INFLATION REPORT

NATIONAL BANK OF GEORGIA

2011

2008 2009 2010 **2011**

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INFLATION REPORT

Q3 2011

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), The annual inflation amounted to 4.6% at end-September 2011. As it was expected, in the latest months the annual inflation sharply declined, owing to the discontinuation of the food price effects.

The annual domestic inflation equaled 7.1% in June, while the import inflation stood at 6.0%. In the reporting period prices grew 5.0% for non-tradable goods and 4.2% for tradable goods. It should be noted that the core inflation indicator (changes in consumer prices excluding food and fuels) remained low at 0.5%. In September prices on services rose 4.8%. Such pattern of inflation clearly indicates that the impact of exogenous shocks on the annual inflation weakened in the reporting period, and the demand pressure on prices was not present.

The dynamics of inflation factors can be described in the following way: in Q2 2011 the real economy grew 4.7%. It should be noted that in the last quarters the rates of economic growth tend to slow down. The households' real final consumption, deflated with the CPI, rose 4.1%. Lower growth rate of consumption compared to real economic growth points to lack of demand pressure of prices.

The growth rates of labor productivity in industry, transport and communication exceeded the growth rates of average wages, lowering unit labor costs and thus pointing to a lack of cost pressure on prices in these sectors. In contrast, in Q2 the unit labor costs rose in trade and agriculture.

In Q3 2011 the lari's real and nominal effective exchange rates appreciated 3.7% and 5.8%, respectively. The lari's appreciation in the reporting period was conditioned by a number of factors, including FDIs inflow, tourism proceeds, and money remittances from abroad. In the reporting quarter there emerged a tendency of the euro's depreciation, further creating expectations of the lari's appreciation. The latter had a downward impact on prices for imported goods.

The credit portfolio of commercial banks expanded in Q3 2011 by GEL 504.2 million, totaling GEL 7.5 billion. The annual growth rate of crediting at end-September 2011 equaled 34.3% (excluding the exchange rate effect). The volume of loans denominated in domestic currency grew by GEL 334 million to GEL 2.3 billion, while that of foreign currency loans increased by USD 112 million to USD 3.1 billion. The annual growth rates equaled 41.5% for domestic currency loans and 31.3% for foreign currency loans. The existing growth rate of economy crediting is in line with the current economic growth forecast (6.3%) and does not contain inflation threats.

In Q3 2011 the deposit liabilities of the banking sector rose by GEL 322 million, equaling GEL 5.3 billion. At end-September the annual growth rate of domestic currency denominated deposits equaled 43.7%, while the deposits in foreign currency grew 16.8% year-on-year. It is remarkable that in the latest two quarters a 17%growth of non-residents deposits took place, with the latter equaling GEL 652 million at end-June. One should also note that in Q3 the volume of time deposits in domestic currency exceeded GEL 500 million (the pre-crisis level), indicating an increased trust of the population towards the domestic currency. In the reporting period the dollarization of deposits decreased by 1.4 pps, standing at 68.5% at end-September.

In the reporting period the NBG continued to use monetary policy instruments with the purpose of effective liquidity management and revitalization in the banking sector. The average balances placed on commercial banks' corresponding accounts in the same period almost equaled the level of required reserves. This indicates an improvement in efficiency of liquidity management in the banking sector. In the reporting period demand for the NBG's Certificates of Deposits significantly exceeded issuance volumes. During the quarter the total placement of securities equaled GEL 245 million.

In Q3 2011 the NBG started monetary policy loosening. Starting from July the Monetary Policy Committee cut the refinancing (policy) rate by 75 basis points to 7.25% in October. This measure was caused by a larger-than-expected decrease in actual inflation with respect to the targeted level.

In line with the NBG's inflation forecast, further decline in annual inflation is to follow. By the current projections the annual inflation will fall in the range of 4.2%-4.8% by end-Q3, while settling at 4.3%-5.5% at end-year.

According to the NBG's inflation forecast, the annual inflation will remain at the existing low level in the following months.In line with the current projections, the annual inflation at the end of the year will oscillate between 2.8% and 3.2%, further declining in Q1 2012 to within 1.3%-2.1%. The inflation rate will return to the targeted level in the second half of 2012.

2. CHANGE IN CONSUMER PRICES

According to the National Statistics Office of Georgia (Geostat), in Q3 2011 the general level of consumer prices remained practically unchanged quarter-on-quarter, increasing marginally at 0.01%. The same figure in 2010 equaled 5.2%. As a result, at end-Q3 2011 the annual inflation rate fell to 4.6% from 10.0% at end-Q2.

The impact of food prices on inflation was significant. The general level of prices on food and non-alcoholic beverages declined, owing to price decreases for the commodity groups of "bread and pastry", "fruits and grapes", and "vegetables and watermelons". Prices remained unchanged for alcoholic beverages and tobacco products.

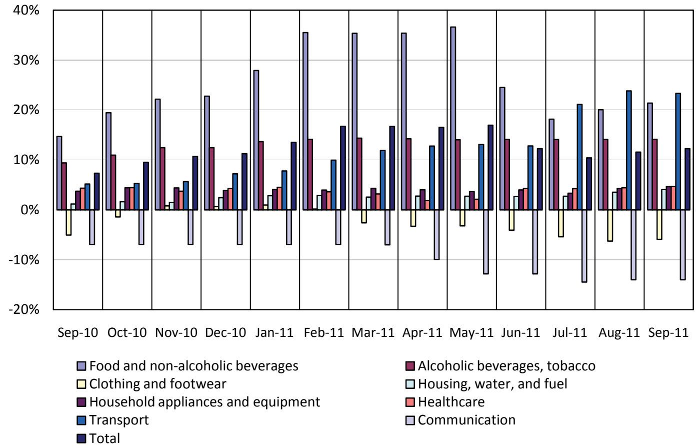
Despite the decline in food prices, the general level of consumer prices still moved up, largely conditioned by prices increases in the transport sector. In quarter-on-quarter terms prices on gasoline and diesel fell, but a drastic rise in transport fees fully offset the downward effect of food prices on inflation.

In Q3 2011 there was an increase in prices for certain types of medical services as well as for medicaments. Analogously, prices rose for "hotels, cafes, and restaurants" and "housing, water, electricity, gas and other fuels".

As already mentioned, in Q3 2011 the consumer prices grew 4.6% year-on-year. The prices increased for diesel and gasoline (18.6% and 16.4%, respectively). Price gains were registered for products making part to food and non-alcoholic beverages as well as to alcoholic beverages and tobacco (5.8% and 4.3%, respectively).

DIAGRAM 2.1.

Price Increases Relative to December 2009



In Q3 the annual growth of general level of prices was significantly influenced by price increases in the "transport" sector. The annual inflation of the latter amounted to 17.3%. Analogously, the general level of prices rose in the "hotels, cafes, and restaurants" category. In parallel, there was an important decrease in price level for the goods and services of the "communication" sphere.

It is also remarkable to consider changes in the general level of prices for goods and services excluding food and fuel. The core inflation rate calcu-

DIAGRAM 2.2

Core Inflation Excluding Food and Fuels

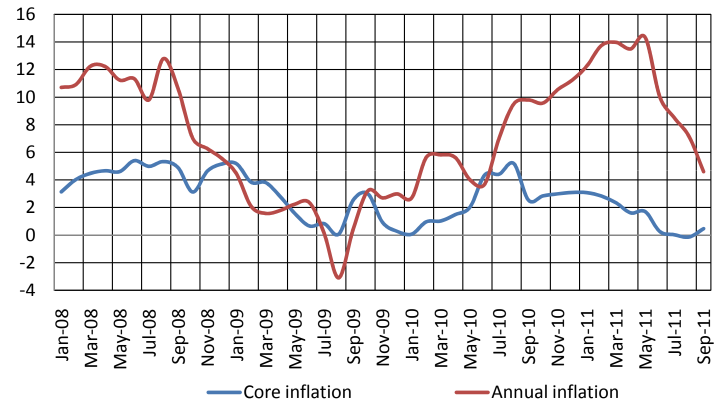


DIAGRAM 2.3
Annual Inflation by Production Location

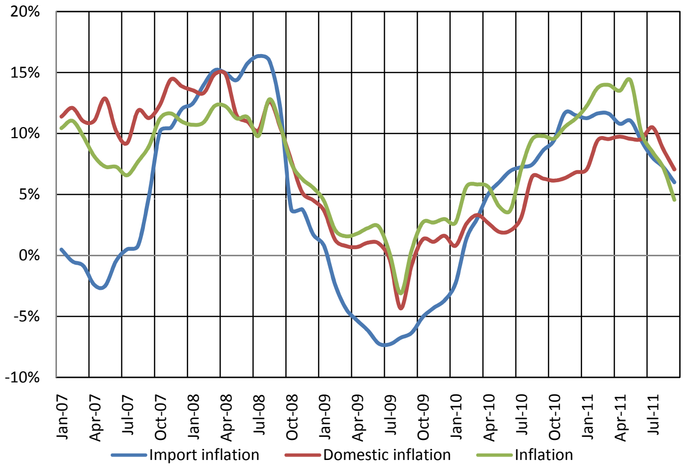


DIAGRAM 2.4
Inflation for Tradable and Non-Tradable Goods

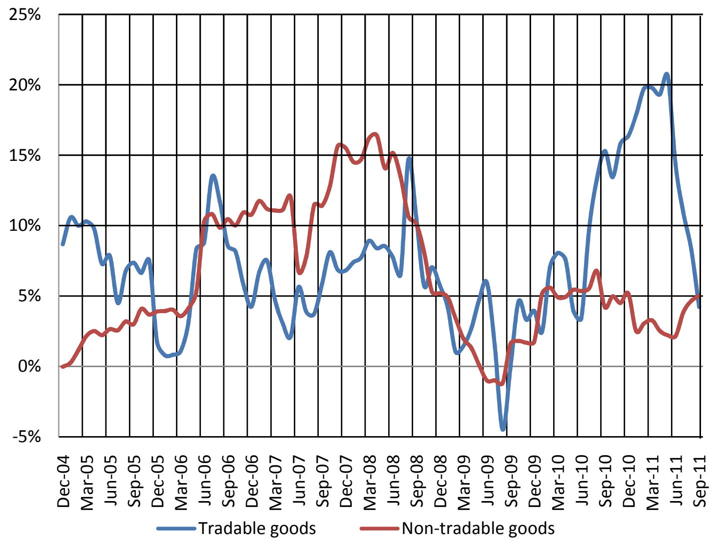
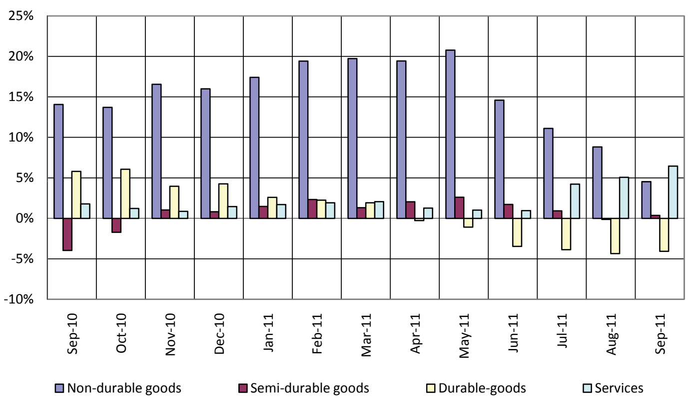


DIAGRAM 2.5
Changes in Annual Inflation Rates for Products with Various Consumption Dirability



lated for the above-mentioned products amounted to 0.5% at the end of the reporting period. This indicates weakness of demand pressure on the price level.

