3. SPECIAL TOPICS

BOX 1. FULFILLMENT OF THE INFLATION TARGET AND AN ASSESSMENT OF THE 2025 CENTRAL SCENARIOS

Changes in monetary policy are transmitted to the economy gradually, and their effects fully materialize, on average, in 4-6 quarters. Therefore, in the conduct of monetary policy, special consideration is given to the forecast presented in the **central scenario** and the distribution of **risks** surrounding it. Therefore, to assess and enhance the effectiveness of monetary policy, the retrospective analysis of scenarios is an important component of the National Bank of Georgia's forecasting and policy analysis system.

In small open economies, where a sizable share of the consumer basket consists of commodities and imported goods, assumptions about exogenous factors (i.e., factors outside the scope of monetary policy) play a critical role, as they shape inflation and, consequently, the trajectory of monetary policy. Amid elevated global uncertainty, accounting for exogenous factors has become more challenging, increasing the **conditionality** of forecasts and significantly reducing the robustness of monetary policy. In response, policymakers increasingly rely on scenario analysis and risk minimization when setting monetary policy. Accordingly, central banks at the monetary policy frontier, such as the U.S. Federal Reserve and the European Central Bank, among others, have integrated uncertainty and the balance of risks into their decision-making frameworks and now conduct policy on a "meeting-by-meeting" approach. In this context, the National Bank of Georgia stands out, as it is one of the frontier banks in advancing the monetary policy framework and, by adopting a scenario-based approach since early 2025, has been considered a best-practice institution. Within a scenario-based approach, policymakers consider alternative, equally relevant trajectories of exogenous factors, form their views, and make policy decisions accordingly. This refers not to the most likely policy rate path, but rather to a **policy rate trajectory that is adjusted for the balance of risks** (corresponding to the central scenario). Accordingly, retrospective analysis not only involves comparing forecasts with actual values, but also assesses how accurately the key risks were identified and how consistently they were incorporated into the policy-making process.

Based on the practice of high transparency, an analysis comparing the inflation forecast to realized data is published in the Monetary Policy Report at the beginning of each year. In this case, we will review the fulfillment of the inflation target in 2025 and assess the central scenarios presented throughout the year.

According to the central scenario presented in last year's February report, the inflation forecast turned out to be higher than the realized data (see Figure 3.1.1). The balance of risks in the scenario was tilted toward a high-inflation environment. Meanwhile, inflation dynamics were driven by heterogeneous factors. Particularly, uncertainty in the first quarter of the year was reducing external inflows, which was moderately widening the current account deficit and, together with elevated dollarization in the previous period, was exerting upward pressure on inflation through the exchange rate channel. Conversely, heightened uncertainty was increasing the propensity to save and, alongside a slowdown in real income growth, was exerting downward pressure on inflation by weakening aggregate demand. In light of these opposing effects, and

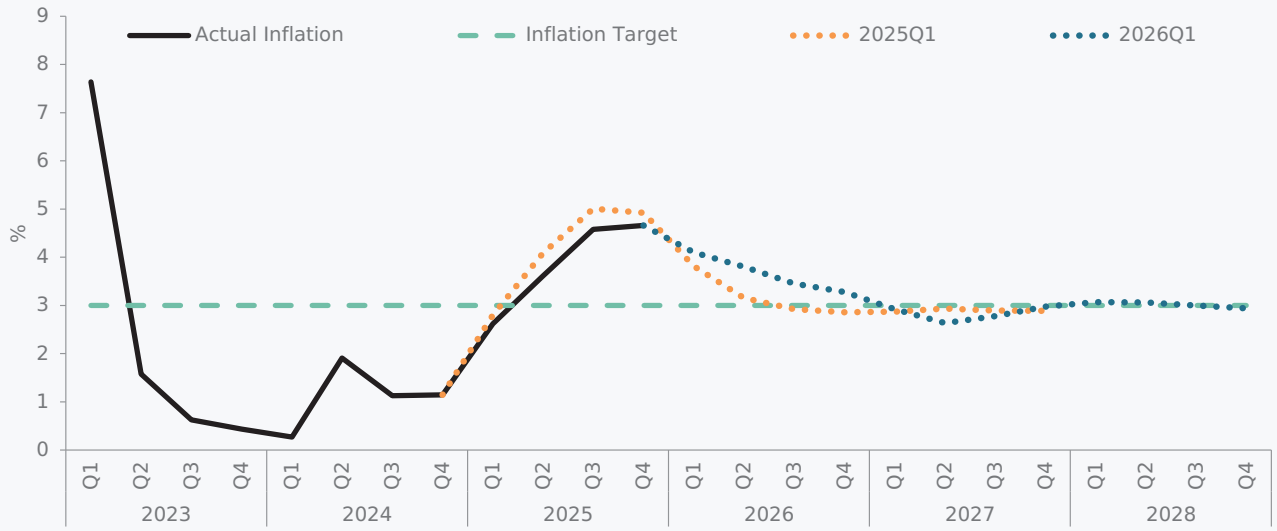

Figure 3.1.1. Comparison of the central scenario forecast from the February 2025 report with actual inflation and the latest forecast

