INFLATION REPORT

NATIONAL BANK OF GEORGIA

2012

2009 2010 2011 **2012**

NATIONAL BANK OF GEORGIA

INFLATION REPORT

Q1 2012

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), in March 2012 the annual inflation declined to -2.2%. The negative inflation rate was mainly the result of the base effect. Starting from June 2012 the annual inflation is expected to grow, albeit still remaining low until end-year.

The annual inflation stood at 4.0% for domestic goods and at 1.0% for imported goods in March. In Q1 2012 the prices for non-tradable goods rose 4.6%, while falling 5.8% for tradable goods. It is remarkable that the core inflation indicator (change in consumer prices excluding food and fuel) remained low at end-Q1, equaling 2.0%. Such pattern of price changes clearly shows the absence of inflationary pressure from exogenous factors.

The main inflation factors can be described in the following way. The real economy grew 8.8% in Q4 2011, resulting in a 7.0% economic growth for 2011. In the current year the real GDP growth is projected to equal 6.4%. During 2011 the real output gap was almost fully closed. This implied that despite rapid growth of real economy and in line with the existing forecasts, the increased demand will not produce inflationary pressure on prices.

In Q4 2011 the unit labor costs in the construction and trade sectors grew approximately 10-12%, while considerably declining in the transport and communication.It should be pointed out that the industry sector also registered a decrease in unit labor costs, which indicates low supply-side pressure on prices.

In Q1 2012 the lari's real and nominal effective exchange rates depreciated 1.7% and 1.1%, respectively. In annual terms the REER appreciated 1.9%. The latter fact was conditioned by a number of factors, which include tourism revenues, money remittances from abroad and investments. The lari's appreciating tendencies exerted a downward impact on prices of imported goods.

The credit portfolio of commercial banks expanded 2.0% in Q1 2012, amounting to GEL 7.8 billion. It should be noted that the growth rate of credit portfolio slowed down, gradually decreasing to 25.7% in annual terms. The interest rates on domestic currency denominated loans declined by 0.9 pps, while rising by 0.3 pps for loans extended in foreign currency.

In Q1 2012 the slowdown in deposit growth should be pointed out. The deposit liabilities of the banking system increased only by GEL 22 million, equaling GEL 6.7 billion. Despite a 0.8 pp quarterly increase up to 60.7%, the annual decline in the deposit dollarization equaled 6.5 pps. The reduction in dollarization enhances efficiency of the monetary policy transmission mechanism.

In Q1 the NBG continued using the monetary policy instruments with the purpose of efficiently managing banking liquidity and promoting revitalization of the banking sector. At end-2011 the increased budget expenditures led to accumulation of excess liquidity in the banking system, reducing demand for refinancing loans and thus impairing the interest rate transmission mechanism. To address the issue the NBG increased issuance volumes of Certificates of Deposits. Despite these measures, in Q1 the excess liquidity was still present in the banking system.

In Q1 2012 the NBG continued loosening of monetary policy by means of gradually reducing the interest rates. Overall, starting from the beginning of 2012 the monetary policy rate was cut by 0.5 pps to 6%. Such a reduction in the policy rate contributes to maintaining the medium-term inflation at the targeted level.

According to the NBG's forecasts, the impact of the base effect will persist in Q2, keeping the inflation rate low. Along with mitigation of this effect, starting from June the inflation rate will begin to rise. The uptrend in inflation will continue in the subsequent period, and the inflation rate is projected to equal the targeted level of 6% in early 2013.

2. CHANGE IN CONSUMER PRICES

According to the National Statistics Office of Georgia (Geostat), in Q1 2012 the general level of consumer prices rose 0.5% in quarterly terms. The analogous figure in 2010 stood at 4.9%. This resulted in a drop in annual inflation from 2.0% at end-2011 to -2.2% in Q1 2012. The inflationary pressure of the demand side remains weak.

Changes in food and fuel prices shaped the pattern of changes in the general level of consumer prices. The prices on food and non-alcoholic beverages rose, primarily fueled by price increases for the commodity group of „vegetables and watermelons". Following price increases due to seasonal factors, the prices for „milk, cheese, and eggs" products posted a decline.

Price gains for petroleum products in the international markets duly affected the Georgian consumer market. In the reporting quarter prices for diesel and petrol increased, resulting in an overall rise of transportation prices.

In Q1 2012 prices grew for "hotels, cafes, and restaurants", producing a significant contribution to the overall quarterly inflation.

As it was already mentioned, at end-March 2012 the consumer price index declined 2.2% in annual terms. Prices fell for products in the category of food and non-alcoholic beverages. Since this category accounts for a large part of the Georgian consumer basket, price changes have a big impact on the overall inflation.

In Q4 the overall level of consumer prices was also affected by "transport" prices, which increased 11.9%. Analogously, a remarkable price growth was registered for "hotels, cafes, and restaurants" and "housing, water, electricity, gas and other fuels". In parallel, a large impact on the overall inflation was made by price decreases for the "communication" goods and services.

It is also 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-March, indicating weak demand pressure on prices.

DIAGRAM 2.1
Price Growth Relative to December 2011

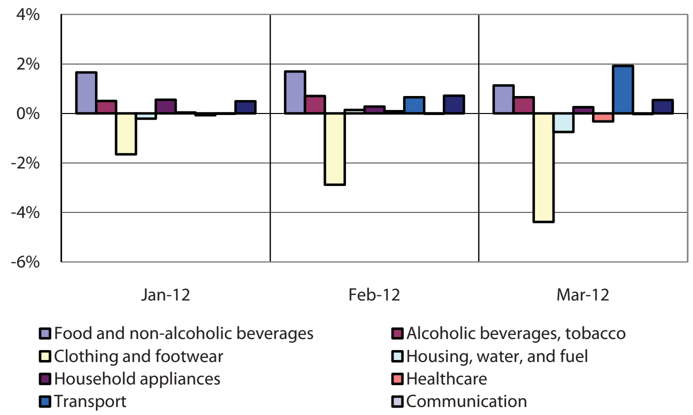


DIAGRAM 2.2
Core Inflation Excluding Food and Fuel

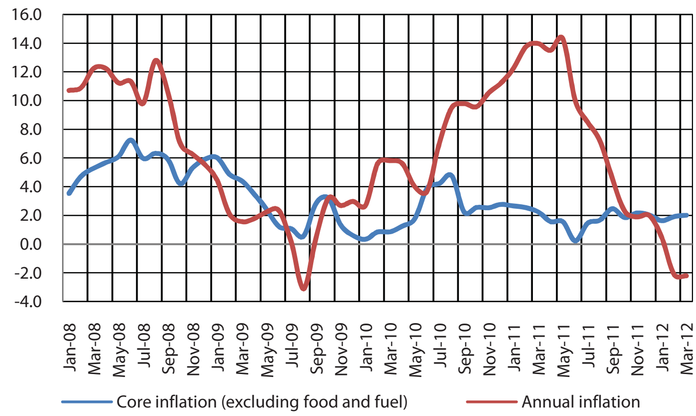


DIAGRAM 2.3
Annual Inflation by Production Location

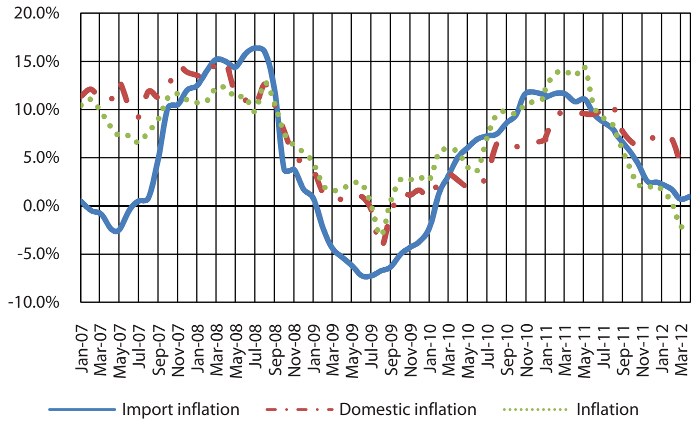


DIAGRAM 2.4
Price Indices for Tradable and Non-Tradable Goods
(December 2006 = 1)

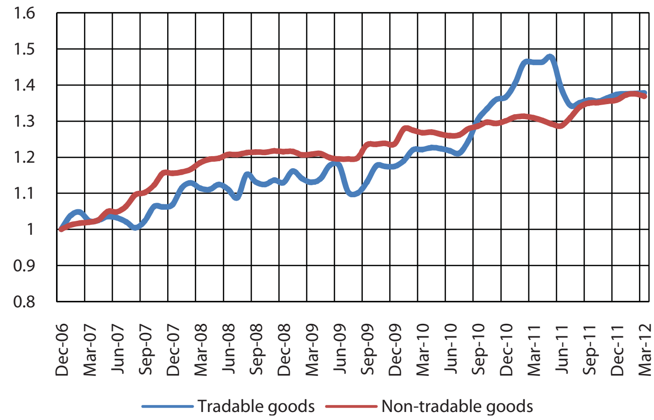
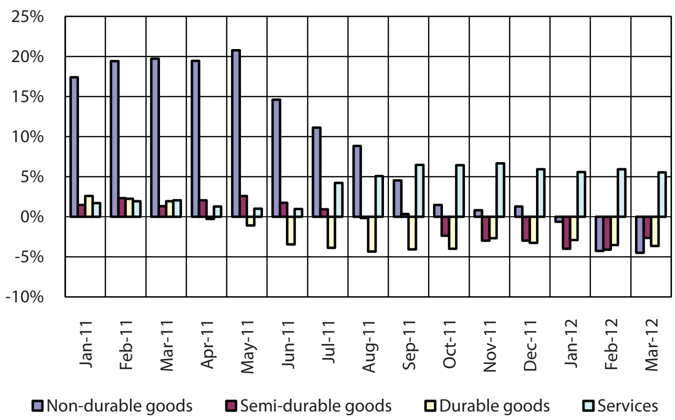


DIAGRAM 2.5
Changes in Annual inflation for Goods with Different Consumption Durability and Services



A significant portion of the Georgian consumer basket represents imported commodities. Hence, price dynamics in the partner countries represent a factor to be taken into consideration. During the year Turkey, Ukraine, Azerbaijan, China, Germany, and Russia accounted for almost 57% of total Georgian imports. Price dynamics in these countries were largely influenced by the downward tendencies in international prices, although their inflation rates turned out to be higher than in Georgia in Q1 2012. In particular, the inflation rates equaled 1.9% in Ukraine, 1.8% in Azerbaijan, 3.3% in Russia, and 2.2% in Russia. The only exception was Turkey where the inflation rate has been on the uptrend in the recent period standing at 10.4%.

