

NATIONAL BANK OF GEORGIA

INFLATION REPORT

II Quarter, 2006



Inflation Report

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In the second quarter of 2006 the prices increased by 4.1% compared to IQ06, which was distinguished by price stability and the annual inflation indicator equaled to 11.4%. The core inflation was also rather high, indicating that demand factors, in addition to exogenous ones, had significant impact on CPI. PPI has also increased and price rise on metal and energy carriers on the world market significantly contributed to the above developments.

High growth of deposits and loans in the bank sector was still observed during the reporting period, amounting respectively to annual 48.9% and 85.3%. The role of the banking sector in the formation of domestic demand was retained through money multiplication. Namely, in June 2006, based on average monthly data, annual growth of reserve money amounted to 24.65%, while that of broad money M2 and M3 aggregates equaled to 40.3% and 44.3%, respectively.

A clearly-defined appreciation trend was observed in the dynamics of GEL nominal rate against the US dollar, which was conditioned both by the increased demand for GEL, as well as by the dynamics of the dollar exchange rate on the world financial markets.

During the reporting period the real effective exchange rate appreciated by 5.5%, while the nominal effective rate – by 2.8%, being the opposite to the tendency observed in the previous quarter.

The current account significantly deteriorated in IIQ06, which was unlike the seasonal tradition formed for the past years. The above could completely be attributed to the problems that emerged in foreign trade in goods. Such developments are in complete compliance with the projections made in 2006 inflation report.

Tax revenues tangibly increased during the accounting period – the growth rate reached two-digit figure on almost all types of tax revenues (except for the tax on gambling business and excise tax). The increase of the state budget facilitated the increase of consumer

expenses, while state investments, traditionally, represented significant source for the formation of fixed capital. The above factors, on the whole, conditioned a significant impact of the state budget on general level of prices.

GDP annual real growth amounted to 8.4% in IQ06. Positive indicators of increase were observed almost for all types of economic activities except for electricity production, conditional rent for the use of own dwellings and public administration.

The increase of CPI by the end of 2006 is projected to be within the range of 8.4-9.1%. The aforementioned rate of increase is conditioned by exogenous shocks, as well as relatively high rate of money supply increase. Respectively, it is expected that the monetary policy will more likely be tightened.

INFLATION DYNAMICS

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Table 2.1
The Impact of Key Exogenous Factors on 2006 Annual Inflation in June

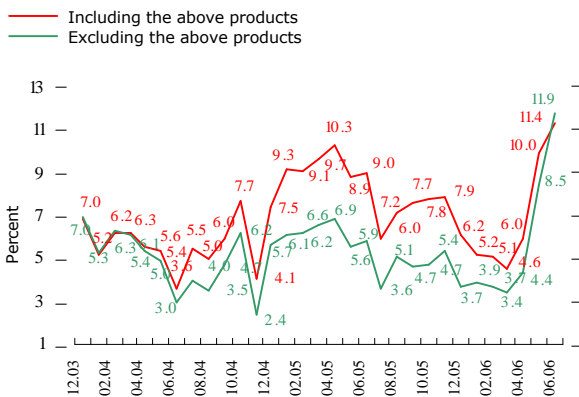
List of products	Annual inflation (%)	Impact (%)	Main Causes
Chicken meat	62.2	0.4	Avian Flu
Chicken legs	34.5	0.3	Avian Flu
Eggs	81.0	0.9	Avian Flu
Potato	75.5	1.5	Limitation of import (Based on five-month-data of the current year potato import accounted for 5% of the analogous indicator for the previous year)
Sugar	51.6	0.9	Increase in world prices
Fee for electricity	56.2	1.5	Increase in regulated price
Natural gas	34.6	0.3	Increase in import tariff
Fuel: „normal“ and „regular“	30.4	0.8	Increase in world prices
Total	52.6	6.6	

After the observed decrease of annual growth rate of consumer prices in IQ06, the indicator sharply increased in IIQ06 and annual inflation in June was equal to 11.4%.

For the purpose of retaining the stability of general level of prices, it is important to analyze the reasons for the rise of prices and evaluate permanent or temporary nature of CPI high growth rate. It is obvious that the consolidated effect of the impact of exogenous (non-monetary) factors on inflation results in the increase of inflation indicator. Namely, 6.6 percentage points out of 11.4% annual inflation accounted for only eight products (with total weight of 12.7%).

Along with this, the impact of exogenous factors on the price decrease was insignificant. Particularly, despite the decrease of excise tax on cigarettes, its impact on the annual inflation in June, in terms of price decrease, was only 0.2 percentage points because of price rise on the above product in the previous period due to non-monetary factors.

Diagram 2.1
Annual CPI Inflation Including and Excluding Tobacco and Oil Products



It is also noteworthy that along with the decrease of VAT from 20 to 18% in July of the last year, the level of tax administration improved. Recent price increase on the imported goods exceeded the price growth rate on locally produced goods, which also demonstrates exogenous, for the most part, nature of high inflation.

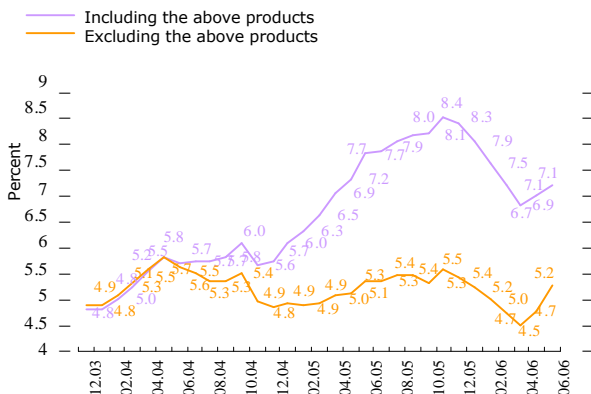
Along with this, we should also note that inflation was even more increased by the demand factor. The above also proceeds from the fact that, recently, in relation with locally produced and mixed final output, rather than in relation with imported goods, there has been close relation between CPI inflation and monetary aggregates. The relation between money supply and inflation without any lag, for the countries having the level of economic development similar to Georgia, is not surprising, which is stipulated by the structure of consumer basket.

Table 2.2
Inflation (CPI) Indicators by Separate Components (percentage),
their Weights in the Consumer Basket (percentage) and Impact
¹ on CPI (percentage point)

	Previous	May-2005 -		June-2006/ June-2005	
		June-2006/ May-2004 - Jun-05	June-2006/ June-2005	Inflation	Impact
Total	100.0	7.1	7.1	11.4	11.4
Food and non-alcoholic beverages	42.6	7.7	3.3	17.8	7.8
Food	41.2	7.6	3.2	18.2	7.7
Bread and bread products	11.4	1.0	0.1	1.0	0.1
Meat and meat products	6.4	17.9	1.2	23.1	1.5
Fish	0.9	17.9	0.2	21.6	0.2
Milk, cheese, egg	5.6	13.1	0.7	30.8	1.6
Oil and fat	3.5	0.2	0.0	1.6	0.1
Fruit, grapes	2.4	16.7	0.5	16.5	0.6
Vegetables, gourds, potato and other bulbous	7.8	0.5	0.0	34.6	3.3
Sugar, jam, honey, syrup, chocolate, confectionary	3.1	15.3	0.5	31.5	0.9
Other food products	0.2	4.3	0.0	3.7	0.0
Non-alcoholic beverages	1.4	8.5	0.1	6.4	0.1
Alcoholic drinks, tobacco	6.2	21.7	1.5	-0.2	0.0
Cloths and footwear	5.0	3.7	0.2	4.8	0.2
Residential house, water, electricity, gas and other means of heating	8.8	8.5	0.7	28.9	2.4
Furniture, household items and other details, house maintenance and repair	3.2	1.9	0.1	-0.2	0.0
Healthcare	7.3	0.6	0.0	1.0	0.1
Transport	11.4	8.4	1.0	10.4	1.1
Communications	4.3	-5.2	-0.2	-7.1	-0.3
Leisure, entertainment, culture	3.1	2.4	0.1	1.0	0.0
Education	3.0	1.2	0.0	-0.4	0.0
Hotels, cafes and restaurants	2.9	6.4	0.2	5.6	0.2
Different goods and service	2.3	1.5	0.0	1.5	0.0
Goods of short-term consumption	65.5	8.8	5.8	14.9	10.2
Semi-durable goods	6.1	2.6	0.2	2.2	0.1
Durable goods	2.3	0.2	0.0	-0.7	0.0
Service	26.1	3.7	0.9	4.0	1.0

¹ When computing the weights are adjusted taking into consideration the dynamics of prices of the consumer basket components for 2004-2005.

Diagram 2.2
Average Annual CPI Inflation Including and Excluding Tobacco and Oil Products



Core Inflation

It is noteworthy that along with annual 11.4% CPI inflation, the 10% symmetrically trimmed index of core inflation equals to 7.7% (respectively, 9.2% in case of 5% trimmed index). The increasing dynamics of the core inflation demonstrated that significant pressure on CPI was not only due to exogenous factors but due to demand, as well.

Price Index of Industrial Goods Producers

Rather high growth of PPI was observed in the second quarter of 2005. Namely, the above indicator increased by 13.9% compared to December 2005, while the growth of the indicator was 16.6% compared to IQ05. The key impact on the growth was due to price increase in the mining industry (annual 47.6% and quarterly 42.4%, of which extraction of metal ore – 81.5% and 72.4%, respectively). Production of food products appreciated by 9.4%, and rubber and plastic goods – by 13.4%. It should also be mentioned that production of chemical industry significantly depreciated (by 15%), as well as production of medical facilities, gauges, optical instruments and equipments (by 12%). Producers' price index is interesting as it provides significant information (sometimes preceding one) on CPI dynamics, and respectively, there is high correlation between them (88.7% in 2005-2006), which is clearly demonstrated by the diagram.

It is noteworthy that if seasonal factors implied projection of PPI drop by IIQ06, in reality a very sharp increase of the above parameter was observed, and the main reason for it was the price rise on energy carriers.

In the whole, the impact of both, exogenous as well as endogenous factors on the general level of prices is obvious. It should be noted that in case of only exogenous factors, the scale of which is so significant that it might trigger inflation expectation-spiral, slowing down the rate of demand increase would still be expedient.

