Central Bank in Georgia was first established in 1919

INFLATION REPORT

2010

NATIONAL BANK OF GEORGIA

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INFLATION REPORT

Q4 2010

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), the annual inflation at end-December 2010 amounted to 11.2%. The core inflation rates stood at 7.7% and 7.6% for the products within two and one standard deviations, respectively. The contribution of food price gains to the overall inflation equaled 86%, compared to an average of 50% for the previous years. An increase in the impact of food on inflation was conditioned by abrupt price gains on these products, which in turn was a result of international price hikes due to natural calamities and bad harvest. Prices grew for almost all types of non-seasonal fruits and vegetables.

The annual domestic inflation in December stood at 7.7%, while the import inflation equaled 11.3%. It should be noted that in the accounting period the inflation for non-tradable goods equaled only 3.2%, while the prices for tradables rose 16.8%. Such difference in price increases clearly shows that high level of inflation is due to price increases in the international commodity markets and that demand pressures are weak. The fact that inflation is driven by exogenous factors is confirmed by only a 1.5% increase in prices for services in December.

The primary inflation factors can be briefly described in the following way: labor productivity of employed in the economy grew 6.4% in Q3 2010, while the average monthly wages of hired employees amounted to GEL 609.5. In the same period the growth rate of wages slowed down, equaling 7.2% quarter-on-quarter. The fact that average wages and labor productivity grew approximately at the same pace indicates that personnel costs per unit of production remained practically unchanged. This means that the labor market did not exert significant influence on inflation dynamics.

In Q4 2010 the reserve money grew 7.5% to GEL 1,822.3 million. The annual growth of reserve money equaled 4.5%. In the accounting period the cash in circulation expanded by GEL 117.5 million, amounting to GEL 1,618.2 million. Growth of cash in circulation was mainly due to approaching of New Year holidays. In the same period the M2 broad money grew 11.0%, while the M3 expanded by GEL 405.5 million. As of end-December these indicators totaled GEL 2,731.2 million and GEL 6,213.7 million, respectively.

Due to an upward revision of the inflation forecast and with the purpose of curbing inflationary expectations, the NBG tightened monetary policy in Q4 2010. In the same period the NBG continued using monetary policy instruments in order to enhance efficient liquidity management in the banking system and to contribute to revitalization of the sector. The average balances on commercial banks' corresponding accounts in Q4 were approximately equal to the level prescribed by the reserve requirements. In the accounting period demand for NBG's Certificates of Deposit grew substantially, which resulted in an aggregate placement of CDs in the amount of GEL 360 million. The weighted average interest rate on CDs amounted to 9.6%. Along with monetary policy tightening, the weighted average interest rate on refinancing loans also increased, standing at 7.57% at end-quarter.

In the accounting period the volume of deposits in the banking sector increased 7.5%, totaling GEL 4,840.7 million. The growth rate of deposits denominated in domestic currency equaled 17.9%. The growth was mainly due to increases in legal persons' current accounts. The volume of foreign currency deposits went up 4%, with the growth rate amounting to 5.9%, if expressed in the US dollars. The difference is due to the lari's appreciation. The deposit dollarization ratio fell 2.5 pps, settling at 71.9%. However, the deposit dollarization for individuals remains high at 87%. In Q4 2010 the volume of loans extended by the commercial banks increased by GEL 420.9 million to equal GEL 6,377.1 million. The annual growth rate of crediting amounted to 20.6% by end-December 2010. The volume of domestic currency denominated loans grew by GEL 39 million to GEL 1,651.9 million, while foreign currency loans expressed in the US dollars rose by USD 260.5 million to USD 2,642.8 million. The growth rates of loans denominated in domestic and foreign currencies equaled 2.4% and 10.9%, respectively. The weighted average interest rate grew by 0.2 pps on lari deposits to equal 10.2%, while remaining unchanged for foreign currency deposits at 7.6%. The weighted average interest on lari loans remained at 22.6%, while shedding 1.8 pps for foreign currency loans down to 14.9%.

In Q4 2010 the lari's real effective exchange rate appreciated 5.6%, while the nominal effective exchange rate strengthened 2.2%. The lari's appreciation in the accounting period was mainly conditioned by foreign investments, tourism revenues, and closure of commercial banks' open FX positions. According to the NBG's preliminary estimates, the current account deficit in the accounting period stands at USD 356 million.

In Q3 2010 the upturn in economic growth was sustained, with the real GDP rising 6.7% and the nominal GDP – 17.5%. In Q4 2010 the real GDP growth is projected at an annual 6%. In line with the current estimates, the 2010 real GDP forecast was revised upwards, standing at 6.5%.

In line with the NBG's forecasts, the inflation rate will remain at a high level in the first half of 2011. Inflation will start to decline in the second half, settling at 7% by end-2011.

2. CHANGES IN CONSUMER PRICES

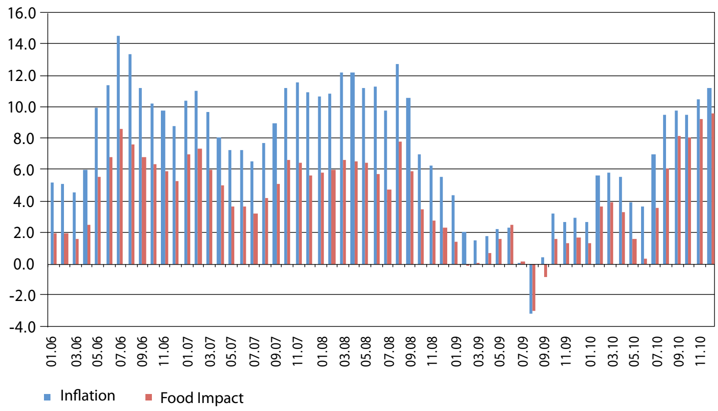
According to the Geostat, the level of consumer prices in Q4 2010 increased 3.6% quarter-on-quarter. In 2009 the same indicator stood at 2.3%. As a result, by end-Q4 2010 the annual inflation grew from 9.8% in Q3 to 11.2% in Q4. The average annual inflation rose by 0.7 pps in the accounting period, standing at 7.1%.

The quarterly inflation was fueled by food price gains. Similar to other less developed countries, Georgia's consumption basket contains a large share of food items, currently equal to 40.5%. Accordingly, the sensitivity of inflation with respect to food price changes is high. Food prices in the international markets are volatile, correspondingly affecting inflation; this implies that a considerable share of inflation volatility is related to food price volatility.

During 2006-2009 changes in food prices accounted on average for 50% of inflation. In 2010, as a result of droughts, fires and other natural calamities, bad harvests essentially affected price formation in the international markets. The wheat price soared, immediately raising prices for bread and bakery products. Higher wheat prices affected both substitutes (cereals, sunflower) and dependent products (beef and chicken meat, milk and dairy products). Sharp price increases were also significantly conditioned by the current deficit of agricultural products due to bad crop capacity. Based on the above-mentioned, against the backdrop of sharp increases of food prices in the international markets, starting from the second half of 2010 the impact of food price gains on the overall inflation equaled almost 86%.

DIAGRAM 2.1

Impact of Food Price Changes on Inflation



In Q4 quarterly price gains were registered for such commodities as potatoes, apples, beans, and other agricultural products. Apart from seasonal products, prices grew for almost all kinds of non-seasonal fruits, vegetables, and melons. Conversely, prices on citruses (oranges, kiwis, and tangerines) dropped. In the accounting period, after a several-month uptrend in garlic prices, the latter was reversed downwards. Consumer prices on cabbage and greens also decreased.

In the accounting period price increases were posted for every group of food consumption.

Compared to the previous quarter, consumer price gains were significantly affected by increases in utility prices (water fee) and transportation prices (bus and micro-bus transportation fees). The latter was influenced by price increases for gasoline and diesel.

Similar to commodity groups of food, transportation, and utilities, prices rose for other groups as well, although at a lower rate. Conversely, prices dropped

DIAGRAM 2.2
Annual Inflation Rates for Goods with Different Consumption Durability

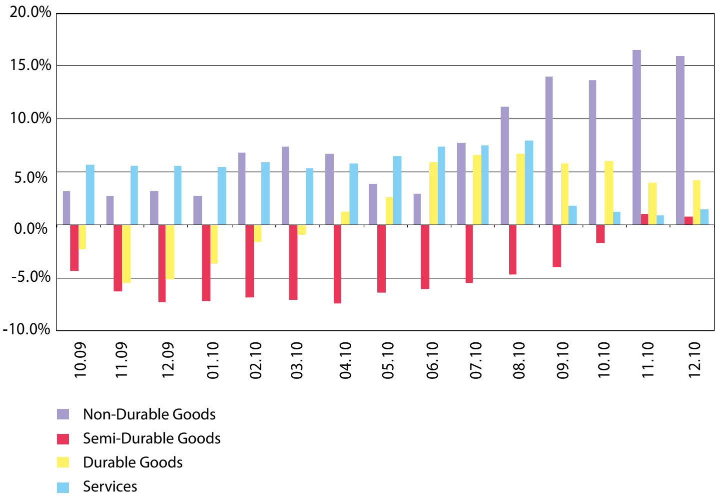


DIAGRAM 2.3
Annual Inflation Rates by Production Location

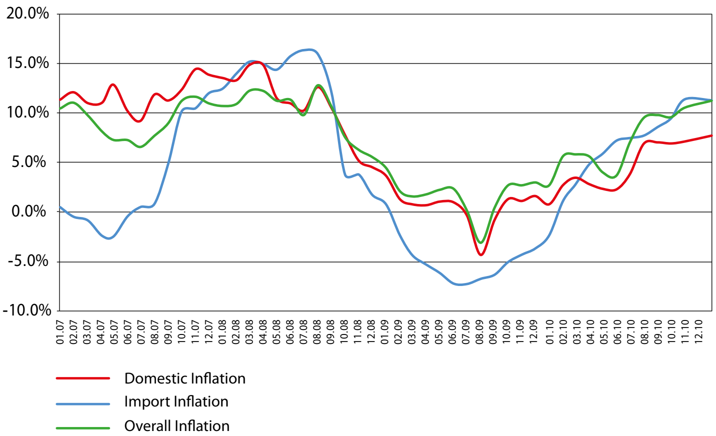
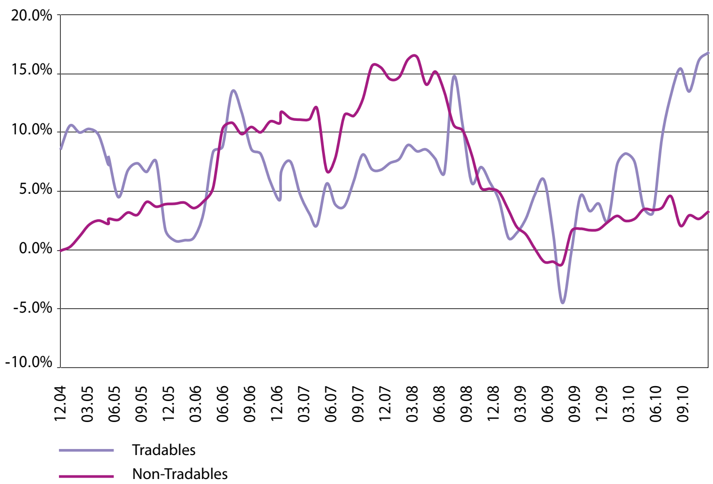


DIAGRAM 2.4
Inflation of Tradable and Non-Tradable Goods



for "education" and "healthcare" commodity groups.

Overall, in Q4 the consumer prices rose 3.6% quarter-on-quarter.

As already mentioned above, the annual inflation rate in December 2010 amounted to 11.2%. Prices grew for diesel and gasoline (19.0% and 15.5%, respectively). High annual inflation was fueled by price gains for products making part to "food and non-alcoholic beverages" and "alcoholic beverages, tobacco" commodity groups. In particular, in the accounting period the annual growth of food prices was as follows: "vegetables and melons" – 44.3%, "oils and fats" – 34.7%, "fruits, grapes" – 32.6%, "bread and bakery" – 19.8%, and "milk, cheese, and eggs" – 14.5%. Price gains on the following categories should also be pointed out: "non-alcoholic beverages" (12.1%), "sugar and pastry" (10.9%), and "meat and meat products" (10.7%). The annual price increase for "alcoholic beverages, tobacco" equaled 12.4%.

In the last quarter of 2010 the annual growth of transportation prices amounted to 7.2%. Administrative prices for "housing, water, electricity, gas, and other fuels" grew 2.4% due to an increase in water fee.

In December 2010, the annual price decrease was posted for only one category. Namely, the "communication" prices fell 6.9%.

In Q4 the core inflation indicators tended to grow. In particular, the core inflation rates for the products within two and one standard deviations equaled 7.7% and 7.6%, respectively.

In Q4 the import inflation stood at 11.3%. The latter indicator has been on the uptrend in the recent months as a result of price gains in the international markets. The domestic inflation equaled 3.2%, while the annual inflation for tradable goods[1] amounted to 16.8%. Such growth of inflation for tradables is also attributed to higher prices in the international markets. Low inflation for non-tradable goods indicates weak pressure on prices on the part of demand.

The annual inflation rates for goods with different consumption durability were as follows: the CPI for non-durable goods equaled 16.0%, prices for semi-durable goods grew 0.8%, and the inflation for durable goods grew 4.3%. In December 2010 the annual growth of prices for services equaled 1.5%.

