



Central Bank in Georgia was first established in 1919

INFLATION REPORT

2011

NATIONAL BANK
OF GEORGIA



NATIONAL BANK OF GEORGIA

INFLATION REPORT
Q1 2011

TBILISI

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), the annual inflation rate amounted to 13.9% at end-March 2011. The contribution of food price increases to the overall inflation equaled 85%, compared to an average of 50% for the same indicator in the recent years. The growth of food share was conditioned by an abrupt rise in prices of this commodity group, as international prices on food products soared owing to the 2010 natural calamities and bad harvests. Prices also grew for all kinds of non-seasonal fruits and vegetables.

The annual inflation equaled 11.3% for domestic goods and 11.5% for imported goods. It should be noted that in the reporting period the inflation rate for non-tradable goods amounted to only 5.7%, while the prices on tradables increased 19.2%. It is remarkable that the core inflation (change in consumer prices excluding food and fuels) oscillates around 2%. The growth rate of prices on services is also low, equaling 2.1% in March. This structure of price increases clearly demonstrates the fact that high level of inflation was caused by price increases in the international commodity markets and that demand pressure on prices is weak.

The dynamics of main inflation factors can be described as follows: the labor productivity of employed in the economy increased 5.2% in Q4 2010, while the average monthly wages of hired employees equaled GEL 664.4. In the same period, the growth rate of wages slowed down relative to the preceding quarter, amounting to 5.5%. Approximately equal growth rates of average wages and labor productivity indicate that unit labor costs practically remained unchanged, implying that the labor market did not exert a significant impact on inflation.

In Q4 2010, the economic growth tendencies were sustained, as the real GDP growth equaled 6%. The real final household consumption adjusted for the CPI rose 3.4%. Lower growth rate of real consumption with respect to the economic growth indicates absence of demand pressure on prices.

In Q4 2011, the lari's real and nominal effective exchange rates appreciated 4.5% and 1.9%, respectively. The lari's appreciation in the reporting period was conditioned by a number of factors. These included tourism revenues, money remittances from abroad, higher growth rates of FX loans relative to domestic currency loans, as well as the US dollar's depreciation in the international markets and, consequently, the expectation of lari's appreciation. The lari's appreciation exerted a downward pressure on import prices.

In Q1 2011, the amount of loans extended by commercial banks increased by GEL 91.8 million, totaling GEL 6,428.9 million. The annual growth rate of economy crediting stood at 18.6% by end-March 2011. The amount of domestic currency loans grew by GEL 68.5 million, amounting to GEL 1,720.3 million, while the volume of foreign currency loans increased by USD 117.3 million to USD 2,760.2 million. The annual growth rates loans denominated in domestic and foreign currency stood at 31.2% and 14.6%, respectively.

In Q1 2011, the deposit liabilities of the banking system contracted by GEL 75.9 million in nominal terms, amounting to GEL 4,764.8 million. The annual growth rate of deposits equaled 34.2%. In the accounting period, the volume of lari denominated deposits contracted 2.2% to GEL 1,329 million, while the foreign currency deposits, excluding the exchange rate effect, rose 2.5% to GEL 3,570 million. In the reporting period there was a remarkable 3.9% increase

in non-residents' deposits, amounting to GEL 555.6 million by end-March.

In the reporting period the total deposit dollarization increased by 0.2 pps to 72.1% at end-March. Dollarization increased for individuals' deposits as well (by 0.1 pp), remaining high at 87.5%. The weighted average interest rates on domestic and foreign currency deposits grew by 1.7 pps and 0.6 pps to equal 11.9% and 8.2%, respectively.

In order to temper inflationary expectations the NBG tightened monetary policy in Q1 2011 by means of interest rate hike and increases in reserve requirements on FX funds to 15%. In the same period, the NBG continued using monetary instruments with the

purpose of enhancing effective liquidity management in the banking sector and promoting revitalizing of the latter. The average volume of funds on commercial banks' corresponding accounts in Q4 2010 approximately equaled the minimum average level of required reserves. In the reporting period demand for the NBG's Certificates of Deposit significantly exceeded supply, resulting in a total CD placement of GEL 455 million.

According to the NBG's forecasts, inflation is set to decline in the following months. The current projections estimate the inflation rate to oscillate in the range of 13.95%-14.35% by end-June and 6.35%-7.69% at end-year.

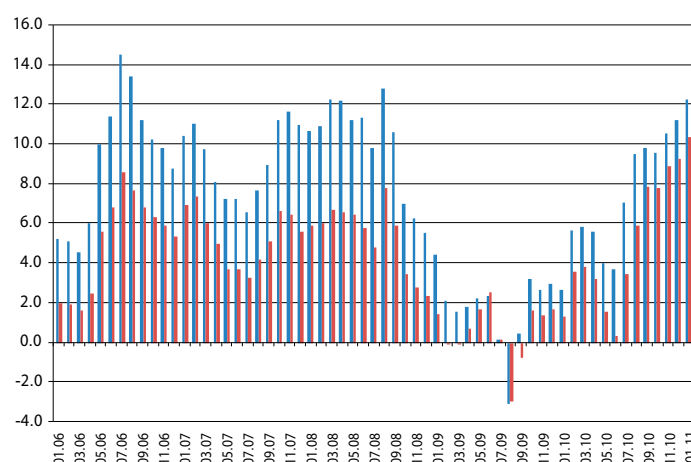
2. CHANGES IN CONSUMER PRICES

According to the National Statistics Office of Georgia (Geostat), in Q1 2011 the general level of consumer prices rose 4.9% in quarterly terms. As a result, the annual inflation rate increased from 11.2% at end-Q4 2010 to 13.9% at end-March 2011. The annual average inflation rate grew by 2.2 pps to 9.3%.

The main impact on the quarterly inflation was exerted by food price increases. In Georgia as a less developed country, the share of food in the consumer basket is relatively large, accounting for 40.5%. Accordingly, sensitivity of inflation to changes in food prices is high. Food prices in the international markets are significantly volatile, thus, affecting inflation, i.e. an essential part of inflation volatility is due to food price changes.

In 2006-2009, the impact of food prices on inflation averaged 50%. In 2010, spoiled harvest due to droughts, fires and other natural calamities significantly influenced formation of international food prices. Wheat prices sharply increased, directly affecting bread and bakery and making an essential impact on substitutes (cereals, sunflower) and products dependent on wheat (beef and poultry meat, milk and dairy products). Sharp increases in food prices were also significantly conditioned by agricultural deficit due to bad harvests. Based on the above, starting from the second half of 2010 against the background of large price gains in the international markets the contribution of food prices to the overall inflation reached almost 86%.

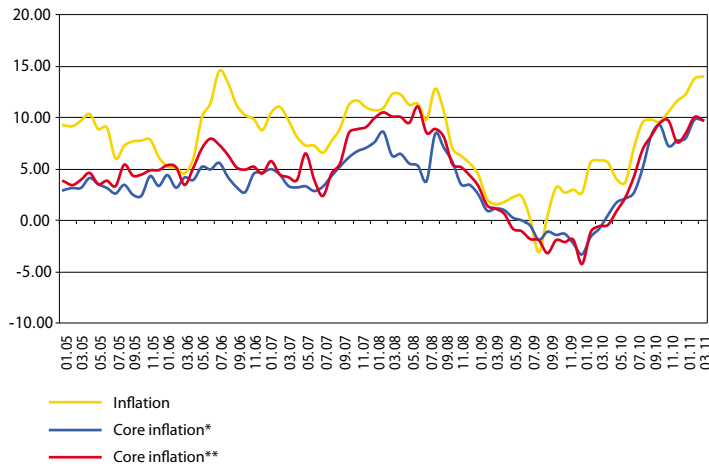
DIAGRAM 2.1
Impact of Food Prices on Inflation



In the reporting period relative to the preceding quarter the rise in consumer prices was significantly conditioned by an increase in utilities fees, in particular, garbage collection fee and bus and minivan fares. The latter in turn represented a result of risen prices on gasoline and diesel. Similar to price gains for food, transport, and utilities, prices grew for other commodity groups as well, although at a lower rate. Conversely, prices declined for healthcare and education commodity groups. Ultimately, in Q1 2011 the consumer prices rose 4.9%.

As it was already mentioned, in March 2011 the annual inflation grew 13.9%. Prices rose for diesel and gasoline (12.1% and 10.0%, respectively). High annual inflation was largely conditioned by goods from the "food and non-alcoholic beverages" and "alcoholic beverages and tobacco" commodity groups. In par-

DIAGRAM 2.2
Annual and Core Inflation Rates (for 266 components of the consumer basket, effective since December 2009)¹



particular, year-on-year price increases for the following commodity groups were registered in March 2011: “fruits and grapes” (65.1%), “vegetables and melons” (41.0%), “oils and fats” (36.8%), “bread and bakery” (25.0%), and “meat and meat products” (22.0%). Prices also grew for “other food products” (20.5%), “milk, cheese, and eggs” (18.5%), and “sugar and pastry” (15.6%). The annual growth rate of prices for “alcoholic beverages, tobacco” amounted to 9.6%.

In March 2011, the annual price growth for “transport” equaled 9.8%. Prices also rose for “other goods and services”, “hotels, cafes, and restaurants”, and “furniture and household appliances” (8.6%, 8.5%, and 4.5%, respectively).

In the same period prices decreased only for two categories. In particular, prices for “communication” and “recreation and culture” declined, respectively, 7.3% and 0.5%.

In Q1 2011, the core inflation rates posted annual increases. In particular, in the reporting period the annual core inflation rates rose 9.74% and 9.73% for products within two and one standard deviations, respectively.

The core inflation rate excluding food and fuels has been low for a long period. In Q1, this indicator tended to decrease, amounting to 2.3% at end-March. A low level of core inflation indicates weak demand pressure on prices.

DIAGRAM 2.3
Core Inflation Excluding Food and Fuels

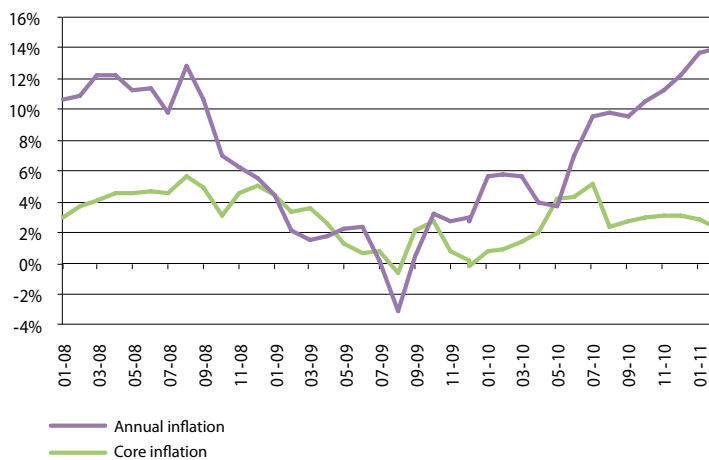
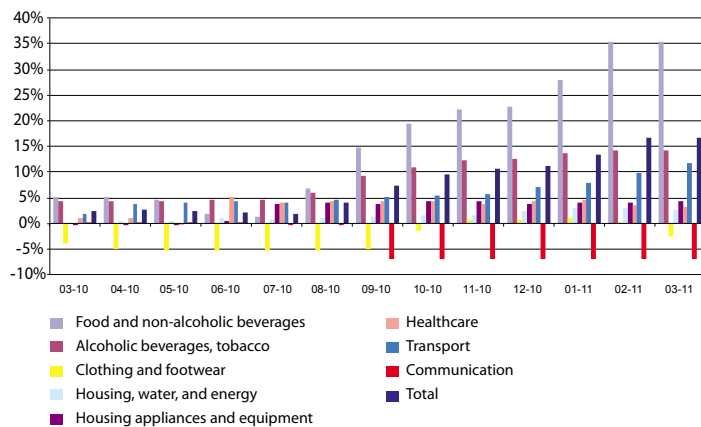


DIAGRAM 2.4
Price Increases with Respect to December 2009



¹* For products within one standard deviation.
²** For products within two standard deviations.

In the reporting quarter the annual inflation on imported goods amounted to 11.5%. This indicator was rapidly increasing in recent months, reflecting tendencies of price increases in the international markets. The domestic inflation rate equaled 11.3%. In the same period, prices for non-tradables rose 5.7%, while the annual price gains for tradable goods reached 19.2%. Such growth of inflation for tradables was also the result of price increases in the international commodity markets.

The analysis of inflation by consumption durability shows the following annual inflation rates: 19.7% for non-durable goods, 1.3% for semi-durable goods, and 1.9% for durable goods. In Q1 the annual inflation rate for services equaled 2.1%.

