NATIONAL BANK OF GEORGIA

INFLATION REPORT

IV Quarter, 2006

CONTENTS

INTRODUCTION 1

High rates of inflation of the previous period decreased in Quarter IV of 2006. The annual inflation rate made up 8.8%. Meanwhile, the monthly inflation rate in every month of QIV was less than 1%, although different parameters of core inflation converged and grew with respect to the analogous parameters of the previous period. This implies the increased impact of demand factors on the prices level growth.

The annual increase in the volume of deposits (58.0%, Q III – 44.6%) and economy crediting (57.3%, Q III – 80.4%) continued. Annual growth rates of reserve money increased and in QIV amounted to 19,2% (in Q III - 17.5%), while the annual increase in M2 and M3 broad money aggregates in QIII and QIV made up 29.8% and 39.3%, respectively.

The trend of Lari exchange rate appreciation with respect to US dollar was sustained in Q IV of 2006 as well as during the whole year. The ultimate appreciation of Lari with respect to US dollar in QIV equaled 1.27%. The real effective exchange rate of Lari in the same period has depreciated insignificantly by 0.31%, while the nominal effective exchange rate depreciated by 1.1%.

The balance of payment equilibrium disturbed by the Russian embargo was somewhat restored in QIV, and the current account deficit amounted to 118% compared to QIV of 2005.

High growth rates of tax revenues continued in QIV of 2006. Compared to the same quarter of 2005, their volume increased by 43.4%. In the same period there was an increase in the share of non-tax revenues and grants in the state budget, although the share of capital revenues decreased.

The real GDP growth in QIV of 2006 increased by 11.5%, compared to the average quarterly GDP growth rate of 2005. In the first three quarters of 2006 the analogous growth rates amounted to, accordingly, 8.4%, 8.0%, and 9.1%. The sectoral analysis of the economic growth shows positive growth rates in almost all economic sectors except agriculture, where the annualized contraction by the first three quarters made up 14.1%.

By the end of mid-year of 2007, the forecasted increase in the CPI is in the range of 6.46-7.19%.

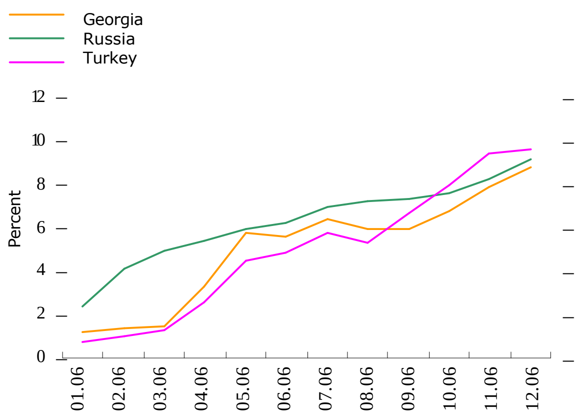
Changes in Consumer Prices

2

According to the Statistics Department of Georgia, the overall level of consumer prices has increased by 8.8% from December 2005 to December 2006. The increase in prices was mainly due to exogenous factors, which have a permanent impact on the price level and a temporary impact on the inflation rate.

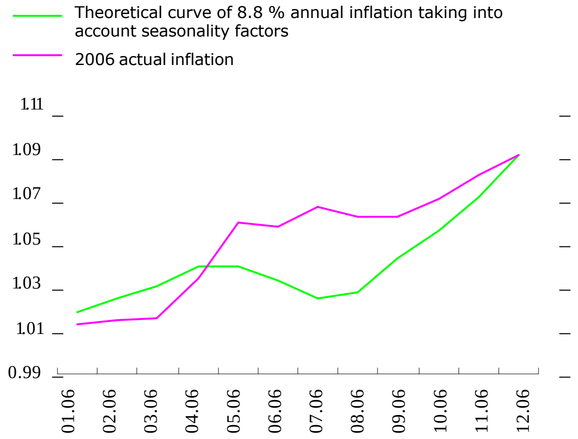
The price level in Georgia was also influenced by the price changes in Georgia's principal trade partner-countries. The annual inflation rate in Russia and Turkey equaled 9.1% and 9.7%, respectively. The correlation of price level changes in Georgia and Turkey has been particularly significant. Such a strong correlation is explained not only by close trade ties, but also by the identical exogenous factors influencing the two countries' economies.

Figure 2.1
Dynamics of Price Increase
(December, 2005 = 100 %)



During 2006 different factors made a negative impact on the price level in Georgia: oil and sugar world prices, avian flu, gas (and, accordingly, electricity) price increase by Russia, climatic conditions. The last quarter of 2006 was not an exception either. It was precisely in this quarter that the consequences of the Russian embargo showed up. In October there was a significant price increase on goods imported from Russia. For example, the buckwheat price has increased by 50%. As it was expected, such price increases were temporary, and by the end of the year the prices were more or less back to their normal level.

Figure 2.2
Dynamics of CPI
(December, 2005 = 1)



The large supply of foreign exchange at the end of 2006 was also significant in respect of price level increase, although the active monetary policy of the NBG minimized the possible negative consequences.

There were also some positive factors in Quarter IV. Thus, the decrease in the oil world prices decreased the fuel prices in Georgia, and in December 2006 the gasoline price was only 0.7% higher than that to December 2005.

The inflationary processes in the period concerned were mainly fueled by the prices on agricultural products, which had a seasonal effect. On the whole, the quarterly inflation rate equaled 2.6%.

Price Changes by Commodity Groups

Analyzing price changes on consumption goods, it is evident that the prices on the non-durable goods have increased most. The increase in non-durables prices made up 9.9% over the year, while the semi-durable goods prices increased by 2.0%, and the durable goods prices remained stable.

Over the year, the prices on transport, communications, clothing, household supplies and equipment remained stable. As a result of the Russian embargo on alcohol and mineral beverages, there was a significant drop in alcohol beverages prices in June, and since then these prices remain basically stable. Also in June there was a significant price increase in the commodity group "Housing, Water, Electricity, Gas and Other Fuel" - their percentage price increase by the end of the year is higher than 20%. The increase in food and health sector is more than 10%. The latter was mainly due to the abolition of the government subsidizing scheme and not by the price increase itself (Since July 2006 in Tbilisi, 200 Lari subsidy for all deliveries was replaced by 400 Lari subsidy for the deliveries of the vulnerable women only. This policy change, due to the specifics of calculating the consumer prices, was registered as 50% price increase).

Table 2.1
Products Mostly Influencing the Inflation Rate and Main Reasons for Price Increase (12 months of 2006)

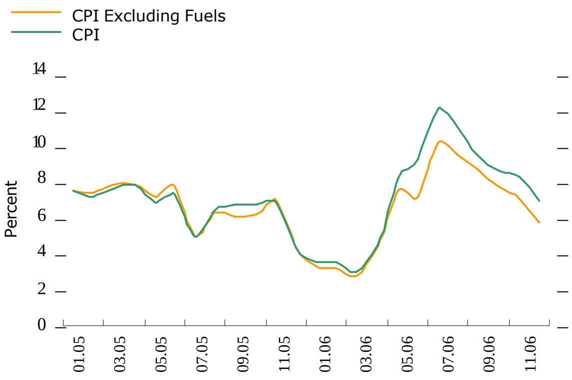
	Increase	Impact	Main reason
Rye Bread White grain	11	0.2	Russian Embargo
Bread, factory-made	4.6	0.3	Russian Embargo
Natural gas	34.9	0.3	Price Increase by Russia
Sugar	15	0.3	World Prices
Imeretian Cheese	11	0.3	Climatic Conditions
Eggs	22	0.4	Birds' flue
Beans, dry	55.2	0.5	Climatic Conditions
Apple	54.3	0.6	Climatic Conditions
Potatoes	68.2	1.3	Climatic Conditions
Electricity fee	58.9	1.6	Consequences of Price Increase
Total		5.6	

Table 2.2
Inflation (CPI) Rates by Commodity Groups (%), Share in Consumption Basket (%) and Influence on the CPI (percentage points)

	Weight December 2006	Weight December 2003	January-2006 - December-2006/ Jaanuary-2004 December-2005		December-2006/ December-2005		December-2006/ November-2006	
			Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0	100.0	9.2	9.1	8.8	8.7	0.9	0.9
Food and Non-alcoholic beverages	45.5	42.6	13.0	5.6	13.4	5.9	1.7	0.8
Food	44.2	41.2	13.3	5.6	13.8	5.9	1.8	0.8
Bread and Bakery	10.2	11.4	2.0	0.2	7.3	0.8	0.8	0.1
Meat and Meat Products	7.0	6.4	15.5	1.1	10.3	0.7	-1.2	-0.1
Milk, Cheese, and Eggs	1.1	0.9	11.8	0.1	9.2	0.1	4.2	0.0
Oil and fat	6.6	5.6	21.9	1.1	13.4	0.8	2.6	0.2
Fruit, grapes	3.1	3.5	1.5	0.0	6.3	0.2	2.5	0.1
Vegetables, Watermelons, incl. Potatoes	4.5	2.4	25.0	0.9	35.6	1.3	8.5	0.4
and other Solanaceae	8.4	7.8	18.9	1.5	21.8	1.6	2.3	0.2
Sugar, Jam, Honey, Syrups, Chocolate,	3.2	3.1	21.4	0.6	11.2	0.3	-1.2	0.0
Pastry	0.2	0.2	4.8	0.0	11.2	0.0	4.3	0.0
Other Food Products	1.3	1.4	3.8	0.1	1.2	0.0	-1.6	0.0
Non-alcoholic Beverages	7.5	6.2	5.4	0.5	-10.5	-1.0	-0.8	-0.1
Clothing and Footwear	4.3	5.0	4.5	0.2	2.9	0.1	0.7	0.0
Housing, Water, Electricity, Gas, and Other Types of Energy	9.5	8.8	19.0	1.6	22.2	1.9	0.7	0.1
Furnishings, Household Equipment and Renovation	2.8	3.2	0.4	0.0	1.5	0.0	0.7	0.0
Health care	6.8	7.3	7.2	0.5	16.0	1.0	-0.1	0.0
Transportation	10.6	11.4	5.9	0.7	2.5	0.3	0.1	0.0
Communication	3.3	4.3	-5.1	-0.2	-0.1	0.0	0.0	0.0
Recreation and Culture	2.5	3.1	0.5	0.0	-0.4	0.0	0.0	0.0
Education	2.3	3.0	0.3	0.0	2.2	0.1	0.0	0.0
Hotels, Cafes, and Restaurants	2.9	2.9	6.5	0.2	7.7	0.2	0.2	0.0
Miscellaneous Goods and Services	1.9	2.3	1.8	0.0	4.3	0.1	0.6	0.0
Non-durable Goods	69.4	65.5	11.2	7.6	9.9	6.8	1.1	0.7
Semi-durable Goods	5.3	6.1	2.3	0.1	2.0	0.1	0.5	0.0
Durable Goods	1.8	2.3	-1.7	0.0	0.0	0.0	-0.4	0.0
Services	23.5	26.1	5.3	1.3	6.9	1.7	0.3	0.1

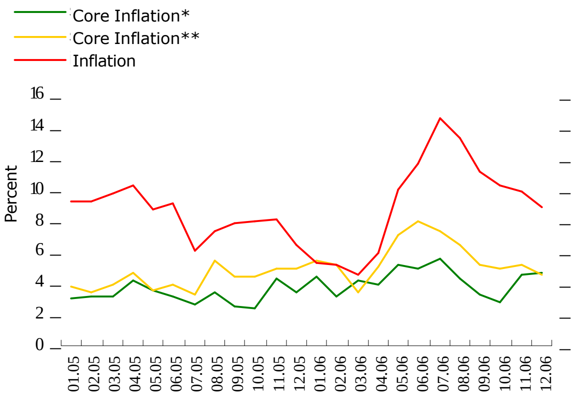
Source: Department of Statistics, NBG

Figure 2.3
CPI Changes Including and Excluding Fuels[1]



[1]Calculations are made with respect to consumption basket weights as of beginning of the period, using geometric average.
Fuels include electricity fee, liquid and natural gas, kerosene, diesel, gasoline

Figure 2.4
Annual CPI and Core Inflation (by 311 Components of the Consumption Basket)



* Products in the range of 1 standard deviation (~85 %)
** Products in the range of 2 standard deviations (~93 %)

Figure 2.5
Annual CPI Inflation with Respect to Consumption Basket Made of Domestic, Imported, and Mixed Final Goods

