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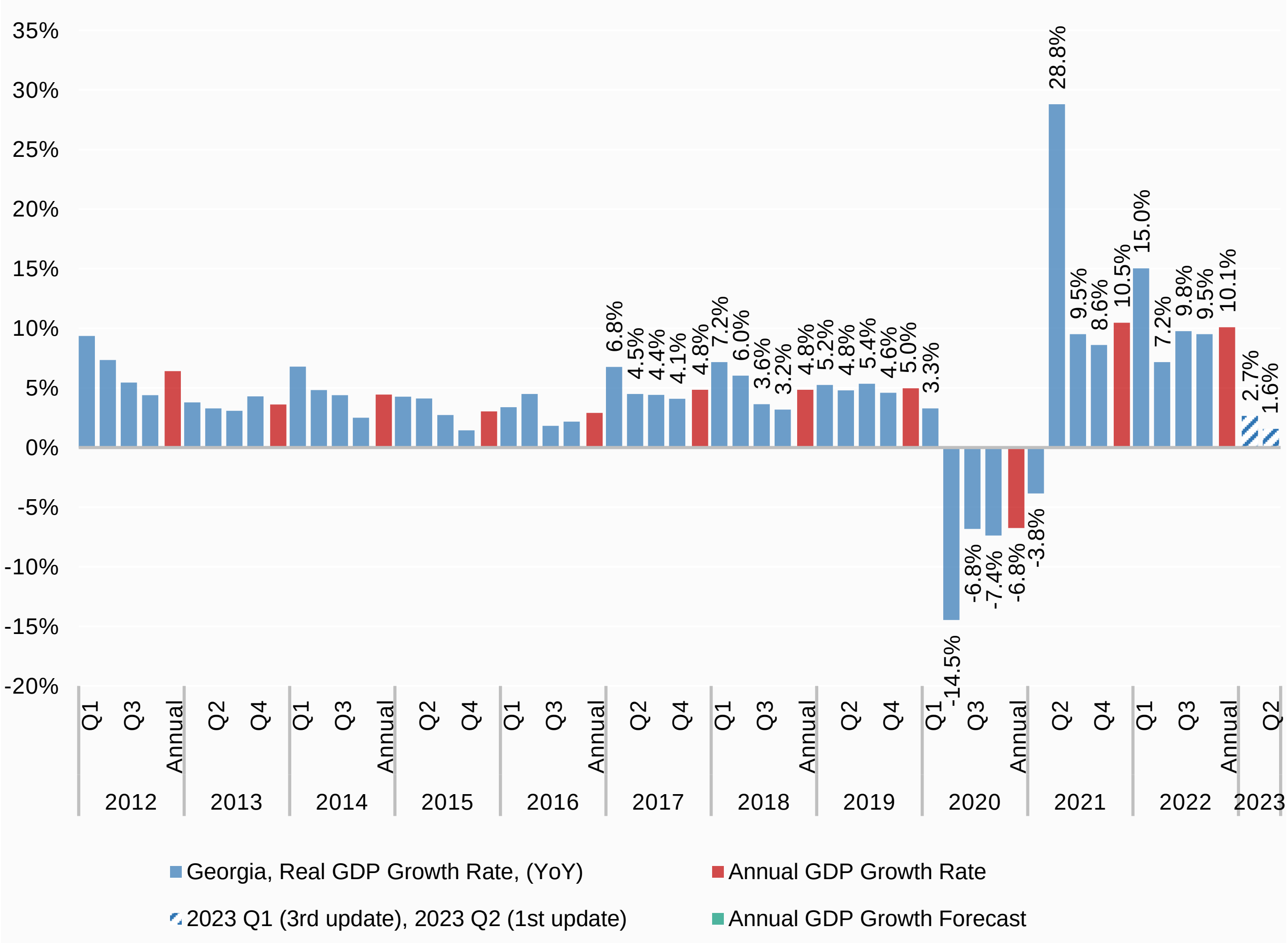
Inflation in Georgia subsides as global oil and food prices decline, but internal price pressures, driven by migration, remain

Figure 1 - Georgia, Real GDP Growth Rate (Y/Y)



ISET-PI has updated its real GDP growth forecast for the first and second quarters of 2023. Here are the highlights of this month's release:

HIGHLIGHTS

- According to Geostat's report titled *"Tendency of Economic Growth, Indicators of Monthly Economic Statistics"*, the real GDP growth in **the fourth quarter of 2022 is estimated to be 9.5%**, which has contributed to an overall **annual real GDP growth of 10.1% in 2022**.
- As a result of the update, the growth **forecast for Q1 of 2023 was revised downward to 2.7%** from 3.9% in January. ISET PI's first **forecast for Q2 of 2023 puts GDP growth at 1.6%.**
- Based on December data, the annual growth in 2023 is expected to be **2% in the worst-case** scenario, and **3% in the best-case or an average long-term growth scenario**. **Our middle-of-**

the road scenario (based on the average growth in the last four quarters) **predicts a 2.4% increase** in real GDP.

