INFLATION REPORT

Central Bank in Georgia was first established in 1919

2010

NATIONAL BANK OF GEORGIA

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INFLATION REPORT

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1. INTRODUCTION

According to the information of the National Statistics Office (NSO) of Georgia, in Q1 2010 the annual inflation increased by 2.8 pps to 5.8%. The annual core inflation rates also were up to -0.6% and -0.8% for products within two and one standard deviations, respectively. It is remarkable that starting from January 2010 the consumer price index is calculated using a new consumption basket. Food and non-alcoholic beverages account for 41.7% in the new basket, the commodity group "housing, water, electricity, gas and other fuels" – for 13.8%, transport – for 9.9% and healthcare – for 8.8%.

In March the annual inflation of domestic and imported goods equaled 3.5% and 2.8%, respectively. Price gains on imported goods in Q1 2010 are due to price increases in the international market in February and March 2010.

Dynamics of principal inflation factors may be described in the following way: against the backdrop of slackened economic activity, the real growth rate of labor productivity as well as the average wage growth rates were low. In Q4 2009 the average monthly wages of hired employees equaled GEL 628.9, posting a 7.6% year-on-year growth. In Q4 2009 growth rates of private expenditures accelerated, fueling the level of inflation. The year-on-year growth rate of personal expenditures in Q4 2009 equaled 15.9%, compared to 14.8% and 7.0% in Q2 and Q3 2009, respectively.

It should be noted that in Q1 2010 the VAT taxpayer companies' turnover grew 17.6% year-on-year, pointing to economic growth tendencies in the beginning of the year.

In Q1 2010 the reserve money fell 6.3% to GEL 1,663.4 million. The annual growth of reserve money amounted to 28.9%. In the accounting period the cash in circulation decreased by GEL 59.1 million to GEL 1,398.8 million. In the same period the M2 broad money aggregate grew by GEL 82.1 million (3.85%), while the M3 aggregate grew GEL 133.5 million (2.9%). By end-March these aggregates amounted to GEL 2,214.8 million and GEL 4,736.2 million, respectively.

In Q1 2010 the NBG continued to use monetary instruments in order to manage the banking sector liquidity and stimulate the banking sector. In Q1 commercial banks' funds placed on the NBG's corresponding accounts still largely exceeded the level stipulated by minimum reserve requirements; however, the downtrend in excess liquidity was manifested. The average level of funds placed on the corresponding accounts in the accounting period was 26% lower in annual terms, equaling GEL 285 million. By end-March the ratio of net liquidity withdrawal to reserve money grew by 2.2 pps to 10.3%. In absolute terms the liquidity withdrawal totaled GEL 149.2 million. In Q1 2010 the total placement of the NBG's Certificates of Deposit equaled GEL 180 million, with the weighted average interest rate equaling 3.7%. The NBG's refinancing rate remained unchanged in the accounting period at 5%. Introduction of new monetary instruments by the NBG – overnight loans and deposits, guaranteed refinancing loans – should be pointed out. The new instruments will promote development of the interbank credit market and dedollarization of the economy (See Box 2).

In the accounting period the volume of deposits in the banking sector grew 5.2%, totaling GEL 3,549.4 million. The growth rates of deposits denominated in the national and foreign currencies equaled 13.8% and 2%, respectively. However, if we exclude the exchange rate effect and analyze the foreign currency denominated deposits in the US dollars, the growth rate amounts to -1.6%. In the same period the deposit dollarization ratio fell 2 pps to 71%. In Q1 2010 the volume of loans extended by commercial banks totaled GEL 5,420.3 million. The growth rate of loans extended in the lari grew 7.6%, while the growth of foreign currency loans expressed in the US dollars fell 1.9%. The loan dollarization ratio decreased by 1 percentage point, equaling 75.8% at end-March. In the accounting period the weighted average interest rate on deposits fell 0.4 pps to 9%. The analogous interest rate on loans decreased 0.6 pps to 20.2%. In Q1 2010 the banking sector posted positive profits.

In the accounting period the lari's real and nominal effective exchange rates depreciated 0.7% and 0.4%, respectively. The trade and current account balances fell 46% and 56%, respectively, during 2009. In the same period the level of FDIs in Georgia plunged 49.8% to USD 764.6 million. It should be noted that according to the NBG's forecasts, in 2010 positive growth of FDIs is expected.

At end-2009 the economic downturn was discontinued, with the year-on-year real GDP growth in Q4 equaling 0.4%. The nominal GDP increased 1%. Preliminary data on 2009 GDP showed a 3.9% contraction, while the real GDP growth rate in 2010 is forecasted at 4%.

In line with the NBG's inflation forecasts, the annual inflation rate is projected at 3% by end-Q2, with a further increase to 6% by end-year.

2. CHANGE IN CONSUMER PRICES

According to the information of the National Statistics Office of Georgia, in Q1 2010 the annual inflation increased by 2.8 pps. Accordingly, in quarter-on-quarter terms the annual inflation grew from 3.0% to 5.8%. The average annual inflation grew 0.5 pps in Q1 2010, amounting to 2.2%.

It is remarkable that starting from January 2010 the consumer price index is calculated using a new consumption basket. At present the consumption basket contains 266 components.

Diagram 2.1
Change in Annual Inflation for Goods with Different Consumption Durability and Services

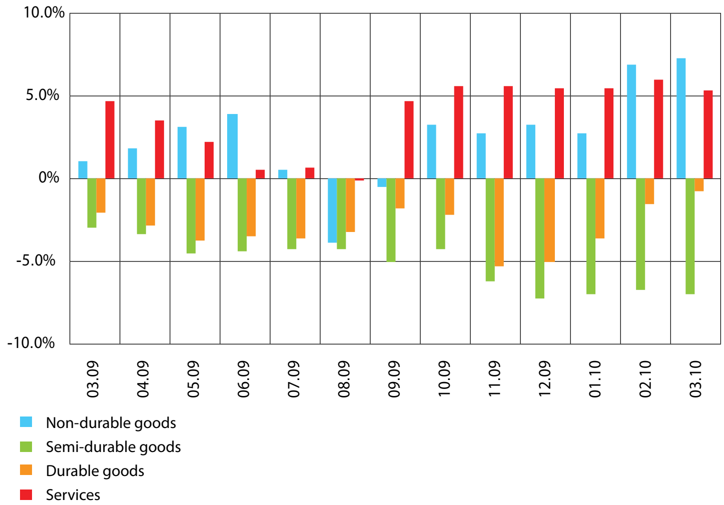
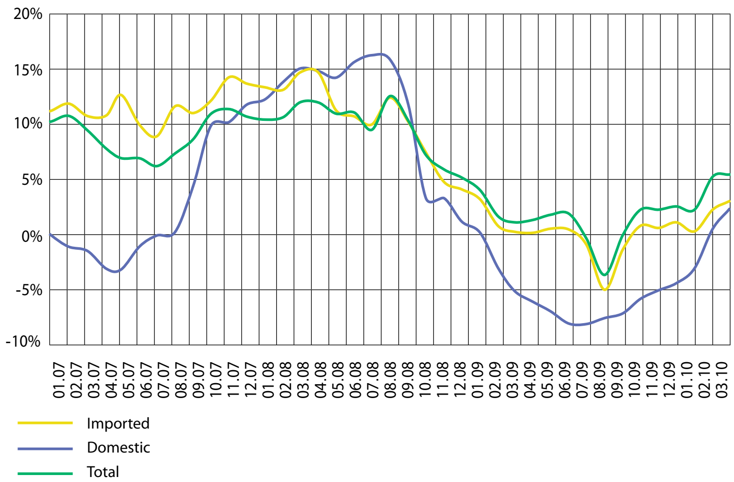


Diagram 2.2
Annual Inflation of Goods by Production Location



The share of food and non-alcoholic beverages in the new consumption basket equals 41.7%, or 2.6 pps less than in the previous basket. The commodity group "housing, water, electricity, gas and other fuels" currently accounts for 13.8% of the basket, against the 10.3% share in the previous basket. Transport and healthcare hold, respectively, 9.9% and 8.8%, posting respective increases of 0.9 pps and 0.8 pps relative to the previous shares. Taking into account a decreased share of food and increased shares of other products in the consumption basket it can be asserted that inflation will be less volatile, since food prices fluctuate more, compared to other products. Along with economic growth and improved welfare of the population, the share of food expenditures will decrease, narrowing inflation volatility.

The major impact on the quarterly inflation was produced by the food prices due to seasonal factors. In particular, prices are increased on vegetables and fruits, bread and bakery products, sugar and confectionery, and oils and fats. Some offsetting effect was produced by price decrease on dairy products.

At end-Q1 the core inflation rates equaled -0.6% and -0.8% for the products within two and one standards deviations, respectively.

As it was already mentioned, in March 2010 the prices of the consumption basket grew 5.8% year-on-year. A 44.9% price increase was registered in education, transport prices grew 13.4%. The commodity groups "food and non-alcoholic beverages" and "alcoholic beverages and tobacco" saw prices increase 9.4% and 5.4%, respectively. Prices in the commodity groups "hotels, cafes and restaurants", "leisure, entertainment and culture" and "communications" were up 1.5%, 0.7% and 0.3%, respectively. Prices fell on "clothing and footwear" (9.9%), "housing, water, electricity, gas and other fuels" (2.5%), "furnishings, household equipment and routine" (4.1%). There were also price decreases on "miscellaneous goods and services" and "healthcare" (1.3% and 0.5%, respectively).

In March the annual inflation of imported goods increased to 2.8%. It should be noted that after a one-year downtrend in prices on imported goods, a positive inflation rate was registered on this type of products in the last two months of Q1, fueled by price gains in the international markets. It is also interesting to observe the dynamics of prices on tradable[1] and non-tradable goods. In March the inflation rates of non-tradable and tradable goods equaled 2.4% and 8.9%, respectively.

In terms of goods with different consumption durability the annual inflation for non-durable goods was 7.4%. The inflation rates for semi-durables and durables equaled, respectively, -7.1% and 0.9%. Prices on services grew 5.4%.

In the period between December 2006 and March 2010 prices on non-durables and services grew 26.2% and 29.1%, respectively. Prices on semi-durables in the same period posted a 14.5% decline.

