



საქართველოს ეროვნული ბანკი
National Bank of Georgia

MONETARY POLICY REPORT

OCTOBER 2026

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 High-Inflation Risk Scenario**, which, compared to the central scenario, incorporates risks that are more inflationary over the monetary policy horizon.
- **The Low-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 8.25 percent.

On October 21, 2026, the Monetary Policy Committee (MPC) of the National Bank of Georgia (NBG) decided to keep the monetary policy rate unchanged. The monetary policy rate stands at 8.25 percent.

Geopolitical tensions in the Middle East have persisted, prolonging the supply-side shock and, consequently, increasing inflationary pressures. As a result, the deviation of inflation from its 3 percent target in Georgia continues to be driven largely by exogenous factors. In September 2026, annual inflation stood at 5.6 percent, of which approximately 2 percentage points were attributable to energy prices. Moreover, disruptions to international transportation and shipping, coupled with higher energy prices, are increasing production and transportation costs, creating additional inflationary pressures through indirect effects on the prices of other goods and services. Against this backdrop, particular attention should be paid to developments in the stickier components of inflation, which provide a better gauge of the anchoring of longer-term inflation expectations. In this regard, core and services inflation remain below headline inflation, standing at 3.5 percent and 3.7 percent, respectively. Accordingly, the impact of the supply-side shock on inflation expectations remains moderate at this stage. However, given the prolonged nature of the shock, this remains an important risk to monitor.

Amid more persistent inflationary pressures than previously anticipated and taking into account global developments, the NBG has revised its central inflation forecast for 2026 upward by 0.2 percentage points to 5.4 percent. All else equal, inflation is expected to gradually converge toward its 3 percent target from the second half of 2027, averaging 3.5 percent for the year.

Economic activity has remained stronger than expected. According to preliminary data, economic growth stood at 6.3 percent in August 2026, averaging 7.6 percent over the first eight months of the year. Notably, growth continues to be driven largely by high-productivity sectors, which offset demand-side inflationary pressures. According to the NBG's updated central forecast, the economic growth projection for 2026 has been revised upward from 6.5 percent to 7.2 percent, while, all else equal, growth in 2027 is expected to be around 5.5 percent.

Uncertainty surrounding the further evolution of geopolitical developments and the magnitude of their impact on the economy remains elevated. Accordingly, alongside the central scenario, the Monetary Policy Committee (MPC) considered both high-inflation and low-inflation risk scenarios.

In the event of the realization of the high-inflation risk scenario, fundamental processes require a higher trajectory of the monetary policy rate than the central scenario. The key risk underlying the high-inflation scenario is a further escalation and prolongation of the conflict in the Middle East, which, amid additional disruptions to oil supply and refining, would push energy prices even higher. Moreover, disruptions to supply chains and the shift to alternative transportation routes would increase production and transportation costs. As a result, heightened global inflationary pressures would spill over to the domestic economy through imported inflation and tighter global financial conditions, requiring further monetary policy tightening and the maintenance of a restrictive stance for a longer period.

On the other hand, under the low-inflation risk scenario considered by the MPC, the realization of the risks would allow a faster normalization of monetary policy stance compared to the central scenario.

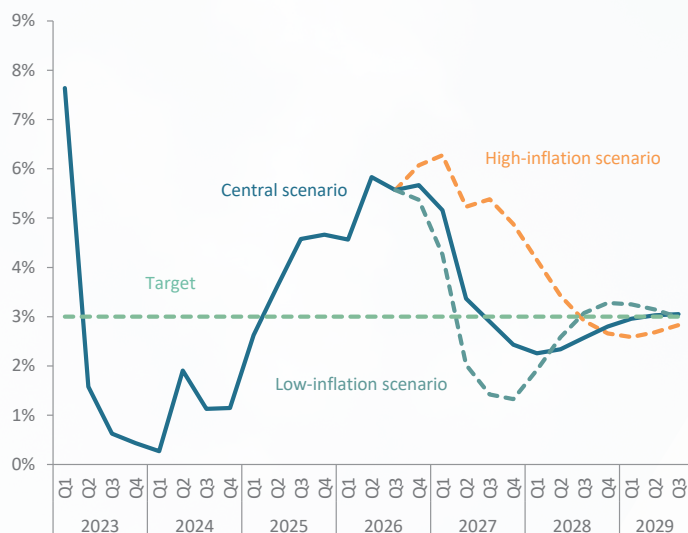
Specifically, under this scenario, strong economic growth, driven largely by high-productivity sectors, would prove more persistent than previously projected. This, in turn, would lead to a sustained improvement in the external position and an upward revision to the assessment of long-term growth potential. These developments would support a fundamental appreciation of the exchange rate and limit inflationary pressures stemming from aggregate demand. In addition, the scenario envisages a de-escalation of the conflict in the Middle East, resulting in lower energy prices compared to the central scenario. Consequently, inflation would converge toward its target more rapidly.

Taking into account the current macroeconomic environment and prevailing risks, the Monetary Policy Committee decided to keep the monetary policy rate unchanged. The moderately tight monetary policy

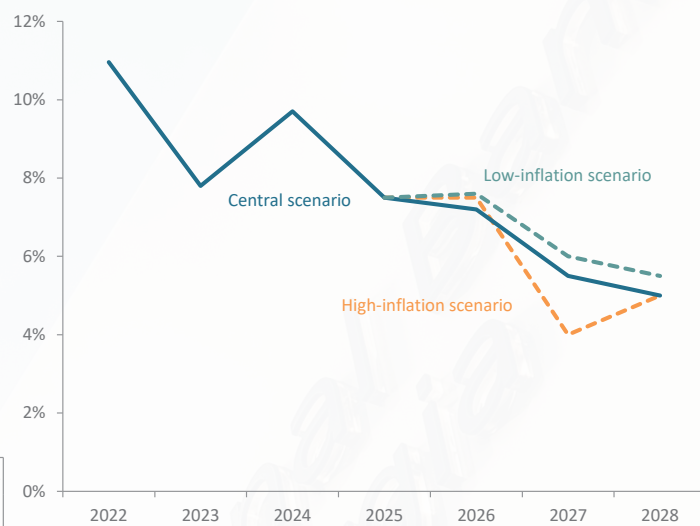
stance aims to minimize the risks of rising inflation expectations and second-round effects, ensuring that inflation returns swiftly to its 3 percent target once the supply shock dissipates. Should the prolonged supply shock lead to an upward trend in inflation expectations, which would amplify second-round effects, the MPC will continue to increase the monetary policy rate moderately. Once the inflationary shock dissipates, the NBG will gradually begin to normalize its monetary policy stance.

NBG's Macroeconomic Forecast Scenarios

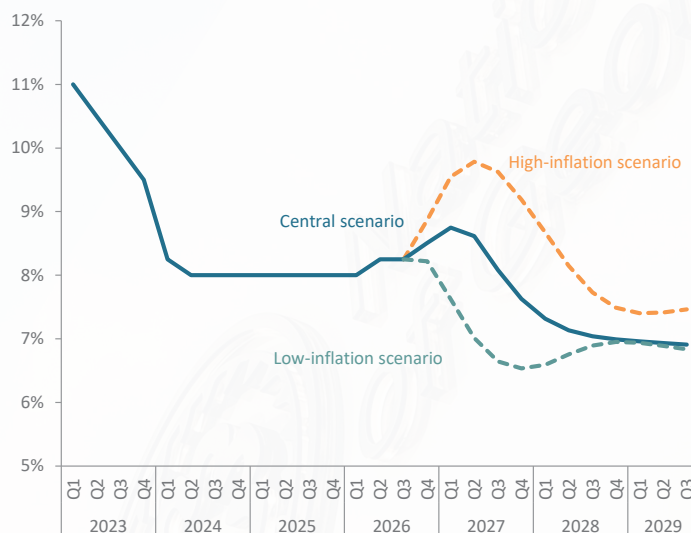
Inflation



Real GDP Growth



Monetary Policy Rate



1. OVERVIEW OF THE GLOBAL MACROECONOMIC ENVIRONMENT

Global inflationary pressures have intensified, with the IMF's updated projections indicating higher inflation in 2027.

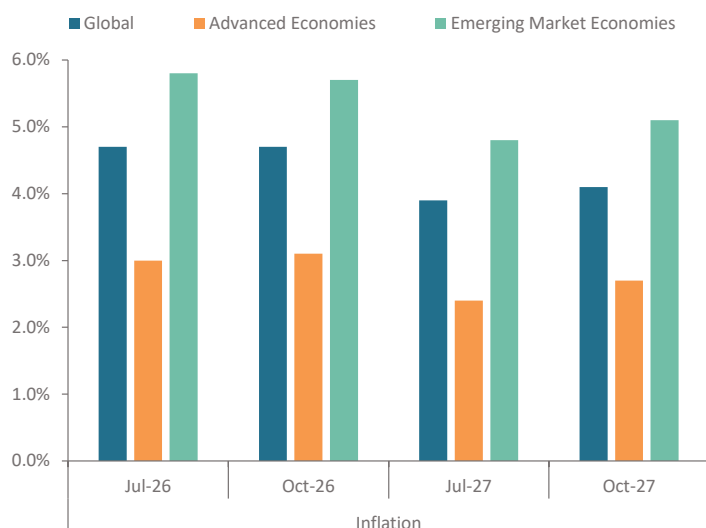


Figure 1.1. Inflation Forecasts for the Global Economy, Advanced Economies, and Emerging Market and Developing Economies

Source: IMF, World Economic Outlook (WEO), October 2026.

Despite prevailing uncertainty, global economic activity has been more resilient than expected.

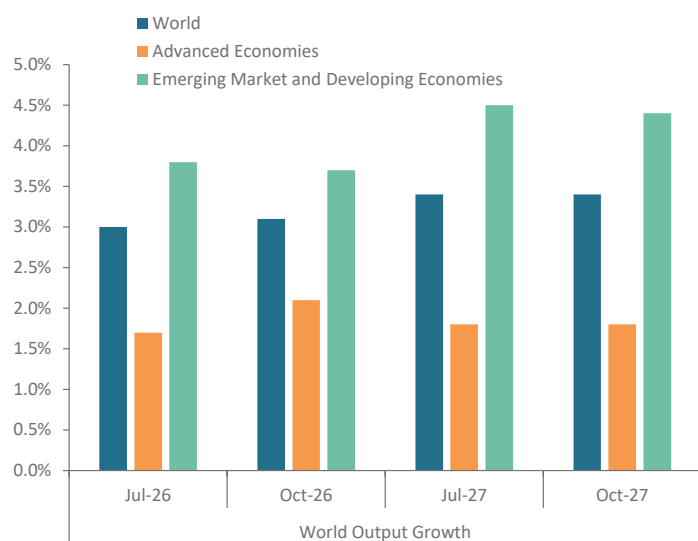


Figure 1.2. Real GDP Growth Forecasts for the Global Economy, Advanced Economies, and Emerging Market and Developing Economies

Source: IMF, World Economic Outlook (WEO), October 2026.

The global economic environment continues to be characterized by elevated uncertainty. **Inflationary risks have increased recently**, primarily driven by persistently high energy prices and disruptions to global supply chains and transportation routes amid ongoing geopolitical tensions. Against this backdrop, according to the International Monetary Fund's (IMF) updated projections, the global inflation forecast for 2026 remained unchanged at 4.7%, while the forecast for 2027 was revised upward by 0.2 percentage points (pp) to 4.1% (see Figure 1.1). **These developments have shifted the expected monetary policy paths in major economies toward further tightening, reinforcing expectations of tighter global financial conditions through the interest rate channel.**

At the same time, economic activity in major economies has proven more resilient than expected, limiting demand-side disinflationary pressures (see Figure 1.2). This resilience is particularly evident in the United States, where, despite some recent signs of moderation in the labor market, economic activity remains strong, with no indications of a sharp slowdown. Consequently, resilient demand amplifies the inflationary effects of ongoing supply-side shocks. Against this backdrop, the US Federal Reserve (Fed) raised its policy rate to 4% in September, while the European Central Bank (ECB) increased its deposit facility rate to 2.5%. Financial markets expect further monetary policy tightening in both the United States and the euro area by the end of the year, with interest rates remaining elevated for an extended period (see Figures 1.3 and 1.4).

Meanwhile, **long-term government bond yields in advanced economies have approached multi-year highs, contributing to tighter global financial conditions** (see Figure 1.5). This development reflects expectations of a tighter monetary policy path, heightened fiscal risks, and rising term premia. To some extent, it also reflects upward revisions to expectations for long-term economic growth and interest rates, supported by elevated investment activity related to artificial intelligence (AI). Nevertheless, **overall global financial conditions remain relatively accommodative, supported by favorable capi-**

Amid intensifying inflationary pressures, policy rates have increased in the United States and the euro area, contributing to tighter global financial conditions.

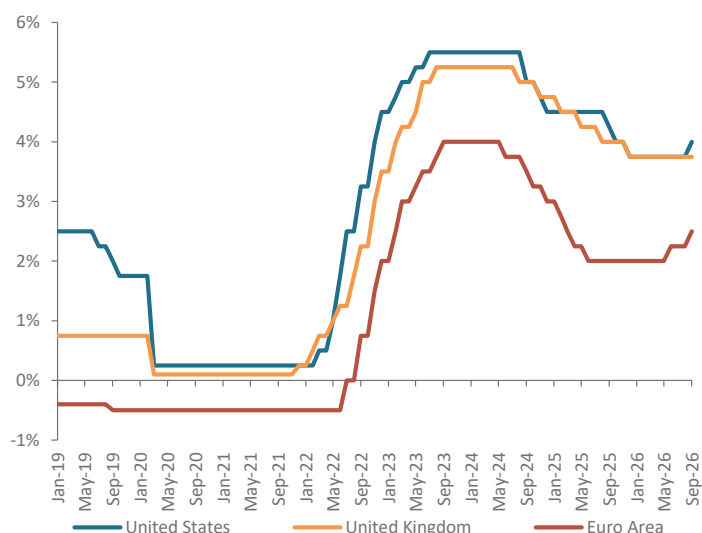


Figure 1.3. Monetary Policy Rates in Major Economies

Source: Respective central banks.

