საქართველოს ეროვნული ბანკი
National Bank of Georgia

MONETARY POLICY REPORT

NOVEMBER 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 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 make 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 adopted a new scenario-based approach to monetary policy communication, enhancing the transparency of its risk management and decision-making processes. This step marks another stage in the development of the NBG's monetary policy framework through which it improves the transparency and comprehensibility of the monetary policy reaction function, thereby strengthening the effectiveness of the policy transmission channels.

Under the scenario-based approach, the National Bank of Georgia publishes **three relevant scenarios**, given the existing uncertainty:

- **The Central Scenario**, which incorporates a broad set of current information, including assumptions on exogenous factors and economic transmission mechanisms. It reflects a monetary policy path that is calibrated by the policymaker through a careful assessment and balancing of heterogeneous risks.
- **The Higher-Inflation Risk Scenario**, which, compared to the central scenario, incorporates risks that are more inflationary over the monetary policy horizon.
- **The Lower-Inflation Risk Scenario**, which, compared to the central scenario, incorporates more disinflationary risks over the monetary policy horizon.

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MONETARY POLICY DECISION

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

On November 5, 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.

As of October 2025, the overall price level in Georgia increased by 5.2 percent year-on-year. The increase in inflation relative to the 3 percent target was mainly driven by food price inflation, which partly reflected the low base effect from the previous year and the impact of exogenous factors. However, inflation excluding food prices, as well as other measures of relatively sticky prices that better reflect long-term inflation expectations, have remained close to the target level. In particular, core inflation, which excludes from the consumer basket the most volatile components, such as food, energy, and tobacco, remained below the 3 percent target, standing at 2.4 percent in October. At the same time, service sector inflation remained near the target, at 2.5 percent. Meanwhile, prices of imported goods remain low (0 percent), largely reflecting the year-on-year decline in fuel prices. Despite these developments, the prolonged high level of inflation in relatively flexible prices (mainly food) warrants attention regarding potential risks to inflation expectations.

According to the NBG's updated central scenario, the inflation forecast for 2025-2026 has been revised slightly upwards, largely due to high food inflation. According to the current central forecast, inflation will average around 4 percent in 2025, and decrease to 3.5 percent in 2026. Other things being equal, elevated food prices are expected to have only a temporary impact on inflation, with their effects gradually fading. The central scenario precisely envisages such a development. In particular, the abovementioned dynamics are temporary in nature and are not expected to create second-round effects, which means that the associated price pressures do not to spill over to the prices of other goods and services.

At the same time, economic activity is gradually converging toward its long-term potential, thereby moderating demand-side pressures on prices. According to preliminary data, in January-September 2025 economic growth amounted to 7.7 percent. The normalization of aggregate demand toward its long-run trend is further supported by the maintenance of tight financial conditions, as reflected in prevailing market interest rates.

Given the high uncertainty, upside risks to inflation are more pronounced, while downside risks continue to remain. Accordingly, the Monetary Policy Committee considered both high-inflation and low-inflation risk-scenarios, along with the central scenario, and the risks operating in different directions were taken into account in the decision-making process.

The high-inflation risk-scenario that the MPC considered, on the one hand, assumes the realization of global inflationary risks. In particular, the re-escalation of US tariff policies will exacerbate global fragmentation more than expected and may have a negative impact on supply chains. This amplifies the risk of additional price increase for certain types of commodities in international markets. In this scenario, beyond tariff policy, the risk of re-escalation of the geopolitical tensions remains noteworthy as it has a significant impact on international commodity prices. The high-inflation scenario, along with exogenous factors, also takes into account the realization of domestic economic risks. In particular, if inflation remains above the target for a prolonged period, this could exacerbate inflationary expectations. At the same time, if aggregate demand remains above its potential level, demand-side pressures on prices are likely to intensify. The materialization of these risks would necessitate a tightening of the policy rate.

On the other hand, the Monetary Policy Committee considered a low-inflation risk-scenario, where the realization of the risks would shape the development of fundamental factors in a way that requires a lower trajectory of the monetary policy rate compared to the central scenario. In particular, this scenario, in line with forecasts by international organizations, anticipates a marked decline in oil prices in international commodity markets, reflecting both an increase in supply and a slowdown in global demand. At the same time, the U.S. dollar index (DXY) will remain relatively weak globally for longer than anticipated, contributing to a reduction in headline inflation through lower imported inflation. Additionally, domestic labor market developments are placing downward pressure on prices, which strengthens the possibilities of developing a low-inflation

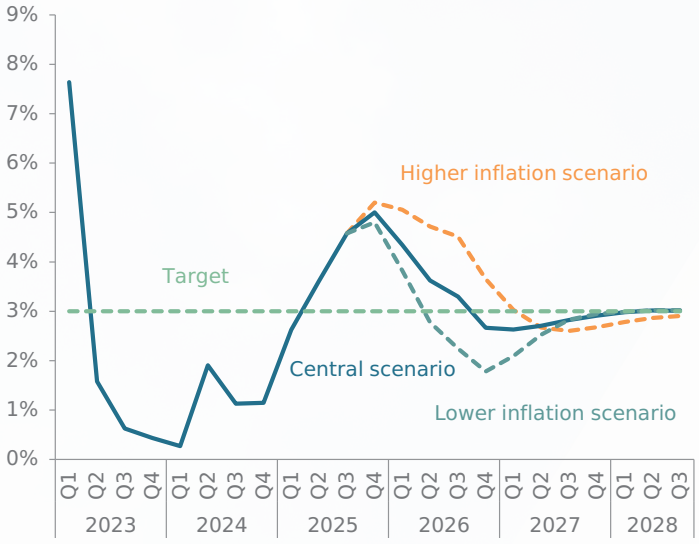
scenario.

As a result of macroeconomic analysis and the assessment of the aforementioned scenarios, the Monetary Policy Committee has considered it optimal to maintain a moderately tight monetary policy stance and kept the policy rate unchanged at 8 percent. Upcoming decisions on the monetary policy rate will depend on updated data and the realization of risks. If the impact of one-off factors on inflation is prolonged, the Monetary Policy Committee stands ready to maintain the current tight stance for longer than expected and, if necessary, to tighten it further.

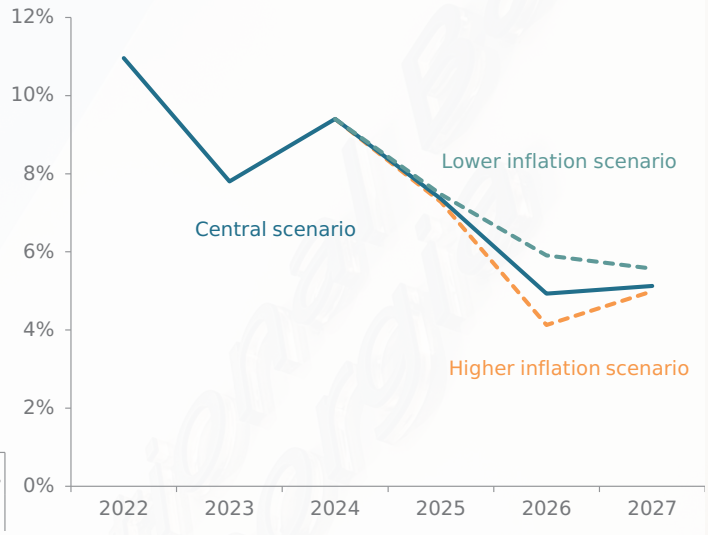
The NBG will use all available instruments to maintain price stability. This means keeping the overall price level increase close to the 3 percent target over the medium term.

NBG's Macroeconomic Forecast Scenarios

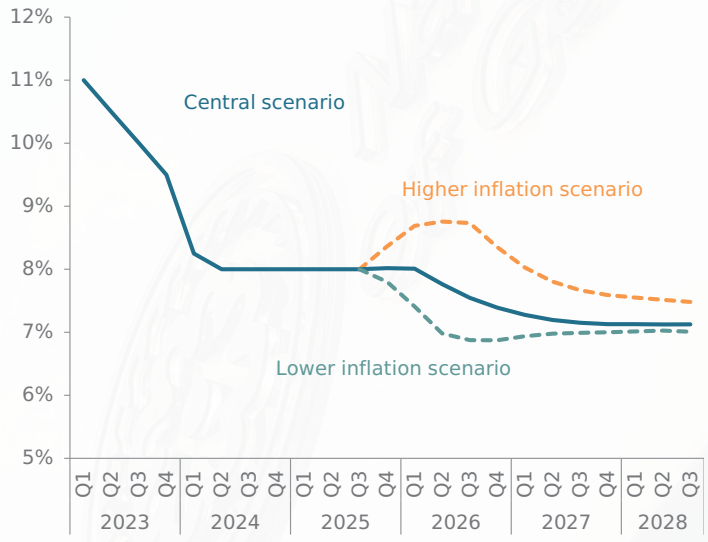
Inflation



Real GDP Growth



Monetary Policy Rate



1. OVERVIEW OF THE GLOBAL MACROECONOMIC ENVIRONMENT

Global economic policy uncertainty indices have declined in recent periods; however, they remain elevated. The main sources of uncertainty continue to be U.S. economic policy, geopolitical developments, fiscal sustainability concerns, and long-term risks associated with stock market developments. As a small open economy, Georgia is affected by global economic conditions through both direct and indirect channels.

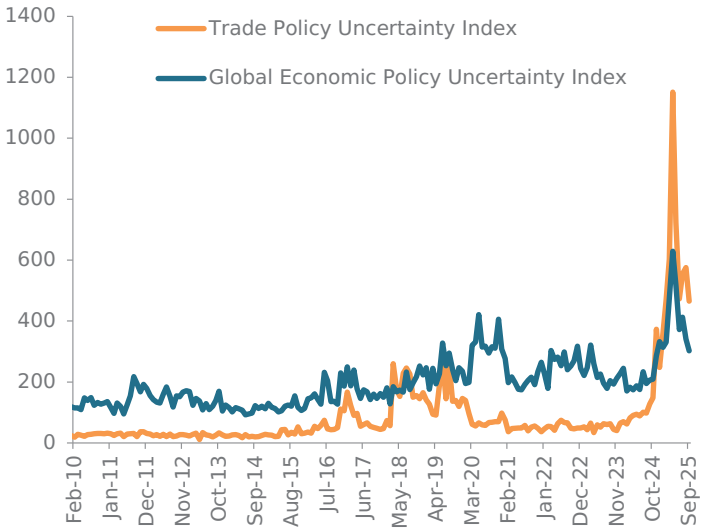


Figure 1.1. Global Economic Policy Uncertainty Index

Source: FRED, TPU.

* Uncertainty index measures the monthly share of newspaper articles discussing policy uncertainty-related terms (relative to the total number of articles), normalized so that a 1% share corresponds to an index value of 100.

The global economic environment continues to be characterized by high uncertainty. Although global uncertainty indicators have declined in recent months, they remain elevated relative to historical averages (see Figure 1.1) and continue to affect the global economic outlook. Uncertainty surrounding U.S. tariff policies remains one of the main sources of global instability and is accelerating the process of economic fragmentation.

Alongside tariff policies, fiscal sustainability risks remain a significant challenge in advanced economies. Specifically, fiscal deficits in these economies remain elevated, contributing to a growing debt burden and posing long-term risks to debt sustainability. At the same time, the influence of artificial intelligence (AI) on investment markets is increasing, with the prices of shares in AI-focused companies rising sharply. More broadly, in recent years, substantial increases in asset prices in equity markets have heightened the risk of so-called bubbles, which could eventually lead to price corrections. These developments reinforce the risk of higher long-term, equilibrium interest rates. Against this backdrop, the term premium remains elevated, which is reflected in the persistently high yields on 10-year Treasury securities.

Against the backdrop of the aforementioned risks, despite slight improvement, the International Monetary Fund's (IMF) October assessments indicate that global economic growth remains at a weak level[1]. While inflation is declining in some countries, stagflationary risks are emerging amid ongoing political uncertainty. Specifically, in October, the IMF revised its global economic growth forecast for 2025 upward from 3.0% in the July projection to 3.2%, while the inflation forecast remained unchanged at 4.2%.

Due to negative supply shocks caused by tariff and immigration policies, the U.S. faces challenges in maintaining a short-term balance between price stability and maximum employment. On one hand, inflationary pressures persist, while the labor market shows signs of weakening. Uncertainty surrounding U.S. economic activity remains

1 *World Economic Outlook, October 2025.*

Amid signs of labor market weakening, the Fed has faced a policy dilemma and initiated a gradual easing of monetary policy. As a result, financial market expectations for rate adjustments remain lower compared to previous months. However, tighter communication ahead of the upcoming decision has slightly altered the expected trajectory.