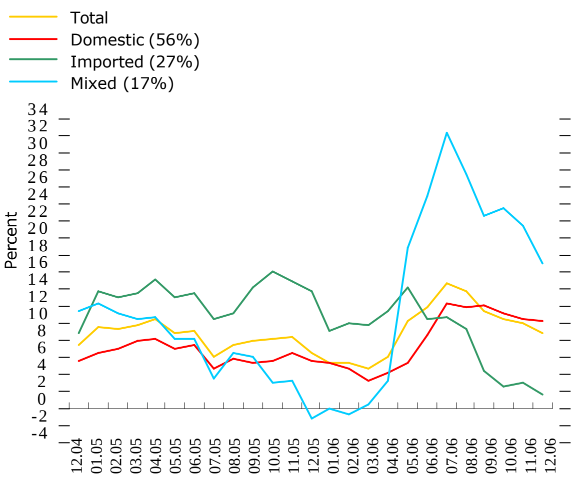


Figure 2.6
Price Increase with Respect to December 2005

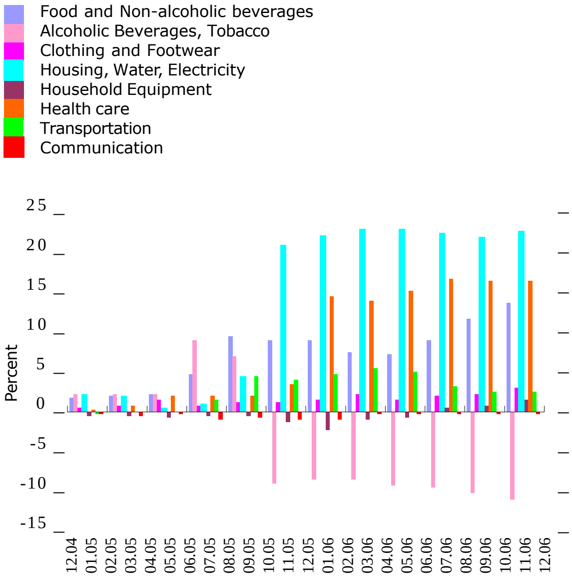


Figure 2.7
Changes in Annual Inflation Rates With Respect to Goods and Services Durability

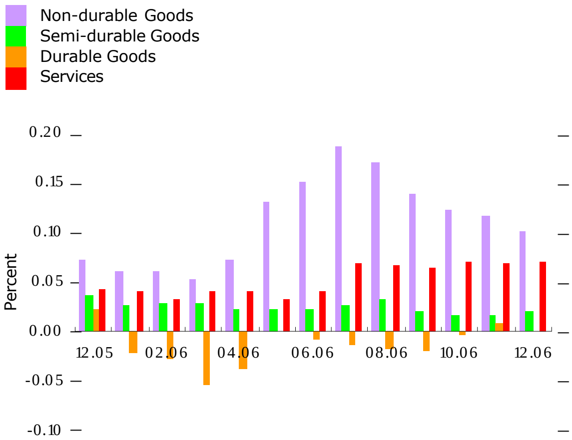
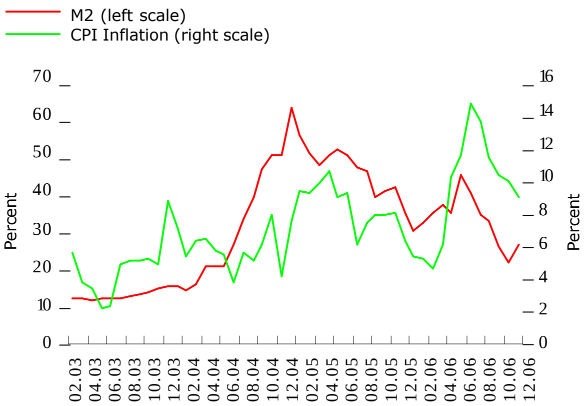


Figure 2.8
Annual Growth Rates of M2 Monetary Mass (month average data) and Consumer Prices



Factors Influencing Inflation

3

3.1. Dynamics of Monetary Aggregates

At the end of Q IV of 2006, the reserve money aggregate amounted to 1193.2 million Lari, which is 191.8 million Lari (19.2%) more than in the same quarter of 2005. The reserve money in December 2006 increased by 303.1 million Lari, compared to December 2005, while the annual growth amounted to 31.4%.

It should be pointed out that the increase in the reserve money level occurred in the last days of November, which, in turn, was mainly conditioned by the supply of foreign currency to the Tbilisi Interbank Foreign Exchange by the "Bank of Georgia". The latter has mobilized the foreign currency (approx. 89 million USD) by means of selling stocks, and the inflow of foreign currency was accordingly met by the NBG purchases. The main reserve money growth factor (14.5%) was the funds available on the corresponding accounts of commercial banks, which were also neutralized by the NBG operations.

The excessive supply of foreign currency to the Tbilisi Interbank Foreign Exchange in December, which contributed to the reserve money growth, has caused the NBG to perform significant foreign currency purchases. The net intervention of the NBG at the Tbilisi Interbank Foreign Exchange amounted to 136.6 million USD, as a result of which the monetary system has been supplied by additional 235 million Lari. The pressure on the foreign exchange market, apart from the seasonal factors, was exerted through the inflow of foreign currency from the privatization proceeds. In particular, the inflow of 30 million USD as a result of privatization of enterprises "Chiaturmanganum" and "Zestafoni Ferroalloys" should be pointed out.

The balance of the government accounts accumulated in the NBG at the end of December increased from 320 million Lari to 360 million Lari. It should also be pointed out that, taking into account the changes in government deposits denominated in foreign currency (the increase of 11 million Lari) and the net NBG purchases of foreign currency as a result of intragovernmental currency conversions (29,8 million

USD worth 51 million GEL), the influence of the governmental monetary operations on the reserve money growth accounted for 22 million Lari.

The average quarterly indicator of cash in circulation has increased in QIV only by 1.7%, which means that the growth of average reserve money was due to the accumulation of funds of the commercial banks on the NBG corresponding accounts. During the period concerned, the balances on the corresponding accounts remained high - approx. at the level of 194 million Lari. It should be pointed out that the funds accumulated on these accounts in December 2006 are 2.5 times as large as those in December 2005. In order to neutralize this volume of excessive liquidity in the monetary system, the NBG actively used the available monetary instruments. As a result of these policy instruments, the balances on the corresponding accounts decreased to 39 million Lari by December 31.

Table 3.1.1

Reserve Money Dynamics

2006, Month Average Data

	12.05	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06	10.06	11.06	12.06
Reserve money	965 679	962 173	980 628	1010 662	994 916	1009 900	1055 670	1088 791	1078 869	1084 228	1096 549	1106 677	1268 754
Money in Circulation	757 856	749 525	750 025	764 167	776 114	771 004	793 176	819 941	834 220	838 575	838 877	819 134	853 042
Banks Deposits	207 823	212 648	230 602	246 495	218 802	238 896	262 493	268 850	244 649	838 575	838 877	819 134	853 042
Compulsory Reserves	130 669	130 971	135 858	139 980	142 765	149 461	156 064	161 170	167 925	245 653	257 673	287 543	415 712
Balances on Corresponding Accounts	77 154	81 677	94 744	106 515	76 037	89 435	106 429	107 680	76 724	56 030	52 355	78 431	194 305
Overnight Deposits													

Table 3.1.2

Reserve Money Dynamics

2006, End-Month Data

	12.05	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06	10.06	11.06	12.06
Reserve money	1001 451	981 862	1003 217	978 908	1035131	1013 794	1044 679	1092892	1083 669	1096913	1084 061	1264 266	1193 231
Money in Circulation	811 400	749 215	756 571	775 443	792 910	776 499	803 260	828941	836 942	853577	832 840	820 592	929 538
Banks Deposits	190 051	232 647	246 646	203 466	242 221	237 295	241 418	263952	246 727	243336	251 221	443 674	263 693
Compulsory Reserves	129 833	133 183	137 960	139 334	143 655	151 959	158 689	162958	177 646	202331	206 242	209 890	224 559
Balances on Corresponding Accounts	60 218	99 464	108 686	64 132	98 566	85 335	82 729	100994	69 081	41005	44 979	233 784	39 135
Overnight Deposits													

Table 3.1.3

Monthly Changes of Money Aggregates

2006, Month Average Data

	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06	10.06	11.06	12.06
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**	**2 435 932**	**2 493 252**	**2 661 674**
Monetary mass (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	1 238 108	1 235 943	1 389 182
Money Outside of Banks	682 176	688 986	709 102	714 856	706 063	729 106	744 932	751 449	773 243	752 451	739 969	827 357
Lari in Circulation	749 215	756 571	775 443	792 910	776 499	803 260	828 941	836 942	853 577	832 840	820 592	929 538
Deposits in National Currency	368 149	363 252	378 414	427 398	440 574	522 700	502 505	500 686	500 148	485 658	495 974	561 824
Deposits in 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	1 197 823	1 257 309	1 272 493

Table 3.1.4

Monthly Changes of Money Aggregates

2006, End-Month Data

	01.06	02.06	03.06	04.06	05.06	06.06	07.06	08.06	09.06	10.06	11.06	12.06
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**	**2 426 109**	**2 453 037**	**2 618 543**
Monetary mass (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	1 250 897	1 229 698	1 327 034
Money Outside of Banks	683 949	683 061	690 421	710 012	691 760	717 759	737 754	751 951	757 246	747 091	734 387	774 437
Lari in Circulation	749 405	751 361	766 587	785 728	765 605	797 349	823 040	836 074	842 073	835 031	818 502	867 628
Deposits in National Currency	342 123	356 134	383 085	407 559	426 872	517 302	510 710	506 880	500 023	503 806	495 311	552 597
Deposits in Foreign Currency	877 555	882 556	920 018	965 413	995 340	1 008 568	1 057 936	1 084 937	1 117 961	1 175 211	1 223 338	1 291 509

Source: NBG

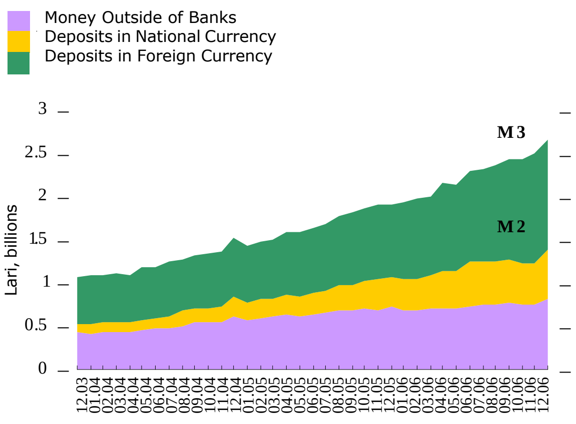
In particular, the NBG started in December to perform open market operations by means of treasury notes. Treasury notes of different maturity (from 16 to 34 months) with the aggregate face value worth 48 million Lari were sold. By means of Certificate of Deposit auctions 269 million Lari has been removed from circulation, while in the same period 7.2 million Lari worth Certificates of Deposits were repaid. By means of this monetary instrument, 261.8 million Lari has been absorbed. Overall, in the last three months of 2006 by means of Certificates of Deposit 287.6 million Lari has been removed from circulation and 20.9 million Lari worth Certificates of Deposit were repaid.

Given the above-mentioned monetary flows, the reserve money aggregate by December 31, compared to the end of QIII, increased by 96.3 million Lari (8.8%) and amounted to 1193.2 million Lari. The annualized growth rate of reserve money increased from 17.5% by the end-September to 19.2% by the end-December. It should also be pointed out that despite high monthly growth rate of reserve money in December this increase in reserve money had a moderate impact on inflation. This is explained by the fact that the high level of reserve money was a result of large balances of commercial banks on the NBG corresponding accounts, and this, in turn, was neutralized by means of the NBG open market operations.

Broad Money

In December 2006 the broad money aggregate (M3), compared to September 2006, increased by 9.9% (240.7 million Lari) and amounted to 2661.7 million Lari. This increase was mainly conditioned by the 10.9% increase in foreign currency deposits. The annual increase in broad money equaled 750.5 million Lari. The increase in foreign currency deposits in QIV equaled 124.9 million Lari, while the analogous increase over 12 months was 431.2 million Lari. By end-December foreign currency deposits amounted to 1272.5 million Lari. The money in circulation grew by 9.1% in QIV and by 12.4% (91.1 million Lari) over the year. In December this monetary agregate equaled 827.4 million Lari. Compared to the beginning of the year, M2 has increased by 29.8% (319.3 million Lari) and amounted to 1389.2 million Lari.

Figure 3.1.1.
Broad Money
2004-2006

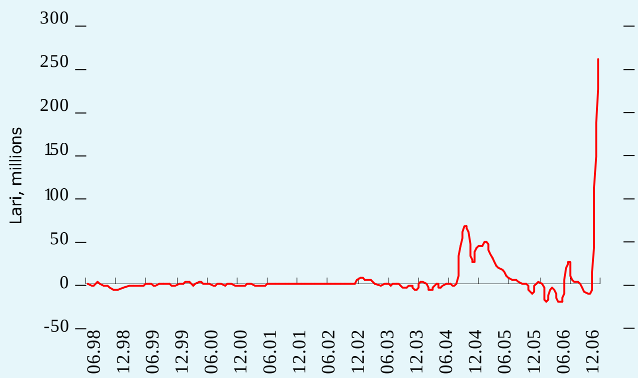


Box 1. Monetary Policy in QIV 2006

In QIV of 2006 the NBG has conducted an active monetary policy in order to dampen the inflationary pressure and sterilize foreign currency inflows. It should be pointed out that in 2006 the NBG has taken two significant steps in order to improve its open market operations. First, securitization of government debt and, second, introduction of a new monetary instrument - Certificates of Deposit (See Box "NBG Monetary instruments").

