Monetary Policy Report

October

2024

საქართველოს ეროვნული ბანკი
National Bank of Georgia

Inflation

0.6%	Inflation remains below the target of 3%.

Economic Growth

According to the updated forecast, the Georgian economy is anticipated to grow by 8.5% in 2024, largely due to an increase of its potential.	8.5%

Monetary Policy

8.0%	Amid continued high uncertainty, the normalization of the monetary policy rate is expected to proceed at a gradual pace.

MONETARY POLICY DECISION

The National Bank of Georgia has decided to keep the monetary policy rate unchanged at 8.0%.

The role of the National Bank of Georgia (NBG) is to influence aggregate demand and inflation expectations through adjustments to interest rates, aiming to keep inflation close to the target of 3% over the medium term. Low and stable inflation supports employment and sustainable economic growth, a goal that takes on even greater importance in the current uncertain environment.

Since the beginning of 2023, inflation in Georgia has remained below the targeted 3%. In September this year, the overall price level increased by 0.6% year on year. The maintenance of inflation within the target range has primarily been ensured by the monetary policy implemented by the NBG, which has included both a timely tightening and a gradual normalization of the policy rate and has been reflected in the stability of long-term inflation expectations. Additionally, increased competition in the economy has contributed to lower profit margins for firms, aiding the maintenance of low inflation. Furthermore, the reduction in electricity tariffs from early 2024 is expected to support low inflation. According to the updated forecast of the National Bank of Georgia, other things being equal, low inflation is projected to persist in 2024, averaging at around 1.2%, with its stabilization around the target rate expected to take place over the medium term.

Despite these positive trends, inflationary risks remain. Recently, there has been increased volatility in oil and food prices on international markets. Moreover, uncertainty remains high due to the ongoing hostilities in Ukraine and the elevated geopolitical tensions in the Middle East. Furthermore, current developments in the Red Sea region pose risks of rising shipping costs. Beyond external factors, domestic economic activity has been stronger than anticipated, leading to an upward revision of the economic growth forecast to 8.5%. However, the overall productive capacity of the economy has also increased, somewhat alleviating demand-side pressures at this stage.

Since May 2023, the National Bank of Georgia has steadily reduced the monetary policy rate by a total of 3.0 pp to 8%. Nevertheless, risks stemming from uncertainties associated with both global and local developments remain. In light of inflationary risks, the NBG has recently decided to maintain the monetary policy rate at 8.0%. This rate will be gradually normalized at a slow pace.

Interest rate changes by the NBG are transmitted to the economy gradually, taking approximately 4-6 quarters to be fully reflected. If factors driving inflation expectations upward re-emerge, a further tightening of monetary policy or maintaining the current tight stance for a longer period may become necessary.

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

CONTENTS

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BRIEF OVERVIEW

Despite robust economic activity, inflation in Georgia remains below the target level. This development has been driven by a confluence of factors. Improvements in employment and productivity across certain sectors have led to increased production capacities, effectively mitigating the inflationary pressures generated by strong demand. In addition, the reduction of inflationary pressure can be attributed to companies maintaining lower profit margins, a trend that is reinforced by heightened competition and stable inflation expectations, and supported by sound monetary policy. Furthermore, Georgia's economy has not experienced significant negative supply-side shocks in recent periods, which might have otherwise precipitated sharp price adjustments. However, despite these developments, it is important to acknowledge that uncertainty has increased, both globally and regionally, due to various economic and geopolitical factors, particularly in Georgia's trading partner countries and on international markets. This heightened uncertainty, alongside higher-than-expected current economic activity, presents a clear risk for inflation in the medium term. As a result, to ensure that inflation remains close to the target, the National Bank of Georgia (NBG) will proceed with a gradual normalization of its monetary policy stance.

In the short term, inflation will remain at a low level. Subsequently, and partly due to the base effect, it will temporarily exceed the 3% target before ultimately stabilizing around it in the medium term.

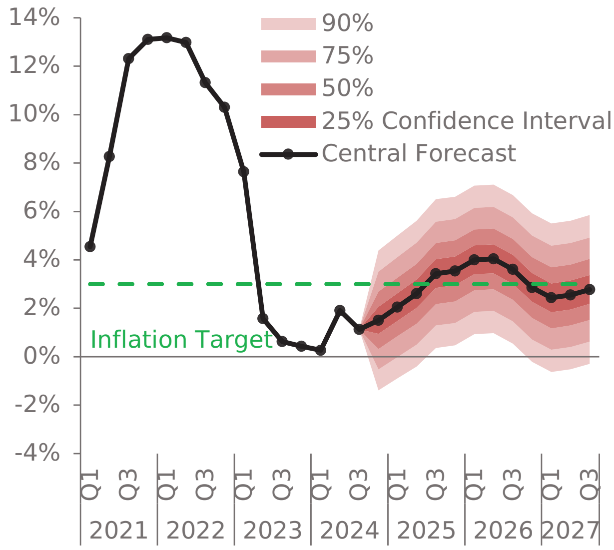

Figure 1. Headline CPI inflation forecast.

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

In the third quarter of 2024, consumer prices increased by an average of 1.1% year on year, continuing the pattern of below-target inflation seen over the past year and a half. This trend is a result of the normalization of supply-side factors, ongoing structural changes to the economy, and adequate monetary policy responses. It is expected that in the short term, inflation will remain at a low level and will then gradually approach the target rate of 3%. Subsequently, partly due to the base effect, it will temporarily exceed this level before ultimately stabilizing around the target in the medium term (see Figure 1). **According to the NBG's baseline forecast, average inflation will be 1.2% in 2024 and 2.9% in 2025**.

The projected inflation dynamics will continue to be influenced downward by the effects of reduced profit margins, driven by increased competition, as well as by the decline in commodity prices on an annual basis. This will be further reinforced by the normalization of demand, which is a consequence of the monetary policy measures enacted by the NBG. On the other hand, upward pressures on inflation have been significantly impacted by the depreciation of the effective exchange rate since the beginning of the year. In light of strong credit expansion, economic activity has exceeded expectations, leading **the NBG to revise its real GDP growth forecast for 2024 upwards to 8.5%** (see Figure 2). With low inflation and rising real household incomes, consumption is expected to be the primary driver of economic growth, while investment and net exports are anticipated to make relatively modest contributions. Nevertheless, the economy's potential is also expanding rapidly, primarily due to increases in the labor force and rising labor produc-

Amid robust credit expansion, economic activity has surpassed initial expectations, prompting the NBG to revise its real GDP growth forecast for 2024 upwards to 8.5%.

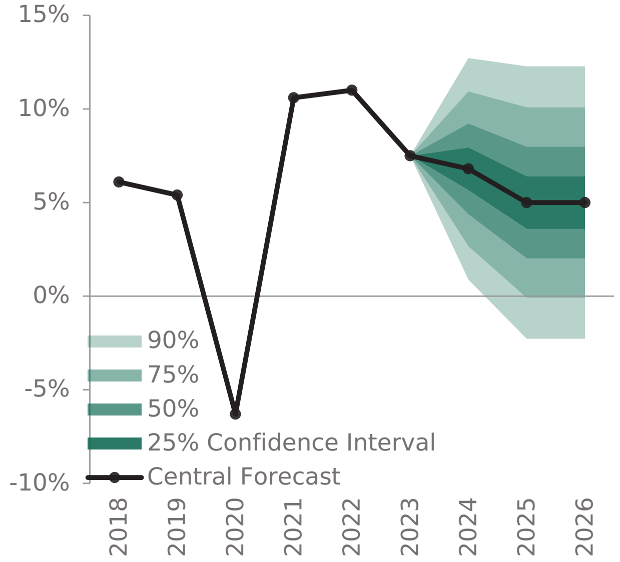

Figure 2. Annual growth forecast of real GDP.

Source: NBG, GeoStat.

At the current stage, maintaining a gradual approach to monetary policy normalization is deemed optimal. This strategy not only facilitates the full neutralization of demand-side pressures but also serves as a measured response to heightened inflationary risks.

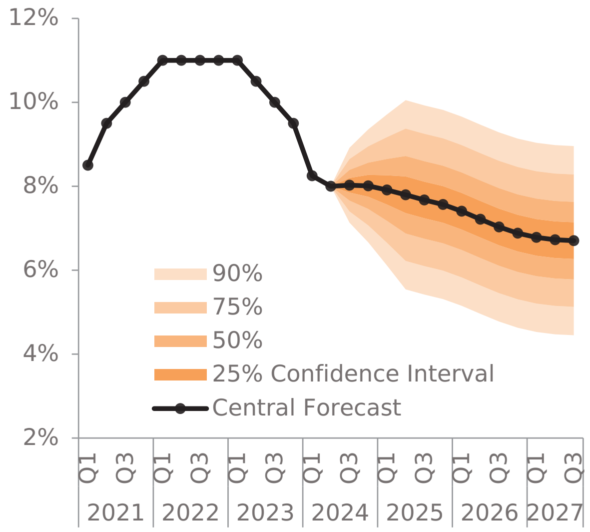

Figure 3. Monetary policy rate forecast.

Source: NBG.

tivity in certain sectors. Over time, these dynamics are expected to converge toward the long-term growth rate of potential output, and by 2025-2026 economic growth is projected to align with this level and stabilize at around 5%.

Nevertheless, the currently elevated level of economic growth presents inflationary risks, which are compounded by various supply-side factors and heightened uncertainty at the domestic, regional and global levels. In light of these considerations, during its meeting on 23 October, the Monetary Policy Committee of the NBG assessed that **it remains prudent to maintain a gradual pace of monetary policy normalization. This approach not only facilitates the full mitigation of demand-side pressures but also addresses the growing inflationary risks.** Following a period of the policy rate being maintained at its current level, a gradual adjustment towards the neutral rate of 7% is anticipated.

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 heightened geopolitical tensions and persistently elevated global interest rates, the global economy is expected to continue its recovery at a moderate pace in 2024, with similar improvements in growth rates projected for 2025. Concurrently, inflationary pressures are subsiding on a global scale, affecting both advanced and emerging markets. In the case of Georgia, the economy has sustained rapid growth in the third quarter. The primary driver of this growth has been stronger-than-anticipated domestic demand. Furthermore, external demand remained robust over the same period, contributing to increased revenues from goods exports, while revenues from services exports also remained elevated. These factors facilitated an improvement in the current account balance. Consequently, according to the revised macroeconomic forecast, the current account deficit as a percentage of GDP is projected to range between 4.5% and 5.0% in 2024. Meanwhile, global inflation continues to remain subdued, reflecting the relative stability of commodity prices on international markets and a decline in domestic inflation.

1.1 OVERVIEW OF THE GLOBAL ECONOMY

1.1.1 OVERVIEW OF TRADE PARTNER ECONOMIES

Amid the Russia-Ukraine war and ongoing conflicts in the Middle East, the global economy is anticipated to experience subdued growth rates in 2024. The complex geopolitical landscape has led to disruptions in supply chains while simultaneously heightening uncertainty. Furthermore, although inflation levels are gradually declining, interest rates remain persistently high. It is important to highlight that the cyclical factors that were prevalent at the beginning of the year are dissipating in many countries, thereby aligning economic activity more closely with potential output. According to the October assessment by the International Monetary Fund (IMF), **global economic growth** in both 2024 and 2025 is projected to be 3.2%.[1] In addition, inflation is expected to decrease relative to the previous year, with forecasts indicating rates of 5.8% in 2024 and 4.3% in 2025. For emerging and developing economies, the forecast for real growth is estimated at 4.2% for both 2024 and 2025. These economies are projected to experience inflation rates of 7.9% in 2024 and 5.9% in 2025.[2]

In 2024, amid heightened global uncertainty, economic activity is expected to grow at a slow pace.

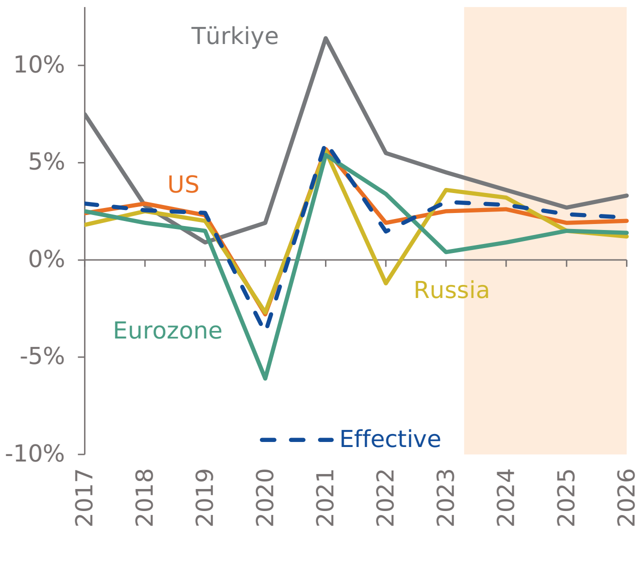

Figure 1.1.1. Real GDP growth of economic partners.

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

In the third quarter of 2024, amid a still-tight financial environment, inflationary pressures declined at a slow pace in both developed and emerging markets. This trend was facilitated by a decrease in oil and food prices on international commodity markets. However, recently, amid the escalating tensions in the Middle East, uncertainty surrounding oil prices has increased

1 *International Monetary Fund. 2024. The World Economic Outlook: Policy Pivot, Rising Threats. Washington, D.C., October.*

2 *Ibid.*

(see section 1.1.2 of this report).

In the third quarter of 2024, economic activity continued to improve at a moderate pace in **the United States**. On the one hand, retail sales and consumer spending remained at elevated levels, and activity in the service sector was also high. On the other hand, conditions in the labor market slightly deteriorated, with employment growth being weaker than expected. Against this backdrop, the Federal Reserve began to lower the federal funds rate. The annual inflation rate in September was 2.4%. According to estimates by the IMF, real GDP growth in the United States is projected to be 2.8% in 2024, with a further slowdown to 2.2% anticipated for 2025. Meanwhile, inflation is expected to moderate to 3% in 2024 and 1.9% in 2025.[3]

Amid still-elevated interest rates, inflation has exhibited a declining trend across the majority of Georgia's trading partner countries, including the US and those within the eurozone.

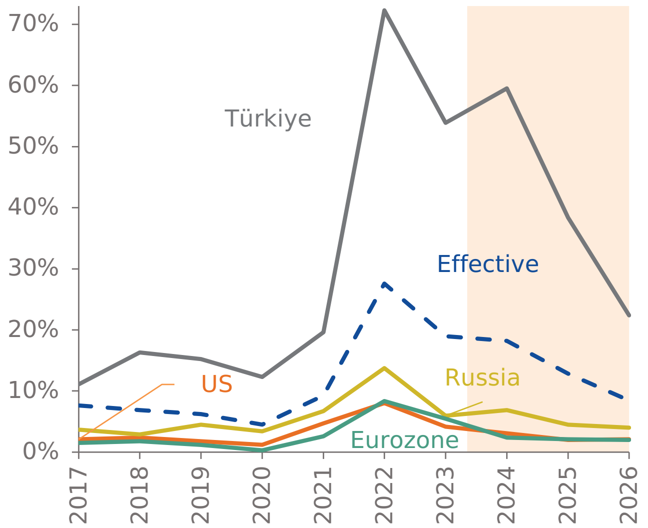

Figure 1.1.2. Headline Inflation rates of economic partners.

Source: IMF, NBG's calculations.

In the third quarter of 2024, the pace of economic activity in the **eurozone** showed slight improvement. This can largely be attributed to increased consumer expenditures, particularly in the service sector, with high levels of activity observed in tourism during the summer months. However, activity in the manufacturing sector remained low. In September, the annual inflation rate decreased to 1.8%. According to IMF projections, economic growth for the eurozone is forecast to be 0.8% in 2024 and 1.2% in 2025. Inflation is anticipated to average 2.4% in 2024 and 2% in 2025.[4] It is important to highlight that European countries continue to enforce economic sanctions against Russia, which exerts additional pressure on their economies.

In the third quarter of 2024, economic activity in **Türkiye** was low. Consumer and business sentiment deteriorated, and the manufacturing index also declined. Both investment and export volumes were subdued. Low economic activity is expected to persist this year amid the implementation of tightened monetary policy. The inflation rate stood at 49.38% in September. According to the IMF, Türkiye's real GDP growth is projected to be 3% in 2024 and 2.7% in 2025, with inflation expected to be 60.9% in 2024 and 33% in 2025.[5]

In the third quarter of 2024, low economic activity persisted in **Russia**, which was characterized by a decline in retail sales and a deterioration in the output of the service sector. The fiscal deficit remains high. However, there has been an improvement in the manufacturing sector, with strong domestic demand observed. It is important to note that the business environment, investment levels, and the foreign sector continue to suffer from ongoing Western sanctions. The inflation rate has also increased, with the annual inflation level reaching 8.6% in September. According to IMF projections, Russia's real GDP growth is expected to be 3.6% in 2024 and 1.3% in 2025, while inflation is forecast to be 7.9% in 2024 and 5.9% in 2025.[6]

3 *Ibid.*
4 *Ibid.*
5 *Ibid.*
6 *Ibid.*

The ongoing war waged by Russia in **Ukraine** has had a profound social and economic impact, leading to the destruction of numerous critical infrastructure facilities and consequently diminishing the country's economic potential. The IMF projects that Ukraine's real GDP growth will be 3% in 2024 and 2.5% in 2025. Additionally, the average inflation rate is anticipated to be 5.8% in 2024 and 9% in 2025.[7]

In the third quarter of 2024, economic activity in **Armenia** was high. This is primarily attributed to robust activity in the construction and retail sectors. However, increased geopolitical uncertainty has negatively impacted external demand. The annual inflation rate in September was 0.6%. According to the IMF, Armenia's real economic growth is projected to be 6% in 2024 and 4.9% in 2025, with inflation anticipated to reach 0.2% in 2024 and 3.1% in 2025.[8]

In the third quarter of 2024, alongside a decline in inflationary pressures, the central banks of several trading partner countries began to lower their monetary policy rates.

