

NATIONAL BANK OF GEORGIA

INFLATION REPORT

III Quarter, 2006



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The third quarter of 2006 demonstrated relatively high inflation rate, although it experienced certain decrease during the quarter. During the first two months, annual inflation indicators were 14,5% and 13,4%, respectively, but in September it equaled to 11,2%. Core inflation indicators also dropped demonstrating relatively small share of the demand factors in the price increase.

Annual growth of deposits (43%) and loans (69.2%) in the banking sector was still observed during the reporting period, although compared with the previous quarter, growth parameters slightly decreased (48.9% and 85.3%, respectively). Money aggregate growth rates also decreased at a certain extent – annual growth of reserve money in terms of IIIQ results comprised 17.5%, and annual growth of broad money M2 and M3 aggregates accounted to 29.6% and 33.9% growth, respectively.

Like before, the trend of GEL appreciation against US dollar continued in IIIQ06, being the consequence of increase in the demand for GEL and the dynamics of US dollar on the world market.

In regard to the real exchange rate of GEL, it depreciated insignificantly – by 0.27% - in the reporting period. The same is true in terms of nominal effective exchange rate, however, in the opposite direction, it appreciated by 0.1%.

The main influence of the deficit of the balance of payments in IIIQ06 had the embargo imposed by Russia accounting for 93% deterioration of balance of trade in goods. Concurrently, the resort season was a success accounting for the positive impact on the balance of payments. On the whole, this parameter showed 89% annual deterioration.

Like in the previous quarter, the reporting period witnessed high growth rate of tax revenues. This parameter, compared with the analogous indicator of the previous quarter, grew by 49.6%. The share of non-tax revenues and grants also went up, however, the share of capital revenues in the State Budget dropped.

In IH06, compared with the analogous period of the previous year, annual real growth rate of the GDP comprised 7.8%. These indicators by quarters are - 8.45 and 7.4% in the first and second quarters, respectively. Positive growth indicator was observed in all the types of economic activities, except for the agriculture in the IIQ.

By the end of 2006, estimated indicator of consumer price index growth will be in the range of 7.10%-9.25%.

According to the information provided by the Department of Statistics at the Ministry of Economic Development of Georgia, general level of consumer prices in the period from December 2005 to September 2006 went up by 6 %.

After consumer price index (CPI) inflation in July and August accounted to 14.5% and 13.4%, respectively, in September annual CPI inflation comprised 11.2%. High inflation indicator during the year was significantly conditioned by exogenous factors: international prices on oil and sugar, Avian flu, increased price on natural gas (and electricity, respectively) from Russia, meteorological factors, etc. Negative influence of most of these factors on prices persisted in September too.

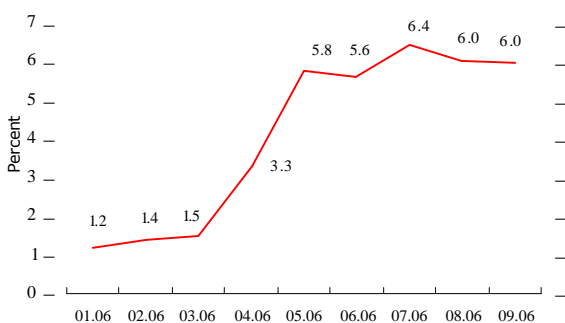
During the year price increase on energy carriers was a strong negative factor for Georgia’s economy. During the recent months, in the period of especially high inflation, the prices on energy carriers promoted the inflation and in June its growth exceeded 2.0 percentage points. In addition to direct impact, price increase on energy carriers led to the production cost increase accounting for price increase in other products too. The fact that international prices on oil products (and sugar) reduces is a positive factor.

Although, the influence of negative exogenous factors have not been eliminated the monetary policy aiming at decrease of money supply and money multiplication, along with the aforementioned positive exogenous factor, ensured price stability in August-September.

Price Change by Commodity Groups

Price rise is especially conspicuous on non-durable goods. Price on them for the last year has equaled to 13.8%, while price rise on semi-durable goods equaled to 1.9%, and prices on durable goods even decreased by 2%.

Diagram 2.1
Price Dynamics in 2006
 (December, 2005=100%)



Core Inflation

While assessing inflation by means of CPI, due to qualitatively different dynamics of prices on particular products from the rest of production – increase or decrease in very big quantities – could distort the actual picture. To carry out correct monetary policy, it is important to assess general trend of prices and temporary price fluctuations on particular goods.

Core annual inflation represents such a measure of inflation. According to the data of IIIQ06, annual core inflation has a downward trend and gives the basis for optimism. It is also likely that simplification of trading regime may account for the price decrease. However, discontinuation of trading with Russia will be a vigorous negative factor for the general price level in Georgia in the short-term period.

Table 2.1
Inflation (CPI) Indicators by Separate Components (percentage), their Weights in the Consumer Basket (percentage) and Impact on CPI (percentage point)

	Weight	September- October- September- October-	September- October- September- October-	September- October- September- October-		September- October- September- October-		
	September 2006			Inflation	Impact	Inflation	Impact	Inflation
Total	100.0	100.0	8.6	8.6	11.2	11.2	6.0	6.0
Food and non-alcoholic beverages	44.1	42.6	10.9	4.7	17.9	7.5	7.1	3.2
Food	42.8	41.2	11.0	4.6	18.6	7.5	7.3	3.1
Bread and bread products	9.8	11.4	0.9	0.1	0.6	0.1	0.8	0.1
Meat and meat products	7.2	6.4	17.7	1.2	14.0	1.0	11.2	0.8
Fish	1.0	0.9	12.1	0.1	3.1	0.0	-5.6	-0.1
Milk, cheese, egg	6.3	5.6	18.3	0.9	32.1	1.7	6.0	0.4
Oil and fat	3.0	3.5	-0.7	0.0	0.1	0.0	2.1	0.1
Fruit, grapes	4.0	2.4	21.3	0.7	40.7	1.3	17.0	0.6
Vegetables, gourds, potato and other bulbous	8.0	7.8	11.4	0.9	44.8	2.7	12.2	0.9
Sugar, jam, honey, syrup, chocolate, confectionary	3.3	3.1	21.5	0.6	21.8	0.7	11.5	0.4
Other food products	0.2	0.2	3.6	0.0	2.6	0.0	2.3	0.0
Non-alcoholic beverages	1.4	1.4	5.7	0.1	0.3	0.0	1.8	0.0
Alcoholic drinks, tobacco	7.8	6.2	15.4	1.3	1.2	0.1	-9.0	-0.8
Cloths and footwear	4.4	5.0	4.7	0.2	4.7	0.2	1.6	0.1
Residential house, water, electricity, gas and other means of heating	9.8	8.8	14.6	1.2	26.4	2.3	22.4	1.9
Furniture, household items and other details, house maintenance and repair	2.8	3.2	0.9	0.0	-0.4	0.0	-0.8	0.0
Healthcare	6.9	7.3	3.5	0.2	15.6	1.0	14.9	0.9
Transport	11.1	11.4	7.8	0.9	0.8	0.1	5.0	0.6
Communications	3.4	4.3	-6.3	-0.3	-4.1	-0.2	-0.3	0.0
Leisure, entertainment, culture	2.6	3.1	1.6	0.0	-1.0	0.0	-1.2	0.0
Education	2.3	3.0	0.8	0.0	-1.4	0.0	-1.4	0.0
Hotels, cafes and restaurants	2.9	2.9	6.1	0.2	4.6	0.1	4.8	0.1
Different goods and service	1.9	2.3	1.4	0.0	0.7	0.0	0.9	0.0
Nondurable goods	69.1	65.5	10.6	7.2	13.8	9.3	6.5	4.5
Semi-durable goods	5.3	6.1	2.7	0.2	1.9	0.1	0.3	0.0
Durable goods	1.8	2.3	-1.0	0.0	-2.0	0.0	-2.4	0.0
Service	23.7	26.1	4.6	1.1	6.5	1.6	5.8	1.4

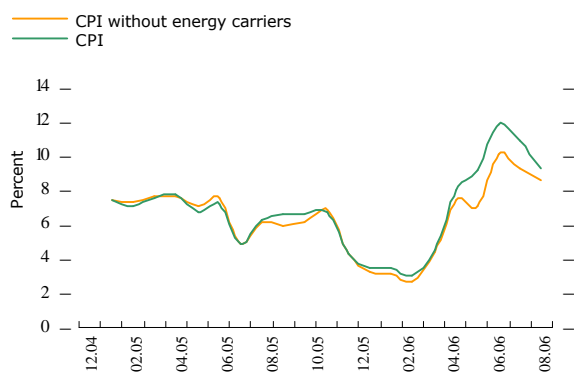
Information source: Calculations made by Department of Statistics at the Ministry of Economic Development and National Bank of Georgia.

Table 2.2
Products Having the Highest Impact on the Inflation Growth
and the Reasons for Price Rise

	Increase	Impact	Main reason
Diesel fuel L-42 & L-62	1.0955	0.07%	World price
One-room flat rent	1.2477	0.07%	International trend
Selling value of one-room flat	1.2467	0.09%	International trend
Travel by bus, car and taxi	1.0329	0.12%	Fuel price
Imeretian cheese	1.0453	0.13%	Meteorological
Chicken meat	1.2476	0.14%	Avian flu
Beans, dry	1.2521	0.22%	Meteorological
Apples	1.2302	0.23%	Meteorological
Eggs	1.1317	0.24%	Avian flu
Natural gas	1.3486	0.27%	Russia's price
sugar	1.1736	0.34%	World price
Gasoline Normal and Regular	1.145	0.43%	World price
Cabbage, leaf	2.5603	0.66%	Meteorological
Potatoes	1.6106	1.12%	Meteorological + import related difficulties
Electricity fee	1.5894	1.57%	Russia's price on gas
Total		5.71%	

The impact of price increase of the products given in the Table of the general inflation indicator is compensated by price decrease on some of the products.

Diagram 2.2
CPI Change Taking into Consideration Prices on
Energy Carriers and without Them¹



¹Calculations are made in compliance with the weights of the initial period of the consumer basket by using geometric middling. Energy carriers include electricity fee, liquid and natural gas, kerosene, diesel fuel and petrol.

Diagram 2.3
Annual CPI Inflation by Local, Imported and Mixed Final Output in the Consumer Basket

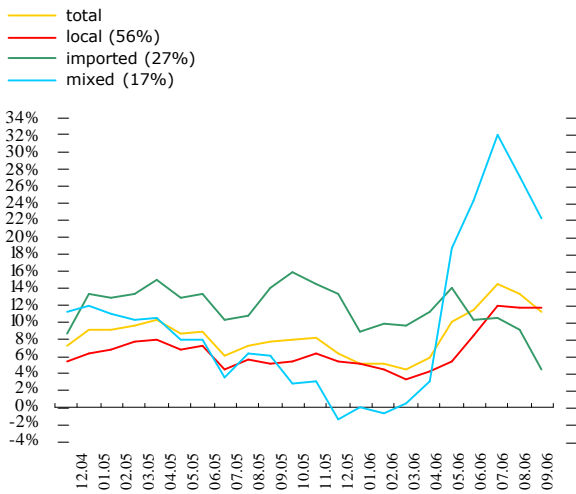


Diagram 2.4
Annual CPI inflation for goods and services of different durability

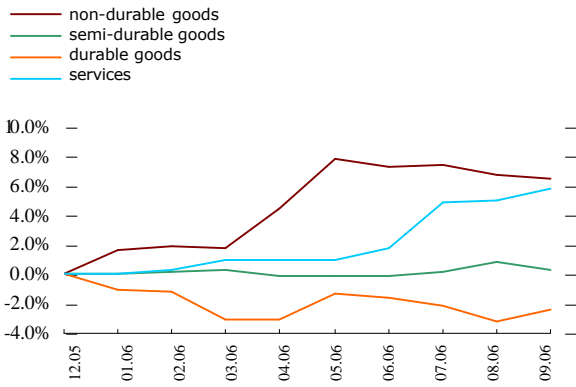
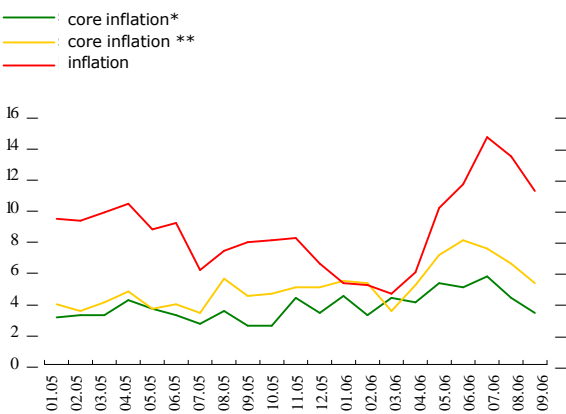


