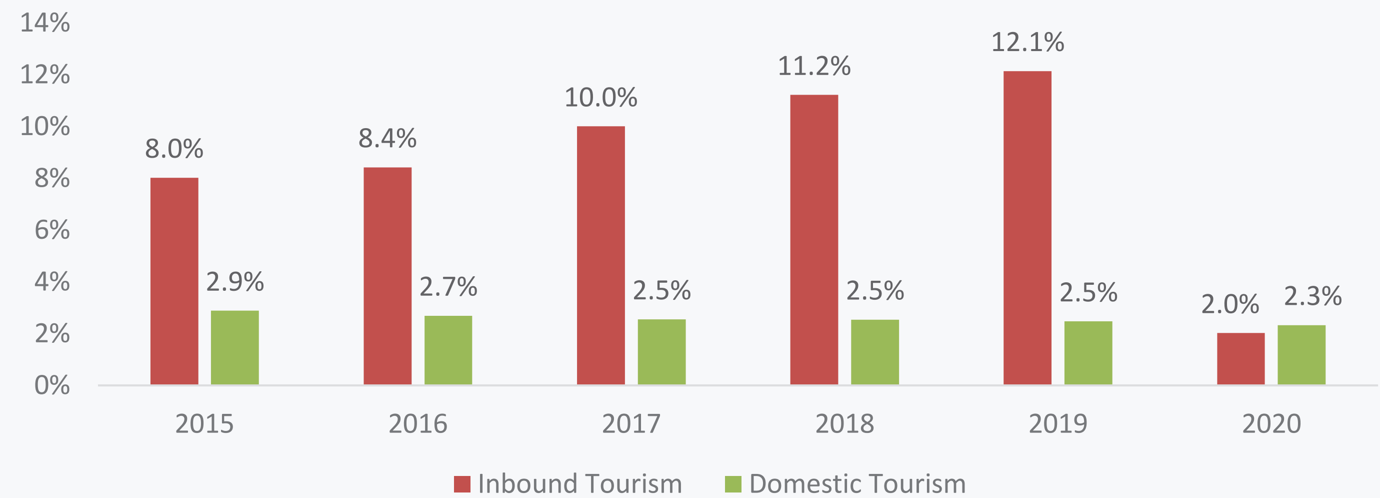

Figure 1.2.9 Share of inbound and domestic tourism in GDP[5]

Source: GeoStat and NBG's calculations

The number of international visitors and, subsequently, tourism inflows have become increasingly important for the Georgian economy over the past several years. Georgia, a country with a population of 3.7 million, had 7.7 million international visitors in 2019. During the same period, tourism revenues were approximately 3.3 billion USD, which was 18.7% of GDP (see Figure 1.2.8). According to the NBG's calculations, the share of added value created by inbound tourism reached 12.1% of GDP, while the share of domestic tourism hovered at around 2.5% of GDP (see Figure 1.2.9). However, due to the pandemic, these positive dynamics totally changed.

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4 *https://www.imf.org/en/News/Articles/2021/02/24/na022521-how-to-save-travel-and-tourism-in-a-post-pandemic-world*

5 *Tourism's share in added value.*

It is worth noting that the tourism industry incorporates a number of interrelated fields (air travel, accommodation and dining, retail trade, hotels and restaurants, entertainment, transport, etc.) and the growth in such sectors was quite high before the pandemic. For instance, those sectors in which the participation of foreigners is especially high – such as accommodation and food service activities (real growth of 18.5% in 2019), real estate activities (real growth 4.1%) and transportation (real growth 8.4%) – saw considerable growth during previous years and contributed 1.6 pp to the 5.0% GDP growth in 2019. However, these growth rates and contributions became negative in 2020.

The COVID-19 pandemic started to have a negative effect on the Georgian economy from February 2020. In March, after the declaration of a state of emergency and the closure of national borders, the entry of foreign visitors to the country and expected revenues from tourism basically stopped (see Figure 1.2.8). Consequently, the share of inbound tourism to GDP, which was around 12% in 2019, fell to 2% of GDP in 2020 (see Figure 1.2.9). That also negatively impacted real GDP growth. Overall, in 2020, real GDP decreased by 6.2% and net exports made a -9.8 pp contribution to that decline. This reduction reflected a sharp drop in exports of services, which stemmed from the disruption of revenues from international travelers. A considerable decline was experienced by those sectors of the economy in which the participation of foreigners is especially high. For instance, real growth in the accommodation and food sector was -37.9%, while real growth in the real estate and transport sectors were -0.1% and -22.3% respectively. Their total contribution to the 6.2% decline of GDP amounted -3.0 pp in 2020.

The sharp decline in tourism exports has led to a significant deterioration of the positive dynamics observed on the current account in recent years. The current account deficit to GDP increased to 12.0% in 2020, rising from the 5.5% of GDP seen in 2019, which had been the lowest level recorded since the beginning of 2000.

The negative impact of the pandemic was also reflected in the growth of unemployment in various tourism-related services. Overall, the unemployment rate increased by 3.8 pp to 20.4% in 2020.

There is a view that technology will play an important role in the revival and development of tourism, as well as in the whole service sector. As social distancing and health and hygiene protocols are likely to remain in place for the foreseeable future, touchless service delivery and investments in digital technology can be an important bridge for economic recovery. Certainly, such solutions will differ from country to country. Moreover, countries will need to gradually create a characteristically different tourism industry, a so-called "new normal". It is assumed that diversifying, shifting to more sustainable tourism models, and investing in new technologies may establish good foundations for a full economic recovery.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

Compared to net exports and investments, consumption was relatively strong in 2020, which may be related to fiscal stimulus and credit growth.

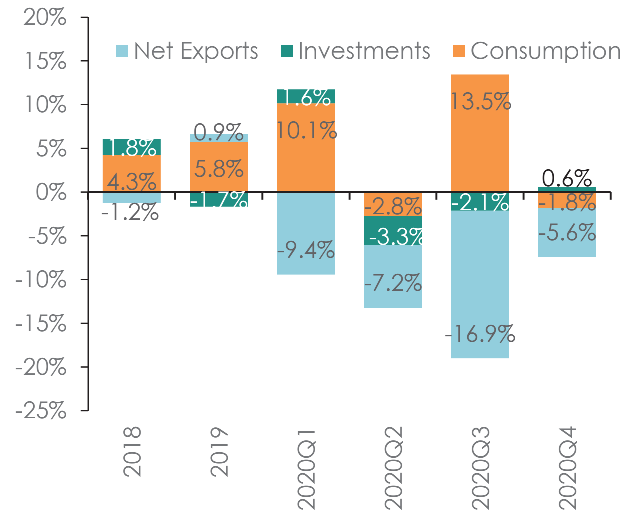

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat; NBG calculations

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

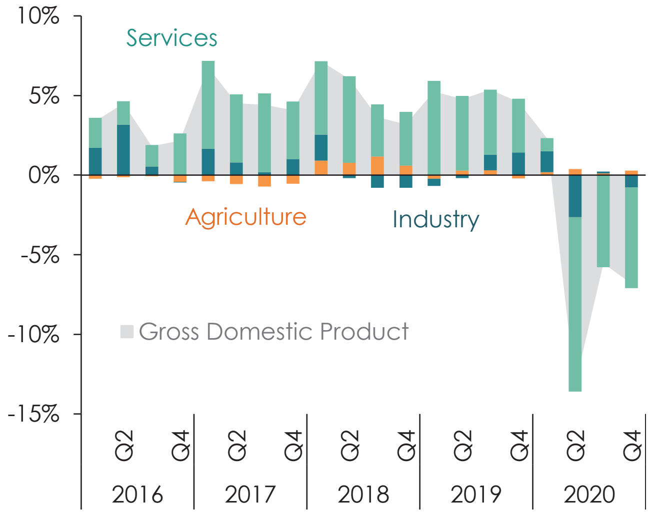

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

In the fourth quarter of 2020, real GDP fell by 6.8% year on year.