Quarter IV started with high inflation. The annual inflation in Quarter III achieved 14.5%, which represented a record high rate since 1999. Responding to this inflationary pressure, the NBG increased the obligatory reserve ratio on national currency deposits. This measure brought the expected results, and the annual inflation rate started to gradually decrease. Along with the decreased liquidity on the money market, the reserve money annualized growth rate decreased from 21.3% in July to 14.1% in October, which turned out crucial in hindering the inflation. It can be said that stricter monetary policy started in July-August bore fruit. However, in November the NBG encountered a more difficult problem. As a result of the Russian embargo, decreased Russian imports and Georgian citizens returned from Russia conditioned the increase of foreign currency. In addition, the stock sales by the "Bank of Georgia" at the London Stock Exchange influenced the increase in reserve money bypassing the national Foreign Exchange. Also in December the currency conversion of a part of outstanding tax arrears paid to the state budget took place at Foreign Exchange. Ultimately, in November-December 2006 the NBG was forced to purchase 238 million USD, in order to prevent the significant fluctuations of Lari exchange rate. As a result of monetary mass growth, the annualized growth of the reserve money in November came to 31.8%, the analogous rate in October being 14.1%. In order to absorb the excessive liquidity, the NBG actively used a new monetary instrument of open market operations - Certificates of Deposit with maturity under 6 months. By means of CDs only in December the NBG removed 269 million Lari from circulation. The highest annual interest rate equaled 12%. Besides, the treasury notes with maturity of 16-34 months were sold out in December. In total, the NBG managed to contract the monetary mass by 318 million Lari, which constitutes a historical maximum.

Figure 1
Liquidity Removed from Money Market by the NBG (+ Net Removal, - Net Supply)
1998-2006



Box 2. NBG Monetary Instruments

In order to conduct monetary policy, central banks usually use the Required Reserve ratio, open market operations and standby facilities.

Open market operations involve direct sales/purchases of securities and performance of repo operations backed with the securities. Central banks usually use the open market operations for regular refinancing by means of short-term (one- and two-week maturity date) as well as long-term (maturity date of over a month) instruments. Such operations are performed in order to avoid temporary short-term fluctuations.

Open market operations are used in order to decrease the liquidity level. First of all, they affect the bank reserves and thus, via the multiplier effect, influence the volume of crediting, economic activities and, finally, the price level. Open market operations may take place through the primary (by means of issuing securities) or the secondary markets.

Standby facilities perform some important functions. On the microeconomic level they assist in adjusting the banking portfolio in case of temporary liquidity problems. With this purpose overnight loans are often used, on which the interest rates are higher than on securities (basically, acting as a penalty rate). On the macroeconomic level standby facilities help the central bank in daily management of liquidity with the perspective of meeting long-term goals.

Overnight deposits are also used in practice. The interest rates on such deposits are lower than the market rates. Standby facilities' maturity date is usually under 14 days.

In 2006 the NBG, together with the Government of Georgia, laid the foundation for using the monetary instruments. Before September 2006 the NBG basically intervened in the interbank credit auctions and used the deposit auction instruments. Interbank credit auctions represent a marketplace, where, with the facilitation of the central bank, liquidity redistribution among the commercial banks takes place by means of secured loans. With the purpose of monetary regulation, the NBG also participated in the trading sessions of credit auctions. Deposit auctions held by the NBG are aimed at mobilizing resources on a competitive basis in the form of NBG deposits. It should be pointed out that although these instruments were not flexible, the use of other more efficient instruments under the conditions of undeveloped financial markets was impossible.

Taking into account all the above-mentioned, in 2006 the NBG has made two important decisions with respect to development of monetary instruments. First, on May 20, 2006 the Government of Georgia and the NBG concluded an agreement "On Measures Regarding the Debt Repayment to the NBG by the Government of Georgia". In line with this agreement, as of May 17, 2006 out of total indebtedness of the Government of Georgia to the NBG, equal to 832.8 million Lari, 48 million Lari was registered in the form of treasury notes with maturity date of 16-60 months. The indebtedness will be completely repaid by 2030. These bonds, as a monetary instrument, may be used by the NBG in open market operations.

The second decision deals with the issuance of the NBG's own securities - Certificates of Deposit (CDs). The CD is more convenient and acceptable for banks than credit and deposit auctions. The CDs usually have 1-6 months maturity and, thus, complement the Treasury notes.

Open market operations with government securities and CDs, which are more efficient modern monetary instruments, have replaced credit market interventions and deposit auctions. These latter instruments have not been used by the NBG since September 2006.

By means of issuance of new securities, the increased stock will contribute to introduction of such new monetary instruments as repo operations, credit auctions and overnight loans. After further perfection of the securities market, the use of monetary instruments by the NBG will be based instead of quantitative regulation on more efficient, price regulation principles.

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

Taking into account the situation on the money market in QIV of 2006, the NBG conducted an active monetary policy. By means of the CDs and government securities issued as a result of government debt securitization, excess liquidity worth 322.4 million Lari has been removed from circulation by the end-year. The share of investment securities in banking sector's assets increased from 0.3% in November to 7.7% in end-December.

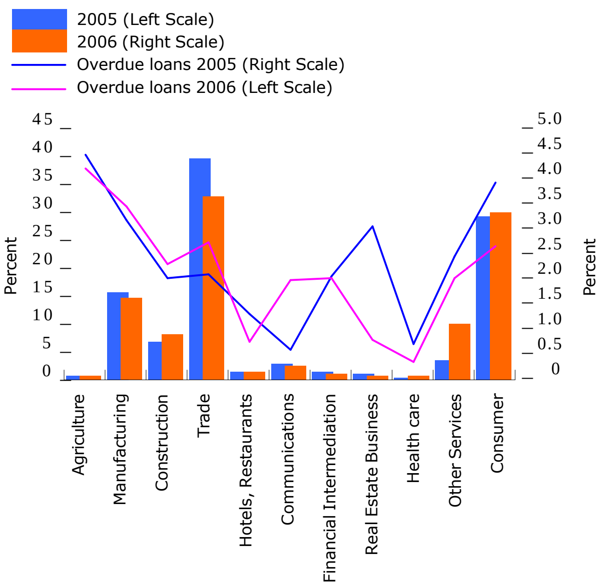
By the end of 2006 the sectoral structure of economy crediting has undergone certain changes. Although in absolute numbers loans given to the trade sector increased from 654 million Lari in end-2005 to 840 million Lari in end-2006, the share of trade sector crediting with respect to total economy crediting significantly dropped. In the same period, the share of trade sector in total economy crediting decreased from 38.5% to 31.9%.

A significant increase has been recorded in the share of service sector crediting - this share growing from 4.7% to 13.7%. Overdue arrears decreased from 2.4% to 2.0%. There was also an increase in the share of construction sector crediting, although overdue loans share slightly increased as well.

The importance of consumer credits has further increased in 2006. If in 2005 the share of consumer credits in total economy crediting equaled 28.5%, by end-2006 this figure increased to 29.3%. Risk management of consumer credits by the commercial banks has considerably improved, which was reflected in the drop of overdue consumer credit rate from 3.8% to 2.6%. The large share of consumer credits in the banks' credit portfolio reflects its importance for the banks' assets. The growth rate of consumer credit in 2006 reached almost 60%. Such rapid growth was one of the factors which triggered the aggregate demand in the economy and increased the inflationary risk over the year.

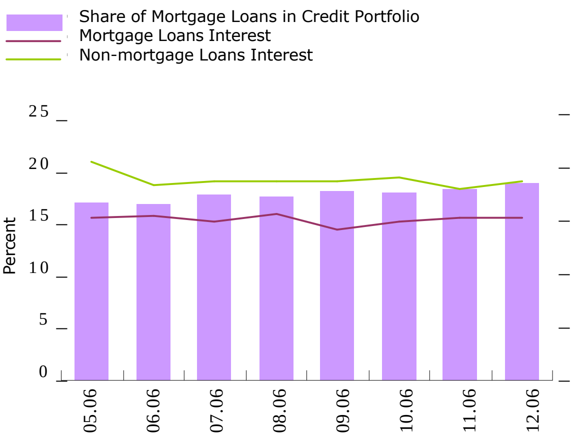
The growth of consumer credit was mainly due to the long-term credit growth. The increase in

Figure 3.2.1
Distribution of Loans by Economic Sectors and Overdue Loans Share



Source: NBG

Figure 3.2.2
Mortgage Loans Dynamics



Source: NBG

short-term consumer credit equaled 39.6%, while the long-term consumer credit grew by 96.6%. Despite such rapid growth, interest rates on long-term consumer credits changed insignificantly and by end-2006 averaged 18.9%.

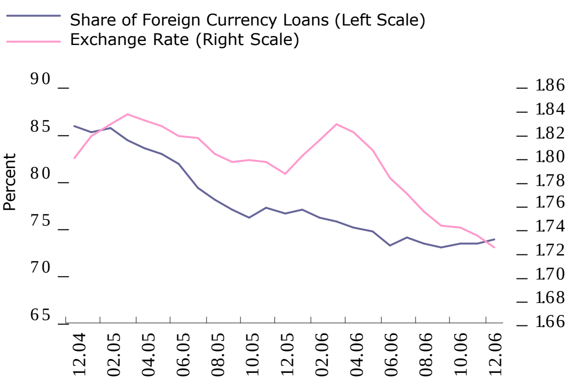
The share of mortgage loans in credit portfolio experienced a stable growth over 2006. During QIV its share increased from 17.6% to 18.3%, the interest rate averaged 15.0%.

Loan Dollarization

In parallel to the Lari exchange rate appreciation, the share of loans denominated in foreign currency tended to decrease during last two years. In QIV of 2006, despite the Lari appreciation the decrease in loan dollarization stopped and was even slightly reversed. As of end-year, 73.8% of loans were given out in foreign currency.

It is remarkable that loan dollarization is growing along with the loan maturity. As of December 31, 2006 dollarization of loans with maturity less than 6 months equaled only 36.6%, with maturity of 1-3 months - 46.7%, and loans with maturity over 1 year - 83.2%. This implies that commercial banks still perceive a high risk of Lari depreciation in a long-run perspective. The same is reflected in devaluation premium by maturity date. In case of long-term loans, banks usually envisage 4% annual average depreciation of Lari, while in the short run the appreciation of Lari is expected.

Figure 3.2.3
Dollarization of Credit Portfolio and Exchange Rate



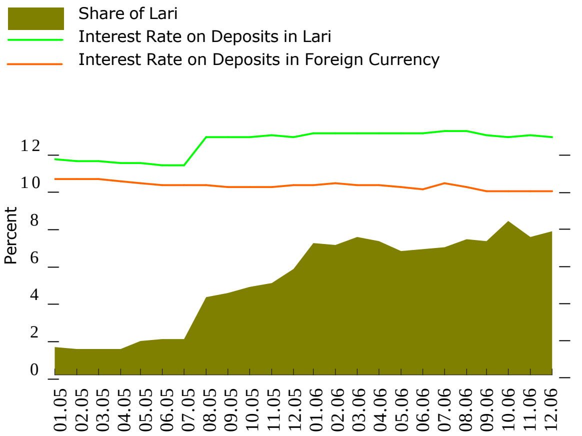
Source: NBG

Deposits

By end-2006 the volume of time deposits grew by 51.2% and amounted to 949.827 million Lari. The interest rate on national currency deposits averages 8.4%, while that on foreign currency deposits - 7.9%. At the beginning of 2006 the average interest rates were, accordingly, 7.4% and 7.3%. The increase in interest rates on deposits denominated both in national and foreign currency is the result of stronger competition between the banks on the deposit market.

It should be pointed out that long-term Lari deposits grew by 73.9%, while increase in foreign currency deposits was only equal to 48.4%. Despite this, time deposits are still highly dollarized. During 2006 the

Figure 3.2.4
Currency and Interest Rate Dynamics of Long-term Deposits



Source: NBG

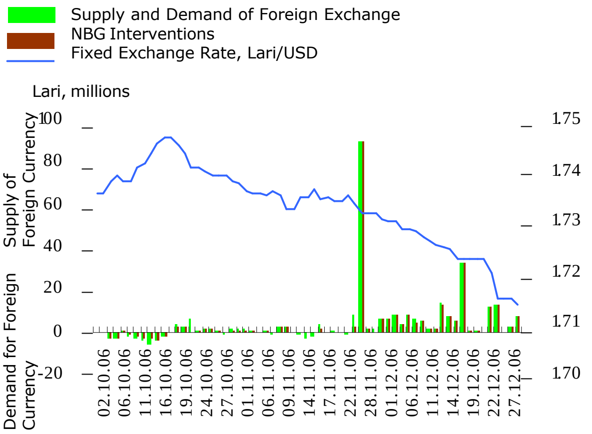
share of foreign currency-denominated time deposits decreased from 88.8% to only 87.1%. This change in deposit dollarization was caused by Lari appreciation and change in interest rates. By end-2006 the interest rate on Lari time deposits averaged 8.4%, while that on foreign currency deposits - 7.9%.

