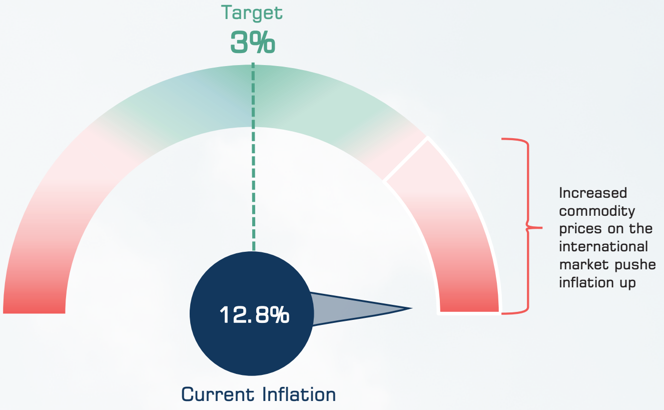
Monetary Policy Report

May

2022

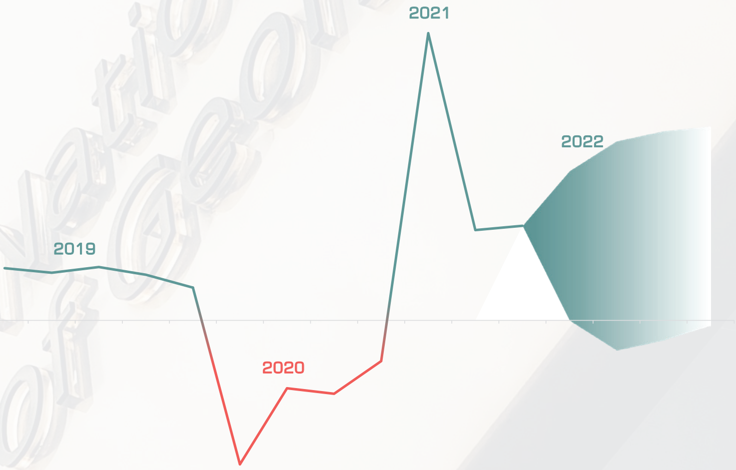
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



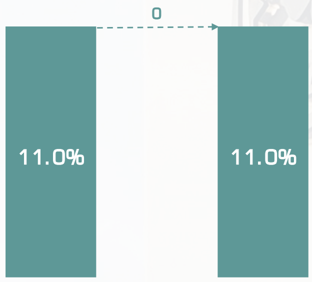
12.8%	Against the background of a sharp rise in international commodity prices, inflation is much higher than the target.

Economic Growth



The war in Ukraine has put the recovery of economic activity in 2022 at risk.	4.5%

Monetary Policy



11%	In order to reduce inflation expecta-tions, the National Bank maintained tightened monetary policy.

MONETARY POLICY DECISION

The monetary policy rate has been left unchanged at 11.0%.

The National Bank of Georgia's role is to set the interest rate to affect total spending in the economy and thereby guide inflation expectations to ensure that inflation returns to the target level of 3%. Low and stable inflation supports employment and economic growth.

Russia's invasion of Ukraine and the ongoing war have posed new challenges. The world economy, which still finds itself in the process of post-pandemic recovery, has found itself in a difficult situation.

Given the important role that Ukraine and Russia play in the export of certain commodity groups, supply chains, which were already disrupted as a result of the pandemic, were further weakened by the outbreak of war. At the same time, the sanctions imposed on Russia, including restrictions on the purchase of Russian energy, raised the price of fuel globally. In the wake of these developments, rising prices on international markets have boosted inflation globally. The global surge in prices was also transmitted to the Georgian market, and inflation in Georgia remains high. Despite this strong inflation shock, as a result of maintaining a tight monetary policy and with the exhaustion of supply-side shocks, inflation will gradually decline in 2022; however, the rate of its decline will be slower than had been expected before the war. Accordingly, in line with inflation expectations and increased inflation risks, monetary policy has been tightened and the monetary policy rate has been maintained at 11%.

Changes in interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If any factors further amplify 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. This means that the medium-term inflation rate will be close to 3%.

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BRIEF OVERVIEW

Russia's military aggression has thrown Ukraine into a severe humanitarian, economic and geopolitical crisis. The civilized world, including Georgia, having perceived this unequal war as an attack on international security, democracy and freedom, was quick to condemn the invasion and extend support to Ukraine. Leading Western countries and institutions imposed financial and other types of restrictive sanctions on Russia. Although these sanctions are costly for the aggressor, their consequences have affected both the regional and global economy. The sharp rise in energy and food prices on international commodity markets has put pressure on consumer prices, including in Georgia. According to the pre-conflict forecast, the pandemic-related, protracted high level of inflation should have been reduced significantly by 2022 with the exhaustion of one-off, exogenous factors. However, the new situation has aggravated the inflationary environment and exacerbates risks of a further hike in inflation expectations, despite the fact that economic activity, according to the updated forecast, will grow at a relatively slower pace. As a result, monetary policy will remain tight to ensure a timely return of inflation to its target.

Inflation will start to decrease from the second quarter; however, it will move back to its target at a slower pace than had been expected before the war in Ukraine.

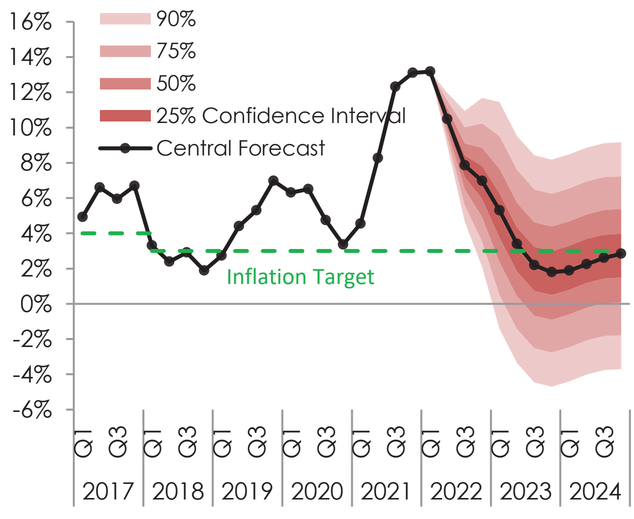

Figure 1. Headline CPI inflation forecast

Source: National Bank of Georgia (NBG), National Statistics Office of Georgia (GeoStat)

According to the National Bank of Georgia's updated baseline forecast, headline inflation will start to decrease from the second quarter of this year and will approach the target of 3% in 2023. The situation created by the war between Russia and Ukraine has caused an upward revision of the previous forecast. In particular, due to a worsened imbalance in global supply and demand, the sharp rises of energy and food prices on international commodity markets have already been transmitted to consumer prices in Georgia, and their impact will be felt in the short run. According to current estimates, **headline inflation will average 9.6% in 2022** (see Figure 1). However, all other things being equal, the automatic exhaustion of the above-mentioned temporary factors will lead to a reduction of inflation, with it reaching its target over the medium term. In addition, in response to the pre-conflict inflation challenges, the National Bank of Georgia (NBG) had already been maintaining a tightened monetary policy stance and the full effect of this on inflation should be reflected in both current and subsequent periods.

According to preliminary estimates, similar to 2021, high economic growth was observed in the first quarter of 2022. Prior to the outbreak of the Russia-Ukraine conflict, the economy was enjoying a post-pandemic recovery, supported by strong domestic activity and a rebound in external demand. However, due to the war in Ukraine and ensuing financial sanctions on Russia, foreign inflows from both countries have sharply dropped and are expected to remain depressed for some time. It is also noteworthy that the difficult geopolitical situation in the region has elevated Georgia's sovereign risk premium, which, in turn, increases the

Despite the worsened external sector, economic growth in 2022 will average 4.5% – mostly as a result of strong credit growth.

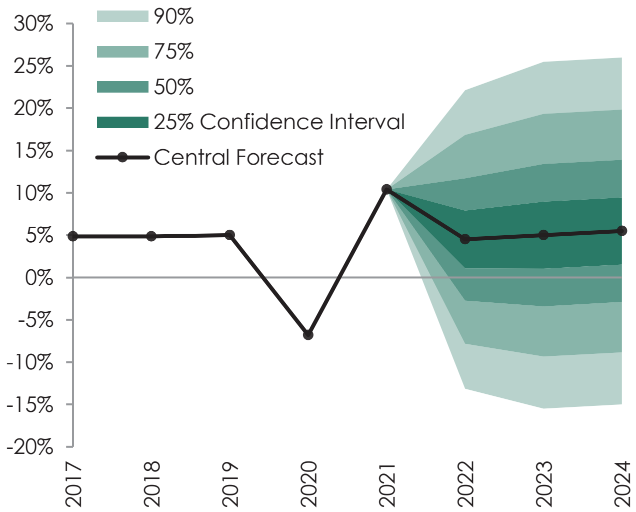

Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat.

A tight monetary policy stance will be maintained to anchor inflation expectations and ensure that inflation returns to the target in the medium term.

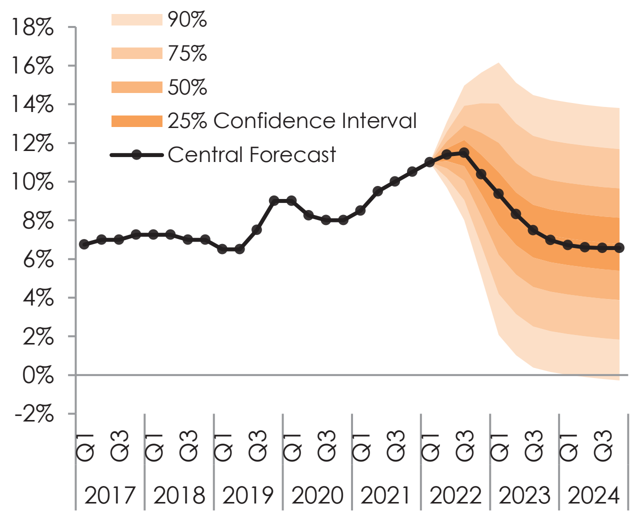

Figure 3. Monetary policy rate forecast

Source: NBG.

risk of lower investments and exchange rate depreciation; however, some reversal in this regard has already been observed. According to the current forecast (see Figure 2), **real GDP will grow by 4.5% this year**, with high credit activity making a significant contribution to that growth. This forecast is 0.5 percentage points lower than the previous estimate – mostly a consequence of the deterioration of both investments and net exports amid the current geopolitical situation.

Given that inflation has deviated from its target for a long period and that the pressure on prices has recently intensified, risks of an additional rise in inflation expectations have emerged. These, in turn, carry the risk of delaying the return of inflation to its target. Therefore, at its meeting on 11 May 2022, **the Monetary Policy Committee decided to maintain its tight stance**. The normalization of the policy will only follow a lowering of inflation expectations, and thus the rate will approach its neutral level (currently estimated at 6.5%) gradually.

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

1 CURRENT MACROECONOMIC SITUATION

The war between Russia and Ukraine has had a significant impact on the global economy. Amid the aggravated demand-supply imbalance and a further deterioration of expectations, there has been a sharp rise in prices on international commodity markets, which have already been reflected on consumer prices worldwide. Moreover, for many countries the current crisis also means a slowdown in economic activity. For Georgia, a potential decline in revenues from exports of goods and tourism, as well as of remittances, carries risk and could lead to a worsening of the current account. However, before the escalation of the conflict, the economy was in an active, post-pandemic recovery phase, which was mostly due to high credit activity and fiscal stimulus. Alongside high economic growth, and with the sharp impact of exogenous factors on consumer prices, a high level of headline inflation was observed.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Amid Russia's invasion of Ukraine in February 2022 and the tense geopolitical situation surrounding that conflict, global macroeconomic challenges increased on international commodity markets, especially in the supply-side direction. Consequently, in response to deteriorating inflation expectations, the monetary policies of a number of countries have been further tightened. In addition, the sanctions imposed by the international community on Russia, which are intended to stop the aggressor, have also created temporary difficulties for the economies of many countries. Therefore, according to the International Monetary Fund's (IMF) April forecast[1], global economic growth in 2022 will be 3.6%, which is 0.8 percentage points (pp) lower than the previous forecast.[2] Also, amid increased inflation expectations, the expected level of global inflation is 7.4%, which is 3.6 pp higher than the previous forecast. For emerging and developing countries, real GDP is expected to grow by 3.8% in 2022, and their inflation is expected to be 8.7%.

Amid the Russia-Ukraine war and the rising humanitarian crisis, a slowdown in global economic activity is expected in 2022.

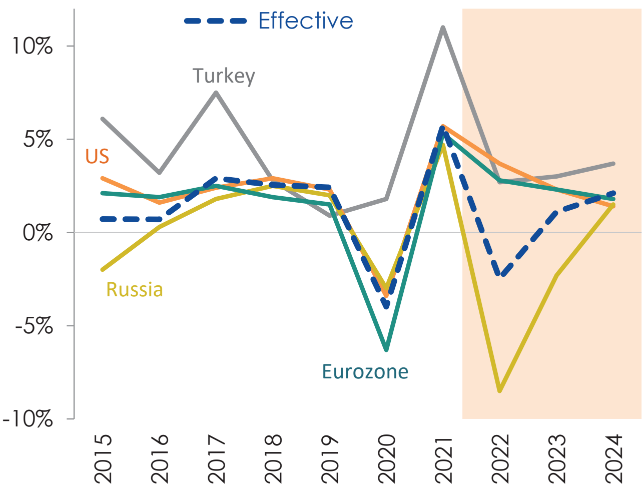

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF.