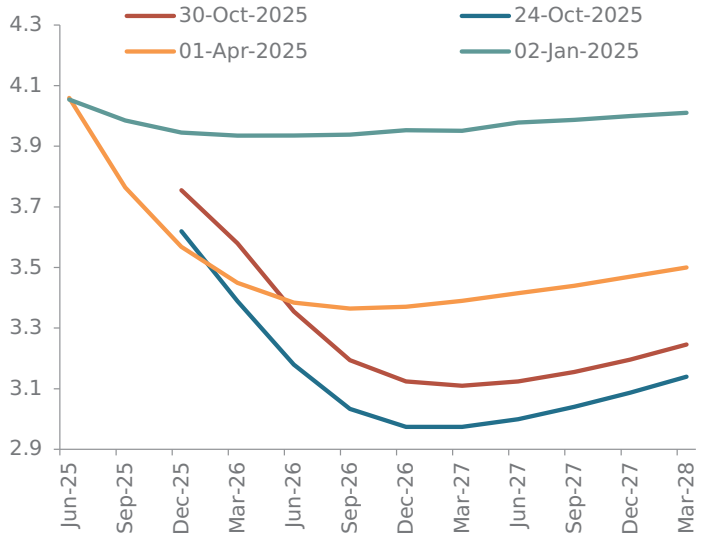


Figure 1.2. Market Expectations of Fed Funds Rate Path

Source: Atlanta Fed.

In recent periods, despite slight improvement, the U.S. dollar index has remained below 100, indicating its persistently weak level. At the same time, amid monetary policy normalization, yields on 10-year Treasury securities have declined; however, they remain elevated considering prevailing risks.

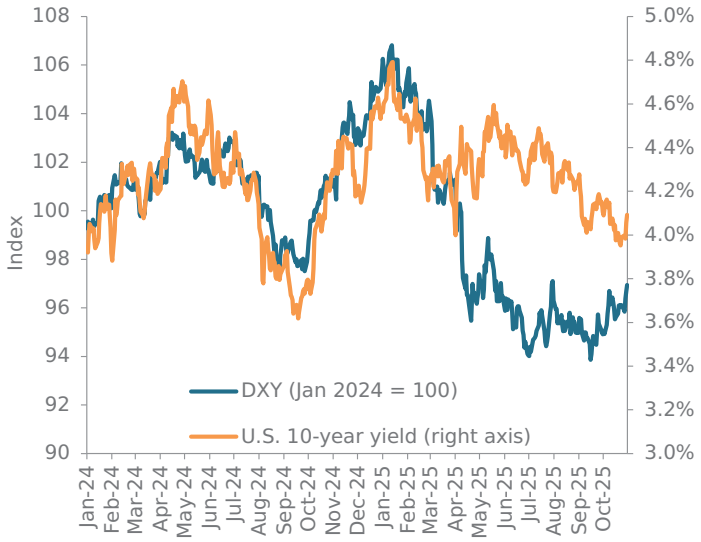


Figure 1.3. Dollar Index (DXY) and the yield of 10-year U.S. treasuries

Source: investing.com, FRED.

high as a result of tariff policies. Following weak economic activity in the first quarter of 2025, largely due to the front-loading of import purchases, strong growth was recorded in the second quarter. Aggregate demand remains robust, with output exceeding its potential level, thereby exerting upward pressure on prices from the demand side. Despite a somewhat reduced contribution, household consumption remains the primary source of aggregate demand, supported by the strong position of household balance sheets, largely reflecting rising financial asset prices. This is accompanied by fiscal stimulus, which, in turn, affects long-term inflation expectations and increases fiscal sustainability risks. As a result, in the U.S., the disinflation, particularly of sticky prices, has slowed. Announced tariff policies and strong demand, combined with tighter immigration policies, further contribute to inflationary pressures by increasing wage pressures and supporting elevated sticky price inflation. In response to labor market challenges, the Federal Reserve has begun a gradual exit from its tight monetary policy stance. Market expectations for the policy rate trajectory have shifted downward (see Figure 1.2). Considering ongoing inflationary risks, yields on 10-year Treasury securities remain elevated, although a declining trend has emerged recently amid monetary policy normalization. Amid prevailing uncertainty, the U.S. dollar index remains in a weak position (see Figure 1.3).

The euro area also faces short-term challenges in maintaining a balance between price stability and output. Headline inflation fluctuates close to the 2% target, standing at 2.1% in October, while services inflation remains elevated at 3.4%. This largely reflects robust wage growth and persistent labor market tightness. However, wage-related pressures are expected to gradually ease in line with productivity gains. Amid these inflationary developments, the European Central Bank continues the normalization of its monetary policy at a gradual pace. In terms of economic activity, divergences persist among member countries. In several euro area economies, weak industrial performance remains a key headwind, although positive trends are observed in both manufacturing and services sectors. In Germany, higher defense and infrastructure spending could have a positive impact on economic growth; however, the overall outcome will depend on whether these expenditures stimulate private investment or increase import dependence. According to the IMF's latest projections, expectations for an improvement in economic activity in the euro area have strengthened (see Figure 1.4).

Under the conditions of a temporary suspen-

Compared to the previous forecast, economic growth expectations in Georgia's main trading partner countries have remained largely unchanged. However, growth prospects in the euro area have slightly improved, supported by planned fiscal stimulus measures and a more accommodative monetary policy stance.

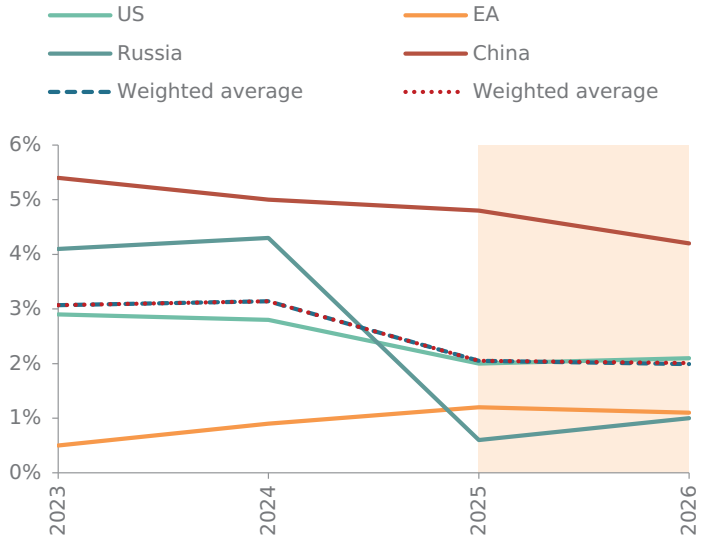


Figure 1.4. Real GDP Growth of Economic Partner Countries*

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.

International food prices exhibit an upward tendency, which is largely driven by the rising cost of certain products. On the other hand, the declining trend in oil prices observed in recent months continues.

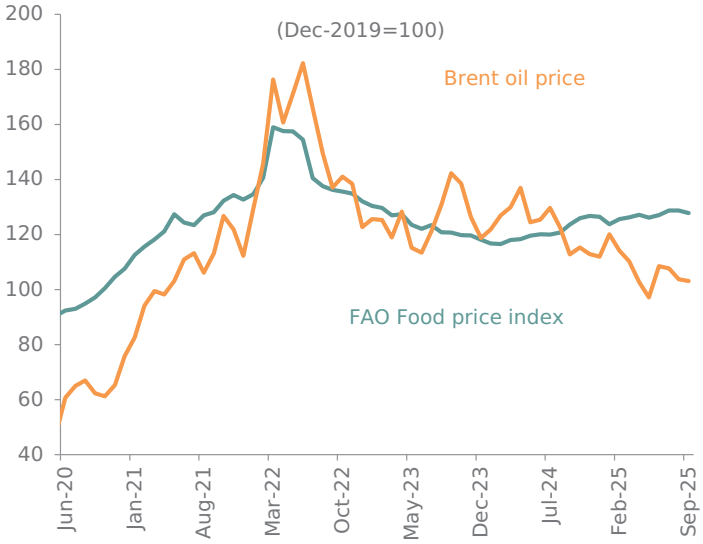


Figure 1.5. International Commodity Prices, Index, Dec-2019=100

Source: FAO, Bloomberg, NBG.

sion of tariffs, China's economy maintained strong growth, with real GDP expanding by 5.2% in the first 9 months of 2025. This outcome reflects robust industrial production and higher-than-expected export performance. Nevertheless, domestic demand remains weak, driven on the one hand by prolonged challenges in the real estate sector. On the other hand, labor market weakness and expectations of declining household income amid prevailing uncertainty have led consumers to adopt a more cautious stance. The IMF projects China's long-term economic growth to slow to around 4%, which, other things being equal, is expected to weigh on global long-term growth prospects as well. Notably, deflationary pressures persisted throughout 2025, with consumer prices falling by 0.3% in September. Against this backdrop, there is a growing need for additional monetary policy easing. However, due to the ongoing real estate crisis, demand for credit has weakened, limiting the effectiveness of traditional monetary policy instruments such as interest rate cuts and additional liquidity provision in stimulating credit and overall economic activity. Considering the relatively reduced effectiveness of monetary policy, the role of fiscal policy will be increasingly important.

Regarding Russia, despite a slight reduction in the policy rate, the central bank continues to maintain a tight monetary policy stance in light of ongoing inflationary pressures. Structural challenges in the economy persist. In addition, according to the IMF, the economic growth outlook for 2025 has been revised downward, partly reflecting a higher base effect resulting from increased fiscal spending in the last quarter of the previous year. Geopolitical risks, alongside current and potential additional economic sanctions, continue to worsen Russia's medium-term growth outlook (see Figure 1.4).

Amid various risks, uncertainty remains particularly high in international commodity markets. Prices in these markets are characterized by significant volatility, and forecasts are often subject to frequent revisions, creating the possibility of multiple scenario developments. Currently, signals from these markets are mixed. International food prices have largely been inflationary annually, while oil prices have shown deflationary trends. Specifically, in September, the international food price index increased by 3.4% annually (see Figure 1.5). This rise was primarily driven by price increases in certain products, including vegetable oils, which have already affected the Georgian market. Nevertheless, globally, stocks of individual food commodities remain relatively abundant, and yields are high. As a result, prices for these

products exhibit a declining trend. The combination of these factors contributes to the presence of mixed signals in the food market.

Global oil prices continue to exhibit significant volatility. On the supply side, both current and projected conditions maintain downward pressure on prices. At the same time, relatively weak demand also exerts a moderating effect on prices. However, higher-than-expected economic activity in the first half of 2025, including in China, partially limited the downward pressure from demand. In the third quarter of 2025, Brent crude oil prices fluctuated within a range of $68–71 per barrel. According to the U.S. Energy Information Administration (EIA), a significant decline in oil prices is expected in 2026. Geopolitical and market risks remain elevated; however, current market expectations are largely tilted toward lower prices. On the one hand, oil production growth, including from OPEC+ countries, and on the other hand, relatively weak expected demand, both contribute to downward pressure on prices. At present, fuel prices in Georgia are disinflationary, though their future impact, other things being equal, will depend largely on developments in the global oil market as well as the exchange rate dynamics of the Georgian lari.

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

Relatively high-productive sectors continue to remain among the main drivers of economic growth. However, the expansion of these sectors is gradually converging toward its long-term pace.

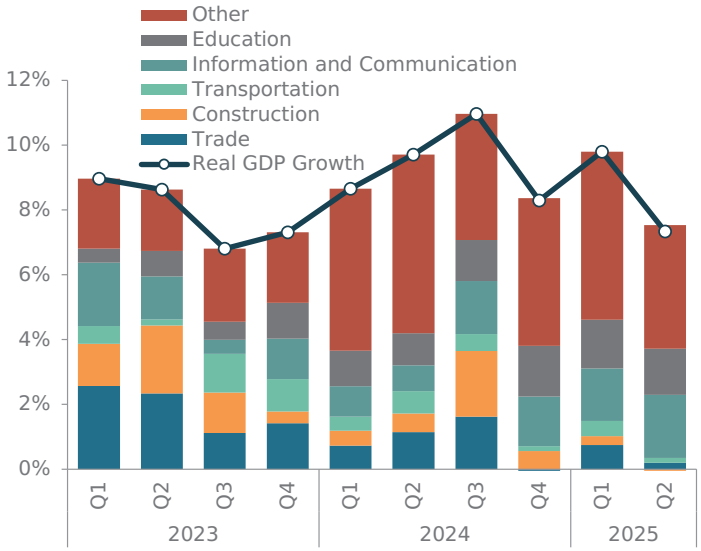


Figure 2.1.1. Sectoral Decomposition of Real GDP growth (Contribution to the Growth)

Source: NBG, Geostat.

