

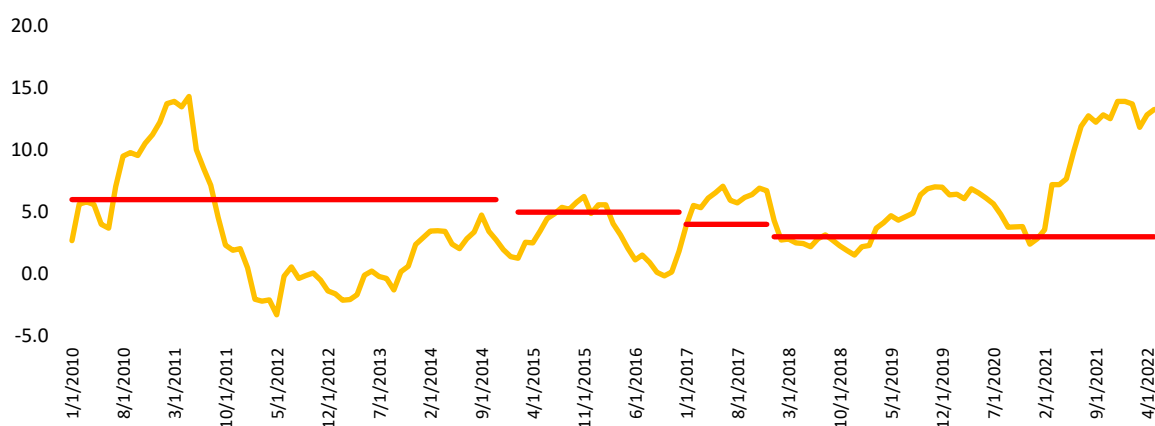
Will the De-dollarization Announced by the National Bank of Georgia Mitigate the Rise of Consumer Prices?

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In June 2022, the annual growth of the Consumer Prices Index (CPI) amounted to 12.8%. The Monetary Policy Committee (MPC) of the National Bank of Georgia (NBG) held its third meeting this year in the second week of May. After this session, the monetary policy rate remained unchanged at 11%.ⁱ Traditionally, the NBG blamed high inflation on external factors - the pandemic and its aftermath. Also, Russia's invasion of Ukraine. Thus, there is the 13th consecutive quarter that inflation is above the target rate (3.0%). At the end of 2021, Georgia was ranked 16th in the globe in terms of high inflation.

In the period mentioned above, the NBG explained high inflation by factors independent of its decisions. The Central Bank named the reason as the restriction of flights by Russia to Georgia in 2019. The NBG has been entirely linking double-digit inflation to the pandemic since 2020. Currently, a similar role has Russia's invasion of Ukraine. In fact, during this period, the NBG and the executive government were counterproductive. Instead of applying anti-inflationary policies and taking responsibility, the NBG tried to find a scapegoatⁱⁱ.

Figure 1: Annual change in the Consumer Price Index (%)



Source: National Statistics Office of Georgia; National Bank of Georgia

As we mentioned above, a significant part of the press release made by the MPC has traditionally been to explain high inflation by external shocks. However, there were exceptions. There are talks about the dynamics of foreign currency (FX) loans and the monetary policy tools available to the Central Bank to change the growth rate of loans. This statement seems like the announcement of new sharp steps. Such steps imply restricting access to FX loans.

The press release mentioned that „*despite monetary policy tightening though, credit activity remains strong, partly due to consumer loans on one hand and foreign currency loans on the other. In response, the NBG will keep the remuneration of reserve requirements on funds borrowed in the US dollar at 0.0%, even as the Fed Funds Rate increases. If necessary, to reduce the growth in FX loans,*

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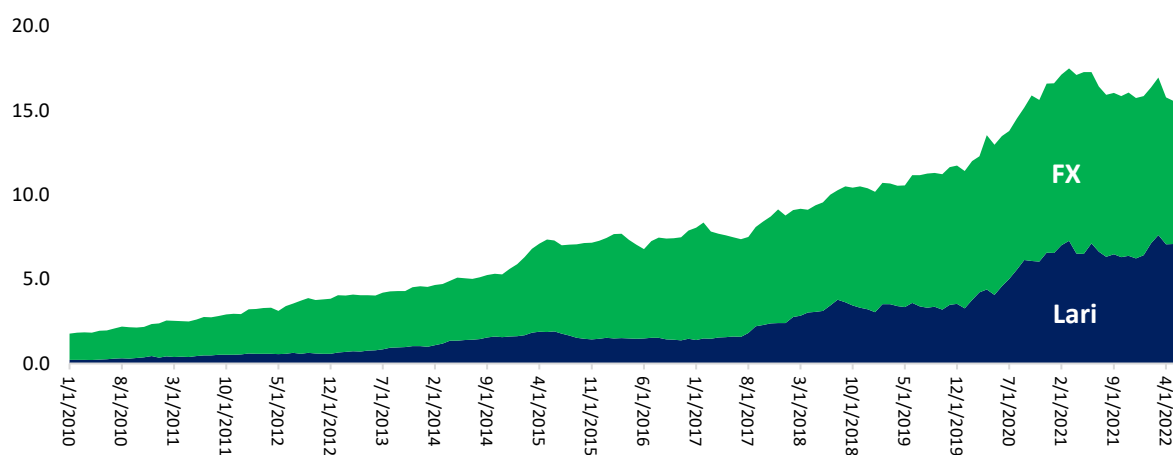
the NBG may also introduce additional measures, including an increase in the upper bound of FX reserve requirements (currently at 25.0%)". The MPC reiterated this on June 22: „if credit [FX] growth remains this high, the NBG will use additional instruments including FX reserve requirements and/or other macroprudential policy measure"ⁱⁱⁱ.

