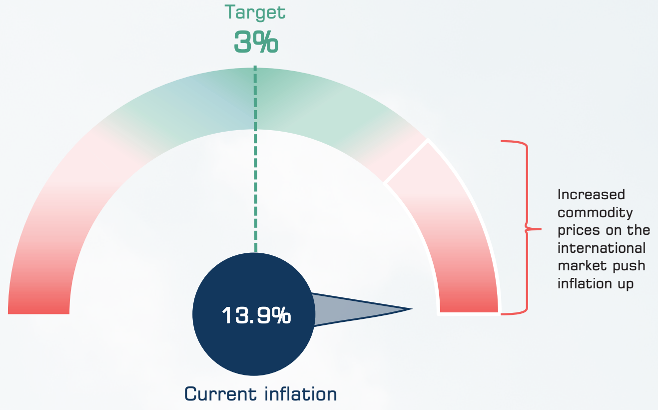
Monetary Policy Report

February

2022

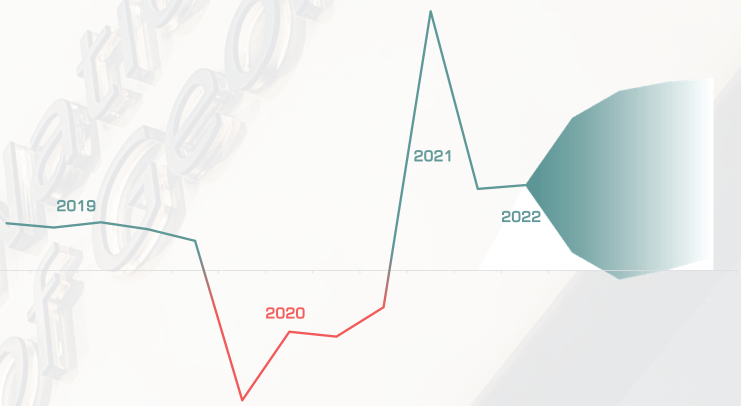
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



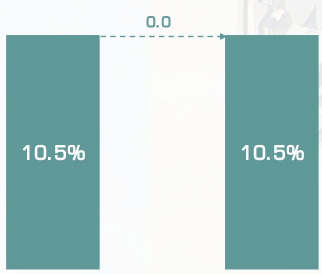
13.9%	Increased commodity prices on international markets have pushed inflation above the target.

Economic Growth



After the pandemic-induced recession, the economy recovered in 2021.	10.6%

Monetary Policy



10.5%	In order to curb inflation expectations, the NBG has maintained a tight monetary policy stance.

MONETARY POLICY DECISION

Monetary policy remains tight and the monetary policy rate has been left unchanged at 10.5%.

The NBG's role is to set the interest rate to affect total spending in the economy and thereby guide inflation expectations to ensure that inflation returns to the target level of 3%.

Low and stable inflation supports employment and economic growth, which are of the utmost importance during challenging times such as those now confronting us as a result of the COVID-19 pandemic.

Pandemic-induced supply-side disruptions, rising commodity prices on international markets and elevated costs of global shipping have caused inflation to rise worldwide. The transmission of global inflationary factors to the local market has led to high headline inflation in Georgia, which significantly exceeds its target level. Nevertheless, it is expected that these global factors will only have a temporary impact on consumer prices. The continued tight monetary policy stance, coupled with the exhaustion of transitory factors, will lead to a gradual reduction of inflation in 2022 and, by the end of the year, inflation will return to the target.

Considering rising inflation expectations and lingering risks, we have maintained a tight monetary policy stance and have kept the monetary policy rate unchanged at 10.5%. This decision aims to ensure that the current price hike does not aggravate long-run inflation expectations.

Changes in interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If strong domestic demand (which highly depends on fiscal stimulus and credit activity) or any other factors further amplify inflation expectations, we are ready to further tighten the monetary policy stance or to maintain the current tight position for a longer period. Whatever the situation, we will use all the instruments at our disposal to ensure price stability and to maintain the purchasing power of the GEL.

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BRIEF OVERVIEW

The year 2021 was characterized by the gradual recovery of the global economy from the COVID-19 pandemic. However, that recovery process faced significant challenges, including inflation. High levels of price growth were observed in many developed and developing countries. Georgia was no exception to this trend, with inflation reaching double digits in the second half of the year, mainly as a consequence of one-off factors independent from monetary policy. It should be noted that the current inflation dynamics bear a strong resemblance to the events of 2011: the double-digit inflation observed during that period was also dominated by temporary exogenous factors, which subsequently resulted in a decline in inflation that was as steep as that of the initial increase. According to the current forecast of the National Bank of Georgia, with the exhaustion of the one-off factors, inflation will start to decrease and will return to its target in 2022. This will be facilitated by the continuation of tight monetary policy, which aims to curb inflation expectations and to neutralize the excess pressure on consumer prices coming from significantly intensified domestic demand.

In 2022, inflation is forecast to decline and to return to its target by the end of the year. This will be a result of the exhaustion of one-off factors and the maintenance of a tight monetary policy stance.

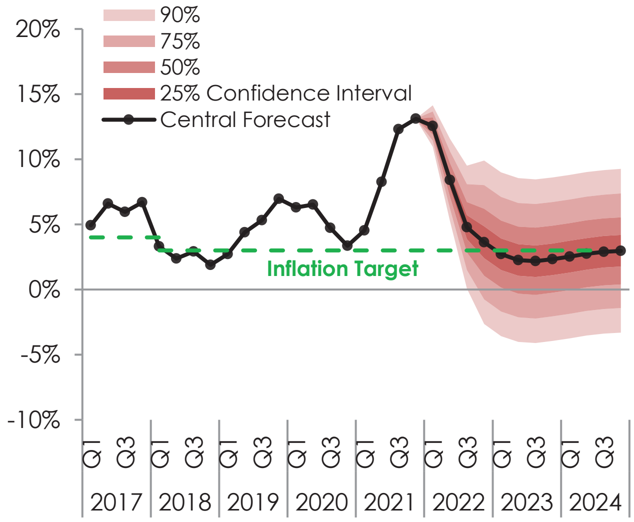


Figure 1. Headline CPI inflation forecast

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

According to the National Bank of Georgia's forecast, following the sharp increase observed last year, headline inflation will begin to decline in 2022 (see Figure 1). This prediction is based on the fact that the current high growth rate of prices is mainly a result of one-off, exogenous supply-side factors induced by the pandemic. Clearly, the exhaustion of these factors will automatically push inflation down on an annual basis. Furthermore, with the identification of mounting risks to inflation, last year the National Bank of Georgia was tightening its monetary policy accordingly. As such changes are transmitted to the economy with a lag, the final impact of this move on inflation will be seen in 2022. It should be noted that the tightening of monetary policy accounted for the potential risk a policy response to supply-side pressures might have in causing additional economic fluctuations. Such risks are the reason why central banks, in general, react to such shocks cautiously, as any additional volatility increases uncertainty and further complicates inflation management. However, as the recent supply shock has been so strong and has had a non-negligible impact on inflation expectations, it required a timely and rigorous monetary policy response. According to the current forecast, amid such a policy response, **inflation will average 7.3% in 2022 and will return to its target by the end of the year**.

Last year's inflation dynamics were also partly affected by the sudden increase in economic activity that resulted from an immediate realization of pent-up demand as the economy reopened, high credit activity and fiscal stimulus. Although the latter was necessary

According to the current forecast, amid modest assumptions about the external sector, decent credit activity and partially maintained fiscal stimulus will help real GDP increase by 5% in 2022.

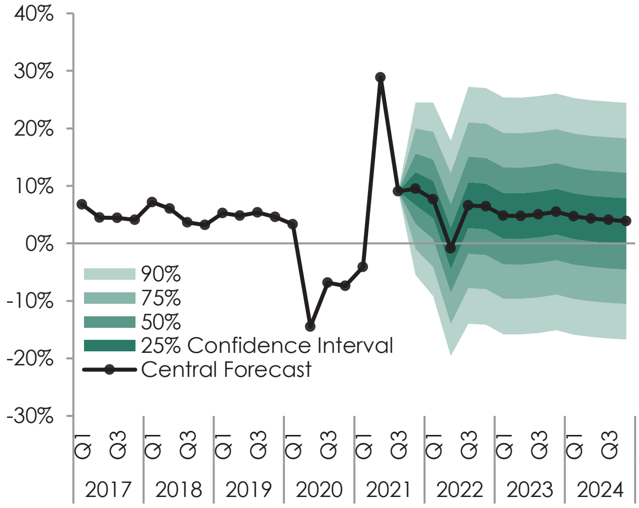


Figure 2. Annual growth forecast of quarterly real GDP

Source: NBG, GeoStat.

A tight monetary policy stance will be maintained and its easing will only start after a lowering of inflation expectations, which, according to current estimates, should start in 2022.

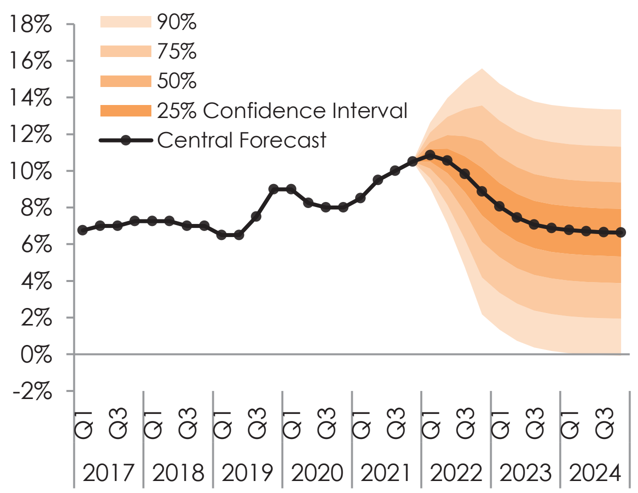


Figure 3. Monetary policy rate forecast

Source: NBG.

for mitigating the negative effects of the pandemic and also served as a significant boost to domestic demand, it hindered a reduction of inflationary pressures. According to preliminary estimates, economic activity grew at a fairly high rate of 10.6% in 2021. **The current forecast – which is similar to the previous one – is that the real GDP growth will reach 5% in 2022** (see Figure 2). For the level of real GDP (but not for the growth rate), the contributions of fiscal spending to support the economy and lending activity will remain significant. Although foreign revenues, including from tourism, have improved recently, according to the baseline scenario, their impact in this regard will be modest in 2022 – a consequence of continued uncertainties surrounding the pandemic.

As mentioned above, monetary policy has been tightened over the past year, with the rate having gradually been increased to 10.5%. This ensured a consistent response to the emergence of each additional pronounced risk to inflation. At its meeting on 2 February 2022, the Monetary Policy Committee decided to maintain this tight stance. **The future trajectory of the policy rate is determined by changes in inflation expectations (see Figure 3).** Consequently, in the medium term, the expectation that inflation will return to its target will lead to a gradual reduction of the policy rate to its neutral level, which is currently estimated at 6.5%.

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

1 CURRENT MACROECONOMIC SITUATION

Following the recession caused by the COVID-19 pandemic, the global economy has improved significantly and is expected to grow by 5.9% in 2021. However, the emergence of a new variant of COVID-19 increased epidemiological risks and, as a result, some countries returned to severe restrictions by the end of the year. Despite this, amid mass vaccination programs, international tourism became more active, and the revenues received from foreign visitors started to gradually recover; money transfers also increased. As a result, Georgia's current account deficit slightly improved in 2021. According to current estimates, the deficit will improve further this year, but may not yet return to pre-pandemic levels. In the third quarter of the previous year, compared to the same period in 2020, aggregate demand improved significantly, with the growth of net exports making a large contribution, albeit with the base effect also being noteworthy. Meanwhile, commodity prices on international markets increased quite significantly, which put some pressure on inflation expectations. In response, the central banks of some countries further tightened their monetary policy.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

Amid the continuation of the COVID-19 pandemic, at the end of 2021 global economic activity continued to improve, albeit doing so a relatively slower pace than had previously been expected.

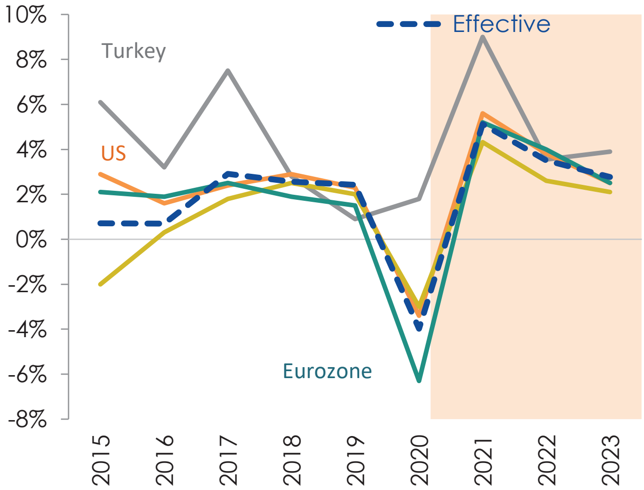


Figure 1.1.1. Real GDP growth of economic partners

Source: Bloomberg.

