საქართველოს ეროვნული ბანკი
National Bank of Georgia

MONETARY POLICY REPORT

JANUARY 2025

PREFACE

The primary objective of the National Bank of Georgia (NBG) is to ensure price stability, which, in turn, supports the country's long-term economic growth. In pursuit of this objective, the NBG operates within an inflation-targeting framework, which was formally adopted in 2009. Within this framework, the NBG conducts its monetary policy in a way that inflation approaches its target level of 3% in the medium term.

The primary tool of the NBG under its inflation-targeting framework is the monetary policy rate. When making decisions about the rate, the primary focus is on the inflation forecast, as the full economic impact of the decision takes some time (4-6 quarters) to materialize. Therefore, macroeconomic forecasts are the key component in shaping monetary policy, and their effective communication is crucial for anchoring inflation expectations. Additionally, the communication of these forecasts plays an important role in the decision-making process of businesses and households.

In recent years, amid global developments, uncertainty has increased. Given the heightened unpredictability of future economic conditions and its broad scale, it is essential for central banks to choose an optimal decision when conducting monetary policy to minimize economic losses in the event of any risk materializing. In a dynamic economic environment, a monetary policy approach focused on managing risks is critical for achieving optimal outcomes. This is evidenced by the experience of central banks in the post-pandemic period. Central banks, including the NBG, that made decisions based on the approach of minimizing the impact of risks, have managed the globally prevailing inflationary pressures with relatively greater success. Accordingly, policymakers are increasingly emphasizing the importance of a scenario-based approach, within which monetary policymakers make decisions based on the development of various relevant scenarios. This systematic assessment of scenarios and their impact enables policymakers to effectively navigate the inflation-output tradeoff.

The NBG is introducing a new, scenario-based approach to monetary policy communication, making the process of risk management and decision-making more transparent. With this step, the NBG is moving to the next stage of developing the framework for monetary policy, where, alongside deepening collaboration between the NBG and financial-market participants, the role of market participants' expectations will gradually gain more significance.

Generally, within a scenario-based approach, the first stage involves assessing market expectations both in Georgia and globally. Subsequently, the NBG analyzes a wide array of risks and, in response, prepares conditional trajectories for the monetary policy rate if those risks were to materialize. This, in turn, enhances the transparency and understanding of the monetary policy reaction function, thereby improving the effectiveness of monetary policy transmission channels.

Under the scenario-based approach, the National Bank of Georgia publishes three forecast scenarios:

- **The Central Scenario**, which incorporates a comprehensive range of current information, including expectations in both the local financial market and global markets, and accounts for risks that are consistent with this information.
- **The Higher-Inflation Risk Scenario**, which, compared to the central scenario, incorporates **risks that are more inflationary** over the monetary policy horizon and is particularly relevant in light of the prevailing uncertainty.
- **The Lower-Inflation Risk Scenario**, which, compared to the central scenario, incorporates **more disinflationary risks** over the monetary policy horizon and is particularly relevant in light of the prevailing uncertainty.

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MONETARY POLICY DECISION

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

On January 29, 2025, the Monetary Policy Committee of the National Bank of Georgia (NBG) decided to keep the monetary policy rate (refinancing rate) unchanged. The monetary policy rate stands at 8 percent.

Since the beginning of 2023, inflation in Georgia has remained below the target level of 3%. In December 2024, the overall price level increased by 1.9% year-on-year. Maintaining inflation close to the target was largely determined by domestic economic factors. Specifically, the stability of long-term inflation expectations is an outcome of the NBG's consistent monetary policy. The prices of domestically produced goods and services, which are relatively sticky and best reflect long-term inflation expectations, are increasing at a slow pace-with an year-over-year change of 2.2% in December. Meanwhile, economic activity in 2024 remained robust, with an average growth of 9.4% from January to November. Growth was significantly driven by an increase in the economy's potential output, which helped ease inflationary pressures stemming from robust aggregate demand. Among external factors, lower fuel prices have contributed to reducing inflation compared to the previous year. However, the increase in international food commodity prices has been partly passed on to the domestic market, leading to a slight rise in inflation compared to the previous month.

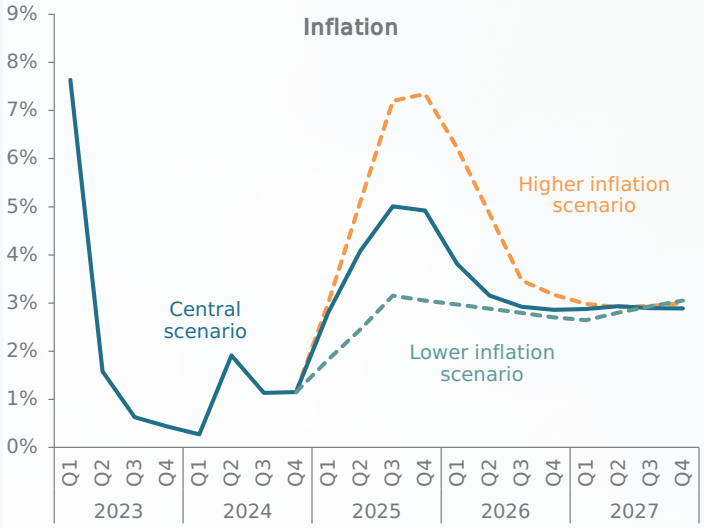
Despite these tendencies, domestic and geopolitical turbulence has increased uncertainty, affecting sentiments. If the prevailing uncertainty dissipates in the short term and the situation in international markets remains stable, inflation is expected to remain close to the target in the first half of 2025. Subsequently, partly due to base effects, inflation may temporarily overshoot the target and stabilize around 3% in the medium term. Meanwhile, economic growth will return to its long-term trend of 5%. A similar potential development is reflected in the NBG's central scenario and is largely in line with the current expectations of financial markets.

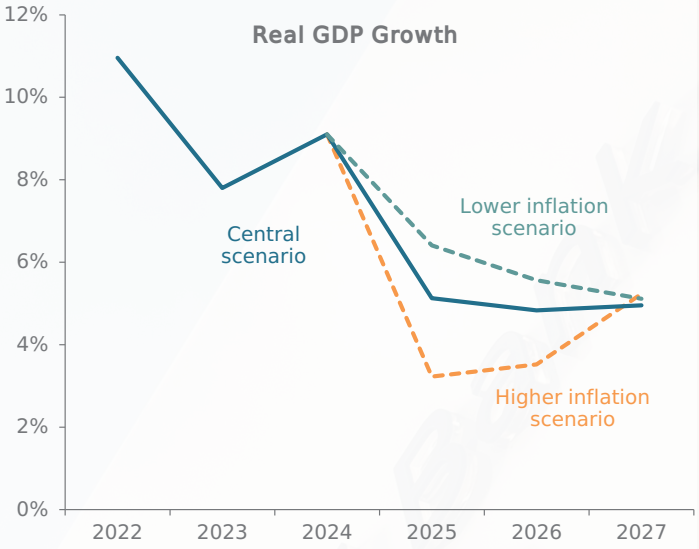
In order to effectively manage the potential risks stemming from high uncertainty, the NBG evaluates various scenarios. On one hand, the Monetary Policy Committee has considered a high-inflation risk scenario, where the realization of fundamental factors would require a higher path for the policy rate than in the central scenario. This scenario entails the prolonged uncertainty, further intensifying the geopolitical situation. The realization of these risks would amplify inflationary pressures coming from external factors and dampen economic growth relative to its long-term trend.

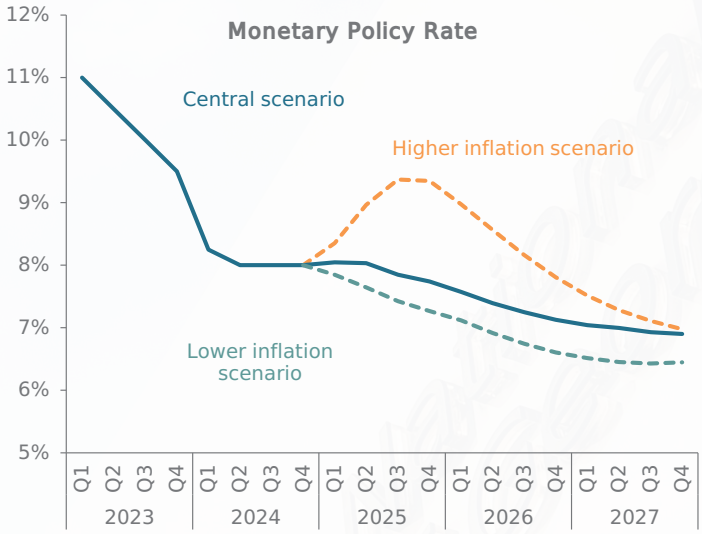
On the other hand, the Monetary Policy Committee has considered a low-inflation risk scenario, where the realization of fundamental factors would require a lower trajectory for the monetary policy rate compared to the central scenario. This risk scenario entails the de-escalation of the geopolitical tensions, which would reduce inflationary pressures arising from external factors. Whilst, economic growth, bolstered by a lower sovereign risk premium, would accelerate relative to its long-term trend. As a result of the analysis of the current state of the economy and forecast scenarios, the Monetary Policy Committee has considered it optimal to adopt a cautious approach toward further normalizing the policy rate, keeping it unchanged at 8%. As the risks subside, the policy rate will gradually normalize toward a neutral level of 7%. If macroeconomic data at the upcoming meeting indicate a more inflationary or disinflationary realization of risks, the Committee will adjust its stance accordingly.

The NBG will use all available instruments to maintain price stability. This means keeping the overall price level increase close to the 3% target over the medium term.

NBG's Macroeconomic Forecast Scenarios







1. OVERVIEW OF THE GLOBAL MACROECONOMIC ENVIRONMENT

In the U.S., the expected path of the Fed Funds Rate for both short and medium terms have been revised substantially upward in recent months due to higher-than-expected inflation and economic growth.

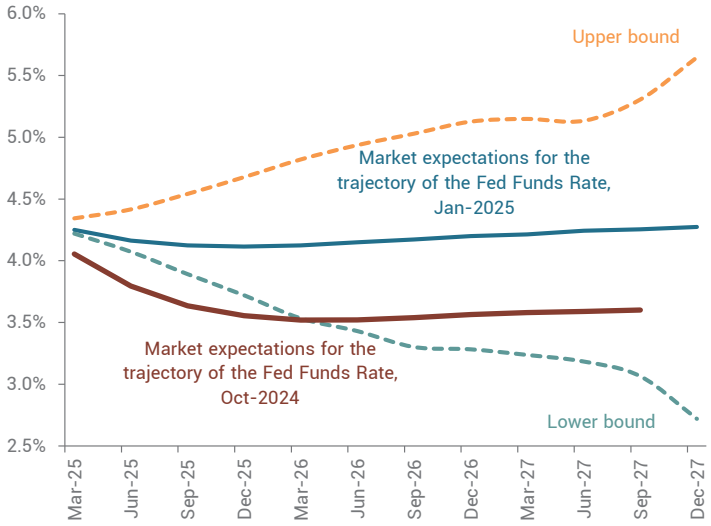


Figure 1.1: Market Expectations of Fed Funds Rate Path

Source: Atlanta Fed.

