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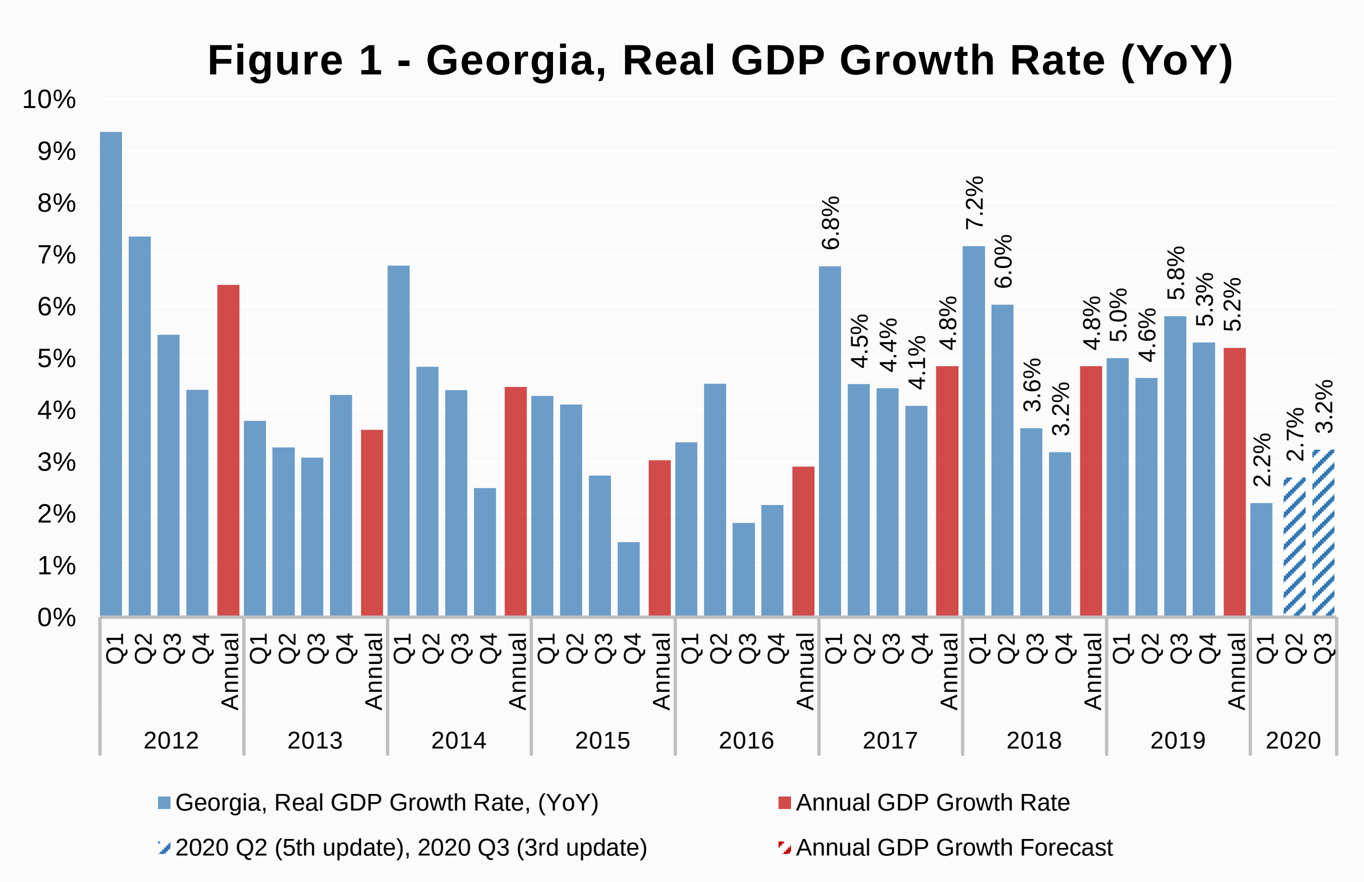
The Perfect Storm: Trade, Tourism, Inflation Indicators Deteriorate Dramatically, while Remittances Are Quick to Recover



ISET-PI has updated its real GDP growth rate forecast for Georgia for the second and third quarters of 2020. Here are the highlights of this month's release:

HIGHLIGHTS

- Geostat has revised its rapid estimate of real GDP growth for the first quarter of 2020. The estimated growth now stands at 2.2%, which is 0.7 percentage points above the average growth rate previously estimated for Q1.
- The real GDP growth rate contracted by 16.6% and 13.5% year-on-year in April and May 2020, respectively. Consequently, the estimated real GDP for the first five months of 2020 amounted to 5.4%.

