Monetary Policy Report

August

2023

საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation

0.6%	Annual inflation decreased and fell short of the 3% target.

Economic Growth

Strong economic growth is expected in 2023.	6%

Monetary Policy

10.25%	Under the conditions of high uncertainty, monetary policy rate cuts are only expected at a slow pace.

MONETARY POLICY DECISION

The National Bank of Georgia (NBG) continues a gradual exit from its tight monetary policy and has reduced the policy rate to 10.25%.

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. This has gained increased importance under the current uncertain circumstances.

Inflation in Georgia has a decreasing trend, and in June 2023 headline inflation fell to 0.6%. This reduction was mainly due to exogenous factors. Prices of raw food commodities and oil on international markets have recently been decreasing. Together with the strengthened GEL exchange rate, this reduces the prices of imported goods in Georgia. Inflation of domestically produced goods is also decreasing, albeit at a relatively slow pace – a trend that is expected to continue during the year. According to the current forecast, headline inflation will be below the 3% target level in the short term, then, taking into account the base effect, it will temporarily exceed the target and stabilize around it the medium term.

Despite positive trends being observed, risks that may increase inflation remain high. Due to the current acute geopolitical situation in the region, a potential increase in the prices of raw materials on commodity markets remains one such risk. The materialization of this risk would increase prices of imported goods. At the same time, local economic trends also carry inflationary risks. In particular, economic growth has remained high this year, and the growth forecast has been revised to 6%, but if, due to strong aggregate demand, economic growth turns out to be even higher than forecast, additional pressure on inflation will arise. In addition, if the trend of wages rising faster than productivity is maintained, production costs will increase and ultimately affect prices. Considering these risks, and under the conditions of high uncertainty, it is expected that the NBG will continue to reduce the monetary policy rate only gradually and to normalize it 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 again become apparent, the monetary policy stance might need to be tightened further or the current level 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

Amid a fall in international commodity prices and the appreciation of the GEL exchange rate, annual inflation is following a decreasing path and has recently fallen short of its target. However, uncertainty surrounding these factors remains high and, given strong aggregate demand, the domestic component of inflation is declining much more slowly than imported inflation. According to the current baseline forecast, in the short term headline inflation will remain below its target. This will be followed by a temporary overshoot mostly related to the base effect, before inflation stabilizes around the 3% target in the medium term. Considering the various risks, it is expected that the exit from the tight monetary policy stance will continue gradually at a moderate pace.

After remaining below the 3% target in the short term, headline inflation will temporarily exceed it (mostly due to base effect) and will eventually stabilize around the target in the medium term.

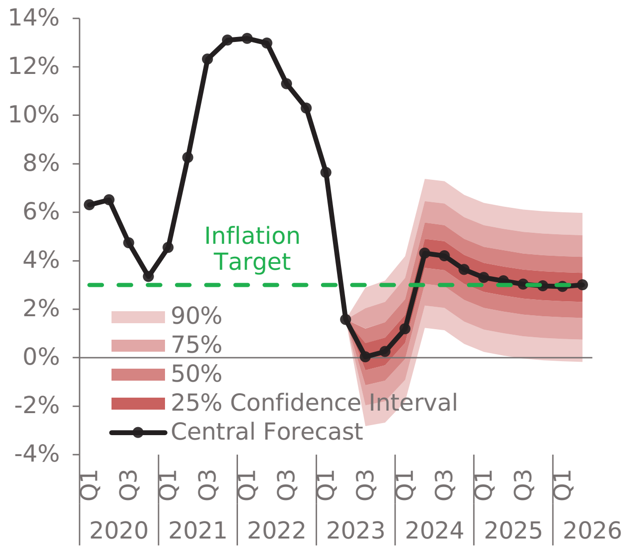


Figure 1. Headline CPI inflation forecast

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

Inflation in Georgia has recently been following a clearly decreasing trend. These dynamics are, on the one hand, a result of imported inflation – the decline of which has been governed by the appreciated GEL exchange rate amid high foreign inflows as well as by decreasing prices on international commodity markets. On the other hand, amid the tight monetary policy implemented in response to the severe shocks of recent years, domestic inflation has also been falling, albeit at a much slower pace as a result of the stronger-than-expected aggregate demand seen in the first half of the year. Headline inflation decreased to 1.6% in the second quarter and **is projected to remain below its target in the short term, implying an average 2.4% increase in consumer prices** in 2023 (see Figure 1). Next year, inflation will temporarily exceed its target, mostly due to the base effect, and will then stabilize around 3% in the medium term.

As mentioned above, in the first half of the year, higher-than-expected economic activity was observed in Georgia and, according to preliminary estimates, annual economic growth was 7.6%. During this period, external demand and foreign inflows remained strong, which had a positive impact on domestic demand and, in general terms, affected inflation in an upward direction. However, amid the growth of investments, an increase in the potential of the economy has also been observed. According to current projections, the National Bank of Georgia revised **the real GDP growth forecast for 2023 upwards by 1 percentage point (pp) to 6% and kept the forecast for 2024 unchanged at 5%.**

High uncertainty continues to surround the determinants of inflation. The risks concerning international commodity markets are mostly upside and include uncertainties related to oil and grain supplies. In addition, due to their nature, war-related money inflows carry a high risk: their immediate reversal may create pres-

Amid strong foreign inflows, which also stimulate domestic demand, real GDP growth in 2023 and 2024 will be around 6% and 5% respectively.

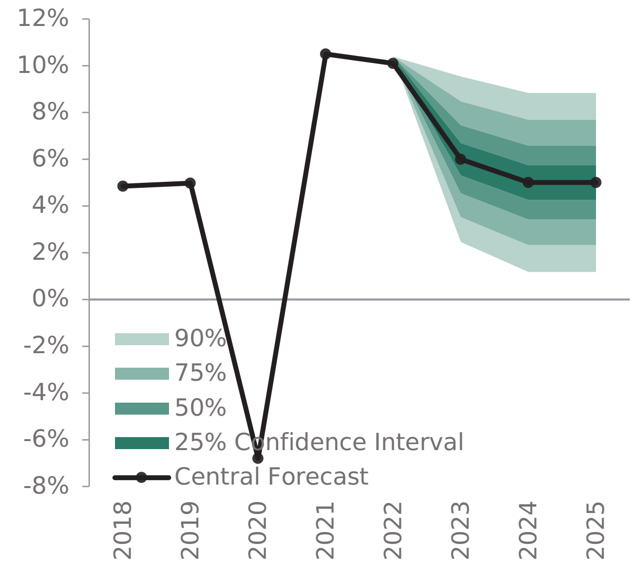


Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat

Considering the high risks, it is expected that the exit from the tightened monetary policy stance will continue only gradually, at a moderate pace.

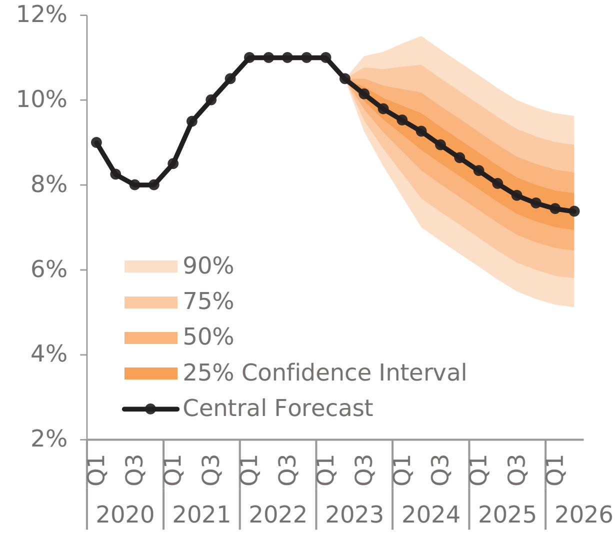


Figure 3. Monetary policy rate forecast

Source: NBG

sure on the foreign exchange market, which will subsequently affect inflation. Strong aggregate demand is also noteworthy and carries the risk of demand-side pressure on prices. The National Bank of Georgia is particularly cautious about such risks in light of the prolonged episode of high inflation seen in recent years. In the event of an additional shock, returning to a high inflationary environment could significantly threaten long-term inflation expectations, which, in turn, will hinder the return of headline inflation to its target. Taking this into account, **the National Bank of Georgia will only continue the normalization of monetary policy at a moderate pace: having left it unchanged at the previous meeting, the policy rate was reduced by 0.25 pp in August**. It is expected that the exit from the tightened policy will be gradual (see Figure 3), and the policy rate will return to its neutral level (currently estimated at 7%) in parallel with the mitigation of risks.

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 continues to be a high level of uncertainty surrounding the post-pandemic recovery of the global economy; however, in the first half of 2023 there was higher-than-expected economic activity globally. As a result, external demand in Georgia remained strong, with the volume of exports of goods, travel revenues, and remittances all continuing to grow. Therefore, according to the current forecast, the current account deficit is expected to remain relatively low in 2023. Given the above-mentioned dynamics and strong domestic demand, economic activity remains high. Meanwhile, amid decreasing prices on international commodity markets and tight financial conditions, the level of inflation in Georgia's trading partner countries has declined gradually. This is another factor that may contribute to the additional reduction of inflation in Georgia, which, amid the appreciated exchange rate and the recent decrease in global commodity prices, has a clear downward trend.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

In 2023, along with the reduction of inflationary pressures, global economic activity is expected to improve slightly. However, uncertainty remains high amid the Russia-Ukraine war.

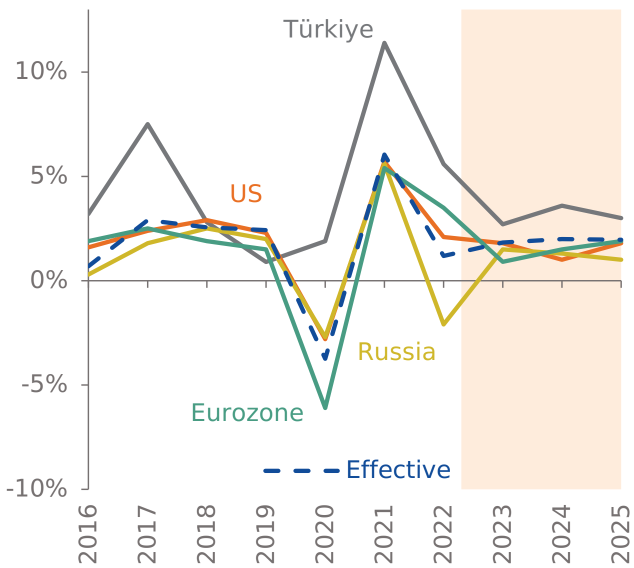


Figure 1.1.1. Real GDP growth of economic partners

Source: IMF

In the wake of the COVID-19 pandemic and amid Russia's ongoing military aggression in Ukraine, uncertainty around the recovery of the global economy remains high. Last year, as a result of strong demand, supply disruptions and attendant price pressures on international commodity markets, inflation and its expectations increased significantly in almost all countries. In response, central banks had to sharply tighten their monetary policies. Although this effect has partly been maintained this year, amid the tightened financial conditions inflationary pressure has gradually been decreasing. Therefore, according to the International Monetary Fund's (IMF) updated forecast in July[1], **global economic growth in 2023 will be 3%,** which is 0.2 percentage points (pp) higher than the previous forecast[2] made in April. In addition, globally inflation pressures are expected to decrease and global inflation is expected to be 6.8% in 2023.[3] For emerging and developing countries, real GDP is forecast to grow by 4% in 2023, while annual inflation is projected to be 8.3%.[4]

A high inflationary environment has prevailed in both developed as well as in emerging and developing countries in the second quarter of 2023. However, it should be noted that amid the recent downward

1 *International Monetary Fund. 2023. The World Economic Outlook Update: Near-Term Resilience, Persistent Challenges. Washington, D.C., July. (Hereafter: WEO July update, 2023).*
2 *International Monetary Fund. 2023. The World Economic Outlook: A Rocky Recovery. Washington, D.C., April. (Hereafter: WEO April 2023).*
3 *WEO July update, 2023.*
4 *Ibid.*

Inflation has had a decreasing trend in Georgia's trading partner countries, including the United States and the eurozone. Moreover, international oil and food prices have followed a downward trend, which creates positive expectations for the future.

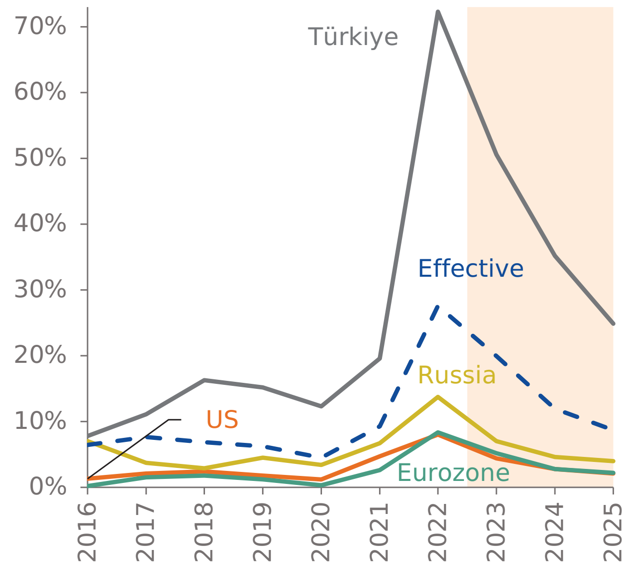


Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF

trend of both oil and food prices (see section 1.1.2 of this report) and tight financial conditions, the level of inflation is gradually decreasing globally.