Against the backdrop of rising inflationary risks and developments in financial markets and the real economy, market expectations of further monetary policy tightening by the Fed and the ECB before year-end have strengthened.

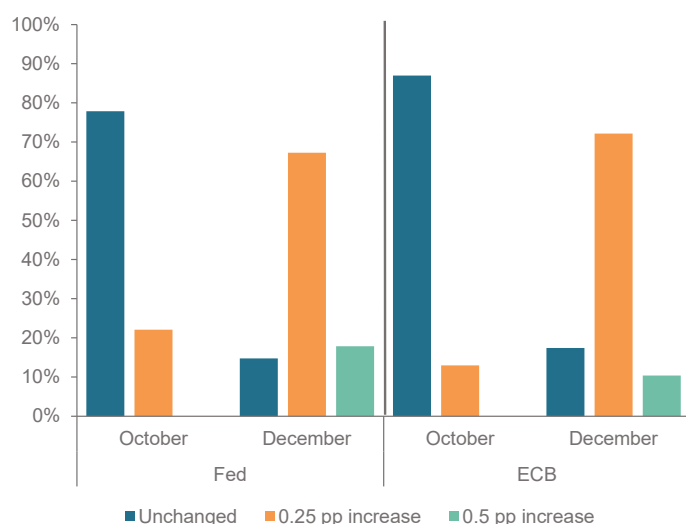


Figure 1.4. Market Expectations for the Policy Rate Paths of the Federal Reserve and the European Central Bank

Source: FedWatch and ECB Watch.

tal market developments, including strong corporate earnings and AI-related optimism. Despite this, higher long-term yields in advanced economies increase the risks of rising external financing costs and greater capital flow volatility for emerging market economies, including Georgia.

Against the backdrop of rising government bond yields in major economies, **the yield differential between domestic government securities in Georgia and other countries in the region and US Treasury securities of comparable maturities has narrowed recently** (see Figure 1.6). On the one hand, this development points to a decline in sovereign risk premia. On the other hand, elevated US interest rates and rising Treasury yields may increase the risk of capital outflows by non-resident investors.

It is also noteworthy that **the historically negative relationship between gold prices and US real yields has weakened in recent years**. Despite elevated real yields, gold prices have increased significantly, supported by heightened global uncertainty and strong demand for safe-haven assets. More recently, however, gold prices have declined from the elevated levels observed before the outbreak of the conflict in the Middle East, reflecting stronger expectations of further monetary policy tightening (see Figure 1.7).

Geopolitical tensions have had a particularly pronounced impact on global energy markets. Existing restrictions in the Strait of Hormuz have been compounded by deteriorating conditions in the Red Sea region. Attacks by Houthi forces on Saudi Arabia's oil pipeline temporarily disrupted oil exports through the Red Sea, placing additional upward pressure on petroleum product prices. Consequently, Brent crude oil prices increased and, despite some correction toward the end of September, remained elevated (see Figure 1.8). Notably, global oil consumption has recently significantly exceeded production, leading to a decline in inventories (see Figure 1.9). Against this backdrop, physical supply constraints, reduced inventories, and disruptions to refining capacity are placing additional pressure on the oil market's supply-demand balance. Supply-side risks are further amplified by China's restrictions on exports of refined petroleum products.

Accordingly, ongoing supply constraints increase the risk of oil prices remaining elevated for longer than previously anticipated. Over the medium term, however, supply is expected to adjust gradually. The development of alternative export routes could reduce supply costs and facilitate the rebuilding of inventories by 2027, there-

Long-term government bond yields in advanced economies have increased significantly, reflecting expectations of tighter monetary policy as well as heightened fiscal and inflation risks.

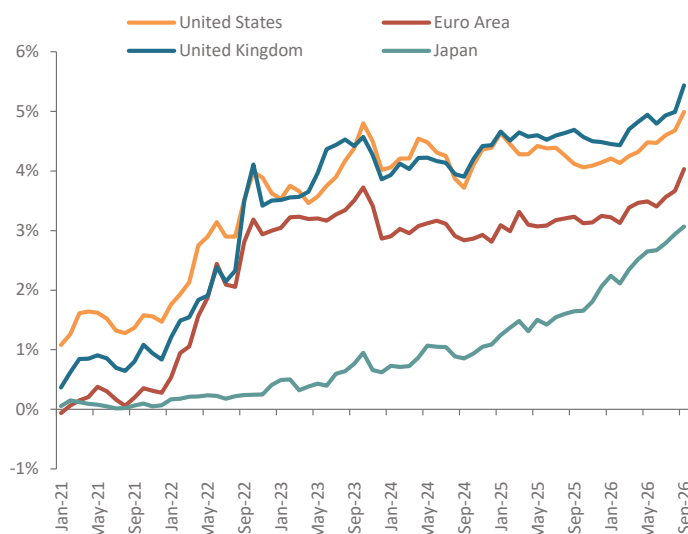


Figure 1.5. Long-Term Government Bond Yields

Source: Respective central banks; Investing.com.

Yield spreads relative to five-year US Treasury securities have narrowed across the region. While this may partly reflect declining sovereign risk premia, elevated US yields also increase the risk of capital outflows from emerging economies.

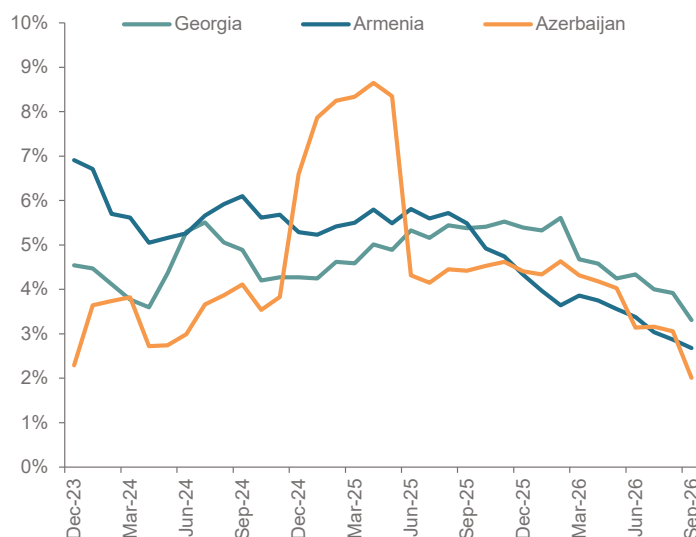


Figure 1.6. Five-Year Government Bond Yield Spreads over Comparable US Treasury Securities in Regional Economies

Source: Respective central banks; FRED.

by easing upward pressure on prices.

Beyond energy markets, geopolitical tensions are also intensifying inflationary pressures through disruptions to global supply chains. Transportation costs have increased sharply since the beginning of 2026, while pressures on global supply chains have intensified further (see Figure 1.10). **The simultaneous increase in energy and transportation costs raises the risk that supply-side shocks will pass through to a broader range of inflation components.**

International food commodity markets also remain an important source of inflation risk. Global food prices continued to increase in September, primarily driven by higher prices for cereals, vegetable oils, and sugar (see Figure 1.11). At the same time, elevated energy prices increase production and transportation costs and place additional upward pressure on certain agricultural commodity prices through stronger demand for biofuels. These pressures are compounded by climate-related risks, which could reduce crop yields and constrain supply. Consequently, the combination of elevated energy prices and climate-related risks increases the likelihood of more persistent global food price inflation.

International prices of industrial metals have also maintained an upward trend (see Figure 1.12). For Georgia, the implications are twofold. On the one hand, higher commodity prices contribute to inflationary pressures. On the other hand, elevated prices for metal-related exports support export revenues.

Overall, current global developments have increased inflationary risks for Georgia. Simultaneous pressures from energy, transportation, and food prices increase the risk of broader pass-through of external shocks to domestic prices and more persistent inflationary pressures. At the same time, persistently high interest rates and long-term bond yields in advanced economies contribute to tighter global financial conditions and narrower interest rate differentials. Other things being equal, this reduces the relative attractiveness of lari-denominated assets and weakens support for exchange rate appreciation. Conversely, higher international prices for certain export commodities support export revenues and contribute positively to Georgia's current account balance.

The historically negative relationship between gold prices and US Treasury real yields has weakened in recent years amid heightened uncertainty and increased macro-financial risks in advanced economies.



Figure 1.7. US 10-Year Treasury Real Yield and Gold Price

Source: FRED; Bloomberg.

Note: For better visualization, the right-hand axis is inverted, with values increasing from top to bottom.

Oil prices remain significantly elevated amid geopolitical tensions, while persistent supply-side risks increase the likelihood of prices remaining high for a prolonged period.

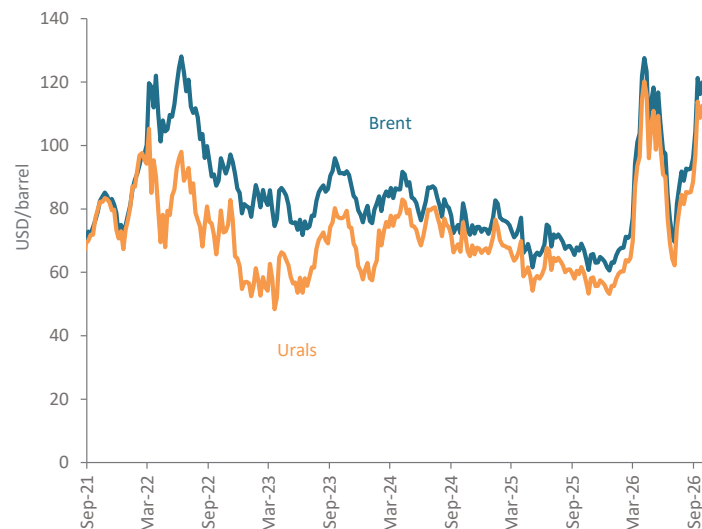


Figure 1.8. Brent and Urals Crude Oil Prices

Source: FRED; Trading Economics.

Throughout of 2026, global oil consumption exceeded production, contributing to inventory drawdowns, which partially softened the upward pressure on oil prices.

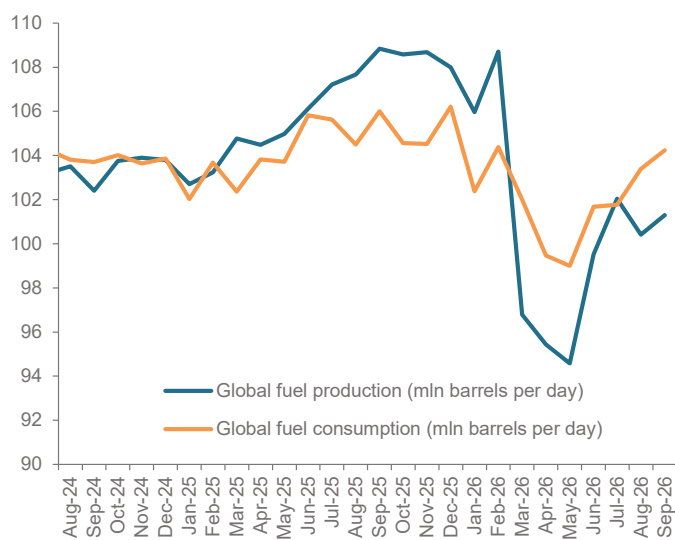


Figure 1.9. Global Oil Production and Consumption

Source: EIA.

Shipping costs have increased sharply amid geopolitical tensions and disruptions to transportation routes, while global supply chain pressures remain elevated, increasing imported inflation risks.

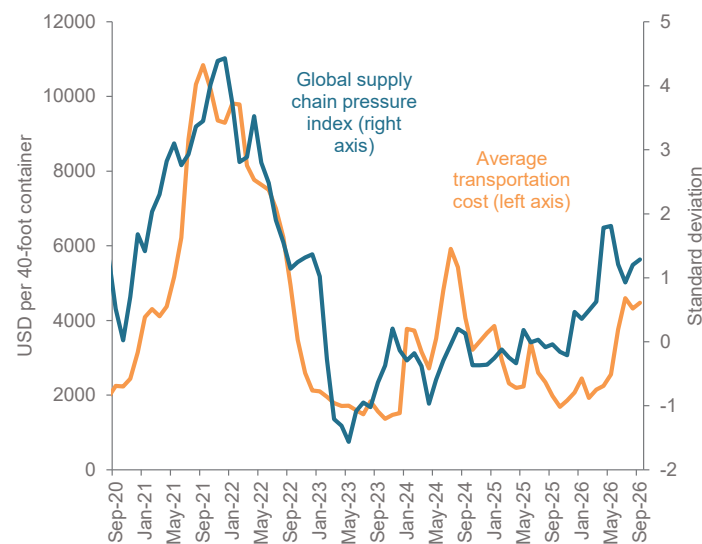


Figure 1.10. Average Shipping Costs and the Global Supply Chain Pressure Index

Source: Drewry World Container Index (WCI); Federal Reserve Bank of New York, Global Supply Chain Pressure Index (GSCPI).

International food prices continued to rise in September, primarily driven by higher prices for cereals, vegetable oils, and sugar.

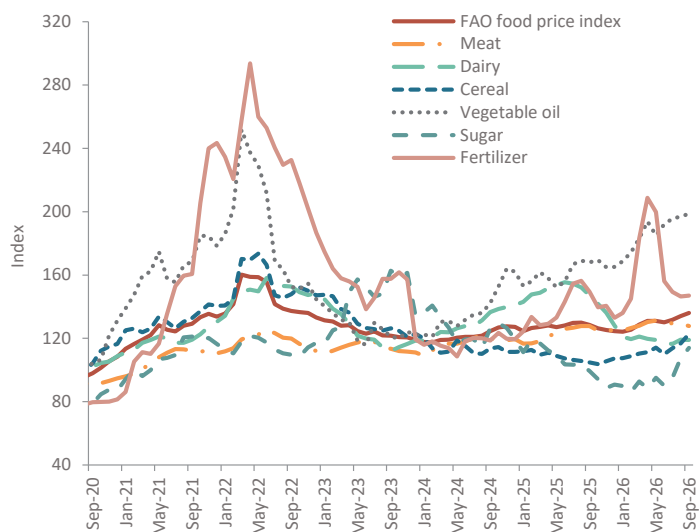


Figure 1.11. International Food and Fertilizer Price Indices (December 2019 = 100)

Source: FAO; World Bank; NBG calculations.