Exports of goods and services decreased by 40% in real terms compared to the previous year. As part of this, exports of services fell by 69.9% amid the almost-complete cessation of foreign tourism revenues. Exports of goods fell by 17.7%. At the same time, imports of goods and services decreased by 22.3%. Finally, net exports contributed 5.6 percentage points (pp) to the economic downturn.

Consumption in 2020 was strong compared to net exports and investment. This fact can be related to the increased fiscal stimulus aimed at mitigating the effects of the pandemic and the growth of lending to the economy.

After declining at the beginning of the pandemic, investment contributions in the fourth quarter became positive again at 0.6 pp. This is largely the result of the increased intensity of infrastructural projects (see Figure 1.3.1).

1.3.2 OUTPUT

As mentioned above, in the fourth quarter of 2020, the real gross domestic product decreased by 6.8% year on year (see Figure 1.3.2). This drop was predominantly caused by the sharp decline of services (6.3 pp), while the contribution of the industrial sectors to the decline was relatively small (0.8 pp). The contribution of agriculture was positive and amounted to 0.3 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. In the fourth quarter, with a sharp increase in the number of coronavirus cases, new restrictions were imposed that had a negative impact on the economic situation.

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 53.8% year on year, making a 2.2 pp negative contribution to the overall economic decline. The transport sector, where the contribution of travel agencies is significant, decreased by 26.7% (making a 1.6 pp contribution to the decline of GDP). Trade decreased by 3.9% (making a 0.5 pp negative contribution to GDP growth).

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. A small increase was also observed in agriculture

1.4 CONSUMER PRICES

Annual inflation rose to 7.2% in March, mainly due to supply factors and the removal of subsidies on utilities.

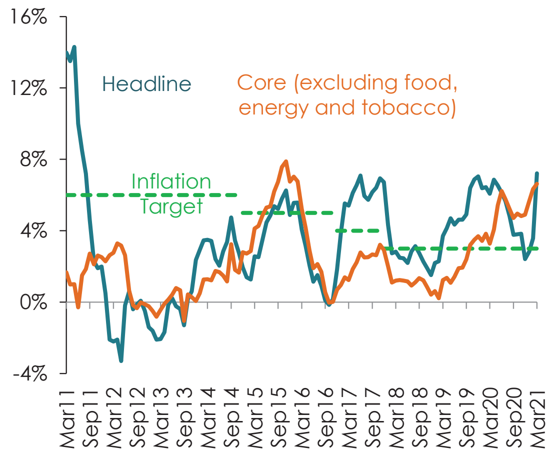

Figure 1.4.1. Headline and core inflation

Source: GeoStat

Annual inflation rose to 7.2% in March (see Figure 1.4.1). An important reason for this is the extraordinary situation caused by the pandemic, due to which several supply-side factors simultaneously affected inflation in the direction of growth. Georgia, as a country highly dependent on tourism, has been particularly affected by the pandemic. As a result, the effective GEL exchange rate depreciated, which was gradually reflected on prices. At the same time, widely used commodities such as wheat, sunflower oil and sugar have become more expensive on the world market. With the restoration of global mobility, demand for oil increased, which also made fuel more expensive. Due to COVID-related restrictions, the operating costs of companies increased, which, to some extent, were reflected in final prices. In addition, government subsidies on utilities reduced the inflation rate during the winter, while the removal of those subsidies in March increased the overall annual inflation rate by 1.2 pp (see Figure 1.4.2).[6]

Meanwhile, core inflation, which excludes volatile food, energy and cigarette prices, amounted to 6.6% in March.

In March, the impact of food prices on inflation was relatively reduced to 1.6 pp. Of this, the most noteworthy is the 63% increase in the price of sunflower oil, which caused a 0.5 pp rise in the overall price level. In addition, the contribution of sugar, eggs and cheese prices totaled another 0.5 pp. On the contrary, potato prices declined by 33%, contributing 0.4 pp to the inflation reduction.

Inflation in March, in contrast with February, was mainly driven by fuel and utility bills.

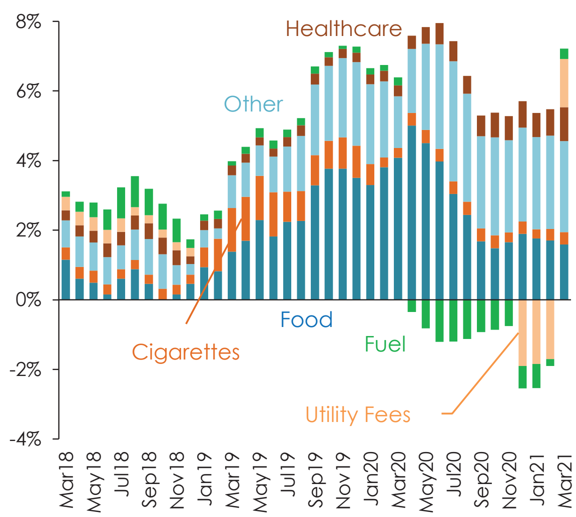

Figure 1.4.2. Contribution of different products to inflation

Source: GeoStat

6 *Due to government subsidies on utilities, in December 2020 the utilities indices decreased compared to November, while in March 2021 the indices increased slightly compared to the November level. However, the percentage increase was much greater than the decrease. Given the unchanged weight of utilities, this difference increased the annual inflation rate by about 1.2 percentage points over the next year.*

The increase in inflation on imported products is caused by the depreciation of the effective exchange rate of the lari and the rise in prices of some goods on the world market.

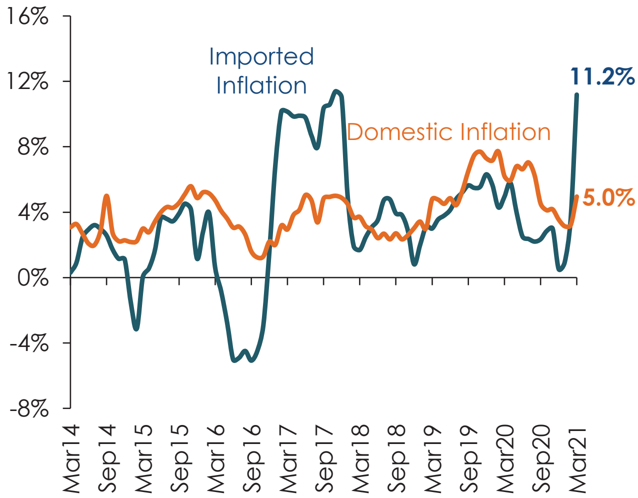

Figure 1.4.3. Domestic and imported inflation

Source: GeoStat

In March, the annual loan portfolio growth decreased and stood at 7.7%, excluding the effect of exchange rate fluctuations.

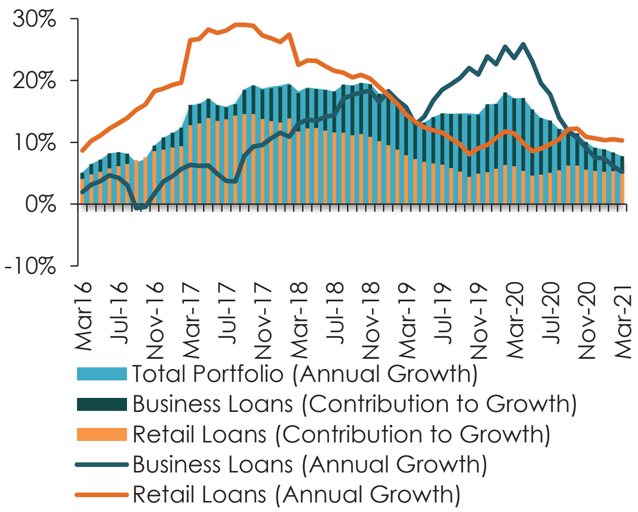

Figure 1.5.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

The 13.6% increase in prices in the healthcare group (making a 1.0 pp contribution to inflation) is significant, where the prices of medicines and doctor services have risen.

