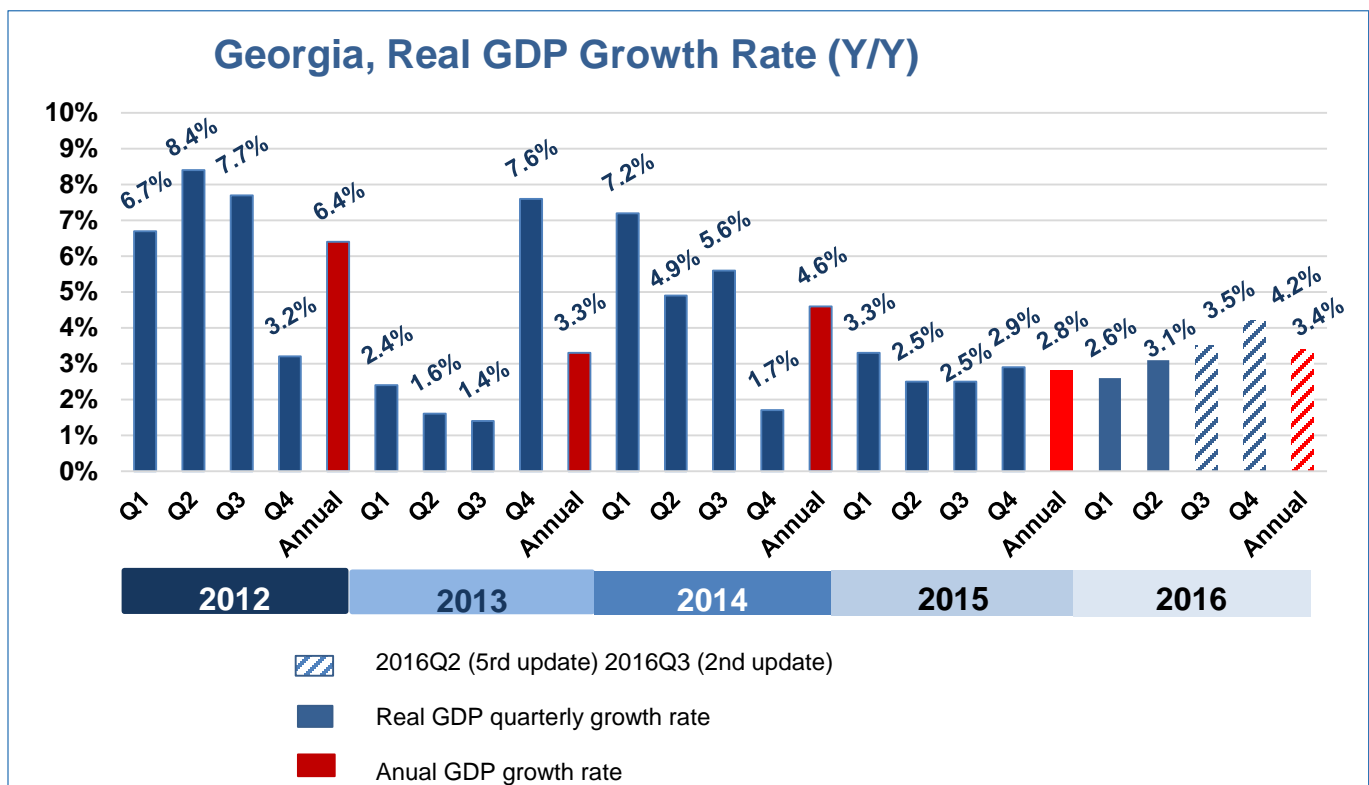


Lari Appreciates against Partner Currencies, but Persistent Dollarization May Be Hurting Growth

ISET-PI has updated its forecast of Georgia’s real GDP growth rate for the third and fourth quarters of 2016. Here are the highlights of this month’s releases:

- The growth forecast for the 3rd quarter of 2016 was **revised downward to 3.5%** from the 4.8% projected in July.
- The first forecast for the 4th quarter GDP growth has been projected at 4.15%.
- Based on the latest data, the updated **annual GDP growth projection is 3.4%**. It is noteworthy that the model starts to provide the most accurate annual estimate in September, when seven months of data is available on core explanatory variables.



If we look at the changes of the model’s explanatory variables, the 1.3% drop of the 3rd quarter growth forecast seems unexpected. Despite negative external shocks and the government’s expansionary fiscal and monetary policy, the core explanatory variables in our model remained quite stable in July. The only changes were related to the **newly arrived data about the 2nd quarter economic growth**, provided by Geostat. According to the latest Rapid Estimates of Economic Growth, –GDP growth in Q2 amounted to 3.1%, which was 1.6% lower than the latest estimate of our model.

