The market forecasts for economic growth in 2024 have been revised upward compared to those of the previous quarter, and projections for 2025 have slightly decreased.

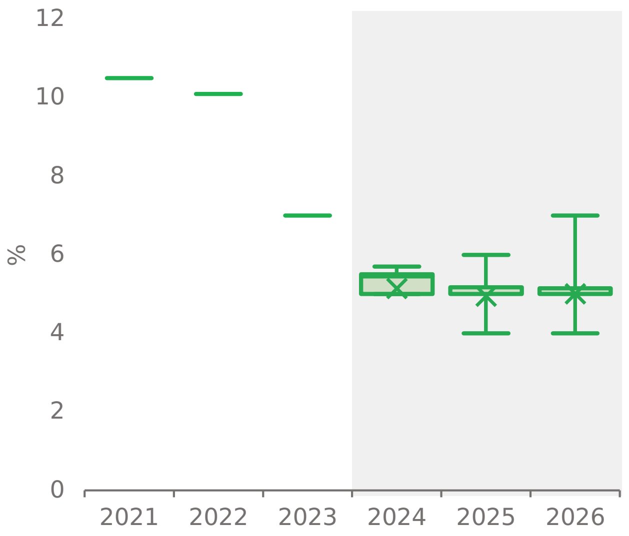

Figure 2.4.3. Actual real GDP growth (2021-2023) and the distribution of market participants' forecasts for 2024-2026

Source: NBG, Financial market participants, GeoStat

BOX 1. EVALUATION OF INFLATION TARGET FULFILLMENT AND AN ASSESSMENT OF THE 2023 FORECASTS

Changes in monetary policy are transmitted to the economy gradually with a certain time lag (of 4-6 quarters). Therefore, in the formation of monetary policy, it is especially important to consider the inflation forecast over the monetary policy horizon. Because of the central importance of this, the inflation targeting regime is also called the inflation forecast targeting regime in academic and institutional circles. To assess the adequacy of monetary policy in achieving its objectives, it is important to analyze the accuracy of the forecasts made in previous periods. A retrospective analysis of inflation forecasts is thus an important dimension of the forecasting and monetary policy analysis system of the National Bank of Georgia. An inflation forecast is assessed as having been accurate if any deviations from the forecast were a result of exogenous factors (that are independent of monetary policy). In Georgia, as in other small open economies, exogenous shocks are an ever-present threat. Such shocks are usually transitory and one-off in nature, and responding to them is commonly associated with more public costs than benefits. Consequently, central banks generally do not react to such shocks, except when supply-side shocks affect medium-/long-term inflation expectations.

According to the policy of transparency, an analysis comparing the inflation forecast with the actual results is included in the Monetary Policy Report at the beginning of each year. In this case, we will evaluate inflation target fulfillment in 2023 and analyze its forecast. Inflation turned out to be significantly higher than had been projected in February 2023 (see Figure 2.4.4). According to the February 2023 update, the inflation forecast for the year was influenced by several opposite factors. In particular, the stabilization of commodity prices on international markets and the appreciated exchange rate as a result of foreign inflows put downward pressure on inflation. In addition, over the forecast horizon, the convergence of inflation to its target was facilitated by the prolongation of the tight monetary policy stance and fiscal consolidation. In contrast, as a result of the high inflation experienced in previous years, inflation expectations remained elevated and this – together with the high unit labor cost and strong aggregate demand amid high migration – put upward pressure on inflation. Therefore, according to these factors, inflation in 2023 should have had a downward trend that would see it return to its target by the end of the year.

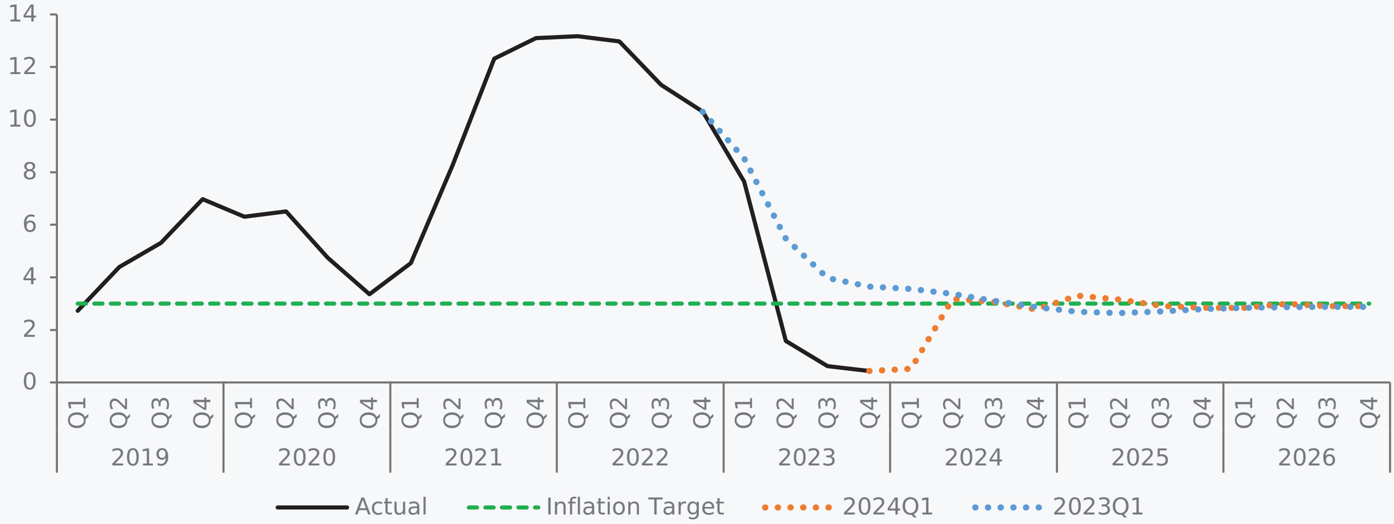

Figure 2.4.4. Comparison of the February 2023 annual inflation forecast with actual inflation and the updated forecast.