In the second quarter of 2023, improvements in economic activity continued at a slower pace in the **United States**. Based on the April-May data, consumer sentiment and retail sales remain improved, being supported by reduced dynamics of consumer prices. However, tight financial conditions and trade barriers with China remain in place. Annual inflation stood at 3% in June. According to IMF's updated forecast, real economic growth in the US will be 1.8% in 2023 and annual inflation for the year as a whole is projected to be 4.4%.[5]

In the second quarter of 2023, the pace of economic activity also 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 inflation dynamics. As a result, consumer and business sentiment improved slightly. In June, the annual rate of inflation stood at 5.5%. It should be noted that European countries continue to impose economic sanctions against Russia, which creates additional pressure on the economy. According to the IMF's updated forecast, the real economic growth forecast for the eurozone is 0.9% in 2023. Annual inflation is projected to be 5.2%.[6]

In the second quarter of 2023, economic activity slightly improved in **Türkiye**. This was mostly due to strong domestic demand and an increased volume of goods exports. However, according to April-May data, industrial production decreased. Although the annual inflation rate is decreasing, it remained high at 38.2% in June. As a consequence, for the first time in a long period, the central bank decided to sharply tighten monetary policy – although perhaps not as sharply as the market expected – which was reflected in a further depreciation of the Turkish lira. According to the IMF, real GDP growth will be 2.7% in 2023, while annual inflation is expected to be 50.6%.[7]

In the second quarter of 2023, economic activity improved slightly in **Russia**. According to April-May data, industrial production and retail sales improved. Unemployment is at a historic low level and wages are up. However, both the business environment and the volume of investments remain deteriorated in light of the economic sanctions imposed by the West. In addition, amid the globally reduced prices of energy carriers and the Western embargo, the external sector continues to deteriorate, and the fiscal deficit increased. Despite a recent sharp depreciation of the Russian ruble, annual inflation is low and equaled 3.2% in June. According to the IMF's updated forecast, Russia's real

5 *Ibid.*
6 *Ibid.*
7 *WEO April, 2023.*

economic growth will be 1.5% in 2023, while annual inflation is projected to be 7%.[8]

Russia's ongoing war has had a devastating impact on **Ukraine**, both socially and economically. Various critical infrastructure has been destroyed, which reduces 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.

In the second quarter of 2023, compared to the previous quarter, economic activity slightly improved in **Armenia**. This was mostly due to the improvement of the trade balance, while the construction sector and credit activity have both increased. The annual inflation rate decreased and stood at -0.5% in June. According to the IMF, the real GDP forecast for Armenia in 2023 is 5.5%, while annual inflation is expected to be 7.1%.[10] However, it should be noted that inflation has been decreasing faster than expected since April.

In the second quarter of 2023, growth rates slowed slightly in **Azerbaijan**. This was mostly due to lower retail sales and fixed investments. However, activity in the non-oil sector continued to be high. The annual rate of inflation remained high and stood at 10.6% in June. Consequently, the central bank tightened its monetary policy. According to the IMF's forecasts, real GDP growth in Azerbaijan will stand at 3% in 2023, while the annual inflation rate is expected to be 11.3%.[11]

In the second quarter of 2023, alongside the high inflationary environment, the majority of the central banks of Georgia's trading partners tightened their monetary policies. Such dynamics have continued into July.

In the second 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 May and again in July, the U. S. Federal Reserve raised its federal funds rate in the 5.25-5.5% range, and the European Central Bank further increased its policy rate to 4.25% in June-July period. As for the Central Bank of the Republic of Turkiye, it decided to further increase its monetary policy rate to 17.5% in July.

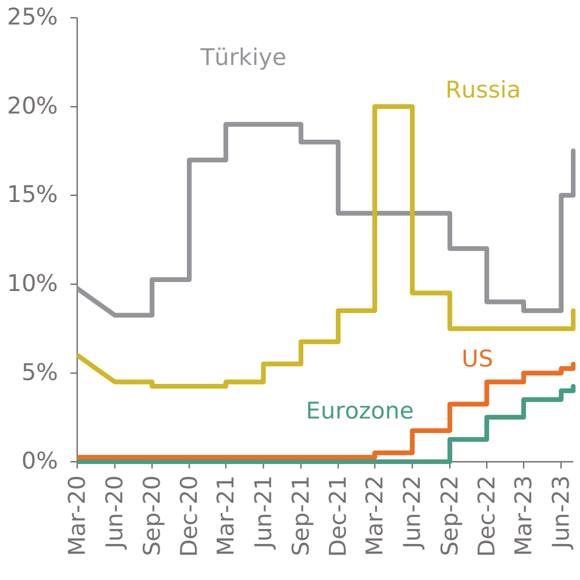


Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.cbrates.com

8 WEO July update, 2023.
9 WEO April, 2023.
10 Ibid.
11 Ibid.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

In the second quarter of 2023, prices continued to decline on international commodity markets. Russia's invasion of Ukraine had initially led to a significant increase in such prices, but these 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 (FAO) of the United Nations decreased by 1.4% in June 2023 compared to the previous month and by 20.9% annually (see Figure 1.1.4). The drop in this index in the second quarter of 2023 was caused by a decrease in prices of sugar, vegetable oil, cereal, and dairy products, while the price of meat remained almost unchanged. Despite the decline, international food prices remain above pre-pandemic levels, and uncertainty about future dynamics continues to be high.

In the second quarter of 2023, the downward trend of food prices continued, although these still exceed pre-pandemic levels.

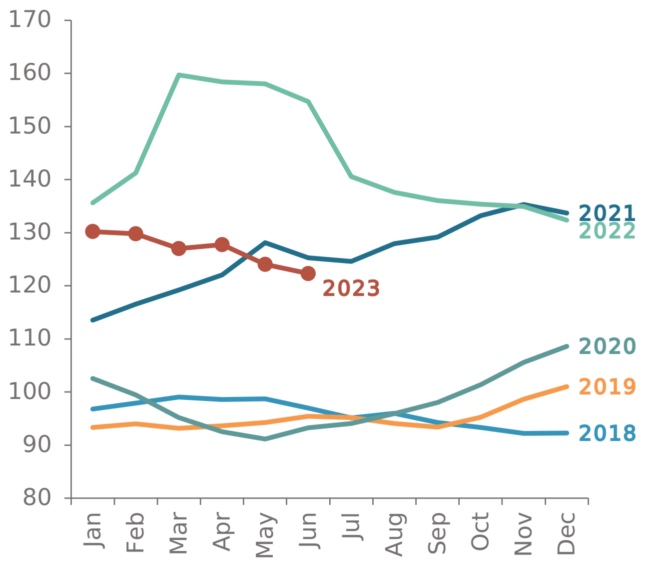


Figure 1.1.4. International food price index

Source: FAO

One of the main factors determining the decline of prices on international commodity markets was the decrease in grain prices. In June, the grain price index decreased by 2.1% compared to the previous month and by 23.9% compared to the previous year. This decrease was driven by increased global supply and related to a global decline in prices for all major grain categories. However, it should be noted that, according to a decision made on 17 July 2023, Russia has pulled out of the Black Sea grain agreement, which will create a significant risk to food security in the Middle East and Africa and may affect the growth of food prices on world commodity markets.

In June, the prices of vegetable oil, dairy products, and sugar on international markets also decreased. The vegetable oil price index fell by 2.4% from the previous month and by 45.3% from the previous year, reaching the lowest point since November 2020. This was mainly due to improved supply as a result of increased production. It should also be noted that the price of sugar decreased in June, which was the first such shift after four consecutive months of increased prices.

After the start of the Russia-Ukraine war, and in light of the sanctions imposed against Russia, a significant drop in oil supply was expected. Oil prices thus rose sharply at the beginning of 2022. However, this year, oil prices have been declining. In June 2023, the average price of Brent oil decreased by 0.4% compared to the previous month and amounted to USD 75.1 per barrel. However, despite this recent decline, oil prices remain 17.0% higher than in the same, pre-crisis period of 2019. Brent oil prices fluctuated slightly in June, and gasoline prices in Europe and Georgia were char-

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

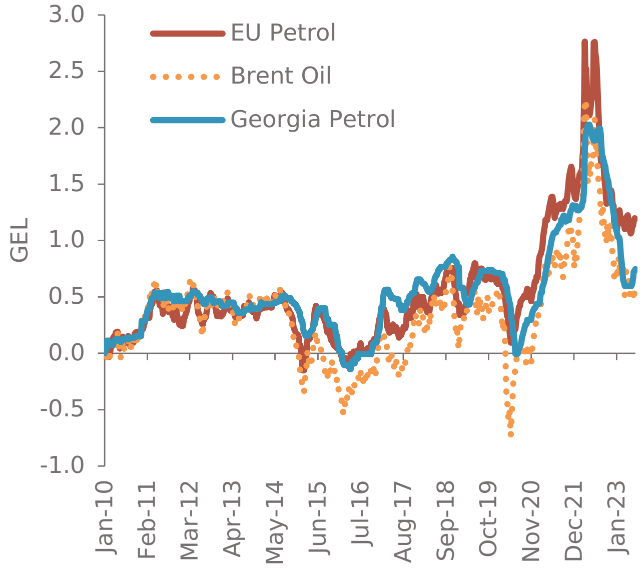


Figure 1.1.5. Petrol price index (Jan 2021=100)

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 continued to decline and has approached pre-pandemic levels.

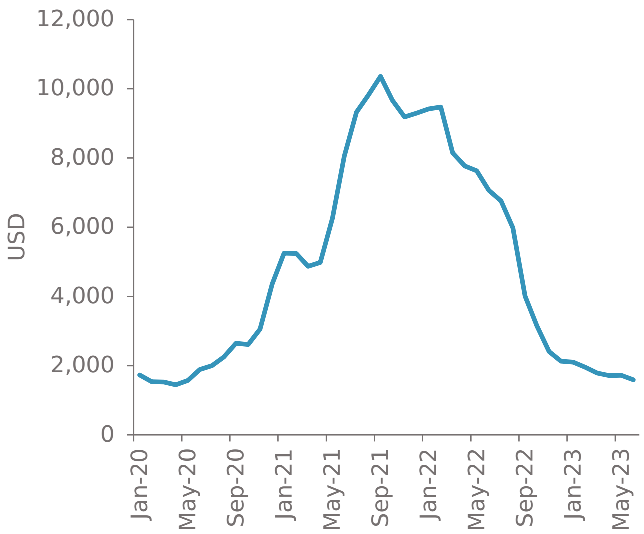


Figure 1.1.6. Average shipping cost of a 40-foot container worldwide

Source: Statista

acterized by similar dynamics (see Figure 1.1.5).

In the European market, the cost of fuel increased by 0.4% in June compared to the previous month. The average price per liter of gasoline in Georgia increased by GEL 0.12 (5.6%) compared to May. According to the updated forecast of the International Energy Association for June 2023, the price of Brent oil is expected to be around USD 79.5 per barrel in 2023 and USD 83.5 by 2024. At the same time, the uncertainty around oil prices on the international market is high. On the one hand, the April decision of the Organization of the Petroleum Exporting Countries (OPEC) to cut oil production increased uncertainty in the market, which resulted in small fluctuations in the prices of crude oil and Brent fuel in Europe, and the risks of rising prices therefore intensified. Given the uncertainty in the market, in June 2023 OPEC left production unchanged, implying a continuation of a cautious, proactive, and preventive approach to maintain this price level in the coming months. On the other hand, Saudi Arabia announced a voluntary cut in oil production by another 1 million barrels per day in July and August – a decision that can be extended.

With the stabilization of fuel prices and the gradual recovery of supply chains, the cost of transportation continues to decline globally. The price of international shipping peaked in September 2021 and has had a downward trend since early 2022, which has had the effect of slowing down imported inflation. In June 2023, freight prices decreased by 7.4% month on month and by 77.5% annually to approach pre-pandemic levels (see Figure 1.1.6).

Against the backdrop of the above-mentioned positive dynamics on international commodity markets, the pressure on inflation emanating from these markets has been eliminated. The resulting reduction of inflation has been further supported by the recent appreciation of the lari.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the second quarter of 2023, external demand remained strong. The main sources of external inflows (exports of goods, tourism, and money transfers) were once again at high levels. Due to the war in Ukraine, international trade is still facing several obstacles. However, due to geopolitical factors, external trade in Georgia is on the rise again. On the one hand, the appreciated lari exchange rate induces a weakness of external competitiveness and, consequently, results in a decline of domestic exports. However, on the other hand, the rising external demand on motors cars from regional countries has induced a rise in re-exports from Georgia. Overall, the latter development outweighed the decline of domestic exports and registered exports of goods increased at a high rate. Simultaneously, the tourism sector has continued to rise gradually. In light of the continued high influx of migrants, the number of international visitors has gained momentum and revenues from travel are thus increasing. In contrast, outflows are again high. As a result of the appreciated exchange rate and strong economic activity, the growth of imports of goods (including real imports) was also high. Because of the lower competitiveness resulting from the appreciated exchange rate, it is expected that the trade deficit will increase, thus negatively impacting the current account balance. According to the updated projections, a moderate worsening of the current account deficit is expected throughout 2023.

Strong external demand has boosted exports of goods.

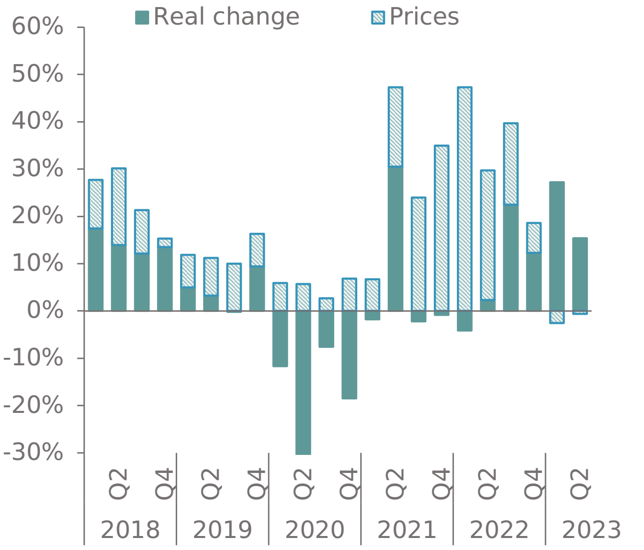


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

Rising external demand induced a rise of exports of goods, however, the decline of domestic exports (which was due to lower sales of ferro-alloys) have slowed down the overall growth of exports. In the second quarter of 2023, registered exports of goods grew by 14.8% annually (see Figure 1.2.1). This growth was mostly driven by rising exports of goods in real terms, while prices of export goods continued to slow.

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

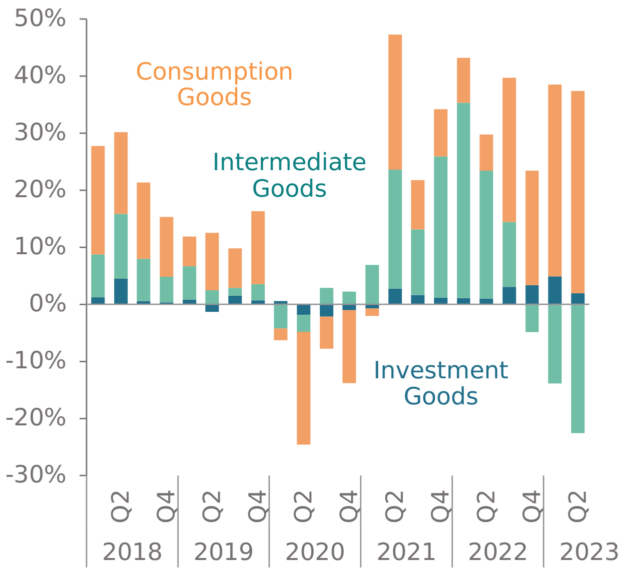


Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

Higher demand for consumer goods was a major contributor to the rise in exports of goods. Meanwhile, investment goods also made a small 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, which, in addition to regional countries, were also resold to central Asian countries. Exports of mineral waters, alcoholic beverages, cigarettes-cigarillos, and grape wines were also substantial. Meanwhile, the lower exports of intermediate goods mainly stemmed from decreased exports of ferro-alloys to the U.S. and Russia, lower exports of copper ores and concentrates to China and Bulgaria, and declined exports of chemical fertilizers to Peru and Armenia. In terms of investment goods, exports of motor vehicles for the transport of tractors, motor vehicles for the transport of goods, as well automatic

Revenues from international travel are on the rise again.

