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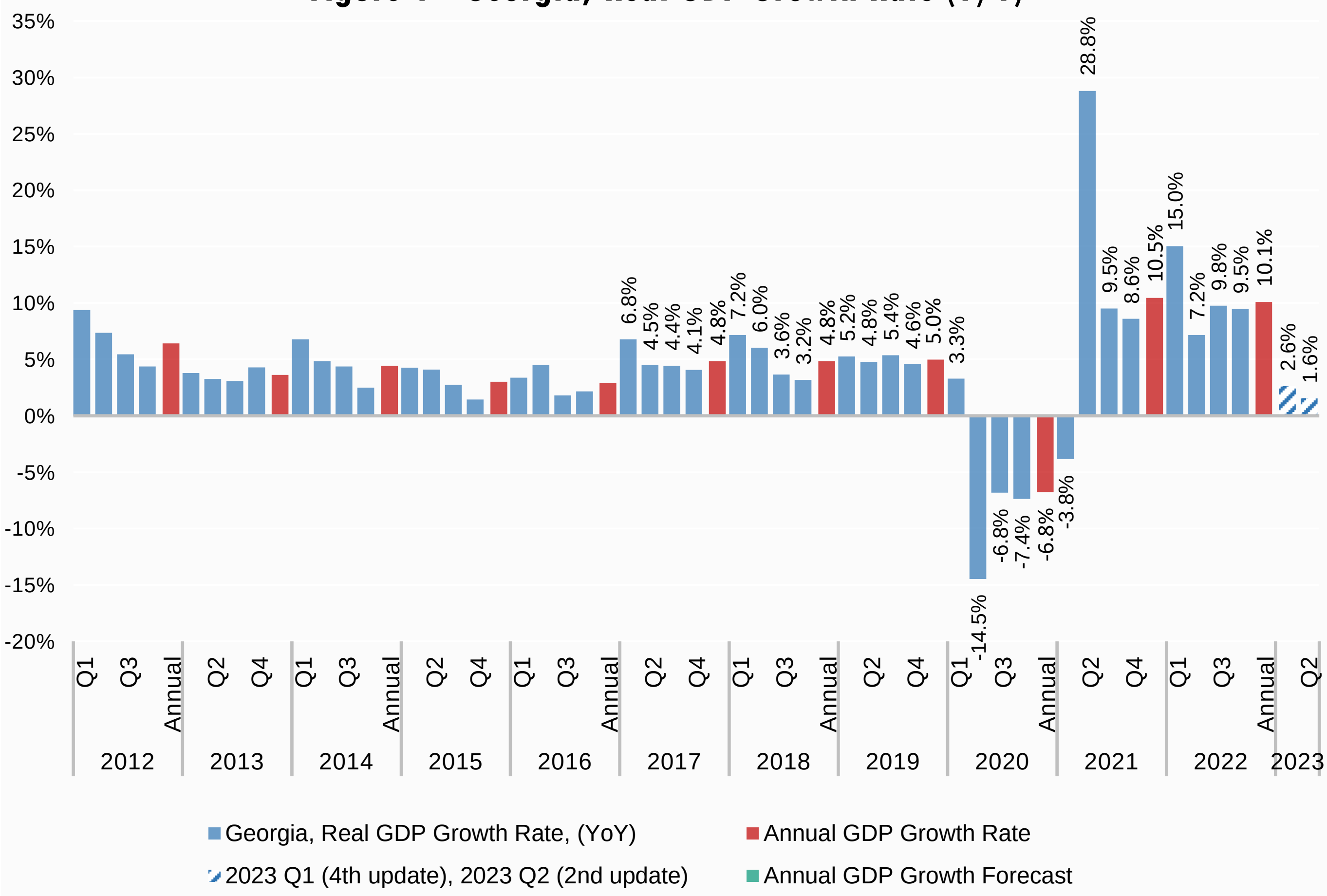
Money transfers from Russia grew by more than thousand percent over the year, driving significant appreciation of the Lari

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

- The real GDP growth rate amounted to 8.4% year-on-year for January 2023.
- As a result of the update, **the growth forecast for Q1 of 2023 reduced by 0.1 percentage point to 2.6%.** ISET PI's second forecast for **Q2 of 2023 puts GDP growth at positive 1.6%.**
- Based on January 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.
- According to the recent Monetary Policy Report of the National Bank of Georgia (NBG), **real economic growth forecast for 2023 is expected to reduce at 4%.** This growth slowdown is driven by the backdrop of reduced migration inflows and the expected slowdown of global economic growth.