In 2022, consumer prices continue to increase sharply in developed as well as in emerging and developing countries. This is mostly due to supply-side disruptions resulting from the pandemic, as well as increased demand together with the relaxing of pandemic-related restrictions and the upward dynamics of product prices on international commodity markets. Also, as a result of Russia's ongoing war in Ukraine, prices of oil and food products have risen significantly.

1 International Monetary Fund. 2022. World Economic Outlook: War Sets Back The Global Recovery. Washington, D.C., April.

2 International Monetary Fund. 2022. World Economic Outlook update: Rising Caseloads, A Disrupted Recovery, and Higher Inflation. Washington, D.C., January.

Amid the Russia-Ukraine war, food and oil prices increased in international markets, boosting inflation in Georgia's trading partners, including the United States and the eurozone. As for Turkey, unprecedentedly high inflation has been observed recently.

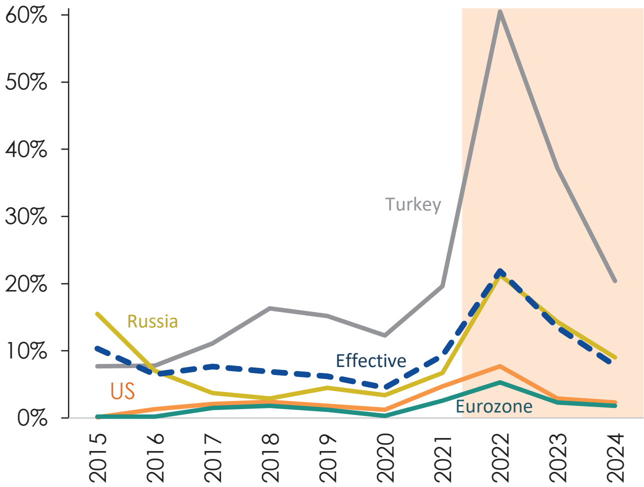

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF.

In March, the food price index increased and stood at 33.6%[3] compared to the same period last year, while the international price of one barrel of oil increased by 80% year on year to average USD 117.

In the first quarter of 2022, the pace of economic activity in the **United States** slowed compared to the previous period. This was related to an increase in COVID-19 infections at the beginning of the year, and a sharp increase in consumer prices. Consequently, net exports deteriorated and inventory investments declined. However, the industrial sector somewhat improved. Amid the Russia-Ukraine war, the US government continues to impose sanctions on Russia. Annual inflation has increased sharply and stood at 8.5% in March, which is the highest level in 40 years. In response to inflation expectations, the Federal Reserve raised its federal reserve rate by 0.25 percentage points (pp). According to IMF's April forecast, real economic growth in the US will be 3.7% in 2022, while inflation is expected to be 7.7%.

In the first quarter of 2022, the pace of improvements in economic activity in the **eurozone** slowed compared to the previous period. The increase in COVID-19 cases earlier this year was compounded by the Russia-Ukraine war, which led to a slight deterioration in consumer and business sentiment. Also, amid rising food and oil prices in international markets, inflation increased to 7.4% in March, which was a record high in the history of the eurozone. It is noteworthy that European countries have imposed several packages of economic sanctions against Russia in order to reduce their dependence on that market. According to the IMF's April forecast, real economic growth for the eurozone will be 2.8% in 2022, while inflation is forecast at 5.3%.

In the first quarter of 2022, after the high growth recorded in 2021, the pace of improvement in economic activity slowed in **Turkey**; consumer sentiment deteriorated, and consumption weakened. Industrial production decreased, as did retail sales. This was mostly due to the recent depreciation of the Turkish lira, which caused even higher inflationary pressure, with annual inflation standing at 61.1% in March. In addition, the volatility caused by the Russia-Ukraine war on international commodity markets has put additional pressure on the current account, exchange rate and consumer prices for Turkey, which is a major importer of energy and food raw materials. According to the IMF, the real GDP growth forecast for Turkey is 2.7% in 2022, while inflation is forecast to be around 60.5%.

On 24 February 2022, after the Russian invasion of Ukraine, the Western world began to impose unprecedented economic sanctions on **Russia**. In the first quarter of the year, economic activity in Russia thus sharply deteriorated. In addition to numerous eco-

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

Since the beginning of 2022, together with rising inflation expectations, many central banks of Georgia's trading partners have tightened their monetary policy rates. Turkey is the only exception to this, where, despite high inflation, the monetary policy rate has gradually declined.

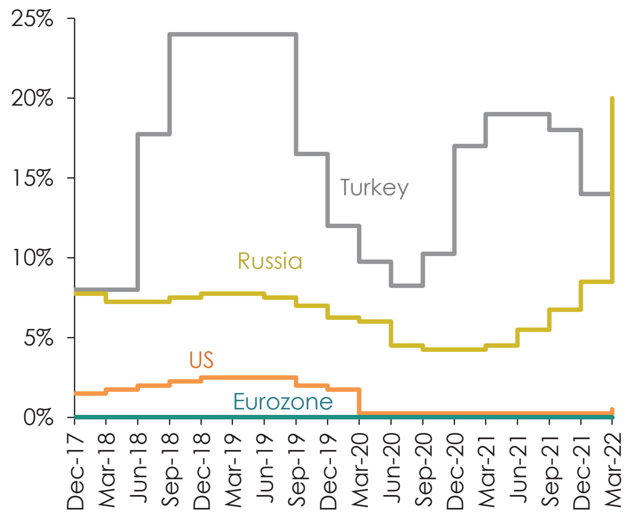

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

nomic sanctions from the Western world, several leading Russian banks have been cut off from the international SWIFT banking system, which was a severe blow to the country and its financial institutions. At the same time, consumers of the Russian banking system can no longer use Visa and MasterCard payment cards, while many international merchants have ceased operations in Russia. Recently, some EU members have intensified talks on imposing an embargo on Russian oil and gas. Amid these developments, Russia's external sector has deteriorated significantly, and investments have fallen sharply. Business sentiment has also decreased. Soon after starting the war, amid the sharp depreciation of the Russian ruble, annual inflation increased significantly and equaled 16.7% in March. As a result, the Central Bank of Russia decided to further tighten its monetary policy to 20% (which was reduced to 17% in April). It is also noteworthy that, since the end of March, as a result of active capital controls, the official exchange rate of the ruble against the US dollar has returned to the pre-war level. According to the IMF's April forecast, the real economy in Russia will decline by 8.5% in 2022. As for inflation, it is forecasted to be 21.3% on average.

Since 24 February 2022, amid Russia's war, the number of deaths in **Ukraine** is increasing daily, and about six million Ukrainians have already left the country. As a result of the war, many cities in Ukraine have been destroyed and the economic losses are huge. Important infrastructure units, such as roads, bridges, ports, airports, fuel storage depots, etc., have been destroyed. It is important that in parallel with the war, the civilized part of the world, including Georgia, supports Ukraine. According to the IMF, Ukraine's real economy will decline by 35% in 2022. According to Bloomberg's consensus forecast, annual inflation is expected to be 20% on average in 2022.[4]

The first quarter of 2022, similar to the previous period, was characterized by weak economic activity in **Armenia**. This was mostly due to the challenges caused by the Russia-Ukraine war. As Russia is the most important trading partner for Armenia, remittances are expected to decline this year. The war will also negatively affect Armenia's exports. In addition, there have been political tensions with Azerbaijan. The annual inflation rate increased to 7.4% in March. According to the IMF, the real GDP forecast for Armenia is 1.5% in 2022, while the inflation rate is expected to be 7.6% on average.

In the first quarter of 2022, **Azerbaijan's** economic activity continued to improve in both the oil and non-oil sectors. This was mostly due to the upward dynamics of oil prices on international markets and an improvement of the industrial sector. Investments also increased. This caused a stabilization of the external

4 *Bloomberg Monthly Survey of Economists.*

sector. However, it is expected that the Russia-Ukraine war will have negative consequences for both remittances and external trade this year. The annual rate of inflation increased and stood at 12.2% in March. According to the IMF, real GDP growth in Azerbaijan will be 2.8% in 2022, while the inflation rate is forecast to be 12.3%.

Since the beginning of 2022, the **central banks** of many of Georgia's main trading partners have further tightened their monetary policies in response to higher inflation and rising inflation expectations. The US Federal Reserve raised its federal funds rate in the 0.25-0.5% range, although it is expected that interest rates in the US will rise further this year. Meanwhile, the European Central Bank's interest rate remains unchanged at 0%. At the same time, it should be noted that, despite increased inflationary pressures and amid the Russia-Ukraine war, the broader quantitative easing program in the eurozone is still being maintained. However, in March the ECB indicated that the program would be phased out and this is expected to be completed by the second half of 2022.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In light of strong external demand prior to the Russia-Ukraine war, registered exports of goods continued to rise at a high rate.

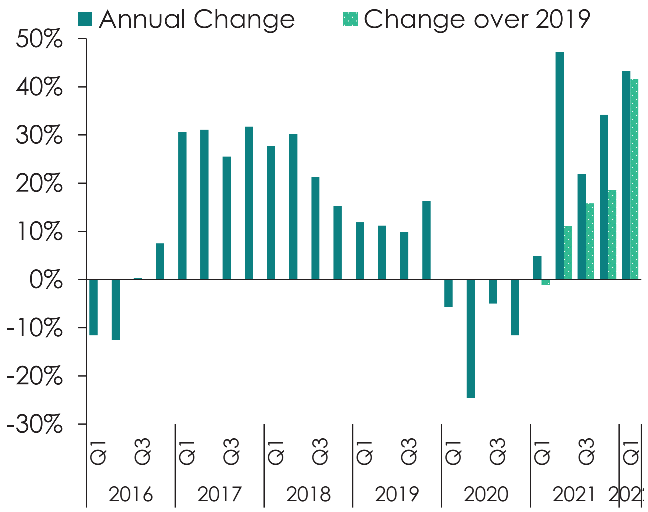

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat.

In the first quarter of 2022, external demand continued to rise. The acceleration of economic growth in trade partner countries and the revival of manufacturing processes from the second half of 2021 positively affected the turnover of Georgia's external trade; however, Russia's invasion of Ukraine induced new challenges for international trade. Alongside higher exports of goods and a gradual rise of international tourism, instant money transfers increased considerably. In line with strong domestic demand, imports of goods substantially increased. In overall terms, due to rising external inflows, which exceeded the rise in imports of goods, the current account deficit[5] improved by USD 131 million in 2021, as compared to the previous year, while the ratio of the deficit to GDP amounted to 9.8%, which was 2.6 pp lower compared to the previous year. However, the possible worsening of the external economic environment (in light of the current conflict in Ukraine and the sanctions against Russia) raises the risks of lower exports of goods, money transfers and revenues from international travelers. A realization of such risks would induce a widening of the current account deficit in 2022.

Against the background of a possible overall weakening of external inflows in 2022, in the first quarter of the year registered exports of goods grew by 43.3% annually (see Figure 1.2.1) and rose by 50.2% compared to the same period in 2020. An increase of exports to China made the highest contribution to the

5 *According to BPM6.*

The rise in exports of goods mainly stemmed from an increase in external demand for intermediate goods. The contribution of investment and consumer goods decreased.

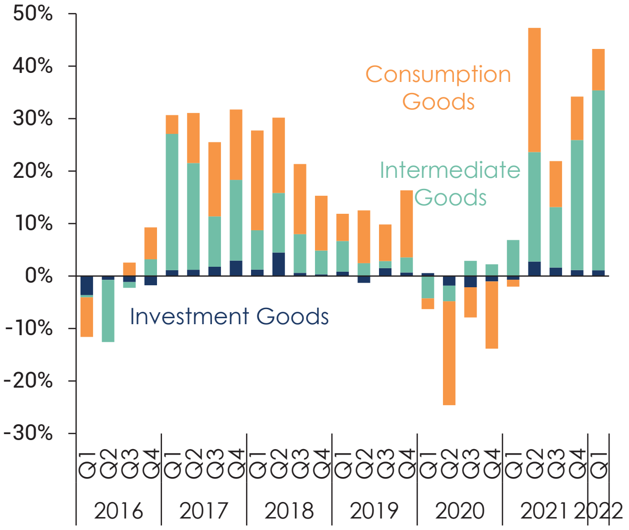

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat.

Revenues from international travelers continued to rise and in the first quarter of 2022, with the volume of revenues received amounting to 68% of those from the same period of 2019.

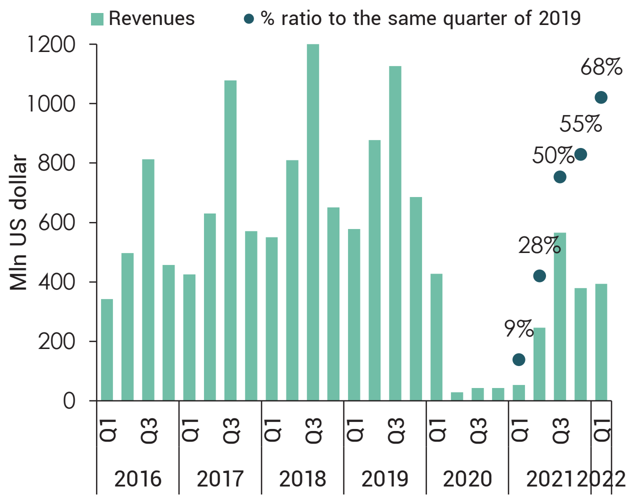

Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG.

overall growth (of 13.5 pp annually), which was mainly a consequence of high demand for copper ores and concentrates (accounting for 81% of total exports to China). From regional countries, exports to Armenia increased considerably, which was due to higher demand on construction machinery and mineral fertilizers. Exports to Turkey increased mainly in terms of substantially high levels of exports of ferro-alloys and ferrous scrap. In the first quarter, as could be expected, in light of the ongoing military conflict, exports to Ukraine substantially decreased from March, while exports to Russia stayed at almost the same level annually. For the EU, exports to Bulgaria grew considerably due to high sales of copper ores and concentrates. In terms of other countries, demand for ferro-alloys was high from the USA (making a 6.5 pp contribution to the overall growth of exports).

