Central Bank in Georgia was first established in 1919

INFLATION REPORT

2009

NATIONAL BANK OF GEORGIA

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INFLATION REPORT

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CONTENT

INTRODUCTION

According to the Department of Statistics of Georgia the annual inflation rate was at 2.3% in June 2009. The average annual inflation rate was at 5.4%, down 2.4 percentage points in the second quarter of 2009. Core inflation rates also decreased, with the annual rates for products within the limits of two and one standard deviations at -1.1% and 0%, respectively.

Driven by price decreases in the international markets annual inflation rate for imported goods also declined in June standing at -7.2%. Dynamics of the main factors of inflation can briefly be described as follows.

In QI 2009 the average monthly wage rate per employee was GEL 531.5, up 5.2% year-on-year, however, it must be noted that wages decreased compared to QIII and QIV 2008.

Reserve money grew 20.7% to GEL 1,528.7 million in QII 2009. Cash in circulation also grew by GEL 60.0 to GEL 1,201.2 million. The M2 aggregate expanded by GEL 75.4 million, while the M3 contracted by GEL 80.5 million. These components of the broad money amounted to GEL 1,709 million and 3,594.3 million, respectively.

In the accounting period the NBG conducted loose monetary policy in order to promote lending to economy. Interest rate on refinancing loans was reduced by 50 basis points to 6%, by the decision of the NBG's Monetary Policy Committee dated April 15. In addition to that, FX swap contracts were introduced as a new monetary policy instrument serving to supply banking sector with liquidity in the national currency, regulate money mass, and assist banking intermediation. Despite the NBG's monetary policy, lending to economy contracted in the accounting period.

Deposit liabilities of the banking system decreased 5.2% to GEL 2573.9 million in QII 2009. This was mainly due to the decrease in foreign currency denominated deposits. Volume of commercial banks' lending to economy totaled GEL 5458.8 million. Interest rates on both loans and deposits also decreased. Rates of return in the banking system turned negative in the accounting period.

In QII 2009 the lari nominal effective exchange rate depreciated 4.1%, and the real effective exchange rate depreciated 3.6%. Trade deficit of the country contracted 43.6%.

Based on the available data for QI 2009, nominal GDP declined 8.1% year-on-year, while the real GDP declined 5.9%. Notwithstanding certain improvement in the second half of 2009, forecasts for the current year remain pessimistic suggesting real GDP to decline 4% at least.

According to the NBG's projections annual inflation rate will rise to near 6% by end-2009.

1. CHANGE IN CONSUMER PRICES

According to the Department of Statistics of Georgia, overall level of consumer prices moved up 1.7% in QII 2009. In the corresponding quarter of 2008 consumer prices were up 0.9%. Accordingly, annual inflation rate was at 2.3% in June 2009, up from 1.6% in the previous quarter. Average annual inflation rate was at 5.4%, down 2.4 percentage points in QII 2009.

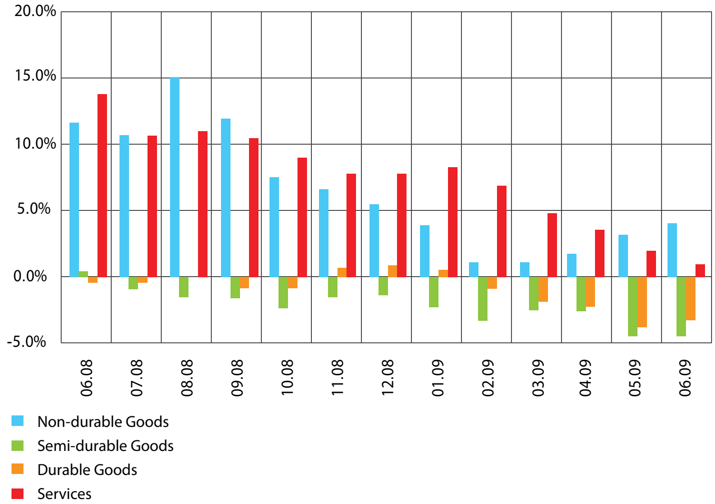
Inflation in the accounting period was mainly driven by oil price increases in the international markets, which pushed up gasoline prices in the domestic market. Gasoline price rose 16.5% in QII. Inflation dynamics were also significantly influenced by seasonal price volatilities on fruits and vegetables. Along with the drop of real estate prices it is remarkable that the decrease in apartment rental rates also had a downward effect on inflation. As the final result, consumption basket prices grew 1.7% in QII 2009.

Core inflation rates also decreased in QII 2009 posting annual -1.1% and 0% for products within the limit of two and one standard deviations, respectively.

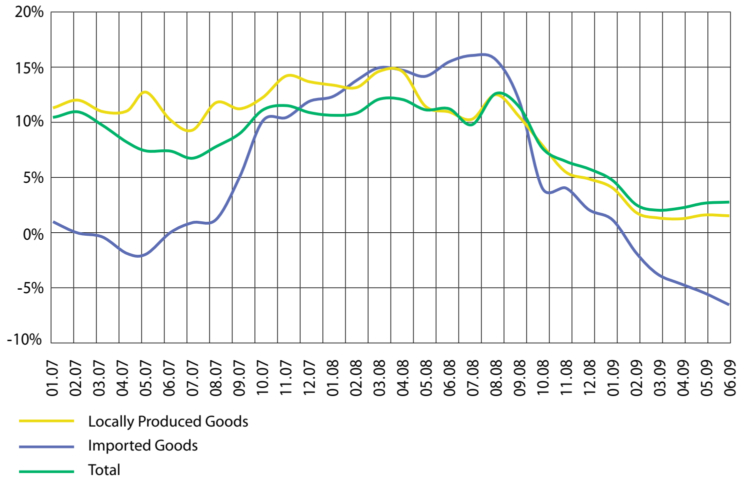
As already mentioned, in June 2009 consumption basket prices grew 2.3% year-on-year. Prices decreased in the clothing and footwear (5.8%), transports (9.6%), and housing, water, electricity, gas and other types of energy (6.0%) commodity groups, while other groups posted price increases, including communications (1.6%), household appliances (0.1%), food and non-alcoholic beverages (5.9%), and alcoholic beverages and tobacco (0.1%). Significant price increase of 11.7% was recorded in healthcare, which is largely due to the November 2008 hike of prices on medicaments.

The annual inflation rate for imported goods fell to -7.2% in June. The decrease in prices on im-

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

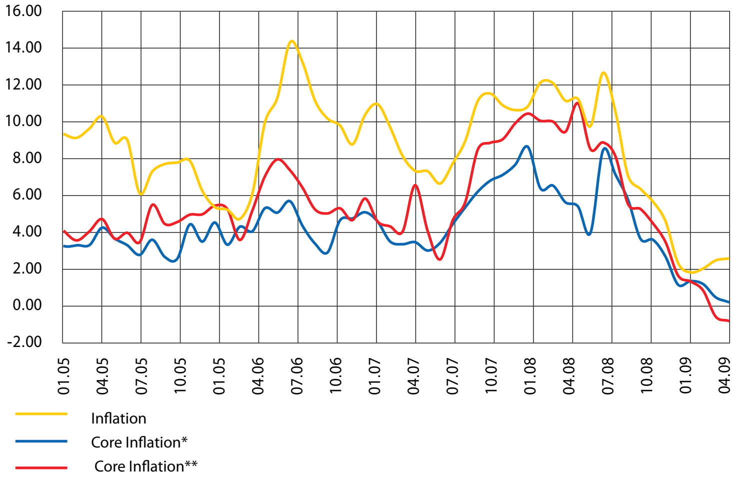


GRAPH 1.2
Annual Inflation by Location of Production

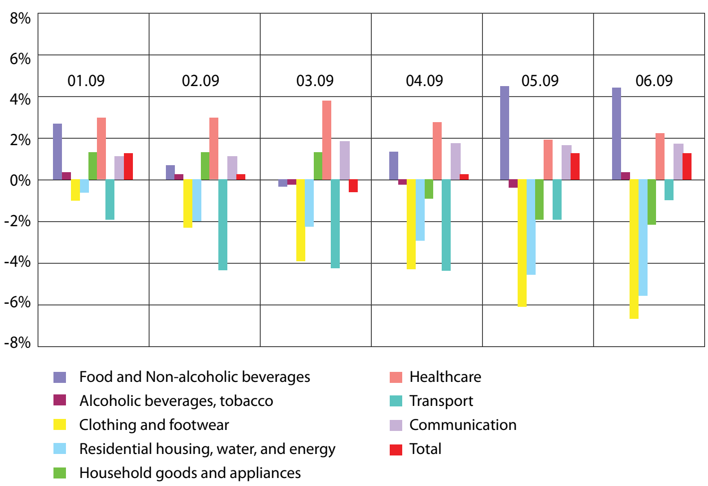


GRAPH 1.3
Inflation for Traded and Non -Traded Goods

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



GRAPH 1.5
Price Increases, Relative to December 2008



ported goods was driven by price decreases in international markets. Inflation rate for domestically produced goods was at 1%.

It is noteworthy to look at the price dynamics of traded[1] and non-traded goods. In June the price inflation for non-tradables decreased to 2%, while the annual inflation for tradables rose to 5.9%. Among goods of various consumption durability annual inflation rate was at 3.9% for non-durables and at 0.5% for services. Over the period of December 2006 through June 2009 prices on non-durables and services grew 21.4% and 21.3%, respectively, while semi-durables posted a 10.1% price decrease.