As a result, starting from June 2011, the growth rate of prices for imported goods relatively slowed down, settling at 1.0% at end-Q1. The domestic inflation equaled 4.0%. Concurrently, there was a sharp decline in prices for tradable goods to -5.8%, while the annual inflation of non-tradables stood at 4.6%.

From the second half of 2011 the pattern of annual inflation by consumption durability changed drastically.The annual percentage growth of prices for non-durable goods fell considerably. The tendency was sustained in Q1 2012. At end-March the prices for non-durables declined in annual terms, posting a 4.5% annual deflation rate. In the same period the inflation rates for durable and semi-durable goods turned negative, pointing anew to weakening of demand.

Table2.1CPI Inflation by Components (%), Consumer Basket Weights (%), and Individual Contributions to Inflation (pps)

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

	December 2011 weights	Mar12/Dec11		Mar12/Mar11	
		Inflation	Contribution	Inflation	Contribution
Total	100.0%	0.5%	0.5%	-2.2%	-2.2%
Food and Nonalcoholic beverages	30.3%	1.1%	0.3%	-7.5%	-2.4%
Food	27.5%	1.2%	0.3%	-7.8%	-2.3%
Bread and bakery	7.4%	-1.9%	-0.1%	-7.5%	-0.6%
Meat and meat products	5.2%	2.8%	0.1%	10.9%	0.5%
Fish products	0.3%	1.6%	0.0%	5.1%	0.0%
Milk, cheese, and eggs	3.9%	-4.7%	-0.2%	2.6%	0.1%
Oils and fats	2.0%	-3.1%	-0.1%	-4.1%	-0.1%
Fruits, grapes	1.2%	25.4%	0.3%	-34.3%	-0.8%
Vegetables, melons, potatoes and other tubers	4.2%	9.0%	0.4%	-17.8%	-1.0%
Sugar, jams, honey, syrups, chocolate, pastry	2.5%	-5.1%	-0.1%	-14.4%	-0.4%
Other food products	0.7%	2.7%	0.0%	3.4%	0.0%
Nonalcoholic beverages	2.9%	0.8%	0.0%	6.4%	0.2%
Alcoholic beverages, tobacco	5.5%	0.7%	0.0%	0.4%	0.0%
Clothing and footwear	2.6%	-4.4%	-0.1%	-6.4%	-0.2%
Housing, water, electricity, gas and other fuels	8.2%	-0.7%	-0.1%	2.4%	0.2%
Furnishings, household equipment, routine house maintenance	5.1%	0.3%	0.0%	-0.8%	0.0%
Healthcare	7.5%	-0.3%	0.0%	1.9%	0.1%
Transport	12.8%	1.9%	0.2%	11.9%	1.4%
Communication	5.6%	0.0%	0.0%	-7.7%	-0.5%
Recreation and Culture	6.8%	-0.7%	0.0%	0.7%	0.0%
Education	6.1%	0.2%	0.0%	0.1%	0.0%
Hotels, cafes and restaurants	4.4%	2.4%	0.1%	6.8%	0.3%
Miscellaneous goods and services	5.0%	0.5%	0.0%	0.4%	0.0%
Non-durable goods	55.6%	0.8%	0.5%	-4.5%	-2.6%
Semi-durable goods	7.1%	-1.9%	-0.1%	-2.6%	-0.2%
Durable goods	4.5%	-0.6%	0.0%	-3.6%	-0.2%
Services	32.7%	0.7%	0.2%	5.6%	1.7%

3. INFLATION FACTORS

3.1 Labor Market

In Q4 2011 the labor productivity of employed in the economy rose 4.6% year-on-year. Concurrently, the average wages of hired employees grew significantly at 14.5%. Hence, in 2011 the labor productivity averaged a 3% growth rate, while the average wages increased 13%.

In Q4 2011 a significant annual growth of real value-added per employed was recorded in the financial intermediation, health, "transport and communication", industry, and construction. Relatively lower sectoral growth of productivity was recorded in the trade, public administration, and "hotels and restaurants". A large contraction was posted by education and agriculture, while the labor productivity in "real estate operations" declined slightly.

According to the Geostat's data, in Q4 2011 the average monthly wages of hired employees in the economy amounted to GEL 761, up 14.5% year-on-year. The growth of average wages of hired employees occurred in the large majority of economic sectors.

The sectoral analysis shows that the most remarkable wage growth rates took place in the real estate, "community, social and personal services", construction, and healthcare. In Q4 the annual growth rates of nominal wages in these sectors exceeded 20%. It should be noted that the high wage growth in these sectors (except for construction) was registered in the preceding quarters as

TABLE 3.1
Growth of Real Value-Added per Employed in Q4 2011, year-on-year

	Value-added Index
Agriculture and Processing of Agricultural Products	96.0
Industry	116.8
Construction	110.9
Trade	103.6
Hotels and Restaurants	101.3
Transport, Communication	126.1
Financial Intermediation	140.8
Real Estate, Renting and Business Activities	99.3
Public Administration, Defense	102.4
Education	94.3
Health and Social Work	121.2
Total	104.6

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

	Nominal Wage Index
Agriculture, hunting and forestry	88.8
Fishing, fishery	89.7
Mining and quarrying	117.6
Manufacturing	111.6
Production and distribution of electricity, gas, and water	107.9
Construction	123.6
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	114.8
Hotels and restaurants	103.7
Transport and communication	115.6
Financial intermediation	104.2
Real estate, renting and business activities	150.2
Public administration	99.5
Education	107.6
Health and social work services	123.7
Other community, social and personal service activities	130.1
Total	114.5

well, hence, indicating an upward trend.

The wage growth rates above 10% were recorded in the manufacturing and mining industry, "transport and communication", and trade. It should be pointed out that wages in the agriculture declined, while remaining practically unchanged in the public administration. Wages rose at relatively lower rates in the remaining sectors of the economy.

In the last quarter of 2011 wide disparities in absolute wage levels were present across economic sectors. Despite low growth rates, the highest average monthly wages were recorded in "financial intermediation" (GEL 1,367), exceeding the average national level 1.8 times. Meanwhile, the average wages in the three least-paid sectors – education, agriculture, and fishing – constituted less than a half of the national average level.

It is remarkable that in the last quarter of 2011 the difference between the highest and the lowest sectoral wages slightly increased in annual terms, while declining 5% in quarterly terms.

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

Overall, in Q4 the annual wage growth rate of hired employees was slightly higher than in the preceding quarter. At the same time, as it was already mentioned, the labor productivity was increasing at a relatively lower rate. This resulted in a 9.5% increase in the ratio of wages to labor productivity (unit labor costs[1]).

DIAGRAM 3.1
Average Sectoral Wages of Hired Employees, Q4 2011 (GEL)

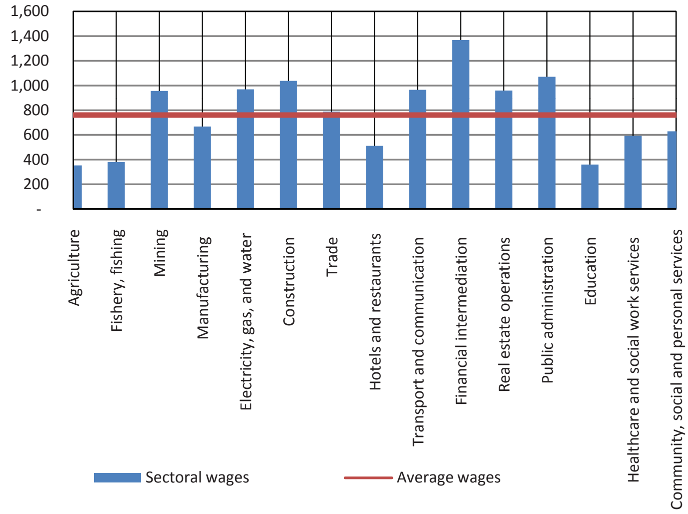
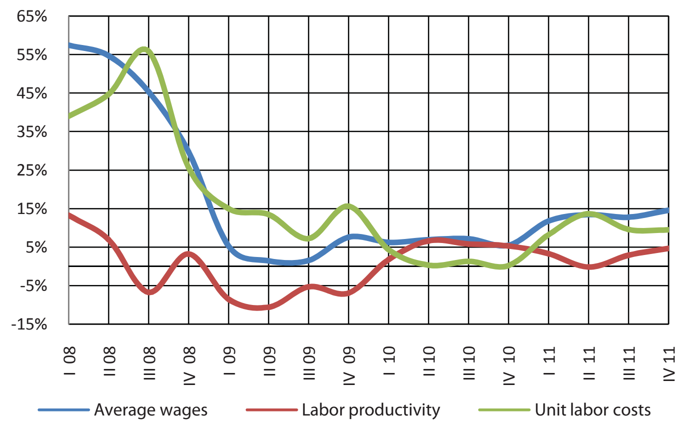


DIAGRAM 3.2
Labor Productivity, Average Monthly Wages of Hired Employees and Unit Labour Costs (annual percentage change)



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 the last quarter of 2011 the construction and

[1] Wage (personnel) costs, as a share of real value-added (GDP).

trade sectors experienced the biggest increases in unit labor costs as a result of modest productivity growth and a significant rise in average wages of hired employees.

Unit labor costs slightly declined in the industry, while falling more considerably in the transport and communication sector.

Overall, as manifested in the actual inflation rate, the above-mentioned growth of unit labor costs did not translate into an increase in the general price level. It is evident that a 10-12% increase in unit labor costs was not sufficient to create a significant pressure on the general price level.

