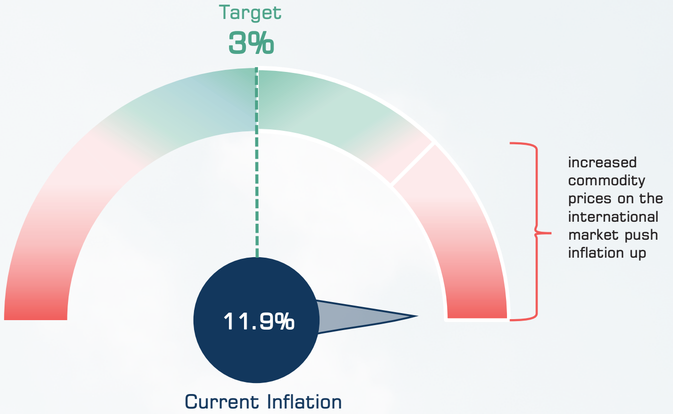
Monetary Policy Report

August

2021

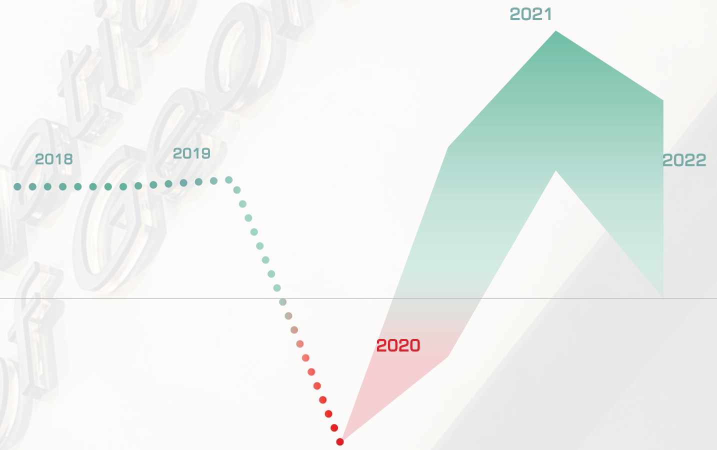
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



11.9%	Inflation was higher than expected.

Economic Growth



In the second quarter of 2021, the economy started to recover at a high speed.	29.8%

Monetary Policy

10.0% **0.5**

10.0%	In order to curb inflation expectations, the NBG raised the policy rate.

MONETARY POLICY DECISION

We have raised the monetary policy rate to 10%.

Our role is to set the interest rate to affect total spending in the economy and thereby guide inflation expectations so as to ensure that inflation returns to the target level of 3%. Low and stable inflation supports employment and economic growth, which are of the utmost importance during challenging times such as those now confronting us as a result of the COVID-19 pandemic. Difficult circumstances such as these should not reduce the credibility of macroeconomic policy.

From the beginning of the year, a trend of increasing inflation has been observed. Elevated food and oil prices on international markets have been transmitted to local market prices. In addition, international shipping costs have increased significantly and supply-side disruptions have pushed production costs up. Meanwhile, inflation expectations have also increased. These factors have led to inflation being above the target in 2021.

Considering rising inflation expectations and continued risks, we have tightened monetary policy and increased the monetary policy rate to 10.0%. This decision aims to ensure that current price hike not to impact on long run inflation expectations.

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

Whatever the situation, we will use all the instruments at our disposal to ensure price stability and to maintain the purchasing power of the GEL.

CONTENTS

MONETARY POLICY DECISION 3
BRIEF OVERVIEW 5

1 CURRENT MACROECONOMIC SITUATION 7
1.1 OVERVIEW OF THE GLOBAL ECONOMY 7
1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS 10
1.3 OVERVIEW OF THE DOMESTIC ECONOMY 13
1.3.1 AGGREGATE DEMAND 13
1.3.2 OUTPUT 13
1.4 FINANCIAL MARKET AND TRENDS 14
1.4.1 LOANS 14
1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS 14
1.4.3 EXCHANGE RATE 15
1.5 LABOR MARKET 17
1.6 CONSUMER PRICES 17

2 MACROECONOMIC FORECAST 20
2.1 BASELINE MACROECONOMIC FORECAST 20
BASELINE FORECAST SCENARIO RISKS 22
2.2 COMPARISON WITH THE PREVIOUS FORECAST 23
2.3 ALTERNATIVE FORECAST SCENARIO 24

3 MONETARY POLICY 26

BOX 1. THE CORRELATION BETWEEN GROWTH OF THE MONEY SUPPLY AND INFLATION .. 18

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BRIEF OVERVIEW

According to preliminary data, a sharp increase in economic activity was observed in the second quarter of 2021. Although the base effect certainly contributed to this (due to the significant drop experienced in the corresponding quarter last year), the current level of activity even exceeded the level observed in 2019. Amid fiscal stimulus and credit growth, this is an indicator reflecting the accelerated recovery of the economy. This, in turn, means that aggregate demand is less able to neutralize inflationary pressures, unlike in previous periods when it was weaker. The inflationary pressures are mostly related to the upward dynamics of oil and food prices on international markets, which have been transmitted to the local market. According to the baseline forecast, as a result of the above-mentioned developments and other one-off factors, inflation will remain above the target in the short run. However, with the exhaustion of these temporary effects, inflation will return to the target in the medium term, with a tightened monetary policy being maintained for a longer period so as to curb inflation expectations. According to the same forecast, in 2021 the Georgian economy will grow by 8.5% amid relatively strong domestic demand.

In the short run, annual inflation will remain above the target. However, it will start to decrease from the beginning of 2022 to approach the target in the second half of the year. The current high inflation is largely due to global factors, which are considered temporary.

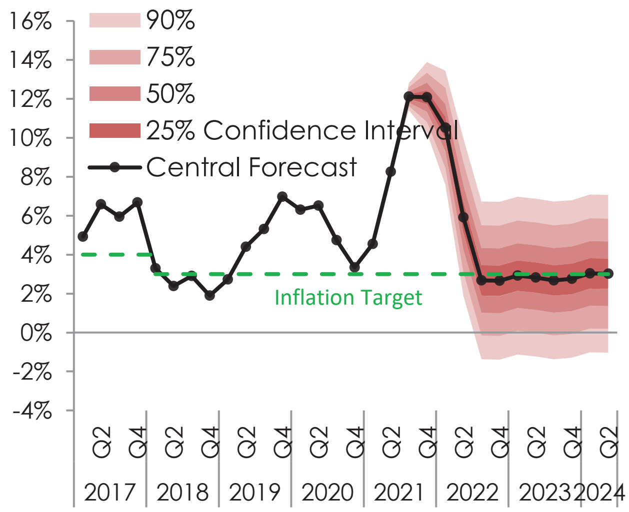


Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia

The recent dynamics of consumer price inflation have been influenced by several important factors simultaneously. The rising prices of oil and food products on international markets are particularly noteworthy. These are transmitted to the local market and, in the short term, result in strong, albeit temporary, inflationary pressure. Annual inflation has also been affected by the government's utility bill subsidy program. After this program was initiated, headline inflation dropped at the end of last year; however, the end of this program saw inflation automatically increase by more than the initial reduction. In addition, despite the recent appreciation of the local currency, imported inflation remained high under the influence of the depreciated lari exchange rate in previous periods. This was accompanied by significant improvements in aggregate demand in the second quarter of this year, which, unlike in previous periods, can no longer counterbalance the above-mentioned inflationary pressures.

Due to the aforementioned factors, according to the National Bank of Georgia's baseline forecast, high inflation is expected to persist in the short run, and **average inflation for 2021 will exceed 9%** (see Figure 1). However, most of the factors affecting the forecast are temporary and, after their elimination, annual inflation should return to the target in the medium term. In this regard, a de-anchoring of inflation expectations could pose a risk that might complicate the maintenance of price stability. The tight monetary policy adopted in the current period serves to avoid exactly this risk.

According to preliminary data, a sharp increase of economic activity was observed in the second quarter of 2021. Although the base effect contributed to this

In 2021, amid strong fiscal stimulus and credit growth, the economy will grow significantly. Real GDP growth is expected to be 8.5%.

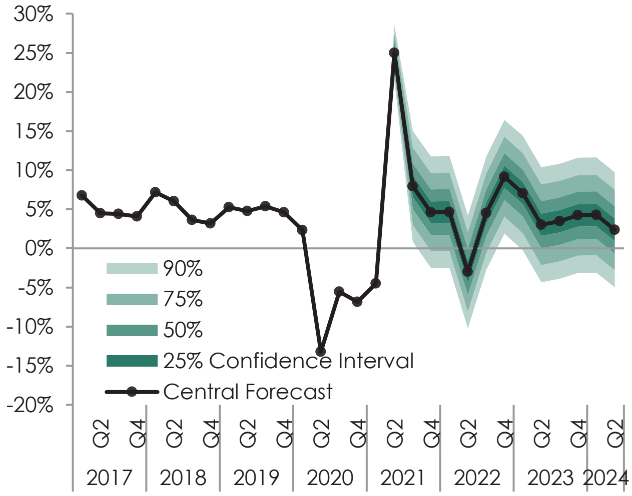


Figure 2. Annual growth forecast of quarterly real GDP

Source: National Bank of Georgia

Monetary policy will remain tightened in the short term to avoid a further increase in inflation expectations. Its further normalization will depend on the rate of decline in inflation expectations.

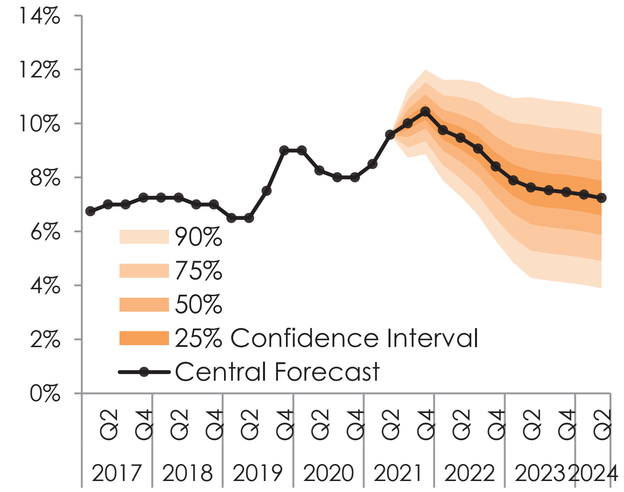


Figure 3. Monetary policy rate forecast

Source: National Bank of Georgia

(due to the significant drop experienced in the corresponding quarter of last year), the current level of activity has even exceeded the level observed in 2019. Amid fiscal stimulus and credit growth, this is an indicator of an accelerated recovery. As a result of the above-mentioned factors, according to the baseline forecast, **real GDP will grow by 8.5% in 2021**. The main driving force of that growth will be consumption, although investments and net exports are also expected make a positive contribution. Amid a recovery in external demand, net exports will benefit from an expected improvement in exports of goods, a slightly slower increase in imports of goods (amid high imported inflation) and the gradual recovery of tourism exports.

As noted above, after the exhaustion of the strong, albeit temporary, supply-side factors, elevated inflation expectations could still cause inflation to deviate from the target. Given that inflation has been above the target for quite a long time – about three years – the risk of a further increase in inflation expectations is noteworthy. To help avoid this, **it is expected that monetary policy will remain in a tight position** in the short run. Its further normalization will depend on the rate of decline in inflation expectations. As inflation expectations recede, the policy rate will gradually decline and approach the long-term neutral level, which, according to current estimates, is about 6.5%.

