

NATIONAL BANK OF GEORGIA

INFLATION REVIEW
QIV 2008

TBILISI

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INTRODUCTION

The overall level of consumer prices fell 0.3% in QIV 2008, as per the Department of Statistics of the Ministry of Economic Development of Georgia. In QIV of the previous year consumer prices were up by 4.5%. Accordingly, annual inflation rate lowered in December 2008 to the mark of 5.5% as opposed to 10.6% for the previous quarter. Average annual inflation rate in QIV 2008 eased by 0.5% to equal 10%.

The quarterly inflation was mainly determined by price decreases in international markets. Annual inflation rate of imported goods dropped to 1.8%. Domestic goods' inflation equaled 4.5%.

The size of reserve money reduced by 302.6 million lari at the end of December 2008 to amount to 1431.9 million lari.

In the accounting period the government deposits grew by 502.7 million lari to total 880.0 million lari, as of the December preliminary data. To a certain degree, such an increase was conditioned by the receipt of donor aid.

The volume of the Certificates of Deposits (CDs) in circulation was reduced to 77.4 million lari at the end of December. Commercial banks were actively using the refinancing loans facility over the accounting period; the outstanding balance of loans extended by means of this instrument totaled 43.7 million lari at the end of December.

Net liabilities of commercial banks increased to amount to 132.0 million lari, as opposed to -17.6 million at the end of September.

In the accounting period, the size of M3 aggregate grew by 292.7 million lari to total 4258.4 million lari, while M2 fell by 17.9% (403.3 million lari) due to the decrease in domestic currency denominated deposits and contraction of the national currency in circulation.

In QIV 2008 the NBG's monetary policy aimed at

providing the banking system with liquidity funds, similar to the previous quarter. Over the reporting period, the interest rate on refinancing loans was decreased from 10% to 8%.

Consequently, the cost of lari-denominated loan resources of the interbank market decreased compared to the previous quarter. For instance, in October-December the weighted average annual interest rate on the lari-denominated overnight loans equaled 6.4%, as opposed to 9% in QIII and 13.4% in QII.

The interest rates on deposits also decreased by a modest amount of 0.2 percentage points.

In QIV the foreign currency denominated deposits grew by 226.4 million US dollars, whereas the national currency denominated deposits decreased by 289.4 million lari. Factoring in the growth rates of deposits denominated both in foreign and national currencies, the deposit dollarization ratio increased in December 2008 by 14.0 percentage points to reach 75.7% by the end of the month. The increase in the risk factor, as a consequence of the August military hostilities along with the global economic crisis, significantly reduced the activity of both banks and their clients, leading to deceleration of the growth rate of total loans over the recent months. The volume of lending in foreign currency increased only by 6.5 million in dollar terms, while the lending in national currency decreased by 133.1 million lari.

It is remarkable that, in terms of maturity, the share of the long-term lending tends to increase, amounting to circa 71.6% in the total volume of lending.

Interest rates on loans in the banking system began to increase during the accounting period, equaling 22.7%. Apparently, the spread between the interest rates on loans and deposits has increased due to the credit risks emerged from the global financial crisis and dampened economic growth.

The lari exchange rate against the USD plummeted from the 1.44 to 1.65 mark in just a few days (November 6-10, 2008). Prior to this, in the period from August 8 through early November, the NBG aimed at avoiding sharp movement of the lari exchange rate against the USD. However, drastic appreciation of the US dollar against other foreign currencies led to the lari appreciation above its natural level. As a consequence, it became necessary to adjust the lari exchange rate. The sharp change in the lari exchange rate has severely undermined the population's sentiment concerning both inflation and overall economic prospects. The rate stability maintained over the subsequent period has relatively tempered the sentiment.

GDP at current prices in QIII 2008 equaled 4793.2 million lari. In nominal terms, this is 6% higher year-on-year. In real terms, GDP decreased by 3.9%.

According to the NBG's projections, negative growth rate of the real GDP will prevail in QIV at approximately -2%.

As of the 2009 forecasts, the growth rate of the real GDP is expected within the range of 2-3%. However, the rate may remain negative in the first six months prior to turning positive in the second half.

As expected, the Russian aggression significantly undermined the country's investment environment, affecting FDIs in the first instance. Investment inflows for QIII 2008 reduced by circa 40%, determining to a great extent the contraction of the real GDP.

Compared to the previous year, in 2008 exports of goods increased by 21.5%, while the imports increased by 20.9%. Consequently, the trade deficit equaled 4806.7 million USD, which is 20.7% higher on annual terms.

Inflation forecasts suggest that the annual inflation will decelerate to reach the rate of 4.3% by the end of QI 2009. The deceleration will continue in QII to bring the

rate to 3.8% by the end of June. As of the average annual inflation, according to the existing estimates the rate will tend to decelerate through H1 2009 to reach 6.3% in June, as opposed to 8.2% in March.

1. CHANGES IN CONSUMER PRICES

The overall level of consumer prices for QIV 2008 moved down by 0.3%, as per the Department of Statistics of the Ministry of Economic Development of Georgia. For QIV 2007 consumer prices were up by 4.5%. Accordingly, annual inflation rate lowered in December

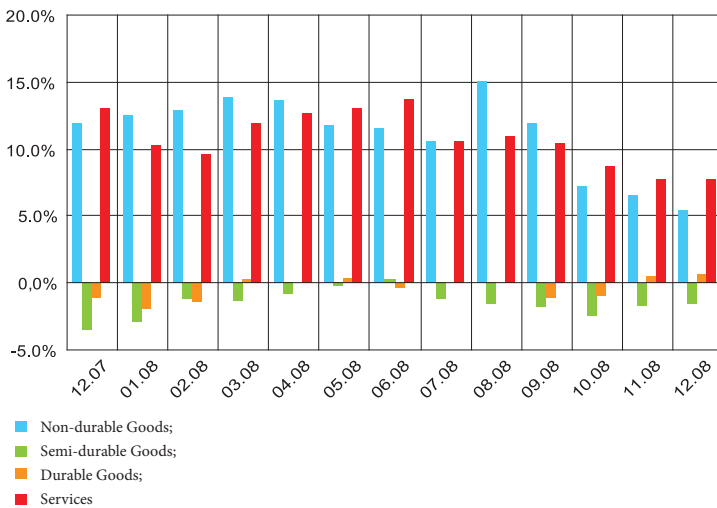
2008 to the mark of 5.5%, as opposed to 10.6% for the previous quarter. Average annual inflation rate for QIV 2008 eased by 0.5% to reach the 10% mark.

Quarterly inflation was largely determined by price decreases in international markets. Prices on gasoline, sunflower oil, and white wheat flour decreased over the accounting period by 30%, 7.8%, and 1.5%, respectively. For these products, the effect of price changes on the inflation equaled -1.3 percentage points. Prices decreased also for certain agricultural products, which advanced in prices during the preceding months. The QIV inflation would have fallen further save for a one-time price hike on medicaments in November. Core inflation rates also decreased in the quarter. In particular, the annual rates for products within the limit of two and one standard deviations equaled 8.1% and 7.1%, respectively; these figures fall within the scope of the NBG's desired targets.

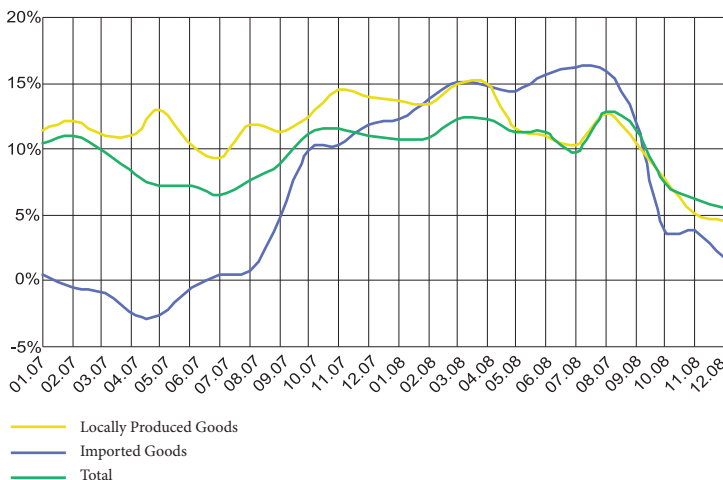
As it was already mentioned, consumption basket prices increased in December by 5.5% year-on-year. Prices for the “clothes” and “alcoholic beverages and tobacco” groups decreased by 2.6% and 0.5%, respectively. The following commodity groups increased in prices as follows: “communications” – 4.4%; “housing, water, electricity, gas and other types of energy” – 3.9%; “household appliances” – 7.4%; “food and non-alcoholic beverages” – 5.5%; and “transport” – 0.5%. Significant price increase is recorded for the “healthcare” group reaching 21.5%, which is largely due to the November hike in prices on medicaments.

Annual inflation rate for imported goods decreased in December to equal 1.8%. The decrease in prices on imported goods is the result of price decreases in the international market. Inflation rate for domestically pro-

GRAPH 1.1
Change in Annual Inflation for Goods by Consumption Durability and Services



GRAPH 1.2
Annual Inflation by Location of Production



1 In addition to intracity bus and subway transportation prices, the average growth of transportation prices is included. These also comprise other means of transport such as intracity taxi, micro bus, and suburban and intercity transport, etc.

duced goods equaled 4.5%. As we can see, Georgia's inflation rate is largely determined by the price dynamics for domestically produced goods.

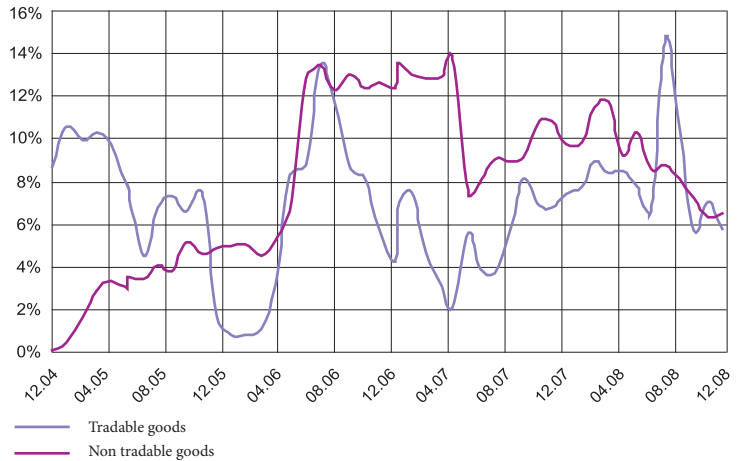
It is noteworthy to look at the dynamics of prices on traded² and non-traded goods. The annual growth rate of prices for non-tradables remained higher than the respective rate for tradables and equaled 6.5% in December. For the tradables, the annual inflation rate equaled 5.7%. Faster price acceleration for tradables as opposed to non-tradables is characteristic for developing countries.

Analysis of goods by consumption durability shows that in December 2008, as compared to the previous month, prices increased by 0.8% for semi-durable goods and decreased by 0.7% and 0.2% for non-durables and durables, respectively. As compared to the corresponding figures for the previous month, prices on services remained unchanged, annual inflation rate for goods by durability is the highest for non-durables to reach 5.4%, and the annual inflation rate for services equaled 7.7%.

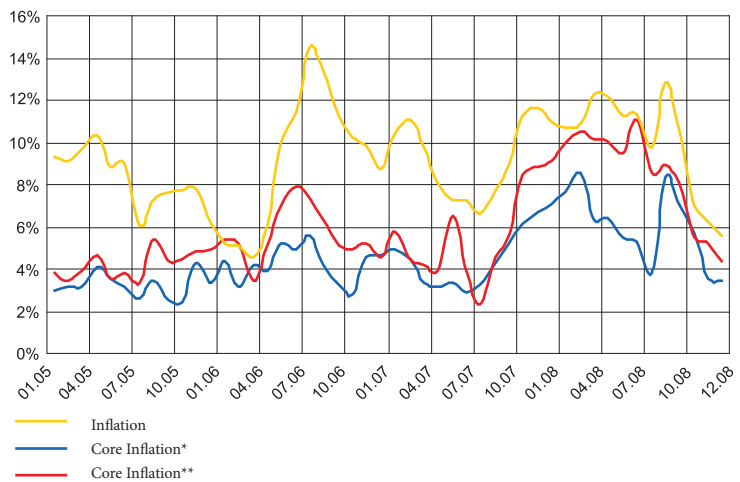
From December 2005 to September 2008, the prices on non-durable goods grew by 30.7%. During the same period the prices on services increased by 29.9%. As for the semi-durable and durable goods, during the same period the prices decreased by 5.2% and 3.4%, respectively.

For the period between December 2005 through December 2008, non-durables and services grew in price by 29.7% and 30.2%, respectively, whereas prices on semi-durables fell by 3.2%.

GRAPH 1.3
Inflation for Traded and Non-Traded Goods

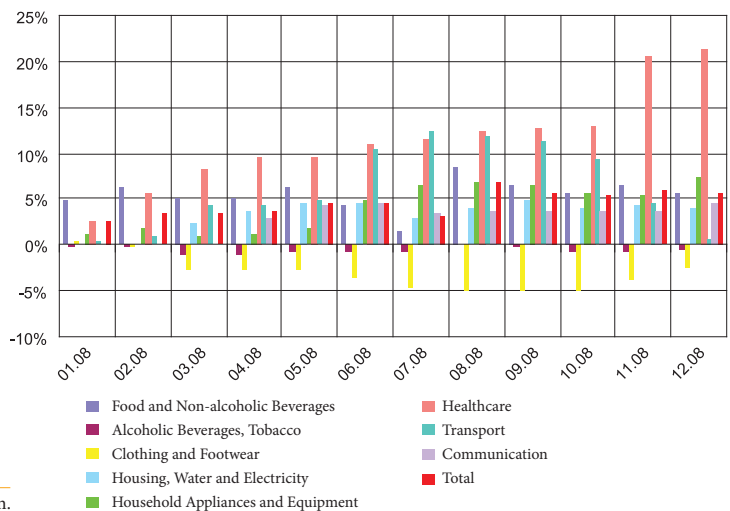


GRAPH 1.4
Annual CPI and Core Inflation (by 282 Components of the Consumption Basket as of Dec. 2006)



* For the products within the limits of one standard deviation.
** For the products within the limits of two standard deviations.

