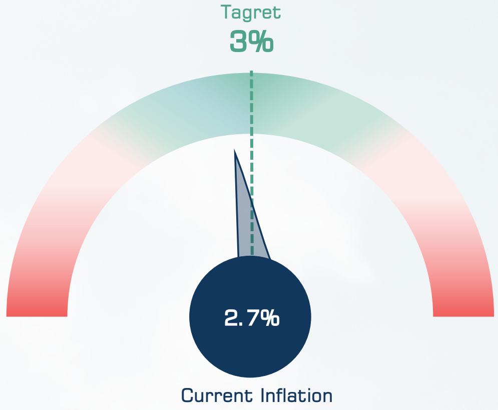
Monetary Policy Report

May

2023

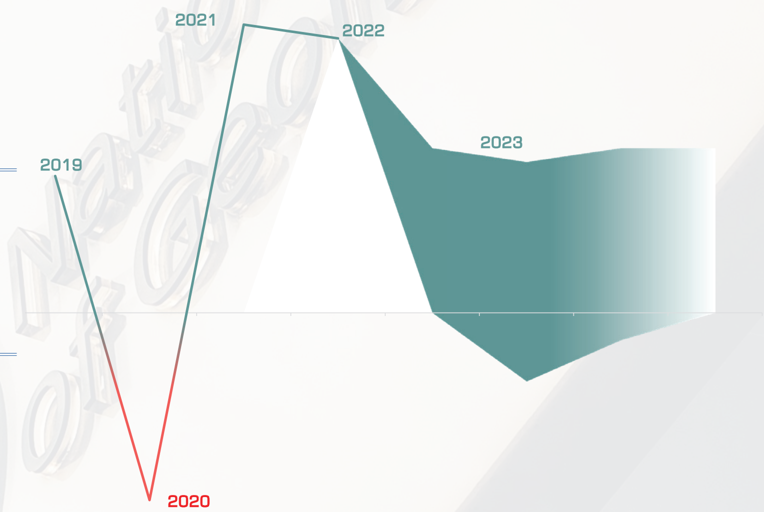
საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation



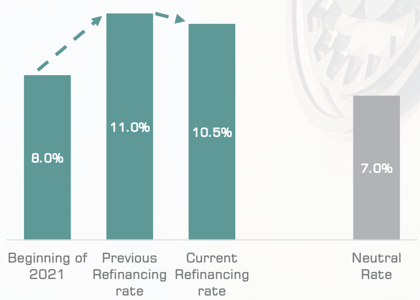
2.7%	Annual inflation has decreased and approached the target level.

Economic Growth



Economic growth is expected to slow down in 2023.	5%

Monetary Policy



10.5%	Under conditions of high uncertainty, monetary policy rate cuts are only expected at a slow pace.

MONETARY POLICY DECISION

The National Bank of Georgia (NBG) has begun a gradual exit from its tight monetary policy and has reduced the policy rate to 10.5%.

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

After reaching a peak of 13.9%, headline inflation in Georgia has significantly decreased and approached the 3% target level. The pace of this reduction was faster than expected. The main source of the decline was the recent elimination of pressure coming from the international markets and the strengthening of the GEL exchange rate. Domestic inflation also has a downward trend and is expected to decrease further during the year, albeit at a relatively slow pace. Against the background of these trends, inflationary expectations are decreasing. During the current year, price pressure from aggregate demand is not expected, which is supported by a steady credit growth rate, as a result of the still-tight monetary policy, and fiscal consolidation. Other things being equal, these factors will make it possible to gradually reduce the monetary policy rate during the year at a slow pace.

According to the current macroeconomic forecast, the annual inflation rate is expected to fall below the target in the short term and then to stabilize at around 3% in the medium term. After a prolonged period of high inflation, below-target inflation in the short run will help a further normalization of long-term inflation expectations, which is a prerequisite for price stability. At this stage, there are no clear signs of a wage-price spiral developing; however, unit labor costs have increased and inflationary pressure from the labor market is still noteworthy. Under such uncertain circumstances, it is expected that the NBG will continue to reduce the monetary policy rate only at a slow pace.

Changes made to interest rates are transmitted to the economy gradually and will be fully reflected in about 4-6 quarters. If factors amplifying inflation expectations become apparent, the monetary policy stance might need to be tightened further or the current level be maintained for a longer period.

Whatever the situation, we will use all the instruments at our disposal to ensure price stability and to maintain the purchasing power of the GEL. This means that the medium-term inflation rate will be close to 3%.

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BRIEF OVERVIEW

According to the current baseline forecast, annual inflation will be close to its target in the second quarter of the year and will stabilize around it in the medium term. This is reflective of a faster decline in inflation than previously forecast, which was mostly a consequence of a sharper-than-expected decrease in international commodity prices and the appreciation of the GEL exchange rate. Although the reduction in inflation mostly stems from imported inflation, there are also early signs of a normalization of domestic inflation amid the maintenance of tight monetary policy. Following the double-digit economic growth of the last two years, which has eliminated the economic slack caused by the pandemic, the forecast of a moderate 5% growth of real GDP in 2023 is an indicator of still-strong aggregate demand. Therefore, amid high uncertainty, and given the long deviation of inflation from its target, it is expected that the National Bank of Georgia will only gradually reduce the policy rate over the medium term so as to ensure the stabilization of inflation around its target with tight monetary policy.

According to the current baseline forecast, inflation will temporarily fall below its target to eventually stabilize around it in the medium term.

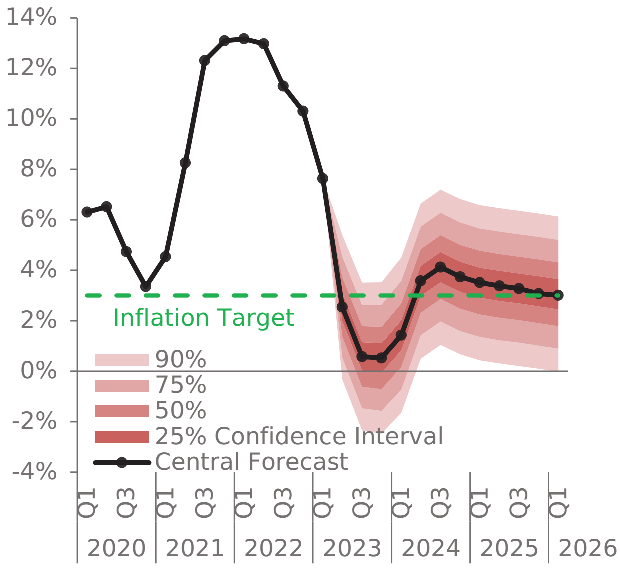

Figure 1. Headline CPI inflation forecast

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

The annual inflation rate has been rapidly declining in recent periods and averaged 7.6% in the first quarter of 2023. According to the current baseline forecast, inflation will temporarily fall below its target for the rest of the year before eventually stabilizing around it in the medium term (see Figure 1). In the short run, these dynamics are partly a result of the base effect; however, significantly cheaper imports and transportation also both play an important role amid a decline in international commodity prices and the appreciation of the GEL exchange rate. **On average, projected inflation will be around 2.8% in 2023**.

According to preliminary estimates, 2023 began with a high level of economic activity and, in the first quarter, real GDP growth averaged 7.2% year on year. Alongside the recovery of the tourism sector, the impact of migration and accompanying financial inflows on aggregate demand are likely to remain important drivers of domestic spending in 2023. In addition, it is expected that the improved dynamics of investment growth observed in recent periods will continue amid a stabilized risk premium. Based on these factors, the National Bank of Georgia has raised the **real GDP growth forecast for 2023 to 5%** (see Figure 2), even though much lower growth is expected in the second quarter of the year due to the high base effect. Following the double-digit economic growth of the last two years, which eliminated the downturn caused by the pandemic, the forecast for 2023 is still indicative of strong aggregate demand.

Amid strong demand, inflationary risks remain. The geopolitical situation in the region is still tense, and the endurance of the declining dynamics of commodity prices has recently been called into question. In addition, local factors that hinder the reduction of domes-

Amid expectations of further growth in consumer spending and investments, real GDP is projected to grow by 5% in 2023.

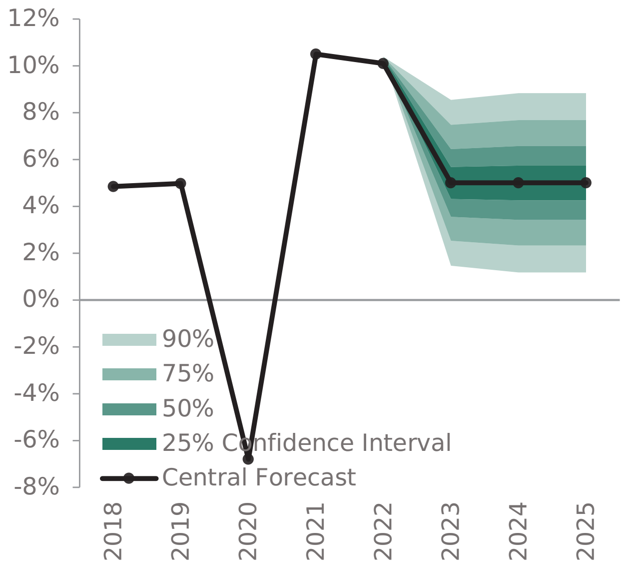

Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat

Even though inflation has dropped sharply in the current period, considering inflationary risks and ongoing uncertainty, monetary policy will only be eased gradually.

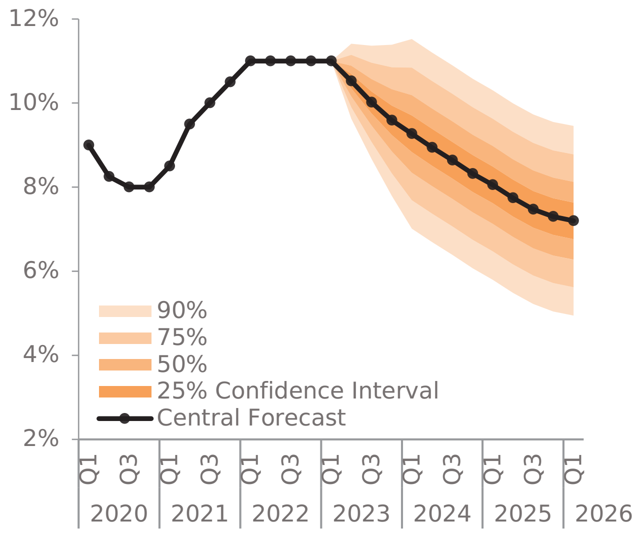

Figure 3. Monetary policy rate forecast

Source: NBG

tic inflation are noteworthy. Taking into account that inflation in Georgia has deviated from its target for a long time, there is a risk of a delayed convergence, which may have a high negative impact if materialized and may significantly worsen long-term expectations. In terms of a preventive response to this threat, it is optimal **to ease monetary policy only gradually** to ensure the stabilization of inflation and inflation expectations around the target rate, including through some undershooting of the target in the short run (see Figure 3). After that, the policy rate will gradually approach its neutral level (currently estimated at 7%).

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 ongoing Russia-Ukraine war, there is high uncertainty surrounding the recovery of the global economy this year. Despite some retreat, prices on international commodity markets remain high, putting pressure on inflation globally, including in Georgia's main trading partners. This situation has necessitated a sharp tightening of the monetary policies of central banks. However, amid tightened financial conditions, a clear trend of disinflation has been observed. On the other hand, despite the slowdown in the economic growth of partner countries, external demand in Georgia is strong. The volume of exports of goods, travel revenues as well as remittances continue to grow. Therefore, according to the current forecast, the current account deficit is expected to remain relatively low in 2023. Considering these factors, high economic growth has been maintained overall while annual inflation has a downward trend and has already approached its target.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

In 2023, along with a reduction of inflationary pressures, global economic activity is expected to improve slightly. However, uncertainty is also high as a result of the ongoing Russia-Ukraine war.

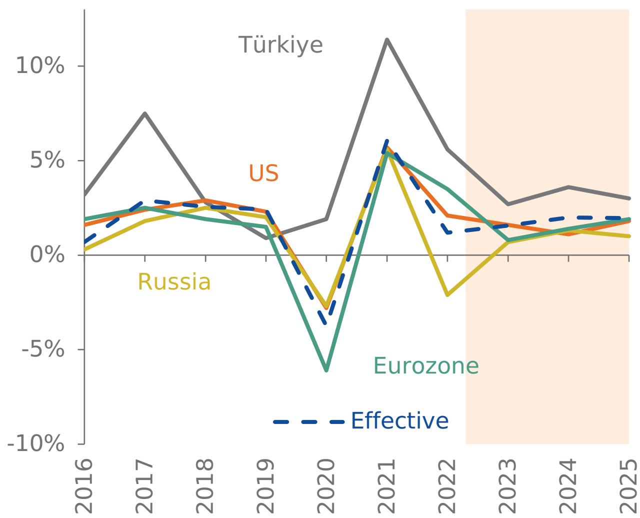

Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

After the COVID-19 pandemic and amid Russia's military aggression in Ukraine, uncertainty around the recovery of the global economy remains high. Last year, as a result of price pressures on international commodity markets and supply disruptions, inflation and its expectations increased significantly in almost all countries, in response to which central banks had to sharply tighten their monetary policies. This effect has been maintained this year and the tightened financial conditions in some countries, along with the reduction of inflationary pressures, have created some problems in terms of both economic activity and financial stability. Therefore, according to the International Monetary Fund's (IMF) April forecast[1], **global economic growth** in 2023 will be 2.8%, which is 0.1 percentage point (pp) lower than the previous forecast.[2] In addition, global inflation pressures should decrease and inflation is expected to be 7% in 2023.[3] For emerging and developing countries, real GDP is forecast to grow by 3.9% in 2023, while annual inflation is projected to be at 8.6%.[4]

A high inflationary environment has prevailed in both developed as well as in emerging and developing countries in the first quarter of 2023. This was mostly related to the challenges surrounding the Russia-Ukraine war and the still-high commodity prices on international markets. However, it should be noted

1 *International Monetary Fund. 2023. The World Economic Outlook: A Rocky Recovery. Washington, D.C., April. (Hereafter: WEO April, 2023).*

2 *International Monetary Fund. 2023. The World Economic Outlook Update: Inflation Peaking amid Low Growth. Washington, D.C., January.*

3 *WEO April, 2023.*

4 *Ibid.*

that both oil and food prices have recently followed a downward trend (see section 1.1.2 of this report).

According to preliminary estimates, the pace of economic activity in the **United States** improved slightly in the first quarter of 2023. Based on the January-February data, consumer sentiment and retail sales improved. This was supported by the reduced dynamics of consumer prices. The employment rate also increased. Although several large banks in the US have recently faced significant financial problems, the timely intervention of the government and the Federal Reserve System has minimized the economic damage. Annual inflation stood at 5% in March. According to the IMF's April forecast, real economic growth in the US will be 1.6% in 2023. Annual inflation is projected to be 4.5% in 2023.[5]

A high-inflationary environment is still maintained in Georgia's trading partner countries, including the United States and the eurozone. However, both oil and food prices have followed a downward trend, which creates positive expectations for the future.

