Monetary Policy Report

January

2024

საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation

0.4%	Inflation remains below the target of 3%.

Economic Growth

A normalization of economic activity is expected, with the economy projected to grow by 5% in 2024.	5.0%

Monetary Policy

9.0%	According to the current forecast, only a gradual reduction of the tight monetary policy rate is expected.

MONETARY POLICY DECISION

The National Bank of Georgia has reduced the monetary policy rate by 0.5 percentage points, bringing it down to 9.0%.

The role of the National Bank of Georgia (NBG) is to influence aggregate demand and inflation expectations by adjusting the interest rate, thereby keeping inflation near to its target level in the medium term. Given the current uncertain circumstances, low and stable inflation has gained heightened importance and is crucial for supporting employment and sustainable economic growth.

In Georgia, inflation has remained below the 3% target since the first half of 2023. In December 2023, the overall price level increased by 0.4% annually, with core inflation reaching 1.9%. The National Bank's monetary policy has effectively contributed to maintaining low and stable inflation. The timely tightening of monetary policy led to a decline in inflationary expectations and reduced inflation on domestically produced goods. Concurrently, inflationary pressures from external factors gradually dissipated. Global decreases in commodity prices, coupled with the appreciated GEL exchange rate, have resulted in the deflation of imported goods prices. According to the current forecasts, inflation is expected to remain close to the target of 3%.

In response to current economic conditions, the National Bank of Georgia has initiated a gradual reduction of the monetary policy rate, lowering it by a cumulative 2 percentage points from its peak of 11% to 9.0%. However, risks associated with rising international prices persist. These inflationary risks are further heightened by the trends of strong local demand coupled with a significant increase in credit activity. Acknowledging these potential risks, the National Bank of Georgia closely monitors ongoing trends and will continue its reduction of the monetary policy rate at a slow pace.

The adjustment of the policy rate by the National Bank of Georgia impacts the economy gradually, taking full effect over a period of 4-6 quarters from the decision date. Depending on the direction of inflation expectations, future monetary policy actions may involve either a further tightening of policy or the extended maintenance of the current position.

In any case, the National Bank of Georgia will employ all available instruments to ensure the stability of prices and the purchasing power of the lari, which implies maintaining an average annual inflation rate of around 3% over the medium term.

CONTENTS

ISSN 1512-0767

BRIEF OVERVIEW

In 2023, inflation in Georgia saw a significant decrease, reaching 0.4% by the year's end. This decline was primarily attributed to the import component of inflation, while robust aggregate demand, despite the tight monetary policy, exerted an opposing influence on domestic prices. Furthermore, throughout 2023, real GDP experienced substantial growth, averaging 7% according to preliminary estimates. This elevated the risk of economic activity surpassing its potential level for a prolonged period. However, the concurrent accelerated growth in investments contributed to an increase in potential output. According to the baseline scenario, excess demand is expected to fully normalize throughout 2024, which will be accompanied by only a gradual reduction in the monetary policy rate. This, in turn, is anticipated to contribute to the stabilization of inflation around its target rate in the medium term. In the alternative scenario, which is equally relevant given the recent robust growth in lending, strong demand may elevate the pressure on consumer prices to some extent. In response to this, the National Bank of Georgia will pause the monetary policy rate reduction process and, depending on credit activity, may even resume a tightening cycle.

According to the current baseline forecast, inflation will remain low at the beginning of 2024. Later, mostly due to base effects, inflation will approach its target relatively quickly to eventually stabilize around it in the medium term.

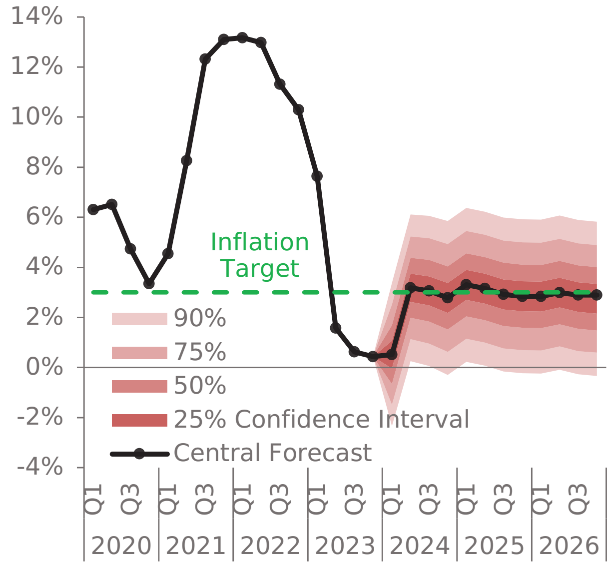

Figure 1. Headline CPI inflation forecast

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

The downward trajectory of inflation persisted in the last quarter of 2023 as annual inflation averaged 0.4% registering a lower rate than the previous forecast. The factors contributing to the decline in inflation are expected to remain over the short term, being further augmented by the one-off effect resulting from the announced reduction in electricity tariffs throughout the year. As a result, while remaining below the target in the beginning of 2024, **inflation will subsequently stabilize close to the target rate by the end of the year. This will be coupled with the normalization of aggregate demand under the baseline forecast.** Inflation is expected to rise slightly above the 3% target in certain periods, which will mostly be a reflection of base effects from the previous year (see Figure 1). **The average inflation forecast for 2024 is 2.4%,** which is 1.2 pp lower than the previous forecast.

In the first half of 2023, imported inflation was a significant factor contributing to the reduction of headline inflation. This occurred amidst a decline in international commodities prices and an appreciated GEL exchange rate. In contrast, the domestic component of inflation exhibited more inertia, with the annual levels of price growth decreasing slowly, especially in the service sector. The predominant reason for the latter was strong aggregate demand. According to preliminary estimates, real GDP growth in 2023 surpassed expectations, standing at 7%. Such continued high economic growth, even after the double-digit growth of previous years, poses a risk of activity persistently exceeding its potential, particularly given the recently elevated credit activity. However, it should be noted that last year witnessed an acceleration of potential growth driven by increased investments. **According**

Fueled by the improving potential of the economy amid substantial contributions from business loans and investment, real GDP is expected to grow by 5% in 2024, while aggregate demand remains strong.

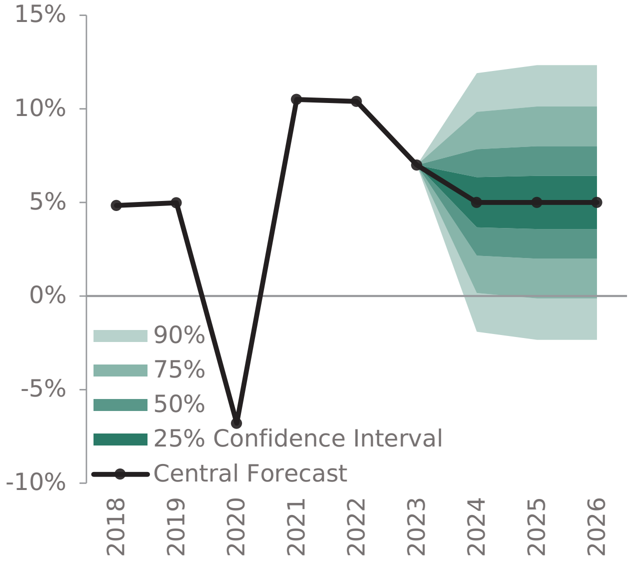

Figure 2. Annual growth forecast of real GDP

Source: NBG, GeoStat

The National Bank of Georgia will only reduce the monetary policy rate at a moderate pace. This approach is in response to both demand- and supply-side risks.

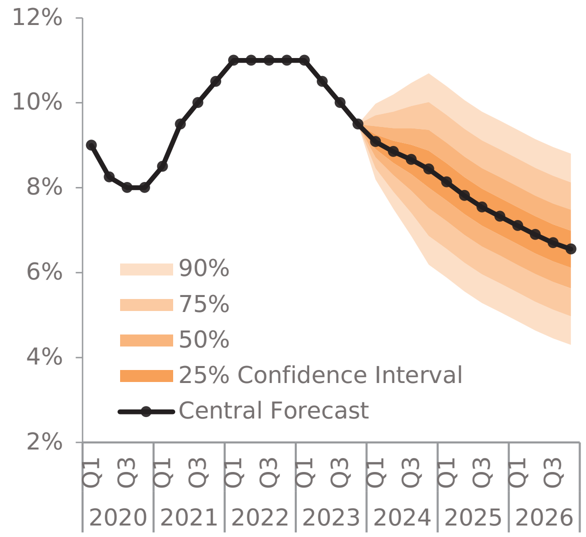

Figure 3. Monetary policy rate forecast

Source: NBG

to the baseline forecast, the growing contribution of business loans to credit growth is expected to further enhance investments and boost production capacity in the economy. This will mitigate the risk of sustaining excess demand and is anticipated to contribute to the 5% growth in the economy in 2024 (see Figure 2). The growth forecast for the following two years also stands at 5%.

Despite the above-mentioned predictions, in terms of its inflationary risks, credit growth will still need to be closely watched in the coming periods to ensure that the reinforcement of overall spending does not exert pressure on consumer prices. Furthermore, amidst the challenging global geopolitical situation, prices on international commodity markets continue to exhibit high volatility. There has also recently been an increase in uncertainty surrounding international transportation. However, as mentioned earlier, **the inflation forecast for 2024 has decreased, leading to a reduction in overall inflationary risks over the medium term. Consequently, at the current stage, the National Bank of Georgia has reduced the policy rate to 9%.** It is also worth noting that the European Union granting Georgia candidacy status for membership resulted in a decrease in Georgia's sovereign risk premium, which is also expected to be reflected in the neutral policy rate. The policy stance thus remains tight, and the projected interest rate trajectory still indicates the need for only a gradual exit from the tight policy stance (see Figure 3). It is likely that the policy rate will only return to its neutral level (of 6.5-7%, according to current estimates) in parallel with a significant reduction of the aforementioned risks.

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

1 CURRENT MACROECONOMIC SITUATION

Amid a difficult geopolitical situation, the post-pandemic recovery of the global economy in 2023 was slow-paced. This was mostly due to globally high inflationary pressures and the tight financial environment. As for Georgia, in the fourth quarter of the year, external demand was relatively weak and was reflected in a slowdown in the growth of goods exports. However, over the same period, travel revenues continued to grow solidly and domestic demand remained strong. Therefore, in general terms, economic activity remained high in Georgia. At the same time, according to the updated forecast, amid the strengthened lari exchange rate, the current account deficit is expected to have deepened only slightly in 2023. Meanwhile, headline inflation remains at a low level against the background of the relative stability of international commodity prices, the appreciated exchange rate, and the maintenance of tight monetary policy.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

In 2024, the pace of economic activity is expected to slow down globally amid a tightening financial environment. In addition, uncertainty is high due to the complicated international geopolitical situation.

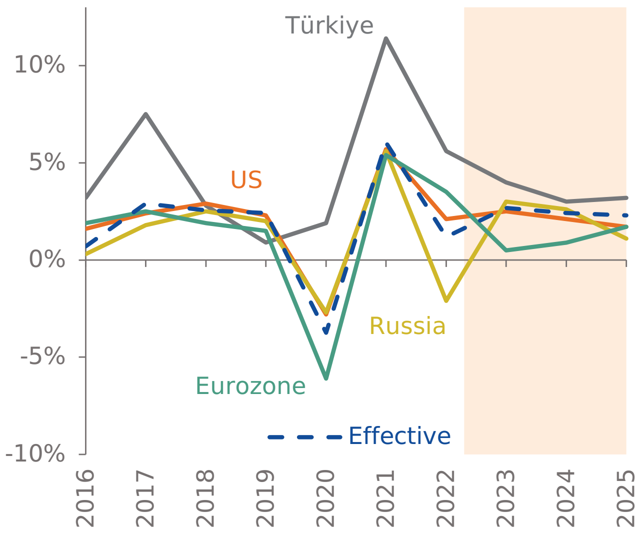

Figure 1.1.1. Real GDP growth of economic partners

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

After the COVID-19 pandemic and amid the ongoing war between Russia-Ukraine and the conflict in the Middle East, the recovery of the global economy only occurred at a slow pace in 2023. This was mostly due to the globally high inflationary environment and the tightened monetary policies adopted in almost all countries. Amid high uncertainty, a further slowdown in economic activity is expected in 2024: the main determining factors of which will be the globally tightened financial environment and supply disruptions resulting from the difficult geopolitical situation. Therefore, according to the International Monetary Fund's (IMF) updated forecast[1] of January 2024, **global economic growth** in both 2023 and 2024 will be 3.1%, which is 0.1-0.2 percentage point (pp) above the previous forecast.[2] In addition, inflationary pressures should decrease globally and inflation is thus expected to be at 6.8% in 2023 and 5.8% in 2024.[3] For emerging and developing countries, real GDP is forecast to grow by 4.1% in both 2023 and 2024, while annual inflation is projected to be 8.4% in 2023 and 8.1% in 2024.[4]

The still-high inflationary environment prevailed in both developed and emerging and developing countries in the fourth quarter of 2023. However, it should

1 *International Monetary Fund. 2024. The World Economic Outlook Update: Moderating Inflation and Steady Growth Open Path to Soft Landing. Washington, D.C., January. (Hereafter: WEO January Update, 2024).*

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

3 *WEO January Update, 2024.*

4 *Ibid.*

be noted that, amid the recent downward trend of both oil and food prices (see section 1.1.2 of this report) and tight financial conditions, the level of inflation has gradually been decreasing globally.

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

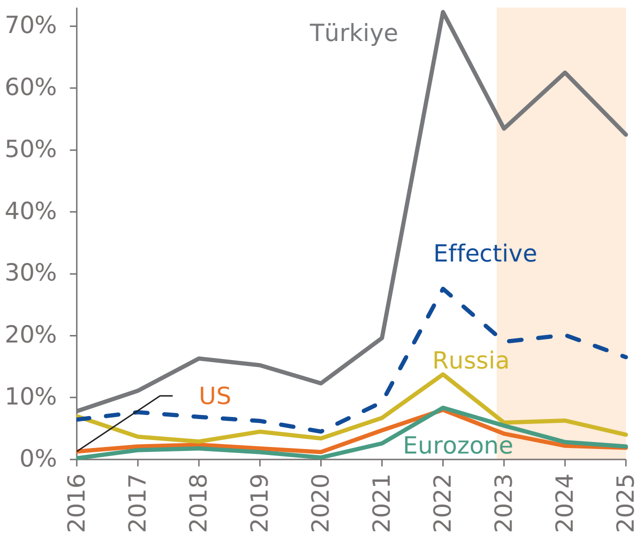

Figure 1.1.2. Headline Inflation rates of economic partners

Source: IMF, NBG's calculations

In the fourth quarter of 2023, improvements in economic activity continued in the **United States**. Based on October-November data, consumer sentiment and retail sales remain improved, being supported by reduced dynamics of consumer prices. The production of industrial goods was also robust. On the other hand, tight financial conditions have had a negative impact on economic activity. According to the IMF's estimates, real economic growth in the US will be 2.5% in 2023 and 2.1% in 2024. Annual inflation in December increased to 3.4% while on average it was 4.1% in 2023 and is projected to be 2.2% in 2024.[5]

In the fourth quarter of 2023, the pace of economic activity slowed in the **eurozone**. This was primarily due to tightened financial conditions. However, from 2024, economic activity is expected to improve alongside projected improvements in external demand. In December, the annual rate of inflation in the eurozone was 2.9%. It should be noted that European countries continue to impose economic sanctions against Russia, which creates additional pressure on their economies. According to the IMF, the real economic growth forecast for the eurozone is 0.5% in 2023 and 0.9% in 2024. Annual inflation was on average 5.5% in 2023 and is projected to be 2.8% in 2024.[6]

In the fourth quarter of 2023, low economic activity was observed in **Türkiye**. This was mainly due to a further devaluation of the Turkish lira amid the increased rate of inflation. According to the October-November data, both retail sales and consumer spending decreased. The production index also deteriorated. A further decrease in economic activity is expected against the backdrop of a sharp tightening of monetary policy. The inflation rate was 64.8% in December. According to the IMF, Türkiye's real economic growth will be 4% in 2023 and 3% in 2024. Annual inflation was 53.4% in 2023 and is expected to be 62.5% in 2024.[7]

In the fourth quarter of 2023, economic activity slowed in **Russia** – a result of the recent decline in both industrial production and retail sales, as well as the increase in the rate of inflation. Also, in light of the economic sanctions imposed by the West, the business environment, volume of investments, and the foreign sector all remain deteriorated. Annual inflation in December increased to 7.4%. According to the IMF, Russia's real economic growth will be 3% in 2023, and 2.6% in 2024. The average level of inflation was around 6% in 2023 and is expected to be 6.3% in 2024.[8]

5 *Ibid.*
6 *Ibid.*
7 *WEO October, 2023.*
8 *WEO January Update, 2024.*

The war waged by Russia in **Ukraine** has had a heavy impact on the country, both socially and economically. Various critical infrastructure has been destroyed, which reduces the potential of the economy. According to the IMF, real economic growth of Ukraine is expected to be around 2% in 2023 and 3.2% in 2024. Meanwhile, inflation was on average 13.4% in 2023 and is projected to be 13% in 2024.[9]

In the fourth quarter of 2023, economic activity increased in **Armenia**. This was mostly due to increased credit activity and consumer spending. In addition, activity was high in the construction and manufacturing sectors. The annual rate of inflation was -0.6% in December. According to the IMF, Armenia's economic growth will equal 7% in 2023 and 5% in 2024. Meanwhile, annual inflation was on average 2.1% in 2023 and is expected to be 4% in 2024.[10]

In the fourth quarter of 2023, growth rates slightly improved in **Azerbaijan**. This was mostly due to high activity in the non-oil sector. Also, it should be noted that the end of the conflict in Nagorno-Karabakh has created positive expectations. Meanwhile, the annual rate of inflation in December was 2.1%, against which the central bank reduced the monetary policy rate in December. According to the IMF, in 2023, as well as in 2024, economic growth in Azerbaijan will equal 2.5%, while the annual inflation rate was on average 8.9% in 2023 and is expected to be 5.6% in 2024.[11]

In the fourth quarter of 2023, alongside the high inflationary environment, the majority of the central banks of Georgia's trading partners maintained tight monetary policy stances.