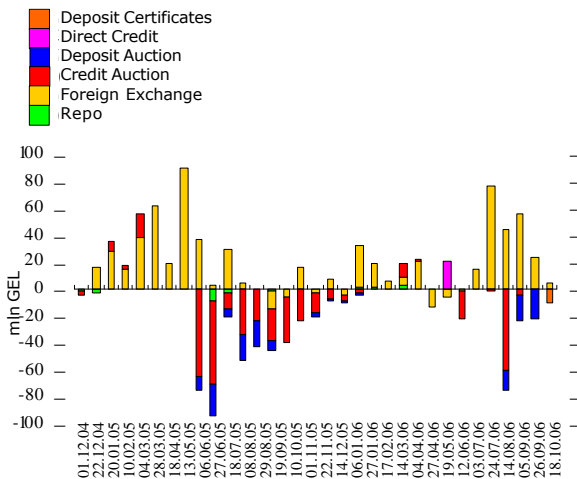
Diagram 2.5
Annual CPI and Core Inflation 1 (Consumer Basket by 311 components)



* By products (about 85%) within one standard deviation.
 ** By products (about 93%) within two standard deviation.

Diagram 3.1.1

Money Supply by the NBG according to Monetary Instruments and Foreign Exchange
2004-2006



3.1. Monetary Aggregates

Reserve money indicator in the 9 months of current year increased by GEL 95.5 mln (95%) and equaled GEL 1096.9 mln by the end-September.

In September a new instrument – deposit certificates – was introduced. Concurrently, to avoid dramatic shocks of GEL rate, the National Bank of Georgia purchased USD 110.5 mln on the exchange market in 9 months by means of which liquidity worth of GEL 197.2 mln was supplied. In total, the National Bank of Georgia supplied the banking system with GEL 202.8 mln via monetary instruments and exchange market in 9 months.

The reserve money was also significantly influenced by government deposits, which increased by GEL 183 mln in 9 months and comprised GEL 370 mln.

In regard to international reserves of the National Bank of Georgia, it increased by USD 144.4 mln in 9 months and accounted to USD 618.5 mln, basically being the consequence of transfers from the following sources: privatization – USD 139 mln (USD 7.1 mln from selling the trolley carbarn, USD 4 mln from selling hotels in Ajara, USD 10 mln – from Likani resort complex, USD 16.2 mln – from “Mziuri”, USD 90 mln from “Elektrokavshiri” and from advance payments made for: Batumi port – USD 3.5 mln, energy objects – USD 8.2 mln), license fee for cellular communication network – USD 39.7 mln, assistance of Ukraine government – USD 2. mln, conversion of the Russian military bases – USD 10.9 mln, also mainly, by the transfer of the following amounts: foreign debt servicing (principals and interests) – USD 89.2 mln, government conversions – USD 151,5 mln (o/w, USD 111.8 mln to the Ministry of Defense) and interventions on Tbilisi Interbank Foreign Exchange Market – USD 110.5 mln.

Along with the abovementioned monetary flow, reserve money grew by GEL 95.5 mln in 9 month starting from the beginning of the year and comprised GEL 1096.9 mln. O/w, the volume of the cash

Diagram 3.1.2

Reserve Money Dynamics
2004-2006

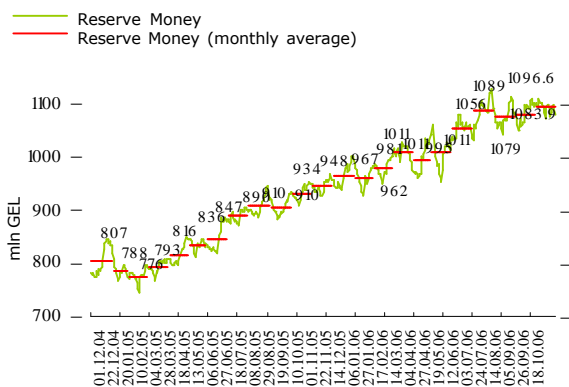
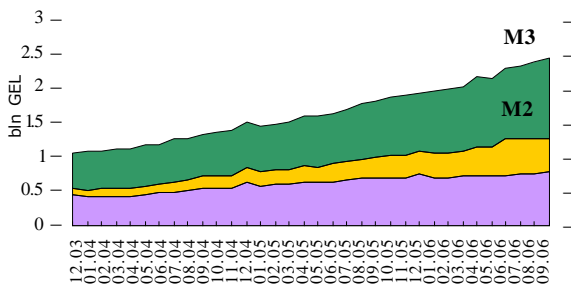


Diagram 3.1.3
Broad Money
2004-2006

■ Cash outside banks
■ Deposit liabilities (national currency)
■ Deposit liabilities (foreign currency)



in circulation is 78%, obligatory reserves – 28%, and 4% - balances on the bank correspondent accounts.

Broad Money

In 9 months of the current year M-3 indicator went up by GEL 509.8 mln and comprised GEL 2421 mln. The growth of M3 was conditioned by increase of all the components.

From the beginning of the year, deposits in the national currency grew by GEL 166.5 mln and comprised GEL 500.1 mln by the end of nine months, and the deposits in foreign currency went up by GEL 306.3 mln and by the end of September comprised GEL 1147.6 mln. In regard to the cash outside the banks, its volume from the beginning of the year increased by 5% (GEL 37.0 mln) and comprised GEL 773.2 mln. Along with the growth of the deposits in the national currency, M2 went up by 19% (GEL 203.5 mln) from the beginning of the year and comprised GEL 1273.4 mln.

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	08.06	09.06
Reserve money	965 679	962 173	980 628	1 010 662	994 916	1 009 900	1 055 670	1 088 791	1 078 869	1 084 228
Money in circulation	757 856	749 525	750 025	764 167	776 114	771 004	793 176	819 941	834 220	838 575
Bank deposits	207 823	212 648	230 602	246 495	218 802	238 896	262 493	268 850	244 649	838 575
Obligatory reserves	130 669	130 971	135 858	139 980	142 765	149 461	156 064	161 170	167 925	245 653
Balances on correspondent accounts	77 154	81 677	94 744	106 515	76 037	89 435	106 429	107 680	76 724	56 030
One-day deposits	-	-	-	-	-	-	-	-	-	-

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	08.06	09.06
Reserve money	1 001 451	981 862	1 003 217	978 908	1 035 131	1 013 794	1 044 679	1 092 892	1 083 669	1 096 913
Money in circulation	811 400	749 215	756 571	775 443	792 910	776 499	803 260	828 941	836 942	853 577
Bank deposits	190 051	232 647	246 646	203 466	242 221	237 295	241 418	263 952	246 727	243 336
Obligatory reserves	129 833	133 183	137 960	139 334	143 655	151 959	158 689	162 958	177 646	202 331
Balances on correspondent accounts	60 218	99 464	108 686	64 132	98 566	85 335	82 729	100 994	69 081	41 005
One-day deposits	-	-	-	-	-	-	-	-	-	-

Table 3.1.3
Monthly Changes of Money Aggregates
by Monthly Average Data, 2006

	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06
Broad Money /M3/	1 937 372	1 967 731	2 003 218	2 166 389	2 157 712	2 284 205	2 318 376	2 369 466	2 421 024
Money supply /M2/	1 050 325	1 052 238	1 087 516	1 142 254	1 146 637	1 251 806	1 247 437	1 252 135	1 273 391
Cash outside the banks	682 176	688 986	709 102	714 856	706 063	729 106	744 932	751 449	773 243
Lari in circulation	749 215	756 571	775 443	792 910	776 499	803 260	828 941	836 942	853 577
Deposits in the national currency	368 149	363 252	378 414	427 398	440 574	522 700	502 505	500 686	500 148
Deposits in the foreign currency	887 047	915 494	915 701	1 024 135	1 011 074	1 032 399	1 070 939	1 117 331	1 147 633

Table 3.1.4
Monthly Changes of Money Aggregates
by Latest Monthly Data 2006

	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06
Broad Money /M3/	1 903 627	1 921 751	1 993 524	2 082 984	2 113 973	2 243 630	2 306 400	2 343 769	2 375 230
Money supply /M2/	1 026 072	1 039 195	1 073 505	1 117 572	1 118 633	1 235 061	1 248 464	1 258 831	1 257 269
Cash outside the banks	683 949	683 061	690 421	710 012	691 760	717 759	737 754	751 951	757 246
Lari in circulation	749 405	751 361	766 587	785 728	765 605	797 349	823 040	836 074	842 073
Deposits in the national currency	342 123	356 134	383 085	407 559	426 872	517 302	510 710	506 880	500 023
Deposits in the foreign currency	877 555	882 556	920 018	965 413	995 340	1 008 568	1 057 936	1 084 937	1 117 961

Diagram 3.2.1
Dynamics of the Economy Crediting by the Banking System and the Reserve Money
(logarithmic scale)

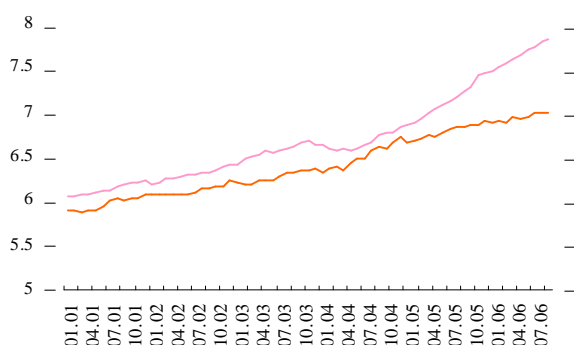


Diagram 3.2.2
Dynamics of the Consumer Loans

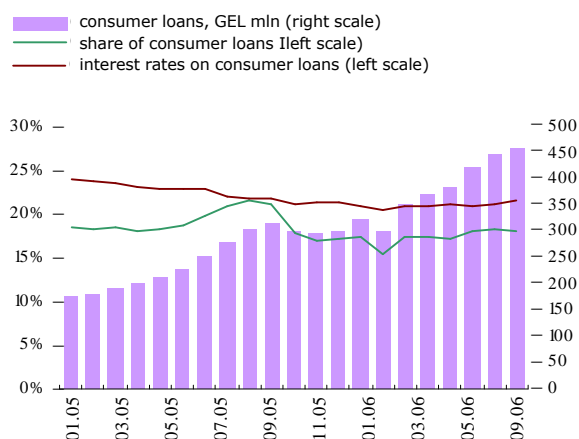


Table 3.2.1
Credit Portfolio Distribution among Economy Sectors

	loan GEL mln	share	growth rate	share of the outstanding loan and interest	interest rate	interest rate a year ago
agriculture	15	1%	7%	4%	16%	20%
industry	342	19%	61%	6%	14%	15%
construction	183	10%	85%	2%	17%	16%
trade	841	48%	82%	2%	19%	16%
hotels and restaurants	32	2%	62%	2%	34%	17%
transport and communication	33	2%	-23%	1%	16%	13%
financial intermediation	38	2%	-20%	1%	8%	7%
real estate transactions, commerce	12	1%	-1%	3%	18%	16%
other services	261	15%	501%	2%	13%	12%

Along with the growth of monetary aggregates, their multipliers also grew: M3 multiplier – from 1.91 to 2.21 (15.6%), and M2- multiplier – from 1.07 to 1.16 (8.6%).