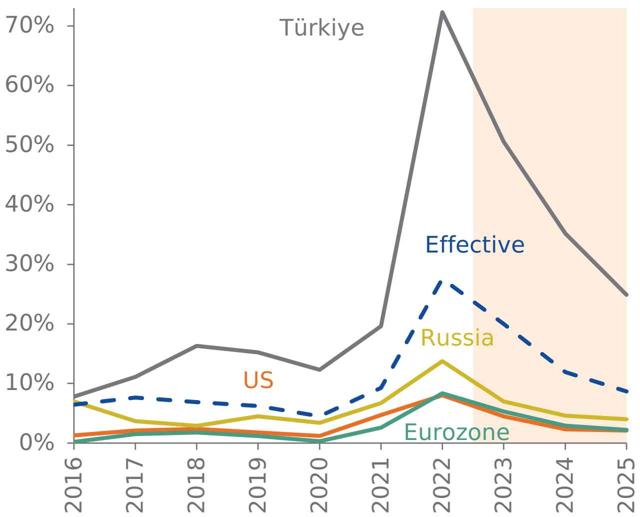

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

In the first quarter of 2023, the pace of economic activity improved slightly in the **eurozone**. This was mostly related to the recovery of supply chains, reduced prices of oil and other energy products, and decreasing dynamics of inflation. As a result, consumer and business sentiment improved slightly. In March, the annual rate of inflation stood at 6.9%. According to the IMF, the real economic growth forecast for the eurozone for 2023 is 0.8%. While annual inflation is projected to be 5.3%.[6]

In the first quarter of 2023, economic activity slowed in **Türkiye**. This was mostly due to the earthquakes that occurred in the south of the country in February, which, along with high human casualties, resulted in infrastructural damage and supply delays in the region. However, external demand was strong. According to the January-February data, the volume exported goods increased significantly. Inflationary pressure remains high, with annual inflation standing at 50.5% in March, although the central bank continues to tighten the monetary policy. According to the IMF, real GDP growth will be 2.7% in 2023, while annual inflation is expected to be 50.6%.[7]

Due to the economic sanctions imposed by the West and war-related costs, economic activity in **Russia** decreased further in the first quarter of 2023. The business environment worsened, and investments declined. Military mobilization has created a labor shortage amid historically low levels of unemployment. In addition, amid the globally reduced prices of energy carriers and the Western embargo, the external sector continues to deteriorate. Despite the recent sharp depreciation of the Russian ruble, annual inflation decreased and equaled 3.5% in March. According to the IMF, Russia's real economic growth will be 0.7% in 2023, while annual inflation is projected to be 7%.[8]

5 *Ibid.*
6 *Ibid.*
7 *Ibid.*
8 *Ibid.*

Russia's ongoing war has had a devastating impact on **Ukraine**, both socially and economically. Various critical infrastructure has been destroyed that has reduced the potential of the economy. According to the IMF, Ukraine's real economy is estimated to decline by 3% in 2023, while inflation is expected to be 21.1%.[9] It should be stressed that, amid the war, the civilized world, including Georgia, supports Ukraine.

According to preliminary estimates, in the first quarter of 2023, economic activity slowed slightly in **Armenia** compared to the previous quarter. This was mostly due to weakened industrial production and lower retail sales. Also, the ongoing military tension with Azerbaijan regarding Nagorno-Karabakh has had a negative effect. However, it should be noted that credit activity increased during this period. The annual inflation rate decreased and stood at 5.4% in March. According to the IMF, the real GDP forecast for Armenia is 5.5% in 2023, while annual inflation is expected to be 7.1%.[10]

In the first quarter of 2023, the improvement of growth continued in **Azerbaijan**. This was mostly due to the non-oil sector, where industrial production increased significantly. However, overall activity has been negatively impacted by reduced oil prices and military tensions with Armenia. At the same time, the annual rate of inflation remained high and stood at 13.6% in March. According to the IMF's forecasts, real GDP growth in Azerbaijan will be 3% in 2023, while the annual inflation rate is expected to be 11.3%.[11]

In 2022-2023, alongside a high inflationary environment, the majority of the central banks of Georgia's trading partners tightened their monetary policies. One exception to this was Türkiye, where, despite high inflation, the monetary policy rate has long been gradually declining.

In the first quarter of 2023, **the central banks** of the majority of Georgia's main trading partners further tightened their monetary policies in response to the still-high inflation and inflation expectations. In particular, in March, the U.S. Federal Reserve raised its federal funds rate to the 4.75-5% range, and the European Central Bank further increased its policy rate to 3.5%.

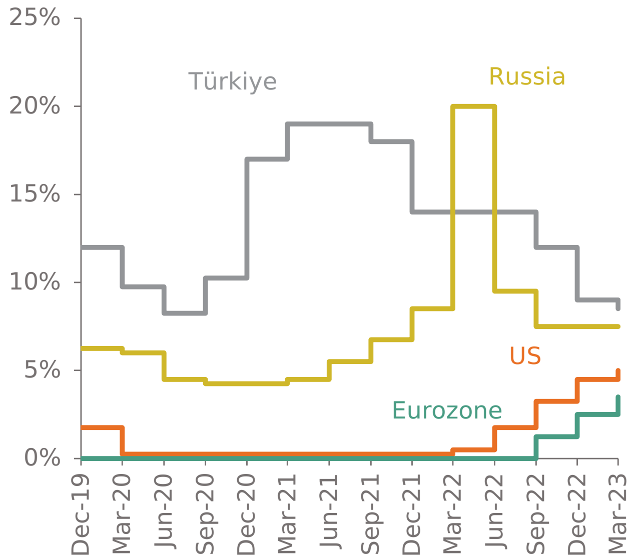

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

9 Ibid.
10 Ibid.
11 Ibid.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

In the first quarter of 2023, prices continued to decline on international commodity markets. Russia's invasion of Ukraine initially led to a significant increase in prices on world commodity markets, but prices subsequently fell with the opening of humanitarian corridors created by the European Union and the grain export agreement concerning Black Sea ports. The international food price index has been declining since March 2022 and this trend has continued into 2023, being supported by an increase in the supply of food on international markets.

The International Food Price Index of the Food and Agriculture Organization of the United Nations decreased by 2.1% in March 2023 compared to the previous month and by 20.5% annually (see Figure 1.1.4). The drop in this index in the first quarter of 2023 was caused by a decrease in prices for almost all commodity categories aside from sugar and meat, which rose. Despite the decline in international food prices, they remain above the pre-pandemic level, and uncertainty about their expected dynamics continues to be high.

In the first quarter of 2023, the downward trend in food prices continued, but these still exceed pre-pandemic levels.

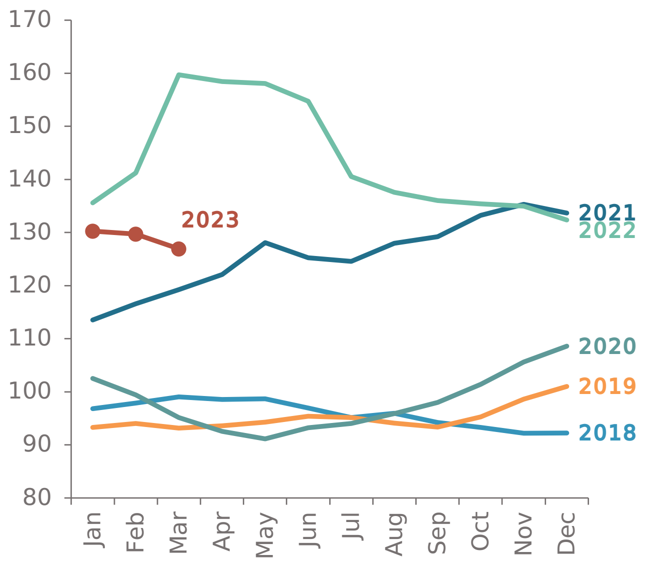

Figure 1.1.4. International food price index

Source: FAO

One of the factors determining the decline of prices on international commodity markets was the decrease in grain prices. In March, the grain price index decreased by 5.6% compared to the previous month and by 18.6% compared to the previous year. This decrease was related to a global decline in prices for all major grain categories, as driven by increased global supply and strong competition among exporters. The extension of the agreement on the export of grain from Ukraine to Black Sea ports also contributed to lower prices. The downward trend in grain prices is expected to continue in the future, driven by increased production in Australia, Russia and the EU, which will further strengthen the global supply outlook and ensure competitive prices.

In March, international markets also saw a downward trend in prices for vegetable oil and dairy products. The price index for vegetable oil decreased by 3.0% in March compared to the previous month and by 47.7% compared to the previous year. Sunflower oil prices also continued to decline due to abundant global supplies. This general decrease was hampered by rising prices on meat and sugar over the past three months. Sugar prices have risen by 1.5% since February and has reached their highest level since October 2016. This increase was mainly due to lower production in India, Thailand and China.

After the start of the Russian-Ukrainian war, in light of the sanctions imposed against Russia, a significant drop in oil supply was expected and oil prices rose sharply at the beginning of 2022. However, there has recently been a positive trend. In March 2023, the average price of Brent oil decreased by 5.1% compared to the previous month and amounted to USD 78.4 per

The downward trend in fuel prices that began in the second half of 2022 continued into the first quarter of 2023.

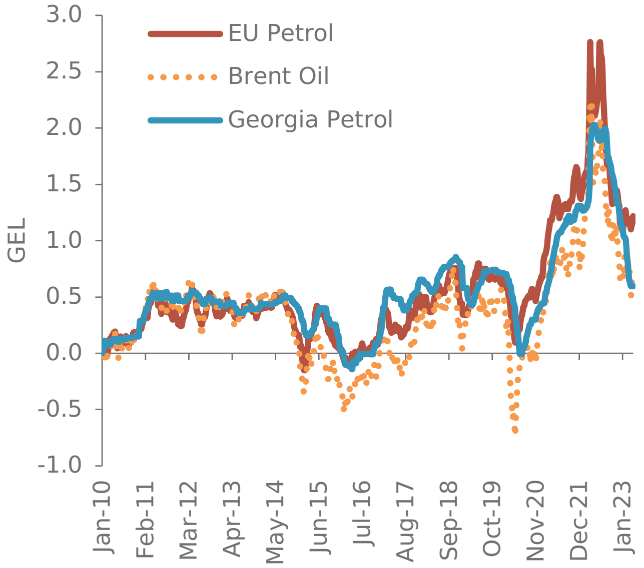

Figure 1.1.5. Petrol price index (Jan 2021=100)

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 and has approached pre-pandemic levels.

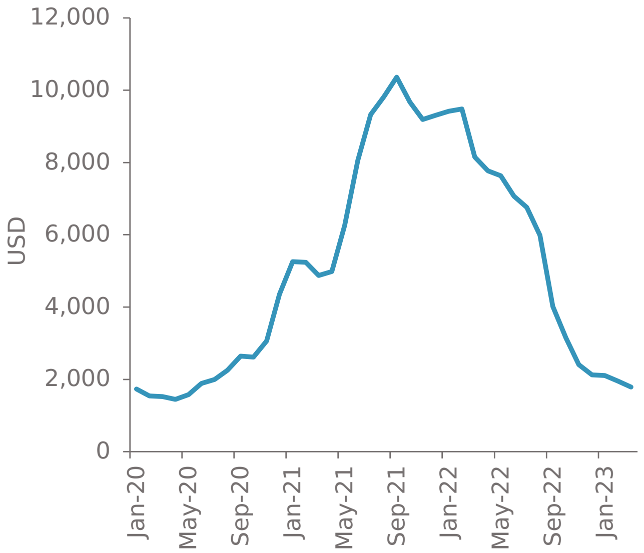

Figure 1.1.5. Average shipping cost of a 40-foot container worldwide

Source: Statista

barrel. Despite this recent decline, oil prices remain 18.6% higher than the same, pre-crisis, period in 2019. As Brent crude prices decline, so do gasoline prices in Europe and Georgia (see Figure 1.1.5).

In the European market, the cost of fuel decreased by 0.2% in March as compared to the previous month. The average price of gasoline per litre in Georgia decreased by GEL 0.11 (5.0%) compared to February, partly reflecting the shift of oil importing companies to Russian oil. However, uncertainty around oil prices on the international market is high. The recent decision by the Organization of Petroleum Exporting Countries (OPEC) to cut oil production has heightened market uncertainty, which has been reflected in some fluctuations in European crude and Brent fuel prices, thereby intensifying risks of price growth.

On the other hand, amid the risks of a global recession and a high inflationary environment, a decrease in oil demand is expected, which will push prices down. Given these risks, according to the updated April 2023 forecast of the International Energy Association, the average Brent oil price is expected to be around USD 85 per barrel in 2023.

With lower fuel prices and the gradual recovery of supply chains, the cost of transportation will continue to decline globally. The price of international shipping peaked in September 2021 and has been on a downward trend since early 2022, which has had the effect of slowing down imported inflation. In March 2023, freight prices decreased by 8.4% month on month and approached pre-pandemic levels (see Figure 1.1.6).

Against the backdrop of the positive price dynamics noted above, the pressure on inflation from international markets has been eliminated and is helping to reduce inflation, which has been further supported by the recent appreciation of the lari exchange rate.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

Strong external demand has outweighed the effect of the appreciated exchange rate and induced a continued rise of registered exports of goods.

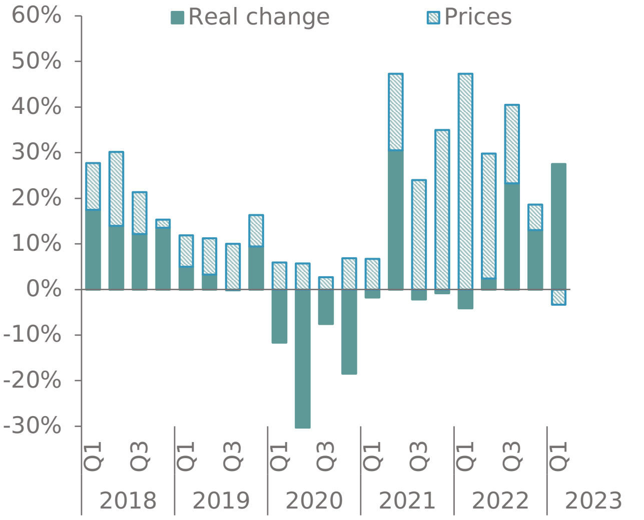

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

The rise in exports of goods mainly stemmed from an increase in external demand for consumer goods (including re-exports of motor cars).

