Central Bank in Georgia was first established in 1919

INFLATION REPORT

2009

NATIONAL BANK OF GEORGIA

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INFLATION REPORT

Q4 2009

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CONTENT

INTRODUCTION

According to the Department of Statistics of Georgia the annual inflation rate was at 3.0% in December 2009. The average annual inflation rate was at 1.7%, down 0.8 percentage points in the forth quarter of 2009. The core inflation also decreased, with the annual rates for products within the limits of two and one standard deviations at -1.9% and -2.3%, respectively.

In December the annual inflation rates for locally produced and imported goods were at 1.7% and -3.7%, respectively. Similar to the previous quarter, the decrease in prices on imported goods was driven by price decreases in the international market. Goods of mixed production origin significantly grew in prices (15.1%), mainly due to those food products that are imported and produced locally.

Dynamics of the main factors of inflation can briefly be described as follows: due to decline in labor demand in the accounting period the growth rate of average monthly wages continued decreasing, which in turn had a negative effect on the growth rate of personal consumption. In QIII 2009 the average monthly wage rate was GEL 568.1, up only 1.6% year-on-year.

Reserve money grew 3.1% to GEL 1,743.9 million in QIV 2009. The annual growth rate of the reserve money was at 21.8%. Cash in circulation also grew by GEL 172.4 million to GEL 1,457.6 million. The M2 and the M3 aggregates expanded, respectively, by GEL 219.1 million and GEL 510.8 million, amounting by end-December to GEL 2,132.6 million and GEL 4,602.7 million.

In the accounting period the NBG continued to use its monetary instruments with the view to support liquidity management of the banking system and lending to the economy. Excess liquidity of the banking system tended to decline. The balance on the banks' correspondent accounts averaged GEL 375.1 million, down 12.5% quarter-on-quarter. By end-December the net liquidity withdrawal totaled GEL 174.1 million or 10% of the reserve money. The interest rate on refinancing loans was at 5% by end-period, but there was practically no demand for these loans throughout the accounting period, which can be explained by banks' excess liquidity.

Deposit liabilities of the banking system increased 12.5% to GEL 3,373.3 million in the accounting period. Deposits denominated in both domestic and foreign currencies grew 10.1% and 12.8%, respectively. The deposit dollarization ratio moved up 0.6 percentage points to 73.2%. The volume of commercial banks' lending in QIV 2009 decreased by GEL 29.6 million to GEL 5,285.1 million. It is worth noting that the lending in domestic currency grew 2.1%, whereas the foreign currency denominated loans contracted 1.9%. The weighted average interest rate on deposits decreased 0.6 percentage points to 9.4%, and that on loans fell 0.5 percentage points to 20.8%. Similar to the previous quarter, the banking sector profitability was negative.

The lari nominal and real effective exchange rates appreciated 0.1% each in the accounting period. In QIII 2009 the trade and current account deficits narrowed, respectively, 50% and 66%. In the first three quarters of 2009 FDI volumes in Georgia contracted 59% to USD 510 million.

According to the QIII 2009 data, the nominal GDP declined 3.6% year-on-year, while the real GDP declined 1.2%. The estimates suggest the real GDP to decline at 0.5%-0.7% in QIV 2009 and 4.3% throughout 2009.

Based on different inflation forecasts, the NBG's projections hold the annual inflation rate to be within 3% - 4.5% in H1 2010, and near 6% by end-2010, with a high probability of comparably lower inflation.

1. CHANGE IN CONSUMER PRICES

According to the Department of Statistics of Georgia, the general level of consumer prices moved up 2.3% in QIV 2009. In QIV 2008 consumer prices were down 0.3%. Accordingly, the annual inflation rate increased to 3.0% in December 2009 from 0.4% in the previous quarter. The average annual inflation rate decreased 0.8 percentage points to 1.7% in QIV 2009.

In the accounting period the inflation was mainly driven by the seasonal increase in prices on food products, including fruits and vegetables, dairy products, sugar, and confectionery. A slight counterbalancing effect had the decrease in prices on meat and meat preparations and oils and fats.

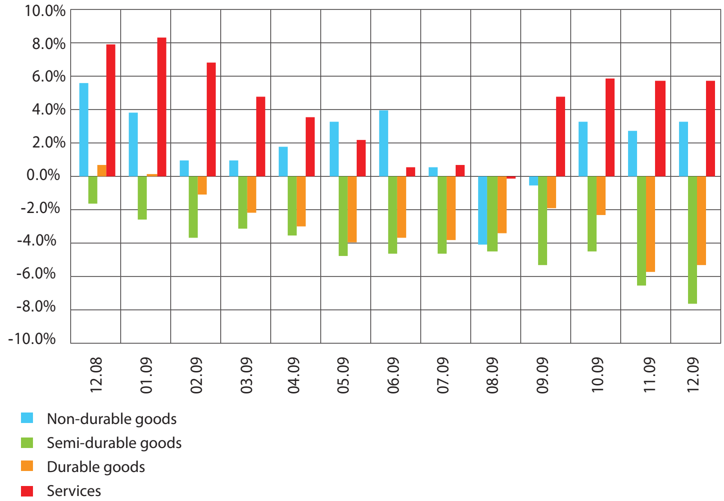
As the final result, the consumption basket prices grew 2.3% in QIV 2009.

The core inflation also decreased in QIV 2009, with the annual rates for the products within the limits of two and one standard deviations at -1.9% and -2.3%, respectively.

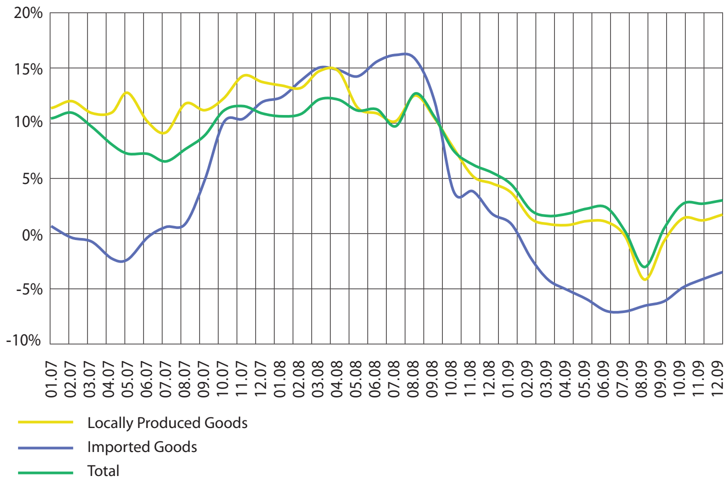
As already mentioned, in December 2009 the consumption basket prices grew 3.0% year-on-year. Prices grew 47.4% in the education sector and 6.4% in the transport sector. The average level of prices moved up in the commodity groups comprising hotels, cafe, and restaurants (4.2%) and food and non-alcoholic beverages (3.8%). Price increases were also registered in the following categories: healthcare (2.3%), communications (1.7%), alcoholic beverages and tobacco (1.0%), and leisure, recreation, and culture (0.6%). Prices decreased in the commodity groups comprising Clothing and footwear (9.7%), Housing, water, electricity, gas and other types of energy (4.8%), furniture, household goods and appliances (3.9%), and other goods and services (1.5%).

The annual inflation rate for imported goods

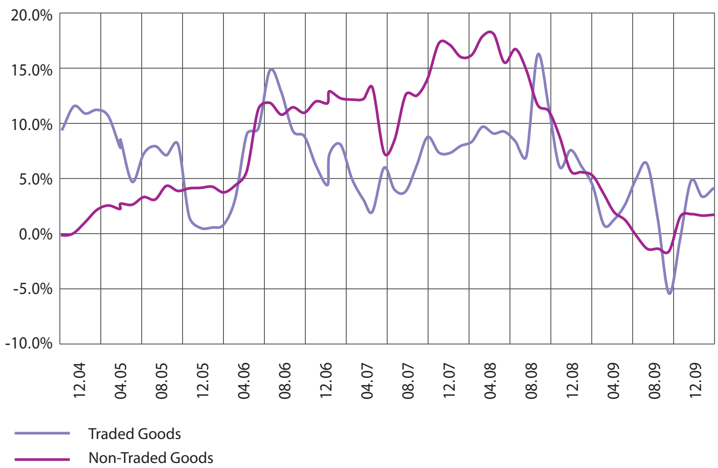
GRAPH 1.1
Change in Annual Inflation for Goods by Consumption Durability and Services



GRAPH 1.2
Domestic vs. Imported Annual Inflation

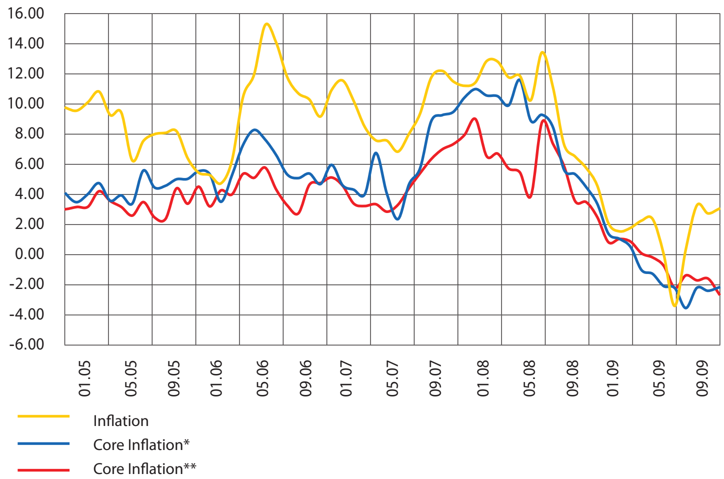


GRAPH 1.3
Inflation for Traded and Non-Traded Goods



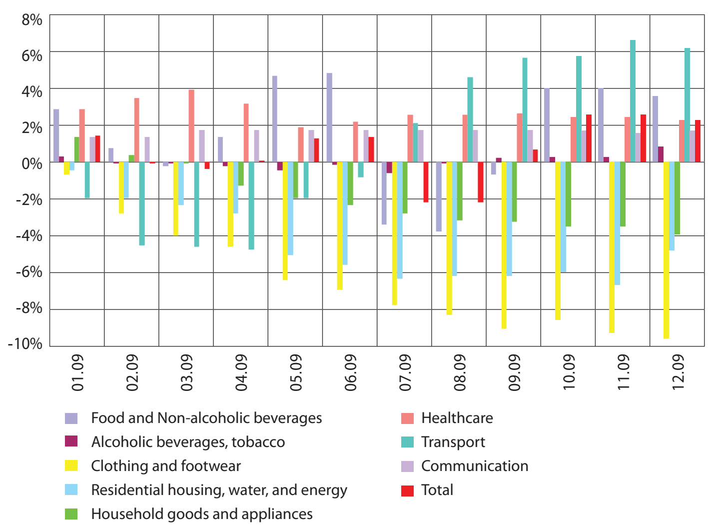
GRAPH 1.4

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



decreased to -3.7% in December. The decrease in prices on imported goods was mainly driven by price decreases in the international market. However, the deflation pressure tends to weaken in the last five months. The inflation rate for domestically produced goods was at 1.6%. Goods of mixed production origin significantly grew in prices (15.1%), mainly due to those food products that can be both imported and produced domestically. It is noteworthy to look at the price dynamics of traded[1] and non-traded goods. In December the price inflation was at 1.7% for non-tradables and at 3.9% for tradables.

Among goods of various consumption durability the annual inflation rate was at 3.2% for non-durables, -7.4% for semi-durables, and -5.2% for durables. Prices on services grew 5.5%

In the period from December 2006 through December 2009 non-durables and services grew in prices 21.8% and 28.5%, whereas semi-durables and durables fell 12.1% and 5.5%, respectively.