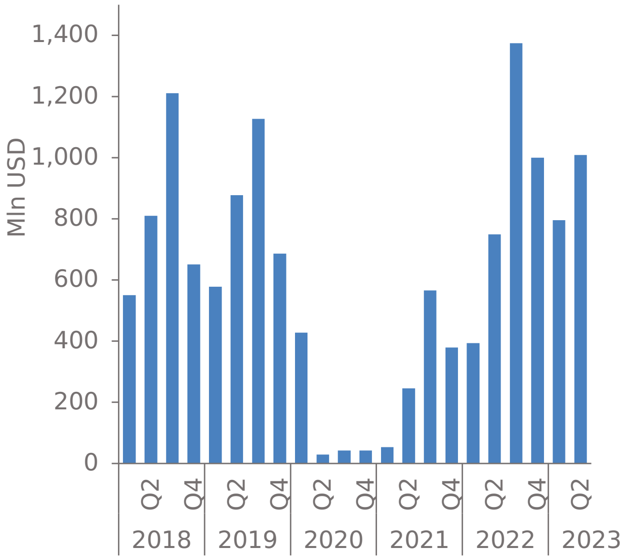


Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG

In the second quarter of 2023, instant money transfers declined annually; however, this was mostly due to the base effect and the volume of transfers remain at a high level.

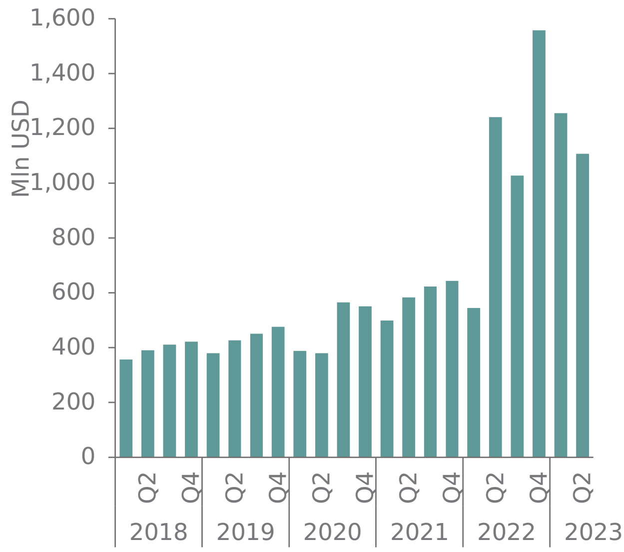


Figure 1.2.4. Annual change in money transfers

Source: NBG

data processing machines and their units each played a leading role in the overall growth.

Given the approaching active tourism season, the number of international visitors to Georgia has been on the rise. In the second quarter of 2023, the number of international visitors rose by 59% annually, but remained below the same period of 2019 (down by 23%). 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.

Given the rise in numbers of foreign visitors and the influx of migrants remaining at a high level, revenues from international travel amounted USD 1 billion, representing annual growth of 34.8% (see Figure 1.2.3). Aside from revenues from regional countries, which were partially related to migration, revenues from visitors from other countries also continued to recover, especially those from Turkey and the EU.

In the second quarter of 2023, instant money transfers to Georgia amounted to USD 1,108 million, which reflects a 10.8% annual decline that is largely related to the base effect (see Figure 1.2.4). Despite the fact that the share of money transfers from Russia continue to be high, an annual decline has been observed and has induced a slowdown of overall growth. It is worth noting that transfers from other countries continued to grow, with transfers from the EU (5.1 pp), the U.S. (2.5 pp) and Israel (0.4 pp) making the largest contributions to total growth.

Due to strong economic activity and the appreciated exchange rate, demand on imports of goods continued to grow. In the second quarter of 2023, the growth of imports of goods reached 11.8% annually (see Figure 1.2.5). From the second half of 2022, the decelerated growth of prices on international markets (on food and energy) was reflected in lower expenses of import goods. Such a trend continued in 2023, with the growth of real imports amounting to 25% in the second quarter.

In the second 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 volume of imports of intermediate goods did not change substantially – a result of a decline in sales of copper ores and concentrates intended for re-export. Meanwhile, purchases of structures of iron and steel, as well as glassware were high. The rise in imports of investment goods stemmed from higher purchases related to increased demand for tractors and increased sales of motor vehicles for the transport of more than ten people.

The rise in imports from regional countries was predominantly related to Türkiye (mostly due to the medicaments) and those from other countries were

During the last period, registered imports of goods moderately increased; however, real imports continued to rise, which reflects the global slowdown of prices.

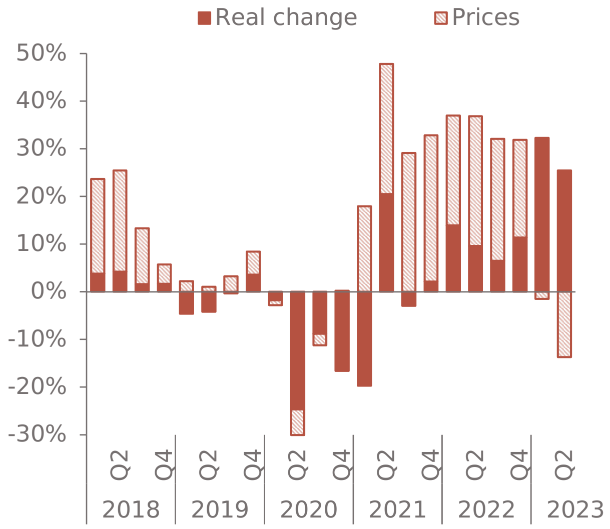


Figure 1.2.5. Annual change in registered imports of goods
Source: GeoStat

In the second quarter of 2023, the rise of imports of goods was mainly due to the growth in imports of consumer goods.

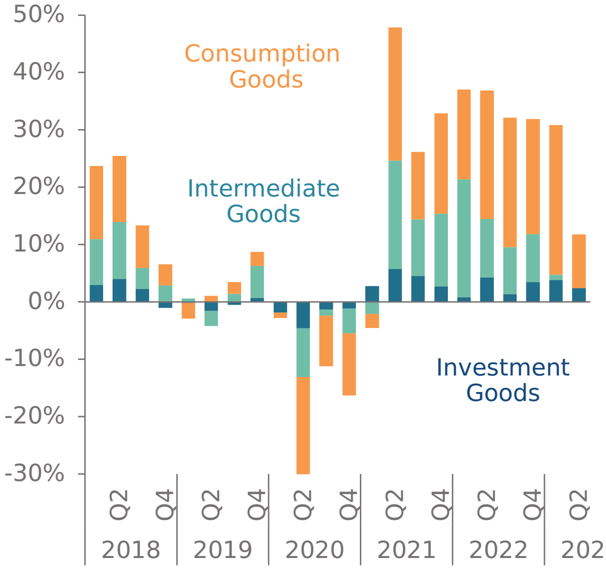


Figure 1.2.6. Annual change in registered imports of goods
Source: GeoStat

related to Germany, the U.S., and Japan (mostly due to motor cars) as well as to China (mostly due to other aircraft vehicles), which made the largest contributions to overall growth. In contrast, imports from Armenia fell due to lower purchases of copper ores and concentrates.

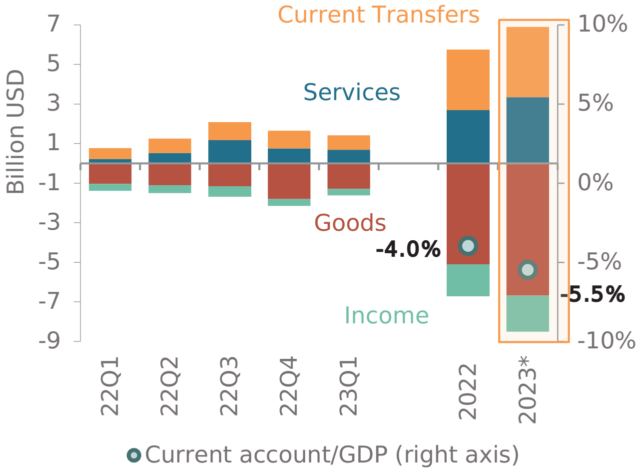
In the first quarter of 2023, high external inflows lowered the current account deficit, which amounted USD 201 million, representing 3.2% of the quarterly deficit. It is worth noting that the improvement of the current account balance mainly stemmed from exports of services, namely from rising revenues from travelers (including migrants[12]), and the steadily increasing volume of workers' remittances from abroad. Revenues from international travel are expected to rise again later in the year. However, the appreciated lari exchange rate will weaken competitiveness and increase the trade deficit. Considering these trends, the ratio of the current account deficit to GDP is expected to rise to 5.5%.

In the first quarter of 2023, the main source of financing the current account deficit was foreign direct investments (FDI). Inward FDI declined by 14% annually and amounted USD 497 million. The majority of FDI, in terms of equity, went to the manufacturing sector. In addition, investments increased in the transport and communications sector, while substantially declined in the energy sector.

From the perspective of savings and investments, in the first quarter of 2023, the annual improvement of the current account balance was due to a substantial increase in savings, rather than being a result of a moderate rise in investments The rise in savings also induces a shrinking of the fiscal deficit (see Figure 1.2.7).

12 By 30 June 2023, a proportion of the Russian, Belarus and Ukraine citizens residing in Georgia are estimated to have been living in the country for over a year (or intend to do so). According to the IMF's methodology, such individuals are considered as Georgian residents and their expenses are thus not included in travel income.

Due to the rise of the trade deficit, the current account deficit is expected to increase in 2023, albeit only moderately in light of the surplus in trade in services.

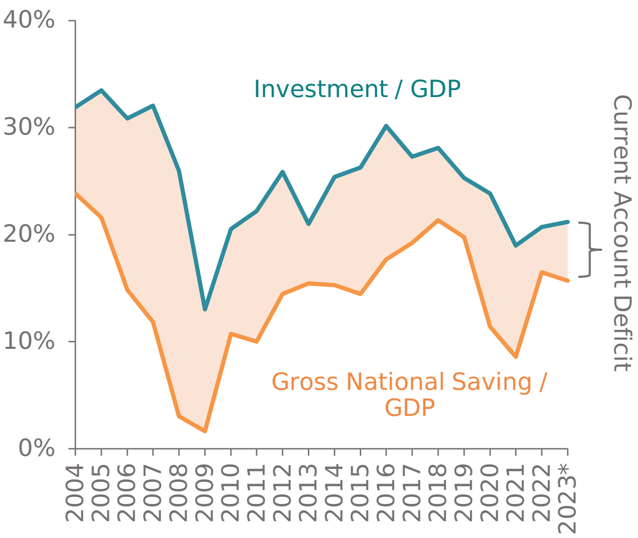


** NBG Forecast*

Figure 1.2.7. Current account balance and its components

Source: NBG

In the first quarter of 2023, the improvement of the current account deficit was mainly due to the rise of savings (along with a decline of the fiscal deficit).



**2023 NBG Forecast*

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 first quarter of 2023, the high growth of the economy was ensured by investments and foreign inflows.

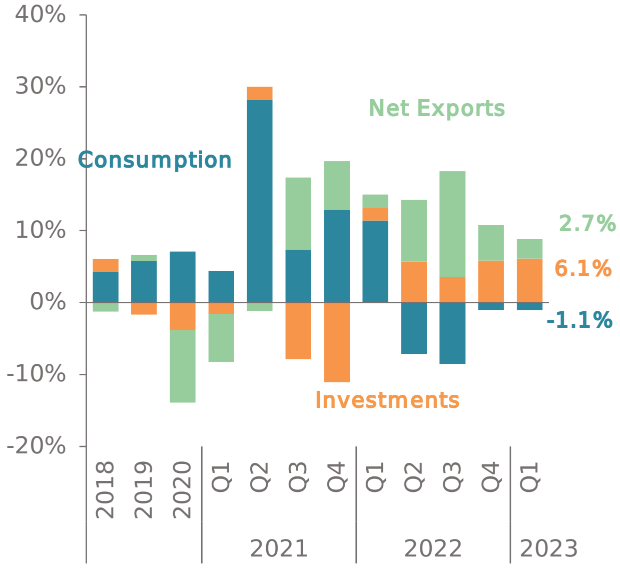


Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the first quarter of 2023, the real Gross Domestic Product increased by 7.7% compared to the corresponding period of the previous year.

Like last year, in the first quarter of 2023, the high growth of the economy was largely due to strong foreign inflows. From 2022, the tourism sector in Georgia has largely recovered. Alongside this, due to the ongoing war in Ukraine, the number of migrants in Georgia has risen significantly, resulting in an attendant significant increase in income from travel. In the first quarter, export of services increased by 54.6% in real terms compared to the corresponding period of the previous year and, in total, exports of goods and services rose by 28.7%. However, along with exports, the growth of imports of goods and services increased, with real growth reaching 17.2%. Due to the increase in imports, the contribution of net exports thus decreased compared to previous periods and amounted to 2.7 pp.

In the same period, investments led real GDP to increase by 6.1 pp. However, contrary to the increasing trend of investments, the contribution of consumption to economic growth has recently been negative – a reflection of slower lending and fiscal consolidation. In the first quarter of 2023, the contribution of consumption to real GDP amounted to a negative 1.1 pp (see Figure 1.3.1).

The high economic growth was again determined by services, which was underpinned by the increased number of foreigners in Georgia.

