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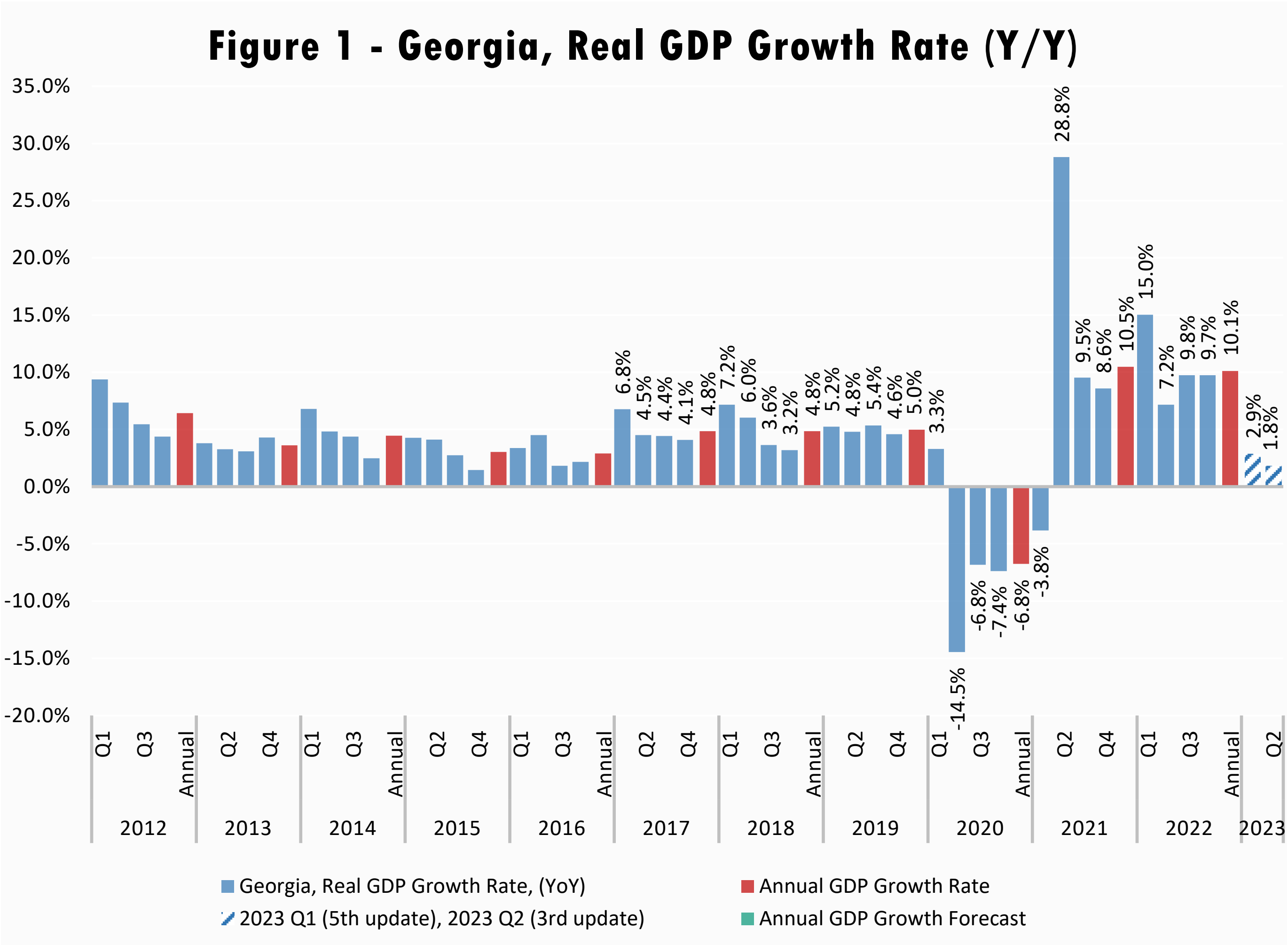
Business and consumer confidence indicators diverge, reflecting uncertainty facing the Georgian economy



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

- Geostat has released its rapid estimate of real GDP growth for February 2023. The estimated growth stands at 5.8%, while the average real GDP growth for January-February 2023 reached 7.1%.
- ISET-PI predicted 2.9% and 1.8% growth for the first and second quarters of 2023 respectively.
- Based on February data, the annual growth in 2023 is expected to be **2.2% in the worst-case** scenario, and **3.2% 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 2.6% increase** in real GDP.