DIAGRAM 2.5
CPI and Core Inflation (for 266 Components of the 2009 Consumer Basket)[1]

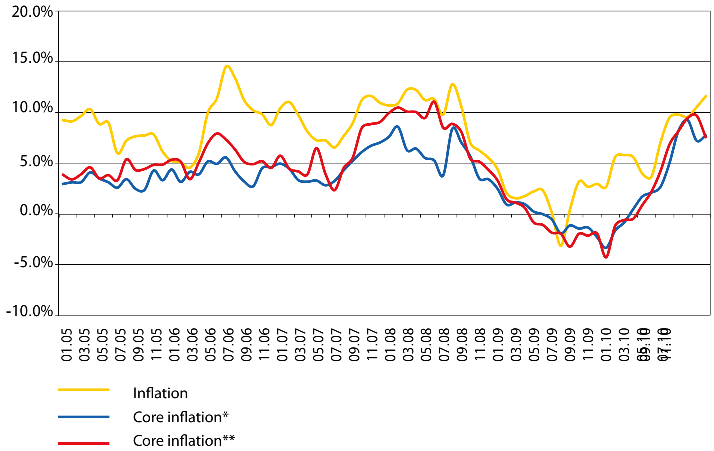
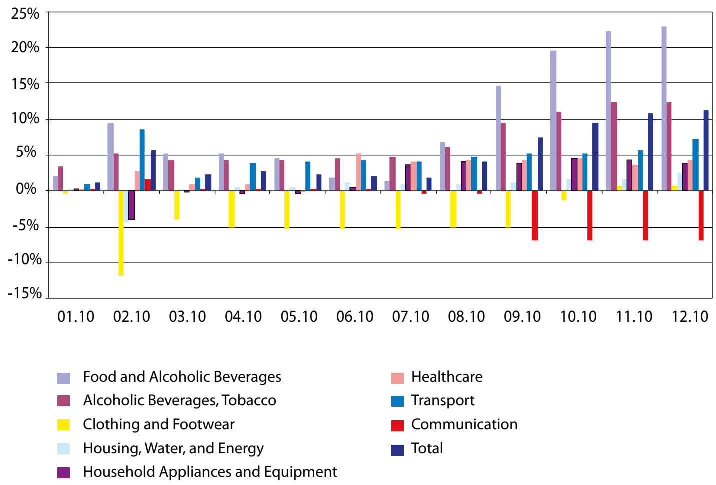


DIAGRAM 2.6
Price Increases Relative to December 2009



[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
CPI Inflation by Components (%), Consumption Basket Weights (%), and Individual Impacts on Inflation (pps).

	December 2009 Weights	Dec10/Sep10		Dec10/Dec09		Jan10 Dec10/ Jan09 Dec09	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	3.6%	3.6%	11.2%	11.2%	7.1%	7.1%
Food and non-alcoholic beverages	41.7%	7.0%	3.0%	22.8%	9.1%	11.7%	4.7%
Food	40.5%	7.2%	3.1%	23.1%	9.4%	11.9%	4.8%
Bread and Bakery Products	11.7%	1.7%	0.2%	19.8%	2.3%	7.4%	0.9%
Meat and Meat Products	6.8%	1.1%	0.1%	10.7%	0.7%	3.9%	0.3%
Fish Products	1.3%	0.5%	0.0%	7.4%	0.1%	-0.5%	-0.0%
Milk, Cheese, Eggs	4.8%	10.4%	0.5%	14.5%	0.7%	7.0%	0.3%
Oils and Fats	3.5%	2.9%	0.1%	34.7%	1.2%	9.4%	0.4%
Fruits, Grapes	1.8%	13.1%	0.3%	32.6%	0.6%	24.0%	0.4%
Vegetables, Watermelons, Potatoes and Other Solanaceae	7.8%	20.2%	1.8%	44.3%	3.4%	18.8%	1.5%
Sugar, Jam, Honey, Syrups, Chocolate, Pastr	2.3%	6.5%	0.1%	10.9%	0.3%	24.0%	0.5%
Other Food Products	0.4%	3.0%	0.0%	7.3%	0.0%	4.5%	0.0%
Non-Alcoholic Beverages	1.3%	3.0%	0.0%	12.1%	0.2%	4.7%	0.1%
Alcoholic Beverages, Tobacco	2.9%	2.8%	0.1%	12.4%	0.4%	7.7%	0.2%
Clothing and Footwear	4.4%	6.0%	0.2%	0.6%	0.0%	-6.6%	-0.3%
Housing, Water, Electricity, Gas, and Other Fuel	13.8%	1.2%	0.2%	2.4%	0.3%	0.4%	0.1%
Furniture, Home Appliances and Equipment, Housing Renovation	3.5%	0.2%	0.0%	3.9%	0.1%	-0.1%	-0.0%
Healthcare	8.8%	-0.1%	-0.0%	4.3%	0.4%	2.3%	0.2%
Transport	9.9%	1.9%	0.2%	7.2%	0.8%	9.5%	1.0%
Communications	4.0%	0.0%	0.0%	-6.9%	-0.3%	-2.2%	-0.1%
Recreation, Leisure and Culture	2.2%	0.2%	0.0%	-0.4%	-0.0%	-0.1%	-0.0%
Education	4.9%	-0.9%	-0.0%	0.9%	0.0%	28.8%	1.2%
Hotels, Cafes, Restaurants	1.6%	0.5%	0.0%	6.1%	0.1%	4.1%	0.1%
Other Goods and Services	2.3%	0.2%	0.0%	9.1%	0.2%	3.8%	0.1%
Non Durable Goods	67.9%	4.7%	3.3%	16.0%	10.9%	9.1%	6.2%
Semi-Durable Goods	5.8%	4.6%	0.2%	0.8%	0.0%	-4.7%	-0.3%
Durable Goods	3.4%	-1.8%	-0.1%	4.3%	0.1%	3.1%	0.1%
Services	22.8%	0.7%	0.2%	1.5%	0.3%	4.7%	1.1%

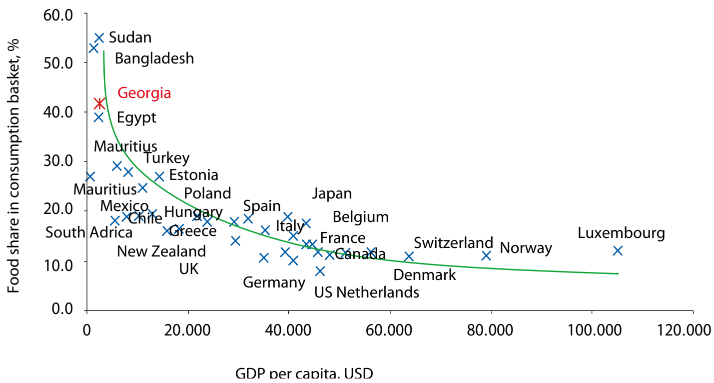
BOX 1. FOOD SHARE IN THE CONSUMPTION BASKET AND INFLATION

In 2010 the annual inflation in Georgia equaled 11.2%, and the impact of food and non-alcoholic beverages amounted to 9.5 pps. The 2010 developments in the world market, bad harvest in Georgia and its neighboring countries due to adverse climatic conditions led to a sharp contraction of supply of food products, pushing food prices upwards in the domestic market. However, it should be noted that food price gains were reflected to a higher extent in relatively low-income countries compared to more affluent and economically advanced states. This phenomenon has the theoretical ground, known since mid-19th century under the name of "Engel effect".

Ernst Engel, the well-known German economist, was the first to express the view that with income increasing the share of food in total expenditures declines. The view does not imply that under higher incomes food expenditures do not rise – the point is that the latter increase at a slower rate relative to income (i.e. food demand is inelastic with respect to income). The richer becomes the population, the more money is spent on food products, the better quality products are purchased, but this increase in expenditures is not proportional to the income growth. When a household consumes the necessary minimum of food products, doubled revenues do not entail doubling in food expenditures.

Accordingly, the share of food in low-income countries exceeds that in advanced countries, since households allocate their income, first of all, to ensure the necessary food minimum. Along with economic development and increase in revenues, expenditures on clothing, household equipment and other consumer goods increase at a higher pace, reducing the share of food expenditures.

DIAGRAM 2.7
Share of Food in the Consumption Basket



This regularity is reflected in the composition of the consumer basket, which is based on the population's spending pattern. The share of food in the consumer baskets of the developing countries is high. Food and non-alcoholic beverages account for 41.7% of Georgia's consumption basket, largely exceeding the same indicator for the Western European and other developed countries, where the food share varies between 10-15%.

The inflation level is measured through changes in prices on commodities making part to the consumption basket. The consumption basket comprises goods and services purchased by an average consumer. Since the share of food is high in the consumption basket of the developing countries, the increases in food prices which took place in 2010 produced a larger effect on inflation of low-income countries. In these countries inflation is more sensitive to changes in food prices. Along with economic development and increasing incomes the composition of the consumption basket will change as well, with the share of food diminishing and the impact of other consumer goods rising. Accordingly, external and domestic factors causing price increases for food products will have a weaker effect on inflation.

3. INFLATION FACTORS

3.1 LABOR MARKET

In Q3 2010 the labor productivity of employed persons significantly increased in quarterly terms. In the accounting period the growth of this indicator (6.4%) almost equaled that of real GDP (6.7%). Compared to the preceding quarter, the annual growth rate of wages of hired employees slightly slowed down, amounting to 7.2% year-on-year.

In Q3 2010 the annual growth rate of real value-added per employed was at its highest in the sector of real estate operations, renting and commercial activity – 21.9%. However, it should be noted that in the preceding quarter the annual growth rate in this sector was approximately twice as high. High real growth rates of labor productivity were also posted in construction (8.4%), education (6.5%), transport and communication (6.0%) and trade (5.6%) sectors. Relatively lower growth rates were registered in public administration (3.9%) and agriculture (1.9%).

Table 3.1
Growth of Real Value-Added per Employed in Q3 2010, year-on-year (percent)

	Growth Index of Value-Added
Agriculture	101.9
Industry	95.4
Construction	108.4
Trade	105.6
Hotels and Restaurants	81.4
Transport, Communication	106.0
Financial Intermediation	95.9
Real Estate, Renting and Business Activities	121.9
Public Administration, Defense	103.9
Education	106.5
Health	99.4
Total	**106.4**

Contrary to the general uptrend in the real value-added, in Q3 2010 the annual decrease was posted in hotels and restaurants (18.6%), industry (4.6%), financial intermediation (4.1%), healthcare (0.6%) and other (-11%) sectors.

In Q3 2010 the average wages of hired employees amounted to GEL 609.5[3], up 7.2% year-on-year. In the accounting period this indicator increased in almost all economic sectors. Particularly high annual growth rates were posted in "fishery, fishing" and "hotels and restaurants" (66% and 27%, respectively). Significant growth rates were also registered in "healthcare and social work" (20%), "community, social, and personal services" (19%), "education" (14%), "mining and quarrying" (14%), "manufacturing" (13%), and "trade" (12%) sectors. Relatively low growth of average wages was in construction (8%) and public administration (7%).

Similar to the preceding quarter, in Q3 2010 the average annual wages decreased only in two sectors – "real estate operations" (-8%) and "agriculture, hunting, and forestry" (-5%).

In Q3 2010 the differences in average wages across sectors still remained in place. The highest average monthly wages were still registered in financial intermediation (GEL 1,279, down 7% q-o-q) and public administration (GEL 939, down 1.4% q-o-q). The wages in these two sectors exceed the national average level by 2.1 and 1.5 times, respectively. The lowest salaries still remain in education (GEL 298) and fishing (GEL 386) sectors, where the wages of hired employees constitute, respectively, 49% and 63% of the national average level. It should also be noted here that the relative difference between wages in the sectors with highest and lowest remu-

[3] Source: Geostat, Enterprise and Labor surveys.

neration is practically unchanged in annual terms, while decreasing 9% in quarter-on-quarter terms (at the expense of lowered wages in the sector with the highest wages).

Agriculture Fishery, fishing Mining Manufacturing Electricity, water, and gas Construction Trade Hotels and Restaurants Transport and communication Financial intermediation Real estate operations Public administration Education Healthcare and social work services Community, social and personal services

In Q3 2010 the growth rate of labor productivity significantly slowed down, falling in quarter-on-quarter terms from a 5-percentage-point increase in Q2 to a 0.6-percentage-point increase in Q3.

Concurrently, with respect to the preceding quarter the year-on-year growth rate of wages somewhat slowed down (by 0.4 pps) amounting to 0.3%.

Overall, in Q3 2010 the average wages and labor productivity grew approximately at the same pace (7.2% and 6.4%, respectively). As a result, their ratio, i.e. unit labour cost[4], remained practically unchanged. This indicates that the labor market did not exert any significant upward or downward influence on the price level.

3.2 MONETARY AGGREGATES

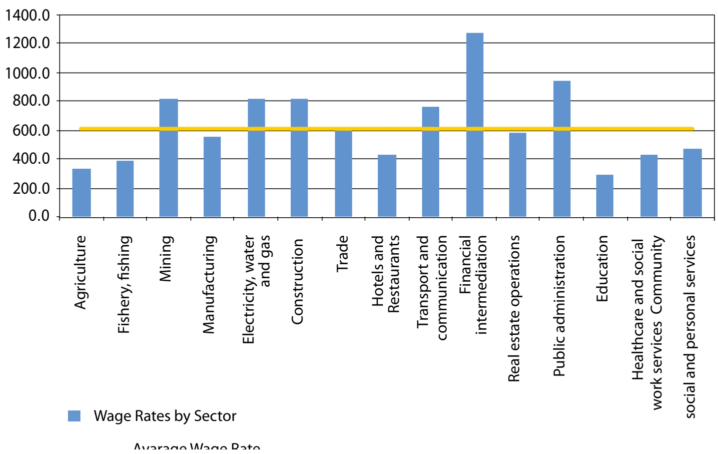
During Q4 2010 the reserve money indicator expanded by GEL 126.8 million (7.5%), totaling GEL 1,822.3 million at end-period. In average terms, the monetary base grew by GEL 8.4 million (0.5%) quarter-on-quarter. The annual growth of the reserve money equaled only 4.5%.

In the accounting period the NBG purchased USD 95.0 million through FX auctions. In the same period,

Table 3.2
Average Wages of Hired Employees in Q3 2010 (relative to Q3 2009, percent)

	Nominal Wage Index
Agriculture, hunting and forestry	95.4
Fishing, fishery	165.8
Mining and quarrying	113.6
Manufacturing	113.0
Production and distribution of electricity, gas, and water	105.7
Construction	107.6
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	112.1
Hotels and restaurants	126.7
Transport and communication	107.0
Financial intermediation	102.5
Real estate, renting and business activities	92.1
Public administration	107.4
Education	114.3
Healthcare and social work services	120.5
Other community, social and personal service activities	118.6
Total	**107.2**

DIAGRAM 3.1
Sectoral Average Wages of Hired Employees, Q3 2010 (GEL)



[4] Similar to wage (personnel) costs, as a part of real gross value-added (GDP).

