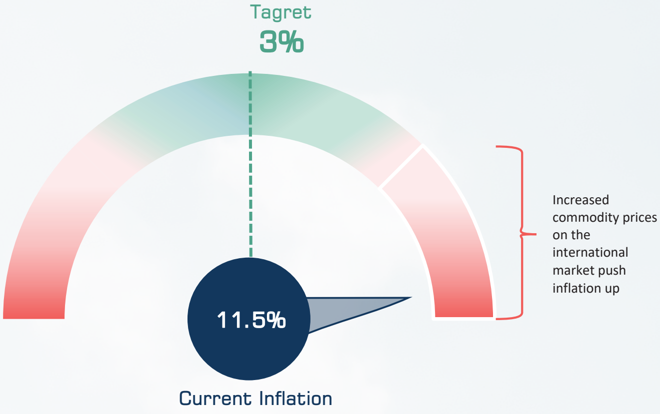
Monetary Policy Report

August

2022

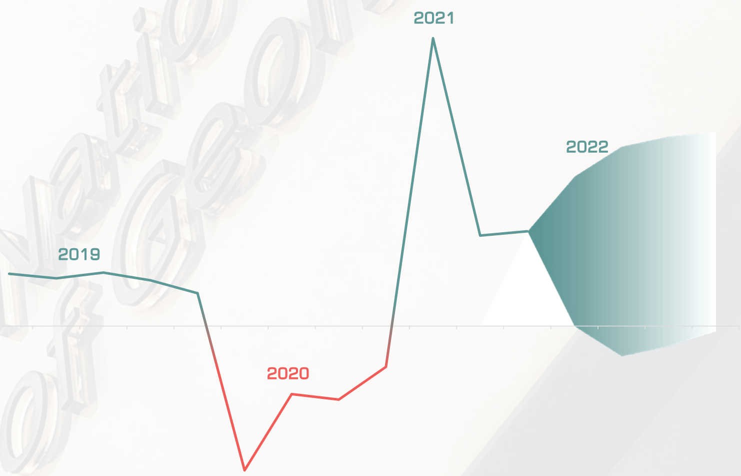
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



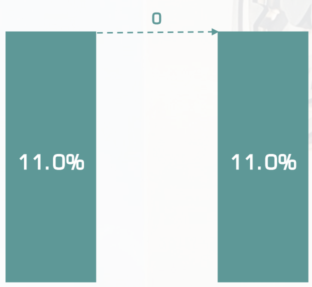
11.5%	Against the background of a sharp rise in international commodity prices, inflation is much higher than the target.

Economic Growth



In the first half of 2022, economic activity will continue to rally and see a fast recovery.	9%

Monetary Policy



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

MONETARY POLICY DECISION

The National Bank of Georgia's monetary policy has been maintained at a tight stance, with the policy rate held at 11.0%.

The role of the National Bank of Georgia (NBG) is to affect aggregate demand and inflation expectations by changing the interest rate so that inflation, in the medium term, remains near its target level of 3%. Low and stable inflation supports employment and stable economic growth, which is something that has gained increased importance in the current uncertain environment.

The hostilities launched by Russia against Ukraine and the corresponding sanctions imposed on Russia have led the world economy to face significant new challenges. Due to the important role of both Russia and Ukraine in international trade, supply chains have been weakened. Moreover, international sanctions, which, among other things, restrict the purchase of Russian energy resources, have increased the price of fuel compared to the pre-war period. In the wake of these developments, high inflation has become a global problem. Georgia is no exception to this and inflation remains at a high level. The strong global inflationary shock significantly complicates central banks' policy decisions, as strict monetary policies become necessary to reduce inflation. According to the World Bank's forecasts, higher interest rates and tighter financial conditions are expected worldwide.

In parallel with these developments, economic activity in Georgia is high and continues to grow at a rapid pace. This has been facilitated by a record level of remittances received from Russia in recent months, alongside a restoration of tourism and credit activity. Against the background of intensified demand, economic activity has recently increased above its long-term potential level and has thus posed risks of putting additional pressure on inflation. Despite this strong inflationary shock, as a result of maintaining a tight monetary policy and with the exhaustion of temporary supply-side shocks, inflation will gradually decline in 2022, albeit at a slower pace than predicted in the previous forecast. Other things being equal, inflation will gradually approach the target level from the second half of 2023.

In line with inflation expectations and increased inflation risks, the NBG's tight monetary policy has been maintained and the monetary policy rate has been held at 11%.

Changes in interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If additional factors amplifying inflation expectations become apparent, the monetary policy stance might need to be further tightened or maintained at the current high level for a longer period. In addition, in order to avoid inflationary pressure arising from high credit activity and strong demand, the NBG considers it appropriate to use additional instruments.

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 inflation rate will be close to the 3% target in the medium term.

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BRIEF OVERVIEW

The continuation of the Russia-Ukraine war, higher global commodity prices, still-elevated international shipping costs, and stronger-than-expected local aggregate demand – especially in the last quarter – have all put additional pressure on inflation. As a result, inflation this year will be higher than estimated in the previous forecast, and its convergence toward the target will be delayed until the second half of 2023. Although unexpectedly strong foreign currency inflows are an important factor behind the growth of aggregate demand, they have also strengthened the exchange rate, softening the pressure on consumer price inflation, but only partly neutralizing it. According to the current baseline forecast, in order to manage inflation expectations, monetary policy is expected to remain tight for a longer period; so that, after the exhaustion of temporary supply-side shocks, consumer price inflation will return to its target over the medium term.

In the short term, inflation will continue to be high, but it will gradually decrease and return to its target in the second half of 2023.

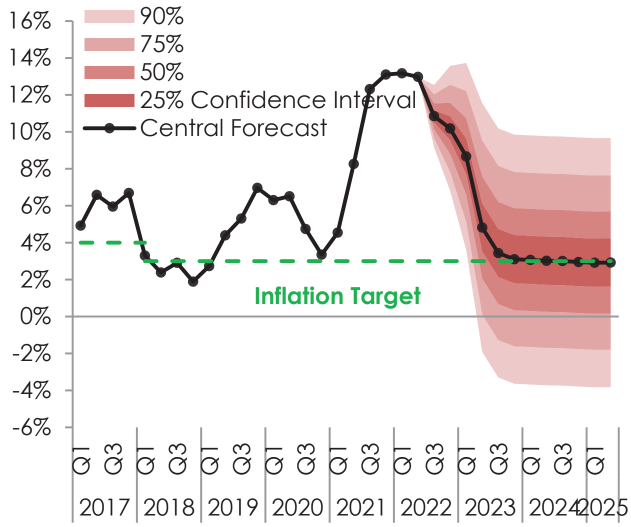


Figure 1. Headline CPI inflation forecast

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

The global upsurge in consumer prices, stemming both from the pandemic and prevailing supply-side disruptions, is now predominantly driven by factors related to the Russia-Ukraine war. In particular, due to the restriction of food exports from Ukraine and the expectation of a global shortage of oil products caused by the severe sanctions imposed on Russia, high pressure remains on international commodity markets. These are also transmitted to Georgia through the import channel, causing high inflation expectations in the short term. At the same time, inflationary pressure has been strengthened by higher-than-expected aggregate demand in the recent period. As a result, **according to the current baseline forecast, inflation in 2022 is expected to be around 11.8% on average**, and will return to its target in the second half of 2023 (see Figure 1). The gradual reduction of inflation has been caused by the automatic exhaustion of temporary supply-side factors, together with the strengthening of the exchange rate over previous periods. Furthermore, the maintenance of a tight monetary policy stance will continue to depress consumer price inflation through the reduction of both credit activity and aggregate demand.

In the second quarter of 2022, aggregate demand, contrary to expectations, increased sharply and, according to preliminary estimates, its annual growth amounted to 7.2%. This is largely related to increased migration to Georgia amid the ongoing war in Ukraine. This has led to the improvement of the external sector, and its effect on economic activity has become notable in the current period. Based on these developments and the high credit activity observed in the first half of the year, **real GDP growth in 2022 is projected at 9%** (see Figure 2). Given the relatively weak investments seen in previous years, the unexpectedly sharp and immediate nature of this growth (it should be noted that

Due to the improvement of the external sector and strong credit activity in the first half of the year, real GDP is expected to grow by 9% in 2022. Over the next few years, growth will stabilize at around 5-5.5%.

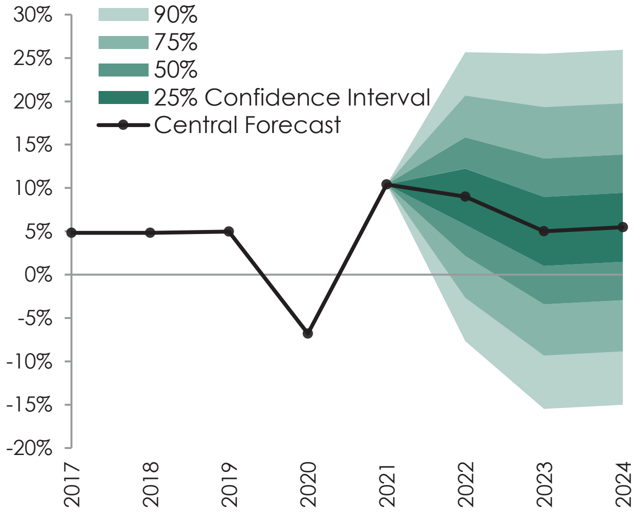


Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat.

Considering the existing risks, monetary policy has been kept at a tight stance. Its normalization will be gradual, only beginning after the reduction of inflation.

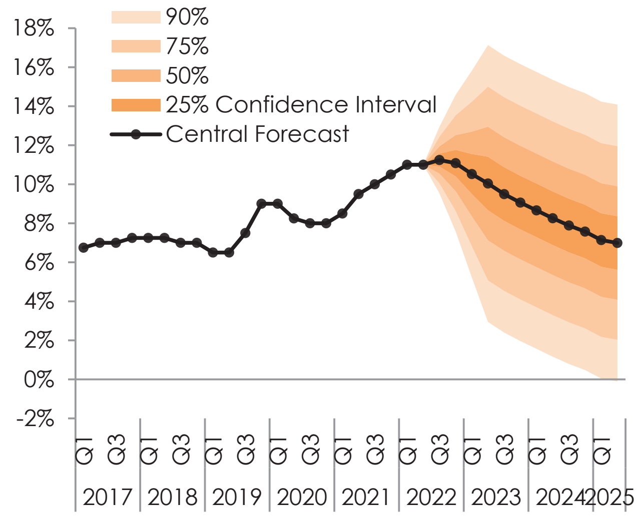


Figure 3. Monetary policy rate forecast

Source: NBG.

in the previous forecast, the expected annual growth was 4.5%) will put additional pressure on inflation.

Taking into account the above-mentioned factors and the fact that inflation has already deviated from its target for quite a long time, risks of rising inflation expectations have intensified. In response, monetary policy remains tight and will be normalized at a slower pace than previously anticipated. Additional macro-prudential measures will also help slow down lending, demand, and, as a result, inflation. Eventually, as inflation expectations stabilize, the policy rate will, over upcoming years, gradually return to its long-term neutral level, which is currently estimated at 6.5%.

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

1 CURRENT MACROECONOMIC SITUATION

The Russia-Ukraine war has had a significant impact on the global economy. In the first half of 2022, amid an aggravated demand-supply imbalance and a further deterioration of expectations, there was a sharp rise in prices on international commodity markets that was gradually reflected on consumer prices worldwide. Moreover, for many countries, the current crisis also means a slowdown in economic activity. However, in the first half of the year, external demand was strong in Georgia; revenues from exports increased, as did the number of visitors and remittances. Aggregate demand also improved on the back of credit growth. Alongside the high economic growth in the recent period and the sharp impact of exogenous factors on consumer prices, a high level of headline inflation was observed.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

After Russia's invasion of Ukraine in February 2022, the global economy, which was still recovering from the turmoil of a two-year pandemic, faced some severe new challenges. In particular, the sanctions imposed by the international community on Russia, which are intended to stop the aggressor, have created temporary difficulties for the economies of many countries. In addition, the export of commodity raw materials from Ukraine has become complicated, which has created severe delays in global supply chains. As a result, inflation rates in a number of countries have increased unprecedentedly, and monetary policy has been tightened in response to a corresponding deterioration of inflation expectations. According to the International Monetary Fund's (IMF) updated forecast of July[1], **global economic growth** in 2022 is 0.4 percentage points (pp) lower than the previous forecast[2] and equals 3.2%. 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 3.6% in 2022, and their inflation is expected to be 8.7%.