Amid the ongoing structural changes in the economy, the contribution of higher-productive service sectors has increased significantly. These sectors remain the main drivers of growth. Consequently, the trend of less import-intensive economic expansion continues.

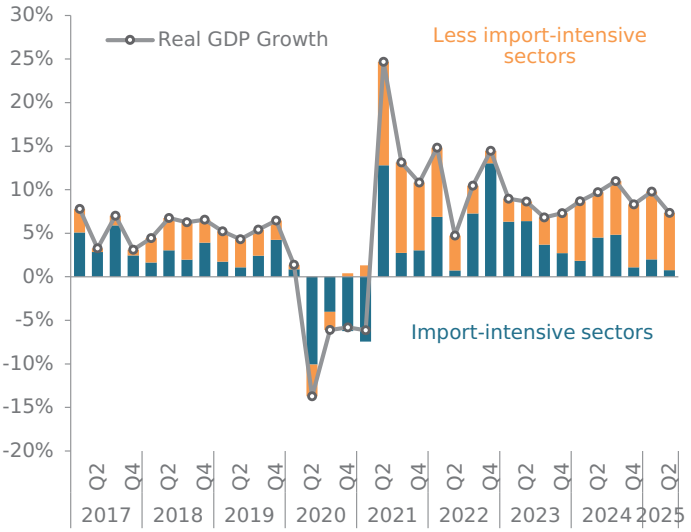


Figure 2.1.2. Sectoral composition of real GDP growth by degree of import dependence (contribution to growth)

Source: NBG, Geostat.

2.1. OVERVIEW OF THE CURRENT MACROECONOMIC ENVIRONMENT IN GEORGIA

In accordance with the NBG's central scenario, economic activity is gradually converging toward its long-term growth rate. Preliminary data indicate that real GDP grew on average by 7.7% in January-September of 2025. In the third quarter, the growth rate normalized partially due to last year's high base effect; however, economic activity remains elevated compared with the previous quarter. Notably, growth in 2025 continues to be driven by higher-productive, service-oriented sectors, with information and communication playing a leading role (see Figure 2.1.1). Consequently, the dynamics of less import-intensive economic growth observed in recent years persists (see Figure 2.1.2). At the same time, signs of normalization toward the economy's long-term trend are emerging, as evidenced by the recent slowdown in growth in the construction and transportation sectors.

Aggregate demand also shows signs of normalization. In the first half of 2025, the positive contribution of consumption declined (see Figure 2.1.3), partly due to the high base effect from the previous year. Moreover, the slowdown in real income growth further indicates the normalization of domestic demand (see Figure 2.1.4). Despite ongoing structural changes in the economy, reflected in the increasingly dominant role of service-oriented sectors, the relatively weak import dynamics also indicate a normalization of domestic demand. Under these conditions, net external demand has had a positive impact on economic growth. As for investment, it has been supporting aggregate demand, contributing to capital formation and potential growth. However, its positive contribution diminished in the second quarter of 2025.

The normalization of aggregate demand is also supported by the convergence of credit activity growth toward its long-term trend (13-15%). In September 2025, the year-over-year growth of total credit portfolio reached 13.3% (see Figure 2.1.5). This development primarily reflects a moderation in lari-denominated lending, alongside a gradual deceleration in the growth of foreign currency–denominated loans. Part of the moderation in credit portfolio growth reflects the repayment of several large loans, both in lari and foreign currency.

Recently, net external demand had a positive impact on growth, while domestic factors are gradually normalizing.

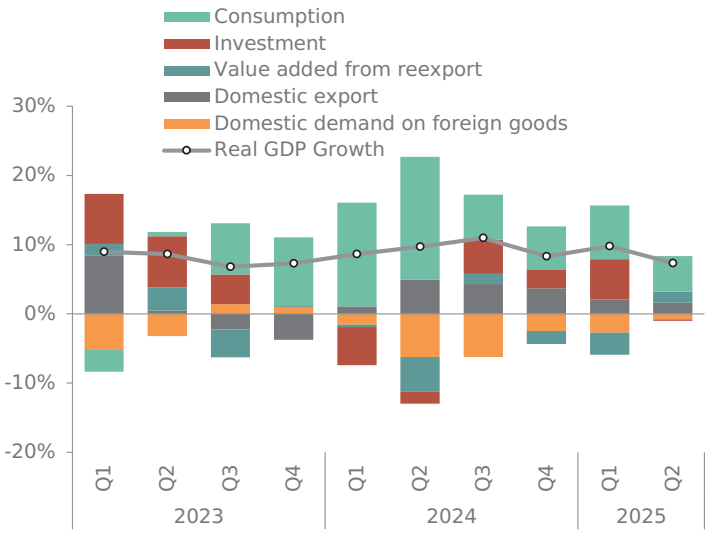


Figure 2.1.3. Decomposition of Real GDP Growth by Expenditures (Contribution to the Growth)

Source: NBG, Geostat.
* **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.

The moderation in real wage growth contributes to the normalization of domestic demand.

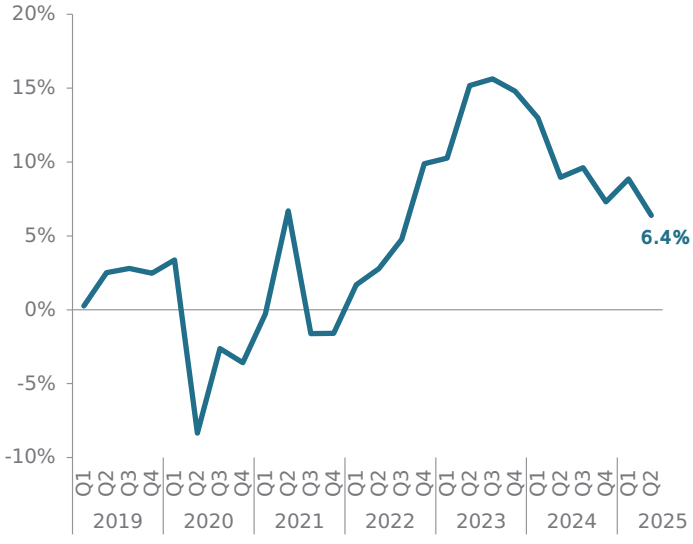


Figure 2.1.4. Year-over-year Growth Rate of Real Wages*

Source: Geostat, NBG estimate.

* **Real wage** is calculated by adjusting nominal wage for the price level.

In addition, the tightening of lari-denominated financial conditions - particularly in the large business segment (see Figure 2.1.6) - has contributed to a slowdown in lending within this category, thereby playing a significant role in moderating overall credit growth. The moderation in credit activity among large businesses, in turn, drives a faster convergence of real GDP growth toward its long-term trend.

On the other hand, other things being equal, the gradual exit from the tight monetary policy stance in advanced economies (see Figure 1.2) is contributing to a decline in interest rates on foreign-currency loans in the domestic market (see Figure 2.1.6). Nevertheless, amid prevailing uncertainty, foreign interest rates remain at elevated levels.

As noted, external demand positively influences economic activity while also supporting an improvement in the current account balance. Structural changes in the economy positively influence current account balance. In particular, against the backdrop of growth in less import-intensive sectors and relatively stable export inflows, the improvement in the trade balance of goods and services contributes to reducing the current account deficit. At the same time, the normalization of domestic demand lowers import-related expenditures. It is noteworthy that under conditions of aggregate demand normalization, not only consumer imports but also investment and intermediate goods imports are expected to gradually normalize - a trend that is already observable. Within the structure of domestically consumed imports, investment goods imports were relatively weak in the second and third quarters (see Figure 2.1.7), reflecting both price and quantity effects. The decline in investment-related imports in the third quarter of 2025 also signals a deceleration of new capital formation. Overall, in the third quarter of 2025, domestically consumed goods imports increased by 4.2%, while domestic exports rose by 9.3%.

Service exports remain an important source of external inflows. In particular, tourism revenues grew by 6.6% year-on-year in the third quarter of 2025. The export growth of the information and communication (ICT) sector is also notable, with its share accounting for 2.9% of GDP in the first half of 2025. Remittances continue to be a significant source of external inflows, with annual growth reaching 12% in the third quarter of 2025. Given the existing dynamics, the current account deficit in 2025 is expected to remain close to the optimal 5% of GDP (see Figure 2.1.8).

Notably, these external inflows, amid a globally

The slowdown in credit activity growth is primarily driven by business loans, which contributes to a faster convergence of economic growth toward its long-term level.

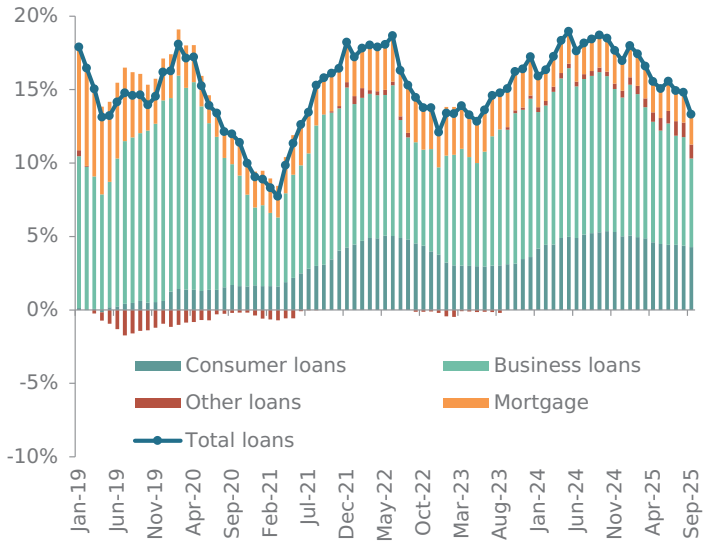


Figure 2.1.5. Year-over-year Growth Rate of Loans in Domestic and Foreign Currencies (Excluding Exchange Rate Effects)

Source: NBG.

The tight financial conditions in GEL are mainly driven by large business loans, while in foreign currency, amid the relative easing of global financial conditions, there are signs of declining interest rates, but still remains high.

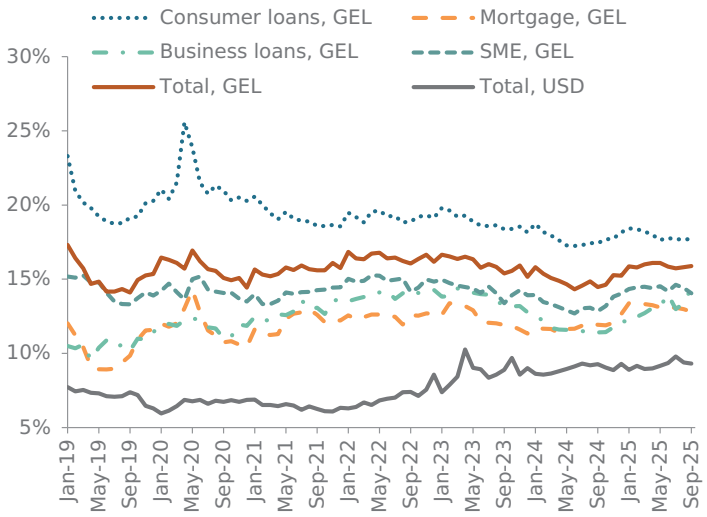


Figure 2.1.6. Interest Rates on Loan Flows in National and Foreign Currencies (Breakdown of GEL-denominated Loans by Purpose)

Source: NBG.

weaker US dollar, help maintain the lari exchange rate at a stable level. This effect is disinflationary through the balance sheet channel. At the same time, alongside the stability of the lari exchange rate, deposit dollarization is declining (see Figure 2.1.9), particularly due to the increase in lari-denominated deposits by households, reflecting stable consumer sentiment. As of September, the level of deposit dollarization has nearly returned to the pre-growth level recorded at the end of 2024.

Meanwhile, the sovereign risk premium remains close to its steady-state level, as evidenced by the spread between 5-year USD-denominated government bond yields of Georgia and the United States (see Figure 2.1.10). This, in turn, is disinflationary through the exchange rate channel.

The globally weak position of the US dollar has also positively affected the exchange rates of Georgia's major trading partner currencies, with the exception of Türkiye. As a result, the lari's nominal effective exchange rate has largely remained stable, supported by appreciations against the Turkish lira and the US dollar. As for the real effective exchange rate, in recent months it has been approaching the equilibrium level from above, primarily influenced by inflation differentials (see Figure 2.1.11). A significant factor in this process is high inflation in Türkiye.

In turn, the year-over-year depreciation of the real effective exchange rate increases the competitiveness of domestically produced tradable goods in international markets. However, it simultaneously exerts upward pressure on imported inflation.

