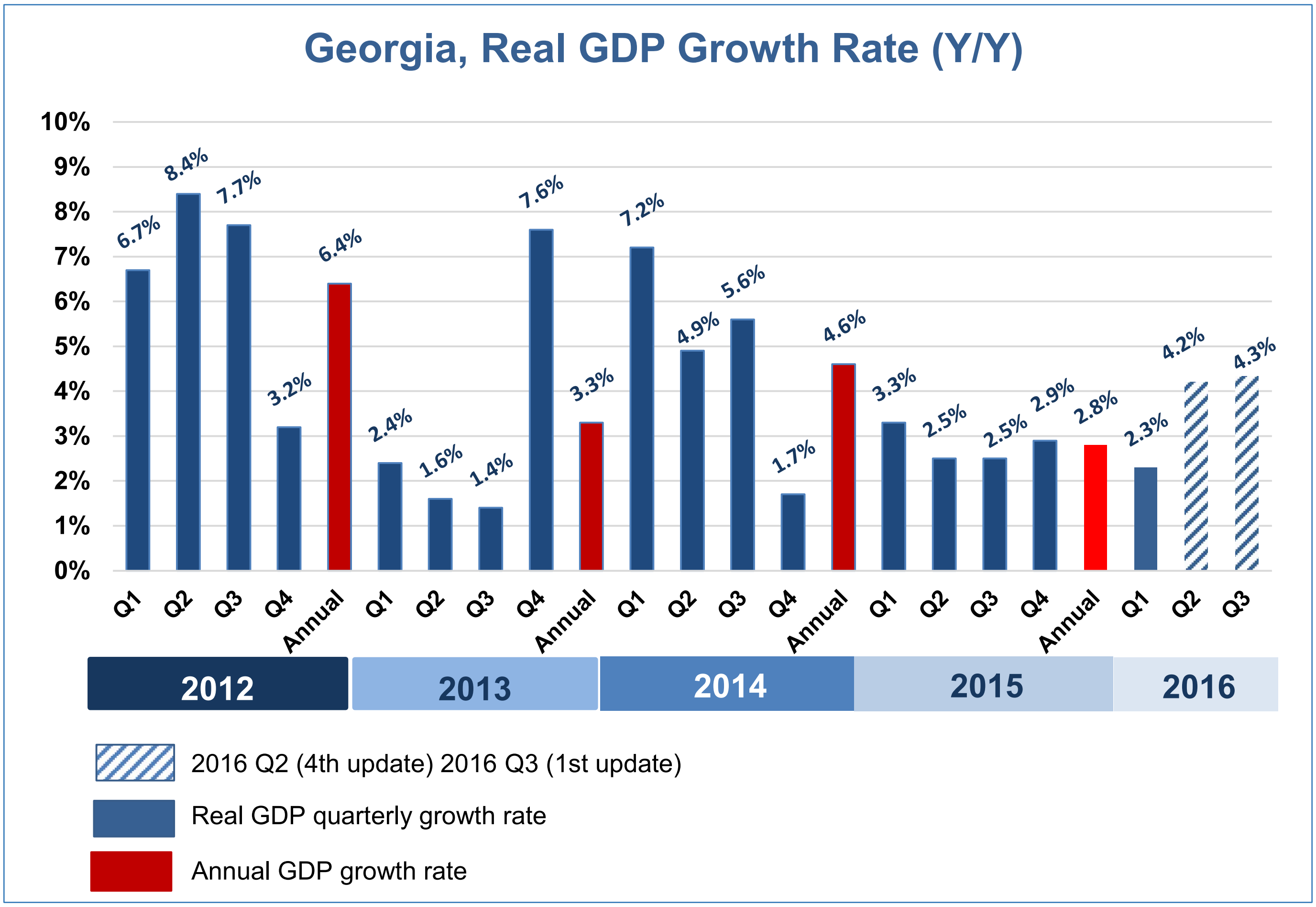
Economic data shows remarkable stability in March. The Annual GDP growth forecast for 2016 reaches 3.4 percent.

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

The growth forecast for the 2nd quarter of 2016 was revised downward from 5.0% to 4.2%. Our first prediction of GDP growth for the third quarter is 4.3%.

Meanwhile, Geostat has updated its GDP growth estimate for the first quarter of 2016. The Q1 growth rate stands at 2.3%, which is 0.6 percentage points below the forecast.

