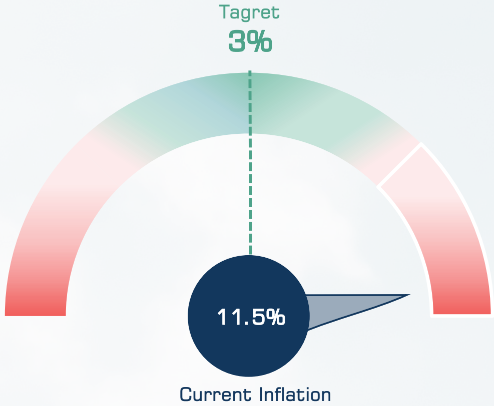
Monetary Policy Report

October

2022

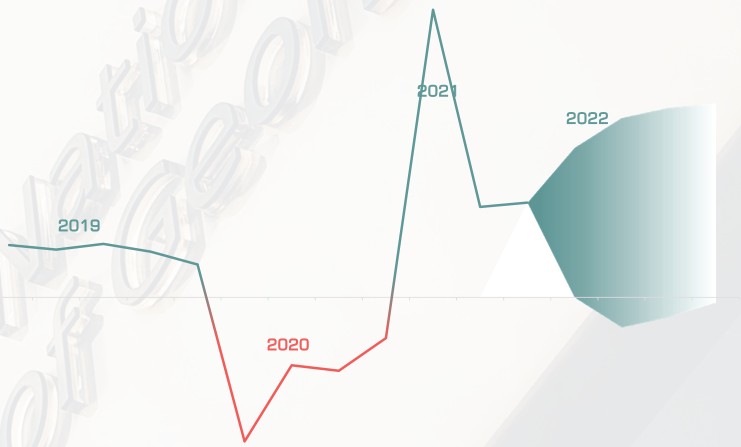
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



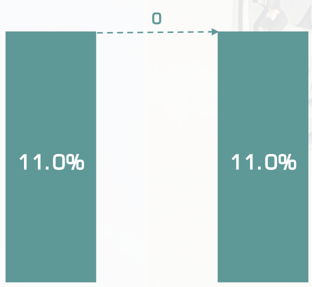
11.5%	Against the backdrop of successive shocks, inflation is well above the target level.

Economic Growth



Economic activity has been quite strong in 2022, which has slowed down the decline of inflation.	10%

Monetary Policy



11%	In order to reduce inflation expectations, the National Bank of Georgia has maintained its tight monetary policy.

MONETARY POLICY DECISION

The National Bank of Georgia's monetary policy has maintained its 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 has gained increased importance given the current uncertain environment.

High inflation is a global economic challenge. In the post-pandemic period, Russia's invasion of Ukraine has further increased energy and food prices on international markets. As a result, consumer prices rose sharply all over the world. These globally increased prices were also transmitted to the Georgian market, and remain the main reason for high inflation in the country. At the same time, economic activity in Georgia has been high, largely facilitated by the restoration of tourism against the backdrop of an increase in long-term visits by Russians and Belarusians.

Strong economic activity increases the risk of demand-side inflationary pressure, although this has been partly offset by the recent appreciation of the lari exchange rate. Moreover, food prices on world markets have recently been declining, which gives grounds for cautious optimism. As a result of the continued tight monetary policy and the exhaustion of supply-side shocks, inflation will gradually decline to return to the target level from the second half of 2023. However, as uncertainty remains and inflationary risks are at a high level, we have kept the monetary policy rate tight 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 further tightening or to be maintained at the current high level 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 inflation rate will be close to the 3% target in the medium term.

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BRIEF OVERVIEW

The Russia-Ukraine war has had a peculiar effect on Georgia's economy. Along with the increased migration that resulted from the war and the accompanying sanctions imposed on Russia, foreign inflows increased significantly, which boosted spending and strengthened the lari exchange rate. Although the latter has helped headline inflation decrease, stronger economic activity alongside still-high global oil and food prices have hampered that retreat. According to the baseline macroeconomic projection, the stabilization of economic activity, as supported by tight monetary policy, will see inflation decrease and approach the target in the second half of 2023. Given the prolonged deviation of inflation from its target, maintaining the credibility of the NBG's core objective of price stability gains even more importance. As a result, monetary policy is expected to remain tight until long-term inflation expectations show clear signs of falling.

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.

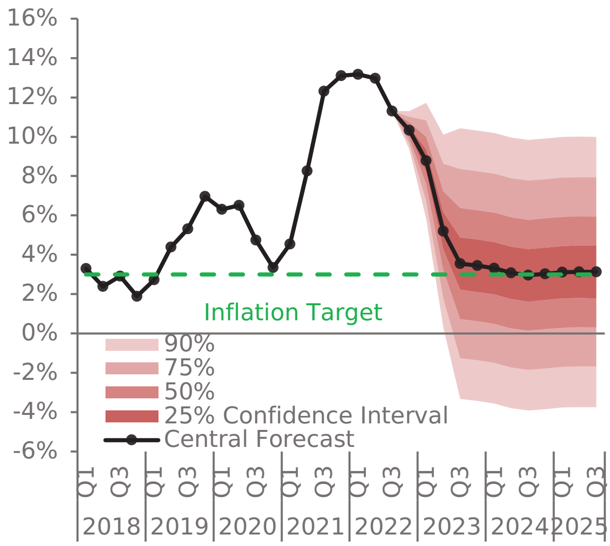

Figure 1. Headline CPI inflation forecast

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

Since reaching a peak at the beginning of the year, headline inflation has followed a downward trend. This was expected. With the gradual elimination of one-off factors related to the pandemic, the annual rate of inflation should have automatically decreased amid the application of tight monetary policy. However, the Russia-Ukraine war and its consequences served to hinder the decline of inflation since it caused international prices of oil and other commodities to surge, which only abated after a while. In addition, amid a sudden increase in migration and foreign inflows, spending in the economy increased, putting upward pressure on inflation. However, at the same time, the lari exchange rate strengthened – a development that, in isolation, would have pushed inflation down. According to the baseline macroeconomic forecast, the above-mentioned factors will continue to shape the inflation dynamics in the short term. Along with the phasing out of their effects, **inflation will average 5.3% in 2023** and will return to its target in the second half of the year (see Figure 1).

Amid the Russia-Ukraine war, and contrary to expectations, aggregate demand increased significantly in the first half of the year. According to preliminary estimates, average growth in the first eight months of the current year was 10.3%. One of the main reasons for this growth was increased migration to Georgia from regional countries and the accompanying foreign inflows. In particular, amid significantly increased revenues from exports of services (mainly from tourism), net exports have made a significant contribution to real GDP growth in the current year. However, in the future, when the given situation stabilizes, a similar growth of foreign inflows is unlikely. Also, it should be noted that credit activity is still relatively strong, despite the fact that its growth has already slowed in recent months as a result of tight monetary policy and the implemen-

Due to improvements observed in external sector data alongside strong credit activity, real GDP is expected to grow by 10% in 2022. Over the next few years, growth will stabilize at around 4-5.5%.

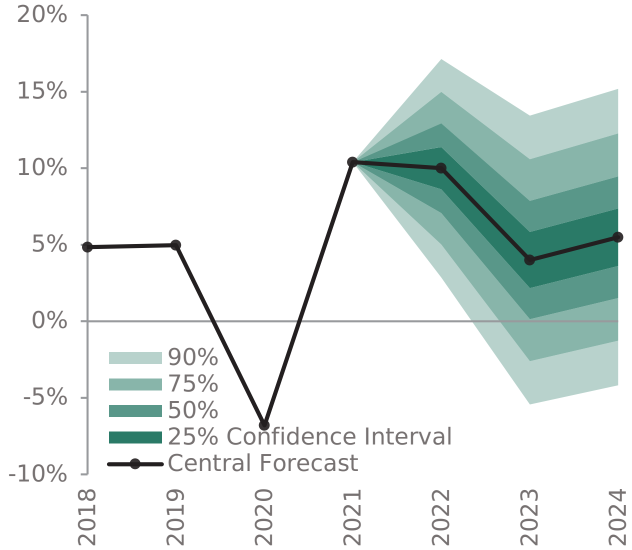

Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat.

In light of existing inflationary risks, the NBG's tight monetary policy stance has been maintained and its future normalization is expected to be a gradual process.

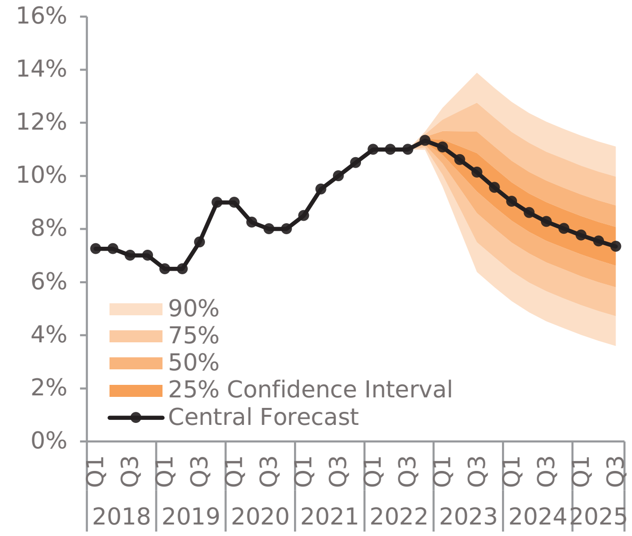

Figure 3. Monetary policy rate forecast

Source: NBG.

tation of recent macroprudential measures. Based on the above-mentioned factors, according to the current baseline macroeconomic forecast, **real GDP will grow by 10% in 2022, and by 4% in 2023** (see Figure 2).

Considering the above-mentioned factors and the fact that inflation has deviated from its target for quite a while, there is still the risk of inflation expectations rising. In response, **the National Bank of Georgia decided to keep the monetary policy rate at a high level of 11%.** Meanwhile, based on existing inflationary risks, the future normalization of the policy rate will be slower than previously forecast. The policy rate will start to decrease to its neutral level (which is currently estimated at 7%) in moderate steps and will only do so after there have been clearly visible reductions in inflation expectations.

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

1 CURRENT MACROECONOMIC SITUATION

Amid the challenges surrounding the ongoing Russia-Ukraine war, which include a humanitarian crisis and a high inflationary environment, a slowdown in global economic activity is expected in 2022. Although the situation on commodity markets has slightly stabilized recently, energy and food prices remain high and have put pressure on consumer prices globally, including in Georgia's main trading partners. Such a climate has necessitated a sharp tightening of monetary policy from central banks. Despite the slowdown in the economic growth of partner countries amid the policy tightening, external demand in Georgia (as supported by increased tourist and migrant spending) is strong, contributing to high economic activity overall. Considering these factors, although annual inflation is still high, the peak period has passed and inflation is following a downward trend.

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 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. Consequently, growth rates are expected to deteriorate, especially for developed countries. In addition, there are still severe disruptions to global supply chains. As a consequence, inflation rates in a number of countries have increased unprecedentedly, and monetary policies have been tightened in response to a corresponding deterioration of inflation expectations. Therefore, according to the International Monetary Fund's (IMF) October forecast[1], **global economic growth** in 2022 will be 3.2%, which was similar to the previous forecast[2], and it is expected to be 2.7% in 2023, which is 0.2 percentage points (pp) lower than in the previous forecast. Also, amid increased inflation expectations, the expected level of global inflation is 8.8% in 2022, and 6.5% in 2023 – which is 1.7 pp higher than in the previous forecast. For emerging and developing countries, real GDP is expected to grow by 3.7% in both 2022 and 2023[3], which is 0.1 pp higher than previously forecast.[4] Inflation in such countries is expected to be around 9.9% in 2022 and 8.1% in 2023.

Amid the challenges surrounding the Russia-Ukraine war, including the humanitarian crisis and high inflationary environment, a slowdown in global economic activity is expected in 2022.

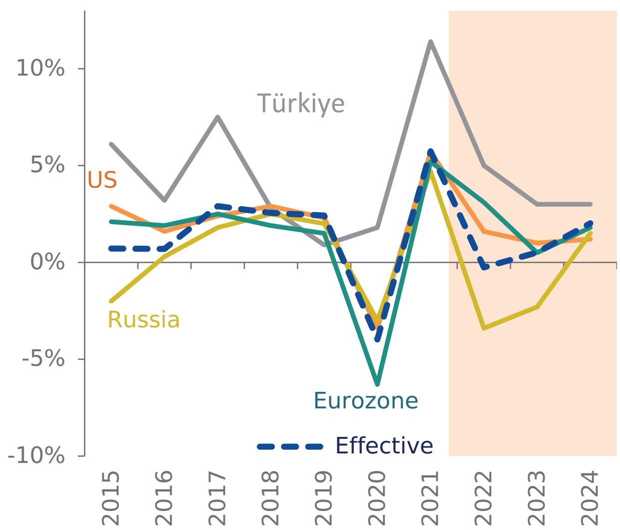

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF.

1 *International Monetary Fund. 2022. World Economic Outlook: Countering the Cost-of-Living Crisis. Washington, D.C., October (Hereafter: WEO, October 2022).*

2 *International Monetary Fund. 2022. World Economic Outlook Update: Gloomy and More Uncertain. Washington, D.C., July (Hereafter: WEO update, July 2022).*

3 *WEO, October 2022.*

4 *WEO update, July 2022.*

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

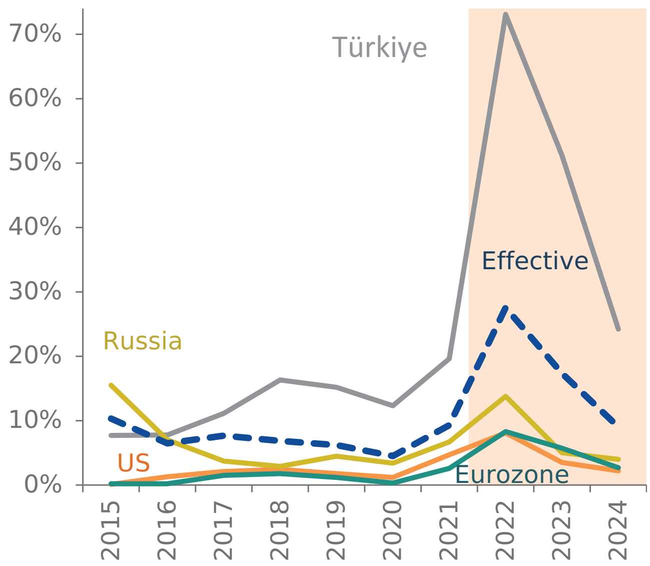

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF.

