Monetary Policy Report

July

2024

საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation

3%

2.2%	Inflation remains below the target of 3%.

Economic Growth

According to the updated forecast, economic growth of 6.8% is expected in 2024.	6.8%

Monetary Policy

8.0%	Given the continued high uncertainty, the monetary policy rate has been kept at 8%.

MONETARY POLICY DECISION

The National Bank of Georgia has maintained the monetary policy rate at 8.0%.

The National Bank uses interest rate adjustments to influence aggregate demand and inflation expectations. This aims to keep inflation close to the medium-term target of 3%. Low and stable inflation supports employment and sustainable economic growth, which are crucial given the current high level of uncertainty.

In Georgia, inflation remains below the target of 3 percent. In June 2024, the overall price level increased by 2.2% year on year, and core inflation was 1.4%. The close-to-target inflation was largely ensured by the monetary policy implemented by the National Bank of Georgia. As a result of both timely monetary policy tightening and gradual normalization, the inflation of domestically produced products stabilized at the 3% target. Increased competition in the economy also helps the low level of inflation.

According to the updated forecast of the National Bank of Georgia, other things being equal, inflation will remain at a low level in the short term and will approach the target rate by the end of the 2024. However, inflationary risks persist. Recently increased prices of commodities on international markets and rising transportation costs from China create the risk imported inflation. In addition, global uncertainty remains a significant challenge both from a geopolitical and economic point of view. Besides external factors, domestic economic activity is stronger than expected. However, at this stage, alongside strong demand, the total potential production of the economy has increased, which reduces the pressure from the demand side.

In accordance with these circumstances and risks, the National Bank of Georgia has kept the monetary policy rate at 8%. The rate of further normalization of monetary policy will depend on the severity of inflationary risks. Interest rate changes by the National Bank are transmitted to the economy gradually, taking approximately 4-6 quarters to be fully reflected. If factors driving inflation expectations upward re-emerge, a further tightening of monetary policy or maintaining the current tight stance for a longer period may become necessary.

We are committed to using all available tools to maintain price stability. This means keeping the overall price level increase close to the 3% target over the medium term.

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BRIEF OVERVIEW

In conjunction with robust economic growth, Georgia continues to experience low inflation. These developments, coupled with the fact that traditional factors have continued to exert moderate pressure on consumer prices, suggest an accelerated increase in the economy's potential. Furthermore, various indicators point to a reduction in profit margins within the economy, which helps mitigate price pressures stemming from demand. However, the current forecast indicates that, beyond the short term, the downward trend in profit margins will moderate, and potential growth will return to a sustainable long-term path. Consequently, an appropriate monetary policy response will match economic activity with the normalized potential output, ensuring the eventual stabilization of inflation at its target rate.

According to the baseline forecast, inflation is projected to remain at a low level this year. It will subsequently exceed the target rate temporarily, primarily due to base effects, and eventually stabilize around the 3% target in the medium term.

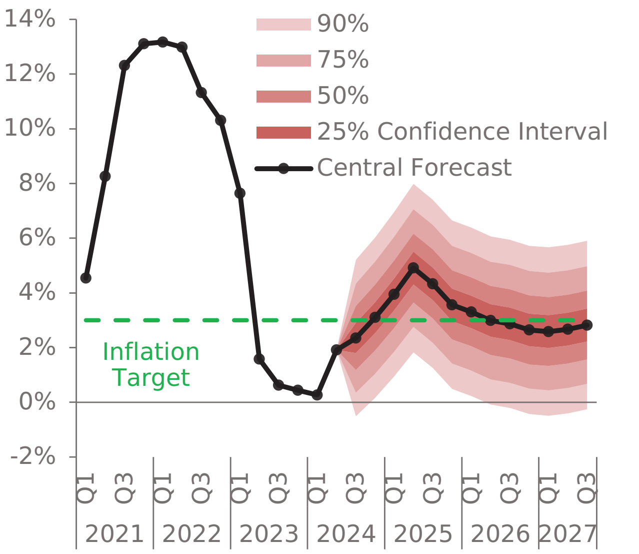


Figure 1. Headline CPI inflation forecast.

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

In the second quarter of 2024, overall inflation remained below the target level at 1.9%, slightly exceeding the previous forecast. Both actual and expected inflation are influenced by the recent volatility of the lari exchange rate and higher-than-anticipated demand. However, this upward pressure has been mitigated by the accelerated growth of potential GDP, as driven by ongoing structural changes in the economy. Additionally, various indicators (see Box) suggest that, among other factors, increased competition is leading firms to reduce their profit margins, thereby counterbalancing the demand-driven pressure on prices. **According to the current forecast, average inflation in 2024 will be 1.9%, while the average inflation for 2025 is projected to be 4.2%,** partially reflecting the low base effect (see Figure 1).

As mentioned above, economic activity has exceeded expectations in the first half of the year. This accelerated growth in potential is attributed to the active entry of new firms into the market and other structural factors, resulting in high growth in employment, among other developments. Consequently, the **real GDP growth estimate for 2024, which was set at 5.6% in the previous forecast, has been revised upward to 6.8%.** This growth will be significantly driven by consumption, bolstered by enhanced purchasing power amid low inflation and substantial real wage increases, and will be further supported by rising credit growth. Looking ahead to next year, assuming other factors remain constant, the normalization of potential growth and an appropriate monetary policy response are expected to bring economic activity growth closer to 5% (see Figure 2).

Despite the aforementioned considerations, **the primary risks to the baseline forecast predominantly stem from external factors**. Notably, amid heightened global uncertainty, significant threats persist concerning the escalation of commodity pric-

Amid stronger-than-anticipated actual economic activity, the forecast for real GDP growth in 2024 has been revised upward to 6.8%. However, in subsequent years this is expected to normalize around the long-term potential growth rate of approximately 5%.

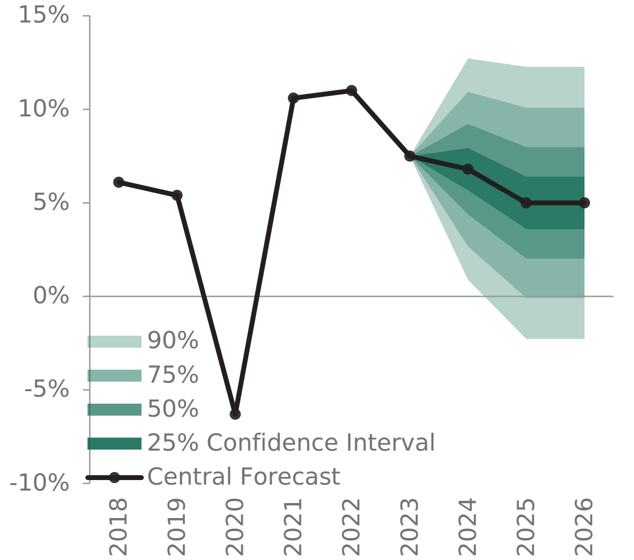


Figure 2. Annual growth forecast of real GDP.

Source: NBG, GeoStat.

In light of inflationary risks induced by both external and internal factors, it has been prudent to decelerate the normalization of monetary policy.

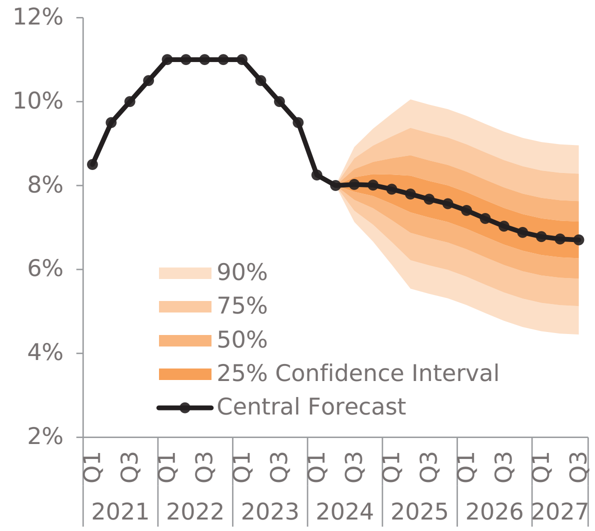


Figure 3. Monetary policy rate forecast.

Source: NBG.

es (including food and fuel), increased international shipping costs, and the deceleration of monetary policy normalization in developed countries, particularly the United States. Domestically, amid rising unit labor costs and stronger-than-anticipated actual economic activity, further increases in lending and rising domestic demand could amplify inflationary pressures.

Considering the above-mentioned factors, **during its meeting on 30 July the Monetary Policy Committee of the National Bank of Georgia (NBG), deemed it optimal to maintain the monetary policy rate at its current level**. Such cautious approach to policy normalization is crucial for stabilizing inflation at its target rate in the medium term, after which the rate will gradually return to its neutral level, which is currently estimated at 7% (see Figure 3).

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 a challenging geopolitical landscape and stringent financial conditions, the global economy is projected to continue its recovery at a gradual pace in 2024. In the context of Georgia, external demand weakened during the second quarter of the year, leading to a decline in both nominal and real export volumes. However, inflows from service exports and other transfer channels increased, offsetting the decline in goods exports, and given low growth in imports, contributed to current account improvement. In contrast to weak external demand, domestic demand was stronger than had been anticipated in the first half of the year, with consumption remaining the primary driver of growth. Consequently, according to the updated macroeconomic forecast, the current account deficit to GDP ratio is expected to be around 5.6% in 2024. Meanwhile, inflation remains low due to the relative stability of commodity prices on international markets and the reduction of local inflation.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

Amid the Russia-Ukraine war and escalating tensions in the Middle East, global economic growth is projected to remain modest in 2024. This subdued growth is primarily attributable to persistently tight financial conditions worldwide and a challenging geopolitical environment that continues to disrupt supply chains. Additionally, there is a high degree of uncertainty. Nevertheless, it is important to note that cyclical factors are diminishing in most countries, and economic activity is approaching its potential level. According to the updated forecast, made in July by the International Monetary Fund (IMF), **global economic growth** is expected to be 3.2% in 2024 and 3.3% in 2025. Inflation is anticipated to decrease compared to the previous year, with projections of 5.9% for 2024 and 4.4% for 2025.[1] For emerging and developing economies, the real growth forecast for both 2024 and 2025 is 4.3%, while inflation is expected to be 8% in 2024 and 6% in 2025.[2]

Economic activity is anticipated to advance at a slower pace in 2024 due to increased global uncertainty.

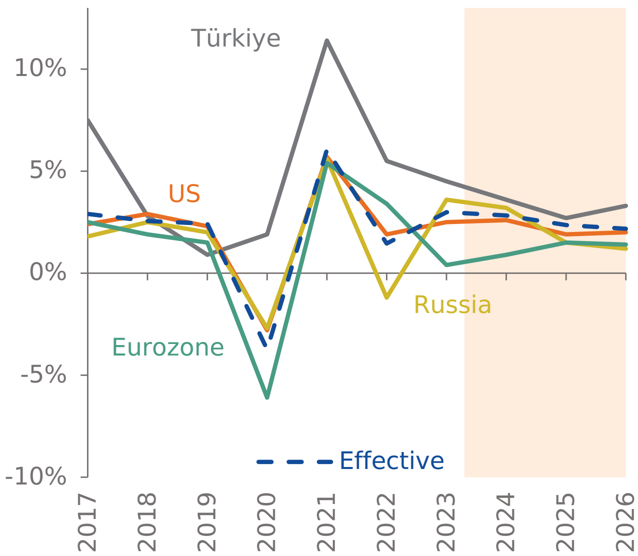


Figure 1.1.1. Real GDP growth of economic partners.

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

In the second quarter of 2024, amid still-tight financial conditions, inflationary pressures gradually diminished across both developed and emerging economies. This moderation in inflation was supported by a decline in food prices on international commodity markets. However, recent observations indicate an uptick in oil prices (see section 1.1.2). Additionally, the elevated inflation observed in the services sector continues to impede the normalization of monetary policy

1 *International Monetary Fund. 2024. The World Economic Outlook Update: The Global Economy in a Sticky Spot. Washington, D.C., July (Hereafter: WEO July 2024 Update).*

2 *Ibid.*

Amid a tightened financial environment, inflation is generally declining across most of Georgia's trading partners, including the eurozone.

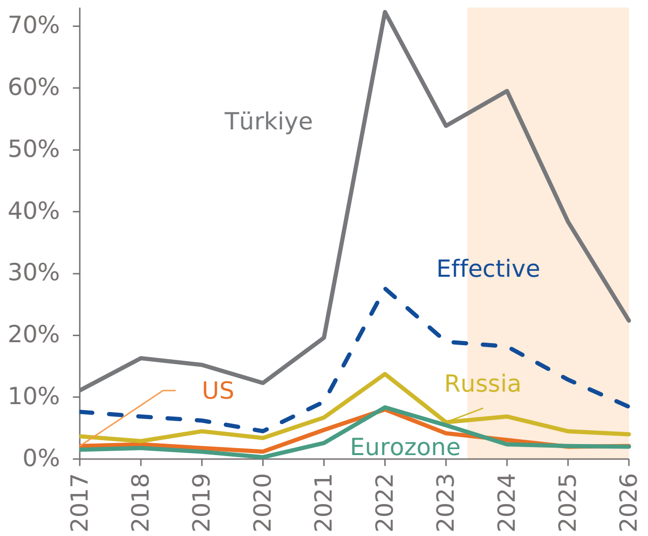


Figure 1.1.2. Headline Inflation rates of economic partners.

Source: IMF, NBG's calculations.

on a global scale.

In the second quarter of 2024, economic activity in the **United States** improved, albeit at a gradual pace. On the positive side, robust labor market conditions, coupled with sustained levels of industrial output and retail sales, were notable. Conversely, the prevailing tight financial environment has exerted a dampening effect on economic activity. Additionally, the annual inflation rate, which stood at 3% in June, remains above the target threshold. According to estimates by the IMF, real GDP growth in the United States is projected to be 2.6% in 2024, with a further slowdown to 1.9% anticipated for 2025. Inflation is expected to moderate to 3.1% in 2024 and 2% in 2025.[3]

In the second quarter of 2024, the **eurozone** experienced a modest improvement in economic activity. This upturn can primarily be attributed to increased consumer expenditure—particularly within the service sector—as well as enhanced export performance. In June, the annual inflation rate was recorded at 2.5%. It is important to highlight that European countries continue to enforce economic sanctions against Russia, which exerts additional pressure on their economies. According to IMF projections, economic growth for the eurozone is forecast to be 0.9% in 2024 and 1.5% in 2025. Inflation is anticipated to average 2.4% in 2024 and 2.1% in 2025.[4]

In the second quarter of 2024, **Türkiye** experienced subdued economic activity primarily due to the continued devaluation of the Turkish lira and the resultant increase in inflation. The deterioration in the external sector and a decline in the production index were notable. Nonetheless, domestic demand remained robust. A reduction in economic activity is anticipated this year, largely as a consequence of the substantial tightening of monetary policy. As of June, the inflation rate was 71.6%. According to the IMF, Türkiye's real GDP growth is projected to be 3.6% in 2024 and 2.7% in 2025[5], with inflation expected to be 59.5% in 2024 and 38.4% in 2025.[6]

In the second quarter of 2024, economic activity in **Russia** remained subdued, characterized by a decline in retail sales and a deteriorating labor market, which has been accompanied by a reduction in real wages. The fiscal deficit also remained elevated. Nonetheless, there have been some improvements in the manufacturing sector and in oil extraction and refining. It is important to note that the business environment, investment levels, and the foreign sector all continue to suffer from the ongoing Western sanctions. Infla-

3 Ibid.
4 Ibid.
5 Ibid.
6 International Monetary Fund. 2024. The World Economic Outlook: Steady but Slow: Resilience Amid Divergence. Washington, D.C., April (Hereafter: WEO April 2024).

tion has risen, with the annual rate reaching 8.6% in June. According to IMF projections, Russia's real GDP growth is expected to be 3.2% in 2024 and 1.5% in 2025[7], while inflation is forecast to be 6.9% in 2024 and 4.5% in 2025.[8]

The ongoing war waged by Russia in **Ukraine** has had a profound social and economic impact, leading to the destruction of numerous critical infrastructure facilities and a reduction of the country's economic potential. The IMF projects that Ukraine's real GDP growth will be 3.2% in 2024 and 6.5% in 2025. Additionally, the average inflation rate is anticipated to be 6.4% in 2024 and 7.6% in 2025.[9]

In the second quarter of 2024, economic activity in **Armenia** remained robust, primarily driven by increased credit activity and consumer spending, as well as notable activity within the construction sector. However, the manufacturing sector experienced a decline. Concurrently, while peace negotiations with Azerbaijan were ongoing, domestic uncertainty increased. The annual inflation rate for June was recorded at 0.8%. According to the IMF, Armenia's real economic growth is projected to be 6% in 2024 and 5.2% in 2025, with inflation anticipated to reach 3.1% in 2024 and 3.7% in 2025.[10]

In the second quarter of 2024, **Azerbaijan** experienced an improvement in its growth rates, attributable to increased activity across both the oil and non-oil sectors. Retail sales also showed positive trends. Concurrently, the annual inflation rate decreased to 1.1% in June. According to the IMF, Azerbaijan's economic growth is projected to be 2.8% in 2024 and 2.3% in 2025, with inflation anticipated to reach 3.5% in 2024 and 5% in 2025.[11]

In the second quarter of 2024, amidst the ongoing high-inflationary environment, the central banks of most of Georgia's trading partners continued to maintain tight monetary policy stances.