3.3. Exchange Rate, Dollarization, and Balance of Payment

Foreign Exchange Market

In QIV of 2006 the trend of Lari appreciation with respect to US dollar (disregarding depreciation of Lari during first two weeks of the Quarter) continued. If the Lari vs. US dollar exchange rate equaled 1.7355 in the beginning of QIV, as of December 31 it reached the level of 1.7135, which equaled 1.27% Lari appreciation. Compared to QIV of 2005, the Lari exchange rate appreciated both as of end-period (4.4%) and by period average (3.4%).

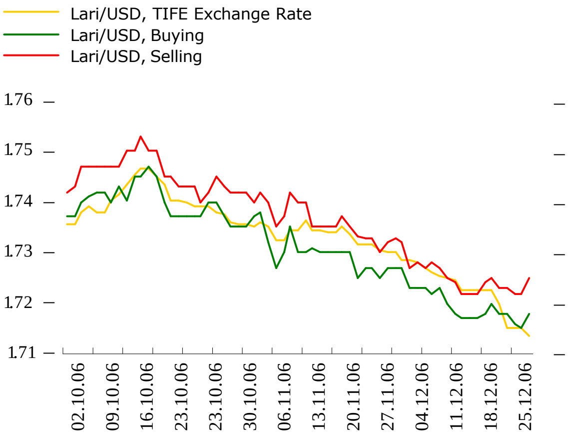
Figure 3.3.1
The Difference in Supply and Demand of Foreign Exchange at Tbilisi Interbank Foreign Exchange and the NBG Interventions
QIV,2006



In QIV of 2006 the Tbilisi Interbank Foreign Exchange was characterized by especially high activity. Compared to the same Quarter of 2005, the supply of foreign currency by commercial banks significantly increased, while the demand somewhat decreased. If in QIV of 2005 the supply of commercial banks totaled 84.5 million US dollars, this figure increased 3.5 times in QIV of 2006 and reached 299.2 million US dollars. In the same Quarters, the demand of commercial banks for foreign currency equaled, respectively, 80 million Lari (2005) and 66.5 million Lari (2006). Under these conditions, the volume of the NBG interventions in the foreign exchange market considerably increased. If in QIV of 2005 the total purchase of foreign currency by the NBG equaled 28.1 million US dollars, in QIV of 2006 it increased 9 times to reach 254.8 US dollars. As of the foreign currency sales by the NBG, these volumes in the same periods amounted to 10.2 million USD and 24.1 USD, accordingly. However, the largest part of foreign currency sales by the NBG in QIV of 2006 is accounted for October, when the NBG sold 22.6 million USD. Like in the previous periods, the NBG interventions were aimed at preventing exchange rate fluctuations, which ultimately was expressed in gradual appreciation of Lari.

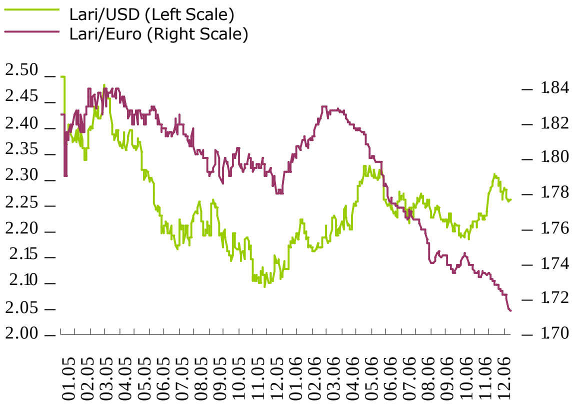
The behavior of the Lari exchange rate in the banknote market segment was similar to that in the Tbilisi Interbank Foreign Exchange, although the

Figure 3.3.2
Lari Banknote Exchange Rate
QIV,2006



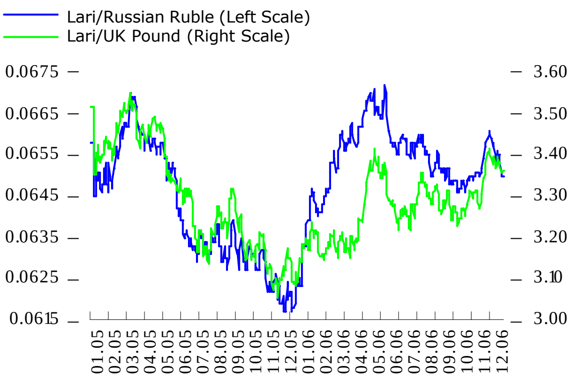
Source: NBG

Figure 3.3.3
Lari Exchange Rate Dynamics Against Euro and USD
2005-2006



Source: NBG

Figure 3.3.4
Lari Exchange Rate Dynamics Against Russian Ruble and UK Pound Sterling
2005-2006



difference between the selling and buying exchange rates in QIV was relatively small (average rates, accordingly, equaled 1.7308 and 1.7366; standard deviations for selling and buying exchange rates - 0.008914 and 0.009023). This shows that the dynamics of Lari exchange rate in the country was determined by the same market forces.

The Lari exchange rate against Euro has been traditionally determined by the cross-rate with respect to US dollar. During QIV Lari exchange rate dropped by 2.69% against Euro, which reversed the QIII appreciation trend and basically returned to the level recorded in the beginning of QIII (2.197 Lari/Euro in the beginning of QIV, 2.2562 Lari/Euro - in end-QIV). The Figure shows the analogous trends with respect to other foreign currencies. For example, the depreciation of Lari with respect to UK pound sterling equaled 3.73%, to Turkish Lira - 5.12%, and to Swiss franc - 1.36%.

Real Exchange Rate

In QIV of 2006 the real effective exchange rate insignificantly depreciated by 0.31% with respect to QIII of 2006, while in comparison to end-2005 it appreciated by 0.09%. During QIV the nominal effective exchange rate depreciated by 1.1%, compared to QIII of 2006, and by 1.72%, compared to December of 2005.

The dynamics of Lari real exchange rate with respect to different foreign currencies has been irregular. During QIV the Lari real exchange rate appreciated against the Russian ruble (0.24%) and the US dollar (4.3%), and depreciated against the Turkish Lira (2.48%) and Euro (0.43%).

External Sector and Balance of Payments[1]

According to preliminary data, the balance of payment equilibrium disturbed by the Russian embargo in QII and QIII of 2006 was somewhat restored in QIV and the current account deficit amounted to 118%, compared to the same Quarter of 2005. In comparison, the CA deficit in QI of 2006 equaled 126%, in QII - 296%, and in QIII - 239% with respect to the same

[1] The NBG data was used

Figure 3.3.5
Lari Exchange Rate Dynamics Against Swiss Franc and Turkish Lira
2005-2006

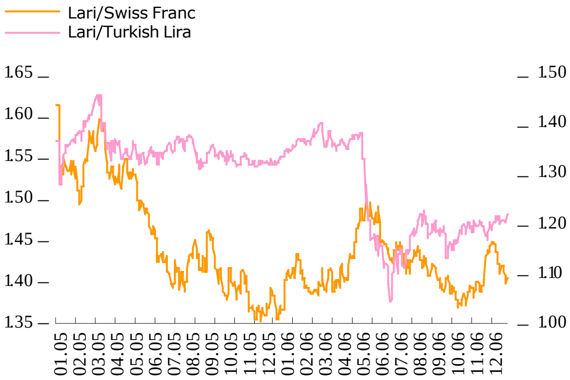
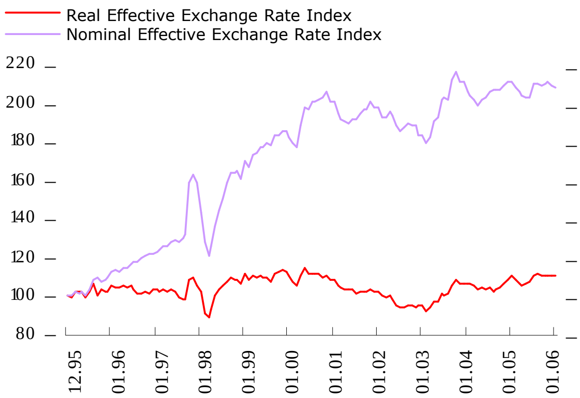
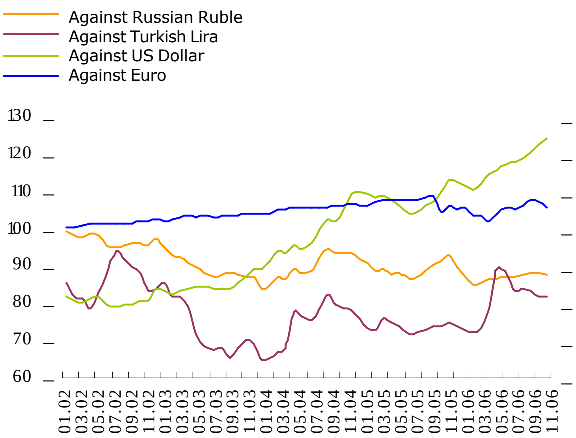


Figure 3.3.6
Real and Nominal Effective Exchange Rate Index
December 2005=100



Source: NBG

Figure 3.3.7
Lari Real Exchange Rate Index Against Different Foreign Currencies



Source: NBG

Quarters of 2005. These positive developments in external economic relations should be attributed to a prompt shift from the largest trade partner Russia to new partners and to strengthening relations with the existing trade partners.

As a result, in QIV of 2006 the CA deficit totaled 162.8 million USD, or 21% of annual CA deficit.

The annual BoP deficit amounted to 771.6 million USD in 2006, which exceeded the 2005 level by 83.9% and was a record high during 2000-2006.

In 2006 the volume of the BoP was still mainly determined by the goods trade. The latter manifests the results of the Russian ban of Georgian goods and the development of events by the end-year. Despite the difficulties, the Georgian exports increased by 21.5% during the year and totaled 1930.2 million USD. However, the exports growth rate in 2006 was lower than the exports growth rates in the previous years, as well as than the 2006 imports growth rate (39.7%). The volume of imports totaled 3522.8 million USD during the year, while the external trade deficit reached 1592.6 USD (exceeding the same 2005 figure by 70.9%).

Economics sanctions imposed by Russia made the Georgian external economic relations more flexible and adaptable. Under the 9-month Russian embargo, Georgia strengthened its economic relations with Turkey, Germany, Ukraine, Bulgaria and some other countries.

Georgian exports ban to the Russian market decreased total exports by approx. 70-80 million USD. However, this drop was to a large extent mitigated by the increase of such exported goods as ferroalloys (9.6 million USD exports, 12% increase against 2005), nitrogen fertilizers, (10.8 million USD exports, 30.1% increase), gold (14.6 million USD exports, 42.1% increase), copper scrap metals (18.7 million USD exports, 2.8-times increase), copper mines and concentrates (43.1 million USD, 2.2-times increase). It is remarkable that 2005 was a record high in terms of wines and mineral water exports. At the same time, 77% of wine exports and 73% of mineral water exports accounted for the Russian market. In 2006 the wine exports to Russia were 1.4 times lower than those in 2000, while the mineral water exports dropped almost to the level of 2001. As a result of the Russian embargo, Georgia fell short of approx.

Table 3.3.1
2006 Current Account Dynamics by Quarters (USD, millions)

	Total	Q1	Q2	Q3	Q4
Current Account	-771.6	-120.5	-231.1	-257.2	-162.8
Trade Balance:					
Goods	-1592.5	-221.2	-382.9	-499.6	-488.8
Services	369.9	22.6	63.1	121.7	162.5

Figure 3.3.8
Current Account Deficit Dynamics

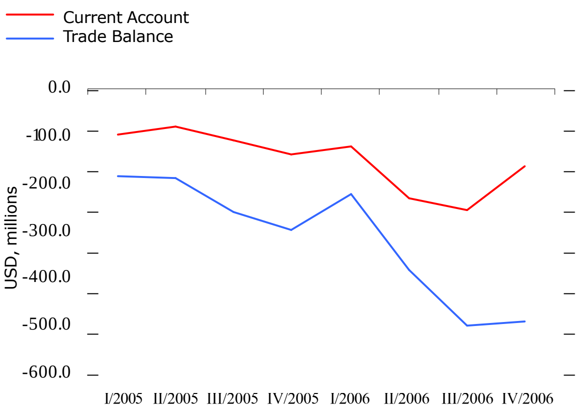
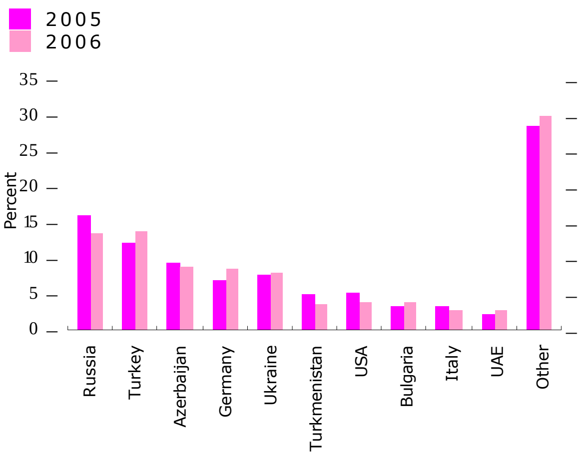


Figure 3.3.9
Georgia's Main Trade Partner Countries
2005-2006



50 million USD worth revenues from wine exports and approx. 15 million USD worth revenues from mineral water exports.

