INFLATION REPORT

NATIONAL BANK OF GEORGIA

2011

2008 2009 2010 **2011**

NATIONAL BANK OF GEORGIA

INFLATION REPORT

Q4 2011

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), at end-2011 the annual inflation equaled 2%. In the recent period the downtrend in inflation turned out bigger than expected. It should be noted that a decline in inflation is witnessed globally, including in almost all Georgia's main traiding partners, reducing risks of import inflation.

The annual inflation amounted to 7.3% for domestic goods and to 2.4% for imported goods. In 2011 the prices on non-tradable goods grew 4.6%, while declining 0.5% for tradables in annual terms. The core inflation rate (change in consumer prices excluding food and fuel) remains low at 0.5%. In December the service inflation stood at 5.9%, largely due to an increase in public transport fees. Such pattern of price growth clearly shows that the impact of exogenous shocks on annual inflation weakened in Q4 and demand pressure on prices was not observed.

Below the dynamics of main inflation factors is described. In Q3 2011 the real economy grew 7.5%, while even higher growth is expected in Q4. The output gap was almost fully eliminated, resulting in weak demand pressure on prices despite rapid economic growth.

In Q4 the unit labor costs slightly grew in the trade sector, while significantly declining in the transport and communication. Such sectoral developments indicate weak supply-side pressure on prices. Conversely, the unit labor costs rose in the industry.

In Q4 2011 the lari's real and nominal effective exchange rates appreciated 1.6% and 2.6%, respectively. The appreciation was caused by several factors, including tourism revenues, money remittances from abroad. The euro's depreciating tendency in the international markets should also be pointed out, as it produced expectations of the lari's appreciation. The uptrend in the lari's exchange rate made a downward impact on prices for imported goods.

The credit portfolio of commercial banks expanded 3.8% in Q4 2011, amounting to GEL 7.7 billion. The annual growth rate of bank loans equaled 28.4% at end-2011 (excluding the exchange rate effect). The data for the last two quarters of 2011 show that the growth of loans in domestic currency was fueled by long-term loans the share of which constituted 58.7% in the total lari denominated loans. In general, an increase in long-term loans denominated in domestic currency creates a good foundation for efficient functioning of the monetary transmission mechanism.

In Q4 arise in interest rates should be noted. The interest rates increased on average by 1.5 pps for lari denominated loans and by 0.6 pps for foreign currency denominated loans.

The deposit liabilities of the banking system grew by 629 million in Q4 2011, totaling GEL 6.7 billion. The growth of domestic currency denominated deposits fueled by increased government expenditures should be particularly noted. The deposit dollarization rate declined significantly by 4 pps to equal 59.9%. A decrease in dollarization enhances efficiency of the monetary transmission mechanism.

In Q4 the NBG continued to use monetary policy instruments with the view of efficiently managing banking liquidity and revitalizing the banking sector. At the end of 2011 the dynamics of budget expenditures contributed to accumulation of excess liquidity in the banking sector, leading to a decrease in refinancing loans and weakening of the monetary transmission mechanism. To address the issue the NBG increased auctioned issuance of the Certificates of Deposit with the aim of withdrawing excess liquidity from the banking system.

In Q4 2011 the NBG continued monetary policy loosening, gradually cutting the monetary policy rate from 8% in July 2011 to 6.5% in January 2012. The monetary policy rate cut will contribute to maintaining the actual inflation at the targeted level in the medium term.

According to the current NBG's forecast, the impact of the base effect will persist in the first half of 2012, resulting in a lower-than-targeted level of inflation. Deflation is projected in Q1 2012, with the inflation rate accelerating from June. An uptrend in inflation will continue in Q3, and the inflation rate is projected to return to the target level of 6% at the end of 2012.

2. CHANGE IN CONSUMER PRICES

According to the National Statistics Office of Georgia (Geostat), in Q4 2011 the general level of consumer prices rose 1.1% in quarterly terms. The analogous figure in 2010 stood at 3.6%. This resulted in a drop in annual inflation from 4.6% in Q3 to 2.0% at end-2011. The inflationary pressure of the demand side so far remains weak.

Food price increases continued to shape the pattern of changes in the general level of consumer prices. The prices on food and non-alcoholic beverages rose, fueled by price increases for products making part to the "vegetables and melons" subgroup. Seasonal factors led to price gains in the "milk, cheese, and eggs" subgroup.

In Q4 2011 there was a rise in prices for certain types of medical services. In addition, the consumer prices of medicaments moved up. As a result, the contribution of the healthcare sector to the overall quarterly inflation proved significant.

The downtrend in international oil prices manifested in domestic prices on diesel and gasoline was preserved, conditioning a decline in the general price level in the transport sector.

As mentioned already, by end-December 2011, the consumer prices rose 2.0% year-on-year. The annual price growth for diesel and gasoline equaled 10.9% and 9.5%, respectively. The prices grew for the commodity groups of alcoholic beverages and tobacco (1.5%) and food and non-alcoholic beverages (0.9%).

Compared to the same period of 2010, a significant contribution to the overall inflation was made by the products belonging to the "transport" commodity group. The annual inflation in the transport sector equaled 14.6%. Similarly, a tangible increase in prices was recorded in the "cafes and restaurants" subgroup. In contrast, a significant counterbalancing effect on the overall inflation was produced by the price decrease for goods and services in the "communication" sector.

It is important to observe changes in the general level of consumer prices for goods and services excluding food and fuel. The core inflation measured in this way stood at 2.0% at end-December. This indicates weakness of demand pressure on prices.

DIAGRAM 2.1

Price Growth Relative to December 2009

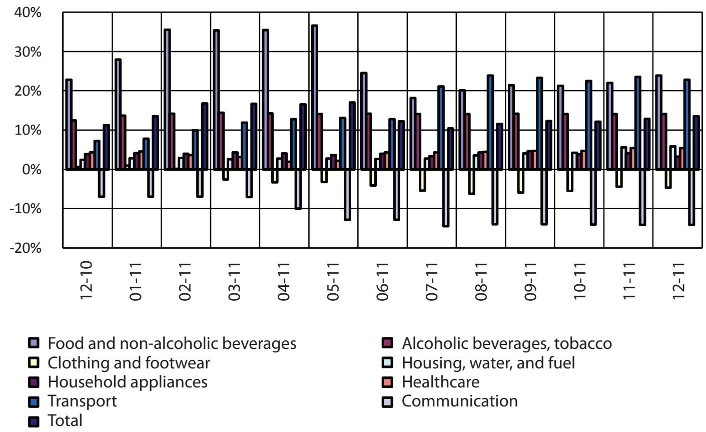


DIAGRAM 2.2

Core Inflation Excluding Food and Fuel

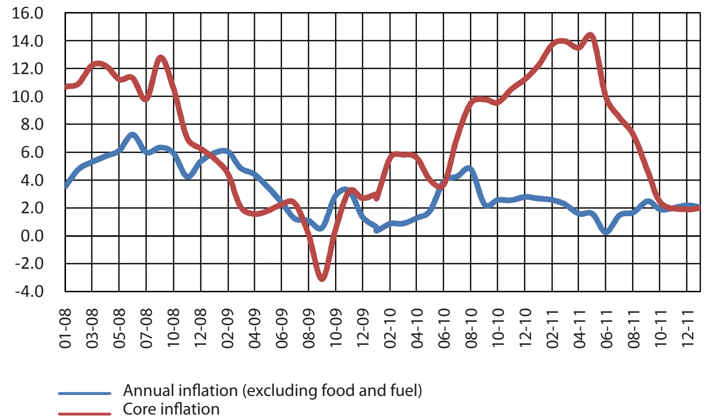


DIAGRAM 2.3
Annual Inflation by Production Location

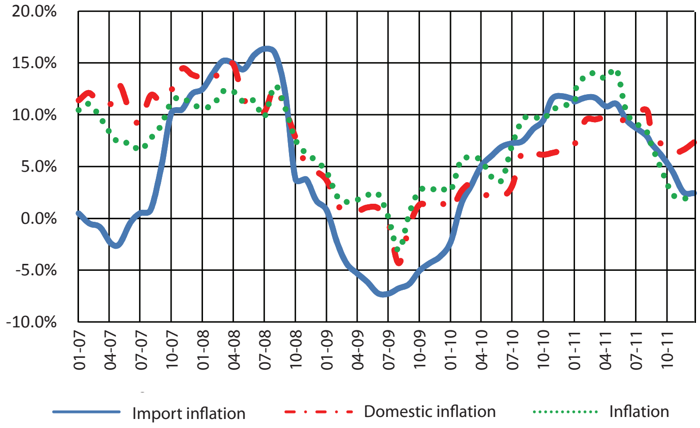


DIAGRAM 2.4
Price Indices for Tradable and Non-Tradable Goods
(December 2006 = 1)

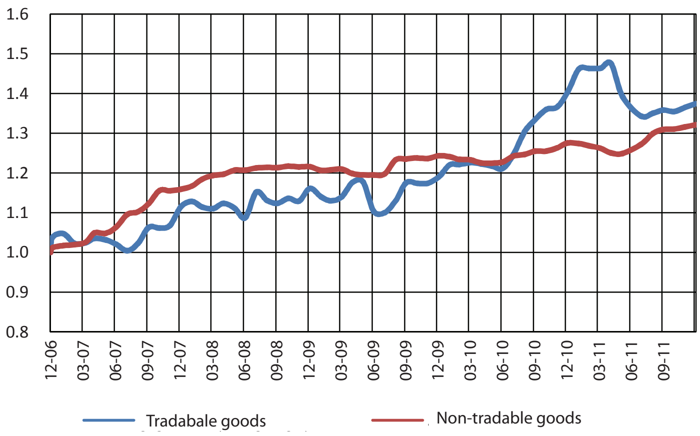
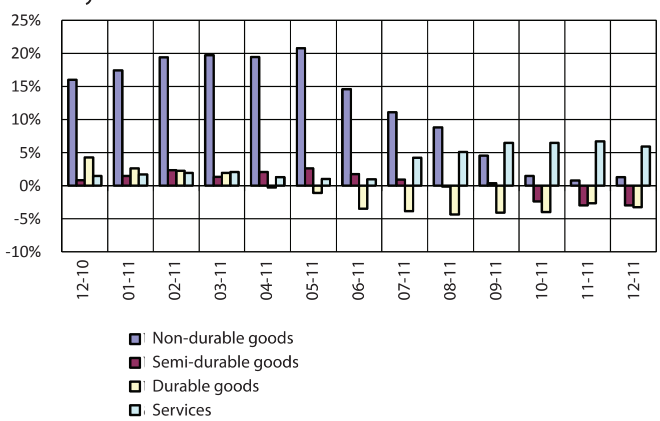


DIAGRAM 2.5
Changes in Annual inflation for Goods with Different Consumption Durability and Services



A significant portion of the Georgian consumer basket represents imported commodities. Hence, price dynamics in the partner countries represents a factor to be taken into account. In 2011 Turkey, Ukraine, Azerbaijan, China, Germany, and Russia accounted for almost 60% of total imports. These countries were largely influenced by the downward tendencies in international prices, although their inflation rates turned out to be higher than in Georgia by the end-year. The inflation rates equaled 3.7% in Ukraine, 5.4% in Azerbaijan, 4.7% in Armenia, and 6.1% in Russia. The only exception was Turkey, where the inflation rate has been on the uptrend in the recent period.

