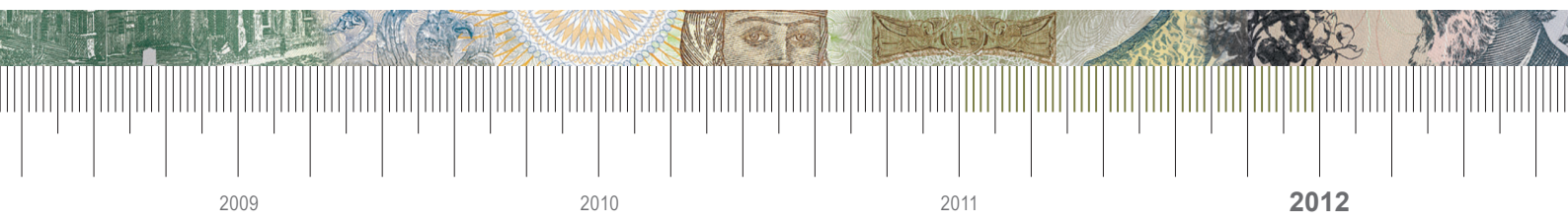
INFLATION REPORT

NATIONAL BANK OF GEORGIA

2012



NATIONAL BANK OF GEORGIA

INFLATION REPORT

Q2 2012

TBILISI

CONTENTS

BOXES

DIAGRAMS

TABLES

1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), the annual inflation equaled -0.2% in Q2 2012. The base effect affecting annual inflation discontinued in June, although the inflation still remained at a low level. A moderate pick-up in annual inflation is expected in the following months. However, the inflation rate is expected to remain low until the end of 2012.

In June 2012 the annual domestic inflation stood at 3.5%, and the imported inflation equaled -0.8%. The prices grew 4.6% for non-tradable goods and 3.0% for tradable goods. It is remarkable that the core inflation (change in consumer prices excluding food and fuel) remained low in Q2, amounting to 2.4%. The services inflation in June stood at 0.1%. Such price dynamics clearly demonstrate the absence of demand pressure on prices.

The dynamics of principal inflation factors can be shortly described as follows: in Q1 2012 the real economy expanded 6.8%, while the annual forecasts of economic growth stand at 6.7%. In 2011 the real output gap was almost closed, resulting in the fact that despite high rates of actual economic growth and growth forecasts, increased demand does not produce inflationary pressure.

In Q1 2012 large sectors such as industry, trade, transport, and communication registered slowdowns in the growth rates of unit labor costs. The deceleration in the growth rates of unit labor costs points to the lack of supply pressure on prices.

The lari's real and nominal effective exchange rates appreciated 2.8% and 3.2%, respectively. In annual terms the lari's REER appreciated 6.4%. The strengthening of the lari's exchange rate was caused by a number of factors, such as tourism revenues, money remittances and investments from abroad. The lari's appreciating tendencies produced a downward impact on import prices.

In Q2 2012 the credit portfolio of commercial banks expanded 6.5%, totaling GEL 8.3 billion. It is remarkable that credit activity of the banking sector increased quarter-on-quarter. However, the annual growth rate of the credit portfolio fell to 21%, owing mainly to the base effect. Recent monetary policy loosening already had a certain effect on loan interest rates. In Q2 the interest rates fell on average by 2.5 ppsfor domestic currency denominated loans and by 0.7% for foreign currency loans.

The banking deposits expanded by GEL 419 million in Q2 2012, amounting to GEL 7.8 million. It should be noted that such an increase in deposits was due to one-time factors (placement of funds from eurobond sales on bank deposits by several companies) and does not reflect permanent shifts in deposit dynamics. Owing to the same factors, the deposit dollarization rose by 2 pps in quarterly terms, although still recording a 2.1 pp decline in annual terms. The reduction in dollarization contributes to improvement of the monetary transmission mechanism.

In Q1 the NBG continued to use the monetary policy instruments with the view of efficient management of banking liquidity and revitalization of the sector. In the beginning of the year the banking system operated under excess liquidity conditions. In response the NBG resumed using government bonds for open market operations in Q2.

In May-July the NBG sold the government bonds with the nominal value of GEL 114 million, resulting in a withdrawal of GEL 128 million from circulation. This led to a significant increase in demand for refinancing loans, enhancing efficiency of the monetary policy.

In Q1 2012 the NBG continued monetary policy loosening, which translated into gradual interest rate cuts. Ultimately, the monetary policy rate was cut by 1.25 pps to 5.75%. Such reduction in the policy rate will contribute to maintaining the medium-term inflation at the targeted level.

In line with the NBG's forecasts, the inflation rate is expected to rise in the second half of 2012, although still remaining at a low level until end-2012 and in early 2013. The existing forecasts project that the inflation rate will converge to the targeted 6% level in the second half of 2013.

2. CHANGE IN CONSUMER PRICES

According to the National Statistics Office of Georgia (Geostat), the general level of consumer prices in Q2 2012 declined 1.8% quarter-on-quarter. The monthly inflation in Q2 2011 stood at -3.8%. This resulted in an increase in the general level of consumer prices from -2.2% at end-Q1 2012 to -0.2% at end-Q2. The inflationary pressure on the part of economic demand still remains weak.

With regard to quarterly changes in the structure of general consumer prices, the prices on food and fuel clearly dominated in Q2. The general level of consumer prices for the category of food and non-alcoholic beverages declined, largely owing to price decreases in the „vegetables and melons" category. Prices continued to drop for the „milk, cheese, and eggs" category, following seasonal price increases in the preceding quarter.

The downtrend in international oil prices had a corresponding effect on the Georgian consumer market as well. During the reporting quarter prices fell for diesel and gasoline. However, the overall price index for transportation still increased as a result of price increases for air transportation.

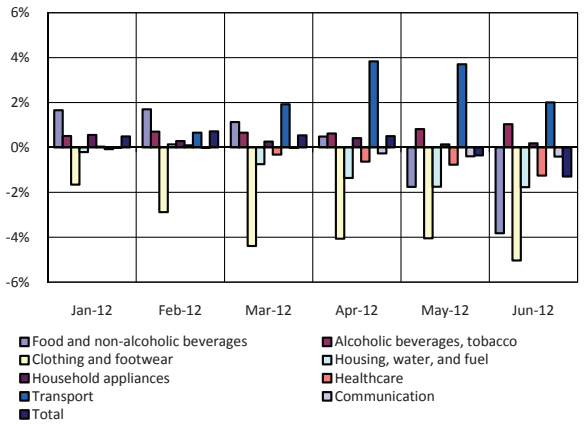
In Q2 2012 quarterly price decreases occurred for services in the "recreation and culture" category, significantly affecting the overall quarterly inflation rate.

As it was already mentioned, at end-June 2012 the consumer price index fell 0.2% year-on-year. Prices fell for food and non-alcoholic beverages which comprise a large part of the Georgian consumer basket and, hence, produce an essential impact on the general price level.

In annual terms the general level of consumer prices was also affected by price increases in the "transport" category. In addition, prices grew for the "hotels, cafes, and restaurants", while falling considerably for the "communication" services.

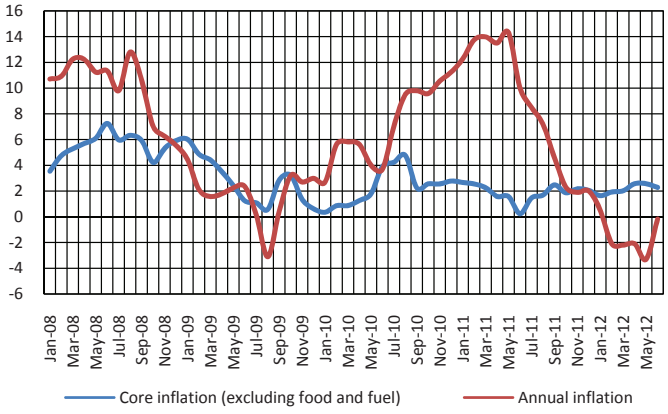
It is also important to observe changes in the general level of consumer prices for goods and services excluding food and fuel. The core inflation

DIAGRAM 2.1
Price Growth Relative to December 2011



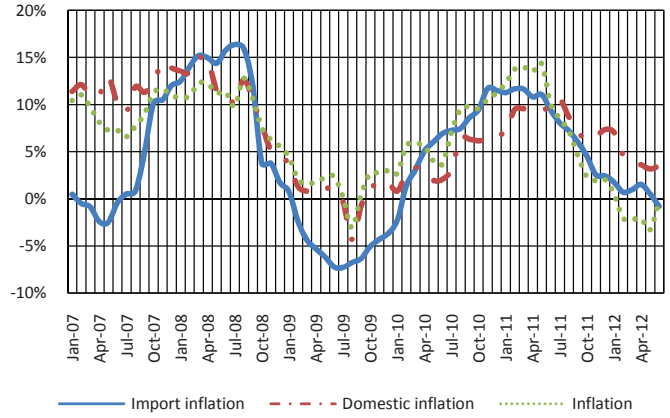
Source: Geostat

DIAGRAM 2.2
Core Inflation Excluding Food and Fuel



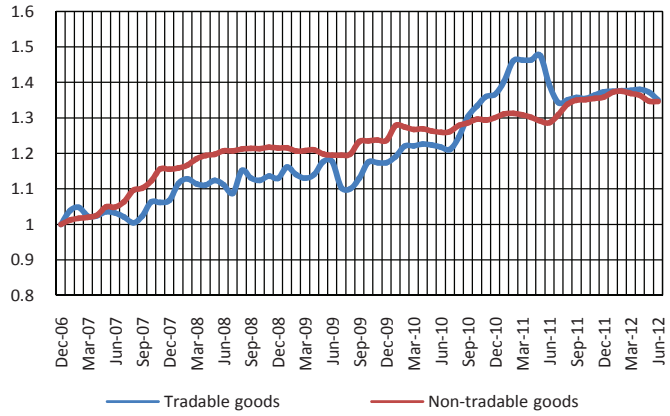
Source: Geostat, NBG calculations

DIAGRAM 2.3
Annual Inflation by Production Location



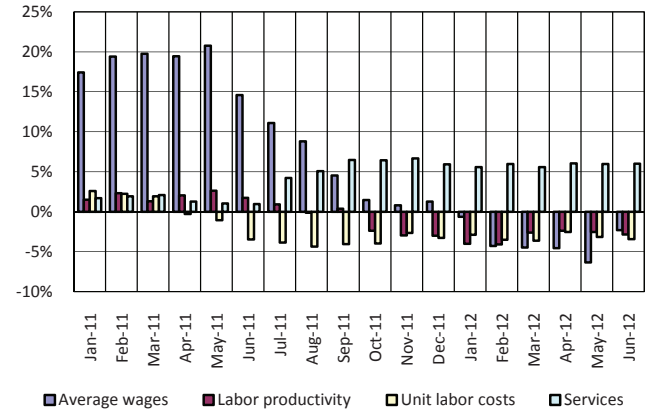
Source: Source: Geostat, NBG calculations

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



Source: Source: Geostat, NBG calculations

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



Source: Geostat

measured in this way stood at 2.4% at end-June, indicating weak demand pressure on prices.

