INFLATION REPORT

Central Bank in Georgia was first established in 1919

2009

NATIONAL BANK OF GEORGIA

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INFLATION REPORT
QI 2009

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CONTENT

INTRODUCTION

According to the Department of Statistics of Georgia the annual inflation rate fell to 1.6% in March 2009, down from 5.5% in the previous quarter. Average annual inflation rate decreased by 2.2 percentage points in the first quarter 2009, standing at 7.8%.

Inflation in the quarter was mainly driven by price decreases in international markets and seasonal factors. Core inflation rates also decreased, with annual rates for products within the limit of two and one standard deviations at 1.14% and 1.16%, respectively.

As it was already mentioned, year-on-year growth of consumption basket prices was at 1.6% in March 2009. Prices for the "clothing and footwear" and "transports" commodity groups decreased by 3.8% and 7.9%, respectively. Significant price increase was recorded for the "healthcare" group standing at 16.6%, which is largely due to growing prices on medicaments.

Annual inflation rate for imported goods decreased in March standing at -4.3%. The decrease in prices on imported goods is the result of price decreases in the international market.

As of QI 2009 the size of reserve money decreased by GEL 165.1 million amounting to GEL 1266.8 million at end-period. The annual decline of the reserve money equaled 10.4% year-on-year.

The annual decline of the M3 aggregate equaled 8.7%, with the M2 growth rate declining to 27.7%.

Being aware of high economic risks commercial banks preferred to maintain significant volumes of liquidity reserves, limiting the lending activities. The volume of lending in national currency decreased by 26% quarter-on-quarter.

The monetary policy was loosened further in the accounting period against the backdrop of sluggish economic and banking activities and sharply decelerated inflation. By the decisions of the NBG's Monetary Policy Committee the minimum interest rate on refinancing loans was gradually eased from 8% to 6.5%. Over the reporting period the total volume of one-week refinancing loans extended by the NBG to commercial banks equaled GEL 689.5 million. The increased activity can be explained by continuous participation of several banks in the loan auctions in January-March. For these banks the refinancing loans represented a stable and inexpensive source of financing.

Along with the reduction of the NBG's key policy rate (refinancing rate), the cost of lari-denominated loan resources of the interbank market decreased further in the reporting period. In particular, in January-March the weighted average annual interest rate on the lari-denominated overnight loans was at 5.3%, as opposed to 6.4% in QIV and 9% in QIII.

The three-month Certificates of Deposits were issued further to assist commercial banks in improving liquidity management. The maximum interest rate on the CDs of this maturity remained at 13%.

Deposit liabilities of the banking system decreased by GEL 461.1 million (14.5 % q-o-q) amounting to GEL 2714.7 million. In year-on-year terms the volume of deposits decreased by GEL 99.6 million. Deposit dollarization ratio decreased by 0.5% quarter-on-quarter equaling 75.2% at end-March.

Interest rates on deposits increased in the accounting period by 0.9%.

Total lending to economy decreased in the accounting period by GEL 318.4 million equaling GEL 5753.9 million. Despite the decrease in quarter-on-quarter terms, year-on-year growth rate of such lending was substantial running at 13.6% at end-March.

Interest rates on commercial bank loans turned downward compared to the previous quarter, equaling 22.4% per annum.

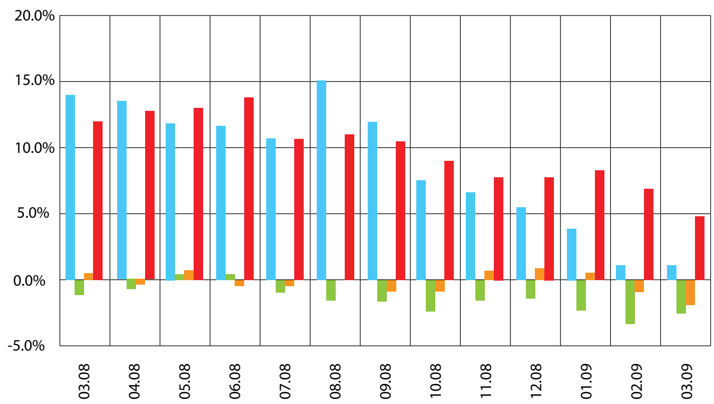
In 2008 the current account deficit totaled USD 2,850 million. Negative tendency in the current account exerts a depreciation pressure on the lari exchange rate. The drastic reduction in FDIs, as followed after the August war, resulted in the depreciation of the lari in QIV 2008 against the backdrop of excessive demand for foreign currency. During the accounting period the depreciation discontinued and the exchange rate was mainly characterized by short-term fluctuations, without a definite trend. In QI 2009 the lari real effective exchange rate appreciated by 1.0%.

In QIV 2008, for the first time in the recent years, both imports and exports posted a decline as a result of the August war and the subsequent impact of the world financial crisis. This tendency developed further in 2009. In the accounting period the external trade turnover totaled USD 1202.2 million, posting a 31% decline year-on-year. Exports of goods equaled USD 220.1 million (down 33% y-o-y) and imports equaled USD 982.1 million (down 30% y-o-y). Consequently, trade deficit amounted to USD 762.0 million posting a 29% decline year-on-year. GDP decline estimates are at least 3% in the accounting period, with the risks remaining to the downside. The majority of sectors are expected to deteriorate, which can be alleviated in part by means of state fiscal stimulus programs.

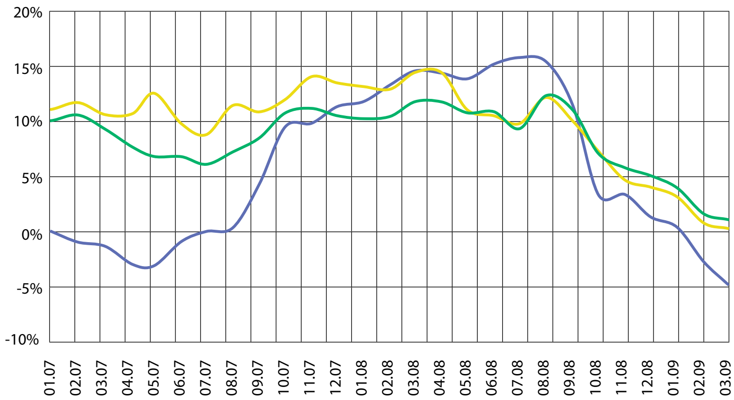
The NBG's forecasts indicate that inflation will likely fall below the target levels in QII and QIII 2009, and move slightly upwards (below 4%) at end-year. In the mid-term perspective, the NBG expects the inflation to settle within the range acceptable for the country's economy.

1. CHANGE IN CONSUMER PRICES

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



GRAPH 1.2
Annual Inflation by Location of Production



According to the Department of Statistics of Georgia, the overall level of consumer prices moved down 0.4% in QI 2009. In the same quarter of 2008 consumer prices were up 4.5%. Accordingly, annual inflation rate lowered to 1.6% in March 2009, down from 5.5% in the previous quarter. Average annual inflation rate decreased by 2.2 percentage points in QI 2009, running at 7.8%.

Inflation in the accounting period was mainly driven by price decreases in international markets and by seasonal factors. Prices on gasoline, sunflower oil, white wheat flour, and Imeretian cheese decreased by 14.7%, 16.9%, 5.4%, and 20.2%, respectively. For these products, the effect of price changes on the inflation equaled -1.8%. Such a downward effect was partially offset by prices on fruits and vegetables pushed up by seasonal factors.

Core inflation rates also decreased in QI, in particular, annual rates for products within the limit of two and one standard deviations were at 1.14% and 1.16%, respectively

As it was already mentioned, year-on-year growth of consumption basket prices was at 1.6% in March 2009. Prices for the “clothing and footwear” and “transport” groups decreased by 3.8% and 7.9%, respectively, while prices for the “housing, water, electricity, gas and other types of energy” decreased by 0.9%. The following commodity groups increased in prices as follows: “communications” – 6.0%; “household appliances” – 6.3%; “food and non-alcoholic beverages” – 0.3%; and “alcoholic beverages and tobacco” – 0.5%. Significant price increase was recorded for the “healthcare” group standing at 16.6%, which is largely due to the November 2008 hike in prices on medicaments.

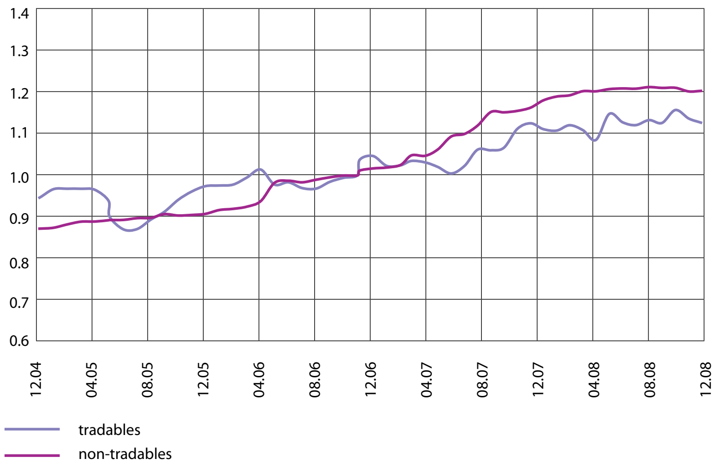
Annual inflation rate for imported goods decreased in March, running at -4.3%. The decrease in prices on imported goods was driven by price decreases in the international market. Inflation rate for domestically produced goods was at 0.8%.

It is noteworthy to look at the price dynamics of traded[1] and non-traded goods. Price inflation for non-tradables decreased in March, running at 2%, while annual inflation for tradables was up to 1.4%. Faster price acceleration for non-tradables as opposed to tradables is typical for developing countries.

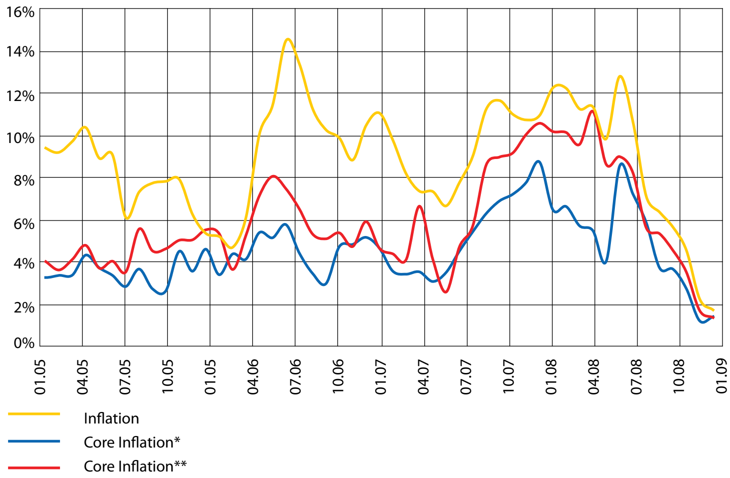
Analysis of goods by consumption durability shows that in quarter-to-quarter terms prices decreased in March 2009 for all three types of goods, with nondurables by 0.4%, semidurables by 3.1%, and durables by 2.4%. Prices on services increased by 0.6% quarter-to-quarter. The annual inflation rate for goods by consumption durability was the highest for non-durables, running at 1.0%. As for services, the annual inflation rate was at 4.6%. The slowing down inflation for non-durables, observed in the recent period, helps improve population's sentiment regarding inflation outlook.

Over the period from December 2006 through March 2009 non-durables and services grew in price by 17.5% and 22.5%, respectively, whereas semidurables fell by 8.0%.

