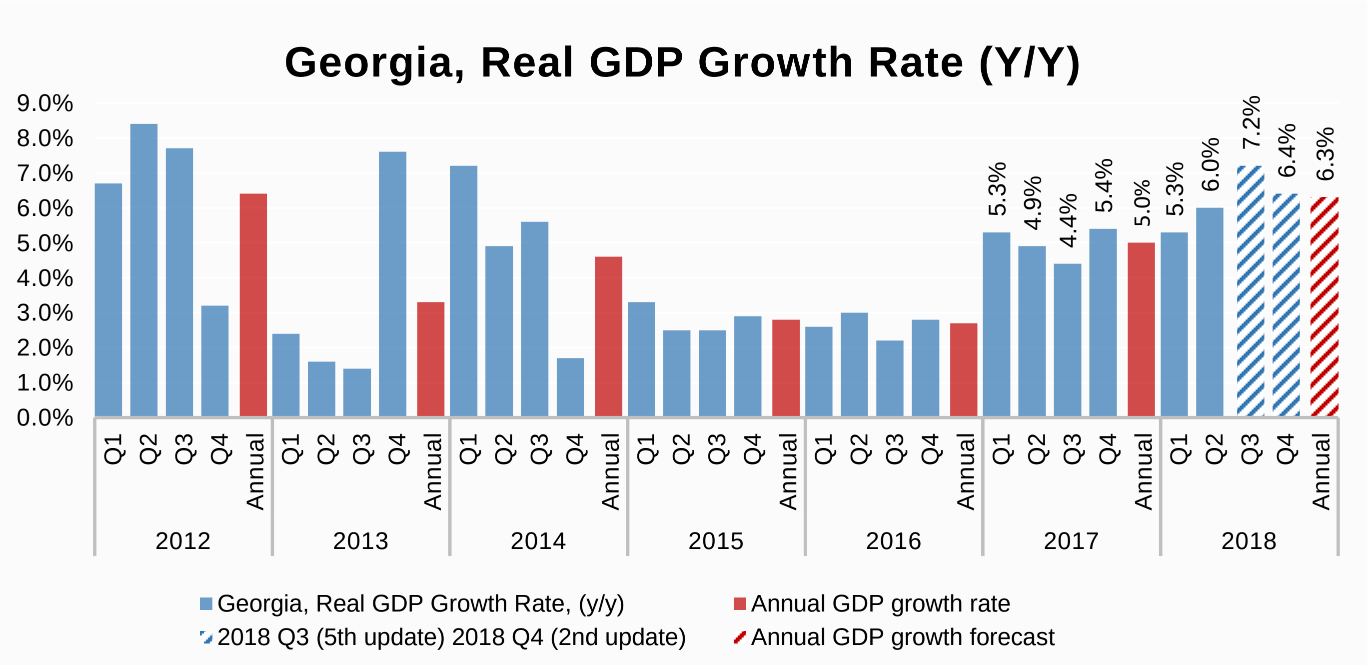
Authors: Davit Keshelava and Yasya Babych

Georgia's growth projections still optimistic, but the downside risks are significant



ISET-PI has updated its forecast of Georgia's real GDP growth rate for the third and fourth quarters of 2018. Here are the highlights of this month's release:

Highlights

- Growth projections for the 3rd and 4th quarters of 2018 were revised downward by less than 0.1 percentage point. They now stand at 7.2% and 6.4% respectively.

- Recently, Geostat published its preliminary estimate of real GDP growth for August, which now stands at 2%. As a result, the real GDP growth estimate for the first eight months of 2018 was reduced to 4.8%.

- Based on the August data, we expect annual growth in 2018 to be 6.3%. Although the growth forecast remains unchanged, we expect a downward correction of the annual GDP growth numbers towards the end of the year.

