3. SPECIAL TOPICS

BOX 1. 2022-2026 GEOPOLITICAL SHOCKS: FINANCIAL CHANNEL AND TRANSMISSION TO GEORGIA

The 2026 Middle East conflict, similar to Russia's invasion of Ukraine in 2022, generated a significant adverse supply shock to the global economy. Both episodes were accompanied by sharp increases in energy prices, disruptions to global supply chains, and a deterioration in the terms of trade. Despite the broadly similar nature of these shocks, their impact on financial markets differed markedly, primarily due to their different initial macroeconomic and financial conditions.

The 2022 shock unfolded against a backdrop of already elevated inflationary pressures and strong pent-up demand following the pandemic. Consequently, major central banks embarked on a rapid monetary policy tightening cycle, resulting in a sharp rise in the cost of dollar funding, a broad tightening of global financial conditions, and significant capital outflows from emerging market economies as investors shifted toward safer assets (flight-to-quality). Consequently, beyond its inflationary effects, the 2022 geopolitical shock significantly amplified the transmission of the shock through the financial channel[2].

By contrast, When the Middle East conflict erupted in 2026, the major monetary policy tightening cycle had largely run its course, and several economies, including the major advanced economies, had already begun the process of policy normalization. However, policy rates remained significantly higher than at the beginning of 2022 (see Figure 3.1.1). Against this backdrop, the conflict heightened global uncertainty but has, so far, not triggered the broad-based tightening of financial conditions for emerging market economies observed in 2022. It is important to note, however, that only one quarter has elapsed since the onset of the conflict, and its full macro-financial implications are still unfolding and remain subject to ongoing assessment.

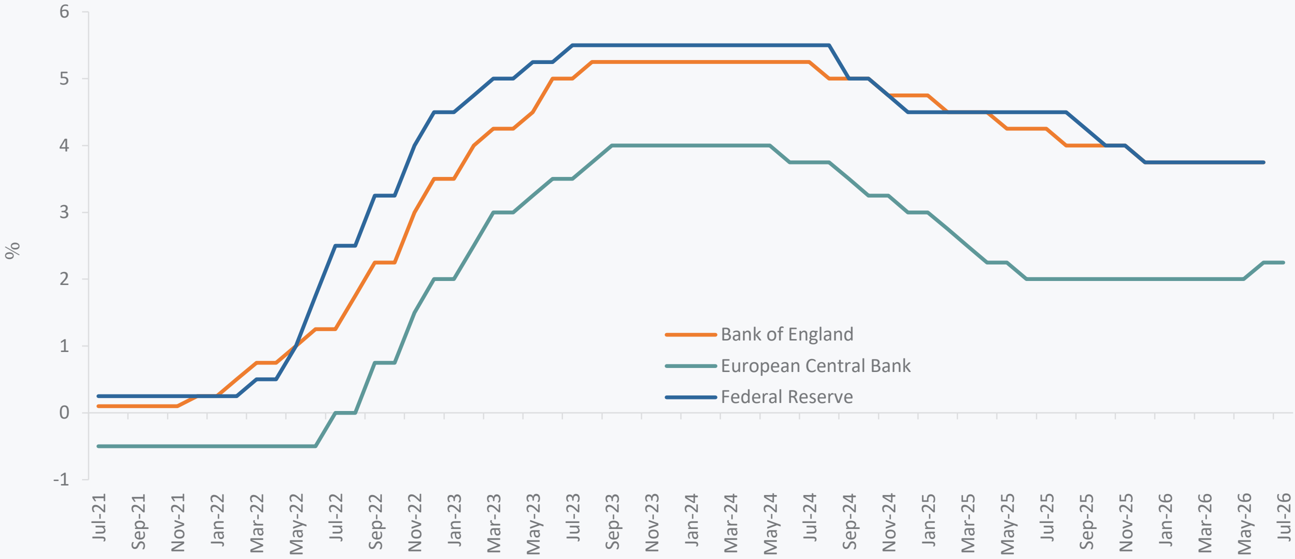

Figure 3.1.1. Monetary Policy Rates.

Source: Relevant central banks.

The divergent response of financial markets across the two episodes largely reflects the different initial macroeconomic and financial conditions prevailing in emerging market economies. While some economies entered the current shock with stronger external positions, lower external vulnerabilities, higher real yields, and improved macroeconomic fundamentals, structural weaknesses remained pronounced in others. As a result, investors' decisions in the current episode were determined more by the country-specific fundamental and to a lesser extent by the increase in geopolitical risk alone.

