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THE COST OF DETERIORATED BUSINESS CONFIDENCE: HOW POLITICAL UNCERTAINTY THREATENS GEORGIAN ECONOMY

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AUTHORS:

ANA BURDULI

MARIAM KATSADZE

GIORGI PAPAVA

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EXECUTIVE SUMMARY

This policy brief examines the role of business confidence as a predictor of economic development. It focuses on the impact of recent political instability and economic uncertainty, drawing insights from both Georgian data and international experience.

Political and economic uncertainty plays a critical role in shaping business confidence, which, in turn, influences broader economic outcomes. While Georgia currently maintains steady economic growth, ongoing political instability has led to a notable deterioration in business confidence. This decline, as reflected in the Business Confidence Index (BCI) published by the ISET Policy Institute, raises concerns about potential economic downturns, particularly given the established link between sentiment indicators and macroeconomic performance.

Recent weakening of governance, policy inconsistency, and heightened sociopolitical tensions in Georgia have created an unpredictable business environment, dampening both current performance and future expectations. The BCI has been on a downward trajectory for the past five quarters, reaching -5.0 in Q1 2025 - the lowest level recorded since 2020[1].

The Expectations Index component of the BCI has seen a significant decline in Q1 2025, falling by approximately 17 points to -9.9, the lowest level recorded since 2020. This sharp decline is largely attributed to the political turbulence following the controversial October 26, 2024, parliamentary elections, which sparked widespread protests and raised concerns over democratic governance. Ongoing political instability and continued demonstrations have exacerbated economic uncertainty, particularly among SMEs, which have shown consistently lower confidence levels as compared to large enterprises.

Regression analysis performed for the Georgian data confirms that business expectations are a statistically significant predictor of real GDP growth. The estimated coefficient suggests that a 1-index point decline in BCI expectations leads to a 0.067 percentage point decrease in quarter-over-quarter real GDP growth. Given that the Expectations Index declined by 16.9 points in Q1 2025, the estimated annualized impact of current deterioration on GDP growth is approximately -4.5 percentage points. Hence, if the current uncertainty remains or deteriorates further, Georgia faces a risk of sub-2 percent economic growth in 2025.

Although most macroeconomic indicators in Georgia have not yet shown significant deterioration, the sustained decline in business confidence clearly suggests risks to future economic stability. Persistent political instability poses growing challenges for businesses, making long-term planning, investment decisions, and overall economic participation increasingly difficult, ultimately threatening the country's growth prospects. Measures aimed at addressing political uncertainty, restoring investor confidence, and ensuring regulatory stability, accountability and transparency will be critical in mitigating downside risks to growth.

[1] The index ranges from -100 to +100, where +100 indicates maximum business confidence, and -100 reflects complete pessimism among surveyed firms.

The document is structured as follows. Section 1 reviews international evidence on the role of business confidence indicators in economic forecasting. Section 2 provides an overview of Georgia's Business Confidence Index, its methodology, and historical trends. Finally, Section 3 explores the statistical relationship between business confidence and real GDP growth in Georgia, incorporating regression analysis to assess its predictive power.