The annual import inflation showed upward tendencies in the recent period, owing to price increases in the international markets. In the reporting period the growth rate of prices on imported goods slowed down, equaling 6.0% in September. The inflation rate for domestic goods stood at 7.1%. In the same period the price level rose 4.2% for tradable goods and 5.0% for non-tradable goods, with the latter being fueled by transport and utilities (in particular, garbage collection fee).

The analysis of inflation by consumption durability shows that in Q3 2011 the prices on non-durable goods fell 1.5%. Analogously, prices dropped for durable and semi-durable goods, albeit at lower rates (1.0% and 0.1%, respectively). Conversely, prices on services rose 4.8%, also influenced by price increases in the transport sector.

Table 2.1
CPI Inflation by Components (%), Consumer Basket Weights (%), and Individual Contributions to Inflation (pps)

	December 2009 weights	Sep11/Jun11		Sep11/Sep10		Oct10- Sep11/ Oct09- Sep10	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	0.0%	0.0%	4.6%	4.6%	10.8%	10.8%
Food and Nonalcoholic beverages	40.1%	-2.5%	-1.1%	5.8%	2.5%	21.8%	8.9%
Food	38.8%	-2.7%	-1.2%	5.7%	2.4%	22.1%	8.7%
Bread and bakery	11.1%	-0.9%	-0.1%	6.2%	0.8%	20.7%	2.3%
Meat and meat products	6.6%	1.2%	0.1%	24.9%	1.7%	19.7%	1.3%
Fish products	1.1%	3.0%	0.0%	1.9%	0.0%	6.6%	0.1%
Milk, cheese, and eggs	4.7%	14.1%	0.6%	11.2%	0.5%	18.2%	0.8%
Oils and fats	3.4%	1.0%	0.0%	8.1%	0.3%	29.5%	1.1%
Fruits, grapes	1.8%	-26.2%	-0.6%	-6.2%	-0.1%	40.0%	0.7%
Vegetables, melons, potatoes and other tubers	7.5%	-15.8%	-1.3%	-14.1%	-1.2%	25.6%	2.1%
Sugar, jams, honey, syrups, chocolate, pastry	2.2%	6.0%	0.1%	15.7%	0.3%	15.0%	0.3%
Other food products	0.3%	0.8%	0.0%	17.7%	0.1%	16.5%	0.1%
Nonalcoholic beverages	1.3%	2.8%	0.0%	11.2%	0.1%	11.2%	0.1%
Alcoholic beverages, tobacco	2.9%	0.0%	0.0%	4.3%	0.1%	9.6%	0.3%
Clothing and footwear	4.3%	-1.9%	-0.1%	-0.9%	0.0%	0.6%	0.0%
Housing, water, electricity, gas and other fuels	13.9%	1.4%	0.2%	2.9%	0.4%	2.3%	0.3%
Furnishings, household equipment, routine house maintenance	3.6%	0.6%	0.0%	0.9%	0.0%	3.1%	0.1%
Healthcare	9.0%	0.4%	0.0%	0.3%	0.0%	2.0%	0.2%
Transport	10.4%	9.3%	1.0%	17.3%	1.8%	10.1%	1.1%
Communication	4.2%	-1.3%	0.0%	-7.6%	-0.3%	-9.5%	-0.4%
Recreation and Culture	2.2%	0.1%	0.0%	0.6%	0.0%	0.2%	0.0%
Education	5.2%	0.6%	0.0%	-1.0%	0.0%	0.0%	0.0%
Hotels, cafes and restaurants	1.8%	2.3%	0.0%	6.7%	0.1%	7.9%	0.1%
Miscellaneous goods and services	2.5%	0.9%	0.0%	2.2%	0.1%	7.0%	0.2%
Non-durable goods	67.9%	-1.5%	-1.1%	4.5%	3.2%	15.0%	10.3%
Semi-durable goods	5.8%	-1.0%	-0.1%	0.4%	0.0%	1.0%	0.1%
Durable goods	3.4%	-0.1%	0.0%	-4.1%	-0.1%	0.3%	0.0%
Services	22.8%	4.8%	1.0%	6.5%	1.4%	2.3%	0.5%

3. INFLATION FACTORS

3.1 Labor Market

In Q2 2011 the the labor productivity of employed in the economy slightly declined (by 0.4%) in annual terms. On the other hand, the average wages of hired employees significantly grew at 13.5% year-on-year. Thus, the uptrend in the annual growth of labor productivity from the preceding quarters was halted, while the growth rate of wages further accelerated.

Compared to the same period of 2010, in Q2 2011 significant growth of value-added per employed was registered in the "financial intermediation", "transport and communication", "hotels and restaurants", and "industry" sectors. Relatively lower growth of labor productivity was manifested in healthcare, trade, and public administration. Conversely, significant annual decrease in labor productivity occurred in the sectors of real estate operations and construction, while the agricultural sector posted a relatively small decline.

Table 3.1
2011Growth of Real Value-Added per Employed in Q2 2011, year-on-year

	Value-Added Index
Agriculture and Processing of Agricultural Products	97.8
Industry	108.3
Construction	88.9
Trade	103.1
Hotels and Restaurants	114.8
Transport, Communication	115.8
Financial Intermediation	137.0
Real Estate, Renting and Business Activities	86.5
Public Administration, Defense	102.2
Education	99.0
Health and Social Work	103.4
Total	99.6

According to the Geostat's enterprise and wage statistics surveys, in Q2 2011 the average monthly wages of employed in the economy equaled GEL 679.5, up 13.5% year-on-year. In the reporting period the largest majority of economic sectors posted positive growth rates of monthly wages.

Sectoral analysis shows that the highest growth rates were registered in the following three sectors of the economy: "community, social, and personal services", "real estate operations", and "healthcare and social work". The nominal wages in these sectors grew at approximately 25% in annual terms.

High growth rates of wages were posted in the following sectors: "hotels and restaurants", "trade", and "transport and communication". Average wages in almost all other sectors grew at 5-10%. Slight decline of average nominal wages was registered in 2 smallest sectors (See.Table 3.2).

Table 3.2
Growth of Average Wages of Hired Employees in Q2 2011, year-on-year

	Nominal Wage Index
Agriculture, hunting and forestry	104.7
Fishing, fishery	91.6
Mining and quarrying	98.6
Manufacturing	106.5
Production and distribution of electricity, gas, and water	108.6
Construction	105.2
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	116.5
Hotels and restaurants	118.9
Transport and communication	113.4
Financial intermediation	107.1
Real estate, renting and business activities	125.6
Public administration	109.8
Education	108.8
Health and social work services	124.2
Other community, social and personal service activities	126.7
Total	113.5

The average wages across economic sectors in Q2 2011 were traditionally characterized by large inequality. The highest monthly wages were registered in the "financial intermediation" (GEL 1,476) and "public administration" (GEL 1,046), exceeding the national average level of monthly wages 2.2 and 1.5 times, respectively.

The average wages in the "education" sector (GEL 323) were traditionally among the lowest in the economy. Similarly low salaries (less than GEL 400) were present in the agriculture and fishery sectors. The average wages in these three sectors equaled approximately a half of the national average.

It should be noted that the difference between the lowest and the highest sectoral wages moderately increased in annual terms, while recording a significant growth with respect to the preceding quarter.

The value-added produced in the country per employed has been growing in 2010 and in Q1 2011. However, the growth rate of labor productivity gradually decelerated starting from Q3 2010, while, as mentioned above, there was a discontinuation of productivity growth in the latest period.

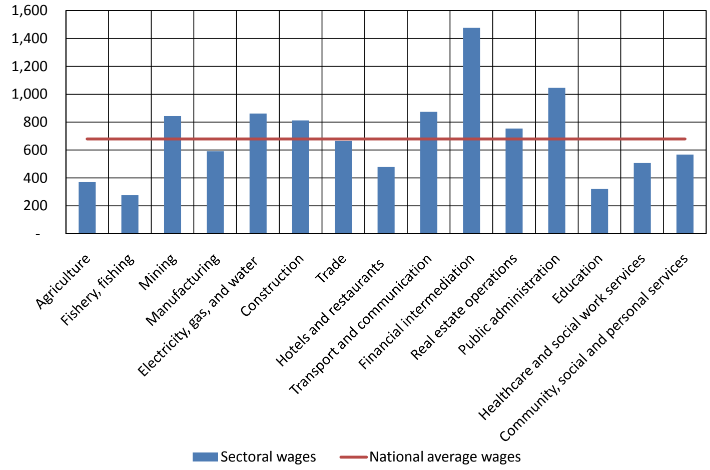
In the first half of 2011 the year-on-year growth of wages of hired employees significantly increased. The annual growth rate in 2010 oscillated between 6-7%, while in the first half of 2011 the average wages have been growing at 12-13%.

As a result, in Q2 2011 the ratio of average wages to labor productivity, i.e. unit labor costs, increased 13.9%.

In order to analyze the impact of unit labor costs on price level it is worthwhile to consider changes in unit labor costs by sectors.

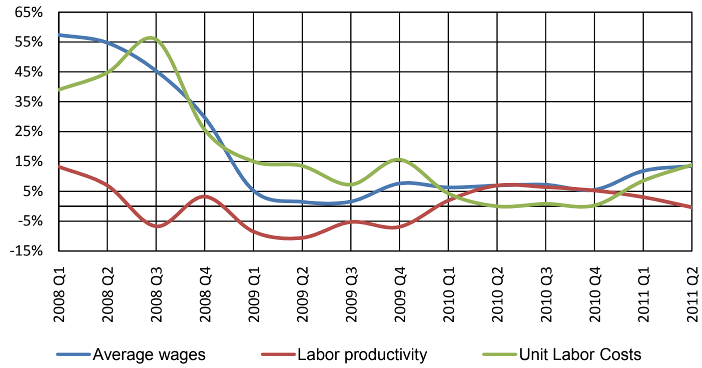
In industry the growth of labor productivity exceeded that of average wages, leading to a decrease in unit labor costs and thus not affecting price growth. Unit labor costs also declined in the transport and communication sector.

DIAGRAM 3.1
Average Sectoral Wages of Hired Employees, Q2 2011 (GEL)



The trade sector recorded a higher growth rate of average wages vis-à-vis labor productivity, causing an upward pressure on prices. Unit labor costs also rose in agriculture; however, due to a very low level of hired employees in this sector, relative growth of average wages had virtually no effect on prices.