Starting from June 2011, the growth rate of prices for imported goods in Georgia relatively slowed down, settling at 2.4% by end-year. The domestic inflation equaled 7.3%. Concurrently, there was a sharp decline in the prices for tradable goods to 0.5%, while the annual inflation of non-tradables stood at 4.6% stemming from price increases for transportation services and utilities.

In 2011 the pattern of annual inflation by consumption durability changed drastically. In parallel to price decreases in the international markets, the annual percentage growth of prices for non-durable goods fell considerably to 3.3% at end-year; in the same period the inflation rates for durable and semi-durable goods turned negative, pointing to weakening of demand. In contrast, the general level of prices for services rose, stemming from price increases for transportation services and utilities.

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

	December 2009 weights	Dec11/Sep11		Dec 11/ Dec10	
		Inflation	Contribution	Inflation	Contribution
Total	100.0%	1.1%	1.1%	2.0%	2.0%
Food and Nonalcoholic beverages	40.1%	2.0%	0.9%	0.9%	0.4%
Food	38.8%	2.1%	0.9%	0.6%	0.3%
Bread and bakery	11.1%	-4.4%	-0.5%	-0.2%	0.0%
Meat and meat products	6.6%	-1.4%	-0.1%	21.9%	1.4%
Fish products	1.1%	3.9%	0.0%	5.4%	0.1%
Milk, cheese, and eggs	4.7%	5.8%	0.3%	6.5%	0.3%
Oils and fats	3.4%	-1.4%	-0.1%	3.6%	0.1%
Fruits, grapes	1.8%	-13.9%	-0.2%	-28.6%	-0.6%
Vegetables, melons, potatoes and other tubers	7.5%	23.3%	1.6%	-11.8%	-1.2%
Sugar, jams, honey, syrups, chocolate, pastry	2.2%	-5.6%	-0.1%	2.5%	0.1%
Other food products	0.3%	-0.5%	0.0%	13.8%	0.0%
Nonalcoholic beverages	1.3%	0.9%	0.0%	8.9%	0.1%
Alcoholic beverages, tobacco	2.9%	0.0%	0.0%	1.5%	0.0%
Clothing and footwear	4.3%	1.3%	0.0%	-5.3%	-0.2%
Housing, water, electricity, gas and other fuels	13.9%	1.7%	0.2%	3.3%	0.4%
Furnishings, household equipment, routine house maintenance	3.6%	-1.4%	0.0%	-0.7%	0.0%
Healthcare	9.0%	0.7%	0.1%	1.1%	0.1%
Transport	10.4%	-0.4%	0.0%	14.6%	1.5%
Communication	4.2%	-0.2%	0.0%	-7.7%	-0.3%
Recreation and Culture	2.2%	0.4%	0.0%	0.8%	0.0%
Education	5.2%	0.1%	0.0%	0.0%	0.0%
Hotels, cafes and restaurants	1.8%	0.8%	0.0%	7.0%	0.1%
Miscellaneous goods and services	2.5%	-0.9%	0.0%	1.0%	0.0%
Non-durable goods	67.9%	1.5%	1.0%	1.3%	0.9%
Semi-durable goods	5.8%	1.1%	0.1%	-3.0%	-0.2%
Durable goods	3.4%	-1.0%	0.0%	-3.3%	-0.1%
Services	22.8%	0.2%	0.1%	5.9%	1.2%

BOX1.
METHODOLOGICAL CHANGES IN CALCULATION OF THE CONSUMER PRICE INDEX

Changes in the Consumer Price Index (CPI) are used to measure changes in the general level of consumer prices in the country. The calculation of the CPI is based on the consumer basket. The latter represents the list of goods and services most frequently consumed in the country and reflects the expenditure pattern of an average consumer. Enumeration of pricestakes place every month during the 10th and the 20th days, inclusively, in five cities (Tbilisi, Batumi, Kutaisi, Gori, and Telavi). The number of retail outlets and service delivery points under the survey equals 1,300 covering every city district and all types of trade objects. The consumer basket is identical for every city and comprises 12 commodity groups, in line with the international classification (COICOP). Aggregated price indices are produced from individual indices for each city and for the whole country.

Since the expenditure pattern of consumers changes over time, the CPI basket needs to be updated. Until present the Georgian consumer basket was updated once in three years, although starting from 2012 the procedures and periodicity of basket updating will change. Before 2012 determination of weights for individual consumer basket components was based on the data from a household survey. In line with the new methodology, the consumer basket will rely on the system of national accounts. The use of national accounts in the process of defining consumer basket weights represents one of the important recommendations given by the Eurostat, the EU's main statistical office, to its member countries. After 2012 the updating of the basket is planned to take place every year.

By means of introducing methodological novelties in 2012, a number of changes are being implemented allowing for significant improvement in calculation of the CPI, and, accordingly, estimation of changes in the level of consumer prices in the country.

According to the existing practices, price enumeration comprised only regional cities and relied on the expenditure pattern of the respective cities. At the same time, determination of city weights was based on the number of population. The new methodology takes into account the expenditure pattern of a whole region, while the regional weights are defined in line with the scope of regional expenditures. As a result of these methodological changes, the coverage area expanded and regional weights altered.

TABLE 2.2
Coverage Area and Regional Weights

Regions	2010	2012
Tbilisi	61.6%	54.8%
Kutaisi	18.2%	17.8%
Batumi	9.3%	11.0%
Gori	6.4%	7.2%
Telavi	4.5%	9.2%

In addition, selection of outlets used to be made by interviewers based on location, which represented a potential source for statistical bias.

The improved methodology allowed for eliminating this deficiency. Starting from 2012 the selection process of surveyed outlets was based on the business statistics data, taking into account turnover volumes in these outlets.

The use of national accounts data allows for estimation of the national expenditure pattern, while the household survey represents a sample of certain groups of population. Furthermore, expenditures on certain types of goods and services are often misreported by households. For example, majority of respondents underreport consumption of alcoholic beverages and tobacco. Also, households tell more comprehensively about food and other everyday expenses, than about recreation and entertainment expenditures. The national accounts data gives a more realistic picture, relying not only on the household survey but also on other information sources. The 2010 consumer basket was based on the expenditure pattern from the 2007-2009 survey data, while the 2012 consumer basket used the 2010 national accounts data. Thus, the basket updating allows for making use of the latest available expenditure data and systematically taking into account renewed consumption patterns. Currently, the consumer basket includes 288 consumer goods and services, each having respective weights in proportion to total consumption.

In accordance with the methodological changes, the 2012 consumer basket weights altered considerably. Food and non-alcoholic beverage still account for the largest share of approximately 30%, which is peculiar to low-income developing countries. However, compared to the 2010 consumer basket, this share shrank significantly. Concurrently, the weight of service groups increased.

TABLE 2.3
Commodity Group Weights

Food and non-alcoholic beverages	2010	2012
Alcoholic beverages, tobacco	40.1%	30.3%
Clothing, footwear	2.9%	5.5%
Housing, water, electricity, natural gas	4.3%	2.6%
Furnishings, household appliances, routine house maintenance	13.9%	8.2%
Healthcare	3.6%	5.1%
Transport	9.0%	7.5%
Communication	10.4%	12.8%
Recreation and culture	4.2%	5.6%
Education	2.2%	6.8%
Hotels, cafes, restaurants	5.2%	6.1%
Miscellaneous goods and services	1.8%	4.4%
sxvadasxva saqoneli da momsaxureba	2.5%	5.0%

The new methodology also envisages changes in calculation of elementary indices. Henceforth, geometric mean will be used for calculation of elementary indices, in line with common international practice. Previously calculation of elementary indices relied on arithmetic mean. The use of arithmetic mean contained a certain deficiency stemming from the substitution effect. By using arithmetic mean it is not possible to reflect the fact that in the case of a price increase an average consumer usually substitutes consumption of more expensive goods and services. A thus-measured inflation indicatoris artificially overestimated. The use of geometric mean allows for partly correcting this deficiency.

3. INFLATION FACTORS

3.1 Labor Market

In Q3 2011 the labor productivity of employed in the economy rose 2.9% year-on-year. Concurrently, the average wages of hired employees grew significantly at 12.8%. Hence, after a decline in Q2 the labor productivity returned to the growth path, while the annual increase in wages of hired employees practically remained at the level of the preceding quarter.

Significant annual growth of real value-added per employed in Q3 2011 was recorded in "financial intermediation", "transport and communication", "hotels and restaurants" and trade. Relatively lower sectoral growth rates were posted in real estate, industry, healthcare, and agriculture. In annual terms the labor productivity fell considerably in public administration and education, while registering a slight decline in the construction sector.

According to the Geostat's quarterly enterprise and labor surveys, in Q3 2011 the average monthly wages of hired employees in the economy amounted to GEL 687.4, up 12.8% year-on-year. The growth of average wages of hired employees occurred in every sector of the economy.

The sectoral analysis shows that the most remarkable wage growth rates took place in real estate, agriculture, "community, social and personal services", and healthcare. In Q3 the growth rates of nominal wages in these sectors exceeded 20%. It should be noted that the high wage growth in these sectors (except for agriculture) was registered in the preceding quarters as well, hence, showing an upward trend.

The wage growth rates above 10% were re-

TABLE 3.1
Growth of Real Value-Added per Employed in Q3 2011, year-on-year

	Value-added Index
Agriculture and Processing of Agricultural Products	100.6
Industry	105.9
Construction	99.5
Trade	111.3
Hotels and Restaurants	115.8
Transport, Communication	126.6
Financial Intermediation	152.1
Real Estate, Renting and Business Activities	106.8
Public Administration, Defense	89.8
Education	95.7
Health and Social Work	105.5
Total	102.9

TABLE 3.2
Growth of Average Wages of Hired Employees in Q3 2011, year-on-year

	Nominal Wage Index
Agriculture, hunting and forestry	126.6
Fishing, fishery	79.9
Mining and quarrying	114.8
Manufacturing	115.8
Production and distribution of electricity, gas, and water	107.6
Construction	110.6
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	113.9
Hotels and restaurants	114.1
Transport and communication	109.5
Financial intermediation	107.2
Real estate, renting and business activities	131.8
Public administration	101.9
Education	110.8
Health and social work services	119.5
Other community, social and personal service activities	121.1
Total	112.8

corded in manufacturing and mining industry, "hotels and restaurants", trade, education, and construction. Wages rose at relatively lower rates in the remaining sectors of the economy.