It is noteworthy that the average real GDP growth in the first two months of the third quarter of 2018 was only 3.3%. ISET-PI's growth projection for the third quarter of 2018 is expected to have overestimated the actual quarterly growth rate due to a combination of factors. Most importantly, our model has not yet fully taken into consideration the negative consequences of the Turkish currency crisis and the announced, or already enacted, tightened credit restrictions (the effect of these was partially reflected in the August growth data).

A number of variables demonstrated significant monthly and yearly changes in August. *In particular, the real effective exchange rate appreciated in both monthly and yearly terms, despite the economic difficulties in the region. Georgia's external statistics are still quite promising, while higher domestic deposits and the ongoing credit expansion resulted in improved monetary aggregates (however, it should be noted that incoming regulations might have a more pronounced effect on the credit growth figures in the next few months).*

Exchange Rate Effect

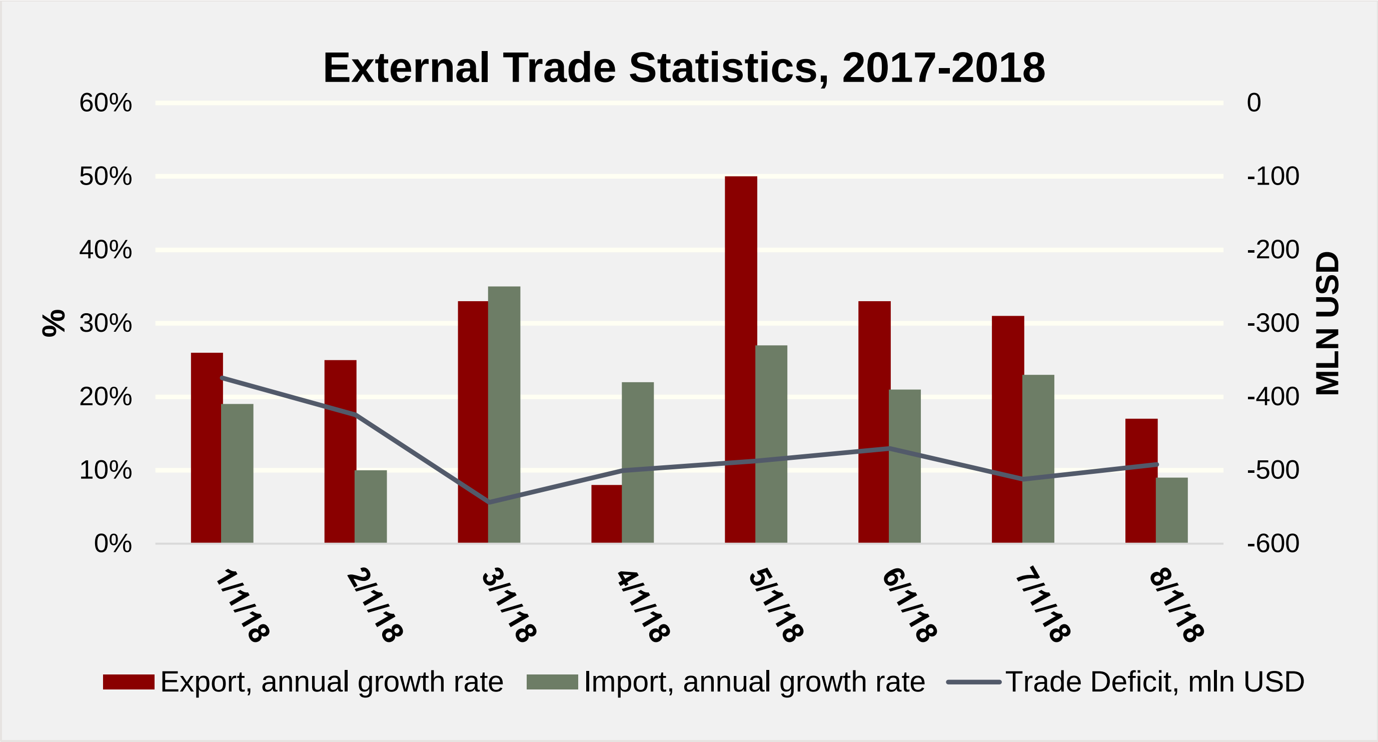
The Real Effective Exchange Rate (REER) appreciated by 1.7% relative to July, and by 4.6% relative to the same month of the previous year. The appreciation of the REER is typically associated with domestic export goods losing competitiveness on foreign markets. Notably, the lari real exchange rate appreciated with respect to the national currencies of two major trading partners – Turkey and Russia. The GEL/TRY and GEL/RUB real exchange rates appreciated compared to the same month of the previous year by 37% and 5% respectively. *In August, Georgia's exports to Turkey declined significantly as a direct result of the lira currency crisis.* In contrast, the lari real exchange rate experienced a slight depreciation against the US dollar and the euro (falling by 5% and 2% respectively in annual terms). Overall, REER-related variables had a small negative contribution to the Q3 and *Q4 real GDP growth projections.*