At the end of 2021, the global economy continued to recover, albeit at a relatively slower pace than had previously been expected. The risks associated with the spread of COVID-19 increased, especially following the identification of a new (Omicron) variant of the virus. Consequently, at the end of the year, in order to reduce mobility, severe restrictions were again imposed in a number of countries, which significantly hampered economic activity. According to the International Monetary Fund's (IMF) updated forecast[1] from January, **global economic growth** was 5.9% in 2021. Meanwhile, growth is projected to be 4.4% in 2022. For emerging and developing countries, real GDP is expected to have grown by 6.5% in 2021 and is predicted to be 4.8% in 2022.[2]

Since the beginning of 2021, consumer prices have been sharply increasing in developed as well as in emerging and developing countries. This is mostly due to the supply-side disruptions during the pandemic, as well as to the upward dynamics of commodity prices on international markets. In December 2021, the global food price index increased and stood at 28.1%[3] compared to the same period of the previous year, while international oil prices almost doubled. According to the IMF's forecast, inflation should return to pre-pandemic levels in the second half of 2022.

In the fourth quarter of 2021, the recovery of economic activity continued in **the United States**. In par-

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

2 *Ibid.*

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

ticular, external demand recovered and, along with a declining unemployment rate, labor market conditions improved. Despite the strong base effect, following a mass vaccination campaign, as well as strong fiscal and monetary stimulus, economic activity has been high. However, the uncertainty around the pandemic and the emergence of the new variant of COVID-19 have had a negative impact. Moreover, inflationary pressure remained high, with the annual inflation rate standing at 7% in December. However, the Federal Reserve System has kept the federal funds rate unchanged. According to Bloomberg's consensus forecast[4], real economic growth in the US was 5.7% in 2021 and is expected to be 3.8% in 2022. The inflation rate stood at 4.7% in 2021 and is forecasted to be around 4.8% in 2022.

In the fourth quarter of 2021, inflation rates have further increased in Georgia's trading partner countries, including in the US and the eurozone. In Turkey, the rise in inflation has become even sharper as a result of domestic factors.

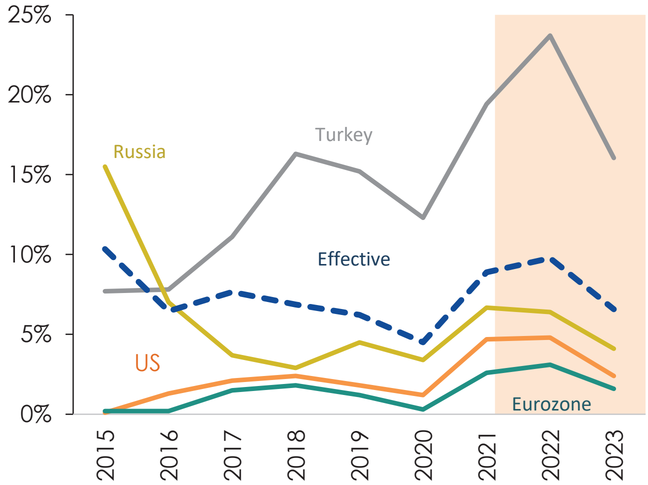


Figure 1.1.2. Headline Inflation rates of economic partners

Source: Bloomberg.

In the third quarter of 2021, economic activity continued to improve in the **eurozone**. According to data from October-November, activity in the manufacturing and industrial sectors recovered, with consumer and business sentiment also improving. However, with emergence of the new variant of COVID-19, restrictions were imposed in some countries, which will hamper economic activity. The annual inflation rate increased to 5% in December. According to the Bloomberg's consensus forecast[5], real economic growth for the eurozone stood at 5.2% in 2021 and will be 4% in 2022. The inflation rate stood at 2.6% in 2021 and is expected to reach 3.1% in 2022.

After the high economic activity observed in **Turkey** during 2021, the pace of improvement slowed down at the end of the year, with consumer and business sentiment falling sharply. This was mostly due to the recent depreciation of the Turkish lira, which caused even higher inflationary pressure, with annual inflation standing at 36.1% in December. According to Bloomberg[6], the real GDP forecast for Turkey is around 9% for 2021 and 3.6% in 2022. The inflation rate averaged 19.4% in 2021 and is forecast to climb to 23.7% in 2022.

In the fourth quarter of 2021, in contrast to the previous period, the pace of recovery in economic activity slowed in **Russia**. This was mostly due to pandemic-related restrictions and geopolitical tensions. Consequently, the manufacturing sector deteriorated somewhat and consumer spending, along with retail sales, declined. However, along with the rise in oil prices, the foreign sector remained improved. Annual inflation increased significantly and equaled 8.4% in December. As a result, the Central Bank of Russia decided to further tighten its monetary policy. According to Bloomberg's consensus forecast[7], real economic

4 *Bloomberg Monthly Survey of Economists.*
5 *Ibid.*
6 *Ibid.*
7 *Ibid.*

growth in Russia was 4.3% in 2021 and is expected to be 2.6% in 2022. The inflation rate was 6.7% in 2021 and is projected to be 6.4% in 2022.

At the end of 2021, economic activity improved slightly in **Ukraine**. The industrial sector improved alongside rising consumer and business sentiment. Consumer spending and retail sales also increased alongside some easing of pandemic-related restrictions. Moreover, in November, the country received an additional USD 700 million in funding from the International Monetary Fund for structural reforms. However, geopolitical tensions have recently flared up. Annual inflation remained high and stood at 10% in December. According to Bloomberg[8], the real GDP growth forecast for Ukraine is 2.5% for 2021 and 3.8% for 2022. The inflation rate was 9.3% in 2021 and is expected to be 7.2% in 2022.

The fourth quarter of 2021 saw the growth rate stabilize in **Armenia**. This was mostly due to some easing of pandemic-related restrictions, which led to a recovery in the manufacturing sector and boosted consumer spending. Remittances, which are a significant source of income for households in the country, also increased. The annual inflation rate decreased slightly, falling from 9.6% in November to 7.7% in December. According to Bloomberg[9], the real GDP forecast for Armenia is 4.4% for 2021 and 5.2% for 2022. The inflation rate stood at 7.2% in 2021 and is expected to average 5% in 2022.

In the last quarter of 2021, **Azerbaijan's** economic activity continued to improve in both the oil and non-oil sectors. This was mostly due to the upward dynamics of oil prices on international markets and an improvement of the industrial sector. These developments also caused a stabilization of the external sector. However, the annual rate of inflation increased and posted 6.7% in December. According to Bloomberg[10], real GDP growth in Azerbaijan was 5% in 2021 and will be 3.2% in 2022. Inflation stood at 4.7% in 2021 and is projected to be 5.2% in 2022.

At the end of 2021, together with a rise in inflation expectations, some central banks of Georgia's trading partners have further tightened their monetary policy rates (or are expected to do so). Turkey is the only exception to this, where, despite high inflation, the monetary policy rate is gradually declining.

At the end of 2021, the central banks of some of Georgia's main trading partners further tightened their monetary policies in response to higher inflation and rising inflation expectations. The US Federal Reserve kept its federal funds rate in the 0-0.25% range, although the market has started to expect a rise of US interest rates earlier than previously anticipated. Meanwhile, the European Central Bank's interest rate remains unchanged at 0%. However, it should be noted that, given the continuation of the pandemic, the eurozone's broader quantitative easing program will be maintained until at least March 2022.

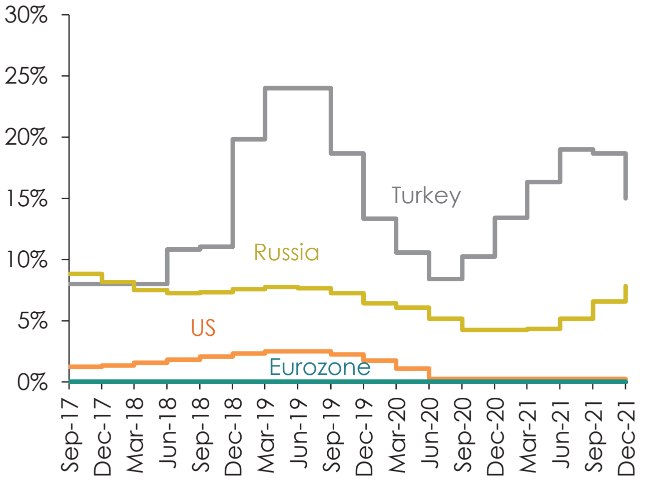


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

8 Ibid.

9 Ibid.

10 Ibid.

In light of the revival of external demand, registered exports of goods increased considerably and substantially exceeded pre-pandemic levels.

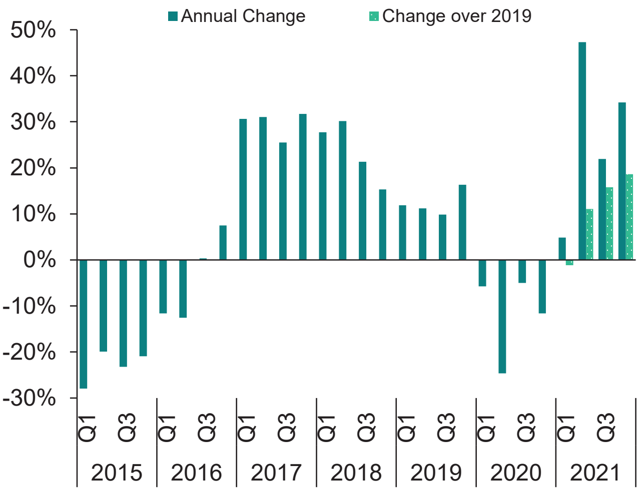


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat.

The rise in exports of goods mainly stemmed from an increase in external demand for consumer and intermediate goods. The contribution of investment goods, as in previous years, was small.

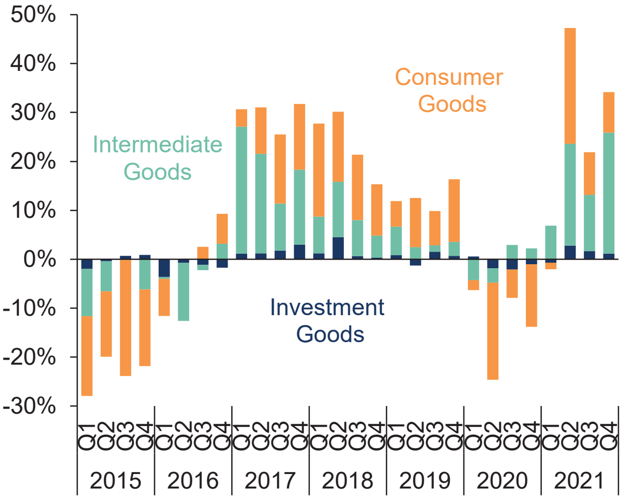


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

The softening of restrictions on global mobility and the revival of manufacturing processes in the trade of services and commodities induced a recovery of economic activities. It is worth noting that several economic indicators have visibly improved compared to 2019 levels. The acceleration of economic growth in trade partner countries has positively affected the turnover of Georgia's external trade. In the fourth quarter of 2021, external demand on goods increased in annual terms. In line with strong domestic demand, imports of goods also considerably increased. In addition, international tourism became active and revenues from international visitors gradually increased. The rise of instant money transfers also continued. In overall terms, due to rising external inflows, the current account deficit improved by USD 203 million in the third quarter of 2021, as compared to the same period of the previous year. According to recent estimates, the 2021 ratio of the current account deficit to GDP will again be in double-digit figures, albeit remaining less than it was in 2020.

In more detail, in the fourth quarter of 2021, registered exports of goods grew by 32.4% annually (see Figure 1.2.1) and rose by 18.6% compared to the same period in 2019. The volume of exports to regional countries increased considerably. In the fourth quarter, an increase of exports to Russia made the highest contribution (of 5.5 pp annually) to the overall growth, which was mainly a consequence of high demand for ferro-alloys and alcoholic beverages. Meanwhile, exports to Turkey increased mainly in terms of substantially high levels of exports of ferro-alloys and clothes; while exports to Armenia rose due to increased sales of frozen meat and construction machinery. From the EU, exports to Spain grew considerably due to high sales of copper ores and concentrates. In terms of other countries, demand for ferro-alloys was high from the USA (making a 5.7 pp contribution to the overall growth of exports).

Exports of goods mainly increased due to high demand for consumer and intermediate goods, while exports of investment goods made only a moderate contribution to the overall growth of exports (see Figure 1.2.2). The increase in consumer goods mainly stemmed from high exports of motor cars. In terms of the rise in exports of intermediate goods, ferro-alloys made the largest positive contribution; while for investment goods, exports of various forms of construction machinery played a leading role in the overall growth.

The softening of restrictions on international travel stimulated a partial recovery of tourism. In the fourth quarter, the number of international visitors rose by

Revenues from international travelers continues to rise.

