

NATIONAL BANK OF GEORGIA

# INFLATION REPORT

Q1 2008

TBILISI



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## INTRODUCTION

In order to serve its main function, the National Bank of Georgia has created the Monetary Policy Committee. From the beginning of 2008 the above-mentioned Committee conducts monthly sessions in accordance with the predetermined schedule. On the same day of the session the monetary policy decision is published on the NBG's official web page. This document presents a brief review of the factors taken into account by the National Bank during the decision making process.

According to the information of the Department of Statistics of the Ministry of Economic Development, in QI of 2008 the overall price level grew by 3.5% to equal the annual rate of 12.3%. The average annual inflation rate has also grown to reach 9.5%. The annual core inflation has decreased slightly reflecting the role of exogenous factors in the increase of the price level.

The influence of exogenous factors on the price level increase is corroborated by the examination of certain goods from the consumer basket. Namely, 3.6 percentage points out of the annual inflation rate of 12.3% fall solely on bread price gains conditioned by the growth of world wheat prices.

The significant negative influence of external factors is confirmed by extremely high inflation rates in Georgia's neighbor countries and its trade partners. As of March 2008, the annual rate of inflation amounted to 13.3% in Russia, 26.2% in Ukraine, 17.1% in Azerbaijan, 9.6% in

Armenia, 9.2% in Turkey, 3.5% in Euro zone, 16.8% in Latvia, 11.3% in Lithuania, 10.9% in Estonia, 14.2% in Bulgaria, and 18.7% in Kazakhstan. As compared to the majority of the countries mentioned above, relatively low inflation rates in Georgia are, along with other factors, determined by the flexible exchange rate policy undertaken by the NBG.

During QI of 2008 the Lari exchange rate appreciated by 4.05% (by 9.05% annually) against the USD and by 0.85% (depreciated by an annual 3.84%) against the Euro. The Lari real effective exchange rate appreciated by 3.94% as compared to QI of 2007 (the annual rate of 2.42%).

In QI of 2008 the volume of the reserve money decreased as compared to the beginning of the year, which was largely due to seasonal factors and operations undertaken by the NBG. At the same time, the rate of growth of broad money aggregates still remained high. Namely, as of March 2008 the annual growth rate of M2 and M3 amounted to 65.4% and 50.6%, respectively.

According to various estimates the rate of inflation will equal approximately 10% in QII of 2008 and 8% in QIII of 2008. The major risk factors which could condition deviations from the forecasted inflation targets are the dynamics of fuel and other core consumption goods, changes in inflationary expectations, high inflation levels in major trade partners of Georgia, high growth rates of money supply, and other factors.

During the period this analysis refers to, the factors affecting the rate of inflation mostly exerted an upward pressure on it. This led to the tightening of the monetary policy, which was reflected in the monetary policy decisions. In QI of 2008 the main interest rate of the monetary policy increased by 2 percentage points to reach the level of 11%.

In line with the current forecasts, either further tightening of the monetary policy or maintenance of its current stance rather its loosening is more anticipated. In order to maintain the rate of inflation within the targeted limits, the NBG will carefully monitor undergoing economic processes along with the events unfolding in the financial markets to take appropriate decisions.

# 1. CHANGES IN CONSUMER PRICES

According to the information of the Department of Statistics of the Ministry of Economic Development, in QI of 2008 the overall level of consumer prices increased by 3.5%. In QI of 2007 the overall price level was 2.4% higher as compared to the respective period of the previous year. Accordingly, in March of 2008 the annual inflation grew from 11.0% to 12.3%. The average annual inflation grew by 0.3 percentage points in QI to reach 9.5%.

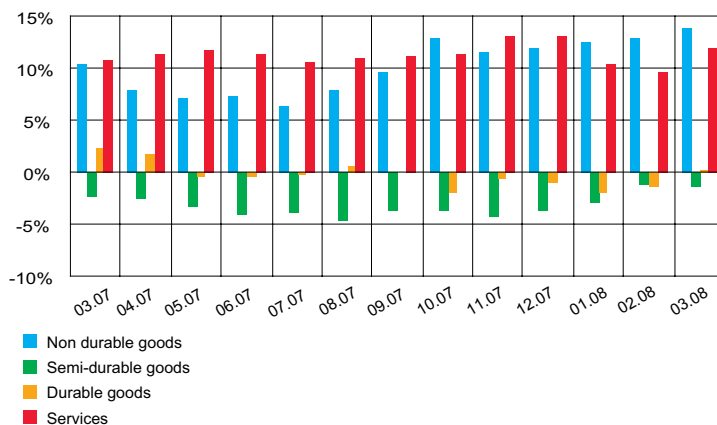
During the quarter under consideration the largest share of the increase in the price level falls on meat price gains and increase in public transportation prices by bus, micro bus and taxi. The rates of inflation measured for these items of the consumption basket amounted to 9.0% and 5.4%, respectively. The share of the above-mentioned factors in QI

inflation amounts to 0.5%. In addition, the increase in prices caused by some seasonal factors, notably price gains on certain vegetables has played an important role in QI inflation.

The annual core inflation rates equal 10.1% and 6.3% for the products within the range of one and two standard deviations, respectively. The core inflation indicators have recently displayed a growth tendency, though there was a decrease in March, in particular, for the products within the range of one standard deviation. Despite this, the core inflation indicators still exceed the target aimed by the NBG.

As already mentioned, in March of 2008 the consumer basket price level was 12.3% higher than in the respective period of the previous year. The 5.1% decrease has been registered on clothing and footwear. The prices in the communications sector decreased by 1.5%, while the prices on alcohol beverages and tobacco have increased by 0.6%. Significant increases of prices have been recorded on the following items of the consumption basket: food and non-alcoholic beverages – 15.2%, home appliances – 12.7%, healthcare – 12.2%, housing, water, electricity, gas and other fuels – 17.2%. In March of 2008 the biggest increase in prices compared to the same period of the previous year has been recorded for transport<sup>1</sup> (20.1%),

GRAPH 1.1  
CHANGES IN ANNUAL INFLATION RATES FOR GOODS  
AND SERVICES WITH VARIOUS CONSUMPTION  
DURABILITY



<sup>1</sup> Not only the prices for city bus and subway transportation are accounted for but also the average increase in transportation price, including prices on other types of transportation, for example intra city taxi, micro bus, suburb and inter city transportation, etc.

which was mostly determined by the increases in prices of intra city bus, micro bus and taxi transportation.

The analysis of goods with respect to durability of their consumption shows that in March of 2008, as compared to the same period of the previous year, prices of semi-durable goods decreased by 1.3% and prices of durables increased slightly (by 0.2%). The annual inflation rate is high for non-durable goods (13.9%). The annual inflation rate is also high in the service sector (11.9%).

GRAPH 1.2  
**ANNUAL CPI AND CORE INFLATION**  
 (ACCORDING TO 282 COMPONENTS OF THE CONSUMPTION BASKET, EFFECTIVE SINCE DECEMBER 2006)

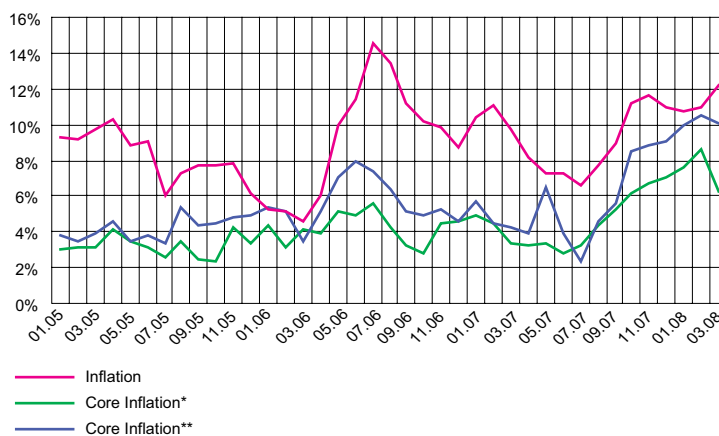


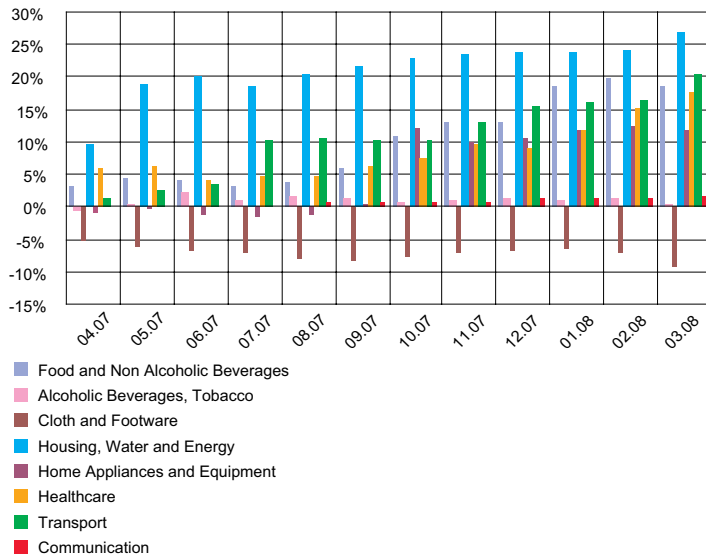
TABLE 1.1  
**INFLATION (CPI) RATES BY COMPONENTS (%), THEIR WEIGHT IN THE CONSUMPTION BASKET (%), AND CPI IMPACT (PERCENTAGE POINTS)**