3.2 Monetary Instruments

In Q1 2012 the NBG's monetary policies took into consideration existing inflation forecasts, macroeconomic trends and international market developments. In the reporting period the annual inflation rate further declined from 2.0% in December to -2.2% at end-March. The existing forecasts pointed to a considerable drop in inflation in the first half of 2012 and a subsequent gradual rise within the targeted limits. Taking into account the existing trends and factors affecting aggregate demand, the Monetary Policy Committee continued monetary policy loosening started in July 2011. The refinancing loan rate (policy rate) was decreased from 6.75% at end-December 2011 to 6.5% in January 2012, while being slashed by additional 25 basis points in April. At the same time it should be pointed out that in December 2011 the government incurred bigger-than-expected expenditures, which led to accumulation of excess liquidity in the banking sector. As a result, the interbank interest rates diverged from the monetary policy rate drawing closer to the NBG's overnight loan interest rate, the latter being 1.5 pp lower than the policy rate. Such a reduction in interest rates is tantamount to additional monetary policy loosening.

In conducting its monetary policies in Q1, the NBG used instruments for both liquidity supply and liquidity withdrawal with the aim of affecting interest rates. Against the backdrop of excess liquidity accumulated in the banking sector, the use of liquidity supply instruments was insignificant. Demand for banking liquidity is influenced by the average level of minimum reserve requirements, taking into account the volume of banks' borrowings and the ratio of minimum reserve requirements. In the period concerned the banks already had necessary funds at their disposal, thus rarely applying for refinancing loans. Currently the minimum reserve requirements stand at 10% for funds attracted in domestic currency and at 15% for foreign currency denominated borrowings.

Primary assessment of the banks' liquidity is made on a weekly basis by means of liquidity forecasts, which project the amount of short-term liquidity needed for the banking sector to comply with the existing reserve requirements. Auctions are then announced for the corresponding amount of liquidity. One-week refinancing loans allow commercial banks to efficiently manage short-term liquidity and obtain necessary funds through refinancing loan auctions. The latter are usually held once a week.

As it was already mentioned, high level of liquidity in the banking sector in Q1 lowered demand for refinancing loans. During January-March 2012 13 refinancing loan auctions were held, and the amount of liquidity supplied oscillated between GEL 2-15 million, while in the preceding quarter a weekly auctioned amount sometimes reached GEL 400 million. The average amount of auctioned amounts of refinancing loans in Q1 equaled GEL 9.5 million, while the weighted average interest rate slightly exceeded the monetary policy rate.

In Q1 the average volume of funds on the commercial banks' corresponding accounts narrowly complied with the requirements. However, along with accumulation of excess liquidity at end-2011, the volumes of funds placed by the commercial banks on the NBG's overnight deposits considerably increased. Under liquidity deficit banks apply for refinancing loans, while available excess liquidity prompts banks to place funds on overnight deposits accruing interest equal to the policy rate minus 1.5 pps.

Use of refinancing loans by commercial banks is very important for the NBG, as the policy rate (i.e. the refinancing loan rate) is transmitted first to interbank market rates and subsequently to market interest rates. Increased volumes of excess liquidity lead to reduction in demand for refinancing loans, impairing efficiency of the monetary policy. In response the NBG amplified the use of Certificates of Deposit, an instrument for liquidity withdrawal. In the period concerned medium-term liquidity withdrawal was performed by means of 3- and 6-month CDs. It is remarkable that starting from January 2012 the NBG increased issuance volumes of CDs to partially offset excess liquidity. The auctioned CD volumes were determined in such a way that the volume of liquidity withdrawal from the banking system would gradually increase by GEL 115 million in Q1, with the stock of CDs in circulation targeted at GEL 565 million at end-March. The total placement of CDs in Q1 equaled GEL 430 million, with demand exceeding supply 2.5 times. The nominal value of 3-month CDs stood at GEL 230 million, and that of 6-month CDs – GEL 200 million. Compared to the preceding quarter, the issuance of CDs grew 48.3% (by GEL 140 million), while demand rose 64.2% (by GEL 423 million). As a result, the ratio of liquidity withdrawal through CDs to reserve money increased to 30% from 21% in December 2011.

As mentioned above, at end-Q4 the dynamics of government expenditures and reserve money led to accumulation of excess liquidity in the banking sector. This decreased demand for refinancing loans weakening the monetary policy

DIAGRAM 3.3
Lari Liquidity

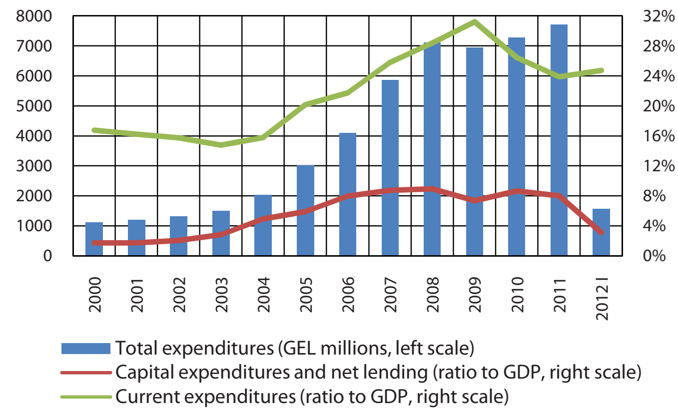
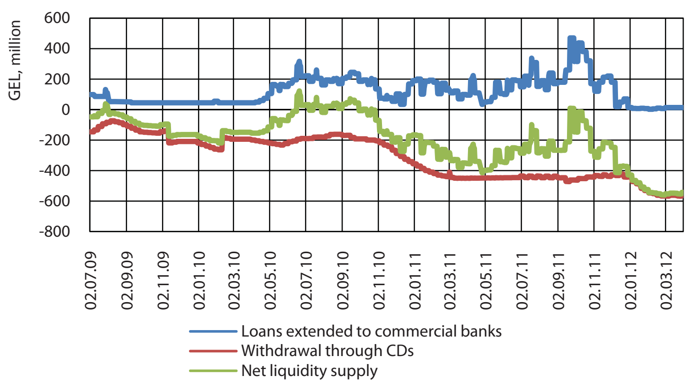


DIAGRAM 3.4
Liquidity Absorptionthrough CDs, Loan Extension to Commercial Banks and Net Liquidity Supply (GEL millions)



transmission mechanism. The NBG countered with increased volumes of CD issuance. The NBG's efforts were complemented with profit tax payment in March 2012, producing an additional contribution to reducing excess liquidity. According to the schedule of CD issuance, the stock of CDs is projected to increase by additional GEL 25 million at end-Q2. The NBG also considers selling of government securities at its disposal for the purposes of sterilizing excess liquidity in the money market.

3.3 Interbank Loans

The interbank money market plays a decisive role in making operational the monetary policy transmission mechanism, since it is precisely this market which is targeted by the NBG through changes in the monetary policy rate with the aim of ensuring price stability. After a certain time lag such changes in the policy rate have an initial impact on the commercial banks' short-term interest rates, subsequently influencing long-term interest rates and ultimately affecting aggregate demand. All this provides for attainment of a targeted inflation level.

In Q1 2012 the turnover in the interbank money market decreased. The total volume of lari denominated loans and deposits equaled GEL 2.2 billion, down by GEL 92.0 million quarter-on-quarter. This reduction was due to lowered liquidity demand on the part of banks, as increased government expenditures at end-2011 led to a rise in liquidity. In general, less dependence of banks on the money market and the NBG's refinancing instruments weakens the transmission mechanism, thus deteriorating the capability to manage the inflation rate. However, the above-mentioned reduction in liquidity was temporary. Amplified efforts of the NBG to withdraw liquidity will gradually lower its level and result in intensifying the interbank market.

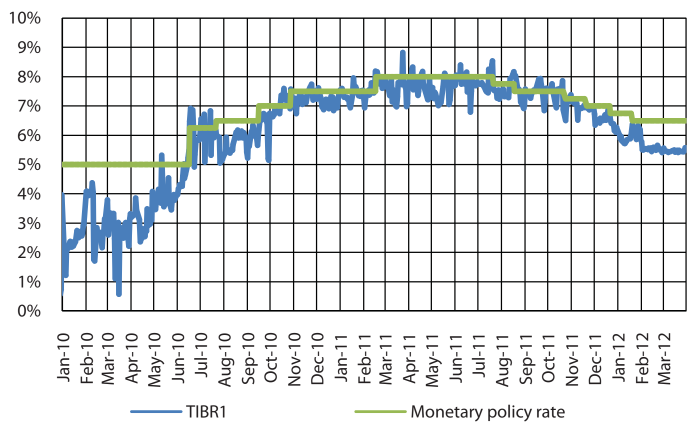
Similar to lari denominated funds, the volume of transactions in the US dollar also shrank. In particular, the reduction equaled 58.8%, or USD 89.1 million. The euro denominated transactions, however, recorded a considerable rise, increasing from only EUR 9.3 million in Q4 2011 to EUR 149.7 million in Q1 2012.

As a result of increased excess banking liquidity and monetary policy rate cuts, the cost of interbank market funds in lari decreased. The interest rate on overnight interbank loans (TIBR1) fell by 1.2 pps to average 5.6%, while the interest on interbank loans with 1-to-7-day maturity dropped from 7.9% to 6.3%. The reduction in short-term interbank interest rates was transmitted to longer-term interest rates as well. Such developments are favorable under low inflation, enhancing economic activity.

With regard to foreign currency loans, the weighted average interest on US dollar denominated funds grew from 2.7% to 3.0%, while declining from 2.4% to 1.0% for euro denominated funds. It is remarkable that in Q1 2012 the absolute majority of transactions in the interbank market still constituted overnight loans and overnight deposits.

DIAGRAM 3.5

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



3.4 Banking Sector

In Q1 2012 the growth of credit activity in the banking sector decelerated. The annual growth rate of credit portfolio gradually decreased to 25.7%, while often exceeding 30% in 2011[2]. Obviously such developments somewhat reduce inflationary risks.

A slowdown in growth is also observed in quarterly terms. In Q1 2012 the volume of extended loans grew only 2.0% (to GEL 7.8 billion), which is 2.3 pps lower than the growth rate in Q1 2011 (See Diagram 3.6). The contribution of lari denominated loans was bigger than that of foreign currency loans: in particular, the former grew by GEL 84 million, while the latter rose by GEL 35 million. This resulted in a 0.5 pp reduction in dollarization rate to 68.2%.