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

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

	2006 December Weigh	Jun09/Mar09		Jun09/Jun08		Jul08-Jun09/Jul07-Jun08	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	1.7%	1.7%	2.3%	2.3%	5.4%	5.4%
Food and non-alcoholic beverages	44.3%	4.9%	2.2%	5.9%	2.7%	6.2%	2.8%
Food	43.0%	5.0%	2.2%	5.8%	2.5%	6.2%	2.7%
Bread and Bakery Products	12.2%	-2.0%	-0.3%	-6.5%	-0.9%	5.0%	0.7%
Meat and Meat Products	6.6%	-1.1%	-0.1%	-0.2%	0.0%	8.2%	0.5%
Fish Products	1.1%	-3.9%	0.0%	-0.3%	0.0%	4.3%	0.0%
Milk, Cheese, Eggs	5.2%	-13.7%	-0.6%	-5.4%	-0.2%	-1.1%	0.0%
Oils and Fats	3.5%	-6.7%	-0.2%	-20.2%	-0.9%	0.8%	0.0%
Fruits, Grapes	2.3%	30.7%	2.0%	89.4%	4.1%	42.3%	1.8%
Vegetables, Watermelons, Potatoes and Other Solanaceae	8.8%	20.6%	1.3%	8.2%	0.6%	-3.0%	-0.2%
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7%	5.5%	0.1%	16.5%	0.3%	6.2%	0.1%
Other Food Products	0.6%	0.3%	0.0%	5.0%	0.0%	4.8%	0.0%
Non-Alcoholic Beverages	1.3%	0.6%	0.0%	8.2%	0.1%	6.5%	0.1%
Alcoholic Beverages, Tobacco	3.7%	-0.2%	0.0%	0.1%	0.0%	-0.1%	0.0%
Clothing and Footwear	5.0%	-3.0%	-0.1%	-5.8%	-0.2%	-4.2%	-0.2%
Housing, Water, Electricity, Gas, and Other Fuels	10.3%	-3.2%	-0.4%	-6.0%	-0.7%	1.9%	0.2%
Furniture, Home Appliances and Equipment, Housing Renovation	3.7%	-2.2%	-0.1%	0.1%	0.0%	8.2%	0.3%
Healthcare	8.0%	-1.6%	-0.2%	11.7%	1.0%	16.6%	1.3%
Transport	9.0%	3.9%	0.3%	-9.6%	-0.9%	2.6%	0.2%
Communications	4.4%	0.0%	0.0%	1.6%	0.1%	4.3%	0.2%
Recreation, Leisure and Culture	2.7%	0.6%	0.0%	1.5%	0.0%	1.6%	0.0%
Education	3.5%	-2.3%	-0.1%	2.8%	0.1%	0.6%	0.0%
Hotels, Cafes, Restaurants	2.4%	-0.6%	0.0%	8.9%	0.2%	8.2%	0.2%
Other Goods and Services	3.2%	-1.9%	-0.1%	5.8%	0.2%	7.4%	0.2%
Non Durable Goods	68.0%	3.3%	2.3%	3.9%	2.7%	5.8%	4.0%
Semi-Durable Goods	6.5%	-2.3%	-0.1%	-4.5%	-0.2%	-2.7%	-0.1%
Durable Goods	1.9%	-3.1%	0.0%	-3.6%	-0.1%	-1.2%	0.0%
Services	23.6%	-1.0%	-0.2%	0.5%	0.1%	6.7%	1.6%

2. INFLATION FACTORS

2.1. LABOR PRODUCTIVITY AND WAGES

The year of 2009 was earmarked by an annual increase in average wages. Namely, in QI 2009 average monthly wage rate equaled GEL 531.3 per employee in the official economy[3], up 5.2% year-on-year. It must be noted, however, that the growth rate significantly slowed down in pace, and average monthly wage rate decreased 5.1% and 9.2% compared to QIV and QIII 2008, respectively. Year-on-year growth of average monthly wage rate was observable in all major sectors of the economy in QI 2009. Sectoral analysis showed that the growth was particularly high in the fish catching and fishery sector, with the average monthly wage rate of employees up 36.9% year-on-year in QI 2009. Wages continued moving up but at a slower pace in those sectors which are largely financed from state budget. In the education, healthcare and social assistance, and communal, social and personal services sectors average wage rates grew 18.9%, 6.7%, and 5.6% year-on-year, respectively. Growth of wage rates was also remarkable in the agriculture (12.5%), construction (8.4%), manufacturing industry (7.1%), and real estate (7.0%) sectors. Average monthly wage rates grew at a comparably slower pace in the trade (4.9%) and transports and communications (1.1%) sectors. Negative growth rates were registered in four sectors of the economy, including financial intermediation (17.3%), mining and quarrying (13.3%), public administration (5.8%), and hotels and restaurants (2.9%).

Significant differences in average wage rates by sectors were still present in QI 2009. The highest monthly average wage rates were recorded in the financial intermediation (GEL 1323.6) and public administration (GEL 857.7) sectors, exceeding the monthly average for the whole economy 2.5 and 1.6 times, respectively. The lowest monthly average wage rates were registered in the fish catching and fishing (GEL 238.0) and education (GEL 254.1), making 44.8% and 47.8% of the monthly average rates for the whole economy, respectively. Wages below the average rate were mainly in those sectors which are largely financed from the state budget (education, healthcare and social assistance, and communal, social and personal services) but growth tendency in wage rates was still observable in these sectors.

In QI 2009 real value-added per employee fell 12.7% year-on-year. Substantial decline was recorded in the construction (31.2%), manufacturing (23.6), real estate operations, renting, consumer services (20.7%), and agriculture (19.1%) sectors. The decline was comparably smaller in the trade, and hotels and restaurants sectors. Notwithstanding overall downtrend in real value-added per employee, some sectors posted positive year-on-year growth rates in

TABLE 2.1.1
Nominal Monthly Average Wage Rates of Employees, QI 2009, Y-o-Y, (%)

	Nominal Rate
Agriculture, Hunting and Forestry	112.5
Fish Catching and Fishery	136.9
Mining and Quarrying	86.7
Manufacturing Industry	107.1
Production and Distribution of Electricity, Gas and Water	101.1
Construction	108.4
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	104.9
Restaurants and Hotels	97.1
Transport and Communications	101.1
Financial Intermediation	82.7
Real Estate Operations, Leasing, Consumer Services	107.0
Public Administration	94.2
Education	119.0
Health Care and Social Assistance	106.7
Communal, Social and Personal Services	105.6
Total	105.2

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

the accounting period. Labor productivity significantly increased in the financial intermediation (35.0%), healthcare (28.0), and education (15.3%) sectors. In the hotels and restaurants and public administration and defense sectors growth rates of real value-added per employee were at 14.7% and 10.1%, 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, which thereby contributed to accelerating inflation at a high pace. Notwithstanding these factors, annual inflation rate essentially slowed down during the accounting period owing to other factors of demand and supply.

2.2. DYNAMICS OF MONETARY AGGREGATES

Monetary Aggregates. As of QII 2009 reserve money grew by GEL 262.0 million (20.7%) amounting to GEL 1528.7 million at end-period. In average terms, monetary base expanded 18.6%, up by GEL 238.1 million year-on-year. Annual decline of reserve money was at 10.4% year-on-year.

Foreign currency supply exceeded demand at the TIBFEX with net supply equaling USD 46.9 million in the accounting period. In April 2009 the NBG intervened on both sides at the TIBFEX. In May interventions were only on currency withdrawal side considering existing foreign exchange market conditions. The NBG decided upon using currency auctions as the only instrument of its intervention policy in the foreign exchange market. Through these auctions, launched in March as a new instrument, the NBG supplied USD 95.4 million, equivalent of circa GEL 158.7 million. Factoring in the operations conducted at both the TIBFEX and currency auctions, in QII 2009 the NBG's net currency supply amounted to USD 0.4 million, equivalent of circa GEL 0.7 million. Net currency withdrawals through intragovernmental conversions amounted to USD 32.2 million, equivalent of circa GEL 53.8 million. As a result of the abovementioned foreign exchange operations volume of money withdrawn from circulation in the accounting period amounted to circa GEL 54.2 million.

In QII 2009 government deposits decreased by GEL 432.0 million and, according to the June data, equaled GEL 379.6 million. This has created sharp excess of budgetary expenditures over the revenues.

In the accounting period the NBG continued is-

GRAPH 2.1
Monthly Average Wage Rates of Employees by Sector, QI 2009, (GEL)

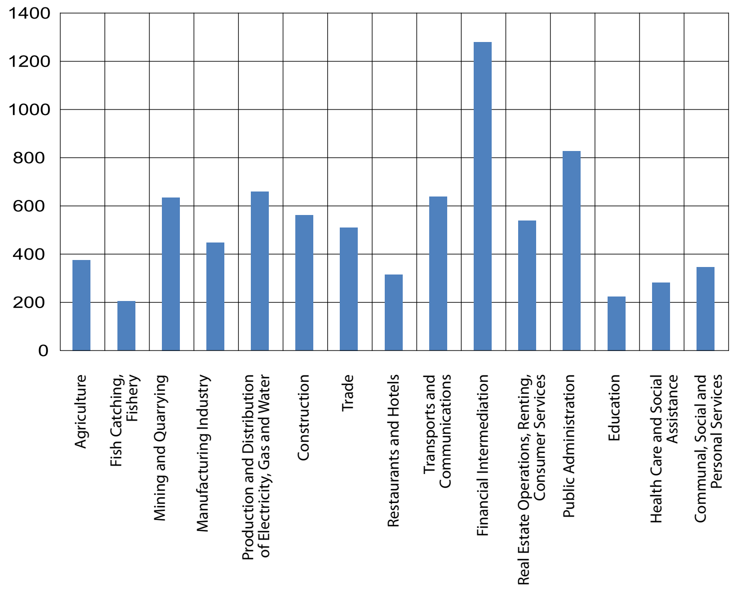
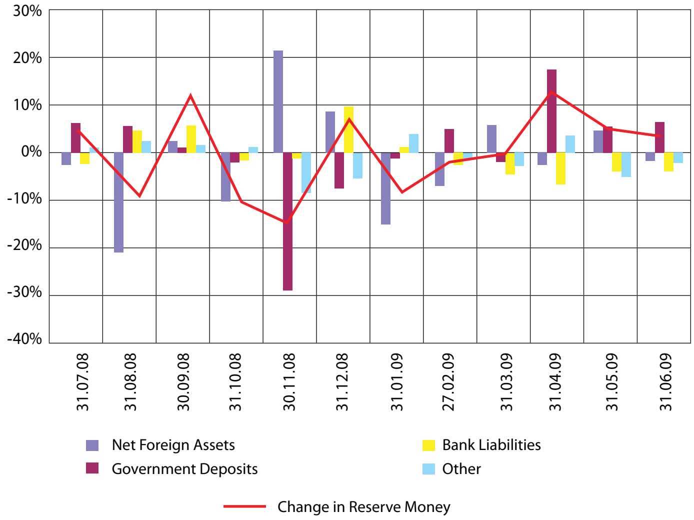


TABLE 2.1.2
TReal Value Added per Employee, QI 2009, Y-o-Y (%)

	Real Value Added
Agriculture	80.9
Manufacturing	76.4
Construction	68.8
Trade	83.5
Hotels and Restaurants	114.7
Transport, Communications	93.5
Financial Intermediation	135.0
Real estate Operations, Leasing and Commercial Activity	79.3
Public Administration, Defense	110.1
Education	115.3
Healthcare	128.0
Total	87.3

GRAPH 2.2.1
Change in Reserve Money



suance of the Certificates of Deposits to assist commercial banks in improving liquidity management. The placement of the CDs equaled GEL 149.0 million in nominal value, while the repayment volumes amounted to GEL 115.5 million. The volume of the CDs in circulation was GEL 148.1 million at end-June, up from GEL 113.7 million at end-March 2009. 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 30.1 million at end-June.