	2006 December	March 2008 / December 2007		March 2008 / March 2007		April 2007 – March 2008/ April 2006 – March 2007	
	Weight	Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0	3.5	3.6	12.3	12.3	9.5	9.5
Food and Non Alcoholic Beverages	44.3	5.1	2.3	15.2	6.8	12.0	5.3
Food	43.0	5.2	2.3	15.6	6.7	12.3	5.3
Bread and Bakery Products	12.2	0.6	0.1	30.2	3.6	20.8	2.5
Meat and Meat Products	6.6	6.9	0.4	8.9	0.6	0.9	0.1
Fish Products	1.1	-3.1	0.0	-5.1	-0.1	5.0	0.1
Milk, Cheese, Eggs	5.2	-6.9	-0.4	20.1	0.9	7.8	0.4
Oils and Fats	3.5	6.1	0.3	43.2	1.5	23.0	0.8
Fruits, Grapes	2.3	21.8	0.8	66.3	2.0	109.2	2.4
Vegetables, Watermelons, Potatoes and Other Solanaceous	8.8	18.0	1.2	-17.7	-1.8	-11.3	-1.1
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7	-0.8	0.0	-1.5	0.0	-7.5	-0.2
Other Food Products	0.6	0.0	0.0	8.1	0.0	12.0	0.1
Non-Alcoholic Beverages	1.3	1.6	0.0	2.9	0.0	1.3	0.0
Alcoholic Beverages, Tobacco	3.7	-0.9	0.0	0.6	0.0	-3.2	-0.1
Clothing and Footwear	5.0	-2.6	-0.1	-5.1	-0.2	-5.7	-0.3
Housing, Water, Electricity, Gas, and Other Fuels	10.3	2.4	0.3	17.2	1.9	22.5	2.3
Furniture, Home Appliances and Equipment, Housing Renovation	3.7	1.0	0.0	12.7	0.5	6.9	0.3
Healthcare	8.0	8.1	0.6	12.2	1.0	11.3	0.9
Transport	9.0	4.2	0.4	20.1	1.8	10.0	0.9
Communications	4.4	0.2	0.0	1.5	0.1	1.0	0.0
Recreation, Leisure and Culture	2.7	0.9	0.0	8.9	0.2	6.0	0.2
Education	3.5	0.4	0.0	2.4	0.1	3.7	0.1
Hotels, Cafes, Restaurants	2.4	1.0	0.0	3.3	0.1	4.2	0.1
Other Goods and Services	3.2	1.9	0.1	7.3	0.2	4.1	0.1
Non Durable Goods	68.0	4.0	2.7	13.9	9.5	10.3	7.0
Semi-Durable Goods	6.5	-1.6	-0.1	-1.3	-0.1	-3.2	-0.2
Durable Goods	1.9	0.4	0.0	0.2	0.0	-0.5	0.0
Services	23.6	3.5	0.9	11.9	2.9	11.4	2.7

\* For the products within one standard deviation

\*\* for the products within two standard deviations

GRAPH 1.3  
PRICE INCREASE COMPARED TO DECEMBER 2006



During the period of December 2005 – March 2008 the prices on non-durables increased by 28%, while the prices of services increased by 25.2%. As of the prices on semi-durables and durables, during the same period they posted a 3.2% and 0.6% decrease, respectively.



## 2. INFLATION FACTORS

### 2.1. LABOR PRODUCTIVITY AND WAGES

The year of 2007 was earmarked with significant growth in wages compared to the relevant period of 2006. Namely, average monthly wages in official economy in the QIV of 2007 equaled 451.2 Lari<sup>1</sup>, which is 36% higher than the respective number for QIV of 2006. Wages grew in all the major sectors of the economy.

In QIV of 2007 the real growth of value-added production per employee increased by 15.2%, as compared to the same period of 2006. In particular, high growth rates have been recorded in the sectors of agriculture, trade, hotels, restaurant business and public administration. The real growth of productivity is a strong counter-inflationary force, although an even faster growth of wages, which took part in the reference period, was conducive to expansion of domestic demand and acceleration of inflation.

### 2.2. MONETARY AGGREGATES

In QI of 2008 the amount of reserve money decreased by 85.1 million Lari (5.7%) to reach 1413.5 million Lari at the end of March. The amount of reserve money increased from the last month of the previous quarter - December - to March by 5.2 million Lari (0.4%).

TABLE 2.1.1  
AMOUNT OF REAL VALUE-ADDED PER EMPLOYEE IN QIV OF 2007 COMPARED TO QIV OF 2006.

	Real Value Added
Agriculture	1.258
Industry	1.043
Construction	1.038
Trade	1.158
Hotels and Restaurants	1.441
Transport and Communications	1.135
Financial Intermediation	0.837
Real Estate, Rent, and Commercial Operations	0.966
Public Administration	1.658
Education	1.009
Healthcare	0.925
Total	1.152

TABLE 2.1.2  
AVERAGE NOMINAL MONTHLY WAGES OF HIRED EMPLOYEES IN QIV OF 2007 (QIV OF 2006 =1)

	Nominal wages
Agriculture, Hunting and Forestry	1.58
Fishing, Fish Industry	1.13
Mining Industry	1.90
Procession Industry	1.39
Production/Distribution of Electricity, Natural Gas and Water	1.30
Construction	1.42
Trade, Repair of Cars, Household Appliances and Goods of Personal Consumption	1.47
Hotels and Restaurants	1.31
Transport and Communications	1.25
Financial Operations	1.31
Real Estate, Rent, and Commercial Operations	1.48
Public administration	1.32
Education	1.30
Health Care and Social Assistance	1.40
Communal, Social and Personal Services	1.51
Total	1.36

<sup>1</sup> Source: Data from current Enterprise and Labor surveys.

**Net Purchases by the NBG at the Tbilisi Interbank Exchange (TIBFEX).** The current situation at the TIBFEX was quite volatile during QI of 2008. Net purchases of the NBG at the foreign exchange amounted to 259.3 million USD. This figure was higher than expected, which was largely conditioned by drastic increase in financial inflows in the period of February-March. The total amount of Lari resources injected into circulation through the NBG operations amounted to approximately 364 million Lari.

**Foreign Exchange Operations by the Government of Georgia.**

During the period under consideration foreign exchange expenditures of the

government exceeded its revenues by 208 million USD, which led to a decrease of the reserve money by approximately 324 million Lari.

Government Deposits. According to the latest information, during QI of 2008 the amount of government deposits grew by 14 million Lari to equal 461 million Lari. This significantly differs from the quarterly target set by the government, according to which the total amount of the government deposits must have been reduced by 231 million Lari in QI of 2008.

**Monetary Operations by the NBG.**

As in the previous period, during QI of 2008 the NBG was actively using the Certificates of Deposit auctions for its monetary operations. Total amount of liquidity withdrawn by means of this instrument increased by approximately 91 million Lari. Total volume of outstanding CDs equaled 467.2 million Lari at the end of the period.

As a result, during QI of 2008 the net liabilities of the NBG to the banking increased from 304 million Lari to 392 million Lari.

Due to the above-mentioned transactions, during QI of 2008 the volume of the reserve money decreased by 85 million to equal 1413.5 million Lari at the end of the period.

Net liabilities of the banking sector represented the major factor influencing contraction of the reserve money. The Certificates of Deposit accounted for 5.9 percentage points in the reserve money decrease.

TABLE 2.2.1  
IMPACT OF RESERVE MONEY COMPONENTS ON THE  
RESERVE MONEY GROWTH  
QI OF 2008

1. Net foreign assets	-4.1%
2. Net domestic assets	-1.6%
Net liabilities of the government	-0.9%
Net liabilities of the banking sector	-5.9%
Claims on the domestic economy	0.1%
Other net assets	5.1%
3. Reserve Money	-5.7%

TABLE 2.2.2  
DYNAMICS OF THE RESERVE MONEY  
END OF MONTH DATA, 2008

	12.07	01.07	02.07	03.07
Reserve money	1498601	1338939	1392331	1413540
Money in circulation	1310488	1184525	1225042	1287123
Bank deposits	188113	154414	167289	1287123
Balances on corresponding accounts	186943	154355	167231	126359

TABLE 2.2.3  
DYNAMICS OF THE RESERVE MONEY  
AVERAGE MONTHLY DATA, 2008

	12.07	01.07	02.07	03.07
Reserve money	1442550	1420749	1413282	1447780
Money in circulation	1209154	1217136	1199674	1244064
Bank deposits	233396	203613	1199674	1244064
Balances on corresponding accounts	211923	203473	213548	203657

### 2.2.1. BROAD MONEY

The broad money indicator M3 amounted to 4026.9 Lari million at the end of March to represent the increase by 46.3 million (1.2%) Lari from December of 2007.

This was mostly due to the increase in domestic currency deposits (the 15.9% increase in QI of 2008). During the period the volume of deposits in national currency grew by 156.1 million Lari and reached 1136.0 million Lari at the end of March. Foreign currency denominated deposits decreased by 80.7 million Lari and equaled 1768.0 million (in Lari) at the end of the period.

In March the annual growth rates of M2 and M3 aggregates amounted to 50.6% and 65.4%, respectively.