In the third quarter of 2024, growth rates improved in **Azerbaijan**. This improvement was driven by increased activity in the oil and gas sectors, as well as sustained high activity in the non-oil sector. Retail sales and consumer expenditures have also shown improvement. Meanwhile, the annual inflation rate in September was 3.5%. According to the IMF, Azerbaijan's economic growth is projected to be 3.2% in 2024 and 2.5% in 2025, with inflation anticipated to reach 2.1% in 2024 and 4.8% in 2025.[9]

In the third quarter of 2024, the **central banks** of some of Georgia's trading partners reduced their monetary policy rates in parallel with a decrease in inflationary pressures. Specifically, the Federal Reserve lowered the federal funds rate to the range of 4.75% to 5%. Meanwhile, the European Central Bank reduced its deposit facility rate to 3.5%. The Central Bank of the Republic of Türkiye maintained its monetary policy rate at 50%. In contrast, the Central Bank of the Russian Federation raised its monetary policy rate to 19%.

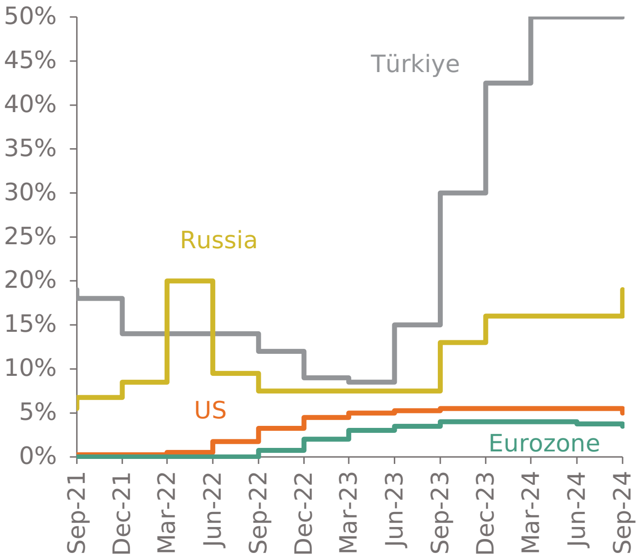

Figure 1.1.3. Monetary policy rates in Georgia's trading partners.

Source: www.global-rates.com, ECB, NBG calculations.

7 Ibid.
8 Ibid.
9 Ibid.

1.1.2 OVERVIEW OF INTERNATIONAL MARKETS

International commodity markets continue to face challenges. Against the backdrop of geopolitical tensions, disruptions in supply chains are still evident. In addition, uncertainty surrounding global economic prospects and unstable climatic conditions continues, ultimately creating high levels of uncertainty in international commodity markets. Ongoing tensions in the Middle East, trade disputes, fears of a recession, and unfavorable climatic conditions could all potentially affect the prices of raw materials.

The UN's Food and Agriculture Organization's International Food Price Index (FFPI) increased by 2.7% in the third quarter of 2024, as compared to the second quarter. The rise in the index in September was attributed to price increases across all commodity groups included in the index. The FFPI was 2.1% higher compared with the corresponding period of the previous year, but 22.4% lower than the peak reached in March 2022 (see Figure 1.1.4).

The food price index has increased in September 2024, which is 2.1% higher than the corresponding month of the previous year.

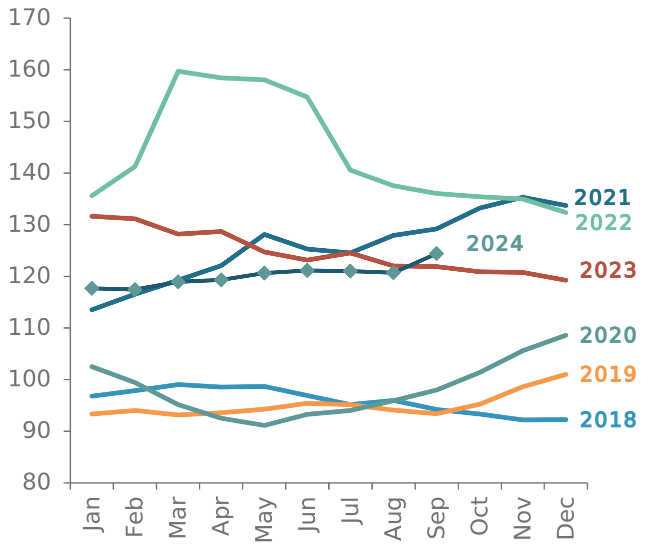

Figure 1.1.4. International food price index.

Source: FAO.

The sugar price index in September was 10.4% higher than in August, but 22.7% lower than in September 2023. Deteriorating crop conditions in Brazil, which resulted from prolonged periods of dry weather and fires that affected sugarcane fields in late August, was the primary reason behind the rise in global sugar prices. Crop yields are also expected to remain subdued in the upcoming season due to the damage caused by the fires. Moreover, concerns that India's sugar exports might be impacted by the Indian government's decision to lift restrictions on using sugarcane for ethanol production also played a role in the overall rise in global sugar prices.

The vegetable oil price index increased by 4.6% in September compared to August, reaching its highest level since January 2023. The ongoing increase in this index was driven by higher prices for palm, soy, sunflower, and rapeseed oils. Additionally, the price increase in sunflower oil was supported by a forecast of a tightening of supply, related to predictions of reduced output of the corresponding oilseeds in the upcoming season.

In September, the cereal price index was 3.0% up from August, but remained 10.2% below the level of September 2023. After three consecutive months of decline, global wheat prices increased in September, primarily due to unfavorable weather conditions in some major exporting countries. Excessively wet conditions in Canada and the EU caused harvest delays and, subsequently, led to a sizable reduction in production forecasts. However, the competitively priced supplies from the Black Sea region somewhat limited the price increase.

In the third quarter of 2024, oil prices significantly decreased, reaching their lowest level since Novem-

In the third quarter of 2024, the average price of oil decreased. However, due to ongoing global events, uncertainty around oil prices remains high.

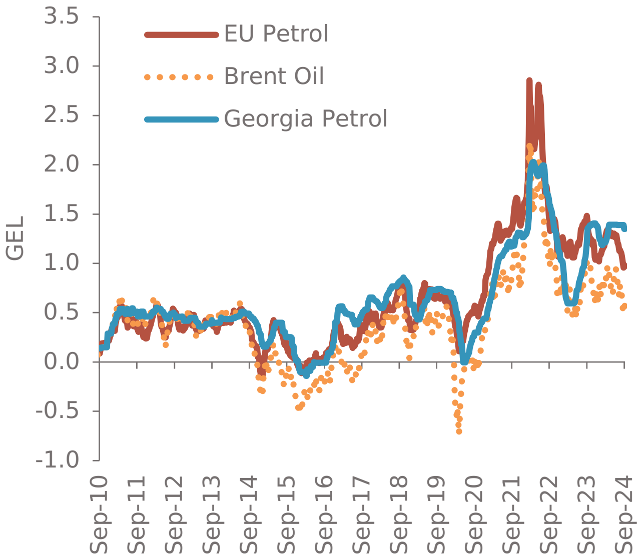

Figure 1.1.5. Petrol price index (Jan 2021=100).

Source: EU Commission, Statista, NBG calculations.

In September 2024, international transportation costs decreased, primarily due to sluggish economic growth.

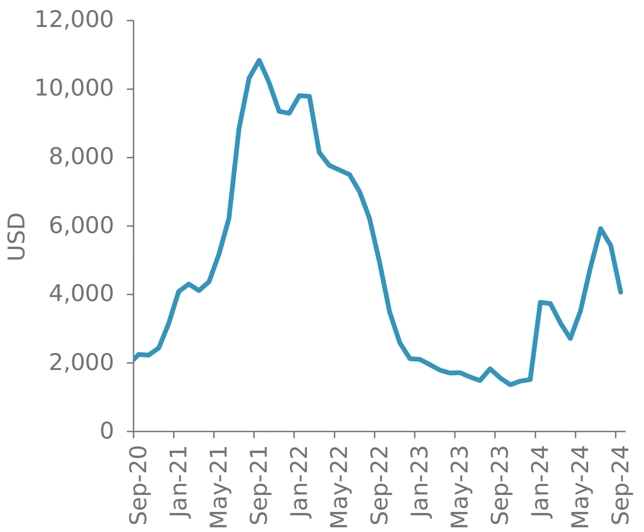

Figure 1.1.6. Average shipping cost of a 40-foot container worldwide.

Source: Drewry World Container Index (WCI).

ber 2022. This sharp decline was due to several factors, including expectations of an end to production disruptions in Libya, weakness in the Chinese economy, low demand in the US, and Russia's dumping strategy. Additionally, OPEC+ members decided to extend their voluntary production cuts of 2.2 million barrels per day until December 2024. These will be gradually lifted over a period ranging from 1 December 2024 to September 2025.

The average oil price decreased by 5.5% in the third quarter of 2024, compared to the second quarter. In September, the average price of a barrel of Brent oil fell by 7.9% compared to the previous month to reach USD 74. Fluctuations in oil prices are reflected on European as well as Georgian gasoline prices (see Figure 1.1.5). Unlike the European market, where fuel prices dropped by an average of 7.0% in September, compared to the previous month, Georgia recorded only a 0.6% decrease. If oil prices further increase against the backdrop of the acute ongoing geopolitical situation, these will be transferred to the Georgian market.

According to the September 2024 updated forecast from the International Energy Association, the price of Brent oil is expected to reach around USD 83 per barrel in the fourth quarter of 2024. Despite the low Brent oil prices in September, the association anticipates that there will be active utilization of inventories, as driven by OPEC+'s decision to postpone production increases until December.

Along with international commodity prices, transportation costs also influence overall inflation through imported goods channels. By the end of the third quarter of 2024, global transportation prices had decreased by 25.0% compared to August (see Figure 1.1.6). This decline is partly due to slowing global economic activity in major economies such as China, Europe, and the US, which has been reflected in cautious approaches by importers, leading to reduced demand for container shipping. These factors have also contributed to a decrease in global transportation costs.

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

BOX 1. GLOBAL ECONOMIC RISKS AND SPILLOVER TO GEORGIA

The global economy is currently navigating a landscape marked by significant uncertainty and risks. The latest IMF World Economic Outlook report projects global growth of 3.2% in 2024 and 3.2% in 2025; however, the underlying economic uncertainties remain substantial. Developments in key economies such as the United States, the EU, and China could lead to weaker-than-expected growth. Moreover, given rising geopolitical tensions, there is significant uncertainty surrounding supply chains and price dynamics in international markets. Since the United States, the EU, and China accounted for nearly half of global GDP as of 2023, the challenges these economies face may have considerable direct and indirect effects on the global economy and, consequently, on Georgia.

Table 1.1, below, illustrates a taxonomy of risks from the global economy and their impact on Georgia:

Potential Risks	Major Channels of Impact	Potential Impact on the Global Economy	Potential Impact on Georgia
Rising Escalation in the Middle East	Commodity Prices	A disruption in oil supply could put upward pressure on global oil prices, elevating inflationary risks.	Increased oil prices could put upward pressure on imported inflation in Georgia. Meanwhile, Georgia's oil-exporting trading partners could receive higher revenues, thereby positively influencing external demand.
Prolonged Weakness in the Chinese Economy	Trade Linkages	Decline in Chinese demand for imports from its key trading partners (e.g., the EU and the US), could lead to a reduction in global export demand.	Decreased demand for metals and ferroalloys, key exports from Georgia to China, could affect Georgia's GDP and current account deficit.
	Commodity Prices	A decrease in demand from China could lower global oil prices, affecting oil exporters globally.	Lower oil prices will translate into diminished imported inflation in Georgia. However, lower oil prices could reduce revenues for oil-exporting countries, including Georgia's trading partners, thereby impacting Georgia's external demand.
	Financial Linkages	Corrections in global equity markets and the potential impact on US Treasury markets if confidence declines. Additionally, there would be an initial global appreciation of the US dollar due to risk averse behavior.	Rising borrowing costs and potentially reduced access to international credit for Georgian financial institutions due to an increasing sovereign risk premium.
	Global Sentiment	Possible recessionary pressures and a deterioration of sentiment in the global economy if China faces prolonged stagnation.	A potential decrease in external demand for Georgia could weigh on aggregate demand.
Subdued growth in the EU	Trade Linkages	A decline in the EU's demand for imports from its trading partners (e.g., the US and China), potentially leading to a reduction in global demand for exports, resulting in a domino effect.	With the EU being a key trading partner, Georgia would likely experience weaker external demand.
	Commodity Prices	Prolonged periods of subdued growth in the EU could exert downward pressure on commodity prices due to diminished consumption.	A fall in imported commodity prices (all else being equal).

Table 1.1. Taxonomy of the most pronounced global risks from current perspectives

Source: NBG

One major factor contributing to these uncertainties, which is intertwined with other risks and further exacerbates them, is the potential slowdown of the Chinese economy. While a full recession in China is unlikely, the prospect of an economic deceleration poses a significant threat to global economic growth. As the world's second-largest economy, China plays a crucial role in global supply chains and commodity markets. China contributes 18% of global GDP and accounts for 15% of global oil consumption, underscoring its considerable influence on commodity prices and the broader global economy. Recently, China's economy has faced considerable strain due to structural challenges in the property market, sluggish consumer confidence, and the need to balance growth with managing financial risks. Although the recent monetary policy measures initiated by the People's Bank of China have restored some stability in Chinese equity markets, underlying vulnerabilities persist as the current measures are part of a broader effort to stabilize the markets rather than provide a long-term solution. Therefore, a weaker Chinese economy could reduce demand for goods and commodities, leading to potential disruptions in global trade and elevated uncertainties.

China's manufacturing sector is a key consumer of commodities. Therefore, if we consider a scenario under which the Chinese economy continues to weaken, reduced demand on these goods will put downward pressure on global commodity prices. This, in turn, could have a disinflationary impact on Georgia through a decline in imported inflation.

It should also be noted that uncertainty around oil prices is increasing due to rising geopolitical tensions, including the escalation of the Iran-Israel conflict. Such developments could disrupt supply chains and drive oil prices higher, ultimately increasing imported inflation in Georgia and exerting upward pressure on overall inflation.

A potential slowdown in China could also impact the Georgian economy through trade linkages. China's role in Georgian trade has been increasing, with Georgia exporting 5% of its foreign-bound total goods to China in 2023. Notably, mineral products, particularly metals and ferroalloys, make up 77% of these exports, with 33% of Georgia's total mineral products sent to China, a significant part of them being imported. Thus, a decline in Chinese manufacturing demand could somewhat reduce demand for Georgian goods and services.

Although Georgia's direct trade exposure to China is relatively low, indirect trade linkages could magnify the effects of economic disruptions. A slowdown in China would likely reduce demand for imports from major economies like the US and the EU. Additionally, as has been noted, a Chinese economic downturn could lead to lower oil prices, further squeezing the revenues of oil-exporting countries and exacerbating the global slowdown of growth. This could trigger a domino effect, weakening global trade, particularly in the EU, where 8.8% of exports are destined for China. Consequently, reduced global economic growth would likely dampen external demand for Georgian goods and services, posing further challenges to Georgia's economic growth. Weaker external demand for both goods and services could also worsen the current account balance, potentially leading to exchange rate depreciation, and partially offsetting the decline in imported inflation.

Financial contagion from China also poses significant risks. Given its roles as a significant holder of US Treasury securities and a key global investor, any crisis in China's financial sector is likely to impact international markets. Should liquidity issues arise at Chinese banks, particularly state-owned ones, these could disrupt credit flows and potentially weaken investor confidence, increasing the likelihood of substantial corrections in equity markets.

These concerns are further compounded by broader economic vulnerabilities, such as the ongoing stagnation in Europe, recent fluctuations in equity markets, and uncertainties related to US fiscal policy. A shock from China could exacerbate these existing weaknesses, likely triggering a ripple effect across global markets that may affect both developed and emerging economies.

Last but not least, Georgia has benefited from structural changes to its economy, with exports of services (especially in international transportation) generating substantial revenues due to the promotion of Georgia's strategic role in the Middle Corridor, a key trade route connecting China to Europe. Therefore, a weakening of the Chinese economy and a reduction in the transit of Chinese goods through Georgia could undermine Georgia's position in this vital trade network, ultimately negatively impacting economic growth.

In the third quarter, demand for goods intended for re-export recovered, which induced a high growth of real exports as well.

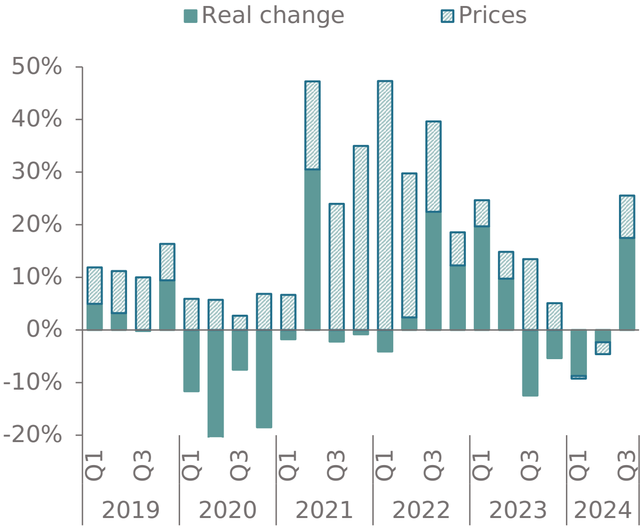

Figure 1.2.1. Annual change in registered exports of goods

Source: GeoStat

The high growth of exports of goods mainly stemmed from re-exports of motor cars and a rise in exports of ferro-alloys; meanwhile, exports of other goods rose moderately.