I. THE BUSINESS CONFIDENCE INDEX AS A BAROMETER OF POLITICAL AND ECONOMIC UNCERTAINTY: INTERNATIONAL EVIDENCE

Economic sentiment indicators are widely recognized for their ability to assess current economic conditions and offer predictive insights into future trends. Studies suggest that the Economic Sentiment Indicator (ESI), constructed by the European Commission, has strong predictive power for Gross Domestic Product (GDP) growth and other key economic variables (Antipa et al., 2012; Cizmesija & Skrinjaric, 2021; Taylor & McNabb, 2007; Tkacova & Gavurova, 2023). It was found that both consumer and business confidence indicators align with the economic cycle and serve as important predictors of recessions (Taylor and McNabb, 2007). The predictive power of sentiment indices was found to be stronger during the economic crisis period (Brzoza-Brzezina & Kotlowski, 2018; Claveria et al, 2016). During times of crisis, a sharp decline in confidence can serve as an indicator of future economic trends, as confidence measures capture a notable shift in the behavior of economic agents, which is likely to have tangible effects on the economy. For instance, when examining recession probabilities alongside consumer confidence data for the euro area, it was shown that the likelihood of a recession rises sharply when the confidence balance falls below -10[2] (European Central Bank, 2013). Further research highlights that incorporating data from business sentiment surveys can enhance economic forecasting accuracy by as much as 50% (Garnitz et al., 2019). Confidence indicators, either independently or in combination with other metrics, are thus widely used for short-term economic forecasting (Mazurek & Mielcova, 2017; Tkacova & Gavurova, 2023; Soric, 2018).

Another strand of the literature suggests that rising political and economic policy uncertainty negatively impacts business confidence, which, in turn, acts as a transmission mechanism affecting investment decisions (Montes & Nogueira, 2022; Escaleras & Kottaridi, 2014). These findings underscore the importance of political stability in maintaining investor trust and fostering a favorable business climate, potentially mitigating the risk of economic slowdowns. This relationship is particularly relevant for Georgia, where persistent political instability has contributed to a significant decline in business confidence, as discussed in more detail in Section 2.

II. GEORGIA'S BUSINESS CONFIDENCE INDEX IN BRIEF

The Business Confidence Index, published by ISET Policy Institute on a quarterly basis, provides insights into the current state and future expectations of business sentiment in Georgia. It

[2] The Consumer ESI quantifies consumer confidence on a scale ranging from -100 to 100, with -100 representing a severe lack of confidence, 0 indicating neutrality, and 100 reflecting extreme confidence.

complements official statistics, providing insights into overall business sentiment and economic trends, making it a valuable reference for policymakers and analysts. The index ranges from -100 to +100, where +100 indicates maximum business confidence, and -100 reflects complete pessimism among surveyed firms. Developed in 2013, the first BCI indicator was recorded in the fourth quarter of that year. The survey and methodology for BCI is based on the European Commission's harmonized Programme of Business and Consumer Surveys, ensuring international comparability and methodological reliability.[3]

The BCI is derived from a quarterly opinion survey conducted among business executives across all sectors of the Georgian economy. Respondent firms are classified as either large or small and medium-sized enterprises (SMEs). Across economic sectors, the survey includes questions about key economic variables such as production/sales, employment, price setting strategies etc., while company responses follow a standardized three-option ordinal scale: increase (+), remain unchanged (=), and decrease (-). The BCI for each economic sector is derived from the balance of positive and negative responses (positive responses minus negative responses) for each question. The overall BCI is then calculated as a weighted sum of sectoral indices.

Along with BCI, three sub-indices are calculated using the survey responses to provide deeper insights into business sentiment:

- **Expectations Index**: Measures business outlook for the upcoming quarter.
- **Sales Price Index**: Tracks expected changes in sales prices.
- **Past Performance Index**: Assesses business performance over the previous quarter.

Additionally, the Business Confidence Survey provides insights into company expectations and past performance in terms of employment and business development by monitoring the proportion of businesses with optimistic and pessimistic assessments.

III. HISTORICAL DEVELOPMENTS IN BUSINESS CONFIDENCE

The following chapter provides an analysis of key indicators derived from the Business Confidence Survey, including the Business Confidence Index, the Expectations Index, and the Past Performance Index. These indicators offer valuable insights into firms' perceptions of current business conditions, their expectations for the near future, and their recent performance. By examining survey responses across different time periods and business sizes, this chapter highlights the evolving trends in business sentiment, employment, and overall economic activity in Georgia. The latest data for Q1 2025 indicates a sharp decline in confidence, driven by worsening expectations and deteriorating past performance, particularly among SMEs.