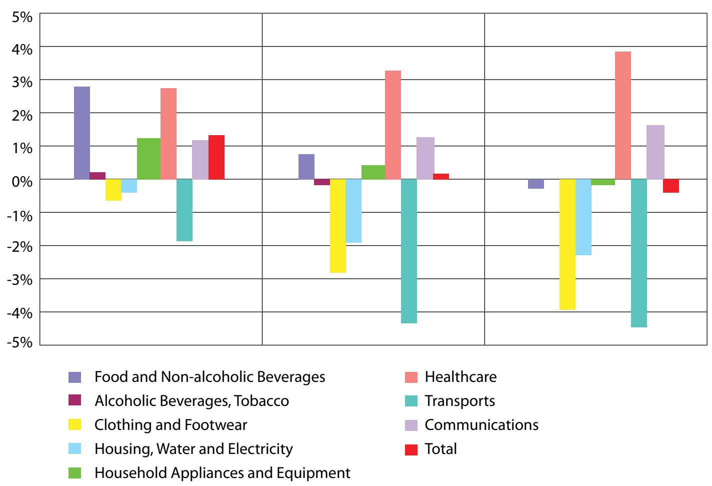
GRAPH 1.3
Inflation for Traded and Non-Traded Goods (2006=100)



GRAPH 1.4
Annual CPI and Core Inflation (by 282 Components of the Consumption Basket as of Dec. 2006) [2]



GRAPH 1.5
Price Increases, as Compared to December 2008



1 Goods and services, which can be sold at a distance from the production location.
2 * For the products within the limits of one standard deviation.
** For the products within the limits of two standard deviations.

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

	2006 December Weigh	Mar09/Dec09		Mar09/Mar08		Apr08-Mar09/Apr07-Mar08	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	-0.4%	-0.4%	1.6%	1.5%	7.8%	7.7%
Food and non-alcoholic beverages	44.3%	-0.9%	-0.4%	0.3%	0.1%	8.8%	4.0%
Food	43.0%	-0.9%	-0.4%	0.0%	0.0%	8.9%	3.9%
Bread and Bakery Products	12.2%	-0.6%	-0.1%	-2.9%	-0.4%	13.4%	1.8%
Meat and Meat Products	6.6%	0.2%	0.0%	6.2%	0.4%	10.9%	0.7%
Fish Products	1.1%	-6.0%	-0.1%	7.3%	0.1%	3.2%	0.0%
Milk, Cheese, Eggs	5.2%	-8.1%	-0.4%	-8.9%	-0.4%	4.0%	0.2%
Oils and Fats	3.5%	-4.0%	-0.2%	-13.2%	-0.6%	16.1%	0.6%
Fruits, Grapes	2.3%	3.7%	0.2%	52.6%	2.3%	24.4%	1.0%
Vegetables, Watermelons, Potatoes and Other Solanaceae	8.8%	-1.2%	-0.1%	-15.7%	-1.2%	-5.8%	-0.4%
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7%	4.2%	0.1%	9.4%	0.2%	2.9%	0.1%
Other Food Products	0.6%	-0.4%	0.0%	7.4%	0.0%	5.6%	0.0%
Non-Alcoholic Beverages	1.3%	0.2%	0.0%	8.2%	0.1%	5.7%	0.1%
Alcoholic Beverages, Tobacco	3.7%	0.0%	0.0%	0.5%	0.0%	-0.2%	0.0%
Clothing and Footwear	5.0%	-1.2%	0.0%	-3.8%	-0.2%	-3.8%	-0.2%
Housing, Water, Electricity, Gas, and Other Fuels	10.3%	-0.4%	0.0%	-0.9%	-0.1%	5.9%	0.7%
Furniture, Home Appliances and Equipment, Housing Renovation	3.7%	-0.4%	0.0%	6.3%	0.2%	11.1%	0.4%
Healthcare	8.0%	0.4%	0.0%	16.6%	1.4%	16.9%	1.3%
Transport	9.0%	-0.1%	0.0%	-7.9%	-0.7%	9.5%	0.9%
Communications	4.4%	0.4%	0.0%	6.0%	0.2%	5.0%	0.2%
Recreation, Leisure and Culture	2.7%	0.8%	0.0%	0.4%	0.0%	2.9%	0.1%
Education	3.5%	0.1%	0.0%	1.6%	0.0%	0.1%	0.0%
Hotels, Cafes, Restaurants	2.4%	3.0%	0.1%	10.4%	0.2%	6.2%	0.1%
Other Goods and Services	3.2%	-0.4%	0.0%	8.3%	0.2%	7.4%	0.2%
Non Durable Goods	68.0%	-0.7%	-0.5%	1.0%	0.7%	8.1%	5.5%
Semi-Durable Goods	6.5%	-0.9%	0.0%	-3.0%	-0.2%	-1.7%	-0.1%
Durable Goods	1.9%	-0.6%	0.0%	-2.1%	0.0%	-0.3%	0.0%
Services	23.6%	0.7%	0.2%	4.6%	1.1%	9.5%	2.3%

2. INFLATION FACTORS

2.1 LABOR PRODUCTIVITY, WAGES

The year of 2008 was earmarked by significant growth in average wages, as compared to 2007. Essential increase in wage rates was observable in 2008 in year-on-year terms. In QIV 2008 average monthly wage rate grew to GEL585.3 per employee in the official economy[3], up 29.7% year-on-year. It must be noted, however, that wages grew at a much slower pace. Wage rates increased in all major sectors of the economy. The sectoral analysis showed that the increase was at highest in the healthcare and social assistance sector, with the average monthly wage rate up 58.0% year-on-year in QIV 2008. For the "education" and "communal, social, and personal services" sectors average wage rates grew respectively by 43.8% and 29.2% year-on-year. Growth of wage rates was also remarkable for the personnel employed in the sectors of hotels and restaurants (44.2%), transports and communications (38.0%), and fish catching and fishery (37.4%). For the "financial intermediation" and "real estate operations" sectors average monthly wage rates grew at comparably slower pace of 24.0% and 18.8%, respectively. Negative growth rates were registered in the "mining and quarrying" and "construction" sectors, with the wages down 5.8% and 0.6%, respectively.

Significant differences in the average wage rates by sectors were still present in QIV 2008. The highest monthly average wage rates were registered for the sectors of financial intermediation (GEL1337.8) and public administration (GEL924.6), exceeding the monthly average for the whole economy 2.3 and 1.6 times, respectively. The lowest monthly average wage rates were registered in the sectors of fish catching and fishing (GEL208.9) and education (GEL259.1), making 35.7% and 44.3% of the monthly average rates for the whole economy, respectively, but there is a remarkable growth tendency in these sectors, as mentioned above.

Growth rate of real value-added per employee decreased in QIV 2008 by 4.9% year-on-year (down 20.9% compared to analogous parameter of 2007). For the "other services" sector real value-added per employee decreased 2.6 times. Particular decrease was registered for the sectors of "financial intermediation" (36.3%), "transports and communications" (29.9%), "agriculture" (18.8%), and "manufacturing" (12.6%). The decline was comparably slower for the "construction" and "hotels and restaurants" sectors. Notwithstanding the overall downtrend, real value-added per employee for some sectors posted a positive year-on-year growth in QIV 2008. Labor productivity significantly increased for the sectors of "real estate operations, leasing and commercial activity" (60.6%), "healthcare" (35.2%), and "education" (34.0%). For the "trade" and "public administration and defense" sectors growth rates of real value-ad-

TABLE 2.1.1
Nominal Monthly Average Wages of Employees, QIV 2008, Y-o-Y, (%)

	Nominal Wages
Agriculture, Hunting and Forestry	128.5
Fish Catching and Fishery	137.4
Mining and Quarrying	94.2
Manufacturing Industry	130.1
Production and Distribution of Electricity, Gas and Water	127.2
Construction	99.4
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	129.5
Restaurants and Hotels	144.2
Transport and Communications	137.0
Financial Intermediation	124.0
Real Estate Operations, Leasing, Consumer Services	118.8
Public Administration	123.4
Education	143.8
Health Care and Social Assistance	158.0
Communal, Social and Personal Services	129.2
Total	129.7

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

GRAPH 2.1
Nominal Monthly Average Wages of Employees by Sector, QIV 2008, (in GEL)

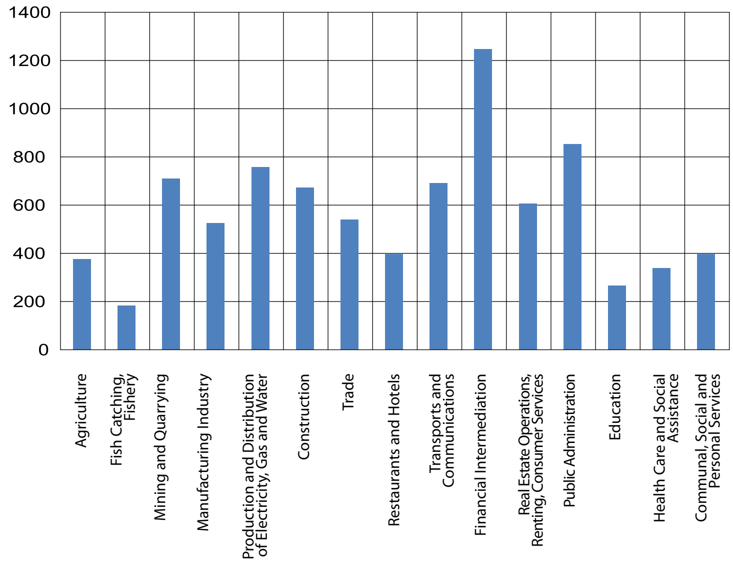


TABLE 2.1.2
Real Value Added per Employee, QIV 2008, Y-o-Y (%)

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Agriculture	81.2
Manufacturing	87.4
Construction	89.5
Trade	107.2
Hotels and Restaurants	93.9
Transport, Communications	70.1
Financial Intermediation	63.7
Real estate Operations, Leasing and Commercial Activity	160.6
Public Administration, Defense	106.0
Education	134.0
Healthcare	135.2
Other Services	90.6
Total	95.1

ded per employee were at 7.2%and 6.0%, 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, which thereby contributed to accelerating high inflation rates. Notwithstanding these factors, annual inflation rate essentially slowed down during the accounting period owing to other factors of demand and supply.

2.2 MONETARY AGGREGATES

As of QI 2009 the size of reserve money decreased by GEL 165.1 million amounting to GEL 1266.8 million at end-period. In average terms, the monetary base contracted by GEL 75.8 million (5.6%) year-on-year. The annual decline of the reserve money was at 10.4% year-on-year.

Demand for foreign currency exceeded the supply at the TIBFEX with the net demand equaling USD 121.0 million in the accounting period. During the first three months of 2009 the NBG intervened on both sides depending on existing foreign exchange market conditions, save for February when interventions were made on the supply side only. In March currency auctions were launched. Net currency supply through these auctions and the TIBFEX totaled USD 142.1 million, equivalent of circa GEL 237.5 million. Net currency withdrawals through intra-governmental conversions amounted to USD 32.1 million, equivalent of circa GEL 53.6 million. As a result of the above-mentioned currency operations, the volume of money withdrawn from circulation in the accounting period amounted to circa GEL 183.9 million.

Government deposits decreased in QI 2009 by GEL 68.4 million and, according to the preliminary March data, amounted to GEL 811.6 million.

During the accounting period the NBG continued issuance of the Certificates of Deposits to assist commercial banks in improving liquidity management. The placement of the CDs equaled GEL 115.5 million in nominal value, while the repayment volumes amounted to GEL 78.0 million. The volume of the CDs in circulation was GEL 113.7 million at end-March, up from GEL 77.4 million at end-December 2008. Commercial banks were actively using refinancing loans facility over the accounting period; the outstanding balance of loans extended by means of this instrument totaled GEL 43.3 million at end-March.