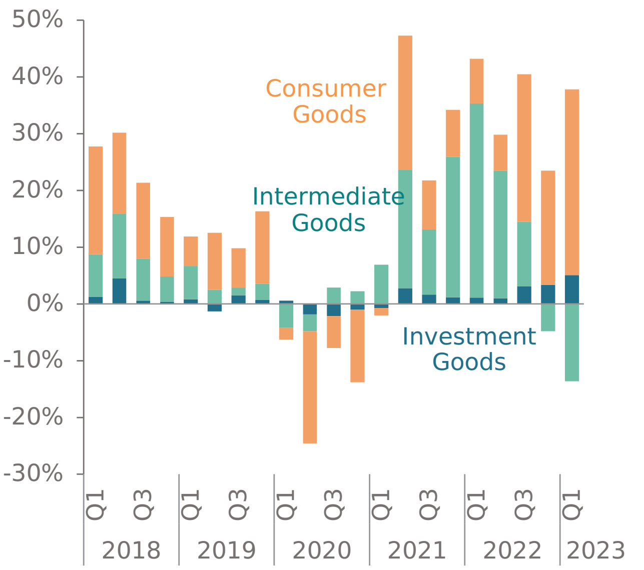

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

In the first quarter of 2023, external demand remained 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. In the first quarter, exports of goods exceeded pre-pandemic levels, while strong domestic demand boosted imports of goods. As a result of increased inflows of immigrants and international visitors, revenues from international travel were again at a high level. It is also worth noting that instant money transfers continued to rise, which further helped narrow the current account deficit. According to the updated projections, a moderate worsening of the current account deficit is expected in 2023. On the one hand, this will be induced by the deceleration of economic growth and, consequently, of lower external demand. On the other hand, lower competitiveness coming from the appreciated exchange rate will widen the trade deficit and thus negatively affect the current account balance.

Strong external demand was reflected in the rise in revenues from exports of goods. In the first quarter of 2023, registered exports of goods grew by 24.7% annually (see Figure 1.2.1). This growth was mostly driven by rising exports of goods in real terms, while prices of export goods moderately decreased.

Higher demand for consumer goods was a major contributor to the rise of exports of goods. Meanwhile, investment goods also made a positive contribution to the overall growth of exports (see Figure 1.2.2). The increase in exports of consumer goods was mainly driven by re-exports of motor cars (mostly to Armenia, Kazakhstan and Kyrgyzstan). Exports of alcoholic beverages and cigarettes-cigarillos were also substantial. Meanwhile, lower exports of intermediate goods mainly stemmed from decreased exports of ferro-alloys to the U.S. and Italy, lower exports of copper ores and concentrates to China, and declined exports of chemical fertilizers to Ukraine. In terms of investment goods, exports of motor vehicles for the transport of more than ten persons and automatic data processing machines played a leading role in the overall growth.

Alongside the recovery of international tourism, the volume of migrant flows from neighboring countries remained at a high level. In the first quarter, the number of international visitors rose by 106.0% annually, but remained below the same period of 2019 (down 22%). Apart from the migrant inflows related to visitors from Russia, Belarus and Ukraine, the number of visitors from the EU, Israel and India also increased.

Despite the fact that the number of visitors remained below pre-pandemic levels, revenues from international travel were 38% higher than in the same

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

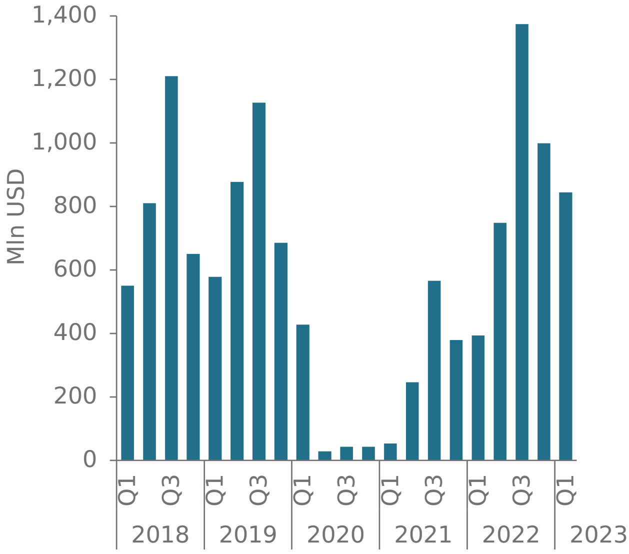

Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG

Instant money transfers have been maintained at a high level, mainly due to inflows from Russia.

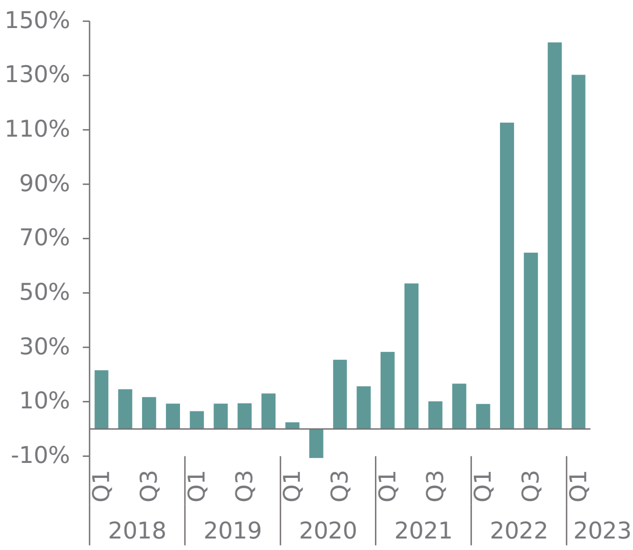

Figure 1.2.4. Annual change in money transfers

Source: NBG

period of 2019. In the first quarter of 2023, such revenues increased two times annually (see Figure 1.2.3). Apart from regional countries, from where most migrants came, revenues from visitors from other countries also continued to recover.

In the first quarter of 2023, instant money transfers to Georgia increased by 130.3% year on year and amounted to USD 1,256 million (see Figure 1.2.4). Such a high volume of transfers, as in the previous quarter, was mainly driven by increased transfers from Russia (inflows were 9.5 times higher, making a 111.3 pp contribution to the overall growth). Aside from Russia, transfers from the EU (9.3 pp), the U.S. (5.1 pp), Kazakhstan (2.0 pp) and Kyrgyzstan (1.5 pp) made the largest contributions to total growth in this period. Due to the ongoing war, money transfers from Ukraine were minimal, while money transfers from Georgia to Ukraine decreased moderately on annual terms.

Due to strong economic activity, imports of goods continued to grow, albeit at a slower pace. In the first quarter of 2023, the growth of imports of goods decelerated and amounted to 21.0% (see Figure 1.2.5). However, this deceleration is just a reflection of the price effect. From the second half of 2022, the decelerated growth of prices on international markets was reflected in lower expenses of import goods. In contrast to this, the growth of real imports accelerated and amounted to 23% in the first quarter of 2023.

In the first quarter of 2023, 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 motor cars, medicaments, and telephone sets, while the rise of imports of intermediate goods was due to higher imports of petroleum gas, coal, and iron/steel parts. Meanwhile, the rise in imports of investment goods stemmed from higher purchases related to increased demand for motor cars and increased sales of motor vehicles for the transport of more than ten persons and those for the transport of goods.

The rise in imports from regional countries was significant, particularly those from Russia and Türkiye; but imports from other regions, including Germany and the U.S. (mostly due to motor cars), made the largest contributions to overall growth. In contrast, imports from Ukraine fell due to impediments in production processes and external trade obstacles resulting from the war, while lower imports from Azerbaijan were related to decreased imports of petroleum products.

In light of higher external inflows, in the fourth quarter of 2022 the current account deficit decreased annually and reached USD 540 million. It is worth noting that the improvement of the current account balance mainly stemmed from the record-high revenues from exports of services, namely from travel (including non-resident migrants) and the steadily increas-

During the last period, the growth in nominal imports of goods slowed; however, this is a reflection of a global slowdown of prices, while real imports continued to rise.

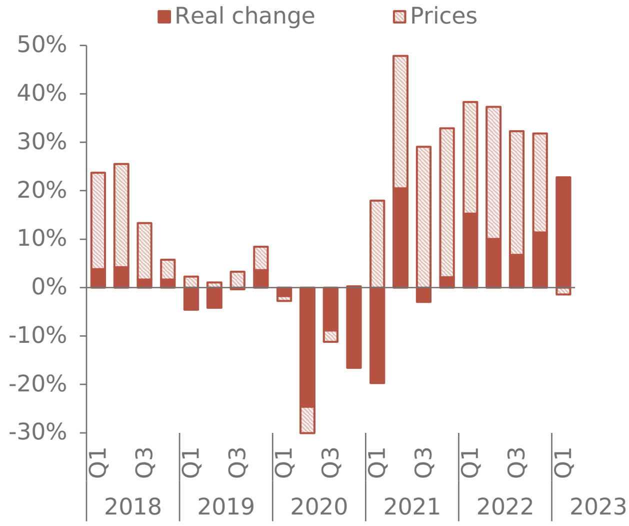

Figure 1.2.5. Annual change in registered imports of goods
Source: GeoStat

In the first quarter of 2023, the rise of imports of goods was mainly due to the growth in imports of consumer goods (mostly motor cars).

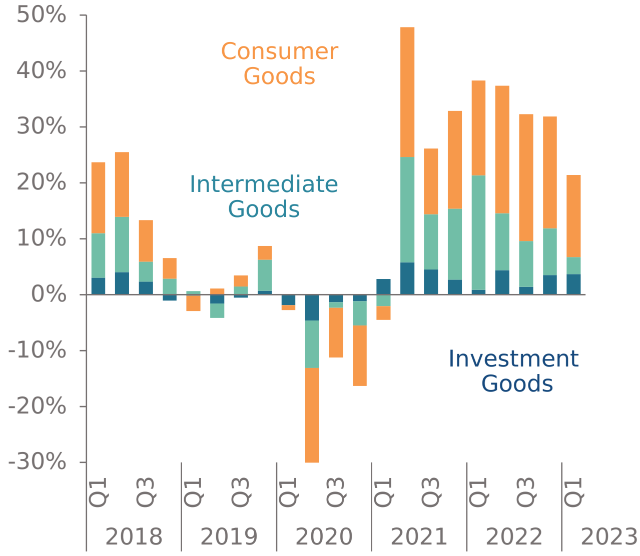

Figure 1.2.6. Annual change in registered imports of goods
Source: GeoStat

ing volume of workers' remittances from abroad. The current account deficit reached USD 1,012 million in 2022 and amounted to the historically lowest level of deficit compared to GDP (4.1%). However, it is expected that the ratio of the current account deficit to GDP will increase moderately to 5.3% in 2023 due to lower external demand coming from decelerated global economic growth and an increased trade deficit as a result of the appreciated exchange rate.

In the fourth quarter of 2022, the main source of financing the current account deficit was foreign direct investments (FDI), despite the fact that such inflows decreased by 21% annually, amounting to USD 324 million. Reinvestments accounted for a major part of FDI. It the fourth quarter, the majority of FDI went to the finance, real estate and communication sectors, while investments in agriculture declined substantially.

From the perspective of savings and investments, in the fourth quarter of 2022, as compared to the same period of the previous year, the improvement of the current account balance was due to a substantial increase in savings, which mainly came from the lower fiscal deficit rather than being a result of a moderate rise in investments (see Figure 1.2.7). Similarly, the improvement of the current account deficit in 2022 as a whole was also related to the rise in savings.

Due to the rise of the trade deficit, the current account deficit is expected to increase moderately in 2023.

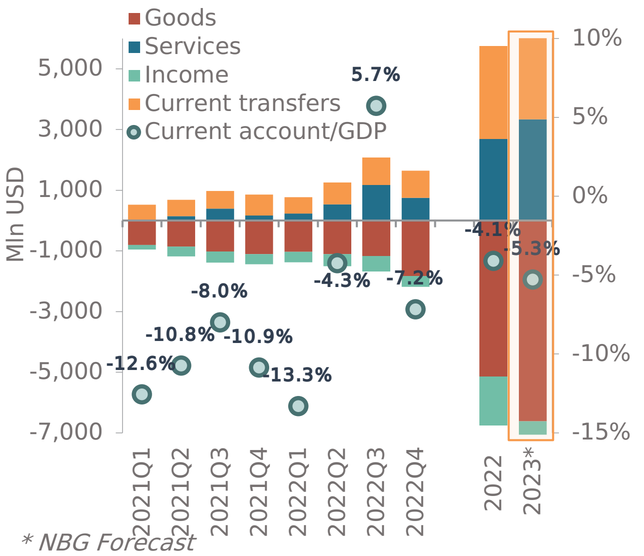

Figure 1.2.7. Current account balance and its components

Source: NBG

In 2022, the improvement of the current account deficit was mainly due to the rise of savings (along with a decline of the fiscal deficit).

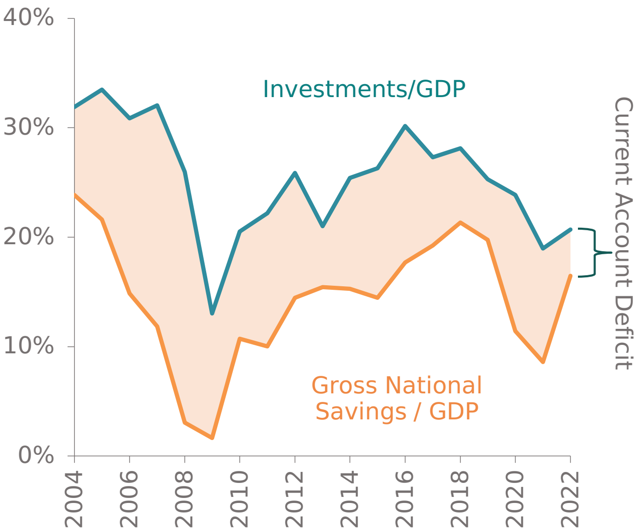

Figure 1.2.8. Investments and savings

Source: GeoStat, NBG Calculations

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

In the fourth quarter of 2022, as well as throughout the year, the high growth of the economy was caused by strong foreign inflows and investments.

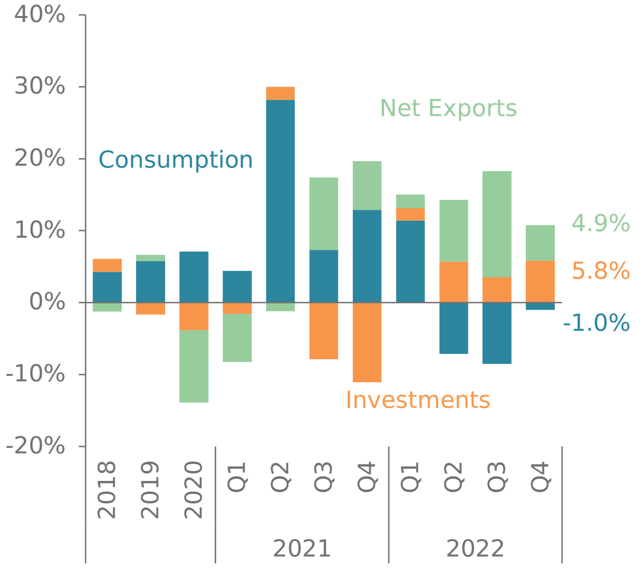

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the fourth quarter of 2022, the real gross domestic product increased by 9.7% compared to the corresponding period of the previous year.

Like in the second and third quarters of 2022, the high growth of the economy in the fourth quarter of the year was largely due to strong foreign inflows. In 2022, tourism in Georgia largely recovered. Due to the war in Ukraine, the number of migrants to Georgia significantly increased, and remittances from abroad rose notably. Against the background of these factors, in the fourth quarter exports of services increased by 77.8% year on year in real terms. In total, exports of goods and services increased by 28.5%, which significantly outweighed the increase in imports of goods and services (12.5%). Ultimately, net exports contributed 4.9 percentage points (pp) to the economy's growth.