Similar to the preceding periods, in Q3 2011 wide disparities in absolute wage levels were present across economic sectors. The highest average wages were traditionally recorded in "financial intermediation" (GEL 1,372), exceeding the average national level 2 times.

In terms of absolute wage level it is possible to single out economic sectors with relatively high wages such as "public administration", "mining industry", "construction", "production and distribution of electricity, water", and "transport and communication". The average wages in these sectors ranged between GEL 840 and GEL 960 in Q3. Relatively low wages are peculiar to "real estate operations", "trade", and "manufacturing industry", where hired employees receive average monthly wages between GEL 640 and GEL 775. The sectors with low wages include "community, social and personal services", healthcare, education, agriculture, and fishing, where the monthly wages oscillate between GEL 310 and GEL 574. In two of the latter sectors – education and fishery – the level of average wages constituted less than a half of the national average.

It is remarkable that in Q3 2011 the difference between the highest and the lowest sectoral wages grew at a moderate rate in annual terms, while significantly decreasing quarter-on-quarter.

In Q3 2011 the average growth rate of wages of hired employees in annual terms was slightly lower than that of the previos quarter. Meanwhile, as already mentioned, the labor productivity returned to the growth path. As a result, in Q3 2011 the ratio of average wages to labor productivity, i. e. unit labor costs, rose 9.6%.

In order to analyze a potential impact of the above increase in unit labor costs on the price level it is useful to consider changes in unit labor costs for the largest sectors of the economy.

In agriculture the unit labor costs grew at the highest rate as a result of big increases in average wages. However, due to a low level of formal employment in this sector the growth of average agricultural wages produces virtually no impact on prices.

DIAGRAM 3.1

Average Sectoral Wages of Hired Employees, Q3 2011 (GEL)

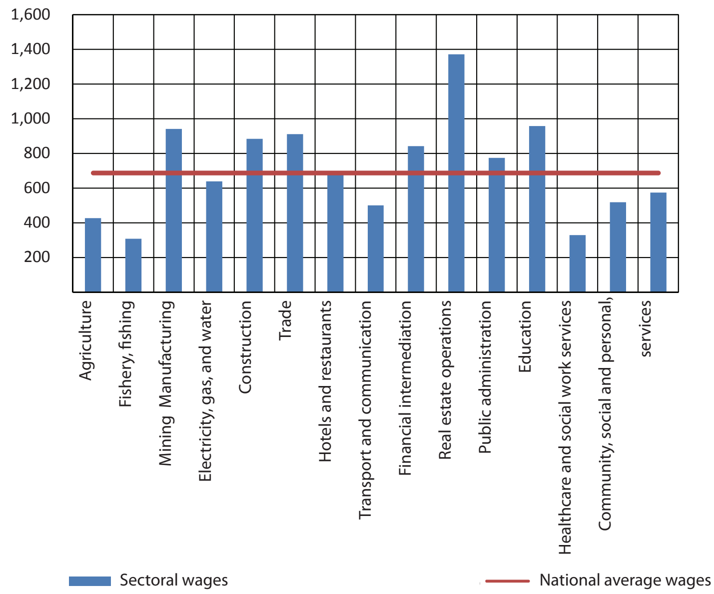
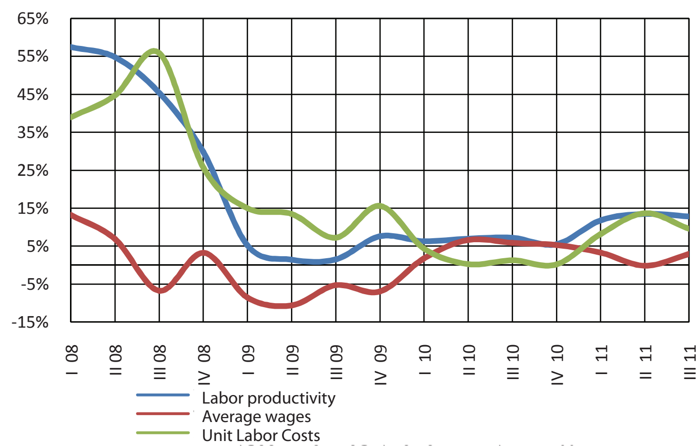


DIAGRAM 3.2

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



A large increase in unit labor costs was recorded in the industry sector, conditioned by a small growth of labor productivity and relatively large increase in average wages.

The unit labor costs rose insignificantly in the trade sector, while considerably declining in the transport and communication sector. Hence, the supply-side pressure on prices in these two sectors appears quite weak.

3.2 Monetary Instruments

In Q4 2011 the NBG's monetary policy took into consideration the existing inflation forecasts, macroeconomic trends and current processes in the international markets. The annual inflation level further declined in quarterly terms, settling at 2% by end-year. A low level of inflation is forecasted to prevail throughout the first half of 2012, while being followed with a moderate growth within the targeted inflation range. Taking into account the existing trends and factors affecting aggregate demand, the NBG's Monetary Policy Committee (MPC) continued monetary policy loosening in Q4 2011. The refinancing rate (policy rate) was cut by 25 basis points each month, declining from 7.5% to 6.75% by end-year. In January 2012 the policy rate was slashed by additional 25 basis points, settlingat 6.5%.

Similar to the preceding period, in Q4 the NBG actively applied monetary instruments for liquidity supply and withdrawal. Short-term liquidity was supplied by means of refinancing loans aimed at regulating short-term interbank interest rates. The monetary policy rate cuts by the NBG are initially reflected on the short-term interbank interest rates, ultimately transmitting to market interest rates and boosting aggregate demand. In Q4 of 2011withdrawal of medium-term excess liquidity was performed through 3- and 6-month Certificates of Deposit.

Demand for banking liquidity was determined by the level of average required reserves. The latter is conditioned by the amount of attracted funds and the required reserve ratio. In Q4 the reserve ratio was unchanged, standing at 10% and 15%for funds attracted in domestic and foreign currency, respectively.

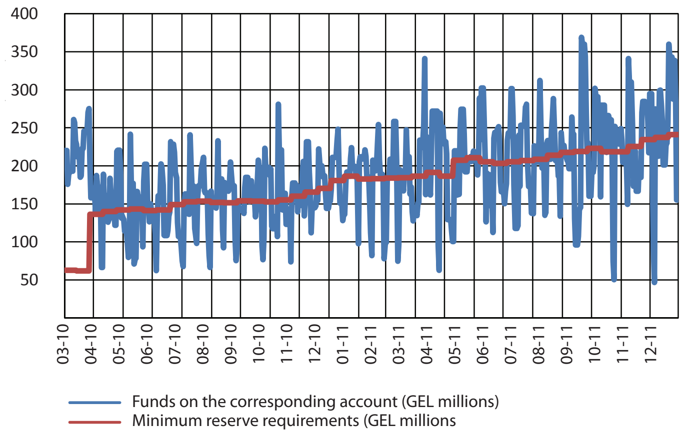
Preliminary estimates of banking liquidity are produced on a weekly basis through liquidity forecasts, determining the volume of short-term liquidity necessary for the banking sector to comply with the reserve requirements. One-week refinancing loans allow commercial banks to efficiently manage short-term liquidity and obtain necessary liquid funds through auctions usually conducted once a week. Demand for this instrument was high in October-November 2011, gradually subsiding in the following two months. Slackened demand was conditioned by accumulation of excess liquidity, which in turn was the result of significant government expenditures at end-December. In Q4 2011 13 auctions for one-week refinancing loans were conducted, where the total amount of extended loans at each auction oscillated between GEL 13 million and GEL 400 million, averaging GEL 178.7 million. In addition, in the considered quarter two permanent one-week refinancing loans were extended in the total amount of GEL 50 million. The total amount of refinancing loans extended in Q4 was 17% lower (20% lower, when including permanent refinancing loans) than in the preceding quarter. As already mentioned, this contraction was the result of an increase in banking liquidity largely related to government sector operations. The weighted average interest rate amounted to 7.37% oscillating around the monetary policy rate.

The ratio of net liquidity withdrawal to reserve money averaged 13.0%. As of December 31, 2011 the net liquidity withdrawal totaled GEL 428.6 million.

In Q4 the average amount of funds on the corresponding accounts equaled GEL 237.3 million, slightly exceeding the average required level of GEL 228.1 million. However, along with accumulation of excess liquidity the volume of commercial banks' funds placed on the NBG's overnight deposits increased and remained at a high level in January 2012. Under the conditions of liquidity deficit the banks resorted to refinancing loans, while accumulation of excess liquidity prompts them to use overnight deposits accruing the monetary policy rate minus 1.5 pps. The use of refinancing instruments by commercial banks is important for the NBG, since it allows for transmission of the monetary policy (refinancing) rate first to interbank interest rates and eventually to market interest rates. Thus, excess liquidity lowers demand for refinancing loans, resulting in decreased efficiency of the monetary policy.

In Q4 2011 the NBG continued issuance of 3- and 6-month Certificates of Deposit with the view of withdrawing medium-term liquidity from the banking system. The auctioned volumes of CDs were determined in such a way that the volume of withdrawn liquidity would remain at the same level. In Q4 the stock of CDs in circulation averaged approximately GEL 440 million. The total amount of placed CDs in the given period equaled GEL 290 million, with demand exceeding supply 2.3 times. The nominal value of placed Certificates of Deposit totaled GEL 115 million for 3-month CDs and GEL 175 million for 6-month CDs. Compared to the preceding quarter, the issuance of CDs rose 18.4%, while demand grew 10.5%.

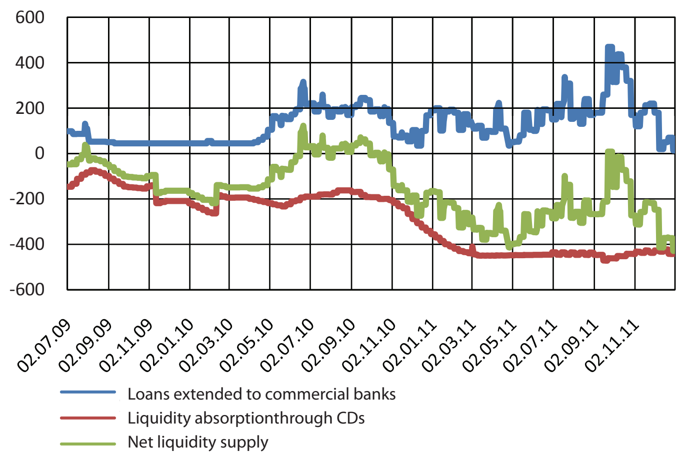
DIAGRAM 3.3
Lari Liquidity



At end-December 2011 the increased government expenditures affected growth of reserve money. As a result, the ratio of liquidity withdrawal through CDs to reserve money declined from 26% at end-Q3 to 21% in Q4.