The key factor for annual growth of the broad money indicator is the dramatic growth of loans being one of the features of rapid development of the banking sector. The reason for dramatic – 14.0% - growth of money multiplier is the same, accounting for 33.9% growth of the broad money.

The National Bank of Georgia decided to introduce changes in regard to compulsory reserve norms to slow down the growth rate of money aggregates, multipliers and money supply. Particularly, minimal norm for the obligatory reserves of the attracted, on average funds, in the national currency increased to 2% since August 20, and to 4% since 10th September.

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

In IIIQ06, fast growth of the banking sector continued. By the end-September the banking sector assets growth rate comprised annual 69.2% and reached GEL 2417 mln in absolute terms. Real annual growth of the banking sector, taking into consideration inflation, comprised 52.1% demonstrating a significant role of the financial sector in the economy.

The loans granted to the economic agents, according to IIIQ06 data increased by annual 80.1% and quarterly 13.4%. The diagram demonstrates that until the end of 2004 the growth rate of crediting of the economy and the key indicator of the monetary policy in Georgia – the reserve money, was almost the same. And starting from the end of 2004, the rate of the economy crediting was significantly higher that took place not only at the expense of loans in foreign currency. The volume of credits granted to the economy in lari in 2005 was substantially exceeding the volume of credits extended in foreign currency. In 2006 the growth rate slowed down but did not lag behind the growth rate of loans extended in foreign currency. Faster growth of the loans denominated in lari, compared to that of reserve money supply, demonstrates the growth of the economic activity. Concurrently, the banking sector tends to be using the financial resources more efficiently.

Diagram 3.2.3
Dynamics of mortgages

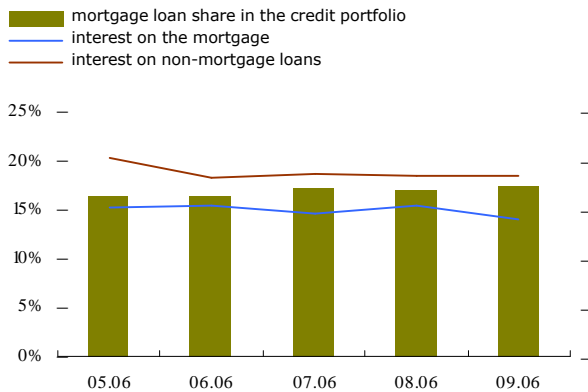


Diagram 3.2.4
Mortgage and non-mortgages loan yields by maturities on the loans allocated in September 2006

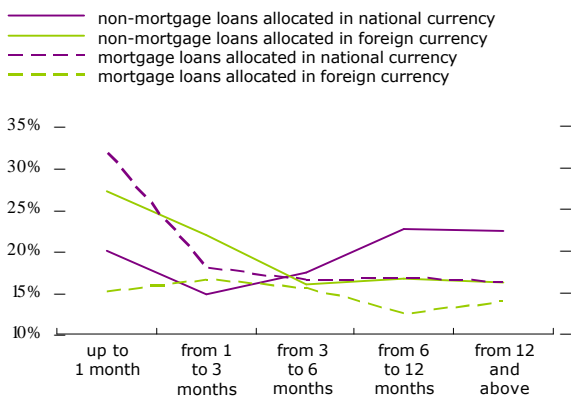
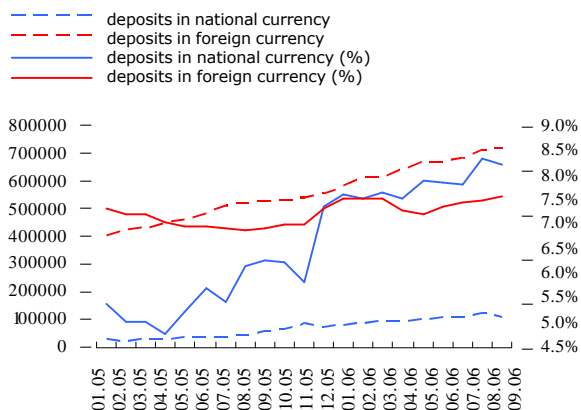


Diagram 3.2.5
Volume of Term Deposits (left scale, GEL mln) and Interest Rates (right scale) in 2005-2006



The volume of the consumer loans by the end of September of 2006 grew by annual 50.6%. Despite the above, the share of the consumer loans in the loans extended to the economy in a year dropped from 21.5% to 18.1%. Hence, consumer loans did not represent the main source for expansion of the credit portfolio of the banking sector. For the last one year, average interest rate of the consumer loans has not changed significantly. By the end of III quarter of 2006, the interest rate comprised 21.6% being only 0.3 percentage point below the last year indicator.

The distribution of non-consumer loans by economic sectors shows that 48% of the allocated loans are concentrated in the trade sphere. The loans extended to this sector increased dramatically – by annual 82%. The loans granted to the trade sector could be considered as the main source for the growth of the credit portfolio of the banks. Note, the interest rate in the trade sphere went up from 16 to 19%, i.e. high growth rate of the loans extended to this sector is conditioned by demand for it. The construction (85% annual growth) and industry (61% of annual growth) sectors also had tangible influence on the growth of the credit portfolio, relatively small though. Since crediting is pro-cyclic to economic activity, we can assume that the economic activity in the aforementioned sectors significantly grew.

In the credit portfolio of the banks the share of the mortgage loans went up. In addition, the interest rate on the mortgage loans was relatively low. The yield on the mortgage loans in September 2006 was 14.05 on average, while on non-mortgage loans – 18.5%.

In the III quarter of the current year, the deposit liabilities increased by annual 44.3% and comprised GEL 1.61 billion. Term deposits during the similar period increased by annual 43% and comprised GEL 831 mln. Deposits denominated in lari are especially fast growing, which demonstrated 92.1% annual growth.

Box 1. Deposit Insurance

Well-developed banking system is one of the determining factors for the growth of the country economy. Deposit insurance system that determines its sustainability and development is one of the important components of the banking system.

Georgia is the only country in Europe that has not yet adopted the law on deposit insurance.

Euro-directive 94/19/EC calls for obligatory deposit insurance system for the state-members and gives detail description of its specificity. In compliance with Article 3 of the directive, all the members shall introduce and officially recognize that at least one system of the obligatory deposit insurance shall be effective on the territory of the country. A special commission shall carry out monitoring over the deposit insurance system, as well as insure harmonization of the country legislation with the aforementioned directive in the state-members.

Goals for Deposit Insurance and Anticipated Outcomes

The deposit insurance system promotes accomplishment of the following goals:

- protection of small depositors

If there is a deposit insurance system in place, it will especially safeguard small deposits.

The accounts of 97% of the physical persons – depositors – do not exceed GEL 3.600. Hence, in case of the bank bankruptcy, a big majority of small depositors will be almost 100% protected. If the deposit insurance system is in place, in case the bank goes bankrupt, the depositors' savings shall be immediately reimbursed within the insured limit.

- Increased public trust towards the banking system

The system of the deposit insurance increases the public's confidence towards the financial sector and decreases the probability of development of the system risks. By increasing the savings, the banks

will have bigger resources for crediting, thus facilitating the economic growth and development. Introduction of the deposit system in Georgia will facilitate the increase of the deposits, as well as their diversification.

Table 1
Deposit Insurance System in Europe and CIS Countries

Country	Law on deposit insurance in place	Obligatory system of deposit insurance
Albania	yes	has
Armenia	yes	has
Austria	yes	has
Azerbaijan	yes	has
Belgium	yes	has
Belorussia	yes	has
Bosnia	yes	has
Bulgaria	yes	has
Czechia	yes	has
Croatia	yes	has
Cyprus	yes	has
Denmark	yes	has
Estonia	yes	has
France	yes	has
Finland	yes	has
Georgia	no	does not have
Germany	yes	has
Greece	yes	has
Hungary	yes	has
Ireland	yes	has
Island	yes	has
Italy	yes	has
Kazakhstan	yes	has
Latvia	yes	has
Lithuania	yes	has
Luxemburg	yes	has
Macedonia	yes	has
Moldova	yes	has
Netherlands	yes	has
Norway	yes	has
Poland	yes	has
Portugal	yes	has
Romania	yes	has
Russia	yes	has
Spain	yes	has
Slovakia	yes	has
Serbia	yes	has
Sweden	yes	has
Switzerland	yes	has
Turkey	yes	has
Ukraine	yes	has

Financing source for the deposit insurance system

Regular source for financing the deposit system is the bank payments. Often the government actively participates in the formation of the fund since formation of the fund only by the banks is rather difficult as it is connected with big funds. The government finances (in the form of a loan or capital) the deposit insurance agencies. Doing so the government, on the one hand, makes the future payments

available for the banks, and on the other, the government makes its contribution to the financial sustainability of the country.

Participation in the deposit insurance system – obligatory or voluntary

Today the world knows two options –based on the voluntary principle and obligatory system. However, the best practice is considered the system

based on the obligatory membership, since in case of voluntary participation only weak banks will become members and the system will not be financially prudent (participation of all banks is necessary so that costs of the system involvement be equally distributed and the scheme retain financial soundness). Proceeding from this, European directive calls for the introduction of the obligatory system of deposit insurance among the state-members. Furthermore, in some European countries along with the obligatory schemes there are private, voluntary schemes (e.g. in Germany).

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

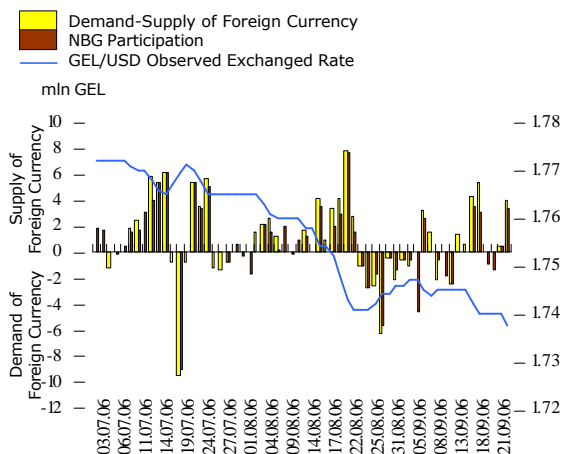


Diagram 3.3.2
GEL Banknote Rate Dynamics
 IIIQ, 2006

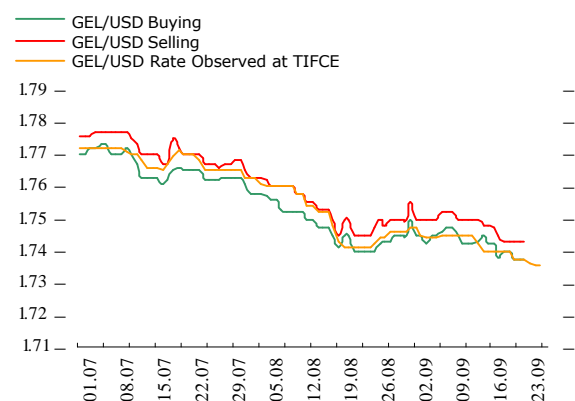
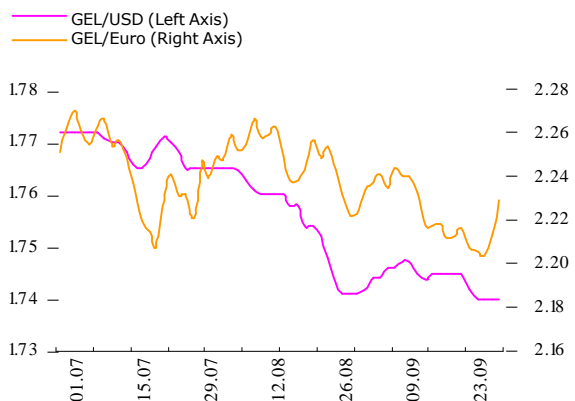


Diagram 3.3.3
GEL Exchange Rate Dynamics Against Euro and USD
 IIIQ, 2006



3.3. Exchange Rate, Dollarization and Balance of Payment

Foreign Exchange Market

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. It should also be mentioned that GEL appreciation was observed by the end of the period (2.18%), as well as by the average data for the period - (1.18%), compared to IIQ05.