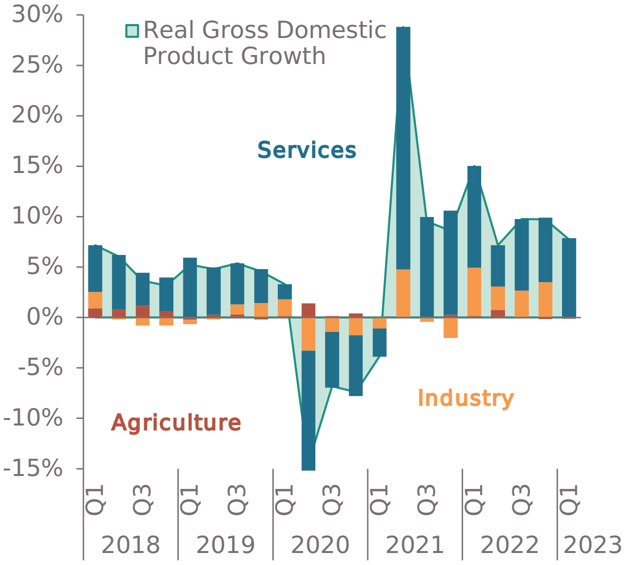


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

1.3.2 OUTPUT

In the first quarter of 2023, services accounted for 7.8 pp of the overall 7.7% economic growth. The contribution of industrial sectors was close to zero, while the contribution of agriculture amounted to a negative 0.1 pp (see Figure 1.3.2).

High economic growth was largely ensured by the foreign sector. The sharp increase in the number of foreign citizens in the country made a significant contribution to the output of the service sector: the combined contribution of trade, transport, accommodation and food supply activities, information and communication, art, entertainment and recreation to economic growth amounted to 4.4 pp.

Among the industrial sectors, the 15.1% growth of construction is notable, which made a 0.9 pp contribution to economic growth.

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

In June, the growth of the annual loan portfolio decreased and equaled 13.5%, excluding the effect of exchange rate fluctuations.

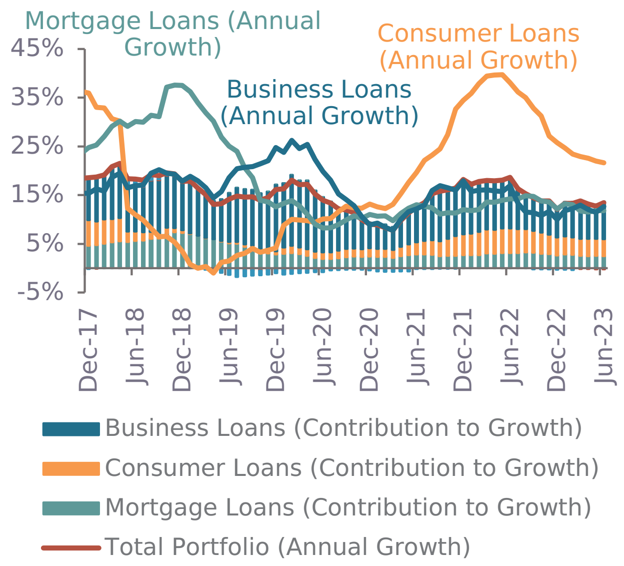


Figure 1.4.1. Loans by pusrpose (excluding the exchange rate effect)

Source: NBG

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

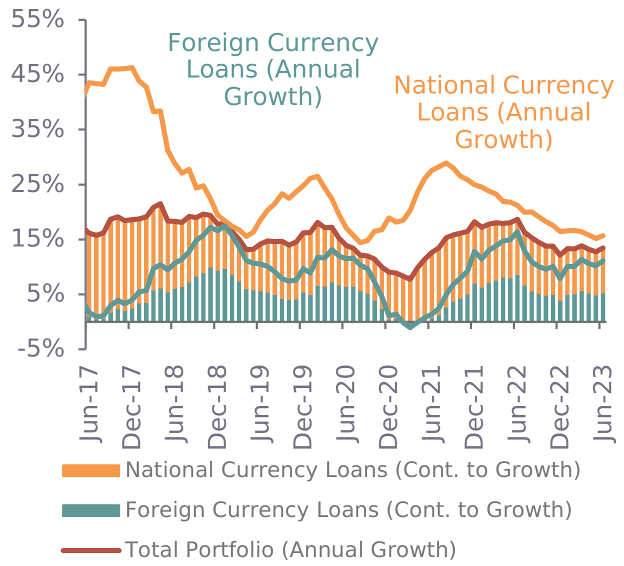


Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

In June, relative to March 2023, the growth of the loan portfolio decreased by 0.4 pp and equaled 13.5% (excluding the effect of exchange rate fluctuations). The slowdown in the growth rate of loans was largely caused by the decrease in the growth of consumer loans, which fell by 1.2 pp as a result of the macroprudential mechanism launched last year. However, the growth rate of consumer loans remains high, amounting to 21.7% in June. Business loans have continued to decrease, with their contribution to total lending falling by 0.2 pp. The contribution of mortgage loans to credit growth practically did not change, with the growth rate increasing by 0.1 pp and equaling 11.8% (see Figure 1.4.1). According to the credit conditions survey[13], representatives of the banking sector expect a slight increase in demand for business loans over the next quarter. In the second quarter of 2023, the growth of the credit portfolio was again largely due to the growth of national currency loans (see Figure 1.4.2). It should be noted that there is a tendency for the growth of both national and foreign currency loans to slow down. In the second quarter, the annual growth rate of national currency-denominated loans decreased by 0.7 pp and equaled 15.7%. The annual growth of foreign currency loans decreased by 0.3 pp, to equal 11.1% at the end of the quarter.

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 both 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.

Relative to the previous month, in June 2023 the dollarization rate increased slightly. Loan dollarization saw a slight 0.3 pp increase and stood at 44.9% (excluding the exchange rate effect). The dollarization of loans to individuals saw practically no change, while the dollarization of loans to legal entities increased by 0.1 pp. Dollarization of total deposits increased by 0.2 pp compared to the previous month and amounted to 51.0% (excluding the exchange rate effect). Over the same period, the dollarization of deposits of individuals decreased by 0.7 pp per month to amount to 66.2%, while the dollarization of deposits of legal entities increased by 0.8 pp and amounted to 38.5%

13 Credit Conditions Survey, 2023 Q2,

Dollarization of both loans and deposits increased slightly.

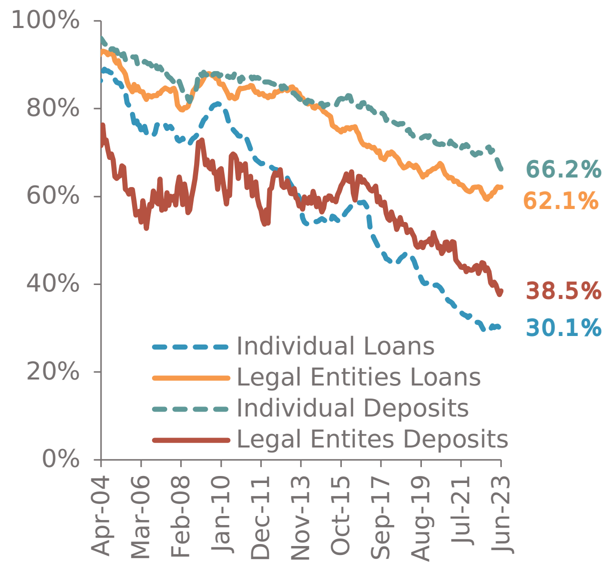


Figure 1.4.3. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG

The NBG has started a gradual exit from its strict monetary policy. As a result of this, in the second quarter of 2023, interest rates on long-term government securities decreased slightly.

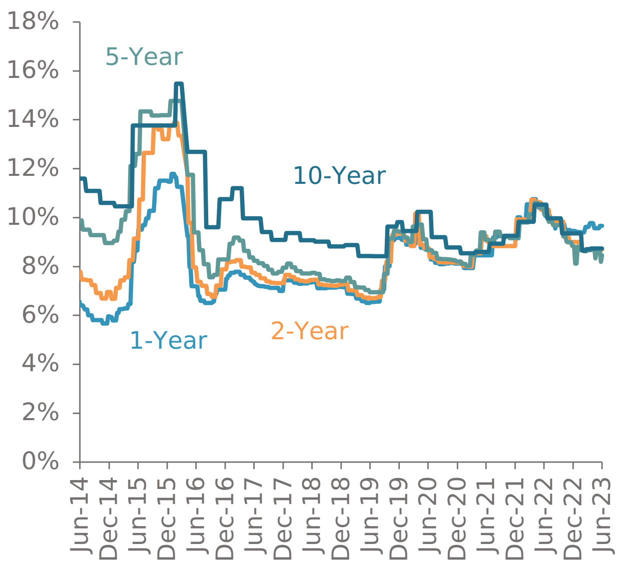


Figure 1.4.4. Interest rates on government securities

Source: NBG

(excluding the effect of the exchange rate) (see Figure 1.4.3).

It is important to continue the process of reducing dollarization. This will be facilitated by, among other things, the macroprudential measures adopted in the recent period and the updated scheme of reserve requirements that increases the motivation of banks to de-dollarize deposits. Reduction of dollarization is an important step in the direction of reducing financial stability risks.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

At the May session of the Monetary Policy Committee, the NBG began a gradual exit from its tight monetary policy. In May, the monetary policy rate was reduced by 0.5 pp and a further reduction is expected by the end of the year. Therefore, in the second quarter of 2023, the rates on government securities decreased slightly (see Figure 1.4.4). Recently, short-term rates have been at a higher level than long-term rates. To some extent this is a reflection of the financial market's inflationary expectations. In the medium and long term, the financial market expects inflation to be maintained at the target rate, as a result of which the policy rate is expected to stabilize around the neutral level of 7% in the long term. In the short term, taking into account the inflationary risks, the monetary policy rate will be kept higher than the neutral rate. Under the conditions of strict monetary policy, the interest rates of the GEL are still at a high level, although they are decreasing slightly. In June, relative to March, interest rates on domestic currency deposits did not change significantly and equaled 11.0%. Interest rates on foreign currency deposits are still low and amount to 1.6%.

As for lending, compared to the first quarter, the average interest rate on loans issued to legal entities in domestic currency decreased by 0.4 pp and equaled 13.7%. At the same time, interest rate hikes by leading central banks have the effect of raising foreign currency interest rates and tightening monetary policy. In particular, the interest rate on foreign currency loans to legal entities increased by 0.4 pp and amounted to 9.4% (see Figure 1.4.6). As a result, the spread between domestic and foreign interest rates narrowed. It is worth mentioning that in June, compared to March, interest rates on consumer loans decreased slightly by 0.2 pp, mortgage loans increased by 0.1 pp, and business loans practically did not change. Rates on consumer, business, and mortgage loans amounted to 16.4%, 11.4% and 10.1%, respectively.

According to the credit conditions survey, in the second quarter of 2023, compared to the previous quarter, lending conditions for business loans in foreign currency tightened slightly, which was mainly caused

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.

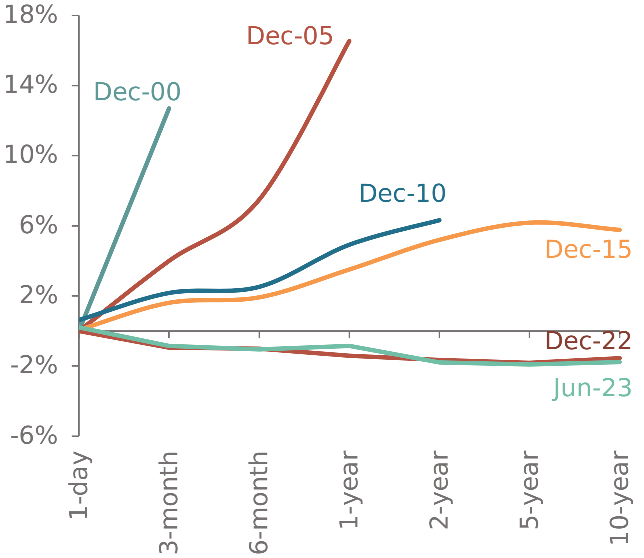


Figure 1.4.5. Spread between the monetary policy rate and the yield curve

Source: NBG

As a result of maintaining a tight monetary policy, interest rates on GEL loans remain at a high level, although they are decreasing slightly. At the same time, the increase of interest rates by leading central banks raise interest rates of foreign currency loans and has the effect of tightening monetary policy in Georgia.

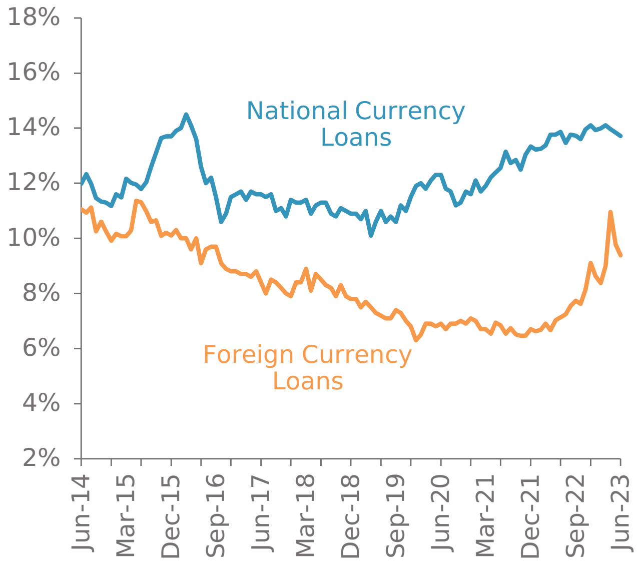


Figure 1.4.6. Average interest rates on business loans

Source: NBG

by an increase in the cost of financial resources. Representatives of the banking sector still expect a slight further tightening of interest conditions for lending in foreign currency over the next quarter. However, it should be noted that the change in monetary policy has had a positive effect on the softening of lending conditions.

1.4.3 EXCHANGE RATE

In the second quarter of 2023, the lari exchange rate continued to appreciate. The GEL nominal exchange rate appreciated against the US dollar and the euro by 3.0% and by 1.5% respectively compared to the previous quarter. The GEL also continued to appreciate against the Turkish lira (11.4%) and the Russian ruble (12.6%). Over the same period, the nominal effective exchange rate appreciated by 6.5% on a quarterly basis and by 28.8% on an annual basis. In terms of the price-adjusted exchange rate, in the second quarter of 2023 the real effective exchange rate appreciated by 3.4% on a quarterly basis and by 17.3% on a year-on-year basis (see Figure 1.4.7). The annual appreciation was due to the appreciation of the nominal effective exchange rate. However, the reduced competitiveness of the economy due to the nominal 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 1.4.8). It should be noted that, according to the latest data, the lari real exchange rate has appreciated against the currencies of all major trading partners (see Table 1.4.1).

The real effective exchange rate remains appreciated. In the second quarter of 2023, the annual appreciation was 17.3%.