DIAGRAM 2.5
Annual Inflation by Production Location

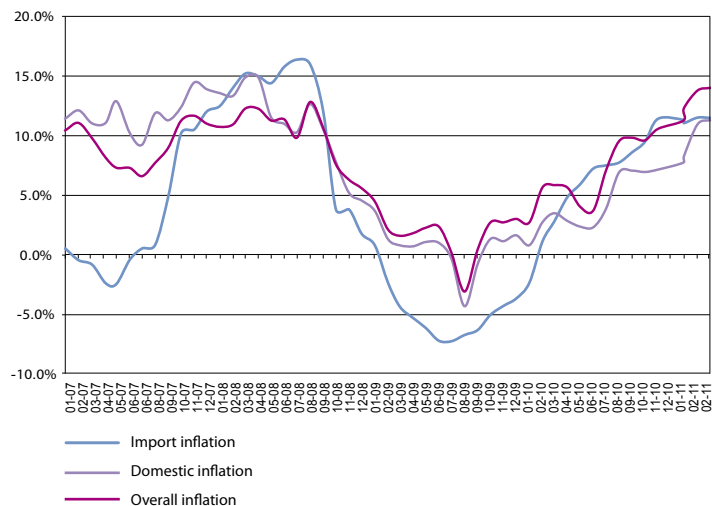


DIAGRAM 2.6
Inflation for Tradable and Non-Tradable Goods

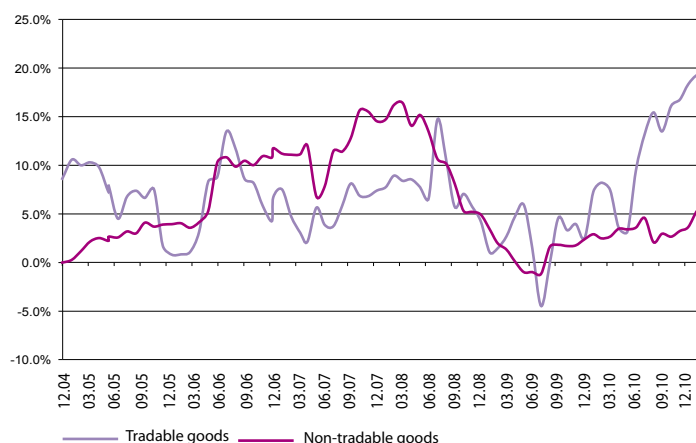


DIAGRAM 2.7
Changes in Annual Inflation Rates for Products with Various Consumption Durability

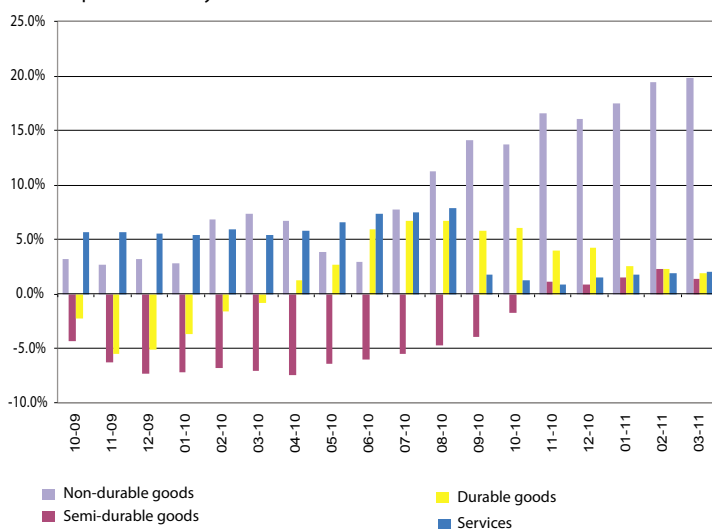


TABLE 2.1
CPI Inflation by Components (%), Consumer Basket Weights (%), and Individual Contributions to Inflation (pps)

	December 2009 weights	Mar10/Dec10		Mar11/Mar10		Mar10-Feb11/Mar09- Feb09	
		Inflation	Impact	Inflation	Impact	Inflation	Impact
Total	100.0%	4.9%	4.9%	13.9%	13.9%	9.3%	9.3%
Food and Nonalcoholic beverages	40.1%	10.2%	4.5%	28.6%	11.8%	17.0%	6.8%
Food	40.5%	10.4%	4.7%	29.2%	12.1%	17.3%	7.0%
Bread and bakery	11.7%	5.8%	0.7%	25.0%	2.9%	13.7%	1.6%
Meat and meat products	6.8%	12.9%	0.9%	22.0%	1.5%	9.0%	0.6%
Fish products	1.3%	1.8%	0.0%	9.8%	0.1%	5.2%	0.1%
Milk, cheese, and eggs	4.8%	-1.0%	-0.1%	18.5%	0.8%	12.4%	0.6%
Oils and fats	3.5%	4.6%	0.2%	36.8%	1.3%	22.2%	0.8%
Fruits, grapes	1.8%	36.1%	0.8%	65.1%	1.3%	30.0%	0.5%
Vegetables, melons, potatoes and other tubers	7.8%	16.9%	1.7%	41.0%	3.7%	25.7%	2.1%
Sugar, jams, honey, syrups, chocolate, pastry	2.3%	13.7%	0.3%	15.6%	0.4%	18.3%	0.4%
Other food products	0.4%	13.1%	0.0%	20.5%	0.1%	9.1%	0.0%
Nonalcoholic beverages	1.3%	3.2%	0.0%	11.0%	0.1%	7.5%	0.1%
Alcoholic beverages, tobacco	2.9%	1.7%	0.0%	9.6%	0.3%	8.9%	0.3%
Clothing and footwear	4.3%	-3.2%	-0.1%	1.5%	0.1%	-3.8%	-0.2%
Housing, water, electricity, gas and other fuels	13.9%	0.1%	0.0%	2.5%	0.3%	1.9%	0.3%
Furnishings, household equipment, routine house maintenance	3.6%	0.4%	0.0%	4.5%	0.2%	2.1%	0.1%
Healthcare	9.0%	-1.1%	-0.1%	2.2%	0.2%	3.3%	0.3%
Transport	10.4%	4.4%	0.4%	9.8%	1.0%	8.6%	0.9%
Communication	4.2%	-0.1%	0.0%	-7.3%	-0.3%	-4.1%	-0.2%
Recreation and Culture	2.2%	-0.6%	0.0%	-0.5%	0.0%	-0.6%	0.0%
Education	5.2%	0.1%	0.0%	0.7%	0.0%	17.3%	0.8%
Hotels, cafes and restaurants	1.8%	2.6%	0.0%	8.5%	0.2%	5.2%	0.1%
Miscellaneous goods and services	2.5%	1.1%	0.0%	8.6%	0.2%	6.3%	0.2%
Non-durable goods	67.9%	6.9%	4.9%	19.7%	13.6%	12.4%	8.5%
Semi-durable goods	5.8%	-2.3%	-0.1%	1.3%	0.1%	-2.5%	-0.1%
Durable goods	3.4%	-0.3%	0.0%	1.9%	0.1%	4.2%	0.1%
Services	22.8%	1.1%	0.2%	2.1%	0.5%	3.7%	0.8%

3. Inflation Factors

3.1 LABOR MARKET

The preliminary data for Q4 2010 shows that the labor productivity of employed in the economy posted a 5.2% growth rate year-on-year. The average wages grew at approximately the same rate (5.5%). However, compared to the preceding two quarters the annual growth rates of labor productivity and average nominal wages slowed down ².

In Q4 2010 significant annual growth rates of real value-added per employed were registered in the following sectors: "transport and communication" (17.3%), "real estate operations, renting and business activities" (16.8%), and "trade" (12.7%). It should be noted that high growth rates in these sectors were present in the preceding period as well.

Relatively slower growth rates of labor productivity were registered in education and construction sectors.

In Q4 2010 an annual decline in real-value added per employed was posted in industry (-8.2%), "hotels and restaurants" (-6.2%), healthcare (-6.2%), public administration (-2.6%) and agriculture (-2.4%).

In Q4 2010 the average monthly wages in the economy equaled GEL 664.4³, up 5.5% year-on-year. The majority of economic sectors posted positive growth rates of average monthly wages in annual terms.

TABLE 3.1

Growth of Real Value-Added per Employed in Q4 2010, year-on-year

	Value-Added Index
Agriculture and Processing of Agricultural Products	97.6
Industry	91.8
Construction	102.0
Trade	112.7
Hotels and Restaurants	93.8
Transport, Communication	117.3
Financial Intermediation	122.2
Real Estate, Renting and Business Activities	116.8
Public Administration, Defense	97.4
Education	105.1
Health	93.8
Total	105.2

The sectoral analysis shows the largest increase in nominal wages in "fishing, fishery", equaling 85% in annual terms. High growth rates were registered in "agriculture" (22%), "hotels and restaurants" (19%), "trade" (16%), "healthcare and social work" (15%) and "mining and quarrying" (14%). Double-digit growth rates (between 10% and 13%) were posted by "manufacturing", "public administration", "education", and "community, social and personal services". A modest growth of average wages was present in the "communication" sector.

² The annual productivity growth in Q2 and Q3 2010 averaged 6.7%, while the average wage growth equaled 7.1%.

³ Source: Business and Labor Statistics surveys, Geostat.

TABLE 3.2.
2010 Average Wages of Hired Employees in Q4 2010

	Nominal Wage Index
Agriculture, hunting and forestry	122.4
Fishing, fishery	185.2
Mining and quarrying	114.1
Manufacturing	111.0
Production and distribution of electricity, gas, and water	100.9
Construction	106.4
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	116.4
Hotels and restaurants	119.4
Transport and communication	105.8
Financial intermediation	90.3
Real estate, renting and business activities	83.8
Public administration	112.6
Education	110.0
Healthcare and social work services	114.8
Other community, social and personal service activities	109.9
Total	105.5

In Q4 2010 significant inequalities in average wages across different sectors were maintained. The highest average monthly wages were still in “financial intermediation” (GEL 1,312, up 3% quarter-on-quarter), and “public administration” (GEL 1,075, up 14.5% quarter-on-quarter). The average wages in these two sectors exceeded the average wage level of the economy 2.0 and 1.6 times, respectively. Despite high quarterly growth rates, the lowest average wages of hired employees are traditionally registered in “education” (GEL 335) and “agriculture” (GEL 398), accounting for 50% and 60%, respectively, of the national average. It should also be noted that the difference between the highest and the lowest sectoral wages narrowed 15% in annual terms (due to a decrease in the highest average wages), while this difference with respect to the preceding quarter remained practically unchanged.

Despite a positive growth of value-added per employed throughout 2010, in Q3 and Q4 the quarterly growth rate of labor productivity in the country slowed down. This came as no surprise since labor productivity was rapidly rising in the first half of the year (by 7 pps on average quarter-on-quarter).

DIAGRAM 3.1
Average Sectoral Wages of Hired Employees, Q4 2010 (GEL).

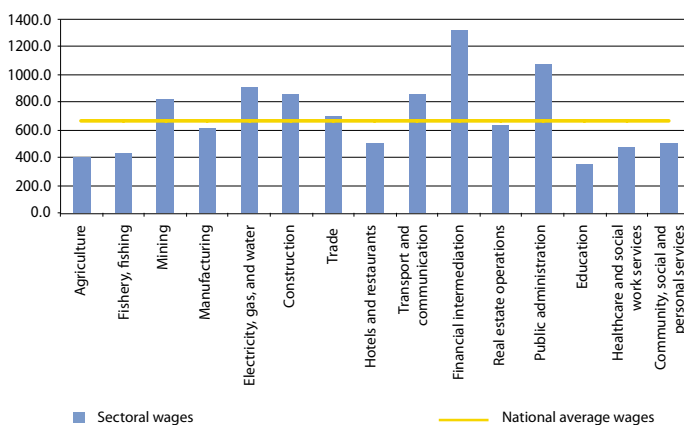
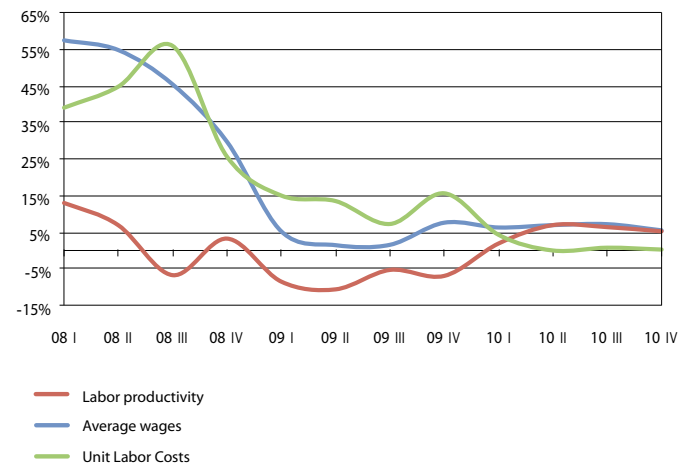


DIAGRAM 3.2
Labor Productivity, Average Monthly Wages of Hired Employees and Unit Labor Costs (Annual percentage change)



In parallel, at the end of 2010 the growth rate of average wages also slowed down, decreasing from 7.2% in Q3 to 5.5% in Q4.

