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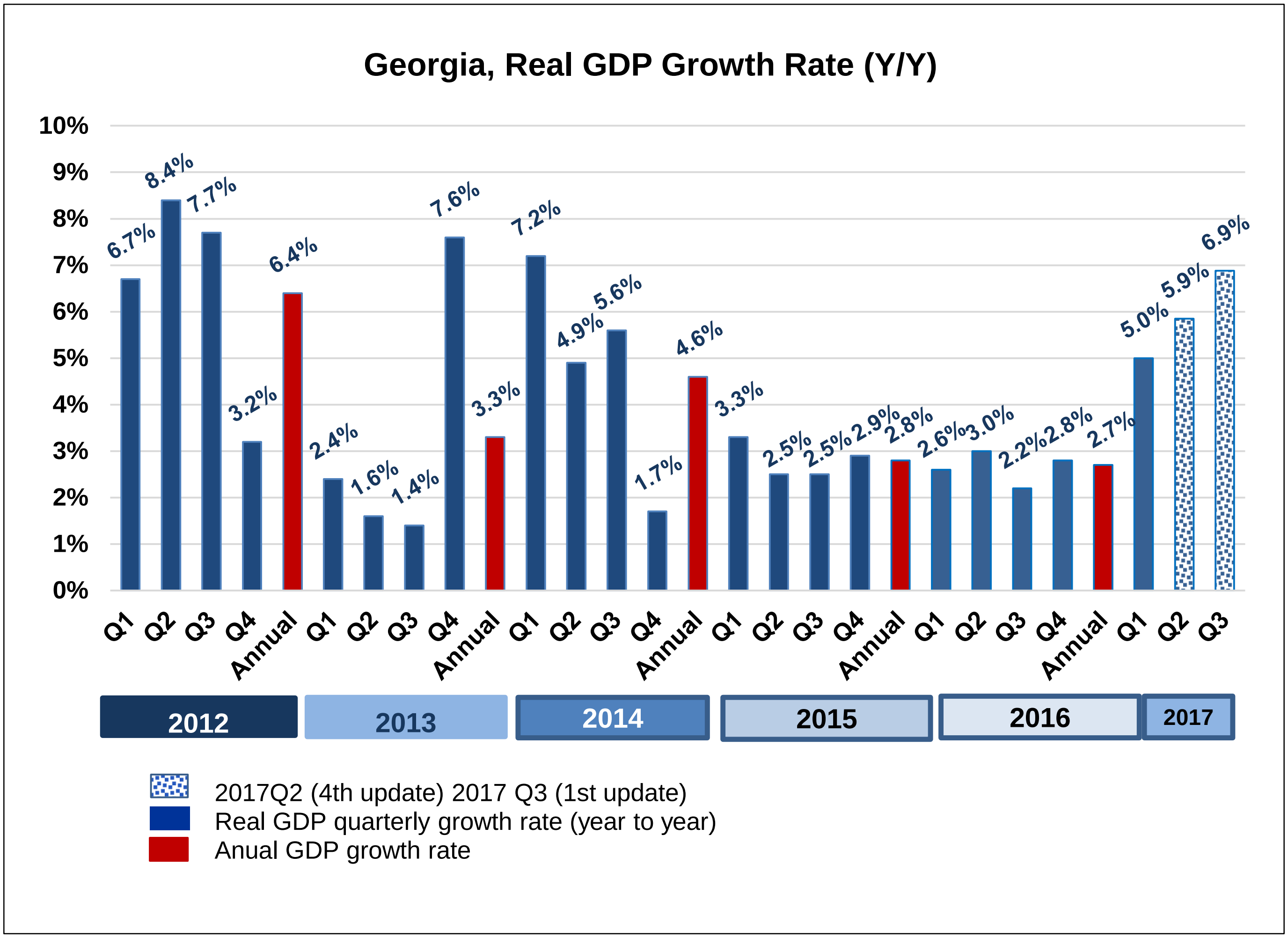
Regional Recovery Data Drives Optimistic Growth Projections for Georgia.

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

- Geostat has released its GDP growth estimate for the first quarter of 2017. The Q1 growth rate now stands at 5.1%, which is 1.6% above the ISET-PI's last forecasted value. Moreover, the average growth rate for the first five month of the year amounted to the 4.5%.
- ISET-PI's forecast of the real GDP growth for the second quarter of 2017 stands at 5.8% - up from 4.4%. The first estimate of the third quarter growth forecast is at 6.9%.
- 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 the January's data, we expect the annual growth in 2017 to be 6.2% in the worst-case or "no growth" scenario, and 6.6% 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 6.3% real GDP growth. It is notable that Georgian government's target of the real GDP growth (4%) does not seem to be an overambitious, as it can be reached even in the worst case scenario.