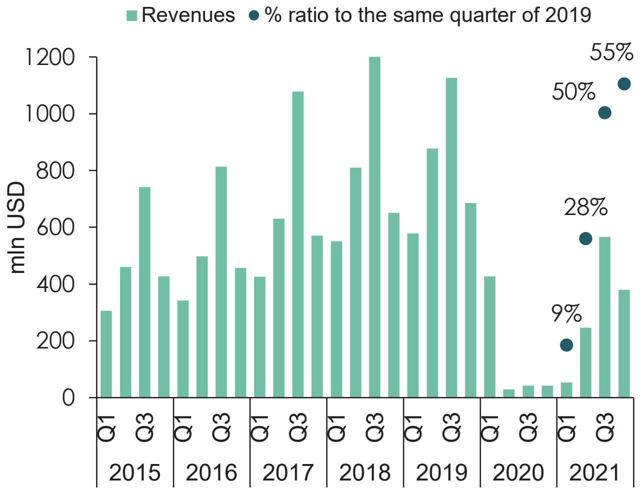


Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG.

In light of the economic recovery of partner countries, instant money transfers continue to rise substantially, not only in annual terms but also compared to pre-pandemic levels.

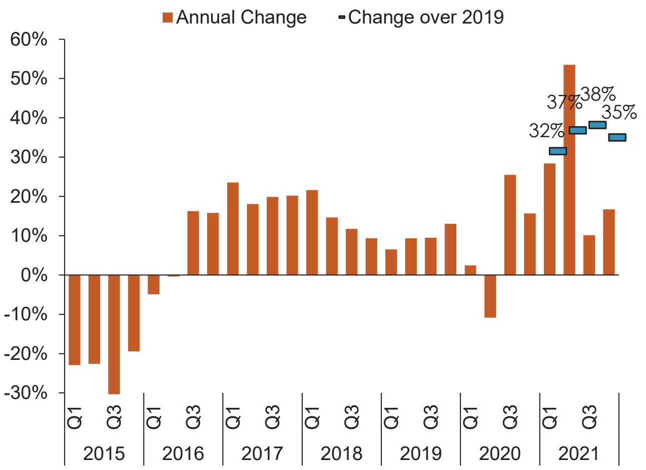


Figure 1.2.4. Annual change in money transfers

Source: NBG.

269.3% annually; however, this number remains significantly below that of the same period in 2019 (down by -69.4%). It should be noted that, because international tourism was at a virtual standstill for most of 2020, the rise in the numbers of visitors in the fourth quarter of 2021 is also related to the base effect. The increase of numbers of international visitors induced a rise in revenues from international travelers, which increased 8.9 times in the fourth quarter (see Figure 1.2.3), but remained 44.7% below the level of revenues received in the same period in 2019. In line with expectations, the annual revenues received from international travelers in 2021 remained below the record highs of 2019 (although only by 38%); however, the recovery of this sector is expected to continue in 2022.

In the fourth quarter of 2021, instant money transfers to Georgia increased by 16.7% annually and amounted to USD 643.5 million (see Figure 1.2.4). During this period, transfers from the EU (especially from Italy and Germany), Kazakhstan, Kyrgyzstan and the USA made the largest contributions to total growth. It is worth noting that, in 2020, despite the beginning of the COVID-19 pandemic, the volume of instant money transfers grew (partially due to the switch to digital channels) and this rise continued in 2021.

Considering the acceleration of economic activities, increased internal demand, as well as the rise of prices of import goods in USD terms, imports of goods rose considerably, increasing by 31.6% annually in the fourth quarter of 2021, reflecting a rise of 10.1% compared to the same period in 2019 (see Figure 1.2.5). The rise in imports from regional countries was significant, particularly those from Turkey and Azerbaijan, but imports from other regions, including China and Romania, made the largest contribution to overall growth. In contrast, imports from Armenia fell because of lower imports of copper ores and concentrates.

In the fourth quarter of 2021, imports of consumer and intermediate goods made largest contributions to the overall growth of imports (see Figure 1.2.6). The increase in imports of consumer goods predominantly stemmed from higher purchases of petroleum products, motor cars and medicaments, while the rise of imports of intermediate goods was due to higher imports of copper ores and concentrates, as well as petroleum gases and immune serums. The rise in imports of investment goods stemmed from higher purchases of automatic data processing machines and their units.

In light of increased exports of goods and higher instant money transfers, in addition to partially recovered revenues from international travelers, the current account deficit significantly declined in the third quarter of 2021 and amounted to 7.2% of quarterly GDP (this indicator was around 12.2% of quarterly GDP in the same period in 2020).

One of the sources of financing the current account

In light of strong domestic demand, registered imports of goods increased considerably in the fourth quarter. The rise of expenses on import goods was also induced by a rise of prices in USD terms.

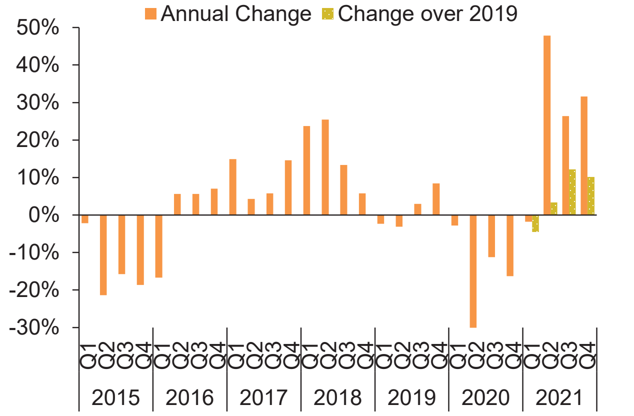


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the fourth quarter of 2021, imports of consumer goods made the largest contribution to the overall growth of imports.

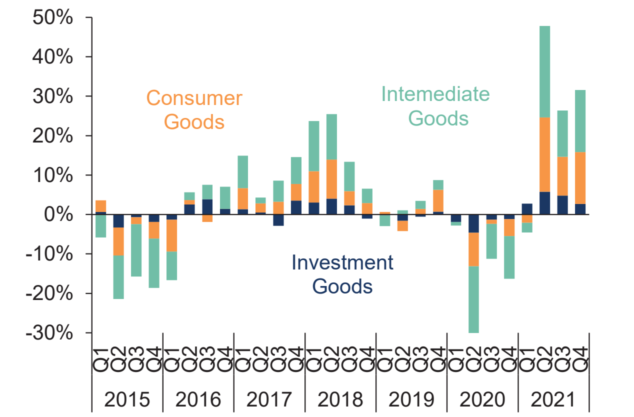
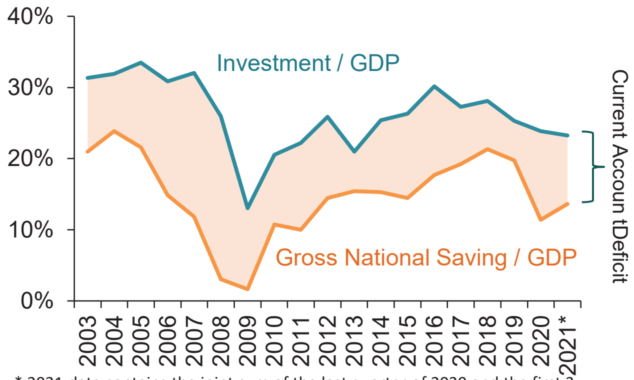


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

From the perspective of savings and investments, the improvement of the current account balance in the third quarter of 2021 was mainly due to a rise in savings, which also reflects the decline of the fiscal deficit compared to 2020.



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

Figure 1.2.7. Investments and savings

Source: GeoStat, NBG Calculations

deficit is foreign direct investments (FDI), which increased by 1.4% annually and reached USD 299.0 million in the third quarter of 2021. The main reason for the increase of FDI was the rise in reinvestments, while investments in equity declined once more. The majority of FDI went to the finance, energy, and manufacturing sectors.

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

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the third quarter of 2021, economic growth was mainly driven by net exports, which were underpinned by a partial recovery of tourism.

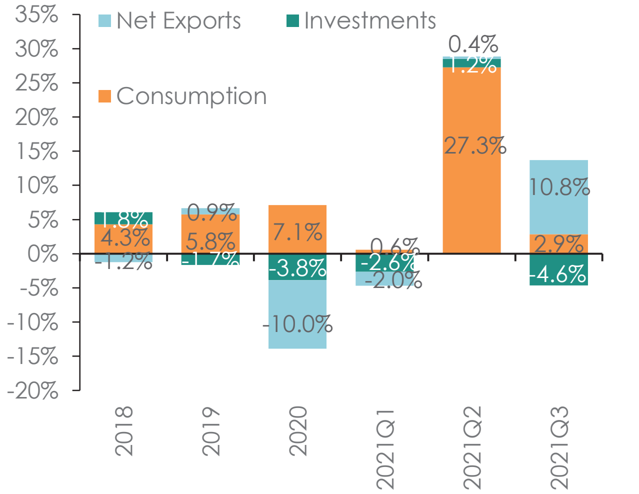


Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the third quarter of 2021, real GDP grew by 9.1% year on year.

The main reason for the high economic growth in the second and third quarters of 2021 was the base effect, as restrictions against the spread of the pandemic were originally imposed in the second quarter of 2020. Despite some of these remaining in effect to varying degrees, since the beginning of the second quarter of 2021, various restrictions were gradually eased, which served to significantly change the economic picture. Another reason for the high growth was the activation of pent-up demand that had been accumulated over months of severe restrictions.

It should be noted that the real volume of GDP in the second and third quarters of 2021 exceeded the corresponding levels of the same periods of 2019 by 10.2% and 1.6% respectively. Unlike in the second quarter, where consumption was the main driver of growth, in the third quarter, this became net exports, which made a contribution of 10.8 percentage points (pp). The main reason for this was a partial restoration of international tourist inflows. In the third quarter, a time when tourism revenues are traditionally most intense, exports of services almost tripled in real terms compared to the same period of 2020.

Consumption maintained positive dynamics in the third quarter of 2021, making a contribution of 2.9 pp. The negative contribution of investments during the same period amounted to 4.6 pp (see Figure 1.3.1).

1.3.2 OUTPUT

Most of the growth came from the services sector, which had been impacted by deferred demand and a partial recovery of tourism.

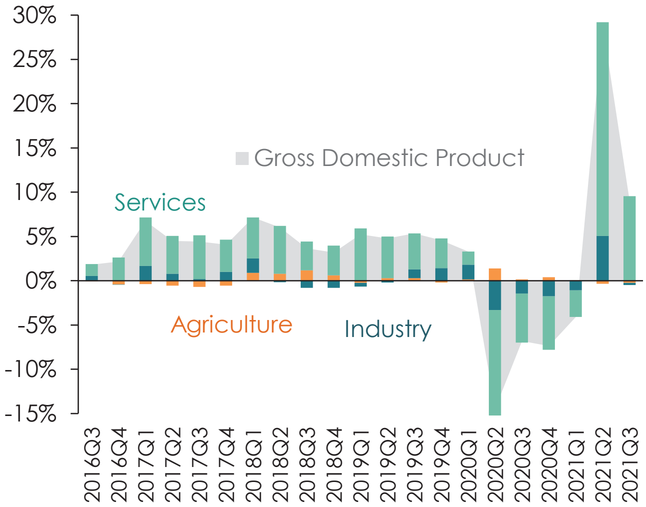


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat

In the third quarter of 2021, the real gross domestic product grew by 9.1% year on year (see Figure 1.3.2). The main driver of that growth, with a contribution of 9.6 pp, was the service sector. The contributions of the industrial sector and agriculture were negative and amounted to 0.2 pp each.

As mentioned in the previous chapter, the main reasons for the high growth observed since the second quarter of 2021 are the base effect, the activation of pent-up demand accumulated due to pandemic-related restrictions, and a partial recovery of foreign tourist inflows to Georgia after a one-year pause. The latter has had a positive impact on the tourism-related businesses that were most affected by the pandemic. Accommodation and catering activities, transport, real estate activities, and arts, entertainment and recreation – all sectors in which foreign participation is high – collectively contributed 4.5 pp to overall GDP growth. Trade, which is the largest sector of the economy, grew by 12.3%, making a 1.7 pp contribution to overall growth.

From the industrial sectors, a significant increase was observed in electricity, gas and water supply (making a 1.5 pp contribution to growth), all of which can be linked to the process of economic recovery. Growth has been maintained in manufacturing, where the weight of export-oriented manufacturing enterprises is high (7.3% growth, making a 0.7 pp contribution to overall growth). In contrast, a 29.7% decline in construction slowed economic growth by 2.5 pp.

During the same period, agriculture fell by 2.9%, contributing a negative 0.2 pp to economic growth (see Figure 1.3.2).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In December, the growth of the annual loan portfolio increased and stood at 18.2%, excluding the effect of exchange rate fluctuations.