In the fourth quarter of 2023, the **central banks** of the majority of Georgia's main trading partners maintained tight monetary policies in response to the still-high inflation and inflation expectations. In particular, the US Federal Reserve left its federal funds rate in the target range of 5.25-5.5%, while the European Central Bank also maintained its policy rate at 4.5%. As for the Central Bank of the Republic of Türkiye, it decided to further increase its monetary policy rate to 42.5%, while the Central Bank of the Russian Federation raised its monetary policy rate to 16%.

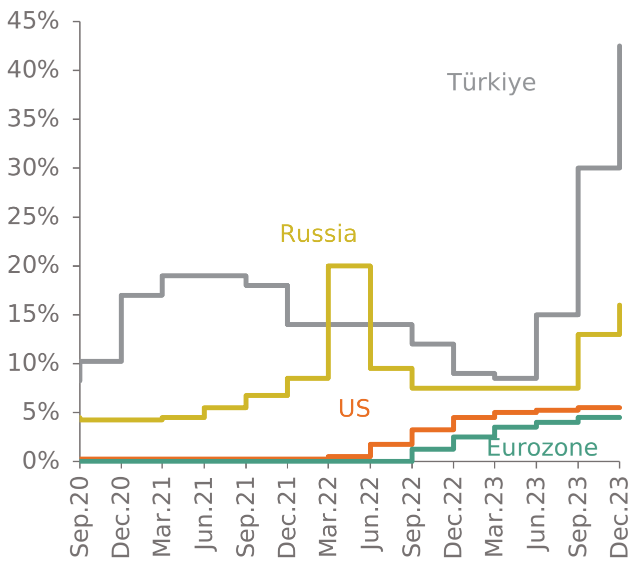

Figure 1.1.3. Monetary policy rates in Georgia's trading partners

Source: www.global-rates.com

9 *WEO October, 2023.*
10 *Ibid.*
11 *Ibid.*

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

In the fourth quarter of 2023, prices on international commodity markets decreased slightly. International food prices continue to decline at a slow pace, although uncertainty over oil prices remains high due to supply and inventory constraints. The prolonged Russian-Ukrainian war and the conflict in the Middle East from the end of 2023 have both increased uncertainty regarding prices on global commodity markets. This was somewhat reflected in rising global shipping costs in December 2023.

The International Food Price Index of the Food and Agriculture Organization of the United Nations decreased by 1.5% in December 2023 compared to the previous month, and by 10.1% over the year (see Figure 1.1.4). In the fourth quarter of 2023, the index declined by 2.4% from the previous quarter. This trend was caused by a decrease in world prices for vegetable oil, meat, and sugar.

The sugar price index fell by 16.6% in month-on-month terms in December, which was the lowest point in nine months, but remained 14.9% higher than the same period of the previous year. The price decline was due to high production rates in Brazil and favorable weather conditions. At the same time, the decision of the Government of India to limit the use of sugarcane for ethanol production in the current season exerted some further downward pressure on prices. However, this was somewhat offset by increased prices of dairy products and cereals. Prices for wheat, corn, rice, and barley rose 1.5% from November, which was partly due to logistical disruptions in supplies from major exporting countries.

In the fourth quarter of 2023, the downward trend of food prices continued but still exceeded pre-pandemic levels.

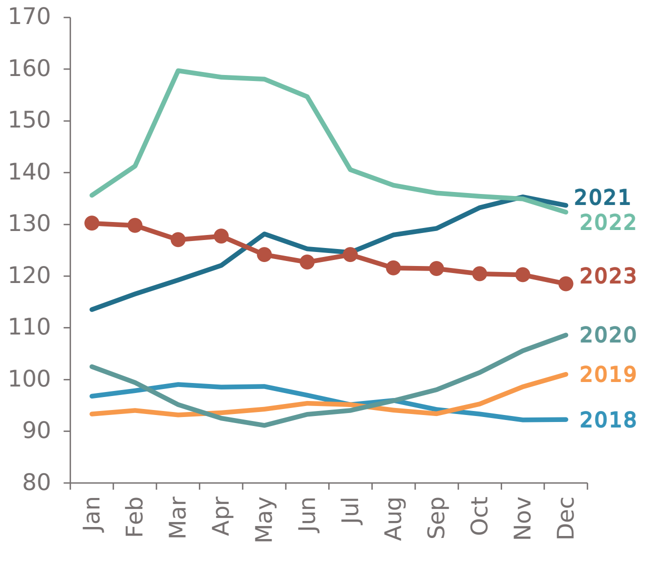

Figure 1.1.4. International food price index

Source: FAO

In general, commodity prices are vulnerable to weather conditions, geopolitical tensions, policy changes and other shocks in commodity markets. These can disrupt the balance of supply and demand and consequently affect global prices. Despite successive shocks, the international food price index has been declining since March 2022. In 2023, the index ended up being 13.7% below the previous year's average.

In the fourth quarter of 2023, oil prices stabilized compared to the third quarter. The average price of a barrel of Brent oil in December decreased by 6.4% compared to the previous month, amounting to USD 77.6 per barrel. However, oil prices remain 15.5% higher than in the same, pre-crisis period of 2019. Gasoline prices in Europe followed a similar trend (see Figure 1.1.5), with the cost of fuel decreasing by 4.7% in December compared to the previous month. In December, the average price of gasoline per liter in Georgia decreased by only GEL 0.02 (0.7%) compared to November. It is expected that the current global market trends will be transferred to the Georgian market and that fuel prices will decrease unless the price of oil on international markets increases once more.

Over the year, oil prices fluctuated but decreased in the fourth quarter of 2023.

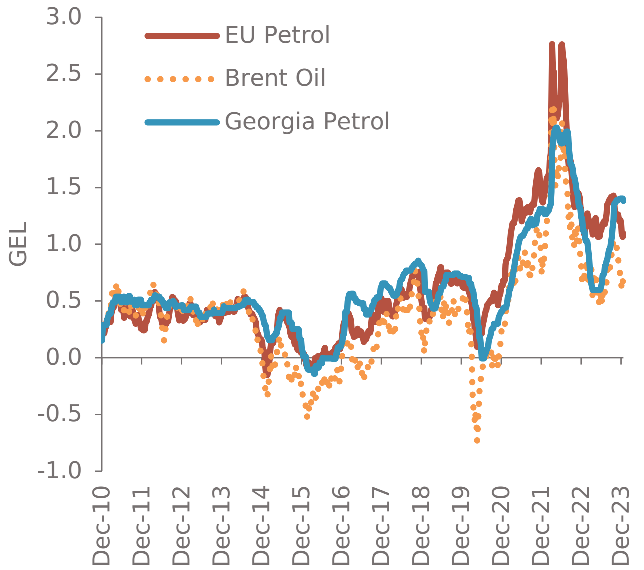

Figure 1.1.5. Petrol price index (Jan 2021=100)

Source: EU Commission, Statista, NBG calculations

At the end of the year, the cost of international transportation increased sharply due to the ongoing conflict in the Red Sea.

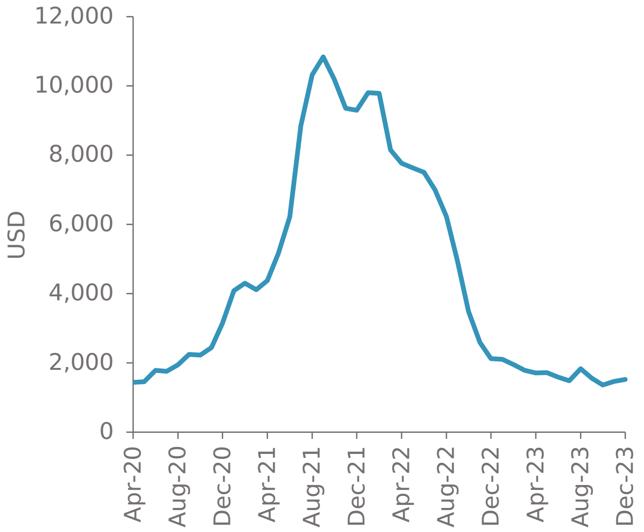

Figure 1.1.6. Average shipping cost of a 40-foot container worldwide

Source: Statista

According to the updated December 2023 forecast of the International Energy Association, the price of Brent oil is expected to be around USD 84 per barrel in the first half of 2024.

Despite the decision by the Organization of the Petroleum Exporting Countries (OPEC) to cut oil production, the International Energy Association's forecast is lower than its previous one (of USD 93 per barrel). In addition to OPEC, a number of OPEC+ countries have also announced additional voluntary production cuts. In total, production cuts of 2.2 million barrels per day will continue until the end of 2024. Despite these announcements, the International Energy Association believes that the voluntary cuts from OPEC+ countries will not continue beyond the first quarter of 2024, leading to higher oil production and lower prices.

In the fourth quarter of 2023, global costs of transportation increased by 3.5% compared to November, which were driven in part by the Houthi attacks on shipping in the Red Sea. However, in annual terms, the price of international transportation fell by 28.5% (see Figure 1.1.6).

The above-mentioned positive dynamics of international food prices have reduced imported inflation in Georgia. However, these dynamics on international markets have recently been partially neutralized by the uncertainty related to the oil market.

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the fourth quarter of 2023, external demand was weak and, consequently, external inflows were moderated. Namely, in light of lower external demand domestic exports continued to decline. At the same time, the growth in demand for motor cars has declined in recent months, inducing a deceleration of re-exports. Along with the fading of the migration effect, in recent months instant money transfers have approached the level seen before the outbreak of war in Ukraine. However, it is worth noting that overall money transfers remain substantially higher than the level before the migration wave, and have predominantly been induced by rising transfers from the US and EU. The moderation of external inflows was balanced by weaker imports of goods, and, according to the recent forecast, the current account deficit is only expected to widen by a small amount.

External demand is weak and thus real exports also declined.

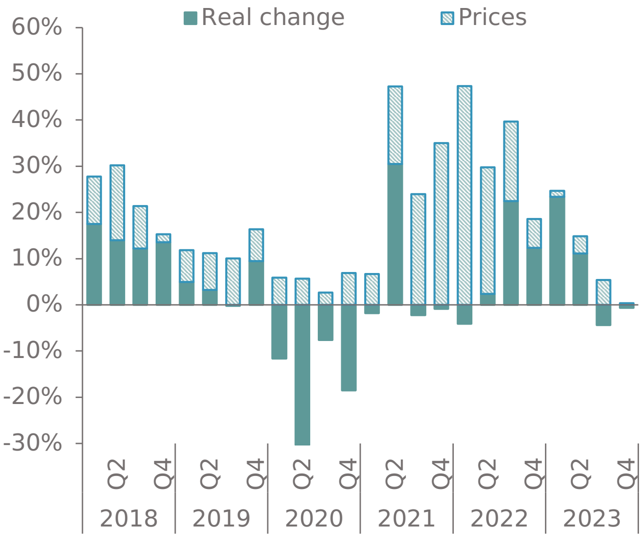

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

In the fourth quarter, external demand was comparatively weak. This was predominantly expressed in a decline of domestic exports (mostly copper ores, wines, and chemical fertilizers). In light of the appreciated lari exchange rate, it is worth noting that trade competitiveness has declined, which resulted in an overall fall in exports. In the fourth quarter of 2023, nominal exports of goods saw almost no change annually, while exports in real terms moderately declined (see Figure 1.2.1).

The fall in exports of goods mainly stemmed from a decline in external demand for intermediate goods. Such an effect was somehow moderated by higher demand for consumer goods (mostly for motor cars).

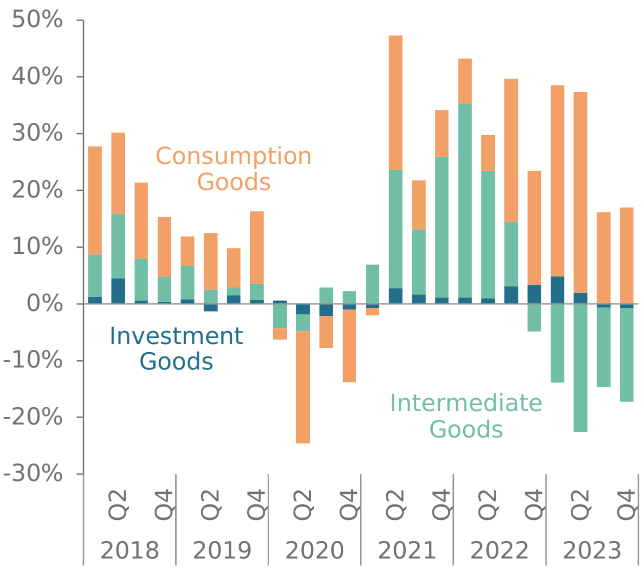

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

Consumer goods made up a major part of exports of goods, while investment goods comprised only a small part of overall exports (see Figure 1.2.2). The increase in consumer goods exports was mainly driven by re-exports of motor cars, which, apart from regional countries, were also resold to central Asia. The volume of exports of alcoholic beverages, medicaments, various fruits, and manufactured tobacco also increased. Meanwhile, the lower exports of intermediate goods mainly stemmed from decreased exports of copper ores and concentrates to China and Bulgaria, and lower exports of mineral and chemical fertilizers to Peru and Ghana. In terms of the decrease in investment goods, reduced exports of motor vehicles for the transport of ten or more persons to Armenia, and exports of automatic data processing machines and units to Lithuania played a leading role in the overall decline.

In 2023, the recovery of international tourism continued and the number of incoming visitors to Georgia was at a high level. However, partially due to the base effect, in the fourth quarter, the number of visitors decreased by 1.5% annually, amounting to 1.5 million visitors.

In line with the rising of number of visitors, revenues from international travel had been continuously increasing in recent years; however, due to the base

Overall annual revenues from international travel rose substantially.