The above-mentioned dynamics of government expenditures and reserve money contributed to accumulation of excess liquidity in the banking system. This resulted in lower demand for refinancing loans and deteriorated monetary transmission mechanism. In response to that the NBG increased the volumes of CD issuance start-

DIAGRAM 3.4
Liquidity Absorptionthrough CDs, Loan Extension to Commercial Banks and Net Liquidity Supply (GEL millions)



ing from the beginning of 2012. In January the amount of issued CDs equaled GEL 160 million, expanding the stock of outstanding CDs by GEL 90 million and partly reducing excess liquidity. According to the issuance schedule, the stock of CDs in circulation will rise by additional GEL 25 million to exceed the Q4 2011 level by GEL 115 million.

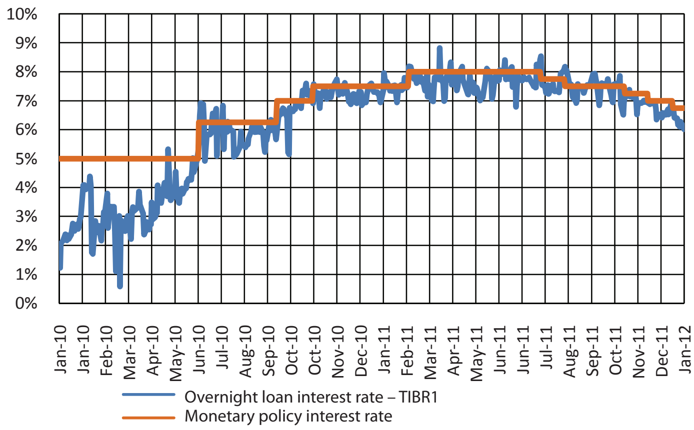
3.3 Interbank Loans

The interbank money market plays a decisive role in the monetary policy transmission mechanism, since the NBG affects the interest rates of this market by altering the monetary policy rate with the view to achieve price stability. After a certain period these changes first affect commercial banks' short-term interest rates, subsequently influencing long-term interest rates and aggregate demand, which in turn allows for attaining a desired level of inflation.

In Q4 2011 the turnover in the interbank money market decreased. The overall amount of lari denominated loans and deposits amounted to GEL 2.3 billion, down by GEL 262.5 million from Q3. The contraction was due to lower demand for liquid funds on the part of banks, as increased government expenditures led to liquidity growth in the banking sector. In general, less dependence of banks on the money market weakens the monetary transmission, thus deteriorating the ability of monetary policy to affect inflation. However, the scale of the mentioned contraction is not large and presumably has a temporary nature.

DIAGRAM 3.5

Average Interest Rates on Short-Term Interbank Loans and Monetary Policy Rate



Similar to lari denominated funds, the volume of the US dollar denominated transactions shrank as well. In particular, the decrease equaled 26.3%, with the transaction volume falling to USD 216.1 million. The euro-denominated turnover fell almost 5 times, equaling only EUR 9.3 million in Q4, likely as a result of the euro's depreciation.

Owing to the growth of government expenditures and, accordingly, the increase in banking liquidity, the lari denominated funds became cheaper, along with the decline in the policy rate. All these factors produced an impact on the interest rates of overnight and 7-day interbank loans in domestic currency: the average level of TIBR-1 fell by 1.5 pps to 6.3%, while that of TIBR-7 shed 1 pp to equal 7.8%. It is likely that such decreases in the interest rates will not have a significant effect on long-term interest rates and price level.

With regard to foreign currency, it turns out that along with a drop in the euro interest rate (almost twice to 2.4%) due to its unattractiveness, the average US dollar interest rate stood at 1.9% at end-Q4, remaining practically unchanged in comparison to the preceding periods.

As of Q4 2011, the transactions related to overnight loans and deposits account for the largest part of the interbank money market activities. The shares of overnight transactions in the euro, the US dollar, and the lari equaled 84.0%, 72.3%, and 90.5%, respectively.

3.4 Banking Sector

In 2011 the credit activity in the banking sector had been permanently growing. However, it should be pointed out that starting from the second half of the year the growth rate of economy crediting slowed down. The contraction of foreign currency denominated loans was presumably related to accumulation of funds by commercial banks for the purposes of external debt repayment due in February-March 2012. The growth rate of lari denominated loans slowed down as well, although at a relatively lower pace. In Q4 2011 the volume of extended loans grew 3.8%[1] to total GEL 7.7 billion (See Diagram 3.6). The contribution of lari denominated loans to the overall growth was larger than that of foreign currency denominated loans: in particular, in quarterly terms the former grew by GEL 152 million, while the latter – by GEL 129.8 million. This resulted in a 1 pp reduction in loan dollarization to 68.8%. It should be noted that compared to December 2010 the dollarization rate declined by 4 pps. On the one hand, this fact indicates increased confidence of commercial banks in the domestic currency, while, on the other hand, it represents a result of active use of monetary instruments by the NBG aimed at managing liquidity.

The banking sector focused on relatively long-term investments of lari resources in the second half of 2011 (See Diagram 3.7). The above-mentioned growth of lari denominated loans in Q4 was fueled precisely by long-term loans, the share of which in total lari denominated loans equaled 58.7%. In general, an increase in long-term loans denominated in lari represents a good foundation for enhancing efficiency of the monetary policy transmission mechanism and, accordingly, for mitigating inflation risks: it is much more effective to influence aggregate demand (and, ultimately, prices) under high de-dollarization. With regard to foreign currency denominated loans it should be noted that the volatility of short-term loans is much higher than that of lari denominated loans. In contrast, the long-term foreign currency loans

DIAGRAM 3.6
Extended Loans (GEL, millions) and Dollarization

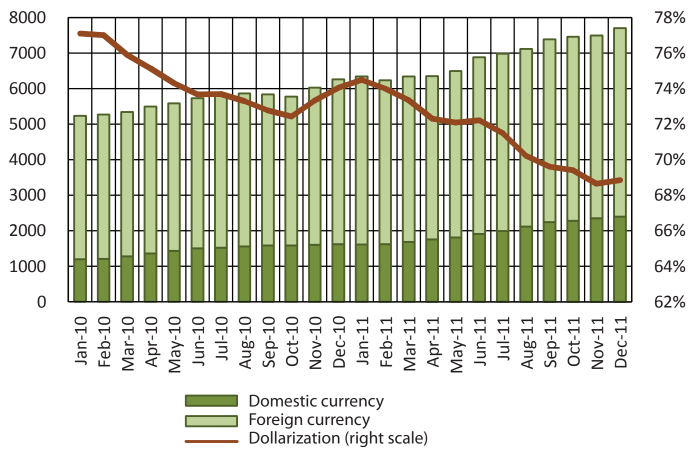
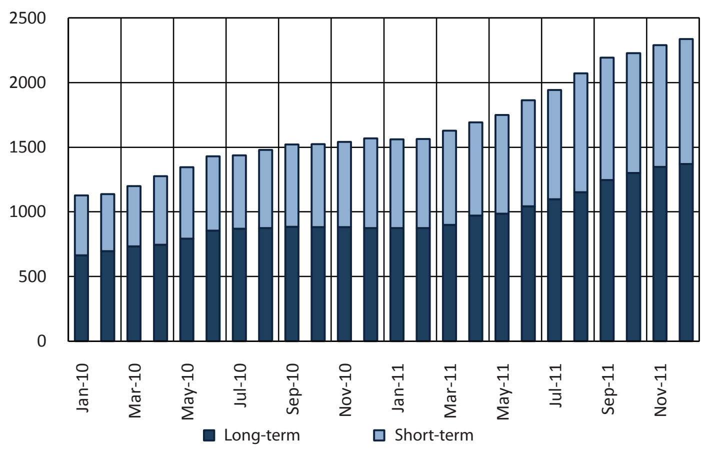


DIAGRAM 3.7
Loans Denominated in Domestic Currency[2] , GEL millions

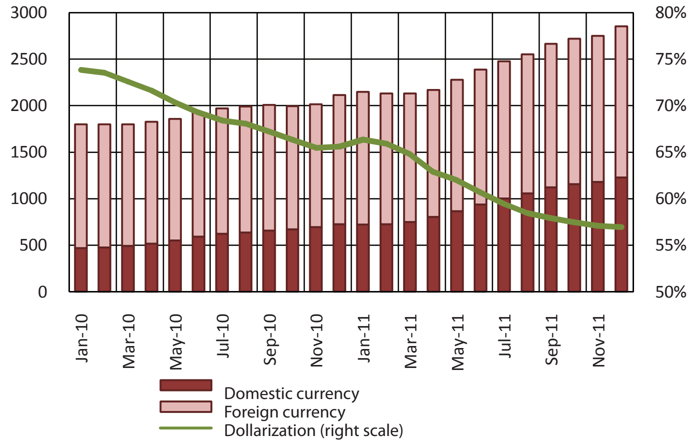


1 The present subchapter treats changes in volumes excluding the exchange rate effect, unless the volumes are expressed only in the lari.

2 Excluding overdue loans

DIAGRAM 3.8

Loans to Individuals (GEL millions) and Dollarization

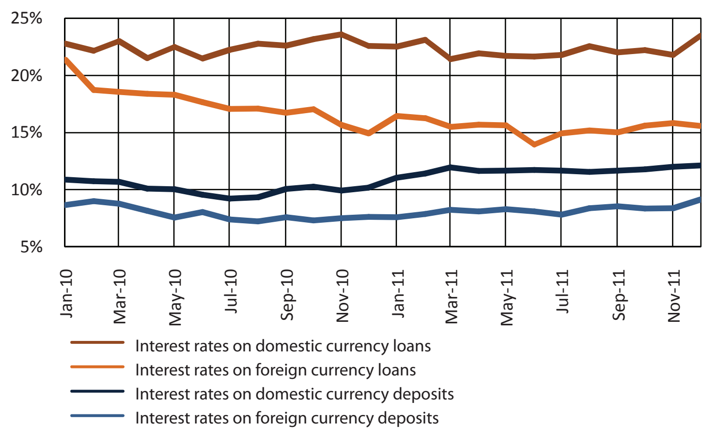


tend to grow over time. The latter fact, however, had no effect on the dollarization rate in Q4, as the latter declined by 1.2 pps in quarterly terms and 3.8% in annual terms, equaling 76%.

In Q4 2011 high growth rates of lari denominated loans extended to individuals were maintained, reducing the dollarization of loans to individuals by additional 1.1 pps (See Diagram 3.8). A 9 pp decline in annual dollarization rate is particularly striking, since, as already mentioned, an efficient monetary policy transmission mechanism requires that the economy should rely more on lari resources. The

DIAGRAM 3.9

Market Interest Rates on Loans and Deposits by Different Currencies



domestic currency denominated loans extended to legal entities is growing as well, albeit at a lower rate: in Q4 the loan growth equaled only 3.5%. Overall, the largest part of loans (approximately 70%) was extended to the legal entities, with the respective dollarization rate standing at 76.1%.