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 limit of two standard deviations

TABLE 1.1
Inflation (CPI) Indicators by Components (%), Their Share in Consumption Basket (%), and Impact on the CPI (%) 0

	December 2006 Weights	Dec 09 / Sep 09		Dec 09 / Dec 08		Jan 08 - Dec 09 / Jan 07 - Dec 08	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	-0.1%	-0.1%	3.0%	3.0%	1.7%	1.7%
Food and non-alcoholic beverages	44.3%	-0.2%	-0.1%	3.8%	1.7%	1.5%	0.7%
Food	43.0%	-0.2%	-0.1%	3.9%	1.7%	1.4%	0.6%
Bread and Bakery Products	12.2%	-0.2%	0.0%	-7.7%	-1.1%	-5.2%	-0.7%
Meat and Meat Products	6.6%	-1.0%	-0.1%	-2.1%	-0.1%	2.0%	0.1%
Fish Products	1.1%	2.1%	0.0%	-13.3%	-0.1%	-4.3%	0.0%
Milk, Cheese, Eggs	5.2%	1.5%	0.1%	-6.2%	-0.3%	-7.4%	-0.3%
Oils and Fats	3.5%	0.7%	0.0%	-18.9%	-0.8%	-16.6%	-0.7%
Fruits, Grapes	2.3%	-1.8%	-0.1%	56.7%	2.8%	55.5%	2.5%
Vegetables, Watermelons, Potatoes and Other Solanaceae	8.8%	0.8%	0.1%	12.2%	0.7%	-4.5%	-0.3%
Sugar, Jam, Honey, Syrups, Chocolate, Pastry	2.7%	0.7%	0.0%	30.1%	0.7%	17.2%	0.4%
Other Food Products	0.6%	1.4%	0.0%	1.2%	0.0%	3.9%	0.0%
Non-Alcoholic Beverages	1.3%	-0.8%	0.0%	-1.2%	0.0%	6.0%	0.1%
Alcoholic Beverages, Tobacco	3.7%	0.7%	0.0%	1.0%	0.0%	0.1%	0.0%
Clothing and Footwear	5.0%	-0.4%	0.0%	-9.7%	-0.4%	-5.9%	-0.2%
Housing, Water, Electricity, Gas, and Other Fuels	10.3%	-0.1%	0.0%	-4.8%	-0.5%	-3.7%	-0.4%
Furniture, Home Appliances and Equipment, Housing Renovation	3.7%	-0.5%	0.0%	-3.9%	-0.1%	1.1%	0.0%
Healthcare	8.0%	-0.3%	0.0%	2.3%	0.2%	11.8%	1.0%
Transport	9.0%	-0.4%	0.0%	6.4%	0.6%	-4.3%	-0.4%
Communications	4.4%	0.0%	0.0%	1.7%	0.1%	3.1%	0.1%
Recreation, Leisure and Culture	2.7%	0.0%	0.0%	0.6%	0.0%	1.2%	0.0%
Education	3.5%	0.0%	0.0%	47.9%	1.5%	17.5%	0.5%
Hotels, Cafes, Restaurants	2.4%	0.5%	0.0%	4.2%	0.1%	7.2%	0.2%
Other Goods and Services	3.2%	-0.1%	0.0%	-1.5%	0.0%	5.6%	0.2%
Non Durable Goods	68.0%	-0.2%	-0.1%	3.2%	2.2%	1.6%	1.1%
Semi-Durable Goods	6.5%	-0.3%	0.0%	-7.4%	-0.4%	-4.5%	-0.2%
Durable Goods	1.9%	0.1%	0.0%	-5.2%	-0.1%	-2.9%	0.0%
Services	23.6%	0.0%	0.0%	5.5%	1.4%	3.9%	1.0%

2. INFLATION FACTORS

2.1. LABOR MARKET

The global financial crisis had a considerable negative effect on labor demand. Due to slump in economic activity the real growth of labor productivity dropped, turning negative from QIII 2008. The growth rate of average wages also slowed down in pace. As a result, the growth rate of personal expenditures essentially decelerated.

In QIII 2009 the real value-added per employee fell 5.1% year-on-year. It must be noted, however, that the rate of decline significantly slowed down. Substantial decline was registered in the real estate operations, renting, and consumer services (38.0%), education (18.7%), trade (9.0%), agriculture (8.7%), and transport and communications (5.2%) sectors. The decline was comparably slower in the public administration and defence (4.2%) and manufacturing (2.9%) sectors. Notwithstanding the overall downtrend in real value-added per employee some economic sectors posted positive year-on-year growth rates in QIII 2009; these sectors include, in particular, construction (30.0%), financial intermediation (19.6%), healthcare (9.6%), and hotels and restaurants (6.8%).

The drop in labor demand was one of the main factors that determined the slowdown in growth of an average monthly wage rate. In QIII 2009 the monthly average wage rate equaled GEL 568.1 per employee in the official economy[3], up 1.6% year-on-year. The average monthly wage rate fell in several economic sectors in the accounting period. Sectoral analysis showed that in QIII 2009 the rate of decline was particularly large in the mining and quarrying and manufacturing sectors, with the average monthly wage rates down circa 21.9% and 10.5% year-on-year, respectively. Comparably slower decline was in the agricultural sector (6.3%). The uptrend observed during the preceding quarters in those sectors which are largely financed from the state budget, changed in the accounting period; the average monthly wage rates grew only in the healthcare and social protection sector (6.8%), and fell year-on-year in the communal, social and personal services (5.2%) and education (2.8%) sectors. The nominal average monthly wage rates grew in all other economic sectors, of which particular growth was observed in the fish catching and fishery (40.1%) and construction (14.0%) sectors. Comparably slower growth was observed in the production and distribution of electricity, gas and water (6.4%), real estate operations renting, and consumer services (5.0%), transport and communications (4.2%), hotels and restaurants (3.1%), public administration (2.4%), trade (1.3%), and financial intermediation (0.2%).

TABLE 2.1.1
Real Value-Added per Employee, QIII 2009, Y-o-Y, (%)

	Real Value-Added
Agriculture	91.3
Manufacturing Industry	97.1
Construction	130.4
Trade	91.1
Hotels and Restaurants	106.8
Transport, Communications	94.8
Financial Intermediation	119.6
Real Estate Operations, Renting, Consumer Services	62.0
Public Administration, Defense	95.8
Education	81.3
Healthcare	109.6
Total	94.9

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

Significant differences in the average sectoral wage rates were still present in QIII 2009. The highest monthly average wage rates remained in the financial intermediation (GEL 1,247.9) and public administration (GEL 874.3) sectors, exceeding the monthly average for the whole economy 2.2 and 1.5 times, respectively. The lowest monthly average wage rates were recoreded in the fish catching and fishery (GEL 232.9) and education (GEL 260.2) sectors, making up 45.8% and 41.0% of the monthly average rates for the whole economy, respectively. It is worth noting that in the accounting period the difference between the highest and the lowest wage rates lessened 6.0% year-on-year and 9.9% quarter-on-quarter.

Consequently, the decline in labor productivity and the slowdown in wage growth rates led to an essential drop in the growth rate of personal expenditures. In QIII 2009 personal expenditures grew 7.0 % year-on-year, compared to the 55.9% growth rate in QIII 2008. The slowed growth of personal expenditures as well as their low level represented one of the main factors of consistently low inflation in the country's economy in the recent period.

2.2 DYNAMICS OF MONETARY AGGREGATES

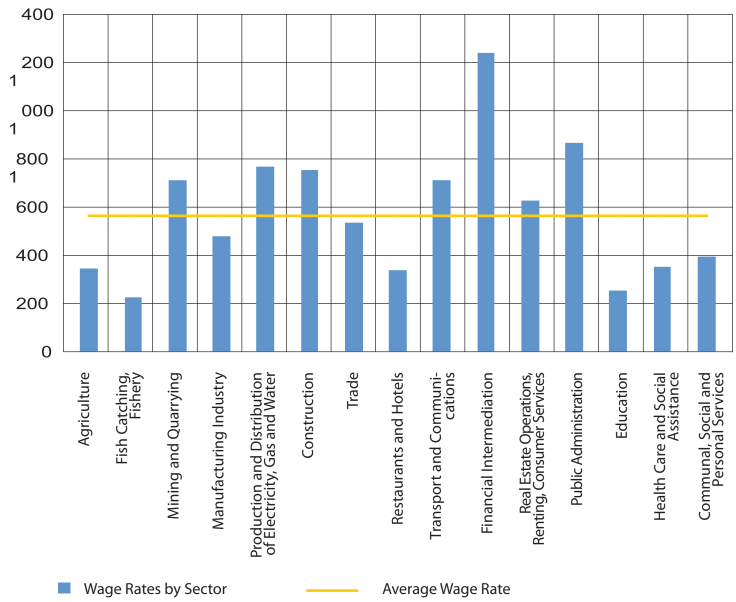
Monetary aggregates. In QIV 2009 reserve money grew by GEL 53.3 million (3.1%), totaling GEL 1,743.9 million at end-period. In average terms, the monetary base contracted by GEL 19.3 million (1.1%) quarter-on-quarter. The annual growth of reserve money was 21.8% compared to end-2008.

In the accounting period the NBG used the FX auctions mechanism solely on the currency supply side in line with the current FX market situation. Through the auctions the NBG supplied

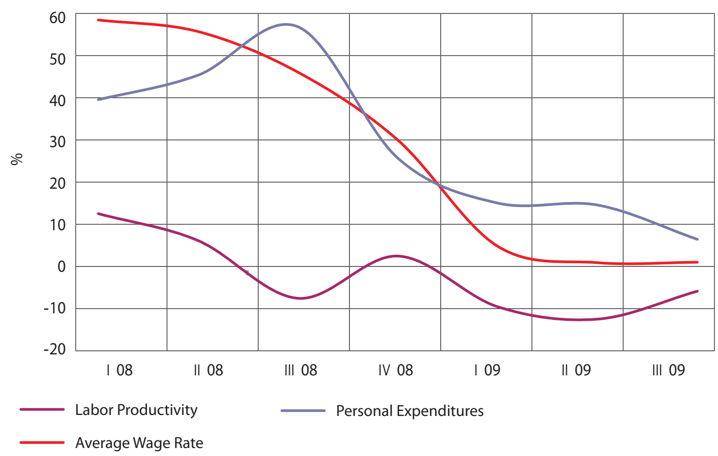
TABLE 2.2
Nominal Monthly Average Wage Rates of Employees, QIII 2009, Y-o-Y, (%)

	Nominal Wage Rate
Agriculture, Hunting and Forestry	93.7
Fish Catching and Fishery	140.1
Mining and Quarrying	78.1
Manufacturing Industry	89.5
Production and Distribution of Electricity, Gas and Water	106.4
Construction	114.0
Trade; Repair of Cars, Home Appliances, and Goods of Personal Consumption	101.3
Hotels and Restaurants	103.1
Transport and Communications	104.2
Financial Intermediation	100.2
Real Estate Operations, Leasing, Consumer Services	105.0
Public Administration	102.4
Education	97.2
Health Care and Social Assistance	106.8
Communal, Social and Personal Services	94.8
Total	101.6

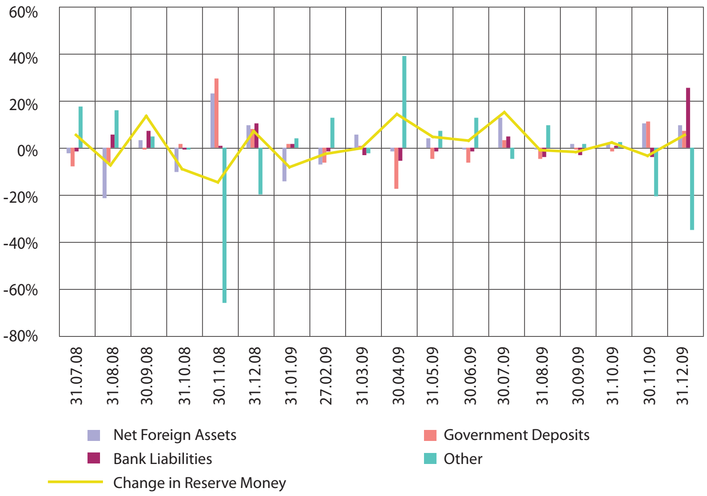
GRAPH 2.1.1
Average Monthly Wage Rates of Employees by Sector, QIII 2009 (GEL)



GRAPH 2.1.2
Real Value-Added per Employee, Average Monthly Wage Rate, and Personal Expenditures (Annual Percent Change)



GRAPH 2.2.1
Change in Reserve Money



USD 15.0 million equivalent of circa GEL 25.2 million. Net foreign currency purchases from the currency conversions for the government amounted to USD 163.5 million equivalent of circa GEL 274.6 million. As a result of the above-mentioned foreign exchange operations, the net foreign assets grew by circa USD 249.4 million.

In QIV 2009 the government deposits grew by GEL 262.4 million and, according to the latest December data, equaled GEL 585.2 million.