It can be asserted that possible negative impact of the Russian embargo was to a certain extent alleviated by the geographical shift of the Georgian goods exports. Despite the difficulties, Georgia basically succeeded to meet the Russian challenge, and in 9 months the destination of wines, ethyl spirits, mineral waters, hazelnuts, and some other goods exports was reoriented to the new markets in Ukraine, Kazakhstan, Azerbaijan, and Eastern Europe countries.

Under the conditions of 2.2 times decrease of Georgian mineral water exports to Russia, there was a significant increase in mineral water exports to Moldova and Ukraine (1.3 times to each), USA and Poland (1.5 times to each), Belarus and Turkmenistan (1.7 times each), Bulgaria (1.8 times), Cyprus (2 times), Kazakhstan (2.2 times). Among new destinations for Georgian mineral water exports can be named Lithuania, Iran, Ireland, Uzbekistan, and Kyrgyzstan.

During 2006 the Georgian imports totaled 3422.8 million USD. The 20% of total imports increase accounted for energy imports growth. The latter was conditioned, on the one hand, by the world price increase on oil and oil products, and, on the other, by the increase in the gas price from Russia. Meanwhile, a significant growth of imports was recorded for the following commodity groups: medicaments (1.2 times), motor vehicles (1.7 times), computers (2.1 times), grain, and mobile telephones (2.2 times each). During 2006 the Russian embargo did not have significant influence on the imports geography. For example, grain imports from Russia were partly replaced by imports from Kazakhstan and the United States.

Foreign trade of services, despite Russia's transportation ban, grew compared to 2005, and its positive balance reached 370 million USD (2.9 times more). Such impressive results are first of all achieved during the tourism season. In addition, revenues related to the operation of pipeline increased, after the pipeline was put into operation and reached an appropriate turnover level. Pipeline revenues totaled 68.8 million USD in 2006, compared to 38.6 million USD in 2005. The situation was reversed in the balance of transport services though: in 2006 the transport services sector experienced a deficit of 74.4 million USD, while in 2005 the balance was positive totaling 117.9 million USD.

Figure 3.3.10
Wine Exports Dynamics

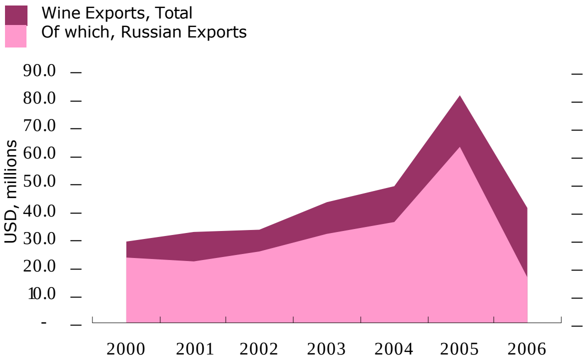


Figure 3.3.11
Mineral Water Exports Dynamics

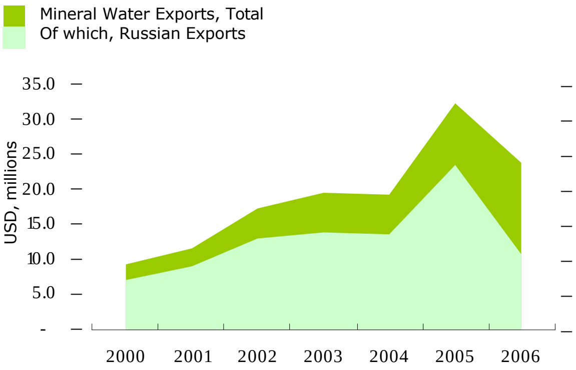


Table 3.3.2
Goods Exports to Foreign Countries by Large Commodity Groups

	Ferro alloys	Copper Mines and Concentrates	Scrap Black Metals	Hazelnuts and Walnuts	Cars	Airplanes	Gold	Fertilizers	Wine	Copper Scrap Metals	Ethyl Spirit	Mineral Water
Share in Total Exports	**9.0**	**8.0**	**7.3**	**5.7**	**5.1**	**5.0**	**5.0**	**4.7**	**4.1**	**3.0**	**3.0**	**2.4**
Austria				1.2			2.1					
Azerbaijan				0.1	64.7						5.9	5.4
USA	33.1		1.5			0.8		40.8	3.9	0.2	0.2	5.0
Belarus									3.8		3.0	1.7
Bulgaria		61.6			0.1							
UK			2.0	0.6		9.2			0.8	0.8	0.1	
Germany		15.9	1.5	20.1					0.5		0.1	
Spain		8.8	3.2	1.9				8.8				
Turkey	13.5	3.8	68.1		15.5			3.0	0.1	30.0		
Turkmenistan						81.6			0.1			
India			0.8							20.2		
Italy				30.3				5.5				
Canada							97.9		0.3			0.1
Mexico	5.8											
Netherlands			1.6	0.5					0.1	1.1	0.8	
Russia	26.0			8.5		6.6			40.5		20.1	45.4
Greece	1.2			2.6				4.9				
France	3.6			2.3				9.3				
Serbia		9.9										
Armenia				1.2	12.9			20.4			1.2	
Ukraine	14.1			2.9	3.7				28.2		55.0	26.2
Kazakhstan				0.1		1.8			11.9		11.0	6.9
Chech Republic				10.2	0.1				0.1		0.2	
China			0.2	0.1					0.5	28.0		
Other Countrie	2.7	0.0	21.1	17.4	3.0	0.0	0.0	7.3	9.2	19.7	2.4	9.3

In 2006 the tourism sector has been considerably expanding as a result of rehabilitation of tourism infrastructure, liberalization of movement with the neighboring countries, and free entry regime for 30 countries. The growth of foreign tourists was not limited to the seaside regions. Such types of tourism as extreme, adventure, business, ecological and wine tourism benefited from tourists inflow. Demand for business tours has emerged, with the purpose of purchasing eco-friendly fruits and vegetables. A few European countries have already expressed their interest in such tours.

In 2007 the "Millennium Challenge Georgia" Fund plans to invest 32.5 million USD worth venture capital into the tourism and agriculture sectors. In 2006 979.7 thousand tourists entered Georgia, 438 thousand tourists (1.8 times) more than in 2005. Increase of tourists in 2006 was promoted by Georgia's participation in international fairs, where the information about the Georgian resorts and recreational possibilities was disseminated.

In 2006 the number of Georgian citizens who traveled abroad increased by 395.4 thousand people and totaled 1.3 million. However, the large part of these trips accounts for the so-called "shop-tours", which is still mainly related to goods imports and relatively less - to tourism imports. Taking into account this situation as well as a significant increase in tourism exports, the positive balance in the tourism service sector amounted to 351.9 million USD, largely determining the positive trajectory of the balance of services.

Current transfers, in particular money remittances[1], still remain a significant factor for not only the balance of payment, but also for the country's consumer market. Money remittances represent the largest share of current transfers - 97.9%. Despite Russia's attempt to stop money remittances to Georgia, their inflow, including from Russia, continued during 2006. As a result, this figure increased by 35.2% against 2005 and reached 545 million USD.

[1] money remittances represent a type of current transfers from international migration of labor and are related to the citizens employed in other countries who send money to their home country. The information on remittances in our country is mainly received from commercial banks in terms of volumes of swift money transfers („Western Union", „Money Gram", „Anelik", „Caucasus Express", etc). However, remittances in Georgia are also effected through informal channels (sending money through friends, etc.), which are less likely to be registered and, thus, are not present in our calculations.

Figure 3.3.12
Dynamics of Volume of 10 Main Exports Items (USD, millions) 2005-2006Figure 3.3.12
Dynamics of Volume of 10 Main Export Items (USD, millions) 2005-2006

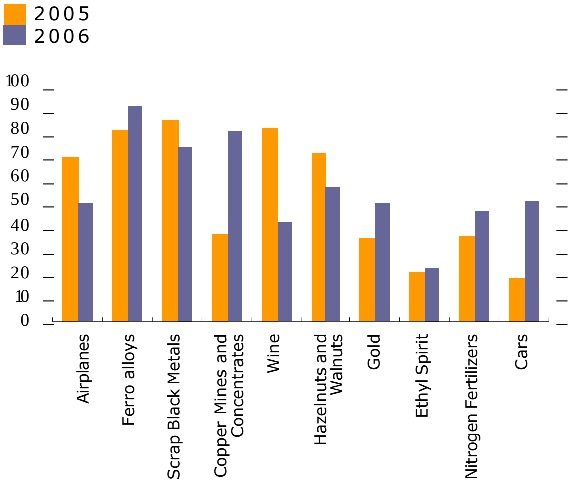
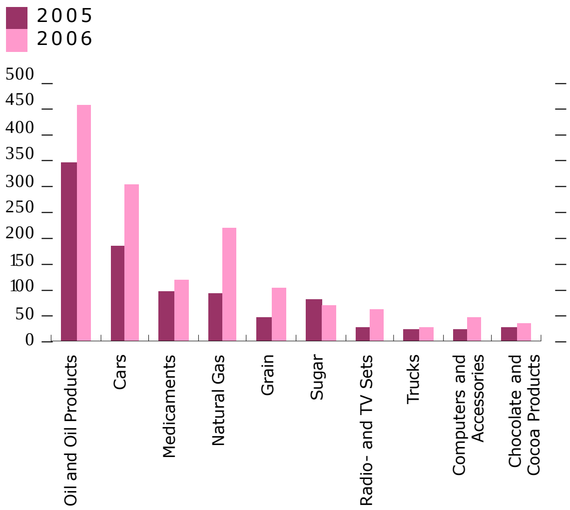


Figure 3.3.13
Dynamics of Volume of 10 Main Imports Items (USD, millions)
2005-2006



The positive balance of capital and financial account totaled 746.8 million USD, which is 1.7 times more than in 2005. The growth in financial account accounts for more than 75% of this increase. The positive balance of financial account, mainly fueled by the significant growth of FDIs, grew 1.6 times and amounted to 626.9 million USD.

Over 2006 significant investments were made in the banking, communications, energy and mechanical engineering sectors. By preliminary estimates, the volume of foreign investments in 2006 exceeded 1 billion USD. Apart from 2005 investments made by the British Petroleum company, significant investments were made by Kazakhstan, Turkey, USA, Azerbaijan, and France.

However, despite all the advantages brought about by FDIs, they also create a significant inflationary pressure for many countries, Georgia being no exception.

It is a well-known fact that, similarly to the exports boom, a large inflow of foreign capital may cause the so-called "Dutch disease" (See Box 3), i. e. disequilibrium on domestic consumers market and foreign exchange market. The investment boom, which started in Georgia since the second half of 2002, continued in the period concerned and presupposed the increase in demand for Lari. However, the Lari appreciation trend significantly hindered the price increase on the consumers market.

In QIV the release of the IMF funds, envisaged under the balance of payment support program, continued. In addition, the payment of liabilities continued in line with the schedule.