As noted, the growth of real wages is decelerating, partly reflecting a decline in labor market tightness. Specifically, the ratio of job vacancies to the unemployment rate has decreased (see Figure 2.1.12). Against the backdrop of slower income growth and still-high productivity gains, unit labor costs declined in the third quarter, exerting downward pressure on inflation (see Figure 2.1.13). At the same time, the slowdown in real wage growth supports the normalization of domestic demand, which, in turn, moderates the pace of inflation.

Overall, both domestic and external economic factors exert both upward and downward pressures on inflation. In recent months, the moderate increase in inflation has been driven mainly by food prices. As of October, out of the 5.2% year-on-year inflation, 3.7 percentage points (pp) were attributable to the rise in food prices.

The increase in food price inflation reflects both last year's low base effect and prevailing dy-

In 2025, the relatively weak position of domestically consumed imports is largely driven by a decline in imports of the investment goods.

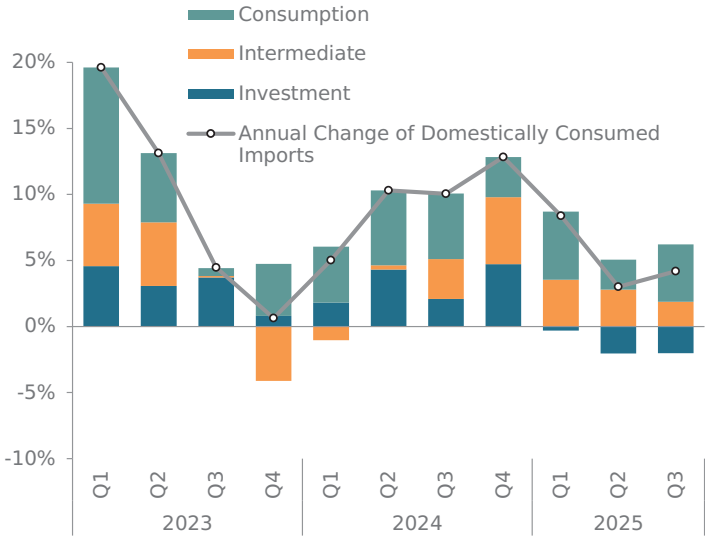


Figure 2.1.7. Breakdown of Domestically Consumed Imports by BEC Category*

Source: NBG, Geostat.
* Domestic imports includes imports excluding those of machinery, gasoline, paintings, copper, and goods of unspecified type.

Current tendencies in the external sector support the maintenance of the current account deficit within its equilibrium level (5-5.5% of GDP).

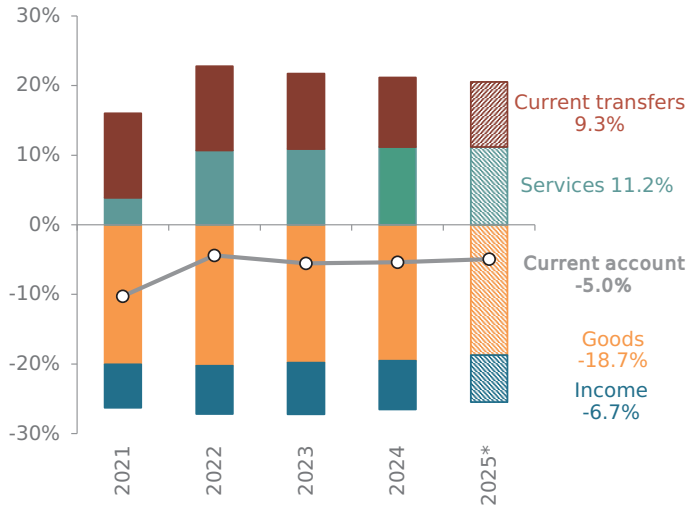


Figure 2.1.8. Current Account Balance Decomposition (% of GDP, according to BPM5)

Source: NBG.

namics in international and domestic food markets. The year-over-year growth in international food commodity prices has partly transmitted to the domestic market (see Figure 2.1.14), contributing to flexible price adjustments. For example, rising oil prices have pushed up mixed inflation on a year-on-year basis, while falling sugar prices have had an offsetting effect. Accordingly, as noted in the global macroeconomic overview, mixed signals continue to prevail from international food markets.

At the same time, among domestic factors, the price increase of certain products, such as bread, which exhibit relatively high stickiness makes a significant contribution both to food inflation and to the rise in domestic price inflation.

Within the context of international commodity markets, mixed signals are also evident in oil prices. Specifically, fuel prices are exerting downward pressure on headline inflation (see Figure 2.1.14). However, risks in the oil market remain elevated, and uncertainty surrounding them persists (see Chapter 1).

Regarding domestic inflation dynamics, price increases in certain types of services (particularly, healthcare) also contribute to inflation. However, the headline inflation of services in October 2025 is below the 3% target, amounting to 2.5%. Given the inherent price stickiness in the services sector, this development suggests stability in long-term inflation expectations. It is also noteworthy that long-term inflation expectations are well reflected in the inflation of sticky prices, which has recently increased due to the effect of bread prices but, excluding this effect, remains below the target level (2.1% as of October).

Overall, amid the persistence of sticky price measures, supply-side inflationary pressures at this stage have not led to a significant increase in inflation expectations. However, given the prevailing uncertainty, risks remain elevated, warranting a cautious monetary policy stance (see Box 1).

Deposit dollarization has nearly returned to its pre-growth level at the end of 2024, supported by the stable position of the lari.

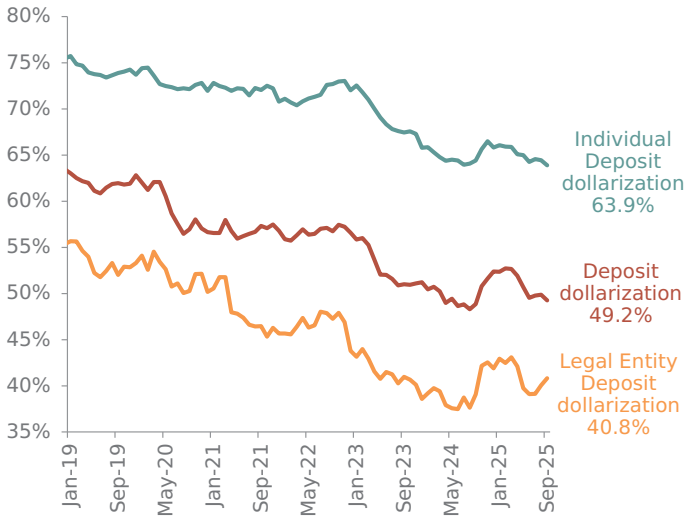


Figure 2.1.9. Deposit Dollarization (Excluding Exchange Rate Effects)

Source: NBG.

Increased uncertainty both globally and locally has also raised Georgia's sovereign risk premium, though at this stage its level remains close to equilibrium.

Figure 2.1.10. Spread Between 5-Year USD-Denominated Government Bond Yields of Georgia and the United States

Source: Bloomberg, NBG.

The real effective exchange rate has been gradually converging toward its equilibrium level, supported by the inflation differential channel.

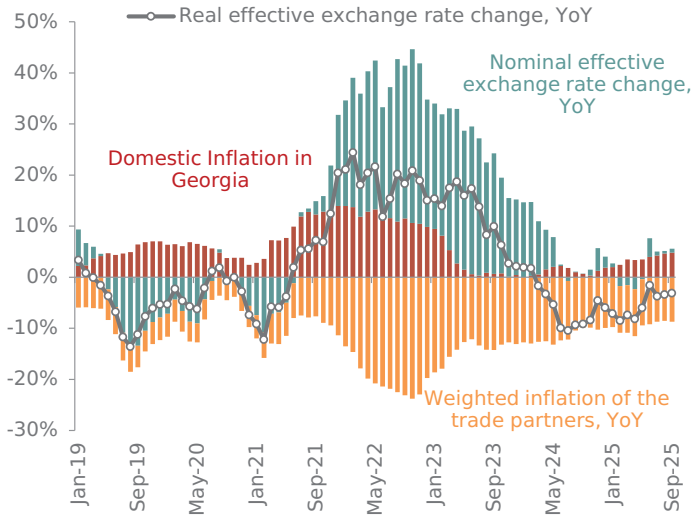


Figure 2.1.11. Decomposition of the Year-over-year Change in the Real Effective Exchange Rate of the Georgian lari*

Source: NBG, Geostat.
* **The Real effective 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.

Labor market tightness exhibits a downward trend.

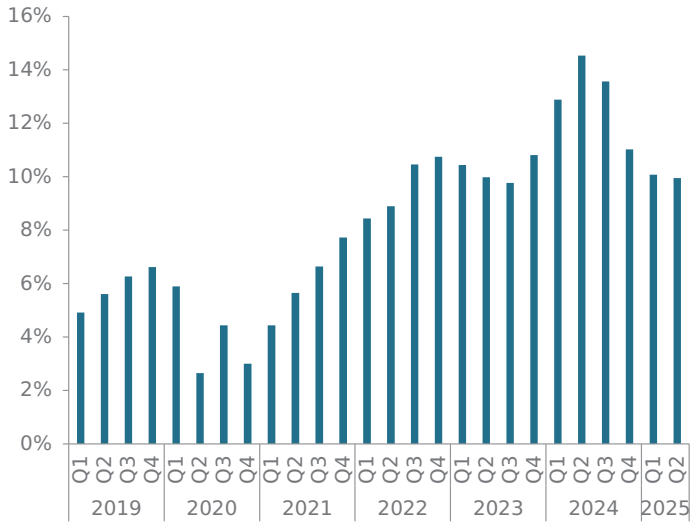


Figure 2.1.12. Ratio of New Job Vacancies to Unemployment Rate (Seasonally Adjusted)

Source: GeoStat, NBG, PMCG.

Against the backdrop of an increasing productivity and a slowing pace of wage growth, year-over-year growth rate of unit labor costs have decreased.

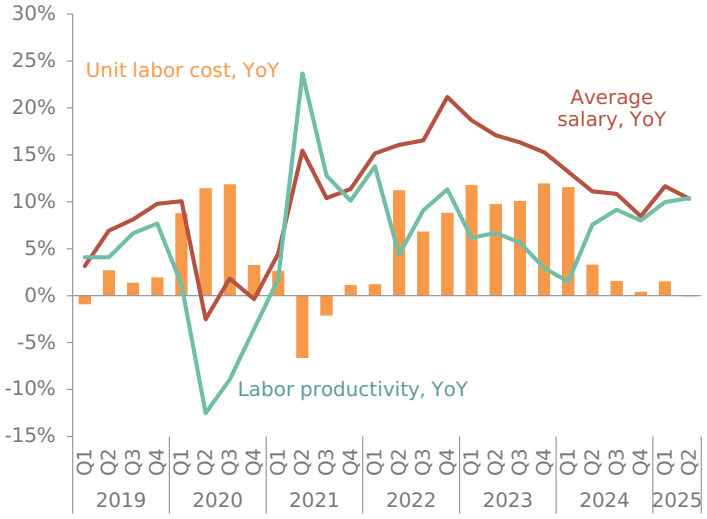


Figure 2.1.13. Average wage, labor productivity, and unit labor cost, y-o-y growth rate

Source: Geostat, NBG.

As in previous months, international food prices continue to exert upward pressure on inflation, while the deflationary effect of fuel persists.

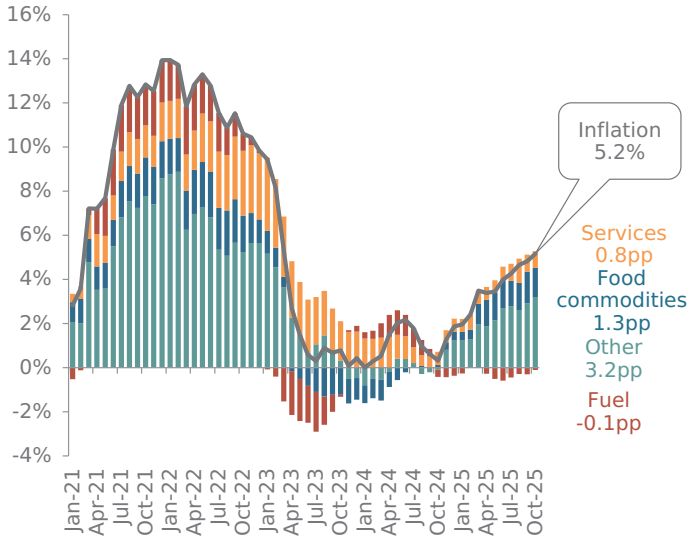


Figure 2.1.14. Inflation by Components

Source: Geostat, NBG.

In recent months, increases in both domestic and international food prices have led to a rise in mixed and domestic inflation. However, the imported inflation component continues to reduce headline inflation.