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

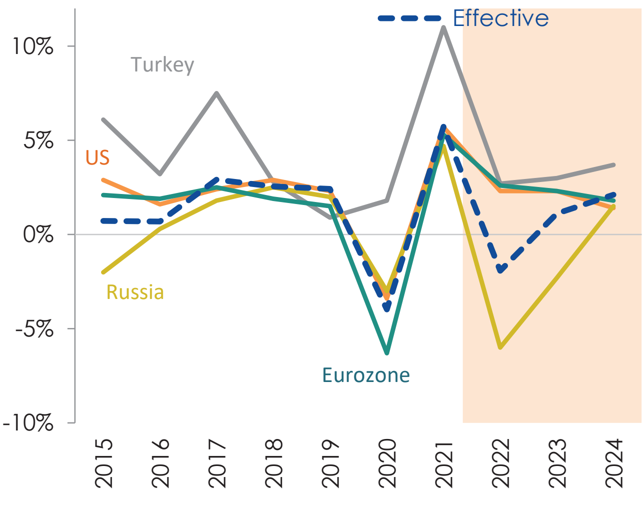


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF.

In the first half of 2022, consumer prices increased further in developed as well as in emerging and developing countries. This was mostly due to supply-side disruptions resulting from the pandemic, as well as increased demand together with the relaxation of pandemic-related restrictions and the upward dynamics of

1 *International Monetary Fund. 2022. World Economic Outlook Update: Gloomy and More Uncertain. Washington, D.C., July.*

2 *International Monetary Fund. 2022. World Economic Outlook: War Sets Back the Global Recovery. Washington, D.C., April.*

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

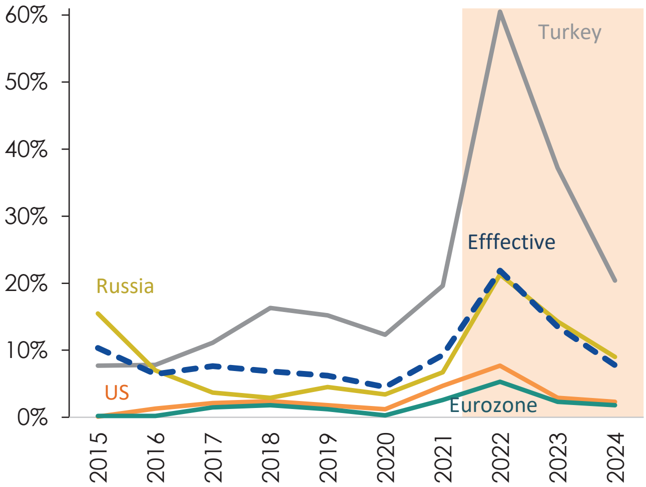


Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF.

product prices on international commodity markets. In June, the food price index increased and stood at 23.1%[3] compared to the same period last year, while the international price of a barrel of oil increased by 68% year on year to average USD 122.

In the first half of 2022, the pace of economic activity in the **United States** slowed. This was related to an increase in COVID-19 infections at the beginning of the year, a sharp increase in consumer prices as well as a tightened financial environment. 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, which represent an additional challenge for the country. Annual inflation has increased sharply and stood at 9.1% in June, the highest level in 40 years. In response to inflation expectations, the Federal Reserve has already raised the Federal Reserve rate by 1.5 pp in June 2022. According to IMF's July forecast, real economic growth in the US will be 2.3% in 2022, while inflation is expected to be 7.7%.

In the first half of 2022, the pace of improvements in economic activity in the **eurozone** slowed. The increase in COVID-19 cases earlier in the year was compounded by the Russia-Ukraine war, which led to a deterioration in consumer and business sentiment. Amid rising food and oil prices in international markets, inflation increased to 8.6% in June, which was a record high in the history of the eurozone. It is noteworthy that the packages of economic sanctions European countries have enacted against Russia, which are designed to reduce their dependence on that market, have put additional pressure on activity. According to the IMF's July forecast, real economic growth for the eurozone will be 2.6% in 2022, while inflation is forecasted at 5.3%.

In the first half of 2022, after the high growth recorded in the previous year, 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 78.62% in June. Moreover, the volatility caused by the Russia-Ukraine war has put additional pressure on the country's external sector. According to the IMF, the real GDP growth forecast for Turkey in 2022 is 2.7%, while inflation is forecast at around 60.5%.

Due to the economic sanctions imposed by the West, economic activity in **Russia** sharply deteriorated in the first half of 2022. Investments, consumer spending and retail sales were all significantly reduced. The

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

business environment has also deteriorated. Soon after starting the war, amid the sharp depreciation of the Russian ruble, and despite its subsequent strengthening, annual inflation increased significantly and equaled 15.9% in June. As a result, the Central Bank of Russia decided to further tighten its monetary policy to 20%, which was reduced to 9.5% in June. It is also noteworthy that, since the end of March, as a result of active capital controls, the official exchange rate of the ruble stabilized against the US dollar. Recently, some EU members have intensified talks on imposing an embargo on Russian oil and gas, which would serve to be a big blow for the Russian economy, since this sector is the largest source of revenues for the country. According to the IMF's July forecast, Russia's real economy will decline by 6% in 2022. Inflation is forecasted to be 21.3% on average.

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, such as roads, bridges, ports, airports, fuel storage depots, etc., have been destroyed. It is important that in parallel with the war, the civilized world, including Georgia, supports Ukraine. According to the IMF, Ukraine's real economy will decline by 35% in 2022.

The first half of 2022 was characterized by weak economic activity in **Armenia**. Both government and consumer spending decreased, which led to a slight reduction in consumption. The challenges stemming from the Russia-Ukraine war have also had a negative impact. As Russia is the most important trading partner for Armenia, remittances are expected to decline this year. The war has also had a negative impact on Armenia's exports. In addition, there have been political tensions with Azerbaijan. The annual inflation rate increased to 10.3% in June. 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 half 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, which caused a stabilization of the external sector. However, it is expected that the Russia-Ukraine war will have negative consequences for both remittances and external trade. The annual rate of inflation increased and stood at 14.2% in June. According to the IMF, real GDP growth in Azerbaijan will be 2.8% in 2022, while the inflation rate is forecasted to be 12.3%.

In the first half of 2022, the **central banks** of many of Georgia's main trading partners further tightened their monetary policies in response to higher inflation and rising inflation expectations. The US Federal

Since the beginning of 2022, together with a rise in 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.

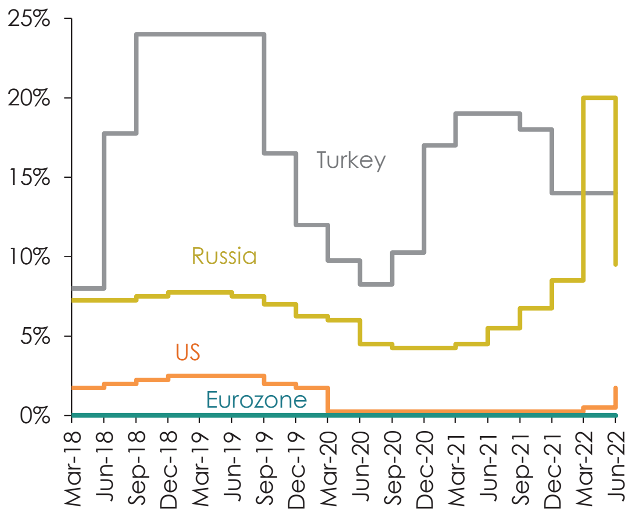


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

In 2021-2022, fuel prices increased sharply.

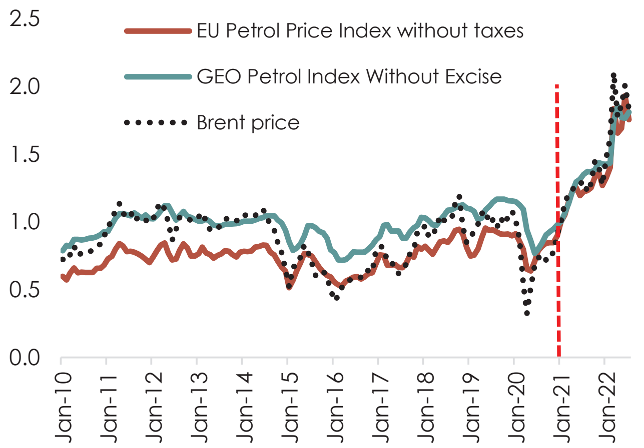


Figure 1.1.4. Petrol price index (Jan 2021=100)

Source: NBG calculations.

Along with restrictions and rising fuel prices, transportation costs also increased.

Figure 1.1.5. Average shipping cost of a 40-foot container worldwide

Source: Statista.

In 2022, food prices have increased sharply; however, a trend of price stabilization has recently been observed.

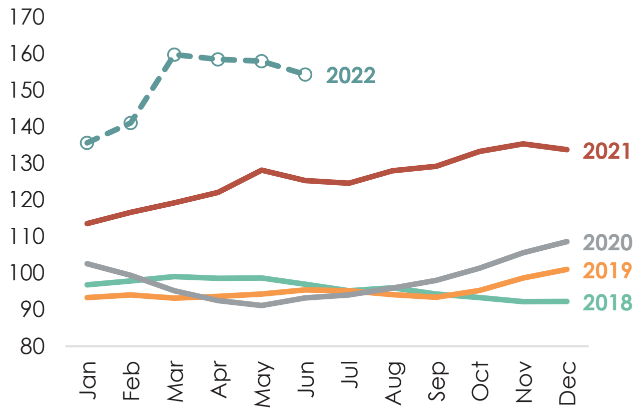


Figure 1.1.6. Food Price Index

Source: FAO.

Reserve raised its federal funds rate to the 1.5-1.75% range in June, although it is expected that interest rates in the US will rise further this year. Meanwhile, in response to high inflationary pressure, for the first time in 11 years, the European Central Bank increased its policy rate by 0.5%. At the same time, it should be noted that the broader pandemic-related quantitative easing program in the eurozone ended on 1 July.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

Russia's invasion of Ukraine has caused supply disruptions and a sharp rise in commodity prices in international markets. The price increase has been particularly significant in those commodity categories for which Russia and Ukraine are main exporters, among which the most important are oil, cereals and food products. Current geopolitical developments have created additional pressure on the already-high global prices resulting from the COVID-19 pandemic, which saw prices rising dramatically in international markets as a result of supply chain disruptions and supply-demand imbalances.

As a result of the above-mentioned factors, fuel prices have been increasing in 2021-2022. In June 2022, the average price of Brent crude oil reached its highest level since the beginning of the COVID-19 pandemic, at USD 123 per barrel, which is a 68.1% increase compared to the same period of 2021, and up by 205.5% as compared to June 2020. The same trend is observed in the European market, where petrol prices increased by 96.7% annually in June and were up by 198.4% compared to June 2020.

Along with rising fuel prices, transportation costs also increased globally in 2021. The price of international shipments reached its peak in September 2021; however, from the beginning of 2022 a decreasing trend has been observed. This development will slow down imported inflation.

According to the Food and Agricultural Organization (FAO), the international food price index has been growing sharply since the second half of 2020 and reached the highest level in March 2022. There have been signs of a stabilization of food prices since April. In particular, wheat prices have decreased in the recent period. Ukraine and Russia are the main exporters of cereals, and after the start of Russia's war against Ukraine, prices rose sharply amid restrictions on the supply of grain to international markets. However, in the recent period, dynamics of a gradual improvement in grain production and supply have been observed – a development that serves to lower prices.

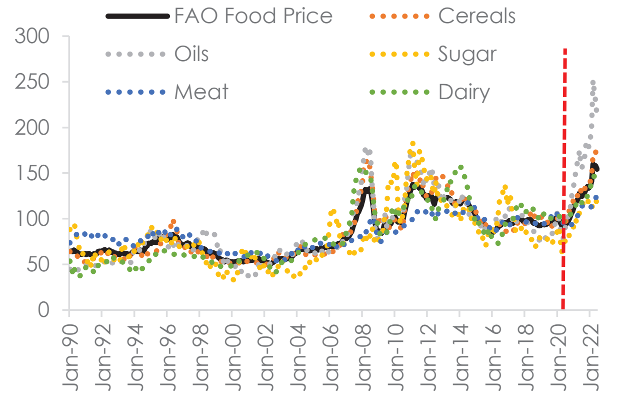


Figure 1.1.7. Food price index by category

Source: FAO.

In light of strong external demand and the rise of prices on intermediate goods, revenues from registered exports of goods continues to rise.

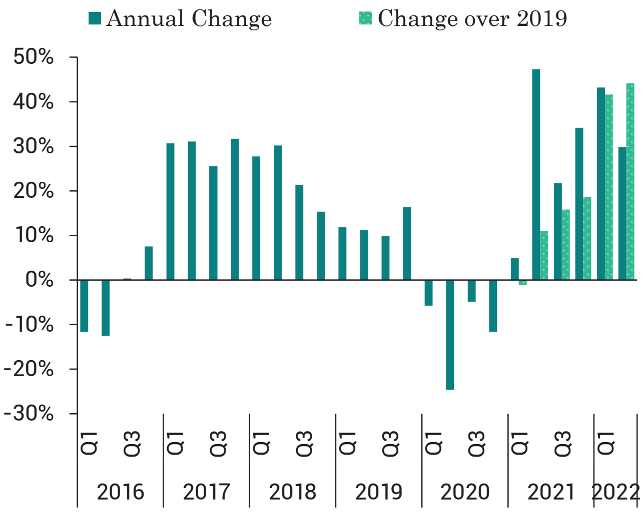


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat.