In the accounting period the NBG continued

TABLE 2.2.1
Reserve Money Dynamics (Jan 2009 – Dec 2009, End-month Data)
(GEL, thousand)

	Jan-09	Feb-09	Mar–09	Apr-09	May-09	Jun-09	Jul-09	Aug–09	Sep-09	Oct-09	Nov-09	Dec-09
Reserve Money	1,314,986	1,273,230	1,266,759	1,433,225	1,492,199	1,528,724	1,751,524	1,730,491	1,690,665	1,722,205	1,659,013	1,743,917
Cash in Circulation	1,165,976	1,140,243	1,141,167	1,198,714	1,180,359	1,201,168	1,245,729	1,295,874	1,285,586	1,303,035	1,315,117	1,457,938
Deposits of Banks	149,010	132,987	125,592	234,511	311,840	327,556	505,795	434,617	405,078	419,170	343,896	285,979
Balances on Corresponding Accounts	149,010	132,987	125,592	234,511	311,840	327,556	505,795	434,617	405,078	419,170	343,896	285,979

TABLE 2.2.2
Reserve Money Dynamics (Jan 2009 – Dec 2009, Monthly Average Data)
(GEL, thousand)

	Jan-09	Feb-09	Mar–09	Apr-09	May-09	Jun-09	Jul-09	Aug–09	Sep-09	Oct-09	Nov-09	Dec-09
Reserve Money	1,314,986	1,273,230	1,266,759	1,433,225	1,492,199	1,528,724	1,751,524	1,730,491	1,690,665	1,722,205	1,659,013	1,743,917
Cash in Circulation	1,165,976	1,140,243	1,141,167	1,198,714	1,180,359	1,201,168	1,245,729	1,295,874	1,285,586	1,303,035	1,315,117	1,457,938
Deposits of Banks	149,010	132,987	125,592	234,511	311,840	327,556	505,795	434,617	405,078	419,170	343,896	285,979
Balances on Corresponding Accounts	149,010	132,987	125,592	234,511	311,840	327,556	505,795	434,617	405,078	419,170	343,896	285,979

TABLE 2.2.1.1
Monthly Changes in Monetary Aggregates (Jan 2009 – Dec 2009, End-Month Data)
(GEL, thousand)

	Jan-09	Feb-09	Mar–09	Apr-09	May-09	Jun-09	Jul-09	Aug–09	Sep-09	Oct-09	Nov-09	Dec-09
Broad Money /M3/	3,993,585	3,870,699	3,674,850	3,487,608	3,519,203	3,594,347	3,746,882	3,960,264	4,091,916	4,231,243	4,205,215	4,602,749
Money Mass /M2/	1,707,794	1,631,696	1,633,590	1,672,904	1,663,771	1,708,962	1,780,361	1,832,843	1,913,512	1,954,537	1,992,716	2,132,621
Cash Outside of Banks	991,498	961,048	960,173	1,005,005	1,004,352	1,020,409	1,075,848	1,083,575	1,093,340	1,110,999	1,100,696	1,229,436
Lari in Circulation	1,165,976	1,140,243	1,141,167	1,198,714	1,180,359	1,201,168	1,245,729	1,295,874	1,285,586	1,303,035	1,315,117	1,457,938
Deposits in National Currency	716,296	670,648	673,417	667,899	659,419	688,553	704,513	749,268	820,172	843,538	892,021	903,185
Deposits in Foreign Currency	2,285,791	2,239,003	2,041,260	1,814,705	1,855,431	1,885,385	1,966,521	2,127,421	2,178,403	2,276,706	2,212,499	2,470,128

issuing the Certificates of Deposits to assist commercial banks in improving liquidity management. The placement of the CDs equaled GEL 225.0 million in nominal terms, while the redemption volumes amounted to GEL 152.0 million. The volume of the CDs in circulation increased to GEL 219.1 million at end-December from GEL 146.1 million at end-September.

As a result of these operations, in QIV 2009 the banks' net liabilities contracted by GEL 72.9 million to GEL 174.1 million.

As a result of the above-mentioned monetary flows, the reserve money grew by GEL 53.3 million in QIV 2009. This involves a GEL 119.1 million decrease in the banks' balances on the lari corresponding accounts with the NBG (totaling GEL 286 million), and a GEL 172.4 million expansion of the currency in circulation (totaling GEL 1,457.9 million).

2.2.1 BROAD MONEY

In QIV 2009 the M3 aggregate expanded by GEL 510.8 million to GEL 4,602.7 million. Foreign currency denominated deposits grew by GEL 291.7 million (15.5%), amounting to GEL 2,470.1 million at end-December. Domestic currency denominated deposits grew by GEL 83.0 million (10.1%), totaling GEL 903.2 million at end-period.

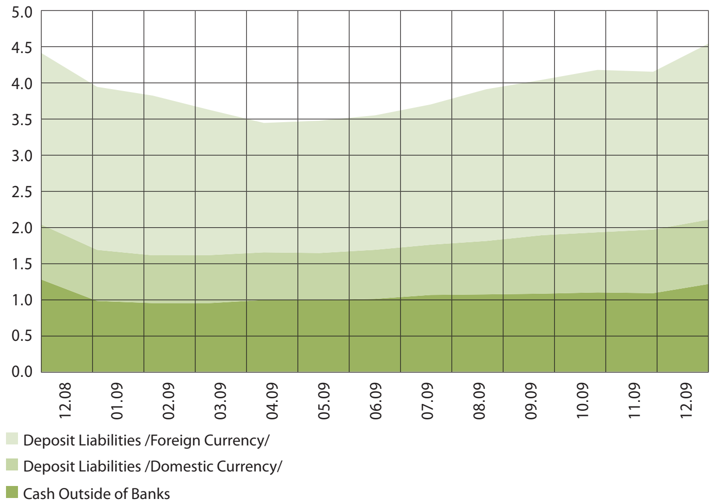
The M2 aggregate grew 11.5% (GEL 219.1 million) in the accounting period, which was largely due to a GEL 172.4 million expansion of the cash in circulation.

At end-December the annual growth rates of the M3 and M2 aggregates were at 8.1% and 15.0%, respectively.

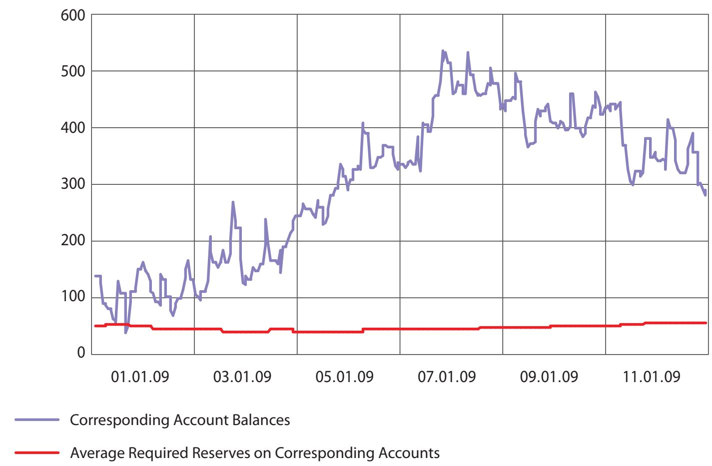
2.3. MONETARY INSTRUMENTS

In QIV 2009 the NBG continued to concentrate the use of its monetary instruments on supporting

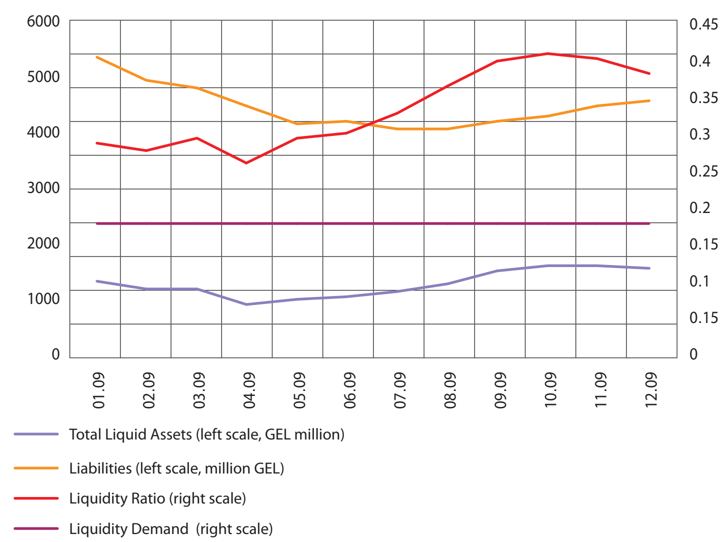
GRAPH 2.2.1.1
Interest Rates on Loans and Deposits (GEL billion)



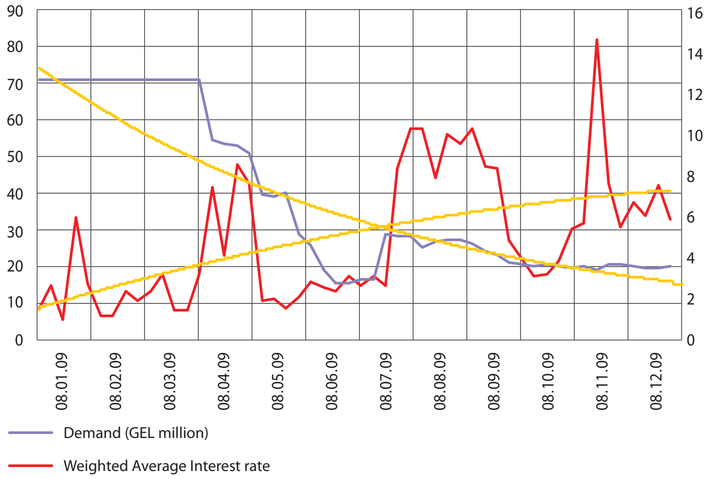
GRAPH 2.3.1
Balances on Banks' Corresponding Accounts in Lari and Average Required Reserves



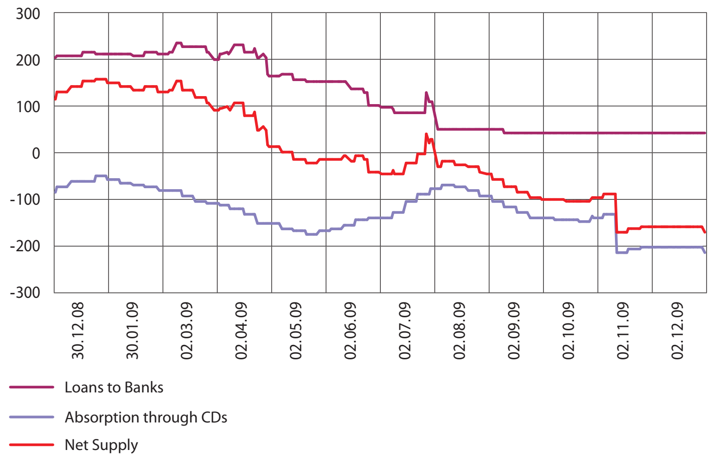
GRAPH 2.3.2
Dynamics of Liquid Assets, Liquidity Ratio, and Liquidity Demand



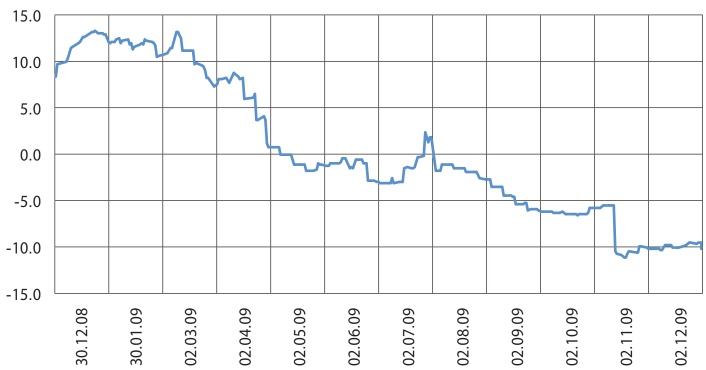
GRAPH 2.3.3
Dynamics of the CD's Auctions



GRAPH 2.3.4
Liquidity Absorption through the CDs, Loans to Banks, and Net Liquidity Supply
(GEL million)



GRAPH 2.3.5
Net Supply/Absorption (% of Reserve Money)



the banks' liquidity management and revitalizing the banking sector.

Similar to the previous quarter, the balances on corresponding accounts considerably exceeded the average required reserves; however, the level of account balances turned downwards in the accounting period, declining to GEL 276.767 million at end-December from the peak of GEL 456.027 million in October. In the accounting period the balances averaged GEL 375.127 million, down 12.5% quarter-on-quarter, which speaks of the formation of a downtrend, even though the system maintained excess liquidity.

With regard to the liquidity ratio, after reaching 41.6% in October (the record high for 2008-2009) the ratio dropped by end-year, averaging 39.1% in December, due to decline in liquid assets.

For liquidity management purposes the NBG continued issuing Certificates of Deposits (CDs), which represent a tool for withdrawing long-term excess liquidity from the banking system and a risk-free asset at the same time, and thereby serve to the development of the domestic currency market. The excess liquidity hampers the efficiency of the monetary policy transmission mechanisms. Moreover, excess amounts on the banks' corresponding accounts may exert an undesired pressure on the exchange rate. Therefore, the NBG seeks to absorb the banks' excess liquidity through the CDs in such a manner as not to hinder the lending to the economy. The maximum interest rate on the CDs ranged within 3.44% - 3.06% in the accounting period. The CDs placement in the accounting period totaled GEL 225 million, up 53% quarter-on-quarter, while the weighted average interest rate moved down to 3.44% from 3.95% in QIII 2009. The interest rate decline pushed up the demand for CD's on the part of banks, whose preference remained on the side of risk-free assets against the backdrop of economic crisis aftershocks.