Diagram 2.3
Annual Inflation by Locally Produced, Imported and Mixed Final Products of the Consumer Basket

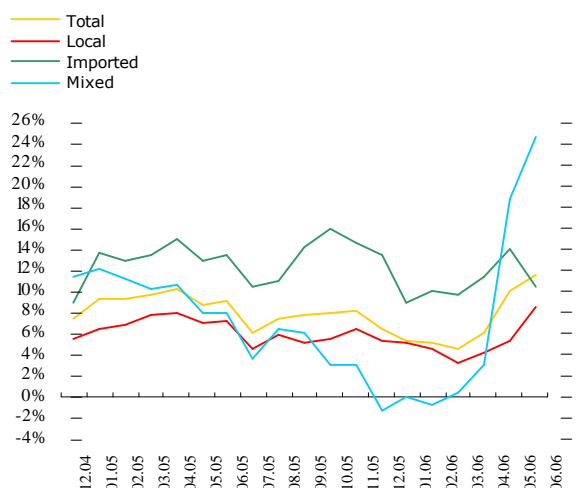


Diagram 2.4
Annual Growth Rate of Broad Money M2 (based on average monthly data) and Consumer Prices

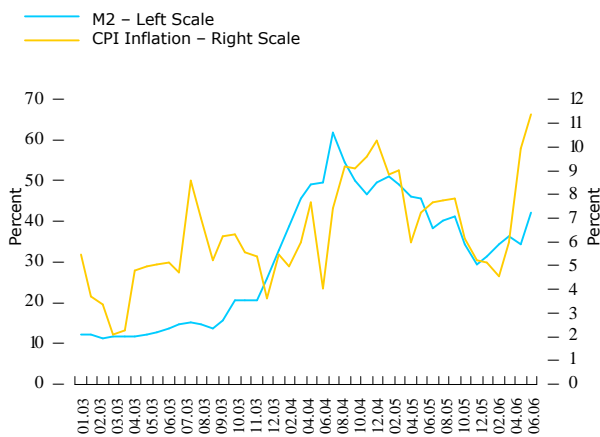


Diagram 2.5
Annual CPI and Core Inflation (by 311 components of the consumer basket)

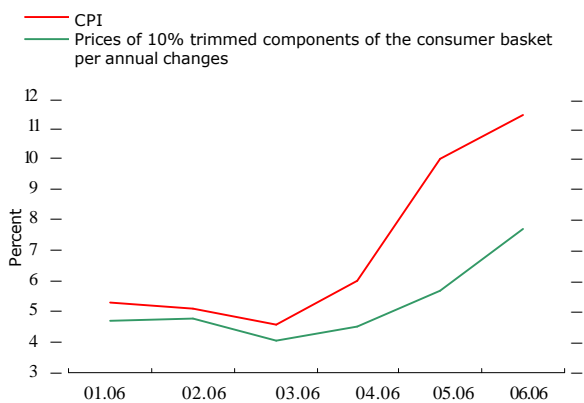


Diagram 2.6
Dynamics of CPI and PPI
 December 2004=100

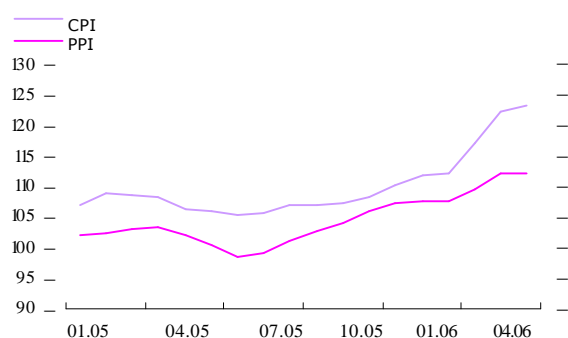


Table 2.3
Price Indices of Industrial Goods Producers
 June, 2006

	Compared to the previous month	Compared to December 2005	Compared to June 2005
	101.0	113.9	107.6
Mining industry	98.7	170.7	153.7
Extraction of energy and fuel mineral wealth	100.0	126.4	92.1
Mining industry excluding the extraction of energy and fuel mineral wealth	98.3	192.3	194.5
Processing industry	100.3	108.3	100.6
Production of food products (including drinks) and production of tobacco	105.2	110.6	108.0
Production of textile and textile products	101.9	101.4	70.1
Production of leather, leather goods and shoes	100.5	101.0	101.0
Tree and wood processing and production of wooden items	102.3	99.8	101.2
Production of cellulose-paper, publishing activities	103.1	110.6	108.0
Production of coke, oil products and nuclear materials	100.0	100.0	104.1
Chemical industry	99.3	104.6	105.1
Production of rubber and plastic goods	100.2	98.5	97.4
Production of non-metal mineral items	99.8	105.5	105.6
Metallurgical industry and production of metal goods	86.0	106.5	75.3
Production of cars and equipments	100.0	100.0	124.7
Production of electric facilities, electric and optical instruments	104.7	107.6	93.8
Production of transportation means and equipment	99.9	102.2	99.6
Other sectors of Industry	104.5	111.0	107.4
Production of electricity, gas and water and their distribution	103.9	110.3	109.3

Table 3.1.1
Reserve Money Dynamics
by Monthly Average Data, 2006

	12.05	01.06	02.06	03.06	04.06	05.06	06.06	07.06
Reserve money	965 679	962 173	980 628	1 010 662	994 916	1 009 900	1 055 670	1 085 049
Money in circulation	757 856	749 525	750 025	764 167	776 114	771 004	793 176	823 040
Bank deposits	207 823	212 648	230 602	246 495	218 802	238 896	262 493	262 008
Obligatory reserves	130 669	130 971	135 858	139 980	142 765	149 461	156 064	161 843
Balances on correspondent accounts	77 154	81 677	94 744	106 515	76 037	89 435	106 429	100 165
Annual growth of reserve money	19,72%	22,14%	26,34%	27,37%	21,88%	20,78%	24,65%	21,95%

Diagram 3.1.1
Dynamics of the Reserve Money
2004-2006

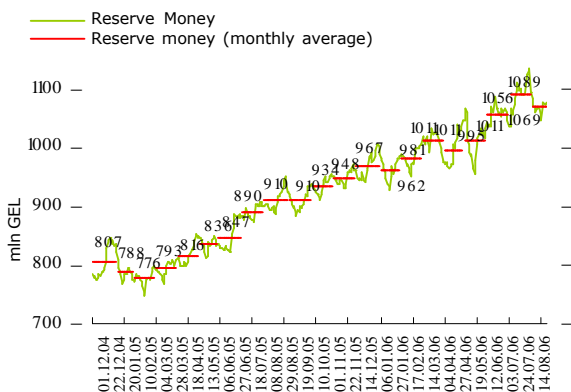


Table 3.1.2
Reserve Money Dynamics
by Latest Monthly Data 2006

	12.05	01.06	02.06	03.06	04.06	05.06	06.06	07.06
Reserve money	1 001 451	981 862	1 003 217	978 908	1 035 131	1 013 794	1 044 679	1 092 892
Money in circulation	811 400	749 215	756 571	775 443	792 910	776 499	803 260	828 941
Bank deposits	190 051	232 647	246 646	203 466	242 221	237 295	241 418	263 952
Obligatory reserves	129 833	133 183	137 960	139 334	143 655	151 959	158 689	162 958
Balances on correspondent accounts	60 218	99 464	108 686	64 132	98 566	85 335	82 729	100 994
Annual growth of reserve money	19,7%	26,9%	25,8%	21,0%	22,2%	21,9%	18,8%	21,3%

3.1. Monetary Aggregates

The annual growth of reserve money in June 2006, based on the monthly average data, equaled to 24.7%, while M2 and M3 increased by 40.7% and 44.3%, respectively. Based on the above, the NBG directed its monetary policy towards neutralization of the excess liquidity. In order to absorb the excess liquidity, NBG actively used the available monetary instruments in the month of June. Liquidity withdrawal through credit and deposit auctions was especially important. GEL 60.1 mln of liquidity was withdrawn through 21 transactions made at the credit auctions, and GEL 15 mln – through deposit auctions.

The necessity of liquidity absorption was caused by significant increase of the money in circulation. One of the reasons for the above was the interventions exercised by NBG at the inter-bank currency exchange. NBG, in order to avoid sharp fluctuation of GEL exchange rate, purchased USD 74.3 mln, on the whole. The total amount that NBG withdrew from circulation through monetary instruments in IIQ06 equaled to GEL 76.1 mln.

Broad Money

In June 2006 the growth of M2 and M3 aggregates, based on the monthly average data, amounted to 15% and 12.5%, respectively, and was mostly conditioned by deposit increase. During the same period deposit liabilities in national and foreign currency increased by GEL 261 mln, of which deposits in foreign currency – by GEL 116.7 mln, while GEL denominated deposits – by 144.3 mln. Along with the increase of cash outside the banking system by GEL 20 mln, as well as increase of deposit liabilities, M3 broad money aggregate has increased by GEL 281.3 mln and M2 broad money aggregate – by GEL 164.3 mln since the beginning of the year. Respectively, by the end of June the amount of M3 aggregate amounted to GEL 2284.2 mln, while M2 – to GEL 1251.8 mln.