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 IIIQ05 the above parameters equaled to USD 80.96 and 110.8 million, respectively, in IIIQ06 they amounted to USD 89.2 and 148 million, corresponding to 10.2 and 33.5% increase, respectively. Interventions of NBG at the exchange market also increased. If in IIIQ05 NBG purchased currency at the amount of USD 45.7 million, in April and May of 2006 the amount purchased by NBG equaled to 89.9 million. NBG indicators for selling currency for IIQ05 and IIQ06 amounted to USD 21 and 42.3 million, respectively. NBG interventions were directed against undesirable hikes, which finally were reflected in the decrease of national currency short-term instability.

The observed dynamics of GEL exchange rate at Tbilisi Inter-bank Foreign Exchange was similar to GEL exchange rate at the banknote segment, demonstrating that GEL exchange rate dynamics was defined by the same driving force all over the country.

GEL exchange rate against Euro appreciated by 2.44% during the quarter (2.252 at the beginning of the quarter, and 2.197 - at the end). As you may see from the diagrams, the dynamics of GEL rate against other currencies was similar, except for Turkish Lira, which continued to have the tendency observed in the previous quarter and appreciated against GEL by 2.5% (in IIQ06 the appreciation amounted to 18.75%).

Diagram 3.3.4
GEL Exchange Rate Dynamics Against Russian Ruble and British Pound Sterling
 IIIQ, 2006

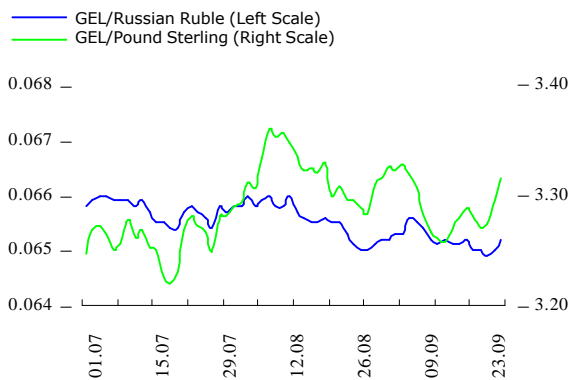


Diagram 3.3.5
GEL Exchange Rate Dynamics Against Swiss Franc and Turkish Lira
 IIIQ, 2006

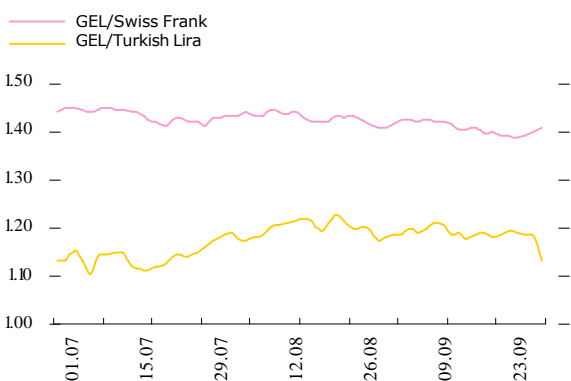
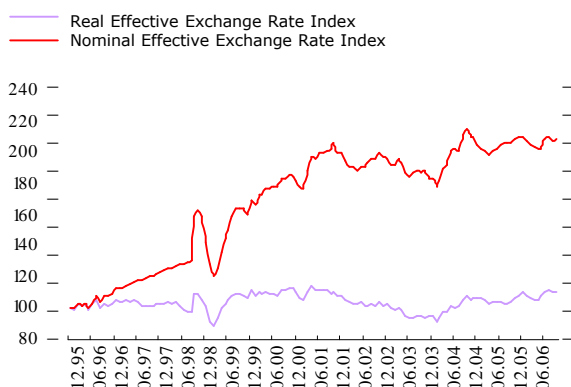


Diagram 3.3.6
Index of Real and Nominal Effective Exchange Rates
 December, 1995=100



Real Exchange Rate

In IIIQ06 the real exchange rate depreciated a little, compared to IIQ06 – 0.27%. However, it should also be mentioned that compared to the end of the last year it appreciated by 0.54%. As for the nominal effective exchange rate, the appreciation was insignificant during the quarter – 0.1%, though, real effective, as well as nominal effective exchange rates appreciated compared to IIQ05 indicators - by 5.96% and 1.5%, respectively.

GEL real exchange rate had similar dynamics against other currencies, excluding Turkish Lira, against which GEL real exchange rate depreciated dramatically at the beginning of the quarter (6.5% during two months), and appreciated a little during the following period (0.2%).

Balance of Payments

Based on preliminary data, in IIQ06 two competing factors affected the size of deficit of the balance of payments. The first – negative factor – was the embargo imposed by Russia on the goods produced in Georgia that resulted in deterioration of the balance of foreign trade in goods by 93% and exceeded USD 1 billion. The other – positive factor – was a successful holiday season. Based on the data, provided by the Department of Frontier Protection, the number of tourists entered Georgia in IIIQ06 was 16 000 more compared to the first half of the year. The result was that the deficit of the balance of payments deteriorated by 94% in IIIQ06 and amounted to USD 210 million. The negative balance of the current accounts during the nine months of 2006 totaled to USD 532 thousand and exceeded the indicator of the analogous period for 2005 by 89%.

The volume of export, during the past nine months of the current year, amounted to USD 1398.7 thousand, which is 31% more compared to the 2005 indicator for the relevant period. The negative results of trade prohibitions imposed by Russia on Georgia were significantly diminished by serious export increase of such products the share of which is rather tangible in Georgian export, i.e. ethyl spirits (the volume of export during 9 months of 2006 increased by 9% compared to the analogous period of 2005), ferroalloy (20%), gold (39%), nitrogen fertilizer (48%), aircrafts (55%), copper ore and concentrates (76%). Only these six types of goods account for 40% of total export. The export of the rest of the goods (that do

Diagram 3.3.7

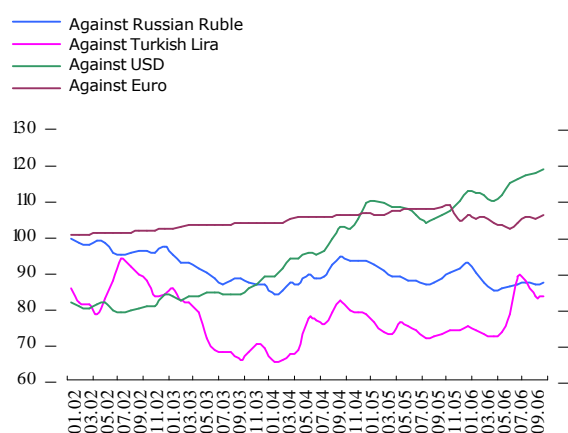
GEL Real Exchange Rate against Individual Currencies
 December, 1995=1000


Diagram 3.3.8

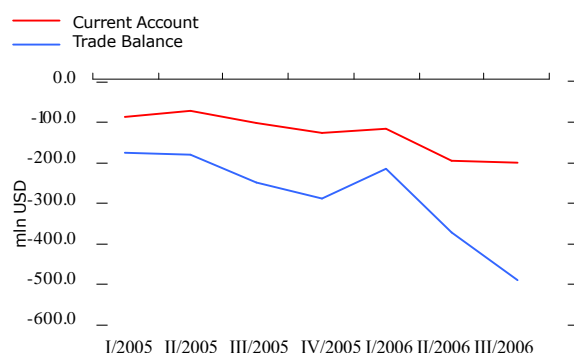
Dynamics of the Current Account Deficit


Table 3.3.1

Dynamics of Georgian Foreign Trade Balance
 9 months, 2006

	total	I Q.	II Q.	III Q.
Foreign Trade balance	-1103.7	-221.2	-382.9	-499.6
Export	1398.7	442	473	483.6
Import	-2502.4	-663.3	-855.9	-983.3
Coefficient of Import Coverage by Export	55.9	66.6	55.3	49.2

not fall under the largest export ten) approximately increased by 27%.

The volume of wine export 75% of which traditionally accounted for Russia (79% during nine months of 2005) decreased by 40%, i.e. USD 22 million. However, as a result of geographic changes of the product export, the export of wine to other countries increased by USD 6 million. The share of Ukraine in wine export increased from 11 to 25%, while the share of Kazakhstan – from 2 to 10%. The maintenance of Russia's big share in total wine export (50%) was conditioned by large amount of wine export to Russia in the first quarter of the current year (table 2).

The share of Russia significantly decreased in the export of nuts (from 23 down to 15%) and ethyl spirits (from 66 down to 27%). The above resulted in export decrease by USD 2.7 and 7.4 million, respectively in the nine months of 2006.

The share of Russia in mineral water export decreased from 74% (during nine months of 2005) down to 53%. Along with this, the share of Ukraine increased from 14% up to 24%, and the share of Kazakhstan – from 3% up to 6%.

In the nine months of the current year the import of goods was still growing at a higher rate, compared to export. Compared to the first nine months of the previous year, the volume of the goods import increased by 47.1% (41% in IQ, 58% – in IIQ, and 44% – in IIIQ), and amounted to USD 2.5 billion. The above was conditioned by price increase on oil and oil products, on the one hand, and on the other – by Russia increasing the price for natural gas for Georgia. However, the volume of import of such goods as - cars (by 84% compared to nine months of 2005, though, the export of cars has also significantly increased), wheat – 2.1 times, transmitting radio and TV equipment - by 89%, equipment for data automated processing – 2.1 times, tricks – by 56% - increased.

Trade obstructions imposed by Russia during the last 9 months did not significantly affect the geographic structure of the import. It is expected that serious changes, in this respect, will impact the annual results.

Balance of service improved compared to the first half of 2005 and amounted to USD 223 mln instead of USD 102 mln (2.2 times more). However, exogenous and

Table 3.3-2
Distribution of the Largest Groups of Export Goods by Importer Countries

Share in the Total Export	Ferroalloy	Crafts	Copper Ore and Concentrates	Non-ferrous Metal Scrap	Gold	Wine	Fertilizers	Nuts and Walnuts	Cars	Spirits
	10	8	8	7.4	5	5	5	4	4	3
Russia	24	5				50		15	2	27
Turkey	7			66					24	
Azerbaijan									54	3
Germany			6	1				16		
Turkmenistan		85								
Ukraine	16					25		3	3	52
USA	42	1		2		3	46			
Bulgaria			71							
Italy							3	38		
Kazakhstan		1				10				10
Czech Republic								10		
Spain			13	2			10	3		
Serbia			10							
Armenia							17	1	14	1
France		2					9	1		
Greece							4	1		
Brazil							10			
Canada					97					
United Kingdom									2	
Other Countries	9	8	0	29	3	12	1	12	1	7

Diagram 3.3-9
Dynamics of Wine Export

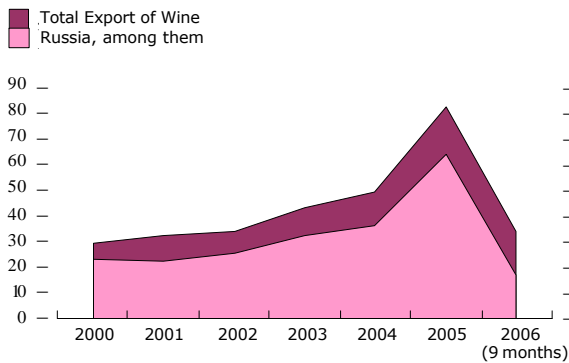
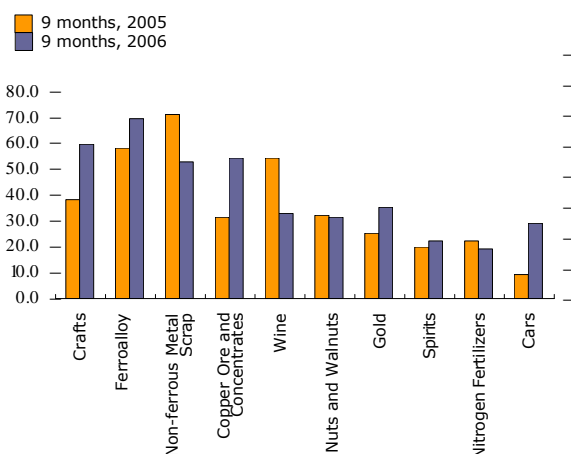


Diagram 3.3-10
Dynamic of Volume of the Ten Largest Export Goods (mln, USD)
 January-September, 2005-2006



endogenous factors had equal serious positive, as well as negative impact on it.