Despite some volatility, international metal prices have maintained an upward trend since 2020 amid the conflict in the Middle East.



Figure 1.12. Global Metals Price Index

Source: IMF.

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

Economic growth continues to be driven by less import-intensive sectors.

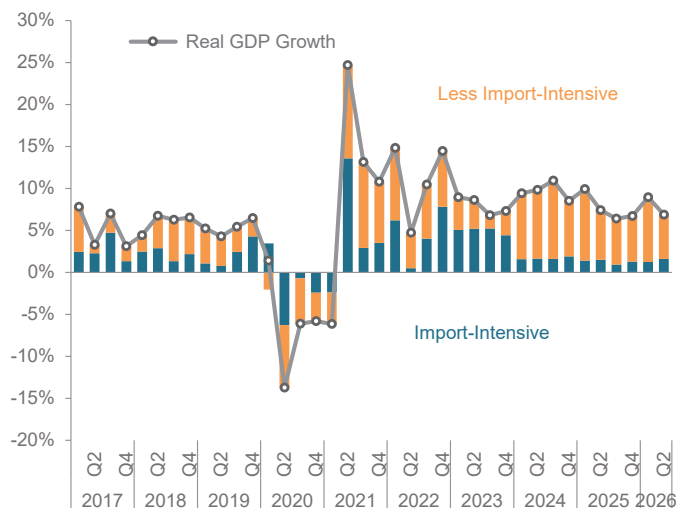


Figure 2.1.1. Sectoral Composition of Real GDP Growth by Degree of Import Dependence (Contribution to Growth)

Source: Geostat, NBG.

High-productivity sectors with strong export potential continue to make the largest contribution to real GDP growth.

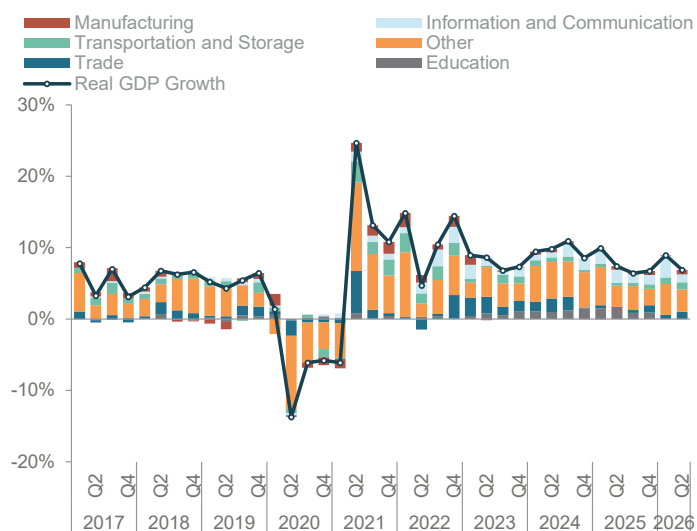


Figure 2.1.2. Sectoral Decomposition of Real GDP growth (Contribution to the Growth)

Source: Geostat, NBG.

2.1. OVERVIEW OF THE CURRENT MACROECONOMIC ENVIRONMENT IN GEORGIA

According to preliminary data for the first eight months of 2026, economic activity has been stronger than projected in the previous central scenario, with real GDP growth averaging 7.6%. At the same time, the sectoral composition of economic growth has remained broadly unchanged, with economic activity continuing to be driven by high-productive and relatively less import-intensive sectors (see Figure 2.1.1). In particular, the information and communication sector remains a major contributor to economic growth, while value added in manufacturing has also increased in recent months (see Figure 2.1.2).

The current sectoral composition of economic growth also contributes to an improvement in the external balance. Alongside relatively moderate import growth, external demand for domestically produced goods remains strong. In particular, during the first nine months of the year, domestic exports increased by 60.3% in nominal terms and by 47.7% in real terms. The strong real growth in domestic exports has been one of the key drivers of economic growth (see Figure 2.1.3).

Real GDP growth continues to be supported by both domestic and external demand.

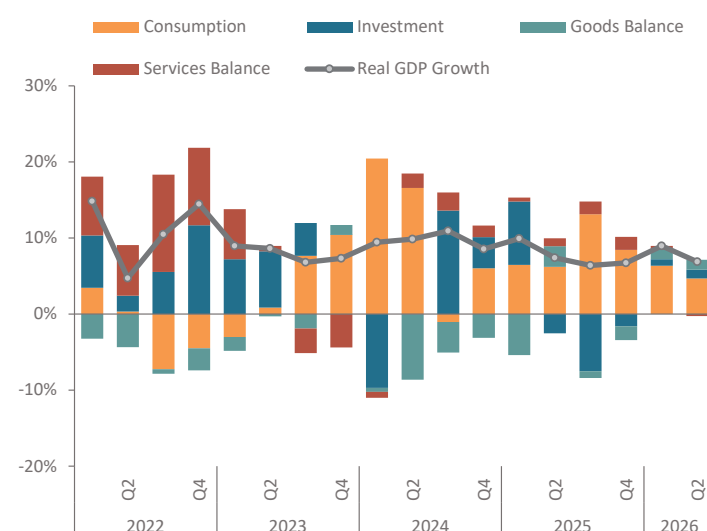


Figure 2.1.3. Real GDP growth by Expenditures (Contribution to the Growth)

Source: Geostat, NBG.

Despite the geopolitical situation, international inflows remain strong.

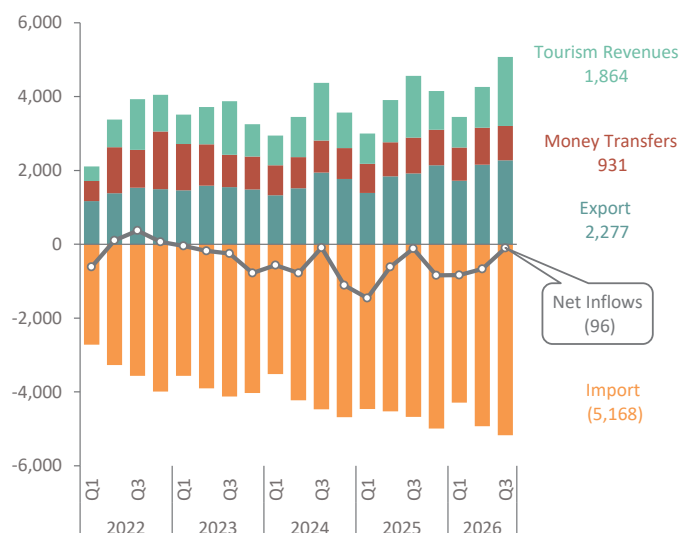


Figure 2.1.4: The dynamics of inflow/outflows from goods export and imports, tourism and remittances

Source: NBG, Geostat.

Developments in the external sector are contributing to an improvement in the current account balance, with the deficit remaining below its estimated long-term optimal level (5% of GDP).

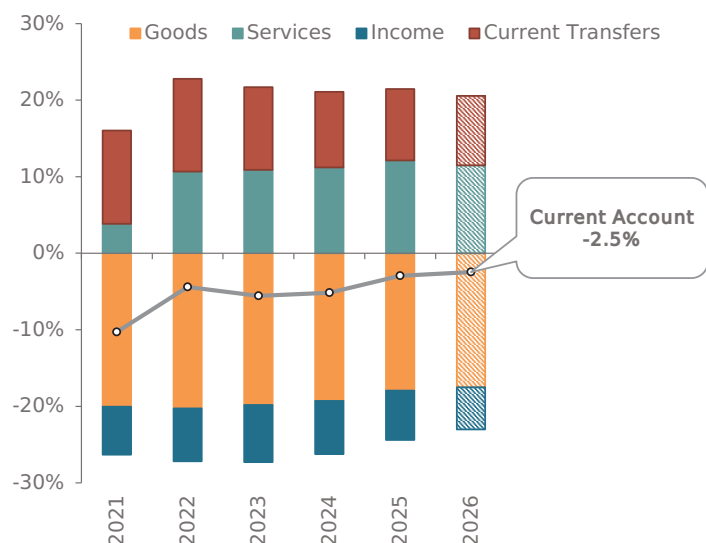


Figure 2.1.5: Current Account Balance Decomposition (% of GDP, according to BPM5)

Source: NBG.

External demand for services exports also remains resilient. Although the ongoing conflict in the Middle East has affected Georgia's economy primarily through the tourism channel, its impact has been limited and temporary. In particular, tourism revenues declined by 3.8% year on year in the second quarter, before increasing by 11.9% in the third quarter. The decline in revenues from selected Middle Eastern countries was partially offset by increased revenues from other markets. Meanwhile, strong growth has been maintained in other categories of services exports, particularly information and communication services, which accounted for 3.8% of GDP in the second quarter of 2026. Accordingly, the diversification of services exports helps mitigate the impact of external shocks and reduces the economy's external vulnerability.

Remittances remain another important source of external inflows. In September, remittances declined by 10.1% year on year, largely reflecting a reduction in inflows from Russia. On the other hand, remittances from Georgia's major economic partner countries have generally maintained an upward dynamic, with total inflows increasing by 5.4% year on year during the first nine months of the year.

The ongoing structural transformation of the economy contributes to both an expansion of potential output and a strengthening of the country's external position (see Figures 2.1.4 and 2.1.5). In the second quarter, the current account deficit amounted to only 1.4% of GDP. Against the backdrop of an improving goods balance, according to the central forecast, the current account deficit is expected to remain below its equilibrium level, at around 2.5% of GDP in 2026 (see Figure 2.1.5).

Meanwhile, foreign direct investment (FDI) remains the main source of financing for the current account deficit, accounting for 4.5% of GDP in the second quarter (see Figure 2.1.6).

The improved external balance has been an important factor supporting the stability of the nominal effective exchange rate (NEER) of the lari. Recently, the NEER has continued to appreciate, contributing to an appreciation of the real effective exchange rate (REER). In the short term, this development helps mitigate imported inflationary pressures. At the same time, according to current estimates, the REER remains slightly appreciated relative to its equilibrium level (see Figure 2.1.7).

The interest rate differential between lari- and foreign currency-denominated deposits has narrowed in recent months but remains relatively high (see Figure 2.1.8) and continues to support the attractiveness of savings in the domestic cur-

Foreign direct investment continues to play an important role in financing the current account deficit.

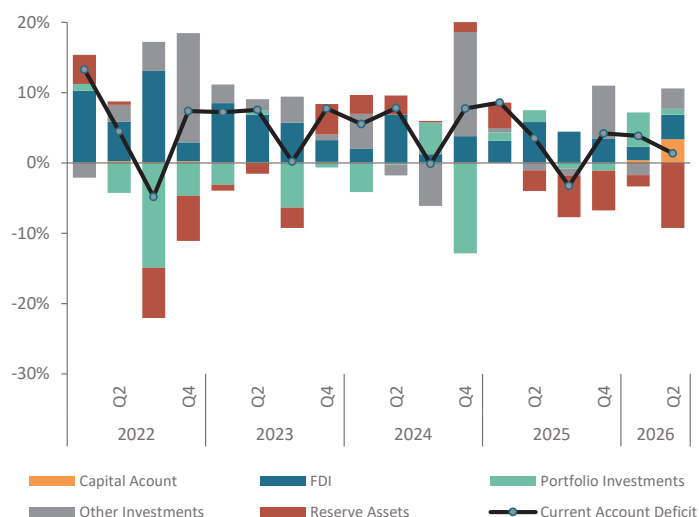


Figure 2.1.6: Sources of Financing for the Current Account Deficit

Source: NBG.

In recent months, both the nominal and real effective exchange rates have appreciated.

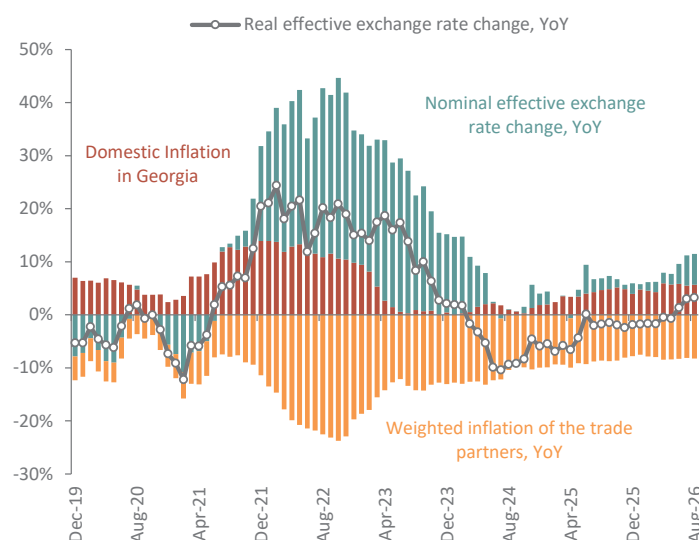


Figure 2.1.7. Decomposition of the Year-over-Year Change in the Real Effective Exchange Rate of the Georgian lari*

Source: NBG.

* 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.

rency and the larization of deposits (see Figure 2.1.9). Importantly, this relationship is mutually reinforcing: exchange rate stability encourages larization, while a higher level of larization reduces vulnerability to exchange rate risks and, in turn, contributes to greater exchange rate stability.