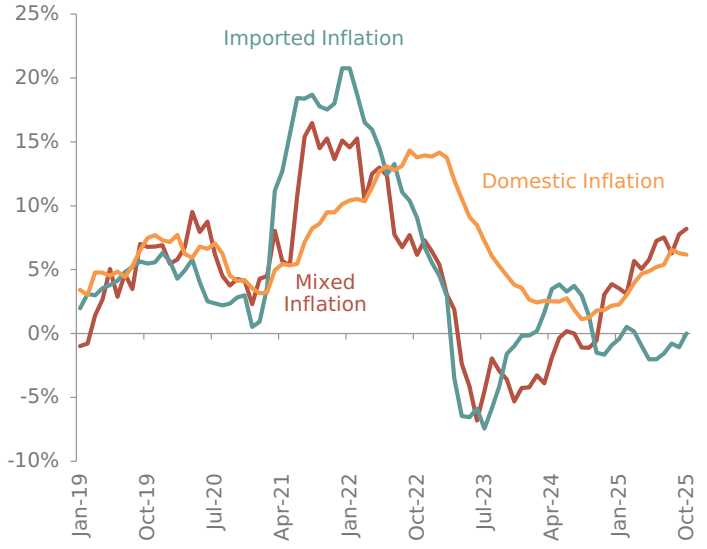


Figure 2.1.15. Mixed, Domestic, and Imported Year-over-year Inflations

Source: Geostat, NBG.

2.2. CENTRAL SCENARIO

In the recent period, the dynamic of the domestic economy has been particularly noteworthy. Specifically, the rise in food prices for both domestic and mixed products has served as a key driver of inflation. Although core inflation remains below the 3% target, the risk of rising inflation expectations remains significant. This, under a risk-minimization approach, calls for a cautious policy stance. Meanwhile, the uncertainty in the global economy remains high. The global economic fragmentation and regional geopolitical turbulence continue to pose significant risks. Amid these tendencies and uncertainties, the National Bank of Georgia's (NBG) central scenario incorporates a broad range of current information discussed in the previous chapters, including assumptions about exogenous factors, transmission mechanisms of the economy, and monetary policy response preferences[2].

One of the main sources of global uncertainty remain the fragmentation of the world economy (driven by trade policy) and the re-escalation of regional conflicts. In addition, global fiscal risks, and consequently the potential rise in financial vulnerabilities, are also noteworthy (see the Overview of the Global Macroeconomic Environment). The direct effects of tariff policy on the Georgian economy are limited. In the central scenario, its impact is largely indirect, considered within the context of already slowed global economic activity and heightened uncertainty. The scenario also assumes the continued maintenance of improved situation in the Middle East and the stability of the global fiscal environment.

The dynamics of domestic economic growth are in line with expectations. The main drivers of growth remain highly productive and service-oriented sectors. Meanwhile, even with a still-positive output gap, indicators for the construction sector and overall capital formation show signs of normalizing toward the economy's long-term level. The central scenario, amid currently robust external inflows, assumes a significant contribution of external demand to economic growth. Consistent with expectations, this implies an unchanged forecast for real GDP growth compared to the previous projection, reflecting both the normalization of fundamental factors and the inertia of economic growth observed in the first 9 months. **Accordingly, economic growth is projected to be 7.4% in 2025 and 5.0% in 2026** (see Figure 2.2.1).

2 The National Bank's priorities to anchor inflation expectations around the inflation target, which may include, among other measures, delayed policy normalization.

The dynamics of economic growth is in line with expectations. Highly productive and service-oriented sectors remain the key drivers of growth. Hence, economic growth is projected at 7.4% in 2025 and 5% in 2026. The average forecast of financial market participants also remains unchanged.

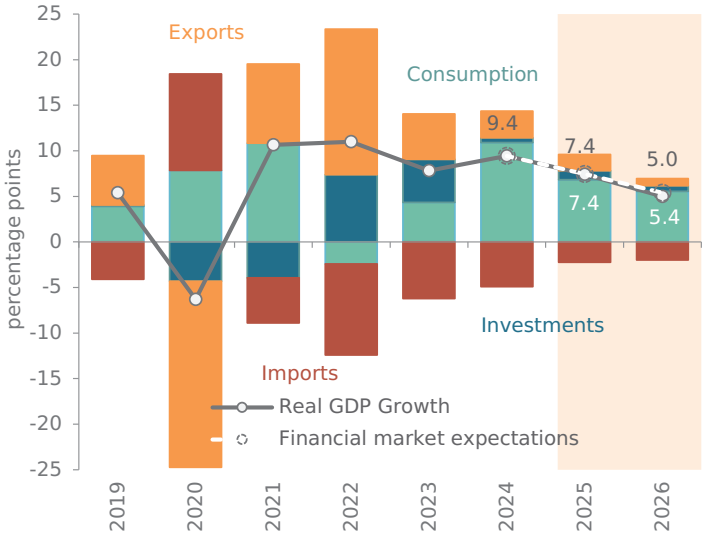


Figure 2.2.1. Central Scenario for Real GDP Growth and Financial Market Participants' Expectations of Economic Activity

Source: NBG, Financial Market Participants, Geostat.

Under the central scenario, given the current inflation inertia, base effects, and exogenous factors, inflation is expected to remain temporarily above 3% and to reach its peak within the current year. In 2026, inflation is projected to average 3.5% and expected to converge toward the target from below.

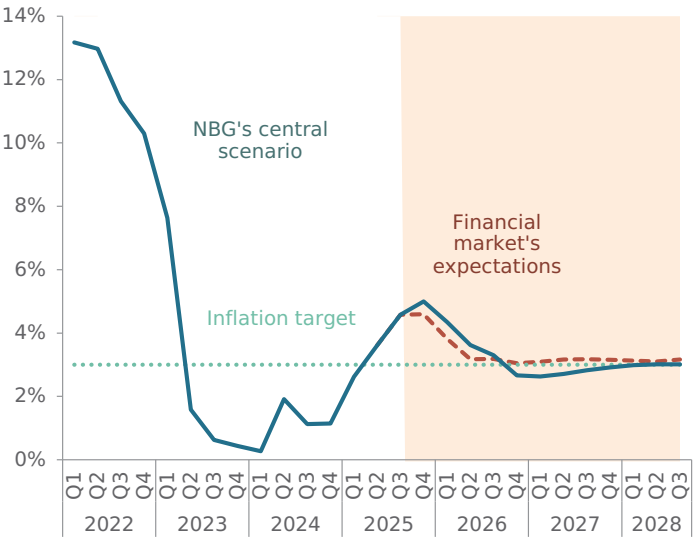


Figure 2.2.2. Central scenario of annual inflation and inflation expectations of financial market participants

Source: NBG, Financial Market Participants.

Notably, expectations regarding economic growth on the financial market largely align with the NBG's central scenario. The average forecast of market participants for economic growth remains unchanged compared to the previous quarter and stands at 7.4% and 5.4% for 2025 and 2026, respectively (see Figure 2.2.1).

Regarding inflation, in the current period, commodity prices have contributed significantly to its dynamics. In particular, the inflationary effect of food and the disinflationary effect of oil are substantial. Given their notable contribution, amid the global and domestic uncertainties surrounding their prices, the current central scenario is largely based on assumptions concerning their first- and second-round effects.

The high food inflation, along the low base effect from the previous year, is explained by factors largely independent of monetary policy. Specifically, amid adverse climate conditions, the supply capacity available to the domestic market weakened. Additionally, global food prices increased, further intensifying inflationary pressures on the domestic market.

The current central scenario, taking into account climate and geopolitical developments, assumes that the international food price index (FAO) for the basket of products relevant to Georgia will remain around the current level. On the domestic market, following the inflationary peak at the end of the year, a decline in food inflation is expected, partly reflecting high base effects. As a result of high weight in the price index, bread prices exert significant pressure on both food and domestic inflation. The recent consecutive increase in bread prices is explained by rising flour costs and, according to sectoral information, catch-up effects for previously lagging wages. Based on the current assessment, over the medium term, the cumulative effect of rising bread prices on overall inflation is estimated at 0.8 pp.

Central banks typically do not respond to exogenous, transitory supply shocks, except in cases when such shocks lead to an increase in medium- and long-term inflation expectations. According to the central scenario, the inflationary pressure stemming from food prices will have only a one-off effect and will gradually fade away. Accordingly, it does not incorporate second-round effects. Nevertheless, this risk remains noteworthy in the current period, as its materialization would create a higher-inflation environment compared with the central scenario, leading to economic losses (see the High-inflation scenario). Therefore, under a risk-minimization approach, additional caution regarding the normalization of monetary policy is incorporated in the central scenario.

The gradual normalization of inflation toward its target, amid a tight monetary policy stance, will be driven by the easing of inflationary pressures stemming from aggregate demand and food prices.

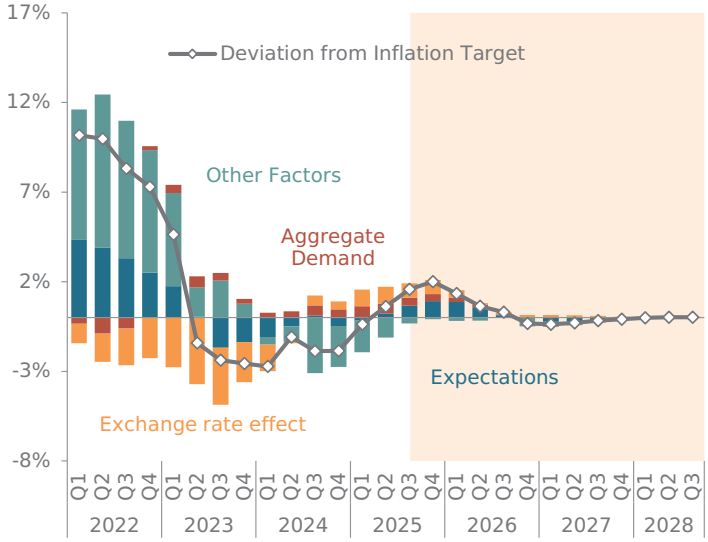


Figure 2.2.3. Decomposition of the deviation from the annual inflation target under the central scenario

Source: NBG, Geostat.

In the central scenario, given short-term inflationary risks that are largely independent of monetary policy, normalization of the policy rate is expected to be slightly delayed and will proceed only once a clear tendency of inflation returning to the target is observed, amid sufficiently eased inflationary risks.

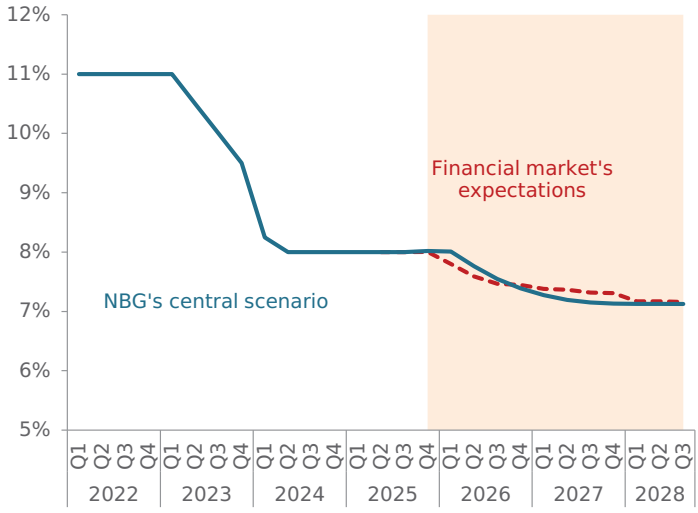


Figure 2.2.4. Central scenario of the monetary policy rate and expectations of financial market participants

Source: NBG, Financial Market Participants.

As noted above, assumptions regarding domestic petroleum product prices have particular importance in the central scenario. According to the October forecast of the U.S. Energy Information Administration (EIA), amid an oversupply on the market and, consequently, increased inventories, oil prices are expected to decline to an average of 52 U.S. dollars per barrel in 2026. In turn, this surplus is driven by the partial easing of supply restrictions imposed by OPEC+ along the increase in production from non-member countries. It is also noteworthy that China's accumulation of strategic reserves exerts upward pressure on prices. Hence, a slower-than-expected pace of this accumulation would further reduce prices. On the other hand, the non-easing of OPEC+ supply restrictions and/or disruptions stemming from the Russia–Ukraine war and related sanctions would put upward pressure on prices.

Despite positive forecasts for international oil prices, the central scenario, under a risk-minimization approach, assumes a conservative pass-through of international prices to the domestic market. The rationale for this conservative assumption, alongside the aforementioned global uncertainties, lies in domestic factors, specifically, the uncertainty related to the reallocation of import sources of petroleum products and the stickiness in domestic prices.

In the central scenario, pressure stemming from the economy's fundamental factors is less inflationary. Against the backdrop of still-high productivity, demand-side inflationary effects remain weak. Meanwhile, amid improvements in the current account, the nominal exchange rate is expected to significantly mitigate inflationary pressures originating from trading partners.