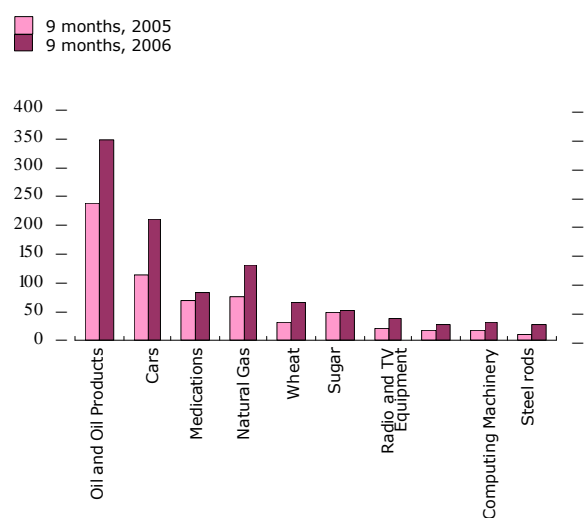
Embargo, imposed by Russia on Georgian production, had not least impact on shipment between the two countries, due to which, during the reporting period the balance of transport service deteriorated and its deficit amounted to USD 47 mln. The balances of other services, such as construction, insurance and some other types of business service also had deficit due to which the total deficit equaled to USD 35 mln. However, positive trends in the spheres of pipe-line transport and tourism had 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 is becoming apparent. In the reporting period, the revenues generated from oil transportation, as compared to the analogous period of the previous year, increased by 68% and exceeded USD 47 mln, comprising 5% (i.e. more than 1 percentage point than on average during 2005) of the revenues generated from service export.

Along with the rehabilitation of tourism infrastructure in the country, as well as liberalization of traveling procedures with the neighboring countries and unilateral visa procedures (with 30 countries), significant increase of the scale of business and private tourism is observed. The number of foreign tourists increased not only in the Black Sea region. Short-term tours are becoming more and more attractive – extreme, adventurous, eco and wine tours. The number of foreigners who entered Georgia during the first nine months of 2006 comprised 310.5 thousand, being 212.1 thousand more, and exceeded the number of visits of foreigners during the analogous period of the last year by 54%. Participation of Georgia in international tourism exhibitions, where the information about the resorts of Georgia is disseminated, plays significant role in the above. The number of visits of Georgians paid to foreign countries increased by 53%, i.e. by 334.3 thousand, and amounted to 967.3 thousand persons during the past nine months. As a result, positive balance of tourism service amounted to USD 208 mln and significantly influenced the maintenance of positive balance in the sphere of service.

Current transfers still remain a significant factor defining not only the balance of payments, but also the consumer market conjuncture of the country. Decrease of money flow from Russia – due to compli-

Diagram 3.3.11
Dynamic of Volume of the Ten Largest Export Goods (mln, USD)
 January-September, 2005-2006



cated relationship between Georgia and Russia and public excitement related with the suspension of money orders from Russia - cannot be observed, so far. However, in some cases, money orders from Russia to Georgia are traveling through the third countries. During the reporting period of the current year, the amount of money transfers to Georgia exceeded USD 400 mln, being 46% more compared to the analogous indicator of the previous year. Traditionally, 68% of the total transfers still account for Russia.

Table 3.3.3
Distribution of the Largest Groups of Export Goods by Importer Countries

	Oil and Oil Products	Cars	Natural Gas	Medications	Wheat	Sugar	Communications Equipment	Computing Machinery	Steel rods	Trucks
Share in the Total Import	13	8	5	3	3	2	1.5	1	1	1
Russia	1	2	96	4	80	3		1	2	10
Turkey	1	1		6		4	22	1		27
Azerbaijan	48		3			13				
Germany		44		10			9	12		24
Turkmenistan	25									
Ukraine				6	4	1	1	9	97	11
USA		19		1			9	4		
Bulgaria	11	1		3	2					1
Arab			5							
United Emirates							20	9		1
Kazakhstan					14					
Brazil						47				
Belarus				1		12			1	13
Netherlands		3		3				33		5
Finland							15	3		
France		2		9		1		1		1
Switzerland				11		12				
Hungary		1		7		4	2	1		
China							2	12		
United Kingdom		1		4		2	3	2		1
Other Countries	14	21	1	35	0	1	17	12	0	6

Box N2. Impact of Russian Embargo on the Key Indicators of Georgian Economy

Along with the tense political relationship, Russia announced the imposition of economic embargo on Georgia in September, 2006. The embargo was followed by persecution of Georgians residing in Russia. In addition, significant increase of tariff on natural gas imported from Russia is also expected.

Evaluation of economic impact of the embargo is rather difficult, though, the analysis of short-term results, to some extent, is still possible. It is also noteworthy that besides expected negative results of economic embargo, the process is accompanied by certain positive factors.

Persecution of Georgians residing in Russia will cause the decrease of their income. Many of them will no more be willing to live in Russia and come back to Georgia (or will move to other countries like Ukraine). If such developments continue for a long time and acquire big scale, the result will be the demand increase for short and long-term perspective, which will promote price rise, especially on real estate. The above will condition GEL appreciation, as well as unemployment. However, on the other hand, qualified labor force will return to Georgia along with capital, which, in long-term perspective, is a significant supporting factor for the development of economy and increase of employment.

As it was expected, the attempt of Russian authorities to introduce legal restrictions on money orders to Georgia was not followed by any results. It is expected that in 2007 the volume of money orders from Russia will maintain the level of 2006.

Impact of Russian Embargo on Inflation

Reduction of import from Russia will create the deficit of certain goods for short-term period. However, the products will still be imported to Georgia through the third countries (for example, Ukraine, Azerbaijan). It is also possible that some products will be substituted by goods produced locally or in other countries, which, in the long-term perspective, shall be a positive change for the development of business in Georgia, reduction of unemployment and increase of GDP.

It goes without saying that reduction of import will cause the price rise on the above goods, though, taking into consideration the decrease of customs tariffs in September, the price rise on the imported goods will be insignificant, and, under moderate monetary policy, its maintenance within the range of 6-7% will be possible.

Impact of Russian Blockade on GDP of Georgia

The damage inflicted by restriction of the import of non-energy carriers will approximately amount to USD 15 mln, being 0.2-0.3% of GDP during the last three months of 2006.

Negative impact of import procedures on 2007 GDP will amount to no more than 0.4-0.5 percentage points (the import value will increase approximately by USD 35 mln).

Energy carriers - such as Electricity and oil - were imported to Georgia from Russia, though their volume was insignificant. The share of Russia in the import of oil and oil products is not very high - 1.6%. Respectively, restrictions imposed on the import of the above products can in no way significantly affect Georgian economy. As for the import of natural gas, it will decrease GDP growth by 1.65 percentage points, at the worst.

Finding access to the new market for the products is less anticipated in the short-term period (1-3 months). Due to lack of possibilities to export goods to Russia, the enterprises will have to suspend production of the goods they were planning to export to Russia. In such case, in 2006 GDP will have shortfall of the production at the amount of USD 12 mln (0.2% of GDP).

Restriction of export of Georgian production (wine, ferroalloy, mineral water, spirits, and agricultural products) to Russia means, at the worst, loosing USD 65 mln of revenues from export for Georgian economy, being 0.7% of GDP.

Table 1.
Impact of Russian Embargo on GDP

	<u>2006</u>	<u>2007</u>
Import of non-energy carriers	0.2-0.3%	0.4-0.5%
Import of energy carriers	-	1.65%
Export	0.20%	0.70%
Embargo total negative impact	0.50%	2.80%
Annual projected GDP increase	7.80%	10.5% ¹
Annual GDP increase taking into considerati	7.30%	7.70%

In the end, it should be noted that imposing economic embargo by Russia is a loss for Russia itself from political, as well as from economic standpoint, which, in financial terms, may even exceed the damage inflicted on Georgia. However, the damage calculated based on relative indicators, taking into consideration the sizes of the countries, will be more tangible for Georgia rather than for Russia.

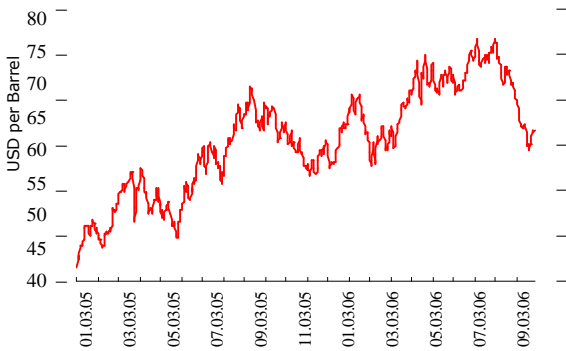
¹ Projection of relatively higher annual increase, compared to 2006, is based on better harvest of agricultural products.

3.4. Costs of Production

Oil Prices

In IIIQ06 the tendency of price rise observed in IH06 was sharply changed. If at the beginning of the quarter high prices on oil and energy carriers were retained, they started to quickly go down starting from August and fell down by 22% - from USD 76.98 down to USD 60.04 – during the period from August 7 to September 22.

Diagram 3.4.1
Dynamics of Oil Prices



Taxes

According to the reference information of the first 9 months of 2006, the revenues and grants of the state budget comprised GEL 2 661.9 mln, and own revenues – GEL 2 570 mln. In the same period tax revenues equaled to GEL 1 898.2 mln. The increase of tax revenues compared to the corresponding period of 2005 comprised 49.6%, and real growth (taking into consideration inflation) – 37.2%. Current year plan of tax revenues was successfully accomplished – by 104.5%, while the plan of revenues and grants, as well as own revenues – by 103.7% and 103.8%, respectively. The share of revenues generated as a result of tax collection made 71.3% of the state budget revenues and grants. The indicator amounted to 70.3 for the analogous period of the previous year. In addition, the share of non-tax revenues and grants increased compared to the previous year, but the share of capital revenues – decreased.

During the first 9 months of 2006 the revenues generated from all types of taxes dramatically increased compared to the analogous period of 2005 and the growth rate was expressed in two-digit figure, among them, the annual growth rate of revenues collected from the excise tax amounted to 16.4%. The share of revenues generated from the excise tax gradually increased in the state budget tax revenues – 11.8% in IQ06, and 12.9% in IIIQ06. The issue of tobacco smuggling should be particularly noted. Before April of the current year, the excise tax rate was higher in Georgia compared to the neighboring countries that was kindling the interest of smugglers. As a result of the changes made to the Tax Code of Georgia at the end of April of the current year, the excise tax rate decreased on a number of tobacco products, which resulted in excise tax revenue increase collected from tobacco products. During the

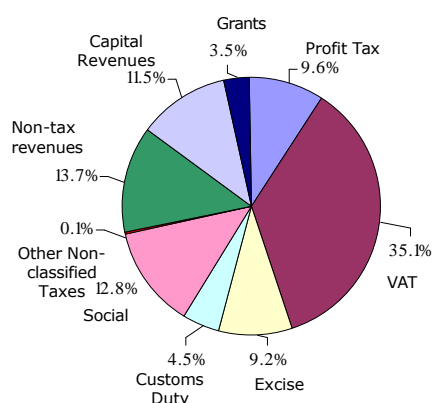
Table 3.4.1
Nominal and Real Growth of 2006 January-September State Budget Compared to 2005 January-September
 (percent)

	Nominal Growth	Real Growth*
Total revenues and Grants	47.5	35.3
Total Revenues	46	34
Tax Revenues	49.6	37.2
Profit**	63.2	49.8
VAT	37	25.7
Excise	16.4	6.8
Customs	38.4	26.9
Social	21.2	11.2
Non-Tax Revenues	69	55.1
Capital Revenues	11.6	2.4
Grants	105	88.1

*Real growth is deflated according to average annual inflation (CPI) for the 9 months of 2006.