DIAGRAM 3.2
Real Value-Added per Employee, Average Monthly Wages of Employees and Unit Labour Cost (Annual percentage change)

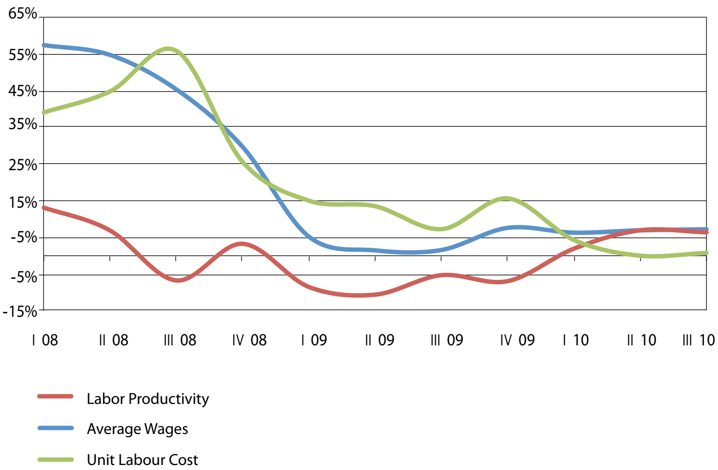


DIAGRAM 3.3
Changes in Reserve Money

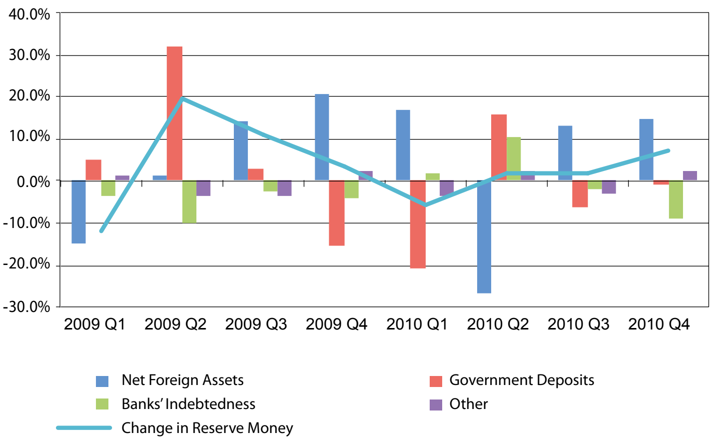


TABLE 3.3
Dynamics of Reserve Money December-2009 – December 2010, end-period data (GEL thousands)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Reserve money	1,743,917	1,633,407	1,660,685	1,695,510	1,822,270
Cash in circulation	1,457,938	1,398,806	1,460,407	1,500,695	1,618,180
Banks' deposits	285,979	234,601	200,278	194,815	204,090
Balance on corresponding accounts	285,979	234,601	126,538	149,685	143,940
Overnight deposits			73,740	45,130	60,150

as a result of intragovernmental currency conversion operations the net foreign currency purchases of the NBG totaled USD 64.0 million. Thus, these operations resulted in an increase of net foreign assets by approximately USD 154.0 million.

In Q4 the funds on the government deposits increased by GEL 18.7 million, amounting to GEL 809.1 million at end-December.

In the accounting period the volume of Certificates of Deposit issued by the NBG significantly expanded. In Q4 the total placement value of the CDs equaled GEL 360.0 million, while the redemption amount stood at GEL 194.7 million. The volume of CDs in circulation grew from GEL 192.3 million at end-September to GEL 355.1 million at end-year. In the same period commercial banks actively used the refinancing loans – by end-December the outstanding stock of refinancing loans stood at GEL 51.9 million. In the accounting period a part of the lender of last resort facility was repaid in the amount of GEL 15.0 million. Commercial banks also made use of overnight loans.

As a result of these transactions, in Q4 2010 the net indebtedness of banks decreased by GEL 157.8 million, standing at GEL -165.1 million.

Against the backdrop of the above monetary flows, in the accounting period the reserve money rose by GEL 126.8 million. The following transactions contributed to this event: balances on commercial banks' corresponding accounts at the NBG decreased by GEL 5.7 million to GEL 143.9 million; balances on commercial banks' overnight deposits in domestic currency grew by GEL 15.0 million. In the same period, the volume of cash in circulation expanded by GEL 117.5 million, totaling GEL 1,618.2 million. During the quarter cash in circulation was on the downtrend; however, along with approaching the New Year holidays it sharply increased, indicating its volatile nature.

BROAD MONEY

In Q4 2010 the M3 broad money expanded by GEL 405.5 million, totaling GEL 6,213.7 million. The foreign currency denominated deposits increased by GEL 132.7 million (4.0%) to equal GEL 3482.4 million at end-year. The domestic currency denominated deposits grew by GEL 206.5 million (17.9%), amounting to GEL 1,358.2 million at end-period.

The M2 broad money grew by GEL 272.8 million (11.0%) in the accounting period, fueled by the increases in both domestic currency denominated deposits and cash in circulation (by GEL 117.5 million).

The annual growth of M3 stood at 35.0%, while that of M2 equaled 28.1%.

3.3 MONETARY INSTRUMENTS

As a result of the inflation forecast increase and with the purpose of curbing inflationary expectations, the NBG applied monetary policy tightening in Q4 2010. However, during this period the minimum reserve requirements remained unchanged.

Similar to the preceding period, funds on the NBG's corresponding account in Q4 did not significantly differ from the minimum balances stipulated by reserve requirements; the average values of the two indicators were almost identical in the accounting period: the quarterly volume of funds on the corresponding account averaged GEL 162.1 million, while the minimum required level of reserves stood at GEL 158.5 million. The largest liquidity surplus was registered on November 11 at GEL 125.6 million, while the largest liquidity deficit in the amount of GEL 81.7 million took place on November 24.

In the accounting period the liquidity ratio slight-

TABLE 3.4
Dynamics of Reserve Money December-2009 – December 2010, period average data (GEL thousands)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Reserve money	1,687,663	1,677,721	1,633,634	1,729,024	1,737,455
Cash in circulation	1,347,936	1,360,994	1,436,513	1,525,337	1,517,155
Banks' deposits	339,727	316,727	197,121	203,687	220,299
Balances on corresponding accounts	339,727	317,792	136,218	150,875	169,264
Overnight deposits			60,903	52,812	51,035

TABLE 3.5
Change in Monetary Aggregates, December 2009 – December 2010, end-period data (GEL thousands)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
M3 Broad Money	4,602,749	4,736,237	5,042,418	5,808,209	6,213,673
M2	2,132,621	2,214,757	2,347,108	2,458,450	2,731,236
Money outside banks	1,229,436	1,186,814	1,269,456	1,306,717	1,372,989
Lari in circulation	1,457,938	1,398,806	1,460,407	1,500,695	1,618,180
Deposits in domestic currency	903,185	1,027,943	1,077,651	1,151,733	1,358,247
Deposits in foreign currency	2,470,128	2,521,480	2,695,311	3,349,759	3,482,437

DIAGRAM 3.4 Lari Liquidity

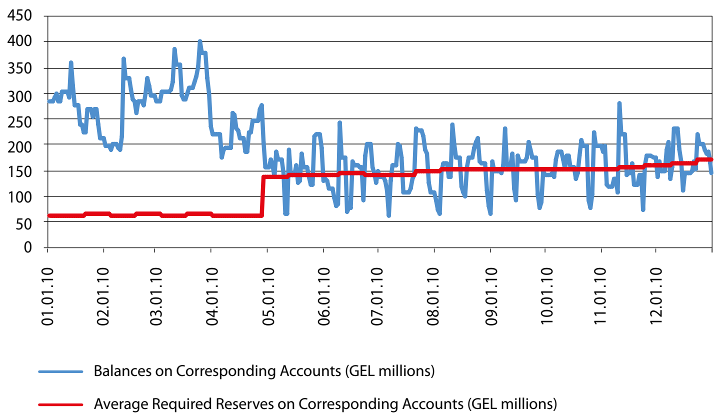


DIAGRAM 3.5
Dynamics of Liquid Assets, Liabilities, Liquidity Ratio and Liquidity Requirements

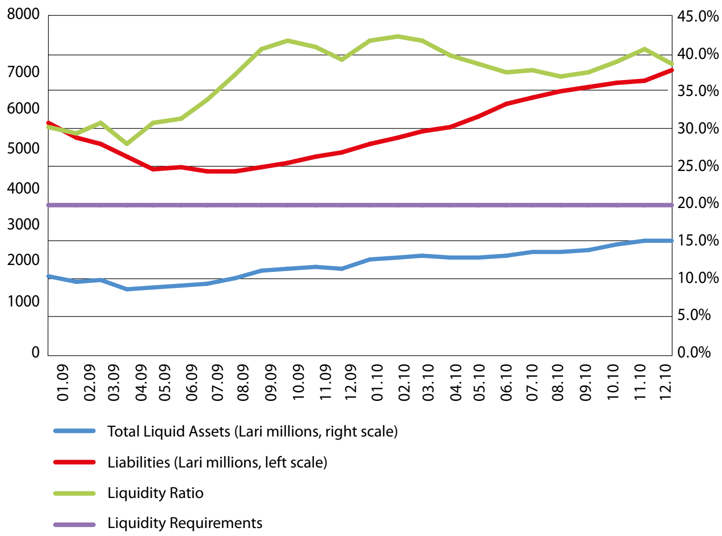


DIAGRAM 3.6 Dynamics of CD Auctions

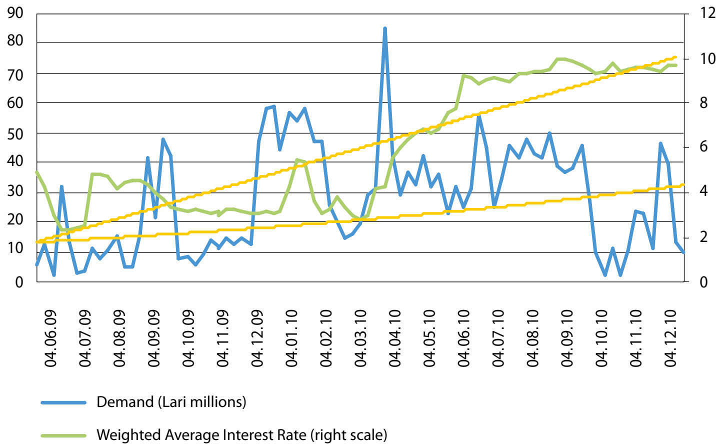
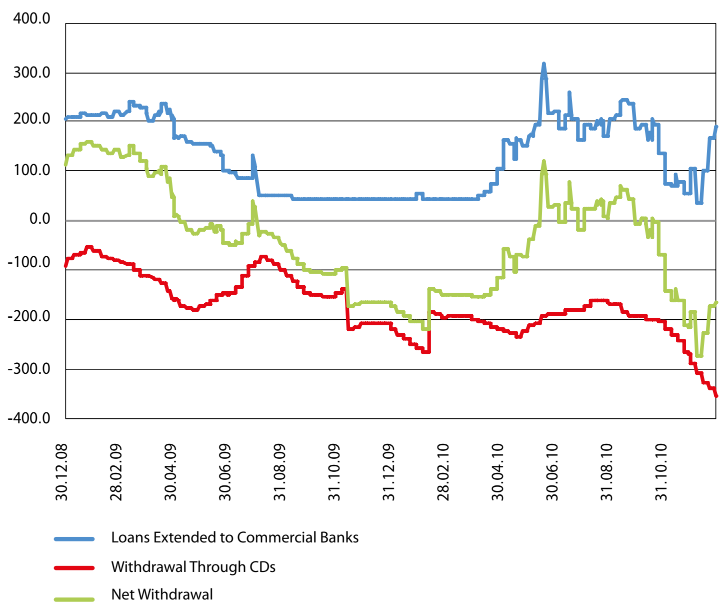


DIAGRAM 3.7 Liquidity Withdrawal through CDs, Loan Extension to Commercial Banks and Net Liquidity Withdrawal (GEL millions)



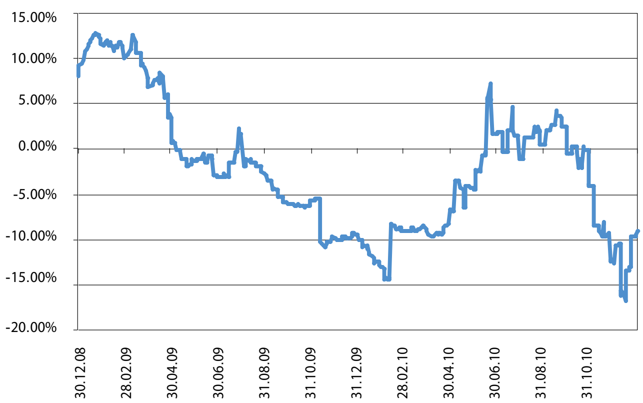
ly increased, with the period average level amounting to 39.3%, up by 1.9 pps quarter-on-quarter.

In Q4 2010 demand for the NBG's 3-month CDs soared. In this period the total placement equaled GEL 360 million, or 67% more than in Q3. The maximum interest rate on the CDs was less volatile during the period, ranging between 9.35% and 9.95%. It should be pointed out that the weighted average interest rate slightly increased to 9.6%.

The auction for refinancing loans, which was resumed starting from Q2, evidenced the transaction volumes during the accounting period in the range of GEL 200 million. The weighted average interest rate grew from 7% to 7.57% by end-quarter.

On average, the ratio of net liquidity withdrawal to reserve money changed from 1.6% to -7.4%. As of December 31, 2010, the net liquidity withdrawal totaled GEL 165.1 million.