Source: NBG, Geostat.

partly taking into account the base effect from the previous year, **inflation was temporarily exceeding the target, averaging 4.2% in 2025**.

In 2025, realized inflation turned out to be 0.3 pp lower than the forecasted one. The risks identified in both the low- and high-inflation scenarios were partially realized.

In line with **the low-inflation scenario**, domestic uncertainty subsided faster than expected, which led to improvements in both investment and consumer sentiment. At the same time, the slower-than-expected normalization of highly productive sectors significantly eased the inflationary pressure stemming from strong economic growth and helped preserve a less import-intensive growth structure. This, alongside an improvement in the trade balance of goods and services, contributed to a significant reduction in the current account deficit. Meanwhile, in line with a risk-minimization approach, the longer-than-expected maintenance of a tight monetary policy helped reduce inflation expectations, as a result, despite exogenous shocks, inflation in the services sector remained, on average, below the target. Meanwhile, amid global weakening of the US dollar, the appreciation of the lari against the dollar, under still high dollarization, reduced the debt service burden and further improved inflation expectations (see Figure 3.1.2).

At the same time, the risks of **the high-inflation scenario** were also partially realized. Despite the slow normalization of productivity, deviation from the inflation forecast was largely explained by stronger-than-expected aggregate demand. Moreover, inflationary pressures also originated from the external sector. Uncertainty surrounding tariff policies in advanced economies increased sharply, and global economic fragmentation turned out to be stronger than anticipated. As a result, a supply shock of sorts emerged in the global economy. Rising inflation among trading partners also led to an increase in imported inflation. Meanwhile, mixed signals were emerging from commodity markets. Amid domestic and global exogenous factors, food inflation proved stronger-than-expected. Prices of food raw materials in certain categories increased on international markets, which was also transmitted to the domestic market. This was accompanied by a one-off price adjustment for certain types of products in the domestic market, as well as volatility in agricultural product prices. Ultimately, amid mentioned effects, food inflation outweighed the disinflationary impact of oil prices (see Figure 3.1.2).

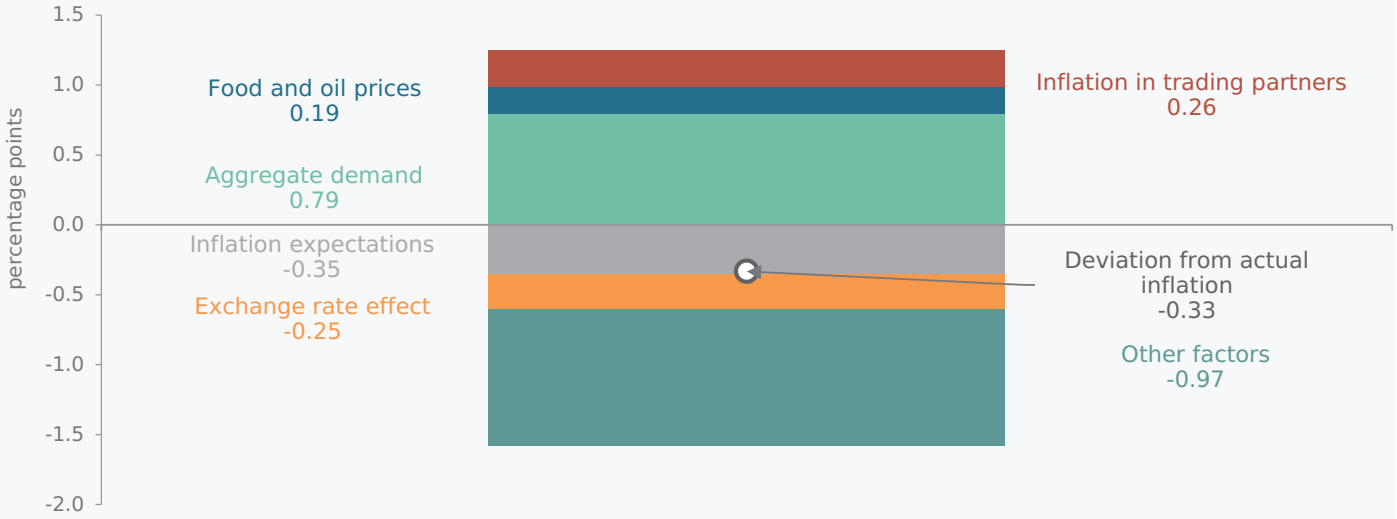

Figure 3.1.2. Decomposition of the Difference between Actual Inflation and the February 2025 Forecast.