DIAGRAM 3.2
Labor Productivity, Average Monthly Wages of Hired Employees and Unit Labour Costs (annual percentage change)

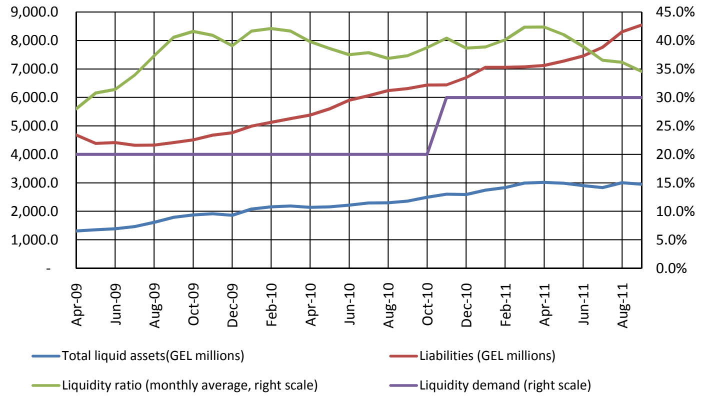


3.2 Monetary Instruments

In Q3 2011 the NBG startedto loosen monetary policy. In July the Monetary Policy Committee lowered the refinancing (policy) rate by 25 basis points to 7.75%, later decreasing it to 7.5%. These

DIAGRAM 3.3

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

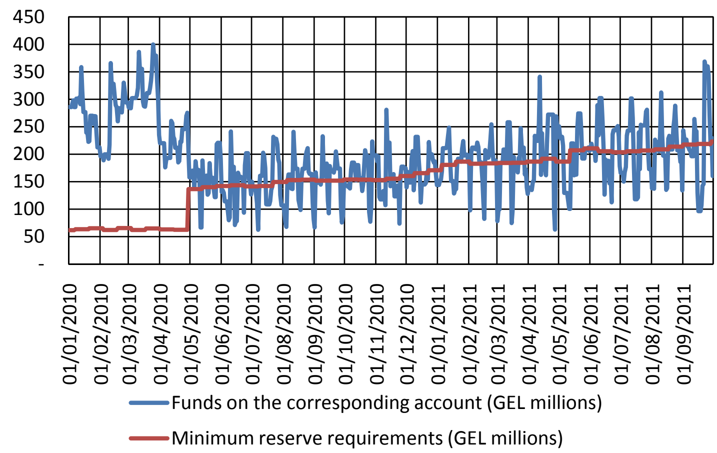


measures were related to a larger-than-expected drop in inflation with respect to its targeted level. It should be noted that at end-September the annual inflation rate amounted to 4.6%, and it is expected that it will be maintained below the targeted level until mid-2012.

In the reporting quarter not only the monetary policy rate, but also the reserve requirements were altered. With the purpose of enhancing long-term financing of commercial banks, the required reserve ratio for long-term borrowings was decreased. In terms of remaining maturity, domestic currency borrowings with more than 1-year maturity period and foreign currency borrowings with

DIAGRAM 3.4

Lari Liquidity



more than 2-year maturity period were exempt from reserve requirements, while the required reserves on foreign currency borrowings with the maturity period between 1 and 2 years were reduced by 5%.

Similar to the preceding period, in Q3 the NBG actively used monetary instruments for liquidity supply and withdrawal. Short-term liquidity was supplied through refinancing loans, with the purpose of affecting the interbank short-term interest rate. The NBG's decision to cut the monetary policy rate is initially reflected in the short-term interbank interest rates, ultimately affecting market interest rates and boosting aggregate demand. In the reporting period liquidity withdrawal was performed by means of the Certificates of Deposits.

Liquidity demand of the banking sector was determined by the average level of required reserves. The preliminary estimates of banks' liquidity situation are made by means of forecasts, identifying volume of short-term liquidity needed by the banking sector to comply with the reserve requirements. One-week refinancing loans allow commercial banks to efficiently manage short-term liquidity and obtain needed funds through refinancing loan auctionsIt is remarkable that commercial banks started to actively use this instrument from Q2 2010, which was mainly due to introduction of permanent refinancing loans. In the reporting period 13 refinancing loan auctions were held and the amount of liquidity supply at each of them averaged GEL 215.2 million. In the reporting period 3 permanent refinancing loans were extended. The weighted average interest rate on refinancing loans equaled 7.68%, oscillating around the monetary policy rate. The ratio of net liquidity withdrawal to reserve money averaged 12.3%. As of September 30, 2011 the net liquidity withdrawal stood at GEL 127 million.

In Q3 the average volume of funds on the corresponding accounts equaled GEL 211.2 million, being almost equal to the average required level of GEL 211.7 million. The respective levels in Q3 2010 stood at GEL 172.8 million and GEL 116.6 million. Narrowing of this difference started from Q2 2010 as a result of increased activity in the interbank money market, a rise in the level of lari's required reserves, and introduction of perfmanent refinancing loans, which enhanced efficiency of commercial banks' liquidity management.

In Q3 2011 the NBG continued to withdraw medium-term liquidity from the banking system by means of the 3-month CDs. In the reporting period the total placement of CDs equaled GEL 245 million, with demand exceeding supply 2.4 times. The face value of placed 3-month CDs equaled GEL 85 million, while that of 6-month CDs – GEL 160 million. With respect to the preceding quarter, the issuance of CDs fell 44.9%. In parallel to issuance of new CDs, the repayment process of due CDs was under way. The issuance volumes of new CDs were determined so that medium-term liquidity withdrawal by means of CDs remained at the existing level.

DIAGRAM 3.5.

Dynamics of 3-Month CD Auctions

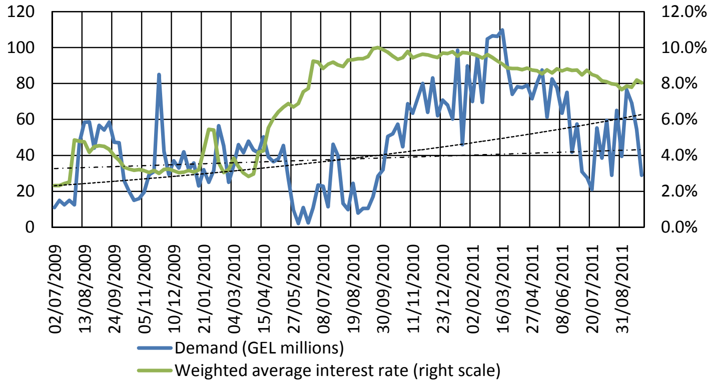
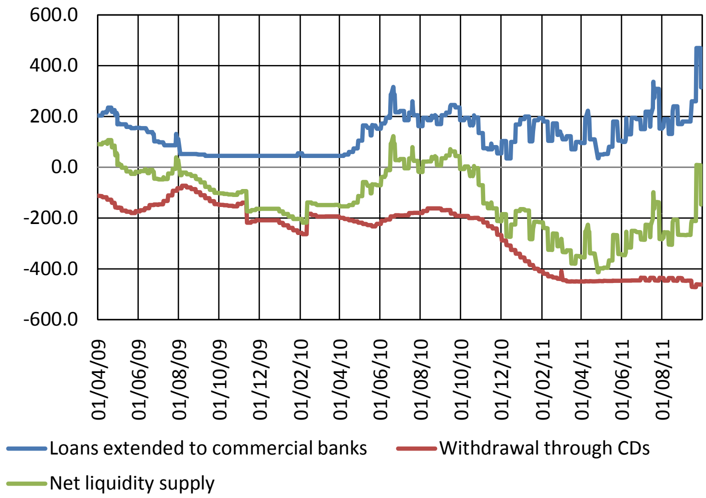


DIAGRAM 3.6

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



Box 1
Minimum Reserve Requirements

Minimum reserve requirements represent one of the monetary policy instruments, enabling a central bank to to control the volume of money mass/crediting in the economy.

Reserve requirements define what share of attracted funds commercial banks should keep at the central bank in the form of reserves. In Georgia reserve requirements are set separately for funds attracted in the domestic and foreign currencies. Calculation of reserve requirements is made with respect to average balances of attracted funds within a two-week period. Required reserves of commercial banks are placed on special accounts at the NBG. The minimum amount of required reserves in foreign currency is frozen throughout the observable period. In the case of the domestic currency, banks are required to keep average balances of reserves on the corresponding accounts. At present the reserve requirements for liabilities in domestic and foreign currencies equal 10% and 15%, respectively. Observance of reserve requirements by a commercial bank results in the NBG's accruing interest on the bank's relevant account. The policy rate is accrued on excess of 5% of reserve funds in the domestic currency, while for the US dollar and the euro the interest rate accrued equals the relevant interest rate of the Fed or the ECB minus 0.5 percentage points.

The reserve requirement instrument is used for various purposes. A change in the required reserve ratio affects the volume of economy crediting as well as interest rates. A central bank can also use this instrument to alter the currency structure of loans and deposits and reduce dollarization, since reserve requirements for foreign currency liabilities represents the primary instrument by means of which the central bank can influence interest rates on foreign currency denominated loans and deposits. In addition, through reserve requirementsit is possible to limit short-term resources and promote banks' seeking of long-term financing.

In July 2010 changes in the Rule on observance of minimum reserve requirements aimed at promoting long-term financing of commercial banks and facilitating long-term foreign capital inflows into the country. In particular, by the decision of the Monetary Policy Committee, domestic currency borrowings with more than 1-year maturity period and foreign currency borrowings with more than 2-year maturity period are exempt from reserve requirements, while the required reserve ratio for foreign currency funds with the maturity period between 1 and 2 years is reduced to 5%. By exempting long-term borrowings from provisioning, commercial banks now face lower borrowing costs, since released funds can now be used for extending a loan yielding higher interest compared to the interest rate accrued by the NBG on required reserves. This will lay the foundation for commercial banks to gradually substitute short-term borrowings with long-term financing.

3.3 Interbank Loans

In the reporting period the volume of interbank loans grew again, conditioned by an abrupt increase in lari denominated loans; with respect to Q2 2011 the volume of domestic currency denominated loans rose 61.6% to GEL 2.25 billion. Compared to the preceding period, the volume of loans extended in the US dollars fell 7.9% to USD 293.05 million; the amount of euro denominated loans increased marginally by 0.3% to equal EUR 50.45 million.

The growth of interbank loans occurred again at the expense of overnight loans, as the latter accounted for 81.5% of total lari denominated loans. The share of overnight loans in the US dollar denominated loans grew slightly to 72.4% from 71.1% in Q2.

Along with the monetary policy cut, the interest rates dropped, conditioning to a certain extent a rise in economic activity. The average interest rate on lari loans with less than 7-day maturity fell from 9.2% to 8.5%, while the interest rates on overnight loans decreased from 5.64% to 5.6%. The average interest rates for the dollar denominated loans posted respective decreases from 5.44% to 4.7% and from 2.17% to 1.89%.

3.4 Banking Sector

At the end of Q3 2011 the credit portfolio of the banking sector totaled GEL 7,478.6 million, or GEL 504.2 million more than in June 2011. In annual terms the credit portfolio expanded 34.3% (excluding the exchange rate effect)[1],the lari denominated loans increased 41.5%, while foreign currency loans grew 31.3%. The consumer loans

1 In this section percentage changes in volumes are expressed excluding the exchange rate effect, unless the volumes are denominated only in lari.

