

# Leading GDP Indicator Forecast for Georgia

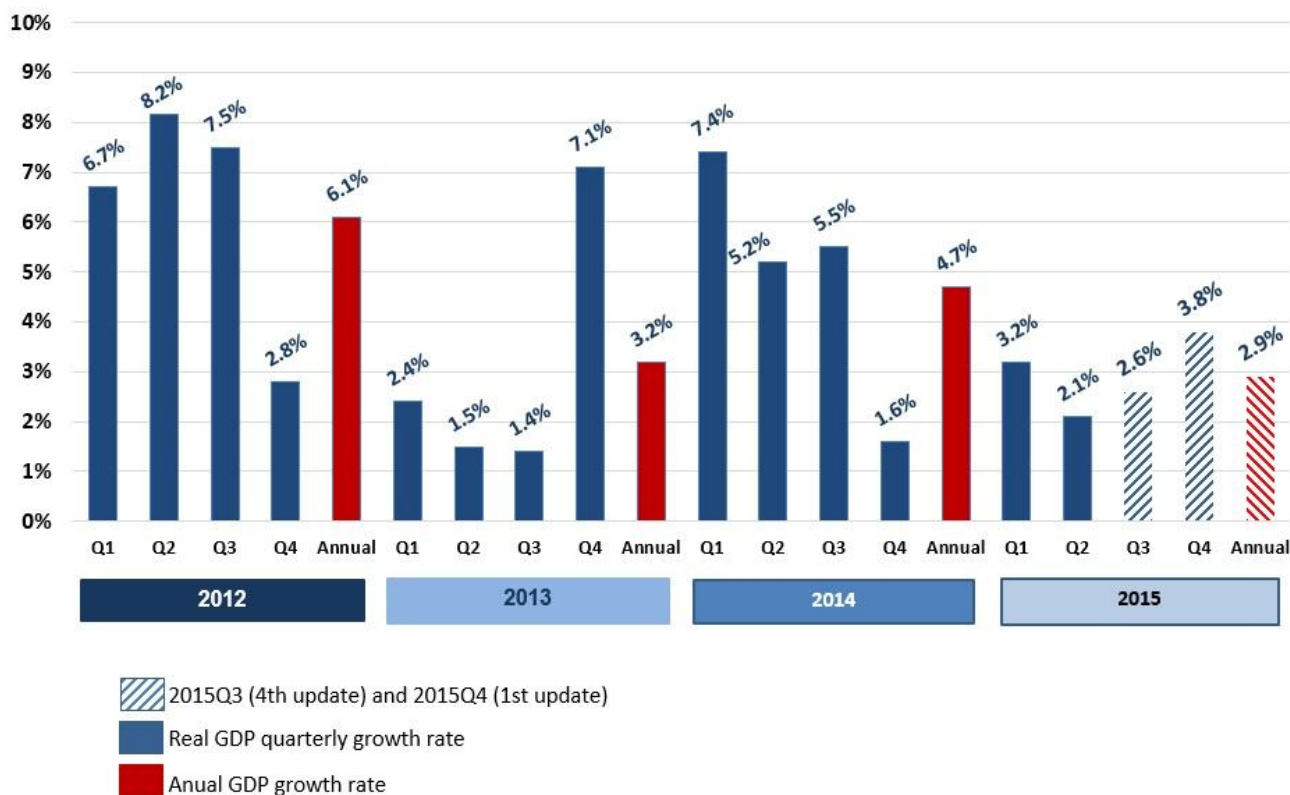
October, 2015

## Deposit dollarization dampens growth forecast

ISET-PI has updated its forecasts for Georgia's real GDP growth rates using the August 2015 releases of various economic indicators.

- The final growth forecast for the third quarter of 2015 has not changed significantly since last month (declining by only 0.02%) and remains at 2.6%.
- Similarly, the second growth forecast for the fourth quarter of 2015 is still 3.8%.
- Based on our forecast, the annual growth for 2015 is expected to be 2.9%.

### Georgia, Real GDP Growth Rate (Y/Y)



This month's growth forecast reflects the largely stable trends in our model's explanatory variables. However, a few changes were noteworthy.

- Inflation, as measured by monthly CPI change and the change in ISET's Khachapuri Index, increased moderately in annual terms by 5% and 7% respectively.
- The volume of foreign currency deposits in commercial banks increased quite significantly. For deposits of less than 3 months maturity, the increase amounted to 110% annually. This was mostly related to the "flight towards the dollar" among Georgian depositors that followed the sharp lari depreciation in 2015.
- Money inflows from abroad continued to decline in August. The decline amounted to 35% annually and 7% compared to July.
- Energy prices were also on the decline, with the Brent Spot Price FOB (dollars per barrel) dipping in monthly and annual terms by 18% and 54% respectively.

For the most part, these changes had little bearing on the GDP forecast, except for the variables related to dollarization of deposits. The overall deposit dollarization ratio increased by 15% annually. In August 2015, 65.4% of all deposits were dollarized, compared to only 57.1% in August 2014. Had it not been for these changes, the current growth forecast would have been higher. Dollarization **negatively** affects the economy, primarily by reducing the power of monetary policy tools.

Another set of indicators which negatively affected the forecast were related to nominal money balances. According to the August data, commercial banks' stock of required reserves increased by 6% in monthly and by 47% in annual terms. This increase is driven by the increase in dollar liabilities of the commercial banks, which typically carry higher reserve requirements than the liabilities denominated in national currency.

Some sets of indicators had a small but **positive effect** on our third quarter GDP growth forecast. In particular, the lari's real exchange rate depreciated against dollar and the euro by 2% and 3% in monthly, and by 22% and 6% in annual terms, respectively. Georgia's real exchange rate only appreciated against the Russian ruble, by 12% in monthly and 23% in annual terms.

These results are generally consistent with theory: real lari depreciation lowers the relative prices of domestic goods and increases the competitiveness of Georgian products, thus positively affecting economic growth. As the lari only appreciated against the ruble, and as Russia's share in Georgian exports in August was only 6.8% (while the share of exports to EU countries was more than 38%), the overall effect of the real effective exchange rate on economic growth was positive.

Although the appreciation of the lari against the ruble certainly created problems for the Georgian economy, especially for the wine sector (since last year Russia became one of the main importers of Georgian wine), in the larger scheme of things wine constitutes less than 4% of

overall exports, which explains why appreciation against the ruble did not tip the balance in the growth forecast.

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 rationale for adding these series was that metals (copper and manganese) form a significant share of Georgia's exports, while food is one of the main import items. In theory, 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 October, metal prices decreased by 6% in monthly terms and by 19% in yearly terms. Meanwhile, agricultural prices decreased by 3% in monthly and by 36% in yearly terms.

The addition of these series into the model turned out to have a very small (but overall positive) effect on our prediction for the third and fourth quarters, with the growth forecast increasing by 0.01% and 0.02% respectively.

Our forecasting model is based on the Leading Economic Indicator (LEI) methodology developed by the [New Economic School](#), Moscow, Russia.<sup>2</sup> 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.