Overall, similar to the preceding quarter in Q4 2010 the average wages and labor productivity rose approximately at the same rate. As a result, their ratio, i.e. unit labor costs⁴ remained practically unchanged. This implied that labor market did not exert significant upward or downward pressure on the general price level.

3.2 MONETARY INSTRUMENTS

In Q1 2011 the NBG applied tight monetary policy aiming at reduction in the level of inflation and inflationary expectations. Changes affected the monetary policy rate and minimum reserve requirements for borrowing in foreign currency. In February the policy rate was increased from 7.5% to 8%, while the reserve requirements for FX liabilities grew initially from 5% to 10%, finally reaching 15% in January-February 2011.

In the reporting period the NBG actively used monetary instruments of both liquidity supply and liquidity withdrawal. Short-term liquidity was supplied through refinancing loans, used for regulating interbank interest rates. Medium-term excess liquidity withdrawal was performed by means of Certificates of Deposit.

Liquidity demand of the banking sector was conditioned by the average required level of reserves. In the reporting period the average volume of funds on the corresponding accounts equaled GEL 183.9 million, only slightly exceeding from the required level of reserves – GEL 183.1 million. In Q1 2010 the available funds on the corresponding accounts totaled

GEL 286.9 million, whereas the required level of reserves was GEL 63.7 million. A narrowing of this difference occurred starting from Q2 2010, owing to an increased activity in the interbank money market, a rise in lari reserve requirements, and an introduction of the permanent refinancing loans, which enhanced more effective liquidity management by commercial banks.

In the reporting period the average liquidity ratio equaled 40.4%, up 1.2 pps quarter-on-quarter. By end-March 2011 the liquidity ratio was registered at 42.2%, significantly exceeding the 30% compulsory level set by the banking supervision.

DIAGRAM 3.3
Lari Liquidity

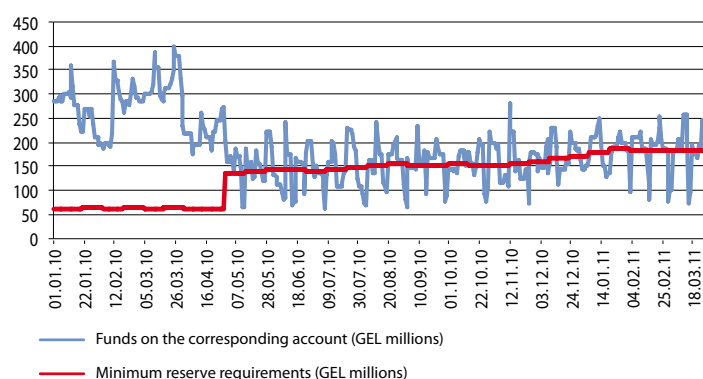
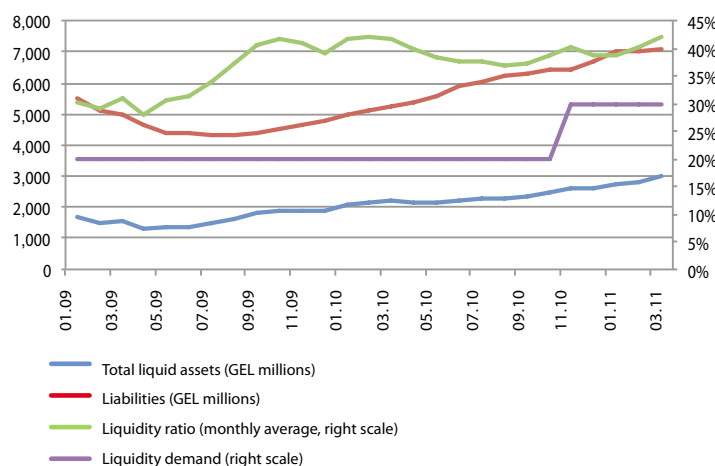


DIAGRAM 3.4
Dynamics of Liquid Assets and Liabilities, Liquidity Ratio, and Liquidity Demand.



⁴ Same as wage (personnel) costs as a percentage of real value-added (GDP).

DIAGRAM 3.5
Dynamics of CD Auctions

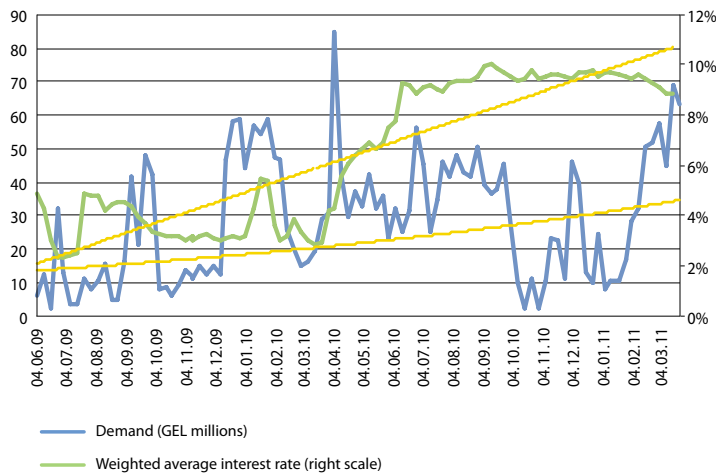
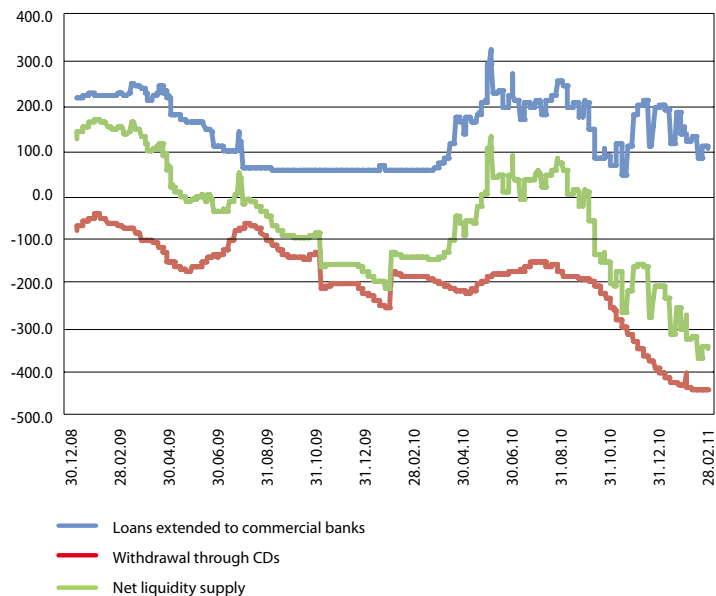


DIAGRAM 3.6
Liquidity Withdrawal through CDs, Loan Extension to Commercial Banks and Net Liquidity Supply (GEL millions)



In Q1 2011 the NBG continued withdrawal of liquidity from the banking system by means of CDs. The placement value of securities totaled GEL 455 million, while demand exceeded supply 2.5 times. Issuance of CDs grew 26.4% in quarterly terms, while demand rose 33.9% in the same period.

The short-term liquidity deficit in the banking system was covered by the NBG through one-week refinancing loans extended via auctions. Banks began actively using this instrument starting from Q2 2010, owing to an introduction of standing refinancing instrument. In the reporting period the total volume of extended one-week refinancing loans equaled GEL 1,705.95 million, exceeding the Q4 2010 level by 21%. In addition, two standing refinancing loans were extended in the total amount of GEL 63 million. The weighted average interest rate increased by 0.5 pps with respect to the preceding quarter, amounting to 7.9%. The growth of the weighted average interest rate was due to monetary policy tightening, manifested in an increase of the policy rate from 7.5% to 8% in February 2011.

In the reporting period the ratio of net liquidity withdrawal to reserve money averaged 16.7%, exceeding 2.2 times the Q4 2010 level. As of March 31, 2011, the net liquidity withdrawal equaled GEL 354.4 million.

3.3 INTERBANK LOANS

In Q1 2011 the volume of loans extended in the Tbilisi interbank credit market decreased relative to Q4 2010; the loans extended in domestic currency fell 14%, totaling 2011 GEL 1.63 billion. On the other hand, the loans denominated in the US dollars increased, amounting to USD 154.6 million, up 18.3%. The euro-denominated loans registered a significant growth, reaching EUR 33.31 million, compared to EUR 2.168 million in Q4 2010.

The share of overnight loans increased again, accounting for 76.5% of the lari loans, up from 66.5% in the preceding quarter.

The share of overnight loans in total US dollar loans equaled 74.9%, while the same rate for the euro-denominated loans remains low at 34.5%.

The dynamics of transactions in the interbank credit market was appropriately reflected in the interest rates and interbank loan indices: the average quarterly rate of TIBR-1 slightly increased to 7.54% from 7.17% in the preceding period. The average quarterly TIBR-7 rate also increased in the same period, rising from 7.92% to 8.33%.

3.4 BANKING SECTOR

At end-Q1 2011 the credit portfolio of the banking sector totaled GEL 6,428.9 million, up by GEL 91.8 million from December, 2010. The annual growth rate amounted to 18.6%.

The quarterly growth was largely conditioned by an increase in lari-denominated loans (65.2%). In this regard the impact of short-term loans extended to legal entities was significant, equaling GEL 36.9 million. Overall, as of Q1 2011, the long-term loans account for 70.9% of the credit portfolio, of which four-fifth is extended in foreign currency.

The portfolio dollarization rate equaled 73.2% in nominal terms by the end of the reporting period, down by 0.7 pps quarter-on-quarter. However, the nominal decline was largely due to appreciation of the domestic currency (with respect to the US dollar).

The volume of lari-denominated loans (excluding overdue loans) was steadily increasing in the reporting period, in contrast to loans in foreign currency. The latter declined by GEL 112.4 million after posting a positive growth in January, owing to a gradual increase in reserve requirements set by the NBG for