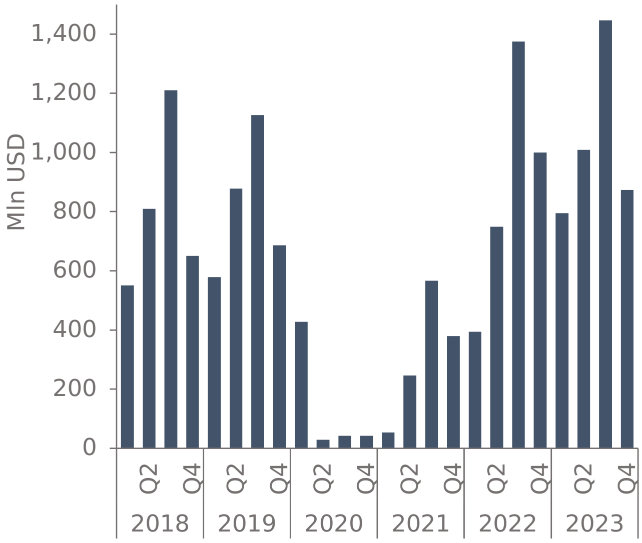

Figure 1.2.3. Annual change in revenues from international travelers

Source: NBG

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

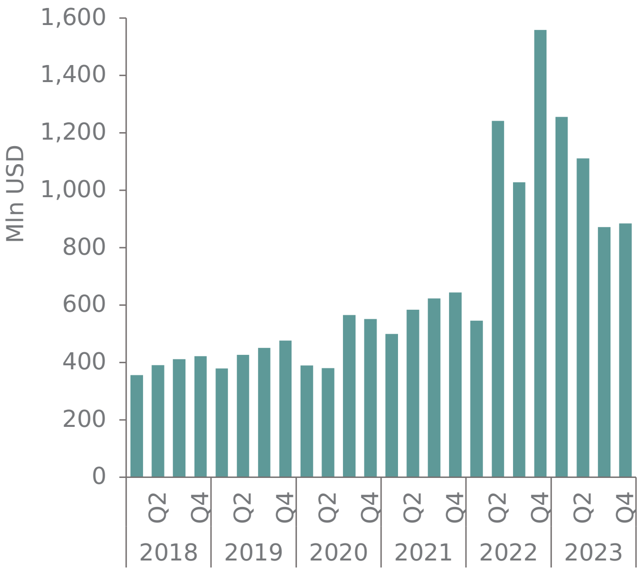

Figure 1.2.4. Money transfers

Source: NBG

effect and the deceleration of migration inflows, revenues from international travel declined by 12.6% annually in the last quarter of 2023 and amounted to USD 874 million (see Figure 1.2.3). With the exception of Türkiye, revenues from visitors from regional countries, the EU and other countries also continued to recover.

In the fourth quarter of 2023, instant money transfers to Georgia amounted to USD 884 million, which reflects a 43.3% annual decline. This was partially related to the base effect and a gradual decline of money transfers from Russia (see Figure 1.2.4). Since the beginning of the war in Ukraine in 2022, money transfers from Russia has been high: a result of both capital inflows and increased migrant inflows. In 2023, as had been expected, such transfers gradually declined. This induced an overall slowdown of money transfers, although transfers from other countries rose significantly, with the largest positive contributions to total growth in this period being made by transfers from the EU (3.2 pp), the US (2.3 pp) and Kazakhstan (1.1 pp).

The demand for imports of goods moderately declined. In the fourth quarter, such imports decreased by 2.7% annually (see Figure 1.2.5), which was induced by a slowdown of prices on global markets (for food as well as energy). Consequently, expenses on import goods were substantially lowered. Due to the beginning of a slowdown of prices on commodity markets, nominal imports of goods were low. However, due to lower prices, imports of goods in real terms increased by 11% in the fourth quarter annually.

In the fourth quarter of 2023, imports of intermediate goods made the largest negative contribution to the overall growth of imports (see Figure 1.2.6). The decline in such imports predominantly stemmed from lower purchases of copper ores and concentrates, as well as of petroleum gases; however, imports of rods of non-alloy steel, structures of iron, and immune vaccines all increased. The rise of consumer goods mostly came from higher purchases of motor cars, petroleum and petroleum products, medicaments, and mixed goods. The rise in imports of investment goods stemmed from higher purchases of motor vehicles for the transport of goods, special purpose motor vehicles, and construction motor vehicles.

The decline in imports from regional countries were predominantly related to a fall in imports from Russia (mostly petroleum and petroleum products) and Armenia (copper and precious metals ores and concentrates). Meanwhile, imports from other countries also fell, including from Ukraine (automatic data processing machines and units) and the United Arab Emirates (telephone sets). In contrast, imports from the US rose due to higher purchases of motor cars, while those from Bulgaria rose mostly due to petroleum products.

In the third quarter of 2023, mostly due to the active

In the last quarter of 2023, imports of goods expressed in USD declined; however, real imports continued to rise, reflecting the fall in global prices.

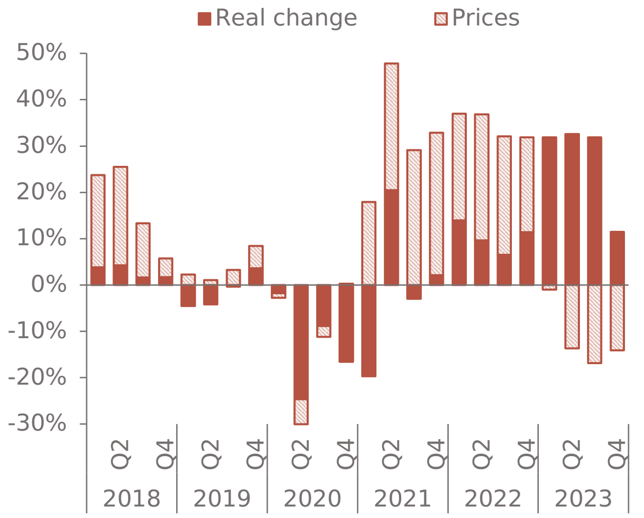

Figure 1.2.5. Annual change in registered imports of goods
Source: GeoStat

In the fourth quarter of 2023, the fall of imports of goods was mainly due to the decline in imports of intermediate goods, while the growth of consumer imports decelerated.

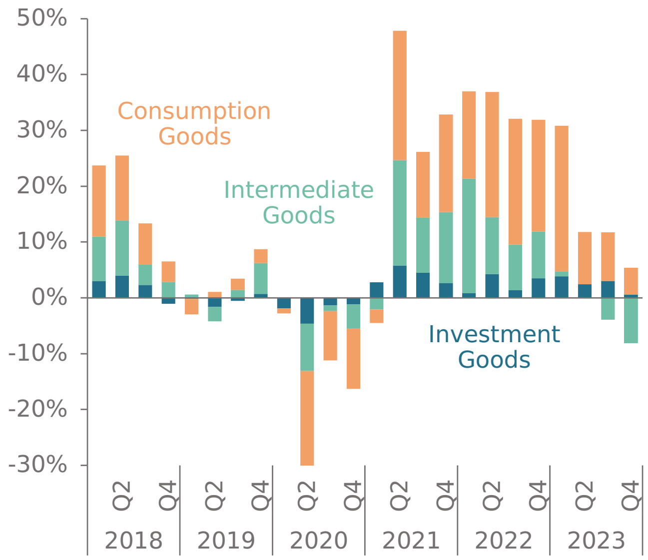

Figure 1.2.6. Annual change in registered imports of goods
Source: GeoStat

tourism season, the current account balance was positive and amounted to USD 164 million, which is 2.0% of GDP. However, the current account surplus was USD 172 million lower annually as a result of a widening trade deficit and the slowdown of money transfers. The volume of remittances and revenues from exports continued to moderate in the fourth quarter of 2023 along with lower imports of goods. Thus, in overall terms, like in the previous year, the current account deficit is expected to be at lower level in 2023.

In the third quarter of 2023, the main source of financing the current account deficit was foreign direct investments (FDI). Inward FDI, partially due to the base effect, declined by 61% annually and amounted to USD 316 million. In overall terms, FDI comprised around 3.9% of GDP. The main reason for the decline of FDI was the reduction of debt instruments and reinvestment. Investments in equity accounted for the largest part of FDI, while the majority of FDI went to the finance and insurance sectors.

From the perspective of savings and investments, in the third quarter of 2023, as compared to the same period of the previous year, the improvement of the current account balance was mainly due to a rise in savings, despite the moderate growth in investments (see Figure 1.2.8).

The moderation of external flows was mostly balanced by the lower level of imports. Consequently, like in the previous year, the current account deficit is expected to be lower in 2024.

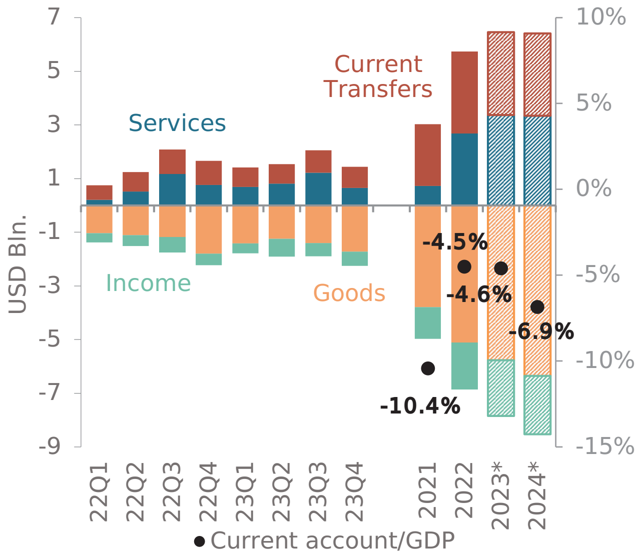

Figure 1.2.7. Current account balance and its components

Source: NBG

In the third quarter of 2023, the improvement of the current account was mainly due to the rise of savings, despite the moderate growth in investment..

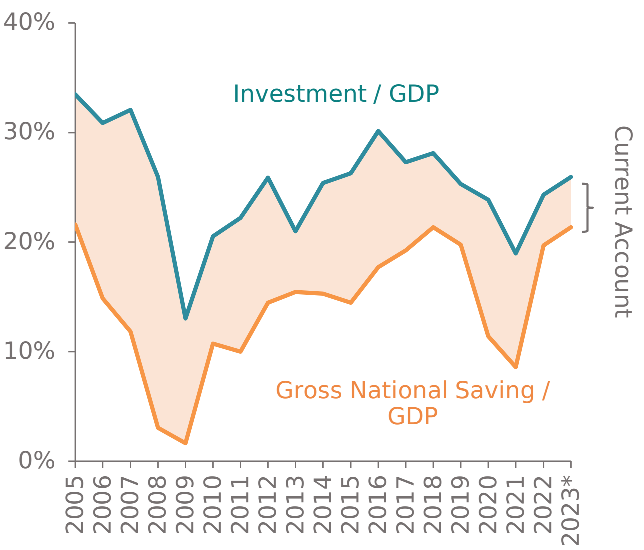

Figure 1.2.8. Investments and savings

Source: GeoStat
* NBG Forecast

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

The main drivers of economic growth in the third quarter of 2023 were investments, while the contribution of net exports turned negative, mainly due to the base effect.

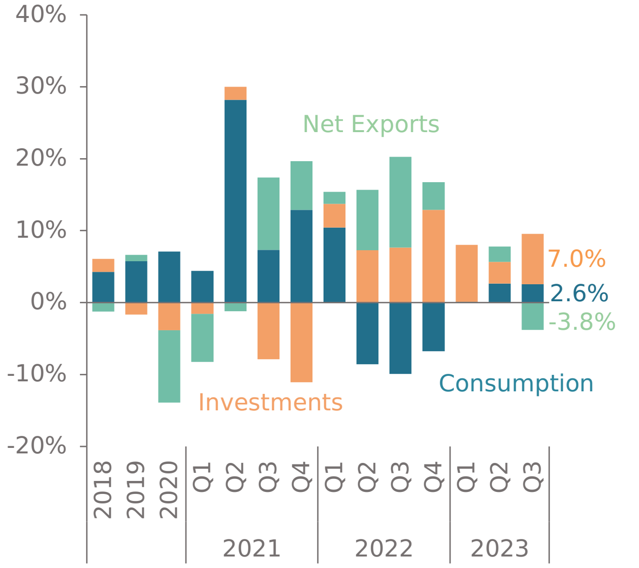

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the third quarter of 2023, the real gross domestic product increased by 5.7%, compared to the corresponding period of 2022. The main determinant of that growth was investments, making a contribution of 7.0 percentage points (pp). Such an increase in investments can to some extent be explained by a significant increase in capital expenditures from the state budget and business loans. In contrast, the contribution of consumption was relatively small, amounting to 2.6 pp.

After the restrictions aimed at preventing the spread of the COVID-19 pandemic were lifted, the flow of foreign visitors to Georgia gradually recovered. The subsequent Russia-Ukraine war gave additional impetus to such inflows. As a result, in real terms exports of services increased by 59% in 2021 and by 87% in 2022. Net exports were thus the main driver of economic growth in those years. Due to the resulting base effect, in 2023 the contribution of net exports to economic growth decreased sharply and became a negative 3.8 pp in the third quarter of the year.

1.3.2 OUTPUT

The high growth of the economy was mainly caused by the service sector.

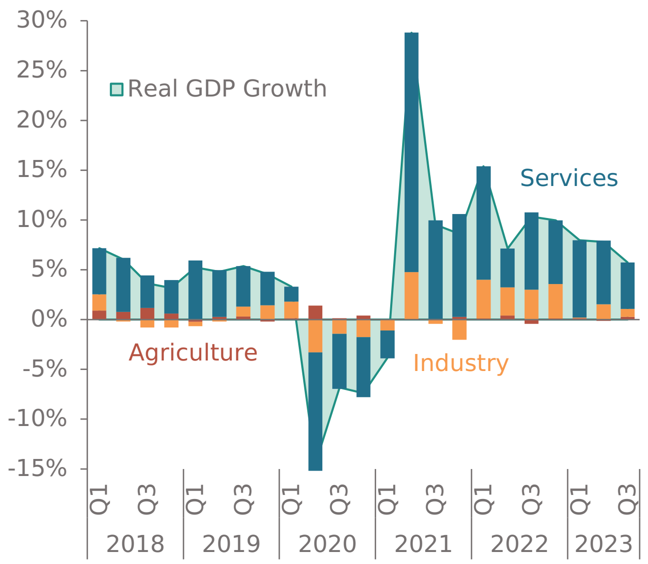

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

In the third quarter of 2023, services accounted for 4.7 pp of the overall 5.7% economic growth. The contribution of industrial sectors was 0.8 pp, and the contribution of agriculture was 0.3 pp (see Figure 1.3.2).

The solid growth in service sector output has continued. Strong domestic demand, the tourism industry, and the significant number of migrants in the country can all be cited as contributing factors. The collective contribution to overall growth of the trade, transport, hotels and restaurants, information and communication, arts, recreation and entertainment sectors was 2.0 pp.

The demand for housing from foreigners can be considered to be one of the reasons behind the high 8.5% growth in construction (a 0.4 pp contribution to overall growth).

In December, the growth of the annual loan portfolio increased and equaled 17.1%, excluding the effect of exchange rate fluctuations.

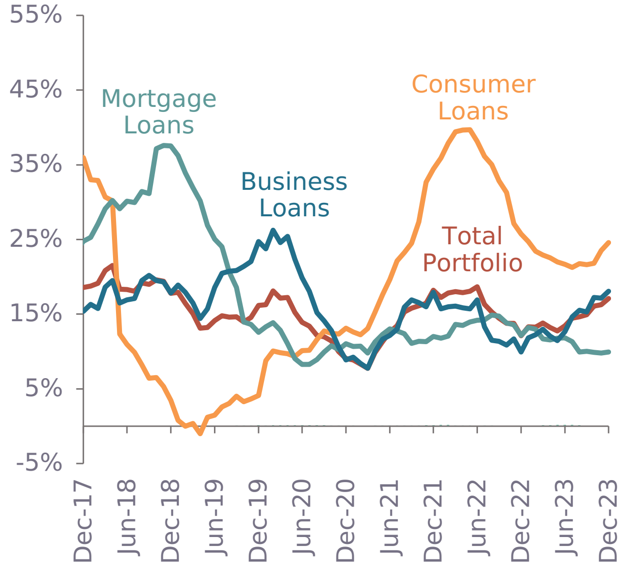

Figure 1.4.1. Annual growth of loans by purposes (excluding the exchange rate effect)

Source: NBG

The growth of the credit portfolio was due to the growth of loans issued in the domestic currency.

