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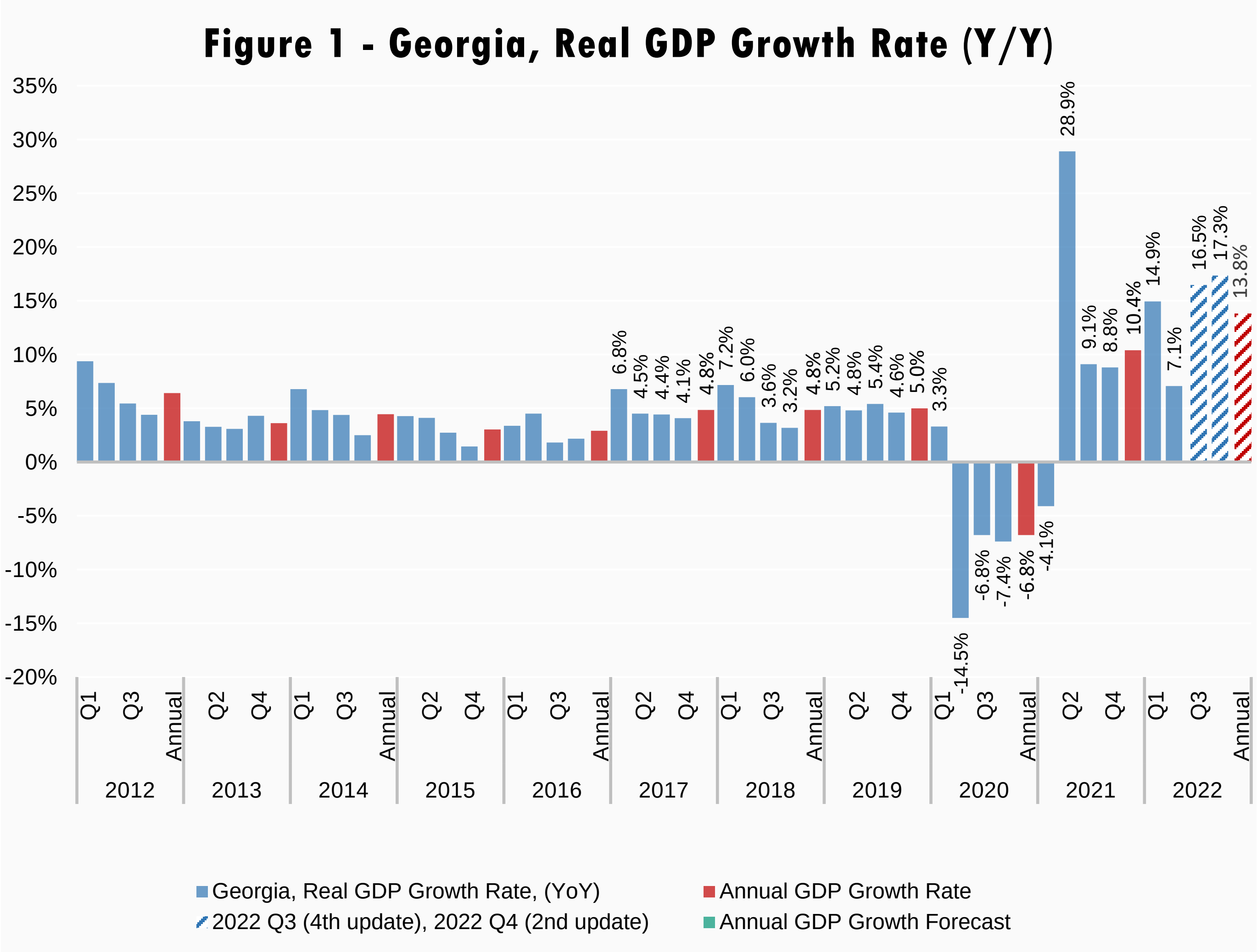
Georgia's growth forecast soars on positive trade, tourism, and remittances data. Inflation and war in Ukraine remain serious sources of risk.



ISET-PI has updated its real GDP growth forecast for the third and fourth quarters of 2022. Here are the highlights of this month's release:

HIGHLIGHTS

- Recently, Geostat has released the preliminary estimate of real GDP growth for the second quarter of 2022, which now stands at 7.1%.
- The real GDP growth rate reached 9.7% year-on-year in July 2022. Consequently, the estimated real GDP for the first seven months of 2022 amounted to 10.3%.

- ISET-PI's forecast of real GDP growth for the third quarter of 2022 stands at 16.5%. The second estimate for the fourth quarter growth forecast stands at 17.3%.
- Based on July's data, we expect annual growth in 2022 to be 13.8%. This number is most likely overestimated by the model at the current point in time. Due to war, sanctions and migration that had not had relevant analogues in the Georgian data.
- In addition, the National Bank of Georgia revised its expectation for real GDP growth from 4.5% to 9% in 2022. According to the Monetary Policy Report, among the reasons behind the prediction's upward revision are the high credit activity, and improved external sector due to increased migration to Georgia amid the ongoing war in Ukraine. However, deteriorated investment sentiment and high inflation remains as a main risk related to the GDP forecast.