It should be noted that the loan dollarization rate tended to decline, shedding 3.5 pps relative to March 2011. On the one hand, this fact points to increased trust of domestic currency on the part of commercial banks, and, on the other hand, it is the result of active use of the NBG's monetary instruments for liquidity management purposes.

Data for the latest three quarters show that the banking sector focuses on long-term investment of lari denominated funds (See Diagram 3.7). Growth of the above-mentioned loans in lari is mainly attributed to long-term loans. At end-March 2012 their share in total lari denominated loans[3] equaled 58.9%. In general, an increase in the share of long-term lari loans represents a favorable pre-requisite for enhancing efficiency of monetary transmission mechanism and, thus, reducing inflationary risks: regulation of aggregate demand (and, ultimately, prices) is much more efficient under high larization. In Q1 2012 the overall dollarization of long-term resources dropped by 0.6 pps in Q1 2012, equaling 75.4%, while the annual decline in dollarization amounted to 4.9 pps.

In Q1 2012 the growth rate of lari denominated

DIAGRAM 3.6

Extended Loans (GEL, millions) and Dollarization

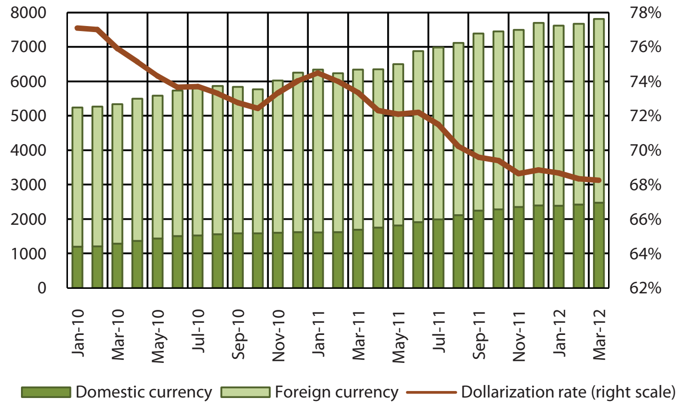
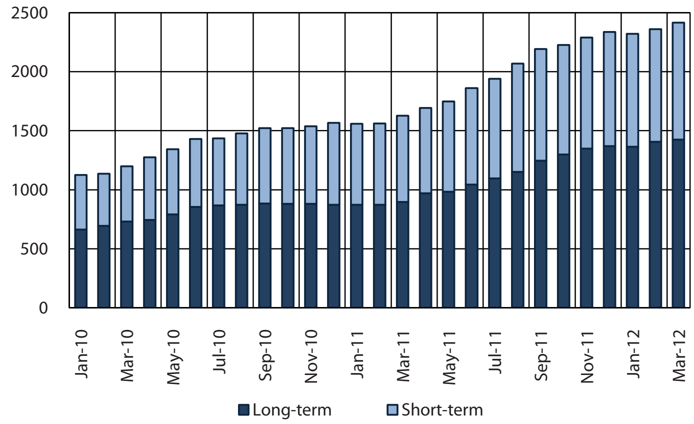


DIAGRAM 3.7

Term Loans[4] in Domestic Currency , GEL Millions

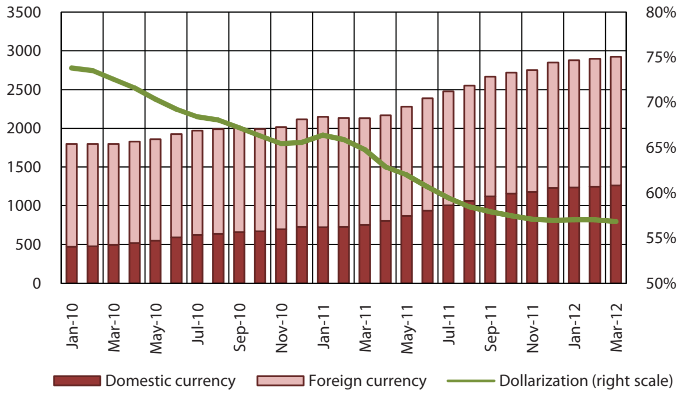


[2] The present subchapter treats changes in volumes excluding the exchange rate effect, unless the volumes are expressed only in the lari.

[3] Excluding overdue loans

[4] Excluding overdue loans

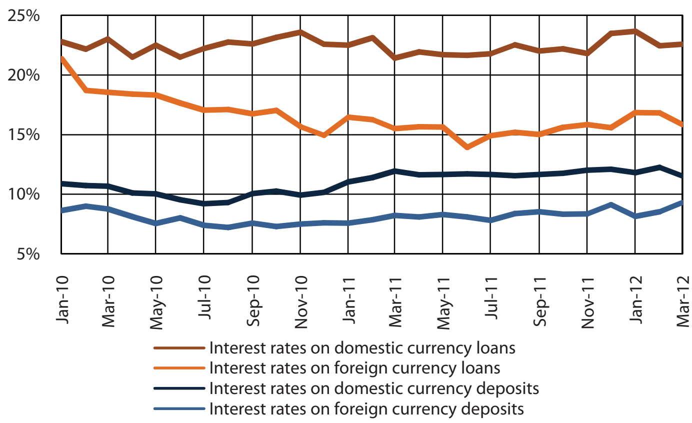
DIAGRAM 3.8
Loans to Individuals (GEL millions) and Dollarization



loans was higher than for foreign currency loans, reducing the dollarization of loans to individuals by additional 0.2 pps (See Diagram 3.8) It should be particularly noted that in annual terms the dollarization rate dropped by 8 pps. The volume of loans to legal entities was expanding as well, with the Q1 growth rate equaling 4.3%. As a result, the dollarization of loans to legal entities declined by 0.7 pps. Overall, legal entities account for the largest part of loans, and their dollarization level stood at 75.4% at end-Q1 2012.

Within the last 12 months the consumer loans expanded 37% to reach GEL 1.1 billion, while the loans secured with real estate property rose 50% to GEL 765 million. It is likely that the growth of the latter had a stimulating effect on revitalization of the real estate market. However, if we consider only the Q1 data, the growth rates of consumer loans and loans secured with mortgages considerably dropped, equaling only 2% and 8%, respectively.

DIAGRAM 3.9
Market Interest Rates on Loans and Deposits by Different Currencies



In Q1 2012 the loan interest rates recorded on average a 0.1 pp decrease. The interest rate on lari denominated loans fell by 0.9 pps to 22.6%, while that on foreign currency loans grew by 0.3 pps to 15.8% (See Diagram 3.9).

The deposit liabilities grew by 0.7 pps in Q1 2012. At end-March 2012 the volume of deposits placed at commercial banks totaled GEL 6.7 billion, up by GEL 1.4 billion year-on-year. The growth was due, on the one hand, to a significant rise in lari denominated deposits at end-2011. The latter increased by GEL 517.8 million as a result of drastic growth of government expenditures. Furthermore, it should be noted that population's trust to the domestic currency is gradually increasing, which was manifested in a considerable annual expansion of lari denominated deposits. As a result, the total deposit dollarization fell by 6.5 pps in annual terms, equaling 60.7%.

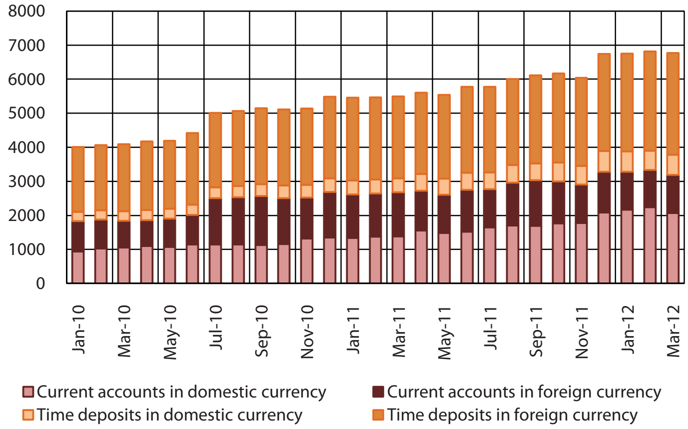
The annual growth of deposits was registered for both current accounts and time deposits. However, unlike domestic currency deposits, the current accounts denominated in foreign currency decreased about 5%, totaling GEL 1.2 billion at end-year. The reporting quarter was no exception either (See Diagram 3.10). At end-March 2012 the total value of current accounts stood at GEL 3.2 billion, with the dollarization rate equaling 35.2%. The situation is opposite for time deposits in terms of dollarization. The share of foreign currency denominated deposits equals 83.5%, decreasing only by 2 pps throughout the year. Individuals hold more than half of time deposits, of which domestic currency deposits account only for 20%.

In Q1 2012 the interest rate on domestic currency deposits declined by 0.6 pps, while rising by 0.2 pps for foreign currency deposits (See Diagram 3.9). Overall, the average deposit interest rates grew on average by 0.3 pps[5].

Along with the recovery from the 2008-2009 recession the financial intermediation grew profitable again in the last two years. Moreover, in 2011 the profit in the banking sector doubled in annual terms, amounting to GEL 323 million. At end-Q1 2012 the banking profit equaled GEL 16 million, the ROE was 2.9% and the ROA was 0.5%. The regulatory capital adequacy ratio stood at 18.1% at end-March 2012.

DIAGRAM 3.10

Deposits (GEL millions)



[5] Due to the fact that interest rates are higher for domestic currency deposits compared to foreign currency deposits, a quarterly reduction in dollarization increased the share of domestic currency deposits, resulting in an increase in average interest rates.

BOX 3-1 FINANCIAL SOUNDNESS INDICATORS (FSI)

Recently the NBG acceded to another statistical initiative. The latter is the IMF's Financial Soundness Indicators (FSI) project, aimed at users interested in the quality of a country's financial stability.

The financial crises of the 1990s laid the basis for initiating this project by the IMF. Prior to that the existing statistical information did not allow for efficient assessment of the situation in the financial sector. In order to resolve this problem the IMF prepared a set of indicators, which described financial soundness of a country's financial institutions and their client households and corporate entities. The indicators comprise consolidated data of individual institutions, as well as the information on the markets in which these institutions operate. In addition, the IMF elaborated an exact methodology for calculating the FSIs to ensure data comparability between countries' financial systems.

