NATIONAL BANK OF GEORGIA

INFLATION REPORT

III Quarter, 2007

CONTENTS

Changes in Consumer Prices

1

Annual inflation in September increased to 9.0%. The average annual inflation rate slightly decreased to 8.8%. In the period between December 2006 and September 2007 the price growth rate equaled 6.2%. Exogenous factors accounted for 3.1 percentage points of the annual inflation.

The annual core inflation rates amounted to 5.56% and 5.25% for the products within the range of one and two standard deviations, respectively. Although the core inflation rates fall behind the overall growth of consumer prices, the increase of the former with respect to the previous months is a noteworthy fact.

Clothing prices have posted an 8.3% decrease. Prices in the communications sector as well as prices of home appliances and equipment have remained practically stable. A moderate price increase has been registered in the following commodity groups of the consumption basket: „Food and Non-Alcoholic Beverages" (5.9%), „Alcoholic Beverages, Tobacco" (1.2%) „Healthcare" (6.4%), „Transport" (10.1%)[1]. During January-September, the most drastic price growth has been registered in the commodity group „Housing, Water, Electricity, Gas, and Other Fuels" (21.7%), which was mainly conditioned by the increase of natural gas, water, and garbage collection fees.

The highest annual inflation rate has been posted for non-durable goods (9.6%) and services (11.1%). This is likely to be explained by slowing down of prices of non-durables and the time lag between the increase of prices of services and the increase of goods prices.

Between December 2005 and September 2007 the prices of non-durable goods grew by 16.7%, while the prices of services increased by 17.6% in the

Figure 1.1
Monthly Inflation In January-September 2007

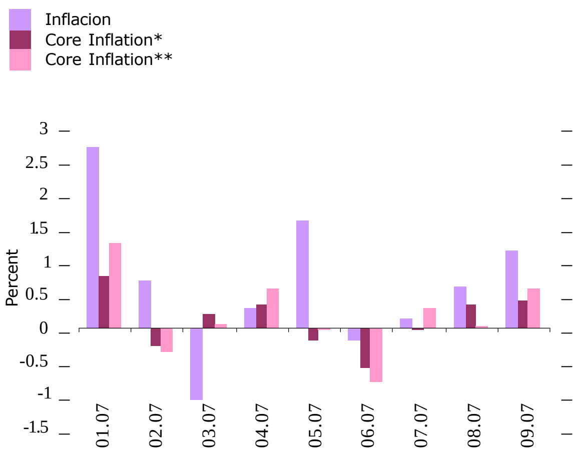
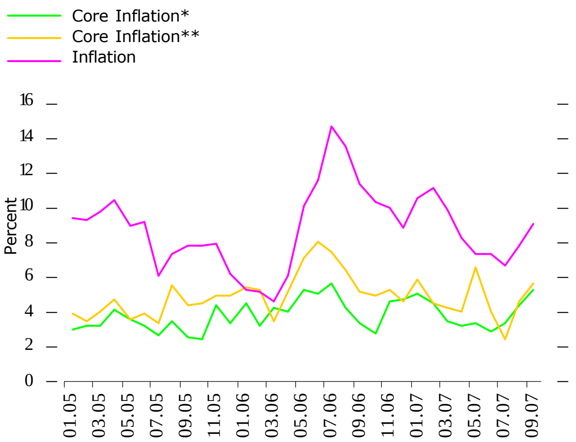


Figure 1.2
Annual CPI And Core Inflation (By 282 Components of the Consumption Basket, Effective December, 2006)



* by products within the range of one standard deviation (~85%)
** by products within the range of two standard deviations (~93%)

[1] This implies not just changes in prices of trips by city buses or underground trains, but the average price growth on transport, including other means of transport as well, e.g. prices of taxi within the city, microbuses, inter-district and inter-city transport, etc.

Table 1.1
Inflation (CPI) Rates by Individual Components (%), Their Weight in the Consumption Basket (%) and CPI Impact (Percentage Points)

	December 2006 Weights	09.07/08.07		09.07/09.06		10.06-09.07/10.05-09.06	
		inflation	impact	inflation	impact	inflation	impact
Total	100.0%	1.2%	1.2%	9.0%	9.0%	8.8%	8.8%
Food and Non-Alcoholic Beverages	44.3%	1.9%	0.9%	12.1%	5.2%	12.5%	5.4%
Food	43.0%	2.0%	0.8%	12.4%	5.2%	12.8%	5.3%
Bread and Bakery Products	12.2%	0.9%	0.1%	22.4%	2.6%	9.4%	1.1%
Meat and Meat Products	6.6%	0.3%	0.0%	-0.8%	-0.1%	3.0%	0.2%
Fish Products	1.1%	1.3%	0.0%	17.7%	0.2%	9.6%	0.1%
Milk, Cheese, and Eggs	5.2%	14.2%	0.6%	0.3%	0.0%	10.6%	0.5%
Oils and Fats	3.5%	15.5%	0.5%	25.5%	0.9%	6.8%	0.2%
Fruits, Grapes	2.3%	-7.0%	-0.3%	121.5%	2.5%	93.8%	1.8%
Vegetables, Watermelons, Potatoes and Other Solanaceous	8.8%	-2.8%	-0.2%	-12.3%	-1.0%	11.8%	1.0%
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7%	0.3%	0.0%	-8.2%	-0.2%	-2.5%	-0.1%
Other Food Products	0.6%	2.3%	0.0%	10.0%	0.1%	8.7%	0.1%
Non-Alcoholic Products	1.3%	1.5%	0.0%	2.2%	0.0%	0.7%	0.0%
Alcoholic Beverages, Tobacco	3.7%	-0.5%	0.0%	-0.5%	0.0%	-8.4%	-0.4%
Clothing and Footwear	5.0%	-0.4%	0.0%	-7.0%	-0.4%	-2.1%	-0.1%
Housing, Water, Electricity, Gas, and Other Fuels	10.3%	1.1%	0.1%	21.5%	2.3%	25.6%	2.5%
Furniture, Home Appliances and Equipment, Housing Renovation	3.7%	1.6%	0.1%	2.8%	0.1%	1.6%	0.1%
Healthcare	8.0%	1.7%	0.1%	7.4%	0.6%	14.9%	1.1%
Transport	9.0%	-0.3%	0.0%	7.6%	0.7%	3.5%	0.3%
Communications	4.4%	0.0%	0.0%	0.9%	0.0%	0.2%	0.0%
Recreation, Leisure, and Culture	2.7%	0.5%	0.0%	6.9%	0.2%	1.3%	0.0%
Education	3.5%	1.5%	0.0%	4.3%	0.1%	3.6%	0.1%
Hotel, Cafes, and Restaurants	2.4%	-1.7%	0.0%	3.2%	0.1%	6.4%	0.2%
Other Goods and Services	3.2%	0.9%	0.0%	4.1%	0.1%	3.5%	0.1%
Non-durable Goods	68.0%	1.4%	0.9%	9.6%	6.5%	9.4%	6.3%
Semi-durable Goods	6.5%	0.4%	0.0%	-3.7%	-0.2%	-1.5%	-0.1%
Durable Goods	1.9%	0.2%	0.0%	0.1%	0.0%	0.6%	0.0%
Services	23.6%	0.9%	0.2%	11.1%	2.7%	9.9%	2.4%

Source: Department of Statistics and NBG data

Table 1.2
Inflation Caused By Monetary and Exogenous Factors

	2006 Weights	Price Increase Between September 2006 and September 2007	Exogenous Price Increase to Average Inflation	Impact
Exogenous factors	18.6%	34.8%	25.8%	4.8%
Wheat Bread	8.1%	22.2%	22.2%	1.8%
Wheat Flour	0.8%	19.2%	19.2%	0.2%
Natural Gas	2.0%	42.7%	42.7%	0.9%
Liquid Gas	0.6%	22.0%	22.0%	0.1%
Sunflower Oil	1.9%	37.3%	37.3%	0.7%
Inter-city Transport By Bus, Microbus, and Taxi	4.4%	9.4%	9.4%	0.4%
Cold Water Fee	0.5%	80.3%	80.3%	0.4%
Garbage Collection Fee	0.2%	137.2%	137.2%	0.3%
Difference Between Overall Inflation and Inflation Calculated by Individual Products				0.6%
All Other Factors (Mainly Monetary)				3.5%
All Products Combined	100.0%	9.0%		8.3%

Figure 1.3
Price Increase With Respect
December, 2006

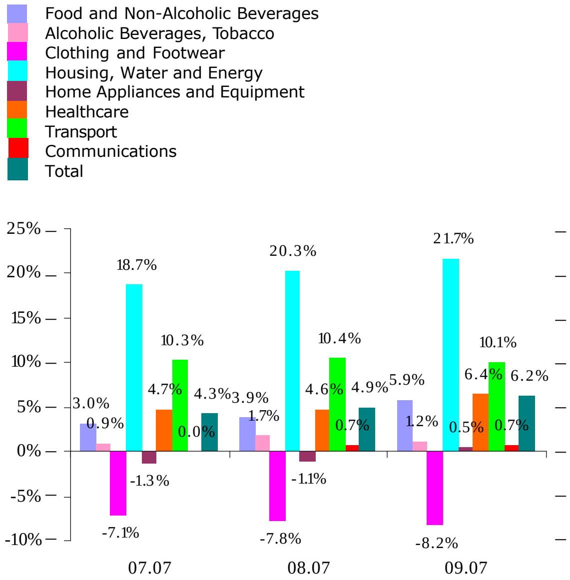
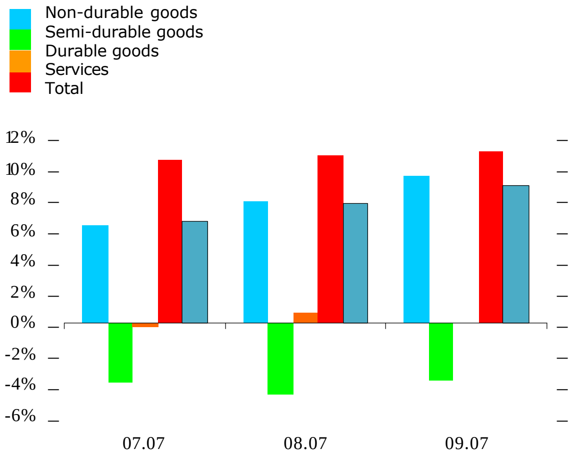


Figure 1.4
Changes in Annual Inflation by Goods and Services of Different Durability



same period. As regards prices of semi-durable and durable goods, in the period between December 2005 and August 2005 they posted a 3.4% and a 2.4% decrease, respectively. Such dynamics of prices reflects changes in demand/supply functions.