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. In Q2 Turkey, Germany, Azerbaijan, China, Ukraine, Russia, and Armenia accounted for almost 78% of total Georgian imports. Price dynamics in these countries were largely influenced by the downward tendencies in international prices. Similar to Georgia, these countries registered low inflation or deflation at end-June. In particular, the inflation rates equaled 4.3% in the Russian Federation, 0.7% in Armenia, while Ukraine and Azerbaijan recorded deflation rates of 1.2% and 0.2%, respectively. The only exception was Turkey where the inflation rate remained high at 8.9%, albeit still experiencing a downward trend.

Owing to the price changes in the international markets, the growth rates of prices for imported goods started to slow down from June 2011, becoming negative at end-Q2 2012. The domestic inflation stood at 3.5%. The inflation rates for tradable and non-tradable goods equaled -3.0% and 4.6%, respectively.

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 Q2 2012. At end-June the prices for non-durables declined in annual terms, posting a 2.3% annual deflation rate. In the same period the inflation rates for durable and semi-durable goods also turned negative, pointing anew to weakening of demand. In contrast, the growth rate for service prices increased.

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

	December 2011 weights	Jun12/ Mar11/		Jun12/ Jun11	
		Inflation	Contribution	Inflation	Contribution
Total	100.0%	-1.8%	-1.8%	-0.2%	-0.2%
Food and Nonalcoholic beverages	30.3%	-4.9%	-1.5%	-4.3%	-1.3%
Food	27.5%	-5.5%	-1.5%	-5.1%	-1.4%
Bread and bakery	7.4%	-1.1%	-0.1%	-8.1%	-0.6%
Meat and meat products	5.2%	-1.3%	-0.1%	1.2%	0.1%
Fish products	0.3%	-0.1%	0.0%	8.6%	0.0%
Milk, cheese, and eggs	3.9%	-9.1%	-0.3%	4.6%	0.2%
Oils and fats	2.0%	0.1%	0.0%	-3.4%	-0.1%
Fruits, grapes	1.2%	3.9%	0.1%	-17.3%	-0.3%
Vegetables, melons, potatoes and other tubers	4.2%	-24.8%	-1.1%	-14.8%	-0.6%
Sugar, jams, honey, syrups, chocolate, pastry	2.5%	0.5%	0.0%	-4.5%	-0.1%
Other food products	0.7%	0.9%	0.0%	4.0%	0.0%
Nonalcoholic beverages	2.9%	1.1%	0.0%	5.7%	0.2%
Alcoholic beverages, tobacco	5.5%	0.4%	0.0%	1.0%	0.1%
Clothing and footwear	2.6%	-0.7%	0.0%	-5.6%	-0.2%
Housing, water, electricity, gas and other fuels	8.2%	-1.0%	-0.1%	1.2%	0.1%
Furnishings, household equipment, routine house maintenance	5.1%	-0.1%	0.0%	-0.6%	0.0%
Healthcare	7.5%	-0.9%	-0.1%	-0.2%	0.0%
Transport	12.8%	0.1%	0.0%	11.1%	1.3%
Communication	5.6%	-0.4%	0.0%	-1.9%	-0.1%
Recreation and Culture	6.8%	-1.5%	-0.1%	-1.7%	-0.1%
Education	6.1%	-0.1%	0.0%	0.8%	0.0%
Hotels, cafes and restaurants	4.4%	-0.5%	0.0%	5.1%	0.2%
Miscellaneous goods and services	5.0%	-0.7%	0.0%	-0.3%	0.0%
Non-durable goods	55.6%	-3.1%	-1.7%	-2.3%	-1.3%
Semi-durable goods	7.1%	-1.0%	-0.1%	-2.9%	-0.2%
Durable goods	4.5%	-1.8%	-0.1%	-3.4%	-0.2%
Services	32.7%	0.1%	0.0%	6.0%	1.9%

Source: Geostat

3. INFLATION FACTORS

3.1 Labor Market

In Q1 2012 the labor productivity of employed in the economy rose 4.5% year-on-year. Concurrently, the average wages of hired employees grew at 7.1%. Hence, the labor productivity was increasing steadily, whereas the growth rate of average wages significantly decelerated.

Similar to the preceding quarter, in Q1 2012 high (more than 15%) growth rates of real value-added per employed were recorded in the financial intermediation, "transport and communication", industry, and construction. Relatively lower growth was manifested in the trade, healthcare, and agriculture. Large annual contraction was registered in "hotels and restaurants", while also declining significantly, albeit at a slower pace, in the education, public administration, and "real estate operations".

TABLE 3.1
Growth of Real Value-Added per Employed in Q1 2012, year-on-year

	Value-added Index
Agriculture and Processing of Agricultural Products	101.3
Industry	118.1
Construction	115.1
Trade	107.4
Hotels and Restaurants	72.2
Transport, Communication	127.3
Financial Intermediation	130.3
Real Estate, Renting and Business Activities	95.1
Public Administration, Defense	94.0
Education	90.9
Health and Social Work	103.1
Total	104.5

Source: Geostat

According to the Geostat's data, the average monthly wages of hired employees in the economy amounted to GEL 676. The nominal growth rate of wages (7.1%) was almost equal to the real GDP growth (6.8%). The growth of average wages of hired employees occurred in the large majority of economic sectors.

The sectoral analysis shows that the highest wage growth rates took place in the agriculture, construction, healthcare, and "transport and communication". In Q1 the average wages in agriculture soared 36%, while rising approximately 20% annually in the remaining sectors mentioned above.

TABLE 3.2
Growth of Average Wages of Hired Employees in Q1 2012, year-on-year

	Nominal Wage Index
Agriculture, hunting and forestry	136.1
Fishing, fishery	52.1
Mining and quarrying	111.0
Manufacturing	104.3
Production and distribution of electricity, gas, and water	113.0
Construction	120.9
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	95.9
Hotels and restaurants	77.9
Transport and communication	119.6
Financial intermediation	107.0
Real estate, renting and business activities	108.1
Public administration	102.3
Education	105.6
Health and social work services	120.9
Other community, social and personal service activities	107.9
Total	107.1

Source: Geostat

High growth rates of wages in construction, "transport and communication" as well as in healthcare already turned into a pronounced tendency.

The above-ten-percent wage growth rate of hired employees was also recorded in the "production and distribution of electricity, gas, and water" and "mining industry". The wage growth in the financial intermediation, real estate operations, education, and "community, social and personal services" was similar (around 6-8%) to the average in the economy. Slow growth of wages occurred in the manufacturing and public administration, while the "hotels and restaurants" and trade saw wages decline in annual terms.

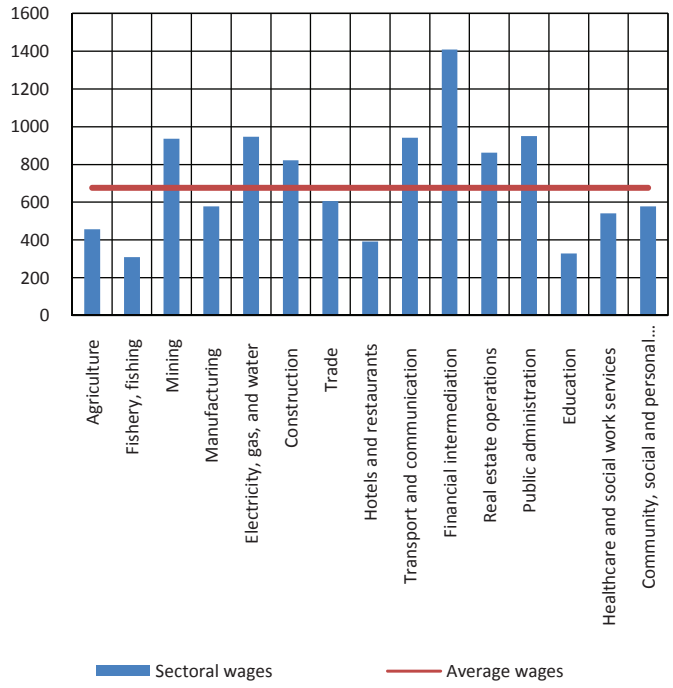
In Q1 2012 wide disparities in absolute wage levels were present across economic sectors. The highest average monthly wages were still recorded in "financial intermediation" (GEL 1,409), exceeding the national average level 2.1 times. Meanwhile, the average wages in the education and fishing were considerably below the national average of GEL 676.

It is remarkable that in Q1 2012the difference between the highest and the lowest sectoral wages increased approximately 9% both in annual and in quarterly terms.