Alongside external demand, domestic demand factors also remain strong, as reflected in credit activity. In August, annual credit growth amounted 14.8% (see Figure 2.1.10). The acceleration in credit growth partly reflects base effects, as lending activity was relatively subdued during the corresponding period of the previous year, partly due to the substitution of large loans with alternative debt instruments. Nevertheless, even after adjusting for base effects, credit activity continues to exhibit an upward trend.

At the current stage, domestic financial conditions remain heterogeneous across loan currencies and purposes. In particular, interest rates on certain categories of lari-denominated loans have declined, reflecting lower risk premia. Specifically, strong economic growth has contributed to a reduction in credit risk premia, while increased larization and improved liquidity conditions in the domestic currency market have reduced liquidity risk premia (see Box 1). These developments have been particularly evident in longer-term lending, especially mortgage loans, contributing to an acceleration in mortgage credit growth (see Figures 2.1.11 and 2.1.12). On the other hand, interest rates on relatively short-term loans have increased as a result of tight monetary policy, offsetting the aforementioned easing effects. Looking ahead, rising global interest rates are expected, all else equal, to gradually transmit to domestic financial conditions, leading to tighter financing conditions in foreign currency.

Against the backdrop of resilient aggregate demand, labor market developments are also important for assessing the risks of second-round effects stemming from supply-side shocks. In recent quarters, wage growth has moderated somewhat, alongside a gradual normalization of productivity growth. Consequently, unit labor cost growth has remained below levels consistent with the 3% inflation target, standing at 1.7% in the second quarter of 2026 (see Figure 2.1.13). Thus, second-quarter data did not indicate any additional inflationary pressures stemming from the labor market.

The implications of the aforementioned factors for inflation are mixed. At the current stage, the deviation of inflation from its target continues to be driven largely by exogenous factors. In September, annual inflation stood at 5.6%, of which

Recently, the interest rate differential between lari- and foreign currency deposits has narrowed, but remains relatively high, supporting demand for lari-denominated assets and the ongoing deposits' larization process.

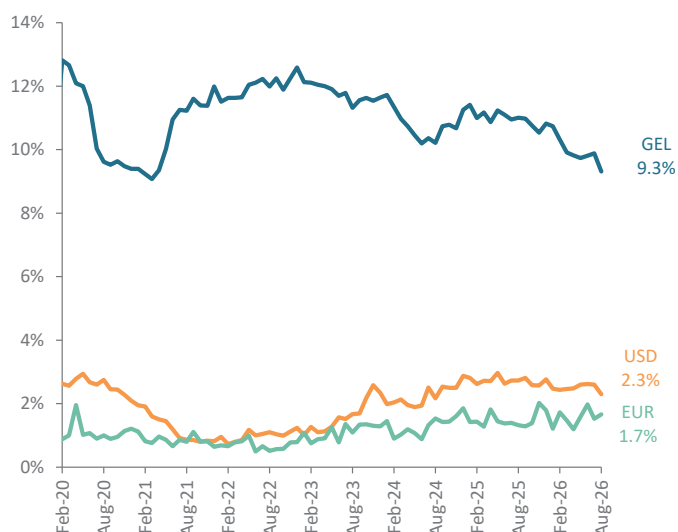


Figure 2.1.8. Interest rates on residents' term deposits in lari and foreign currency, excluding government, flow

Source: NBG.

Amid continued stability of the lari exchange rate, deposit dollarization has declined.

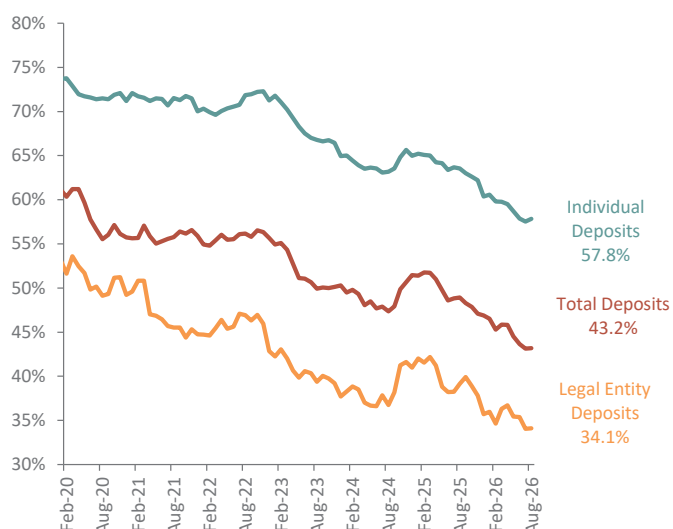


Figure 2.1.9. Deposit Dollarization (Excluding Exchange Rate Effects)

Source: NBG.

approximately 2 percentage points (pp) were attributable to energy prices (see Figure 2.1.14). Meanwhile, food inflation declined slightly, partly reflecting high base effects and the fading impact of certain one-off factors in the domestic market. Nevertheless, risks surrounding food price developments remain relevant, particularly in light of potential increases in the prices of certain food commodities on international markets (see Overview of the Global Macroeconomic Environment). Accordingly, while exogenous factors continue to play a significant role in explaining the deviation of inflation from its target, domestic price developments also warrant close attention.

In particular, core inflation stood at 3.5% in September, while services inflation reached 3.7% (see Figure 2.1.15). However, even within these relatively moderate aggregate measures, some signs of more broad-based inflationary pressures have emerged, warranting close attention. Importantly, the decline in sticky-price inflation was significantly influenced by price developments in the education sector. Specifically, the abolition of tuition fees for first-year students at public universities contributed approximately -0.7 pp to headline inflation. Beyond the impact of this one-off factor, price increases have accelerated across several components of services inflation. These developments are particularly important for assessing medium-term inflation dynamics, including the risks of indirect pass-through from higher energy prices and the emergence of second-round effects.

Recently, credit growth has accelerated, supporting domestic demand.

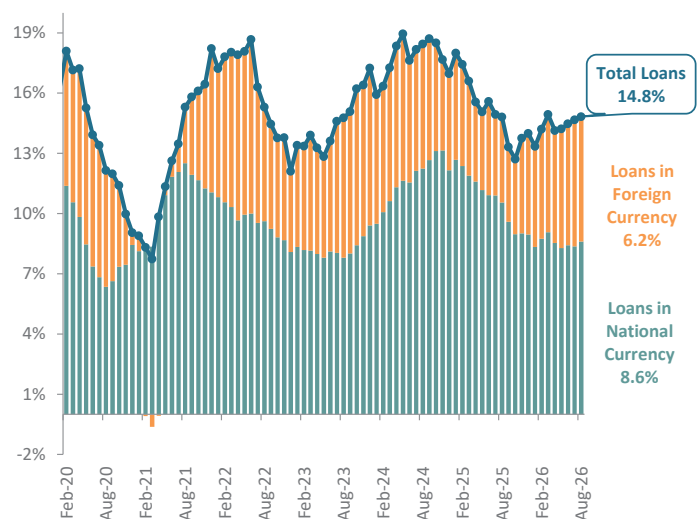


Figure 2.1.10. The annual growth rate of loans by currency (Contribution to the Growth, Excluding Exchange Rate Effects).

Source: NBG.

At this stage, domestic financial conditions remain broadly unchanged, as interest rate trends on lari-denominated loans have been mixed.

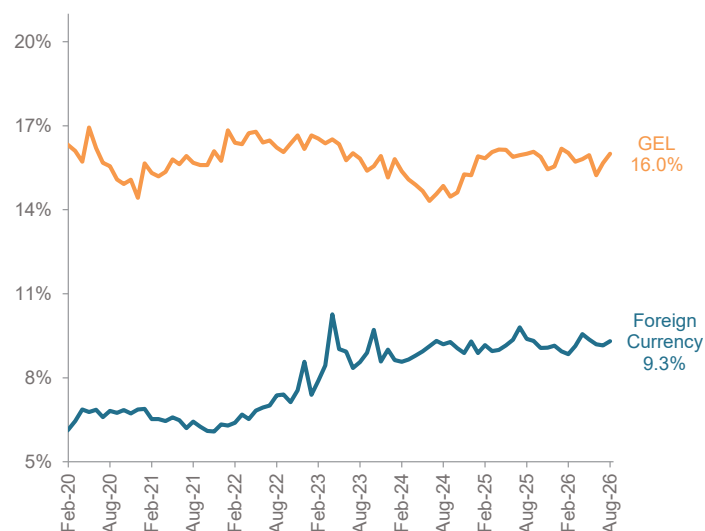


Figure 2.1.11. Interest rates on loans in lari and foreign currency, flow.

Source: NBG.

Amid declining interest rates on lari-denominated mortgage loans, mortgage lending has accelerated, while business loan growth has remained stable.

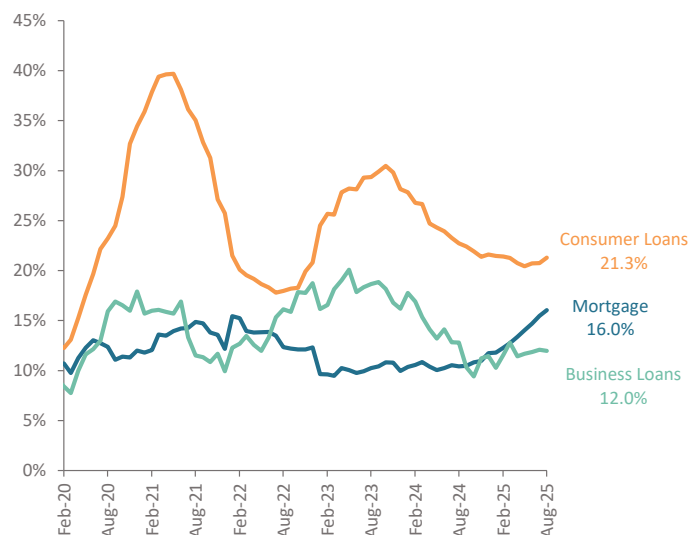


Figure 2.1.12. The annual growth rate of loans by purpose (Contribution to the Growth, Excluding Exchange Rate Effects)

Source: NBG.

Alongside the gradual normalization of productivity growth, wage growth has moderated somewhat. As a result, unit labor cost growth has moved closer to, but remains below, the 3% target.

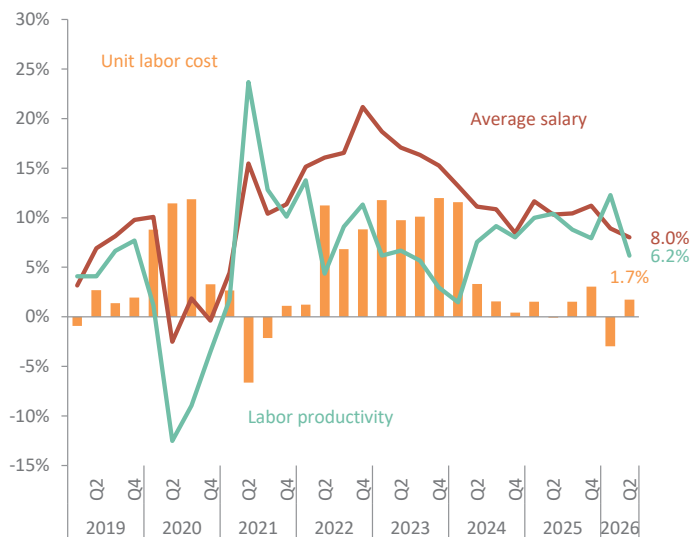


Figure 2.1.13. Average Wage, Labor Productivity, and Unit Labor Cost, Year-over-year Growth Rate

Source: Geostat, NBG.

The deviation of headline inflation from its target is largely driven by exogenous factors. However, the persistence of the shock increases the risk of spillovers to other goods and services.

A prolonged period of elevated flexible price inflation increases the risk of an acceleration in sticky price inflation.

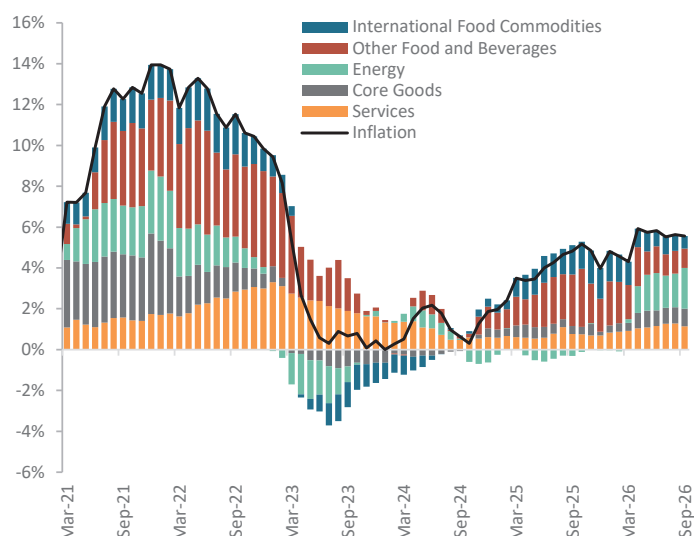


Figure 2.1.14. Headline Inflation Decomposition

Source: Geostat, NBG.

Definition: Core goods comprise all goods excluding food, non-alcoholic beverages, energy products and services. These include tobacco products, clothing, appliances and other goods, primarily those intended for medium- and long-term use.

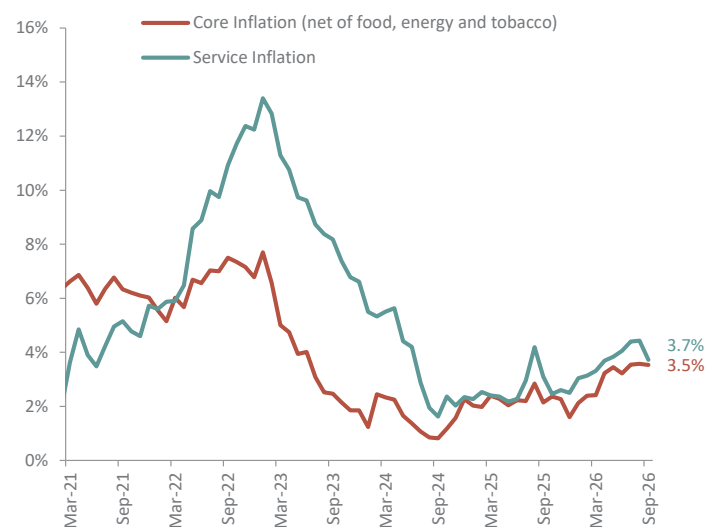


Figure 2.1.15. Core (net of food, energy and tobacco) and Service Sector Year-over-year Inflation Measures.