The rise in exports of goods mainly stemmed from an increase in external demand for intermediate goods. In contrast, the contribution of investment and consumer goods was small.

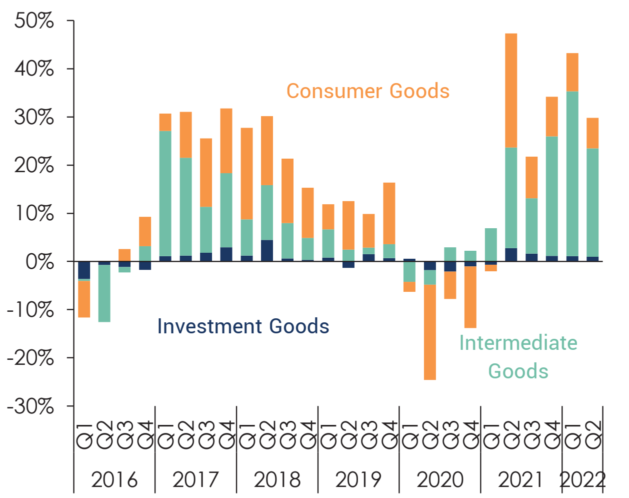


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the second quarter of 2022, external demand was strong once again. The revival of economic growth in trade partner countries and the recovery of manufacturing processes has positively affected the turnover of Georgia's external trade; however, Russia's invasion of Ukraine induced new challenges for international trade. As a result of the current geopolitical environment, the number of long-term visitors arriving in Georgia from Ukraine, Russia and Belarus increased, which has raised revenues from international travelers. In addition, as a result of the lifting of pandemic-related restrictions on mobility and a revival of international tourism, the number of visitors arriving from other countries also rose. Instant money transfers also increased considerably, which were mostly related to a record-high level of transfers from Russia. Moreover, in line with strong domestic demand, imports of goods substantially increased.

Against the background of strong external demand and the rise of prices on intermediate goods, revenues from exports of goods have continued to grow. In the second quarter of 2022, registered exports of goods grew by 29.8% annually (see Figure 1.2.1). Such growth is mostly related to increased prices on export goods, while real exports of goods stayed at almost the same level. In the second quarter, as was expected in light of the ongoing war, exports to Ukraine fell substantially, although exports to Russia remained at the same levels. From regional countries, exports to Turkey and Armenia were noteworthy, while Bulgaria and Peru were top export destinations among other countries.

Exports of goods mainly increased due to increased levels of intermediate goods being exported. This 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 exports of intermediate goods mainly stemmed from high exports of copper ores and concentrates to Bulgaria (accounting for 93% of total exports to Bulgaria), electricity to Turkey, and ferro-alloys to the USA. In terms of the rise in exports of consumer goods, motor cars exported to Azerbaijan, Armenia and Kazakhstan made the largest positive contribution. In terms of investment goods, exports of construction machinery and equipment played a leading role in the overall growth.

In line with the lifting of restrictions on international travel, the recovery of tourism has continued. The number of international visitors to Georgia, especially tourists, are on the rise again. In the second quarter, the number of international visitors rose by 176.2% annually; however, this number remains below that of

Revenues from international travelers continued to rise and their volume is gradually reaching the pre-pandemic levels of 2019.

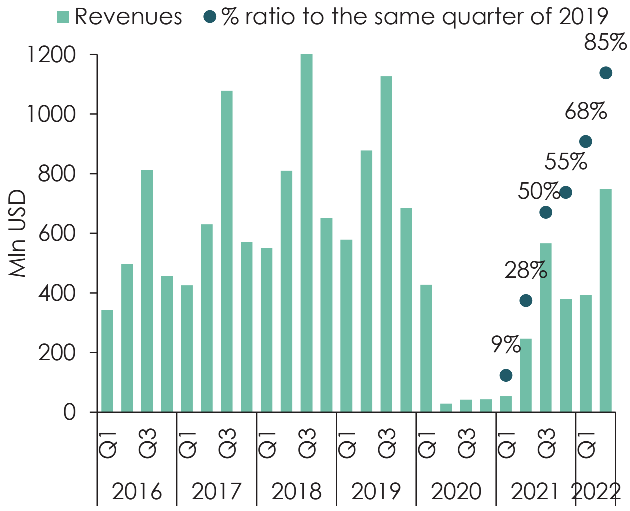


Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG.

Instant money transfers were at a record-high level, mainly due to inflows from Russia.

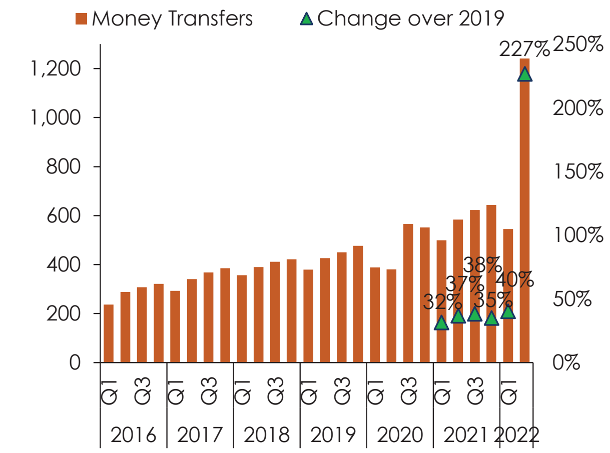


Figure 1.2.4. Annual change in money transfers

Source: NBG.

the same period in 2019 (reflecting a recovery of 49%). As international tourism began to gradually increase from the second half of 2021, it should be noted that the rise in numbers of visitors in the second quarter of 2022 was also related to the base effect. Against the background of the current geopolitical environment, one of the largest segments (27%) of visitors was related to long-term stays of visitors from Russia, Belarus and Ukraine. Meanwhile, the numbers of visitors from Turkey, Armenia, the EU and Israel (76 pp in the overall growth of visitors) have also been on the rise.

In line with the growing number of visitors, the rise of annual revenues received from international travelers, as seen gradually from 2021, continued. In the second quarter of 2022, such revenues increased three times annually (see Figure 1.2.3), albeit remaining lower than pre-pandemic levels (14.7% below the levels received in the same period in 2019).

In the second quarter of 2022, instant money transfers to Georgia increased by 112.7% annually and amounted to USD 1,241.4 million (see Figure 1.2.4). Such a high volume of transfers was mainly due to a rise in transfers from Russia (6.5 times higher inflows, making a 98.4 pp contribution to the overall growth). Aside from Russia, transfers from Kazakhstan (8.2 pp) and the EU (4.7 pp) made the largest contributions to total growth in this period. As could be expected, due to the war, money transfers from Ukraine were minimal, while transfers to Ukraine increased by 68% (up to USD 11.7 million).

Considering the acceleration of economic activities and higher internal demand, imports of goods rose considerably in the second quarter of 2022, increasing by 32.8% 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 Russia and Turkey, but imports from other regions, including China and the USA, made the largest contribution to overall growth. In contrast, imports from Ukraine fell due to impediments related to the ongoing war.

In the second 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 and motor cars, while the rise of imports of intermediate goods was due to higher imports of wheat flour, bars of non-alloy steel and various turbines. The rise in imports of investment goods stemmed from higher purchases of automatic data processing machines and their units, and of construction machinery. It is worth noting that the significant 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

In light of strong domestic demand, imports of goods have risen at a high rate. Against the background of higher import prices in USD terms, it is worth noting that expenses on import goods also rose.

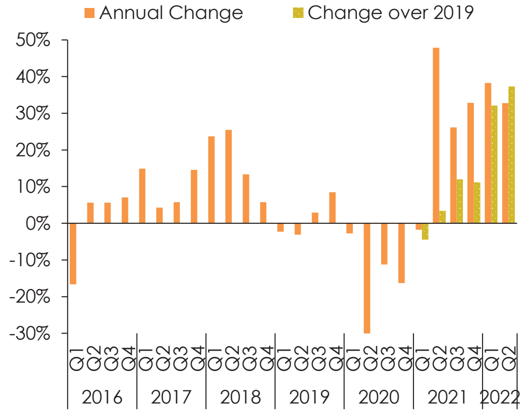


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the second quarter of 2022, imports of consumer and intermediate goods made the largest contributions to the overall growth of imports, which is partially related to the record-high level of commodity prices on international markets.

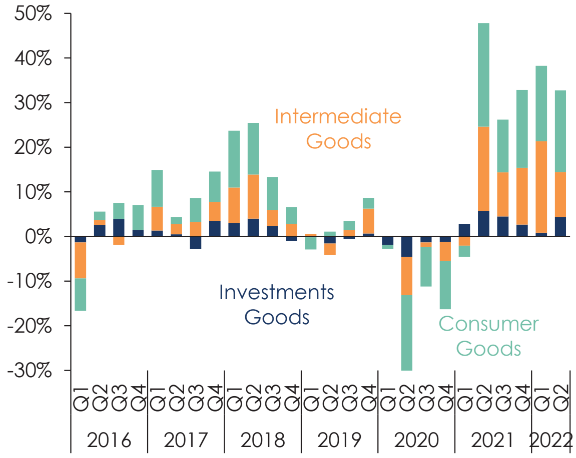
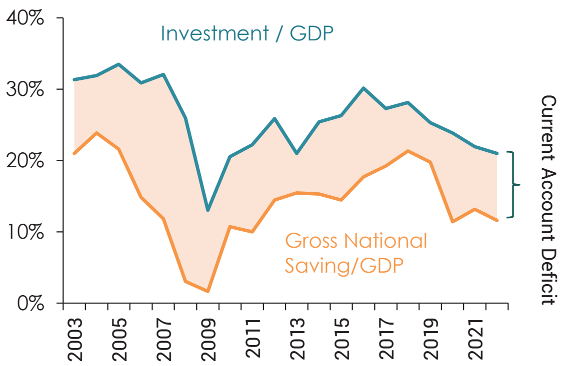


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

In 2021, the worsening of the current account balance was mainly due to the decline of savings, rather than to investments.



* 2022 data contains the joint sum of the last three quarters of 2021 and the first quarter of 2022.

Figure 1.2.7. Investments and savings

Source: GeoStat, NBG Calculations

instance, due to accelerated prices on international markets, expenses on imports of petroleum products increased. In the second quarter, the volume of imports in USD terms increased by 79% annually, which was mostly due to the 78% rise of energy product prices on global markets.

In the first quarter of 2022, the current account deficit increased by USD 164 million and amounted to 13.0% of quarterly GDP. Compared to the same period of 2021, the worsening of the current account deficit is mainly due to the rise of imports of goods and a higher investment income deficit. At the same time, revenues from travelers were limited from the beginning of the year. However, due to current tendencies, an improvement of the current account deficit is expected. According to the NBG's forecast, revenues from international travelers received in 2022 will reach 91% of the levels from 2019. In light of the global increase in commodity prices, the growth of both imports and exports will be at a high level and the current account deficit will be around 8% of GDP. In 2019, this indicator was around 5.8% of GDP.

The main source of financing the current account deficit was foreign direct investments (FDI). In the first quarter, the volume of these increased by 4.3 times annually and amounted USD 568 million. The rise in FDI mainly stemmed from a higher level of reinvestments. In the first quarter, the majority of FDI went to the energy and finance sectors. However, inflows of other investments decreased by USD 353 million, which was mostly due to the decreased level of long-term public loans compared to the same level of 2021.

From the perspective of savings and investments, in the first quarter of 2022, as compared to the same period of the previous year, the worsening of the current account balance was due to a fall in savings, rather than to investments (see Figure 1.2.7). This also reflects a rise in aggregate demand compared to 2021.

BOX 1. THE IMPORTANCE OF THE TOURISM SECTOR FOR GEORGIA'S ECONOMY

Before the COVID-19 pandemic, one of the more important parts of the Georgian economy was the tourism and hospitality sector. According to the NBG's data, revenues from international travelers amounted to USD 3.4 billion in 2019. The tourism industry consists of many interrelated sectors and comprises a vital part of the national economy. According to the NBG's estimates, in 2019, prior to the pandemic, the share of value added created by inbound tourism activity in GDP reached 12.0%, while the share of domestic tourism fluctuated around 2.5% (see Diagram 1.2.9).

The tourism sector faced unprecedented damage due to COVID-19 in 2020-2021. The mobility restrictions and global lockdown to contain the spread of coronavirus induced a massive drop in international travel. Tourism-related sectors worldwide were severely impacted in terms of employment and revenue generation. Georgia was no exception to this trend.