As a result of these operations, net liabilities of commercial banks decreased by GEL 42.1 million in the first three months of 2009, amounting to GEL 89.9 million.

As a result of the above–mentioned monetary flows, reserve money decreased by GEL 165.1 million. This includes a GEL 15.6 million decrease of commercial banks' balances on the lari corresponding accounts with the NBG, down to GEL 125.6 million. Cash in circulation fell by GEL 149.5 million, totaling GEL 1141.2 million in the accounting period.

2.2.1 BROAD MONEY

The M3 aggregate was GEL 3674.9 million in QI 2009, down GEL 583.5 million. Foreign currency denominated deposits decreased by GEL 362.9 million (15.1%), equaling GEL 2041.3 million by end-March. Deposits denominated in national currency also decreased by GEL 98.2 million (12.7%), amounting to GEL 673.4 million by end-period.

The M2 aggregate was GEL 1633 million in the accounting period, down GEL 220.5 million (11.9%).

Both M3 and M2 aggregates declined in annual terms at the rates of 8.7% and 27.7%, respectively.

2.3. MONETARY INSTRUMENTS

Being aware of high economic risks commercial banks preferred to maintain significant volumes of liquidity reserves, limiting lending activities in QI 2009. The volume of lending in national currency decreased by 26% quarter-on-quarter.

The monetary policy was loosened further in QI 2009 against the backdrop of sluggish economic and banking activities and sharply decelerated inflation. In such conditions, the NBG's objective was to stimulate the economy. After the introduction of refinancing loans in early September (as the main monetary policy instrument) the minimum interest rate thereof was consistently reduced by the decisions of

GRAPH 2.2.1
Change in Reserve Money

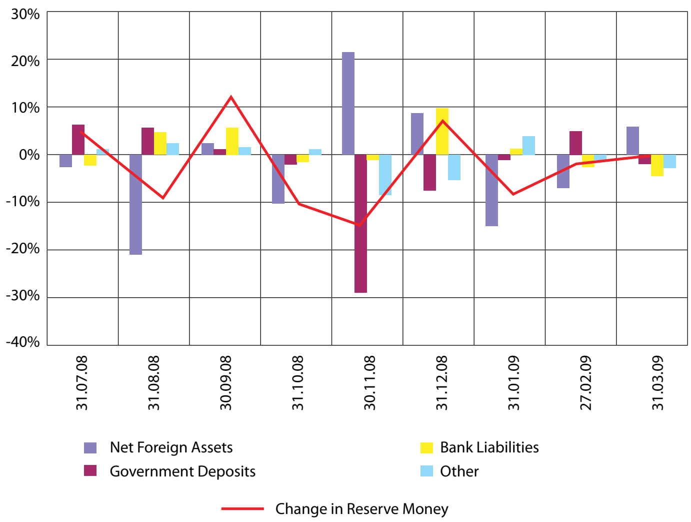


TABLE 2.2.1
Reserve Money Dynamics (Dec. 2008 – Mar. 2009, End-month Data, in Thousand GEL)

	Dec-08	Jan-09	Feb-09	Mar–09
Reserve Money	1,431,893	1,314,986	1,273,230	1,266,759
Cash in Circulation	1,290,703	1,165,976	1,140,243	1,141,167
Deposits of Banks	141,190	149,010	132,987	125,592
Balances on Corresponding Accounts	141,190	149,010	132,987	125,592

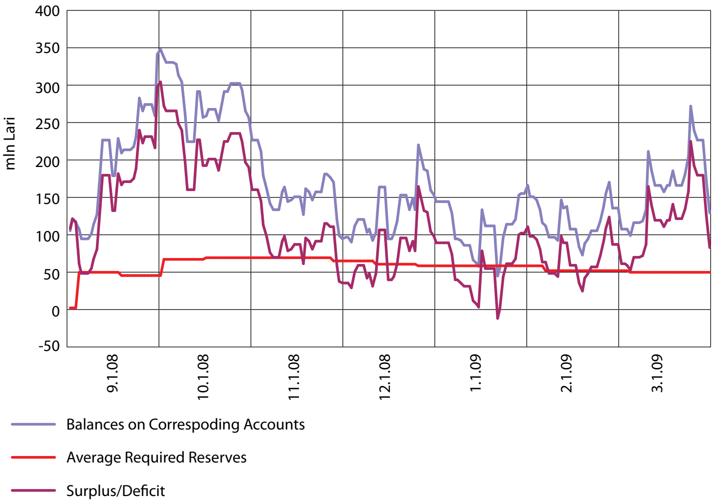
TABLE 2.2.2
Reserve Money Dynamics (Dec. 2008 – Mar. 2009, Average Month Data, in Thousand GEL)

	Dec-08	Jan-09	Feb-09	Mar–09
Reserve Money	1,354,180	1,284,901	1,245,729	1,278,369
Cash in Circulation	1,226,474	1,179,213	1,128,597	1,115,190
Deposits of Banks	127,706	105,688	117,133	163,179
Balances on Corresponding Accounts	127,706	105,688	117,133	163,179

TABLE 2.2.1.1
Monthly Changes in Monetary Aggregates (Dec. 2008 – Mar. 2009, end-Month Data, in Thousand GEL)

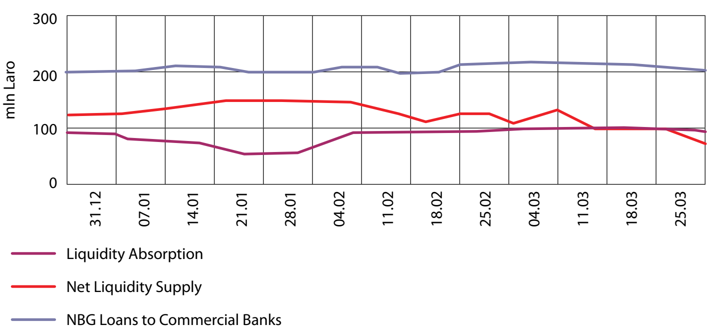
	Dec-08	Jan-09	Feb-09	Mar-09
Broad Money /M3/	4,258,362	3,993,585	3,870,699	3,674,850
Money Mass /M2/	1,854,131	1,707,794	1,631,696	1,633,590
Cash Outside of Banks	1,082,554	991,498	961,048	960,173
Lari in Circulation	1,290,703	1,165,976	1,140,243	1,141,167
Deposits in National Currency	771,577	716,296	670,648	673,417
Deposits in Foreign Currency	2,404,231	2,285,791	2,239,003	2,041,260

GRAPH 2.3.1
Balances on Lari Corresponding Accounts of Banks, Average Required Reserves, and Liquidity Surplus/Deficit



GRAPH 2.3.2
Refinancing Loans, Their Weighted Average Interest Rate, and Key Policy Rate, QI 2009

GRAPH 2.3.3
Liquidity Absorption through CDs, Net Liquidity Supply, and NBG Loans to Commercial Banks (Million GEL)



the NBG's Monetary Policy Committee to 8% on December 25, 7% on February 19, and 6.5% on March 19[4]. Over the reporting period the total volume of one-week refinancing loans extended by the NBG to commercial banks equaled GEL 689.5 million, whereas in the previous quarter these loans amounted to GEL 270.7 million only. The increased activity can be explained by continuous participation of several banks in the loan auctions in January-March. For these banks refinancing loans represented a stable and inexpensive source of financing.

The volumes of refinancing loans amounted to GEL 233.7 million in January, GEL 237 million in February, and GEL 218.6 million in February, with the weighted average annual interest rates at 8.5%, 8.2%, and 7.6%, respectively. The weighted average annual interest rate of refinancing loans at the auctions declined in line with the changes in the key policy rate.

There was no demand for the one-day loans in QI 2009. Interest rate on such loans was up to 13% in the period from the beginning of the year through March 19, falling subsequently to 11%. In addition to that, only one bank applied for the lending of last resort facility over the accounting period. The volume of the latter equaled GEL 20 million at 13% interest without collateral. The slump in demand for the one-day loans and lending of last resort facility indicates that commercial banks maintained sufficient liquidity against the background of sluggish banking activity, opting in case of need for refinancing loans as the lower-cost financing source.

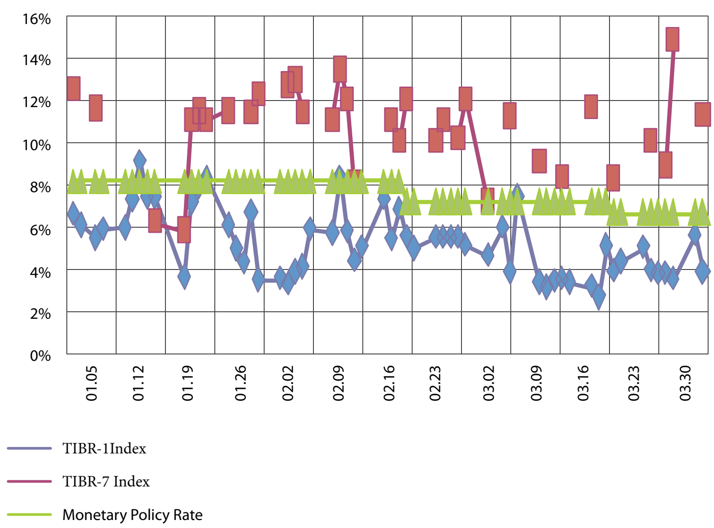
The issuance of the three-month Certificates of Deposits was continued in order to assist commercial banks in improving liquidity management. The maximum interest rate on the CDs of this maturity remained at 13%. The demand for these CDs increased in January-March, with the placements amoun-

4 The monetary policy rate was reduced to 6% by the decision of the Monetary Policy Committee of the NBG, dated April 15, 2009.

ting to GEL 115.5 million, up from GEL 93.1 million in October-December. The weighted average interest rate was at 13% in the accounting period.

Liquidity absorption through the CDs increased in QI 2009, totaling GEL 113.7 million as at March 31. However, net absorption was negative, if we take into account the NBG loans to commercial banks, meaning there was liquidity supply equaling GEL 89.5 million by end-quarter. Overall, liquidity supply comprised 7.1% of reserve money, down from 9.2% as of December 31, 2008.

GRAPH 2.4.1
Tbilisi Interbank Rates on Short-Term Loans, QI 2009



2.4. INTERBANK MARKET

Interbank loans denominated in domestic currency further decreased in volumes in QI 2009, totaling GEL 636.6 million, down from GEL 1380.4 million quarter-on-quarter. In QIII and QII 2008 the same parameters equaled GEL 1547 million and GEL 2964 million, respectively. Loans denominated in the US dollar amounted to USD 360 million in January-March, down from USD 532.7 million quarter-on-quarter, while loans denominated in the euro equaled EUR 361.8 million in the same period, up from EUR 247 million quarter-on-quarter.

Short-term loans continued to dominate in the accounting period. The lari-denominated loans with under 7-day maturity comprised 91% of the total volume of loans, while the share of overnight loans was 66%. A similar observation applies to loans denominated in the US dollars and the euro, comprising 77% and 74% of total loans, respectively (for overnight loans).

The lari-denominated credit resources continued to decrease in cost in QI 2009. The weighted average annual interest rate on the lari-denominated overnight loans was 5.3% in January-March, down from 6.4% and 9.0% in QIV and QIII 2008, respectively. Similar trend was observable for the 7-day loans, with the weighted average annual interest rate at 10.8%, down from 11.2% and 13.5% in QIV and QIII 2008, respectively.

The TIBR-1 and TIBR-7[5] indices speak of changes in interbank interest rates. It must be noted, that deals for the overnight interbank loans were concluded each day, whereas deals for loans with different maturity were non-existent on some days. The TIBR-1 decline indicates of the decrease in interest rates on overnight loans in January-March. As regards TIBR-7, it is difficult to relate with each other the key policy rate and interbank loan rates due to scarcity and variability of the data available.