### 2.3. CERTIFICATES OF DEPOSITS AND OVERNIGHT LOANS

As of March 31, 2008 the amount of money withdrawn by means of CDs equaled 467.2 million Lari. In total, net withdrawal including loans to commercial banks stood at 392.2 million Lari. As compared to the end of 2007, the amount of withdrawals by means of CDs decreased in January and February to reach the minimum level for QI of 2008 on February 13 (251.2 million Lari, or 17.7% of the reserve money). At the same time, the volume of withdrawn liquidity equaled 376.5 million Lari as of December 31, 2007, or 25.1% of the reserve money. However, the situation reversed in the second half of February and the amount of withdrawals reached 377.6 million Lari by February 28, equaling 27.4% of the reserve money. The liquidity withdrawal process

continued later on. The next drastic change was registered on March 27 when withdrawal of excess liquidity exceeded the previous day's level by 66 million Lari. In addition, the reserve money also

GRAPH 2.2.1.1  
BROAD MONEY

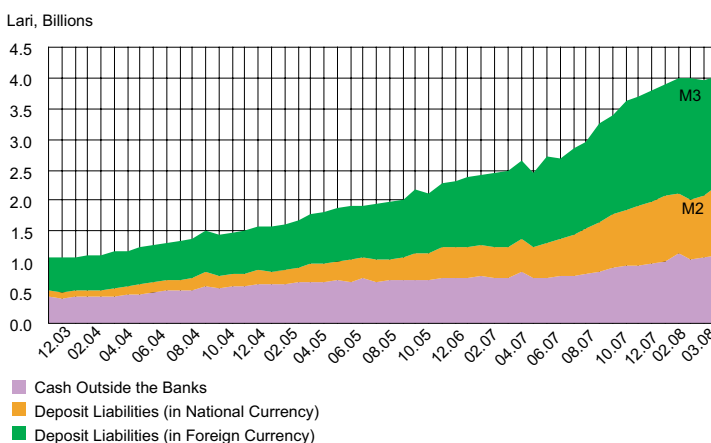
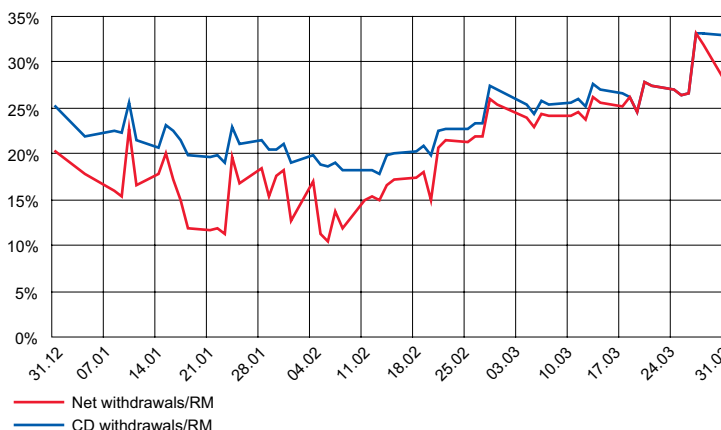


TABLE 2.2.1.1  
MONTHLY CHANGES IN MONETARY AGGREGATES  
END OF MONTH DATA, 2008

	01.07	02.07	03.07
<b>Broad money /M3/</b>	<b>3981686</b>	<b>3951402</b>	<b>4026932</b>
Monetary mass /M2/	2018547	2071878	2258946
Cash outside the banking sector	1038612	1072474	1122923
Lari in circulation	1184525	1225042	1287123
Deposits in national currency	979935	999404	1136024
Deposits in foreign currency	1963139	1879524	1767985

GRAPH 2.3.1  
RATIO OF ABSORBED LIQUIDITY THROUGH THE CDS  
TO RESERVE MONEY AND NET WITHDRAWALS OF THE  
RESERVE MONEY  
31 DECEMBER, 2007 – 31 MARCH, 2008



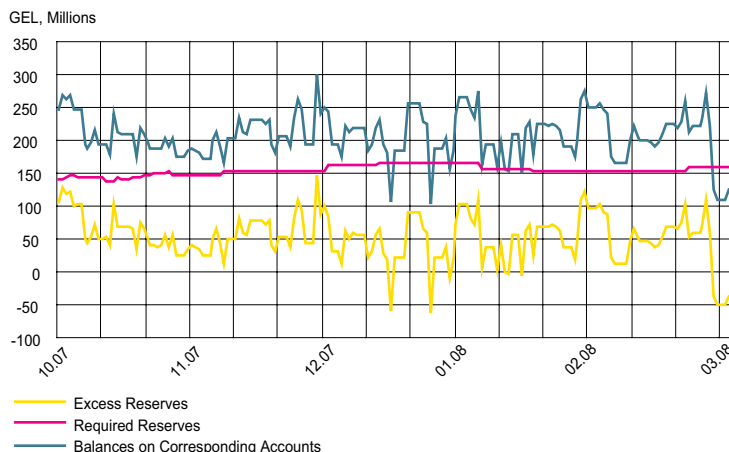
decreased by 97.4 million Lari, which was reflected in a sharp decrease of balances on banks' corresponding accounts. As a result, the volume of withdrawals through the CDs reached 33.1% of the reserve money, which substantially exceeds the same indicator for December of 2007.

The funds on the Lari corresponding accounts in QIV of 2007, as a rule, significantly exceeded the level of required reserves. In November-December of 2007 the average level of excess reserves was 25.6%, the standard deviation being equal to 12.6%. During the reference period there was only one day with liquidity deficit. This happened on December 30, which might be explained by peculiarities of a New Year period. In QI of 2008 the situation somewhat changed. The average indicator of the excess reserves shrunk to 20%, while the level of standard deviation grew up to 20.3%. There were several cases of liquidity crises in the banking sector. During the period of March 27-31 the ratio of liquidity deficit (taking into account required reserves) to the balances on corresponding accounts varied within the range of 30-46%. In

general, the tendency of QI of 2008 might be characterized as a positive one, as it might be an indication of the fact that banks are better managing free resources, whereas in case of temporary liquidity deficits they are actively using the NBG overnight loans and participating in interbank transactions.

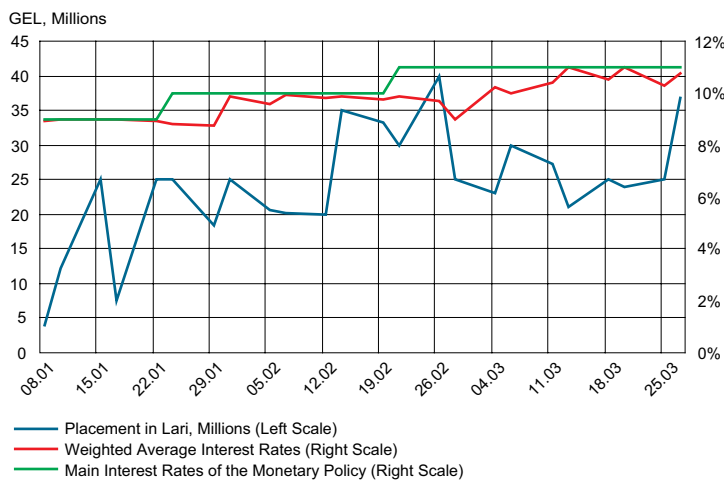
In QI of 2008 the NBG placed only 7- and 91-day CDs. Emission of 7-day CDs took place on Tuesdays and Thursdays, while 91-day CDs were issued only on Thursdays. In addition, the process of the CDs repayment with various maturity periods (including longer maturities) placed in 2007 was also under way. According to the decision of the Monetary Policy Committee, the main interest rate of the monetary policy (interest rate on 7-day CDs) was increased twice. On January 24 it was raised from 9% to 10% with a subsequent hike to 11% on February 21. This decision was motivated by a desire to support aggregate demand contraction and to slow down inflation through the increase of the interest rate and thus making monetary funds more expensive. In particular, during the period of January 8-23 7.42 million Lari worth of 7-day CDs with the weighted average annual interest rate of 9% have been issued. During the period January 24 – February 20 CDs worth 197.5 million Lari with the annual weighted average interest rate of 9.6% have been issued. The CDs worth 307 million Lari with the annual weighted average interest rate of 10.2% have been placed at the auctions held during the period of February 21 – end of March. In total, during the period of January-March CD-s worth 578.8 million Lari with the weighted average annual interest rate of 9.8% have been placed on the 7-day CD auctions.

GRAPH 2.3.2  
**LARI BALANCES ON BANKS' CORRESPONDING ACCOUNTS, REQUIRED AND EXCESS RESERVES**  
 AS OF QIV OF 2007 – QI OF 2008



During the period of January-March 2008 the total amount of the 91-day CDs placed at the auctions equaled 289.6 million Lari. The weighted average annual interest rate on these deposits was 16.6%. From the beginning of this year until January 23 only 1 million Lari was placed at one auction with the annual weighted average interest rate of 13%. The 91-day CDs worth 35 million Lari have been placed at 4 auctions during the period of January 24 – February 20. The weighted average annual interest rate on those was 14.1%. During the period of February

GRAPH 2.3.3  
PLACEMENT OF THE 7-DAY CDS, THEIR WEIGHTED  
AVERAGE ANNUAL INTEREST RATE AND  
PREDETERMINED MAXIMUM ANNUAL INTEREST RATE  
QI 2008



### BOX 1. MONETARY POLICY DECISIONS

In QI of 2008 three sessions of the Monetary Policy Committee of the NBG have been held. The sessions took place on January 31, February 20, and March 19. During QI of 2008 the main interest rate of the monetary policy grew by 2 percentage points to equal 11%. In two cases the interest rate grew by 1%, while it was left unchanged in accordance with the decision of one of the three sessions above.

