

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

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

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

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

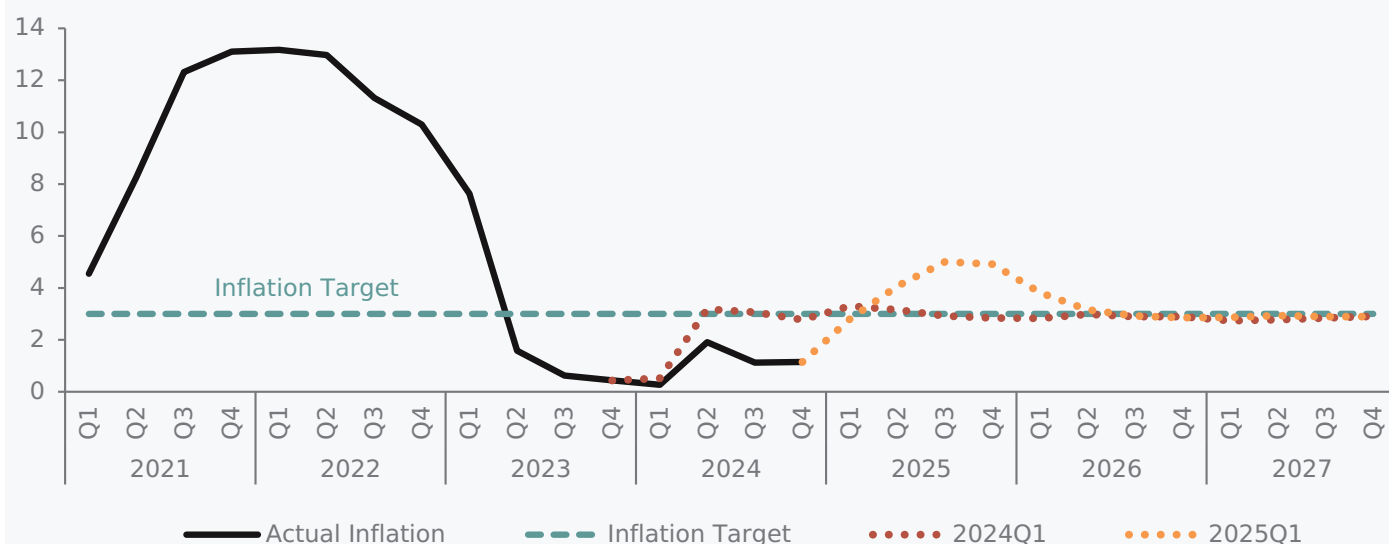


Figure 3.2.1: Comparison of the February 2024 Annual Inflation Forecast with Actual Inflation and the Current Forecast.

Source: NBG, Geostat.