Overall, in Q4 the annual wage growth rate of hired employees slowed down significantly in comparison to the preceding quarters. At the same time, as it was already mentioned, the labor productivity increased at approximately the same pace as in the preceding quarter. This resulted in only a 2.5% increase in the ratio of wages to labor productivity (unit labor costs[1])

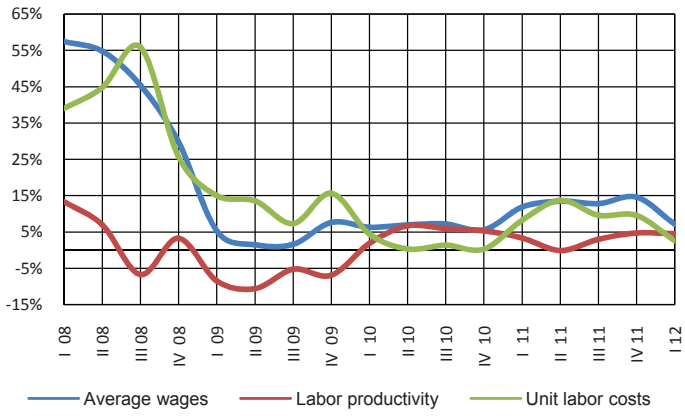
Among large economic sectors the unit labor costs grew only in the public administration and construction, while considerably declining in the industry, trade, and "transport and communication". Thus, the inflationary pressure on the part of the labor market remained low.

DIAGRAM 3.1
Average Sectoral Wages of Hired Employees, Q1 2012 (GEL)



Source: Geostat

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



Source: Geostat

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

3.2 Monetary Instruments

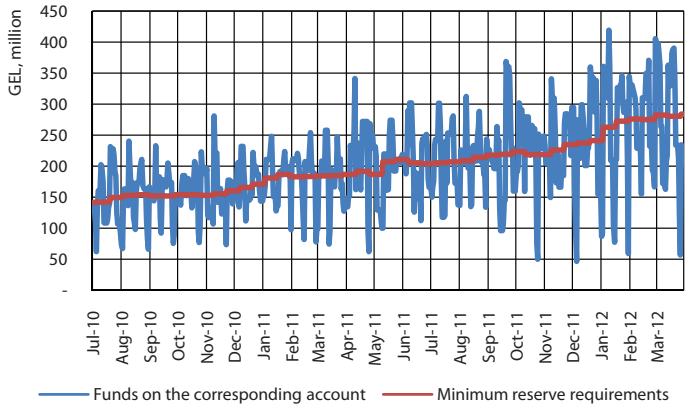
In Q2 2012 the NBG's monetary policies took into consideration existing inflation forecasts, macroeconomic trends and international market developments. In the reporting period the annual inflation rate remained negative largely owing to the base effect. The existing forecasts pointed to a moderateincrease in the inflation rate in the second half of 2012, although the latter still remained below the targeted level. 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 each month in April-June by 25 basis points, falling from 6.5% at end-March 2012 to 5.75% in June.

In conducting the Q2 monetary policies, the NBG used instruments for both liquidity supply and liquidity withdrawal with the aim of affecting interest rates. In Q2 along with elimination of excess liquidity in the banking sector, banks increased use of refinancing instruments, and interbank interest rates moved closer to the policy rate. 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 minimum reserve requirements stand at 10% for domestic currency borrowings and at 15% for foreign currency borrowings.

Primary assessment of the banks' liquidity is made on a weekly basis by means of liquidity forecasts, projecting 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. Demand for one-week loans rose considerably after Q1, triggered by contraction of banking liquidity. In April-June 2012 13 auctions for one-week refinancing loans were held, and the amount of auctioned liquidity oscillated between GEL 6-235 million, while the maximum amount placed during the Q1 auctions equaled GEL 15 million. The average amount of placed loans at an auction in Q2 equaled GEL 91.3 million. In the same period three guaranteed one-week refinancing loans were placed equaling GEL 70 million, GEL 6.5 million, and GEL 40 million.The weighted average interest rate of refinancing loans slightly exceeded the monetary policy rate.

In Q2 the average volume of funds on the commercial banks' corresponding accounts was adequate to the reserve requirements. Along with reduction in excess liquidity in the banking sector, the volumes of the NBG's overnight deposits placed by commercial banks shrank. Liquidity defi-

DIAGRAM 3.3
Lari Liquidity



Source: NBG

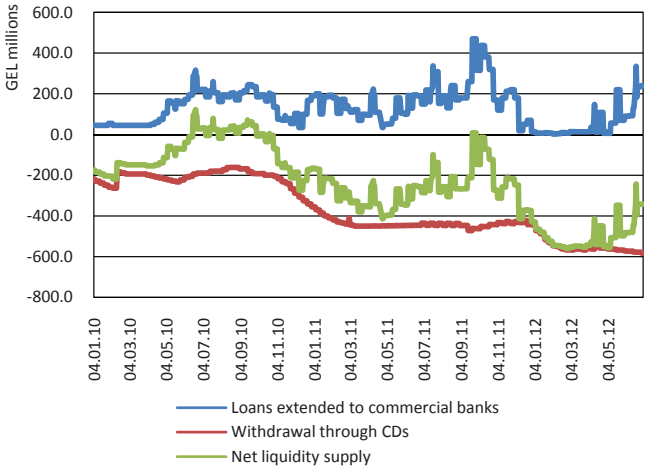
cit prompted banks to apply for refinancing loans, while under excess liquidity conditions banks placed funds on overnight deposits. The latter accrued the policy rate minus 1.5 pps.

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. On the contrary, liquidity deficit induces demand for refinancing loans, thus enhancing the monetary policy transmission mechanism. For this purpose the NBG amplified the use of Certificates of Deposit, an instrument for liquidity withdrawal. 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, and by GEL 25 million in Q2. At end-June the stock of CDs in circulation equaled GEL 565 million. The total placement of CDs in Q2 equaled GEL 390 million, with demand exceeding supply 2.5 times. The nominal value of 6-month CDs stood at GEL 210 million, and that of 3-month CDs – GEL 180 million. Compared to the preceding quarter, the issuance of CDs fell 9.3% (by GEL 40 million), and demand dropped10.2% (by GEL 115 million). As a result, the ratio of liquidity withdrawal through CDs to reserve money increased to 30% from 29.8% in March 2012.

By end-Q2 2012, the ratio of net liquidity withdrawal to reserve money averaged 27.2%. As of June 30, 2012 the net liquidity withdrawal totaled Gel 342.2 million.

In May 2012, based on the decision of the Monetary Policy Committee, the NBG resumed the use of another instrument of open market operations – Treasury bonds. These securities were issued with the purpose of securitization of government debt to the NBG accumulated during 1990s. In 2006 the NBG and the government concluded an agreement stipulating annual transformation of a part of the government's debt into T-bonds. These securities can be used in open market operations. The T-bond auctions were resumed on May 31. In May-July the nominal value of T-bonds placed by the NBG totaled GEL 114 million. In Q2 the volume of placed T-bonds equaled GEL 72 million. The maturity period of T-bonds oscillated between 12 and 57 months, while the weighted average interest rate ranged within 6.6-8.8%.

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



Source: NBG

BOX 3-1 GOVERNMENT BONDS

One of the important monetary policy instruments represents open market operations. The latter allows the NBG to manage interbank interest rates within desired limits by means of affecting banking liquidity. Changes in interbank interest rates are transmitted to the economy and are manifested in market interest rates. Ultimately, these changes affect aggregate demand and inflation.

Sales of securities through open market operations reduced liquidity in the financial sector, producing an upward impact on interest rates. Purchases of securities lead to an opposite outcome. Apart from managing interest rates, open market operations also serve other objectives. They promote circulation of lari denominated securities in the money market, provide banks with lari liquidity, and contribute to money market development. Financial market development is also critical for enhancing efficiency of monetary policy and facilitating provision of needed financial resources for private businesses. In order to conduct open market operations the NBG mainly uses its Certificates of Deposits and the Ministry of Finance's Treasury securities.

In 2006 the NBG's portfolio included a new instrument – Treasury bonds – created with the purpose of securitization of government debt to the NBG accumulated during 1990s. On the basis of agreement between the NBG and the government, GEL 48 million out of the outstanding stock of debt will be annually transformed into T-bonds. These securities are transferrable, i.e. can be used in open market operations. The maturity period of T-bonds oscillates between 16 and 60 months. The NBG offers these securities to public through auctions. The T-bonds may be purchased by commercial banks and by resident and non-resident individuals and legal entities through commercial banks. The securities are issued in domestic currency.

After enactment of the Agreement on measures to cover government debt to the NBG, the latter sold T-bonds in the amount of GEL 58 million in 2006-2007. The issuance was suspended thereafter, since withdrawal of excess liquidity was conducted by means of the NBG's Certificates of Deposit. At end-2011 the banking sector accumulated a large amount of liquidity as a result of larger-than-expected government expenditures. The issue whether to resume issuance of T-bonds was raised again. The Monetary Policy Committee decided to resume T-bond auctions from May 2012. The sales of T-bonds were planned in the amount of GEL 114 million; the placement in Q2 equaled GEL 72 million, while the remaining amount was placed in July. The outstanding maturity for these securities oscillates between 12 and 57 months.

Treasury bonds enjoyed big popularity from the moment the auctions were resumed. Demand exceeded issuance volumes 3-4 times. The main reason for investing free domestic currency funds into the T-bonds is the fact that the latter represent a practically risk-free, profitable, and liquid asset. In addition, commercial banks are allowed to use T-bonds as collateral in their transactions with the NBG.

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 effect 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.

