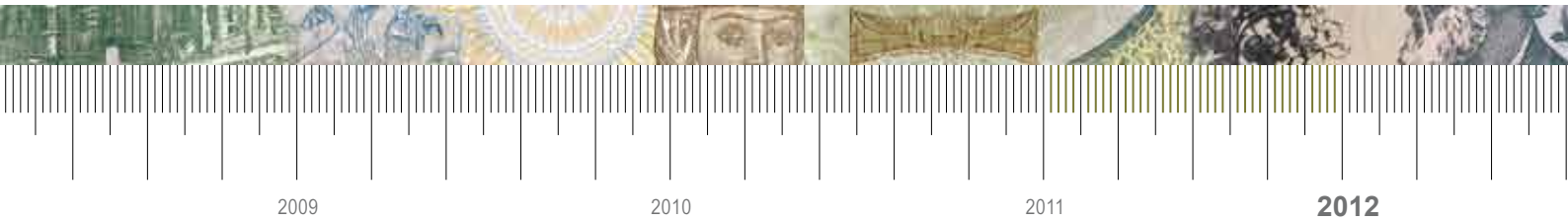
National Bank of Georgia

INFLATION REPORT

2012



NATIONAL BANK OF GEORGIA

INFLATION REPORT
Q3 2012

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1. INTRODUCTION

According to the National Statistics Office of Georgia (Geostat), in Q3 2012 the annual inflation amounted to -0.1%. The low inflation in Georgia is affected by low inflation rates in the neighboring countries. In the subsequent months a moderate growth in annual inflation is expected, although the latter is likely to remain at a low level in early 2013.

The annual inflation amounted to 1.4% for domestic goods and -1.3% for imported goods in September 2012. In Q3 prices rose at an annual 0.9% for non-tradable goods, while dropping 1.2% for tradable goods. It is remarkable that the core inflation (a change in consumer prices excluding food and fuel) was negative, equaling -1.3% at end-Q3. These changes clearly indicate that there is no demand pressure on prices.

The dynamics of main inflation factors can be described as follows. In Q2 2012 the real economy expanded 8.2%. In the recent period the economic growth was largely driven by service sectors, as well as manufacturing and construction. In 2012 the real growth rate is forecasted to equal 6.9%. Despite high growth, deviation of real output from its potential level is close to zero, implying no risks related to demand pressure on prices.

The unit labor costs grew at an annual 1% in Q2 2012, pointing to absence of supply pressure on prices.

In Q3 2012 the lari's real and nominal effective exchange rates depreciated 3% and 2.5%, respectively. In annual terms the real effective interest rate posted a 0.5% depreciation. In the recent years the lari's REER tended to appreciate at an annual 3%. Such dynamics of the real exchange rate does not create risks of economy overheating and, accordingly, of inflation.

In Q3 2012 the credit portfolio of commercial banks grew 3%, totaling GEL 8.7 billion. The credit activity of the banking sector continued to expand in 2012, albeit with a slowdown in growth rates from 28% in January to 16% in September. Recent monetary loosening policies already produced an effect on loan interest rates: compared to January 2012 the interest rate on domestic currency denominated loans fell by 1.7 pps, with an even bigger drop in interest rates (by 2.2 pps) registered for loans in foreign currency.

In September 2012 the deposit liabilities grew at annual 22.4%, amounting to GEL 7.5 billion. It should be noted that between August and September the volume of deposits decreased 4%, partly reflecting the existing uncertainties about the future. The deposit dollarization remained high at 63.8% in September. Despite a 1 pp increase in quarterly terms, the dollarization rate declined by 0.4 pps compared to September 2011.

Taking into account inflation forecasts and considering factors affecting the country's aggregate demand, the Monetary Policy Committee stopped monetary policy loosening in July 2012, as the discontinuation of the base effect would lead to a moderate growth in inflation. Accordingly, in July-September 2012 the refinancing rate stood at 5.75%.

