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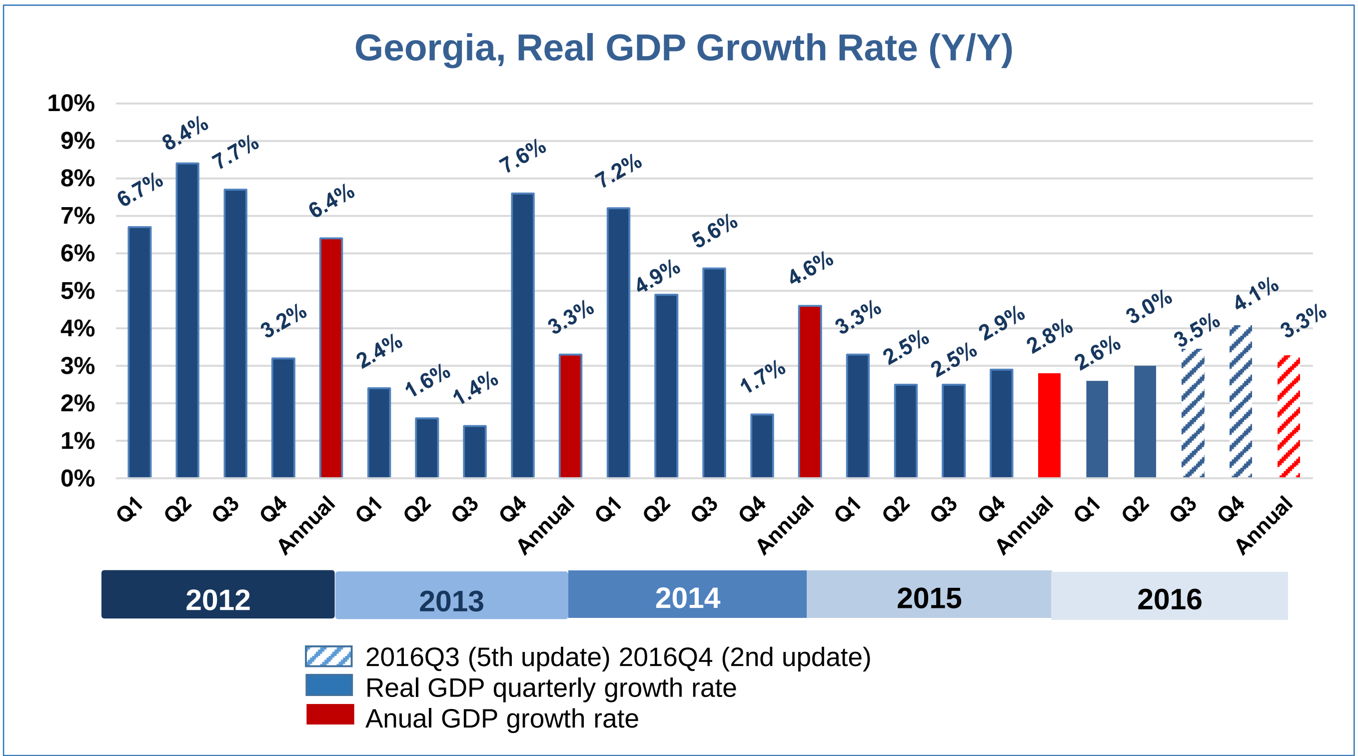
Expansionary monetary policy stimulates economic growth, while negative external shocks continue to impede economic activities.

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 release:

- The growth projections for the 3rd and 4th quarters of 2016 were revised downward by less than 0.1%. They now stand at 3.45% and 4.08% respectively.[1]



- Based on the latest data, we expect **annual growth in 2016** to be 3.3%. This is just 0.1% below the recently released annual economic growth projections of the International Monetary Fund (IMF) and 0.2% lower than the annual forecast of the National Bank of Georgia.