Diagram 2.3
Inflation of Tradable and Non-Tradable Goods

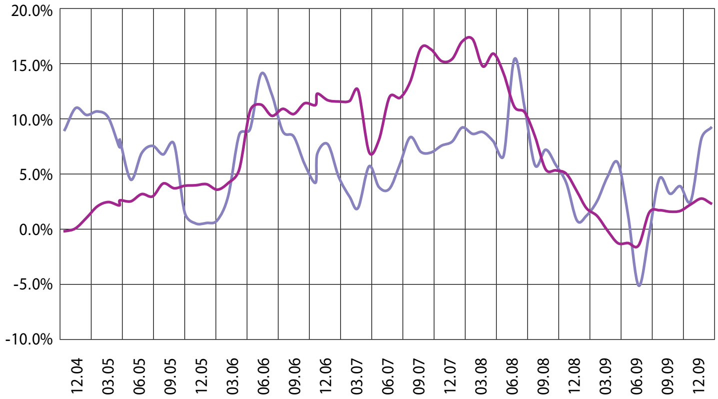


Diagram 2.4
Annual CPI and Core Inflation (by 266 Components of the Consumption Basket, Effective since December 2009)[2]

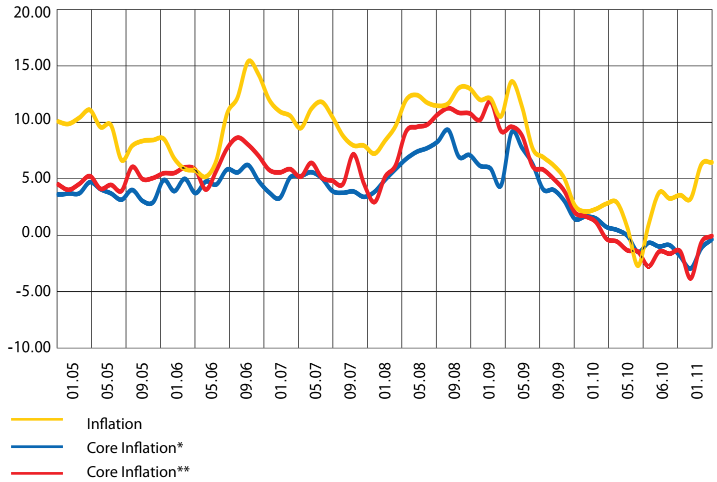
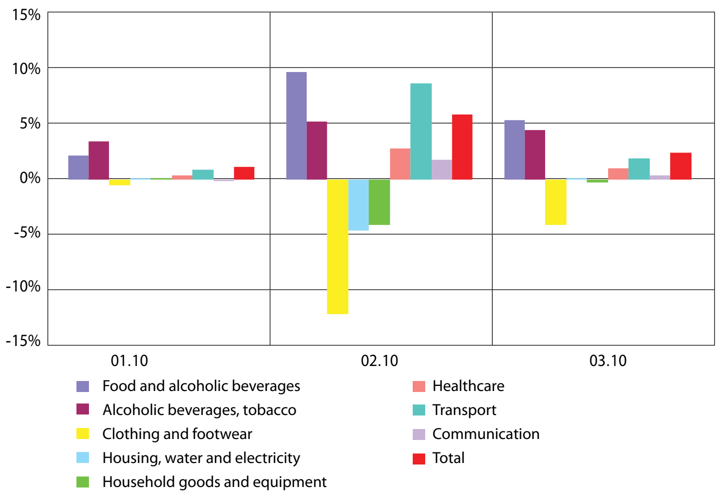


Diagram 2.5
Price Increases relative to December 2009



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

Table 2.1
Inflation Rates (CPI) by Components, Their Weight in the Consumption Basket and Impact on CPI

	December 2009 Weights	Mar10/Dec09		Mar10/Mar09		Apr09Mar10/ Apr08Mar09	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	2.4%	2.4%	5.8%	5.8%	2.2%	2.2%
Food and nonalcoholic beverages	41.7%	5.2%	2.2%	9.4%	3.9%	3.0%	1.2%
Alcoholic beverages and tobacco	2.9%	4.4%	0.1%	5.4%	0.2%	1.3%	0.0%
Clothing and footwear	4.4%	-4.0%	-0.2%	-9.9%	-0.5%	-7.3%	-0.4%
Housing, water, electricity, gas and other fuels	13.8%	0.1%	0.0%	-2.5%	-0.4%	-4.8%	-0.7%
Furnishings, household equipment and routine	3.5%	-0.2%	0.0%	-4.1%	-0.2%	-1.6%	-0.1%
Health	8.8%	1.0%	0.1%	-0.5%	0.0%	6.9%	0.6%
Transportation	9.9%	1.9%	0.2%	13.4%	1.2%	-0.4%	0.0%
Communications	4.0%	0.3%	0.0%	0.3%	0.0%	1.8%	0.1%
Recreation and culture	2.2%	-0.5%	0.0%	0.7%	0.0%	1.3%	0.0%
Education	4.9%	0.3%	0.0%	44.9%	1.6%	29.1%	1.0%
Hotels, cafes and restaurants	1.6%	0.3%	0.0%	1.5%	0.0%	6.0%	0.1%
Miscellaneous goods and services	2.3%	1.5%	0.0%	-1.3%	0.0%	3.0%	0.1%
Non-durable goods	67.9%	3.6%	2.4%	7.4%	5.0%	2.6%	1.7%
Semi-durable goods	5.8%	-2.8%	-0.2%	-7.1%	-0.4%	-5.5%	-0.4%
Durable goods	3.4%	2.0%	0.1%	-0.9%	0.0%	-3.2%	-0.1%
Services	22.8%	0.5%	0.1%	5.4%	1.2%	3.8%	0.8%

3. INFLATION FACTORS

3.1 LABOR MARKET

The global financial crisis produced a significant adverse impact on labor demand. Against the backdrop of slackened economic activity, the real growth of labor productivity of employees declined, becoming negative from Q4 2008. Growth rates of average wages also slowed down. Accordingly, growth rates of personal expenditures fell considerably.

In Q4 2009 the real value-added per employee fell 7.2% year-on-year. Significant declines were registered in "real estate, renting and business activities" (48.8%), "education" (17.5%), "hotels and restaurants" (14.8%), "trade" (11.2%), and "transport and communications" (10.0%). Single-digit decreases were posted in "agriculture" (8.2%) and "public administration, defense" (6.2%). Despite the general downtrend in value-added produced per employee, several sectors enjoyed positive growth rates, including "financial intermediation" (35.9%), "healthcare" (19.1%), "construction" (15.3%) and "industry" (1.5%).

In Q4 2009 the average annual wages of hired employees in the official economy equaled GEL 629.8[3], posting a 7.6% growth year-on-year. In the accounting period, a number of sectors showed average wage declines. Sectoral analysis showed that an average wage decline was particularly evident in "agriculture", amounting to 26.8%. Relatively small decreases in average wages were manifested in "hotels and restaurants", "manufacturing" and "mining" sectors (4.8%, 3.5%, and 0.4%, respectively). Wages in the sectors with significant budget financing continue to grow at quite high quarter-on-quarter rates in Q4: the average monthly wages in the "education" and "health and social assistance" sectors increased, respectively, 17.5% and 10.4%, while average wages in "community, social and personal services" grew 5.4%.

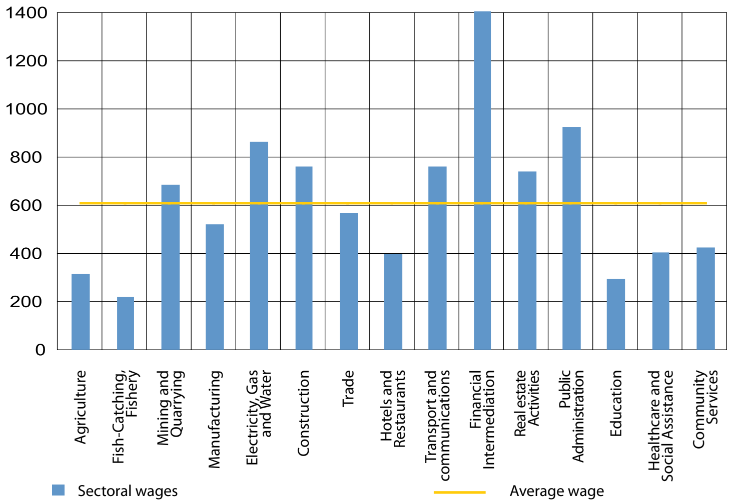
Table 3.1
Real Value-Added Index per Employee, Q4 2009 (y-o-y)

	Real Value-Added
Agriculture	91.8
Industry	101.5
Construction	115.3
Trade	88.8
Hotels and Restaurants	85.2
Transport, Communications	90.0
Financial Intermediation	135.9
Real estate, renting and business activities	51.2
Public Administration, Defense	93.8
Education	82.5
Healthcare	119.1
Total	**92.8**

Table 3.2
Average Monthly Nominal Wages of Hired Employees in Q4 2009 (y-o-y growth indices)

	Nominal Wages
Agriculture, Hunting and Foresting	73.2
Fish-Catching, Fishery	109.6
Mining and Quarrying	99.6
Manufacturing	96.5
Production and Distribution of Electricity, Gas and Water	112.3
Construction	109.9
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	102.5
Hotels and Restaurants	95.2
Transport and communications	108.3
Financial Intermediation	108.6
Real estate, Renting and Business Activities	113.6
Public Administration	105.3
Education	117.5
Healthcare and Social Assistance	110.4
Community, Social and Personal Services	105.4
Total	**107.6**

Diagram 3.1
Sectoral Average Monthly Wages of Hired Employees, Q4 2009



3 Source: Business and Labor Surveys, NSO.

Diagram 3.2
Real Value-Added per Employee, Average Monthly Wages of Hired Employees and Private Expenditures (y-o-y percent change).

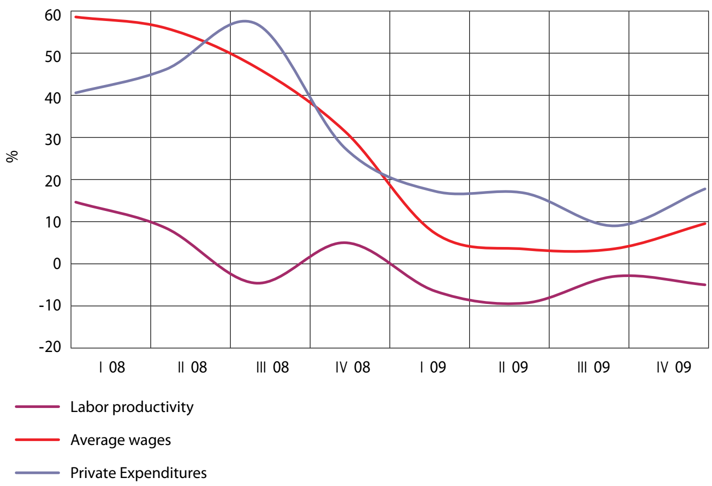


Diagram 3.3
Changes in Reserve Money

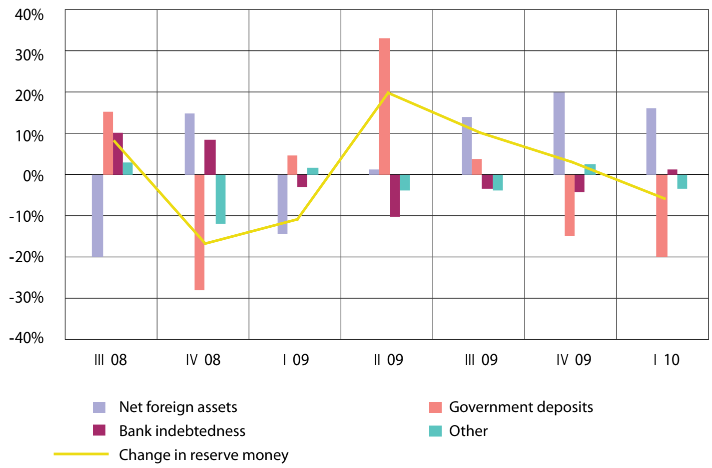


Table 3.3
Dynamics of Reserve Money, end-period data
GEL thousands

	Dec-09	Jan-10	Feb-10	Mar-10
Reserve Money	1,743,917	1,570,021	1,650,499	1,633,407
Cash in Circulation	1,457,938	1,357,686	1,356,142	1,398,806
Bank Deposits	285,979	212,335	294,358	234,601

Table 3.4
Dynamics of Reserve Money, period average data
GEL thousands

	Dec-09	Jan-10	Feb-10	Mar-10
Reserve Money	1,687,663	1,663,657	1,597,929	1,677,721
Cash in Circulation	1,347,936	1,390,171	1,336,958	1,360,994
Bank Deposits	339,727	273,486	260,970	316,727

In addition, in the accounting quarter large wage growth rates were registered in "real estate operations (13.6%), "production and distribution of electricity, gas and water" (12.3%), "construction" (9.9%), and "fish-catching and fishery" (9.6%).