According to the central scenario, accounting for the inertia of current inflation and exogenous factors, **inflation will temporarily remain above the 3% target and is expected to reach its peak this year. As a result, inflation is projected to average 4.0% in 2025**. Considering the gradual dissipation of the inflationary effect of food prices, the base effect from the previous year, and other aforementioned factors, **inflation is projected to average 3.5% in 2026. By the end of the year, it is expected to converge toward the target from below** (see Figures 2.2.2–2.2.3).

Over the forecast horizon, compared to the previous central scenario, the inflation has been revised up by 0.2 pp in 2025 and by 0.4 pp in 2026. Partially, both high- and low-inflation risks have been materialized. In terms of agricultural product prices, inflationary pressures in the sector were stronger than expected. Moreover, an additional, unexpected shift in bread prices added

The high-inflation scenario is primarily based on a prolongation of elevated food inflation and the rapid normalization of the economy's potential. It also envisages a renewed escalation of geopolitical tensions and tariff policy, as well as inflationary pressures stemming from commodity markets.

High-Inflation Risks	
◦ A slowdown in global economic activity, notably amid structural challenges in China's economy. ◦ Globally, a stronger-than-expected intensification of economic fragmentation - a re-escalation of tariff policies. ◦ A deepening of fiscal imbalances in advanced economies. ◦ A re-escalation of the geopolitical situation in the Middle East. ◦ A fast normalization of the domestic economy's potential.	
Indicators of risk realization	**Impact on inflation**
A deterioration of short-term inflation expectations.	↑
Higher-than-expected commodity prices in global and domestic markets.	↑
Weak external inflows and a deterioration of the current account balance.	↑
A slowdown in the growth of highly productive sectors.	↑
An increase in the country risk premium alongside persistently high global interest rates.	↑
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.

0.2–0.3 pp to inflation. On the contrary, foreign currency inflows were higher than expected, supporting a stronger-than-anticipated position of the Lari. Notably, despite positive forecasts for the oil market, the central scenario, as in the previous scenario, envisions limited disinflationary impact stemming from petroleum prices, which is not the most likely outcome, but rather an assumption based on a risk-minimization approach.

Similar to economic growth expectations, inflation expectations of financial market participants are largely in line with the NBG's central scenario. In particular, according to financial market forecasts, average inflation for 2025 has increased by 0.1 pp, averaging 3.9%, while for 2026 it remains unchanged at 3.3% (see Figure 2.2.2). It is noteworthy that financial market forecasts may not capture the effects of the recent increase in bread prices.

Under the central scenario, taking into account short-term domestic and global inflationary risks that are independent of monetary policy, the monetary policy normalization will be slightly delayed and will proceed only once inflationary risks have sufficiently eased. This implies a relatively delayed normalization of the policy rate compared with financial market expectations (see Figure 2.2.4).

2.3. HIGH-INFLATION SCENARIO

Amid high uncertainty, the **High-Inflation Scenario** is as relevant as the central scenario and considers the realization of the identified risks that would result in a higher inflation than in the central scenario. In particular, the scenario assumes a more pronounced materialization of both domestic and global inflationary risks identified in the current data, relative to the central scenario, and also takes into account elevated inflationary pressures stemming from commodity markets. Accordingly, if these risks materialize, the NBG will pursue a tighter monetary policy compared with the central scenario to prevent a deterioration of long-term inflation expectations.

As highlighted in the overview of the global macroeconomic environment[3], amid China's structural problems, risks of a slowdown of global economic growth are emerging. Meanwhile, uncertainty surrounding global tariff policy persists, as its agenda has been revised several times. Its re-escalation would accelerate global economic fragmentation more than anticipated, creating a

3 *See Chapter 1, Overview of the Global Macroeconomic Environment.*

stagflationary environment and further increasing uncertainty in the global economy (See Figure 1.1). At the same time, alongside the slowdown in the global economy, fiscal imbalances in advanced economies are rising, which is expected to put upward pressure on long-term interest rates. The materialization of these risks, on the one hand, will be reflected in reduced external demand due to the slowdown in global economic growth. On the other hand, they will lead to higher global interest rates and an increase in risk premiums. This, amid capital flows from emerging markets to safe-haven assets and a tightening of financial conditions, will hinder access to financing and increase the domestic neutral rate.

This scenario also assumes a re-escalation of the geopolitical tensions in the Middle East, which would significantly increase regional risks and create upward pressure on the oil market. Given that the recent decline in petroleum product prices has been the primary factor exerting downward pressure on inflation, any reversal in their price dynamics due to this or other geopolitical developments could potentially generate nonlinear effects on overall inflation. Consequently, this would necessitate an appropriate monetary policy response and would further dampen economic activity.

The high-inflation scenario, alongside global challenges, also envisions the realization of domestic risks. Specifically, it assumes, relative to the central scenario, a faster normalization of growth in high-productive sectors, including transportation, information, and communications (see Figure 2.1.1), and consequently, of the economy's potential. Accordingly, amid a slower moderation of economic activity compared to its potential, inflationary pressures emerge. In addition, the scenario envisions a prolonged period of elevated food inflation due to adverse climate conditions in previous periods, which may give rise to second-round effects (see Figure 2.1.14). The materialization of these supply-side risks would keep inflation above the target for a prolonged period, thereby influencing long-term inflation expectations. Therefore, in response, the National Bank will tighten its monetary policy stance.

Ultimately, economic growth is projected to decelerate, on the one hand due to the weakening of global economic activity and external demand, and on the other hand as a result of the rapid moderation in the growth of high-productive sectors domestically and the effects of tightened monetary policy. In particular, **under the high-inflation scenario, real GDP growth will be 7.3% in 2025 and 4% in 2026** (see Figure 2.3.1).

Amid fast normalization of economy's potential, monetary policy tightening in response to inflationary pressures, and a slowdown in global economic activity, real GDP growth is expected to fall to 4% in 2026.

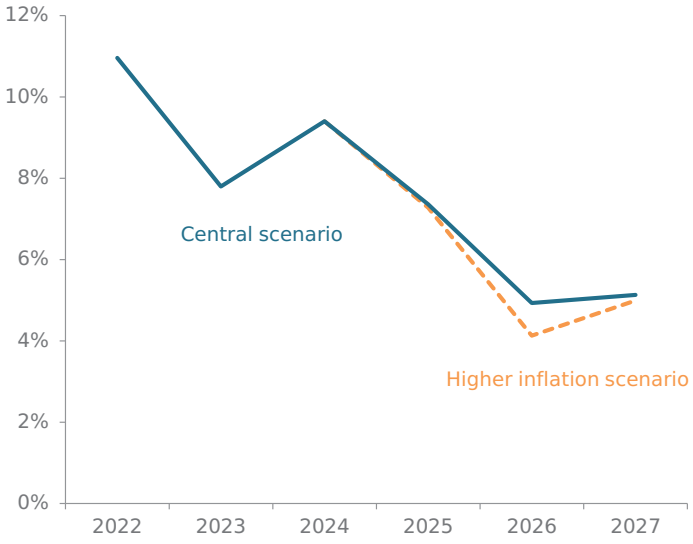


Figure 2.3.1. Real GDP Growth Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

A prolonged period of elevated food inflation, depreciation pressures on the exchange rate, and instability on commodity markets are expected to significantly increase inflationary pressures over the monetary policy horizon.

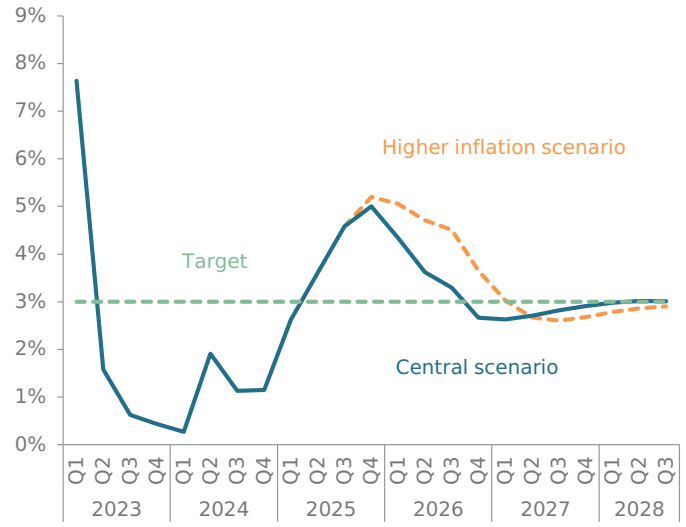


Figure 2.3.2. Year-over-year Headline Inflation Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

The National Bank of Georgia has a low tolerance against the rise in inflation expectations. Consequently, the high inflationary environment in this scenario, compared to the central scenario, will lead to a tightening of monetary policy and its normalization will begin at a gradual pace, contingent on the stabilization of the inflationary environment, towards 7.5% level.

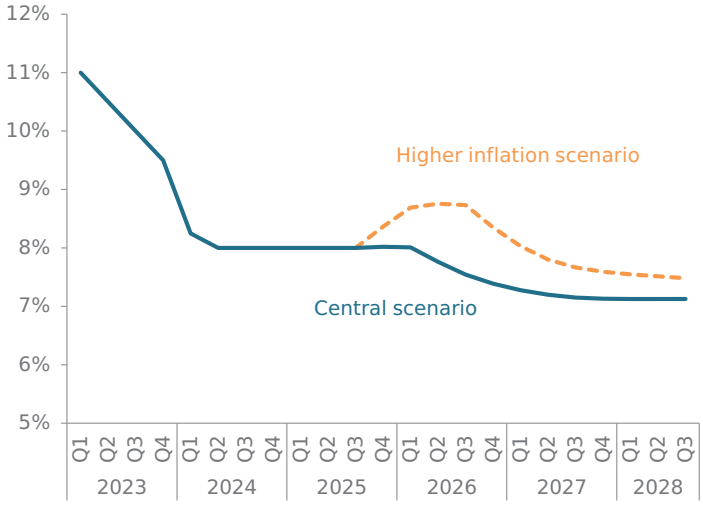


Figure 2.3.3. Monetary Policy Rate Under Central and High-Inflation Scenarios

Source: NBG.

As noted, under this scenario, the globally deteriorated macroeconomic environment will reduce external inflows, which, relative to the central scenario, would widen the current account deficit and exert depreciation pressure on the exchange rate. Meanwhile, effects stemming from international commodity markets and the prolonged period of elevated food inflation will become particularly noteworthy, posing a threat to inflation expectations. **Accordingly, in case of materialization of high-inflation risks, inflation will increase in the current period relative to the central scenario, and in 2026 it is expected to be 1 pp higher, averaging 4.5%** (see Figure 2.3.2).

The NBG exhibits a low tolerance against rising inflation expectations. Consequently, the above-mentioned developments would lead to a tightening of monetary policy. Moreover, the increase in neutral rates in some advanced economies, driven by heightened fiscal risks, **will be transmitted to the domestic neutral rate, driving it up to 7.5%.** Accordingly, **the policy rate will be tightened in the current period and in 2026 it will be 1 pp higher compared to the central scenario.** Subsequently, the policy rate's normalization toward the 7.5% level is expected to continue gradually, contingent on the stabilization of the inflationary environment (see Figure 2.3.3).

2.4. LOW-INFLATION SCENARIO

The low-inflation scenario, compared to the central, envisions lower-than-expected oil and food prices. In addition, the scenario considers a maintenance of productivity at a relatively high level, and the prolonged disinflationary effect stemming from the labor market.

Low-Inflation Risks	
◦ Low oil prices on the international commodity markets and full pass-through to the domestic market. ◦ Amid the slow normalization of highly productive sectors, productivity will remain at a relatively high level. ◦ The prolonged disinflationary effects stemming from the labor market in Georgia. ◦ The longer-than-expected weak position of the U.S. dollar.	
Indicators of risk realization	**Impact on inflation**
Lower-than-expected prices of petroleum products in the domestic market	↓
Robust growth in highly productive sectors	↓
Low unit labor costs	↓
A stronger-than-expected improvement in external inflows and the reduction of the current account deficit	↓
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 is as relevant as the high-inflation and central scenarios. It envisions materialization of the relevant risks that are less inflationary compared to the central scenario (see Table 2.4.1). Particularly, this scenario assumes a rapid decline in global oil prices and full pass-through to the domestic market. Additionally, it implies maintenance of a relatively high level of productivity and, consequently, a prolonged disinflationary tendency stemming from the labor market. Furthermore, the scenario considers the maintenance of weak U.S. dollar positions globally and the geopolitical risks at a low level.

