Monetary Policy Report

October

2023

საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation

3%

0.7%	Annual inflation remains low and below the 3% target.

Economic Growth

Strong economic growth is again expected in 2023, which includes inflationary risks.	6%

Monetary Policy

10.0%	Under conditions of high uncertainty, the policy rate remains at a high level and its reduction is only expected at a slow pace.

MONETARY POLICY DECISION

Monetary policy remained tight with the policy rate kept at 10%.

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

Inflation in Georgia has been below the target rate of 3% for several months now, with headline inflation standing at 0.7% and core inflation at 2.5% as of September 2023. Such low inflation has been caused by both the weakening of price pressures stemming from the pandemic and the Russia-Ukraine war, and the decline of the inflation of locally produced products (which equaled 5.3% in September). However, there is still high global uncertainty, which has increased as a consequence of the emerging conflict in the Middle East. In addition, recent trends on the fuel market have also worsened somewhat, in terms of both price and supply volatility. Domestic economic trends also contain inflationary risks.

Considering each of these risks, the monetary policy rate was kept unchanged at 10%. 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 the 3% target.

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ISSN 1512-0767

BRIEF OVERVIEW

In the current period, headline inflation is below the target, which is mainly a consequence of reduced prices on imported goods in annual terms. However, a clear declining trend in domestic inflation is also evident. According to the current baseline forecast, inflation will remain below its target in the short term. However, next year this will be followed by a temporary overshoot, mostly due to the base effect, before headline inflation eventually stabilizes around the target in the medium term. This will be ensured by retaining a tight monetary policy, which is induced by strong aggregate demand and serves as a response to the high uncertainty surrounding external factors.

According to the current baseline forecast, inflation will remain low until the end of this year. However, in 2024, mostly due to the base effect, inflation will temporarily exceed its target, and will eventually stabilize around it in the medium term.

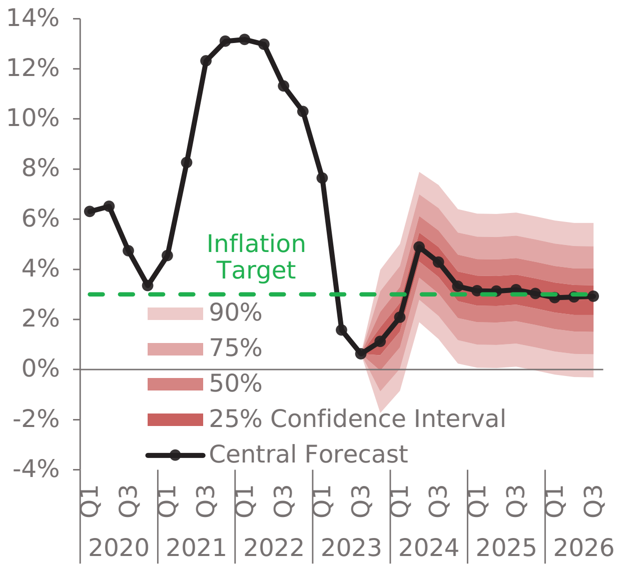

Figure 1. Headline CPI inflation forecast

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

In the third quarter of 2023, headline inflation amounted to 0.6%. This low level of inflation was, to a large extent, a result of external factors being reflected in the annual appreciation of the GEL exchange rate, reduced prices of commodities, and falling shipping costs. These factors counterbalanced the inflationary pressure coming from the still-strong domestic spending, even if this has been constrained by the tight monetary policy. In the short term, this trend will continue. **According to the current baseline forecast, all other things being equal, inflation will remain around 1% on average until the end of the year. However, in 2024, mostly due to the base effect, inflation will temporarily exceed its target and will average 3.6%.** Eventually, in the medium term, inflation will stabilize around the 3% target (see Figure 1).

Foreign inflows continue to make a significant contribution to economic activity, both in terms of service exports and domestic spending. However, on the back of improved investments and the rising productivity of production factors, the potential growth of the economy has also accelerated in the current period. According to the current baseline forecast (see Figure 2), these factors will **lead to 6% growth of real GDP in 2023, while growth of 5% is expected next year** in parallel with the expected stabilization of potential GDP growth at its long-term level.

However, positive dynamics in economic activity also contain certain threats in terms of inflationary pressures. In a tight labor market, the risk of wage pressures passing through to prices due to high labor costs remains a concern. In addition, against the background of high uncertainty in both the region and globally, the volatility of imported oil prices has increased. Since fuel is a large component of the CPI basket in Georgia, this can cause a significant secondary impact, which can be reflected in the deterioration of inflationary expectations. The National Bank of Georgia is especially cautious of such risks as a result

After the double-digit economic growth of the previous two years, amid the improving potential of the economy, real GDP will continue to grow by 6% in 2023 and 5% in 2024.

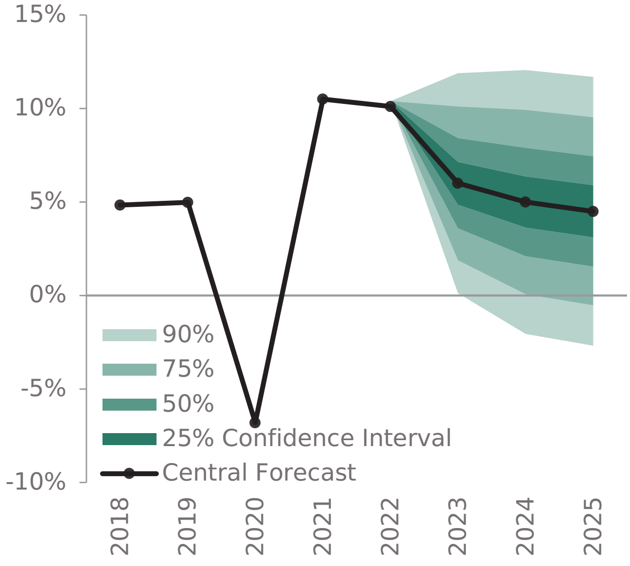

Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat

At this stage, the monetary policy rate remains unchanged at 10%, which reflects the need for only a gradual exit from the tight monetary policy stance.

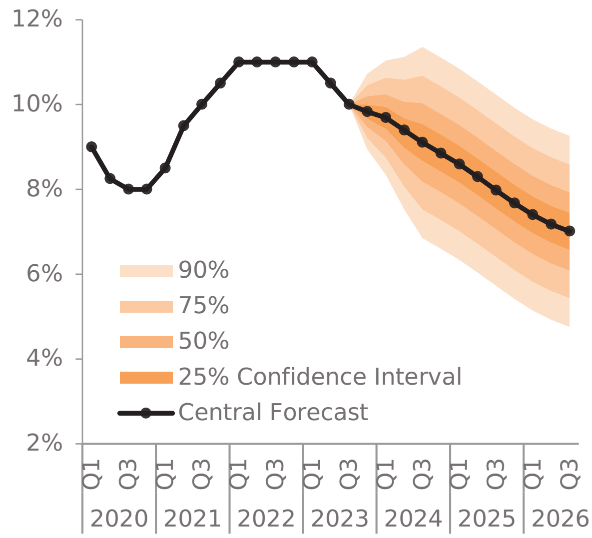

Figure 3. Monetary policy rate forecast

Source: NBG

of the long episode of high inflation experienced in recent years. In the event of an additional shock, returning to a high inflationary environment will significantly worsen long-term expectations and inflation may be prevented from hitting its target in the medium term. Taking this into account, **the National Bank of Georgia, after reducing the policy rate by 0.25 percentage points (pp) at the previous meeting, decided to keep the monetary policy rate unchanged at 10% in October**. This decision is consistent with a gradual exit from the tight monetary policy stance and indicates that normalization will continue only at a moderate pace (see Figure 3). It is expected that the policy rate will return to its neutral level (currently estimated at 7%) in parallel with the reduction 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, the process of the post-pandemic recovery of the global economy has been slow-paced; however, there has been higher-than-expected economic global activity over the year, which has been reflected in strong external demand for the Georgian economy. Despite a slight slowdown in growth, exports of goods, travel revenues, and remittances all remain at a high level. Domestic demand remains strong too. Against the backdrop of this, economic activity is still high. However, at the same time, reduced competitiveness, due to the strengthened lari exchange rate, will deepen the trade balance and, consequently, according to the updated forecast, a moderate increase in the current account deficit is expected in 2023. Meanwhile, headline inflation remains at a low level against the background of the relative stability of international commodity and transportation prices, the appreciated exchange rate, and the maintenance of strict monetary policy.

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.

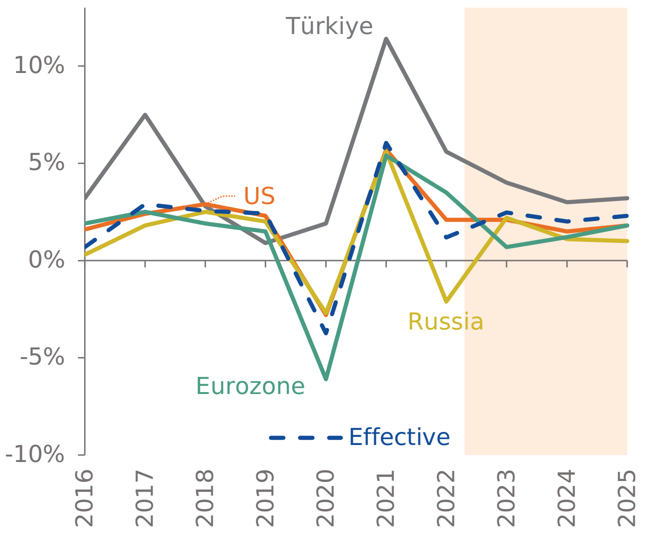

Figure 1.1.1. Real GDP growth of economic partners

Source: International Monetary Fund (IMF), NBG's calculations

After the COVID-19 pandemic and amid the Russia-Ukraine war, the recovery of the global economy in 2023 continues at a slow pace. Last year, as a result of strong disruptions to demand and supply, 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. As a result of the tight financial conditions, inflationary pressure has subsequently gradually been decreasing. Therefore, according to the International Monetary Fund's (IMF) October[1] assessment, similar to its previous forecast[2], **global economic growth in 2023 will be 3%,** while 2.9% growth is expected in 2024[3]. In addition, global inflation will decrease compared to the previous year and is expected to be 6.9% in 2023 and 5.8% in 2024. For emerging and developing countries, real GDP is forecast to grow by 4% in 2023 and by 4.7% in 2024 , while annual inflation is projected to average 8.5% in 2023 and 7.8% in 2024[4].

A high inflationary environment has prevailed in both developed as well as in emerging and developing countries in the third quarter of 2023. However, it should be noted that amid the recent downward trend of both oil and food prices (see section 1.1.2 of this

1 *International Monetary Fund. 2023. The World Economic Outlook: Navigating Global Divergences. Washington, D.C., October. (Hereafter: WEO October, 2023).*

2 *International Monetary Fund. 2023. The World Economic Outlook Update: Near-Term Resilience, Persistent Challenges. Washington, D.C., July.*

3 *WEO October, 2023.*

4 *Ibid.*

report) and tight financial conditions, the level of inflation was gradually decreasing globally.

In the third quarter of 2023, improvements in economic activity continued in the **United States**. Based on July-August data, consumer sentiment and retail sales remain improved, being supported by reduced dynamics of consumer prices. The production of industrial goods was also robust. However, tight financial conditions and uncertainty regarding next year's budget have had a negative impact on economic activity. In September, the annual rate of inflation was 3.7%. According to IMF's estimates, real economic growth in the US will be 2.1% in 2023 and 1.5% in 2024. While annual inflation is projected to be 4.1% in 2023 and 2.8% in 2024[5].

Inflation has had a decreasing trend in Georgia's trading partners, including the United States and the eurozone. Moreover, food prices have followed a downward trend on international commodity markets, which provides further positive expectations.

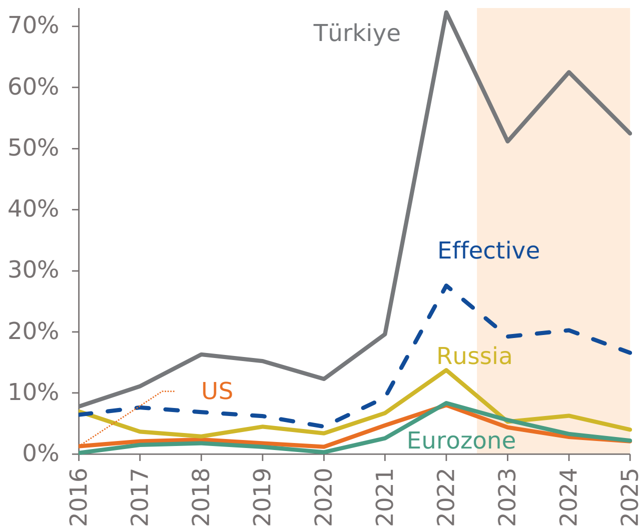

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF, NBG's calculations

In the third quarter of 2023, the pace of economic activity slowed in the **eurozone**. This, to a large extent, was due to tightened financial conditions. In September, the annual rate of inflation decreased slightly and amounted to 4.3%. It should be noted that European countries continue to impose economic sanctions against Russia, which creates additional pressure on their economies. According to the IMF, the real economic growth forecast for the eurozone is 0.7% in 2023 and 1.2% in 2024. Annual inflation is projected to be 5.6% in 2023 and 3.3% in 2024[6].

In the third quarter of 2023, economic activity slowed in **Türkiye**. This was mainly due to a decrease in both retail sales and consumer spending. The production index also deteriorated. A further decrease in economic activity is expected against the backdrop of a sharp tightening of monetary policy. As for the inflation rate, it was 61.5% in September. According to the IMF, Türkiye's real economic growth will be 4% in 2023 and 3% in 2024. Annual inflation is forecast to be 51.2% in 2023 and 62.5% in 2024[7].

In the third quarter of 2023, economic activity improved slightly in **Russia**. According to July-August data, industrial production and retail sales improved. However, the Russian ruble has recently depreciated considerably, and the inflation rate has increased. Also, in light of the economic sanctions imposed by the West, the business environment, volume of investments, as well as the foreign sector all remain deteriorated. At the same time, the fiscal deficit is increasing. Amid the depreciated ruble, annual inflation in September increased to 6%. According to the IMF, Russia's real economic growth will be 2.2% in 2023, and 1.1% in 2024. The average level of inflation is predicted to be around 5.3% in 2023 and 6.3% in 2024[8].