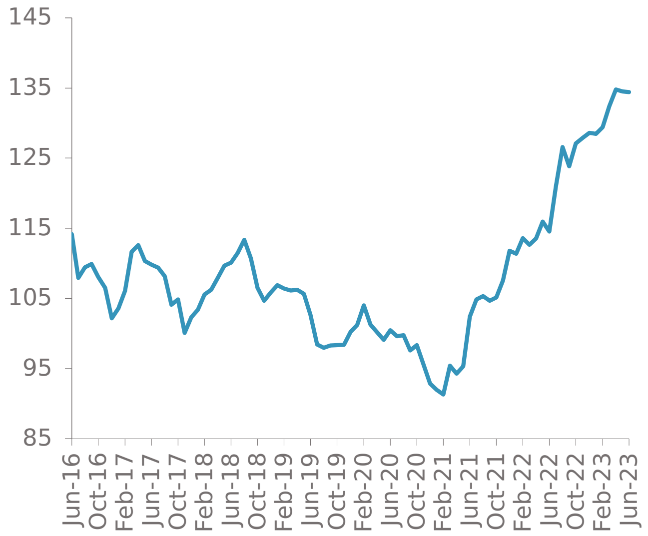


Figure 1.4.7. Real effective exchange rate (Jan 2008=100)

Source: NBG

The annual appreciation of the GEL real effective exchange rate was caused by the appreciation of the nominal effective exchange rate and the increase in local prices. In contrast, lower inflation in Georgia, as compared to its trading partners, tends to depreciate the real exchange rate, which is good for competitiveness.

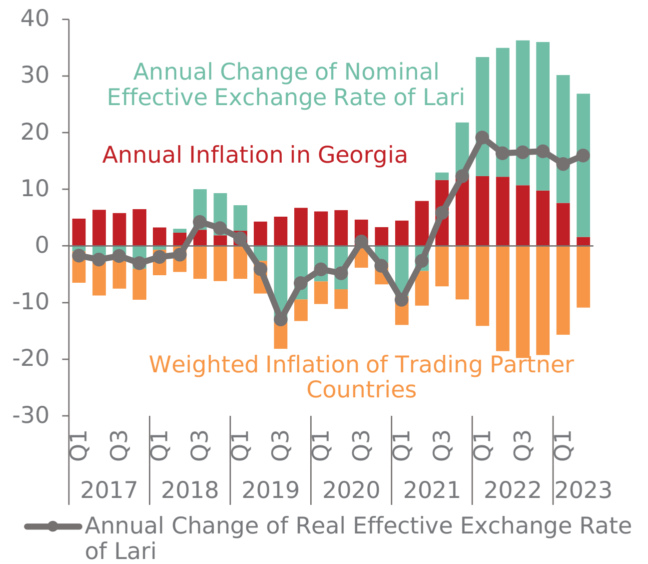


Figure 1.4.8. Decomposition of the annual change of the GEL real effective exchange rate*

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 the real appreciation of the lari against all major trading partner currencies.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate*	**28.8**	**17.3**	**17.3**
Eurozone	14.8	9.8	1.6
Türkiye	54.3	11.6	2.2
Ukraine	46.4	29.0	1.0
Armenia	0.7	0.9	0.1
US	17.1	14.4	1.2
Russia	41.1	39.6	6.7
Azerbaijan	17.3	6.7	0.6
China	24.3	26.1	3.3
Bulgaria	14.8	5.9	0.2
Poland	12.3	0.8	0.0

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

Source: NBG

* Growth implies appreciation of the lari

1.5 LABOR MARKET

In the first quarter of 2023, the country's economic productivity (real value added per employee) rose by 5.0% on a yearly basis (see Figure 1.5.1). Over the same period, the nominal wage growth for employed workers was 18.7%, and the average monthly gross wage reached GEL 1,717.

Due to the lower growth rate of productivity compared to wage growth, the annual growth of unit labor cost is still high and amounted to 13.1%. However, it should be noted that in the first quarter of 2023, compared to the previous quarter, the growth rate of wages decreased, which also slowed down the increasing unit labor cost trend. Therefore, at this stage, there are no clear signs of the development of a wage-price spiral. However, the still-high level of unit labor cost means that inflationary pressure from the labor market remains a noteworthy factor (see Figure 1.5.1).

The annual growth rate of unit labor cost has slowed down, although it remains high at 13.1%, leaving inflationary pressures from the labor market as a factor to watch out for.

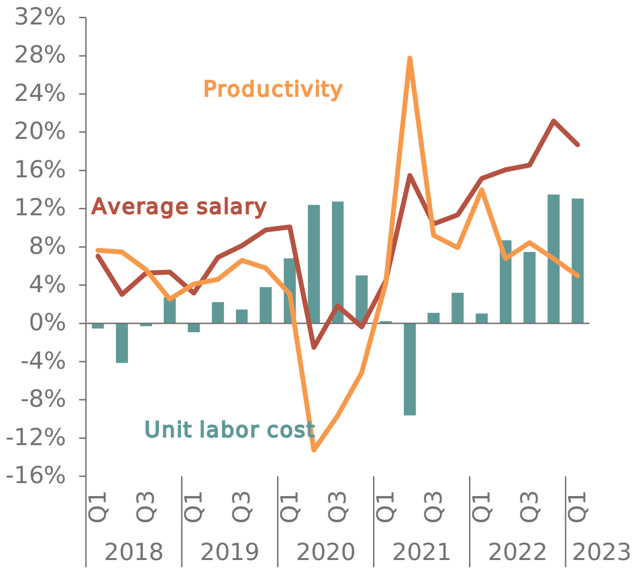


Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat

BOX 1. CONTRIBUTION OF PROFITS AND WAGES TO INFLATION

Consecutive economic shocks, the disruption of supply chains caused by the pandemic and the Russia-Ukraine war have created global inflationary pressures. Although inflation has passed its peak in many countries and has a downward trend, it remains a major challenge throughout the world. Considering this, it is necessary to monitor the factors affecting inflation and to study the main drivers causing prices to rise. Together with many other indicators, we present a description of the contribution of profits and employee compensation to inflation dynamics. While analyzing the main causes of inflation, policy makers pay particular attention to the dynamics of profits and wages[14]. The decomposition presented in this box is the straightforward extension of GDP deflator calculations[15], which is the measure of prices for locally produced goods and services. In turn, there is a strong linkage between the inflation of the GDP deflator and the CPI (see Figure 1.5.2).

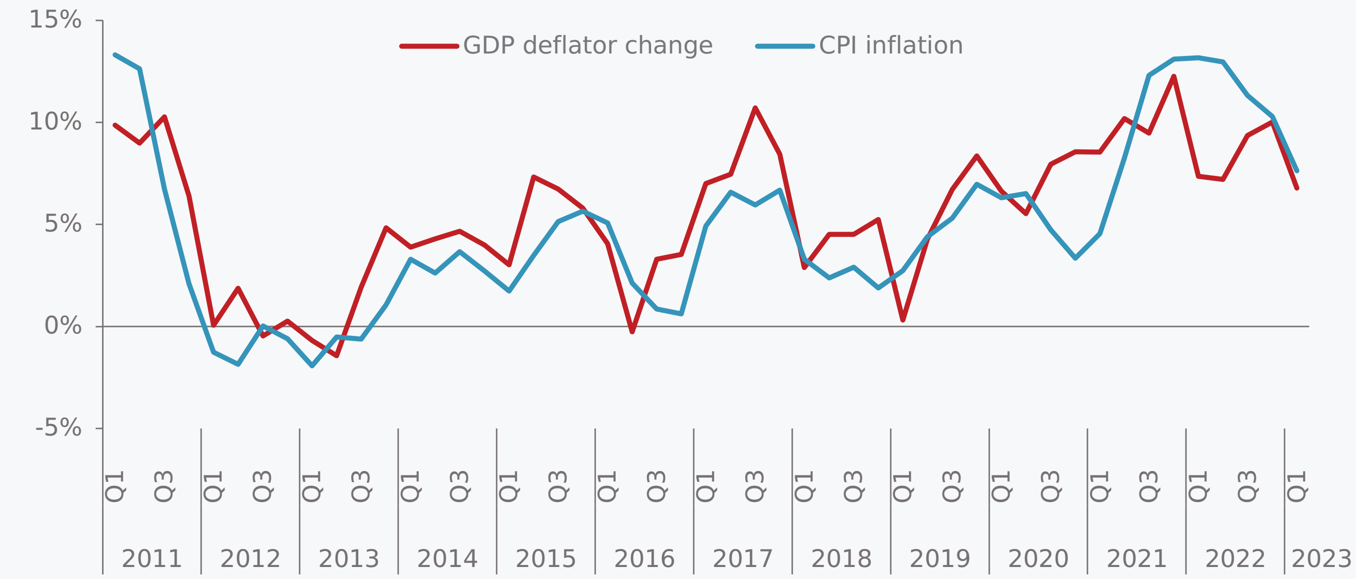


Figure 1.5.2. Annual change of CPI and GDP deflator

Source: GeoStat

In general, when aggregate demand rises, both prices and company profits follow. However, later, when inflationary pressure evolves, employees have the stimulus to ask for higher compensation, which, if granted, causes wages to rise. In this situation, two scenarios are possible:

1. Since higher wages imply higher nominal unit labor costs for employers, companies further increase their prices to maintain high profit margins. In the literature, this is known as a wage-price spiral. In this scenario, we may observe that fast growing nominal profits and wages eventually make a larger contribution to inflation.
2. Employees demand higher wages and companies satisfy their needs by reducing the growth of their profits. In this case, inflation, which was initially caused by increased profits, will decline, even though the wage increase will be high during transition.

Based on the recent data, the analysis presented in this box addresses which of these two scenarios is more probable in Georgia. As shown in the GDP deflator decomposition (Diagram 1.5.3), the increase in the overall price level during the pandemic was indeed associated with higher profits. Pandemic-related rules and prohibitions, alongside bottlenecks in supply chains, made some products scarce and this deficit encouraged producers to increase prices. Later, price pressures became more acute when pent-up demand was released as a result of the lifting of regulations. By that time, the supply chains were still weak and pent-

14 For example, in an interview, Philip Lane, a member of the ECB council, noted that company profits are unusually high (source); while his colleague, Fabio Panetta, is more concerned with profit-price spiral risks (source).

15 Gross National Product represents the sum of incomes of economic units (profits of companies, compensation of employees, net taxes, and other income). By construction, it helps evaluate the weight of each component on GDP deflator inflation.

up demand gave stronger stimulus for companies to increase their prices (and, consequently, raise their profits). A similar effect resulted from the Russia-Ukraine war-related migration waves. Taken together, these factors explain why producers increased prices, which led them to higher profits.

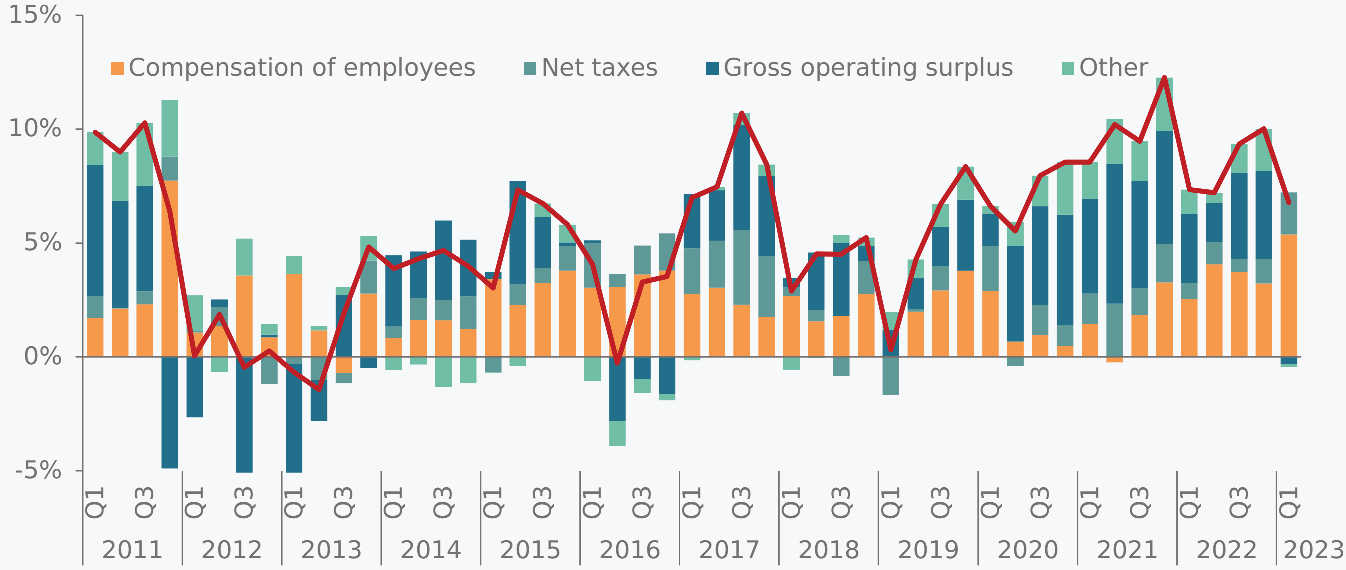


Figure 1.5.3. Decomposition of GDP deflator inflation

Source: GeoStat, NBG calculations

It should be noted that as a result of higher prices and strong inflationary pressures employees started to negotiate for higher wages. An important factor that had a significant impact on wage-increase decisions was the labor market tightness.[16] To keep or attract a qualified labor force, companies started to increase the compensation offered. However, the main question posited above is still open: given the two aforementioned scenarios, in favor of which does the data support? In which way did companies choose to satisfy the demand for higher wages? As shown in Figure 1.5.3, companies decided to increase compensation to employees while giving up some portion of their increased profits. This decision indicates that, with sufficiently high probability, the development of a wage-price spiral in Georgia is not realistic. Despite this conclusion, the NBG retains a cautious stance and will only gradually loosen its strict monetary policy so as to minimize the risk of inflationary processes.

16 A tight labor market indicates that companies face difficulties in finding a qualified workforce because of low unemployment and the scarcity of sufficiently skilled workers. More information on labor market tightness can be found in the Monetary Policy Report of Q1, 2023 (link).

Inflation continues to fall in Georgia. In June, annual inflation decreased to 0.6%. This decrease was mainly caused by reduced prices on international markets, together with the strengthened exchange rate. The tightened monetary policy also contributed to the decrease of inflation.