Amid expectations of higher interest rates in the U.S. and heightened uncertainty, the global Dollar Index (DXY) has strengthened significantly.

Figure 1.2: Dollar Index (DXY)

Source: Bloomberg.

The latest IMF World Economic Outlook report projects global growth of 3.3% for both 2025 and 2026[1], but the global economy continues to navigate a landscape marked by significant uncertainty and risks.

Substantial uncertainty remains in the U.S. as well. Recently, the expected path of the Fed Funds Rate has been revised upward, due to higher than expected inflation expectations (see Figure 1.1). This was driven, on the one hand, by stronger-than-expected economic growth, primarily fueled by consumption, and on the other hand, by potential policy shifts in the U.S. – such as stricter immigration controls, corporate tax cuts, and higher tariffs. The latter also highlights the risks of deglobalization, a concern increasingly discussed by monetary policymakers[2]. Meanwhile, these aforementioned changes put upward pressure on the U.S. neutral rate and contribute to the tightening of global financial conditions.

Additionally, since the dollar is the globally dominant currency, demand for it has risen amid heightened global uncertainties, as reflected in the strengthening of the Dollar Index (DXY) (see Figure 1.2). This, in turn, reinforces the incentives for capital outflow from emerging countries and exerts upward pressure on their neutral rate.

Economic activity in the Eurozone has slowed, largely due to ongoing challenges in the manufacturing sector. The service sector remains the primary driver of current economic activity. Meanwhile, the medium-term outlook has also deteriorated, driven by underlying structural issues (see Figure 1.3). The possible introduction of U.S. tariffs is expected to further exacerbate the slowdown in productivity growth and reduced competitiveness.

Furthermore, China's economic growth forecast still remains below potential, fueled by challenges in their property market and a decline in

1 *International Monetary Fund. 2025. The World Economic Outlook Update: Global Growth: Divergent and Uncertain. Washington D.C., January.*

2 *Christopher J. Waller, Fed board member; https://www.federalreserve.gov/newsevents/speech/waller20250108a.htm*

Economic growth expectations among trade partners have deteriorated, largely due to structural challenges in these economies.

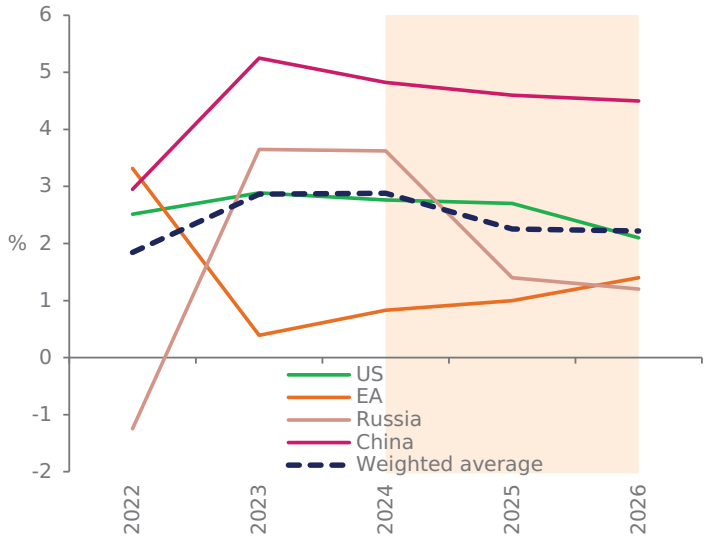


Figure 1.3: Real GDP Growth of Economic Partner Countries*

Source: International Monetary Fund (IMF), NBG.

*The weights for the weighted average growth are determined by the country's share in Georgia's foreign trade turnover.

Amid weak demand from China, oil prices have been characterized by decreasing tendency, while food prices have risen due to unfavorable climatic conditions. On the other hand, amid heightened uncertainty worldwide, global demand remains volatile. Consequently, the medium-term outlook for commodity prices continues to be uncertain.

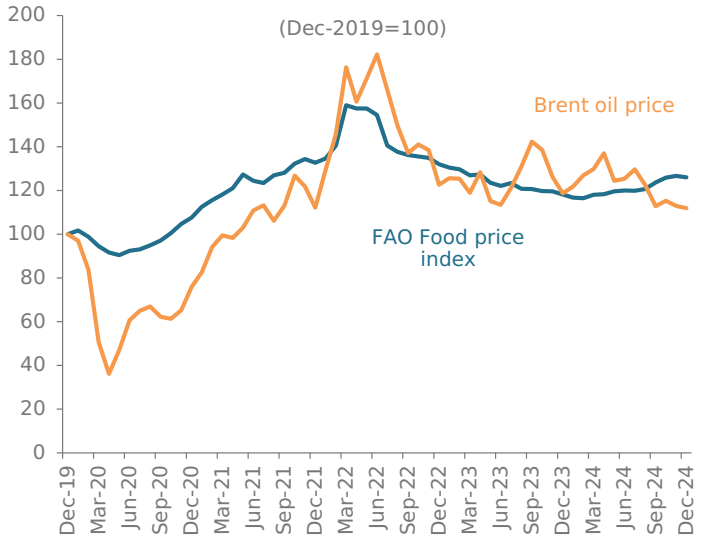


Figure 1.4: International Commodity Prices, Index, Dec-2019=100

Source: FAO, FRED, NBG.

consumer sentiment, both of which have dampening effects on domestic demand. Sluggish demand from the Eurozone and the possible introduction of U.S. tariffs could worsen the growth prospects of export-dependent economies in the medium term.

According to the IMF's assessment, Russia experienced strong growth in 2024, largely due to increased military spending. In response to inflationary pressures, stemming from a tight labor market, the central bank has tightened monetary policy, with the possibility of further tightening because of elevated inflation expectations. Alongside anticipated stricter sanctions, these factors are likely to weaken Russia's economic growth outlook in the medium term.

As a result, the slowdown in economic activity in these countries will dampen external demand for Georgia, both through direct trade and financial channels. Consequently, this will have a negative impact on the current account balance.

Elevated uncertainty is also contributing to fluctuations in the international commodity prices. Amid unfavorable climatic conditions, food prices exhibited an upward tendency in 2024, although this was partially offset by weakening aggregate demand in China and other major economies. As for oil products, considering factors from both the supply and demand sides, prices continued to normalize (see Figure 1.4). However, some fluctuations have been observed in the recent period. Amid the recent US sanctions imposed on Russia, the price of Brent crude oil initially moved higher but after a ceasefire agreement was reached in the Middle East prices have since moderated.

Amid elevated uncertainty, there are competing views on the future direction of commodity prices. On the one hand, from the second half of 2025, the anticipated lifting of supply restrictions by OPEC and the potential increase in oil product supply by non-OPEC countries will ease pressure on oil prices. Meanwhile, ongoing geopolitical tensions in the Middle East, supply chain disruptions, and worsening climatic conditions could exert upward pressure on international food prices. Accordingly, in Georgia, on the one hand, declining international Brent oil prices would put downward pressure on imported inflation (without taking into account the exchange rate effect), while on the other hand, the potential rise in international food prices will have the opposite effect.

2. OVERVIEW OF THE CURRENT MACROECONOMIC ENVIRONMENT IN GEORGIA AND FORECAST SCENARIOS

In recent years, high economic growth has been driven, on the one hand, by structural changes in the economy. On the other hand, by strong aggregate demand.

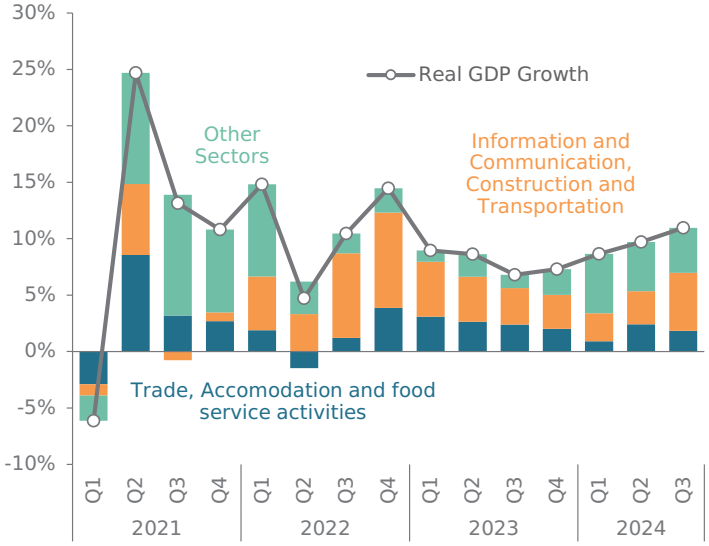


Figure 2.1.1: Sectoral Decomposition of Real GDP growth (Contribution to the Growth)

Source: NBG, Geostat.

Strong aggregate demand was supported by a combination of external and domestic factors.

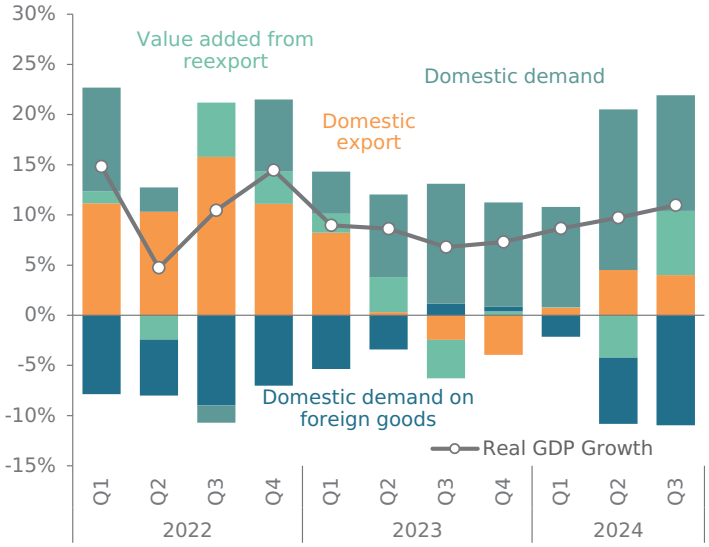


Figure 2.1.2: Decomposition of Real GDP Growth by Expenditures (Contribution to the Growth)

Source: NBG, Geostat

*__Domestic demand__ includes final consumption expenditures and gross capital formation (so-called absorption).

__The value added from re-export__ refers to the revenue generated from re-exports, excluding the imports intended for re-export.