GRAPH 1.5
Price Increases, as Compared to December 2007



² Goods and services, which can be sold at a distance from the production location.

TABLE 1.1
Inflation (CPI) Indicators by Components (%), their Share in the Consumption Basket (%), and Impact on the CPI (%)

	2006 December Weigh	Dec-08/Sep-08		Dec-08/Dec-07		Jan08-Dec08/ Jan07-Dec07	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	-0.3%	-0.3%	5.5%	5.5%	10.0%	10.0%
Food and non-alcoholic beverages	44.3%	-0.9%	-0.4%	5.5%	2.5%	12.2%	5.4%
Food	43.0%	-1.1%	-0.5%	5.4%	2.4%	12.4%	5.4%
Bread and Bakery Products	12.2%	0.4%	0.1%	4.6%	0.7%	21.3%	2.7%
Meat and Meat Products	6.6%	0.0%	0.0%	11.3%	0.7%	10.3%	0.7%
Fish Products	1.1%	4.8%	0.0%	9.9%	0.1%	0.9%	0.0%
Milk, Cheese, Eggs	5.2%	5.8%	0.3%	-2.5%	-0.1%	10.0%	0.5%
Oils and Fats	3.5%	-4.1%	-0.2%	3.0%	0.1%	27.8%	1.0%
Fruits, Grapes	2.3%	5.8%	0.3%	38.4%	1.4%	27.4%	1.1%
Vegetables, Watermelons, Potatoes and Other Solanaceae	8.8%	-11.2%	-0.7%	-5.9%	-0.4%	-6.8%	-0.6%
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7%	1.4%	0.0%	7.5%	0.2%	-1.0%	0.0%
Other Food Products	0.6%	1.9%	0.0%	7.7%	0.0%	5.4%	0.0%
Non-Alcoholic Beverages	1.3%	5.2%	0.1%	8.5%	0.1%	4.6%	0.1%
Alcoholic Beverages, Tobacco	3.7%	-0.1%	0.0%	-0.5%	0.0%	0.0%	0.0%
Clothing and Footwear	5.0%	2.6%	0.1%	-2.6%	-0.1%	-4.1%	-0.2%
Housing, Water, Electricity, Gas, and Other Fuels	10.3%	-0.8%	-0.1%	3.9%	0.4%	9.5%	1.1%
Furniture, Home Appliances and Equipment, Housing Renovation	3.7%	0.9%	0.0%	7.4%	0.3%	12.6%	0.5%
Healthcare	8.0%	7.9%	0.7%	21.5%	1.7%	14.9%	1.2%
Transport	9.0%	-9.6%	-0.9%	0.5%	0.0%	15.4%	1.4%
Communications	4.4%	0.6%	0.0%	4.4%	0.2%	3.9%	0.2%
Recreation, Leisure and Culture	2.7%	1.3%	0.0%	2.0%	0.1%	4.8%	0.1%
Education	3.5%	2.7%	0.1%	-0.4%	0.0%	0.7%	0.0%
Hotels, Cafes, Restaurants	2.4%	2.3%	0.1%	8.4%	0.2%	4.9%	0.1%
Other Goods and Services	3.2%	5.4%	0.2%	8.9%	0.3%	6.8%	0.2%
Non Durable Goods	68.0%	-0.7%	-0.5%	5.4%	3.7%	11.0%	7.5%
Semi-Durable Goods	6.5%	2.1%	0.1%	-1.6%	-0.1%	-1.4%	-0.1%
Durable Goods	1.9%	3.2%	0.0%	0.7%	0.0%	-0.3%	0.0%
Services	23.6%	0.2%	0.1%	7.7%	1.9%	10.6%	2.6%

BOX 1. WORLD CRISIS AND ITS CONSEQUENCES

The world economic crisis reached its peak in September 2008 when financial problems grew evident on the global level.

Causes of the economic crisis are related to the real and financial sectors. During the second half of the 2000's prices were significantly increasing for primary raw materials and food products (this includes oil and agricultural products in the first instance). Oil price hit the all-times high record of 100USD per barrel in early 2008 and continued to the absolute peak of 147.30USD/barrel in June. In the period of 2006 through 2008 world prices increased on average 3.2 times for rice, 2.4 times for wheat, 2.3 times for corn, and 2.1 times for soy. Price gains for oil and food commodities

were interrelated to a certain degree: increasing oil prices created a stimulus to seek for alternative sources of energy with primary emphasis on biological energy. Accordingly, the lack of cultivated areas intended to produce food products resulted in a shortage of such products and, as a consequence, in increase in prices. On the other hand, the US economy, being world's leading economy, encountered such institutional problems and market conditions which led to an unprecedented financial crisis since the Great Recession of the 1930's.

The Gramm-Leach-Bliley Act of 1999 considerably contributed to the deregulation of the US financial system and virtually repealed those provisions of the Glass-Steagall Act,

adopted in the Great Depression period, which differentiated comparably high-risk investment banking activities from low-risk commercial banking. On the other hand, low interest rates, set by the Fed which was chaired by A. Greenspan in the 1990-2000 period, encouraged financial institutions to engage in more profitable (thus, more high-risk) investment transactions, while the regulating bodies were practically unable to react adequately due to the inconsistent institutional framework in place.

In addition, it is noteworthy to mention that banks were unrestrictedly extending mortgage loans, so-called subprime lending, to the households with a blemished credit history. Although the banks were widely applying risk pooling and assets securitization mechanisms, these actions failed to reduce credit risks leading to their significant increase instead. As a general rule, banks were issuing securities for various assets to sell such combined securities to special investment vehicles. By doing so, the banks were moving risk assets off their own balance sheets, distorting the actual picture on the risks side. In the financial market, overtaken by moral hazard and asymmetric information, the above-said disproportions resulted in the collapse of the real estate market, which spread into financial markets of the US and many other economies.

The first signs of financial crisis have already emerged in 2006-2007. However it took the first substantial victim in March 2008, when the investment company Bear Stern was sold to the JP Morgan Chase on exceptional terms. During the same period, the Fed lent to the economy 100 billion USD within a one-week period, which resulted in significant depreciation of the US dollar.

The crisis reached its peak in September 2008, when two of the largest companies of real estate market – the Fannie Mae and the Freddy Mac – were nationalized upon joint efforts of the Fed and the US Treasury. These companies accounted for 50% of the 12 trillion dollar worth real estate market. Several largest investment companies have been sold or granted multi-billion-dollar rescue plans, whereas the Lehman Brothers became bankrupt.

As it was already mentioned, the subprime lending crisis passed onto the financial institutions of other economies and penetrated the real sector of the world economy.

As a result of the world crisis many major economies (USA, EU member countries), as well as the countries with

less developed or transition economies, fell in economic recession, meaning that they had negative growth rate for at least two consecutive quarters. The decreased demand in the USA and the Euro area markets was the main reason of the reduction in production growth rates in “the world factory” China, further aggravating negative tendencies in the global production. It must be noted that, in parallel with these developments, oil prices and Russian stock indices simultaneously dropped 4 times the July levels by the end of 2008.

The prospects of the world economy for 2009 are unclear and less optimistic yet. In the forecasts made in late 2008 by international organizations, the growth rate ranges within 0-1%. According to the International Labor Organization, the employment forecasts suggest that by the end of 2009 the world economy will lose not less than 20 million jobs, the major share of which falls within the “construction, real estate, financial services, and automobile sectors”. Such a forecast for these sectors is directly related to the US mortgage market, as reviewed above, and automobile industry – due to the drop in cars demand two out of the three US car construction giants (the General Motors and the Chrysler) would have become bankrupt if it were not for a multi-billion dollar assistance of the US Government. As for the optimistic forecasts, experts anticipate that the growth rate will turn upwards in H2 2009 to manifest economic revival of the US.

The crisis will essentially affect Georgia in 2009. The receipts from exports will significantly decline against the backdrop of the global decrease in prices on metals, as ferroalloys and ferrous scrap represented the main export items over the recent years. For the banking sector, impaired external borrowing conditions and reduced FDI inflows may involve the reduction in bank lending volumes and, thereby, diminish the role of the financial sector as a powerful contributor to economic growth. Construction sector, being already in a detrimental state, will face further problems, to a large part due to difficult conditions in the financial sector.

Along with the detrimental consequences of the August 2008 war, the global economic crisis will affect virtually all economic sectors of Georgia. GDP growth rate that went negative in QIII 2008 will continue decreasing over the first two quarters of 2009, whereas the positive reversal of the growth rate is expected to start in QIII 2009.

2. INFLATION FACTORS

2.1 LABOR PRODUCTIVITY, WAGES

The year of 2008 was earmarked by significant growth in average wages, as compared to 2007. Namely, in QIII 2008 the average monthly wages per employee in the official economy increased to 560.0 lari¹, which is 45.4% higher than for the same period of 2007. The growth in the average monthly wages per employee was observable in all major sectors of the economy. Based on the sectoral analysis, the highest growth rate was achieved in the agriculture, hunting, and forestry sector, in which the average monthly wages of employees increased by 61.7% in QIII 2008, as compared to the same period of the previous year. It is remarkable that wages significantly increased in those sectors, which are largely financed by the state budget. Compared to the same period of the previous year, average wages in the “education” and “healthcare and social assistance” sectors increased by 89.2% and 60.6%, respectively, while the increase in wages for the communal, social and personal services equaled 46.6%. Remuneration of employees particu-

larly increased in the spheres of public administration (48.3%), trade (46.2%), and manufacturing industry (42.0%). The lowest positive growth rate in average monthly wages was recorded for the hotels and restaurants (19.3%) and construction (4.1%) sectors.

Significant differences in the average wages by sectors still remained in QIII 2008. The highest monthly average wages were registered for the sectors of financial intermediation (1245.9 lari) and mining and quarrying (924.6 lari), exceeding 2.2 and 1.7 times the monthly average for the whole economy, respectively. The lowest monthly average wages were registered in the sectors of fish catching and fishing (166.3 lari) and education (267.8 lari), equaling 29.7% and 47.8% of the monthly average wages for the whole economy, respectively. Wages that stand below the monthly average for the whole economy were mainly registered in those sectors, which are largely financed by the state budget (education, healthcare and social assistance, and communal, social and personal services) but there is a remarkable wage growth tendency, as mentioned above.

In QIII 2008 the growth rate of real value-added per employee decreased by 5.9% year-on-year. Particular decrease was registered for the sectors of other services (56.0%), construction (37.6%), transport and communications (19.8%), and financial intermediation (14.9%). For the sectors of public administration and defense, manufacturing, and agriculture, the decline was comparatively slower. Notwithstanding the overall trend going down, the real value-added per employee for some sectors of the economy recorded a positive annual growth rate. Labor productivity significantly increased for the sectors of real estate operations, leasing and commercial activity (68.1%) and education (33.5%). For the sec-

Table 2.1
Nominal Monthly Average Wages of Employees, QIII 2008, compared to QIII 2007, (%)

	Nominal Wages
Agriculture, Hunting and Forestry	161.7
Fish Catching and Fishery	124.7
Mining and Quarrying	138.4
Manufacturing Industry	142.0
Production and Distribution of Electricity, Gas and Water	135.2
Construction	104.1
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption Restaurants and Hotels	146.2
Transport and Communications	119.3
Financial Intermediation	137.9
Real Estate Operations, Leasing, Consumer Services	124.5
Public Administration	143.6
Education	148.3
Health Care and Social Assistance	189.2
Communal, Social and Personal Services	160.6
Total	146.6
	145.4

¹ Source: data from the current production and labor statistics.

tors of restaurants and hotels, healthcare, and trade the growth rate of real value-added per employee equaled 21.0%, 17.1%, and 5.1%, respectively.

The decrease in labor productivity, being indicative of the supply contraction, represents by itself an important pro-inflationary factor. At the same time, the increase in wages, that took place over the accounting period, created an even deeper gap between supply and demand, and thereby contributed to accelerating high inflation rate. Notwithstanding these factors, the annual inflation rate for the quarter essentially decreased owing to other factors of demand and supply.

2.2 MONETARY AGGREGATES

In QIV 2008 the reserve money decreased by 302.6 million lari (17.4%) to total 1431.9 million by the end of December. In terms of the monthly average, the reserve money in December decreased by 241.3 million lari (15.1%), as compared to September, whereas in terms of annual figures, the monetary base contracted by 4.5%

In QIV the NBG was committed to reduce the monetary base by means of monetary interventions at the TIBFEX. The foreign currency demand sharply exceeded the supply at the TIBFEX and the net demand equaled 637.7 million USD. Net sales by the NBG amounted to USD 557.8 million (circa 922.0 million lari) owing to the current foreign exchange conditions and the depreciation of lari (from 1.406 GEL/USD to 1.668 GEL/USD). In addition, as a result of currency conversions by the government, the net purchases by the NBG amounted to USD 571 million (circa 886 million lari).