As a result of these operations, net liabilities of commercial banks decreased by GEL 136.5 million in QII 2009, amounting to GEL 46.5 million.

Accordingly, reserve money grew by GEL 262.0 million in the accounting period, of which GEL 202.0 million accounted for the growth of balances of commercial banks' corresponding accounts with the NBG (totaling GEL 327.6 million), and GEL 60.0 million accounted for the growth of cash in circulation (totaling 1201.2 million).

2.2.1. BROAD MONEY

In QII 2009 the M3 aggregate was GEL 3,594.3 million, down by GEL 80.5 million. Foreign currency denominated deposits contracted by GEL 155.9 million (7.6%), equaling GEL 1,885.4 million by end-June. Domestic currency denominated deposits grew by GEL 15.1 million (2.2%), amounting to GEL 688.6 million by end-period.

The M2 aggregate grew 4.6% (GEL 75.4 million) in the accounting period, which was conditioned by growth of cash in circulation by GEL 60.0 million.

Both M3 and M2 aggregates declined in annual terms at 14.2% and 29.3%, respectively.

2.3. MONETARY INSTRUMENTS

In QII 2009 the NBG continued implementing the policy it has embarked upon a year earlier, which is oriented towards providing banks with liquidity and promoting lending to economy.

Being aware of high economic risks commercial banks preferred to maintain significant volumes of liquidity reserves, limiting lending activities. As a result, banks' balances on the lari corresponding accounts with the NBG significantly exceeded average required reserves, which led to excessive liquidity surplus in the banking system. Although quarter-on-quarter lending to economy increased by number of loans, overall volume of such lending contracted.

Monetary policy was subject to certain modification in June 2009. Namely, a new instrument was introduced – FX swap operations. By means of this instrument the NBG carries out auction-based purchases of foreign exchange at a spot price for a one-year term. Swap price is given by an interest rate. Swaps are used by the NBG to supply banking sector with liquidity in national currency, regulate money mass, and assist banking intermediation. Auctions are conducted once per two weeks and operate the USD/GEL currency pair. There were 4 such auctions conducted in the accounting period, with GEL 10 million each supplied through the June 3 and June 10 auctions, and GEL 5 million each supplied through the June 17 and June 24 auctions. Weighted average interest rate recorded at these auctions was within the range of 0.44%-1.13%.

Monetary policy was loosened further in April-June against the backdrop of sluggish economic and banking activities and sharply decelerated inflation. The NBG continued to pursue the objective of stimulating the economy. Minimum interest rate on refinancing loans, representing the main monetary policy instrument, was reduced to 6% from 6.5%, by the decision of the NBG's Monetary Policy Committee dated April 15. Notwithstanding such a reduction, demand for refinancing loans gradually decreased. In particular, the volume of refinancing loans extended by the NBG decreased to GEL 53 million in June from GEL 218.9 million in April. Overall volume of refinancing loans extended to commercial banks in QII 2009 amounted to GEL 348.1 million, down from GEL 689.5 million in the previous quarter. Such a downward tendency can be explained by the fact that the banking system accumulated excessive liquidity, and that banks did not need new sources due to their cautious approach to lending. Weighted average interest rate on refinancing loans at the auctions also declined, along with the decrease in demand and reduction of the key interest rate.

In QII 2009 the NBG extended GEL 20 million through overnight loans, with the whole amount falling on April. Commencing April 16 the NBG reduced the interest rate on such loans to 10% from earlier 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 15 million at 11% interest without collateral.

Issuance of the three-month Certificates of Deposits was continued in order to assist commercial banks in improving liquidity management. To ensure

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

	Jan-09	Feb-09	Mar–09	Apr-09	May-09	Jun-09
Reserve Money	1,314,986	1,273,230	1,266,759	1,433,225	1,492,199	1,528,724
Cash in Circulation	1,165,976	1,140,243	1,141,167	1,198,714	1,180,359	1,201,168
Deposits of Banks	149,010	132,987	125,592	234,511	311,840	327,556
Balances on Corresponding Accounts	149,010	132,987	125,592	234,511	311,840	327,556

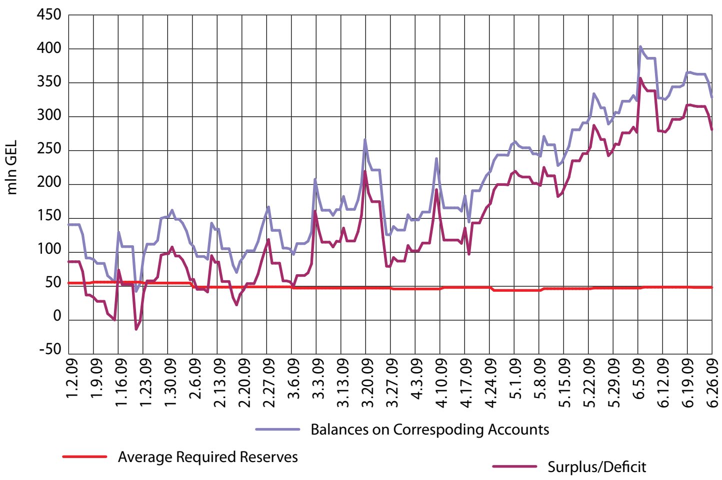
TABLE 2.2.2
Reserve Money Dynamics
(Jan. 2008 – Jun. 2009, Average Month Data, in Thousand GEL)

	Jan-09	Feb-09	Mar–09	Apr-09	May-09	Jun-09
Reserve Money	1,284,901	1,245,729	1,278,369	1,352,463	1,437,441	1,516,452
Cash in Circulation	1,179,213	1,128,597	1,115,190	1,176,766	1,171,289	1,176,915
Deposits of Banks	105,688	117,133	163,179	175,698	266,152	339,537
Balances on Corresponding Accounts	105,688	117,133	163,179	175,698	266,152	339,537

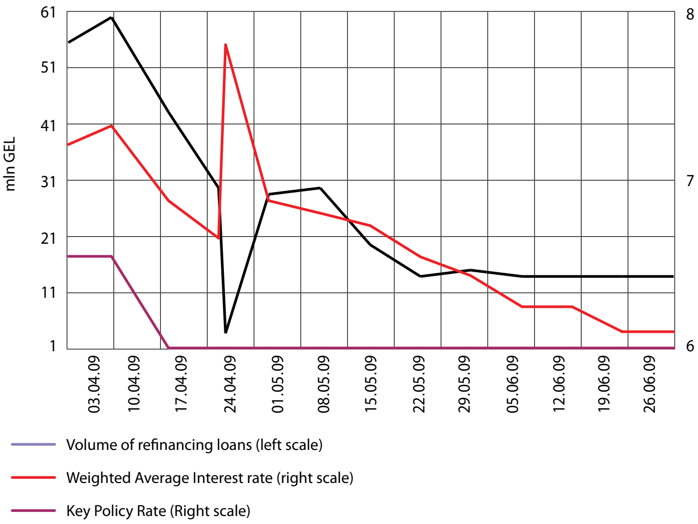
TABLE 2.2.1.1
Monthly Changes in Monetary Aggregates
(Jan. 2008 – Jun. 2009, end-Month Data, in Thousand GEL)

	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09
Broad Money /M3/	3,993,585	3,870,699	3,674,850	3,487,608	3,519,203	3,594,347
Money Mass /M2/	1,707,794	1,631,696	1,633,590	1,672,904	1,663,771	1,708,962
Cash Outside of Banks	991,498	961,048	960,173	1,005,005	1,004,352	1,020,409
Lari in Circulation	1,165,976	1,140,243	1,141,167	1,198,714	1,180,359	1,201,168
Deposits in National Currency	716,296	670,648	673,417	667,899	659,419	688,553
Deposits in Foreign Currency	2,285,791	2,239,003	2,041,260	1,814,705	1,855,431	1,885,385

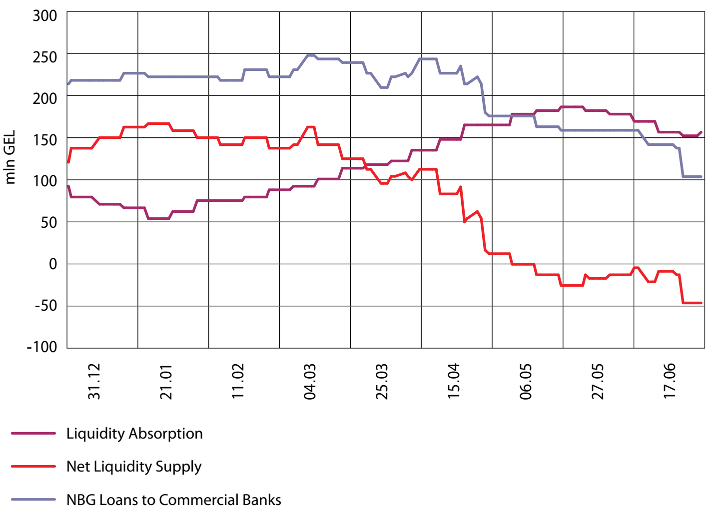
GRAPH 2.3.1
Balances on Lari Corresponding Accounts of Banks, Average Required Reserves, and Liquidity Surplus/Deficit



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



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



that the CDs do not compete with the refinancing loans in volumes the NBG reduced the interest rate on the CDs from earlier 13% to 10% on April 16, and then to 7% on May 14. Starting from May 28 the weekly emission volume was reduced to GEL 3 million from GEL 25 million. Demand for the CDs increased in the accounting period, with the placements amounting to GEL 149 million as opposed to GEL 115.5 million in the previous quarter. Notwithstanding the reduction of interest rate, commercial banks were ready to purchase the CDs. Interest rates at the auctions sharply fell after the NBG reduced the limit to GEL 3 million. Overall, weighted average interest rate on the CDs at auctions was at 9.2% as opposed to 13% in the previous quarter.

Based on the repayment schedule, in April-June liquidity absorption through the CDs grew to GEL 148.1 million as on June 30. At the same time, in the conditions of decreased demand for refinancing loans, liquidity supply to the banking system was overrun by the absorption starting from May. Net absorption of liquidity from the banking system amounted to GEL 56.5 million or 3% of the reserve money as on June 30, whereas there was a net supply of GEL 89.5 million or 7.1% of reserve money as on March 31.