In Q4 2009 significant differences in average sectoral wages remained in place. The highest average monthly wages were still enjoyed by the "financial intermediation" (GEL 1453.0) and "public administration" (GEL 955.2), exceeding the average wages for the whole economy 2.3 times and 1.5 times, respectively. The lowest wages were registered in "fish-catching, fishery" (GEL 228.9, 36.5% of the national average) and "education" (GEL 304.4, 48.3% of the national average). It should also be noted that the difference between the highest and lowest average sectoral wages in Q4 grew 8.4% year-on-year and 20.6% quarter-on-quarter.

Thus, a decline in labor productivity and a slowdown in wage growth rates led to a deceleration in the growth rates of private expenditures. In Q4 2008 the growth rates of private expenditures plunged by approximately 30.0 pps and the downtrend continued throughout 2009. Slowed down growth rates of private expenditures as well as a low absolute level thereof essentially conditioned a low inflation level. However, in Q4 2009 the year-on-year growth of private expenditures equaled 15.9%, pointing to an uptrend recovery (growth rates in Q2 and Q3 were, respectively, 14.8% and 7.0%). In Q4 2009 resurgent growth rates of private expenditures conditioned an increase in the inflation rate.

3.2 MONETARY AGGREGATES

As of Q1 2010, the reserve money contracted by GEL 110.5 million (6.3%) amounting to GEL 1,633.4 million by end-period. With respect to December 2009, the monetary base decreased only by GEL 9.9 million (0.6%).

In the accounting period the NBG sold USD 125.0 million (equivalent to circa GEL 214.7 million) through FX auctions. In Q1 2010 the net foreign currency purchases of the NBG through intragovernmental currency conversions totaled USD 271.1 million (equivalent of circa GEL 468.6 million). In the accounting period the IMF released a program tranche in the amount of USD 221.9 million. As a result of these operations, the net foreign assets grew by approximately USD 146.9 million.

In Q1 the funds on government deposits expanded by GEL 355.3 million, amounting to GEL 811.6 million by end-March.

In the accounting period the NBG continued issuance of Certificates of Deposits with the purpose of enhancing commercial banks' liquidity management. In this period the CDs worth of GEL 180.0 million were placed, and the CDs in the amount of GEL 205.0 million were redeemed. By end-December 2009 the volume of CDs in circulation decreased from GEL 219.1 million to GEL 194.2 million. In the same period the commercial banks used the refinancing loans in small amounts. As a result, in the first three months of 2010 the banks' net indebtedness decreased by GEL 24.8 million amounting to GEL -149.2 million.

Due to the above-mentioned flows, in the accounting period the reserve money decreased by GEL 110.5 million. This included a GEL 51.4 million decline in commercial banks' deposits at the NBG, the amount of which totaled GEL 234.6 million. In the same period, cash in circulation was down by GEL 59.1 million to GEL 1,398.8 million.

In Q1 2010, the M3 broad money expanded by GEL 133.5 to GEL 4,736.2 million. The foreign currency deposits 2010 grew by GEL 51.4 million (2.1%), standing at GEL 2,521.5 million by end-period. The lari deposits grew by GEL 124.8 million to GEL 1,027.9 million by end-period.

The M2 broad money expanded by GEL 82.1 million

Table 3.5
Dynamics of Broad Money, end-period data
GEL thousands

	Dec-09	Jan-10	Feb-10	Mar-10
Broad Money /M3/	4,602,749	4,575,602	4,625,643	4,736,237
Broad Money/M2/	2,132,621	2,018,709	2,099,847	2,214,757
Cash outside of Banks	1,229,436	1,132,677	1,142,394	1,186,814
Lari in Circulation	1,457,938	1,357,686	1,356,142	1,398,806
Lari Deposits	903,185	886,031	957,452	1,027,943
Foreign Currency Deposits	2,470,128	2,556,893	2,525,796	2,521,480

Diagram 3.4
Lari Liquidity

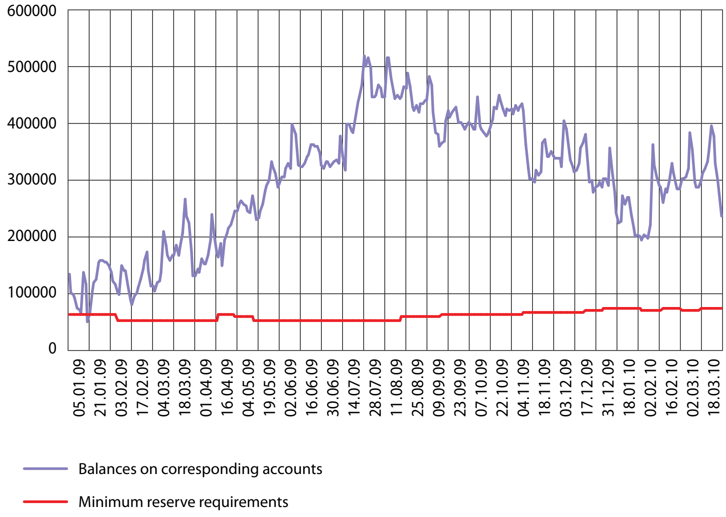


Diagram 3.5
Dynamics of Liquid Assets, Liabilities, Liquidity Ratio and Liquidity Demand

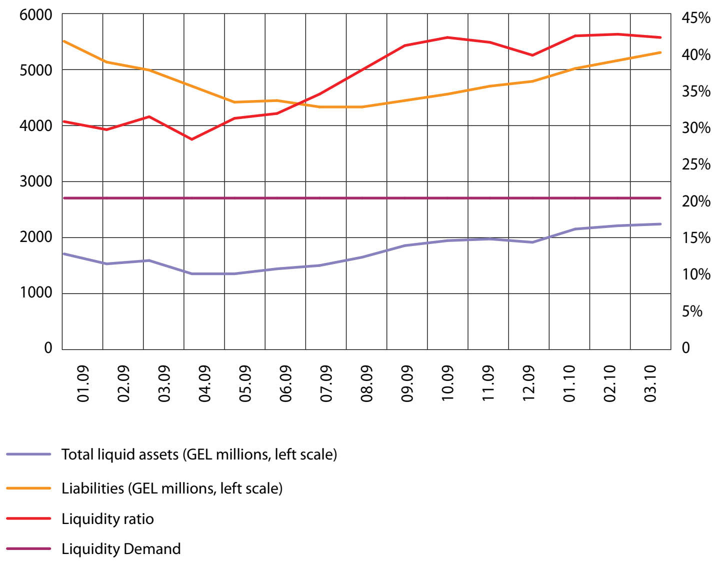


Diagram 3.6
Dynamics of CD Auctions

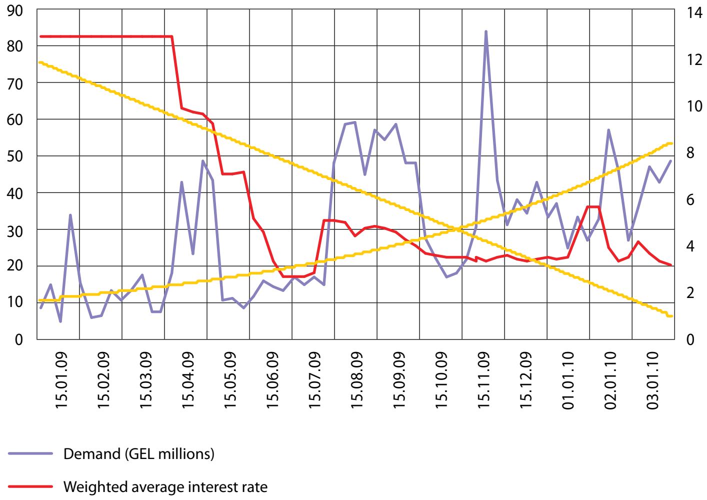


Diagram 3.7
Withdrawal of Liquidity by the NBG through CDs, Loans to Commercial Banks and Net Liquidity Supply

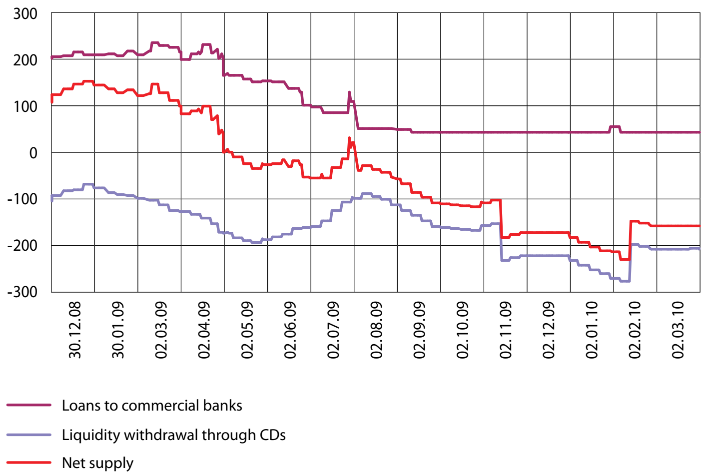
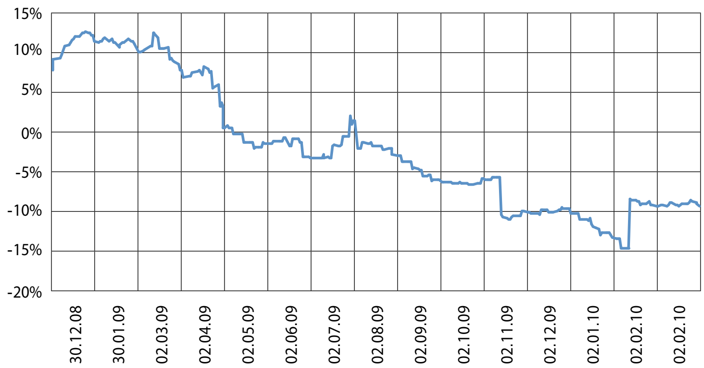


Diagram 3.8
Ratio of Net Liquidity Supply (Withdrawal) to Reserve Money



(3.9%) to 2,214.8 million.

The annual growth rates of the M3 and M2 aggregates equaled 2.9% and 3.9%, respectively.

3.3 MONETARY INSTRUMENTS

Similar to the previous periods, the NBG's monetary policy in Q1 2010 was oriented towards liquidity management and enhancing the banking sector activities.