**The Source for profit tax data is the consolidated budget for the period of January-September 2005-2006.

Diagram 3.4.2
Total Revenues of the State Budget Per Types of revenues
 January-September, 2006



first 9 months of 2006, the tax revenues collected by means of excise tax on cigars, filter-tipped cigarettes and other tobacco products (except for the raw material) exceeded the analogous period indicator of the last year by 37.4%. On the whole, the planned indicator for excise tax revenues for January-September of 2006 was accomplished by 102%.

In the first 9 months of 2006 the state budget received GEL 254.6 mln from profit tax. On the whole, the revenues in the consolidated budget received from profit tax exceed the analogous period indicator of the previous year by 63.2%. The latter may indicate both: improvement of tax administration, as well as higher profit in the private sector. The nine-month plan of the state budget was accomplished by 103.5% by profit tax. It should be taken into consideration that from the beginning of the current year the revenue generated from profit tax was assigned to the state budget, while in 2005 – to the local budgets.

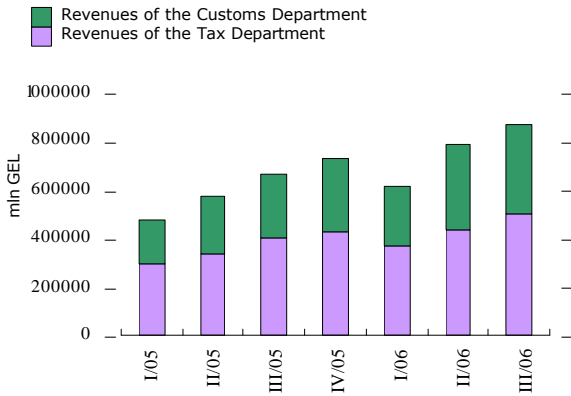
The biggest share in the budget tax revenues accounts for value-added tax (49.3%). Amendments were introduced to the Tax Code of Georgia at the end of 2005, which obliged the persons carrying out economic activities to record the information on the settlement in cash only by means of cash-registers. The goals of the measure are the improvement of VAT administration and reduction of scale of smuggling. The above resulted in GEL 934.9 mln generated from VAT during the 9 months of 2006 that exceeds the indicator for the corresponding period of the previous year by 37%. The plan was accomplished by 105.6%.

The revenues collected from customs tax significantly increased in the 9 months of the current year, and the annual growth rate equaled to 38.4%. The plan for customs tax was accomplished by 102.9%.

The indicator, planned for social tax, the rate of which according to the Tax Code, is 20%, was implemented by 103.8% for the period from January to September of the current year. The revenues generated from social tax exceeded the indicator of the last year analogous period by 21.2%, among them, from non-budgetary sector – by 19.4% - being the indicator of increasing legalization of economy.

Like state budget, the planned indicators of the 9 months of 2006 for the consolidated budget were successfully accomplished. According to the reference information, the own revenues of the consolidated

Diagram 3.4.3
Consolidated Budget revenues



budget exceeded the planned one by 4.3%, and the increase amounted to 35.4% compared to the corresponding period of the previous year. Along with this, the plan for tax revenues was accomplished by 104.5% and exceeded the indicator of the last year analogous period by 32.6%. All taxes, including income, property and gambling business were collected in excess.

The increase of revenues of the Customs and Tax departments clearly demonstrates the improvement of tax administration. In the period from January to September of the current year, the Tax Department fulfilled the plan of the consolidated budget by 103.5%, and the Customs Department – by 105.8%. In addition, the revenues dramatically grew in comparison with the analogous period of the last year, particularly, the revenues of the Tax Department – by GEL 267.2 mln, and the revenues of the Customs Department – by 289.5 mln.

The revenues generated from selling fixed capital amounted to GEL 281.2 mln in the 9 months of 2006, while the revenues received from selling land and non-tangible assets – GEL 25 mln. Total capital revenues amounted to GEL 307 mln. The plan for 9 months of 2006 was accomplished by 100.3%. In the analogous period of the previous year, the capital revenues equaled to GEL 275 mln. Large-scale privatization of the state property carried out in 2005-2006 conditioned the dramatic increase of revenues from transactions involving capital.

Non-tax revenues totaled to GEL 364.9 mln in the period from January to September, 2006. Big share of the above accounts for the revenues generated from state fees, including the revenues received from licensing the activities in communications and post spheres – GEL 139 mln, sanctions and fines, as well as revenues received from NBG profit (GEL 51 mln). GEL 91.9 mln was received as grants, equaling 99.6% of the planned indicator.

In the period of January-September of 2006, the revenues and grants of the state budget exceeded expenditures by GEL 84.8 mln. T-bills, still in circulation, (GEL 20.3 mln) were repaid in the first half of 2006, while the balances on the Treasury consolidated account increased by GEL 159.4 mln compared to the beginning of the year. Respectively, the deficit was financed through foreign credits.

Labor Productivity, Wages

In IIQ06 the value added generated per employee actually grew by 12.7%. High rate of actual growth was observed in the spheres of industry, trade, healthcare, real-estate transactions and commercial activities. The value added also increased per employee in financial intermediation, education and other spheres of service. The tendency of decrease was observed in the rest of the fields.

Table 3.4.2
The Growth Rate of Value Added Generated Per Employee and Average Monthly Wages in IIIQ06 Compared to the Relevant Period of 2005

	Real Growth of value Added (in percentage)	Nominal Growth of Wages (in percentage)
Agriculture	85.5	118.8
Industry	141	113.3
Construction	90.8	148.4
Trade	192.5	125.3
Hotels and Restaurants	73.5	113.2
Transport and Communications	78.8	125.1
Financial Intermediation	113.7	250.5
Real Estate Transactions	159.1	132
Public Administration, Defence	93.8	136.9
Education	111.7	127.2
Healthcare	168.5	136.3
Other service types	119.3	70.3
Total	112.7	125.8

IIQ06 witnessed dramatic growth of average nominal wages compared to IIQ05, as well as IQ06 – by 25.8% and 9%, respectively. The wages grew both, in the private, as well as in public sector. In IIQ06, the average monthly wages (after taxes) comprised GEL 187.1. Real growth of wages amounted to 15.3%, compared to the IIQ of the previous year.

In IIQ06 nominal growth rate of average wages exceeded two times the real growth of total value added per employee, though, if we deduct such non-market spheres from the above, as public administration and defence, where the growth of nominal wages was rather high, the difference between nominal wages and real growth of value added per employee makes more than 10.5%, including certain risk of inflationary pressure. However, the process, to some extent, is neutralized by high level of unemployment in the country.

Unemployment

In the IIQ06 the situation on the labor market improved to some extent, compared to the IQ, which was reflected in the decreased level of unemployment. However, the number of economically active population decreased from 2036 thousand down to 1952 thousand, compared to the analogous period of the last year, which is related with the increasing number of elderly people and their leaving the labor force due to pension age. During the same period due to decrease of number of the employed, as well as the number of people actively looking for job, the coefficient of labor force participation fell down from 64.7% to 62.2%. The number of the employed in the IIQ06 decreased by 37.6 thousand compared to QII05, while the number of self-employed – by 27.6 thousand. The above was mainly noticeable in such sectors, as industry, trade, public administration, education, healthcare and social assistance. In return, the number of the employed increased in the spheres of

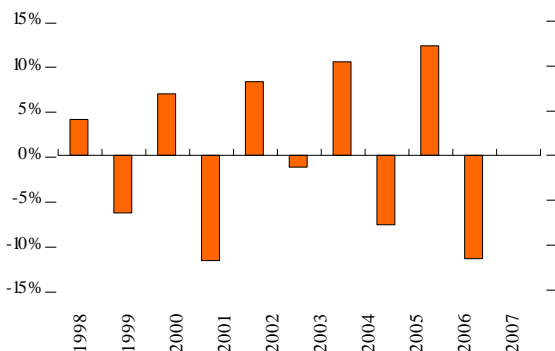
Table 3.4.3
Economically Active Population and Unemployment (in thousands) by WTO strict Criteria

	Total Population at the age of 15 and above	Economically Active Population	Coefficient of Labor Force Participation (percentage)	Total Unemployment	Level of Unemployment (percentage)
2002	3240	2104	65	265	12.6
2003	3105	2051	66.1	236	11.5
2004	3151	2041	64.8	258	12.6
2005	3162	2024	64	279	13.8
I Q.	3178	1999	62.9	294	14.7
II Q.	3149	2036	64.7	272	13.4
III Q.	3132	2012	64.1	270	13.3
IV Q.	3191	2049	64.1	284	13.8
2006					
I Q.	3170	1925	60.7	282	14.6
II Q.	3139	1952	62.2	252.4	12.9

transport and communications, financial activities, hotels and restaurants. In the employment sector the number of the self-employed still dominates (approximately 66.5%), which, first of all, accounts for agricultural sphere. 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. As for the unemployment level¹, it amounted to 12.9% in the IIQ06, whereas it was 13.4% for the analogous period of the previous year.

3.5 Production and Demand

Diagram 3.5.1
Growth Rate of Value Added Generated in Agriculture

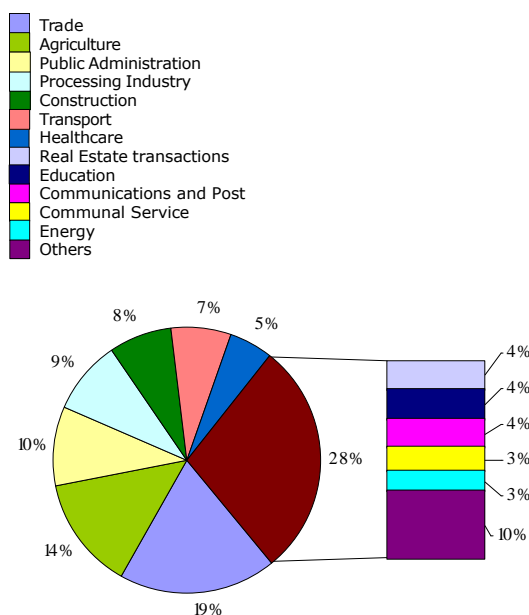


GDP nominal growth was observed based on the data of the IIQ06. Despite significant negative impact of exogenous factors, the annual growth rate of GDP is satisfactory. Based on the available information, economic growth was conditioned by both, domestic and foreign demand².

Production

In the IH06, compared to the analogous period of the previous year, real annual GDP growth rate comprised 7.8%. The indicator was 8.4% in the IQ, and 7.4% - in the IIQ.

Diagram 3.5.2
GDP by Types of Economic Activities



The industry by industry study of the economic growth proves positive growth rate in all the spheres of economic activities, except for agriculture. Due to unfavorable meteorological conditions the real amount of value added generated in the sphere of agriculture decreased by 14.4%, compared to the second quarter of 2005. The aforementioned significantly conditioned the deficit of agricultural products, and respectively, the price rise. The price rise on agricultural products is especially noticeable and creates exaggerated perception of inflation by population compared to its real level.

Traditionally, the years of decrease and increase of value added take turns. Taking into consideration the above pattern, significant increase of value added in the sphere of agriculture is anticipated.

¹ Has been calculated based on WTO strict criteria.

² Foreign Trade is reviewed in the "Balance of Payments" part of the issue.