The FSIs include 12 core and 28 recommended indicators. Every member country releases these indicators with certain periodicity. At present approximately 70 countries provide the data on the IMF web-site. Calculation and release of the indicators is aimed at supporting macroprudential analysis. This includes observation and assessment of resilience and vulnerability of the financial system, and minimization of the probability of the financial collapses.

After receiving an invitation from the IMF to participate in the project in 2010, the NBG conducted a significant volume of preparatory activities, comprising collection, processing, and systematization of financial stability indicators and related metadata in line with the international standards. It is remarkable that production of FSIs requires from the NBG's statistical entity an implementation of new approaches to coordination of statistical activities. This implies expansion of cooperation not only between the NBG's structural entities but also with the Geostat through jointly conducting specialized surveys.

In April 2012 the quarterly dissemination of the FSI data was started on the IMF's website: (FSIs - http://elibrary-data.imf.org/Report.aspx?Report=4160268, metadata - http://fsi.imf.org/CountryList.aspx).

The FSI project has an important function of disseminating the information about Georgia across the world. It is also important that apart from the banking sector the indicators contain the information on other financial corporations (microfinance organizations, credit unions, insurance companies, etc.), non-financial corporations and households. Today from the existing 40 indicators (12 core and 28 recommended) Georgia produces 28 indicators (12 core and 16 recommended). These include 23 indicators on deposit corporations (commercial banks), 2 indicators on the real estate market, 2 indicators on the financial markets' liquidity, 1 indicator on non-financial corporations. 4 indicators which largely comprise the banking sector and other financial corporations are currently being developed, and their production will be ready in the nearest future. With regard to the remaining 8 indicators, describing the non-financial sector and households' financial situation, the necessary data are not yet available. However, in order to resolve the issue the NBG closely collaborates with

Core Set ofIndicators (Only deposit takers)		Status		
		Done	In progress	Future
Capital Ad-equacy	Regulatory capital to risk-weighted assets	X		
	Regulatory Tier 1 capital to risk-weighted assets	X		
	Nonperforming loans net of provisions to capital	X		
Asset quality	Nonperforming loans to total gross loans	X		
	Sectoral distribution of loans to total loans	X		
Earnings and profitability	Return on assets	X		
	Return on equity	X		
	Interest margin to gross income	X		
	Non-interest expenses to gross income	X		
Liquidity	Liquid assets to total assets (Liquid asset ratio)	X		
	Liquid assets to short term liabilities	X		
Sensitivity to market risk	Net open position in foreign exchange to capital	X		

Encouraged Set of Indicators				
Deposit Takers	Capital to asset	X		
	Large exposures to capital		X	
	Geographical distribution of loans to total loans		X	
	Gross asset position in financial derivatives to capital	X		
	Gross liability position in financial derivatives to capital	X		
	Trading income to total income	X		
	Personnel expenses to non-interest expenses	X		
	Spread between reference lending and deposit rates	X		
	Spread between highest and lowest interbank rate	X		
	Customer deposits to total (non-interbank) loans	X		
	Foreign-currency denominated loans to total loans	X		
	Foreign-currency denominated liabilities to total liabilities	X		
	Net open position in equities to capital	X		
Other Financial Corporations	Assets to total financial system assets		X	
	Assets to gross domestic product.		X	
Nonfinancial Corporations	Total debt to equity			X
	Return on equity			X
	Earnings to interest and principal expenses			X
	Net foreign exchange exposure to equity			X
	Number of bankruptcy proceedings initiated	X		
Households	Household debt to GDP			X
	Household debt service and principal payments to income			X
Financial Mar-kets	Average bid-ask spread in the securities market	X		
	Average daily turnover ratio in the securities market	X		
Real estate Mar-kets	Residential real estate prices			X
	Commercial real estate prices			X
	Residential real estate loans to total loans	X		
		X		

the Geostat and specialized surveys are planned to be jointly conducted in the coming months. After successful implementation of the surveys the financial data on households and non-financial corporation will be available.

The information on FSIs and the NBG's activities in this field are summarized in the Table below: It should be noted that the NBG is already a member of such international statistical initiatives and the Special Data Dissemination System (from May 2010, with the Geostat and the Ministry of Finance; http://dsbb.imf.org/Pages/SDDS/CtyCtgList.aspx?ctycode=GEO) and International Reserves and Foreign Currency Liquidity (from April 2010:http://www.imf.org/external/np/sta/ir/IRProcessWeb/data/geo/eng/curgeo.htm).

3.5 Exchange Rate Factors

The primary goal of the NBG consists in price stability. Therefore, it is important to monitor and thoroughly analyze all factors affecting price stability. It is generally agreed that in small open economies there exists a strong link between exchange rate and inflation. On the one hand, the exchange rate determines prices on imported goods with the latter having a large share in the Georgian consumer basket, while, on the other hand, a variation in the exchange rate, via changing terms of trade, causes a 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.

For the analysis of the lari's exchange rate it is important to observe the latter with respect to the Turkish lira, since Turkey represents Georgia's main trading partner. Starting from January 2012 the TL/GEL exchange rate recorded an increase, followed by a decline. For end-period data the lari depreciated 6.6% against the lira. Starting from April the exchange rate dynamics against the lira reversed again. In Q1 2012 the US dollar was depreciating in the international markets, which resulted in a 0.6% depreciation against the lari, with the USD/GEL exchange rate settling at 1.66 at end-March (See Diagram 3.11). As of end-quarter, the lari depreciated 2.5% against the euro and 3.1% against the pound sterling. The lari's nominal and real effective exchange rate indices fell 1.1% and 1.7%, respectively. The real effective exchange rate is directly related to the country's competitiveness in trade prices, as depreciation of the former improves competitiveness of exports. In Q1 2012 the lari's real depreciation was due to a fall in inflation rate relative to Georgia's trading partners as well as to the exchange rate depreciation.

In Q1 2012 the exchange rate dynamics were influenced by a number of factors. The domestic currency's exchange rate was pushed up by money remittances from abroad and tourism revenues, while the increased demand for foreign currency fueled by rising imports created depreciating pressure. The fluctuations caused by depreciation

DIAGRAM 3.11

Lari's Nominal Exchange Rate indices, 2010-2012

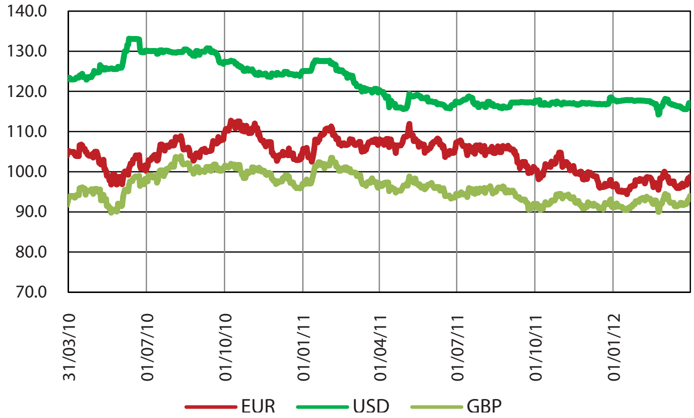


DIAGRAM 3.12

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

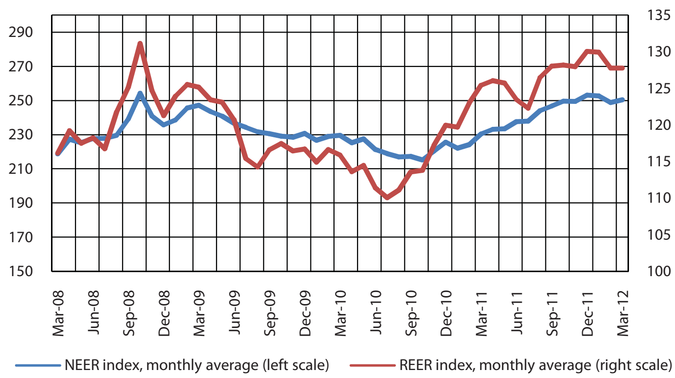


DIAGRAM 3.13

NBG's Interventions in the FX Market

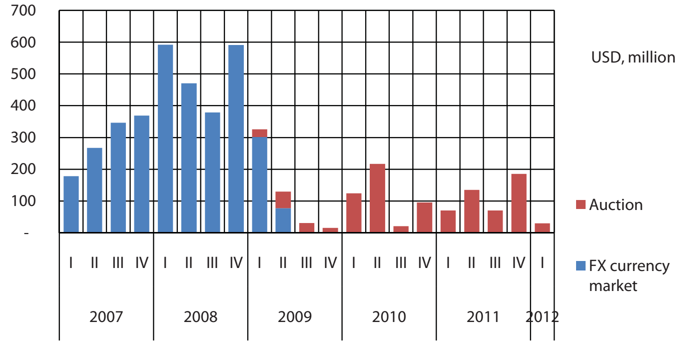


DIAGRAM 3.14

Dynamics of Georgia's Current Account and Trade Balances

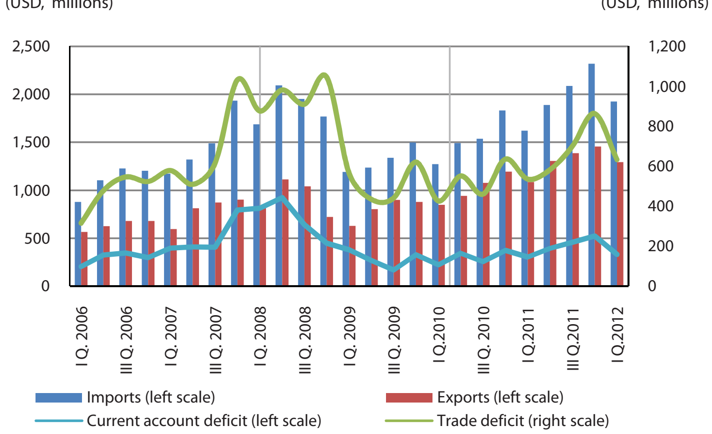
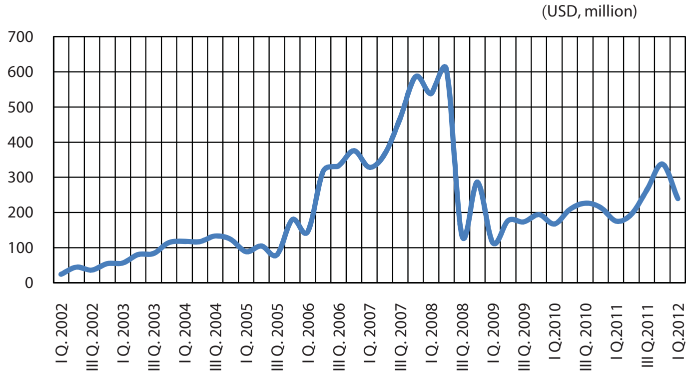


DIAGRAM 3.15

FDIs in Georgia



of the dollar in the international markets also influenced expectations with respect to the lari's exchange rate.