In the third quarter of 2022, a high inflationary environment prevailed in both developed as well as in emerging and developing countries. This was mostly related to the challenges surrounding the Russia-Ukraine war and the high commodity prices on international markets. However, it should be noted that both oil and food prices have recently followed a downward trend (see section 1.1.2 of this report).

In the third quarter of 2022, the pace of economic activity in the **United States** slowed. This was related to a sharp increase in consumer prices and a tightened financial environment. Consequently, exports slightly deteriorated and inventory investments declined. Amid the Russia-Ukraine war, the US government continues to impose sanctions on Russia, which represent an additional challenge for the country. Annual inflation remains high and stood at 8.2% in September. In response to inflation expectations, the Federal Reserve has already raised its federal funds rate to the 3-3.5% range. According to IMF's October forecast[5], real economic growth in the US will be 1.6% in 2022, which is 0.7 pp lower than the previous forecast[6], while growth is expected to be at 1% in 2023. Annual inflation is projected to be at 8.1% in 2022 and 3.5% in 2023.

In the third quarter of 2022, the pace of improvements in economic activity slowed in the **eurozone**. This was mostly related to challenges stemming from the Russia-Ukraine war. Due to the economic sanctions on Russia, there is the expectation of an energy crisis. As a result, consumer and business sentiment has deteriorated. Amid the recent depreciation of the euro, annual inflation is still high and stood at 10% in September, which was a record high for the eurozone. The packages of economic sanctions European countries have enacted against Russia, which are designed to reduce their dependence on the latter's market, have put additional pressure on activity. According to the IMF, real economic growth for the eurozone will be 3.1% in 2022,[7] which is 0.5 pp higher than the previous forecast,[8] and is mostly explained by the higher-than-expected growth rates seen in the first half of the year. Growth is expected to be at 0.5% in 2023, while annual inflation is forecast to be at 8.3% in 2022 and 5.7% in 2023.

In the third quarter of 2022, the pace of improvement in economic activity also slowed in **Türkiye**. Both consumer sentiment and consumption weakened, which was mostly due to the recent depreciation of the Turkish lira. This caused even higher inflationary pressure, with annual inflation standing at 83.5% in September. Meanwhile, the volume of exports has increased. According to the IMF's October forecast[9], real

5 *WEO, October 2022.*
6 *WEO update, July 2022.*
7 *WEO, October 2022.*
8 *WEO update, July 2022.*
9 *WEO, October 2022.*

GDP growth will be 5% in 2022, which is 2.3 pp higher than the previous forecast[10], while growth is expected to be 3% in 2023. Annual inflation is projected to be around 73.1% in 2022 and 51.2% in 2023.

Due to the economic sanctions imposed by the West, economic activity in **Russia** remained deteriorated in the third quarter of 2022. Investments, consumer spending and retail sales were all reduced. The business environment has also worsened. Soon after starting the war, amid a sharp depreciation of the Russian ruble, and in spite of its subsequent strengthening, annual inflation increased significantly to equal 13.7% in September. As a result, the Central Bank of Russia decided to further tighten its monetary policy to 20%, which was gradually reduced to 7.5% in September. 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. According to the IMF, the real economy will decline by 3.4% in 2022[11], which is 2.6 pp better than the previous forecast[12], while it is expected to decline by 2.3% in 2023. Inflation is forecast to be 13.8% in 2022 and 5% in 2023.

Amid Russia's war, the number of deaths in **Ukraine** is increasing daily, and about eight 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, and fuel storage depots, have been destroyed. According to the IMF, Ukraine's real economy will decline by 35% in 2022, while inflation is expected to stand at 20.6%.[13] It is important to emphasize that the civilized world, including Georgia, has expressed its support for Ukraine.

In the third quarter of 2022, alongside rising inflation expectations, many of the central banks of Georgia's trading partners have further tightened their monetary policy rates. Türkiye is an exception to this, where, despite high inflation, the monetary policy rate has gradually declined. The Central Bank of Russia has also reduced its policy rate.

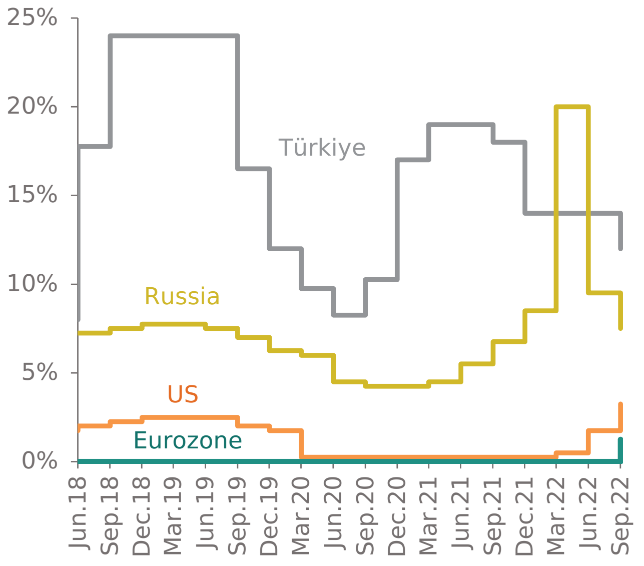

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

The third quarter of 2022 was characterized by high economic activity in **Armenia**. This was mostly due to the increased migration of Russian citizens into the country, which caused improvements to the business environment and the service sector. However, both the tense geopolitical situation and military confrontation with Azerbaijan have exerted a negative impact on the economy. The annual inflation rate was high and stood at 9.9% in September. According to the IMF, the real GDP forecast for Armenia in 2022 is 7%[14], which is 5.5 pp higher than the previous forecast[15], while growth is expected to be around 3.5% in 2023. The annual inflation rate is projected to be 8.5% on average in 2022 and 7% in 2023.

In the first half of 2022, **Azerbaijan's** economic ac-

10 International Monetary Fund. 2022. World Economic Outlook: War Sets Back the Global Recovery. Washington, D.C., April. (Hereafter: WEO, April 2022).
11 WEO, October 2022.
12 WEO update, July 2022.
13 WEO, October 2022.
14 WEO, October 2022.
15 WEO, April 2022.

tivity 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, the annual rate of inflation rose and stood at 15.6% in September. According to the IMF, real GDP growth in Azerbaijan will be 3.7% in 2022[16], which is 0.9 pp higher than the previous forecast[17], while growth is expected to be 2.5% in 2023. The annual inflation rate is forecast to be around 12.2% in 2022 and 10.8% in 2023.

In the third quarter 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. In particular, in September, the U. S. Federal Reserve raised its federal funds rate in the 3-3.25% range. Meanwhile, the European Central Bank has increased its policy rate to 1.25%.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

In 2022, food prices increased sharply, although the recent period has seen a stabilization and reduction of prices.

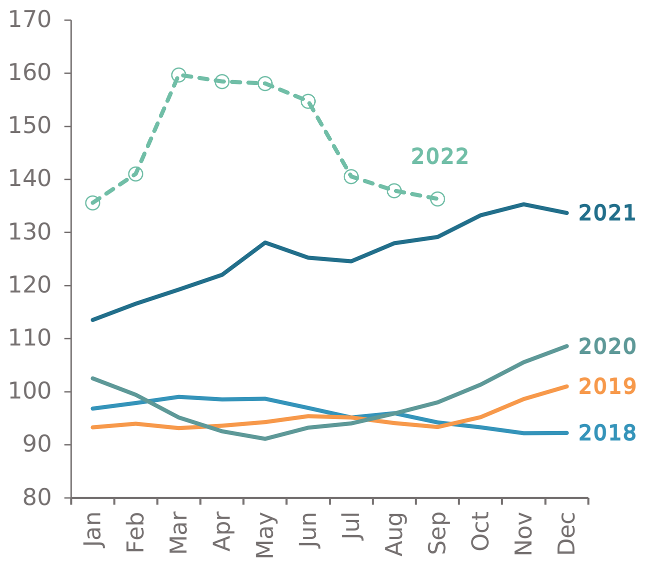

Figure 1.1.4. International food price index

Source: FAO.

According to the latest data of the Food and Agriculture Organization of the United Nations (FAO), a trend of decreasing prices on international commodity markets has been revealed. Despite this, prices are still significantly higher than pre-pandemic levels, and uncertainty regarding their dynamics remains high.

In September, the food price index amounted to 136.3 points, which is 1.5 points (1.1%) less than in August. This index has been decreasing for six months in a row. One of the reasons for this positive dynamic is the improvement of grain production prospects in North America and Russia and the recovery of exports from Ukraine to the Black Sea ports. In July, Ukraine and Russia reached an agreement to remove those restrictions on grain exports that had been imposed against the backdrop of the Russia-Ukraine war; as a result, grain prices decreased and this downward trend continued in the months that followed. However, the validity of this agreement lasts only until November of this year, and it is currently unclear how further events will develop. Against the background of this uncertainty, grain prices increased by 2.2 points (1.5%) in September compared to August.

A declining trend of prices on international markets was evident for all other types of food products. In particular, the vegetable oil price index decreased by 10.8 points (6.6%) compared to August and averaged 152.6 points, which was the lowest rate since February 2021. This drop in the index was a reflection of the decrease in prices of sunflower, palm and soybean oils. At the same time, prices of dairy products, meat and sugar have also fallen. The sugar price index reached

16 WEO, October 2022.
17 WEO, April 2022.

In 2021-2022, fuel prices increased sharply, however, prices have had a declining trend from the second half of 2022.

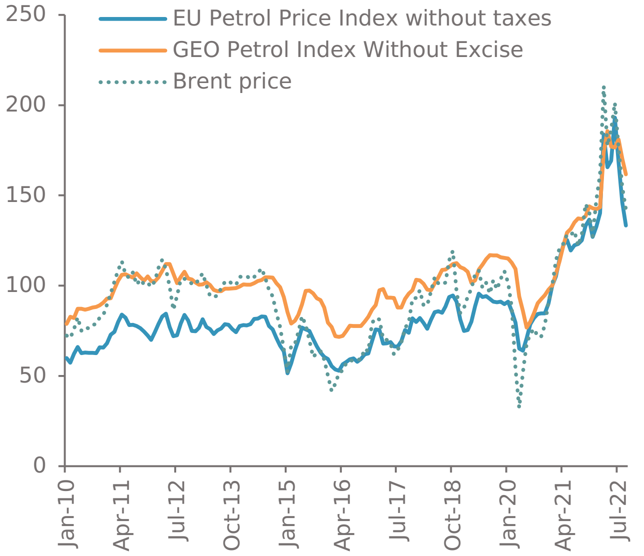

Figure 1.1.5. Petrol price index (Jan 2021=100)

Source: EU Commission, Statista, NBG calculations.

In line with the gradual easing of pandemic-related restrictions and the drop of oil prices, the cost of international transportation has continued to decline.

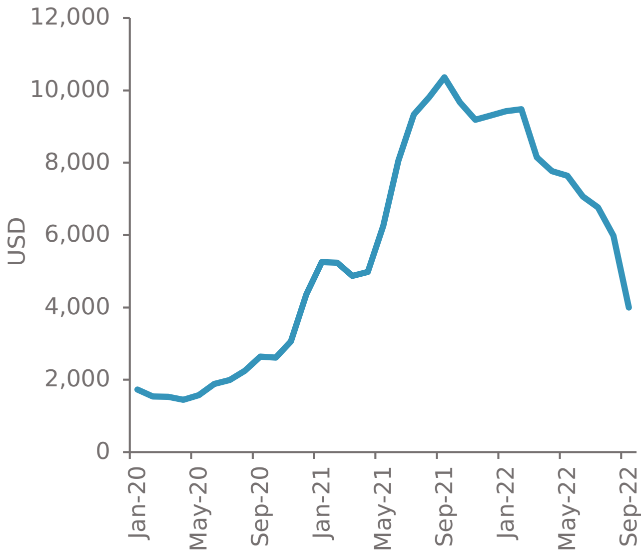

Figure 1.1.5. Average shipping cost of a 40-foot container worldwide

Source: Statista.

its lowest level since July 2021. The main driver for the price reduction was the improvement of production potential.

After the start of the Russia-Ukraine war a significant drop in oil supply was expected as a result of the sanctions imposed on Russia. As a result, oil prices rose sharply in early 2022. However, more recently, a positive trend in prices has been observed. In September, the average prices of Brent oil declined by 10.6% compared to the previous month and amounted to USD 90.0 per barrel. However, despite this recent decline, oil prices are 43.4% higher than in the same pre-pandemic period of 2019. According to the updated forecast of the International Energy Association from September, it is expected that the price of Brent oil will be USD 104.2 per barrel in 2022, and USD 96.9 in 2023, which creates expectations of a decrease in prices on international markets. On the other hand, the recent decision by the Organization of the Petroleum Exporting Countries (OPEC) to cut oil production has increased uncertainties on the market and has thus exacerbated risks of price increases.

Petrol prices have had a downward trend in the EU market as well, where prices fell by 9.3% compared to August. In line with the drop of oil prices and a gradual recovery of supply chains, the international cost of transportation continues to decline. The price of international transportation reached a peak in September 2021, and a downward trend has been observed since the beginning of 2022, falling by 61.4% annually in September. These movements will slow down imported inflation.

Against the background of the price dynamics mentioned above, it is expected that the pressure on inflation coming from international markets will decrease; this will be further supported by the recent strengthening of the GEL exchange rate.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

Despite the slowdown of economic growth in trade partner countries, external demand is strong. In light of this and the rise of prices, revenues from registered exports of goods continues to rise.