Source: NBG, Geostat.

During the first half of the year, alongside the gradual easing of turbulence, fundamental factors demonstrated notable resilience. Strong growth was maintained in high-productive, less import-intensive sectors. Moreover, in light of positive dynamics in the services balance, the global weakening of the U.S. dollar, and improved economic sentiment, the lari's exchange rate strengthened significantly. As a result, according to the central scenario presented in the second quarter, the forecast for average inflation in 2025 was revised downward to 3.8 percent. Over the remainder of the year, the forecast fluctuated within the 3.8–4.0 percent range, which turned out to be significantly aligned with the actual outcome of 3.9% (see Figure 3.1.3). Amid an improved economic outlook, during the first half of the year, **market participants'** average expectations for economic growth in 2025 increased from 4.5% to 6.4%, while inflation forecast rose from 3.2% to 3.5%. Consequently, their forecasts gradually converged toward the NBG's central scenario.

The global turbulence and domestic sticky prices, rendered the high-inflation scenario risks particularly relevant. For this reason, despite reduced inflation over the policy horizon, the National Bank of Georgia

employed a conservative, risk-minimization approach and maintained a moderate and cautious pace in exiting the **tightened monetary policy stance**, which was reflected in keeping the policy rate unchanged at 8 percent through the end of the year.

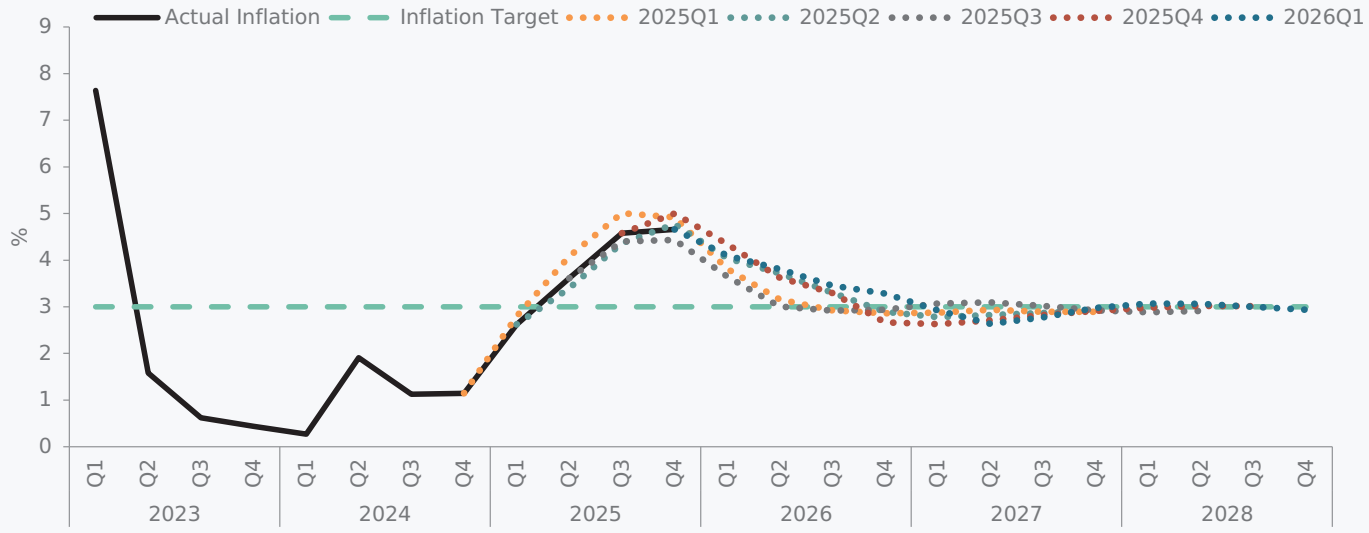

Figure 3.1.3. Comparison of the inflation forecast presented in the central scenario (Q1 2025 – Q1 2026).

Source: NBG, Geostat.