__Domestic demand on foreign goods__ includes imports, excluding products intended for re-export.

2.1. OVERVIEW OF THE CURRENT MACROECONOMIC ENVIRONMENT IN GEORGIA

According to preliminary estimates, economic growth averaged 9.4% from January to November 2024. Robust economic growth stemmed, on the one hand, from structural changes within the economy. Specifically, during the post-pandemic period, the contribution of sectors characterized by relatively high labor productivity increased. For example, growth in the information and communication, construction, and transportation sectors accelerated significantly, contributing to the expansion of the economy's long-term potential (see Figure 2.1.1). On the other hand, strong aggregate demand also supported high economic activity. Consequently, sectors such as trade and accommodation services made a significant contribution to economic growth.

Notably, robust aggregate demand was influenced by both domestic and external factors (see Figure 2.1.2). Against the backdrop of monetary policy normalization, the increase in credit activity denominated in Georgian Lari (GEL) also served as a stimulus for domestic demand. Moreover, the extension of the maximum maturity period for non-collateral consumer loans by the NBG further boosted GEL-denominated consumer lending, leading to an additional rise in overall credit activity (see Figure 2.1.3).

The strong domestic demand was also supported by rising real income. Since 2023, real incomes and wages have risen sharply, serving also as the drivers of consumption. Wage growth can be attributed to increased labor productivity as well as, compensation for the past inflation (see Box 1). Additionally, the prevailing low-inflation environment has sustained strong real wage growth, further underpinning consumption (see Figure 2.1.4).

In terms of external demand, the dynamics of inflows from both goods and especially services exports are noteworthy. In recent years, the promotion of Georgia's role as a Middle Corridor country has intensified international transportation; further emphasizing the importance of the transportation sector. Data from the first three quarters of 2024 show that income from transportation services averaged 5.2% of GDP. Additionally, since 2022, the significantly increased income from computer and information services has currently remained at a relatively high level,

Credit activity is one of the sources of domestic demand.

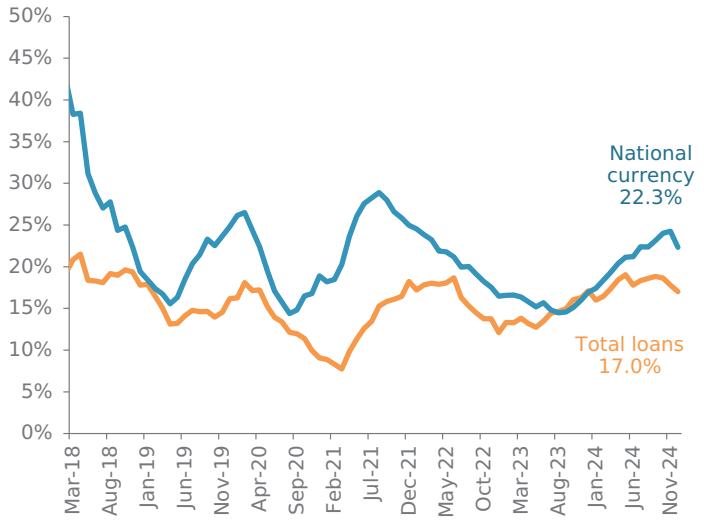


Figure 2.1.3: Year-over-year Growth Rate of Loans (Excluding Exchange Rate Effects)

Source: NBG.

The high growth of real wages stimulates strong consumption.

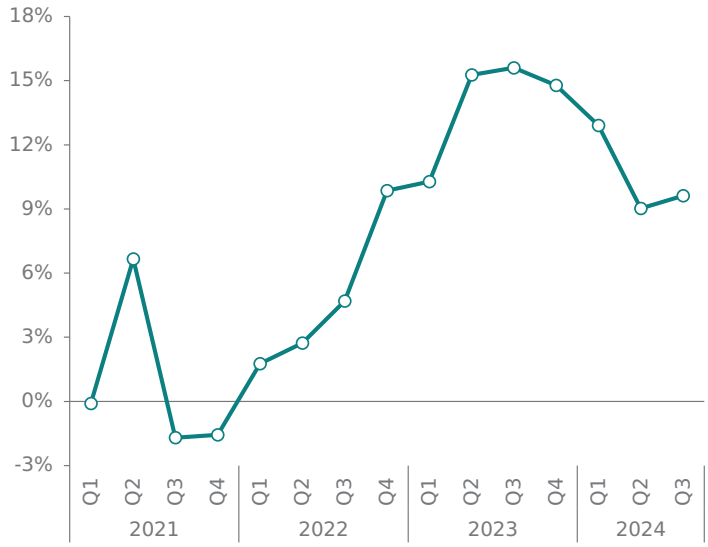


Figure 2.1.4: Year-over-year Growth Rate of Real Wages*

Source: Geostat, NBG

* **Real wages** represent adjusted nominal wages by the price level.

accounting for an average of 1.9% of GDP in the first three quarters of 2024. Furthermore, in 2024, income from service exports was also augmented by a 7.3% year-on-year increase in tourism inflows.

Meanwhile, in 2024, the import of goods increased due to robust consumption. However, purchases of motor cars intended for re-export slowed, as previously imported cars were re-exported after a brief period. This delay resulted in a higher-than-expected increase in re-export revenue. Revenues from domestic goods exports increased year-on-year, partly reflecting the base effect from the previous year. As a result, goods exports grew by 7.8% in 2024 (see Figures 2.1.2 and 2.1.5).

Given the aforementioned, according to the latest estimates, the current account deficit as a percentage of GDP in 2024 remains close to its sustainable level (current estimate: 5-5.5%). This, coupled with the depreciation of exchange rates in trading partner countries, also supported the maintenance of the previously appreciated nominal exchange rate of the GEL (see Figure 2.1.6). Recently, against the backdrop of the fading effect of the appreciated nominal exchange rate on a yearly basis and the domestic low-inflation environment, the real effective exchange rate has depreciated year-on-year. However, according to current estimates, it remains above its equilibrium level.

In turn, the heightened uncertainty exerts an impact on sentiment, which has already been manifested in the volatility of certain indicators. Specifically, by the end of 2024, the spread between the yields on Georgia's and the U.S. government's 5-year dollar-denominated bonds widened, potentially signaling an increase in sovereign risk (see Figure 2.1.7). However, at this point, its level remains near equilibrium, with a slight decrease observed at the beginning of 2025.

Notably, the global dollar index has strengthened. Following higher-than-expected inflation and robust economic activity in the US, the pace of monetary policy normalization has slowed (as mentioned above), leading to the tighter financial conditions. The current heightened global uncertainty and domestic circumstances, along with exchange rate volatility, are prompting both businesses and households to hold their capital in the dominant currency. This shift is further supported by higher interest rates on foreign currency deposits (see Figure 2.1.8). This tendency has been observed in the recent rise in deposit dollarization as well (see Figure 2.1.9).

Ultimately, amid heightened uncertainty cer-

According to current estimates, the current account deficit as a percentage of GDP in 2024-2025 will remain close to its sustainable level.

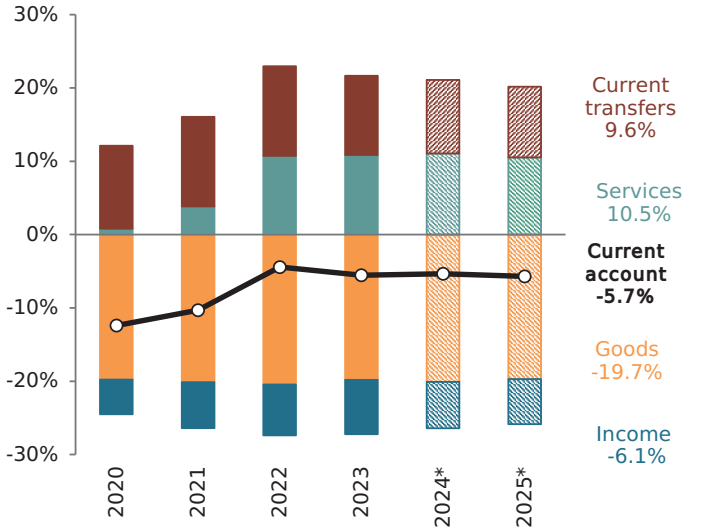


Figure 2.1.5: Current Account Balance Decomposition (% of GDP)

Source: NBG

*According to the BPM5

In 2024, the real effective exchange rate showed a year-over-year depreciation, influenced by both the inflation differential and the nominal effective exchange rate. According to current estimates, it has been converging toward its equilibrium level.

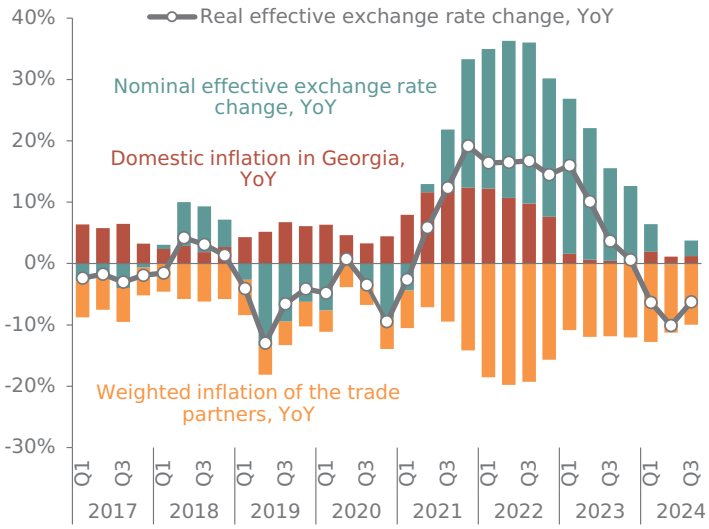


Figure 2.1.6: Decomposition of the Year-over-year Change in the Real Effective Exchange Rate of the Georgian Lari (GEL).

Source: NBG, Geostat.

* **The Real exchange rate** and its components are presented in logarithmic terms, and, accordingly, their year-over-year changes are a first-order approximation of percentage changes.

tain risks have emerged, but have not yet materialized into inflationary pressures. Inflation remains below the target level of 3%. Low inflation is driven by the domestic economic factors. Specifically, inflation of domestically produced goods and services is within the target range, indicating stability in long-term inflation expectations. Additionally, improvement in the overall potential of the economy in the last year has somewhat eased the pressure from high aggregate demand. On the other hand, improved productivity has helped relieve cost pressures on firms, which has eased upward pressure on prices. Regarding international market tendencies and their impact, the drop in fuel prices compared to the previous year has driven deflation in imported goods (see Figure 2.1.10). However, the recent increase in international food commodity prices, such as sunflower oil and sugar, has partially transmitted to the domestic market, leading to a moderate rise in inflation compared to previous months (see Figure 2.1.11).