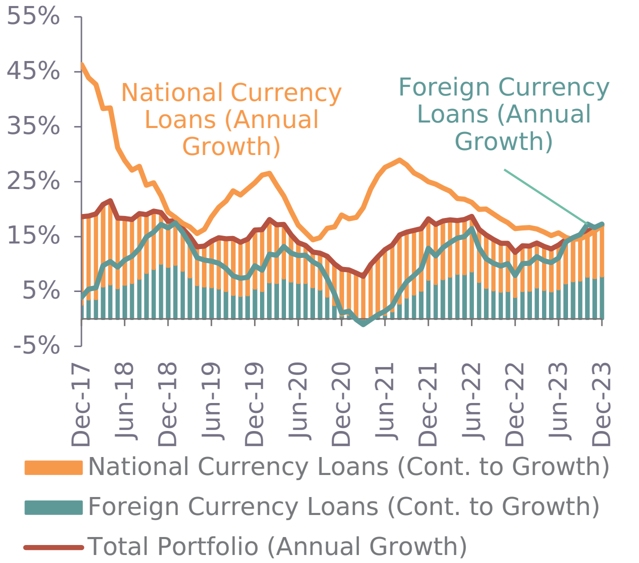

Figure 1.4.2. Annual growth of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

Credit activity increased at the end of 2023. In December, relative to November, the growth of the loan portfolio rose by 0.9 pp and equaled 17.1% (excluding the impact of exchange rate impact). The increased growth rate of loans was largely caused by the growth of business loans. Meanwhile, consumer loans has also accelerated, the contribution of which to total loans increased by 1.0 pp over November and amounted to 24.6% in December (see Figure 1.4.1). The increase in consumer lending activity is a result of the NBG's policy, effective from 1 November 2023, that increased the maximum term of unsecured consumer loans to four years.

According to the credit conditions survey, representatives of the banking sector expect a marginal decrease in demand for business loans in the next quarter. In December 2023, the growth of the loan portfolio was primarily due to the growth of domestic currency loans (see Figure 1.4.2). In December, compared to November, the annual growth of the lari loan portfolio increased by 1.0 pp to 17.0%, and loans in foreign currency rose by 0.7 pp up to 17.3%.

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 respond appropriately to reduce the currency risk and related credit risks of individual borrowers and to promote long-term economic growth.

In December 2023, compared to the previous month, the dollarization of loans decreased by 0.04 pp and amounted to 45.2% (excluding the impact of exchange rate fluctuations). Dollarization of individual loans increased by 0.2 pp compared to November and amounted to 28.8%. Dollarization of loans to legal entities decreased by 0.6 pp and equaled 63.6% as of December. Dollarization of total deposits increased by 0.2 pp compared to the previous month and amounted to 50.7% (excluding the impact of exchange rate fluctuations). In the same period, the dollarization of deposits of individuals and legal entities decreased by 1.5 pp and 1.4 pp, respectively, and amounted to 65.3% and 38.1% (excluding the impact of exchange rate fluctuations) (see Figure 1.4.3).

In order to mitigate the risks caused by dollarization, the NBG has imposed an additional requirement on regulated financial institutions. Starting from 1 January 2024, such institutions can only issue new foreign currency loans to individuals whose total debt is up to

Loan dollarization marginally decreased, though deposit dollarization has increased.

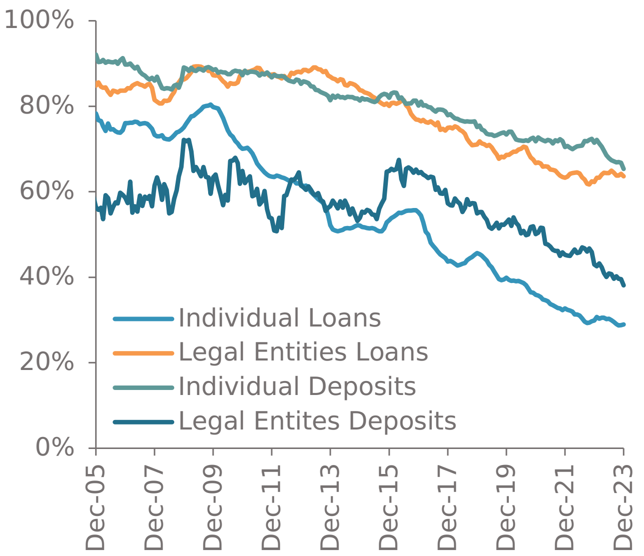

Figure 1.4.3. Dollarization of loans and deposits (excluding the exchange rate effect)

Source: NBG

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

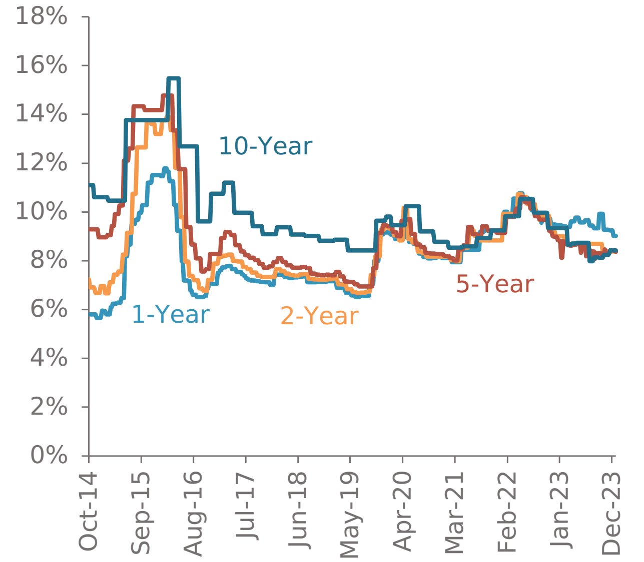

Figure 1.4.4. Interest rates on government securities

Source: NBG

300,000 GEL under hedged currency risk conditions.

It is important to continue the process of reducing dollarization. This will be facilitated, among other things, by the macroprudential measures adopted in the recent period. 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 and up to January 2024 the monetary policy rate has been gradually reduced by a total of 2.0 pp to 9.0%.

Thus, in the fourth quarter of 2023, rates on government securities decreased slightly (see Figure 1.4.4). Recently, short-term rates have been at higher levels than long-term rates. To some extent this is a reflection of the financial market's inflationary expectations. In particular, in the medium and long term, the financial market expects inflation to be maintained at the target rate, as a result of which the policy rate is expected to stabilize around the neutral level in the long term. In the short term, taking into account inflationary risks, the monetary policy rate will be higher than the neutral level.

Under the conditions of strict monetary policy, GEL interest rates remain at a high level, although they are decreasing slightly. In December, interest rates on domestic currency deposits saw practically no change and amounted 10.8%, while interest rates on foreign currency deposits increased by 0.1 pp and amounted to 2.0% compared to November.

As for lending, along with the reduction of the monetary policy rate, interest rates on mortgage loans and legal entity loans in the national currency decreased during 2023. 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. However, interest rates on mortgage loans are characterized by certain fluctuations and in December, compared to November, the average interest rate on loans issued to legal entities in the domestic currency decreased by 0.2 pp and amounted to 12.9%. Regarding foreign currency loans, due to tightened global financial conditions, foreign currency interest rates in Georgia also increased throughout 2023. In particular, interest rates on foreign currency loans to legal entities increased by 0.5 pp and amounted to 9.5% (see Figure 1.4.6). The spread between local and foreign rates has narrowed. It should further be noted that in December, compared to November, interest rates on business and mortgage loans remained particularly unchanged, amounting to 11.3% and 10.1% respectively; however, *The spread between long- and short-term interest rates remained negative. This is a reflection of expectations of decreasing inflation and, consequently, of a fall in the policy rate.*

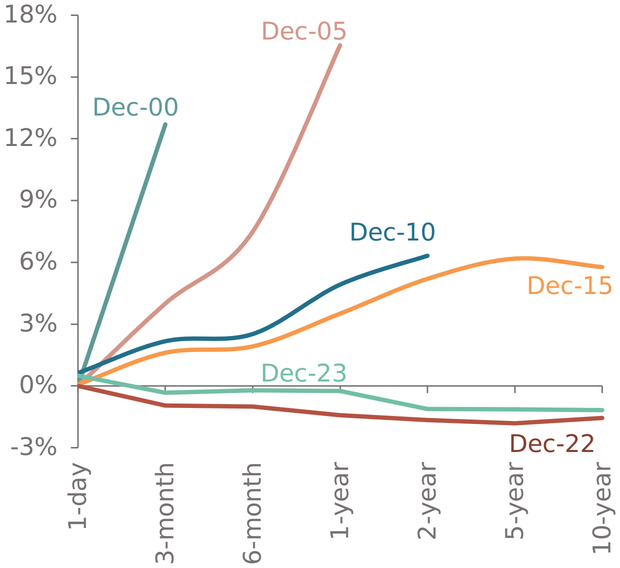

Figure 1.4.5. Spread between the monetary policy rate and the yield curve

Source: NBG

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

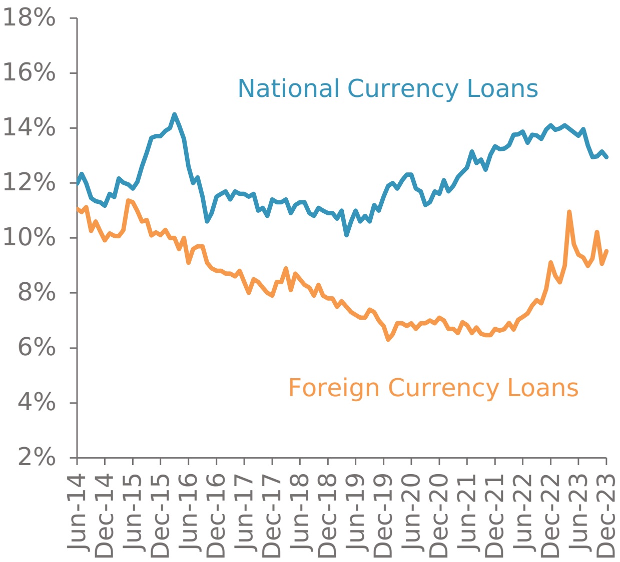

Figure 1.4.6. Average interest rates on business loans

Source: NBG

consumer loans decreased by 0.2 pp compared to November and amounted to 16.0%.

According to the credit conditions survey, in the fourth quarter of 2023, compared to the previous quarter, business loan lending conditions softened slightly in both foreign and local currencies. Representatives of the banking sector do not expect a change in interest rates on foreign currency lending in the next quarter. However, in the case of domestic currency lending, a slight decrease in interest rates is expected.

1.4.3 EXCHANGE RATE

In the fourth quarter of 2023, the GEL exchange rate remained appreciated on a year-on-year basis; however, the GEL nominal exchange rate depreciated against both the US dollar and the euro by 2.8% and 1.6% respectively compared to the previous quarter. The GEL depreciated against the Russian ruble by 4.3%, however it appreciated by 3.4% against the Turkish lira. As a result, in the same period, the nominal effective exchange rate depreciated by 1.3% on a quarterly basis and appreciated by 16.3% on an annual basis. In terms of the price-adjusted exchange rate, in the fourth quarter of 2023, the real effective exchange rate depreciated by 3.2% on a quarterly basis and appreciated by 3.7% on a year-on-year basis (see Figure 1.4.7). The annual appreciation was due to the appreciation of the nominal effective exchange rate. However, the reduced competitiveness of the economy due to the nominal appreciation of the lari was balanced to a larger extent by the fact that the increase in consumer prices in Georgia was lower than those in its trading partners (see Figure 1.4.8). It should also be noted that the lari real exchange rate has appreciated against the currencies of Armenia, Russia and China (see Table 1.4.1).

The real effective exchange rate remains appreciated, with annual appreciation standing at 3.7%.

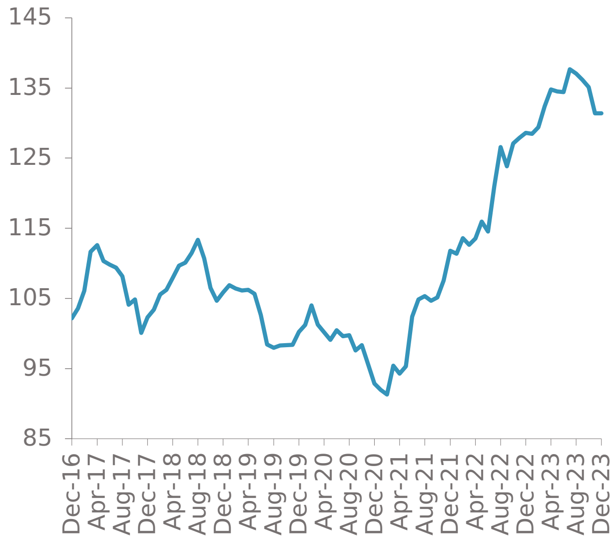

Figure 1.4.7. Real effective exchange rate (Jan 2008=100)

Source: NBG

The annual appreciation of the GEL real effective exchange rate was mainly caused by the appreciation of the nominal effective exchange rate.

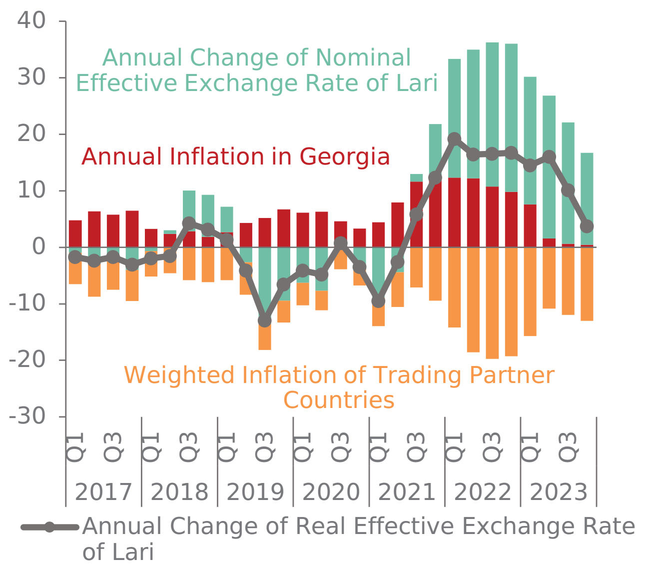

Figure 1.4.8. Decomposition of the annual change of the GEL real effective exchange rate*

Source: NBG

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

The GEL real effective exchange rate appreciation is due to real appreciation against most major trading partner currencies.

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate*	**16.3**	**3.7**	**3.7**
Eurozone	-3.9	-6.1	-1.0
Türkiye	55.4	-4.1	-0.8
Ukraine	0.6	-3.9	-0.1
Armenia	2.7	3.4	0.3
US	1.4	-1.3	-0.1
Russia	50.2	40.8	6.9
Azerbaijan	1.7	-0.8	-0.1
China	3.1	3.9	0.5
Bulgaria	-3.9	-8.4	-0.4
Poland	-10.2	-15.2	-0.3

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

Source: NBG

* *Growth implies appreciation of the lari*

1.5 LABOR MARKET

In the third quarter of 2023, Georgia's economic productivity (real value added per employee) rose by 4.4% on a yearly basis (see Figure 1.5.1). Over the same period, the nominal wage growth for employed workers was 16.3%, and the average monthly gross wage reached GEL 1,855.

Compared to the previous quarter, the growth rate of wages decreased slightly, despite remaining significantly higher than the growth of productivity. As a result, the annual increase in the unit labor cost was at the high rate of 11.4%.

At this stage there are no clear signs of the development of a wage-price spiral; however, the still-high level of the unit labor cost means that inflationary pressure from the labor market remains noteworthy (see Figure 1.5.1).

The annual increase of the unit labor cost (ULC) is high at 11.4% and inflationary pressures from the labor market thus continue to be noteworthy.