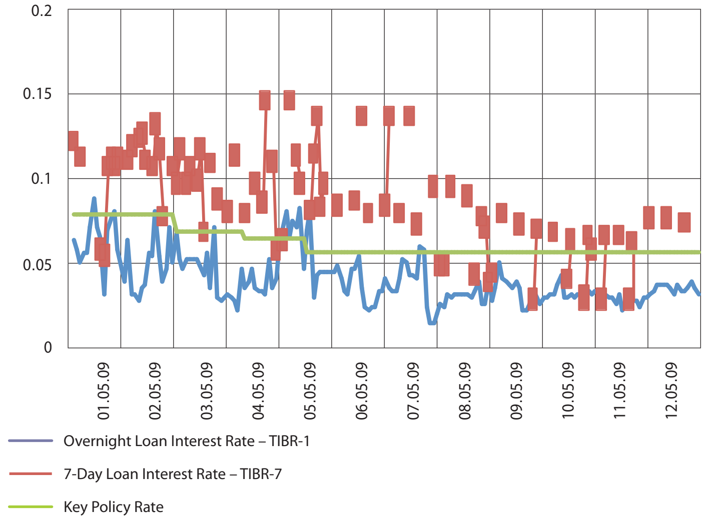
As of December 31 the net absorption of liquidity amounted to GEL 174.1 million (10% of reserve money), up from GEL 101.11 million in QIII 2009 (5.9% of reserve money).

2.4. INTERBANK MARKET

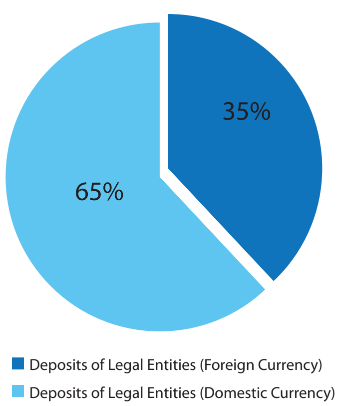
In the accounting period the volume of interbank loans denominated in domestic currency contracted 28.3% to GEL 455.6 million. A similar decline was observed for the US dollar denominated loans, the volume of which fell 22.01% to USD 271.6 million. The euro denominated loans grew almost twice quarter-on-quarter to 20.08 million, and the UK pound loans moved to 0.6 million from 0.12 million.

Short-term loans continued to dominate in the accounting period. The lari-denominated loans with maturity of less than 7 days comprised 96.4% of the total volume of loans, where the share of overnight loans equaled 76%. 99.1% of the US dollar-denominated loans were loans with maturity of less than 7 days (a remarkable

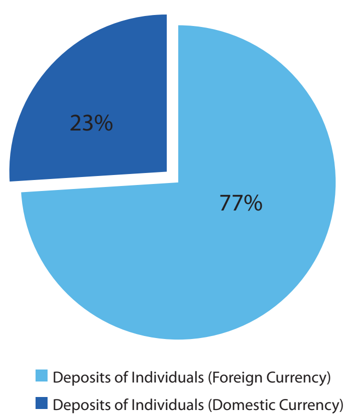
GRAPH 2.4
Interbank Short-Term Loan Indices and Key Policy Rate



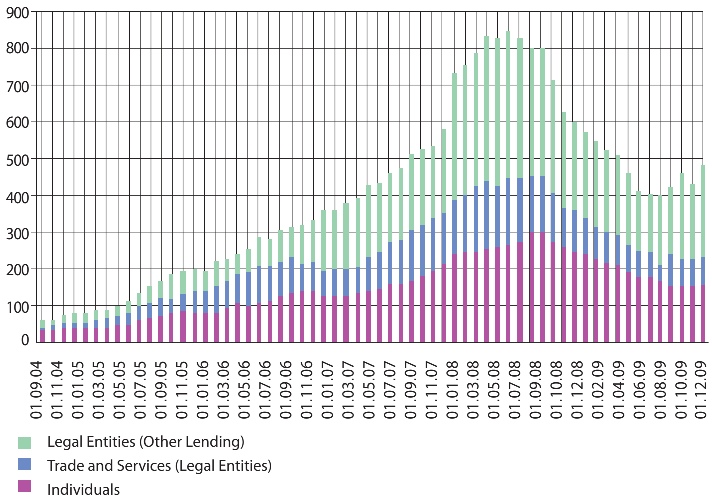
GRAPH 2.5.1
Deposits in Foreign Currency



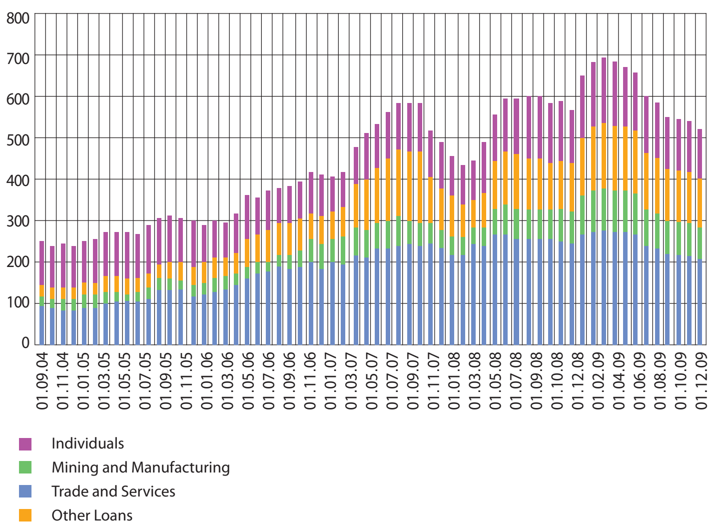
GRAPH 2.5.2
Deposits in National Currency



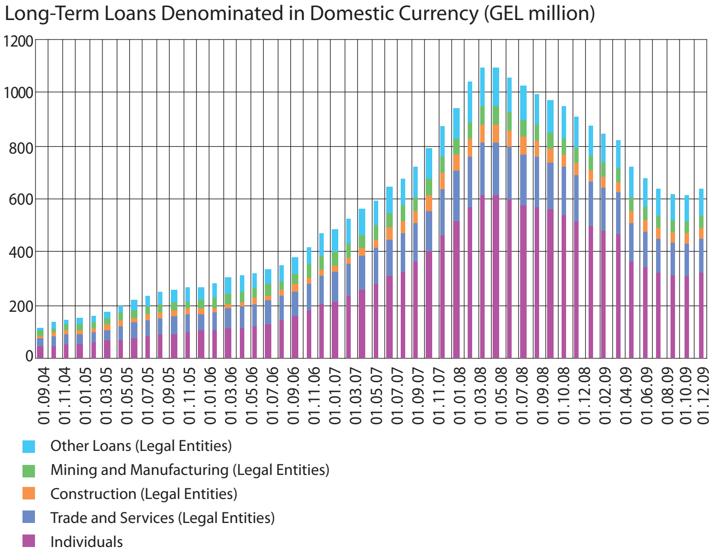
GRAPH 2.5.3
Short-Term Loans Denominated in Domestic Currency (GEL million)



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



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



quarter-on-quarter increase from 75.3%), with the share of overnight loans equaling circa 33%. As regards the euro-denominated loans, loans with a less than 7-day maturity comprised only 47% thereof.

From the loan maturity perspective, the lari denominated loans with the maturity of more than 7 days grew in volumes, accounting for 63% of the total volume of loans against 52% in the previous quarter. With regard to foreign currency denominated loans, overnight loans posted a quarterly growth, with the percentage of total loans up at 60.8% from 56.4% for the US dollar and 62.1% from 46.1% for the euro.

The volume dynamics of the above-mentioned loans were reflected in the interest rate behavior during the accounting period: the weighted average interest rate on the lari denominated overnight loans moved down and the average quarterly rate of TIBR-1 fell to 1.3% from 3.28%. TIBR-7 ranged within 3% and 8.67%, with the average quarterly rate increasing to 6.5% from 6.04%. At end-period TIBR-7 was at 7.06%.

The TIBR-1 dynamics show that interest rates on the overnight loans tended downwards, largely owing to excess liquidity and slackened demand.

2.5. BANKING SECTOR

Deposit liabilities of the banking system amounted to GEL 3,373.3 million in QIV 2009, up 12.5% (GEL 374.7 million) quarter-on-quarter and 9.6% year-on-year.

Foreign currency denominated deposits `in lari terms grew by GEL 291.7 million to GEL 2,470.1 million. The growth was evident mainly for term deposits of individuals. In US dollar terms, foreign currency denominated deposits grew by USD 166.3 million, or 12.8%. Term deposits accounted for 73.9% of total foreign currency deposits. It is noteworthy that the largest share of foreign currency deposits (64.7%) fell on individuals.

Domestic currency denominated deposits amounted to GEL 903.1 million, up by GEL 83.0 million or 10.1% quarter-on-quarter. The growth was mainly due to term deposits of legal entities.

Factoring in the growth rates of deposits denominated in both foreign and domestic currency, the deposit dollarization ratio moved up 0.6% to 73.2% at end-December.

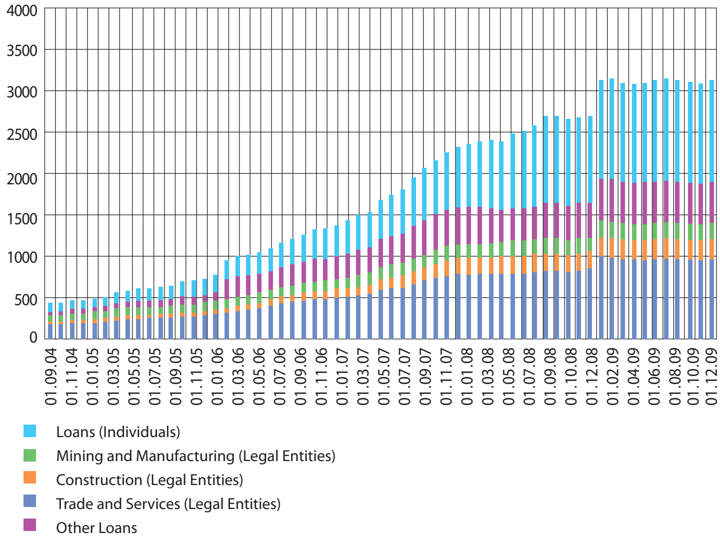
Interest rates on deposits decreased 0.6 percentage points to 9.4% in the accounting period. The weighted average annual interest rate on the lari-denominated deposits at banks was at 10.7%, down 0.2 percentage points quarter-on-quarter. The interest on foreign currency denominated deposits was at 9.2%, down 0.7 percentage points quarter-on-quarter. In the case of foreign currency denominated deposits of legal entities, the interest rate moved down 2.2 percentage points to 9.3% at end-period. In annual terms, the interest rate on the lari-denominated deposits fell 0.5 percentage points, while that on foreign currency deposits remained at 9.2%.

The volume of lending to the economy in QIV 2009 decreased by GEL 29.6 million to GEL 5,255.6 million.

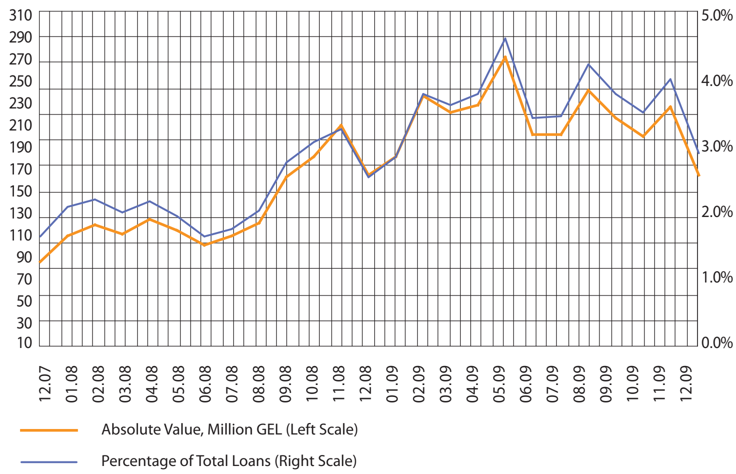
Domestic currency loans amounted to GEL 1,218.5 million in the accounting period, up 2.1% or GEL 25.2 million. Loans to legal entities accounted for 58.2% of total loans, of which 57.8% represent long-term loans.