In the accounting period, the funds placed on the corresponding accounts at the NBG still significantly exceeded the minimum reserve requirements; the downtrend started in January was quickly reversed in February, when high growth rates were registered. The minimum amount of funds on the corresponding accounts equaled GEL 188.79 million in early February, while the maximum amount was reached in end-March, standing at GEL 399.856 million. In average terms, there was a 26.2% quarter-on-quarter decline, with the value equaling GEL 285.013 million. This showed that, despite excess liquidity in the banking system, decreasing tendencies appeared to form.

In the accounting period, due to increased issuance of the Georgian government's securities and the NBG's Certificates of Deposit, the liquidity ratio went up, reaching its highest value (42.1%) in February. Its average value was 1.3 pps higher than in the previous quarter.

In order to manage liquidity, the NBG continued to use 3-month CDs. The maximum interest rate on CDs fluctuated between 2.83% and 5.95% throughout the period. Overall, in Q1 2010 the CD placement totaled GEL 180 million, or 20% less quarter-on-quarter.

The weighted average interest rate slightly went up from 3.15% to 3.69%. The interest rate hike points to a decrease in excess liquidity.

The ratio of net liquidity withdrawal to reserve money again posted a quarter-on-quarter increase, rising from 8.13% to 10.35%. As of March 31, 2010, the net liquidity withdrawal stood at GEL 149.2 million.

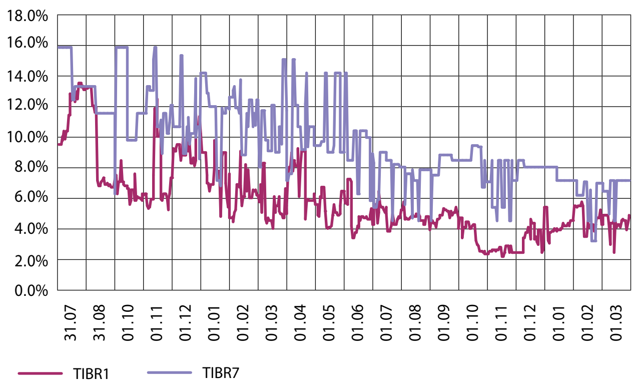
BOX 1. NEW MONETARY POLICY INSTRUMENTS

One of the important preconditions for effective monetary policy transmission mechanism is the existence of a developed interbank money market. In such environment commercial are able to manage short-term liquidity more efficiently, while the central bank is in the position to intervene in this market to achieve a desirable short-term interest rate; the latter is transmitted to relatively long-term interest rates and, in the end, to loan interest rates. At present the Georgian interbank market is not sufficiently developed – the volume of transactions is low and interest rates have a high volatility. In such conditions forecasting of interest rates is complicated, commercial banks do not trust the interbank market which ultimately results in low turnover levels. Less interest rate volatility will allow banks to better estimate a short-term interest rate on their market borrowings and rely more on the money market. This will lead to an increase in the volume of market transactions, transforming the interbank market into an important source of short-term resources.

In order to reduce money market volatility, by the decision of the NBG's Monetary Policy Committee, new permanent instruments, overnight loans and overnight deposits, were put into operation starting from April 2010. Use of these instruments implied an establishment of an interest rate band, equal to +/- 2% of the monetary policy rate. A commercial bank will not lend in the interbank money market at less than 3%, as it is always able to place funds on the NBG's overnight deposits, and vice versa: a commercial bank will not borrow at more than 7%, being able to draw funds at this rate through the NBG's overnight loan facility. Thus, after introduction of these instruments the money market interest rates will fluctuate between 3-7%. In the future the NBG plans to further narrow the interest rate band in order to keep the interbank market interest less volatile and more predictable.

Another factor hindering efficiency of the monetary policy represents high dollarization. Before the global financial crisis when the world economy was booming the Georgian banks could easily attract funds from abroad, with subsequent on-lending to the domestic economy. In such circumstances mobilization of resources from the domestic market was less favorable for banks, which, on the one hand, promoted dollarization of the economy and, on the other hand, conditioned increase in the country's external risks. In order to enhance de-dollarization process in the economy and promote granting loans in the lari, starting from April the NBG introduced a guaranteed refinancing loan facility. The latter guarantees commercial banks to receive a loan at a variable interest rate linked to the monetary policy rate (key policy rate + 1), without auction procedures. Types of collateral used for guaranteed refinancing loans include state securities, international bank guarantees and loan assets of the commercial banks.

Diagram 3.9
Dynamics of Interbank Interest Rates



3.4 INTERBANK LOANS

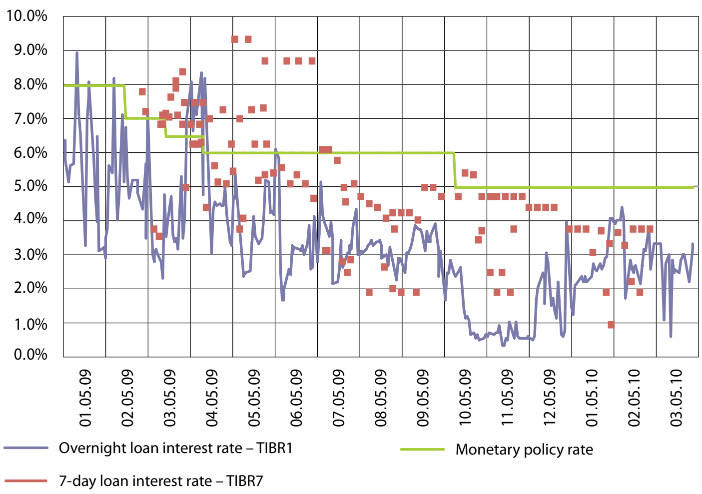
In Q1 2010 the amount of loans extended in the national currency in the interbank credit market totaled GEL 513.36 million, or 12.7% higher year-on-year. Similar to the previous period, the share of loans denominated in the US dollars fell 37.7% amounting to USD 169.3 million. The volume of loans extended in euro continued to show an upward trend in Q1 2010, posting a 24.2% quarter-on-quarter growth to reach EUR 24.9 million. The volume of loans extended in the UK pounds decreased by 23.5% to GBP 0.46 million.

In respect of maturity of transactions, the share of 7-day lari-denominated loans fell quarter-on-quarter from 63% to 37.4%. Similar to the previous period, in the foreign currency-denominated loans the share of overnight loans grew from 60.8% to 82.2% for the US dollars and from 48.5% to 60.8% for the euro.

The dynamics in the interbank loan market described above was correspondingly reflected in the interest rate and interbank loan indices: the average quarterly TIBR-1 grew from 1.3% to 2.75%, while TIBR-7 fluctuated between 1.5% and 6%, falling in average terms from 6.5% to 4.95%.

A relative uptrend in TIBR–1 expresses growth tendencies in overnight interest rates owing to increased demand.

Diagram 3.10
Short-Term Interbank Indices and Monetary Policy Rate



3.5 BANKING SECTOR

In Q1 the deposit liabilities of the banking sector grew 5.22% quarter-on-quarter (by GEL 176.1 million), amounting to GEL 3,549.42 million. For comparison, this growth rate is 7 pps less than the analogous rate posted in Q4 2009. The annual growth equaled 30.7%. Such a large difference is explained by the fact that in Q1 2009 the volume of deposits fell to quite a low level (See Diagram 3.11).

Looking separately at the lari-denominated deposits, after a slight decline in January 2010 their volume amounted to GEL 1027.9 million at end-March, rising 13.8% with respect to December 2009. The dynamics of legal entities' deposits should be pointed out: this type of deposits in the lari grew 15.5%, while the deposits in foreign currency fell 1.63%.

The deposit dollarization ratio remains high, currently at 71%, which is 2 pps lower than in Q1 2009. The deposits of individuals denominated in the foreign currency (expressed in the US dollars) increased 1.4%, accounting for 66.7% of total foreign currency deposits placed at the commercial banks.

In Q1 2010 the weighted average interest rate on deposits fell 0.4 pps, equaling 9%. The interest rate on lari-denominated deposits remained unchanged at 10.7%, while the interest rate on deposits in foreign currency dropped 0.4 pps, currently standing at 8.8%. Here a 2.2 pps interest rate decrease on legal entities' deposits in foreign currency should be pointed out. In annual terms the weighted average interest rate fell 1.4 pps, with the interest rate on legal entities' deposits in foreign currency dropping 3.9 pps.

In the accounting period the economy crediting by commercial banks increased GEL 164.7 million, totaling GEL 5,420.3 million at end-March (note that the preceding quarter posted a decline). The lari loans grew 7.6%, while the foreign-currency denominated loans (expressed in the US dollars) fell 1.9%. The dollarization ratio equaled 75.8%, or 1 percentage point less than in December.

The short-term loans as well as loans to individuals, both denominated in foreign currency, dropped 6.1% and 4.2%, respectively. A significant (10.6%) growth was posted for long-term loans in the national currency, while short-term loans in the lari shrank 3.5%. The government sector crediting by commercial banks grew significantly by 42.5%.

In Q1 2010 the weighted average interest rate on loans equaled 20.2%, or 0.6 pps less quarter-on-quarter. This implied a continuation of the downtrend in interest rates, peculiar to 2009 (apart from a few exceptions during the quarter). The interest rates decreased 0.4 and 0.7 pps for loans denominated in the lari and in the foreign currency, respectively.

In the accounting period the banking sector displayed the following financial stability indicators: Tier II adequacy ratio – 18.3%, return on assets (ROA) – 0.7%, return on equity (ROE) – 4.0%.

3.6 FACTORS AFFECTING THE EXCHANGE RATE

The main goal of the NBG's monetary and exchange rate policies consists in maintaining the inflation level in line with the predefined inflation target. Hence it is important to monitor and analyze all inflation factors. A conventional assumption stipulates that in small open economies there exists a strong link between the exchange rate and the inflation, since the former, on the one hand, influences prices on imported goods, accounting for a considerable share in the consumption basket, and has an impact on the country's export competitiveness and gross national income, on the other. The dynamics of exchange rate is also important in banks' estimates of credit risk, thus being a significant factor for the country's financial stability.