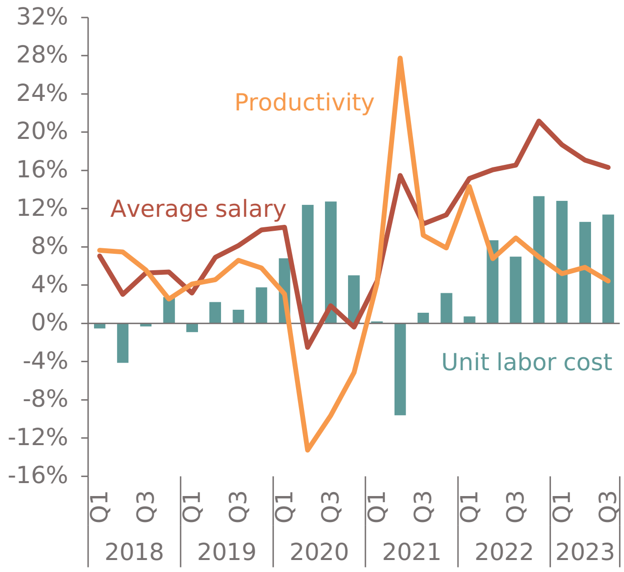

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual growth)

Source: GeoStat, NBG calculations

In Georgia, since the beginning of 2023, inflation remained at a fairly low level compared to the target rate. Low inflation was ensured by the enactment of timely and sufficiently tight monetary policy. At the same time, the relative stability of commodity prices on the world market and the solid position of the GEL exchange rate contributed to low inflation.

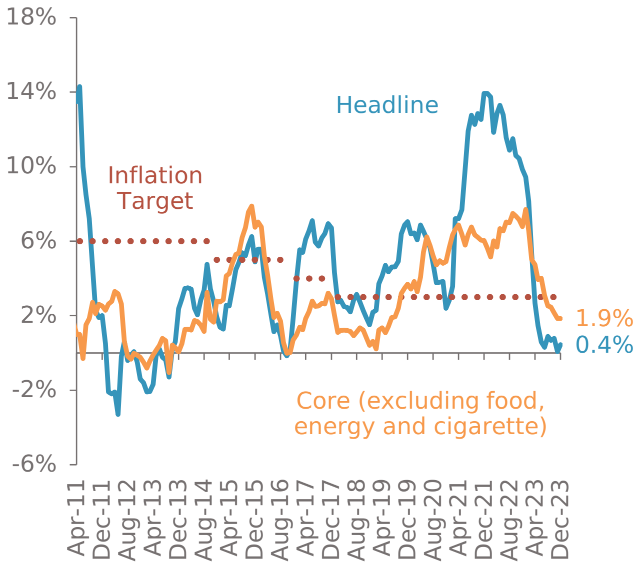

Figure 1.6.1. Headline and core inflation

Source: GeoStat

Domestic inflation continues to decrease, while deflation on imported products is close to zero.

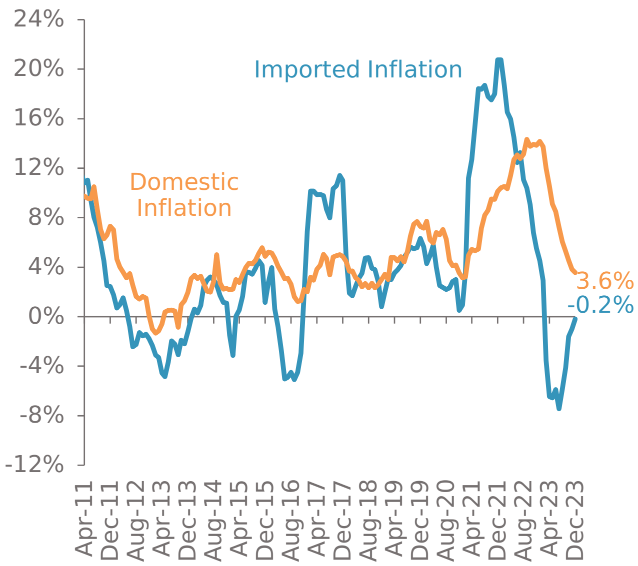

Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

1.6 CONSUMER PRICES

In December, annual inflation stood at 0.4%. Core inflation – which excludes the highly volatile prices of food, energy, and cigarettes from the consumer basket – equaled 1.9% (see Figure 1.6.1).

Low inflation was caused by the decreasing trend of domestic inflation that resulted from the maintenance of strict monetary policy. At the same time, the downward trend of global food prices has continued to a large extent. The real effective exchange rate of the GEL maintains a strong position. This, together with the gradual reduction of external shocks, helps keep imported inflation at a low level.

In December and January, the tensions in the Red Sea region sharply increased prices of international transportation. Although this fact has not yet had a significant impact on commodity prices, further changes in transportation prices will depend on the duration and intensity of the ongoing conflict in the region.

The inflation of domestically produced products continues to decrease and is largely related to the annual decrease in food prices and the exhaustion of the base effect on some services (apartment rent, medical services, etc.). Inflation of domestically produced products decreased to 3.6% in December. The annual decrease in food prices was also reflected in the decrease in price inflation of mixed products (-4.3%). Meanwhile, the deflation of imported products is decreasing (-0.2%) and is primarily related to the increase in gasoline prices and the base effect.

Relatively high domestic inflation was due to annually increased prices of services (6.6%). The contribution of services to domestic inflation was 3.6 pp and thus, excluding services, domestic inflation was equal to zero.

In terms of product groups, it is worth noting that food and healthcare (due to falling prices of medicines) became cheaper in December, falling by 3.1% and 3.8% respectively, and lowering inflation by 1.0 pp and 0.4 pp. After several months of significant growth, the fuel price hike stopped in November and decreased slightly in December. However, the price of gasoline in December exceeded that of the same month in 2022 by 9.7%, which increased inflation by 0.4 pp.

In December, inflation was mainly reduced by the food and healthcare groups. In terms of growth, the annual increase in the price of gasoline was most noticeable.

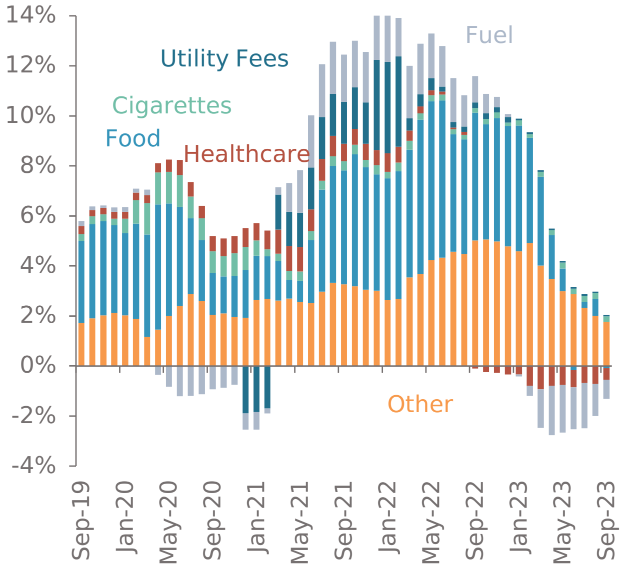

Figure 1.6.3. Inflation by major categories (contribution to headline inflation)

Source: GeoStat, NBG calculations

2 MACROECONOMIC FORECAST

According to the current baseline forecast, inflation in 2024 will be 2.4% on average, which is below the target. This is explained by both the low inflation of the current period – resulting from the normalization of international commodity product prices and the appreciated lari exchange rate – and one-off factors, such as the announced reduction in electricity tariffs, which will also have a downward impact on inflation during the year. However, taking into account the base effect of the previous year, it is noteworthy that inflation will temporarily exceed its target before stabilizing around it from the end of the year. Despite the rapid growth of the potential level of the economy, inflationary pressures stemming from strong domestic demand are still noteworthy, and risks of rising imported inflation remain in place. As for economic activity, in 2024-2025, other things being equal, together with the normalization of the potential growth of the economy, real GDP will increase by 5% each year.
The alternative scenario, which we consider to be as relevant as the baseline, assumes economic activity – amid relatively strong credit growth – above potential levels, coupled with an increase in the cost of international shipping, and a global delay in the reduction of inflation. This inflationary pressure would require a tightening of monetary policy and would increase the need to use additional instruments.

Inflation will remain below the target in the short run. However, partly because of the base effect from the previous year, it will be stabilizing around it from the end of 2024.

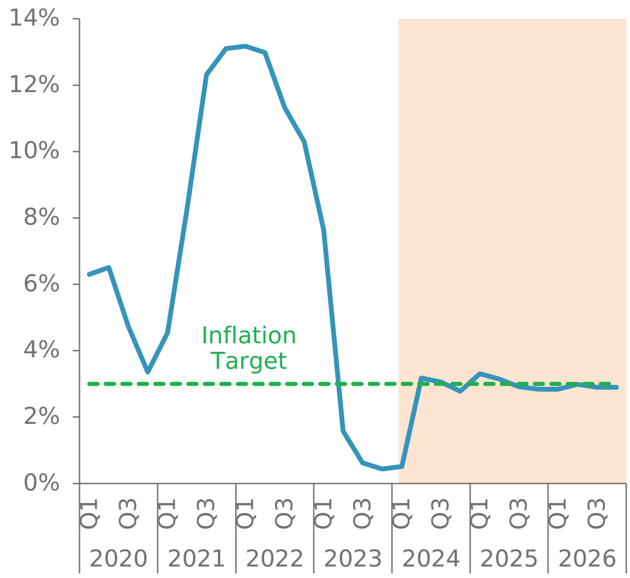

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

2.1 BASELINE MACROECONOMIC FORECAST

In 2023, annual inflation was 2.6%, which was 0.1 pp lower than the baseline forecast of the previous quarter. The average inflation forecast for 2024, ceteris paribus, is 2.4%, which is partly a reflection of the low inflation forecast for the current period amid the faster-than-expected inflation seen at the end of 2023. Over the next quarters of 2024, inflation, because of the base effect, will slightly exceed its target level, but this will be balanced by the one-off effect of reduced electricity tariffs. As a result, other things being equal, inflation will stabilize around 3% from the end of 2024 (see Figure 2.1.1).

The deviation of projected inflation from its target can be explained by several factors. In particular, in the short term, the appreciated GEL exchange rate will put downward pressure on prices, which should mostly balance the inflationary pressure caused by strong local spending. However, as was pointed out before, amid the normalization of foreign inflows, ceteris paribus, the effect of both the strengthened exchange rate and strong demand will gradually wear off, which will help bring inflation closer to the target (see Figure 2.1.2).

Alongside the aforementioned factors, the baseline forecast takes into account the high inflationary expectations in Georgia's trade partner countries, especially those in Türkiye, and the expected dynamics of prices on international commodity markets over the forecast horizon. It is noteworthy that international food prices continue to normalize, which has a positive impact

The deviation of inflation from the target is still driven by counterbalancing factors, the effect of which will significantly decline from the second half of this year, ceteris paribus supporting inflation to hover around its target.

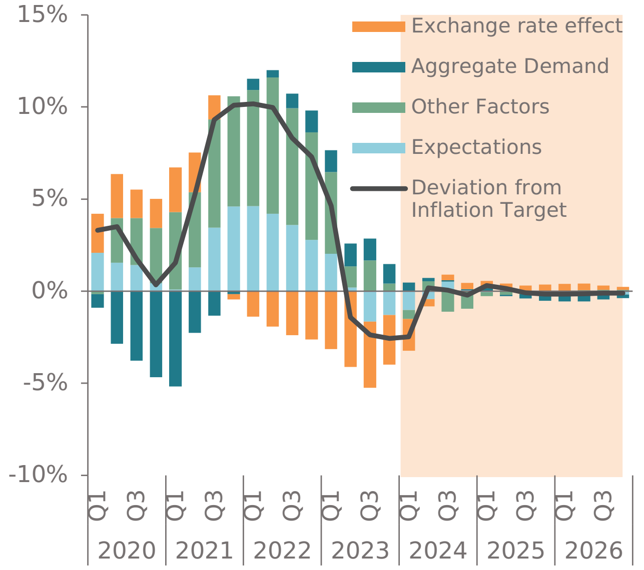

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the baseline scenario, investments and consumption will be the main contributors to growth in 2024-2025, owing to which the growth will be within 5% for both of these years.

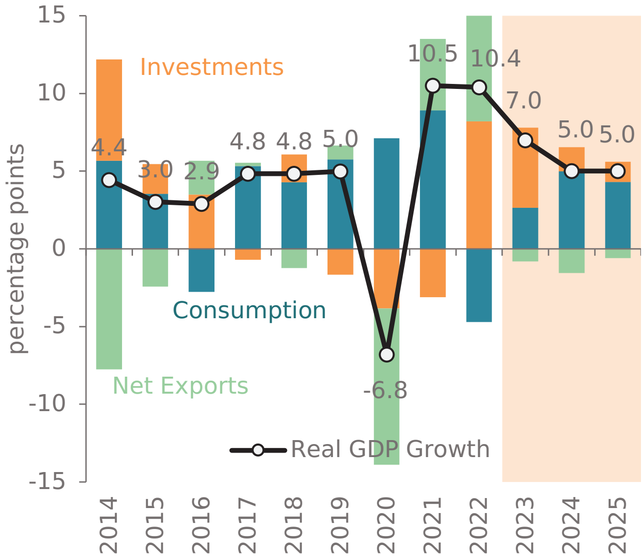

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

on local food price inflation. In addition, according to the current forecasts of international organizations, expectations regarding the international price of Brent oil have recently been revised downward; despite that, OPEC members are extending oil supply restrictions. The latter can be explained by both the increase in supply by non-OPEC countries and by the slowdown in global demand growth. As a result, other things being equal, oil prices will be less inflationary than we expected in the previous quarter. However, amid the difficult geopolitical situation and the recently increased uncertainty surrounding international transportation, fluctuations of prices on international markets are high. The aforementioned forecast could thus be revised in either direction in the future.

As for economic activity, the 7% growth of real GDP in 2023 can be explained by both the relatively high growth of the economy's potential – which in the current period, amid a growth of investments, has also been stimulated by the increased productivity of production factors – and by strong aggregate demand, as driven by solid growth in travel-related income and credit. The effect of the latter will be noticeable in 2024 as well, having a positive impact on consumption and investments and will cause a 5% increase in real GDP in both 2024 and 2025 (see Figure 2.1.3).

Taking the above-mentioned factors and risks into consideration, the National Bank of Georgia will continue to decrease the monetary policy rate at a moderate pace in accordance with the current macroeconomic forecasts. Thus, the monetary policy rate will approach the neutral level in the medium term in parallel with the mitigation of existing inflationary risks.

2.1.1 BASELINE FORECAST SCENARIO RISKS

Amidst strong domestic demand, coupled with delays in the reduction of inflation in Georgia's trading partners and severe geopolitical tensions, macroeconomic forecasts continue to exhibit high uncertainty. The high-impact risks are primarily inflationary in nature and their realization will result in deviations from the baseline macroeconomic forecast, necessitating an appropriate monetary policy response.

Despite some normalization of external inflows, the expected inflation trajectory remains significantly contingent on the indicators of foreign currency inflows related to the Russia-Ukraine war, with uncertainty related to a potential further escalation of the military conflict and the nature of its resolution. Rapid outflows of migrant-related foreign currency will deepen the current account deficit, worsen the investment climate, and create pressure on the GEL to depreciate. The latter, given the still-high level of dollarization in Geor-

Amidst strong domestic demand, coupled with delays in the reduction of inflation in trading partner countries and exacerbated by severe geopolitical tensions, macroeconomic forecasts continue to exhibit high uncertainty.

Macroeconomic Forecast Risks	Impact on Inflation
A sharp reversal of Russia-Ukraine war-related inflows and a deterioration of the current account balance	↑
Stronger-than-expected domestic demand	↑
A higher-than-expected jump in international shipping costs	↑
Higher-than-expected commodity prices	↑
Faster-than-expected global disinflation	↓
Low-impact risk	High-impact risk
↑	Upward Pressure on Inflation
→	Same Level of Inflation
↓	Downward Pressure on Inflation

Table 2.1.1 Baseline macroeconomic forecast risks

Source: NBG

gia, will increase inflationary pressures through the inflation expectations and intermediate input costs channels. In the event that these risks materialize, the NBG will tighten its monetary policy compared to the baseline scenario. Such a response would help mitigate the impact of the shock and anchor long-term inflation expectations.