Over the same period, investments caused real GDP to rise by an additional 5.8 pp. Contrary to the trend of increasing investments, the contribution of consumption to economic growth has recently turned negative – a reflection of slower lending and fiscal consolidation. In the fourth quarter of 2022, the contribution of consumption amounted to a negative 1.0 pp (see Figure 1.3.1).

The largest share of economic growth came from services, which was facilitated by an increased number of foreign citizens in Georgia.

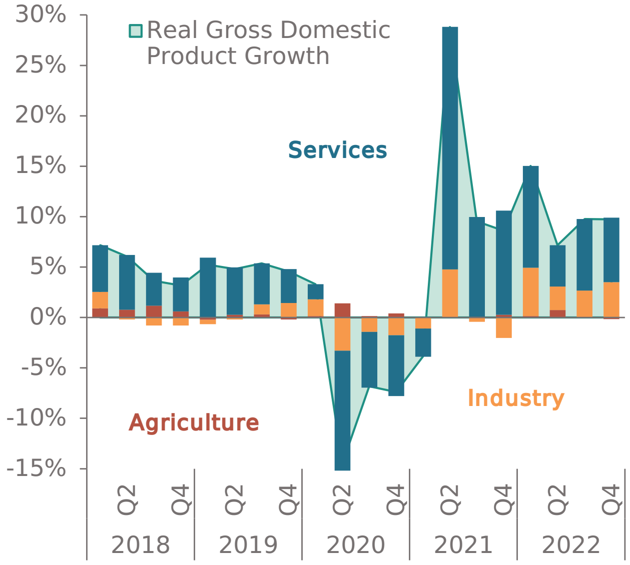

Figure 1.3.3. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

1.3.2 OUTPUT

In the fourth quarter of 2022, services were the main drivers of the 9.7% economic growth, making a contribution of 6.4 pp. The contribution of industrial sectors amounted to 3.5 pp, while agriculture made a negative 0.1 pp contribution to economic growth (see Figure 1.3.2).

The high level of economic growth was ensured by the foreign sector. The sharp increase in the number of foreign citizens in the country contributed to the improvement of the service sector. In particular, the trade, transport, accommodation and food supply, information and communication, art, and entertainment and recreation sectors made a 6.2 pp contribution to economic growth.

Among the industrial sectors, the 33.2% growth of construction (making a 2.4 pp contribution to economic growth), 5.0% growth of manufacturing industry (a contribution of 0.5 pp) and 25.3% growth of mining industry (a contribution of 0.3 pp) are particularly notable.

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In March, as a result of an increase in loans issued to legal entities, the growth of the annual loan portfolio increased and equaled 13.8%, excluding the effect of exchange rate fluctuations.

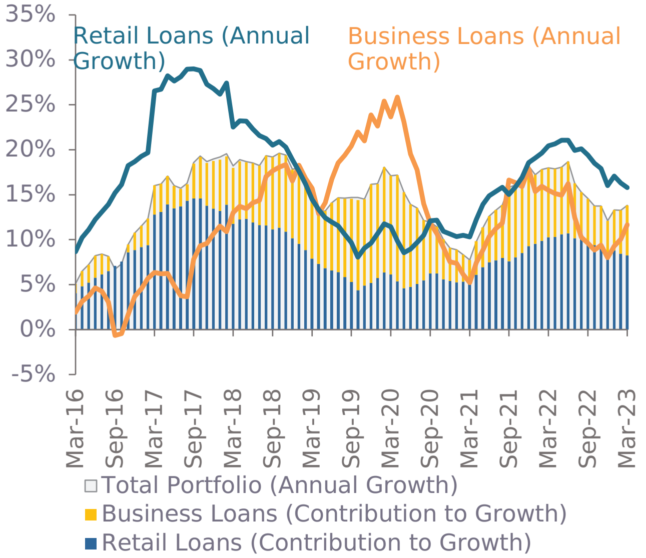

Figure 1.4.1. Annual growth rates of retail and business loans (excluding the exchange rate effect)

Source: NBG

The growth of the loan portfolio was mainly driven by an increase in domestic currency loans.

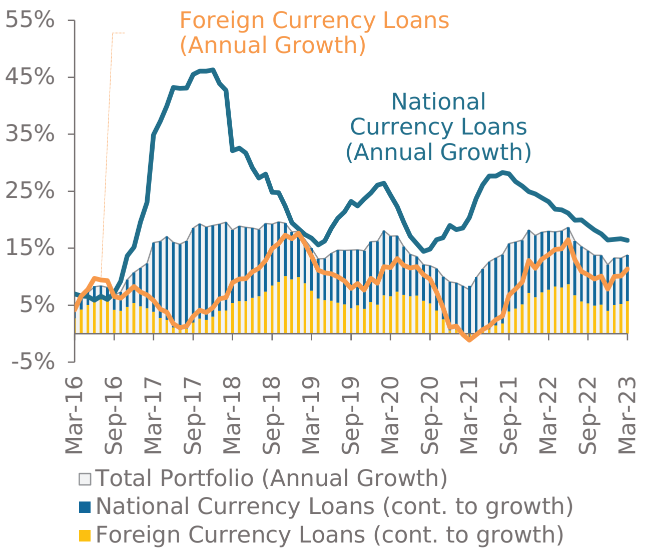

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

In March 2023, relative to December 2022, the growth of the loan portfolio increased by 1.7 pp and equaled 13.8% (excluding the effect of exchange rate fluctuations). During this period, the growth rate of retail loans decreased slightly and equaled 15.8%, while the growth of loans to legal entities decreased by 3.6 pp to 11.6% (see Figure 1.4.1). The growth in business loans was primarily driven by an increase in loans issued to the agriculture sector. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for retail and business loans over the next quarter.

In terms of currencies, it is important to emphasize that the growth of the loan portfolio in the first quarter of 2023 was mainly driven by domestic currency loans (see Figure 1.4.2). However, the trend of increasing foreign currency loans is also noteworthy. In the first quarter, the annual growth rate of foreign currency-denominated loans increased by 3.5 pp and equaled 11.3%, while the growth rate of loans issued in the domestic currency did not change significantly and stood at 16.4%. Consequently, in the first quarter, the loan larization ratio increased only slightly and equaled 55.5%, 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 and macro prudential measures will motivate banks to increase larization, which is one step towards reducing risks to financial stability.

Interest rates on government securities decreased slightly in the first quarter of 2023 as a result of expectations of a monetary policy rate reduction.

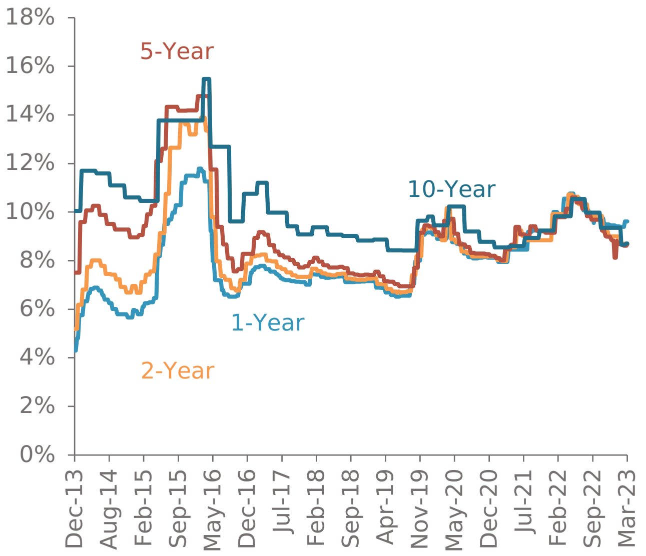

Figure 1.4.3. Interest rates on government securities

Source: NBG

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

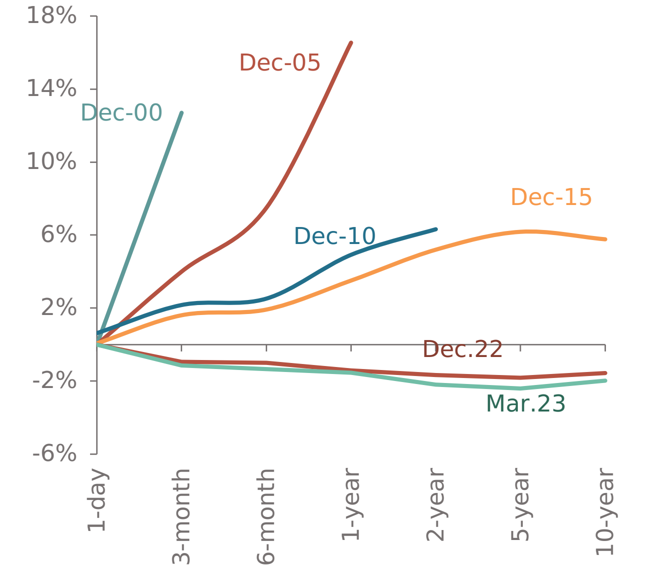

Figure 1.4.4. Spread between the monetary policy rate and the yield curve

Source: NBG

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In March, the monetary policy rate was 11.0%. In the first quarter of 2023, interest rates on government securities decreased slightly (see Figure 1.4.3). Compared to the previous quarter, the spread between long- and short-term interest rates increased slightly. This indicator remains at a low level, which suggests the increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate. Compared to long-term rates, the higher short-term rates were, in part, a reflection of financial market expectations that, in the short term, an increase in the policy rate will cause a lowering of inflation, which will be a prerequisite for a reduction of the policy rate in the future.

In March, relative to December, interest rates on domestic and foreign currency deposits did not change significantly and equaled 11.2% and 1.5%, respectively. According to the credit conditions survey, representatives of the banking sector do not expect significant changes in the cost of funds over the next quarter. According to the same survey, interest rate conditions have tightened slightly for retail loans issued in both domestic and foreign currencies. Interest rate conditions for business loans issued in foreign currency also tightened slightly.

In March, relative to December, interest rates on retail and small and medium enterprises (SMEs) loans increased slightly to equal 16.4% and 11.7% respectively, while interest rates for corporate loans decreased by 1.0 pp to 10.9%.

As of March, relative to December, average interest rates on the stock of loans issued to legal entities in both domestic and foreign currencies did not change significantly, standing at 14.0% and 9.0% respectively (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 March, similar to previous months, average interest rates for loans issued to legal entities in the domestic currency remain significantly high compared to foreign currency loans, despite the increase of the latter in recent periods.

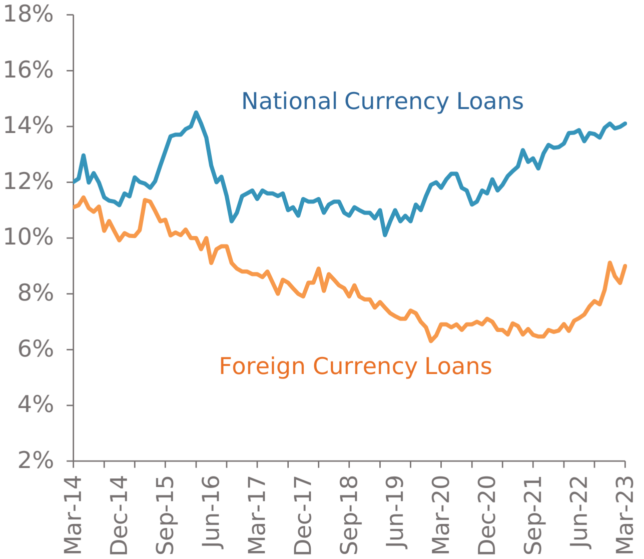

Figure 1.4.5. Average interest rates on business loans

Source: NBG

The real effective exchange rate remains appreciated. In the first quarter of the current year, annual appreciation was 15.6%.

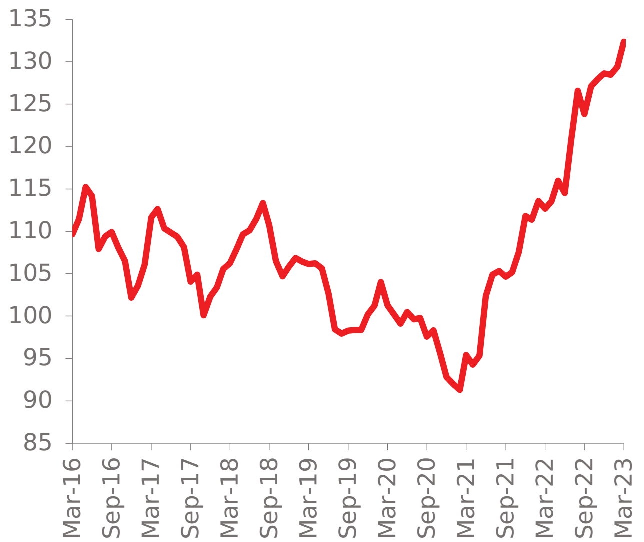

Figure 1.4.6. Real effective exchange rate (Jan 2008=100)

Source: NBG

1.4.3 EXCHANGE RATE

In the first quarter of 2023, the lari exchange rate continued to appreciate. The GEL nominal exchange rate appreciated against the US dollar by 3.5%, but depreciated insignificantly by 1.6% against the euro compared to the previous quarter. The GEL continued to appreciate against the Turkish lira (4.8%) and the Russian ruble (17.3%). In the same period, the nominal effective exchange rate appreciated by 4.7% on a quarterly basis and by 25.3% on an annual basis.

In terms of the price-adjusted exchange rate, in the first quarter of 2023 the real effective exchange rate appreciated by 1.7% on a quarterly basis and by 15.6% on a year-on-year basis (see Figure 1.4.6). The annual appreciation was due to the appreciation of the nominal effective exchange rate. However, the reduced competitiveness of the economy due to the real appreciation of the lari was partially balanced by the fact that the increase in consumer prices in Georgia was lower than those of its trading partners (see Figure 1.4.7). Similarly, for future periods, the lost competitiveness of the economy related to the real appreciation of the lari can be rebuilt not only by the depreciation of the lari nominal exchange rate, but also by significantly reducing inflation in Georgia compared to that of its trading partners. It should be noted that, according to the latest data, the lari real exchange rate has appreciated against the currencies of most trading partners (see Table 1.4.1).

The annual appreciation of the real effective exchange rate was caused by both the appreciation of the nominal effective exchange rate of the lari and the increase in local prices.

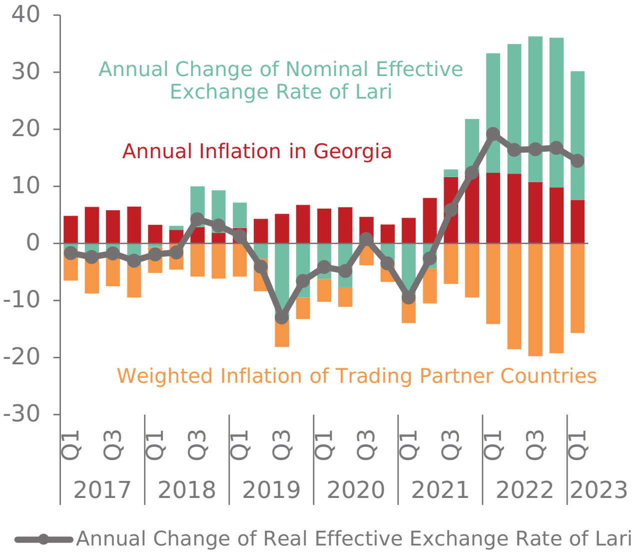

Figure 1.4.7. Decomposition of the annual change of the GEL real effective exchange rate*

Source: NBG

* The real exchange rate and its components are presented in the form of logarithmic values, and therefore their annual changes are a first-order approximation of percentage changes.