Business Confidence Index

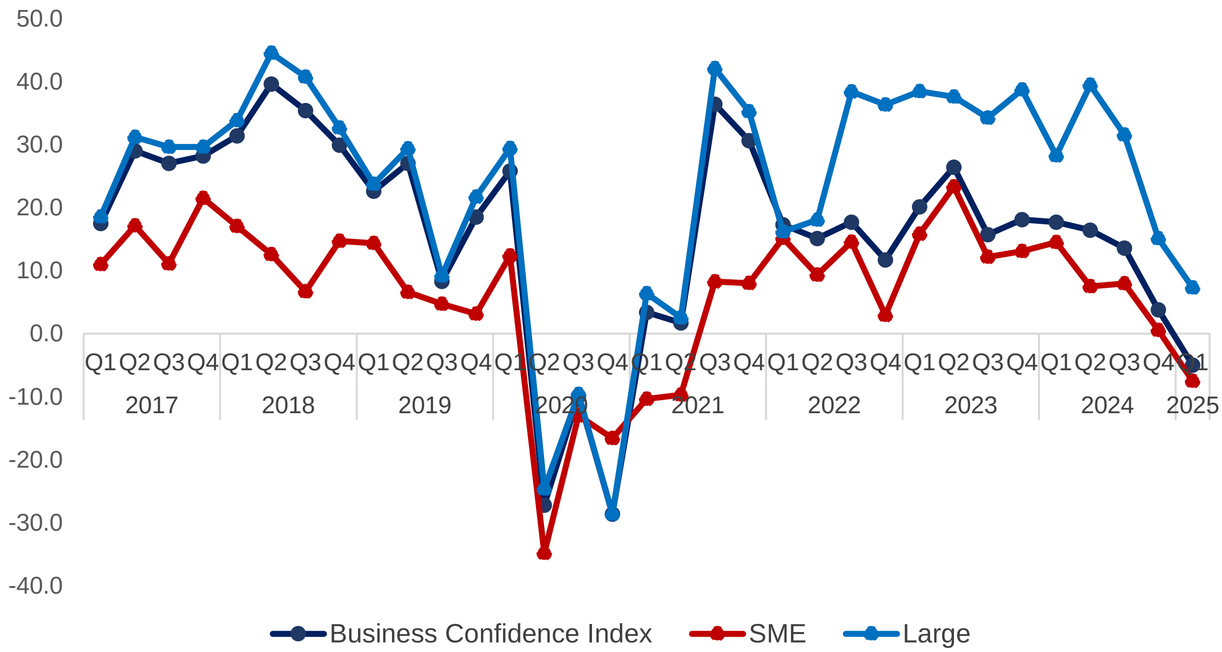
Chart 1 below presents the overall Business Confidence Index and corresponding indices for small and medium (SME) and large enterprises. BCI has experienced fluctuations over the years,

[3] The Joint Harmonized EU Programme of Business and Consumer Surveys

with notable declines during periods of economic uncertainty. Prior to the COVID-19 pandemic, the index generally remained positive, reflecting stable business sentiment. However, in 2020, BCI saw a sharp decline, remaining negative through Q2-Q4 2020 and reaching its lowest level in the fourth quarter due to the pandemic's economic impact.

Since the beginning of 2021, business confidence recovered, remaining positive for four years. However, the most recent data shows a decline to -5.0 in Q1 2025, marking the lowest BCI value since 2020. This decline is largely linked to ongoing political instability following the controversial October 26, 2024, parliamentary elections, which triggered widespread protests and concerns over democratic governance. Current political instability and ongoing protests suggest renewed economic concerns, particularly among SMEs, which have shown consistently lower confidence levels compared to large enterprises.