The session of the Monetary Policy Committee discusses all the available information at a certain point of time and takes into consideration all the factors capable of increasing price level at an undesired rate. The inflation anticipated within a 6-to-12-month period is a major target due to the fact that the impact of the monetary policy on inflation occurs after the passage of this period.

Based on the analysis of the information available on the day of the Monetary Policy Committee session, the interest rate is set at a level necessary to reach the targeted inflation rate.

Every new statistical evidence and information, which becomes available in the period following the last session, is fully reflected in the decision of the subsequent session.

All of the sessions focused on high growth rate of the money mass as one of the major inflation factors which was caused by the growth of the money multiplier due to exceptional expansion of economy crediting.

In various periods increase in capital flows, anticipated high economic activity, parliamentary elections, inflationary expectations, growth of oil prices, inflation in Georgia's major trading partners, and other factors were also important.

As a result of the above-mentioned and due to the factors exerting mostly an upward pressure on inflation during QI of 2008, the monetary policy has been tightened, which was reflected in the decisions of the Monetary Policy Committee.

21 – end-March 7-day deposits with the total worth of 253.6 million Lari have been placed at 6 auctions. The weighted average annual interest rate on those was 17%. It is noteworthy that in accordance with the decision of the Monetary Policy Committee in January-March of 2008, in parallel with the increase of the main interest rate, the maximum interest rate on 91-day CDs grew initially from 13% to 15% and ultimately to 17%. In addition, the interest rate on the NBG overnight loans grew from 14% to 15% and later on to 16%. Frequently the interest rates registered at the 91-day CD auctions either neared to, or coincided with, the maximum rate, which might be explained by the fact that emission (supply) substantially exceeded demand resulting in increase of annual interest rates on the NBG securities.

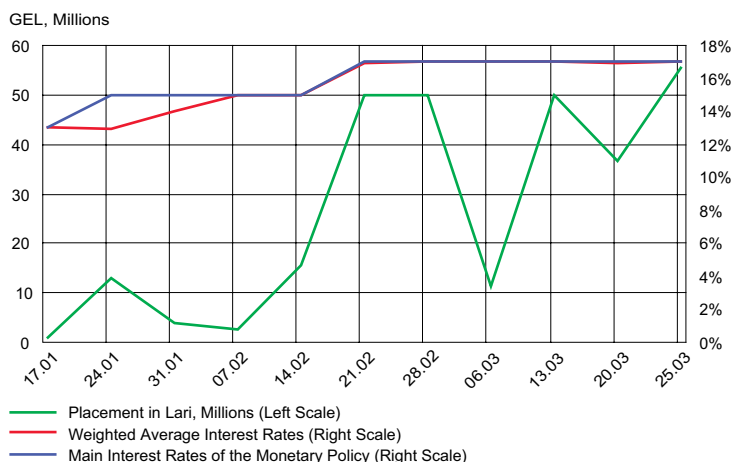
The liquidity deficit problem grew important along with contraction of the excess liquidity in the banking sector. That is why the overnight loan

instrument was used so intensively. The total amount of transactions in this market reached 35 in QI and the NBG issued overnight loans worth 1064.1 million Lari (621.6 million Lari in January, 350.3 million Lari in February, and 92.1 million Lari in March). In most cases only four banks took part in these deals. Commercial banks used both CDs and foreign exchange, namely the Euro and the US dollar, as collateral. To compare, only four deals took place in QIV of 2007 in the total amount of 73 million Lari. In general, significant fluctuations of reserves on corresponding accounts of the commercial banks have been observed. The banks did not try to maintain excess liquidity and preferred to lend off, while actively relying on the NBG overnight loans instrument for overcoming temporary liquidity deficit problem.

## 2.4. INTERBANK LOANS

According to information from the banks, during QI of 2008 the amount of loans extended in the national currency in the interbank credit market soared to exceed the level of 2 billion Lari (more than half of the total amount of transactions was denominated in the national currency). To compare, the volume of Lari-denominated loans was only 394 million Lari in QI of 2007. The volume of transactions in the Euro has also grown significantly to exceed the volume of transactions in the US dollar. Increased activity of the interbank market can be considered a positive event. In total, during QI of

GRAPH 2.3.4  
**PLACEMENT OF THE 91-DAY CDS, THEIR WEIGHTED AVERAGE ANNUAL INTEREST RATE AND PREDETERMINED MAXIMUM ANNUAL INTEREST RATE**  
 QI 2008



the current year more than half of Lari denominated contracts fell on overnight loans<sup>1</sup>, whose weighted average annual interest rate was 11.1% in the QI<sup>2</sup> of 2008. In total, the overwhelming majority of the loans denominated in Lari (more than 98%) fell on 1- to 15-day maturity loans. In general, interest rates on overnight loans tended to decrease despite the fact that the main interest rate of the monetary policy grew twice in QI of 2008 (January 24 and February 21).

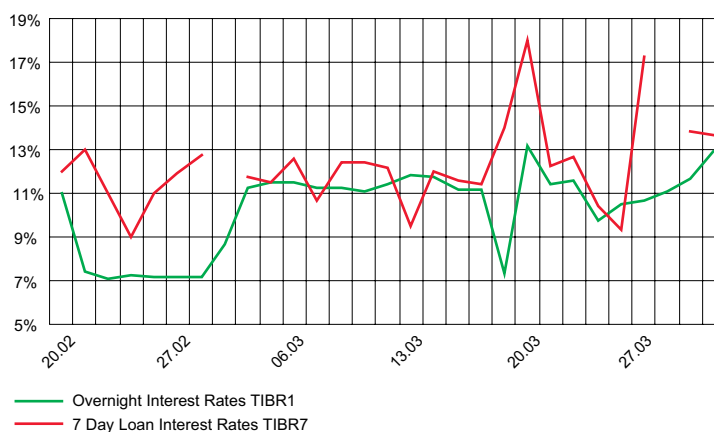
During the period of January 1– January 23 the weighted average annual interest rate on Lari denominated overnight loans amounted to 16.5% while the same indicator stood at 11.4% during the period of January 24 – February 20, and at 10.4% during the period of February 21 – March 31. As compared to QIV of 2007, the volume of transactions rose sharply in QI of 2008. Significant increase in these indicators was registered in March when the volume of overnight loans amounted to 897 million Lari, fueled by the increase in the number of oncall deposits (loro deposits). Increased activity may be indicative of formation of a competitive interbank market.

As regards 7-day loans, their amount was 276 million Lari in QI, which substantially exceeds the same indicator for QIV of 2007 but significantly falls behind the volume of overnight loans in

QI of 2008. Accordingly, the 7-day loans market is less competitive than overnight loans market. During the period under consideration there were no transactions at all on some banking days. As a result, the level of volatility of the interest rate was also high, which is clearly reflected in the TIBR7 index (The graph 2.4.1). At the same time the tendency of loans to become more expensive was still evident.

Since February 20, 2008 the NBG has been calculating the TIBR1 and TIBR7 indices<sup>3</sup>. The above-mentioned is the weighted average annual interest rate on loans denominated in Lari in the interbank market. This creates a possibility to analyze the impact of the NBG monetary policy on the interest rates.

GRAPH 2.4.1  
TBILISI INTERBANK INTEREST RATES ON LARI  
DENOMINATED SHORT-TERM LOANS\*  
20.02.2008 - 01.04.2008



\* Note: If no transactions for a given loan category are recorded at any banking day, empty space is left on the graph, instead of the interest rate .

<sup>1</sup> If interest is not charged on oncall deposits the latter are also regarded as overnight loans. The volume of the loan is the balance left on the deposit at the end of a day.

<sup>2</sup> The calculation comprises the deals reached during the QI 2008, except for the period of February 14-19 due to inexistence of data for this period.

<sup>3</sup> TIBR1 index comprises loans, whose maturity is one operational day and which are not collateralized. TIBR7 index comprises loans, whose maturity is up to 7 days and all those uncollateralized loans, which are not included into the TIBR1 calculation.



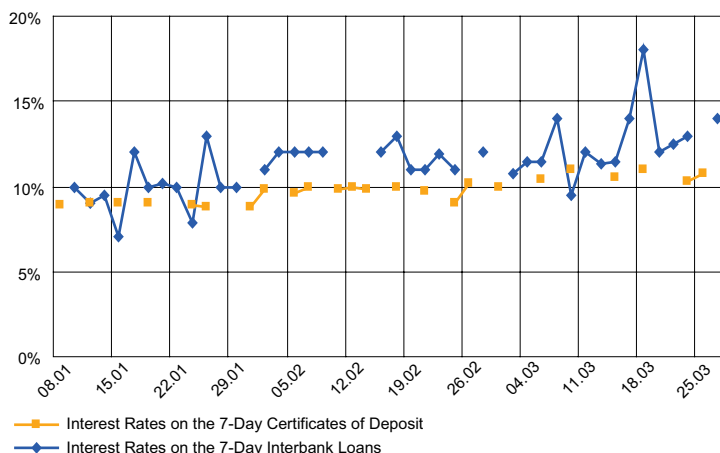
The interest rate on interbank loans (for example 76-day loans) is higher than the interest rate on the CDs with the same maturity. This is conditioned by the fact that, as a rule, revenues derived from the CDs are more profitable than revenues derived from extending loans to other commercial banks. The advantage of the CDs represents their lower risk, whereas, interbank loans require more own capital in terms of reserves which makes this type of lending unfavorable for a commercial bank. However, during QI of the current year there were cases when the interest rate on interbank loans with 7-day maturity was either lower or coincided with the interest rate on the analogous CDs issued on the same day.