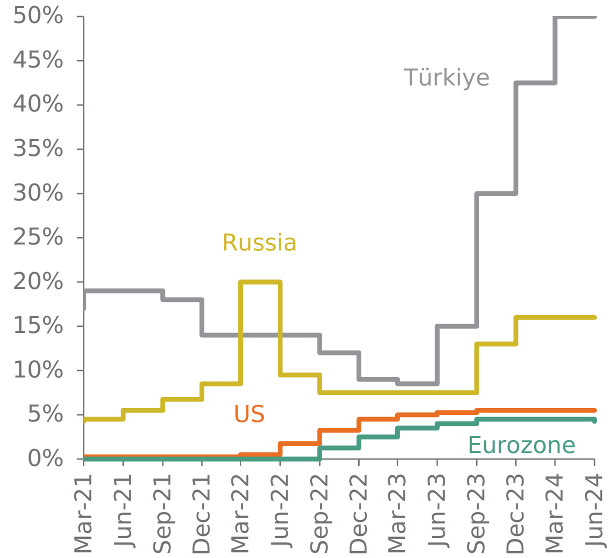


Figure 1.1.3. Monetary policy rates in Georgia's trading partners.

Source: www.global-rates.com

In the second quarter of 2024, several **central banks** in Georgia's trading partners continued to maintain tight monetary policies in response to persistent high inflationary pressures and expectations. Specifically, the US Federal Reserve left the federal funds rate within the range of 5.25-5.5%. Similarly, the Central Bank of Türkiye retained its monetary policy rate at 50%, while the Central Bank of the Russian Federation kept its rate at 16%. In contrast, the European Central Bank, responding to relatively subdued economic activity, began to reduce its interest rate, lowering it to 4.25%.

7 *WEO July 2024 Update.*
8 *WEO April 2024.*
9 *Ibid.*
10 *Ibid.*
11 *Ibid.*

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

Uncertainty in international commodity markets remains high due to global geopolitical challenges. Current tensions in the Middle East are putting upward pressure on prices in major commodity markets, including oil. A conflict-driven increase in commodity prices could worsen global inflation, which in turn would slow down monetary policy easing. In general, commodity prices are vulnerable to weather conditions, geopolitical tensions, policy changes, and other market shocks. These can disrupt the balance of supply and demand, and, consequently, affect global prices.

The Food and Agriculture Organization's International Food Price Index of the United Nations increased slightly, rising by 1.4% in the second quarter of 2024. However, despite a three-month growth in the index, it was still down by 2.1% compared to the corresponding period of last year. In June, the index was unchanged from May, as increases in the price indices for vegetable oil, sugar and dairy products were balanced out by the decrease in the price index for cereals, while the meat index was almost unchanged (see Figure 1.1.4).

In the second quarter of 2024, the food price index increased slightly. However, the index remains low compared to the previous year.

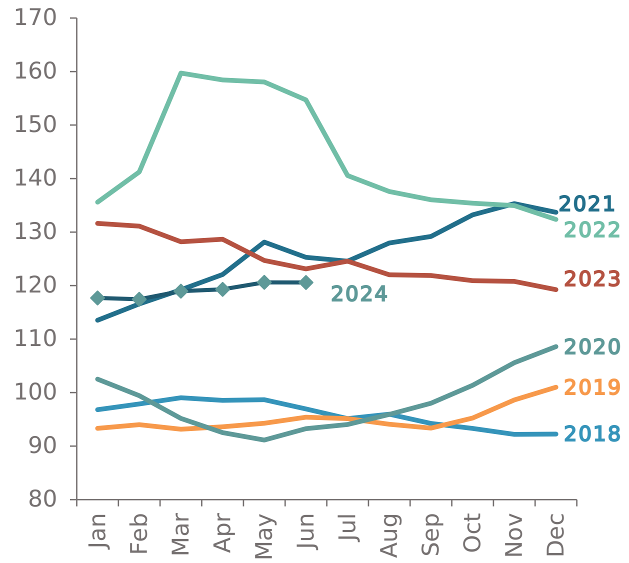


Figure 1.1.4. International food price index.

Source: FAO.

In June 2024, the FAO cereal index decreased by 3.0% from May and by 9.0% compared to June 2023. Global export prices for all major cereal groups decreased month on month. The decline in wheat prices mostly reflected slightly improved production prospects in some major exporting countries, including Kazakhstan and Ukraine. The implementation of a temporary import ban by Türkiye (from 21 June to mid-October) has also contributed to the softer price trend.

The vegetable oil price index rose by 3.1% in June compared to May, reaching its highest level since March 2023. Meanwhile, sunflower oil prices continued to rise as a result of robust demand from the biofuel sector in the Americas and a decline in exports from the Black Sea region.

After a three-month decline, the sugar price index rose by 1.9% in June; however, this was still down in year-on-year terms and was 21.6% lower than in June 2023. The rise in the sugar price index in June was mainly driven by a lower-than-expected harvest in Brazil in May, which heightened concerns over the potential impact of prolonged dry weather conditions on sugar production in the coming months. Erratic monsoon rainfalls in India and a downward revision to crop forecasts in the European Union also contributed to the overall upward pressure on world sugar prices.

Oil prices rose slightly in the second quarter of 2024. Recently, oil prices have been characterized by high volatility stemming from various ongoing developments: on 2 June, OPEC+ agreed to extend their official crude output cuts into 2025; in addition, it is extending its cut of 2.2 million barrels per day, which

Average oil prices increased slightly in the second quarter of 2024, while uncertainty around oil prices remains high due to global events.

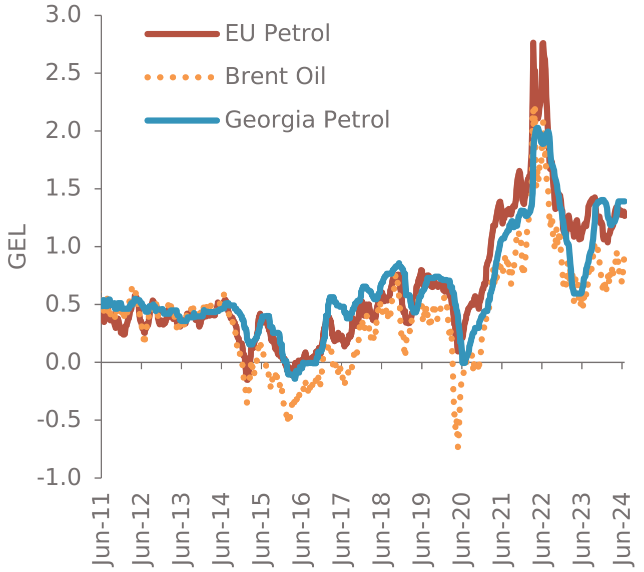


Figure 1.1.5. Petrol price index (Jan 2021=100).

Source: EU Commission, Statista, NBG calculations.

In June 2024, the cost of international transportation increased, which was mainly due to increased geopolitical risks.

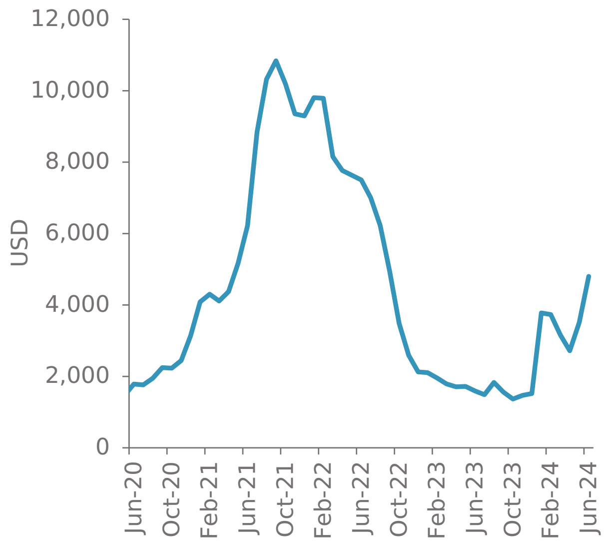


Figure 1.1.6. Average shipping cost of a 40-foot container worldwide.

Source: Drewry World Container Index (WCI).

were announced in November last year, until the end of September 2024, before gradually phasing this out on a monthly basis by the end of September 2025. In addition, uncertainty around oil prices increased in April due to the escalation of the Iran-Israel conflict and ongoing tensions in the Red Sea region. These could disrupt supply chains and further increase oil prices.

In the second quarter of 2024, average oil prices increased by 2.1% compared to the first quarter. In June, the average price of a barrel of Brent oil increased to USD 82.2, a rise of 0.6% compared to the previous month. Fluctuations in oil prices are reflected on European as well as Georgian gasoline prices (see Figure 1.1.5). If, against the backdrop of the acute current geopolitical situation, oil prices further increase, these will be transferred to the Georgian market.

According to the updated July forecast of the International Energy Association, the price of Brent crude oil is expected to be around USD 89 per barrel in the second half of 2024. The moderate increase in oil prices expected in the second half of the year is due to the extension of oil production cuts by OPEC+ members.

Along with international commodity prices, the cost of transporting imported goods affects total inflation. At the end of the second quarter of 2024, global transportation costs were up 36.7% from May (see Figure 1.1.6). This was largely driven by ongoing tensions in the Red Sea region and US imposed tariffs on Chinese imports. These caused disruption in supply chains and companies had to look for alternative delivery channels (for example, air transport, which is more expensive but more reliable). These factors have significantly increased the cost of global shipping.

Uncertainty in commodity markets has increased amid rising geopolitical tensions, and expected inflationary pressures from external factors thus remain noteworthy. The trends observed in international food and oil prices, alongside rising transportation costs and supply chain disruptions, are indicators of inflation risks. In the event of a rise in commodity prices, price dynamics will increase imported inflation in Georgia and put upward pressure on overall inflation.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the beginning of 2024, external demand was weak once again; however, foreign currency inflows from several channels began to rise, which supported a narrowing of the current account deficit. In the second quarter, the slowdown of external demand on motor cars induced an overall fall in revenues from exports of goods, but revenues from domestic goods exports remained at a high level. On the other hand, in light of lower purchases of certain goods intended for re-export (cars and copper ores), expenses on import goods decelerated. Moreover, due to existing structural changes in the economy, exports of services generated substantial revenues—in particular, international transportation as a result of the promotion of Georgia's role as a Middle Corridor country. At the same time, exports of information and computer services, despite seeing an annual decrease, remained responsible for substantial revenues. In addition, rising revenues from international travel and the the high level of instant money transfers have induced a slowdown of the deterioration of the current account.

As demand for goods intended for re-export remained weak, total exports of goods declined in both nominal and real terms.

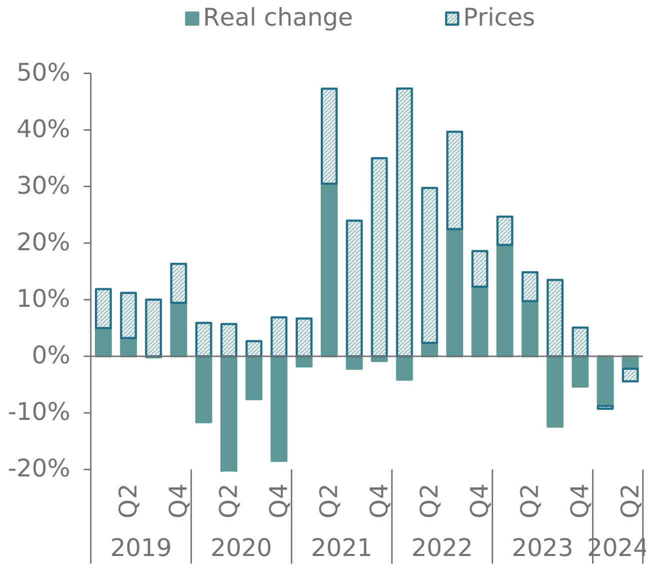


Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

Although external circumstances have exhibited positive signs overall, imports of goods are likely to rise in light of increased economic activity. Consequently, the current account deficit is expected to worsen slightly by around 5.6% of GDP. It is worth mentioning that, considering Georgia's situation as a small open market economy, a fluctuation of the current account deficit to GDP in the margin of around 5% represents a sustainable level.

In the second quarter, external demand on goods intended for re-export was comparatively weak, which caused overall exports of goods to decline. Alongside the slowdown of economic activity in the construction sector in China, re-exports of copper ores and concentrates from Georgia were substantially lowered. On the other hand, external demand for ferro-alloys gradually recovered. In overall terms, exports of goods declined in the second quarter, falling by 4.4% in real and by 2.2% in nominal terms (see Figure 1.2.1).

The decline in exports of goods mainly stemmed from a fall in exports of motor cars and re-exports of copper.

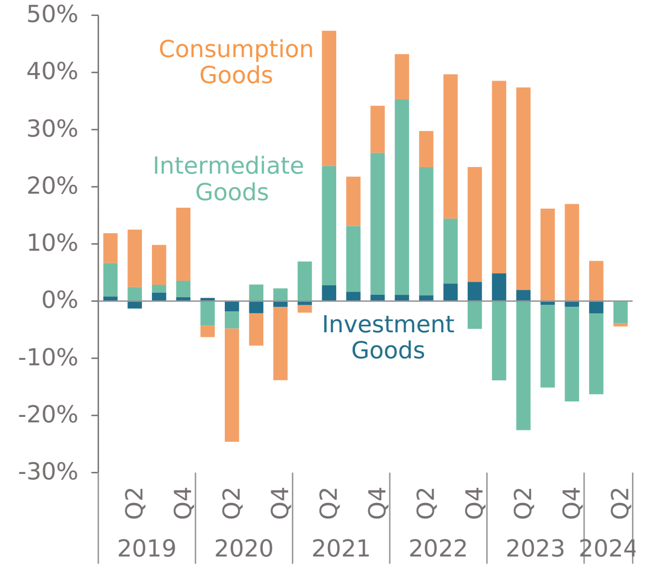


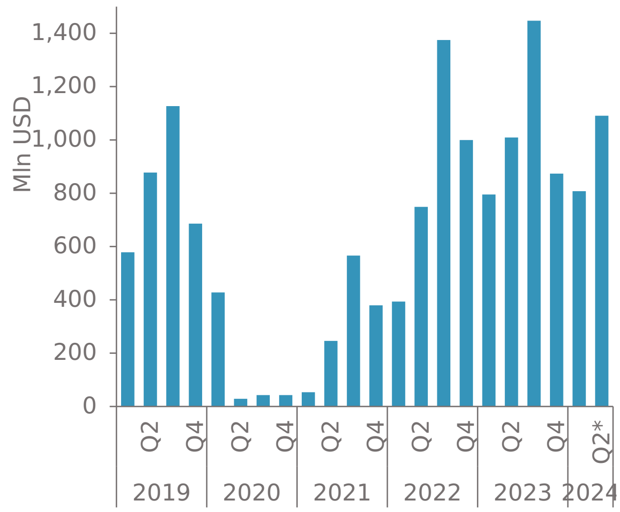
Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

The reduction in exports of goods was predominantly driven by a decline in exports of intermediate goods. The fall of re-exports of motor cars negatively affected the volume of exports of consumer goods, although some domestic goods (mostly nuts/hazelnuts and wines) have returned to positive growth. Exports of investment goods have remained at almost the same level annually (see Figure 1.2.2).