Amid heightened uncertainty, the country's sovereign risk premium increased in the second half of 2024 compared to the beginning of the year, but remains close to its equilibrium level.

Figure 2.1.7: The Spread between the Yields on 5-year Dollar-denominated Government Bonds of Georgia and the U.S.

Source: Bloomberg, NBG.

The upward revision of the expected trajectory of the U.S. monetary policy rate was also reflected in the increase in interest rates on foreign currency deposits.

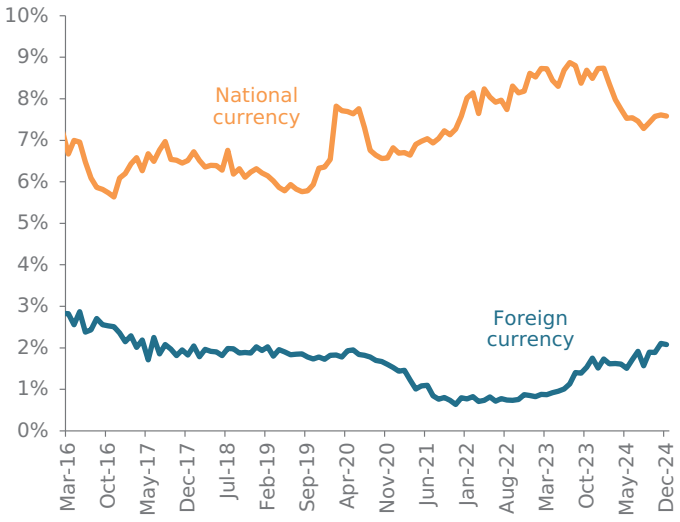


Figure 2.1.8: Interest Rates on the Deposit Flows Issued in National and Foreign Currencies.

Source: NBG.

Recently, elevated uncertainty has been reflected in the rise of deposit dollarization.

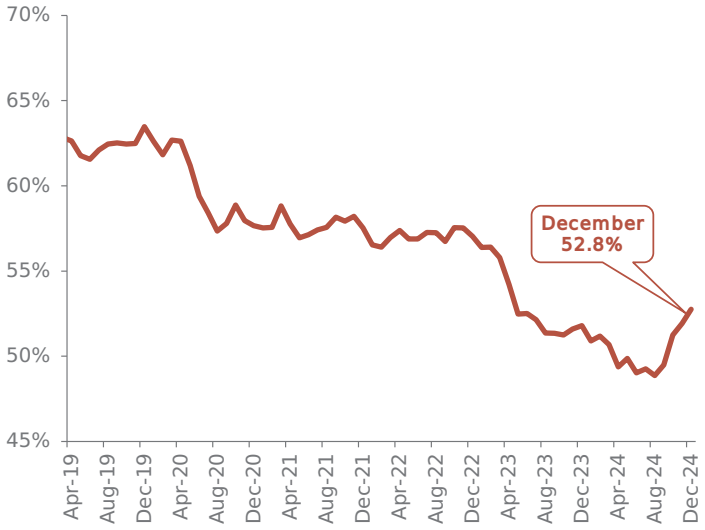


Figure 2.1.9: Deposit Dollarization (Excluding Exchange Rate Effects)

Source: NBG.

Inflation remains below the target level, due to both, domestic and imported factors.

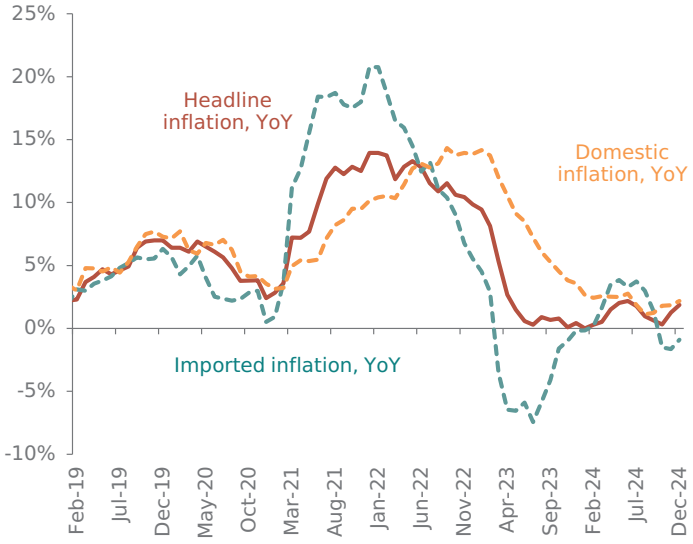


Figure 2.1.10: Headline, Domestic, and Imported Year-over-year Inflations.

Source: Geostat, NBG.

Recently, the rise in international food commodity prices has contributed to a moderate increase in inflation compared to previous months.

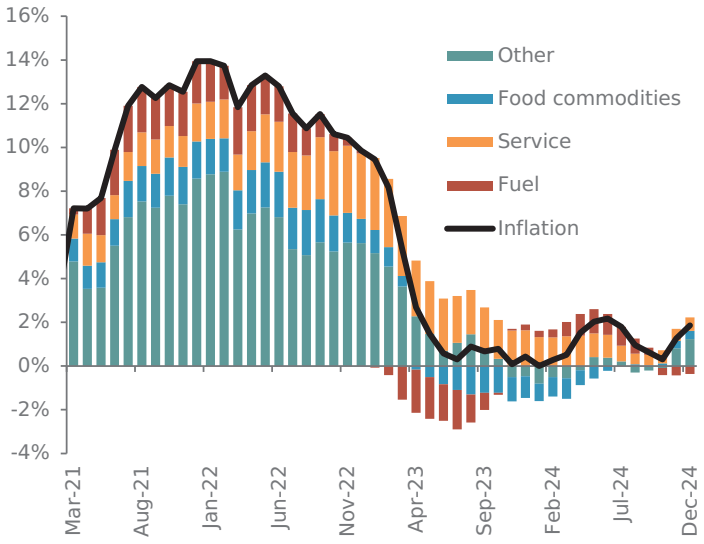


Figure 2.1.11: Inflation by Components

Source: Geostat, NBG.

2.2. CENTRAL SCENARIO

In the central scenario, economic activity is expected to stabilize around its long-term growth rate of 5% from 2025.

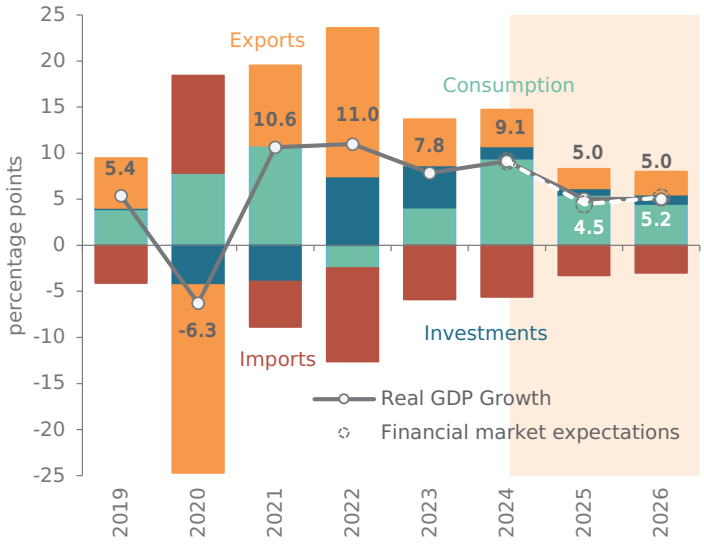


Figure 2.2.1: Real GDP Growth Under Central Scenario and Expectations of Financial Market Participants.

Source: NBG, Financial Market Participants, Geostat.

Under the central scenario, considering imported inflation and the base effect from the previous year, average annual headline inflation is expected to be around 4.2% in 2025. This projected inflation trajectory aligns with financial market expectations.

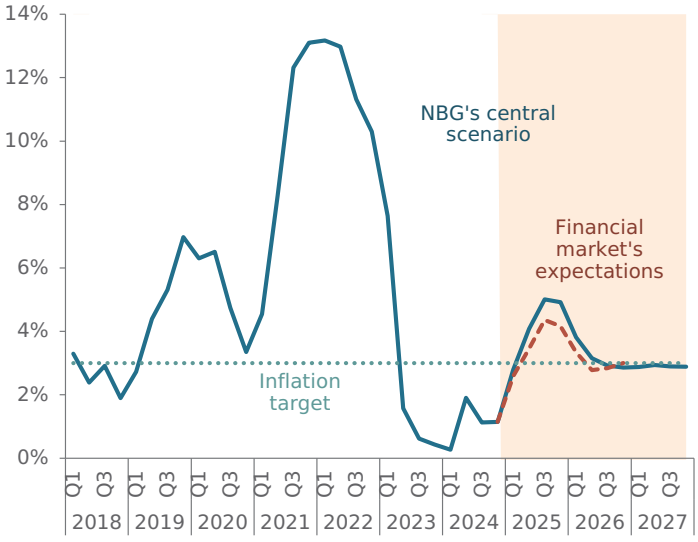


Figure 2.2.2: Year-over-year Headline Inflation Under Central Scenario and Expectations of Financial Market Participants.

Source: NBG, Financial Market Participants, Geostat.

The Central Scenario incorporates a comprehensive range of current information, including expectations in both the local financial market and global markets, and accounts for risks that are consistent with this information.

In the context of the global economy, amidst elevated uncertainty, an upward revision of interest rates in the US may tighten financial conditions worldwide. This, in turn, increases the risk of a slowdown in global economic activity. As a small open economy, Georgia is inevitably exposed to these risks; However, the extent of their transmission will depend on the duration of geopolitical turbulence and domestic uncertainty. This uncertainty poses risks, including a potential rise in the sovereign risk premium and a slowdown in economic activity, which have already been partially reflected in some leading indicators. Accordingly, the central scenario envisages a moderate realization of these risks in the future. Explicitly, amid both domestic and external uncertainty, consumer and business sentiment in the first quarter of 2025 will remain at a subdued level compared to previous months.

Heightened uncertainty is likely to result in an increased propensity to save in the short term. This will accelerate the normalization of domestic consumption alongside the expected slowdown in real income growth. Consequently, under this scenario, excess demand would be fully absorbed within the year, leading to a disinflationary effect. Additionally, uncertainty maintained in the short term would influence investment sentiments. Ultimately, under this scenario, the contribution of both domestic and external demand to growth will decline in 2025, and **the economy will return to its long-term growth rate of 5%.**

Notably, economic growth expectations in the financial market, as of January 9, 2025, are largely aligned with the NBG's central scenario. This latter is evidenced by the survey of financial market participants (FMP) (see Figure 2.2.1).