Foreign currency denominated loans amounted to GEL 4,037.0 million, down GEL 54.8 million. In US dollar terms, this type of lending decreased to 2,394.7 million at end-period, down 1.9% or USD 45.1 million. Loans to legal entities

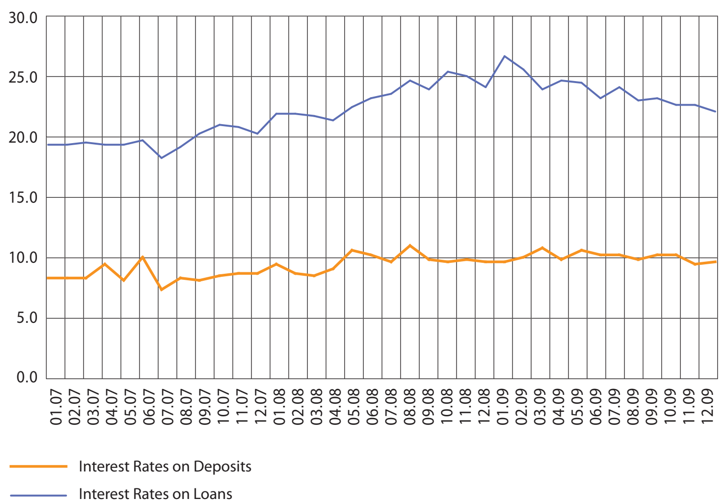
GRAPH 2.5.6
Long-Term Loans Denominated in Foreign Currency (GEL million)



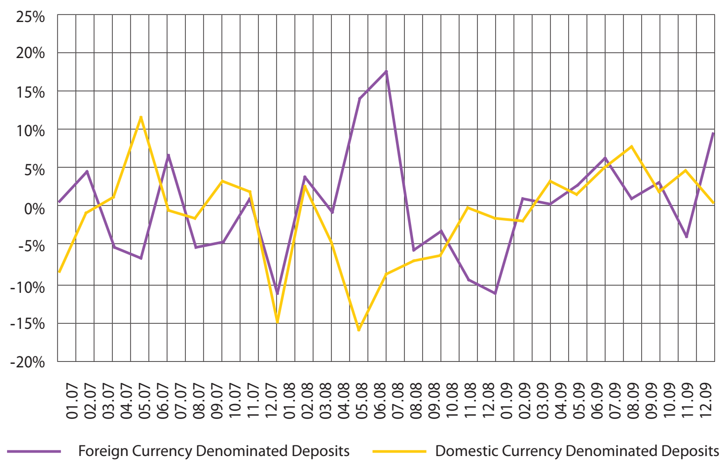
GRAPH 2.5.7
Overdue Loans



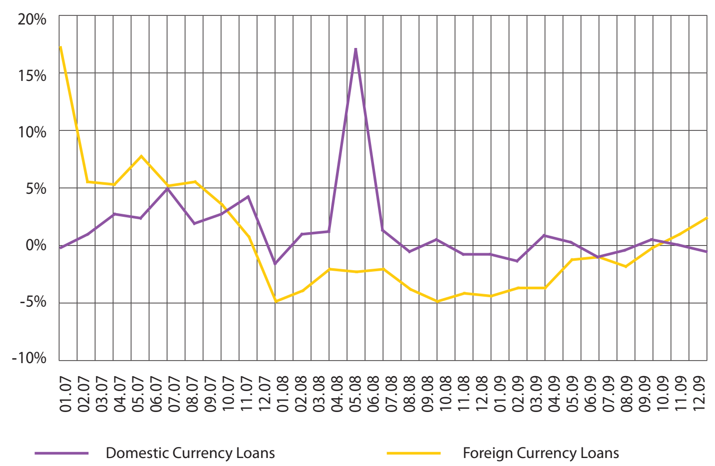
GRAPH 2.5.8
Interest Rates on Loans and Deposits



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



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



accounted for 63.5% of these loans, while long-term loans accounted for 78.6%. The decrease in lending in foreign currency was largely due to loans to legal entities.

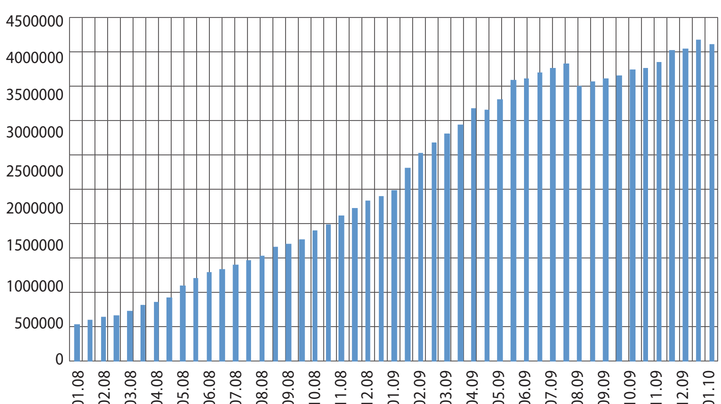
Overdue loans totaled GEL 159.8 million in QIV 2009, down 25.8% or GEL 55.5 million.

Interest rates in the banking system moved down quarter-on-quarter running at an annual 20.8% in QIV 2009. The weighted average annual interest rate on foreign currency loans decreased to 19.3%. For legal persons the interest rate on foreign currency loans was near 17.3%. For domestic currency denominated loans the rate grew 0.2 percentage points to 23.4%. In annual terms, interest rates moved down 2.6 percentage points for foreign currency denominated loans, and 0.7 percentage points for domestic currency loans.

Return on assets (ROA) and return on equity (ROE) ratios were negative in the accounting period. As of December 2009, the ROA was at -0.8% while the ROE was at -4.3%.

BOX 1. TENDENCIES IN USE OF PLASTIC CARDS

GRAPH 1
Number of Plastic Cards in Circulation (monthly data)



Growth of the number of plastic cards in circulation is one of the important development criteria of the Georgian banking system. The use of plastic cards makes settlement transactions more cost-effective and ensures their transparency.

In the recent years the number of plastic cards in circulation, as well as the quantity and volumes of transactions thereof considerably grew in Georgia.

It is remarkable that in 2008 the per capita number of plastic cards in Georgia was 0.81, which is close to the respective average number in the Eastern

European countries. The number of ATMs per million population (305)[4] in Georgia is also close to the EEC average numbers.

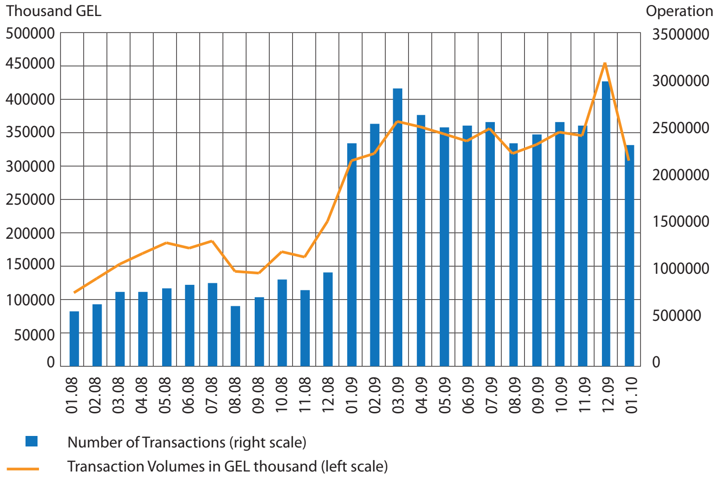
However, in terms of an average number of transactions per plastic card (8 transactions), an average annual turnover per plastic card (USD 649), and a quantity of POS-terminals per million population (1384) Georgia stands by far below an average Eastern European country.

PLASTIC CARD SERVICES

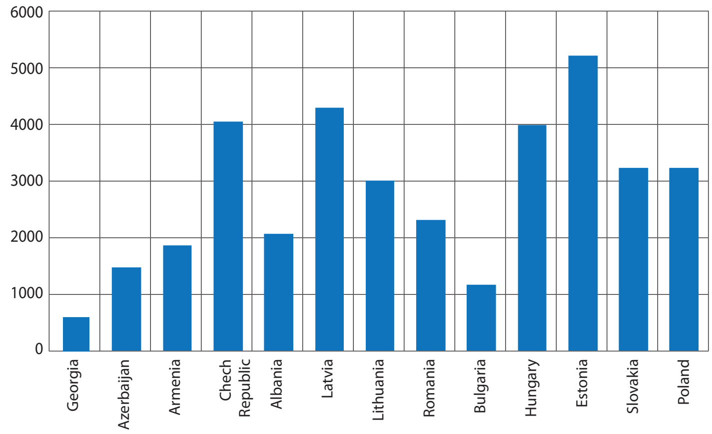
Plastic card transactions can be carried out in four main ways: via ATMs, POS-terminals, banks' service center terminals, and by internet. Obviously, the use of plastic cards depends on the availability and cost-effectiveness of these card processing services. In addition, the use of plastic cards via POS-terminals at trade outlets and by internet also significantly depends on consumer habits.

Despite the fact that in 2009 the number of POS-terminals was almost three times higher at trade/service outlets than at banks, the total turnover of the bank terminals was considerably higher.

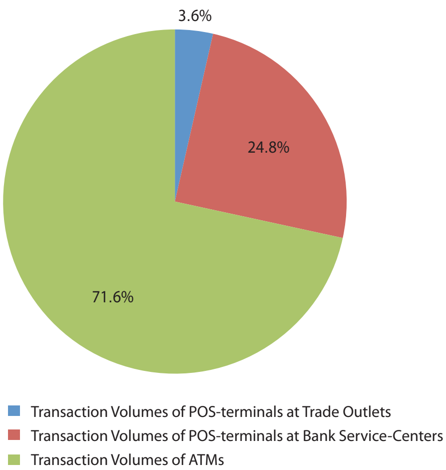
GRAPH 2
Transactions within Georgian Territory at Services of Plastic Cards Issued by Resident Banks.



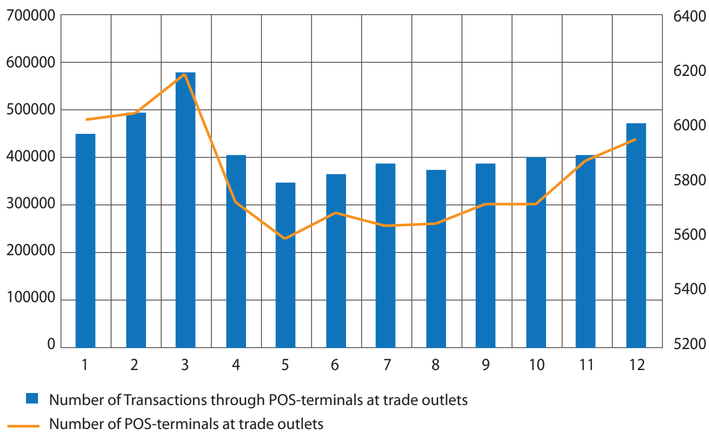
GRAPH 3
Average Annual Turnover per Plastic Card (USD)



GRAPH 4
2009 Turnover of Plastic Card Transaction by types of Plastic Card Services



GRAPH 5
Number of Transactions through Georgian POS-terminals Using Plastic Cards Issued by Resident Banks and Number of such POS-terminals. 2009, Monthly Data.



4 Source – Official websites of the European Central Bank, Central Banks of Armenia and Albania, and the Bulletin of the Central Bank of Azerbaijan

Concurrently, the largest share of total plastic card transactions was processed through ATMs.

It must be noted that the average value per one plastic card transaction practically did not change in the previous year, amounting to circa GEL 135. The average turnover amount per one ATM and POS-terminal also remained steady.

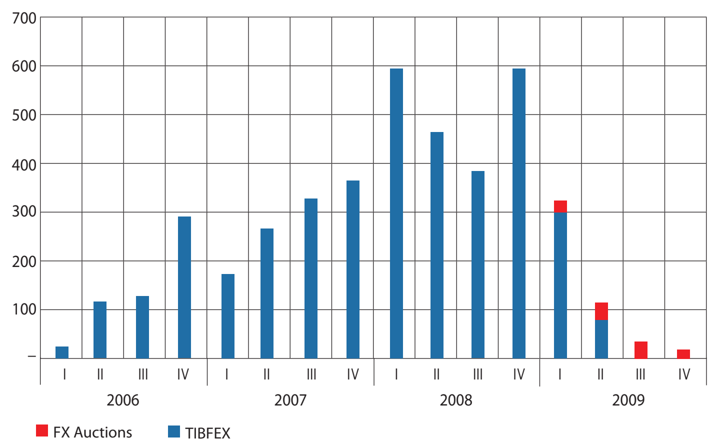
The monthly quantity of transactions through POS-terminals at trade/service outlets and the number of such terminals show strong correlation (0.945), which indicates that the growth in number of trade outlets with POS-terminals may likely result in greater quantity of transactions.