- These numbers are most likely **underestimated by the model at the current point in time**. This is due to the fact that ongoing large-scale in-migration had not had relevant analogues in the Georgian data in the past.

Variables behind the GDP growth forecast:

National and Foreign Currency Deposits. The other set of variables with a moderate effect on our forecast relates to national and foreign currency deposits in commercial banks. All categories of national currency deposits experienced growth in annual terms, while some of them (e.g. time deposits and time deposit with maturity less than 3 month) declining on a month-to-month basis in December. In particular, national currency demand deposits saw an annual increase of 58.1%, while time deposits increased by 33.5% annually. **Consequently, national currency total deposits increased by 31.9% yearly.** In the same time period, demand deposits and currency in circulation increased by 23.4% and 2.2% respectively compared to the previous month. *The national currency deposits had a positive contribution to the real GDP growth.*

In contrast to domestic currency deposits, **foreign currency total deposits increased relatively moderately by 13.9%** compared to the same month of the previous year. In the same time period, foreign currency current account and demand deposits increased by more than 10% in annual terms, while foreign currency time deposits decreased by 12% yearly. The slowdown of the annual growth of foreign currency deposits is partially driven by the appreciation of the national currency. As a result, **deposit dollarization decreased by 0.6 percentage points monthly and by 3.8 percentage points yearly.** *Despite the positive annual trends, foreign currency deposit-related variables still had a slight negative contribution to real GDP growth based on our model.*

Money Supply. In December, all monetary aggregates including the narrowest, Narrow Money (M0) and Broad Money (M3), experience notable growth in annual terms. Monetary aggregates M2 and M3 saw a yearly growth of 22.9% and 11.4%, respectively. Meanwhile, currency in circulation increased relatively moderately, by 9.8% yearly. Moreover, the Narrow Money (M0) also increased by 9.8% in annual terms. *Overall, money supply related variables had a slight positive contribution to the real GDP growth for the first and second quarter of 2023 based on our model.*

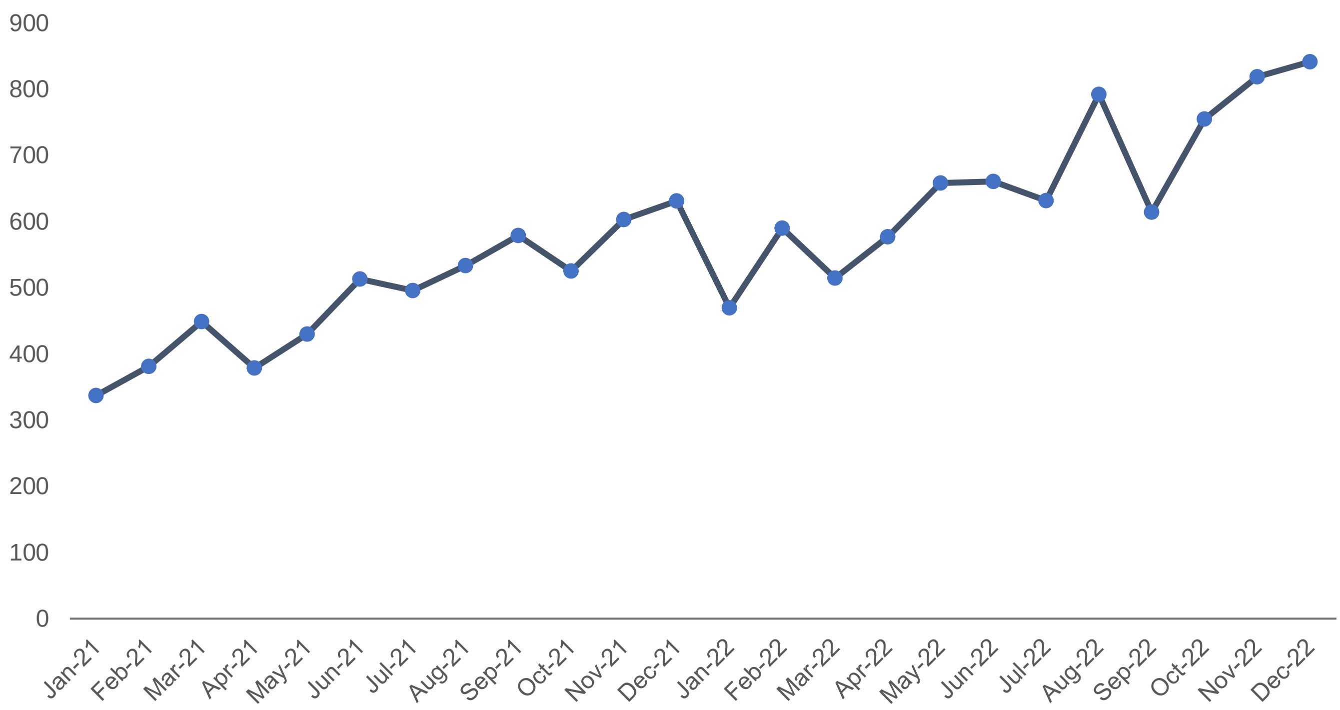
Merchandise Trade. In December, Georgia's exports experienced a moderate 32.5% annual growth. This was mainly driven by increased export/re-export of *motor cars* (increased by 262.1% YoY, which is 24.3 ppts), *copper ores and concentrates* (increased by 39.8% YoY, 6.2 ppts), *mineral or chemical fertilizers, nitrogenous* (increased by 47.9% YoY, 2.5 ppts), *motor vehicles for the transport of ten or more persons* (increased by 6303.3% YoY, 2 ppts), *cigars, cheroots, cigarillos and cigarettes* (increased by 235.7% YoY, 1.9 ppts), *automatic data processing machines and units thereof* (increased by 829.3% YoY, 1.3 ppts), and *live bovine animals* (increased by 104.7% YoY, 1 ppt). In contrast, exports of *ferro-alloys* (decreased by 92.1% YoY, which is -13.8 ppts[1]), *citrus fruit, fresh or dried* (decreased by 39.6% YoY, -1.5 ppts), and *ferrous waste and scrap; remelting scrap ingots of iron or steel* (decreased by 99.3% YoY, -1.3