Source: Geostat.

2.2. CENTRAL SCENARIO

Similar to the global economy, developments in international commodity markets remain important drivers of inflation dynamics in Georgia. As noted in the "Overview of the Global Macroeconomic Environment" chapter, restrictions in the Strait of Hormuz were exacerbated in September by attacks on Saudi Arabia's oil pipeline, which temporarily disrupted oil exports via the Red Sea. This, along with increased costs of transportation, insurance, and oil refining, **exerted additional upward pressure on petroleum product prices and worsened the global inflation outlook.**

The National Bank of Georgia's central scenario is based on an **analysis of current economic conditions and assumptions** regarding future developments in the global economy. Against the backdrop of a worsening global inflation outlook, **the updated central scenario assumes that heightened geopolitical tensions in the Middle East will persist into the fourth quarter of 2026, resulting in Brent crude oil prices averaging USD 115 per barrel.** Starting next year, as alternative transportation routes become more widely utilized and oil production recovers, supply will increase gradually, with most oil production in the region returning to pre-conflict levels by the end of the second quarter of 2027. In turn, **alongside the gradual recovery in supply, the average price of Brent crude oil will decrease to USD 100 and USD 94 per barrel in the first and second quarters of 2027, respectively, while the annual average will stand at USD 92.**

The monetary policy rate path presented in the central scenario reflects the NBG's decision, which, alongside the central scenario, also takes into account the possible outcomes of risk scenarios. This approach involves selecting a monetary policy trajectory that, taking into account the balance of existing risks, minimizes economic losses while preserving the ability to respond appropriately should alternative, yet also relevant, scenarios materialize.

In the current year, **economic growth** has been stronger than expected, driven in part by robust external demand. Export growth in high-productivity service sectors, especially ICT, remains strong. Meanwhile, compared with the previous central scenario, heightened geopolitical tensions in the Middle East have persisted for longer, keeping commodity prices elevated in international markets, which further supports growth in exports of these products from Georgia. Alongside increased external inflows, domestic demand also remains strong.

According to the updated central scenario,

Amid stronger-than-expected economic growth momentum in the current period, the slow normalization of the economy's potential, and strong external demand, the GDP growth forecasts for 2026 and 2027 have been revised upward to 7.2% and 5.5%, respectively.

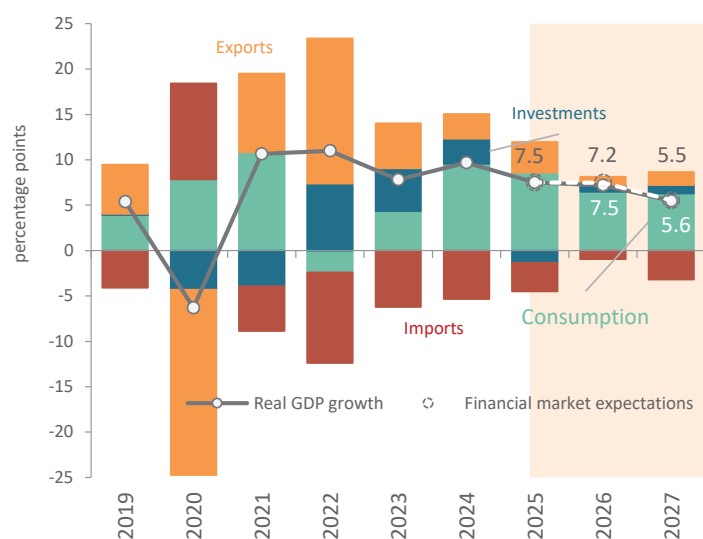


Figure 2.2.1. Central Scenario for Real GDP Growth and Financial Market Participants' Expectations of Economic Activity

Source: NBG, Financial Market Participants, Geostat.

high-productivity, service-oriented sectors remain the main drivers of growth in 2026, supporting an expansion of the country's productive capacity and easing demand-side inflationary pressures. Driven by these factors, the current economic growth outlook has improved compared with the previous central scenario, and **the economic growth forecast for 2026 has been revised upward to 7.2%**. In 2027, as global and domestic interest rate conditions tighten, real GDP growth will gradually converge toward the economy's long-term growth rate. Meanwhile, accounting for the inertia stemming from strong economic activity in the current year, **the economic growth forecast for 2027 has been revised upward to 5.5%** (see Figure 2.2.1). In turn, amid improved macroeconomic fundamentals, the average real GDP growth forecast of financial market participants for 2026 increased from 7.1% to 7.5%, while the forecast for 2027 remained unchanged at 5.6%.

Despite the less inflationary economic growth outlook, **the prolongation of global supply shocks** is postponing the return of inflation to its target. According to the central scenario, short-term inflation dynamics will be driven mainly by **restrictions on oil supply from the Middle East remaining in place until the end of the year**. Alongside these restrictions, additional pressure on crude oil prices will be driven by already reduced global inventories and the acute shortage in the diesel market, the latter implying that refiners' demand for crude oil will remain strong.

In the domestic fuel market, higher transportation and insurance costs, alongside elevated oil refining margins, will put additional pressure on prices in the short term. This will also affect the prices of various goods and services through the production and transportation cost channels. However, from the second quarter of 2027, as the above-mentioned factors gradually subside, declining petroleum product prices and the high base effect from the previous year will reduce fuel inflation.

The persistence of heightened geopolitical tensions in the Middle East is exerting additional upward pressure on **food commodity** prices in international markets, as higher energy prices increase production and processing costs. At the same time, deteriorating climate conditions are an additional factor driving up food prices. According to the central scenario, these tendencies will also be transmitted to Georgia's domestic market. However, their impact on domestic annual food inflation will, in turn, be partly offset by the high base effect from the previous year.

Amid an acceleration in relatively sticky-price inflation in the current period and the prolongation of the conflict, the inflation forecasts for 2026 and 2027 have been revised upward by 0.2 pp and 0.8 pp, respectively, to 5.4% and 3.5%.

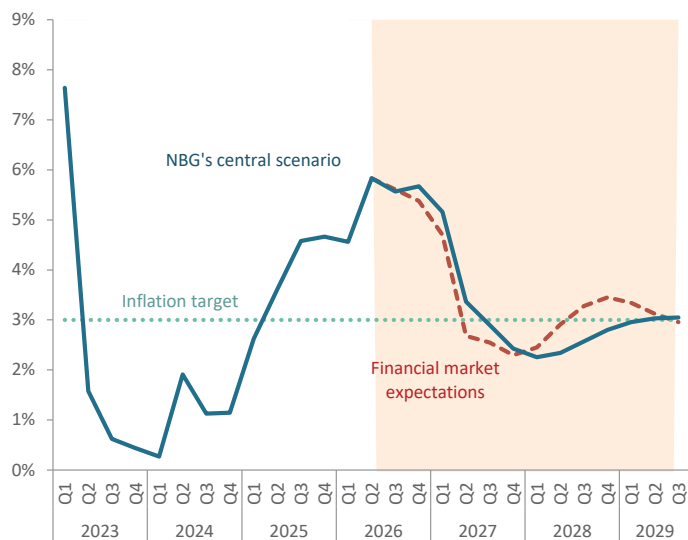


Figure 2.2.2. Central scenario of annual inflation and inflation expectations of financial market participants

Source: NBG, Financial Market Participants.

Amid tightened monetary policy over the policy horizon, the gradual dissipation of inflationary pressures from commodity markets, the disinflationary effects of regulated prices, and high base effects for certain products will support a sharp decline in inflation from the second quarter of 2027.

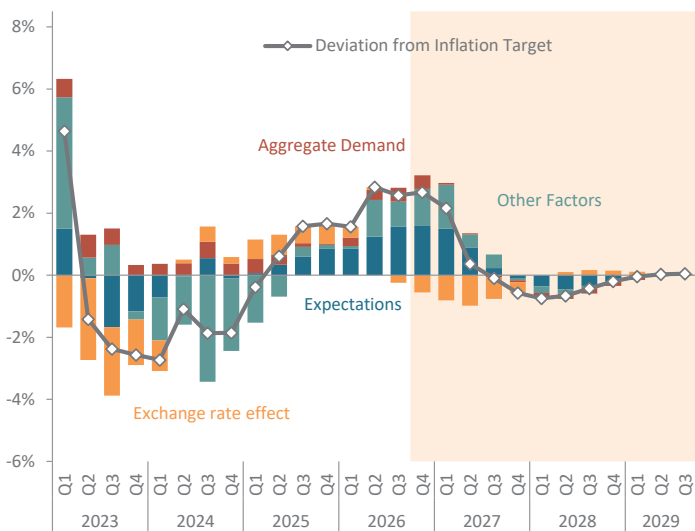


Figure 2.2.3. Decomposition of annual inflation deviations from target under the central scenario

Source: NBG, Geostat.

Against the backdrop of the abovementioned factors, the short-term deviation of inflation from its target will be driven mainly by an intensification of inflationary pressures stemming from external factors. At the same time, the magnitude and persistence of external shocks are also causing a moderate strengthening of indirect effects and second-round risks, including through higher inflation expectations.

The increased inflationary pressures are partly offset by the disinflationary effect of the exchange rate. Amid an improved external position, both the nominal and real effective exchange rates of the lari will remain strong, exerting downward pressure on imported inflation. According to the central scenario, the NBG's tightened monetary policy over the policy horizon, tight global and domestic interest rate conditions, and the prospect of a sharp decline in inflation from the second quarter of 2027 will ensure stable **inflation expectations**. Under these conditions, the direct and indirect effects of higher energy prices will be temporary, while second-round effects will be contained.

Ultimately, amid higher-than-expected inflation in the current period and a further prolongation of the presumed temporary supply shock, **headline inflation will average 5.4% in 2026. From the second half of 2027, inflation will fall below its target, while the annual average will decline to 3.5%** (see Figures 2.2.2–2.2.3). **Compared with the previous central scenario, the average inflation forecasts for 2026 and 2027 have been revised upward by 0.2 and 0.8 percentage points, respectively.**

Inflation expectations of financial market participants are consistent with the NBG's central scenario. Compared with the previous quarter, the average inflation forecast for 2026 increased by 0.2 pp to 5.3%. Meanwhile, the forecast for 2027 decreased slightly to 3.1% (see Figure 2.2.2).

Taking all of the above into account, **the National Bank of Georgia kept the monetary policy rate unchanged at the current meeting but shifted its projected path upward** (see Figure 2.2.4). Amid the prolonged external shock, the NBG will maintain a tight monetary policy stance for an extended period, in line with its cautious approach. This will limit the broader propagation of inflationary pressures stemming from the supply shock and their incorporation into medium- and long-term inflation expectations. In turn, as the impact of the shock fades, this will support the return of inflation to the 3% target. This type of a risk management approach will, over the medium term, minimize the economic losses required to

At the current meeting, the NBG kept the monetary policy rate unchanged but shifted its projected path upward.

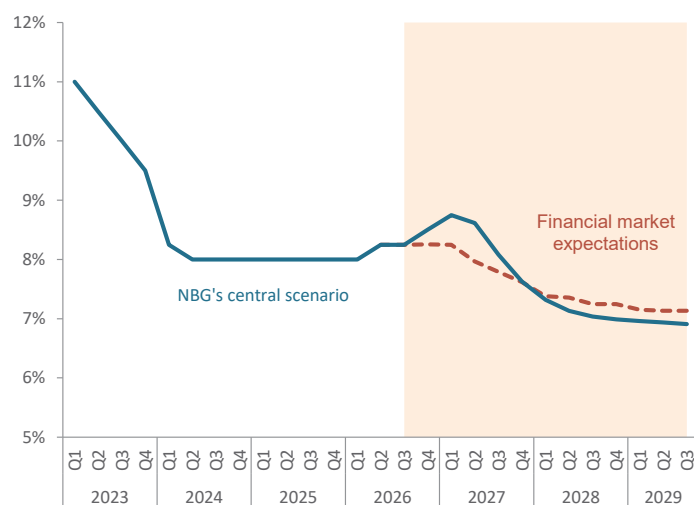


Figure 2.2.4. Central scenario of the monetary policy rate and expectations of financial market participants

Source: NBG, Financial Market Participants.

stabilize inflation.

According to this scenario, from the second quarter of 2027, as headline inflation shows a clear downward dynamics and inflation expectations stabilize, the NBG will begin normalizing monetary policy toward its **long-term neutral level of 7%**.

It should be noted that the monetary policy path is consistent with the current assumptions underlying the central scenario and the balance of risks surrounding them. Accordingly, it does not represent a commitment by the NBG. Subsequent policy decisions will be made meeting by meeting by the Monetary Policy Committee based on updated information and risk assessments. A further materialization of high-inflation risks will warrant an additional policy response. Conversely, a clear reduction in these risks and a faster-than-expected and sustained convergence of inflation toward the target will create room for a gradual normalization of monetary policy.

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 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, compared to the central scenario. In this context, the periodic escalations of the ongoing conflict in the Middle East are particularly noteworthy, resulting in heightened volatility in oil prices. Accordingly, one of the key risks under the high-inflation scenario remains a further escalation of the conflict in the Middle East and, consequently, additional disruptions to oil supply and refining capacity, which would exert further upward pressure on elevated energy prices (see Table 2.3.1). If these risks materialize, the NBG will pursue tighter monetary policy compared with the central scenario to prevent deterioration in long-term inflation expectations.