Increased prices on gasoline and diesel were already causing inflation to grow (by 0.4 pp in March). Meanwhile the contribution of the increase of cigarette prices was 0.4 pp.

In March, inflation for imported, domestically produced and mixed goods was 11.2%, 5.0%, and 8.0% respectively. The increase in inflation on imported products was caused by the depreciation of the effective exchange rate of the lari and the rise in prices of some goods on the world market (see Figure 1.4.3).

1.5 FINANCIAL MARKET AND TRENDS

1.5.1 LOANS

In March, relative to December, the growth of the loan portfolio decreased and stood at 7.7% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans decreased by 0.3 pp to stand at 10.3%, while loans to legal entities decreased by 2.3 pp and equaled 5.2% (see Figure 1.5.1). The growth of business loans was primarily driven by an increase in loans issued to the construction, agriculture and energy sectors. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for retail loans, while no significant changes in demand for business loans are expected.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the first quarter of 2021 was driven by domestic currency loans (see Figure 1.5.2). In March, 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 1.4 pp and equaled 20.4%. In the first quarter, the loan larization ratio did not change significantly and stood at 44.5%. It is expected that the larization (de-dollarization) process will continue in the future. Increased larization is a step towards reducing risks to financial stability.

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

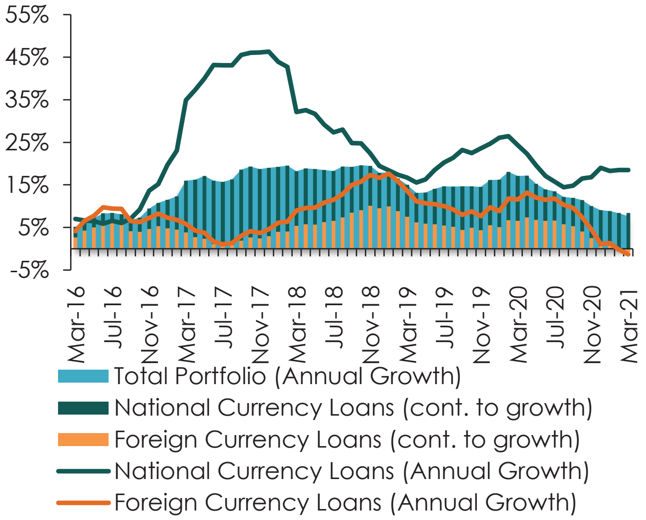

Figure 1.5.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

As the monetary policy rate increased insignificantly, interest rates on government securities did not change significantly in the first quarter of 2021.

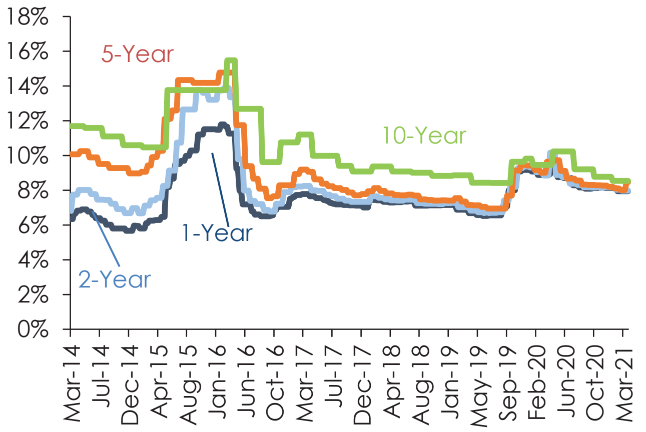

Figure 1.5.3. Interest rates on government securities

Source: National Bank of Georgia

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

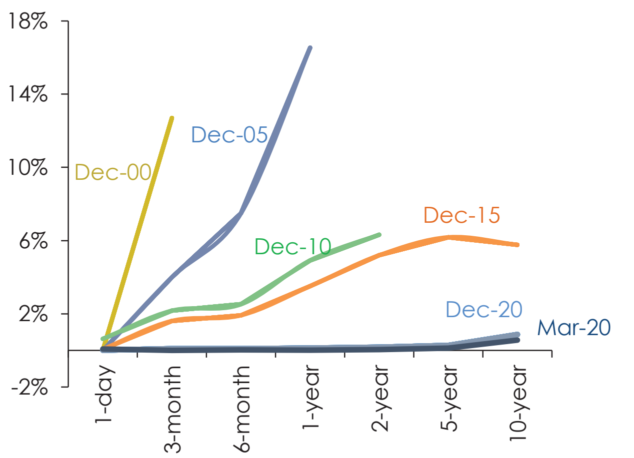

Figure 1.5.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

1.5.2 INTEREST RATES AND CREDIT CONSTRAINTS

In March, the monetary policy rate was 8.5%. In the first quarter of 2021, interest rates on government securities did not change significantly as the monetary policy rate increased insignificantly (see Figure 1.5.3).

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 increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate.

In March, relative to December, interest rates on domestic currency deposits did not change significantly and equaled 9.2%. Meanwhile, interest rates on foreign currency deposits decreased by 0.4 pp and equaled 2.2%. 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 do not expect significant changes to credit conditions; however, it is important to note that it is difficult to form expectations due to the ongoing uncertainty caused by the COVID-19 pandemic. In March, relative to December, interest rates on loans for small and medium enterprises (SMEs) and on corporate loans decreased. Interest rates on SME loans decreased by 0.3 pp and equaled 9.9%, while interest rates on corporate loans decreased by 0.9 pp and stood at 8.8%. Meanwhile, interest rates on retail loans increased by 1.5 pp and equaled 15.6%.

As of March, average interest rates on the stock of legal entities for domestic currency loans increased slightly and stood at 11.9%, while interest rates for foreign currency loans declined slightly and equaled 6.7% (see Figure 1.5.5). Representatives of the banking sector expect a slight increase in interest rates for loans in foreign currency.

As of March, average interest rates on the stock of legal entities for domestic currency loans increased slightly, while interest rates for foreign currency loans declined.

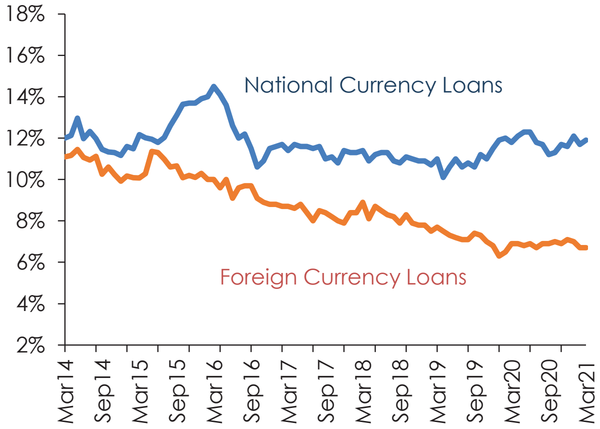

Figure 1.5.5. Average interest rates on business loans

Source: National Bank of Georgia

The real effective exchange rate remains undervalued (annual depreciation 9.1%).