It should be stressed that **the monetary policy rate forecast is not a commitment to future decisions** made by the National Bank of Georgia. Rather, it is the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. Hence, if external or domestic factors evolve differently than is currently expected, this may influence macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

1 CURRENT MACROECONOMIC SITUATION

Amid the easing of COVID-19 pandemic-related restrictions, the global economy continues to improve and is expected to grow by 6% in 2021. Alongside the commencement of mass immunization programs, expectations have improved in Georgia's trading partner countries. Meanwhile, the upward dynamics of commodity prices on international markets have put some pressure on inflation expectations and various central banks have responded by tightening monetary policy. Amid the continued restrictions on tourism, Georgia's current account deficit remains deteriorated; however, in the second quarter of 2021, an annual increase in exports of goods and services was observed. Money transfers have also increased. Along with mass immunization of the population and an easing of pandemic-related regulations, a gradual increase in tourism revenues is also expected. In the first quarter of 2021, similar to the previous period, aggregate demand remained weak; however, final consumption was strong as a consequence of sizable fiscal stimulus and a fair growth of lending activity. Recently, inflationary pressures have been high, which are closely related to rising prices of consumption goods.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Despite the COVID-19 pandemic, in the first half of 2021, the global economy started to recover amid mass vaccination programs and unprecedentedly strong fiscal and monetary stimulus.

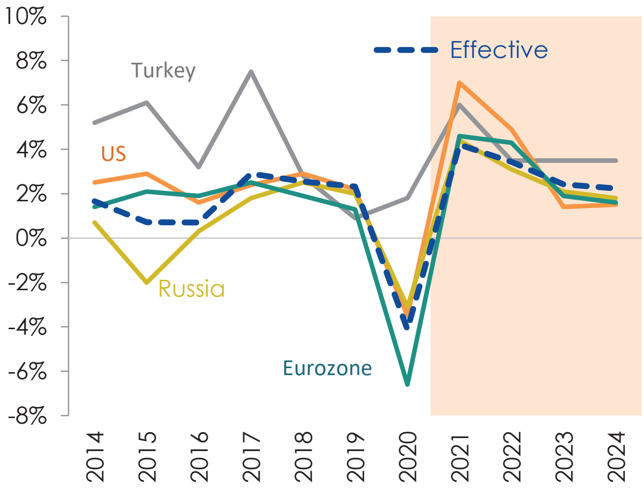


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

Following the deep economic crisis caused by the COVID-19 pandemic, the global economy began to recover in the first half of 2021. Risks associated with the spread of the virus nevertheless remain high. In a number of countries, various restrictions are still in place, which significantly hamper economic activity. However, along with the start of mass vaccination programs and a gradual easing of pandemic-related restrictions, economic activity in developed countries has slightly improved. In contrast, the vaccination process is proceeding more slowly in emerging and developing countries and infection rates remain quite high. As a result, the economic recovery in such economies remains relatively weak.

According to the IMF's updated forecast[1] from July, **global economic growth** will be 6% in 2021 – a projection similar to the previous forecast[2] made in April. It should be noted that, in light of the strong fiscal and monetary stimulus implemented in many countries, growth is expected to be stronger in the second half of the year. Meanwhile, according to the same forecast, growth is projected to be 4.4% in 2022. For emerging and developing countries, real GDP is expected to grow by 6.3% in 2021, and by 5.2% in 2022.[3] Inflation

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

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

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

expectations have also increased globally this year, with the expected global inflation rate being 3.5%.[4]

Together with the easing of pandemic-related restrictions, the growth rate in **the United States** increased significantly in the second quarter of 2021. In particular, external demand recovered and, along with a declining unemployment rate, consumer spending and consumer sentiment increased. Follow a mass vaccination campaign, as well as strong fiscal and monetary stimulus, a further improvement in economic activity is expected. Although the annual inflation rate increased, reaching 5.4% in June, the Federal Reserve has kept the federal funds rate unchanged. According to the IMF's July forecast, real economic growth is expected to be 7% in 2021 and 4.9% in 2022.[5] The inflation forecast for 2021 is 2.3% and around 2.4% for 2022.

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

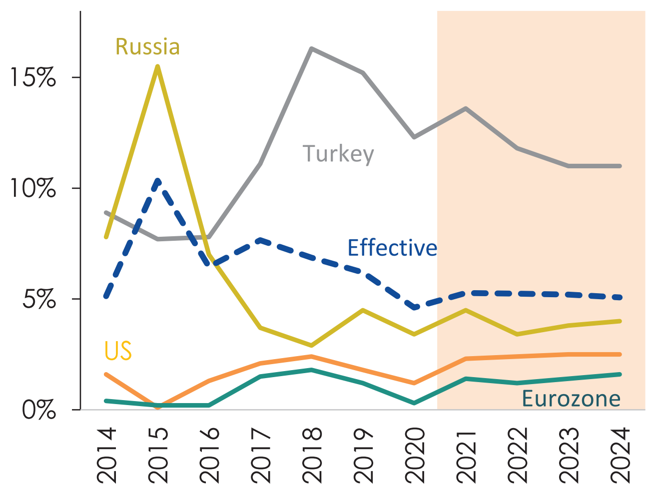


Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

In the second quarter of 2021, amid the easing of pandemic-related restrictions, economic activity continued to improve in the **eurozone**. According to the data from July, activity in the manufacturing and industrial sectors recovered, with consumer and business sentiment improving slightly. Expectations regarding investments and tourism have also improved alongside the progress made with vaccination campaigns. According to the IMF's July forecast, real economic growth for the eurozone will be 4.6% in 2021 and 4.3% in 2022.[6] The inflation rate is projected to be 1.4% in 2021 and 1.2% in 2022.

In the second quarter of 2021, economic activity continued to recover in **Turkey**. 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 tourism sector remains weak. Inflationary pressure continues to be high amid the depreciation of the Turkish lira, with annual inflation standing at 17.5% in June. According to the IMF, the real GDP forecast for Turkey is 6% in 2021 and 3.5% in 2021.[7] Inflation is currently forecast at 13.6% for 2021 and 11.8% for 2022.

In the second quarter of 2021, similar to the previous period, economic activity continued to improve in **Russia**. This was mostly due to the easing of pandemic-related restrictions and the start of the vaccination process. Consumer spending and retail sales

4 The inflation forecast for Georgia's trading partners is taken from: International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.
5 International Monetary Fund. 2021. World Economic Outlook Update: Fault Lines Widen in the Global Recovery. Washington, D.C., July.
6 Ibid.
7 International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.

increased slightly, and consumer and business sentiment improved. Along with the increase in global oil prices, an improvement in the external sector is expected. However, annual inflation has increased significantly and equaled 6.5% in June. As a result, the Central Bank of Russia decided to tighten their monetary policy. According to the IMF's July forecast, real economic growth in Russia will be 4.4% in 2021 and 3.1% in 2022.[8] The inflation rate is projected to be 4.5% in 2021 and 3.4% in 2022.

After the weak economic activity observed in early 2021, the second quarter of the year saw a slight improvement in **Ukraine**. The industrial sector improved alongside rising consumer and business sentiment. Consumer spending and retail sales also increased with the easing of pandemic-related restrictions, and there are positive expectations for the trade balance amid improvements in global activity. However, annual inflation also increased and stood at 9.5% in June. According to the IMF, the real GDP growth forecast for Ukraine is 4% in 2021 and 3.4% in 2022.[9] Inflation is expected to be 7.9% in 2021 and 6.8% in 2022.

In the second quarter of 2021, the growth rate slightly stabilized in **Armenia**. This was mostly due to the easing of pandemic-related restrictions, which led to a recovery in the manufacturing sector and increased consumer spending. Remittances also increased. However, the external sector of the country remains weak, with declining exports and increasing imports. After the war with Azerbaijan, business sentiment also remains poor. The uncertain political environment in the country serves to exacerbate this situation. The annual rate of inflation increased significantly and stood at 6.5% in June, leading to the Central Bank of Armenia to a further tightening of monetary policy. According to the IMF, the real GDP forecast for Armenia is 1% in 2021 and 3.5% in 2022.[10] The inflation rate is projected to be 3.9% in 2021 and is expected to be 3.2% on average in 2022.

In the second quarter of 2021, **Azerbaijan's** economic activity improved slightly in both the oil and non-oil sectors. This was mostly due to the upward dynamics of oil prices on international markets and an improvement of the manufacturing sector. Compared to the previous quarter, oil production and refining increased, which led to a slight stabilization of the external sector. According to the IMF's forecast, real GDP growth in Azerbaijan will be 2.3% in 2021 and 1.7% in 2022.[11] Inflation is projected to be 3.5% in 2021 and

In the first half of 2021, together with the rise in inflation expectations, the central banks of Georgia's trading partners started to tighten their monetary policy rates. The exception to this is Turkey, where, due to high inflationary pressures, the monetary policy rate remains high.

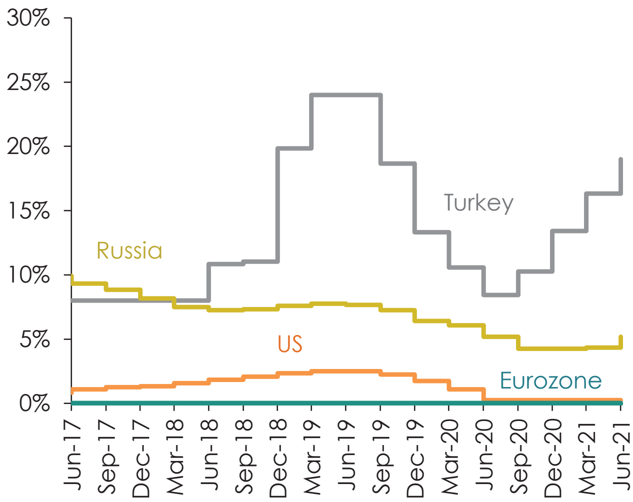


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

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

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

10 Ibid.

11 Ibid.

3.2% in 2022.

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

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the second quarter of 2021, external demand on goods increased compared to the same quarter of 2020. In light of the acceleration of global vaccination programs and a gradual reopening of economies in the wake of the pandemic, business sentiment has improved. The revival of domestic economic activities within countries and the recovery of international trade began quickly, which has positively affected the growth of Georgian external trade. Although international tourism still functions under restrictions, thanks to the commencement of universal vaccination programs, this sector became active and revenues from tourism gradually began to increase. Against the background of a partial improvement in global economic activities, instant money transfers increased considerably. According to recent estimates, all else being equal, the current account deficit will decrease in 2021, but it will still hover on a high level.

The high growth of registered exports of goods in the second quarter is partially due to the base effect in 2020.