GDP Growth by Sector in Q2. The Georgian statistics office, Geostat, has released its preliminary estimate of the GDP growth for the second quarter of 2022 (based on VAT taxpayers' turnover data). The estimated growth in Q2 is 7.1%. According to Geostat, the following sectors had the largest positive contribution to the annual real GDP growth in this period: electricity, gas, steam and air conditioning supply (75.9% growth yearly); information and communication (27.7% yearly); administrative and support service activities (24.4% yearly); transportation and storage (18.6% yearly); mining and quarrying (12.6% yearly); education (12% yearly); activities of households as employers (11% yearly); Agriculture, forestry and fishing (10.9% yearly), and water supply; sewerage, waste management and remediation activities (10.7% yearly). While the human health and social work activities (-12.7% growth yearly), professional, scientific and technical activities (-9.2% yearly), construction (-3.2% yearly), real estate activities (-2.7% yearly), and manufacturing (-1.6% yearly) were the only sectors that shrunk in Q2.

Variables behind the GDP growth forecast:

Merchandise Trade. In July, Georgia's exports experienced an 40.3% annual growth. This was mainly driven by increased export/re-export of motor cars, copper ores and concentrates, ferro alloys, and mineral and chemical fertilizers. In contrast, exports of mineral water, medicines and telephone equipment experienced annual decline. It is notable that dramatic increase of the goods export is mainly a reflection of higher prices, and the volume of exports increased by 22.2% yearly.

During this period, the import of goods increased by 26.3%, driven by an increased import/re-import of petroleum (mostly driven by increased prices), motor cars, medicines, and copper ores and concentrates. Furthermore, the volume of imports increased by only 2.4% yearly. **Consequently, the trade deficit widened by 15.3% yearly, and amounted to 571.8 million USD.** *Overall, trade related variables still had a small positive contribution to the GDP growth forecast.*

Remittances. In July, remittances increased by 46.8% annually and reached 306 million USD. The main contributors to this increase were Russian Federation (contributing 29 ppts), Belarus (4.6 ppts), Kyrgyzstan (3.7 ppts), Armenia (3.3 ppts), Kazakhstan (2.5 ppts), Germany (2.2 ppts), United States of America (1.5 ppts), Italy (1.3 ppts), and Tajikistan (1.2 ppts). Whereas money inflows decreased from Ukraine (3.5 ppts), Azerbaijan (1.1 ppts) and Greece (0.7 ppts). *Overall, the recovery of remittances flows made a positive contribution to the growth forecast.*

Tourism. Tourism arrivals and receipts notably recovered in July of 2022 after a sharp decline in 2020 and a recovery process in 2021. **In July, the number of international visitors increased by 158.9% yearly** (decreased by 32.2% compared to the same month in 2019), **while the increase in tourist numbers (visitors who spent 24 hours or more in Georgia) amounted to 115.3%**. *Overall, recovering numbers of visitors and tourists, along with an increase in touristic spending has made a positive contribution to the growth forecast.*

Real Effective Exchange Rate (REER). REER appreciated by 5.7% monthly and 15.4% yearly in july. The Lari Real Exchange Rate (RER) appreciated monthly with respect to the currencies of the major partner countries - Euro (EUR) (by 7.9%), Russian Ruble (RUB) (by 7.4%), Turkish Lira (TRY) (by 4.1%) and US Dollar (USD) (by 4%). **Moreover, the GEL/EUR, GEL/USD, and GEL/TRY real exchange rate appreciated (except GEL/RUB, which depreciated by 15%) compared to the same month of the previous year by 30.5%, 13.0%, and 38.1% respectively.** *Overall, REER-related variables had a small positive contribution to the real GDP growth projections.*

Money Supply. All monetary aggregates experience notable growth in annual terms. Monetary aggregates M2 and M3 experienced yearly growth of 14.8% and 7.6%, respectively. Moreover, Currency in Circulation and Narrow Money (M0) increased relatively moderately by 2.1% and 2.7% yearly, respectively. *Overall, money supply related variables had a positive contribution to the real GDP growth for the third and fourth quarters of 2022 based on our model.*

World Prices. The other variables of interest in our growth forecast were Metals Price Index (PMETA) and the Agricultural Raw Materials Index (PRAWM). Metals form a significant share in Georgia's exports, while food and oil are among the main imports. Therefore, a global increase in the price of metal will likely cause improvement to the Georgian economy, whereas an increase in the price of agricultural products will be damaging. **In annual terms, metal prices as well as agricultural raw material prices decreased by 19.6% and 4.1% respectively in July.** *On the balance, adding the PMETA and PRAWM indicators to the model thus decrease the growth forecast for both quarters.*

Inflation. In July, the annual inflation of consumer prices amounted to 11.5%, which is notably higher than the targeted 3%. Approximately 4.7 percentage points of CPI inflation were related to higher food prices (this was driven by the hike in food prices worldwide – FAO Food Price Index increased by 13.0% yearly). Furthermore, increased fuel prices made a notable positive contribution (1.8 ppts) to the annual inflation measure. **The latter trend is mostly a reflection of significantly increased oil prices on the global market (Euro Brent Spot Price (COP) increased by 48.9% yearly).** However, the same variable decreased by 8.8% monthly. Hence, there are two factors giving us a reason for optimism: (1) oil prices started to decrease and (2) exchange rate appreciated against the currencies of the main trading partners. Meanwhile, the measure of core inflation amounted to 7.0%. Due to higher annual inflation rate compared to the targeted 3% and risks of emerging inflationary expectations, National Bank of Georgia (NBG) remained Monetary Policy Rate (MPR) by unchanged to 11% in May, June, August and September of 2022. Overall, *CPI related variables had a slight negative contribution to the GDP forecast.*

Our forecasting model is based on the Leading Economic Indicator (LEI) methodology developed by the New Economic School, Moscow, Russia. We have 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 passes. Our first forecast (the 1st vintage) is available around five months before the end of the quarter in question. The last forecast (the 5th vintage) is published in the first month of the next quarter.