Box 1. Oil Impact On World Prices

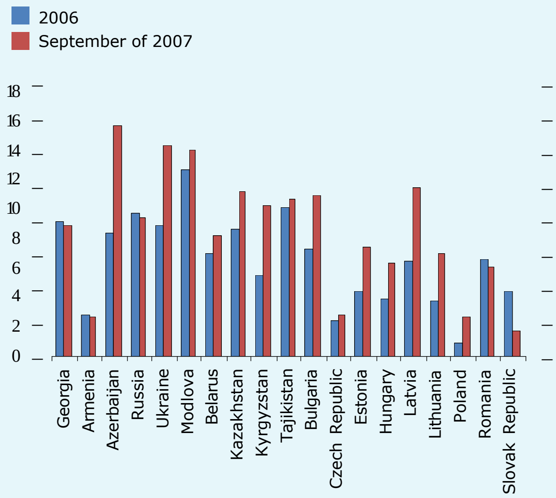
In the last two years there has been a strong upward trend in world oil prices. This year the list of goods which posted price gains in the world markets has become longer. This list now includes copper, lead, cotton, wheat, soy, cocoa, coffee, sugar, meat, and vegetable oil. The price of gold reached a 27 year maximum.

Table 1
World Bank CPI Growth For Low- And Middle-Income Countries

Energy Sources	6.8%
Other Products	12.7%
Agriculture	16.4%
Produce	16.6%
Food	26.6%
Fats and Oils	54.7%
Grain	23.3%
Other Food	1.8%
Processed Products	5.3%
Wood and Timber	8.3%
Other Processed Products	3.3%
Fertilizers	20.6%
Metals and Mineral Products	7.3%

As a result, inflation rates are high in many countries of the world. For clarity and comparison purposes, Graph 1 shows average annual inflation rates registered in September 2006 and September 2007:

Figure 1
Average Annual Inflation Rates
2006 and September, 2007



Experts give different explanations of such price dynamics. In the first version, the Iraq war and general tension in the Middle East is cited as the prime reason. As a result, intensive development of alternative sources of fuels has been launched. In particular, in order to obtain ethanol, the are as of grain crops have expanded, which, in turn, reduced the production of grain crops destined for food. Accordingly, prices of grain crops and cattle increased. This shows the logical reasoning behind the assumption that inflationary processes have been triggered by soaring oil prices.

The second explanation of the increased world prices is the US dollar depreciation. However, between September 2006 and September 2007 the US dollar depreciated by 11.1% against the Euro, by 8.5% against the UK pound, and by 2.6% against the Japanese yen, which makes it difficult to explain satisfactorily the double-digit price increase.

Real estate investments were named to be behind the price increase on housing. An analogy to this reasoning can be found in the article „Oil is not the only commodity on a tear" published in *The Economist* on October 18, 2007.

Credit crunch may be one of the causes of price gains as well. New options are explored for investing speculative money – money is invested into different goods, primarily gold, instead of the declining US dollar.

To sum up the above-mentioned, we can conclude that price gains in the world commodity markets have been determined by a number of reasons.

Inflation Factors

2

2.1. Monetary Aggregates

In QIII of 2007, the reserve money parameter grew by 72.3 million Lari (5.5%) to total 1379.8 million Lari by end-September. In the accounting period under the existing market conditions, the NBG interventions in the Tbilisi Interbank Foreign Exchange (TIBFEX) led to the increase of monetary base. Significant differences between demand and supply of foreign currency present at the TIBFEX, equaled 283.0 million USD. As a result, the national currency appreciated, and the NBG net purchases in QIII totaled 259.3 million USD. By means of this monetary instrument the increase in money supply amounted to 430.6 million Lari. In addition, as a result of intragovernmental currency conversion during July-September net foreign currency sales by the NBG totaled 40.5 million USD
(67.2 million Lari). It can be said that in QIII by means of TIBFEX operations and intragovernmental correncу conversions the total money supply grew by approximately 363.4 million Lari.

In QIII accumulation of funds on the governmental deposits continued, the increase amounting to 85.8 million Lari. According to end-September data, the volume of governmental deposits equaled 765.6 million Lari. In this period the single Treasury account of budgetary revenues grew by 187.7 million Lari.

Table 2.1.1

Dynamics of reserve money

End-month data, as of September, 2007

	01.07	02.07	03.07	04.07	05.07	06.07	07.07	08.07	09.07
Reserve money	1 226 839	1 200 329	1 152 684	1 275 289	1 349 489	1 307 509	1 342 130	1 410 360	1 379 801
Money in circulation	834 396	840 606	857 971	893 463	922 622	967 394	1 026 111	1 065 079	1 081 077
Bank deposits	392 443	359 723	294 713	381 826	426 867	340 115	316 019	345 281	298 724
Required reserves	219 303	223 649	231 147	243 528	253 685	139 880	133 787	116 986	65 737
Balances on corresponding accounts	173 140	136 074	63 566	138 298	173 182	200 235	182 232	228 296	232 988

Table 2.1.2

Dynamics of reserve money

Monthly average data, as of September, 2007

	01.07	02.07	03.07	04.07	05.07	06.07	07.07	08.07	09.07
Reserve money	1 218 235	1 208 282	1 185 314	1 236 298	1 299 819	1 314 985	1 365 013	1 374 932	1 365 490
Money in circulation	848 825	834 789	843 270	877 041	902 371	937 892	998 142	1 047 942	1 068 789
Bank deposits	369 411	373 493	342 044	359 258	397 448	377 093	366 871	326 990	296 701
Required reserves	224 227	222 223	230 922	232 818	251 264	161 124	137 197	126 692	99 654
Balances on corresponding accounts	145 183	151 270	111 123	126 440	146 185	215 969	229 674	200 298	197 047

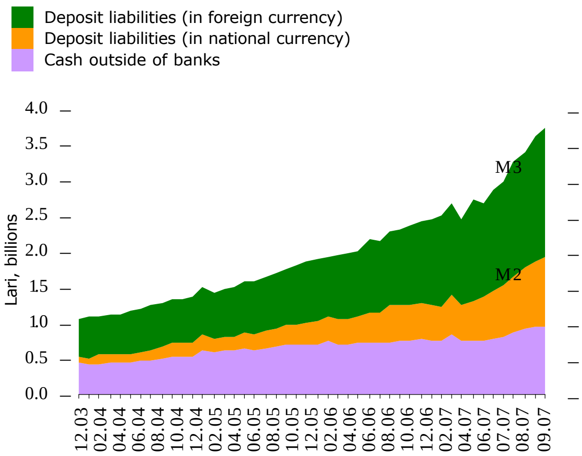
Similar to the previous period, in conducting its monetary operations the NBG actively used Certificates of Deposits (CDs) auctions. Concurrently, the volume of absorbed liquidity by means of this instrument essentially increased. By end-September, the volume of CDs in circulation amounted to 464.1 million Lari.

In the accounting period, the banks' net liabilities decreased as of June from -353.1 million Lari to -448.3 million Lari.

Under the existing monetary flows, the reserve money aggregate in September 2007 totaled 1379.8 million Lari (end-month data), making the QIII growth equal to 72.3 million Lari. The annual growth of reserve money in September, by monthly-average data, equaled 25.9%. In the same period the volume of cash in circulation grew by 113.7 million Lari to total 1081.1 million Lari.

Broad Money

Figure 2.1.1
Dynamics of M2 and M3 Annual Growth Rates
September, 2007



In September 2007, the M3 broad money aggregate totaled 3708.6 million Lari, posting a 460.7 million Lari (14.2%) QIII growth. The latter was conditioned by both national currency and foreign currency denominated deposits (22.7% and 11.1% growth rates in QIII, respectively). In the accounting period, foreign currency denominated deposits grew by 178.5 million Lari to reach 1.780 billion Lari in September, whereas the volume of deposits in national currency grew by 180.8 million Lari to total 975.9 million Lari.

The M2 broad money aggregate grew by 17.1% (282.2 million Lari) in QIII, which was mainly achieved due to a 180.8 million Lari increase in national currency denominated deposits.

The annual growth rates of M3 and M2 in September equaled 53.2% and 51.45%, respectively.

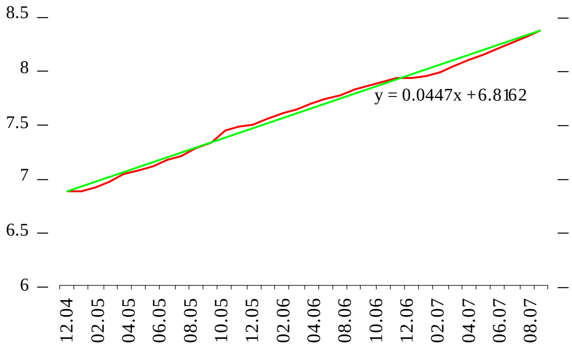
Table 2.1.3
Monthly Changes of Monetary Aggregates
End-Month Data, September, 2007

	01.07	02.07	03.07	04.07	05.07	06.07	07.07	08.07	09.07
Broad Money (M3)	2 583 541	2 712 182	2 674 368	2 863 189	2 967 426	3 247 908	3 391 100	3 612 537	3 708 562
Monetary Mass (M2)	1297 637	1298 772	1365 417	1454 927	1536 421	1646 161	1 781 935	1 863 591	1 928 320
Cash Outside of Banks	739 864	752 811	761 988	781 242	819 339	851 145	908 966	943 985	952 466
Lari in Circulation	834 396	840 606	857 971	893 463	922 622	967 394	1026 111	1065 079	1081 077
Deposits in National Currency	557 773	545 961	603 429	673 686	717 081	795 016	872 969	919 606	975 854
Deposits in Foreign Currency	1 285 905	1 413 409	1 308 951	1 408 262	1 431 005	1 601 747	1 609 165	1 748 946	1 780 242

2.2. Banking Sector

In QIII of 2007, commercial banks' lending continued growing at high rate, with annual growth amounting to 64.9% by end-period. As a result, the volume of credit portfolio reached 4,187.0 million Lari. It should be noted that since the end of 2004 economy lending by the commercial banks has shown a stable, upward trend. As shown on the loan dynamics figure, loans grew at a monthly 4.4%, amounting to an annual 70% growth rate.