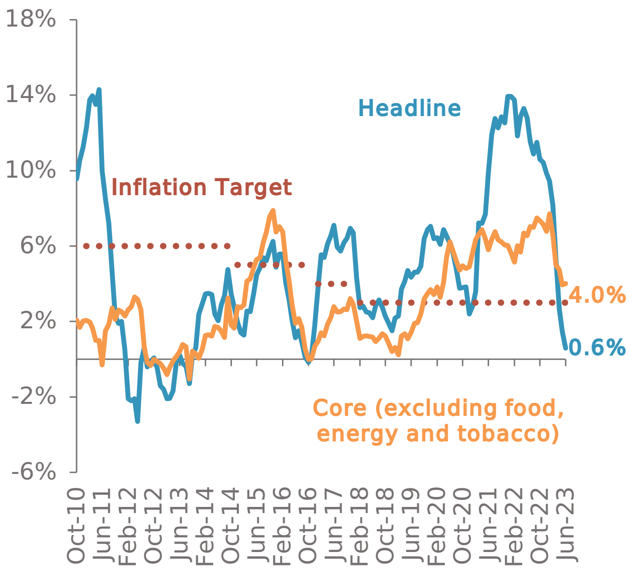


Figure 1.6.1. Headline and core inflation

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.

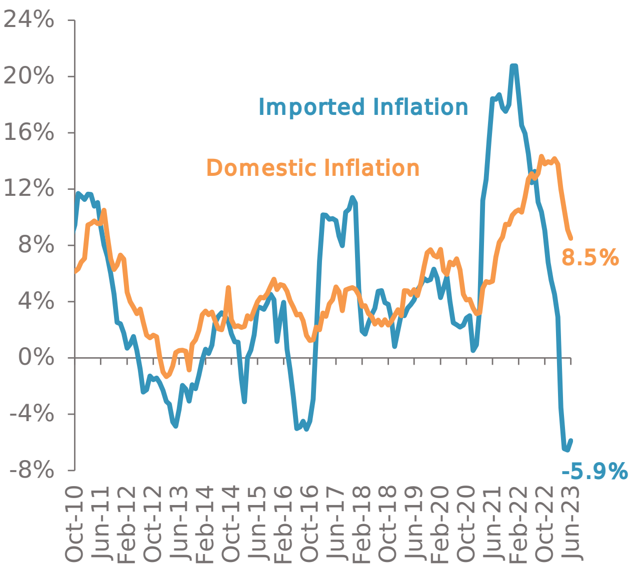


Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

1.6 CONSUMER PRICES

Inflation in Georgia is falling faster than expected and is lower than the target rate. In June, annual inflation decreased to 0.6%. Core inflation, which excludes highly volatile food, energy, and cigarette prices from the consumer basket, equaled 4.0% (see Figure 1.6.1).

The decline in inflation is largely due to the gradual elimination of exogenous shocks. Prices on international commodity markets have a decreasing trend. The price of transportation is also decreasing and is approaching pre-pandemic levels. These developments, together with the strengthened lari exchange rate, reduce the prices of imported goods in Georgia.

In June, prices of imported products decreased by 5.9% year on year. This was also supported by the tightened monetary policy maintained during the year. As a result, the inflation of domestically produced products has a declining trend, although it remains high and amounted to 8.5% in June (see Figure 1.6.2).

High domestic inflation is largely related to the increase in the price of services, of which the highest contributions were made by the increase in prices of banking services, apartment rent, notary tax, and cafes and restaurants. Of the 8.5% local inflation in June, 5.4 pp came from services. The high inflation in services is partially a result of a sharp increase in the number of foreigners in the country and a reflection of increased pressure on prices.

In terms of groups, inflation was mostly reduced by cheaper fuel and medicine. Despite the recent increase in the price of gasoline, in June, gasoline and diesel were by 30.3% and 31.9% cheaper year on year, respectively, and their negative contribution to inflation totaled 1.7 pp. Meanwhile, the decrease in the price of the healthcare group was due to the decrease in the prices of widely used medicines, the total contribution of which was a negative 1.0 pp to inflation.

A reduction was also observed over the last months in food prices (which is the largest group). In June, compared to the previous year, food prices decreased by 0.6%, which contributed a negative 0.2 pp to total inflation.

The impact of other products on inflation is still high, where services are included along with other components. This fact, to some extent, reflects a realization of so-called "second round" effects and implies the need for tight monetary policy (see Figure 1.6.3).

Inflation was mostly reduced by cheaper fuel and medicine.

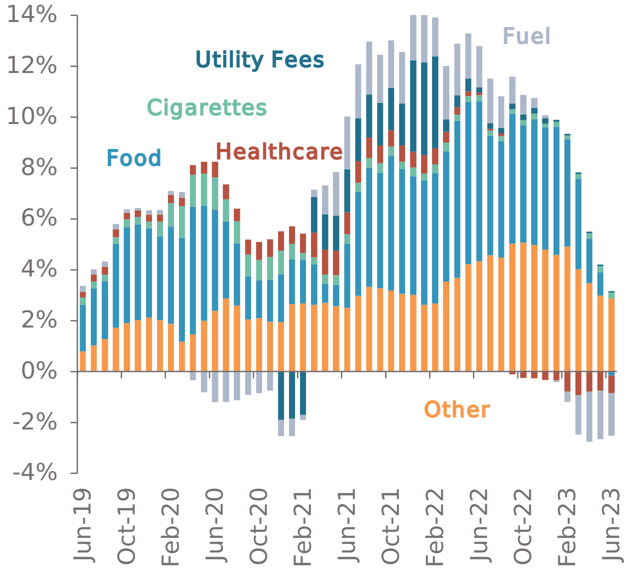


Figure 1.6.3. Contribution of different products to inflation

Source: GeoStat

2 MACROECONOMIC FORECAST

In 2023, inflation will decrease at a faster pace than had been expected in previous quarters. It will stay somewhat below its 3% target in the short term, then it will temporarily overshoot the target due to the base effect to eventually hover around it in the medium term. The rapid reduction of inflation is facilitated by the appreciated GEL exchange rate fueled by strong foreign inflows, the cheapening of commodity products on international markets, and the normalization of short-term inflation expectations. In contrast, in the short term, strong external demand partly boosts domestic demand, which puts upward pressure on inflation. Amid the faster-than-expected recovery of the economy's potential in the post-pandemic period, real GDP growth will be around 6% in 2023 and 5% in 2024 under the current baseline scenario. Despite the recent rapid disinflation, 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. These would imply a sharp tightening of monetary policy and, if necessary, the use of additional instruments.

In the short term, inflation is expected to remain below the target. However, next year it will temporarily exceed the target, largely as a result of the base effect from the current year, and will subsequently stabilize around it.

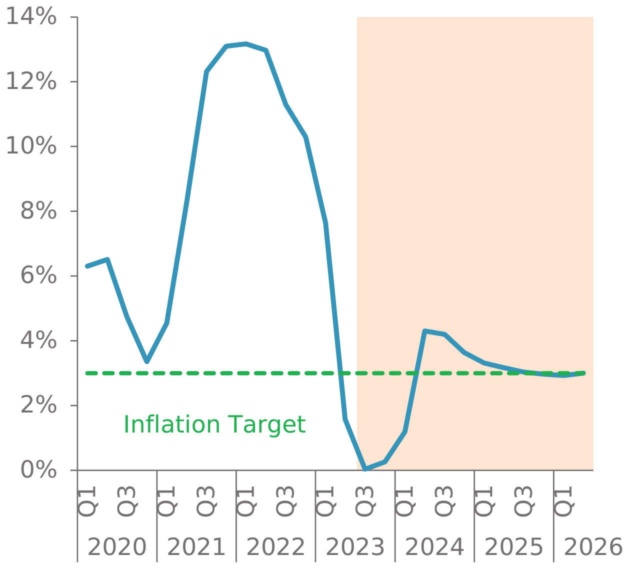


Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

2.1 BASELINE MACROECONOMIC FORECAST

In the second quarter of 2023, annual inflation continued falling faster than had been expected and amounted to 1.6%. The rapid drop in inflation was driven by the appreciated GEL exchange rate and falling international commodity prices, the total effect of which outweighs the inflationary pressure stemming from demand. Accordingly, short-term inflation expectations have been revised slightly downwards compared to the previous projection. In particular, according to the updated baseline forecast, other things being equal, inflation will continue to decrease in the second half of 2023 and will be around 2.4% on average in the year as a whole (see Figure 2.1.1). Given the base effect of the current year, inflation will then slightly exceed the target level in 2024 before stabilizing around it.

The below-target deviation of expected inflation is largely driven by the appreciated exchange rate, which, in turn, is fueled by strong foreign inflows and ultimately offsets the inflationary pressure coming from strong domestic spending. The effects of both the appreciated exchange rate and strong demand will slowly fade away amid the anticipated normalization of foreign inflows (see Figure 2.1.2), which will help to bring inflation closer to the target.

Alongside the aforementioned factors, the rapidly decreasing inflation is also driven by declining short-term inflation expectations. In addition, the prices of international commodity products have been stabilizing. In particular, international Brent oil prices have already fallen below pre-war levels, and the international food price index continues to decline. However, *The downward deviation of inflation from its target has been driven by the appreciated GEL exchange rate and decreasing international food prices, the total effect of which outweighs the inflationary pressure stemming from demand. Other things being equal, both effects will start to fade away from next year, which will help inflation to stabilize around the target.*

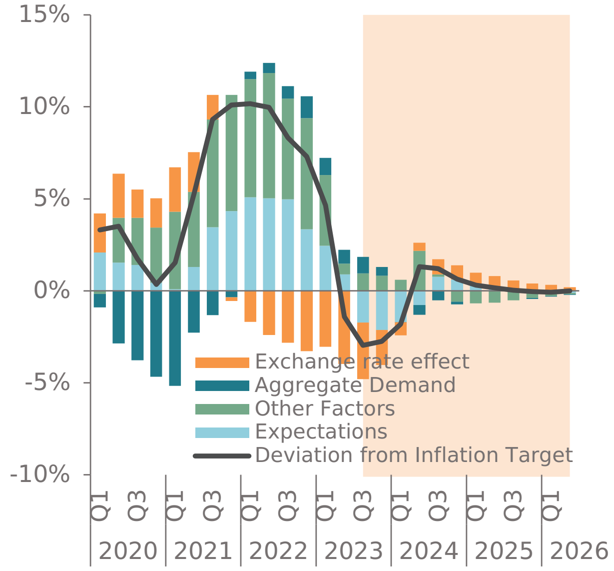


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the baseline scenario, investments and domestic demand will spur growth of around 6% this year.

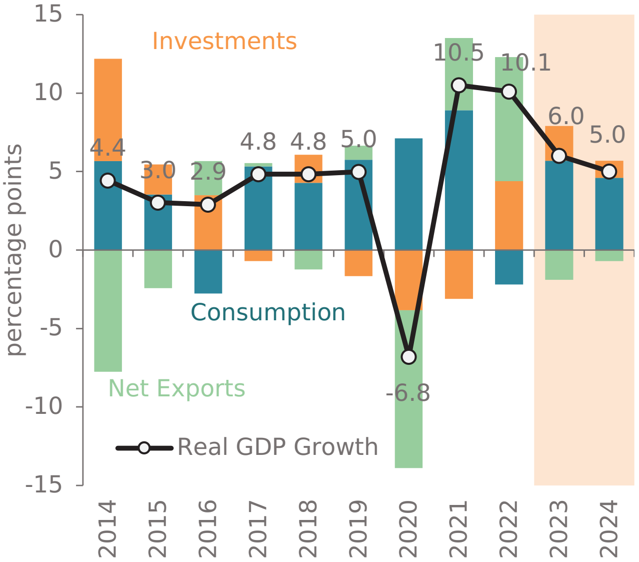


Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

it should be noted that the situation in international commodity markets is characterized by high volatility, which can lead to prompt changes being made to the forecasts of reputable international organizations. In particular, the U.S. Energy Information Administration (EIA) has revised its forecasts for 2023-2024 upward after the recent announcement from OPEC about the extension of oil supply restrictions. Therefore, other things being equal, rising international oil prices may strengthen inflationary pressures once again.

As for economic activity, according to the current forecast, the economy will grow by 6% in 2023, ceteris paribus. It is worth noting that expectations about economic activity have improved compared to those of the previous forecast, which is largely explained by the faster-than-expected recovery of the economy's potential in the post-pandemic period. In particular, the rising productivity of production factors and investments are spurring the acceleration of potential growth in the current period. In addition, the sovereign risk premium is expected to stabilize around a sustainable level amid the adoption of adequate macroeconomic policies, which will boost investments and positively reflect economic activity. At the same time, solid foreign inflows owing to the recent geopolitical situation reinforce domestic spending. In addition, the base effect from last year will result in domestic demand making a high contribution to economic growth this year. If economic growth was mainly driven by foreign demand in 2022, it will be boosted by domestic consumption and investments this year (see Figure 2.1.3).

It should be noted that the situation is rapidly changing in the wake of high uncertainties from both global and, especially, regional perspectives. Even though inflation is quickly converging with its target, and is even falling below it in the short run, the National Bank of Georgia takes into consideration the risks to the baseline scenario and will continue to only decrease the monetary policy rate at a moderate pace in accordance with the current baseline forecast. Thus, the monetary policy rate will approach the neutral level (currently estimated at 7%) in the medium term in parallel with the mitigation of existing inflationary risks.

2.1.1 BASELINE FORECAST SCENARIO RISKS

Despite rapid disinflation in Georgia, the uncertainty surrounding the Russia-Ukraine war and the adverse effects of still-high global inflation continue to pose exceptional risks.

Macroeconomic Forecast Risks	Impact on Inflation
A sharp decrease in Russia-Ukraine war-related inflows and a deterioration of the current account balance	↑
Strong domestic demand	↑
Credibility shock and aggravation of a wage-price spiral	↑
Limited supply of commodity products for 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

Despite positive trends, against the backdrop of sluggish global economic growth, still-elevated and above-target global inflation, and the uncertainty surrounding the Russia-Ukraine war, macroeconomic forecasts continue to be characterized by exceptional uncertainty and risks. The realization of these risks will lead to a deviation from the baseline macroeconomic forecast and will require an appropriate policy response.

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. Further escalation of the war could significantly increase the riskiness of the region and divert migration-related flows to other countries. As a result, 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. This may also lead to the imposition of new international sanctions against Russia and/or the tightening of existing ones, which will result in additional supply restrictions and an increase in prices of commodity products on international markets. If these risks are realized, monetary policy will tighten compared to the baseline scenario to ensure the stabilization of long-term inflation expectations and to mitigate the potential impact of the shock.

Despite the recent disinflation, against the backdrop of a prolonged period of high inflation in Georgia, additional strong inflationary pressure could elevate long-term inflation expectations and increase the likelihood of a credibility shock. Among other consequences, this would intensify pressures coming from the labor market. The realization of this risk, compared to the baseline scenario, would necessitate policy tightening to prevent long-term inflation expectations from deviating from the target rate.