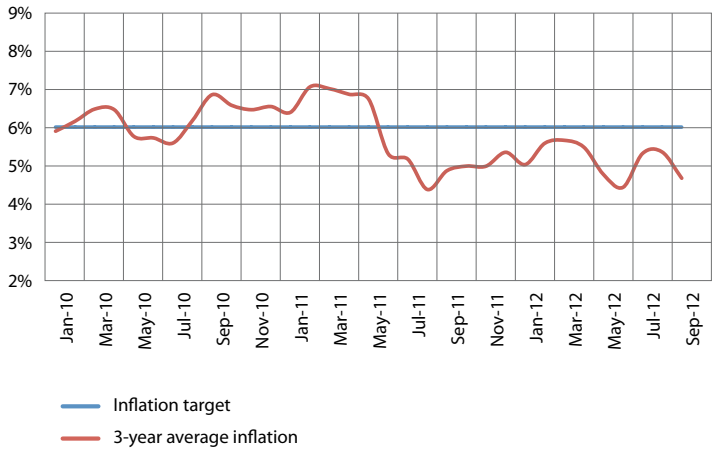
In line with the NBG's forecasts, it is expected that the inflation rate will tend to rise in 2013. The existing forecasts suggest that the inflation will converge to the targeted level (6%) in the second half of 2013.

2. CHANGES IN CONSUMER PRICES

DIAGRAM 2.1
Annual and Core Inflation

Source: Geostat

DIAGRAM 2.2
Inflation Target and 3-Year Average Inflation



Source: Geostat

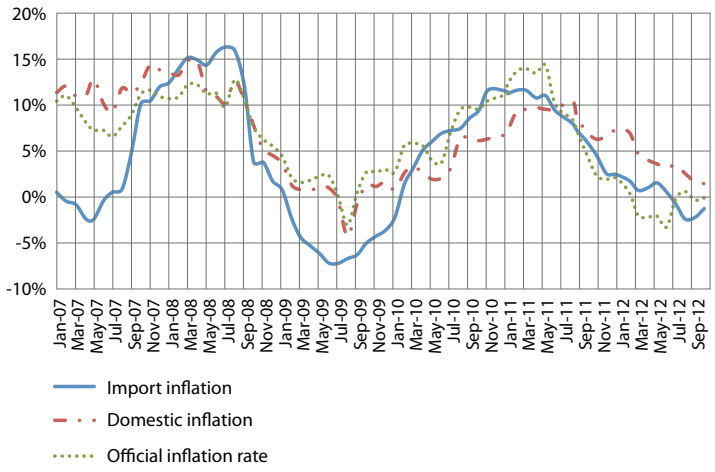
According to the National Statistics Office of Georgia (Geostat), the downtrend in the general level of consumer prices was reversed in Q3 2012. In this period the consumer price index rose 0.1% in monthly terms. As a result, the annual change in the general level of consumer prices moved up from -0.2% in September to 0.1% in October(See Diagram 2.1). Like in the preceding periods, these deflationary processes indicate weak demand pressure on prices in the economy. The NBG's targeted level of medium-term inflation stands at 6% for 2012-2014. Accordingly, it is important to observe the dynamics of a 3-year average of annual inflation rates. This indicator also reveals a decreasing trend. In 2010-2011 it oscillated around the 6% level, while recording a decline from the second half of 2011 (See Diagram 2.2).

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. Turkey, Germany, Azerbaijan, China, Ukraine, Russia, and Armenia accounted for almost 80% 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-September. The only exception was Turkey where the inflation rate remained high, albeit still recording a certain slowdown in price growth in the recent period.

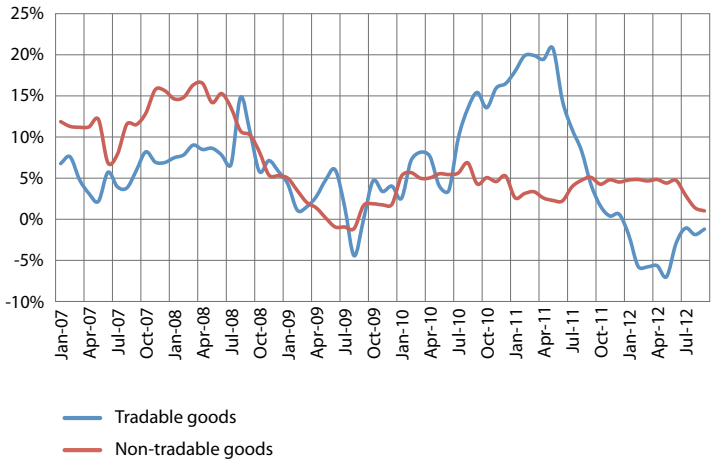
Owing to the price changes in the international markets, the growth rates of prices for imported goods started to slow down from June 2011, resulting in deflation for these products by end-Q2 2012. This tendency was sustained in Q3, as the deflation rate increased further. By end-September the general level of prices for imported goods declined 1.3% (See Diagram 2.3). The inflation rate equaled -1.2% for tradable goods and 0.9% for non-tradable goods (See Diagram 2.4).