The war waged by Russia in **Ukraine** has had a heavy

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

impact, both socially and economically. Various critical infrastructure has been destroyed, which reduces the potential of the economy. According to the IMF, real economic growth of Ukraine is expected to be around 2% in 2023 and 3.2% in 2024. Meanwhile, inflation will average 17.7% in 2023 and 13% in 2024[9]. It should be stressed that, in the context of the war, the civilized world, including Georgia, supports Ukraine.

In the third quarter of 2023, economic activity decreased in **Armenia**. This was mostly due to the deterioration of the production sector and the reduction of exports. As a result of the Nagorno-Karabakh conflict, the influx of a large number of migrants from that region has created negative expectations. However, activity was high in the construction and manufacturing sectors. The annual rate of inflation was 0.1% in September. According to the IMF, Armenia's economic growth will equal 7% in 2023 and 5% in 2024. Meanwhile, annual inflation is predicted to average 3.5% in 2023 and 4% in 2024[10].

In the third quarter of 2023, growth rates slightly improved in **Azerbaijan**. This was mostly due to high activity in the non-oil sector. Also, it should be noted that the end of the conflict in Nagorno-Karabakh has created positive expectations. Meanwhile, the annual rate of inflation has been declining and reached 5.1% in September, which was largely due to the central bank's tight monetary policy. According to the IMF, in 2023, as well as in 2024, economic growth in Azerbaijan will equal 2.5%, while the annual inflation rate is expected to be 10.3% in 2023 and 5.6% in 2024[11].

In the third quarter of 2023, alongside the high inflationary environment, the majority of the central banks of Georgia's trading partners tightened their monetary policies.

In the third 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 July, the US Federal Reserve lifted its federal funds rate to the target range of 5.25-5.5%, while in September the European Central Bank further raised its policy rate to 4.5%. In September, the Central Bank of the Republic of Türkiye decided to further increase its monetary policy rate to 30%, while the central bank of Russia raised its monetary policy rate to 13%.

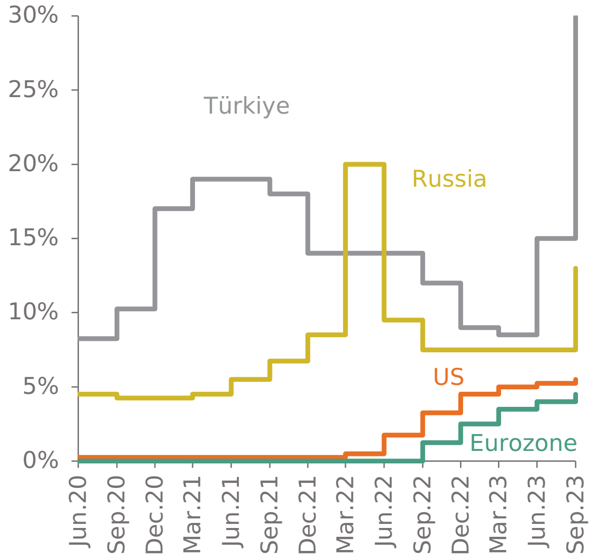

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.global-rates.com

9 Ibid.
10 Ibid.
11 Ibid.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

In the third quarter of 2023, prices on international commodity markets were characterized by certain fluctuations. International food prices continued to decline at a slow pace, although oil prices rose due to tight supplies and inventories.

The International Food Price Index of the Food and Agriculture Organization of the United Nations decreased by 0.1% in September 2023 compared to the previous month, and by 10.7% over the year (see Figure 1.1.4). The index for the third quarter of 2023 was practically unchanged compared to the previous month. This was due to the fact that the decline in prices of vegetable oil, dairy products and meat were outweighed by the increase in prices for sugar and cereals. Despite the slow decline, international food prices remain above pre-pandemic levels, and uncertainty about their future dynamics continues to be high.

In the third quarter of 2023, the downward trend of food prices continued, despite still exceeding pre-pandemic levels.

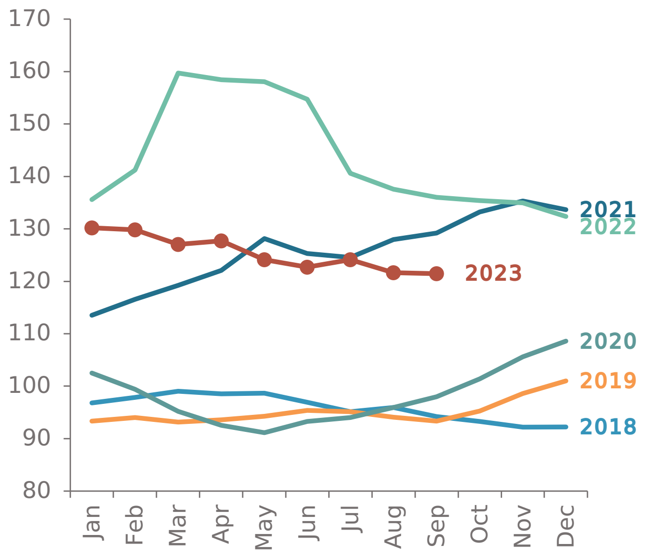

Figure 1.1.4. International food price index

Source: FAO

In September, the decline in food prices on international commodity markets was largely caused by lower prices for vegetable oil. The vegetable oil price index decreased by 3.9% in September compared to the previous month, and by 20.8% compared to the previous year. This decrease was mainly due to a seasonal increase in production in the main producing countries of Southeast Asia and was a result of the active trading of farmers in the Black Sea region and abundant export stocks around the world.

In the same month, grain and sugar prices rose. The increase in grain prices after seven months of decline was due to an increase in international prices for raw grain. The rise in the grain price index was driven by strong demand for Brazilian supplies, slower sales by farmers in Argentina, and higher transportation costs due to low water levels in the Mississippi River. The rise in sugar prices was due to a reduction in production from the main sugar producers – Thailand and India – due to poor weather.

In general, commodity prices are vulnerable to weather conditions, geopolitical tensions, policy changes and other shocks in commodity markets. These can disrupt the balance of supply and demand and consequently affect global prices.

After the start of the Russia-Ukraine war, and in light of the sanctions imposed on Russia, a significant drop in oil supplies was expected. Against this background, at the beginning of 2022, oil prices rose sharply. Despite some further stabilization, prices began to rise again in the second half of 2023, with the average price of Brent oil rising by 8.8% in September compared to the previous month and amounting to USD 93.7 per barrel. Oil prices remain 49.0% higher than in the same, pre-crisis period of 2019. Gasoline prices in Europe and Georgia showed a similar trend (see Figure 1.1.5). In the European market, the cost of

In 2021-2022, fuel prices increased sharply and the increasing trend resumed in the third quarter of 2023.

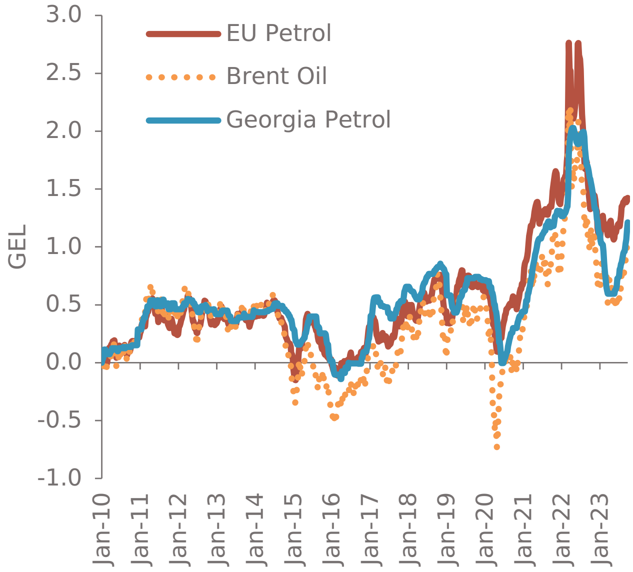

Figure 1.1.5. Petrol price index (Jan 2021=100)

Source: EU Commission, Statista, NBG calculations

The cost of international transportation continued to decline and has approached pre-pandemic levels.

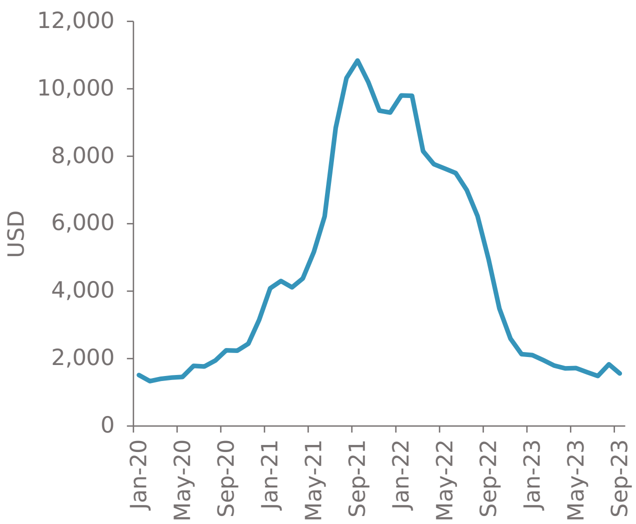

Figure 1.1.6. Average shipping cost of a 40-foot container worldwide

Source: Statista

fuel increased by 1.1% in September compared to the previous month. The average price per liter of gasoline in Georgia increased by GEL 0.25 (10.1%) compared to August. According to the updated forecast of the International Energy Association for September 2023, the price of Brent oil is expected to be around USD 84.1 per barrel in 2023, and USD 94.9 by 2024. At the same time, uncertainty around oil prices on the international market is high. The June 2023 decision made by the Organization of Petroleum Exporting Countries (OPEC) to cut oil production increased uncertainty in the market, which resulted in fluctuations in the prices of crude oil and Brent fuels in Europe, and thereby aggravated the risk of price increases. In addition, Saudi Arabia extended its voluntary reduction in daily oil production by another 1 million barrels until the end of 2023.

The cost of transportation continues decline globally. The price of international shipping peaked in September 2021 and has had a downward trend since early 2022. This has had the effect of slowing down imported inflation. In September 2023, freight prices decreased by 14.8% month on month and by 68.4% annually and have approached pre-pandemic levels (see Figure 1.1.6).

The above-mentioned positive dynamics of international food prices have reduced imported inflation in Georgia, but have been somewhat offset by rising oil prices.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

External demand continued to grow, albeit at a lower rate.

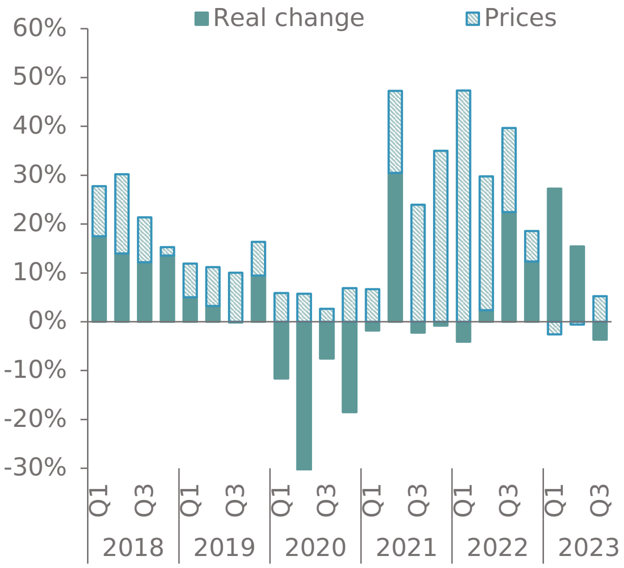

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

In the third quarter of 2023, external demand remained strong, although the growth rate slowed down. Despite the fact that the main sources of external inflows (exports of goods, tourism, and money transfers) increased, their growth was only moderate. Due to the war in Ukraine, international trade still faces several obstacles. However, external trade in Georgia, due to its geopolitical environment, is on the rise again, mostly thanks to the rise of re-exports of motor cars; however, the growth rate of exports has slowed. In light of the appreciated GEL exchange rate, the weakness of external competitiveness induced a decline of exports of domestically produced goods. In the third quarter of 2023, domestic exports of goods declined by 24.5% annually. Despite this, the rising external demand on motors cars from regional countries outweighed the decline of domestic exports and thus the overall export of goods increased, albeit at a slower rate. Due to the appreciated exchange rate and strong economic activity, imports of goods also continued to rise at a lower rate. Because of the lower competitiveness resulting from the appreciated exchange rate, it is expected that the trade deficit will increase; in addition, declining money transfers will widen the current account balance. According to the updated projections, a moderate worsening of the current account deficit is expected in 2023; however, due to rising revenues from international travelers, the deficit will not increase as much as it widened in previous years.

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

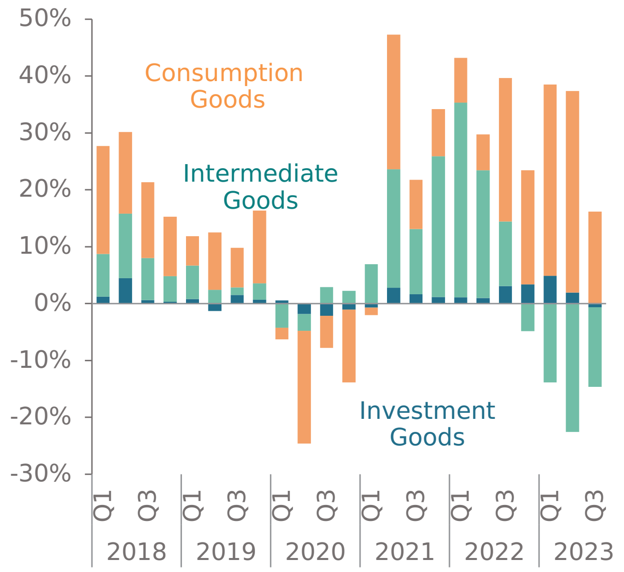

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

In light of high external demand, exports of goods continued to rise, albeit at a slower rate. In the third quarter of 2023, the growth rate of registered exports of goods slowed and grew only by 1.6% annually (see Figure 1.2.1). This deceleration was mostly driven by declining domestic exports (mostly sales of ferro-alloys and copper ores). In the third quarter of 2023, exports of goods grew moderately, while exports in real terms declined.