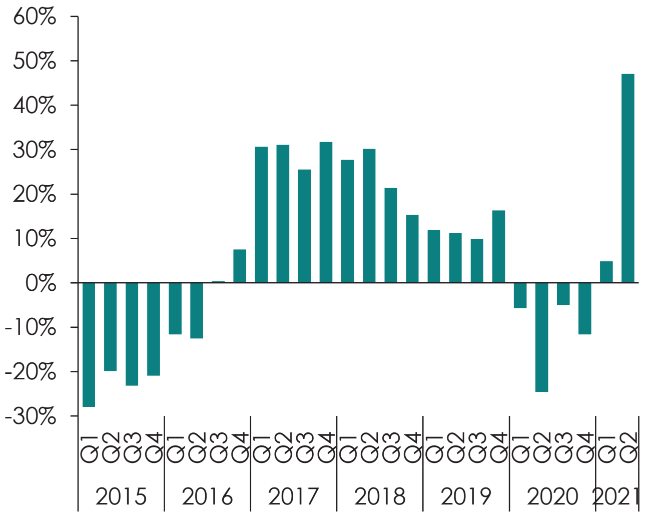


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat (National Statistics Office of Georgia)

The rise in exports of goods mainly stemmed from an increase of external demand on consumer and intermediate goods.

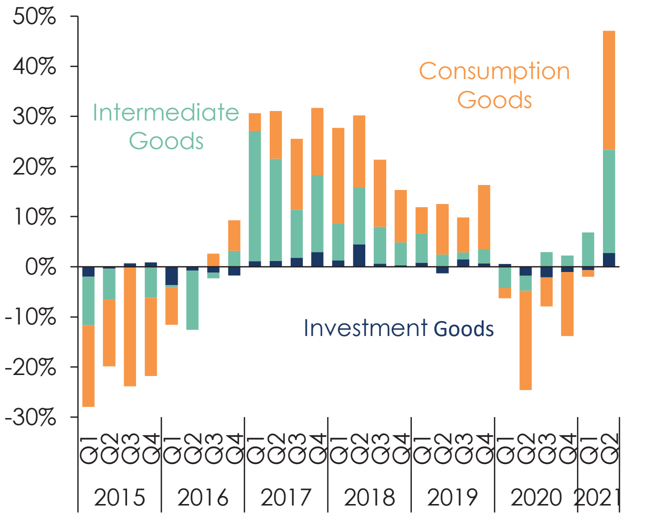


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

Registered exports of goods grew by 47.1% annually in the second quarter of 2021 (see Figure 1.2.1). The volume of exports to Azerbaijan and Russia, as well as to other regional countries increased. In the second quarter, the increase of exports to Azerbaijan made the highest contribution to overall growth (of 8.5 pp annually), which was mainly a consequence of high demand for motor cars and motor vehicles for the transport of goods. Meanwhile, exports to Russia increased mainly in terms of substantially high levels of exports of ferro-alloys, natural grape wines and mineral waters; while exports to Ukraine rose due to increased sales of motor cars, as well as automatic data processing machines and chemical fertilizers. Ferrous waste/scrap and clothes made a high contribution to the growth of exports to Turkey, while alcoholic beverages were the dominant export group to Armenia. In contrast, exports to Uzbekistan fell, mainly due to lower sales of medicaments. For European countries, exports to Bulgaria and Spain decreased in terms of sales of copper ores and concentrates, while exports to Switzerland fell because of low demand for semi-man-

In the second quarter, revenues from international travelers began to rise.

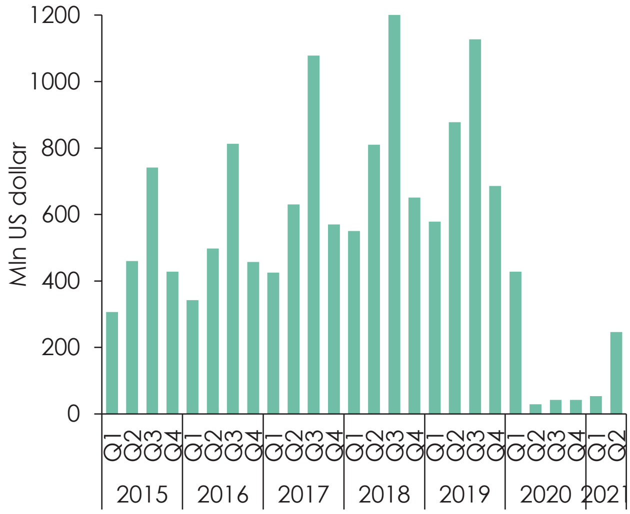


Figure 1.2.3. Annual change in revenues from international travelers

Source: National Bank of Georgia

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

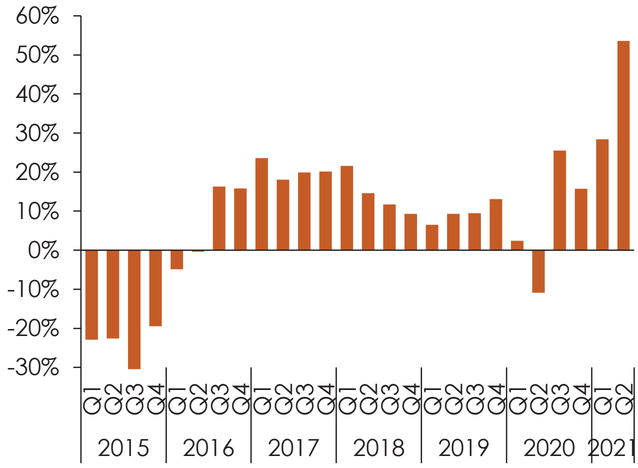


Figure 1.2.4. Annual change in money transfers

Source: National Bank of Georgia

ufactured gold. Demand for ores and concentrates of copper, as well as for unwrought aluminum, was also high from China (making a 9.5 pp contribution to the overall export growth).

Exports of goods mainly increased due to high demand for consumer and intermediate goods, while exports of investment goods made only a moderate contribution to the overall growth of exports (see Figure 1.2.2). The increase in consumer goods mainly stemmed from high exports of motor cars. In terms of the rise in exports of intermediate goods, copper ores and concentrates, as well as ferro-alloys had the biggest contribution; while for exports of investment goods, automatic data processing machines played a leading role in the overall growth.

The gradual lifting of restrictions on international air and land mobility alongside universal vaccination programs positively affected the number of international visitors to Georgia. In the second quarter of 2021, the number of international visitors rose by 207.4% annually; however, the figure was still significantly below the number of visitors in the same period in 2019 (by -82.4%). As would be expected, the rise in the number of visitors induced a rise in revenues from international travelers. In the second quarter, revenues from international travelers increased 8.5 times, but remained 72.0% below the level of revenues received in the same period in 2019 (see Figure 1.2.3).

It is worth noting that international tourism was at a standstill in the second quarter of 2020. As a result, the rise of revenues from international travelers in the second quarter of 2021 is also related to the base effect. Until national borders reopen and international tourism recovers, which will depend on the speed of the vaccination campaign and its effectiveness, it is expected that the number of visitors and the revenues received from international travelers will remain below the record high level of 2019.

In the second quarter of 2021, instant money transfers to Georgia increased by 53.5% annually and amounted 583.7 million USD (see Figure 1.2.4). Once again, transfers from the EU (especially from Italy, Greece and Germany), the USA, Israel and Azerbaijan made the largest contributions to total growth.

Considering increased internal demand, imports of goods rose by 44.8% annually in the second quarter of 2021, and the volume of imports was at almost the same level as in the second quarter of 2019 (see Figure 1.2.5). The rise in imports from regional countries was significant, particularly those from Turkey and Russia, meanwhile imports from other countries, including Romania and China, made the largest contribution to overall growth. In contrast, imports from Peru fell because of lower imports of copper ores and concentrates for subsequent re-export.

In the second quarter of 2021, imports of consum-

In the second quarter, registered imports of goods increased considerably in light of strong domestic demand.

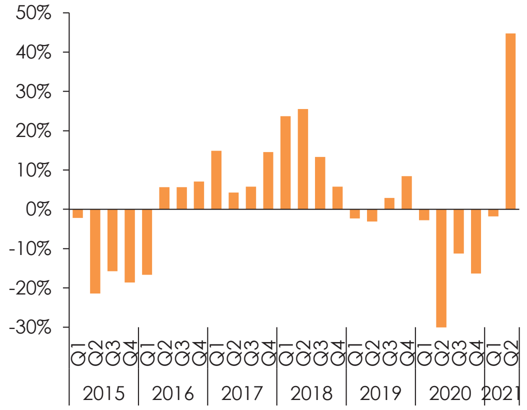


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

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

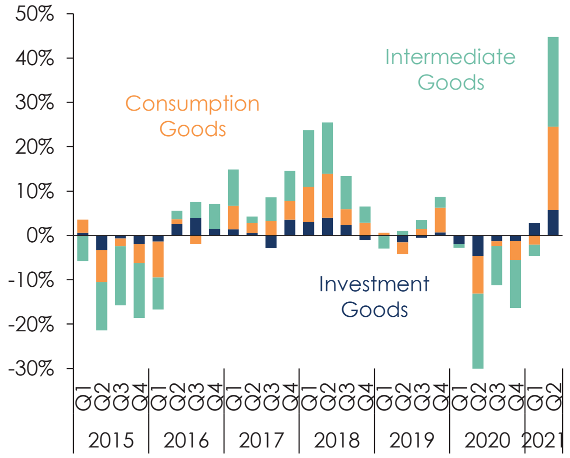
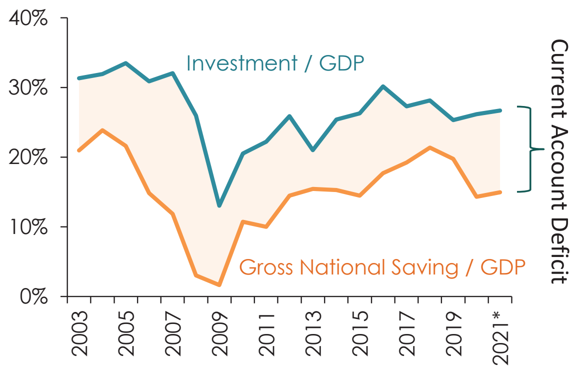


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

From the perspective of savings and investments, the worsening of the current account balance was mainly due to a decline in savings (which is also related to the budget deficit). However, there has been a slight improvement compared to 2020.



* 2021 data contains the joint sum of the last 3 quarters of 2020 and the first quarter of 2021.

Figure 1.2.7. Investments and savings

Source: Calculations of GeoStat and the National Bank of Georgia

er and intermediate goods made largest contributions to the overall growth of imports (see Figure 1.2.6). The increase in imports of consumer goods predominantly stemmed from higher purchases of petroleum products, motor cars and telephones, while the rise of imports of intermediate goods was due to higher imports of immune serum, unglazed tiles and various pipes. The rise in imports of investment goods stemmed from higher purchases of motor vehicles for the transport of ten or more persons and those for the transport of goods.

In light of increased exports of goods and instant money transfers, and despite lower exports of services (especially revenues from tourism), the current account deficit amounted to 364 million USD in the first quarter of 2021, which was 10.7% of quarterly GDP. This represents an improvement of 0.5 pp of GDP (or 60 million USD) compared to the same quarter of 2020. According to preliminary estimates, the current account deficit will stay at a high level in 2021.

The primary source of financing the current account deficit is foreign direct investments, which fell by 23.8% annually and reached 125.4 million USD. The main reasons for the decline of FDI was the transfer of ownership of several companies from non-resident to resident units and the reduction of reinvestments. The majority of FDI went to the finance, energy and manufacturing sectors.

From the perspective of savings and investments, the worsening of the current account balance was mainly due to a decline in savings (which is also related to the budget deficit). However, there has been a slight improvement compared to 2020, which, in light of the modest rise in investments, was mainly due to the rise in savings (see Figure 1.2.7).