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



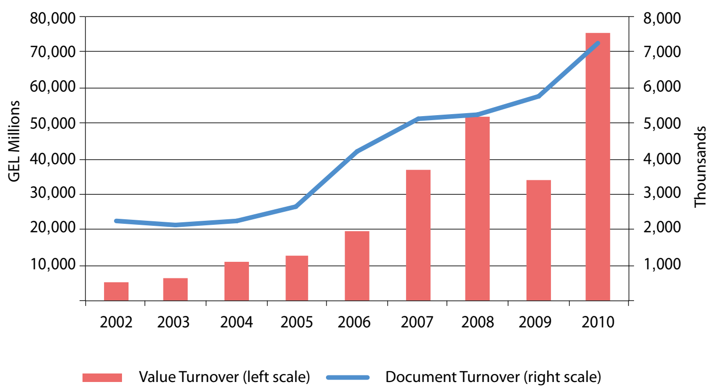
BOX 2. NEW REAL TIME GROSS SETTLEMENT (RTGS) SYSTEM

Rapid development of the banking sector and financial markets requires existence of an effective and comprehensive system with the purpose of ensuring security, timeliness, and minimum operating costs of transactions. Starting from 2010 the NBG put into operation a new RTGS system, replacing the existing one. The latter could no longer satisfy current requirements in terms of its functionality, necessitating its further modernization. The RTGS is a high-tech model of operations management, which performs concurrent, real-time processing and settlement of transactions. The primary advantage of RTGS consists in the fact that settlement process is performed in line with payment orders, or "gross" settlement principle, i.e. transfer of funds is made on an individual basis for each payment order. It should be noted that circulation of funds in the system takes place in an "electronic" form: transaction outcomes are reflected on electronic accounts of participants at the NBG in real time. At the same time, the transaction is final and irreversible. This significantly reduces transaction-related credit risk which is sometimes caused by settlement lags. In this regard there are large differences with respect to other standard settlement systems: thus, the Bankers' Automated Clearing Services (BACS) and Electronic Funds Transfer (EFT) systems conduct operations only in pre-defined hours, which implies simultaneous processing of pending transactions.

Immediate participants of the new RTGS system are commercial banks and the state Treasury. It is integrated with the state Central Securities Depository (CDS). This allows commercial banks – in case of liquidity shortages – to use a completely new liquidity management mechanism, such as daily liquidity facility. The latter can be used by banks only if they have duly registered collateral in the CSD system. If the bank is unable to cover the daily liquidity facility by the end of the day, the latter is transformed into an overnight loan through the RTGS and CSD systems under the same collateral. Formation and use of the daily liquidity facility is performed by the bank itself. All of the above-mentioned, on the one hand, allows the NBG to conduct more efficient monetary policy, and, on the other hand, contributes to development of the securities market.

Starting from 2002 by means of the earlier and the new RTGS versions approximately 36.8 million documents were processed with the total value of GEL 252.1 billion. In 2010 the value turnover grew 122%, amounting to GEL 75.3 billion.

DIAGRAM 3.9 Transfer payments by means of RTGS (2002-2010)



3.4 INTERBANK LOANS

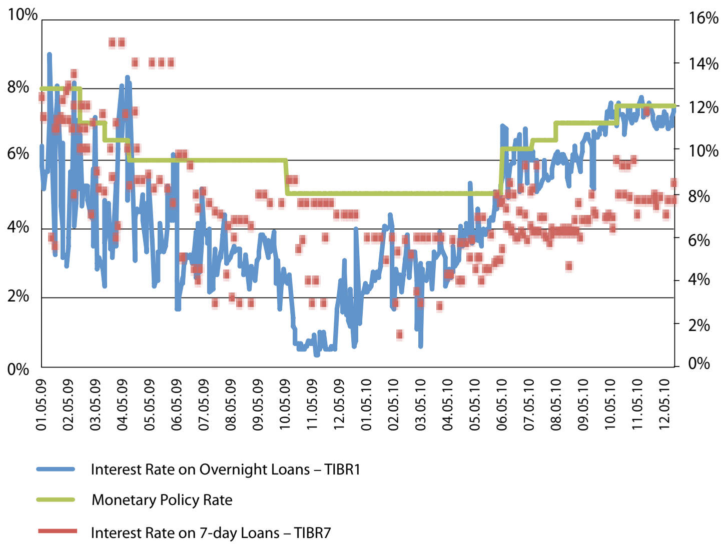
In Q4 2010 the volume of domestic currency denominated loans in the interbank credit market grew 1% to GEL 1.89 billion.

Contrary to the preceding period, the volume of US dollar denominated loans dropped from USD 210.4 million to USD 130.56 million. The volume of euro denominated loans posted a small decrease, totaling EUR 2.168 million.

With regard to maturity terms, the share of overnight loans denominated in lari relative to total lari denominated loans remained high at 66.5%. Similar trends were registered for loans denominated in US dollar and euro. The share of overnight loans denominated in US dollars grew from 56% to 89%, while in the case of the euro the same share fell from 63% to 30%.

The dynamics of the above-mentioned transactions was duly reflected in interest rates and interbank loan indices; the average quarterly level of TIBR-1 rose to 7.17% from 5.94%, while that of TIBR-7 increased to 7.92% to 6.68%.

DIAGRAM 3.10
Interbank Short-Term Loan Indices and Monetary Policy Rate



3.5 BANKING SECTOR

In Q4 2010 the deposit liabilities of the banking sector increased by GEL 339.2 million (7.5%) to total GEL 4,840.7 million. Compared to December 2010, the annual growth of deposits amounted to 43.5%. In the accounting period the quarterly growth rate of deposits is 2.6 times lower than the one registered in Q3 (19.3%). Such a difference is largely explained by the fact that in Q3 the Georgian railway company issued euro bonds in the amount of USD 246 million, and these funds were placed on the banking account entailing a sharp change in the volume of deposits. If we exclude this transaction from deposit calculations, the Q3 growth rate of deposits becomes 7.5%, equal to the Q4 level.

The volume of foreign currency denominated deposits expressed in domestic currency grew by GEL 132.7 million (4%) to GEL 3,482.4 million. The largest impact was due to the growth of legal entities' deposits (GEL 90.2 million). It should be noted that individuals hold a 57% share of total deposits in foreign currency. With respect to term structure of foreign currency denominated deposits, time deposits account for 68.9%, up 2.4 pps quarter-on-quarter.

The foreign currency denominated deposits (expressed in the US dollars) rose by USD 110 million (5.9%) in Q4. This indicator exceeds the growth rate of deposit volumes expressed in the lari due to the appreciation of the latter against the US dollar. In the accounting period the lari strengthened against the US dollar by 1.9%.

In the accounting period the deposits in domestic currency increased by GEL 206.5 million (17.9%) to GEL 1,358.2 million, fueled by the increases in legal entities' deposits. The dollarization rate of individuals still remains high at 87%, compared with the 58% rate for legal entities. The individuals hold 21%

of lari deposits and 57% of foreign currency deposits. However, it should be pointed out that 85% of legal entities' deposits in domestic currency represent current accounts and other demand deposits, while the same indicators for individuals stands at 65%. This indicates that a larger part of individuals keep lari deposits for long-term purposes.

Against the backdrop of the Q4 growth rates of deposits in foreign and domestic currency, the deposit dollarization rate in December 2010 lowered by 2.5 pps with respect to September 2010, settling at 71.94% by end-year.

In the accounting period the deposit interest rates fell by 0.1 pps to 7.9%. The weighted average interest rate on lari denominated deposits equaled 10.2%, posting an increase of 0.2 pps with respect to September. This growth was due to a 0.7 pp hike in market interest rate for individuals. The interest rate on lari deposits for legal persons decreased by 1.3 pps, averaging 8.8%. With respect to foreign currency deposits, the Q4 interest rate remained unchanged since September at 7.6%. A hike in interest rates on lari deposits for individuals relative to foreign currency denominated deposits should create incentives for individuals to keep their savings in the domestic currency, which represents one of the dedollarization factors.

With respect to December 2009, the interest rates on lari and foreign currency denominated deposits fell by 0.5 and 1.6 pps, respectively.

In Q4 2010 the economy crediting on the part of commercial banks increased by GEL 420.9 million to GEL 6,337.1 million. The largest impact was due to loans extended to legal entities' (9.2%), while loans to individuals increased 5.2%. The annual growth of loans in December 2010 amounted to 20.6%. The respective monthly growth of loans in November

DIAGRAM 3.11 Composition of Lari Deposits

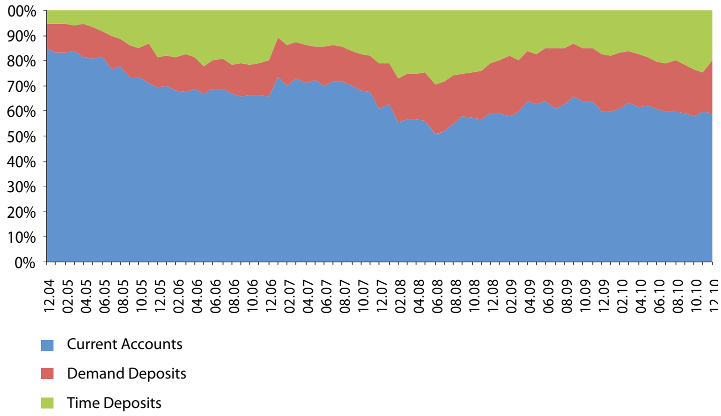


DIAGRAM 3.12 Composition of Foreign Currency Deposits

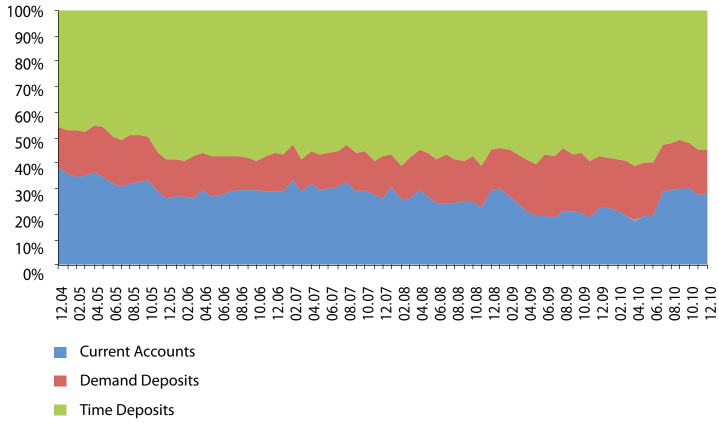


DIAGRAM 3.13 Deposits in Domestic Currency

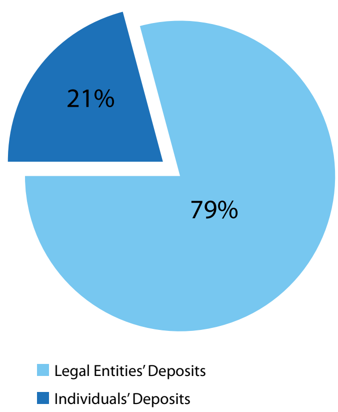


DIAGRAM 3.14 Deposits in Foreign Currency

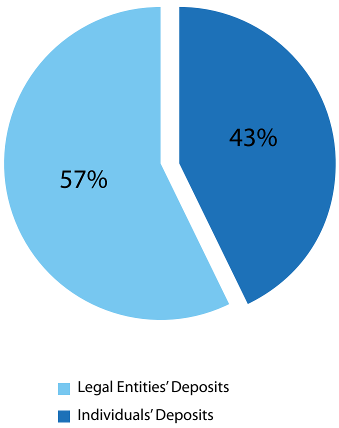


DIAGRAM 3.15 Short-Term Loans in Domestic Currency

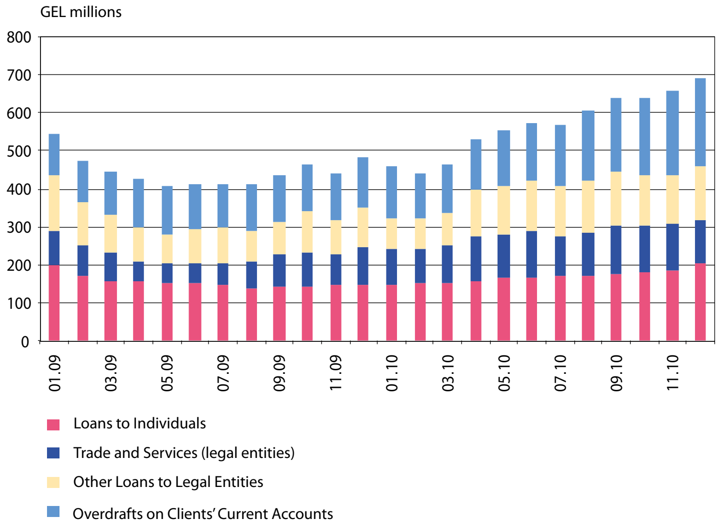
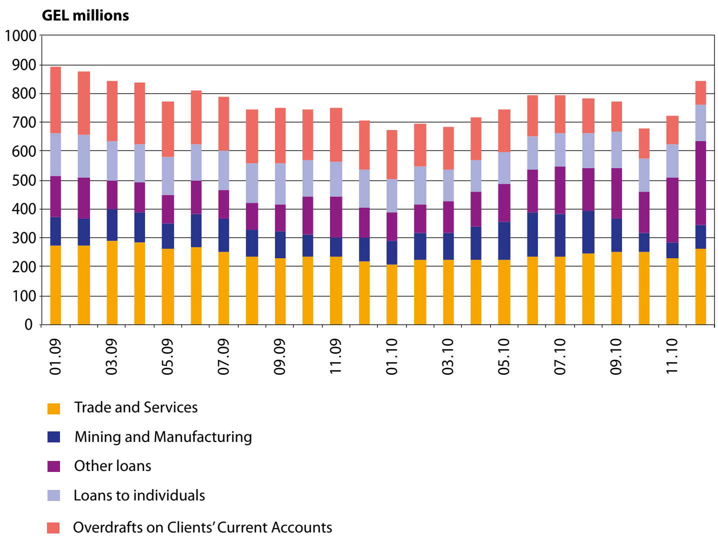


DIAGRAM 3.16 Short-Term Loans in Foreign Currency



and December was 4.2% and 4.0%, in September and October there were monthly decreases at 0.4% and 1.1%, while in the remaining months of the year monthly growth rates oscillated between 0.6% and 2.8%. In Q4 the growth of crediting was due to expansion of loans to individuals, trade and services, energy, and construction.

The loans in domestic currency grew by GEL 39.0 million (2.4%) to GEL 1,651.9 million. Short-term loans posted an increase, while the long-term loans contracted. In the accounting period, 53.6% of loan stock was held by legal entities. Long-term loans accounted for 55.8%.

