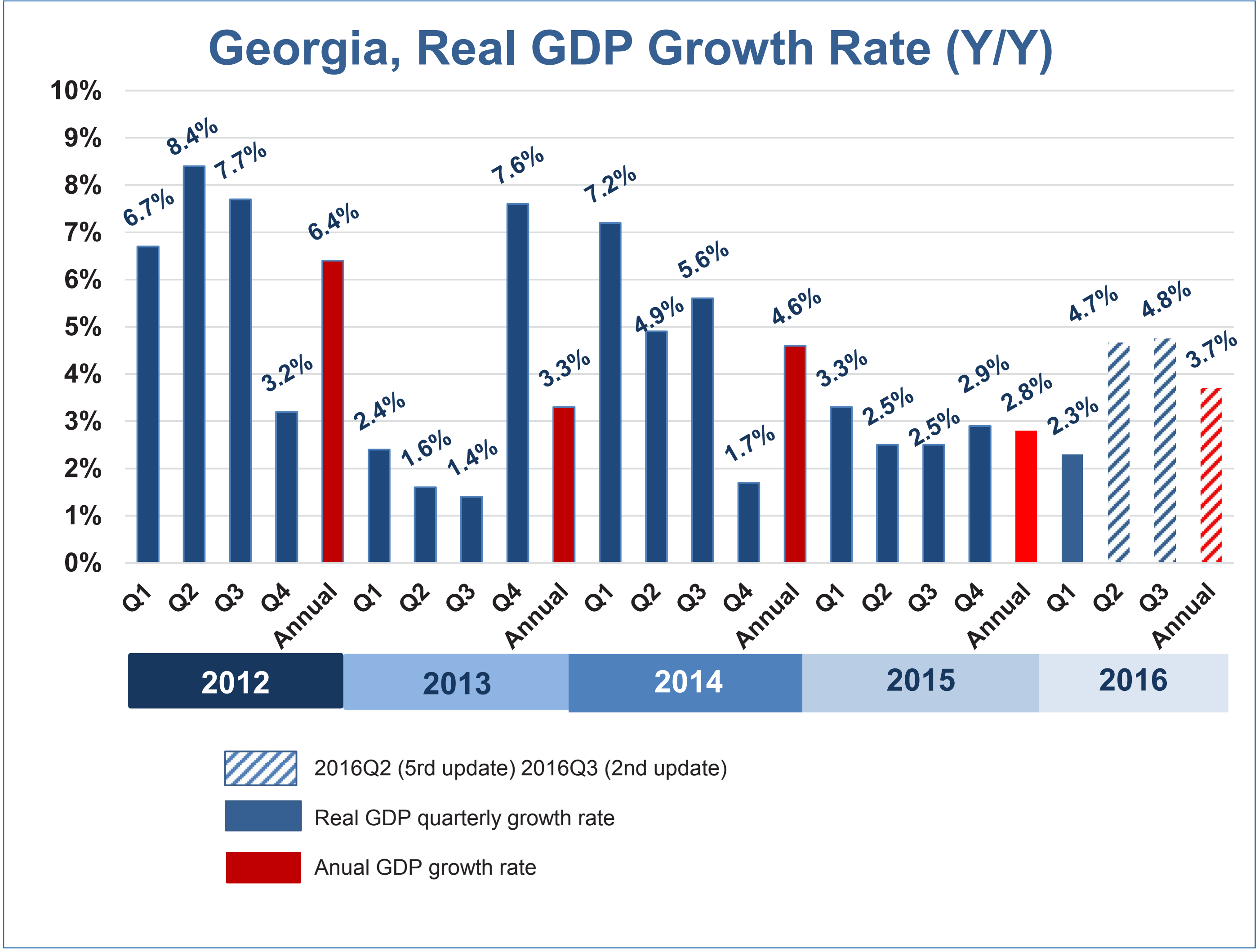
Growth forecast edges upward following revised Q1 statistics from Geostat

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 release:

- The growth forecast for the 2nd and 3rd quarters of 2016 were revised upward by 0.5%. They now stand at 4.7% and 4.8% respectively.
- Based on the available data, **we expect annual growth in 2016 to be 3.7%**. This is our "middle-of-the-road" scenario (based on the average growth in the last four quarters). Annual real GDP growth is predicted to be 2.9% in the worst-case or "no growth" scenario, and 4.4% in the best-case or "average long-term growth" scenario (see our January 2014 and February 2014 publications for a note on methodology).