DIAGRAM 3.7
Short-term Interbank money market rate and Monetary Policy Rate

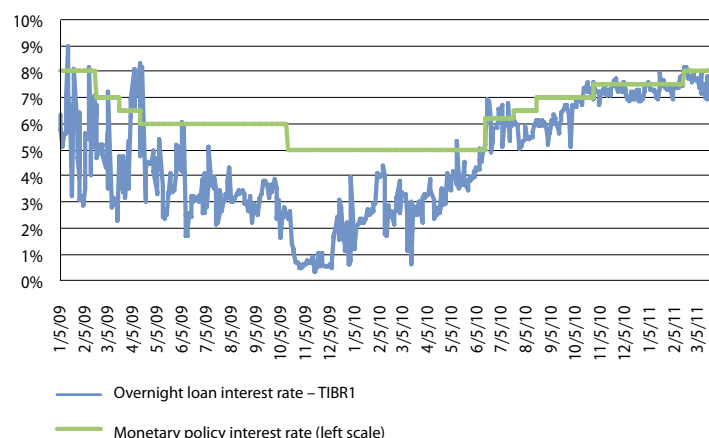


DIAGRAM 3.8
Short-Term Loans in Domestic Currency, GEL millions

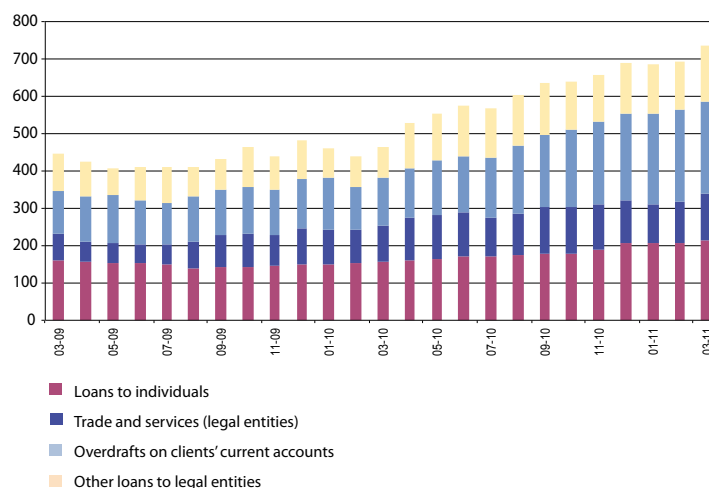


DIAGRAM 3.9
Short-Term Loans in Foreign Currency, GEL millions

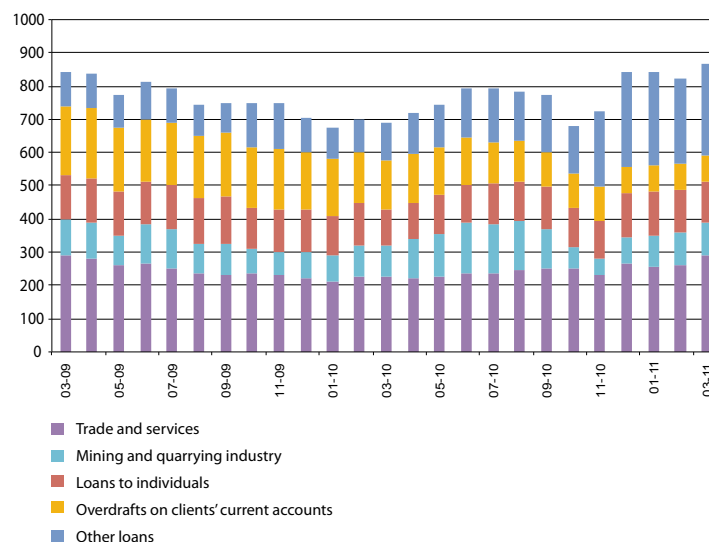


DIAGRAM 3.10
Long-Term Loans in Domestic Currency, GEL millions

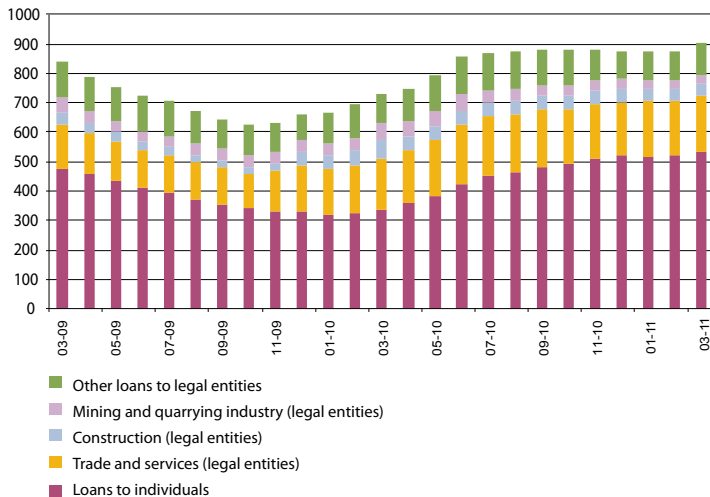


DIAGRAM 3.11
Long-Term Loans in Foreign Currency, GEL millions

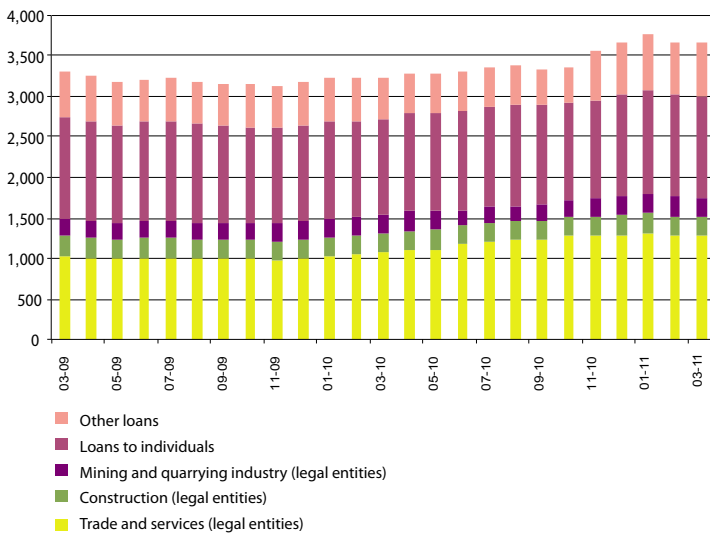
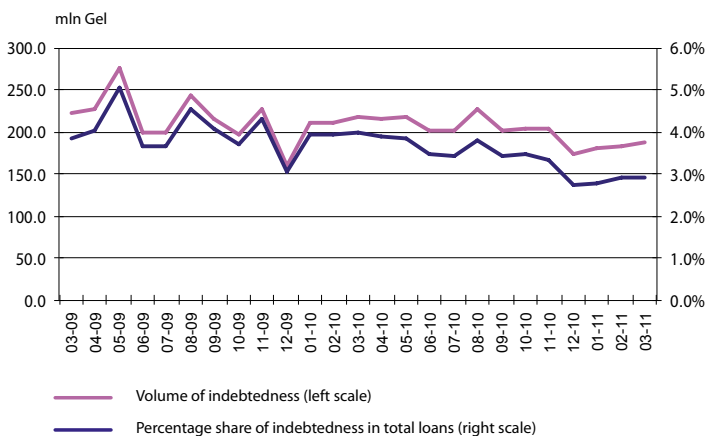


DIAGRAM 3.12
Overdue Loans



FX funds. However, the expansion of foreign currency denominated loans resumed in March.

In Q1 2011 the overdue loans grew by GEL 14.5 million, amounting to GEL 188.5 million. The share of overdue loans in total loans stood at 2.9%, up by 0.2 pps quarter-on-quarter. It should be noted that the overdue loans denominated in foreign currency account for 66.3% of total overdue loans. With regard to non-performing loans, in the reporting period the NPLs denominated in domestic currency increased 2.7% to equal GEL 125.4 million, while the foreign currency denominated loans declined 4.6% to GEL 632 million. It is remarkable that the total amount of write-offs by banks in Q1 equaled GEL 28.8 million, with the share of FX loans accounting for 62.8%. As of March 2011, the share of NPLs in the credit portfolio constituted 11.8%.

The market interest rates on loans went up by 0.3 pps in Q1 2011, amounting to 18% in annual terms. The loan interest rates declined by 1.1 pps for lari loans, while rising by 0.6 pps for foreign currency loans. The probable reasons included the lari's appreciation against the US dollar as well as the increase in reserve requirements. However, it should be noted that in December 2010 the interest rates on foreign currency denominated loans dropped to 14.9%, reaching a historical minimum for the Georgian credit market.

Deposit liabilities of the banking system decreased by GEL 75.9 million in nominal terms, equaling GEL 4,764.8 million in Q1 2011. Despite this fact the volume of deposits posted an annual 34.2% increase.

In the reporting period the volume of lari-denominated deposits declined 2.2% to GEL 1,329 million, while the foreign currency deposits, excluding the exchange rate effect, grew 2.5% to GEL 3,570 million⁵.

DIAGRAM 3.13
Deposits in Domestic and Foreign Currency



The overall deposit dollarization rose by 0.2 pps, currently settling at 72.1%. Increase in dollarization was registered in the case of individuals' deposits as well (by 0.1 pp), still remaining high at 87.5%. It should also be pointed out that at the end of the reporting period the time deposits in foreign currency account for 85.4% of total time deposits, pointing to a higher confidence in foreign currency relative to domestic currency on the part of both depositors and banks.

Despite the fact that in the reporting period an overall decline in lari deposits was registered, the volume of individuals' deposits denominated in lari rose 1.5%, amounting to GEL 291 million by end-March. The growth of domestic currency denominated deposits occurred for time deposits as well, with the latter increasing from GEL 405.4 million to GEL 410 million.

In the reporting period the non-residents' deposits rose 3.9%, amounting to GEL 555.6 million by end-March. The growth was driven by an increase in foreign currency deposits from GEL 516 million to GEL 537.2 million. The share of non-residents in total deposits grew by 0.4 pps to 10.1%.

The deposit interest rates increased by 0.8 pps in the reporting period, reaching 8.8%. Compared to

December 2010, the interest rates grew from 10.2% to 11.9% for lari denominated funds, and from 7.6% to 8.2% for foreign currency denominated funds. It

DIAGRAM 3.14
Composition of Lari Deposits

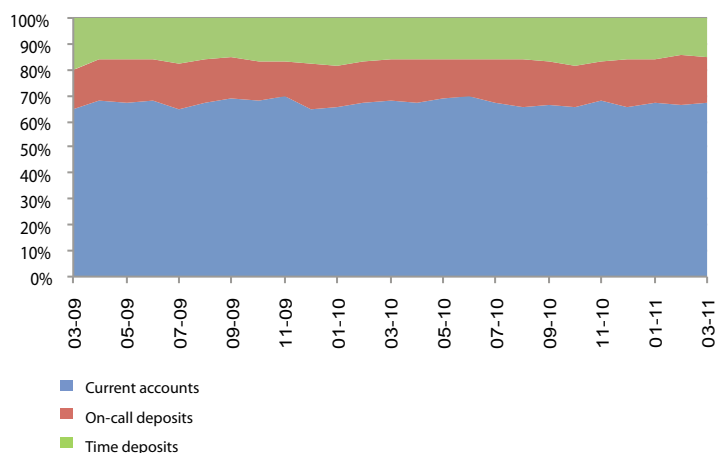
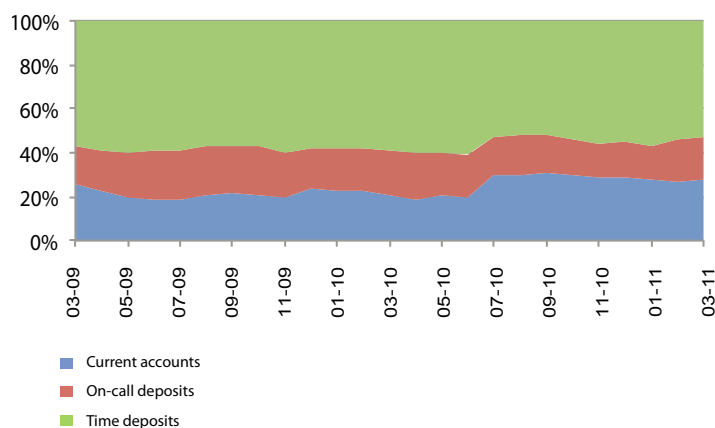


DIAGRAM 3.15
Composition of Foreign Currency Deposits



⁵ The volume is calculated at the GEL/USD exchange rate, effective in December 2010. If we express changes in the US dollars, the growth equals USD 49.7 million.

DIAGRAM 3.16
Interest Rates on Loans and Deposits (%)



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

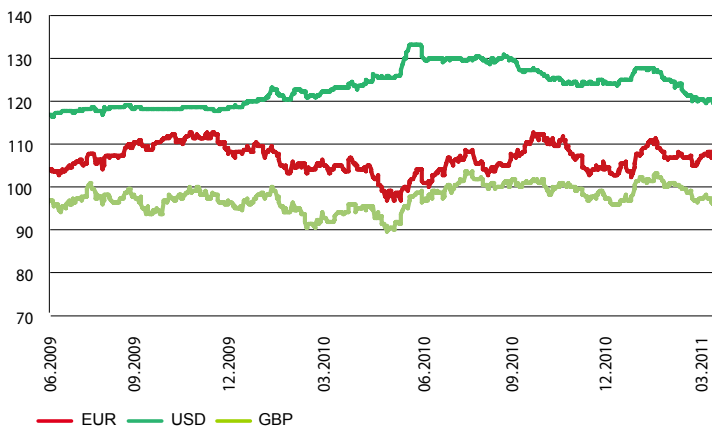


DIAGRAM 3.18
Lari's Nominal Effective Exchange Rate Index (2007-2011)



should also be noted that the interest rate differential for the above funds equaled 3.7 pps, a 2-year maximum. This fact could to a certain extent contribute to a partial dedollarization of deposits.

In the reporting period the interest rates on legal entities' deposits denominated in domestic currency rose from 2.9% to 11.7%. The same indicator for individuals' deposits (in domestic currency) increased from 10.7% to 12.2%.

Compared to the Q1 2010 level, the interest rates on non-bank deposits rose by 1.3 pps for domestic currency denominated deposits and fell by 0.5 pps for foreign currency denominated deposits. Overall, the weighted interest rate decreased by 0.2 pps.

In Q1 2011 the banking sector's profit totaled GEL 44 million, up by GEL 28.6 million year-on-year. Relative to December 2010, the return on equity (ROE) rose by 0.4 pps to 10%, while the return on assets (ROA) declined from 1.7% to 1.6%. The regulatory capital adequacy ratio slightly dropped from 17.4% to 17.3%.