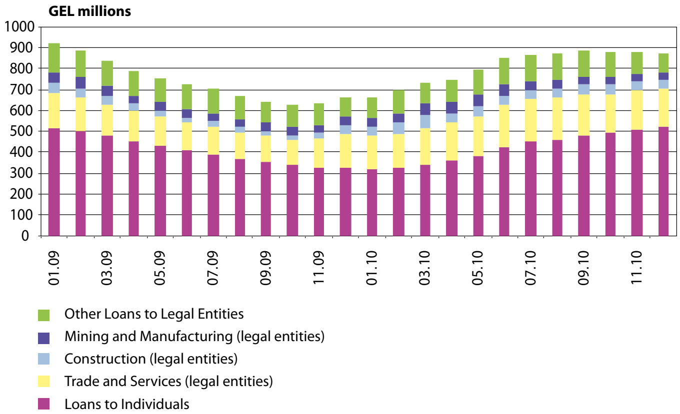
The foreign currency denominated loans, expressed in the US dollars, grew by USD 260.5 million (10.9%), standing at USD 2,642.8 million at end-period. Legal entities hold 69.3% of this type of loans, while the share of long-term loans constitutes 81.4%.

The loans in foreign currency grew 10.9%. It should be noted that positive growth was registered in November and December, while a contraction took place in October. The Q4 growth was largely fueled by legal entities' long-term loans.

In Q4 2010 the overdue loans decreased by GEL 28.5 million (14.1%) to GEL 174.0 million, while the share of indebtedness in total loans fell by 0.68 pps to 2.75%. This fact points to improvement in loan quality.

The loan interest rates in the banking system fell by 1.2 pps in Q4 2010 to 17.7% in annual terms. This was due to a 1.8 pp decrease in interest rates on foreign currency denominated loans, down to 14.9%. The loans denominated in foreign currency were extended to legal persons at approximately 13.9%. The weighted average interest rate on domestic

DIAGRAM 3.17
Long-Term Loans in Domestic Currency



currency loans stood at 22.6%, unchanged from September 2010. Compared to December 2009, the interest rates on foreign and domestic currency denominated loans fell by 4.4 and 0.8 pps, respectively.

In the accounting period the banking sector posted the following financial stability indicators: Tier I adequacy ratio – 17.4%, return on assets (ROA) – 1.7%, return on equity (ROE) – 9.6%. In Q3 the profitability ratios were on the uptrend, with the increases in ROA and ROE rising by 0.3 and 1.6 pps, respectively; the adequacy ratio decreased by 0.8 pps.

DIAGRAM 3.18
Long-Term Loans in Foreign Currency

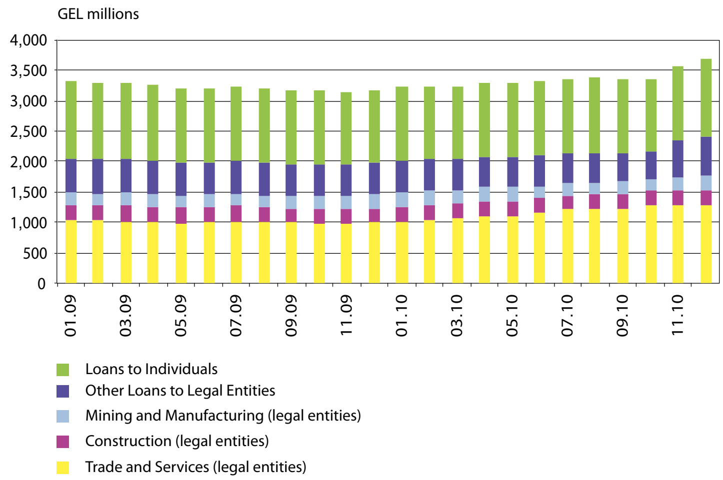


DIAGRAM 3.19 Overdue Indebtedness

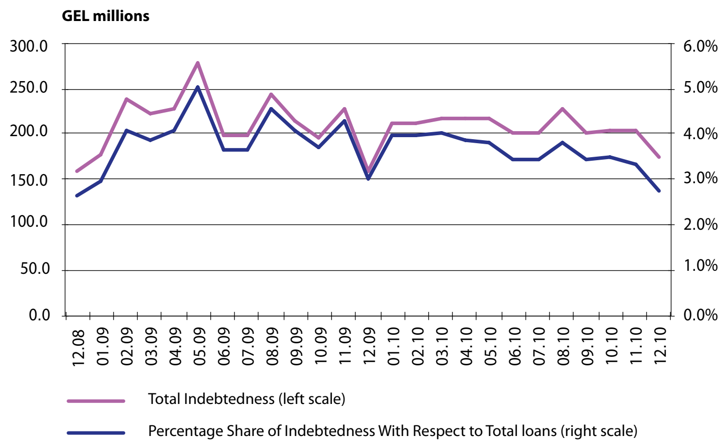
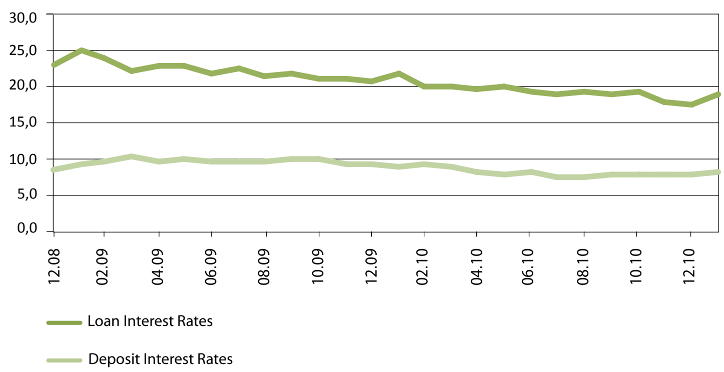


DIAGRAM 3.20 Interest Rates on Loans and Deposits



BOX 3 MACROPRUDENTIAL POLICY TIGHTENING

Along with monetary policy tightening and gradual increases in minimum reserve requirements the NBG also raised supervisory requirements for commercial banks. Starting from November 1, 2010 the monthly average required liquidity ratio was brought back to the 2008 August level of 30%. The latter was reduced to 20% in September 2008 due to negative developments after the August war. Against the backdrop of increased economic risks, this measure freed additional funds in the banking system. The liquidity deficit reemphasized the fundamental role of adequate provision of liquid funds in the banking system for maintaining financial stability. Along with improved economic situation and decreased macroprudential risks in the country it becomes necessary to restore the adequate level of supervisory requirements.

Capital adequacy requirement for commercial banks was also tightened, with the weight of risky assets subject to currency risk-weighting being increased from 50% to 75%. Accumulation of foreign currency assets creates exchange rate risk and currency induced credit risk, since significant fluctuations of the exchange rate may affect commercial banks' liquidity and profitability, and in the case of domestic currency depreciation the credit portfolio is deteriorated due to impaired solvency of borrowers. The capital adequacy requirement is needed to protect banks from this type of risks, and according to the new requirements, banks will be obliged to keep more equity capital against foreign currency denominated assets.

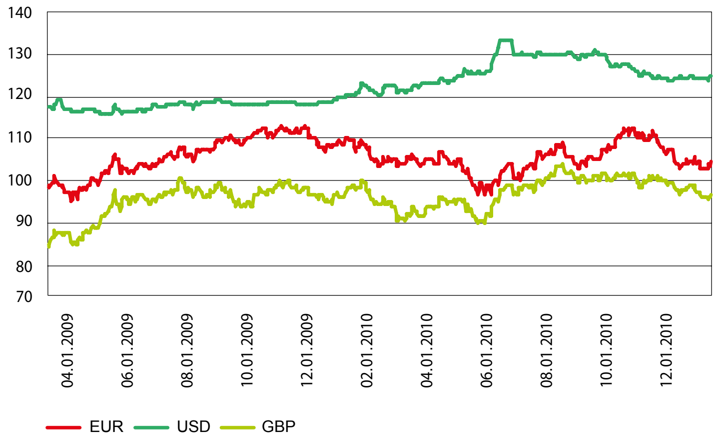
3.6 EXCHANGE RATE FACTORS

As it is well-known, the primary goal of the NBG consists in price stability. Therefore, it is important to monitor and thoroughly analyze all factors affecting price stability. It is generally agreed that in small open economies there exists a strong relation between exchange rate and inflation: on the one hand, the exchange rate determines prices on imported goods with the latter having a large share in the consumption basket, while, on the other hand, the exchange rate affects the country's national wealth. The exchange rate risk is of great importance for the banking sector, since in a partially dollarized economy borrowers are not fully hedged, thus being exposed to currency induced credit risk[5].

In Q4 2010 the lari's exchange rate tended upwards with slight fluctuations. The lari's nominal exchange rate against the US dollar averaged 1.7735, appreciating 1.9% against the US dollar (See Diagram 3.21), 4.4% against the euro, and 4% against the pound sterling. The lari's nominal and real effective exchange rate appreciated 2.2% and 5.6%, respectively.

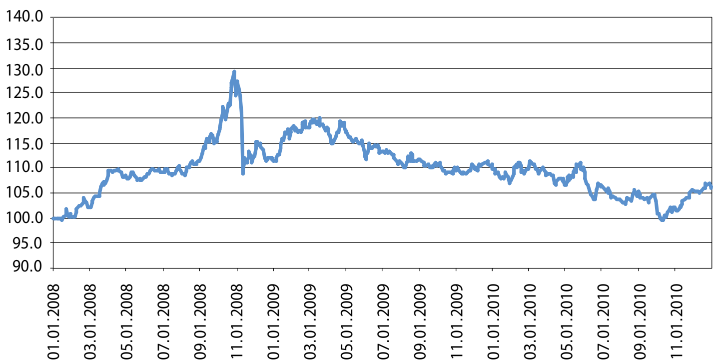
In Q4 2010 the lari's appreciation was largely due to foreign direct investments, tourism revenues and closure of commercial banks' open foreign currency positions. In addition, lari's appreciation was enhanced by downtrend tendencies in the US dollar's exchange rate in the international markets and, accordingly, expectations of lari's appreciation. A more pronounced appreciation of the real effective exchange rate compared to the nominal effective exchange rate was due to faster growth of prices in Georgia relative to its trading partners.

DIAGRAM 3.21
Dynamics of Lari's Nominal Exchange Rate (2008-2010)



The lari's exchange rate against a foreign currency is determined through interaction of demand and supply in the FX market. In general, demand for foreign currency is driven by imports, which should be financed by exports and foreign capital inflows. It should also be noted that the FX auctions introduced by the NBG play an important role in smoothing exchange rate fluctuations caused by temporary misbalances between supply and demand.

DIAGRAM 3.22
Lari's Nominal Effective Exchange Rate Index (2008-2010)



According to the NBG's preliminary data[6], in Q4 2010 the current account deficit widened to USD 356 million. Also in line with preliminary estimates, there is an annual contraction in current transfers; on a positive note, FDI and tourism revenues posted 27% and 50% increases, respectively.

[5] See: 2009 Financial Stability Report.

[6] The specified BoP data are published on the 90th day after the end of the quarter.

DIAGRAM 3.23
Lari's Real Effective Exchange Rate (2007-2010)

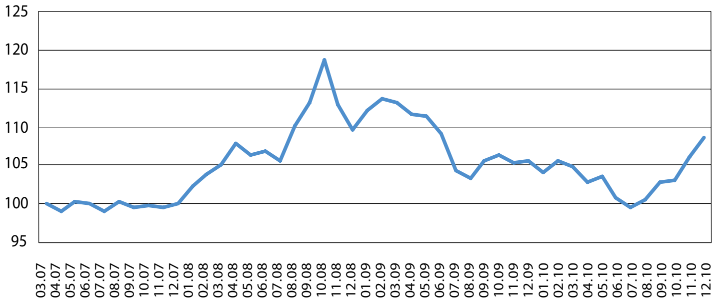


DIAGRAM 3.24
NBG's Interventions in the FX Market

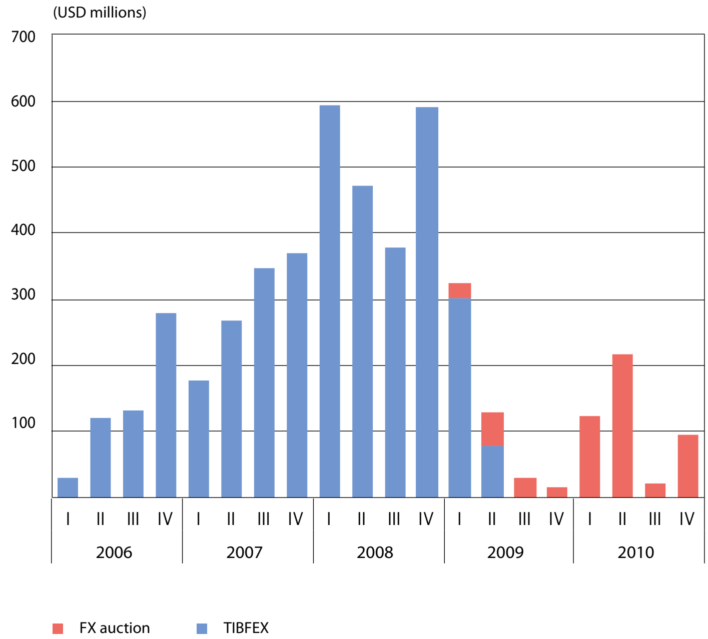
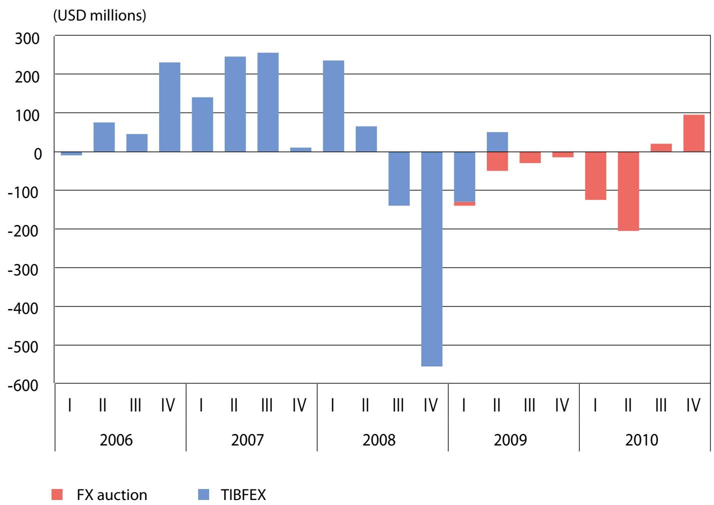


DIAGRAM 3.25
NBG's Net Purchases in the FX Market



Thus, higher tourism revenues and increased FDI created demand for domestic currency, moving the exchange rate upwards. In Q4 2010 commercial banks tended to sell foreign currency they excessively purchased in the preceding quarter. In this regard we should underline the role of the NBG's FX auctions aimed at avoiding sharp exchange rate fluctuations due to temporary supply-and-demand misbalances (See: Diagram 3.24).