Table 3.1.3
Monthly Changes of Money Aggregates
 2006 (average monthly data)

	01.06	02.06	03.06	04.06	05.06	06.06	07.06
Broad Money /M3/	1 903 627	1 921 751	1 993 524	2 082 984	2 113 973	2 243 630	2 306 400
Money supply /M2/	1 026 072	1 039 195	1 073 505	1 117 572	1 118 633	1 235 061	1 248 464
Cash outside the banking system	683 949	683 061	690 421	710 012	691 760	717 759	737 754
GEL in circulation	749 405	751 361	766 587	785 728	765 605	797 349	823 040
Deposits in National currency	342 123	356 134	383 085	407 559	426 872	517 302	510 710
Deposits in Foreign currency	877 555	882 556	920 018	965 413	995 340	1 008 568	1 057 936
Broad money /M3/ annual increase	32,8%	32,3%	34,0%	36,4%	33,9%	40,3%	39,7%
Broad money /M2/ annual increase	29,7%	31,6%	34,4%	36,4%	34,6%	44,3%	39,6%

Diagram 3.1.2
Broad Money
 2004-2006

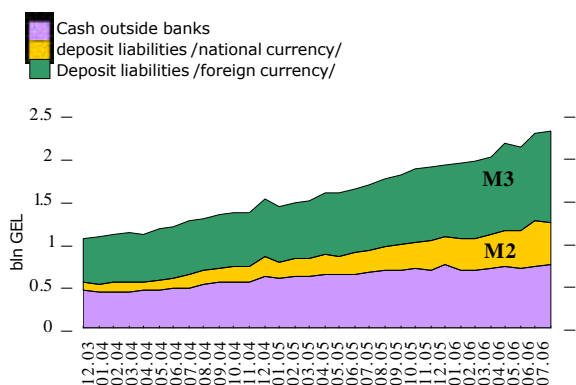


Table 3.1.4
Monthly Changes of Money Aggregates
 2006 (by month latest data)

	01.06	02.06	03.06	04.06	05.06	06.06	07.06
Broad money /M3/	1 937 372	1 967 731	2 003 218	2 166 389	2 157 712	2 284 205	2 318 376
Money supply /M2/	1 050 325	1 052 238	1 087 516	1 142 254	1 146 637	1 251 806	1 247 437
Cash outside banks	682 176	688 986	709 102	714 856	706 063	729 106	744 932
GEL in circulation	749 215	756 571	775 443	792 910	776 499	803 260	828 941
Deposits in National currency	368 149	363 252	378 414	427 398	440 574	522 700	502 505
Deposits in Foreign currency	887 047	915 494	915 701	1 024 135	1 011 074	1 032 399	1 070 939
Broad money /M3/ annual increase	35,5%	33,6%	33,8%	36,6%	36,5%	40,3%	37,8%
Broad money /M2/ annual increase	34,2%	30,3%	33,9%	33,4%	36,5%	40,7%	35,9%

3.2. Dynamics of Interest Rates, Deposit Liabilities and Crediting of Economy

In the second quarter of the current year deposit liabilities increased significantly – by GEL 261 mln, and amounted to GEL 1.555 mln by the end of June. The deposits in national currency grew by GEL 144.3 mln, while those in foreign currency – by GEL 116.7 mln. Similar increase was observed in crediting by banks. In the second quarter the loans in national and foreign currency increased by GEL 301.9 mln, of which GEL denominated loans amounted to 126.2 mln, being 41.8% of the total loans issued during the period. It should also be mention that large amount of the loans issued in GEL is short-term ones. During IIQ06 the share of long-term loans issued in national currency decreased in the total portfolio, and the interest rate on long-term loans stayed unchanged. The above points out the position of the banks, thinking that issuing long-term loans in GEL with fixed interest rate, compared to the loans in Euro and US Dollar is risky. Two-digit inflation cannot facilitate the decrease of dollarization.

High growth rate of assets and liabilities demonstrates strengthening of population’s confidence in the banking system in general. Physical persons and legal entities allocate their resources on the deposit accounts; in addition, banks have resources from credit lines on preferential terms extended by foreign financial institutions, rather, than to depositors. Along with the growth of banks’ credit portfolio, the trend of reduction of interest rates is continuing, which is caused by following two factors: (1) growth of competition, and (2) reduction of credit risk. Bank products and level of service, especially in the largest banks, becomes more homogenous, which allows the customers to differentiate the banks by interest rates. It is also noteworthy that creation of more stable macro-economic environment for economic activities stipulated the reduction of risk premium. Both, the banks as well as their customers have become more effective. Economy of scale is characteristic to the banking systems and, along with growth they acquire better conditions for effective cost management. Generally, the solvency of bank customers also improved, which is related with the creation of improved conditions for running the business in the country. In the World Bank report, published in 2006 (Anticorruption in Transition 3: Who is Succeeding... and Why?), which reviews the fight against corruption in the countries with transitional economy, it is unambiguously stated that Georgia has achieved tangible and significant progress in fighting corruption, which means that the country

Diagram 3.2.1
Volume of Term Deposits (left axis, mln GEL) and Interest Rate (right axis)
 2005-2006

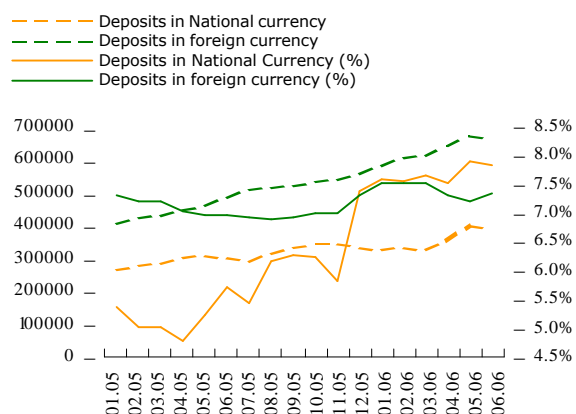


Diagram 3.2.2
Loan Volume (left axis, Thousand GEL) and Interest Rates (Right axis)
 2005-2006

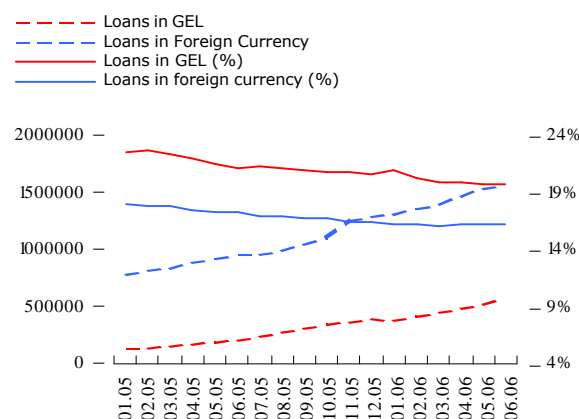
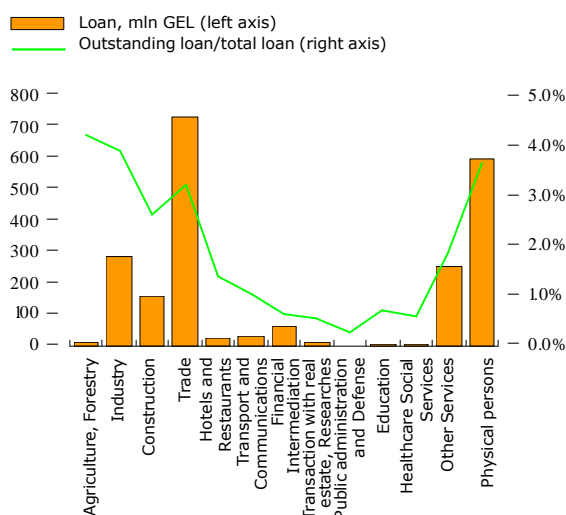


Diagram 3.2.3
Distribution of Total and Outstanding Loans by Resident Physical Persons and Legal Entities
 (as of June 1, 2006)



achieved cost reduction for entrepreneurs. Along with the process of creating stable macroeconomic environment in Georgia, reducing risk premium on loans will continue in future, as well.

Credit distribution by sectors demonstrates that the credits are mostly accumulated in trade, industry and construction. Also, significant share comes on physical persons. It is noteworthy that most of the credits, except for the financial and public sectors, are extended in foreign currency. The indicator of loans outstanding is the highest in agriculture. Embargo, imposed by Russia against Georgia, has had especially negative impact on the loans extended to agricultural sector.

Review of loan structure by terms demonstrates that the share of GEL is especially high in short-term loans. By the end of the second quarter GEL denominated short-term loans amounted to 90% of the loans extended in foreign currency, while in long-term loans GEL only approximated to 10% of foreign currency. Interest premium (the % by which the interest rates on the loans extended in GEL exceed that in foreign currency) on long-term loans is rather high (about 30%), while on short-term, GEL denominated loans – 5%, only. The above demonstrates that banks, like other economic agents, in the long-term perspective expect GEL depreciation. But there also are some signs proving that the above expectation is changing. The share of loans extended in GEL is characterized by clearly-shaped increasing tendency. Moreover, the interest premium has not increased, rather vice-versa: its reduction is observed in the long-term loans. Significant increase of the share of short-term loans extended in national currency without significant reduction of interest premium is conditioned by demand factors and points to the reduction of dollarization of economy.

3.3. Exchange Rate, Dollarization and Balance of Payment

During the period of IIQ06, GEL exchange rate against US dollar demonstrated obvious tendency of appreciation. If at the beginning of the quarter GEL rate was 1.827, by June 30 it dropped down to 1.772, corresponding to 3% appreciation. GEL appreciation was associated with the increased demand. At the same time, compared to IIQ05 GEL exchange rate appreciated based on the data by the end of the period (2.18%), as well as by the middle of the period – (1.18%).

Diagram 3.2.4
Change of Deposit Currency Structure and Interest Rate

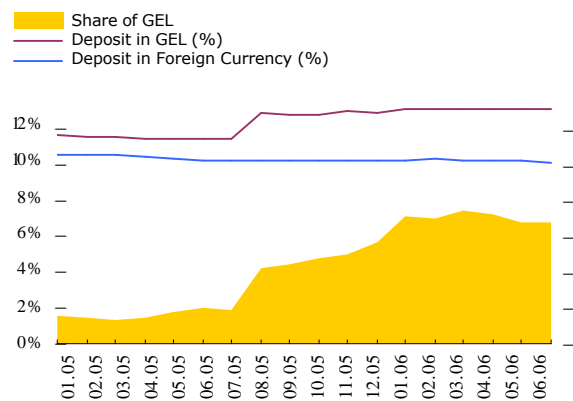


Diagram 3.2.5
Ratio of Loans Extended in National Currency to the Loans in Foreign Currency (left axis) and Interest Premium on Loans in GEL (right axis)

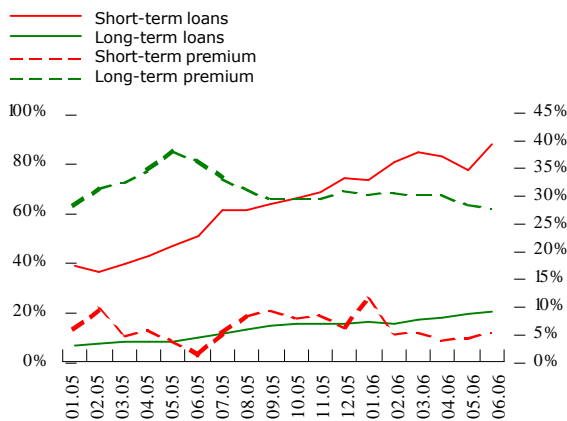
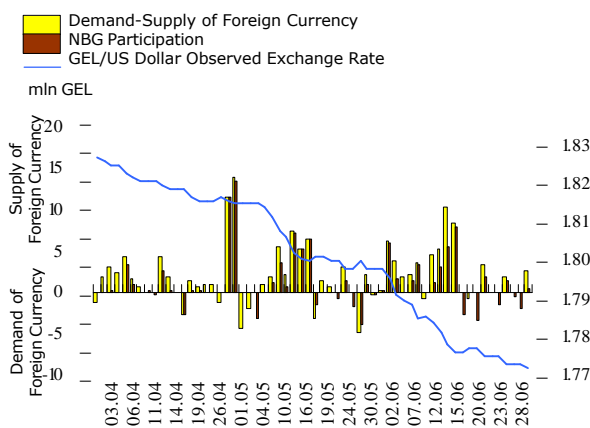