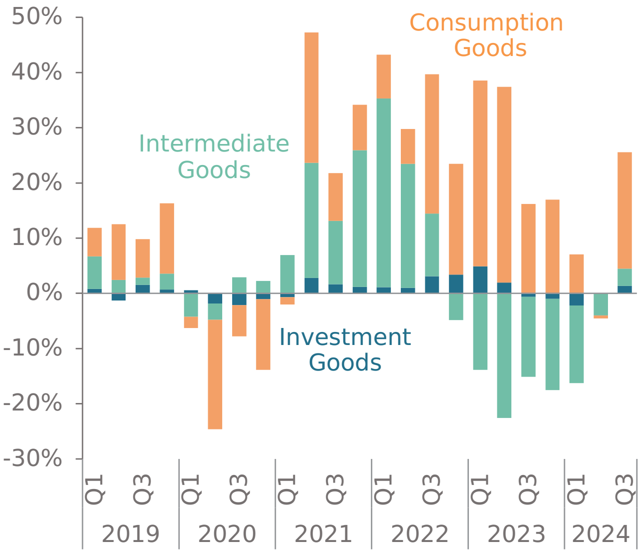

Figure 1.2.2. Annual change in registered exports of goods by category

Source: GeoStat

1.2 EXTERNAL DEMAND AND BALANCE OF PAYMENTS

In the third quarter of 2024, external demand was strong. Foreign currency inflows from several channels continued to grow, which supported the improvement of the current account balance. External demand on motor cars recovered, which induced higher growth of revenues from exports of goods. In addition, revenues from domestic exports, mostly from higher sales of ferro-alloys and precious metals, were also high. Apart from this, considering lower purchases of several goods intended for re-export (cars, tractors and copper ores), expenses on import goods decelerated. Moreover, due to structural changes in the economy, exports of services generated substantial revenues. Namely, the promotion of Georgia's role as a Middle Corridor country has intensified international transportation. Exports of information and computer services, despite seeing an annual decrease, also generated substantial revenues. Meanwhile, rising revenues from international travel have supported an improvement of the current account deficit. Therefore, in general terms, there were signs of positive external developments. However, in light of higher economic activity, imports of goods are likely to rise and the current account deficit is thus expected to hover around 4.5-5.0% of GDP. It is worth mentioning that, considering Georgia's economic circumstances (as a small open market economy), a fluctuation of the current account deficit to GDP at around 5% is considered a sustainable level.

In the third quarter, external demand on goods intended for re-export recovered, which made overall exports of goods rise substantially. Exports of motor cars, motor vehicles for the transport of goods, and construction machineries to regional countries were all at a high level. Moreover, demand for ferro-alloys has risen again. In contrast, alongside a slowdown of construction activities in China, re-exports of copper ores and concentrates from Georgia were substantially low. Overall, in the third quarter, exports of goods grew in both nominal and real terms, rising by 25.6% and 17.5% respectively (see Figure 1.2.1).

The rise in exports of goods was predominantly driven by higher exports of consumer goods (motor cars, alcoholic beverages and mineral waters). The increased volume of ferro-alloys, semi-manufactured gold and precious metals sales positively impacted the growth in intermediate goods exports (see Figure 1.2.2).

The summer saw quite an active tourism season. In the third quarter, the number of international visitors increased annually to almost reach pre-pandemic levels (see Figure 1.2.3). Since the beginning of the year, the slowdown of migration has been balanced by rising numbers of incoming travelers from other coun-

In the third quarter of 2024, the number of international visitors increased again in annual terms.

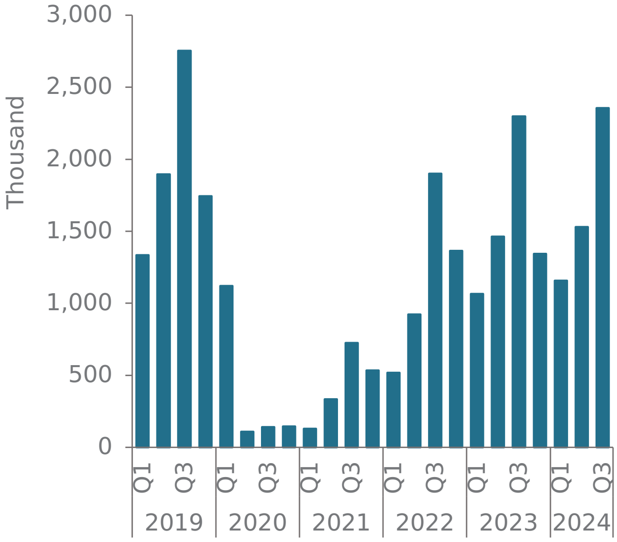

Figure 1.2.3. The number of international visitors

Source: Georgian National Tourism Agency

In the third quarter of 2024, instant money transfers declined moderately. Specifically, the effect of decline of transfers from Russia have gradually faded.

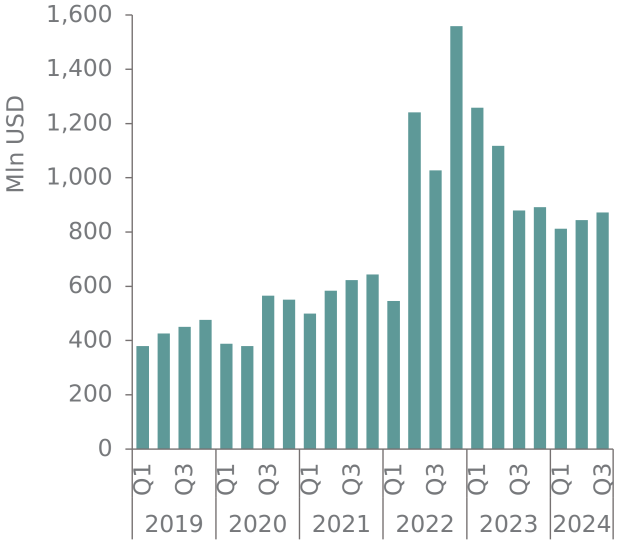

Figure 1.2.4. Instant money transfers.

Source: NBG.

tries, specifically those from Israel, Saudi Arabia and Iran. It is also worth mentioning that positive structural changes in terms of international travel have been observed. The diversification of the market and rise of international visitors have induced the opening of new touristic sites, which increases the potential of the tourism sector.

In line with the rising number of visitors, according to preliminary data, revenues from international travel have risen. It is worth mentioning that the gradual fading of the migration effect has been outweighed by revenues coming from visitors from other countries. Besides regional countries, revenues from travelers from Iran, Israel and Saudi Arabia each made an increased positive contribution to the overall growth of revenues from travelers.

In the third quarter of 2024, instant money transfers to Georgia declined by 0.9% annually and amounted to USD 872 million (see Figure 1.2.4). As expected, migrant inflows and associated money transfers have declined in annual terms. In addition, money transfers from Russia have declined gradually and have reached a stable level during the last period. In contrast, money transfers from the US have increased substantially, as have transfers from Israel and the EU.

Against the background of higher economic activity, demand for imports of goods has risen (excluding those goods imported for re-export). However, considering the drastic fall in purchases of motor cars intended for re-export, while overall imports of goods increased slightly in nominal terms, rising by 3.6% annually, in real terms these saw an annual decline of 3.3% (see Figure 1.2.5).

In the third quarter of 2024, imports of investments goods made the largest positive contribution to the overall change of imports (see Figure 1.2.6). At the same time, purchases of motor cars declined substantially, while imports of other types of consumer goods rose once again. Meanwhile, the decline of intermediate goods imports was mainly driven by falling purchases of copper ores and concentrates intended for re-export.

In light of the positive external environment, the current account balance has improved annually, amounting to 7.4% of quarterly GDP in the second quarter of the year. Revenues from exports of services made the main contribution to the improvement of the balance. Not only were revenues from international travel substantially high, but so too were revenues from the services sector resulting from structural changes to the economy. At the same time, compensation of employees from abroad, despite seeing a moderate annual decline, remained quite high. Apart from this, other types of transfers in the private sector increased by almost 1.5 times annually. According to the updated macroeconomic forecast, in light of higher external

In the third quarter, total imports of goods grew at a low rate as a result of a decline in imports of motor cars.

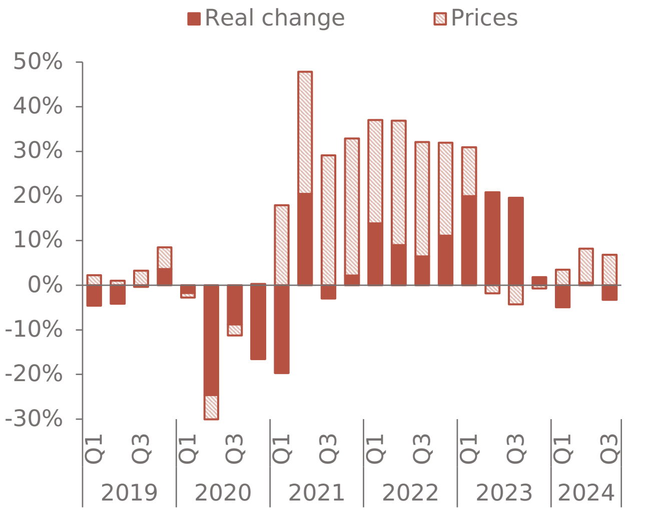

Figure 1.2.5. Annual change in registered imports of goods

Source: GeoStat

In the third quarter of 2024, the slow growth of imports of goods was predominantly driven by lower imports of intermediate goods (copper ores) and consumer goods (mostly motor cars).

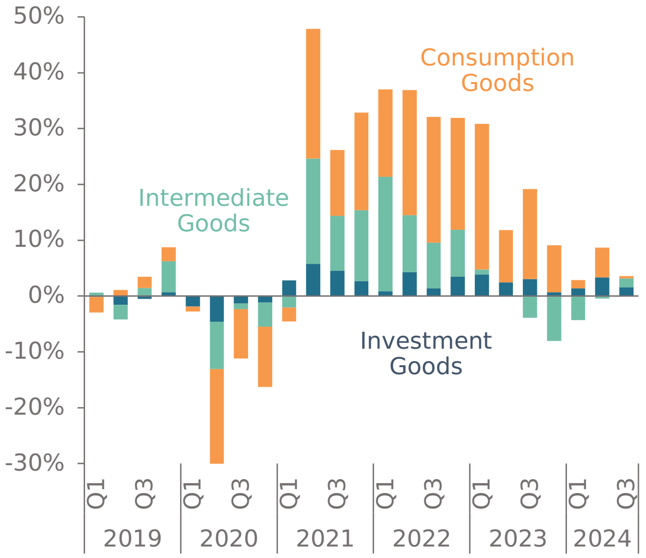

Figure 1.2.6. Annual change in registered imports of goods

Source: GeoStat

inflows and a slight improvement in the trade deficit, the current account deficit is expected to hover around 4.5-5.0% of GDP.

In the second quarter of 2024, the main source of financing the current account deficit was foreign direct investment (FDI) inflows. Inward FDI increased by 10.3% annually and amounted to USD 574 million (7.1% of quarterly GDP). The main rise in FDI stemmed from higher investments in terms of equity and debt instruments. It is also worth mentioning that a major part of FDI went to the finance and manufacturing sectors.

From the perspective of savings and investments, in the second quarter of 2024, as compared to the same period of the previous year, the moderate improvement of the current account balance was mainly due to a slowdown of investments, rather than a decline in savings (see Figure 1.2.8).

In light of high economic growth and a substantial rise in external inflows, the current account deficit is expected to normalize moderately, at around 4.5-5.0% of GDP.

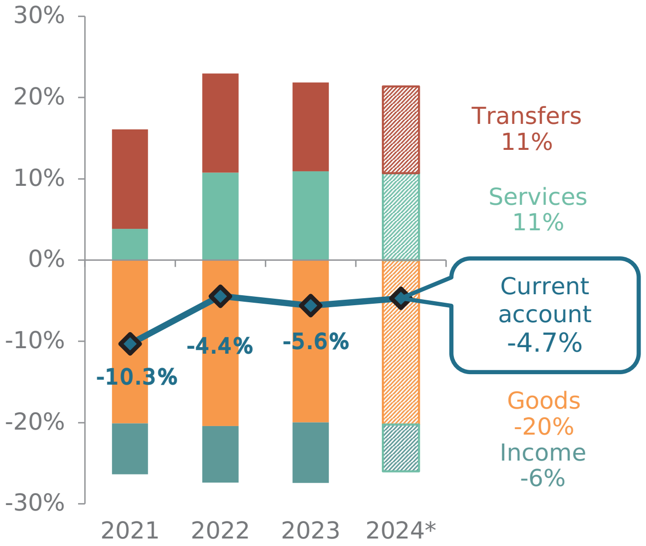

Figure 1.2.7. Current account balance and its components as a % of GDP

Source: NBG

In the second quarter of 2024, the slight improvement of the current account was mainly due to the slowdown of investments, rather than a decline in savings.

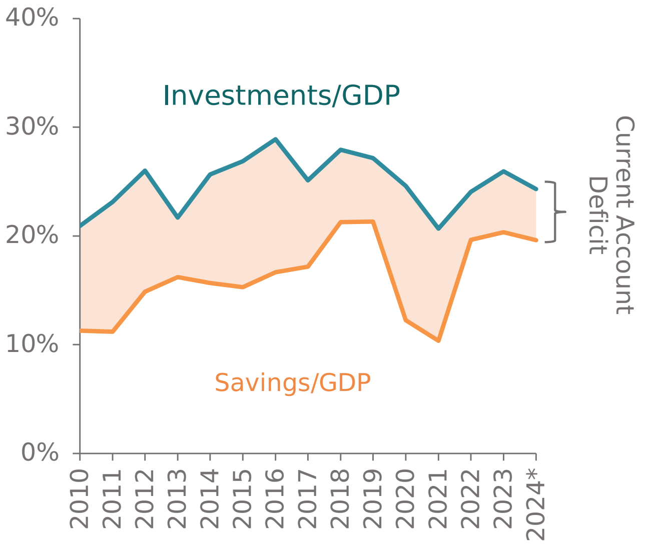

Figure 1.2.8. Investments and savings

Source: GeoStat
* NBG Forecast

1.3 OVERVIEW OF THE DOMESTIC ECONOMY

1.3.1 AGGREGATE DEMAND

Amid high economic activity, rising loans, and wage growth, the spending capacity of the population has increased. This was reflected in a significant rise in consumption during the first half of 2024.

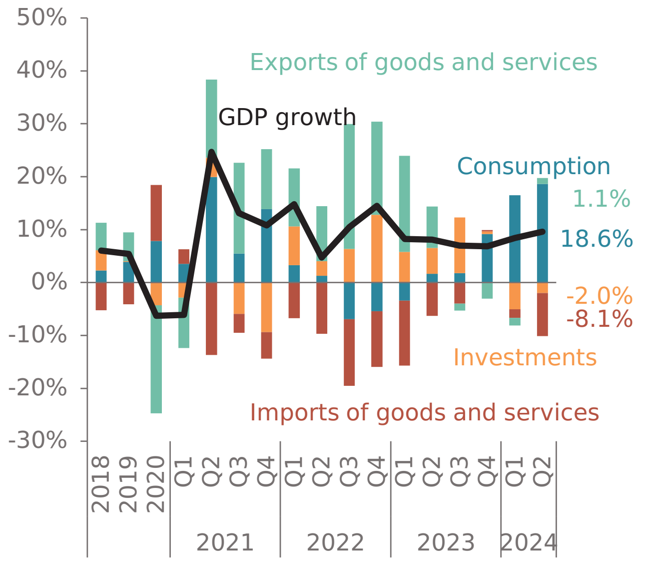

Figure 1.3.1. GDP by categories of use (contribution to growth)

Source: GeoStat, NBG calculations

In the second quarter of 2024, real GDP grew by 9.6% compared to the same period of the previous year. The main driver of economic growth was consumption, contributing 18.6 percentage points (pp) to the total. The contributions of investments and net exports were negative, amounting to -2.0 pp and -7.0 pp, respectively. From net exports, the export of goods and services added 1.1 pp to real GDP growth, while the contribution of imports was negative at -8.1 pp.

The significant growth in consumption is occurring alongside an increase in the population's spending capacity, which has been driven by high economic activity, the expansion of loans, and rising wages. Additionally, in recent years, there has been a substantial increase in the number of economically active foreigners residing in Georgia for extended periods, who provide an additional boost to consumption. Another factor contributing to the high 18.6% growth in consumption is the base effect, resulting from the fact that in the second quarter of 2023 consumption growth was relatively weak at 1.7%.

The opposite can be said about capital formation/investments, with one of the main reasons for their decline being the base effect. Following high investment growth over the past two years, a year-on-year decrease in investment expenditure was recorded in the first half of this year. In 2021 and 2022, the end of the pandemic and the recovery of tourism, followed by increased migration flows due to the war in Ukraine, significantly boosted service exports. As a result, the contribution of net exports to growth was high during those years. Starting in 2023, due to the influence of the base effect, as well as the reclassification of a portion of migrants as residents and an overall decrease in the number of migrants, the growth of service exports started to slow. Consequently, the overall contribution of net exports initially declined and then turned negative. The effect of migration on service exports has partially been balanced by the high growth of revenues from transportation services, which represents a certain realization of Georgia's transit potential (see Figure 1.3.1).

1.3.2 OUTPUT

Economic growth continues to be driven by the services sector.