BOX 1. INTRODUCTION OF FX SWAPS

On June 3, 2009 the NBG introduced a new monetary policy instrument – foreign exchange swap facility. The goal of this new instrument is to promote money market development and support financial intermediation with the use of national currency. FX Swap is essentially a combination of two loans in different currencies, which reduces borrowers' exchange rate risks and conduces to dedollarization of the economy. The facility also helps commercial banks to expand their portfolio in domestic currency. Under the FX swaps NBG lends to local banks domestic currency in return of foreign currency, at a current market interest rate determined at the auction. On the swap repayment (forward) day the NBG returns the US dollars against the receipt of the lari equivalent, plus interest earned. Accordingly, the FX swap's pricing is determined with account of interest rates in domestic and foreign currencies. FX swaps have one-year maturity allowing banks to employ lari resources obtained through swap auctions for increasing their long-term lending portfolio. This way they will meet increased demand for domestic currency lending, without being exposed to exchange rate risks. Swap auctions are held by the NBG once in two weeks, on Wednesdays. Banks submit their applications for participation in the auctions through the Bloomberg trading system. Auctions are held using the multiple price method. NBG does not set limits on interest rates, which means that the rates are market-determined.

In line with the settings approved for each auction by the Monetary Policy Committee of the NBG starting from June 3, 2009 bids of commercial banks at 7 swap operations auctions totaled GEL 93.7 million, whereas actual purchases of the lari resources amounted to GEL 45 million. Placement rate, which implies the actual-placements-to-planned-sales ratio, equaled 1.0, while the bids-to-planned-sales ratio equaled 2.1. All auctions operated the GEL/USD currency pair. Average weighted interest rate was 0.89%.

2.4 INTERBANK MARKET

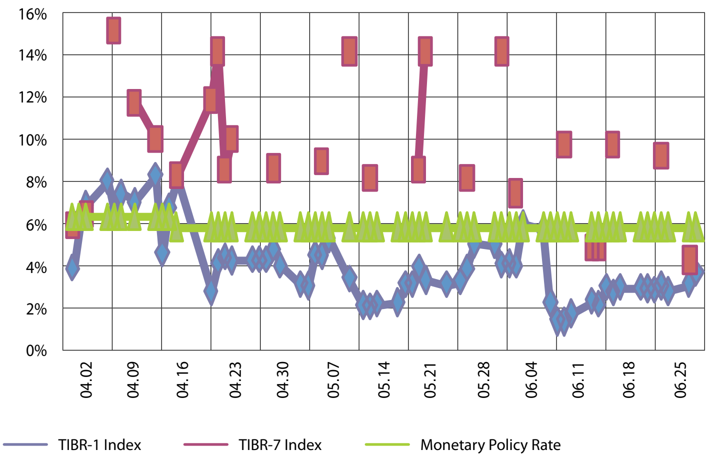
There was some slackening of activity in the interbank market in QII 2009. Loans denominated in domestic currency further contracted in volumes to GEL 550.1 million from GEL 636.6 million quarter-on-quarter and from GEL 2,964 million year-on-year. Deals denominated in foreign currency also decreased quarter-on-quarter, in particular, the US dollar denominated deals moved down to USD 236.2 million from USD 360 million, and the euro denominated deals fell to EUR 94.4 million from EUR 361.8 million.

Short-term loans continued to dominate in April-June. The lari-denominated loans with under 7-day maturity comprised 86.2% of the total volume of loans, while the share of overnight loans equaled 57.7%. Similar observation applies to loans denominated in the US dollars and the euro, comprising 75.3% and 72.5% of total loans, respectively (for loans with under 7-day maturity).

The lari-denominated credit resources continued to decrease in cost in QII 2009. Weighted average annual interest rate on the lari-denominated overnight loans was at 4.5% in April-June, down from 5.3% in QI 2009, 6.4% in QIV 2008, and 9.0% in QIII 2008. Similar trend was observable for the 7-day loans, with weighted average annual interest rate at 8.5%, down from 10.8% quarter-on-quarter, 11.2% in QIV 2008, and 13.5% in QIII 2008.

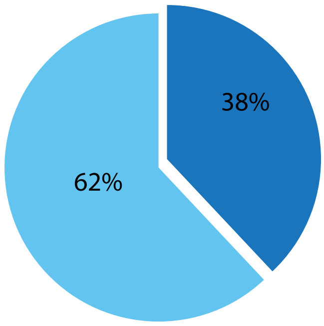
The TIBR-1 and TIBR-7 indices indicate changes in the interbank interest rates. Deals for the overnight interbank loans were concluded practically each day[4], whereas deals for loans with different maturity were absent for more than half of cumulative business days of the accounting period. The TIBR-1 indicated that interest rates on the overnight loans tended downwards in QII 2009. As regards the TIBR-7, despite the scarcity and high variability of the data available, the index nonetheless showed a downward quarter-on-quarter trend.

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

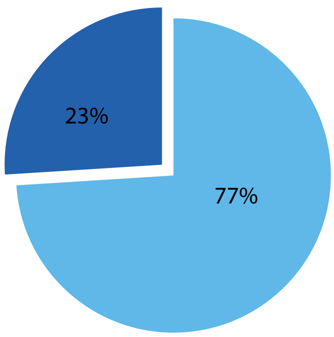


4 Save for April 17 and 20, and May 12

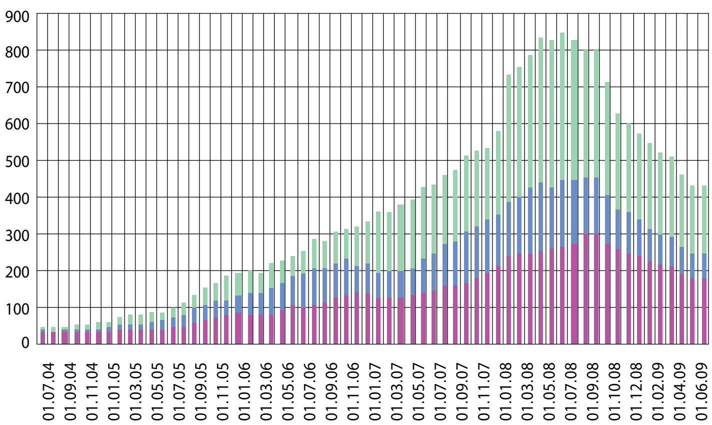
GRAPH 2.5.1
Foreign Currency Denominated Deposits



GRAPH 2.5.2
Domestic Currency Denominated Deposits



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



2.5. BANKING SECTOR

Deposit liabilities of the banking system totaled GEL 2,573.9 million in QII 2009, down 5.2% (GEL 140.7 million) quarter-on-quarter and 19.0% from December 2008.

Foreign currency denominated deposits in the lari terms decreased by GEL 155.9 million to GEL 1,885.4 million. The decrease was evident for current accounts of legal persons. In the US dollar terms, foreign currency denominated deposits also decreased by USD 85.1 million or 7.0%. Term deposits comprised 77.5% of foreign currency deposits. It is remarkable that the share of term deposits decreased in the beginning of the year, but the tendency reversed in the subsequent period with the share of term deposits posting an 11.0% increase as per data available for June 2009.

Domestic currency denominated deposits amounted to GEL 688.6 million, up by GEL 15.1 million or 2.3% quarter-on-quarter. The whole growth took place solely in June during which domestic currency denominated deposits grew by GEL 29.1 million.

Factoring in the growth rates of deposits denominated in both foreign and domestic currency, deposit dollarization ratio was at 73.3% by end-June, down 1.9% from March 2009.

Interest rates on deposits decreased 0.5% in the accounting period. Weighted average annual interest rate on the lari-denominated deposits at commercial banks was at 11.4%, up 1.2 percentage points quarter-on-quarter. For foreign currency denominated deposits the rate was at 9.7%, down 0.7 percentage points quarter-on-quarter. For the foreign currency denominated deposits of legal persons, interest rate was at 10.2%, down 0.8 percentage points. In annual terms, interest rate on the lari-denominated deposits remained unchanged, while the rate on foreign currency deposits increased 1.0 percentage point.

Volume of lending to the economy totaled GEL 4,558.8 million in QII 2009, down by GEL 295.8 million.

Domestic currency loans amounted to GEL 1,139.1 million in the accounting period, down 11.5% or GEL 148.5 million. Loans to legal persons accounted for 50.6%, of which 36.3% represent short-term loans.

Foreign currency loans amounted to GEL 4,022.9 million, down GEL 123.0 million. In the US dollar terms, this type of loans decreased to 2,426.6 million by end-period, down 2.3% or USD 56.1 million. Loans to legal persons comprised 66.4% of these loans, while long-term loans comprised 79.8%. The decrease in lending in foreign currency was largely due to long-term loans. By economic sectors, the decrease was at lowest for trade loans.

Overdue loans totaled GEL 198.9 million in QII 2009, down 10.4% or GEL 23.1.

Interest rates in the banking system moved down quarter-on-quarter running at an annual 21.9%. Weighted average annual interest rate on domestic currency loans was at 22.9%, while that on foreign currency loans - at 20.9%, down 0.5%. For legal persons interest rate on foreign currency loans was around 18.6%. In year-on-year terms interest rates on both foreign and domestic currency loans increased 0.2 and 0.8 percentage points, respectively.

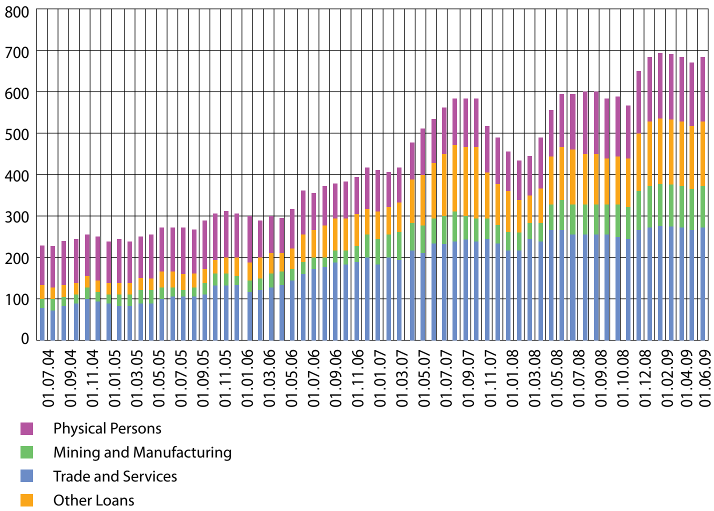
Returns on assets (ROA) and returns on equity (ROE) were negative in the accounting period. As of June 2009, the ROA was at -1.6% while the ROE was at -8.4%.