Exports of goods mainly increased due to raised levels of intermediate goods being exported, which was mostly a reflection of substantially increased prices on such goods; meanwhile, consumer and investment goods made only a moderate contribution to the overall growth of exports (see Figure 1.2.2). The increase in the export of intermediate goods mainly stemmed from high exports of copper ores and concentrates. In terms of the rise in exports of consumer goods, telephone sets made the largest positive contribution; while for investment goods, exports of various forms of aircraft played a leading role in the overall growth.

The gradual lifting of restrictions on international travel stimulated a recovery of tourism. In the first quarter, the number of international visitors rose by 297.3% annually; however, this number remains below that of the same period in 2020 (down by -53.8%). It should be noted that, because international tourism was at a virtual standstill for most of 2020 and only began to gradually increase from the second half of 2021, the rise in the numbers of visitors in the first quarter of 2022 was also related to the base effect. In terms of countries of origin, the majority of visitors (51%) came from neighboring countries, while increasing numbers of travelers from Israel, Iran and Saudi Arabia also made a significant contribution to the overall growth of visitors.

The increase in the numbers of international visitors was reflected in a rise in revenues from international travelers. Such revenues increased by 7.4 times in the first quarter (see Figure 1.2.3), but remained lower than pre-pandemic levels, remaining 31.9% below the level of revenues received in the same period in 2019. In line with expectations, the gradual rise of annual revenues received from international travelers in 2021 continued in the first quarter of 2022; however, compared to the record highs seen in 2019, the recovery of this sector is still underway.

Instant money transfers continue to rise substantially, not only in annual terms but also compared to pre-pandemic levels.

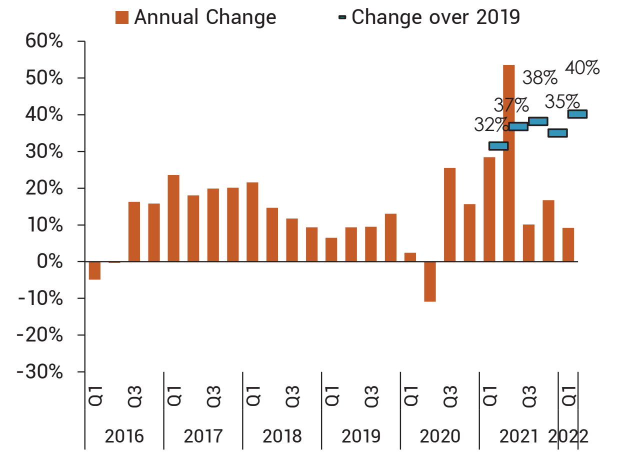

Figure 1.2.4. Annual change in money transfers

Source: NBG.

The rise in domestic demand was reflected in higher imports of registered goods. It is worth noting that an increase of import prices in USD terms was revealed in the rise of expenses on import goods.

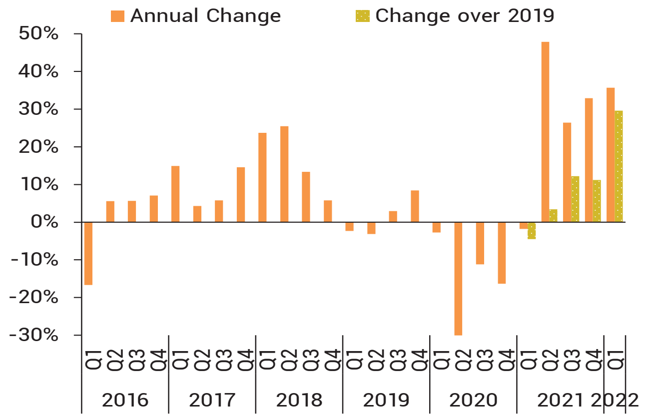

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the first quarter of 2022, imports of consumer and intermediate goods made the largest contributions to the overall growth of imports. In light of low aggregate investments, imports of investment goods were low.

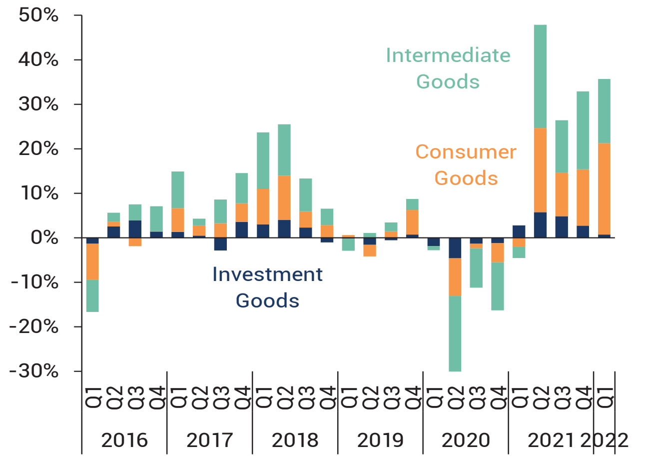

Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

In the first quarter of 2022, instant money transfers to Georgia increased by 9.2% annually and amounted to USD 545.3 million (see Figure 1.2.4). During this period, transfers from the EU (especially from Italy and Germany), Kazakhstan and the USA made the largest contributions to total growth. As could be expected, due to the war, money transfers from Ukraine were minimal in March, while transfers from Russia only declined by USD 5 million over the same period. In light of the ongoing war and existing sanctions against Russia, money transfers are expected to decline from both countries.

Considering the acceleration of economic activities and higher internal demand, imports of goods rose considerably in the first quarter of 2022, increasing by 35.7% annually. This reflected a rise of 29.6% compared to the same period in 2019 (see Figure 1.2.5). The rise in imports from regional countries was significant, particularly those from Turkey and Azerbaijan, but imports from other regions, including China and Bulgaria, made the largest contribution to overall growth. In contrast, imports from the USA fell because of lower imports of motor cars for subsequent re-export.

In the first quarter of 2022, imports of consumer and intermediate goods made the largest contributions to the overall growth of imports (see Figure 1.2.6). The increase in imports of consumer goods predominantly stemmed from higher purchases of petroleum products, medicaments and motor cars, while the rise of imports of intermediate goods was due to higher imports of copper ores and concentrates, as well as petroleum gases. The rise in imports of investment goods stemmed from higher purchases of automatic data processing machines and their units. It is worth noting that the noticeable rise of imports in nominal terms was influenced by the substantial increase of prices on consumer and intermediate goods in USD terms on global markets. For instance, due to accelerated prices on international markets, expenses on imports of petroleum products increased. In the first quarter, the volume of imports in USD terms increased by 72% annually, which was mostly due to the 61% rise of energy product prices on global markets.

In light of increased exports of goods and services, in addition to rising instant money transfers, the current account deficit declined by USD 35 million in the fourth quarter of 2022 and amounted to 9.6% of quarterly GDP. This indicator was around 13.2% of quarterly GDP in the same period in 2021.

The sources of financing the current account deficit not only included foreign direct investments (FDI), but also other investments.[6] The inflow of other investments amounted USD 692 million, which was USD

6 *According to BPM6.*

From the perspective of savings and investments, the improvement of the current account balance in 2021 was due not only to a rise in savings (which reflects a decline of the fiscal deficit compared to 2020), but also due to a decline of investments.

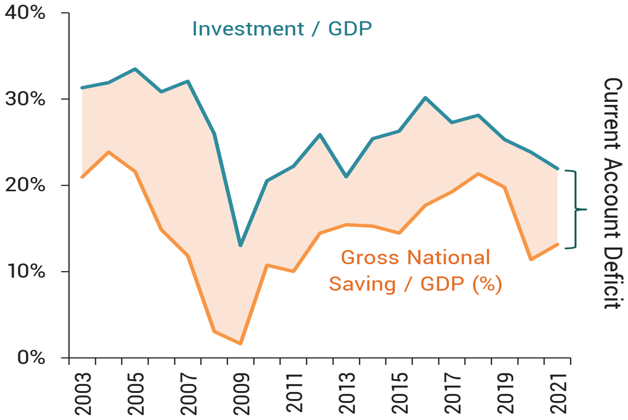

Figure 1.2.7. Investments and savings

Source: GeoStat, NBG Calculations

340 million higher compared to the same quarter of 2021. The main source of increased other investments was public long-term loans. In the fourth quarter, FDI amounted to USD 437 million, with the rise in FDI mainly stemming from a higher level of reinvestments. The majority of FDI went to the finance and real estate sectors.

From the perspective of savings and investments, in the fourth quarter of 2021, as compared to the same period in the previous year, the improvement of the current account balance was due to a fall in investments and a rise in savings (see Figure 1.2.7). This also reflects a decline of the fiscal deficit as compared to 2020.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the fourth quarter of 2021, real GDP grew by 8.8%. The main drivers of economic growth were local consumption and the partial recovery of tourism from abroad.

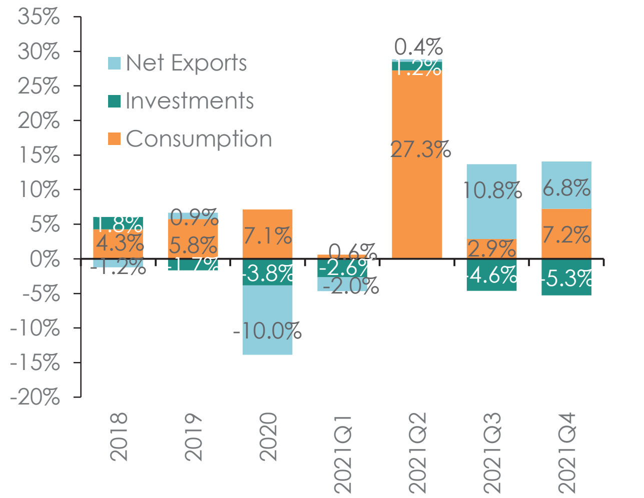

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In 2021, economic activity grew by 2.9% compared to 2019.

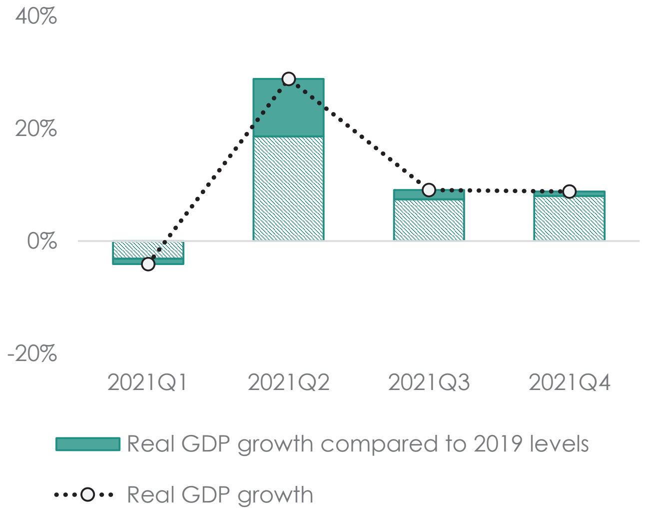

Figure 1.3.2. Comparison of the real level of GDP in 2021 with 2019

Source: GeoStat.

In the fourth quarter of 2021, real GDP grew by 8.8% year on year.

Economic growth in the fourth quarter of 2021 was still largely linked to the base effect. By the end of 2020, restrictions were once again tightened in the wake of a new wave of the pandemic. This led to a slowdown in economic growth. By 2021, the restrictions were eased, and the economy began to recover. It is noteworthy that the real lag of GDP caused by COVID-19 was eliminated and this figure exceeded the pre-crisis level. Real GDP in the fourth quarter of 2021 increased by 0.8% compared to the same period in 2019 (see Figure 1.3.2). In total, the real volume of GDP in 2021 exceeded the pre-crisis level of 2019 by 2.9%.

The main drivers of economic growth in the fourth quarter of 2021 were consumption and net exports. Against the backdrop of high credit activity and fiscal spending, consumption grew by 7.4% and contributed 7.2 pp to overall economic growth. At the same time, the gradual recovery of tourist inflows has had a positive impact. The easing of pandemic-related restrictions led to an increase in tourist visits from the second half of 2021. As a result, in the fourth quarter of the year, services exports actually increased 2.3 times compared to the same period of the previous year, and the positive contribution of net exports to economic growth amounted to 6.8 pp. Investment activity remained weak. In the fourth quarter of 2021, investment in real GDP contributed a negative 5.3 pp to overall growth (see Figure 1.3.1).

The growth of real GDP was conditioned by the activation of the service sector, which, in addition to strong demand, was supported by the partial recovery of tourism.