Talking about the dynamics of FX loans by the MPC is not only an exception but even strange in terms of inflation. The Central Bank has not tried to explain the link between FX loans and inflation. Such a relationship does not exist either, as inflation is called increased CPI expressed in the national currency. For example, issuing more loans in dollars by commercial banks does not increase the money supply. Ceteris Paribus, Conversely, the increase in FX loans strengthens the national currency nominal exchange rate. Therefore, the prices of separate imported goods and services will decrease. Thus, the relationship between the increased lending in FX and inflation by the NBG is unexplained and unsubstantiated.

The purpose of such a policy is to strengthen and expand the monetary power of the NBG. The mandate of the NBG and the monetary tools at its disposal ultimately control the money supply and its dynamics. The money supply is banknotes of Lari in people's pockets and deposits in commercial banks. The monetary policy affects the dynamics of the money supply. The result of which is a change in the overall level of prices. An increase in the overall level of prices is called inflation. Price level change is measured in the national currency. Under national law, "the Lari shall be the only legal tender on the territory of Georgia "and "only the NBG shall have the right to produce Lari banknotes and coins intended for circulation, collection and/or for other purposes and issue them on the territory of Georgia."

Thus, the magnitude of NBG's power depends on national and foreign currency distribution. The more FX loans and savings, the smaller the share of the Lari in an economy. In this circumstance, the NBG has less power and influence on an economy.

Figure 2: Time deposits, stocks (billion GEL)



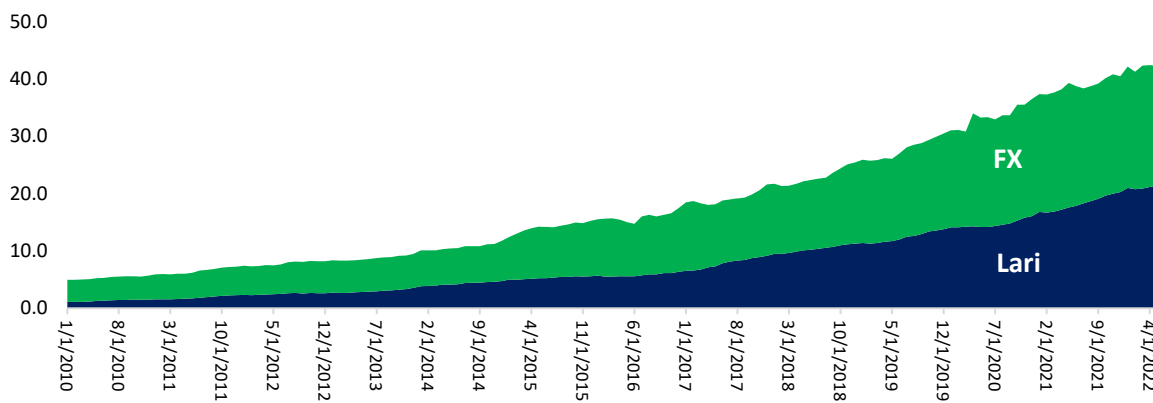
Source: National Bank of Georgia

Although the legal means of exchange is Lari, the dollar's allocation in savings and borrowing is high. According to the NBG, the percentage of FX in individuals' total deposits since the beginning of 2002 is, on average, 82%. The picture is similar according to the types. For example, the share of FX deposits in total time deposits averages 87.9%. For its part, the ratio of the US dollar in time deposits

in FX has averaged 84.3% since 2004. This data reflects that an individual's preference is FX (especially US dollars) to save money. The dollar is the dominant currency globally, but people use it more widely in post-Soviet countries. The reason is the experience of past and current monetary policies. For example, in the early stages of independence, Georgia experienced several years of hyperinflation (inflation amounted to 1 177% in 1992 and 1993 - 7 487%^{iv}).

Indeed, the growth rate of FX loans is upward, but this does not affect the overall level of the prices. The high dynamics of FX loans are related to the sharp increase in loans to firms. In the first quarter of this year, the growth rate of FX loans was 14.8%. During this period, the growth dynamics of FX loans to households reached 12.3%.