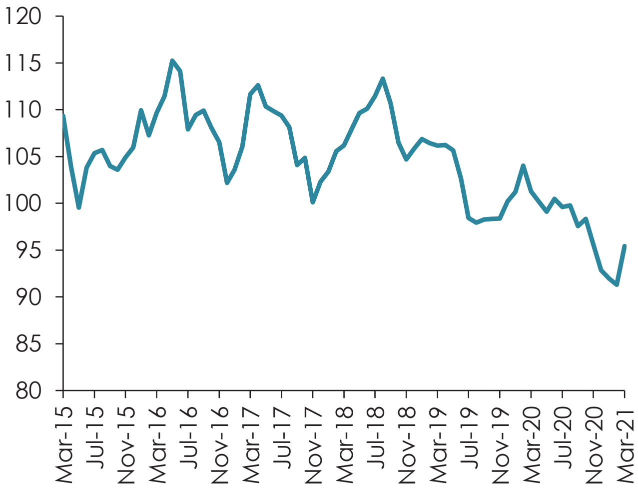

Figure 1.5.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

1.5.3 EXCHANGE RATE

In the first quarter of 2021, the GEL nominal exchange rate depreciated by 1.3% against the US dollar and by 2.5% against the euro, compared to the previous quarter. According to average quarterly data, the GEL depreciated against the Russian ruble by 3.7% and against the Turkish lira by 8.3%. In the same period, the nominal effective exchange rate depreciated by 3.2% on a quarterly basis and by 8.5% on an annual basis. As for the price-adjusted exchange rate, in the first quarter of 2021, the real effective exchange rate depreciated by 2.8% on a quarterly basis and by 9.1% on a year-on-year basis (see Figure 1.5.6). It should be noted that the real exchange rate depreciated against all trading partner countries (see Table 1.5.1).

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	**-8.5**	**-9.1**	**-9.1**
Eurozone	-19.4	-16.6	-3.0
Turkey	6.6	-3.6	-0.6
Ukraine	-1.5	-4.1	-0.3
Armenia	-4.2	-4.8	-0.3
US	-11.8	-9.5	-0.6
Russia	-1.2	-2.1	-0.3
Azerbaijan	-11.7	-11.1	-1.1
China	-18.1	-14.3	-1.9
Other	-18.2	-15.2	-0.9

Table 1.5.1. Effective exchange rates annual growth (first quarter of 2021)

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

1.6 LABOR MARKET

The annual growth rate of unit labor cost decreased to 4.4%.

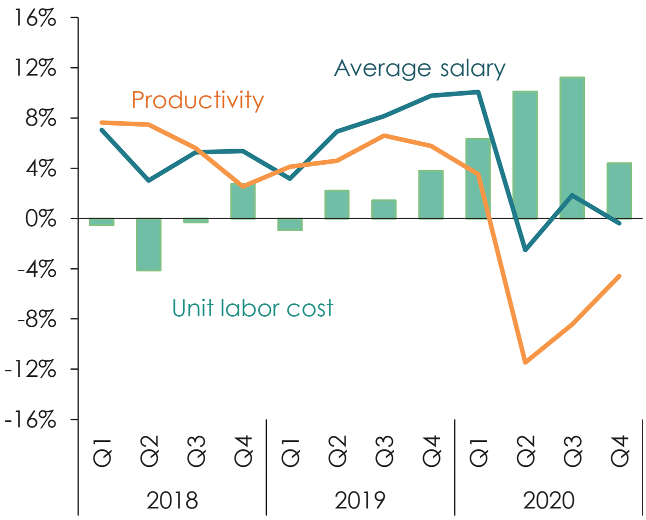

Figure 1.6.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

In the fourth quarter of 2020, the real value added produced per employee (labor productivity/productivity) in the country's economy decreased by 4.6% annually (see Figure 1.6.1).

At the same time, the salaries of employees averaged 1,315 GEL, which was a 0.4% nominal annual decrease.

As a result, the growth in unit labor cost was maintained, although the growth rate in the fourth quarter was lower than in the second and third quarters. The reason for the increase of the growth rate of unit labor cost in 2020 was the smaller decrease in salaries than in output. However, given the supply constraints and declining output in the face of the pandemic, this increase was expected and was one of the factors behind the growth of inflation. As previously predicted, this figure decreased compared to previous periods and stood at 4.4% in the fourth quarter. In subsequent periods, the recovery from the economic downturn will push the unit labor cost in a downward direction (see Figure 1.6.1).

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, economic activity will gradually recover in 2021, with real GDP growing by 4%. However, according to current estimates, the economy will remain below its potential level. Against this backdrop, aggregate demand will continue to exert downward pressure on inflation. In contrast, the effects of sharply rising commodity prices on international markets and the depreciated GEL exchange rate will push inflation up. Meanwhile, pandemic-related restrictions to contain the spread of the virus will keep production costs at an increased level, which will ultimately push inflation up. Given these factors, in the short term, inflation will likely hover above the target. As a response, a tight monetary policy stance will be maintained throughout the current year.

The alternative forecast scenario envisages a more acute development of the current epidemiological situation. In particular, a prolongation of the pandemic will exacerbate the external shock, which will raise the country's sovereign and currency risk premiums and slow down the economic recovery. According to this scenario, the inflationary pressure intensifies, which leads to a tightening of monetary policy and begets the subsequent maintenance of a tighter stance for a relatively long period (on average, in 2021-2022, the monetary policy rate will be 1.1 pp higher compared to the baseline scenario).

2.1 BASELINE MACROECONOMIC FORECAST

In 2021, inflation will remain above the target (see Figure 2.1.1). In the short term, high inflation is primarily driven by sharply rising commodity prices in the international market and by the depreciated GEL exchange rate. At the same time, restrictions and regulations to contain the spread of the virus remain active amid the prolonged pandemic. This latter factor, in turn, leaves firms with increased production costs that are ultimately reflected in inflation. These factors will have a temporary impact on consumer prices similar to the base effect of the government subsidies on utilities.[7] From the start of 2022, upon the exhaustion of these factors, in tandem with the tightened monetary policy stance, inflation will start to decline and approach the target from below in the medium term.

In the short term, inflation will remain above the target. From 2022, inflation will start to decline and will gradually approach the target from below.

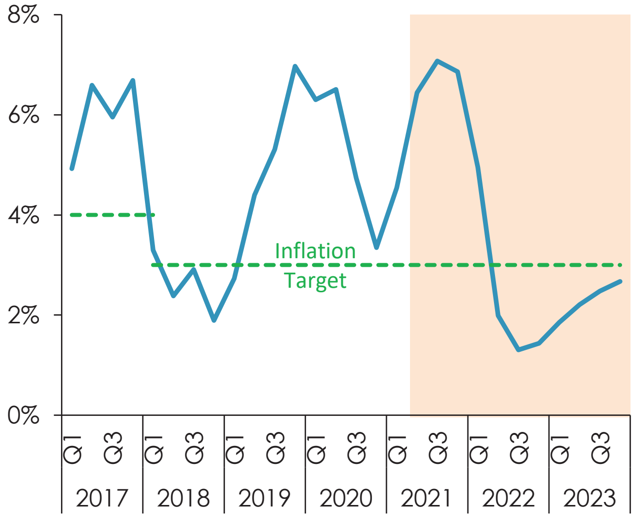

Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

Weak aggregate demand will continue to be disinflationary (inclined to reduce inflation) throughout the current year (see Figure 2.1.2). However, this will be outweighed by the factors driving consumer prices up, maintaining inflation above the target. The rise of oil and commodity prices on the international market will lead to inflation hovering above the target. Concurrently, the real effective exchange rate remains sharply depreciated, which causes an upsurge in the prices of imported goods. The recent depreciation of the GEL

7 In particular, at the end of 2021 and the onset of 2022, annual headline inflation will further increase once due to the base effect. At the end of 2020 and the beginning of 2021, the government subsidy program on utilities temporarily reduced inflation by 1.85 pp on average.