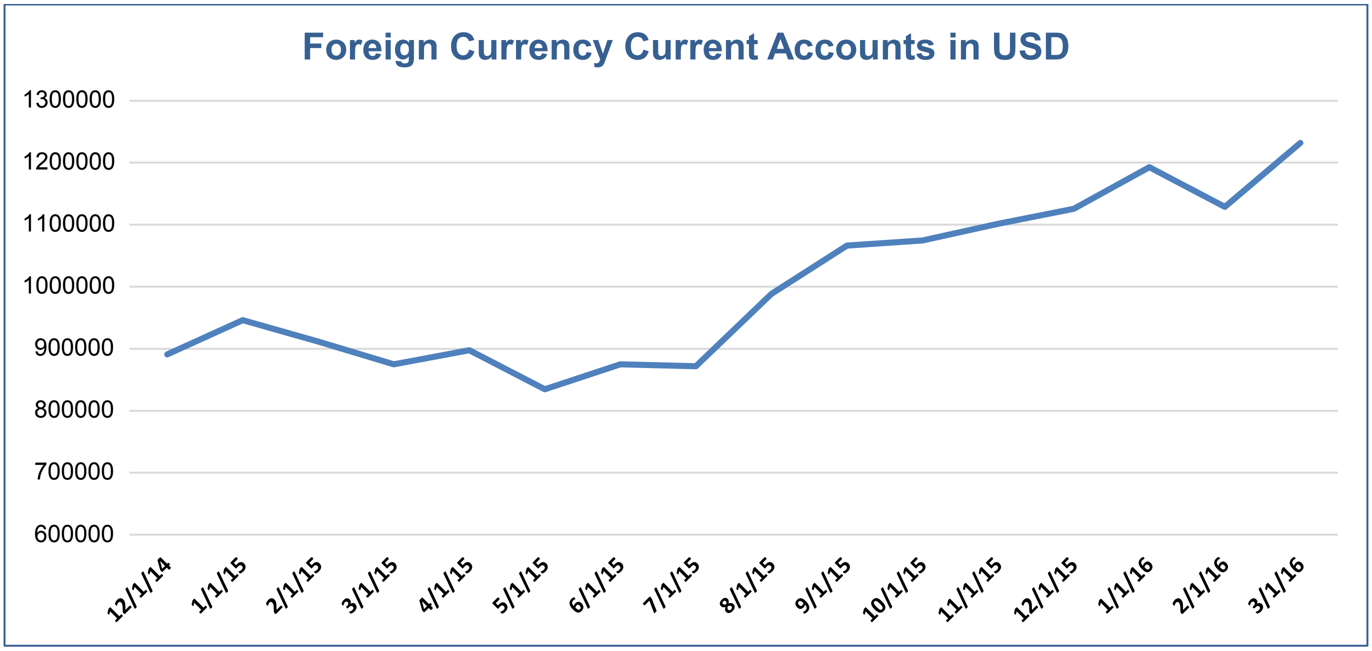
We started forecasting the annual growth rate at the beginning of 2014 (see our January 2014 and February 2014 publications for a note on methodology). Based on this month's data, we expect annual growth in 2016 to be 2.7% in the worst-case or "no growth" scenario, and 4.1% in the best-case or "average long-term growth" scenario. Our "middle-of-the-road" scenario (based on the average growth in the last four quarters) predicts a **3.4% real GDP increase in 2016.**



The latest 0.8 percentage point drop in the Q2 forecast seems surprising, as, when we look at our model's explanatory variables, the typical key drivers of the forecast (e.g. currency in circulation and other monetary indicators) exhibit remarkable stability. The only change was the arrival of new data from Geostat on the actual numbers behind the first quarter growth. Since these numbers turned out to be somewhat lower than expected, the downward revision of the subsequent forecast makes sense. However, most of the economic indicators in our model were unusually stable in March.

The only significant monthly changes were observed in current account-related variables. The **Interest Rate on Demand Deposits** in foreign currency decreased by 12% in monthly terms, while increasing by 32% for national currency deposits. For long term deposits, the trend looks similar, except that the magnitudes of the month to month changes were miniscule: interest rates on **Foreign Currency Time Deposits** decreased by 2% month on month (and by 13% annually), whereas interest on **National Currency Time Deposits** *increased* by 2% month on month (and by 29% in annual terms).

As discussed in our previous publications, the reason behind this phenomenon was that the depreciation of the Georgian lari in 2015 made people more cautious, and caused a "flight to safety" of the US dollar among Georgian depositors. The volume of **Foreign Currency Current Accounts** thus increased by 46% in annual terms. Part of this increase was certainly due to the lari devaluation (since the statistics are reported in lari terms). However, depreciation was not the only culprit. The graph below shows the lari values of foreign currency deposits converted into USD. It is clear that the volume of **Foreign Currency Current Accounts** started accelerating from August 2015. That month saw an unusual spike of the lari depreciation caused by temporary panic on the currency market. The exchange rate pressure has since subsided, but the trend towards the dollarization of deposits has clearly persisted.



Another variable that had a relatively high monthly decrease (10%) and exerted a very modest impact on the forecast was the **Producer Price Index in Textiles Manufacturing**. The reason behind this was the decrease of textile prices in Turkey – one of the main destination countries for Georgian textile exports.

The unusual stability in March was mainly observed in connection with **Currency in Circulation**-related variables. These explanatory variables are typically very volatile and sharp ups and downs are regularly observed, even in monthly terms. Taking them out of the model can significantly affect our GDP growth forecast. However, in March 2016 none of the variables in this group changed by more than 8% compared to the previous month.

From September, we started to include the **Metals Price Index (PMETA)** and the **Agricultural Raw Materials Index (PRAWM**) as explanatory variables in our forecast. The reason for adding these series was that metals form a significant share of Georgia's exports, while food is one of the main import items. Therefore, a global increase in the price of metals should help the Georgian economy, while an increase in the price of agricultural produce is more likely to hurt it. In March, metal and agriculture prices both decreased by 21% and 14% respectively in annual terms. As was the case with other variables this month, the addition of these series turned out to have a very small (but overall positive) effect on our prediction for the GDP growth of the second and third quarters, increasing both by less than 0.01%.

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.