Due to the pandemic, revenues from international travelers fell sharply to USD 0.5 billion in 2020 and 1.2 billion in 2021. However, as the pandemic started to fade away and the restrictions began to be lifted, inflows of international visitors began to quickly increase and are gradually reaching pre-pandemic levels. It is expected that revenues from international travelers during 2022 will reach around 91% of the level recorded in 2019. As the NBG estimates, the share of inbound tourism this year will be around 7.8% of GDP, while the share of domestic tourism will be around 1.9% of GDP. However, there is still a high degree of uncertainty related to the spread of other variants of coronavirus, high reinfection rates, uneven vaccination rates and the rise of petroleum prices (and thus an increase in transportation costs).

As tourism has an important impact on the Georgian economy, it is of vital importance to refine the statistics of foreign visitors and to undertake a permanent analysis of these dynamics. For this reason, thanks to data taken from the Ministry of Internal Affairs, the NBG has begun to produce everyday statistics about foreign visitors in Georgia. Based on that data, the NBG calculates the number of foreign citizens within Georgia on a daily basis.

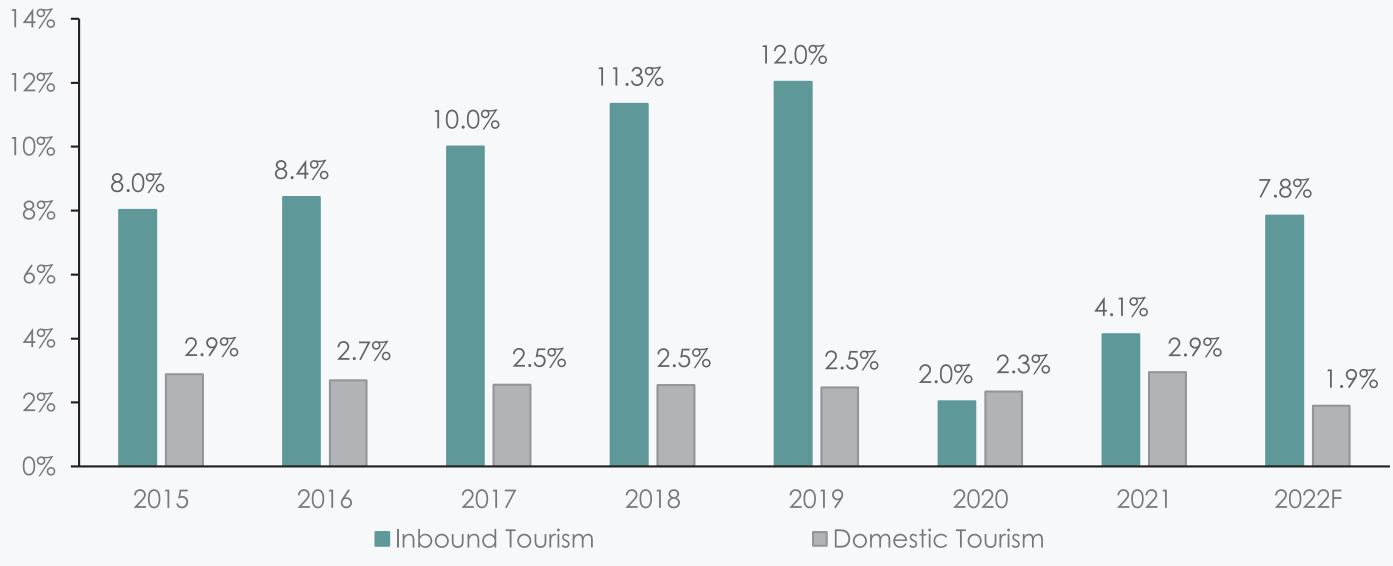


Figure 1.2.9. Share of inbound and domestic tourism in GDP

Source: GeoStat and NBG calculations.

These data have an important role in the current environment. After Russia's invasion of Ukraine, the number of Ukrainian, Russian and Belarussian citizens in the country have increased, and the average duration of their visits are longer. Such details captured by the everyday statistics help the estimation of revenues from international travelers. As of 30 June, 162,622 foreign citizens were present in Georgia, of which 62,917 were from Russia, 20,230 from Ukraine and 19,514 from Belarus, which is a 4.8 times higher number than before the start of the Russia-Ukraine war.

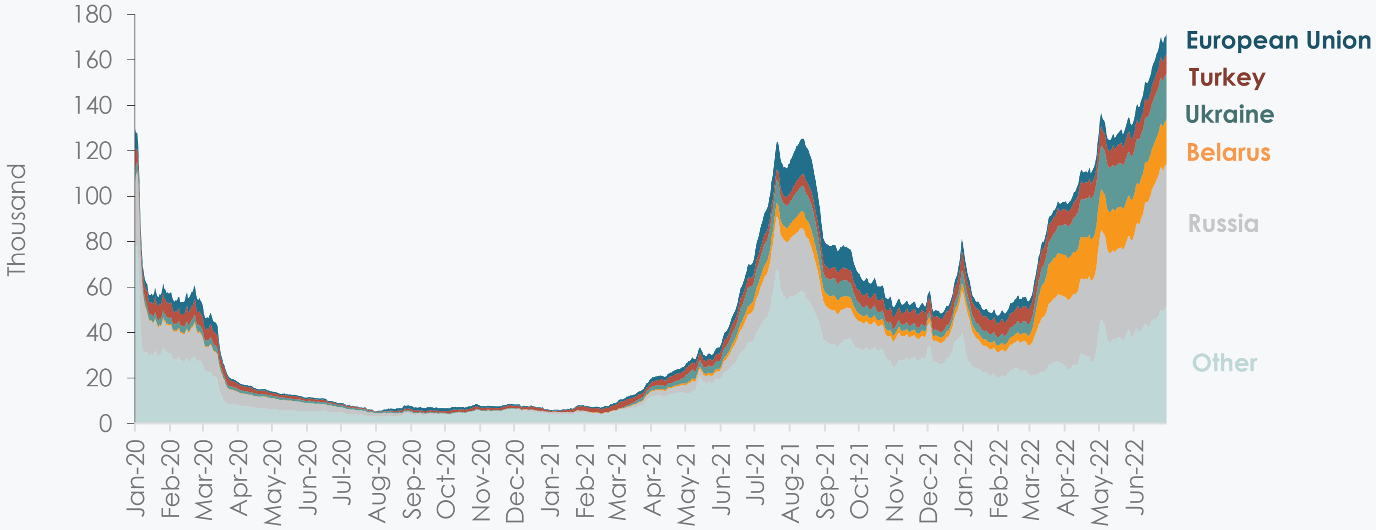


Figure 1.2.10. The number of foreign citizens in Georgia

Source: Ministry of Internal Affairs; NBG calculations.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the first quarter of 2022, as in the previous year, high economic growth was fueled by robust consumption.

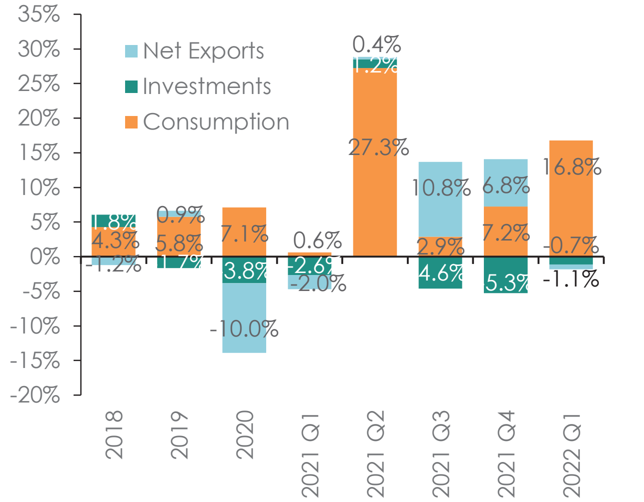


Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

The real volume of GDP in the first quarter of 2022 was 13.9% higher than in the same, pre-pandemic, period in 2019.

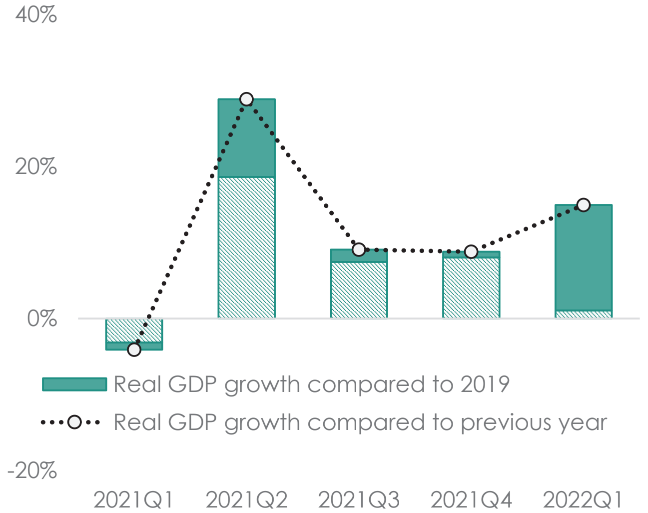


Figure 1.3.2. Comparison of the real level of GDP in 2021 with 2019

Source: GeoStat.

Real GDP increased by 14.9% in the first quarter of 2022, as compared to the same period of the previous year. Preliminary estimates indicate that strong economic growth has persisted beyond the first quarter to reach 10.5% on average in the first half of 2022.

It should be emphasized that the real volume of GDP in the first quarter of 2022 was 13.9% higher than the pre-pandemic first quarter of 2019, indicating that the base effect's potential for influencing economic growth has been fully realized (see Figure 1.3.2). The NBG estimates that present economic activity is above its potential level and therefore poses a threat of the economy overheating.

Consumption (accounting for 16.8 percentage points of the overall growth) was the main factor behind the high growth seen in the first quarter. The intensification of credit activity is the key driver of domestic demand. Revenues from tourism continued to increase during this time, as seen by the 2.14 times increase in real annual service exports. However, in addition to the substantial rise in exports of goods and services (up by 34.9%), strong domestic demand means that real import expenditure was also high, rising by 24.1% in the first quarter of 2022. As a result, net exports had a negative 0.7 percentage point impact on GDP growth. Investments continued to be modest, contributing only 1.1 pp in a negative direction (see Figure 1.3.1). The last three years have seen a decline in the actual volume of investments, which has had a negative effect on the country's overall output potential.

The primary determinant of economic growth is the service sector, which has been fueled by strong domestic demand and a partial recovery in tourism.

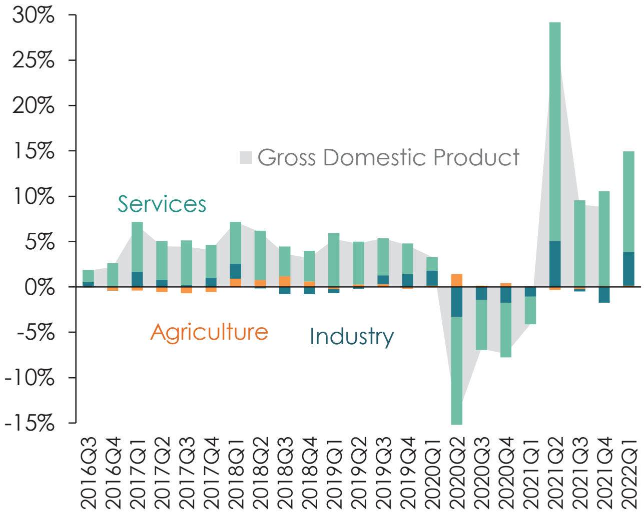


Figure 1.3.3. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

1.3.2 OUTPUT

As was previously indicated, real GDP increased by 14.9% in the first quarter of 2022, as compared to the same period in 2021. The service sector, which contributed 11.1 pp, was the primary factor behind that growth. The renewal of tourist and hospitality industries is connected to the activation of the service sector, meanwhile domestic demand for service industries has also grown with high expenditure. Agriculture contributed 0.1 pp to the overall GDP growth, while the industrial sector contributed 3.7 pp.

Increased domestic demand and a rebound in tourist arrivals benefited the hospitality sector. A total of 4.9 pp of the overall GDP increase came from activities such as transportation, real estate-related activities, arts, entertainment, and recreation – all areas in which a large percentage of foreigners participate. Trade, the economy's largest sector, expanded by 8.9% and added 1.2 percentage points to overall economic growth.

In terms of industrial sectors, the electricity, gas, and water supply sector grew by 54.7% (making a 1.5 pp contribution to overall growth), manufacturing grew by 13.2% (a 1.2 pp contribution), and the construction sector grew by 7.3% (a 0.5 pp contribution).

Agriculture expanded by 2.3% over the same period, making a 0.1 percentage point contribution to overall 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 18.7%, excluding the effect of exchange rate fluctuations.