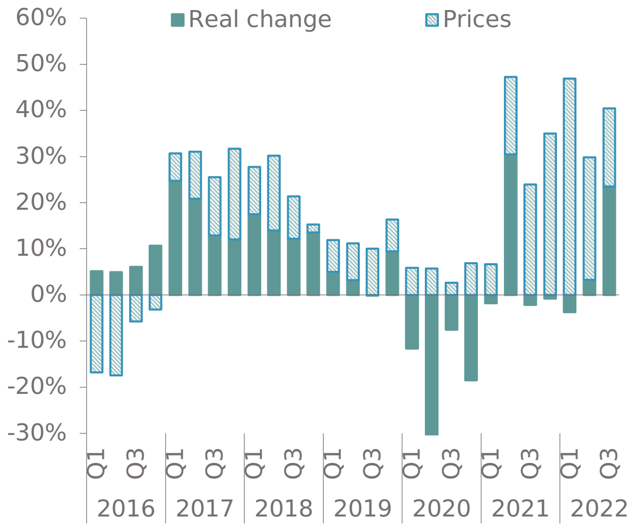

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat.

The rise in exports of goods mainly stemmed from an increase in external demand for consumer goods.

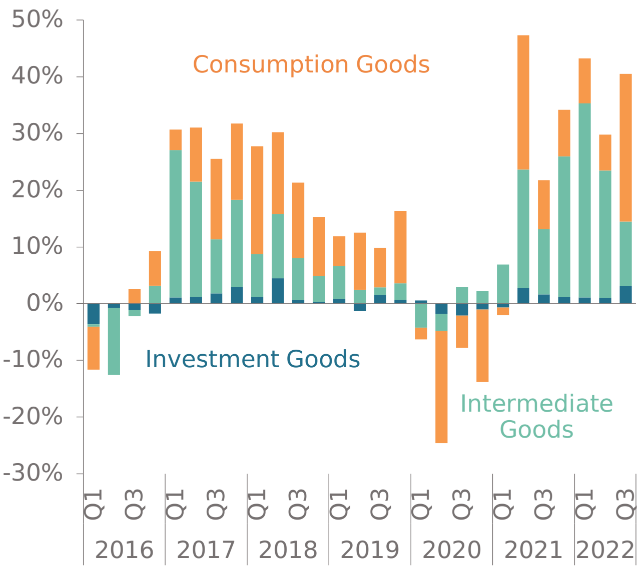

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat.

In the third quarter of 2022, external demand was strong. Despite the fact that new challenges to international trade arose as a consequence of Russia's invasion of Ukraine, Georgia's external trade turnover continued to grow. Exports of goods increased substantially and outweighed the volume of pre-pandemic levels as seen in 2019. Due to heightened domestic demand, imports of goods increased considerably. As a result of the severe geopolitical environment, the rise in long-term visitors arriving in Georgia from Ukraine, Russia and Belarus has supported the continued growth of revenues from international travelers. In addition, the lifting of pandemic-related restrictions on mobility and a revival of international tourism have also led to a rise in the number of visitors arriving from other countries. Against this background, the current account deficit continued to decline and this trend is expected to have continued in the third quarter of 2022.

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 third quarter of 2022, registered exports of goods grew by 40.5% annually (see Figure 1.2.1). Such growth is mostly related to increased prices on export goods, while the real annual growth of exports of goods was around 24%. In light of the ongoing war, as expected, exports of goods to Ukraine declined, however these began to recover in the third quarter, mainly due to a rise of re-exports of motor cars. Higher exports to Armenia were induced by increased sales of motor cars and mineral waters. In terms of regional countries, exports to Russia and Azerbaijan were also noteworthy, while Bulgaria and the USA were top export destinations among other countries. In contrast, exports to China fell substantially because of lower re-exports of copper ores and concentrates.

Exports of goods mainly increased due to increased levels of consumer goods being exported. This was mostly a reflection of the substantially increased prices of such goods; meanwhile, investment goods also made an increased contribution to the overall growth of exports in the third quarter (see Figure 1.2.2). In terms of the rise in exports of consumer goods, motor cars exported to Ukraine, Armenia and Russia made the largest positive contributions. The increased exports of intermediate goods mainly stemmed from high exports of copper ores and concentrates to Bulgaria, electricity to Türkiye, and ferro-alloys to Peru. In terms of investment goods, exports of other aircraft vehicles and bovine animals played a leading role in the overall growth.

In line with the high tourist season, the number of

Revenues from international travelers were on the rise and their volume outnumbered the pre-pandemic levels seen in 2019.

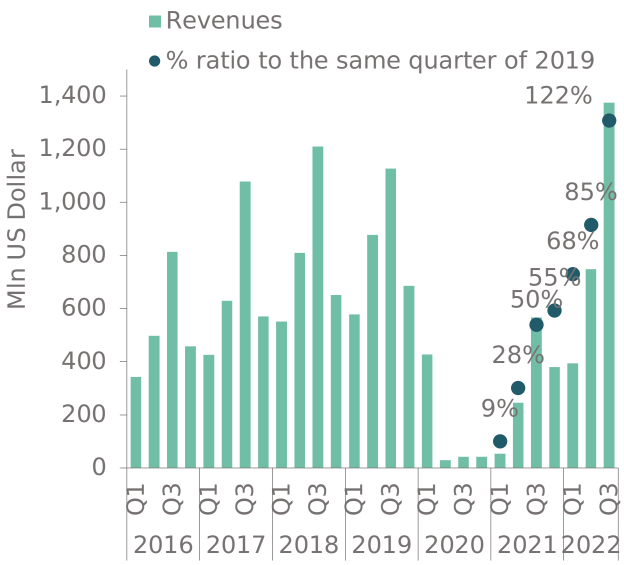

Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG.

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

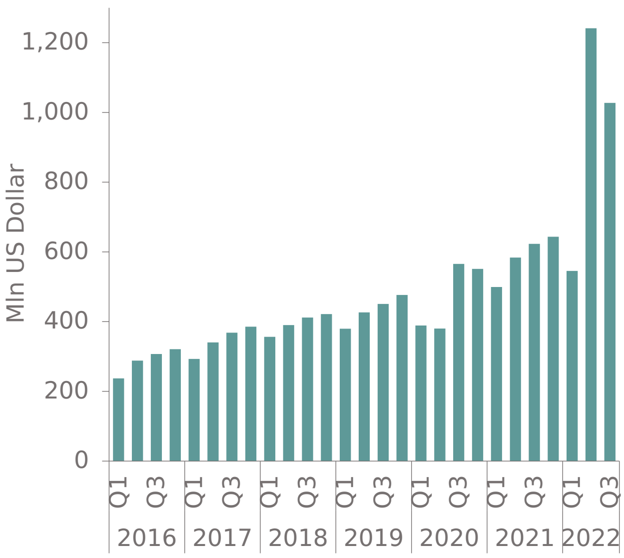

Figure 1.2.4. Annual change in money transfers

Source: NBG.

international visitors was on the rise. In the third quarter, the number of international visitors rose by 162.4% annually, although the total remained below that of the same period in 2019 (down by 31%). Against the background of the current geopolitical environment, numbers of long-term visitors from Russia, Belarus and Ukraine continued to grow. Meanwhile, increased numbers of visitors from Israel and Saudi Arabia also made a significant contribution (around 12 pp of the overall increase of visitors).

Despite the fact that the number of visitors were below pre-pandemic levels, the volume of revenues received from international travelers were 22% higher than the same period of 2019. In the third quarter of 2022, such revenues increased by 2.4 times annually (see Figure 1.2.3). The increased revenues are predominately related to the increase of long-term visitors from Russia and Belarus following the start of the war in Ukraine, but revenues from visitors of other countries also continued to rise.

In the third quarter of 2022, instant money transfers to Georgia increased by 64.9% annually and amounted to USD 1,027.5 million (see Figure 1.2.4). Such a high volume of transfers, as in the previous quarter, was mainly due to a rise in transfers from Russia (inflows were 3.3 times higher, making a 43.2 pp contribution to the overall growth). Aside from Russia, transfers from Kyrgyzstan (5.5 pp), the EU (3.8 pp) and Kazakhstan (2.7 pp) made the largest contributions to total growth in this period. Similar to the previous quarter, money transfers from Ukraine were minimal.

Considering the higher internal demand and an acceleration of economic activities, imports of goods rose considerably, increasing by 29.0% in the third quarter of 2022 (see Figure 1.2.5). The rise in imports from regional countries was significant, particularly those from Russia and Türkiye; but imports from other regions, including Romania and China, made the largest contributions to overall growth. In contrast, imports from Ukraine fell due to impediments in the production process and external trade obstacles resulting from the war.

In the third quarter of 2022, imports of consumer goods made the largest contribution to the overall growth of imports (see Figure 1.2.6). The increase in such imports 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 copper and precious metals ores and concentrates, as well as of wheat flour. Meanwhile, the rise in imports of investment goods stemmed from higher purchases of other aircraft vehicles and telephones.

It is worth noting that the significant rise of imports in nominal terms was influenced by the substantial increase of prices. Global prices in USD terms, despite

In light of strong domestic demand, imports of goods have risen at a high rate, which is related to higher prices on international markets. Higher import prices in USD terms induce rising expenditures on import goods.

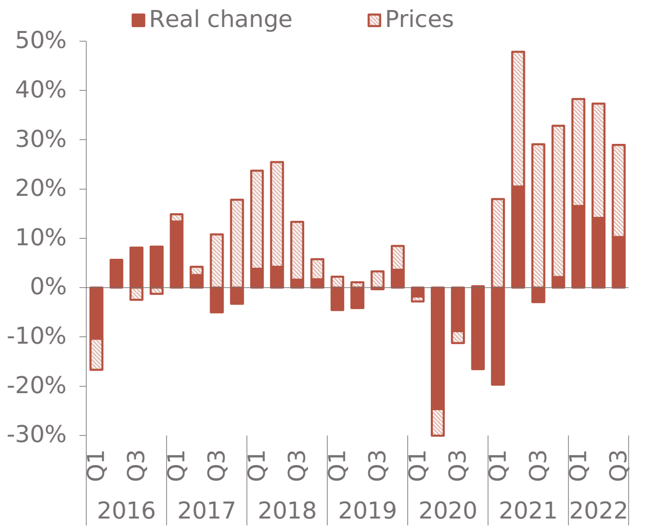

Figure 1.2.5. Annual change in registered imports of goods
Source: GeoStat

In the third quarter of 2022, imports of consumer goods made the largest contribution to the overall growth of imports, which was partially related to the higher level of commodity prices on international markets.

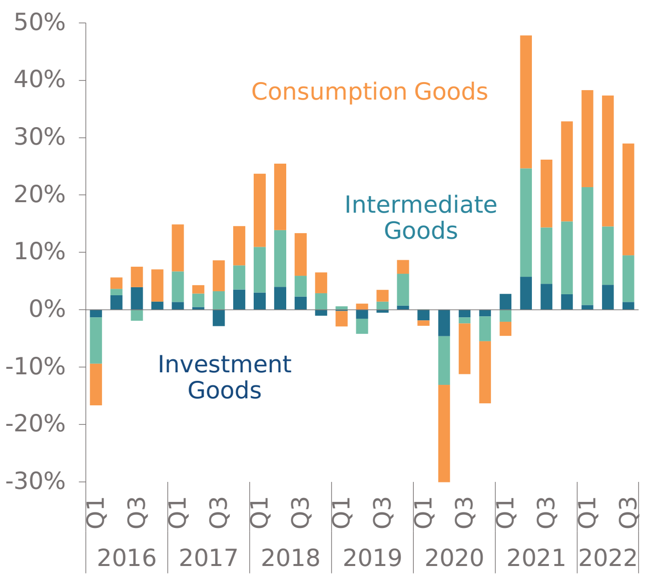

Figure 1.2.6. Annual change in registered imports of goods
Source: GeoStat

a recent moderation, remain at a high level, which increases the cost of import goods. In the third quarter, the volume of imports in USD terms increased by 78% annually, which was mostly due to the rise of energy prices on global markets. In real terms, imports of goods increased by an annual 10.3% in the third quarter.

In light of higher external inflows, the current account deficit improved, reaching around USD 252 million and amounting to 4.2% of quarterly GDP. Compared to the same period of 2021, the narrowing of the current account deficit is mainly due to the rise of exports of goods, especially revenues from international travelers. In addition, the high volume of workers' remittances received from abroad induced a further improvement of the current account balance. According to the NBG's forecast, revenues received from international travelers in 2022 will reach 104% of those of 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 5.5% of GDP in 2022.

The main source of financing the current account deficit was foreign direct investments (FDI). In the second quarter, the volume of inward FDI amounted to USD 352 million. The rise in FDI mainly stemmed from a higher level of equity investments. In the second quarter, the majority of FDI went to the energy and real estate sectors.

From the perspective of savings and investments, in the second quarter of 2022, as compared to the same period of the previous year, the improvement of the current account balance was due to a rise in savings, rather than of investments (see Figure 1.2.7). This also reflects a rise in aggregate income compared to 2021. The expected narrowing of the current account deficit in 2022 is also related to the rise in savings.

In light of higher revenues from international visitors, the current account deficit is expected to decrease in 2022.

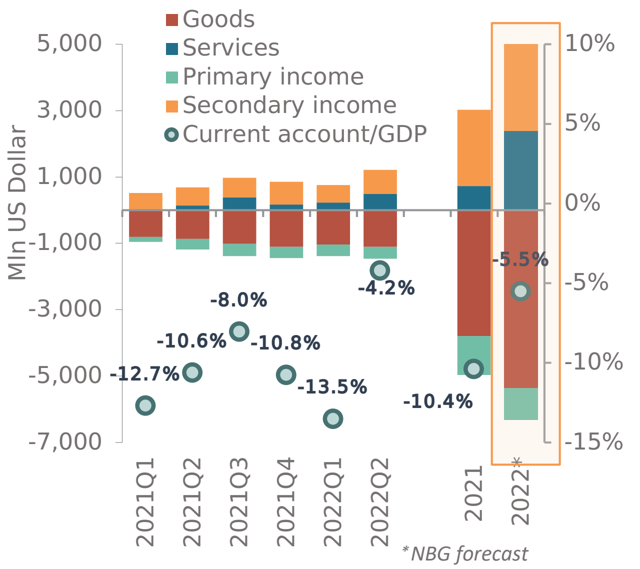

Figure 1.2.7. Current account balance and its components

Source: NBG

In 2022, the expected improvement of the current account deficit (around 5.5% of GDP) is mainly due to the rise of savings (along with a decline of the fiscal deficit).