The summer, in line with the start of the tourism season, has been quite active in terms of international travel. In the second quarter, the number of visitors increased by 4.6% annually—albeit remaining 19.0% lower than pre-pandemic levels. Since the beginning

Revenues from international travel have continued to increase annually.



2024Q2* preliminary estimates

Figure 1.2.3. Revenues from international travelers

Source: NBG

In the second quarter of 2024, instant money transfers again declined annually—a result of a decline of transfers from Russia and the base effect.

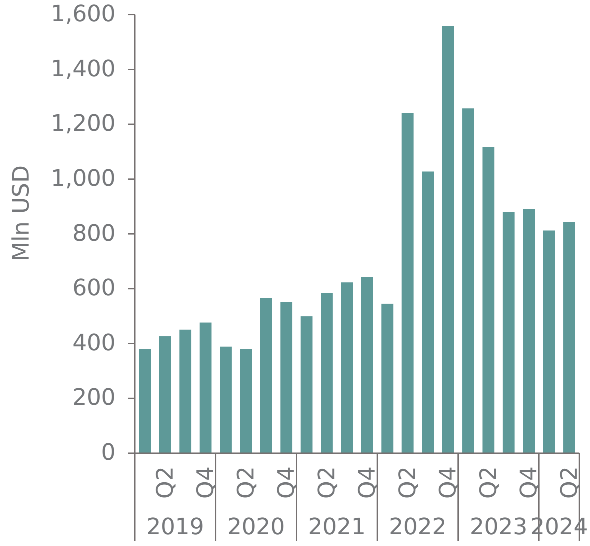


Figure 1.2.4. Instant money transfers.

Source: NBG.

of the year, the slowdown seen in terms of a reduction of migration was balanced by increased numbers of incoming travelers from other countries. Namely, numbers of visitors from Israel, India and China were on the rise. It is also worth mentioning that positive structural changes have taken place in terms of international travel. Market diversification and the opening of new tourist sites have positively affected revenues from international travel. At the same time, in the second quarter, the total number of nights spent during tourist visits and average daily expenses both increased, being additional drivers of aggregate demand.

In line with the rising number of visitors, revenues from international travel increased by 8.1% annually. Despite the gradual fading of the migration effect and the accounting of some previous migrants as residents, revenues from international travel amounted to USD 1,091[12] million in the second quarter (see Figure 1.2.3). This accounted for a substantial amount in terms of external inflows. For comparison, that figure represents the highest volume of second-quarter revenues seen during the last decade. Besides regional countries, revenues from visitors from the EU and other countries continued to rise.

In the second quarter of 2024, instant money transfers to Georgia amounted to USD 844 million, reflecting an annual decline of 24.5%. This fall was partially related to the base effect and a gradual decline of money transfers from Russia (see Figure 1.2.4). As had been expected, migrant inflows as a result of the ongoing war in Ukraine and associated money transfers have declined annually. Despite the annual fall of money transfers from Russia, which induced the overall slowdown, transfers from other countries rose significantly. In light of higher-than-expected economic growth in the USA, money transfers from that country increased substantially, along with transfers from Israel and the EU.

Against the background of higher economic activity, demand for imports of goods increased in the second quarter. Imports of goods rose by 1.9% in nominal terms, while declining by 6.2% in real terms (see Figure 1.2.5). Apart from this, purchases of motor cars intended for re-export significantly declined, which significantly restricted the higher growth of imports of goods.

In the second quarter of 2024, imports of intermediate goods made the largest negative contribution to the overall change of imports (see Figure 1.2.6). Despite the fact that purchases of motor cars substantially declined, imports of other types of goods increased. It is worth noting that the fall in purchases of motor cars is partially connected to the adoption of a new regulation regarding imports and as well as to the fall

12 Preliminary estimates.

In the second quarter, imports of goods slightly increased; however, due to the still-high level of prices on global markets, imports of goods in real terms declined.

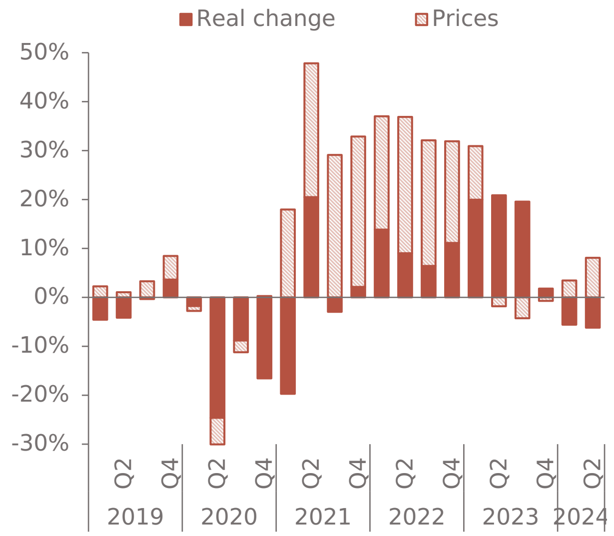


Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the second quarter of 2024, the deceleration of import growth rate was mainly due to the fall in imports of intermediate goods, as well as a decline of re-exports of motor cars. However, imports of other types of consumer goods rose.

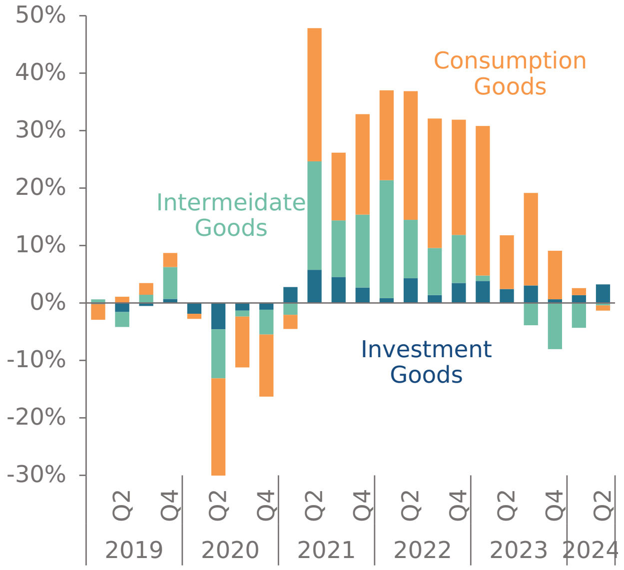


Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

in re-exports (according to the new law, from 2024, in line with the adoption of Euro 5 Standards, the import of motor cars produced before 2013 has been banned; during the last three years, such cars accounted for a 13% share of overall imports of motor cars).

Higher economic growth has been reflected in a rise of purchases of consumer-type petroleum products, medicaments intended for re-export, and household appliances. At the same time, the growth of investment goods imports stemmed from higher purchases of motor vehicles for the transport of goods and special purpose motor vehicles intended for re-export, and automatic data processing machines and units.

Despite the fact that imports of goods declined in the first quarter of 2024, the trade deficit still deteriorated because exports of goods declined even further. In light of weak external demand and a drastic fall in re-exports of motor cars, overall exports of goods declined. Yet due to the fall of re-exports of motor cars and copper ores, imports of goods also declined. In contrast, exports of services continued to rise. Not only were revenues from international travel substantially high, but so too were revenues from the services sector as a result of structural changes to the economy. At the same time, compensation of employees from primary income was quite high, despite exhibiting only moderate annual growth. Apart from this, other types of transfers in the private sector almost doubled annually. Taking everything into account, these developments have positively affected the narrowing of the current account deficit, which amounted to 5.0% of quarterly GDP, reflecting an improved indicator in annual terms. According to the updated macroeconomic forecast, in light of a widening trade deficit, along with the normalization of external inflows, the current account deficit is expected to grow and reach 5.6% of GDP in 2024.

In terms of other investments, in the first quarter the main source of financing the current account deficit was long-term loan liabilities (in both the private and public sectors). Inward foreign direct investment (FDI) contributed less to the financing of the deficit. Inward FDI amounted to USD 201 million (2.8% of quarterly GDP) and, partially due to the base effect, declined by 64% annually. The main reason for the decline of FDI was the annual reduction of investments in equity capital. It is worth mentioning that the majority of FDI went to the energy and transport sectors.

From the perspective of savings and investments, in the first quarter of 2024, as compared to the same period of the previous year, the moderate improvement of the current account balance was mainly due to a rise in savings, rather than a decline in investments (see Figure 1.2.7).

In light of the normalization of external inflows and higher economic growth, expenses on goods imports are expected to rise. Subsequently, the current account deficit is expected to worsen slightly in 2024 to reach 5.6% of GDP.

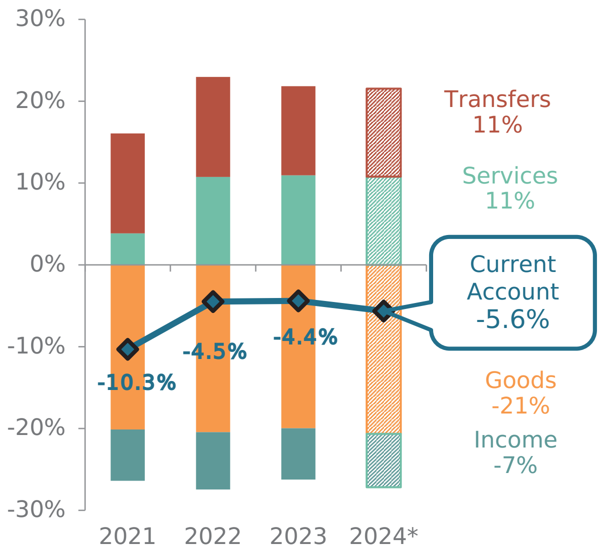


Figure 1.2.7. Current account balance and its components as a % of GDP

Source: NBG

In the first quarter of 2024, the improvement of the current account was mainly due to the rise of savings, despite the moderate growth in investment; however, in overall terms, the balance is expected to worsen slightly in 2024.

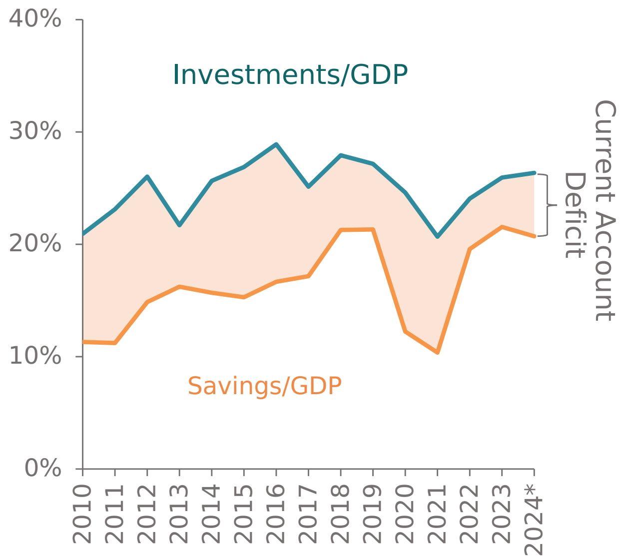


Figure 1.2.8. Investments and savings

Source: GeoStat

* NBG Forecast

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

Amid high economic, credit, and wage growth, the spending capacity of the population has increased. This was reflected in a significant increase in consumption in the first quarter of 2024.

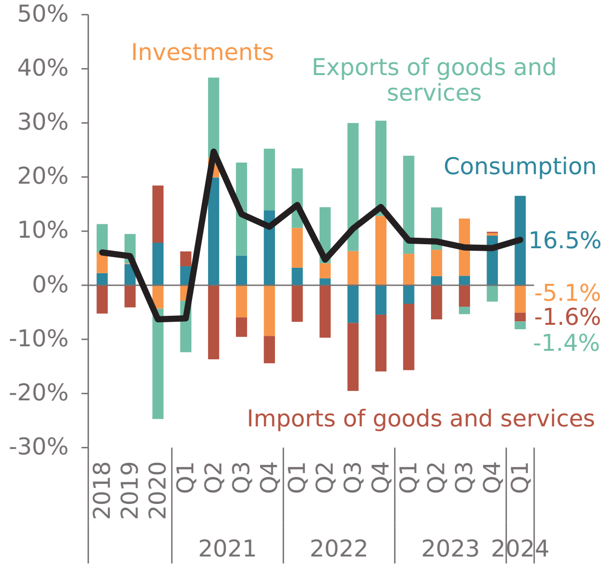


Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the first quarter of 2024, real Gross Domestic Product (GDP) increased by 8.4% compared to the same period of the previous year. The driving force behind this growth, based on expenditures, was consumption, which made a contribution of 16.5 percentage points (pp). The contributions of investments, goods and services exports and imports to growth were all negative, amounting to -5.1 pp, -1.4 pp, and -1.6 pp, respectively.

The spending capacity of the population has increased against the backdrop of high economic activity, increased lending, and rising wages. This was reflected in the 18.8% real growth in consumption in the first quarter of 2024. The base effect was another factor behind the high growth in consumption, as there was a year-on-year decline in consumption in the first quarter of 2023.

The base effect was also a reason behind the decline in capital formation/investments. After the high growth in investments observed over the past two years, there was a year-on-year decline in investment expenditures at the beginning of the current year. The end of the pandemic and the recovery of tourism in 2021-2022 was followed by increased migration flows related to the Russia-Ukraine war, which led to a significant boost in the export of services. The contribution of net exports to growth was thus particularly high in those years. Since 2023, due to the base effect, as well as the overall reduction in the number of migrants and the reclassification of some former migrants as residents, the growth of services exports has decreased. Subsequently, the overall contribution of net exports first decreased and then became negative. However, the effect of migration on the reduction of services exports is partially balanced by the high growth in income from transportation services, reflecting a realization of Georgia's transit potential.

1.3.2 OUTPUT

High economic growth continues to be driven by the services sector.

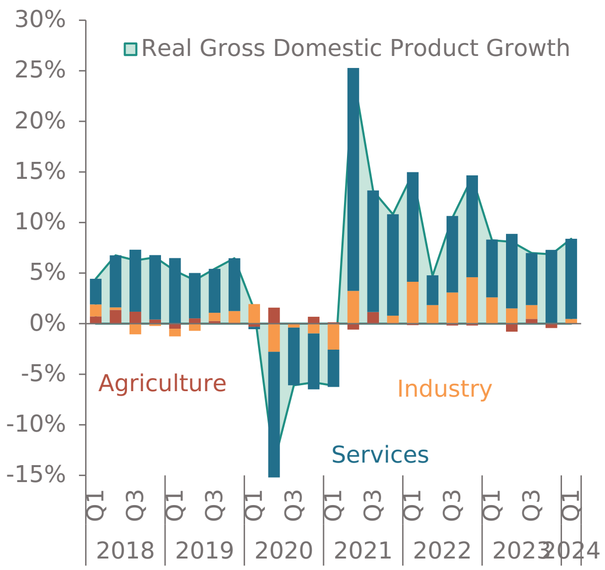


Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

In the first quarter of 2024, 7.9 percentage points (pp) of the total 8.4% economic growth came from the services sector. The contribution of industrial sectors was 0.4 pp, while the contribution of agriculture was close to zero (see Figure 1.3.2).

The solid growth in the output of the services sector continues. Contributing factors include strong domestic demand, the robust tourism sector, and the significant number of migrants that remain in the country. Within the services sector, particularly noteworthy is the growth observed in trade, transport, information and communication, real estate activities, arts, entertainment, and recreation, whose combined contribution to overall growth was 3.8 pp. Within the industrial sector, the standout was the 10.3% growth in construction, which made a 0.6 pp contribution to overall GDP growth (see Figure 1.3.2).

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

Credit activity accelerated in the second quarter of 2024. In June, the annual growth of the credit portfolio, excluding the effect of the exchange rate, was 17.8%. Consumer and business loans made the main contributions to this growth.