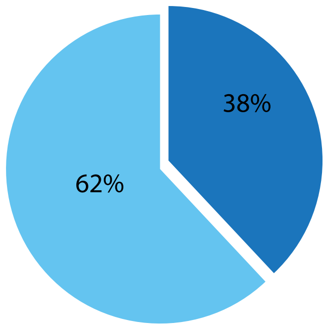
2.5. BANKING SECTOR

Deposit liabilities of the banking system totaled GEL 2714.7 million in QI 2009, down by GEL 461.1 million (14.5%) quarter-on-quarter and GEL 99.6 million year-on-year.

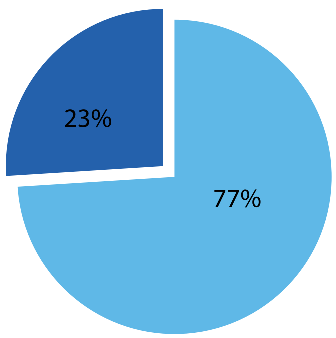
Foreign currency denominated deposits in lari terms decreased by GEL 363.0 million, totaling GEL

5 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.

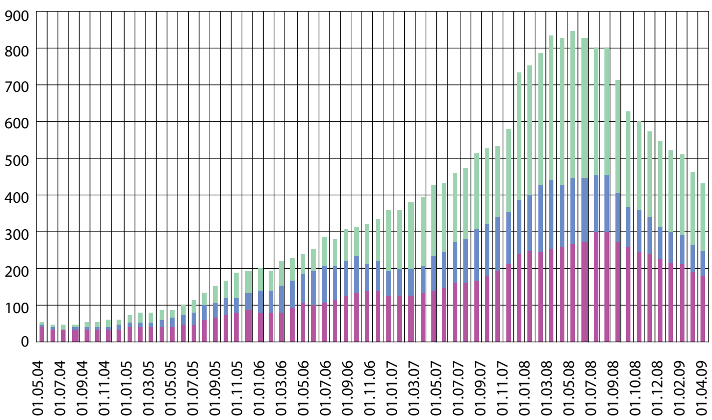
GRAPH 2.5.1
Foreign Currency Denominated Deposits



GRAPH 2.5.2
Domestic Currency Denominated Deposits



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



2041.2 million. The decrease was evident for both current accounts and term deposits, down USD 118.9 million and USD 101.1 million, respectively. In dollar terms, the volume of these deposits also decreased by USD 219.9 million (15.3%). Term deposits comprised 70.2% of foreign currency deposits. It is remarkable that the share of term deposits was decreasing in January, but this trend reversed in February and March with the share of term deposits rebounding. Foreign currency deposits of legal persons also decreased by USD 107.6 million (18.7%).

Domestic currency denominated deposits fell in the accounting period by GEL 98.2 million (12.7%) totaling GEL 673.4 million. Such a reduction was largely due to shrinking deposits of legal persons, the volume of which fell by GEL 59.2 million, equaling GEL 518.7 million.

Factoring in the growth rates for deposits denominated in both foreign and domestic currency, deposit dollarization ratio increased in March 2009 by 0.5 percentage points against December 2008, running at 75.2% by end-month.

Deposit interest rates increased by 0.9 percentage points in the accounting period. The weighted average annual interest rate on the lari-denominated deposits at commercial banks was 10.2%, down 1.0 percentage point quarter-on-quarter. For the foreign currency denominated deposits the rate was at 10.4%, up 1.2 percentage points quarter-on-quarter. For the foreign currency denominated deposits of physical persons, interest rate was at 9.9%, up 0.9 percentage points. In annual terms, interest rates increased by 0.3 and 2.5 percentage points for domestic and foreign currency deposits, respectively.

The volume of lending extended by commercial banks to economy decreased in QI 2009 by GEL 318.4 million totaling GEL 5753.9 million. Domestic currency loans decreased in the accounting period by GEL 223.1 million (13.4%) amounting to GEL 1441.2

million, with the loans to legal persons accounting for 45.1%, of which 31.0% being the short-term loans.

Foreign currency loans decreased by GEL 95.3 million equaling GEL 4312.8 million. In the US dollar terms, this type of loans decreased by 61.8 million (2.3%) amounting to 2582.5 millon at end-period. Loans to legal persons comprised 63.8% of these loans, while long-term loans comprised 76.6%. The decrease in lending in foreign currency was largely due to long-term loans. By economic sectors, the decrease was at lowest for commercial loans.

Despite that the lending to the economy decreased in quarter-on-quarter terms, there is a substantial year-on-year increase, running at 13.6% at end-March.

Overdue loans grew in QI 2009 by GEL 62.8 million (39.4%) totaling GEL 222.0 million.

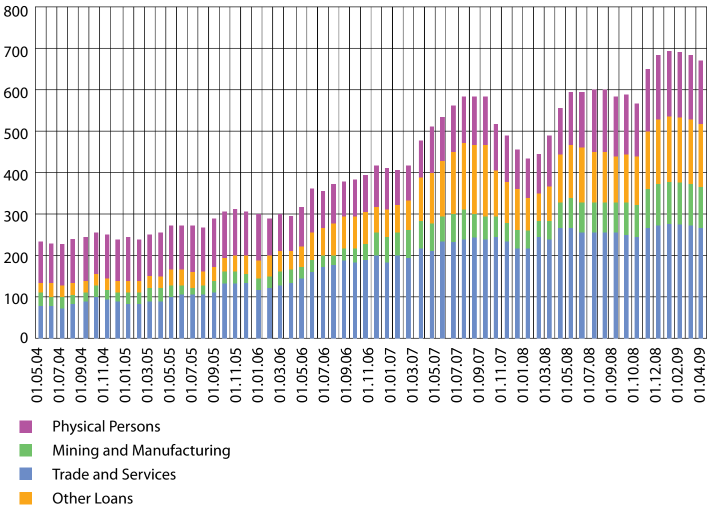
Interest rates in the banking system decreased quarter-on-quarter averaging 22.4% in QI 2009. The weighted average annual interest rate on domestic currency loans was at 24.4%, while that on foreign currency loans was at 21.4%, down 0.5%. For legal persons interest rate on foreign currency loans was around 18.8%. In year-on-year terms interest rates on both foreign and domestic currency loans increased by 2.3 and 1.9 percentage points, respectively.

The returns on assets (ROA) and returns on equity (ROE) were negative in the accounting period. As of March 2009, the ROA was at -1.4% while the ROE was at -7.6%.

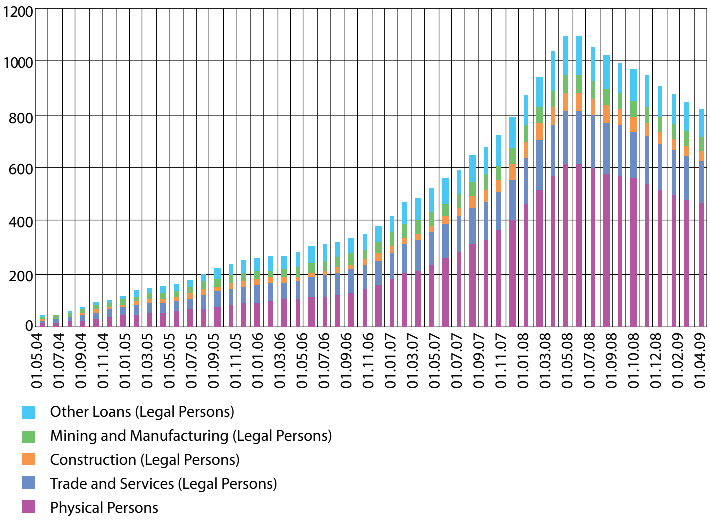
2.6 EXCHANGE RATE FACTORS

The exchange rate is determined by demand and supply of foreign currency. Supply is generally driven by foreign capital inflows, mainly powered by the FDIs. Demand is primarily conditioned by current account deficit. Thus, it is critical to analyze determinants of investment inflows and current account

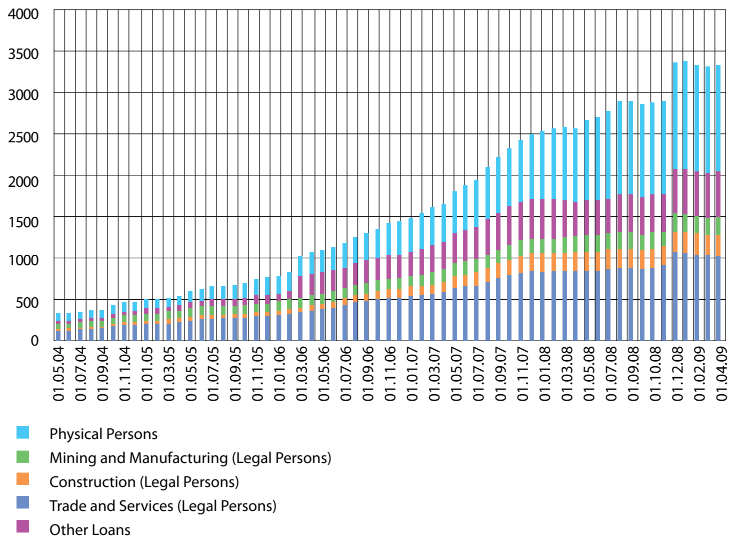
GRAPH. 2.5.4
Short-Term Loans Denominated in Foreign Currency (million GEL)



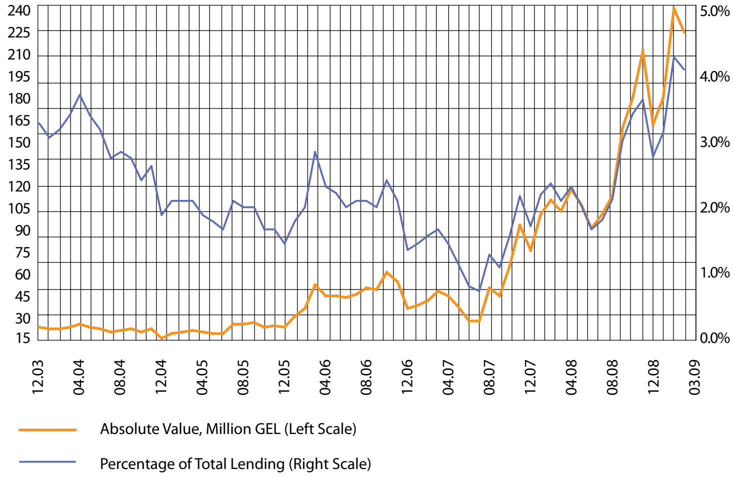
GRAPH 2.5.5
Long-Term Loans Denominated in Domestic Currency (million GEL)



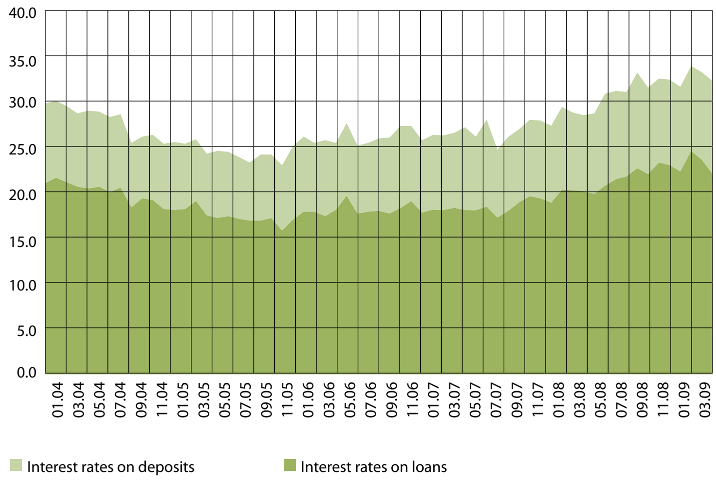
GRAPH 2.5.6
Long-Term Loans Denominated in Foreign Currency