According to the central scenario of the NBG, **headline inflation is expected** to converge to the target level **in 2025** as the disinflationary effects from imported goods gradually fade. Considering the base effect from the previous year, inflation is projected to temporarily surpass the 3% target in the second half of the year, with an annual **average of around 4.2%.** However, starting from the end of 2025, inflation is expected to stabilize around the target level (see Figure 2.2.2).

Under this scenario, the expected inflation trajectory is shaped by a range of heterogene-

In the central scenario, aggregate demand is expected to exert a disinflationary effect. However, due to the base effect from the previous year and the fading disinflationary impact of imported goods, inflation will temporarily exceed the target level in the short term. While, inflation is projected to stabilize close to the target level by the end of 2025.

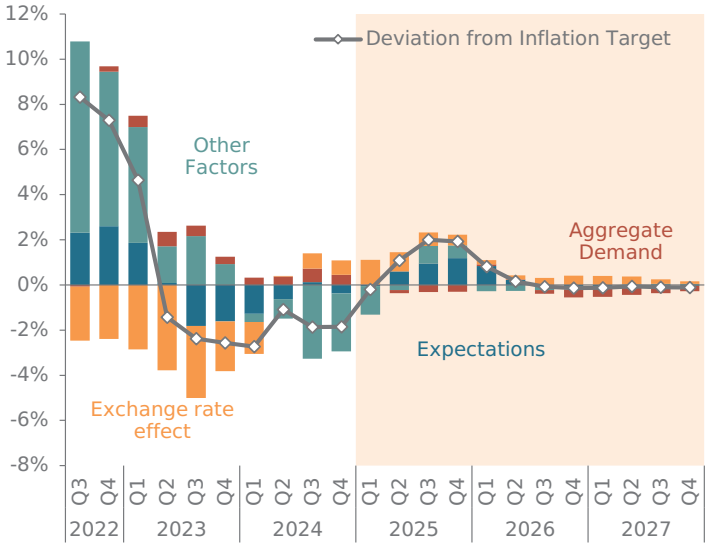


Figure 2.2.3: Decomposition of the Year-over-Year Headline Inflation Deviation from the Target Under the Central Scenario.

Source: NBG, Geostat.

Under the central scenario, the normalization of monetary policy will commence in parallel to the easing of inflationary risks, aligning with expectations in financial markets.

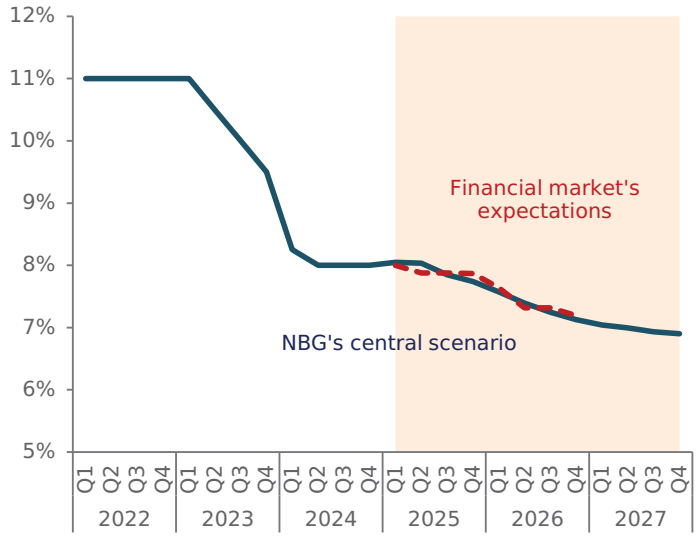


Figure 2.2.4: Monetary Policy Rate Under Central Scenario and Expectations of Financial Market Participants.

Source: NBG, Financial Market Participants.

ous factors, each exerting a distinct impact on inflation. Particularly, in the first quarter of 2025, prolonged high uncertainty is anticipated to slow the growth rate of external inflows, leading to a moderate widening of the current account deficit. This, in turn, will put upward pressure on inflation through the imported goods channel. However, the elimination of excess demand will partially offset these inflationary pressures.

Furthermore, as mentioned, geopolitical developments play a significant role in shaping the price dynamics of international commodities. In this context, the central scenario envisages projections from the U.S. Energy Information Administration (EIA) for Brent oil prices, which suggest a gradual decline over the coming years. Putting downward pressure on domestic oil prices as well. Regarding international food prices, considering climatic and geopolitical factors, the central scenario accounts for a slower pace of normalization compared to oil prices, influenced by climatic and geopolitical factors, which lead to a weaker disinflationary effect (see Figure 2.2.3).

It should also be noted that similar to economic growth expectations, inflation expectations among financial market participants are consistent with the NBG's central scenario. Particularly, considering the current outlook and associated risks, **financial market participants have revised their 2025 average inflation expectations upward** by 0.3 percentage points compared to the October 2024 survey, **reaching 3.6%** (see Figure 2.2.2).

Under the central scenario, amidst increased uncertainty in the short-term horizon and relatively heightened inflationary risks, as also reflected in the trajectory of financial market forecasts, **the monetary policy rate is expected to remain unchanged for the next two quarters, ceteris paribus, in order to minimize risks**. Eventually, as inflationary pressures subside, the NBG will gradually begin normalization of the policy rate in the second half of the year, aligning with financial market expectations (see Figure 2.2.4).

2.3. HIGH-INFLATION SCENARIO

The high-inflation scenario is based on a further deterioration in geopolitical conditions and domestic sentiments compared to the central scenario, alongside the intensification of deglobalization tendencies and inflationary pressures stemming from commodity markets.

High-Inflation Risks	
◦ The prolonged escalation of the geopolitical situation ◦ Deterioration of sentiments	
Indicators of risk realization	**Impact on inflation**
Increase in risk premium and the higher cost of financing the current account deficit	↑
Deterioration of the current account balance	↑
High commodity prices in international markets	↑
Slowdown in investment and consumer spending	↓
Impact size	
Neutral / Low / Medium / High	
↑ Upward Pressure on Inflation	
→ Same Level of Inflation	
↓ Downward Pressure on Inflation	

Table 2.3.1: Taxonomy of Risks in High-inflation Scenario

Source: NBG.

Amid high turbulence both globally and locally, macroeconomic forecasts are characterized by considerable uncertainty. In this context, the analysis of risk scenarios and the determination of optimal policy responses with proper communication are particularly important for maintaining the effectiveness of monetary policy. Additionally, the presented risks in the economy are diverse and require corresponding policy actions if they materialize.

The High-Inflation Scenario is equally relevant as the central scenario. Specifically, this scenario incorporates inflationary risks identified from the current data but considers a more pronounced propagation of these risks due to existing uncertainty. In particular, it is based on the further deterioration of geopolitical and domestic conditions compared to the central scenario, the intensification of deglobalization tendencies, and inflationary pressures coming from commodity markets (see Table 2.3.1). As noted above, given various sources of global geopolitical tensions, real GDP growth in our trading partners has decelerated. The high-inflation scenario assumes a further slowdown in these dynamics, accompanied by a corresponding reduction in external inflows relative to the central scenario. Moreover, an increase in both geopolitical and domestic turbulence would elevate the country and regional risk premiums. This would reduce investment and consumer spending, which, in turn, is expected to negatively influence both current and potential growth in the medium term. As a result, **economic growth is projected to slow to 3% in 2025 and 3.5% in 2026**, respectively (see Figure 2.3.1).

The economic outlook in the United States is also noteworthy, where the reduction in personal consumption expenditure (PCE) inflation has been delayed, while the economic activity remains relatively robust. Meanwhile, the implementation of the announced changes in tax, tariff and migration policies could significantly slow the normalization pace of the Fed funds rate. The latter will pose a risk of capital outflows to the advanced economies and further exacerbate the reduced dynamics in external inflows. Under the prevailing high dollarization, this will amplify inflationary pressures through the exchange rate channel compared to the central scenario. Furthermore, in the context of rising sovereign risk, attracting external funds to finance an increasing current account deficit will become even more expensive.

If the high-inflation scenario materializes, **inflation is projected to reach 5.7% and 4.4% in 2025 and 2026, respectively (see Figure 2.3.2).**

Amid heightened turbulence, economic growth is projected to slow to 3% in 2025 and 3.5% in 2026.

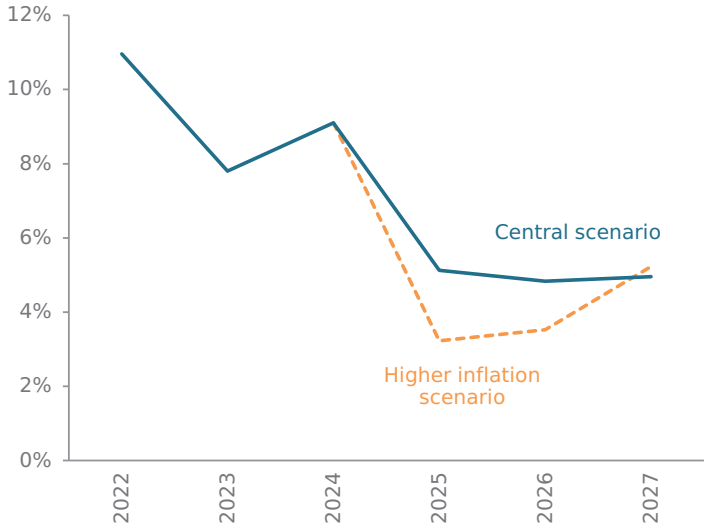


Figure 2.3.1: Real GDP Growth Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

The NBG exhibits a low tolerance against rising inflation expectations, which is reflected in its **risk-minimization approach** (also called "Least Regrets Policy") through tightening of monetary policy and, if necessary, the use of additional instruments. Particularly in this case, the trajectory of monetary policy rate will be on average 1.1 percentage points higher over the next 2 years. Its normalization will begin at a gradual pace, contingent on the stabilization of the inflationary environment (see Figure 2.3.3).

Increased uncertainty, deglobalization tendencies, and rising prices in commodity markets will significantly heighten inflationary pressures over the horizon of monetary policy.

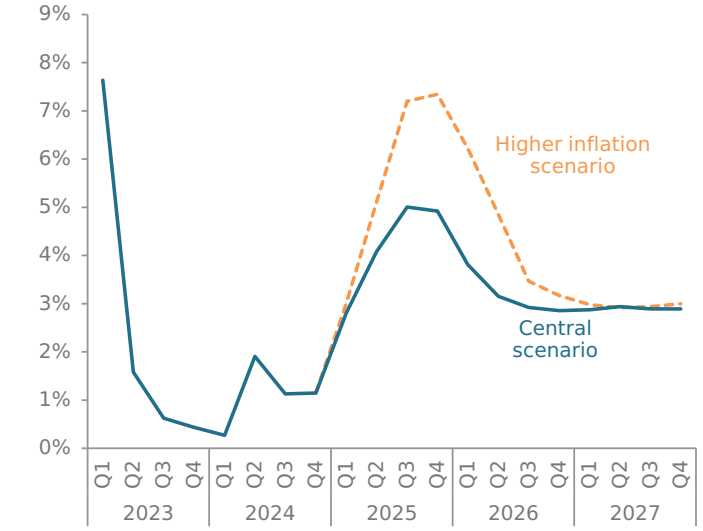


Figure 2.3.2: Year-over-year Headline Inflation Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

The National Bank of Georgia has a low tolerance against inflation and/or the rise in inflation expectations, which is reflected in its risk-minimization approach through tightening monetary policy and, if necessary, the use of additional instruments.