## 2.5. BANKING SECTOR

In QI of 2008 the number of commercial banks in Georgia equaled, 22, compared to 19 banks at the end of the previous year<sup>1</sup>. The growth rate of economy crediting by commercial banks slowed to equal the quarterly rate of 9.3%. The annual growth rate of economy crediting by commercial banks equaled 67.7%, which is less than the analogous annual rate (71%) for the end of 2007 (December of 2007). The volume of the credit portfolio equaled 5,067.5 million Lari. The share of long-term credits in total loans amounted to 66.5%, which is also lower than in December 2007 (68.4%) but equals the analogous indicator for March 2007 (66.5%).

At the end-QI of 2008 long-term credits were more dollarized than short-term credits, the respective levels standing at 76.4% and 43.3%. Traditionally, commercial banks were using Lari more actively in short-term crediting than in long-term crediting. In total, the dollarization of loans equaled 65.8%, while in December 2007 it stood at 68.5% and at 74.7% in March of the same year. All this is indicative of an evident dedollarization trend. Obviously, stable appreciation of the Lari against the US dollar played its role as well. Dedollarization process is also manifested by the fact that the quarterly growth rate of loans extended in Lari (the claims on the economy) equaled 19% in QI of 2008, compared to only 5% for loans denominated in foreign currency.

GRAPH 2.4.2  
WEIGHTED AVERAGE ANNUAL INTEREST RATES ON THE  
7 DAY CD-S AND INTERBANK LOANS  
QI 2008



<sup>1</sup> During 2008 three new banks – JSC "Core Bank – Georgia", JSC "Khalik Bank", and JSC "Progress Bank" started operations.



During the period of January-March of 2008 the volume of loans extended to physical persons grew faster than loans to legal entities. As of April 1, 2007 the annual growth rate of consumer liabilities to commercial banks amounted to 49% although the quarterly growth rate was negative. In particular, in February 2008 the volume of consumer debt to commercial banks dropped significantly to equal 885.3 million Lari by April 1, 2008, while it stood at 1135.1 million Lari as of January 1 2007. It is noteworthy that in QI of 2007 the 18% increase was registered only for long-term consumer liabilities denominated in the national currency. As regards the QI interest rates registered on short-term consumer loans and on Lari-denominated long-term consumer loans, they have dropped. At the same time the interest rates on long-term consumer loans denominated in foreign currency grew higher as compared to QIV of 2007, which might be explained by expected depreciation of the US Dollar.

Growth of mortgage loans showed similar trends. The annual growth rate amounted to 38% (212.2 million Lari) in March 2008. If the residents' liabilities to commercial banks are considered separately, their volume grew fast during 2007, while a decelerating trend was more evident in QI of 2008. Namely, in March 2008 as compared to December 2007, the total decrease of this type of liabilities equaled 75.6 million Lari (17.1%). It is remarkable that during the period of January – March of 2008 new mortgage loans extended to physical persons amounted to 81.2 million Lari and their large part was denominated in foreign currency.

As of March 2008 the volume of deposits equaled 2,904 million Lari with the annual growth rate of 51.9% (including 88.3% for Lari-denominated deposits) and the quarterly growth rate of 2.7% (including 15.9% for the Lari denominated deposits). However, these indicators are lower than the annual growth rate of loans. In particular, the annual growth of loans in 2008 equaled 67.7% (including 127% in Lari denominated credit), and quarterly growth rate amounted to 9.3% (including 18,9% in Lari-denominated loans). It is worthwhile to mention that the volume of time deposits continued to grow in QI of 2008, which was largely due to attraction of deposits denominated in the national currency. In particular, the quarterly growth rate equaled 5% (including 32.7% for Lari-denominated deposits) and the annual growth rate amounted to 69.5% and 267% respectively. The dollarization rate of deposits equaled 60.9% in March, while the same parameter stood at 65.4% and 68.4% in December of 2007 and March of 2007, respectively. This fully coincides with the dedollarisation trend for the comparable period. It should be mentioned that the Euro replaces the US Dollar in foreign currency denominated deposits at an increasing rate, with the US dollar's share (expressed in Lari) dropping from 80.6% to 69.9%.

As regards the interest rates on loans extended to the economy, overall, they increased in QI of 2008 as compared to both QIV of 2007 and QI of 2007. This is explained by increased costs of loans denominated in foreign currency, which was probably conditioned by the depreciation of the US dollar. In total, the weighted average annual interest rate on extended loans in QI of 2008

**BOX 2. SURVEY OF COMMERCIAL BANKS' MANAGERS**

The NBG periodically conducts a survey of commercial banks' managers in Georgia with regard to future economic development, anticipated changes in the Lari exchange rate, and inflationary processes. The survey of banks' managers allows assessing expectations of commercial banks, as the major players of the Georgian financial market, related to future tendencies of economic development.

Approximately half of the respondents expect some changes in overall economic conditions within the three-month timeframe, while the other half does not expect any changes. The forecast is more optimistic for one-year period. In this case the majority of managers, 74%, anticipate improvement of overall economic conditions. It should be mentioned that bank managers do not expect worsening of economic conditions either in a short-term or a long-term period.

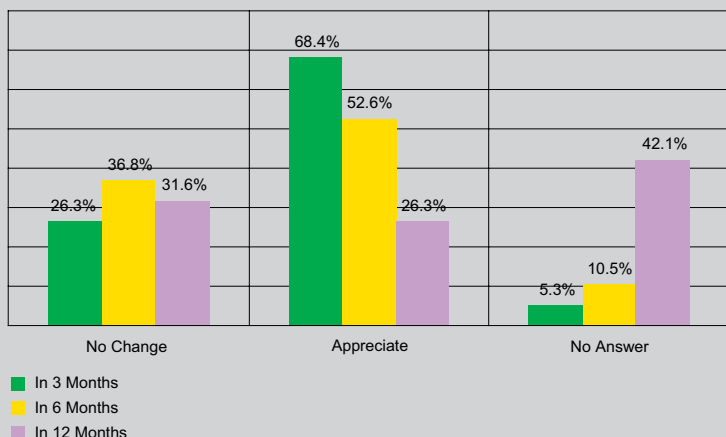
According to the survey, the economic growth within the period of one year is more anticipated in construction and trade sectors. These sectors are mentioned by 85% and 79% of the respondents, respectively. 53% of the bank managers interviewed perceive economic growth the least likely in manufacturing sector.

The majority of managers interviewed think that the Lari exchange rate will either appreciate even further (68.4%) or remain stable (26.3%) in the short run,. 5.3% of the respondents do not have a definite answer.

In the medium term, during the upcoming 6-month period, commercial banks' managers mostly expect appreciation of the Lari exchange rate. 52.6% of them think that the US Dollar will depreciate against the Lari, 36.8% think that the national currency exchange rate will be stable, and 10% do not have a definite answer.

According to the survey, likely changes in the exchange rate after one year are vague for the significant part of the managers, with 42.1% not having a definite answer. Approximately 31.6% think that changes in the Lari exchange rate are not anticipated and it will mostly remain stable. A relatively smaller part of the respondents, 26.3%, anticipates even further appreciation of the Lari exchange rate. It should be noted that neither in the short-run nor in the long-run do commercial banks anticipate the Lari

GRAPH 1  
THE FORECAST OF THE RESPONDENTS WITH REGARD TO THE LARI EXCHANGE RATE



depreciation, which probably even further reinforces the upward pressure on the Lari exchange rate (Graph 1).

The analysis of the expectations of commercial banks; managers with regard to the Lari exchange rate is possible by examining the difference between the interest rates on deposits denominated in Lari and in the US Dollar. If the deposits of physical persons attracted in the accounting period are taken as an indicator, it becomes evident that there is a tendency for narrowing the gap between the interest rates on deposits denominated in Lari and the USD. Based on this finding, we may assume that banks anticipate depreciation of the Lari exchange rate in the long run. In the short run though, in QI of 2008, the opposite tendency emerges, indicating banks' expectations of the Lari appreciation (Graph 2).

The survey also includes banks' inflationary expectations. According to QI of 2008 survey, banks expect the inflation rate at the level of 9.7% after one year. As of the inflation rate after two years, the average inflationary expectations of the commercial banks equals 9.3%. It is noteworthy that the inflationary expectation after two years is characterized by a higher dispersion than the inflationary expectation after one year (Graph 3).

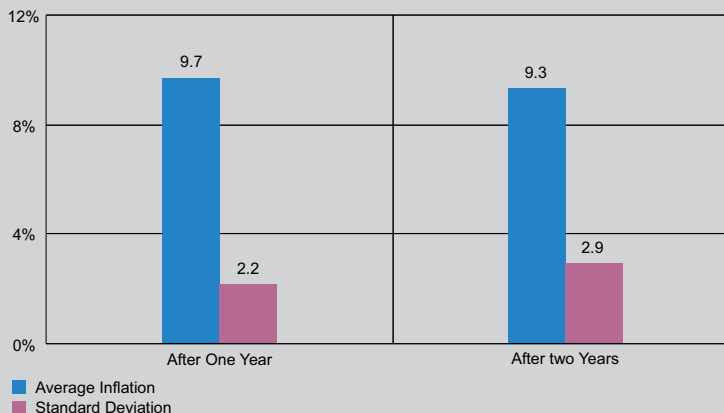
The survey of bank managers in QI of 2008 suggests that banks anticipate the overall improvement of economic

conditions in the long run. The growth is mostly anticipated in the construction, trade, communications, and agricultural sectors. Bank managers anticipate further appreciation of Lari in short and medium term, though they face difficulties in expressing their opinion regarding the long-term period. As of the rate of inflation after one and two years, the expectations of commercial banks are confined to one digit numbers.