- These numbers are **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[1].

Real GDP by Categories of Use. In 2022, the real gross domestic product experienced a significant increase of 10.1% compared to the previous year. This growth was driven by strong foreign inflows, which were supported by the recovery of foreign tourism in Georgia after it suffered a decline due to COVID-19 pandemic and later the war in Ukraine. Furthermore, there was a significant increase in the number of migrants, resulting in a surge in remittances from abroad. The export of services increased by 85.7% compared to the previous year, while the total export of goods and services rose by 38.2%, which was much higher than the increase in the import of goods and services (14.4%). Net exports contributed around 6.3 percentage points to the economy's growth. In the same period, investments increased the real GDP by an additional 3.7 percentage points. Nevertheless, in contrast to the increasing trend of investments, the contribution of consumption (household consumption as well as general government expenditure) to economic growth was negative in the recent period, reflecting the slowdown in lending and fiscal consolidation.

Variables behind the GDP growth forecast:

National and Foreign Currency Deposits. The first set of variables with a moderate effect on our forecast relates to national and foreign currency deposits in commercial banks. Almost all categories of national currency deposits experienced growth in annual terms, while some of them (e.g. demand deposits and time deposits with maturity less than 3 month) declining on a month-to-month basis in February. In particular, national currency demand deposits saw an annual increase of 64.9%, while time deposits increased by 18.5% annually. Nevertheless, time deposits with maturity less than 3 month (short-term deposits) declined by 8% in annual terms. **Consequently, national currency total deposits increased by 27.6% yearly.** *The national currency deposits had a notable positive contribution to the real GDP growth.*

In contrast to domestic currency deposits, **foreign currency total deposits increased relatively moderately by 7.9%** 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 12.8% 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 just 0.1 percentage points monthly and by 4.5 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.*

Merchandise Trade. In February, Georgia's exports experienced a moderate 6.3% annual growth. This was mainly driven by increased export/re-export of *motor cars* (increased by 266.3% YoY), *wine of fresh grapes* (increased by 0.6% YoY), *undenatured ethyl alcohol, spirits, liqueurs and other spirituous beverages* (increased by 30.9% YoY), *precious metal ores and concentrates* (increased by 99.8% YoY), *hazelnuts and other nuts* (increased by 56.9% YoY), *cigars, cheroots, cigarillos and cigarettes* (increased by 303.7% YoY), *T-shirts and other vests, knitted or crocheted* (increased by 6.2% YoY), and *automatic data processing machines and units thereof* (increased by 28.7% YoY). On the contrary, the following

[1] The recently published rapid estimate of economic growth by Geostat reveals that GDP increased by 7.2% during the first quarter of 2023. This is significantly higher than what ISET-PI had predicted, and this difference is noteworthy. This growth rate is significantly higher than what ISET-PI had forecasted.

variables showed a significant annual decline: *copper ores and concentrates* (decreased by 16.3% YoY), ferro-alloys (decreased by 69.8% YoY), *mineral or chemical fertilizers, nitrogenous* (decreased by 99.4% YoY), *medicaments put up in measured doses* (decreased by 36.1% YoY), waters, natural or artificial mineral and aerated waters, not containing added sugar (decreased by 27.1% YoY) and *gold unwrought or in semi-manufactured forms, or in powder form* (decreased by 5.7% YoY).

During this period, the import of goods decreased by 4.5%, driven by a decreased import/re-import of *copper ores and concentrates* (decreased by 74.9% YoY), and *petroleum and petroleum oils* (decreased by 15.7% YoY). In contrast, imports/re-import of *motor cars* (increased by 57.3% YoY), *petroleum gases and other gaseous hydrocarbons* (increased by 58.3% YoY), and *medicaments put up in measured doses* (increased by 70.2% YoY) experienced annual increase. **Consequently, the trade deficit decreased by 13.9% yearly, and amounted to 507.9 million USD.** *Overall, trade related variables still had a positive contribution to the GDP growth forecast.*