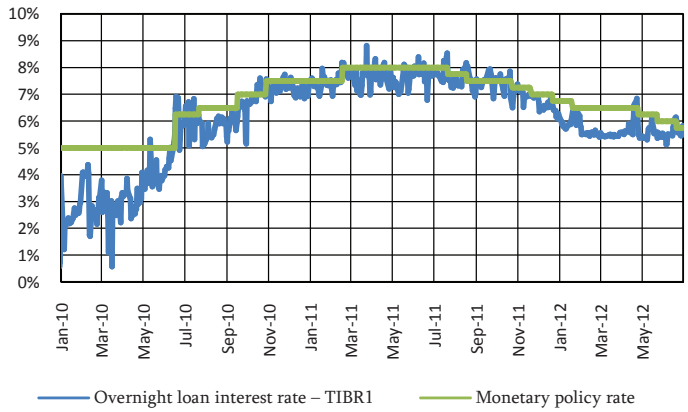
In Q2 2012 the interbank money market witnessed higher activity level. The turnover increased for both domestic and foreign currency denominated funds. The combined volume of extended loans and placed deposits in lari equaled GEL 2.3 billion, up by GEL 139.6 million quarter-on-quarter. The increased turnover in the interbank market was due to reduction in excess liquidity, triggering liquidity trade among banks. In general, banks' dependence on the money market and the NBG's refinancing instruments improves the transition mechanism simplifying management of inflation.

Similar to domestic currency denominated funds, the volume of US dollar denominated transactions increased as well. In particular, the growth rate equaled 315.9%, bringing the transaction volume up to USD 315.9 million. The transactions of euro denominated funds increased in Q2 to EUR 189.3 million.

As a result of reduction in excess banking liquidity and monetary policy rate cuts, the cost of interbank market funds denominated in lari changed insignificantly. Contraction of excess liquidity applies an upward pressure on interest rates, while monetary policy loosening has an opposite effect. The weighted average interest on overnight loans - TIBR1 – grew by 0.05 pps in Q2, averaging 5.7%, while the interest rate on 1-to-7-day loans fell from 6.3% to 5.8%. 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, the weighted average interest rate dropped from 3.0% to 1.9% for US dollar denominated funds and from 1.0% to 0.6% for euro denominated funds. It should be noted that, similar to the preceding quarters, in Q2 2012 the overnight loans and deposits constituted the absolute majority of transactions in the interbank money market.

DIAGRAM 3.5
Average Interest Rates on Short-Term Interbank Loans and Monetary Policy Rate



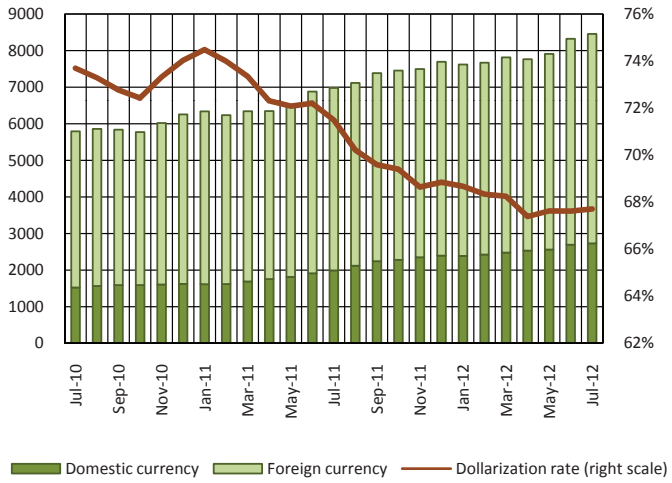
Source: NBG

3.4 Banking Sector

The growth rate of bank crediting continued to decelerate. In June and July the average annual growth equaled 21%, down from 27-28% in the beginning of the year. It should be especially mentioned that the growth rate of loans to individuals dropped significantly from 41.2% in January to 27.3% in June, as credit activity in this segment exerts an immediate impact on consumer prices.

DIAGRAM 3.6

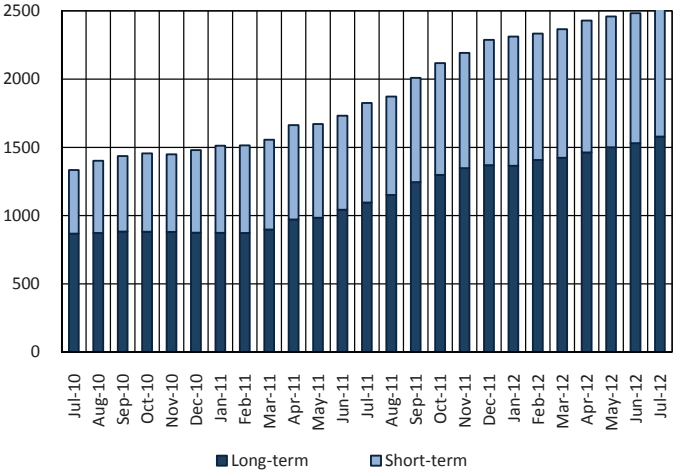
Extended Loans (GEL, millions) and Dollarization



Source: NBG

DIAGRAM 3.7

Term Loans[4] in Domestic Currency , GEL Millions



Source: NBG

The loan dollarization rate tends to decline (See Diagram3.6). This enhances efficiency of monetary policy since proper management of inflation requires a more extensive use of lari resources. The annual average decline in dollarization equaled 3.6 pps, as the dollarization rate stood at 67.7% in July 2012. This fact, on the one hand, indicates an increased trust in the domestic currency on the part of commercial banks, and represents a result of the NBG's extensive use of monetary instruments, on the other.

A larger decline in loan dollarization is evident in the case of individuals, as the respective dollarization rate dropped by 4.8 pps (See Diagram3.8). Besides, the gradual process of long-term loan larization (de-dollarization) is becoming evident, which should lead to higher efficiency of the monetary transmission mechanism.

As it was mentioned above, despite expansion of the credit portfolio, demand pressure on prices is unlikely. It should be noted that, similar to other types of loans, the annual growth rate of consumer and mortgage loans is decelerating as well. Since the beginning of the year the growth rate of consumer loans fell by 5.4 pps to 29.3% and that of mortgage loans shed 4.4 pps to equal 40.8%.

The loan interest rates continue to decrease, improving loan affordability in the future (See Diagram3.9). It should be pointed out that domestic currency denominated loans witnessed particularly big drops in interest rates equaling approximately 2.5 pps. This represents a positive fact for promoting larization and hence efficient inflation management.

In July 2012 an abrupt rise in deposit liabilities

[2] Include all types of loans except overdue loans

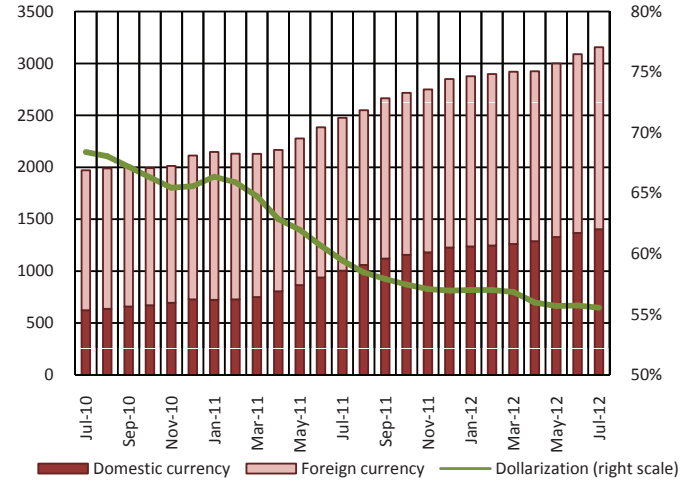
occurred (See Diagram 3.10). The annual growth rate of deposit liabilities averaged 25%, with the total amount equaling GEL 7.8 billion. This fact has a temporary nature and does not reflect an abrupt shift in clients' behavior with respect to savings. In particular, in early July a large Georgian company issued eurobonds in the amount of USD 500 million and deposited a part of attracted funds in the banking sector (another rise in the deposit level which occurred in May was also related to issuance of eurobonds by another company).

In order to attain monetary policy objectives, it is crucial that the banking sector use domestic currency denominated funds for conducting financial intermediation. As of July 2012, the deposit dollarization rate still remains high at 62.5%, although it declined in annual terms (See Diagram 3.10)[3]. Historically, the dollarization of time deposits is particularly high at 84.2%, and the primary reason still consists in insufficient trust towards lari as a long-term asset. Similar to loan interest rates, the deposit interest rates slightly decreased from the beginning of the year as well (See Diagram 3.9).

With the exception of January losses, the banking sector's profits were positive. As of July 2012, the net profit equaled GEL 88.8 million, the ROA was 1.4% and the ROE – 7.8%. The regulatory capital adequacy ratio stood at 17.3%, up by 0.7 pps year-on-year.

DIAGRAM 3.8

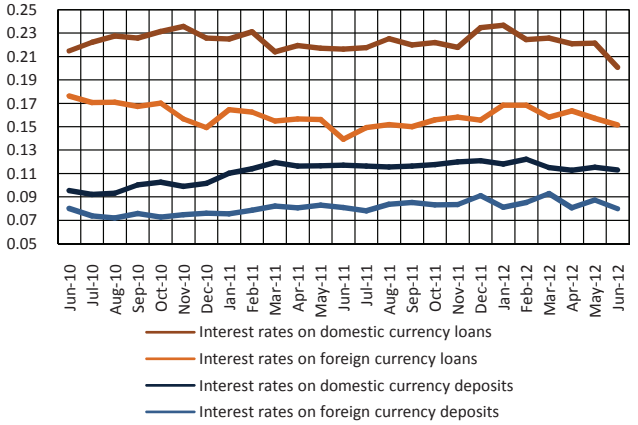
Loans to Individuals (GEL millions) and Dollarization



Source: NBG

DIAGRAM 3.9

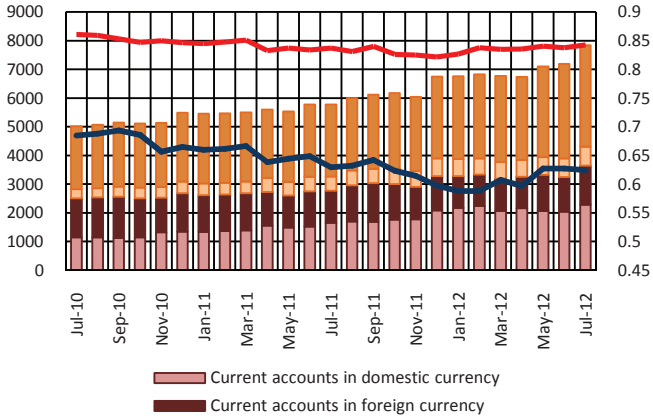
Market Interest Rates on Loans and Deposits by Different Currencies



Source: NBG

DIAGRAM 3.10

Deposits (GEL millions)



Source: NBG

[3] The increase in dollarization rate starting from May is related to growth of foreign currency deposits placed by the above-mentioned companies

BOX 3-2 CASH CENTER

In order to fully satisfy the economy's demand for cashthe National Bank of Georgia within its competences conducts cash emission activities comprising production, import, storage, and emission of notes and coins, quality improvement of notes and coins in circulation, appropriate processing of cash withdrawn from circulation, improvement of expertise, and destruction of worn out bank notes.