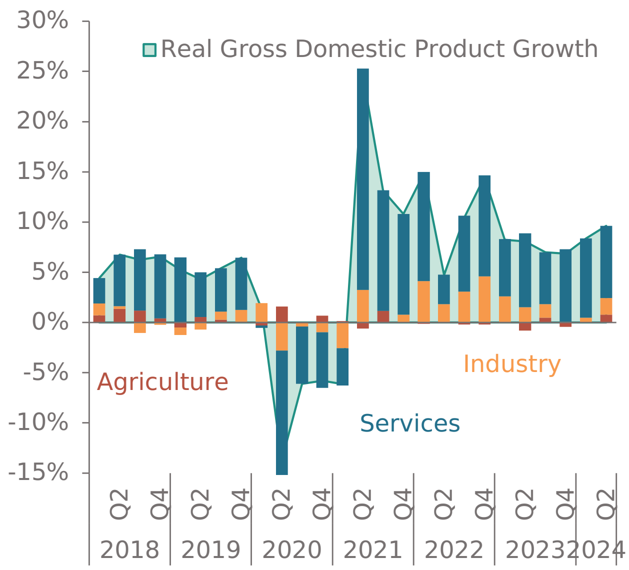

Figure 1.3.2. Contribution of sectors of the economy to real GDP growth

Source: GeoStat and NBG calculations

In the second quarter of 2024, 7.2 percentage points (pp) of the overall economic growth of 9.6% were attributed to the services sector. The contribution of the industrial sector was 1.7 pp, while agriculture contributed 0.8 pp (see Figure 1.3.2).

The solid growth of the services sector has continued, driven by strong domestic demand, tourism, and the significant number of migrants in the country. Key activities within the services sector include trade, transportation, information and communications, accommodation services, food delivery, as well as growth in arts, entertainment, and recreation, which collectively contributed 3.9 pp to the overall growth. From industry, the construction sector exhibited significant growth of 13.0%, contributing 0.9 pp to GDP growth.

BOX 2. HIGHER GROWTH OF REAL INCOME DRIVES STRONGER CONSUMPTION

Since the beginning of 2024, stronger-than-expected economic growth has been observed in Georgia. Based on incoming data, the primary driver of GDP growth from the expenditure side has been consumption, which increased by 22% in real terms during the first half of the year. The acceleration of households' real income and wage growth that occurred in 2023, which was the highest in recent years, had a significant role in this development, as real wages grew by 24% and overall real household income increased by 18% (see Figure 1.3.3). Additionally, low inflation this year has had a positive impact on real incomes. The improvement in households' financial conditions has driven the increase in consumer spending in 2024.

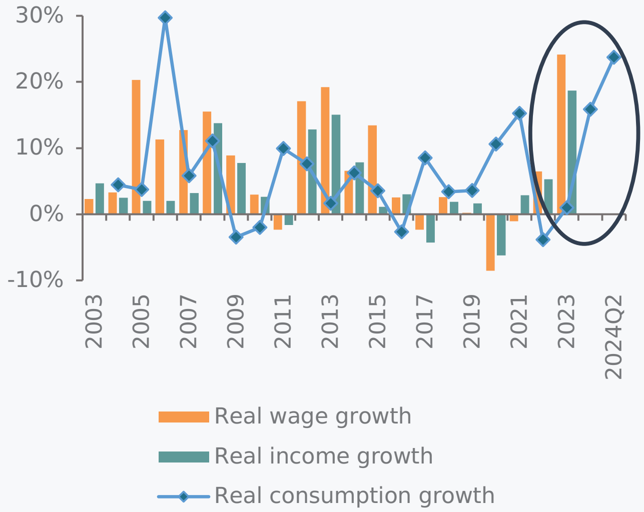

Figure 1.3.3. Households' real wage and income growth.

Source: GeoStat

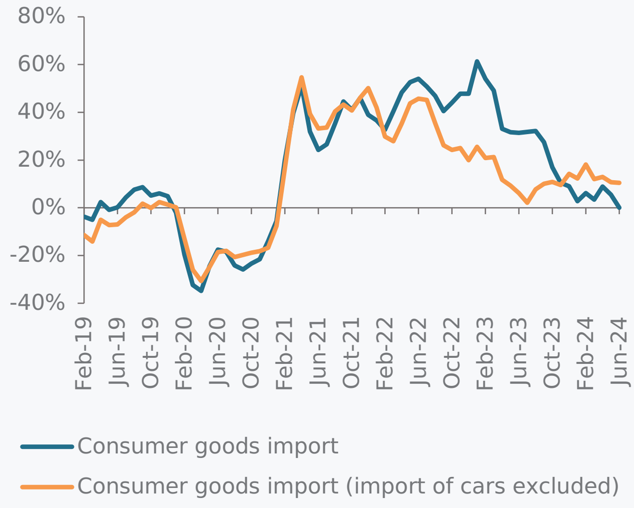

Figure 1.3.4. Nominal imports growth in USD.

Source: GeoStat

An increase in consumer spending, ceteris paribus, typically leads to higher imports and a worsening of the current account balance. However, a positive dynamic is noticeable in this regard too, with the growth in imports, including of consumer goods, remaining low (see Figure 1.3.4). It is important to consider that a slowdown in the import of certain products intended for re-export has also contributed to the overall deceleration of imports. For example, excluding imports of vehicles, the annual growth rate of consumer goods imports has been quite strong over recent months, fluctuating at around 10%. The moderate growth in imports has also been driven by price stability in certain commodity products, particularly food prices. While consumption is growing, investment remains weak. However, it should be noted that the decline of investments in the first half of the year was mainly driven by a sharp decline in inventories, whereas investments in fixed capital have been steadily increasing (see Figure 1.3.5).

The decline in inventories may also explain the relatively weak growth in imports against the backdrop of strong consumption. It is likely that firms are utilizing the inventories accumulated in previous periods to meet currently strong consumption, resulting in a relatively modest growth in imports and stability in the current account. Moreover, it is possible that the increased consumption is more directed toward services rather than goods, reflecting a growing trend in demand for services in the post-pandemic period. During the pandemic, disruptions in service provision led to higher spending on goods; however, as is shown in Figure 1.3.6, there has been a marked increase in household expenditures on services in the post-pandemic period. Although spending on services has yet to reach pre-pandemic levels, it is expected that this trend will continue in the future.

Additionally, the role of commodity products is noteworthy, as the increase in their prices—as driven by the pandemic and then the Russia-Ukraine war—has contributed to shifts in global spending patterns. Currently, the stability of commodity prices supports an increased share of services in consumer expenditures.

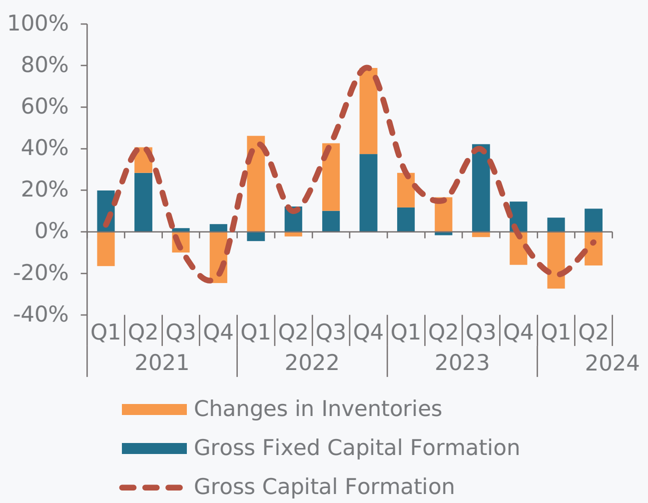

Figure 1.3.5. Growth decomposition of gross nominal capital formation.

Source: GeoStat

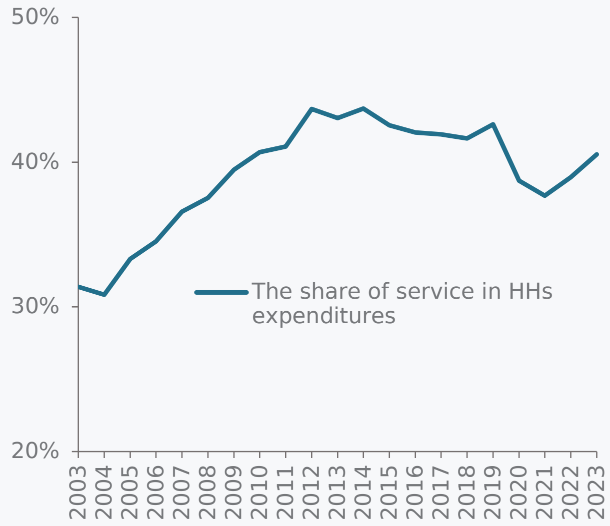

Figure 1.3.6. The share of services in households' expenditure.

Source: GeoStat

In summary, the increase in real wages and incomes last year has supported strong consumption, which in turn influences economic growth. Against this backdrop, the relative weakness in consumer goods imports can be explained by a decrease in specific components of imports unrelated to local consumption and an increased reliance on inventories (which could lead to increased imports in the future under similar conditions). Furthermore, an increase in demand for services has been observed globally in the post-pandemic period, and is also evident in the local economy. However, in this context, it is important to note that the inflation rate for services, while low, remains relatively high compared to headline inflation.

1.4 FINANCIAL MARKET AND TRENDS

1.4.1 LOANS

Credit activity is robust and stimulates overall demand in the economy. Following the NBG's decision to reduce the monetary policy rate, lending accelerated to 18.6%, marking an increase of 5.8pp.

Following the normalization of monetary policy, credit activity has strengthened and is stimulating overall demand in the economy. In August 2024, lending increased by 18.6% (excluding the exchange rate effect). Since the NBG began reducing the monetary policy rate in May 2023, lending has accelerated by 5.8 pp (see Figure 1.4.1). The rise in business loans made a significant contribution to credit activity. Alongside the normalization of monetary policy, the NBG's increase in the maximum maturity for unsecured consumer loans has also stimulated lari-denominated consumer lending, further boosting total credit (see Figure 1.4.1). However, it should be noted that the impact of this change in the maximum maturity for consumer loans on overall lending is gradually diminishing due to base effects. The growth rate of consumer loans thus moderated in August.

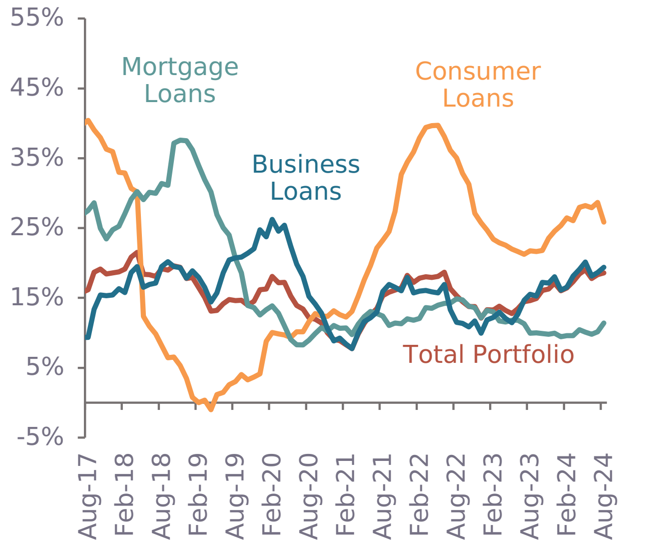

Figure 1.4.1. Annual growth of loans by purposes (excluding the exchange rate effect)

Source: NBG

As a result of the policies implemented by the NBG, domestic currency lending is on the rise, while foreign currency lending has slowed compared to the previous year (see Figure 1.4.2). Specifically, since the beginning of the year, lending in foreign currency to individuals has been declining, facilitated by an increase in the limit for unhedged foreign currency loans to GEL

The growth of the credit portfolio predominantly stems from loans issued in the national currency. This development is a clear result of the policies implemented by the NBG.

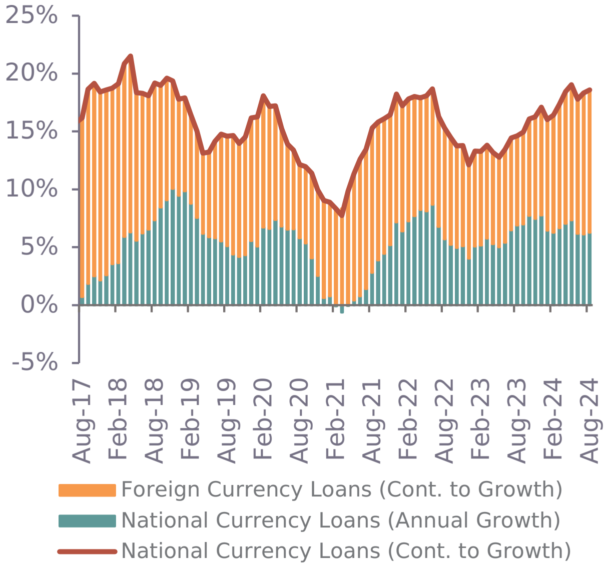

Figure 1.4.2. Annual growth of domestic and foreign currency loans (excluding the exchange rate effect)

Source: NBG

As a result of the policies implemented by the NBG, the dollarization of loans continues to decline, having decreased by a cumulative 1.4 pp since the beginning of the year.

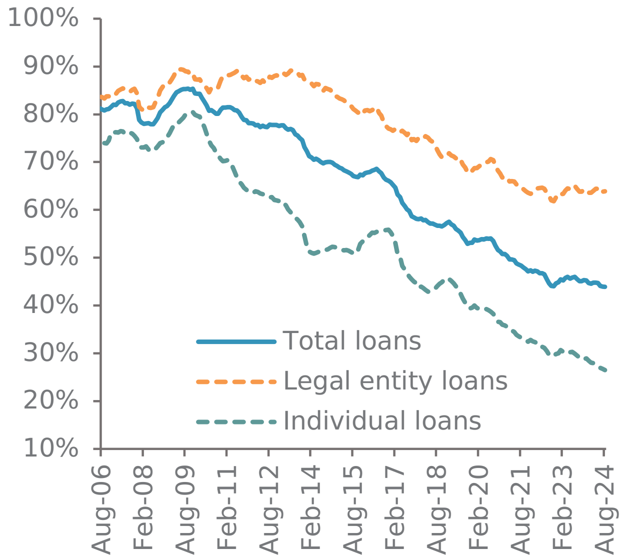

Figure 1.4.3. Dollarization of loans (excluding the exchange rate effect)

Source: NBG

300,000 as of 1 January 2024, which then rose to GEL 400,000 as of 1 May 2024. Furthermore, under the still-tight financial conditions set by leading central banks, foreign currency interest rates in Georgia remain at elevated levels, making foreign currency lending less attractive. However, in recent periods, leading central banks have also begun to gradually ease their policy rates, which is expected to eventually translate into lower foreign currency interest rates in Georgia.

Reducing dollarization remains a significant challenge for the Georgian economy. High dollarization not only restricts the effectiveness of monetary policy but also poses risks to financial stability. Furthermore, it impacts the country's risk profile and hinders improvements in credit ratings. Therefore, the NBG continuously analyzes the dynamics of dollarization and takes appropriate measures to tackle it when necessary. This not only reduces currency and related credit risks for individual borrowers but also supports long-term economic growth.

Despite positive trends seen in recent years, dollarization and its associated risks continue to present significant challenges for the financial sector. Loans denominated in foreign currency, primarily offered with variable exchange rates, carry interest and exchange rate risks. These become particularly concerning given the high share of non-hedged borrowers, the increased volatility of regional currencies, and globally tight financial conditions. To mitigate these risks, the NBG increased the limits on non-hedged foreign currency loans, first doing so on 1 January 2024, and further extending these on 1 May 2024. As expected, this measure has contributed to a reduction of loan dollarization, which decreased by 0.8 pp to 43.9% compared to May 2023. It is important to note that the dollarization of loans to individuals has a declining trend and remains at a low level. In contrast, the dollarization of loans to legal entities has remained in the range of 64-65% over the past year (see Figure 1.4.3).

Deposit dollarization has been characterized by a downward trend in a climate of low inflation and strong macroeconomic fundamentals. Since the beginning of the year, deposit dollarization has fallen below 50% There is also a decreasing trend in the dollarization of deposits held by individuals, while the dollarization of deposits held by legal entities has remained below 40% since February (see Figure 1.4.4).

It is crucial that the process of reducing dollarization continues. This will be supported by the recently implemented macroprudential measures. Reducing dollarization is a step towards mitigating financial stability risks.

Against the backdrop of low inflation and strong macroeconomic fundamentals, the dollarization of deposits has a downward trend. After March 2024, the dollarization of deposits fell below 50%.

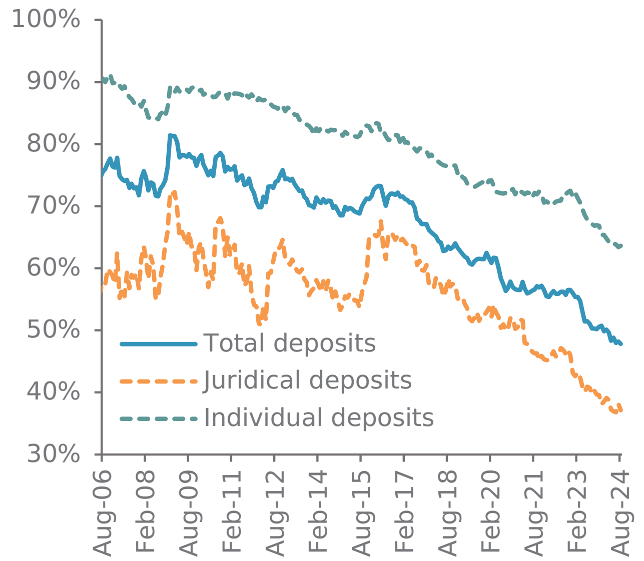

Figure 1.4.4. Dollarization of deposits (excluding the exchange rate effect)

Source: NBG

The NBG began normalizing its monetary policy at the start of 2023. As of the third quarter of 2024, interest rates on long-term government securities have decreased compared to the previous quarter, although they remain elevated relative to the beginning of the year.