DIAGRAM 3.7

Short-Term Interbank Loan Indices and Monetary Policy Rate

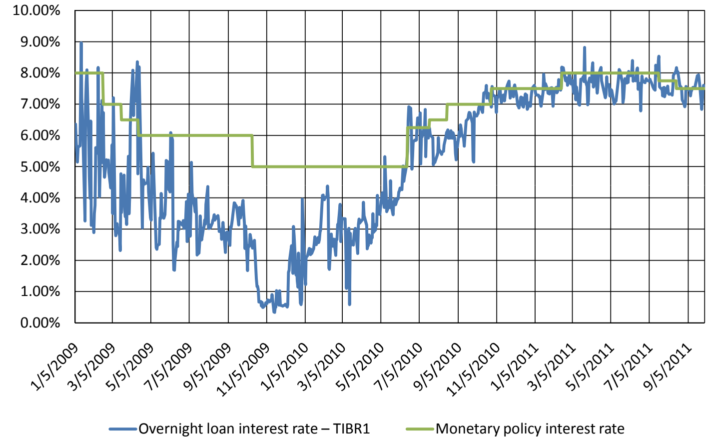


DIAGRAM 3.8

Short-Term Loans in Domestic Currency, GEL millions

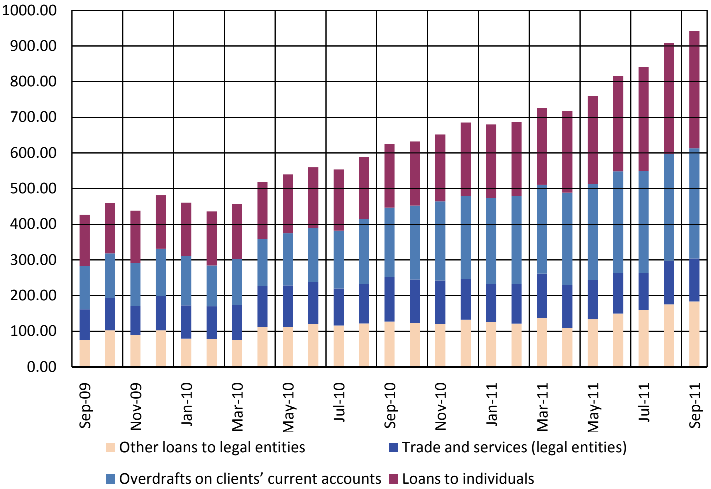


DIAGRAM 3.9

Short-Term Loans in Foreign Currency, GEL millions

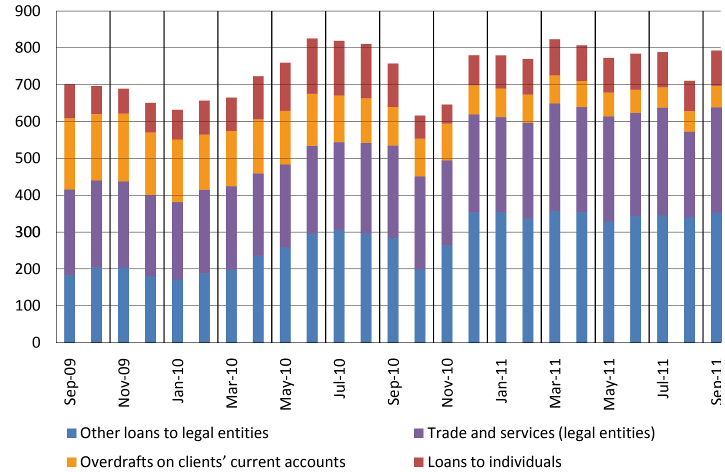


DIAGRAM 3.10
Long-Term Loans in Domestic Currency, GEL millions

DIAGRAM 3.11
Long-Term Loans in Foreign Currency, GEL millions

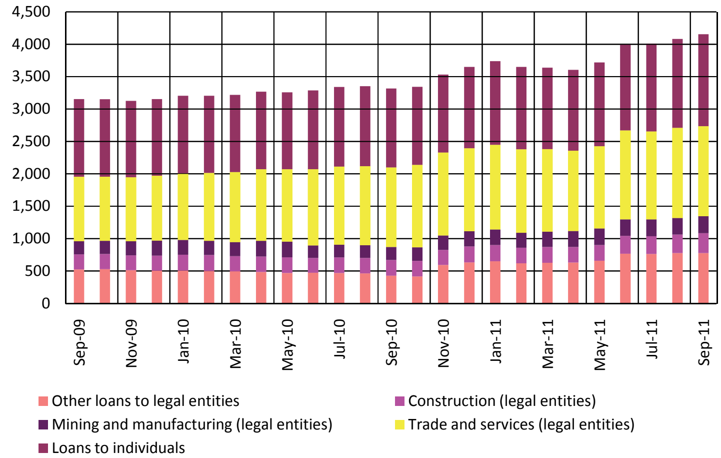
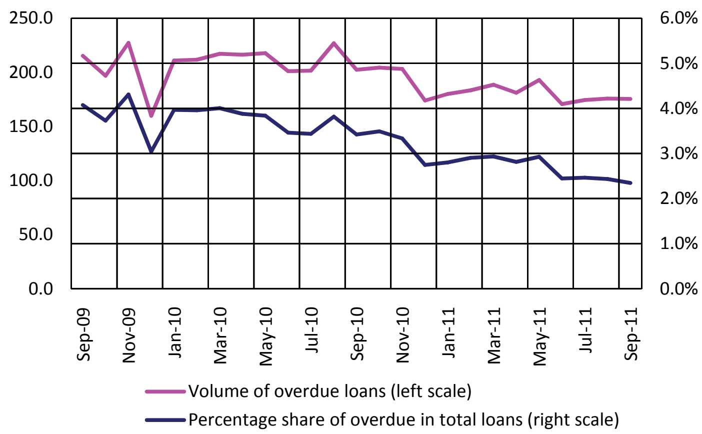


DIAGRAM 3.12
Overdue Loans



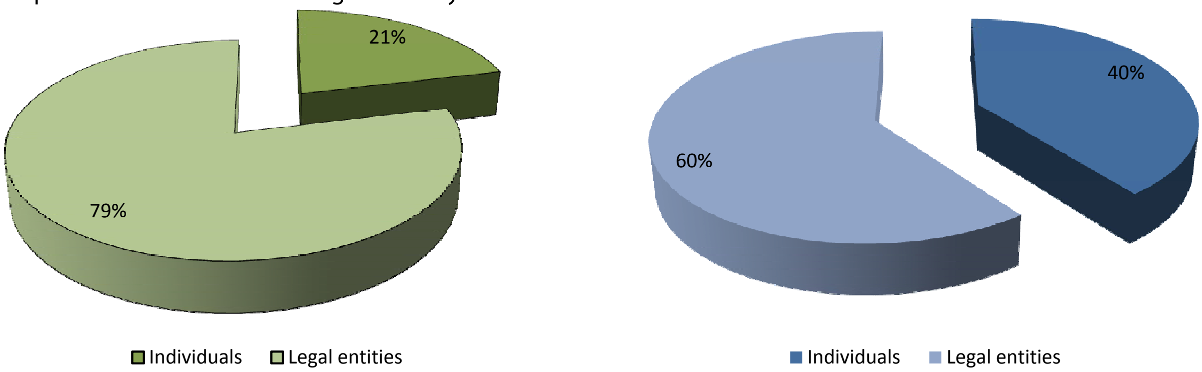
denominated in lari posted a remarkable 70.2% growth.

The portfolio dollarization at the end of the reporting period stood at 69.5% in nominal terms, down by 2.5 pps against June 2011 and by 1.6 pps against September 2011. The dollarization rate of long-term loans and loans to individuals continues to decline as well: in Q3 the dollarization rate of the former fell by 2.3 pps to 77.1%, while that of the latter shed 2.7 pps down to 57.9% (the year-on-year respective changes equaled -0.6 pps and -7.4 pps).

In Q3 2011 the overdue loans grew by GEL 5.1 million to equal GEL 175.4 million (against GEL 202.5 million in September 2010). This quarterly increase was almost equally distributed among loans denominated in lari and foreign currency, while the latter's share in the total overdue loans still remains high at 70%. After a decline in the preceding period the non-performing loans denominated in lari rose 23.7% to GEL 139.2 million, while the NPLs in foreign currency, on the opposite, posted a 7% decrease to GEL 557.7 million. It should be pointed out that the decline in lari denominated NPLs was due to increased loan write-offs, whereas the write-offs in July-September declined by GEL 18 million to GEL 21.5 million. However, against the background of expanded overall credit portfolio, the share of NPLs in total loans declined by 1.2 pps as of September 2011, standing at 9.4%.

In contrast to the first two quarters of 2011, in Q3 the market interest rates went up. In particular, growth of the weighted annual interest rate in September equaled 1.7 pps, with the latter settling at 18.6%; the increase was largely caused by a 2.3 percentage point jump in the interest rates on lari denominated consumer loans (to annual 27.5%). It should be pointed out that the interest

DIAGRAM 3.13
Deposits in Domestic and Foreign Currency



rate increases for loans denominated in lari and in foreign currency equaled 0.4 pps and 1.1 pps to annual 22% and 15%, respectively.

The deposit liabilities of the banking system in Q3 2011 grew by GEL 322 million to GEL 5,251.9 million. Compared to September 2010, the volume of deposits increased 24.1%.

Deposits denominated in lari and in foreign currency almost equally contributed to the overall deposit growth. In terms of annual growth rates, a remarkable 43.4% growth of lari deposits should be pointed out, with the foreign currency deposits rising only at 16.8%. Current accounts account for 80% of overall growth, where the domestic currency share prevails. The time deposits increased 2.2% to GEL 3 billion, although time deposits in lari fell 1.3% to GEL 493 million.

The non-residents' deposits grew 10.9% in the reporting period, amounting to GEL 651.9 million at end-September. The growth was conditioned by a GEL 53 million increase in foreign currency denominated deposits of individuals, up to GEL 381.9 million. The share of non-residents' deposits in total deposits rose by 0.4 pps to equal 9.7%.

The deposit dollarization rate fell by 1.4 pps in the reporting month to 68.5%. The decrease occurred for individuals' and legal entities' deposits, equaling 0.6 pps and 1.4 pps, respectively. It should also be note that at the end of the reporting period the dollarization of time deposits rose by 0.6% to 84.0%.