3.5 FACTORS INFLUENCING EXCHANGE RATE DYNAMIC

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 cur-

rency induced credit risk⁶.

In Q1 2011 the lari's exchange rate tended upwards, with slight fluctuations present. The lari's nominal exchange rate against the US dollar averaged 1.7609, appreciating 3.8% (See Diagram 3.17). The lari's exchange rate against the euro depreciated 2.3%, averaging 2.4061. An initial depreciation occurred with respect to the pound sterling, followed by a gradual appreciation, resulting in no quarterly change in the GBP/GEL exchange rate. The lari's nominal and real effective exchange rates appreciated 1.9% and 4.5%, respectively. A higher rate of REER's appreciation with respect to NEER was largely due to a higher growth of consumer prices in Georgia relative to the trading partners.

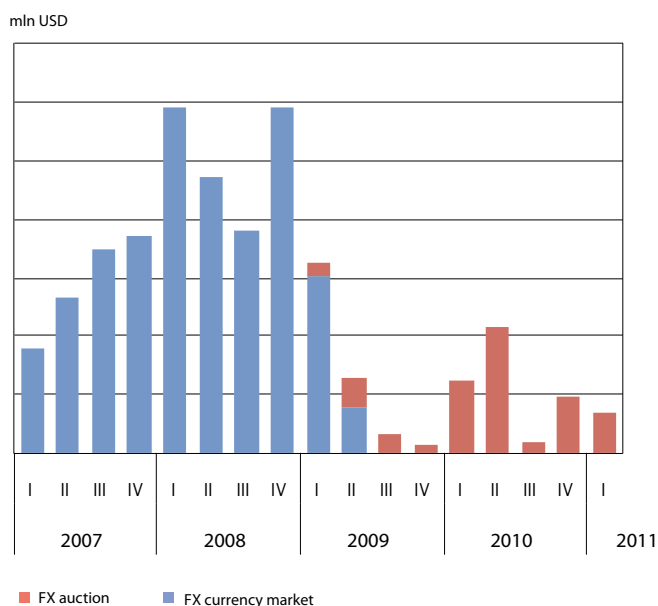
The lari's appreciation was conditioned by a number of factors. Those included tourism receipts, money remittances from abroad, banks' external borrowings, higher relative growth of foreign currency loans with respect to domestic currency loans extended by commercial banks, and the depreciation tendencies of the US dollar in the international market forming expectations of the lari's appreciation.

According to the preliminary data⁷, in Q1 2011 the current account deficit contracted, leading to a decrease in demand for foreign currency. Tourism revenues boosted demand for domestic currency, exerting an upward pressure on the exchange rate. In the same period the money remittances from abroad amounted to USD 208.9 million, up 15% year-on-year. In the reporting period the net external borrowings by commercial banks totaled USD 85.7 million. The growth rate of foreign currency loans extended by

commercial banks exceeded that of lari denominated loans. In Q1 2011 the volume of foreign currency loans in banks' credit portfolio equaled USD 117.3 million, while the lari denominated loans extended by commercial banks amounted to GEL 68.5 million. Such a proportion of extended loans by the banking sector pushed the lari's exchange rate vis-à-vis the US dollar upwards. Appreciation expectations of the lari were strengthened by the US dollar's depreciation tendencies with respect to the euro, influencing formation of demand for foreign currency.

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, with the latter being financed through 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 imbalances between supply and demand.

DIAGRAM 3.19
NBG's Interventions in the FX Market



⁶ See 2009 Financial Stability Report.

⁷ Preliminary estimates are based on the commercial banks' reporting on financial operations with non-residents of Georgia. The specified balance-of-payments data is released 90 days after the end of the quarter.

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

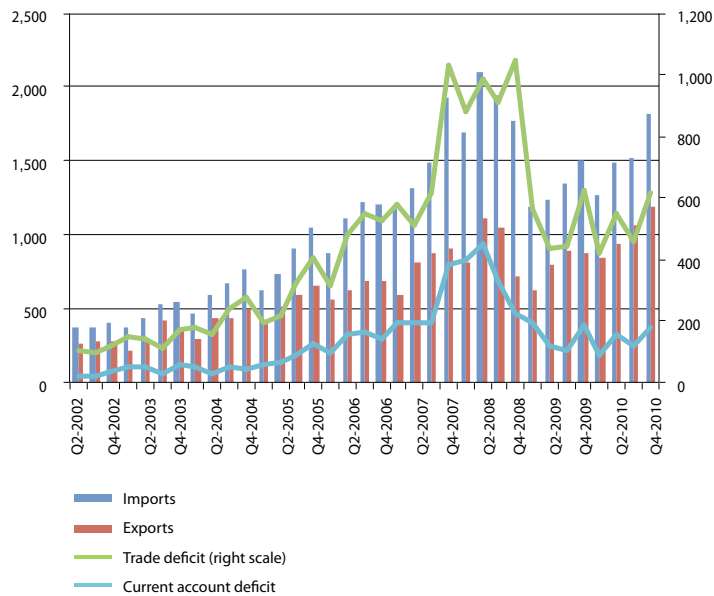


DIAGRAM 3.21
FDIs in Georgia

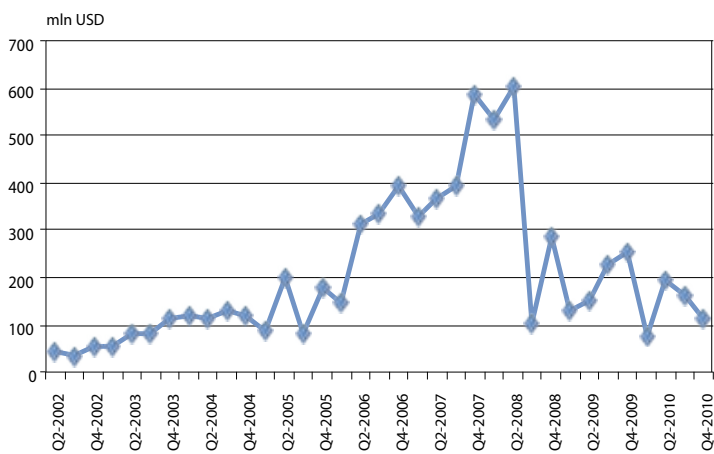
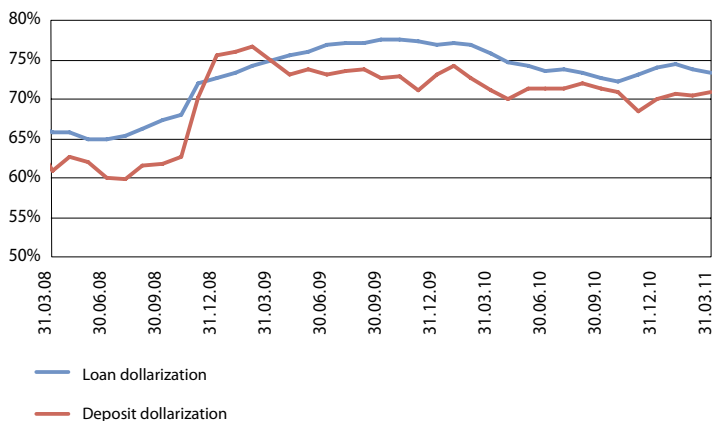


DIAGRAM 3.22
Loan and Deposit Dollarization Rates



In Q1 2011 the net purchases of foreign currency by the NBG equaled USD 10 million.

Important determinants of demand for foreign currency also include dollarization level of the economy and speculative capital which form certain expectations in the market. The downtrend in the dollar's exchange rate in the international markets also influenced demand for lari.

In the reporting period the deposit dollarization rate rose by 0.7 pps, whereas the loan dollarization decreased by 0.7 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, conducting to population's mistrust of the lari and giving the US dollar a status of a risk-free currency.

BOX 1. OFFICIAL INTERNATIONAL RESERVES

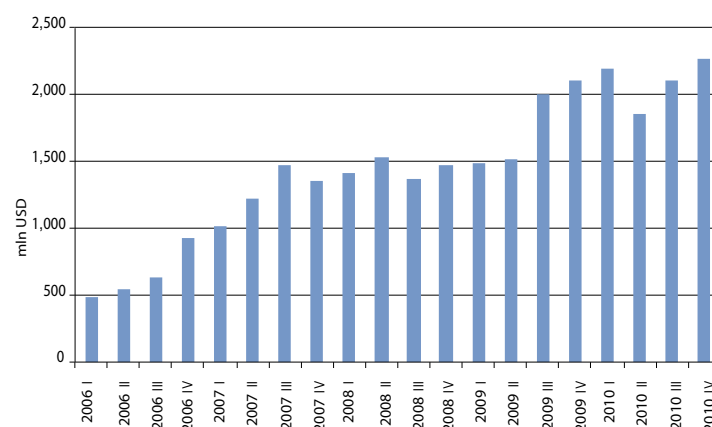
Maintenance of international reserve assets at an adequate level is essential for mitigating external and domestic shocks to the economy. The dynamics of Georgia's official international reserves is given below, and its adequacy assessment in line with traditional and composite indicators is presented.

Georgia's official international reserves grew almost 5 times with respect to the end-2005 level, equal to USD 478.6 million, amounting to USD 2,263.9 million at end-2010. In 2010 the annual growth rate of international reserves stood at 7.3%. Despite the 2008-2009 shocks there was no essential decline in reserves in that period.

A number of indicators providing assessment of the country's international reserve adequacy are presented below.

The official reserves coverage of imports (months of import ratio) shows how many months a country is capable of financing its imports without external revenues. By the end of 2010 this ratio equaled 4.5, exceeding the recommended 3-month level. The highest level of this ratio was attained in 2009. Despite an annual increase of reserve assets in 2010, the ratio

DIAGRAM 3.23
Dynamics of Georgia's Official International Reserves



posted an annual decline due to a relatively higher growth rate of imports.

The ratio of reserves to broad money (M2) used for assessing potential capital outflow risks significantly exceeds the recommended 20% benchmark.

The value of reserves constituted 103% of foreign currency deposits.

The short-term external debt coverage ratio assesses a country's capacity to service short-term external liabilities in the event of dry-up of capital inflows. The ratio is still above the recommended level.

TABLE 3.3
Office International Reserve Coverage

	2006	2007	2008	2009	2010
Months of Imports	2.5	2.8	2.4	4.8	4.5
Broad Money	115	101	132	166	147
FX Deposits	101	96	87	124	103
Short-Term External Debt (Excluding Intercompany Loans)	205	215	147	211	165
Short-Term External Debt (Including Intercompany Loans)	150	137	104	148	125

TABLE 3.4
Coverage of Official International Reserves and Liquid FX Assets of the Banking System

	2006	2007	2008	2009	2010
Broad Money	140	129	194	209	197
FX Deposits	124	122	127	155	139
Short-Term External Debt (Excluding Intercompany Loans)	251	275	215	264	222
Short-Term External Debt (Including Intercompany Loans)	184	175	152	185	168

Thus, Georgia's international reserves are adequate based on the above traditional indicators.

In addition, reserve assessment is also performed by means of the so-called composite indicators. In contrast to traditional indicators, composite indicators consider a simultaneous effect of a few potential shocks. One indicator of this kind represents the ratio of reserves to the sum of 100% of external debt and 10% of broad money. In 2010 this ratio equaled 115%, significantly exceeding the recommended limit

of 100%. The second composite indicator, which also takes into account necessary import expenses, represents a ratio of reserves to the sum of short-term debt, 10% of broad money, and 20% of imports. This stood at 97%, slightly falling behind the recommended limit of 100%.

To sum up, Georgia's international reserve assets manifest an upward tendency and remain adequate with respect to a number of assessment indicators.

3.6 PRODUCTION AND DEMAND

In Q4 2010 the real GDP increased 6% year-on-year. The nominal growth rate of GDP equaled 17.6% in annual terms. Accordingly, the GDP deflator amounted to 11%.

As it is show in Table 3.5 below, the largest contribution to the real GDP growth in annual terms was made by trade and manufacturing sectors (similar to Q2 and Q3 2010). An essential positive impact was produced by the following sectors: "financial intermediation", "transport", "construction", "hotels and

restaurants", "communications", and "real estate operations, renting and business activities". In addition, "education" and "community, social and personal services" also positively influenced the GDP growth. An annual contraction of value-added occurred in "agriculture", "production and distribution of electricity, natural gas, and water", and "processing of products by households", hindering economic development to a certain extent. The dynamics of the remaining sectors produced an insignificant impact on the annual growth of real GDP.