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	**25.3**	**15.6**	**15.6**
Eurozone	23.4	23.0	3.8
Türkiye	59.7	11.3	2.2
Ukraine	50.9	31.0	1.1
Armenia	-5.0	-4.6	-0.4
US	17.9	19.9	1.6
Russia	-0.9	-1.6	-0.3
Azerbaijan	17.8	11.5	1.0
China	27.1	35.1	4.5
Bulgaria	23.4	14.9	0.6
Poland	25.8	15.0	0.3

Table 1.4.1. Effective exchange rates annual growth (first quarter of 2023)

Source: NBG

* Growth implies appreciation of the lari

1.5 LABOR MARKET

The annual growth of the unit labor cost rose to 13.5%, meaning that inflationary pressures from the labor market remain a factor to watch out for.

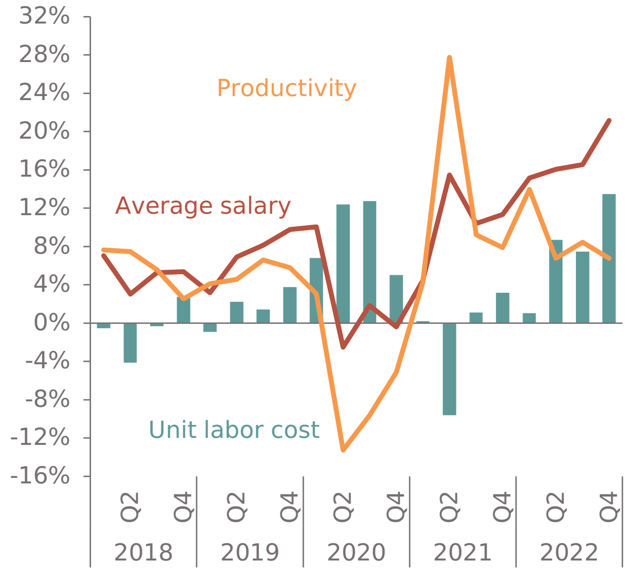

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

In the fourth quarter of 2022, the country's economic productivity (real value added per employee) rose by 6.8% on a yearly basis (see Figure 1.5.1). Over the same period, the nominal wage growth for employed workers was 21.2%, and the average monthly gross wage reached GEL 1,774.

Higher wage growth compared to productivity growth pushed up the unit labor cost (ULC) by 13.5% year on year. At this stage, there are no clear signs of the development of a wage-price spiral, although the annual growth of the ULC has increased, which means that inflationary pressure from the labor market is still a noteworthy factor (see Figure 1.5.1).

BOX 1. CATCHING-UP OR A WAGE-PRICE SPIRAL? UNDERSTANDING THE RECENT SURGE IN WAGES

Against the backdrop of rapid, post-pandemic inflation, there has also been a trend of rapid wage growth. This development has set off discussions of the possibility of wage-price spiral globally (a situation in which inflationary expectations start to be priced in the wage-setting process). On the other hand, along with the high-price environment and because of increasing profit margins, a one-time upward revision of wages has become necessary for keeping the labor supply/employment healthy. As wages are more rigid in the short run than prices, nominal wages are expected lag behind price growth for some time; however, against the background of decreasing real wages, and a subsequent decline of the labor supply, an upward revision in wages would become necessary. It is thus meaningful to analyze whether the recent acceleration of wage growth (that is increasing more than actual inflation) indicates an emerging wage-price spiral – or is it just a one-off catch-up process?

In this regard, it is worthwhile to look not only at the wage growth rate, which has certainly accelerated recently, but also to analyze the levels of wages. By observing these levels, it could indicate that wages have lagged behind in the past and we are now observing the catch-up process. In general, wage growth should be equal to the sum of the productivity and price index growth rates. In other words, if nominal wages, after excluding the productivity gain, increase more moderately than prices, then this indicates a deterioration of workers' conditions that cannot last long.

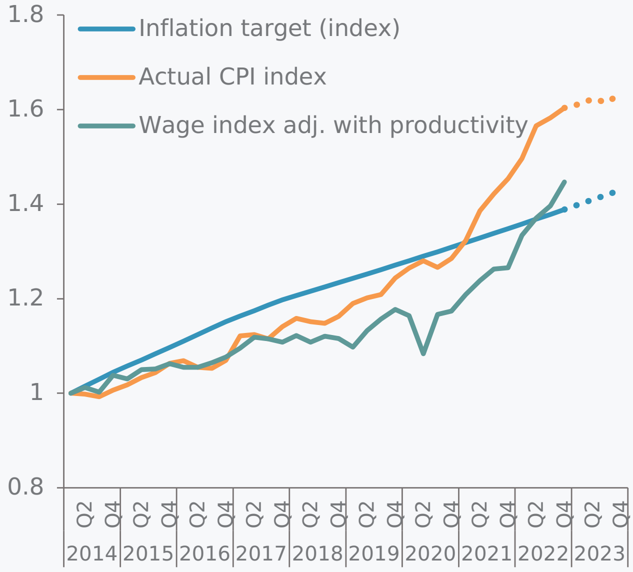

Figure 1.5.2. Comparison of inflation and wage indices (2014Q1=1)[12]

Source: GeoStat, NBG

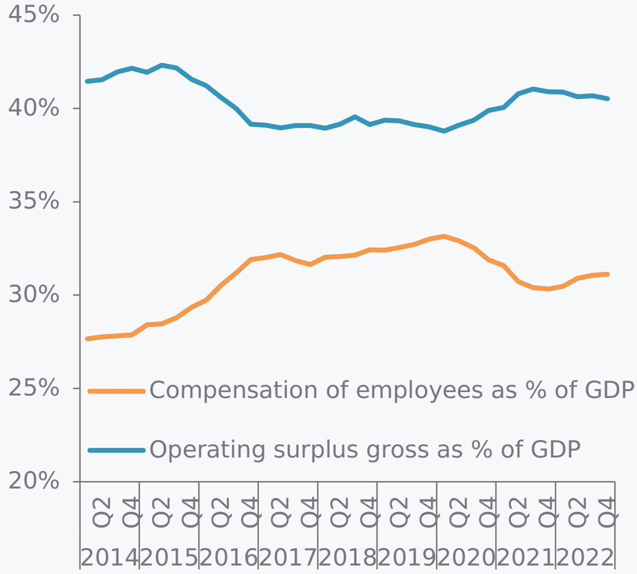

Figure 1.5.3. Compensation of employees and gross operating surplus as % of GDP

Source: GeoStat

Figure 1.5.2 shows the nominal wage index, after netting off productivity gain, and the price indices based on actual and targeted inflation in Georgia. As we can see, the nominal wage index has lagged behind the inflation index since 2019 and the gap especially increased during the pandemic when inflation accelerated. Although wages have been increasing since 2022, which opened up concerted discussion about the possibility of a wage-price spiral, it could be that case that we are observing the catch-up process against the background of the recent divergence between wages and prices. In turn, the lagged wage index indicates increased profit margins of firms when a more active upward revision of wages becomes more feasible – at such a time, it could put less pressure on prices (see Figure 1.5.3).

However, there might be several critical arguments against the above-mentioned analysis, which makes it necessary for us to continue to keep close watch on incoming data on wage growth. On the one hand, recent inflation is mainly driven by a commodity price shock, which usually has only transitory effects. On the other hand, while comparing price and wage levels to each other, we keep the assumption that real wage growth should mimic productivity improvement. However, it could be the case that some structural changes

12 The dashed line along the price index shows its possible dynamics in 2023 based on the inflation forecast, while the index of the inflation target is projected consistent with the 3% inflation target. Potential GDP growth is used for adjusting wage growth.

take place in the economy when the share of less labor-intensive sectors are expanding and they retain high profit margins. In such a scenario, they would respond to wage growth by increasing prices once again. This encourages us to retain a tight monetary policy stance to ensure the stability of long-run inflationary expectations along with the undershooting of the inflation target before convergence, and this would also reduce the necessity for future wage growth.

1.6 CONSUMER PRICES

Inflation in Georgia has a decreasing trend. In April, it approached the 3% target level and amounted to 2.7%. A trend of decreasing prices has recently been observed on international markets. Together with the strengthening of the GEL and the tightened monetary policy, this has contributed to the reduction of inflation.

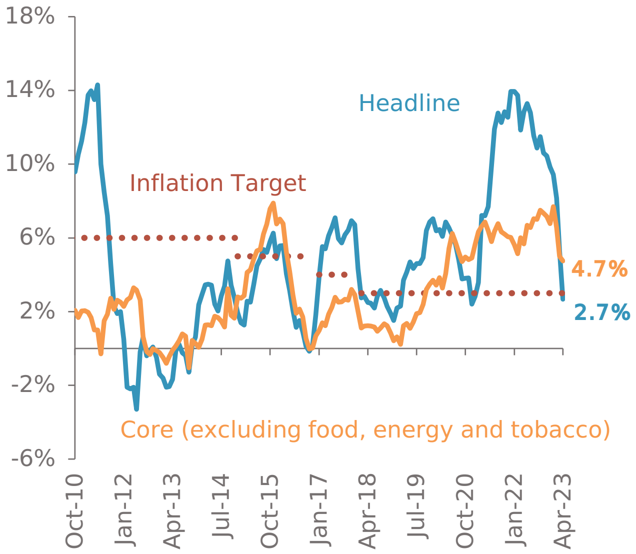

Figure 1.6.1. Headline and core inflation

Source: GeoStat

The decrease in inflation is mainly caused by the decrease in prices of imported products. High domestic inflation is related to food and services.

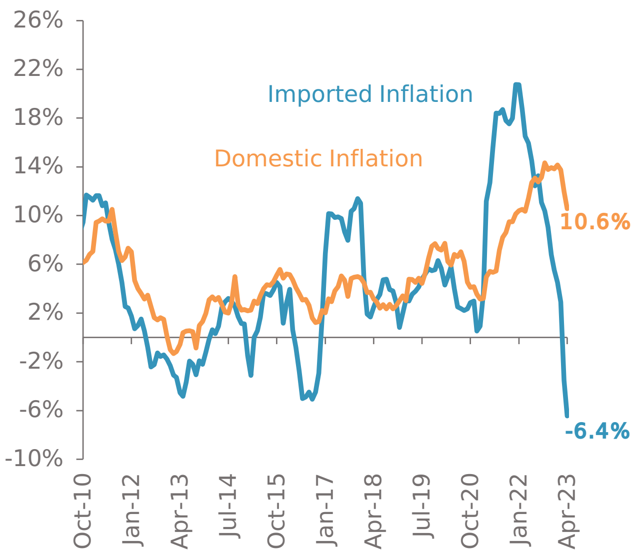

Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

Inflation in Georgia has a decreasing trend. In April, it approached the 3% target level and amounted to 2.7%. Core inflation, which excludes the highly volatile prices of food, energy and cigarettes, stood at 4.7% (see Figure 1.6.1).

The war started by Russia in Ukraine put the world in front of new economic challenges, one of the most acute of which has been the rise in commodity market prices and disruptions to supply chains. These became the main reasons for high inflation globally, including in Georgia. However, in recent months, prices on international commodity markets have had a decreasing tendency. Transportation prices have also been declining and are approaching pre-pandemic levels. These factors, together with the tightened monetary policy and the strengthened GEL, have reduced inflation in Georgia.

The above-mentioned factors have primarily reduced the inflation of imported products. In April, prices of imported products decreased by 6.4% year on year. Inflation on domestically produced products has also seen a decreasing trend, although this remains high, standing at 10.6% in April (see Figure 1.6.2).

High domestic inflation is related to both an increase in the prices of food (meat, cheese, and bread) and an increase in the price of services. The high inflation of services is mainly related to a sharp increase in the number of foreigners in the country. In terms of services, the increase in the price of apartment rentals and in cafe and restaurant services were particularly notable. A significant part (3.9 pp) of the 10.8% service inflation in April came from these sectors.

In terms of product groups, inflation was reduced the most by cheaper fuel and medicines. In April, gasoline and diesel became 37.3% and 23.1% cheaper respectively, making a total negative contribution to inflation of 2.0 pp. The decrease of prices in the healthcare group is due to falling prices of widely consumed medicines, the total contribution of which to inflation was a negative 1.1 pp. Meanwhile, food inflation is falling, standing at 5.8% in April, making a 1.8 pp contribution to inflation.

The impact of other products on inflation remained high, where, among other components, services are also included. This fact, to some extent, reflects a realization of so-called “second round” effects and implies the need for a tight monetary policy.

In terms of product groups, inflation was reduced the most because of cheaper fuel and medicines.

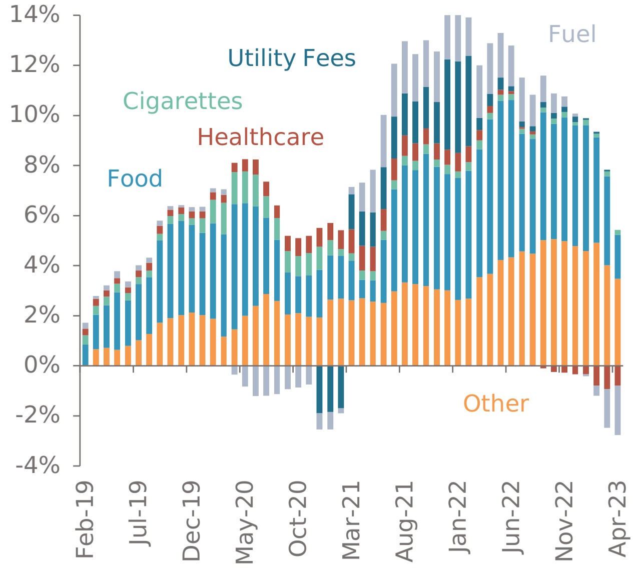

Figure 1.6.3. Contribution of different products to inflation

Source: GeoStat

2 MACROECONOMIC FORECAST

In 2023, inflation will moderate at a faster pace than had been expected at the onset of the year. It will stay somewhat below the target in the short term and will then hover around it in the medium term. The faster-than-expected decline in inflation was driven by the rapid normalization of international commodity prices and by the appreciated GEL exchange rate owing to solid external inflows in the recent period. In addition, strong external demand fueled by foreign inflows strengthens domestic spending, contributing to the upward pressures on inflation in the short term. Meanwhile, real GDP growth is expected to average 5% in 2023 amid moderate external inflows and the base effect resulting from the high growth of the previous year. However, high-impact risks remain around the baseline scenario. The alternative forecast scenario presented below envisages the realization of relatively acute risks, towards which the National Bank would have a low tolerance. This implies a sharp tightening of monetary policy and, if necessary, the use of additional instruments.

2.1 BASELINE MACROECONOMIC FORECAST

Amid the tight monetary policy stance, inflation will gradually decline. In the short term, it is expected to be lower than its 3% target, before stabilizing around the target in the medium term.