Higher demand for consumer goods was a major contributor to the rise in exports of goods. Meanwhile, investment goods made a small negative 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 were resold to central Asian countries as well as regional countries. The rise of exports of medicaments, mixed goods and alcoholic beverages were also significant. Meanwhile, lower exports of intermediate goods mainly stemmed from decreased exports of ferro-alloys to the US and Russia, lower exports of copper ores and concentrates to China, declined exports of mineral fertilizers to Peru, and lower exports of motor cars to Ukraine. In terms of the decrease in investment goods, exports of other aircraft vehicles and live bovine animals played a lead-

In the third quarter of 2023, due to the decline of transfers from Russia and the base effect, instant money transfers declined annually.

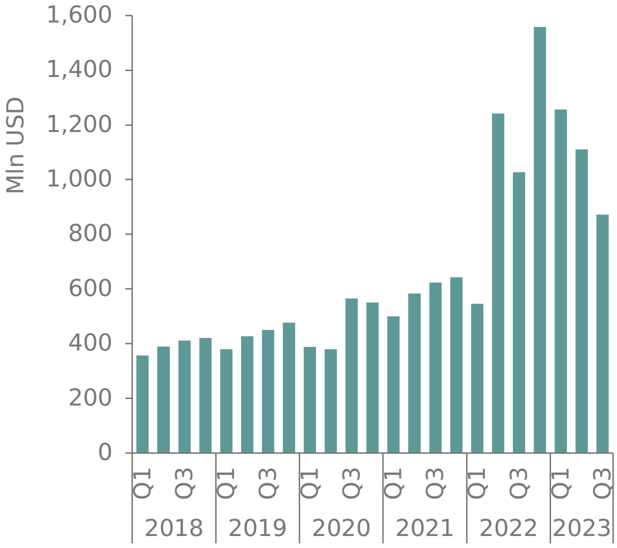

Figure 1.2.3. Annual change in money transfers
Source: NBG

The demand for imports of goods is strong. In the third quarter of 2023, the real change of imports amounted to 25%.

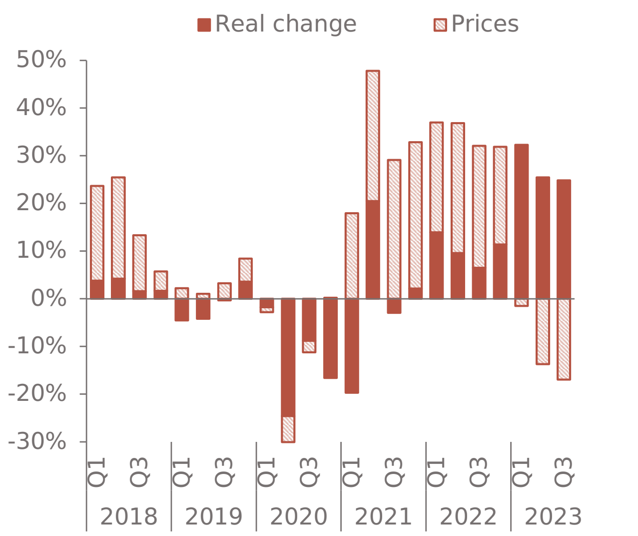

Figure 1.2.4. Annual change in registered imports of goods
Source: GeoStat

ing role in the overall decline.

International travel was quite prominent during the summer period. In the third quarter, the number of international visitors to Georgia rose by 21.0% annually but remained below the same period of 2019 (down 16.5%). Although migrant inflows related to visitors from Russia, Belarus and Ukraine slowed down, the number of visitors from the EU, Turkey and Kazakhstan increased.

In the third quarter of 2023, instant money transfers to Georgia amounted to USD 872 million, which reflects a 15.1% annual decline that is partially related to the base effect and the gradual decline of money transfers from Russia (see Figure 1.2.3). Since the beginning of the war in Ukraine in 2022, money transfers from Russia have been high, being related to both capital inflows and increased migrant inflows. As was expected, such transfers have gradually declined. Despite the gradual annual fall of money transfers from Russia, which also induced an overall slowdown of money transfers, transfers from other countries rose significantly. Transfers from the EU (6.5 pp), the US (3.4 pp) and Kazakhstan (2.1 pp) made the largest positive contributions to the total growth in this period.

Due to strong economic activity and the appreciated GEL exchange rate, there was strong demand on imports of goods. However, due to lower prices of raw commodities – specifically raw food – the growth rate of imports slowed. In addition, despite a recent rise, prices on petroleum products are lower in annual terms, which were reflected in lower expenses of import goods. As a result, in the third quarter of 2023, imports of goods grew by 7.9%, while increasing by 25% annually in real terms (see Figure 1.2.4).

In the third quarter of 2023, imports of consumer goods made the largest contribution to the overall growth of imports (see Figure 1.2.5). The increase in such imports predominantly stemmed from higher purchases of motor cars (mostly for re-export), medicaments, mixed goods and telephones. The decline of intermediate goods mostly came from lower purchases of copper ores, wheat flour and petroleum gases. However, imports of ferrous semi-products and manganese concentrates were high. The rise in imports of investment goods stemmed from higher purchases related to increased demand for tractors, motor vehicles for the transport of goods, and construction motor vehicles.

The rise in imports from regional countries were predominantly related to imports of petroleum products and cement from Azerbaijan. Meanwhile, imports from other countries, including Germany, the US and Japan (mostly due to motor cars), China (mostly due to air conditioning machines and rubber tires), and the Netherlands (mostly floating vessels) made the largest contributions to overall growth. In contrast, imports

In the third quarter of 2023, the rise of imports of goods was mainly due to the growth in imports of consumer goods, while imports of intermediate goods declined.

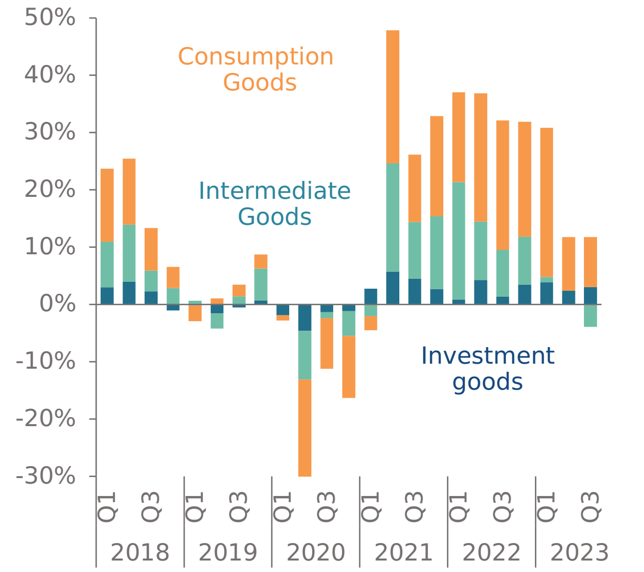

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

Due to the rise of the trade deficit, the current account deficit is expected to increase in 2023. However, in light of expected rising revenues from international travelers, the widening of the deficit will be moderate, unlike in the previous year.

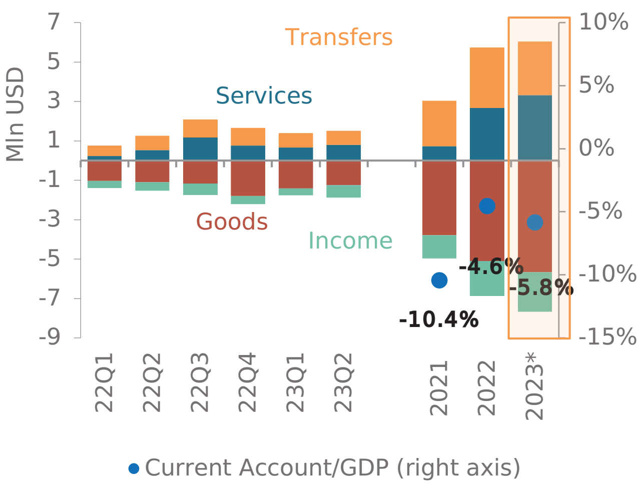

Figure 1.2.6. Current account balance and its components

Source: NBG

from Russia fell due to lower purchases of petroleum products (in light of decreasing prices) and wheat flour, while those from Armenia declined mostly as a consequence of lower purchases of copper ores and concentrates, and other aircraft vehicles.

In light of high external inflows related to exports of goods and services (mostly revenues from international travelers and instant money transfers), and despite the lower growth of imports, the current account deficit increased. In the second quarter of 2023, it amounted USD 366 million, which is 4.9% of the quarterly deficit. It is worth noting that the worsening of the current account balance related not only to higher imports of goods, but also to the negative balance of investment income (due to increased reinvestment income). On the other hand, rising exports of services and a steadily increasing volume of workers' remittances from abroad tempered a further widening of the current account deficit. In the second half of 2023, the trade deficit is expected to increase, reflecting the lower competitiveness stemming from the strengthened GEL exchange rate. Considering these trends, the ratio of the current account deficit to GDP is expected to rise to 5.8%.

In the second quarter of 2023, the main source of financing the current account deficit was foreign direct investments (FDI). Inward FDI increased by 30% annually and amounted USD 506 million. The majority of FDI was in the form of higher reinvestments in the finance and energy sectors, while investments in the real estate and construction sectors declined annually.

From the perspective of savings and investments, in the second quarter of 2023, the annual worsening of the current account balance was due to a substantial decline in savings, despite a moderate growth in investments. Fiscal consolidation somehow decelerates the decline of savings. (see Figure 1.2.6).

In the second quarter of 2023, the worsening of the current account deficit was mainly due to the decline of savings, despite the moderate growth in investment.

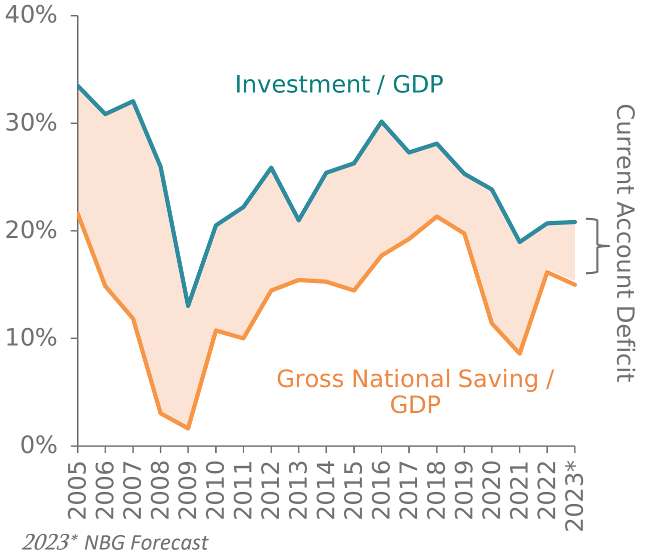

Figure 1.2.7. Investments and savings

Source: GeoStat, NBG Calculations

BOX 1. NOWCASTING THE NUMBER OF INTERNATIONAL VISITORS

Inflows related to international travel have become increasingly important in terms of improving the current account balance. Information on this variable is thus a key input for decision-making processes. Inflows of visitors to Georgia reduced sharply at the onset of COVID-19 and led to the deterioration of the current account balance. However, tourism revenues have subsequently experienced a rapid recovery and, as a percentage of GDP, are returning to pre-pandemic levels (see Figure 1.2.7.). The assessment of such revenues is based on the number of international visitors to Georgia. However, since 2023 it has only been possible to obtain information on the number of visitors at a quarterly frequency (after a transition from monthly to quarterly updates of border crossing data). Nevertheless, a short-term assessment of tourism data can be "nowcasted" by using some publicly available high-frequency indicators. For example, we could exploit the data on internet search intensity on popular travel destinations (Google Trends). By employing this approach, it would be possible to update travel-related data at a greater frequency relative to the official statistics and, at the same time, precision would be assured.

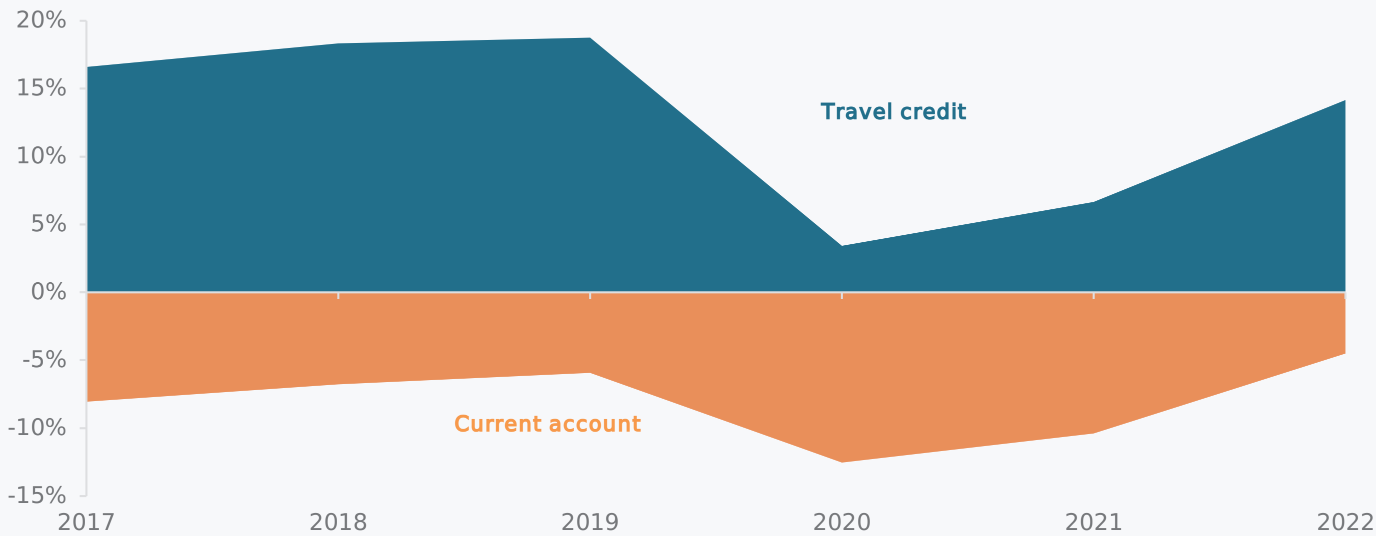

Figure 1.2.8. Revenues from international travel and the current account balance, as a percentage of GDP

Source: NBG

In general, use of high-frequency indicators enables us to update relevant variables through the use of econometric procedures. This, among other things, gives us the possibility of assessing the monthly data for the ongoing quarter (so-called "nowcasting") by using high-frequency leading indicators prior to the publication of official information. Various studies conducted on this subject show that the intensity of searches performed by potential visitors via internet search engines could be a good indicator of the number of subsequent visits. Indeed, as Figure 1.2.8. illustrates, the intensity of travel-related searches from different countries using the Google search engine closely coincides with the cycle of visitors' inflows (including seasonal traffic) in the case of Georgia. A mixed frequency regression analysis (MIDAS regression) was applied for nowcasting the number of visitors, since the dependent variable is only available at a low frequency (monthly until 2022, and quarterly from 2023), while the explanatory variables on the intensity of searches are available on a weekly basis. Taking into account the seasonal characteristics of tourism in Georgia, the two busiest tourist destinations (Tbilisi and Batumi) were selected for measuring search intensity. Finally, an assessment was made based on the annual growth rates for 2018-2022.