According to the NBG's estimates, the net revenues from tourism grew annually at 48% in Q1 2012, increasing demand for the domestic currency. In the same period the amount of money remittances from abroad also rose in annual terms, equaling USD 288.9 million and exceeding the Q1 2011 figure by 11.3%. Similar to the preceding periods, the amount of money remittances transferred abroad was insignificant in comparison to the inflow of remittances. The foreign currency supply was affected by the inflow of USD 337.5 million of net foreign investments in Georgia, as the latter posted a 57.7% growth rate year-on-year. In line with the NBG's preliminary data[6], the current account deficit grew in Q4 2011. The estimates for Q1 2012 see further deterioration of the current account in annual terms, which represents an important factor underlying increased demand for foreign currency.

The NBG's policy consisted in minimizing the FX market interventions. In Q1 2012 the net FX purchases of the NBG equaled USD 30 million, being one of the lowest figures in the recent years. Aiming at ensuring exchange rate stability of the lari, the NBG's interventions served to maintaining an adequate level of international reserves.

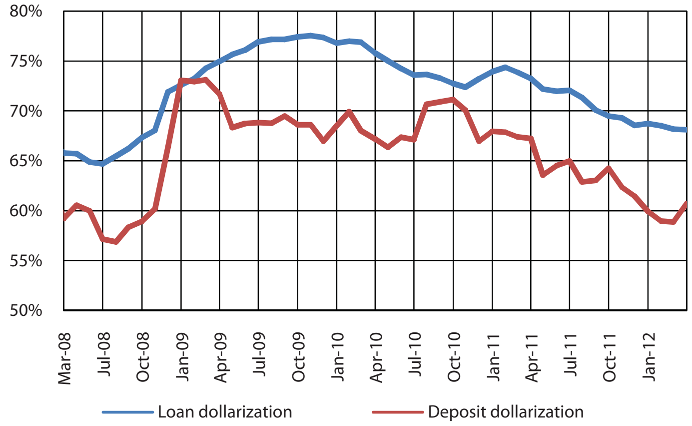
the dollarization rate and speculative capital, creating certain expectations in the market, represent important determinant of demand for foreign currency. The NBG actively continues to enhance the process of larization (dedollarization) in the country. Certain positive outcomes of the dedol-

[6] Updated balance-of-payments data are released in 90 days after the end of the quarter.

larization policies are gradually becoming manifest. In the reporting period the loan dollarization rate dropped by 0.6 pps. The deposit dollarization rate rose by 0.8 pps, which was consistent with a considerable drop in the preceding quarter.

DIAGRAM 3.16

Loan and Deposit Dollarization Rates



BOX 3-2 IMF'S NEW LOAN PROGRAMS (SBA AND SCF)

Following a request from the Government of Georgia, on April 11, 2012 the IMF's Executive Board decided to allocate credit resources in the framework of the Stand-By Arrangement (SBA) and the Stand-By Credit Facility (SCF), aimed at supporting the Georgian government in conducting economic and financial programs during 2012-2014. Under the SBA and SCF programs it is planned to complete the process of post-crisis macroeconomic recovery, balance the external position, further strengthen market confidence, and intensify donors' financial assistance. The credit line is regulated by the IMF's financing mechanism, according to which the government does not immediately absorb the allocated financial resources but uses them only under extraordinary circumstances such as materialization of adverse risks, possible deterioration of the balance-of-payments, i.e. in case of necessity.

The above-mentioned allocation of resources by the IMF aimed at supporting the government's economic and financial program. The latter comprises the following macroeconomic policies:

• Further fiscal consolidation with the view to ensure sustainability of public liabilities and macroeconomic stability;

• Maintenance of the flexible exchange rate management system to balance the external position;

• Strengthening of risk monitoring in the banking system and improvement of the regulatory framework of the financial system in order to ensure resilience to shocks.

In addition to the above-mentioned allocation of financial resources, a technical assistance program was initiated with the view to enhance strengthening of the authorities' financial management and fiscal transparency capacity. The TA program envisages improvement in national accounts and external statistics, modernization of payment system and further development of the monetary policy modeling framework.

The allocation of new concessional loans, as already mentioned, will be implemented through the Stand-By Arrangement and Stand-By Credit Facility programs. The SBA represents one of the most important credit instruments of the IMF, aimed at ensuring provision of external financial resources in a timely manner for developing and developed economies in crisis times, as well as at promoting sustainable growth. The SBA interest rates are non-concessional, but, as a rule, lower than market interest rates; the maturity periods are flexible typically covering 12-24 months up to 36 months. This is in full accordance with the fact that the loan is aimed at resolving short-term problems related to balance-of-payments problems. Access to the SBA resources is quite flexible, depending on financial need, solvency and relationship with the Fund. In excess of the norm, equal to 200% of quota for 12-month period and 600% of quota for total credit outstanding, it is possible obtain credit in an expedited manner. The repayment of the SBA loan is started after 39 months from contraction of the loan, on a quarterly basis, in 8 equal payments. The loan's interest rate is tied to the IMF's basic rate of charge, which in turn is dependent on the SDR's interest rate. If the disbursements exceed 300% of the quota, a surcharge of 200 basis points will be added on top of the present interest rate. In addition, if the outstanding credit amount exceeded 300% of the quota after 3 years, the surcharge increases to 300 basis points and complicates access to the IMF's long-term financing. Under the SBA program the agreed amount of financial resources, in the beginning of each 12-month period, is accrued a so-called commitment fee[7] (commitment fee), which is fully refunded if the amount is borrowed.

The SCF supports LICs that have reached broadly sustainable macroeconomic positions, but may experience episodic, short-term financing and adjustment needs, including those caused by shocks. The funds under the SCF are available for the member countries of the Poverty Reduction and Growth Trust (PRGT) fund. The maturity of the SCF credit line is 12 to 24 months and due to the fact that it largely serves to resolving periodic short-term problems, its use is limited to two and a half years. The SCF agreement may be terminated or, vise versa, extended, in line with existing developments in a country. The credit represents a concessional liability and is limited to 100% of quota for 1-year period and 300% of quota in total. The period for access to SCF funds is 4 years, while the repayment deadline is 8 years. Under the SCF program the applicable interest rate equals 0.25%. Until the end of 2012 the outstanding amounts are exempt from accruing interest. Apart from the main interest rate, in every 6-month period the availability fee is levied on the undrawn amount, equal to 0.15% per annum.

[7] 15 basis points on agreed amount of less than 200% of quota;
30 basis points on agreed amount of 200%-1000% of quota;
60 basis points onagreed amount of more than 1000% of quota

The SBA and the SCF credit lines are subject to the IMF's financing mechanism, according to which a country borrows allocated funds only in the case of exceptional circumstances and needs.

In parallel to the guaranteed IMF credit, a country agrees on a fiscal and monetary stabilization policy program aimed at fulfilling defined goals. The review of the country's commitments follows quantitative performance criteria or structural benchmarks and is provided to the Executive Board through regular reports. In 2012-2014 4 reviews are planned under the joint SBA and SCF programs.

The new IMF's credit program to some extent represents a continuation of the 33-month SBA program started in 2008 with the view to provide macroeconomic support. Borrowing of the SBA resources ended in June 2011. By means of using these funds the country succeeded to achieve higher-than-expected growth rates, ending the 2011 with a 7% GDP growth. The annual inflation dropped to a one-digit level. The debt-to-GDP ratio decreased to 34%, while the gross international reserves rose to USD 2.8 billion dollars.

Despite good performance, unstable external position increases risks related to exogenous factors. This is particularly important during the concentration period of external repayments. In addition, narrowing of the current account deficit and reduction in unemployment still represent a medium-term challenge. It is precisely the existence of these risks that underlied the government's request to the IMF for receiving financial assistance. The new program lasts 2 years and envisages provision of access to credits of up to SDR 250 million (166.3% of quota). These funds will be evenly divided between the SBA and the SCF arrangements. The agreement covers the whole

TABLE 3.3
2012-2014 Reviews and Available Purchases and Loans

TariRi		Available purchases underSBA		Available purchases underSCF		Total available purchases and loans	
		SDR millions	Per cent of quota	SDR millions	Per cent of quota	SDR millions	Per cent of quota
15/03/2012	Approval of the 24-month agreement	12.5	8.3	12.5	8.3	25.0	16.6
15/08/2012	End of the first review, as of June 2012	22.5	15.0	22.5	15.0	45.0	29.9
15/02/2013	End of the second review, as of December 2012	30.0	20.0	30.0	20.0	60.0	39.9
15/08/2013	End of the third review, as of June 2013	30.0	20.0	30.0	20.0	60.0	39.9
15/02/2014	End of the fourth review, as of December 2013	30.0	20.0	30.0	20.0	60.0	39.9
SDR millions		125.0	83.2	125.0	83.2	250.0	166.3

2013 year until approval of the 2014 budget. Under the program the funds are concentrated near the end of the drawing period, taking into account the fact that in 2013-2014 the risk probability is relatively higher.

3.6 Production and Demand

In the last quarter of 2011 the economic growth equaled 8.8%, significantly exceeding the growth rates recorded in the preceding quarters. The nominal GDP rose 15.4%. Accordingly, the Q4 deflator grew 6% in annual terms.

The annual growth of the Q4 GDP growth was mainly fueled by the manufacturing, construction, and trade sectors. High growth in manufacturing (19%) was the result of production expansion in the chemical and food industry, as well as in the "production of machinery, electrical and transport equipment" subsector.

