

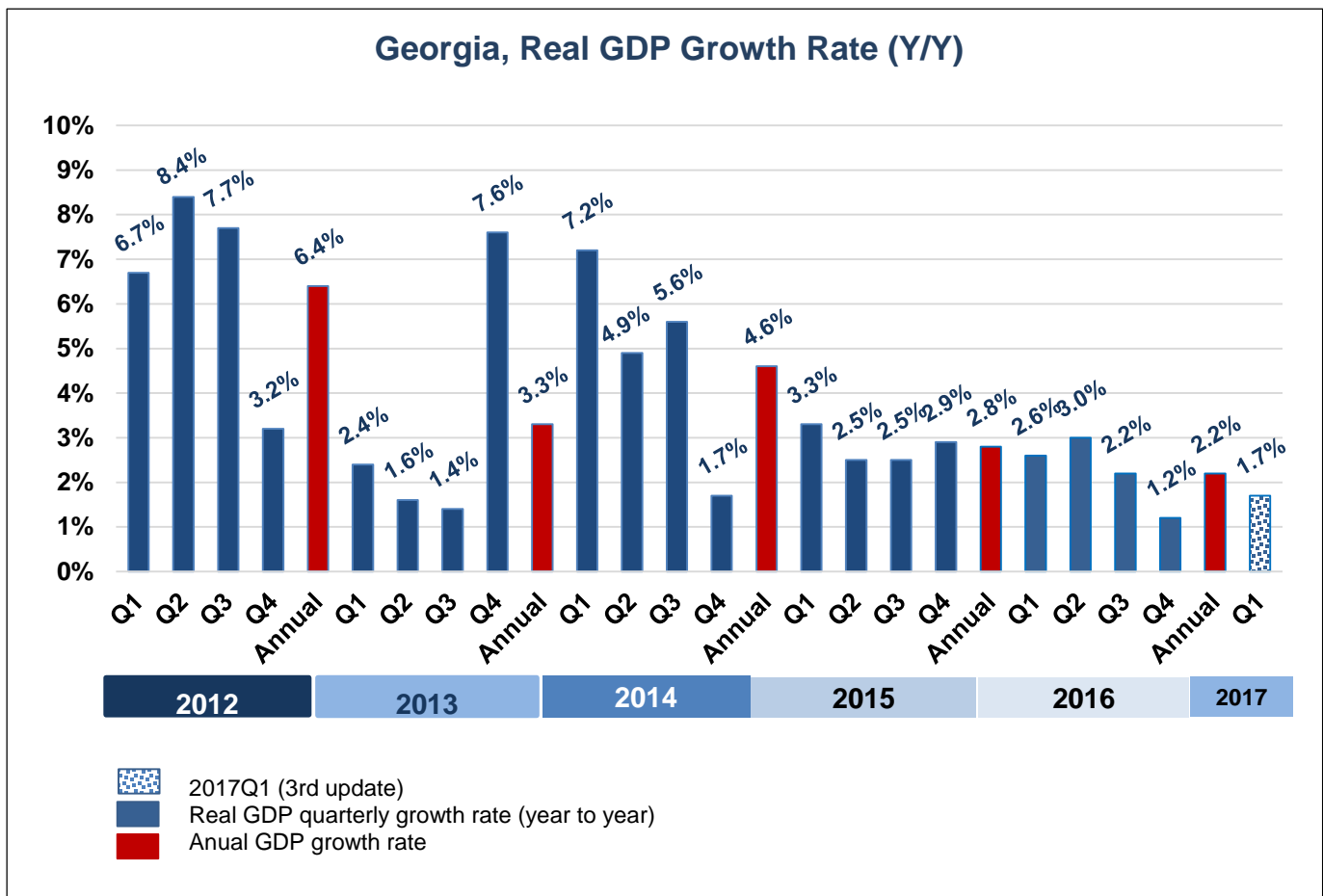


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## A disappointing last quarter of 2016 drives grimmer growth predictions

ISSET-PI has updated its forecast of Georgia's real GDP growth rate for the first and second quarters of 2017. Here are the highlights of this month's release:

- ISSET-PI's forecast of the real GDP growth for the first quarter of 2017 now stands at 1.7% - down from 3.5% in January.
- We started forecasting the annual growth rate at the start 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 2017 to be 2.5% in the worst-case or "no growth" scenario, and 3.4% 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 2.7% real GDP growth in 2017.** However, based on the evidence so far, even the best-case scenario of the GDP forecast is significantly lower than the government's growth predictions (4% annual growth in 2017).





According to the ISET-PI's recent forecast, GDP growth for the first quarter of 2017 was downgraded from 3.5% to 1.7%. This correction can be explained by the fact that it is the first time when our model has taken into consideration the rapid estimate of the Q4 GDP growth. As it was already mentioned in our previous publication, **estimated real GDP growth in the fourth quarter of 2016 amounted only 1.2%, far below our predicted 2.9%.**

Otherwise, looking at the economic landscape from the standpoint of the December data, several variables changed significantly and effected growth predictions in different ways. Increased money supply and slightly improved external statistics are main contributors for the GDP growth, while depreciated domestic currency (especially depreciation of the Real Effective Exchange Rate) had negative effect on the growth predictions.

The first important group of variables that experienced some changes in December were Deposits in National and Foreign currencies with different maturities. For instance, Current Account (CA) and Demand Deposits in the national currency experienced significant yearly increase (15% and 22% respectively), while the Time Deposits with 3 months and 12 months maturities reduced substantially by 11% and 29% respectively compared to the same month of the previous year. As a result, Total Deposits in the National Currency increased by 9% in year on year bases.