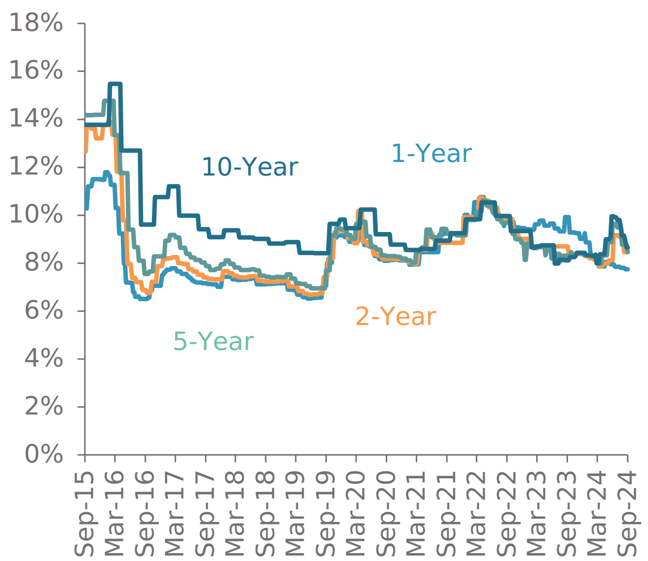

Figure 1.4.5. Interest rates on government securities

Source: NBG

1.4.2 INTEREST RATES AND CREDIT CONSTRAINTS

The NBG began normalizing its monetary policy at the start of 2023. Since May 2023, the monetary policy rate has been progressively reduced by a total of 3.0 pp to 8.0%. This lowered rate has been reflected in both government securities and bank interest rates (see Figure 1.4.5). Short-term government bond yields are close to the monetary policy rate, while long-term rates are higher. However, it is noteworthy that there has been a declining trend in recent periods. This reflects, to some extent, the financial market's inflation expectations. Specifically, inflation expectations in the financial market have stabilized recently for the medium and long term.

GEL interest rates have a declining trend. In August, interest rates on deposits denominated in the national currency decreased by 1.1 pp compared to May 2023, standing at 9.9%, while rates on foreign currency deposits rose to 2.4%.

In terms of lending, the reduction in the monetary policy rate also contributed to a decrease in interest rates on loans in the national currency, facilitating an increase in lending. However, in recent months, the declining trend in interest rates on lari mortgage loans and loans to legal entities has slowed, with a slight increase in mortgage loan rates being observed. This reflects the NBG's cautious monetary policy as well as both domestic and external uncertainties (see Figure 1.4.6). At this stage, there continues to be a strong transmission of the monetary policy rate to loans issued to legal entities in the national currency. In August 2024, compared to December of the previous year, the average interest rate on loans to legal entities in the local currency decreased by 1.2 pp to 11.8%. In terms of foreign currency loans, due to globally tightened financial conditions, foreign currency interest rates in Georgia rose during the first half of 2023 and remained high in the first half of 2024 (see Figure 1.4.7). The spread between local and foreign rates has narrowed. Notably, following the easing of monetary policy in May, 2023, interest rates on consumer and business loans have been decreasing, while mortgage loan rates remain stable at around 10%.

As a result of the gradual normalization of monetary policy, interest rates on mortgage loans issued in the national currency have been decreasing. However, in recent periods, this declining trend has halted and shown a slight increase. These developments can be attributed to heightened risk premiums resulting from anticipated uncertainties.

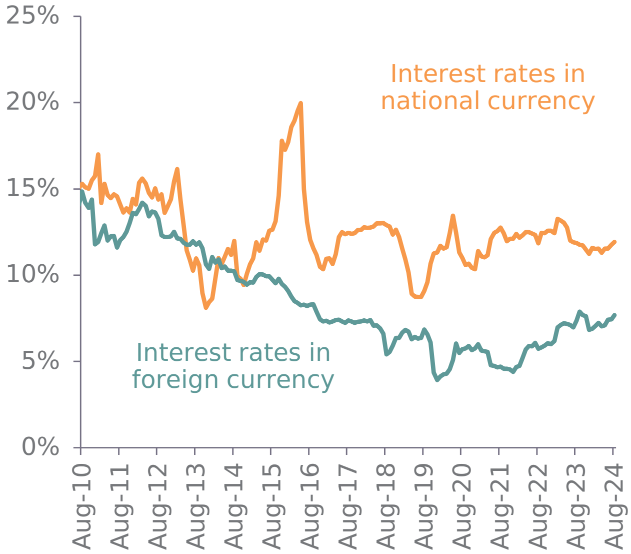

Figure 1.4.6. Interest rates on mortgage loans (flow)

Source: NBG

Interest rates on national currency loans are declining, while those on foreign currency loans remain at elevated levels. However, as leading central banks gradually ease their tight financial conditions, it is expected that reductions in policy rates in Georgia will also progressively translate into lower interest rates on foreign currency loans.

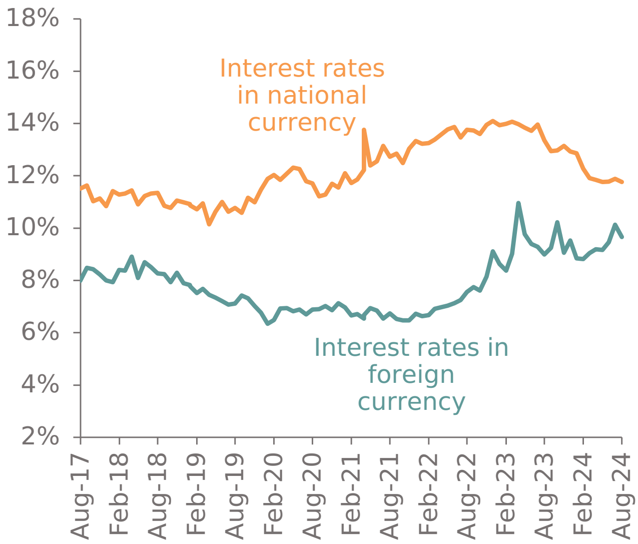

Figure 1.4.7. Average interest rates on legal entities loans (flow)

Source: NBG

1.4.3 EXCHANGE RATE

In the third quarter of 2024, the GEL exchange rate depreciated on a year-on-year basis (see Figure 1.4.8). Over the same period, the nominal effective exchange rate depreciated insignificantly.

In terms of specific currencies, the GEL nominal exchange rate appreciated against the US dollar by 1.1% and depreciated against the euro by 0.6%, compared to the previous quarter. The GEL continued to appreciate against the Turkish lira by 4.0%; however, it depreciated against the Russian ruble by 1.3%. In terms of the price-adjusted exchange rate, in the third quarter of 2024 the real effective exchange rate depreciated by 2.0% on a quarterly basis and by 9.6% year on year (see Figure 1.4.9).

It should be noted that the GEL real exchange rate depreciated against all main trading partner countries except Russia (see Table 1.4.1).

The real effective exchange rate depreciated in the third quarter, reflecting an annual depreciation of 9.6%.

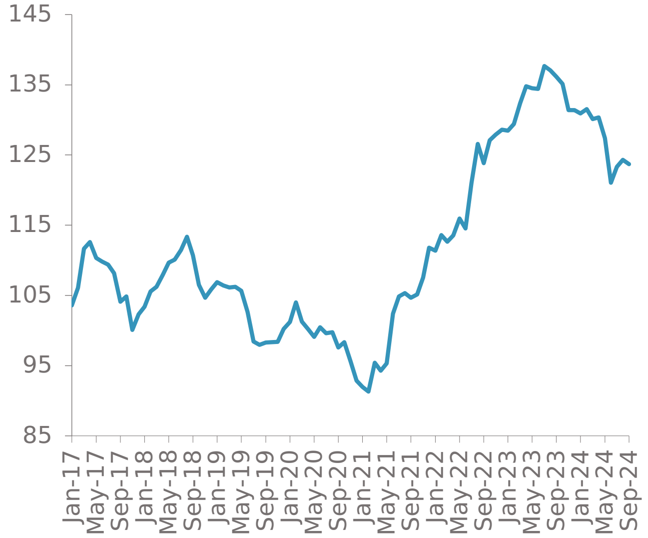

Figure 1.4.8. Real effective exchange rate (Jan 2008=100)

Source: NBG

The annual depreciation of the GEL real effective exchange rate was mostly caused by the higher inflation in Georgia's main trading partners.

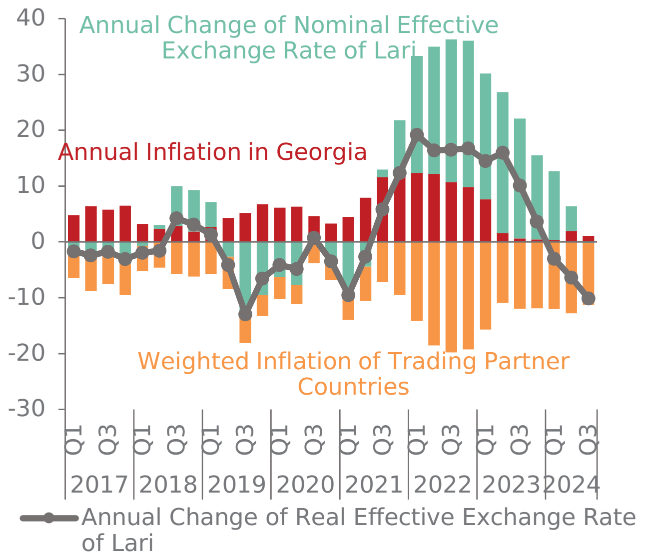

Figure 1.4.9. Decomposition of the annual change of the GEL real effective exchange rate*

Source: NBG

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

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

	Change in Nominal Exchange Rate %	Change in Real Exchange Rate %	Contribution to the Change in Real Exchange Rate, pp
Effective exchange rate*	**-0.2**	**-9.6**	**-9.6**
Eurozone	-4.3	-5.2	-1.0
Türkiye	21.0	-20.8	-3.9
Ukraine	7.7	1.6	0.0
Armenia	-3.0	-3.0	-0.2
US	-3.4	-4.8	-0.6
Russia	-8.3	-14.9	-2.3
Azerbaijan	-3.3	-5.3	-0.5
China	-4.5	-3.9	-0.4
Bulgaria	-4.3	-5.0	-0.1
Poland	-8.9	-11.8	-0.2

Table 1.4.1. Annual change in effective exchange rates, Q3 2024

Source: NBG

* *Growth implies appreciation of the lari*

1.5 LABOR MARKET

In the second quarter of 2024, productivity in the country's economy (real added value produced per employed individual) increased by 7.5% year on year (see Figure 1.5.1). During the same period, the nominal wages of hired employees in the country rose by 11.1%, averaging GEL 2,004.9 gross per month.

Compared to the previous quarter, the pace of wage growth has slowed, while productivity has significantly increased amid high economic growth. As a result, the growth in unit labor cost sharply decreased to 3.4%. Consequently, the pressure on inflation from rising wages has eased (see Figure 1.5.1).

In the second quarter of the year, the growth of unit labor cost sharply decreased to 3.4%. As a result, the pressure on inflation from the labor market has eased.

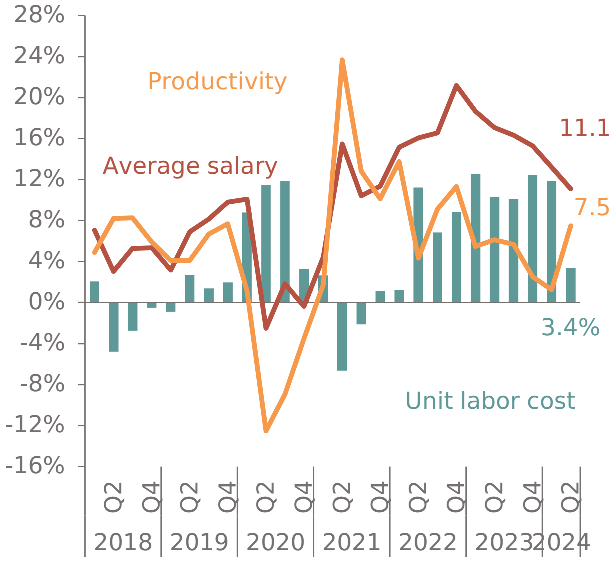

Figure 1.5.1. Productivity, average salary, and unit labor cost (annual growth)

Source: GeoStat, NBG calculations

1.6 CONSUMER PRICES

In September, annual inflation again decreased compared to previous months, standing at 0.6%. This low rate can largely be attributed to the low levels of inflation for domestically produced goods and services, which indicates stability in long-term inflation expectations. Additionally, the reduction in imported inflation has further contributed to the overall decrease. Core inflation, which excludes the prices of highly volatile items such as food, energy resources, and cigarettes from the consumer basket, stood at 0.8% (see Figure 1.6.1).

Inflation in Georgia remains below the target level.

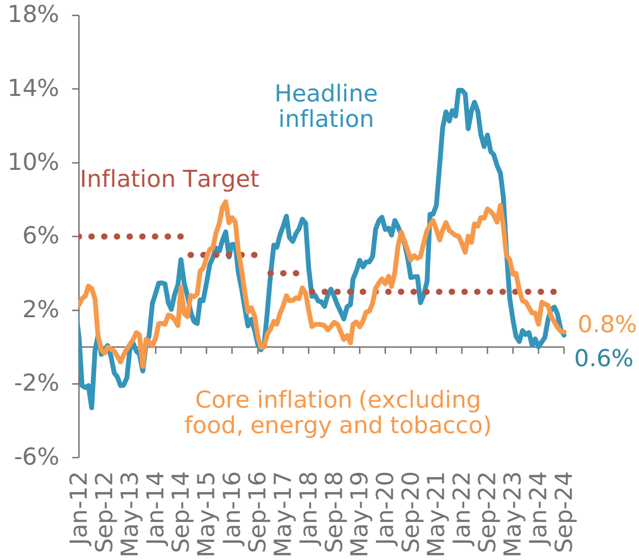

Figure 1.6.1. Headline and core inflation

Source: GeoStat

In September, domestic inflation stood at 1.2%. This low level was driven by the decrease in service inflation, which is largely associated with a gradual fading of the base effect. Service inflation decreased to 1.6% in September. Additionally, the improvement in internet quality, which began in July and continued into August without a corresponding price increase (resulting in a total contribution of -1.7 percentage points), had a notable impact on reducing service inflation. The recent decline in imported inflation primarily reflects the gradual easing of the base effect caused by rising fuel prices. Meanwhile, the deflation of mixed products, most notably the annual decrease in electricity tariffs and the lower price of antibiotics, has also contributed to the overall decrease of inflation (see Figure 1.6.2).

In terms of product groups, inflation was primarily driven by the increase in gasoline prices. Compared to September 2023, gasoline prices rose by an average of 7.2%, contributing 0.3 percentage points (pp) to overall inflation. However, because of the gradual fading of the base effect, it is noteworthy that the contribution of gasoline to total inflation has decreased compared to previous months.

Conversely, the reduction in inflation was most significantly influenced by the decrease in internet and electricity costs, which had a contribution of 0.4 pp and 0.3 pp, respectively. Food prices were 0.8% lower than those in September 2023, contributing -0.2 pp to inflation. Of the latter, particularly noteworthy were the price drops for greens and Imeretian cheese, which contributed a total reduction of 0.4 pp to inflation (see Figure 1.6.3).

Domestic inflation remains at a low level, reflecting reduced inflation expectations.

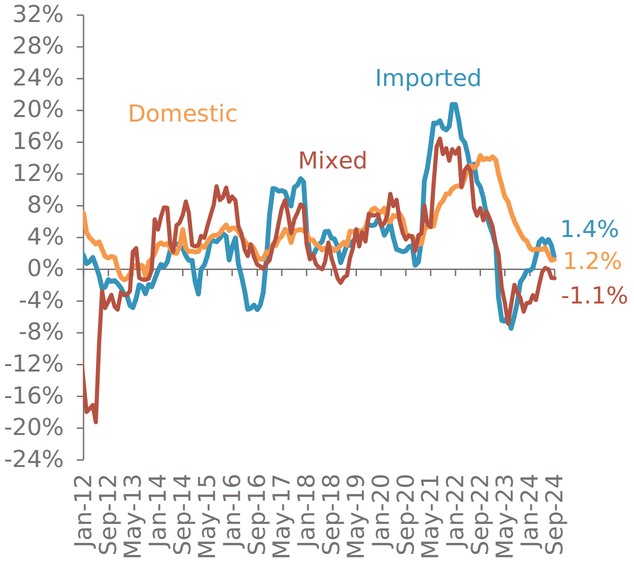

Figure 1.6.2. Domestic and imported inflation

Source: GeoStat

In September, inflation was primarily driven by an annual increase in fuel prices, while a decrease in internet and electricity costs helped reduce it.

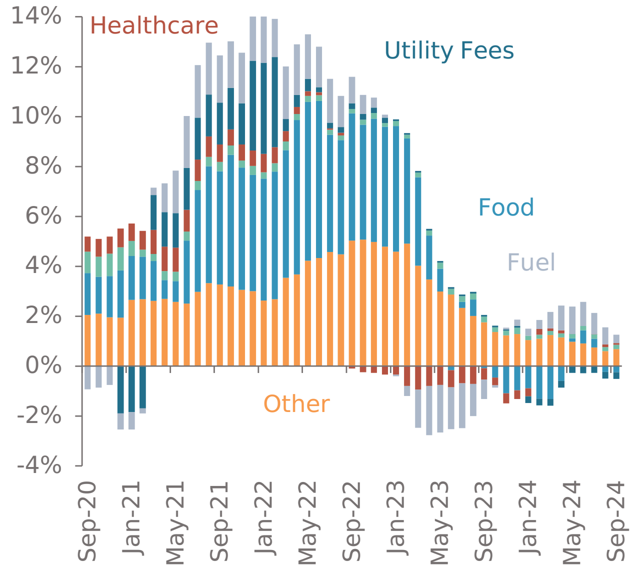

Figure 1.6.3. Inflation by major categories (contribution to headline inflation)

Source: GeoStat, NBG calculations

2 MACROECONOMIC FORECAST

According to the revised forecast, inflation will remain below the target level in 2024 before stabilizing around it in the medium term. Low inflation has been driven by the stability of long-term inflationary expectations, which is reflected in the low inflation of sticky prices over the year. In addition, supply-side factors are also disinflationary, neutralizing the price pressures stemming from strong demand. Both food and oil prices have remained stable on international markets this year. Productivity improvements, reduces pressures on firms' costs as well as on final prices. In the medium term, the impact of these factors on inflation is expected to diminish, resulting in inflation stabilizing around its target level.