In the reporting period the interest rates on attracted deposits increased by 0.3 pps to 8.9%. While the interest rates on lari denominated deposits declined by 0.1 pp to 11.6%, the interest of

DIAGRAM 3.14
Composition of Lari Deposits

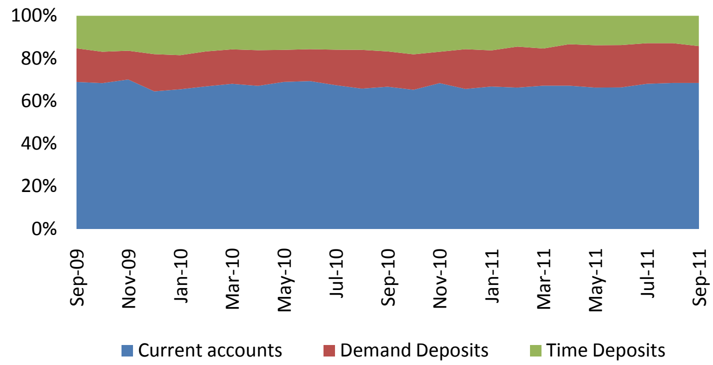


DIAGRAM 3.15
Composition of Foreign Currency Deposits

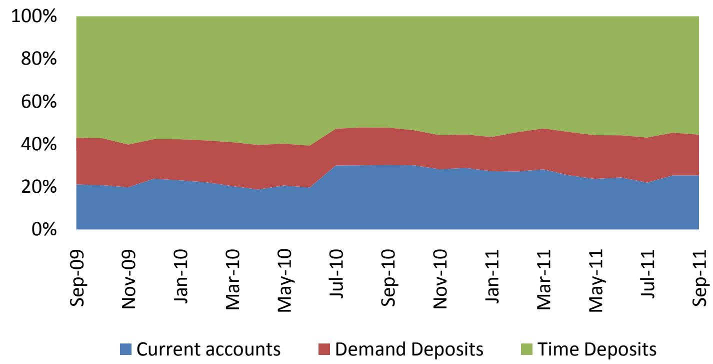
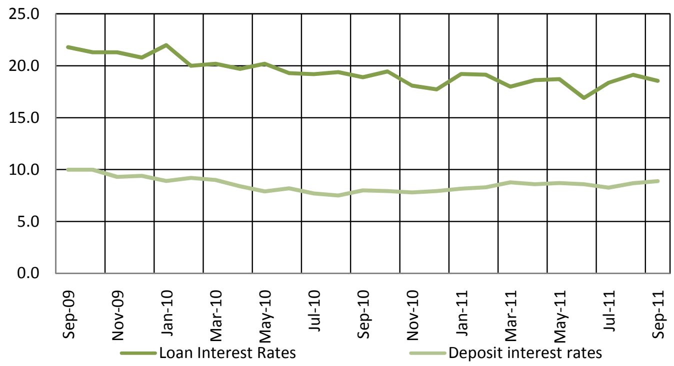


DIAGRAM 3.16
Interest Rates on Loans and Deposits (%)



foreign currency deposits went up by 0.4 pps to 8.5%. It should also be pointed out that, similar to the preceding quarter, the difference between the interest rates on the above-mentioned funds remains quite high at 3.1 pps. This fact should probably provide incentives for partial deposit dedollarization.

The interest rate on legal persons' lari deposits practically did not change, remaining at 11.2%, while the interest rates on individuals' lari deposits moved down from 12.3% to 11.9%.

Comparing current interest rates on total non-banking deposits with the ones in Q3 2010, there are 1.6 and 0.9 percentage point increases for domestic and foreign currency deposits, respectively. Overall, the weighted market interest rates rose by 0.9 pps.

In Q3 2011 the banking sector's profit totaled GEL 95.9 million, up GEL 37.9 million year-on-year. Relative to July 2011, the ROE rose by 2.4 pps to 15.7%, while the ROA grew from 2.2% to 2.6%. In the reporting period the regulatory capital adequacy ratio fell from 16.5% to 16.2%.

3.5 Exchange Rate Factors

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 link 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 Georgian consumer basket, while, on the other hand, a variation in the exchange rate, via changing terms of trade, causes demand shift from the domestic market to imports and vice versa. The exchange rate risk is also of great importance for the banking sector. In a partially dollarized economy borrowers are not fully hedged, thus being exposed to currency induced credit risk.

In Q3 2011 the lari's nominal exchange rate appreciated against the three main forign currencies – the US dollar, the euro, and the pound sterling. The appreciation of the domestic currency was recorded with respect to the primary trading partner's currency, the Turkish lira. The lari's nominal exchange rate against the US dollar averaged 1.6595, cumulatively appreciating 0.3% in Q3 (See Diagram 3.17). The nominal exchange rate of the domestic currency against the euro appreciated 5.9% at end-Q3, averaging 2.3480. At end-Q3 2011 the nominal exchange rate against the pound sterling was recorded at the level of 2.5990. In the reporting period the domestic currency appreciated 12.0% against the Turkish lira, with the TL/GEL nominal exchange rate declining from 1.0233 to 0.8966.The appreciation of the lari's nominal effective exchange rate in the accounting period cumulatively amounted to 5.8%, where the monthly average nominal effective exchange rate index increased 3.8%. The lari's monthly average real effective exchange rate strengthened 3.7% in

Q3 2011, implying real appreciation of the domestic currency. The lari's real appreciation was largely caused by the strengthening of the nominal effective exchange rate. It is important to note that the low level of current inflation in Georgia relative to its trading partners exerted a downward impact on the real effective exchange rate.

In Q3 2011 a number of factors conditioned appreciation of the lari's exchange rate. These included: FDI inflows, proceeds from tourism, and money remittances from abroad. In the reporting quarter there emerged a tendency of the euro's depreciation in the international markets, further creating expectations of the lari's appreciation. Appreciation was counterbalanced by an increased demand for foreign currency stemming from a widened current account deficit of the balance of payments and lower growth rates of loans extended in foreign currency compared to loans in domestic currency.

In Q2 2011 the amount of FDIs in Georgia totaled USD 203.4 million, exceeding the respective 2010 level 17.1%. The inflow of investments increased supply of foreign currency, strengthening the exchange rate. Proceeds from tourism created demand for the domestic currency, also affecting the exchange rate in the way similar to foreign investments. In Q3 2011 the amount of money remittances from abroad went up. In the reporting period the total amount equaled USD 303.1 million, up 22.5% year-on-year and 7.5% quarter-on-quarter. In Q3 the amount of money transfers abroad equaled USD 21.8 million. The expectations of the lari's appreciation were amplified by the prevailing tendency of the euro's depreciation in the international markets, accordingly affect-

DIAGRAM 3.17
Lari's Nominate Exchange Rate, 2009-2011

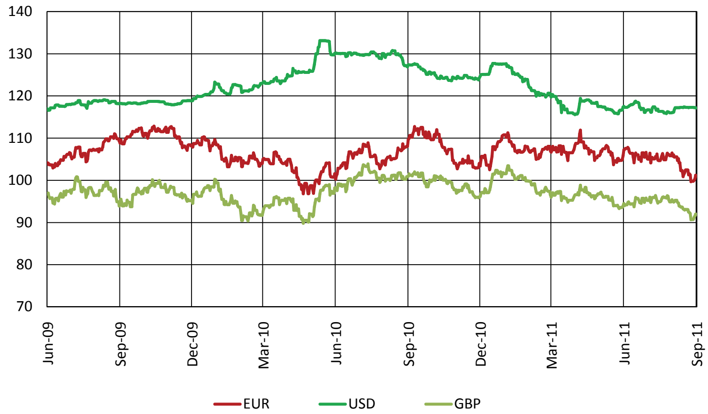


DIAGRAM 3.18
Monthly Nominal and Real Effective Exchange Rate Indices (2007-2011, relative to December 1995)

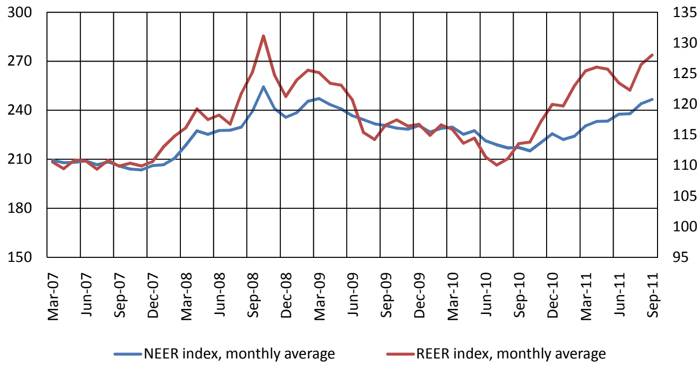


DIAGRAM 3.19
NBG's Interventions in the FX Market

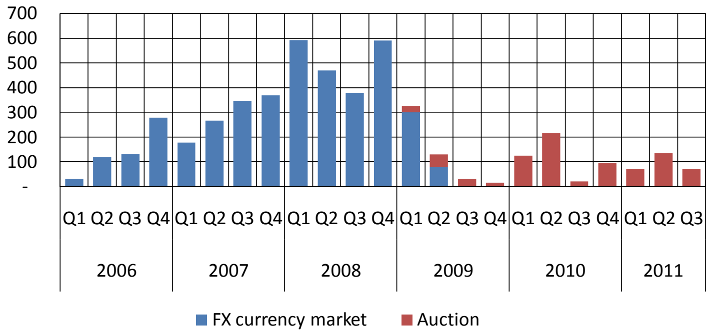


DIAGRAM 3.20
Dynamics of Georgia's Current Account and Trade Balances

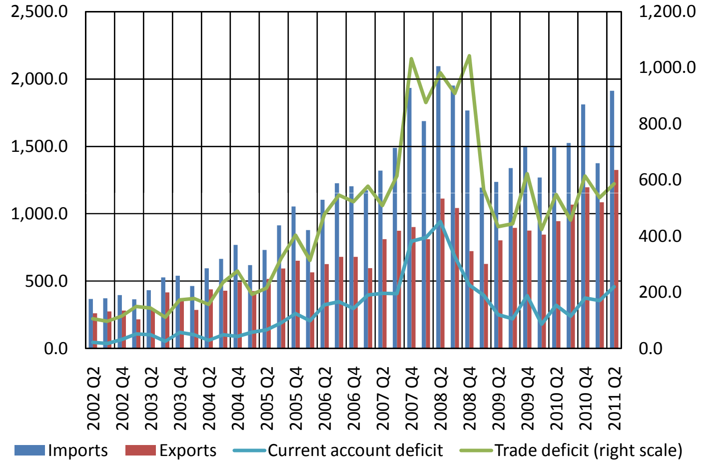


DIAGRAM 3.21
FDIs in Georgia

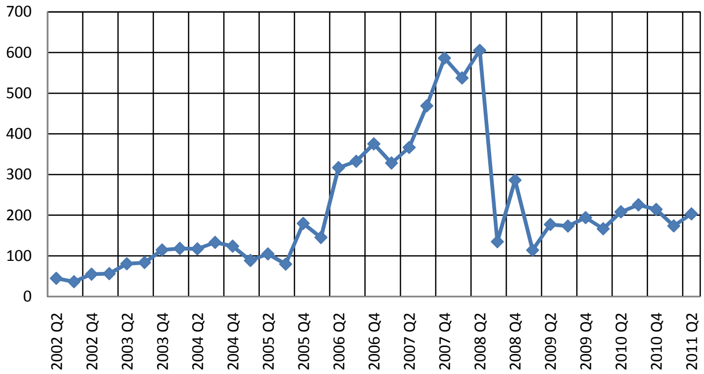
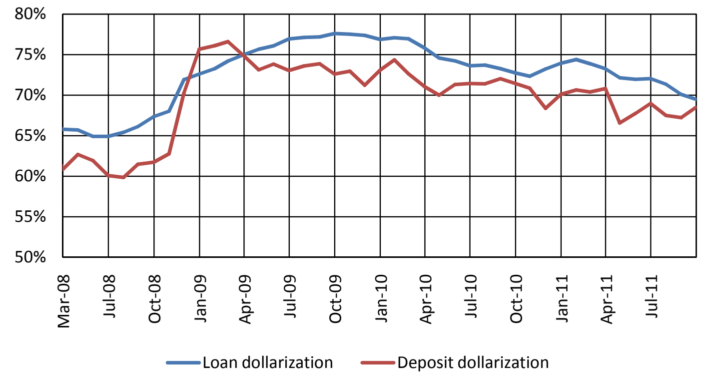


DIAGRAM 3.22
Loan and Deposit Dollarization Rates



ing demand for foreign currency. According to the available preliminary data,[2] in Q3 2011 the current account deficit – one of the important determinants of demand for foreign currency – widened. In the reporting period the loans extended by commercial banks in foreign currency grew at a lower rate than loans in domestic currency. In August-September 2011 the amount of bank loans extended in foreign currency equaled USD 112.2 million, while the domestic currency loans totaled GEL 334.4 million. In Q3 such dynamics of the commercial banks' credit portfolio did not conduce to strengthening of the lari's exchange rate against the US dollar. Taking into account the above-mentioned factors, in Q3 2011 the domestic currency appreciated against the main foreign currencies.