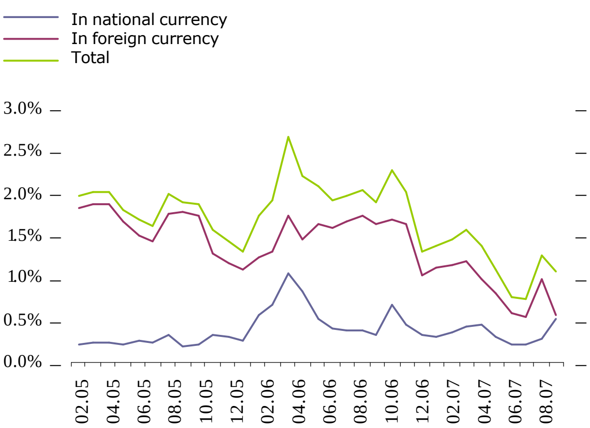
Figure 2.2.1
Dynamics of Economy Lending
(Logarithmic Scale)



Along with the growth of credit portfolio, banks significantly increased long-term crediting, which led to an increased share of long-term loans in the total loans. By the end of QIII of 2007 the share of short-term loans in total economy lending made up 29.7%. In the same period of 2006, the above share equaled 32.5%. The increase of long-term loans' share in the loan structure is explained by the banks' active policies. Banks improve risk management, which allows them to manage long-term credit portfolio better. Increase of loan maturity date reduces banks' costs associated with extending new loans and meets the economic agents' demand for long-term loans, promoting better allocation of resources.

The banks' activities in the consumer market show an upward trend, resulting in higher growth rates of loans extended to physical persons compared to those extended to legal persons. By the end of QIII of 2007, compared to the same period of 2006, loans extended to physical persons grew by 85.0%, while the growth rate of loans extended to legal persons equaled 59.2%. Such rapid expansion of consumer credit contains significant risks due to a number of reasons.

Figure 2.2.2
The Share of Overdue Liabilities in Total Loans



First, it should be noted that consumer credit is new to the Georgian market. As a result, there exists a risk of consumers' sub-optimally using this product. Under the conditions of low and unstable revenues, the probability of excessive loan burden for the consumers is rising, which raises risk factors in the credit portfolio.

At the end of QIII of 2007, the share of overdue loans in national currency grew significantly, amounting to 2.0% of total loans extended in national currency. So far, it is difficult to assert whether this fact is due to a systematic factor or to incidental fluctuations. It should be noted that in relative terms the share of overdue loans in national currency has exceeded the share of foreign currency denominated loans. Traditionally, overdue loans in foreign currency always surpassed overdue loans in national currency. This

Figure 2.2.3
The Share of Loans Extended in Foreign Currency

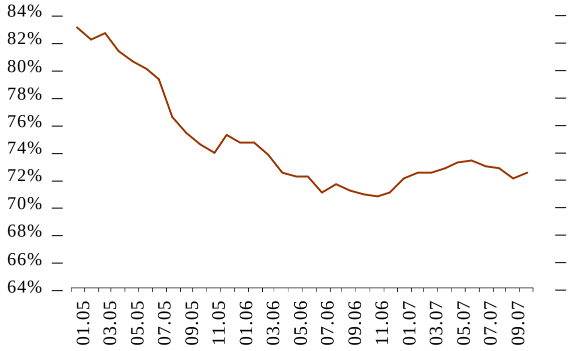


Figure 2.2.4
Deposit Liabilities

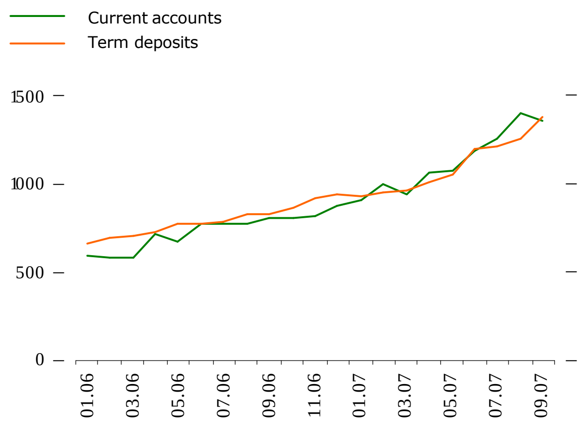
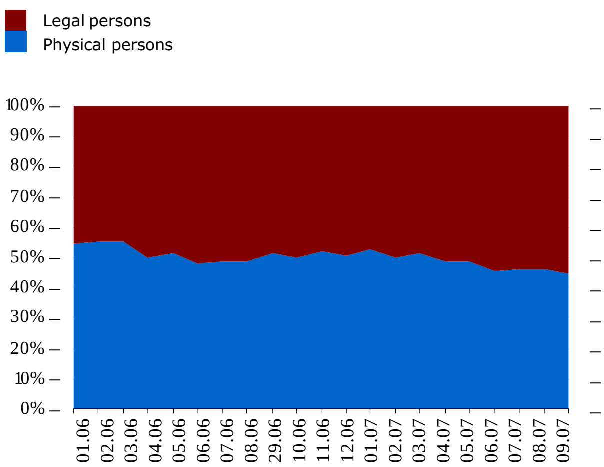


Figure 2.2.5
Deposit by Form of Ownership



was caused by the fact that commercial banks more actively used foreign currency in the high-risk segments of the credit market. Overall, in the recent years there has been a clear downward trend with respect to the share of overdue loans.

The loan dollarization rate reached bottom in 2006, but started to grow thereafter. The share of loans extended in foreign currency at the end of QIII of 2007 made up 72.3% of total loans. In the same period of 2006, this rate equaled 70.7%. Taking into account the Lari exchange rate appreciation[1], it becomes evident that foreign currency denominated loans grow at a considerably higher rate than loans extended in national currency. The volume of loans extended in foreign currency (expressed in the US dollars) grew by 73.9%, whereas loans denominated in national currency increased only by 56.1% in nominal terms.

It should be pointed out that long-term loans are dollarized at a considerably higher rate than short-term loans. At the end of QIII of 2007, the dollarization rate of long-term loans stood at 81.6%, while dollarization of short-term loans equaled 56.6%. The growth of dollarization occurred mainly due to short-term loans dollarization. During one year short-term loans dollarization grew by 4.6 percentage points, while long-term loans dollarization dropped 1.8 percentage points.

By the end of QIII of 2007, the annual growth rate of deposits attracted by commercial banks amounted to 67.3%, reaching 2756.1 million Lari. Growth rates of current accounts and term deposits equaled each other.

The volumes of legal persons' deposits grew by 89.2%, whereas the volumes of physical persons' deposits – only by 46.5%. It should be pointed out that in terms of deposit growth, legal persons equally increase their deposits in national and foreign currency, but the physical persons rather favor the national currency. The physical persons' deposits in national currency annually grew by 133.7% whereas their foreign currency denominated deposits increased only by 37.5%.

[1] When calculating the share of loans extended in foreign currency, foreign currency denominated loans are expressed in national currency using the relevant exchange rate.

Figure 2.2.6
Dollarization of Deposit Liabilities

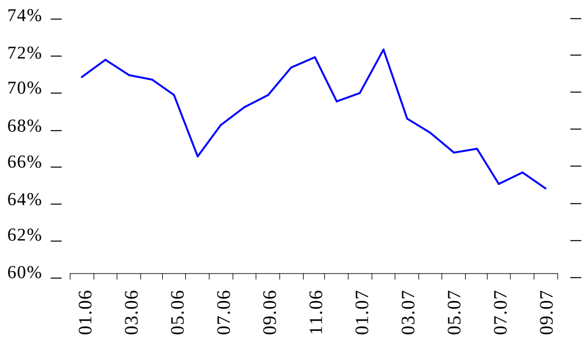


Figure 2.2.7
The Share of Mortgage Loans In Total Loans

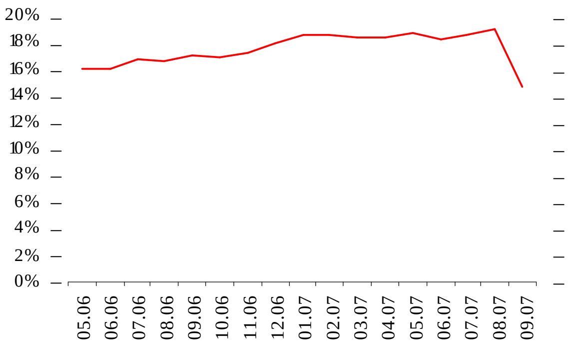


Figure 2.2.8
Growth Rates of One-Room Apartment Prices and Annual Rent

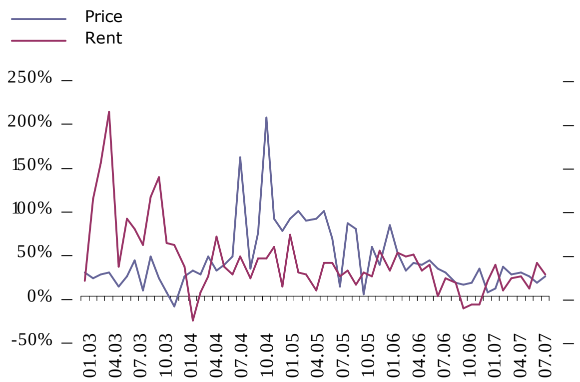
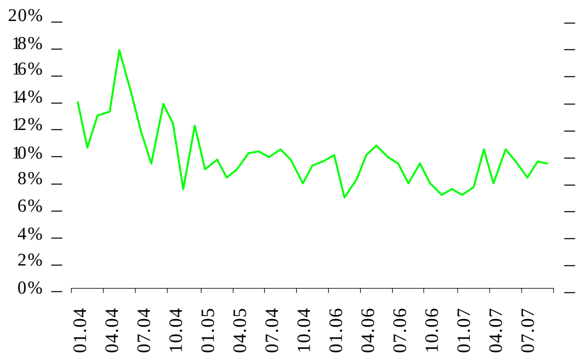


Figure 2.2.9
Housing Rent/Price



By the end of QIII of 2007, the share of deposits in foreign currency made up 64.6%. It is noteworthy that deposit dollarization significantly falls behind loan dollarization. This difference is explained by the fact that commercial banks attract significant amounts of foreign currency and directly lend them to avoid currency risks. This happens despite the existing demand for Lari-denominated loans. The proof of the last assertion is in the fact that the interest rates on loans in national currency are higher than on loans in foreign currency.

According to data from QIII of 2007, the average interest rate on loans extended in national currency equaled 22.7%. To compare, the average interest rate on foreign currency denominated loans was 18.1%.

The Georgian real estate market has been rapidly developing. It gradually assumes the financial market's functions as well and presents alternative investment opportunities. These opportunities are further promoted by the fact that the stock exchange is illiquid. There also exists certain distrust towards financial institutions and different financial instruments. In the recent year real estate prices were growing rapidly. The expectations of economic agents are bullish. Drastic changes of price dynamics might bring about essential risks and transmit them to the financial markets.

