3. SPECIAL TOPICS

BOX 1. GLOBAL FRAGMENTATION AND THE IMPLICATIONS OF TARIFFS FOR THE GEORGIAN ECONOMY

The U.S. administration's tariff policy has sent shockwaves throughout the global economy. Despite a 90-day delay in implementing reciprocal tariffs against the U.S.'s main trading partners, a universal 10% tariff on most imported goods remains in effect, while China faces a particularly high 145% tariff. These measures are framed as efforts to support U.S. manufacturing and reduce trade deficits. However, alongside other risk factors of the U.S. economy, their potential effects are widespread.

The intensification of U.S.-China trade tensions has spillover effects beyond bilateral trade. Disruptions to global supply chains could prompt multinational firms to reassess production strategies. Trade-dependent economies across the globe are facing the need to find new partners and markets. All of these factors increase the risks of fragmentation. Financial markets have reacted to this risk with considerable volatility. Global investors have cautiously diversified away from dollar-denominated assets and U.S. equity indices have undergone sharp corrections; bond yields have risen due to elevated risk perceptions, and the U.S. dollar has exhibited fluctuations linked to concerns over competitiveness.

The prevailing tendencies are exerting a negative impact on the global economic outlook. Elevated uncertainty reduces the investment incentives and worsens consumer sentiments contributing to a lower growth outlook. On the other hand, the enforcement of the announced tariff policy is expected to lead to price adjustments. At the same time, growing economic fragmentation is likely to result in supply chain disruptions. These developments pose upside risks to global inflation. As a result, monetary policymakers face a difficult situation to manage the short-term balance between price stability and output.

Against the backdrop of global trade fragmentation, it is important to assess the potential spillover effects on the Georgian economy. First, it should be emphasized that Georgia is not a direct participant in the ongoing trade disputes, and thus the direct transmission through trade channels is expected to be limited. However, it is also important to consider that Georgia is a small, open economy, and the current global economic environment can influence the economy through various indirect channels.

In 2024, exports to the U.S. accounted for only 0.4% of Georgia's GDP (see Figure 3.1.1). Therefore, the direct impact of U.S. tariff policy on the Georgian economy is expected to be relatively small. To assess this, we rely on the export price elasticity approach, which, in simple terms, reflects how sensitive external demand is to changes in the prices of exported goods. According to a World Bank study, the price elasticity for Georgia is estimated at 0.45, meaning that a 1% increase in the price of Georgian exports reduces foreign demand by 0.45%. If we assume that a 10% tariff is fully passed through to export prices (i.e., U.S. buyers pay 10% more for Georgian goods), then demand for Georgian exports in the U.S. would decline by approximately 4.5%. This would reduce the U.S. share in Georgia's total exports by only 0.1 pp - from 2.2% to around 2.1%. As a result, the ratio of exports to the U.S. relative to Georgia's GDP would remain virtually unchanged (around -0.02 pp).

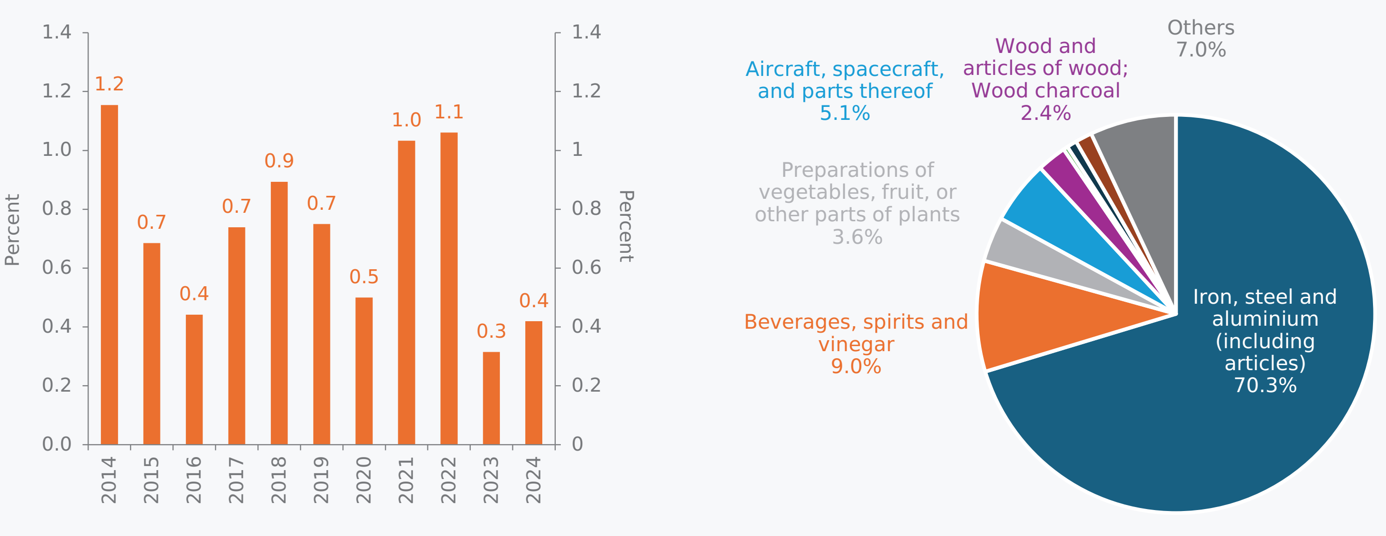

Figure 3.1.1. The ratio of exports to the U.S. relative to Georgia's GDP and the structure of exports to the U.S. in 2024

Source: Geostat, Authors' calculations.