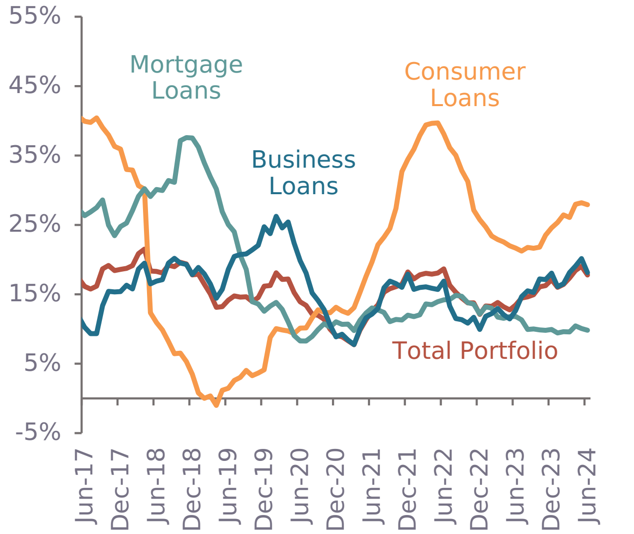


Figure 1.4.1. Annual growth of loans by purposes (excluding the exchange rate effect)

Source: NBG

The exit from tight monetary policy stance stimulates credit activity. In June, compared to the first quarter of 2024, credit growth accelerated by 0.4 pp to 17.8%, although a month-on-month decrease of 1.2 pp was observed (see Figure 1.4.1). The growth of business lending made a significant contribution to lending activity. Meanwhile, because of the normalization of monetary policy, business loans denominated in GEL have been increasing since the beginning of the year. However, a noticeable 2.0 pp decrease was observed in June (see Figure 1.4.1).

The growth of the loan portfolio is due to an increase in national currency loans, which is a direct result of the policy pursued by the National Bank of Georgia.

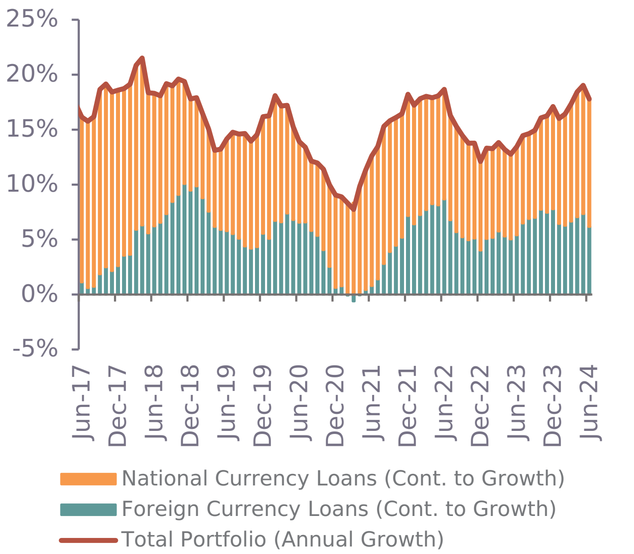


Figure 1.4.2. Annual growth of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

The policies implemented by the National Bank of Georgia have accelerated lending in the local currency (see Figure 1.4.2). It should be noted that since the beginning of the year, foreign currency lending to individuals has slowed. This was facilitated by successive increases to the limit for unsecured foreign currency loans, which rose to GEL 300,000 from 1 January 2024 and then increased to GEL 400,000 from 1 May. In addition, the maintenance of high foreign currency interest rates against the backdrop of tightened financial conditions by leading central banks has had the effect of tightening monetary policy in Georgia. As a result of the above-mentioned policies and the high foreign interest rates, a decrease in annual growth of FX loans was observed. Fx business loans growth rate has also decreased. However, according to the Credit Conditions Survey, representatives of the banking sector expect a slight increase in demand for business loans in the next 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, where necessary, will adopt the appropriate response to reduce the currency risk and related credit risks of individual borrowers and to promote long-term economic growth.

Despite the significant positive developments observed in recent years, dollarization and related risks remain significant challenges for the Georgian financial sector. Foreign currency denominated loans, which are mostly floating interest rate loans, are accompanied by interest and exchange rate risks. The latter is particularly noteworthy given the high share

Dollarization of loans over the last year fluctuated between 44-47%, thus prompting the National Bank of Georgia to launch additional mechanisms.

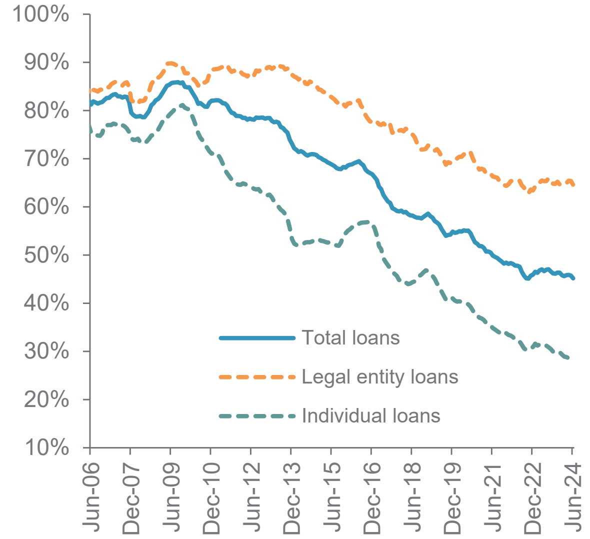


Figure 1.4.3. Dollarization of loans (excluding the exchange rate effect)

Source: NBG

In the second quarter of 2024, compared to the first quarter, the dollarization of deposits decreased by 2.8%. The de-dollarization of deposits is a clear result of the NBG's policy, and dollarization of deposits fell below 50% in the second quarter of 2024.

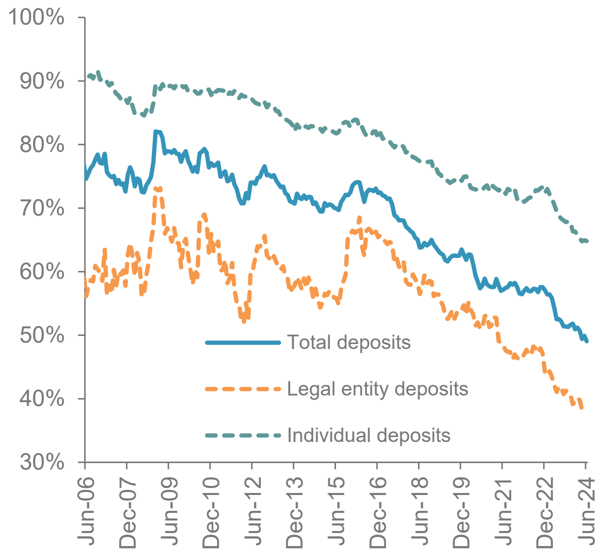


Figure 1.4.4. Dollarization of deposits (excluding the exchange rate effect)

Source: NBG

of unhedged borrowers in foreign currency loans, the increased volatility of regional currencies' exchange rates, and globally tightened financial conditions. In order to mitigate the abovementioned risks, starting from 1 January 2024, and additionally from 1 May, the NBG increased the limit on unhedged foreign currency loans. As expected, the dollarization of both loans and deposits declined. Dollarization of loans has fluctuated around 45-47% over the past year; dollarization of loans to individuals has a downward trend and remains at a low level, while dollarization of loans to legal entities is around 64-66% (see Figure 1.4.3). As for the dollarization of deposits, for the first time in the existence of the modern financial sector of Georgia, it fell below the 50% mark, despite the fact that high interest rates on foreign currency deposits persist. Dollarization of the deposits of individuals follows a decreasing trend, falling by 1.5 pp since the beginning of the year, whereas the dollarization of deposits of legal entities remains below 40% (see Figure 1.4.4).

It is important to continue the process of reducing dollarization. This will be facilitated by, among other things, the recently adopted macroprudential measures. The reduction of dollarization is a step forward in the direction of reducing financial stability risks.

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

In 2023, the NBG began a gradual exit from its tightened monetary policy, a process that has continued in 2024. Since May 2023, the monetary policy rate has been gradually reduced, lowered by a total of 3.0 pp to 8.00%. The reduction in interest rates subsequently affected both government securities and bank interest rates (see Figure 1.4.5). Interest rates on government securities are close to the monetary policy rate. However, short-term rates have been somewhat lower than long-term rates. To some extent this is a reflection of the financial market's inflationary expectations.

National currency interest rates are trending downwards. In June, the interest rate on deposits placed in the national currency decreased by 0.2 pp and amounted to 10.3% after the easing of monetary policy, and interest rates for foreign currency deposits increased to 2.4%.

In terms of lending, along with the reduction of the monetary policy rate, interest rates on mortgage loans and legal entity loans in the national currency continued to decrease in the second quarter of 2024. The refinancing rate has the strongest effect on mortgage loans, since such loans are mostly offered at a variable rate and are directly affected by the monetary policy rate. In June 2024, compared to May 2023, the average interest rate on GEL-denominated mortgage loans decreased by 1.2 pp (see Figure 1.4.6). The refinancing

The NBG has started a gradual exit from its strict monetary policy. As a result, interest rates on long-term government securities increased in the second quarter of 2024.

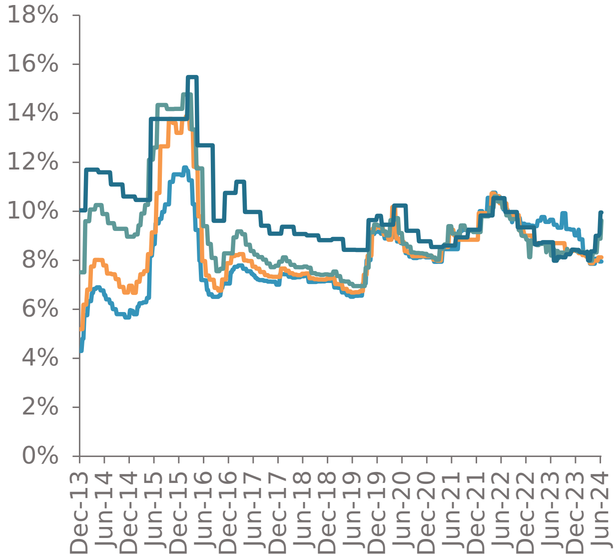


Figure 1.4.5. Interest rates on government securities

Source: NBG

After the easing of monetary policy, interest rates on mortgage loans in the national currency have reduced. Since May 2023, interest rates have decreased by 1.2 pp, amounting to 11.5% in June.

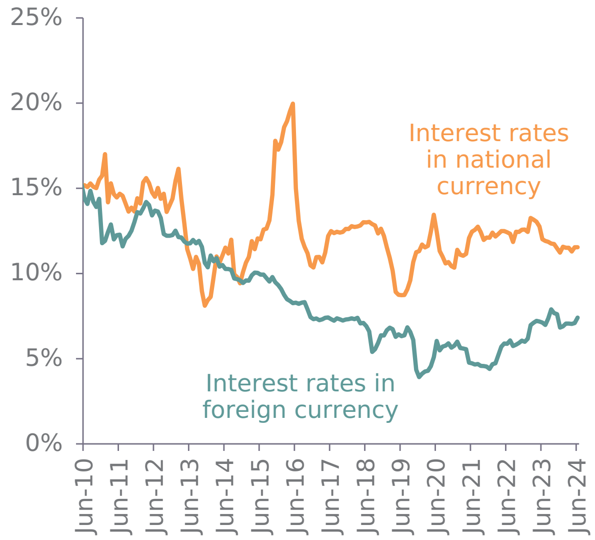


Figure 1.4.6. Interest rates on mortgage loans (flow)

Source: NBG

rate also has a strong effect on loans issued by legal entities in the national currency. In June 2024, the average interest rate of such loans decreased by 2.1 pp compared to May 2023 and amounted to 11.8%. In terms of foreign currency loans, due to tightened global financial conditions, interest rates in Georgia also increased during 2023, before beginning to decline in 2024 (see Figure 1.4.7). The spread between local and foreign loan interest rates has narrowed. Overall, interest rates on consumer, business, and mortgage loans each decreased in May amid the easing of monetary policy. According to the credit conditions survey, in the second quarter of 2024 demand for business loans increased compared to the previous quarter. According to the same survey, lending conditions for business loans in foreign currency slightly tightened in the second quarter. Representatives of the banking sector expect a slight easing of lending conditions for loans issued in the national currency, and a possible tightening of foreign currency loans in the next quarter.

National currency interest rates are declining, although these remain slightly higher compared to the monetary policy rate. As a result of the tightened financial conditions by leading central banks, increases in foreign currency interest rates have the effect of tightening the monetary policy in Georgia.

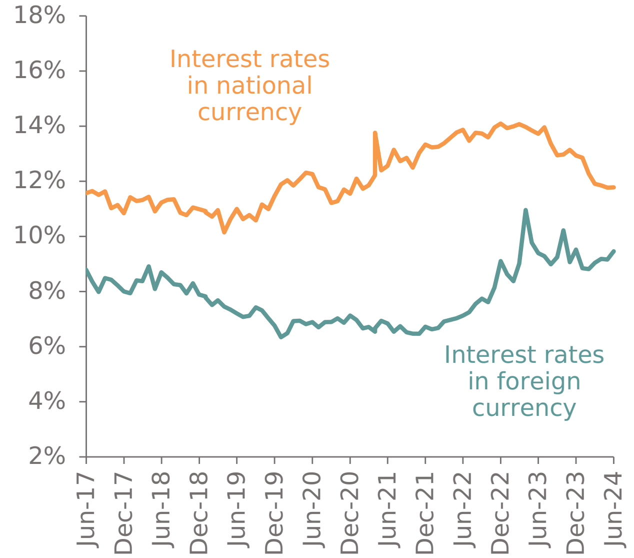


Figure 1.4.7. Average interest rates on legal entities loans (flow)

Source: NBG

In the second quarter of 2024, the real effective exchange rate (REER) depreciated by 6.2% annually, approaching its historical trend.

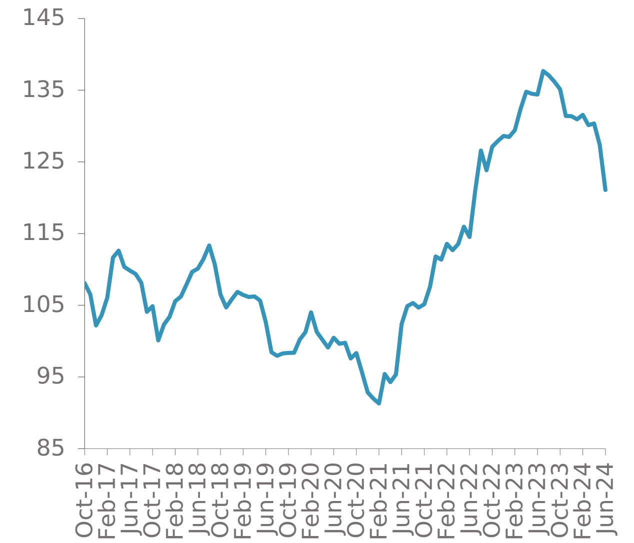


Figure 1.4.8. Real effective exchange rate (Jan 2008=100)

Source: NBG

1.4.3 EXCHANGE RATE

In the second quarter of 2024, the real effective exchange rate (REER) of the Georgian lari depreciated annually (see Figure 1.4.8). During the same period, the nominal effective exchange rate (NEER) appreciated annually, but the comparatively higher inflation rates in Georgia's trading partner countries balanced the reduced competitiveness caused by the nominal appreciation of the lari (see Figure 1.4.9).

In terms of specific currencies, the nominal exchange rate of the lari depreciated by 2.6% against the US dollar and by 1.7% against the euro compared to the previous quarter. The lari continued to appreciate against the Turkish lira, increasing by 2.1%, while depreciating by 3.0% against the Russian ruble. As a result, the nominal effective exchange rate of the lari depreciated by 1.5% quarterly but appreciated by 4.6% annually. When adjusted for price level differentials, in the second quarter of 2024, the real effective exchange rate depreciated by 3.5% quarterly and by 6.2% annually.

Notably, in the second quarter, the lari real effective exchange rate depreciated against all trading partner currencies (see Table 1.4.1).

The primary contributor to the depreciation of the REER was the comparatively higher inflation in Georgia's trading partner countries.