In 2011 loans extended to the trade and service sectors grew at a particularly high rate in the overall loan portfolio, expanding by GEL 305 million to GEL 2.1billion. The expansion of consumer loans and mortgage loans was also remarkable, as the former grew by GEL 240.2 million to GEL 1 billion and the latter rose by GEL 213.5 million to GEL 1.2 billion. The growth of mortgage loans is likely to revitalize the real estate market.

The interest rates on extended loans rose by end-2011, affected by the above-mentioned accumulation of funds. In particular, in order to attract a suffucient amount of funds commercial banks increased interest on deposits (See below for more details), which led to a hike in loan interest rates. The interest rate on lari denominated loans grew in Q4 from 22% to 23.5% on average, while that on foreign currency denominated loans increased by 0.6 pps to 15.6% (See Diagram 3.9).

In 2011 the issuance of CDs expanded considerably. During the year the volume of deposits placed in commercial banks exceeded GEL 6 billion, settling at GEL 6.7 billion in December and exceeding the 2010 level by GEL 1.5 billion. The above growth mainly took place in the last quarter of 2011 owing to a large increase in lari denominated deposits: their volume rose by GEL 517.8 million, fueled by a drastic growth of government deposits. It should be noted that the contribution of domestic currency denominated deposits to the overall annual growth is also considerable, conditioning a 6.7 pp reduction in dollarization to 59.9%.

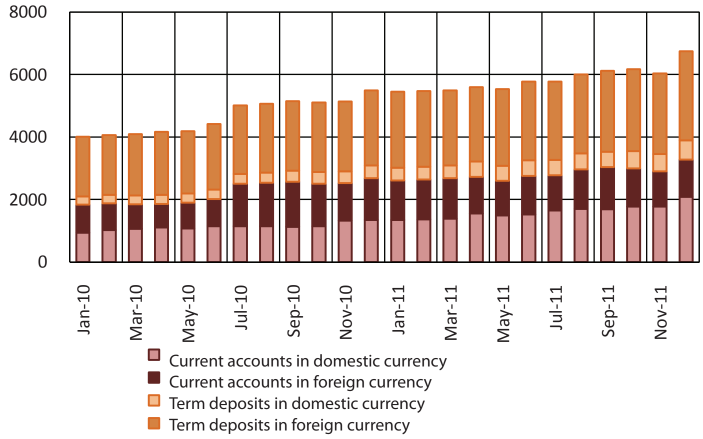
The annual growth of deposits was influenced by current and term accounts. However, it should be pointed out that unlike the lari denominated deposits, the deposits in foreign currency posted a decline of approximately 5% to GEL 1.2 billion. The last quarter was no exception either (See Diagram 3.10). The volume of current accounts stood at GEL 3.3 billion at end 2011, with the dollarization rate equaling 36.3%. The situation with dollarization is opposite for term deposits: the share of foreign currency denominated deposits equaled 82.2%, declining only 2.5 pps by end-year. The reason presumably is the population's low confidence in lari as a long-term asset: individuals hold more than half of term deposits, and their deposits denominated in lari account for only 12%.

Increased demand for foreign currency on the part of banks led to an increase in interest rates on the respective deposits, while in turn conditioning a rise in lari interest rates. The average annual growth of deposits denominated in domestic currency equaled 2 pps (See Diagram 3.9). Similar to loan interest rates, the average deposit rates also rose, growing on average by 1.5 pps. A particular increase was recorded in December, equaling 0.9 pps.

Along with the post-crisis recovery the financial intermediation grew profitable again in the last two years. Moreover, in 2011 the banking sector profit doubled with respect to 2010, equaling GEL 323 million. The return on equity amounted to 17.3%, and the return on assets was 2.9%. The regulatory capital adequacy ratio declined from 17.4% to 17%, partially due to a considerable expansion of the loan portfolio.

DIAGRAM 3.10

Deposits (GEL millions)



3.5 Factors Influencing Exchange Rate Dynamic

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 Q4 2011 it was important to observe the lari's exchange rate dynamics against the Turkish lira, as Turkey is Georgia's main trading partner. In the beginning of Q4 the TRY/GEL nominal exchange rate initially increased, following with a sharp decline. By end-year data, the lari appreciated 2.7% against the Turkish lira quarter-on-quarter. However, the

DIAGRAM 3.11

Lari's Nominal Exchange Rate indices, 2009-2011

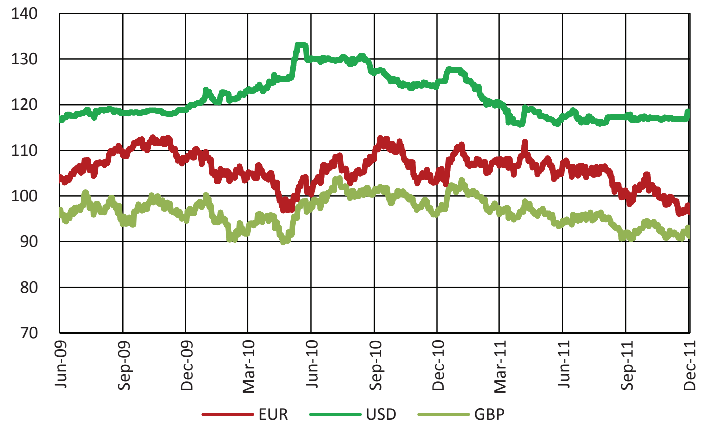


DIAGRAM 3.12

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

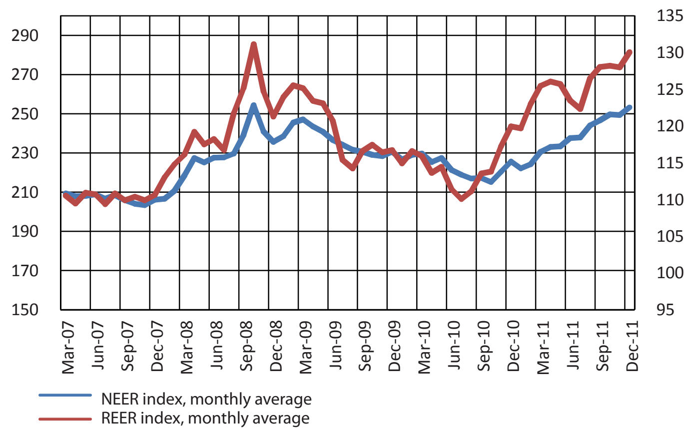
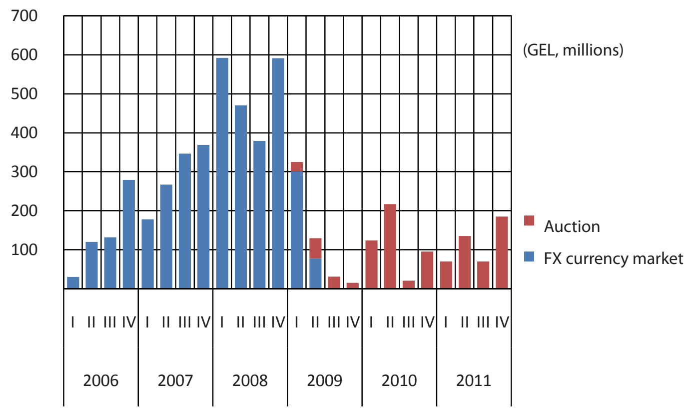


DIAGRAM 3.13

NBG's Interventions in the FX Market



lari's appreciation trend with respect to the Turkish lira reversed again in January 2012. In the reporting period the lari slightly depreciated against the US dollar, falling 0.6% (See Diagram 3.11), while the end-period data shows a 4.5% appreciation of the lari against the euro. National currency cumulative appreciation against GBP totaled 0.8 % in Q4 2011. Cumulatively, the appreciation of the lari's nominal effective exchange rate equaled 1.7%, while the monthly average nominal effective exchange rate index grew 2.6%. The lari's monthly average real effective exchange rate rose 1.6% in Q4, implying real appreciation of the domestic currency. The real effective exchange rate is closely related to the country's competitiveness. Its real appreciation deteriorates the country's competitiveness. The lari's real appreciation was mainly caused by strengthening of the nominal effective exchange rate. It should be noted that low inflation in Georgia relative to its trading partners moved the real effective exchange rate downward.

The lari's exchange rate dynamics in Q4 2011 was conditioned by several factors. The domestic currency's exchange rate was pushed up by money remittances from abroad and tourism revenues. In addition, the euro's downward tendencies in the international markets created expectations of the lari's appreciation. The appreciation was partly offset by increased demand for foreign currency fueled by a widening current account and lower growth rates of foreign currency loans compared to domestic currency denominated loans.

According to the NBG's estimates, the net revenues from tourism grew annually at 24.1% in Q4, increasing demand for the domestic currency. In Q4 2011 the amount of money remittances from abroad also rose in annual terms, equaling USD 338.0 million and exceeding the Q4 2010 figure by

14.0%. The foreign currency supply was affected by the inflow of USD 266.0 million of net foreign investments in Georgia, as the latterposted a 17.6% growth rate year-on-year. Expectations of the lari's appreciation were amplified by the euro's depreciating tendencies, in turn affecting demand for foreign currency. In line with the NBG's preliminary data[3] , the current account deficit grew in Q3 2011. The estimates for Q4 2011 see further widening of the deficit, as the latter represents an important factor underlying increased demand for foreign currency. The increase of domestic currency supply was triggered by lower growth rates of foreign currency denominated loans in comparison to domestic currency loans. In Q4 2011 the amount of loans extended in foreign currency equaled USD 78.1 million, while the domestic currency denominated loans totaled GEL 153.8 million. Such dynamics of the credit portfolio moved the lari's nominal exchange rate downward in Q4.

The banking sector attracted USD 136.2 million in the form of long-term external loans in Q4 2011. 90% of these funds are denominated in foreign currency, strengthening the lari's nominal exchange rate. The total external debt repayments in the form of principal and interest payments by the banking sector in Q4 totaled USD 31.6 million, in turn affecting foreign currency demand.

In Q4 the NBG's interventions in the FX market served to maintaining an adequate level of international reserves. In Q4 2011 the net purchases of foreign currency by the NBG at the FX auctions equaled USD 185 million.