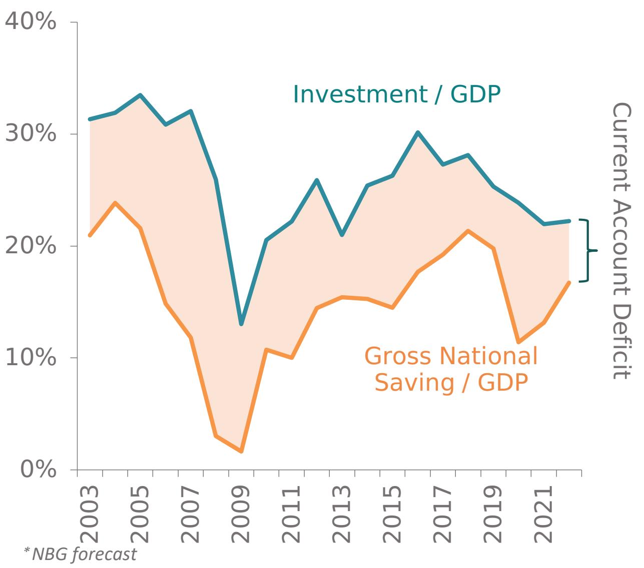

Figure 1.2.8. Investments and savings

Source: GeoStat, NBG Calculations

BOX 1. THE IMPACT OF MIGRATION (FROM RUSSIA AND BELARUS) ON TOURISM REVENUES

Tourism revenues have a significant impact on economic conditions in small and open economies like Georgia. Russia's invasion of Ukraine at the end of February 2022 has led to an increase in the number of Russian and Belarusian visitors arriving in Georgia. The increased number of visitors has positively affected demand for accommodation and food services and boosted aggregate demand. Based on the current statistical methodology, migration expenditures are included in tourism revenues. However, to analyze the situation more precisely, it becomes necessary to separate the effect of accelerated migration on the current account balance and on the economic growth of Georgia, since the effect of migration on economic growth is assumed to be temporary. To achieve this goal, we have to estimate the number of visitors who would have visited Georgia if the war had not occurred (or, in other words, we need the counterfactual number of visitors).

Based on historical trend analysis and econometric estimation, starting from 24 February, migration gradually increased, peaking in July-August. At that time, actual visitors from Russia exceeded the counterfactual number of visitors by 70,000 (the difference between the actual and counterfactual number of visitors are considered migrants). Although the number of visitors slowly went down to 50,000 after the peak, the 21 September announcement of mobilization in the Russian Federation created a second wave of arrivals. The second wave implies a further 30,000 entrants. As a result, the estimated total number of Russians who migrated to Georgia is around 80,000.

Up until August, the number of Belarusian migrants increased by 13,000 as a result of the war. In September, this number lowered to 10,000. In sum, migration from these two countries (Russia and Belarus) was estimated to be 80,000-90,000 higher than the counterfactual number in the absence of war (see Diagrams 1.2.9 and 1.2.10). This extra influx is considered are considered to be migrants.

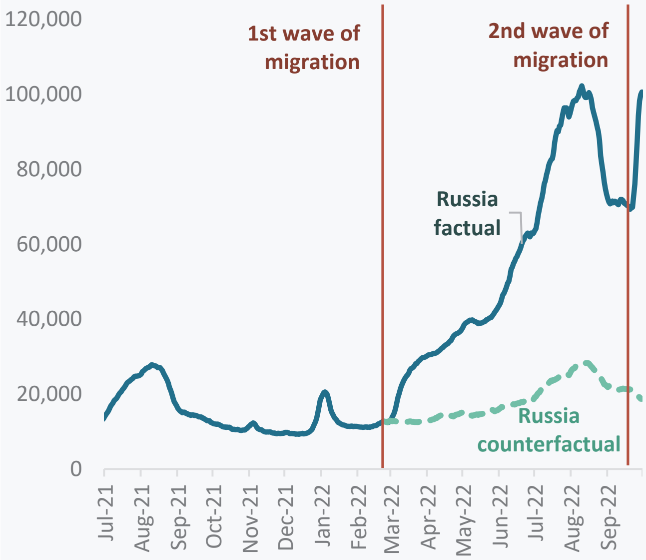

Figure 1.2.9. Actual and counterfactual numbers of Russian citizens in Georgia

Source: Ministry of Internal Affairs of Georgia, NBG.

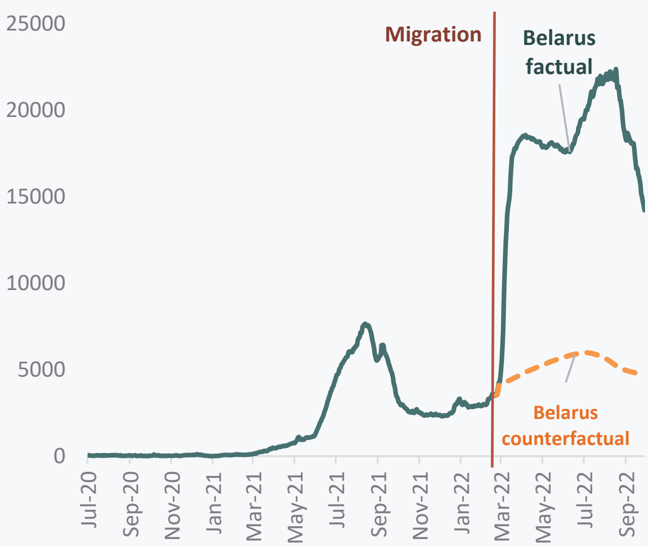

Figure 1.2.10. Actual and counterfactual numbers of Belarusian citizens in Georgia

Source: Ministry of Internal Affairs of Georgia, NBG.

According to survey-based research conducted in the summer of 2022 by the German Economic Team, the majority of Russian and Belarusian migrants currently living in Georgia are young and have higher education. Also, the majority hold full-time jobs in the field of Information and Communication Technologies. Based on this research, the average monthly expenditures of Russian migrant households are around USD 1,730, while Belarusian migrant households spend USD 1,440 per month. The same survey suggests that such migrants are planning to stay in Georgia for more than half-year. Based on this information and the abovementioned assumptions, we can estimate migration's impact on the current account balance and economic growth. Meanwhile, we should take into account the socio-economic differences in the backgrounds of the pre- and post-mobilization entrants. We assume that the second wave (post-mobilization) migrants are less skilled and have lower incomes than their first-wave counterparts. According to our assumption, the second-wave of migrants will spend USD 1,000 per month (necessary for basic needs such as renting a room, buying food, etc.).

Based on these assumptions and the estimation of the number of migrants, the additional income generated from migration in 2022 is around USD 500 million (see Table 1). If we further assume that 40% of tourism-generated revenues are spent on imported goods, the current account balance in 2022 is 1.5 pp higher than the counterfactual value. Specifically, in the absence of migration, the current account deficit would have been 7% rather than 5.5% (see Diagram 1.2.11).

2022 Forecast	Without migration	With migration
Tourism-generated revenues (million USD)	**2,756**	**3,265**
Migration		509
Russia		422
Belarus		88
Imporst of goods	12,394	12,597
Current Account Balance/GDP	**7.0%**	**5.5%**

Table 1 – Current account balance in 2022 as a percentage of GDP, with and without migration

Source: NBG estimates.

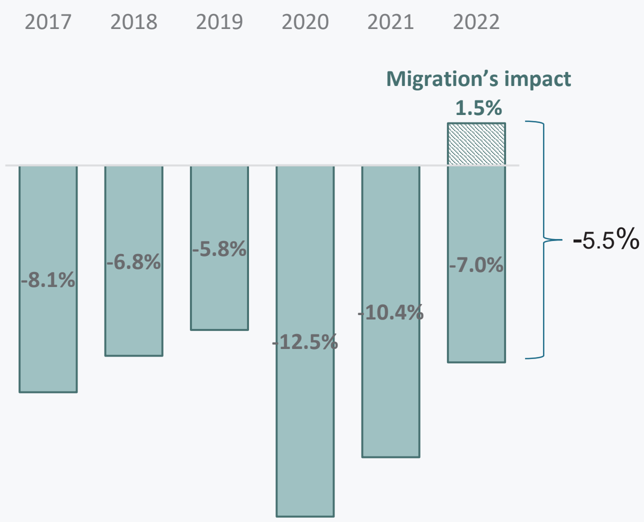

Figure 1.2.11. Current account deficit and the migration effect

Source: NBG estimates.

We also estimated migration's impact on economic growth. According to the NBG's forecast, real GDP growth will be around 10% in 2022, and migration will have made a substantial contribution to that growth. Based on our estimates, the net contribution of migration to real economic growth is similar to the effect of the influx on the current account deficit, at 1.5 pp. It should also be noted that the effect of migration on economic growth does not include the influence of sharply increased money transfers, some portion of which will have been spent on domestic goods and services (for example, on real estate). This implies that the one-time effect of migration on current economic growth might be well above the conservative estimate of 1.5 pp. This judgement is already reflected on the 2023 economic outlook.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

The high economic growth of the second quarter of 2022 was driven by investments and net exports, while the contribution of consumption was sharply negative due to the base effect.

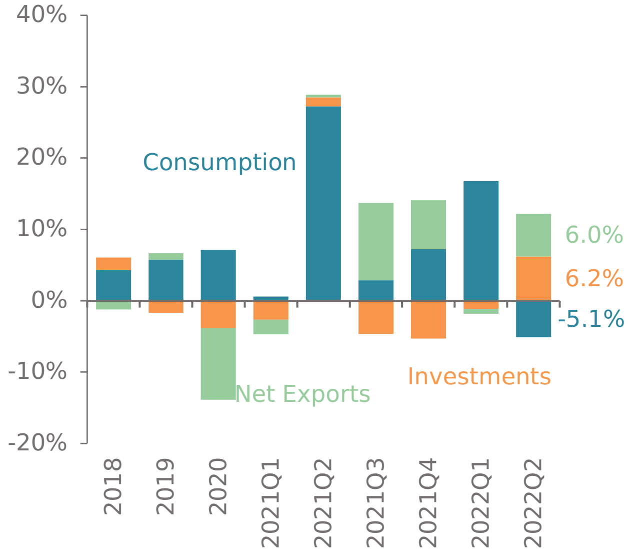

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

The real level of GDP in the second quarter of 2022 exceeded that of the pre-pandemic second quarter of 2019 by 18.0%.

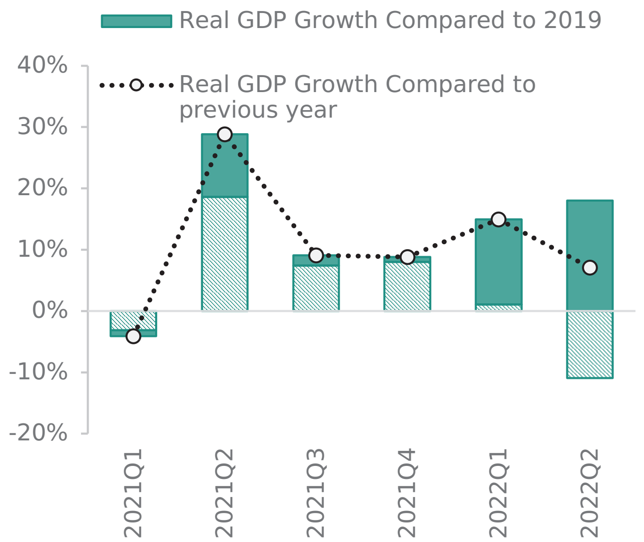

Figure 1.3.2. Comparison of the real level of GDP in 2022 with 2019

Source: GeoStat.

Aggregate demand remains strong, with real GDP growing by 7.1% year on year in the second quarter of 2022.

The real volume of GDP in the second quarter of 2022 exceeded the pre-pandemic level of the second quarter of 2019 by 18.0% (see Figure 1.3.2). It should also be noted that economic growth in the second quarter of 2021 was high – a result of a realization of the accumulated demand that had been built up as a consequence of pandemic-related mobility restrictions. Accordingly, in the second quarter of 2022, the base effect had a negative effect on economic growth (see Figure 1.3.2). Nevertheless, the positive growth in economic activity in the second quarter of 2022 indicates strong aggregate demand. According to the NBG's assessment, economic activity at that scale exceeds the potential level and poses additional inflationary risks.

The high growth in the second quarter of 2022 was driven by investments (6.2 pp) and net exports (6.0 pp), while the contribution of consumption was sharply negative (-5.1 pp) as a consequence of the large base effect (see Figure 1.3.1).

The high contribution of net exports is mainly due to a sharp increase in foreign visitors (including migrants) to the country and a resulting real 81% increase in service exports.

Although domestic demand is strong, it actually lags behind the figures observed during the second quarter of 2021 due to base effects. In particular, in the second quarter of 2021, the restrictions that had been imposed to contain the spread of the pandemic were mostly lifted, and the demand that had accumulated over the preceding months was realized at once, resulting in a sharp increase in consumption.

According to preliminary estimates, high economic activity has continued in the third quarter, and overall economic growth in the period January-August 2022 amounted to 10.3%.

The main driver of economic growth is the services sector, which together with the recovery of tourism, has been supported by strong domestic demand.