It should be pointed out that the NBG's FX auctions play an important role in neutralizing temporary imbalances in demand and supply. In Q3 2011 the NBG's net purchases of foreign currency amounted to USD 70 million.

An important determinant of foreign currency demand represents the level of dollarization and speculative capital created by specific expectations in the market. In Q3 2011 the US dollar was appreciating against the euro, affecting in turn demand for the lari.

The NBG will continue to actively enhance the process of de-dollarization (larization). Certain positive results of the dedollarization policies are clearly taking shape. In the reporting period the levels of loan and deposit dollarization declined. The loan dollarization exhibited a monthly down-

2 Adjusted balance-of-payments data is released in 90 days after the end of the quarter.

Table 3.3
Sectoral Contributions to Real GDP Growth, Q2 2011 (%)

	Nominal weights (Q2 2010)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	7.2%	4.9%	0.4%
Mining and quarrying	1.0%	-13.6%	-0.1%
Manufacturing	7.8%	11.1%	0.9%
Electricity, gas and water supply	2.6%	8.2%	0.2%
Processing of products by households	2.3%	4.3%	0.1%
Construction	5.2%	-3.9%	-0.2%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	12.3%	9.3%	1.1%
Hotels and restaurants	2.0%	11.6%	0.2%
Transport	6.9%	6.3%	0.4%
Communication	3.4%	9.3%	0.3%
Financial intermediation	2.6%	29.1%	0.7%
Real estate, renting and business activities	4.3%	8.4%	0.4%
Imputed rent of own occupied dwellings	2.9%	2.4%	0.1%
Public administration	13.0%	1.3%	0.2%
Education	4.0%	1.9%	0.1%
Health and social work	5.8%	2.0%	0.1%
Other community, social and personal service activities	4.0%	5.8%	0.2%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	15.2%	0.0%
FISIM adjustment	-1.0%	27.5%	-0.3%
GDP at basic prices	86.4%	5.6%	
Taxes on products	14.2%	-0.9%	-0.1%
Subsidies on products	-0.6%	0.5%	0.0%
GDP at market prices	100.0%	4.7%	4.7%

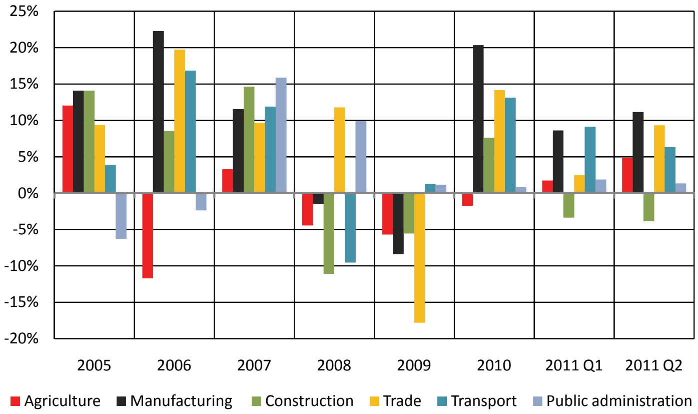
trend, decreasing by 2.6 pps in Q3. The deposit dollarization fell by 0.5%. High level of deposit dollarization is in turn conditioned by economic agents' expectations with respect to the lari's possible depreciation in the future. A general psychological factor related to political risks should be also mentioned, conducing to population's mistrust of the lari and giving the US dollar a status of a risk-free currency.

3.6. Production and Demand

In Q2 2011 the real growth of the gross domestic product slightly slowed down, increasing 4.7% year-on-year. The nominal GDP grew 15.9%, and the deflator rose 10.7%.

The largest contribution to the real GDP growth was produced by the trade sector, followed by manufacturing and financial intermediation. Significant positive impact was also made by transport, real estate, communication, and, to be noted

DIAGRAM 3.23
Dynamics of Value-Added Growth in the Leading Economic Sectors (2005 – Q2 2011)



in particular, agriculture[3].

Real contraction of value-added was recorded in construction and mining. Almost all other sectors posted positive growth rates in Q2, although their contributions to the annual GDP growth were relatively small.

The sectoral analysis of produced value-added accounting for seasonability shows that financial intermediation and manufacturing industry displayed high and stable growth rates during the last year.

Despite annual contraction of real value-added in construction, the seasonally adjusted data showed a positive growth of the sector in Q2.

During the last years the real growth of the largest economic sectors in Georgia is characterized with dissimilar trends. In 2010 the majority of these sectors grew significantly (See Diagram 3.23), while slowing down in the first half of the year[4]. It is remarkable that after a few-year recession the agricultural sector started to grow.

3.6.1 Private and Government Consumption

In Q2 2011 the nominal GDP increased 15.9% year-on-year powered by growth of final consumption and exports. In Q2 the final consumption expenditures rose 12.2%, while exports grew 30%.

It is remarkable that in contrast to the preceding years, export of goods and services became the driving force of the economic growth, producing a large positive impact on the overall value-added.

In Q2 2011 the largest component of the total final consumption, “final household consumption“[5] grew 18.1% year-on-year. As a result, deflating with the CPI, the real final consumption of households rose approximately 5% year-on-year. Besides, the real final expenditures on households[6] grew at a lower rate(4.1%) than the real GDP (4.7%), displaying the lack of inflationary pressure on the part of consumption.

Relative to Q2 2011, the government expenditures declined 7.1%, owing to a 10.2% decrease in expenditures on collective services.

The import of goods and services grew 18.7% year-on-year. It should be noted that the growth rate of imports remained high (at 25-30%) after Q1 2010, implying a significant slowdown in the growth rate of imports in Q2 2011.

3 The growth rate of agriculture and its contribution to the overall GDP were the highest in more than 3 years.

4 The base effect is important in describing these developments. In particular, in the first half of 2010 the growth rate of primary economic sectors was “enhanced” by the 2009 recession background, while the economic performance in the first half of 2011 is measured against positive developments of the first half of 2010.

5 The share of households in the total final consumption expenditures equaled 82.3% in Q2 2011.

6 “Real final expenditures on households” are calculated as the difference in expenditures on “total final consumption” and “collective government services”.

3.6.2 Investments

In Q2 2011 the growth rate of fixed capital investments decelerated to annual 15.5%. The enterprise inventories rose significantly again (at 73%), albeit still falling behind the pre-crisis level in absolute terms.

Overall, the annual growth rate of "gross capital formation" equaled 22.2% in Q2 2010. It should be noted that the latter almost reached the pre-crisis level in nominal terms, conditioned by high growth rates of investment during 2010 and the first half of 2011. After being on an impressive uptrend over an extended period, in Q2 2011 the growth rate of investment relatively stabilized.

3.6.3 2011 Forecast

In Q2 2011 the actual GDP growth turned out to be higher than it was forecasted, leading to upward revisions of Q3 and Q4 growth forecasts. These revisions were mainly conditioned by higher-than-expected level of economic activity of large enterprises.

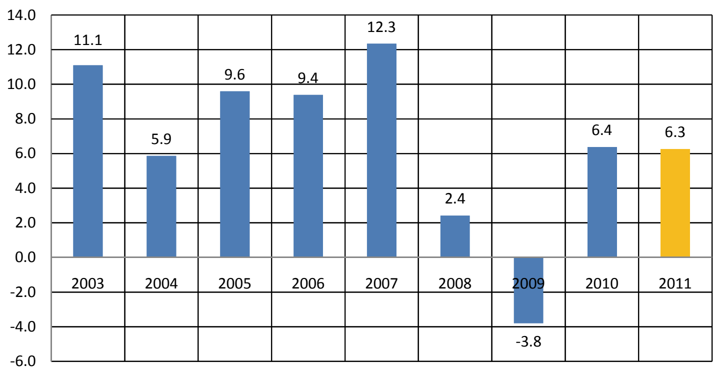
In Q3 2011 the GDP is expected to grow at approximately 7.3%. This forecast, along with sectoral data analysis, takes into account VAT taxpayers' turnover in Q3 (a 23.2% growth year-on-year) as well as the dynamics of PPI and CPI.

The primary contributions to the 7.3% real GDP growth in Q2 2011 are expected to be produced by trade, manufacturing, financial intermediation, real estate operations, communication, and agriculture. Due to the large growth, positive impact on GDP will be made by "hotels and restaurants" and "production and distribution of electricity, natural gas, and water".

In Q3 2011 the nominal GDP is projected to growth 16%. In terms of categories of use, the largest growth determinant represents the "final consumption" component with an annual 15% increase. In Q3 the "gross capital formation" component is likely to play an important role as well.

On the whole, the 2011 real GDP growth forecast has been revised upwards to 6.3%, almost equaling the actual 2010 growth level (6.4%).

DIAGRAM 3.24
Real GDP Growth, 2003-2011[7](%)



7 NBG's projections are used for the 2011 growth rate.

Box 2
Dynamics of Savings in Georgia

With the view of sustaining long-term economic growth it is desirable to have a high rate of a national saving rate[8]. The latter remains quite low in Georgia, and in the recent years it rather tended downwards. During the last eight years final consumption in the country has been growing more rapidly compared to gross disposable income.