Remittances. In February, remittances increased by 103% annually and reached 372.3 million USD. The main contributors to this increase were *Russian Federation* (increased by 753.7% YoY, 90.2 ppts), *United States of America* (increased by 44.3% YoY, 5.1 ppts), *Italy* (increased by 18% YoY, 3.2 ppts), *Germany* (increased by 29% YoY, 1.8 ppts), *Kyrgyzstan* (increased by 83.3% YoY, 1.5 ppts), *Israel* (increased by 16.4% YoY, 1.3 ppts), *Greece* (increased by 12.3% YoY, 1 ppt), *Turkey* (increased by 19.3% YoY, 0.8 ppts), *Tajikistan* (increased by 71% YoY, 0.5 ppts) and UK (increased by 35.5% YoY, 0.5 ppts). Whereas money inflows decreased from *Ukraine* (decreased by 99.1% YoY, -2.7 ppts), *Azerbaijan* (decreased by 28.6% YoY, -0.7 ppts), *Kazakhstan* (decreased by 6.4% YoY, 0.5 ppts), and Kuwait (decreased by 82.9% YoY, 0.5 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 February. The most significant **appreciation was observable with respect to the Euro** (3.7% in month and 21.3% in annual terms) and **Turkish lira** (0.9% in month and 37.8% in yearly terms). The **GEL/USD** exchange rate appreciated by 0.5% and 16.7% monthly and yearly respectively, while the **GEL/RUB** exchange rate appreciated by 7.8% monthly and 6.6% yearly. Furthermore, **REER appreciated by 0.7% and 13.9% monthly and yearly correspondingly. REER appreciation is mostly related to the relocation of the Russian citizens.** On one hand, the rise in the value of the Georgian lari has favorable effects on the Georgian population as the country relies heavily on imports and has high levels of debt dollarization (businesses having income and liabilities in different currency). However, the appreciation also leads to a reduction in the competitiveness of exports, which could have negative impacts on Georgia's growth in the medium to long term. *Overall, REER-related variables had a negative contribution to the real GDP growth projections.*

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 decreased by 14.6% in February, while raw agricultural material prices decreased by 14.3%. *On the balance, adding the PMETA have negative and PRAWM positive contribution to the growth forecast.*

Money Supply. In February, 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 22.2% and 8.5%, respectively. The currency in circulation and Narrow Money (M0) increased by 12.9% and 11.4% in annual terms, correspondingly. *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.*

Consumer Credit. In February 2023, the total volume of commercial banks' consumer credit increased by a mere 1.1% monthly and by 20.4% yearly. However, the credit volume of commercial banks' short-term consumer credits declined by 3.2% and 0.9% in monthly and yearly terms, respectively (the main driver behind this negative trend being short-term consumer loans in foreign currency, which went down by 10.2% and 39.3% monthly and annually respectively). Whereas, the credit volume of commercial banks' long-term consumer credits increased by 1.2% monthly and 21% yearly. *Overall, the variables related to consumer credit have had a positive impact on the growth forecast.*

Inflation. In February, the annual inflation of consumer prices amounted to 8.1%, which is notably higher than the targeted 3%. Approximately 4.2 percentage points of CPI inflation were related to higher food prices. Furthermore, decreased fuel prices made a slight negative contribution (0.4 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 15% 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 6.6%. Overall*, CPI related variables had a slight positive contribution to the GDP forecast.*

Expectations. For the first quarter of 2023, business confidence (BCI) in Georgia increased (by 8.4 index points) and reached 20.1. The Past Performance Index, which considers the business sector's assessment of their own economic performance in the previous quarter, increased by 4.3 points compared to Q4 2022 and reached 14.7 for Q1 2023. The Expectations Index, which reflects business optimism, increased significantly, amounting to 34.9 index points.

Conversely, consumer confidence (CCI) decreased by 5.9 index points – from -28.1 in January to -34 in February. Both the Present Situation Index and the Expectations Index contributed to the decrease. Consumers appear largely concerned about the expected general economic situation in the country, unemployment levels, and savings. Given that the declining trend in prices is relatively new, there might be a lag in the impact of these falling prices on consumer sentiment; consumers may still consider prices as high due to the extended period of inflation. This could help explain the unwillingness to make savings, where inflation produces two contradictory consumer impulses: to buy before prices rise further and to save.

Our forecasting model is based on the Leading Economic Indicator (LEI) methodology developed by 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.