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

Consumption still makes a positive contribution to economic growth, while the negative contribution of net exports has diminished as a result of the base effect.

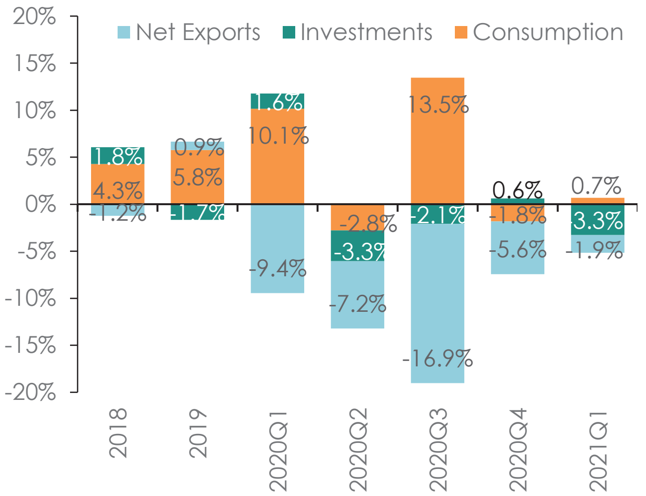


Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat; NBG calculations

In the first quarter of 2021, real GDP fell by 4.5% year on year.

The largest contribution to the economic downturn in 2020 came from net exports, which were down mainly due to the closure of national borders because of the pandemic and the significant obstacles facing the tourism sector. In the first quarter of 2021, Georgia's borders remained closed for foreign tourists, but due to the base effect (as the negative effects of the pandemic began in the first quarter of last year), the annual decline in service exports fell to 50.9%. In addition, exports of goods increased in real terms by 10.8% year on year. Ultimately, in the first quarter of 2021, exports of goods and services fell by 15.0%, while imports of goods and services fell by 8.1%. Net exports contributed -1.9 pp to the decline of the economy.

The volume of investments decreased by 12.3% in real terms compared to last year, making a 3.3 pp negative contribution to economic growth. Consumption increased by 0.8%, making a positive contribution of 0.7 pp (see Figure 1.3.1).

1.3.2 OUTPUT

The pandemic primarily affected tourism, which covers a large part of services and was the main driver of economic growth before the pandemic.

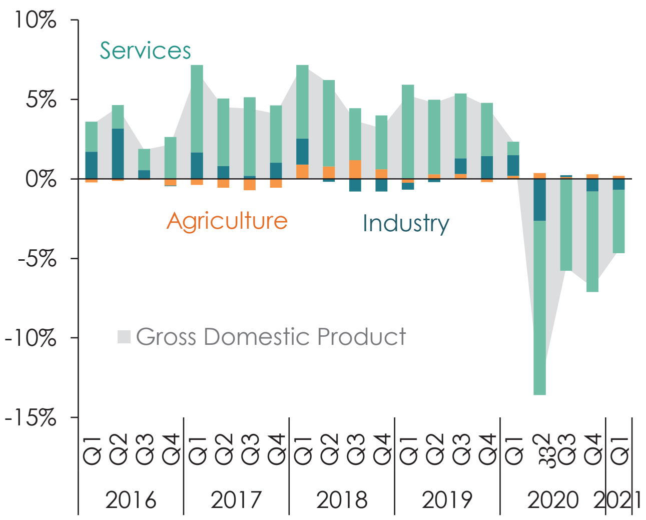


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

As mentioned above, in the first quarter of 2021, the real gross domestic product decreased by 4.5% year on year (see Figure 1.3.2). This decline was largely due to a decrease in services (by -4.0 pp), as had been the case in the previous year. The contribution of industrial sectors (-0.8 pp) to the decline was relatively small, while the contribution of agriculture was positive and amounted to 0.2 pp.

In the first quarter of 2021, due to the pandemic, Georgia remained closed for foreign visitors and thus experienced a significant reduction in foreign revenues. Like last year, the most difficult situation was observed in activities related to providing accommodation and catering, where the biggest contribution comes from hotels and restaurants. The output of this sector decreased by 54.0% year on year, making the largest (-2.1 pp) contribution to the economic decline. The reduction in output in sectors closely related to tourism – specifically transport, where the weight of travel agencies is high, real estate activities, and arts, entertainment and recreation – contributed a total -2.1 pp to the overall reduction of the economy. In the services sector, the growth of financial and insurance activities and the trade sector was notable, making positive contributions of 1.1 pp and 0.5 pp respectively.

In the industrial sector, construction fell by a notable 19.4% (making a -1.1 pp contribution to economic growth) and the mining industry grew by 50.3% (a contribution of 0.7 pp).

During the same period, agriculture grew by 3.4%, contributing 0.2 pp to economic growth (see Figure 1.3.2).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In June, the growth of the annual loan portfolio increased and stood at 12.6%, excluding the effect of exchange rate fluctuations.

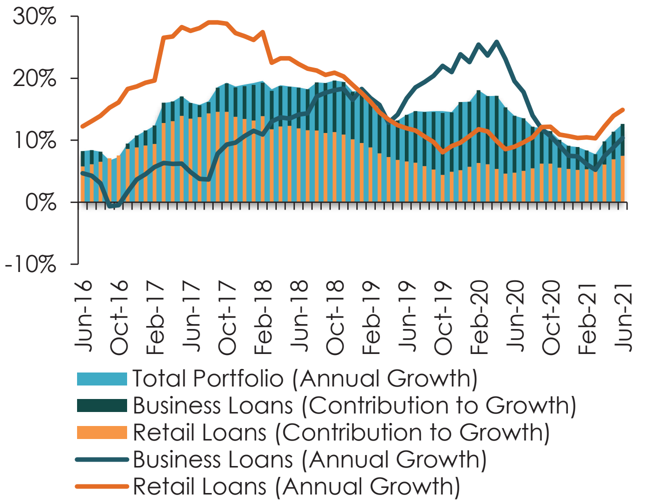


Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: National Bank of Georgia

In June, relative to March, the growth of the loan portfolio increased and stood at 12.6% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 4.6 pp to stand at 14.9%, while the growth of loans to legal entities increased by 5.1 pp and equaled 10.3% (see Figure 1.4.1). 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 an increase in demand for retail and business loans.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the second quarter of 2021 was driven by domestic currency loans (see Figure 1.4.2). In June, the annual growth rate of foreign currency-denominated loans increased and stood at 1.3%, while the growth rate of loans in the domestic currency increased by 7.2 pp and equaled 27.6%. In the second quarter, the loan larization ratio did not change significantly and stood at 47.2%. 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.

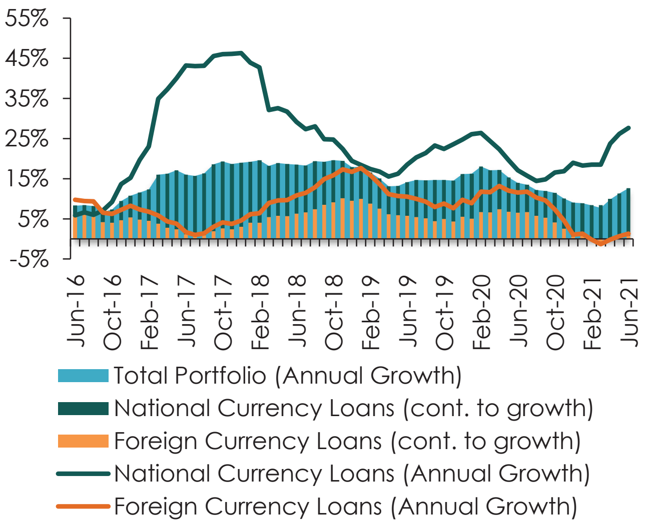


Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: National Bank of Georgia

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In June, the monetary policy rate was 9.5%. In the second quarter of 2021, interest rates on government securities increased due to the increase in the monetary policy rate (see Figure 1.4.3).

Compared to the previous quarter, the spread between long- and short-term interest rates increased 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 June, relative to March, interest rates on domestic currency deposits increased slightly and equaled 9.6%. Meanwhile, interest rates on foreign currency deposits decreased and equaled 2.1%. 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 tightened slightly. Representatives of the banking sector

As the monetary policy rate increased, interest rates on government securities increased in the second quarter of 2021.

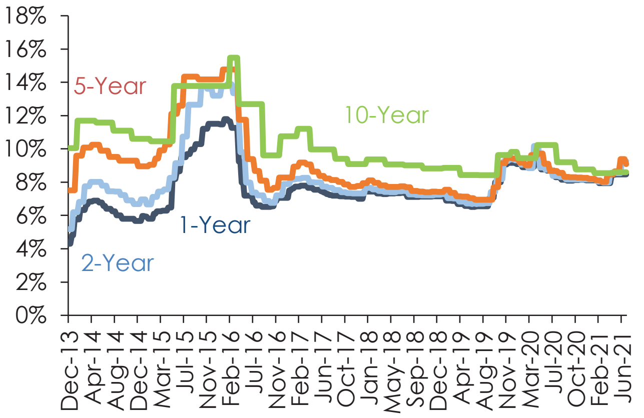


Figure 1.4.3. Interest rates on government securities

Source: National Bank of Georgia

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

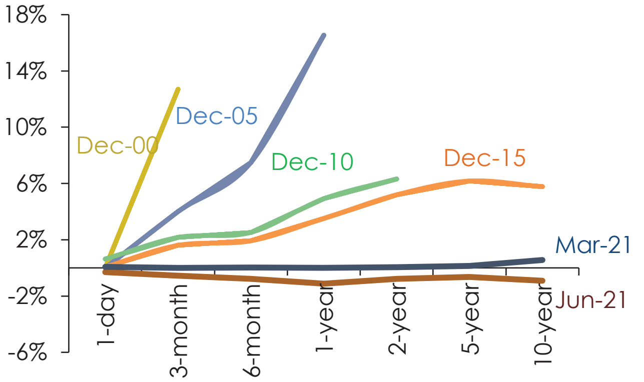


Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: National Bank of Georgia

As of June, average interest rates on the stock of legal entities for domestic currency loans increased slightly, while interest rates for foreign currency loans did not change significantly.

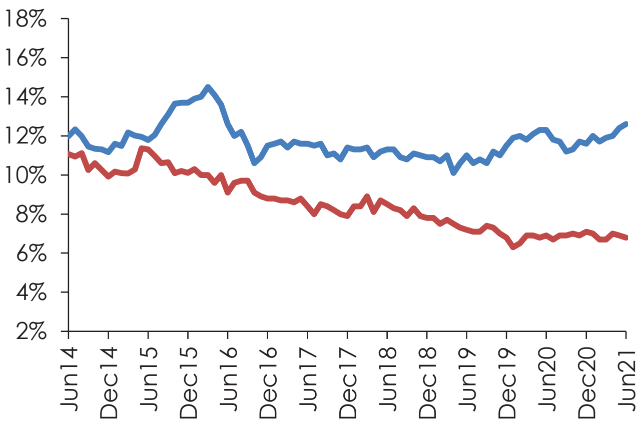


Figure 1.4.5. Average interest rates on business loans

Source: National Bank of Georgia

expect a slight tightening of credit conditions for retail loans, but do not expect significant changes to credit conditions for business loans; however, it is important to note that it is difficult to form expectations due to the ongoing uncertainty caused by the COVID-19 pandemic. In June, relative to March, interest rates on loans for small and medium enterprises (SMEs) did not change significantly, while interest rates on retail loans decreased slightly. Interest rates on corporate loans increased by 0.7 pp and equaled 9.5%, while interest rates on retail loans decreased by 0.5 pp and stood at 15.1%. Meanwhile, interest rates for SMEs loans did not change significantly and equaled 10.0%.