In the period between January and August 2007, the volume of mortgage loans has been increasing at the same rate as the overall credit portfolio. September posted a drastic drop in the share of mortgage loans. Only 16.6% of mortgage loans are extended in the national currency.

In the last year the growth rates of apartment prices slowed down. However, at the end of QIII of 2007 the apartment prices grew by 23.1%, and the housing rent - by 24%.

Real estate is actively used as collateral in concluding economic contracts, its high prices promoting contract execution and maintaining low default levels.

Figure 2.3.1
The NBG Interventions at the TIBFEX
2006-2007

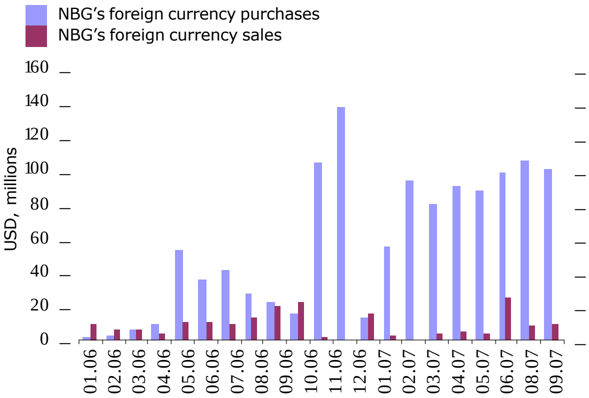


Figure 2.3.2
The Lari/USD and Lari/Euro Nominal Exchange Rate
2006-2007

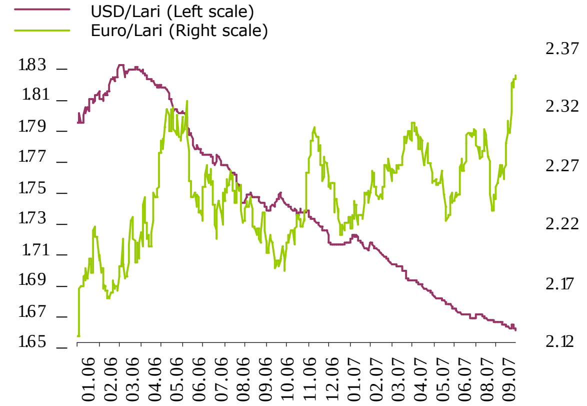


Figure 2.3.3
The Lari/USD Nominal Exchange Rate at the TIBFEX and at Foreign Exchange Offices (Purchases and Sales)

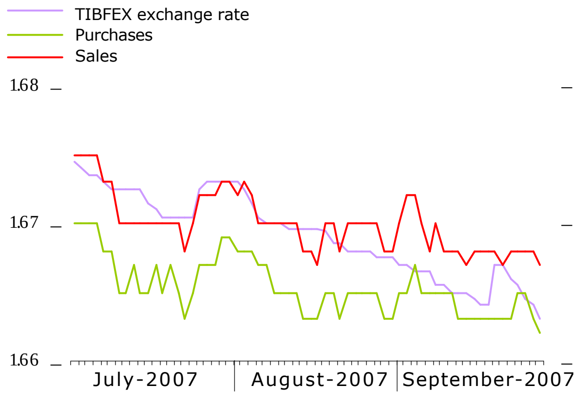
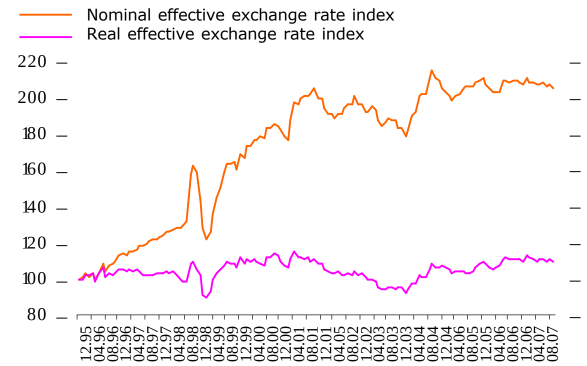


Figure 2.3.4
The Lari Real and Nominal Effective Exchange Rate Indices
December, 1995=100



2.3. Foreign Exchange Market

From the beginning of 2007 until the end of September, the NBG's total purchases at the TIBFEX equaled 720.3 million USD, while total sales amounted to 76.7 million USD, of which in QIII total purchases and sales were 303.0 million USD and 43.7 million USD, respectively. In QIII, the net purchases of the US dollars by the NBG increased by 14.9%, compared to QII.

From the beginning of 2007 until the end of September the Lari exchange rate against the US dollar gradually changed from 1.7135 to 1.6580, posting a 3.2% appreciation. QIII of 2007 accounted for 0.7 percentage points of this appreciation. In spite of this fact, in the period from December 2006 to September 2007 the nominal effective exchange rate depreciated by 0.8% and the real effective exchange rate – by 0.2% (monthly average data).

In September 2007, compared to September 2006, the real effective exchange rate depreciated by 0.7%. In the same period, the nominal effective exchange rate posted 1.9% depreciation. In the accounting period, the nominal effective exchange rate depreciated more than the real effective exchange rate, which indicates that the inflation level in Georgia surpassed that in its main trade partner countries. In particular, inflation is less than 3% in the EU countries and Armenia. Compared to Georgia, the inflation rate is also lower in Turkey (7.1%), although in some other countries the annual inflation in September exceeded the Georgian 9.0% inflation rate: 9.5% in Russia, 14.4% in Ukraine, 15.9% in Azerbaijan.

It should also be pointed out that if we consider the same figures in the previous months, the dynamics of real and nominal effective exchange rates is quite consistent, which shows that the inflation in Georgia and its main trade partner countries (on average, taking into account relevant weights) fluctuates at an approximately equal rate.

The nominal and real effective exchange rates have depreciated since December 2005. In particular, in September 2007, with respect to December 2005, the real effective exchange rate depreciated by 0.3% and the nominal effective exchange rate – by 2.5%.

Figure 2.3.5

The Real and Nominal Effective Exchange Rate Indices
December, 2006=100

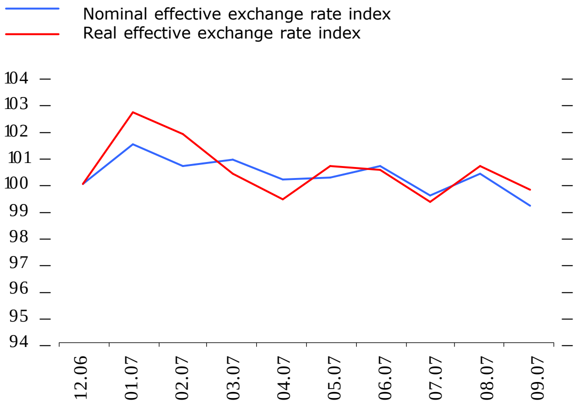


Figure 2.3.6

Dynamics of Lari/Euro (Left Scale) and Lari/USD (Right Scale) Exchange Rate
2007

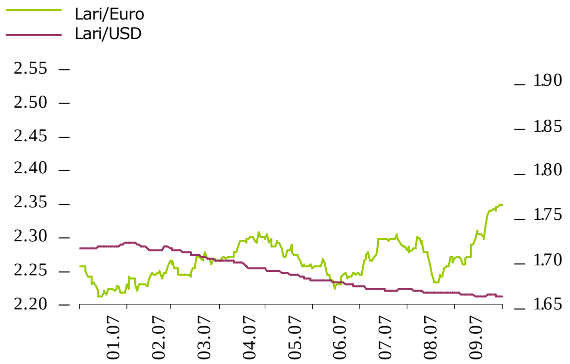


Figure 2.3.7

Dynamics of the Lari/Russian Ruble (Left Scale) and Lari/UK Pound (Right Scale) Exchange Rate
2007

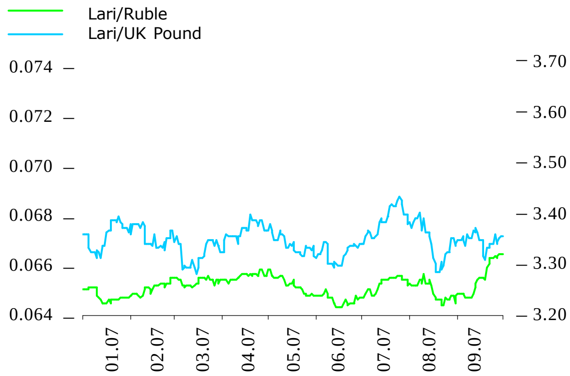
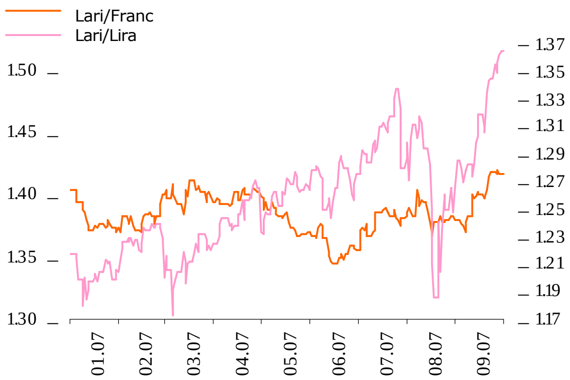


Figure 2.3.8

Dynamics of the Lari/Swiss Franc (Left Scale) and Lari/Turkish Lira (Right Scale) Exchange Rate
2007



Box 2. Are operating losses a problem for national banks?

At first glance, a negative balance at a country's central bank might look alarming. However, for central banks all over the world, negative operating balances are not an experience out of the ordinary. A quick look at data from the recent years shows that the national banks of Czech Republic, Romania, Slovakia, Slovenia, and Sweden all ran negative year-end balances in 2006. Depending on the movement of exchange rates, accounting practises and size of international reserves, the value adjustment of balance sheet items may cause the overall balance of a central bank to be negative by the end of the year.

As the central banks are holders of international reserves, this makes their balance sheets uniquely vulnerable to the fluctuations in the foreign exchange market. In particular, significant appreciation of a bank's domestic currency can lead it to post negative end-year profits. Cental banks do not pay attention to the balance sheet loss or profits as their main goal is financial stability and management of inflation and not revenue generation.