GRAPH 2  
DIFFERENCE BETWEEN THE INTEREST RATES ON DEPOSITS DENOMINATED IN LARI AND IN FOREIGN CURRENCY



GRAPH 3  
ANNUAL INFLATION FORECAST



equaled 20.6%, while the same indicator stood at 19.6% in QIV of 2007. As for the interest rate on deposits, after a certain increase in January it returned back to the average level of QIV of 2007, largely due to decreased interest rates on foreign currency denominated deposits attracted in February and March.

In total, in QI of 2008 high growth rate of Lari-denominated loans extended to the economy exceeded the growth rate of deposit accumulation leading to aggregate demand expansion and, hence, higher inflation.

While assessing the ongoing changes in the banking sector, it can be said that banks are trying to minimize the amount of unprofitable excess liquidity resources. Higher rates of credit expansion compared to deposit accumulation might expose certain banks to liquidity problems. Volatility in levels of excess liquidity has grown significantly. In order to overcome temporary liquidity problems banks were actively using overnight loans both from the NBG and in the interbank market.

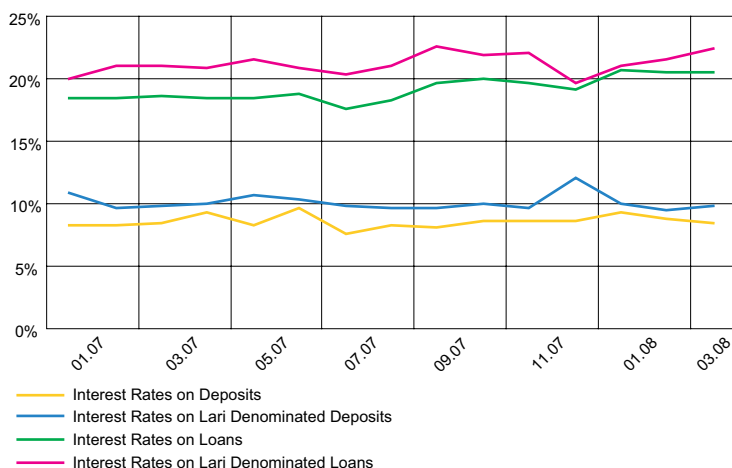
## 2.6. FACTORS AFFECTING THE EXCHANGE RATE

The balance of payments deficit in QIV of 2007 worsened 2.5 times as compared to the analogous period of 2006 equaling 745.2 million US Dollars, while posting a 95% growth rate with respect to QIII 2007 level. The same growth rate was recorded in QIV of 2003 when the deterioration of the current account deficit reached 127%. This made a negative impact on the annual indicator as well worsening it by 67%. Despite of the fact that deterioration of the current account was accompanied by a strong economic growth, the ratio of the negative CAB to the GDP grew alarmingly to reach 24.35% against 12.84% in QIV of 2006.

In QIV of 2007 sharp deterioration of the current account was traditionally conditioned by the negative trade balance of goods. The external trade deficit grew by 48.7% compared to the previous quarter and reached -1021.24 million USD. Its annual growth rate reached 87.1% and equaled 33.7% of the GDP, which is 10% higher than the analogous indicator for 2006. In QI of the current year the negative external trade balance grew by 31.4% to reach 1079.8 USD. During the same period a 47.8% increase in export revenues on a year-to-year basis has been registered, while export revenues dropped by 9.6% with respect to the previous quarter.

In QIV of the previous year the demand of imported goods grew significantly. As a result, the volumes of imports soared by an annual rate of 30.2% and a quarterly rate of 58.1%. As of QI of the current year, the import expenditures

GRAPH.2.5.1  
ANNUAL INTEREST RATES ON LOANS AND DEPOSITS  
JANUARY 2007 – MARCH 2008



grew by 34.9% annually and dropped by 17.8% quarterly. Upswing in demand for energy products, notably petroleum, petroleum products, petroleum gases and other hydrocarbons in QIV of 2007 was one of the major factors determining the seasonality pattern of the import expenditures.

The balance of services account, which showed an upward trend before this period, plunged. In particular, it dropped by 95.4% as compared to the previous quarter to equal 4.03 million USD against 87.05 million USD.

The volume of current transfers, which had a modest share in financing the current account deficit, grew by 51.5% in QIV of 2007 as compared to the same period of 2006 to equal 238.1 million USD posting a quarterly growth rate of 35.8%.

The capital and finance account balance equaled 859.9 million US Dollars, which is 3.2 times higher than the analogous indicator for 2006. Similar to the previous period this was caused by the still rising level of inflows of FDIs and other types of investments.

The events described above determined the formation of the Lari exchange rate against various foreign currencies. Namely, on an annual basis the Lari exchange rate appreciated by 9.01% against the US dollar. As compared to the previous quarter the Lari exchange rate appreciated by 4.05%. The Lari depreciated by 3.84% against the Euro on an annual basis and appreciated insignificantly, by 0.85%, with respect to the previous quarter.

As of the dynamics of the Lari real exchange rate against various foreign currencies, they were characterized by an evident appreciation tendency. Notably, the Lari exchange rate appreciated by 6.27% against the Turkish Lira, while the appreciation rate against the Russian ruble was comparatively insignificant – only 1.7%.

Accordingly, the Lari real effective exchange rate appreciated by 2.42% annually and by 3.94% as compared to QIV of 2007.

The circumstances described above conditioned the dynamics of varying events at the TIBFEX. Despite appreciation of the exchange rate, the supply of the US dollars fell only slightly behind the volume of demand in January 2008 (by 75.17 million USD). In the next month the situation reversed and in March the supply of the foreign exchange exceeded its supply by the largest amount registered for the previous several months equaling 220.5 million USD.

GRAPH 2.6.1  
LARI REAL EXCHANGE RATES AGAINST THE TURKISH LIRA AND THE RUSSIAN RUBLE; REAL EFFECTIVE EXCHANGE RATE

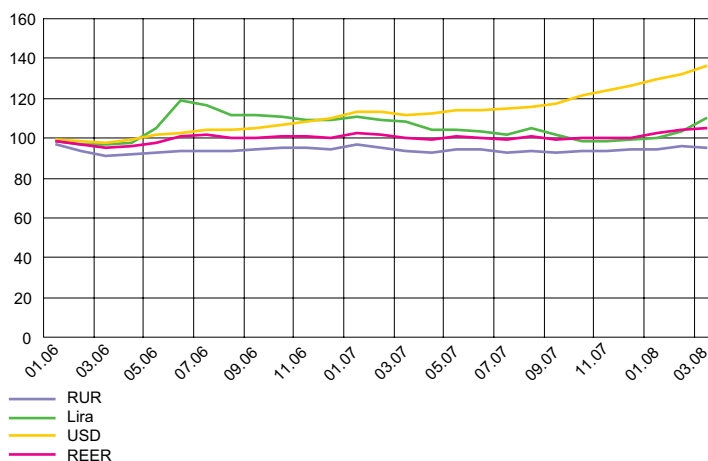


TABLE 2.7.1  
THE GDP OF GEORGIA BY SECTORS OF ECONOMY (%)  
QIV OF 2007

	Share in GDP	Real Growth Rate	Share in GDP Growth
Agriculture, Forestry and Fishing	17.7	19.6	2.2
Mining and Quarrying	0.4	39.9	0.4
Manufacturing	11.5	12.4	1.1
Electricity, Gas and Water Supply	2.7	-8.6	-0.2
Processing Products by Households	5.0	16.6	0.4
Construction	7.6	15.0	1.0
Trade	14.8	6.2	0.8
Hotels and Restaurants	3.0	5.5	0.1
Transport	8.7	9.3	0.7
Communications	2.3	4.5	0.2
Intermediation	8.4	-3.1	-0.1
Real Estate, Renting and Business Activities	3.5	9.0	0.3
Imputed Rent on Own Occupied Dwellings	4.2	7.1	0.2
Public Administration, Defense	1.6	28.9	2.5
Education	1.4	4.5	0.2
Healthcare	1.5	5.3	0.2
Other Community, Social and Personal Service Activities	2.6	6.7	0.2
Private Households with Employed Persons	0.1	11.4	0.0
FISIM Adjustment	-3.0	5.3	0.0
<b>GDP at Market Prices</b>	<b>93.9</b>	<b>11.0</b>	<b>9.6</b>
Taxes on Goods	6.3	16.0	2.1
Subsidies on Goods	-0.4	20.8	-0.1
<b>GDP at Market Prices</b>	<b>100.0</b>	<b>11.7</b>	<b>11.7</b>

## 2.7. OUTPUT AND DEMAND

In QIV of 2007 the volume of the gross domestic product of Georgia at current market prices amounted to 4963 million Lari. On a per capita basis this equals 1129.3 Lari. The real growth rate of the GDP in QIV of 2007 compared to the same period of 2006 stood at 11.7%. The sectoral analysis of the economy shows that positive growth rates have been registered in almost all sectors. Especially high growth rates have been registered in mining and quarrying (39.9%). However, it is noteworthy that the value added created in this sector is quite unevenly distributed by quarters, which reduces the annual growth rate to just 20%. Stable growth rates are peculiar to the construction sector (15%).

