

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

ed 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 depository 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.

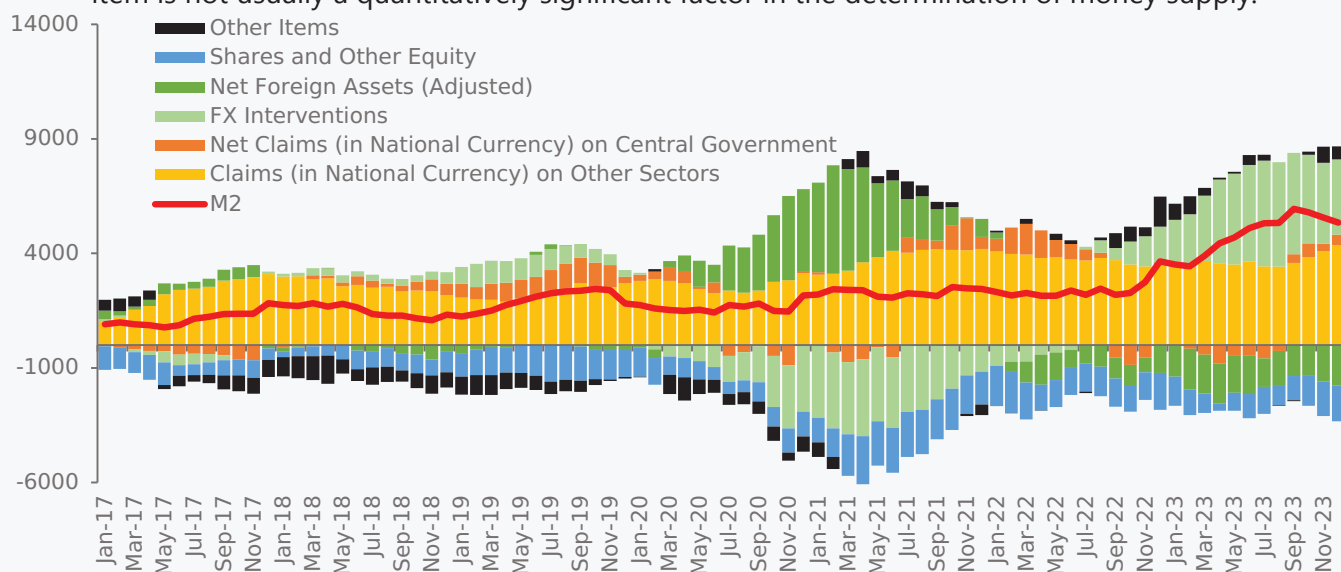


Figure 3.4 Decomposition of the Broad Money (M2), GEL Millions.

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.