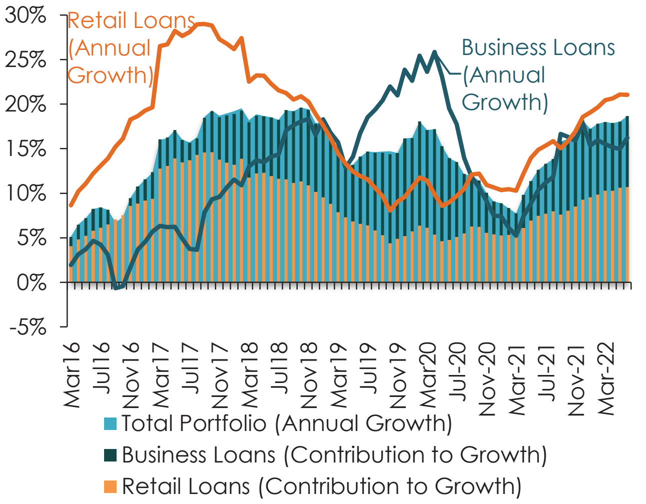


Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: NBG

In June, relative to March, the growth of the loan portfolio increased slightly and equaled 18.7% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 0.6 pp to stand at 21.1%, while the growth of loans to legal entities increased by 0.7 pp and equaled 16.2% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the agriculture 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 second quarter of 2022 was mainly driven by domestic currency loans, a development that was supported by recent macroprudential measures (see Figure 1.4.2). However, in June the annual growth rate of foreign currency denominated loans increased and stood at 16.5%, while the growth rate of loans issued in the domestic currency decreased by 2.0 pp and equaled 21.1%. This was expected given the tightening of monetary policy. In the second quarter, the loan larization ratio increased slightly and equaled 51.4%, 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 made by loans issued in foreign currency to the overall growth of the portfolio increased.

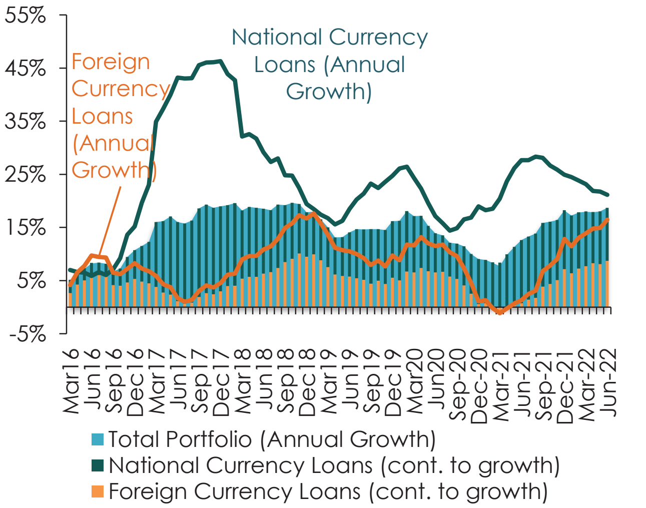


Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In June, the monetary policy rate was 11.0%. In the second quarter of 2022, interest rates on government securities did not change significantly as the monetary policy rate remained unchanged (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 June, relative to March, interest rates on domestic currency deposits increased slightly and equaled 10.9%. Meanwhile, interest rates on foreign currency deposits did not change significantly and stood at 1.5%. According to the credit conditions survey, representatives of the banking sector expect a slight in-

Because monetary policy remained unchanged, interest rates on government securities did not change significantly in the second quarter of 2022.

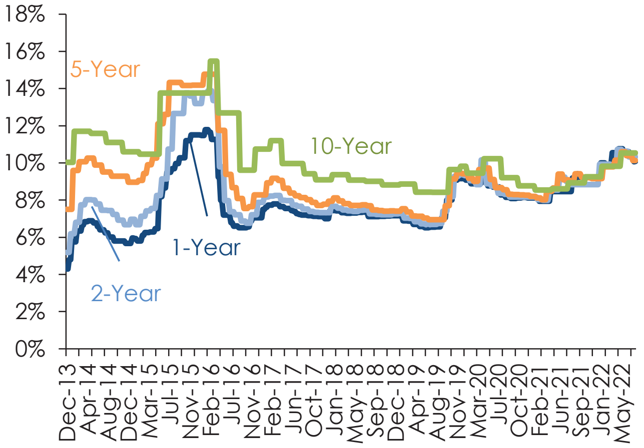


Figure 1.4.3. Interest rates on government securities

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.

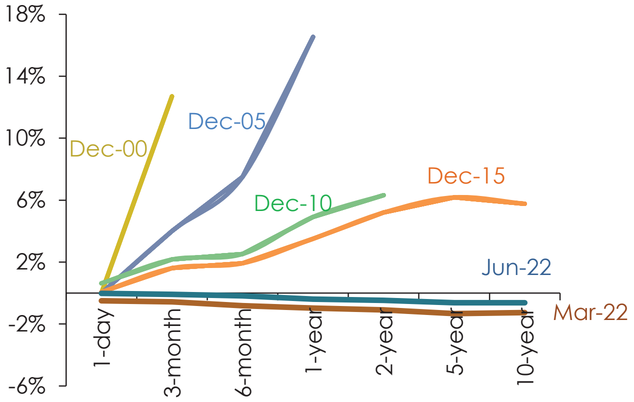


Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: NBG

crease 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, as did interest rates on business loans issued in GEL. Representatives of the banking sector expect a slight tightening of interest rate conditions. In June, relative to March, interest rates on corporate loans increased slightly by 0.9 pp to equal 10.5%, while interest rates on loans to small and medium enterprises (SMEs) and on retail loans did not change significantly, equaling 16.5% and 10.5% respectively.

As of June, relative to March, average interest rates on domestic and foreign currency loans on the stock of legal entities did not change significantly. In particular, interest rates on domestic currency loans stood at 13.9%, while equaling 7.1% for foreign currency loans (see Figure 1.4.5). Representatives of the banking sector expect a slight increase in interest rates for foreign currency loans.

In June 2022, similar to previous months, average interest rates for domestic currency loans issued to legal entities in remain significantly high relative to foreign currency loans.

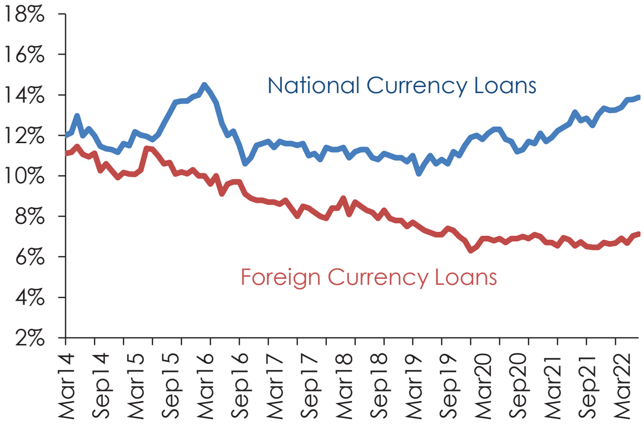


Figure 1.4.5. Average interest rates on business loans

Source: NBG

The real effective exchange rate appreciated significantly, rising by 17.8% on an annual basis.

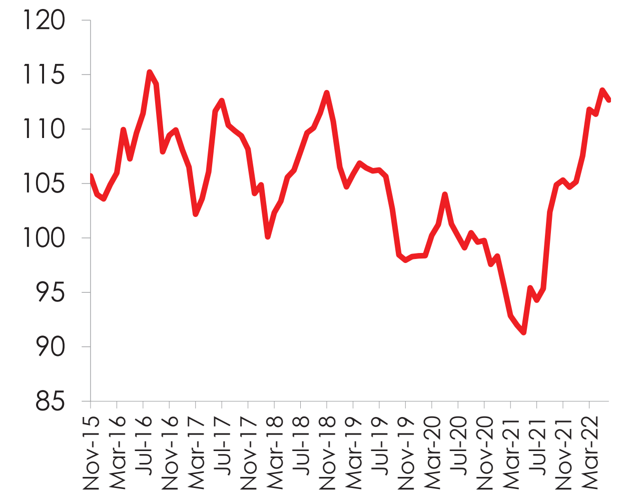


Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: NBG.

1.4.3 EXCHANGE RATE

In the second quarter of 2022, the GEL nominal exchange rate appreciated against both the US dollar and the euro by an average 3.6% and 8.3%, respectively, compared to the previous quarter. The GEL continued to appreciate against the Turkish lira by 14.3%, but depreciated against the Russian ruble by 24.3%. In the same period, the nominal effective exchange rate appreciated by 3.7% on a quarterly basis and by 25.5% on an annual basis. As for the price-adjusted exchange rate, in the second quarter of 2022, the real effective exchange rate appreciated by 1.9% on a quarterly basis and by 17.8% on a year-on-year basis (see Figure 1.4.6). It should also be noted that the real exchange rate appreciated against currencies of almost 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	**25.5**	**17.8**	**17.8**
Eurozone	25.1	30.8	5.4
Turkey	108.4	35.2	6.7
Ukraine	18.8	13.1	0.9
Armenia	-4.1	-0.9	-0.1
US	10.9	15.3	1.1
Russia	0.5	-3.0	-0.4
Azerbaijan	10.6	9.9	1.0
China	13.3	25.2	3.3
Bulgaria	25.1	22.2	0.9
Poland	28.3	27.2	0.5

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

Source: NBG

* Growth implies appreciation of the lari.

1.5 LABOR MARKET

Due to high economic growth, productivity increased, leading to decrease of Unit Labor Cost (ULC) growth to 1.1%. At this stage, this does not put pressure on prices from the labor market.

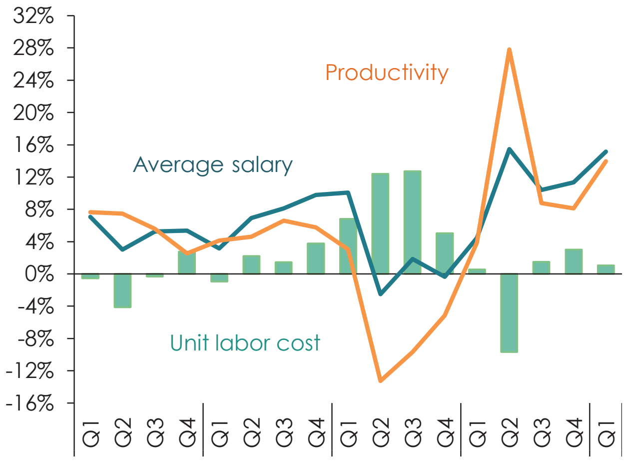


Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

In the first quarter of 2022, the country's economic productivity (real value added per employee) rose by 13.9% on a yearly basis (see Figure 1.5.1). Over the same time frame, the nominal wage growth for employed workers was 15.1%, and the average monthly gross wage reached 1,447 GEL.

Despite substantial wage increases, the increased productivity brought by rapid economic expansion has majorly offset the rise in Unit Labor Cost (ULC). Data from the first quarter of 2022 show that the ULC only increased by 1.1%. As this is only a modest pace, at this point the labor market is not creating pressure on prices (see Figure 1.5.1).

1.6 CONSUMER PRICES

The fundamental cause of the significant annual inflation observed worldwide, including in Georgia, has been the continued high level of prices on global markets. However, there have recently been signs of stabilization in global commodity markets, with prices of wheat and oil beginning to decline.

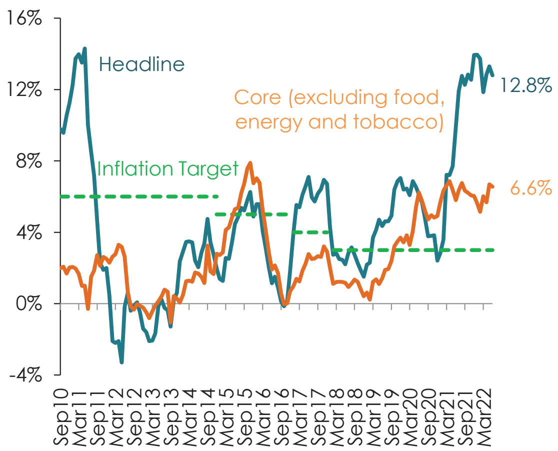


Figure 1.6.1. Headline and core inflation

Source: GeoStat

The inflation rate in June 2022 was 12.8%. As stated in the previous Monetary Policy Report, due to Russia's invasion of Ukraine, the world now faces a range of new issues, one of the most critical of which being the rise in commodity prices. The fundamental cause of high inflation worldwide, including in Georgia, is that commodity prices remain high on global markets, despite a recent stabilization.

In June, the Food Price Index, as developed by the UN Food and Agriculture Organization, increased by 23.1% over the previous year. This effect has spread to the local market and, like in many other nations, Georgia is experiencing substantial food inflation (annual food inflation in June was 21.9%). Food prices are particularly significant in developing countries, like Georgia, because food accounts for a considerable part of the consumer basket.

Food-related inflation accounted for nearly half of all inflation in June (6.3 pp), which was mainly attributed to rising food prices in global commodities markets. In particular, wheat bread made a significant contribution to food inflation (1.2 pp) because of increasing costs worldwide. The rise in potato and cheese prices was also significant (up by 47% and 25% respectively), with these adding a total 1.1 pp to inflation.