Significant sectoral contributions to the real GDP growth were made by the financial intermediation, "production and distribution of electricity, natural gas, and water", and "community, social, and personal services". It is remarkable that the agriculture and the closely related "processing of products by households" registered positive growth in all four quarters of 2011.

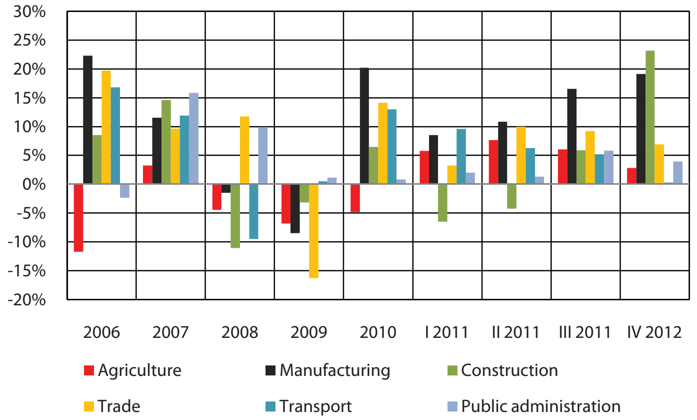
In Q4 the real value-added increased in almost all the remaining sectors, albeit producing relatively less significant contribution to the annual GDP growth. The contraction was recorded only in the mining industry, as the latter posted negative growth rates after Q1 2011.

TABLE3.4
Sectoral Contributions to Real GDP Growth, Q4 2011 (%)

	Nominal weights (Q4 2010)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	6.9%	2.8%	0.2%
Mining and quarrying	0.8%	-5.2%	0.0%
Manufacturing	8.0%	19.1%	1.5%
Electricity, gas and water supply	2.6%	14.4%	0.4%
Processing of products by households	2.7%	6.7%	0.2%
Construction	5.9%	23.2%	1.4%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	17.4%	6.9%	1.2%
Hotels and restaurants	1.8%	2.0%	0.0%
Transport	6.5%	0.3%	0.0%
Communication	2.8%	6.4%	0.2%
Financial intermediation	2.0%	18.8%	0.4%
Real estate, renting and business activities	4.3%	4.8%	0.2%
Imputed rent of own occupied dwellings	2.5%	3.6%	0.1%
Public administration	11.7%	3.9%	0.5%
Education	4.2%	2.4%	0.1%
Health and social work	5.2%	1.3%	0.1%
Other community, social and personal service activities	3.4%	10.5%	0.4%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	13.6%	0.0%
FISIM adjustment	-1.0%	16.6%	-0.2%
GDP at basic prices	**87.9%**	**6.5%**	
Taxes on products	12.6%	18.4%	2.3%
Subsidies on products	-0.5%	1.9%	0.0%
GDP at market prices	**100.0%**	**8.8%**	**8.8%**

DIAGRAM 3.17

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



The analysis of seasonally adjusted data shows that the financial intermediation registered a sustainable economic growth for more than a one-year period.

In the recent years the major economic sectors in Georgia manifested varying dynamics of real growth. In 2011 high growth rates in the manufacturing industry were evident, where the light industry could be particularly singled out in terms of economic performance. The construction sector posted negative real growth rates in the first half of 2011, however, returning to growth in the second half of the year with a 23% annual growth in Q4. It is remarkable that in the transport sector the growth rates tended to slow down through the year. The remaining large sectors developed at a relatively stable pace.

3.6.1 Private and Government Consumption

In Q4 2011 the nominal GDP rose 15.4% year-on-year. The growth was powered by the increases in capital expenditures, as the annual growth rate of the “gross capital formation” equaled 42%. The Q4 exports produced a relatively modest contribution to the overall growth, while the final consumption grew at approximately the same volume as the imports.

With a decline in inflation, the nominal growth of households’ final consumption decreased as well. At the same time, the growth rate of real household consumption slowed down as well, amounting to about 7% in Q4. On the other hand, relatively high growth (14%) was registered for government expenditures on final consumption.

In Q4 the “actual household consumption” (which includes all types of final consumption excluding general government’s “collective services”) grew at a relatively lower rate (6.7%) in comparison with the real GDP growth (8.8%). This implies that in Q4 there was practically no inflationary pressure on the part of aggregate demand.

20% annual growth in government expenditures on collective services[8] resulted in a significant year-on-year increases in total government expendituresin Q4. It should be noted that the government expenditures on individual goods and services shrank 4%.

In quarter-on-quarter terms the growth rate of “export of goods and services” slowed down, thus,

[8] Expenditures on collective services comprise government expenditures on defense, public order, and other general government services. It is impossible to quantify what volume of such services is used by individual households (persons), as these services represent a collective benefit for the whole society.

making a smaller contribution to the overall GDP growth. The growth rate of imports was largely stable, rising 19% per annum in Q4.

3.6.2 Investments

In Q4 2011 the nominal value of gross capital formation exceeded GEL 2.2 billion, significantly surpassing analogous quarterly figures in the last decade.

The 42% annual growth of gross capital formation was the result of a 45% growth of investment in fixed capital. The latter reached a remarkable level of approximately GEL 2 billion. It is remarkable that in quarterly terms the growth rate of capital formation significantly slowed down in Q2 and Q3, although rebounding in Q4 to return to the previous level.

The enterprise inventories grew at annual 24%, considerably slowing down in comparison with the other quarters of 2011.

3.6.3 2012 forecast

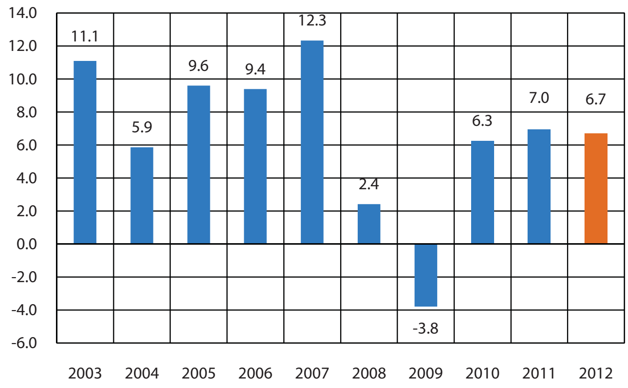
The difference between the forecasted and the actual Q4 2011 growth rates published in the previous report equaled -0.7 pps.

In predicting the Q1 2012 GDP growth rate it should be taken into account that the annual growth rate of VAT taxpayers' turnover equaled 14.4%. Using these data and based on the sectoral projections it is projected that in Q1 2012 the nominal GDP will grow at about 7%, while the real GDP growth will equal about 6.5%. The expected slowdown in the economic growth is partly due to lower growth rate of business crediting.

In sectoral terms, the real growth of value-added will be mainly driven by the trade, manufacturing, "community, social, and personal services", and construction sectors. Significant positive contributions will be produced by the financial intermediation and real estate sectors.

DIAGRAM 3.18

Real GDP Growth, 2003-2012[9] (%)



With regard to the categories of use, in Q1 2012 the projected growth of nominal GDP will be equally conditioned by growth of exports and capital formation. At the same time it is projected that the growth of final consumption will still be offset through growth of imports.

Overall, the 2012 GDP growth will equal 6.7%. In line with the sectoral developments, it is projected that the main drivers of economic growth will include the manufacturing, trade, and construction sectors. In terms of categories of use, the largest impact is likely to be produced by the final consumption category.

[9] The NBG's projections are used for the 2012 growth rate.

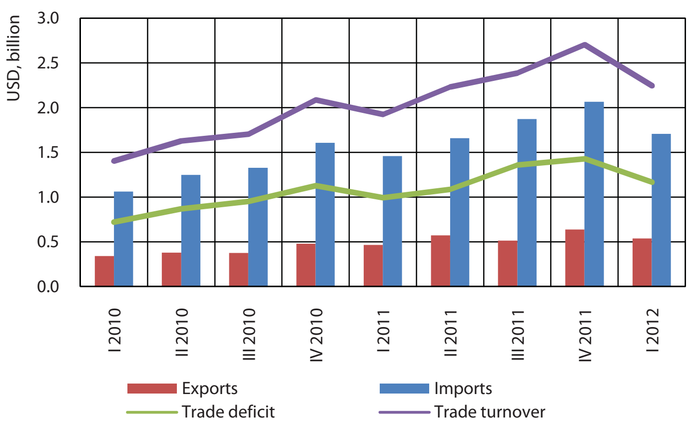
3.7 External Trade

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. The actual data for 2011 and projected 2012 data show that the trade deficit oscillates around 18% of GDP. The balance of goods trade is negative, standing at USD -860.5 million in Q1 2012. On the other hand, the balance of trade in services is a relatively smaller positive component of the trade balance, and its Q1 forecast equaled USD 220.6 million.

In Q1 2012 the turnover of registered[10] trade in goods totaled USD 2.2 billion, up by 16.6% year-on-year. The registered exports of goods equaled USD 538.8 million, up 15.8% year-on-year. The registered imports of goods totaled USD 1.7 billion, posting an annual growth rate of 16.9%. Despite the fact that the growth rate of exports was slightly lower than that of imports, the trade deficit widened considerably, since in absolute terms the annual increase of imports exceeded that of exports by USD 173.0 million. In Q1 2012 the trade deficit grew 17.4% in annual terms, equaling USD 1.2 billion.

DIAGRAM 3.19

Exports, Imports, Trade Deficit and Trade Turnover



The export of goods by end-use categories was distributed as follows: capital goods – 8.8%, intermediate consumption goods – 44.8%, final consumption goods – 46.4%. Compared to the preceding periods, the share of capital and consumer goods in total exports increased (in Q1 2011 the respective figures stood at 3.3% and 38.8%); similar to the preceding quarter, in Q1 the largest contribution to export growth was produced by hazelnut exports, which totaled USD 40.4 million. The hazelnut exports occupied the third position after motor cars and ferroalloys, growing 2.8 times in the last two quarters as a result of good harvest and international price increases. The growth of intermediate goods' share in total exports was also induced by re-export of motor cars, as the latter occupied the top place in the export list starting from 2011. The annual growth rate of motor car re-exports equaled 10.9%, comprising 68.3% of imported cars. The export of spirituous beverages should also be singled out with a 51.0% annual growth rate. The increase in the share of investment goods was mainly conditioned by re-export of trucks and equipment.