In contrast to domestic currency deposits, all types of the Foreign Currency Deposits increased by more than 10% compared to the same month of the previous year. When we take into consideration exchange rate effect, changes become relatively moderate, but increasing trend is still maintained. As a result, deposit dollarization<sup>1</sup> increased by 3% in yearly terms and amounted to 71.4.

### **Increasing money supply drives the forecast up, while real depreciation hurts growth**

One more group of variables that significantly and positively influenced model's predictions is monetary aggregates. All the monetary aggregates including the most important ones (Currency in Circulation, Narrow Money (M1) and Broad Money (M3)) increased by more than 10% yearly in December. In theory, an increase in the money supply should lower interest rates and stimulate GDP growth. Thus, our model's outcome conforms to the theory.

The other set of variables that had a positive effect on the predicted GDP growth were those related to the external sector. December was the fourth consecutive month in which annual export statistics increased. Exports increased by 5% yearly. The main contributor was the rise in the exports of Ferroalloys (75% yoy), motor cars (19% yoy), wine (10% yoy) and Manganese ores and concentrates (8030%). However, reductions in other basic components of export, like the Copper ores and concentrates (-11% yoy), nuts (-8% yoy), mineral water (-22% yoy) and citrus (-45% yoy), dampened the export statistics.

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<sup>1</sup> Deposit dollarization is computed as a share of the foreign currency deposits in total deposits.

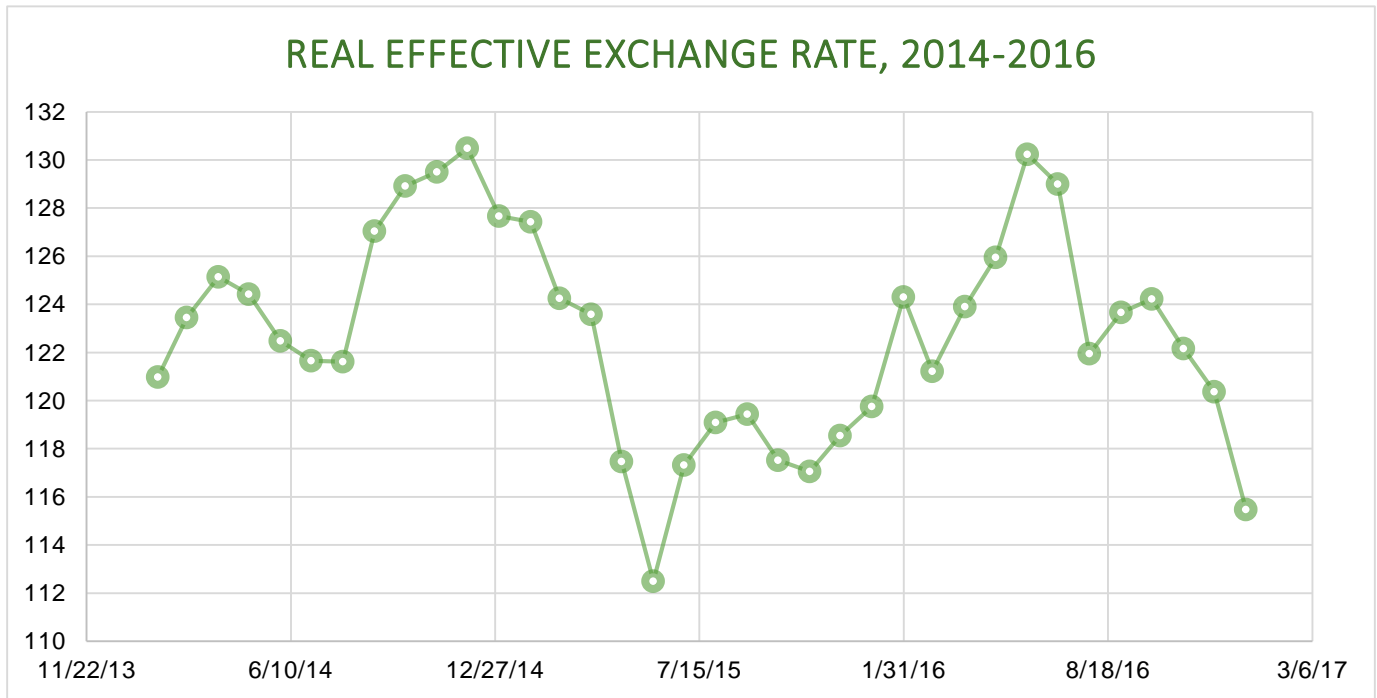


Georgian imports experience a 2% increase, while trade deficit deepens with only 0.8%. Despite the fact that an increase in imports was relatively moderate, import of some categories like oil and motor cars increased significantly in yearly terms. This phenomenon can be explained by the fact that under expected increase of the excise tax (expected increase in costs for importers), importer companies started to buy these goods in advance.

Furthermore, it is worth noting that increased Money Inflows from abroad positively affected growth predictions. In December, remittances increased by 17% yearly. This change affected people's disposable income, consumption and the real GDP growth.

Finally, the depreciation of the Real Effective Exchange Rate (REER) dampened our growth forecast. In theory, the impact of the REER on the real GDP growth is ambiguous. There are two possible channels through which REER affects the economy: the aggregate demand and supply. On the demand side, REER depreciation makes domestic products cheaper abroad, rises competitiveness of the domestic production, increases export (foreign demand) and positively affects the real GDP growth. On the other hand, REER depreciation also increases the costs of imported raw materials that further increases prices and affects growth negatively (Aggregate Supply effect).

In Georgia, Real Effective Exchange Rate depreciated in December by 4% both in monthly and yearly terms (see the graph below).



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.