An important determinant of demand for foreign currency represents the level of dollarization and speculative capital, creating certain expecta-

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

DIAGRAM 3.14

Dynamics of Georgia's Current Account and Trade Balances

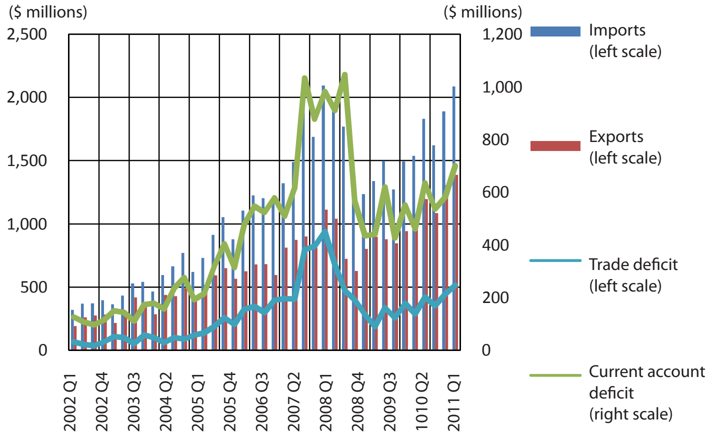


DIAGRAM 3.15

FDIs in Georgia

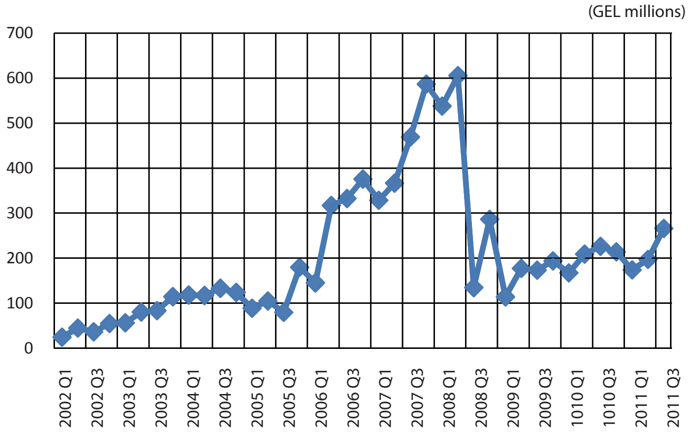
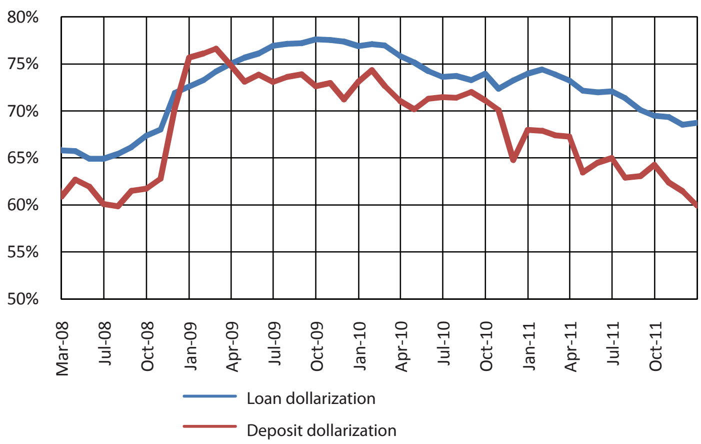


DIAGRAM 3.16

Loan and Deposit Dollarization Rates



tions in the market. Despite the initial strengthening in the beginning of Q4, the end-year data showed depreciation of the euro with respect to the US dollar. Such dynamics of the EUR/USD exchange rate made a certain impact on demand for the lari.

The NBG actively continued to enhance the process of larization (dedollarization) in the country. Certain positive outcomes of the dedollarization policies are already visible. In Q4 the dollarization rates declined for both loans and deposits. The loan dollarization fell by 0.7 pps, while the deposit dollarization dropped significantly, losing 4.3 pps. High level of deposit dollarization is in turn conditioned by economic agents' expectations with respect to the lari's possible depreciation in the future. A general psychological factor related to political risks should be also mentioned, conducing to population's mistrust of the lari and giving the US dollar a status of a risk-free currency.

3.6 Production and Demand

In Q3 2011 the annual growth rate of the real gross domestic product equaled 7.5%, significantly exceeding the Q2 rate. The nominal GDP grew 15.7%. Accordingly, the deflator posted a 7.7% growth rate in annual terms.

Relatively higher contributions to the growth of the quarterly GDP were made by trade and manufacturing industry. The expansion of the lat-

TABLE 3.3
Sectoral Contributions to Real GDP Growth, Q3 2011 (%)

	Nominal weights (Q3 2010)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	7.1%	6.1%	0.4%
Mining and quarrying	0.9%	-6.2%	-0.1%
Manufacturing	8.3%	16.6%	1.4%
Electricity, gas and water supply	2.2%	1.4%	0.0%
Processing of products by households	3.0%	8.5%	0.3%
Construction	6.3%	5.9%	0.4%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	14.7%	9.2%	1.4%
Hotels and restaurants	2.1%	10.9%	0.2%
Transport	6.9%	5.2%	0.4%
Communication	3.5%	8.2%	0.3%
Financial intermediation	2.1%	24.9%	0.5%
Real estate, renting and business activities	4.2%	4.9%	0.2%
Imputed rent of own occupied dwellings	2.8%	2.8%	0.1%
Public administration	10.6%	5.8%	0.6%
Education	4.2%	3.4%	0.1%
Health and social work	5.5%	0.7%	0.0%
Other community, social and personal service activities	3.0%	11.3%	0.3%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	15.6%	0.0%
FISIM adjustment	-1.2%	11.9%	-0.1%
GDP at basic prices	**86.4%**	**6.5%**	
Taxes on products	14.0%	7.1%	1.0%
Subsidies on products	0.4%	0.7%	0.0%
GDP at market prices	***100.0%***	***7.5%***	***7.5%***

ter was largely fueled by light, metallurgic, food, and chemical industries.

A smaller but still a significant impact on the overall economic growth was produced by public administration, financial intermediation, agriculture, construction, and transport. It should be stressed that in contrast to the preceding years, agriculture and the closely related "processing of products by households" posted positive growth rates throughout 2011. In Q3 the real value-added also rose in almost all remaining sectors, although their contributions to the annual GDP growth were insignificant. Contraction of production was recorded only in the mining industry.

It is remarkable that the "financial intermediation" registered stable growth rates in the past year. This fact is clearly observed from the seasonally adjusted data of sectoral production.

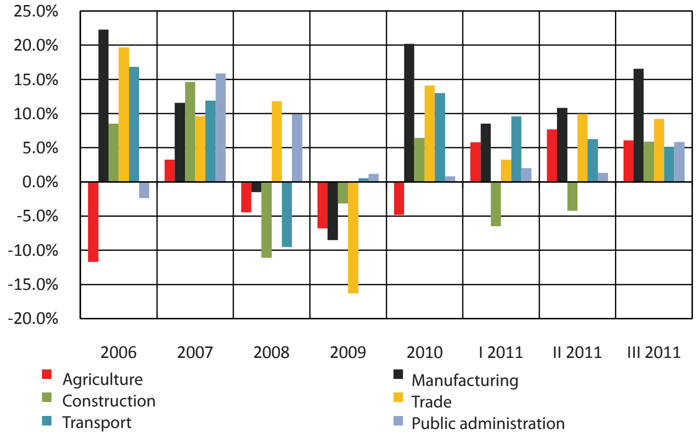
The dynamics of real growth in Georgia's leading economic sectors were varying. As already mentioned, after a several-year contraction the agricultural sector returned to a steady growth path. In 2011 acceleration in the growth rates of manufacturing was clearly pronounced. Particularly high growth throughout the year was recorded in the light and food industries. The construction sector entered a downtrend in the first half of the year, but returned to growth in Q3. The remaining large sectors developed in a relatively stable manner.

3.6.1 Private and Government Consumption

In Q3 2011 the nominal GDP posted a 15.7% growth rate in annual terms, powered by a 16.2% expansion of household final consumption. The overall final consumption, due to contraction of government expenditures, increased only 12%.

Despite a decline in annual inflation, the "household final consumption" still registered high growth rates in Q3, comparable to the first

DIAGRAM 3.17
Dynamics of Value-Added Growth in the Leading Economic Sectors (2005 – Q3 2011)



half of the year (under high inflation), rising at approximately 9% in the real terms.

The "actual household final consumption" (which includes all types of final consumption excluding general government's "collective services") rose in real terms approximately at the same rate (7.8%) as the real GDP (7.5%). This implies that in Q3 there was practically no aggregate demand pressure on prices.

Compared to Q3 2010, the general government expenditures declined 3.7%, mainly due to a 3.9% decrease in expenditures on collective services. The expenditures on individual goods and services also fell, posting a 3% contraction rate.

The growth rate of "export of goods and services" decelerated in comparison to the preceding quarters, accordingly, reducing this category's contribution to the GDP growth. The growth rate of imports, on the other hand, rose, recording a 22.5% increase.

3.6.2 Investments

In Q3 2011 the gross capital formation expanded 29%, largely fueled by a drastic increase in inventories. It should be noted that such a large nominal increase in inventories within a quarter (gel 344 million) as registered only once, in 2007.

The investment in fixed capital increased 12.3% in annual terms. It is remarkable that the growth rates significantly decelerated in the last two quarters. An average growth of investments in fixed capital between Q2 2010 and Q2 2011 equaled 60%. Such a rapid growth was related to the post-crisis recovery processes in the economy and, thus, was impossible to sustain for an extended period.

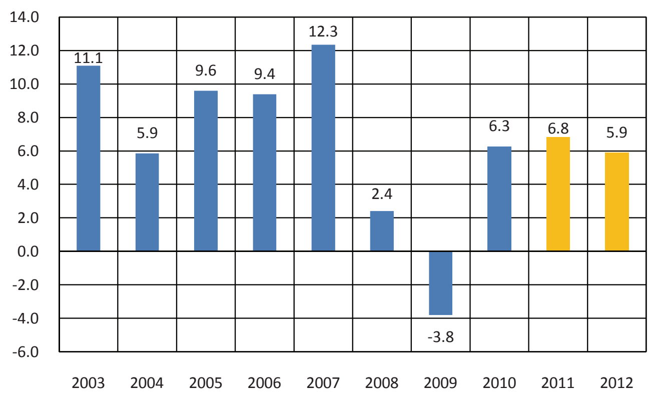
Overall, the "gross capital formation" category posted a higher annual growth rate in comparison to Q2. It should be stressed that in Q3 the nominal volume of total investments exceeded the pre-crisis level as a result of rapid investment growth.

3.6.3 2011 and 2012 Forecasts

The actual GDP growth in Q3 turned out 0.2 pp higher than the corresponding estimate made in the previous report. The difference was mainly due to higher-than-expected real growth in public administration and construction.

DIAGRAM 3.18

Real GDP Growth, 2003-2012[4] (%)



4 The NBG's projections are used for the 2011 and 2012 growth rates.

The Q4 GDP forecast was also revised upwards, conditioned by larger expansion of local production used for domestic consumption. Despite a decline in the inflation rate, the growth of VAT taxpayers' turnover amounted to 19.2% in Q4 2011,

The real GDP in Q4 2011 is projected to increase at approximately 8.1%.

With regard to sectoral forecasts of value-added, the real GDP growth is likely to be powered by manufacturing industry, trade, "community, social, and personal services", and transport. Positive contributions will be also made by financial intermediation, communication, and construction.

With regard to categories of use, the nominal GDP will be fueled by a 12% expansion of "final consumption", the latter being conditioned in turn by higher-than 15% growth of household final expenditures. Other expenditure components are not expected to produce significant positive contributions to the GDP expansion.