Based on the above-mentioned, it is important to analyze all the factors affecting the exchange rate. At present the lari exchange rate is determined in the foreign exchange market through demand and supply. Demand for foreign currency is mainly driven by imports,

Diagram 3.11
Deposits at Commercial Banks

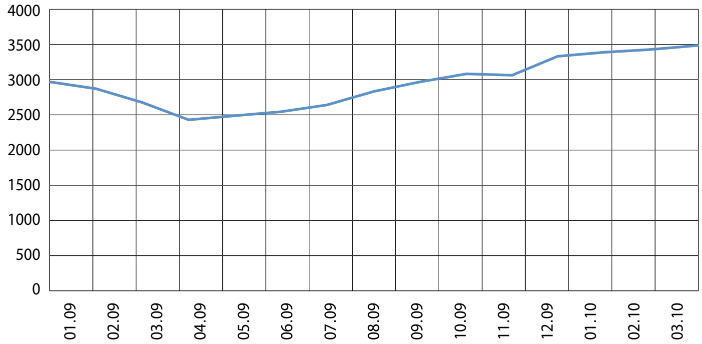


Diagram 3.12
Loans in National Currency to Residents

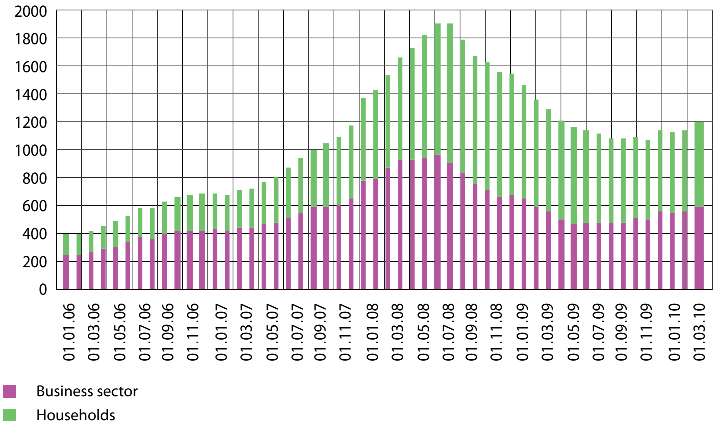


Diagram 3.13
Loans in Foreign Currency to Residents

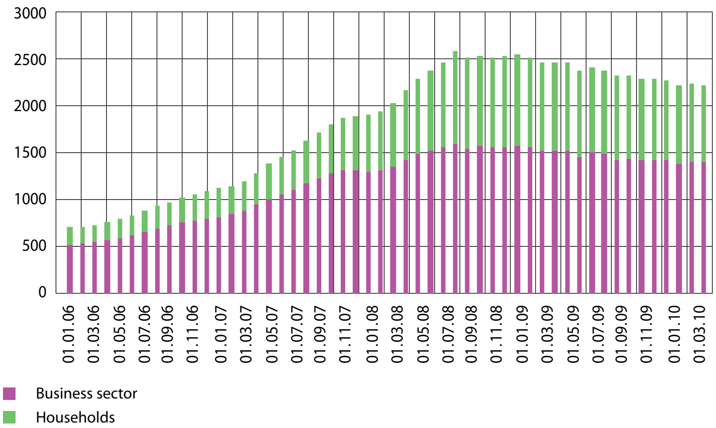


Diagram 3.14
Overdue Arrears

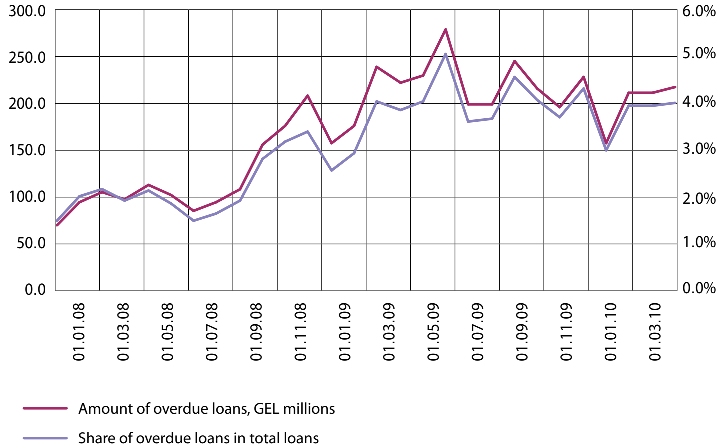


Diagram 3.15
Interest Rates on Loans and Deposits

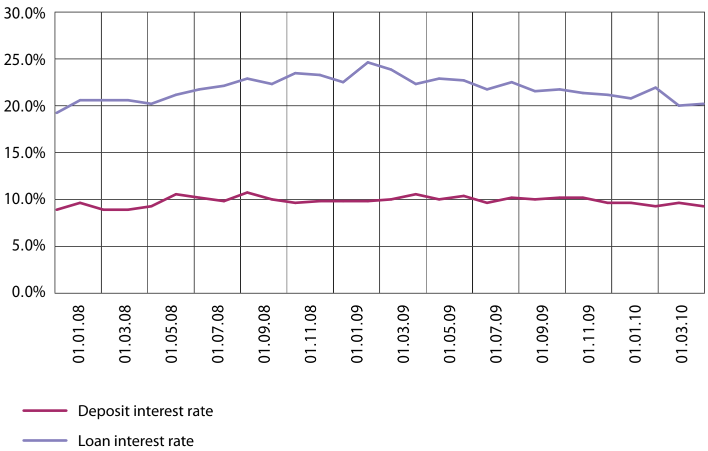
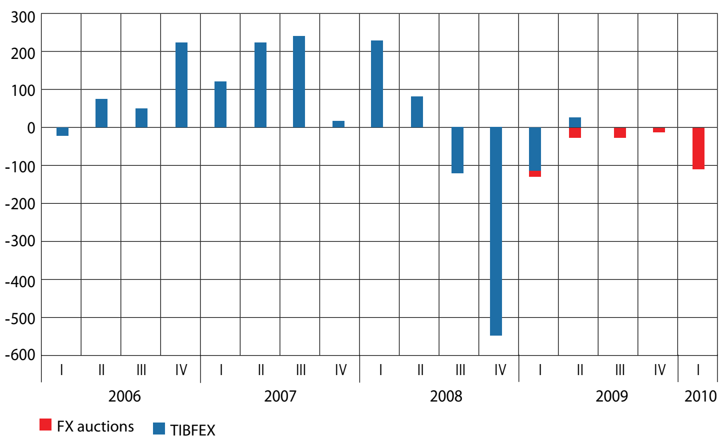


Diagram 3.16
Net FX Interventions of the NBG



with the latter being financed by exports and capital inflows. It should also be noted that the FX auctions introduced by the NBG play an important role in avoiding sharp exchange rate fluctuations caused by temporary imbalances of demand and supply.

The NBG initiated the FX auctions in March 2009. After abolishment of the Tbilisi Interbank Foreign Exchange the FX auctions remained the only channel for the NBG's interventions. It should also be mentioned that the FX auctions are more market-oriented than direct intervention in the foreign exchange market. After abolishment of the TIBFEX and introduction of the FX auctions the public perception that the NBG artificially manages the exchange rate significantly altered.

Demand for foreign currency is significantly influenced by the economy's dollarization level. In Q1 2010, however, the dollarization ratio of deposits and loans declined 2 and 1.1 pps, respectively. The dollarization level in turn depends on economic agents' expectations with respect to likely changes in exchange rate in the future. This determines the agents' choice of a currency to keep savings. A general psychological factor influenced by political risks adds up, ultimately underlying the population's distrust of the lari and granting the US dollar a safe currency's status.

The 50% year-on-year drop of FDIs in 2009 should be pointed out. A decline in foreign capital inflows mainly started in Q3 2008 as a result of the Russian-Georgian war and the evolvement of the global financial crisis.

It is noteworthy that the dry-up of foreign capital inflows was partly offset by financial assistance of donor countries and an increase in external debt. According to the forecasts of the NBG and the government, in 2010 the growth of FDIs is expected.

In parallel to slackening economic activity and declining foreign investments, the volume of imports also dropped. In 2009 the annual contraction of imports stood at 30%. The trade and current account balances narrowed even further, by 46% and 56%, respectively, owing to a more rapid downturn in imports with respect to exports. The above-mentioned improvement of the 2009 current account decreased demand for foreign currency.

According to the NSO data, the current account deficit in Q1 2010 amounted to GEL 522 million[4]. In the same period the net banking money remittances totaled USD 182 million[5], or USD 36 million more than in Q1 2009. According to the NBG's preliminary data, the volume of foreign investments in Q1 2010 was less than expected.[6] The net domestic assets of commercial banks decreased by GEL 45 million. All these factors contributed to the lari's nominal exchange rate depreciation.

It is generally agreed that under perfect capital mobility the exchange rate dynamics is significantly influenced by the interest rate differentials on corresponding domestic and foreign assets. This relationship between interest rate differentials and the exchange rate is known as uncovered interest rate parity, stipulating that higher interest rates on domestic assets compared to those on foreign assets, under the same risk conditions, are ascribed to expectations of domestic currency appreciation. For comparison, in Q1 2010 the interest rates on the 6-month and 1-year Treasury bills stood at 5% and 6.5%, whereas the interest rates on the US T-bills with the same maturity periods equaled 0.15% and 0.4%, respectively[7]. However, it should be noted that these interest rate differentials are due to increased political and economic risks rather than to expected depreciation of the lari.

In January 2010 the lari's real effective exchange rate depreciated 1.5%, although fully recovering in February. In March the REER depreciated 0.6%, resulting in a 0.6% depreciation in Q1 2010. The lari's nominal exchange rate depreciation with respect to the US dollar in Q1 equaled 3.8%, appreciating 2.5% and 1.3% with respect to the euro and the UK pound respectively. Overall, in the

Diagram 3.17
Loan and Deposit Dollarization Rates

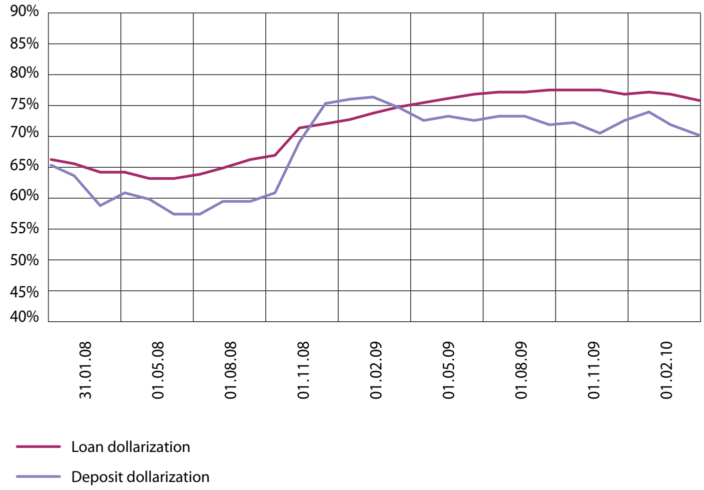


Diagram 3.18
FDIs in Georgia

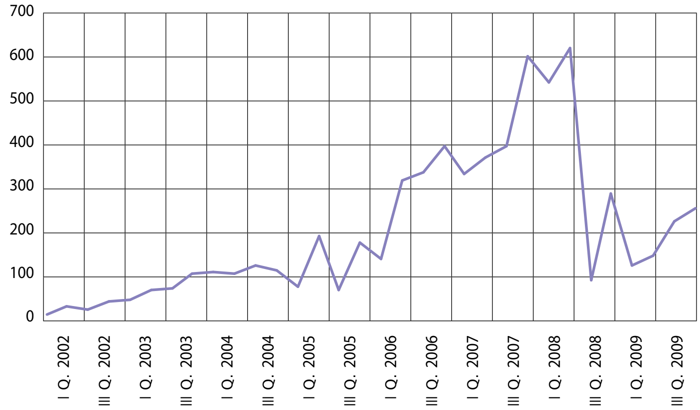
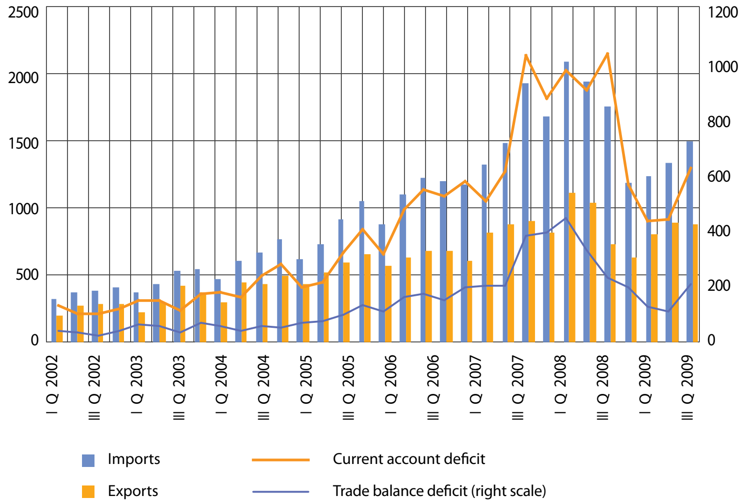


Diagram 3.19
Dynamics of the Georgian Trade and Current Account Balances



4 This includes only the difference between registered exports and imports of goods, excluding unregistered trade and exports and imports of services.
5 This does not include money remittances received through other non-banking channels.
6 Preliminary data are based on commercial banks' reports with respect to purposes of money transfers. Revised balance of payment data are released on the 90th day after the end of the quarter.
7 Data from the NBG's and US Fed's websites.

