Assessment of the National Bank's Effectiveness Over the Past Twenty Years

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Consumer prices are rapidly rising in Georgia. It has already been 14 months with double-digit inflation (measured by yearly changes in the consumer price index) and inflation remains above target (3.0%)[a] for 42 consecutive months (14 quarters [b]). This is the first time since 1999 that consumer prices continue double-digit growth for that long. However, looking at monthly data, inflation was highest in July 2006 and May 2011 with 14.5% and 14.3%, respectively (see Graph 1).

Inflation is a general increase in the prices of goods and services in an economy. It is often called a hidden tax which is levied on most people in favour of a smaller group. However, as opposed to government-mandated taxes, there are no pre-determined subjects and objects of taxation when it comes to inflation. As a result, inflation causes an arbitrary redistribution of incomes (Romer and Romer, 1998; Dolmas et al., 2000; Bagchi et al., 2019; Mumtaz and Theophilopoulou, 2020), when an unknown majority subsidizes a known minority. Moreover, such redistribution goes against the government's main social activity. In particular, the government usually taxes the richer population to aid the poorer individuals whereas in case of inflation it is the poorer majority that is getting taxed so the most affluent people of the society can get richer.

Inflation is a bigger burden for a relatively less well-off population because the incomes of people in this group – social transfers or wages – are largely fixed (Kahn, 1997; Campbell and Kamlani, 1997; Smith, 2000) and grow more sluggishly compared to prices. Therefore, when a price level increases in the economy, these people become worse off. For instance, as of 2020, there are 958.3 thousand recipients of social transfers in Georgia and social transfer accounts for 21.8% of the gross money incomes of a statistically average domestic household. Wages, in turn, constitute 44.4% of money incomes on average. Therefore, unsurprisingly, polling results show that inflation has been consistently named one of the biggest problems for the Georgian population. For instance, according to the opinion poll conducted in mid-December 2021, 42% of the population believes that inflation is the country's biggest problem (CRRC, 2021).

National Bank of Georgia (NBG), given its constitutional mandate to ensure price stability, is responsible for these concerns of the population. To this aim, the NBG is equipped with monetary power which implies a money emission and having a monopoly on that. Monopoly on money and money supply is a massive power which affects society at large.

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Price stability, viewed from the lenses of the NBG, means keeping the target inflation figure in the medium term. The NBG highlights that it "keeps price stability through ensuring low and predictable inflation". Therefore, NBG performs its primary function properly only when the general price growth rate in the economy is low and predictable. **Low inflation** means the consumer price index changes in the medium term without exceeding the target level (3.0% since 2018). However, as mentioned earlier, it has been 42 consecutive months when annual growth in consumer prices exceeds the target (see Graph 1), which goes beyond several medium-term periods through any lenses, including those of the NBG's (NBG considers a quarter as a medium-term period, see Tvalodze et al. 2016). At the same time, **predictability** refers to an inflation dynamic that implies minimal deviation from the targeted level and low volatility in the medium term. A predictable environment can only be achieved when the NBG's policy is widely regarded as reliable.

Policy transparency is critical for credibility. As claimed by the officials of the NBG, the bank's credibility depends on the latter's effectiveness. In particular, the credibility of the NBG hinges on the deviation of current inflation from the previous period and target (Tvalodze et al., 2016). Authors argue that the bank's credibility will collapse if inflation deviates from a target level for an extended time.

In this respect, it has been a year since the consumer price growth rate has been on average four times higher as compared to the target level for each month (see Graph 4). In turn, high and volatile inflation contributes to uncertainty which is a further burden on people's day-by-day decisions. This environment is unwelcoming for investments because returns become increasingly less predictable (Dixon, 2022). In addition, high and volatile inflation negatively affects economic growth – a claim which is both theoretically and empirically supported (Judson and Orphanides, 1999; Grier et al. 2004; Apergis, 2005; Wilson, 2006; Barro, 2013; Mandeya and Ho, 2021).

Given the circumstances mentioned above, inflation and its volatility would be a relevant indicator to measure how effectively the NBG carries out its constitutional authority to ensure price stability. In this regard, like in many post-communist countries, the first years of Georgia's independence were marred with hyperinflation (Kaser, 1999). In the first decade since gaining independence, there has been run-away inflation, sometimes exceeding several thousand per cent. The growth of the consumer price index remained at a high level in the following years as well. For example, one year after the introduction of the GEL, the average annual inflation exceeded 50.0%.