Table 3.3.3
Country Distribution of Main Import Items by Large Commodity Groups

	Oil and Oil Products	Cars	Natural Gas	Medicaments	Grain	Sugar	Communications Appliances	Computers and Accessories	Trucks
Share in Total Imports	**12.0**	**8.0**	**5.8**	**3.1**	**2.7**	**1.8**	**1.6**	**1.3**	**1.1**
Austria		0.7		5.2				1.3	0.2
UAE		5.2				0.1	25.7	9.5	0.4
Azerbaijan	52.5		2.7	0.2	0.2	18.2	0.1		0.1
USA	0.1	17.3		1.0	7.2		18.5	3.9	0.2
Belarus				1.3		9.1			8.7
Belgium		4.2		3.3		0.1		0.2	3.5
Bulgaria	10.0	0.8	0.2	4.9	1.8				0.8
Brazil						40.0			
UK				2.9		1.7	2.3	4.4	1.0
Germany	0.4	45.6		10.2		0.1	8.7	12.4	22.3
Spain		0.2		0.4					0.2
Turkey	1.1	1.6		6.8	0.3	3.9	15.3	1.5	18.9
Turkmenistan	22.3		0.7						
Japan		10.9		0.1			0.5	0.1	0.1
India				1.7					
Netherlands		3.3		3.4			0.4	29.8	5.2
Romania	8.2			0.3					
Russia	1.3	1.8	95.9	3.2	68.3	3.3	0.2	0.4	7.2
France		2.1		8.0		8.9	0.4	0.8	0.8
Armenia				0.5	0.9				0.3
Ukraine	0.3			6.1	0.4	1.2	0.4	6.2	27.6
Finland							12.9	2.7	
Kazakhstan					16.9				
China		0.1		0.1			1.3	11.1	
Other Countries	3.8	6.2	0.5	40.4	4.0	13.4	13.3	15.7	2.5

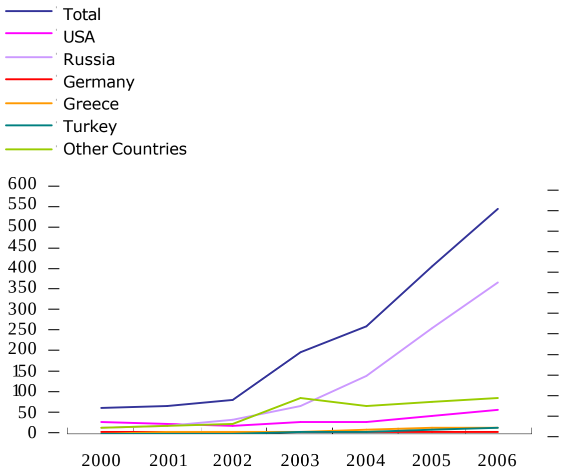
Table 3.3.4
Dynamics of Balance of Services

	Total 2006	Q1	Q2	Q3	Q4
	369.9	22.6	63.1	121.7	162.5
Balance of Services	-74.4	-5.1	-10.4	-30.2	-28.7
Transportation Services	68.8	15.9	15.8	18.5	18.6
Pipeline Services	351.9	6.5	53.6	126.4	165.3
Tourism	23.7	5.4	4.0	6.9	7.4

Table 3.3.5
Number of Foreign Tourists, thousand persons

	Total, 2006	Q1	Q2	Q3	Q4
Number of Foreign Tourists					
2005	542.0	84.4	125.5	182.6	149.5
2006	979.7	119.8	174.4	310.5	375.0

Figure 3.3.14
Growth Trends of Money Remittances by Main Countries



Box 3. „Dutch Disease"

In the 1960s the discovery of natural gas by the Netherlands in the Northern Sea brought about the windfall of export revenues in the country. However, they caused the gulden appreciation and the deterioration of competitiveness in traditional export industries. Thereafter this phenomenon known as the "Dutch disease" has become a problem for many countries.

This paradoxically negative outcome of wealth increase was explained in 1982 by M. Corden and P. Neary. They developed a classical model of the "Dutch disease". The essence of the "disease" consists in the fact that booming natural resources sector disturbs the equilibrium between this sector, tradable sector and non-tradable sector (retail trade, restaurants, hotels, construction). Initially, as a result of exports of natural resources the revenues denominated in foreign currency start to grow. If these revenues are used for financing imports, the foreign capital inflow does not directly affect the money supply and demand on domestic goods. However, the unlimited increase of imports is not feasible either. That is why the growing revenues from exports of natural resources are converted into the national currency on the domestic foreign exchange market.

If the country has a fixed exchange rate regime, then conversion of foreign currency into the national currency requires the increase in money supply. This will cause, in turn, an increase in domestic price level. If the exchange rate regime is not fixed, then the supply-and-demand disequilibrium on the foreign exchange market will entail an appreciation of the national currency. In both cases, the national currency real exchange rate increases, which means that with one unit of foreign currency we will buy less goods and services on the domestic consumers market, than it was possible previously. Under such circumstances, the profitability of traditional exports, since growth of domestic prices makes more expensive exports less competitive on the international market, which is followed by a decline in the traditional tradable sectors. The process is not finished though: the so-called "resource movement effect" takes place and both capital and labor move to the non-tradable sector. Positive development of this process necessarily depends on renovating the sector infrastructure, retraining personnel, etc. If this fails due to financial problems and/or rigid administrative system, then unemployment and related social problems will be inevitable.

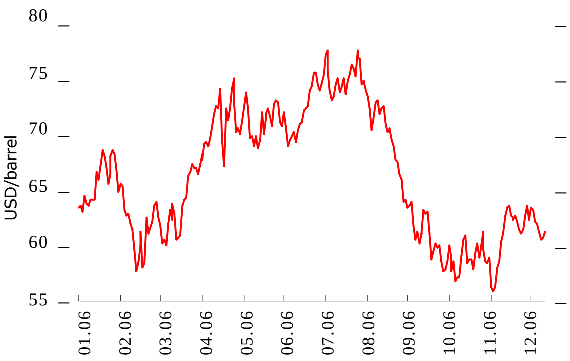
3.4. Production Costs

Dynamics of Oil Prices

In QIV of 2006 the world oil prices were stable with respect to QIII. When over QIII the oil prices kept decreasing, the ultimate price drop being 22%, in QIV the oil prices fell by further 3%. There was a corresponding price decrease on the Georgian energy market in QIII - on average, the gasoline price fell by 15%.

In QIV of 2006 the world sugar prices virtually remained unchanged, contrary to the decreasing trend during the previous months of the year.

Figure 3.4.1
Dynamics of Crude Oil Prices (USA Oil Market)



Source: Bloomberg

Figure 3.4.2
Dynamics of World Prices on Sugar

Source: Bloomberg

Taxes

In accordance with the 2006 on-line information, the state budget revenues and grants amounted to 3 773.2 million Lari, of which own revenues - 3 579.2 million Lari. The annual revenue plan was thus fulfilled by 104.8 % and 104.7 %, accordingly. The tax revenues in 2006 totaled 2 633.1 million Lari. Compared to 2005, the nominal growth of tax revenues made up 43.4 %, while the real growth equaled 31.3 %. The tax revenues annual plan was fulfilled by 103.8 %. In 2006 the share of tax revenues in the state budget revenues and grants equaled 69.8 %, the same figure in 2005 being 70.4 %. In the same period the share of non-tax revenues and grants increased, while the capital revenues share dropped.

Table 3.4.1
Nominal and Real Growth of State Budget Revenues in 2006 vs. 2005 (%)

	Nominal Growth	Real Growth*
Total Revenues and Grants	44.7	32.5
Total Revenues	43.0	31.0
Tax Revenues	43.4	31.3
Profit Tax**	54.5	41.5
VAT	35.0	23.6
Excise Tax	17.5	7.6
Customs Duty	7.3	-1.7
Social Tax	17.3	7.4
Non-Tax Revenues	72.1	57.6
Capital gains	19.8	9.7
Grants	86.3	70.6

Source: Ministry of Finance.

* Real growth is 2006 CPI-deflated
** Information source of profit tax is the 2005-2006 consolidated budget in January-September.

In 2006 the customs duty revenue plan was fulfilled by 103.8 %, the annual growth rate achieving 7.3 %. In 2005 customs revenues increased by 38.4 %. In 2006 the Parliament of Georgia enacted the new Law "On Customs Duty" effective since September 1, 2006. In accordance with this Law, the highest customs duty rate was decreased to 12 %, while for a number of commodities the duty was abolished altogether. Since January 1, 2007 the new Customs Code was put into effect, abolishing the above-mentioned Law. The issues related to customs duty will be regulated by Part XII (1) norms of the Customs Code.

The improvement in tax administration is well manifested by the tax revenue increases in customs and tax agencies. Compared to 2005, in 2006 the Tax Department revenues were higher by 463.8 million

Figure 3.4.3
Types of State Budget Total Revenues
2006

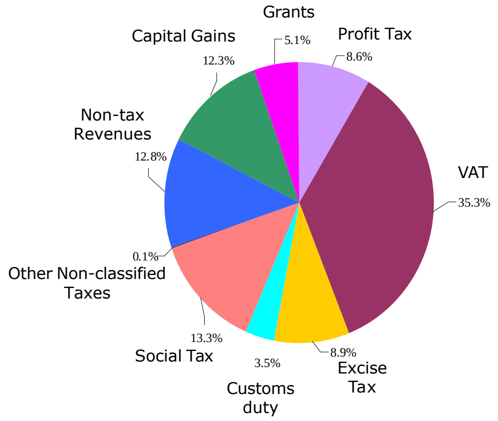
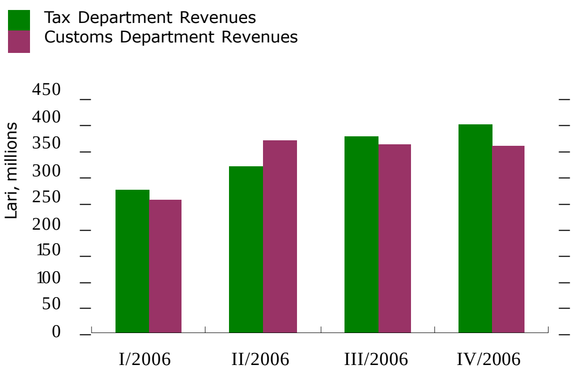


Figure 3.4.4
State Budget Revenues by Sources



Source: Ministry of Finance

Table 3.4.2
Mirror Data on Georgian Imports from Turkey

	2003	2004	2005	2006 9 months
National Statistics Institute of Turkey (USD, thousands)	155068	198738	271781	276386
Department of Statistics of Georgia (USD, thousands)	102153	192176	268860	326905
Correlation Coefficient	1.50	1.00	1.00	0.85

Lari, while the Customs Department revenues - by 333.3 million Lari. The Tax Department fulfilled the state budget revenues plan by 104.4 %, while the Customs Department - by 103.2 %. Meanwhile, the improvement in imports taxation is reflected in the mirror statistics analysis of Turkish imports in Georgia since 2004. In particular, the correlation coefficient in 9 months of 2006 made up 0.85.

In 2006 the state budget expenditures exceeded the revenues and grants by 48.2 million Lari. Thus the budget deficit turned out significantly less than planned - 277.2 million Lari, which happened at the expense of higher revenues (171.8 million Lari) and decreased expenditures. In addition the balances on the unified Treasury account grew by 105 million Lari. In the first half of 2006 the outstanding liabilities on Treasury bills in circulation worth 20.3 million Lari were also covered. The budget deficit was covered by means of concessionary loans from external sources.

The financial budget revenues received in 2006 in the form of foreign currency exceeded the government expenditures in foreign currency by approx. 32 million USD (57 million GEL). This implied the corresponding increase of monetary mass in circulation. On the other hand, the volume of government deposits at the NBG grew on the average by 111 million Lari, i. e. more than 57 million Lari was removed from circulation. Thus, contrary to the previous periods, in QIV of 2006 the fiscal policy did not influence the monetary mass growth and didn't create inflationary pressure.

Labor Productivity, Wages

In QIII of 2006 the value-added per employed person increased by 12.4 % in real terms, compared to the same Quarter of 2005. In particular, double-digit labor productivity growth rates were manifested in trade, financial intermediation, healthcare, education, which promoted the economic growth in these sectors. Growth in manufacturing, hotels and restaurants, transport and communications was less impressive. In agriculture, construction, and public administration there was a decrease in labor productivity.

In QIII of 2006 the growth rate of nominal wages with respect to QIII of 2005 amounted to 21.1 %, whereas with respect to QII of 2006 it grew by 1 %. Over the last year wages grew in both private and public sector. In QIII of 2006 the net average monthly wages

Table 3.4.3
Growth Rates of Value-Added Per Employed Person and Average Monthly Wages in QIII of 2006 Against QIII of 2005

	Real Growth of Value-Added (%)	Nominal Growth of Wages (%)
Agriculture	87.9	129.4
Manufacturing	103.3	188.9
Construction	98.9	150.9
Trade	176.2	128.7
Hotels and Restaurants	107.8	59.3
Transportation and Communications	105.3	110.6
Financial Intermediation	153.7	175.9
Real Estate Business	87.5	105.7
Public Administration, Defence	89.0	117.4
Education	133.8	137.1
Health Care	128.9	152.2
Other Kinds of Services	89.3	98.3
Total	112.4	121.1

Source: Department of Statistics

amounted to 188.9 Lari[1]. The real growth rate of wages made up 10.9%.

In Q III of 2006, compared to the same Quarter of 2005, the nominal growth rate of average wages exceeded the real growth of value-added per employed person by 8.7%. Moreover, excluding public sector, the above difference increases to 11% indicating inflationary risks. In such real economy sectors as manufacturing, agriculture, and construction the wages increase significantly exceeds the growth of labor productivity. In QIII the annual growth rate of average wages made up 20.2% in public sector and 21.4% in private sector. It should be pointed out that despite the employment decrease in the manufacturing sector, the value-added of the sector increased indicating significant growth in labor productivity.