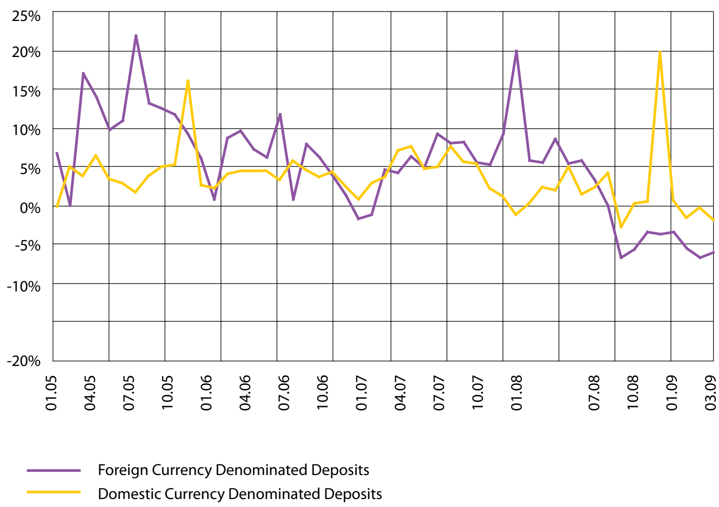
GRAPH 2.5.7
Overdue Loans (million GEL)



GRAPH 2.5.8
Interest Rates on Loans and Deposits



GRAPH 2.5.9
Deposit Growth Rates (Compared to Previous Month)



deficit, and compare them with the corresponding parameters of other countries.

Foreign capital inflows primarily depend on the country's economic growth as it preconditions the return on investment opportunities. Market interest rates also play an important role. Interest rates hikes on both loans and deposits in the banking system represent 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 effort to stimulate their economies to the highest extent possible, which led to a substantial reduction in the interbank interest rate (for instance, by end-March 2009, the rates in the US, the EU, and the UK were at 0.2%, 2.8%, and 0.7%, respectively).

Needless to say, the 2008 global financial crisis had a detrimental impact on the economic development of world economies, including Georgia. In 2007 the country had one of the fastest growing rates of real GDP among developing economies, running at 12.4%. However the tendency reversed after the 2008 developments (the global financial crisis and the war with Russia), with the annual growth rate of real GDP falling from 8% in H1 2008 to 2% at end-year.

The rapidly developing economies enjoy strong foreign capital inflows, as a general rule. Georgia maintained high levels of economic growth over the past years, which made the country attractive for investment activities. However, the August war with Russia, amid the global financial crisis, severely undermined the country's economic growth, significantly reducing the FDIs volumes to USD 1,280 million in 2008, down from USD 1,750 million in 2007. Contraction obviously took place in the last two quarters.

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

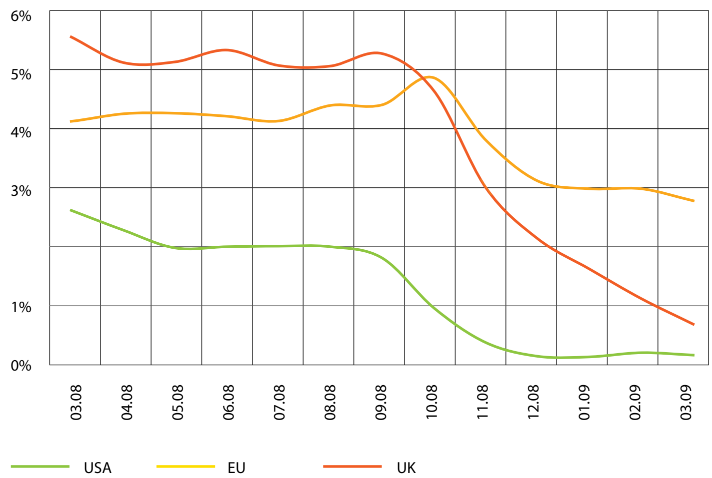
Current account deficit exceeded USD 2.850 million in 2008, up 42% year-on-year. The 2008 current account deficit widened to 22% of the GDP, up from a 5% level in 2004. Such a continuous deterioration is largely due to the foreign trade deficit caused by a much faster pace of imports as opposed to exports.

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 contraction of FDIs, as followed after the August war, impaired the existing trend, and the lari depreciated in QIV 2008 against the backdrop of excessive demand for foreign currency. The depreciating tendency discontinued in QI 2009, and the exchange rate was mainly characterized by short-term fluctuations, without a definite trend.

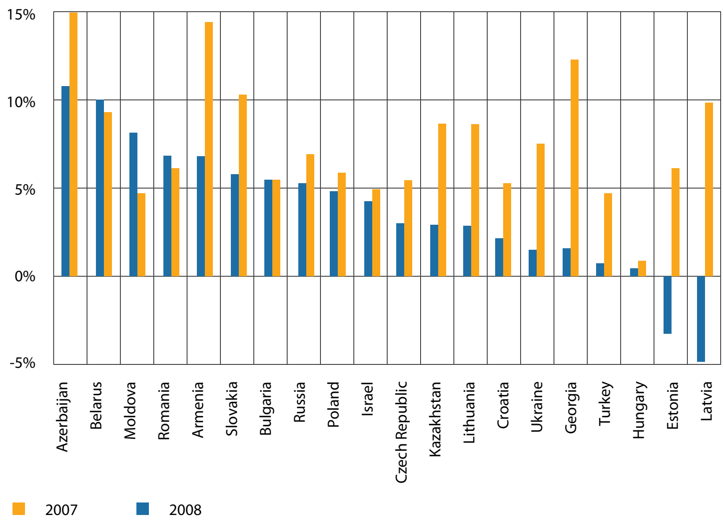
Over a period of several years the NBG's interventions at the TIBFEX were mostly on the side of foreign currency withdrawal. In QIII 2008 there emerged an excessive demand for foreign currency and, accordingly, the NBG began intervening at the TIBFEX on the supply side (save for March 2009).

The lari real effective exchange rate appreciated by 1% in QI 2009, which was mainly due to the appreciation against the Russian ruble and the Turkish lira by 5.07% and 4.68%, respectively. At the same time, the lari real effective exchange rate depreciated against the US dollar and the euro by 2.77% and 0.52%, respectively.

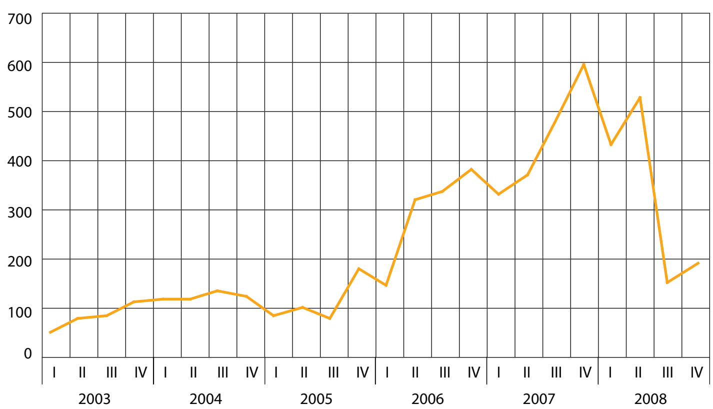
GRAPH 2.6.1
Interbank Interest Rates (monthly average)



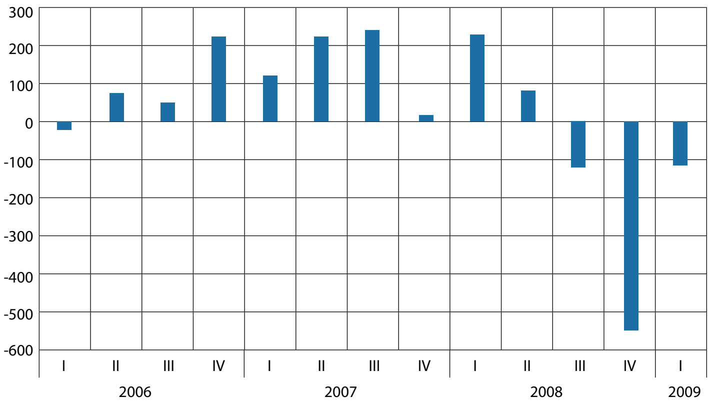
GRAPH 2.6.2
Real GDP Growth, the CIS and the CEE Countries, 2007 and 2008



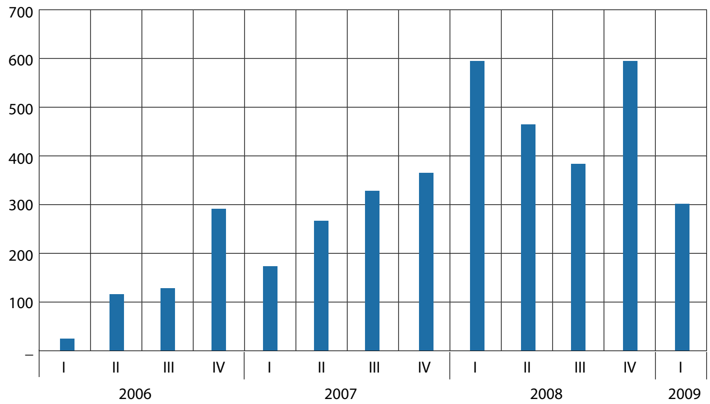
GRAPH 2.6.3
Foreign Direct Investments Inflow in Georgia (million USD)



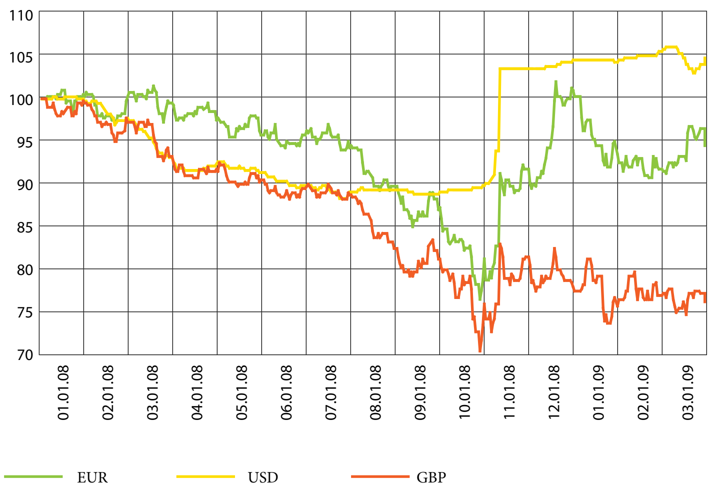
GRAPH 2.6.4
Net Purchases of the NBG at the TIBFEX (millions USD)



GRAPH 2.6.5
NBG Interventions at the TIBFEX (million USD)



GRAPH 2.6.6
Dynamics of the Lari Nominal Exchange Rate (2008)



2.7. PRODUCTION AND DEMAND

The GDP slowdown continued in QIV 2008. In nominal terms, the GDP grew only by 2.6%, equaling GEL 5098.8 million. The real GDP decline was at 2.5%.

In QIV 2008 the August war, representing a devastating shock by itself, was aggravated by the global economic crisis. This led to a significant real GDP decline in almost all major sectors, except for a few. Growth rates reduction was particularly large in such sectors as agriculture (-15.8%), transports (-20.1%), financial intermediation (-25.6%), and construction (-10.4 %). Negative growth rates were also recorded in the manufacturing, production and distribution of electricity, gas and water, and real estate operations sectors. It is remarkable that extremely large contraction of the financial intermediation sector was due to a one-time reservation of the non-performing loans at the end-year period. At the same time, a 10% reduction in the suffering construction sector, indicating of significant improvement against a 32% reduction in the previous quarter, is largely due to the construction projects under the budgetary financing.