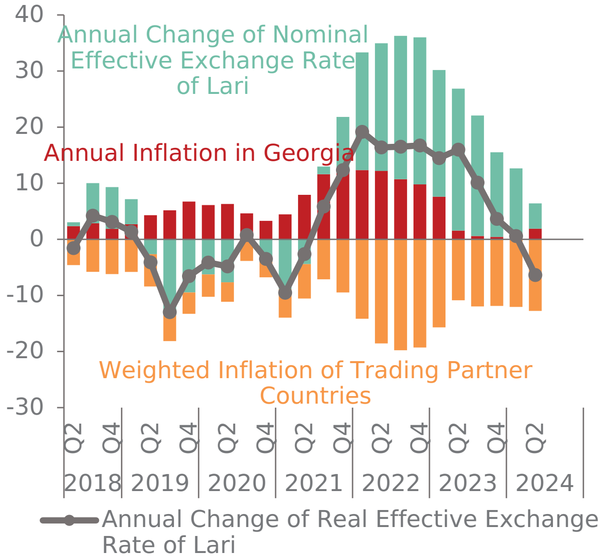


Figure 1.4.9. Decomposition of the annual change of the GEL real effective exchange rate*

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 annual depreciation of the REER was driven by depreciation against all trading partner countries.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate*	**4.6**	**-6.2**	**-6.2**
Eurozone	-5.5	-6.0	-1.2
Türkiye	45.7	-13.6	-2.6
Ukraine	0.8	-1.0	0.0
Armenia	-6.0	-4.4	-0.3
US	-6.6	-7.7	-1.0
Russia	4.8	-1.3	-0.2
Azerbaijan	-6.5	-5.1	-0.5
China	-3.4	-1.8	-0.2
Bulgaria	-5.5	-5.9	-0.2
Poland	-10.6	-11.2	-0.2

Table 1.4.1. Annual change in effective exchange rates, Q2 2024

Source: NBG

** Growth implies appreciation of the lari*

Compared to the previous quarter, the growth rate of wages has slowed down and the growth rate of productivity has decreased even further. As a result, the unit labor cost has increased by 11.8% year on year. As this remains quite high, inflationary pressures from the labor market continue to be noteworthy.

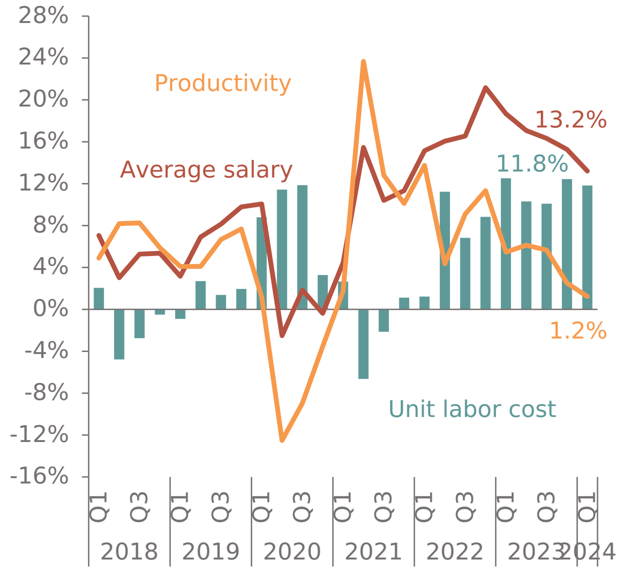


Figure 1.5.1. Productivity, average salary, and unit labor cost (annual growth)

Source: GeoStat, NBG calculations

Inflation in Georgia remains below the target level.

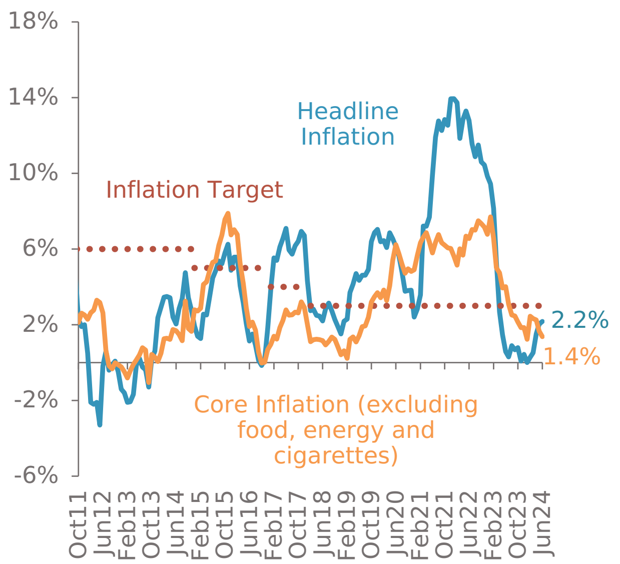


Figure 1.6.1. Headline and core inflation

Source: GeoStat

1.5 LABOR MARKET

Productivity in the country's economy (real value added per employee) increased by 1.2% year on year in the first quarter of 2024 (see Figure 1.5.1). During the same period, the nominal wages of employed workers increased by 13.2%, reaching an average of GEL 1,943.4 per month.

Compared to the previous quarter, the rate of wage growth has slowed down, which, while somewhat easing inflationary pressure, has been accompanied by a more significant decline in the rate of productivity growth. As a result, the unit labor cost increased by 11.8% year on year. As this remains quite high, inflationary pressures from the labor market still continue to be noteworthy (see Figure 1.5.1).

1.6 CONSUMER PRICES

Inflation in Georgia remains below the target of 3%, standing at 2.2% in June 2024. Core inflation, which excludes the prices of highly volatile items such as food, energy, and cigarettes from the consumer basket, has seen a declining trend in recent months. In June, core inflation was 1.4% (see Figure 1.6.1).

As the base effect wears off, inflation is gradually returning to the target level. At the same time, an increase in fuel prices has elevated overall inflation through the channel of imported inflation. On the other hand, the effect of rising service prices is gradually diminishing, which serves to reduce core inflation.

Domestic inflation has normalized close to the target level of 3%. In June, domestic inflation was 2.8%, with the main contribution coming from changes in service prices (1.9 pp), which are largely influenced by long-term factors and inflationary expectations. With the normalization of long-term inflationary expectations, service inflation has been declining since the beginning of 2023, which has reduced domestic inflation. Mixed products were 0.2% more expensive overall compared to the same period of last year. The main factors, which keep mixed inflation on a low level, are annual price decreases of oil, antibiotics, and electricity tariffs. Imported product inflation was 3.3%, with the largest contribution coming from the increase in fuel prices. Service inflation continues to decline, reaching 4.2% in June. This gradual decrease is related

Domestic inflation has normalized close to the target of 3%, reflecting reduced inflationary expectations.

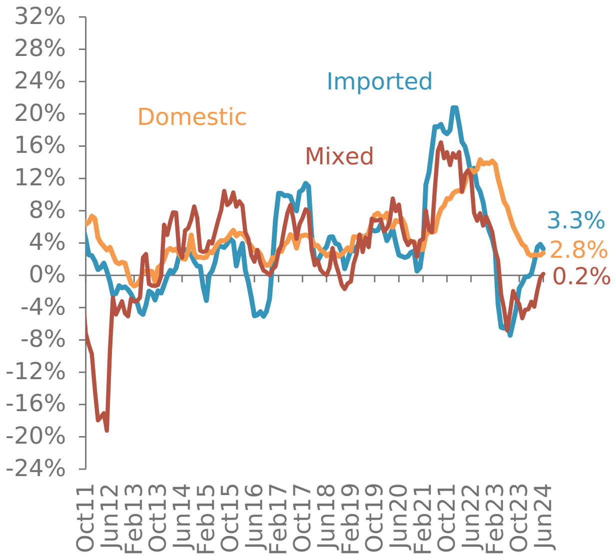


Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

In June, inflation was most significantly driven up by the annual increase in fuel prices; meanwhile, the decrease in electricity tariffs had a dampening effect.

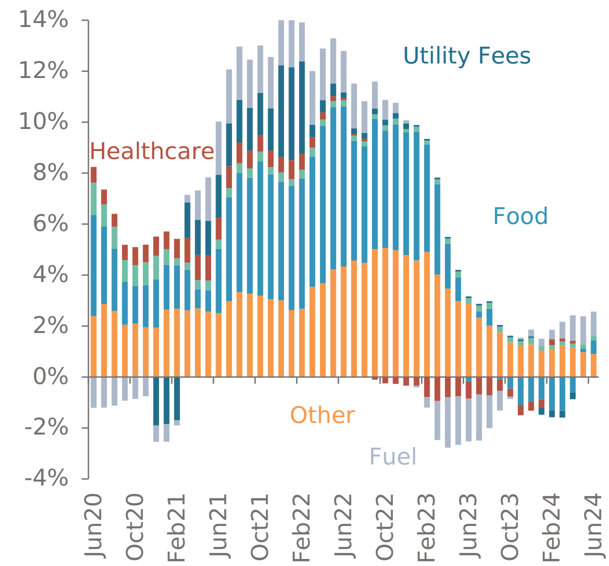


Figure 1.6.3. Inflation by major categories (contribution to headline inflation)

Source: GeoStat, NBG calculations

to the base effect, with impact of the previous increase in banking service costs having been exhausted.

On a yearly basis, the most significant contributor to inflation was the increase in gasoline prices. Compared to June last year, gasoline prices were on average 25.2% higher, contributing 0.9 pp to inflation. Meanwhile, the largest factor reducing inflation was the decrease in electricity tariffs, which decreased by 13.2% year on year, reducing inflation by 0.3 pp. Food prices were 1.7% higher than in June 2023.

BOX 1. PROFIT MARGINS AND THE CYCLICAL CONDITION OF THE ECONOMY

Following the dissipation of inflationary pressures stemming from the COVID-19 pandemic, the Russia-Ukraine war, and supply chain disruptions, prices quickly stabilized from 2023 onwards. This stabilization was aided, among other factors, by timely and strict monetary policy responses. Currently, alongside high economic activity, inflation remains low. This is a result of several factors. On the one hand, high economic growth has been driven by structural changes to the economy that have accelerated potential GDP growth and reduced the output gap. On the other hand, based on observations of various trends and analysis using structural models, the low inflationary pressure can partly be explained by the trend of decreasing profit margins in the economy.

It is thus interesting to explore how profit margins change with the economic cycle and to analyze the compatibility of a reduction of profit margins with strong demand (high economic growth). In Georgia, as in developing economies more generally, a tendency for profit margins to decrease has been observed (see Figure 1.6.4).

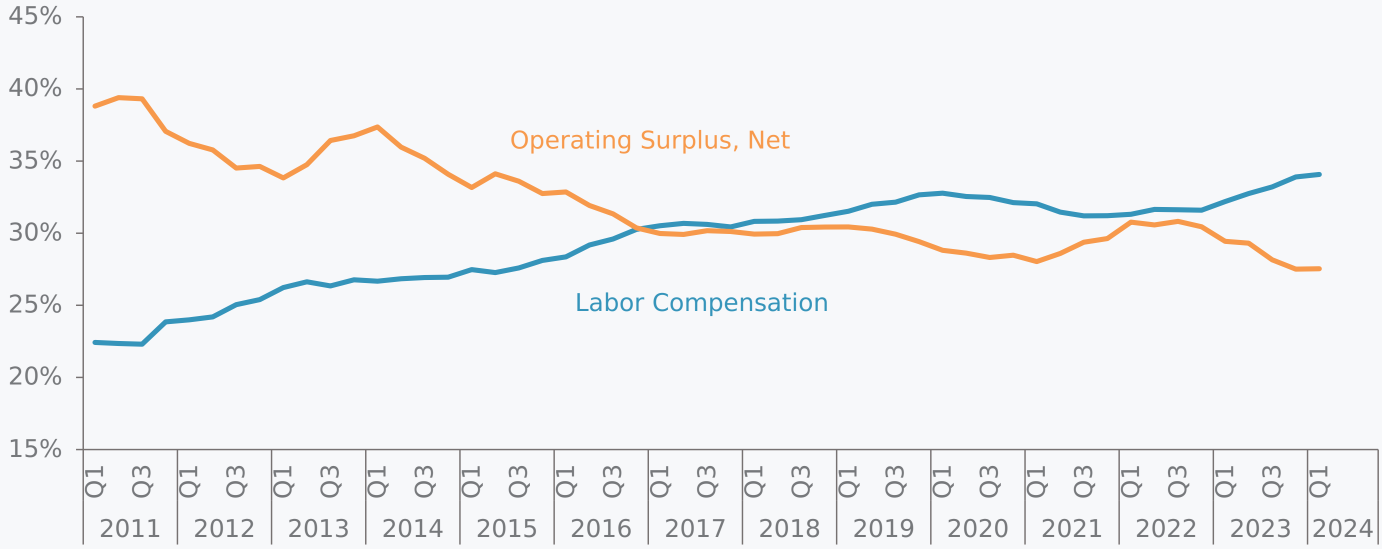


Figure 1.6.4. GDP decomposition according to the generation of income account

Source: GeoStat

This can be explained by ongoing long-term structural processes in the economy, where returns on capital decrease and competition improves. This latter trend has emerged in recent years and has been aided by, among other things, increased market entry by new enterprises (see Figure 1.6.5). However, it should be noted that post-pandemic margins cyclically increased, and thus recent changes likely reflect a cyclical reduction in margins along with a return to trend.

Generally, profit margins are procyclical and increase when demand is strong. However, three factors influence the determination and cyclical dynamics of profit margins: the rigidity of prices and wages and the so-called desired margin level of firms. Considering economic theory as well as empirical facts, we can say that wages are more rigid than prices. As a result, a reduction in profit margins may occur during the winding down of the economic cycle, when wage adjustments happen intensively against the backdrop of high economic activity; meanwhile, price adjustments occur earlier in the cycle, increasing margins. Also, profit margins may decrease due to a reduction of a firm's desired margin, which typically happens during a slowdown in economic activity, when firms lower prices to retain or attract customers.

Another measure by which the dynamics of profit margins can be assessed is presented in Figure 1.6.6, which evaluates the dynamics based on the profit and loss indicators of business entities as a ratio to their value added. As we can see, this measure is characterized by pronounced procyclicality.