- ISET-PI's forecast for the second quarter of 2020 now stands at 2.7% – up from 2.0% in May. The third quarter growth forecast currently stands at 3.2%. The forecast, based on past and current data, does not yet fully account for the negative impacts of the COVID-19 pandemic on the national economy, thus, overestimates the reality.
- Based on the data from May, we expect the annual growth in 2020 to be 2.8% in the worst-case or "no growth" scenario, and 3.2% in the best-case or "average long-term growth" scenario. Our "middle-of-the-road" scenario (from the average growth over the last four quarters) predicts 3.0% real GDP growth in 2020. These scenarios are based on the current data and, again, do not fully reflect the expected impact of the pandemic.
- Moreover, the National Bank of Georgia (NBG) has released its annual growth forecast for 2020, with the number now standing at -4.0%. The main factors behind GDP contraction are decline in both external and domestic demand, reduced revenues from export, remittances, tourism, and weak domestic demand, especially for long-term consumption goods and services.

External Merchandise Trade. In the face of the harsh measures governments have taken to overcome the COVID-19 pandemic, trade in all commodities, except food and medicine, is projected to decline; though the extent is dependent on the duration of the shock. In May, Georgia's exports experienced a 30.3% annual decline. This drop was driven by a reduction in the export/re-export of motor cars, cigarettes, and medicine to Azerbaijan, alongside the declining export of ferro-alleys and mineral water to Russia; export/re-export of motor cars, alcoholic beverages, and mineral water to Ukraine; and the re-export of cars to Armenia. There was moreover a slight decline in the export of goods to the European Union.

During this period, the import of goods decreased by 34.5%, driven by a reduction in petroleum and fuel products from Russia and Azerbaijan, motor cars from the United States, and fewer imports from China, Turkey, Germany, and Poland. Consequently, the trade deficit shrank notably, by 37.8% yearly, and amounted to 261.1 million USD.

Money Inflow. As every country will suffer economically in the aftermath of the health and oil price crises, we expect a significant slowdown in remittance inflows from the rest of the world. For instance, in May, remittances decreased by 9.6% yearly, thus reducing disposable income, consumption, and real GDP growth. The main contributors to this decline were the Russian Federation, Turkey, and Israel, whereas money inflow increased from the EU. It is also notable that remittances unexpectedly increased by 17.8% annually in June.

International Visits and Tourism. Tourism arrivals and receipts are expected to decline sharply as a result of numerous travel bans, and due to precautionary behaviors. In May, the number of international visitors decreased by 94.1% yearly, while the decline in tourist numbers (visitors who spent 24 hours or more in Georgia) amounted to 93.8%. In addition, Georgia has already opened its borders unconditionally for Germany, France, Latvia, Lithuania, and Estonia (from July). In summary, decreased inflows and the dramatically reduced number of visitors and tourists over the corresponding month have made a significant negative contribution to the growth forecast.

Real Effective Exchange Rate. In May, the Georgian lari real exchange rate sharply depreciated in both monthly and yearly terms against all main trading currencies. The most significant real depreciation was observed against the Russian ruble (3.8% monthly). The Real Effective Exchange Rate (REER) depreciated by 1.1%, relative to the previous months, and 6.2%, relative to the same month of the previous year (this pattern can also be seen in the Nominal Effective Exchange Rate). It is also notable that during May of 2020 NBG sold 40 million USD in foreign currency reserves (in aggregate, from 13 March to 2 July, NGB sold 229.650 million USD in foreign currency reserves in their Foreign Exchange Auctions). Overall, REER-related variables have only had a small negative contribution to the real GDP growth projections.

Inflation. According to our model, another negative contributor to growth was the increased consumer price index level, compared to the same month of the previous year. In May, the annual inflation of consumer prices amounted to 6.5%, which is notably higher than the targeted 3%. Approximately 4.5 percentage points of CPI inflation were related to higher food prices (15.1% annual increase), while tobacco prices contributed 0.4 percentage points (13.6% annual growth). However, decreased oil prices (7.1% annually) made only a slight negative contribution (0.2 ppts) to the annual inflation measure. The latter trend is mostly a reflection of significantly weakened oil prices on the global market (Europe Brent Spot Price (COP) decreased by 58.8% yearly).[1] While, the measure of core inflation amounted to 5.4%, its highest value since February 2016.

World Prices. The other variables highlighting a negative contribution to the growth forecast are the 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 some of the main imports. Therefore, a global decrease in the price of metal will likely cause deterioration to the Georgian economy, whereas a decrease in the price of agricultural products will likely be beneficial. In annual terms, metal prices decreased by 13.5% in May, while raw agricultural material prices declined by 6.8%. Adding the PMETA and PRAWM indicators to the model thus decreases the growth forecast for both quarters.

Money Supply. All monetary aggregates, including the largest, Broad Money (M3), and the smallest, Narrow Money (M0), experienced significant yearly growth – 17.1% and 21.4%, respectively. Moreover, currency in circulation increased by 19.8% yearly. The Monetary Policy Committee of NBG met in June and has since reduced the monetary policy rate by 0.25 percentage points to 8.25% (a reduction in the monetary policy rate was not overly significant due to the relatively high, but stable, inflation rates), which is expected to further increase the future money supply. Consequently, the rapid expansion of monetary aggregates has positively contributed to the growth 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.

[1] However, Europe Brent Spot Price was 59.8% lower in April than May (the lowest in the last 18 years).