As of June average interest rates for domestic currency loans on the stock of legal entities increased slightly and stood at 11.9%, while interest rates for foreign currency loans declined slightly and equaled 6.7% (see Figure 1.4.5). Representatives of the banking sector expect a slight increase in interest rates for loans in foreign currency.

1.4.3 EXCHANGE RATE

In the second quarter of 2021, the GEL nominal exchange rate depreciated by 0.4% against the US dollar and by 0.2% against the euro, compared to the previous quarter. According to average quarterly data, the GEL depreciated against the Russian ruble by 3.5%, but appreciated against the Turkish lira by 11.6%. In the same period, the nominal effective exchange rate appreciated by 1.8% on a quarterly basis and depreciated by 4.3% on an annual basis. As for the price-adjusted exchange rate, in the second quarter of 2021, the real effective exchange rate appreciated by 4.8% on a quarterly basis and depreciated by 2.6% on a year-on-year basis (see Figure 1.4.6).

It should be noted that the real exchange rate depreciated against almost all trading partner countries, although it appreciated against the currencies of Turkey and Armenia (see Table 1.4.1).

Despite the recent period of appreciation, the real effective exchange rate remains undervalued (annual depreciation of 2.6%).

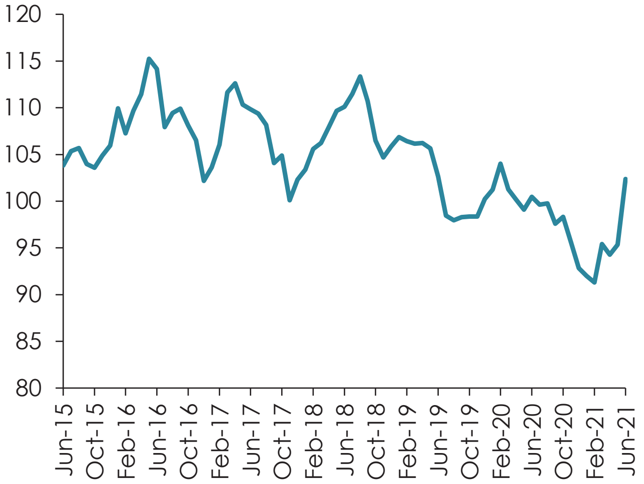


Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: National Bank of Georgia

The depreciation of the real effective exchange rate is caused by real depreciation against the currencies of all major trading partners.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	**-4.3**	**-2.6**	**-2.6**
Eurozone	-13.7	-8.3	-1.5
Turkey	15.2	6.5	1.1
Ukraine	-3.3	-4.0	-0.3
Armenia	1.4	3.3	0.2
US	-5.6	-2.5	-0.2
Russia	-3.4	-1.4	-0.2
Azerbaijan	-5.6	-2.3	-0.2
China	-14.0	-7.9	-1.0
Other	-13.6	-9.1	-0.6

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

Source: National Bank of Georgia

* Growth implies appreciation of the lari.

The annual growth rate of unit labor cost has fallen to 2.3%, which reduces inflationary pressure.

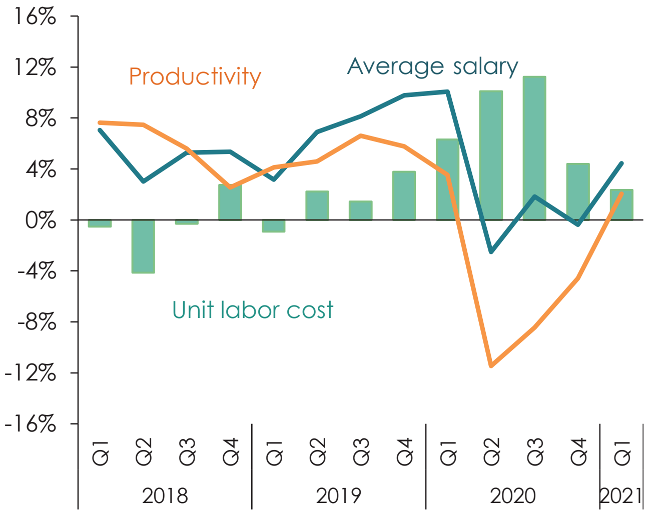


Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

Inflation reached 11.9% in July, with temporary supply-side factors making a significant contribution, including the sharp rise in prices of oil and consumer goods on world markets.

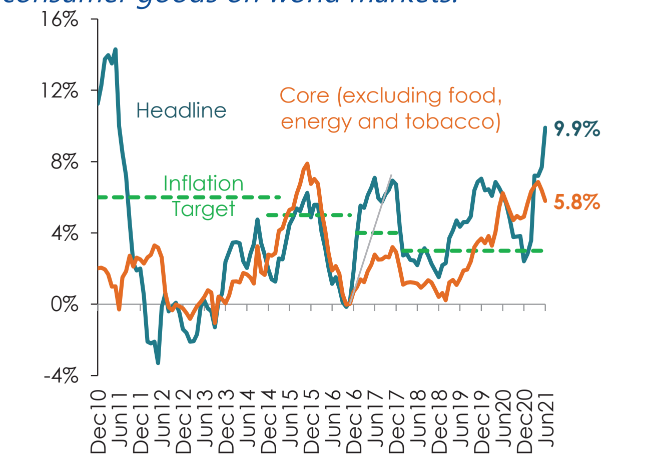


Figure 1.6.1. Headline and core inflation

Source: GeoStat

Food, fuel and utility fees were the main drivers of inflation in July.

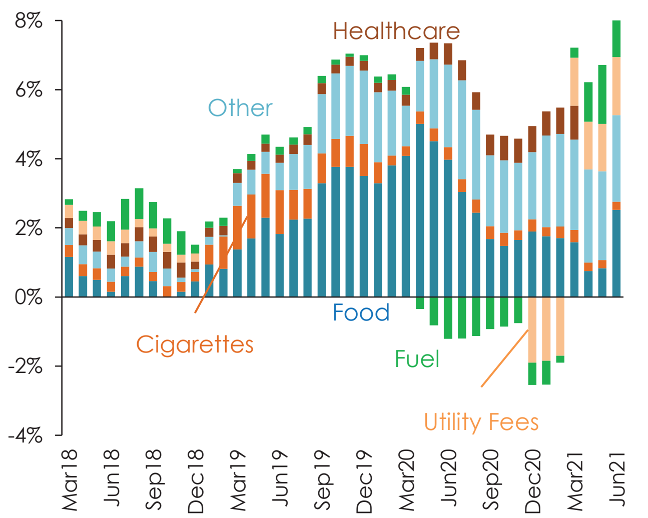


Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

1.5 LABOR MARKET

In the first quarter of 2021, the real value added produced per employee (labor productivity/productivity) in the country's economy increased by 2.1% annually (see Figure 1.6.1). At the same time, the gross salaries of employees averaged 1,256 GEL, which reflects nominal annual growth of 4.4%. Last year, the unit labor cost increased due to a smaller reduction in wages compared to the decrease in output. Against the background of the pandemic, and given supply constraints and declining output, this acceleration had been expected as a factor contributing to inflation. Alongside the recovery of the economy, this rate began to gradually decline from the end of last year. In the first quarter of 2021, the growth rate slowed to 2.3%, which reduced the inflationary pressure on prices (see Figure 1.5.1).

1.6 CONSUMER PRICES

Annual inflation rose to 11.9% in July (see Figure 1.4.1). An important reason for this growth was the extraordinary situation caused by the pandemic, which led to several supply-side factors simultaneously affecting inflation in the direction of growth.

Rising inflation in Georgia is closely linked to rising prices for consumer goods around the world. Indeed, global inflation has been one of the main topics featured in the periodicals of the International Monetary Fund, the World Bank and other international organizations. Rising food prices are one of the most noteworthy developments. Due to various pandemic-related delays, poor harvests and increased transportation costs, world food prices have been at a record high for the last ten years.

Rising food prices have particularly affected developing countries, where the weight of food in the consumer basket tends to be high compared to developed countries. The weight of food in the consumer basket of Georgia is also high, comprising 28.9%. As a consequence, changes in food prices have a significant impact on inflation.

Among imported foods, some of the most notable developments concern the nearly doubled price of sunflower oil (making a 0.7 pp contribution to headline inflation) and the 35.5% increase in the price of sugar (a 0.2 pp contribution). Due to government subsidies, for much of the year, the significant increase observed in global wheat prices was not fully reflected on the price of bread in Georgia, and its impact on overall inflation was only 0.1 pp. However, after the removal of these subsidies in July, bread prices rose and the contribution of this product to total inflation increased to 0.5 pp.

With the restoration of mobility, demand for oil and its price on international markets have increased.

The increase in inflation on imported products is mainly due to a sharp rise in prices for certain goods on the world market (fuel, sunflower oil, etc.).

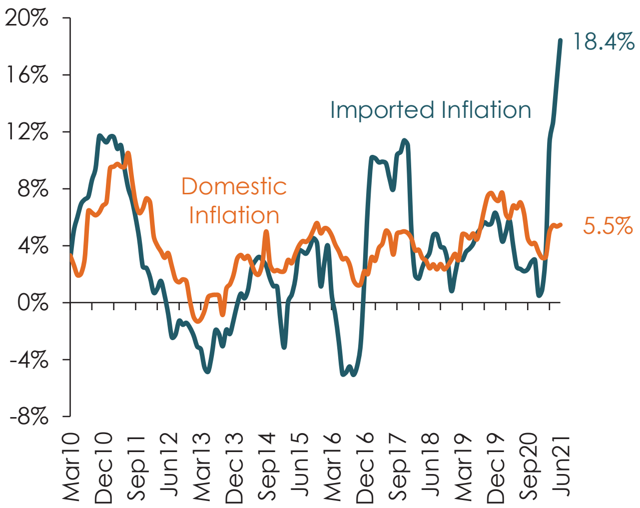


Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

World oil prices are at a three-year high, which has meant that fuel prices have been rising steadily since the beginning of the year, making a 2.1 pp contribution to inflation in July.

Amid restrictions aimed at countering the spread of COVID-19, companies' international transport and other operating costs remain high, which are reflected in the final prices of their goods and services.

It should also be noted that the increase in natural gas tariffs in Tbilisi since June has increased the contribution of utility bills to annual inflation by an additional 0.3 pp to 1.7 pp.

The 11.4% increase in prices in the healthcare group (making a 0.9 pp contribution to inflation) is also significant, where the prices of medicines and doctor services have risen (see Figure 1.4.2).

In July, inflation for imported, domestically produced and mixed goods was 18.4%, 15.4%, and 7.2% respectively. Rising inflation on imported products is caused by rising prices for various goods on the world market (see Figure 1.4.3).

Meanwhile, core inflation, which excludes volatile food, energy, and cigarette prices, amounted to 6.3% in July (see Figure 1.4.1). It is worth noting that service inflation was relatively low and stood at 4.2%. The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation signals a reduction of headline inflation in the future.