For the last 20 years, the average annual inflation in Georgia is 5.6% (standard deviation - 4.1). In the same period, the average inflation in Armenia is 4.0% (see Graph 2). Armenia is comparable to Georgia given similarities in historical experience, scale, and structure of the economy. Although Armenia's inflation is lower as compared to Georgia's in the long-term period, it is similarly characterized by sharp

volatility. It is possible to say that the only exception was 2016-2020 when average annual inflation in Armenia and Georgia were 1.0% and 4.2%, respectively (see Graph 3).

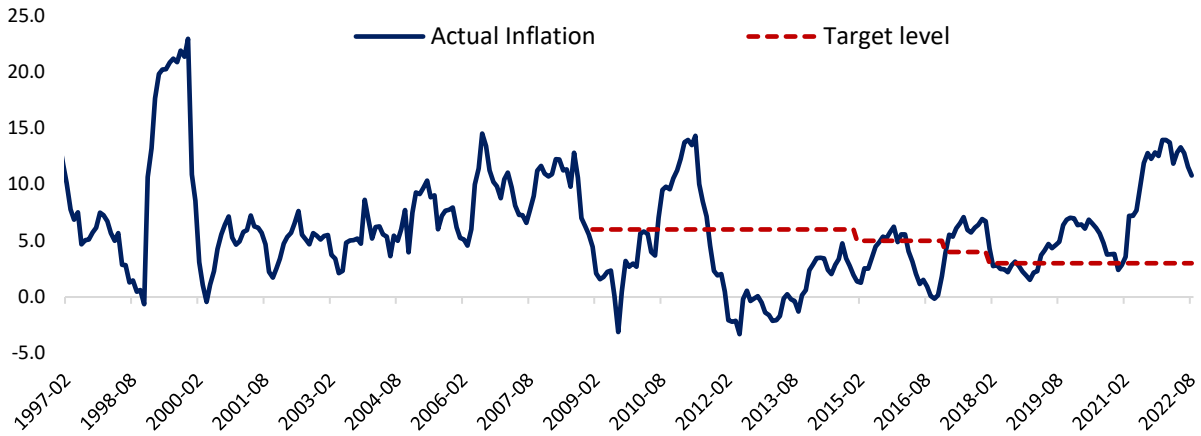
At the same time, inflation should also be compared against the target level. Georgia has been pursuing inflation targeting since 2009. From that period, actual inflation largely deviates from the target and deviation is characterized by strong fluctuation (see Graph 4). For instance, in a one-month period, inflation deviated by 88.5% on average as compared to the target level with 85.7% deviation in a medium-term period and 71.1% over the course of one year. Recently, the average deviation rate of the inflation from the target increased further whereas the situation did also worsen. In the first half since the introduction of inflation targeting, the deviation of annual inflation from a target level in a one-year period was 64.0% on average which increased to 78.2% in the second half. Armenia's performance in this regard is relatively better. From 2009 until today, annual inflation in Armenia deviated by 58.9% on average from its target level. As opposed to Georgia, inflation in Armenia was more often below the target (see Graph 5).

The state of the developed economies has been fundamentally different over the course of 20 years as they are characterized by low inflation. For the last 20 years, annual inflation in the USA and UK is on average 2.4% and 2.2%, respectively. Inflation in the Eurozone is much lower at 1.8% (see Graph 2 and Graph 6). Of note is that in these economies, target inflation is 2.0% whereas deviation from that figure is less frequent and shorter in duration as compared to Georgia. A comparison of Georgia's inflation dynamic to those of the above-mentioned countries is a perfect illustration of how high and prone to volatility Georgia's inflation is (see Graph 6).

Consequently, the NBG does not meet any of the two criteria mentioned above, which are used to assess the effectiveness of the bank's policy and how properly it performs its functions. Inflation is high in Georgia and, in most cases, deviates from its target (more often, actual inflation exceeds the target). At the same time, inflation displays intense volatility, effectively hindering a predictable environment. Eventually, this failure of the NBG resulted in a slower economic growth rate. Further, it impoverishes the already poor population, which makes up not only economic but social and moral problems.

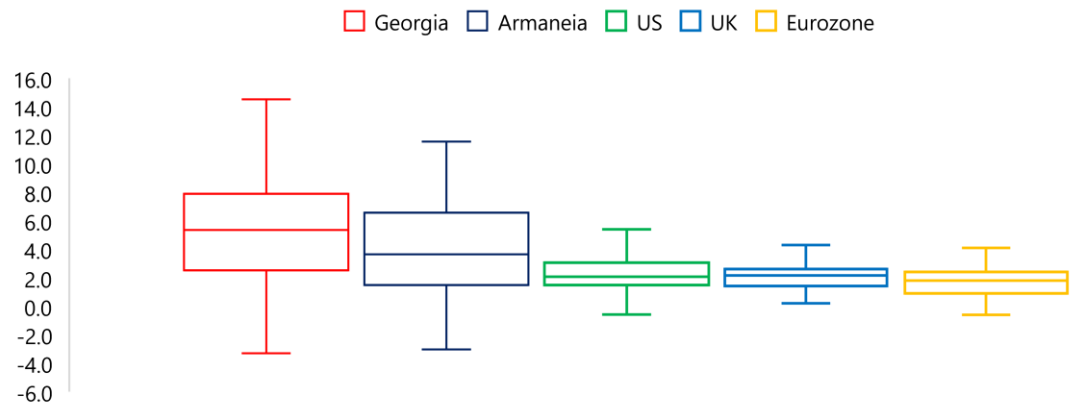
Graphs:

Graph 1: Georgia's annual inflation and target level (%)



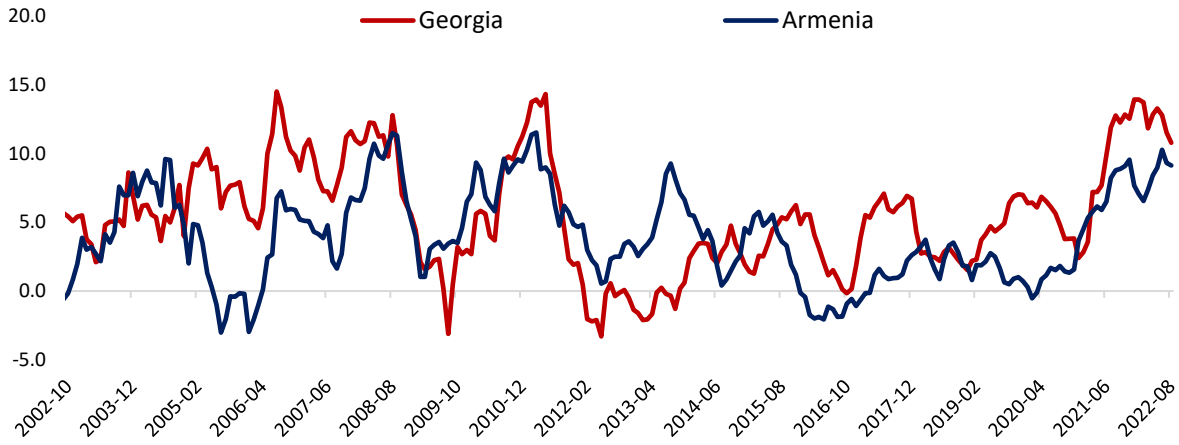
Source: National Bank of Georgia

Graph 2: Annual inflation, boxplot: 09.2002 – 08.2022 (%)



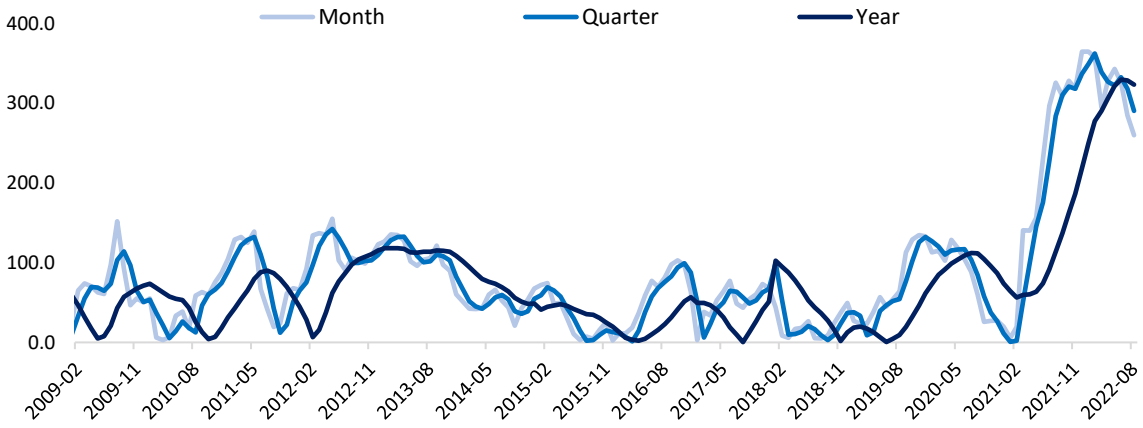
Source: Central banks; Author's calculations

Graph 3: Annual inflation of Georgia and Armenia (%)