Diagram 3.3.1
Difference Between Demand and Supply at Tbilisi Inter-Bank Foreign Currency Exchange and NBG Participation
IIQ, 2006



During the reporting period, compared to IQ06, the activity at Tbilisi Inter-bank Foreign Exchange was even higher. Demand for foreign currency, as well as its supply by commercial banks significantly increased compared to the analogous period of the previous year – if in IQ05 the above parameters equaled to 39.3 and 65.6 mln US dollars, respectively, in IQ06 they totaled to USD 58.4 and 183.1 mln. The dynamics of GEL exchange rate at the banknote segment was similar to GEL behavior observed at Tbilisi Inter-bank Foreign Exchange. Namely, GEL exchange rate in exchange outlets fluctuated from 1.767 to 1.83, while the difference between selling and purchasing rates was relatively small (average 1.8008-1.8062 during the quarter, 0.018 and 0.0175 standard deviations, respectively for buying and selling rates), demonstrating that GEL exchange rate dynamics was defined by one and the same driving force all over the country.

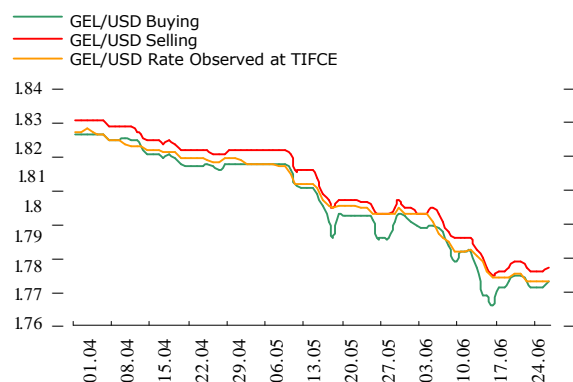
Quarterly change of GEL rate against Euro was insignificant (2.213 at the beginning of the quarter, and 2.2233 – at the end). However, during the most part of the reporting period GEL was depreciating against Euro and it equaled to its minimal value – 2.326 by June 6, after which rapid appreciation of the rate was observed. As you may see from the diagrams, the dynamics of GEL rate against other currencies was similar, except for Turkish Lira, which dramatically depreciated against GEL – 18.75%.

Real Exchange Rate

Depreciation trend observed in IQ changed and swung around in IIQ06 – if at the end of 2005 the real effective exchange rate index was 110.2, and amounted to 105.3 by the end of March, it totaled to 111.1 at the end of June, corresponding to 5.5% appreciation. The same may be noted in terms of the nominal effective exchange rate, which appreciated by 2.8% during the quarter (from 203.8 to 209.6). However, it should also be noted that both: nominal as well as real effective exchange rates appreciated by 8.13% and 1.8%, respectively, compared to IIQ05 indicators.

GEL real exchange rate against individual foreign currencies was characterized by analogous dynamics, as well. Especially significant was GEL real exchange rate appreciation against Turkish Lira – 23.2%, which could be explained by GEL sharp appreciation, as well as by relatively high inflation (3.6%) observed in Turkey in IIQ06.

Diagram 3.3.2
Dynamics of GEL Banknote Rate
 IIQ, 2006



Balance of Payment

Based on preliminary data, the trend of balance of payment deterioration continued in IIQ06. Unlike the previous years, when in the second and third quarters the current account deficit reduction was observed (due to reduced demand for energy carriers and, respectively, reduction of their import), the indicator significantly deteriorated in IIQ06, which could completely be attributed to the problems created in the field of foreign trade in goods.

During the six months of the current year the deficit of balance of payment, compared to the first half of 2005, deteriorated by 76.9% and equaled to USD 307.6 mln, of which USD 207.8 mln (67.6%) accounts for the second quarter due to significant impact of the embargo on Georgian production imposed by Russia.

Influence of Exchange Rate on Inflation in Georgia

By using vector autoregressive model we updated the research of exchange rate transmission mechanism for Georgia. Based on the data of 1999-2006, it was confirmed that the impact of the exchange rate on the inflation reduced from 60% to 20% that could be explained by appreciation of the exchange rate and decrease of its volatility, however, it does not mean that exchange rate shocks became less significant for the macroeconomic environment. In the conditions of inflation and import growth, the impact of the exchange rate on the inflation even more calls for attention;

Note, the carried out work demonstrated that:

- the impact of the exchange rate lasts for quite a long period of time and diminishes only after 18 months;
- the impact of the exchange rate on the inflation is asymmetric and its depreciation is more reflected on the inflation than appreciation. However, the shocks caused by appreciation have more long-lasting effect on the inflation;
- as the calculations demonstrated, shocks of the exchange rate slightly though more affect the change in consumer prices than import inflation;

- during the first two months 90% and later – 80% of change of consumer prices is mainly accounted for the shocks of the local prices.

As the research done by the Bank of Finland revealed, the impact of the exchange rate on the inflation is much higher in Russia and it reaches – 42%. For the last years the increase in oil prices resulted in appreciation of Russian ruble against the USD, and the Central Bank was trying to stop the appreciation that resulted in the inflation growth; Hence, appreciation of the actual rate is due to nominal rate appreciation and increase in local prices; as a result local currency appreciation is in correlation with the inflation growth.

In regard to Turkey, the impact of the exchange rate on the inflation varies from 31% to 38% and the rate of transmission is relatively low and after six months goes close to 0.56.

In the countries of Eastern Europe, whose economic policy was directed towards integration in the European Union, the impact of Euro exchange rate on the inflation is much higher and varies from 10% (Croatia) to 67% (Slovenia), however, the rate of impact is relatively low.

Diagram 3.3.3
GEL Exchange Rate Dynamics against Euro and USD
 IIQ, 2006

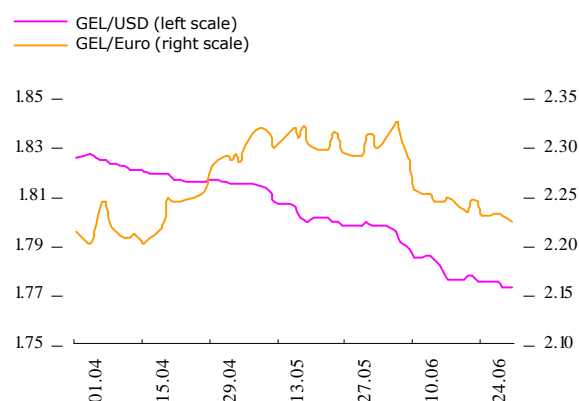


Diagram 3.3.4
GEL Exchange Rate Dynamics against Russian Ruble and British Pound Sterling
 IIQ, 2006

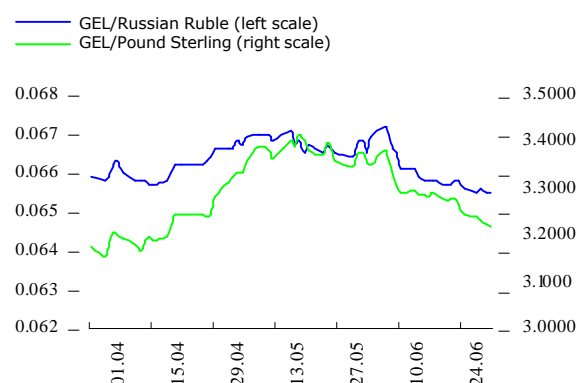
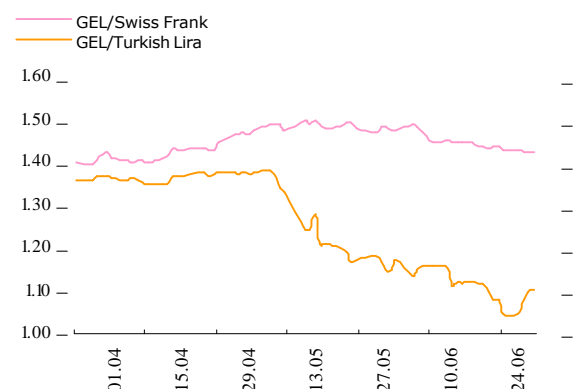


Diagram 3.3.5
GEL Exchange Rate Dynamics against Swiss Frank and Turkish Lira
 IIQ, 2006



Deficit of foreign trade¹ in goods increased by 61.8% during the last 6 months compared to the analogous period of the last year, amounting to USD 604.1 mln. If import coverage coefficient by export, compared to 2005 analogous indicator (63%), increased by 3.6 percentage points in the first quarter and amounted to 66.6%, in the second quarter it decreased by 7.7 percentage points, amounting to 55.3%. However, it should be noted that the results of embargo imposed by Russia could have been even worse in the second quarter of the current year if not serious export increase of some types of production that have serious share in Georgian export.

The volume of export, during six months of 2006, increased by 43.2% compared to the analogous period of the previous year, amounting to USD 915.1 mln, instead of USD 639.0 mln. Despite the fact that due to Russian embargo the volume of Georgian export reduced by about USD 35-40 mln in IIQ06, the increase, during the same period, was conditioned by significant growth of export of such goods as aircrafts (export volume increased 2.3 times in IIQ), copper ore and concentrates (2.3 times, respectively), cars (2.0 times), non-ferrous metal scrap (1.5 times). Only these four types of goods account for 30% of total export. Relatively small increase was observed in terms of gold (6.8%) and ferroalloy (2.4%) export. The export of the rest of the products (that do not fall under the largest export ten) increased by 25.9% on average.

In the six month of the current year the wine export, 3/4 of which traditionally accounted for Russia, totaled to USD 27.1 mln, being 14.9% less compared to the analogous period of 2005. However, its volume in the second quarter decreased by 69.4% compared to IIQ05, and – by 74.0% compared to IQ06.