With respect to intermediate goods, the export of second-placed ferroalloys should be singled out, as the latter recorded an 8.9% annual growth rate, totaling USD 59.2 million.

The registered import of goods comprised 16.7% of investment goods, 39.9% of intermediate consumption goods, and 42.9% of final consumption goods. The petroleum products (largely gaso-

[10] 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.

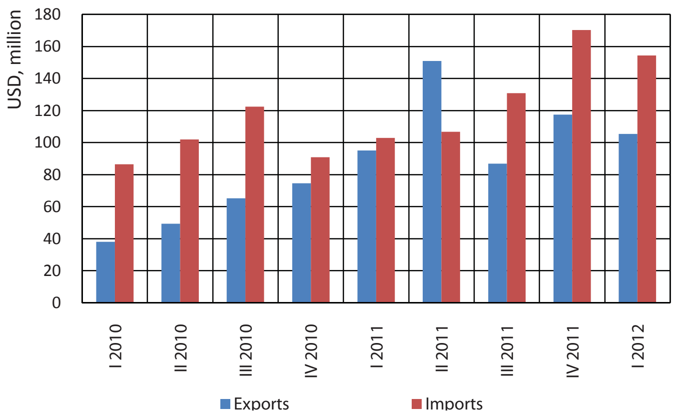
line) and motor cars, which occupied, respectively, the first and the second positions in the list, are classified as final consumption goods. The annual growth rate of petroleum products equaled 6.9%, completely due to the price effect.

According to the IMF forecast[11], oil prices are not projected to decline in 2012-2013. Despite quite conservative expectations with respect to global economic growth, which are likely to slacken demand for oil, certain geopolitical risks arise, which have an adverse effect on oil supply and, hence, prices. Prices for most of other commodities are expected to drop due to falling demand.

The import of petroleum gases, making part to the intermediate consumption category, fell 9.8% in annual terms. In Q1 2012 food products accounted for 13.2% of total imports, increasing only 0.8% year-on-year in value terms to USD 224.6 million. The import of wheat constituted 23.5% of food imports (3.1% of total registered imports), increasing 8.4% in value terms as a result of both price and volume effects. The import of meat products held the second largest share in total food imports (13.0%), posting an annual 48.5% growth rate. The import of sugar and confectionery constituted 7.2% of food imports. The import of tobacco and alcoholic beverages accounted for 2.1% of total registered imports, recording a 13.0% increase in annual terms.

DIAGRAM 3.20
Annual Growth Rates of Exports, Imports, and Trade Deficit

DIAGRAM 3.21
Export and Import of Motor Cars



3.8 Government Operations

In 2012 the government continues the fiscal consolidation process. Despite the fact that the consolidated budget deficit increases in 2012 by a few tens of millions of lari (presumably to GEL 918 million), its share with respect to GDP declines from 3.6% to 3.5%. The planned level of budget deficit did not have a significant impact on inflation. In Q1 2012 the budget surplus totaled GEL 204 million, implying that in the remaining three quarters the budget expenditures will exceed the budget revenues by GEL 1.1 billion.

The above-mentioned budget surplus constituted 3.6% of the Q1 GDP. The proceeds from pri-

[11] World Economic Outlook Update, April 2012, International Monetary Fund

TABLE3.5
Consolidated Budget Parameters

	Q1 2012 (GEL Million)	Ratio to GDP (Q1 2012)
Total revenues and grants	1,782	31.5%
Revenues	1,696	30%
Tax revenues	1,552	27.5%
Non-tax revenues	144	2.5%
Grants	86	1.5%
Total expenditures	1,578	27.9%
Current expenditures	1,375	24.3%
Capital expenditures and net lending	204	3.6%
Surplus	204	3.6%
Deficit Financing	-205	-3.6%
Privatization	63	1.1%
Use of free circulating funds	-319	-5.6%
Net increase in domestic liabilities	10	0.2%
Net increase in external liabilities	42	0.7%

vatization amounted to GEL 63 million, while the net increases in external and domestic liabilities equaled GEL 42.4 million and GEL 10 million, respectively. Accordingly, the government's circulating funds grew by GEL 319.6 million.

In Q1 2012 the consolidated budget revenues and grants totaled GEL 1.8 billion, of which the grants were GEL 86.4 million and the tax and non-tax revenues were GEL 1,695.6 million. The Q1 revenues constituted 31.7% of GDP[12], down by 2.2 pps year-on-year. The tax burden (tax-to-GDP ratio) stood at 27.6%, down by 2.3 pps year-on-year.

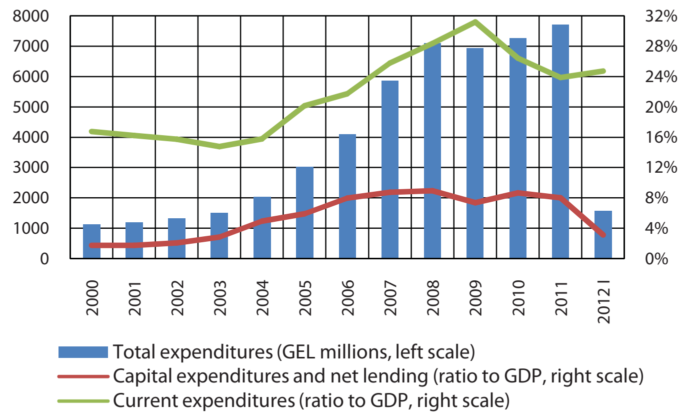
The consolidated budget expenditures totaled GEL 1.6 billion in Q1, slightly increasing in annual terms. Since the nominal economic growth stood at 8.7%, the ratio of total expenditures to GDP declined by 2.2 pps to 27.9%.

In annual terms the share of capital expenditures in the total consolidated budget expenditures shrank considerably, falling by 7.6 pps to 12.1%. The net lending component also contracted. On the other hand, the share of current expenditures increased to almost 88%.

At end-March 2012 the total government debt grew by GEL 87 million to GEL 8.07 billion, constituting 33.3% of the 2011 GDP, and thus being considerably lower than the critical level of 60% of GDP. It is projected that at end-2012 the government debt will further increase by GEL 770 million, but its share with respect to GDP will decrease to 33% due to a more rapid economic growth.

The stock of treasury bills in circulation grew by GEL 15 million in Q1 2012. According to the 2012 issuance schedule, the stock will further increase by GEL 78 million to GEL 586 million, or 2.2% of GDP. 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.

DIAGRAM 3.22
Dynamics of Budget Expenditures



[12] The NBG's projections for Q1 2012 GDP are used.

4. INFLATION FORECAST

In March 2012 the annual inflation amounted to -2.2%. The lower-than-targeted inflation was largely due to the base effect. In line with the NBG's current forecast (based on the combination of results of three different models[13]), the impact of the base effect will still be present in Q2 2012, underlying the low level of inflation. Starting from June a pick-up in inflation is projected. The uptrend in inflation will be present in the subsequent period, and, according to the forecasts, the inflation will converge to the targeted level of 6% by end-year (See Diagram 4.1).

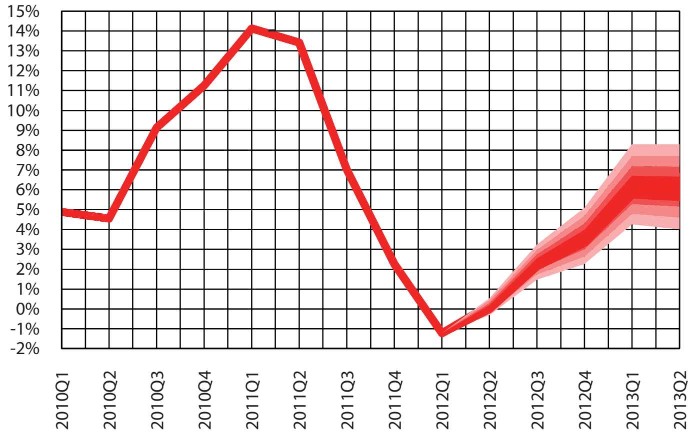
The short-term inflation forecast relies on the following principal assumptions:

- The annual growth of broad money will average 23%;
- Regulated prices will remain unchanged;
- Prices on fruits and vegetables will change in line with seasonal factors;
- The annual growth rate of real GDP equaled 8.8% in Q4 2011 and will be approximately 6.4% in 2012;
- The nominal effective exchange rate will not change;

Indicators of economic activity suggest a high Q1 growth. Annual economic growth forecasts are also optimistic, implying an increase in medium-term inflation forecasts. These tendencies will be further enhanced by loose monetary policy and expected growth of economy crediting.

[13] 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.

DIAGRAM 4.1
Annual Inflation Forecast



However, it should also be noted that in early 2012 the loan growth was relatively low. If such a situation persists, it may lead to downward revisions of economic growth and inflation forecasts. This in turn will necessitate monetary policy softening.

In analizing inflationary risks it should be stressed that the domestic price level in small open economies like Georgia is largely influenced by 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 Q1 2012 the NBG's Monetary Policy Committee convened for three meetings. At these meetings the NBG reiterated its stance on the monetary policy loosening started in the preceding quarter. At the January 18 meeting the MPC cut the policy rate by 25 basis points, while deciding to keep the policy rate unchanged at the two subsequent meetings.

In early 2012 the inflation rate turned negative, largely as a result of the base effect. The existing forecasts suggested that the inflation will be low until summer and accelerate thereafter, albeit still remaining below the target level. Accordingly, the MPC continued loosening of monetary policy. In Q4 2011 the economy grew at a faster-than-expected rate, with high economic growth being also maintained in Q1 2012. Despite good economic performance the deviation from the potential output level equaled zero, indicating no inflationary pressure from aggregate demand.

At the end of 2011 the increase in government expenditures led to accumulation of excess liquidity in the banking sector, resulting in drops in interbank interest rates. In Q1 the short-term interest rates were lower than the policy rate, thus implying additional softening of monetary policy. Under such circumstances the MPC decided at its February and March meetings to keep the policy rate unchanged.

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