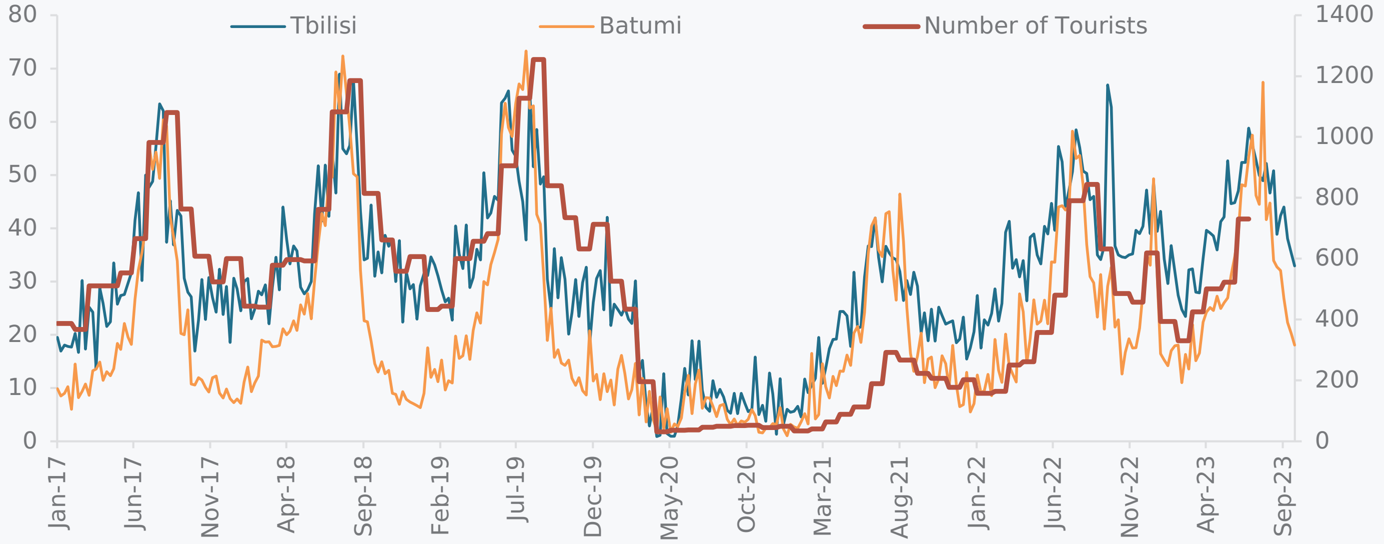

Figure 1.2.9. Number of visitors (actual, thousands), right, and Google Trends on travel-related searches on the two locations (weighted average of 12 main partner economies), left[12]

Source: The Ministry of Internal Affairs, Google Trends

As Figure 1.2.9. shows, the model's forecast for 2023 is quite close to the actual data (which is currently available up to the second quarter of the year). It also shows that the number of visitors is expected to grow by 29% in the third quarter of 2023 compared to the corresponding period of the previous year.

12 The number of tourists at a monthly frequency is assessed based on the quarterly annual growth rates for the first six months of 2023.

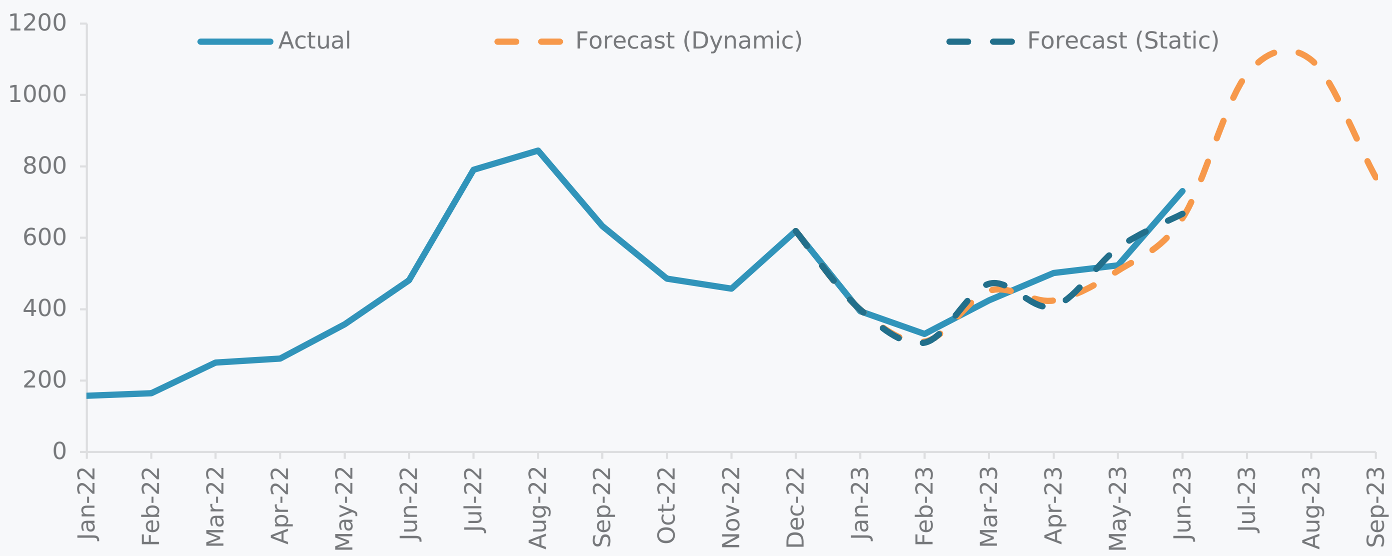

Figure 1.2.10. Number of visitors, actual and forecasted values (thousands)

Source: The Ministry of Internal Affairs, NBG calculations

The performance of the dynamic[13] "out-of-sample" forecast obtained by applying the MIDAS regression outperforms alternative methods, and the mean absolute percentage error of the 2023 forecast is 7.08% (see Table 1.2.1). Furthermore, a comparison of the forecasts of models estimated by using weekly (relative to monthly) search intensity indicators shows that the use of weekly data improves the quality of the forecast. The MIDAS regression thus has an advantage over other alternatives; for instance, relative to an ARDL[14] model. In addition, a comparison with an ARMA[15] model shows that high-frequency data on search intensity is an important information source for nowcasting the number of visitors. The results obtained from this method can be used for the future estimation of tourism revenues.

	SF	DF
MIDAS-weekly	9.34%	7.08%
ARDL-monthly	10.96%	13.59%
ARMA	17.01%	55.63%

Table 1.2.1. Comparison of mean absolute percentage errors for dynamic (DF) and static (SF) forecasts

Source: NBG calculations

13 In contrast to static forecasting, where the forecast of the dependent variable is made based on actual data from the previous period, the dynamic forecasting method employs the forecasted value of the previous period to make a forecast for the current period.

14 Autoregressive Distributed Lag Model (ARDL) – the dependent variable is explained with its and the independent variables' lags at the same frequency.

15 ARMA includes the autoregressive and moving average components simultaneously.

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

Although the contribution of net exports to economic growth in 2023 has, due to the base effect, decreased on average compared to last year, these continued to be a driving factor in the second quarter.

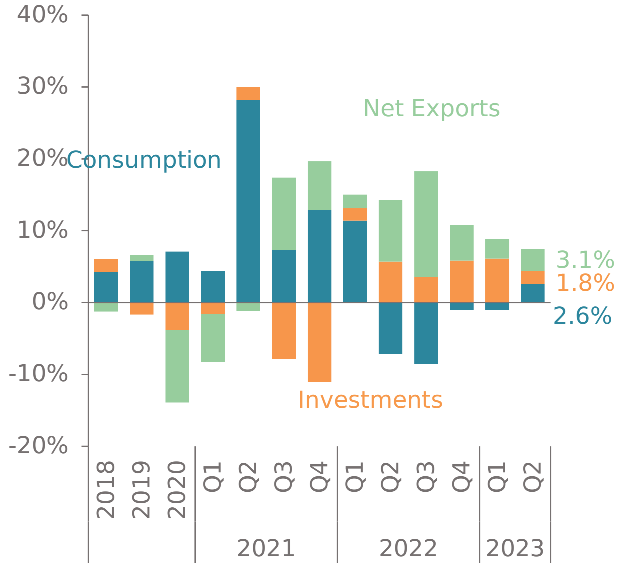

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the second quarter of 2023, the real Gross Domestic Product increased by 7.5% compared to the corresponding period of the previous year.

Like last year, the high growth of the economy in the first half of 2023 was largely determined by strong foreign inflows. The contribution of net exports, due to the base effect, decreased on average compared to last year, but continued to be a driving factor in the second quarter.

Since 2022, tourism in Georgia has largely recovered, with the increase in income from tourism continuing in 2023. In addition, due to the ongoing war in Ukraine, a significant number of migrants have entered Georgia. Against the background of these factors, in the second quarter of 2023, real exports of services continued to grow solidly (at 15.5%), while exports of goods and services increased by 12.7% in total. This significantly outweighed the 5.5% increase in imports of goods and services, and the overall contribution of net exports to economic growth was thus 3.1 percentage points (pp).

Over the same period, the contribution of services and investments to growth amounted to 2.6 pp and 1.8 pp respectively (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.

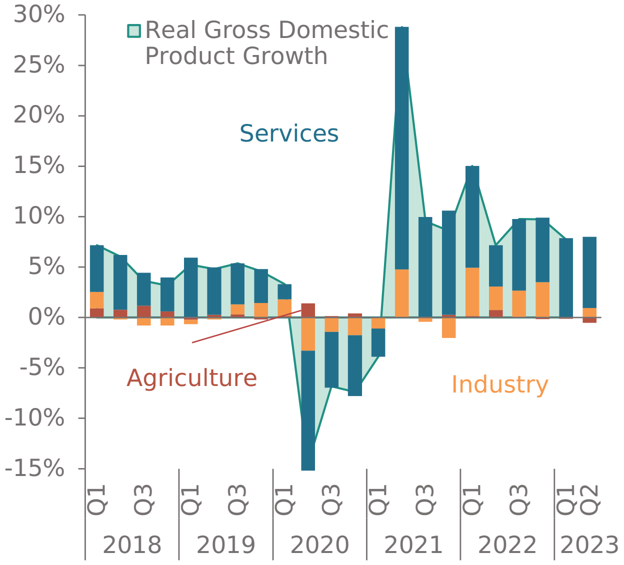

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

1.3.2 OUTPUT

In the second quarter of 2023, services accounted for 7.1 pp of the overall 7.5% economic growth. The industrial sector contributed 0.9 pp, and agriculture made a negative contribution of 0.5 pp (see Figure 1.3.2)

The 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: with a combined 3.6 pp contribution to economic growth being made by trade, transport, accommodation and food supply activities, information and communication, art, entertainment and recreation.

Among the industrial sectors, the 22.7% growth of construction is notable, making a 1.4 pp contribution to economic growth.

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

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

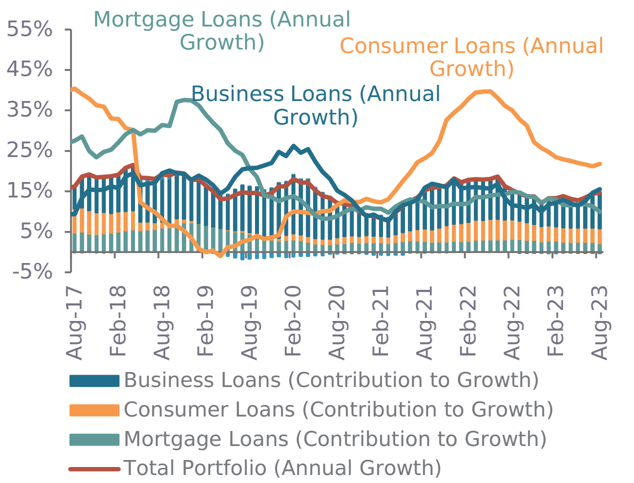

Figure 1.4.1. Loans by pusrpose (excluding the exchange rate effect)

Source: NBG

The growth rate of loans accelerated chiefly as a result of the growth of foreign currency loans.

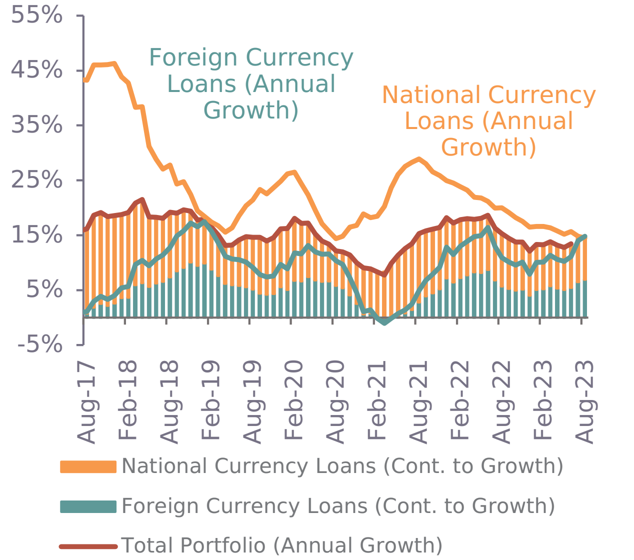

Figure 1.4.2. Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

In August 2023, the growth of the loan portfolio increased by 0.2 pp relative to July and equaled 14.6% (excluding the effect of exchange rate fluctuations). The increased growth rate of loans was largely caused by the growth of business loans, the share of which increased by 0.5 pp. A relatively small increase was observed in consumer loans as well, with their contribution to total loans increasing by 0.1 pp relative to July. Compared to the previous month, the growth rate of consumer loans also increased and amounted to 21.8% in August. Meanwhile, the contribution of mortgage loans to credit growth decreased by 0.3 pp, with the growth rate being 1.4 pp lower than in July, and equaling 9.9% in August (see Figure 1.4.1). The growth of the credit portfolio in August was mainly due to the growth of foreign currency loans (see Figure 1.4.2). The growth rate of loans accelerated chiefly as a result of the growth of foreign currency loans. Compared to July, the annual growth of the national currency loan portfolio decreased by 0.3 pp and amounted to 14.5%, while the annual growth of foreign currency loans increased by 0.8 pp, equaling 14.8% according to August data.