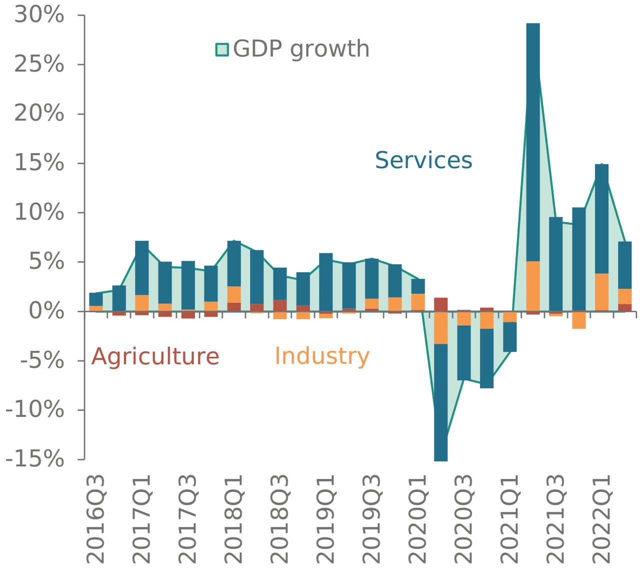

Figure 1.3.3. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

1.3.2 OUTPUT

In the second quarter of 2022, the services sector was the main driver of the 7.1% economic growth, making a total contribution of 4.8 pp. Meanwhile, the contributions of the industrial sector and agriculture were 1.5 pp and 0.8 pp respectively.

The activation of the services sector was related to both the restoration of the tourism and hospitality sector, and the activation of domestic demand for services. Accommodation and food supply activities, transport, and trade contributed a combined 1.8 pp to the overall growth.

From the industrial sector, the 75.9% increase in the supply of electricity, gas and water is particularly notable (making a 1.6 pp contribution to growth). Over the same period, agriculture grew by 10.9%, contributing 0.8 pp to economic growth (see Figure 1.3.3).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In September, the growth of the annual loan portfolio decreased and equaled 14.6%, excluding the effect of exchange rate fluctuations.

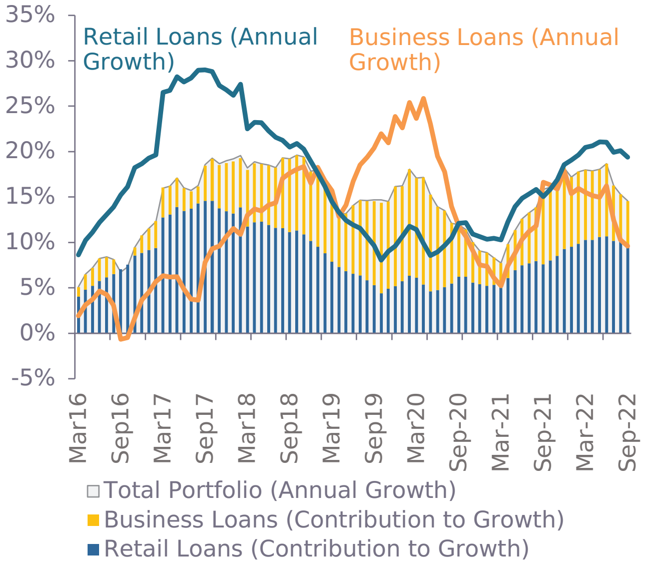

Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: NBG

In September, relative to June, the growth of the loan portfolio decreased by 4.1 pp and equaled 14.6% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans decreased slightly and equaled at 19.4%, while the growth of loans to legal entities decreased by 6.6 pp to 9.6% (see Figure 1.4.1). The growth of business loans decreased in the agricultural, energy and transport sectors, while the reduction of loan growth in the trade, construction and manufacture sectors was small. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for both retail and business loans over the next quarter.

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.

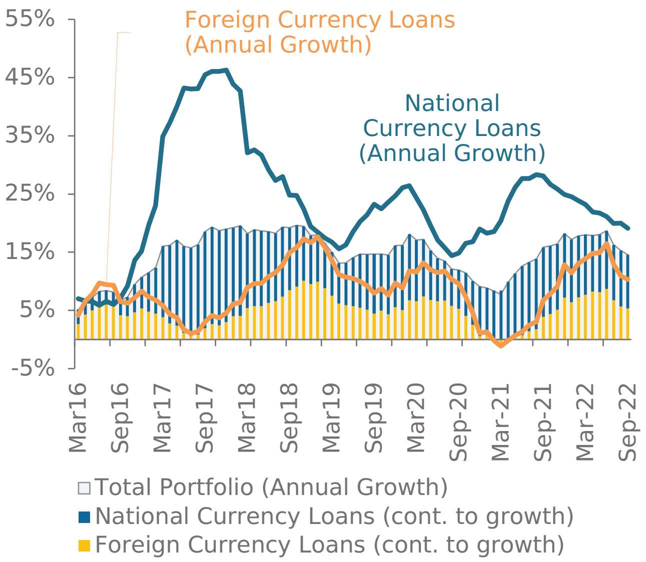

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the third quarter of 2022 was mainly driven by domestic currency loans, a development that was supported by recent macroprudential measures (see Figure 1.4.2). In September, relative to June, the annual growth rate of foreign currency denominated loans decreased by 6.1 pp and equaled 10.3%, while the growth rate of loans issued in the domestic currency decreased by 2.1 pp and equaled 19.1%. These reductions were mainly due to the tightening of monetary policy rates by the U. S. Federal Reserve and the European Central Bank, which were reflected in increased interest rates for foreign currency loans. In addition, in the third quarter, the loan larization ratio increased slightly and equaled 52.6%, 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.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In September, the monetary policy rate was 11.0%. In the third 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 Septem-

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

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 lower inflation and, consequently, of a fall in the policy rate.

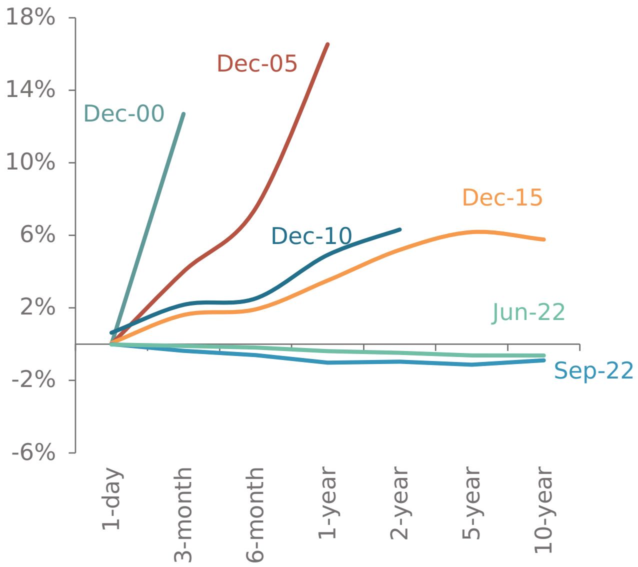

Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: NBG

ber, relative to June, interest rates on domestic and foreign currency deposits did not change significantly and equaled 10.5% and 1.5%, respectively. According to the credit conditions survey, representatives of the banking sector expect a slight increase in the cost of funds in the next quarter. According to the same survey, interest rate conditions have tightened slightly for retail and business loans, and representatives of the banking sector expect a further slight tightening of interest rate conditions over the next quarter.

In September, relative to June, interest rates on corporate loans increased slightly by 1.4 pp to equal 11.9%, while interest rates for small and medium enterprises (SMEs) and retail loans did not change significantly, equaling 10.9% and 15.9% respectively.

As of September, relative to June, average interest rates on domestic and foreign currency loans on the stock of legal entities did not change significantly. Interest rates on domestic currency loans stood at 13.8%, while equaling 7.7% 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 over the next quarter.

In September, similar to previous months, average interest rates for loans to legal entities in domestic currency remained significantly high relative to foreign currency loans, despite a recent increase of the latter.

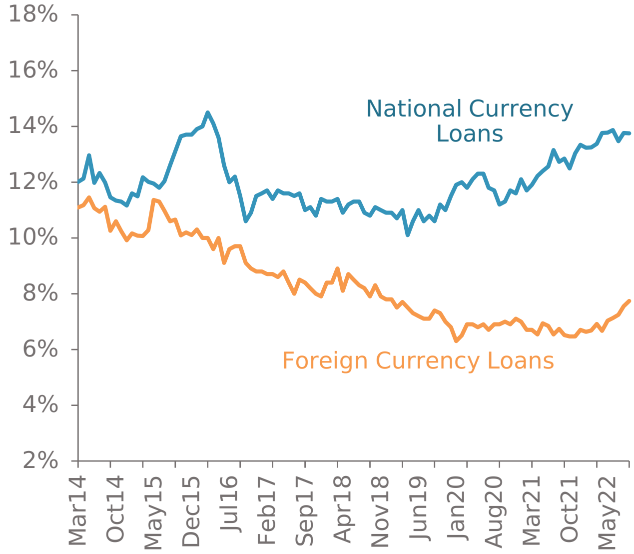

Figure 1.4.5. Average interest rates on business loans

Source: NBG

The real effective exchange rate appreciated on both a quarterly and year-on-year basis: appreciating by 18.0% on an annual basis.

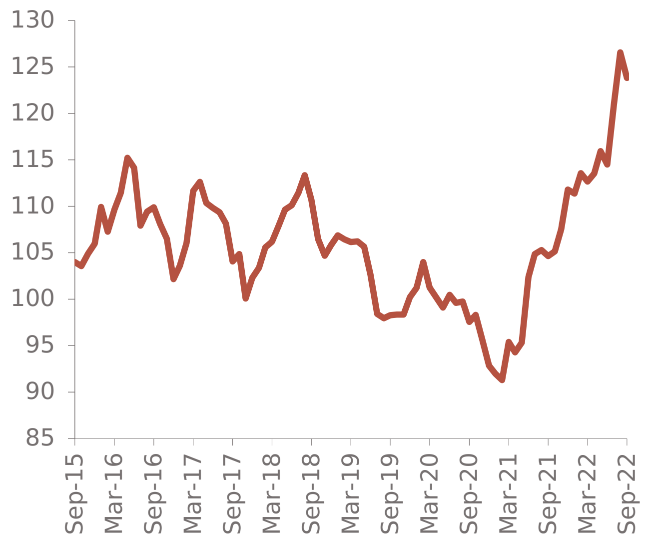

Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: NBG.

1.4.3 EXCHANGE RATE

The lari exchange rate has continued to appreciate. This was a result of a sharp increase in income from tourism, migrants and remittances this year. In the third quarter of 2022, the GEL nominal exchange rate appreciated against the US dollar by 5.8% and against the euro by 11.0%, as compared to the previous quarter. The GEL continued to appreciate against the Turkish lira by 17.5% while depreciating against the Russian ruble by 4.3%. In the same period, the nominal effective exchange rate appreciated by 9.7% on a quarterly basis and by 29.1% on a year-on-year basis. As for the price-adjusted exchange rate, in the third quarter of 2022 the real effective exchange rate appreciated by 8.0% on a quarterly basis and by 18.0% on a year-on-year basis (see Figure 1.4.6).

The appreciation of the real effective exchange rate, which started in 2022, was due to a significant reduction in the current account deficit. Accordingly, the future medium-term dynamics of the exchange rate will also depend on the development of the current account deficit. It should be noted that the lari real exchange rate appreciated against the currencies of most of Georgia's trading partners (see Table 1.4.1).

The real effective exchange rate appreciation is caused by real appreciation of the lari against all major trading partners, except for Russia and Armenia.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	**29.1**	**18.0**	**18.0**
Eurozone	29.2	31.6	5.5
Türkiye	131.8	42.5	8.1
Ukraine	44.3	29.9	2.0
Armenia	-8.0	-6.4	-0.4
US	10.5	13.6	1.0
Russia	-9.9	-12.3	-1.8
Azerbaijan	10.2	7.2	0.7
China	16.9	26.8	3.5
Bulgaria	29.2	22.0	0.8
Poland	34.2	28.4	0.5

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

Source: NBG

* Growth implies appreciation of the lari.

The Unit Labor Cost (ULC) has increased by 8.8%, which makes the inflationary pressure from the labor market noteworthy. However, to some extent this is a reflection of the base effect. Observation of ULC dynamics over the next quarters will be important.

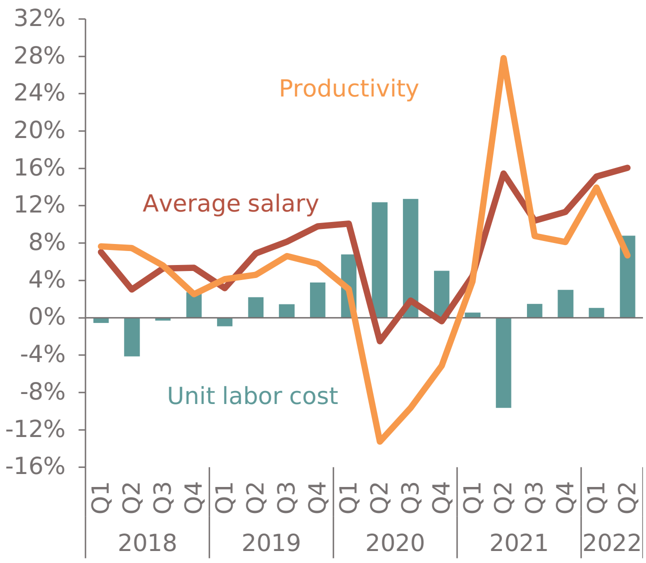

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

1.5 LABOR MARKET

In the second quarter of 2022, the country's economic productivity (real value added per employee) rose by 6.7% on a yearly basis (see Figure 1.5.1).

Over the same timeframe, the nominal wage growth for employed workers was 16.1%, and the average monthly gross wage reached GEL 1,541.

In contrast to the high growth of productivity, the rate of wage growth was even higher, leading to the Unit Labor Cost (ULC) increasing by 8.8%. This makes the inflationary pressure coming from the labor market noteworthy. However, it should be recognized that the base effect is substantial. The corresponding period of last year was marked by sharp economic growth, which significantly increased the productivity rate. Therefore, observing the ULC dynamics over the next quarters will be important (see Figure 1.5.1).

1.6 CONSUMER PRICES

Inflation has passed its peak and has a decreasing trend, which is largely related to a decrease in the inflation of imported goods. However, headline inflation remains high, with the overall price level rising by 11.5% YoY in September. On the other hand, the increase in core inflation is noteworthy.