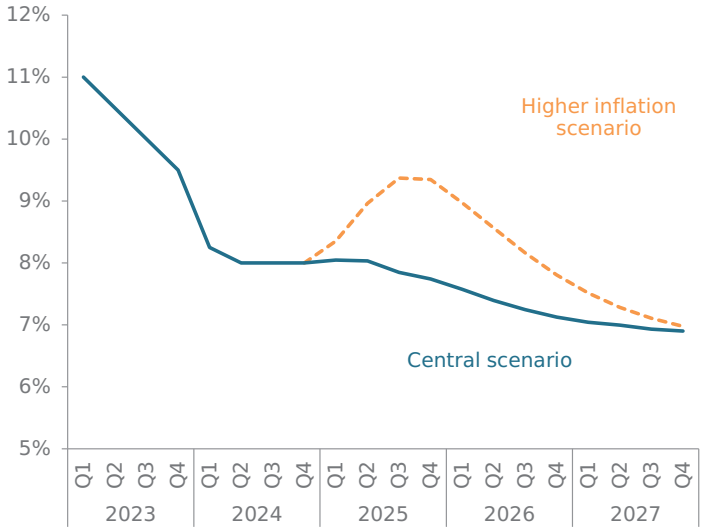


Figure 2.3.3: Monetary Policy Rate Under Central and High-Inflation Scenarios

Source: NBG.

2.4. LOW-INFLATION SCENARIO

The low-inflation scenario is based on a faster normalization of both geopolitical conditions and domestic sentiments compared to the central scenario, higher economic activity, and lower inflationary pressures originating from commodity markets.

Low-Inflation Risks	
◦ De-escalation of the geopolitical situation ◦ Improvement of domestic sentiments	
Indicators of risk realization	**Impact on inflation**
Reduction in risk premium	↓
Maintaining the current account balance around its sustainable level	↓
Restoration of global supply chains: Rapid reduction in transportation and commodity prices	↓
Improvement of sentiments: High economic activity	↑
Impact size	
Neutral / Low / Medium / High	
↑ Upward Pressure on Inflation → Same Level of Inflation ↓ Downward Pressure on Inflation	

Table 2.4.1: Taxonomy of Risks in Low-inflation Scenario

Source: NBG.

The Low-Inflation Scenario entails materialization of the risks, which are less inflationary compared to the central scenario (see Table 2.4.1). Particularly, according to this scenario, the heightened geopolitical and domestic turbulence normalizes relatively quickly, which would result in the maintenance of both the region's and the country's risk premiums at a relatively lower level in the medium term. Furthermore, maintaining the current account balance at its sustainable level, would ease the pressure on the exchange rate. Meanwhile, reduced uncertainty would positively influence sentiments and result in relatively robust aggregate demand compared to the central scenario.

Additionally, a rapid resolution of uncertainty will have a positive impact on investment sentiments. As a result, supply-side factors will largely continue to serve as a driving force behind economic growth. All of this implies higher economic activity compared to the central scenario. Specifically, real GDP **is projected to grow by 6.5% and 5.5% in 2025 and 2026**, respectively (see Figure 2.4.1).

As economic activity continues to be driven largely by fundamental factors, aggregate demand is expected to exert less inflationary pressure, supporting the maintenance of low domestic inflation. On the other hand, resolution of uncertainties at a faster pace compared to the central scenario will support a higher level of external inflows, which will appreciate the exchange rate and result in lower imported inflation compared to the central scenario.

Concurrently, a relatively rapid normalization of the geopolitical situation will lead to a faster-than-expected recovery in supply chains, exerting downward pressure on international commodity prices. As a result, local food and fuel prices will be less inflationary. If this scenario materializes, **inflation is projected to be 1.6 pp and 0.4 pp lower on average in 2025 and 2026, compared to the central scenario, reaching 2.6% and 2.8%,** respectively (see Figure 2.4.2).

Under such scenario, the sustained improvement of fundamental factors in the medium term would lead to a revision of the neutral rate to 6.5%. Furthermore, with inflationary risks subsiding more rapidly, **the monetary policy rate in 2025 is expected to be, on average, 0.4 percentage points lower than the central scenario, and 0.5 percentage points lower in 2026.** This implies a faster normalization of the monetary policy rate toward its neutral level (see Figure 2.4.3).

Under the low-inflation scenario, supported by strong fundamental factors, real GDP growth is expected to be 6.5% in 2025 and 5.5% in 2026.

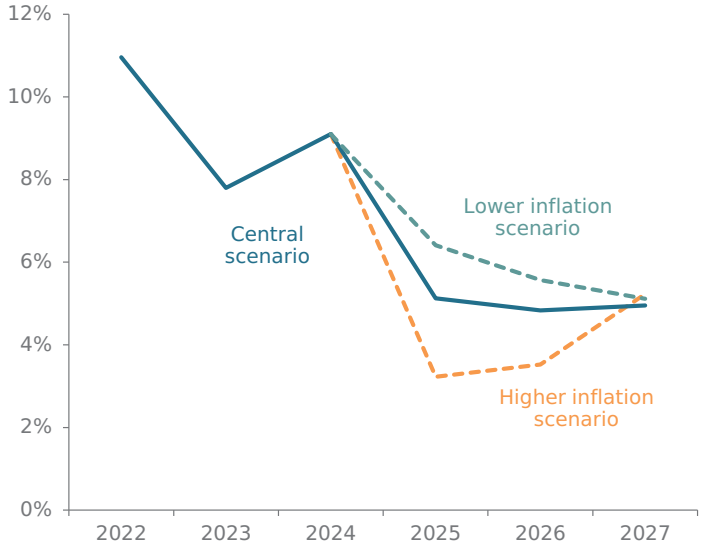


Figure 2.4.1: Real GDP Growth Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

Against the backdrop of economic growth driven by strong fundamental factors and a decrease in international commodity prices, inflation is expected to remain low and stabilize more quickly toward the target level compared to the central scenario.

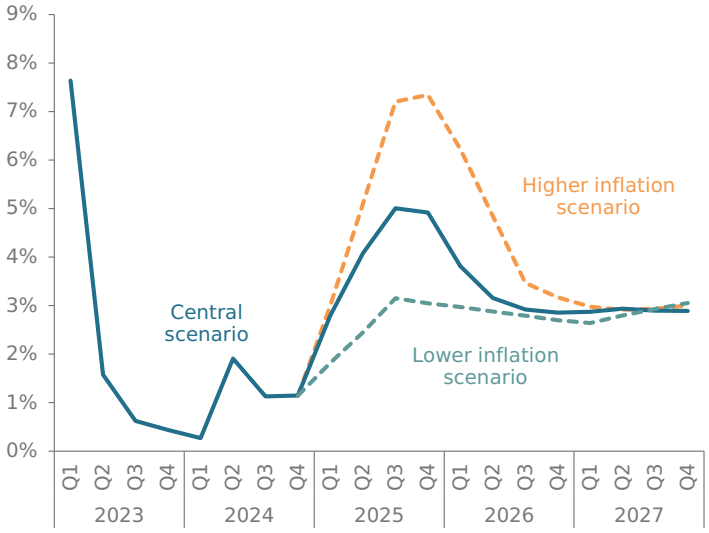


Figure 2.4.2: Year-over-year Headline Inflation Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

In the low-inflation scenario, with the rapid mitigation of risks, monetary policy normalizes more quickly compared to the central scenario.

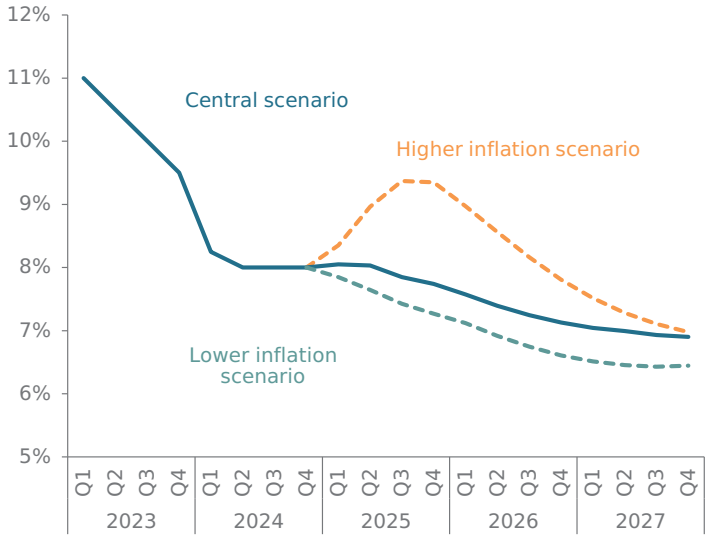


Figure 2.4.3: Monetary Policy Rate Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG.

3. SPECIAL TOPICS

BOX 1. POST-PANDEMIC PRODUCTIVITY GROWTH: WHAT MAKES THE DIFFERENCE?

In recent years, economic growth has been strong, exceeding the pre-pandemic trend growth. Alongside high economic activity, inflation has remained below the target level over the past two years, and strong demand has not exerted upward pressure on prices. This, among other factors, has been driven by high productivity growth in the economy. During the pre-pandemic period, the potential growth rate of the economy was within the range of 4-5%, whereas in the post-pandemic period, it has fluctuated within the band of 7-8%. It is noteworthy that this reflects the consensus of three analytical models of the NBG (see Figure 3.1.1[3]). According to estimates of the production factors model, the contribution of the labor force to potential growth increased in 2023, which has led to an increase in the total potential output. At the same time, the model indicates that the contribution of productivity to potential growth has risen in the post-pandemic period, reflecting structural changes in the economy. Specifically, in recent years, the contribution of relatively high-productive sectors, such as information and communication, transportation, and construction, has increased in economic growth. Despite the high economic growth, a trend of stabilization in the potential growth has recently emerged, moving toward a long-term equilibrium level. As noted, the labor force made a significant contribution to potential growth in 2023, but this is expected to have a temporary effect, as the impact of labor force growth is limited in the long term perspective. Consequently, a trend of decreasing contribution from the labor force is already apparent in 2024.