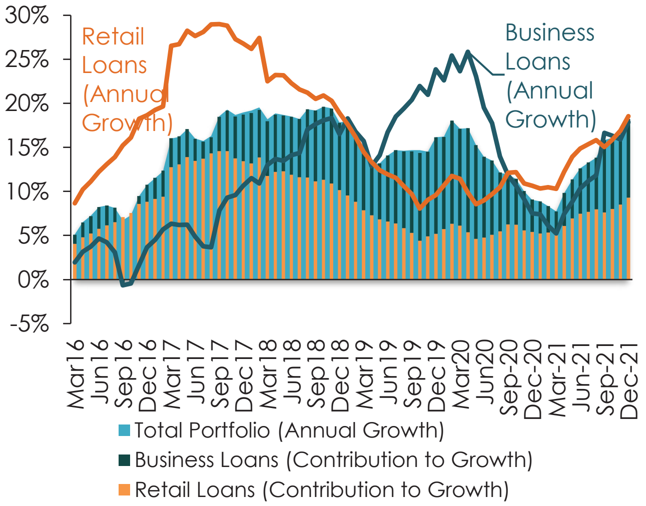


Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: NBG

In December 2021, relative to September, the growth of the loan portfolio increased and stood at 18.2% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans increased by 3.5 pp to stand at 18.6%, while the growth of loans to legal entities increased by 1.2 pp and equaled 17.9% (see Figure 1.4.1). The growth of business loans was primarily driven by an increase in loans issued to the agriculture, construction and transport and communications sectors. According to the credit conditions survey, representatives of the banking sector expect a slight decrease in demand for retail and business loans.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the fourth quarter of 2021 was mainly driven by domestic currency loans (see Figure 1.4.2). In December, the annual growth rate of foreign currency denominated loans increased and stood at 12.9%, while the growth rate of loans in the domestic currency decreased by 3.1 pp and equaled 24.9%. In the fourth quarter, the loan larization ratio did not change significantly and equaled 49.1%, 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 a step towards reducing risks to financial stability.

The contribution of loans issued in foreign currency to the growth of the loan portfolio has increased.

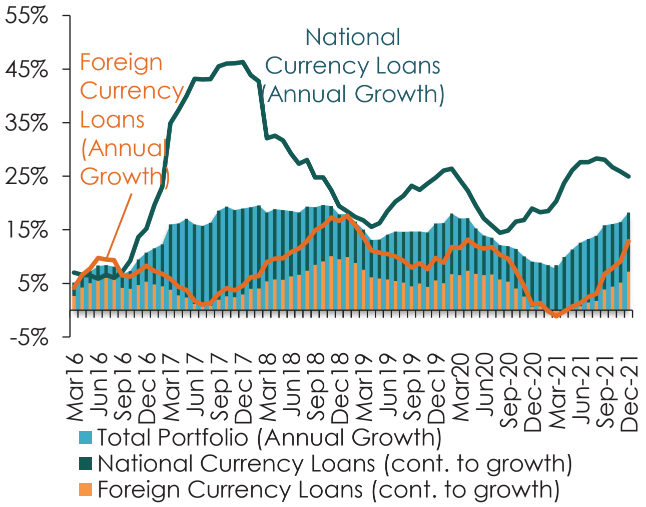


Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In December, the monetary policy rate was 10.5%. In the fourth quarter of 2021, interest rates on government securities did not change significantly, which was mainly due to slight increase in the monetary policy rate (see Figure 1.4.3).

Compared to the previous quarter, the spread between long- and short-term interest rates decreased slightly. This indicator remains at a low level, which suggests the increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate. Compared to long-term rates, the increase in short-term rates was, in part, a reflection of expectations in the financial market 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 December, relative to September, interest rates on domestic currency deposits increased slightly and equaled 10.3%. Meanwhile, interest rates on foreign currency deposits decreased slightly and equaled 1.7%. According to the credit conditions survey, representatives of the banking sector expect no significant

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

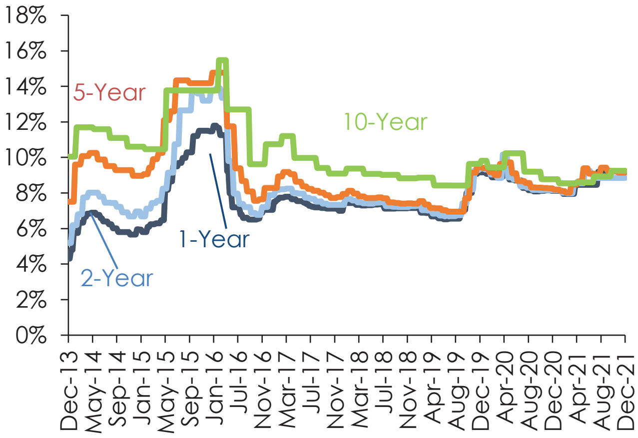


Figure 1.4.3. Interest rates on government securities

Source: NBG

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

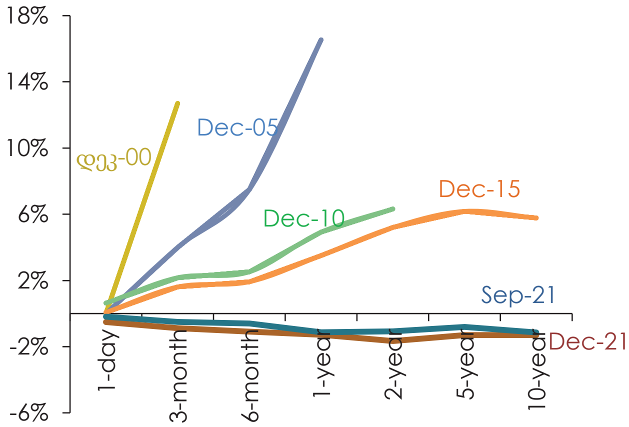


Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: NBG

change in the cost of funds in the next quarter.

Furthermore, according to the same survey, interest rates on consumer and mortgage loans issued in a foreign currency decreased slightly; meanwhile, interest rates on business loans issued in the domestic currency increased slightly. Although representatives of the banking sector expect a slight tightening of interest rate conditions for retail loans, significant changes in interest rate conditions for business loans are not expected. However, it is important to note that it is difficult to form expectations due to the ongoing uncertainty caused by the COVID-19 pandemic. In December, relative to September, interest rates on corporate loans increased slightly, while interest rates on loans to small and medium enterprises (SMEs) and retail loans decreased slightly. In particular, interest rates on corporate loans increased by 0.4 pp and equaled 10.2%. While interest rates on loans to SMEs and retail loans decreased by 0.3 pp and 1.5 pp and equaled 9.9% and 14.1%, respectively.

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

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

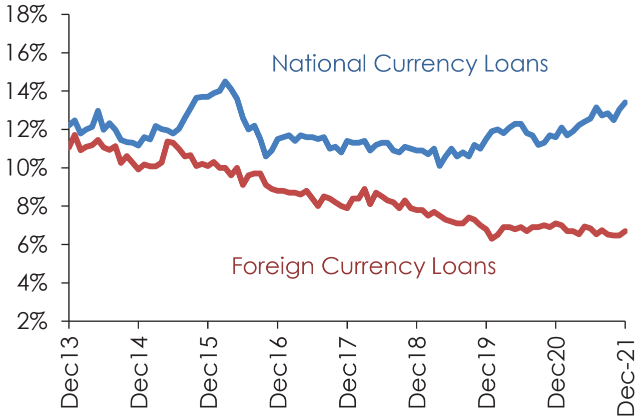


Figure 1.4.5. Average interest rates on business loans

Source: NBG

The real effective exchange rate appreciated by 13.2% on an annual basis.

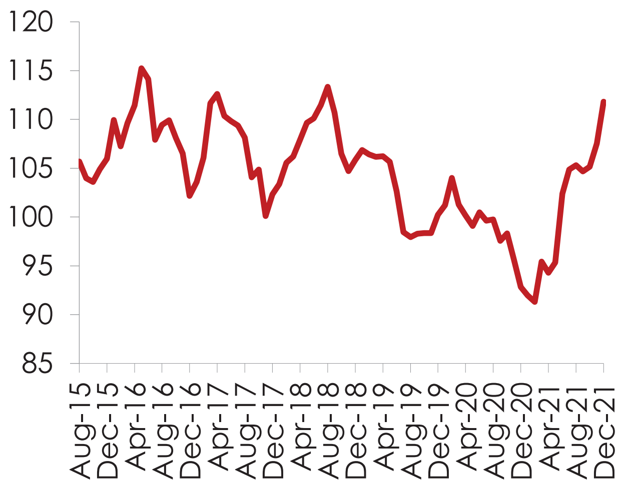


Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: NBG.

1.4.3 EXCHANGE RATE

In the fourth quarter of 2021, the GEL nominal exchange rate depreciated by 0.2% against the US dollar and appreciated by 2.8% against the euro, compared to the previous quarter. The GEL continued to appreciate against the Turkish lira and, according to average quarterly data, the appreciation was 20.5%, while the GEL depreciated against the Russian ruble by 1.3%. In the same period, the nominal effective exchange rate appreciated by 4.6% and 10.0% on a quarterly and an annual basis, respectively. As for the price-adjusted exchange rate, in the fourth quarter of 2021, the real effective exchange rate appreciated by 3.1% on a quarterly basis and by 13.2% on a year-on-year basis (see Figure 1.4.6). It should be noted that the real exchange rate appreciated against all trading partner countries (see Table 1.4.1).

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

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate	**10.0**	**13.2**	**13.2**
Eurozone	9.0	17.8	3.2
Turkey	47.0	31.2	5.5
Ukraine	-1.2	1.2	0.1
Armenia	0.3	4.2	0.3
US	4.6	10.9	0.7
Russia	-0.3	4.1	0.6
Azerbaijan	4.7	6.6	0.7
China	1.0	12.3	1.6
Other	9.8	15.7	0.5

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

Source: NBG

* Growth implies appreciation of the lari.

Unlike in 2020, in the second quarter of 2021, a sharp increase in productivity reduced the unit labor cost (ULC). In the third quarter, the ULC increased moderately, by an annual 1.5%, which does not create pressure on inflation from the labor market.

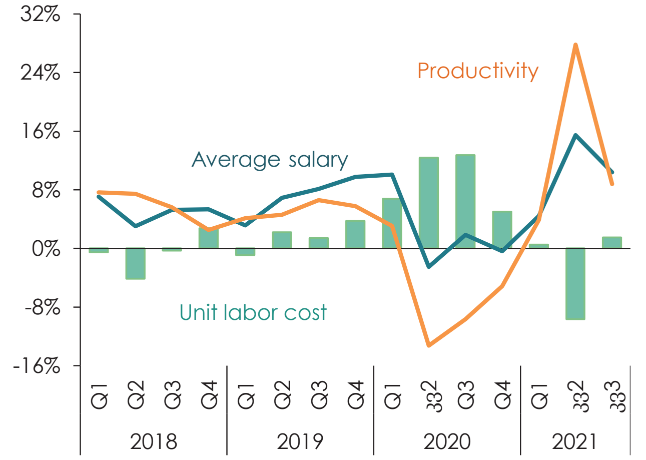


Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

In December, the base effect of the government's subsidies on utilities was added to the existing set of exogenous factors affecting inflation. Ultimately, inflation increased to 13.9%.

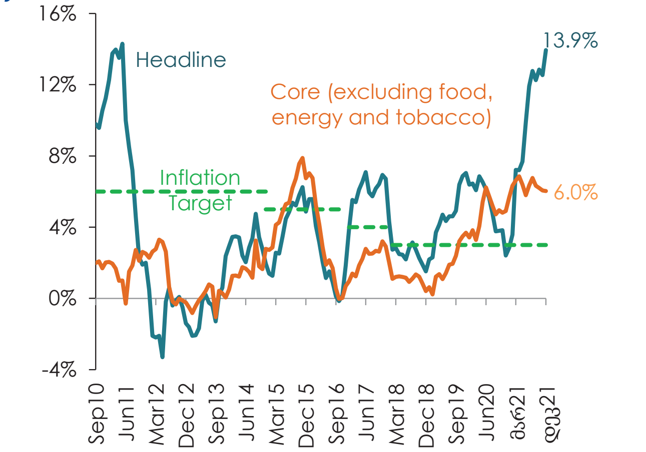


Figure 1.6.1. Headline and core inflation

Source: GeoStat

Food, fuel and utility bills continue to make a large contribution to inflation.

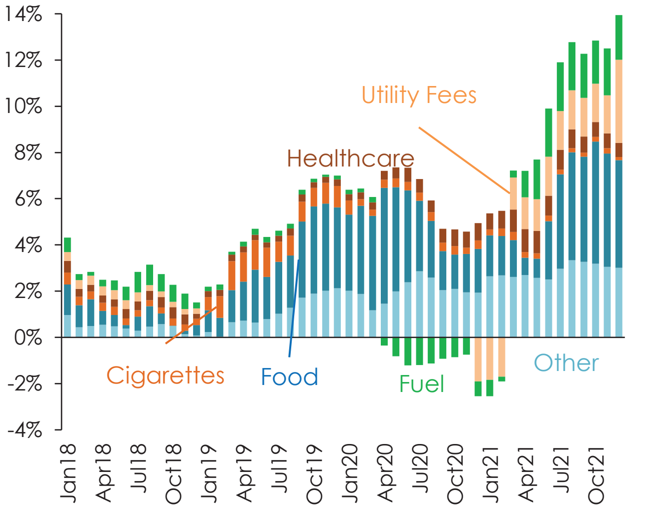


Figure 1.6.2. Contribution of different products to inflation

Source: GeoStat

1.5 LABOR MARKET

In the third quarter of 2021, the real value added produced per employee (labor productivity/productivity) in the country's economy increased by 8.8% annually (see Figure 1.5.1). At the same time, the gross salaries of employees averaged 1,369 GEL, which reflects a nominal annual growth of 10.4%.