These differences were also reflected in international capital flows. Specifically, the escalation of geopolitical tensions in March 2026 triggered a temporary but sizeable net outflow of portfolio capital from emerging market economies. However, according to the Institute of International Finance (IIF)[3], capital flows rebounded significantly as early as April. Thereafter, capital flow dynamics became increasingly differentiated across countries: inflows stabilized in economies with relatively strong macroeconomic fundamentals, while structurally

2 *These developments are discussed in detail in the International Monetary Fund's 2022 Global Financial Stability Report. See. https://www.imf.org/-/media/files/publications/gfsr/2022/october/english/text.pdf*

3 *See. https://www.iif.com/Products/Capital-Flows-Tracker*

more vulnerable economies continued to experience sustained capital outflows.

This pattern is also corroborated by financial market indicators. Despite the sharp decline observed in March, the MSCI Emerging Markets Stock Index resumed its upward trajectory during the current period, while sovereign bond spreads in emerging economies (EMBI Global Diversified Index), despite an initial increase, have returned to pre-conflict levels (see Figure 3.1.2–3.1.3). Accordingly, there is no sign of a large-scale repricing of emerging market risk at this stage.

Figure 3.1.2: MSCI Emerging Market Stock Index, Dec-1987=100

Source: MSCI.

Figure 3.1.3: EMBI Global Diversified Index, Jan-2022=100

Source: NBG calculation.

This pattern of financial market behavior partly reflects structural changes in the international financial system. Whereas international banks played a dominant role in financing emerging economies prior to the 2008 global financial crisis (GFC), non-bank financial institutions (NBFIs) - particularly portfolio investors - have since become increasingly important providers of cross-border financing (see Figure 3.1.4). According to the IMF and the BIS, in such conditions, international capital flows have become increasingly sensitive not only to country-specific macroeconomic fundamentals but also to the type of specific investor and its tolerance for risk. As a result, capital flows are no longer uniform even in conditions of global uncertainty. The IMF describes this phenomenon as "K-shape investing," reflecting the increasingly divergent performance of different categories of capital flows and asset classes. In particular, portfolio debt inflows to emerging market economies have remained relatively resilient, whereas the recovery in foreign direct investment (FDI) and portfolio equity flows has been more subdued. Within portfolio debt flows, investor demand has remained robust and has been concentrated primarily in bond instruments, supported by relatively attractive yields.

At the same time, the traditional behavior of safe-haven assets has also partially changed during the current episode. Despite heightened geopolitical tensions, long-term US government bonds (10- and 30-year) yields increased rather than declined (see Figure 3.1.5). This appears to reflect, to a significant extent, rising concerns over fiscal sustainability, a higher term premium, and persistently elevated real interest rates. Consequently, financial market dynamics are increasingly being shaped by fiscal and structural factors in advanced economies, partially reducing the extent to which geopolitical shocks alone drive capital flows to and from emerging market economies.

From a monetary policy perspective, these developments carry two important implications. First, the transmission of geopolitical shocks through financial channels now depends more on the country-specific macroeconomic fundamentals and the policy credibility rather than on the rise in global risk alone. Second, strong external positions, low sovereign risk premium, and credible monetary policy substantially reduce the likelihood that a geopolitical shock will evolve into a systemic financial stability risk. As a result, the inflationary impact transmitted through capital outflows channel (exchange rate) is likely to be more limited.

It is noteworthy that the geopolitical shock of 2026 did not result in large-scale capital outflows from Georgia. Against the backdrop of a more differentiated allocation of capital by global investors and the country's improved macroeconomic fundamentals, Georgia's sovereign risk premium remained low (see Chapter 2, Figure 2.1.11), while the non-residents' interest in domestic treasury securities remained high (see Figure 3.1.6).

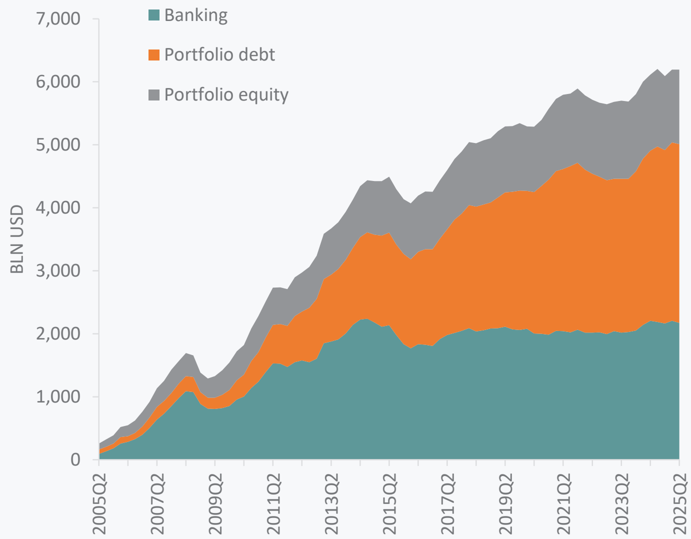

Figure 3.1.4: Cross-Border Investment by Nonbank Financial Investors in Emerging Markets

Source: [IMF, Global Financial Stability Report 2026](#).