2.6 EXCHANGE RATE FACTORS

In small open economies like Georgia the exchange rate determines local prices on imported goods. Considering that imported goods comprise an essential share of the consumption basket, and hence have an effect on inflation, it is critical to analyse factors affecting the exchange rate in order to ensure price stability Exchange rate dynamics also play an important role in terms of financial stability as long as adverse exchange rate movement increases banks' currency-induced credit risk.

The abolishment of the Tbilisi Interbank Foreign Exchange in March 2009 and the introduction of the NBG's FX auctions in May essentially decreased the NBG's role in the FX market, and hence increased influence of market mechanisms on the exchange rate formation. According to the IMF classification of official exchange rate regimes the current Georgian scheme falls under the 'Managed floating without pre-announced path for the exchange rate' regime. In other words, the NBG's foreign exchange interventions serve only to avoid acute short-term exchange rate fluctuations, while in the long term the exchange rate follows its optimal level dynamics. It is worth noting that the NBG's intervention volumes drastically decreased after the introduction of the FX auctions; in QIV 2009 these interventions amounted to USD 15 million, almost half the volumes of the previous quarter.

GRAPH 2.6.1
NBG's Interventions in the FX Market (USD million)



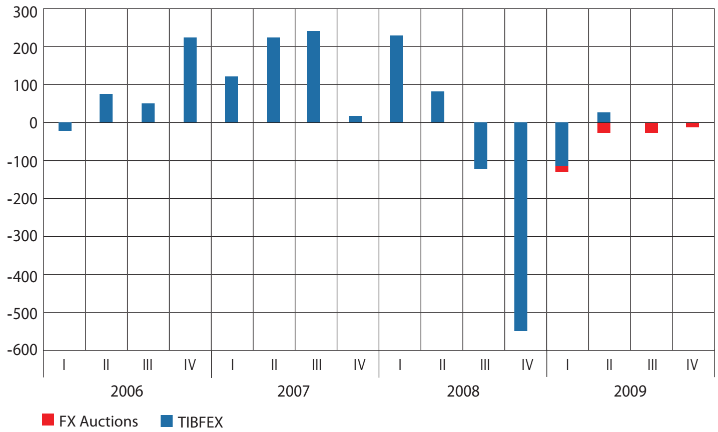
In the conditions of the exchange rate being determined by market mechanisms it is important to analyse all factors affecting demand and supply of foreign currency, which are mainly influenced by the country's external trade. Demand for foreign currency is mainly affected by imports; when the value of imports exceeds that of exports, the resulting trade deficit is covered by foreign capital inflows and money remittances. In addition, the importance of the NBG's FX auctions must be stressed again in the context of adjusting temporary demand-and-supply imbalances.

Dollarization of the economy represents another important factor affecting demand for foreign currency. The level of dollarization depends on economic agents' expectations regarding future exchange rate movement as well as their confidence in domestic currency. To measure this factor it is necessary to look at the dollarization ratios of deposit and loan flows. In QIV 2009 the average dollarization ratio of deposit flows was at 41.5%, up from 40% quarter-on-quarter. For loan flows the respective ratio grew to 62.8% from 61.5%. These changes were not significant and did not argue for any fundamental change in the choice of a currency. However, the overall dollarization level in the country is notably high as the US dollar enjoys a certain status of a risk-free currency.

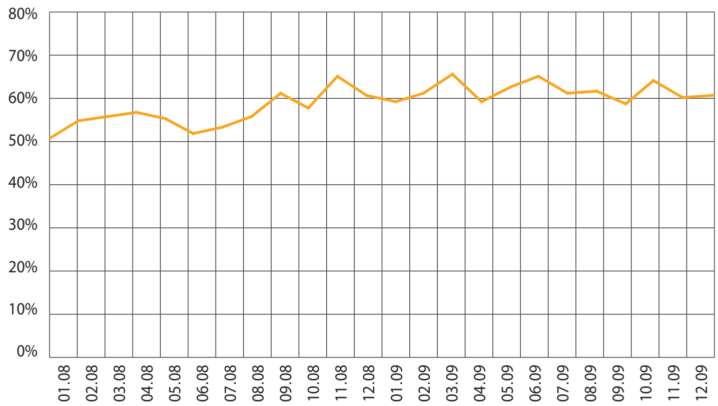
In 2009 FDI volumes considerably contracted year-on-year. In the first three quarters the FDIs amounted to only USD 510 million, down 59% from USD 1.2 billion in the corresponding period of 2008. Portfolio investments also fell in 2009, amounting to USD 14 million in the first three quarters. Such a drop in foreign capital inflows was largely due to the Russian aggression in August 2008 and the global financial crisis. Against the backdrop of dried up foreign private investments, the grants and loans extended to Georgia by international financial institutions and donor countries played an important role.

The decline in international trade volumes against the backdrop of the global economic crisis was also reflected in the country's external trade dynamics. In QIII 2009 the import of goods and services amounted to USD 1,335 million, down 31.5% year-on-year, and exports fell 15% to USD 883 million. Due to the fact that imports declined at a faster pace than exports, in 2009 the trade and current account deficits considerably narrowed. According to the QIII 2009 data, the annual decline rates of these parameters were at 50% and 66%, respectively. As a rule, a narrowed current account deficit exerts a downward pressure on the demand for foreign exchange, and hence it would be reasonable to expect the exchange rate to appreciate in 2009. However, a counterbalancing pressure in the form of

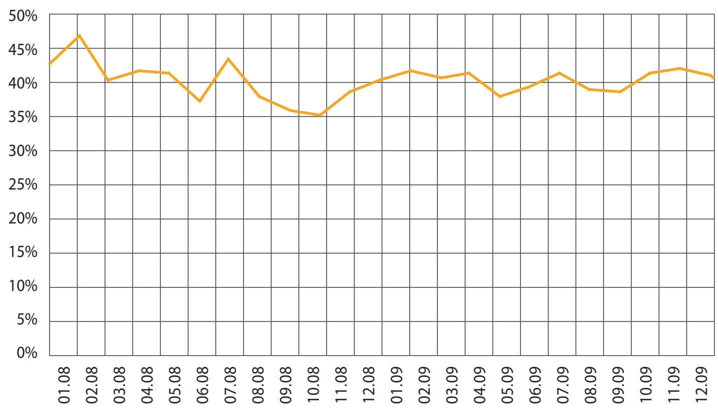
GRAPH 2.6.2
Net Purchases of the NBG (USD million)



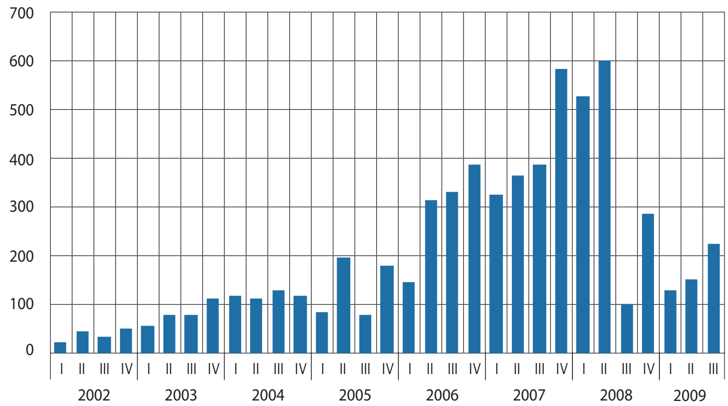
GRAPH 2.6.3
Dollarization of Loan Flows



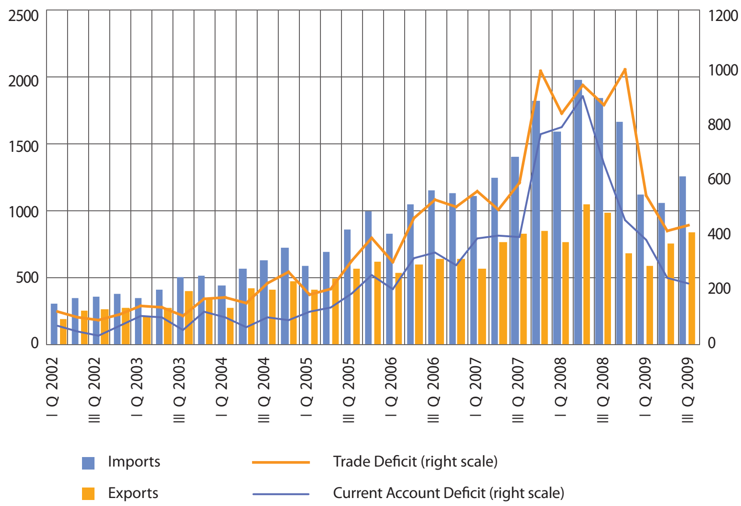
GRAPH 2.6.4
Dollarization of Deposit Flows



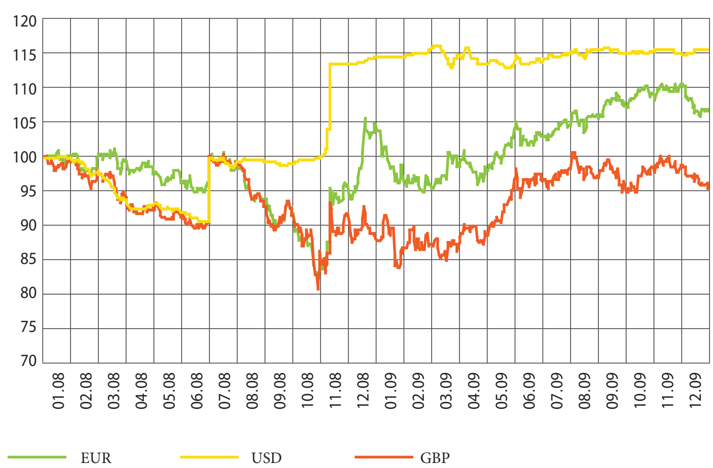
GRAPH 2.6.5
Foreign Direct Investments in Georgia (USD million)



GRAPH 2.6.6
Dynamics of Georgian Trade and Current Account Balances



grafiki 2.6.7
Lari Nominal Exchange Rate Dynamics (2008 year)



foreign exchange shortage owing to the decline in investments must be taken into account.

As of December 31, 2009 the USD/GEL exchange rate appreciated to 1.6858 from 1.6771 at end-QIII, while the EUR/GEL rate depreciated to 2.4195 from 2.4405. In QIV 2009 the lari nominal and real effective exchange rates appreciated 0.1% each.

2.7. PRODUCTION AND DEMAND

In QIII 2009 the Georgian economy continued declining and the nominal GDP fell 3.6% year-on-year. In the same period the real GDP moved down only 1.2% – due to specific deflating methodology in the Public administration sector and low inflation the GDP deflator was at -2.4%.

On the upside, in QIII 2009 the GDP growth rate substantially grew compared to the preceding quarter, when the real GDP decline was at -10.7%. Positive growth rates were registered in such sectors as production and distribution of electricity, gas, and water, construction, transport, financial intermediation, public administration, and several other sectors.

The improvement in the annual growth rate of real GDP was largely due to base effect – the military hostilities that took place in the corresponding quarter of 2008 resulted in a 5% economic decline.

The sectoral analysis with seasonality adjustment showed that the real GDP decline discontinued in the majority of sectors, but the growth tendency is not yet manifested. Comparably higher quarter-on-quarter growth rates were recorded in the trade and manufacturing sectors. To the contrary, the transport and construction sectors posted essential quarterly declines, even though annual growth rates were positive. While such a decline may have been of a temporary nature in the construction sector, the downtrend was persistent in the transport sector through the last four quarters.

Ultimately, it can be stated that Georgia has overcome the deepest stage of economic recession. However, recovery of a sustainable economic growth remains pending with no clear time horizon projected.

2.7.1. HOUSEHOLD AND GOVERNMENT CONSUMPTION

In QIII 2009 the final consumption amounted to GEL 4,641.3 million, down by GEL 47 million year-on-year. Compared to the preceding quarter, when the final consumption unprecedentedly contracted 14.7%[5], the rate of decline was only at 1.0%.

On the other hand, a low contraction rate of total consumption was largely due to the QIII 2008 base effect. Taking into account seasonality factors, total consumption did not improve on a quarterly basis, which points to the rigidity of the consumption component.

2.7.2. INVESTMENTS

Gross capital formation considerably grew quarter-on-quarter, totaling in nominal terms GEL 637.5 million (from GEL 338.8million). The growth was largely due to increase in FDIs compared to the previous quarters.

Notwithstanding the above, the annual rate of decline in the investments component was very significant, running at 44.2%.