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 to reduce the currency and related credit risks of individual borrowers and to promote long-term economic growth. Given the high share of unhedged borrowers in foreign currency and the increased fluctuation of the exchange rates of regional currencies, in order to mitigate the risks caused by dollarization, according to the decision of the Financial Stability Committee meeting held on 18 October[16], the NBG will impose an additional requirement on regulated financial institutions. From 1 January 2024, persons whose total debt is up to GEL 300,000 will only be able to be issued a new loan in foreign currency under the conditions of a hedged currency risk. This regulation serves to reduce structural risks caused by the high level of financial dollarization.

As of August 2023, loan dollarization saw a 0.8 pp increase and stood at 44.9% (excluding the exchange rate effect). Compared to August of the previous year, the dollarization of individual loans decreased by 0.1 pp and amounted to 29.1%. The dollarization of loans to legal entities increased by 1.5 pp, which equaled

16 See Financial Stability Report.

Deposit dollarization is decreasing, while the decreasing trend of loan dollarization has slowed – a situation that the NBG is carefully monitoring.

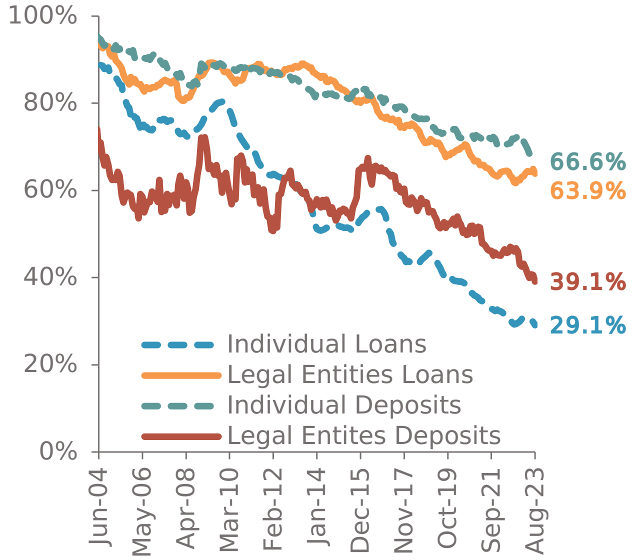

Figure 1.4.3. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG

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

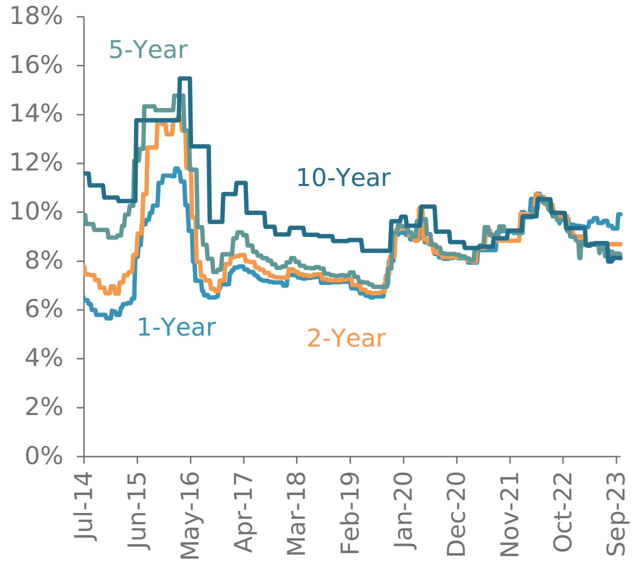

Figure 1.4.4. Interest rates on government securities

Source: NBG

63.9% as of August. It is expected that these dynamics will continue to decrease after the implementation of the macroprudential decisions taken over the last period.

In August, dollarization of total deposits decreased by 0.8 pp compared to the previous month and amounted to 49.7% (excluding the exchange rate effect). Over the same period, the dollarization of deposits of individuals decreased by 0.3 pp over the previous month, while the dollarization of deposits of legal entities fell by 1.0 pp, amounting to 66.6% and 39.1% respectively (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, among other things, by the macroprudential measures adopted in the recent period. Reduction of dollarization is a step forward in the direction of reducing financial stability risks.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In the current year, a gradual exit from the tightened monetary policy began. The monetary policy rate was reduced by a total of 1 pp and currently amounts to 10%. In the third quarter of 2023, rates on government securities thus decreased slightly (see Figure 1.4.4). Recently, short-term rates have been at a higher level than long-term rates. This is to some extent a reflection of the financial market's inflationary expectations. In particular, in the medium and long term, the financial market expects inflation to be maintained at the target rate. As a result, the policy rate is expected to stabilize around the neutral level of 7% in the long term. However, in the short term, taking into account the inflationary risks, the monetary policy rate will be retained higher than the neutral level.

Under the conditions of strict monetary policy, GEL interest rates remain at a high level, although are decreasing slightly. In August, relative to July 2023, interest rates on domestic currency deposits decreased by 0.1pp (to equal 10.9%); meanwhile, interest rates on foreign currency deposits practically did not change, and remain low at 1.7%.

As for lending, in August, compared to July, the average interest rate on loans issued to legal entities in the domestic currency decreased by 0.6 pp to equal 13.4%. Meanwhile, interest rates on foreign currency loans to legal entities decreased by 0.3 pp and amounted to 9.0% (see Figure 1.4.6). As a result, the spread between domestic and foreign interest rates narrowed. It worth mentioning that in August, compared to July, interest rates on consumer loans decreased slightly (by 0.1 pp), while those on business and mortgage loans saw practically no change. In particular, consumer, business, and mortgage loans amounted to 16.3%, 11.4%, and 10.1% respectively.

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.

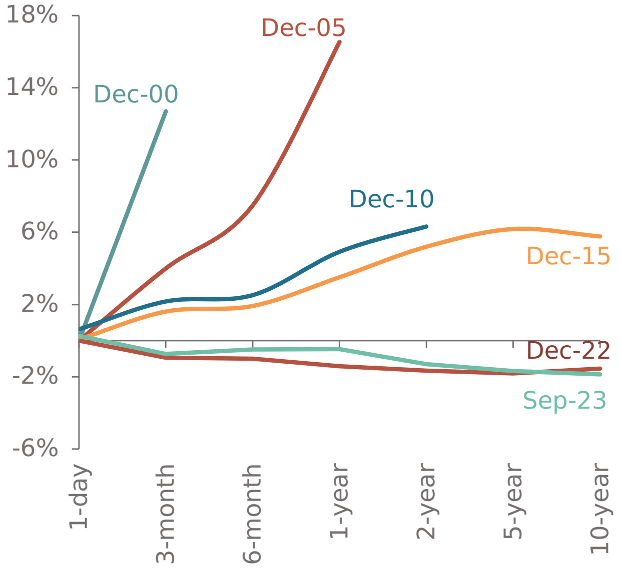

Figure 1.4.5. Spread between the monetary policy rate and the yield curve

Source: NBG

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

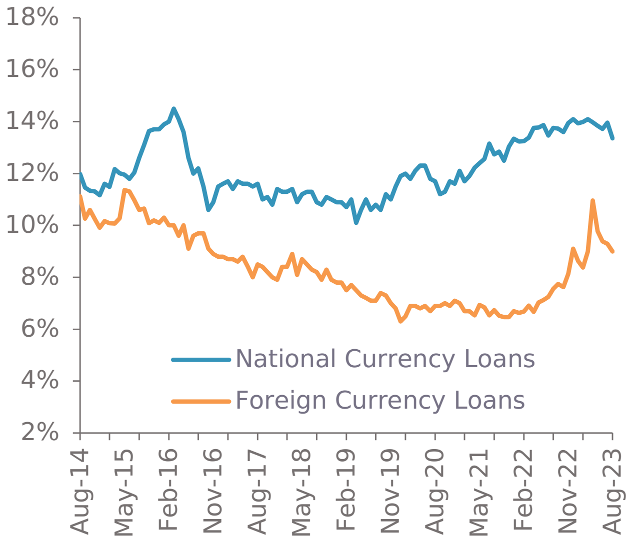

Figure 1.4.6. Average interest rates on business loans

Source: NBG

1.4.3 EXCHANGE RATE

In the third quarter of 2023, the GEL exchange rate continued to appreciate; however, the GEL nominal exchange rate depreciated against both the US dollar and the euro by 2.5% and 2.4%, respectively, compared to the previous quarter. The GEL continued to appreciate against the Turkish lira (20.9%) and the Russian ruble (11.8%). In the same period, the nominal effective exchange rate appreciated by 5.6% on a quarterly basis and by 24.0% on an annual basis. In terms of the price-adjusted exchange rate, in the third quarter of 2023 the real effective exchange rate appreciated by 1.8% on a quarterly basis and by 10.6% 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 nominal appreciation of the lari was partially balanced by the fact that the increase in consumer prices in Georgia was lower than those in its trading partners (see Figure 1.4.7).

It should be noted that the lari real exchange rate has appreciated against the currencies of most of Georgia's trading partners (see Table 1.4.1).

The real effective exchange rate remains appreciated, with annual appreciation standing at 10.6%.

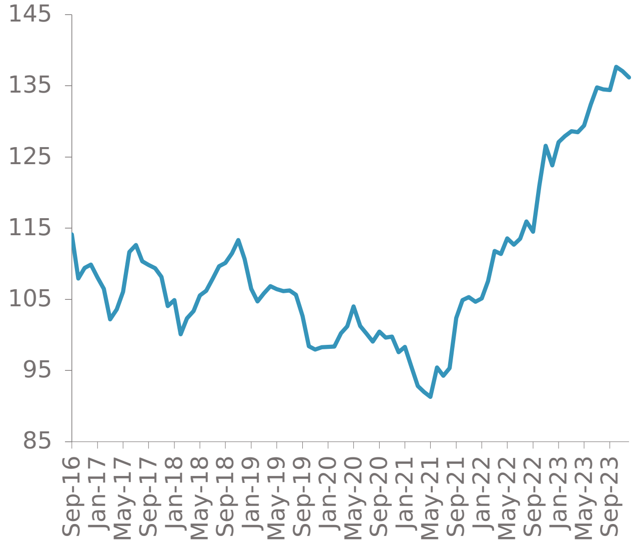

Figure 1.4.7. Real effective exchange rate (Jan 2008=100)

Source: NBG

The annual appreciation of the GEL real effective exchange rate was mainly caused by the appreciation of the nominal effective exchange rate. Despite this, low inflation in Georgia is good for competitiveness.

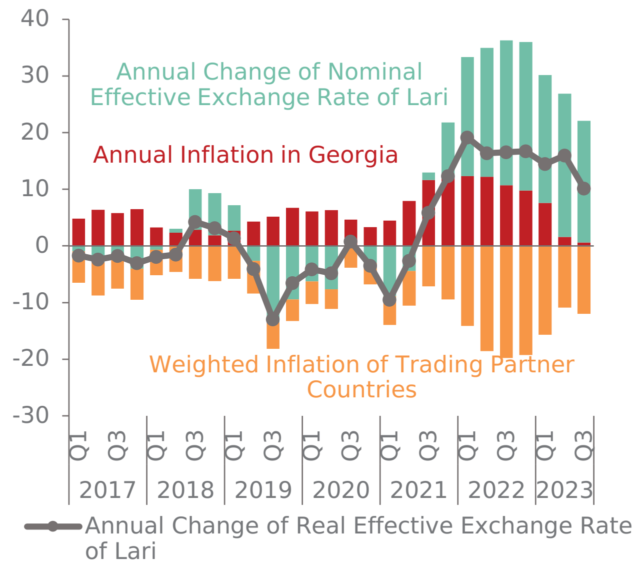

Figure 1.4.8. Decomposition of the annual change of the GEL real effective exchange rate*

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 GEL real effective exchange rate appreciation is due to real appreciation against most 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*	**24.0**	**10.6**	**10.6**
Eurozone	-0.2	-4.3	-0.7
Türkiye	61.1	4.0	0.8
Ukraine	13.3	4.6	0.2
Armenia	2.0	2.7	0.2
US	7.7	4.7	0.4
Russia	69.2	62.0	10.5
Azerbaijan	7.9	1.0	0.1
China	14.0	14.8	1.9
Bulgaria	-0.2	-6.5	-0.3
Poland	-5.2	-12.9	-0.2

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

Source: NBG

* Growth implies appreciation of the lari

1.5 LABOR MARKET

In the second quarter of 2023, Georgia's economic productivity (real value added per employee) rose by 5.5% on a yearly basis (see Figure 1.5.1). Over the same period, the nominal wage growth for employed workers was 17.1%, and the average monthly gross wage reached GEL 1,805.

Compared to the previous quarter, the growth rate of wages slowed, and productivity increased slightly, which also slowed down the trend of the increasing unit labor cost. 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 noteworthy (see Figure 1.5.1).

The annual growth rate of unit labor cost has slowed down, but remains high at 10.9%. Inflationary pressures from the labor market thus continue to be noteworthy.

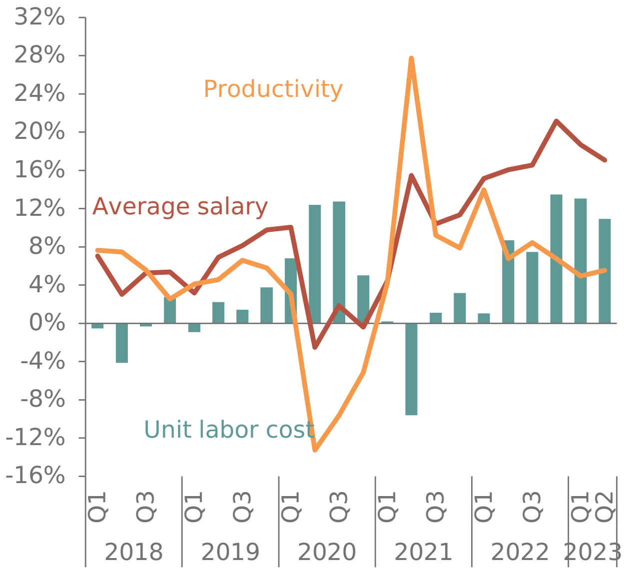

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual percentage change)

Source: GeoStat, NBG calculations

1.6 CONSUMER PRICES

In September, annual inflation stood at 0.7%. Base inflation, which excludes highly volatile prices of food, energy and cigarettes from the consumer basket, equaled 2.5% (see Figure 1.6.1).