2.6. EXCHANGE RATE FACTORS

Supply and demand for foreign currency are determined by different factors, and foreign trade in the first instance. Depending on the trade balance, a country may face either excess or deficit in foreign currency. Georgia's imports traditionally have been in significant excess over imports, and the high de-

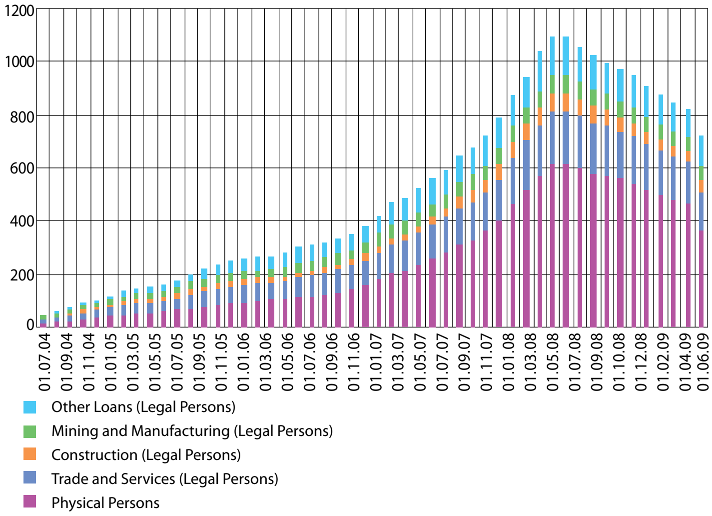
GRAPH 2.5.4

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



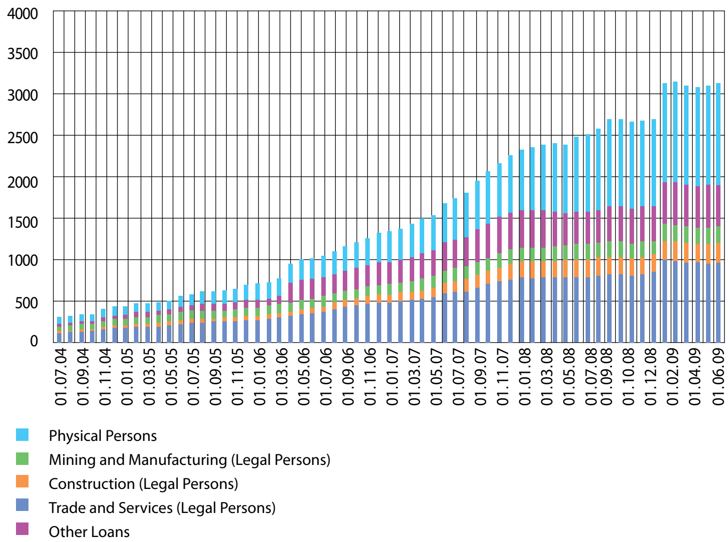
GRAPH 2.5.5

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

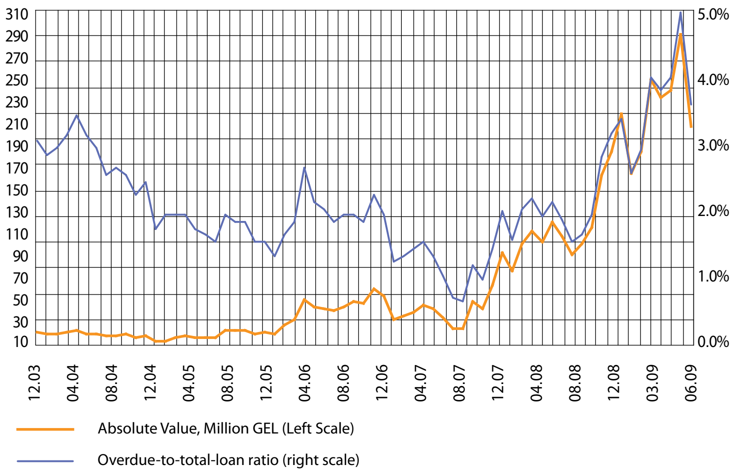


GRAPH 2.5.6

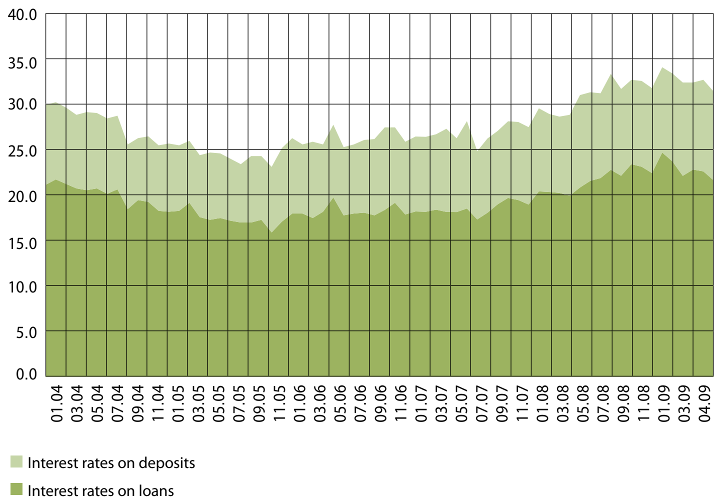
Long-Term Loans Denominated in Foreign Currency



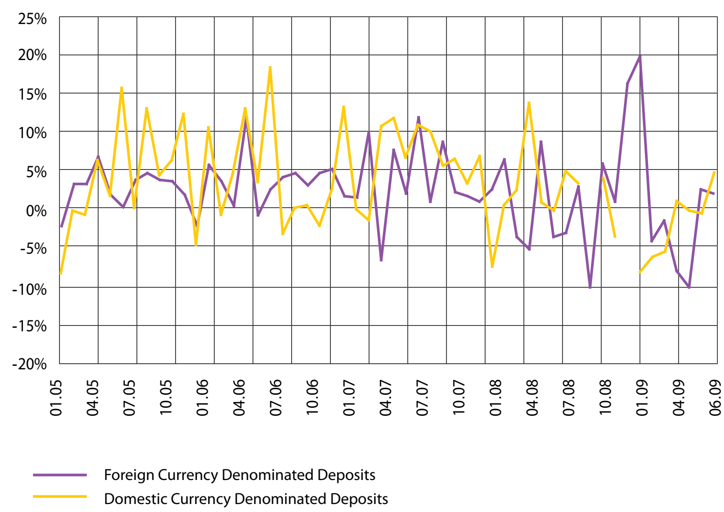
GRAPH 2.5.7
Overdue Loans



GRAPH 2.5.8
Interest Rates on Loans and Deposits



GRAPH 2.5.9
Deposit Growth Rates (month-on-month)



mand for foreign currency, existing by that reason, was mainly counterbalanced by capital inflows. As a general rule, these inflows are powered by the FDIs, proceeds from privatization, and money remittances.

Economic agent's choice of holding domestic or foreign currency is an important causal factor of demand and supply. This factor becomes particularly important when there are expectations of currency appreciation or depreciation.

The ongoing global economic crisis led to significant contraction in world trade volumes. This obviously did not bypass Georgia, and the country faced downfall in both imports and exports. Imports contracted at a much faster pace than exports, which resulted in a 43.6% shrinking of trade deficit.

Georgia enjoyed substantial investment inflows over the recent years. 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 125 million in QI 2009 from USD 538 million in 2008. Unfavorable investment environment was further aggravated by political instability in QII 2009.

Lack of confidence in domestic currency triggered foreign currency demand. Even an insignificant movement of exchange rate was perceived as inability of the NBG to maintain its level. On the other hand, the NBG intervention in interbank foreign exchange market was seen as an unreliable attempt of managing the exchange rate in an artificial way.

Seeking to resolve the situation, the NBG launched foreign exchange auctions in March 2009. Initially the auctions were held in parallel with the TIBFEX but the latter was abolished by the NBG starting from May. Unlike direct intervention at the TIBFEX, the auctions rely more on market mechanisms. The first months of operation proved effectiveness of the auctions. Perception that the NBG artificially manages exchange rate essentially faded away. Volumes of currency, needed to prevent large deviations from long-term trends and to avoid speculative currency deals, are significantly smaller when supplied through the auctions compared to those supplied by means of direct interventions at the TIBFEX.

In QII 2009 the lari appreciated 0.7% relative to the US dollar but depreciated 5.7% and 15.9% relative to the euro and the UK pound, respectively. Consequently, the NEER and REER depreciated 4.1% and 3.6%.

2.7. PRODUCTION AND DEMAND

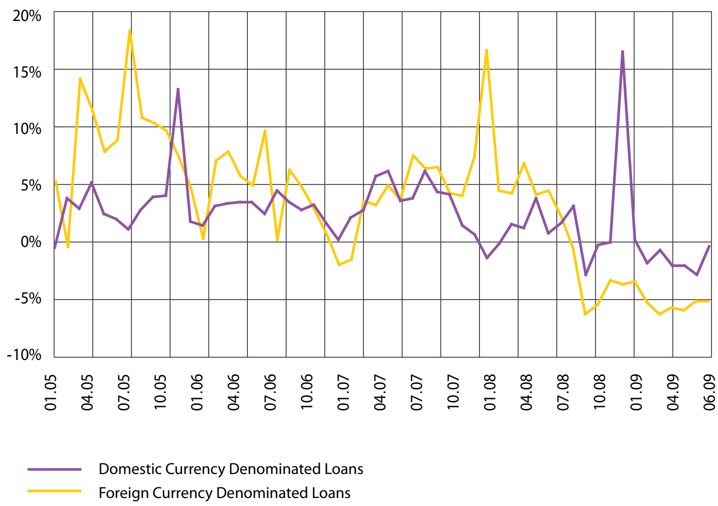
Georgia's GDP continued contracting in 2009. Based on data available for QI 2009, to the nominal GDP equaled GEL 3 845.8 million, down 8.1% year-on-year. For the first time in the recent years the GDP deflator turned negative (-2.1%), causing the real GDP to decline slower than the nominal GDP. The real GDP fell 5.9% in QI 2009.

Quarter-on-quarter worsening of the GDP data was primarily due to negative growth rates in the public administration and trade sectors posting annual -3.8% and -17.7%, respectively. Negative growth rates were also recorded in the agriculture (-6.1%), manufacturing industry (-17.7%), construction (-23.9%), and transports (-8.0%) sectors. Positive growth rates were registered only in a few sectors but their impact on the overall economic situation was insignificant.