Due to space shortages the NBG's warehouses for valuables, banknote processing shops, units serving commercial banks and other clientele, structural units conducting expertise, transportation of valuables, regulation of cash emission activities, etc. were not optimally allocated. As a result, these activities containing high-risk were not performed in single closed environment, thus somewhat jeopardizing safety and security aspects.

The location of the NBG's cash center is also problematic: in particular, the premises are located in a densely populated urban area and surrounded by residential buildings. Besides, a hotel next to the NBG premises and a narrow road leading into the NBG's yard did not allow for safely conducting operations related to collection of cash and other valuables. Thus, in the event of any extraordinary situation there were reasonably high risks with respect to security and transportation of valuables.

Under these circumstances, in order to ensure improvement of cash-related activities, technical modernization and optimization of related risks, a comprehensive resolution of issues related to collection, processing, expertise, secure placement of bank notes as well as destruction of worn-out bank notes was needed. This envisaged, on the one hand, construction of a new cash center equipped with modern secure technologies in line with the European standards, and, on the other hand, provision of necessary logistics and implementation of automated systems for registration of cash emission activities.

Construction of a new cash center in line with international standards, proper equipment of warehouses (with machinery, computers and containers), and installation of automated systems for registration of cash emission activities will allow for achievement of the following objectives:

• Compliance with international standards in such spheres as collection, counting, grading, expertise, destruction, storage, protection, and provision of cash in relations with producers of bank notes, commercial banks and other clientele.

• Improvements in the quality of services provided by commercial banks, such as collection and payment of cash.

• Provision of bank notes on the whole territory of the country, withdrawal of work-out and fake bank notes, and eventual strengthening of population's confidence in lari.

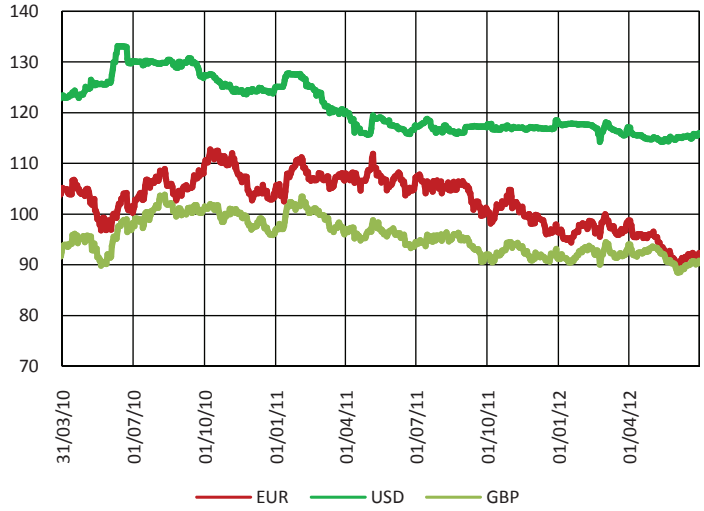
• Optimization of working conditions for personnel involved in conducting cash operations.

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.

In order to analyze behavior 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. In Q2 2012 the lari appreciated 2.7% against the lira. After the end of the quarter the GEL/TRY exchange rate dynamics reversed again, and the Georgian currency slightly depreciated. In Q2 2012 the lari's nominal exchange rate appreciated 0.9% against the US dollar, 6.5% against the euro, and 3.4% against the UK pound sterling (See Diagram 3.11). This resulted in a 3.2% increase in the Average monthly nominal effective exchange rate index. Meanwhile, the lari's monthly average real effective exchange rate index rose 2.8%, implying a real appreciation of the domestic currency. The real effective exchange rate is directly related to the country's competitiveness in trade prices, as appreciation of the former impairs competitiveness of exports. In Q2 2012 the lari's real appreciation was due to nominal appreciation of the domestic currency, which was partly offset by a relatively low level of consumer prices in Georgia vis-à-vis its trading partners.

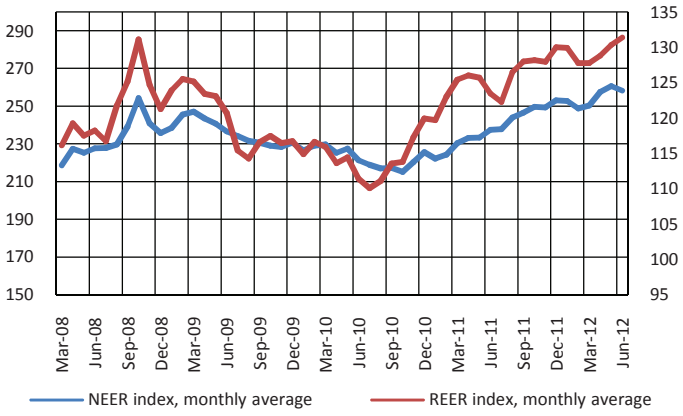
DIAGRAM 3.11
Lari's Nominal Exchange Rate indices, 2010-2012



Source: NBG

In Q2 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 increased demand for foreign currency fueled by rising imports created a downward pres-

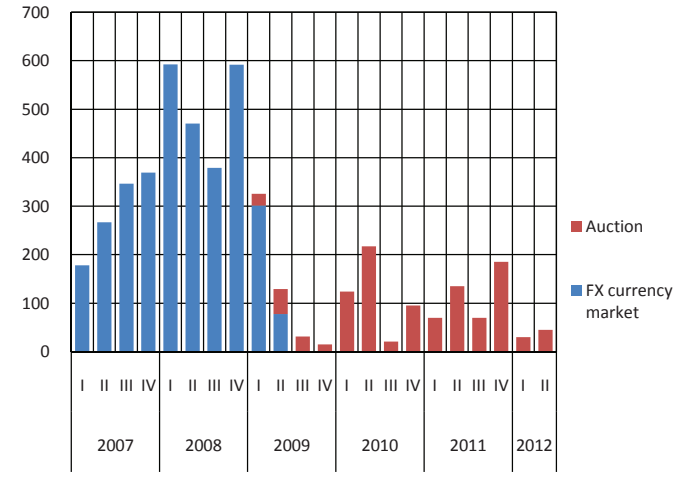
DIAGRAM 3.12
Monthly Nominal and Real Effective Exchange Rate Indices (2007-2011, relative to December 1995)



Source: NBG

DIAGRAM 3.13

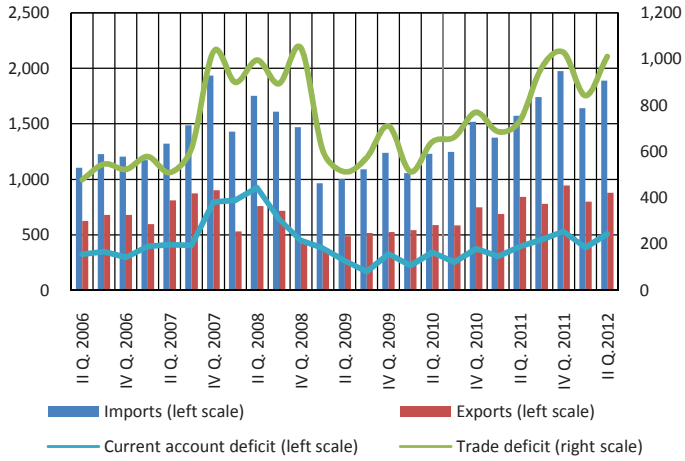
NBG's Interventions in the FX Market



Source: NBG

DIAGRAM 3.14

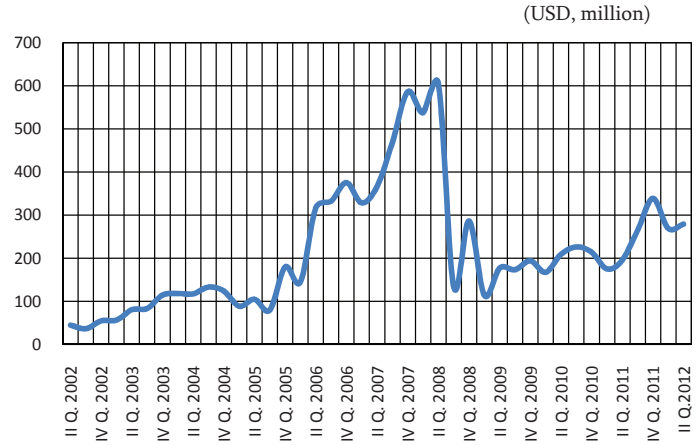
Dynamics of Georgia's Current Account and Trade Balances



Source: NBG

DIAGRAM 3.15

FDIs in Georgia



Source: NBG

sure. Depreciation of the euro in the international markets led to additional expectations of the lari's appreciation.