Economic activity has been stronger than expected, and the growth forecast for 2024 has been revised upward from 6.8% to 8.5%. Increased consumption, which has been stimulated by the growth in real wages and household incomes, as well as strong credit activity, has contributed to this revision. However, it is also worth noting that accelerated growth in certain sectors of the economy points to an improvement in economic potential, which, along with increased competition, contributes to reduced cost pressures and supports a low-inflation environment.

Nevertheless, certain risks have recently become more pronounced. Their realization could lead to higher inflation than forecast under the baseline scenario. These risks have intensified due to both external and domestic uncertainties. Specifically, the current acute geopolitical situation has created uncertainty regarding commodity prices on international markets, and it could also increase the country's risk premium more than expected. If these risks were to materialize, a tighter monetary policy will be required than under the baseline scenario.

As the baseline forecast shows, in the short term, inflation will remain below the target level; stable long-term inflationary expectations and supply-side factors offset demand-side pressure and the impact of the depreciation of the effective exchange rate this year. In the medium term, disinflationary factors will gradually dissipate, and inflation will thus stabilize around the 3% target level.

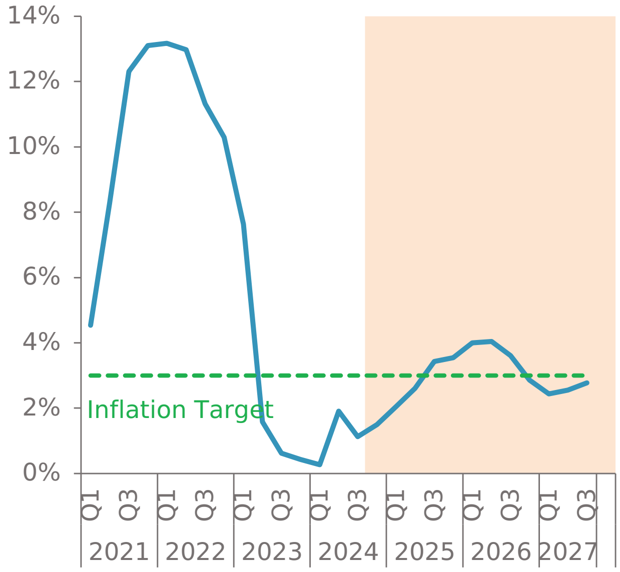

Figure 2.1.1. Headline inflation

Source: NBG, GeoStat

2.1 BASELINE MACROECONOMIC FORECAST

According to the updated forecast, inflation will average 1.2% in 2024, which is 0.7 pp lower than the previous forecast. The stability of long-term inflation expectations and improvements to the supply side have resulted in lower-than-expected inflation over the year, even though economic activity has remained high. Incoming data indicate high activity in terms of GDP growth in the third quarter of 2024, and, considering the data from the first half of the year and recent tendencies, consumption remains strong. Taken alongside a slight depreciation of the exchange rate, these factors represent inflationary pressures this year. Nevertheless, as previously mentioned, a combination of various supply-side factors has offset these pressures, keeping inflation low. In this regard, it is worth noting the trend of declining profit margins for firms alongside increased competition (which were discussed in the previous Monetary Policy Report). During the recovery period following the COVID-19 pandemic, firms responded quickly to cost pressures by raising prices, which in turn led to increased profit margins. However, since last year, margins have tended to return to their long-term trend, with heightened competition contributing to this shift, among other factors.

It is also worth mentioning that high economic growth in certain sectors (in particular, information and commu-

Positive supply-side factors have put downward pressure on inflation this year, but those effects are expected to fade away in the medium term. Additionally, the moderate depreciation of the effective exchange rate seen this year will contribute to inflation rising in the coming period, causing it to moderately exceed the target level in 2025.

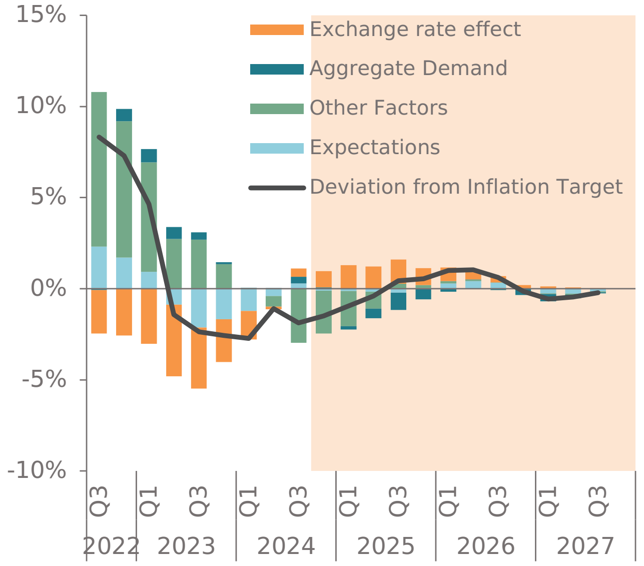

Figure 2.1.2. Deviation of inflation from the target and its decomposition

Source: NBG, GeoStat

According to the revised baseline scenario, real GDP is projected to grow by 8.5% in 2024. This will be driven by accelerated potential growth and robust demand.

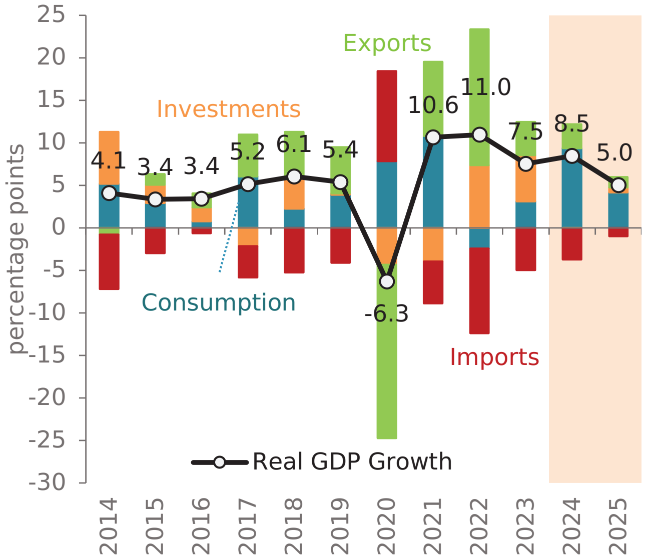

Figure 2.1.3. Real GDP growth decomposition

Source: NBG, GeoStat

nication, and transportation) have enhanced the country's economic potential. In turn, increased productivity reduces inflationary pressures. The improved efficiency of the economy also relaxes the trade-off between inflation and output; when inflation sensitivity to demand is lower, inflationary pressures are reduced. Additionally, productivity improved significantly in the second quarter of 2024, reducing labor costs per worker, and pressure on final prices. Furthermore, the stability of commodity prices, especially food prices, supports the stability of prices in a significant portion of the consumer basket and prevents second-round effects.

Despite these developments, global food prices increased significantly in September (rising by 6% compared to the previous quarter) due to price hikes across all commodity groups. Additionally, growing uncertainty regarding oil prices is present due to ongoing conflicts. Geopolitical uncertainty increases risk assessments for the region, together with domestic uncertainties, it could effect on the country risk premium. If Georgia's risk premium rises, pressure could emerge on the foreign exchange market, which could also have an impact on imported inflation. Considering these factors and as a consequence of base effects, inflation is expected to rise in upcoming quarters, surpassing the target rate in the second half of 2025 before returning to the target level in the second half of 2026.

Based on incoming data from the first eight months of 2024, economic growth has been higher than was expected at the beginning of the year. Real income and wages have increased substantially since last year, which has led to strong consumption. Additionally, credit activity remains high; and the significant share of business lending has a positive impact on the economy's potential. At the same time, the situation with external inflows has also improved; specifically, both goods and services exports have increased, while the growth rate of imports remains low. Despite strong consumption, the relative weakness of imports indicates an increase in local spending, particularly on services. As noted earlier, the high contribution of certain sectors to economic growth, together with the increase in employment, has positively affected the economy's potential. Taking into account the improvement of both domestic and external demand, the forecast for economic growth in 2024 has increased from 6.8% to 8.5%. In 2025, due to the base effect and a return to long-term potential growth, the Georgian economy is expected to increase by 5%.

Despite the low inflationary environment, given the existing demand pressures, as well as geopolitical and domestic uncertainties, it is optimal to keep the monetary policy rate unchanged at this stage. The monetary policy rate is close to its neutral level (estimated by the NBG to be 7%) and thus the further normalization of monetary policy toward that neutral rate will continue at a slow pace.

Against the backdrop of strong domestic and foreign demand, the continued high growth of the potential economy, and possible escalation of geopolitical tensions, macroeconomic forecasts remain characterized by high uncertainty.

Macroeconomic Forecast Risks	Impact on Inflation
A greater-than-expected increase in uncertainty due to both global and domestic factors.	↑
A worsening of the current account deficit in the medium term.	↑
Higher-than-expected prices of commodity products on international markets.	↑
Higher-than-expected international shipping prices.	↑

Impact size			
Neutral	Low	Medium	High

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

Table 2.1.1 Baseline macroeconomic forecast risks

Source: NBG

2.1.1 BASELINE FORECAST SCENARIO RISKS

Against the backdrop of strong domestic and foreign demand, the continued high growth of the potential economy, and the possible escalation of geopolitical tensions, macroeconomic forecasts remain characterized by high uncertainty. These risks are primarily inflationary in nature and their realization would result in deviations from the baseline macroeconomic forecast and would necessitate an appropriate monetary policy response.

During the current year, credit activity in both domestic and foreign currencies has been stronger than expected. Credit growth has largely been driven by business loans, which, in turn, have stimulated potential output and, therefore, softened inflationary pressures stemming from overall credit activity. Despite this effect, in parallel with a gradual closing of the credit-to-GDP gap, credit activity remains an important driver of demand. Consequently, stronger credit compared to the baseline scenario would heighten the risk that economic activity will exceed its potential level even further, which would create additional pressure on inflation. As monetary policy is particularly intolerant to demand-driven inflation, in response to these developments, additional instruments would be employed where necessary to ensure the stability of long-term inflation expectations and to mitigate shocks.

Alongside the Russia-Ukraine war, the situation in the Middle East has become particularly acute. The confrontation between Israel and Hezbollah has entered a new stage, and Iran's open involvement in the conflict has increased the likelihood of a large-scale war. In the event that the mentioned risk materializes, oil and gas extractions will be interrupted, and the strategic Strait of Hormuz, which accounts for 20-30% of the world's oil supply, may be completely or partially blocked. This will increase the cost of international shipping, which will immediately be reflected in the prices of imported products and will create significant pressure on inflation. It should be noted that the increase in uncertainty has already changed the situation on international markets to some extent and has balanced the effects of weak global demand on the price of crude oil. In addition, the reduction of interest rates in developed countries and the economic stimulus packages of the Chinese government may drive oil prices upward. In the event that the mentioned risks materialize, the National Bank of Georgia will respond to the increased inflationary expectations arising from the supply shock with a stricter monetary policy, thereby ensuring the stabilization of long-term inflation around its target rate.

Against the background of complex geopolitical processes, the positive trends observed in relation to foreign inflows are also at risk. A decrease in foreign inflows and an increase in Georgia's sovereign risk will create significant pressure on the GEL exchange rate and, given the still-high level of dollarization in the economy, will drive inflation upward through the intermediate costs and ex-

With the current update, the average inflation forecast for 2024 has significantly decreased (by 0.7 percentage points). As a result, inflation will remain at a lower level over the short term, while in 2025 it is expected to moderately exceed the target level due to base effects and other contributing factors.

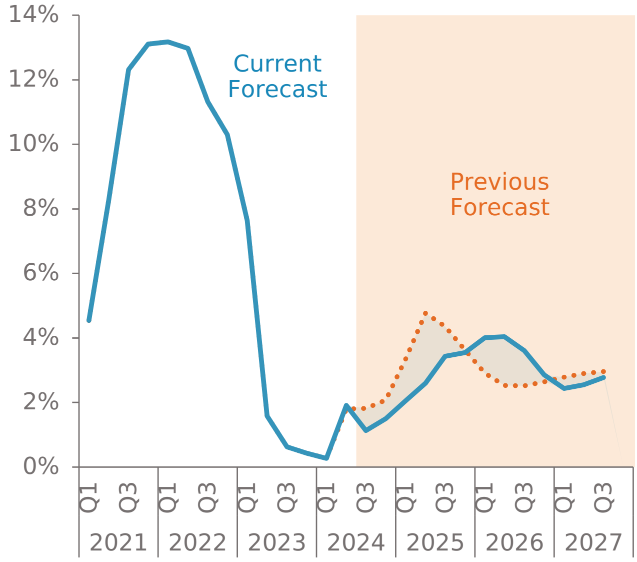

Figure 2.2.1. Changes in the forecast of headline inflation

Source: NBG, GeoStat

Based on the incoming data from the first eight months of 2024, economic activity has been stronger than previously expected, and was largely driven by increased consumption. As a result, the economic growth forecast for the current year has been revised upwards to 8.5%, compared to the previous estimate of 6.8%. In 2025, GDP growth is expected to remain at around 5%.

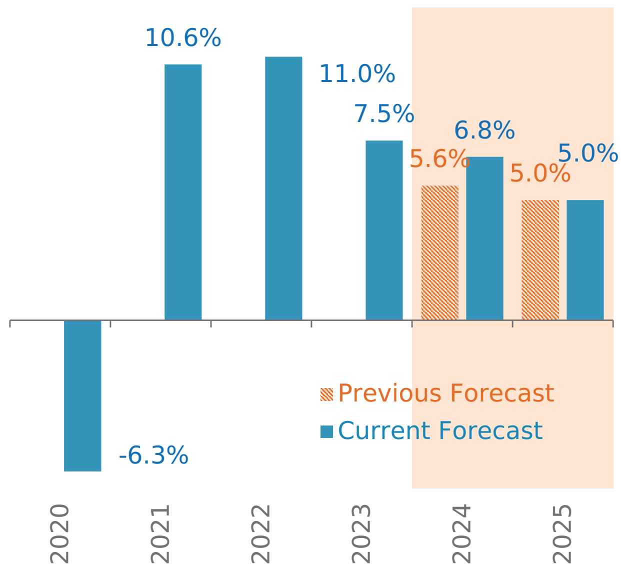

Figure 2.2.2. Changes in the forecast of real GDP

Source: NBG, GeoStat

pectations channels. In the event that these risks materialize, the monetary policy will be tightened compared to the baseline scenario to stabilize long-term inflation expectations and mitigate the impact of the shock.

2.2 COMPARISON TO THE PREVIOUS FORECAST

Compared to the previous forecast, inflation has been revised down over the short-run horizon (see Figure 2.2.1), driven by lower-than-expected actual inflation. As a result, the updated baseline forecast projects that inflation in 2024 will be 1.2% instead of the previously forecasted 1.9%. Due to this development, the inflation forecast for the entire short-term horizon has been revised downward and is expected to exceed the target level only in the second half of 2025. The upward movement will be influenced by the strength of both domestic and external consumption as external and internal uncertainties normalize. Base effects will also contribute to this dynamic.

The economic growth forecast for the current year has been significantly revised upward, from 6.8% to 8.5% (see Figure 2.2.2). The higher-than-expected economic activity this year is linked to increased consumption, which is supported by the high growth of real wages and incomes of households, as well as the continued strength of credit activity. Contrary to strong demand, an improvement of supply-side factors is also noticeable. Specifically, high growth observed in certain sectors of the economy indicates an acceleration of economic potential, which positively affects long-term growth. However, according to the baseline scenario, potential growth will moderate from 2025 onwards to return to its long-term level. As a result, the economic growth forecast for 2025 remains around 5%.

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

According to the updated forecast, the weighted inflation of Georgia's trading partners has slightly increased for 2024 due to rising inflation expectations in Türkiye. Additionally, given the higher-than-expected growth forecast for Russia, the overall economic growth forecast for Georgia's trading partners has also been revised slightly upward for 2024 (see Figure 2.2.3). China's economic situation should also be closely watched, where lower-than-expected economic growth is projected for 2024. This will affect global economic activity and, considering potential second-round effects, may affect conditions and prices on commodity markets.

The economic growth forecast for Georgia's trading partners has slightly improved for 2024, while inflation projections have been revised upwards, primarily due to rising inflation expectations in Türkiye.

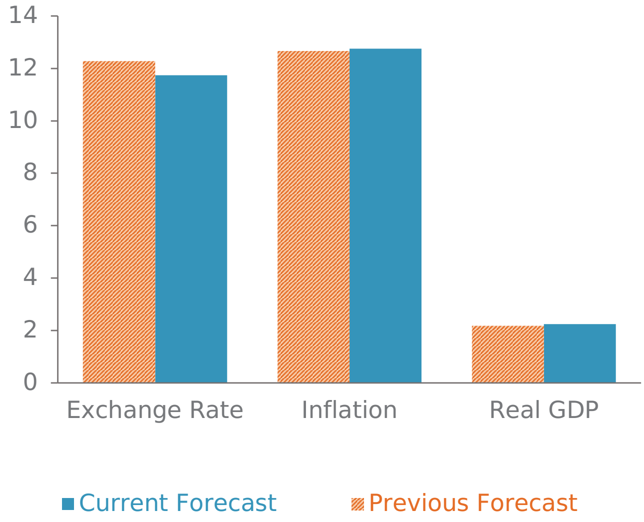

Figure 2.2.3. Changes in assumptions about trading partners

Source: Bloomberg, NBG

Under the alternative scenario, following sustained high economic activity through the end of the year, real GDP is expected to grow by 9% in 2024. However, due to a subsequent realization of pronounced risks, the growth rate is projected to decrease to 3% in 2025.