External Statistics

Despite the ***deterioration of economic conditions in the wider region*** – notably the currency crisis and economic downturn in Turkey along with the depreciation of the Russian ruble – Georgia's external statistics continue to improve. ***Exports grew by 16.6% year-over-year in August of 2018*** and were driven by significantly larger exports/re-exports of motor cars, cigarettes and cigars to Azerbaijan, increased exports/re-exports of copper ores and concentrates to China, and recovered exports of ferroalloys to Russia (which happened despite the appreciation of the lari against the ruble). However, Georgian exports to Turkey declined significantly due to the lari appreciation against the Turkish lira and the deterioration of economic conditions in Turkey. During the same period, imports increased by 8.3%. The **trade deficit thus deepened by 4.1% compared to the same month in 2017 and reached 492.3 million USD.**

In addition, both remittances and tourism showed significant yearly increases in August. Money transfers increased by 11.4% in the first eight months of 2018. These were driven by a rise in remittances from Israel (20.3%), Azerbaijan (51.7%), Italy (28.2%), Greece (9.8%) and France (52.0%). However, remittances from Turkey declined significantly. Were it not for the latter decline, money transfers would have increased by 13.5% instead of 11.4%.

The number of international visitors to Georgia increased by 10.7% in August compared to the same month of the previous year, while the number of tourists increased by 13.9% annually and accounted for 70.8% of all international visitors. **According to the model, both tourism and remittances made a significant positive contribution to the GDP growth forecast.**



Source: National Bank of Georgia

Deposits, Credit expansion and Improved Monetary Aggregates

The other group of variables that experienced remarkable monthly and yearly changes and made a significant positive contribution to the Q3 and Q4 forecasts was ***the volume of domestic and foreign currency deposits*** in commercial banks. In particular, ***the total volume of domestic currency deposits*** increased by 33% annually, while ***the total volume of foreign currency deposits*** went up by 15% compared to the same month of the previous year. In addition, despite more restrictive regulations introduced by the National Bank of Georgia, the ***total volume of commercial banks' consumer credit*** increased by 19% relative to the same month of the previous year.

The credit expansion contributed to an increase in the amount of currency in circulation**.** All monetary aggregates, including the largest Broad Money (M3) and M2 aggregates experienced significant yearly growth (the M3 and M2 aggregates rose by 17% and 19% respectively). **Our model's outcomes confirm the standard textbook result that an increase in monetary aggregates positively contribute to real GDP growth in the short run.**

Our forecasting model is based on the Leading Economic Indicator (LEI) methodology developed by the New Economic School, Moscow, Russia. We constructed a dynamic model of the Georgian economy, which assumes that all economic variables, including GDP itself, are driven by a small number of factors that can be extracted from the data well before the GDP growth estimates are published. For each quarter, ISET-PI produces five consecutive monthly forecasts (or "vintages"), which increase in precision as time goes on. Our first forecast (1st vintage) is available about five months before the end of the quarter in question. The last forecast (5th vintage) is published in the first month of the next quarter.