Chart 1. Business Confidence Index, 2017-2025



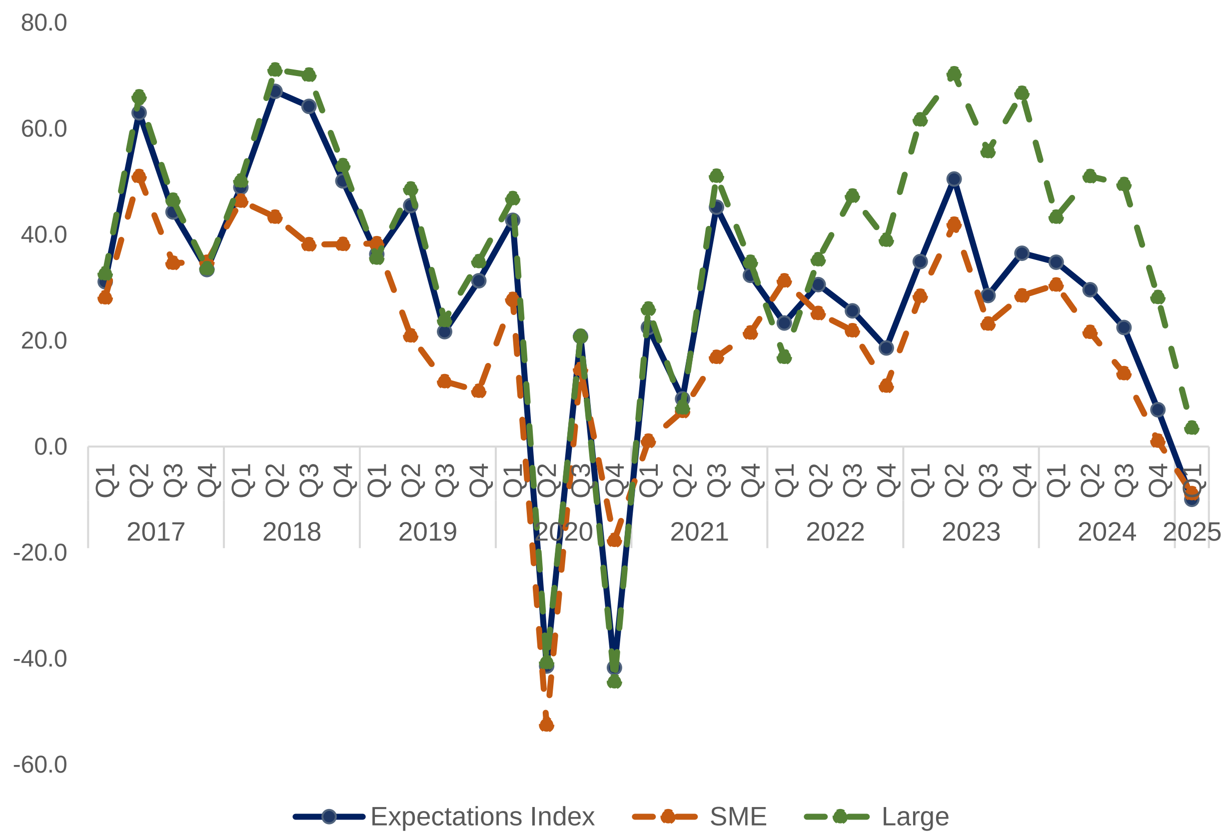
Source: Business Confidence Survey, ISET Policy Institute

Expectations Index

The Expectations Index measures businesses' outlook for the upcoming quarter, capturing their sentiment regarding future economic conditions, employment, and overall business activity. This indicator reflects firms' confidence in short-term economic stability and serves as a key predictor of investment, hiring, and operational decisions. Historically, the Expectations Index has fluctuated in response to economic and political developments, with notable declines during periods of uncertainty and recoveries during stable economic conditions. After a record low value during the pandemic in 2020, the Expectations Index (Chart 2), similar to BCI also showed a recovery, remaining positive for four years. However, signs of weakening confidence began to emerge in 2024, with a noticeable drop in Q4. The disparity between large enterprises and SMEs remains evident, as smaller firms have consistently reported lower expectations, suggesting they are more vulnerable to economic fluctuations.