Diagram 3.20
Dynamics of Lari's Nominal Exchange Rate

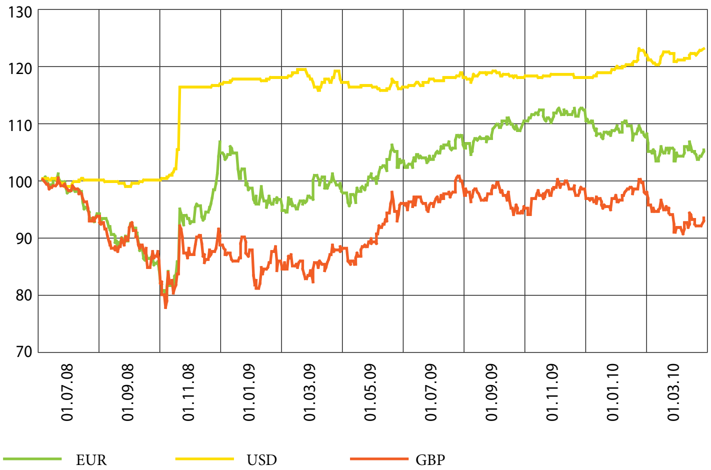
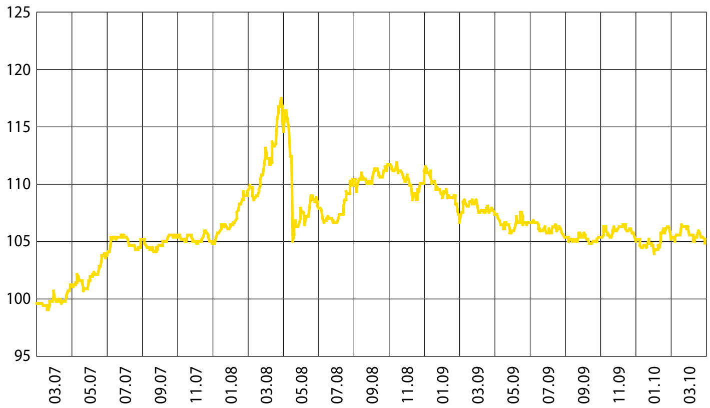


Diagram 3.21
Lari's NEER Index, 2008-2010

Diagram 3.22
Lari's REER Index, 2007-2010



accounting period the lari's nominal effective exchange rate depreciated 1.3%.

3.7 PRODUCTION AND DEMAND

The economic downturn started in Q3 2008 was discontinued in Q4 2009. In particular, the real GDP growth rate equaled 0.4% year-on-year, with the nominal GDP growth rate standing at 1%. The GDP deflator was 0.6%.

Overall, the real GDP growth in Q4 2009 was largely fueled by increases in value-added in transport and healthcare and social assistance. Positive growth rates were also posted in production and distribution of electricity, gas and water, financial intermediation, and education.

In the same period a real decline in economic activity was registered in a number of sectors, with trade and construction sectors to be mentioned in particular. The most adverse impact on GDP growth was largely due to value-added decreases in these two sectors.

The analysis of seasonally adjusted sectoral GDP data shows that despite real growth in a number of sectors in recent quarters, none of the economic sectors displayed explicit growth tendencies in 2009.

Overall, we may conclude that the country's economy exited recession and it is likely that real GDP growth started in Q4 will turn into a pronounced tendency.

3.7.1 Private and Government Consumption

In Q4 2009 total final consumption expenditures grew almost 4% (by GEL 190 million), powered by household consumption. The latter increased by almost 5% (GEL 173 million). The analysis of seasonally adjusted data confirms that in the second half of 2009 household consumption manifested significant growth rates.

The recent downtrend in government consumption was reversed in Q4 2009, posting a 1.1% increase. In parallel to decreased collective government services

(-2.5%), the growth rate of individual government services amounted to approximately 17%.

3.7.2 Investments

Despite a 44% quarter-on-quarter increase in gross capital formation, the year-on-year contraction still remained high at 37%.

Formation of fixed capital posted a -32% year-on-year decline. However, taking into account quarterly growth rates and planned investment activities, it is likely that in 2010 the positive growth rates of this investment component will be recovered.

It should be noted that after a continuous decrease in inventories throughout the year, the Q4 change in inventories turned positive, indicating an upswing in the consumer market.

3.7.3 2010 GDP Forecast

Despite that Q4 2009 forecasts pointed to a small GDP decline (-0.6%), the official GDP released by the NSO posted a slightly positive growth rate.

Taking into account the existing macroeconomic tendencies and the sectoral analysis of the economy, it becomes evident that starting from Q1 2010 a strong economic growth should be expected. The forecasts hold the 2010 real GDP growth rate to be around 4%, whereas in Q1 an economic growth is projected to equal approximately 2%. One of the indications of an upturn in economic activity represents an increased turnover of the VAT-payer enterprises. The latter posted a 17.6% year-on-year increase. This fact is important since historically the VAT-payer companies' turnover is highly correlated with the nominal GDP.

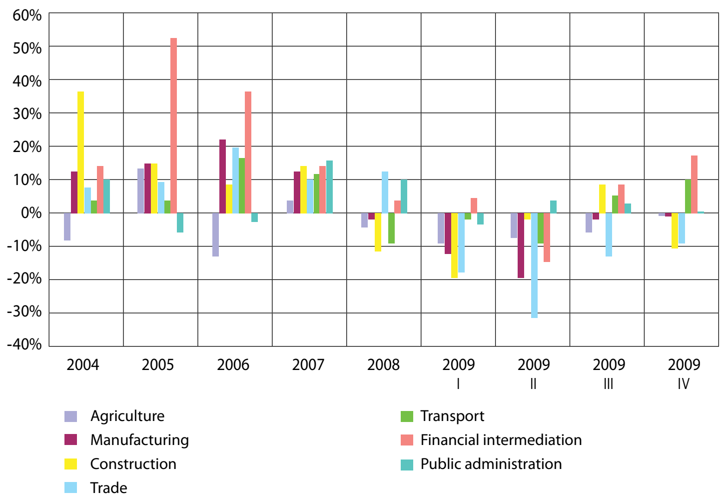
The 2010 GDP deflator is projected at 5%, implying a 9% growth of the nominal GDP.

The real growth of value-added will be powered by growth in such sectors as trade, manufacturing and construction. A considerable revival of the financial intermediation sector is also expected.

Table 3.6
Sectoral Impact on GDP, Q4 2009

	Annual growth	Share in GDP	Impact on GDP growth
Agriculture, forestry, fishing	-0.9%	7.6%	-0.1%
Mining and quarrying	2.1%	0.5%	0.0%
Manufacturing	-1.8%	7.6%	-0.1%
Electricity, gas and water production and distribution	13.5%	2.4%	0.3%
Processing products by household	-0.6%	3.1%	0.0%
Construction	-11.6%	7.1%	-0.8%
Trade services, Repair services	-7.9%	14.0%	-1.1%
Restaurant and Hotel services	2.1%	2.0%	0.0%
Transport and storage	10.2%	5.7%	0.6%
Communications	1.6%	3.2%	0.1%
Financial intermediation	16.6%	1.9%	0.3%
Real estate, renting and business activities	-3.0%	3.5%	-0.1%
Imputed rent of own occupied dwellings	2.3%	2.4%	0.1%
Public administration and defense	0.9%	15.4%	0.1%
Education	4.4%	3.9%	0.2%
Health care and social assistance	12.4%	4.4%	0.5%
Other community, social and personal service activities	3.5%	4.0%	0.1%
Private households with employed persons	4.5%	0.1%	0.0%
(-) FISIM adjustment	-12.2%	-1.2%	0.1%
(=)Gross Domestic Product at basic prices			**0.3%**
(+) Taxes on products	0.9%	12.9%	0.1%
(-) Subsidies on products	4.2%	0.4%	0.0%
(=)Gross domestic product at market prices	**0.4%**	**100.0%**	**0.4%**

Diagram 3.23
Growth Dynamics in Main Economic Sectors



BOX 2. DYNAMICS OF FINAL CONSUMPTION IN 2008-2009

Diagram 3.24
GDP by Categories of Use (GEL millions)

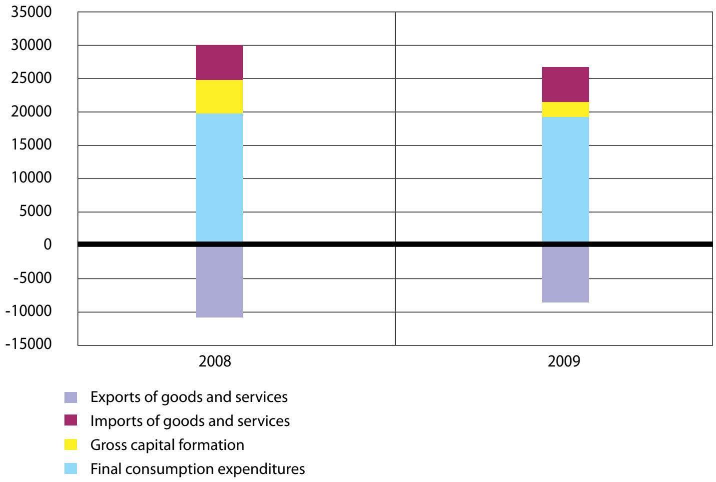
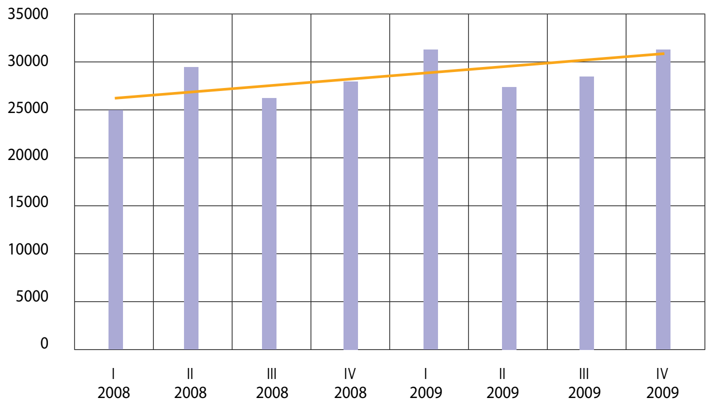


Diagram 3.25
Actual Final Consumption of Households excluding Consumer Imports (2008-2009, at current prices)



Analysis of the country's gross domestic product by the categories of use is of particular importance.