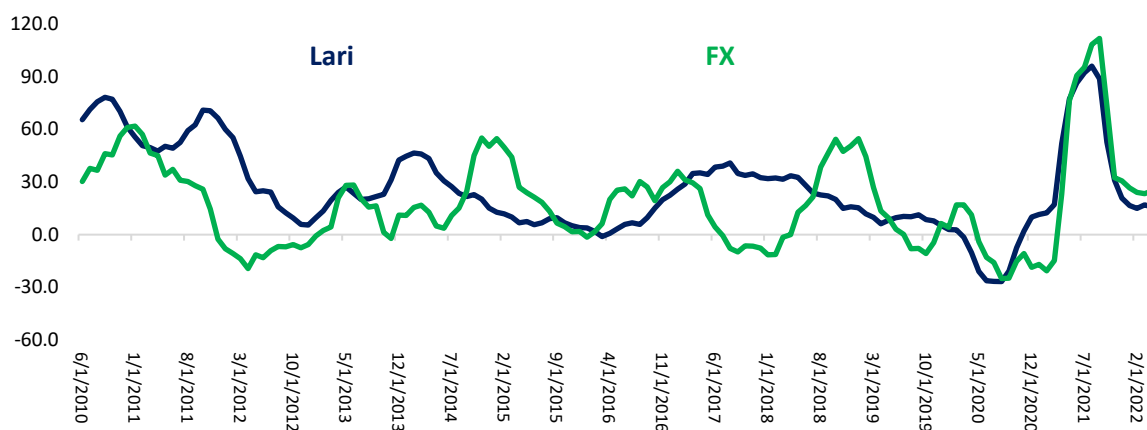
Figure 3: Loans, Granted by Commercial Banks, stocks (billion GEL)



Source: National Bank of Georgia

As for the loans in national currency - Lari, there were growing until the 3Q2021. However, in the 1Q2022, it decreased by 23.2%. Lending to firms in the national currency is declining, while the dynamics of lending to households are increasing. This tendency results from the active de-dollarization policy implemented by the Central Bank. The NBG’s paternalistic approach has limited access to FX loans for households. Beyond this measure, the tightened monetary policy during the last period. Ceteris Paribus, the tightening of the monetary policy by the Central Bank (respectively, the increase of interest rates Lari) increases the demand for FX loans. Increased FX loans are less accessible to households for a reason mentioned above. Thus, the growth dynamics of FX loans to firms are higher than loans to households.

Figure 4: The annual growth rate of loans granted by commercial banks to residents, 6-month moving average (%)



Source: National Bank of Georgia

The NBG's De-dollarization policy aims to reduce the share of FX (especially the US dollar) in the distribution of deposits and loans in the economy. Accordingly, the policy strives to increase the distribution of Lari. The NBG announced a similar policy in 2010, which entered the active phase in 2017^v. The first large-scale measure of the active policy can be considered the Larization program. This policy meant converting FX loans taken before 2015 into national currency. The government subsidized the necessary expenses for this. In addition, the Central bank implemented another sharp intervention from the demand side in 2019. This measure implies that loans up to 200 thousand Lari (small loans) shall be granted only in national currency^{vi}.

Within this policy, a more extensive measure was a drastic change in the FX policy by the NBG. since May 2016, the Central bank has tightened the Minimum Reserve Requirements (MRR) in FX. At the same time, the NBG has eased MMR in Lari. Since then, the MMR in FX has increased from 15.0% to 20.0%. In Lari, this norm has decreased from 10.0% to 7.0%. From the 2H2018, the MRR increased to 25.0% (30.0% between April and October 2019), while this norm in Lari decreased to 5.0%. Today, in FX, the MRRs are differentiated, depending on the bank's credit portfolio composition, in the range of 10.0%-25.0%^{vii}.

The new information publicly released by the NBG via MPC's press release is perceived as an announcement - further tightening the already increased MRR. Ceteris Paribus, this affects the decrease in the dynamics of loans because, at such times, commercial banks must reserve a larger share of the resources raised in FX. Accordingly, FX loans become more expensive. However, slowing down the growth rate of FX loans will not be a means of suppressing inflation. As we mentioned above, a general price level increase - inflation, is measured by the change in the prices expressed in Lari to the average consumer's basket.

Moreover, Ceteris Priebus, because of the measure of the Central Bank, the increased interest rates of FX loans will increase the lending in Lari. Increased lending in Lari would reflect the rising overall level of prices. Therefore, the real goal of the new policy is not to mitigate inflation pressure but to expand economic power and increase the scale of hidden taxation.

ⁱ May. Press Release of Monetary Policy Committee's monetary policy decisions. <https://bit.ly/3ODe67A>

ⁱⁱ Egnate Shamugia. Double-digit inflation and the National Bank in search of a scapegoat. <https://bit.ly/3QEINe1>

ⁱⁱⁱ June. Press Release of Monetary Policy Committee's monetary policy decisions. <https://bit.ly/3Ifvgpi>

^{iv} Giorgi Isakadze. 8 History of Hyperinflation. <https://bit.ly/3yefvM3>

^v Shalva Mkhattrishvili. De-dollarization: why? <https://bit.ly/3tR3Lg3>

^{vi} Larization Measures. <https://bit.ly/3ahX4Nw>

^{vii} Egnate Shamugia. Twenty-year history of the exchange rate of the Lari and the reasons for its depreciation. <https://bit.ly/3OvcU5l>