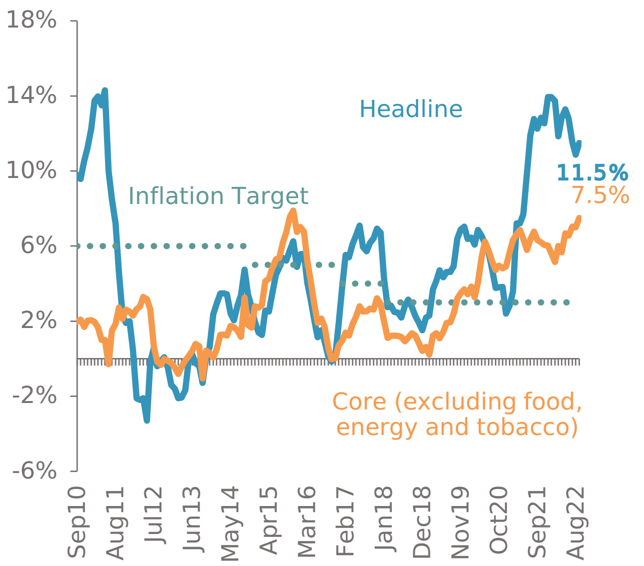

Figure 1.6.1. Headline and core inflation

Source: GeoStat

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.

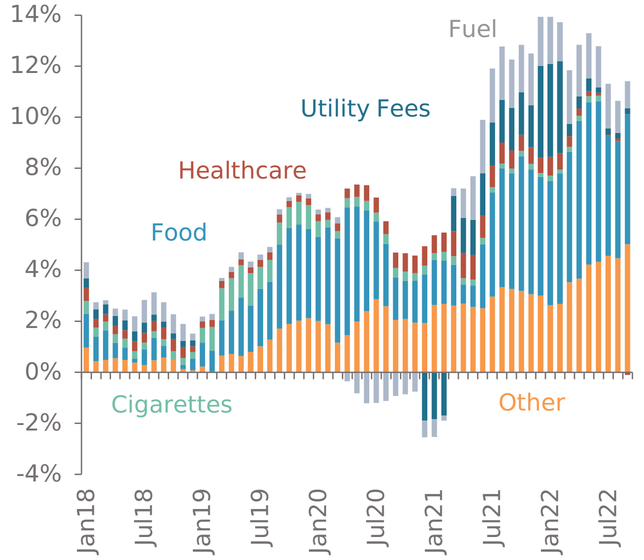

Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

Inflation has passed its peak and has a decreasing trend that is largely related to a decrease in the inflation of imported goods. Despite falling, overall inflation remains at a high level, standing at 11.5% in September 2022. Core inflation, which excludes highly volatile prices of food, energy and cigarettes, amounts to 7.5%, but its growth dynamic is noteworthy (see Figure 1.6.2).

The main reasons for the high inflation this year, both in Georgia and worldwide, are geopolitical. As a result of the war started by Russia in Ukraine, prices of oil and food products on international markets have risen sharply. However, in recent months, a certain stabilization and a downward trend of such prices have been revealed. Taken together with the strengthening of the GEL and the tight monetary policy maintained by the NBG, this should contribute to the reduction of inflation in Georgia.

In September, a large part of the total inflation (5.1 pp) came from food, of which the increase of bread and cheese prices alone contributed a total of 1.9 pp (see Figure 1.6.2). Despite the generally positive dynamics recently observed on the world market and the strengthening of the GEL exchange rate, fuel prices remain at a high level, making a total contribution of 1.1 pp to inflation. Moreover, the contribution of other products to inflation has also recently been rising, indicating to some extent a realization of so-called second round effects that further stress the need for a strict monetary policy.

From the beginning of 2022, imported inflation has had a decreasing trend. Together with a certain stabilization of international commodity product prices and the reduction of transportation costs, this contributes to strengthening of the lari exchange rate. In September, prices of imported goods increased by 10.4%. However, prices of domestically produced goods and services are increasing at a faster rate, rising by 14.3% year on year in September. The increase in domestic inflation is related both to the increase in food (bread, cheese, and meat) prices and to the increase in the price of services, of which apartment rent and notary fees are particularly notable (see Figure 1.6.3). The increasing cost of apartment rent is a reflection of the sharply increased demand resulting from the increased number of long-term visitors (migrants) from Russia and Belarus.

Imported inflation continues to decrease, although the prices of locally produced products are increasing, which is related to both the increase in food prices and to the increase in the price of services. Of the latter, the prices of apartment rentals and notary fees are important.

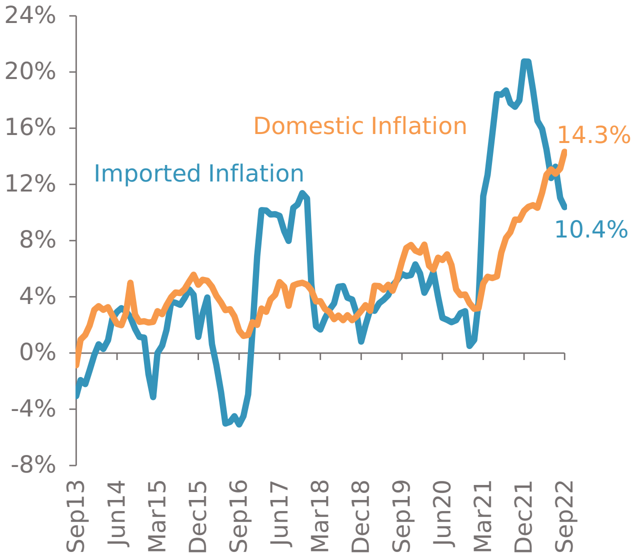

Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

2 MACROECONOMIC FORECAST

According to the baseline forecast scenario, inflation will continue to gradually decline and will converge with the target in the second half of 2023. Demand-driven inflationary pressures have intensified due to a sharp increase in migration against the tense geopolitical background, but these are partially balanced by the GEL appreciation stemming from rising external inflows. Amid higher-than-expected external demand, signs of a faster recovery of Georgia's economic potential, and the continuation of relatively solid credit activity, Georgia's real GDP is expected to grow by 10% this year; however, this growth rate is subsequently expected to slow to 4% in 2023.

Against this backdrop, high-impact risks remain around the baseline scenario. The alternative forecast scenario considers the realization of the most acute of those risks.[18] In particular, the threats include a global recession, as caused by a stronger-than-expected response from the central banks of developed countries in reaction to the global inflationary environment, and the immediate cut in foreign currency flows from Russia as a result of a further escalation/prolongation of the Russia-Ukraine war. Against this background, the prolongation of inflation's deviation from its target will significantly increase the probability of a credibility shock and, accordingly, of a hike in long-term inflation expectations. The National Bank of Georgia has the lowest tolerance to this scenario, which implies a sharp tightening of monetary policy, the use of additional instruments where necessary, and, subsequently, maintaining the tight monetary policy stance for a relatively long period.

2.1 BASELINE MACROECONOMIC FORECAST

Under the tight monetary policy stance, inflation will gradually decline and is expected to hit the 3% target in the second half of 2023.

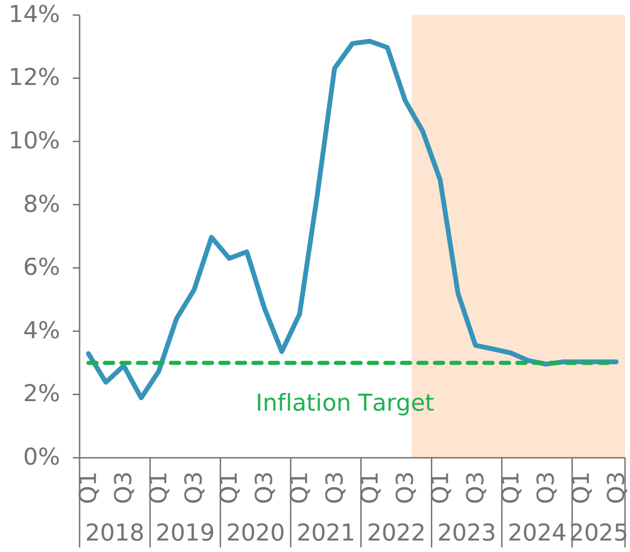

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat.

In the third quarter of 2022, annual inflation started to decline compared to the previous quarters and averaged 11.3%. Despite the downward dynamics, inflationary pressures prevail in the short term. In particular, according to the updated baseline macroeconomic forecast, other things being equal, inflation will average 11.9% in 2022 and 5.3% in 2023, converging with the target rate in the second half of that year (see Figure 2.1.1).

The historic and projected higher-than-targeted inflation is fueled by heterogeneous factors. In particular, energy and food commodity prices rose vigorously amid the Russia-Ukraine war, and, since Georgia is an importer of these products, these have been transmitted to the Georgian consumer price index. However, recently, international commodity prices have started to normalize, contributing to a decline in inflation. This will, other things being equal, help inflation converge with the target in the medium term. At the same time, economic activity was also high in the first half of 2022. In particular, domestic and foreign demand both turned out to be stronger than expected. Specifically, high foreign inflows driven by intensified migration re-

18 The current alternative scenario is not presented as the most probable (considering existing risks to the baseline scenario), but as potentially the most costly (in terms of welfare loss) to which the National Bank will react sharply.

The deviation of inflation from its target is still driven by elevated short-term inflation expectations and high commodity prices on international markets. Other things being equal, the impact of these factors will gradually wane in light of a normalization of commodity prices and the appreciated lari exchange rate.

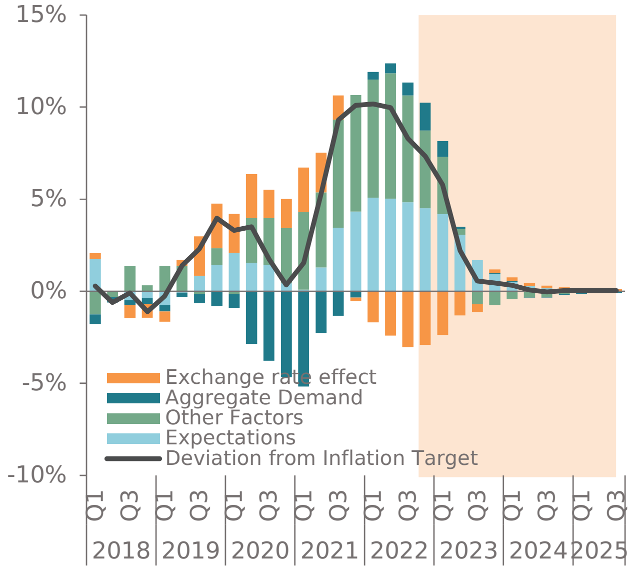

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat.

Amid the increased external demand, solid credit activity and rising economic potential, the economy is projected to grow by 10% in 2022, but the growth rate will decelerate to 4% in 2023.

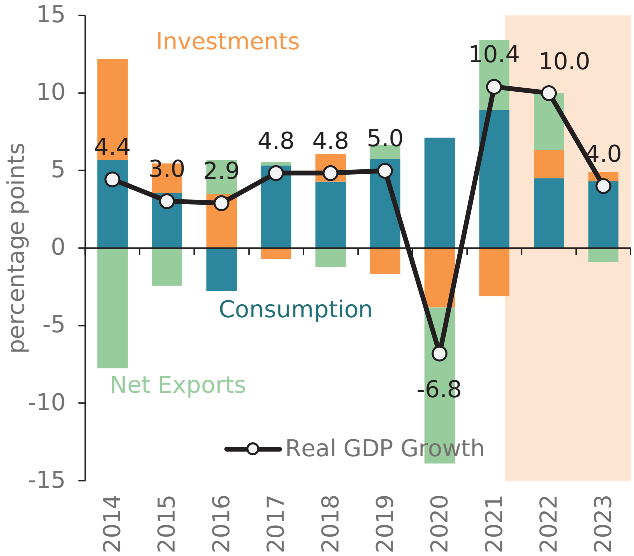

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat.

sulted in strong spending, elevating price pressures locally. However, this was partly counterbalanced by the strengthened lari exchange rate. In addition, domestic demand, fueled by solid credit activity, bears inflationary risks, since it exacerbates the price pressures fueled by current spending, increases imports and, thus, raises expectations of exchange rate depreciation. It should be noted that, alongside its tightened monetary policy, the NBG recently launched a number of macroprudential instruments that have already moderated the growth of credit activity. This contractionary effect is likely to strengthen in the future and, other things being equal, will help to reduce inflation. However, it should also be recognized that, as a result of the various shocks experienced over the last couple of years, inflation has deviated from its target for a long time, which, amid a climate of highly amplified uncertainties, serves to further elevate long-term inflation expectations and slow down the retreat of inflation (see Figure 2.1.2).

Intensified inflationary pressures and risks require the tightened monetary policy stance to be maintained for a longer period as compared to the previous forecasts. The policy rate will then gradually decline in line with easing price pressures and a stabilization of inflation expectations before approaching the neutral level (currently estimated at 7%) in the medium term.

Given the above-mentioned factors and amid the Russia-Ukraine war, increased foreign inflows have positively contributed to domestic economic activity. Concurrently, the economic potential reveals signs of a faster-than-expected recovery in light of the post-pandemic period having been partly stimulated by rising investments. In addition, despite a declining growth rate observed in recent months, credit activity remains one of the main contributors to domestic demand. Taking into consideration these trends, the economy will grow by 10% in 2022, falling to 4% in 2023 in the wake of the normalization of foreign inflows (see Figure 2.1.3). However, it should be noted that the situation is rapidly changing as a result of 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

Increased global inflation, a slowdown in the global economy, and the prolongation of the war between Russia and Ukraine all remain global challenges.

Macroeconomic Forecast Risks	Impact on Inflation
Higher-than-expected interest rate hikes in advanced economies	↑
Worsening of the geopolitical situation	↑
Declining credibility of central banks amid increased global inflation	↑
A faster-than-expected reduction of commodity prices on international markets	↓
Low-impact risk	High-impact 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 global economy, and the prolongation of the Russia-Ukraine war, macroeconomic forecasts continue to be characterized by exceptional uncertainty. Compared to the previous update, the structure of high-impact risks – the realization of which would lead to a deviation from the baseline macroeconomic forecast – have remained largely unchanged. In turn, it is worth noting that, in the background of consecutive shocks, a delay in the convergence of inflation with its target will significantly threaten credibility and therefore strengthen inflationary risks.