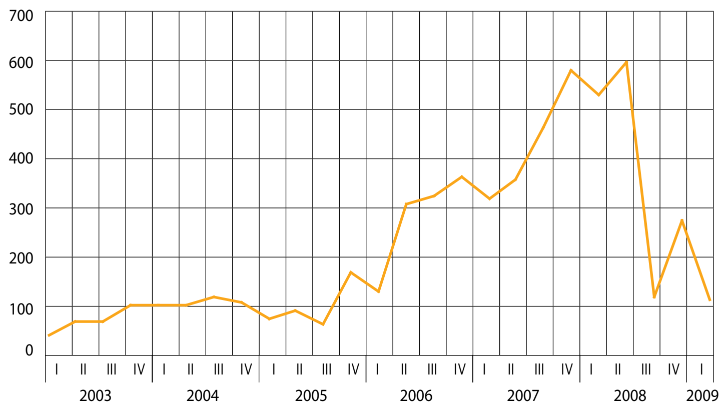
2.7.1. HOUSEHOLD AND GOVERNMENT CONSUMPTION

Despite downward tendency in GDP growth rate, total consumption in nominal terms slightly grew to GEL 4,464.6 million. Consumption grew 3.2%year-on-year. It must be noted, however, that the growth rate of nominal consumption showed a clear downward trend starting from H2 2008. Consumption growth rate was maintained at a two-digit level in

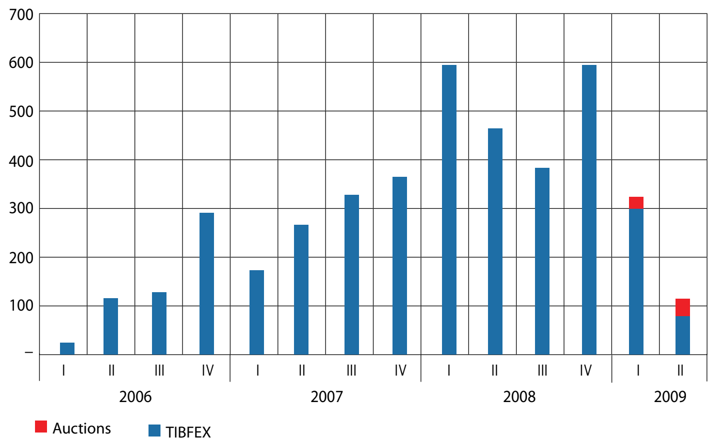
GRAPH 2.5.10
Loan Growth Rates (month-on-month)



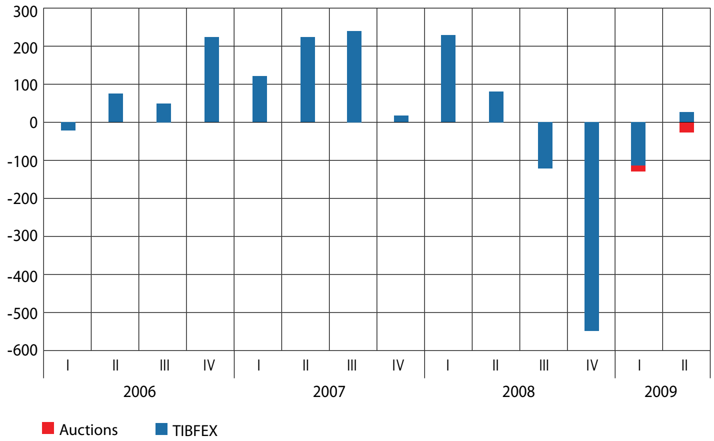
GRAPH 2.6.1
Foreign Direct Investments Inflow in Georgia (million USD)



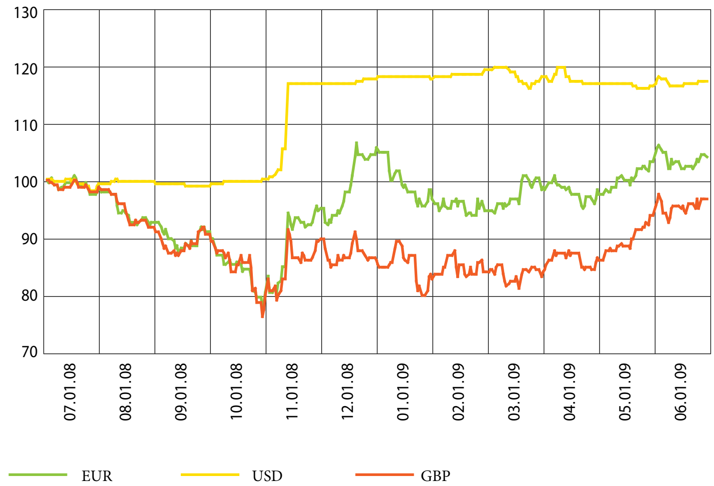
GRAPH 2.6.2
NBG Interventions at the TIBFEX (million USD)



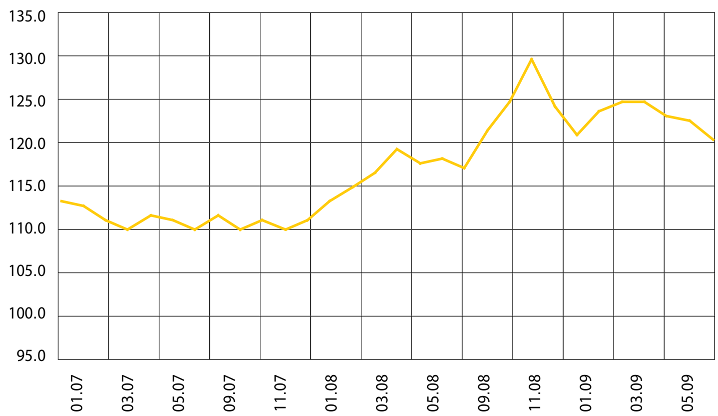
GRAPH 2.6.3
Net Purchases of the NBG at the TIBFEX (millions USD)



GRAPH 2.6.4
Dynamics of the Lari Nominal Exchange Rate (2008-2009)



GRAPH 2.6.5
Dynamics of the Lari Nominal Exchange Rate (2008)



the pre-crisis period.

Household consumption had a decisive impact on consumption growth. On the other hand, government consumption contracted for the first time in the recent quarters to GEL 896.1 million (-16.9%).

2.7.2. INVESTMENTS

The slump in gross capital formation was catastrophic in QI 2009 – total investments plummeted by 64% to GEL 403.3 million year-on-year. Decrease in aggregate demand, contraction of the FDIs volumes, and uncertain economic outlook represented the cornerstone factors in the recent period that caused companies to postpone investment decisions. As a result, the share of gross capital formation in the GDP fell to 10.5% from 26.8% in QI.

2.7.3. GDP ESTIMATIONS FOR QII 2009 AND THE 2009 FORECASTS

Implications of the August war and the global economic crisis were further aggravated by political instability occurred in QII 2009. Estimates based on current collateral data suggest that GDP decline will be by far more essential in QII 2009, and is most likely to post a double-digit figure.

Accordingly, the 2009 projections are even more pessimistic. Notwithstanding certain improvement in H2 2009 (and taking into consideration the base effect), annual GDP will decline at the rate of 4% at least.

2.8. EXTERNAL TRADE

Georgia's external trade turnover had a permanently growing tendency since 2003. In 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 crisis. In particular, decline of external trade turnover was at 12.9% quarter-on-quarter in QIII 2009 (in spite of conventional seasonal trends) and at 19% in QIV 2008 year-on-year. This tendency developed further in 2009. In H1 2009 external trade turnover totaled USD 2507.6 million, down 36.7% year-on-year, of which the exports of goods equaled USD 515.1 million (down 35.3% y/y), and the imports – USD 1992.5 million (down 37.1% y/y) Consequently, trade deficit amounted to USD 1477.4 million in H1 2009, posting a 37.7% decline year-on-year. It must be noted, however, that both imports and exports posted positive quarter-on-quarter growth rates in the accounting period, with the growth rate for exports (35.2%) significantly exceeding the rate for imports (6.3%). Such a quarter-on-quarter growth could be conditioned solely by seasonal factors, especially if we take into account conventionally low economic activity in the first quarter. At the same time, the rebound in exports could partially be explained by the growth in external demand as the world financial crisis subsides.

In QII 2009 exports and imports contracted 36.6% and 41.8% year-on-year, respectively, while trade deficit shrank 43.6%. Exports of ferroalloys grew 3.4 times by value and 4 times by volumes, thus, regaining the first position in the country's exports. Exports of ferroalloys contributed the largest to the growth of total exports in QII 2009. Exports of copper mines grew 2.2 times, thanks to the increase in quantities of exported mines and prices thereon. Exports of motor cars and ferrous scrap also grew 30% quarter-on-quarter each.

In QII the top ten export items were as follows: ferroalloys, gold, motor cars, ferrous scrap, copper mines, mineral fertilizers, spirits, nuts, flours of oilseeds and oleaginous fruits, and mineral waters. In H1 2009 exported goods included investment goods (4%), intermediate consumption goods (62%), and consumer goods (33%).

GRAPH 2.7.1
GDP Deflator (Y-o-Y Change)

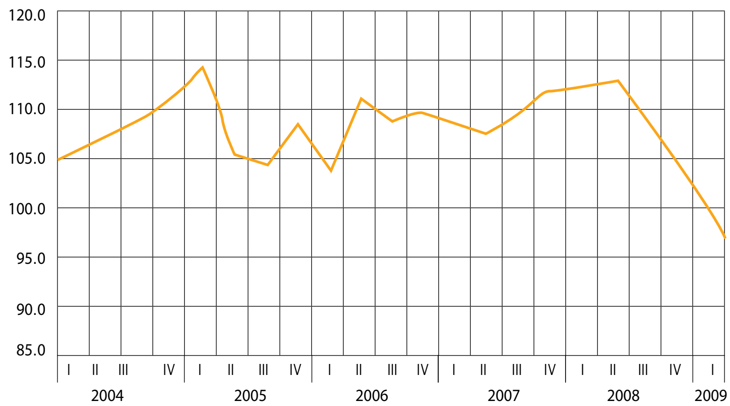
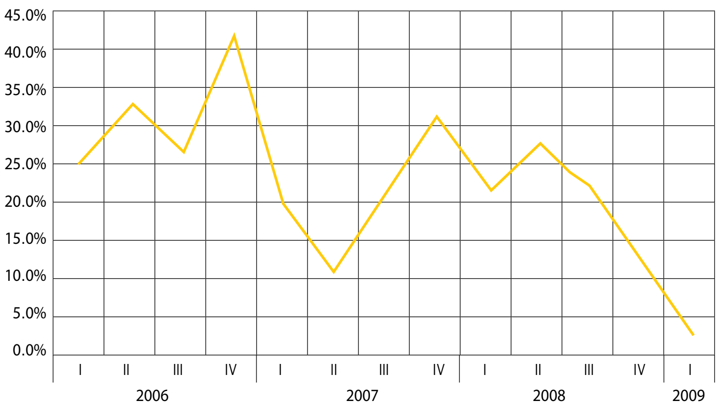