The deviation of inflation from the target is largely driven by both the upsurge of prices on international commodity markets and the depreciation of the GEL exchange rate.

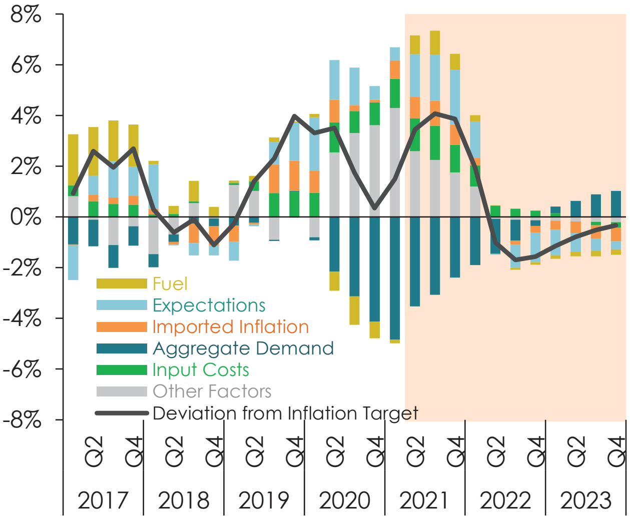

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

In 2021, the economy will gradually recover. Real GDP will grow by 4% on behalf of domestic demand driven by fiscal stimulus and credit activities.

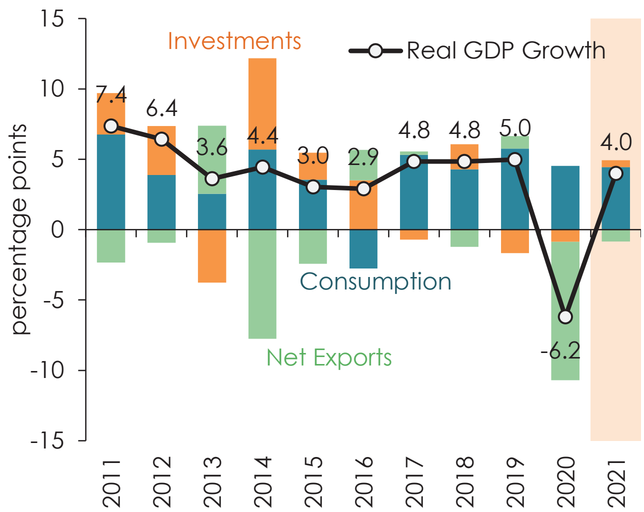

Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

against both the USD and the euro has increased the cost of servicing loans for firms, eventually pushing them to increase prices. Inflation expectations have also intensified in light of current trends. The deviation of inflation from the target for a relatively long period further exacerbates inflation expectations.

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 usually do not respond to the supply-side shocks, as doing so creates additional economic fluctuations. However, in the current stance, the strong supply-side shock underpins the threat of elevated inflation expectations and creates so-called "second-round" effects. Moreover, as a result of various types of 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 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.

According to the baseline forecast scenario, real GDP will grow by 4% in 2021 (see Figure 2.1.3). Domestic consumption will continue being the major driver of economic growth, which, in turn, will be further encouraged by fiscal stimulus and credit activities this year. Amid fiscal stimulus and a moderate growth of the credit portfolio, investments will positively contribute to the economic recovery, albeit to a smaller extent. In line with the prolonged pandemic, reduced foreign demand will negatively contribute to economic growth. However, mobility between countries around the world, including Georgia, will gradually increase together with the rollout of vaccination programs. Given the latter assumption, tourism revenues will recover at a slow pace in the second half of the year, but will remain significantly lower than 2019 levels. Revenues from exports of goods will moderately increase in 2021 alongside a gradual economic recovery of trading partner countries. Nevertheless, limited external demand will be one of the main obstacles to economic growth in 2021.

BASELINE FORECAST SCENARIO RISKS

Macroeconomic Forecast Risks	Impact on Inflation
Prolongation of the pandemic	↑
Slow immunization process in Georgia	→
Persistence of rising commodity prices in international markets	↑
Escalation of geopolitical risks	↑
The pandemic ending earlier than expected	↓
Low Risk	High Risk
↑	Upward Pressure on Inflation
→	Same Level of Inflation
↓	Downward Pressure on Inflation

Table 2.1.1 Baseline Macroeconomic Forecast Risks.

Given the current situation worldwide, macroeconomic forecasts are characterized by extraordinary uncertainty. The duration of the pandemic remains the major source of such uncertainty. Several COVID-19 vaccines are already available, and immunization is an ongoing process worldwide. However, increasing the availability and dissemination of the vaccines will take some time. In the event of a slower rollout, the global economic crisis will be more severe. Mobility across countries will be restricted for a longer period to curb new waves of the virus. This will deepen the external shock for Georgia, intensifying inflationary pressures through the channels of direct imported inflation and increased input costs. Increased risk premiums will create depreciation pressures.

The immunization process contains some risks at the local level. If the vaccination process in Georgia takes longer than expected, domestic economic activity will be weaker compared to the baseline scenario and will hinder economic recovery. On the one hand, the weak demand will create disinflationary effects. Conversely, a long delay of local economic activity will reduce the overall potential of the economy, leading to the weak demand being less disinflationary.

The trend of rising commodity prices in international markets poses risks to macroeconomic forecasts. Increased prices have already been transmitted to the local market. However, the persistence of this tendency will further amplify inflationary risks. Moreover, geopolitical tensions between Ukraine and Russia, two of Georgia's trading partners, further intensifies the risks. An escalation of that situation would ignite an external shock through the trade balance and the increased risk in the region.

The termination of the pandemic earlier than expected would also lead to a deviation from the baseline forecast scenario. This would be a positive shock, which would hasten the economic recovery. However, on the other hand, inflation would be lower compared to the baseline scenario amid a relaxing of regulations, the recovery of tourism, and improvements in the current account balance. In such a case, intensified inflationary pressures stemming from the depreciated GEL exchange rate and increased production costs would be exhausted. However, the realization of this shock seems less probable given the current perspective and the assessments of reputable international institutions.

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast for the short term has been revised upward. An upsurge of commodity prices in international markets has driven the increased inflation outlook. Meanwhile, a higher-than-expected depreciation of the GEL exchange rate pushed projected inflation up in the short term through the imported inflation and intermediate costs channels.

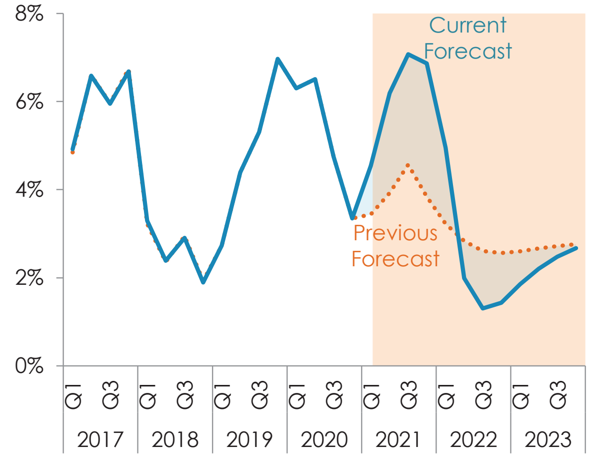

Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). The upsurge of commodity prices in international markets has led to an increased inflation outlook. Recent upward trends of oil and commodity goods (vegetable oil, sugar, cereals) prices have increased both the current and short term inflation forecast. The upward revision of inflation forecast was also driven by the higher-than-expected depreciation of the GEL exchange rate. A depreciated effective exchange rate increases prices of imported goods from trading partner countries, while the depreciated exchange rate against the USD pushed local prices up through the dollarization channel. The GEL depreciation against the USD (and, in part, against the euro) increases firms' debt service burdens and squeezes their profits, which ultimately impacts prices. According to the revised projection, inflation will remain above the target throughout 2021. However, it will subsequently decline from the end of 2021 and will gradually approach the 3% target level from below.