DIAGRAM 2.3
Annual inflation by production location



Source: Geostat, NBG calculations

DIAGRAM 2.4
Price indexes for tradable and non-tradable goods



Source: Geostat, NBG calculations

3. Inflation Factors

3.1 LABOR MARKET

In the last four quarters the growth rate of labor productivity has been permanently increasing. In Q2 2012 the labor productivity of employed in the economy rose 5.6% in annual terms, reaching a 1.5-year high.

In Q2 the growth of labor productivity was largely fueled by the service sectors, whereas in the preceding two quarters it was mainly driven by the industry. The labor productivity in agriculture tended to decline in the first half of 2012.

TABLE 3.1
Growth of Real Value-Added Per Employed in Q2 2012, year-on-year

	Value-Added Index
Agriculture and Processing of Agricultural Products by Households	97.1
Industry	104.0
Services	106.0
Total	**105.5**

Source: Geostat

It should be noted that in the last two years high sustainable annual growth exceeding 20% was registered in the financial intermediation.

From early 2012 the growth rate of wages of hired employees slowed down, averaging 6.5% year-on-year in Q2 2012. The latest Geostat figures show that the average monthly wages of hired employees in the economy equaled GEL 724.

The sectoral analysis reveals that annual increases in wages were shown in the manufacturing, construction, "transport and communication", "real estate", and healthcare. The trade and "hotel and restaurants" displayed annual declines in wages in the first half of 2012.

TABLE 3.2
Growth of Average Monthly Nominal Wages of Hired Employees in Q2 2012, year-on-year

	Nominal Wage Index
Agriculture, hunting and forestry	175.2
Fishing, fishery	87.4
Mining and quarrying	103.3
Manufacturing	109.8
Production and distribution of electricity, gas, and water	103.7
Construction	125.4
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	96.9
Hotels and restaurants	89.9
Transport and communication	110.7
Financial intermediation	96.8
Real estate, renting and business activities	112.2
Public administration	98.1
Education	109.2
Health and social work services	119.9
Other community, social and personal service activities	113.3
Total	**106.5**

Source: Geostat

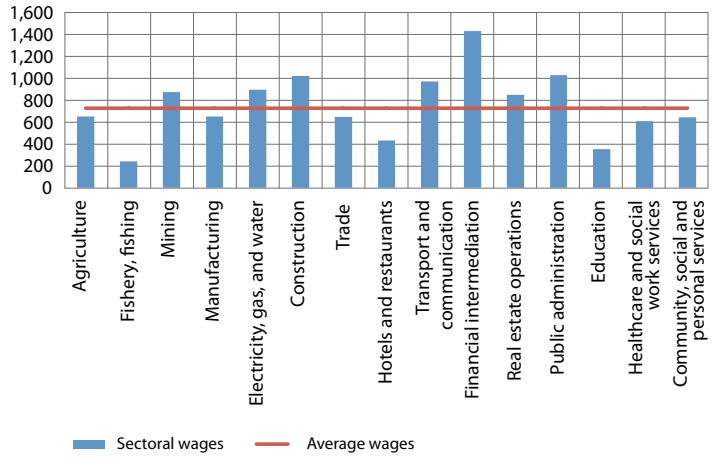
The disparity in absolute wage levels across economic sectors still remained significant. The highest average monthly wages were anew registered in the "financial intermediation" (GEL 1,428). Meanwhile, the average wages in the traditionally low-paid education and fishing sectors accounted for less than a half of the national average level (GEL 724).