Unemployment

In QIII of 2006 labor market deteriorated, the unemployment rate increasing to 13.7% from 12.9% in the previous Quarter. The unemployment rate equaled 13.3% in QIII of 2005. Mainly due to the aging processes, the labor force in Georgia tends to decrease. In particular, in comparison to QIII of 2005, the labor force decreased by 51 thousand persons[2]. The number of employed decreased by 53.4 thousand persons, including 40.5 thousand decrease in self-employed. Accordingly, the labor participation rate decreased from 64.1% to 63%. However, this indicator is higher in Georgia than in developed countries, which probably reflects the fact that the economic situation compels people to actively seek employment.

Table 3.4.4
Labor Force and Unemployment (in thousand persons) by ILO (International Labor Organization) Criteria

	Population over 15, Total	Labor Force	Labor Force Participation Rate (%)	Unemployment, Total	Unemployment Rate (%)
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
Q1	3178	1999	62.9	294	14.7
Q2	3149	2036	64.7	272	13.4
Q3	3132	2012	64.1	270	13.3
Q4	3191	2049	64.1	284	13.8
2006					
Q1	3170	1925	60.7	282	14.6
Q2	3139	1952	62.2	252.4	12.9
Q3	3113	1961	63	269	13.7

Source: Department of Statistics

During the last year[3] the employment increased in construction, education, utilities and other social sectors. The situation is opposite in other sectors, in particular, in manufacturing, trade, restaurants and hotels, household services, public administration and healthcare. The share of self-employed is still very large in total employment (66 %) and is mainly related to agriculture.

[1] calculations are based on the results of the household survey, however the current labor statistics shows monthly nominal income in QII of 2006 to be equal to 276.4 Lari.
[2] calculations made in accordance with the ILO (International Labor Organization) strict criterion.
[3] 5 comparison of QIII of 2005 data to QIII of 2006 data is implied.

Figure 3.5.1
Growth Rate of Value-Added in Agriculture

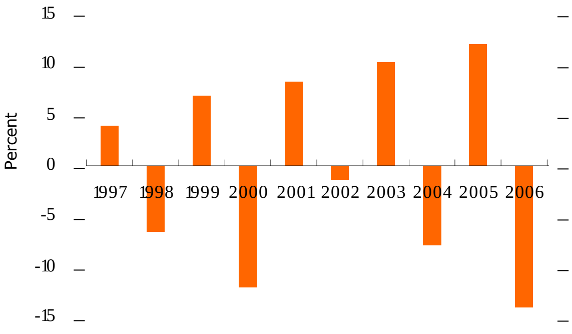


Figure 3.5.2
GPD by Types of Economic Activities in Current Market Prices

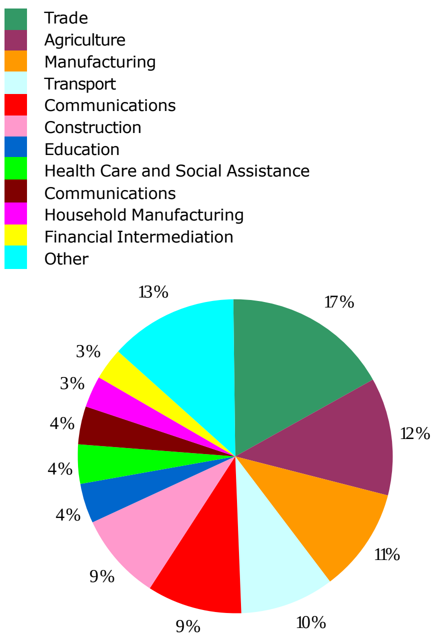
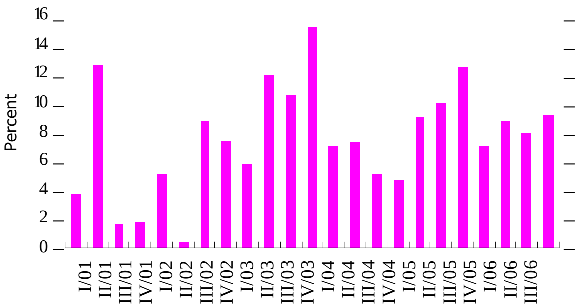


Figure 3.5.3
Annual Growth Rates of GDP by Quarters
(With respect to the same period of previous year, season-adjusted)



3.5. Production and Demand

According to QIII of 2006, despite significant negative exogenous economy shocks, the nominal GDP grew from 3033 million Lari in QIII of 2005 to 3649 million Lari.

Production

In the first 9 months of 2006, compared to the same period of 2005, the real GDP growth amounted to 8.5%. The analogous indicator by Quarters made up 8.4%, 8.0%, and 9.1%, accordingly.

The sectoral analysis of economic growth shows that a number of sectors experienced positive economic growth in QIII. Especially impressive growth rates were achieved in trade (43.5%), financial intermediation (52.6%), and manufacturing industry (23.1%). As a result of unfavorable climatic conditions, in agriculture the real value-added product decreased by 18.4 %. In the first three Quarters, the contraction in the agricultural sector equaled 14.1%, which entailed significant deficit of agricultural goods and, correspondingly, agricultural price level increase. The increase of agricultural prices is particularly evident and creates an exaggerated perception of inflationary level. Traditionally, the value-added product in the agricultural sector experiences the alternating periods of expansion and contraction. Thus, in 2007 we should expect significant growth in the agricultural sector. However, these developments are largely dependent on climatic conditions.

Household Consumption

In QIII of 2006 the nominal household consumption increased by 40.2 %, compared to the same Quarter of 2005. However, it should be mentioned that high statistical error in GPD calculations by production and consumption methods does not give us a convincing picture. In QIII of 2006 the statistical error equaled 14.2 %, increasing the GDP level calculated by production method.

Government Spending

In QIII of 2006 the government spending decreased by 12.1 %, in comparison to QIII of 2005. A similar

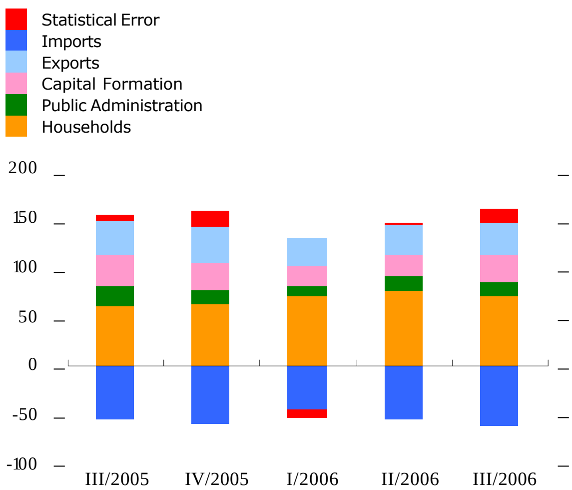
Table 3.5.1
Annual Real Growth Rate of GDP (%) and Growth Impact (Percentage points) by Types of Economic Activities

	2005*		I/2006**		II/2006**		III/2006**	
	Growth	Impact	Growth	Impact	Growth	Impact	Growth	Impact
Agriculture, Forestry, Fishing	12.0%	2.0%	-8.8%	-1.3%	-14.4%	-2.1%	-18.4%	-2.7%
Mining and quarrying	-7.8%	-0.1%	-7.6%	-0.1%	49.4%	0.4%	35.2%	0.3%
Manufacturing	14.1%	1.2%	19.8%	1.7%	32.6%	2.8%	23.1%	2.0%
Electricity, gas and water supply	5.1%	0.2%	-3.8%	-0.1%	6.5%	0.2%	19.1%	0.5%
Processing products by household	12.4%	0.5%	2.5%	0.1%	-3.2%	-0.1%	9.0%	0.3%
Construction	14.1%	1.1%	10.6%	0.9%	-2.2%	-0.2%	12.2%	1.0%
Trade services, Repair services	9.4%	1.2%	16.0%	1.9%	17.5%	2.1%	43.5%	5.2%
Restaurant and Hotel services	17.1%	0.5%	8.3%	0.2%	9.8%	0.3%	-3.5%	-0.1%
Transport and storage	3.9%	0.4%	24.0%	2.0%	12.3%	1.0%	11.2%	0.9%
Communications	28.7%	1.1%	18.5%	0.7%	3.4%	0.1%	6.1%	0.2%
Financial intermediation	52.8%	0.7%	46.5%	0.9%	37.9%	0.8%	52.6%	1.0%
Real estate, renting and business activities	10.6%	0.3%	35.0%	0.9%	6.9%	0.2%	1.6%	0.0%
Imputed rent of own occupied dwellings	0.9%	0.0%	-1.3%	0.0%	-1.2%	0.0%	-0.8%	0.0%
Public administration and defense	-6.3%	-0.4%	-6.8%	-0.4%	-2.8%	-0.2%	-19.2%	-1.2%
Education	13.8%	0.5%	9.6%	0.3%	13.5%	0.4%	2.5%	0.1%
Health care and social Services	7.6%	0.3%	1.2%	0.0%	28.0%	1.0%	21.0%	0.7%
Other community, social and personal service activities	18.3%	0.5%	14.6%	0.5%	23.2%	0.7%	0.2%	0.0%
Private households with employed persons	28.2%	0.0%	29.3%	0.0%	15.5%	0.0%	6.4%	0.0%
(-) FISIM adjustment	57.5%	-0.4%	2.8%	0.0%	-17.8%	0.2%	5.0%	-0.1%
Gross Domestic Product at basic prices	10.4%	9.5%	8.5%	7.5%	8.7%	7.7%	9.1%	8.1%
(+) Taxes on products	1.2%	0.1%	4.1%	0.5%	3.8%	0.5%	8.7%	1.0%
(-) Subsidies on products	0.5%	0.0%	-1.7%	0.0%	-6.6%	0.0%	-17.6%	0.1%
GDP at Market Prices	9.6%	9.6%	8.4%	8.4%	8.0%	8.0%	9.1%	9.1%

*Final Estimations;
**Final Estimations will be published in end-November 2007.

Source: Department of Statistics, NBG calculations.

Figure 3.5.4
Use of Imported and Domestically Produced Goods (as % of GDP)

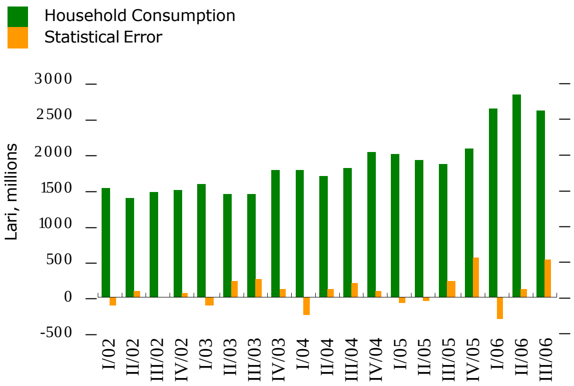


situation (11.5% decrease) stands with the government expenditures in the first 9 months. The main part of the government spending influences the domestic demand. However, an important part of these expenditures, after currency conversion, is used for imports. In the first 9 months currency conversion of 151.5 million USD has been made. This is 67% higher than in the same period of 2005 and 8% higher than the total currency conversion transactions in the whole 2005. Currency conversion reached one fifth of total government spending. Accordingly, we can say that state expenditures did not negatively affect the inflationary processes.

Investment

Similar to the household consumption expenditures, in QIII of 2006 the capital investments totaled 1006.6 million Lari. This figure is 21.3% higher than in the previous Quarter, but with respect to QIII of 2005 its nominal growth was only 5.2%, which is tantamount to decrease in real terms. However, this fact does not give much reason for concern and a relatively high 2005 figure is explained by the large-scale investment projects made in the energy sector.

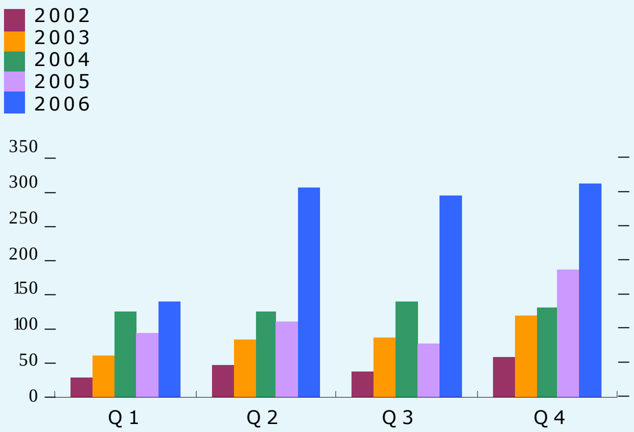
Figure 3.5.5
Household Consumption and Statistical Error between GDP Calculations by Production and Expenditure Methods, Current Prices



Box 4. Investments Inflow in Georgia

The year of 2006 was very important for Georgia in terms of foreign capital inflows. During the year the volume of FDIs in Georgia totaled approx. 1 billion USD (the QIV information is not yet finalized). The comparison with the previous years shows that the FDIs in 2006 were almost twice as high as in 2005 (539 million USD).