Therefore, if we accept the notion that margins are procyclical and the discussed measures accurately reflect the state of firms, this may indicate—even given the recent wage increases—the winding down and

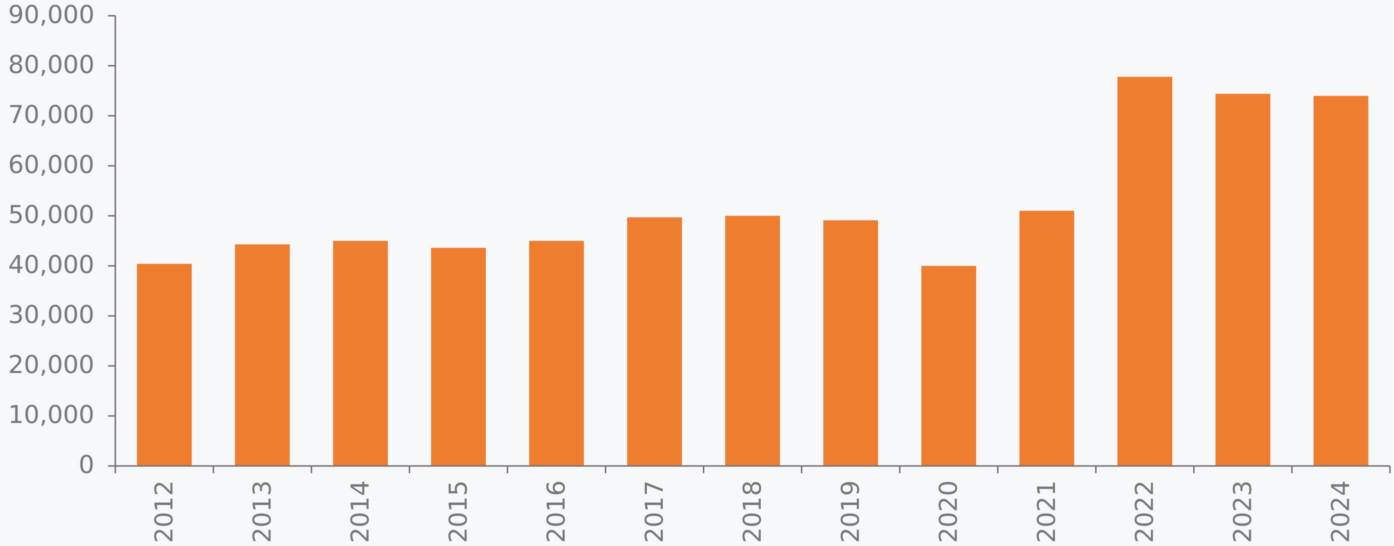


Figure 1.6.5. Number of newly registered enterprises (units)

Source: GeoStat

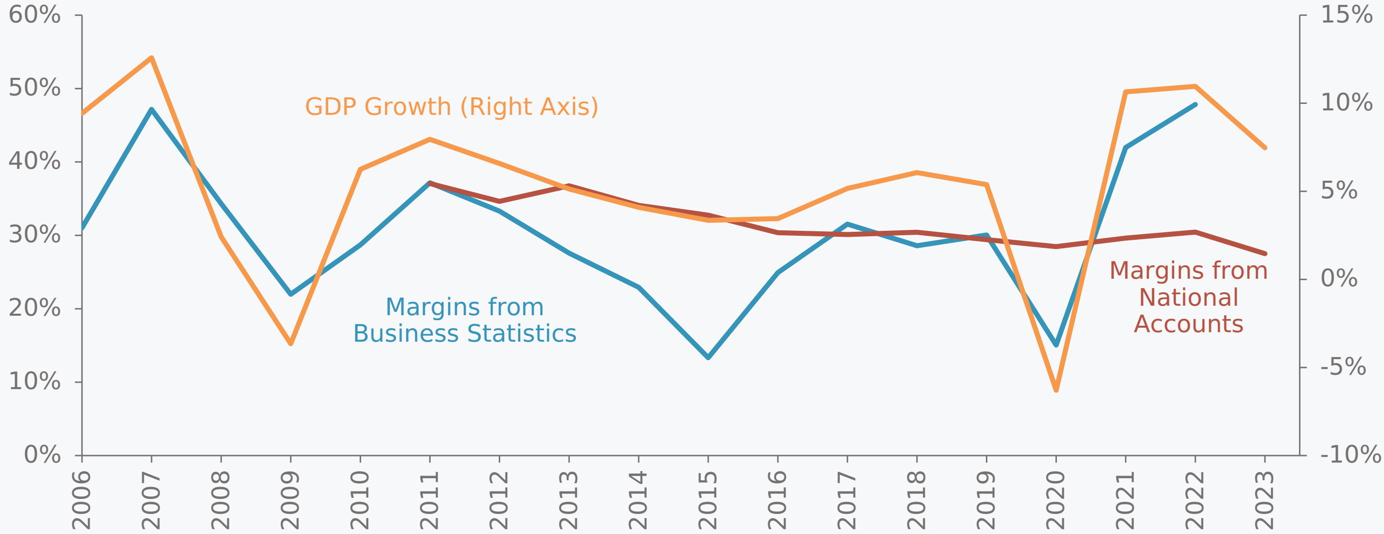


Figure 1.6.6. Profit margins and GDP growth

Source: GeoStat

stabilization of the economic cycle. However, this does not necessarily imply low economic growth in the future. As seen in Figure 1.6.7, post-pandemic growth has been concentrated in two sectors: transportation and storage, and information and communication. If this represents a structural change, then long-term economic growth is expected to be maintained, although the additional contribution from demand will dissipate. It is also possible that the profit margin calculated from national accounts is an imperfect measure for discussing the economic cycle (since it does not show a strong correlation). The updated 2023 data on profit indicators taken from business statistics might provide a different picture. If their dynamics remain strong, talking about the end of the cycle would be premature.

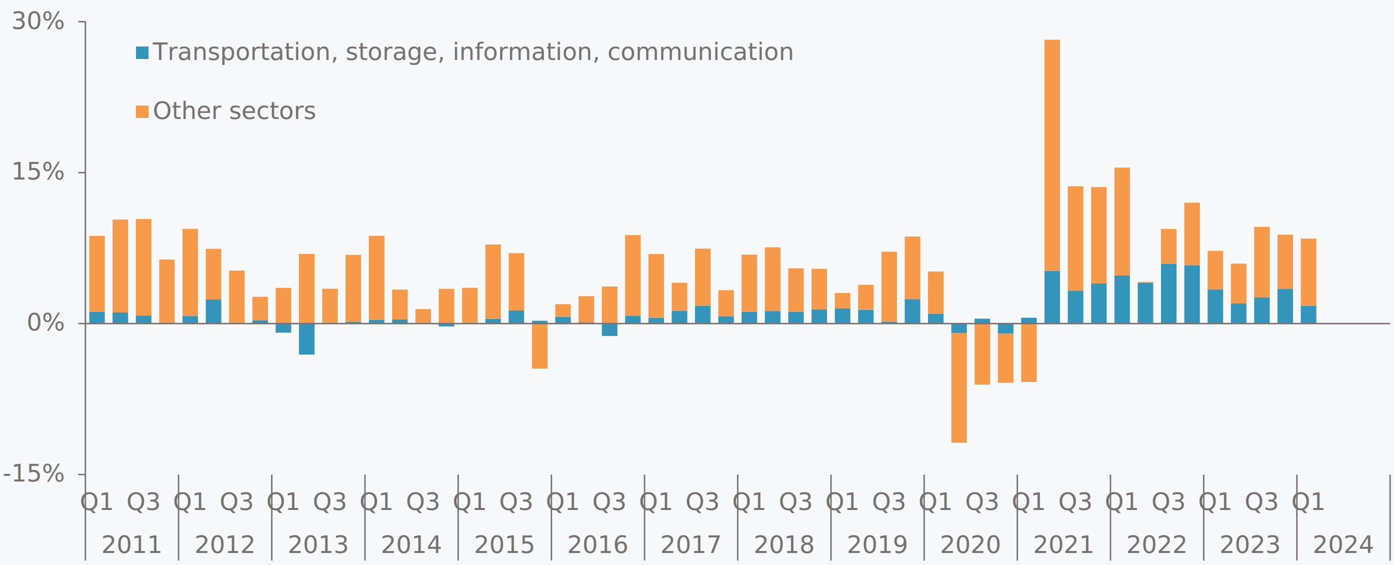


Figure 1.6.7. Real GDP growth by sector

Source: GeoStat

In summary, the reduction in profit margins, which had sharply increased in the post-pandemic period amidst the growth of prices and a return to the long-term trend, reflects the gradual correction of those prices distinguished by greater rigidity. It also explains why the recent sharp wage increases have not been passed on to prices. It should be noted that the stabilization of margins reduces the ability to use profits as a buffer to absorb shocks, which increases the risk of shocks being passed to final prices in the case of intensified inflationary pressure in the economy. This underlines the need for active monitoring and caution regarding current economic trends by monetary policy makers.

2 MACROECONOMIC FORECAST

In 2024, consumer prices are projected to increase by an average of 1.9%. Towards the end of the year, inflation is expected to approach the 3% target. Due to the base effect, it will subsequently exceed that target temporarily before stabilizing around it by the end of 2025. The maintenance of low inflation in the short term is primarily attributed to subdued actual inflationary pressures, partly reflecting the reduced profit margins of firms in response to heightened competition in the economy. However, risks related to rising imported inflation remain, and despite the accelerated growth in the economy's potential level, domestic demand pressure on consumer prices remains noteworthy. Amidst stronger-than-expected economic activity, the real GDP forecast for 2024 has been revised to 6.8%. The economic growth forecast for 2025 remains at 5%.

The alternative scenario, which is considered as relevant as the baseline scenario, envisions stronger credit growth amid eased financial conditions and a delay in monetary policy easing in the US stemming from rising uncertainty, which ultimately increases inflationary pressures in Georgia. These developments, in turn, would require a tightening of monetary policy and may prompt the need for additional instruments.

2.1 BASELINE MACROECONOMIC FORECAST

Inflation averaged 1.9% in the second quarter of 2024, which is 0.1 percentage point higher than previously expected. The low inflation in the current period can be partially attributed to the heightened competition between firms, amid increased entry rates of new enterprises into the market, and the resulting reduction of profit margins. The latter is also a result of the normalization of inflationary expectations, which was facilitated by maintaining actual inflation below the target rate over the past year. Prior to its final stabilization at the target rate, inflation is expected to remain low in the short term, averaging 1.9% in 2024, and will temporarily exceed the 3% target in the following year, primarily due to the base effect (see Figure 2.1.1).

Given the context of low actual inflation, inflation is only projected to approach the target rate towards the end of the year. Subsequently, primarily due to the base effect, it will temporarily exceed the 3% level before stabilizing around this target from the end of the following year.

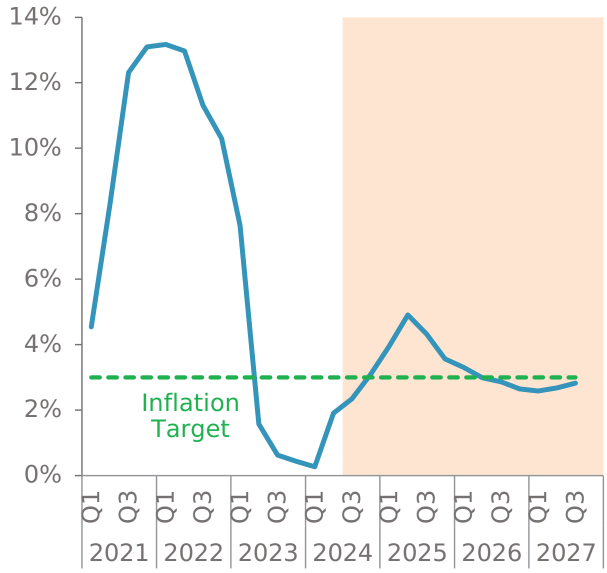


Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

The deviation of both actual and predicted inflation from the target level can be attributed to opposing factors. Reduced profit margins in firms, resulting from increased competition, exert downward pressure on inflation. Conversely, high domestic demand and the depreciated exchange rate in recent months have exerted upward pressure. The effects of these factors, under the conditions of an appropriate monetary policy response, are expected to diminish over time, thereby facilitating the convergence of inflation with the target level (see Figure 2.1.2).

In addition to the aforementioned factors, the dynamics of expected prices for international commodities are noteworthy. In 2021 and the first half of 2022, following a period of high inflation in global markets, international food prices began to decline. However, since the beginning of the current year, the normalization of these prices has been delayed due to relatively

The deviation of inflation from the target, which is attributable to lower inflationary expectations and reduced profit margins of firms, is expected to be rectified in the short term. This correction will be driven by strong demand and the impact of the depreciated exchange rate in recent months.

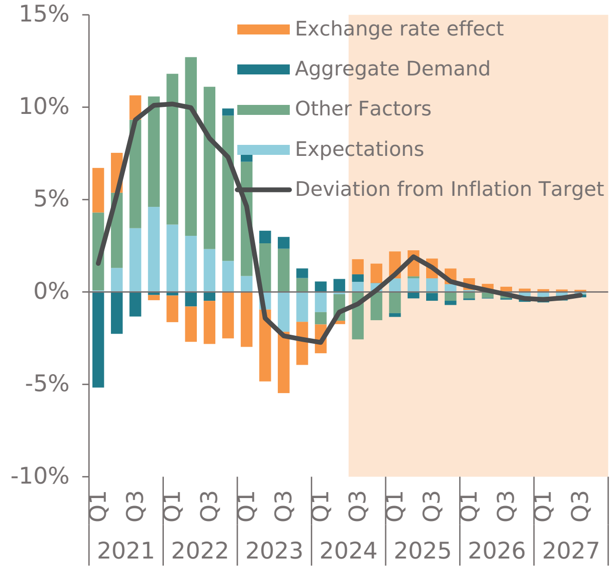


Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the revised baseline scenario, real GDP is projected to grow by 6.8% in 2024. This will be driven by accelerated potential growth and robust demand.

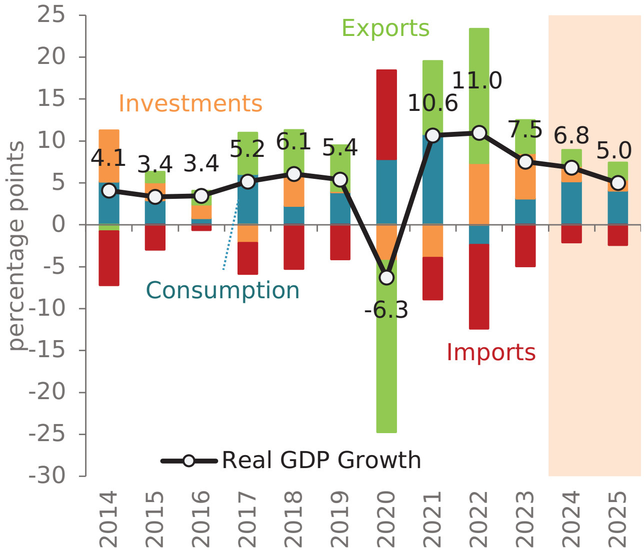


Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

complicated global climatic conditions, resulting in a trend of rising prices (see section 1.1.2). Moreover, in light of recent geopolitical developments, current forecasts from influential international organizations indicate a slight upward revision in expectations related to Brent oil prices. The cost of international transportation has been rising for the same reason. As a result, other things being equal, the impact of these factors will be inflationary to some extent. It is also important to note that, given the uncertainties in the geopolitical landscape, prices on international markets are subject to significant fluctuations. Therefore, these forecasts may be revised in either direction in the future.

Regarding economic activity, the current baseline forecast projects that the Georgian economy will grow by 6.8% in 2024. This is a higher rate than the previous forecast of 5.6% and is primarily attributed to the improved assessment of the economy's growth potential and stronger-than-expected domestic demand. Notably, structural changes in the economy have significantly enhanced the productivity of production factors in certain sectors, such as information and communication. Additionally, Georgia's increasing role as a Middle Corridor country has been reflected in improved capacities in related sectors. Furthermore, the increased rate of new firms entering the market has continued, which not only boosts the economy's potential but also intensifies competition and reduces prices. In light of improved purchasing power, consumption is anticipated to significantly contribute to economic growth (see Figure 2.1.3), being further stimulated by high credit activity in the current period. It is worth noting that the relatively modest contribution of imports partially indicates a shift in consumption towards services, as evidenced by the growing dynamics of real output in this sector (see section 1.3.2).

Credit activity has accelerated in recent months, reflecting softened financial conditions within the banking sector amid the normalization of monetary policy (see section 1.4.2). This is particularly significant because, in the context of the rising unit labor cost of output (see section 1.5), a sustained excess of demand over the economy's potential output may prompt firms to revise their pricing strategies upward. Taking these and the other aforementioned risks into account, the current macroeconomic forecast indicates that the National Bank of Georgia will continue to normalize its monetary policy rate at a moderate pace. In the medium term, assuming other factors remain constant, the rate is projected to stabilize around its neutral level, which is currently estimated at 7%.

Amidst strong domestic demand and alleged improvements in potential output, coupled with heightened global uncertainty as a consequence of various geopolitical factors, current macroeconomic forecasts are characterized by significant risks.

Macroeconomic Forecast Risks	Impact on Inflation
Stronger-than-expected domestic demand	↑
A greater-than-expected increase in uncertainty due to both domestic and global factors	↑
Stronger-than-expected external demand	→
Higher-than-expected commodity prices	↑
Higher-than-expected growth in Georgia's potential GDP	↓

Impact size			
Neutral	Low	Medium	High

↑	Increase in Inflation
→	Same Level of Inflation
↓	Decrease in Inflation

Table 2.1.1 Baseline macroeconomic forecast risks

Source: NBG

2.1.1 BASELINE FORECAST SCENARIO RISKS

Amidst strong domestic demand and alleged improvements in potential output, coupled with heightened global uncertainty as a consequence of various geopolitical factors, current macroeconomic forecasts are characterized by significant risks. These risks are primarily inflationary in nature and their realization would result in deviations from the baseline macroeconomic forecast and would necessitate an appropriate monetary policy response.

Since the beginning of the current year, credit activity in both foreign and domestic currencies has been expanding more rapidly than anticipated. This credit dynamic, which was particularly pronounced in the second quarter, heightens the risk of economic activity exceeding its potential level for an extended period. Such a scenario could lead to heightened inflationary pressures due to increased unit labor costs. Monetary policy is particularly intolerant to demand-driven inflation and, if necessary, additional instruments will thus be used in response to ensure the stabilization of long-term inflation expectations and to mitigate potential shocks.