BOX 1. THE CORRELATION BETWEEN GROWTH OF THE MONEY SUPPLY AND INFLATION

Fluctuations in the inflation rate are regularly followed by intense discussions within economic circles. In these discussions, changes in the money supply are often suggested as being an underlying cause of such fluctuations. In particular, there is the opinion that an increase in the money supply has an unequivocal effect on inflation: a claim that is often corroborated by evidence of a seemingly positive correlation found in the data at certain periods. However, even without considering the fact that such a relationship cannot have a theoretical basis under the monetary framework of the National Bank of Georgia, the quantitative evidence and the dynamics of the variables (presented below) show that these assumptions lack any empirical basis (see Figure 1.6.4 and Table 1.6.1).

These figures show a few simple findings: (1) The change in money supply is almost always higher than inflation, reflecting the strengthening of money as a means of saving. This was especially evident in 2004-2008, when the money supply was growing rapidly at a time when inflation was not really that high (moreover, the exchange rate was strengthening during this period); (2) Since 2010, the correlation between money supply changes and inflation has virtually disappeared. Thus, using the money supply to explain inflation, under the current regime, is incorrect; (3) We can see periods when the money supply decreased but inflation increased (and the exchange rate also depreciated). For example, in 2015, under conditions of severe external shock and other factors, the demand for GEL decreased. This reduced GEL deposits and, as a result, the GEL money stock (M2). Reducing demand for the lari, in turn, further depreciated the exchange rate and boosted inflation. This example once again underscores that a change in the money supply alone offers insufficient information unless we know what factors lie behind the change – is it a reflection of a change in demand or a reflection of a change in supply? That is why we need to consider the price of money – the interest rate. Thus, if the money supply increases but the price of money (the interest rate) does not decrease, then the demand for money increases, which cannot be the cause of inflation. This is especially true after 2016, when the process of larization was intensified.

As the data show, changes in the money supply and inflation have regularly been misaligned with each other since 2010 – the point at which the National Bank switched to the inflation targeting regime. This serves to underscore the fact that claims about a link between money supply changes and inflation would lead to erroneous conclusions in such circumstances where the central bank uses the interest rate as its operating target (as is the case with the inflation targeting approach).

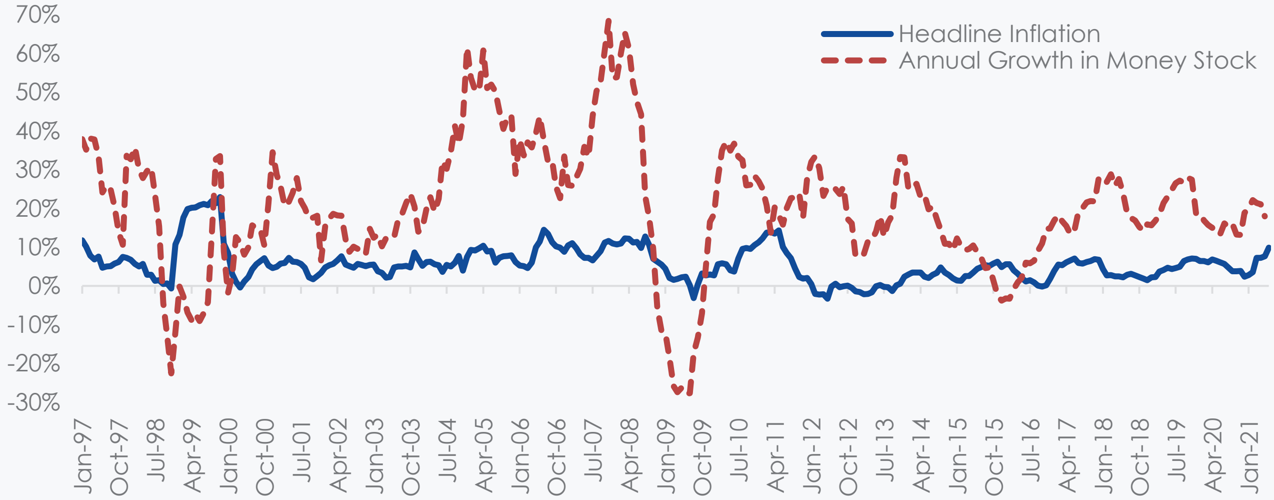


Figure 1.6.4 Annual change in M2 money stock and headline inflation

Source: GeoStat; National Bank of Georgia

There is a perception that any reflection of money supply change on inflation takes time, thereby concealing the correlation between the two variables. However, no correlation is seen in this regard. According to the data, an increase in the money supply after 6-12 months is associated not with an increase in inflation but with a slight decrease (i.e., a slightly negative correlation, not a positive one). This is especially true after 2016, when the process of larization was intensified.

1997-2021	2000-2010	2011-2021	2011-2016	2017-2021	2017-2021 (1-month lag)	2017-2021 (2-month lag)	2017-2021 (3-month lag)	2017-2021 (6-month lag)	2017-2021 (9-month lag)	2017-2021 (12-month lag)
22.4%	67.1%	-1.5%	-12.2%	0.9%	4.7%	5.9%	4.8%	-21.1%	-30.1%	-38.3%

Table 1.6.1 Correlation between annual change in M2 money supply and headline inflation

Source: GeoStat; National Bank of Georgia

Finally, we can also look at whether the link between money supply change and inflation is hidden in the shift of time periods. For example, it might be postulated that an increase in the money supply in the current period may not cause inflation in the same period, but may do so after a delay (a so-called lag) in subsequent periods. However, the data do not show any such delay (see Table 1.6.1). Moreover, according to the data, an increase in the money supply after 6-12 months is actually associated with a slight decrease in inflation. However, the latter in itself does not imply a cause-and-effect relationship; it instead underscores the same argument we make above: if an increase in the money supply is a reflection of an increase in demand, it cannot be the cause of an increase in inflation. Therefore, basing an analysis on such blank correlation will most likely prove to be misleading.

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, economic activity will recover in 2021, with real GDP growing by 8.5%. Domestic demand will be a major contributor to this recovery. Strong private consumption has closed the output gap and domestic demand is not disinflationary. Meanwhile, increased oil and commodity prices on international markets have been transmitted to the local market and have pushed inflation up. Given these factors, in the short term, inflation will be above the target. As a response, a tight monetary policy stance will be maintained throughout the current year. In the medium term, this tight monetary policy will help lower inflation back to the target. The alternative forecast scenario envisages higher domestic demand compared to the baseline scenario. In particular, if relatively strong fiscal stimulus is maintained for a long time, consumers will display a greater propensity to spend. Besides, consumer and business sentiment will improve owing to a reduction of uncertainties about the vaccination program, which will be positively reflected on credit activity. As a result, inflationary pressures stemming from domestic demand will increase significantly, leading to a sharp tightening of monetary policy and, subsequently, to the relatively long-term maintenance of such a stance. As a result of this tightening, and despite increased pressures, inflation will still return to its 3% target, albeit slightly later than in the baseline scenario.

2.1 BASELINE MACROECONOMIC FORECAST

In the short term, inflation will remain above the target. From 2022, a tightened monetary policy will help reduce inflation back to the target level.

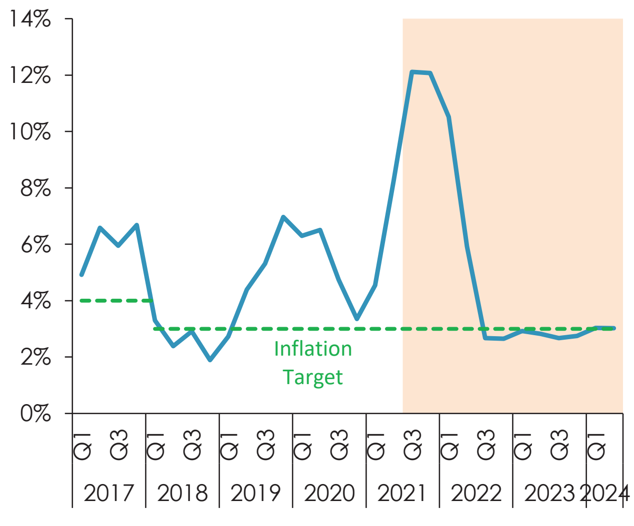


Figure 2.1.1. Headline inflation

Source: National Bank of Georgia

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 on the international market. It is expected that prices for oil, sugar, and cereal will remain at a high level throughout this year. High commodity prices push up the short-term inflation outlook. It is noteworthy that the government subsidy of wheat flour had been neutralizing higher wheat prices on the local market, but the end of that subsidy program places additional pressure on consumer prices. Meanwhile, an increase in natural gas bills creates additional inflation pressures. These factors will have a temporary impact on consumer prices, similar to the base effect of the government subsidies on utilities.[12] In addition, inflation remaining over the target for a prolonged period has increased short-term inflation expectations and poses the risk of second-round effects. From the start of 2022, upon the exhaustion of these factors, and in tandem with the tightened monetary policy stance, inflation will start to decline and then approach the target in the medium term.

The rise of oil and commodity prices on international markets and increased inflationary expectations will lead to inflation hovering above the target (see Fig-

12 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 increased short-term inflation expectations.

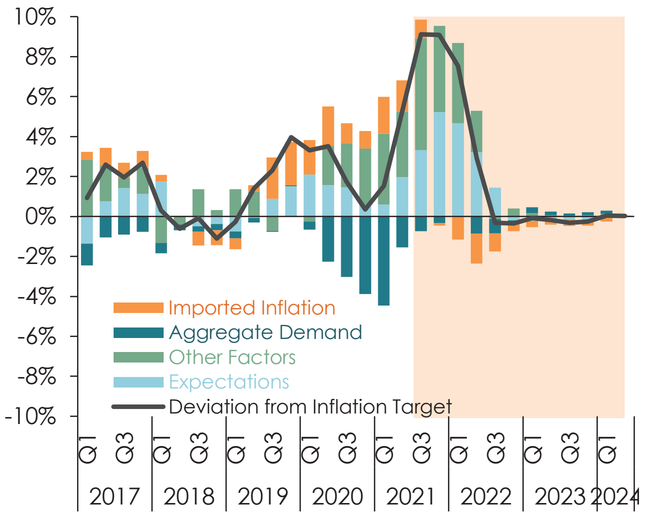


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: National Bank of Georgia

In 2021, the economy will gradually recover. Real GDP will grow by 8.5% on behalf of domestic demand driven by fiscal stimulus and credit activities.

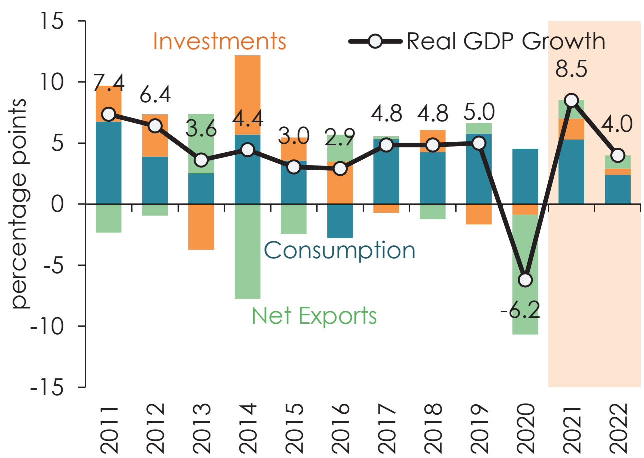


Figure 2.1.3. Real GDP growth decomposition

Source: National Bank of Georgia

ure 2.1.2). The above-target inflation for a prolonged period has elevated short-term inflation expectations. Higher-than-expected domestic demand has almost closed the output gap and demand cannot neutralize inflationary pressures. Meanwhile, the recent appreciation of the exchange rate will help push inflation down through the direct import and input costs channels.