This is particularly true in countries with liberal exchange rate regimes whose national banks keep their foreign reserves on their balance sheets (as is the case with the NBG). More specifically, if a country is experiencing large-scale foreign currency inflows, a bank might be creating money to satisfy the existing demand for the local currency and boost its FX reserves. At the time, these liabilities would have been exactly offset by the foreign-currency denominated assets the bank put on its balance sheet. However, if the national currency appreciates over time, the size of the bank's stock of FX assets will decrease (when converted back into the national currency), while its liabilities will remain unchanged. It might cause the bank to post negative operating income.

Should the government be concerned? Not necessarily. In a discussion of similar issues at the Czech National Bank, Frait (2005) notes that negative balance does not have to be detrimental to the mission of a central bank per se: much depends on the sources of the bank's losses. If most losses are due to revaluation, the credibility of the bank's monetary policies will not suffer. Because the losses are not due to the injection of additional liquidity into the monetary system, inflationary expectations are not affected. And because the bank owes money to itself, it is impossible to see how this position could trigger a financial crisis.

2.4. External Sector and the Balance of Payment

In QII of 2007, the current account deficit posted a significant growth equaling 12.1% with respect to QI and 33.2% with respect to QII of 2006. In absolute terms, it totaled 426.4 million USD, a record high figure in 2000-2007. The current account deficit in QII of 2007 was still determined by the goods trade, while the latter was negatively affected by more than doubled prices of Russian natural gas. As a result, the value of natural gas imports soared from 44.7 million USD in QII of 2006 to 60.5 million US in QII of 2007, amounting to a 35% increase. In addition, increased prices of natural gas indirectly affected the trade deficit. In particular, gas price increase raised production costs, including exports production. This obviously affected

Table 2.4.1
Top 10 List of Partner Countries in Terms of Imports, (USD, millions)
2007,QIII

	QI.06	QII.06	QIII.06	QIV.06	QI.07	QII.07	QIII.07
Imports, Total	682.5	887.1	1023.2	1085.0	1045.6	1183.8	1321.2
Of Which:							
Turkey	77.7	121.2	144.9	178.8	136.2	167.4	184.0
Ukraine	51.1	71.9	98.4	98.8	92.4	133.1	152.7
Russia	128.2	141.6	140.9	148.0	168.5	129.6	125.4
Germany	68.1	92.2	86.3	104.6	86.3	92.6	99.2
Azerbaijan	50.2	82.9	86.0	99.3	76.7	90.0	90.3
United States	27.1	30.1	28.5	44.0	35.5	39.7	71.2
China	17.4	23.5	29.1	33.3	41.5	45.2	56.9
U.A.E.	21.2	22.4	25.8	39.6	42.4	45.5	53.2
Bulgaria	26.8	32.8	33.8	22.1	38.5	35.5	46.3
Turkmenistan	19.2	27.8	39.6	14.4	21.2	33.5	41.5
Other Countries	195.5	240.6	309.8	302.1	306.3	371.6	400.4

Table 2.4.2
Top 10 Main Exports Partner Countries, (USD, millions)
2007,QIII

	QI.06	QII.06	QIII.06	QIV.06	QI.07	QII.07	QIII.07
Exports. Total	221.4	236.0	248.3	286.8	225.2	323.2	336.2
Of Which:							
Turkey	17.3	27.3	36.6	43.7	35.8	48.3	49.0
United States	15.6	12.5	23.9	6.8	10.6	23.6	44.0
Azerbaijan	14.6	20.2	22.4	34.9	22.2	41.5	36.0
Armenia	12.4	20.8	18.2	22.2	21.5	21.8	34.1
Bulgaria	11.6	20.2	18.3	12.2	7.9	22.3	20.9
Canada	10.1	12.0	12.8	14.0	9.5	14.5	19.7
Russia	43.8	10.0	13.1	8.7	13.3	10.6	19.6
Ukraine	12.8	14.0	14.8	15.5	17.0	21.0	19.5
Germany	6.9	10.9	6.5	21.1	11.8	9.5	14.6
Finland	0	0	0	0.2	0	0	6.9
Other Countries	76.3	88.2	81.6	107.5	75.6	109.9	72.1

Table 2.4.3
Top 10 Exports Items (USD, millions)
2007,QIII

	QI.06	QII.06	QIII.06	QIV.06	QI.07	QII.07	QIII.07
Exports, Total	221.4	236.0	248.3	286.8	225.2	323.2	336.2
Of which:							
Ferroalloys	19.6	20.1	30.2	19.9	18.1	33.9	43.3
Copper mines and concentrates	10.2	23.0	21.6	24.7	21.0	24.0	27.5
Ferrous scrap metals and waste	13.5	20.3	19.5	19.1	20.8	30.2	24.4
Crude, semi processed or sand gold	11.1	11.8	12.5	13.9	9.4	14.5	19.3
Concrete	4.1	7.4	7.9	9.4	9.2	17.5	18.7
Electricity	1.0	-	1.3	-	0.8	3.8	18.2
Cars	4.5	9.5	15.5	21.2	13.1	20.0	17.0
Walnuts – nec, fresh or dry	17.0	8.6	6.3	24.7	10.7	8.0	15.9
Ethyl alcohol, alcoholic beverages	8.4	5.3	8.4	8.0	11.6	14.3	12.3
Fertilizers – mineral or chemical, nitrogen	10.0	9.0	13.5	14.2	14.3	14.5	11.6
Other goods	122.1	120.9	111.7	131.8	96.2	142.5	127.9

exports. On the other hand, increased production costs of goods produced for domestic consumption promoted imports. All this had an adverse impact on the trade deficit. Another factor which deepened the current account deficit in QII of 2007 was a negative revenue balance, which deteriorated by 107 million USD, compared to the same Quarter of 2006, and made up 17.9%. Such drastic revenue fall was caused by significant amounts of dividends' distribution at a few companies, which only has a one-time effect.

The officially registered foreign trade turnover in QIII of 2007 totaled 1657.3 million USD, or 30% more than in QIII of 2006. Exports grew by 35% and imports – by 29%. Compared to QII of 2007 exports growth equaled 4%, while imports growth – 12%. Comparing 9-month data of 2007 and 2006, it turns out that trade turnover increased by 34%, of which exports grew by 25% and imports – by 37%.

The list of top 10 trade partner countries has changed for both exports and imports. Compared to QI of 2007, when Russia was the top country in terms of Georgian imports, in QIII it dropped to the third position after Turkey and Ukraine. The list of top 10 importer countries in QIII of 2007 is shown on the Table 2.4.1.

Turkey has firmly assumed the role of Georgia's main trade partner country after the Russian embargo. Georgian exports to Turkey in the first 9 months of 2007 compared to the same period of 2006 grew 1.6 times to total 133.2 million USD, which makes up 15% of total Georgian exports. Main Georgian exports items to Turkey include ferrous scrap metals, aluminium, and copper scrap.

In the first 9 months of 2007, compared to the same period of 2006, exports to Russia dropped by 23.4 million USD, or 35%. Exports ban on wine, mineral water, and agricultural products is still effective. In three quarters of 2007 the main commodity groups exported to Russia included ferroalloys, electricity, spare parts of railway and tramway locomotives, and fire-proof construction materials.

Certain changes have occurred in the exporting commodities structure.

In QIII and in all 9 months of 2007 ferroalloys remains the top exports item. In the accounting period, it made up 11% of total exports. In the 9 months of 2007, ferrous scrap metals occupy the second place (9% of exports); while in QIII of 2007,

Table 2.4.4
Top Ten Imports Items (USD, millions)
2007,QIII

	QI.06	QII.06	QIII.06	QIV.06	QI.07	QII.07	QIII.07
Imports, Total Of Which:	682.5	887.1	1023.2	1085.0	1044.5	1183.8	1321.2
Petroleum and petroleum products	80.8	122.5	142.1	97.7	97.0	131.2	141.7
Cars	65.5	72.8	70.2	86.9	79.1	88.5	96.2
Petroleum gases and other gaseous hydrocarbons	57.4	44.7	40.6	70.4	116.8	60.5	45.4
Medicaments	25.4	31.1	25.5	32.6	36.5	32.4	36.2
Wheat and meslin	16.9	20.7	26.9	34.5	26.4	26.9	36.1
Aircraft and associated equipment	6.0	-	0	1.6	-	-	28.5
Radio-broadcast receivers and telecommunications equipment	8.1	12.5	18.6	19.6	13.9	29.8	25.7
Sugar	11.0	16.4	22.4	15.8	12.6	19.5	25.3
Automatic data-processing machines and units thereof	8.0	10.3	14.2	14.0	14.1	20.1	19.1
Tubes, pipes, nec, of iron or steel	0.3	1.4	0.9	0	0.1	1.2	18.1
Other goods	403.2	554.8	661.7	711.8	649.0	773.7	848.8

they are on the third place, after copper mines and concentrates.

Outside of top ten exports item list remained such important goods as mineral water, natural grape wines, copper and aluminum scrap metals.

The largest imported commodity group remains petroleum and petroleum products, making up 10.7% of total imports in QIII of 2007. The second place was up to cars, while import of natural gas dropped from the first place in QI to the third place in QIII. Natural gas accounts for 3.4% of registered imports, exceeding 1.6 times the 9-month data of 2006. This increase is conditioned by higher prices of natural gas, the price difference amounting to 91.1 million USD.

Significant increase is posted in the imports of goods made of ferrous metals. This is explained by the construction boom in Georgia. The import of medicaments in 9 months of 2007, compared to the same period of 2006, grew by 23 million USD, or 28%.

In QIII of 2007 341.9 thousand foreign citizens entered Georgia, which is 36% higher than in QIII of 2006. This suggests significant growth of tourism service exports. In the same period 423.6 Georgian citizens, or 20% more than in 9 months of 2006, went abroad. As for returning Georgian citizens, their number equaled 405.1 thousand persons, which exceeds the same number of 2006 by 16%. However, the number of Georgian citizens leaving the country still exceeds the number of returning citizens, which is likely to mean that the number of Georgians going abroad to work is rising.