Positive growth rates remained in a few economic sectors in QIV 2008. It is remarkable that most of these sectors largely depend on public expenditures, including public administration (10.2%), education (6.5 %), and healthcare (5.7 %). The GDP growth contribution of these sectors equaled 2.2 percentage points. Among other sectors with a positive growth, significant growth rate was registered for the trade sector (6.4%), having a high share in the GDP. Remarkable growth rates were also recorded for the hotels and restaurants, and mining and quarrying sectors.

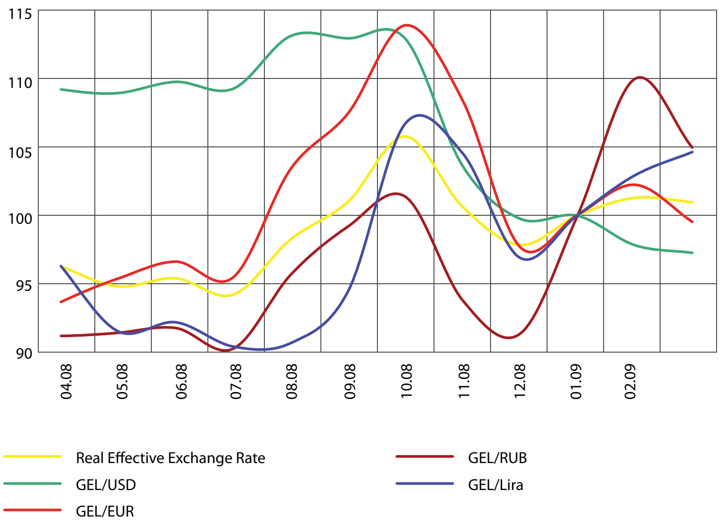
2.7.1 HOUSEHOLD AND GOVERNMENT CONSUMPTION

Quarter-on-quarter growth rate of total consumption in nominal terms slowed down in QIV 2008 but

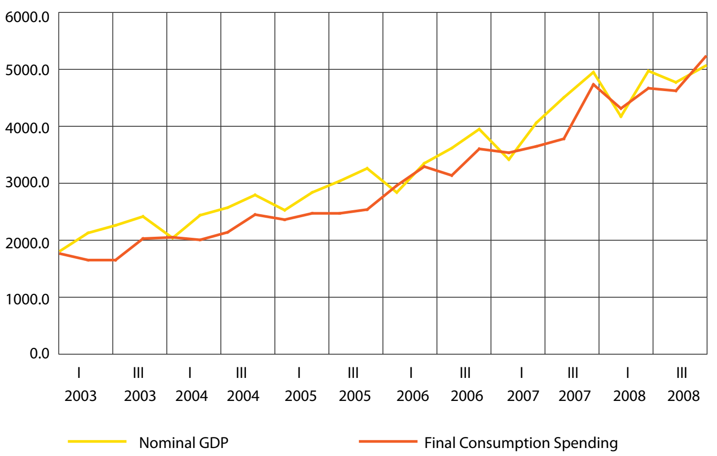
TABLE 2.7.1
Contribution of Economic Sectors to Georgia's GDP Growth (%)

Economic Sectors	Growth Rates	Share in GDP (%)	GDP Growth Contribution
Agriculture, Hunting and Forestry, Fish Catching and Fishery	-15.8%	7.4%	-1.2%
Mining and Quarrying	20.3%	0.5%	0.1%
Manufacturing	-3.6%	8.3%	-0.3%
Production and Distribution of Electricity, Gas and Water	-15.2%	2.1%	-0.3%
Processing Products by Households	-10.6%	3.2%	-0.3%
Construction	-10.4%	6.1%	-0.6%
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	6.4%	14.1%	0.9%
Hotels and Restaurants	12.8%	2.5%	0.3%
Transport	-20.1%	5.8%	-1.2%
Communications and Post	3.4%	3.2%	0.1%
Financial Intermediation	-25.6%	1.7%	-0.4%
Real Estate, Renting, and Business Activities	-5.8%	3.3%	-0.2%
Imputed Rent of Own Occupied Dwellings	2.2%	2.2%	0.0%
Public Administration	10.2%	15.6%	1.6%
Education	6.5%	4.0%	0.3%
Health Care and Social Assistance	5.7%	4.5%	0.3%
Communal, Social and Personal Services	-0.3%	3.9%	0.0%
Private Households with Employed Persons	2.0%	0.1%	0.0%
FISIM Adjustment	22.8%	-1.2%	-0.3%
GDP at Basic Prices	**-2.1%**	**87.3%**	**-1.9%**
Taxes on Goods	-4.3%	13.1%	-0.6%
Subsidies on Goods	12.6%	-0.4%	-0.1%
GDP at market prices	**-2.5%**	**100.0%**	**-2.5%**

GRAPH 2.6.7
Dynamics of the Lari Real Exchange Rate (2009, January = 100)



GRAPH. 2.7.1.1
Quarterly GDP and Consumption, 2003-2008



still remained at a two-digit level. The household and government consumption grew by 10.9%, amounting to GEL 5262.3 million. It is noteworthy that the QIV consumption comprised 103.2% of the GDP.

As shown in the graph below, consumption appeared to determine the nominal GDP behavior throughout all quarters. Based on this, consumption is likely to negatively impact the GDP over 2009, as it is expected to decrease against the backdrop of worsening economic conditions and increasing precautionary savings observed in times of economic crises.

2.7.2. INVESTMENTS

The nominal value of gross capital formation was GEL 1134.9 million in QIV 2009, up GEL 204 million quarter-on-quarter. The increase was largely due to the implementation of state infrastructure projects in the accounting period. However, year-on-year gross capital formation decreased by GEL 70 million.

2.7.3 GDP ESTIMATIONS FOR QI 2009, AND THE 2009 FORECASTS

The growth rate of real GDP estimates are being updated as more current data become available. The aggravation of the global economic crisis, on the one hand, and the political instability in the country, on the other, contribute to uncertainty of the estimates. As of the current stance, GDP decline estimates are at least 3% in QI 2009, with the risks weighted to the downside. The majority of economic sectors are expected to deteriorate, which can be somewhat alleviated by means of state fiscal stimulus programs.

Accordingly, the 2009 GDP forecasts worsened, taking into account deteriorating conditions of economic recovery in H2 2009. As of today, the GDP annual growth rate is expected to be near zero, with the downside estimation risks.

BOX 1. WORLD ECONOMIC OUTLOOK

The world economic outlook projections were made upon the end of QI 2009. The majority of international organizations agree that the global economic recession, and the recovery as well, will last longer than previously envisaged.

According to the IMF World Economic Outlook (WEO) Report released in April 2009, the world production is projected to contract by 1.3% in 2009, which appears to be a downturn from the 2008 end-year projections that assumed a 1% world economic growth. This represents the deepest recession by far after the World War II.

The 2009 forecasts worsened on the assumption that the global economic crisis aftershocks will remain strong through the year. Even with determined steps undertaken by the governments of different countries quarter-on-quarter GDP growth rate of developed economies contracted by record high 7.5% in QIV 2008, and the tendency was expected to continue in QI 2009. The contraction of aggregate demand in developed economies will significantly affect the emerging economies, especially those strongly relying upon exports.

World financial markets still experience low activity, and overall credit to the private sector is likely to continue declining over 2009-2010. In advanced economies the solution of this problem is hampered by the uncertainties related to financial losses. The April 2009 issue of the Global Financial Stability Report (GFSR) estimates that possible credit write-downs related to the US-originated bad assets will total $2.7 trillion over the period of 2007 through 2010, compared to an estimate of $2.2 trillion in the January 2009 GFSR Update. Two-thirds of this burden will be borne by banks, while the rest will fall on insurance companies and other financial institutions. In emerging economies the attraction of foreign resources, and hence, capital inflows will sharply contract, and the economic situation is projected to show only slow improvement. Taking into account the aforesaid, strong macroeconomic policy support is envisaged worldwide over 2009, involving both monetary and fiscal instruments. Central banks will continue to loosen their monetary policies, and the monetary policy interest rates are expected to be near zero bound in the major advanced economies. Particular role is assigned to the central bank's unconventional measures to be implemented by means of changes in the size and structure of their balance sheets.

The implementation of fiscal stimulus packages, already launched or planned by many economies in H2 2008, will continue. In G20 countries the total amount of such packages will amount to 2% of GDP in 2009 and 1.5% of GDP in 2010. As a result of these measures fiscal deficits are expected to sharply widen in both advanced and emerging economies.

The current global economic outlook is exceptionally uncertain notwithstanding the unprecedented macroeconomic measures undertaken worldwide. A key concern is that the monetary policies in operation may appear to be insufficient against the backdrop of deteriorating financial conditions and decreasing economic growth rates. In conditions of economic uncertainty, fiscal and monetary policies may fail to gain traction, since high rates of precautionary savings could lower fiscal multipliers, whereas excessive money supply could fail to slow the process of deleveraging. On the upside, however, bold fiscal and monetary actions assume the crucial role in convincing markets that financial strains are being dealt with decisively. Restoration of positive expectations in the markets in turn represents a necessary precondition for boosting confidence and increasing consumption.

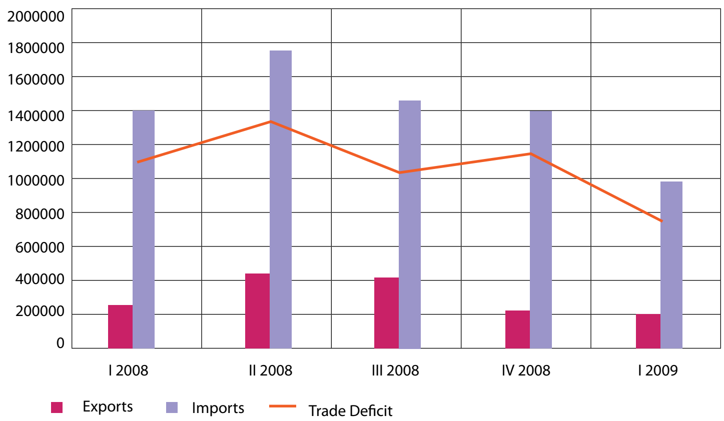
2.8. EXTERNAL TRADE

Georgia's external trade turnover had a permanently growing tendency for years. In QIV 2008, for the first time in the recent years, both imports and exports posted a decline as a result of the August war and subsequent impact of the world financial. This tendency developed further in 2009. In the accounting period the external trade turnover totaled USD 1202.2 million, posting a 31% decline year-on-year. Exports of goods equaled USD 220.1 million (down 33% y-o-y) and imports totaled USD 982.1 million (down 30% y-o-y). Consequently, trade deficit amounted to USD 762.0 million recording a 29% decline year-on-year.