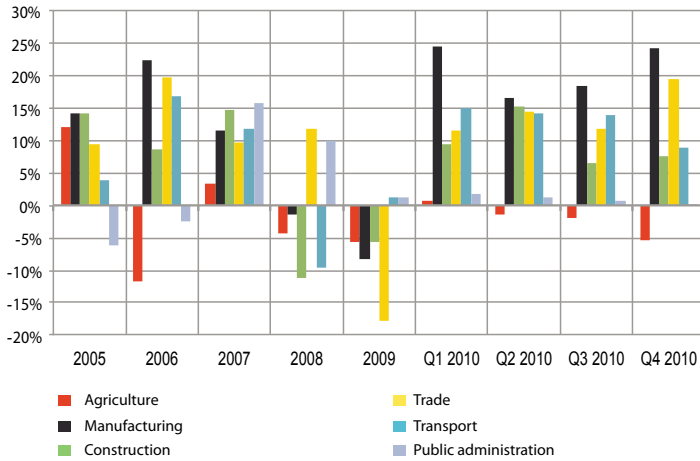
TABLE 3.5
Sectoral Contributions to Real GDP Growth, Q4 2010 (%)

	Nominal weights (Q4 2009)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	7.9%	-5.3%	-0.4%
Mining and quarrying	0.7%	5.1%	0.0%
Manufacturing	6.7%	24.2%	1.6%
Electricity, gas and water supply	2.8%	-7.4%	-0.2%
Processing of products by households	3.1%	-6.4%	-0.2%
Construction	5.8%	7.7%	0.4%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	13.3%	19.5%	2.6%
Hotels and restaurants	1.8%	15.6%	0.3%
Transport	6.2%	8.8%	0.5%
Communication	3.2%	10.8%	0.3%
Financial intermediation	1.9%	31.5%	0.6%
Real estate, renting and business activities	3.1%	11.1%	0.3%
Imputed rent of own occupied dwellings	2.7%	2.6%	0.1%
Public administration	15.1%	0.2%	0.0%
Education	4.5%	3.3%	0.2%
Health and social work	5.8%	2.0%	0.1%
Other community, social and personal service activities	3.5%	5.5%	0.2%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	11.1%	0.0%
FISIM adjustment	-0.9%	29.7%	-0.3%
GDP at basic prices	87.1%	7.2%	
Taxes on products	13.3%	-1.6%	-0.2%
Subsidies on products	0.5%	4.0%	0.0%
GDP at market prices	100.00%	6.0%	6.0%

The sectors characterized with high and stable growth rates throughout the whole 2010 included “hotels and restaurants” and “manufacturing”. The seasonally adjusted data showed that only these sectors registered stable upward trends. Other sectors despite posting rapid growth rates in the last quarters of 2010 did not manifest sustainable growth tendencies.

In the recent years the largest sectors of the economy displayed dissimilar real growth rates. In 2010 the majority of these sectors expanded considerably (See Diagram 3.24). The reasons behind real contraction of agriculture and low growth rates in public administration consist, respectively, in bad harvests and slowed down employment growth.

DIAGRAM 3.24
Dynamics of GDP Growth in the Leading Economic Sectors (2005 – Q4 2010)



3.6.1 PRIVATE AND GOVERNMENT CONSUMPTION

As it was already mentioned, in Q4 2010 the nominal GDP grew 17.6% in annual terms. Adjusting for seasonality, the same indicator increased 5% quarter-on-quarter.

A significant growth of the nominal GDP was the result of increases for all GDP categories of use. Final consumption expenditures rose 8.8%, gross capital formation – 55.9%, exports – 44.1%, and imports – 27.7%.

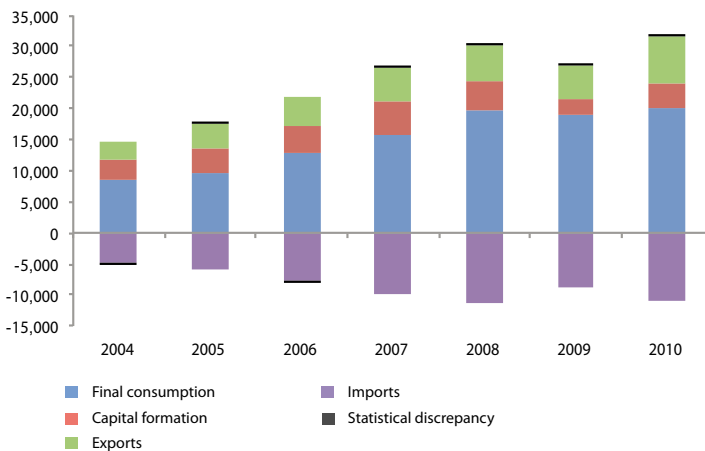
In Q4 2010 the largest component of total final consumption, final household consumption, posted a high growth rate in annual terms (14%). Adjusting for the CPI, the real final household consumption increased approximately 3.4%. In contrast to this component, the second largest component of final consumption, government expenditures on collective services, contracted 9.7%.

The government expenditures on individual goods and services posted a 5.6% increase year-on-year. However, if adjusted for the CPI, this component of government expenditures contracted in real terms.

Overall, it is obvious that, similar to the preceding quarters, in Q4 2010 the growth rate of real consumption expenditures fell behind the real GDP growth. This pointed to weak demand pressure on consumer prices.

In Q4 2010 exports of goods and services posted an impressive 44.1% growth rate year-on-year. On the other hand, the growth rate of imports was also significant, standing at 27.7%. It should be noted that the price effect represented a significant factor for both export and import increases.

DIAGRAM 3.25
Nominal GDP by General Categories of Use, 2004-2010⁹ (GEL millions)



⁹ Data for 2010 is preliminary.

3.6.2 INVESTMENT

In the reporting period the growth of investments in fixed capital equaled 48.7% in annual terms. The quarter-on-quarter growth amounted to 8.3%.

The volume of production inventories considerably expanded. The increase in changes in inventories reached 131% year-on-year and 82.6% quarter-on-quarter. The quarterly growth, however, was largely conditioned by seasonal factors.

In total, in Q4 2010 the gross capital formation posted an impressive 55.9% annual growth, following a 38% annual contraction in Q4 2009. The growth was largely fueled by domestic investments in fixed capital and inventories. With respect to the preceding quarter this component rose 14.3%.

In every quarter of 2010 the gross capital formation was steadily increasing, implying a stable growth of production capacity in the economy, on the one hand, and creating positive future perspectives, on the other.

3.6.3 2011 FORECAST

In Q4 2010 the real GDP was projected at 6%, which completely coincided with the actual indicator.

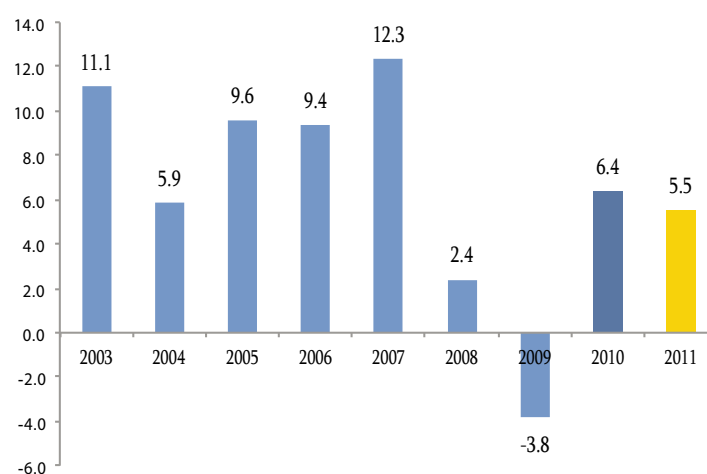
Based on analysis of the existing sectoral and aggregated data, in Q1 2011 the real GDP is forecasted at approximately 5.8%. This forecast, along with sectoral data analysis, takes into account VAT taxpayers' turnover (registered a 29.5% growth year-on-year) as well as dynamics of PPI and CPI.

The sectoral contributions to the 5.8% real GDP growth in Q1 2011 are projected to include the impact of trade (1.6 pps), transport (0.5 pps), financial intermediation (0.4%), manufacturing (0.3%), hotels and restaurants (0.3%) and communication (0.3%). Positive rates of economic growth are expected in "real estate operations, renting and business activities", "healthcare and social work services", and "construction".

In terms of expenditure method, in Q1 2011 a forecasted 18.6% nominal GDP growth will be powered by final consumption and exports. The growth rates of these GDP components are projected at 18% and 31%, respectively.

In line with the current forecasts, the real GDP growth in 2011 will equal approximately 5.5%. A lower GDP growth in 2011 relative to the previous year is conditioned by monetary policy tightening started in the second half of 2010 and low growth of employment.

DIAGRAM 3.26
Real GDP Growth, 2003-2011¹⁰ (%)



¹⁰ NBG's projections are used for the 2011 growth rate.

BOX 2. PURCHASING POWER PARITY

The purchasing power parity (PPP) represents a concept used for determining alternative exchange rates for different currencies. As prices of goods and services differ across countries, PPP practically determines the purchasing power of different currencies in the form of a single international currency unit. At present, the mostly used single international unit is a hypothetical “international dollar”, the so-called Geary-Khamis dollar¹¹, which has the same purchasing power, as the US dollar has in the United States at a given period¹².

Initially PPP developed as a theory for defining interest rates. However, at present the use of the concept is broader. By means of PPP relative prices across countries are adjusted. Accordingly, PPP-based calculation of GDP or other national account indicators for individual countries provides for assessment, comparison, and regional aggregation of economic performance and welfare. PPP is also used to rank countries for defining loan terms as well as for analytical purposes. It is the PPP-based method which is used by the World Bank and the IMF to calculate the size and growth rates of national economies.

According to the purchasing power parity, the nominal exchange rate of two currencies determines their purchasing power expressed in domestic price level:

$$E = P^* / P, \text{ where } P = \sum_{i=1}^n w_i p_i \text{ and } P^* = E \sum_{i=1}^n w_i^* p_i^*$$

p_i and p_i^* denote, respectively, domestic and foreign prices for the i -th good, w_i and w_i^* are weights of the i -th good, E is the exchange rate (one unit of do-

mestic currency expressed in foreign currency units), P and P^* are, respectively, general domestic and foreign price levels. The simplest form of PPP – absolute PPP – is based on the law of one price. The law implies that, in the absence of transaction expenses, competitive arbitrage ensures that the price for the same commodity in different countries is the same. Assuming that goods and their weights in the consumer basket are almost identical and the law of one price holds for all goods, PPP implies that one unit of domestic currency has the same purchasing power domestically and abroad. On the other hand, if the nominal exchange rate is lower than the PPP exchange rate, then the purchasing power of the domestic currency is weaker abroad relative to the domestic market. It is remarkable that in the case of the absolute PPP the real exchange rate equals one.

In practice, the absolute PPP does not hold due to a number of reasons, implying an exchange rate deviation from PPP. The primary reasons include:

- Existence of non-tradable goods and services;
- Significant transaction expenses for tradable goods (transportation expenses, tariffs, taxes and other non-tariff trade barriers);
- Different baskets on the international level;
- Real exchange rate volatility: in the short run prices are sticky, being influenced by money and stock markets; in the long run real shocks may produce an effect thereupon.

In the following version of PPP – relative PPP – the differences in growth rates of price level across countries, i.e. differences in inflation rates, are related to the percentage change in appreciation or depreciation of exchange rate:

¹¹ The “international dollar” system was proposed by Roy Geary in 1958. The system was subsequently developed by Salem Hanna Khamis in 1970-1972.

¹² To date, the years of 1990 or 2000 are used as a base period.

$$\% \Delta E \approx \% \Delta P^* - \% \Delta P$$

Relative PPP means that over time inflation adjustment across countries will lead to an exchange rate adjustment. Therefore, if the exchange rate shocks represent rather monetary than real phenomena, then it becomes possible to explain exchange rate fluctuations in two countries by the relative PPP.

Empirical evidence shows that PPP (either absolute or relative) does not hold in the short run. However, the relative PPP is manifested in the medium- and long-run period, since economic processes cancel out purchasing power differences over time.

As it was already mentioned, at present the PPP concept is broadly used for comparing size of economies and living standards. One of the most commonly used indicators for assessing living standards represents GDP per capita. For the purposes of comparability it is necessary to express data on per capita GDP in a single currency (usually the US dollar). However, in this case a large part of price differences for goods and services not sensitive to exchange rate changes is neglected. In addition, in the event of a significant depreciation of nominal exchange rate, per capita GDP also falls considerably. However, the depreciation may reflect the situation in the international commodity and financial markets and not imply the same degree of deterioration in living standards of the country's population. Assuming that imports represent an important determinant of welfare and that the population's income and prices in domestic currency remain unchanged, the population's standard of living does not change (or deteriorates at a relatively smaller scale). The use of purchasing power parity in such case depicts the situation more realistically.