The largest category is the expenditures on final consumption, being also quite an objective indicator of household welfare. However, to assess the actual household consumption it would be more reasonable to observe the total final consumption expenditures excluding expenditures on government's collective services.

Overall, in 2008-2009 despite the economic shock, the actual household expenditures on final consumption (in current prices) posted a slightly positive, 1.3% annual increase.

In order to determine a change in real household consumption, we may use the consumer price index. In 2009 the average monthly CPI equaled 1.7%. Hence it can be asserted that in 2009 the real household consumption practically remained at the 2008 level.

At the same time, in 2009 the imports of consumer products (always exceeding 40% of total imports in the recent years) fell 18.4% (approx. GEL 870 million).

In 2009 the imported consumer products accounted for ¼ of total final consumption of households, while in 2008 the above share equaled 31%. Taking into account the fact that the actual household consumption remained practically flat, it becomes evident that in 2009 the consumer demand was satisfied through a larger share of domestic production than in 2008. An increase in the share of domestic production took place mainly at the expense of the business sector, and due to decreases in the existing inventories at households' disposal (in 2009 the inventories of the business sector only declined by GEL 415.5 million).

The diagram below clearly shows that the actual "domestic" final consumption of households tends to increase. The latter grew significantly, at 10% (by GEL 1,062 million), in 2009.

It is obvious that, apart from the factors related to the economic crisis, decrease in consumer imports was conditioned by a relative depreciation of the national currency. In annual terms the lari's average exchange rate with respect to the US dollar declined 11%.

3.8 FOREIGN TRADE

Georgia's external trade turnover has been in an uptrend since 2003. As a result of the August 2008 hostilities and the global financial crisis, in Q3 2008 a quarterly decline in both exports and imports was registered, followed by an annual external trade contraction. In 2009 quarterly growth tendencies were recovered, but annual growth rates still remained negative. In Q1 2010 the external trade turnover falls behind the Q1 2008 level by significant 21.6%; however, with respect to Q1 2007 it posted a 7.1% increase. It should be noted that the growth rate of exports largely exceeded that of imports, resulting in the fact that in Q1 2010 the trade deficit was at its lowest level in the last four years. The registered exports exceed the Q1 2007 level by 51.6%, while the imports are 2.4% lower with respect to the same period.

As of Q1 2010, Georgia's external trade turnover totaled USD 1,358.7 million, or 14.8% more year-on-year[8]. The registered exports of goods equaled USD 339.0 million, or 55.0% more in annual terms[9]. The registered imports of goods totaled USD 1,019.7 million, declining 5.7% year-on-year. Hence the trade deficit amounted to USD 680.6 million, or 8.8% less in annual terms.

In Q1 2010 the registered exports of goods posted an 8.1% quarter-on-quarter growth (owing to seasonal factors, the first quarter is characterized by lower economic activity than the fourth quarter of a previous year). At the same time, in quarter-on-quarter terms the imports and the trade deficit declined 19.3% and 28.3%, respectively.

In the accounting period the significant growth of exports was powered by ferroalloys, the export of which almost tripled in year-on-year terms due to both quantity and price effects. In Q1 2010 ferroalloys traditionally were on top of the export commodity list. The exports of ferrous and non-ferrous metals also increased considerably. It should be noted that in the base period international prices on ferrous and non-ferrous metals were extremely low owing to the global financial crisis, drastically decreasing the export value. On the export list ferroalloys were followed by exports/re-exports of cars, which posted a 128% annual increase.

Diagram 3.26
Exports, Imports, Trade Deficit and Turnover
(USD thousands)

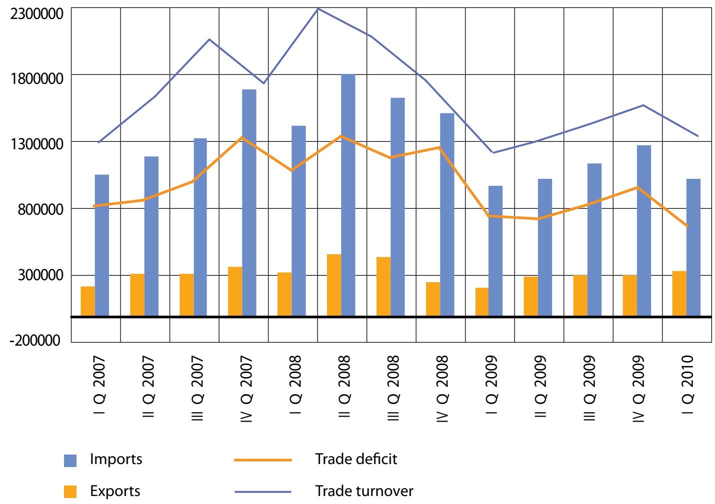
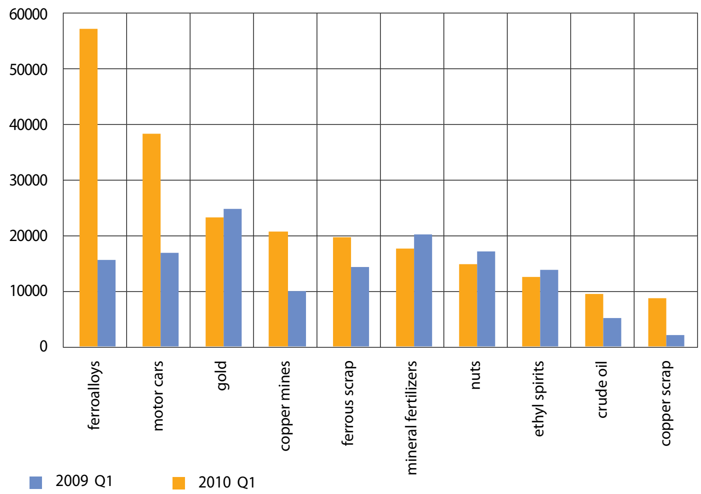


Diagram 3.27
Top Export Goods in Q4 of 2008 and 2009 (USD thousands)



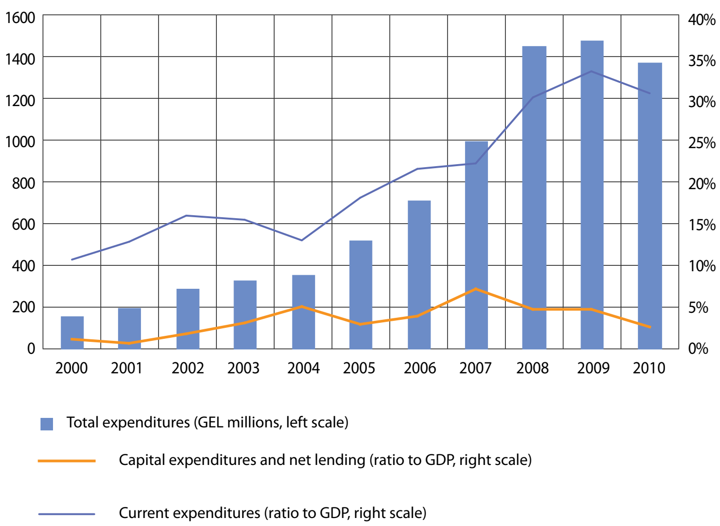
8 The source of foreign trade data is the information from the NSO. Data on good exports and imports in the balance of payments differ from the foreign trade data due to methodological discrepancies.

9 The registered trade did not include cars imported under the customs storage regime and subsequently reexported. Starting from 2010 this type of exports is registered, with the total value in Q1 amounting to USD 20 million. This increases the value of exports, and, since the same cars are not included in imports, the trade deficit is artificially decreased by the corresponding amount.

Table 3.7
Consolidated Budget Components (GEL millions)

	Q1 2010	Ratio to GDP (Q1 2010)
Total Revenues and Grants	**1266**	**30,5%**
Revenues	1175	28,3%
Tax Revenues	1095	26,4%
Non-tax Revenues	80	1,9%
Grants	92	2,2%
Total Expenditures	**1402**	**33,4%**
Current Expenditures	1278	30,8%
Capital Expenditures and Net Lending	108	2,6%
Deficit	**-119,5**	**-2,9%**
Deficit Financing	**119,5**	**2,9%**
Privatization	29	0,7%
Use of Free Circulating Funds	-387	-9,3%
Net Increase in Domestic Liabilities	67	1,6%
Net Increase in External Liabilities	411	9,9%

Diagram 3.28
Dynamics of Budget Expenditures



The growth was largely due to exports of used cars. Starting from end-2008 a new commodity appeared in the Georgian export list – live bovine animals. The exports of the latter were quite stable throughout the last four quarters, with the exports in the accounting period increasing 1.5 times year-on-year.

In Q1 2010 the top 10 export commodities included ferroalloys, motor cars, gold, copper mines, ferrous scrap, mineral fertilizers, nuts, ethyl spirits, crude oil and copper scrap. In total exports investment goods accounted for 5.4%, intermediate goods – for 60.4%, and consumer goods – for 34.1%.

In the accounting period the top import commodity traditionally represented petroleum products, with the annual growth rate running at 39.9% due to oil price gains. Imports of motor cars followed on the list, posting a 3.9% increase year-on-year. A significant year-on-year increase was registered for manganese imports serving as raw materials for production of ferroalloys. This was conditioned by the fact that in Q1 2009 the exports of ferroalloys were disrupted causing a corresponding decline in manganese imports.

In Q1 2010 13.5% of total imports included investment goods, 39.5% - intermediate goods, and 46.8% - consumer goods.

In Q1 2010 Georgia's top ten trading partners for exports included Turkey, Azerbaijan, Armenia, the United States, Canada, Bulgaria, Ukraine, Germany, and Romania. These countries accounted for 73.6% of total registered exports.

Georgia's top ten trading partners for imports were Turkey, Ukraine, Azerbaijan, Russia, China, Germany, the United States, the United Arab Emirates, Italy, and Romania. The share of registered imports from these countries equaled 67.5%.

3.9 GOVERNMENT OPERATIONS

In Q1 2010 the revenues and grants of the consolidated budget totaled GEL 1266.3 million, including GEL 91.5 million in grant revenues and GEL 1,174.8 million in tax and non-tax revenues. The ratio of Q1 revenues to GDP[10] equaled 30.5%, or 0.2 pps more quarter-on-quarter and 2.7 pps less year-on-year. The tax burden (tax-to-GDP ratio) in Q1 2010 equaled 26.4%, or 4.3 pps more than in Q4 2009 and 2.9 pps less than in Q1 2009. The volume of received grants in Q1 amounted to 2.2% of GDP.

In Q1 2010 the consolidated budget expenditures totaled GEL 1,385.8 million, or GEL 648 million less than in Q4 2009 and 7% lower than in Q1 2009. The current and capital expenditures in Q1 amounted to GEL 1,287 million and GEL 113 million, respectively. The capital expenditures decreased almost 3 times quarter-on-quarter and by 24% year-on-year. The ratio of consolidated budget expenditures to GDP equals 33.4%, which is 5 pps less both quarter-on-quarter and year-on-year. Decline in the ratio is explained by reduction in expenditures and expected GDP growth.