Geopolitical tensions in the Middle East remain elevated amid recurrent escalations of the conflict that began in March of the current year. Alongside disruptions to oil flows through the Strait of Hormuz, the situation on alternative transportation routes, notably the Bab el-Mandeb Strait, also remains unstable. Moreover, disruptions to refining capacity have recently emerged, resulting in shortages of refined petroleum products. Ultimately, these developments further exacerbate the vulnerability of the global petroleum products market and leads to significant volatility

The high-inflation scenario is based on the assumption that the geopolitical situation will deteriorate further and persist for longer than envisaged in the central scenario. According to this scenario, the Brent oil price is projected to reach USD 125 per barrel in the fourth quarter of 2026 and to average USD 100 per barrel in 2027.

High-Inflation Risks			
◦ A further escalation of geopolitical tensions in the Middle East, accompanied by protracted disruptions to oil supply and refining capacity. ◦ Elevated international oil and domestic fuel prices and heightened risks of strong second-round effects. ◦ An increase in international food prices driven by higher transportation and production costs, alongside adverse climate conditions.			
Indicators of risk realization	Impact on inflation		
A deterioration in short-term inflation expectations			
High inflation resulting from increases in international commodity prices and a deterioration of short-term inflation expectations.			
A worsening of the current account deficit amid slowing external demand and higher imports.			
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 the High-inflation Scenario

Source: NBG.

in their prices. Accordingly, **the high-inflation scenario envisages a prolongation and intensification of the active phase of the conflict in the Middle East and, consequently, more persistent and severe disruptions to oil supply and refining capacity.** This would further reduce the supply of petroleum products on international markets and, amid heightened market vulnerability, lead to a further increase in international oil and petroleum product prices, keeping them elevated for an extended period. Specifically, in the high-inflation scenario, oil prices are projected to reach USD 125 per barrel in the fourth quarter of 2026, before gradually declining towards USD 90 per barrel over the course of 2027. Moreover, a sustained re-escalation of the conflict would lead to supply chain disruptions in the region, which, in turn, would require the use of alternative transportation routes and the realignment of production networks. Combined with elevated petroleum product prices, this would lead to a significant increase in transportation costs, which, amid deteriorating climate conditions, would place additional upward pressure on international food prices. As a result, these factors would substantially amplify inflationary pressures, leading, on the one hand, to tighter monetary policy and higher interest rates globally, and, on the other hand, to their transmission to the domestic market through imported inflation channel.

Under a prolonged escalation of geopolitical tensions in the Middle East, higher international commodity prices would support strong export growth this year. Consequently, **real GDP growth would reach 7.5% in 2026** (see Figure 2.3.1). However, amid a large supply shock, global economic activity would decelerate in 2027, resulting in weaker external demand. This, alongside the normalization of potential growth, reduced purchasing power, and tighter monetary policy in response to inflationary pressures, would dampen economic activity relative to the central scenario. Ultimately, **real GDP growth would be 4.0% in 2027.**

Higher international commodity prices would also increase the value of imported goods and, in 2027, alongside lower tourism revenues stemming from the slowdown in regional economic activity, would widen the current account deficit. This, in turn, would exert depreciation pressure on the exchange rate and, combined with the above-mentioned factors, would significantly increase imported inflationary pressures. Moreover, given the severity and duration of the shock, the risks of second-round effects would increase significantly. In particular, a prolonged period of inflation above the target would worsen short-

With the maintenance of strong export growth in the short-term, real GDP growth will amount to 7.5% in 2026, while in 2027, amid slowing external inflows, weakening domestic real purchasing power, and tighter monetary policy in response to inflationary pressures, it will slow to 4.0%.

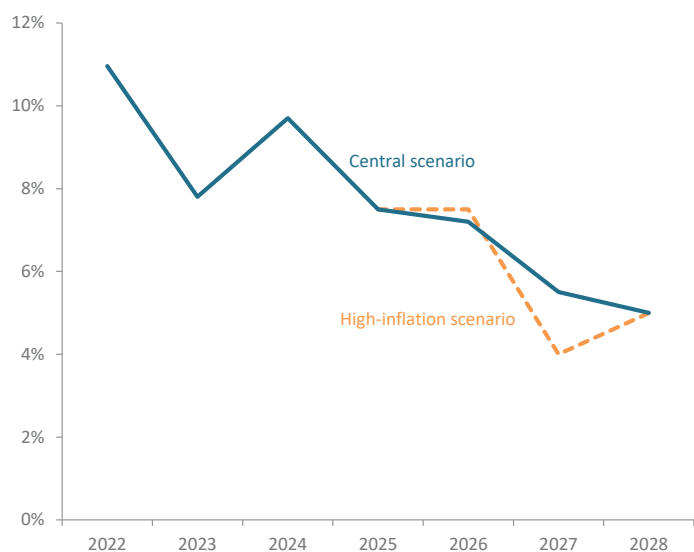


Figure 2.3.1. Real GDP Growth Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

Higher international commodity prices, the depreciation of the lari exchange rate and a deterioration in short-term inflation expectations, will substantially increase inflationary pressures over the monetary policy horizon and will delay the return of inflation to the target for an extended period.

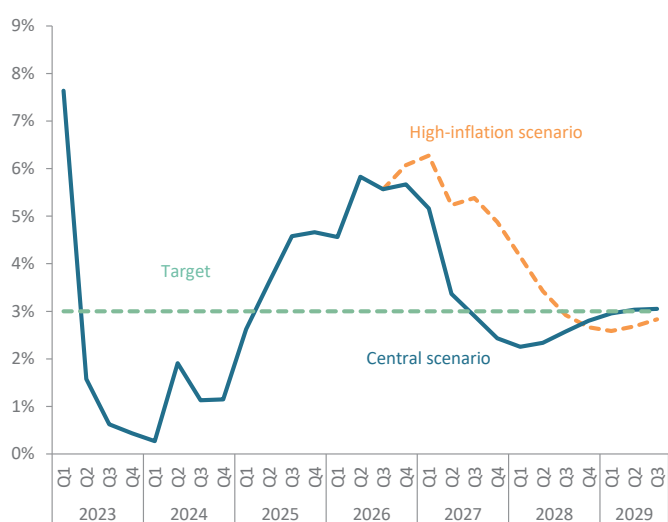


Figure 2.3.2. Year-over-year Headline Inflation Under Central and High-Inflation Scenarios

Source: NBG, Geostat.

term inflation expectations and lead to an increase in relatively sticky prices, which, in turn, would impede the return of inflation to its target. Consequently, **under the high-inflation scenario, inflation would be higher** than in the central scenario **by 0.1 pp in 2026 and by 2.0 pp in 2027, averaging 5.5% and 5.4%, respectively** (see Figure 2.3.2).

The NBG exhibits a low tolerance against strong inflationary pressures. Consequently, the above-mentioned developments would lead to an additional tightening of monetary policy and a more prolonged maintenance of a tight policy stance: **the monetary policy rate would be higher** than in the central scenario **by 1.3 pp in 2027**. In addition, the high-inflation scenario also envisages an upward revision of **the domestic neutral interest rate to 7.5%**, reflecting both heightened global uncertainty and the sustained deterioration of fundamental factors. Over the medium term, the normalization of policy rate toward this level will proceed at a gradual pace, contingent on the dissipation of inflationary risks and the stabilization of the inflationary environment (see Figure 2.3.3).

The high inflationary environment in this scenario, compared to the central scenario, will lead to a tightening of monetary policy and a more prolonged tightened stance. Its normalization will begin at a gradual pace, contingent on the stabilization of the inflationary environment, towards 7.5% level.

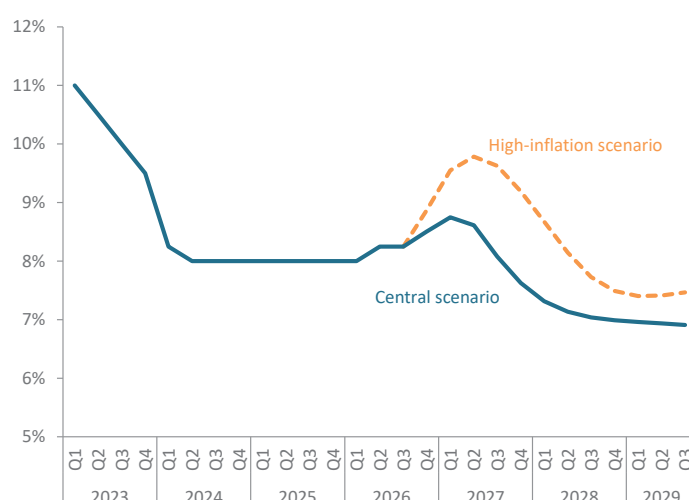


Figure 2.3.3. Monetary Policy Rate Under Central and High-Inflation Scenarios

Source: NBG.

The low-inflation scenario, relative to the central, envisions a faster-than-expected de-escalation of the conflict in the Middle East and the full pass-through of lower international oil prices to the domestic market. Moreover, the scenario assumes the maintenance of high productivity growth.

Low-Inflation Risks	
◦ A faster-than-expected de-escalation of the ongoing geopolitical tensions in the Middle East and a strong pass-through of lower oil prices in international commodity markets to the domestic market. ◦ Reallocation of global supply chains and the growing role of Georgia as the Middle Corridor country. ◦ Amid the slow normalization in the growth of highly productive sectors, sustained disinflationary dynamics stemming from the labor market.	
Indicators of risk realization	Impact on inflation
Low prices of petroleum products in the domestic market.	
The sustained high potential economic growth.	
Low domestic sovereign risk premium.	
Amid strong external inflows, the maintenance of an improved current account balance.	
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.

2.4. LOW-INFLATION SCENARIO

The Low-Inflation Scenario is as relevant as the central and high-inflation scenarios. It envisions the materialization of relevant risks that are less inflationary compared to the central scenario (see Table 2.4.1). In particular, this scenario assumes that current global tendencies will sustain strong external demand on high-productivity sectors in Georgia over a prolonged period. This will support investment and productive capacity expansion in these sectors, boosting productivity and strengthening the economy's overall production potential. At the same time, the scenario assumes a de-escalation of the conflict in the Middle East, resulting in lower oil prices relative to the central scenario. Specifically, in the low-inflation scenario, oil prices are projected to average USD 95 per barrel in the fourth quarter of 2026, before gradually declining towards USD 75 per barrel over the course of 2027. The materialization of these risks will lead to a faster normalization of monetary policy compared with the central scenario.

In recent years the acceleration in the potential economic growth rate has been supported by ongoing structural changes in Georgia. The low-inflation scenario assumes that the accelerated process of global trade diversification will be maintained. As a result, the realignment and regionalization of supply chains will further strengthen Georgia's role as a Middle Corridor country, additionally boosting the international transportation flows. Accordingly, highly productive sectors including transportation and storage, will remain the primary drivers of economic activity and its potential growth. This will also be supported by the information and communication sector, partly reflecting the active process of integrating artificial intelligence. Furthermore, a faster-than-expected easing of geopolitical tensions in the Middle East will contribute to the normalization of geopolitical risks, and the resulting improvement in investment sentiments will have a positive effect on the domestic economic potential. Eventually, in the low-inflation scenario, **real GDP growth will be higher by 0.4 pp and 0.5 pp in 2026 and 2027, compared to the central scenario, respectively averaging 7.6% and 6%. Meanwhile, strengthened macroeconomic fundamentals lead to a revision of long-term potential growth to 5.5-6%, and economic growth in 2028 will average 5.5%** (see Figure 2.4.1).

The assumptions regarding international commodity markets remain a significant driver of the low-inflation scenario. Particularly, the scenario assumes a relatively rapid normalization of oil supply in international markets and a gradual recovery in refining capacity. In addition, it envisages a strong pass-through of lower oil prices to domestic fuel prices, exerting downward pressure on inflation and its expectations.

Under the low-inflation scenario, amid rising external inflows and sustained strong fundamental factors, real GDP growth will remain at a higher level compared to the central scenario, averaging 7.6% and 6%, in 2026 and 2027, respectively.

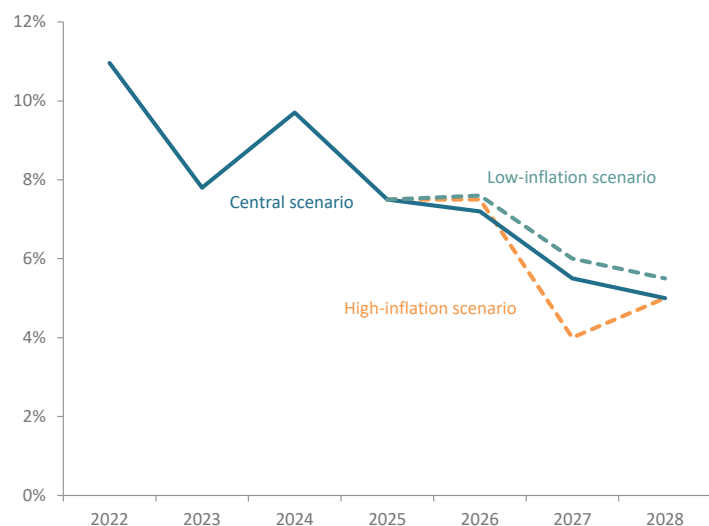


Figure 2.4.1. Real GDP Growth Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

Following the strong pass-through of lower-than-expected international oil prices to the domestic market, alongside a slow normalization of productivity growth, inflation will average 5.3% and 2.3%, in 2026 and 2027 respectively. Over the long term, it will stabilize around its target level.