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

Georgia's economy is projected to grow by 8.5% in 2021 (see Figure 2.1.3). Private consumption will continue to be the major driver of that economic growth, which, in turn, will be further encouraged by fiscal stimulus and credit activities during the year. Amid fiscal stimulus and a moderate growth of the credit portfolio, investments will positively contribute to the economic recovery. The slow recovery of the tourism sector will also have a positive impact on economic activities. Mobility between countries 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 the gradual economic recovery of trading partner countries. Meanwhile, increased prices of imported goods reduce real imports of goods and thus net exports will make a positive contribution to real GDP growth.

Macroeconomic forecasts risks are mostly inflationary. Monetary policy will thus be hawkish in order to maintain price stability.

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

Table 2.1.1 Baseline Macroeconomic Forecast Risks.

BASELINE FORECAST SCENARIO RISKS

Macroeconomic forecasts are characterized by a high degree of uncertainty. It has been over a year since COVID-19 was declared a pandemic and the spread of the virus remains a challenge. Several vaccines have already been made available, and immunization is an ongoing process worldwide. However, increasing the availability and dissemination of vaccines will take some time and a slower-than-anticipated vaccine rollout would potentially allow the virus to mutate further. In the event of a slower immunization process, 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 as tourism is a major component of the current account balance. The slower-than-expected recovery of the tourism sector will cause the current account balance to deteriorate, which will create depreciation pressures. Eventually, this will intensify inflationary pressures through the channels of direct imported inflation and increased input costs.

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

The immunization process contains some risks at the local level as well. A slower-than-expected vaccination process in Georgia will hinder economic recovery. In such an event, weak demand will create disinflationary effects. However, a long delay of local economic activity would reduce the overall potential of the economy, thereby leading to weak demand being less disinflationary.

The trend of rising commodity prices on international markets poses risks to the macroeconomic forecast. Increased international prices have already been transmitted to the local market, but if this tendency persists, inflationary risks will be further amplified.

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 relaxation of regulations, the recovery of tourism, and improvements to the current account balance. In such a case, *The inflation forecast has been revised upward. An upsurge of commodity prices on international markets has driven the increased inflation outlook.*

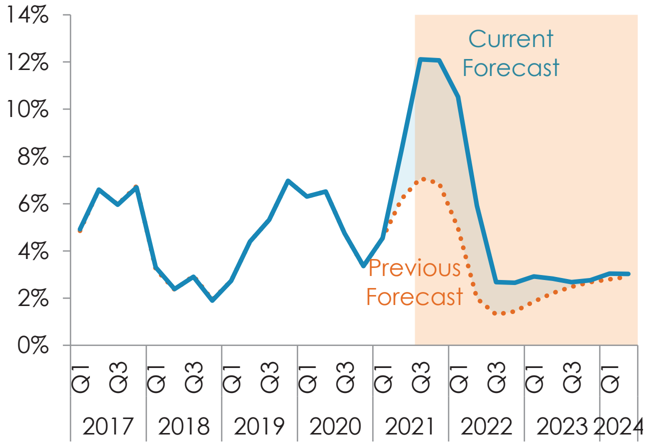


Figure 2.2.1. Changes in the forecast of headline inflation

Source: National Bank of Georgia

The real GDP growth forecast has been revised upward to 8.5%.

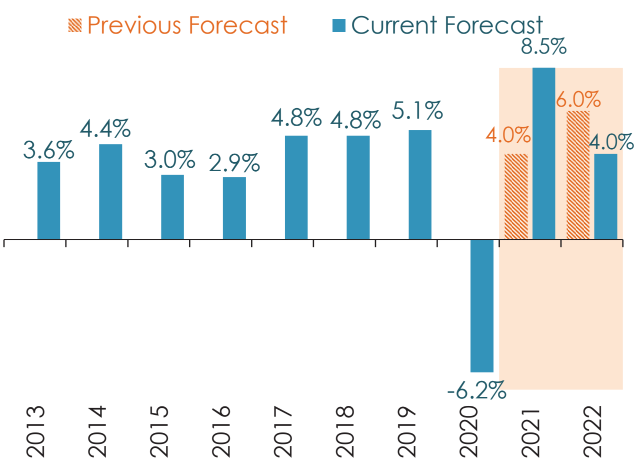


Figure 2.2.2. Changes in the forecast of real GDP

Source: National Bank of Georgia

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

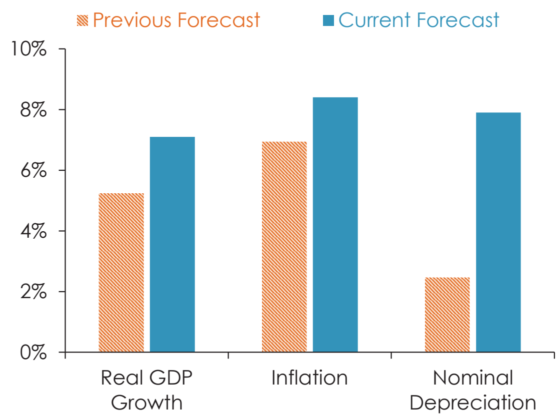


Figure 2.2.3. Changes in the forecast of external assumptions for 2021

Source: Bloomberg

the 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 likely given the current perspective and the assessments of reputable international institutions.

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). The upsurge of commodity prices on international markets has led to an increased inflation outlook. Meanwhile, the increase of natural gas prices has pushed inflation up. It is also noteworthy that the government subsidy of wheat flour had been neutralizing the effect of higher wheat prices, but the end of that program puts additional pressures on consumer prices. Higher-than-expected aggregate demand has also led to upward revision of the inflation outlook. The output gap is almost closed and cannot neutralize inflationary pressures.

The real GDP growth forecast has been revised upward to 8.5% (see Figure 2.2.2). A higher-than-expected upsurge in domestic economic activities has led to an upward revision of the economic outlook. The recent upsurge of domestic demand is partially a reflection of pent-up demand. Meanwhile, based on the updated assumptions, strong fiscal stimulus and credit activities will push domestic demand. According to the updated forecasts, domestic consumption will be a major contributor to economic growth.

Georgia is a small open economy and the economic stances of its trading partners thus have a significant impact. Macroeconomic forecasts thereby strongly depend on assumptions regarding the economic growth, inflation and exchange rates of Georgia's trading partners. Changes in these assumptions will affect the baseline forecast as well as associated risks (see Figure 2.2.3).[13]

According to the updated projections for 2021, the pace of the economic recovery of Georgia's main trading partners has been improved. An upward revision of the expected depreciation of trading partners' currencies is also notable. Lower expectations about trading partners' currencies, together with relatively improved demand, will eventually put upward pressure on inflation expectations. Meanwhile, the increase of short-term inflation expectations compared to the previous projection can be considered a reflection of the upsurge in international commodity prices.

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

2.3 ALTERNATIVE FORECAST SCENARIO

According to the alternative scenario, domestic demand will significantly increase, resulting in an economic growth rate 2-2 pp higher than the baseline scenario for 2021-2022.

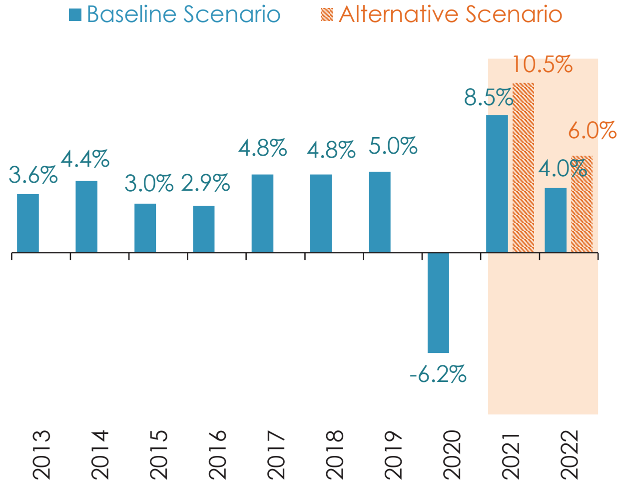


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

Amid higher-than-potential domestic demand and a depreciated exchange rate driven by strong imports, inflation will be 1.1 pp higher than in the baseline scenario over 2021-2022. However, in light of the monetary policy reaction, inflation will converge with the target, albeit slightly later than in the baseline scenario.

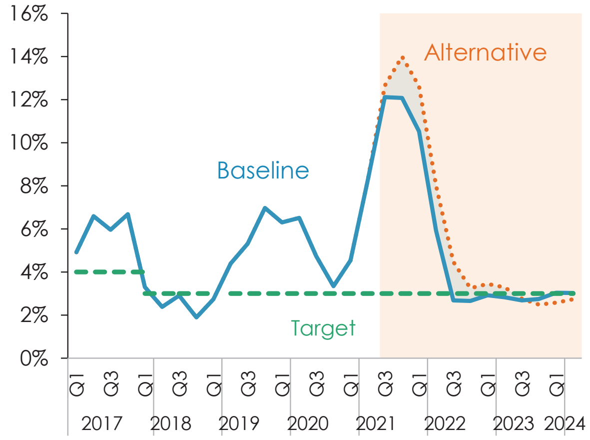


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: GeoStat; National Bank of Georgia

The alternative forecast scenario considers higher domestic demand compared to the baseline. The latter could stem from prolonged strong fiscal stimulus, resulting in an increasing propensity to consume. Furthermore, business confidence and the investment environment will improve amid a reduction of uncertainties about immunization. This, in turn, will be positively reflected on credit activity. As a consequence, the alternative scenario considers higher-than-expected credit growth.

Greater credit activity and relatively strong and prolonged fiscal stimulus will be positively reflected on the economic growth rate. Against this backdrop, under the alternative scenario, real GDP will grow by around 10.5% in 2021 and by 6% in 2022 (see Figure 2.3.1).

According to this scenario, growing domestic demand will boost imports of goods. Concurrently, with the same expectations about the tourism perspectives, net external demand will remain at the same level as in the baseline scenario. Consequently, an increase in domestic demand will worsen the current account balance, putting additional pressure on the country's risk premium and exchange rate. This will eventually aggravate inflationary pressures. Hence, higher-than-expected growth in domestic demand pushes inflation upward through both higher-than-potential domestic demand and a higher-than-expected depreciation of the exchange rate. In particular, according to the alternative scenario, in 2021-2022 inflation will be 1.1 pp higher than in the baseline scenario (see Figure 2.3.2).

Monetary policy will be significantly tightened in response to intensified inflationary pressures and such a stance will be maintained for a relatively long period. Under the alternative forecast scenario, the monetary policy rate trajectory, on average, will see a hike of 2 pp in 2021-2022 compared to the baseline scenario (see Figure 2.3.3). In this scenario, the sharp response of monetary policy reflects inflation stemming from domestic demand. However, alongside a neutralization of domestic demand-side pressure on inflation, the policy rate will start to decline in the medium term. The appropriate monetary policy response will eventually drive inflation towards the target level of 3%, albeit with a moderate time lag compared to the baseline scenario.