In recent years, Georgia's sustained strong economic growth has been primarily driven by structural changes, particularly the rapid expansion of the information and communication, as well as transportation sectors. The structural changes have enhanced the economy's potential and ensured a high pace of potential growth. The low-inflation scenario assumes that abovementioned sectors will continue to serve as the primary drivers of economic growth. Accordingly, the potential growth will remain at a relatively high level over the long-term compared with the central scenario. This, in turn, will result in stronger productivity growth compared with the central scenario.

The high productivity will offset the pressure stemming from strong demand and, amid disinflationary effects from supply side (primarily due to petroleum product prices), will lead to a rapid normalization of the policy rate. Eventually, under this scenario, **economic growth is projected to average 7.5% in 2025 and 6.0% in 2026, before stabilizing around 5.5% in the long term** (see Figure 2.4.1).

As noted above, under the low-inflation scenario, the high growth rates in highly productive sectors will persist. Consequently, amid stronger services exports (especially IT services) compared with the central scenario, the current account deficit will decrease. Additionally, maintaining the risk premium at a low level will support improvements in business and consumer sentiment, putting further appreciation pressure on the exchange rate (see Figure 2.1.10). This will also be reinforced by the prolonged weakness of the U.S. dollar. All the aforementioned, ultimately, will significantly reduce headline inflation through the imported inflation channel.

A key assumption of the low-inflation scenario is the judgment regarding commodity markets. In particular, according to the latest forecast by the U.S. Energy Information Administration

Under the low-inflation scenario, amid rising external inflows, strong potential growth, and a rapid easing of monetary policy, real GDP growth in 2025 and 2026 will average at 7.5% and 6.0%, respectively.

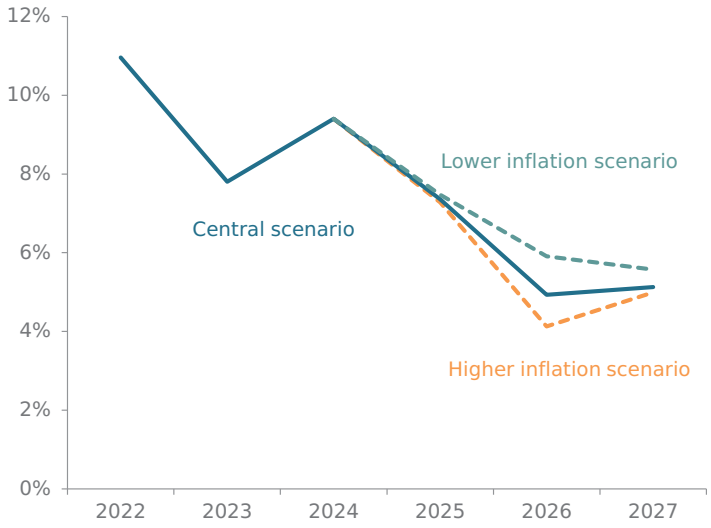


Figure 2.4.1. Real GDP Growth Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

(EIA), amid an increase in global oil supply and high inventory levels, oil prices are expected to decline sharply, reaching 52 U.S. dollar per barrel. The low-inflation scenario assumes rapid and full transmission of this dynamic to domestic petroleum prices. Furthermore, previously elevated domestic food prices will rapidly normalize. Consequently, the abovementioned factors will exert downward pressure on inflation and its expectations.

Amid high productivity and reduced inflation expectations, unit labor costs will remain at a low level, and the disinflationary tendency stemming from the labor market will persist, further reducing domestic inflation. **Thus, compared with the central scenario, inflation will start to decline in the current period, and in 2026 it will be 0.8 pp lower, averaging 2.7%** (see Figure 2.4.2).

Amid subsiding inflationary risks and maintenance of strong fundamental factors, monetary policy normalization will proceed at a faster pace relative to the central scenario. Particularly, alongside an appreciation of the exchange rate, a sharp decline in international oil prices and robust productivity growth will generate significant disinflationary pressures, reducing inflation expectations. **Consequently, the monetary policy rate will ease in the current period and average 7% in 2026** (see Figure 2.4.3).

Amid the lower-than-expected international commodity prices, the prolonged maintenance of high productivity and the disinflationary pressure stemming from the labor market, in 2025 and 2026, inflation will average 3.9% and 2.7%, respectively.

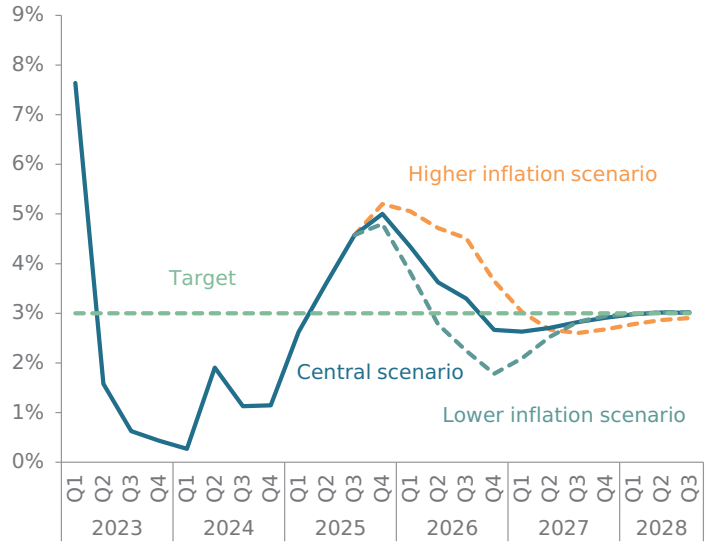


Figure 2.4.2. Year-over-year Headline Inflation Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

Amid the disinflationary pressures stemming from supply-side factors, monetary policy under the low-inflation scenario will normalize toward its neutral level more swiftly than in the central scenario.

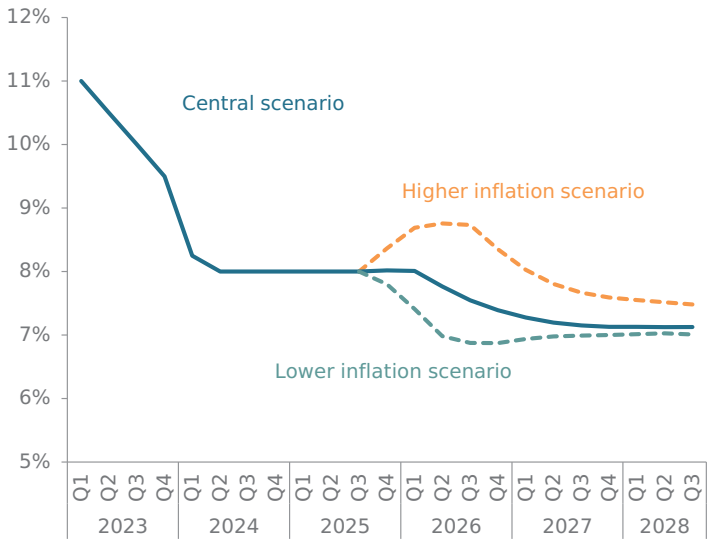


Figure 2.4.3. Monetary Policy Rate Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG.

3. SPECIAL TOPICS

BOX 1. OPTIMAL MONETARY POLICY RESPONSE TO SUPPLY-SIDE SHOCKS

Recent global economic developments highlight that inflation dynamics in both advanced and emerging economies have been largely driven by supply-side shocks. These include disruptions in global supply chains and sharp increases in energy and food prices. Under an inflation-targeting framework, central banks typically do not respond directly to supply-side shocks, as such responses are considered to amplify economic volatility. However, the frequency and magnitude of consecutive supply shocks in recent years raise important questions regarding the appropriate monetary policy response in this context.

As noted, in inflation-targeting economies, the ability of monetary policy to respond effectively to supply-side shocks is often considered limited. This view is based on the assumption that supply shocks are generally temporary and short-lived, while the transmission of monetary policy to the real economy operates with a time lag. Consequently, by the time the impact of monetary policy reaches its peak, the initial shock to prices has already subsided, and policy intervention at that stage could generate additional economic volatility, reduce growth, and push inflation below its target level. Under such conditions, it is optimal for monetary policy to "look through" short-term supply shocks. However, when a supply shock is sufficiently prolonged and/or large in scale to generate so-called "second-round" effects through which the shock begins to influence inflation expectations, a policy response becomes necessary to safeguard price stability over the medium term.

During and after the pandemic, the relatively delayed monetary policy response ("Falling behind the curve") to consecutive supply shocks, particularly in advanced economies, contributed to the materialization of these second-round effects. As a result, measures of sticky price inflation, which serve as reliable indicators of long-term inflation expectations, have remained above the 2% target to this day. In contrast, in emerging economies, including Georgia, monetary policy responded to inflationary pressures more promptly during the pandemic. This partly reflects the greater vulnerability of such economies to supply-side shocks. Nevertheless, despite the swift response, inflationary pressures in emerging markets remained strong: on the one hand, due to the large magnitude of external shocks, and on the other, because structural frictions such as high dollarization and faster transmission of external shocks limited the overall effectiveness of monetary policy.

In general, the extent to which supply shocks can influence long-term inflation expectations depends on several factors, including the existing inflation environment, labor market tightness, and the cyclical position of the economy. Specifically, in a tight labor market where demand for labor is high, employees have greater bargaining power to demand higher wages. At the same time, if aggregate demand exceeds its sustainable level, firms can maintain profit margins by passing higher production costs onto prices. When supply and demand shocks occur together, this amplifies inflationary pressures, increasing the need for monetary tightening to mitigate the risk of a wage-price spiral. It is also important to note that the likelihood of "second-round" effects is particularly high in a high-inflation environment, where price flexibility tends to increase, including in sectors traditionally characterized by sticky prices, since keeping prices unchanged for an extended period becomes more costly for firms. Moreover, price flexibility is typically asymmetric: it tends to increase more quickly than it declines. Under such circumstances, the risks to the stability of inflation expectations and to the credibility of monetary policy intensify.

The vulnerability of inflation expectations to adverse supply shocks is also strongly influenced by the composition of the consumer basket. When the share of flexible-price items (such as food and energy, for which demand is relatively inelastic) is high, any shock that affects their prices has a pronounced impact on both headline inflation and the formation of inflation expectations. In emerging economies, including Georgia, this picture is especially evident: the share of flexible prices in the consumer basket typically varies between 60% and 70%. Consequently, during such shocks, both headline and relative price dynamics exhibit greater volatility, heightening the risk of rising inflation expectations. This, in turn, calls for a more cautious monetary policy stance.

As noted, the transmission of supply shocks to inflation expectations depends on several factors, including the endogenous credibility of the central bank, which is largely shaped by its past inflation performance. When a central bank is characterized by high endogenous credibility, households and firms are more forward-looking and anchor their expectations of future inflation around the target level. In this context, the risk of adverse supply shocks feeding into inflation expectations is minimal, and it may be appropriate for

policymakers to "look through" short-term inflationary pressures without changing the monetary policy stance. However, in emerging economies, where the share of flexible prices is high and inflation is more volatile, expectations tend to be partly backward-looking, reflecting past inflation experiences. Under such conditions, adverse supply shocks increase the risk of inflation expectations becoming unanchored. Against this backdrop, moderate monetary tightening, or maintaining a restrictive stance, may be needed, even at the cost of slower economic activity. This is because if supply shocks become more frequent or persistent, a delayed policy response would later necessitate a much sharper tightening, ultimately leading to greater welfare losses manifested through larger deviations of inflation from the target, reduced economic activity, increased interest rate volatility, and a higher overall price level (see Figure 3.1.1).

The figure 3.1.1 illustrates the impulse response functions describing the dynamics of four key macroeconomic variables - inflation, the output gap, the monetary policy rate, and the price level - in response to demand and supply shocks. In the case of a supply shock, two distinct scenarios are considered: in the first, monetary policy reacts promptly to a one-off, short-term supply shock; in the second, the policy rate remains unchanged for two quarters in the face of several consecutive supply shocks. As the IRFs suggest, when the monetary policy response is delayed by two quarters, headline inflation rises by 1.2 percentage points, requiring a cumulative tightening of 1 percentage point to bring it back toward target. Under this response decline in output (real GDP gap) is more pronounced. In contrast, if the policy reaction were immediate, inflation would increase by only 0.3 percentage points, and its impact on the economy would dissipate much faster. Importantly, even when responding to a one-time supply shock, the welfare loss[4] is estimated to be about twice as large as that arising from demand shocks. This finding underscores the fact that monetary policy is most effective in addressing shocks that originate from the demand side of the economy.

Figure 3.1.1. Impulse Response Functions (IRFs) according to New-Keynesian Semi-Structural Georgian Economy Model (GEMO)

Source: NBG.