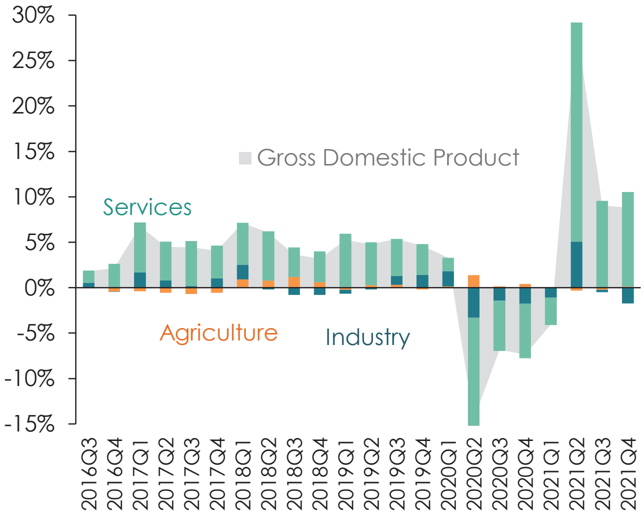

Figure 1.3.3. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

1.3.2 OUTPUT

In the fourth quarter of 2021, the real gross domestic product grew by 8.8% year on year (see Figure 1.3.2). The main driver of that growth, with a contribution of 10.4 pp, was the service sector. The contribution of agriculture was 0.1 pp, while the contribution of the industrial sector was a negative 1.7 pp.

As mentioned in the previous section, the main reasons for the high growth observed in the fourth quarter of 2021 were the base effect, consumption and the gradual recovery of the flow of foreign tourists to Georgia after a one-year pause. The latter had a positive impact on tourism-related businesses that were most affected by the pandemic. Accommodation and catering activities, transport, real estate activities, and arts, entertainment and recreation – all sectors in which foreign participation is high – collectively contributed 5.7 pp to overall GDP growth. Trade, which is the largest sector of the economy, grew by 11.2%, making a 1.6 pp contribution to overall growth.

Among the industrial sectors, the significant increase in electricity, gas and water supply is noteworthy (making a 1.3 pp contribution to growth). In contrast, a 33.4% decline in construction reduced economic growth by 3.1 pp.

During the same period, agriculture grew by 1.9%, contributing 0.1 pp to economic growth (see Figure 1.3.3).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In March, the growth of the annual loan portfolio did not change significantly and stood at 18.0%, excluding the effect of exchange rate fluctuations.

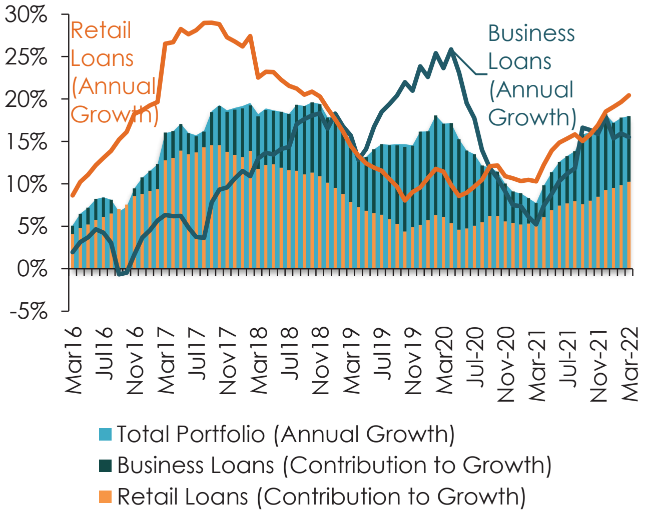

Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: NBG

In March, relative to December, the growth of the loan portfolio did not change significantly and stood at 18.0% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 1.9 pp to stand at 20.5%, while the growth of loans to legal entities decreased by 2.4 pp and equaled 15.5% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the energy sector. According to the credit conditions survey, representatives of the banking sector expect a slight 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 first quarter of 2022 was mainly driven by domestic currency loans, which is a development that was supported by recent macroprudential measures (see Figure 1.4.2). However, in March the annual growth rate of foreign currency denominated loans increased and stood at 13.9%, while the growth rate of loans in the domestic currency decreased by 1.8 pp and equaled 23.2%. This was expected given the tightening of monetary policy. In the first quarter, the loan larization ratio did not change significantly and equaled 49.4%, excluding the effect of exchange rate fluctuations. It is expected that the larization (de-dollarization) process will continue in the future. Recent changes made to reserve requirements will motivate banks to increase larization, which is one step towards reducing risks to financial stability.

The growth of the loan portfolio was mainly driven by an increase in domestic currency loans. However, the contribution of loans issued in foreign currency to the overall growth of the portfolio increased.

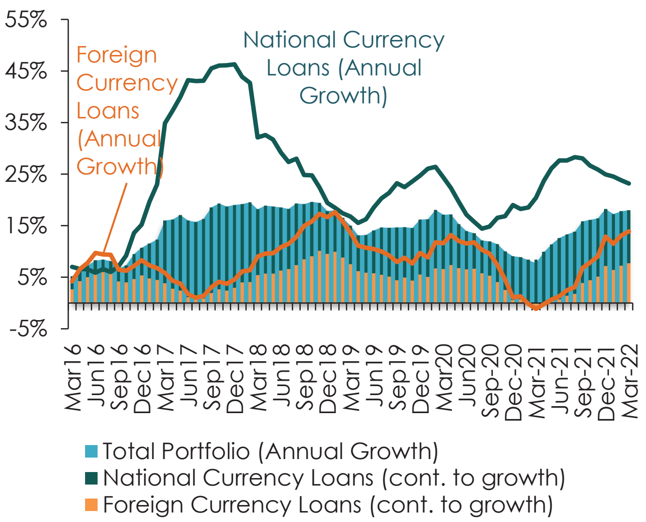

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In March, the monetary policy rate was 11.0%. In the first quarter of 2022, interest rates on government securities increased slightly, which was mainly due to a slight increase in the monetary policy rate (see Figure 1.4.3).

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

In March, relative to December, interest rates on domestic currency deposits increased slightly and equaled 10.6%. Meanwhile, interest rates on foreign currency deposits decreased slightly and equaled 1.6%. According to the credit conditions survey, repre-

As the monetary policy rate increased slightly, interest rates on government securities also rose moderately in the first quarter of 2022.

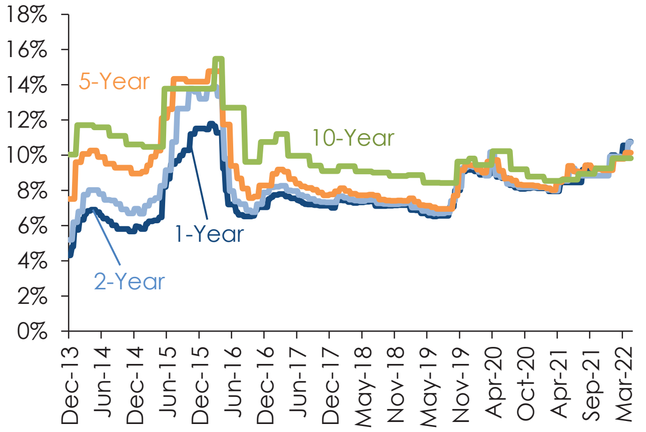

Figure 1.4.3. Interest rates on government securities

Source: NBG

The spread between long- and short-term interest rates remained negative. This is a reflection of expectations of decreasing inflation and, consequently, of a fall in the policy rate.

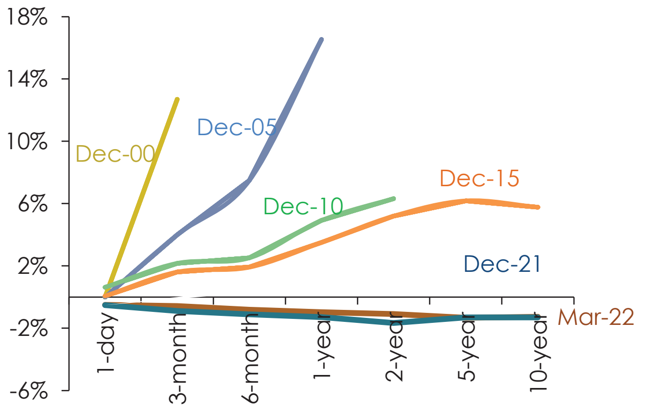

Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: NBG

sentatives of the banking sector expect no significant change in the cost of funds in the next quarter.

Furthermore, according to the same survey, interest rates on consumer and mortgage loans issued in a foreign currency increased slightly; meanwhile, interest rates on business loans issued in the domestic currency increased slightly. However, representatives of the banking sector do not expect significant changes in interest rate conditions. In March, relative to December, interest rates on corporate loans decreased slightly, while interest rates on loans to small and medium enterprises (SMEs) and on retail loans increased slightly. In particular, interest rates on corporate loans decreased by 0.6 pp and equaled 9.7%. While interest rates on loans to SMEs increased by 0.6 pp and equaled 10.4%. Retail loan interest rates increased by 2.4 pp and equaled 16.5%.

As of March, relative to December, average interest rates for domestic and foreign currency loans on the stock of legal entities did not change significantly. In particular, interest rates for domestic currency loans stood at 13.4%, while equaling 6.7% for foreign currency loans (see Figure 1.4.5). Representatives of the banking sector do not expect significant changes in interest rates for loans in foreign currency.

As of March, compared to December, average interest rates for domestic and foreign currency loans on the stock of legal entities did not change significantly.

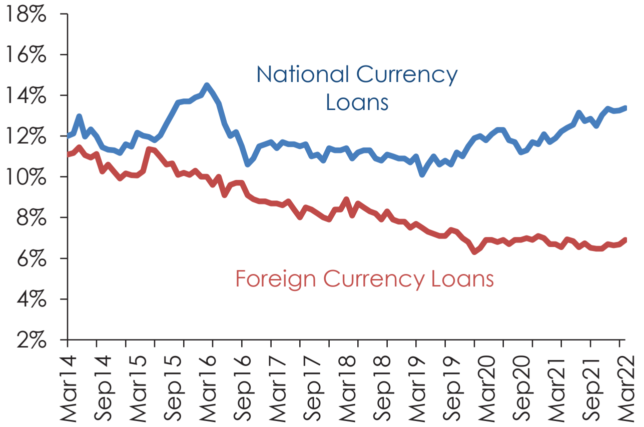

Figure 1.4.5. Average interest rates on business loans

Source: NBG

The real effective exchange rate appreciated on both a quarterly and on a year-on-year basis.

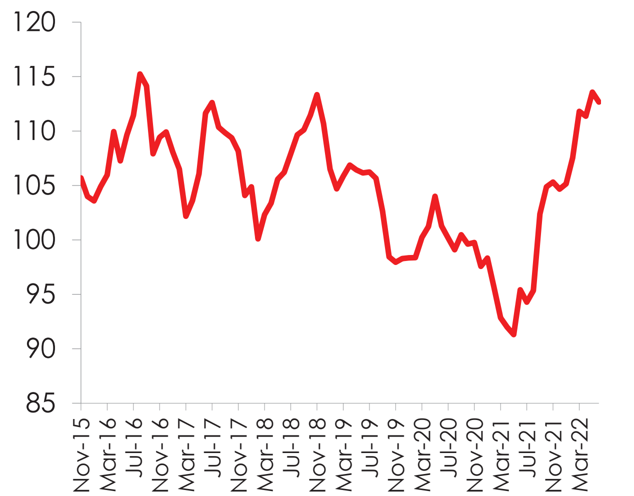

Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: NBG.

1.4.3 EXCHANGE RATE

In the first quarter of 2022, the GEL nominal exchange rate appreciated against the US dollar and against the euro on average by 0.5% and 2.4%, respectively, compared to the previous quarter. The GEL continued to appreciate against the Turkish lira by 23.2% and against the Russian ruble by 15.4%. In the same period, the nominal effective exchange rate appreciated by 8.6% and 23.3% on a quarterly and annual basis, respectively. The price-adjusted exchange rate has a greater impact on external competitiveness; in the first quarter of 2022, the real effective exchange rate appreciated by 4.0% on a quarterly basis and by 21.1% on a year-on-year basis (see Figure 1.4.6). It should also be noted that the real exchange rate appreciated against all trading partner countries (see Table 1.4.1).

The real effective exchange rate appreciation was caused by real appreciation against all major trading partner currencies.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	**23.3**	**21.1**	**21.1**
Eurozone	14.6	22.1	3.9
Turkey	101.6	47.4	9.0
Ukraine	9.9	11.6	0.8
Armenia	-0.8	4.9	0.3
US	6.7	11.8	0.9
Russia	24.5	26.0	3.8
Azerbaijan	6.5	7.5	0.8
China	4.5	16.9	2.2
Bulgaria	14.6	17.3	0.7
Poland	16.5	20.3	0.4

Table 1.4.1. Effective exchange rates annual growth (first quarter of 2022)

Source: NBG

* Growth implies appreciation of the lari.

In the fourth quarter of 2021, the unit labor cost increased by an annual 3.0% – a moderate figure that does not create pressure on inflation from the labor market.

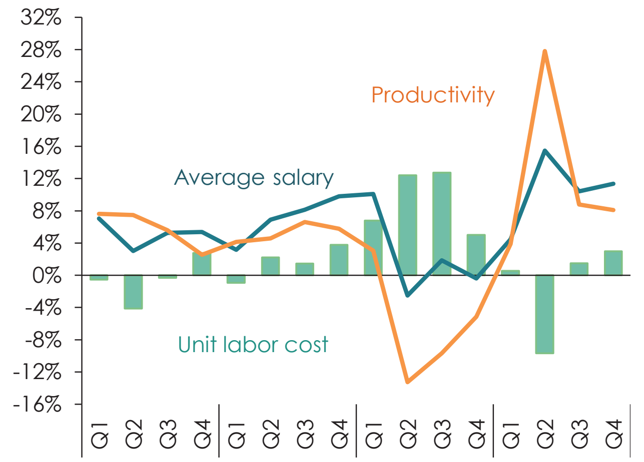

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

Inflation equaled 12.8% in April. However, were it not for Russia's invasion of Ukraine, a rapid decline in inflation would have been expected.