The 2021 real GDP growth forecast has been maintained at 4%. Fiscal stimulus and credit activities are still the major contributors to growth.

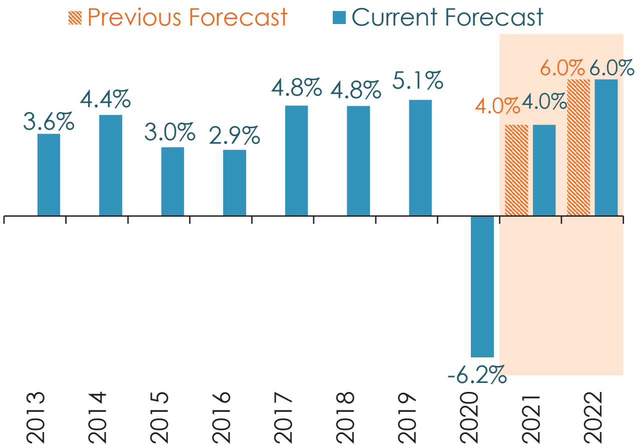

Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

The real GDP growth forecast has been maintained at 4% (see Figure 2.2.2). The forecast assumptions that were used to define the pace of the economic recovery, have not been changed. Akin to the previous forecast, real GDP growth in 2021 is still largely expected to be driven by credit activity and fiscal stimulus, 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 as associated risks (see Figure 2.2.3).[8]

According to the updated projections for 2021, the pace of the economic recovery of Georgia's main trading partners has been improved, albeit to a small extent. An upward revision of the expected depreciation of trading partners' currencies is also notable. This largely stems from developments in Turkey that have significantly depreciated the lira. The deteriorated expectations about trading partners' currencies, together with relatively improved demand, will eventually put upward pressure on inflation expectations. Meanwhile, increased short term inflation expectations compared to the previous projection could be a reflection of the upsurge of international commodity prices.

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

According to the updated projections for 2021, the pace of the economic recovery of Georgia's main trading partners has been improved, albeit to a small extent. Meanwhile, the expected depreciation of their currencies has been revised upward, which has led to relatively intensified inflation expectations.

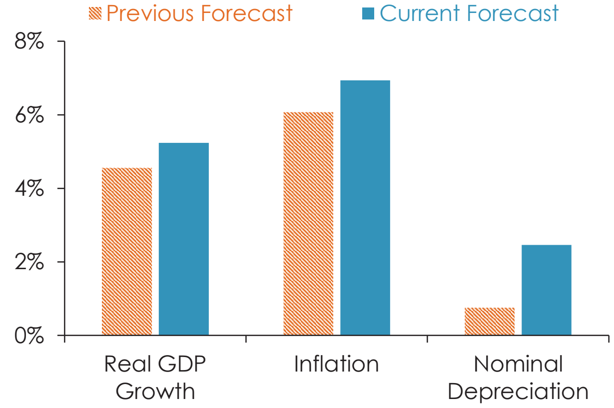

Figure 2.2.3. Changes in the forecast of external assumptions for 2021

Source: Bloomberg

The alternative forecast scenario considers a more prolonged pandemic compared to the baseline scenario. As a consequence, aggregate demand will shrink, slowing down the recovery process. In the alternative scenario, real GDP is expected to grow by 0.5% in 2021.

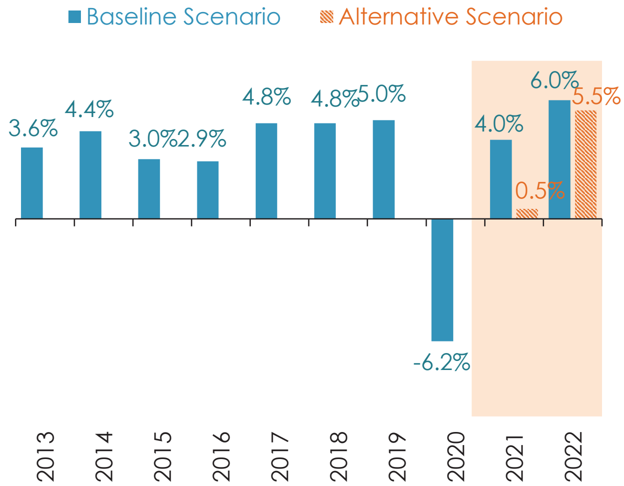

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario envisages risks stemming from a prolongation of the pandemic, driven by the outbreak of a new wave and/or the slow pace of the immunization process, both in Georgia and its trading partner countries. Against this background, there will be a need to further tighten regulations to prevent the increased risks, leading to an extension of mobility restrictions between countries. Under such a scenario, countries significantly dependent on tourism will suffer a severe economic blow. Georgia is particularly vulnerable in this regard. As a consequence, the negative impact of external shocks will deepen, which will be reflected in increased sovereign and currency risk premiums in developing countries, including Georgia. This circumstance will drastically worsen business sentiment and investments, aggravating the economic crisis.

In the alternative forecast scenario, consumer sentiment will deteriorate together with business confidence. Consumers will thus be less inclined to consume, causing a further reduction of domestic demand. Ultimately, real GDP growth in 2021 will be around 0.5% under a realization of all of the above-mentioned risks (see Figure 2.3.1).

Amid an aggravated economic crisis, inflation will increase compared to the baseline scenario. In that case, factors playing in opposite directions will affect consumer prices. On the one hand, a further reduction of aggregate demand will push prices down, while the worsened current account balance stemming from the exacerbated external shock will further increase the risk premium and depreciate the GEL exchange rate. Ultimately, this interplay of factors will push inflation up owing to the still-high dollarization levels in Georgia. In particular, over 2021-2022 inflation will be 1.2 pp

According to the alternative scenario, inflation in 2021-2022 will increase by an average 1.2 pp compared to the baseline scenario due to exacerbated external demand shock and the depreciation of the GEL exchange rate.

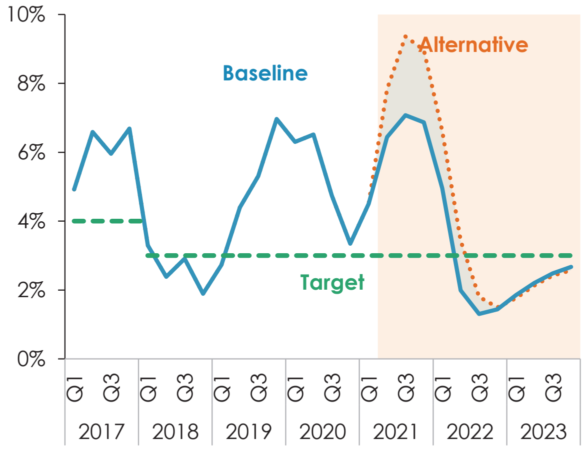

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

In response to the increased inflationary pressures, the monetary policy stance will be tighter compared to the baseline scenario. Under the alternative scenario, the monetary policy rate trajectory will shift up by 1.1 pp in 2021-2022.

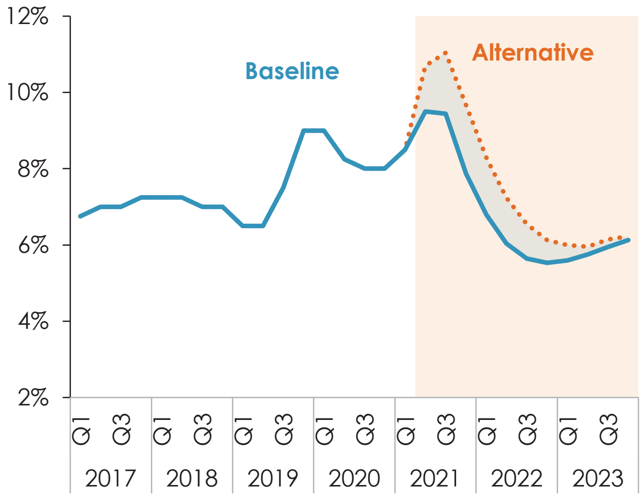

Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

higher than in the baseline scenario (see Figure 2.3.2).