Government deposits increased in QIV by 502.7 million lari and, according to the preliminary December data, stood at 880.0 million lari. To a certain degree, such an increase was favored by the receipt of donor aid

Taking into account the forecasts for fundamental factors determining the country's economy, continuing

Graph 2.1
Nominal Monthly Average Wages of Employees by Sector, QIII 2008

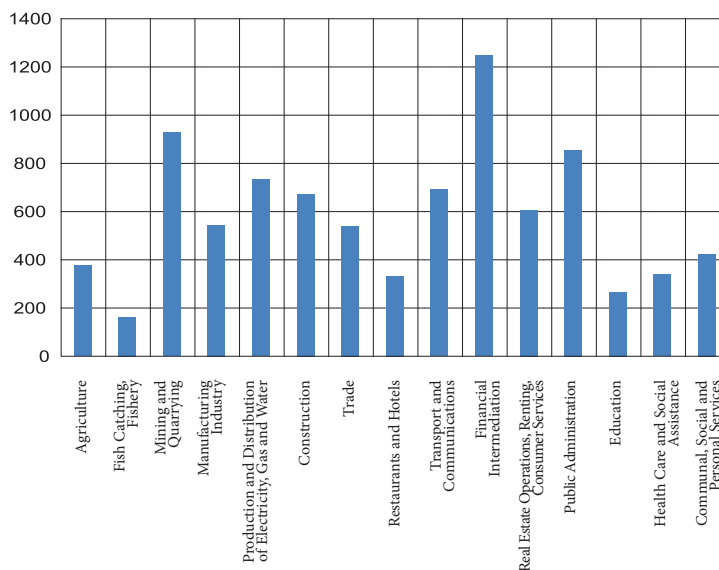


Table 2.2
Real Value Added per Employee, QIII 2008, compared to QIII 2007 (%)

	Real Value Added
Agriculture	94.4
Manufacturing	91.1
Construction	62.4
Trade	105.1
Hotels and Restaurants	121.0
Transport, Communications	80.2
Financial Intermediation	85.1
Real estate Operations, Leasing and Commercial Activity	168.1
Public Administration, Defense	87.9
Education	133.5
Healthcare	117.1
Other Services	44.0
Total	94.1

downside trend for global prices on staple goods, and low growth rate for monetary aggregates, the NBG made a decision to loosen its monetary policy. In line with this decision, the monetary policy rate (refinancing rate) was reduced to 9%, followed by a subsequent reduction to an annual 8% in December.

During the accounting quarter the NBG continued issuance of the Certificates of Deposits to assist commercial banks in improving liquidity management. For the latest three months, the placement of the CDs equa-

led 97.5 million lari in nominal value, while the repayment volumes amounted to 200.9 million lari. By the end of December the volume of the CDs in circulation reduced from 143.0 to 77.4 million lari.

Commercial banks were actively using the refinancing loans facility over the period; the outstanding balance of loans extended by means of this instrument totaled 53.5 million lari at the end of December. Volumes of net liabilities of commercial banks increased to amount to 132.0 million lari as opposed to -17.6 million as at the end of September.

As a result of the above-mentioned monetary flows, the monetary base contracted over the accounting quarter by 302.6 million lari, of which 108.5 million falls on the reduction in cash in circulation (totaling 1290.7 million lari). The volume of balances on the lari corresponding accounts of commercial banks in the NBG decreased by 194.1 million lari to equal 141.2 million.

2.2.1 Broad Money

The M3 aggregate in QIV 2008 expanded by 292.7 million lari to total 4258.4 million lari. The foreign currency denominated deposits increased by 696.0 million

lari to equal 2404.2 million lari by the end of December. Deposits denominated in the national currency decreased by 289.4 million lari to equal 771.6 million lari by the end of the period.

In the accounting quarter, the M2 aggregate reduced by 17.9% (403.3 million lari), due to the contraction of domestic currency in circulation and the reduction in volumes of lari-denominated deposit liabilities.

By the end of December, the annual growth rates of broad money aggregates, M3 and M2, stood at 7% and -13%, respectively.

2.3. MONETARY INSTRUMENTS

The Russian aggression and the global financial crisis substantially affected activities of both the NBG and the commercial banks. In order to provide commercial banks with sufficient liquidity, following the concession measures initiated in August-September, the NBG set the reserve requirement at 5% for the reserve observance periods commencing October 2. The banks, on their part, tried to maintain significant liquidity reserves and tightened their lending terms. As of December 31, 2008, the volume of lending denominated in domestic

Table 2.2.1
Reserve Money Dynamics (2008, Average Month Data)

	01.08	02.08	03.08	04.08	05.08	06.08	07.08	08.08	09.08	10.08	11.08	12.08
Reserve Money	1,338,939	1,392,331	1,413,540	1,522,132	1,508,768	1,600,239	1,672,181	1,536,234	1,734,450	1,572,483	1,341,737	1,431,893
Cash in Circulation	1,184,525	1,225,042	1,287,123	1,391,544	1,348,253	1,413,237	1,468,171	1,439,132	1,399,208	1,350,739	1,248,192	1,290,703
Deposits of Banks	154,414	167,289	126,418	130,588	160,515	187,002	204,010	97,102	335,242	221,744	93,545	141,190
Balances on Corresponding Accounts	154,355	167,231	126,359	130,529	160,456	187,002	204,010	97,102	335,242	221,744	93,545	141,190

Table 2.2.2
Reserve Money Dynamics (2008 end-Month Data)

	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08
Reserve Money	1,420,749	1,413,282	1,447,780	1,533,334	1,572,458	1,572,458	1,618,715	1,605,961	1,595,511	1,649,505	1,418,689	1,354,180
Cash in Circulation	1,217,136	1,199,674	1,244,064	1,334,405	1,360,751	1,360,751	1,402,286	1,470,569	1,408,946	1,369,555	1,268,806	1,226,474
Deposits of Banks	203,613	213,607	203,716	198,929	211,707	211,707	216,429	135,392	186,565	279,950	149,883	127,706
Balances on Corresponding Accounts	203,473	213,548	203,657	198,870	211,654	211,654	216,405	135,392	186,565	279,950	149,883	127,706

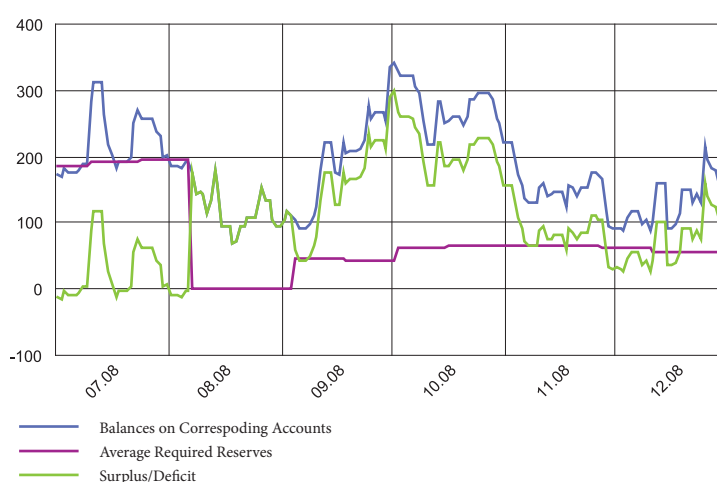
Table 2.2.1.1
Monthly Changes in Monetary Aggregates (2008, end-Month Data)

	01.08	02.08	03.08	04.08	05.08	06.08	07.08	08.08	09.08	10.08	11.08	12.08
Broad Money /M3/	3,981,686	3,951,402	4,026,932	4,278,872	4,155,079	4,187,900	4,321,265	3,887,149	3,965,657	3,886,103	3,907,277	4,258,362
Money Mass /M2/	2,018,547	2,071,878	2,258,946	2,358,767	2,316,461	2,417,078	2,507,358	2,269,819	2,257,449	2,170,136	1,907,526	1,854,131
Cash Outside of Banks	1,038,612	1,072,474	1,122,923	1,219,459	1,186,454	1,235,407	1,290,945	1,245,779	1,196,489	1,154,045	1,059,340	1,082,554
lari in Circulation	1,184,525	1,225,042	1,287,123	1,391,544	1,348,253	1,413,237	1,468,171	1,439,132	1,399,208	1,350,739	1,248,192	1,290,703
Deposits in National Currency	979,935	999,404	1,136,024	1,139,308	1,130,008	1,181,671	1,216,413	1,024,040	1,060,961	1,016,091	848,186	771,577
Deposits in Foreign Currency	1,963,139	1,879,524	1,767,985	1,920,106	1,838,618	1,770,822	1,813,907	1,617,331	1,708,208	1,715,967	1,999,751	2,404,231

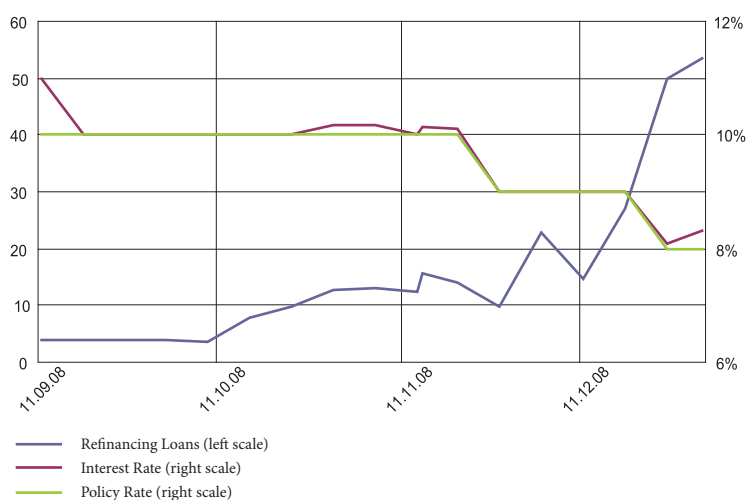
currency amounted to GEL 1633.4 million, as opposed to 1797.4 million as of September 30, 2008. The annual growth rate of total lending extended to economy equaled 30.8% as of the end of December, whereas the lending rate on domestic currency stood at 13.4%. The corresponding parameters as of September 30, 2008, totaled 36.4% and 69.9%, respectively. Overall, the liquidity of the banking system was maintained at sufficient levels.

In QIV 2008 the main objective of the NBG's monetary policy was to provide the banking system with liquidity funds, similar to the previous quarter. Moreover, the policy was loosened as the business risks increased and the economy, including bank activity, continued to slacken. In early September a new policy instrument was introduced – refinancing loans. In the period commencing September 11 through November 26, the policy rate stood at 10%. The NBG subsequently reduced the rate to 9% on November 27 and then to 8% on December 8. As the inflation weakened in pace but the economic slump continued, in QIV the NBG aimed at maintaining price stability (avoiding sharp deflation) and, at the same time, tried to support activities in the financial sector and the economy as a whole. The total volume of refinancing loans (with 7-day maturity) borrowed by banks over QIV amounted to GEL 270.7 million, whereas the same parameter for QIII (in September) equaled GEL 11.6 million. The largest share of refinancing loans was issued in December, amounting to GEL 168 million at an 8.5% weighted average annual interest rate. As of November and October, the volumes

GRAPH 2.3.1
Balances on lari Corresponding Accounts of Banks, Average Required Reserves, and Liquidity Surplus/Deficit. (Million GEL)



GRAPH 2.3.2
Refinancing Loans, Their Weighted Average Interest Rate, and the Policy Rate, QIV 2008. (Million GEL)



of refinancing loans equaled GEL 64.9 million and GEL 37.7 million, at 9.9% and 10.1% weighted average annual interest rates, respectively. The auction rates on refinancing loans show a strong correlation with the policy rate, either equaling or slightly exceeding the latter.

The volume of the NBG’s overnight loans dropped in QIV, despite the fact that the interest rate thereon was reduced from 20% to 13%. Overall, the quarterly volume of these loans totaled GEL 19 million against GEL 41.5 million in QIII.

In QIV commercial banks had sufficient liquidity to meet their current needs, and hence, they preferred to use lower-cost refinancing loans rather than higher-cost overnight loans and lending of last resort facility.

In order to help commercial banks to improve the liquidity management, the NBG continued issuance of the three-month Certificates of Deposits (CDs). The highest interest rate on these CDs remained at 13%. Overall, the volume of the CDs placement in QIV totaled GEL 93,1 million at 11.9% weighted average annual interest rate, of which GEL 75 million was placed in October at 11.7% weighted average. The November depreciation of the lari led to reduction in idle domestic currency assets of the banks, and hence, in the demand on the CDs. As a result, the CDs placement for Novem-

ber through December totaled only GEL 18.1 million at 12.9% weighted average annual interest rate. In the same QIV 3-month CDs of GEL 160.9 million worth were repaid. In the accounting period the total amount of liquidity absorbed by means of this instrument from the money market amounted to 1761.7 million lari. The total volume of liquidity absorption by means of the CDs amounted to GEL 143 million as of September 30, whereas the net absorption equaled only GEL 17.6 million, which represents 1% of reserve money (the difference between the total and net absorptions is GEL 125.5 million in the form of loans extended by the NBG to commercial banks). As of December 31, the total absorption amounted to GEL 77.4 million, whereas the net absorption turned negative (including GEL 209.4 million in the form of NBG loans to commercial banks). In total, this resulted in the liquidity supply of GEL 132.1 million. The liquidity absorption equaled 9.2% of the reserve money.

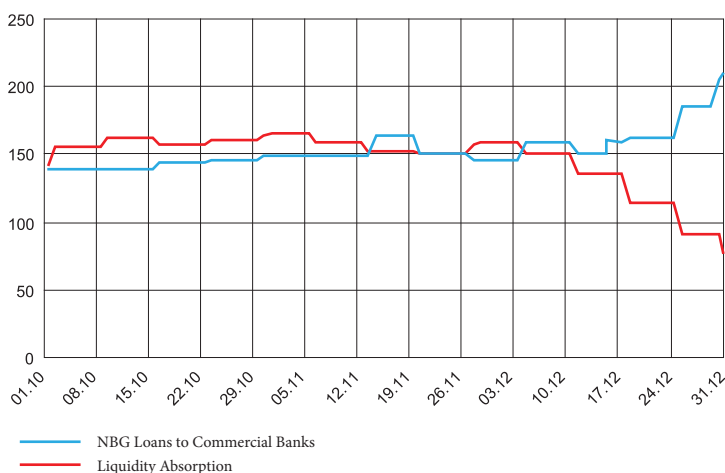
2.4. INTERBANK MARKET

Based on the QIV 2008 data obtained from commercial banks, the total volume of interbank market loans denominated in domestic currency reduced to GEL 1380.4 million, as opposed to GEL 1547 million and GEL 2964 million for QIII and QII, respectively.

In comparison with the previous quarter, there was a sharp reduction in volumes of the euro denominated deals (from EUR 2318 million to EUR 247.8 million), and an increase in volumes of the US dollar denominated deals (from USD 498 million to USD 532.7 million). As of QII, the volumes equaled EUR 2162 million and USD 579 million, respectively.