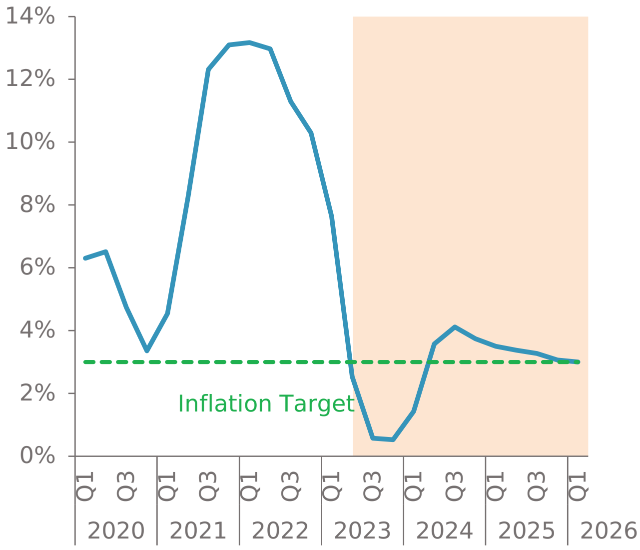

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

In the first quarter of 2023, annual inflation kept its momentum and continued falling to 7.6%. Amid the maintenance of tight monetary policy, the rapid reduction of inflation has been facilitated by both the base effect stemming from the high inflation of the previous year and by the reduction of commodity products on international markets in tandem with the appreciated GEL exchange rate. According to the current baseline forecast, the latter factors have had a more accelerated effect than previously anticipated, leading inflation to fall at a faster pace than expected in the first quarter. In particular, inflation will be below the target in the short term and will then converge with it from below. Other things being equal, inflation will be around 2.8% on average in 2023 (see Figure 2.1.1). In 2024, given the base effect of the current year, other things being equal, inflation will slightly exceed the target level and will finally hover around it at the end of the year.

The historic and projected higher-than-targeted inflation is fueled by heterogeneous factors. In particular, stronger-than-expected foreign inflows in the wake of the Russia-Ukraine war will keep stimulating domestic spending and demand-driven price pressures, albeit being counterbalanced by a significantly appreciated exchange rate. However, those effects are expected to start fading away in the second half of 2023 in parallel with the anticipated normalization of foreign inflows (see Figure 2.1.2).

Against the background of the aforementioned factors, the normalization of aggregate demand due to the planned fiscal consolidation and the rapid reduction of short-term inflation expectations will help moderate inflation. Furthermore, exogenous factors, *The deviation of inflation from its target has been driven by strong demand in tandem with various supply-side factors. On the other hand, the normalization of short-term inflation expectations and international commodity prices amid a significantly appreciated lari will lead inflation to hover around its target in the medium term.*

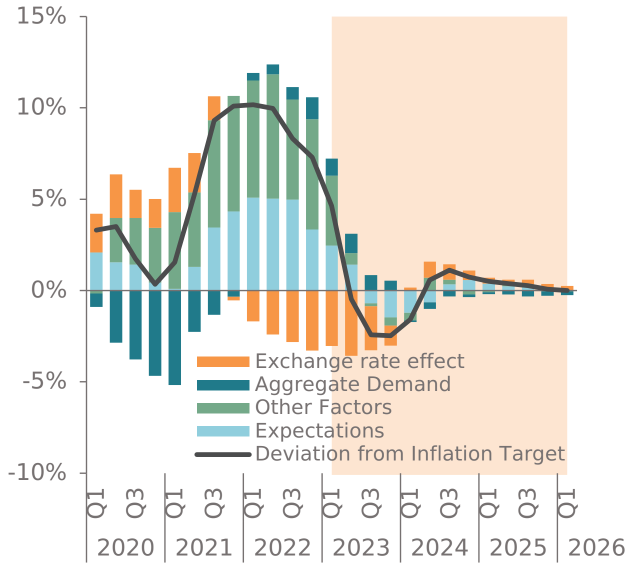

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the updated baseline scenario, domestic consumption and investment will spur growth in 2023, amounting to around 5%.

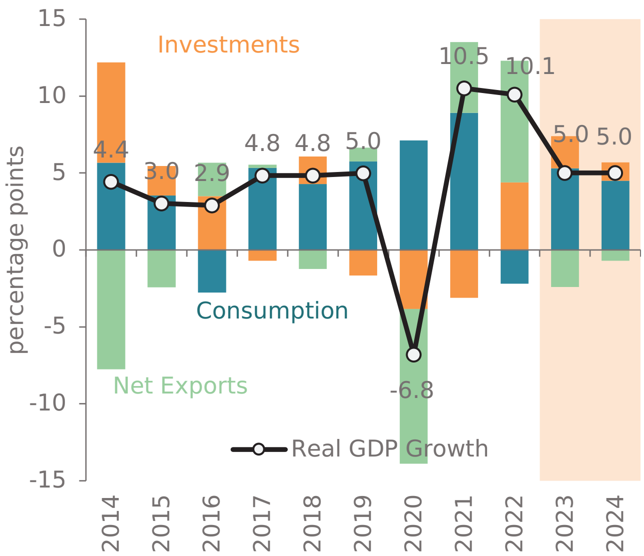

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

such as international commodity prices, have also been stabilizing faster than expected. In particular, international Brent oil prices have already approached pre-war levels, which has occurred in tandem with a normalization of the FAO index. According to the projections of reputable international organizations (the Energy Information Administration (EIA), Bloomberg, etc.), food and Brent oil prices will keep dropping this year, putting downward pressure on inflation. However, it should be noted that the forecasts of international commodity prices are characterized by high uncertainty. In particular, the recent announcements made by OPEC about supply restrictions are worth noting as these, to some extent, may slightly slow down the pace of the rapid reduction in international oil prices and put upward pressure on headline inflation.

The National Bank has recently maintained a tight policy stance in response to inflationary risks. Even though inflation is quickly converging with its target, and is even expected to fall below it in the short run, the National Bank of Georgia has become less tolerant towards those risks that could further aggravate inflation because of the multiyear deviations from the target. According to the current macroeconomic forecast, the expected trajectory of the monetary policy rate encompasses its slow pace of normalization in parallel with the mitigation of existing inflationary risks, and will thus approach the neutral level (currently estimated at 7%) only gradually, over the medium term.

As for the economic activity of the current year, real GDP will grow by around 5% in light of the high base effect of the previous year. The overall potential of the economy is showing signs of a faster-than-expected recovery in the post-pandemic period. This will be spurred on by growing investment, including foreign direct investment. In addition, the sovereign risk premium is expected to stabilize around a sustainable level amid the adoption of adequate macroeconomic policies, which will positively be reflected in economic activity. At the same time, solid foreign inflows owing to the recent geopolitical situation have reinforced domestic spending, which will positively contribute to growth, especially in the wake of the base effect of the previous year. Hence, if economic growth was mainly driven by foreign demand in 2022, it will boosted by domestic consumption and investments this year (see Figure 2.1.3). However, it should be noted that the situation is rapidly changing and uncertainties remain acute. 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

Recent global challenges relate to the delay in the reduction of inflation, the slowdown of the world economy, and the turmoil associated with the Russia-Ukraine war.

Macroeconomic Forecast Risks	Impact on Inflation
A worsening of the geo-political situation	↑
A sharp decrease in Russia-Ukraine war-related inflows and a deterioration of the current account balance	↑
Aggravation of the wage-price spiral	↑
Limited supply of commodity products to international markets	↑
Increase in the probability of a recession in developed countries	↓
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 the global economic slowdown, the slower-than-expected decline in monetary policy-relevant inflation, and uncertainty surrounding the Russia-Ukraine war, macroeconomic forecasts continue to be characterized by exceptional uncertainty. The high-impact risks are mostly inflationary – the realization of which would lead to a deviation from the baseline macroeconomic forecast.

The expected trajectory of inflation significantly depends on the indicators of foreign currency inflows related to the Russia-Ukraine war, as well as to the potential escalation of the war and the nature of its resolution. A sharp decrease in war-related inflows 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. In addition, the above-mentioned is also likely to reveal those channels, the adverse effects of which have not yet been reflected on the Georgian economy against the background of migration-related inflows.

Further escalation of the war in Ukraine could significantly increase the riskiness of the region, divert migrational flows to other countries, and provoke capital outflow. This may also lead to additional supply restrictions and the imposition of new international sanctions against Russia and/or a tightening of existing ones.

In turn, it is worth noting that, in the background of consecutive shocks, additional strong inflationary pressure would increase long-run inflation expectations and the likelihood of credibility shock. This, among other things, would generate a wage-price spiral amid a further excess of nominal wage growth over productivity growth, and would worsen the inflation outlook.

In addition, the reduction of prices on international commodity markets may be threatened by the decrease in oil production by the Organization of the Petroleum Exporting Countries (OPEC+) and disagreements related to the transportation of Ukrainian grain through the Black Sea.

In contrast to these risks, an additional increase in the probability of a recession in developed countries may exert downward pressure on inflation. In particular, this would lead to a slowdown of policy tightening by the central banks of these countries or their reduction, which would result in their currency devaluation. Consequently, this would strengthen the currencies of developing countries.

According to the updated forecast, expected inflation for the short-term has decreased. The improvement of the inflation outlook is mainly driven by the improvement of external factors and expectations.

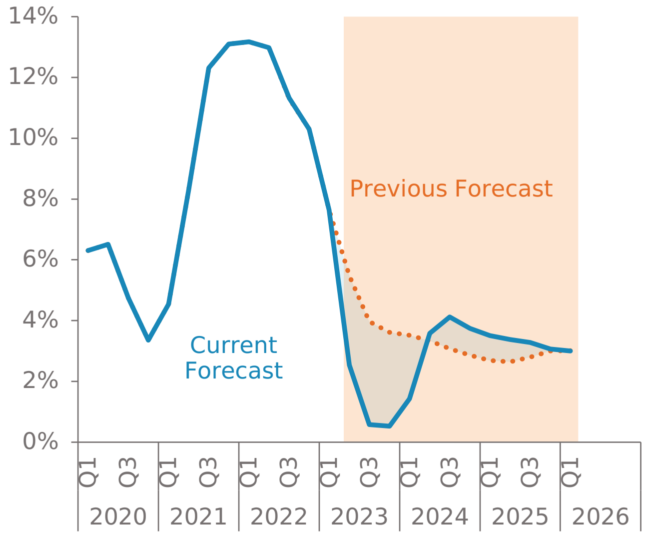

Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

As a result of improved expectations, the economy will accelerate by one percentage point to 5% in 2023.

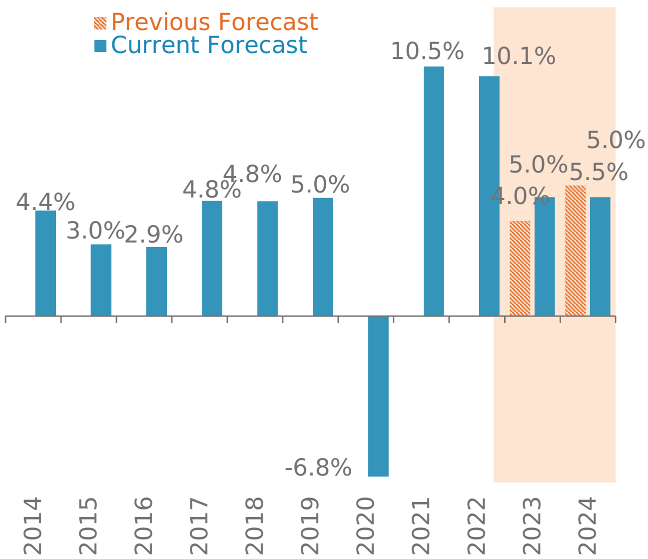

Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expected inflation over the short-term has decreased (see Figure 2.2.1). The improvement in the inflation outlook is primarily driven by the improvement of external factors and local short-term expectations. In particular, the prices of food products and oil on international commodity markets have recently declined more than had been expected. Additionally, the stronger-than-expected exchange rate has further diminished short-term inflation expectations. As a result, contrary to the previous forecast, inflation is projected to decline to the extent that it will temporarily fall below the 3% target rate in 2023.

According to the updated forecast, real GDP growth will accelerate by 1 percentage point to 5% in 2023 (see Figure 2.2.2). However, in the second quarter of the year, taking into account the large base effect, a much lower annual growth rate is expected. The assumptions that determined the economic growth projections for 2022-2023 are consistent with those of the previous forecast. However, after several years of decline, investments have increased, which can be considered an accelerator of both current and potential economic growth. The main source of the 1 pp revision of the 2023 forecast is improved expectations in the direction of investments.

Georgia is a small open economy, and the economic 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.

In the updated forecast, the outlook for inflation in Georgia's trading partners in 2023 has improved amid lower-than-expected commodity prices. Meanwhile, expectations for GDP growth and exchange rate depreciation against the US dollar have worsened. However, the prospect of a strengthening the euro exchange rate is worth noting, which would result from the expectations of a faster monetary policy normalization in the US than in the eurozone.

In the updated forecast, the 2023 outlook for inflation in Georgia's trading partners has improved amid lower-than-expected commodity prices; however, expectations regarding exchange rates and GDP growth have worsened.

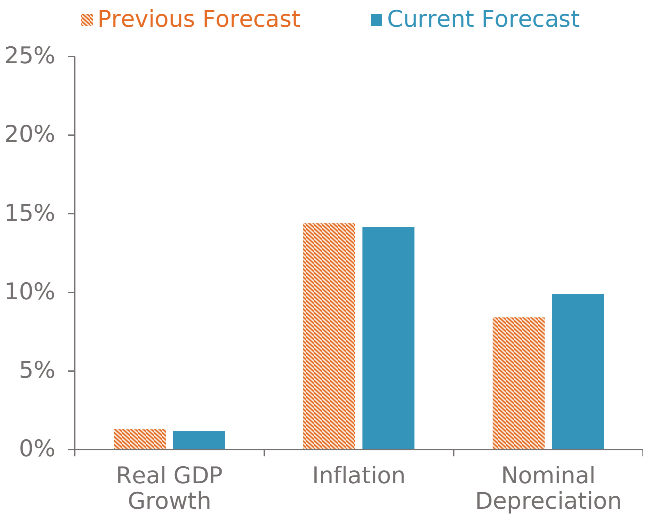

Figure 2.2.3. Changes in the forecast of external assumptions for 2023

Source: Bloomberg, NBG

According to the alternative scenario, with the occurrence of particularly acute risks, the current and financial accounts will deteriorate due to a reduction of foreign inflows, resulting in a slowdown of economic growth to 3% in 2023 and to 1% in 2024.

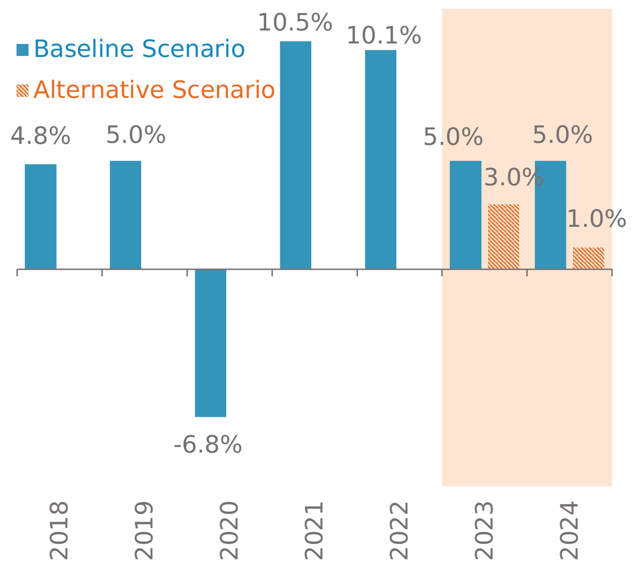

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat

2.3 ALTERNATIVE FORECAST SCENARIO

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 a sharp decrease in inflows related to the Russia-Ukraine war and an aggravation of the wage-price spiral. Additionally, the situation will be further worsened by both the weakened demand from developed countries and the constrained supply of commodity products to international markets. If the mentioned scenario materializes, economic activity will experience a sharp slowdown, with GDP growth projected to reach 3% and 1% in 2023 and 2024 respectively (see Figure 2.3.1).