TABLE 2.7.1
Contribution of Economic Sectors to Georgia's GDP Growth (%), QI 2009
(Jan. 2008 – Jun. 2009, End-month Data, in Thousand GEL)

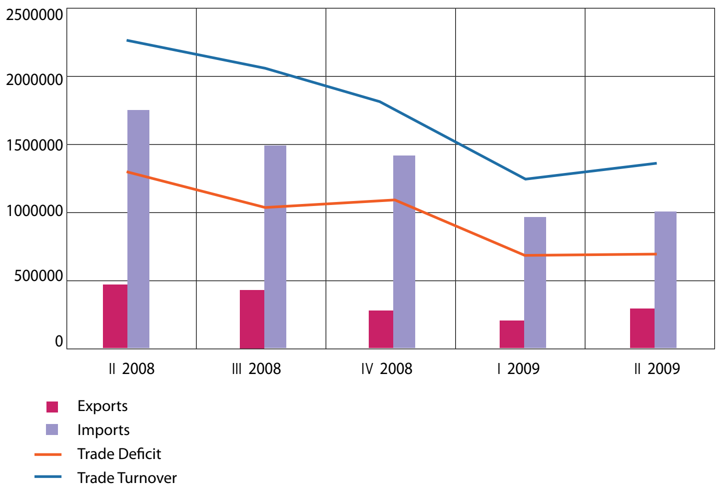
Economic Sector	Growth Rates	Share in GDP (%)	GDP Growth Contribution
Agriculture, Hunting and Forestry, Fish Catching and Fishery	-6.1%	9.6%	-0.6%
Mining and Quarrying	12.5%	0.8%	0.1%
Manufacturing	-17.1%	7.6%	-1.3%
Production and Distribution of Electricity, Gas and Water	-11.5%	3.1%	-0.4%
Processing Products by Households	-4.9%	1.9%	-0.1%
Construction	-23.9%	5.0%	-1.2%
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	-17.7%	13.5%	-2.4%
Hotels and Restaurants	-12.1%	1.9%	-0.2%
Transport	-8.0%	8.3%	-0.7%
Communications and Post	0.1%	3.5%	0.0%
Financial Intermediation	1.5%	2.3%	0.0%
Real Estate, Renting, and Business Activities	-10.2%	3.1%	-0.3%
Imputed Rent of Own Occupied Dwellings	3.4%	2.5%	0.1%
Public Administration	-3.8%	13.4%	-0.5%
Education	5.8%	2.8%	0.2%
Health Care and Social Assistance	3.3%	3.3%	0.1%
Communal, Social and Personal Services	-18.1%	4.4%	-0.8%
Private Households with Employed Persons	2.4%	0.1%	0.0%
FISIM Adjustment	24.4%	-1.1%	-0.3%
GDP at Basic Prices	**-9.5%**	**86.1%**	**-8.2%**
Taxes on Goods	15.8%	14.4%	2.3%[5]
Subsidies on Goods	6.2%	-0.5%	0.0%
GDP at market prices	**-5.9%**	**100.0%**	**-5.9%**

5 High figure of the contribution of taxation of goods is the result of delayed payment of tax revenues due in 2008 made to the State Budget in QI 2009.

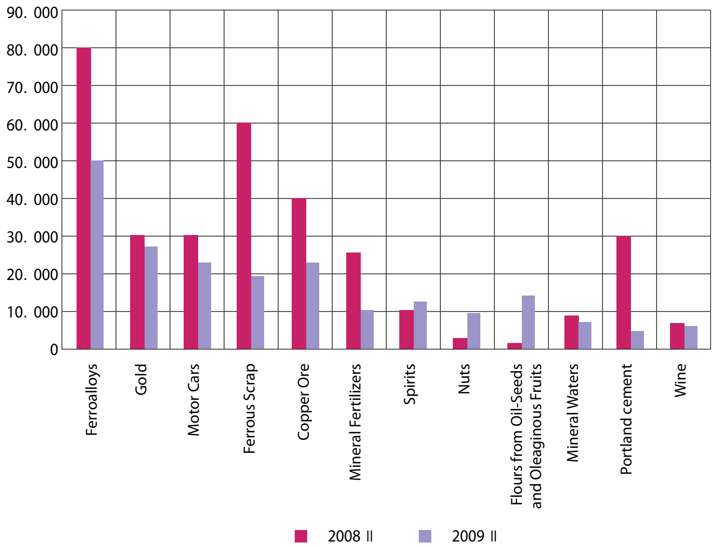
GRAPH 2.7.2
Consumption Growth Rate (y/y, %)



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



GRAPH 2.8.2
Top Export Items, QII 2009 vs. QII 2008 (in thousand US dollars)



On the imports side, for the first time in the last year oil products posted quarter-on-quarter increase of 50% in QII 2009 which was conditioned by world price increases on these products. Imports of oil products traditionally held the first position in the imports list. Imports of motor cars decreased 36% in the accounting period, holding the second position.

In QI 2009 main destinations of the Georgian exports were in the following order: Turkey, Azerbaijan, Canada, Bulgaria, Ukraine, Armenia, the USA, the Russian Federation, and the United Arab Emirates. The share of these trading partners accounted for 84% of total exports. On the imports side, major partner countries were Turkey, Ukraine, Azerbaijan, Germany, the USA, the Russian Federation, China, Romania, Italy, and the Netherlands, overall accounting for 68% of total imports.

2.9. GOVERNMENT OPERATIONS

State budget deficit amounted to GEL 512 million in QII 2009 (deficit calculation takes into account current expenditures as well as expenditures on financial and non-financial assets), which is GEL 113 million less than the target. The difference between the actual and planned budget execution is mostly due to the over-mobilization of budget revenues by all revenue categories (except for increase in liabilities). In particular, in the accounting period proceeds from the decrease of non-financial assets exceeded the target by 146%, while other revenues posted a surplus of 11.4%, of which the largest share falls on goods and services, and tax sanctions. Revenues from grants exceeded the target by 4.7%. For tax revenues the actual-to-target ratio was slightly higher than 1. Actual execution of budget expenditures was at 93.8% of the target, with the largest deviation from the target being for expenditures on financial assets (84.6% execution). It is noteworthy that in QII 2009 current expenditures of the state budget decreased 11% year-on-year, while revenues contracted 46.6%.

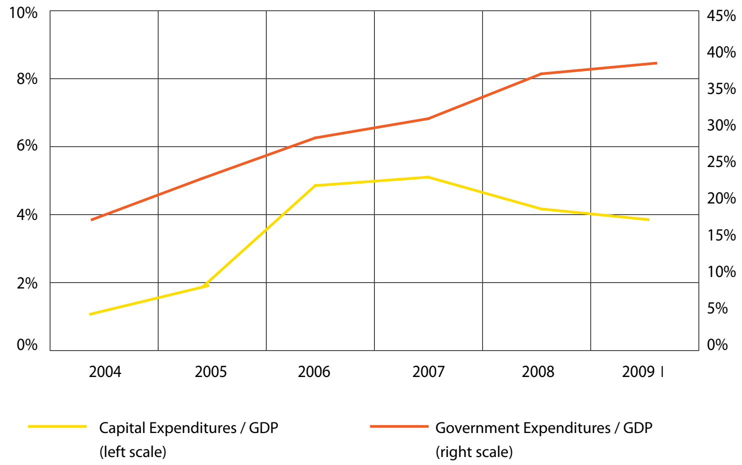
TABLE 2.9.1
State Budget Execution Parameters

State Budget (GEL thousand)	QII 2009	Execution %	Annual Growth, %	Ratio to GDP (2009)	Ratio to GDP (2008)
Revenues	**1193,862**	**103.5%**	**-46.6%**	**29.8%**	**44.8%**
Income Tax	253,434	100.0%	-18.6%	6.3%	6.2%
Profit Tax	111,929	102.1%	-30.2%	2.8%	3.2%
VAT	428,104	100.1%	-21.5%	10.7%	10.9%
Excise Duty	107,444	100.2%	-23.8%	2.7%	2.8%
Customs Duty	8,559	100.0%	-36.4%	0.2%	0.3%
Other Non-classified Taxes	14,207	100.0%	-33.8%	0.4%	0.4%
Grants	47,531	104.7%	171.1%	1.2%	0.4%
Other Revenues	55,728	111.4%	-37.2%	1.4%	1.8%
Decrease in Non-financial Assets	60,712	246.1%	-82.3%	1.5%	6.9%
Decrease in Financial Assets	45,864	100.0%	885.7%	1.1%	0.1%
Increase in Liabilities	59,677	88.5%	-89.9%	1.5%	11.8%
Expenditures	**1571,853**	**93.8%**	**-30.9%**	**39.3%**	**45.5%**
Current Expenditures	1308,452	95.4%	-11.0%	32.7%	29.4%
Capital expenditures	209,707	85.9%	-0.4%	5.2%	4.2%
Expenditures on Financial Assets	21,332	84.6%	-96.3%	0.5%	11.4%
Decrease in Liabilities	32,362	91.5%	42.7%	0.8%	0.5%

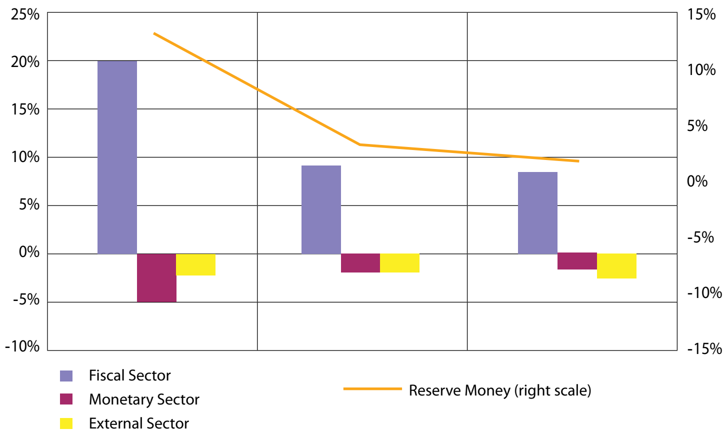
In QII 2009 59% of state budget expenditures were covered by tax revenues, while the share of privatization proceeds equaled only 4%. Actual execution of tax revenues was at 100.4% of the official target. In particular, actual revenues from direct taxes were at 100.8% of the target, while the execution of indirect taxation revenues (which are more sensitive to demand pressures) was at 100.1%.