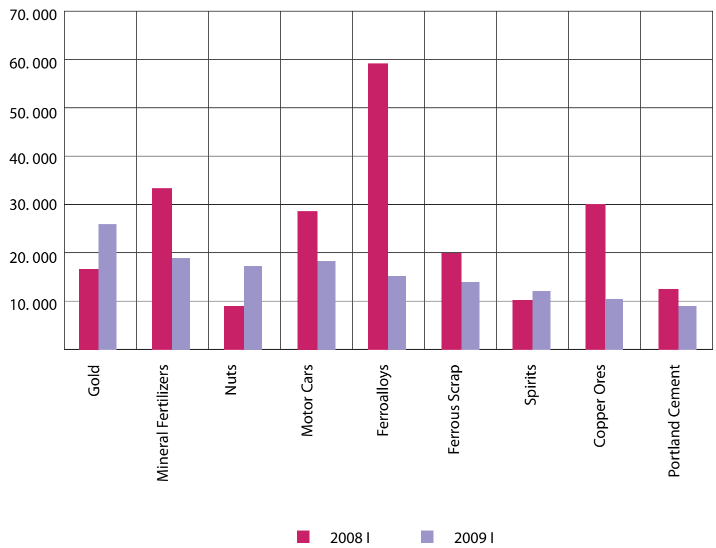
The global financial crisis, with the world prices sharply fallen, essentially affected Georgia's external trade. As stated above, exports of goods contracted by 33% year-on-year, which was largely due to the world price decreases on ferrous and nonferrous metals, leading to the contraction of both volumes and value of exports thereof.

In QI the top ten export items were as follows: gold, mineral fertilizers, nuts, motor cars, ferroalloys, ferrous scrap, spirits, copper ores, portland cement, and wines of fresh grapes. Although the composition did not significantly change in terms of commo-

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



GRAPH 2.8.2
Main Ten Export Items QI 2009 vs. QI 2008.



dities after the previous quarter, there was a change by positions in the accounting quarter. Namely, the ferroalloys moved down from the first position (held through 2008) to the fifth, with the annual decline rate at 73.5% in value terms and at 51% in volumes. Significant decline was also registered for such important export items as ferrous scrap (37% in value terms and 33% in volumes) and copper ores (71% in value terms and 35% in volumes). As shown in the diagram below year-on-year growth rates increased only for gold, nuts, and spirits.

The major trading partners of Georgia in QI 2009 were in the following order: Turkey, Azerbaijan, Ukraine, Russia, the US, Germany, Italy, China, Bulgaria, and Armenia. The share of these trading partners comprised 69% of total trade turnover.

BOX 2. INTERNATIONAL TRANSACTIONS REPORTING SYSTEM (ITRS)

The NBG conducts the external sector statistics since 2007, covering, in particular, the balance of payments (BOP) data, total external debt, and international investment position. To ensure accuracy of these data and their compliance with international standards, it became necessary to search for additional sources of information. Based on the IMF recommendation, there was made a decision to implement the International Transactions Reporting System (ITRS) in Georgia, which is already implemented in many CIS and other countries, including Ukraine, Belarus, Moldova, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Germany, France, Bulgaria, Romania, Japan, Indonesia, and others, serving as the principal database for the compilation of external sector statistics.

The ITRS serves to collect data on BOP operations conducted through the banking system. The use of this system will essentially improve both quality and operational availability of statistical information on the BOP and the external economic operations. Based on relevant reporting templates, banks submit reports on operations conducted through their correspondent accounts with foreign banks, and on operations of non-residents having current accounts with such banks. Accordingly, the system facilitates the monitoring of funds flow on external correspondent accounts (nostro and loro) and current accounts of non-residents. Each account transaction is assigned relevant partner country and economic sector codes prescribed by the BOP operations standard classification, and is then submitted to the NBG.

The Georgia ITRS implementation concept was elaborated by the NBG in close cooperation with the IMF regional advisor. The reporting templates and transaction codes supported with relevant instructions were worked out, and the main sectors were defined (NBG, commercial banks, non-bank financial corporations and non-financial corporations having accounts with foreign banks). The ITRS implementation plan envisaged two main phases, where Phase I provided for putting the system in operation in the NBG and the banking system, and Phase II – for the subsequent integration of non-bank financial corporations and non-financial corporations.

The preparatory works included presentation and training activities conducted with the representatives of commercial banks. Based on consultations, testing outcomes, and suggestions proposed by the representatives of commercial banks, the transaction codes system was optimized and the instructions for filling in the reporting templates were modified. The system was subject to certain simplification. The format of electronic reports to be submitted to the NBG was reconciled with the IT divisions of the NBG and commercial banks.

In January 2009 the ITRS was put in operation in the NBG and the banking system in line with the phased implementation plan. The reports on transactions conducted by commercial banks over QI 2009 were submitted. The ITRS is intended for the collection of statistical information required for the assessment of the BOP and external economic operations. During Phase I the system will facilitate the monitoring of funds flow between Georgia's banking system and the rest of the world. Each transaction is classified with the breakdown by country of sender/recipent, date of valuation, currency type, sector of sender/recipient, and description of operation, in accordance with the standard classification of the BOP items. The information presented in the coded form enables to determine the funds flow by both direction and destination, implying in particular: receipt/payment of funds for export/import of goods and services, by country and currency; receipts or payments by residents; current transfers; investments in- and outflows: direct, portfolio; etc.

Consequently, the information received and aggregated on a monthly basis through the ITRS is beneficial for both the NBG and the commercial banks, as it provides for analyzing the international operations conducted in Georgia, and their dynamics by country, currencies, and their essence itself.

2.9. GOVERNMENT OPERATIONS

State budget deficit amounted to GEL 88 million in QI 2009 (deficit calculation takes into account current expenditures as well as expenditures on financial and non-financial assets), which is GEL 116.4 million less than the planned target . The difference between the actual and planned budget execution is mostly due to the over-mobilization of budget revenues by all revenue categories. In particular, in the accounting period actual grant revenues exceeded the target by 9.6%, and other revenues posted a surplus of 7.6%, of which the largest share falls on revenues from goods and services, and sanctions (tax offences, penalties and fines). For tax revenues the actual-to-target ratio was insignificantly higher than 1. The actual execution of budget expenditures was at 93.8% of the target, with the largest deviation from the target being for goods and services (85.3% execution). It is noteworthy that the QI 2009 state budget expenditures increased by 3.5%, whereas revenues contracted by 3% year-on-year.

In QI 2009 75% of state budget expenditures were covered from tax revenues, while revenues from the share of privatization equaled only 2%. The actual execution of tax revenues was at 101.1% of the official target. In particular, actual revenues from direct taxes exceeded the target by 1,5%, while the execution of indirect taxation revenues (which is more sensitive to deman pressures) equaled 100.9% of the target.

The share of government investments in the GDP was increasing over the period of 2004 through 2007 but the tendency reversed downwards since 2007, which was most probably due to the contraction of the state budget deficit. However, by QI 2009 this parameter equaled 3.1% (vs a 3.7% target), up from 2,9% year-on-year. Considering that this parameter is characterized by seasonality patterns, it is expected to grow over the next quarters to reach the maximum value by end-year. It is noteworthy that the increase in expenditures on non-financial assets contributes to the reduction of unemployment and promoting economic growth in the country in both short and long-term perspectives.

The size of the reserve money contracted by 12% (GEL165 million) in QI 2009. Contributions to the

TABLE 2.9.1
State Budget Execution Parameters [by Categories]

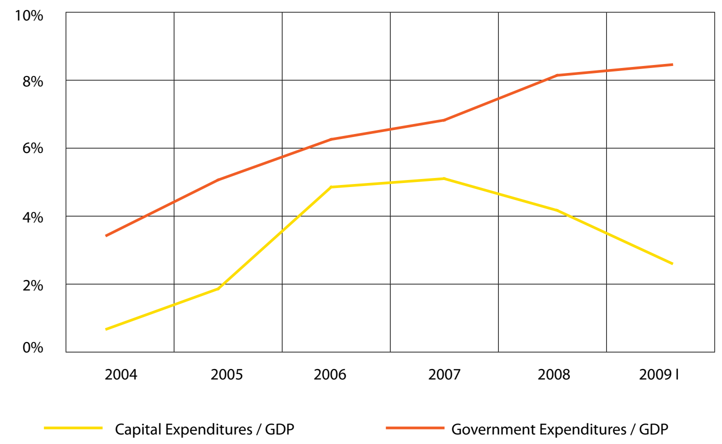
State Budget (GEL thousand)	**QI 2009**	**Execution %**	**Annual Growth, %**	**Ratio to GDP (2009)**	**Ratio to GDP (2008)**
Revenues	**1 363 038**	**102,3%**	**-3,2%**	**34,1%**	**33,7%**
Income Tax	238 254	100,5%	-2,3%	6,0%	5,8%
Profit Tax	171 159	102,9%	-10,8%	4,3%	4,6%
VAT	571 929	101,1%	20,4%	14,3%	11,4%
Excise Duty	99 968	100,0%	-13,6%	2,5%	2,8%
Customs Duty	9 083	101,4%	-23,4%	0,2%	0,3%
Other Non-classified Taxes	9 191	100,0%	-79,5%	0,2%	1,1%
Grants	37 497	109,6%	28,4%	0,9%	0,7%
Other Revenues	54 826	107,6%	-56,8%	1,4%	3,0%
Decrease in Non-financial Assets	23 605	105,2%	-83,0%	0,6%	3,3%
Decrease in Financial Assets	110 879	101,8%	3708,4%	2,8%	0,1%
Increase in Liabilities	36 594	128,7%	38,1%	0,9%	0,6%
Expenditures	**1 470 020**	**93,8%**	**3,5%**	**36,8%**	**34,0%**
Current Expenditures	1 118 993	94,4%	-11,2%	28,0%	30,1%
Capital expenditures	122 082	82,4%	2,0%	3,1%	2,9%
Expenditures on Financial Assets	38 662	89,7%	89,4%	1,0%	0,5%
Decrease in Liabilities	190 282	99,7%	842,3%	4,8%	0,5%

change in reserve money are as follows: 9.5% for government operations, -2.9% for monetary operations (implying net liabilities of commercial banks to the NBG), and -18.1% for external sector (implying net foreign currency purchases of the NBG through the TIBFEX and currency auctions). As is evident from these figures, only government operations posted a positive contribution value, which clearly indicates that the government was pursuing expansionary monetary policy to support domestic economic activity. In the accounting period expenditures on social protection should be pointed out, which totaled GEL 292 million in QI 2009, and where the major expenditures fall on old-age assistance, family allowances, and social safety of children, as well as such unclassifiable expenditures as social alienation.

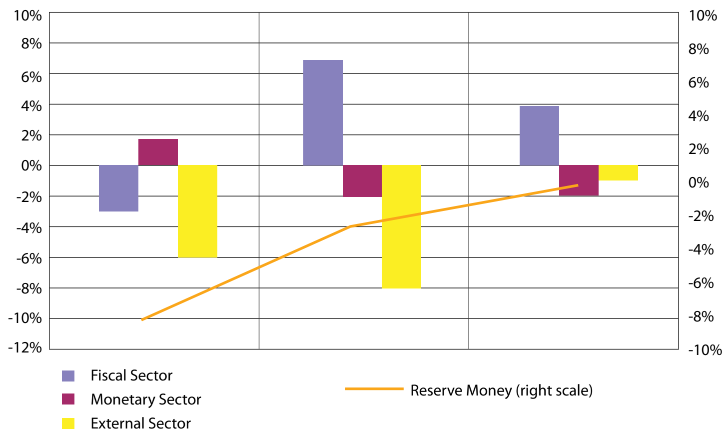
The second largest portion of government expenditures represented expenditures on general public services, amounting to GEL 264 million in QI 2009. These expenditures were incurred to provide for grants to local governments, financial and fiscal activities of executive and representative bodies, and servicing of state debt. Government expenditures on public order and security amounted to GEL 221 millon in QI 2009. The appropriations under this category were executed mainly in the form of wages and improvement of logistics in police and state security services, and provision of services in the judicial, public prosecution, and penitentiary system.