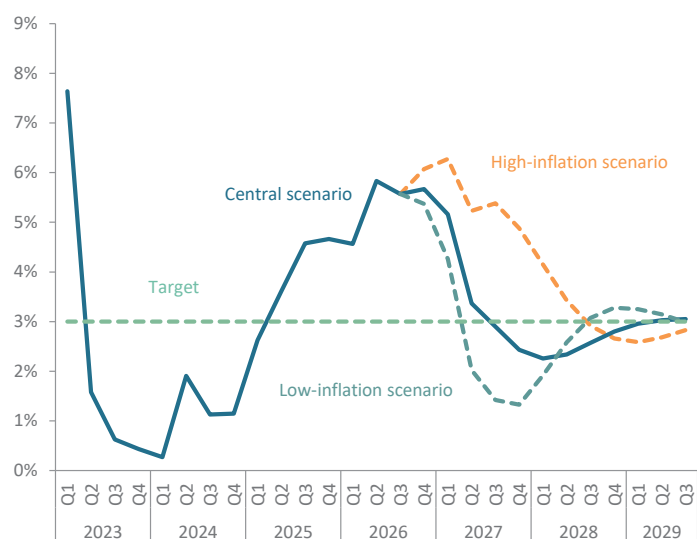


Figure 2.4.2. Year-over-year Headline Inflation Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG, Geostat.

Furthermore, a faster-than-expected de-escalation of the conflict and the maintenance of Georgia's sovereign risk premium at a low level, will support stronger external inflows. In particular, increased services exports (including tourism and transportation), alongside less import-intensive economic growth, will improve the current account balance and contribute to a fundamental appreciation of the exchange rate. All the aforementioned, ultimately, will significantly reduce headline inflation through the imported inflation channel.

Meanwhile, amid strong productivity growth driven by structural changes, alongside a sharp decline in inflation expectations, unit labor costs will remain at a low level. Consequently, labor market dynamics will further reduce domestic inflation. Thus, under the realization of this scenario, **headline inflation, compared to the central scenario, will be lower averaging 5.3% in 2026, and 2.3% in 2027, before stabilizing around the target in 2028** (see Figure 2.4.2).

Amid fading inflationary risks and the maintenance of strong fundamental factors, monetary policy normalization will proceed at a faster pace compared to the central scenario. Particularly, stabilization on international oil market and the full pass-through of lower petroleum prices to domestic fuel prices, will generate significant disinflationary effects, and alongside an exchange rate appreciation, further reduce inflation expectations. Accordingly, **the monetary policy rate is projected to be on average 0.1 pp lower in 2026 compared to the central scenario and stabilize around its long-term neutral level of 7% in 2027** (see Figure 2.4.3).

Amid stronger disinflationary dynamics compared to the central scenario, monetary policy will normalize at a faster pace.

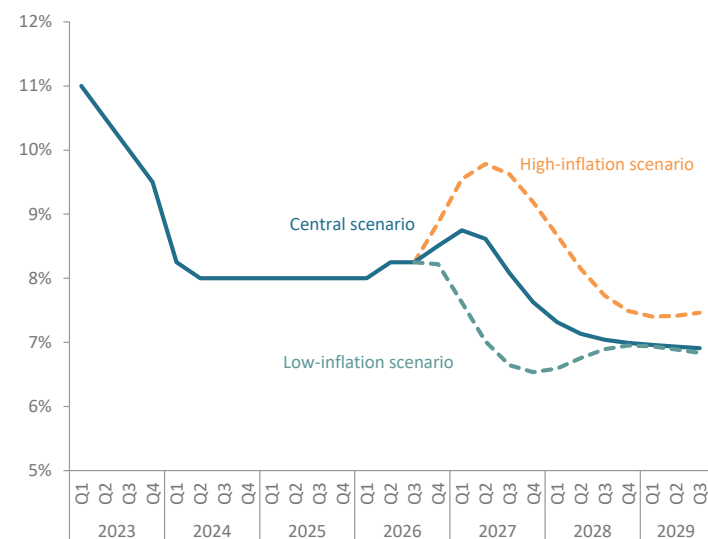


Figure 2.4.3. Monetary Policy Rate Under Central, High-Inflation, and Low-Inflation Scenarios

Source: NBG.

3. SPECIAL TOPICS

BOX 1. THE SPREAD BETWEEN LENDING AND MONETARY POLICY RATES: THE TRANSMISSION MECHANISM AND THE ROLE OF RISK PREMIA

One of the main channels through which monetary policy is transmitted to the economy is the interest rate channel. For this channel to function effectively, changes in the monetary policy rate must first be reflected in short-term interbank interest rates - the operational target of monetary policy - and subsequently transmitted to longer-term market interest rates. In Georgia, short-term money market rates closely follow the monetary policy rate, indicating the effectiveness of the operational stage of the transmission mechanism (see Figure 3.1.1).

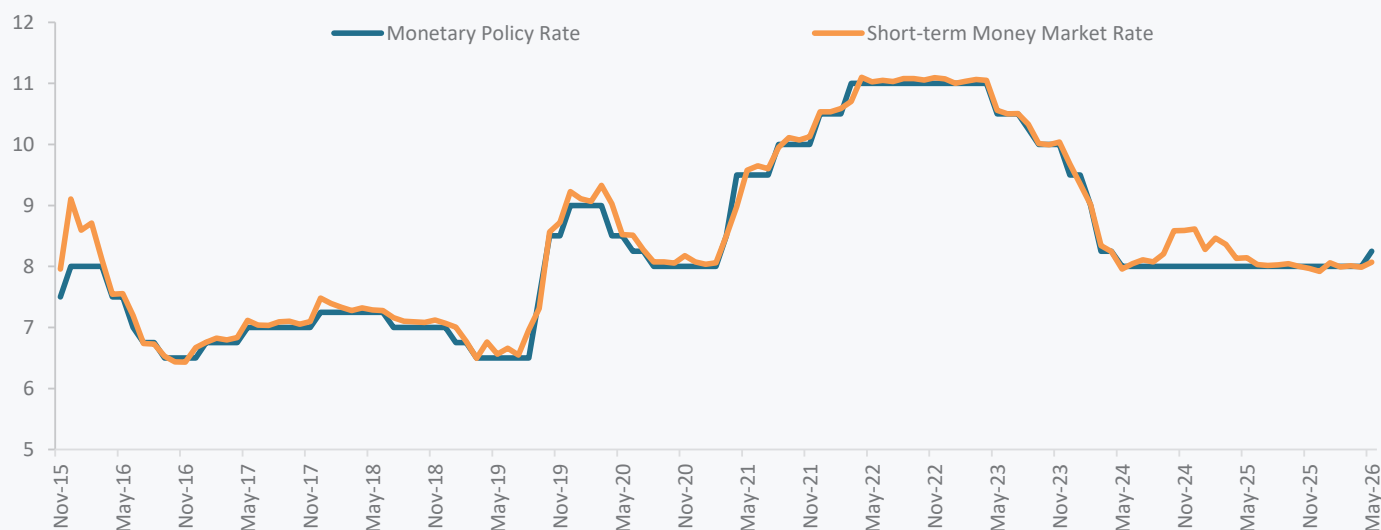


Figure 3.1.1. Money Market and Monetary Policy Rates.

Source: NBG.

In addition to the risk-free money market interest rate and its expected path, various risk premia constitute an additional component in the determination of market interest rates. Changes in these premia contribute to movements in market interest rates and may even exert an influence in the opposite direction to changes in the monetary policy rate. Accordingly, effective monetary policy transmission requires, on the one hand, the efficient pass-through of policy rate changes to money market interest rates and, on the other hand, a reduction in risk premia. Conceptually, market interest rates can be represented as follows:

$$i^L \approx \frac{\sum_{i=0}^T i_{t+1}}{T} + \rho^i + \rho^l + \rho^c + \mu$$

where the market interest rate i^L is determined by the average of current and expected short-term money market rates ($\frac{\sum_{i=0}^T i_{t+1}}{T}$), the term premium (ρ^i), liquidity (ρ^l) and credit risk (ρ^c) premia, and other factors affecting commercial banks' pricing decisions (μ), including operating costs and profit margins and etc.

As noted above, changes in the monetary policy rate and communication of its expected path are primarily reflected in interbank money market rates. At the same time, the central bank can also influence certain risk premia. In this regard, the short-term liquidity risk premium is particularly important, as one of the main objectives of the central bank's liquidity management framework is to contain this premium. Specifically, through its liquidity management instruments, the central bank balances the short-term demand for and supply of liquidity in the banking system to keep money market interest rates close to the monetary policy rate. Accordingly, effective liquidity management reduces interest rate volatility arising from short-term liquidity shortages or surpluses, as well as the associated risk premium.

The term premium plays an important role in determining longer-term interest rates. It is influenced by both domestic and global factors, including uncertainty surrounding the economic outlook and long-term

expectations of inflation and economic growth. Lending rates also incorporate a credit risk premium, reflecting borrowers' creditworthiness and expected credit losses. In turn, developments in the credit risk premium are influenced by the macroeconomic environment, including borrowers' income dynamics, macroprudential policy, and other factors.

Independent changes in these components may either amplify or weaken the impact of the monetary policy rate on financial conditions. Therefore, assessing monetary policy transmission requires considering not only the policy rate but also current and expected developments in various risk premia. However, estimating risk premia is challenging, as they are not directly observable. The economic literature employs various approaches to estimate them, including term structure models of interest rates and methods based on market indicators. The latter approach is also used in studies by the Bank for International Settlements (BIS), where observable market interest rates serve as proxies for individual risk premia. Since these indicators may simultaneously reflect several factors, their interpretation requires assessing whether the results are consistent with the macroeconomic and financial developments observed in the country during the relevant period.

In this context, Georgia's experience is particularly relevant. Alongside the development of the inflation-targeting regime and the monetary policy framework, the spread between market interest rates and the monetary policy rate has gradually narrowed. For example, the spread between interest rates on lari-denominated mortgage loans and the monetary policy rate declined from approximately 10–11 percentage points (pp) at the end of 2015 to around 3 pp in 2026 (see Figure 3.1.2). However, this development reflects changes in both the expected monetary policy path and various risk premia. Therefore, it is important to assess which factors contributed to the historical narrowing of the spread, the magnitude of their contributions, and the factors determining its current level and sustainability.

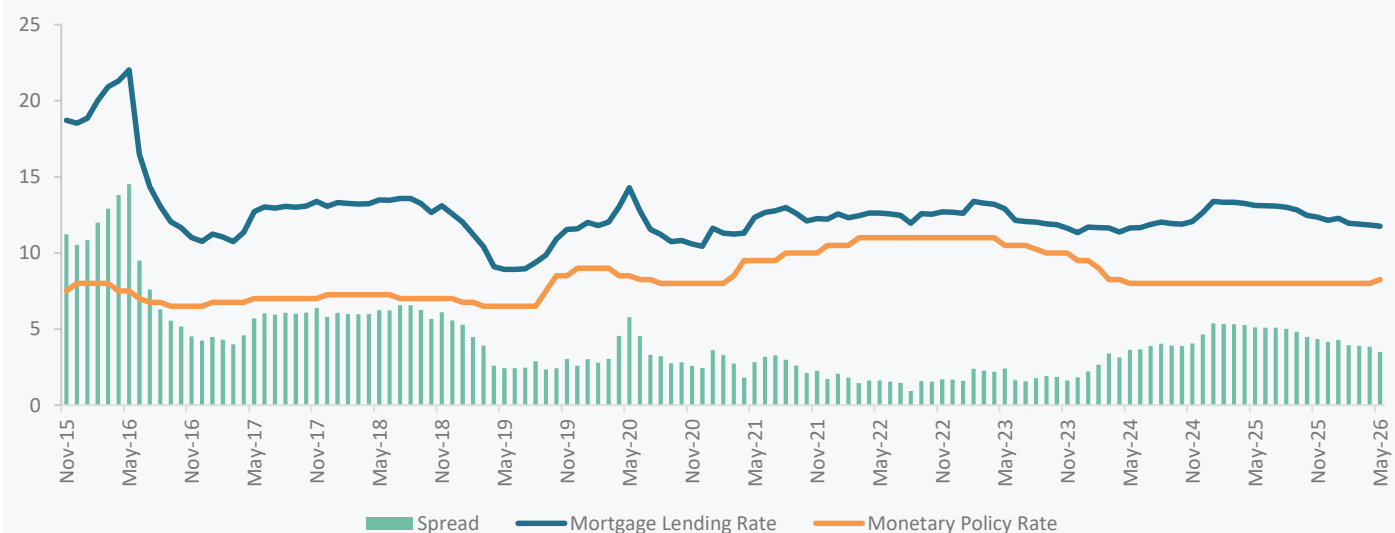


Figure 3.1.2. Interest Rates on New Lari-Denominated Mortgage Loans, the Monetary Policy Rate, and the Spread between Them.

Source: NBG.

To this end, drawing on the BIS methodological approach, a two-stage analysis was conducted. Observable market indicators are used as proxies for risk premia, while the results are interpreted in the context of Georgia's macroeconomic developments.

In the first stage, following the conceptual framework outlined above and the BIS methodological approach, the spread between lending and monetary policy rates is decomposed, based on an accounting identity, into components associated with the short-term money market, the government securities yield curve, and bank lending:

$$(L_t - P_t) = (l_t - P_t) + (G_t^{2Y} - I_t) + (G_t^{5Y} - G_t^{2Y}) + (L_t - G_t^{5Y})$$

Specifically:

- **Lending-policy rate spread (Lending Rate (L_t) - Policy Rate (P_t)):** Measures the difference between interest rates on newly issued lari-denominated mortgage loans and the monetary policy rate.
- **Short-term liquidity spread (Liquidity Price (I_t) - Policy Rate (P_t)):** Captures the deviation of the short-term money market interest rate from the monetary policy rate and serves as a proxy for the

short-term liquidity risk premium.

- **Expected interest rate path (2-year Government Yield (G_t^{2Y}) - Liquidity Price (I_t)):** Measures the difference between the yield on two-year government securities and the short-term money market rate. It serves as a proxy for market expectations of the future monetary policy path. However, its dynamics may also be influenced by other factors, including supply and demand for government securities and associated risk premia.
- **Term spread (5-year Government Yield (G_t^{5Y}) - 2-year Government Yield (G_t^{2Y})):** Captures the slope of the government securities yield curve, which reflects both the expected path of interest rates and longer-term risks and uncertainty. Accordingly, it serves only as an approximate indicator of changes in the term premium.
- **Credit risk and other factors (Lending Rate (L_t) - 5-year Government Yield (G_t^{5Y})):** Captures the additional component of mortgage lending rates relative to the yield on five-year government securities, incorporating credit risk premia, bank intermediation costs, funding conditions, and other factors.