Under this scenario, as compared to the baseline, the exchange rate depreciates. In particular, the abrupt reduction of cash flows associated with the Russia-Ukraine war will be accompanied by a decrease in foreign demand, which, through the deteriorating current account, will exert significant devaluation pressure. 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 prolonged high inflation in the past and the presence of additional strong inflationary pressures, the probability of a monetary policy credibility shock will significantly increase, leading to a deterioration in long-term inflation expectations. In turn, wage pressures will increase, and with nominal wage growth exceeding productivity growth, the inflation outlook will be further worsened.

The inflation outlook could be further worsened by a deceleration in the decline of prices on international commodity markets. Hence, if this acute alternative scenario is realized, the convergence of inflation towards its target will be delayed and inflation will be 2.8 percentage points higher on average in 2023-2024 compared to the baseline scenario (see Figure 2.3.2).

The National Bank of Georgia has the lowest tolerance to this scenario, which would imply a sharp tightening of monetary policy and the use of additional instruments as necessary. As compared to the baseline scenario, the trajectory of the monetary policy rate in 2023-2024 will be shifted upward by an average of 1.7 pp and will only gradually normalize after the stabilization of inflation expectations (see Figure 2.3.3).

According to the alternative scenario, against the backdrop of a deterioration of the current and financial accounts, the exchange rate will depreciate and inflation will increase. As a result, the convergence of inflation to the target rate will be postponed, which, in turn, will further worsen the inflation outlook through a wage-price spiral.

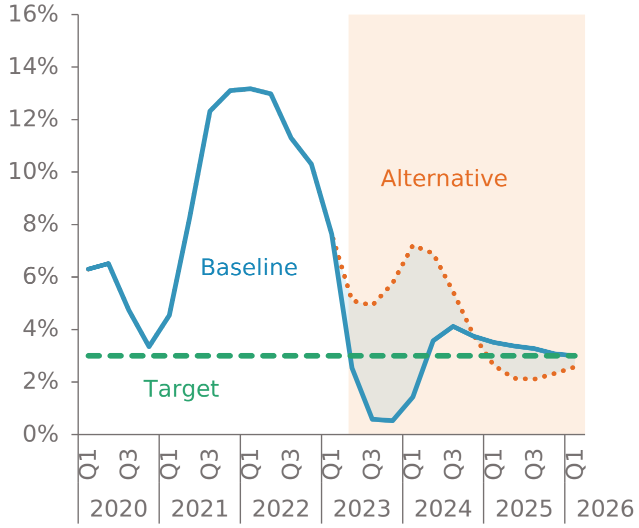

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

Monetary policy will not tolerate increased inflationary pressures and credibility shocks. This would imply a sharp tightening of the policy rate and, if necessary, the use of additional instruments.

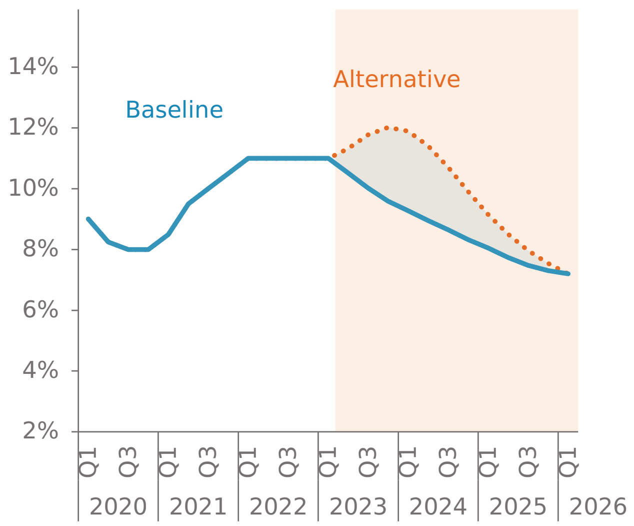

Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

Inflation expectations of financial market participants are lower than those of the previous quarter and gradually approach the target of 3% in the medium term.

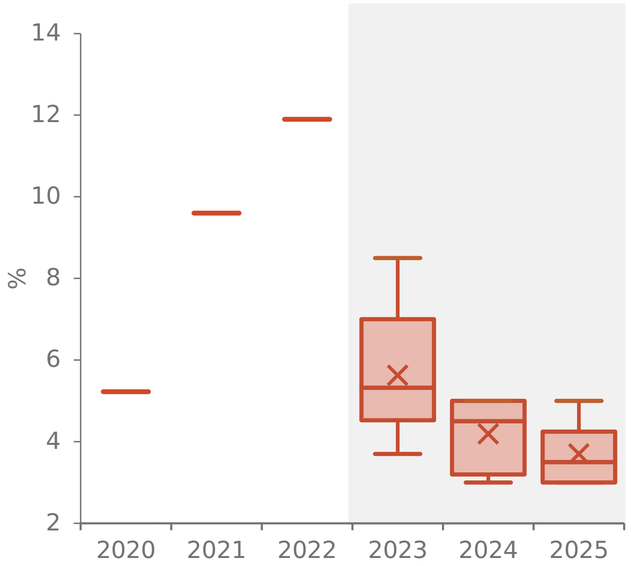

Figure 2.4.1. Actual average inflation (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

Monetary policy expectations for the coming years have been revised upward compared to the previous quarter.

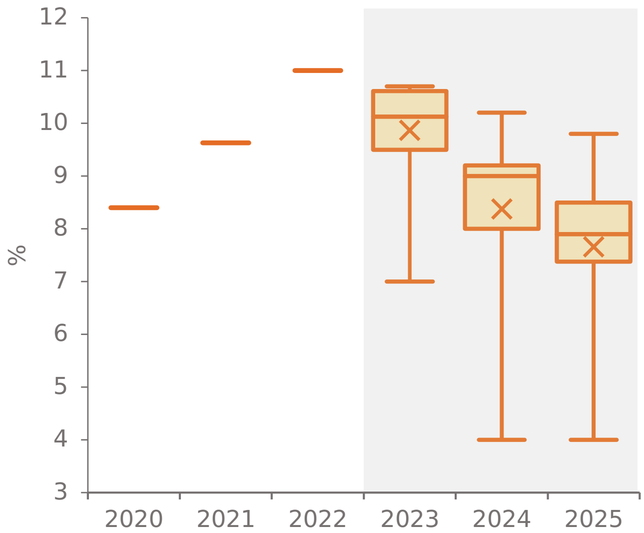

Figure 2.4.2. Actual monetary policy rate (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants

In the second quarter of 2023, 10 financial organizations participated in a survey of macroeconomic forecasts. According to the results of this survey, the financial market's economic expectations for 2023-2025 have been revised over those of the previous quarter.

Akin to the forecast of the National Bank, the inflation expectations of financial market representatives for the years 2023-2025 have decreased compared to the previous quarter. In particular, the median inflation expectation for 2023 is 1.4 pp lower, while the average inflation forecast is 1.3 pp lower, amounting to 5.3% and 5.6% respectively. As for 2024, the median projection shifted down by 0.5 pp to 4.5%, and the average fell by 0.9 pp to 4.2%. The inflation expectations of financial market participants gradually approach the target in the medium term. The median inflation expectations for 2025 decreased by 0.5 pp and equal 3.5%, while average inflation expectations fell by 0.6 pp to 3.7% (see Figure 2.4.1).

Against the backdrop of reduced inflation expectations, the market expects a slightly higher monetary policy rate as compared to the expectations of the previous quarter. In particular, their median projection for 2023 rose by 0.1 pp to 10.1%, while the average forecast rose by 0.2 pp over the previous quarter's forecast, reaching 9.9%. Their median projection for 2023 went up by 0.5 pp to 10%, while the average forecast rose by 0.3 pp, reaching 9.7%. As for 2024, the median and average projections for monetary policy increased by 0.3 pp and 0.1 pp to 9% and 8.4% respectively. Expectations for the monetary policy rate are slowly converging to its neutral level in line with a curbing of inflation expectations. In particular, the median forecast for 2025 fell by 0.1 pp to 7.9%, and the average expectation, similar to the previous quarter, stands at 7.7% (see Figure 2.4.2). However, these forecasts remain highly variable.

According to the current survey, real GDP growth expectations are largely unchanged. In particular, the median forecast of economic growth shifted up by 0.5 pp to 6%, while the average forecast has not changed since the previous quarter and amounts to 6.2%. Similar to the previous quarter, the median and average forecasts for economic growth in 2024 remain at 5% and 5.2% respectively. In 2025, according to market participants' expectations, the median and average expectations of real GDP growth have increased by 0.2 pp and 0.3 pp respectively, reaching 5.2% in both cases (see Figure 2.4.3).

At this stage, we are presenting the aggregate survey results of the macroeconomic forecasts made by market participants. However, since the official statistics for all three variables are made available on the websites of the National Bank and GeoStat in the sec-

The market forecasts for economic growth over 2023-2025 remain largely unchanged compared to those of the previous quarter.

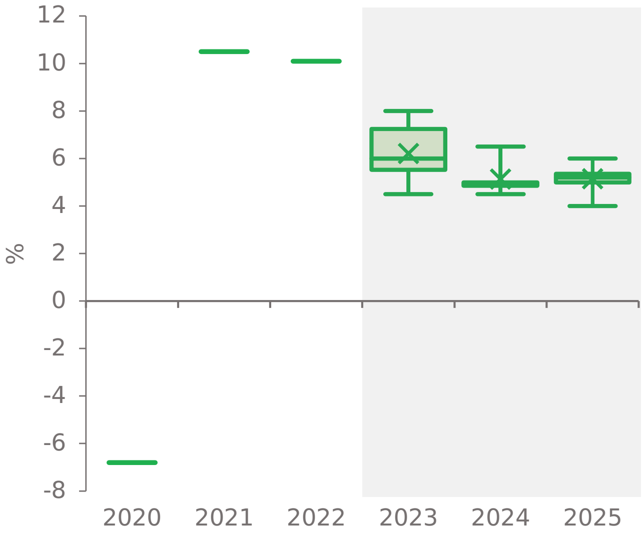

Figure 2.4.3. Actual real GDP growth (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

ond quarter of each year, the NBG is able to name the best financial forecaster organization. The indicator used to evaluate the accuracy of the forecasts is an average root mean square error (RMSE). The organizations with the lowest RMSE are named as the best forecasters. Having evaluated the results of 2022, the NBG revealed that the forecasts provided by Silk Road Bank were distinguished as having the smallest RMSE.

BOX 2. REAL GDP LEVEL AND THE PRE-PANDEMIC TREND

The National Bank of Georgia (NBG) relies on an inflation-targeting regime to ensure price stability. Under this regime, the monetary policy rate is the key instrument by which NBG neutralizes pressures on consumer prices and brings inflation closer to the target. Demand is often the source of price pressures and the NBG thus constantly monitors economic activity and evaluates the inflationary pressures stemming from it.

In recent years, aggregate demand has been characterized by high volatility amid significant macroeconomic shocks. The COVID-19 pandemic, which was characterized by a combination of demand- and supply-side shocks, triggered a severe recession in Georgia (as well as globally) in 2020, with real GDP falling by 6.8%. Once pandemic-related restrictions eased, pent-up demand became a prerequisite for the unprecedentedly high output observed in 2021, with economic growth reaching 10.5%. In 2022, the economy again grew by a double-digit number (10.1%) in the wake of high levels of regional migration and accompanying financial inflows due to the Russia-Ukraine war. As a result, the real GDP recovery followed a V-Shape (see Figure 2.4.4), similar to that of many other countries. However, it should be noted that the size of Georgia's real economy in 2022 had already converged to the level that was projected if the COVID-19 pandemic had not happened. In particular, according to pre-pandemic estimates, real GDP would have continued to grow by 4.5% from 2020, which was the approximate average of the past ten years' growth (2010-2019).

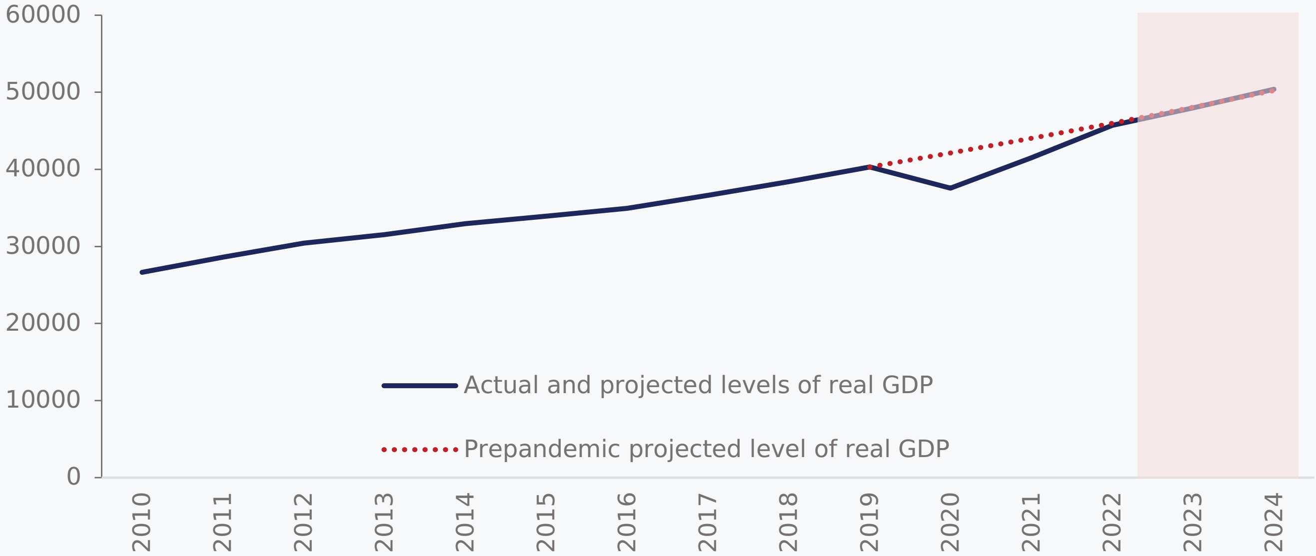

Figure 2.4.4. Actual and pre-pandemic estimated levels of real GDP for 2020-2024

Source: NBG, GeoStat

Accordingly, given the current potential of the economy and its impact on inflation, the recent forecast of economic growth of around 5% for 2023 seems quite solid, even though it is lower than the figures recorded in previous years. The inflationary pressure coming from strong aggregate demand still calls for monitoring, since its neglect may significantly slow down the pace of the current reduction in inflation and prolong the process of its convergence with the target beyond the short term. Put differently, strengthening the potential of the economy seems vital to maintaining economic growth at such a high level so that it does not bolster inflationary pressures.