According to the NBG's estimates, in the first half of 2012 the net revenues from tourism increased 1.5 times in annual terms, triggering demand for domestic currency. The volume of remittances from abroad also posted an annual increase in Q2. The amount of remittances received in Q2 totaled USD 337.1 million, up 16.7% quarter-on-quarter. Similar to the preceding periods, in Q2 2012 the amount of remittances transferred abroad was insignificant in comparison to the inflows. According to the NBG's preliminary data[4], in the first half of 2012 the volume of foreign direct investments in Georgia grew 47.9% year-on-year. It should be noted that in Q1 2012 the current account deficit widened. The estimates for Q2 2012also show further deterioration of the current account, which represents an important factor underlying increased demand for foreign currency.

In the first half of 2012 the financial flows underlying demand and supply of foreign currency were balanced. In the period concerned against the backdrop of limited central bank interventions the lari's exchange rate with respect to the US dollar remained stable. The NBG's policies were aimed at minimizing interventions in the FX market. In Q2 2012 the net NBG's purchases of foreign currency equaled only USD 45 million.

An important determinant of demand for foreign currency represents the dollarization rate and speculative capital, creating certain expectations in the market. The NBG actively continues to enhance the process of larization in the country.

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

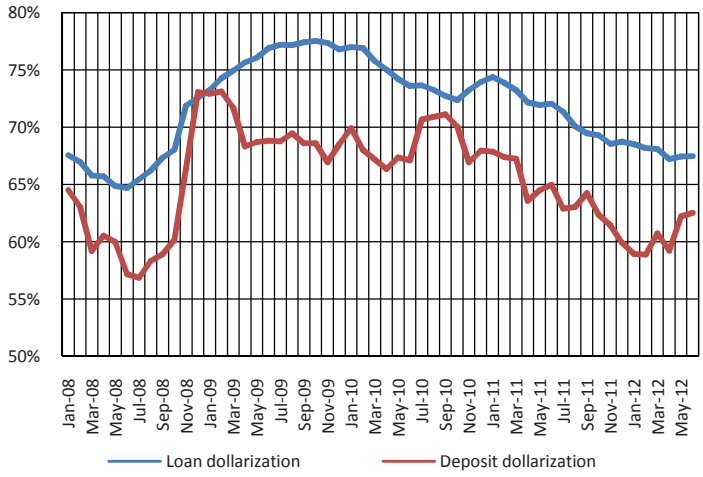
Certain positive outcomes of the dedollarization policies are gradually becoming manifest. In the recent period the share of lari denominated loans in the total credit portfolio of commercial banks increased. In Q2 the loan dollarization rate dropped by 0.6 pps. After a significant drop in Q4 2011, the deposit dollarization rate rose by 1.8 pps.

3.6 Production and Demand

In Q1 2012 the real GDP grew 6.8% in annual terms. The nominal growth stood at 8.7%, and the GDP deflator rose 1.7%.

Similar to the preceding period, the annual

DIAGRAM 3.16
Loan and Deposit Dollarization Rates



Source: NBG

TABLE 3.3
Sectoral Contributions to Real GDP Growth, Q1 2012 (%)

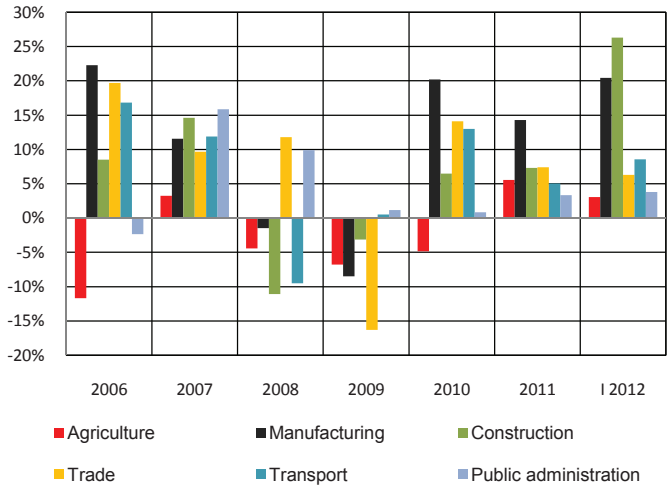
	Nominal weights (Q1 2011)	Real growth	Contribution
Agriculture, hunting and forestry; fishing	8.1%	3.1%	0.2%
Mining and quarrying	1.0%	-4.1%	0.0%
Manufacturing	9.0%	20.4%	1.8%
Electricity, gas and water supply	3.1%	6.4%	0.2%
Processing of products by households	2.3%	-1.4%	0.0%
Construction	3.0%	26.3%	0.8%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	13.8%	6.3%	0.9%
Hotels and restaurants	2.2%	9.4%	0.2%
Transport	7.1%	8.6%	0.6%
Communication	2.8%	7.8%	0.2%
Financial intermediation	2.7%	16.7%	0.4%
Real estate, renting and business activities	4.2%	6.8%	0.3%
Imputed rent of own occupied dwellings	3.1%	3.5%	0.1%
Public administration	8.8%	3.8%	0.3%
Education	4.1%	2.2%	0.1%
Health and social work	5.7%	0.4%	0.0%
Other community, social and personal service activities	4.8%	6.0%	0.3%
Private households employing domestic staff and undifferentiated production activities of households for own use	0.1%	13.8%	0.0%
FISIM adjustment	-1.4%	8.8%	-0.1%
GDP at basic prices	**84.5%**	**7.6%**	
Taxes on products	16.2%	2.3%	0.4%
Subsidies on products	-0.7%	-12.2%	0.1%
GDP at market prices	**100.0%**	**6.8%**	**6.8%**

Source: Geostat

growth of real GDP was mainly driven by the manufacturing, trade, and construction sectors. A considerable (20%) expansion of manufacturing was largely due to increased production in the subsectors of "machinery, electrical and transport equipment manufacture" of basic metals and fabricated metal products and "manufacture of food products".

High growth and a significant contribution to the overall economic growth were recorded for the transport sector. Positive contributions to the GDP growth were also made by the financial intermediation, real estate operations, public administration, and "community, social, and personal services". It is remarkable that agriculture manifested positive growth rates again, albeit lower than in the preceding quarters.

DIAGRAM 3.17
Dynamics of Value-Added Growth in the Leading Economic Sectors (2006 – Q1 2012)



Source: Geostat

In Q1 2012 the real value-added increased in almost all the remaining sectors of the economy, but their contributions to the annual GDP growth were relatively insignificant. Contraction of value-added occurred only in the mining[5] and "processing of products by households".

The sectoral analysis of seasonally adjusted data shows that the financial intermediation and manufacturing sectors manifested sustainable economic growth over a medium-term (1-2 years) period.

In 2008-2010 the largest sectors of the Georgian economy manifested varying real growth rates. Starting from 2011 they displayed positive and more stable growth, which continued in early 2012.

In 2011 the agriculture recorded moderate growth, which was sustained in early 2012. The growth rates in manufacturing have been rising from 2010, whereas the uptrend in construction was started in mid-2011. It is remarkable that the growth in the transport sector tended to decelerate, but the growth rates recovered in early 2012. The remaining large sectors have shown relatively stable growth rates.

3.6.1 Private and Government Consumption

In Q1 2012 the nominal GDP growth equaled 8.7% in annual terms. The growth was powered by an increase in capital expenditures: similar to the preceding quarter the "gross capital formation" rose approximately 40% year-on-year. A certain contribution to the Q1 GDP growth was also produced by exports. The total final consumption went up slightly, while imports rose considerably.

With regard to the components of final consumption, the nominal volume of household consumption grew only 1.8%. The growth rate of real household consumption[6] continued to slow

[5] Value-added produced in this sector is on the downtrend since Q1 2011.

[6] The real household consumption is deflated with the CPI

down, increasing 4% in annual terms.

The government final expenditures registered a significant growth (9%) in Q1 2012. The growth was mainly fueled by a 10% increase in government expenditures on collective services. However, the growth of government expenditures on individual goods and services was also considerable, standing at 7.7%.

In Q1 the CPI-deflated "actual household consumption" (which includes all types of final consumption excluding general government's "collective services") grew at a relatively lower rate (4.2%) than the real GDP did (8.8%). This implies that there was practically no inflationary pressure on the part of aggregate demand.

In comparison to the preceding quarters, the nominal growth rate of "exports of goods and services" declined. Despite this fact the contribution of this component to the real GDP growth was approximately equal to that in 2011. The annual growth rate of real imports slightly decelerated, equaling 12% in nominal terms (i.e. real growth rate of approximately 10-11%).

3.6.2 Investments

The 40% expansion of gross capital formation was powered by a 46% growth of investment in fixed capital. It is remarkable that the growth rate of capital investments has been on the uptrend for the last two quarters. Such increase in fixed capital investments creates expectations of sustainable economic growth.

In Q1 2012 the volume of the enterprise inventories grew by 2.8 percent less than year before. It should be noted that the annual growth of this indicator had been positive since 2010.

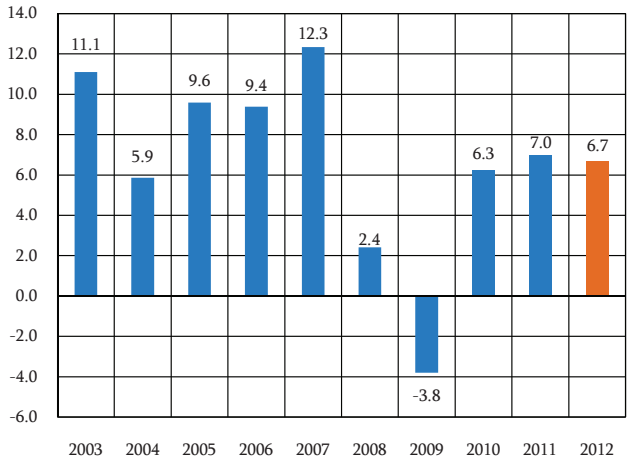
3.6.3 2012 Forecast

The difference between the actual Q1 2012 growth rate and its forecast published in the previous report equaled 0.8 pps.