DIAGRAM 3.26
Dynamics of Georgian Trade and Current Account Balances

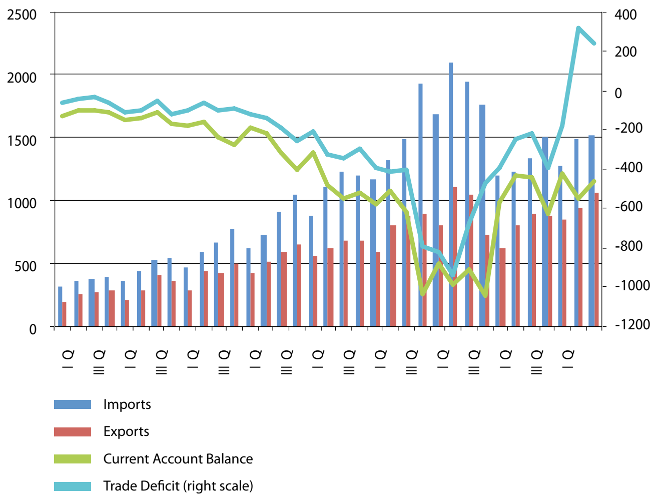
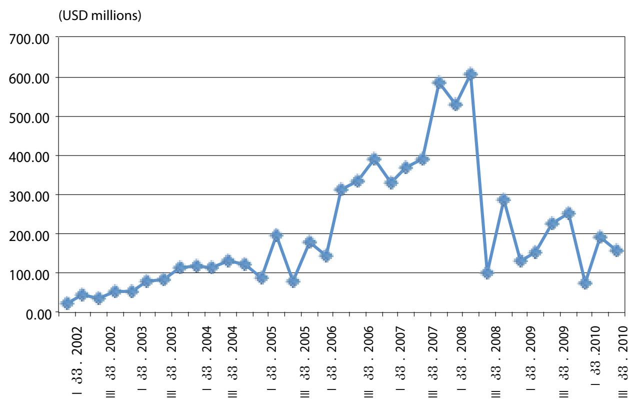


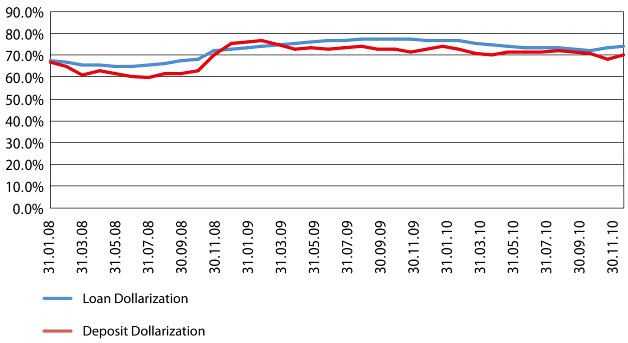
DIAGRAM 3.27
FDIs in Georgia



Important determinants of demand for foreign currency also include dollarization level of the economy and speculative capital forming certain expectations in the market. For instance, in the beginning of the accounting period, contrary to the preceding periods, there emerged expectations of the lari's appreciation, which affected demand for the lari. Such expectations are mainly related to the dollar's downtrends in the international markets. However, the expectations were reversed along with the approaching of the New Year period.

In the accounting period the deposit dollarization rate rose by 1.2 pps, whereas the loan dollarization decreased by 0.3 pps. High level of deposit dollarization is in turn conditioned by economic agents' expectations with respect to the lari's possible depreciation in the future. A general psychological factor related to political risks should be also mentioned, conducing to population's mistrust of the lari and giving the US dollar a status of a risk-free currency.

DIAGRAM 3.28
Loan and Deposit Dollarization Rates



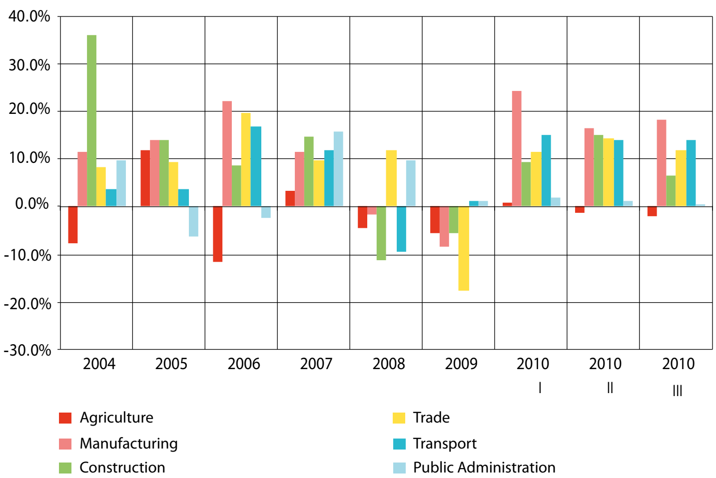
3.7 PRODUCTION AND DEMAND

In Q3 2010 the economy manifested a significant growth rate. The annual growth of real GDP amounted to 6.7%[7], while the nominal GDP rose 17.5%. The GDP deflator equaled 10.2% year-on-year.

As it is shown in Table 3.6, the largest contribution to the real GDP growth was made by increase in value-added produced by trade, manufacturing, and transport sectors (similar to Q2 2010). Essential positive impact on the real GDP was also produced by the following sectors: construction, real estate operations, renting and business activities, hotels and restaurants, financial intermediation, and community, social, and personal services. Small growth rates were registered in healthcare, education, and communication sectors. The impact of the remaining sectors on the real GDP growth was insignificant. (See: Table 3.6)

Three economic sectors – manufacturing, real estate operations, renting and business activities, and hotels and restaurants – can be singled out in terms of sustainable growth. Starting from March 2009 seasonally adjusted production of value-added in these sectors is characterized with strong growth trends. Despite high growth rates in some other sectors, their growth tendencies are not as clearly pronounced.

DIAGRAM 3.29
Dynamics of GDP Growth in the Leading Economic Sectors (2004 – Q3 2010)



[7] Source: Geostat

TABLE 3.6 Sectoral Share in Real GDP, Q3 2010 (%)

	Nominal weights (Q3 2009)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	7.7%	-1.8%	-0.1%
Mining and quarrying	0.7%	3.6%	0.0%
Manufacturing	7.6%	18.3%	1.4%
Electricity, gas and water supply	2.5%	2.9%	0.1%
Processing of products by households	3.2%	-3.5%	-0.1%
Construction	6.3%	6.5%	0.4%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	12.8%	11.7%	1.5%
Hotels and restaurants	1.9%	15.7%	0.3%
Transport	6.4%	13.9%	0.9%
Communication	3.5%	2.9%	0.1%
Financial intermediation	2.2%	12.2%	0.3%
Real estate, renting and business activities	4.4%	7.6%	0.3%
Imputed rent of own occupied dwellings	2.9%	2.4%	0.1%
Public administration	13.5%	0.6%	0.1%
Education	4.4%	3.5%	0.2%
Health and social work	5.5%	2.9%	0.2%
Other community, social and personal service activities	2.7%	9.7%	0.3%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	11.0%	0.0%
FISIM adjustment	-1.3%	6.4%	-0.1%
GDP at basic prices	**86.9%**	**6.5%**	
Taxes on products	13.5%	7.6%	1.0%
Subsidies on products	-0.4%	5.6%	0.0%
GDP at market prices	**100.0%**	**6.7%**	**6.7%**

3.7.1 PRIVATE AND GOVERNMENT CONSUMPTION

The nominal GDP registered high growth rates in Q3 2010. It was the result of significant growth in all categories of use of the nominal GDP. Namely, in the accounting period the annual expenditure growth rates equaled 8.6% for final consumption, 72.1% for gross capital formation, 30.7% for exports, and 24.6% for imports.

In Q3 2010 the total final consumption remained at the Q2 level. The largest subcomponent "final consumption of households" increased both in year-on-year (14%) and quarter-on-quarter (3.7%) terms. Conversely, the second largest subcomponent "government expenditures on collective services" posted an annual decline of 11.9%.

In order to analyze the annual dynamics of household consumption, we apply deflation of this component by the CPI. By excluding the CPI growth effect, the real final consumption[8] grew 4.8% year-on-year and 3.9% quarter-on-quarter.

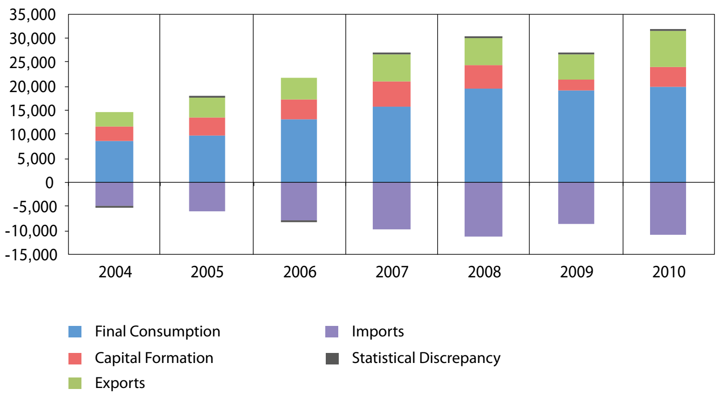
As it was mentioned, in Q3 2010 the government expenditures on collective services posted an 11.9% annual contraction. In quarter-on-quarter terms the reduction in this component amounted to 17.1%. The growth rate of government expenditures on in-

[8] In Q3 the households accounted for 79% of total final consumption

dividual goods and services equaled 4.5% annually and only 0.5% in quarterly terms.

The exports of goods and services grew significantly both quarter-on-quarter (15.4%) and year-on-year (30.7%). The imports rose significantly at 24.6% with respect to Q3 2009, but only at 4.5% quarter-on-quarter. It should be noted that such large annual increases for both exports and imports are essentially conditioned by price gains for tradable goods.

DIAGRAM 3.30
Nominal GDP by General Categories of Use, 2004-2010[9] (GEL millions)



3.7.2 INVESTMENTS

In the accounting period the annual growth of investments in fixed capital reached 43.6%. A similar growth rate (44.3%) was registered in quarter-on-quarter terms.

Production inventories continued to growth, albeit at a lower rate compared to the preceding quarters. In general, production inventories have been on the uptrend in 2010; however, the growth rates are slower than those in the pre-crisis period.

Overall, in Q3 2010 the annual growth of gross capital formation soared, amounting to 72.1%. It should be taken into consideration, however, that in the corresponding period of 2009 there was a 37% plunge registered for the same indicator. The quarterly growth rate of gross capital formation was 38.6%. This growth was mainly conditioned by domestic investments in fixed capital.

In nine months of 2010 the gross capital formation tended to grow, on the one hand, contributing to sustainable economic development, and, on the other hand, creating positive economic outlook.

3.7.3 2010 FORECAST

The Q3 2010 real GDP growth forecast was projected at 7.7%, while the corresponding figure officially released by Geostat equaled 6.7%. It should also be pointed out that seasonally corrected data showed a 1.1% decline in Q3 real GDP with respect to the preceding quarter.

The analysis based on the current sectoral and aggregated data shows that in Q4 2010 the real GDP will grow at approximately 6.0%. The estimate takes into account the actual growth rate of VAT taxpayers' turnover (28% in Q4 2010 year-on-year) as well as the increases in producers' and consumer prices.

Overall, the 2010 forecast of real GDP growth has been slightly revised in the accounting period. Based on the latest estimates, the 2010 real GDP growth may reach 6.5%, whereas the nominal growth is projected at 15-16%.

The 6.5% growth in 2010 is largely conditioned by sectoral contributions of trade (1.5 pps), manufacturing (1.3%), transport (1.0%), construction (0.5%). A significant positive contribution will be produced by community, social, and personal services, hotels and restaurants, financial intermediation, and real estate operations, renting and business activities.

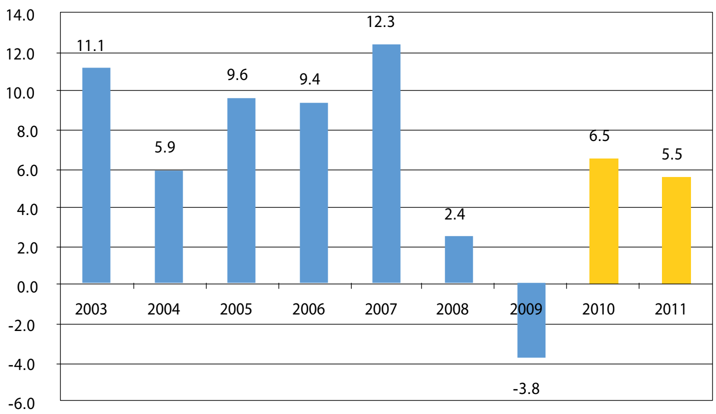
In terms of categories of use (expenditures), the growth of the 2010 nominal GDP will be fueled by

[9] 2010 growth rate represents the NBG's projections

gross capital formation and exports. Final consumption expenditures will grow nominally, although posting a decline in real terms. The real contraction is due to the fact that the growth of total final consumption (4.5%) is outweighed by the average annual price increases (7.1%).

It is projected that the 2011 real GDP will grow at annual 5.5%. A slowdown in growth relative to 2010 is caused by a few factors. First, in 2010 the "base effect" was essential (following a 3.8% contraction in 2009), which will be discontinued in 2011. Second, as a result of monetary policy tightening started in summer 2010 a slowdown in credit activity is expected, affecting real economy. In addition, in 2011 the government deficit will be reduced compared to 2010, further curbing aggregate demand.