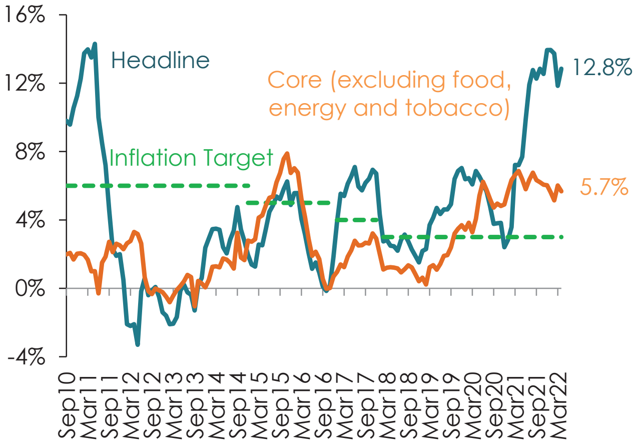

Figure 1.6.1. Headline and core inflation

Source: GeoStat

Amid the Russia-Ukraine war, food and oil prices on international markets rose sharply. The main contribution to April's inflation comes from food and fuel.

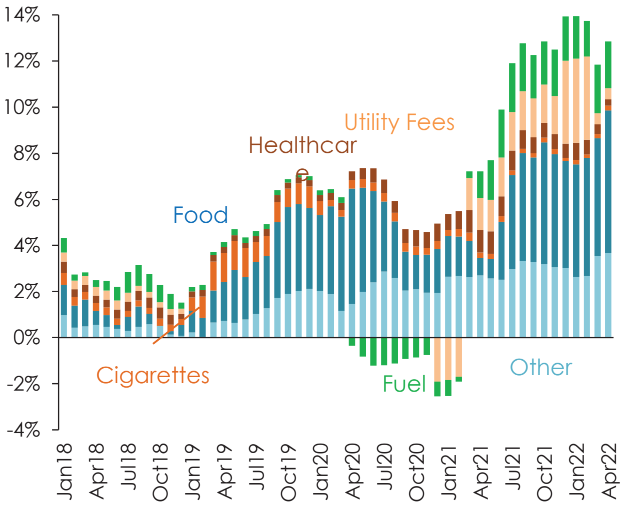

Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

1.5 LABOR MARKET

In the fourth quarter of 2021, productivity (real value added produced per employee) in the country's economy increased by 8.1% annually (see Figure 1.5.1). At the same time, the gross salaries of employees averaged 1,464 GEL, which reflects nominal annual growth of 11.3%.

In 2020, the unit labor cost (ULC) increased due to a smaller reduction in wages compared to the decrease in output. In turn, the increase in cost per unit of product pushes producers to increase prices. During the pandemic, the increase of ULC, given supply-side delays and the decrease in output, was one of the factors behind the rise of inflation.

As expected, with the recovery of the economy, from the end of 2020 the unit labor cost began to gradually decline. However, from the second half of 2021, the ULC began to grow moderately once more, with an annual growth rate of 3.0% in the fourth quarter. However, this is a moderate figure and does not create pressure on inflation from the labor market (see Figure 1.5.1).

1.6 CONSUMER PRICES

In April 2022, inflation equaled 12.8% (see Figure 1.6.1). However, had Russia not started the war in Ukraine a rapid decline in inflation would have been expected. The war has given rise to new risks; in particular, the sanctions imposed on Russia due to the hostilities and restrictions on supplies have significantly increased the prices of certain categories of goods on international markets.

Before the war, Ukraine and Russia, both major exporters, were important participants in the international transport system and global supply chain. The total share of Ukraine and Russia in the international wheat market was about 25%. Due to the war, the supply of wheat to the market is expected to decline, with wheat prices rising sharply as a consequence. At the same time, the sanctions against Russia, which restrict the sale of energy resources, are causing the price of fuel to rise globally. While the supply chain problems caused by COVID-19 and the supply-demand imbalance in the international market have not yet been completely overcome, the current war has further hampered supply chains and deepened the imbalance in the international market. As a result of the conflict, a strong impetus for price growth has emerged worldwide. For Georgia, however, this challenge poses additional difficulties as Ukraine and Russia are both major trading countries and the impact of the war is more directly reflected in foreign exchange inflows (particularly in declined exports and remittances).

Due to the current situation, prices of wheat, sugar, vegetable oil and other food products have sharply

The increase in domestic prices is mainly due to imported goods, which is a reflection of the increase in prices of raw materials in US dollars on international markets.

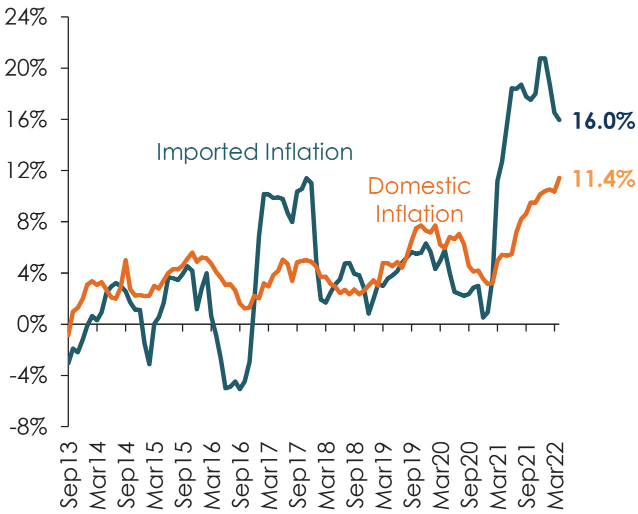

Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

risen on the world market. The FAO (Food and Agriculture Organization of the United Nations) food price index rose by 29.8% year on year in April. Globally increased prices have also been transferred to the local market. As a result, the rise in food prices contributed 6.2 pp to the rise of inflation in April, whereas the contributions of bread (1.0 pp), cheese (0.5 pp), oil (0.2 pp), and sugar (0.2 pp) are also notable.

Since the beginning of the war, the price of oil has risen sharply and this development was soon transferred to the Georgian market. Surging fuel prices thus contributed a total 2.0 pp to April's inflation.

Since March, the impact of utility subsidies on inflation has largely ended. Its contribution to inflation fell from 3.6 pp in February to 0.5 pp and has remained at the same level in April.

Inflation of imported goods fell to 16.0% in April, although this significantly exceeded the inflation of both domestically produced goods (11.4%) and service inflation (6.5%). The reason for this difference is the lower dependence on service prices on the world market. The fact that the inflation of imported goods is higher than the inflation of domestic products and services, in spite of the appreciation of the nominal effective GEL exchange rate, indicates that the increase in prices is mainly a consequence of rising prices of products on the world market (see Figure 1.6.3).

Meanwhile, core inflation, which excludes volatile food, energy, and cigarette prices, amounted to 5.7% in April (see Figure 1.6.1).

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, inflation will gradually decline from the current quarter, although it will remain above the target during the year as a consequence of the aggravated exogenous shocks caused by the Russian invasion of Ukraine. Since Russia launched its wide-ranging attack on Ukraine, international commodity prices surged starkly, and supply chains are still highly disrupted, amplifying existing inflationary pressures. Hence, the expected downward pace of inflation slowed compared to the pre-war forecast. Concurrently, real GDP will grow by 4.5% this year. This is driven by domestic consumption that reflects the maintenance of high credit growth.

Against this backdrop, the baseline forecasts are characterized by a high degree of uncertainty. In general, the alternative risk scenario considers a realization of the most probable risks. The current alternative forecast envisages a prolongation of the war, as compared to the baseline, resulting in a tightening of sanctions against Russia. Under such a scenario, the trend of rising commodity prices on international markets will be prolonged. Moreover, external demand in the goods and services sectors will be lower, resulting in a deterioration of the current account balance and a depreciation of the exchange rate. As a consequence, other things being equal, supply-side factors and external demand will exacerbate inflationary pressures, leading to a further tightening of monetary policy and, subsequently, to a relatively long-term tightened stance.

2.1 BASELINE MACROECONOMIC FORECAST

Starting from the current quarter, inflation will start to decrease, albeit at a slower pace than the pre-conflict forecast. Inflation is expected to approach the target by the second quarter of 2023.

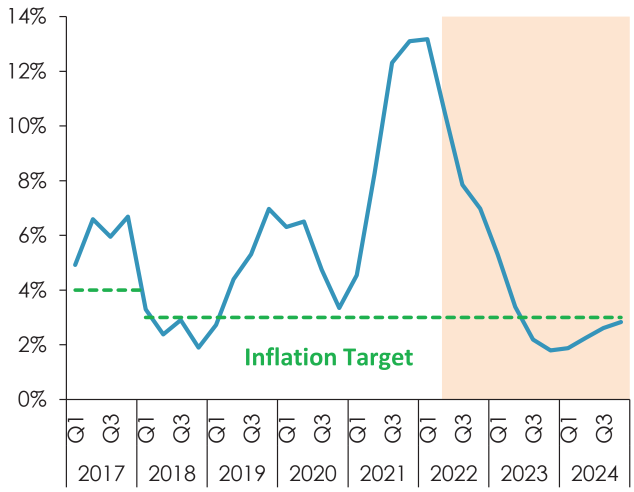

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat.

The inflationary risks posed by the post-pandemic period have been further amplified by Russia's unjustified military aggression against Ukraine. Hence, inflationary pressures have intensified in Georgia in the short-run, and the projected point at which inflation will converge with its target has been prolonged. Based on the updated baseline macroeconomic forecast, inflation will start to fall from the current quarter, albeit at a slower pace than as previously predicted. Other things being equal, inflation will approach the target by the second quarter of 2023 (see Figure 2.1.1). The exhaustion of the base effect of the subsidies on utilities will put downward pressure on inflation from the current quarter.

The historical and projected higher-than-targeted inflation are fueled by supply-side factors that are independent of monetary policy. In particular, the sanctions imposed against Russia in response to the outbreak of the war served to elevate pressure on international commodity prices, particularly on oil and food commodities, of which Russia and Ukraine are key exporters. At the same time, regional transportation costs remain high due to shipping-related challenges. Shipping costs are expected to remain high so long as the war continues. The aforementioned factors encourage suppliers to increase prices and put upward pressure on inflation expectations (see Figure 2.1.2). On the other hand, the appreciation of the GEL against major trading partner currencies and the USD will help align inflation with the target through the direct imported inflation and input costs channels.

Higher-than-targeted inflation is largely driven by supply-side factors. Other things being equal, the impact of these factors will gradually be eliminated from the current quarter.

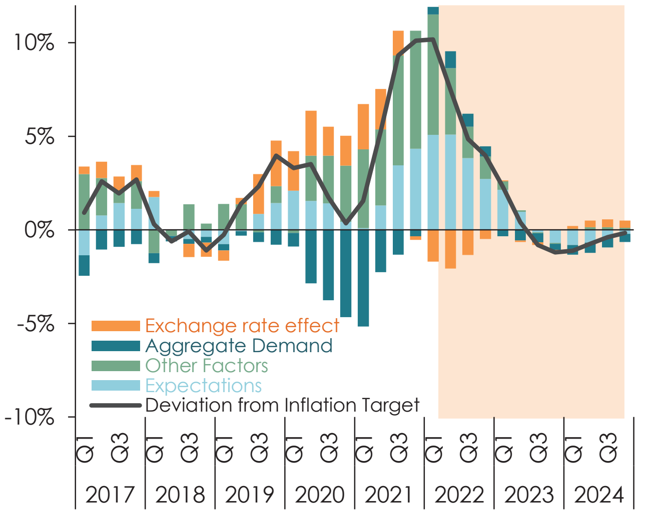

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat.

In 2022, the post-pandemic recovery process will be slower due to the military actions against Ukraine. Real GDP is expected to grow by 4.5%, with domestic demand, driven by strong credit growth, being the key contributor to that growth.

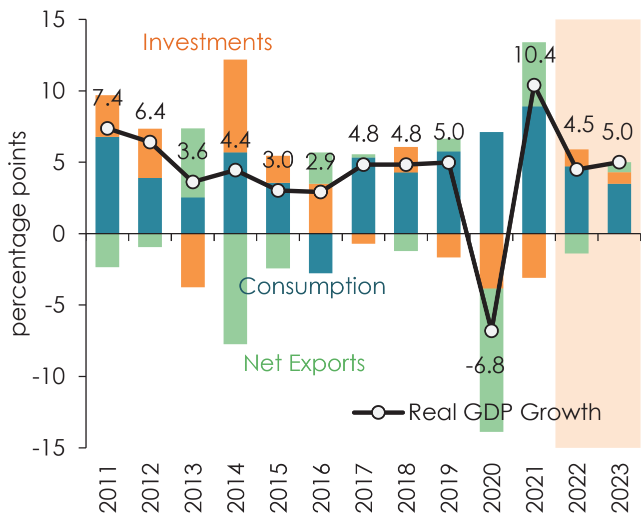

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat.