Some domestic economic tendencies also present notable risks. In particular, strong credit activity, including an acceleration of foreign currency lending, stands out as a significant risk. This increases the likelihood of economic activity remaining above its potential level for a prolonged period, which in future could put additional pressure on inflation. It should be noted that monetary policy will be particularly intolerant towards demand-driven inflation. If necessary, additional instruments will be used to ensure the stabilization of long-term inflation expectations and the mitigation of shocks.

The recent disinflation was largely driven by a decline in imported inflation. However, this highlights vulnerability to a potential resurgence of imported inflation, particularly that driven by heightened tensions in the Middle East, specifically the crisis around the Red Sea. Recent incidents, such as the Houthi's attacks on commercial shipping, have significantly disrupted the efficient functioning of global supply chains, leading to prolonged delivery times and increased costs. In the event of a protracted crisis, and should international shipping prices remain elevated for an extended period, this would inevitably result in higher prices for imported goods, both consumer and durable goods, in their respective destination countries, including Georgia.

A prolonged increase in international shipping prices will exacerbate the global inflationary environment and further underscore the challenges of addressing persistent issues related to the disinflation of sticky prices. This may, in turn, aggravate wage-related inflationary pressures and would consequently necessitate appropriate monetary policy actions to be taken in developed countries (in the US, in particular). Tighter monetary policy in developed countries would heighten the risk of capital outflows and a subsequent depreciation of domestic currencies in emerging and developing countries, like Georgia. Should this risk materialize, the NBG stands ready to sufficiently tighten its monetary policy to anchor inflation expectations around the long-term target of 3%. However, some probability exists of rapid disinflation in developed countries. This could ameliorate global financial conditions and alleviate inflationary pressures in developing nations.

According to the updated forecast, expected inflation has decreased. The main contributors to this downward revision include lower-than-forecasted actual inflation, improved inflation expectations and the announced decline in electricity prices.

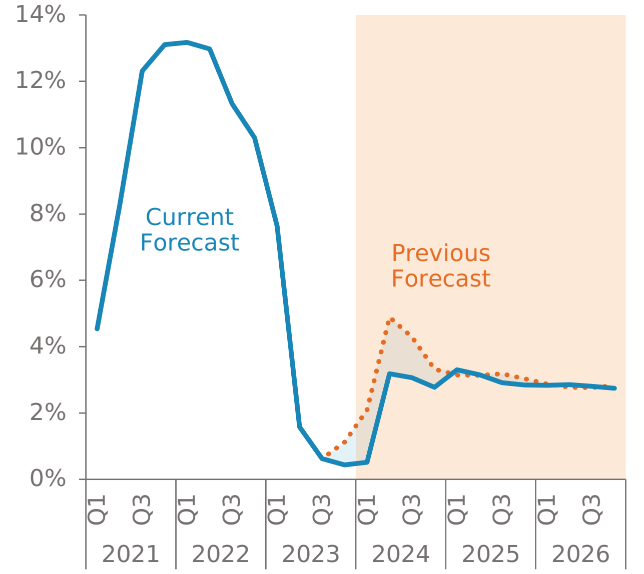

Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

According to the updated forecast, the economic growth projection for 2024 has been retained, while that for 2025 has seen a slight improvement.

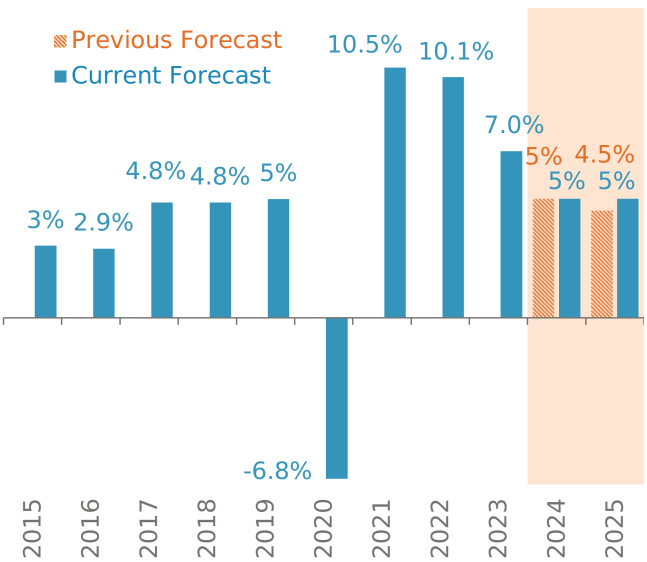

Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

2.2 COMPARISON TO THE PREVIOUS FORECAST

According to the updated forecast, expected inflation has decreased (see Figure 2.2.1). The main contributors to this downward revision include lower-than-forecasted actual inflation, improved inflation expectations, and the announced decline in electricity prices. Expectations about an accelerated normalization of commodity prices and the impact of the prolonged appreciation of the effective exchange rate, compared to the previous forecast, have further contributed to moderating inflation expectations. Consequently, in the next quarter, inflation is projected to exceed the target by a smaller margin than previously expected, while in the second half of 2024, alongside a gradual policy easing, it will stabilize around 3%.

According to the updated forecast, the economic growth projection for 2024 has been retained, while slightly improving for 2025 (see Figure 2.2.2). The assumptions underpinning the growth forecast largely align with those of the previous projection. During 2024-2025, alongside the expected easing of monetary policy, improved credit conditions, and a reduction in the country risk premium attributed to Georgia receiving EU candidate status, the investment climate is expected to improve, contributing to an increase in economic potential.

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 the country's trading partners.

According to the latest forecasts, inflation expectations for 2024 have improved for the EU and Ukraine but have worsened for Russia and Türkiye. The exchange rate expectations for the USD against the euro and Russian ruble have deteriorated, while improving against the Turkish lira. As for real economic growth, the positive outlook is primarily influenced by improved prospects for the US and Russia (see Figure 2.2.3).

According to the updated forecast for 2024, expectations for inflation and economic growth in Georgia's main trade partner countries have slightly improved, while worsening in terms of exchange rates.

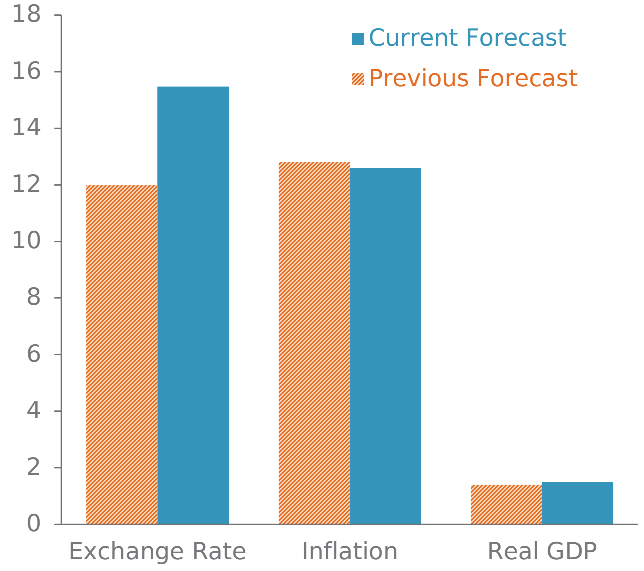

Figure 2.2.3. Changes in assumptions about trading partners

Source: Bloomberg, NBG

Similar to the baseline forecast, the alternative scenario envisions a 6.5% growth rate of real GDP.

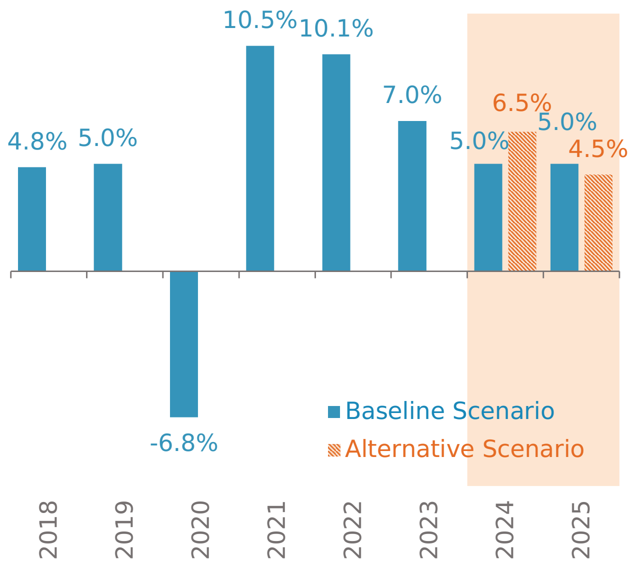

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat

2.3 ALTERNATIVE FORECAST SCENARIO

The alternative scenario addresses the most probable risks identified in the baseline macroeconomic projection. In this context, given the recent acceleration in credit extension, economic activity in 2024 is expected to surpass its potential level, resulting in a growth rate of 6.5% (see Figure 2.3.1). Excess demand is poised to yield two unfavorable outcomes: higher wage-related inflation pressures due to increased utilization rates of factors of production, such as labor, and a worsened current account deficit stemming from intensified imports. Given the high level of dollarization, a weaker current account deficit and, consequently, the depreciation of the domestic currency will further stimulate inflation through the intermediate production costs and inflation expectations channels. On the supply side, as a result of the ongoing Middle East crisis, international transportation costs are expected to remain elevated in the current year. Consequently, the deceleration of global inflation will be protracted, contributing to higher imported inflation. Ultimately, under the alternative forecast scenario, the inflation rate in 2024 is projected to be 1.5 percentage points above that of the baseline forecast (see Figure 2.3.2).

The National Bank of Georgia is least tolerant to this scenario and its realization will imply an appropriate tightening of monetary policy and the use of additional instruments as necessary. Compared to the baseline scenario, in the alternative scenario the trajectory of the monetary policy rate in 2024 will shift upward by an average of 1.3 percentage points and will only gradually normalize after a moderation of inflation expectations (see Figure 2.3.3).

Economic activity exceeding its potential level and increased international transportation costs substantially amplify inflationary risks.

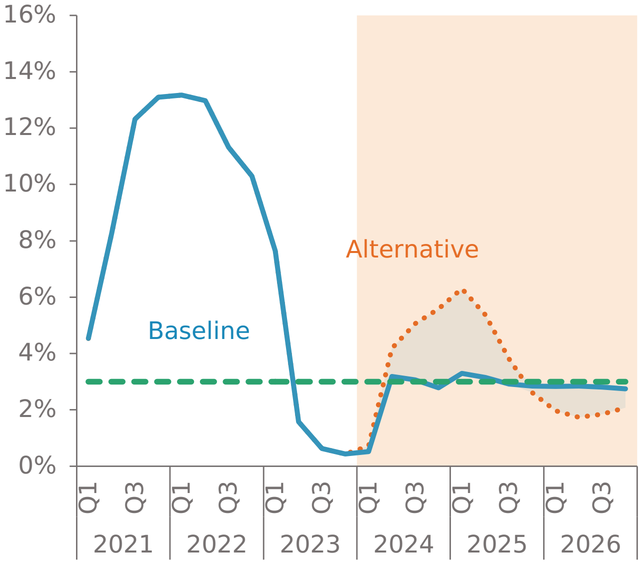

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

The National Bank of Georgia is least tolerant to increased inflation/inflation expectations. Realization of this scenario would definitely imply an appropriate tightening of monetary policy and the use of additional instruments as necessary.

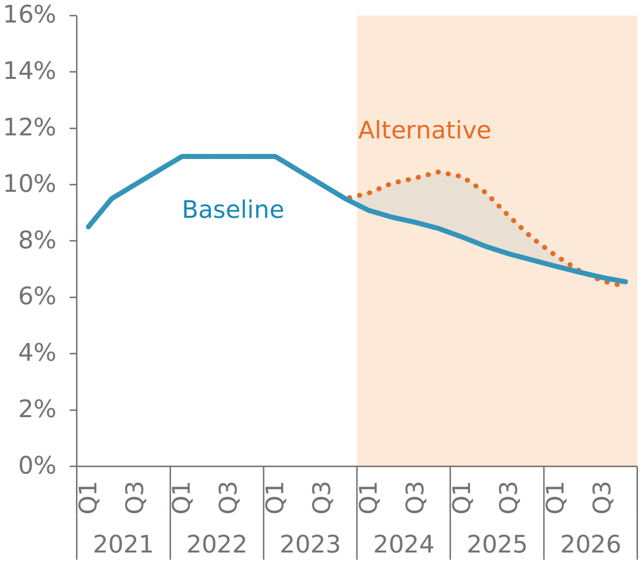

Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

Akin to the NBG's forecasts, the inflation expectations of financial market participants for 2024-2025 have decreased compared to the previous quarter.

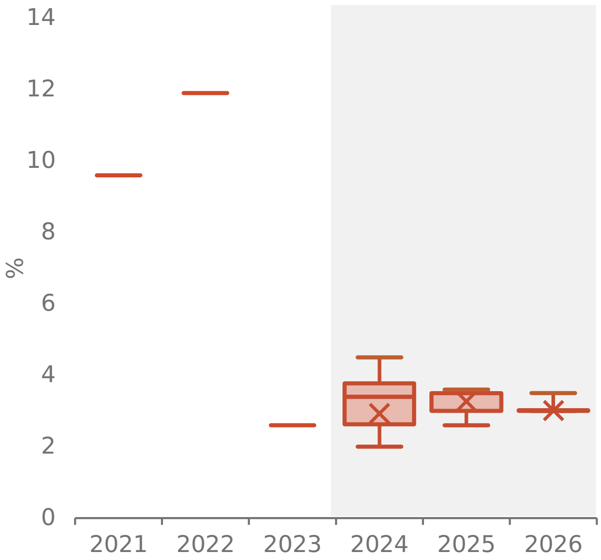

Figure 2.4.1. Actual average inflation (2021-2023) and the distribution of market participants' forecasts for 2024-2026

Source: NBG, Financial market participants, GeoStat

Financial market participants have slightly revised their expectations upwards for the monetary policy rate compared to the previous quarter.

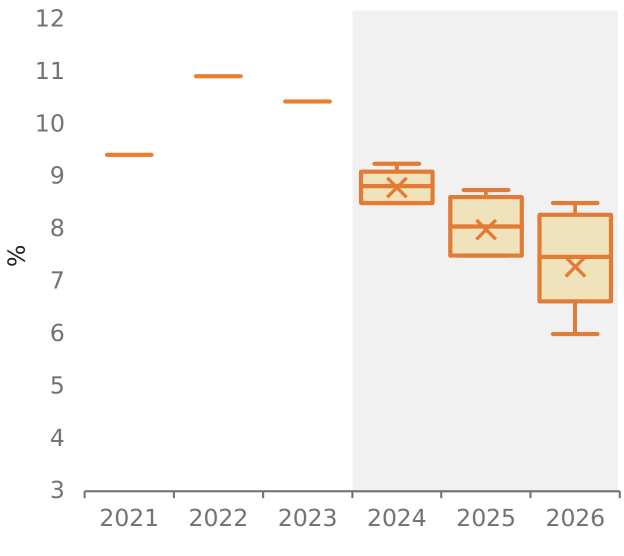

Figure 2.4.2. Actual monetary policy rate (2021-2023) and the distribution of market participants' forecasts for 2024-2026

Source: NBG, Financial market participants

In the first quarter of 2024, 10 financial organizations participated in a survey of macroeconomic forecasts. According to the results of this survey, the financial market's economic expectations for 2024-2025 show some changes over those of the previous quarter.

The inflation expectations of financial market representatives for 2024-2025 have decreased compared to the previous quarter. In particular, the median inflation expectations for 2024 fell by 0.1 pp to 3.4%, and the average (mean) index decreased by 0.7 pp to 2.9%. As for 2025, the median rate is 0.2 pp lower and amounts to 3%, while the average rate is reduced by 0.1 pp to 3.3%. In the financial market, the median and average inflation expectations for 2026 are equal to 3% (see Figure 2.4.1).