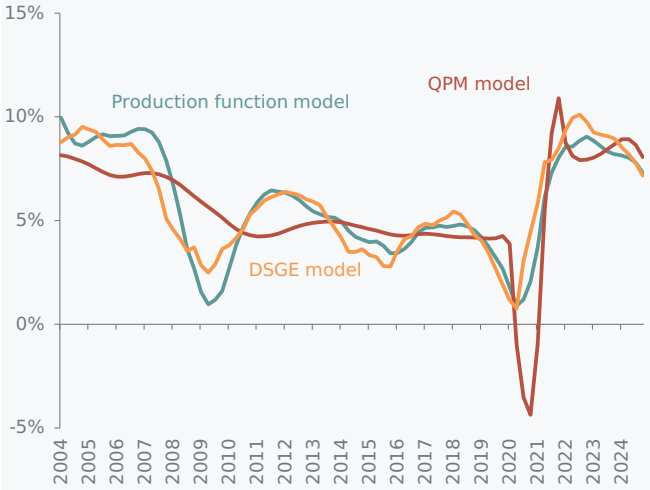


Figure 3.1.1: Estimates of Potential Growth Rate

Source: NBG.

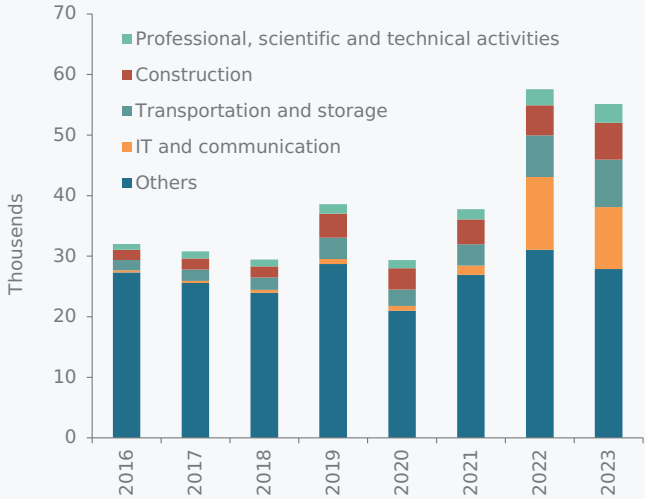


Figure 3.1.2: Composition of Newly Registered Firms

Source: Geostat.

Evaluating outlook of the economy's total potential for the upcoming period is crucial from a monetary policy perspective. The potential output is the combined outcome of production factors—labor, capital, and productivity. Regarding the dynamic of productivity growth, two scenarios can be considered: 1. Productivity returns to its pre-pandemic growth rate. 2. The high growth of productivity stabilizes at a higher level than in the pre-pandemic period, despite some moderation. In this context, it is important to assess the factors that differ today and could positively impact sustaining high productivity growth rates in the future. High economic activity in the transportation and information and communication sectors—both high-productive industries—has been a driving force in maintaining productivity growth at elevated levels in the post-pandemic period, provided that the development of these sectors continues. An additional noteworthy factor is the composition of newly registered enterprises. For example, during the pre-pandemic period, only 1 in 10 newly established enterprises belonged to these sectors, whereas in the post-pandemic period, 1 in 3 new enterprises is related to transportation or information technology. If this tendency continues, it could

3 The potential level of output is an unobservable variable and is estimated using macroeconomic models. These models have different characteristics, which may influence the estimation. To mitigate the impact of model specification on the assessment, it is important to rely on estimates from multiple alternative models to verify the consistency of the results.

positively influence the contribution of highly productive sectors to the economy and, consequently, the potential growth rate. Under such conditions, despite some moderation (as base effects dissipate), there is a possibility that the contribution of productivity to potential growth will remain higher than the pre-pandemic trend (in the range of 3-4 percentage points, compared to the pre-pandemic 2-3 percentage points, see Figure 3.1.4). The accelerated adoption of artificial intelligence globally and its positive impact on labor productivity could also be a contributing factor. Sustained activity in the productive sectors of the economy will depend on increasing the number and qualifications of local specialists in these fields. Although formal education indicators do not yet reflect this trend[4], it is likely that skill enhancements (particularly in information technology) occur through informal education channels.

Assessing potential growth, and the contribution of productivity to it, is essential for analyzing the impact of economic activity on inflation. High productivity, on one hand, helps alleviate price pressures stemming from demand. On the other hand, even amid relatively high wage growth, productivity growth leads reduction in the unit labor costs, ultimately reflected in lower price pressures. In the previous monetary policy reports it was highlighted that despite a high-inflation episode and strong potential growth during the post-pandemic period (which should gradually be reflected in wages), the average nominal wage level still lags behind the price level (see Figure 3.1.3). It is worth noting that if the contribution of labor force growth to potential growth is significant, firms may face limited capacity to fully adjust wages to compensate for real economic growth without creating additional cost and price pressures. However, if real wages grow in line with productivity, additional inflationary pressures is not expected to emerge.

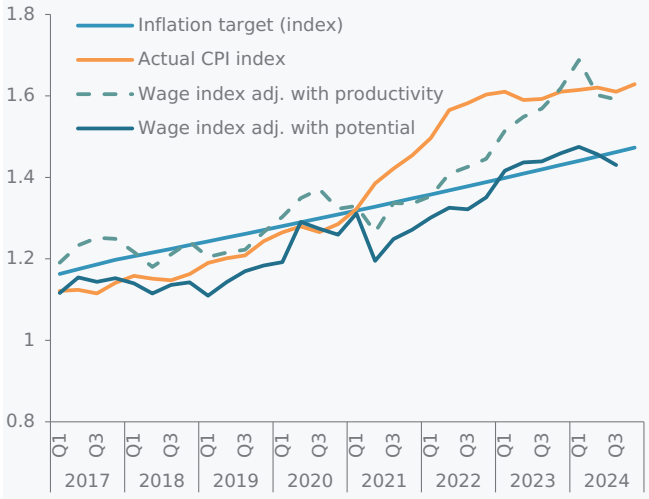


Figure 3.1.3: Wage "Catch-Up" (Index 2014Q1=1).

Source: NBG, Geostat.

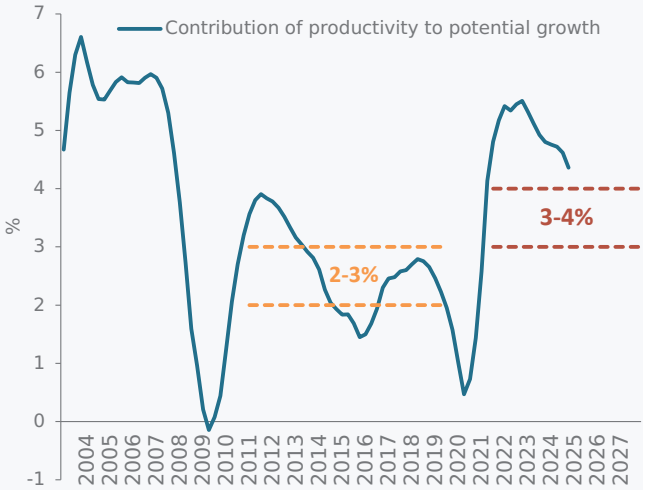


Figure 3.1.4: Contribution of Productivity to Potential Growth.

Source: NBG.

In 2023, labor force growth made a significant contribution to potential growth. Against this backdrop, the increase in productivity was slower than potential growth. As a result, the nominal wage level—excluding total potential growth—remained below the price level. However, when accounting for productivity alone, the wage gap relative to the price level was effectively closed. Conversely, in 2024, as the contribution of labor force growth on potential growth diminished, productivity grew at a faster pace. This acceleration in productivity significantly alleviated wage-induced pressures. As a result, by the beginning of the year, wages were no longer lagging behind the price level, suggesting that they had 'caught up' after the period of high inflation. Against the backdrop of accelerating productivity, wage growth showed signs of slowing, contributing to easing price pressures stemming from the labor market. In the event of productivity moderation, monitoring wage growth dynamics will be critical to analyzing potential inflationary pressures originating from the labor market.

4 In 2018, one out of every 16 undergraduate students enrolled in IT related programs, whereas in 2023, this number increased to one out of every 12.

BOX 2. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2024 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters). Therefore, in the formation of monetary policy, it is especially important to consider the inflation forecast over the monetary policy horizon. Because of the central importance of this, the inflation targeting regime is also called the inflation forecast targeting regime in academic and institutional circles. To assess the adequacy of monetary policy in achieving its objectives, it is important to analyze the accuracy of the forecasts made in previous periods. A retrospective analysis of inflation forecasts is thus an important dimension of the forecasting and monetary policy analysis system of the National Bank of Georgia (NBG). An inflation forecast is considered adequate if any deviations from actual data result solely from unexpected exogenous factors (that are independent of monetary policy). Exogenous shocks are usually transitory and one-off in nature and responding to them is commonly associated with more social welfare costs rather than benefits. Consequently, central banks generally do not react to such shocks, except when supply-side shocks affect medium and long-term inflation expectations.

Notably, under high uncertainty, consideration of events independent of monetary policy is particularly challenging. Thus, the trajectory of monetary policy and, consequently, the dynamics of inflation, which largely relies on assumptions about exogenous events, becomes increasingly vulnerable. In response to this, a monetary policy based on scenario analysis and risk minimization becomes critically important. Under this approach, policymakers evaluate alternative developments in relevant exogenous factors and incorporate these risk considerations into their decision-making process. This, in turn, ensures the effective communication of the policy rate and, hence, the inflation trajectory.

Based on the practice of high transparency, an analysis comparing the inflation forecast to the actual data is published in the Monetary Policy Report at the beginning of each year. In this case, we will evaluate inflation target fulfillment in 2024 and analyze its forecast. Realized inflation turned out to be lower compared to what had been projected in February of the previous year (see Figure 3.2.1). The inflation forecast for 2024 was influenced by heterogenous factors. Specifically, amid low inflation inertia, the appreciation of the Lari in the first half of the year was exerting downward pressure on prices and was largely offsetting the inflationary pressures stemming from strong domestic demand. In the second half of the year, as external inflows were normalizing, the effects of both the exchange rate appreciation and strong demand were gradually fading, bringing inflation closer to its target level. Along with the aforementioned factors, throughout the year, the inflation forecast was also being influenced in an upward direction by high inflation expectations in our trading partner countries, particularly in Turkey, as well as by uncertainty related to international container shipping prices amid the geopolitical tensions. Meanwhile, the inflation forecast was being influenced in a downward direction by the normalization of food prices in international commodity markets and the one-off effect of the announced reduction in electricity tariffs. Amid these opposing effects, inflation remained at a low level at the beginning of 2024, while in the second quarter, it was stabilizing around the target level of 3%, primarily due to base effects.