Figure 3.1.5: 10 and 30-year US government bonds yields

Source: Fred.

This pattern is consistent with the IMF's "K-shaped" investment behavior, whereby periods of heightened uncertainty lead investors to become more selective, allocating capital toward economies with stronger fundamentals and more favorable risk-return profiles. In this environment, sovereign credit ratings assigned by the major international rating agencies become an increasingly important signal of creditworthiness, influencing investors' portfolio allocation decisions. In Georgia's case, the reaffirmation of its sovereign credit rating following the outbreak of the 2026 conflict helped strengthen investor confidence and mitigate the risk of capital outflows.

The relatively stable dynamics of financial flows have also contributed to the resilience of the external sector. Notably, since 2022, the current account balance has improved significantly, reflecting migration-related inflows and subsequent structural changes in the economy (see Chapter 2, Figure 2.1.7). As a result, the exchange rate - which amplified imported inflation during the pandemic - has continued to serve as a shock absorber in the current episode, albeit with a disinflationary effect. In particular, the strengthening of both the actual and equilibrium levels of the real effective exchange rate slows down imported inflation (see Figure 3.1.7). At the same time, the accumulation of international reserves (see Chapter 2, Figure 2.1.12), together with improvements in reserve adequacy indicators serve as a buffer for the country's external liquidity and further reduce its vulnerability to external shocks.

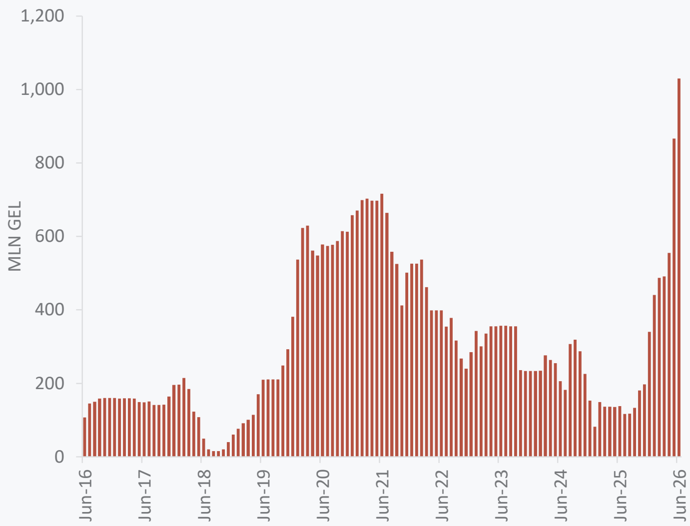

Figure: 3.1.6 Treasury securities held by non-residents

Source: NBG.

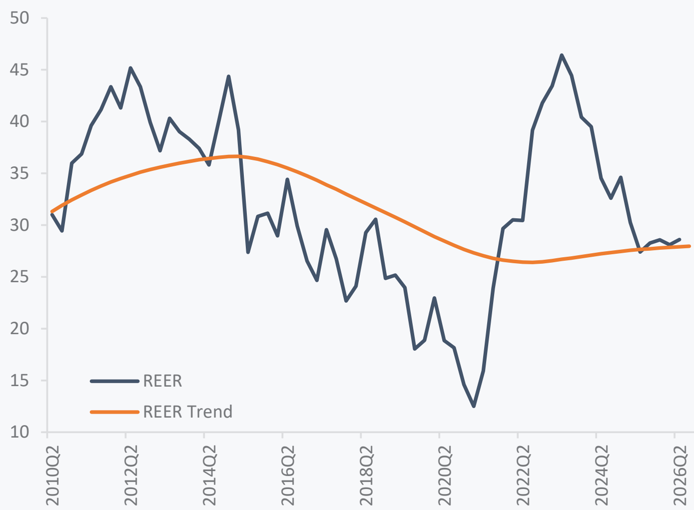

Figure: 3.1.7 REER and its trend

Source: NBG's Estimation.

From an inflation perspective, both geopolitical shocks were accompanied by increases in energy and other commodity prices, leading to an acceleration in flexible price inflation in Georgia. However, when Russia's invasion of Ukraine began in 2022, Georgia was already experiencing relatively elevated underlying inflationary pressures, including higher sticky-price and services inflation, which significantly increased the risk of second-round effects. By contrast, at the onset of the 2026 Middle East conflict, underlying inflationary pressures were more subdued. Nevertheless, should elevated flexible price inflation prove more persistent, the risk of second-round effects warrants close attention.

Overall, compared with the 2022-2023 episode, the current geopolitical shock is being transmitted to the Georgian economy primarily through inflationary channels, while spillovers through financial channels have so far remained relatively limited. Nevertheless, as the conflict remains ongoing, its ultimate macroeconomic and financial implications will depend critically on how the geopolitical situation evolves.