The global economy, which is still in the process of a post-pandemic recovery, faced 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 in the increase of the global inflation forecast. All this has led to a sharp tightening of monetary policy rates in leading economies (especially in the U. S.). Moreover, despite recent positive trends in international markets, 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 problems in a less painful way by winter, the global economy will be prone to a recession.

Higher-than-expected interest rates[19] 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 still-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 will lead to upward pressure on inflation through a weakened exchange rate, which will only partially be balanced by depressed aggregate demand and decreased energy and food prices. In particular, a global recession would reduce international demand for energy resources and food, which, ceteris paribus, implies a

19 Only a moderate increase in interest rates in the US and the eurozone would help reduce local demand and, therefore, slow inflation, because in such a case there will be less pressure on the GEL exchange rate to depreciate. The reason for this is the elimination of the remuneration of reserve requirements on funds raised in foreign currency, which neutralizes the incentive to transfer GEL deposits to foreign currency and, accordingly, reduces pressure on the exchange rate.

According to the updated forecast, the expected inflation rate for the medium term has not changed significantly as the latest data are consistent with the previous forecast.

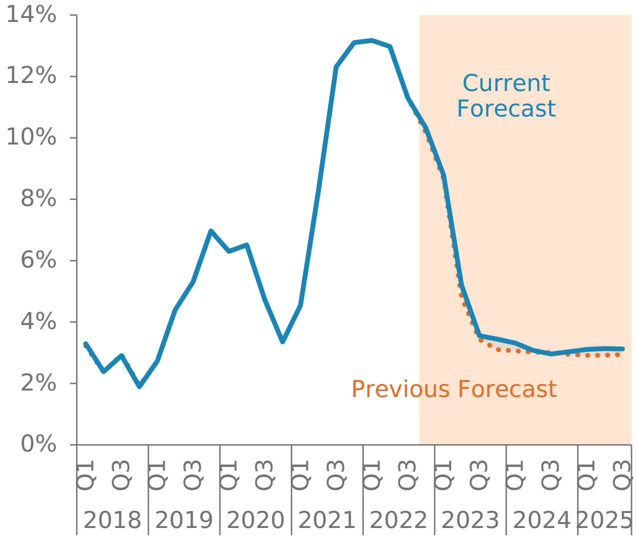

Figure 2.2.1. Changes in the forecast of headline inflation
Source: NBG, GeoStat.

In light of improved external demand and strong credit activity, the real GDP growth forecast has been revised upward to 10% for 2022 and revised downward to 4% for 2023.

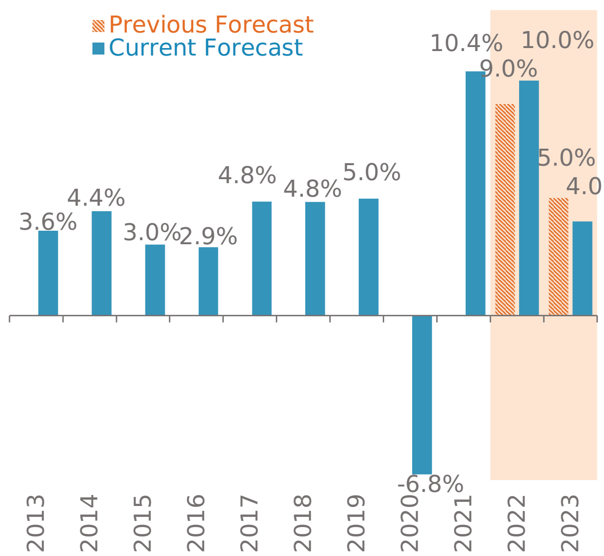

Figure 2.2.2. Changes in the forecast of real GDP
Source: NBG, GeoStat.

decline in their price.

The expected trajectory of inflation also depends on the indicators of foreign currency inflows from Russia, a potential escalation/prolongation of the Russia-Ukraine war and the nature of its resolution. A sharp decrease in inflows from Russia will create pressure on the foreign exchange market to depreciate, which, given the still-high level of dollarization, will increase inflationary pressure through the inflation expectations and input costs channels. Moreover, a further escalation/prolongation 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.

Ultimately, a realization of these risks will significantly delay the convergence of inflation toward its target, which would threaten the stability of long-term inflation expectations and cause a credibility shock, further worsening the inflation outlook.

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expected inflation in the medium term has not changed significantly (see Figure 2.2.1). The inflation forecast has increased in terms of strengthened aggregate demand and inflationary expectations, while being reduced by an appreciated effective exchange rate and price stabilization in international markets. Ultimately, these two effects balance each other out, and, despite the risks, against the backdrop of the elimination of one-off shocks and the maintenance of a tight monetary policy stance for a relatively long time, inflation will remain close to the 3% target from the second half of 2023.

The real GDP growth forecast for 2022 has increased to 10%, while the forecast for 2023 has decreased to 4%, partially because of the base effect (see Figure 2.2.2). As such, the assumptions regarding 2022-2023 economic growth have changed. In particular, the current account deficit has improved more than had been expected and has become one of the most important drivers of aggregate demand. After several years of decline, investments have also increased which has helped the potential of the economy to recover and should have the effect of easing inflationary pressure. It should also be noted that, despite a decline in the growth rate of foreign currency loans (which is a result of increased interest rates on dominant currencies and strict prudential policies), the rate of credit growth continues to be relatively strong, which, in turn, stimulates consumption.

Georgia is a small open economy, and the economic

According to the updated forecast for 2023, against the backdrop of globally increased inflation and interest rates, the key macroeconomic parameters of Georgia's trading partner countries have worsened.

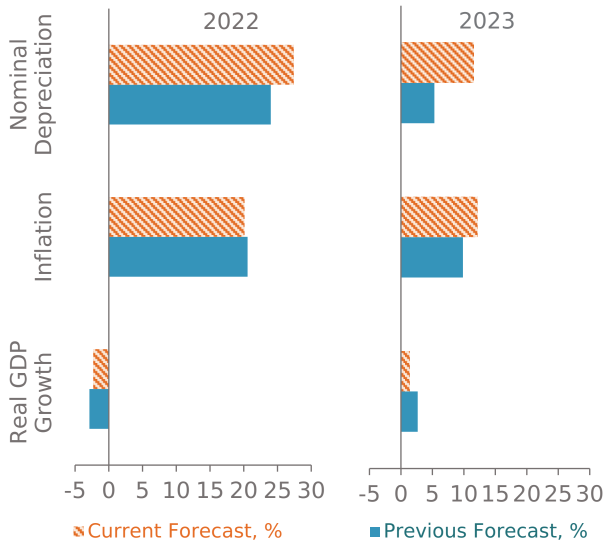

Figure 2.2.3. Changes in the forecast of external assumptions for 2022-2023
Source: Bloomberg, NBG.

stances of its trading partners thus have a significant influence on the domestic economy. The 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 2023, against the background of Russia's invasion of Ukraine, globally increased inflation, and corresponding higher interest rates, the key macroeconomic parameters of Georgia's trading partners have worsened. However, the outlook for 2022, in terms of inflation and economic growth, have turned out to be more positive than had previously been expected, while the scale of the expected depreciation of trading partner currencies increased (see Figure 2.2.3).[20]

20 These calculations are based on forecasts for the five main trading partners of Georgia: the US, the EU, Türkiye, Ukraine and Russia.

2.3 ALTERNATIVE FORECAST SCENARIO

In the alternative, particularly acute risk scenario, external demand will be constrained and the current account deficit will worsen amid global stagflation[21], a sharp decline in cash flows from Russia, and a further escalation/prolongation of the Russia-Ukraine war. As a result, the economy will grow at a slower pace in 2022-2023.

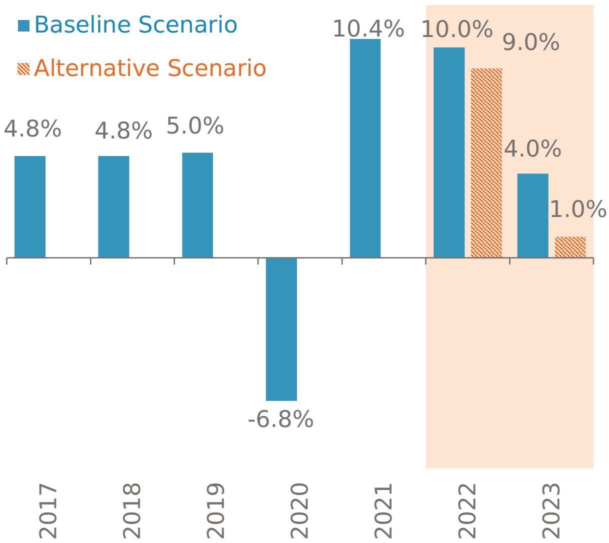

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat.

According to the alternative scenario, against the background of a worsening of the current account (as a result of exchange rate depreciation and raised inflationary expectations) the convergence towards the target will be delayed, which will increase the probability of a credibility shock and further worsen the inflation outlook.

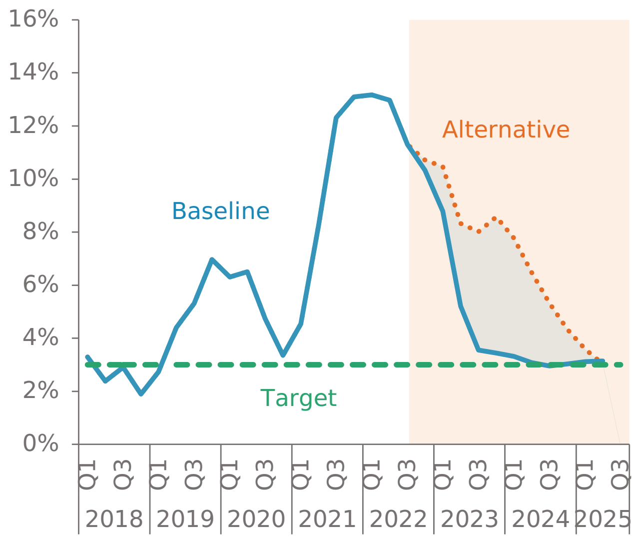

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat.

The alternative forecast scenario considers a realization of those risks that would have an especially high impact on inflation. In particular, the current alternative scenario is mainly based on there being a global recession caused by a sharp response of the central banks of leading economies to the global inflationary environment. In addition, the alternative scenario envisages an immediate cut in foreign currency inflows from Russia and a further escalation/prolongation of the Russia-Ukraine war, which will further worsen the local situation.

Under this scenario, as compared to the baseline, external demand for Georgian goods and services will fall and, ultimately, will have a negative impact on the current account balance. 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. As a result of a realization of these risks, the economy will grow by 9% in 2022, and only by 1% in 2023 (see Figure 2.3.1).

In the event of a realization of such an acute scenario, foreign demand will decrease, the expectations of economic agents will worsen, and the pressure on the exchange rate to depreciate will rise. The latter, taking into account the level of dollarization in the economy, will increase inflationary pressure through the channels of intermediate costs and expectations. In light of inflation remaining high for a protracted period, the probability of a credibility shock will also increase. This inflationary effect will only be partially contained by lower energy resource prices (because of weak global demand). Hence, if this acute alternative scenario is realized, the convergence of inflation towards its target will be delayed and inflation will be 3.2 percentage points higher on average in 2023-2024 as compared to the baseline scenario (see Figure 2.3.2).

Under this scenario, the National Bank of Georgia has the lowest tolerance, which implies a sharp tightening of monetary policy, the use of additional instruments where necessary and, subsequently, maintaining a tightened stance for a relatively long period. In particular, under this scenario, the trajectory of the monetary policy rate in 2023-2024, as compared to the baseline scenario, will be shifted upward by an average of 2.7 pp and will only normalize gradually after the stabilization of inflation expectations (see Figure 2.3.3).

21 *Stagflation is an economic situation characterized by economic decline (stagnation) at the same time as high inflation.*

Monetary policy will not tolerate increased inflationary pressures and credibility shocks, implying a sharp tightening of the policy rate, the use of additional instruments where necessary, and, subsequently, the maintenance of a tight stance for a relatively long period.

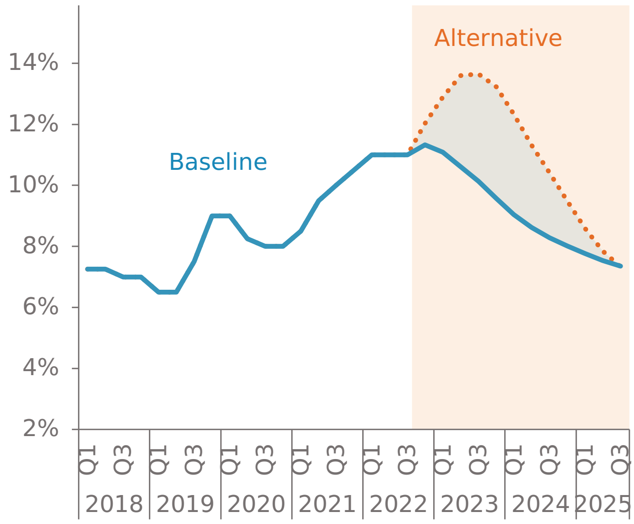

Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG.

Inflation expectations of financial market participants are gradually approaching the target of 3% in the medium term.

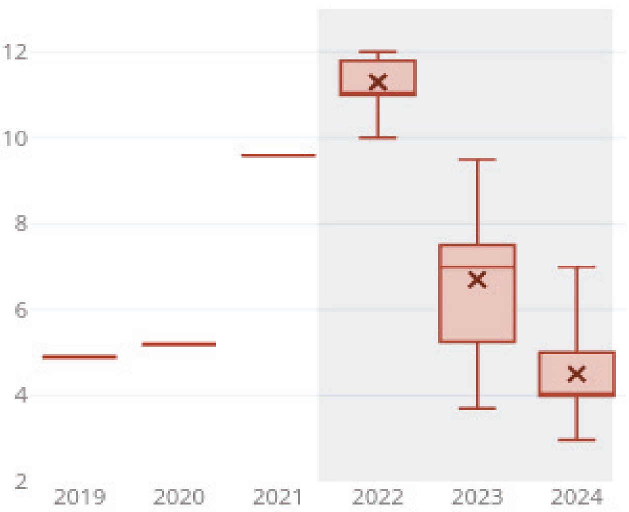

Figure 2.4.1. Actual average inflation (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the fourth quarter of 2022, 11 financial organizations participated in a survey of macroeconomic forecasts. According to the results of this survey, the financial market's economic expectations for 2022-2024 have been revised.