Intensified inflationary pressures require a tightened policy stance to be maintained for a relatively long-term period. As mentioned, the current inflationary pressures are caused by temporary exogenous supply-side shocks. Other things being equal, central banks do not usually respond to supply-side shocks, since the effects of such risks are exhausted by themselves. Under such shocks, a monetary policy reaction can create additional economic fluctuations and strengthen uncertainties, thereby complicating the anchoring of inflation. However, in the current situation, the strong supply-side shock has elevated inflation expectations and creates so-called "second-round" effects. Furthermore, amid the various shocks experienced over the last couple of years, inflation has been deviated from the 3% target for a long time, which serves to further amplify long-term inflation expectations. The NBG will thus maintain tight monetary policy to curb inflation expectations. Subsequently, the policy rate will gradually decline in line with falling inflation expectations before approaching the neutral level (which is currently estimated at 6.5%) in the medium term.

Amid the ongoing war, external inflows from Russia and Ukraine, two of Georgia's most important trading partners, are expected to drop. Concurrently, the war puts upward pressure on regional and sovereign risk premia, hindering inflows of foreign investment. Consequently, the post-pandemic recovery process will slow down and real GDP is expected to grow by 4.5% in 2022 (see Figure 2.1.3). The major driver of economic growth will be domestic consumption in the wake of high credit growth.

Against the background of Russia's invasion of Ukraine and the full-scale military conflict, risks are high. Their realization will lead to a deviation from the baseline macroeconomic forecast. Moreover, as the risks are mainly inflationary, monetary policy remains prone to tightening.

Macroeconomic Forecast Risks	Impact on Inflation
Prolongation of the war, tightening of sanctions against Russia	↑
Upward trends in product prices on international markets being maintained	↑
Upward trends in international transportation costs being maintained	↑
Higher-than-expected interest rate hikes in advanced economies	↑
Stronger-than-expected domestic demand	↑
A faster-than-expected recovery of tourism	↓
Low Risk	High Risk
↑	Upward Pressure on Inflation
→	Same Level of Inflation
↓	Downward Pressure on Inflation

Table 2.1.1 Baseline macroeconomic forecast Risks.

2.1.1 BASELINE FORECAST SCENARIO RISKS

Against the background of Russia's invasion of Ukraine and the resulting full-scale military conflict, macroeconomic forecasts have become characterized by a high degree of uncertainty. In an economy still in the process of the post-pandemic recovery, this new shock has mainly created inflationary risks, which, if realized, would lead to a deviation from the baseline macroeconomic forecast.

The duration of the Russia-Ukraine war and the potential outcomes and resolution of the conflict are major sources of uncertainty. A later-than-expected end of the full-scale conflict would directly weaken the already war-damaged trade and financial channels, and would further increase the region's risk level, as well as the likelihood of supply restrictions and the imposition of additional sanctions against Russia. As a result of these developments, external inflows may be reduced to a greater extent than expected and supply constraints may be exacerbated, creating an additional shock to the economy. The latter will then be transmitted to the real sector by declining net exports and to inflation by rising inflationary expectations, commodity prices, and intermediate costs. In turn, the increased risk premia in the region and the reduction in foreign inflows, ceteris paribus, put pressure on the exchange rate to depreciate.

Rising commodity prices on international markets still pose a significant risk to macroeconomic forecasts. Increased prices have already affected the local market. Against the background of rising oil prices, a sharp rise in fuel prices is particularly noteworthy. If this trend in commodities prices is maintained, in light of high inflation for a protracted period, high inflationary risks are also posed by the inflation expectations channel. This, in turn, threatens the stability of long-term inflation expectations and highlights the need for an additional monetary policy response.

The disruption to supply chains was also reflected in rising product prices. If the trend of increasing global transportation costs continues, the pressure on inflation may increase.

If the aforementioned shocks raise inflation forecasts more than expected, there will be a necessity for higher interest rate hikes in developed economies (especially in the US), despite the accelerated normalization of the monetary policy rate. In Georgian-type open economies, this puts pressure on capital outflows and, consequently, can lead to depreciation in the foreign exchange market. Furthermore, given the high level of dollarization in the economy, a materialization of this risk will have a significant impact on inflation through the inflation expectations and input costs channels.

Inflationary risks can also be generated by strong

The inflation forecast for the short-term has been revised upward. Increased regional and global inflationary pressures resulting from the full-scale Russia-Ukraine war have driven the increased inflation outlook.

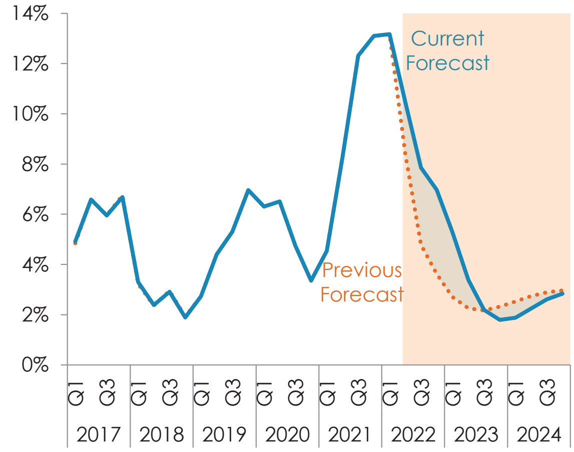

Figure 2.2.1. Changes in the forecast of headline inflation
Source: NBG, Geostat.

The real GDP growth forecast for 2022 has been reduced to 4.5%.

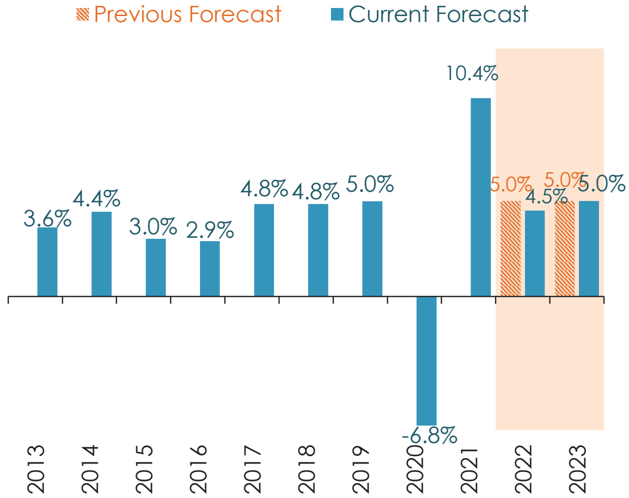

Figure 2.2.2. Changes in the forecast of real GDP
Source: NBG, Geostat.

According to the updated forecast, Against the background of Russia's invasion of Ukraine, the key macroeconomic parameters of trading partner countries have deteriorated.

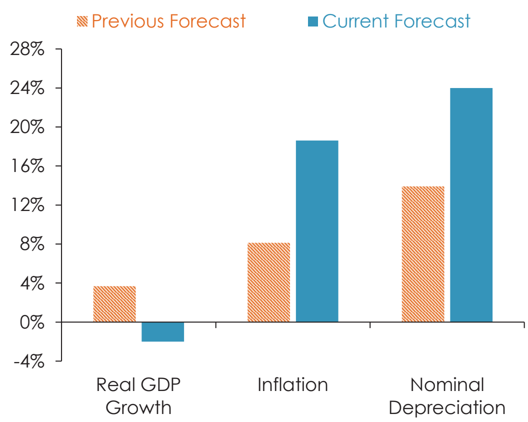

Figure 2.2.3. Changes in the forecast of external assumptions for 2022
Source: Bloomberg.

domestic demand. The high economic growth observed in the previous year has eliminated the negative output gap. Consequently, at this stage, despite an expected slowdown in economic growth, a realization of higher domestic demand, as compared to the baseline scenario, will increase inflationary pressures.

Higher-than-expected foreign demand would also lead to deviations from the baseline scenario, but this would be a positive shock. In particular, a faster-than-expected recovery of tourism would improve the current account deficit and, ceteris paribus, through the exchange rate channel, would reduce inflation and inflation expectations. It would also help improve the potential level of GDP.

2.2 COMPARISON TO THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). Increased regional and global inflationary pressures resulting from the full-scale Russia-Ukraine war have driven the increased inflation outlook. Despite the increased risks, the inflation forecast has a downward trajectory. As in the previous projection, the elevated level of inflation will start to gradually decline as temporary supply-side disruptions are eased.

The open military conflict between two of Georgia's main trading partners has increased pressure on the current account and regional risk premia, and amid supply restrictions and sanctions against Russia, commodity prices on world markets have risen sharply. Among the latter, the impact of oil and food prices on local consumer prices is noteworthy. In turn, in light of inflation remaining high for a protracted period, high inflationary pressures serve to increase inflation expectations, appearing to be an important driver of change in the inflation forecast.

The real GDP growth forecast for 2022 has been reduced to 4.5% (see Figure 2.2.2). The assumptions and expectations behind the projected economic growth have changed. In particular, given the current situation, the normalization of the current account deficit to pre-pandemic levels will be delayed, while the increased risk premia in the region will have a negative impact on the forecasted level of investments.

Georgia is a small open economy, and the economic stances of its trading partners thus have a significant influence. Macroeconomic forecasts thereby strongly depend on assumptions regarding the economic growth, inflation, and exchange rates of trading partners.

According to the updated forecast, against the background of Russia's invasion of Ukraine, the key macroeconomic parameters of trading partner countries have deteriorated (see Figure 2.2.3). These changes are largely explained by factors related to the war, but in analyzing the inflation of trading partners, along with the effects

Under the alternative scenario, external demand will severely fall, and foreign investment inflows will be lowered as a result of a protracted war. The economy will thus grow by 2% in 2022.

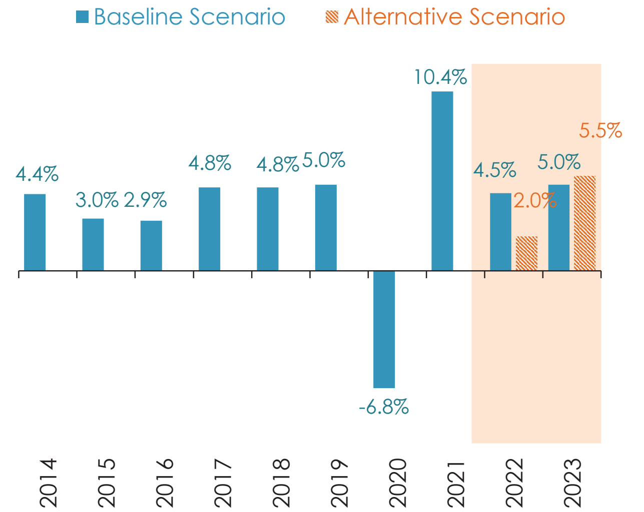

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat.

Under the alternative scenario, inflationary pressures will intensify due to the exchange rate depreciation, an upsurge in international commodity prices and amplified inflation expectations. Inflation in 2022 will thus be 1.1 pp higher than in the baseline scenario.

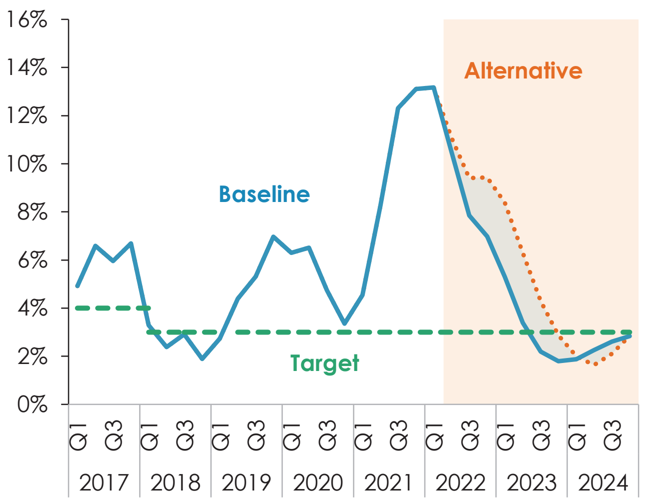

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat.

of rising global commodity prices and the depreciated exchange rate, Turkey's high-inflation environment also plays an important role.

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative forecast scenario considers a realization of the most probable risks to the baseline macroeconomic forecast. In particular, the current alternative scenario envisages an escalation of geopolitical tension stemming from a protracted war, resulting in tightened sanctions against Russia. In this case, external demand for Georgian goods and services will fall significantly compared to the baseline scenario. Furthermore, a prolonged war will put further upward pressure on regional and sovereign risk premia, elevating the risks of further capital outflows and hindering the inflow of foreign investment. Realization of this scenario in tandem with a tightened monetary policy position will cause a severe drop in economic activity. Ultimately, the economy will grow by 2% in 2022 and by 5.5% in 2023 (see Figure 2.3.1).

Under the realization of such a risk scenario, external demand will fall as a result of a sharper drop in exports of goods and services as compared to imports, reflecting relatively strong domestic demand. Consequently, the current account balance will deteriorate, which, in turn, will intensify pressures on the exchange rate. The prolongation of the war and the corresponding tightening of sanctions will be reflected in a further rising of commodity prices on international markets. In addition, increased regional shipping costs will further increase in the wake of disrupted supply chains. These factors will elevate inflation expectations. Hence, according to this alternative scenario, inflation will be 1.1 pp higher in 2022 than under the baseline scenario (see Figure 2.3.2).