Monetary policy will be tightened in response to intensified inflationary pressures and this tighter stance will be maintained for a relatively long period. According to current projections, this will decline in line with a curbing of inflationary risks and will gradually approach the neutral level in the medium term.

Under the alternative forecast scenario, the monetary policy rate trajectory, on average, will increase by 1.1 pp for 2021-2022 compared to the baseline scenario (see Figure 2.3.3). The appropriate monetary policy response will eventually drive inflation towards the target level of 3% in the medium term.

3 MONETARY POLICY

Due to increased prices on commodity markets and the end of the utility subsidy program, annual inflation rose to 7.2% in March. At the same time, the depreciated lari exchange rate continues to exert upward pressure on inflation. According to the current forecast, other things being equal, inflation will remain around 6.5% on average in 2021 and will then gradually approach the target level. In addition, on the back of a significant drop in output due to the pandemic, average production costs are still high – representing another source of upward pressure on inflation. Taking these factors into account, on 28 April, the Monetary Policy Committee further tightened monetary policy and raised the monetary policy rate by 1 pp to 9.5%.

According to a decision made on 28 April 2021, the refinancing rate was increased by 1 pp to 9.5%.

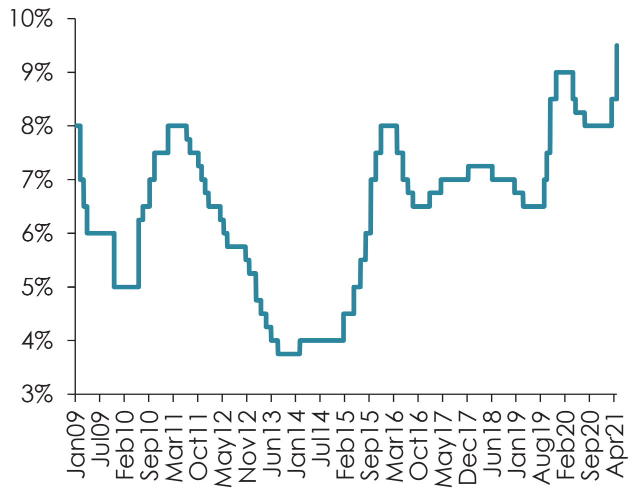

Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

From the second half of last year, risks related to inflation expectations became evident. These were linked to increased volatility in foreign exchange markets and the long-term maintenance of a higher-than-target inflation rate. Potential supply-side risks associated with an extension of the pandemic and related restrictions should also be noted. Moreover, negative expectations were formed by a worsening of the geopolitical situation. As a result, the normalization of monetary policy stopped from August 2020 and the policy rate remained unchanged at 8%. However, from the beginning of 2021, the risks of a sharp growth of inflation emerged. At its March meeting, the Monetary Policy Committee (MPC) thus made the decision to increase the refinancing rate by 0.5 pp to 8.5%.

Annual inflation stood at 7.2% in March. The reduction of inflation since last December was related to the temporary subsidization of utility fees. The end of this subsidy program in March 2021 was reflected in an upward shift of inflation. It is noteworthy that the subsidy will also have a base effect, with a significant upward impact on the annual inflation rate in December 2021 and January-February 2022. Circumstances have changed since the publication of the previous report and, according to the updated forecast, other things being equal, inflation will average around 6.5% in 2021 and then gradually approach the target. Inflationary pressures, coming from rising prices on international commodity markets, have persisted – being reflected in increased prices for oil products and selected food items. At the same time, on the back of a significant drop in output due to the pandemic, average production costs are still high, representing another source of upward pressure on inflation. The MPC also took into account the fact that recent developments in Georgia's trading partner economies have, to some extent, been transferred to the local foreign exchange market. Given the high dollarization of the economy, this puts even more pressure on prices. Moreover, high uncertainty remains about the prospects of the tourism industry in Georgia as well as globally. Amid deteriorating epidemiological conditions, the fiscal deficit remains at a high level, pushing up domestic demand. As for the lending, despite the recent slowdown, as a result of maintaining adequate buffers of liquidity in the financial sector, it continues to grow fairly. Overall, the increase in domestic demand boosts imports. In view of the prolonged deviation of inflation from its target and intensified inflationary pressures, on 28 April the MPC decided to increase the monetary policy rate by 1 pp to 9.5%.

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 that can cause an increase in the inflation forecast.

According to preliminary data, there are signs of recovery in aggregate demand. Based on rapid estimates, economic activity fell by 5.1% year on year in February, while, amid an easing of restrictions since the start of the year, a gradual recovery of economic activity is expected from March – the main driver of which will be domestic demand. The forecast for economic growth is about 4% in the baseline scenario. In contrast, external demand remains significantly reduced compared to the pre-pandemic situation. As for the current indicators, exports of goods increased by 31% in March, which was partly due to the base effect. At the same time, revenues from international travelers are down by 60% year on year in March, while the drop since the same period in 2019 amounts to 88%. As for imports of goods, annual growth of 18% was recorded in March.

Based on the abovementioned factors, it is clear that the pressure on inflation coming from high dollarization and the exchange rate is still strong. In addition to limiting the efficiency of monetary policy, dollarization also carries risks to financial stability, and thus its gradual reduction remains a long-term priority of the NBG. For this purpose, starting from July, the minimum reserve requirements for funds attracted in foreign currency will be determined for each commercial bank individually according to the deposit dollarization of each bank. In particular, unless the deposit dollarization rate exceeds 40%, the reserve requirement norm will be reduced from 25% to 10% for funds borrowed in a foreign currency with a remaining maturity of up to one year. If the deposit dollarization rate is 70% or above, the reserve requirements will remain at 25%. Finally, for a deposit dollarization rate in the range of 40-70%, the reserve requirement norm will decrease linearly from 25% to 10% along with a decrease in deposit dollarization. Similarly, the reserve requirement will be reduced from 15% to 10% for foreign currency-denominated funds with a remaining maturity of one to two years. This change will help intensify competition in the GEL deposit market, gradually increasing demand for the GEL and easing pressure on the foreign exchange market.

To ensure the efficiency of monetary policy, it is important that changes in the monetary policy rate are reflected on interbank interest rates and ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. At the same time, in the light of the COVID-19 pandemic, it is important not to increase liquidity risks in the financial sector. In response, the NBG has launched temporary instruments to supply liquidity. To manage short-term liquidity, the banking sector mainly relies on refinancing loans and the interbank money market. In addition to standard refinancing loans, the NBG also provides liquidity support to commercial banks and microfinance organizations through additional "swap" operations. Due to the ongoing pandemic, the period of use for these operations was extended until the spring of 2022. In addition, to facilitate lending to small- and medium-sized businesses the liquidity support instrument is available. The NBG provides the required amount of short-term liquidity to ensure that interest rates in the interbank money market vary around the policy rate.

Interbank money market rates vary around the monetary policy rate.