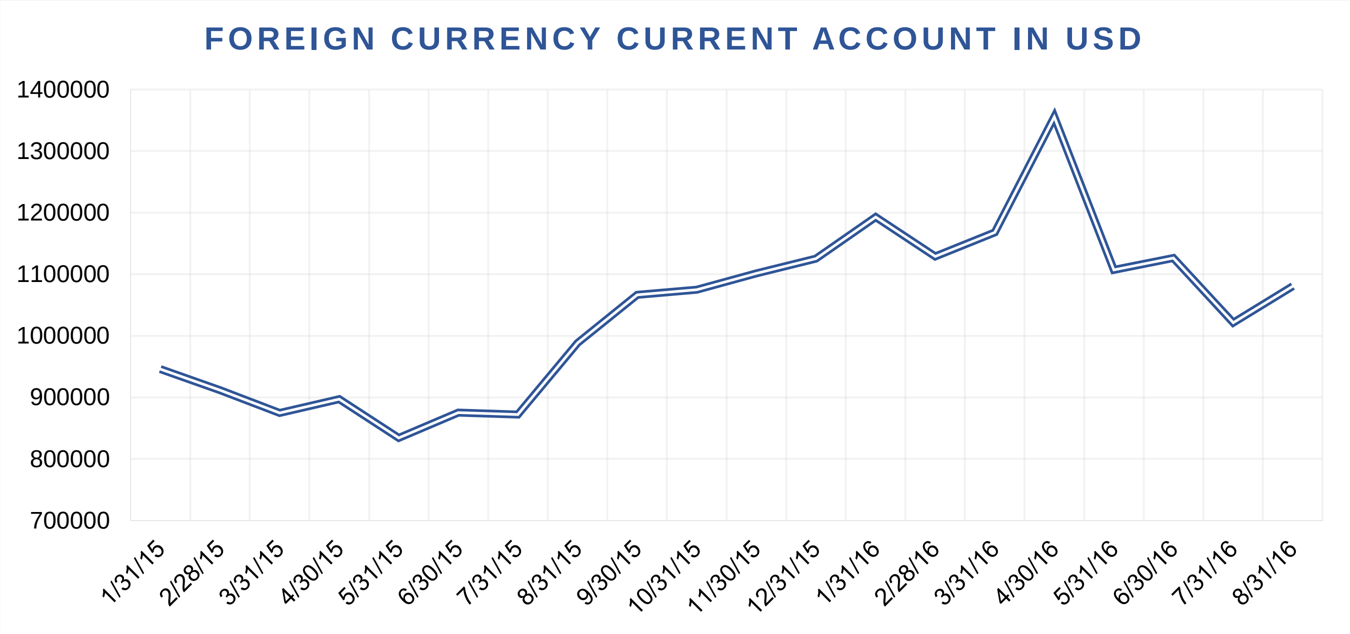
As one would expect, the traditionally calm month of August had only a very slight effect on our forecast for the third and the fourth quarters. Our model's Q3 and Q4 growth projections were reduced by just 0.059 and 0.06 percentage points respectively. The changes were mainly driven by a few core explanatory variables that experienced significant monthly and yearly changes. Expansionary monetary policy and pre-election spending continued to stimulate economic growth, while negative external shocks and a deteriorating trade balance significantly impeded economic activities.

One group of variables that experienced remarkable monthly and yearly changes and had a significant positive contribution to the Q3 and Q4 forecast was the **Volume of Foreign Currency Deposits** in commercial banks. In particular, *Foreign Currency Demand Deposits* increased by 22% relative to the same month of the previous year. Longer-term *Foreign Currency Time Deposits* increased modestly, by 8%, in annual terms.

[1] The recently released Rapid Growth Estimates (RGE) for Georgia put the estimated real GDP growth for the 3rd quarter at 2.2%. This is 1.3 percentage points lower than our model's forecast. The difference is likely to be due to a combination of factors: first, the slight upward bias of our model in the quarterly forecasts may play a role; secondly, tourism and services data is not part of the RGE estimate, while GDP growth in September may be rather heavily influenced by the high increase in tourism numbers in 2016.

The way to capture the real trend of the Foreign Currency Current Account (FCCA) is to disregard the exchange rate effect by denominating the variable in USD (see the graph below). Doing so shows that although the FCCA has gradually been falling from the peak observed in April 2016, it has still increased by 9.31% compared to the same month of the previous year. Overall, the increasing trend of the Volume of Foreign Currency Deposits indicates more savings in the economy, which in turn stimulates growth.

In addition, demand deposits in domestic currency have increased quite significantly. In particular, *National Currency Demand Deposits* and long-term *National Currency Time Deposits* increased in yearly terms by 38% and 29%, respectively. The overall contribution of Domestic Currency Deposits to real GDP growth in our model was small, but positive.



The dollarization trend, which has plagued the Georgian economy ever since the lari devaluation in 2015, appears to have stabilized. In August, the Dollarization index increased by only 0.4% in monthly and by 2% in yearly terms.

Another set of indicators that experienced significant changes in August relate to **monetary aggregates**. The National Bank of Georgia has continued to pursue a cautious expansionary policy, and Money Outside Banks (M0) has grown in both monthly and yearly terms, by 4% and 9% respectively. Broad Money (M3) did not change much in monthly terms, but showed an annual increase of 10% relative to August 2015.

According to our model, the set of variables related to monetary aggregates had an overall negative contribution to Q3 real growth, but a positive effect on Q4 projections. The result for Q3 might appear somewhat surprising as monetary expansion should typically boost growth, as increased money supply causes a reduction in interest rates and boosts aggregate demand. The explanation for this is tied to the issue of reverse causality. Low economic growth creates incentives for government authorities to stimulate economic activities through expansionary monetary policy. The model might thus be picking up the correlation between low growth and the subsequent expansionary policy of the National Bank.

The Real Effective Exchange Rate (REER) appreciated by 1% relative to July, and by 4% relative to the same month of the previous year. Appreciation of the REER is associated with the loss of competitiveness of local production in foreign markets. On the positive side, the lari real exchange rate depreciated with respect to the national currencies of two major trading partners – Turkey and Russia. The GEL/TRY and GEL/RUB real exchange rates depreciated by 3% and 6% respectively compared to the same month of the previous year. Furthermore, the lari real exchange rate experienced a very minor depreciation with respect to the US dollar and the euro (0.09% and 0.006% respectively, in annual terms). Overall, REER-related variables had a small positive contribution to the Q3 and Q4 real GDP growth projections.

While the increase in savings, expansionary monetary and fiscal policy stance, and increased business confidence all stimulate economic activities in Georgia, **external shocks** remain one of the most important factors hindering rapid real GDP growth.

In August, exports increased by 10% relative to the previous month, but it seems that this was mainly driven by seasonality, as the annual increase amounted to only 0.1%. On the other hand, imports increased by 2% and 10% in monthly and yearly terms respectively. Overall**, the increase in the trade deficit had a significant negative** contribution to the real 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.