Traditionally, more than 70% of the mineral water exported from the country accounted for Russia (up to 2006). Export of the above product during six months of the current year equaled to USD 18.9 mln, which, despite the restriction of its import by Russia, was still 31.1% more compared to the indicator of the analogous period of 2005. The above was conditioned by the fact that in IQ06 the mineral water export exceeded the indicator of the analogous period of the previous year by 2.1 times. However, in the second quarter compared to IIQ05, it decreased by 14.3%, while the decrease equaled to 30.3% compared to IQ06.

¹ Here and further on, foreign trade in goods means export and import registered at the Georgian customs adjusted based on the mirror method.

Diagram 3.3.6

Index of Real and Nominal Effective Exchange Rates

December, 1995=100

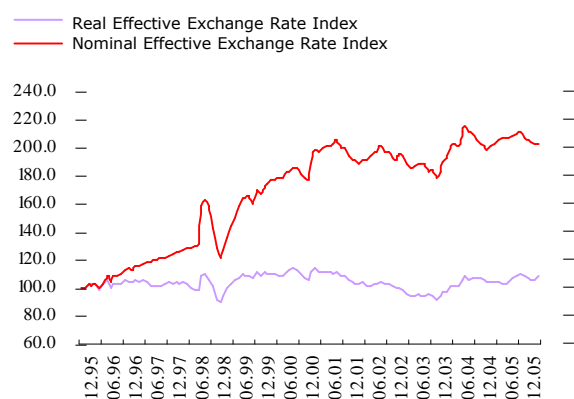
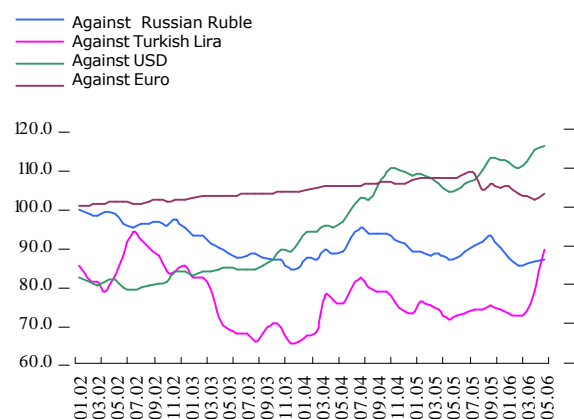


Diagram 3.3.7

GEL Real Exchange Rate Index against Individual Currencies

December, 1995=100



During the six months of 2006 the trend of import increase, compared to export, at preceding rate continued. The import volume, compared to the first half of 2005, increased by 50.1%. Serious increase of import was observed in the second quarter – 58.0% compared to IIQ05, and 29.0%, compared to IQ06. This, on the one hand, was conditioned by world price rise on oil and oil products, and on the other – by price rise of natural gas by Russia for Georgia. Only these two types of products accounted for one fifth of the total import increase. However, the import of the following goods was rather significant, as well: cars – the import of which increased 2.1 times compared to the first half of 2005; wheat – 2.1 times; radio and TV equipment and equipment for data automated processing – 1.8 times, each; other types of goods – 1.6 times each, on average. Such increase of import could also be explained by simplification of customs procedures. The result was that during the six months of 2006, the import of investment goods, compared to the first half of the previous year, increased by 81.1%, amounting to 13.8% of the total import (instead of 12.3%). The import of consumer goods, during the same period of time, increased by 55.5%, though, its share within the total import volume, decreased from 39.5% down to 37.9%.

Balance of service improved compared to the first quarter of 2005 and amounted to USD 96.6 mln instead of USD 60.4 mln (i.e. 59.9% more). However, exogenous and endogenous factors had serious positive, as well as negative impact on it.

Embargo, imposed by Russia on Georgian production had not least impact on shipment between the two countries, due to which, during the reporting period the balance of transport service deteriorated and its deficit exceeded USD 26 mln. The balances of other services, such as construction, insurance, financial and others also had deficit due to which total deficit amounted about USD 30 mln. However, positive trends in the fields of pipe-line transport and tourism had the key impact on the total balance of service.

As the pipeline is put into operation and loaded with relevant capacity, the trend of revenue growth from pipeline transportation is becoming apparent. In the reporting period, the revenues generated from oil transportation as compared to the analogous period of the previous year, went up by 38.8% and exceeded USD 26 mln. comprising 5% (i.e. more than 1 percentage point than on average during 2005) of the revenues generated from the export.

Diagram 3.3.g
Dynamics of the Current Account Deficit

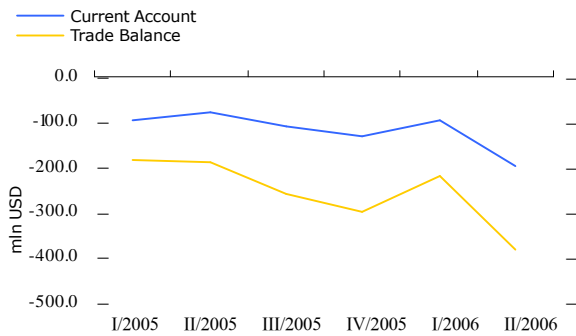
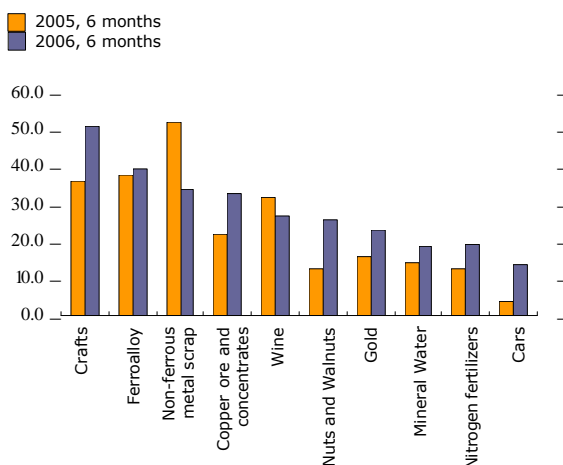


Diagram 3.3.g
Dynamics of Volume of the Ten Largest Export Goods in the First Quarters of 2005-2006, Mln Dollar



Along with the rehabilitation process of tourism infrastructure in the country, also along with the liberalization of traveling procedures with the neighboring countries, the scale of business and private tourism increased in the reporting period. The number of foreigners who entered Georgia during the first 6 months of 2006 comprised 294.2 thousand, being 84.3 thousand more, i.e. it exceeds the number of visits in the analogous period of the previous year by 40.2%. The number of Georgian citizens traveling abroad increased by 47.6%, i.e. by 168.2 thousand and comprised 521.2 thousand people for the past half year. As a result, positive balance of tourist services comprised USD 126.5 mln and significantly influenced the direction of trajectory of service balance.

Revenue account still has less effect on the status of the balance of payment. In the reporting period it was negative, however, only 7% of the current account deficit came on it.

Unlike revenue account, current transfers still remain a significant factor influencing not only balance of payment but also the consumer market conjuncture of the country. Its influence is especially significant on the market in terms of demand increase as the biggest part of the current transfers having entered the country still remains to be money transfers. In the first half of the current year, 87% (compared to 84% in IH05) of the current transfers comes exactly on money transfers, thus comprising about USD 240 mln (USD 153.4 mln, respectively) being within 7-8% of the GDP. To compare: labor remuneration in 2005 comprised 20% of the GDP generated in the country. Simultaneously, the ratio of money transfers against direct foreign investment volume is still high – almost 75% (it was 90% in 2005), demonstrating serious impact of such remittances on the national economy.

Positive balance of capital and financial account reached USD 300 mln in the first half of the current year being USD 125.9 mln more than the same indicator in the analogous period of the last year. This is the consequence of increase of positive balance of the capital account by USD 23.3 mln and financial account by USD 120.6 mln. Such an impressive growth of the financial account was triggered by increase of direct foreign investment flows. During the reporting period, serious investments were made in the country's banking sector, communications sphere, energy and mechanical engineering sectors. According to the preliminary assessment, direct foreign investments that entered Georgia in the first half of the

Diagram 3.3.10
Dynamics of Volume of the Ten Largest Export Goods in the First Quarters of 2005-2006, Mln Dollar

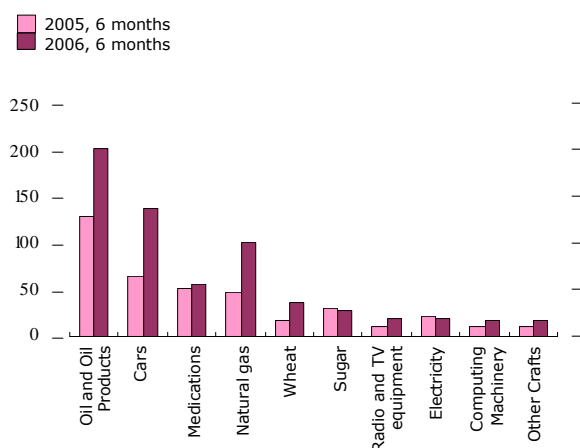
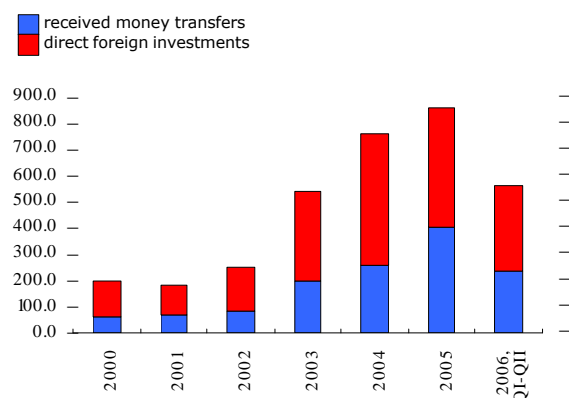


Diagram 3.3.11
Dynamics of Foreign Capital Inflow to Georgia, mln USD



current year comprised USD 321.2 mln, the biggest portion of which comes on British Petroleum. However, investments from Kazakhstan, Turkey, the US, Azerbaijan in the same period were similarly important.

In the reporting period the sources envisaged by the International Monetary Fund (IMF) program to support balance of payment continued to come in, as well as financing of the programs to promote the reforms.

Foreign liabilities of the *government sector* (including liabilities guaranteed by the government) reduced by USD 109.9 mln in the reporting period that is connected with both principal (USD 53.3 mln) and interest (USD 56.6 mln) repayment. However, new liabilities were also taken. During this period new financial liabilities of the government grew by USD 40.3 mln.