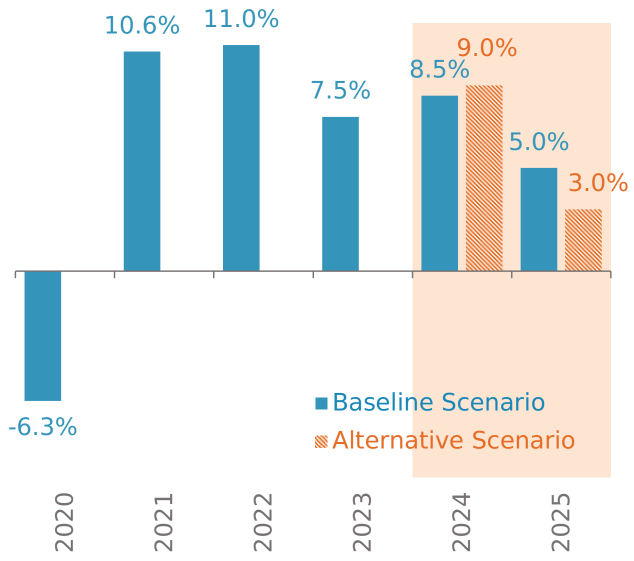

Figure 2.3.1. Real GDP growth according to the baseline and alternative forecasts

Source: NBG, GeoStat

2.3 ALTERNATIVE FORECAST SCENARIO

We consider the alternative scenario to be as relevant and equally plausible as the baseline one. It accounts for those risks surrounding the baseline macroeconomic forecast, the realization of which is either particularly likely or would be particularly significant. Under the alternative scenario, with high credit growth having been driven by recently loosened financial conditions, economic activity in 2024 is projected to grow at 9% (see Figure 2.3.1). However, prolonged global uncertainty and an increase in the risk premium may affect consumer sentiment and, as a result, under the alternative scenario, the economic growth rate is subsequently expected to decrease to 3% in 2025 (see Figure 2.3.1). Furthermore, amid heightened global uncertainty and the emergence of new geopolitical risks in the Middle East, an increase in commodity prices on international markets is expected. The intensification of geopolitical risks related to the region may also be reflected in a higher risk premium, which in turn would exert pressure on the GEL exchange rate. Considering the high level of dollarization in the economy, a depreciated exchange rate would further fuel inflationary pressures through the channels of intermediate costs and expectations. Consequently, inflation under the alternative scenario is expected to be 0.4 percentage points higher, on average, in 2024 (see Figure 2.3.2). Despite the slowdown in economic activity, inflationary pressures driven by supply factors are likely to outweigh the effects of weaker demand, leading to inflation that is 1.9 percentage points higher in 2025 than

Amid heightened global uncertainty, an increased risk premium, and rising commodity prices on international markets, inflation is expected to temporarily exceed its target.

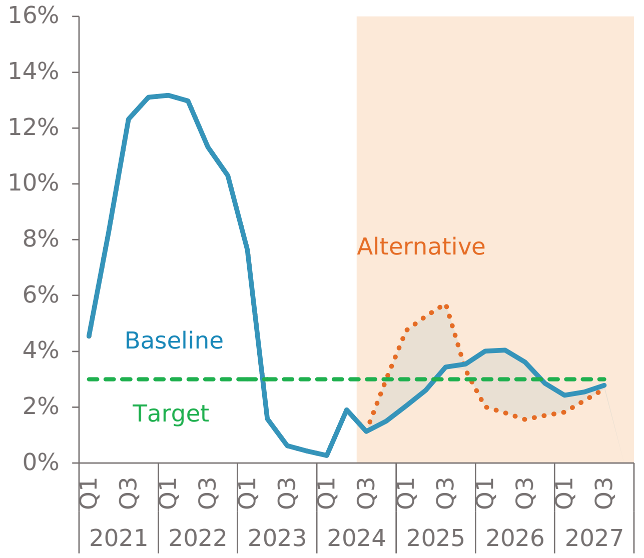

Figure 2.3.2. Headline CPI inflation according to the baseline and alternative forecasts

Source: NBG, GeoStat

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

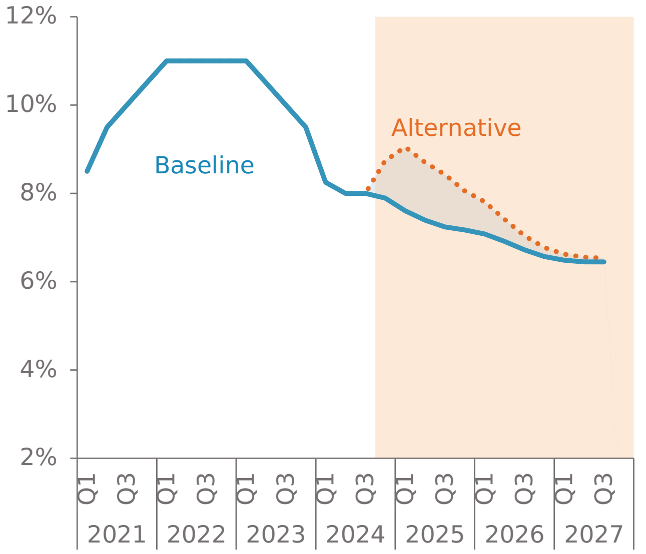

Figure 2.3.3. The monetary policy rate according to the baseline and alternative forecasts

Source: NBG

the forecast under the baseline scenario (see Figure 2.3.2).

Considering the National Bank of Georgia's risk management approach, it has a particularly low tolerance for increasing inflationary expectations. The latter would be met by a tightening of monetary policy and, if necessary, by the use of additional instruments. Should the alternative scenario be materialized, as compared to the baseline scenario, the trajectory of the monetary policy rate would shift upward by an average of 0.25 percentage points in 2024 and by a further 1.25 percentage points in 2025, with normalization occurring only gradually following a moderation of inflation expectations (see Figure 2.3.3).

2.4 FORECASTS OF FINANCIAL MARKET PARTICIPANTS

The short- and medium-term inflation expectations among financial market participants have been revised downward compared to the previous quarter's survey, while long-term expectations remain anchored around the target level.

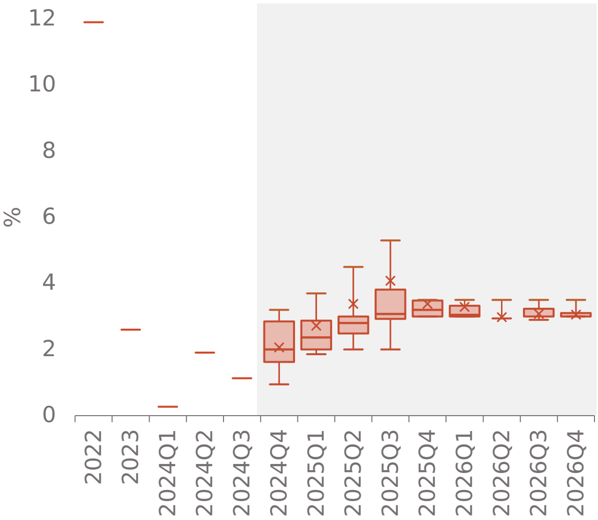

Figure 2.4.1. Actual average inflation (2022-2024Q3) and the distribution of market participants' forecasts for 2024Q4-2026Q4[10]

Source: NBG, financial market participants, GeoStat.

As of 10 October 2024, financial market representatives from eight organizations participated in the National Bank of Georgia's survey of macroeconomic forecasts. The survey results indicate shifts in short-, medium-, and long-term economic expectations compared to the previous quarter's survey.

Amid lower-than-expected actual inflation in the third quarter of 2024, financial market participants have revised their short-term inflation forecasts downward. As a result, the median inflation expectation for 2024 has decreased by 0.6 percentage points (pp) to 1.3%, while the average estimate declined by 0.9 pp, also reaching 1.3%. However, both medium- and long-term inflation expectations remain broadly aligned with the inflation target, similar to the previous quarter's results. Specifically, expectations for 2025 show both the median and average rates decreasing by 0.3 pp to reach 2.9% and 3.4%, respectively. For 2026, the median forecast remains unchanged at 3.0%, while the average has increased slightly by 0.3 pp to 3.1% (see Figure 2.4.1).

Amid the current macroeconomic environment, financial market participants' expectations for the monetary policy rate in the short to medium term have remained largely unchanged compared to the previous quarter.

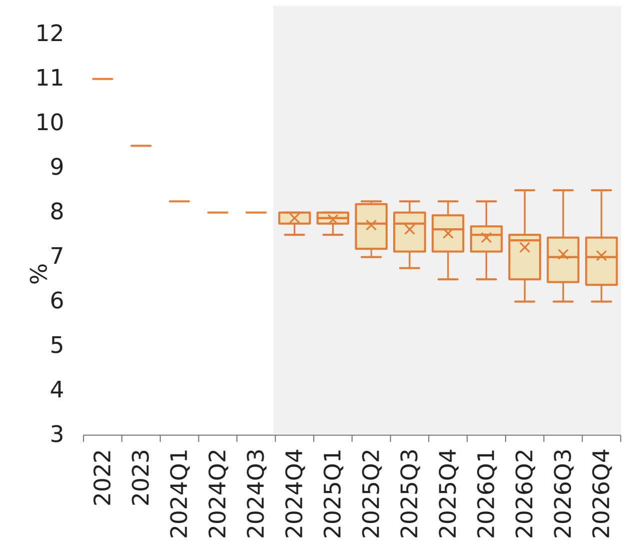

Figure 2.4.2. Actual monetary policy rate (2022-2024Q3) and the distribution of market participants' forecasts for 2024Q4-2026Q4

Source: NBG, financial market participants

In light of reduced short- and medium-term inflation expectations, forecasts for the monetary policy rate over these horizons have remained largely stable, with slight upward revisions made for the long-term period. The median forecast for the policy rate in 2024 remains at 8.1%, consistent with the previous quarter's projections, while the average has increased by 0.1 pp to 8.1%. For 2025, the median expectation has risen by 0.1 pp to 7.8%, while the mean remains unchanged at 7.8%, which is similar to the previous survey. Looking further ahead, as inflation expectations gradually align with the target, the projections for the monetary policy rate suggest a normalization towards the neutral rate. However, the outlook for 2026 has been adjusted slightly upward, with the median forecast rising by 0.2 pp to 7.2%, and the average increasing by 0.1 pp to 7.3% (see Figure 2.4.2).

Stronger-than-anticipated economic activity in the third quarter of 2024 has led to a significant upward revision in short-term growth forecasts by financial market participants. For 2024, the median expectation for real GDP growth has been adjusted upwards by 1.7 pp to 9.3%, while the average has increased by 1.8 pp to 9.2%. Medium-term growth forecasts for 2025 have also improved, with the median and average estimates both rising by 0.6 pp to reach 6.2% and 5.9%, respec-

10 The distribution of forecasts is depicted using boxplots. The upper horizontal line denotes the highest expectations of market participants, while the lower line signifies the lowest expectations. The central, colored rectangle displays the interquartile range, encapsulating the middle 50% of forecasts. The line within the rectangle indicates the median value, and the mean average forecast is represented by an "x".

In the current period, amid robust actual economic activity, financial market participants have significantly revised their short-term growth expectations upward compared to the previous quarter. It is noteworthy that their long-term growth expectations have also been adjusted upward.

tively. In the long-term outlook, the median forecast for real GDP growth in 2026 has increased by 0.2 pp to 5.5%, while the average rose by 0.1 pp to 5.4% (see Figure 2.4.3).

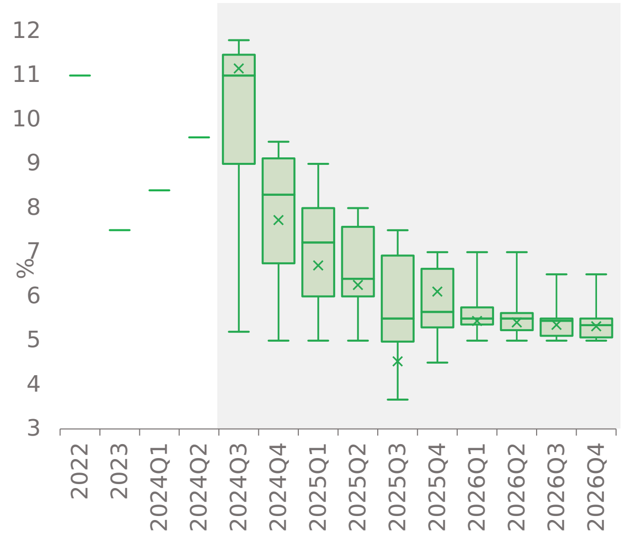

Figure 2.4.3. Actual real GDP growth (2022-2024Q2) and the distribution of market participants' forecasts for 2024Q3-2026Q4

Source: NBG, financial market participants, GeoStat

BOX 3. ESTIMATION OF THE NEUTRAL RATE IN GEORGIA

How tight is the monetary policy of the National Bank? What is the expected interest rate that economic participants should anticipate in the long run, after the dissipation of cyclical shocks?

Under an inflation-targeting regime, an assessment of the neutral rate can address such critically important questions. In the economic literature, the neutral rate is defined as the equilibrium rate that is formed in the market when cyclical factors in the economy are dissipated, output is at its potential, and inflation is maintained at the target level. Accordingly, if the monetary policy rate exceeds its neutral level, the stance of monetary policy is considered tight; whereas if it is lower, it stimulates aggregate demand and, all else being equal, accelerates inflation. In turn, it is the neutral rate that determines the optimal level of the monetary policy rate. Thus, inflation-targeting central banks, including the National Bank of Georgia, which primarily base their decisions on the Taylor-type monetary policy reaction function, consider the neutral rate to be a key variable (see FPAS documentation).[11] However, the neutral rate is an unobservable variable that needs to be estimated accordingly. When discussing it, it is important to consider its components. According to the Fisher equation, the nominal neutral rate can be expressed as follows:

Nominal neutral interest rate (i^N)=

Inflation expectations (π^e)+ Real neutral interest rate (r^*)

In turn, there are long-term and relatively short-term definitions for both inflation expectations and the real neutral rate. Specifically, regarding inflation expectations, under a credible monetary policy, we consider the inflation target to be a reliable proxy for long-term inflation expectations, while the expected year-over-year inflation after four quarters serves as a proxy for short-term inflation expectations. As for the real neutral rate, we refer to its relative long-term indicator as the natural or equilibrium (steady-state r^*) rate. It should be noted that, according to neoclassical economic growth theory, the natural real rate equates the demand and supply of savings in the long term and is driven by fundamental factors such as demographic conditions, technological progress, productivity, and others. In the relatively short term, the trend of the real neutral rate is more flexible in response to economic shocks.

11 Tvalodze, S., Mkhatrishvili, S., Mdivnishvili, T., Tutberidze, D., & Zedginidze, Z. (2016). The National Bank of Georgia's forecasting and policy analysis system. Available at: https://nbg.gov.ge/fm/fpas/nbg-wp-2016-01.pdf?v=8htvn

It should be noted that the estimation of the real neutral rate can be approached in different ways. One such approach is the real uncovered interest rate parity (real UIP), which is often used by inflation-targeting central banks. UIP is essentially a no-arbitrage condition, which implies that, given exchange rate expectations, risk-adjusted returns should be equal in both domestic and foreign equity markets. According to the uncovered interest rate parity, the neutral interest rate can be expressed as follows:

$$r^{*}=r^{*,foreign} + \textbf{Equilibrium of the Country Risk Premium} + \textbf{Expected Trend Change of RER}$$

The estimation of the neutral rate depends on assessing the equilibrium levels of various unobservable variables, such as the foreign neutral interest rate, the country's risk premium, and the expected changes in the real exchange rate. In the case of Georgia, the evaluation of these variables is grounded in both empirical and theoretical foundations and is as follows:

- In the case of **the foreign equilibrium interest rate**, the dynamics of US interest rates are considered due to their significance to both the Georgian and global economies. The estimate of the US neutral rate aligns with the communications of the US Federal Reserve System and the long-term expectations of US financial markets. In particular, recently, as a result of the pandemic and post-pandemic shocks, the estimate of the neutral rate in the US has been revised upward, and the current estimate of its equilibrium level is within the range of approximately 0.5-1.5%. In turn, considering capital mobility, a high neutral rate in the US also pushes the domestic real neutral rate to increase.
- **The UIP risk premium**, on the other hand, includes both Georgia's sovereign risk and GEL exchange rate risks. The evaluation of the sovereign risk premium is carried out using the bond index of developing countries (the EMBI Index), which has been improving since 2009. As for the exchange rate risk premium, since this is an unobservable variable, we estimate it using GEMO and empirical methods. Finally, the long-term equilibrium level of the UIP risk premium is in the range of 3.5%, while the short-term trend of the premium is around 3-3.5% and is characterized by relatively high volatility (see Figures 2.4.4. and 2.4.5.).
- **The expected change in the exchange rate** is an important component of the real neutral rate. A strengthening of the exchange rate reduces the real neutral rate, while depreciation has the opposite effect. It should be noted that, after 2022, Georgia's real exchange rate against the dollar and other main trading partner currencies strengthened significantly. This can be explained by both cyclical and fundamental factors. In particular, against the backdrop of strong foreign inflows and structural changes to the economy, as revealed by significantly increased productivity in the trade sector, the long-term equilibrium level of the exchange rate has in-

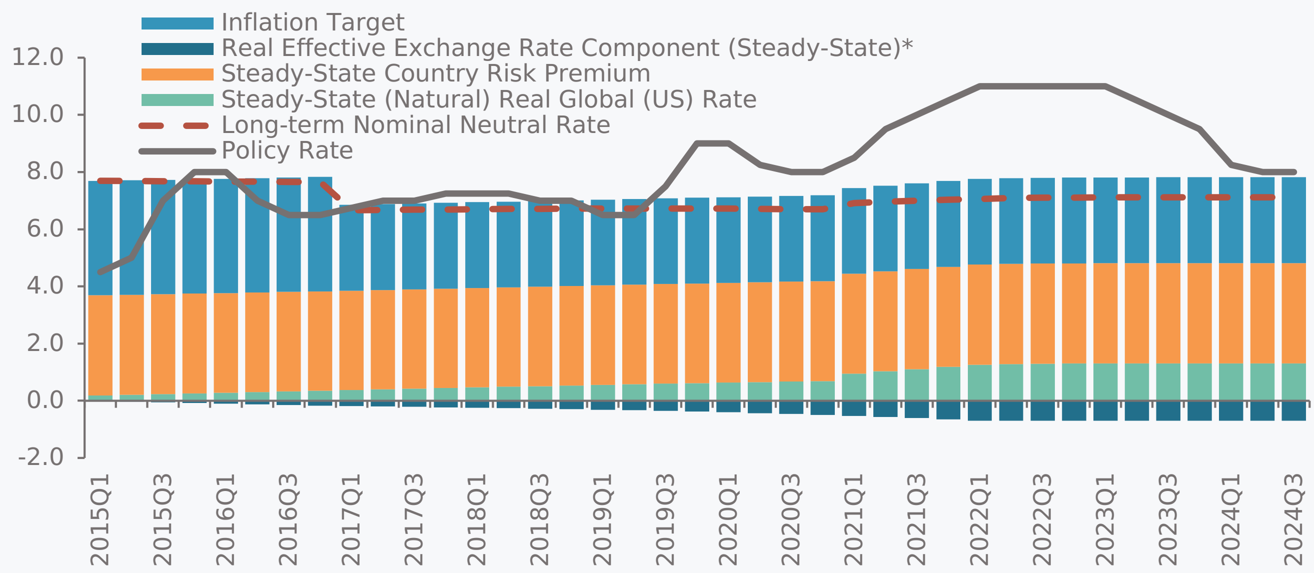

Figure 2.4.4. Decomposition of the long-term neutral rate[12]

Source: NBG

12 *Based on the Real Effective Exchange Rate (REER) of the real UIP, we assume that the trend depreciation of the currencies of trading partners against the US dollar is zero. A strengthening REER lowers the neutral rate, while depreciation increases it.

creased and is currently estimated to be within the range of 0.5-1% appreciation. However, it should be noted that both geopolitical and internal risks, as well as the normalization of productivity, contribute to high uncertainty surrounding the exchange rate.