In 2020, the unit labor cost increased due to a smaller reduction in wages compared to the decrease in output. This acceleration was one of the drivers of inflation, given the supply-side delays and declining output that occurred in the face of the pandemic.

As expected, with the recovery of the economy, from the end of 2020, the unit labor cost began to gradually decline. And, in the second quarter of 2021, with high economic and productivity growth, it shrank sharply, falling by 9.7% year on year. In the third quarter, the unit labor cost increased by an annual 1.5% – a moderate figure that does not reflect pressure on prices coming from the labor market (Figure 1.5.1).

1.6 CONSUMER PRICES

Annual inflation rose to 13.9% in December (see Figure 1.6.1). As we explained in previous reports, an important reason for this growth was the extraordinary situation caused by the pandemic, which led to several factors simultaneously affecting rising inflation.

The increased inflation in Georgia is closely linked to the rising prices of consumer goods around the world. One of the most noteworthy developments concerns rising food prices. As a consequence of various pandemic-related delays, poor harvests and increased transportation costs, world food prices have been at a record high for the last ten years.

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

In December, as expected, the base effect of the government's utility subsidies (which had been provided in 2020) was added to the existing set of exogenous factors affecting inflation, after which the contribution of utilities to annual inflation increased to 3.6 pp (up from 1.6 pp in November).

Food prices rose by 16.1% year on year in December, contributing 4.7 pp to inflation. Among imported foods, the rise in prices of sunflower oil, bread, sugar and chocolate were particularly notable, making a combined 1.5 pp contribution to inflation. Inflation for eggs, potatoes, cheese, cabbages, and chickens, which

Despite the recent strengthening of the GEL exchange rate, the increase in local prices has mainly been due to imported goods. This is a reflection of an increase of USD prices on international markets.

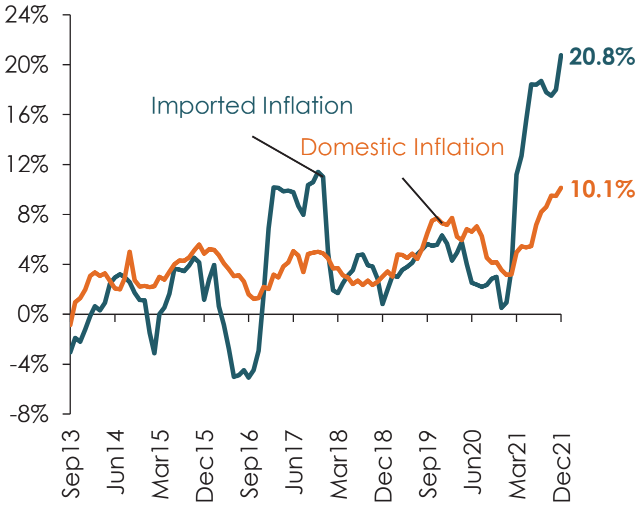


Figure 1.6.3. Domestic and imported inflation

Source: GeoStat

are generally locally produced, totaled 1.4 pp.

The impact of the pandemic on locally produced food has mainly been transmitted through the increased intermediate costs of their production.

With the restoration of mobility, demand for oil and its price on international markets remains high, which obviously has affected fuel prices. In December, the contribution of fuel to inflation equaled 1.9 pp.

The 7.9% increase in prices in the healthcare group (making a 0.7 pp contribution to inflation) is also significant, a significant share of which came from an increase in the prices of medicine (see Figure 1.6.2)

The fact that the annual inflation of imported and mixed products (20.8% and 15.1% respectively) continues to be higher than the inflation of domestic products (10.1%), in spite of the appreciation of the nominal effective GEL exchange rate, indicates that the increase in prices is mainly a consequence of rising prices of products on the world market (see Figure 1.6.3).

Meanwhile, core inflation, which excludes volatile food, energy, and cigarette prices, amounted to 6.0% in December (see Figure 1.6.1). It is worth noting that service inflation was even lower and stood at 5.7%. An analysis of core and service inflation is particularly significant as it reflects the long-term trend: lower core and service inflation signal a reduction of headline inflation in the future.

2 MACROECONOMIC FORECAST

Based on the baseline macroeconomic forecast, inflation will start to fall from the second quarter of 2022 and will gradually approach the target level by the end of the year. Although supply-side shocks have pushed inflation up, these shocks are only expected to be transitory. The current elevated inflation will decline as supply-side disruptions ease and temporary pressures retreat. Real GDP is expected to grow by 5% in 2022. Private demand will be a major driver of economic activity, while tourism is expected to remain subdued. However, uncertainty remains high as considerable pandemic-related risks linger, which could cause deviations from the baseline macroeconomic forecast. The alternative forecast scenario envisages the risk of stronger domestic demand compared to the baseline scenario and an earlier tightening of monetary conditions in response to high inflation in developed countries. In particular, this scenario foresees an increased domestic propensity to consume amid higher-than-expected credit activity. At the same time, tightening from the U.S. Federal Reserve System will result in a global strengthening of the USD, which, in turn, will lead to a drop in oil and food prices on international markets. Ultimately, this scenario considers a further tightening of the monetary policy stance in the wake of intensified inflationary pressures stemming from domestic demand and the exchange rate depreciation.

2.1 BASELINE MACROECONOMIC FORECAST

In the short run, inflation will be higher than the target, but from the second quarter of 2022 it will start to decline and will gradually approach the target by the end of the year.

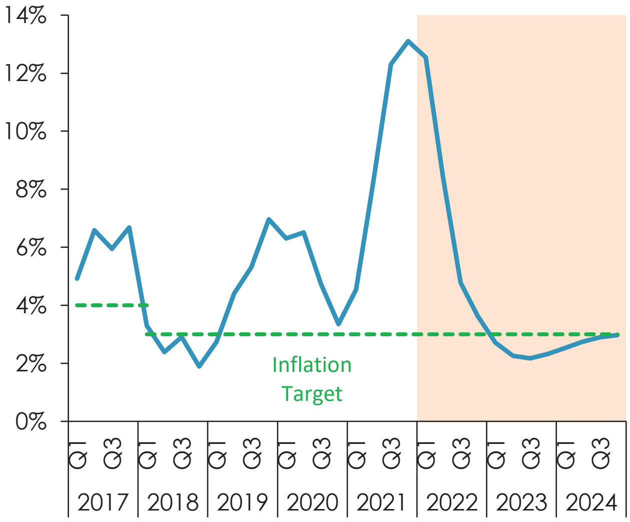


Figure 2.1.1. Headline inflation

Source: NBG, Geostat.

From the second quarter of 2022, inflation will start to decline and will gradually approach the target by the end of the year (see Figure 2.1.1). In the short run, inflation is mostly driven by exogenous supply-side shocks resulting from the pandemic. Rising commodity prices on international markets and international shipping disruptions have pushed inflation up. The rapid increase in commodity prices is expected to lessen and transportation disruptions will eventually ease during 2022, which will help contain headline inflation. Meanwhile, the base effect related to the government's utilities subsidy program has temporarily increased inflation. Inflation will start to recede from the second quarter of 2022 as supply-side disruptions ease and the tightened monetary policy stance curbs inflationary pressures. Inflation will gradually approach the target and will be maintained around it in the medium term.

In the short term, exogenous shocks push inflation above the target (see "other factors" in Figure 2.1.2). Inflation is expected to remain elevated at the beginning of 2022. However, as supply-side shocks abate, higher inflation should start to decline from the second quarter of the year. The current appreciation of the Georgian lari against trading partners' currencies helps scale down imported inflation, while the appreciation against the US dollar reduces producers' debt servicing costs – eventually leading to local price cuts. Thus, in the medium term, the recent appreciation of the exchange rate will help inflation align with the target through the direct import and input costs chan-

In the short term, temporary exogenous shocks push inflation above the target, but higher inflation will start to fade as those exogenous shocks abate.

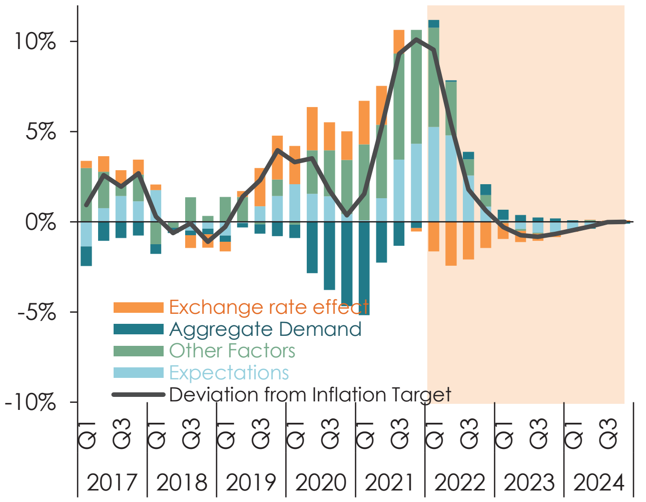


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, Geostat.

Real GDP will grow by 5% in 2022 because of domestic demand driven by fiscal stimulus and credit activities.

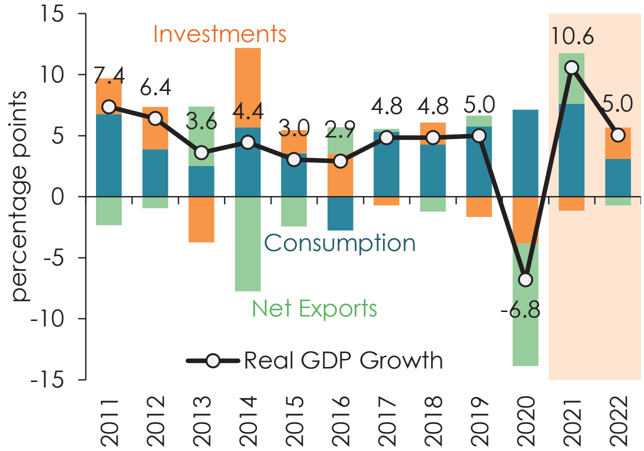


Figure 2.1.3. Real GDP growth decomposition

Source: NBG, Geostat.

nels. However, it is worth noting that strong domestic demand has almost closed the output gap and that demand cannot neutralize inflationary pressures; it will even have a slightly positive impact on inflation in 2022.

In response to increased inflation, a tight monetary policy will be maintained. It is noteworthy that current inflationary pressures are caused by temporary exogenous supply-side shocks. Other things being equal, central banks do not usually respond to supply-side shocks, as doing so risks creating additional economic fluctuations. However, in the current situation, the strong supply-side shock elevates inflation expectations and creates so-called "second-round" effects. Moreover, in the wake of the various shocks experienced over the last couple of years, inflation has deviated from the 3% target for a long time, which further amplifies long-term inflation expectations. The NBG will thus maintain a tight monetary policy to curb inflation expectations. Afterwards, the policy rate will gradually decline in line with falling inflation expectations before approaching the neutral level (which is currently estimated at 6.5%) in the medium term.

Real GDP is expected to grow by 5% in 2022 (see Figure 2.1.3). Based on the baseline scenario, private consumption will continue to be a major driver of economic growth. Meanwhile, improved investment activity will positively contribute to economic growth. Domestic demand will be encouraged by fiscal stimulus and credit activity, while tourism will remain subdued during 2022. After the imposition of strict regulations and lockdowns in 2020, tourist inflows started to recover in 2021, which positively contributed to economic growth. However, tourism is still lower than pre-pandemic levels, as both strict mobility restrictions and fears of contracting the virus continue to reduce mobility across countries.

2.1.1 BASELINE FORECAST SCENARIO RISKS

Pandemic-induced risks remain high, which could cause a deviation from the baseline macroeconomic forecast. Those risks are mostly inflationary and monetary policy will thus be hawkish in order to maintain price stability.

Macroeconomic Forecast Risks	Impact on Inflation
Prolongation of the pandemic	↑
Tightening monetary conditions in developing countries	↑
Strong domestic demand	↑
Escalation of geopolitical risks	↑
Rising commodity prices on international markets	↑
Rising global shipping costs	↑
Faster-than-expected recovery of tourism	↓
Low Risk	High Risk
↑	Upward Pressure on Inflation
→	Same Level of Inflation
↓	Downward Pressure on Inflation

Table 2.1.1 Baseline Macroeconomic Forecast Risks.