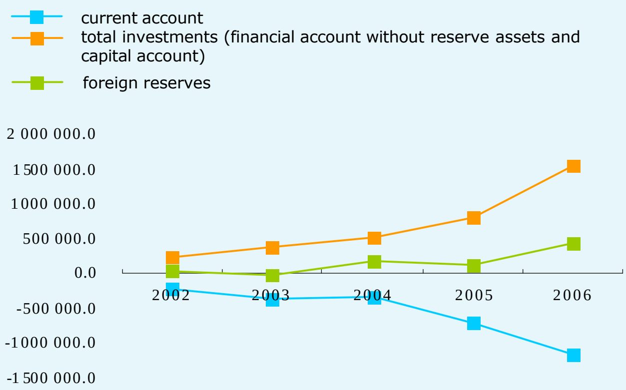
In 2007 the volume of money remittances considerably increased, largely compensating for the current account deficit. In QIII 247.0 million USD has been transferred to Georgia, which exceeds the same quarterly figure of 2006 by 51.8%. Overall, in 9 months of 2007 599.8 million USD has been transferred to Georgia, exceeding the analogous figure of 2006 by 57.3%. In QIII Russia accounted for 65.7% of total money transfers (64.1% in 9 months of 2007). The second place is up to the United States (86.1 million USD transferred to Georgia in 9 months of 2007, or 14.4% of total money transfers). The shares of other countries are small, with Spain accounting for 2.9%, Greece – 2.4%, Ukraine – 2.1%, and Turkey – 2.0% in 9 months of 2007.

Box 3. Balance of Payments

Balance of payments represents a statistical report reflecting foreign economic transactions of the country, i.e. transactions between residents and non-residents. The balance of payments is composed of two main accounts: „current account" and „capital and financial account". The latter is split into the capital account and financial account. The current account summarizes real sector operations, which the financial account - the means of financing the former.

The Georgian current account is negative. It is conditioned by the goods account deficit, which is mitigated to a certain extent by a positive balance of some other components. The current account deficit is primarily balanced by the following subaccounts of the financial account – FDIs and other investments. The share of portfolio investments and financial derivatives is insignificant. Reserve assets may also be used to finance the current account deficit. In the recent years such necessity has not arised, and reserve assets are accumulated at a high rate.

Figure 1
The Georgian Balance of Payments (USD, millions)



2.5. Production and Demand

Production

In QII of 2007, GDP growth equaled 13.4% with respect to QII of 2006. As a result, in the first 6 months of 2007, compared to the same period of 2006, the GDP growth rate amounted to 12.5%.

The sectoral analysis of economic growth shows that in QII of the current year positive growth rates were posted in almost every sector. „Financial intermediation" should be particularly singled out, where growth rates reached 33.2%. Overall, in the first half of 2007 "financial intermediation" grew by 26.2% with respect to the same period of 2006.

With regard to GDP shares, the first place is still occupied by trade, whose GDP share in the first 6 months of 2007 equaled 13.5%. It should be pointed out that in the first half of 2006, agriculture was second with 12.5% GDP share, but in 2007, it accounted only for 10.2% of the GDP, ceding the second place to public administration. The latter experienced a significant growth of its GDP share – from 7.9% (first half of 2006) to 11.2% (first half of 2007).

Table 2.5.1
The Georgian Gross Domestic Product by Sectors

	2006 GDP Share	Real Growth in QI of 2007	Real Growth in QII of 2007	Real Growth in 6 Months of 2007	GDP Growth Impact in QI of 2007	GDP Growth Impact in QII of 2007	GDP Growth Impact in 6 Months of 2007
Agriculture, Forestry, Fishing	11.3%	93.5%	106.0%	99.9%	-0.7%	0.7%	0.0%
Mining and quarrying	1.0%	127.8%	109.7%	115.2%	0.3%	0.1%	0.2%
Manufacturing	8.6%	109.4%	116.9%	114.1%	0.8%	1.5%	1.2%
Electricity, gas and water supply	2.7%	106.8%	107.2%	107.0%	0.2%	0.2%	0.2%
Processing products by household	2.5%	113.2%	115.3%	114.3%	0.3%	0.4%	0.4%
Construction	6.8%	112.1%	107.0%	109.6%	0.8%	0.5%	0.7%
Trade services, Repair services	13.6%	113.9%	117.8%	116.1%	1.9%	2.4%	2.2%
Restaurant and Hotel services	2.2%	104.7%	119.5%	112.8%	0.1%	0.4%	0.3%
Transport and storage	8.0%	123.2%	116.8%	119.8%	1.9%	1.3%	1.6%
Communications	3.5%	105.6%	114.0%	109.7%	0.2%	0.5%	0.3%
Financial intermediation	2.3%	118.2%	133.2%	126.1%	0.4%	0.8%	0.6%
Real estate, renting and business activities	3.2%	110.4%	114.9%	112.6%	0.3%	0.5%	0.4%
Imputed rent of own occupied dwellings	2.4%	106.9%	106.5%	106.7%	0.2%	0.2%	0.2%
Public administration and defense	8.6%	110.8%	106.8%	108.7%	0.9%	0.6%	0.7%
Education	3.6%	102.8%	120.2%	111.5%	0.1%	0.7%	0.4%
Health care and social Services	4.3%	116.1%	111.9%	113.4%	0.7%	0.5%	0.6%
Other community, social and personal service activities	3.4%	103.1%	107.9%	105.4%	0.1%	0.3%	0.2%
Private households with employed persons	0.1%	103.3%	104.8%	104.1%	0.0%	0.0%	0.0%
(-) FISIM adjustment	-0.9%	236.5%	150.3%	192.6%	-1.2%	-0.5%	-0.8%
(=)Gross Domestic Product at basic prices	87.4%	108.6%	113.3%	111.2%	7.5%	11.7%	9.8%
(+) Taxes on products	13.1%	127.2%	114.5%	120.8%	3.6%	1.9%	2.7%
(-) Subsidies on products	-0.4%	102.1%	103.3%	102.7%	0.0%	0.0%	0.0%
(=)Gross domestic product at market prices	100.0%	111.4%	113.4%	112.5%	11.4%	13.4%	12.5%

Source:Calculations are based on the data from the Department of Statistics under the Ministry of Economic Development of Georgia*.

* To calculate each sector's share in the GDP growth during a given time period, the growth rate is multiplied by the sector's share in the GDP at the previous time period. Such calculation method does not provide absolutely correct data, but it sufficiently approximates the existing situation and is suitable for describing each sector's impact on the GDP growth.

Figure 2.5.1
The Sectoral Shares of the GDP
in the First Half of 2006

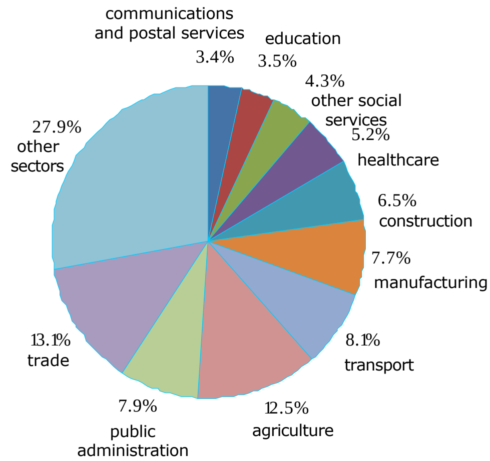


Figure 2.5.2
The Sectoral Shares of the GDP
in the First Half of 2007

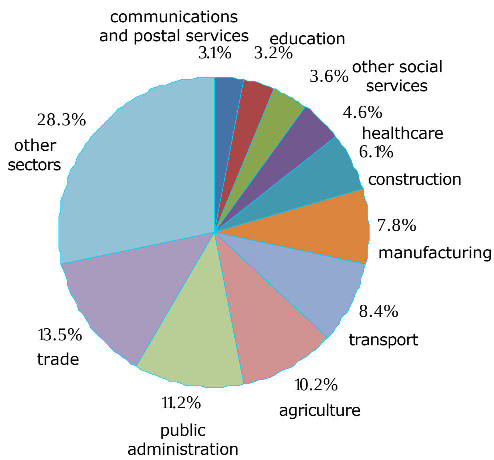


Figure 2.5.3
Quarterly GDP Growth with Respect to the Annual Average of the Previous Year

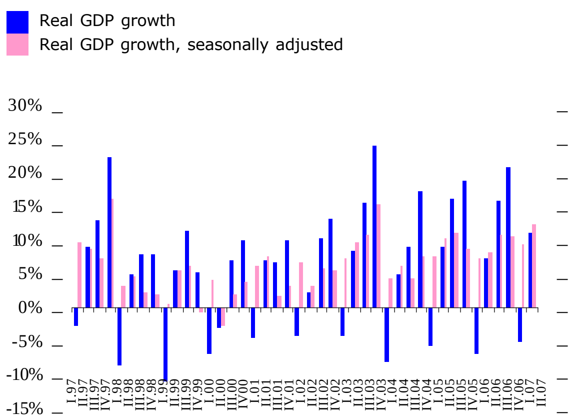


Figure 2.5.4
Sectoral Growth Rates in the First Halves of 2006 and 2007

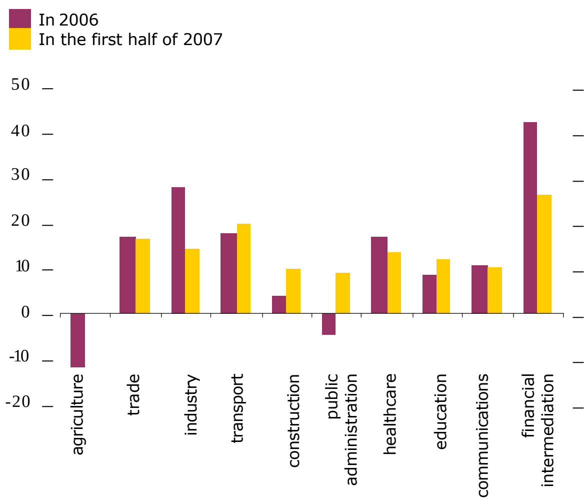
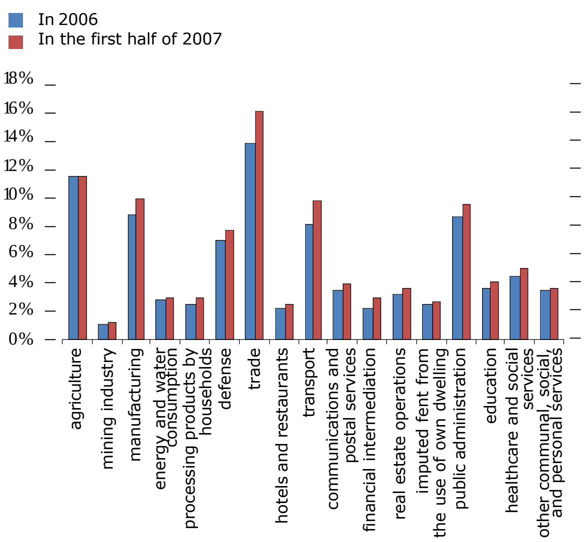


Figure 2.5.5
Dynamics of the Sectoral Share in the GDP



Household Consumption

In QII of 2007, compared to the same Quarter of 2006, household consumption grew only by 1.9% in nominal terms. Overall growth in the first half of 2007, with respect to the same period of 2006, equaled 6.3%, which indicates, taking into account inflation, that real consumption decreased (in the 6 months of 2007 consumer prices increased by 9.0%, compared to the same period of 2006).