Underlining the weakening business sentiment, the Expectations Index has seen a significant decline in Q1 2025, falling to -9.9, the lowest level recorded since 2020. This shift reflects growing uncertainty about short-term business conditions, particularly among SMEs, which reported -8.8, while large enterprises remained slightly positive at 3.5.

Chart 2. Expectations Index, 2017-2025



Source: Business Confidence Survey, ISET Policy Institute

Survey results further highlight the deteriorating sentiment among businesses, particularly in terms of employment expectations. In Q1 2025, 17% of firms anticipate a decline in their employment over the next three months, marking the highest proportion of firms expecting job cuts in four years (Chart 3). At the same time, only 17% of firms plan to expand employment, the lowest share recorded since Q4 2020. This sharp decline in hiring optimism signals a broader reluctance among businesses to expand their workforce. Compared to the previous year, when employment expectations were significantly more positive - only 9% anticipated reductions while 29% planned increases in Q1 2024 - this shift underscores growing caution. The downturn in employment expectations aligns with the overall weakening of the Expectations Index, indicating that firms are becoming more risk-averse, opting to freeze hiring or even reduce staff as they brace for potential economic instability.

Chart 3. Employment expectations, 2017-2025

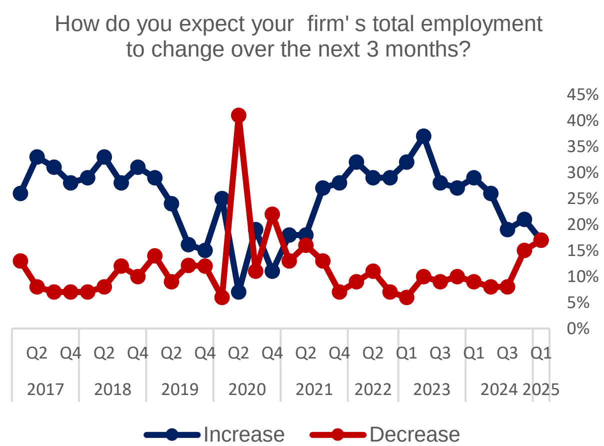
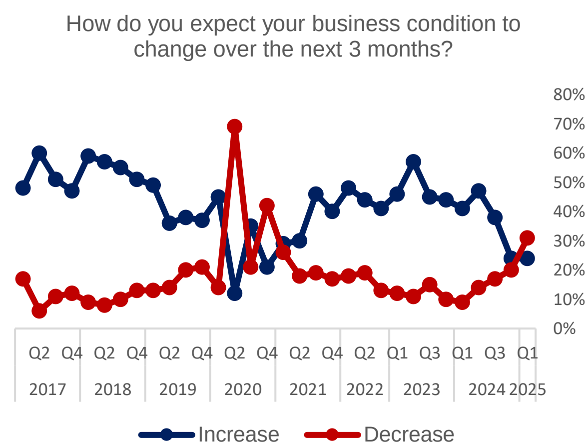


Chart 4. Expectations on business condition, 2017-2025



Source: Business Confidence Survey, ISET Policy Institute

A similar pattern emerges in firms' expectations regarding overall business conditions (Chart 4), where Q1 2025 marks the worst outlook in four years. The share of businesses expecting a deterioration in conditions surged to 31%, the highest since the economic disruption of 2020, while only 24% foresee improvement. This is in stark contrast with Q1 2024, when only 9% expected a decline and 41% predicted improvements.