DIAGRAM 3.31
Real GDP Growth, 2003-2011[10] (%)



10 Growth rates for 2010 and 2011 are the NBG's projections

BOX 4 2011 INDEX OF ECONOMIC FREEDOM

A joint rating of Heritage Foundation and The Wall Street Journal entitled „Index of Economic Freedom" measures countries' economic environment since 1995. It includes 10 criteria assessing openness, rule of law, and competitiveness of countries and regions. The 10 criteria are: business freedom, trade freedom, fiscal freedom, government size/spending, monetary freedom, investment freedom, financial freedom, freedom from corruption, labor freedom, and property rights. Based on the obtained measurements, country ratings are produced annually. The index measure the countries on the scale from 0 to 100, in accordance with the following categories:

100-80	79.9-70	69.9-60
Free	Mostly free	Moderately free
59.9-50	**49.9-0**	**N/A**
Mostly unfree	Repressed	Not rated

In 2011 183 countries were rated. The world average index amounted to 59.7, up 3 points compared to the previous year. According to the 2011 ratings, the economic freedom improved in 117 countries, deteriorated in 58, and remained unchanged in 4 (Georgia was one of these 4 countries). Countries with an improved index mainly represent developing or emerging economies.

The Index of Economic Freedom in Georgia equaled 70.4 in 2011, giving the country the 29th place. After 2010 Georgia retained the "mostly free" rating, going 4 places up (last year Georgia was in the 33rd place). Georgia ranks 15th out of 43 in its region (Europe), with its overall index being higher than both the average regional and the average global index. The average index of top ten countries exceeds that of Georgia by 13.7 points. Estonia ranks 14th with 75.2 points, which is the best result among the post-Soviet countries. With regard to the neighboring countries, Azerbaijan ranks 92nd (59.3 points) and Armenia ranks 36th (69.7 points).

The report notes that important reforms conducted in the recent years in the direction of business, trade, fiscal, and labor freedoms stimulated economic development. Despite sharp contraction caused by the Russian aggression and the global economic crisis, the Georgian economy grew on average at 4.5% in the last 5 years. Georgia has large economic growth potential. Competitive tax regime and effective regulatory framework represent a favorable environment for business development. Reforms are being conducted in public finance management. Corruption had a huge adverse impact on economic freedom, but the anti-corruption policy adopted in 2003 conditioned certain progress. In the accounting year a sharp growth in monetary freedom was offset by increased government expenditures.

In line with the criteria of the Index of Economic Freedom in 2011, Georgia's performance and its comparison to the previous year is shown below:

Criteria	Points	Change	Place
Business freedom	87.3	-0.6	№ 18
Trade freedom	89.2	+0.1	№ 6
Fiscal freedom	87.5	-1.6	№29
Government size/ spending	60.3	-5.0	№ 113
Monetary freedom	76.7	+6.5	№ 69
Investment freedom	70.0	No change	№ 38
Financial freedom	60.0	No change	№ 38
Property rights	40.0	No change	№ 73
Freedom from corruption	41.0	+2.0	№ 65
Labor freedom	92.1	-1.6	№ 6

BUSINESS FREEDOM

The criterion is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process. The business freedom score for each country is a number between 0 and 100. The score is based on 10 factors, all weighted equally, using data from the World Bank's Doing Business study.

The 2011 report states that business environment in Georgia improved considerably in the recent years. Business start-up process is quite fast and license requirements are significantly reduced. In the accounting period, however, the improvement pace relatively slowed down.

TRADE FREEDOM

Trade freedom is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.

It is mentioned in the 2011 report that the weighted average tariff in Georgia equaled 0.4 in 2009. The country achieved significant progress in terms of trade liberalization. Almost 86% of imports is tax-free. At present, inadequate infrastructure increases trade costs. In certain cases, trade is not registered at the border. Due to non-tariff barriers, the Georgian trade freedom index is 10 points shy of maximum measure.

FISCAL FREEDOM

Fiscal freedom is a measure of the tax burden imposed by government. It includes both the direct tax burden in terms of the top tax rates on individual and corporate incomes and the overall amount of tax revenue as a percentage of GDP. Thus, the fiscal freedom component is composed of three quantitative factors:

- The top tax rate on individual income,
- The top tax rate on corporate income, and
- Total tax revenue as a percentage of GDP.

The 2011 report states that the tax burden in Georgia is low. The income tax is 20%, and the decision on its further reduction to 15% is suspended. Other taxes include the VAT, tax on interest income and dividends. Last year the total tax revenues amounted to 24.9% of GDP.

GOVERNMENT SPENDING

This component considers the level of government expenditures as a percentage of GDP. The scale for scoring government spending (including consumption and transfers) is non-linear, which means that government spending that is close to zero is lightly penalized, while levels of government spending that exceed 30 percent of GDP receive much worse scores in a quadratic fashion (for example, doubling spending yields four times less freedom), so that only really large governments receive very low scores.

In recent years the total government spending, including consumption and transfers, amounted to 36.4% of GDP. The budget deficit grew to 9.3% of

GDP, while the government-debt-to-GDP ratio exceeded 30%. The process of state enterprise privatization slowed down.

MONETARY FREEDOM

Monetary freedom combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.

The score for the monetary freedom factor is based on two factors:

- The weighted average inflation rate for the most recent three years and
- Price controls.

It is pointed out in the 2011 report that against the backdrop of the 2008 developments and rapid economic growth in the preceding years, high inflation eased in 2009, following economic contraction and decline in international prices. The average inflation in 2007-2009 equaled 4.4%. Price formation is mainly market-based, although the government may impose price control through state-owned enterprises. In addition, subsidizing of agricultural and energy sectors takes place. Due to non-market influence distorting domestic prices, 10 points are deducted from the monetary freedom index.

INVESTMENT FREEDOM

In an economically free country, there would be no constraints on the flow of investment capital. Individuals and firms would be allowed to move their resources into and out of specific activities both internally and across the country's borders without restriction. Such an ideal country would receive a score of 100 on the investment freedom component of the Index of Economic Freedom.

The 2011 report states that in Georgia foreign and domestic investments are put in equal conditions. Non-resident companies can participate in privatization in a free and transparent way. Both residents and non-residents are eligible to possess external bank accounts. International payments and current transfers are not restricted but must be registered. Foreign individuals and companies may buy non-agricultural land. Agricultural land can be purchased by forming a Georgian corporation that may be up to 100 percent foreign-owned.

FINANCIAL FREEDOM

Financial freedom is a measure of banking efficiency as well as a measure of independence from government control and interference in the financial sector. In an ideal banking and financing environment where a minimum level of government interference exists, independent central bank supervision and regulation of financial institutions are limited to enforcing contractual obligations and preventing fraud. Credit is allocated on market terms, and the government does not own financial institutions. Financial institutions provide various types of financial services to individuals and companies. Banks are free to extend credit, accept deposits, and conduct operations in foreign currencies. Foreign financial institutions operate freely and are treated the same as domestic institutions.

The 2011 report states that the Georgian financial sector underwent substantial liberalization. In March 2008, the Georgian Parliament approved the Global Competitiveness of the Financial Services Sector Act to enhance the sector's efficiency. Despite some ups and downs in recent years, loans to the private sector have been on the rise. There are no formal barriers to foreign bank branches and subsidiaries. The government does not have a financial stake in any bank. Significant informal transactions undermine the banking sector to some degree, and the stock exchange is small and underdeveloped. Although the financial system has shown a considerable degree of resilience to external shocks, its overall strength is impaired by the country's limited economic diversification.

PROPERTY RIGHTS

The property rights component is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state. It measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. The more certain the legal protection of property, the higher a country's score; similarly, the greater the chances of government expropriation of property, the lower a country's score.

It is mentioned in the 2011 report that judges now have to pass tests before appointment, but foreigners and Georgians continue to doubt the judicial system's ability to protect private property and contracts. Enforcement of laws protecting intellectual property rights is weak.

FREEDOM FROM CORRUPTION

The score for this component is derived primarily from Transparency International's Corruption Perceptions Index (CPI), which measures the level of corruption in 180 countries.

The CPI is based on a 10-point scale in which a score of 10 indicates very little corruption and a score of 0 indicates a very corrupt government. In scoring freedom from corruption, the Index converts the raw CPI data to a scale of 0 to 100 by multiplying the CPI score by 10. For example, if a country's raw CPI data score is 5.5, its overall freedom from corruption score is 55.

The 2011 report states that corruption is perceived as significant. Georgia ranks 66th out of 180 countries in Transparency International's Corruption Perceptions Index for 2009. The government has improved its performance in fighting corruption; it has fired thousands of civil servants and police, and several high-level officials have been prosecuted for corruption-related offenses. The law provides criminal penalties for official corruption. While the government implemented these laws effectively against low-level corruption, some non-governmental organizations alleged that senior-level officials engaged in corruption with impunity.

LABOR FREEDOM

The labor freedom component is a quantitative measure that looks into various aspects of the legal and regulatory framework of a country's labor market. In measuring labor freedom, 6 equally weighted factors are analyzed with each counted as one-sixth of the labor freedom component. The factors are as follows:

- Ratio of minimum wage to the average value added per worker,
- Hindrance to hiring additional workers,
- Rigidity of hours,
- Difficulty of firing redundant employees,
- Legally mandated notice period, and
- Mandatory severance pay.

The 2011 report states that l labor regulations are very flexible. The non-salary cost of employing a worker can be moderate, and dismissing an employee is not burdensome. Rules on work hours are very flexible.

3.8 EXTERNAL TRADE

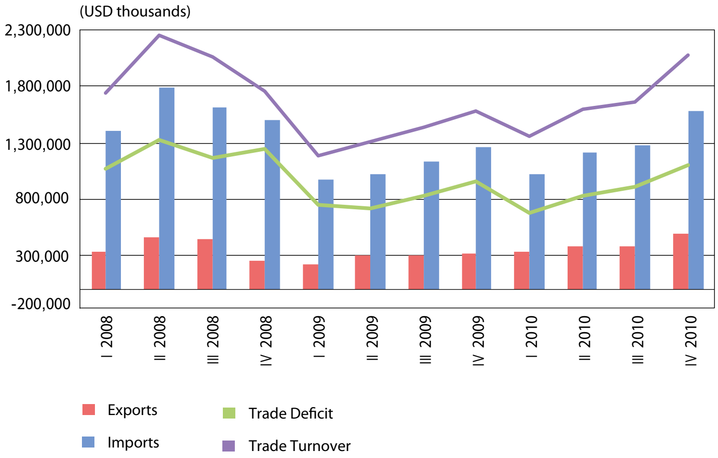
Georgia's foreign trade turnover had been growing since 2003. In Q2 2008 both exports and imports reached record highs. Against the backdrop of August military hostilities and the global financial crisis the Q3 2008 registered exports and imports posted declines, followed by annual contractions. In Q4 2010 the registered exports exceeded their record high level by 4%, whereas the registered imports and the trade deficit still lagged behind their maximum level of Q2 2008 by 11.6% and 17.0%, respectively.

As of Q4 2010, Georgia's foreign trade turnover totaled USD 2,069.9 million, up 31.3% year-on-year[11]. The registered imports of goods amounted to 485.4 million, up 54.8%[12], while the registered imports stood at USD 1,584.5 million, up 25.4% annually. This resulted in a USD 1,099.1 million trade deficit in Q4 2010, exceeding the corresponding indicator for 2009 by 15.8%.

In quarterly terms, the Q4 2010 registered exports of goods went up 28.6%, while the registered imports and the trade deficit grew 23.6% and 21.5%, respectively, in the same period.

In the accounting period, the exports were fueled by ferroalloys, posting a 73.2% annual growth rate and moving up to the first position in the export list. The increase in exports of ferroalloys mainly took place at the expense of physical volumes (2.38-time growth); price effects were relatively small. The second position was occupied by re-export of cars, largely due to increases in exports of used cars. Significant annual export growth was registered for ferrous and non-ferrous metals. It should be pointed out that in the base period international prices on ferrous and non-ferrous metals were extremely low due to lingering effects of the global financial crisis, negatively affecting export values. Starting from Q2 2010 a new product – rods and bars of iron or non-alloy steel – entered the top ten export item list with the Q4 export value equaling USD 10.6 million. The Q4 value of parts of aircrafts exported to Azerbaijan equaled USD 11.2 million.

DIAGRAM 3.32
Exports, Imports, Trade Deficit and Trade Turnover



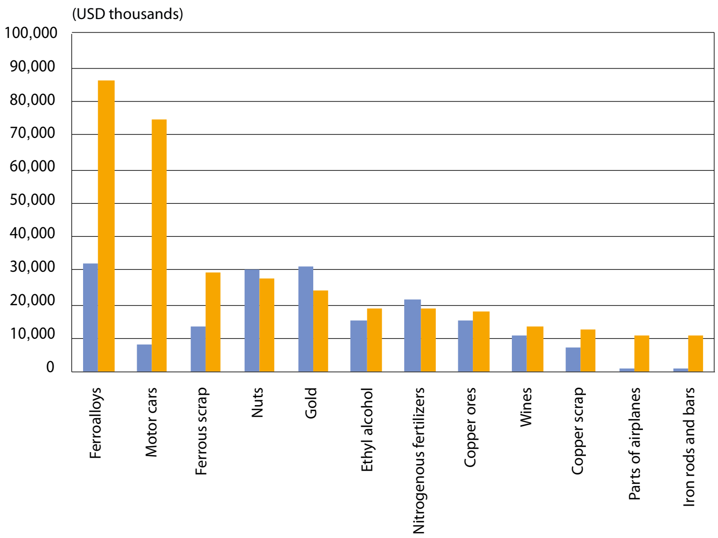
In Q4 2010 the top ten export commodities included: ferroalloys, motor cars, ferrous waste and scrap, nuts, gold, alcohol and spirituous beverages, mineral fertilizers, copper ores, wines, and copper waste and scrap. 4.6% of exports represented investment goods, 56.1% - intermediate consumption goods, and 39.2% - consumer goods.