Overall, the 2011 real GDP growth was revised upwards to 6.8%, significantly exceeding the 2010 growth rate (6.3%).

In 2012 the domestic economy is expected to grow at annual 6%. The largest positive impact is likely to be produced by manufacturing and trade sectors. Similar to the second half of 2011, in terms of categories of use the GDP will be largely powered by the final consumption component.

3.7 External Trade

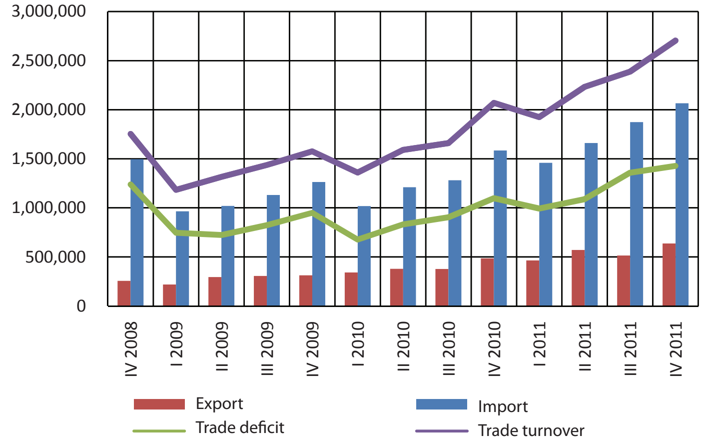
The trade balance (trade in goods and services) of the balance-of-payments of Georgia remains negative, producing a negative impact on the GDP growth. In line with the actual data for 2010 and projected 2011 data, the trade deficit oscillates around 18% of GDP. The balance of trade in goods is negative, with the projected value for Q4 2011 standing at USD -1 billion. On the other hand, the balance of trade in services is a relatively smaller positive component of the trade balance, as its Q4 forecast amounted to USD 185.7 million.

In Q4 2011 the turnover of registered[5] trade in goods totaled USD 2.8 billion, up by 30.6% year-on-year and 13.2% quarter-on-quarter. The registered exports of goods equaled USD 637.7 million, up 31.4% year-on-year and 24.0% quarter-on-quarter. The registered imports of goods totaled USD 2.1billion, posting annual and quarterly growth rates of 30.4% and 10.3%, respectively. Despite the fact that the annual and quarterly growth rates of exports were higher than those of imports, the trade deficit widened again, since in absolute terms the value of imports exceeded that of exports by USD 1.4billion. In Q4 2011 the trade deficit grew 29.9% in annual terms and 5.1% in quarterly terms.

The export of goods by end-use categories was distributed as follows: capital goods – 5.2%, 46.8% intermediate consumption goods – 46.8%, 47.7% - final consumption goods. In Q4 the share of consumer goods in total exports increased from 38.7% in the preceding quarter, while the share of intermediate consumption goods shrank. The largest contribution to the share increase for final consumption goods was made by the export of nuts, reaching a record high level of USD 75.9 million and occupying the second position in the top export item list after motor cars re-export. The export of nuts grew 2.7 times quarter-on-quarter, as a result of good harvest, on the one hand, and favorable international prices, on the other. A large

DIAGRAM 3.19

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

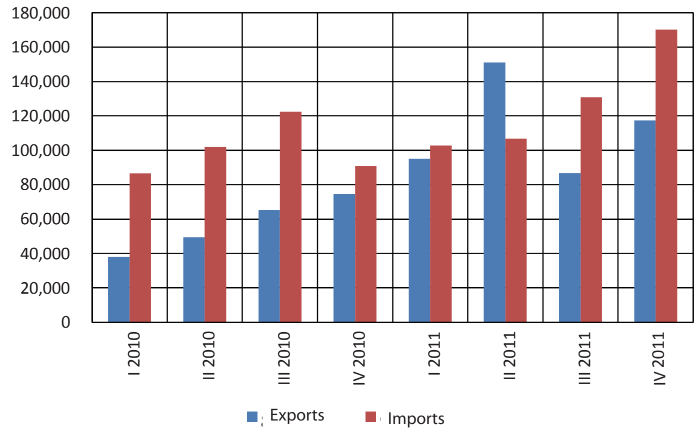


positive impact on expansion of exports of consumer goods was produced by re-export of motor cars, which retained the top position throughout 2011. The annual growth rate of motor car re-export reached a record high 57.2%, accounting for 69.0% of all imported motor cars.

From intermediate consumption goods the export of mineral fertilizers should be singled out, growing 2.6 times year-on-year to USD 48.4 million. The export of ferroalloys occupied the third position in the top export item list, equaling USD 58.2 million with 32.9 contraction year-on-year.

DIAGRAM 3.20

Imports and Exports of Motor Cars (USD thousands)



5 The statistics of goods trade mainly relies on the principle of border crossing, while compilation of the goods trade component of the balance of payments is based on the transfer of ownership rights between residents and non-residents. There are also some other methodological differences between these two approaches.

The registered imports of goods consisted of 15.3% of capital goods, 36.6% of intermediate consumption goods, and 47.8% of final consumption goods. This structure did not significantly change from the preceding periods. Petroleum products (largely, gasoline) and motor cars, occupying the top and the second positions, respectively, belong to final consumption goods. The annual growth rate of petroleum products equaled 18.2%, mainly due to price effects.

In line with the IMF forecasts[6] , oil prices are not projected to decline considerably in 2012. Despite pessimistic expectations with respect to global economic growth, likely to slacken demand for oil, certain geopolitical risks arise, which have an adverse effect on oil supply and, hence, prices.

The import of petroleum gases, making part to the intermediate consumption category, grew 18.7% in annual terms. In Q4 2011 food products accounted for 12.3% of total imports. The value of food imports increased only 0.9% year-on-year, equaling USD 254.4 million. The wheat imports accounted for 17.5% of food imports and 2.1% of total registered imports. The value of wheat imports declined 34.7% in annual terms, due to both price and volume effects. The import of meat products held the second largest share in total food imports, namely 12.7%, posting an annual 32.9% growth rate. The import of sugar and confectionery constituted 10.3% of food imports (and 1.3% of total imports). The import of tobacco and alcoholic beverages accounted for 2.2% of total registered imports, recording a 5.3% growth in annual terms.

3.8 Government Operations

In Q4 2011 the consolidated budget revenues and grants totaled GEL 1.8 billion. The grants equaled GEL 36.1 million, while tax and non-tax revenues amounted to GEL 1.8 billion. The Q4 revenues accounted for 26.9% of GDP[7] , down by 0.3 pps year-on-year. The tax burden (ratio of tax revenues to GDP) equaled 24.4%, or 3 pp more in annual terms. The largest contribution to the increase in tax burden was made by the VAT.

TABLE 3.4
Consolidated Budget Parameters
(GEL millions)

	QIV - 2011	Percent of GDP (QIV - 2011)
Total revenues and grants	1,844	26.9%
Revenues	1,808	26.4%
Tax revenues	1,668	24.4%
Non-tax revenues	139	2.0%
Grants	36	0.5%
Total expenditures	2,524	36.8%
Current expenditures	1,688	24.6%
Capital expenditures and net lending	835	12.2%
Surplus	-680	-9.9%
Deficit Financing	680	9,9%
Privatization	239	3.5%
Use of free circulating funds	220	3.2%
Net increase in domestic liabilities	2	0%
Net increase in external liabilities	219	3.2%

The total expenditures of the consolidated budget in Q4 2011 equaled GEL 2.5 billion, up 12.8% year-on-year. Due to a higher nominal economic growth in the period concerned, the ratio of consolidated budget expenditures to GDP fell by

6 World Economic Outlook Update, January 24 2012, International Monetary Fund

7 The NBG's projections for Q4 2011 GDP are used.

0.6 pps to 36.8%.

In Q4 2011 the consolidated budget deficit amounted to GEL 680 million, or 9.9% of GDP. The primary source of deficit financing in Q4 was privatization (GEL 239 million) and net increase in external liabilities (GEL 219 million). The net issuance of Treasury bills (i.e. issuance minus redemption) equaled GEL 16.4 million, while the government deposits declined by GEL 219 million.

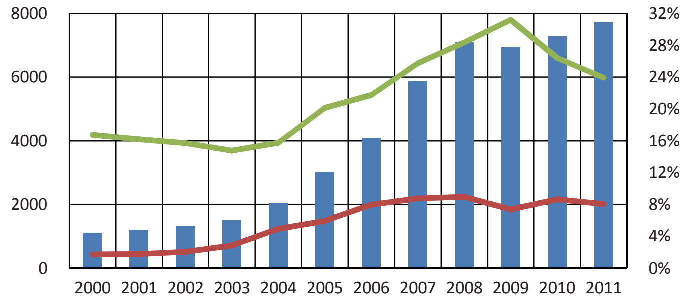
The deficit level in Q4 was higher than in the preceding quarters, owing to an increase in government expenditures. The growth of expenditures was mainly related to non-financial assets and goods and services, constituting, respectively, 9.8% and 5.4% of the Q4 GDP estimate. The expenditures on these categories usually contain relatively small inflationary risks.

As of end-December 2011, the total government debt grew by GEL 212 million quarter-on-quarter to GEL 8 billion, constituting 33.1% of the 2011 GDP estimate. This level is significantly lower than the critical level of 60% of GDP. It is likely that in 2012 the government debt will increase by GEL 900 million, or 3.8 pps with respect to GDP.

According to the 2012 budget plan, the consolidated budget revenues and expenditures are projected to rise 5% and 5.8%, respectively. The largest impact on the expenditure growth is produced by social and capital expenditures. The increase in social expenditures is partly conditioned by higher pension payments. Overall, augmented pension payments stimulate demand. However, in 2012 the growth rate of social expenditures (9.7%) falls

DIAGRAM 3.21

Dynamics of Budget Expenditures



behind the nominal economic growth (11.3%), resulting in a 0.1 pp decline with respect to GDP. Therefore, the 2012 pension growth is likely to have an insignificant impact on inflation. Despite a planned increase in budget deficit by almost GEL 100 million, the deficit-to-GDP ratio will remain unchanged at 3.5%. The deficit financing mainly relies on net increase in foreign liabilities (GEL 850 million); proceeds from privatization are projected to equal GEL 140 million. As a result, the government will be able to increase circulating funds by approximately GEL 100 million.

In 2012 the government will continue issuance of Treasury bills, as their overall volume in circulation is expected to increase by GEL 93 million. Accordingly, the share of T-bills in total debt will grow by 0.4 pps to 6.8%. Use of these instruments promotes development of the securities market and thus enhances liquidity management by commercial banks. This reduces banks' costs, ultimately having a downward effect on bank interest rates.

BOX 2
CREDIT RATINGS

Credit ratings are used for evaluating credit worthiness of an issuer of special types of debt, specifically, debt issued by governments or corporate businesses. The credit rating represents an evaluation made by a credit rating agency of a debt issuer's likelihood of default. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government (including non-public information obtained by the credit rating agencies analysts). Credit ratings are not based on mathematical formulas. Instead, credit rating agencies use expert judgment based on experience.