The market participants' monetary policy rate forecast was revised upward compared to the previous quarter: the median rate forecast for 2024 is higher by 0.2 pp, and the average forecast increased by 0.5 pp, both equaling 8.8%. Also, the median expectations for 2025 increased by 0.1 pp to 8.1%, and the mean increased by 0.4 pp to 8%. In the long run, as inflation expectations move closer to the target level, monetary policy projections approach the neutral rate. In particular, the median forecast for 2026 is 7.5%, and the average is 7.3% (see Figure 2.4.2).

Compared to the previous quarter, market participants' economic growth expectations have also changed. In particular, the median forecast of economic growth increased by 0.5 pp to 5.5%, and the average forecast rose by 0.1 pp to 5.1%. In contrast, the median and mean forecasts for economic growth in 2025 are down slightly, by 0.1 pp to 5% and 0.2 pp to 4.9%, respectively. Both the median and mean forecasts for 2026 equal 5% (see Figure 2.4.3).

The market forecasts for economic growth in 2024 have been revised upward compared to those of the previous quarter, and projections for 2025 have slightly decreased.

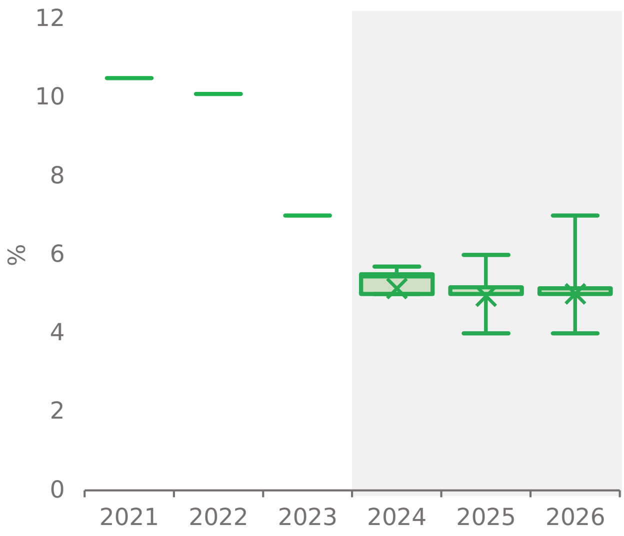

Figure 2.4.3. Actual real GDP growth (2021-2023) and the distribution of market participants' forecasts for 2024-2026

Source: NBG, Financial market participants, GeoStat

BOX 1. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2023 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters). Therefore, in the formation of monetary policy, it is especially important to consider the inflation forecast over the monetary policy horizon. Because of the central importance of this, the inflation targeting regime is also called the inflation forecast targeting regime in academic and institutional circles. To assess the adequacy of monetary policy in achieving its objectives, it is important to analyze the accuracy of the forecasts made in previous periods. A retrospective analysis of inflation forecasts is thus an important dimension of the forecasting and monetary policy analysis system of the National Bank of Georgia. An inflation forecast is assessed as having been accurate if any deviations from the forecast were a result of exogenous factors (that are independent of monetary policy). In Georgia, as in other small open economies, exogenous shocks are an ever-present threat. Such shocks are usually transitory and one-off in nature, and responding to them is commonly associated with more public costs than benefits. Consequently, central banks generally do not react to such shocks, except when supply-side shocks affect medium-/long-term inflation expectations.

According to the policy of transparency, an analysis comparing the inflation forecast with the actual results is included in the Monetary Policy Report at the beginning of each year. In this case, we will evaluate inflation target fulfillment in 2023 and analyze its forecast. Inflation turned out to be significantly higher than had been projected in February 2023 (see Figure 2.4.4). According to the February 2023 update, the inflation forecast for the year was influenced by several opposite factors. In particular, the stabilization of commodity prices on international markets and the appreciated exchange rate as a result of foreign inflows put downward pressure on inflation. In addition, over the forecast horizon, the convergence of inflation to its target was facilitated by the prolongation of the tight monetary policy stance and fiscal consolidation. In contrast, as a result of the high inflation experienced in previous years, inflation expectations remained elevated and this – together with the high unit labor cost and strong aggregate demand amid high migration – put upward pressure on inflation. Therefore, according to these factors, inflation in 2023 should have had a downward trend that would see it return to its target by the end of the year.

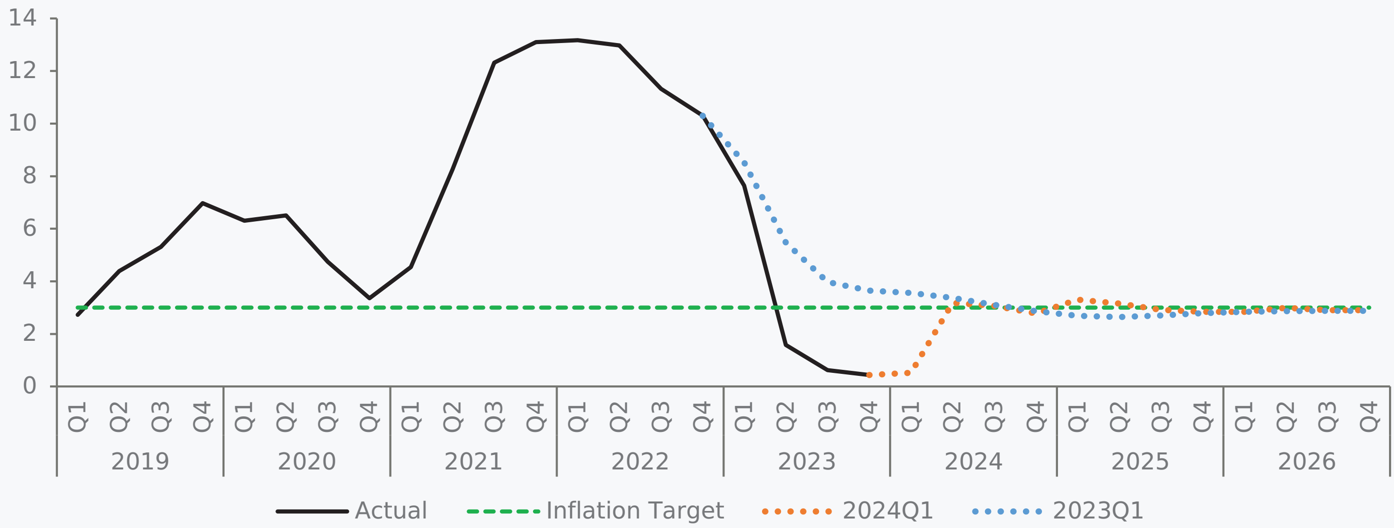

Figure 2.4.4. Comparison of the February 2023 annual inflation forecast with actual inflation and the updated forecast.

Source: NBG, GeoStat

In 2023, inflation had a downward trend in line with the forecast, although this occurred faster than we had expected. As a result, inflation turned out to be 2.8 pp lower than had been forecast. The main reason for the deviation was the different realization of the assumptions made regarding commodity products and foreign inflows (see Figure 2.4.5). According to the inflation decomposition analysis, the lower-than-forecast inflation can mostly be explained by exchange rate and imported inflation effects, which were accompanied by improved inflation expectations. In particular, migration and accompanying financial flows related to the Russia-Ukraine war turned out to be stronger than had been expected, which caused an even greater strengthening of the exchange rate. On the one hand, the strengthened exchange rate and a sharp decrease in international commodity prices and transportation costs significantly reduced imported inflation and, at the same time, lowered inflation expectations. It is noteworthy that even in a high dollarization environment, the exchange rate is an important factor affecting inflationary expectations. Migration flows also had the opposite impact on inflation: strong external demand also boosted domestic demand, and despite accelerating potential growth, economic activity turned out to be above its potential, which was inflationary.

Amid lower-than-expected actual inflation, in the second quarter of 2023 the NBG significantly revised its inflation forecast. Over the rest of the year the inflation forecast differed slightly from actual data: the average annual rate as forecast ranged from 2.4% to 2.8%, while the actual rate was 2.6% (see Figure 2.4.6). It is noteworthy that the financial market also expected high inflation at the beginning of the year, with partic-

Figure 2.4.5. Decomposition of the difference between actual inflation and the February 2023 forecast.

Source: NBG, GeoStat

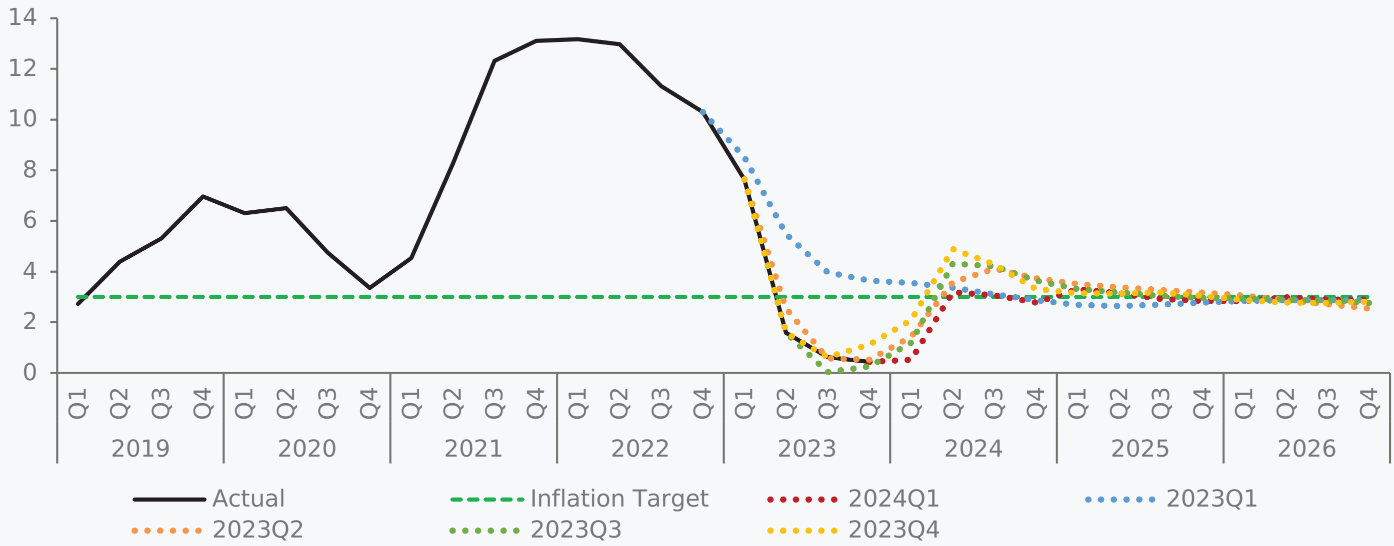

Figure 2.4.6. Comparison of headline inflation forecasts (2023Q1-2024Q1).

Source: NBG, GeoStat

ipants' median and mean forecasts standing at 6.7% and 6.9%, respectively[12]. Like those of the NBG, market participants' expectations gradually decreased during the year.

According to the inflation forecast, which took into account the economic situation and risks at the time, NBG decided to gradually exit from its tight monetary policy in May 2023 and thus reduced the monetary policy rate by 50 basis points to 10.50%. However, as discussed, the factors affecting inflation were exogenous, and while overall inflation was declining rapidly, domestic inflation was only slowly normalizing. At the same time, aggregate demand was still inflationary, and the effects of reduced imported inflation were characterized by uncertainty amid high risks. As a result, the stabilization of inflationary expectations was significantly delayed, partly as a consequence of inflation having been over the target for a long time, and this thus required a relatively tight monetary policy stance to be maintained. That is why the NBG chose to pursue a conservative, risk-management approach and, despite inflation having been below the target since April, the pace of exiting from the tight monetary policy stance was moderate and cautious. During the year, the monetary policy rate was thus only gradually decreased by 1.5 pp to 9.5%.

12 Macroeconomic forecasts of financial market participants are traditionally published in subsection 2.4 of the monetary policy report, "Forecasts of Financial Market Participants".

3 MONETARY POLICY

In 2023, the overall inflation rate in Georgia fell below the 3% target. This reduction can be attributed to a combination of several factors. On the one hand, it was influenced by a tight monetary policy and diminished inflationary expectations, resulting in a decline in inflation for domestically produced goods. On the other hand, it resulted from the gradual dissipation of exogenous shocks that had arisen from geopolitical conflicts and the pandemic. The NBG's updated forecast shows lower than target inflation in short run, while in medium term it stabilizes around 3% target. However, global economic risks and geopolitical challenges, such as the tensions in the Red Sea region and the Middle East, persist. These ongoing conflicts contribute to increased transportation costs and place inflationary pressure on imported goods. In contrast, Georgia receiving EU candidate status at the end of 2023 reduced the country's risk premium, which should reduce the neutral policy rate. In response to these factors, the National Bank of Georgia continues its cautious exit from the accommodative monetary policy. According to the decision made on 31 January 2024, the monetary policy rate was cut by 0.5 percentage points to 9.0%.

On 31 January 2024, the monetary policy rate was reduced to 9.0%. The NBG continues to maintain a tight policy stance.

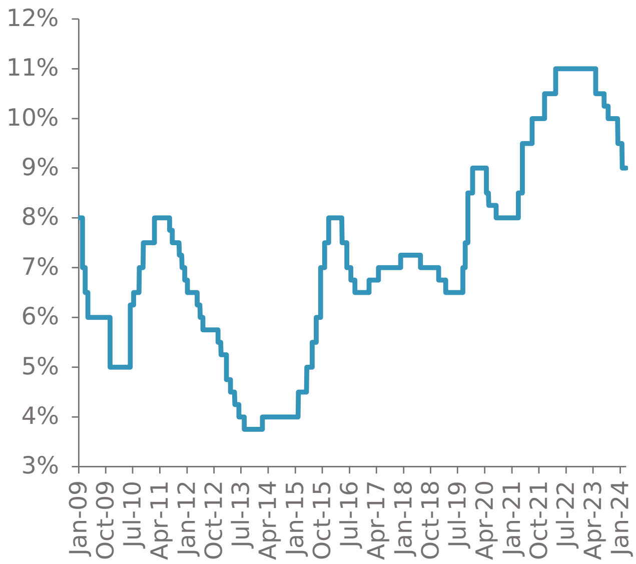

Figure 3.1. Monetary policy rate

Source: NBG

Recent years have seen consecutive shocks and shifts in the geopolitical environment that have been exacerbated by new conflicts in the Red Sea region and the Middle East, heightening global uncertainties regarding price dynamics. To combat significant inflationary pressures, many central banks worldwide have tightened their monetary policies. Global tightened financial conditions, in combination with the aggravated geopolitical situation and challenges faced by the US financial sector, initially worsened global economic growth perspectives. Current forecasts indicate a pessimistic outlook for near-future economic growth. Currently, global inflation has passed its peak and follows a declining trend in a plethora of countries. Nevertheless, strong inflationary pressure remains a main challenge for policy makers, which is the main reason that many countries have continued to retain tight monetary policy stances.

Despite strong global inflationary pressures, Georgia has experienced a declining trend in the average price level since 2023. Inflation in Georgia is currently below the 3% target, influenced by both internal and external factors.

The reduction of inflation was predominantly the result of the enactment of adequate monetary policy, which has helped normalize inflationary expectations and reduced price pressure. Fiscal consolidation, improved access to the Turkish market for medicines, and low import activity have also contributed to this decline. Another positive factor is the decision from the EU to grant candidate status to Georgia. It is expected that this decision will reduce the country's risk premium and should lower the neutral policy rate. However, cautious monitoring is required as a result of persistent strong internal demand, increased credit activity, global risks affecting transportation costs, uncertainties in international price developments, and labor market tendencies.

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

Despite weak external inflows, the current account deficit remains small, mainly as a result of low import activity. The nominal and real GEL exchange rates are still over-appreciated relative to the long-run trend. The appreciated GEL, in combination with downward price trends on international commodity markets, has led to deflation of imported good prices. By the end of 2023, the deflationary effect of imported prices had considerably reduced. The increased supply of commodity goods reduced the food price index as well. This reduction, in turn, contributed to the low inflation in Georgia. In spite of the persistent downward dynamics of food prices, the index is still higher relative to pre-pandemic levels and future price dynamics are ambiguous.