Macroeconomic forecasts are characterized by a high degree of uncertainty. The emergence of the Omicron variant of COVID-19 threatens to set back the tentative path to recovery. With the spread of the new variant, various countries have started to re-impose mobility restrictions. Based on preliminary studies, although Omicron appears to be more transmissible than previous variants, its symptoms are perhaps less severe. However, the net effect of the variant on hospitalizations and mortality is still unknown. Meanwhile, vaccine efficacy against the new variant has declined. If Omicron turns out to be a more severe threat, strict regulations will be prolonged. A possible resurgence of the pandemic carries the risk of prolonged supply chain disruptions, which would push production costs up and these would eventually be transmitted to prices. Meanwhile, a prolongation of the pandemic would exert downward pressure on the service sector, which is responsible for a significant part of the Georgian current account balance. Thus, a materialization of this risk will cause the current account balance to deteriorate and will push up the country risk premium, thereby putting depreciation pressure on the local currency. The latter, in turn, will eventually put upward pressure on inflation through the direct imported inflation and input costs channels.

Global inflation has been higher and more broad-based than anticipated. Supply-side disruptions, pandemic-related impediments to transportation, and elevated commodity prices on international markets have pushed inflation significantly above targets, even in developed economies. Such factors are expected to have only a temporary impact on inflation and thus central banks in developed economies will only moderately tighten their policy stances. Although these pressures are expected to be temporary, upside risks remain. Inflation could turn out to be higher than expected and this will push inflation expectations up. Should this occur, an accelerated normalization of policy stances in developed economies will be required. This will lead to a reassessment of risks by financial markets and will be reflected in a tightening of financial conditions. This, in turn, will give rise to capital outflows and depreciation pressures. Given the high level of dollarization in the Georgian economy, a materialization of this risk will have a significant impact on inflation through the input costs channel.

Meanwhile, strong domestic demand adds to inflationary pressures. Large fiscal support, which prioritized health and social spending, strong credit activity, and a realization of pent-up demand boosted domestic consumption faster than had been expected. The output gap has almost closed and so de-

The inflation outlook and the factors that affect prices are almost the same as in the previous projection.

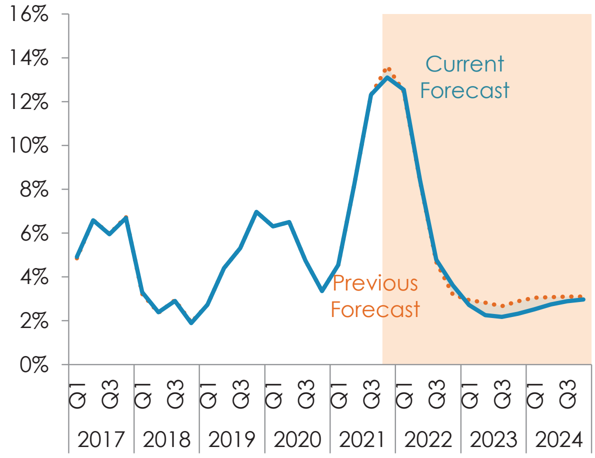


Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, Geostat.

The 2022 real GDP growth forecast has been maintained at 5%.

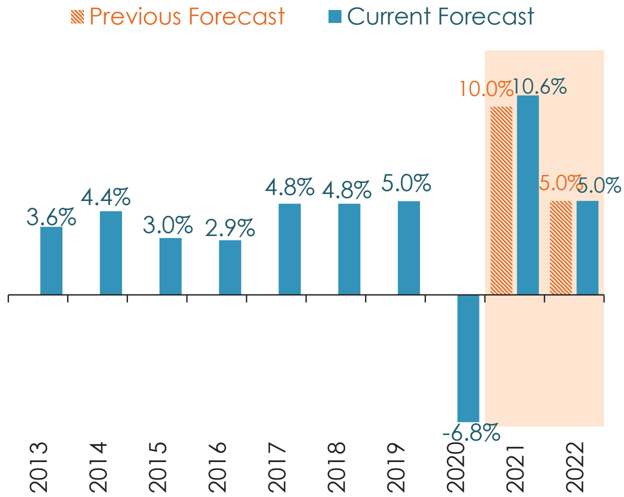


Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, Geostat.

Expectations related to main trading partner currencies have deteriorated drastically. Greater-than-expected inflationary pressures, coupled with a worsened outlook around exchange rate trajectories, have pushed up inflation expectations in trading partner economies.

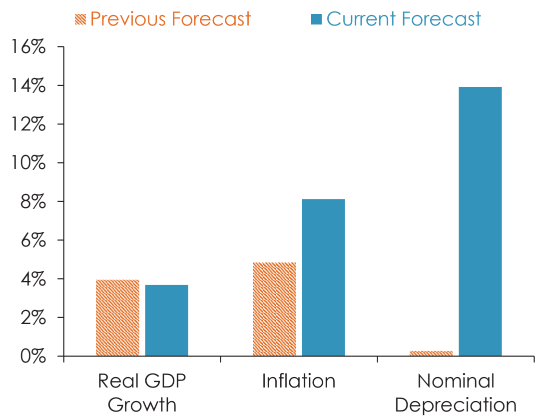


Figure 2.2.3. Changes in the forecast of external assumptions for 2022

Source: Bloomberg.

mand cannot neutralize the inflation strain. Further, if demand turns out to be higher than expected in 2022, it will put upside pressure on inflation.

Geopolitical tensions between Ukraine and Russia pose inflationary risks as well. A materialization of such risks will cause the trade balance to deteriorate and lead to a reassessment of the country's sovereign risk.

External factors, such as rising commodity prices on international markets, also pose risks to the macroeconomic forecast. Elevated international prices have already been transmitted to the local market, but if this tendency persists, inflationary risks will be further amplified. Moreover, increasing shipping costs affect inflation. If shipping expenditures continue to grow, this will push up prices further.

In contrast, a faster-than-expected recovery would lead to a deviation from the baseline forecast scenario in a positive direction, hastening the economic recovery. A recovery of tourism will improve the current account balance, and inflation would be lower compared to the baseline scenario.

2.2 COMPARISON WITH THE PREVIOUS FORECAST

The inflation outlook has remained the same as in the previous forecast (see Figure 2.2.1), with the assumptions that affect the forecast remaining almost identical. Elevated inflation will start to decline as temporary supply-side disruptions ease. Meanwhile, the tight monetary policy is expected to curb inflationary pressures. As a result, inflation will start to recede from the second quarter of 2022 and will approach the target level. In the medium term, inflation will be maintained around the target.

The real GDP growth forecast for 2022 has been maintained at 5% (see Figure 2.2.2). The assumptions that have been used to forecast the pace of economic recovery have not changed. As in the previous forecast, real GDP growth in 2022 is still largely expected to be driven by domestic demand, while tourism will remain subdued.

Georgia is a small open economy, and the economic stances of its trading partners thus have a significant influence. Macroeconomic forecasts thereby strongly depend on assumptions regarding the economic growth, inflation, and exchange rates of trading partners. Changes in any of those assumptions will affect the baseline forecast as well as associated risks (see Figure 2.2.3).[11]

According to the updated projections, the expected depreciation of Georgia's trading partner currencies has been revised significantly upward. This revision has mostly been driven by the weakness of the Turkish lira. Deteriorated expectations about trading partners' currencies,

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

together with rising prices on international markets, have put upward pressure on inflation expectations. The depreciation of trading partner currencies strengthen the Georgian lari's effective exchange rate, which will ultimately reduce the prices of imported goods and help inflation to fall. However, the competitiveness of Georgian goods will diminish, which will negatively affect economic growth. Expectations related to the real GDP growth of trading partners remain almost the same as in the previous forecast.

2.3 ALTERNATIVE FORECAST SCENARIO

According to the alternative scenario, domestic demand will intensify in 2022, resulting in economic growth of 6%. In 2023, real GDP growth is expected to be 3.5% due to the negative external shock and the relevant monetary policy reaction.

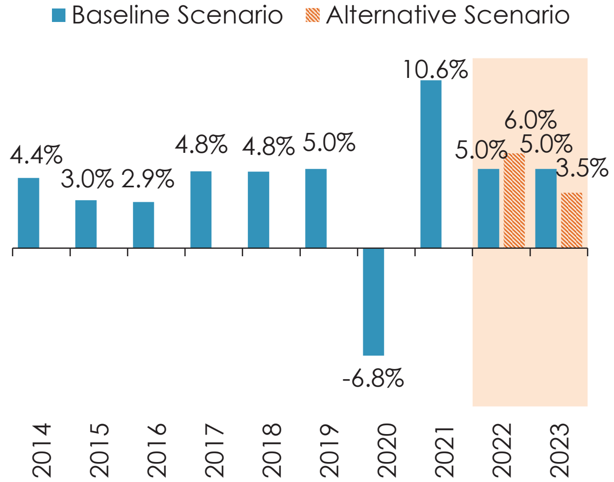


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat.

Under the alternative scenario inflationary pressures will intensify, driven by strong domestic demand and the exchange rate depreciation. Inflation in 2022 will thus be 1.5 pp higher as compared to the baseline scenario.

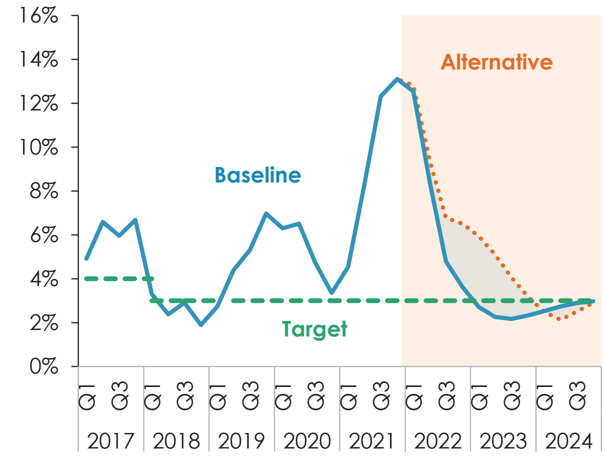


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat.

The alternative forecast scenario considers a realization of the most probable risks related to the baseline macroeconomic forecast. Akin to the previous alternative forecast, the current scenario foresees the maintenance of strong domestic demand throughout 2022, driven by an increased propensity to consume. At the same time, amid strong domestic demand, higher-than-expected credit activity will further contribute to domestic consumption. As a result, the economy will grow by 6% in 2022 (see Figure 2.3.1). Under this scenario, real GDP growth will be around 3.5% in 2023 in light of tightened global financial conditions and the relevant monetary policy response in Georgia.

Along with strong domestic demand, this scenario assumes that the U.S. Federal Reserve System (Fed) will hike the interest rate earlier than expected. These factors will have a heterogeneous effect on inflation. On the one hand, strong domestic demand will boost imports of goods, resulting in a worsened current account balance. The latter will put pressure on the country's risk premium and exchange rate, aggravating inflation. On the other hand, an interest rate hike by the Fed will strengthen the USD globally, further exacerbating risks of capital outflows and inflationary pressures stemming from the exchange rate depreciation. On the flip side, amid a global strengthening of the USD, the upward pressure on prices coming from international commodity markets will be reduced as compared to the baseline scenario. This would somewhat neutralize the pressure stemming from the exchange rate. In the case of a realization of these risks, inflation will be 1.5 pp higher in 2022 than under the baseline scenario (see Figure 2.3.2).

Under the aforementioned scenario, monetary policy will gradually be tightened and this contractionary stance will be maintained for a relatively long period. Therefore, the monetary policy rate trajectory will see a hike of 2.4 pp in 2022 compared to the baseline forecast (see Figure 2.3.3). However, alongside a neutralization of the pressures stemming from domestic demand and external factors, the policy rate will start to decrease. Ultimately, as a result of the appropriate monetary policy response, inflation will approach the 3% target over the medium term.

In response to increased inflationary pressures, the monetary policy stance will gradually be tightened. Such a relatively contractionary position will be maintained for a longer period as compared to the baseline scenario. Under the alternative scenario, the monetary policy rate trajectory will shift upwards by 2.4 pp in 2022.

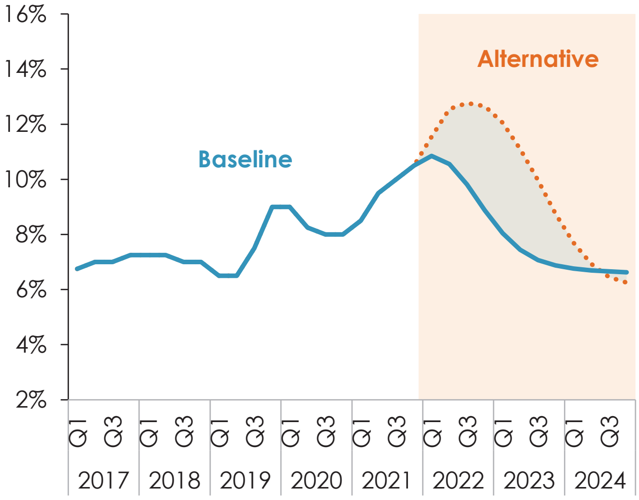


Figure 2.3.3. Monetary policy rate according to the baseline and alternative forecasts

Source: NBG.

The financial market's expectations are largely in line with the baseline forecasts of the National Bank of Georgia. In particular, market participants expect that inflation will gradually converge to its target in the medium term.