[1] The reason for the decline was the reduction in prices, which can be linked to Russia's war in Ukraine and the subsequent sanctions. In addition, in December 2022, Russia and the Eurasian markets enforced a tax on Georgian goods.

ppts), experienced annual decline. It is notable that the volume of exports (real export) increased notably by 39.1% yearly.

During this period, the import of goods increased by 33%, driven by an increased import/re-import of *motor cars*, *telephone devices, and petroleum and petroleum oils*. In contrast, imports of *copper ores and concentrates (Intended for re-export)* experienced moderate annual decline. However, the volume of imports increased by 19.8% yearly (hence, the growth was partially driven by increased prices). **Consequently, the trade deficit increased by 33.3% yearly, and amounted to 841.5 million USD** (it is notable that trade deficit widened dramatically in 2022, which was mostly driven by increased import partially associated with increased migration from Russia and Belarus after Russia's war in Ukraine – see Figure 2)**.** *Overall, trade related variables still had a positive contribution to the GDP growth forecast.*

Figure 2: Dynamics of the trade deficit (in mln USD)



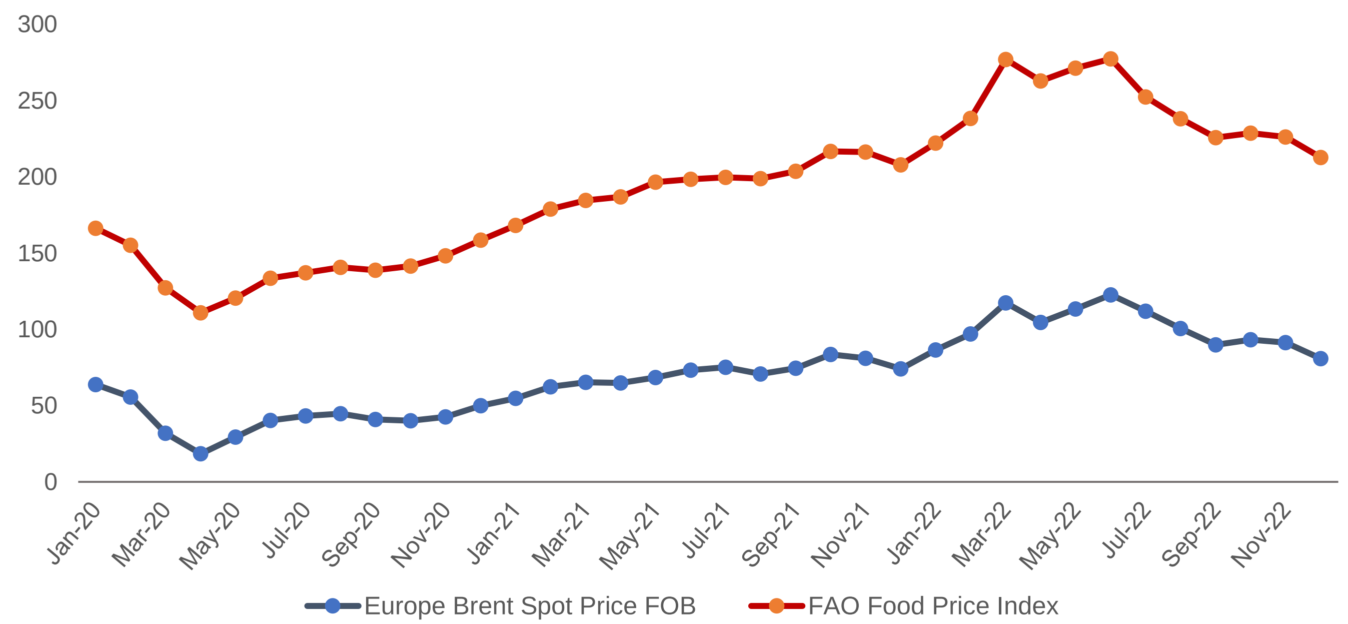
Source: Geostat

Remittances. In December, **remittances increased by 133.2% annually and reached 535.3 million USD.** The main contributors to this increase were *Russian Federation* (contributing to 121 ppts), *Italy* (7.9 ppts), *Kyrgyz Republic* (2.1 ppts), and Kazakhstan (0.6 ppt). Whereas money inflows decreased from *Ukraine* (-3.4 ppts). The percentage of the share held by Russia was 59%, whereas that of the European Union was 20%. *Overall, the significant increase in remittances flows made a notable positive contribution to the growth forecast.*

Tourism. In December, the number of international visitors increased by 213.9% yearly, **while the increase in tourist numbers (visitors who spent 24 hours or more in Georgia) amounted to 110.7%**. *Overall, recovering numbers of visitors and tourists, along with an increase in touristic spending has made a positive contribution to the growth forecast.*