Neighboring Countries' Real GDP Growth Varied Amid War; Russian Economy Hardest Hit While Armenia and Georgia Experience Strong Growth

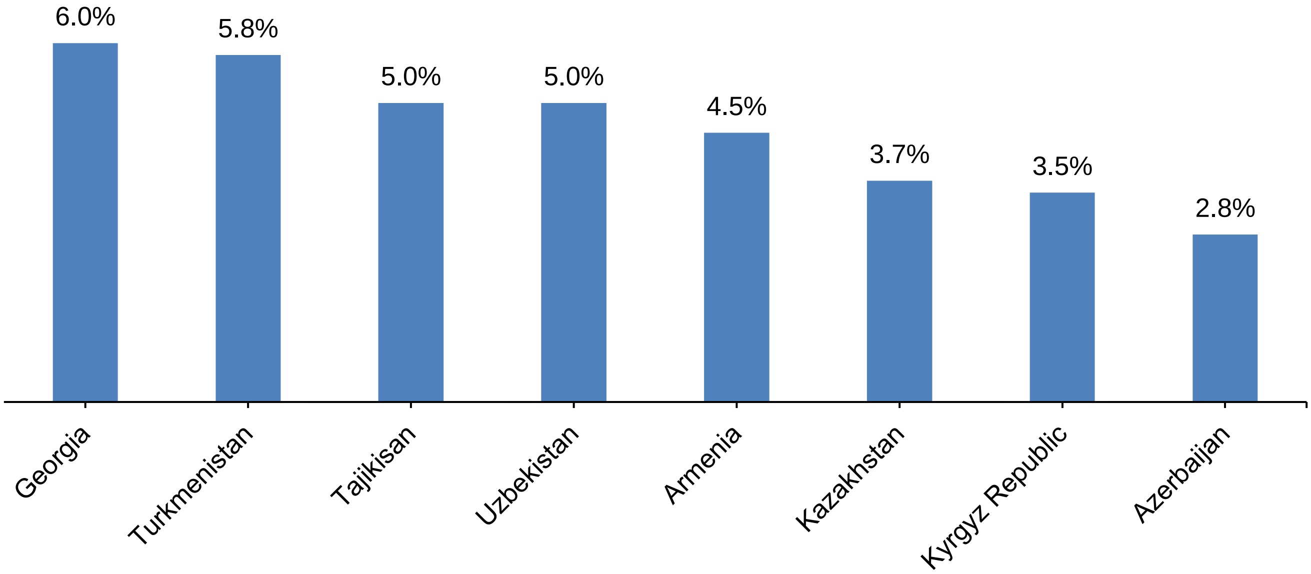
The neighboring countries experienced a mixed real GDP growth, with the impact of Russia's war in Ukraine varying across different economies. Among these countries, **the Russian economy was particularly hard hit, with a contraction of 2.1% in the previous year**, as confirmed by the *Federal Statistics Service of Russia*. This represents a significant decline compared to the 5.6% year-on-year rise witnessed in 2021, and can be attributed to a combination of the ongoing war and a series of sanctions imposed on the country.

On the other hand, Armenia and Georgia experienced strong economic growth, which was partly fueled by the influx of Russian migrants[1]. According to the *National Statistical Committee*, **Armenia's GDP in 2022 grew by 12.6% compared to the previous year.** Meanwhile, Turkey and Azerbaijan reported more moderate growth rates in their economies. **The Turkish economy expanded by 5.6% in 2022**, with the country's gross domestic product reaching 15 trillion Turkish liras ($905.5 billion) in the same year, as announced by the *Turkish Statistical Institute (TurkStat)*. **Azerbaijan's real GDP,** as confirmed by *the Ministry of Economy and Secretary of the National Coordination Council on Sustainable Development of Azerbaijan*, **increased by 4.6% following the results of 2022,** according to *Trend reports*.

In the context of the year 2023, the Economic Outlook report by the Asian Development Bank (ADB) released in September 2022 predicts that **Georgia's economy will demonstrate the highest growth rate of 6%.** In contrast, the forecast for **Azerbaijan's economic growth is much lower at 2.8%.** In addition, the report indicates that **Armenia's economy is expected to grow by 4.5%**, as depicted in Figure 2, which provides further detailed information on this matter.

[1] Despite the apparent economic benefits associated with the influx of high-earning Russian migrants in 2022, there are significant economic risks inherent in the situation under the status quo. For a detailed analysis of the economic risks associated with Russian migration into Georgia see ISET-PI policy brief "In the Shadow of the War: Economic Impact of Russian Migration into Georgia since 2022"

Figure 2: Real GDP Growth Rate, 2023 Forecast (% per year)



Source: Asian Development Bank. Asian Development Outlook 2022 Update (September 2022)

Variables behind the GDP growth forecast:

Money Supply. In January, all monetary aggregates including the narrowest, Narrow Money (M0) and Broad Money (M3), experience notable growth in annual terms and decline in monthly terms. Monetary aggregates M2 and M3 saw a yearly growth of 22.8% and 11%, respectively. However, on a monthly basis, both M2 and M3 aggregates decreased by 3.8% and 3.9%, correspondingly. The currency in circulation increased by 12.9% yearly, but declined by 5.9% monthly. Moreover, the Narrow Money (M0) increased by 11.4% in annual terms, and declined by 6.2% in monthly terms. *Overall, money supply related variables had a slight positive contribution to the real GDP growth for the first quarter of 2023 based on our model.*