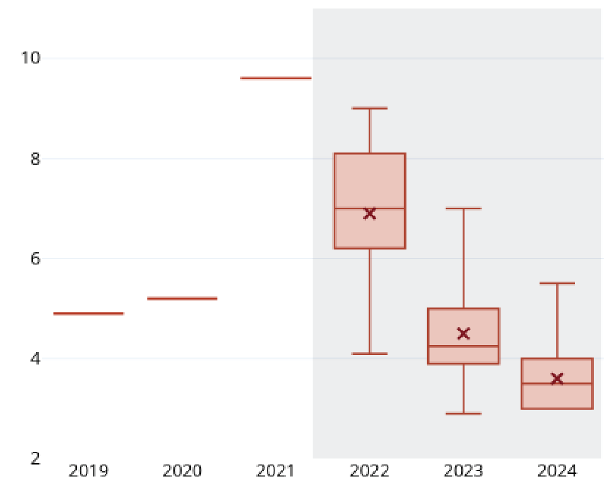


Figure 2.4.1. Actual average inflation (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, Geostat.

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the first quarter of 2022, 12 organizations participated in a survey of macroeconomic forecasts. The results revealed that financial market participants have revised their inflation expectations for 2022-2023 upward compared to the same survey carried out in the fourth quarter of 2021. In particular, the median of their inflation expectations for 2022 increased by 1.3 pp compared to the previous quarter and reached 7%, while the average inflation forecast went up by 0.9 pp, equaling 6.9%. The median of the 2023 inflation forecast is 0.3 pp higher than in the survey from the fourth quarter of 2021 and stands at 4.3%, while the average forecast shifted up by 0.7 pp to 4.5%. In the medium term, market participants expect inflation to converge to its target. In particular, the median of inflation expectations for 2024 fell to 3.5%, whilst the average fell to 3.6% (see Figure 2.4.1). It should be noted that the market's inflation expectations are in line with the baseline forecasts of the National Bank of Georgia.

Amid increased inflation expectations, market participants have revised their monetary policy forecasts upward compared to the previous quarter. Particularly, the median forecast for 2022 increased by 0.8 pp and reached 9.5%, while the average forecast is 0.5 pp higher and stands at 9.2%. Similarly, the median and average forecasts for 2023 have gone up by 0.4 pp, reaching 8% and 8.1% respectively. The monetary policy forecasts for 2024 are slowly converging to the neutral level in line with declining inflation expectations, with the median and average projections stand-

The monetary policy rate (MPR) is expected to fall in the wake of descending inflation expectations in the medium term. However, akin to the previous survey of macroeconomic forecasts, MPR expectations are characterized by high variability.

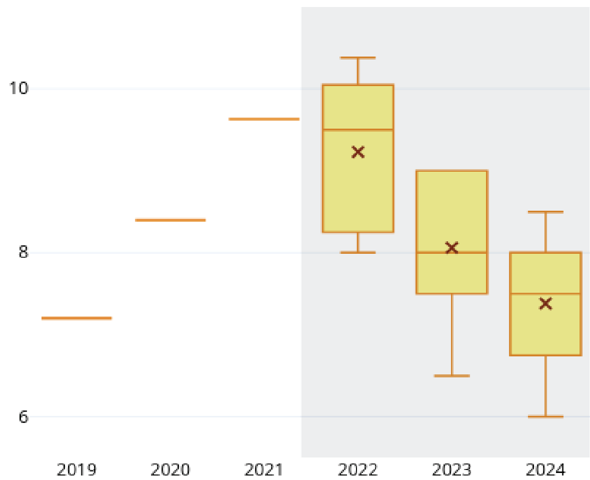


Figure 2.4.2. Actual monetary policy rate (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants.

Market expectations about real GDP growth have improved compared to the previous quarter, but uncertainty has remained.

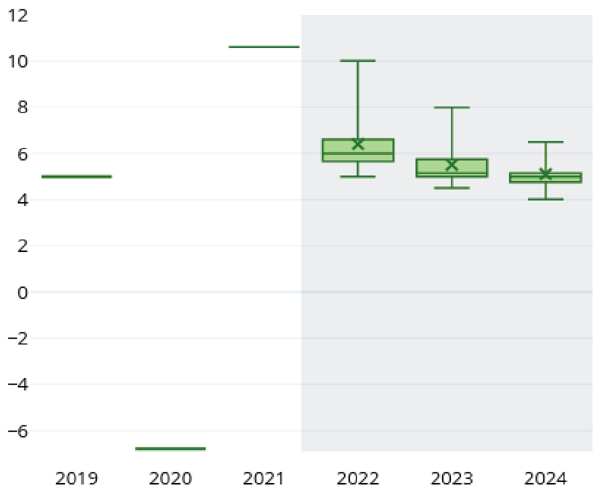


Figure 2.4.3. Actual real GDP growth (2019-2021) and the distribution of market participants' forecasts for 2022-2024

Source: NBG, Financial market participants, GeoStat.

ing at 7.5% and 7.4% respectively (see Figure 2.4.2). However, the survey's results reveal that expectations about the monetary policy rate are characterized by high variability.

According to the current survey, real GDP growth forecasts are highly volatile. The median forecast of economic growth in 2022 is similar to the previous survey and stands at 6%, while the average forecast has shifted up by 0.5 pp, reaching 6.4%. The median forecast of real GDP growth in 2023 dropped by 0.2 pp to 5.2%, although the average forecast increased by 0.2 pp to 5.5%. In 2024, the market's median real GDP growth forecast is 5%, while the average is 5.1% (see Figure 2.4.3).

BOX 1. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2021 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters). Hence, the inflation forecast is key to monetary policy formation in the medium term. To assess the adequacy of monetary policy in achieving its monetary objectives, it is important to analyze accuracy of the forecasts made in previous periods. The inflation forecast is assessed as having been accurate if any deviations from the forecast were a result of exogenous factors (that are independent of monetary policy). In Georgia, as in other small open economies, exogenous shocks are an ever-present threat. Exogenous factors can cause actual inflation to deviate from the target level. Monetary policy is a tool to affect aggregate demand and is thus the central bank's response to demand shocks. Central banks do not usually react to exogenous supply-side shocks, as doing so would risk leading to economic fluctuations and increase social costs. Consequently, central banks only respond to exogenous shocks when a deviation is so significant that it affects inflation expectations and influences inflation in the medium or long term.

Inflation turned out significantly higher than had been projected in February of 2021 (see Figure 2.4.4). Based on that projection, inflation was expected to hover around the target in 2021 and to temporarily pick up by the end of the year due to the base effect from the government's subsidy of utilities. At the beginning of 2021, several effective vaccines had started to rollout around the world, generating hopes that the pandemic would ease its grip. However, slow immunization rates in developing countries, uneven vaccination progress between developed and developing economies, and the spread of new mutations of the virus all led to a prolongation of the pandemic. This served to intensify supply chain disruptions. Clogged ports added to shipping problems and raised international transportation costs. Nevertheless, strict restrictions on mobility were lifted in 2021 and pent-up demand was realized faster than had been expected. The resulting supply-demand imbalance on the international market put upward pressure on commodity prices. These factors pushed inflation up, not only in Georgia but in the global economy as a whole. Inflation even significantly exceeded those targets set in developed economies.

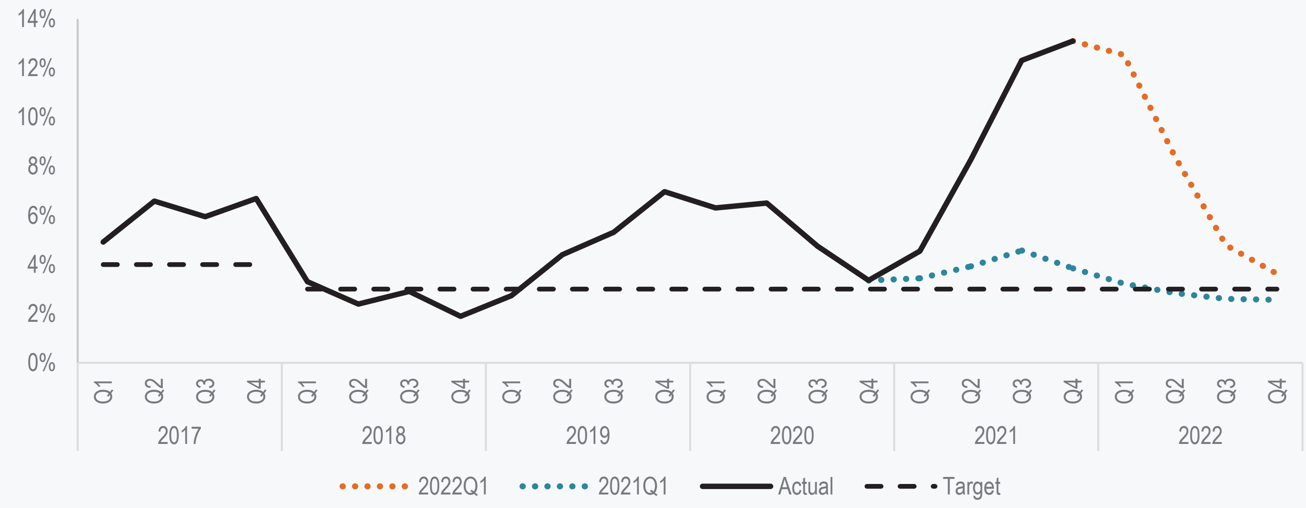


Figure 2.4.4. Comparison of annual inflation forecasts

Source: NBG, Geostat.

Actual average inflation in 2021 was 5.6 pp higher than had previously been predicted (see Figure 2.4.5). Inflation decompositions reveal that this higher-than-expected inflation was a result of supply-side shocks. The prolonged pandemic induced supply chain disruptions on global markets. Rising commodity prices on international markets resulting from demand-supply imbalances pushed up the prices of sugar, cereals, and sunflower oil. As Georgia imports all of those commodity goods, the global price dynamics were transmitted to the local market. In the meantime, elevated crude oil prices increased local fuel prices, which added to the causes of the higher-than-expected inflation. Although the government's subsidy program on utilities temporarily reduced inflation in the beginning of 2021, once that program was terminated, utility bill prices statistically increased more than the initial reduction and led to an increase in the overall inflation rate. This effect of the subsidy-related change, coupled with its base effect, eventually made a positive contribution to the deviation of inflation from its target. Moreover, short-run inflation expectations intensified against the background of high headline inflation in 2021. Moreover, in the wake of various shocks over the last couple of years, inflation has deviated from its 3% target for a long period, further amplifying inflation expectations. It is also worth noting that the output gap has almost closed and its disinflationary impact was therefore rather weak.

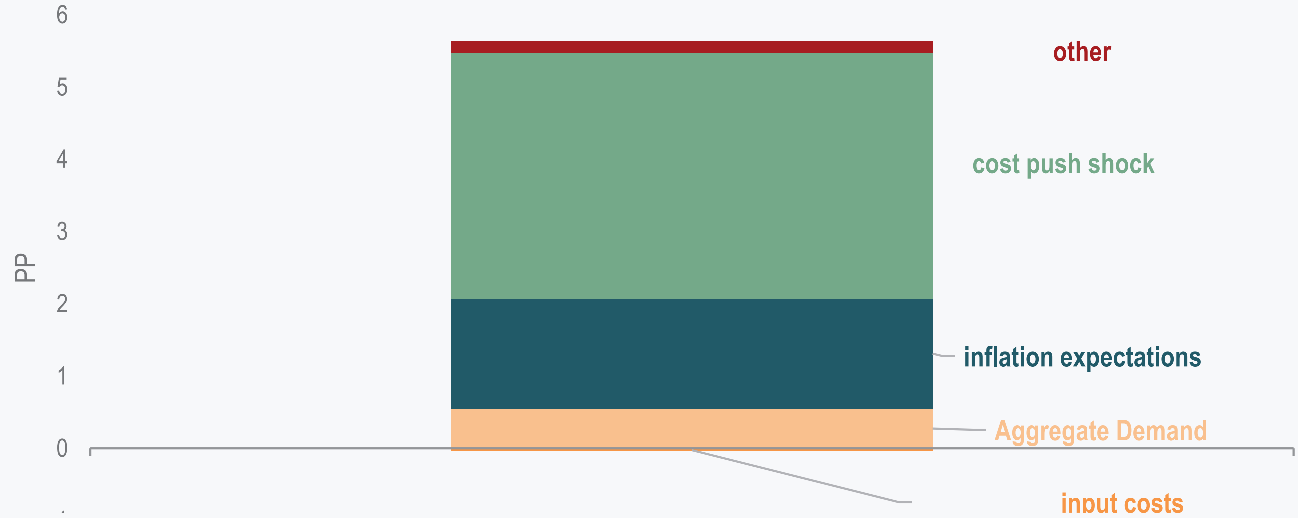


Figure 2.4.5. Comparison of headline inflation forecasts (2021Q1-2021Q4)

Source: NBG, Geostat.

In terms of the quarterly inflation forecasts, as the pandemic retained its grip and supply-side shocks intensified, the inflation outlook worsened during 2021 (see Figure 2.4.6). However, in each forecast round inflation was expected to gradually decline as a result of the tightened monetary policy stance and an easing of pandemic-induced disruptions. Inflation was expected to approach and remain around the target in the medium term.