Amid significantly increased foreign inflows, strengthened local consumption also holds particular importance. Despite signs of a faster-than-expected recovery of potential GDP, if economic activity exceeds its potential further and for a protracted period, the threat of the economy overheating will put pressure on inflation as well. Inflation arising from the demand side will be neutralized by adopting a relatively stricter policy stance.

In contrast to the above-mentioned risks, an additional increase in the probability of a recession in developed countries may exert downward pressure on inflation and the policy rate. Specifically, this would lead to a slowdown of policy tightening (or a reduction), by the central banks of these countries, which would result in their currency depreciation and an attendant strengthening of the currencies of developing countries.

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expected inflation over the forecast horizon has improved slightly. The main sources of this change are external factors and improved expectations.

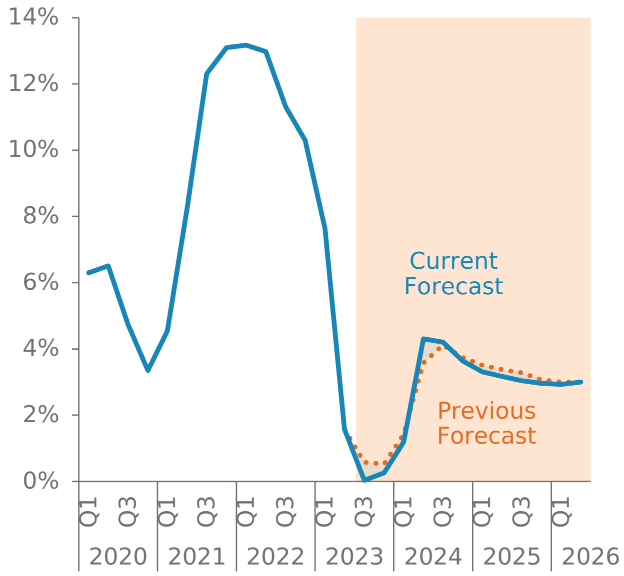


Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

According to the updated forecast, expected inflation over the forecast horizon has improved slightly (see Figure 2.2.1). This improvement in the inflation outlook is primarily driven by the improvement of external factors and local short-term expectations. Notably, oil prices on international commodity markets have recently declined more than had been anticipated. Alongside this, the exchange rate has strengthened more than had been expected, leading to a greater-than-predicted reduction in imported inflation. As a result, under the current forecast, inflation will decline further in the second half of 2023 and will then stabilize close to the target towards the end of 2024, after adjusting for base effects.

Against the backdrop of a faster recovery of its potential level, the economy will grow by 6% in 2023, which means a 1 pp acceleration of growth compared to the previous forecast.

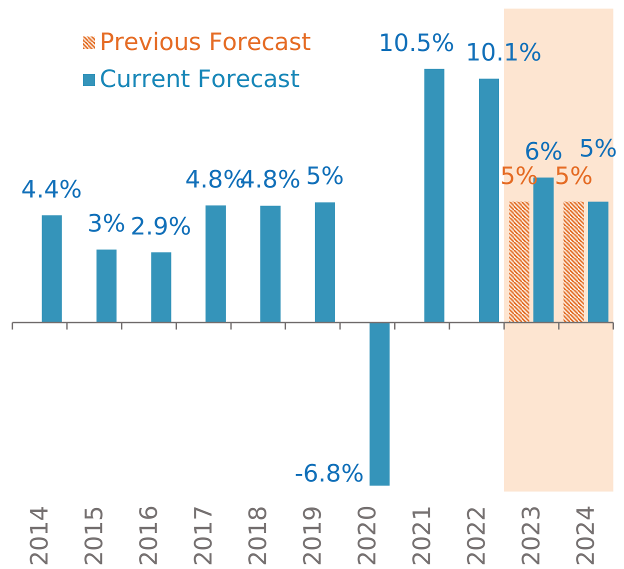


Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

According to the updated forecast, real GDP growth will accelerate by 1 percentage point to 6% in 2023 (see Figure 2.2.2). The improvement in the forecast is primarily driven by the accelerated recovery of the economy's potential level, along with increased consumption driven by sustained foreign inflows, and enhanced investment expectations.

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

According to the updated forecast, the inflation outlook for all major trade partner countries has improved for 2023 (see Figure 2.2.3). The primary driver for the change in economic growth and exchange rate expectations is the revised outlook for the Russian economy. By 2024, the forecast of the inflation and economic growth of trading partners worsens, while that of their exchange rates improves.

In the updated forecast, the 2023 outlook for inflation and economic growth in Georgia's trading partners has improved, while that for their exchange rates has worsened.

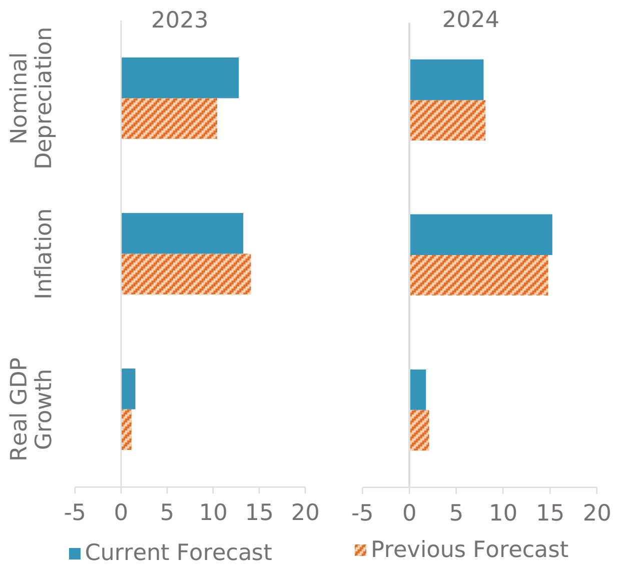


Figure 2.2.3. Changes in assumptions about trading partners

Source: Bloomberg, NBG

According to the alternative scenario, with the realization 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 5% in 2023 and 3% in 2024.

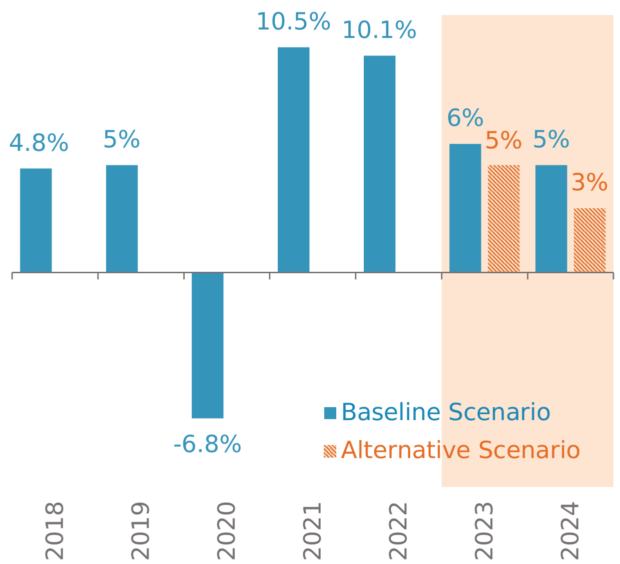


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

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. It is worth noting that this situation will be further exacerbated by the increased riskiness of the region, which will accordingly affect the country's risk premium and will temporarily put pressure on the neutral interest rate to increase.

In the case of the materialization of this less probable scenario, economic activity will undergo a substantial slowdown, with projected GDP growth rates of 5% and 3% for 2023 and 2024, respectively (see Figure 2.3.1).

Under this scenario, as compared to the baseline, the lari 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 depreciation 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. Against the backdrop of prolonged high inflation in Georgia, and despite the recent disinflation, additional strong inflationary pressure could increase the likelihood of a credibility shock, which in turn could de-anchor long-term inflation expectations. This will, among other things, intensify pressures from the labor market, generate a wage-price spiral, and worsen the inflation outlook. The inflation outlook could be further worsened by a deceleration in the decline of prices on international commodity markets.

In the case of the realization of this acute, albeit less likely, scenario, inflation in 2024 will be an average 1.5 percentage points higher than the baseline scenario (see Figure 2.3.2), even though the alternative scenario assumes a much tighter monetary policy stance.

The National Bank of Georgia has the lowest tolerance to this scenario and its realization would thus imply a sharp tightening of monetary policy and the use of additional instruments as necessary. Compared to the baseline scenario, in the alternative scenario the trajectory of the monetary policy rate in 2024 will shift upward by an average of 2 percentage points and will only gradually normalize in an environment of increased risks 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 lari exchange rate will depreciate and inflation will increase. As a result, in the medium term, the convergence of inflation to the target will be postponed, which, in turn, will further worsen the inflation outlook through a wage-price spiral.

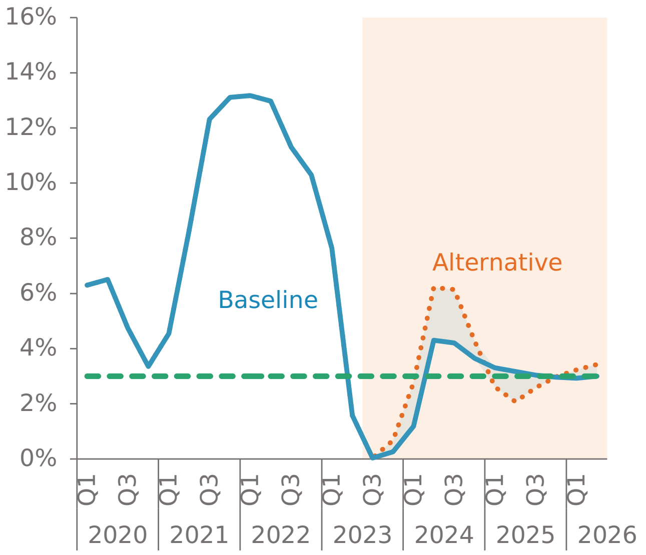


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

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

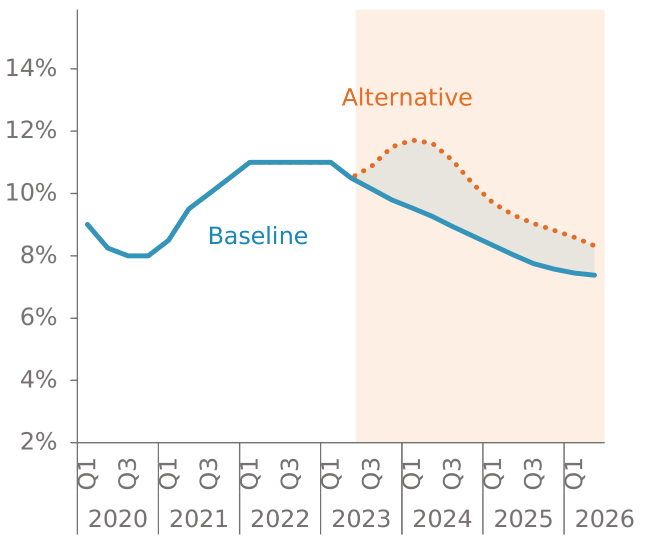


Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

The inflation expectations of financial market participants are lower compared to those of the previous quarter, similar to the forecasts of the NBG.

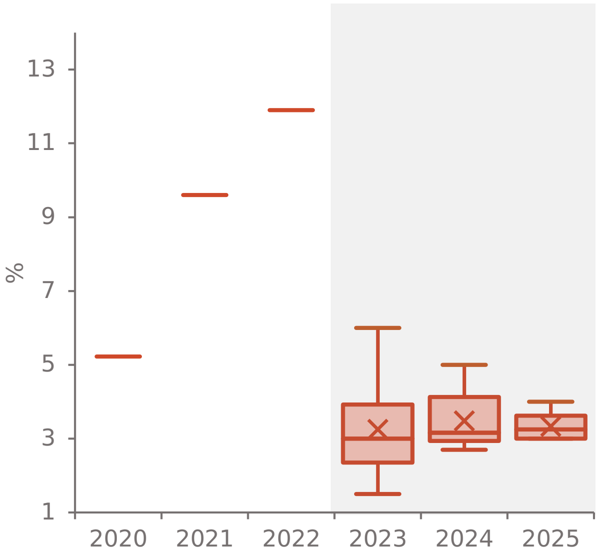


Figure 2.4.1. Actual average inflation (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

Amid reduced inflation expectations, financial market participants have slightly revised their expectations for the monetary policy rate compared to the previous quarter.

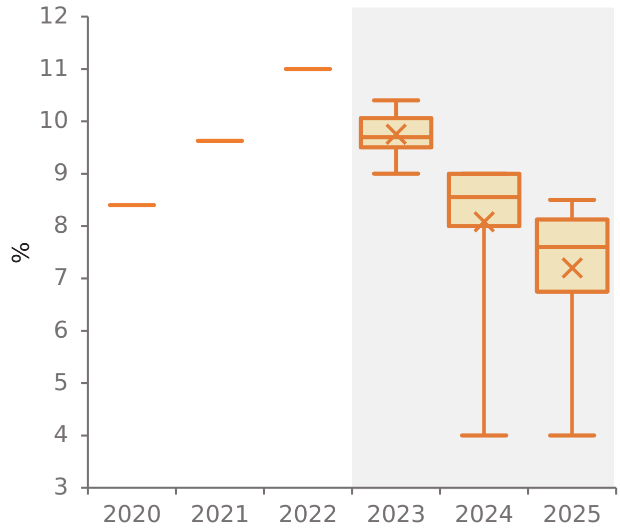


Figure 2.4.2. Actual monetary policy rate (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants

In the third 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 of Georgia, the inflation expectations of financial market representatives for the period 2023-2025 have decreased compared to the previous quarter. In particular, the median inflation expectation for 2023 is 2.3 pp lower, while the average inflation forecast is 2.4 pp lower, amounting to 3% and 3.3% respectively. As for 2024, the median projection shifted down by 1.3 pp to 3.2%, and the average fell by 0.7 pp to 3.5%. The inflation expectations of financial market participants gradually approach the target in the medium term. The median inflation expectations for 2025 decreased by 0.3 pp and equaled 3.2%, while average inflation expectations fell by 0.4 pp to 3.3% (see Figure 2.4.1).

In parallel with the tapering of inflation expectations, the market has lowered its expectations for monetary policy rate compared to the previous quarter. In particular, their median projection for 2023 fell by 0.4 pp to 9.7%, while the average forecast shifted down by 0.1 pp over the previous quarter's forecast, amounting to 9.8%. Their median projection for 2024 went down by 0.4 pp to 8.6%, while the average forecast decreased by 0.3 pp, reaching 8.1%. The monetary policy rate will slowly converge with its neutral level in line with a curbing of inflation expectations in 2025. In particular, the median forecast for 2025 fell by 0.3 pp to 7.6%, while the average expectation declined by 0.5 pp and stands at 7.2% (see Figure 2.4.2).