Foreign liabilities of the *monetary regulatory bodies* (of the National Bank) decreased by USD 25.3 mln in the same period entirely connected with the repayment of arrears against the IMF. However, in the same period, the international reserves of the National Banks were replenished by USD 20.5 mln from the same international financial institute.

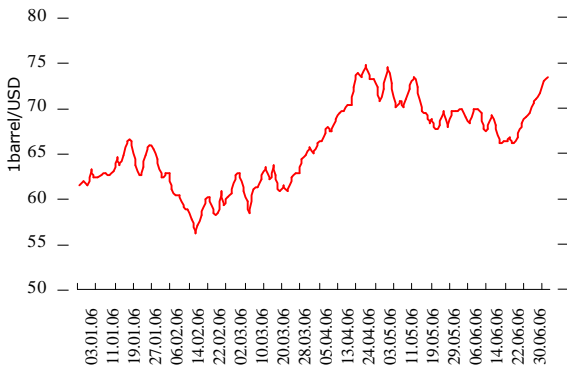
In the reporting period, international liabilities of the *banking sector* increased much more rapidly (38.0%) than the corresponding assets (30.9%). Likewise, negative net international investment status of the commercial banks (difference between assets and liabilities) increased by USD 86.1 mln in the reporting period and comprised USD 283.5 mln. Such an increase of foreign liabilities in the Georgian banks is the result of increase of non-resident deposit volume, loans from non-residents and direct foreign investments (USD 6.7, USD 103.9 and USD 19.7 mln, respectively). Growth of international assets of the banking sector in the reporting period almost entirely is the result of growth of foreign exchange balance (by USD 17.1 mln) and deposits of resident banks in non-resident banks (by USD 31.4 mln).

3.4. Production Costs

Oil Prices

In IIQ 2006, the price on oil on the world market went up again and at the end of IIQ06 it comprised USD 73.93 per one barrel oil that will be adequately

Diagram 3.4.1
Dynamics of Oil Prices



reflected on the prices of oil and energy carriers in Georgia, and respectively on almost all types of consumer goods.

Among the main reasons for price-rise on crude oil, the increased demand on energy resources worldwide, which by OPEC (Organization of Petroleum Exporting Countries) forecast will not decrease in the foreseeable future, is especially worth mentioning.

The military actions going on in some countries of the Middle East, tension between Iran and the USA, etc. dramatically affect oil prices (in upward direction). Due the aforementioned factors, the world fears that the large oil producer countries will suspend the export of this raw material either partially or entirely.

The price increase on oil in the reporting period was conditioned and this factor still sustains, by the problems in oil refineries emerged as a result of natural calamities of 2005 in the USA, which are not operating at full capacity yet.

Interesting to note, despite such price rise on oil on the international markets, the demand on oil in comparison with the supply grew at a higher rate in some of the big countries (especially in the USA, China, India).

Table 3.4.1
Nominal and Real Growth of Consolidated Budget Revenues of IH06 Compared to IH05 (in percentage)

	Nominal Growth	Real Growth*
Total revenues and grants	24.50%	16.40%
Total revenues	25.70%	17.50%
Tax revenues	34.10%	25.40%
Income	22.50%	14.50%
Profit	61.80%	51.20%
VAT	34.50%	25.70%
Excise	14.30%	6.80%
Social tax	61.80%	51.20%
Customs	29.70%	21.20%
Property	43.80%	34.40%
Gambling business	-20.40%	-25.60%
Non-tax revenues	76.50%	65.00%
Capital revenues	-37.70%	-41.70%
Grants	-34.30%	-38.60%

* Real growth is deflated in compliance with annual inflation of IH06 (CPI)

Taxes

According to the reference information of IH06, the revenues and grants of the consolidated budget comprised GEL 1842.7 mln, and own revenues – GEL 1 822.6 mln. In the same period tax revenues equaled to GEL 1 390.3 mln. The increase in tax revenues compared to the corresponding period of the previous year comprised 34.1%, and real (taking into consideration inflation) growth – 25.4%. Total plan of tax revenues was successfully accomplished – by 103.5%.

In IH06, the revenues generated from all the types of taxes dramatically grew and the growth rate was expressed in two-digit figure, excluding gambling business. The rate of growth of the revenues collected from excise was relatively modest affecting the composition of tax revenues. Growth rate of revenues collected by means of excise was only 14.3% and its share in the total revenues decreased from 12.5% to 10.6%. The reason for that could be the large scale of smuggling of tobacco products triggered by rather

Diagram 3.4.2
Consolidated Budget Tax Revenues by Types of Taxes
 IH2006

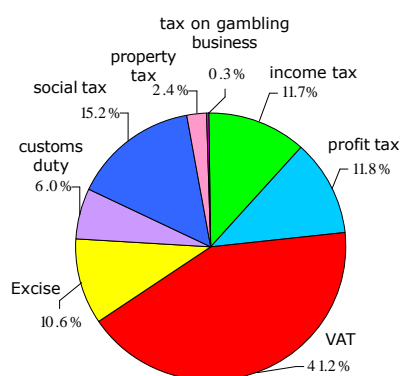


Diagram 3.4.3
Tax Revenues of the Consolidated Budget
 2005-IH2006

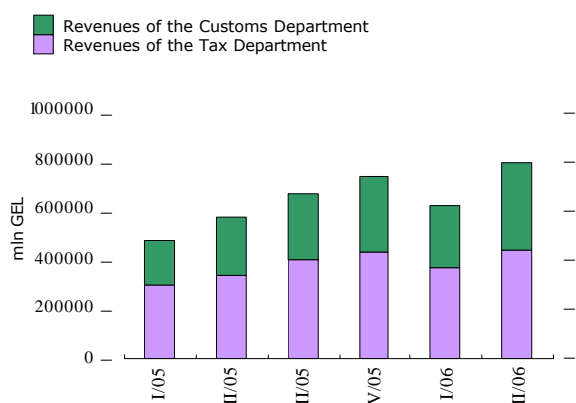


Table 3.4.2
Import Data from Turkey to Georgia

	2003	2004	2005	I-IV months 2006
State Statistics Department of Georgia (th USD)	102 153	192 176	268 860	56 694
State Statistics Institute of Turkey (th USD)	155 068	198 738	268 427	72 625
Coverage coefficient	1.5	1.0	1.0	0.78

high rate of excise on tobacco products. Compared to the neighboring countries, excise tax rates in Georgia were the highest kindling smugglers' interest. As a result of amendments introduced in the Tax Code of Georgia at the end of April, the excise tax rates on a number of tobacco products were reduced. It is anticipated that this measure will restrict smuggling and increase excise tax revenues. Unlike excise tax, the share of profit tax severely grew from 9.8% to 11.8% perhaps, demonstrating growth of profit amount in the private sector.

The biggest share in the budget tax revenues comes on value-added tax (more than 41%). At the end of last year, amendments were introduced in the Tax Code of Georgia that obligated the persons carrying out economic activities to record the information on the settlement in cash only by means of cash registers. The goals of this measure are to improve VAT administering and reduce the scale of smuggling. And indeed, GEL 572.8 mln revenue was generated in IH06 in the form of VAT being 35% more than in the corresponding period of the previous year.

Improvement of tax administration, particularly, dramatic growth of revenues collected from VAT may be supporting price-rise. Since VAT is added directly to the value of goods and services, the prices on goods and services also go up. However, concurrently the improvement of tax administration that is followed by creating equal conditions for all the entrepreneurs and reducing unofficial taxes, as a result of improvement of the entrepreneurial environment leads to the price reduction. In the long-term period, improvement of the tax administration has positive influence on price-rise and economic growth, but in the short-term period, it could trigger single time price-rise.

Like consolidated budget, the planned indicators of the IH06 State Budget were also successfully accomplished. According to reference information, the own revenues exceeded the planned one by GEL 41.3 mln, and tax revenues – by GEL 33.4 mln. The revenues gained from all types of taxes significantly exceeded the plan. The same is true in regard to the budgets of the territorial units. Income, profit, property and gambling business taxes were mobilized in excess.

The revenues of the Customs and Tax departments clearly reflect the improvement of the tax administration. In first half of the year, the Tax Department fulfilled the plan by 104%, and the Customs Department – by 103.5%. In addition, the revenues dramati-

Table 3.4.3

The Growth Rate of Value Added Generated Per Employee and Average Monthly Wages in IQ06 Compared to the Relevant Period of 2005

	Real growth of value added (in percentage)	Nominal growth of wages (in percentage)
agriculture	-2,9%	6%
industry	17,8%	19,4%
construction	37,2%	31,8%
trade	84,5%	20,1%
hotels and restaurants	-4,5%	8,9%
transport and communication	9,3%	8,3%
financial intermediation	28,7%	61,5%
real estate transactions	219,4%	27%
public administration, defense	20,5%	71,8%
education	-2%	42,9%
healthcare	-18,7%	24,6%
other service types	-3,2%	1,8%
total	27,6%	29,4%

Table 3.4.4

Real Annual Growth of GDP (%) and Impact on the Economic Growth (percentage points) by Economic Activities

	Total number of population of 15 and more years old	Economically active population	Coefficient of labor force participation (%)	Total unemployment	Unemployment level (%)
2002	3 240	2 104	65	265	12.6
2003	3 105	2 051	66.1	236	11.5
2004	3 151	2 041	64.8	258	12.6
2005	3 162	2 024	64	279	13.8
I quarter	3 178	1 999	62.9	294	14.7
II quarter	3 149	2 036	64.6	272	13.4
III quarter	3 132	2 012	64.2	270	13.3
IV quarter	3 191	2 049	64.2	284	13.8
2006					
I quarter	3 170	1 925	60.7	282	14.6
II quarter	3 139	1 952	62.2	252	12.9

cally grew in comparison with the last year. In IQ06, the revenues of the Tax Department exceeded the previous year indicators by 27%, while the revenues of the Customs Department grew by 45%. Dramatic growth of collection by the Customs Department demonstrates improvement of import taxation administration that is proved by the mirror analysis of the import data from Turkey to Georgia.

However, it should be noted that compared to first half of the last year, the collection of VAT and customs duty at the Customs also increased dramatically – by 55 and 62%, respectively, while the collection of excise tax – only by 11.5% demonstrating the scale of smuggling of excise goods.

The revenues generated in the State Budget as a result of state property privatization totaled GEL 107.4 mln as planned. Non-tax revenues comprised GEL 255.3 mln instead of planned GEL 247.4 mln. In the non-tax revenues, the fees collected from the licensing of activities in the communications and post services and revenues from the profit of the NBG play significant role in non-tax revenues.