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. currency in circulation and demand deposits) declining on a month-to-month basis in January. In particular, national currency demand deposits saw an annual increase of 62.3%, while time deposits increased by 26.1% annually. **Consequently, national currency total deposits increased by 29.7% yearly.** In the same time period, time deposits increased by 4.9% in monthly terms, and demand deposits and currency in circulation declined by 2.4% and 4.5% 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 13.1%** 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 11.3% 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 1.2 percentage points monthly and by 3.7 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.*

VAT Turnover. As far as other variables of interest, **VAT turnover in January increased by 23.8% yearly and 0.5% monthly.** *Consequently, this variable had a positive contribution to real GDP growth.*

Merchandise Trade. In January, Georgia's exports experienced a moderate 38.5% annual growth. This was mainly driven by increased export/re-export of *motor cars* (increased by 186.6% YoY), *ferro-alloys* (increased by 61.8% YoY), *automatic data processing machines and units thereof* (increased by 1363.5% YoY), *undenatured ethyl alcohol, spirits, liqueurs and other spirituous beverages* (increased by 43.7% YoY), *gold unwrought or in semi-manufactured forms, or in powder form* (increased by 49.4% YoY), *mineral or chemical fertilizers, nitrogenous* (increased by 18.1% YoY), *cigars, cheroots, cigarillos and cigarettes* (increased by 154.6% YoY), *petroleum and petroleum oils* (increased by 115% YoY), *waters, mineral and aerated waters, containing added sugar* (increased by 51% YoY), *copper ores and concentrates* (increased by 2.7% YoY), and *wine of fresh grapes* (increased by 8.1% YoY). It is notable that the volume of exports (real export) increased notably by 45.3% yearly.

During this period, the import of goods increased by 27.3%, driven by an increased import/re-import of *petroleum and petroleum oils*, and *copper ores and concentrates*. In contrast, imports/re-import of *electricity and motor cars* experienced annual decline. However, the volume of imports increased only by 12.5% yearly (hence, the growth was mostly driven by increased prices). **Consequently, the trade deficit increased by 19.4% yearly, and amounted to 560.7 million USD.** *Overall, trade related variables still had a positive contribution to the GDP growth forecast.*

Remittances. In November, **remittances increased by 163.5% annually and reached 445 million USD.** The main contributors to this increase were *Russian Federation* (increased by 1095.7%, 145.2 ppts), *United States of America* (increased by 40.8%, 4.9 ppts), *Italy* (increased by 18.9%, 3.7 ppts), *Germany* (increased by 61.8%, 3.2 ppts), *Israel* (increased by 14.5%, 1.3 ppts), *Kazakhstan* (increased by 32.1%, 1.3 ppts), *Kyrgyzstan* (increased by 60.1%, 1 ppts), and *Turkey* (increased by 26.1%, 1 ppts). Whereas money inflows decreased from *Ukraine* (decreased by 99.1%, -3.2 ppts), and *Azerbaijan* (decreased by 24.2%, -0.6 ppts). *Overall, the significant increase in remittances flows made a notable positive contribution to the growth forecast.*

Exchange Rate. Georgian lari appreciated against nearly all of the trading partner currencies in January. The most significant **appreciation was observable with respect to the US dollar** (2.3% in month and 13.5% in annual terms) and **Turkish lira** (2.7% in month and 37.3% in yearly terms). The **GEL/EURO** exchange rate appreciated by 0.1% and 15.2% monthly and yearly respectively, while the **GEL/RUB** exchange rate appreciated by 3.2% yearly and depreciated by 3% monthly. Furthermore, **REER depreciated by 0.1% monthly and appreciated by 15.4% yearly. REER appreciation is mostly related to the relocation of the Russian and Belarusian citizens.** *Overall, REER-related variables had a small negative contribution to the real GDP growth projections.*

Inflation. In January, the annual inflation of consumer prices amounted to 9.4%, which is notably higher than the targeted 3%. Approximately 4.4 percentage points of CPI inflation were related to higher food prices. Furthermore, decreased fuel prices made a slight negative contribution (0.1 ppts) to the annual inflation measure (the contribution of oil prices has been decreasing monthly, and even reached to negative number in January). **The latter trend is mostly a reflection of decreased oil prices on the global market (Euro Brent Spot Price (COP) decreased by 4.6% 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 prices started to decrease from their peak earlier in the year, and (2) GEL exchange rate appreciated against the currencies of the main trading partners. Although the supply side factors are no longer that significant, high inflation persists due to demand side factors such as increased migration of Russian citizens following the Russia's war in Ukraine. Meanwhile, the measure of core inflation amounted to 7.7%. 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.