Overall, the annual growth rate of average wages of hired employees in the economy considerably decelerated in Q1 2012. In the same period, as it was shown, the growth rate of labor productivity was increasing. This resulted in a slowdown in growth of unit labor costs[1] in the first half of 2012. In Q2 2012 the annual growth of unit labor costs amounted to only 0.9%.

With regard to the largest economic sectors, the unit labor costs declined 6% on average in the trade and public administration, while averaging a 10% growth in the industry and "transport and communication".

Overall, the existing data showed that the impact of labor as a factor of production on prices was decreasing in the last quarters. In Q2 2012 the labor market only marginally affected the general level of prices.

DIAGRAM 3.1
Average Sectoral Wages of Hired Employees, Q2 2012 (GEL)



Source: Geostat

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

Source: Geostat

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

BOX 1 COMMERCIAL BANK CERTIFICATES OF DEPOSITS (CBCDS)

In May 2012 the Decree of the President of the NBG approved the "Regulation on Standard Commercial Bank Certificates of Deposits", regulating issues related to issuance, registration, circulation, and repayment of CBCDs.

Various countries such as the United States, Italy, Columbia, Jamaica, etc. have been using commercial bank CBCDs for a long time. The CBCD is a type of a bank deposit. Its peculiarity consists in the fact that in case of pre-scheduled termination of a deposit agreement the bank is not obliged to redeem the CBCD and the latter remains effective until maturity. In addition, unlike ordinary deposits, a standard CBCD can be used as an asset for securing another liability.

In this regard, one of the primary goals for introducing CBCDs is to increase average maturity of deposits. Obviously this will improve general financial stability of the banking system. Besides, this measure should promote development of the secondary market for securities.

The Decree stipulates that any transaction related to standard CBCDs should be performed in lari, through non-cash settlement. A standard CBCD should not be pegged to any foreign currency. These requirements should enhance the larization process.

One of the CBCD's features that will evoke particular interest from banks is that received interest is not taxed. Besides, the NBG's reserve requirements are lower for funds attracted through CBCDs than for regular deposits. Also, in calculating the liquidity ratio the liquidity requirement will not apply to CBCDs with less than 6 months of remaining maturity. Finally, for the purposes of reporting the liquidity coverage ratio, CBCDs have a preferential approach

The maturity of standard CBDSs is 3, 6, 8, 12, and 24 months, which facilitates inter-bank comparison for buyers and makes the secondary market more liquid.

Attractiveness of CBCDs for buyers is also ensured by the fact that the secondary trade is tax-exempt. In addition, one of the NBG's requirements to commercial banks with regard to issuance of CBCDs is utmost transparency, which will improve clients' awareness and simplify the decision-making process.

For effective use of this instrument, it is crucial that banks create necessary infrastructure for issuance, recording and accounting of CBCDs, ensure their circulation in the secondary market and communicate the news to wide circles of population.

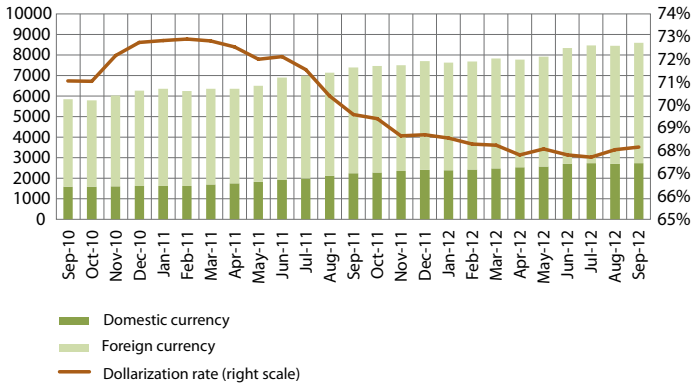
3.2 BANKING SECTOR

The credit activity of the banking sector continued to expand in 2012, although the annual growth rate slowed down to 16% in September from 28% in January. The deceleration of loan growth was present for individuals as well as for the legal entities: the growth rate of loans to individuals amounted to 41.2% in January and to 21.6% in September. Similarly, in the same period the growth rate of loans to legal entities declined by 8 pps. However, it should be noted that the Q3 slowdown in loan growth rates was related to slackened demand in the pre-election period. Taking into account large amount of banking liquidity, an increase in credit activities is expected in the subsequent months. It should also be noted that a reduction in credit activity, on the one hand, decreases inflationary risks, but increases deflationary risks, on the other.