In 2006, remaining T-bills were gradually withdrawn from the circulation and this process was completed on July 6. Hence, the revenues from T-bills in the State Budget decreased by GEL 20.4 mln, compared to the forecast. On the whole, the State Budget deficit comprised GEL 21.9 mln, and its financing source was long-term international credits.

Labor Productivity, Wages

In IQ06 the value added generated per employee grew by 27.6%. The level and the dynamics of the value added per employee are very different by industries. The least value added is generated in agriculture and education sectors that could be explained by the fact that these sectors lack fixed capital per worker. The highest is in construction, hotels and restaurants, also transport and communications sectors.

In IQ06, as compared to the relevant period of the previous year, real value added grew the most in construction, trade, financial intermediation and real estate transactions. However, it dropped in agriculture, hotels and restaurants, healthcare, education, other spheres of services.

IQ06 witnessed quite a remarkable growth of wages both in the private and public sector. In IQ06, average monthly wage (after taxes) comprised GEL 171.6. Nominal growth of average monthly wages in GEL comprised 29.4% compared to the previous year and real growth – 23.2%. Nominal growth of the wage level exceeds the real growth of labor productivity by 1.8%. However, excluding such non-market sphere as public administration and defense where nominal wage increase was the highest – 72%, the difference between nominal wage and labor productivity is disappearing and the growth rate of the latter even exceeds the wage growth reducing the inflation risk and on the contrary, affect the price reduction. Note, annual growth rate of wages in the public sector was quite high (57%) that should promote rapid growth of wages in the private sector also, however, high unemployment level in the country impedes this process.

Unemployment

Coefficient of labor force participation in IIQ06 dropped to 62.2% while in the relevant period of the last year it was 64.6%. The number of the employed also decreased, particularly, the number of the employed by 37.6 thousand people, and by 27.6 thousand people – the number of the self-employed compared to IIQ of the last year. The number of the self-employed (about 66.5%) in the employment still exceeds that basically comes on the agriculture. It is notable that the coefficient of the labor force participation in Georgia is higher than in the well-developed countries that demonstrates that the economic situation in Georgia forces many people to be more active in looking for a job.

In regard to the unemployment level¹ it dropped to 12.9% in IIQ06 (in IIQ05 the unemployment was 13.4%). True, the unemployment tends to decrease but proceeding from its still high level, it cannot be considered as a serious source for inflation growth in Georgia.

3.5 Production and Demand

Despite significant negative impact of exogenous factors, the GDP annual growth rate in IQ06 still demonstrated rapid upward tendency. According to

¹ Calculated on the basis of strict criterion of World Labor Organization.

available information, economic growth was conditioned by both domestic and foreign demand¹.

Production

In IQ06, compared to the analogous period of the previous year, real annual GDP growth comprised 8.4%. The industry by industry study of the economic growth proves that rather high growth rate of the GDP is not as much specific for a sector as represents the consequence of joint growth. Particularly, except for the agriculture, electrical power generation, conditional rent for use of own dwelling and public administration, all the types of economic activities demonstrated positive indicator of growth. In addition, we have to take into account such exogenous factors as:

- temporary problems in the energy sector due to the damage of trunk pipeline and limitation of power import, which negatively affect not only the energy generation but naturally other industries, especially industrial production;
- information spread in regard to Avian flu due to which the number of poultry and production of eggs almost halved;
- unfavorable climatic conditions for the agricultural production;
- fulfillment of construction works conducted in the framework of large energy projects;
- recent increase of price on energy carriers being a significant factor of production that reduces the economic potential.

Taking all aforementioned factors into account, the review of the economic growth by industries allows us to make quite positive conclusions. Among the economic activities, 57% annual growth rate of financial intermediation is worth to mention that was mostly conditioned by increase of net interest yield - the largest segment of the industry, as a result of expending crediting of the private sector by the banking system at an expedited rate. In regard to the impact of Russia's embargo, this factor will slow down the GDP growth rate from IIQ06.

Diagram 3.5.1
GDP Real Annual Growth Rate

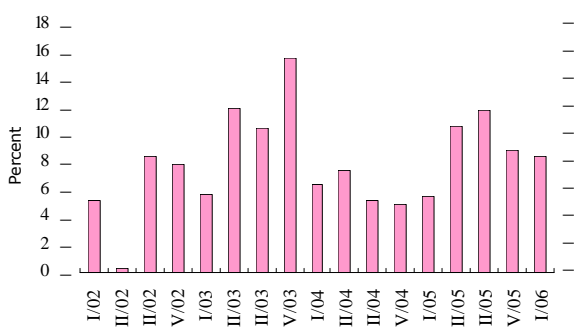


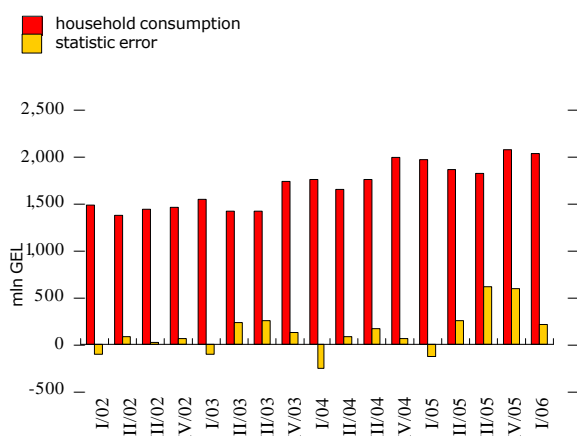
Table 3.4.5
GDP Real Annual Growth Rate (in percentage) and Impact on Growth (in percentage points) by Types of Economic Activities

	2005		IQ 2006	
	growth	impact	growth	impact
Agriculture, hunting and forestry, fishery and fishing	12	2	-8.3	-1.2
Mining industry	-13.5	-0.1	1.6	0
Processing industry	14.3	1.2	2.5	0.2
Generation and distribution of electricity, natural gas and water	5	0.2	-8.7	-0.2
Production processing by households	12.5	0.5	2.5	0.1
Construction	22.3	1.8	25.9	2.3
Trade, repair of cars, household items and personal objects	3.4	0.4	13.8	1.6
Hotels and restaurants	16.4	0.4	8.5	0.2
Transport, auxiliary and additional transport activities	5.7	0.5	37.7	3.2
Communication and post	29.5	1.1	19.5	0.8
Financial intermediation	52.2	0.7	56.7	1.1
Real estate transactions, leasing and commercial services	7.6	0.2	11.4	0.3
Conditional rent for using own dwelling	-0.3	0	-1.6	0
Public administration, defense	-6.1	-0.4	-6.2	-0.4
Education	13.5	0.5	9.6	0.3
Healthcare and social services	3.7	0.1	3.3	0.1
Other communal, social and personal services	4	0.1	17.2	0.5
Hired services in households	24.9	0	29.4	0
Indirect evaluation of application of financial intermediation in business activities	57.6	-0.4	2.8	0
GDP in reference prices	10.1	9.3	9.9	9
(+) Taxes on products	1	0.1	-6.8	-0.8
(-) Subsidies	0.5	0	-12	0.1
GDP in market prices	9.3	9.3	8.4	8.4

¹ Foreign trade is being discussed in the part of Balance of payment of this review.

Diagram 3.5.2

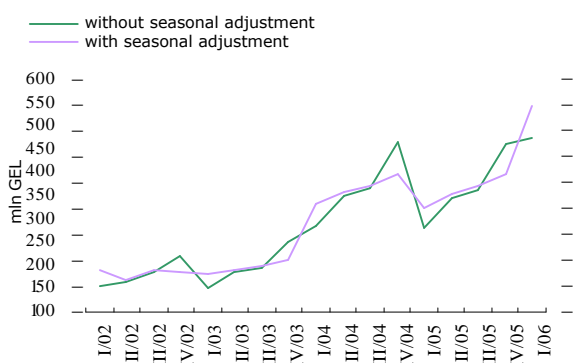
Household Consumption and Statistic Error Noticeable Between the Volumes Calculated by Methods of GDP Generation and Expenditure, in Current Prices



Positive indicator of statistic error demonstrates excess of the amount calculated by means of GDP generation method.

Diagram 3.5.3

Public Consumption, in Current Prices



Household Consumption

In IQ06 compared to the same period of the previous year, household consumption in nominal terms increased by 2.6%, which in case of adjustment by consumer price index would equal real reduction in the same amount. However, it should be noted that like in the previous period, significant statistic error was noticeable between the volumes calculated by methods of the GDP generation and expenditure that unlike to IQ05 was now expressed in the excess of the GDP volume calculated by production method. Proceeding from the fact that the GDP calculated by means of production is considered as an official indicator in Georgia and correspondingly, is more reliable, the consumption expenditure of the households in reality should have been significantly more that is obvious because of increased import indicators.

Public Consumption

In IQ06, the indicator of public consumption compared to the same period of the last year grew dramatically – by 68%. Notably, annual growth rate of the total budgetary expenditures was more moderate, – 23%. Such a growth of the public consumption in the accounting period along with its growth could be accounted for low base indicator. The pressure on the formation of the internal demand of the public sector was still the most essential¹.

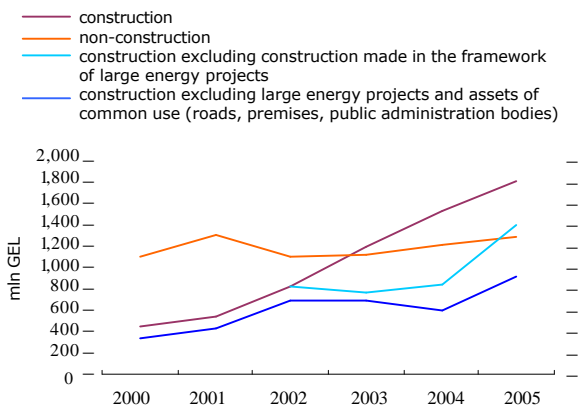
Investments

Like household consumer expenses, the investments made in the fixed capital in IQ06 also remained modest. Moreover, compared to the same period of the previous year, this indicator even in nominal terms and even excluding consumption of the fixed capital – still reduced. True, as mentioned above, construction works fulfilled within large energy projects reduced. However, as a result of the expenses incurred by the public sector to develop the infrastructure and expansion of housing construction, the construction investments still dramatically went up. The investment drop came on non-construction segment. However, for the last three quarters the ratio indicator of the latter to the GDP had an upward tendency.