2.7.3. 2009 ESTIMATES AND 2010 FORECAST

The growth rate of real GDP in QIII 2009 was 1 percentage point higher than the forecast made in the preceding quarter (-1.2% vs. -2%, respectively). Such a difference was largely due to subsequent adjustment of quarterly GDP growth rates for 2008, as a result of which the QII 2008 growth rate was revised to -5.0% from -3.9%

GRAPH 2.6.8
Lari REER (Dec 95 = 100)

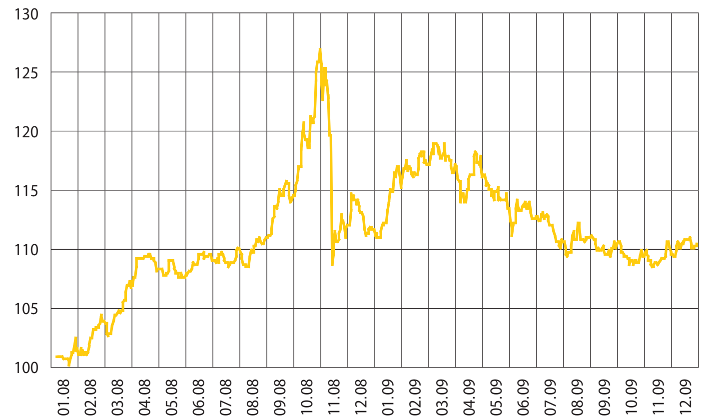
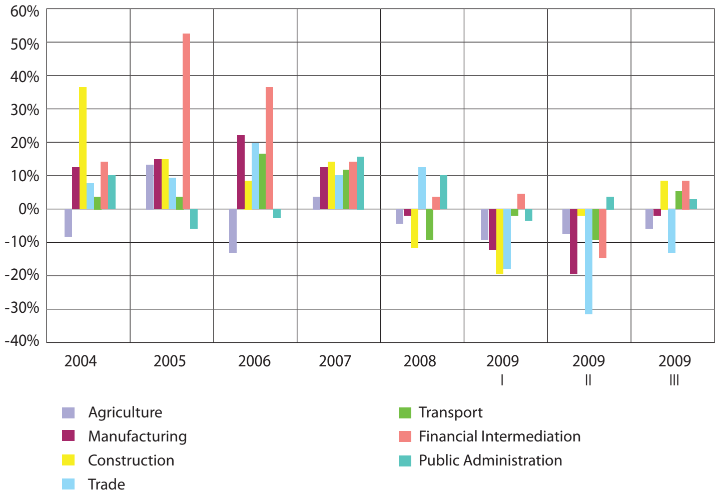


TABLE 2.7
Contribution of Economic Sectors to Georgia's GDP Growth (%), QIII 2009

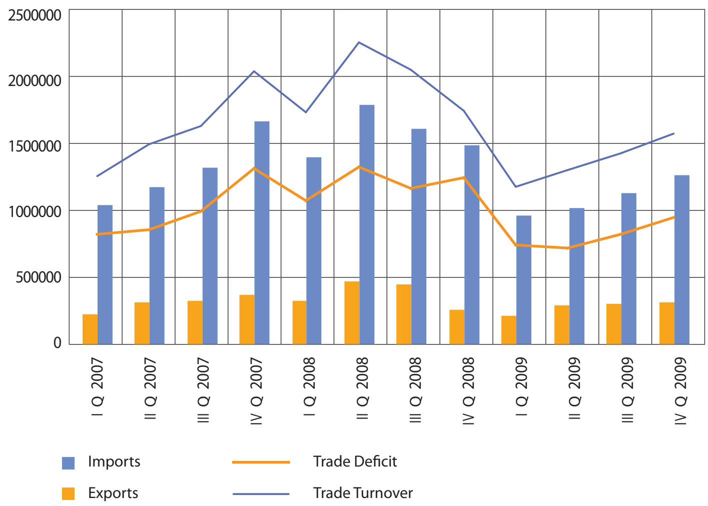
	Growth Rate	GDP Weight	Impact
Agriculture, Hunting and Forestry; Fishing	-5.2%	7.6%	-0.4%
Mining and quarrying	6.8%	0.8%	0.1%
Manufacturing	-1.1%	8.5%	-0.1%
Electricity, gas and water Supply	10.3%	2.0%	0.2%
Processing products by households	-2.2%	3.1%	-0.1%
Construction	9.2%	5.6%	0.5%
Trade services, Repair services	-13.2%	14.1%	-1.9%
Restaurant and Hotel services	-3.4%	2.1%	-0.1%
Transport and storage	5.2%	6.0%	0.3%
Communications	-2.4%	3.7%	-0.1%
Financial intermediation	9.2%	2.0%	0.2%
Real estate, rental and business activities	2.0%	3.6%	0.1%
Imputed rent of own occupied dwellings	2.6%	2.5%	0.1%
Public administration	2.1%	14.5%	0.3%
Education	-1.4%	4.1%	-0.1%
Healthcare and social services	5.0%	4.3%	0.2%
Other community, social and personal service activities	-5.2%	3.1%	-0.2%
Private households with employed persons	2.2%	0.1%	0.0%
FISIM adjustment	1.5%	-1.3%	0.0%
Gross Domestic Product at basic prices			**-0.9%**
(+) Taxes on products	-2.4%	14.0%	-0.3%
(-) Subsidies on products	2.2%	-0.4%	0.0%
Gross domestic product at market prices	**-1.2%**	**100.0%**	**-1.2%**

5 At end-November of each year the Statistics Department releases adjusted GDP figures for the previous year, which has a corresponding impact not only on the quarterly growth rates of a previous year but also on those of a current year. After releasing the final GDP numbers for 2008, the total consumption in QII 2008 changed to GEL 5,335.0 million from GEL 4,684.9 million.

GRAPH 2.7
Growth Dynamics of Main GDP Sectors (2004 – QIII 2009)



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



The current estimates suggest the rate of GDP contraction to be near 0.5% – 0.7% in QIV 2009. Hence, the real economic growth in 2009 is projected at circa -4.3%. The level of the GDP deflator for 2009 is estimated at -2.5%, implying the nominal GDP decline to be around 7%.

In 2010 the economic growth is expected to renew in the second quarter, with the conservative forecasts of the annual growth rate estimated at 2%. The 2010 GDP deflator is projected to equal 1.5% – 2%.

2.8. EXTERNAL TRADE

Georgia's external trade turnover had a permanently growing tendency since 2003. Starting from QIII 2008, after the August war and the following impact of the world financial crisis, both imports and exports of the country posted quarterly and then annual declines, which continued in QIV 2008 and QI 2009. Later in 2009 the trend changed upwards quarter-on-quarter but remained negative year-on-year (save for the QIV exports).

In 2009, the Georgian external trade turnover contracted 29.3% year-on-year to USD 5,513.3 million[6], of which USD 1,135.0 million was exports of goods (down 24.1% y/y) and USD 4,378.3 million was imports (down 30.6% y/y). Consequently, in 2009 trade deficit narrowed 32.5% year-on-year to USD 3,243.4 million.

In QIV 2009, after a continuos downtrend through several consequtive quarters, exports moved up 22.0% year-on-year to USD 313.6 million, which was in part due to a low level in QIV 2008. Imports contracted 15.6% to USD 1,263.4 million. Hence, the trade deficit narrowed 23.4% to USD 949.5 million.

It must be noted that in 2009 seasonal growth tendencies fully recovered, and hence in QIV both exports and imports posted positive quarter-on-quarter growth rates equaling 5.5% and 11.7%. As a rule, economic activity starts from its lowest in the first quarter and moves upwards throughout the next three quarters.

In QIV 2009 ferroalloys traditionally represented the the top export item (both q/q and y/y). These were followed by gold, export of which grew 38.0% y/y mostly due to price gains in the internatonal market. Gold export prices in QIV 2009 rose 48.0% y/y. Gold export volumes declined 6.8% y/y. Exports of nuts increased 2.3 times y/y, holding the third place

6 External trade data are based on the information from the Georgian Department of Statistics. Due to methodological differences, the balance-of-payments and export-import data differ from external trade data.

on the export items list. The increase was observed in both value and volumes, which grew 40.0% and 68.5 y/y, respectively. The next place was held by mineral fertilizers. Exports/re-exports of motor cars in QIV 2009 essentially fell 62% y/y against the backdrop of slackened international sales volumes of the Toyota cars due to detection of flaws. The Toyota cars comprise a large part of motor car exports from Georgia to the neighboring countries. In QIV 2009 exports of citrus plants sharply increased, with the value thereof up 4 times y/y. 75% of citrus exports went to Ukraine, 16% – to Azerbaijan, 7% – to Belarus.

Starting from QIV 2008 the new export items included live sheep and bovine animals. In 2009 annual export of sheep totaled USD 17.0 million, whereas in QIV 2009 this item increased 11,9 times y/y to USD 12.7 million. The sheep were mainly exported to Saudi Arabia. Exports of bovine animals in 2009 amounted to USD 16.9 million, mostly to Azerbaijan.

In the accounting period the top ten export items were as follows: ferroalloys, gold, nuts, mineral fertilizers, citrus, copper mines, spirits, ferrous scrap, live sheep, and wine.

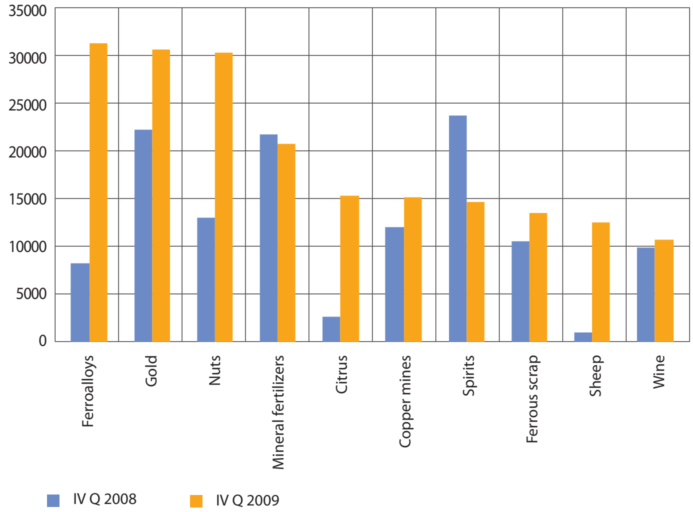
In QIV 2009 investment goods accounted for 2.9% of total exports, intermediate goods accounted for 59.2%, and consumer goods – for 37.9%.

With regard to registered imports in QIV 2009, petroleum products, being traditionally on top of the list, continued to increase at 24.1% y/y, with the growth observed in both prices and volumes. Motor cars, holding the second place, grew 7.6% q/q.

In the accounting period investment goods accounted for 12.2% of total imports, intermediate goods accounted for 44.8%, and consumer goods – for 42.9%.

In 2009 the main destinations of the Georgian exports were in the following order: Turkey, Azerbaijan, Canada, Armenia, Ukraine, Bulgaria, and the Russian Federation. The share of these trading partners accounted for 76.6% of total exports. The major trading partners in imports were Turkey, Ukraine, Azerbaijan, Germany, Russian Federation, the US, China, Bulgaria, Italy, and Romania, accounting for 67.8% of total imports.

GRAPH 2.8.2
Top Export Items, QII 2009 vs. QII 2008 (USD thousand)



2.9. GOVERNMENT OPERATIONS

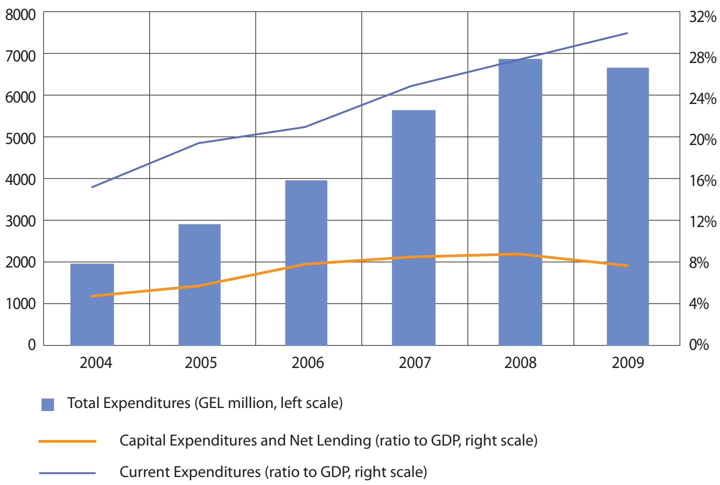
In QIV 2009 the consolidated budget revenues and grants totaled GEL 1,588 million, of which grants amounted to GEL 212 million and tax and non-tax revenues – to GEL 1,376 million. The revenues accounted for 31.2% of GDP, up 2.5 percentage points q/q and down 4 percentage points y/y. Tax burden (tax-revenues-to-GDP ratio) was at 22.7%, down 1.2 percentage points q/q and 0.1 percentage points y/y. Grant receipts, with the major portion thereof falling on the EU grants, comprised quite a high ratio of 4.2% with respect to GDP.