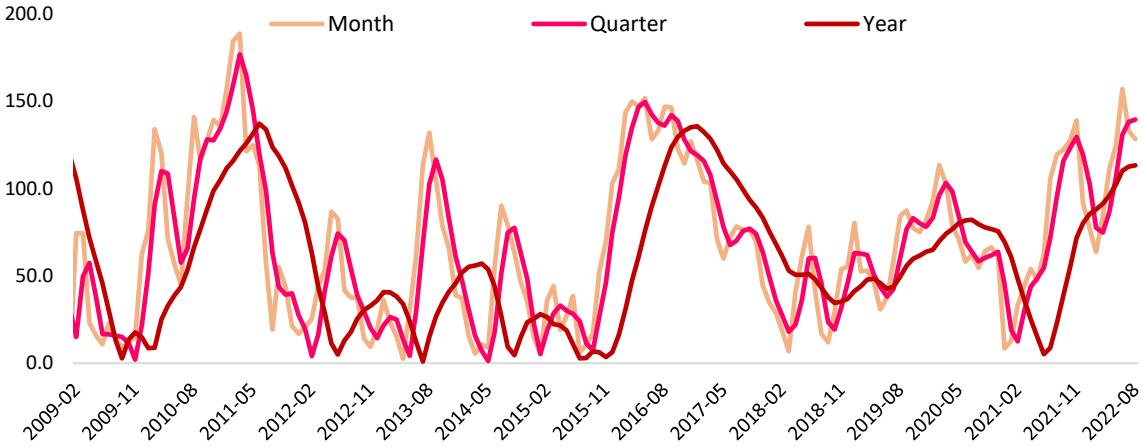
Source: Central banks

Graph 4: Georgia's annual inflation deviation from the target level (%)



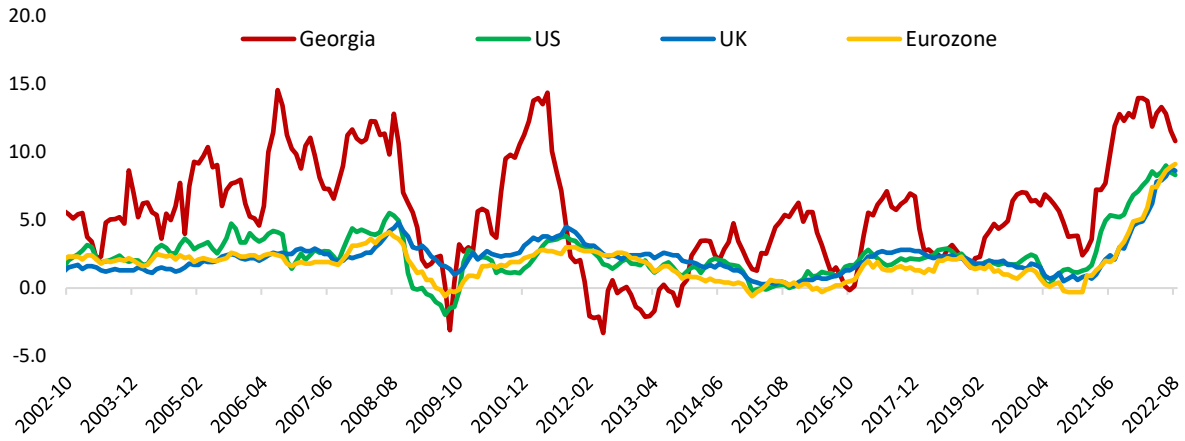
Source: National Bank of Georgia

Graph 5: Armenia’s annual inflation deviation from the target level (%)



Source: Central Bank of Armenia

Graph 6: Annual inflation (%)



Source: Central banks

Notes:

a. Since 2018, the inflation target has been 3.0% which is a task of the National Bank's monetary policy. The aim of the NBG's policy is to maintain inflation at this level. The target figure is determined by the National Bank which is approved and politically endorsed by the Parliament of Georgia.

b. Annual growth of consumer prices, as reported by the National Statistics Office of Georgia (GeoStat), was lower than 3.0% by the end of 2020 and at the beginning of 2021. However, this was attributable to methodological elements. During that period the Government of Georgia subsidized utility bills and their price changes were not considered by the GeoStat when measuring price level changes. Telara Gelantia. Effect of "Utility Subsidies" – Is Annual Inflation 2.4% or 4.34%? https://bm.ge/ka/article/komunalurebis-subsidirebis-efeqti-wliuri-inflacia-24-ia-tu-434/72782/

c. Based on data from the National Statistics Office of Georgia. Egnate Shamugia, Social Burden of Price Growth https://bm.ge/ka/article/fasebis-zrdis-socialuri-tvirti/101092

d. The document of the National Bank, which reads: "[National Bank] keeps price stability by ensuring low and predictable inflation growth rate" most likely contains a mechanical error, because inflation is itself growth. Therefore, the correct version should be: "low and predictable inflation". National Bank. https://bit.ly/3R2ypvP

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