Short-term deals continued to dominate the interbank market. For instance, the lari-denominated loans with under 7-day maturity accounted for 92.7% in the total volume of loans, while the share of overnight loans stood at 84.1%. A similar observation applies to the loans issued in the U.S. dollars and the euro, the shares

GRAPH 2.3.3
Liquidity Absorption/Supply, QIV 2008. (Million GEL)



of which stand at 82.6 % and 72.6%, respectively (for overnight loans).

During the quarter under review, the interest rates on the lari-denominated loans in the interbank market decreased, compared to QIII. Namely, in October-December the weighted average annual interest rate on the lari-denominated overnight loans equaled 6.4%, as opposed to 9% in QIII and 13.4% in QII. In addition, the weighted average annual interest rate on the 7-day loans denominated in lari equaled 11.2% in QIV, whereas the same parameters for QIII and QII stood at 13.5% and 15.2%, respectively.

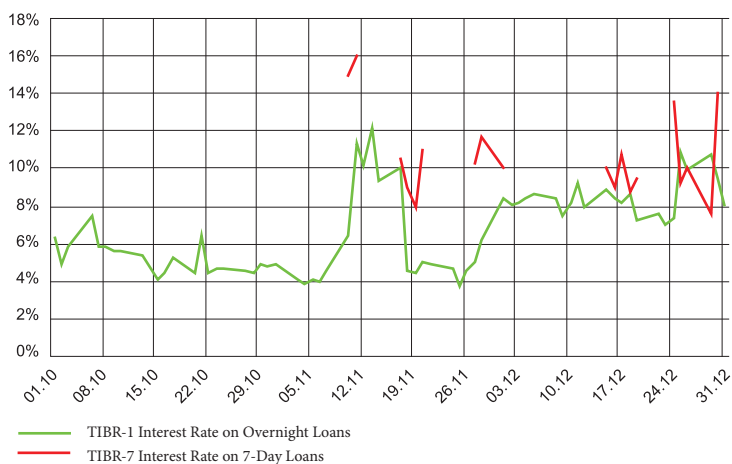
The TIBR-1 and TIBR-7¹ indices clearly demonstrate the changes in interbank interest rates. The deals for the overnight interbank loans were concluded each day, whereas the deals for 2-7 day loans were absent on some days, particularly in October. The depreciation of the lari in November was followed by an increase in the TIBR-1 and TIBR-2, which can be explained by the fact that commercial banks have converted their lari-denominated assets into foreign currency, and thereby, contributed to the increase in the interbank interest rates, due to the lari shortage. However, the TIBR indices settled back to the earlier levels soon.

The interest rates on the 7-day interbank loans and the monetary policy rate demonstrate strong correlation in the majority of cases. But on some occasions there were significant spreads between them, which can be explained by the scarcity of deals and lack of participants in the interbank market. Frequently, there was at most one deal concluded during a day.

2.5. BANKING SECTOR

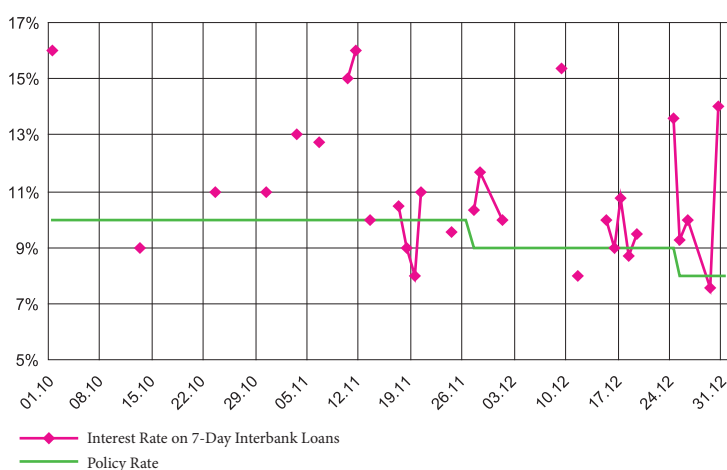
In QIV 2008 deposit liabilities of the banking system increased by 406.6 million lari (14.7%) to total 3175.8 million lari. This was solely due to the increase in foreign currency denominated deposits.

GRAPH 2.4.1
Tbilisi Interbank Rates on Short-Term lari-Denominated Loans*, QIV 2008



*Note: empty curve segments correspond to the banking days on which there were no deals for the given loans

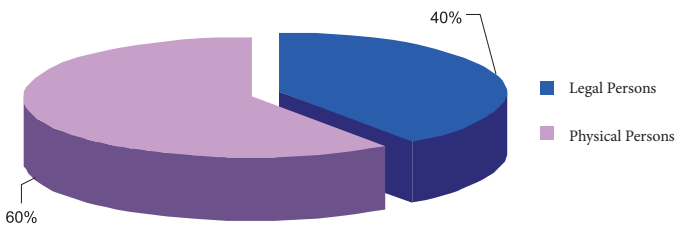
GRAPH 2.4.2
Interest Rate on 7-Day Interbank Loans and the Policy Rate, QIV 2008.



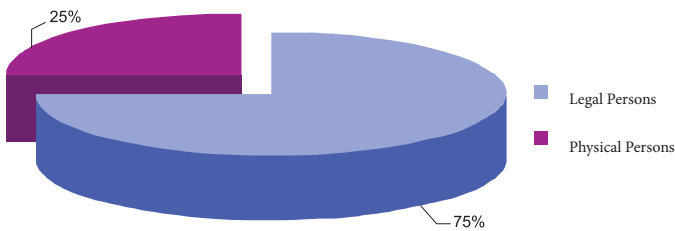
Foreign currency denominated deposits increased by 696.0 million lari to equal 2404.2 million. In dollar terms, the volume of these deposits increased by USD 226.4 million. It is remarkable that the increase was evident for both current and term deposits. In particular, current accounts in foreign currency increased by USD 125.3 million (35.0%) and term deposits increased by USD 101.1 million (11.8%). In addition, significant increase was registered for the foreign currency depo-

¹ The TIBR1 index comprises non-secured loans with a maturity of 1 transaction day. The TIBR7 index comprises all non-secured loans with a maturity of up to 7 days which are not included in TIBR1.

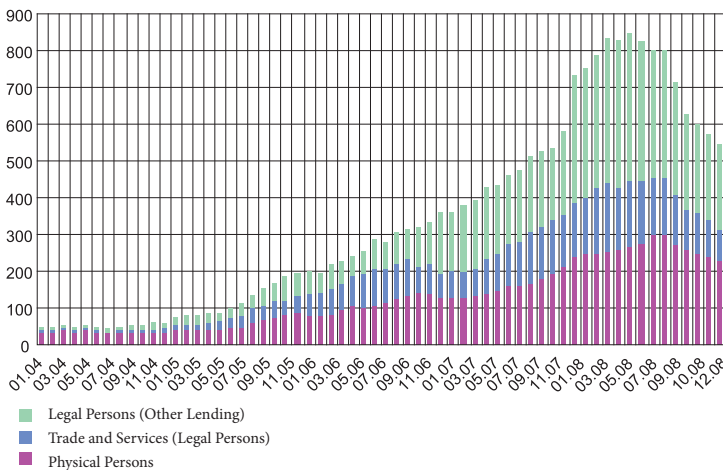
GRAPH 2.5.1
Foreign Currency Denominated Deposits



GRAPH 2.5.2
Domestic Currency Denominated Deposits



GRAPH 2.5.3
Short-Term Loans Denominated in Domestic Currency (million GEL)



sits of physical persons – these increased by USD 147.1 million (20.4%).

Domestic currency denominated deposits dropped by 289.4 million lari (27.3%) to total 771.6 million lari in the accounting period. The reduction was registered for both current accounts and term deposits. Furthermore, the reduction in domestic currency denominated deposits was largely due to shrinking deposits of legal persons, the volume of which fell by 226.7 million lari to equal 577.9 million lari.

Factoring in the growth rates for the deposits denominated in both foreign and domestic currency, the deposit dollarization ratio increased in December 2008 by 14.0 percentage points to reach 75.7% by the end of the month.

Deposits interest rates increased by 0.2 percentage points in the quarter. The weighted average annual interest rate on the lari-denominated deposits at commercial banks declined by 0.1 percentage point against September to equal 11.2%. As of the foreign currency denominated deposits, the interest rate thereon was down by 0.1%, as compared to September, to 9.2%. For the foreign currency denominated deposits of physical persons, the interest rate increased by 0.4 percentage points to equal 9.0%. Compared to December 2007, interest rates decreased for the foreign currency deposits by 0.9 percentage points and increased for the domestic currency deposits by 1.0 percentage point.

The increase in the risk factor, as a consequence of the August military hostilities, significantly reduced the activity of both banks and their clients, leading to deceleration of the growth rate of the total volume of loans over the recent months. In QIV 2008 the volume of loans extended by commercial banks to the economy grew by 568.8 million lari (10.3%) to total 6072.4 million lari. It must be noted however, that while the loans denominated in domestic currency reduced, the actual growth of loans denominated in foreign currency was insignificant, taking into account the exchange rate changes on the banks' balance sheet.

The loans denominated in foreign currency increased by 701.9 million lari to total 4408.1 million. However, in dollar terms, this parameter increased only by USD 6.5 million (0.2%) to equal USD 2644.3 million at the end of the accounting quarter. 64.2% of this type of loans was extended to legal persons, and long-term lending accounted for 76.7% of the total loans. In the accounting period foreign currency denominated loans to legal persons increased, while physical persons' crediting dropped.

Loans denominated in domestic currency fell by 133.1 million lari (7.4%) to amount to 1664.3 million. In the accounting period 46.7% of this type of loans was extended to legal persons, while 65.1% represented long-term lending.

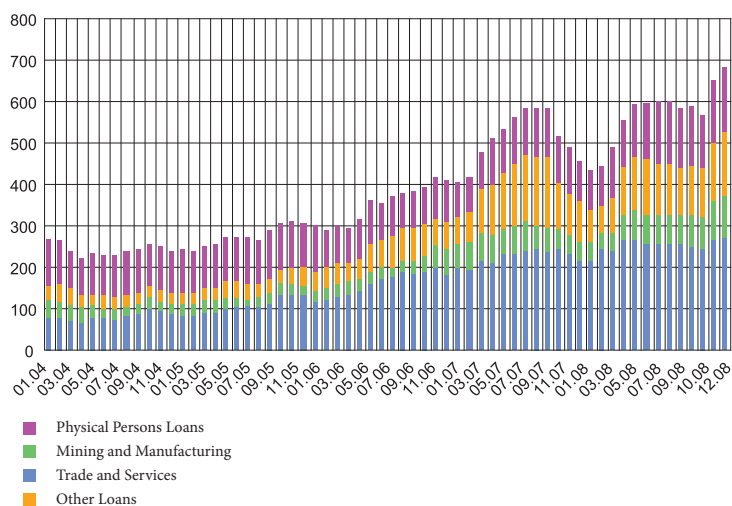
It is remarkable that the volume of long-term loans extended by commercial banks has increased by 11.9%. In addition to that, the share of such loans in the total volume of loans extended to the economy has increased, standing at circa 71.6%.

Overdue loans in QIV 2008 grew by 1.9 million lari (1.2%) to total 159.2 million lari. The share of overdue loans increased quarter-on-quarter equaling 2.6%.

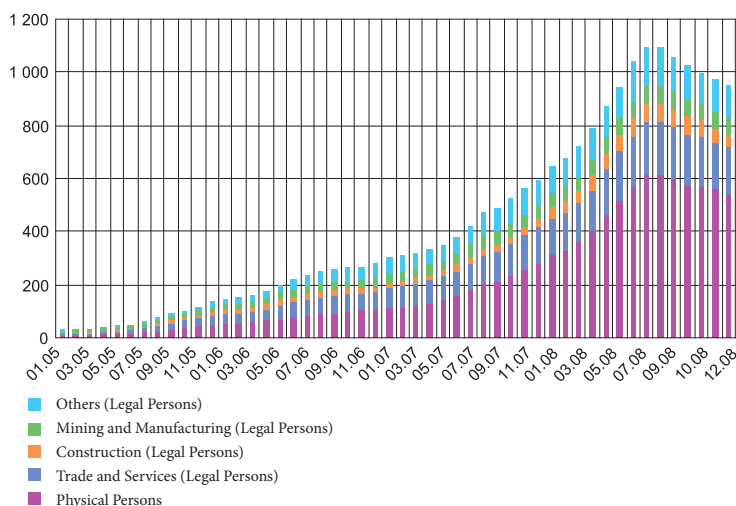
In QIV 2008 the interest rates in the banking system reversed upward to 22.7%. In particular, the weighted average annual interest rate on domestic currency loans equaled 24.1%. In the same period, the same parameter for the foreign currency decreased by 0.3 percentage points to 21.9%. The annual interest rate on foreign currency loans extended to legal persons was around 18.6%. Compared to December 2007, interest rates on foreign and domestic currency loans increased by 3.1 and 3.5 percentage points, respectively.

The negative values of the returns on assets (ROA) and returns on equity (ROE) increased over the accounting quarter. As of December 31, 2008, the return on assets ratio equaled -2.6%, whereas the return on equity ratio stood at -12.6%.