¹ See: Inflation Report, I quarter, 2006, National Bank of Georgia, pp. 31-32.

Diagram 3.5.4

Investments in Fixed Capital by Construction and Non-construction type (in current prices)

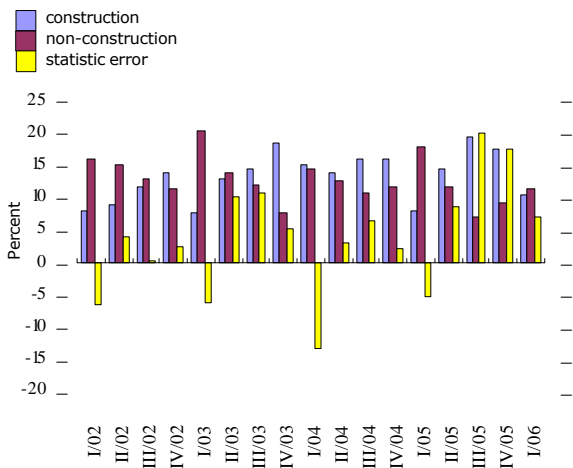


Construction type investments are presented in base prices while total investments – in market prices. Hence, due to the difference of VAT accrued on the formal sector of construction, actually, the share of construction type investments in total investments compared to the one displayed on the diagram is respectively more.

While reviewing the dynamics of the investment demand, before making more or less important conclusions, it should be noted that the statistic error mentioned above should be taken into consideration here too. Obviously the investments were larger.

Diagram 3.5.5

Ratio of Total Formation of Fixed Capital by Construction and Non-construction Type and Statistic Error With the GDP Calculated by Production



Positive indicator of the statistic error reflects the excess of the indicator calculated by GDP generation method over the indicator calculated by expenditure method. Furthermore, the issue explained in the previous diagram in regard to VAT accrued on the formal part of the construction sector, still remains actual.

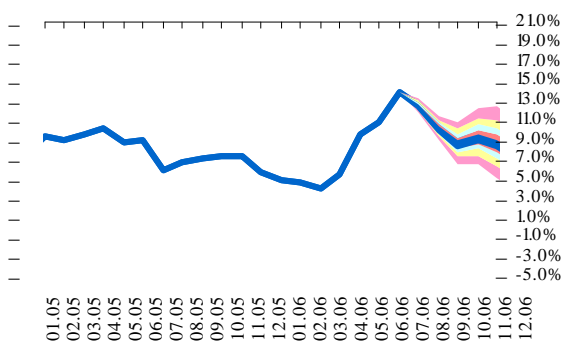
Expected inflation – under unchanged monetary policy, but in the conditions of projected increase of GDP by 8.5% and money supply – by 33%, also, in the condition of GEL/USD unchanged exchange rate, as well as price rise on oil according to market expectation, harvest- worse than last year, small increase of imported inflation and without the impact of other possible exogenous factors – will look as follows¹ :

In accordance with the obtained forecast, annual inflation in the December of current year will change from 8.3% to 8.98% with 10% probability.

However, it should be noted that it is impossible to take into account all potential risks in the model. Because of that, such risks as bad climatic conditions, price increase conditioned by Avian flu, increase in domestic demand due to expansive fiscal policy planned in the second half of the year, etc are worth to mention. The factors influencing downward direction of prices are also worth mentioning.

Hence, based on what was said above and in the conditions of current high inflation, in the medium-run tightening of monetary policy by the NBG is anticipated.

Diagram 4.1
Inflation Forecast
2005-2006



¹ for additional information on forecast model of inflation see A. Mestvirishvili, T. Mdivnishvili., Inflation Simulation and Forecast for Georgia, magazine Banki 3(20), 2004.

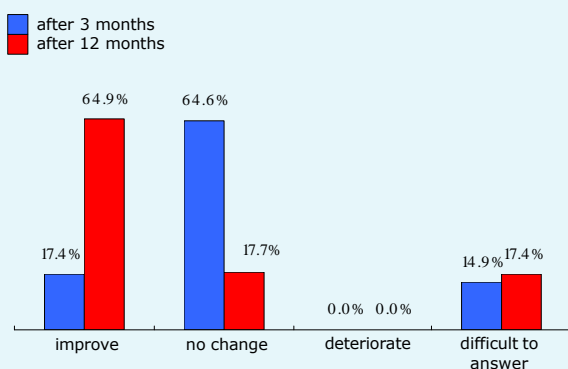
Results of the Polls of the Commercial Bank Managers

In the conditions of the market economy, one of the driving forces of the market is the expectation of economic agents towards various economic processes. In this regard, the National Bank of Georgia from May 2006 started to carry out monthly polls with the managers of the commercial banks, as important participants of monetary and financial markets of Georgia, on their expectations from future economic development, in regard to GEL exchange rate fluctuation, inflation processes, etc.

As the poll demonstrated, in the long-term perspective (after one year) commercial banks assume improvement of the general state of the economy. 64.9% of the commercial bank managers think that the economic condition will improve, 17.7% considers that the situation will remain unchanged and 17.45 found it difficult answer the question.

64.6% of the commercial bank managers consider that in the short-term perspective (after three months) the state of the economy will not be changed. Only 17.45 expected improvement, and 14.9% found it difficult to answer the question. Note, neither in short nor in long-term perspective do the commercial bank managers expect deterioration of the general condition of economy (see diagram N1).

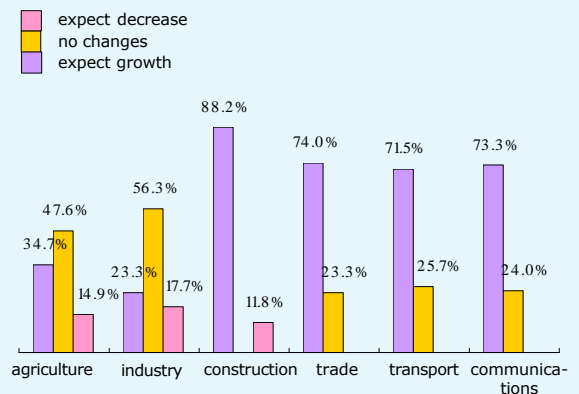
Diagram 1
Economic Condition of Georgia



Commercial banks during the following one year expect economic growth in construction, trade, communications and transport. 88.2%, 74%, 73.3%, 71.5%, respectively, of those interviewed assume growth of these sectors of economy. In regard to the agriculture, only 34.7% of the commercial bank managers think that the growth in this sector is

anticipated. It should be noted that the commercial banks expect the growth the least in industry: only 23.3% of the respondents consider that there will be growth in industry. In industry and agriculture most of the commercial banks (56.3% and 47.6%, respectively) suppose that changes should not be expected (see diagram N2).

Diagram 2
Economic Growth in Various Sectors During the Coming Year



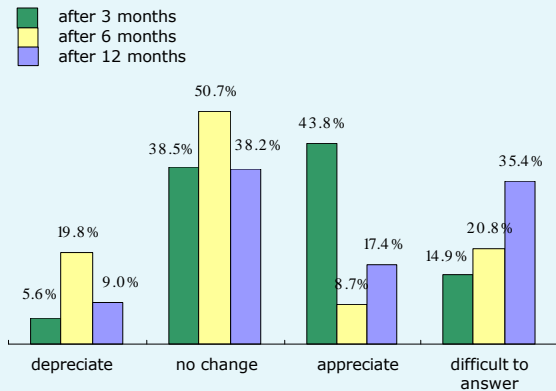
Furthermore, the poll contains the evaluation of the future changes in the exchange rate of GEL against USD. The poll demonstrated that in the short-term perspective most of the commercial bank authorities consider that GEL exchange rate will either further appreciate or will be relatively stable (43.8% and 38.5%, respectively). Lari depreciation is expected by only 5.6%, and 14.9% found it difficult to make a forecast.

In the mid-term perspective (after 6 months), the most of respondents (50.7%) consider that GEL exchange rate will not change substantially. Compared to the short-term, in the mid-term perspective fewer consider that in this period GEL exchange rate will further appreciate – only 8.7%. On the contrary, 20% of the respondents think GEL will depreciate against USD. Note, the number of the respondents who expect depreciation of GEL in the mid-term perspective has significantly grew from May to June. If in May only 6.3% expected depreciation, in June this indicator increased to 33.3%.

Most of the commercial bank managers (38.2%) think that in the long-term perspective, GEL exchange rate will be stable. The exchange rate change is more ambiguous after a year: 35.4% of the

respondents found it difficult to make a forecast. Compared to the short-term, the share of the managers who expects appreciation of the exchange rate is less – 17.4%. And in the long-term perspective, GEL depreciation is expected by only 9% (see diagram N3).

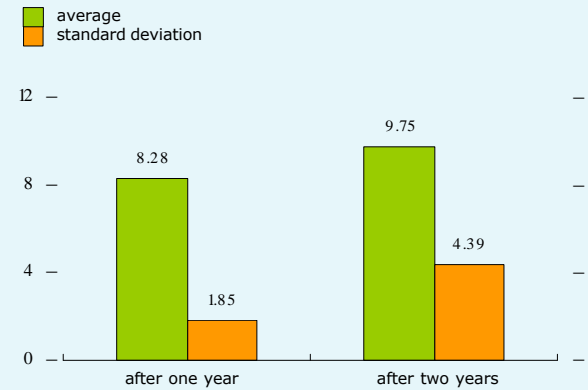
Diagram 3
How GEL Exchange Rate Will Change



In regard to the inflation expectation of the commercial bank managers, they expect 8.28% annual inflation after a year. The inflation expectation is even higher two years later – approximately 9.75%. It is worth to mention the inflation expectation after a year from May to June increased: if in May the bank managers expected 7.42% annual inflation, in June this indicator increased to 8.82%. Inflation expectation after

two years tends to be relatively stable month to month, but concurrently it has higher dispersion than the inflation expectation after a year (see diagram N4).

Diagram 4
Annual Inflation Forecast Indicators



Hence, as the poll demonstrated, the commercial banks in the country expect economic growth in the long-term perspective, basically in such sectors as construction, trade, communications and transport. GEL exchange rate according to bank managers' forecast will be relatively stable, however, in the short-term perspective more expect appreciation and in the long-term – depreciation. After one year, inflation expectation has upward tendency, concurrently, commercial banks expect higher inflation after two years.

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