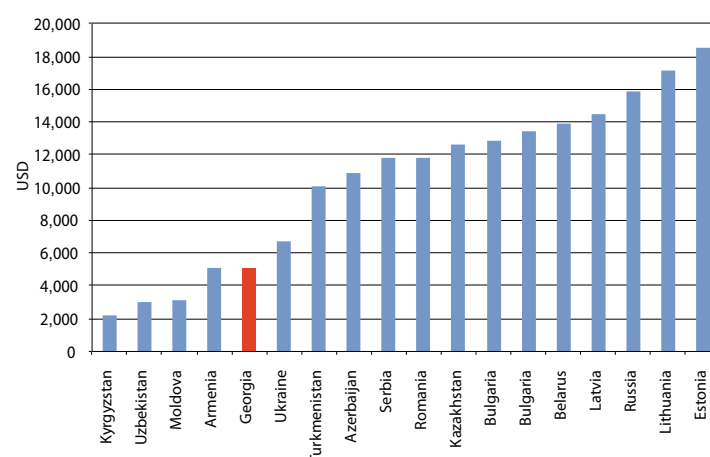
Calculation and release of PPP rates is made by the International Comparison Program. The program, initially under the name of international comparison

project, was founded by the UN and the World Bank at the University of Pennsylvania in 1968. The first results were published in 1975 and included only 10 countries. The second round already comprised 34 countries. Starting from the third round, international comparisons were conducted at 5-year intervals and the number of participating countries equaled 64. Starting from 1989 the project was called the International Comparison Program (ICP). In 1993 the ICP already covered 86 countries, and it was precisely the time when Georgia joined the Program.

In order to determine the purchasing power parity, every country participating in the ICP calculates average domestic prices on more than 1,000 specified goods and services. For this purpose prices are collected quarterly, in urban and rural areas, in formal and informal markets and trade outlets. The PPP rate for a country not participating in the ICP is calculated by means of regression-based estimations.

The difference between a nominal exchange rate and a PPP rate may be often significant. For instance, in 2010 the per capita GDP for Georgia stood at 2,658 US dollars, while the same indicator adjusted with the PPP rate equaled 5,114 "international dollars".

DIAGRAM 3.27
GDP Per Capita (PPP)



¹³ For the 2011 round it is intended to use a so-called Core List, which envisages inclusion of basic commodities into every regional list.

3.7 EXTERNAL TRADE

In Q1 2011 Georgia's external trade turnover totaled USD 1,862.4 million, up 36.9% year-on-year. In annual terms the registered exports amounted to USD 464.0 million, up 35.8%, and the registered imports equaled USD 1,398.4 million, up 37.3%. As a result, the trade deficit widened to USD 934.5 million, exceeding the 2010 level by 38.0%.

In quarter-on-quarter terms the registered exports grew 4.4%, while the registered imports and trade deficit contracted 11.7% and 15.0%, respectively, owing to seasonal factors.

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



In the reporting period the top export item represented re-export of motor cars. The latter grew 2.5 times relative to Q1 2010, while posting a 27.3% increase with respect to Q4 2010. The destinations for used car reexport were primarily the neighboring countries, such as Azerbaijan, Armenia, and Kazakhstan. The traditionally largest export item, ferroalloys, moved down to the second position, posting year-on-year and quarter-on-quarter decreases of 2.1% and 37.2%, respectively. The annual decline in physical volumes was 28.7%, while the effect of price increases

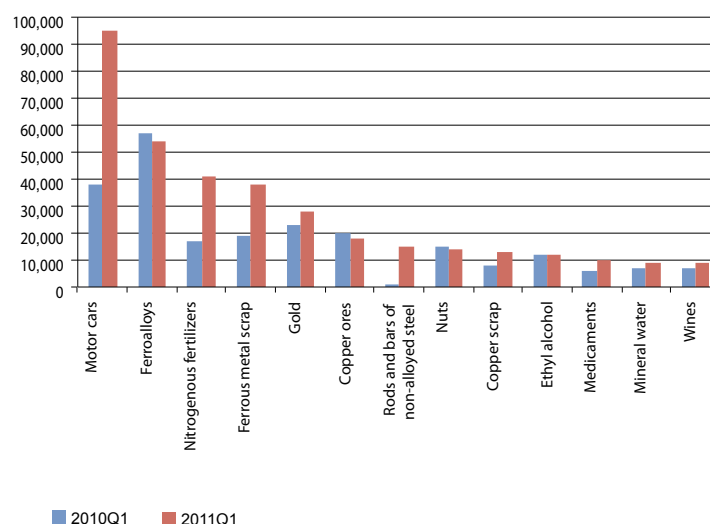
equaled 33.9%. Ferroalloys are mainly exported to the United States, Mexico, and Ukraine. The third position in the export list was occupied by nitrogenous fertilizers, which posted 2.3- and 2.2-time increases in year-on-year and quarter-on-quarter terms, respectively. The growth was conditioned by increases in both physical volumes and prices; however, the effect of the latter was relatively smaller. The export destinations of nitrogenous fertilizers mainly included the United States and the EU countries. In annual terms, the export of ferrous and non-ferrous metals rose considerably. At the same time, it should be pointed out that in the base period, in the aftermath of the global financial crisis, the international prices on ferrous and non-ferrous metals remained low, driving the export value down. Thus, the increase in exports for these commodities was fully due to the price effect, while in terms of physical volumes there was a contraction. Starting from Q2 2010 a new commodity – rods and bars of non-alloy steel – emerged in the list of top ten export commodities, amounting at USD 14.5 million in exports in the reporting period. The export of mineral water grew 44.4% year-on-year, totaling USD 9.4 million. Ukraine accounted for more than 50% of mineral water exports, as Kazakhstan followed in the list (11.6%). The export of wines increased 43.2% in annual terms to USD 9.2 million. Similar to mineral water, more than half of wine exports went to Ukraine, while Belarus accounted for 11.4%.

In Q1 2011 the top ten export items included: motor cars, ferroalloys, nitrogenous fertilizers, ferrous metal scrap, gold, copper ores, rods and bars of non-alloyed steel, nuts, copper scrap, and alcohol and spirituous beverages. Investment goods accounted for 3.3%, intermediate consumption goods for 57.7%, and consumer goods for 39.0% of total exports.

With regard to imports, in the reporting period the first position was traditionally held by petroleum products. The value of petroleum imports continued to rise, posting a 42.6% price-induced growth rate. The import of petroleum gases grew at an annual 76.7%, totaling USD 85.9 million. It should be pointed out that petroleum gases are used as an input for production of nitrogenous fertilizers. The latter, in turn, significantly increased, registering a 58.6% annual growth in physical volumes only. Therefore, increased import of petroleum gases was partly used for mineral fertilizers. In the same period the import of motor cars, occupying the third position, expanded 23.0% year-on-year. In Q1 2011 the import of structures and construction materials made of ferrous metals totaled USD 38.0 million, exceeding the 2010 figure 2.3 times. These products were mainly used for railway construction.

In Q1 2011 food products accounted for 15.8% of imports, of which 25.7% (4.1% of total registered imports) represented wheat and other grains. The expenses on wheat imports grew 65.0% in annual terms, owing to increases in international wheat prices. Sugar and sugar confectionery followed in the food export list with a 25.9% annual growth rate. Meat products were in the third position (8.8% of food imports), increasing 26.6%. The import of tobacco and alcohol products accounted for 2% of total registered imports, up 25.8%.

DIAGRAM 3.29
Top Export Commodities in Q1 2010 and Q1 2011 (USD thousands)



In Q1 2011 investment goods accounted for 12.6%, intermediate consumption goods for 41.6%, and consumer goods for 45.3% of total imports.

Georgia's top ten trading partners for exports were ranked as follows: Azerbaijan, Turkey, Armenia, the United States, Canada, Ukraine, Kazakhstan, Italy, Spain, and Mexico. These countries accounted for 72.7% of total registered exports.

In terms of imports, the top ten trading partners included Turkey, Ukraine, Azerbaijan, China, Germany, Russia, United Arab Emirates, Bulgaria, Italy, and Kazakhstan, accounting for 67.3% of total registered imports.

3.8 GOVERNMENT OPERATIONS

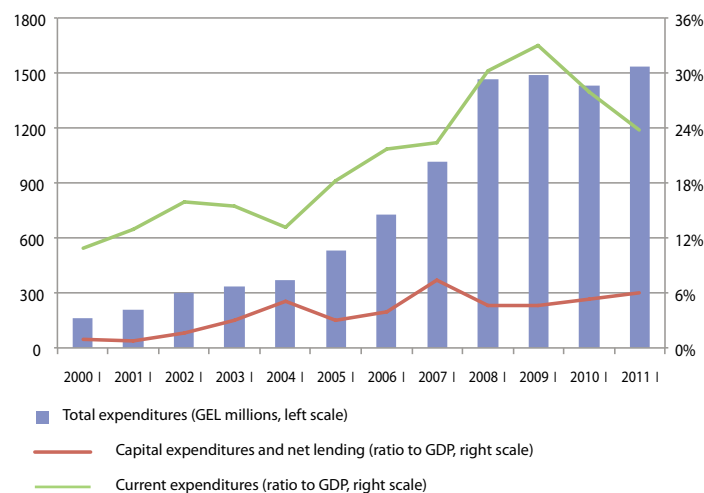
In Q1 2011 the consolidated budget revenues and grants totaled GEL 1,764.1 million. The grants equaled GEL 78.2 million, while tax and non-tax revenues stood at GEL 1,685.9 million. The revenue-to-GDP¹⁴ ratio was 34.4%, up 7.5 pps quarter-o-quarter and 3.7% year-on-year. The tax burden (tax-to-GDP ratio) amounted to 30.4%, up 9.3 pps quarter-on-quarter and 4.1 pps year-on-year. The ratio of grants to GDP equaled 1.5%.

ABLE 3.6 Consolidated Budget Indicators

GEL millions

	Q1 2011	Ratio to GDP (Q1 2011)
Total revenues and grants	1,764	34.4%
Revenues	1,686	32.9%
Tax revenues	1,559	30.4%
Non-tax revenues	127	2.5%
Grants	78	1.5%
Total expenditures	1,566	30.6%
Current expenditures	1,232	24.0%
Capital expenditures and net lending	334	6.5%
Deficit	198	3.9%
Deficit Financing	40	0.8%
Privatization	-289	-5.6%
Use of free circulating funds	-1	-0.1%
Net increase in domestic liabilities	52	1.0%

DIAGRAM 3.30. Dynamics of Budget Expenditures



The total expenditures of the consolidated budget amounted to GEL 1,566 million in Q1 2011, down GEL 670.5 million quarter-on-quarter and up 9.5% year-on-year. The current and capital expenses amounted to GEL 1,232 million and GEL 334 million, respectively. Capital expenses decreased 39% relative to Q4 2010, while rising 32.5% compared to Q1 2010. The ratio of total expenditures of the consolidated budget to GDP stood at 30.6%, down 6.3 pps quarter-on-quarter and up 2.7 pps year-on-year.

In Q1 2011 the consolidated budget surplus of GEL 198 million emerged, constituting 3.9% of GDP. The proceeds from privatization equaled GEL 40 million, external liabilities increased by GEL 52 million, while domestic liabilities declined by GEL 1 million. Due to the budget surplus free circulating funds rose by GEL 289 million.

In Q1 2011 the NBG's reserve money declined 15.9% (GEL 289 million). The contribution of government operations to the change in reserve money was -6.3 pps. Thus, in Q1 the fiscal policy contributed to narrowing of reserve money, i.e. the government conducted tight fiscal policies aimed at containing inflation.

The second largest category of government expenditures represented social assistance expenditures, which amounted to GEL 362.5 million (24.3%). A large share of these expenditures was used for social protection of elderly persons, social protection of households and children, and social alienation problems.

¹⁴ NBG projections for Q1 2011 GDP are used.

In the reporting period the expenditures on economic activities totaled GEL 193.5 million (13%). Funds in this category were primarily channeled into road infrastructure development, transport means, and multi-purpose development projects.

As of end-March 2011, the total state debt grew by GEL 130 million year-on-year, totaling GEL 9.3 billion.

This included a GEL 115 million increase in external liabilities and a GEL 15 million increase in domestic liabilities. At the end of Q1 the total state debt constituted 44.7% of 2010 GDP, slightly bypassing the same figure for the end of 2010. This indicator remains far from the critical level (60% of GDP).