In QIV 2009 total expenditures of the consolidated budget amounted to GEL 2,021 million, up by GEL 285 million q/q, but down 0.4% y/y. Current and capital expenditures amounted to GEL 1,537 million and GEL 484 million, respectively. The latter grew 15.2% q/q, but contracted 20.5% y/y. Total-expenditures-to-GDP ratio was at 39.7%, up 1.2% q/q and 0.5% y/y.

TABLE 2.9.1
Consolidated Budget Parameters (GEL million)

	QIV 2009	Ratio to GDP (2009)
Total Revenues and Grants	**1588**	**31,2%**
Revenues	1376	27%
Tax Revenues	1159	22,7%
Non-Tax Revenues	217	4,3%
Grants	212	4,2%
Total Expenditures	**2021**	**39,7%**
Current Expenditures	1537	30,2%
Capital Exp. and Net Lending	484	9,5%
Deficit	**-433**	**-8,5%**
Deficit Financing	**433**	**8,5%**
Privatization	91	1,8%
Use of Free Current Assets	-116	-2,3%
Net Increase in Domestic Liabilities	187	3,7%
Net Increase in Foreign Liabilities	271	5,3%

GRAPH 2.9.1
Budgetary Expenditures Dynamics



In QIV 2009 the consolidated budget deficit amounted to GEL 433 million, or 8.5% of GDP. The main source of budget deficit financing represented a GEL 271 million increase in foreign liabilities. In this context, it is worth noting the loans received from the IMF and the World Bank, totaling USD 200 million. GEL 91 million was mobilized by means of proceeds from privatization. The use of free current assets was equal to GEL 116 million, while the net growth in internal liabilities stood at GEL 187 million.

In the accounting period the fiscal policy continued to have an essential effect on money supply against the backdrop of decreased capital inflows and excessive liquidity in the banking system. Grants and loans extended by international financial institutions and donor countries, remaining one of the main sources of money supply, contributed to the growth of money mass on the one hand, and to the economic stimulus, on the other. Reserve money expanded by GEL 53.3 million or 3.15% in QIII 2009. Contribution of government operations to the change in reserve money was 9%. Consequently, in the accounting period the fiscal policy conduced to increase in reserve money, which indicates that the government conducted an expansionary policy to promote economic activity. State budget expenditures were particularly large in December (GEL 890 million) mostly comprising capital expenditures and government purchases.

In the accounting period expenditures on general public services represented a considerable portion of state budgetary expenditures, amounting to GEL 490 million. These expenditures were used to finance different levels of the government, financial and fiscal activities of executive and representative bodies, and to service state debt.

Expenditures on social protection represented the second largest portion of state expenditures, amounting to GEL 336 million. The major share of these expenditures was used to finance social assistance to elderly persons, family allowances, and social safety of children. National defense expenditures amounted to GEL 288 million

At end-December 2009 total state debt grew 24.5% y/y to GEL 7,4 billion (up by GEL 1,457 million), with external debt up by GEL 1,214 million and domestic debt up by GEL 243 million. At end-period the total state debt accounted for 41.5% of the 2009 GDP, exceeding the December 2008 level by 14.1 percentage points. Domestic debt significantly grew in percentage of GDP, mainly due to the IMF loans and Eurobonds, but the level still remains below the critical.

BOX 2. GOVERNMENT SECURITIES

On August 5 2009 the government of Georgia issued GEL 5,000,000 worth of Treasury Bills, with the subsequent issues gradually increasing in volumes. As of December 31, 2009 the total volume of T-bills reached GEL 270 million.

Economists agree that during crisis times, against the backdrop of the slackened economic growth and low personal saving rates, the government has to increase budgetary spending. For this purpose authorities increase a budget deficit, which obviously needs financing from some source. External and domestic types of financing represent two sources for funding deficit.

At first sight, external sources may seem more convenient as long as the interest rates are low. However, raising money from abroad contains various difficulties, in the first place, concerning the refinancing risk. It cannot be ruled out that refinancing may become complicated due to lack of confidence, accumulation of large external debt, or liquidity shortfall in the international market.

Exchange rate risk is equally important. An exchange rate may depreciate in the period between the receipt and repayment of an external loan. A government collects revenues mostly in domestic currency and in case of an external loan repayable in foreign currency the depreciation of domestic currency may sharply increase the effective interest rate on such loans. For instance, the nominal interest rate on the 2008 Eurobonds issue is at 7.5%, but factoring in the exchange rate changes that took place until present (2 years) the actual interest rate grew to near 17%, which is much higher than the interest paid on funds attracted through the T-bills.

The above-mentioned risks are not applicable to the funds mobilized to the budget through issuance of government securities in the domestic market. Naturally, these budgetary funds are also not absolutely risk-free as they are subject to an interest rate risk occurring when the market rates increase at the time of redemption. Such a risk may particularly increase in the event of a government's failure to duly control the securities emission and spending of attracted funds. However, even under such circumstances the money spent by the government stays within the economy, without flowing out abroad.

The best way to reduce domestic risks is to issue long-term securities. The advantage is that the government will redeem such securities in different years and the refinancing problems in a certain year will not bring forth the need to repay a large portion of the borrowed funds. The interest rate risk will also be lower as once issued securities will have a fixed coupon payable through several years.

Securities have a positive impact not only for the government but also for the economic development as a whole. A government security is deemed to be a risk-free asset required for the formation of a yield curve, which is necessary for the development of the banking sector. It helps balancing the banking sector portfolio as well as managing liquidity. Also it can be used by banks as collateral.

The gradual popularity of the T-bills will promote the development of the secondary securities market. Population's demand for risk-free assets is expected to grow, which will serve to the creation of medium-term savings in lari.

The development of the T-bills market meets the NBG's interests. The yield curve as mentioned above helps banks to transform short-term resources into long-term assets, which increases the volumes of the lari-denominated loans, thus promoting economic growth. The monetary policy becomes more efficient. The yield curve enhances transmission mechanisms of the monetary policy. Hence, the interest rate on 1-week refinancing will pass to the 1- and 2-year refinancing, whereby the NBG's key policy rate will have an effect on the medium- and long-term interest rates.

Summing up, it can be said that compared to borrowing from external sources the issuance of T-bills in the domestic market has many advantages that are convenient not only for the government but also for the banking sector, monetary policy, population, and the economy as a whole. The Georgian government issued the T-bills prior to 2005, but the process was discontinued due to the reasons of either mismanagement or speculative pressure. We believe that such a failure will recur no more and that the T-bills issuance launched in 2009 will lay the ground for an irreversible process of securities market development.

3. INFLATION FORECAST

In forecasting inflation the NBG uses two approaches. On the one hand, the NBG monitors each of the product indices making part to 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. In 2010 inflation dynamics will be determined mainly by price changes on food products. Certain growth is expected for wheat prices. The assumptions for dynamics of prices on fruits, vegetables, and dairy products are based on seasonal factors. Based on the assumptions made for inflation forecasting the changes in transportation costs will follow the dynamics of oil prices in 2010, while the latter are expected to fluctuate near 80 USD/barrel. Another assumption is that regulated prices will remain unchanged over the next year. Also unchanged will remain prices on sunflower oil. The September 2008 price hike in education is assumed to discontinue its effect on annual inflation in QIV 2010. For the price dynamics of the rest of the product groups in the consumption basket, the assumptions are based on the existing trend expectations in the respective economic sectors. Inflation forecasts for 2010 based on this methodology suggest that the after moving up to 4.5% at end-QI, the annual inflation rate will decrease to 1.5% at end-June, which will be followed by a slight uptrend throughout the subsequent period to 2.7% at end-year.

It is worth noting that inflation forecasts made in December were revised downwards by 1.3 percentage points.

It must be pointed out that the inflation projections made by using this methodology are suitable for a six-month time horizon, as the precision level 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:

$$\delta p = 0{,}103\delta e_{-2} - 0{,}063\delta e_{-4} + 0{,}046\delta m_{-1} + 0{,}039\delta m_{-2} - $$
$$- 0{,}016\delta m_{-3} + 0{,}007\delta p^{oil}_{-1} + 0{,}087\delta p^{food}_{-1} - 0{,}019ecm;$$

where:

P – Consumer Price Index;

m – Money Mass;

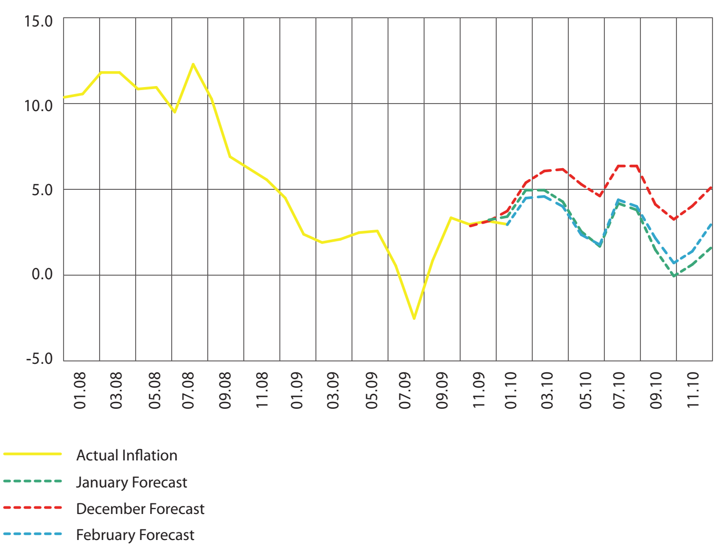
e – Exchange Rate GEL/USD;

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

p^{food} – Fruits and Vegetables Price;

ecm – is a variable depicting a long-term

GRAPH 3.1
Annual Inflation Forecast



$$ecm = p_{-1} - 0{,}42e_{-1} - 0{,}58m_{-1} + 0{,}79y_{-1} - 5{,}84$$

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 for 2010:

❑ Broad money excluding foreign currency deposits will grow 0.3% at end-QI , and 19.3% at end-year;

❑ Annual growth rate of real GDP will be at 4.6%;

❑ The lari nominal exchange rate relative to the US dollar will remain at the current level;

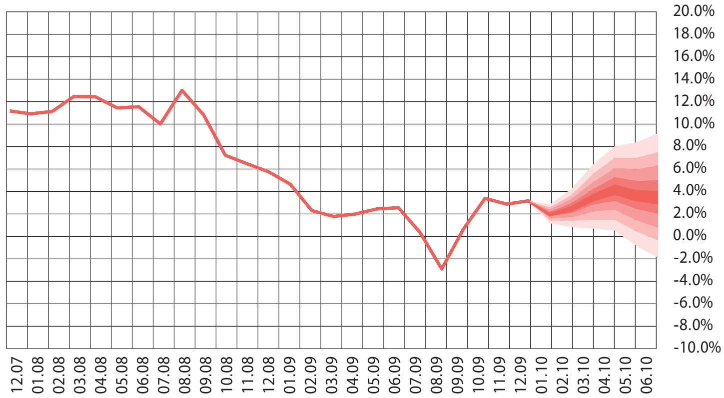
❑ Prices on fruits and vegetables will increase on a seasonal basis, in line with the previous tendencies;

❑ Oil prices will not change in international markets and average 73 USD/barrel in QI;

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

Based on the obtained results, the annual inflation rate is projected at 10% probability to be within 3.05% - 3.59% at end-QI 2010.

GRAPH 3.2
Average Annual Inflation Forecast



4. DECISIONS OF THE MONETARY POLICY COMMITTEE

The Monetary Policy Committee held three meetings in QIV 2009. Having retained the key policy rate unchanged at the October and December meetings, the Committee cut the rate to 5% from 6% at the November meeting.

The forecasts made during the accounting period suggested the annual rate of inflation to be within 3% - 4% at end-2009, and near the target level of 6% throughout 2010.

Based on the available information, during the accounting period positive and negative economic factors in the international and domestic markets were changing and offsetting each other. This particularly pertains to banks' financial positions, interbank market, real sector development, external trade data, lending to economy, and economic development and monetary policies in other countries.

Consequently, the Committee found no reasoned grounds for either loosening or tightening its monetary policy in the accounting period. At the same time, giving due consideration to the weakening of transmission mechanisms and the necessity to enhance their effect, the NBG reduced the key policy rate and increased the CDs transactions to withdraw the excess liquidity. The absorption of excess liquidity served to increase the banks' borrowing both in the interbank market and from the NBG.

The Monetary Policy Committee of the NBG was well aware of the fact that, notwithstanding a temporary inactivity of the key policy interest rate, the primary task of the NBG was to enhance the transmission mechanisms of the monetary policy. With the view to achieve this task, the NBG plans, in addition to the above-mentioned measures, to elaborate further steps towards the enhancement of transmission mechanisms.

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