The low level of inflation in Georgia is due to the relative stability of prices of goods and transportation on the world market, the solid position of the GEL exchange rate, and the continued use of tight monetary policy.

Low inflation was ensured by imported goods, which became cheaper in annual terms. In September, deflation of 4.1% and 2.9% was recorded for imported and mixed goods, respectively.

Inflation on domestically produced products is gradually decreasing, although it remained high and amounted to 5.3% in September (see Figure 1.6.2).

The decrease in domestic inflation was largely due to the depletion of the base effect related to some services and food. High domestic inflation is predominantly caused by the 8.2% annual increase in the price of services, which made an overall contribution of 4.4 pp. The increase of banking services prices and the increased cost of renting an apartment (as a result of the sharp increase of the number of foreigners in the country) both made high contributions to service inflation (of 1.6 pp and 0.9 pp, respectively).

In September, inflation was reduced the most by the annual decrease in the prices of fuel (-0.8 pp) and medicines (-0.8 pp). However, it should be noted that the recent rapid increase in the price of fuel was only partially reflected in September's inflation. Compared to September last year, gasoline prices are down by 13.3%, and diesel prices by 23.5%. Although further fuel increases are expected to weigh on October's inflation, headline inflation will still be well below the 3% target.

The impact of other products on inflation continues to be 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 continued need for a tight monetary policy (see Figure 1.6.3).

The low inflation in Georgia is due to the relative stability of the prices of goods and transportation on the world market, the solid position of the GEL exchange rate, and the tight monetary policy.

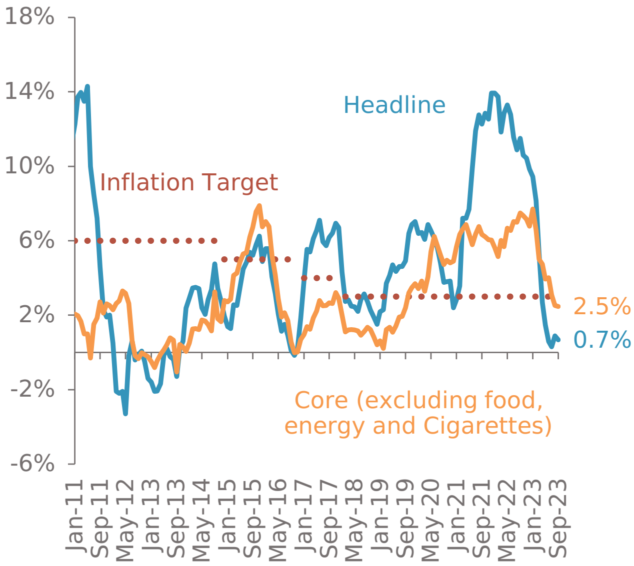

Figure 1.6.1. Headline and core inflation

Source: GeoStat

Low inflation is mainly due to cheaper imported goods in comparison with the previous year. At the same time, inflation of domestically produced products is decreasing.

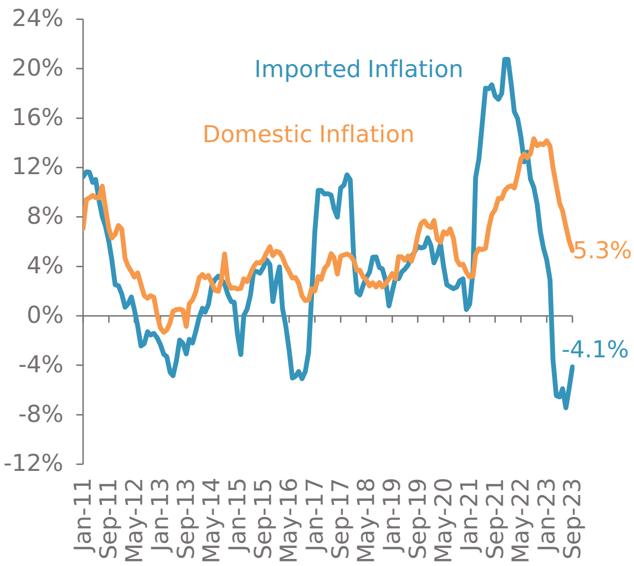

Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

In September, inflation was mostly reduced by an annual reduction in the prices of fuel and medicines. The recent rapid increase of fuel prices was only partially reflected in September's inflation, with the rest of the impact expected to be reflected in October; however, headline inflation will still be below the 3% target.

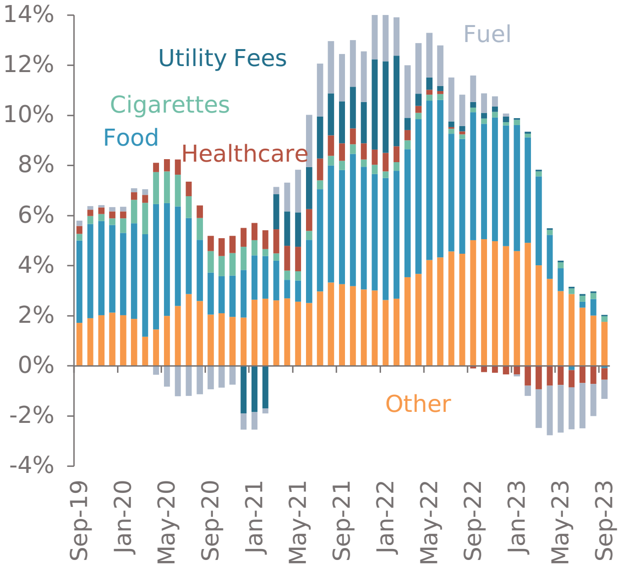

Figure 1.6.3. Contribution of different products to inflation

Source: GeoStat , NBG calculations

2 MACROECONOMIC FORECAST

According to the current baseline scenario, inflation will remain below its target in the short run but will be higher than had been expected in the previous quarter. Inflation will average 1% by the end of the year. Next year, partly due to the base effect, it will temporarily exceed its 3% target before eventually stabilizing around that target from the second half of the year. The expected deviation of inflation from the target will be driven by counterbalancing factors. Specifically, strong domestic demand, higher fuel prices, and rising inflation in trade partners' economies will strengthen inflationary pressures, but these will be counterbalanced by an appreciated exchange rate on an annual basis, decreasing international commodity prices, and stable short-term inflation expectations. In terms of economic activity, akin to previous forecasts, real GDP growth is expected to be around 6% in 2023, and 5% in 2024.
Despite inflation remaining below the 3%, high-impact risks persist around the baseline scenario. The alternative forecast scenario presented below thus envisages the realization of relatively acute risks towards which the National Bank would have low tolerance. The realization of these would imply a sharp tightening of monetary policy and, if necessary, the use of additional instruments.

Inflation will remain below the target in the short run. However, next year, it will temporarily exceed the target, partly as a result of the base effect from the current year, before stabilizing around the target from the second half of the year.

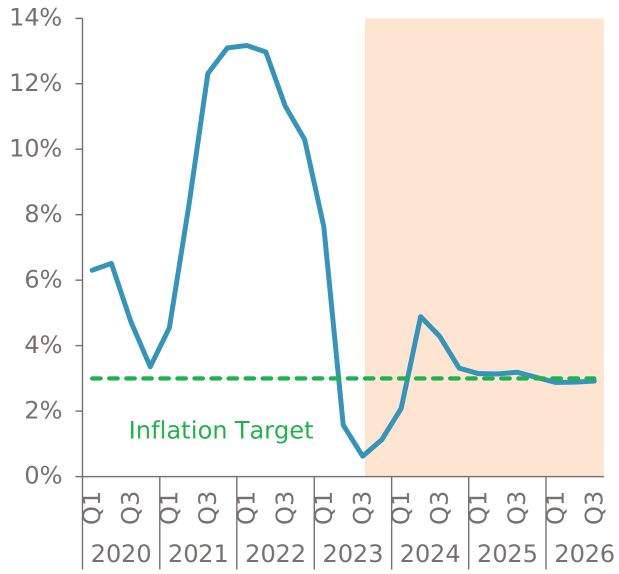

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

2.1 BASELINE MACROECONOMIC FORECAST

According to the baseline scenario, headline inflation will be around 2.7% in 2023, which exceeds the previous quarter's projection by 0.3 percentage points (pp). This revision of the inflation forecast was, to some extent, driven by higher-than-expected actual inflation in the third quarter. The latter can be explained by increasing oil prices alongside still-solid economic activity, which puts upward pressure on prices. Notably, inflation will remain below its target in 2023, although the following year, partly due to the base effect, will see inflation temporarily exceed its target before stabilizing around it from the second part of 2024 (see Figure 2.1.1).

Counterbalancing factors will lead expected inflation to deviate from its target. In particular, an appreciated exchange rate driven by strong foreign inflows will put downward pressure on annual inflation in the short term and will balance domestic spending-driven inflationary pressures. However, as previously mentioned, these effects are expected to start fading away in parallel with a likely normalization of foreign inflows, which will support inflation converging with the target (see Figure 2.1.2). In addition, it should be noted that imported inflation-related risks are tilted upward, which can be explained by exacerbated inflation expectations in Georgia's trading partners, especially in Turkey.

Alongside the aforementioned factors, international commodity prices have diverse effects on inflation. On the one hand, international food prices have continued to normalize, leading to lower domestic food

The deviation of inflation from the target is driven by counterbalancing factors, the effect of which will significantly decline from the second half of next year. Ceteris paribus, this will support inflation to stabilize around its target.

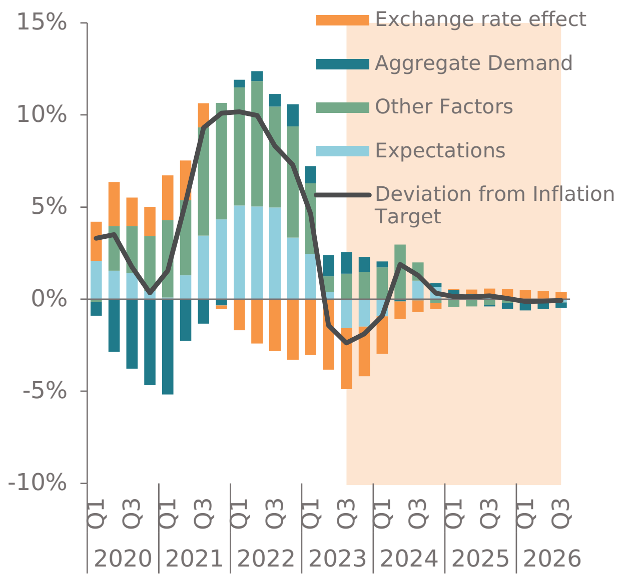

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the baseline scenario, investments and domestic demand will spur growth in 2023-2024. As a result, the economy will grow by 6% and 5% respectively.

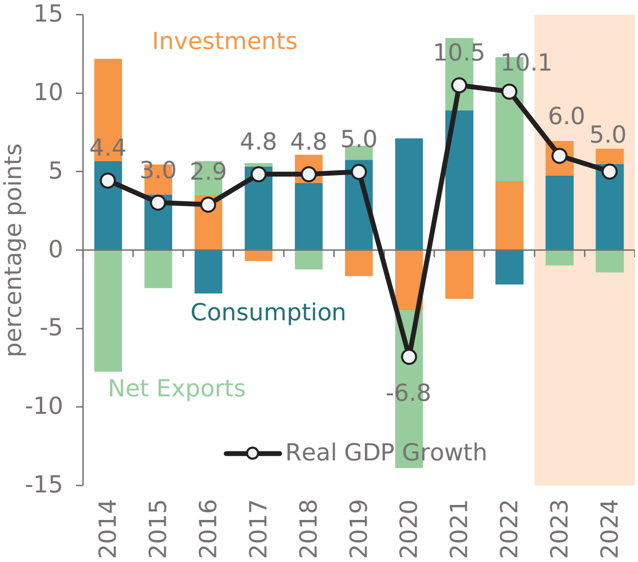

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

price inflation. On another hand, international Brent oil prices continue to exhibit a rising dynamic – and are likely to stay at a higher level according to recent projections made by respectable international organizations – which will eventually aggravate inflationary pressures. The latter developments are largely tied to the extensions of supply restrictions by OPEC countries. Besides, the Russian government has recently banned gasoline fuel exports, forcing importers in Georgia to switch to alternative and relatively more expensive suppliers. In general, the situation on international commodity markets is highly volatile and these forecasts could thus be revised upwards or downwards in the future.

As for economic activity, the NBG's forecast for real GDP growth in 2023-2024 has been left unchanged: the economy will grow by 6% in 2023 and by 5% in 2024, ceteris paribus. The faster-than-expected recovery of the economy's potential in the post-pandemic period, stemming from the rising productivity of production factors and investments, continues to represent one of the major drivers of economic growth. It should further be noted that the gap between the pre- and post-pandemic trends has now been fully closed. At the same time, solid foreign inflows owing to the geopolitical situation will still significantly contribute to 2023 growth, boosting both export services and enhancing domestic spending. Concurrently, credit growth will help investments amid a normalization of the monetary policy. Real GDP growth in 2023-2024 will thus be driven by domestic demand and investments (see Figure 2.1.3).

Taking the above-mentioned factors and risks into consideration, the National Bank of Georgia will continue to decrease the monetary policy rate at a moderate pace in accordance with the current macroeconomic forecasts. The monetary policy rate will thus 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

Amidst strong domestic demand, elevated inflation in trading partner countries, and current geopolitical tensions, macroeconomic forecasts continue to carry significant risks.

Macroeconomic Forecast Risks	Impact on Inflation
A sharp decrease in Russia-Ukraine war-related inflows and a deterioration of the current account balance	↑
Worsening of the investment climate and credibility shock	↑
Strong domestic demand	↑
Limited supply of commodity products in 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

Amidst strong domestic demand, high inflation in trading partner countries, uncertainty regarding the Russia-Ukraine war and the ongoing conflict in the Middle East, macroeconomic forecasts remain highly uncertain. The high-impact risks are primarily inflationary in nature. Their realization will result in 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, a potential escalation of the military conflict, and the nature of its resolution. A further increase in the riskiness of the region or a sharp decrease in war-related inflows will deepen the current account deficit, worsen the investment climate, and create pressure on the foreign exchange market to depreciate. The latter, given the still-high level of dollarization in the economy, will increase inflationary pressure through the inflation expectations and input costs channels. Furthermore, amid geopolitical uncertainty, supply constraints on international commodity markets remain a challenge and also carry inflationary risks. If these risks are realized, monetary policy will be tightened as compared to the baseline scenario.