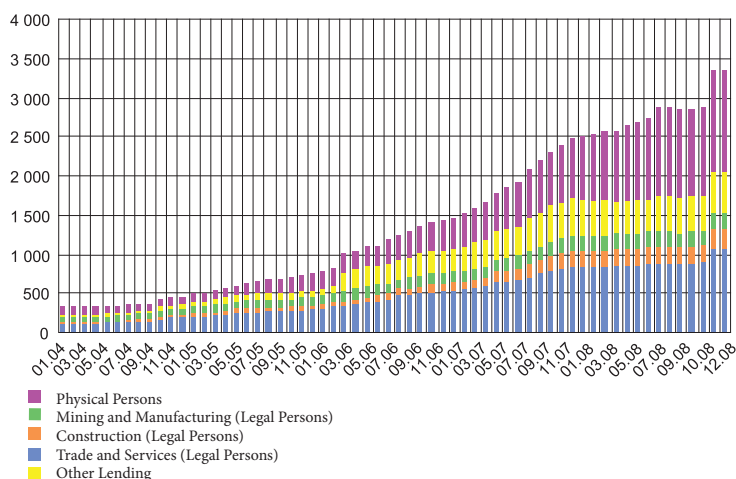
GRAPH. 2.5.4
Short-Term Loans Denominated in Foreign Currency (million lari)



GRAPH 2.5.5
Long-Term Loans Denominated in Domestic Currency (million lari)



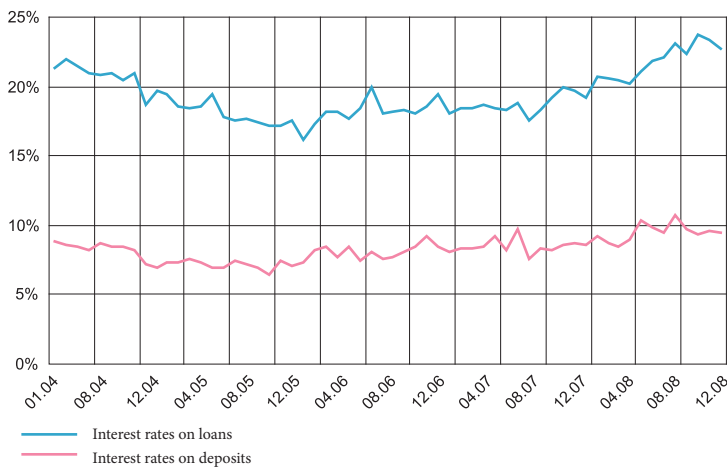
GRAPH 2.5.6
Long-Term Loans Denominated in Foreign Currency (million lari)



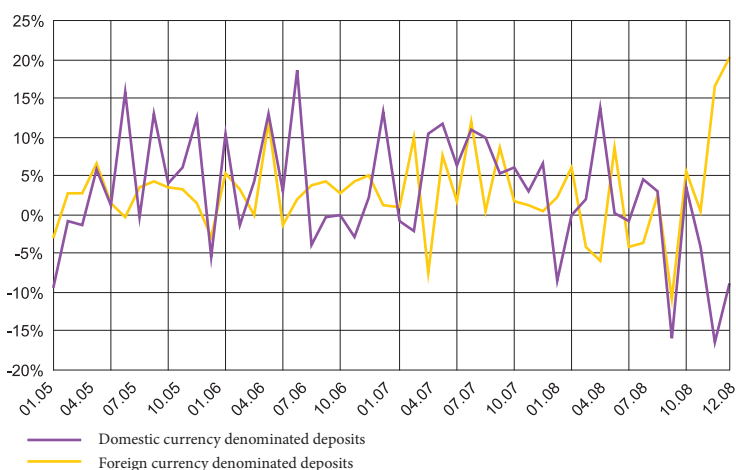
GRAPH 2.5.7
Overdue Loans (million lari)



GRAPH 2.5.8
Interest Rates on Loans and Deposits



GRAPH 2.5.9
Deposit Growth Rates (Month-on-Month Changes)



2.6 EXCHANGE RATE FACTORS

The main objective of the National Bank of Georgia is to ensure price stability. Accordingly, in order to secure exchange rate stability, the NBG intervenes on both sides at the TIBFEX within the limits consistent with the NBG’s main objective.

The exchange rate is determined by demand and supply of foreign currency. Foreign capital inflows represent one of the most important factors affecting supply. Subsequently, it is critical to analyze the determinants of the investment inflows and compare them with the corresponding parameters of other countries. In particular, these determinants include market interest rates and the growth rate of the economy.

The interest rates hikes on both loans and deposits in the banking system, represents an immediate consequence of the August war and the global financial crisis.

Owing to the global financial crisis, central banks of the developed countries spared no efforts to stimulate their economies to the highest extent possible, which led to a substantial reduction of the interbank interest rate (for instance, by the end of 2008, the rates in the US, the EU, and the UK were down to 0.5%, 2.0%, and 3.1%, respectively).

The main determinant of foreign investment inflows is the country’s economic growth, which along with high interest rates, preconditions high returns on investments.

In H1 2008 Georgia maintained one of the highest growth rates among other developing countries. However, the situation changed dramatically after the Russian aggression in August. In particular, in QIII 2008 GDP dropped by 3.9% year-on-year.

FDIs represent one of the most important factors determining sustainable economic growth of developing nations. Georgia’s FDI inflows were significantly increasing over the recent years, in parallel with the high economic growth. In H1 2008 the volumes the-

reof reached USD 1 billion, which is 36% higher year-on-year. Needless to say, the August war not only impeded Georgia's economic growth, but it also adversely impacted the country's investment climate. As a result, the volume of FDIs in QIII 2008 equaled USD 150 million, while the QIV forecasts suggest the figure of USD 184 million.

A greater inflow of foreign capital implied a greater supply of foreign currency in the domestic market, which in turn contributes to the domestic currency appreciation. Opposite to the foreign capital inflow, current account deficit increases demand for foreign capital, thus, leading to depreciation of the domestic currency. Georgia's current account has been negative for years, and the deficit continues widening each year.

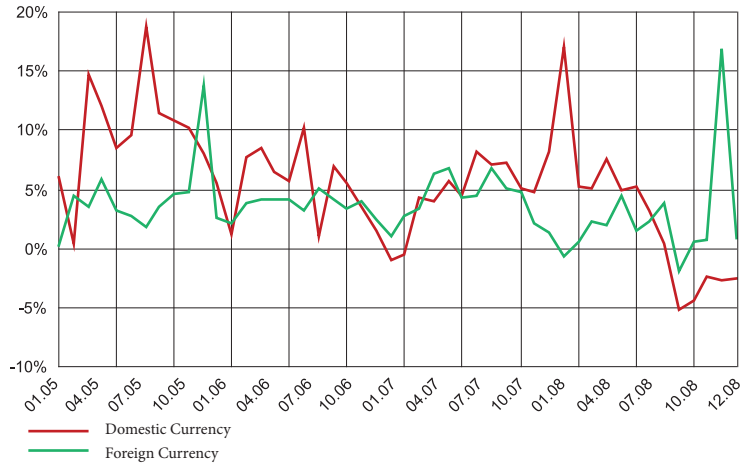
Current account deficit exceeded USD 2.3 billion over the first three quarters of 2008, which is almost 100% larger than the deficit for the previous year.

The current account deficit in QI 2008 widened to approximately 30% of the GDP, compared to the 5% level in 2004. According to the 2008 9-month data, the deficit equaled 24% of the GDP. Such a perpetual worsening is largely due to the foreign trade deficit caused by a much faster pace of imports as opposed to the exports.

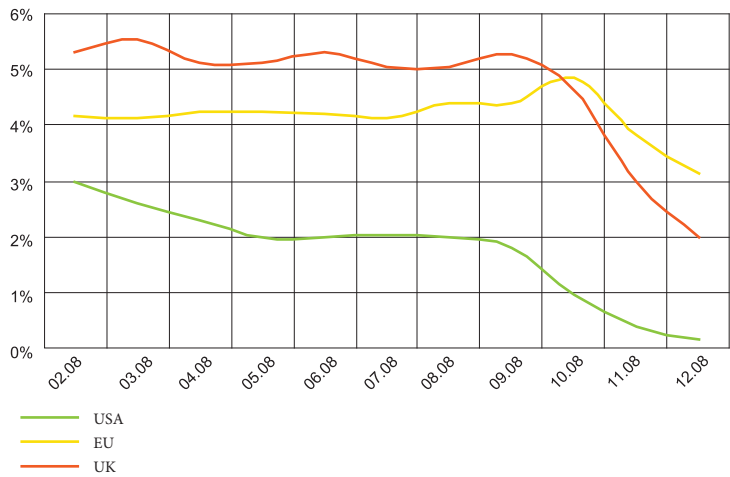
The negative tendency in the current account exerts a depreciation pressure on the lari exchange rate. The volume of capital inflows that existed before August was overweighting the adverse effect of the current account, and hence, the domestic currency was steadily appreciating at the time. However, the subsequent drastic reduction in FDIs, as followed after the August war, impaired the existing trend, and lari depreciated against the backdrop of excessive demand for foreign currency.

Over a period of several years the NBG was intervening at the TIBFEX on the side of foreign currency purchases, in the majority of cases. In QIII 2008 there emerged an excessive demand for foreign currency and, accordingly, the NBG began intervening at the TIBFEX on the side of domestic currency purchases.

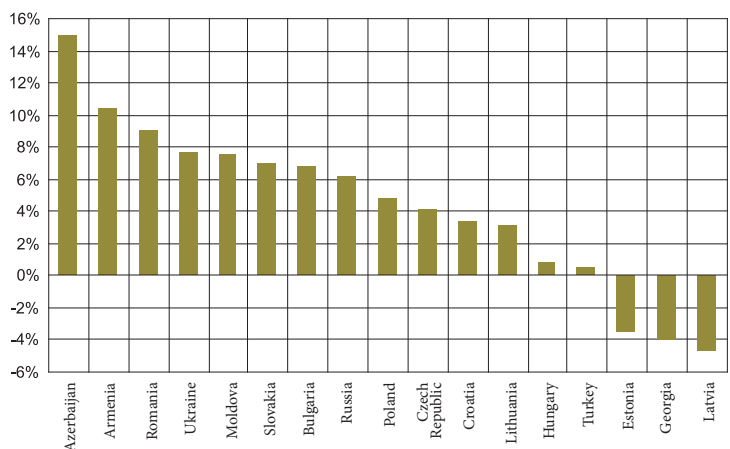
GRAPH 2.5.10
Loan Growth Rates (Compared to Previous Month)



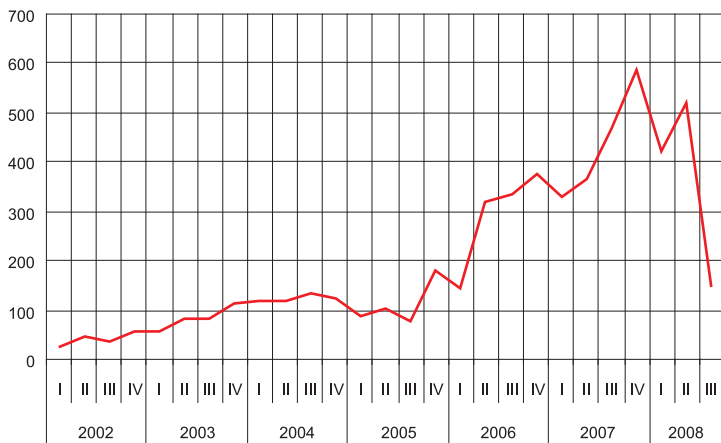
GRAPH 2.6.1
Interbank Interest Rates (monthly average)



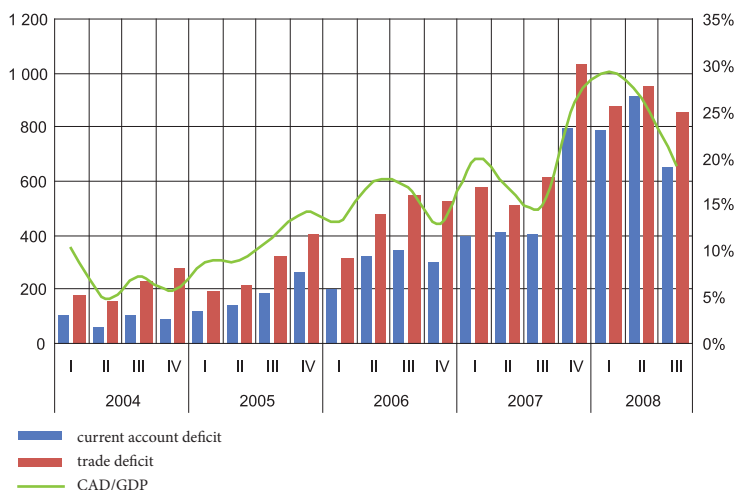
GRAPH 2.6.2
Real GDP Growth, the CIS and the CEE Countries, QIII 2008



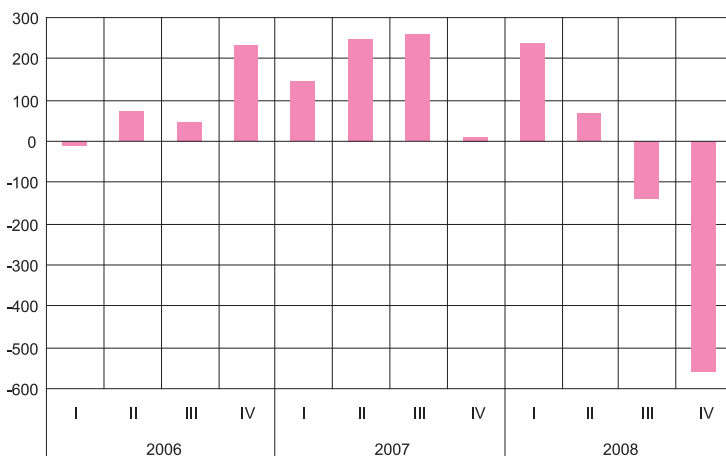
GRAPH 2.6.3
Foreign Direct Investments Inflow in Georgia (million USD)



GRAPH 2.6.4
CAD-to-GDP Ratio (million USD)



GRAPH 2.6.5
Net Purchases of the NBG at the TIBFEX (millions USD)



In the period from August through November the NBG's interventions at the TIBFEX were aimed at maintaining stability of the lari exchange rate against the USD. In November it became necessary to undertake a one-time adjustment of the exchange rate (see Box 3 for details). Notwithstanding the November depreciation of lari, the real exchange rate in 2008 appreciated with respect to almost all foreign currencies: for instance, against the Euro (5.48%), the Russian Ruble (2.62%), and the Turkish Lira (19.59%). Against the US dollar, the lari real exchange rate depreciated by an insignificant amount (0.55%).

Ultimately, the real effective exchange rate of lari in 2008 appreciated by 7.29%.

