

BOX 1. INTRODUCING NEW MEASURES OF INFLATION: “NON-TRADABLE STICKY” AND “FLEXIBLE” PRICE INFLATION

Decomposing inflation into “flexible” and “non-tradable sticky” prices provides valuable insights into the dynamics of inflation. “Flexible” inflation encompasses the prices of products within the consumer basket that respond swiftly to external factors, as well as changes in demand and supply. In this regard, market conditions predominantly influence current inflation through the impact of flexible prices, which could serve as a warning signal for long-term inflationary pressures. Conversely, “non-tradable sticky” prices are characterized by more gradual movements and are closely tied to inflation expectations. Thus, non-tradable sticky price inflation provides a more nuanced view of inflation expectations.

For instance, when the upsurge in international commodity prices and shipping costs in the post-pandemic period were transmitted to the Georgian market, these immediately increased flexible inflation. Concurrently, the pent-up demand that had been accumulated during the economic lockdowns began to fully materialize, further exerting upward pressure on flexible prices. This strong inflationary shock eventually led to elevated inflation expectations, leading to a rise in non-tradable sticky price inflation. Headline inflation stabilized at a low level (0%-1%) from the summer of 2023, primarily driven by the normalization of commodity prices in international markets. Specifically, flexible prices became deflationary, while non-tradable sticky inflation decreased at a slower pace, reflecting price pressures from the domestic economy. Consequently, the National Bank of Georgia adopted a cautious strategy to gradually exit from its strict monetary policy stance. With this occurring, non-tradable sticky prices normalized near the inflation target (see Figure 1.6.4).

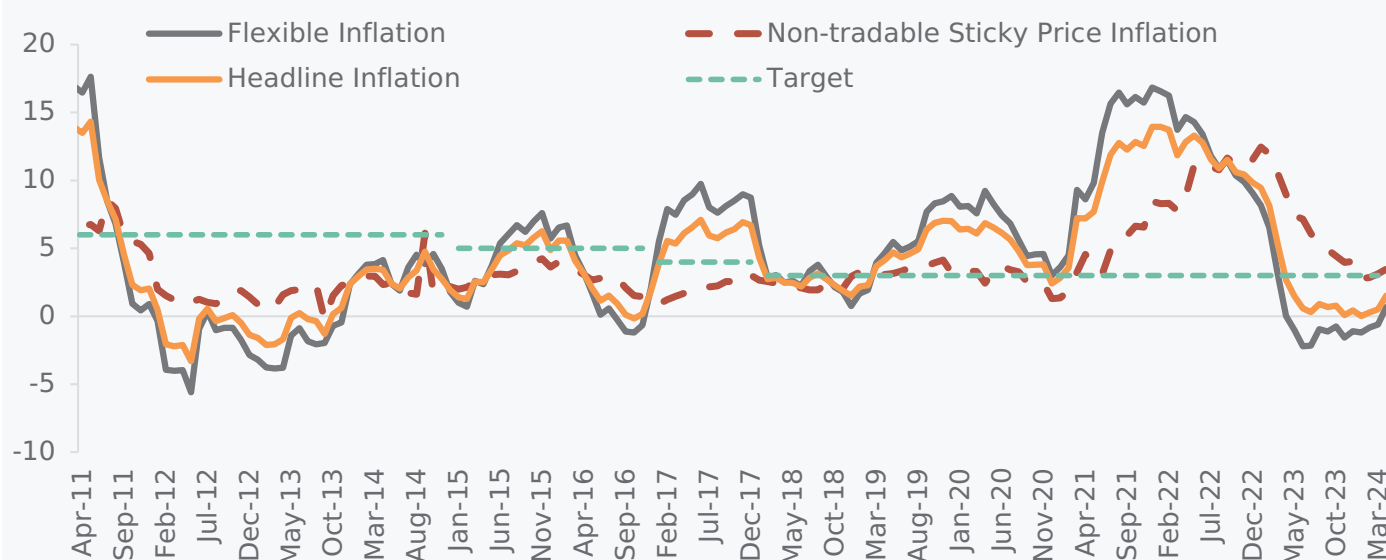


Figure 1.6.4. Headline, non-tradable sticky and flexible price inflation in Georgia