The tariff policy through direct trade channels may have the greatest impact on the light vehicle market. As of May 2025, a 25% tariff on imported cars and key automotive parts is active in the U.S. For Georgia, 50% of imported vehicles originate from the U.S. Notably, a large portion of this import is intended for re-export, generating value add within the Georgian economy. Therefore, the implementation of the announced tariff policy would, on one hand, reduce imports due to higher prices, but on the other hand, could negatively affect economic activity by lowering the value added from re-export operations. Assuming the full 25% tariff is passed through to consumer prices, and considering an import demand elasticity of 0.79 (World Bank estimate), Georgia's vehicle imports from the U.S. could decline by approximately 10.7%. Also, assuming that the elasticity of export with respect to price is 0.45, Georgian re-export may decline by 10.8% as well. It should be noted that this is the preliminary estimate and due to the high uncertainty around the tariff policy, it may be revised when new data becomes available.

Furthermore, both new and used vehicles are components of the consumer basket, and if global car prices increase, this could contribute an additional 0.1 pp to headline inflation. Under an alternative scenario, the structure of Georgia's automobile market may shift, with imports from the United States being replaced by other sources. However, if these alternative sources cannot fully substitute for U.S. supply, this could lead to a decline in Georgia's vehicle trade with the region.

The fragmentation of trade and economic relations also affects the Georgian economy through financial channels. Specifically, the global slowdown in economic activity heightens the risks of reduced income from external demand, as well as lower remittance and capital inflows. This, in turn, puts pressure on the exchange rate. At the same time, increased global risk aversion tightens financial conditions, which also transmits to Georgia. Notably, the rise in yields on long-term U.S. Treasury securities may signal an increase in the neutral interest rate, which - under the assumption of uncovered interest rate parity (UIP) - would also raise Georgia's neutral rate. However, if global productivity declines as a result of fragmentation, slower potential growth would lead to a decrease in the neutral interest rate.

In addition to the direct impact of U.S. tariffs, indirect effects may also arise, particularly those related to a decline in global demand. Furthermore, the escalated trade tensions is expected to hit and slowdown economic growth in Georgia's main trading partners - China, the European Union, Kazakhstan, and Turkey - especially hard. The materialization of this risk could adversely affect their demand for Georgia's export products. Under such circumstances, the increasingly fragmented and uncertain nature of global trade may translate into second-round effects on Georgia's exports—even though the country itself is not directly targeted by U.S. tariffs.

On the other hand, against the backdrop of these risks, Georgia's strategic location and its role as part of the "Middle Corridor" create new types of opportunities. Specifically, in the context of export redirection resulting from trade fragmentation, revenues from transport and transit services may increase, which would contribute to an improvement in the current account balance.

The scenario-based analytical framework suggests that current global economic uncertainty gives rise to both inflationary and disinflationary pressures. The table below summarizes the main transmission channels through which these changes may be passed on to the Georgian economy and presents the potential inflationary and disinflationary outcomes.

Type of Effect	Disinflationary Risks	Inflationary Risks
Global Trade Dynamics	Exporters (e.g., China) lower prices to access alternative markets ⟶ Lower global prices ⟶ Lower imported inflation in Georgia	Tariffs raise cost of imported intermediate goods in U.S. ⟶ Global production costs rise ⟶ Higher imported inflation
	Trade reroutes through Georgia (Middle Corridor) ⟶ Higher transit revenue ⟶ Stronger lari ⟶ Lower imported inflation	Supply chain bottlenecks raise costs globally ⟶ Input shortages ⟶ Price increases across traded goods
	Global economic slowdown/recession reduces global demand ⟶ Lower prices on international markets ⟶ Lower imported inflation	Global demand shocks from tariff wars weakens external demand for Georgia's goods ⟶ Lari depreciated ⟶ Higher imported inflation

Type of Effect	Disinflationary Risks	Inflationary Risks
Financial Spillovers	To combat global disinflation, most central banks are easing policy ⟶ Interest rates are declining globally ⟶ Lari appreciates	Higher interest rate in U.S. in response to inflation ⟶ Capital outflows from developing to developed countries ⟶ Weaker lari ⟶ Higher imported inflation
Consumer/Business Behavior (Sentiments)	High uncertainty exacerbates tensions ⟶ Delayed consumption and investment in Georgia ⟶ Weak aggregate demand ⟶ Disinflationary pressure	
Remittances Channel	Global economic slowdown ⟶ Job losses or income drops for Georgian migrants ⟶ Lower remittances ⟶ Reduced household demand ⟶ Disinflationary pressure	Global economic slowdown ⟶ Job losses or income drops for Georgian migrants ⟶ Lower remittances ⟶ Weaker lari ⟶ Higher imported inflation
Commodity market	Lower Oil Prices ⟶ Lowers gasoline prices ⟶ Reduces inflation	
Cars market		Rising car prices ⟶ Increase of CPI in Georgia ⟶ Decrease in the ratio of value add from cars re-export to GDP