Diagram 3.5.3

GDP Growth Rate Per Quarters
(compared to the previous year average data)

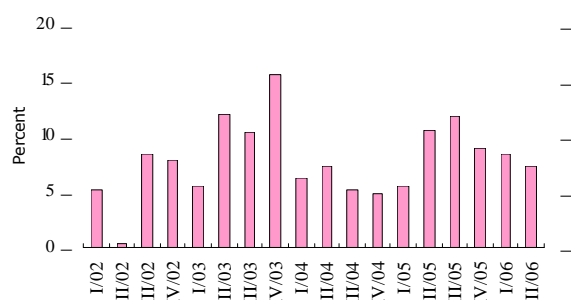


Table 3.5.1

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

	2005		2006 I		2006 II	
	increase	influenc	increase	influenc	increase	influenc
Agriculture, Hunting and Forestry, Fishery and Fishing	12	2	-8.3	-1.2	-14.4	-2.1
Mining Industry	-13.5	-0.1	1.6	0	23.9	0.2
Processing Industry	14.3	1.2	2.5	0.2	20.1	1.7
Generation and distribution of electricity, natural gas and water	5	0.2	-8.7	-0.2	9.6	0.3
Production processing by households	12.5	0.5	2.5	0.1	0.1	0
Construction	22.3	1.8	25.9	2.3	19.1	1.7
Trade, repair of cars, household items and personal objects	3.4	0.4	13.8	1.6	9.8	1.1
Hotels and Restaurants	16.4	0.4	8.5	0.2	10.6	0.3
Transport, auxiliary and additional transport activities	5.7	0.5	37.7	3.2	12.9	1.1
Communications and Post	29.5	1.1	19.5	0.8	16.1	0.7
Financial Intermediation	52.2	0.7	56.7	1.1	20.3	0.4
Real Estate Transactions, leasing and commercial services	7.6	0.2	11.4	0.3	6	0.2
Conditional rent for using own dwelling	-0.3	0	-1.6	0	0.9	0
Public Administration, defence	-6.1	-0.4	-6.2	-0.4	0.2	0
Education	13.5	0.5	9.6	0.3	9.8	0.3
Healthcare and social services	3.7	0.1	3.3	0.1	14	0.5
Other communal, social and personal services	4	0.1	17.2	0.5	19.2	0.6
Hired Services in Households	24.9	0	29.4	0	1.1	0
Indirect evaluation of application of financial intermediation in business activities	57.6	-0.4	2.8	0	2.5	0
based on GDP base price	10.1	9.3	9.9	9	7.9	7
(+) Taxes on products	1	0.1	-6.8	-0.8	3.9	0.5
(-) Subsidies	0.5	0	-12	0.1	-6.6	0
GDP in market prices	9.3	9.3	8.4	8.4	7.4	7.4

Information source: Calculations made by the MoED, Statistics Department and NBG

¹Adjusted evaluation for 2005 will be published at the end of November, 2006

²Adjusted evaluation for 2006 will be published at the end of November, 2007

In IIQ06 the biggest share in GDP growth accounts for processing industry and construction (1.7%). During 2004–2005, after significant decrease, intensive growth was observed in the mining industry (23.9). The growth rate of credits issued by banking sector conditions value added growth generated by financial intermedia-tion. It is true that the annual growth rate of the sector (56.7% in the IQ06) decreased in the IIQ06, but it still remains to be high and amounts to 20.3%.

Household Consumption

Household consumption in nominal terms increased by 10.2% in the IIQ06 compared to the analogous period of the previous year. In case of adjustment by consumer price index, the real indicator would practically be similar to the one for the analogous period of the previous year. However, it should be noted that statistic error existing between the volumes calculated by methods of GDP generation and expenditure makes the discussions about exact sizes complicated. 29% statistic error was observed in IIQ06. The above was expressed in the excess of GDP calculated based on generation method. Proceeding from the fact that GDP calculated by means of generation method is considered as an official indicator in Georgia and respectively, is more reliable, the consumption expenditure of the households in reality could have been significantly higher.

Public Consumption

In IIQ06, the indicator of public consumption compared to the analogous period of the last year grew by 37%. The nominal values for IQ06 and IIQ06 are similar, which, taking into consideration the seasonality, equals to 11% reduction. The major part of the public expenditure affects the formation of domestic demand. However, it should also be noted that part of the incurred expenses, after conversion, are spent on the imported goods. USD 95.2 mln was converted in the first half of the year, being 54% more compared to the analogous period of the last year. If USD 31.4 mln was converted in IQ06, in IIQ06 it grew up to USD 63.8 mln.

Investments

Like household consumer expenses, the investments made in the fixed capital in IIQ06 were also modest

Diagram 3.5.4
GDP Consumption

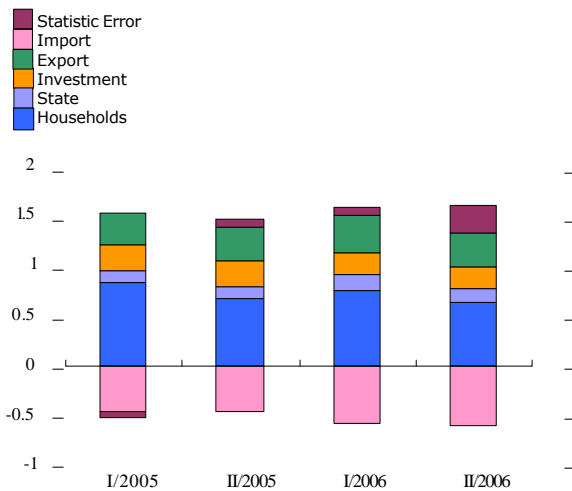
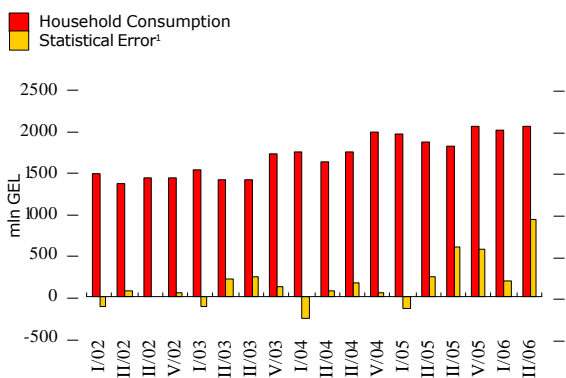
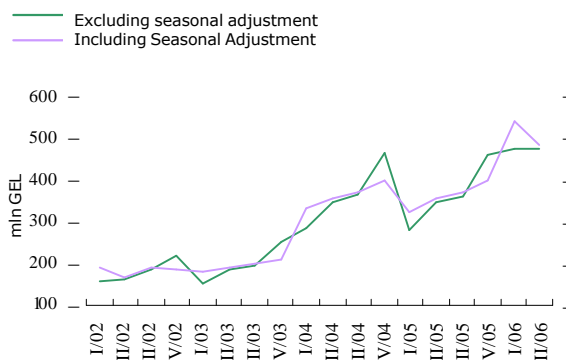


Diagram 3.5.5
Household Consumption and Statistic Error Observed Between the Volumes Calculated by methods of GDP Generation and Expenditure, in Current Prices



¹ Positive Indicator of statistic error demonstrates the excess of GDP amount calculated by means of generation method.

Diagram 3.5.6
State Consumption in Current Price4s



and comprised GEL 706.3 mln. True, the indicator exceeds the one for IQ by 18.8%, but compared to IIQ05, even in nominal terms, it decreased by 4.0%, which is the result of the investments, made in large energy projects, being used up.

Real Estate Price

NBG carries out observation of the prices on housing and commercial space to make analysis of the prices on real estate. Saburtalo and Varketili districts have been selected for this purpose. Weekly survey was carried out on one and tree-room apartments.

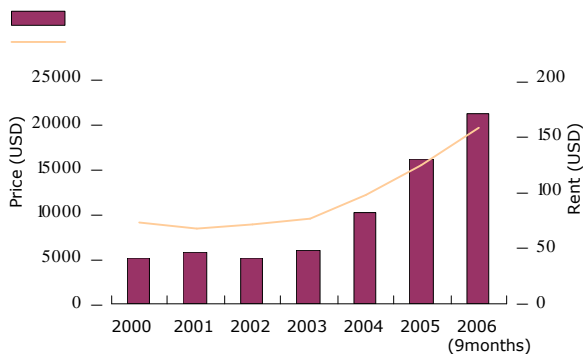
Based on the average data of 2006, the prices on housing space went up by 11-110%, compared to the analogous period of 2004. In the same period, the rent (for one-room apartment) in Saburtalo district grew up by 46%, while in Varketili district – by 101%.

In IIQ the process fell down in Saburtalo district, but remain almost the same in Varketili. Price fall has seasonal character, since small price changes are annually observed in this period. In IIIQ06 the process still went up by 2-3% compared to IIQ06, though it never reached the level of IQ06. Respectively, the average growth rate changed, which was observed to be 27-35%, while compared to the analogous indicators of 2004, it was within the range of 101-111%, being a little higher than six-month indicator.

Despite the fact that 70% profitability, observed in 2004, has lately dropped down, real state still remains to be one of the most attractive investment spheres. By September 2006, the annual yield generated from price rise and rent amounted to 40%.

The increase of mortgage lending made by commercial banks also facilitates the stable maintenance of high prices for housing. Mortgage loans became more available for consumers during 2004-2006. The number of people who had spare resources and for whom investing in housing was profitable, was increased by adding the number of persons who were granted the opportunity to use mortgage lending. They substituted the rent by interest rate to be paid to the bank. The above is demonstrated by dramatic increase of mortgage lending during 2004-2006. The amount of mortgage loans issued by

Diagram 3.5.7
Average rice and Rent for One-room Apartment



banks tripled in 2004, and 1.6 times – in 2005. As of September 2006, the total amount of mortgage lending made by banks in national and foreign currency amounts to GEL 431.8 mln, being 17.02% of the total loans.

Diagram 3.5.g
Housing Space – Saburtalo District

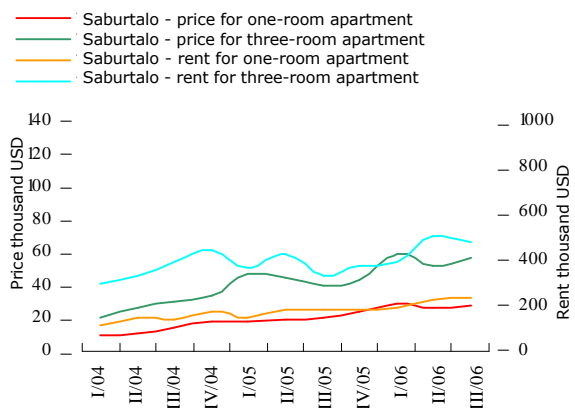


Diagram 3.5.g
Housing Space – Saburtalo District

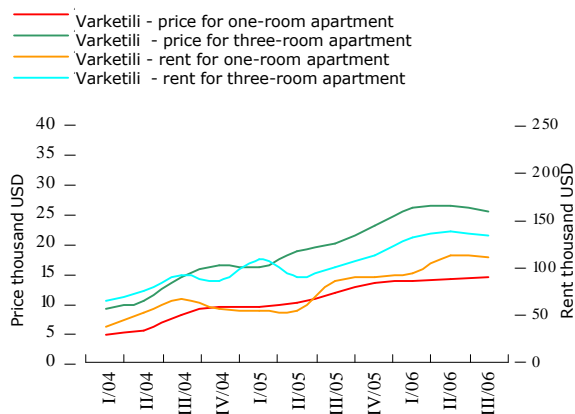
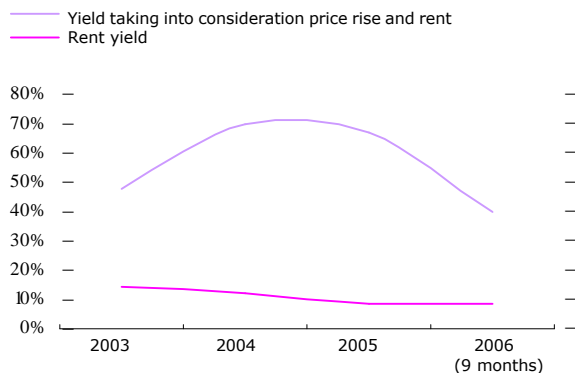


Diagram 3.5.10
Average Annual Yield of Dwellings



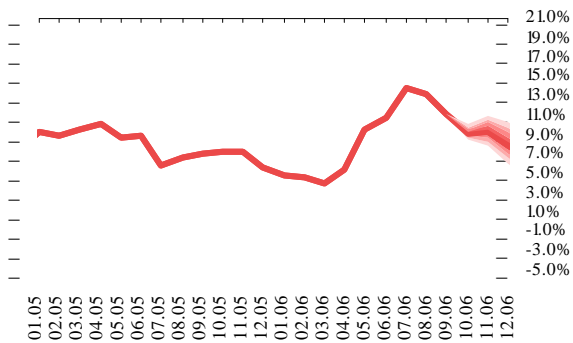
Inflation Forecast

4

Expected inflation – under existing monetary policy, but in the conditions of the projected increase of GDP and money supply, stable GEL exchange rate, market expectation for oil price (USD 60 per barrel), harvest – worse than last year, small increase of imported inflation and without the impact of other possible exogenous factors – will look as follows¹:

According to the made projections, the annual inflation, in the current December, will change from 7.10% to 9.25%, at 50% probability.