In predicting the Q2 2012 GDP growth rate it should be taken into account that the annual growth rate of VAT taxpayers' turnover equaled 20%. Also taking into account export and import data as well as sectoral projections, the Q2 2012 forecast of nominal GDP equals approximately 9%, while the real economic growth is projected at 8%.

In sectoral terms, the real growth of value-added in Q2 2012 will be mainly driven by the manufacturing, construction, and trade sectors. Significant positive contributions will be also produced by the transport and financial intermediation.

DIAGRAM 3.18
Real GDP Growth, 2003-2012[7] (%)



Source: Geostat, NBG projections

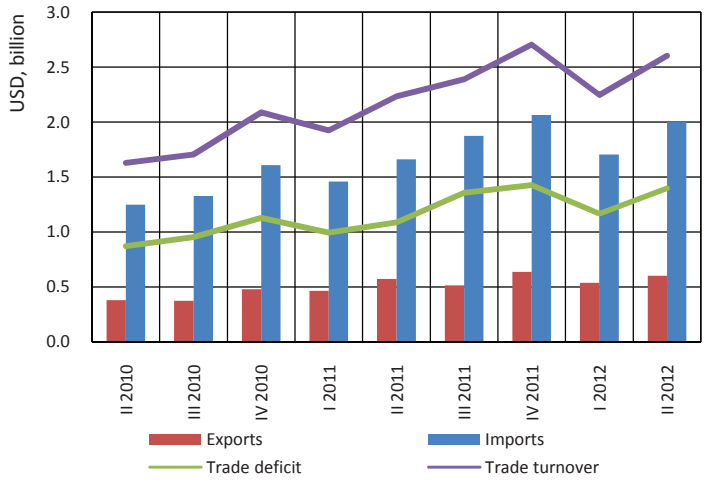
With regard to the categories of use, in Q2 2012 the projected growth of nominal GDP will still be fueled by gross capital formation. At the same time it is projected that the growth of final consumption will be insignificant. The export growth is expected to slow down while the import growth

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

will accelerate, decreasing the contribution of the external sector to the economic growth.

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

DIAGRAM 3.19
Exports, Imports, Trade Deficit and Trade Turnover



Source: Geostat

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

Source: Geostat

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 -1.0billion in Q2 2012. On the other hand, the balance of trade in services is a relatively smaller positive component of the trade balance, and its Q2 forecast equaled USD 243.2 million.

In Q2 2012 the turnover of registered[8] trade in goods totaled USD 2.6billion, up by 16.6% year-on-year. The registered exports of goods equaled USD 601.7 million, up 5.2% year-on-year. The annual growth rate of exports declined largely due to a reduction in scrap metal exports. Significant negative impact on export growth was also produced by gold and rods and bars of non-alloyed steel (armature). The registered imports of goods totaled USD 2.0 billion, posting an annual growth rate of 20.5%. The annual growth rates of imports accelerated in comparison to the preceding quarters. As a result, the trade deficit widened considerably, equaling USD 1.4 billion at the annual growth rate of 28.5%. In absolute terms the annual growth ofimports exceeded that of exports by USD 310.4 million.

The export of goods by end-use categories was distributed as follows: capital goods – 3.2%, intermediate consumption goods – 48.2%, final consumption goods – 48.6%. Compared to the preceding periods, the share of capital and consumer goods in total exports decreased (in Q1

[8] 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. For detailed information See Box 3: 'External merchandise trade statistics and goods trade in the balance of payments' in Inflation Report, Q2, 2010

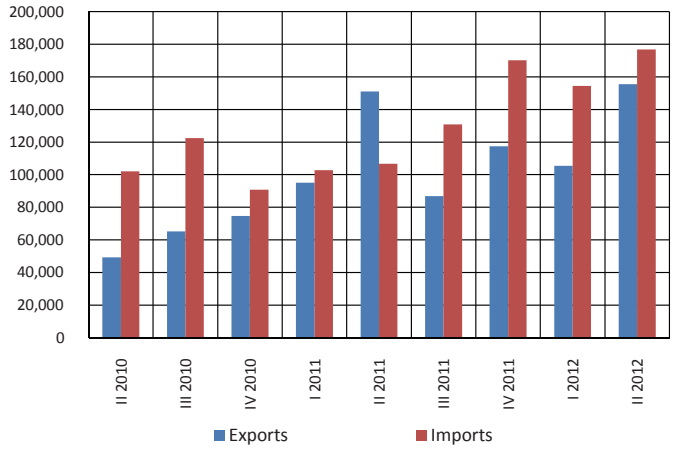
2011 a larger share of capital goods exports was due to re-export of motor cars and machinery).

The increased share of consumer goods exports was powered by export of spirituous beverages, which stood in the fourth position of the top exports list and posted a significant rise in annual terms. The export of consumer goods was also pushed up by motor cars and medicaments, which occupied the first and the ninth position, respectively. Starting from 2011, the re-export of motor cars was permanently the top export item, accounting for 87.9% of total imports of motor cars. Exports of intermediate consumption goods as well as total exports were largely increased as a result of risen export of mineral fertilizers, occupying the third position. The export of ferroalloys stood in the second position, albeit producing a negative contribution to the annual exports growth.

The registered import of goods comprised 16.8% of investment goods, 37.3% of intermediate consumption goods, and 45.5% of final consumption goods. The petroleum products (largely gasoline) 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 accelerated in the reporting quarterequaling 25.2%, completely due to the volume effect. The annual growth rate of motor car imports also increased, amounting to 65.7%. However, it should be noted that a large part of this type of imports is then re-exported to the neighboring countries.

According to the IMF forecast[9] , oil price risks were mitigated for 2012-2013. Supply has been increased due to production expansion of main exporter countries, namely Saudi Arabia. On the other hand, conservative forecasts with respect to global economic growth lead to slackened demand for oil. Meanwhile, due to decreased geopolitical risks, adverse expectations about oil supply were also mitigated. All of the above ensures stability of oil prices in the nearest future.

DIAGRAM 3.21
Export and Import of Motor Cars



Source: Geostat

The import of petroleum gases, making part to the intermediate consumption category, contracted in annual terms. Despite positive growth in Q2 2012, the share of food products in total imports shrank, equaling 11.5%. In value terms the food imports amounted toUSD 230.8 million, increasing only 3.4%. The import of wheat, the largest component of food imports, posted an annual contraction due to the price effect. The import of meat products held the second largest share in total food imports (12.4%), posting an annual 11.5% growth rate. The import of sugar and confectionery followed in the list. The import of tobacco and alcoholic beverages accounted for 2.2% of total registered imports, recording a 9.7% increase in annual terms.

[9] World Economic Outlook Update, July 2012, International Monetary Fund

BOX 3-3 EXPORT AND IMPORT PRICE INDICES

At present there is no statistics on export and import price indices in Georgia. Production of these indices is important, since they allow for calculation of real growth of exports and imports. Export-import price indices are also crucial for macroeconomic modeling. These indices allow researchers to study export and import elasticities with respect to exchange rate, which in turn will facilitate calculations of current account elasticities and, hence, a real equilibrium exchange rate.

The customs agency's database was used for constructing the indices. The first data in the database refer to July 2005, hence the indices are available starting from this period. The export and import data are expressed in the US dollars, and the indices are based on dollar prices (the indices can be converted into lari terms by using average monthly exchange rates between the lari and the US dollar). The goods were selected at 6-digit code level. Calculation of the indices is also possible at 11-digit level of goods nomenclature; however, at this level goods are very concrete and the probability of miscoding is quite high (such facts are not infrequent).

Although it is impossible to use all types of goods for calculating the indices, but it is desirable that monthly selection of goods cover thelargest possible part of total turnover. As the Georgian exports are quite concentrated, the top 20 items were selected each month. Then those goods were excluded, which did not make the list at least 15 times over the entire period (78 months). This resulted in selection of 78 goods, accounting on average for 73.5% of total exports. Analogously, 400 goods were selected on a monthly basis for imports (the number is bigger than for exports, since imports are much more diversified). Eventually 443 goods were selected, the share of which in total imports averaged 78%.

Monthly prices of goods are calculated by dividing the total value of the goods by its quantity. For some goods there are clear outliers. The latter are discarded (i.e. it is considered that prices are missing for the period concerned), since using outliers may significantly distort the index.

In constructing the indices, the base-period method was used. Chain-linked indices were not used since export and import data often contain missing values. The weights used for constructing the indices change annually and are calculated as annual averages. Since data are available from July 2005, the 2006 average is used for the 2005 weights.

The index is calculated in the following way:

Initially price indices for each goods are calculated separately, with the reference year being December of the previous year (while for 2005M8-2006M12 period the base month is July 2005):

$$PSi_y^m = Pi_y^m / Pi_{y-1}^{12}$$

whereydenotes year, m–month,i – goods code/ ID number, and P- price. Then the weighted average is calculated:

$$AP_y^m = \sum PSi_y^m * Wi_y$$

where Wiis weight of thei-th goods (annual average). The final step involves linking of indices for each year, since the base period for each year is December of the previous year:

$$PI_y^m = AP_y^m * AP_{y-1}^{12}$$

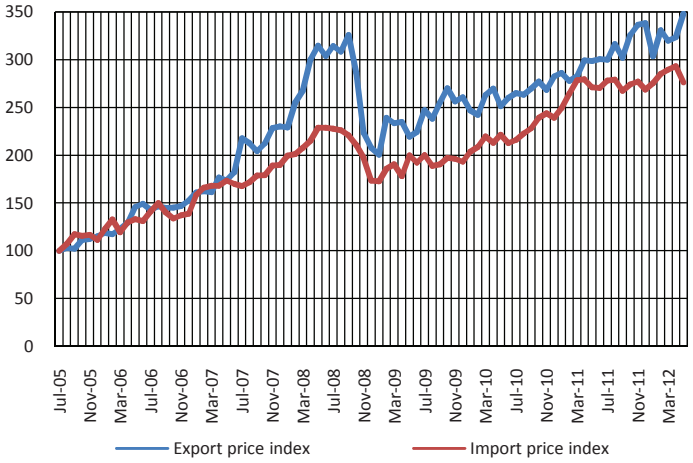
Since December of the previous year represents the base period, missing(either discarded or non-existent)prices for some goods in December imply that such goods will not be present in the index during the following year. In such cases, the nearest available prices for such goods are taken and used in index calculationsfor the following year only.