Fuel costs have remained high, contributing a total of 1.6 percentage points to inflation, despite recent positive market dynamics and the strengthening of the lari.

The price of locally produced goods has been rising rapidly in recent months, with this indicator rising to 13.1% in June (see Figure 1.6.3). The increase in prices

As a result of the rise in prices on global commodity markets due to the ongoing war in Ukraine, food and gasoline prices continue to contribute significantly to inflation.

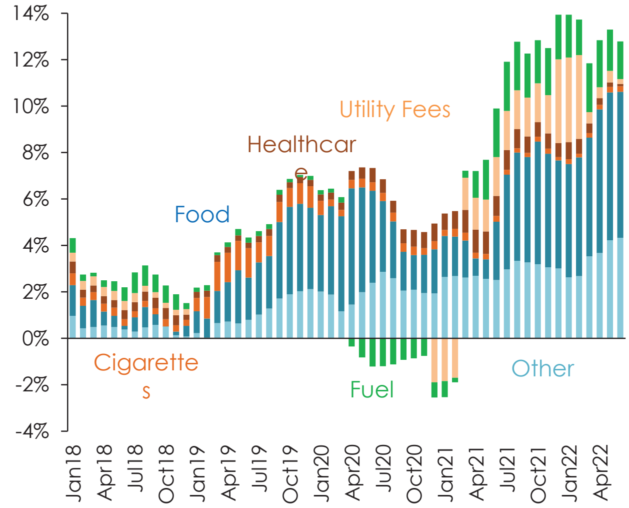


Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

The increase in prices of locally produced goods is related to a number of ongoing global processes; the most notable of which concerns the production of bread, which primarily uses imported flour.

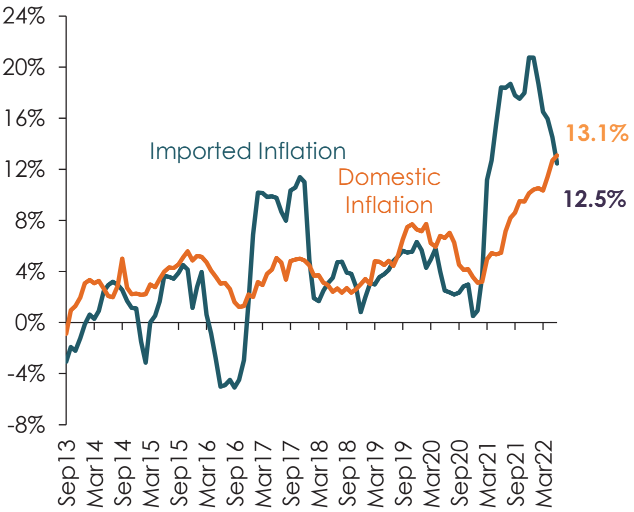


Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

of locally produced goods is a result of ongoing global processes; the most notable of which concerns the production of bread, which primarily uses imported flour. Moreover, the price of property rentals, which forms part of local services, have climbed significantly, rising by 26% annually alongside the growth in the number of international visitors.

Core inflation, which excludes volatile food, energy, and cigarette prices, amounted to 6.6% in June (see Figure 1.6.1).

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, inflation will gradually decline from the current quarter and will then converge with the target by the middle of 2023. The recent brisk increase in international commodity prices alongside continued supply-side disruptions have served to intensify the inflationary environment. Consequently, Georgia, as a small open economy, is struggling with elevated inflationary pressures. In terms of economic activity, Georgia's real GDP will grow by 9% this year amid stronger-than-expected external demand and domestic consumption driven by solid credit activity.

Against this backdrop, the baseline forecasts are characterized by a high degree of uncertainty. The alternative forecast scenario considers a realization of these highly probable/relevant risks. In particular, the current alternative scenario is mainly based on there being a global recession and its consequences. Such a recession would be caused by a sharp response from the central banks of developed countries to the global inflationary environment. Moreover, a longer-than-expected prolongation of the Russia-Ukraine military conflict would further worsen the situation. Finally, against the background of reduced foreign demand, increased regional risk, and a depreciated exchange rate, inflation in Georgia would increase, which would lead to an additional tightening of monetary policy, the use of additional instruments where necessary, and, subsequently, maintaining a tightened stance for a relatively long period.

2.1 BASELINE MACROECONOMIC FORECAST

Starting from the current quarter, inflation will start to decrease and is expected to approach the 3% target by the middle of 2023.

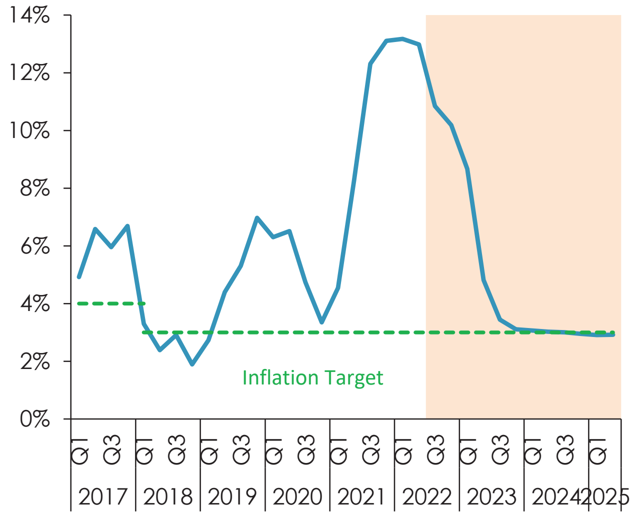


Figure 2.1.1. Headline inflation

Source: NBG, GeoStat.

Since Russia's invasion of Ukraine, the global inflationary risks that began during the pandemic have been further amplified. Inflationary pressures will thus be maintained in Georgia in the short run. According to the updated macroeconomic projection, other things being equal, inflation will start to decrease gradually and will converge with its target from the middle of 2023 (see Figure 2.1.1).

Amid a tense geopolitical background, the current and projected higher-than-target inflation is mostly fueled by exogenous factors that are independent of monetary policy. In particular, energy and food commodity prices rose vigorously because of the beginning of the Russia-Ukraine war and aggravated supply-side disruptions. Elevated inflationary pressures on international commodity markets have been transmitted to the consumer price index since Georgia is an exporter of these products. Concurrently, aggregate demand is strong enough, having a heterogeneous effect on inflation. Other things being equal, increased foreign inflows (remittances, tourism revenues, and revenues from goods exports) are strengthening the exchange rate and supporting the alignment of inflation with the target through the direct imported inflation and input costs channels. On the other hand, intensified aggregate demand puts upward pressure on inflation. Ultimately, these abovementioned factors serve to amplify inflation expectations amid a high degree of uncertainty (see Figure 2.1.2). In contrast to external demand, economic activity driven by domestic

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

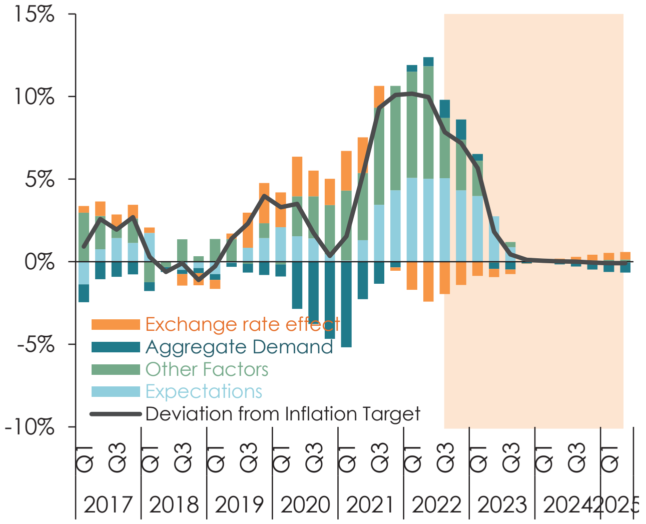


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat.

In 2022, the economy is projected to grow by 9% amid increased external demand and strong credit growth.

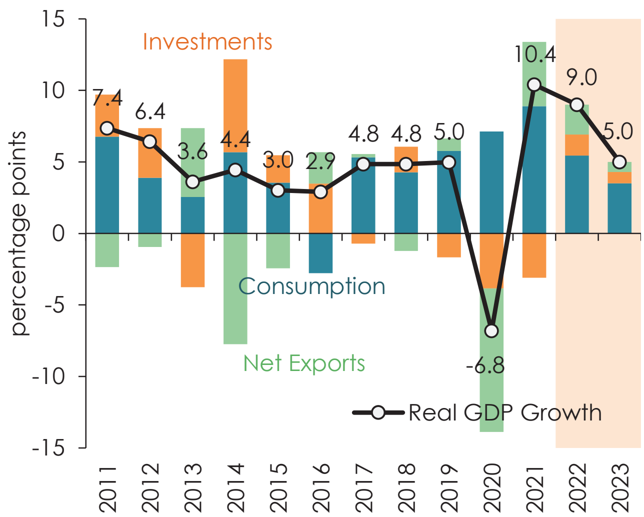


Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat.

demand (fiscal deficit and credit growth) is distinctly inflationary, as it exerts both demand-driven inflationary pressures and increases imports, and thereby exerts depreciation pressure on the exchange rate.

Intensified inflationary pressures require the tight policy stance to be maintained for a longer period as compared to the previous forecast. It is noteworthy that, other things being equal, central banks do not usually respond to supply-side shocks, since the effects of such risks are exhausted by themselves. A monetary policy reaction in response to such shocks can create additional economic fluctuations and strengthen uncertainties, thereby complicating the anchoring of inflation. However, in the current situation, the powerful supply-side shock has elevated inflation expectations and created so-called "second-round" effects. Furthermore, as a result of the various shocks experienced over the last couple of years, inflation has deviated from its 3% target for a long time, which serves to further amplify long-term inflation expectations. In addition, strong aggregate demand further aggravates inflationary pressures. The NBG will thus maintain a tight monetary policy for a relatively long period, this will occur in tandem with various macroprudential measures to curb inflation expectations. The policy rate will subsequently gradually decline in line with falling inflation expectations, before approaching the neutral level (estimated at 6.5%) in the medium term.

The current geopolitical environment has seen rising foreign inflows serve stronger economic activity. Economic growth expectations have thus been significantly improved compared to the previous forecast. According to the baseline forecast, the economy is projected to grow by 9% in 2022 amid intensified external demand and solid credit activity (see Figure 2.1.3). However, it should be noted that the situation is rapidly changing due to increased uncertainties. The current forecasts of the NBG may thus be revised in both upward as well as downward directions.

2.1.1 BASELINE FORECAST SCENARIO RISKS

Against the backdrop of increased global inflation, a slowdown in the world economy, and the prolongation of the war between Russia and Ukraine, risks remain high. Realization of these risks will lead to a deviation from the baseline macroeconomic forecast. As these risks are largely inflationary, monetary policy maintains a tightened bias.

Macroeconomic Forecast Risks	Impact on Inflation
Higher-than-expected interest rate hikes in advanced economies	↑
Prolongation of the war	↑
Decrease in foreign demand, global recession	↓
Gradual reduction of commodity prices on international markets	↓

Low Risk — High Risk

↑ Upward Pressure on Inflation

→ Same Level of Inflation

↓ Downward Pressure on Inflation

Table 2.1.1 Baseline macroeconomic forecast Risks.

Source: NBG.

Against the background of globally increased inflation, the slowdown of the world economy, and the prolongation of the Russia-Ukraine war, macroeconomic forecasts continue to be characterized by exceptional uncertainty. The risks are mainly inflationary, and their realization will lead to a deviation from the baseline macroeconomic forecast.

The global economy, which is still in the process of the post-pandemic recovery, was faced with new challenges as a result of the war between Russia and Ukraine. The already difficult situation in international commodity markets has worsened and, together with strong, subdued demand, has become the main driver of the increase in the global inflation forecast. All this has led to a sharp tightening of monetary policy rates in the leading economies (especially in the US). If there is a necessity for higher-than-expected interest rate hikes in developed economies or if European countries fail to solve their energy security problem in a less painful way by winter, the global economy will likely face a recession.

Higher-than-expected interest rates in developed countries put pressure on capital outflows from open economies like Georgia and, consequently, can lead to local currency depreciation on foreign exchange markets. Furthermore, given the high level of dollarization in Georgia's economy, a materialization of this risk will have a significant impact on inflation through the inflation expectations and input costs channels.

In the case of a global recession, a decrease in external demand and a worsening of the current account balance is expected. This, on the one hand, will lead to upward pressure on inflation through a weakened exchange rate, while, on the other, it will depress aggregate demand and, through this channel, will have downward pressure on inflation. In particular, a global recession would reduce international demand for energy resources, which, ceteris paribus, implies a decrease in their price.