According to the current survey, the real GDP growth expectations of financial market participants have been revised upward. In particular, the median forecast of economic growth shifted up by 0.8 pp to 6.8%, while the average forecast has risen by 0.1 pp to amount to 6.4%. Similar to the previous quarter, the median forecast for economic growth in 2024 remains at 5%, though the average projection fell by 0.1 pp to 5.1%. In 2025, according to market participants' expectations, the median and average expectations of real GDP growth have remained unchanged, standing at 5.2% in both cases (see Figure 2.4.3).

The market forecasts for economic growth in 2023 have improved compared to those of the previous quarter, though have largely remained unchanged for 2024-2025.

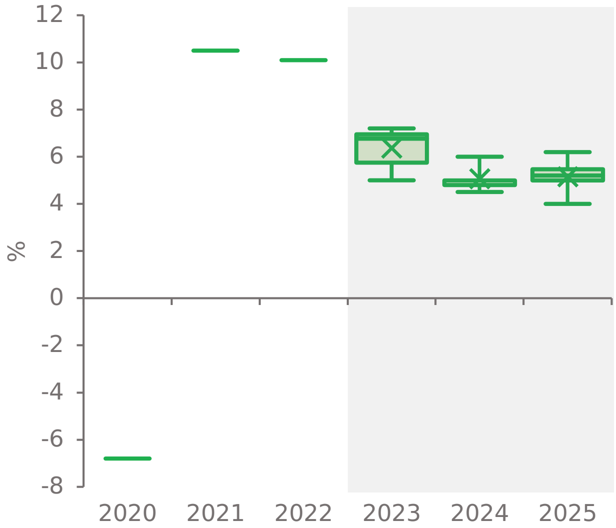


Figure 2.4.3. Actual real GDP growth (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

3 MONETARY POLICY

Inflation was 0.6% in June and the inflation dynamics are mostly governed by external factors. Starting from 2022, global prices of commodity goods and energy had a declining trend and the cost of international transportation fell to pre-pandemic levels. These factors, together with the appreciated Georgian lari, lowered the pressure from imported inflation. In addition, the strict monetary policy stance and improved inflationary expectations gave further support to lower inflation. As a result, local inflation retreated but did so at a slower pace than total inflation. Local inflation was 8.5% in June and will be even lower during the year. According to the recent forecast, keeping everything constant, inflation has fallen from its peak and now follows a downward trend. According to the current forecast, other things being equal, inflation will be below the target of 3% in the upcoming months of 2023 and later, due to the base effect, will temporarily be above the target. In the medium run, inflation will stabilize and fluctuate around the 3% target. However, despite recent positive tendencies, global economic risks and the current geopolitical environment remain the main sources of ambiguity. It should also be noted that in 2023 aggregate demand has been stronger than expected, which creates inflationary risks. In accordance with these factors, the National Bank of Georgia is cautiously and gradually moving from its strict to a moderate policy at a slow pace. As a result, in August 2023 the Monetary Policy Committee decided to cut the monetary policy rate by 0.25 pp, from 10.50% to 10.25%.

On 2 August 2023, the monetary policy rate decreased by 0.25 pp, falling from 10.50% to 10.25%. Nevertheless, the NBG continues to maintain a tight policy stance.

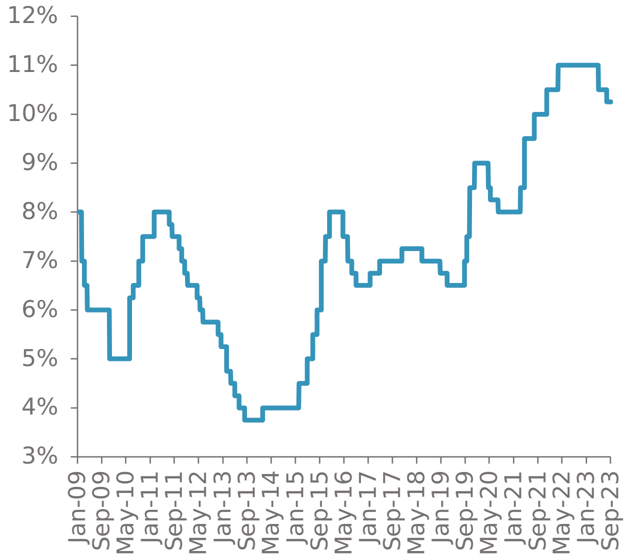


Figure 3.1. Monetary policy rate

Source: NBG

Due to the consecutive shocks of the past three years and current shifts in the geopolitical environment, global uncertainties are high. To fight increased inflationary pressures, the vast majority of central banks have tightened their monetary policies. Stricter financial conditions, the aggravated geopolitical situation and the challenges faced by the US financial sector all initially worsened global economic growth perspectives; however, the current tendencies of global economic growth are more optimistic than previously expected. The main source of the positive dynamics is the strong service sector activity. Meanwhile, global inflation has passed its peak and has a declining trend in a plethora of countries. Nevertheless, strong inflationary pressure remains a main challenge of policy makers and it is the main reason why a large number of countries continue to retain tight monetary policy stances.

The current shocks and global events have different effects on different countries. Although the world and international trade have faced new challenges, the negative effects of the Russia-Ukraine war on other countries of the region – including Georgia, due to its geopolitical location – have not yet materialized. In particular, in the background of high levels of migration and increased remittances to the countries of the region, foreign demand is strong, which has further been supported by higher-than-expected global economic growth. As a result, economic activity in Georgia during the first half of 2023 remained high and average economic growth of the first two quarters was 7.6%. According to the recent NBG forecast, overall economic growth will be 6.0% in 2023. The improved forecast is partially influenced by the faster increase of potential GDP during the post-pandemic period.

In turn, strong external inflows of money improve the current account and appreciates the nominal as well as the real exchange rate. The appreciated lari, together with decreased international commodity prices, reduced prices of imported goods in Georgia. Since March 2022, global commodity prices have continued to decrease. Initially, Russia's invasion of Ukraine led to a significant increase in the prices of energy resources and food products on international markets. However, later a significant price reduction was observed – mostly, due to the humanitarian corridors created by the European Union, which implied an agreement on the export of grain through the Black Sea ports. The declining dynamics of the international food price index were preserved in 2023, as supply chains gradually recovered. However, it should be recognized that food prices are still higher than pre-pandemic levels and there is high uncertainty about the future path of the prices.

Meanwhile, according to the planned fiscal consolidation in 2023, the fiscal stimulus will decrease. Strict monetary policy and fiscal consolidation are the other driving forces behind the reduction of inflation. Moreover, as a result of tightened 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 the recent positive tendencies, inflation and inflation-related expectations in Georgia are decreasing. Local inflation has a declining trend, but is occurring at a slower pace and remains at a high level. Global uncertainty and inflationary risks are the main reasons for caution. As a small open economy, Georgia is vulnerable to global developments. Along with the global uncertainties, monitoring inflation-related risks remains a primary task. One of the biggest potential threats is the high volatility of global food prices caused by worsened geopolitical conditions. In addition, risks coming from the local economy, such as strong demand and labor market tendencies, deserve close monitoring. In the first quarter of 2023, as compared to the previous quarter, the wage growth rate was lower and thus wage-price spiral risks are not expected to evolve; however, the unit labor cost is still high, which makes inflationary risks originating in the labor market noteworthy. Taken together, these points imply that the NBG will only be able to cut down the monetary policy rate at a slow pace.

Taking the abovementioned factors into account, at the Monetary Policy Committee meeting held on 2 August 2023, the monetary policy rate was reduced by 0.25 pp, from 10.50% to 10.25%. Despite this moderate cut, the NBG has retained 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.

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

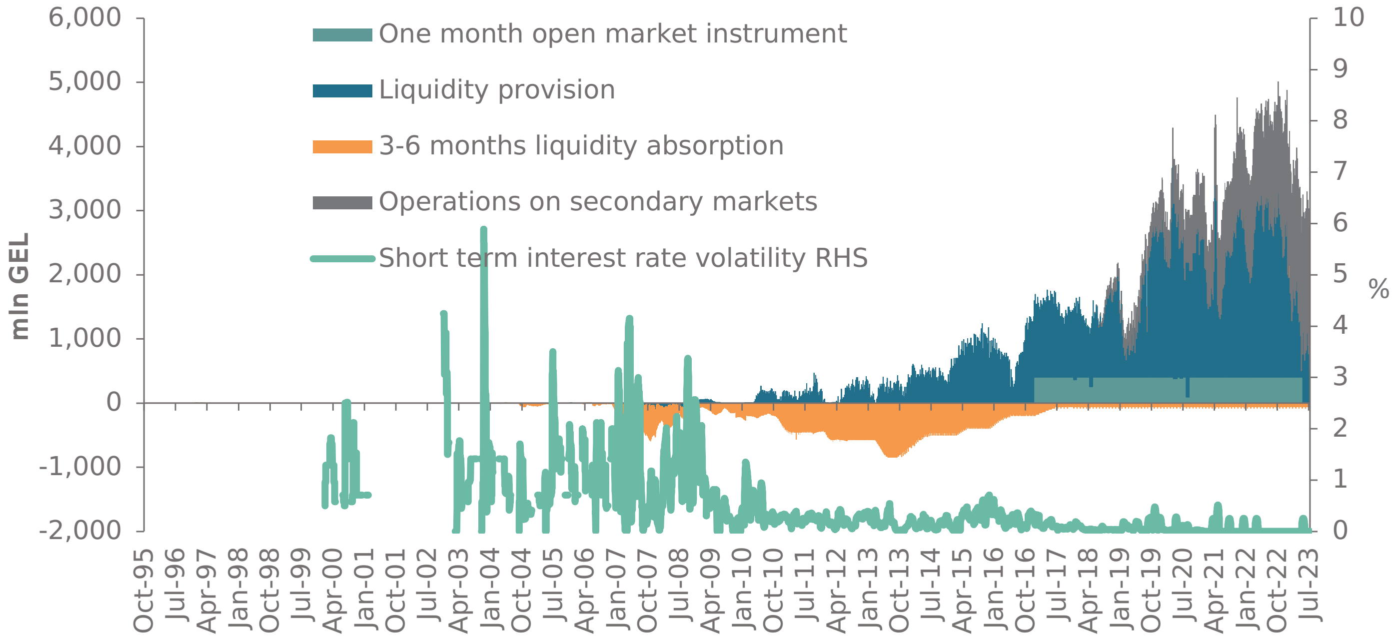


Figure 3.2. Liquidity instruments

Source: NBG

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

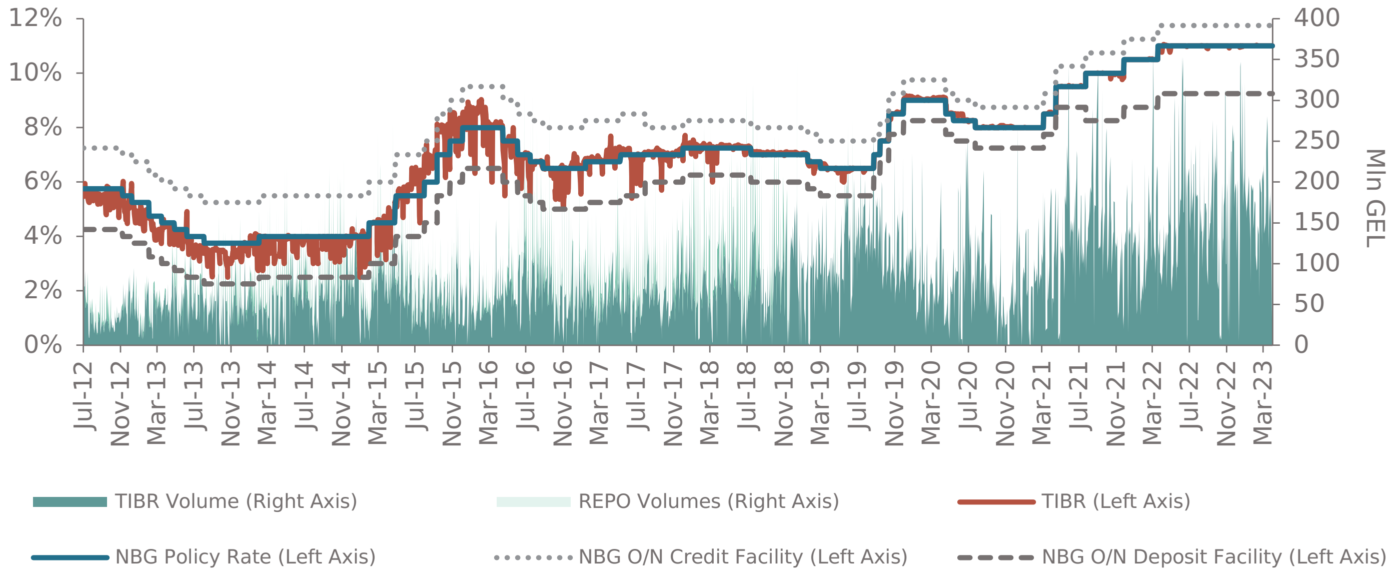


Figure 3.3. Interbank money market

Source: NBG

affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. The NBG provides sufficient liquidity to the banking sector through liquidity provision instruments. Commercial banks generally satisfy their extra-liquidity needs by use of the main instrument of the NBG – refinancing loans. In those cases when the financial system experiences episodes of extra liquidity, the NBG uses liquidity absorption instruments. At the initial stage of implementing the inflation-targeting regime in the early 2010s, the main instrument of the NBG for liquidity absorption was certificates of deposit.

The liquidity provided by the NBG equals the demand of commercial banks. The NBG guarantees that rates on the interbank money market are close to the monetary policy rate. Currently, the appreciated lari enables the NBG to buy foreign currency through interventions. This operation has a liquidity-provision effect. Considering the NBG's interventions, the financial system has lower demand for refinancing loans to satisfy their needs for liquidity. Lower demand causes a reduction in refinancing loans. 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 and, whenever necessary, the NBG is ready to activate liquidity absorption instruments as well.

1, Zviad Gamsakhurdia Embankment, Tbilisi 0114, Georgia

Tel.: (995 32) 240 6480; Fax: (995 32) 240 6571; Hot line: (995 32) 240 6406

E-mail: info@nbg.ge; www.nbg.ge

საქართველოს ეროვნული ბანკი
National Bank of Georgia