Following the onset of the Russia-Ukraine war, global geopolitical events that impact regional affairs have become a persistent source of uncertainty for macroeconomic forecasts. Adding to this uncertainty is the US presidential election scheduled for November. High levels of uncertainty in the US could have global repercussions through both financial (interest rate) and geopolitical channels. Potential delays in the normalization of the tight US monetary policy might heighten the risk of capital outflows from developing countries (including Georgia), leading to increased inflationary pressures through the exchange rate and expectations channels. Furthermore, the current account could come under strain if regional geopolitical developments disrupt the recent positive trend observed in external inflows. In the event of the realization of this risk, the National Bank of Georgia will respond to the resulting shock with a rapid tightening of monetary policy, thereby ensuring that long-term inflation expectations remain anchored around the target level.

Conversely, an improvement in the current account deficit is expected if global conditions lead to higher-than-anticipated external demand for domestic goods and services. The realization of such a risk could impact inflation in two opposing ways. On the one hand, the strengthened exchange rate resulting from increased external inflows may reduce inflation in the short term through the imported inflation and balance sheet channels. On the other hand, increased demand for locally produced goods and services may put upward pressure on domestic prices in the medium term. It is anticipated that these two effects will balance each other out and such a shock is thus unlikely to have a significant impact on inflation in the medium term.

The dynamics of international commodity prices remain constantly relevant for small open economies like Georgia. In the event of the exacerbation and realization of these risks, the National Bank of Georgia will respond to increased inflationary expectations arising from supply shocks with a stringent monetary policy, thereby ensuring the stabilization of long-term inflation around its target level.

Finally, against the backdrop of ongoing structural changes in the economy, the risk of a faster-than-expected acceleration in the growth of Georgia's economic potential (due to its increased potential as a Middle Corridor country, improved productivity in the information and communication sector, and the entry of new companies into the services sector) becomes significant. In such a scenario, inflation might remain below the target level for an extended period due to the negative output gap. Should this risk materialize, the National Bank will reassess the pace of monetary policy normalization, aiming to stabilize inflation around the target level in the medium term by bringing economic activity closer to its potential level.

In the current update, average inflation for 2024 has slightly increased. Strong aggregate demand and a depreciated GEL has led to this upward revision, feeding into both higher actual and expected inflation.

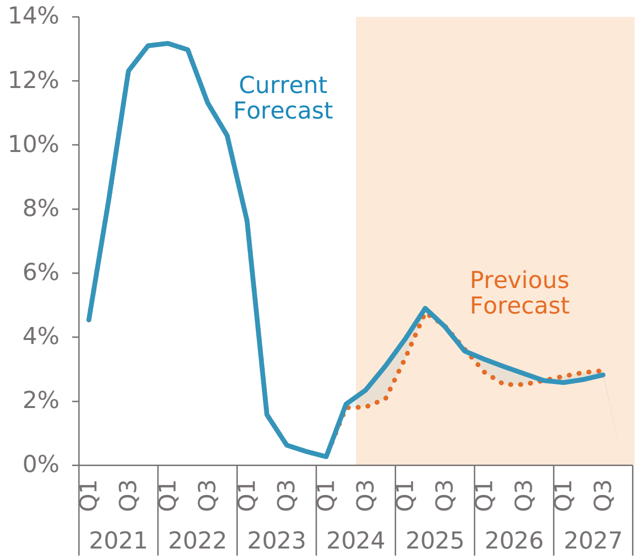


Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

Against the backdrop of significantly higher-than-anticipated economic activity in the first half of 2024, the economic growth forecast for the year has been revised upwards to 6.8%; while GDP growth is expected to remain within the 5% range in 2025.

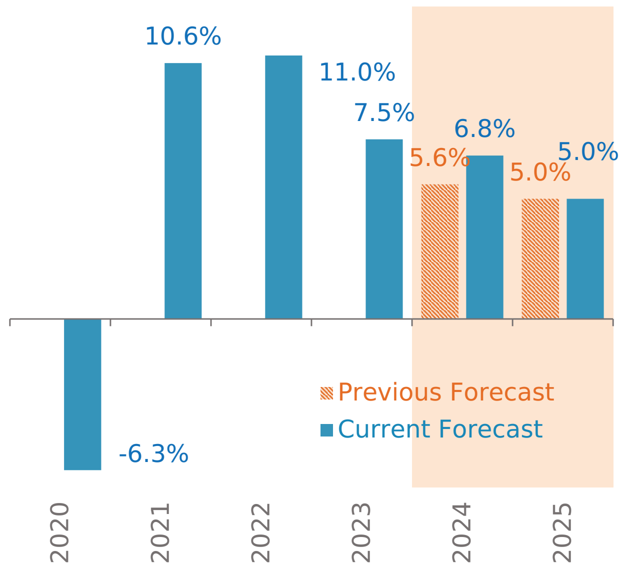


Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expectations regarding both short- and medium-term inflation have slightly increased (see Figure 2.2.1). The realization of stronger-than-expected aggregate demand and the depreciated GEL were the main sources of this upward revision. Consequently, in the next quarter, inflation will fall behind the target level at a smaller margin than had been previously forecast. However, it is still expected to be slightly above the target by the end of the year. As for the medium term, in line with the gradual normalization of tight monetary policy, inflation is expected to start decelerating from the second half of 2025 to stabilize around the target level of 3%.

Against the backdrop of stronger-than-expected economic activity in the first half of the current year, the real GDP growth forecast for 2024 has been revised upwards from 5.6% to 6.8%, while the forecast for 2025 remains at 5%. This revision is driven by both improved potential activity and stronger-than-expected aggregate demand. For 2024-2025, potential GDP is expected to grow faster than previously forecast due to structural improvements and stronger credit activity in the business sector in line with the anticipated normalization of monetary policy.

As a small open economy, Georgia is notably influenced by the economic positions of its trading partners. Consequently, the above-presented macroeconomic forecast hinges heavily upon assumptions about the expected dynamics of economic growth, inflation, and the exchange rates of these partners.

According to the updated forecast for 2024, inflation expectations have improved for the eurozone, Ukraine, and Türkiye, while worsening for the US and Russia. Expectations for the Turkish lira and Russian ruble against the US dollar have improved, whereas the euro is expected to weaken against the dollar. Regarding economic growth, all trading partners, except for Ukraine, are anticipated to perform better than previously thought (see Figure 2.2.3).[13]

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

According to the updated forecast for 2024, economic growth, inflation, and exchange rate expectations have all improved for Georgia's major trading partner countries..

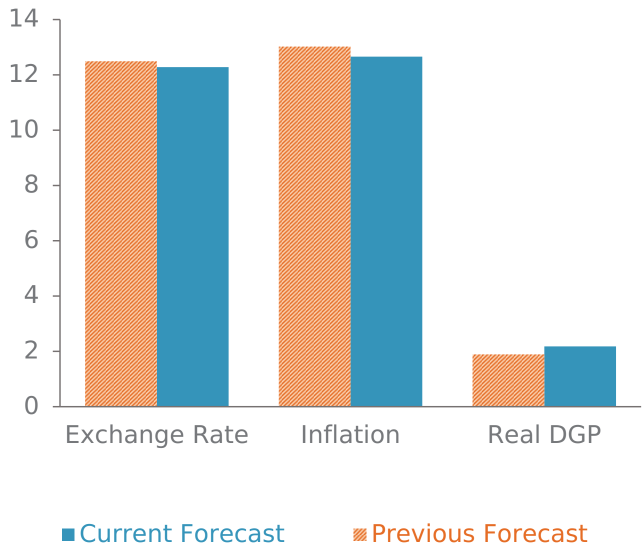


Figure 2.2.3. Changes in assumptions about trading partners

Source: Bloomberg, NBG

According to the alternative scenario, which is as relevant as the baseline one, real GDP will grow by 8.1% in 2024 on the back of economic activity being above the potential level.

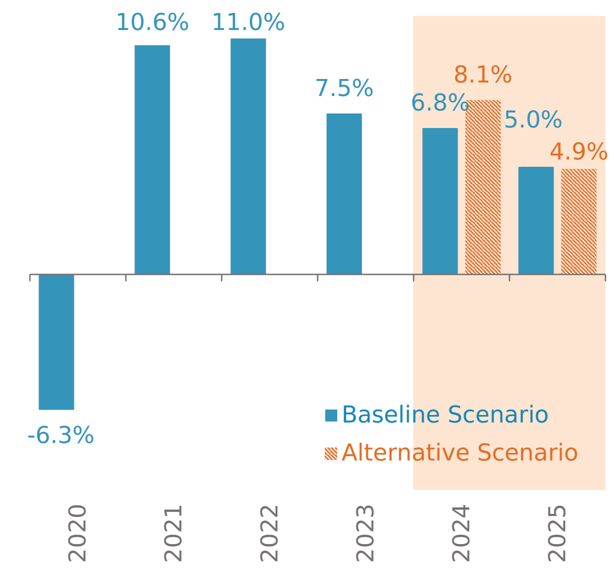


Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat

2.3 ALTERNATIVE FORECAST SCENARIO

We consider the alternative scenario to be as relevant as the baseline scenario. It accounts for risks surrounding the baseline macroeconomic forecast, the realization of which are either particularly likely or would be particularly significant. In this scenario, with high credit growth driven by the recent loosening of financial conditions, economic activity is projected to outperform its potential level, and real GDP is expected to grow by 8.1% (see Figure 2.3.1). In the context of excess demand, inflationary pressures originating from wage factors—as driven by production inputs being utilized beyond their sustainable capacity—are anticipated to intensify. Meanwhile, amid heightened uncertainty in the US, potential delays in the normalization of tight monetary policy could heighten the risk of capital outflows from developing countries. As a result, and given the still-significant level of dollarization, a depreciated GEL is likely to deteriorate the inflation outlook through both the expectations and intermediate input cost channels. As a result, compared to the baseline forecast, inflation is expected to be an average 0.5 percentage points higher in 2024 and 2.6 percentage points higher in 2025 (see Figure 2.3.2).

Considering the National Bank of Georgia's risk management approach, it has a particularly low tolerance for a rise in inflationary expectations. These would be met by a tightening of monetary policy and, if necessary, by the use of additional instruments. Should the alternative scenario be materialized, as compared to the baseline scenario, the trajectory of the monetary policy rate would shift upward by an average of 0.3 percentage points in 2024 and by 1.5 percentage points in 2025, with normalization only gradually occurring following a moderation of inflation expectations (see Figure 2.3.3).

According to the alternative scenario, significantly higher-than-potential domestic economic activity, coupled with potential delays in the normalization of tight monetary policy amid growing uncertainty in the US, will substantially increase inflationary pressures.

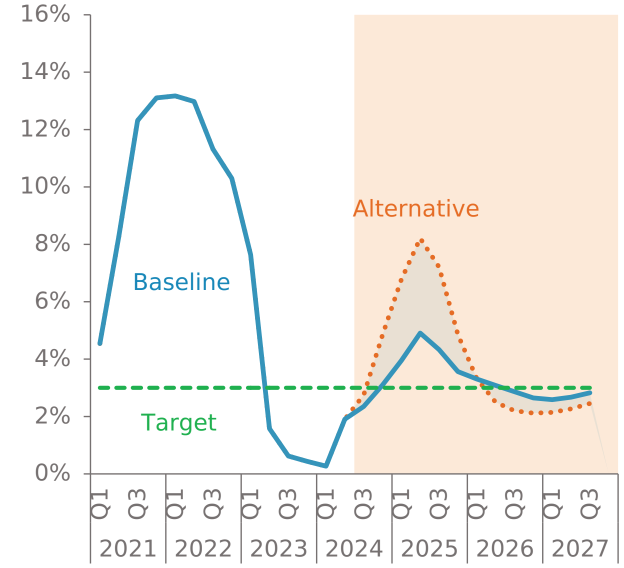


Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

The National Bank of Georgia has low tolerance for rising inflation expectations. In line with its risk minimization approach, these would be met by a further tightening of monetary policy and, if necessary, by the use of additional instruments.

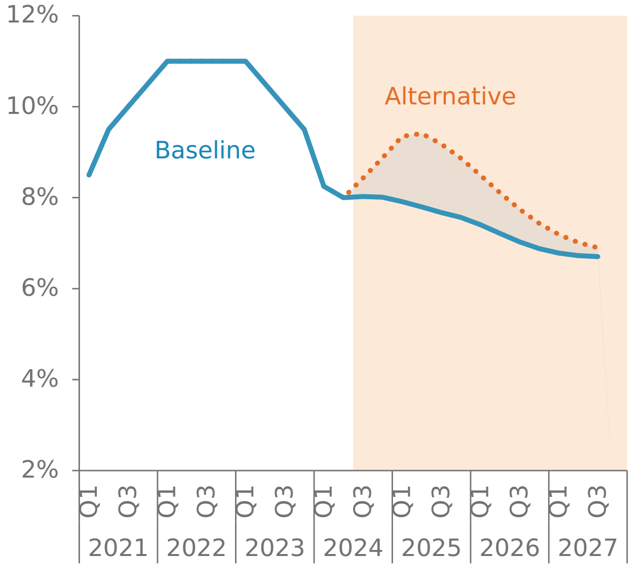


Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

Compared to the previous quarter, short-term inflationary expectations among financial market participants have been revised upward. However, medium- and long-term expectations have gradually stabilized at the target level.

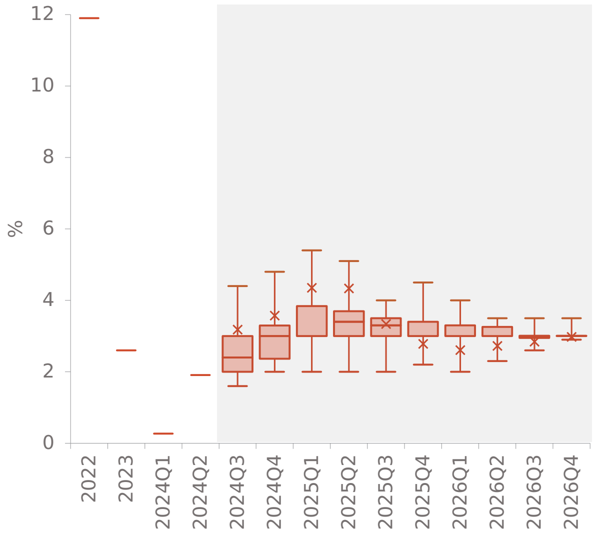


Figure 2.4.1. Actual average inflation (2022-2024Q2) and the distribution of market participants' forecasts for 2024Q3-2026Q4[13]

Source: NBG, financial market participants, GeoStat

Amid the current macroeconomic conditions, the expectations of financial market representatives regarding the monetary policy rate have remained mostly unchanged since the previous quarter.

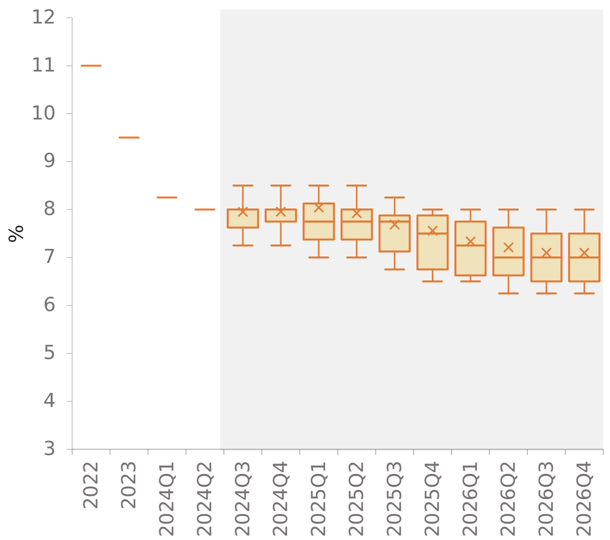


Figure 2.4.2. Actual monetary policy rate (2022-2024Q2) and the distribution of market participants' forecasts for 2024Q3-2026Q4

Source: NBG, financial market participants

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

Beginning from the second quarter of 2024, the National Bank of Georgia adopted an updated format for surveying financial market participants. Specifically, representatives of the financial market now provide their forecasts on a quarterly basis, which offers a more detailed view of market expectations. In the third quarter of 2024, as of 15 July, nine organizations participated in the survey. The results indicate that economic expectations for the period 2024-2026 have been revised in distinct directions compared to the previous quarter's survey.