The expected trajectory of inflation also depends on the duration of the Russia-Ukraine war and the nature of its resolution. In this regard, high uncertainty remains. A later-than-expected end of the conflict would further weaken the war-damaged trade and financial channels, the negative effects of which have not yet been reflected on the Georgian economy in the background of capital inflows from Russia. It would also further increase the region's risk level as well as enhancing the likelihood of supply restrictions and the imposition of additional sanctions against Russia.

Were these to occur, an additional shock for the economy of Georgia would develop. This would be transmitted to the real economy mainly through a

The inflation forecast for the medium-term has been revised upward. The main driver of the increased inflation outlook is stronger aggregate demand, which is currently estimated to be above its long-term potential level.

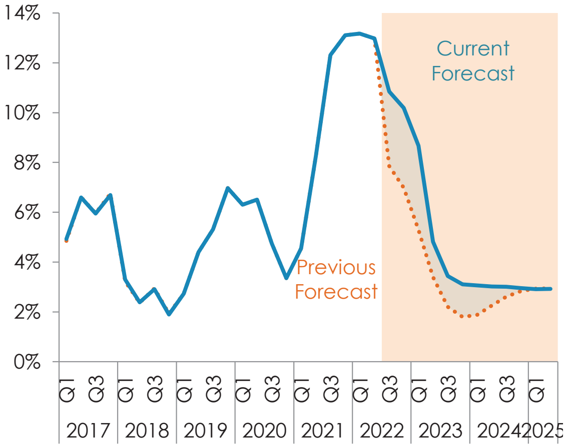


Figure 2.2.1. Changes in the forecast of headline inflation
Source: NBG, GeoStat.

In the light of improved external demand and strong credit activity, the real GDP growth forecast for 2022 has been revised upward to 9%.

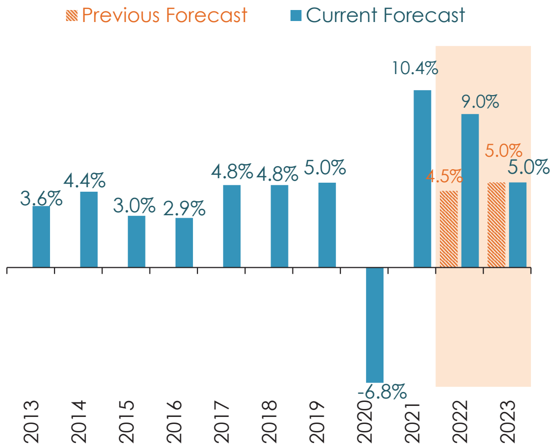


Figure 2.2.2. Changes in the forecast of real GDP
Source: NBG, GeoStat.

According to the updated forecast for 2022, against the backdrop of increased global inflation and the prolongation of the Russia-Ukraine military conflict, the main macroeconomic parameters of trading partner countries have become largely stagflationary. It should be noted that expectations regarding the exchange rate have not changed significantly.

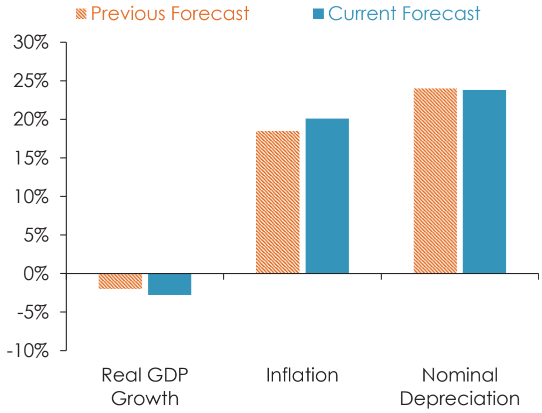


Figure 2.2.3. Changes in the forecast of external assumptions for 2022
Source: Bloomberg, NBG.

reduction of net exports and to inflation through an increase in inflationary expectations, commodity prices, and intermediate costs. In turn, the increased risk premia in the region, ceteris paribus, would put pressure on the exchange rate to depreciate.

2.2 COMPARISON TO THE PREVIOUS FORECAST

The updated inflation forecast for the medium term has been revised upward (see Figure 2.2.1). The main driver of the increased inflation outlook is stronger aggregate demand, which is currently estimated to be above its long-term potential level. Despite the increased risks, the inflation forecast has a downward trajectory. As in the previous projection, inflation will start to gradually decline as temporary supply-side shocks are exhausted.

The open military conflict between two of Georgia's main trading partners has increased regional risk premia and uncertainty in the economy, and, amid supply restrictions and the prolongation and tightening of sanctions against Russia, commodity prices on world markets remain elevated. In turn, the increased number of long-term visitors to Georgia from Russia, Belarus, and Ukraine have led to abrupt hikes in rental prices on the local market, which has also affected headline inflation. In light of inflation remaining high for a protracted period, strong aggregate demand has recently put additional pressure on inflation expectations.

The real GDP growth forecast for 2022 has been revised upward to 9% (see Figure 2.2.2). The assumptions and expectations behind the projected economic growth have changed. In particular, contrary to previous expectations, the current account deficit improved sharply, and the credit growth rate turned out to be higher than expected.

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

According to the updated forecast for 2022, against the background of Russia's invasion of Ukraine, globally increased inflation, and corresponding higher interest rates, the main indicators of trading partner countries have become largely stagflationary (see Figure 2.2.3).[4]

4 *These 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

Under the alternative scenario, against the backdrop of global stagflation and the prolongation of the Russia-Ukraine war, external demand will fall and the current account balance will worsen. As a result, the economy will grow at a slower pace in 2022-2023.

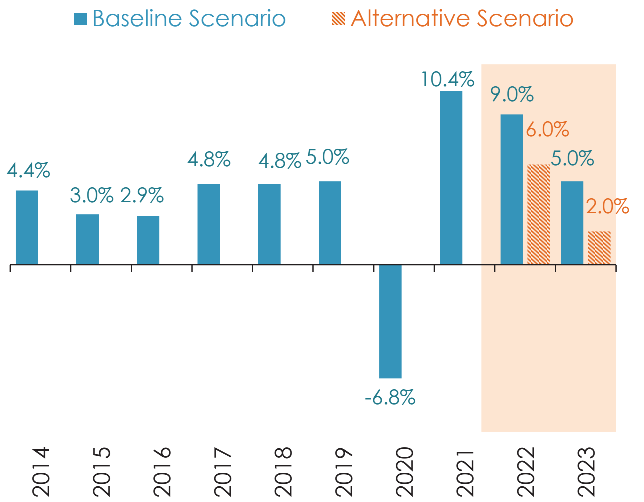


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat.

Under the alternative scenario, inflationary pressure will intensify due to the exchange rate depreciation and rising inflationary expectations against the backdrop of a deterioration of the current account balance. However, this pressure will be partially restrained by weak aggregate demand.

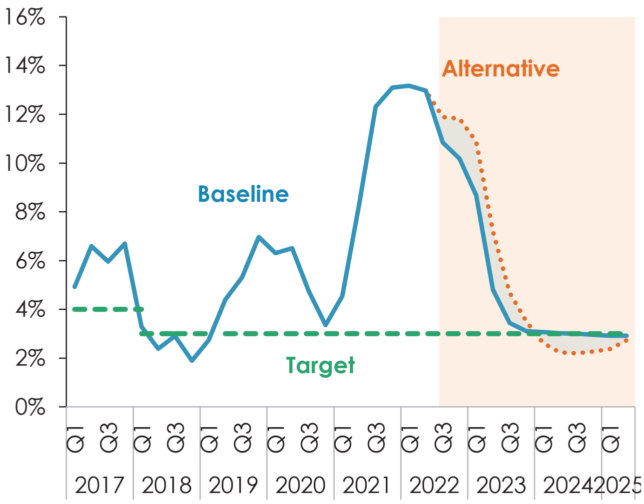


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat.

The alternative forecast scenario considers a realization of the most probable/relevant risks to the baseline macroeconomic forecast. In particular, the current alternative scenario is mainly based on there being a global recession and the consequences of this. The envisaged recession is caused by the sharp response of the central banks of the leading economies to the global inflationary environment. The alternative scenario also envisages a longer-than-expected prolongation of the Russia-Ukraine military conflict.

Under this case, compared to the baseline scenario, external demand for Georgian goods and services will decrease and, ultimately, will have a negative impact on the current account balance. The regional and country risk premia will increase, which will elevate the risks of further capital outflow and hinder inflows of foreign investment. This, in turn, will put pressure on the exchange rate and inflation. Furthermore, against the background of worsening business expectations, domestic investments will further decline. As a result of a realization of these risks, the economy will grow by 6% in 2022, and by only 2% in 2023 (see Figure 2.3.1).

In the event of a realization of the alternative scenario, foreign demand will decrease, the expectations of economic agents will worsen, and the pressure on the exchange rate to depreciate will increase. The latter, taking into account levels of dollarization, will increase inflationary pressure through the channels of intermediate costs and expectations. In turn, in light of inflation remaining high for a protracted period, high inflationary pressures will further worsen inflationary expectations. This inflationary effect will only be partially contained by lower energy resource prices (as a result of weak global demand). Hence, if the given alternative scenario is realized, in 2022-2023 inflation will be 1.1 percentage points higher on average compared to the baseline scenario (see Figure 2.3.2).

Under this scenario, monetary policy will be significantly tightened during 2022 and, compared to the baseline scenario, this contractionary stance will be maintained for a relatively long period. In particular, the trajectory of the monetary policy rate in 2022-2023, compared to the baseline scenario, will be shifted upward by an average of 1.3 pp (see Figure 2.3.3). Furthermore, if necessary, the National Bank of Georgia will use additional measures to tighten policy. However, alongside the end of the war in Ukraine and the neutralization of negative pressures from the external sector, 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 and, if necessary, additional measures will be used.

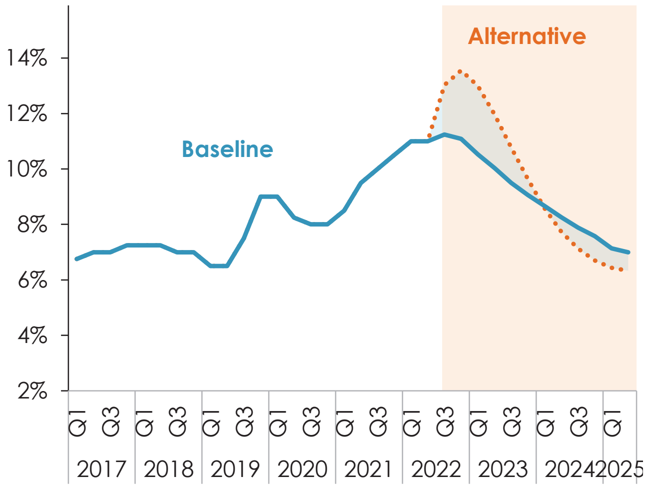


Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG.

Short-term inflation expectations are once again elevated in the financial market, whereas they are gradually approaching the target (of 3%) in the medium term. However, it should be noted that inflation forecasts are characterized by significant variability, which is reflective of intensified inflationary risks.

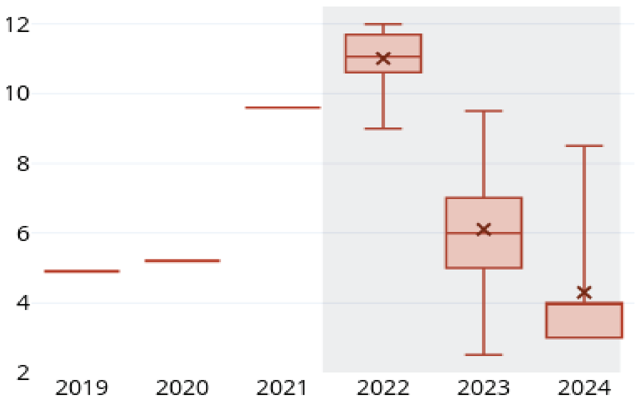


Figure 2.4.1. Actual average inflation (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the third quarter of 2022, 10 financial organizations participated in a survey of macroeconomic forecasts. According to the current results, the financial market's economic expectations for 2022-2024 have been significantly revised in some directions compared to the previous quarter.

In 2022, average and median inflation expectations have been revised significantly upward. In particular, the median of inflation expectations rose by 1.1 pp compared to the previous quarter and amounted to 11.1%, while the average inflation forecast increased by 1.3 pp to 11%. Regarding 2023, the median forecast has not changed since the previous quarter and amounts to 6%, while the average is 0.1 pp lower and equals 6.1%. As for 2024, expectations are reduced compared to the previous survey. Specifically, the median and average expectations decreased by 0.1 pp and 0.5 pp respectively, equaling 4% and 4.3% (see Figure 2.4.1). It should be noted that the inflation expectations for 2023-2024 are characterized by high variability amid increased uncertainty.