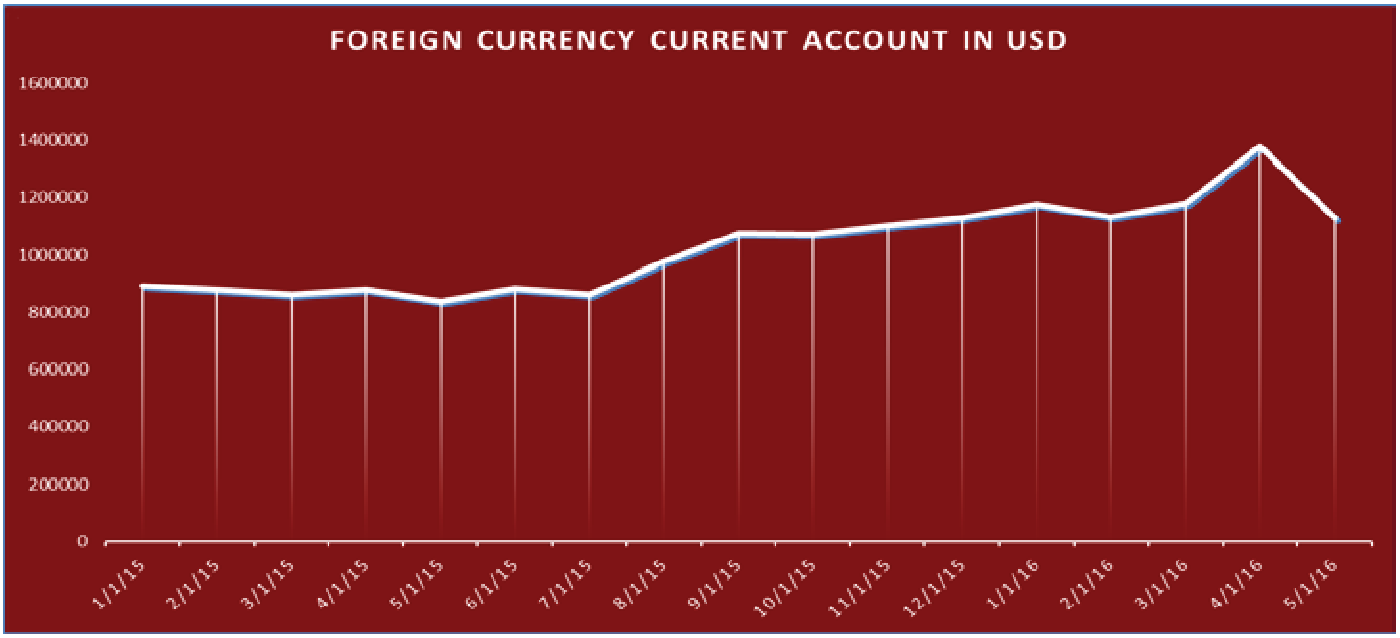
The latest 0.5% increase of the 2nd and 3rd quarter forecasts may seem surprising as the explanatory variables of the model exhibited only moderate changes. However, **the main driver of the upward revision was the final update of** Geostat's Q1 growth rate , which now stands at 2.6% – 0.3% above the previously estimated value. The final revision was based on new statistical information about the components of the Gross Domestic Product.

Despite the remarkable stability of the explanatory variables, some sets of variables experienced significant monthly and yearly changes. One group that changed considerably in May was the **Volume of the National Currency Deposits** of Enterprises and Households in Commercial Banks.

The National Currency Current Account increased by 6% and 4% in monthly and yearly terms respectively. Moreover, a sizeable annual **increase** was observable on **Demand Deposits and Long-term Time Deposits** (rising by 28% and 46% respectively). At the same time, the volume of **Short-term Time Deposits declined** by over fifty percent in annual terms.

The **Foreign Currency Current Account (FCCA)** was another variable that saw sizeable movements in May. The FCCA declined by 21% in monthly terms, but increased by 25% annually.

As mentioned in earlier publications, these sets of variables are denominated in the national currency and the change might thus be driven by the appreciation of the lari in May. Therefore, in order to determine the "real" change, we convert the FCCA into dollar terms (see the graph below). Doing so shows that the FCCA denominated in dollar terms **decreased by 18% in monthly terms, but increased by 34% annually**. Judging by the month-to-month changes, the appetite of depositors for foreign-currency denominated deposits seems to have subsided.



The set of variables that had a **significant positive effect on our forecast** related to **currency in circulation**. In the corresponding month, the National Bank of Georgia (NBG) increased the money supply by adopting an **expansionary monetary policy**. In May alone, the NBG purchased 140 million USD in six separate auctions. These operations were aimed at building foreign currency reserves (official reserves increased by 11% in monthly and by 19% in yearly terms) and avoiding a sharp appreciation of the domestic currency. Furthermore, the Monetary Policy Committee (MPC) of the National Bank of Georgia met on 27 April and decided to **reduce the refinancing rate by 0.5 percentage points to 7.5%**, which further stimulated the money supply in the economy. As a consequence, all monetary aggregates aside from broad money (M3) increased in monthly terms. In addition, currency in circulation declined by less than 1% in both monthly and yearly terms.

Certain changes had a negative effect on the forecast. In particular, **the lari appreciation** against all foreign currencies pulled the forecast downward. The most significant appreciations were observable with respect to the Russian ruble (6% in monthly and 26% in annual terms) and the Turkish lira (8% in monthly and 16% in yearly terms). In addition, the **Real Effective Exchange Rate** appreciated by 3% relative to the previous month and by 16% relative to the same month in the previous year. Appreciation is typically associated with the loss of competitiveness of local products on foreign markets - hence, the negative effect these variables had on the GDP growth forecast.

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.