In the alternative scenario, monetary policy will be significantly tightened, and this stance will be maintained for a longer time in response to intensified inflationary pressures. The policy rate trajectory of 2021-2022 is on average 2 pp higher than in the baseline scenario. In the alternative scenario, a sharp policy response reflects inflation stemming from domestic demand.

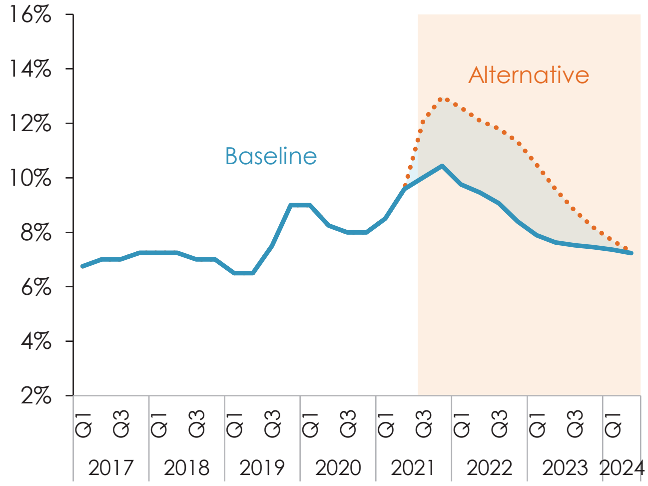


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: National Bank of Georgia

3 MONETARY POLICY

Georgia's annual inflation was unexpectedly high at 11.9% in July. The predominant driving forces behind this high level of inflation are one-off factors that are independent from monetary policy – specifically the sharply increased prices of food and oil on international markets. International shipping costs have also increased significantly, affecting prices of imported goods. Moreover, it is noteworthy that domestic demand has been more active than expected. Against the background of a high level of fiscal stimulus, the current lending rate is higher than desired, which puts additional pressure on inflation. According to the updated forecast, other things being equal, average inflation in 2021 will be above 9%. Taking these factors into account, on 4 August the Monetary Policy Committee (MPC) tightened monetary policy and increased the refinancing rate by 0.5 pp to 10%. The long-term maintenance of tight monetary policy alongside the expected fade-out of the one-off exogenous factors will ensure that inflation will gradually approach the target from the second quarter of 2022.

On 4 August 2021 the refinancing rate was increased by 0.5 pp to 10%. The aim of this move was to prevent the current high inflation caused by one-off factors from turning into long-term inflation expectations.

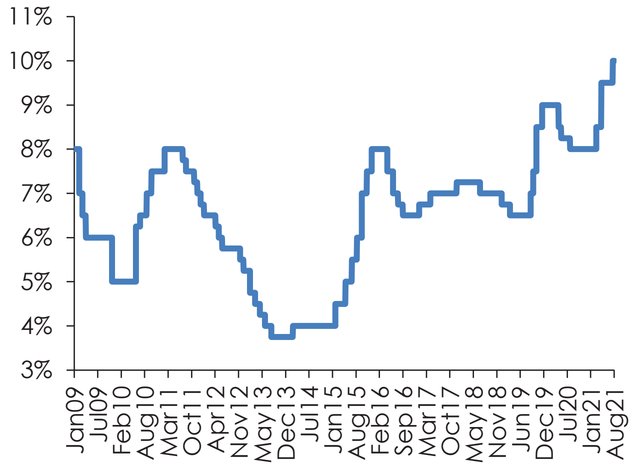


Figure 3.1. Monetary policy rate

Source: National Bank of Georgia

The year 2021 started with inflation below the target, which was related to the temporary subsidization of utility bills from the government. The end of this subsidy program in March 2021 was reflected in an upward shift of inflation. At the same time, since the beginning of the year, the dynamics of price growth in commodity markets has accelerated and made a significant contribution to the growth of inflation as well as its forecast. In particular, this was reflected in increased prices for oil products and selected food items. From April, aggregate demand started to activate more than had been expected. Against the background of these factors, in order to curb inflation expectations, the MPC increased the refinancing rate by 1.5 pp to 9.5% in the March and April sessions, leaving this unchanged at the June session.

Georgia's annual inflation came out unexpectedly high at 11.9% in July. High inflation has been a global challenge and the price growth in July exceeded the forecasts of many countries. The driving forces of the high rate of inflation are predominately one-off and independent from monetary policy – specifically the sharply increased prices of food and oil on international markets. In addition, international shipping costs have increased significantly, affecting prices of imported goods. Prices of imported products increased by 18.4% in July, which was significantly higher than the 7.2% increase in prices of domestic products. However, it should be noted that there has recently been some reduction in the prices of a number of food products on international markets, and, if this trend persists, it should positively affect local markets after some time. In terms of local one-off factors, the rise in utility bills is notable, contributing 1.7 pp to annual inflation.

In addition to the temporary factors mentioned

The sharp increase in inflation in 2021 is due to temporary shocks, the most acute of which are increased prices on international markets. Excluding these shocks, inflation is close to the target.

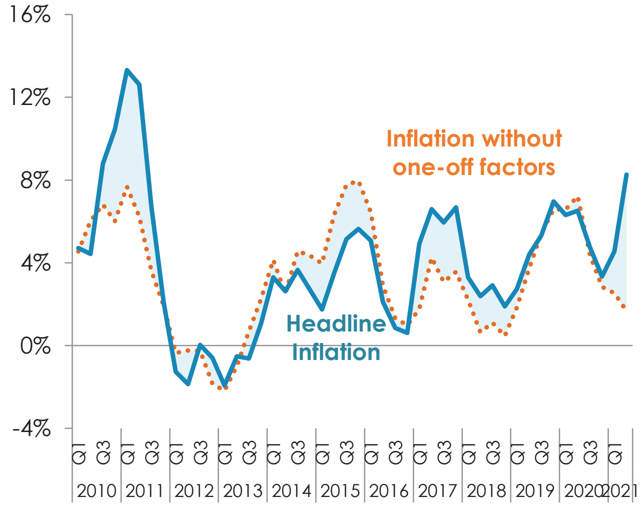


Figure 3.2. Inflation without one-off factors and headline inflation

Source: Calculations of the National Bank of Georgia

above, domestic demand has significantly increased, with economic growth in the first half of the year standing at 12.7%. At the same time, while strong fiscal stimulus is maintained, the current level of lending growth is higher than desired. Based on the updated data, the short-term inflation forecast has increased considerably compared to the previous forecast. Other things being equal, it is expected that average inflation in 2021 will be higher than 9%.

The risks to inflation forecasting should also be considered. Inflation forecast risks include further price increases in commodity markets, foreign exchange market volatility, a greater-than-expected activation of domestic demand (fiscal stimulus, lending), rising interest rates in developed countries, a slow rate of vaccination, and rising production costs as a result of restrictions imposed to control the spread of the virus.

Taking into account the abovementioned factors, at its August 2021 meeting, the MPC decided to increase the refinancing rate by 0.5 pp to 10%. In order to ensure that recent price increases – even if driven by temporary factors – do not result in high inflation expectations becoming entrenched, the NBG will maintain a contractionary policy for a protracted period of time and, if necessary, may tighten it further. With such a policy in place and with the expected fade-out of one-off exogenous factors, inflation is projected to decline in 2022 to gradually approach its medium-term target.

As for the recent dynamics of the external sector, external demand continues to grow. However, on aggregate – taking into account the situation with the tourism sector – it remains below pre-pandemic levels. According to preliminary data, exports of goods increased by 30% year on year in June and were 13% higher compared to June 2019. Revenues from international travelers increased 11 times year on year in June; however, this was still reflective of a decline of 64% compared to the same period in 2019. As for imports of goods, annual growth of 37% was recorded in June, which reflected growth of 13% compared to June 2019.

High dollarization remains a challenge for the country and, in addition to limiting the effectiveness of monetary policy, it also carries risks to financial stability. Its gradual reduction thus remains a long-term priority for the NBG. In order to encourage de-dollarization of liabilities, in April, minimum reserve requirements for foreign currency funds were determined individually for each commercial bank according to their deposit dollarization. This reduces the reserve requirements for banks with less than 70% deposit dollarization. This amendment came into force on 6 July.

To ensure the efficiency of monetary policy, it is important that changes in the monetary policy rate are reflected on interbank interest rates and ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. When necessary, commercial banks mainly obtain additional liquidity through refinancing loans, which is the main instrument of the NBG. In addition, the NBG provides liquidity support through temporary instruments, such as swap operations and a liquidity supply instrument to facilitate lending to small and medium-sized businesses. It should be noted that these temporary instruments (through banks) are also made available to microfinance organizations. 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.

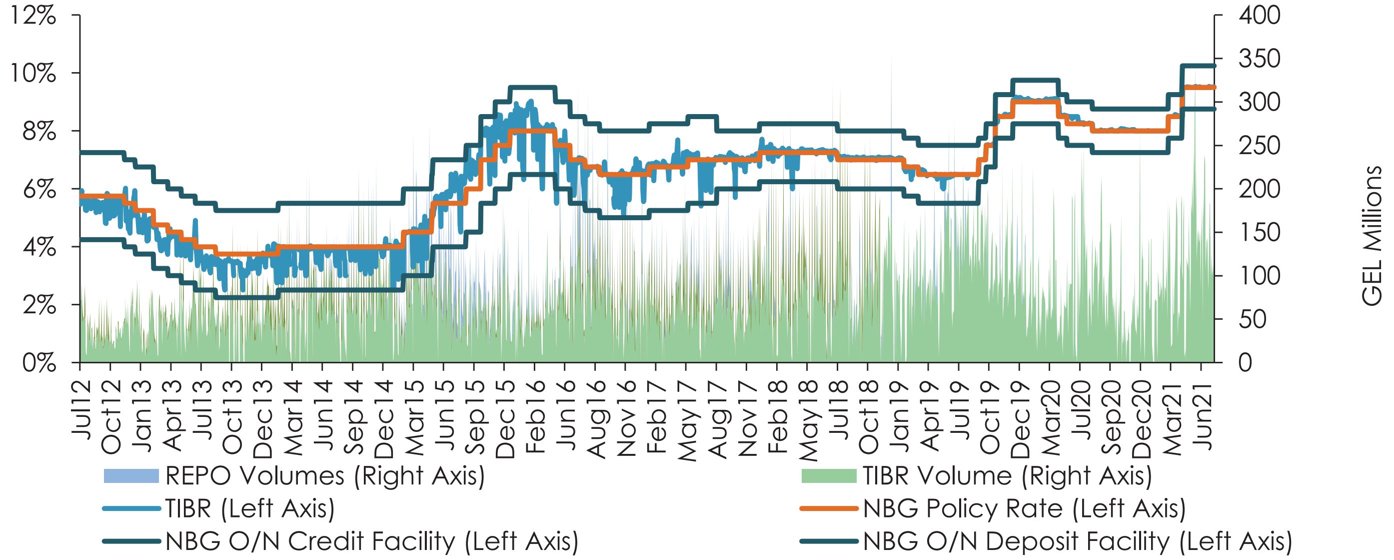


Figure 3.3. Interbank money market

Source: National Bank of Georgia

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