Past Performance Index

The Past Performance Index provides insights into the recent business activity and overall performance of firms, reflecting changes in economic conditions over the past three months. The latest data for Q1 2025 reveals a sharp decline, with the Past Performance Index dropping to -18.6, marking its lowest value since the economic disruption of 2020 (Chart 5). Breakdown by firm size further highlights the persistent disparity between large enterprises and SMEs. In Q1 2025, the Past Performance Index for SMEs fell to -23.9, while large enterprises reported a much stronger performance at 2.0. This widening gap once again underscores the vulnerability of smaller firms to economic instability, as they continue to struggle with weak demand and financial constraints. Large enterprises, while also experiencing challenges, have demonstrated greater resilience, managing to maintain a positive performance index despite the broader economic downturn.

Chart 5. Past Performance Index, 2017-2025

Source: Business Confidence Survey, ISET Policy Institute

IV. BUSINESS CONFIDENCE AS A PREDICTOR OF ECONOMIC DEVELOPMENT IN GEORGIA

As explained in Section 1 above, the role of business confidence as a predictor of economic activity has been widely documented in international literature, with various studies highlighting its strong correlation with key macroeconomic indicators such as GDP growth, investment, and employment. Building on this evidence, this section examines the relationship between business confidence and economic performance in Georgia, focusing on the predictive power of the Expectations Index in anticipating future economic trends.

This leads us to the subsequent regression analysis to examine the statistical relationship between the BCI Expectations index and Quarter-Over-Quarter (QoQ) real GDP growth rates, aiming to determine whether business expectations can serve as a reliable predictor of economic growth or decline. While Georgia's macroeconomic fundamentals remain stable, the sustained decline in business confidence suggests heightened downside risks to real GDP growth.

For the purpose of this analysis, the Autoregressive Distributed Lag (ARDL) model was used on time series data. The ARDL model examines the relationship between real GDP growth rates and business expectations over the period Q2 2014 to Q4 2024, using a maximum lag of 1 for both variables. Since the analysis is performed on quarterly data, real GDP data is seasonally adjusted.

Table 1. Regression analysis results

DEPENDENT VARIABLE: REAL GDP (QOQ) GROWTH	COEFFICIENT
Lagged (QoQ) Real GDP Growth Rate	-0.1293 (.148)
BCI Expectations Index	**0.0672***** (.024)
Lagged BCI Expectations Index	-0.0593* (.025)
Constant	1.3745 (1.034)
Number of observations	*43*

Source: Authors' calculations

Note: *** significant at 1% significance level; ** significant at 5% significance level; * significant at 1% significance level. Standard errors in parentheses.

Regression results in Table 1 suggest that business expectations have a positive and significant relationship with real GDP growth. The coefficient (0.0672) suggests that a 1-index point increase in BCI expectations leads to a 0.067 percentage point (pp) increase in quarter-over-quarter real GDP growth[4]. When annualized, this translates to an approximately 0.269 pp[5] annualized increase in GDP growth rate.

Based on Business Confidence Survey data, in Q1 2025, the BCI Expectations Index dropped sharply from 6.9 in Q4 2024 to -9.9, marking a decline of 16.9 index points. Based on the estimates of the regression model, an annualized impact on real GDP growth is approximately -4.5 pp. This suggests that the observed decline in business expectations could potentially reduce Georgia's annual GDP growth rate for 2025 by approximately 4.5 percentage points if the current political and economic uncertainty continues beyond Q1. Considering pre-election economic growth forecasts of about 6 percent for 2025, our estimates will suggest an annual growth rate of below 2 percent.

In summary, if the confidence levels in the private sector continue to decline, Georgia will face reduced investment, stagnated labor market, and a broader economic slowdown. Addressing political and economic uncertainty will be crucial in ensuring sustained economic growth and stability in the future.

[4] To test predictive accuracy of BCI expectations, additional variables such as foreign direct investment levels, household consumption, and budget deficit (as a percentage of GDP) were incorporated into the model. Notably, the statistical significance and magnitude of the business expectations coefficient remained largely unchanged, suggesting the robustness of its predictive power.

[5] Annualized impact is calculated following the formula: (1+0.000672) ^4 -1= 0.269.

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