With regard to imports, the import of petroleum products remained the top import commodity, rising at an annual 15.7% due to international price gains.

[11] The source of external trade data represents the NSO of Georgia. The data on exports and imports of goods in the balance of payments differ from external trade data due to methodological differences.

[12] Registered trade did not include cars imported under the warehouse regime, the part of which was further reexported. Starting from 2010 this part of exports is registered, increasing the export growth rate. Concurrently, the same cars are not included in imports, reducing trade deficit.

DIAGRAM 3.33
Top Export Commodities, Q4 2009 and Q4 2010



Increases in international prices represented the underlying factor of domestic price gains for fuel. In the same period, the second-placed motor car imports grew 25.0% year-on-year. Import of telephone sets soared, increasing 3.5 times.

In Q4 2010 food products accounted for 15.9% of total imports. The share of wheat and other grain crops in food imports equaled 28.6% (or 4.5% of total registered imports). In annual terms the import of wheat doubled, mainly due to the effect of international price gains. The share of meat - another important food commodity after wheat – equaled 9.7% in total food imports. This was followed by sugar and sugar-made pastry with a 9.4% share, growing 44.1% year-on-year. Price increases on these products were transmitted to food prices in the domestic prices, primarily determining high inflation. The import of tobacco and alcoholic beverages accounted for 2.4% of total registered imports, posting an annual 26.4% growth.

In the accounting period investment goods represented 12.7% of total imports, while the respective shares of investment goods and intermediate consumption goods in total imports equaled 37.8% and 49.2%.

In Q4 2010 the top ten trading partners for Georgian exports stood in the following order: Azerbaijan, the United States, Turkey, Armenia, Ukraine, Canada, Kazakhstan, Bulgaria, Egypt, and Germany. These countries accounted for 73.6% of total registered exports.

The ranking of top ten trading partners for imports was as follows: Turkey, Ukraine, Azerbaijan, China, Germany, Russia, the United Arab Emirates, Bulgaria, Italy, and Kazakhstan. The share of these countries in total registered imports equaled 69.2%.

3.9 GOVERNMENT OPERATIONS

In Q4 2010 the revenues and grants of the consolidated budget totaled GEL 1,630.4 million. The grant revenues equaled GEL 187.7 million, while the tax and non-tax revenues stood at GEL 1,442.7 million. In Q4 the revenue-to-GDP[13] ratio equaled 27.1%, down 0.4 pps quarter-on-quarter and 3.7 pps year-on-year. The tax burden (tax-to-GDP ratio) stood at 21.3%, down 1.5 pps quarter-on-quarter and 1.2 pps year-on-year. The share of grants in GDP was 3.1%. See: Table 3.7

The consolidated budget expenditures in Q4 2010 amounted to GEL 2,322 million, up GEL 521 million quarter-on-quarter and 14.7% year-on-year. The current and capital expenditures (including net lending) in Q4 stood at GEL 1,691 million and GEL 641 million, respectively. The capital expenditures decreased 18% compared to the previous quarter, remaining unchanged in annual terms. The ratio of consolidated budget expenditures to GDP equals 38.7%: up 5.1 pps quarter-on-quarter and down 0.8 pps year-on-year.

[13] Q4 GDP projection.

TABLE 3.7 Consolidated Budget Indicators (GEL millions)

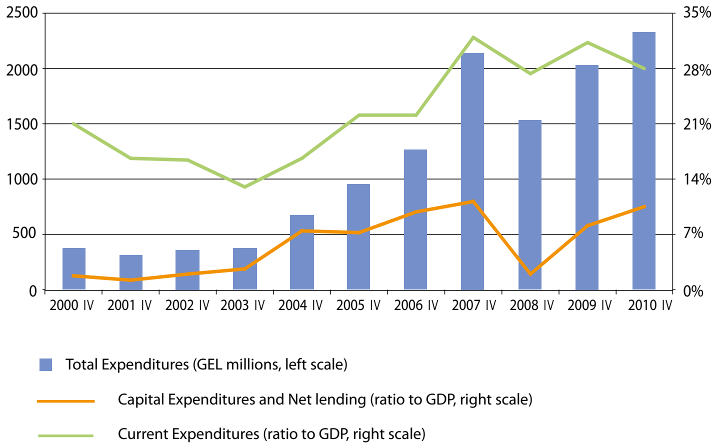
	Q4 2010	Percent of GDP (Q4 2010)
Total revenues and grants	1630	27,1%
Revenues	1443	23,9%
Tax revenues	1280	21,3%
Non-tax revenues	162	2,7%
Grants	188	3,1%
Total expenditures	2322	38,7%
Current expenditures	1691	28,1%
Capital expenditures and net lending	641	10,6%
Deficit	-701	-11,6%
Deficit financing	701	11,6%
Privatization	87	1,4%
Use of free circulating funds	81	1,3%
Net increase in domestic liabilities	4	0,1%
Net increase in foreign liabilities	529	8,8%

In Q4 2010 the consolidated budget deficit amounted to GEL 701 million, or 11.6% of GDP. The primary source of deficit financing represented an increase in liabilities: the net increase in external liabilities covered GEL 529 million, while issuance of T-bills (excluding redemption) amounted to GEL 4 million. Privatization proceeds totaled GEL 87 million. The government deposits at the NBG decreased by GEL 144.3 million, while the circulating funds grew by GEL 55.8 million.

In the account period the fiscal policy essentially affected money supply. A significant source of money supply still represented grants and loans from international financial institutions and donor countries, exerting impact on the growth of money mass, on the one hand and on expansion of economic activity, on the other. In Q4 2010 the NBG's reserve money grew 7.5% (by GEL 126.8 million). The government operations accounted for 6.86 pps in the money mass change.

In the accounting period the largest share of state budget expenditures represented expenditures on

DIAGRAM 3.34 Dynamics of Government Expenditures



general government (24%), spent on the activities of different executive and representative organs, provision of financial and fiscal activities, and servicing state debt.

The second largest category of state budget expenditures represented expenditures on social assistance, totaling GEL 318 million (17%). A significant share of these expenditures was used for social protection of aged persons, social insurance of households and children, social alienation problems and social protection of sick persons and persons with limited capabilities.

In the accounting period GEL 317 million (17%) was spent on economic activities. Expenditures in this category were largely spent on motor car transport and rehabilitation of road infrastructure, multipurpose development projects, tourism, and energy.

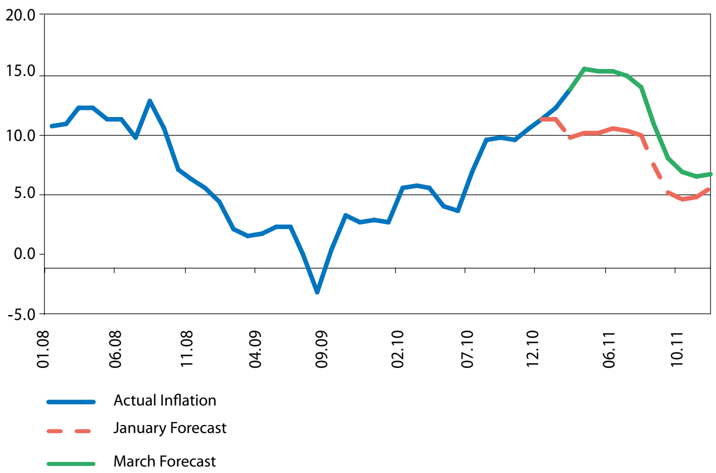
By end-December 2010 the total state debt posted a slight 0.2% quarterly increase (GEL 22 million) to equal GEL 9.15 billion. The external liabilities increased by GEL 30 million, while domestic liabilities diminished by GEL 8 million. At the end of Q4 the forecast of the 2010 state debt constitutes 44.1% of GDP, which is approximately equal to the Q3 level. The forecast does not exceed the critical level (60% of GDP).

4. INFLATION FORECAST

In forecasting inflation the NBG uses two approaches. On the one hand, the NBG observes 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 order to estimate price dynamics of individual commodity groups of the consumption basket, all available information on such commodities is used (seasonality, expected changes in international prices, changes in administrative prices, etc.). The price dynamics at the end of 2010 and in the first half of 2011 will be largely determined by food prices. Starting from summer 2010 the main food products registered price increases in the international markets, and the current forecasts predict that this uptrend will persist for the next few months.

DIAGRAM 4.1
Annual Inflation Forecast by Individual Components of the Consumption Basket



One of the main determinant of food price gains represented bad harvest due to adverse climatic conditions, entailing price increases for a number of agricultural commodities. Based on the assumption that the current agricultural harvest will be more like in normal years (in terms of climatic conditions), it is likely that the current prices for fruits and vegetables will move down. It should be noted that price gains on certain agricultural products (potatoes, beans, apples, cucumbers, cabbage) exert a significant impact on inflation. Thus, the recent increases in food prices represent a one-time factor, and it is expected that after one year food price gains will no longer affect inflation and the latter will return to the targeted level. In line with the assumptions on inflation forecasts, the change in transport fees will be related to oil price dynamics during 2010. Current projections estimate the price of oil to oscillate in the range of USD 90-100. The forecast assumes that administrative prices will remain unchanged in the next year. Forecasts on price dynamics for other commodity groups take into account the information on expected tendencies for relevant economic sectors. Using this method inflation forecasts show that in the first half of 2011 the inflation will remain high, starting to decrease from the second half of the year down to 7% at end-2011.

It should be noted that the inflation forecast was revised upwards since the previous quarter. The revision was mainly conditioned by unfavorable dynamics of main commodities in the international markets, fueling expectations with respect to global price increases.

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.

An updated inflation forecasting model is determined as follows:

$$\delta p = 0{,}10\delta e_{-2} - 0{,}051\delta e_{-4} + 0{,}044\delta m_{-1} + 0{,}046\delta m_{-2} - $$
$$+ 0{,}003\delta p^{oil}{}_{-1} + 0{,}09\delta p^{food}{}_{-1} - 0{,}011 ecm;$$

where:

P is CPI;

m – money mass;

e – GEL/USD exchange rate;

P^{oil} – world average price for oil;

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

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

$$ecm = p_{-1} - 0{,}42e_{-1} - 0{,}58m_{-1} + 0{,}8y_{-1} - 5{,}9$$

y – GDP.

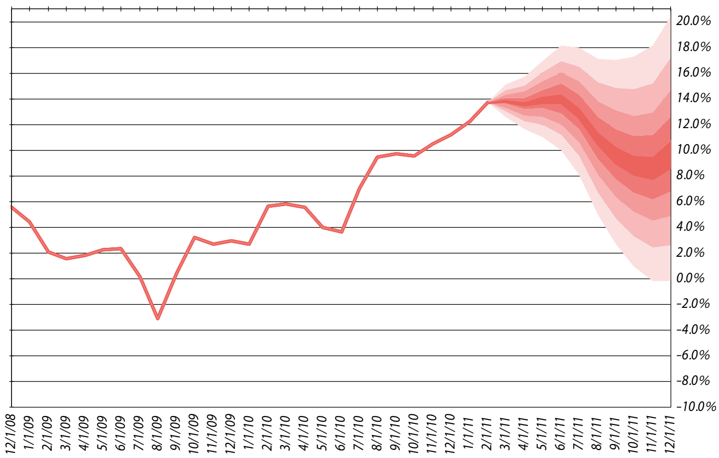
The equation also includes seasonal and dummy variables to account for seasonality and structural breaks.

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

- Broad money excluding foreign currency deposits will expand 18.6% in June 2011 and 20.2% at end-year in annual terms
- The real GDP growth will equal 5.5%;
- The nominal exchange rate against the US dollar will remain unchanged;
- Prices on fruits and vegetables will follow the previous year's trends, accounting for seasonality;
- The average oil price in the world market will slightly increase, averaging 89 USD/barrel in Q1 and approaching 98 USD/barrel by end-year;

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

DIAGRAM 4.2
Inflation Forecast (Econometric Modeling)



According to the obtained results, at 10% probability the annual inflation will be in the range of 10.9% and 11.2% in February 2011, moving up to 11.3%-12.2% by end-June. At the end of the year the inflation level will ease within the 6.3%-8.2% interval.

5. DECISIONS OF THE MONETARY POLICY COMMITTEE

During Q4 2010 the NBG's Monetary Policy Committee (MPC) convened three meetings. The policy rate was hiked by 50 bps at the first meeting, remaining unchanged after the second meeting. At the third meeting the MPC decided to increase the reserve requirements for funds attracted in foreign currency from 5% to 15%.

The annual inflation posted a high growth rate during the quarter. The growth was mainly due to exogenous (independent from monetary policy) factors. International price gains for wheat led to price increases for main components of the Georgian consumption basket. In particular, significant price growth was registered for bakery products, cereals, sunflower oil, meat, and eggs. Prices were also affected by bad harvest due to bad climatic conditions in Georgia and in the whole region. Monetary policy cannot influence exogenous factors, but it should be pointed out that high level of inflation creates unfavorable inflationary expectations amplifying pressure on prices. The MPC also took into consideration that the growth of monetary aggregates was slowing down, but with the purpose of curbing inflationary expectations and bringing inflation down to its target level of 6% in the medium term the MPC voted for monetary policy tightening.

During recent months the commercial banks significantly expanded economy crediting. Particularly high growth was registered in December for loans extended in foreign currency. It should be noted that monetary policy tightening has already been reflected in interest rates on lari denominated loans, but had no effect on foreign currency loans. As a result, the differential between the interest rates on loans denominated in domestic and in foreign currency widened. In order to extend the monetary policy tightening to the FX loan market, the MPC decided to gradually increase the reserve requirement for funds mobilized in foreign currency up to 15%. Initially, the reserve requirement will be raised to 10% starting from January 20, 2011. Effects of the monetary policy are characterized with time lags. Thus, the above-mentioned decisions have not been fully reflected in the economy. Meanwhile, the MPC stands ready to continue monetary policy tightening, should inflationary pressure remain in place.

At the December 22 meeting, with the purpose of promoting development of the money market the NBG reduced the interest rate band from 4 to 3 pps. In particular, the interest rate on overnight loans/deposits is defined as the policy rate plus/minus 1.5 pps (instead of 2 pps). This measure will contribute to further reduction in interbank interest rate volatility and stimulate money market activity.

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