The credit rating agencies usually report long- and short-term credit ratings. Short-term ratings evaluate probability of an entity's default in one year. In contrast, long-term ratings reflect assess longer time spans.

At present there are several credit rating agencies. The most important and influential agencies include Standard & Poor's, Moody's and Fitch Ratings. In the recent period a Bejing-based Dagong Global Credit Rating agency grew in importance, being popular in different countries but not recognized in the United States.

The rating process is almost identical for all agencies. Despite differencies, the rating systems use the same designation letters. As a rule, letters A, B, C are used and the rating scale ranges from excellent to poor. The rating scales from Standard & Poor's, Moody's and Fitch are presented below. The ratings from Dagong Global Credit Rating are similar, although simpler.

Along with reporting credit ratings, credit rating agencies evaluate the outlook of a coporation or a country. The outlook reflects probability of a change in the current rating withing the following 12-18 months. The outlook can be "positive", "stable" or "negative". A "positive" outlook implies a possible improvement in the ratings, a "stable" outlook indicates that the ratings are likely to remain unchanged, while a "negative" outlook points to a possible downgrading. "Positive" or "negative" outlook does not necessarily mean that the ratings will change accordingly. The outlook only reflects a probable direction of changes in the ratings under the current conditions.

TABLE 3.5
Evaluation Systems of Main Rating Agencies

Moody's		S&P		Fitch		
Long-term	**Short-term**	**Long-term**	**Long-term**	**Short-term**	**Long-term**	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3		BBB-		BBB-		
Ba1	Not prime	BB+	B	BB+	B	Non-investment grade specula-tive
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly specula-tive
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely specu-lative
Caa3		CCC-				In default with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default

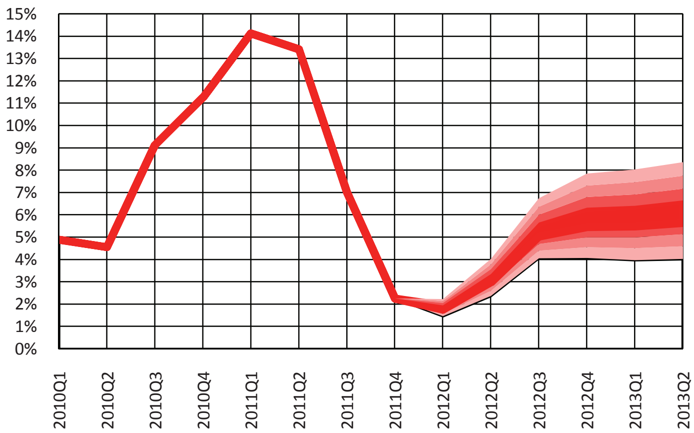
4. INFLATION FORECAST

In December 2011 the annual inflation fell below the targeted level, settling at 2%. The lower-than-targeted inflation was largely due to the base effect and stabilization of food prices in the international markets.

In line with the NBG's current forecast (based on the combination of results of three different models[8]), the impact of the base effect will still be present in the first half of 2012, conditioning maintanance of the inflation rate below target. In Q1 deflation is expected, while inflation will pick up startin from June. The uptrend in inflation will be maintained in Q3, and according to the forecasts, the inflation will converge to the targeted level of 6% by end-year (See Diagram 4.1).

The short-term inflation forecast relies on the following principal assumptions:

DIAGRAM 4.1
Annual Inflation Forecast



8 These models include: a macro model based on the New Keynesian approach; a vectoral error-correction econometric model; and a model estimating price indices for individual components of the consumer basket.

- The annual growth of broad money will average 20-25%;
- Demand pressure on prices will remain low;
- Regulated prices will remain unchanged;
- Prices on fruits and vegetables will increase due to seasonal factors;
- The annual growth rate of real GDP will amount to approximately 6%;
- The nominal effective exchange rate will not change;

In the medium term, the current forecasts show that output will remain at the natural level, implying no domestic demand pressure on prices. Furthermore, against the backdrop of the global developments, a higher level of world prices is expected. A possible increase in prices is to a certain extent conditioned by a rise in oil prices, related to supply-side risks. The global developments will have a corresponding effect on the Georgian prices, affecting the current inflation forecast.

In analizing inflationary risks it should be stressed that price level in small open economies like Georgia are largely dependent on international prices for oil, wheat, and sugar. Prices on these products are in turn significantly conditioned by global economic growth, geopolitical factors, and climatic conditions. All these factors contribute to domestic price volatility in the short term. However, consistent monetary policies should ensure stability of the inflation rate with respect to its target in the medium- and long-term.

5. DECISIONS OF THE MONETARY POLICY COMMITTEE

In Q4 2011 the NBG's Monetary Policy Committee convened three meetings. The NBG continued loosening of the monetary policy started in the precedingquarter. At each of the Q4 meetings the NBG consistently cut the monetary policy rate by 25 basis points. At the meeting held on January 18, 2012 the MPC decided to cut the policy rate by additional 25 basis points, setting the policy rate at 6.5%.

From the second half of 2011 a significant downtrend in inflation has emerged. The annual inflation fell from 10% in June to 2% at end-year. A decline in the consumer price index was foreseen, but the rate of decline was bigger than expected. The current forecasts indicate that low inflation will prevail in the first half of 2012. In the following period the inflation is projected to accelerate, although still remaining below the target. Therefore, the MPC decided to continue monetary policy loosening. At the same time the loosening policy will be implemented step by step with the view to avoid additional fluctuations in the money market. At each of its Q4 meetings the MPC slashed the policy rate by 25 basis points. The loose monetary policy was maintained in January 2012 as well, when the MPC cut the policy rate by additional 25 basis points. Overall, the monetary policy rate decreased from 8% in July 2011 to 6.5% in January 2012 with the aim of keeping the inflation rate at the targeted level in the medium-term period.

At the November meeting the MPC noted that the recent economic growth indicators point to a considerable GDP growth. As a result, it is projected that the 2011 economic growth will exceed 6%. Despite the acceleration of the GDP growth rate, the total output still remains lower than its potential level. Hence the mentioned expansion of aggregate demand will not exert pressure on prices. It was also mentioned that in Q4 the growth rate of extended bank loans slowed down, which is likely to weaken domestic demand.

The increase in government expenditures in December 2011 led to accumulation of excess liquidity in the banking system. As a result, demand for refinancing loans fell, adversely affecting the monetary transmission mechanism. In response to that the MPC made a decision in Decemberto increase issuance of Certificates of Deposit with the view of withdrawing excess liquidity. Liquidity absorption from the banking system through CDs is performed gradually, conditioning the fact that in January 2012 the banking system still operated under excess liquidity. Taking into account the schedule of CD auctions it is predicted that reduction in excess liquidity and a corresponding increase in demand for refinancing loan will occur approximately in March 2012.

BOX3 QUALITY ASSESSMENT OF STATISTICAL ACTIVITIES IN GEORGIA

Following an invitation from the Georgian authorities, the IMF's Report on Observance of Standards and Codes (ROSC) mission visited Georgia during October 4-17, 2011. The mission's aim was to assess quality of statistical production (involving the Geostat, the NBG, and the Ministry of Finance). The previous ROSC mission was in Georgia 2002, and its findings were published on the IMF's website in May 2003. (http://www.imf.org/external/pubs/ft/scr/2003/cr03140.pdf)

The aim of the ROSC mission is to assess whether a country's system of macroeconomic statistics (covering, in particular, national accounts, monetary, government finance, balance-of-payments, and price statistics) is compliant with the international standards in terms of production processes and quality of statistics and to provide recommendations for further improvement of a country's statistical system. This implies quality assessment of a country's statistical system based on the internationally recognized principles of the Data Quality Assessment Framework (DQAF, July 2003).

The report of the IMF's ROSC mission indicated that following the 2002 ROSC mission Georgia made tangible improvements in statistical compilation and dissemination, which allowed the country to accede first to the IMF's General Data Dissemination System (GDDS) in 2006 and then to the Special Data Dissemination Standard (SDDS) from May 17, 2010; the Georgian statistical system is based on a sound legal base, complies with the international standards, and meets users' requirements.

During the IMF mission assessment of statistical activities performed by the NBG and the quality of produced data was also assessed.

According to the Organic Law of Georgia "On the National Bank of Georgia", the NBG is responsible for producing financial and external statistics.

The ROSC mission mentioned in the report that the production of monetary and financial statistics as well as external statistics (balance of payments, international investment position, external debt) by the NBG is compliant with the international standards and methodologies. Accordingly, following the ROSC mission until present:

- A reporting system of monetary statistics has been established in line with international standards;
- The standardized report form (SRF), an up-to-date reporting form, has been implemented. Georgia is among 124 countries which use the SRF for submitting information to the IMF, published in the IMF's monthly publication "International Financial Statistics" (http://elibrary-data.imf.org/DataReport.aspx?p=1449282);
- The monetary and banking statistics bulletin is regularly published in electronic (monthly) and printed (annual) format.
- Statistical time-series are updated regularly on the NBG's web-site, in line with the dissemination calendar;
- Metadata for relevant statistical data has been placed on the NBG's web-site;
- The data collection and information systems for external trade statistics has been considerably improved;
- The International Transaction Reporting Sys-

tem (ITRS) has been implemented in the external sector statistics;

• Compilation of international investment position has been introduced;

• Compilation of external debt statistics has been started;

• Time-series revisions have been completed for external economic stastistics, now fully available since 2000;

• Publication on external economic statistics has been introduced on an annual basis (in printed and electronic format).

• As a participant in the IMF's SDDS, the NBG together with other producers of official economic statistics (Geostat and Ministry of Finance) systematically disseminates relevant statistical data in line with the SDDS calendar

(http://dsbb.imf.org/Pages/SDDS/CtyCtgList.aspx?ctycode=GEO);

• In 2010 the NBG acceded to the IMF's international Reserves and Foreign Currency Liquidity Initiative, disseminating relevant data on a monthly basis throught the IMF's web-page

(http://www.imf.org/external/np/sta/ir/IRProcessWeb/data/geo/eng/curgeo.htm) ;

• Observance of international statistical standards is a pre-requisite for the NBG's active cooperation with international organizations (the IMF, the World Bank, the Eurostat, the Asian Development Bank, etc.) in this area, promoting information availability about Georgia across the world.

However, the ROSC mission report also notes certain areas which require further improvement. Such issues include: more active cooperation with other producers of official statistics; coverage of all subsectors of the financial sector with statistical reporting (at present the information is insufficient on non-banking financial institutions); provision of detailed information to users on data revisions, new data sources and methodological novelties.

Currently creation of new software for the purposes of monetary statistics is under way at the NBG. The software will significantly improve data quality and enhance successful implementation of the ROSC mission's recommendations.

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