

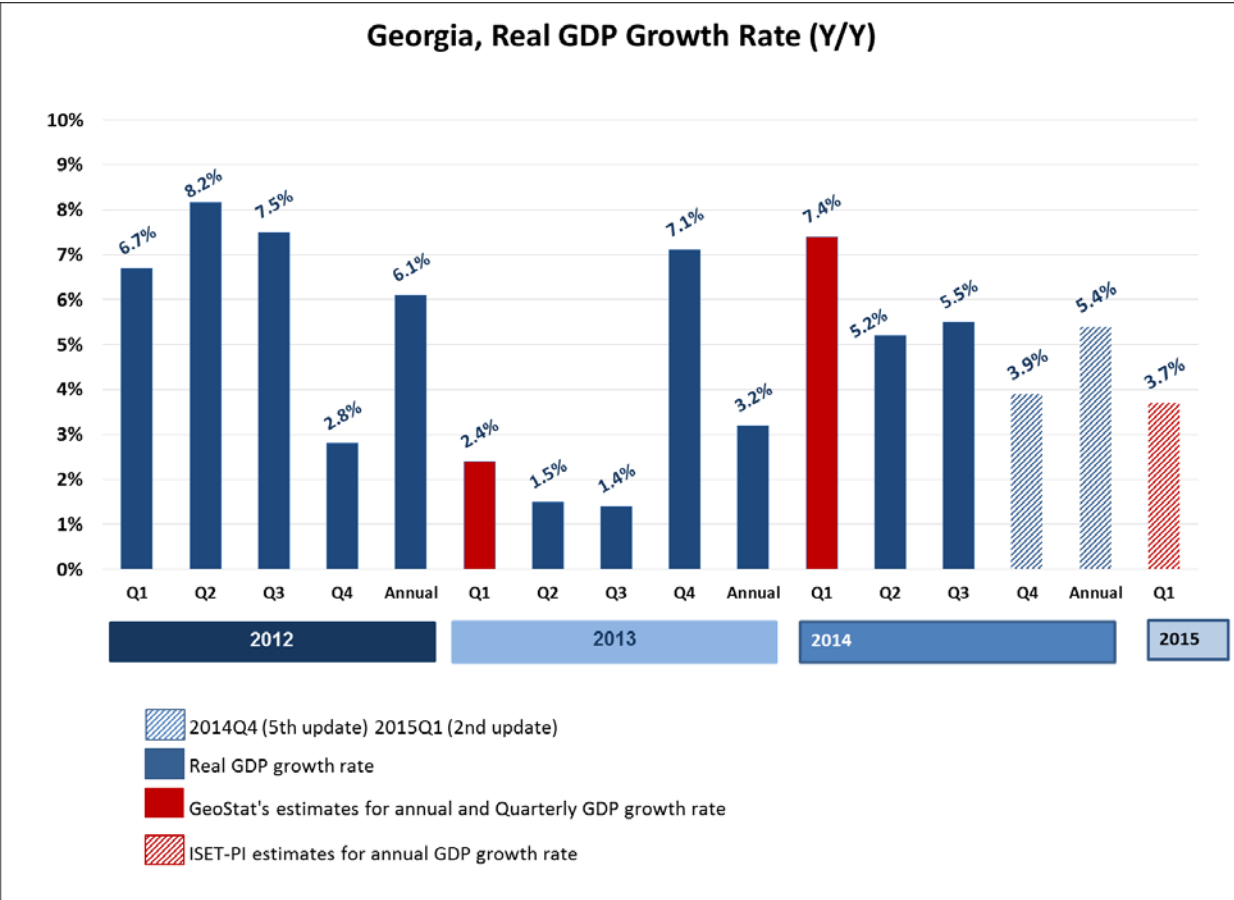
Leading GDP Indicator Forecast for Georgia

January, 2015

High hopes for robust growth continue despite a difficult November.

ISET-PI has updated its forecasts for Georgia's real GDP growth rates using the November 2014 releases of various economic indicators.