BOX 2. EXCHANGE RATE REGIMES

Throughout the history of existence of an exchange rate there continue perpetual debates as to which exchange regime is the “best”. However, none of the existing regimes can be chosen as the only effective for all economies. Furthermore, there is no exchange rate regime which is permanently optimal for a given economy. In making the optimal choice each country should proceed from the specifics of its own economy and the world architecture, analyzing various crucial factors over definite time horizon.

What are the advantages and disadvantages of each of the exchange regimes?

The fixed exchange rate regime helps to form expectations of stability, in what follows, the importers and exporters will not be apprehensive about the exchange rate fluctuations, and hence, can conduct their activities in a less risky environment. This regime also facilitates price stability, but is not capable of protecting economy from speculative attacks, and, in the event of excessive demand for foreign currency, may fail to avoid a financial crisis. When the exchange rate is not adaptive to changes in economic environment, the economy may develop not as effectively as it would in case of the exchange rate that reflects the actual state of matters.

The floating exchange rate regime enables a country to conduct an independent monetary policy without setting limits on capital flows. The feature of “flexibility” by itself

is the main advantage and disadvantage of this regime. “Flexibility”, on the one hand, enables an economy to easily adapt to changes in the environment, but, on the other hand, creates to a certain degree a perception of unpredictability of the future.

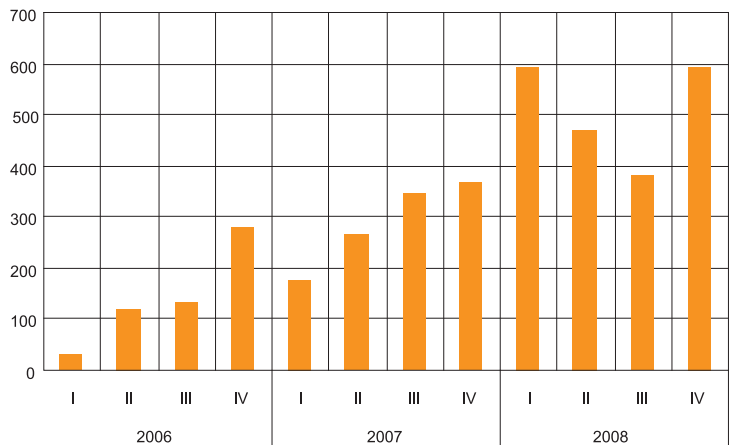
The majority of economies had more than once opted from one of the exchange rate regimes to another. After World War II, the leading states chose the Bretton Woods system of monetary management, according to which the exchange rates of the currencies involved were pegged to the US dollar, whereas the latter was fixed to gold. The system operated until 1973, whereafter most of the states changed the course toward the floating exchange rate regime. The Bretton Woods system collapsed in 1971 as the US dollar became overvalued, and the United States terminated convertibility of the dollars to gold. Thus, other economies also discontinued pegging their currencies to dollar. The Bretton Woods exchange market was officially closed in 1973.

In the 90s, especially after the Asian financial crisis, it seemed as though the economists came to an agreement that economies should stick to either of the two opposing options: the hard peg exchange rate regime, or the fully floating exchange rate regime. It must be noted, however, that the majority of economists still did not rule out government interventions in foreign exchange markets, as they were not fully confident in the market efficiency as compared to government’s competence. Morris Goldstein argues in his book “Managed Floating Plus” that the “managed plus” exchange rate regime is “the least worst” choice for emerging economies. Goldstein stresses that central bank interventions in foreign exchange markets are necessary to alleviate short-term currency volatility and to maintain market liquidity. The “plus” feature mainly implies that the managed floating exchange rate regime is implemented in coordination with the monetary policy based on inflation targeting.

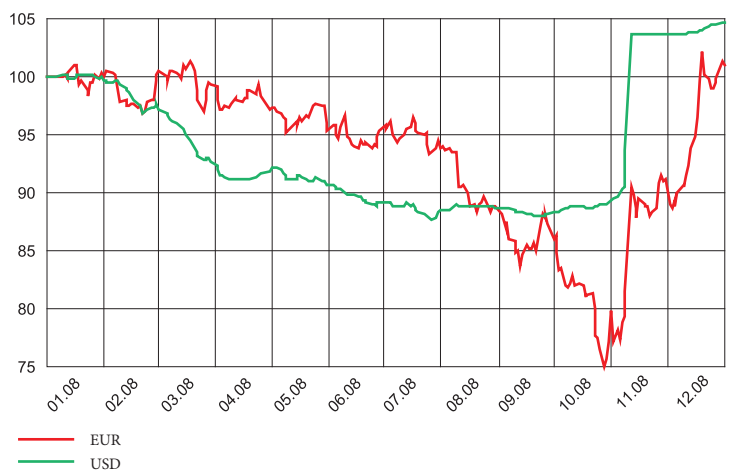
It must be stressed once again that none of the invented exchange rate regimes has proven to perform flawlessly under all environment conditions. Thus, each economy should ponder upon positive and negative aspects of each exchange rate regimes before making a choice that would best suit the actual conditions.

The exchange rate regime should meet several major criteria:

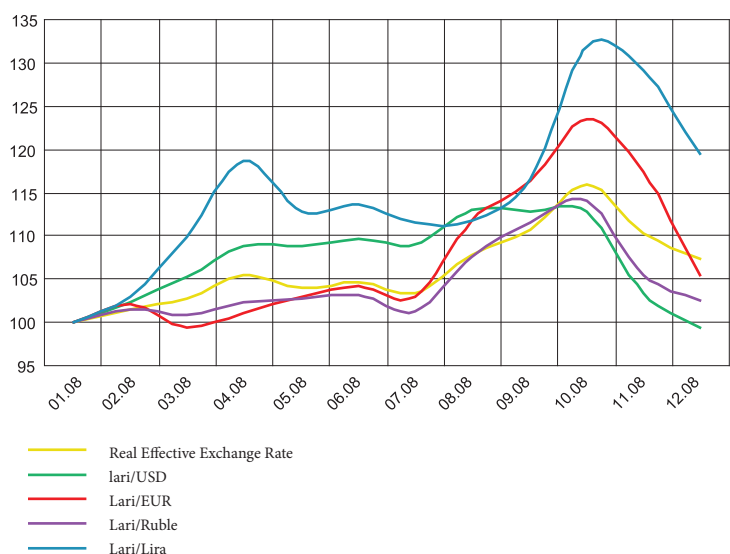
GRAPH 2.6.6
NBG Interventions at the TIBFEX (million USD)



GRAPH 2.6.7
Dynamics of the Nominal Exchange rate of lari (2008)



GRAPH 2.6.8
Dynamics of the lari Real Exchange Rate (2008)



First, the exchange rate regime should be instrumental for the government to implement a reliable macroeconomic policy in line with the internal economic goals. The domestic policy deals with inflation, as well as with the country’s adaptability to external factors, and active monetary policy.

It is also crucial for the exchange rate regime not to propel the economy toward a financial crisis. Therefore, the system should have the capacity to easily absorb drastic changes conditioned by various shocks.

The market expectations that the foundation of the government’s monetary policy is to keep inflation within reasonable limits enable market participants to forecast further exchange rate movement based on previous records, without having a fear of uncertainty.

The table below shows how various types of exchange rate regimes conform to the criteria as described above.

In case of a nominal shock, caused by excessive change in money demand or supply, the fixed exchange rate regime proves to be the most effective choice. For instance, when a money supply shock results in inflation the floating exchange rate regime allows the domestic currency to depreciate, and hence, the nominal shock transforms into real shock.

In opposite, real shocks are easier to deal with under the floating exchange rate regime. This regime proves to be the most effective in the event of the labor productivity shock or in the event of drastic changes in terms of trade (when changes in demand/supply result in breaking relation of export/import prices). For instance, in case of changes in terms of trade, the floating regime allows the economy to find a new equilibrium point by adjusting the exchange rate, whereas, under the fixed regime, demand for national currency falls and the central bank will be forced to purchase excess national currency (by means of selling international reserves). As a result, under perfect capital mobility, foreign currency

outflows from the countries amplifying the shock.

The implementation of the fixed exchange rate regime is not feasible in Georgia, as the present economic conditions do not meet the majority of those requirements, which are necessary for the regime to benefit the country’s economy. In particular, desirable and, mostly, mandatory requirements for effective operation of the fixed regime, include the following: 1. the country should fix its currency to the currency of a country, which holds a significant share in its external trade; 2. the country should experience shocks of the same type and nature as the country the national currency is pegged to; 3. the country should abandon independence of its own monetary policy; 4. the country’s economy and financial system shall be historically dependent on the currency to which it is pegged; 5. the country should have an extremely flexible labor market, as well as flexible prices and wages; and 6. the country should hold a significant volume of international reserves.

Georgia does not have a distinguished trade partner. Fixing the lari to the US dollar is unreasonable, considering that the changes in the economic and political environment of the country are by far more different and specific. Low flexibility of the labor market and not a very high volume of international reserves also fall out of the fixed exchange rate regime requirements, and it would be inexpedient to introduce the fixed exchange rate based only on the high dollarization ratio. It would also be inexpedient to implement full dollarization because of unavailability of a distinguished trade partner. The economic shocks that take place in Georgia differ by nature from those taking place in the USA or Europe.

The floating exchange rate regime is also not the best choice for Georgia, as it does not suit the country’s actual conditions. Imports and FDIs account for a large share of the Georgian economy, and hence, any significant change in the exchange rate will lead to substantial shocks in the real economy. Moreover, considering that the credit portfolio of commercial banks is mostly denominated in dollars, the lari depreciation will essentially impair the country’s financial system.

As of today, it can be safely asserted that the best choice for Georgia is the monetary policy of inflation targeting mixed with a managed floating exchange rate regime. Such a choice prevents expectations of uncertainty and unpredictability, as well as offers all benefits associated with the flexibility.

Domestic Policy	Exchange Rate Regime		
	Fixed	Floating	Managed Floating Plus
Low Inflation	yes	no	yes
Adaptation to “real shocks”	no	yes	partial
Adaptation to “nominal shocks”	yes	no	partial
Active monetary policy	no	yes	yes
Protection from financial crisis	no	partial	yes
Perception of stability	yes	no	partial

* Besides the exchange rate regimes included in this table, there exist other modifications, however they are not considered here.

BOX 3. EXCHANGE RATE ADJUSTMENT IN NOVEMBER 2008

On November 6, 2008, the Lari/USD exchange rate at the TIBFEX equaled 1.44. On the next day, the rate bounced up to 1.49 GEL/USD. Such a sharp change was unusual for the population. Hence, this fact caused certain confusion and led to intensive operations at foreign exchange bureaus. Ultimately the exchange rate reached the 1.65 mark at November 10, and did not change for a long time thereafter.

Such a sharp change in the exchange rate had its objective reasons. In the period from August 8 through early September the NBG aimed at avoiding sharp movement of the lari exchange rate versus the U.S. dollar. Otherwise, it was likely to be associated with the war with Russia and the ongoing global financial crisis, and hence, to lead to undesirable and unfounded market turmoil with detrimental economic and financial consequences. Therefore, the NBG practically fixed the domestic currency to the U.S. dollar. In the second half of October, due to the worsening global financial crisis, the U.S. dollar sharply appreciated against other major currencies. As a result, the fixing of the lari and drastic appreciation of the U.S. dollar led to the lari appreciation above its natural level. This was confirmed by further lari exchange rate dynamics over the latest three months, as well as by the excessive demand for the U.S. dollar at the interbank foreign exchange.

The NBG is committed to strictly follow the policy of maintaining the lari exchange rate close to the equilibrium point. This represents a mandatory condition for sound economic development. Unstable exchange rate is undesirable for the dynamic economic development. In particular, an overvalued exchange rate hinders exports, the economy becomes overwhelmingly dependent on imports, and domestic production stagnates in development. The country consumes more than the revenues it has. Such a stance of matters can not last long and will heavily undermine the economy. Therefore, it is necessary to adjust the exchange rate.

The majority of experts agreed that the exchange rate was overvalued in early November and needed to be depreciated. At the same time, many of them were concerned that a one-time adjustment would trigger inflationary process. These arguments were quite reasonable for a country, which is largely dependent on imports, but the NBG did not share

the opinion. It seemed likely that, for instance, a 100 dollar worth imported item, being currently equivalent of 145 lari, would increase to 165 lari in a few days. And some importers behaved in a similar way.

The subsequent developments showed that the price increases appeared not as dramatic as initially expected. This was related to one of the arguments presented by the NBG. In particular, the bank stressed that the change in the exchange rate will by no means affect prices on goods of purely domestic origin (services, various agriculture products, etc.).

The world price dynamics in early November were favorable to prevent exchange rate depreciation from triggering inflation. Prices were decreasing for oil, wheat, and a variety of staple goods. As a rule, the impact of the world price decreases onto the consumer prices in Georgia is not immediate, and in some cases, requires a lag of several months. Hence, the November downside tendency in world prices was not fully reflected in the domestic consumer prices. Accordingly, it was expected that this factor would offset, to a certain degree, the increase in prices on imported goods, which would objectively take place after the exchange rate adjustment.

In addition, significant volume of trade between Georgia and its foreign trading partners is being carried out via currencies other than the US dollar. Prices on various commodities are set in the Turkish lira, the euro, the Russian ruble, etc. For instance, in trading with Turkey prices are mostly fixed in liras (often, even when the contractual price is specified in USD). Despite the drastic depreciation of the lari exchange rate against the U.S. dollar in early November, according to the data for the recent months, the lari appreciated in relation to other foreign currencies. Although the lari depreciated against the US dollar, other currencies weakened against USD even more than the lari. Accordingly, trade with such countries should have decreased in cost.

The level of prices increased less over the period from November through December 2008 than over the respective period of 2007. The inflation rate equaled 5.5% at the end of 2008, to prove that the fear of dramatic price increases fell short of expectations.

2.7. PRODUCTION AND DEMAND

GDP at current prices in QIII 2008 equaled 4793.2 million lari. In nominal terms, this is 6% higher year-on-year. In real terms, the GDP decreased by 3.9%.