3 MONETARY POLICY

During 2023, the inflation rate in Georgia has declined faster than expected. In April, it was 2.7% and close to the target of 3%. These dynamics were mostly led by lowering the pressure of imported inflation, which, in turn, was the result of the appreciated lari exchange rate in combination with globally decreasing commodity prices and transportation costs. Local inflation also retreated from its peak and is following a downward trend. According to the current forecast, other things being equal, as a result of maintaining a tight monetary policy, inflation will continue to decrease and will temporarily be below its target level before stabilizing around the 3% target. As a result, inflation expectations will be normalized, which is a prerequisite of medium- and long-run stability. In accordance with this rationale, in May 2023 the Monetary Policy Committee decided to cut the monetary policy rate by 0.5 pp, from 11.0% to 10.5%. However, risks and uncertainties remain high. Taking these into account, the NBG will only be able to continue the reduction of the monetary policy rate at a slow pace.

On 10 May 2023, the monetary policy rate was lowered by 0.5 pp, from 11.0% to 10.5%. Nevertheless, the NBG continues to maintain a tight policy stance.

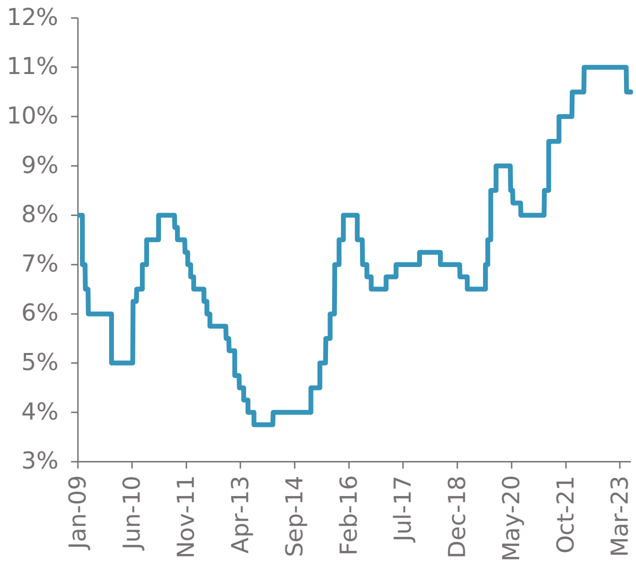

Figure 3.1. Monetary policy rate

Source: NBG

Due to the consecutive shocks of the past three years and current shifts in the geopolitical environment, uncertainties are high globally. As a result of the Russian invasion of Ukraine, against the background of challenges facing the U.S. financial sector and the tightening of financial conditions, economic growth outlooks have worsened globally. However, the current shocks have had different effects on different countries. Although the world and international trade faced new challenges, the negative effects of the war on the countries of the region, including Georgia, have not yet materialized due to its geopolitical location. In the background of high levels of migration and increased remittances to the countries of the region, foreign demand has increased more than expected. As a result, economic activity in Georgia during the first quarter of 2023 remained high and thus hindered the fight against inflation.

During the first quarter of 2023, global commodity prices continued to decrease. Initially, Russia's invasion of Ukraine led to a significant increase in prices of energy resources and food products on international markets. However, a significant price reduction was subsequently observed – mostly due to the humanitarian corridors created by the European Union, which implied an agreement on the export of grain to Black Sea ports. The international food price index has had declining dynamics from March 2022, and this trend has persisted in 2023 as supply chains gradually recovered. In line with the drop of oil prices, the international cost of transportation has continued to decline which, together with the strengthened lari exchange rate, helps to reduce inflation.

Meanwhile, according to the planned fiscal consolidation measures for 2023, fiscal stimulus will also decrease. Also, as a result of the tight monetary policy and recently implemented macroprudential instruments, credit activity has slowed. In addition, the tightened monetary policies of the European Central Bank and the U.S. Federal Reserve have had the effect of tightening policies on foreign currency lending. Taking into account these tendencies, economic activity in 2023 will be close to its potential level and inflationary pressure will be neutralized.

Taking the recent positive tendencies into consideration, inflation in Georgia is decreasing faster than expected. This fact helps to reduce inflationary risks and lower inflation expectations. However, as a small open economy, Georgia is vulnerable to global developments. Along with global uncertainties, monitoring inflation-related risks remains a primary task. Also, local wages exhibit an increasing trend, which makes labor market-related inflationary pressure noteworthy. Although there is no strong evidence of a wage-price spiral developing, the unit labor cost is still high. In addition, global uncertainties remain one of the biggest sources of risk. These points imply that the NBG will only be able to cut the monetary policy rate at a slow pace.

Taking the abovementioned factors into account, at the Monetary Policy Committee meeting held on 10 May 2023, the monetary policy rate was reduced by 0.5 pp, from 11.0% to 10.5%. Despite this moderate cut, the NBG maintains a tight policy stance. Monetary policy will remain tight until the risks of rising inflation expectations are sufficiently mitigated. If inflation expectations rise and/or additional demand-side price pressures emerge, a further tightening of policy or maintaining the current tight stance for a longer period might be necessary. In such a case, the NBG will take additional measures to fight against demand-side inflationary risks.

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

The reduction of dollarization is an important challenge for the Georgian economy. 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. As a result of the NBG's larization (de-dollarization) policy, the dollarization of loans and deposits is gradually declining, which not only reduces currency risks and the related credit risks of individual borrowers, but also promotes long-term economic growth.

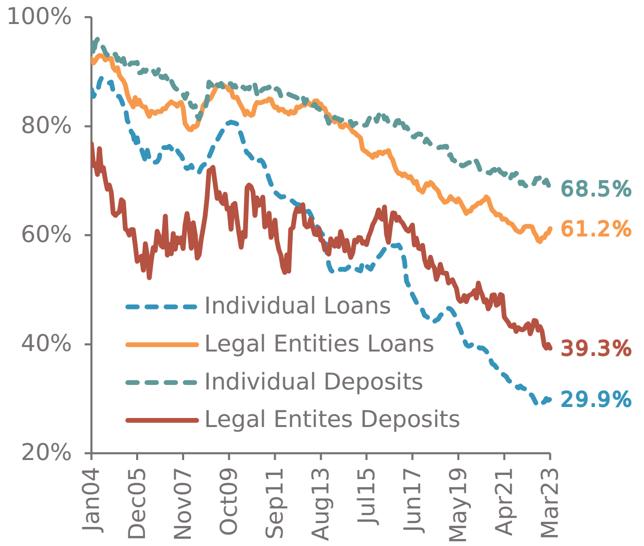

Figure 3.2. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG

Relative to the previous month, in March 2023 the dollarization rate (excluding the exchange rate effect) still followed a downward path; however, loan dollarization saw a slight 0.5 pp increase and stood at 44.3%. Loan dollarization negligibly rose for both individual borrowers and legal entities, by 0.2 and 0.8 pp respectively. Meanwhile, the downward trend of deposit dollarization continued, falling by 0.7 pp for both individuals and legal entities to 68.5% and 39.3% respectively (excluding the exchange rate effect) compared to the previous month.

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 short-term interest rates on the interbank money market vary around the policy rate.

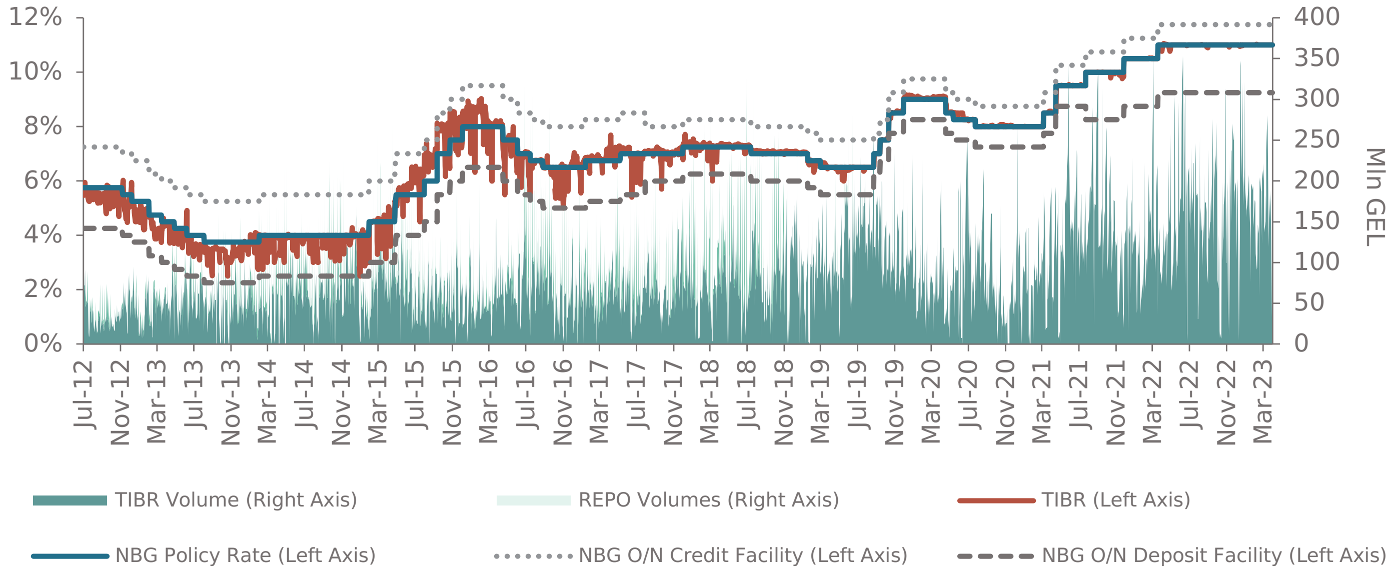

Figure 3.3. Interbank money market

Source: NBG

BOX 3. THE SIGNIFICANCE OF THE REAL INTEREST RATE

In response to high inflationary pressures around the world, central banks tightened their monetary policies. This was reflected in higher real interest rates. The real interest rate is the inflation-adjusted interest rate that shows the real cost of borrowing for the borrower and the real benefit for the lender/investor. Accordingly, it is the real interest rate that affects incentives to save or borrow. Therefore, the real interest rate is one of the main monetary policy instruments that affects aggregate demand and, ultimately, prices. A high real interest rate increases the cost of borrowing and makes it less attractive, while making saving more attractive. An increase in the propensity to save and a decrease in demand for loans, in turn, is reflected in a decrease in overall demand, which ultimately alleviates inflationary pressures; conversely, a low real interest rate stimulates borrowing, boosts economic activity, and increases inflation. The real interest rate is calculated as the difference between the nominal interest rate and inflation expectations.

It is, therefore, interesting to compare and analyze the real interest rates of different countries. If we rely on the updated inflation forecasts of the International Monetary Fund as a measure of inflation expectations in different countries, then it turns out that Georgia has one of the highest real interest rates, as compared to other countries in the region and trading partners (see Figure 3.4). Georgia's high real interest rate is caused by both lower inflationary expectations and the continued maintenance of a high monetary policy rate.

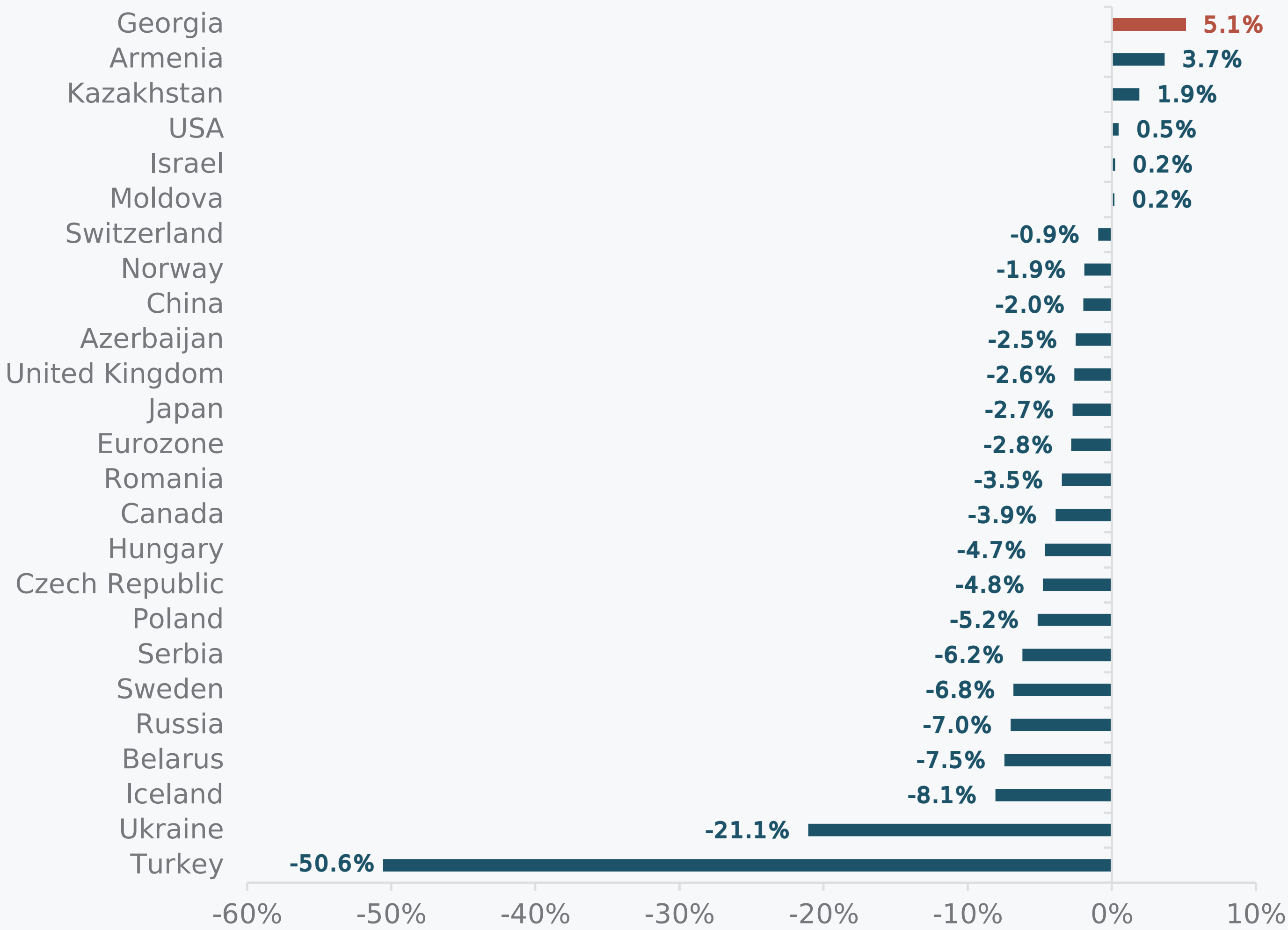

Figure 2.4.4. Actual and pre-pandemic estimated levels of real GDP for 2020-2024

Source: NBG, GeoStat

This comparison indicates the NBG's commitment to price stability, which is why it maintains a tight monetary policy. As has been repeatedly stated, maintaining a tight policy is expected to continue until long-term inflation expectations show clear signs of stabilizing at the target level of 3%.

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