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

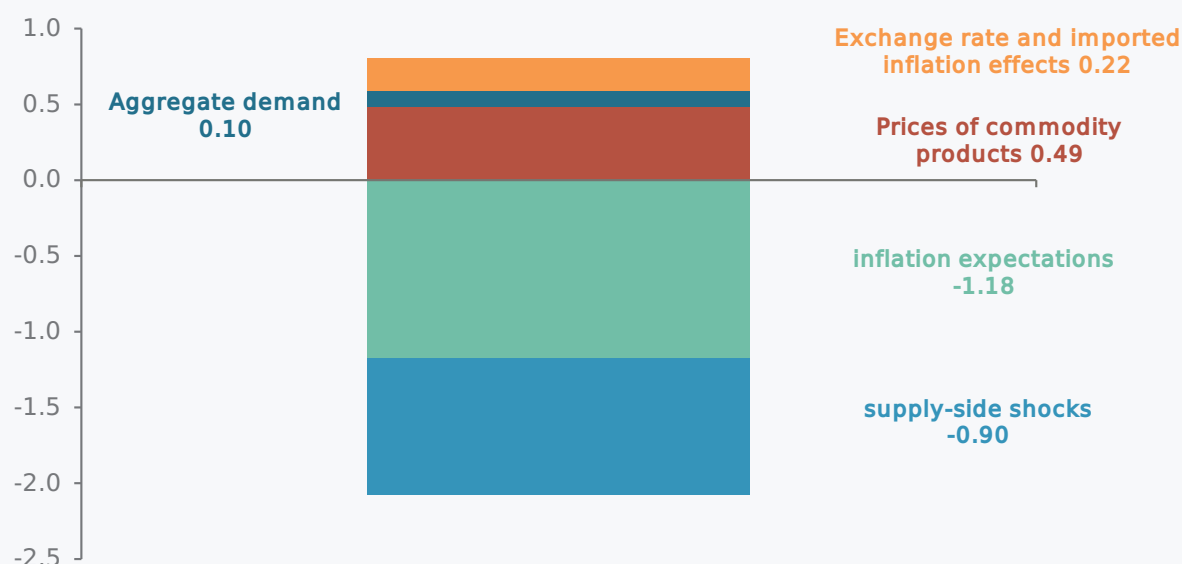


Figure 3.2.2: Decomposition of the Difference between Actual Inflation and the February 2024 Forecast.

Source: NBG, GeoStat.

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

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

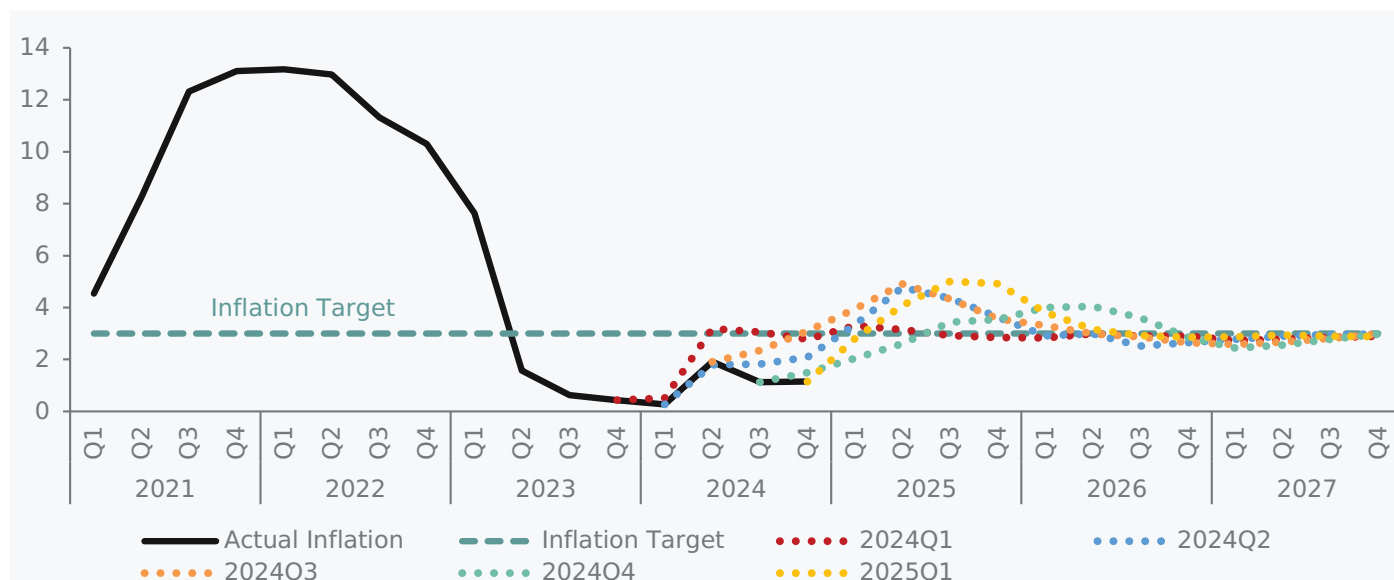


Figure 3.2.3: Comparison of Headline Inflation Forecasts (2024Q1-2025Q1).

Source: NBG, Geostat.

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