As it can be seen on the Diagram below, from July 2005 until December 2011 the export prices grew faster (3.4 times) than the import prices (2.7 times). In the post-crisis period, the growth rates equaled 68.7% for export prices and 55.5% for import prices.

Changes in export prices mainly occurred for ferrosilicon manganese, ferrous and non-ferrous metal scrap, and gold (the index fell during crisis and rose in the post-crisis period).

The growth of the import price index in the post-crisis period was largely related to price increases for petroleum products, wheat, electricity, and coffee. A considerable jump in import prices took place in the second half of 2010 and Q1 2011. In July-September 2010 the wheat price almost doubled (base effect), significantly affecting the index. In the second half of 2011 the import price index ceased to rise, owing to the discontinuation of the base effect for wheat prices as well as to price decreases for petroleum products.

DIAGRAM 3.22
Export and Import price indices



Source: NBG calculations

3.8 Government Operations

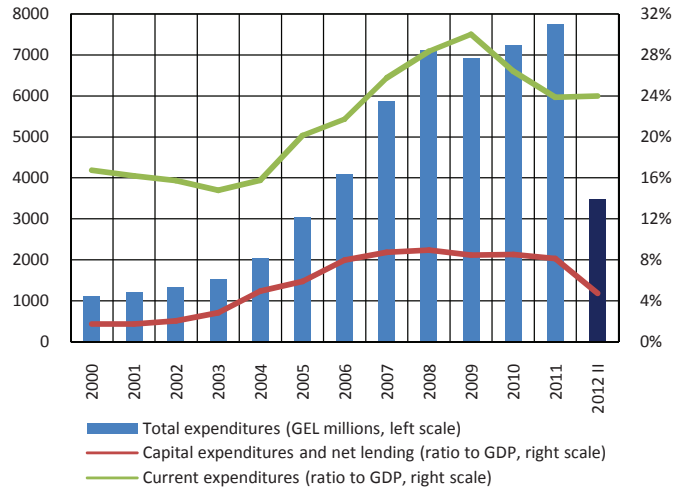
In 2012 the government continues a fiscal consolidation process. Despite the fact that the consolidated budget deficit increases in 2012 by a few tens of millions of lari (presumably to GEL 948 million), its share with respect to GDP declines from 3.6% to 3.5%. The targeted level of budget deficit did not have a significant impact on inflation. In the first half of 2012 the budget deficit totaled GEL 18.2 million, implying that in the remaining three quarters the budget expenditures will exceed the budget revenues approximately by GEL 930 million.

TABLE 3.4
Consolidated Budget Parameters

	Q1 2012 (GEL Million)	Ratio to GDP (Q2 2012)
Total revenues and grants	1,735	27.2%
Revenues	1,707	26.7%
Tax revenues	1,602	25.1%
Non-tax revenues	105	1.6%
Grants	28	0.5%
Total expenditures	1,899	29.8%
Current expenditures	1,531	24.0%
Capital expenditures and net lending	368	5.8%
Surplus	-164	-2.6%
Deficit Financing	164	2.6%
Privatization	137	2.1%
Use of free circulating funds	-94	-1.5%
Net increase in domestic liabilities	14	0.2%
Net increase in external liabilities	107	1.7%

Source: Ministry of Finance

DIAGRAM 3.23
Dynamics of Budget Expenditures



Source: NBG calculations

In Q2 2012 the consolidated budget deficit equaled GEL 164 million, or 2.6% of the Q2 GDP. The deficit was largely financed through proceeds from privatization (GEL 137 million) and net increases in external liabilities (GEL 107 million). The net increases in domestic liabilities amounted to gel 14 million. As a result, the government's circulating funds grew by GEL 94 million.

In Q2 2012 the consolidated budget revenues and grants totaled GEL 1.7 billion, of which the grants were GEL 28.3 million and the tax and non-tax revenues accounted for the remaining part. The Q2 revenues constituted 27.2% of GDP, down by 0.3 pps year-on-year. The tax burden (tax-to-GDP ratio) stood at 25.1%, up by 1.0 pp year-on-year.

In Q2 2012 the consolidated budget expenditures totaled GEL 1.9 billion, up 5.3% year-on-year. Since the nominal economic growth was higher in the same period (9.3%), the ratio of total expenditures to GDP declined by 0.7 pps to 29.8%. The structure of consolidated budget expenditures changed insignificantly in comparison to the same period of 2011.

At end-June 2012 the total government debt decreased by GEL 275 million to GEL 7.9 billion, constituting 32.6% of the 2011 GDP, and thus being considerably lower than the critical level of

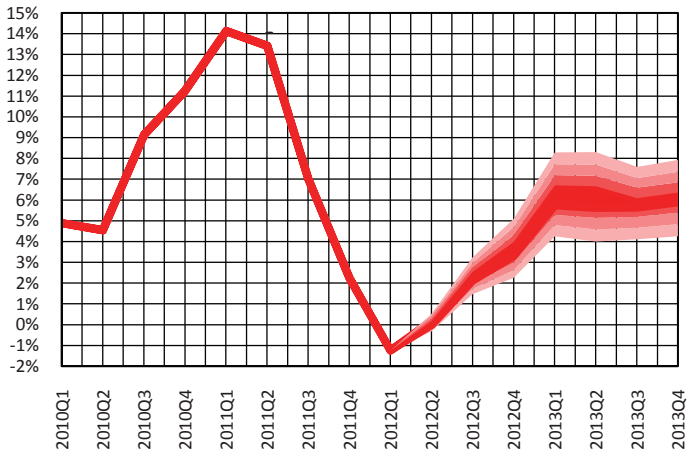
60% of GDP.It is projected that at end-2012 the government debt will further increase by GEL 530 million, and its share with respect to GDP will amount to 33.2%.

The stock of T-bills (including redemption) grew GEL 20 million in Q2 2012. In line with the schedule, the stock will further increase by GEL 58 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.

4. INFLATION FORECAST

In June 2012 the annual inflation amounted to -0.2%.Maintenance of lower-than-targeted inflation was largely due to the base effect. From June a pick-up in inflation started.The uptrend will be presentin the subsequent period as well, and in line with the NBG's forecast (based on the combination of three different models[10]), the inflation will converge to the targeted level of 6% by the end of Q4 2013 (See Diagram 4.1).

DIAGRAM 4.1
Annual Inflation Forecast



Source: NBG

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 6.8% in Q1 2012 and will be amount to 6-7% in 2012-2013;

• The nominal effective exchange rate will not change;

Indicators of economic activity point to high economic growth in the first half of 2012. The annual forecast of economic growth is also optimistic, implying an increase in medium-term inflation forecasts. These tendencies will be further enhanced by lower interest rates and expected growth of economy creditinginduced by loose monetary policy.

In a medium-term perspective, according to the existing forecasts the output will be close to its potential level, hence excluding significant supply-induced inflationary pressure. It should also be pointed out that international market developments are likely to influence the price level in Georgia. In particular, recent price increases for wheat and upward tendencies in fuel prices has a corresponding effect on the Georgian prices, affecting current inflation forecasts.

When 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.

[10] 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.

5. MONETARY POLICY DECISIONS

In Q2 2012 the NBG's Monetary Policy Committee convened for three meetings. At these meetings the NBG continued monetary policy loosening started in the preceding periods. At each meeting the MPC cut the policy rate by 25 basis points, eventually bringing it down to 5.75%.

It was mentioned at the MPC meetings that in Q1 2012 the economy expanded 6.8%. Based on the available economic indicators, rapid economic growth was likely to be sustained in Q2 as well. Despite high growth, the output gap remained close to zero, implying no demand pressure on prices.

In Q2 the inflation rate was negative, mainly owing to the base effect. The existing forecasts pointed to maintenance of low inflation throughout 2012 and growth of inflation to the targeted level in the beginning of 2013. At the MPC meeting in April it was noted that starting from early 2012 the banking system operated under excess liquidity conditions. As a result, short-term interbank interest rates declined deviating from the policy rate and leading to a reduction in longer-term interest rates as well. Such decreases in interest rates were tantamount to monetary policy loosening. Potential reduction in excess liquidity entails a rise in interbank interest rates. This was considered to be counterproductive, and the MPC decided to cut the policy rate in parallel to withdrawal of excess liquidity.

In the following months the downtrend in consumer prices accelerated, resulting in a drop in medium-term inflation target. The inflation forecasts available in May and June projected that inflation would start rising from June, although still remaining below target throughout 2012 and in early 2013. Thus, the MPC cut the policy rate down to 6% in May and to 5.75% in June.

The above-mentioned excess liquidity in the banking system amplified volatility of interbank interest rates. With the purpose of reducing interest rate volatility and enhancing efficiency of monetary policy the MPC decided to sell government bonds with the view to sterilize excess liquidity in the money market. By means of these operations the NBG withdrew GEL 128 million from circulation in May and June, which resulted in increased demand for refinancing instruments and hence improved efficiency of monetary policy.

3/5 Leonidze Str., Tbilisi 0105, Georgia
Tel: 240 64 88; Fax: 240 65 77; Hot line: 240 64 06
E-mail: Info@nbg.ge; www.nbg.ge