In QI 2009 year-on-year total state debt contracted by 1.2% (GEL 63 million) amounting to GEL 5090.5 million, with external and domestic debt down by 1.5% (GEL 55 million) and 0.6% (GEL 8 million), respectively. The effect of the exchange rate change equaled GEL 6.6% million. Modest external debt growth, if used for stimulating economic activity during the crisis times, should be considered as a positive phenomenon.

GRAPH. 2.9.1
Government Expenditures/GDP



GRAPH 2.9.2
Change in Reserve Money, 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 short-term inflation forecasts under certain assumptions and projections. On the other hand, the NBG applies econometric modeling of inflation dynamics.

For short-term inflation forecasting, the NBG takes into account assumed dynamics of world prices on certain important products of the consumption basket. According to the current assumptions, prices on oil products are expected to grow in QIV 2009. Based on the assumptions made for inflation forecasting, transportation costs will follow the dynamics of oil product prices throughout 2009. Certain growth is expected for wheat prices. Another assumption is that regulated prices will remain unchanged over the next year. Also unchanged will remain prices on sunflower oil. The assumptions for dynamics of prices on fruits, vegetables, and dairy products are based on seasonal factors. For the rest of the product groups in the consumption basket, the assumptions are based on the existing trend expectations in respective economic sectors. The inflation forecasts based on this methodology suggest that the annual rate of inflation will decrease to 1.6% by the end of QII 2009, and continue decreasing over QIII to reach 0.8% by end-September. However, the rate is expected to rise afterward to circa 3.6% at end year. As of the average annual rate of inflation, according to the existing estimates, the downward tendency will prevail in 2009, and the rate will decrease to 5.2% in June and 2.8% at end-September.

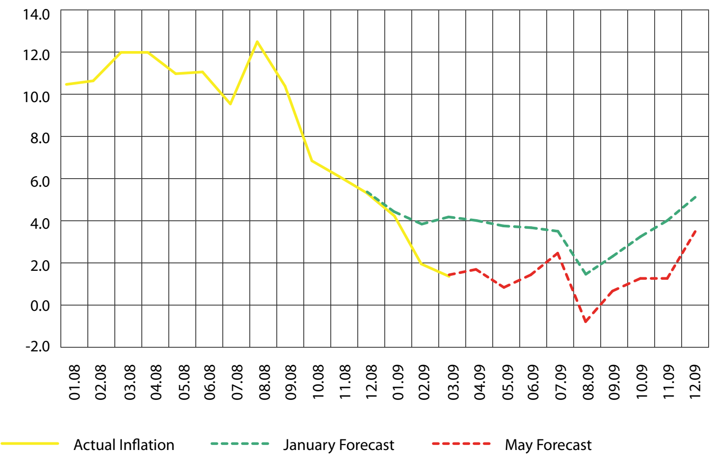
It is remarkable that the QI 2009 inflation forecasts were revised downwards from the previous quarter. This is largely due to the continued drop of world prices on oil products and certain important products of the consumption basket, such as wheat and sunflower oil, in QIV. Consequently, quarter-on-quarter projection of annual inflation decreased by circa 1.6% percentage points.

As of the projected average annual inflation, the rate decreased by circa 1.1 percentage points for end-QII 2009, and by 1.5 percentage points for end-QIII, compared to the projections for the previous quarter.

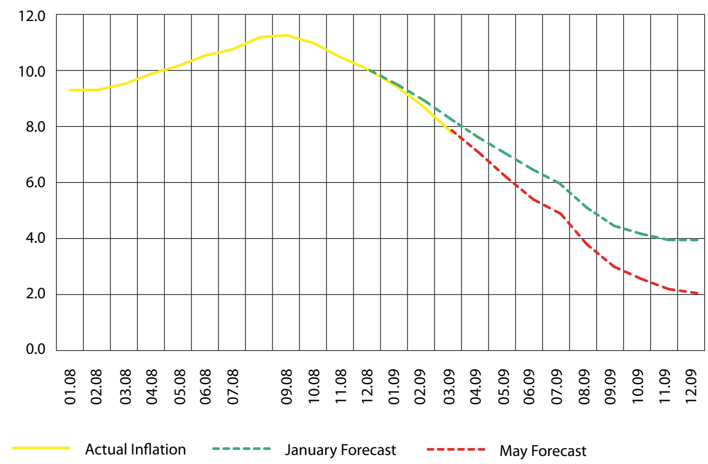
It must be pointed out that the inflation projections made by using this methodology are suitable for a six-month time horizon, as the level of accuracy falls for a longer period.

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

GRAPH 3.1
Annual Inflation Forecasts (by products)



GRAPH 3.2
Average Annual Inflation Forecasts (by products)



The estimated equation is given as follows

$$\delta p = 0{,}111\delta e_{-2} - 0{,}057\delta e_{-4} + 0{,}029\delta m_{-1} + 0{,}035\delta m_{-2} - $$
$$- 0{,}039\delta m_{-3} + 0{,}012\delta p^{oil}{}_{-1} + 0{,}024\delta p^{food}{}_{-1} - 0{,}054ecm;$$

where:

P - Consumer Price Index;

m – Money Mass;

e – Exchange Rate GEL/USD;

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

P^{food} – Fruits and Vegetables Price;

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

$$ecm = p_{-1} - 0{,}46e_{-1} - 0{,}54m_{-1} + 0{,}66y_{-1} - 5{,}21$$

where:

y is GDP

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

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

☐ Broad money excluding foreign currency deposits will grow at the annual rate of 5.6% by end-year;

☐ The growth rate of real GDP will be at -1,5%;

☐ The lari nominal exchange rate against the USD will remain at the current level;

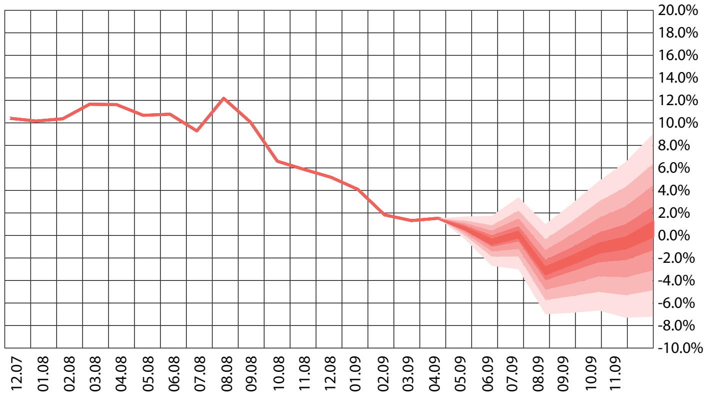
☐ Fruits and vegetables price will increase on a seasonal basis, in line with the previous year tendency;

☐ the oil prices in international markets will not decrease averaging 62 USD/barrel;

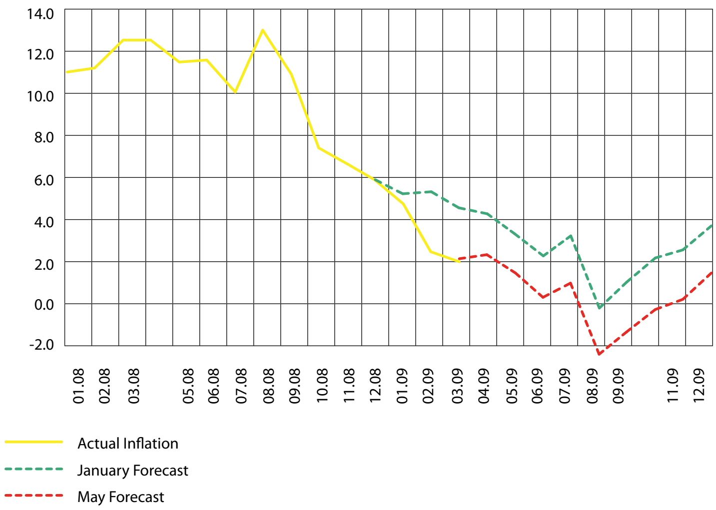
The annual inflation forecasts obtained by using the estimated model can be depicted as follows (GRAPH 3.3).

Based on the obtained results, the annual inflation rate is projected at 10% probability to be within the following ranges, : from 0.78% to 1.02% by May; from -0.53% to -0.07% by end-QII; from -2.36% to -1.58% by September; and from0.12% to 1.53% by end-year. The average annual inflation will be at 5.1% by June, 2.0% by September, and 0.4% by end-year.

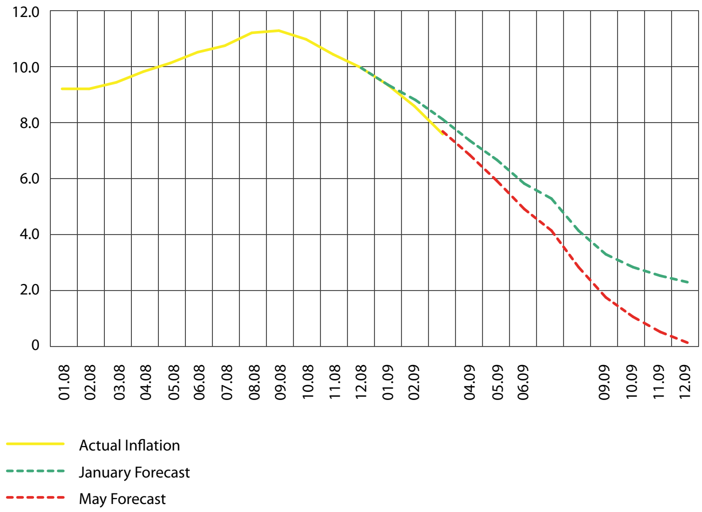
GRAPH 3.3
Annual Inflation Forecast



GRAPH 3.4
Annual Inflation Forecast (based on the model)



GRAPH 3.5
Average Annual Inflation Forecast (based on the model)



4. DECISIONS OF THE MONETARY POLICY COMMITTEE

The Monetary Policy Committee of the NBG held three meetings in QI 2009. At the January 21 meeting the Committee retained the interest rate on refinancing loans at 8%, reducing it at the two subsequent meetings of February 18 and March 18 by 100 and 50 basis points, respectively. As a result, the key interest rate equaled 6.5% by end-March.

It was stated at the January 21 meeting that the inflation rate continues to decline but the inflation risks have not changed after the preceding meeting. Lending to economy posted no growth despite a slight increase in deposits volume. Based on the NBG's studies, certain recovery of foreign capital inflows is anticipated in H2 2009 that will promote lending activities. The current economic growth forecasts are pessimistic yet, and there is uncertainty regarding future price dynamics in the international financial and commodity markets. Based on these considerations, the Committee kept the key interest rate unchanged.

At the meetings of February 18 and March 18 the Committee emphasized that downside risks to inflation increased, and that the slowdown in price increases is particularly notable for non-durable goods, helping improve population's sentiment regarding inflation outlook. Growth perspectives are particularly low for Georgia's neighboring countries and main economic partners. In addition to that, the NBG revised the estimates of the country's economic growth to the downside. Based on the existing assumptions, significant contraction is also expected in exports. Considering the expected slowdown of economic growth and the downside inflation dynamics, the Committee made a decision to loosen monetary policy, which was reflected in the reduction of the key policy rate from 8% to 6.5%.

The Committee decision regarding the launch of currency auctions as a new monetary instrument should be particularly pointed out. According to this decision, currency auctions will be held twice a week, partially replacing the TIBFEX, whereas the latter will operate on the other week days. The bid/ask volumes will be announced by the NBG prior to auctions, and the auctions will be conducted based on the multiple price principle. These auctions will serve to provide the economy with the US dollar liquidity, and represent an important step toward abatement of exchange rate management and establishment of market based exchange rate mechanisms.

3/5 Leonidze Str., Tbilisi 0105, Georgia
Tel: 44 24 88; Fax: 44 25 77;
E-mail: Info@nbg.ge; www.nbg.ge