Government Consumption

In QII of 2007, government consumption increased by 24.9%, compared to the previous quarter. With respect to QII of 2006 the same figure grew 74.3%. The main part of the government expenditures affects domestic demand. However, it should also be noted that a certain part of incurred expenditures is spent on goods imports.

Investments

In QII of 2007 capital formation totaled 1172.3 million Lari, excceding the QII of 2006 figure by 41.3%. Accordingly, in the period between QII of 2006 and QII of 2007 the investments share in the GDP grew from 24.7% to 28.6%. In the first half of 2007 overall capital formation growth rate in nominal terms amounted to 30.0% with respect to the same period of 2006.

The volume of FDIs in QII of 2007 equaled 370.5 million USD, which is 22% higher than in the same quarter of 2006. The drastic rise of foreign investments in the country is conditioned by improved business environment and successful privatization process.

The main flows of FDIs come from: Czech Republic (19.9%), Kazakhstan (17.1%), Netherlands (11.3%), United States (10.4%), Virgin Islands (8.4%), Turkey (7.9%), Russia (5.5%).

Drastic growth of FDIs has been one of the main factors underpinning strong demand for national currency and Lari appreciation in the foreign exchange market.

Figure 2.5.6
Use of Imported and Domestic Production (GDP, %)

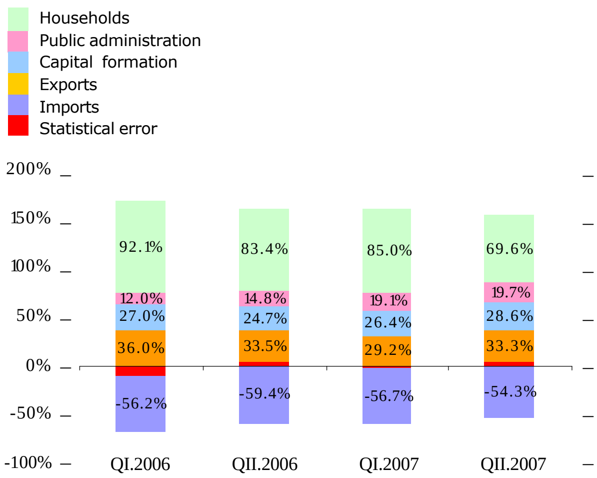
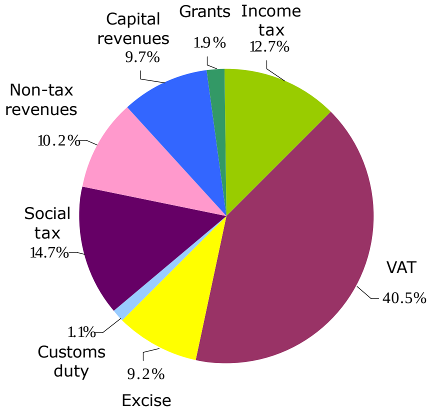


Table 2.5.2
State Budget Revenues and Their Nominal and Real Growth Rates in January-September 2007, Compared to the Same Period of 2006

	Nine-Month Collection	Nominal Growth	Real Growth*
Total Revenues and Grants	3458.1	29.9	19.7
Total Revenues	3392.4	32	21.7
Tax Revenues	2707.1	42.6	31.4
Profit Tax	437.4	71.8	58.3
V.A.T	1392.7	49	37.3
Of which:			
Tax Department V.A.T. Collection	491.1	75.6	61.8
Customs Department V.A.T. Collection	901.6	37.6	26.8
Excise	315.1	28.4	18.3
Of which:			
Tax Department V.A.T. Collection	90.4	40.4	29.4
Customs Department V.A.T. Collection	224.7	24.2	14.5
Customs Duty	39.3	-67.2	-69.8
Social Tax	505.2	48.2	37.6
Non-tax Revenues	352.5	-3.4	-11
Capital Revenues	332.8	8.4	-0.1
Grants	65.7	-28.5	-34.1

* Real growth is deflated by the average annual inflation rate of three Quarters of 2007

Figure 2.5.7
State Budget Revenues by Types
January-September, 2007



Taxes

According to January-September 2007 information, state budget revenues and grants totaled 3458.1 million Lari, and own revenues - 3392.4 million Lari. Collection of both types of taxes equaled 100.7% with respect to 9-month forecasts. In the same period, tax revenues equaled 2707.1 million Lari, 0.5% more than forecasted. In QIII of 2007, tax revenues collection amounted to 1010 million Lari, compared to 891 million Lari in QII and 806.4 million Lari in QI of 2007. In QIII, the share of tax revenues in the state budget revenues and grants is 78.3%, compared to 81.1% in the first half of the year and 71.3% in the 9 months of 2007.

In 9 months of 2007, with respect to the same period of 2006, the nominal growth rate of tax revenues equaled 42.6%, while the real growth (taking into account inflation) stood at 31.4%.

In 9 months of 2007, state budget deficit was envisaged at the level of 52.2 million Lari. However, higher-than-forecasted revenues and lower actual expenditures resulted in 94.3 million Lari budgetary surpluses. Concurrently, 128.1 million Lari worth long-term loans were received from external sources, and as of September 1, 2007, the balances on the Treasury accounts grew by 226.9 million Lari with respect to January 1, 2007[1].

With respect to the consolidated budget of the country (the sum of state and territorial entities' budgets), total revenues and grants in 9 months of 2007 amounted to 4108.4 million Lari, of which own revenues equaled 4042.2 million Lari and tax revenues - 3179.7 million Lari. Total revenues and net lending of the consolidated budget equaled 3841.8 million Lari. Revenues exceeded expenditures (including debt service) by 266.5 million Lari.

In 9 months of 2007 the overall volume of government deposits at the NBG grew by 405 million Lari, conditioning a decrease of the monetary mass in circulation.

Labor Productivity, Wages

In QII of 2007, average wages posted a considerable growth. Compared to QII of 2006, average nominal

[1] The volume of returned budgetary funds in previous years equaled 4.4 million Lari.

Table 2.5.3
Real Value-Added Per Employed in QII of 2007 With Respect to QII of 2006 (%)

	Real Value-Added
Agriculture	129.3
Industry	103.2
Construction	79.6
Trade	111.9
Hotels and Restaurants	102.6
Transport and Communications	135.2
Financial Intermediation	94.7
Public Administration, Defense	127.5
Education	133.8
Healthcare	67.2
Total	119.5

Table 2.5.4
Average Monthly Nominal Wages of Employed Persons in QII of 2007 With Respect to QII of 2006 (%)

	Nominal Wages
Agriculture	147.6
Mining Industry	187.9
Manufacturing Industry	126.5
Production/Distribution of Electricity, Gas, and Water	143.5
Construction	135.5
Trade	154.1
Hotels and Restaurants	138.4
Transport, Communications	138.7
Public Administration, Defense	124.7
Education	118.6
Healthcare	127.3
Total	135.3

wages grew by 35.4%. The growth of wages occurred almost in every sector. In QII of 2007 the average monthly wages in the official economy equaled 356.8 Lari[1].

In QII of 2007, compared to the same quarter of 2006, real growth of value-added per employed person amounted to 19.5%. In particular, high growth rates were posted in agriculture, transport and communications, trade, public administration, and education.

In QII of 2007, the annual growth rate of average wages exceeded real growth of value-added per employed, contributing to inflationary pressure.

[1] Source: Data from enterprise and labor statistics surveys

3 Inflation Forecasts

In forecasting inflation, the following assumptions have been made with respect to the model variables:

• Broad money excluding foreign deposits (M2) will annually growth by 50% by December 2007, if the NBG continues to remove Lari from circulation and the state budget deficit does not grow. It is likely that 50% growth of M2 is maintained, which, under the conditions of capital inflows, may develop in line with pessmistic scenario;

• The annual GDP growth will equal 12.5% in 2007 and 8.8% in 2008, which is based on sectoral analysis of quarterly trends;

• Since in general the exchange rate is well described by the random walk processes, we have assumed that it will not change in the next year;

• Contrary to the previous year, crops have improved in 2007. Thus, we have assumed that prices of fruits and vegetables by end-December will not change on a year-to-year basis. As of the next year, under the pessimistic scenario the annual growth of prices of fruits and vegetables will reach 10%;

• According to various international sources, the world oil price will drop due to larger supply;

The model is estimated using least squares method and looks as follows:

$$\delta p=0{,}066\delta e+0{,}085\delta e_{-2}+0{,}04\delta m_{-1}+0{,}023\delta m_{-2}+0{,}011\delta p^{oil}+$$
$$+0{,}112\delta p^{food}-0{,}014ecm-0{,}005DUM3-0{,}005DUM7+0{,}003DUM8+$$
$$+0{,}004DUM11+0{,}007DUM10-0{,}004DUM5-0{,}005DUM6+$$
$$+0{,}006DUM12+0{,}1D9812+0{,}034D0311+0{,}01D0501$$

where:

p - inflation;

m – money mass;

e – Lari/USD exchange rate;

p^{oil} - average world oil price;

p^{food} - prices of fruits and vegetables;

DUMn - dummy variable, to exclude seasonality of n^{th} month;

D9812 - dummy variable, to exclude Russian crisis effects;

D0311 - dummy variable, to exclude November 2003;

D0501 - dummy variable, to exclude 2005 natural gas price increase;

ecm - long-run equilibrium variable having the form:

$$ecm = p_{-1} - 0{,}2e_{-1} - 0{,}8m_{-1} + 1{,}23y_{-1} - 7{,}09$$

where:

y - GDP

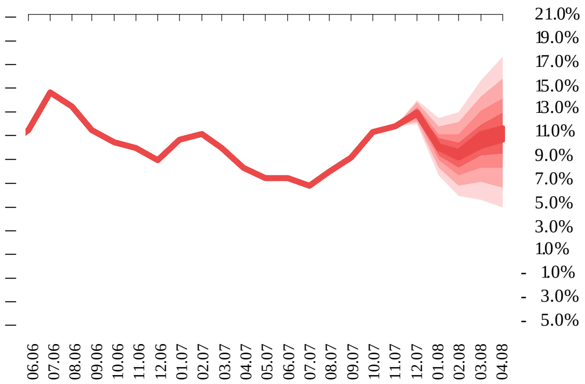
By means of the model estimation the annual inflation forecast looks as follows:

In line with the obtained forecasts, the annual inflation will vary from 12.44% to 12.94% with 20% probability.