Figure 1
Dynamics of FDIs in Georgia by Quarters[1] (USD, millions)



[1] 1 QI of 2006 Data is an estimation

The above Figure shows that during last years the FDIs experienced positive growth rates. This trend was reversed in the first three Quarters of 2005. The decrease of investments was mainly caused by the finalization of the Baku-Tbilisi-Ceyhan pipeline project and, accordingly, decrease of investments by the main project operator British Petroleum. However, since end-2005 the privatization program was fully put into operation, and the foreign investment inflows continued at an increasing rate.

The largest investor in 2006 was the BP, which invested more than 200 million USD over the year. The share of investments attracted through the state privatization program was high. In the first three Quarters of 2006 the volume of investments related to privatization reached 220 million USD. Large investments were made in the construction sector; over 100 million USD was invested in the construction of airports and hotels. In 2006 the banking sector significantly benefited from foreign investments. A few large foreign banking groups entered the Georgian banking sector, and, as a result, the investments volume increased by 150 million USD.

In accordance with preliminary forecasts, the volume of investments is likely to grow further in 2007. The British Petroleum plans to invest additional 200 million USD into the Georgian economy. Approximately 160 million USD worth of investment is expected from state property privatization. About 200 million USD will be invested into the construction of hotels and airports, and the expected foreign inflows into the banking sector exceed 500 million USD. In total the total volume of FDIs into the Georgian economy is expected on the level of 1 500 million USD.

Inflation Forecasts 4

Figure 4.1
Inflation Forecast
2005-2006

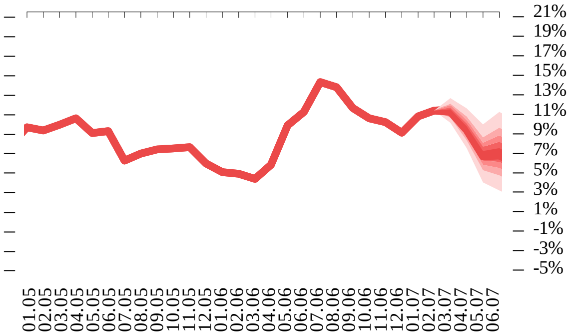
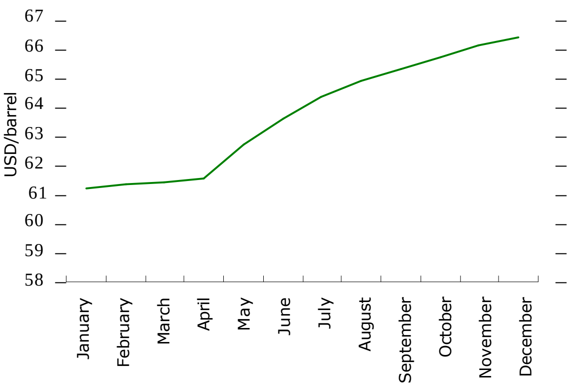


Figure 4.2
Oil Prices on the World Market
2007



According to the NBG forecasts, the economic growth rate will be strong in the range of 9-10%. Stable growth is expected in financial intermediation, agriculture, restaurants and hotels, transport and communications, construction, and mining sectors. In 2007 the most critical factor of economic growth will be agriculture, which, in its turn, largely depends on climatic conditions. The above-mentioned forecasts assume "normal" climatic conditions and do not take into account, for example, possible contraction of poultry and eggs production due to "avian flu". The forecast does not include either a possible aggravation of bilateral relations with Russia, or, on the contrary, - a complete conflict resolution. The above factors may essentially influence the forecasted GDP level.

In the first half of 2007 the prices on oil products will have a large impact on the price level; the decreasing trend in price changes is expected. In QI of 2007 the oil prices are expected to drop significantly, in comparison to 2006, although their level is forecasted to increase from May. In any case, according to experts' opinion, the oil price in 2007 will be much lower than that of record high levels in 2006.

In 2007, especially from its mid-period, taking into account the basis effect, the price-decreasing trend will be influenced by the prices on agricultural products. According to preliminary data, climatic conditions are favorable. A possible factor influencing the price increase on agricultural products could be a lift of the Russian ban on the Georgian agricultural products. However, this would only have a one-time effect on inflation.

The economic development of Georgia's main trade partners allows us to make a forecast, similar to 2005, of 8-9% imports inflation.

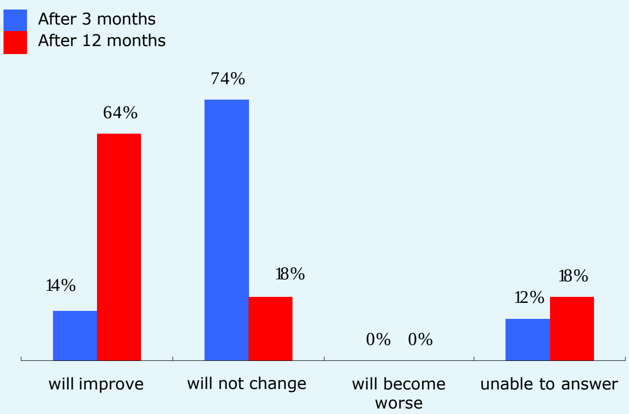
On the basis of the above assumptions and taking into account the stability of the Lari exchange rate against the US dollar, we can expect the inflation rate by end-June of 2007 to be in the range of 6.46-7.19%. It should also be pointed out that the reliability of the forecast depends both on the precision of the assumptions and on unforeseen factors. Accordingly, the forecasted inflation chart is presented - it has a “fan-like” form and shows the inflation forecast in accordance with probability distribution.

Box 5. Results of the Survey of Managers at Commercial Banks

The monthly NBG survey of managers at commercial banks allows us to estimate the expectations of the principal players on the financial market with respect to economy development, future changes of the Lari exchange rate, and inflationary processes.

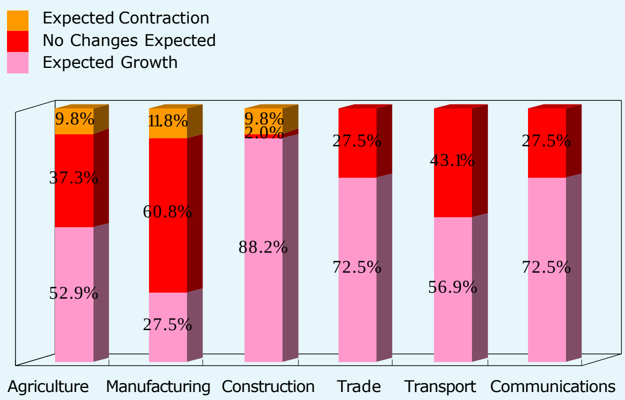
In the three-month perspective the commercial banks do not expect changes in the general economic situation. 74% do not expect any changes, 14% expect the situation to improve, and 1% was not able to answer. In the one-year perspective, the majority of managers, approx. 64% expect the overall economic situation to improve, while 18% think that even after one year no significant changes are to come. It is remarkable that banks do not expect deterioration of economic situation either in the short- or in the long-run (Figure 1).

Figure 1
Economic Situation in Georgia



According to the survey results, the economic growth is expected in construction, trade, communications, transport, and agricultural sectors. The growth in these sectors was predicted by 88.2%, 72.5%, 72.5%, 56.9%, and 52.9% of respondents, respectively. Regarding the industrial sector, 60% of respondents do not expect any changes, while only 27% think that the situation will improve, and 12% predict a contraction of the sector (Figure 2). It should be noted that in QIV, compared to QIII of 2006, the expectation of economic growth in the agricultural and communications sector is increasing.

Figure 2
Economic Growth in Different Economic Sectors After One Year



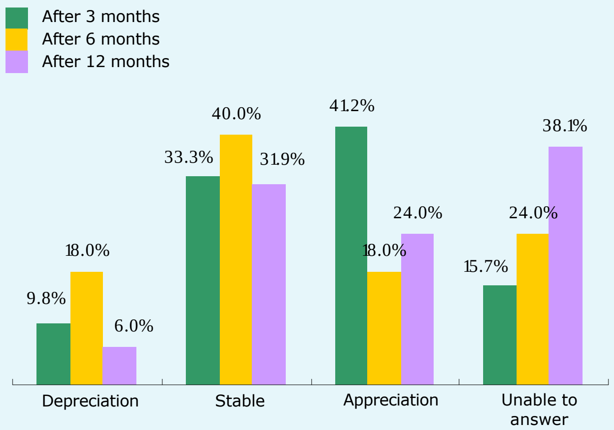
As it becomes clear from the survey, the expectations of the commercial banks with respect to future changes of the Lari exchange rate are similar to those of the previous periods. In the short-run, the majority expects the appreciation of Lari or its exchange rate stability - 41.2% and 33.3%, respectively. The depreciation of Lari is expected by only 9.8%, while 15.7% of respondents were unable to respond to this question.

In the medium-run, during 6 months, the managers of commercial banks mainly forecast a stable Lari exchange rate - approx. 40% of respondents think that the exchange rate will not change. It should be pointed out that in the short-run the appreciation trend was expected by 41.2%, while in the medium-term perspective - by 18% only.

According to the survey results, in one-year perspective the Lari exchange rate is unclear for the majority of the managers, 38.1% were unable to answer this question, 40% think that changes in the exchange rate should not be expected and it will mainly be stable. A relatively small part of managers, approx. 24%, expects a further appreciation of Lari, while about 10% think that the Lari exchange rate against the US dollar will fall.

In total, according to the expectations of the commercial banks, the Lari exchange rate against the US dollar will be stable. It should be pointed out that the banks' expectations in QIV are similar to those in the previous period: in the short-run they expect the Lari appreciation, while in the long run the managers found it difficult to answer this question (Figure 3).

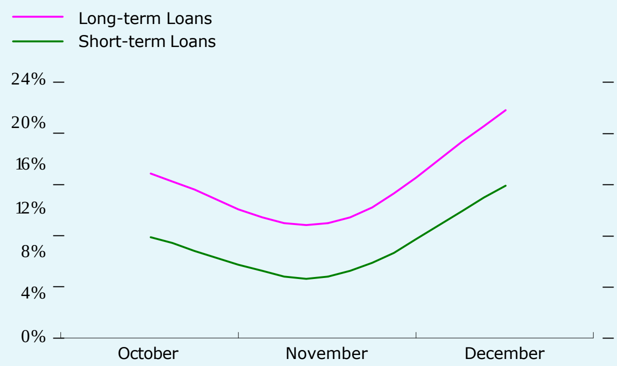
Figure 3
Changes in Lari Exchange Rate



The evaluation of the commercial banks' expectations with respect to the Lari exchange rate can be made by analyzing the difference between the interest rates on loans denominated in Lari and in US dollars. In this case, if we use as a benchmark the consumer loans given out in QIV, it becomes evident that interest rates on Lari-denominated loans are higher than those on US dollar-denominated loans in both short- and long-run. We can therefore infer that banks expect the Lari depreciation in both short- and long-run. It is also remarkable that the interest rate spread is larger on long-term loans, which indicates that banks expect more changes in the long-run (Figure 4).

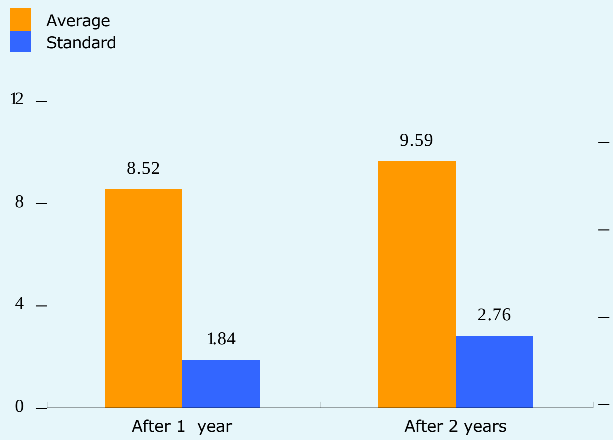
In QIV of 2006 the inflationary expectations of commercial banks after one year averages 5.52%. This is slightly lower than the same indicator one Quarter before (5.54%). As regards the inflationary expectations in two years' perspective, a higher figure was recorded in comparison to the previous

Figure 4
Interest Rate Spread



Quarter. If in QIII the commercial banks predicted 9.45 % inflation, in QIV the inflationary expectations made up 9.59 %. Similar to the previous period, one-year inflationary expectations are characterized by higher dispersion than two-year expectations (Figure 5).

Figure 5
Forecasted Rate of Annual Inflation



Thus the survey of commercial banks' managers in QIV of 2006 shows than the banks expect an improvement of general economic situation in one-year perspective and no changes in the short-run. The growth is mainly expected in construction, trade, communications, transport, and agricultural sectors. The bank managers generally expect the stable Lari exchange rate during 2007, in the short-run they tend to predict the Lari appreciation, while in the long-run they find it difficult to make exchange rate forecasts. Similar to the previous periods, the inflationary expectations of commercial banks are stronger in two-year perspective than in one-year perspective.

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

3/5 Leonidze Str., Tbilisi 0105, Georgia