Source: NBG, GeoStat

In general, non-tradable sticky price inflation is a reliable indicator of a central bank’s ability to anchor inflation expectations. Therefore, it can be used to evaluate the efficiency of monetary policy and the credibility of the central bank. We were particularly interested in how well non-tradable sticky price inflation could explain the endogenous credibility of the National Bank of Georgia, especially after the adoption of the inflation-targeting regime. To this end, we constructed an endogenous credibility measure and compared it to the bank’s monetary policy decisions. Notably, when non-tradable sticky price inflation converges to its normal level, averaging at around 2%, the central bank’s credibility remains at its maximum, and the index equals one. However, if it deviates from this normal level, the central bank’s credibility then diminishes. Given the frequent episodes of high inflation in Georgia, this change in credibility is asymmetric. Specifically, the credibility of the NBG decreases when non-tradable sticky price inflation exceeds its normal level. As illustrated in Figure 1.6.5, the correlation between endogenous credibility, estimated by non-tradable sticky price inflation, and the monetary policy rate is significantly negative. When the National Bank of Georgia’s credibility decreased, it raised the policy rate, and vice versa. Therefore, we can conclude that after adopting the inflation-targeting regime, non-tradable sticky price inflation and the endogenous central bank cred-

ibility measure estimated by this inflation can effectively explain the rationale behind the monetary policy decisions.

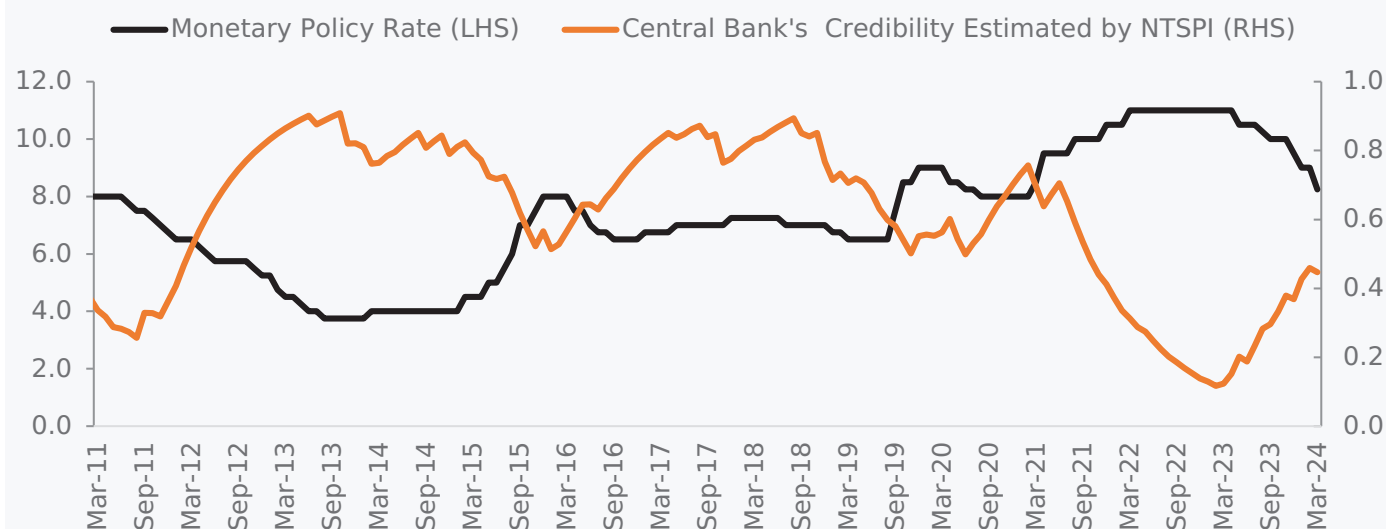


Figure 1.6.5. Monetary policy rate and the Central Bank's Credibility Index in Georgia

Source: NBG