Inflation. In December, the annual inflation of consumer prices amounted to 9.8%, which is notably higher than the targeted 3%. Approximately 4.8 percentage points of CPI inflation were related to higher food prices. However, increased fuel prices made a moderate positive contribution (0.1 ppts) to the annual inflation measure (the contribution of oil prices decreased monthly). **The latter trend is mostly a reflection of increased oil prices on the global market (Euro Brent Spot Price (COP) increased by 9.1% yearly).** We can safely conclude that current inflation is notably related to increased demand related to the relocation of Russian and Belarusian citizens. There are two factors giving us a reason for optimism on inflation: (1) oil and food prices started to decrease from their peak earlier in the year (see Figure 3) and (2) GEL exchange rate appreciated against the currencies of the main trading partners (e.g. in December, on average, Georgian lari appreciated with respect to USD by 1.5%, Russian ruble by 8.3%, and Turkish lira by 1.7% in monthly terms. Georgian lari depreciated with respect to Euro by 2.3% monthly. Real Effective Exchange Rate (REER) appreciated by 0.6% monthly and 15.1% yearly). Meanwhile, the measure of core inflation amounted to 6.8%. Overall*, CPI related variables had a slight negative contribution to the GDP forecast.*

Figure 3: Europe Brent Spot Price FOB (Dollars per Barrel) and FAO Food Price Index (2014-2016=100)



Source: U.S. Energy Information Administration, and Food and Agriculture Organization (FAO)

Foreign Direct Investment. Foreign direct investment (FDI) in Georgia amounted to about 2 billion USD in 2022 (the greatest number of all time for Georgia), which is 61.1% higher than in 2021. According to Geostat, the main reasons for increasing FDI was reinvestment of earnings, which amounted up to 1.3 billion USD (which was 64.5% of total FDI)[2]. In addition, FDI experienced notable increase in real estate activities (contributing 29.4 ppts); water supply, sewerage, waste management and remediation activities (15.8 ppts); information and communication (11.7 ppts); construction (8.6 ppts); transportation and storage (6.2 ppts); and financial and insurance activities (4.4 ppts), while FDI decreased in wholesale

[2] Equity investment increased by 226.4% yearly, while reinvestment of earnings increased by 67.5% yearly.

and retail trade, repair of motor vehicles and motorcycles (contributing -8.1 ppts); and arts, entertainment and recreation (-4.8 ppts). The recent trends in FDI are not taken into consideration in our model yet.

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.