In particular, the median of inflation expectations for 2022 decreased by 0.1 pp compared to the previous quarter and amounted to 11%, while the average inflation forecast increased by 0.3 pp to 11.3%. Regarding 2023, the median forecast shifted up by 1 pp compared to the previous quarter to 7%, while the average is 0.6 pp higher and equals 6.7%. As for 2024, the median forecast has not changed since the previous quarter and stands at 4%, while the average expectation increased by 0.2 pp to 4.5% (see Figure 2.4.1).

As for the monetary policy rate, market participants have revised their forecasts upward for 2022 as compared to the previous quarter. Their median projection went up by 0.1 pp and the average forecast by 0.2 pp, both reaching 11%. The median forecast for 2023 has not changed compared to the previous quarter and stands at 9.5%, while the average expectation rose by 0.3 pp to 9.4%. As for 2024, the median forecast has shifted down by 0.3 pp, while the average projection rose by 0.3 pp, both amounting to 8% (see Figure 2.4.2). However, given the amplified uncertainties, it is evident that monetary policy forecasts for the medium

Amid soaring uncertainties, monetary policy expectations for the coming years are still characterized by high variability.

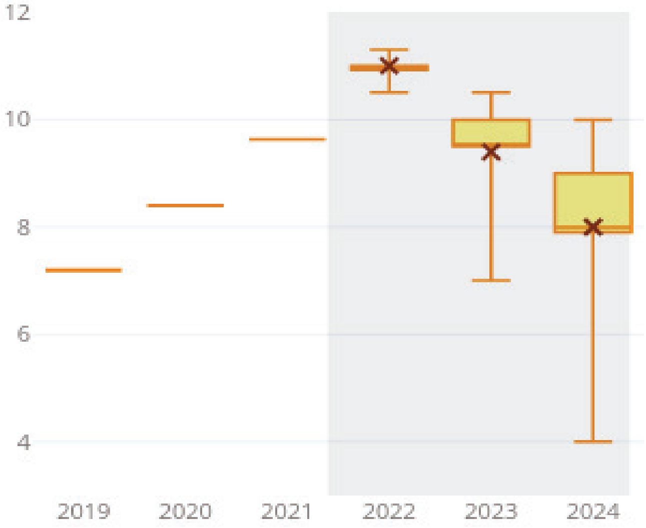

Figure 2.4.2. Actual monetary policy rate (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants.

The median and average market forecasts for economic growth over 2022-2024 have changed slightly compared to those of the previous quarter.

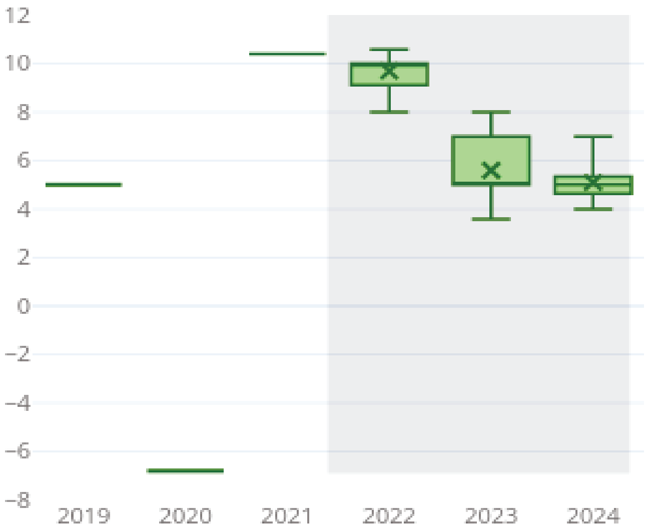

Figure 2.4.3. Actual real GDP growth (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

term still exhibit a high degree of variability.

The market's forecasts for real GDP growth have also changed compared to the previous quarter. Specifically, the median real GDP forecast for 2022 increased by 0.5 pp to 10% and the average expectation rose by 0.6 pp to 9.7%. The median projection for economic growth in 2023 has not changed compared to the previous quarter and remains at 5%, whereas the average expectation rose by 0.2 pp to 5.6%. The median forecast for 2024 remains 5%, as in the previous quarter, while the average projection fell by 0.1 pp to 5.1% (see Figure 2.4.3).

3 MONETARY POLICY

Globally, inflationary pressures remain high and the central banks of various countries have pursued interest rate hikes. As a result, against the background of tighter monetary policy, expected economic growth outlooks have worsened globally and stagflation risks have arisen. Although inflation in Georgia has retreated from its peak, it remains at a high level, amounting to 11.5% in September. Inflation is expected to decline further due to the recent positive trends observed on international commodity markets, declining international shipping costs, and the appreciated lari exchange rate. However, risks and uncertainty remain high. Among the inflationary risks, the pressure coming from strong demand, inflationary expectations, and the increasing trend of unit labor costs are important. Under the conditions of a high global inflationary environment, the NBG remains focused on reducing inflation. On 26 October 2022, the NBG's Monetary Policy Committee decided to maintain its tight monetary policy stance and left the policy rate unchanged at 11%. Should inflation expectations rise, a further tightening of policy or maintaining the current tight stance for a longer period may become necessary. In addition, as necessary, the NBG will employ additional instruments. According to the updated forecast, as a result of the tight monetary policy and the mitigation of external factors, inflation will approach its target from the second half of 2023.

To eliminate additional inflationary pressures and reduce the risk of medium-term inflation expectations, on 26 October 2022 the Monetary Policy Committee decided to maintain the historically tight monetary policy stance of 11%.

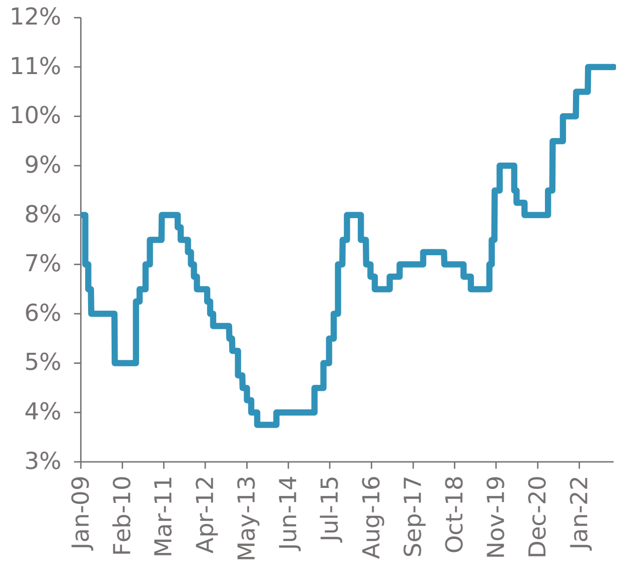

Figure 3.1. Monetary policy rate

Source: NBG.

Along with the economic damage caused by the COVID-19 pandemic, Russia's invasion of Ukraine has significantly dampened global economic growth prospects. This has been accompanied by a high-inflationary environment, in response to which central banks have tightened their monetary policies, and a further tightening is expected. Against the backdrop of increased interest rates, stagflationary risks have also increased. The tightening of financial conditions globally creates additional risks of increasing sovereign risk premia and enhancing inflationary risks for developing and emerging countries. As a small open economy, Georgia is vulnerable to global developments; consequently, under the conditions of the current high inflationary environment, the NBG remains focused on reducing inflation and has thus maintained a tightened monetary policy.

Russia's invasion of Ukraine has led to an increase in prices of energy resources and food products on international markets. 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 the two countries and, as a result, global prices of energy resources and food increased. However, from the second half of 2022, following the recovery of supply chains on the international commodity markets, a trend of price reductions was evident. One of the reasons for this positive development was the improvement of grain production prospects in North America and Russia and the recovery of exports from Ukraine to the Black Sea ports. At the same time, the cost of international shipment continues to decline, which, along with the strengthened lari exchange rate, will help reduce inflation. Although the current trends on international markets are a reason for cautious optimism, inflationary risks remain and the high uncertainty surrounding global trends is noteworthy.

The current war has had different effects on different countries. Due to Georgia's geopolitical location, foreign demand has increased more than expected. Against the background of the war, the large influx of arrivals from Russia, Belarus and Ukraine, alongside a gradual recovery of tourism, has had a positive impact on economic activity.

The potential economy is showing signs of a faster-than-expected recovery, which is also stimulated by growing foreign direct investment. Consequently, the forecast of economic growth in 2022 has increased to 10.0%. According to the NBG's estimations, Georgia's current economic growth exceeds its potential level. However, credit activity has slowed as a result of tightened monetary policy and recently implemented macroprudential instruments. On the other hand, the tightened monetary policies of the European Central Bank and the U. S. Federal Reserve have had the effect of tightening the policy on foreign currency lending. Fiscal stimulus is also decreasing. Taking into account these tendencies, economic activity is expected to return to its potential level next year.

Under the 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 risks of so-called second round effects and of inflation expectations rising over the medium term. Moreover, due to the long-term deviation of inflation from its target level, the risks of a wage-price spiral increase. At the same time, the risks are inflationary, both geopolitically and in terms of a faster-than-expected tightening of global financial conditions.

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. In addition, in order to avoid inflationary pressures arising from the demand side, the NBG considers it appropriate to use additional instruments.

The reduction of dollarization is an important challenge for the Georgian economy. This has become especially relevant with the increase in GEL interest rates

The dollarization of 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. However, the dollarization of deposits has increased.

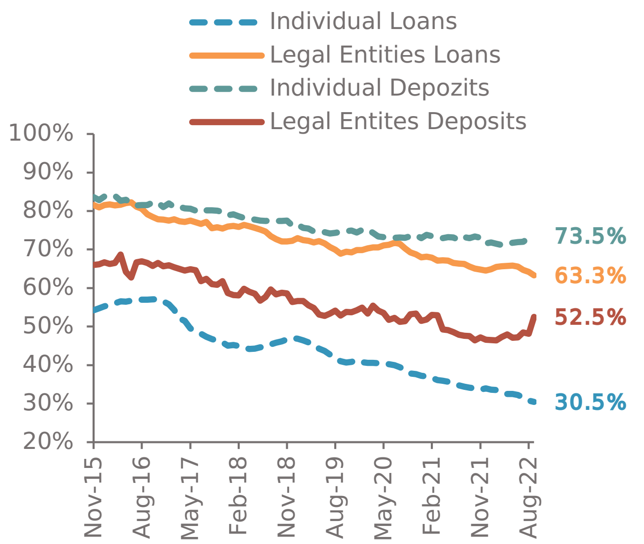

Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG.

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

The dollarization of total loans (excluding the exchange rate effect) decreased by 0.6 pp in September 2022 and stood at 45.4%. However, due to the increased amount of foreign currency inflows, the dollarization of deposits increased. Deposits of individuals and legal entities increased by 0.5 pp and 4.3 pp respectively to 73.5% and 52.5% (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.

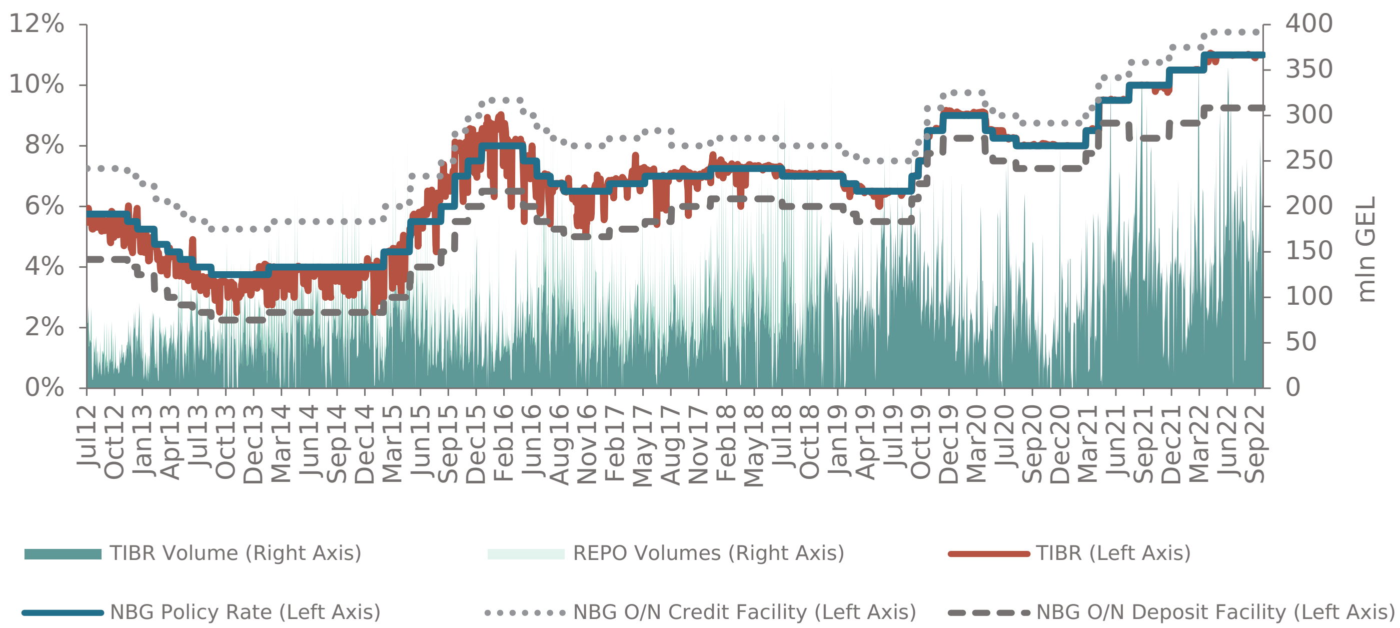

Figure 3.3. Interbank money market

Source: NBG.

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