Based on the above reasoning and considering that the inflation target is 3%, the nominal long-term neutral rate is approximately 7% (see Figure 2.4.4).

Over the relatively short-term horizon, in consideration of cyclical factors, inflation expectations after four quarters, and the assessment of short-term trends in the aforementioned variables, the neutral rate is much more volatile. Currently, the short-term neutral rate is also estimated to be around 7% (see Figure 2.4.5).

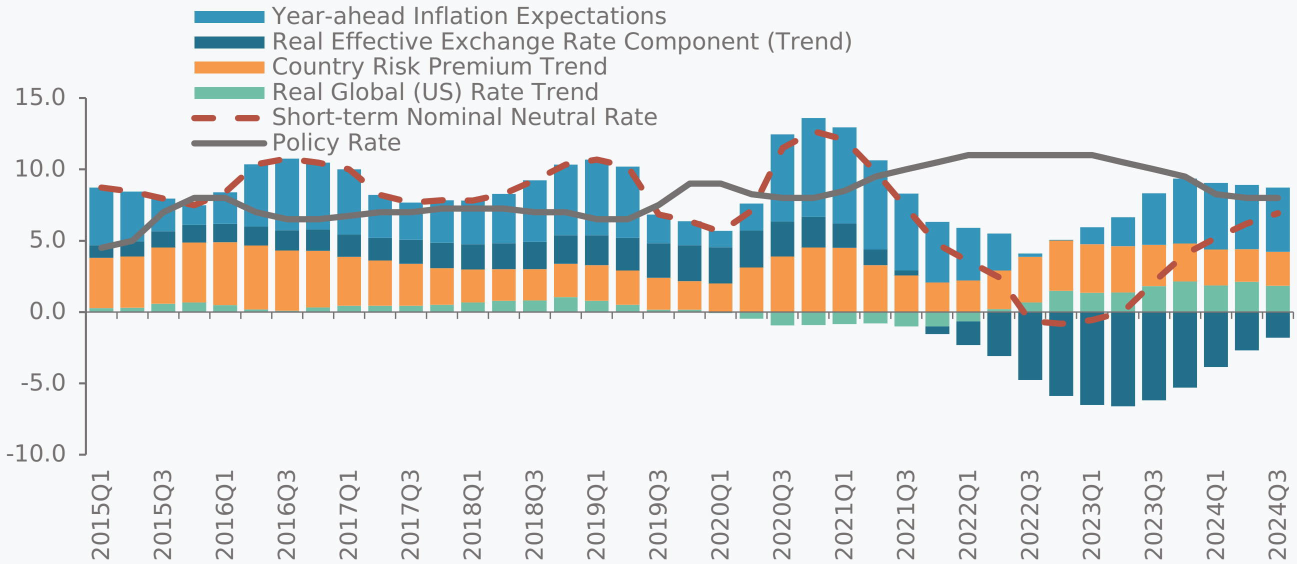

Figure 2.4.5. Decomposition of the short-term neutral rate

Source: NBG

3 MONETARY POLICY

Throughout 2024, the overall increase in the price level was significantly lower than the target of 3%. Considering the 0.6% inflation rate in September, average inflation for the third quarter stood at 1.1%. This containment of inflation within the target range was largely achieved by the monetary policy implemented by the National Bank of Georgia, which involved both timely tightening and a gradual normalization. The policy contributed to the stabilization of long-term inflation expectations. The inflation of domestically produced goods remains lower than the target rate of 3%. At the same time, increased competition and reduced margins by companies have supported the low level of inflation. According to the NBG's updated forecast, inflation is expected to remain below the target in 2024, averaging 1.2%. Subsequently, inflation will gradually approach the target rate and, partly due to base effects, will then temporarily exceed 3%, before stabilizing around the target level again. However, despite certain positive trends being observed, uncertainties related to both external and domestic sectors remain. Additionally, despite the rapid growth of the economy's potential, inflationary pressure stemming from domestic demand remains a significant concern.

In light of these factors, the National Bank of Georgia continues to follow a cautious approach, pursuing a policy of exiting its tight monetary stance in small steps. Accordingly, at its meeting on 23 October 2024, the NBG decided to leave the monetary policy rate unchanged at 8.0%.

On 23 October 2024, the NBG decided to keep the policy rate unchanged at 8.0%. The National Bank of Georgia will continue the neutralization of its tight monetary policy stance at a slow pace.

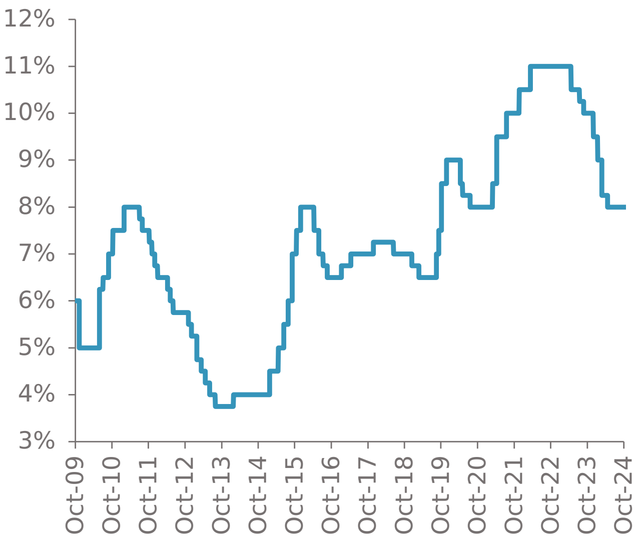

Figure 3.1. Monetary policy rate

Source: NBG

Against the backdrop of external shocks and the geopolitical developments of recent years, uncertainty regarding inflation dynamics remained high globally. In response to high inflationary pressures, leading central banks significantly tightened their monetary policies. Recent indicators show that economic growth has normalized globally, inflation has passed its peak, and a decreasing trend is evident among many of Georgia's trade partners. In response, most central banks, including major ones, have begun lowering their policy rates. However, despite the downward trend, inflationary pressures, especially in the service sector, remain a significant challenge, thus limiting the pace at which financial conditions can be eased.

In Georgia, inflation has been declining since the beginning of 2023 and has remained below the target since then. The maintenance of low inflation is supported by the trend of relatively rigid prices. Specifically, domestic inflation, as influenced by long-term factors and characterized by rigidity, remains below the target.

In contrast, geopolitical factors and trends in international markets have exerted more pressure on imported inflation. As a result, average imported inflation exceeded 3% in the second quarter of 2024 but showed signs of normalization towards the target in the third quarter. Additionally, since the beginning of the year, the reduction in electricity tariffs has been another factor contributing to low inflation. Prices of mixed-type goods continue the deflationary trend from the previous year, with the average in the third quarter of 2024 standing at -0.7%. Notably, in the first half of the year, the same indicator was -2.2%, indicating a trend that the deflationary impact of mixed goods' prices is gradually weakening. Service inflation also continues to show a declining dynamic. According to the National Bank of Georgia's updated forecast, keeping everything else constant, low inflation is expected to persist in 2024, averaging 1.2%. Inflation will then approach the target rate in the first half of 2025, temporarily exceeding it due to base effects, before stabilizing around 3% by the end of 2026.

It is also noteworthy that, amid stronger-than-expected economic activity, the forecast for real GDP growth in 2024 has been revised upwards to 8.5%, while the forecast for economic growth in 2025 remains around 5%. The current forecast is higher than previous expectations as a result of the growth of the economy's potential and stronger-than-expected aggregate demand. Strong domestic demand has mainly been supported by two factors: high credit activity and the growth of real disposable incomes due to low inflation. Credit activity positively impacts consumption and, consequently, it will contribute positively to 8.5% economic growth in 2024.

Due to the uncertainty surrounding global and local processes, risks that could alter the current forecast remain high. In case of realization, these risks may increase the risk premium of the region and create pressure of prices from various channels. Considering the war in Ukraine and geopolitical tensions in the Middle East, external risks are noteworthy.

Specifically, since the beginning of the year, the trend of declining prices on international commodity markets has significantly slowed and, by September, rising prices had replaced the previous decline. Although commodity prices are lower than their peak levels, they still exceed pre-pandemic levels, and there is little likelihood that they will return to the latter. Overall, uncertainty surrounding future price dynamics remains high.

A similar picture is emerging regarding fuel price dynamics. Given the tensions in the Middle East, it is expected that the price of Brent crude oil may rise. Moreover, geopolitical risks stemming from the tense relationship between Israel and Iran are likely to push transportation costs higher. Events in the Red Sea region also exert some influence on rising shipping costs. It should be noted that in the early months of 2024, transportation costs gradually declined compared to the end of 2023. However, an escalation of ongoing conflicts could negatively impact the cost of transportation. Whilst deteriorating expectations surrounding the Red Sea route increase the attractiveness of the Middle Corridor, the development of a recession in China may negatively affect cargo turnover through the Middle Corridor.

The discussed trends highlight the significance of evaluating external risks. As a small open economy, Georgia is vulnerable to international developments and global inflationary risks also remain relevant.

Domestic economic trends also continue to be of concern. Credit activity is still on the rise and, as a result, domestic demand remains strong, pushing total output above its potential level. The increase in credit activity and strong domestic demand justify the retention of a cautious approach. Given geopolitical tensions, uncertainty surrounding transportation costs, and the prices of raw materials and commodities on international markets, inflationary risks persist.

Overall, amid strong domestic demand and heightened uncertainty due to various geopolitical factors, macroeconomic forecasts continue to carry high risks that are primarily inflationary in nature. Should these risks materialize, adopting appropriate monetary policy responses will be necessary.

It is worth noting that against the backdrop of the trends observed over the past few quarters, monetary policy has gradually normalized, with the policy rate steadily reduced by 3 percentage points from its peak of 11%. However, due to existing risks and the fact that the policy rate is approaching its neutral level, the pace of the reduction has slowed.

In light of the aforementioned factors, at a meeting held on 23 October 2024, it was decided to maintain the monetary policy rate at 8.0%. If factors emerge that push inflation expectations upward, a further tightening of monetary policy or the prolonged maintenance of the current stance may be required. If necessary, the National Bank of Georgia will use additional tools to mitigate inflationary pressures stemming from demand.

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.

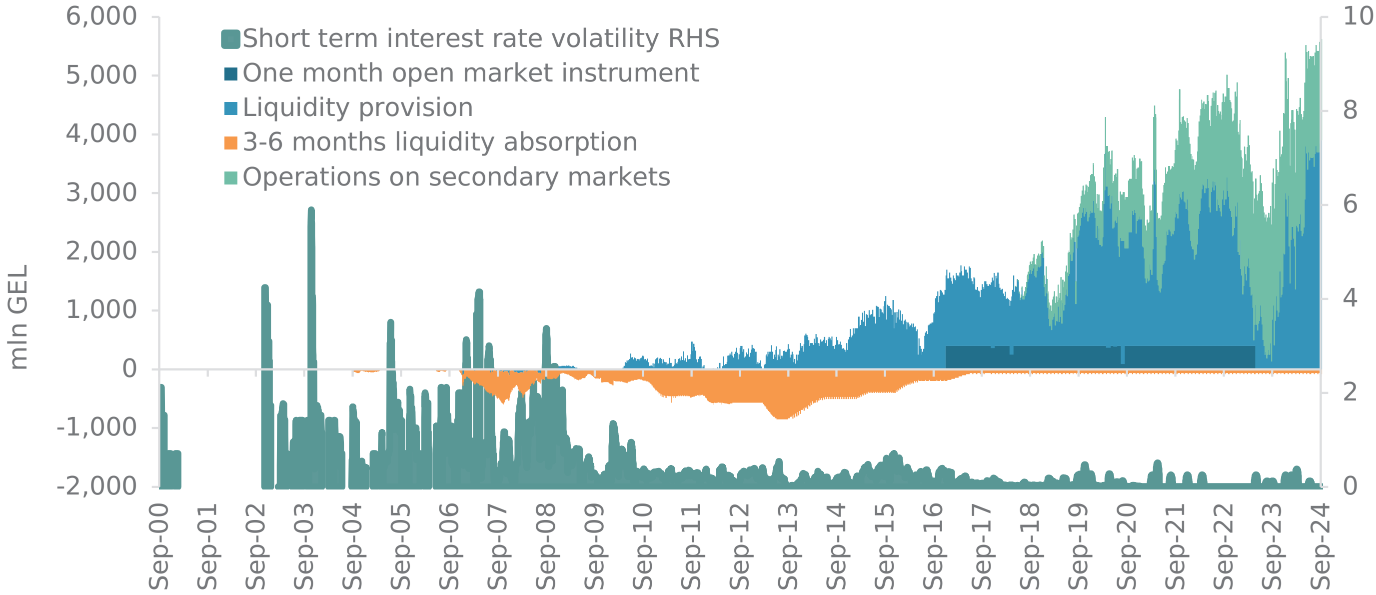

Figure 3.2. Liquidity instruments

Source: NBG

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

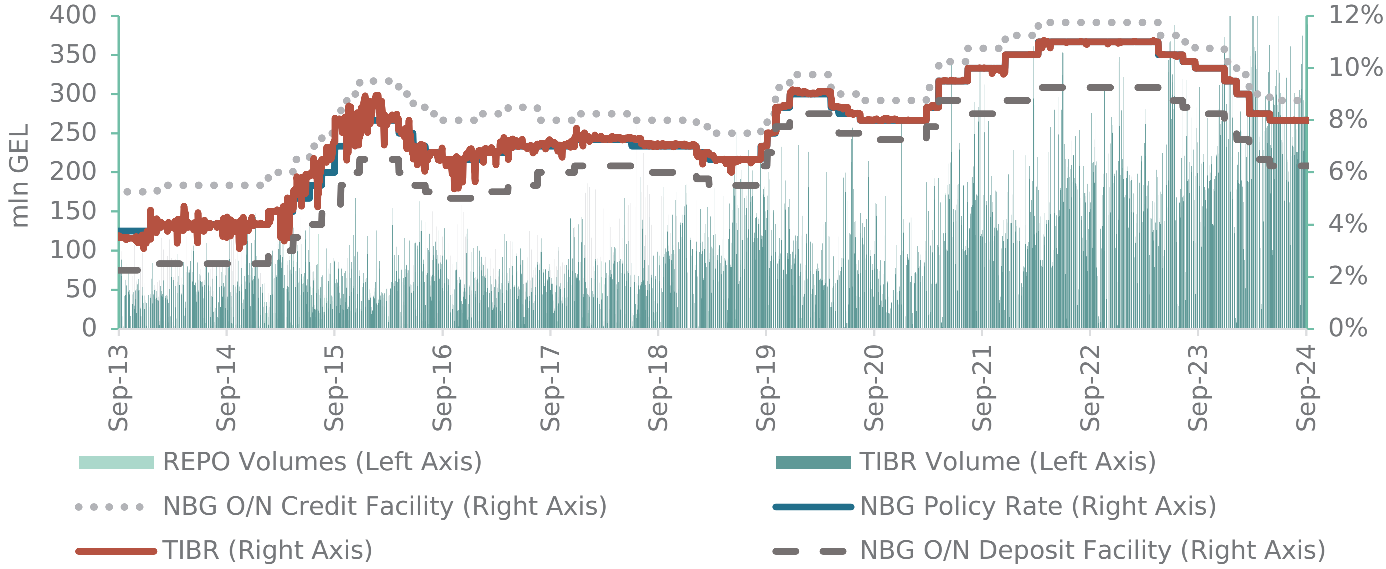

Figure 3.3. Interbank money market

Source: NBG

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