Under the aforementioned scenario, monetary policy will be significantly tightened and this contractionary stance will be maintained for a relatively long period. The monetary policy rate trajectory will thus see a hike of 2.3 pp in 2022 compared to the baseline forecast (see Figure 2.3.3). However, alongside the end of the war in Ukraine and the neutralization of negative pressures from external sectors, the policy rate will start to decrease. Ultimately, as a result of adopting an appropriate monetary policy response, inflation will approach the 3% target over the medium term.

In response to increased inflationary pressures, the monetary policy stance will be tightened. The monetary policy rate trajectory will shift upwards by 2.3 pp compared to the baseline in 2022.

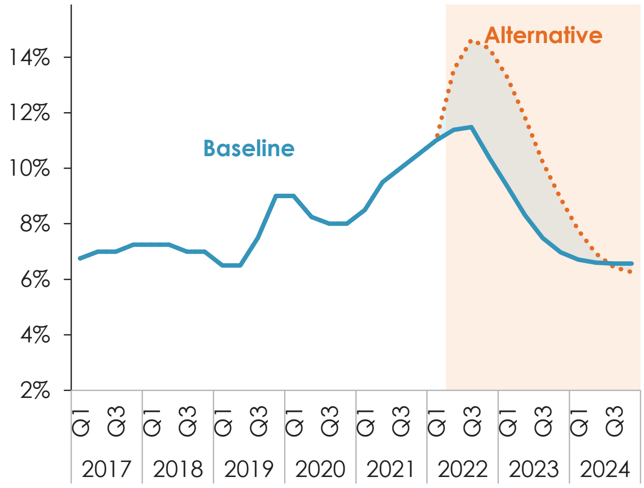

Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: NBG.

Financial market participants have revised their inflation expectations upward in the short run, whereas their medium-term expectations are gradually approaching the target (3%). However, it should be noted that inflation forecasts are characterized by significant variability, which is reflective of intensified inflationary risks.

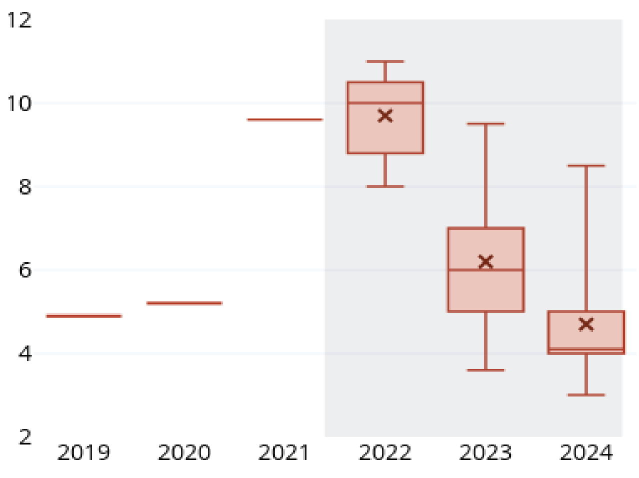

Figure 2.4.1. Actual average inflation (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the second quarter of 2022, 10 financial organizations participated in a survey of macroeconomic forecasts. The results depict sharp changes in economic expectations on the financial market for 2022-2024 as compared to the pre-war period.

In particular, both median and average inflation expectations have been significantly revised upward. The median of inflation expectations for 2022 went up by 3 pp compared to the previous quarter and amounted to 10%, while the average inflation forecast increased by 2.8 pp to 9.7%. Meanwhile, the median forecast for 2023 shifted up by 1.8 pp to 6%, while the average was higher by 1.6 pp to equal 6.2%. As for 2024, the median of inflation expectations rose by 0.6 pp compared to the previous survey to reach 4.1%, while the average inflation forecast stands at 4.7%, which is 1.1 pp higher than the pre-war indicator (see Figure 2.4.1). It should be noted that inflation expectations are characterized by high variability amid increased uncertainty.

Market participants have revised their monetary policy forecasts upward compared to the previous quarter amid amplified inflationary pressures. Specifically, their median and average projections for monetary policy in 2022 increased by 1.3 pp and 1.5 pp to 10.8% and 10.7% respectively. Similarly, the median forecast for 2023 is 1.4 pp higher and equals 9.4%, while the average forecast has shifted up by 1.1 pp to reach 9.1%. The monetary policy outlook for the financial market is slowly approaching a neutral level in line

The monetary policy rate (MPR) is expected to fall in the wake of descending inflation expectations in the medium term. However, expectations are characterized by high variability due to rising uncertainties.

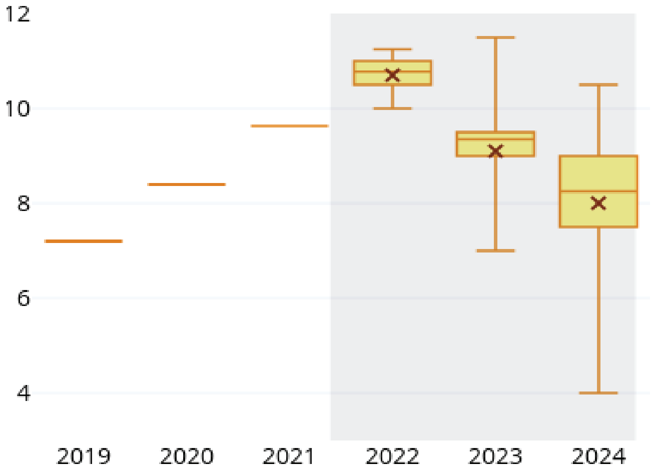

Figure 2.4.2. Actual monetary policy rate (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants.

The median and average market forecasts for economic growth have deteriorated compared to the pre-war period. However, these projections are highly variable.

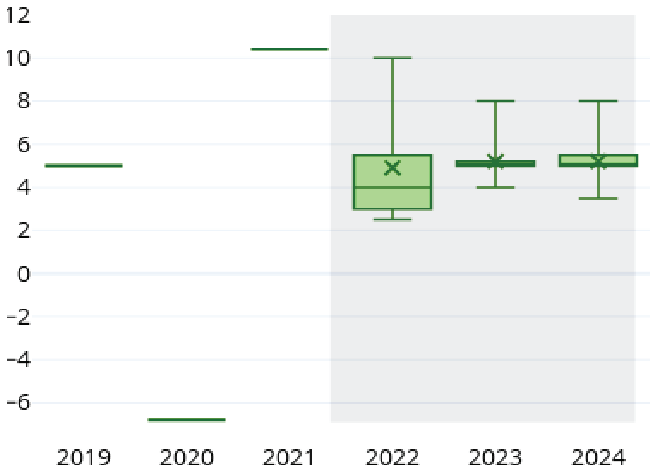

Figure 2.4.3. Actual real GDP growth (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

with curbing inflation expectations. In particular, the median forecast for 2024 increased by 0.8 pp, while the average rose by 0.6 pp, reaching 8.3% and 8% respectively (see Figure 2.4.2). Akin to inflation expectations, monetary policy forecasts show a high degree of variability.

Regarding economic growth, market forecasts for real GDP growth in 2022, similar to the NBG's forecast, have deteriorated compared to the previous quarter. Specifically, the median real GDP forecast decreased by 2 pp to 4% and the average by 1.5 pp to 4.9%. The median and average projections for economic growth in 2023 fell by 0.2-0.3 pp, reaching 5% and 5.2% respectively. The median forecast for 2024 has not changed since the previous quarter and amounts to 5%, while the average forecast increased by 0.1 pp and equals 5.2% (see Figure 2.4.3).

At this stage, we are presenting aggregate survey results of the macroeconomic forecasts made by market participants. However, since the official statistics for all three variables are available on the webpages of the National Bank and GeoStat, in the second quarter of each year, the NBG names the best financial forecaster organization. The indicator used to evaluate the accuracy of the forecasts is an average root mean square error (RMSE). The organizations with the lowest RMSE are named as the best forecasters. Having evaluated the results in 2021, the NBG revealed that the forecasts provided by TBC Capital were distinguished by having the smallest RMSE.

3 MONETARY POLICY

Elevated inflation and inflationary risks remain a global challenge. While inflationary processes had been envisaged to stabilize in 2022, the Russian war against Ukraine has created new risks. A global surge in prices was transmitted to the Georgian market and inflation stood at 12.8% in April. Had the Russia-Ukraine war not materialized, a sharp deceleration in inflation would have been expected. As a result of the military actions by Russia in Ukraine, prices of a number of product categories have risen sharply on international markets. Among these, increased prices of fuel and oil products have been transferred to the Georgian market and are driving inflation up. As a result, inflationary pressures have intensified, which in turn poses a risk of raising medium-term inflation expectations. According to the current forecast, other things being equal, inflation will follow a declining path, but it will remain high over the course of the year. Taking these factors into account, in order to eliminate additional inflationary pressures and reduce the risk of medium-term inflation expectations, on 11 May 2022 the Monetary Policy Committee decided to maintain its tight monetary policy stance and left the policy rate unchanged at 11%. Monetary policy will remain tight until the risks to rising inflation expectations are sufficiently mitigated.

To eliminate additional inflationary pressures and reduce the risk of medium-term inflation expectations, on 11 May 2022 the Monetary Policy Committee decided to maintain a tight monetary policy stance and left the policy rate unchanged at 11%.

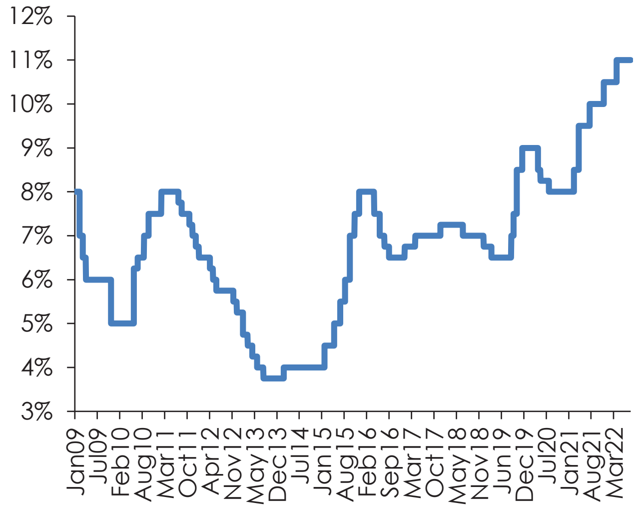

Figure 3.1. Monetary policy rate

Source: NBG.

Developments occurring in early 2022 posed new challenges to the world. In particular, as a result of Russia's invasion of Ukraine, the world economy, which is still in the process of a post-pandemic recovery, was placed in a difficult situation. Following this new shock, the demand-supply imbalance on the international market deepened, energy resources became more expensive, and additional supply-side disruptions occurred. As a result, global inflation has risen sharply. Inflation in the USA was 8.5% in March, which is the highest level in 40 years. Inflation in the eurozone was at a record level of 7.5%. High inflation was also recorded in the Baltic countries: in March 2022, Estonia had inflation of 12.0%, Lithuania of 15.7%, and Latvia of 11.5%. This high-inflation environment is a particularly significant challenge for Georgia as well. As a result of simultaneous shocks, inflation has long exceeded the target level and this poses a risk of rising medium-term inflation expectations. In early 2022, the expected downward trend of inflation slowed down, which was mainly due to the acceleration of price growth dynamics on international commodity markets. However, it should be noted that the recent strengthening of the nominal effective GEL exchange rate has somewhat eased the pressure from international markets.

In response to the increased risks, and to reduce medium-term inflation expectations, on 11 May 2022 the Monetary Policy Committee decided to maintain a tight monetary policy stance and left the policy rate unchanged at 11%. Monetary policy will remain tight until the risks of rising inflation expectations are sufficiently mitigated.

The global surge in prices was transmitted to the Georgian market as well and, despite a slowdown compared to the beginning of the year, inflation in Georgia remains high at 12.8%. Had the aforementioned shock not materialized, a sharp deceleration in inflation would have been expected. Against the backdrop of the war in Ukraine, the outlook of the external sector is highly uncertain. However, at the same time, the recent appreciation of the lari has supported a decrease in imported inflation. Moreover, while nominal wage growth rates have recently increased, total productivity is improving as well, meaning that there are no significant pressures on prices stemming from the labor market at this stage. According to the current forecast, other things being equal, inflation will remain high over the course of the year; however, it will have a declining trajectory once the one-off effects of last year are phased out.

Other things being equal, central banks do not respond to increased inflation due to supply shocks by tightening monetary policy. However, in the current situation, the supply-side shocks are strong and various exogenous shocks have lasted over a prolonged period. In response, the monetary policy rate has gradually been increased over the past year and monetary policy remains in a tightened phase. Under conditions of strong supply shocks, maintaining a low level of long-term inflation expectations is relevant. At the same time, the risks are inflationary, both geopolitically and in terms of a faster-than-expected tightening of global financial conditions. In response to rising inflationary risks, the gradual increase in the monetary policy rate over the past year has led to a tight monetary policy stance. Monetary policy will keep a tightened orientation until the risks of rising inflation expectations are sufficiently mitigated.

As for aggregate demand, according to preliminary data, real GDP growth was 14.4% in the first quarter of 2022. The main driver of economic growth is still strong domestic consumption, which is the result of credit activity and fiscal stimulus. At the same time, the gradual resumption of tourism has had a positive impact on economic activity. According to the revised forecast, the economy is expected to grow by about 4.5% in 2022. However, it should be noted that given the course of current events, uncertainty in the forecast is particularly high.