Regarding the monetary policy rate, market participants have revised upward their forecasts for 2022 compared to the previous quarter. Specifically, their median and average projections for monetary policy in 2022 both went up by 0.1 pp to 10.9% and 10.8% respectively. Similarly, the median forecast for 2023 is 0.1 pp higher and equals 9.5%, while the average forecast has shifted down by 0.1 pp to 9%. As for 2024, the median forecast has been maintained at 8.3%, akin to that of the previous quarter, while the average decreased by 0.2 pp to equal 7.8% (see Figure 2.4.2). Given the amplified inflation risks, monetary policy forecasts also show a high degree of variability.

Amid high uncertainties, monetary policy expectations are characterized by soaring variability.

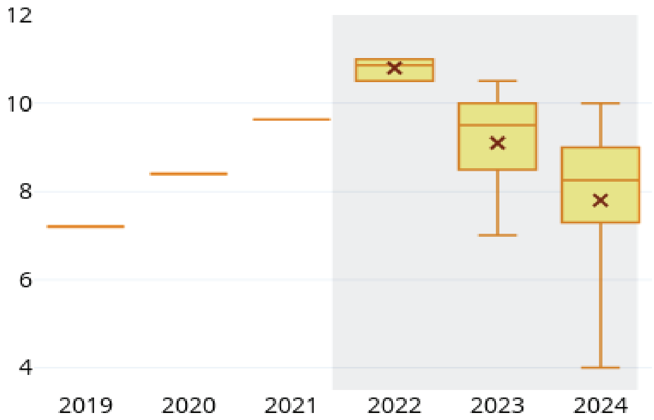


Figure 2.4.2. Actual monetary policy rate (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants.

In 2022, the median and average market forecasts for economic growth significantly improved compared to the previous quarter. However, these projections are highly variable.

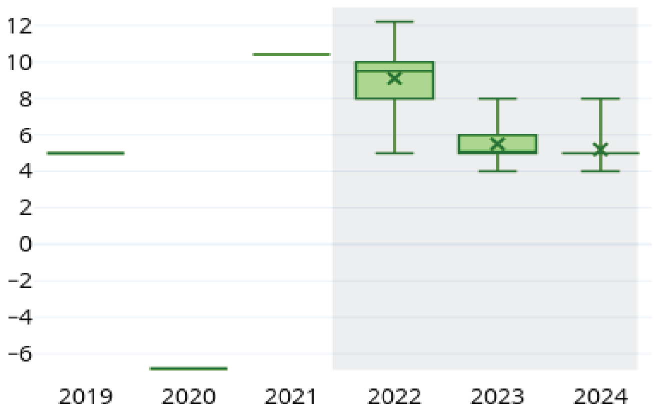


Figure 2.4.3. Actual real GDP growth (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

The market's forecasts for real GDP growth in 2022, similar to the NBG's forecast, have improved compared to the previous quarter. Specifically, the median real GDP forecast increased by 5.5 pp to 9.5% and the average rose by 4.2 pp to 9.1%. The median projection for economic growth in 2023 amounts to 5%, as in the previous quarter, whereas the average projection rose by 0.3 pp to 5.3%. The median and average forecasts for 2024 have not changed since the previous quarter and stand at 5% and 5.2% respectively (see Figure 2.4.3).

3 MONETARY POLICY

Global inflationary risks have soared since Russia's invasion of Ukraine. At the same time, the ongoing war has severely set back global economic prospects, which is further reinforced by rising interest rates and worsening risk premia in several countries. As a result of the surge in prices in international markets and the distribution of supply, inflation in Georgia remains at a high level and amounted to 12.8% in June. Moreover, aggregate demand has been strong. According to current estimations, aggregate demand has exceeded its potential level, posing additional risks of pressure on prices. The main drivers of high economic growth are increased credit activity and a record increase in the amount of remittances received. At the same time, the gradual resumption of tourism has had a positive impact on economic activity. Under the conditions of a high global inflationary environment, the NBG remains focused on reducing inflation. On 3 August 2022, the Monetary Policy Committee decided to maintain its tight monetary policy stance and left the policy rate unchanged at 11%. The NBG considers it appropriate to use additional instruments to avoid the inflationary pressure arising from high credit activity and demand. According to the updated forecast, as a result of the mitigation of external factors and tightened monetary policy, inflation will approach its target from the middle of 2023.

To eliminate additional inflationary pressures and reduce the risk of medium-term inflation expectations, on 3 August 2022 the Monetary Policy Committee decided to maintain a tight monetary policy stance at the historically high level of 11%.

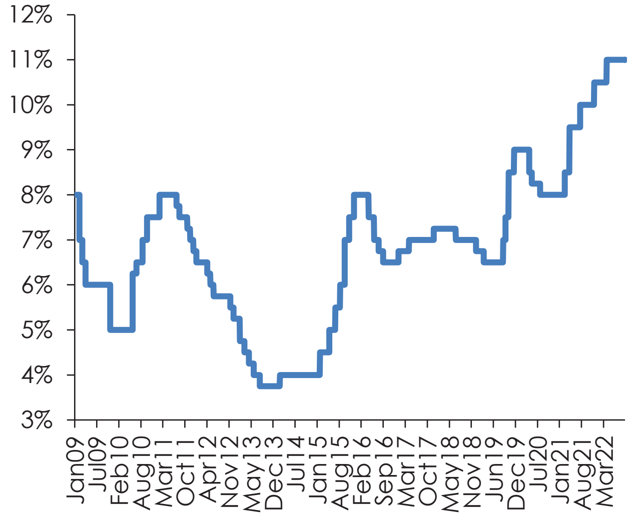


Figure 3.1. Monetary policy rate

Source: NBG.

The elevated inflationary environment remains a global challenge. During the COVID-19 pandemic, prices increased globally due to the demand-supply imbalance on the international market, the disruption of supply chains and complications related to transportation. However, it was considered that this increase in prices was a one-time event and that in the post-pandemic period inflation would decrease along with a balancing of supply and demand. Nevertheless, in order to avoid inflationary pressure arising from the growth of medium-term inflationary expectations and so-called "second round" effects, the NBG started to tighten monetary policy from the second half of 2021 and, since then, has increased the policy rate by 3 pp. As a result of Russia's invasion of Ukraine, global inflationary pressures have risen sharply. Before the war, Russia and Ukraine were two of the largest exporters of basic raw materials. The sanctions imposed against Russia and the ongoing war in Ukraine have disrupted the supply chains for commodity products from these countries and, as a result, the prices of energy resources and food increased in international markets. Georgia, as a small open economy, is vulnerable to global developments. The increase in prices on international markets are thus transmitted to the Georgian market and create inflationary pressure.

At the same time, aggregate demand is growing faster than expected. According to preliminary data, real GDP growth was 10.5% in the first half of 2022. The main driver of that growth is still strong domestic consumption, which is a result of high credit activity. In addition, due to its geopolitical location, and despite the Russia-Ukraine war, foreign demand has increased in Georgia. Against the backdrop of a large influx of citizens from Russia, Belarus and Ukraine and the gradual recovery of tourism, the 2022 forecast for economic growth has increased to 9%. According to the NBG, current economic activity is exceeding its potential level, which creates risks of additional pressure on prices.

Despite the tight monetary policy, credit activity remains strong, due to both consumer and foreign currency (FX) loans. In this regard, in order to slow down consumer lending, the Monetary Policy Committee considers it appropriate to use additional macroprudential instruments alongside maintaining a tight monetary policy. In addition, interest rate hikes by the US Federal Reserve and other leading central banks will have an additional tightening effect on credit conditions in Georgia.

Under conditions of strong supply shocks, maintaining a low level of long-term inflation expectations remains a significant challenge. As a consequence of a series of consecutive shocks, inflation has long been above its target level, creating a risk of inflation expectations rising over the medium term. At the same time, the risks are inflationary, both geopolitically and in terms of a faster-than-expected tightening of global financial conditions. Consequently, uncertainties surrounding the further development of the economy have increased significantly. On the one hand, there is increased global inflationary pressure and, on the other, there is a slowdown in economic activity. Eliminating that uncertainty will depend on the dynamics of the geopolitical situation and the duration of the Russia-Ukraine war.

It should be noted that the increase in money transfers and foreign capital inflows contributes to the appreciation of the GEL. The recent strengthening of the GEL nominal effective exchange rate certainly softens the pressure coming from international markets, which puts downward pressure on inflation.

Taking these factors into account, in order to eliminate additional inflationary pressures and reduce the risk of medium-term inflation expectations, on 3 August 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 of rising inflation expectations are sufficiently mitigated. Should inflation expectations rise, a further tightening of policy or maintaining the current tight stance for a longer period may become necessary.

The reduction of dollarization is an important challenge for the Georgian economy. This has become especially relevant with the increase in GEL interest rates, because the increase in the spread between the interest rates of the GEL and foreign currency is reflected in an increase in lending in foreign currency. 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 hin-

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

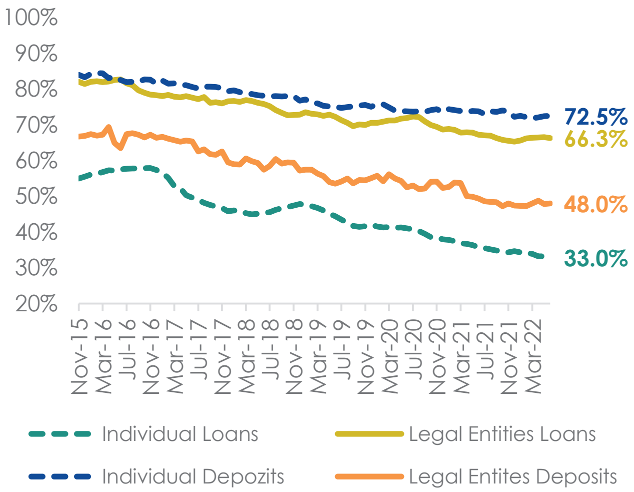


Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG.

ders 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 not only reduces the currency and related credit risks of individual borrowers, but also promotes long-term economic growth.

The dollarization of total loans decreased by 0.2 pp (excluding the exchange rate effect) in June 2022 and stood at 48.6%. Due to the high differential between the interest rates of GEL and foreign currency deposits, the downward trend of the dollarization of individuals' and legal entities' deposits also continued, falling by 1.1 pp and 4.3 pp respectively to 72.5% and 48.0% (excluding the exchange rate effect) over the same period.

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 can obtain additional liquidity through refinancing loans, which is the main instrument of the NBG.

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.

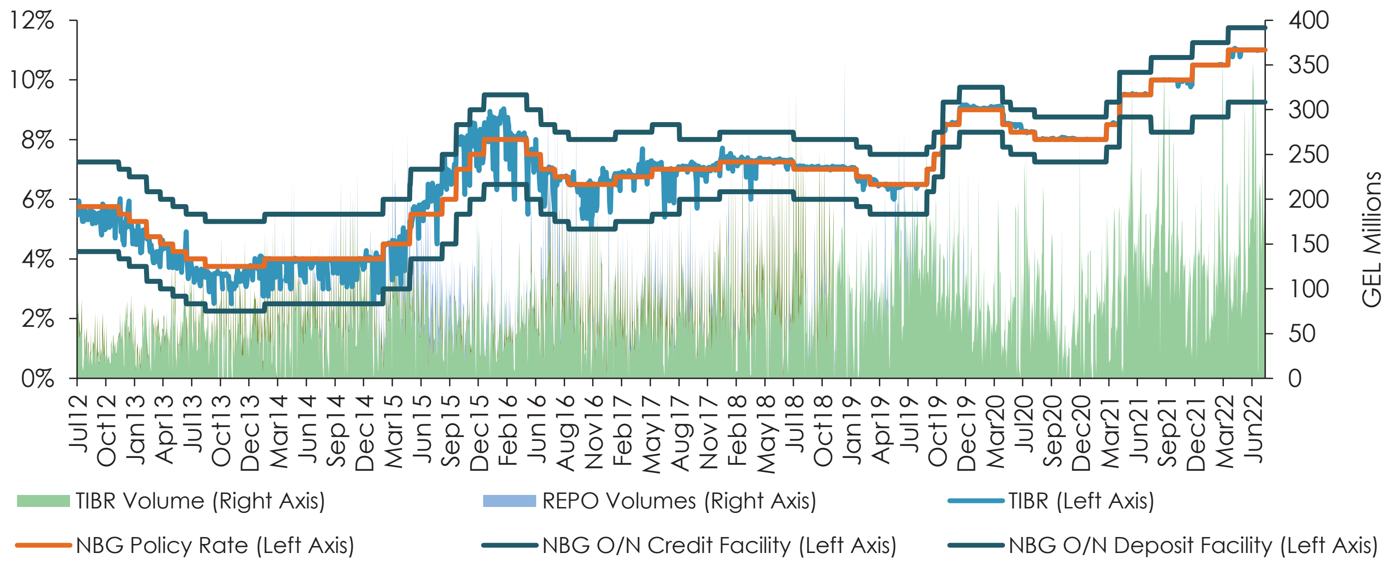


Figure 3.3. Interbank money market

Source: NBG.

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