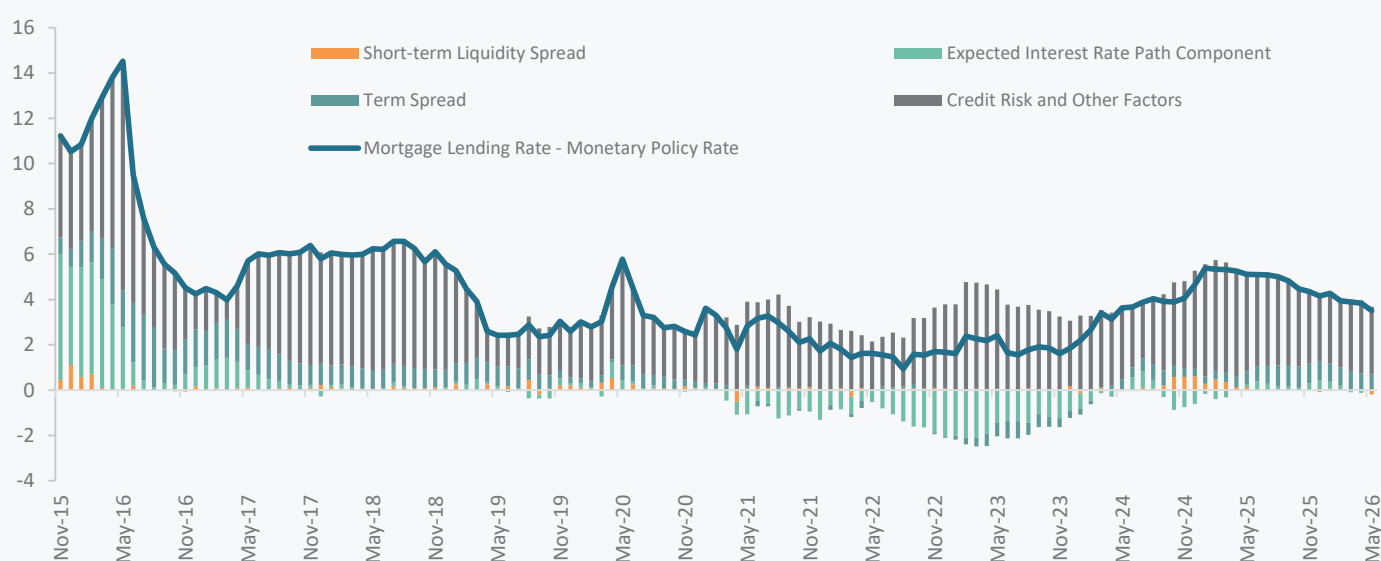


Figure 3.1.3. Decomposition of the Spread Between Lending and Monetary Policy Rates.

Source: NBG.

The results indicate that different factors have contributed to the narrowing of the spread between mortgage lending rates and the monetary policy rate over time. Historically, the contribution of the short-term liquidity spread has been negligible, reflecting the close alignment of interbank money market rates with the monetary policy rate and the effectiveness of the NBG's liquidity management framework.

A significant part of the historical decline in the spread, particularly in 2016, is associated with a reduction in the expected interest rate path component (see Figure 3.1.3). Notably, this development coincided with improvements in the NBG's Forecasting and Policy Analysis System (FPAS) and the introduction of forward guidance on the expected monetary policy path. These developments helped improve the formation of market expectations and their incorporation into interest rates, as reflected in lower yields along the yield curve and narrower spreads relative to short-term rates. This suggests a strengthening of monetary policy transmission through the expectations channel.

The term premium also plays a role in determining longer-term interest rates, although its contribution in Georgia has historically been moderate. Nevertheless, increases in this component during certain periods, including recent years, have coincided with heightened economic and financial uncertainty. Accordingly, tighter global financial conditions or increased long-term risks may exert upward pressure on domestic long-term interest rates, even in the absence of changes in the current monetary policy rate.

Furthermore, the decomposition indicates that the spread between mortgage lending rates and five-year government securities yields accounts for a significant share of the overall lending spread. This component reflects the combined effects of credit risk, liquidity and funding conditions, regulatory requirements, and other factors, including operating costs and profit margins.

Since the individual contributions of these factors are not directly observable, the second stage of the anal-

ysis employs a state-space model and the Kalman filter to obtain approximate estimates based on observable banking and macroeconomic indicators. Specifically, the spread between mortgage lending rates and five-year government securities yields is decomposed into various risk premium components and other factors, with their unobserved dynamics linked to relevant observable indicators.

Non-performing and overdue loan ratios are used to estimate the credit risk premium. Liquidity and funding conditions are assessed using the ratio of liquid assets to total assets, dollarization, and the difference between loan and deposit growth rates. Changes in term deposit interest rates are used to capture funding costs, while capital, reserve, and macroprudential requirements are used to assess regulatory effects. The remaining component captures the effects of operating costs, profit margins, and other unexplained factors. This approach allows the contribution of each component to the historical dynamics and current level of the lending spread to be assessed.

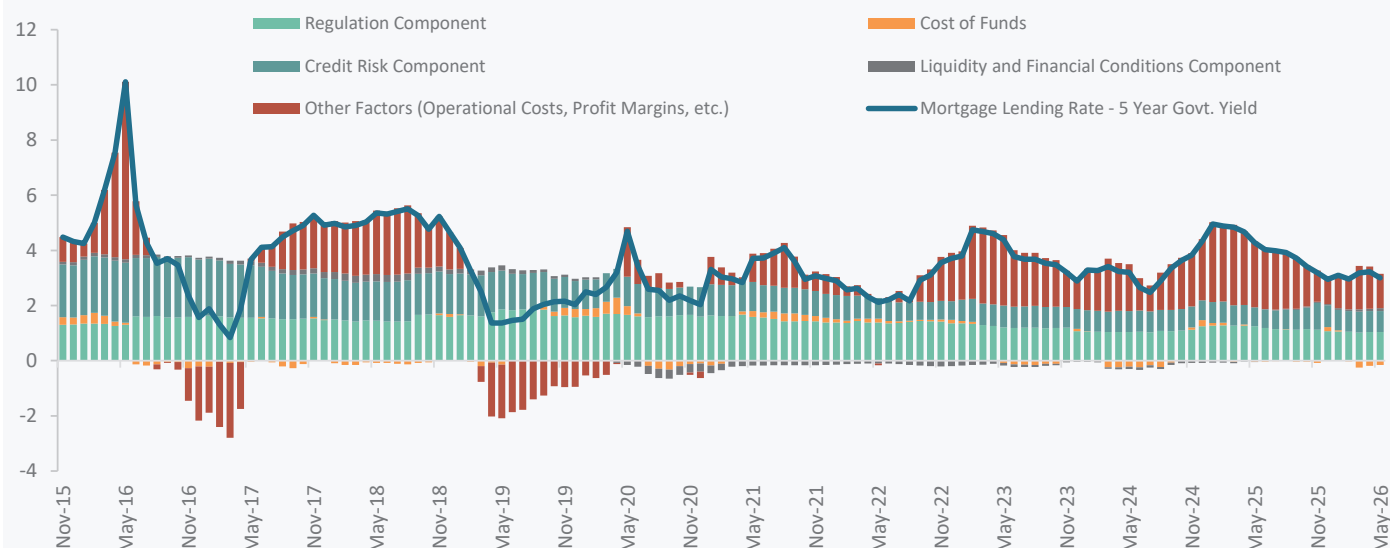


Figure 3.1.4. Decomposition of the Spread Between Mortgage Lending Rates and Five-Year Government Bond Yields.

Source: NBG.

According to current estimates, the contribution of the credit risk component has declined over the longer term. This trend was particularly evident in 2019, when its contribution decreased from 1.5 pp to 1.0 pp, reflecting the effects of the responsible lending framework and changes in macroprudential policy. These measures have contributed to improved lending standards and reduced credit risks. At the same time, the estimated credit risk component exhibits a negative relationship with the economic cycle. During the pandemic, amid a sharp contraction in economic activity and declining incomes, its contribution temporarily increased to above 1.1 pp. Subsequently, supported by strong economic activity and improvements in borrowers' debt-servicing capacity, it declined to around 0.7–0.8 pp.

More recently, increased dollarization has contributed to higher dollar liquidity in commercial banks, reducing the need to attract additional funding and supporting a decline in interest rates on term deposits. As a result, banks' dollar funding costs have decreased, exerting downward pressure on interest rates on dollar-denominated loans. This trend is also reflected in the decomposition results, which indicate that the contribution of the funding cost component has recently been relatively small but has continued to decline.

As for the component capturing operating costs, bank margins, and other factors, this component exhibits a positive relationship with the economic cycle, suggesting some degree of procyclicality. In particular, during periods of strong aggregate demand and elevated economic activity, the contribution of this component tends to increase, potentially reflecting higher bank margins. At the same time, its dynamics are also influenced by other factors, including the degree of competition and operational efficiency in the banking sector.

Overall, the historical narrowing of the spread between lending and monetary policy rates reflects improvements in the monetary policy transmission mechanism, the development of financial markets, and a reduction in risk premia. The analysis also shows that the extent of monetary policy transmission to lending rates depends not only on the expected monetary policy path but also on developments in risk premia, bank funding conditions, intermediation costs, and other pricing factors. Accordingly, these factors need to be taken into account when assessing the effectiveness of monetary policy, as changes in their dynamics may either amplify or weaken the transmission of monetary policy to financial conditions.

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		
	2025	2026	2027	2028	2026	2027	2028	2026	2027	2028
Inflation (%)	3.9	5.4	3.5	2.5	5.5	5.4	3.3	5.3	2.3	2.7
Real GDP Growth (%)	7.5	7.2	5.5	5.0	7.5	4.0	5.0	7.6	6.0	5.5
Monetary Policy Rate (%)	8.0	8.3	8.3	7.1	8.3	9.5	8.0	8.2	7.0	6.8

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

Source: NBG, financial market participants, Geostat.

* The table reports annual averages for the variables.

FORECASTS OF FINANCIAL MARKET PARTICIPANTS

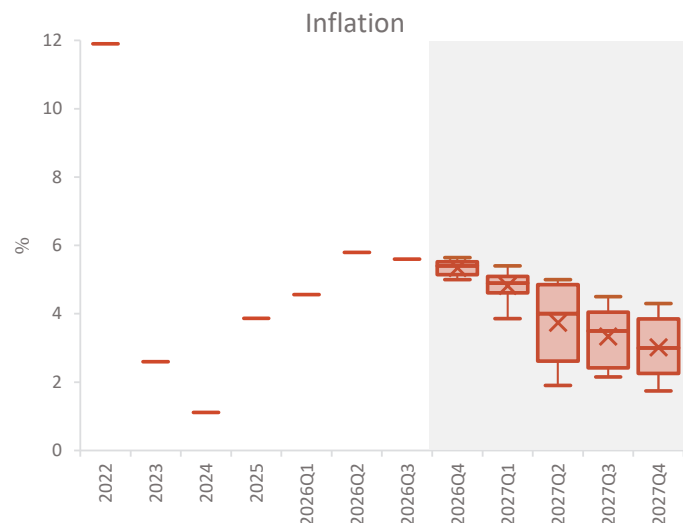


Figure 4.1. Actual average inflation and the distribution of market participants' forecasts

Source: NBG, financial market participants, Geostat.

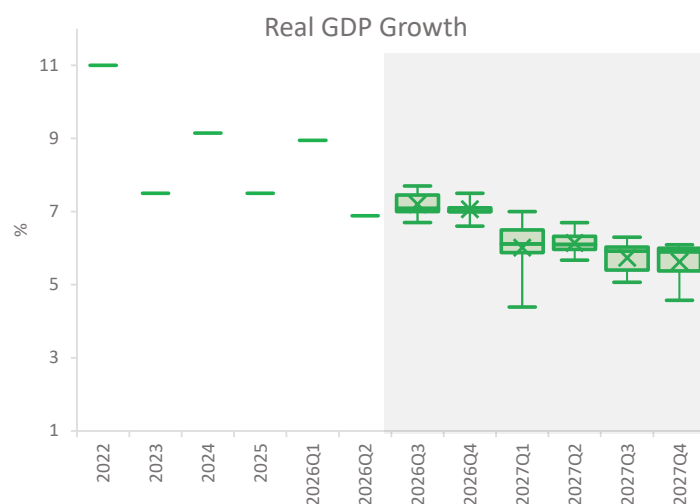


Figure 4.2. Actual real GDP growth and the distribution of market participants' forecasts

Source: NBG, financial market participants, Geostat.

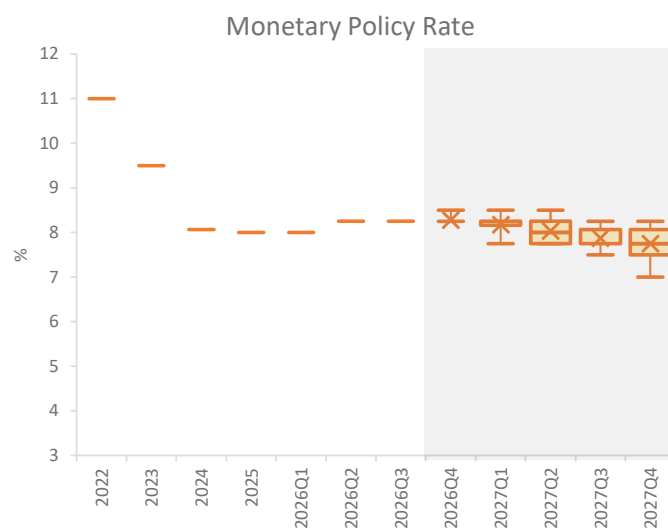


Figure 4.3. Actual monetary policy rate and the distribution of market participants' forecasts

Source: NBG, financial market participants.

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