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 with the purpose of cutting the state budget deficit. However, by QII 2009 this parameter equaled 5.2% (vs. a 6.1% target), essentially up from 4.2% year-on-year. Cumulative share of government investments for two quarters of 2009 equaled 4%, up from 3.6% year-on-year. Considering that this parameter is characterized by

GRAPH 2.9.1
Government Expenditures/GDP



GRAPH 2.9.2
Change in Reserve Money, 2009



seasonality patterns, it is expected to grow over the next quarters to reach its maximum by end-year. It is noteworthy that the increase in expenditures on non-financial assets contributes to the reduction of unemployment as well as to the promoting of economic growth in the country in both short and long-term perspectives.

Reserve money grew 20.7% (GEL 262 million) in QII 2009. Contributions to the change in reserve money are as follows: 32.1% for government operations, -10.9% for monetary operations (implying commercial banks' net liabilities owed to the NBG), and -0.5% 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. Expenditures on social protection are particularly worth mentioning - these totaled GEL 310 million in QII 2009, with the major share spent on pensioners' 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 the expenditures on general public services, amounting to GEL 2,774 million in QII 2009. These expenditures were directed to provide transfers to local governments, to pay for financial and fiscal activities of executive and representative bodies, as well as to service state debt.

Government expenditures on public order and security amounted to GEL 212 million in the accounting period. 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 QII 2009 total state debt grew 1.9% y/y to GEL 5,214.3 million (up GEL 61 million), with external debt up 1.9% (GEL 69 million) and domestic debt down 0.6% (GEL 8.3 million). Modest external debt growth, if used for stimulating economic activity during the crisis times, should be considered as a positive phenomenon.

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, 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 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. The November 2008 price hike on medicaments is assumed to discontinue its effect on annual inflation by end-year. For prices on the rest of the product groups in the consumption basket, the assumptions are based on the existing trend expectations in the respective economic sectors. The inflation forecasts based on this methodology suggest that the annual rate of inflation will decrease to 1.4% by the end of QIII 2009, and increase up to 4% in QIV mostly due to price increases on oil products. As of the average annual rate of inflation, according to the existing projections, the downward tendency will prevail in 2009, and the rate will decrease to 3.2% in September and 2.3% at end-year.

It is remarkable that inflation forecasts made in the previous quarter were revised upwards due to the higher than expected price increases on oil products in the recent period. Accordingly, quarter-on-quarter projection of annual inflation increased circa 0.6% percentage points.

As regards the projected average annual inflation, the rate increased circa 1.1% for end-QIII 2009, and 0.8% for end-year, compared to the previous quarter projections.

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.

The estimated equation is given as follows

$$\delta p = 0{,}10\delta e_{-2} - 0{,}064\delta e_{-4} + 0{,}046\delta m_{-1} + 0{,}041\delta m_{-2} - 0{,}015\delta m_{-3} + 0{,}009\delta p^{oil}{}_{-1} + 0{,}083\delta p^{food}{}_{-1} - 0{,}015ecm;$$

where:

P - Consumer Price Index;

m – Money Mass;

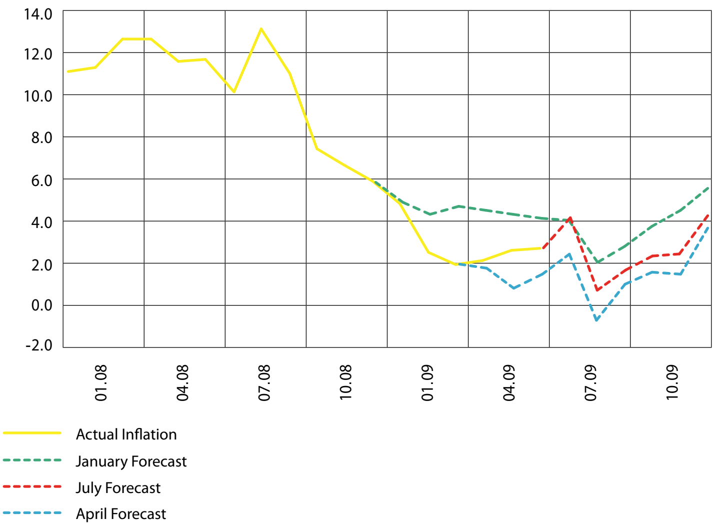
e – Exchange Rate GEL/USD;

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

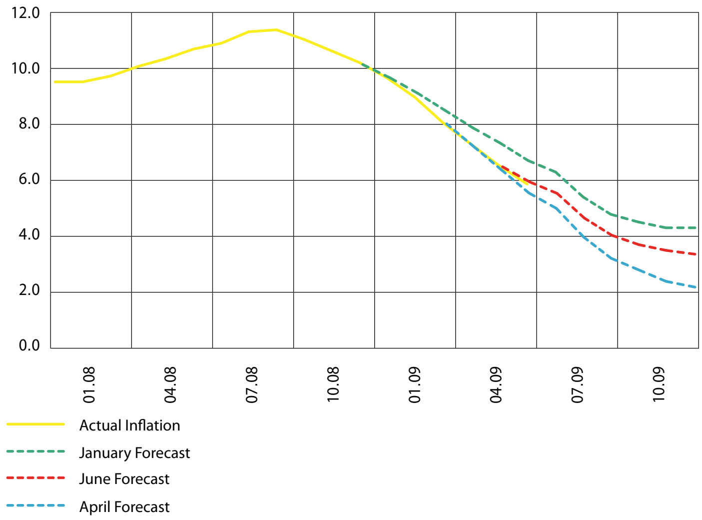
P^{food} – Fruits and Vegetables Price;

ecm – is a variable depicting a long-term equilibrium

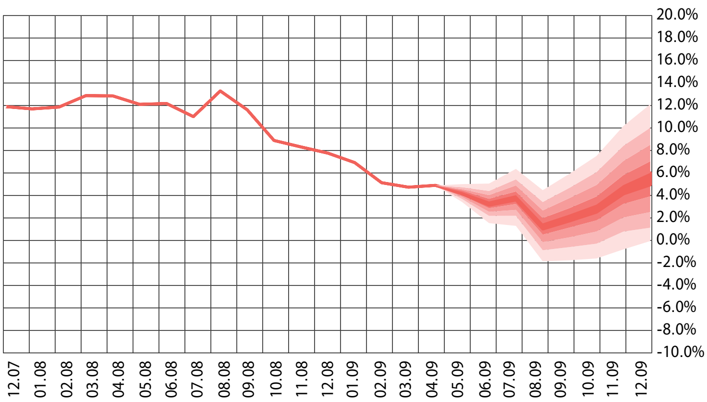
GRAPH 3.1
Annual Inflation Forecasts



GRAPH 3.2
Average Annual Inflation Forecasts



GRAPH 3.3
Annual Inflation Forecast



and is expressed as follows:

$$ecm = p_{-1} - 0{,}48e_{-1} - 0{,}52m_{-1} + 0{,}83y_{-1} - 6{,}43$$

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 4.2% by end-year;
- ☐ The growth rate of real GDP will be at -4,0%;
- ☐ The lari nominal exchange rate relative to the US dollar 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 increase to average 68 USD/barrel in QIV;

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

Based on the obtained results, annual inflation rate is projected at 10% probability to be within 1.61% – 2.46% by September, and 5.45% –¬ 6.78% by end-year. Average annual inflation will be at 2.2% by June, 2.0% by September, and 6.1% by end-year.

4. DECISIONS OF THE MONETARY POLICY COMMITTEE

The NBG's estimates remained below the target levels in QII 2009. This was conditioned by consumer price dynamics, growth rates of monetary aggregates, and the forecasts of international prices on staple goods. The NBG considered it expedient to reduce the key policy rate by 0.5 percentage points in April.

It became more evident with time that balances of commercial banks' corresponding accounts at the NBG accumulated in excess over the required reserves. Reduction of the CDs' emission redounded to this process as well. Being aware of the Government's plans to launch the issuance of Treasury bills the NBG decided upon limiting the CDs emission volumes, with the intention of conducing to effective operation of the T-bills as well as releasing additional funds for commercial banks.

There was a redundant distrust toward the lari denominated assets emerged over the last year. However, there was still a certain demand for lari denominated loans in the economy. To meet this demand the NBG introduced foreign exchange swaps. The rationale was that a commercial bank could issue the lari denominated loans in such a manner that its assets were ultimately retained in the foreign currency. Exchange rate risk is assumed by the NBG. It must be noted that swaps failed to bring desired results at the initial stage, and most probably some time is needed before they become accustomed to. The contemplation is that this instrument will contribute to the restoration of confidence in the lari.

There were held 4 currency swap auctions in June operating the USD/GEL currency pair, with a total of GEL 30 million exchanged for a 364-days term.

BOX 2. THE FIRST TBILISI INTERNATIONAL CONFERENCE

On June 26-27, 2009 the National Bank of Georgia, with the support of the United States Agency for International Development (USAID) and the Asian Development Bank (ADB), hosted an international conference on The Modern Role of Central Banks in Small Open Economies. High-ranking central bank officials from more than 20 countries, representatives of international financial institutions, and a number of the world's leading universities participated in the conference. Dr. Robert Mundell, Professor of Economics at Columbia University and Nobel Prize winner, served as the keynote speaker.

This was the first time a banking sector conference of such rank and scope was organized in Georgia. The goal of the conference was to incept the discussions on economic difficulties faced by small open economies. Numerous forums scrutinize the theme of the global crisis but, as a general rule, the focus is made on the advanced economies.

The first Tbilisi International Conference laid the foundation for the exchange of knowledge and experience among countries with small open economies. Following the evaluation of real losses incurred due to the financial and banking crisis, the Conference participants touched upon the role of active monetary policies of central banks in today's world.

The focal topic of the Conference was the modern role of central banks in preventing and overcoming economic crises. Central banks representatives discussed the primary and secondary task choices of a central bank.

Particularly interesting was the speech delivered by the keynote speaker Dr. Robert Mundell, well known as one of the authors of the Mundell-Fleming model. This model argues that in the environment of free capital movement an economy cannot simultaneously maintain a fixed exchange rate and an independent monetary policy. Among other renowned findings the emphasis could be placed on Dr. Mundell's theory of optimum currency areas, which underlies creation of the euro area. In the recent years Dr. Mundell advocates the ideas of introducing a worldwide single monetary system. In the speech delivered at the Conference, he stressed that the existence of different currencies is disadvantageous for the whole world, and that small economies would essentially benefit if the advanced nations had agreed upon establishing a single monetary system.

Exchange rate issues were discussed in detail at the Conference. It was stressed that the choice of exchange rate policy depends on peculiarities of an individual economy. Different economies pursue dissimilar exchange rate policies. The majority of the Conference participants unanimously underlined the advantage of floating exchange rate over the fixed exchange rate. Particular attention was paid to inflation targeting challenges posed by the global crisis unfolding in the developing economies. It was emphasized that the inflation targeting may be considered the most successful policy nowadays.

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