4 *In this context, the welfare loss is assessed as the deviation and volatility of key macroeconomic variables (inflation, the output gap, the monetary policy rate, and the price level) from their optimal levels.*

More broadly, the inflation-targeting framework is based on the principle that the current rate of inflation, not the price level, is the primary policy objective, in line with the principle that "bygones are bygones." Nevertheless, when monetary policy reacts with delay, the resulting persistent increase in the price level complicates anchoring of inflation expectations. Therefore, a delayed response to supply shocks, especially when their transitory nature is uncertain, significantly heightens macroeconomic stability risks. At the same time, it is clear that monetary policy should react more decisively to demand shocks, since under an inflation-targeting regime, the policy rate serves as the key instrument for countering inflationary or deflationary pressures arising from fluctuations in aggregate demand.

Georgia, as a small and open economy, remains vulnerable to both supply and external demand shocks. Therefore, analyzing past experience is essential to better determine what constitutes an optimal monetary policy response (see Figure 3.1.2). Since the adoption of the inflation-targeting regime, supply-side shocks can broadly be classified into three categories: (i) negative supply shocks that caused only a one-off increase in inflation without generating "second-round" effects, in which case the NBG adopted a "look-through" approach and did not react; (ii) negative supply shocks that required a policy response due to their intensity and the associated risks of rising inflation expectations; and (iii) positive shocks.

An example of the first category is the increase in excise taxes on tobacco in 2017. Although this policy change temporarily raised inflation, the NBG maintained a neutral stance, confident in the transitory nature of the shock. Effective communication helped anchor inflation expectations, and inflation subsequently returned to its target level once the base effect dissipated.

The second category includes negative supply shocks whose magnitude gave rise to "second-round" effects, necessitating monetary policy action to neutralize inflationary pressures. Examples include: the surge in global commodity prices in 2011; the oil price shock and global appreciation of the US dollar during 2014-2015; the depreciation of the lari in 2019 following flight restrictions from Russia, which triggered an external demand shock; and the pandemic-induced supply chain disruptions during 2020-2021, which sharply increased global commodity and shipping costs. Negative supply shock was further exacerbated with the pent-up demand and tight labor market pressures. It should be noted that during the early phase of the pandemic, despite the presence of a negative demand shock, monetary policy was eased only modestly by 1 percentage point to 8% reflecting the already high-inflation environment of the preceding period. Later, as sequential supply and demand shocks intensified, monetary policy was significantly tightened. In 2022, the Russia-Ukraine war introduced additional supply shocks, pushing up flexible prices and transmitting inflationary pressures to relatively sticky-price sectors as well. To stabilize inflation expectations, the policy rate was cumulatively raised by 3 percentage points to 11%, and the tight stance was maintained for an extended period, which ultimately contributed to the reduction of inflation in sticky-price components.

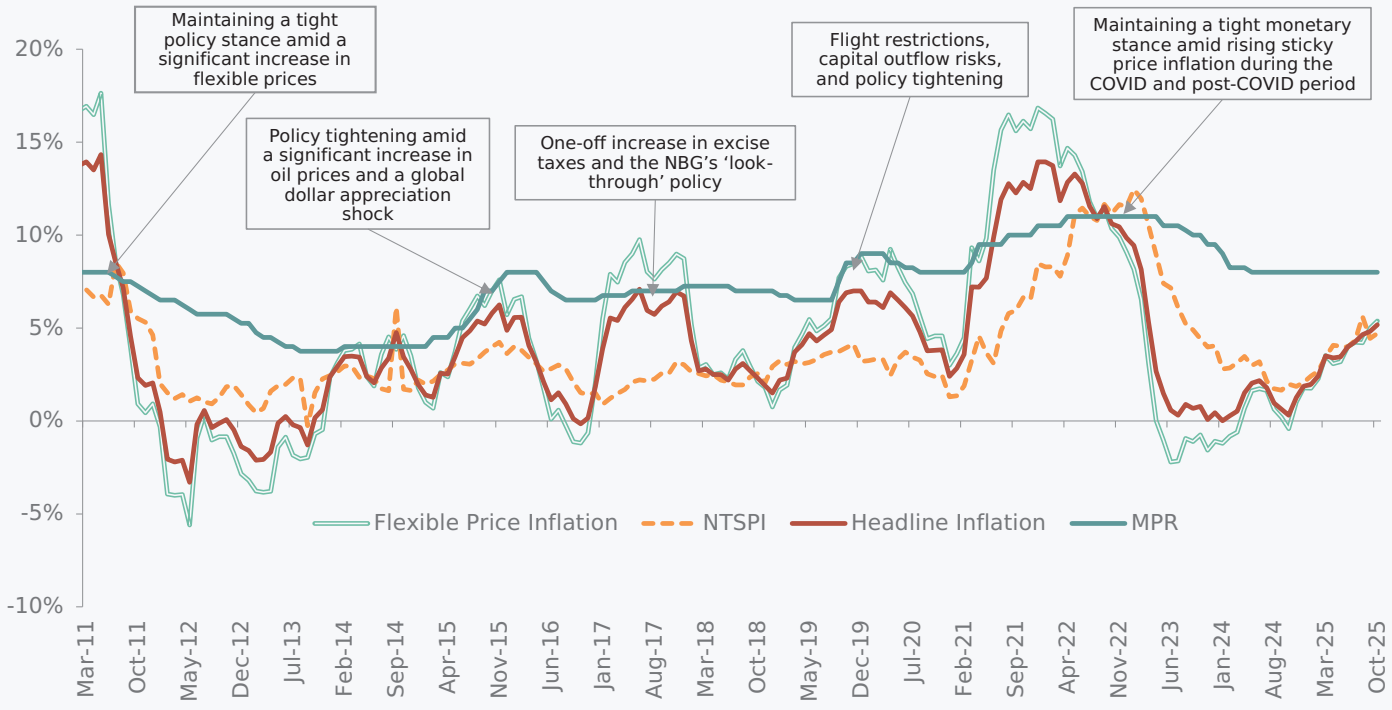


Figure 3.1.2. Sticky and flexible price dynamics in Georgia and the response of the monetary policy on external shocks

Source: NBG, Geostat.

It is noteworthy that, starting from 2023, a positive supply shock induced structural changes in the economy, enhancing productive capacity and generating a disinflationary effect not only through the demand channel but also via the exchange rate channel. During this period, the gradual normalization of monetary policy began; however, given prevailing domestic and external risks, the policy stance remained moderately tight. This, in turn, contributed to the sustained maintenance of a low-inflation environment. In 2025, due to low base effects from previous years and supply-side factors independent of monetary policy[5], inflation has again increased slightly. Nevertheless, conditions in the labor market, the cyclical position of the economy, and the relatively low-inflation environment of recent years have significantly mitigated the risk of a sharp rise in inflation expectations. Moreover, **the maintenance of a prolonged tight monetary policy stance has reduced the likelihood of the current shock being transmitted to inflation expectations**.

To summarize, the monetary policy response to supply shocks differs fundamentally from that to demand shocks. Reacting to supply shocks tends to amplify economic volatility; however, delayed responses may lead to larger welfare losses and require sharper tightening in the future. In the case of a negative supply shock, characterized by rising prices and declining output, a more cautious and moderate policy reaction is important compared to that for a demand-driven shock. **Nonetheless, in order to minimize risks, in a highly uncertain environment where shocks are inevitable and their nature is unclear, it remains important to maintain a tight policy stance over the medium term**. Such an approach enables policymakers to mitigate the adverse effects of uncertainty and to avoid the need for abrupt policy tightening later on. This, in turn, reinforces confidence in monetary policy and supports the stability of inflation expectations over the medium term.

5 *Among these factors is the increase in prices in regulated and food markets compared to the previous year.*

4. SUMMARY OF THE MACROECONOMIC FORECASTS OF THE NBG AND FINANCIAL MARKET PARTICIPANTS

SUMMARY OF THE MACROECONOMIC FORECASTS OF THE NATIONAL BANK OF GEORGIA

	Fact	Central Scenario			High-Inflation Scenario			Low-Inflation Scenario		
	2024	2025	2026	2027	2025	2026	2027	2025	2026	2027
Inflation (%)	1.1	4.0	3.5	2.8	4.0	4.5	2.7	3.9	2.7	2.6
Real GDP Growth (%)	9.4	7.4	5.0	5.0	7.3	4.0	5.0	7.5	6.0	5.5
Monetary Policy Rate (%)	8.0	8.0	7.7	7.2	8.1	8.6	7.8	8.0	7.0	7.0

Table 4.1. Summary of the Macroeconomic Scenarios of the National Bank of Georgia

Source: NBG, financial market participants, Geostat.

* The table displays the average annual changes of the variables

FORECASTS OF FINANCIAL MARKET PARTICIPANTS

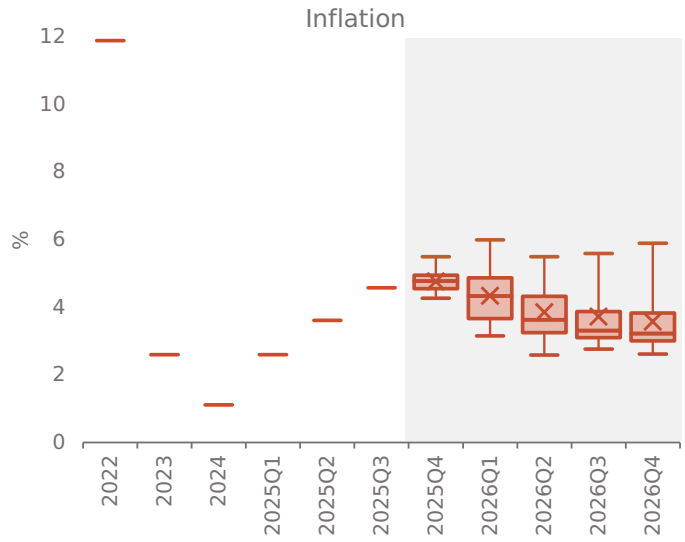


Figure 4.1. Actual average inflation and the distribution of market participants' forecasts

Source: NBG, financial market participants, Geostat.

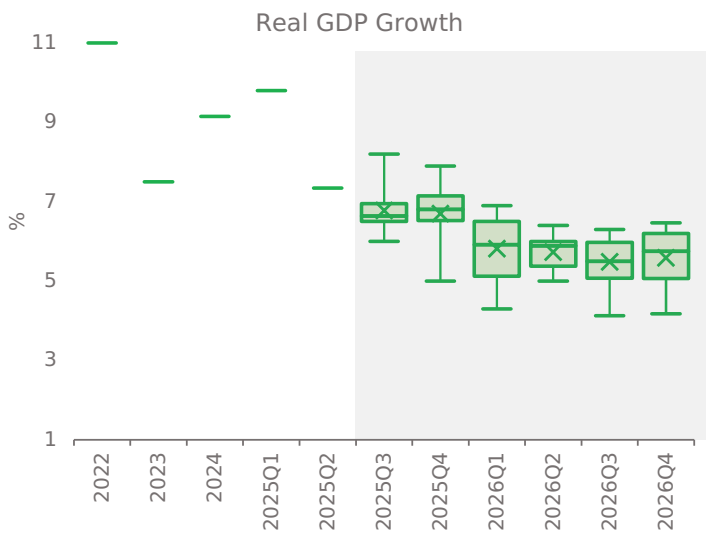


Figure 4.2. Actual real GDP growth and the distribution of market participants' forecasts

Source: NBG, financial market participants, Geostat.

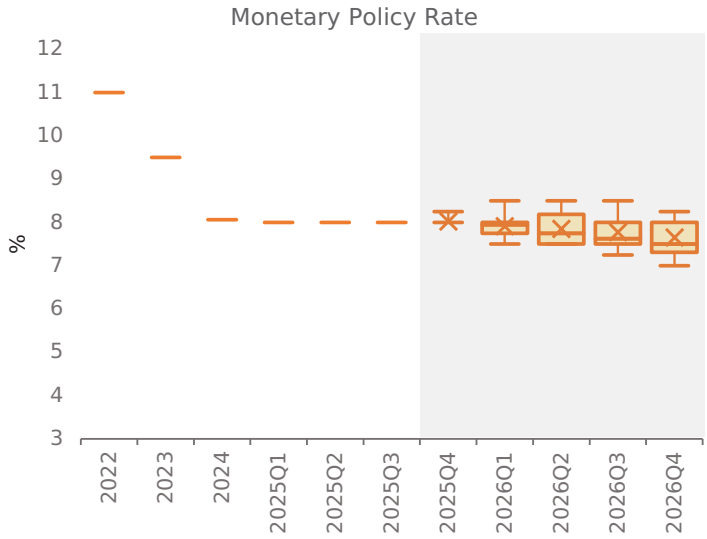


Figure 4.3. Actual monetary policy rate and the distribution of market participants' forecasts

Source: NBG, financial market participants.

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