DIAGRAM 2.7.1  
THE SHARE OF THE LARGEST SECTORS IN THE GDP  
QIV OF 2007

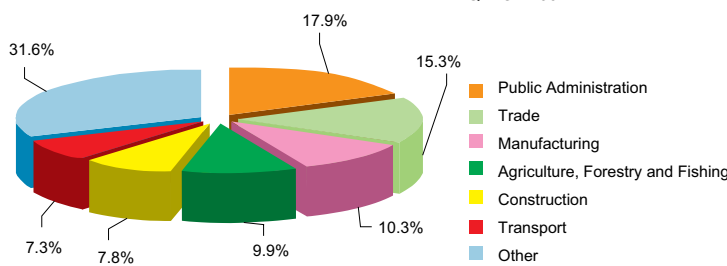
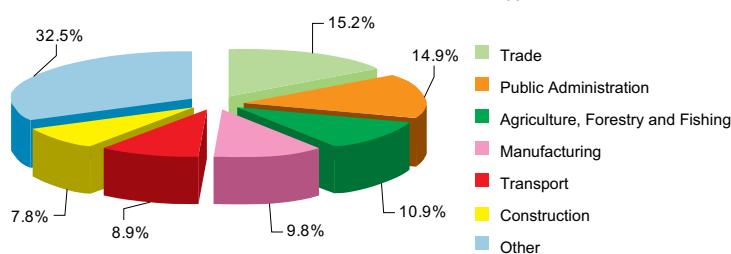


DIAGRAM 2.7.2  
SHARES OF THE LARGE SECTORS OF THE ECONOMY  
IN THE GDP  
IN 2007



### 2.7.1. HOUSEHOLD CONSUMPTION

Household consumption grew by 21.1% from QIV of 2006 to QIV of 2007, which significantly exceeds the same indicators for the other quarters (graph 2.7.1.1). At the same time it must be said that due to statistical discrepancy between the methodologies of GDP calculation by production and expenditure, it is hard to talk about precise numbers. The statistical discrepancy for QIV of 2006 equaled 4.6% while the same indicator for QIV of 2007 stood at 6.5%. Thus, it was possible for the real growth of household consumption to be higher.

### 2.7.2. GOVERNMENT SPENDING

According to the nominal indicator of QIV of 2007, government spending grew by 30.4% as compared to the previous quarter. This is 71.9% higher than in the same period of 2006. The major part of government spending influences the formation of aggregate demand. However, it is worthwhile to mention that part of the expenditures after currency conversion is spent on imports. In QIV of 2007 at the request of the Government of Georgia the NBG undertook conversion worth 273 million USD, which is 4.1 times higher than the analogous indicator for 2006. The volume of conversion operations equaled approximately 15% of aggregate government spending.

### 2.7.3. INVESTMENTS

In QIV of 2007 gross capital formation amounted to 1526.6 million Lari to exceed the 2006 indicator by 41.3%. This is significantly higher than the nominal growth rate of the GDP (25%). Respectively, during the period of QIV of 2006 – QIV of 2007 the share of gross investment in the GDP grew from 27% to 31%.

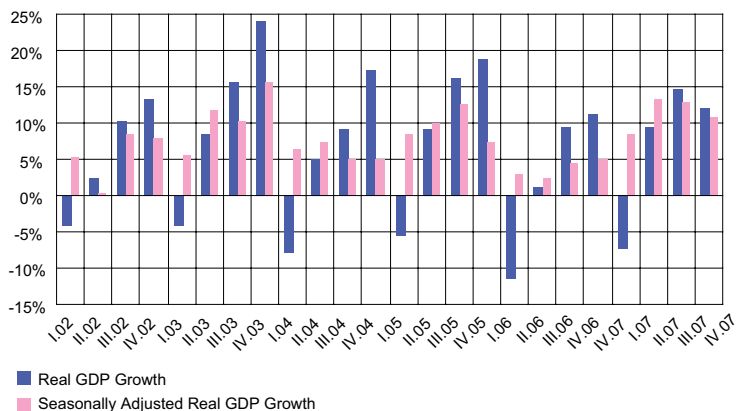
The major factor contributing to economic growth during the last year was the inflow of foreign capital. The sharp increase of foreign investments in the country is determined by improvement of the business environment and successful privatization process. The quarterly

dynamics of the data show that the recent political tensions have not hampered the investment inflows. The net foreign capital inflow in QIV of 2007 amounted to 23% of the GDP. It must be mentioned that the largest share of this, 20% of the GDP, falls on FDI or the low risk financing. The volume of FDIs in absolute terms amounted to 618.2 million USD in QIV of 2007. This is 2.2 times higher than the analogous indicator for 2006.

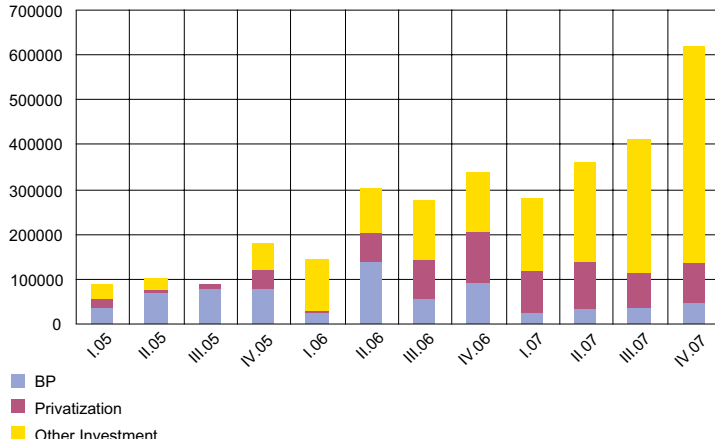
At the same time, contrary to the past years, largest part of investments in 2006 and 2007 is not linked to pipeline construction. In QIV of 2007 the share of such investments along with the privatization precedes accounted for only 22% of the total FDIs. Based on the above-mentioned, it can be assumed that the investment inflows will be stable this year as well.

The FDI inflows to Georgia stem from the following countries: Czech Republic (24.1%), Cyprus (13.7%), UAE (11%),

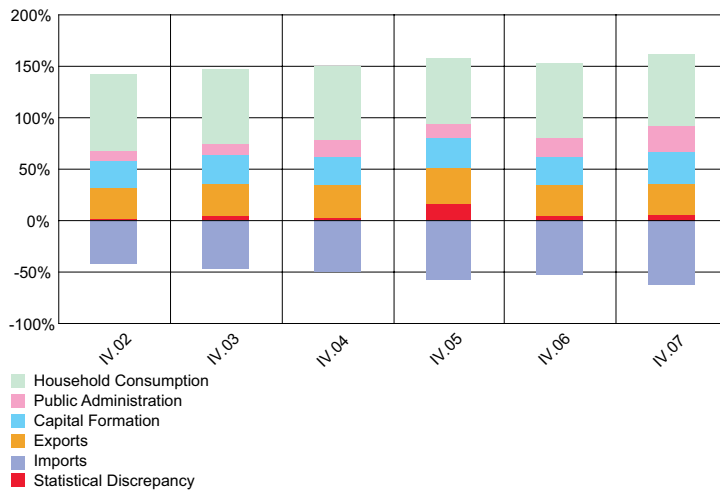
GRAPH 2.7.1.1  
GROWTH OF THE QUARTERLY GDP COMPARED TO THE AVERAGE INDICATOR FOR THE PREVIOUS YEAR 2002-2007



GRAPH 2.7.3.1  
DYNAMICS OF THE FOREIGN DIRECT INVESTMENTS  
2005-2007



GRAPH 2.7.3.2  
GDP BY USE  
QIV OF 2002 – QIV OF 2007



and Virgin Islands (8.5%). The sharp increase in FDI inflows was one of the factors, which determined high demand for the domestic currency and led to appreciation of the Lari exchange rate in the foreign exchange market. The FDI inflows allow households to maintain high consumption levels, which also promoted the GDP growth.

In QIV of 2007 trade deficit increased even further to reach 33% of the GDP. This is caused by exceedingly higher growth rates of imports as compared to exports. The positive balance in services, income and current transfer accounts partially offsets the gap in the trade balance. Despite this, the current account deficit was still characterized by the increasing deficit equal to 24% of the GDP in QIV of 2007.



# 3. INFLATION FORECAST

During the last year high inflation rates were mostly determined by several factors, namely world price gains on goods like wheat flour, sunflower oil, sugar and petroleum products. These goods have quite a large share in the consumption basket. Thus, sharp increase of world prices on these goods had a significant negative impact on the inflation in Georgia.

In order to calculate the expected inflation in the short run the NBG takes into account the likely dynamics of world prices for a number of products constituting the consumption basket, with the dynamics mostly having a decreasing trend. As a result, in case the regulated prices are left unchanged, it is anticipated that the annual inflation rates for QII and QIII of 2008 will drop.

As already mentioned, price gains on some important goods of the consumption basket probably represented a one-time increase. Thus, the negative effect from price gains on these goods will not adversely affect the current year inflation rate. For example, in May 2007 the natural gas fee became more expensive, which pushed the annual inflation indicator up by 0.9%. During the subsequent period the natural gas fee did not change. As a result, beginning from May of the current year the effect of the increased price on natural gas will not affect the annual inflation. Table 3.1 below shows the list of the consumption basket items with price increases of mostly one-time nature whose effect will

no longer affect the current rate of the annual inflation.

Taking into account all the above-mentioned, it is expected that the annual inflation rate will stand at 10.4% and 7.3% in QII and QIII of the current year, respectively.