Both Russia and Ukraine are major trading partners of Georgia and the current situation resulting from their conflict is transmitted directly to the economy of Georgia. The sanctions imposed on Russia shrink its economy, while the Ukrainian economy is falling sharply as a result of the war. These factors negatively affect the foreign demand of Georgia and export revenues from both countries have declined. However, it should be noted that, despite the geopolitical situation, exports have continued to rise and in March these increased by 26.3% annually, which exceeded pre-pandemic levels. At the same time, revenues from international travelers continue to grow as a result of the easing of pandemic-related restrictions. These revenues rose approximately six-fold in March, although they are still well below pre-pandemic levels; compared to March 2019, they are down by a significant 28.7%. Imports have also increased against the backdrop of higher domestic demand, with 15.6% year-on-year growth being observed in March 2022, reflecting an increase of about 13.9% compared to the corresponding period of 2019.

Despite the tightening of monetary policy , credit activity remains strong, due to both consumer and foreign currency loans. In response, the NBG will keep the remuneration of reserve requirements on funds borrowed in US dollars at 0%, even as the Fed's funds rate increases. If necessary, in order to reduce the growth in foreign currency (FX) loans, the NBG may also introduce additional measures, including an increase in the upper bound of FX reserve requirements (currently at 25%). At the same time, recent macroprudential measures are expected to support a slowdown of the current high growth in consumer lending.

The dollarization of deposits and loans continues to decline. This is largely as a result of larization measures, including the use of a number of macroprudential instruments.

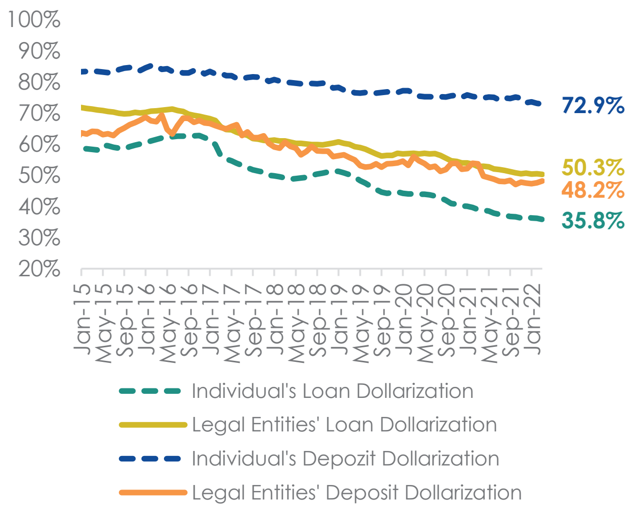

Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG.

Despite a significant decline, dollarization remains a challenge for the financial sector. In addition to limiting the effectiveness of monetary policy, dollarization also carries risks to financial stability. At the same time, it affects the risk premium of the country and hinders the improvement of credit ratings. The NBG thus continues to constantly analyze dollarization dynamics and will respond appropriately where necessary. It is important to note that, as a result of the NBG's larization (de-dollarization) policy, the dollarization of loans and deposits is gradually declining, which also reduces the currency and related credit risks of individual borrowers.

The dollarization of total loans decreased by 2.5 pp (excluding the exchange rate effect) and stood at 50.3% in March 2022. The dollarization of deposits of individuals and legal entities also decreased by 1.7 pp to 59.7% (excluding the exchange rate effect) over the same period, this was also facilitated by the high differential between interest rates on GEL and foreign currency deposits.

To ensure the efficiency of monetary policy, it is important that changes in the monetary policy rate are reflected on interbank interest rates and ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. When necessary, commercial banks generally obtain additional liquidity through refinancing loans, which is the main instrument of the NBG. In addition, the NBG provides liquidity support through temporary instruments, such as swap operations and a liquidity supply instrument to facilitate lending to small- and medium-sized businesses. These temporary instruments are also made available to microfinance organizations through banks. It should be noted that the validity period of FX swap operations expired on 15 April 2022, and the stand-by swap instrument, which was valid until 1 May 2022, will still be available until the Board of the NBG decides on its termination.

Interbank money market rates vary around the monetary policy rate, which is the result of a good liquidity management framework.

The NBG provides the required amount of liquidity to ensure that interest rates on the interbank money market vary around the policy rate.

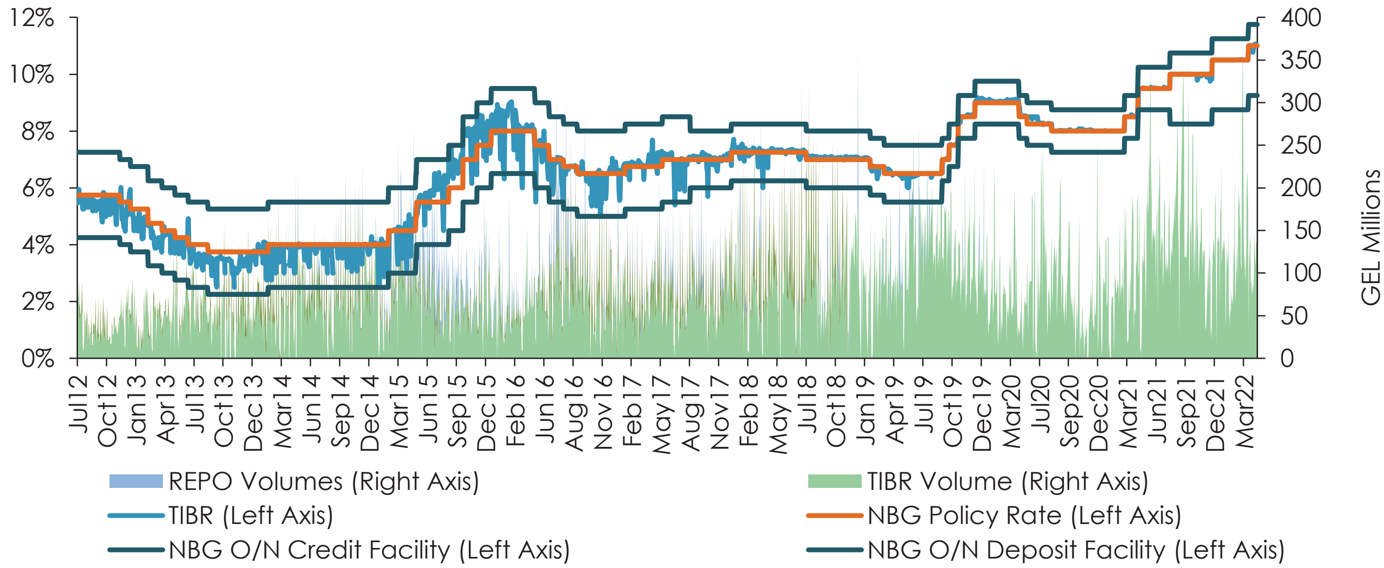

Figure 3.3. Interbank money market

Source: NBG.

BOX 1. FACTORS AFFECTING LIQUIDITY

The amount of liquidity available to the financial sector is influenced by many different factors, such as government operations, demand for cash, and FX interventions. To manage financial sector liquidity and to support the monetary policy transmission mechanism, the NBG has both liquidity supply and liquidity absorption tools. For almost the last ten years, the financial sector has been operating under a structural liquidity deficit.[7] Consequently, the main monetary policy tool for supplying liquidity is the refinancing loan instrument.

In general, the liquidity of the banking sector fluctuates widely in the short run. In order for these fluctuations not to be reflected in interest rate fluctuations, the supply of liquidity needs to be in line with demand. The NBG provides the required amount of liquidity that is demanded under the current interest rate. Also, it should be noted that refinancing loans are issued in exchange for appropriate collateral (government securities, etc.). For a long period of time, until 2014, the financial system operated under structural surplus conditions. Thus, because the monetary policy rate is the refinancing rate, until 2014 the National Bank took liquidity from the system with certificates of deposit to increase demand for the refinancing instrument and, consequently, enhance the effectiveness of monetary policy. However, the reduction of the structural liquidity surplus started in 2013 and gradually shifted to a structural deficit in 2014. Consequently, this naturally increased the demand for refinancing loans as an instrument to meet the liquidity demands of the financial system, without absorbing liquidity from the system with certificates of deposit.

7 A structural liquidity deficit means that without the short-term market operations of the central bank (e.g., refinancing loans), the financial system would have less liquid balances than required. Structural liquidity deficits are a normal part of the financial system, and many countries are in this position – except, for example, countries with quantitative easing policies (which involve the purchase of long-term assets by central banks to supply local currency liquidity) or those that seek the active accumulation of foreign exchange reserves (which also assumes the supply of local currency liquidity).

The transition of the financial system to structural deficit conditions in 2014 and, consequently, the natural increase in demand for refinancing loans was a result of two main factors: FX interventions by the NBG and the growing demand for cash.

1. When the NBG sells foreign currency at FX auctions in exchange for GEL, the GEL liquidity in the financial system decreases and vice versa. For example, in 2006-2007, the NBG actively bought foreign currency through FX interventions, which was an important source for the GEL liquidity supply. Consequently, the absorption of liquidity was more relevant at this time and was achieved through sales of certificates of deposit. On the other hand, since 2014, against the exchange rate depreciation, the NBG has sold a significant amount of foreign currency, which has reduced the GEL liquidity (and increased the structural liquidity deficit). In response, in order to ensure the smooth functioning of the banking system, banks are filling their liquidity shortages with refinancing loans (see Figure 3.4).
2. In addition, with the steady increase in income, the population increases consumption, which, in turn, leads to a relatively high demand for cash. This is a consequence of long-term economic growth. Demand for cash is also growing as the financial sector deepens and access to financial resources increases. At the same time, the increase in GEL cash demand for is partly an indicator of the transition of entities from foreign currency to GEL (the larization of cash). The increase in demand for cash in circulation reduces the liquidity of commercial banks and, consequently, the demand for refinancing loans naturally increases.

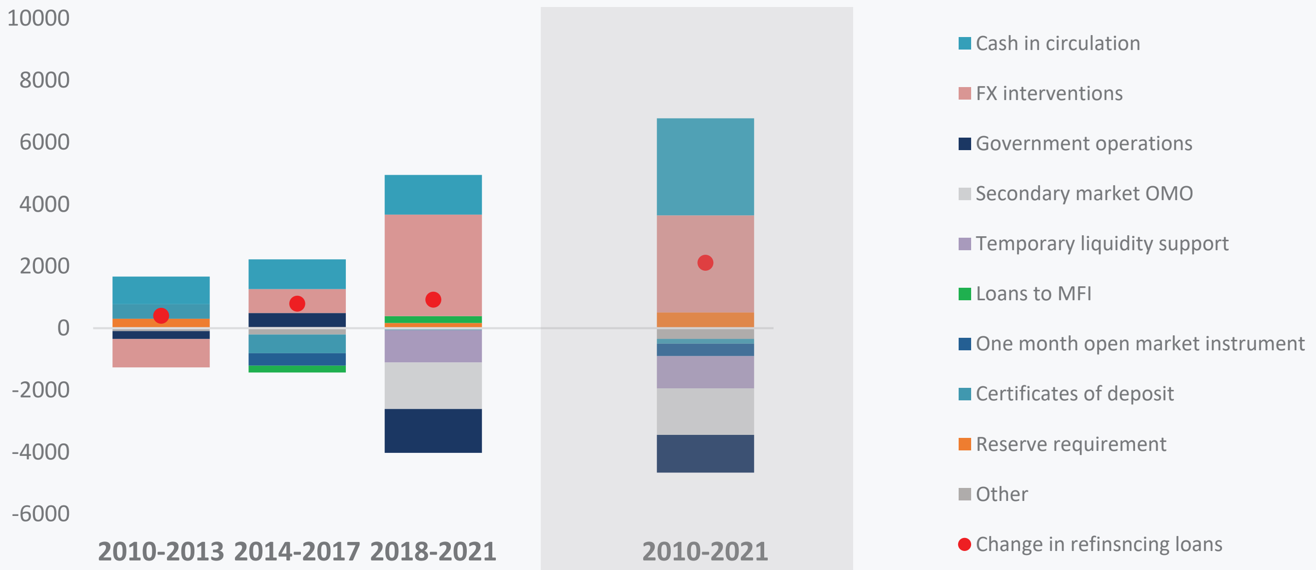

Figure 3.4. Change in refinancing loans and its decomposition by factors

Source: NBG.

In terms of liquidity demand, the impact of government operations in certain periods should also be considered; in some cases, these have increased the liquidity of the financial sector, and in others have decreased it. For example, in 2010-2013 a major part of the budget deficit was financed by external debt, which increased the money supply. In following years, in line with the government's strategy, the financing of the budget deficit with domestic debt increased. In this case, the government was buying treasury bonds, thereby reducing GEL liquidity. In 2014-2017, against the reduced GEL liquidity, demand for refinancing loans increased.

To summarize, the activation of demand for liquidity and, consequently, for refinancing loans, especially since 2014, was mainly due to the sale of foreign currency by the NBG through FX interventions and the increase in demand for cash. As Figure 3.4 shows, the increase in FX interventions and the demand for cash (which increase the demand for liquidity) over these years has outpaced other instruments of liquidity delivery, leading to an increased use of the refinancing loan instrument (represented by the large red dots on the chart). As a result, the need for the NBG to absorb liquidity by certificates of deposit was replaced in 2014 by the need to provide liquidity through refinancing loans, so that the amount of liquidity held by the financial system would remain equal to the demand for that liquidity. As noted above, equality between liquidity demand and supply is an important condition for the stability of short-term market interest rates and, consequently, for the effectiveness of monetary policy.

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