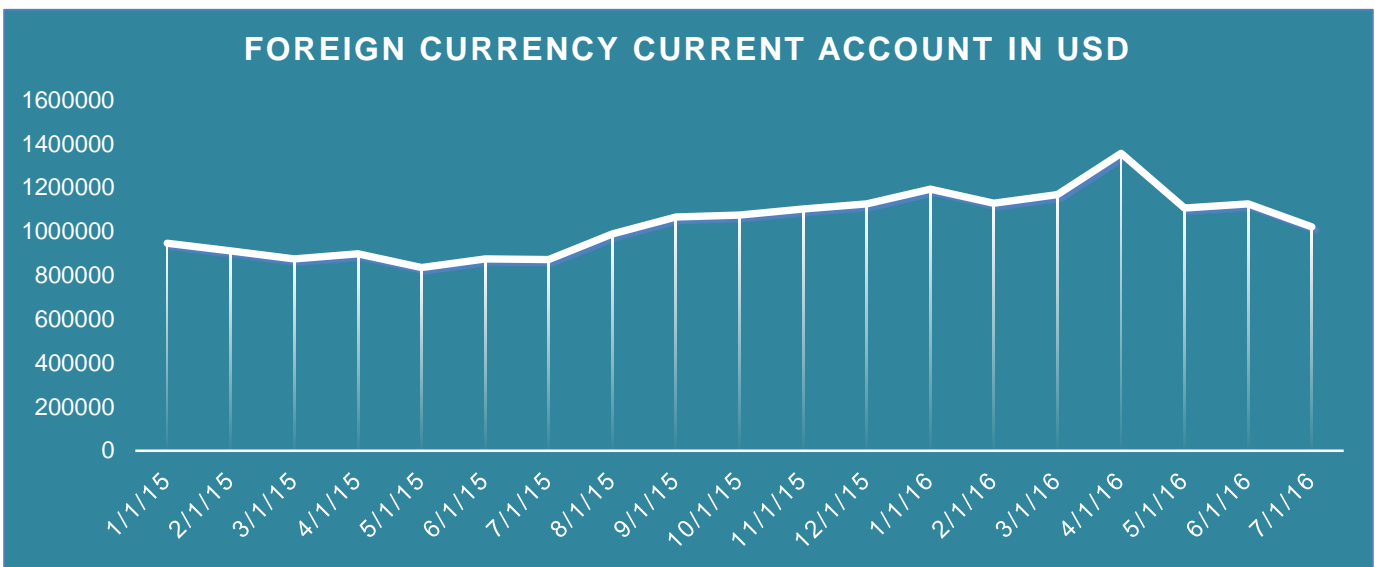
However, some core explanatory variables still experienced significant monthly and yearly changes. In terms of our model, we see that the group of variables related to **foreign currency deposits** in commercial banks **had a significant negative effect on the Q3 and Q4 forecasts**. Most of the variable in this group (including *Foreign*

Currency Direct Deposits and *Foreign Currency Time Deposits*) have increased quite a bit in monthly and yearly terms.

The very liquid *Foreign Currency Current Accounts (FCCA)* fell only slightly by 3% in monthly terms. (Even if we disregard the exchange rate effect by denominating this variable in US dollars, the outcome does not change and FCCA still declined in monthly terms, albeit increasing annually - as can be seen on the chart below).

Thus, despite the aggressive policy of the National Bank of Georgia to reduce dollarization, there is little evidence that dollarization is abating (e.g. the **Dollarization Index** increased by 3% monthly and 5% annually), and this may be affecting growth.

Another set of variables that had a significant positive contribution to the growth forecast in our model were those related to monetary aggregates in the economy.



Despite the fact that the National Bank of Georgia made no notable intervention in the money market in July, all of the monetary aggregates increased significantly. The most dramatic changes were experienced in the *Currency in Circulation* indicator. This variable increased by 4% in monthly terms and by 23% in annual terms. Moreover, *Broad Money (M3)* increased by 4% in monthly and by 15% in annual terms.

Thus, the expansionary monetary policy of the previous months has apparently stimulated aggregate demand.

Foreign currency-related variables in our model negatively affected economic growth. Another wave of **oil price decline in Russia and economic problems in Turkey** resulted in the significant **appreciation** of the lari with respect to corresponding currencies (appreciating by 4% monthly, on average). The appreciation of the domestic currency (lari) made domestic production less competitive in the markets of Georgia's main trading partners. In addition, lari **depreciated** significantly with respect to the USD and the euro in July (falling on average by 7% m-o-m in the case of the USD and by 5% m-o-m in the case of the euro).

The *Real Effective Exchange Rate (REER)* **appreciated** by 5% relative to the preceding month and depreciated by 2% relative to the same month of the previous year. The appreciation of the REER is associated with the loss of competitiveness of local production in foreign markets and thus negatively affected projected GDP growth.

Exchange rate depreciation creates the risk of high inflation. However, the impact of the previous year's sharp devaluation has already been resolved and **prices have started to stabilize**. The *monthly inflation rate in July* was 0.2%, while the annual increase was 1.5%

One more variable that experienced a remarkable increase in July is the number of foreign visitors to Georgia. According to the Tourism Agency of Georgia, the **number of foreign visitors increased by 48% in monthly and by 4% in annual terms**. While tourism is an important provider of jobs in Georgia, one should note that, in overall terms, the tourism sector is not a large part of the country's GDP. The share of tourism income in GDP varies from 6% to 7%. This is why the contribution of this variable to the GDP forecast in our model is currently very small.

Our forecasting model is based on the Leading Economic Indicator (LEI) methodology developed by the [New Economic School](#), Moscow, Russia. We constructed a dynamic model of the Georgian economy which assumes that all economic variables, including the 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 goes on. Our first forecast (1st vintage) is available about five months before the end of the quarter in question. The last forecast (5th vintage) is published in the first month of the next quarter.