Specifically, the short-term inflation expectations of financial market representatives were revised upward, resulting in a median increase of 0.6 pp in the forecasts for inflation for 2024 and a 0.1 pp increase in the mean. Consequently, the median for the current year is 1.9%, and the mean is 2.2%. For 2025, the median has decreased by 0.1 pp to 3.2% compared to the previous quarter, while the mean has increased by 0.4 pp to 3.7%. It is noteworthy that both the median and mean of long-term inflationary expectations across financial market representatives remain close to the target level, which was similar to the previous quarter's survey (see Figure 2.4.1).

Given the current macroeconomic conditions in both Georgia and globally, financial market participants' expectations related to the monetary policy rate for 2024-2026 have mostly remained stable. Specifically, the median and mean of the forecasts for 2024 are consistent with the previous quarter, standing at 8.1% and 8.0%, respectively. For 2025, the median remains at 7.7%, while the mean has been adjusted upward by 0.3 pp to 7.8%. As inflation expectations gradually converge towards the target level, both the median and mean for the monetary policy rate are trending towards the neutral rate. Nevertheless, over the long term, the variation remains relatively broad, ranging between 6.25% and 8.0% (see Figure 2.4.2).

Amidst robust current economic activity, financial market participants have significantly revised their short-term economic growth forecasts compared to the previous quarter. Specifically, for 2024, the median for real GDP growth forecasts has risen by 1.5 pp to 7.6%, while the mean has increased by 1.1 pp to 7.4%. Regarding the medium- to long-term expectations,

14 The distribution of forecasts is depicted using boxplots, wherein the upper horizontal line represents the highest expectation among market participants, and the lower horizontal line indicates the lowest expectation. The shaded rectangle illustrates the interquartile range (the middle 50% of the predictions), with the horizontal line inside it representing the median. The symbol "x" denotes the weighted average value, with the weights corresponding to the share of financial market participants in the total credit portfolio of the banking sector.

In the current period, amid robust actual economic activity, short-term economic growth expectations within financial markets have significantly improved, as compared to the previous quarter. However, medium- and long-term expectations remain relatively stable.

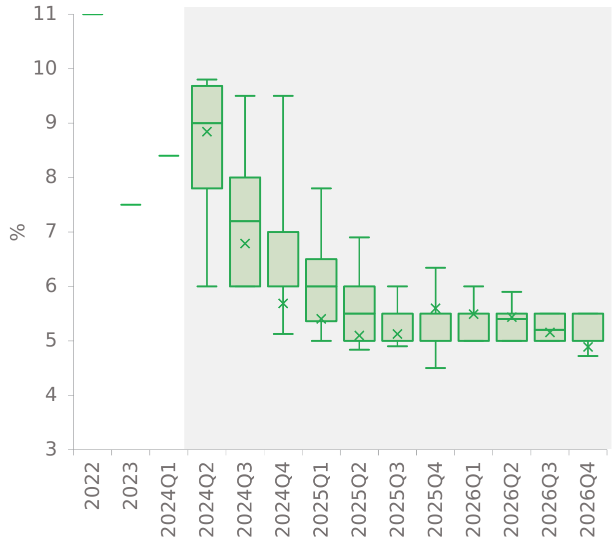


Figure 2.4.3. Actual real GDP growth (2022-2024Q1) and the distribution of market participants' forecasts for 2024Q2-2026Q4

Source: NBG, financial market participants, GeoStat

the median for 2025 has increased by 0.1 pp to 5.6%, while the mean has decreased by 0.2 pp to 5.3%. For the long-term horizon, economic growth forecasts for 2026 predominantly remain within the range of 5% to 5.5% (see Figure 2.4.3).

3 MONETARY POLICY

In the first half of 2024, the overall level of prices fell lower than the target rate of 3%. Considering the monthly inflation rate of 2.2% in June, average inflation for the second quarter equaled 1.9%, while average inflation for the first half of the year was 1.1%. Maintaining inflation within the target range was largely ensured by the monetary policy implemented by the National Bank of Georgia, resulting from both timely tightening and gradual normalization. Inflation for domestically produced goods stabilized around the target rate of 3% which reflects the normalization of long-term inflation expectations. Additionally, increased competition in the economy and, subsequently, reduced profit margins for firms contributed to the low level of inflation. According to the National Bank's updated forecast, keeping everything else equal, low inflation will be maintained in 2024 and will average around 1.9%. In the fourth quarter of the year, inflation will approach its 3% target rate, and then, considering the base effect, will temporarily exceed that target before stabilizing around it from the end of 2025. Nevertheless, risks from the external sector persist and despite the rapid growth of the economy's potential level, domestic economic activities remain noteworthy.

Taking into account the aforementioned factors, the National Bank decided to leave the monetary policy rate unchanged at 8.0% at its meeting on 30 July 2024.

On 30 July 2024, the NBG decided to keep the policy rate at 8.0%. The National Bank of Georgia will continue the neutralization of the monetary policy stance at a slow pace.

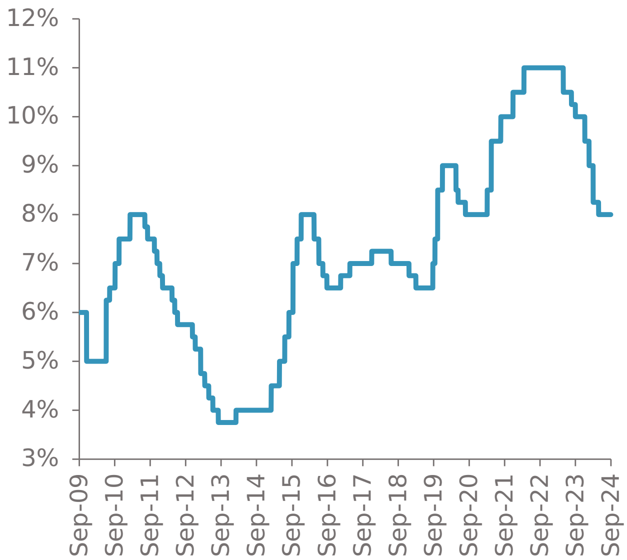


Figure 3.1. Monetary policy rate

Source: NBG

Although the majority of Georgia's trading partners are experiencing a trend of declining inflation, as a result of the external shocks of recent years and the ongoing geopolitical situation, uncertainty regarding inflation dynamics has remained high globally. Throughout 2023, central banks significantly tightened their monetary policies due to persistent high inflationary pressures. Globally, economic growth has normalized and global inflation has passed its peak, showing a downward trend in most countries. Despite this declining trend, inflationary pressures, especially the dynamics of service prices, remain a significant challenge worldwide, allowing for only a gradual easing of financial conditions.

With the dissipation of base effects, inflation has been gradually returning to the 3% target in recent months, although remaining below that target as a result of relatively rigid price inflation trends. Domestic inflation, as influenced by long-term factors and characterized by rigidity, is gradually normalizing around the target rate of 3%.

However, given the current geopolitical situation and trends in international markets, pressure has been exerted on imported inflation, with the average imported inflation for the second quarter exceeding 3%. This situation has fundamentally changed compared to the first quarter when imported inflation was significantly below the target rate.

At the beginning of the year, low imported inflation was supported by a strengthened exchange rate position—which itself was a result of an improved current account balance. In 2023, the ratio of Georgia's current account deficit to GDP reached a historic low of 4.4%, which can be explained by structural changes to the economy. According to the current forecast, the 2024 deficit is slightly worse than previously forecast, which can be attributed to lower-than-expected service exports in the first quarter of 2024. Despite this minor deterioration, the projected ratio of the current account deficit to GDP remains around a stable 5.5%.

Despite the increase in imported inflation, the prices of mixed goods have continued the deflationary trend seen in the previous year, with the average rate for the second quarter of 2024 being -0.7%. It is noteworthy that in the first quarter the same rate was -3.8%, indicating that the deflationary impact from mixed goods prices is gradually weakening. Additionally, despite the declining dynamics, service inflation still exceeds the target rate. Keeping everything else equal, low inflation will be maintained in 2024, with an annual average of 1.9%. In the fourth quarter, inflation will approach its target rate and then, partially due to the base effect, will temporarily exceed it before stabilizing around 3% from the end of 2025.

It is also noteworthy that, against the backdrop of stronger-than-expected economic activity, the forecast for real GDP growth in 2024 has been revised upwards to 6.8%, while the forecast for economic growth in 2025 remains within the 5% range. The current forecast is higher than previously expected. This can be explained by the growth of the economy's potential and stronger-than-expected total demand (both external and domestic). High credit activity supports strong domestic demand. Credit activity positively affects both consumption and investments. As a result, both components of GDP will significantly contribute to the 6.8% economic growth in 2024.

Risks that could alter the current forecast remain high due to ongoing global developments. Specifically, the trend of declining prices in international commodity markets has significantly slowed. Although price levels in commodity markets have decreased compared to their peak, international prices still exceed pre-pandemic levels, and it is unlikely that they will return to 2020 levels. Moreover, uncertainty about expected dynamics remains high.

A similar picture emerges regarding oil price dynamics. According to updated forecasts, the price of Brent crude oil is expected to remain high. Geopolitical risks have also emerged, pushing transportation costs higher. Events in the Red Sea region have had some impact on increasing shipping costs. Initially, in January 2024, shipping costs significantly increased due to elevated military tensions in the region. Despite the gradual decrease of transportation costs during the early months of 2024, recently it exhibits the upward trend. Thus, the risks stemming from the transportation costs remain noteworthy. Meanwhile, if the potential of the Middle Corridor is better utilized, Georgia's revenues from transportation will increase, further improving the current account balance.

The trends discussed above highlight the importance of assessing external risks. Georgia, as a small open economy, is vulnerable to international events and global inflationary risks are thus highly relevant for Georgia.

Domestic economic trends also remain a significant factor. Credit activity is characterized by a growth trend and, consequently, domestic demand remains strong. However, the overall production capacity of the economy has risen, which mitigates inflationary pressures from the demand side. The increase in credit activity and strong domestic demand provide a basis for maintaining a cautious approach. Against a backdrop of geopolitical tensions, high uncertainty regarding transportation costs, coupled with fluctuations international prices of raw materials and food, present inflationary risks.

Given strong domestic demand, the improvements in the economy’s potential output, as well as the increased global uncertainty due to various geopolitical factors, macroeconomic forecasts continue to be characterized by high risks. These risks are predominantly inflationary in nature, and if they materialize, an appropriate monetary policy response will be necessary.

In light of the above considerations, at its meeting on 30 July 2024, the Monetary Policy Committee decided to keep the monetary policy rate unchanged at 8.0%. If factors influencing inflation expectations upward reemerge, tightening of monetary policy, or a prolonged maintenance of the current position, may be required.

To ensure the effectiveness of monetary policy, it is crucial that changes in the monetary policy rate are reflected in interbank interest rates, ultimately influencing the real economy. Currently, the Georgian banking sector operates under a short-term liquidity deficit. The NBG provides sufficient liquidity through various 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 used by the NBG for liquidity absorption was certificates of deposit.

The liquidity provided by the NBG equals the demand of commercial banks, and interbank money market rates are closely aligned with the monetary policy rate.

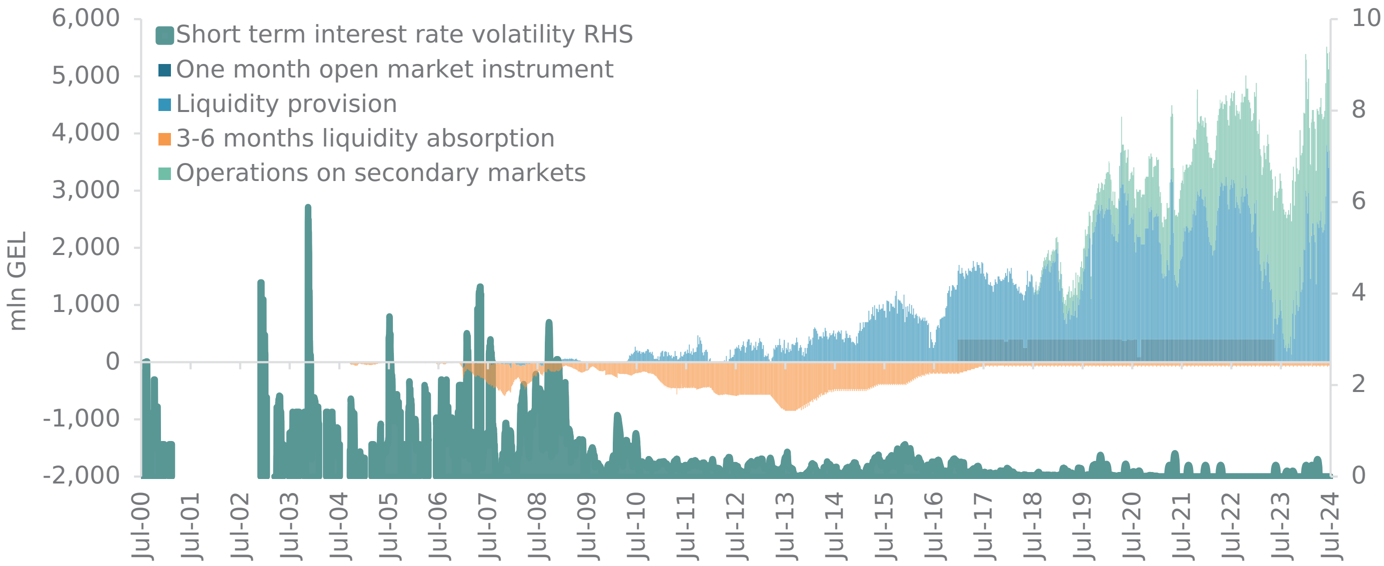


Figure 3.2. Liquidity instruments

Source: NBG

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

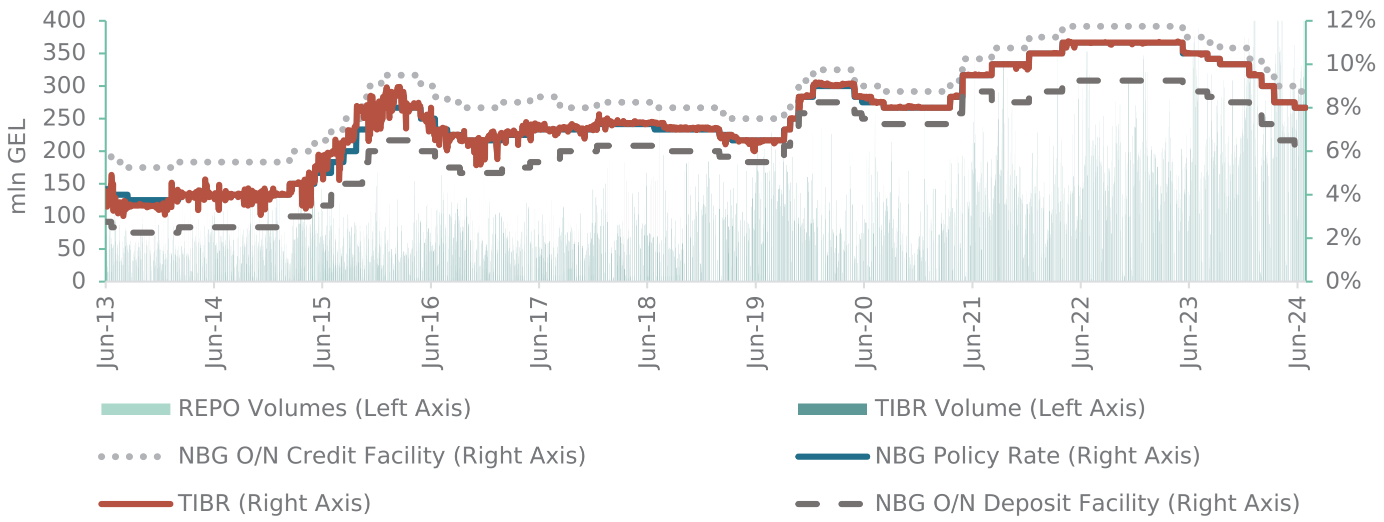


Figure 3.3. Interbank money market

Source: NBG

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