Some local economic tendencies pose a particularly high level of risk. In the wake of still-high foreign inflows, strong credit activity is notable, including an acceleration in foreign currency lending. This increases the risk of economic activity exceeding its potential level, which in the future could put additional pressure on inflation. It should be noted that monetary policy will be particularly intolerant of demand-driven inflation and, where necessary, additional instruments will be used to ensure the stabilization of long-term inflation expectations and the mitigation of shocks.

The recent disinflation has largely been driven by a decline in imported inflation. This underscores the risk of a further increase in imported inflation, which could be driven by rising inflationary expectations in trade partner countries or by the extension of oil supply restrictions from OPEC members. In the case of a new, strong supply shock, monetary policy will be tightened relative to the baseline scenario, thereby ensuring that long-term inflation expectations remain closely aligned with the target.

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 a depreciation of their currencies and an attendant strengthening of the currencies of developing countries.

With the current update, expected inflation in the short term has increased slightly, primarily being driven by rising commodity prices.

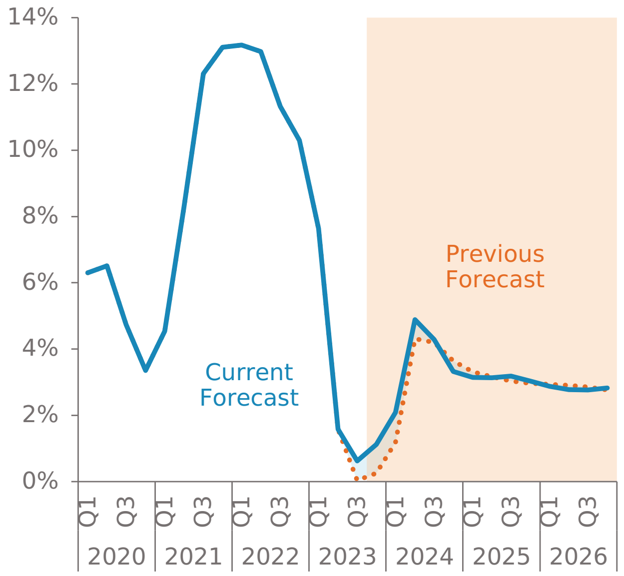

Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

The real GDP growth forecast for 2023-2024 has not changed. The assumptions that determine it remain consistent with those of the previous forecast.

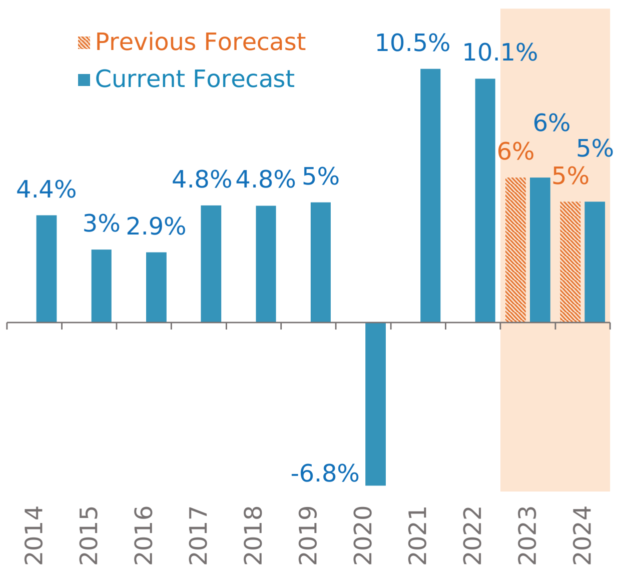

Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expected inflation in the short-term has increased slightly (see Figure 2.2.1). The primary sources of this change relate to commodity price and effective exchange rate dynamics. In particular, higher-than-expected commodity prices increase the forecast, while a prolonged impact of a strengthened effective exchange rate contributes to its reduction. In 2023, inflation will remain below the target. In 2024, partially due to the base effect, it will exceed the of 3% target before stabilizing around that target in the second half of the year alongside a gradual policy easing.

According to the updated forecast, the economic growth forecast for 2023-2024 has not changed (see Figure 2.2.2). As the assumptions that determined it are consistent with those of the previous forecast, other things being equal, real GDP growth in 2023 will be 6%, and in the years that follow it will approach its long-term potential growth rate of 5%.

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 expected inflation of Georgia's main trading partners for 2023-2024 has increased. The short-term forecast related to the exchange rate has worsened, although the relatively long-term one has improved. Real growth expectations have improved for 2023, driven by higher-than-expected actual economic activity in both Russia and the US. Economic growth expectations for 2024 have worsened for all major trading partners except for the US (see Figure 2.2.3).[17]

17 These calculations are based on forecasts for the five main trading partners of Georgia: the US, the EU, Turkey, Ukraine and Russia. It should be noted that their weights were updated in the current quarter.

According to the updated forecast, the expectations for inflation and economic growth in Georgia's main trade partners up to 2024 have worsened, while improving for the exchange rate.

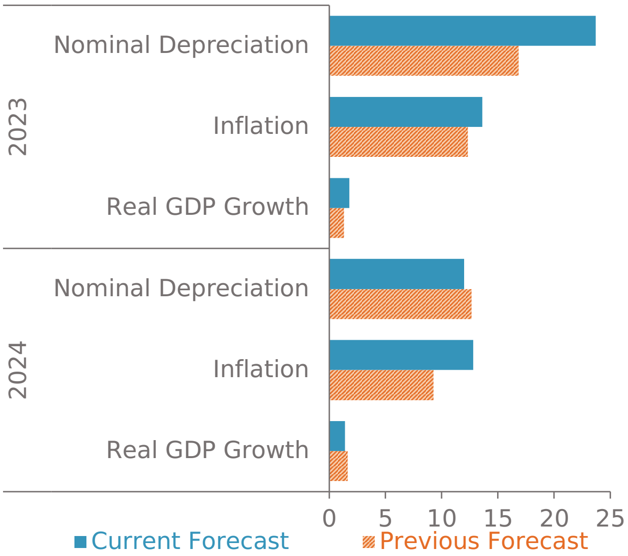

Figure 2.2.3. Changes in assumptions about trading partners

Source: Bloomberg, NBG

According to the alternative scenario, real GDP is projected to grow by 6.5% in 2024 amid economic activity exceeding its potential level. In the subsequent period, under the conditions of a tighter monetary policy, real economic growth then has to decelerate sharply in order to return to its sustainable, long-term potential level.

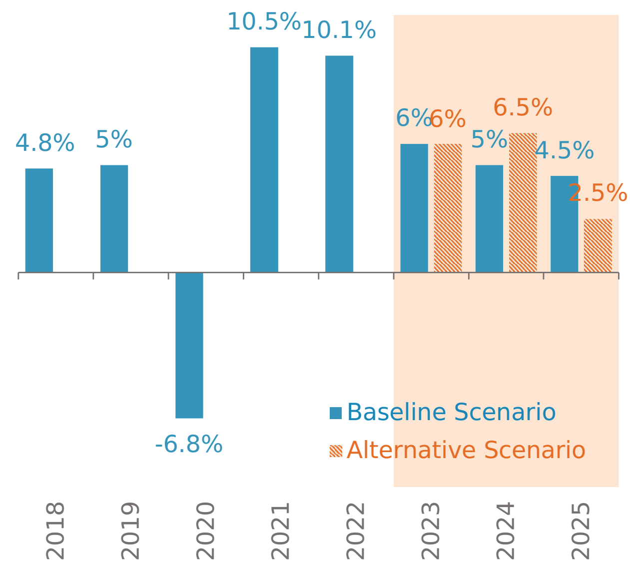

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

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. The current scenario takes into account stronger-than-expected credit growth leading to higher-than-potential economic activity, which would have inflationary implications. Moreover, pressures on the inflation will be further intensified both by the supply constraints on 'Brent' crude oil on international markets and by globally increased inflation.

In the case of a materialization of this scenario, the real economy will increase by 6.5% in 2024 (see Figure 2.3.1). However, in the subsequent period, under the conditions of the tighter monetary policy, real economic growth has to decelerate sharply to return to its sustainable, long-term potential level. In 2025, economic growth will thus slow to 2.5%. It is important to note that episodes of economic overheating typically entail risks related to a widening of the current account deficit and excessive asset price growth. Additionally, the potential level of the economy is threatened by the increased economic volatility.

In the alternative scenario, in comparison to the baseline, the inflationary pressures arising from the intensive utilization of production factors will be further intensified by a depreciated exchange rate resulting from the worsening current account deficit. The latter, considering the level of dollarization in the economy, will increase inflationary pressure through the intermediate costs and expectations channels. In turn, and despite the recent disinflation, against the backdrop of the prolonged period of high inflation experienced in recent years, additional strong inflationary pressure could increase the likelihood of a credibility shock, which in turn could de-anchor long-term inflation expectations. In the event of a realization of this acute, albeit less likely, scenario, inflation in 2024 will be an average 1.8 percentage points higher than in the baseline scenario (see Figure 2.3.2).

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, under the alternative scenario the trajectory of the monetary policy rate in 2024 will shift upward by an average of 1.5 percentage points and will only gradually normalize after the stabilization of inflation expectations (see Figure 2.3.3).

In the alternative scenario, by exceeding its potential level, economic activity will significantly increase inflationary pressure, which is largely driven by the high utilization of production factors.

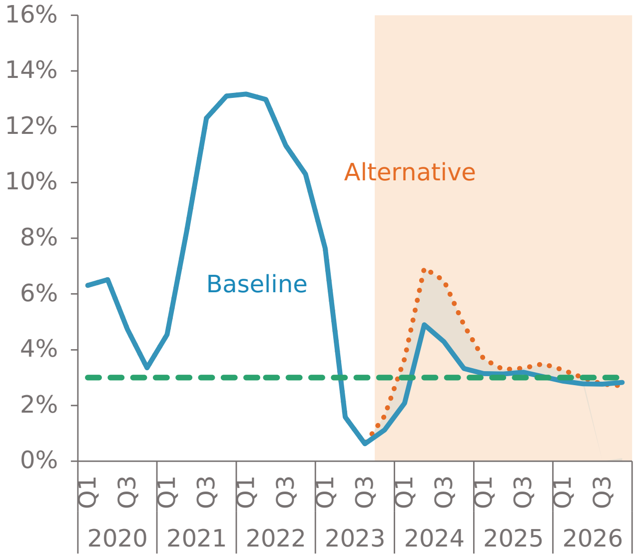

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

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

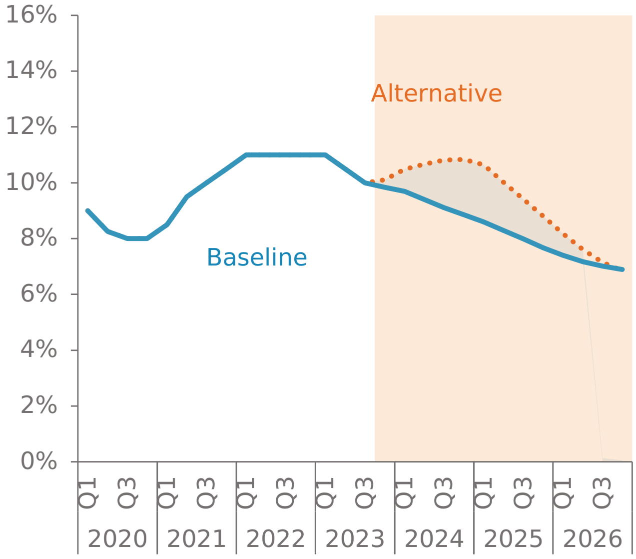

Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

Akin to the NBG's forecasts, the inflation expectations of financial market participants were negligibly revised upward for the medium term as compared to those of the previous quarter.

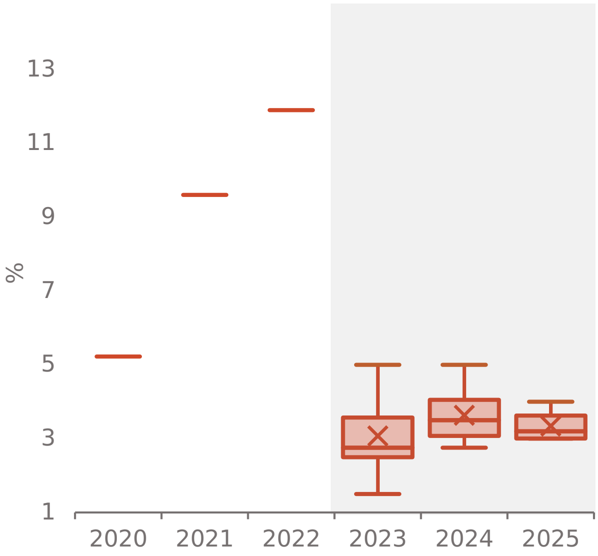

Figure 2.4.1. Actual average inflation (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

Financial market participants have slightly revised their expectations upwards for the medium-term monetary policy rate as compared to the previous quarter. However, forecast dispersion remains high.

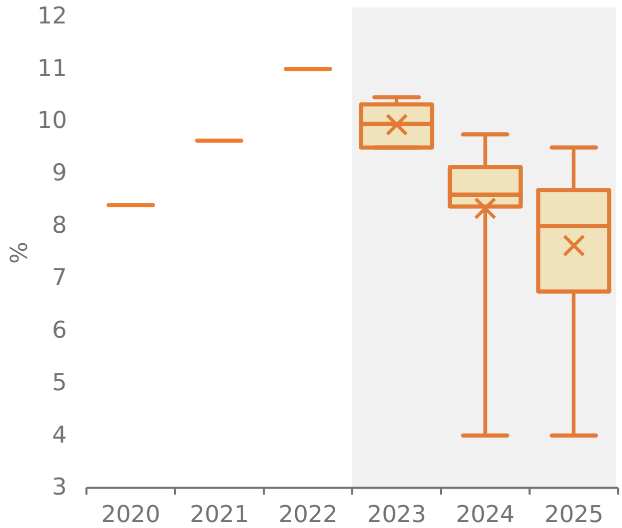

Figure 2.4.2. Actual monetary policy rate (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

In the fourth 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 show negligible changes over those of the previous quarter.