DIAGRAM 3.25
Breakdown of Gross National Disposable Income

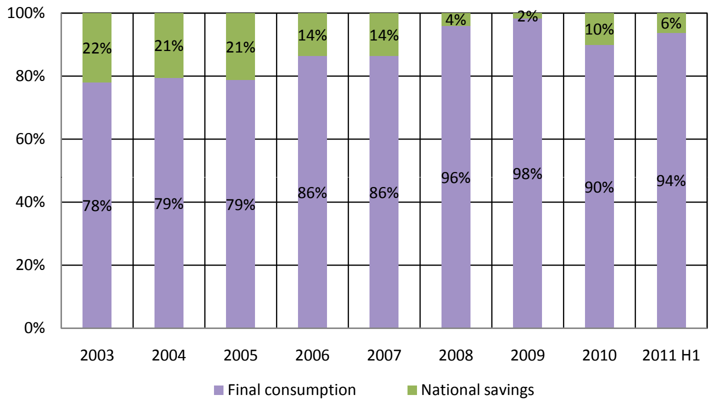
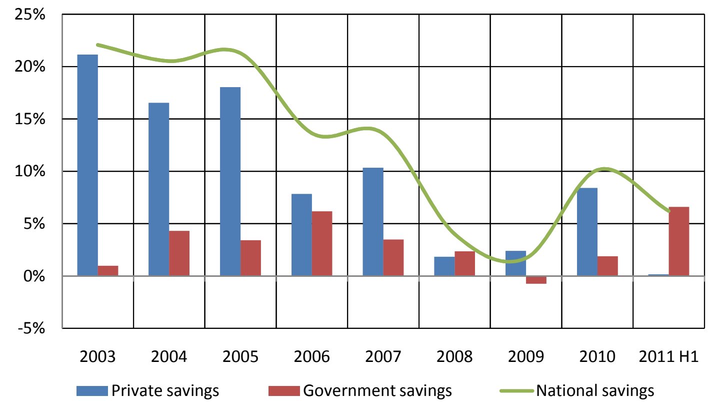


DIAGRAM 3.26
Ratios of National, Government, and Private Savings with Respect to Gross Disposable Income (%)



The national savings particularly declined during 2005-2009. The indicators can be considered as the sum of savings in the private and government[9] sectors.

As we can see from the Diagram above (See Diagram 3.26), private savings accounted for the largest share of national savings, and the decline in the latter was largely conditioned by decreased private savings.

In 2006-2008 the growth of final consumption (and, thus, decrease in savings) was fueled by consumer credit boom (See Diagram 3.27)against the backdrop of essentially positive economic expectations among the population.

In 2006-2008 the volume of banks' credit portfolio had been growing at a particularly high pace, with the growth rate of deposits falling behind that of credits by 10 pps. The reasons of such credit boom were related to a rapid increase in FDIs and relatively cheap external borrowings. As a result, by end-Q2 2008 the overall volume of bank loans extended exceeded the volume of deposits in the system by 32%. This obviously increased supply in the consumer loan market as well, translating into an increased household consumption.

In the second half of 2008 and in 2009 subsequent decline in private savings is explained by the fact that the population did not cut total consumption under the deteriorated conditions

8 A national saving rate is calculated as the difference between the gross national disposable income and total final consumption.

9 Government savings equal the sum of the budget deficit (surplus) and government sector's investments in non-financial assets.

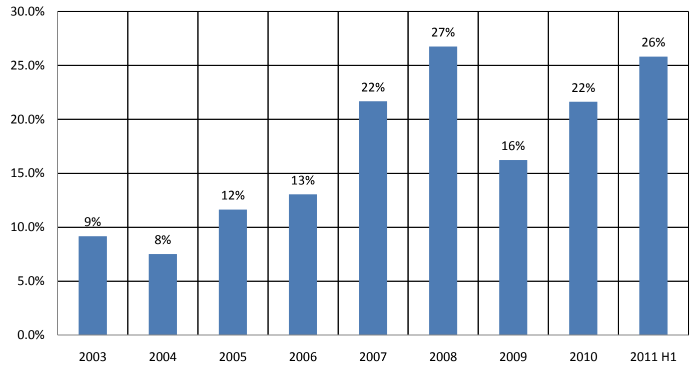
of credit availability. In addition, in 2009 the total disposable income in the country fell approximately 5%, which, along with maintenance of the same consumption level, led to a sharp decline in savings.

In 2010 the growth of consumption was accompanied with a certain increase in private savings. However, in the first half of 2011 a sharp rise in consumer credit moved private expenditures down again, and national savings were almost equal to government savings.

The households' saving rate is determined by such fundamental factors as the level of incomes, demographic and cultural factors, political and economic environment, etc. Changes in the saving rate require implementation of long-term steady policies.

DIAGRAM 3.27

Ratio of Consumer Credit Volume to Household Consumption, %



3.7 External Trade

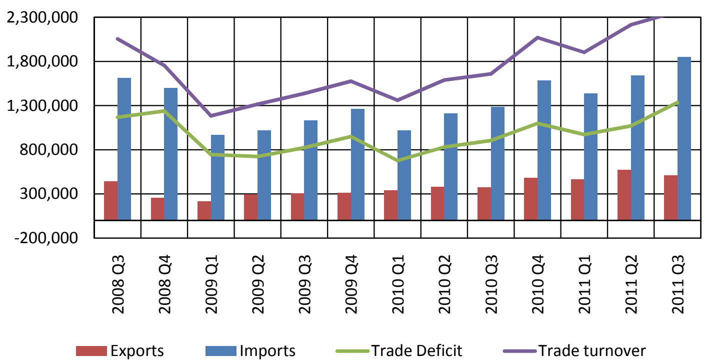
In Q3 2011 Georgia's external trade turnover totaled USD 2.4 billion, up 42.5% year-on-year. The registered exports and imports of goods equaled USD 514.5 million and USD 1.8 billion, up 36.3% and 44.3% year-on-year, respectively. As a result, in Q3 2011 the trade deficit widened to USD 1.3 billion, exceeding the corresponding level of 2011 by 42.5%.

In Q3 2011 the registered exports of goods declined 10.1% quarter-on-quarter, due to a drop in motor car re-export, while the registered imports and trade deficit posted respective growth rates of 12.6% and 24.8%.

In the reporting period the top export item represented re-export of motor cars, recording a 33.2% increase year-on-year and a 42.5% drop quarter-on-quarter. In Q2 2011 re-export of motor cars to Kazakhstan accounted for 62.0% of total motor car re-exports (USD 93.6 million). The reason of such increase was a legislative change with respect to motor car import duty in Kazakhstan. In Q3 2011 the value of total motor car exports to Kazakhstan equaled only USD 0.5 million. In the reporting period the largest part of motor car re-exports was traditionally shipped to Azerbaijan and Armenia.

The export of ferroalloys, traditional item in the Georgian exports, occupied the second position in Q3. The growth rate of ferroalloy exports equaled 53.4% year-on-year and 9.4% quarter-on-quarter. The growth was conditioned by both price and volume effects. The United States accounted for 39% of ferroalloy exports, followed by Turkey (19.2%). The third position in the export list was held by hazelnuts, posting a 73.8% year-on-year growth rate. 55.8% of hazelnut exports went to the EU countries. The export of gold, fourth in the export list, grew 36.3% year-on-year and 2.1% quarter-on-quarter, fueled by increases in international gold prices. The contraction of export of ferrous metals amounted to 5.1% in annual terms. The export of nitrogenous fertilizers, occupying the sixth place, rose 32.4% year-on-year and 32.2% quarter-on-quarter. The largest part of fertilizer exports went to the United States (42.6%), followed by Bulgaria (26.0%). In the reporting period the export of spirit and spirituous beverages totaled USD 16.3 million, posting an annual growth rate of 88.8%. The largest export destination of the latter products was Ukraine. Starting from Q2 2010 a new industrial commodity, rods and bars of non-alloy steel (so-called "armature"), entered the list of top ten export items, generating USD 15.3 million of export revenues in the reporting period and settling at the eighth position. The largest importer of the latter product is Azerbaijan. The export of wines posted a 34.1% annual growth rate, equaling USD 13.0 million. Ukraine accounted for almost half of wine exports, followed by Kazakhstan (14.4%). The export of mineral water grew 47.8% year-on-year to USD 12.0 million. 39% of mineral water exports went to Ukraine and 28.4% - to Kazakhstan. The export of livestock rose 2.4 times in annual terms to USD 8.5 million, with Azerbaijan being the only

DIAGRAM 3.28
Exports, Imports, Trade Deficit and Trade Turnover (USD thousands)



export destination.

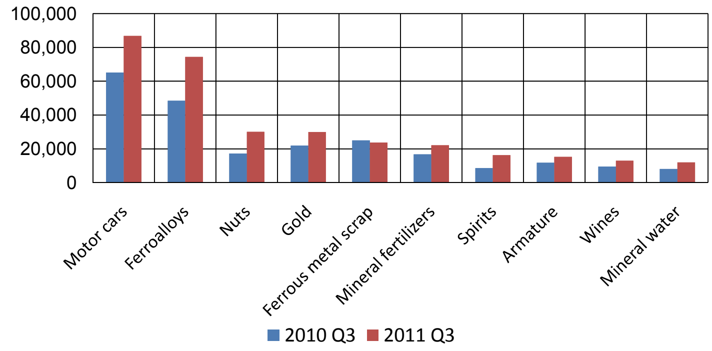
In Q3 2011 the top ten export items included: motor cars, ferroalloys, nuts, gold, ferrous metal scrap, mineral fertilizers, spirits, rods and bars of non-alloyed steel (so-called "armature"), wines, and mineral water. Investment goods accounted for 4.7%, intermediate consumption goods for 56.4%, and consumer goods for 38.7% of total exports.

With regard to imports, in the reporting period petroleum products traditionally occupied the first position, remaining on the uptrend with the 51.1% annual growth rate. The import of motor cars followed in the list, rising 15.2% year-on-year. The import of motor cars, second in the list, rose 22.9% year-on-year. The annual growth rate of import of petroleum gases equaled 34.3%, amounting to USD 27.3 million. The import of structures and construction materials made from ferrous metals totaled USD 31.7 million. These products were mainly used for different types of construction.

In Q3 2011 food products accounted for 12.3% of total imports, posting a 29.1% growth rate year-on-year and amounting to USD 228.2 million. The share of wheat and other grains in food imports equaled 24.3% (3.1% of total registered imports). The value of wheat imports rose 43.6% in annual terms. The following positions in food imports were occupied by sugar and sugar confectionery

DIAGRAM 3.29

Top Export Commodities in Q32010 and Q3 2011 (USD thousands)



(18.6% of food imports and 2.3% of total imports), meat and meat products (12.9% of food imports, with annual growth of 61.2%). The import of tobacco and alcohol products accounted for 2.4% of total registered imports, up 21.3% per annum.

The structure of imports in Q3 2011 was as follows: investment goods accounted for 14.1%, intermediate consumption goods for 39.5%, and consumer goods for 46.1%.

Georgia's top ten trading partners for exports were ranked as follows: Azerbaijan, Armenia, Turkey, the United States, Ukraine, Canada, Bulgaria, Italy, Kazakhstan, and Germany. These countries accounted for 75.2% of total registered exports.

In terms of imports, the top ten trading partners included Turkey, Ukraine, Azerbaijan, China, Russia, Germany, Bulgaria, the United States, Romania, and Italy, accounting for 70.5% of total registered imports.