Growth picks up in the region, lifting Georgia's economy in Q1

According to the rapid estimate of economic growth released by Geostat, Georgian GDP in Q1 of 2017 grew by 5.1% yoy - the highest growth rate since Q3 2014. Moreover, relatively improved growth statistics raises optimistic expectations that Georgia started to recover from the growth slowdown caused by the recent regional currency crisis. The main reason behind this spectacular number is the **genuine improvement in the economic situation in the region**, which has resulted in increased exports, FDI, remittances, and tourism.

All the neighboring countries saw their growth statistics pick up in the first quarter of 2017. Even the Russian economy showed positive growth figures for the first time after a seven-quarter recession. Azerbaijan continued its slow path to recovery over the first five months of the year, but it is struggling to deal with the legacy of the last year's recession. Azerbaijan's GDP contracted by only 0.9% in the January-May period, while non-oil GDP growth continued to accelerate fueled by healthy industrial production growth. Armenia has become a leader of the region in terms of real GDP growth. It is notable that Armenian GDP grew by the unexpectedly high 6.5% in the first quarter of 2017 (the government targeted only 3.2% by the beginning of this year).

In April, the real GDP growth rate fell sharply to 2.1% yoy in Georgia, somewhat dampening hopes for swift growth in 2017. This pattern was shared by the other countries of the region as well. According to short-term rapid estimates, economic growth in April 2017 came in at 3.4% yoy in Armenia, 3.1% yoy in Russia, and down 1.2% yoy in Azerbaijan. Nevertheless, all of the countries in the region recovered in May 2017, as the growth figures went up to 5.3% yoy in Georgia, 8.9% yoy in Armenia, 5.6% yoy in Russia, and down 0.9% yoy in Azerbaijan.

Is Georgia's growth forecast too optimistic?

Sharp ups and downs of the year-on-year growth rate from one quarter to the next are not usual. Typically, quarterly growth rates follow particular patterns, which are captured by ISET-PI's empirical forecast model. Therefore, the unusually high growth in the first quarter could result in an *overly optimistic predictions* about the next quarter's performance. Indeed, the forecast for Q2 and Q3 is largely influenced by the high Q1 actual growth. Yet, looking at the economic landscape from the standpoint of the April data, several variables changed significantly and effected growth predictions in different ways. The increase of *monetary base* and significant improvements in the *external statistics (exports, imports)* are the main positive drivers of the optimistic growth figures, while high *inflation* and appreciated *real effective exchange rate* had a negative impact on the forecast.

Which variables contributed to the forecast and how?

In terms of our model, we see that both *foreign currency and national currency deposits in commercial banks* grew significantly, and this had a positive effect on the Q2 and Q3 forecasts. For example, *Foreign Currency Demand Deposits* and *Foreign Currency Time Deposits* increased by 28% and 8% yoy respectively and this increasing trend does not fade away even after elimination of an exchange rate effect. *National Currency Total Deposits* saw a 17% yearly growth. An increasing amount of deposits again indicates that either individuals raised their savings, or they trust commercial banks more, or both.

Monetary aggregates were also positively affecting growth forecast. Currency in Circulation, Narrow Money (M1) and Broad Money (M3)) increased by more than 15% yearly, underlying the improved GDP growth numbers.

The other set of variables that had a positive effect on the predicted GDP growth were those related to the *external sector*. Georgian export continues increasing trend and increased by 28% yearly in April 2017, while Georgian import increased only by 8%. The trade deficit tightened by 1% relative to the same month of previous year. Again, these positive trends in trade statistics were mainly related to the improved economic conditions in the neighboring countries.

Furthermore, increased *Money Inflows* from abroad positively affected our growth forecast as well. In April, remittances increased by 12% yearly raising people's disposable income, consumption and real GDP growth. The main contributors to this increase were the Russian Federation (12% increase yoy), Israel (92% yoy), Turkey (19% yoy) and Spain (7% yoy).

On the negative side, the increase in Consumer Price Index dampened our growth predictions. An increase in world food prices exerted upward pressure on the CPI prices level. Moreover, April marked the fourth month since the Georgian government increased excise on a variety of goods. As a result, annual *inflation* rate reached 6.1%. However, one should note that this type of the tax hike can increase only the level of prices, not the inflation rate going forward. It is expected that this effect will be exhausted by the end of this year (if inflation expectations are appropriately controlled by the National Bank of Georgia).

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.