- Based on the November data, the growth forecast for the last quarter of 2014 was revised upward from 3.6% to 3.9%.
- The second forecast for the first quarter of 2015 increased from the initial 3.2% to 3.7%.
- For the first time since June 2013, Geostat's "rapid estimate" of monthly growth is negative, with GDP growth for November estimated at -0.5%.
- We started drawing conclusions about the annual growth rate for 2014 at the beginning of the year. Using official Geostat quarterly growth estimates (when available), we arrive at a 5.4% GDP growth forecast for 2014. If we instead use the predictions generated by our model, namely the 5th vintages of growth forecasts for each quarter, then the annual growth prediction for 2014 falls to 5.1%. At the same time, the Georgian government's official forecast is 5% economic growth for 2014.



Although the calendar year 2014 is over, from the perspective of data availability, the year will not be “officially over” until a month’s time, when the data for December is released. Until then, we continue to forecast the growth rate for the last quarter of the year.

November 2014 was a difficult month, not only for Georgia, but for the entire region and many former Soviet bloc countries, most notably Russia and Ukraine. November was also marked by a slowdown of growth in many of the OECD economies. For Georgia, however, the negative preliminary growth estimate for November can also be attributed, at least in part, to the high base level of GDP in November 2013.

Despite a difficult November, the growth forecasts for the last quarter of 2014 and the first quarter of 2015 were both revised slightly upward. This may be driven by the fact that the existing data has not yet incorporated all of the shocks that have recently affected the economy – in particular the strong headwinds coming from Georgia’s main trading partner countries. Given the strong downside economic pressures affecting the wider region, including both

OECD countries and developed Europe, the annual growth forecast of more than 5% and the quarterly forecast of nearly 4% can still be considered a very good outcome for the country.

Below we analyze some of the factors that influenced the dynamics of our forecast between October and November.

To begin with, positive signals were coming from the economically-important energy sector. Electricity generation increased in both month-on-month and year-on-year terms. In comparison to November 2013, electricity generation increased by 9.5% and by 8.9% compared to October 2014. Fortunately, this increase was mainly due to an increase in cheaper hydropower generation and not to the more expensive thermopower. Despite the increase in electricity generation, net exports of electricity actually declined, mainly because of the unusual increase in electricity consumption in November (which was up by 12% compared to last year).

One of the significant factors for the Georgian economy in November was the appreciation of the US dollar against the lari. The depreciation of a national currency normally positively affects a country's trade balance and GDP. However, the dollar not only appreciated against the lari, but also against currencies of Georgia's important trading partners. Turkey, Armenia and Russia were each affected by the dollar appreciation to an ever greater extent. The ongoing conflict in Ukraine and sanctions against Russia, coupled with low oil prices, put pressure on both of these countries' currencies against the dollar. Georgian goods thus became relatively more expensive in both Russia and Ukraine. Overall, the Georgian lari slightly appreciated in real terms relative to partner countries' currencies, preventing Georgia from reaping the fruits of the nominal depreciation against the dollar. As a result, exports in November decreased in both month-on-month and year-on-year terms, by 25% and 35% respectively. Imports declined as well, by about 7% in comparison to both October 2014 and November 2013. The trade balance deteriorated, and net imports increased by 2.5% and 11.5% in m-o-m and y-o-y terms respectively. The overall effect of trade dynamics on GDP growth were slightly negative in November. Since the exchange rate fluctuations continued in December and their effect might be lagged, we should expect a stronger impact in the December data.

In order to better understand the reasons for the upward revision of the fourth quarter growth forecast, we analyzed the changes in variables as well as the effects of different variable groups on the overall growth forecast. We found that a number of variables had a small but positive effect on growth. Among these were those related to money aggregates, including the

growth in bank deposits in both foreign and national currencies, as well as a year-on-year increase in the currency in circulation. The variable groups which negatively affect growth rates were mainly related to exchange rates. For example, the appreciation of real effective exchange rates against partner countries' currencies had a negative impact on the forecast. Another relatively strong negative effect was driven by the decline in the Official Reserve Assets of the Central Bank, which decreased by 2% in monthly terms and by 14% in yearly terms. An increase in the average maturity of bank loans also had a negative impact on our forecast.

At the same time, the cost of living, measured by the Consumer Price Index (CPI) and the [Khachapuri Index](#) slightly decreased between October and November. The CPI in particular increased relatively little in annual terms, by 2.8%, and fell by 1.4% in monthly terms. This had a negative impact on the forecast, as the lowering of prices is usually associated with sluggish demand conditions - at both home and abroad.

Overall, the slight increase in forecasted growth rates did little to mask the growing headwind pressures facing the Georgian economy in November.

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