The last contraction of the real GDP was registered 10 years ago in QIV 1998, when the August 1998 financial crisis in Russia passed onto Georgia and led to drastic depreciation of the lari in November. As a result of these detrimental developments, Georgia's GDP fell by 2.3% at that time.

The economic slump of QIII 2008 was primarily caused by the August war with Russia. As expected, the military hostilities with Russia led to essential contraction in such important sectors of the country's economy as transport (isolation of inland roads and sea ports, and

temporary suspension of the pipeline operation), financial intermediation (bank panic, and subsequent decrease of banking activity), and hotels and restaurants (broken holiday season). Apart from certain exceptions, the situation worsened in almost all sectors of the economy.

In addition to the aforesaid, the value added decreased in other important sectors as well. The agriculture contracted in real terms by 1.9%, which is largely due to the cattle breeding industry (the latter was essentially impaired by the Montgomery virus in 2007 reducing the stock of swine circa 3 times). Upon worsened funding conditions, particular contraction was registered in the construction sector, equal to circa 1/3 year-on-year. Significant decreases were also registered in the production and distribution of electricity, gas and water (-11.8%), manufacturing (-6.2%), and communal, social and personal services sector (-13.9 %).

Table 2.7.1
Share of Economic Sectors in GDP (%)

Economic Sectors	Share in GDP (%)	Growth Rates	GDP Growth Contribution
Agriculture, Hunting and Forestry, Fish Catching and Fishery	8.7	-1.9	-0.17
Mining and Quarrying	0.8	16.4	0.13
Manufacturing	8.6	-6.2	-0.53
Production and Distribution of Electricity, Gas and Water	2.2	-11.8	-0.26
Processing Products by Households	3.0	-3.2	-0.10
Construction	8.2	-31.7	-2.59
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	11.9	9.5	1.13
Hotels and Restaurants	2.1	-6.0	-0.13
Transport	7.2	-21.8	-1.57
Communications and Post	3.2	21.7	0.70
Financial Intermediation	2.1	-18.4	-0.39
Real Estate, Renting, and Business Activities	3.4	2.1	0.07
Imputed Rent of Own Occupied Dwellings	2.1	2.2	0.05
Public Administration	12.6	3.1	0.39
Education	3.4	28.7	0.97
Health Care and Social Assistance	3.5	1.7	0.06
Communal, Social and Personal Services	3.4	-13.9	-0.47
Private Households with Employed Persons	0.1	2.8	0.00
FISIM Adjustment	-0.8	50.9	-0.42
GDP in Basic Prices	85.8	-3.6	-3.13
Taxes on Goods	14.5	-5.2	-0.76
Subsidies on Goods	-0.3	10.5	-0.04
GDP at market prices	100.0	-3.9	-3.9

2.7.1 Household and Government Consumption

In QIII 2008 total consumption in nominal terms increased by 22.8% year-on-year to GEL 4636.8 million. It is noteworthy that households consumption and government consumption increased by almost the same level of circa 22-23%.

It can be said that the consumption component was not affected by the decrease of real GDP, and hence, appeared to post at a high growth rate. On the other hand, this component has a lagged response to the GDP decreases. Therefore it is expected that the consumption growth rate will significantly decrease over the next quarters. Such decrease will occur at the expense of private consumption in the first instance, and mostly affect durable goods.

2.7.2. Investments

As expected, the Russian aggression in August has significantly undermined the country's investment environment, affecting FDIs in the first instance.

Whereas in QII 2008 the nominal growth rate of gross capital formation has reached 45%, the growth rate of investment inflows in QIII reduced by circa 40%, determining to a great extent the contraction of the real GDP. Gross capital formation in QIII equaled GEL 1134.9 million only.

2.7.3 GDP Estimations for QIV 2008, and the 2009 Forecasts

According to the NBG's projections, in QIV the negative growth rate of the real GDP will prevail at approximately -2%.

On the one hand, the situation in certain sectors (such as transport) is expected to improve compared to QIII, as the August military hostilities discontinued; on the other hand, growth rates of such important sectors as construction and financial intermediation are likely to remain at the same levels or continue worsening.

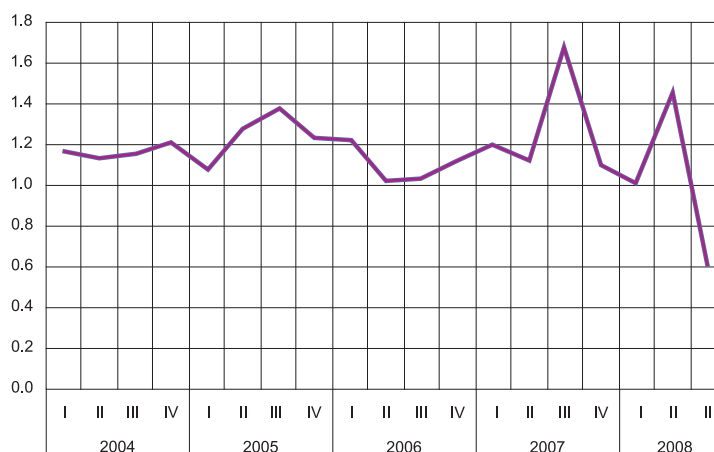
As of the 2009 forecasts, the growth rate of the real GDP is expected within the range of 2-3%. However, the rate may remain negative in the first six months prior to turning positive in the second half.

2.8. EXTERNAL TRADE

The external trade turnover in 2008 totaled USD 7802 million, or 21% higher year-on-year. In annual terms, the exports of goods increased by 21.5% (USD 1498.7 million), while the imports increased by 20.9% (USD 6304.3 million). Consequently, the trade deficit equaled USD 4806.7 million, or 20.7%.

The external trade turnover in H2 2008 decreased by 5% year-on-year, breaking the tendency observed over the preceding years. At the same time, the trade turnover decreases in QIII and QIV were caused by different reasons. In QIII, the decrease was caused by the August war. During this period the imports were decreasing at a faster pace than the exports, which resulted in a 12% reduction in the trade deficit quarter-on-quarter.

GRAPH 2.7.2.1
Investments Year-on-Year Growth Ratio



GRAPH 2.8.1
Imports, Exports, and Trade Deficit (thousands of USD)



Table 2.8.1
Annual Growth Rates (%)

	QI 2008	QII 2008	QIII 2008	QIV 2008	2008
Exports	47.3%	45.8%	37.6%	-29.8%	21.5%
Imports	34.4%	52.0%	22.3%	-10.6%	20.9%
Trade Deficit	31.0%	54.2%	17.4%	-5.3%	20.7%

Source: Statistics Department

In QIV 2008, the trade turnover dropped by 14%, whereas the trade deficit decreased by 5% quarter-on-quarter. The consequences of the global financial crisis, which led to a sharp drop in world prices, also affected the country's external trade. Exports of goods in QIV fell by 5%, and by 7% quarter-on-quarter. The reduction in imports was largely determined by the price decreases on oil products. At the same time, growth rate of the exports decelerated at much faster pace than in the case of the imports, by 30% in annual terms, and by 42%

on a quarterly basis. Such a deceleration rate was largely determined by the world price decreases on export items of ferrous and nonferrous metals, which led to the decrease in exports of these goods by both value and volumes.

In 2008 the major trading partners of Georgia were in the following order: Turkey, Azerbaijan, Ukraine, Germany, Russia, the USA, China, United Arab Emirates, Bulgaria, and Italy. The share of these trading partners equaled 61% in Georgia's total trade turnover.

BOX 4. BALANCE OF PAYMENTS. 2008-2009

The year of 2008 has been earmarked by significant changes in the country's economy, caused by both external and internal factors. While H1 2008 was characterized by a growth in all main components of the balance of payments, the situation essentially changed in H2. The current account deficit diminished, on the one hand, but there was also a significant reduction in FDIs, on the other.

The current account deficit in H1 2008 amounted to USD 1724.5 million, which implies a more than 2-time annual increase. In H2, the deficit equaled USD 1186.3 million only, or 1.2% less year-on-year. The annual deficit stood at circa USD 2910.8 million, which is 45.1% higher than in 2007. In 2009 the current account deficit is expected to fall by 27.4%, with relatively higher deficit in QI and QIV. Trade deficit remains the main determinant of the current account deficit.

Trade deficit in QIII 2008 widened by 28.6% year-on-year, but fell by 10.2% quarter-on-quarter. Trade deficit was largely influenced by the Russian aggression, which caused reduction in both imports and exports of goods, while imports dropped to a higher extent than exports. The trade deficit in QIV 2008 widened by 1.8% year-on-year, and by 17.7% quarter-on-quarter. The global financial crisis, which led to dramatic decreases in world prices on almost all goods, also impacted the country's external trade. On the one hand, the price decreases favored the reduction in cost of imports, which is primarily associated with oil. But on the other hand, price decreases on ferroalloys and ferrous scrap, which represent the main export article of the economy, led

to significant reduction in Georgian exports. Subsequently, in QIV 2008, the country's exports reduced by 30%, whereas the imports reduced by 10% year-on-year.

The impact of the financial crisis will probably continue in 2009. However, the economic recovery is expected to start in H2. According to the 2009 estimates, annual imports and exports will drop by 29.4% and 21.7%, respectively, in what follows, the 2009 trade deficit will fall by circa 17%.

The Georgian balance of services is traditionally positive in Georgia, and partially offsets the trade deficit. According to preliminary estimates, the 2008 balance of services diminished circa 12 times annually to equal USD 13.6 million. This was conditioned by a reduction in revenues from tourism, as well as the suspended operation of the pipeline, due to repair works. As the services sector is the most sensitive to political changes in the country, the balance of services turned negative in the second half of 2008 (USD – 26.4 million) as a consequence of the August military hostilities. Compared to H1 2008, the credit of services diminished by 3.7%, whereas the debit of services increased by 7.2%. According to the 2009 forecasts, the balance of services will increase to reach USD 216.6 million, due to an 8.8% increase in exports of services and a 7.5% decrease in imports. For the transport component, the balance will probably be positive in 2009, with a 13.2% increase in the credit and a 14.3% decrease in the debit. As for the tourism, another major component of the balance of services, the exports thereof will increase in 2009 by 5.3% and the imports will decrease by 8.0% year-on-

year. Other components of the services are not expected to undergo significant changes.

The income balance, being traditionally positive, turned negative in 2008. This was conditioned by a rapid increase in investment volumes for the period of 2007-2008, which led to the increase in the investment income debit that was particularly high in H1 2008. The investment income of direct investors sharply decreased in H2 2008, which caused the investment income debit to fall to USD 201.3 million, as opposed to USD 421.9 million. In 2009, along with the new investments, the investment income debit is expected to slightly increase to reach USD 587.0 million, or 5.8% lower year-on-year. The income credit mainly consists of labor revenues, which increased in 2008 by an annual 4.5%. According to the 2009 NBG estimates, labor revenues will slightly increase to total USD 468.8 million. Overall, there will be the following situation on the income side in 2009: the income credit will decrease by 0.9% to USD 490.8 million; the debit will fall by 5.0% to USD 633.8 million; and, accordingly, the income balance will equal USD -143.0 million, as opposed to USD -171.6 million for 2008.

The transfers disbursed hold an insignificant share of current transfers. As for the transfers received, these amounted to USD 380.1 million in H1 2008. Current transfers in H2 2008 sharply increased reaching USD 244.1 million in QIII, and this parameter is expected to increase further in QIV up to USD 547.2 million, which ensures a two-time increase of the transfers received in H2 2008. Overall, the 2008 net current transfers increased by an annual 58% to equal USD 1087.7 million. It is expected that high level of current transfers will be maintained in 2009, but with a more balanced structure. The net current transfers for 2009 are expected to equal USD 1005.8 million.

The capital account mainly consists of credit records. The capital transfers in H1 2008 decreased by 33.5%. Despite that capital transfers in H2 2008 increased by 83.5% compared to H1, the parameter is still 13.7% lower on an annual basis. As a result, the net capital transfers in 2008 decreased by 21.8% to USD 99.7 million. In 2009 the capital transfers are expected to increase by 13-14% to amount to USD 113.1 million.

The financial account in QIV 2007 sharply increased and its high level was maintained over H1 2008. Respectively, the net position of the financial account in H1 2008

increased 2.3 times year-on-year to equal USD 1710.3 million. The net balance of the financial account in H2 2008 decreased to USD 1082.6 million, which is 8.3% lower in annual terms. Overall, the 2008 financial account increased by 46.3% to USD 2792.9 million. In 2009 the financial account is expected to decrease by 28-29% due to a reduction in portfolio and other investments.

The 2008 FDIs fell by 30% in annual terms equaling USD 1218.1 million. Due to the August war, the volumes in H2 plunged to USD 276.1 million, or 73.8% and 70.7% lower year-on-year and period-to-period, respectively. For 2009, the FDI volumes are expected to reduce by circa 15% to reach approximately USD 1034 million.

The portfolio investments soared in 2008. The 2008 net portfolio investments totaled USD 678.1 million. A total of USD 635.7 million was attracted over H1, which is 30-times more than the total portfolio investments in 2007. In QII the public sector attracted USD 500 million in the form of Eurobonds. However, this tendency discontinued, and there was a significant decline in H2 2008, in what follows, the net portfolio investments for this period equaled USD 42.4 million only. According to the NBG's projections for 2009, the portfolio investments will continue declining to an annual USD 42.6 million. It must be noted, however, that despite such a decline, the projected figure is still two-times higher than the 2007 portfolio investments.

The net inflow of other investments in 2008 increased by an annual 81.3% totaling USD 1066.8 million. Both liabilities and assets significantly increased. For 2009, the net inflows are expected to decrease by circa 40% to equal USD 644.7 million, which is largely due to the projected increase in liabilities (USD 342.3 million) and decrease in assets (USD 302.4 million).