BOX 3. IMF PROGRAM

In the second half of 2008 the Georgian economy endured two strong negative shocks. The first was related to the military aggression of the Russian Federation, while the second was due to the financial crisis, as the latter led to a drastic stop of investment inflows in the whole world and in Georgia, in particular. It should also be noted that in the preceding period it were precisely foreign direct investments that fueled economic growth. The August 2008 military hostilities induced a panic among the population, triggering the process of deposit withdrawal from the banking system. The situation was complicated by the fact that deepening of the global financial crisis significantly deteriorated possibilities of external borrowings and sharply contracted private capital inflows.

In order to address these challenges, in September 2008 an agreement with the IMF was reached on the allocation of a USD 750 million stand-by loan. The loan was aimed at financing temporary imbalances in the balance of payments and replenishing the country's international FX reserves with the view to strengthen confidence in the domestic currency and the financial system on the part of the market and potential investors. It is remarkable that in August-September 2008 the exchange rate pressure increased, resulting in a considerable reduction in international

reserves. Thus, replenishment of FX reserves from the IMF source was of crucial importance for maintaining stability in the FX market.

In the first half of 2009 it became obvious that the financial crisis would have stronger and more lasting effects than it had been initially anticipated, which was first of all reflected in more drastic contraction of private capital inflows. The projections with respect to capital inflows were revised downwards, and the balance of payments deficit widened. Consequently, in July 2009 the Georgian government and the IMF agreed on expansion of the stand-by loan by USD 420 million.

The IMF's stand-by loan is aimed at financing temporary imbalances in the balance of payments. In the framework of this program a full loan amount is allocated, which could be received by a country throughout the duration of the program in line with a pre-defined schedule. Disbursement of each tranche is conditional upon the IMF mission assessment of a country's economic situation and economic policies. In most cases the IMF mission reports and the following release of funds take place on a quarterly basis. Based on the need of financing temporary imbalances, a country may refuse withdrawal of a tranche. The effective period of a stand-by loan is usually between

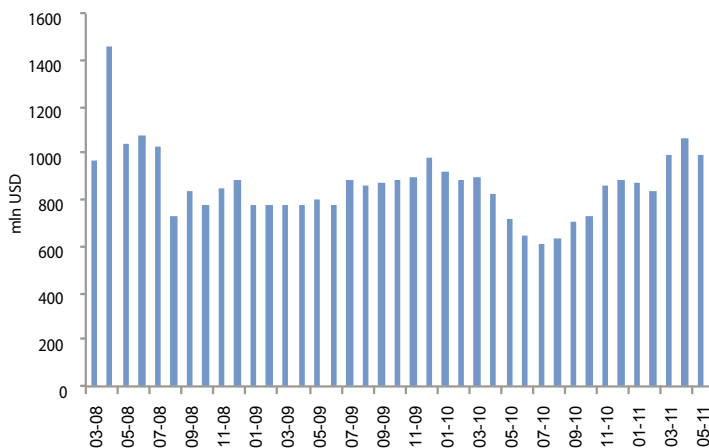
12 and 24 months. Repayment of a loan is made 3-5 years after the receipt of the loan. The interest rate on this type of loan is linked to the SDR interest rate, while the latter is in turn determined by the interest rates of the major world currencies (the US dollar, the euro, the yen, and the pound sterling). Thus, an interest rate on a stand-by loan varies, approaching the key policy rate (equal to 1.52%, as of May 2011) plus 1 percentage point. The interest rate on the part of a loan exceeding 300% of a country's quota is defined as the key policy rate plus 2 pps. Along with interest rate hikes for major world currencies a country's interest rate expenses increase, although still being lower than the interest rates at which a country can contract a loan in the international capital markets.

In order to monitor performance of the program the IMF sets certain benchmarks for countries, observance of which is obligatory for obtaining a tranche. In the case of Georgia such benchmarks represent a minimum level of international reserves, the maximum amount of net domestic assets of the NBG (the sum of net positions to banks and to the government), and the maximum amount of consolidated budget deficit.

As it was already pointed out the primary goal of a stand-by loan represents replenishment of a country's international reserves to the level sufficient for maintaining confidence in the domestic currency and the whole financial system. Following the August 2008 period the net international reserves (total international reserves minus liabilities to the IMF and commercial banks' funds on reserve accounts) significantly declined. Along with contraction of foreign capital inflows there was an increase in the inflow of funds to the government sector from international financial institutions and donor countries. As a result, the net international reserves remained relatively stable in the post-crisis period. Starting from the second half of 2010 the economy recovery began, positively affecting the country's revenues in foreign currency. In particular, revenues from exports of goods and services must be pointed out. Thus, since September 2010 the NBG's net international reserves have been on the up-trend. Georgia will start repayment of the IMF's stand-by loan from 2011.

Existence of an IMF program is important for strengthening confidence of international financial institutions and potential investors in a country. Within the framework of its program the IMF permanently monitors a country's economic policies and its assessments and forecasts are available for interested parties. Therefore, existence of the IMF program represents a guarantee for potential investors that a country conducts consistent economic policies and probability of a domestic crisis is low. The IMF program in Georgia also significantly simplified and accelerated provision of financial assistance on the part of international financial institutions and donor countries in the recent period.

DIAGRAM 3.31
Net International Reserves



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.

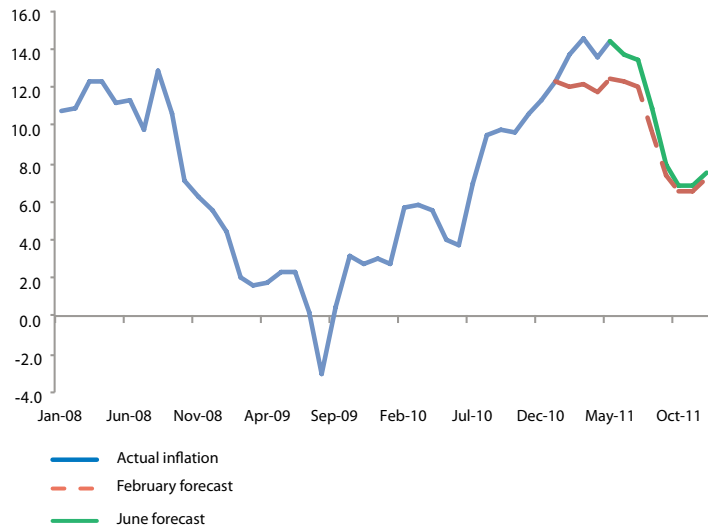
For short-term inflation forecasting, the NBG takes into account price trends for different commodity groups. In order to project price dynamics for individual commodity groups of the consumer basket, the available information on price determinants of individual products is used (seasonality, expected changes in international prices, changes in regulated prices, etc.).

The inflation dynamics is largely conditioned by food price changes in the first half of 2011. Starting from spring 2010 international prices on main food commodities rose significantly and the uptrend in prices is projected to prevail for the next few months. One of the significant determinants of food price increases also represented especially bad harvests due to unfavorable climatic conditions in 2010, pushing prices for a number of agricultural commodities up. Assuming that climatic conditions will be similar to those during usual years, i.e. the harvest will be "normal", the current prices on fruits and vegetables are likely to decrease. It should be noted that price increases for certain agricultural products (potatoes, beans, apples, cucumbers, cabbage) make a large

contribution to the overall annual inflation. Thus, the recent food price gains have been due to one-time factors, implying that they will no longer affect the annual inflation after one year and the inflation rate will return to its targeted level. According to other assumptions, fuel prices and transport fees will change in line with 2010 prices on petroleum products. The oil prices for the current year are forecasted at around USD 100. The assumption is made that regulated prices will remain unchanged in 2011. Price forecasts for other commodity groups are based on the information related to appropriate sectoral tendencies. At present, the high level of annual inflation includes the effect of food price increases, which were of one-time nature; thus, it is expected that in the following months these effects will cancel out in the annual inflation. The demand pressure on prices is currently insignificant. Based on the above, the inflation forecast shows that at end-Q2 2011 the annual inflation rate will be in the range of 13-14%, while starting to decline in the second half of 2011 to settle at 7.5% by end-year.

It should be noted that the end-year inflation forecast has not been revised after the preceding quarter. The 6-month inflation forecast was slightly altered upwards to account for the effect of temporary price increases for certain commodities in the domestic market due to unfavorable price dynamics in the international markets.

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

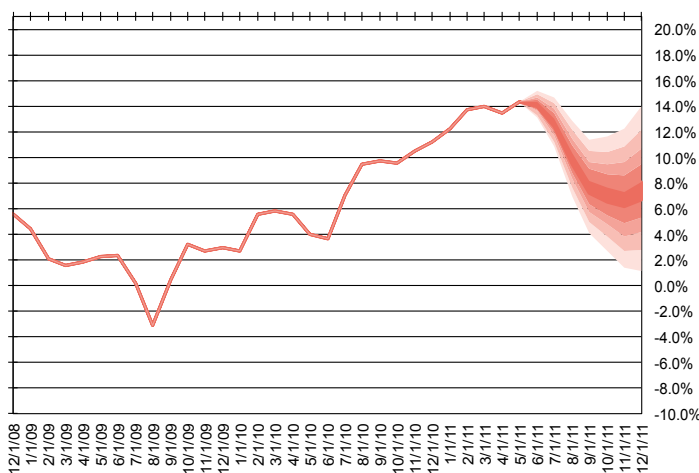


It should be noted that inflation forecasts based on this method are useful for a 6-month time horizon, losing its precision for a longer period.

An updated inflation forecasting model is determined as follows:

$$\delta p = 0,080\delta p_{-1} + 0,037\delta m_{-1} + 0,033\delta m_{-2} + 0,034\delta m_{-6} - 0,078\delta e - 0,049\delta e_{-2} + 0,09\delta p^{food}_{-1} - 0,003ecm;$$

DIAGRAM 4.2. Inflation Forecast (Econometric Modeling)



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:

$$ecm = p_{-1} + 0,5e_{-1} - 1,5m_{-1} + 4,8y_{-1} - 28,4$$

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 forecasted values of the explanatory variables within the model:

- Broad money will grow 19.5% by end-June 2011 and 19.5% by end-2011;
- The real GDP growth will equal 5.5% per annum;
- The nominal exchange rate against the US dollar will remain unchanged;
- Prices for fruits and vegetables will change in line with seasonal patterns.

As a result of model estimations, the annual inflation forecast has the following form:

According to the obtained results, the annual inflation will oscillate in the range of 13.95% and 14.35% in end-June, while falling to 6.35%-7.69% by end-2011.

5. Decisions of the Monetary Policy Committee

In Q1 2011 the NBG's Monetary Policy Committee held three meetings. At the first meeting, the reserve requirements for FX funds were increased to 15%, at the second the policy rate was hiked by 50 basis points, while at the third the policy rate was left unchanged.

In December 2010, the MPC decided to gradually increase the reserve requirements for FX funds from 5% to 15%. At the first stage, the reserve requirements were raised to 10% starting from January 20. This decision was aimed at spreading the effect of monetary policy tightening on FX loans. At the January 19 meeting, the MPC made a decision on continuation of tight monetary policies with the view to avoid possible demand pressure on prices, increasing the reserve requirements for FX funds to 15% from February 17.

The annual inflation registered significant growth during the quarter. World price increases for wheat led to price increases for main components of the Georgian consumer basket. In particular, prices on bakery and meat products grew significantly. Influenced by seasonal factors, prices on fruits and vegetables also rose. The MPC took into consideration that it was necessary to correctly assess inflation factors and their impact on the general price level in the medium term. Similar to other countries in the region, high inflation in Georgia represented the result of drastic

prices gains for fuels and agricultural products in the international commodity markets. Preclusion of this kind of inflation by means of monetary instruments is possible only at the expense of significant economic contraction. Such (exogenous) factors have a temporary effect on inflation, and central banks do not address them, since social costs of cutting this type of inflation exceed social benefits. However, it should be taken into account that food products account for a large share of consumer expenditures in Georgia; this implies that food price increases accelerate inflationary expectations. Inflationary expectations in turn negatively affect medium-term inflation, containment of which represents the primary goal of the NBG. Based on the above, the MPC voted for further monetary policy tightening with the purpose of curbing inflationary expectations, increasing the policy rate by 50 basis points to 8%.

A certain time period is needed before monetary policy tightening produces a relevant effect on real economy. The impact of the above-mentioned decisions is already visible in the economy, as the extension of foreign currency loans slowed down, but the full effect of policy tightening is not yet produced. Therefore, at the March 16 meeting the MPC decided against further policy tightening.