In Q1 2010 the consolidated budget deficit totaled GEL 120 million, amounting to 3% of GDP. The main source of deficit financing in Q1 represented a net increase in external liabilities, equal to GEL 411 million. Two IMF tranches of USD 73.6 million and USD 148.3 million should be noted. In addition, privatization proceeds equaled GEL 29 million. In the accounting period the free circulating funds grew by GEL 388 million, while the net increase of domestic (Treasury) liabilities stood at GEL 67 million.

In the accounting period, against the backdrop of decreased capital inflows and excess liquidity in the banking sector, the impact of the fiscal policy on money supply remained significant. Spending of loans received from the international financial institutions remained a significant source of money supply. On the one hand, this contributed to growth of money mass, while stimulating the economic activity, on the other. In Q1 2010 the NBG's reserve money declined 6.34% (by GEL 110.5 million). However, as it was already mentioned, the government operations in Q1 contributed to reserve money growth. The impact of the fiscal sector on changes in the reserve money equaled 7.6 pps. Thus, the government conducted an expansionary monetary policy in Q1 to enhance economic activity. The state budget expenditures were particularly large in March (GEL 563 million), mainly falling on capital expenditures and government purchases.

In the accounting period, the largest share (31%) of the state budget expenditures was allocated on general government services (GEL 404 million). These funds were channeled to finance activities of different levels of the executive and legislative organs, to provide for financial and fiscal activities and to service state debt.

In Q1 2010 the second largest category of the state budget expenditures represented expenses on social assistance, amounting to GEL 305 million (23%). A significant share of these expenses was allocated for social protection of elderly people, families and children as well as for activities related to social alienation issues.

In the accounting period funds allocated for social order and security totaled GEL 168 million (13%). The expenditures of this category were mainly directed to finance activities of police and state protection, correction institutions, courts and public prosecutor's offices.

As of end-March 2010, the total state debt grew 6.5% (by GEL 478 million) quarter-on-quarter, amounting to GEL 7.9 billion. The external liabilities increased by GEL 411 million, and domestic liabilities were up by GEL 67 million. By end-Q1 the total state debt equaled 44% of the 2009 GDP, exceeding the end-2009 level by 2.5 pps. However, it should be noted that the volume of external debt is far from a critical level.

10 Q1 2010 forecasts (in this sub-section)

4. INFLATION FORECAST

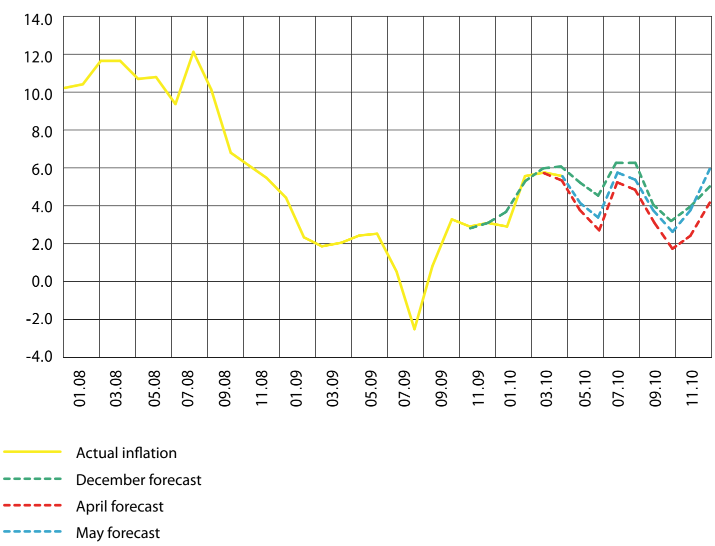
In forecasting inflation the NBG uses two approaches. On the one hand, the NBG monitors indices for each product making part to the consumption basket and makes inflation forecasts under certain assumptions and projections. On the other hand, the NBG applies econometric modeling of inflation dynamics.

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 will be determined mainly by price changes on fruits and vegetables, bread and bakery products and fuels. Certain growth is expected for wheat prices. Forecasts of price dynamics on fruits and vegetables and dairy products were made, taking into consideration seasonal factors. In line with the assumptions made for inflation forecasts, changes in transportation fee in 2010 will correlate with the oil prices. Based on the existing forecasts, the oil price in the current year will fluctuate near 80 USD/barrel. For forecasting purposes it was assumed that regulated prices will remain unchanged throughout the year. No change will be observed with respect to the sunflower oil price. In Q4 2010 the one-time effect of increase in tuition fee will be excluded from the annual inflation. In order to forecast price dynamics of other commodity groups in the consumption basket, the existing projections with respect to the relevant sectoral trends were used. Using this method, the inflation forecasts show a decrease in inflation to 3.2% in end-Q2, with a subsequent rise to 3.7% by end-September. At end-year the annual inflation is expected to further increase to 6.1%.

It should be noted that the inflation forecast was revised upwards after the previous quarter, although remaining within the inflation target range.

It should be noted that inflation forecasts based on this method are useful for a 6-month time horizon, losing its precision for a longer period.

Diagram 4.1
Annual Inflation Forecast based on Forecasting of Individual Components



An updated inflation forecasting model is determined as follows:

$$\delta p = 0,10\delta e_{-2} - 0,061\delta e_{-4} + 0,045\delta m_{-1} + 0,043\delta m_{-2} - $$
$$- 0,0146\delta m_{-3} + 0,006\delta p^{oil}{}_{-1} + 0,087\delta p^{food}{}_{-1} - 0,02ecm;$$

where:

P is CPI;

m – money mass;

e – GEL/USD exchange rate;

P^{oil} – a world average price on oil;

P^{food} – prices on fruits and vegetables;

ecm – a long-term equilibrium variable having the following form:

$$ecm = p_{-1} - 0{,}42e_{-1} - 0{,}58m_{-1} + 0{,}79y_{-1} - 5{,}8\,\mathrm{y}$$

– GDP.

The equation also includes seasonal and dummy variables to account for seasonality and structural breaks.

The following assumptions were made with respect to future values of the explanatory variables within the model:

• Broad money excluding foreign deposits will grow 21.5% from March until end-year, posting a 25.8% growth with respect to December 2009;

• The real GDP growth will equal 4.4% per annum;

• The nominal exchange rate against the US dollar will remain unchanged at GEL 1.7577;

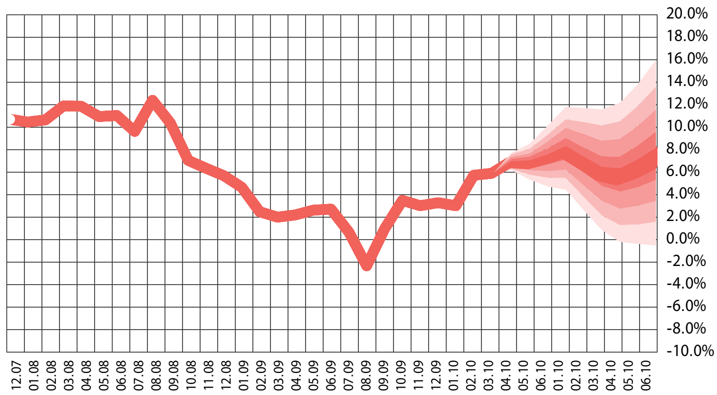
• Prices on fruits and vegetables will follow the previous year's trends, accounting for seasonality;

• The average oil price in the world market will increase to 85.8 USD/barrel in Q2, approaching 90 USD/barrel by end-year.

As a result of model estimations, the annual inflation forecast looks as follows:

According to the obtained results, at 10% probability, the annual inflation in Q2 2010 will change between 6.86% and 7.09%, falling into the interval between 7.12% and 7.47% by end-June.

Diagram 4.2
Inflation Forecast (in line with the Econometric Model)



5. DECISIONS OF THE MONETARY POLICY COMMITTEE

In Q1 2010 three meetings of the NBG's Monetary Policy Committee (MPC) were held. At all these meetings the MPC kept the monetary policy rate unchanged at 5%.

In the accounting period forecasts did not change significantly, showing that in the medium term the inflation level will remain around 6%. In Q1 a number of positive tendencies were manifested. These included in particular: a considerable growth rate of swift money transfers in the first months of 2010; an increase in export volumes, with the agricultural production accounting for a significant share; a slow but steady growth of economy crediting by the commercial banks. It should be noted that growth of loans took place mainly owing to loans extended in the lari. In the accounting period the growth rates of monetary aggregates increased. All the above-mentioned factors contribute to growth of the aggregate demand in the country, as the latter underlies the current economic growth. Based on the above, the MPC did not have significant reasons for tightening or loosening its monetary policy.

At the same time, the MPC realized that at present the transmission mechanism is weak, and an important prerequisite for its strengthening represents development of the interbank money market. Hence, against the backdrop of excess liquidity accumulation in the banking system, by the decision of the MPC the emission of 3-month CDs was twice increased to GEL 20 million. In addition, a decision has been made to introduce permanent instruments, overnight loans and overnight deposits, aimed at reducing interest rate volatility in the interbank market. The overnight loans and deposits will be put into operation starting from Q2. In order to enhance the monetary transmission mechanism, the refinancing loan facility was modified. In particular, the existing refinancing loans were complemented by non-auction guaranteed refinancing loans with a variable interest rate linked to the monetary policy rate. In addition, the types of collateral eligible for receiving refinancing loans now include a bank's credit portfolio, which should satisfy predefined criteria.

BOX 3. AMENDMENTS TO THE ORGANIC LAW OF GEORGIA "ON THE NATIONAL BANK OF GEORGIA"

According to the Decree of the President of Georgia dated September 24, 2009, the amended Organic Law "On the National Bank of Georgia" became effective. The revised Law stipulates that starting from December 2009 the NBG is responsible for financial sector supervision, in terms of systemic and individual risks, and is entitled to define the main directions of supervision and regulation activities related to the financial sector. The financial sector comprises commercial banks, non-banking deposit institutions, microfinance organizations, insurance and brokerage companies, stock exchange, non-state pension schemes, money remittance service providers and currency exchange bureaus. In line with the Law, the Financial Sector Supervision Committee has been established at the NBG to elaborate and implement supervision policies.

The transfer of the functions related to the financial sector supervison from a central bank to an independent organization is concerned with the conflict of interests between two main goals – price stability and financial stability. The assignment of these two goals, extremely important for economic welfare, aimed at eradicating the conflict of interests. Despite separating these two goals, the NBG's influence on the financial sector and the decisive role in ensuring financial stability was preserved, since the central bank's monetary policies are transmitted to the real economy through the banking sector, and it is the central bank which represents the lender of last resort. Accordingly, establishment of an independent financial supervision agency did not resolve the problem of conflict of interests. On the other hand, transfer of the supervision function to a different organization deteriorates communication and complicates assessment of the general situation in the financial sector, taking into account micro and macro factors. Thus, unification of these two aspects in one organization significantly contributes to efficient functioning of the financial system.

According to the revised Law, the draft document on main directions of the monetary policy submitted to the Parliament of Georgia now includes three years, instead of one year. The Law also stipulates that monetary policy decisions should not serve to meet such short-term objectives, which could make an adverse impact on price stability in the medium term. The above-mentioned amendments shall contribute to efficiently managing the inflation targeting regime and increasing trust in the NBG's inflation target. It should also be noted that the inflation target is now defined as annual inflation, instead of previously used average annual inflation.

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