The reserve assets in H1 2008 increased by USD 137.4 million (operational changes). This parameter initially decreased in QIII by USD 110.8 million with a subsequent increase by USD 104.9 million in QIV, which ultimately resulted in an annual increase of USD 131.6 million. Accordingly, the reserve assets of the NBG totaled USD 1480.2 million as of December 31, 2008. This parameter is expected to decrease by approximately USD 377 million in H1 2009, with a subsequent recovery in H2, which will result in an annual decrease of USD 280 million in 2009.

3. INFLATION FORECAST

In forecasting inflation the NBG mainly uses two approaches. On the one hand, the NBG monitors each of the product indices included in the consumption basket and makes inflation forecasts under certain assumptions and projections. On the other hand, it applies econometric modeling of inflation dynamics.

For short-term inflation forecasting, the NBG takes into account expected dynamics' of world prices on certain important products of the consumption basket. According to the current forecasts, prices on oil products are expected to increase slightly from H2 2009. According to the assumptions made for inflation forecasting, transportation costs will follow the dynamics of oil product prices throughout 2009. Wheat prices will remain stable over H1, but are expected to somewhat increase in H2. Another assumption is that regulated prices will remain unchanged over the next year. Also unchanged will remain prices on sunflower oil. As for the rest of the products, the prices are expected to increase at annual 6%, which represents the inflation growth rate conditioned by monetary factors for the preceding months. The inflation forecasts based on this methodology suggest that the rate of inflation will decrease to 4.3% by the end of QI 2009, and continue decreasing over QII to reach

3.8% by the end of June. As for the average annual rate of inflation, according to the existing estimates, the downward tendency will prevail in H1 2009 and the rate will decrease to 6.3% in June, as opposed to 8.2% in March.

It is remarkable that the inflation forecast for QIV decreased, compared to the previous quarter forecast. This is largely due to the continued drop of world prices on oil products and certain important products of the consumption basket, such as wheat and sunflower oil, in QIV. Consequently, the projected annual inflation rate for H1 2009 decreased by circa 4%, compared to the rate projected for the previous quarter.

As of the projected average annual inflation, the rate decreased by circa 2 percentage points for end-QI 2009, and by 3 percentage points for end-QII, compared to the projections for the previous quarter.

It must be pointed out that the inflation projections made by using this methodology are suitable for a six-month time horizon, as the precision degree falls for a longer term.

The monthly inflation forecasting model, based on the long-term equilibrium was updated and reviewed.

The estimated equation is given as follows:

$$\begin{aligned} \delta p = & 0,136\delta e_{-2} - 0,074\delta e_{-4} + 0,038\delta m_{-1} + \\ & + 0,035\delta m_{-2} - 0,038\delta m_{-3} + 0,012\delta p^{oil}_{-1} + \\ & + 0,025\delta p^{food}_{-1} - 0,019ecm; \end{aligned}$$

where:

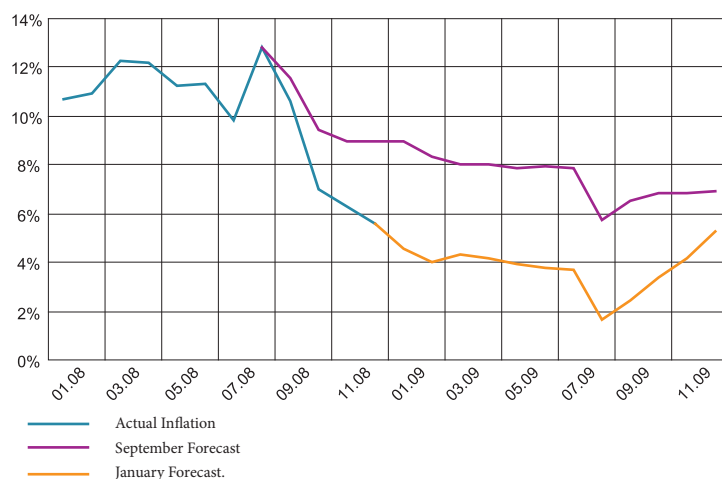
P - Consumer Price Index;

m - Money Mass;

e - Exchange Rate GEL/USD;

P^{oil} - Average Global Price of Oil;

GRAPH 3.1
Annual Inflation Forecasts



P^{food} – Fruits and Vegetables Price;

ecm is a variable depicting a long-term equilibrium and is expressed as follows:

$$ecm = p_{-1} - 0,40e_{-1} - 0,60m_{-1} + 1,04y_{-1} - 6,91;$$

where:

y is GDP.

The equation also includes seasonal and dummy variables to describe seasonality and structural changes. The model also includes the dummy variable describing the consequences of the August war.

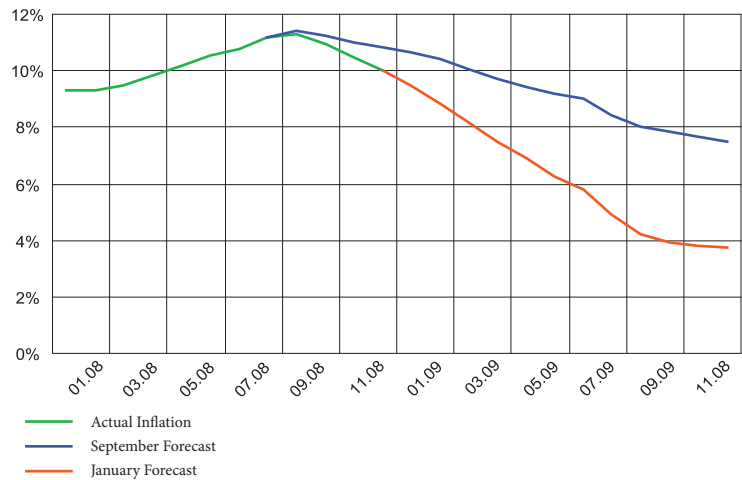
With regard to the explanatory variables included in the model, the following assumptions are made:

- The volume of broad money excluding foreign currency deposits will decrease by annual 5% by the end of March 2009, and by 17.9% by the end of June, in annual terms;
- The growth rate of real GDP will be -1,5% for QIV 2008, --1.1% for QI 2009, and -0.5% for for QII;
- The lari nominal exchange rate against the USD will not change; prices on fruit and vegetables will be 1% higher than the overall inflation level;
- Based on different international sources, the oil price dynamics in international markets will be as follows: 41.22 USD/barrel by the end of QI 2009, and 51.69 USD/barrel by the end of QII;

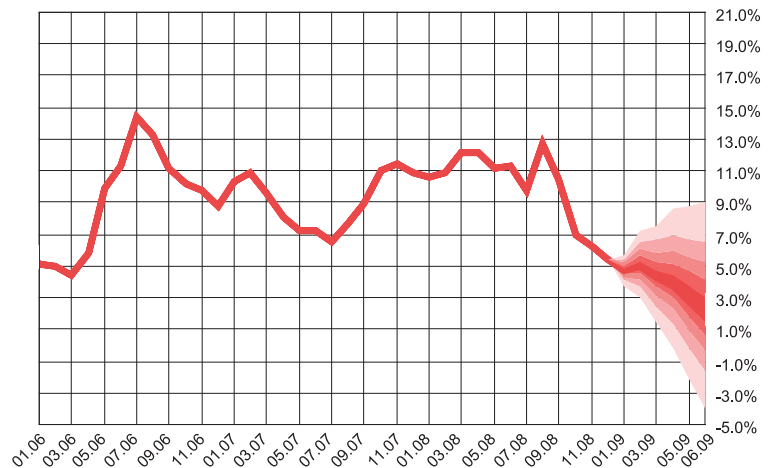
The annual inflation forecasts obtained by using the estimated model can be depicted as follows:

Based on the obtained results, the annual inflation will be within the range from 4.3% to 4.8% by end-QI 2009, and from 1.7% to 3% by end-QII 2009, with 10% probability. The average annual inflation will equal 8.3% by March and 6.2% by June.

GRAPH 3.2
Average Annual Inflation Forecasts



GRAPH 3.3
Annual Inflation Forecast



BOX 5. Inflation Targeting

Today the central banks of the world make a choice out of the three monetary regimes, including: 1. Money Mass Targeting; 2. Nominal Exchange Rate Targeting (fixed exchange rate regime, exchange rate band, etc); and 3. Inflation Targeting.

Inflation targeting is a comparatively new regime which becomes more and more popular. The New Zealand was the first nation who opted in favor of the inflation targeting regime in 1991. As of today, this regime operates in a number of economies, such as Australia, New Zealand, Brazil, United Kingdom, Turkey, Iceland, Israel, Indonesia, Canada, Colombia, Mexico, Norway, Peru, Poland, Romania, South Africa, South Korea, Slovakia, Armenia, Thailand, Hungary, Philippines, Switzerland, Czech Republic, and Chile. The United States, the European Central Bank, and Switzerland also operate frameworks similar to the inflation targeting regime.

Under the inflation targeting regime central bank aims at meeting the inflation target of certain value. Unlike the two other regimes, such an inflation target cannot be immediately controlled. To meet the target, central bank needs to maintain not just a single parameter (e.g. money mass, or exchange rate, etc.) but a set of macroeconomic parameters which may affect inflation. These parameters include imports and exports prices, manufacturers' prices and wage levels, interest rates, real exchange rate, public expenditures, GDP level, etc.

In the case of Georgia, the NBG obtains on a daily basis the information from commercial banks and government, observes the interbank market conditions, analyses general tendencies in conjunction with particular actions of financial agents, and carries out macroeconomic researches of current domestic and world tendencies. The outcomes of these analysis and research activities are submitted to the Monetary Policy Committee Meeting which convenes on a monthly basis to make relevant decisions on monetary instruments to be used for inflation targeting purposes.

Under the inflation targeting regime, the mandate of central bank is clearly defined. In particular, the central bank is responsible for maintaining price stability. Any other objective shall be subject to this main goal and can be included

in the agenda only if it does interfere with the main goal – control over inflation. A clear mid-term inflation target is announced. It is recognized by the modern economics that price stability is the main condition for sustainable economic development, which implies containing inflation within moderate limits.

The monetary instruments of inflation control are supplemented with active communication with the public and price level targeting by means of forming expectations. Transparency of the monetary policy strategy, as well as that of its implementation process, is the key to successful communication with the public. This implies a high degree of accountability of central banks. Independence is another factor which determines the degree of public confidence in the central bank. In this context, in order to reinforce the NBG's independence guaranteed by the Constitution of Georgia, the country has implemented significant legislative changes, which prohibit executive and other authorities to interfere in the NBG's activities.

The inflation targeting implies determination of a specific time horizon over which the inflation target is announced (as a rule, the target is defined by the government and approved by legislative body). In addition, the inflation target is given a certain deviation band. In the case of Georgia, the 2009 annual inflation target is set at 9% with the deviation band within $\pm 2\%$. In particular, this means that if the resulting inflation equals 7.1%, then the inflation target is deemed to be achieved. It is presumed, however, that the central bank, as a rule, uses its best endeavors to bring the inflation level as close to the target as possible.

The economies, which have recently adopted the inflation targeting regime, opt for wider deviation bands in order to avoid effects of unexpected exogenous shocks and errors related to modeling of inflation and transmission mechanisms. Some economies apply the so-called escape clause, which justifies extra-band deviations, subject to special conditions (cases, such as sharp changes in regulated prices, indirect taxes, and prices on petroleum and food products).

In the event of failure to maintain inflation within the deviation band, the central bank shall submit a reasoned

explanation to the legislative body which set the inflation deviation band.

In order to avoid unpredicted fluctuations, the inflation target may be defined with reference to core inflation, or average annual inflation, or inflation with certain product prices excluded, etc. However, in most of cases the reference is made to the official annual inflation. This approach is useful as the announced inflation target should anchor the inflation expectations, and hence, be indicative for economic

agents and understandable for the population. Moreover, the inflation target should serve as one of the performance criteria for the central bank's accountability purposes, which is difficult to manipulate. As already mentioned above, the inflation target in Georgia is represented in terms of average annual inflation. The annual inflation is calculated by the Department of Statistics of the Ministry of Economic Development of Georgia. Accordingly, this ensures transparency of the NBG's performance evaluation.

4. DECISIONS OF THE MONETARY POLICY COMMITTEE

In order to provide commercial banks with sufficient liquidity, following the concession measures initiated in August-September, the NBG defined the reserve requirement at a rather low level of 5% commencing October 2.

Three Monetary Policy Committee meetings were held during QIII 2008. At the first meeting on October 15 the Committee maintained the interest rate on refinancing loans at 10%, but reduced it at the two subsequent meetings of November 26 and December 24 by 100 basis points each meeting to bring the monetary policy rate to 8%.

At the October 15 meeting it was stated that there was more than sufficient liquidity in the banking system. In addition to that, it was expected that the IMF stand-by loan facility, high international reserves, and high capitalization ratio of local banks would facilitate soundness of the country's financial system. Taking into account considerable aid expected from the international financial institutions and donor organizations, the stability of foreign inflows in the banking sector is anticipated to recover in near future.

Certain positive changes were visible in the banking sector, namely, tendency of deposit growth. However, commercial banks, being aware of increased borrowing risks, kept a cautious approach to lending, which is why there was no growth in the lending to economy.

At that time the annual inflation rate was still high (10.6%), but the inflation dynamics were expected to continue the downward trend. At the November 26 and December 24 meetings the Monetary Policy Committee took into consideration pessimistic global macroeconomic forecasts, expected sharp drop of the global GDP growth, with possible impact on Georgia's exports. By the date the country's economy was operating under a double pressure of two strong shocks. The develop-

ments in the international market, in conjunction with the Russian aggression in the country, severely undermined the expectations/confidence of local and foreign investors. This led to the reduction of investment and consumption spending. As a result, import demand and prices thereof fell. Notwithstanding the expected reduction of imports, in line with the aforesaid factors, Georgia's GDP growth for 2008 and 2009 will decrease compared to the preceding years.

The strong price decreases tendency for main commodities in the international markets was expected to continue, increasing deflation risks. Inflation forecasts suggested that actual inflation was most likely to be lower than the inflation target. The slackened growth of money aggregates was also contributing to price decreases.

Such estimates of inflation dynamics enabled the NBG to loosen its monetary policy, which would promote the country's economic growth.