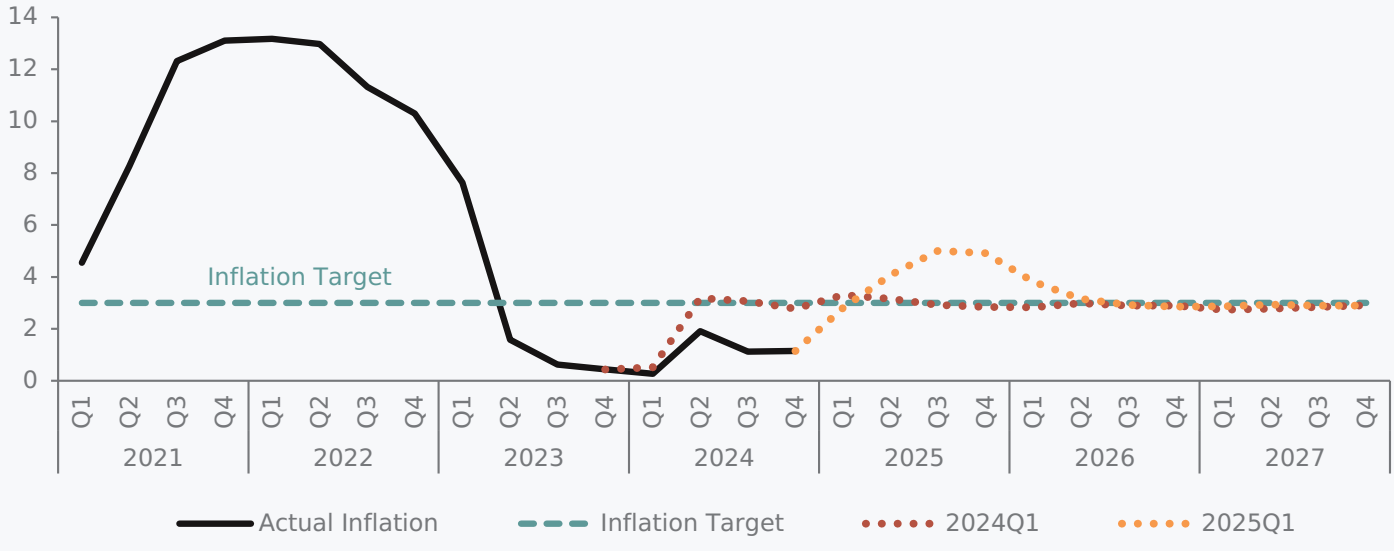


Figure 3.2.1: Comparison of the February 2024 Annual Inflation Forecast with Actual Inflation and the Current Forecast.

Source: NBG, Geostat.

In 2024, realized inflation turned out to be 1.3 percentage points lower than the forecasted level. According to the inflation decomposition analysis, the lower-than-forecasted inflation is largely due to reduced inflation expectations and stronger-than-anticipated improvements in structural factors within the real sector (see Figure 3.2.2). The maintenance of a low-inflation environment was largely ensured by an optimal monetary policy, which was reflected in the stabilization of both long-term and short-term inflation expectations. This is evidenced by the slow rise in the prices of domestically produced goods and services, which remain relatively rigid and reflect well long-term inflation expectations. Meanwhile, as a result of structural changes in the economy, the exports of services increased more than expected, particularly in the information, computer, and transportation sectors. This significantly reduced the current account deficit and improved consumer and business sentiments. Although on an annual basis, the real effective exchange rate of the Lari aligned with expectations, in the first quarter of the year it was stronger than anticipated. Amidst still-high dollarization, this further reduced inflation expectations. Moreover, productivity improvements across certain sectors and the entry of new enterprises into the market unfolded some kind of positive supply-side shock. This outweighed the inflationary pressures stemming from stronger-than-expected demand and further reduced both current and expected inflation. Conversely, both the geopolitical and domestic conditions turned out to be more turbulent than expected. Amid sharply rising geopolitical uncertainty and supply chain disruptions, the cost of international shipping turned out to be higher than expected. Additionally, worsening global climatic conditions delayed the normalization of prices in international commodity markets. All of this was further exacerbated by high imported inflation from trading partners, putting upward pressure on inflation.

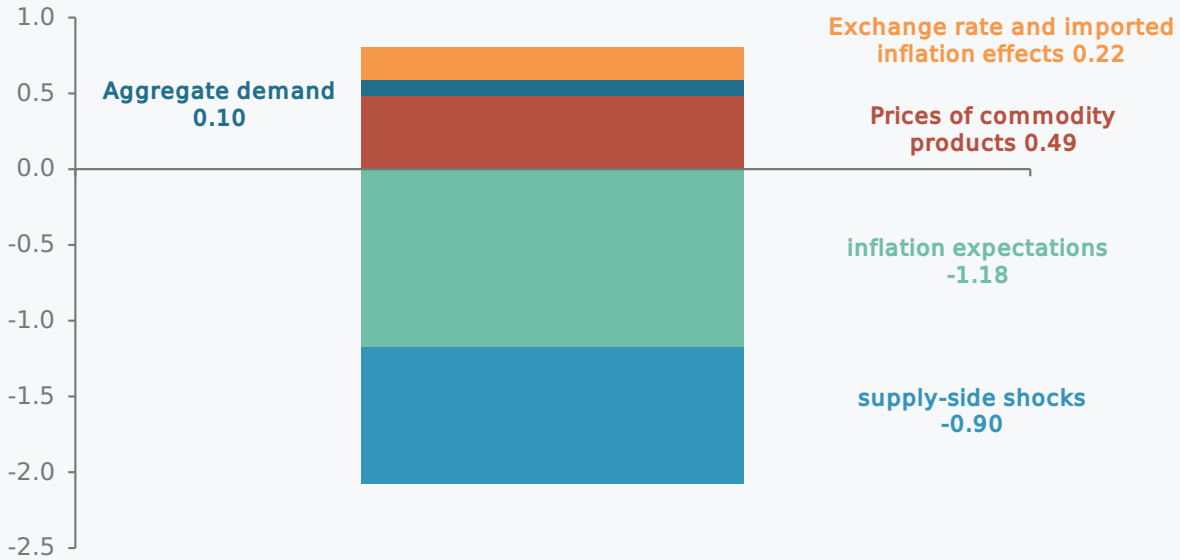


Figure 3.2.2: Decomposition of the Difference between Actual Inflation and the February 2024 Forecast.

Source: NBG, GeoStat.

The realization of lower-than-expected inflation also reduced inflation expectations. Amid this, in the second quarter of 2024, the NBG revised its inflation forecast downward by 0.9 percentage points to 1.5 percent. For the rest of the year, both geopolitical and domestic turbulence exerted upward pressure on the inflation forecast, while structural improvements in the domestic economy contributed to its decline (see Figure 3.2.3).

Notably, the financial market also anticipated relatively high inflation at the beginning of the year, with participants' median and mean forecasts at 2.9% and 3.4%, respectively. Similar to the NBG, market participants' expectations gradually declined throughout the year.

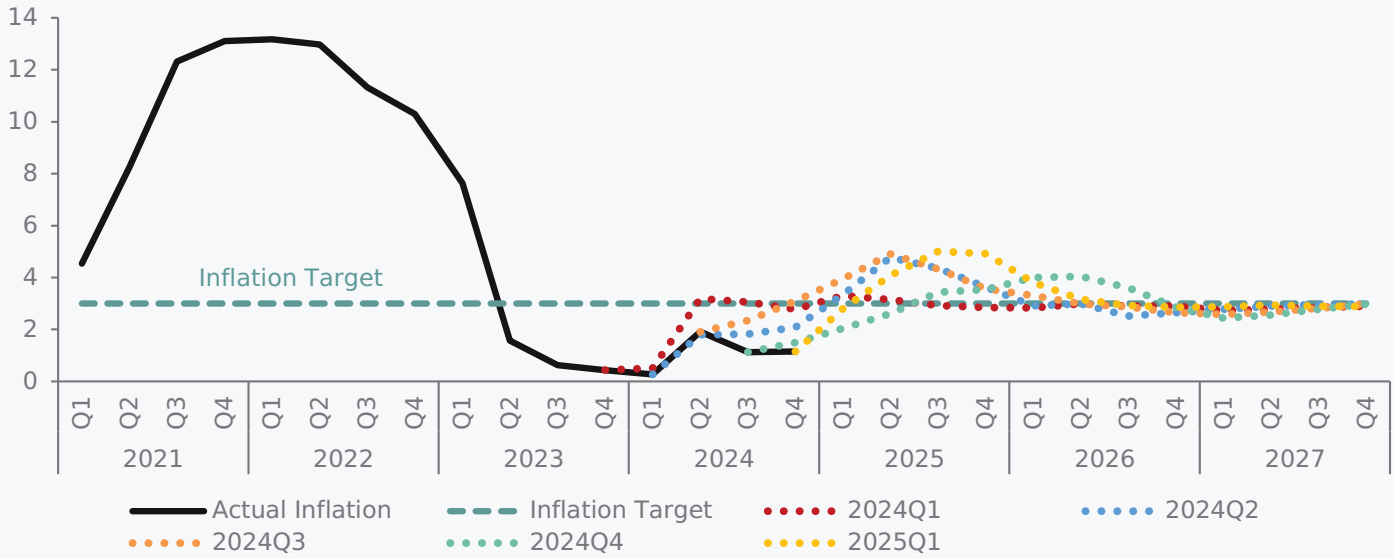


Figure 3.2.3: Comparison of Headline Inflation Forecasts (2024Q1-2025Q1).

Source: NBG, Geostat.

Amid the country's economic conditions, also in line with efforts to maintain a low-inflation environment and a downward revision in the inflation forecast, the NBG accelerated the normalization of monetary policy in the first half of 2024, lowering the policy rate by an aggregate of 150 basis points to 8 percent. In the second half of the year, amid rising domestic and geopolitical turbulence, volatility was observed in both international commodity and domestic markets. This, against the backdrop of strong demand, underscored the relevance of risks considered in alternative forecast scenarios. Given this, the NBG adopted a conservative, risk-minimization approach and, despite prolonged inflation below the target level, maintained a moderate and cautious pace in unwinding tight monetary policy. This was reflected in keeping the policy rate at 8 percent through the end of the year.

SUMMARY OF MACROECONOMIC FORECASTS

	Fact	Macroeconomic Forecast Scenarios*								
		Central Scenario			Higher-Inflation Scenario			Lower-Inflation Scenario		
	2024	2025	2026	2027	2025	2026	2027	2025	2026	2027
Inflation (%)	1.1	4.2	3.2	2.9	5.7	4.4	3.0	2.6	2.8	2.9
Real GDP Growth (%)	9.1**	5.0	5.0	5.0	3.0	3.5	5.1	6.5	5.5	5.2
Monetary Policy Rate (%)	8.1	7.9	7.3	7.0	9.0	8.4	7.2	7.5	6.8	6.5

* The table displays the average annual changes of the variables
** Preliminary estimate

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