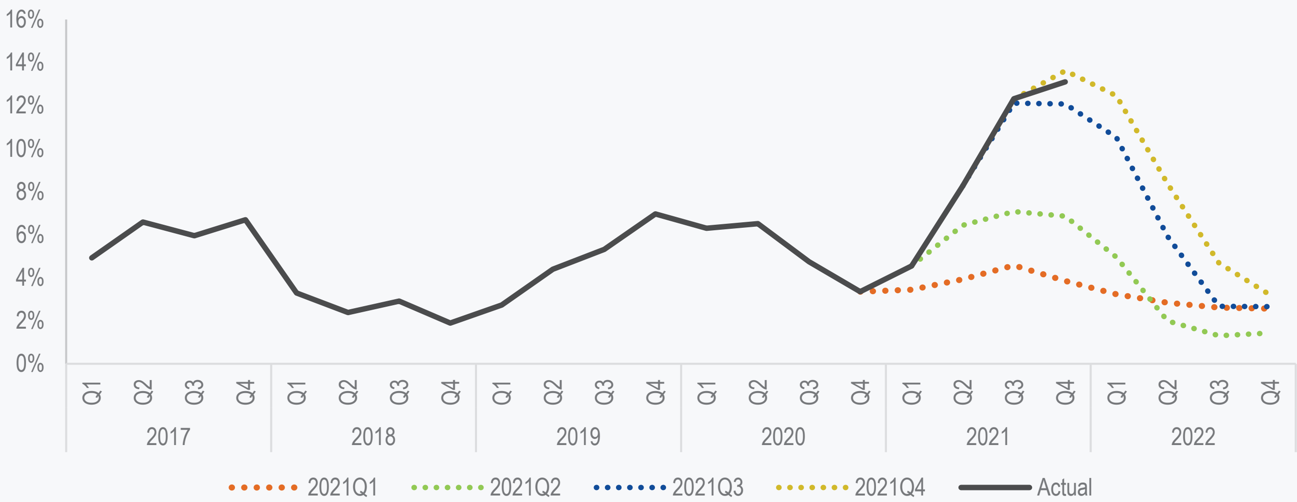


Figure 2.4.6. Comparison of headline inflation forecasts (2021Q1-2021Q4)

Source: NBG, Geostat.

During 2021, inflationary pressures were temporary and exogenous. In general, once such shocks pass, the inflation rate should automatically return to its target level. However, in an effort to curb co-increasing inflation expectations, the NBG's Monetary Policy Committee decided to gradually raise the monetary policy rate from 8% to 10.5%. Other things being equal, central banks do not usually react to exogenous supply-side shocks, as doing so would risk leading to economic fluctuations. However, the current shock turned out to be so strong that it started to affect medium-term inflation expectations and escalated the risks of so-called "second-round effects". Thus, to suppress additional inflation pressures, the NBG's decision to tighten monetary policy stance was adequate. This move, along with exhaustion of one-off factors, will lead to a reduction of inflation in 2022. Afterwards, the policy rate will gradually decline in line with a lowering of inflation expectations before approaching its neutral level (which is currently estimated at 6.5%) in the medium term.

3 MONETARY POLICY

Against the backdrop of the pandemic, high inflation has become a major challenge for the global economy. In December 2021, annual inflation in Georgia stood at 13.9%. As mentioned in previous reports, external factors are the main reasons for the high rate of inflation . In particular, inflation over the past year has been largely driven by sharply rising commodity prices on international markets and significant increases in international shipping costs. In addition, the contribution of regulated prices in the period December 2021 to February 2022 will be higher due to the base effect of the government's 2020 utilities subsidy program. According to the current forecast, other things being equal, from the second quarter of 2022, inflation will begin to decline, and will gradually approach the target by the end of the year. This will be facilitated by planned fiscal consolidation and tighter monetary policy, along with the mitigation of temporary factors. To reduce the risk of medium- and long-term inflation expectations, at its February meeting, the Monetary Policy Committee decided to maintain monetary policy at a tight level and left the policy rate unchanged at 10.5%.

To reduce the risk of medium- and long-term inflation expectations, on 2 February 2022 the Monetary Policy Committee decided to maintain monetary policy at a tight level and left the policy rate at 10.5%.

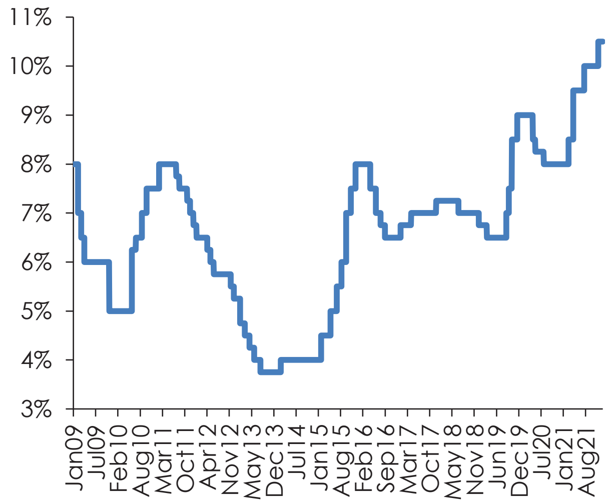


Figure 3.1. Monetary policy rate

Source: NBG.

The extraordinary situation caused by the pandemic has led to many uncertainties in the world economy. These have emerged in stages and challenged policymakers. Particularly concerning is the high inflation environment, which is especially relevant for Georgia. Inflation began to rise in the spring of 2021, mainly due to the acceleration of price growth dynamics on international commodity markets. Prices for oil products and some food groups have risen significantly. In addition, international shipping costs have increased, which put additional pressure on prices of imported products. However, it should be noted that the recent strengthening of the nominal effective GEL exchange rate has somewhat eased the pressure from international markets. Against this background, the monetary policy rate was gradually increased from 8.0% to 10.5% during 2021. In February 2022, the decision was made to maintain the tight monetary policy.

In December 2021, the annual inflation rate rose to 13.9%. The base effect of the government's 2020 subsidy of utility bills was the main driver of this increase. As mentioned in previous reports, this effect will temporarily persist over January-February 2022. It is noteworthy that both core and monthly inflation have shown early signs of stabilization in recent months.

According to the current forecast, other things being equal, inflation will start to decline gradually from the spring of 2022 and will approach the target by the end of the year. Tighter monetary policy, along with the fading out of one-off factors and fiscal consolidation, will contribute to this reduction in inflation.

As for aggregate demand, according to preliminary data, real GDP growth was 10.6% in 2021. The high level of economic activity in 2021 was a result of the re-

The dollarization of deposits and loans continues to decline, largely as a result of larization measures, which include a number of macroprudential instruments. This trend will be facilitated by recent changes in reserve requirements and the method of calculating the currency induced credit risk buffer.

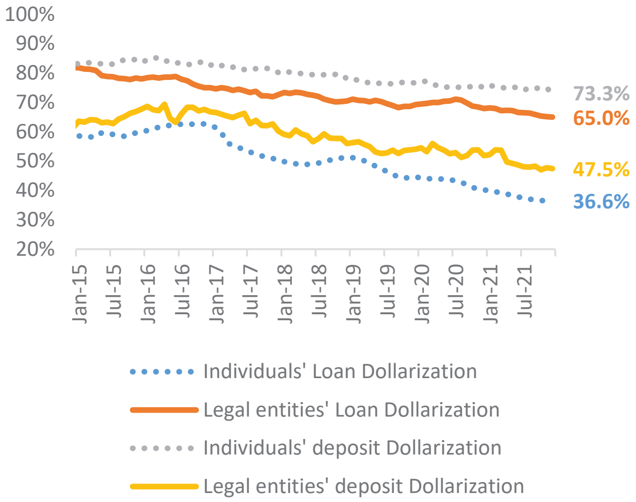


Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG.

lease of pent-up demand since the enactment of pandemic-related restrictions, continued high credit activity and fiscal stimulus. According to the baseline scenario, economic growth is projected to be 5% in 2022.

Against the backdrop of the risk of rising inflation expectations, the gradual increase in the monetary policy rate over the past year has led to a tight monetary policy stance. In the face of strong supply-side shocks, it is still important that persistently high inflation does not raise long-term inflation expectations. At the same time, risks are apparent in terms of both rising geopolitical tensions as well as a faster-than-expected tightening of global financial conditions. Taking these factors into account, the Monetary Policy Committee decided to maintain a tight monetary policy stance and left the rate unchanged at 10.5%. Monetary policy will remain tight until the risks of rising inflation expectations are sufficiently mitigated

In the wake of the global economic recovery, foreign demand continues to grow. According to preliminary data, exports in December 2021 increased by about 28.8% annually, reflecting an increase of 5.9% compared to the corresponding period of 2019. Revenue from international travelers also increased annually, rising approximately nine-fold in December, although it is still well below the level of December 2019 (by 42%). Imports have also increased against the backdrop of higher domestic demand, with 26.3% year-on-year growth being observed in December 2021, reflecting an increase of about 6.7% compared to the corresponding period of 2019.

Despite a significant decline, dollarization remains a challenge for the financial sector. In addition to limiting the effectiveness of monetary policy, dollarization also carries risks to financial stability. At the same time, it affects the risk premium of the country and hinders the improvement of credit ratings. The NBG thus continues to constantly analyze dollarization dynamics and will respond appropriately where necessary. It is important to note that, as a result of the NBG's larization (de-dollarization) policy, the dollarization of loans and deposits is gradually declining, which also reduces the currency and related credit risks of individual borrowers. However, in the context of increased lending, the contribution of foreign currency loans has increased amid a recent rise in the cost of lari resources. To avoid an increase in risks, the NBG responded with macroprudential policies. In particular, according to the decision of the Financial Stability Committee, the currency induced credit risk (CICR) buffer has become dependent on the level of dollarization of commercial banks' loan portfolios. This amendment came into force on 1 January 2022. In addition, in order to stop the accelerated growth of foreign currency mortgage loans, the maximum term of such loans was reduced from 15 to 10 years.

In 2021, the dollarization of total loans decreased by

3.3 pp (excluding the exchange rate effect) and stood at 50.6% at the end of December. The dynamics of the dollarization of deposits also continued, which was also facilitated by the high differential between interest rates on GEL and foreign currency deposits. The dollarization of deposits of individuals and legal entities decreased by 0.1 pp during the year to 60.2% (excluding the exchange rate effect). The declining rate of deposit dollarization is partially offset by the process of capital recovery in the banking system.

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

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

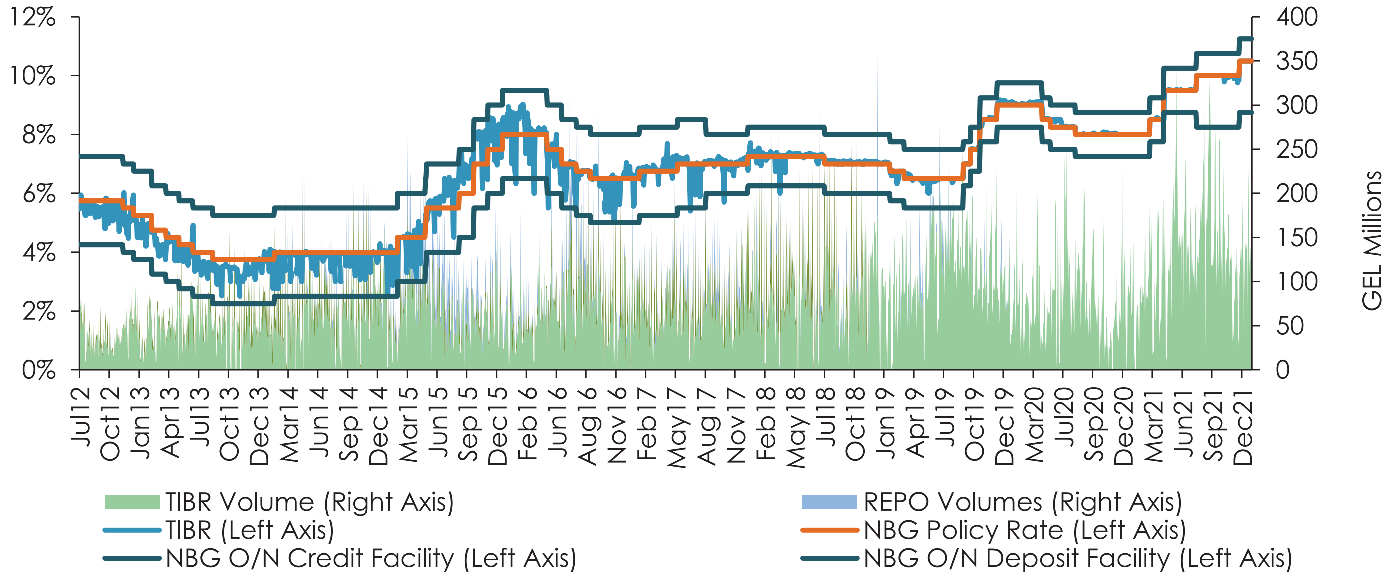


Figure 3.3. Interbank money market

Source: NBG.

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