In order to estimate the impact of the world prices, it is possible to use the forecast for certain products of the consumption basket presented in table 3.2 below.

Thus, the quarterly inflation model has the following form:

$$\delta p = 0,015 \delta e_{-2} - 0,077 \delta e_{-4} + 0,037 \delta m_{-1} + 0,026 \delta m_{-2} - 0,044 \delta m_{-3} + 0,009 \delta p^{oil}_{-1} + 0,031 \delta p^{food}_{-1} - 0,014 ecm$$

where:

$p$  is a consumer price index;

$m$  – money mass;

$e$  – Lari/US dollar exchange rate;

$p^{oil}$  – average oil price in the world market;

TABLE 3.1  
EFFECTS TO BE EXCLUDED FROM THE 2008 ANNUAL INFLATION (%)

	05.07	06.07	07.07	08.07	09.07	10.07	11.07	12.07
White Wheat Bread	0.0	0.0	0.2	1.4	1.4	1.9	2.8	2.8
Wheat Flour	0.0	0.0	0.0	0.1	0.1	0.2	0.3	0.3
Sunflower Oil	0.0	0.0	0.0	0.1	0.7	1.2	1.1	1.1
Waste Disposal Fee	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Natural Gas	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Liquid Gas	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Intracity Bus, Micro Bus and Taxi Transportation	-0.1	-0.1	0.4	0.4	0.4	0.3	0.5	0.5
Total	0.8	0.8	1.6	2.9	3.5	4.6	5.6	5.6

$p^{food}$  – prices on fruits and vegetables;  
 $ecm$  – is a long-run equilibrium variable  
 having the following form:

$$ecm = p_{-1} - 0,35e_{-1} - 0,65m_{-1} + 1,15y_{-1} - 7,31$$

while  
 $y$  is the GDP.

The equation also includes seasonal and dummy variables to describe certain seasonal and structural changes;

The discrepancy of the QIV 2007 inflation forecast presented in the previous issue of the Quarterly Report was due to the fact that the forecast was based on incorrect, more pessimistic assumptions. In particular, prices on fruits and vegetables grew to a lesser degree and the Lari exchange rate against the US Dollar appreciated more than it was assumed in the model. As a result, the actual rate of inflation equaled 10.82% in February against the forecasted 11.18-11.36%.

TABLE 3.2  
**FORECAST OF CERTAIN GOODS PRICE INDICES AND THEIR SHARE IN THE ANNUAL INFLATION UNTIL SEPTEMBER OF 2008**

	Price Indices of Goods from Consumption Basket (December 2006 = 1)									Share in Inflation %	Share in Average Annual Inflation %	Share in Inflation %	Share in Average Annual Inflation %	Assumption
	Factual				Forecast									
	01.08	02.08	03.08	04.08	05.08	06.08	07.08	08.08	09.08	06.08	09.08			
Overall Inflation										10.4	10.4	7.3	10.4	
White Wheat Bread	1.35	1.35	1.36	1.36	1.36	1.36	1.36	1.36	1.36	2.9	2.5	1.5	2.6	Constant
Wheat	1.28	1.28	1.29	1.29	1.29	1.29	1.29	1.29	1.29	0.0	0.0	0.0	0.0	International Forecast
Wheat Flour	1.32	1.33	1.37	1.36	1.36	1.36	1.36	1.36	1.36	0.3	0.3	0.2	0.3	International Forecast
Maize Flour	1.25	1.26	1.25	1.19	1.19	1.19	1.19	1.19	1.19	0.0	0.1	-0.1	0.0	Constant
Sunflower Oil	1.60	1.69	1.78	1.81	1.81	1.81	1.81	1.81	1.81	1.5	1.1	0.8	1.3	Constant
Sugar	0.84	0.82	0.86	0.86	0.88	0.88	0.91	0.91	0.91	0.0	-0.2	0.1	-0.1	International Forecast
Salt	1.08	1.07	1.08	1.08	1.08	1.08	1.08	1.08	1.08	0.0	0.1	0.0	0.1	Constant
Cold Water Fee	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80	0.0	0.2	0.0	0.1	Constant
Garbage Collection Fee	2.37	2.37	2.37	2.37	2.37	2.37	2.37	2.37	2.37	0.0	0.2	0.0	0.1	Constant
Electricity Fee	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.0	0.0	0.0	0.0	Constant
Natural Gas	1.43	1.43	1.43	1.43	1.43	1.43	1.43	1.43	1.43	0.0	0.7	0.0	0.5	Constant
Liquid Gas	1.24	1.26	1.25	1.22	1.22	1.22	1.18	1.18	1.18	0.1	0.1	0.0	0.1	International Forecast
Kerosene	1.09	1.09	1.11	1.11	1.11	1.11	1.06	1.06	1.06	0.0	0.0	0.0	0.0	International Forecast
Diesel Fuel (L-42, L-62)	1.26	1.25	1.32	1.34	1.34	1.34	1.32	1.32	1.32	0.0	0.0	0.0	0.0	International Forecast
Gasoline (Regular, Premium)	1.20	1.20	1.23	1.23	1.23	1.23	1.23	1.23	1.23	0.3	0.3	0.4	0.4	International Forecast
Transportation by Suburb Train	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.0	0.0	0.0	0.0	Constant
Long Distance Train Transportation	1.01	1.01	1.02	1.02	1.02	1.02	1.02	1.02	1.02	0.0	0.0	0.0	0.0	Constant
Transportation by Subway and Bus	1.61	1.61	1.62	1.62	1.62	1.62	1.62	1.62	1.62	0.0	0.0	0.0	0.0	Constant
Intracity Bus, Micro Bus and Taxi Transportation	1.13	1.14	1.19	1.19	1.19	1.19	1.19	1.19	1.19	0.9	0.6	0.4	0.6	Constant
Suburb Bus Transportation	1.01	1.16	1.17	1.17	1.17	1.17	1.17	1.17	1.17	0.1	0.0	0.1	0.0	Constant
Intercity Micro Bus Transportation	1.03	1.03	1.03	1.04	1.04	1.04	1.04	1.04	1.04	0.0	0.0	0.0	0.0	Constant
Other Products										4.2	4.2	4.1	4.2	6.0% Annual Growth

Note: ????????????????????

The forecasted rate for March, 12.54-12.90%, approached closer to the actual indicator of 12.16%. This is caused by a partial offset of the above pessimistic conditions by a greater growth of money mass and petroleum prices than we have assumed.

As regards the explanatory variables entering the renewed model described above we have made the following assumptions:

- The amount of broad money excluding foreign currency will grow by an annual 70% by the end of the current year;
- The real growth rate of the GDP will equal 8.8%, which is based on the sectoral trends of the economy;
- The nominal exchange rate against the US dollar will not change, which is explained by the fact that in general the exchange rate is described by a random walk process;
- Prices on fruits and vegetables will grow by 15%, similar to the previous year;
- The oil price will not drop in the world market and the price per barrel will equal 110 USD on average.

### **BOX 3. AMENDMENTS TO THE ORGANIC LAW ON THE NATIONAL BANK**

The Parliament of Georgia made amendments to the Law of Georgia on National Bank on March 14, 2008, which essentially meant the adoption of a new Law.

According to these amendments, maintenance of price stability is defined as the main function of the Bank, whereas if the main function is not under threat the Bank will undertake its other functions. The National Bank of Georgia is empowered at the legislative level to undertake inflation targeting, a new regime of the monetary policy. Preparations for transition to this regime started back in 2005 and the transition period is likely to stretch until 2010.

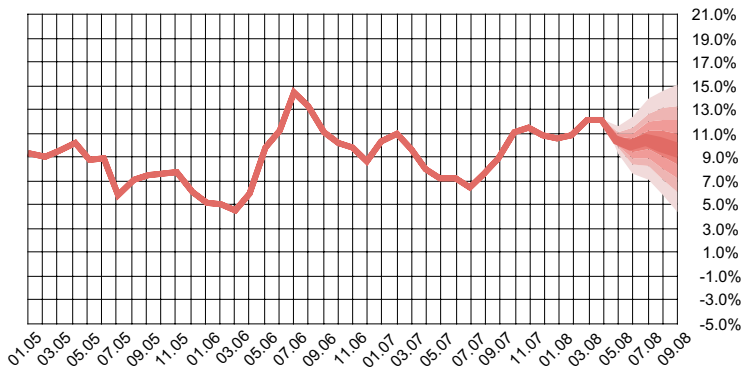
The Monetary Policy Committee will be in charge of monetary and exchange rate policies formulation and implementation, although the final decision is made by the President of the NBG. Also, the President of

the NBG will be held responsible for maintenance of price stability. In particular, if the average annual rate of inflation differs from the targeted rate by more than two percentage points during four consecutive quarters, while the state budget has surpluses, the Parliament of Georgia may (and if the inflation exceeds 12% during 6 consecutive quarters it must) vote for the revocation of responsibilities of the President of the NBG.

In accordance with the new legislation, the NBG will mostly concentrate its efforts on the monetary policy while the supervision of the financial sector will be implemented by the Unified Supervisory Service, a legal entity of public law,.

Overall, the above-mentioned Law is a step forward towards the improvement of the efficiency of the monetary policy in the country.

GRAPH 3.1  
ANNUAL INFLATION FORECATS



As a result of the estimated model, the annual inflation forecast appears as on graph 3.1.

According to the obtained results, the annual inflation will be in the range between 9.73% and 10.4% with 10% probability by the end of QII of the current year. This indicator fits quite well with the forecasts made for particular products.