The median inflation expectation for 2023 was 0.3 pp lower and the average inflation forecast was 0.2 pp lower, amounting to 2.8% and 3.1% respectively. The median projection for 2024 shifted up by 0.3 pp to 3.5%, while the average rose by 0.2 pp to 3.6%. The median and average projections for 2025 have remained unchanged, standing at 3.2% and 3.3% respectively (see Figure 2.4.1). It should be noted that the financial market participants' expectations are in line with the NBG's forecasts.

The market has also slightly changed its outlook on the monetary policy rate compared to the previous quarter. The median projection for 2023 rose by 0.3 pp to 10%, while the average forecast shifted up by 0.2 pp to 9.9%. The median projection for 2024 remained at 8.6%, while the average forecast increased by 0.3 pp, reaching 8.3%. Notably, the financial market participants revised their medium-term outlook upwards. The median and average forecasts for 2025 both rose by 0.4 pp, reaching 8% and 7.6% respectively (see Figure 2.4.2). However, it should be noted that the medium-term forecasts are continue to be characterized by high variability.

According to the current survey, real GDP growth expectations are almost unchanged. In particular, the median forecast of economic growth shifted down by 0.2 pp to 6.6%, while the average forecast remained at 6.4%. Similar to the previous quarter, the median and average projections for economic growth in 2024 remain at 5% and 5.1%. The median and average expectations of real GDP growth in 2025 declined by 0.1 pp, standing at 5.1% in both cases (see Figure 2.4.3).

The market forecasts for economic growth were negligibly revised upwards compared to those of the previous quarter.

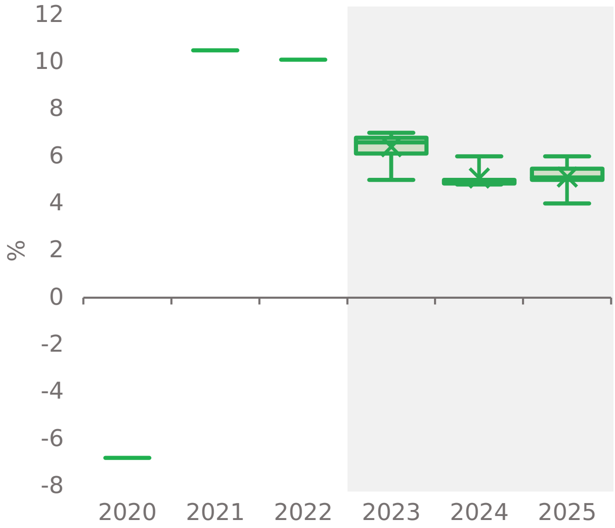

Figure 2.4.3. Actual real GDP growth (2020-2022) and the distribution of market participants' forecasts for 2023-2025

Source: NBG, Financial market participants, GeoStat

3 MONETARY POLICY

In the third quarter of 2023, inflation was lower than the target of 3%. The low inflation resulted from both the gradually vanishing effects of exogenous shocks and the decrease in the prices of locally produced goods, which was a consequence of maintaining a tight monetary policy and the normalization of inflation expectations. Other things being equal, inflation will be below 3% in 2023 and will later stabilize around the target. Despite positive tendencies, global economic risks and the current geopolitical environment remain sources of ambiguity. It should also be noted that, according to recent NBG estimates, aggregate demand remains strong and real economic growth in 2023 is forecast to be around 6%. As high growth imposes further inflationary pressures, the National Bank of Georgia is cautiously and gradually moving from a strict to a moderate monetary policy. In line with this, on 25 October 2023, the Monetary Policy Committee decided to keep the monetary policy rate unchanged at 10.0%.

On 25 October 2023, the monetary policy rate was kept unchanged at 10%. The NBG continues to maintain a tight policy stance.

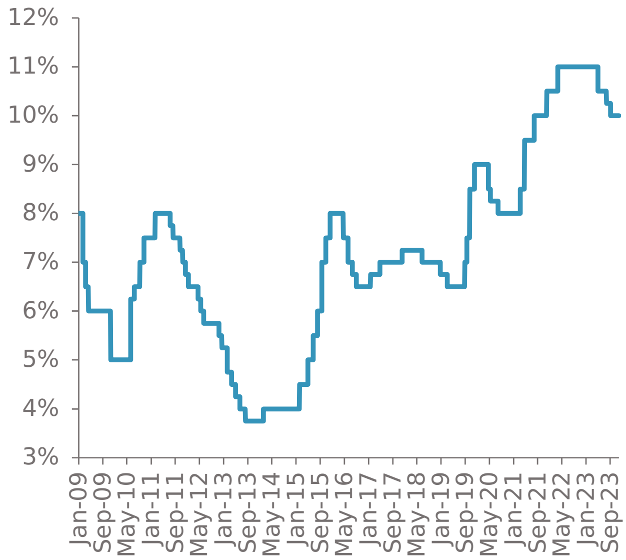

Figure 3.1. Monetary policy rate

Source: NBG

Due to the consecutive shocks of recent years and current shifts in the geopolitical environment, global uncertainties towards price dynamics 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. Global inflation has since passed its peak and has begun a declining trend in a plethora of countries. Nevertheless, strong inflationary pressure remains a main challenge for policy makers and is the main reason why a large number of countries continue to retain tight monetary policy stances.

The current shocks and global events have had 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, against the background of high levels of migration and increased remittances to the countries of the region, foreign demand is strong compared to the pre-war period. As a result, economic activity in Georgia remains high and, according to a recent estimate, the average growth of first eight months of the year has been around 7%. According to a recent NBG forecast, overall economic growth will be 6.0% in 2023. The improved forecast is also partially influenced by the faster-than-expected increase of potential GDP during the post-pandemic period.

Despite strong global inflationary pressure, the average price level in Georgia has had a declining trend starting from 2023. Inflation in Georgia is currently below the target of 3%. This declining tendency is a result of both external and internal factors.

Strong external money inflows appreciates both the nominal and real GEL exchange rates. The appreciated lari, together with decreased international commodity prices, has reduced prices of imported goods in Georgia. Global commodity prices have continued to decrease, which is partially due to increased supply on global markets. However, the average price index for commodities is still above pre-pandemic levels and ambiguity related to future price dynamics is high.

In contrast to the positive tendencies, the risk and volatility related to the oil market is significant. Given the strong demand from China and India, threat of a price increase on oil has increased. In addition, Russia has imposed export restrictions on petrol. Georgian importers will thus have to find another channel and buy petrol from a different supplier, the price of which is a-priori above the price of Russian petrol due to international sanctions. These two factors together imply that costs on petrol and transportation are expected to increase.

Putting external factors aside, the recent inflation dynamics in Georgia have been strongly influenced by local events. The maintenance of tight monetary policy has normalized expectations towards future price developments, which softened inflationary pressures. Meanwhile, fiscal consolidation and improved access to the Turkish market for medicines also played a role. Moreover, as a result of tightened monetary policy and recently implemented macroprudential instruments, credit activity has been stable, representing another important factor behind the low inflation.

The downward trend of inflation in 2023 is a result of both tight monetary policy and planned fiscal consolidation. However, strong domestic demand, the recent increase in credit activity, the restrictions set by Russian officials on petrol exports, ambiguity in terms of global prices, and labor market tendencies all create solid ground for pursuing a cautious monetary policy.

According to the latest data, credit activity has increased. Demand for business loans denominated in foreign currency has seen a hike. According to the NBG's expectations, the tightened monetary policies of the European Central Bank and the US Federal Reserve should have had the effect of tightening policies on foreign currency lending; however, an analysis of credit activity tendencies reveals that business credits as well as loans denominated in foreign currency have risen. Given the background of strong internal demand, such credit activity patterns require careful monitoring. The tight monetary policy and recently implemented macro prudential measures will keep credit activity at a reasonable level, but future dynamics will be closely monitored by the NBG.

Shifts on the labor market also continue to draw attention. The risk of a wage-price spiral developing has not materialized and the pressure originating from the labor market has been neutralized as the unit labor cost has decreased. However, total production costs remain high and the growth rate of wages is above the productivity rate. The dynamics of the labor market thus remain under the focus of the NBG.

Taking into account the recent positive tendencies, inflation and inflation-related expectations in Georgia are decreasing. Domestic inflation has a declining trend, but is falling at a slower pace and remains high. Despite the existence of positive factors, global uncertainty and inflationary risks are the main reasons for caution. As a small open economy, Georgia is vulnerable to global developments. Global uncertainties make

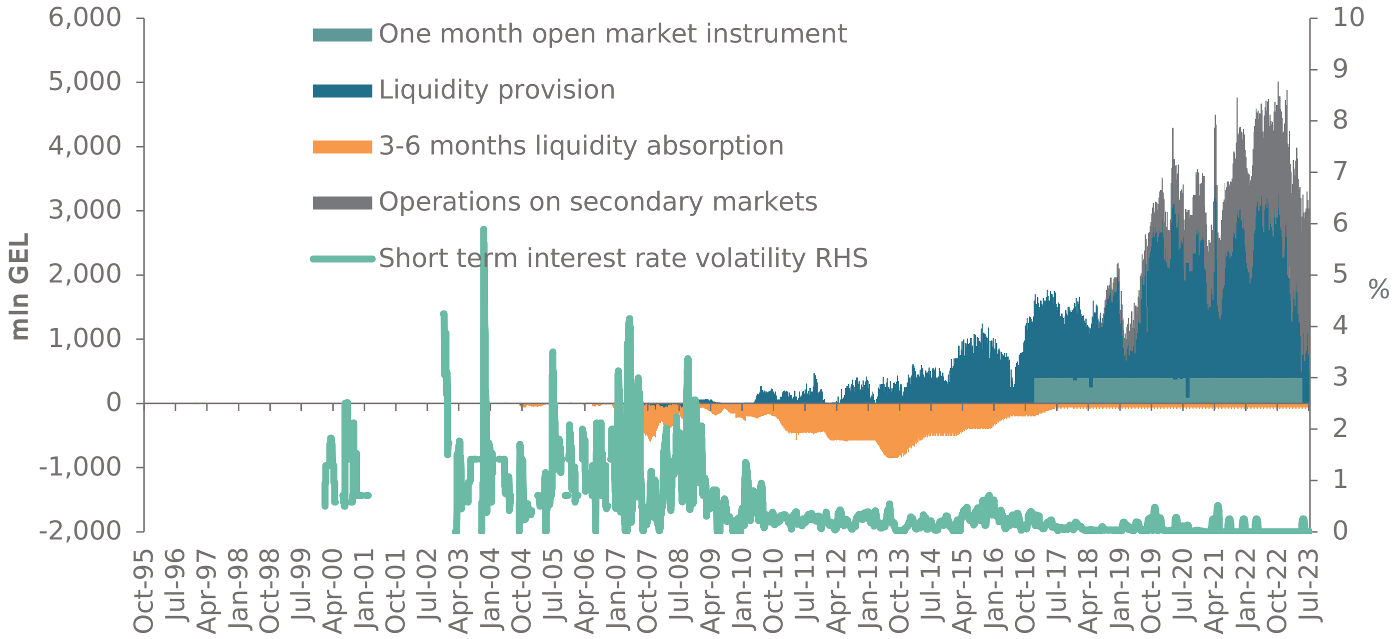

Figure 3.2. Liquidity instruments

Source: NBG

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

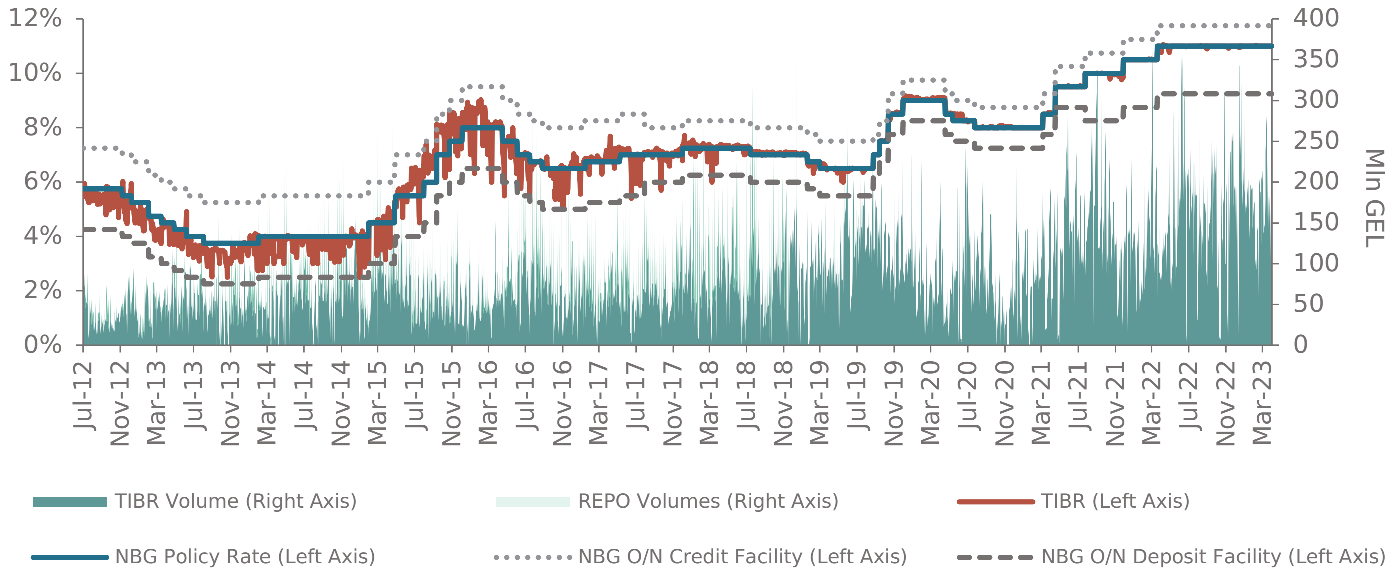

Figure 3.3. Interbank money market

Source: NBG

monitoring inflation-related risks a primary task for the NBG. One of the biggest potential threats is the high volatility of global prices – especially petrol – 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, the wage growth rate was lower than in the previous quarter 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 the monetary policy rate at a slow pace. In accordance with this, the Monetary Policy Committee, at a meeting held on 25 October 2023, decided to maintain the policy rate at 10%. A strict policy will be maintained until acute risks and inflationary pressures are sufficiently softened. If the factors negatively affecting inflation expectations continue to evolve, it may be necessary to implement a tighter policy or to maintain the tight stance for a prolonged period. In the event of necessity, the NBG may also implement additional instruments to reduce demand-side inflationary pressures.

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. 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, and the NBG guarantees that rates on the interbank money market are close to the monetary policy rate.

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