Domestic inflation in Georgia is moving closer to the target level, which is the main contributor to the low headline inflation. Inflationary pressure fell considerably due to the dissipation of the external shocks caused by the war in Ukraine and the pandemic. The National Bank of Georgia has revised its inflation forecast downwards because actual inflation turned out to be lower than had previously been expected. This reduction not only aligns with the low inflationary environment but also partially mitigates the risks associated with inflation for the foreseeable period. Keeping everything else constant, inflation in 2024 is expected to remain below the 3% target at the beginning of the year before stabilizing around the target in the medium term.

Despite positive trends, global risks are still evident. Georgia, as a relatively small, open economy, remains vulnerable to international developments and existing global inflationary pressures significantly influence the dynamics of the local aggregate price level.

The risks and volatility related to the oil market are also noteworthy, leading to higher transportation costs. Ongoing military tensions in the Red Sea and the Middle East have considerably restricted transportation through the Red Sea, significantly increasing costs because of the need for alternative routes. The anticipated rises in transportation costs due to rising petrol prices and geopolitical risks are expected to be transmitted to Georgian inflation through the import channel with some delay.

Considering the abovementioned arguments, the NBG's Monetary Policy Committee decided to cut the monetary policy rate by 0.5 percentage points to 9.0% on 31 January 2024. The NBG acknowledges that, due to the aforementioned risks, pursuing a gradual reduction of the monetary policy rate is prudent. The

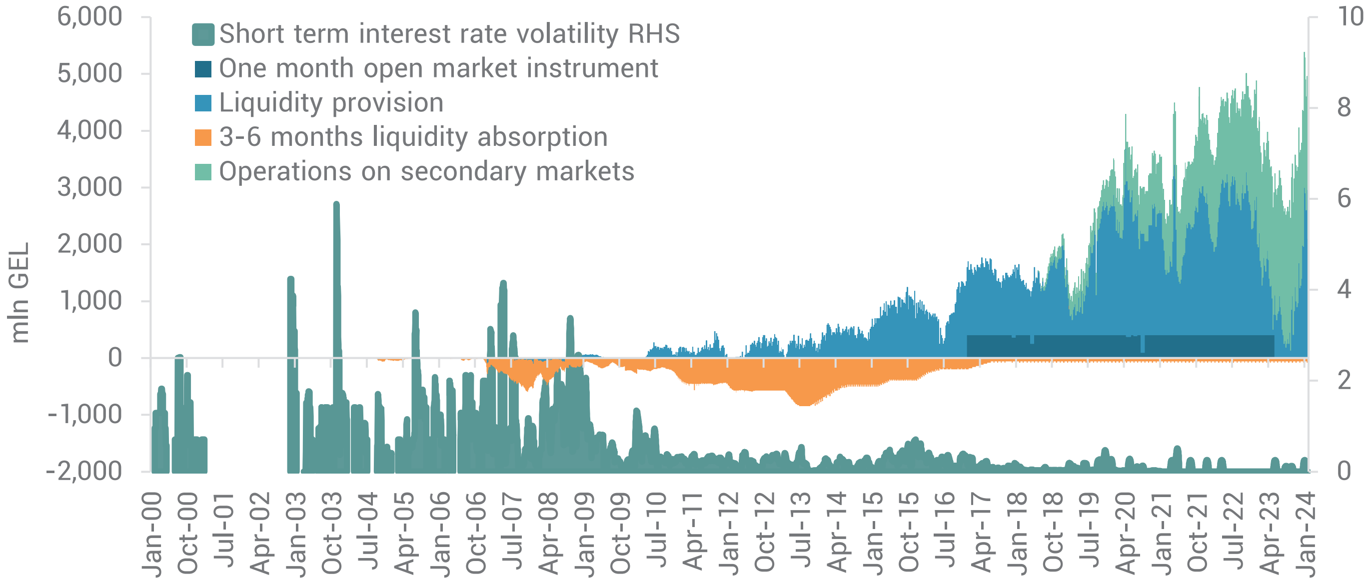

Figure 3.2. Liquidity instruments

Source: NBG

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

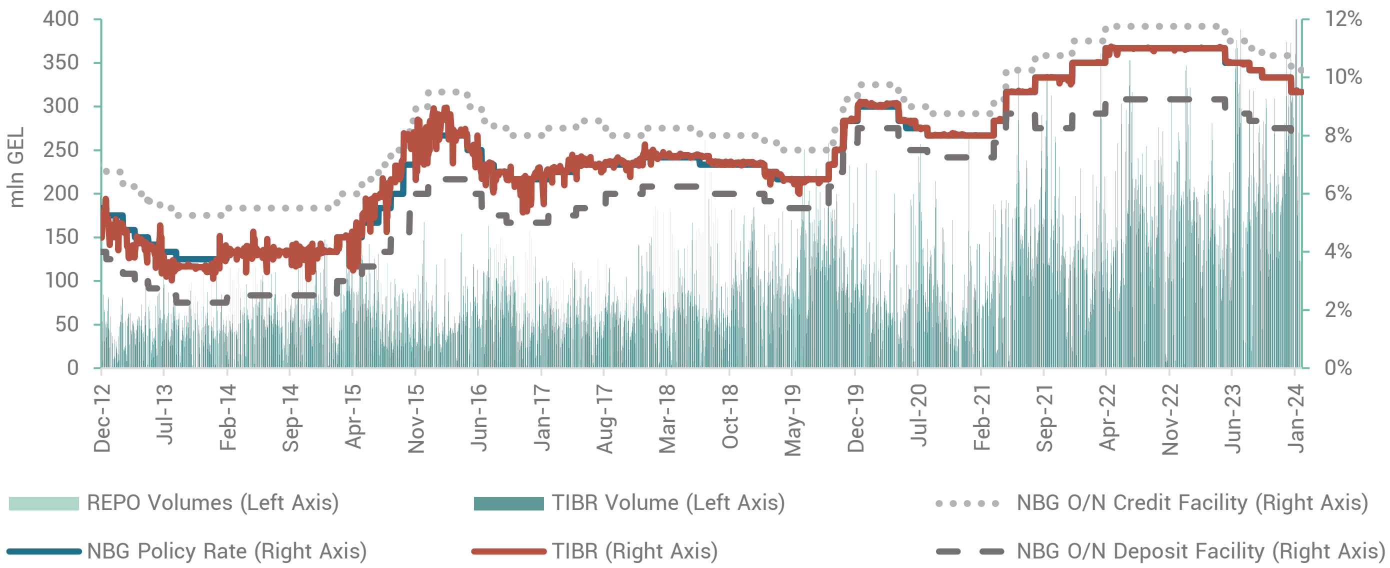

Figure 3.3. Interbank money market

Source: NBG

Monetary Policy Committee emphasizes the need for a cautious stance that entails maintaining a tight policy until acute risks and inflationary pressures sufficiently soften. If those factors negatively impacting inflation expectations persist, the NBG may consider implementing a tighter policy or maintaining the current stance for an extended period. Additional instruments may also be deployed as necessary to mitigate demand-side inflationary pressures.

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 of 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.

BOX 2. MONEY CREATION IN THE ECONOMY: THE CASE OF GEORGIA

Questions such as, “how is money created in the modern economy?”, “who participate in this process?” and “what is the central bank’s role in this?”, are often seen in the headlines. However, the answers that follow these questions commonly focus on only a single aspect of money creation, leading to potential misconceptions. Assuming a positive correlation between the growth rate of broad money (M2) and inflation is one such misconception. In a previous Monetary Policy Report, we addressed this issue using relevant data, revealing no clear positive correlation between a change in the quantity of money and inflation since 2010. This finding might make one wonder why we do not see an apparent correlation between these two variables when, surely, according to simple logic, it should be there? The answer here lies in distinguishing between the reasons for the increase in the quantity of money: whether it is an increase in money supply or an increase in the demand for money. To make such distinction, it is crucial to understand who contributes to the money supply and through what actions. In this box, we delve into this topic by describing the decomposition of changes in money supply based on the sources of such changes.

All sources of money creation/supply will ultimately be reflected in the balance sheets of depository corporations. Depository corporations are financial institutions that issue broad money liabilities. According to the international methodology, this sector is divided into two parts: the central bank, which releases M0 (cash outside of banks), and other depository corporations, which release deposits included in broad money (in the case of broad money, M2, we only consider GEL deposits, that is (M2 - M0)). Other depository corporations in the monetary space of Georgia are represented by commercial banks. Obviously, this decomposition of the money supply comes from the accounting identity, not cause-and-effect theory, but that is exactly the advantage of such approach: it always holds true.

Therefore, in order to see what components determine the change in the quantity of M2 money, we need to look into the “financial kingdom” of the banking system. In other words, we must look at the aggregated balance sheets of the central bank and other depository corporations. The goal is to reorganize the balance sheet items in such a way that M0 (in the case of the central bank) and M2 - M0 (in the case of the aggregated balance sheet of commercial banks) are left on one side and everything else is on the other. After making appropriate groupings/adjustments of the balance sheet items, which makes interpretation easier, we arrive at the following five main items as determining the supply of M2:

1. **Net foreign assets (with appropriate adjustments)** – this item is equal to the central bank's net foreign assets, excluding foreign currency liabilities to the central government and to other depository corporations (reserve requirements, as well as the amounts on commercial banks' foreign currency correspondent accounts). It reflects the sources (transactions) of the money supply that affect M2 and, at the same time, show up in adjusted net foreign assets. The central bank's intervention on the FX market represents one such transaction. For example, the purchase of foreign currency by the central bank increases M2, while its sale works the other way around. Furthermore, the same item reflects the government's foreign currency transactions, which ultimately affect the money supply. One such transaction could be the issuance of foreign currency debt which finances the purchase of goods or services from residents in the national currency or is used as a form social transfer. Conversely, paying off foreign debt with taxes collected by the government from residents in the national currency will reduce M2. Therefore, the main sources of money supply represented by this item are the central bank's foreign exchange interventions and the part of the government's budget deficit that is financed by foreign debt.

2. **Net claims on the central government in the national currency** – this item is equal to the difference between the claims and liabilities of depositary corporations (central bank and commercial banks) to and on the central government in the national currency. Government transactions in the national currency changing M2 are reflected here. For example, the central government debt in the national currency that is ultimately accumulated on residents' accounts is included here. Therefore, the main source of money supply represented by this item is the government budget deficit financed through national debt.

3. **Claims on other sectors in the national currency** – this item mostly includes national currency loans extended by commercial banks to the national economy. In terms of both its meaning, as well as statistically, this item is the main determinant of the money supply, and it is commercial banks that create the largest part of money in the economy.

4. **Shares and other equity** – this item includes transactions related to a change in capital. As an increase in the capital of depository corporations requires a decline in other liabilities on their balance sheets, such operations lead to a decline in the share of deposits (which is the main part of M2). On the contrary, a decrease in capital increases M2. Consequently, capital growth requirements in the banking sector reduce the growth of money supply.

5. **Other items** – all items present in the aggregated balance sheet of depository corporations and excluded from the above categories are grouped in this last category. These include net errors and omissions and other miscellaneous items left after forming the four main groups listed above. This item is not usually a quantitatively significant factor in the determination of money supply.

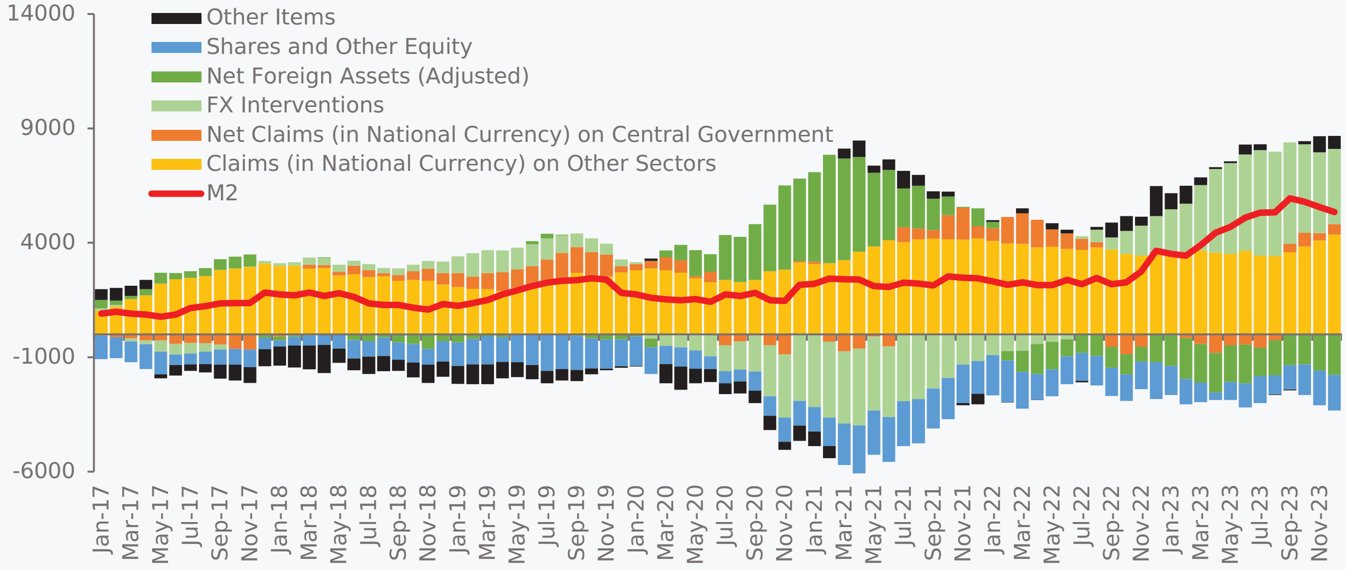

Figure 3.4 Decomposition of the Broad Money (M2), GEL Millions.

Source: NBG

Figure 3.4 depicts annual changes in the five items described above over the period January 2017 to December 2023. Summing up to an annual change in M2, these annual changes over each month explain the corresponding change in the quantity of money. In line with our expectations and the modern description of money creation (the so-called credit theory of money creation), loans to residents in the domestic economy in the national currency contributed the most to the annual change in M2 over the whole horizon. Shares and other equity was the next most significant component, which is also to be expected given the fact that changes in capital are directly reflected upon M2. While loan extensions were pumping M2, capital gains were deflating it.

As the results on the figure show, the years 2020-2023 stand out as particularly interesting for our analysis. To make the story more compelling, we have further extracted the central bank's net FX interventions (the difference between USD purchases and sales) from the net foreign assets (these are colored light green). Examining the chart, we can observe that throughout 2020 and the first half of 2021, the central bank's selling of dollars on the foreign exchange market had a significant negative impact on the change in money supply, restraining its growth. However, this was offset by the government's foreign currency operations, which largely financed the budget deficit, accelerating the growth of the money supply. In contrast, from the second half of 2021 onward, these effects acted in opposite directions. The central bank's foreign exchange interventions (net purchase of dollars) positively influenced the change in M2. Meanwhile, other operations affecting the change in adjusted net foreign assets had the opposite effect, slowing down the growth of the money supply.

By breaking down the growth of the quantity of money into its primary contributors (loans, budget deficit, and central bank interventions) we can gain insights into the sources of this growth, distinguishing between demand and supply factors. For example, while high credit growth and a substantial budget deficit are typically regarded as the supply of money, central bank interventions are, as a rule, a reflection of the demand for money. For instance, when confidence in Georgian lari deposits rises, leading to increased demand for the local currency, we observe a decrease in inflation and an appreciation of the lari exchange rate. The central bank's purchase of US dollars through foreign exchange interventions usually occurs during periods of exchange rate appreciation. As a result, foreign exchange interventions contribute to the growth of the quantity of money in times of elevated demand. These can easily lead to a coincidence between higher growth in the quantity of money, lower inflation and exchange rate appreciation, as is shown on the figure during 2023. Obviously, there could be instances when these things might coincide in the opposite direction. The final outcome of such situations is that a positive correlation between the growth rate of the quantity of money and inflation is no longer observed in the data.

1, Zviad Gamsakhurdia Embankment, Tbilisi 0114, Georgia
Tel.: (995 32) 240 6480; Fax: (995 32) 240 6571; Hot line: (995 32) 240 6406
E-mail: info@nbg.ge; www.nbg.ge

საქართველოს ეროვნული ბანკი
National Bank of Georgia