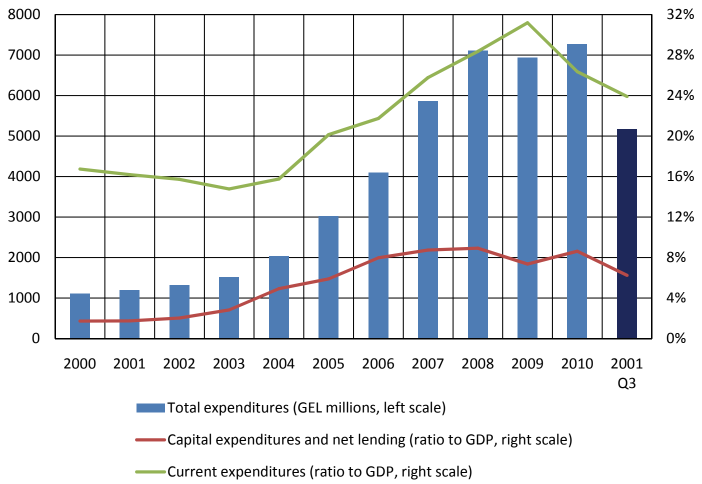
3.8 Government Operations

In Q3 2011 the consolidated budget revenues and grants totaled GEL 1,640.8 million. The grants equaled GEL 41.5 million, while tax and non-tax revenues stood at GEL 1,599.3 million. The revenue-to-GDP[10] ratio was 26.2%, down 1.3 pps quarter-on-quarter and 1.4 pps year-on-year. The tax burden (tax-to-GDP ratio) amounted to 23.6%, down0.5 pps quarter-on-quarter and up 0.7 pps year-on-year. The ratio of grants to GDP equaled 0.7%.

Table N 3.4
Consolidated Budget Parameters

	Q3 2011	Ratio to GDP (Q3 2011)
Total revenues and grants	1,641	26,2%
Revenues	1599	25,5%
Tax revenues	1481	23,6%
Non-tax revenues	119	1,9%
Grants	41	0,7%
Total expenditures	1842	29,4%
Current expenditures	1407	22,4%
Capital expenditures and net lending	435	7,0%
Deficit	-201	-3,2%
Deficit Financing	201	3,2%
Privatization	47	0,7%
Use of free circulating funds	37	0,6%
Net increase in domestic liabilities	-8	-0,1%

DIAGRAM 3.30
Dynamics of Budget Expenditures



10 NBG projections for Q3 2011 GDP are used.

The total expenditures of the consolidated budget amounted to GEL 1,842.1 million in Q3 2011, up GEL 49.2 million quarter-on-quarter and down0.4% year-on-year. The current and capital expenses amounted to GEL 1,407.2 million and GEL 434.9million, respectively. Capital expenses increased 32% relative to Q2 2011, but fell 20.1% with respect to Q3 2010. The ratio of total consolidated budget expenditures to GDP stood at 29.4%, down 0.9 pps quarter-on-quarter and 5.1 pps year-on-year.

In Q3 2011 the consolidated budget deficit amounted to GEL 201.3 million, constituting 3.2% of GDP. The primary source of deficit financing represented an increase in liabilities: a net growth of external liabilities equaled GEL 124.9million, and proceeds from privatization equaled GEL 47.2 million. . The volume of T-bills decreased by GEL 2.1 million, while government deposits at the NBG and circulating funds grew by GEL 5.3 million and GEL 31.6 million, respectively.

In Q3 the fiscal policy had an essential effect on money supply. In Q3 2011 the NBG's reserve money grew 5.6% (GEL 180.6 million). The contribution of government operations to the change in reserve money equaled -10.87 pps. The respective contributions of monetary operations and external sector equaled 9.5% and 7%.

As of end-September 2011, the state debt declined 4.7% (by GEL 422 million) quarter-on-quarter, equaling GEL 8.9 billion. The external liabilities decreased by GEL 422 million, while the domestic liabilities dropped by GEL 12 million. At the end of Q3 the total state debt constituted 37.1% of the forecasted GDP for 2011, down almost 2 pps from Q2 2011. The indicator remains far from the critical level (60% of GDP).

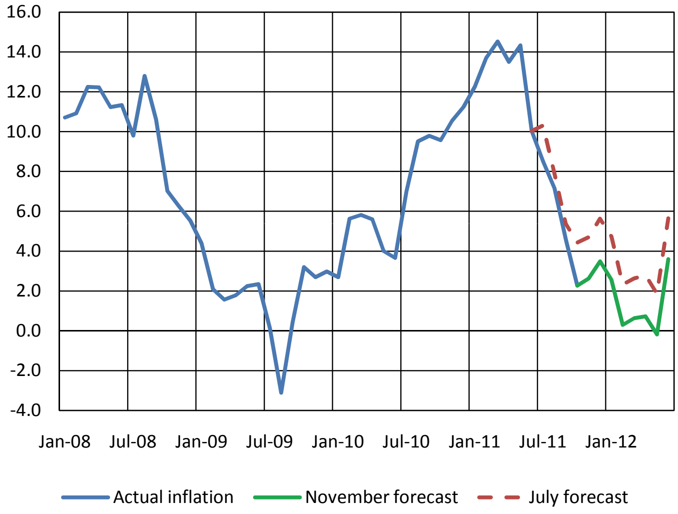
4. INFLATION FORECAST

In forecasting inflation the NBG uses two approaches. On the one hand, the NBG monitors indices for each product making part to the consumer 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 price trends for different commodity groups. In order to project price dynamics for individual commodity groups of the consumer basket, the available information on price determinants of individual products is used (seasonality, expected changes in international prices, changes in regulated prices, etc.).

In Q3 2011 the impact of external shocks on the annual inflation weakened, leading to an essential drop in inflation. In September the inflation rate equaled 4.6%. The core inflation indicators remain low, indicating weak demand pressure on prices and low inflation risks. By the end of the year seasonal factors are expected to move the consumer prices up, although the inflation rate will remain below the targeted level. In the first half of 2012 a further decline in annual inflation is expected, largely due to the base year effect, since the CPI significantly increased in the first half of 2011, plunging thereafter. In line with the current forecasts, a low inflation will prevail in the beginning of 2012, returning to the targeted level in the second half of 2012.Price dynamics in the international commodity markets are important for inflation forecasting. The forecast uses an assumption that regulated prices will remain unchanged in the coming year. Forecasts for other commodity groups of the consumer basket are based on the respective sectoral trends. In line with the above-mentioned, the inflation forecast shows that at the end of 2011 the inflation rate will stand at approximately 3.5%, further declining to 0.3% at end-Q1 2012, and then rising again to 3.6% at end-June 2012.

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



The econometric model of inflation dynamics represents a vector error correction model. It is remarkable that inflation forecasts based on this method are useful in a 6-month time horizon, losing precision for a longer period.

An updated inflation forecasting model is determined as follows:

$$\delta p = 0.071\delta p_{-1} + 0.037\delta m_{-1} + 0.032\delta m_{-2} + 0.034\delta m_{-6} - 0.077\delta e - 0.049\delta e_{-2} + 0.091\delta p^{food} + 0.01\delta p^{oil} + 0.004ecm$$

where:

p is CPI;

m is money mass;

e is GEL/USD exchange rate;

p^{oil} is an average world price on oil;

p^{food} are prices on fruits and vegetables;

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

$$ecm = p_{-1} + 0{,}1e_{-1} - 1{,}1m_{-1} + 3{,}0y_{-1} - 17{,}3$$

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

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

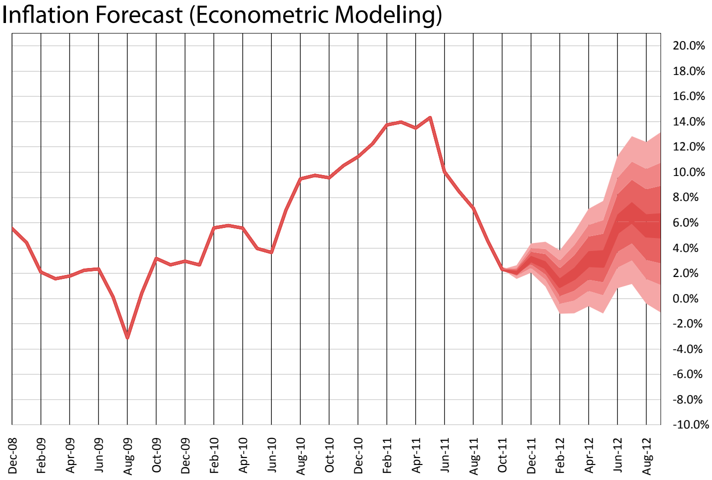
- Broad money M3 will annually grow at 16.8% by end-November 2011 and 15.5% by end-2011. The annual growth rate in 2012 will equal 22%;
- Prices on fruits and vegetables are assumed to follow an autoregressive process;
- The real GDP growth rate will equal 6.3%;
- The nominal effective exchange rate will remain unchanged;

The model estimation yields the following picture of the annual inflation forecast:

According to the obtained results, the annual inflation will oscillate in the range of 2.8% and 3.2% at end-2011. In Q1 2012 the annual inflation will decline to within 1.3%-2.1%, returning to the targeted level in the second half of 2012.

DIAGRAM 4.2

Inflation Forecast (Econometric Modeling)



5. DECISIONS OF THE MONETARY POLICY COMMITTEE

In Q3 2011 the NBG's Monetary Policy Committee held three meetings. At these meetings the NBG started a monetary loosening policy. During the first two meetings it was decided to cut the policy rate by 25 basis points, while at the September meeting the policy rate was left unchanged. At the October 26 meeting, the MPC decided to cut the policy rate further by 25 basis points, continuing the policy of monetary loosening.

Starting from Q3 2011 the annual inflation rate went into a pronounced downtrend. The annual inflation declined from 10% in June to 4.6% in September. These dynamics pointed to a larger-than-expected drop in actual inflation. As a result, the inflation forecasts were revised downwards, and the risks related to drop in inflation below the targeted level emerged. Accordingly, the MPC started monetary policy loosening with the purpose of keeping the inflation rate at the targeted level. It should be noted that the NBG conducts monetary policy loosening at small steps in order to avoid abrupt volatility of interbank interest rates. Stability of interest rates makes the interbank market more attractive for commercial banks, thus enhancing its development.

At the August MPC meeting it was pointed out that demand pressure on prices remained weak, as manifested in the dynamics of core inflation. The latter – inflation excluding food and fuel prices – amounted to 0.03% in August. Based on the above, the MPC decided to continue monetary policy loosening, cutting the policy rate by additional 25 basis points.

The MPC noted at the September meeting that the growth of banks' credit portfolio was significant, with a pronounced increase in domestic currency denominated loans. Due to the fact that the effects of monetary policy loosening were not yet fully reflected on the real economy, the Committee decided to leave the interest rate unchanged.

Meanwhile, with the view of promoting long-term financing of commercial banks, the MPC decided to reduce the required reserve ratios for long-term borrowings. In terms of remaining maturity, domestic currency borrowings with more than 1-year maturity period and foreign currency borrowings with more than 2-year maturity period were exempt from reserve requirements, while the required reserves on foreign currency borrowings with the maturity period between 1 and 2 years were reduced to 5%. These changes will provide incentives to commercial banks to focus on attracting long-termresources, containing less systemic risks.

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