Diagram 4.1
Inflation Forecast
 2005-2006



¹ For more information on inflation projection model, please, see „Inflation Modeling and Projection for Georgia“ by A. Mestvirishvili, and T. Mdivnishvili//Bank.-N3 (20).-2004

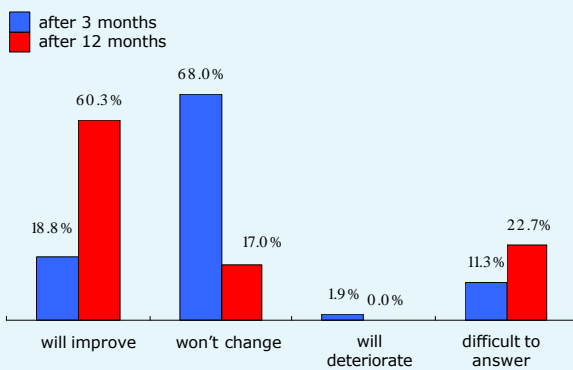
Box 3 – Results of Polls with Commercial Bank Managers

On a monthly basis the National Bank of Georgia carries out polls with the commercial bank managers about their expectations in regard to future development of economy, lari exchange rate fluctuations, inflations processes, etc.

The poll demonstrated that in IIIQ06 the expectations of the commercial bank managers on the general trend of economy development will have the tendency similar to the II quarter. In the long-term perspective (in 1 year), the commercial bank managers assume that general status of economy will improve: 60.3% of them believe that the economy will improve, 17% think that the situation will not change and 22.7% found it difficult to respond to the question.

According to the opinion of 68% of the commercial bank managers, in the short-term perspective (in 3 months) the economy will not change. Only 18.8% considers it possible to change the economic situation in the country, 11.3% restrained from making any forecast. Note, a small percentage of commercial bank managers still expect deterioration of the general condition of economy (Diagram N1).

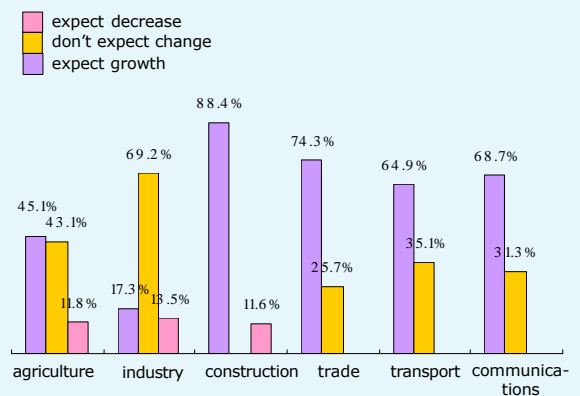
Diagram 1
Condition of Economy in Georgia



For the coming one year, economic growth is anticipated in construction, trade, communications and transport. According to the polls results, 88.4%, 74.3%, 68.7% and 64.9%, respectively, of bank CEO-s expect growth in the aforementioned sectors. In regard to the industry, majority (69.2%) of the respondents does not expect any changes in this sector and only according to the forecast of 17.3% - growth in industry is possible. In agriculture, eco-

nomie growth is anticipated by 45.1%, and 43.1% does not expect any changes. Note, like in the previous period, in IIIQ06 the commercial bank managers expect growth in the industry least (Diagram N2). If we compare III quarter results with the previous period data, we'll see that the opinion of the bank managers on the future development of economy has not changed much. The number of those managers who expected general improvement of the economy slightly decreased (from 65% to 60%) and the share of those who did not expect substantial changes - respectively grew (from 64% to 68%). Note, economic sanctions introduced by the Russian Federation did not have significant impact on the expectations of the future economic development of the managers.

Diagram 2
Economic Growth In various Sectors of Economy during the coming one year



Banks' expectations in regard to lari exchange rate do not change in the IIIQ06 and have the same tendency as in the previous period. Majority of the respondents expect further appreciation of lari rate against the American dollar in the short-term period. 45.3% of the respondents believe that lari exchange rate will further appreciate and 34.15 predict relative stability of the rate and exclude significant changes. In the short-term perspective, only 7.5% expects depreciation of lari exchange rate, and 13.15 found it difficult to respond to the question.

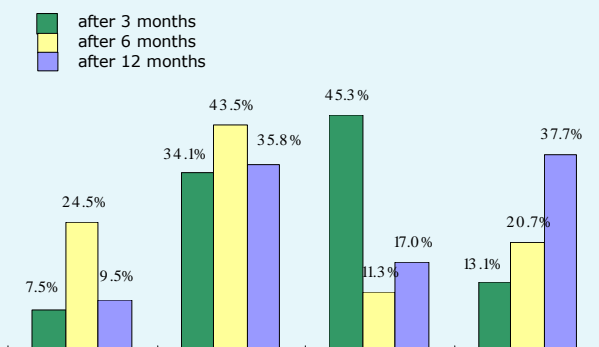
In the mid-term period (in 6 months) majority of the bank managers – 43.5% - expects stability of the exchange rate. Relatively smaller proportion – 24.5% - believes that lari rate will depreciate against US dollar, and 20.7% found it difficult to answer the

question. Note, if in the short-term perspective the exchange rate appreciation was expected by 45% of the respondents, in the medium-term perspective this idea is shared by only 11.3%.

In the long-term perspective, the lari exchange rate change is rather vague for the commercial bank managers, 37.7% restrains from making a forecast. For 35.8% significant changes in lari exchange rate are not expected. Compared to the short-term forecasts, the share of those managers who expects appreciation of the exchange rate is 17%, and lari depreciation in the long-term perspective is expected by only 9.5% (Diagram N3). Compared to the previous quarter, in the III quarter, the bank managers' expectation in regard to future shocks of the lari exchange rate has not experienced serious changes. If in the previous period the share of those respondents who expected stability of the exchange rate fluctuated from 38% to 50%. In the III quarter the mentioned range is within 34-43.5%. Compared to Quarter II, the number of the managers expecting the future exchange rate fluctuations (either appreciation or depreciation) slightly increased.

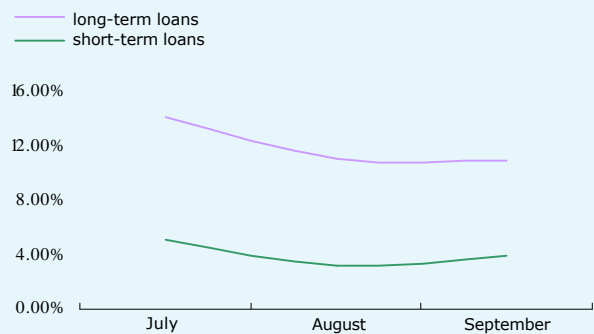
The expectation of the commercial banks in regard to the anticipated changes of lari exchange rate is similarly expressed in the spread of interest rates on the loans extended in both lari and US dollar. If, on the consumer loans, we describe the difference between interest rates as the bank expectation indicator, then we will receive a little bit different picture. In short-term (up to one year) and long-term perspective (more than one year) for the banking system higher interest rate is characteristic for the loans extended in GEL than for the loans allocated in US dollar. However, it is worth to

Diagram 3



mention that the difference between the interest rates is higher on the long-term loans, i.e. commercial banks expect big fluctuations in the long-term perspective rather than in the short-term (Diagram N4).

Diagram 4
Interest Rate Spread

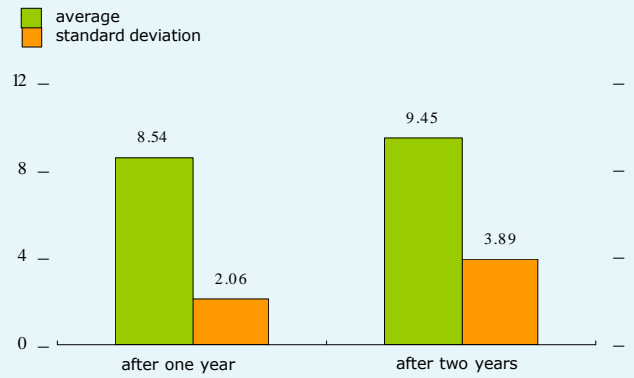


In regard to the inflation expectation of the commercial banks, a year from now the inflation expectation will be 8.54%, being slightly more than II quarter (8.28%). Two years later the inflation expectation relatively reduced compared to the expectation of the previous interview with the respondents. If in the II quarter commercial banks expected 9.75% inflation, in the III quarter this indicator comprised 9.45%. Note, like previously, in the III quarter, „inflation expectation after two years“ tends to be more dispersed than „inflation expectation after a year“ (Diagram N5). To assess the inflation expectation among the population more accurately, the National Bank of Georgia carried out ad hoc poll among ordinary citizens in regard to their expectations about the prices. Respondents had to answer the question – how the prices will change, in their opinion, in a year. The test had three potential answers: will increase, won't change, will decrease. Majority of the respondents, around 88%, thinks that the prices will further go up during the future one year, 11% believes that the prices will be relatively stable and only 1 percent expects the price decrease.

In the III quarter 2006, the commercial bank managers expect general improvement of economy in the long-term perspective (after one year). Growth is expected in such sectors as construction, trade, communications, and transport. Concurrently, in the opinion of the bank CEO-s, in the short-term perspective significant changes are not expected.

The poll demonstrates that according to the forecast of the bank authorities, lari exchange rate against the US dollar will be relatively stable. Furthermore, in the short-term perspective the banks less expect exchange rate depreciation than in the long-term perspective. Like the previous poll showed, in the III quarter the commercial banks expect higher inflation after two years rather than a year from now.

Diagram 5
Annual Inflation Forecast Indicators



„Inflation Report“ was prepared for publishing at National Bank of Georgia

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the 1990s, the number of people in the UK who are employed in the public sector has increased from 10.5 million to 12.5 million, and the number of people in the public sector who are employed in health care has increased from 2.5 million to 3.5 million (Department of Health 2000).

There are a number of reasons for this increase in the number of people employed in the public sector. One reason is that the public sector has become a more important part of the economy. Another reason is that the public sector has become a more attractive place to work. A third reason is that the public sector has become a more important part of the welfare state.

The increase in the number of people employed in the public sector has led to a number of changes in the way that the public sector is organized. One change is that the public sector has become more decentralized. Another change is that the public sector has become more market-oriented. A third change is that the public sector has become more customer-oriented.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is funded. One change is that the public sector has become more dependent on government funding. Another change is that the public sector has become more dependent on private funding. A third change is that the public sector has become more dependent on user fees.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is managed. One change is that the public sector has become more professionalized. Another change is that the public sector has become more bureaucratic. A third change is that the public sector has become more hierarchical.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is evaluated. One change is that the public sector has become more subject to external evaluation. Another change is that the public sector has become more subject to internal evaluation. A third change is that the public sector has become more subject to self-evaluation.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is perceived. One change is that the public sector has become more respected. Another change is that the public sector has become more valued. A third change is that the public sector has become more appreciated.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is viewed. One change is that the public sector has become more visible. Another change is that the public sector has become more accessible. A third change is that the public sector has become more transparent.