The forecast period is based on historical fluctuations and, accordingly, the inflation model does not take into account higher or lower fluctuations caused by other structural factors; such unpredictable factors include, for example: impact of recent political events in the country, unpredictable oil price behavior in the world markets, dependence of agricultural crops on climatic conditions, etc.

According to the inflation forecasts, in the next few months it is more likely that the NBG will continue to tighten the monetary policy, rather than keep it unchanged or loosen it.

Table 3.1
Inflation Forecast
(Q III, 2006-Q I, 2008)



Appendix

Dynamics of Registered Goods Exports in 2002-2007

Table 1
The Export Volumes and Exports Growth Rates (USD, millions)
QII, 2002-2007

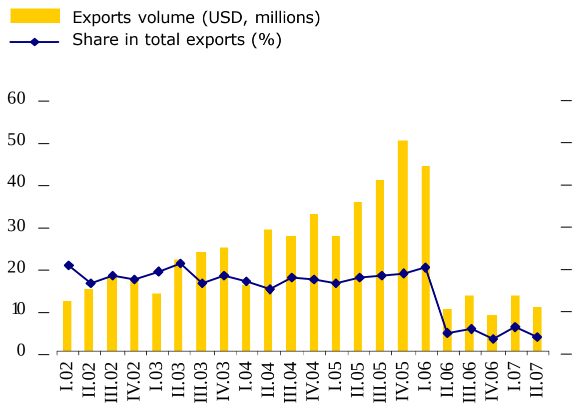
	2002	2003	2004	2005	2006	2007*
Total Exports	345.93	461.41	646.90	865.45	992.54	543.99
Growth Rate (%)	8.9	33.4	40.2	33.8	14.7	18.9
Exports, excluding Russia	284.80	377.46	542.37	711.73	916.89	520.54
Growth Rate (%)	16.9	32.5	43.7	31.2	28.8	29.0

* Data on QI-II of 2007 are give. Growth rates are calculated with respect to the analogous period of the previous year.

In the last five years, a strong upward trend in the volumes of registered goods exports has been obvious. In QI-QII of 2007, compared to the same period of 2002, the volume of goods exports grew 3.7 times, while with respect to the same period of 2006 the exports grew by 20%. Growth rates of goods exports were particularly impressive in 2003, 2004, and 2005, amounting to 33%, 40%, and 34%, respectively. Since April 2006, the Russian embargo on Georgian exports adversely influenced the exports of wine, natural water, and certain agricultural products, which slowed down export growth rates to a certain extent. As a result, in 2006 the exports increased only 15%. The situation started to improve in 2007. In QII, the growth rate of goods exports, with respect to the same period of 2006, amounted to 35.1%.

In QII of 2006, before the Russian embargo was in place, Russia was the top exports partner of Georgia. In QI of 2006, it accounted for 20% of total goods exports. However, this share plummeted to 8% on a year-to-year basis, which was 10 percentage points, and – in absolute terms – more than 50% lower than in 2005. After two quarters of 2007, this figure dropped even further to a mere 4%, and Russia moved to the seventh place in the list of Georgia's partner countries in goods exports.

Figure 1
Registered Goods Exports to Russia
QI of 2002, QII of 2007



It should be noted that the Russian embargo negatively affected only certain commodity groups. In particular, wine and mineral water exports suffered the most. In 2002-2005, the share of wine in total exports was under 10%, and the share of mineral water – under 5%. In 2005 45.7 thousand tons of wine has been exported to Russia, with the total value amounting to 63 million USD. It is also noteworthy that during 2002-2005 the Russian market accounted for 74-77% of the Georgian wine exports in monetary terms, while in quantitative terms the share of the Russian market equaled 85-87%. It is can be inferred that wine exported to Russia was relatively less expensive. The price of wine exported to Russia was approximately 10% lower than the average price of total exported

Figure 2
Dynamics of Wine Exports
QII 2002-2007

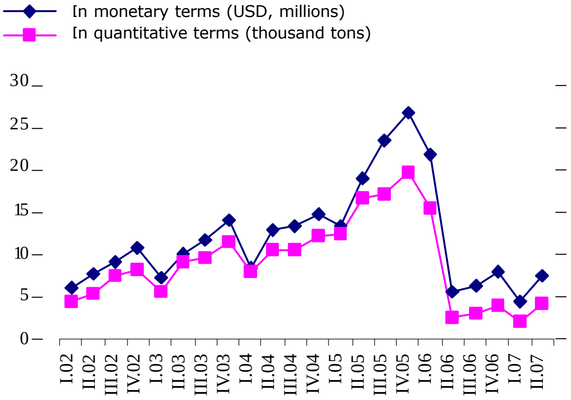


Figure 3
Dynamics of Mineral Water Exports
QII,2002-2007

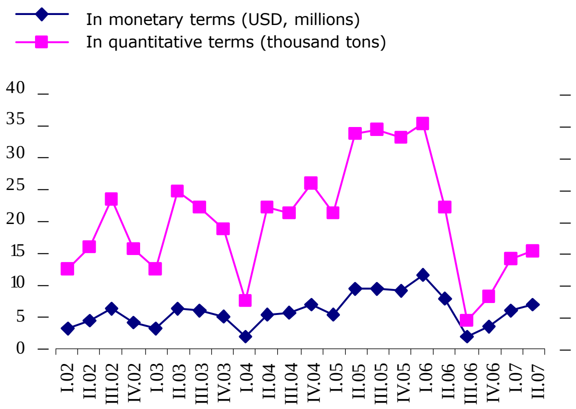
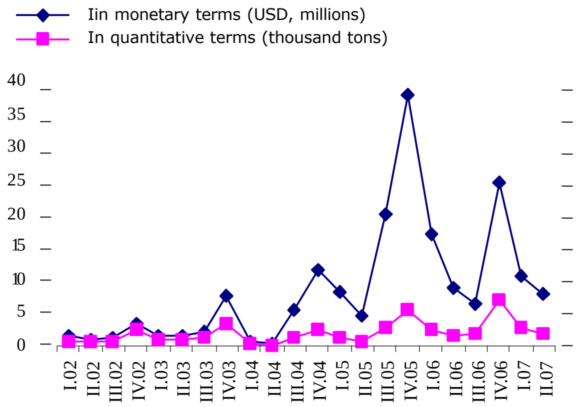


Figure 4
Dynamics of Hazelnut Exports
QII,2002-2007



wine. Thus, before the Russian embargo the wine exports accounted for nearly 10% of total exports and occupied the second place in the 2005 top export items list. Based on QI-II of 2007 data, wine accounts for only 2.2% in total exports volume. The wine exports to other countries (excluding Russia) in QI-II of 2007, with respect to the same period of 2006, grew by 12.8%.

By 2005 data, the Russian market accounted for almost 73% of total registered mineral water exports. In QI of 2006 11.2 million USD worth of mineral water was exported. The same figure dropped to 5.7 million USD in QI of 2007, which is almost half as much as in QI of 2006, slightly exceeding the QI of 2005 level. However, it becomes possible to partially redirect mineral water exports to other countries, leading to a rapid growth of mineral water exports after the Russian embargo. In QII of 2007, the growth rate equaled 17% with respect to the previous quarter. The average exports price also increased. In QI-II of 2007, compared to the same period of 2006, exports to other countries (excluding Russia) totaled 12.5 million USD, exceeding the 2006 figure by 56%.

Hazelnut exports, an important exports item largely dependent on the Russian market (the Russian market accounted for 20% of total hazelnut exports in monetary terms and 25% – in quantitative terms), not only did not decrease after the Russian embargo, but even expanded. In 2005 hazelnut exports volume equaled 10.0 thousand tons (of which 2.5 thousand tons were exported to Russia), 12.6 thousand tons were exported in 2006, while in QI-II of 2007 exports grew by further 6% with respect to the same period of 2006. It should also be pointed out that due to price decrease exports have decreased in monetary terms. Georgian hazelnut is primarily exported to the EU countries and Ukraine.

The Russian embargo did not affect exports of ferroalloys, whose share in exports to Russia and in overall exports is constantly rising. By QI-II of 2007 data, ferroalloys occupy the first place in the top export items list. In this period, 10.2 million USD worth of ferroalloys were exported to Russia, exceeding the 2006 figure by 8%. Total ferroalloys exports in QI-II of 2007 amounted to 52 million USD, accounting for almost 10% of overall exports.

Negative effects of the Russian embargo have been neutralized for the commodity group „Alcoholic beverages", where the share of the Russian market in QI of 2006 accounted for 66%, or 5.55 million USD.

Table 2
Dynamics of Registered Exports (USD, millions)

	2002	2003	2004	2005	2006	2007*	QI-II of 2007/ QI-II of 2006 (%)
EU Countries	59.03	77.75	101.86	149.10	168.42	80.64	22.7
C.I.S Countries	168.70	224.83	327.64	407.17	394.73	211.15	-3.9
Turkey	53.74	82.55	118.61	121.86	124.92	82.06	84.1
Other	64.47	76.27	98.80	187.32	304.48	170.14	33.6
Total	**345.93**	**461.41**	**646.90**	**865.45**	**992.54**	**543.99**	18.9

* QI-II of 2007 data is given

After the embargo, exports of alcoholic drinks grew, posting a 38% increase in QI of 2007 with respect to the same quarter of 2006. In QII of 2007 growth rate of exports amounted to 23%, compared to the previous quarter.

In the post-embargo period the place of the main Georgian partner country in exports was occupied by Turkey. In Table 3 dynamics of Georgian exports by geographical regions is presented.

Thus, before the embargo Russia was Georgia's main trade partner country. In the pre-embargo period, i.e. in 2005 and QI of 2006, the main commodities exported to Russia included natural grape wines, mineral water, ferroalloys, „alcoholic beverages" and hazelnuts, jointly accounting for 90% of overall Russian exports. As it has been indicated, at the end of QI of 2007 negative effects of the embargo have been neutralized to a certain extent with regard to mineral water, „alcoholic beverages" and hazelnut exports by means of market diversification. Although the overall volume of mineral water exports in QI of 2005 equaled 53.7 thousand tons, exceding the corresponding 2007 figure more than twice, due to the increased average price, the total value of mineral water exports in the first half of 2007 made up 86% of the value of mineral water exported in the same period of 2005. Ferroalloys exports were not affected by the Russian ban. Situation is much more difficult with respect to natural grape wines. The process of finding new markets is likely to take longer. As mentioned above, wine exports to Russia were relatively cheap, and market reorientation process should involve restructuring of wine production.

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