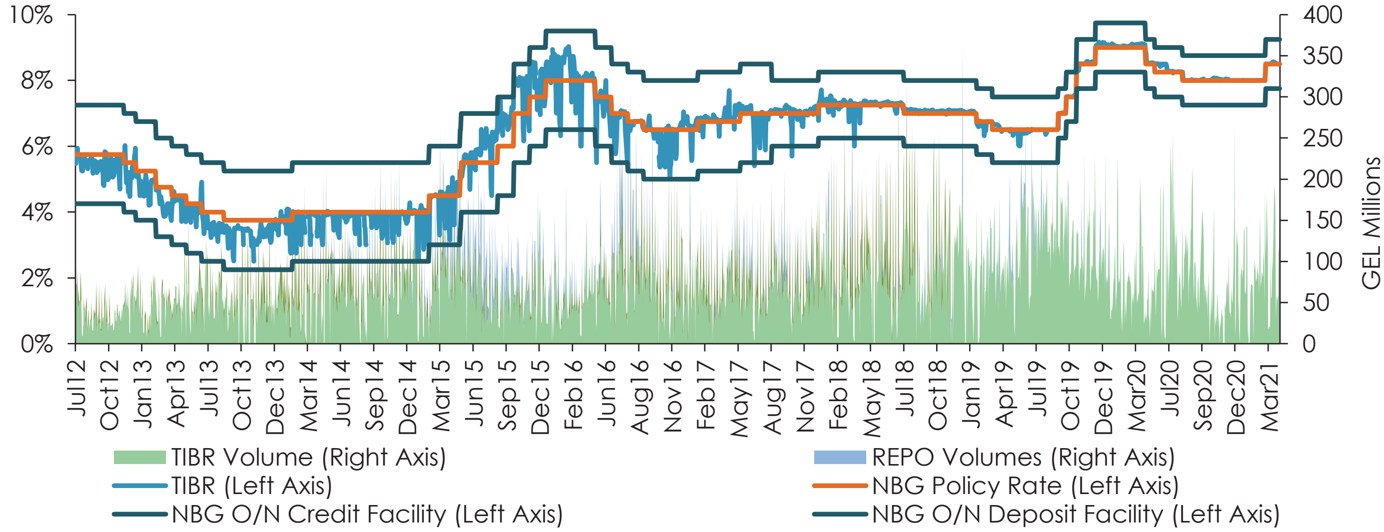

Figure 3.2. Interbank money market

Source: National Bank of Georgia

BOX 2. TEMPORARY SHOCKS TO INFLATION AND THE OPTIMAL MONETARY POLICY RESPONSE

The main mandate of the National Bank of Georgia is to ensure price stability, which means keeping inflation close to the 3% target. However, certain types of shocks can always cause deviations from the target, sometimes in one direction, sometimes in the other. In case of such shocks, the National Bank of Georgia conducts monetary policy so that inflation returns to the target in the medium term. However, there are certain shocks that we know will have only a temporary impact. Once such shocks pass, the inflation rate will return to the target level. Under these conditions, responding to short-term changes with monetary policy is usually counterproductive. Such a response only occurs when a shock, despite being of a temporary nature, starts to affect medium- and long-term inflation expectations and produces so-called "second-round effects".

Thus, when we analyze inflation, it is important to distinguish between those factors that are a direct result of temporary effects and those that have a more medium-term impact. This section discusses the following, apparently temporary shocks:

- US-dollar-denominated price changes on commodities on international markets
- The change of the indirect tax rate
- Subsidies

It is impossible to constantly change the tax rate or subsidy scheme in one direction. Thus, their impact, as explained above, is temporary. Also, if the US-dollar-denominated price of a commodity rises on the international market, we know that it will not last forever. As a result, the transmission to domestic inflation will also be temporary. If we exclude the direct effects of similar types of temporary shocks from Georgia's CPI inflation, we get the result presented in the figure below.

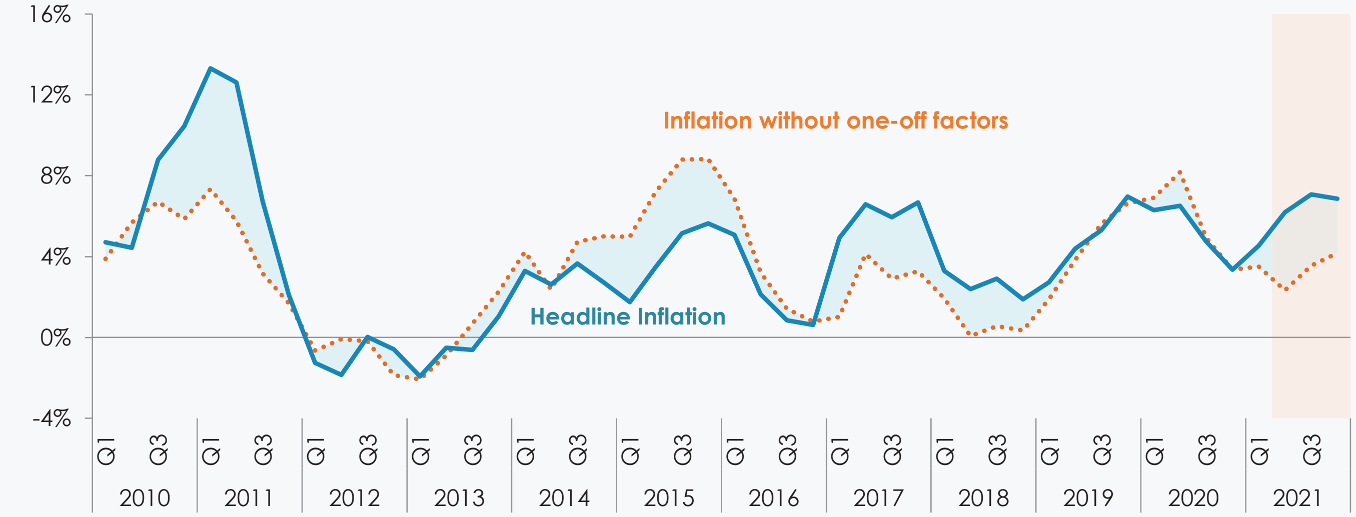

Figure 3.3. Inflation without one-off factors and headline inflation.

Source: Calculations of the National Bank of Georgia

This analytical measurement logically characterizes the history of inflation and monetary policy in Georgia. In particular, in 2010-11 international prices on commodities increased significantly. The rise in these prices was also reflected in the domestic market, and inflation in this period sharply exceeded the target. However, that shock was temporary, as shown by the trajectory of inflation without the one-off factors. A year later, its effects phased out, headline inflation fell below the target, and, in subsequent years, deflation was even observed. The year 2015 is also interesting. Headline inflation was below the 5% target, although monetary policy was still tightening. This situation is well explained by the alternative measurement, which shows that headline inflation in 2015 was low due to temporary factors (mainly due to a sharp decline in international oil prices). Because the National Bank took this into account, it tightened monetary policy during that period.

Also noteworthy is the impact that the increased excise tax on cigarettes and fuel had on inflation in 2017. A year later, the inflationary effect of the tax increase was completely exhausted, and inflation automatically returned to the target. This expected result is illustrated by the alternative measurement presented in Figure 3.3 for 2017. If, in response to the elevated inflation resulting from the excise tax increase, the NBG had tightened monetary policy, the aggregate demand of the economy would have been reduced. It takes some time for monetary policy to affect final prices, and inflation cannot return to the target immediately. As a result, prices in 2017 would have still remained above the target, but, a year later, once the excise tax effect had faded away, further reduced aggregate demand would have additionally reduced inflation in 2018. Similarly, the NBG does not respond to subsidy effects. Inflation was temporarily reduced as a result of subsidizing utility bills in early 2021, but this did not become a reason for an easing of monetary policy because, again, this was only a temporary effect.

If we count on this analytical measurement, in 2022, when the temporary effects of the sharp rise in prices on the international market at the end of 2020 and beginning of 2021 are eliminated, inflation will have to return to the target, provided that medium- and long-term inflation expectations do not increase further and are close to the 3% target.

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