Source: NBG, GeoStat

In 2023, inflation had a downward trend in line with the forecast, although this occurred faster than we had expected. As a result, inflation turned out to be 2.8 pp lower than had been forecast. The main reason for the deviation was the different realization of the assumptions made regarding commodity products and foreign inflows (see Figure 2.4.5). According to the inflation decomposition analysis, the lower-than-forecast inflation can mostly be explained by exchange rate and imported inflation effects, which were accompanied by improved inflation expectations. In particular, migration and accompanying financial flows related to the Russia-Ukraine war turned out to be stronger than had been expected, which caused an even greater strengthening of the exchange rate. On the one hand, the strengthened exchange rate and a sharp decrease in international commodity prices and transportation costs significantly reduced imported inflation and, at the same time, lowered inflation expectations. It is noteworthy that even in a high dollarization environment, the exchange rate is an important factor affecting inflationary expectations. Migration flows also had the opposite impact on inflation: strong external demand also boosted domestic demand, and despite accelerating potential growth, economic activity turned out to be above its potential, which was inflationary.

Amid lower-than-expected actual inflation, in the second quarter of 2023 the NBG significantly revised its inflation forecast. Over the rest of the year the inflation forecast differed slightly from actual data: the average annual rate as forecast ranged from 2.4% to 2.8%, while the actual rate was 2.6% (see Figure 2.4.6). It is noteworthy that the financial market also expected high inflation at the beginning of the year, with partic-

Figure 2.4.5. Decomposition of the difference between actual inflation and the February 2023 forecast.

Source: NBG, GeoStat

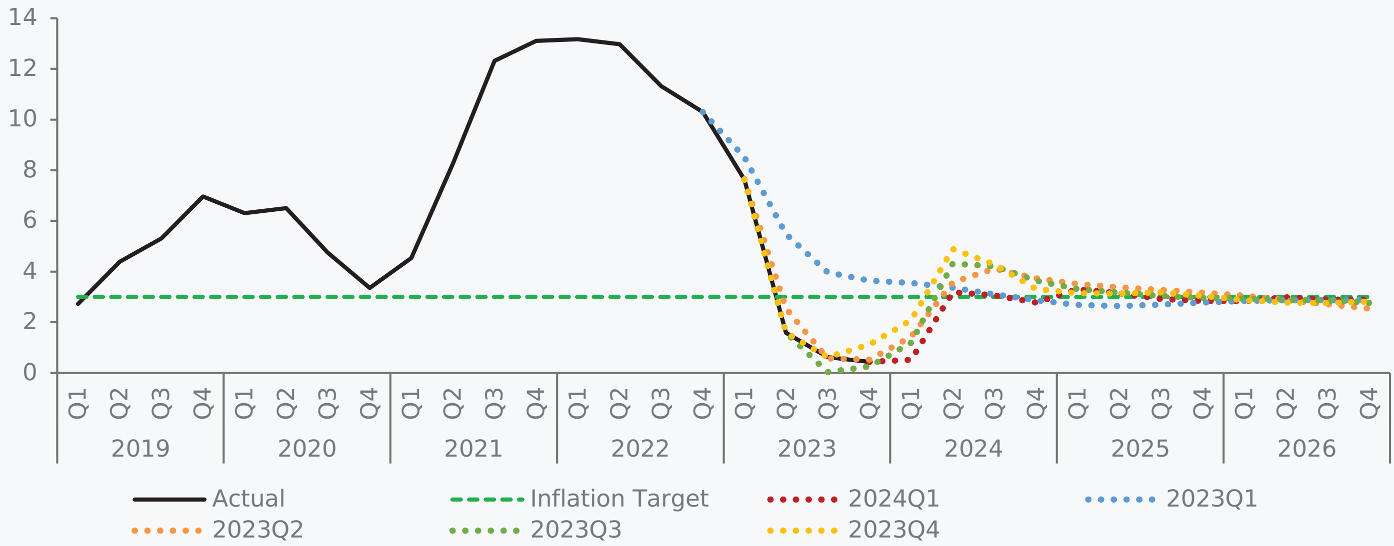

Figure 2.4.6. Comparison of headline inflation forecasts (2023Q1-2024Q1).

Source: NBG, GeoStat

ipants' median and mean forecasts standing at 6.7% and 6.9%, respectively[12]. Like those of the NBG, market participants' expectations gradually decreased during the year.

According to the inflation forecast, which took into account the economic situation and risks at the time, NBG decided to gradually exit from its tight monetary policy in May 2023 and thus reduced the monetary policy rate by 50 basis points to 10.50%. However, as discussed, the factors affecting inflation were exogenous, and while overall inflation was declining rapidly, domestic inflation was only slowly normalizing. At the same time, aggregate demand was still inflationary, and the effects of reduced imported inflation were characterized by uncertainty amid high risks. As a result, the stabilization of inflationary expectations was significantly delayed, partly as a consequence of inflation having been over the target for a long time, and this thus required a relatively tight monetary policy stance to be maintained. That is why the NBG chose to pursue a conservative, risk-management approach and, despite inflation having been below the target since April, the pace of exiting from the tight monetary policy stance was moderate and cautious. During the year, the monetary policy rate was thus only gradually decreased by 1.5 pp to 9.5%.

12 Macroeconomic forecasts of financial market participants are traditionally published in subsection 2.4 of the monetary policy report, "Forecasts of Financial Market Participants".