The downtrend in the loan dollarization rate (accounting for exchange rate effect) discontinued in Q3 (See Diagram 3.3). The average dollarization rate rose by 0.3 pps in August-September, relative to June-July, being partly a result of unclear expectations. However, the average annual dollarization rate fell by 1.4 pps, amounting to 68.2% in September. On the one hand, this pointed to increase confidence of commercial banks towards the domestic currency, while also being the result of the NBG's extensive use of monetary instruments, on the other.

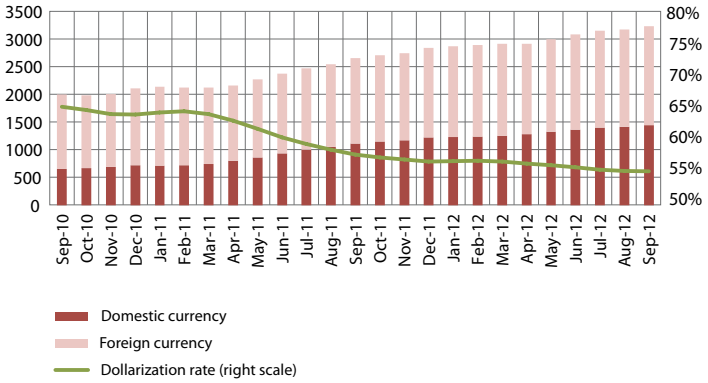
A reduction in loan dollarization is particularly evident in the case of loans to individuals, as the respective dollarization rate fell by 2.6 pps from September 2011 to September 2012 (See Diagram 3.4). The larization (dedollarization) of long-term loans also rose by 2 pps in the same period. This fact enhances efficiency of monetary policy transmission mechanism See Diagram 3.5).

DIAGRAM 3.3
Extended Loans (GEL millions) and Dollarization



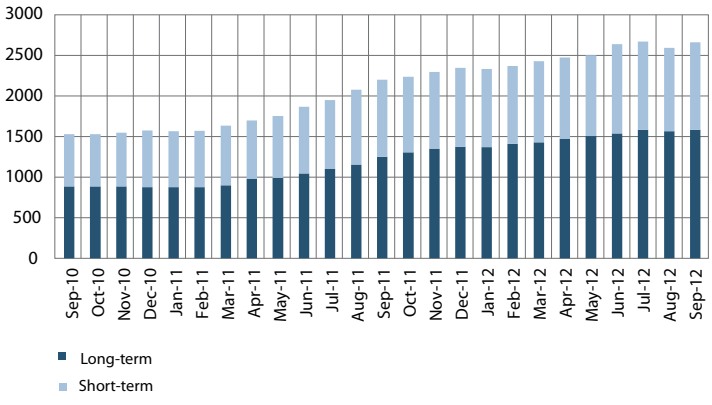
Source: NBG

DIAGRAM 3.4
Loans to Individuals (GEL millions) and Dollarization



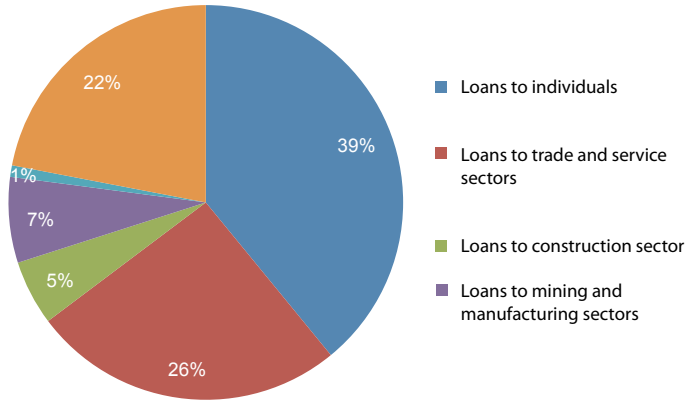
Source: NBG

DIAGRAM 3.5
Time Loans in Domestic Currency, GEL millions



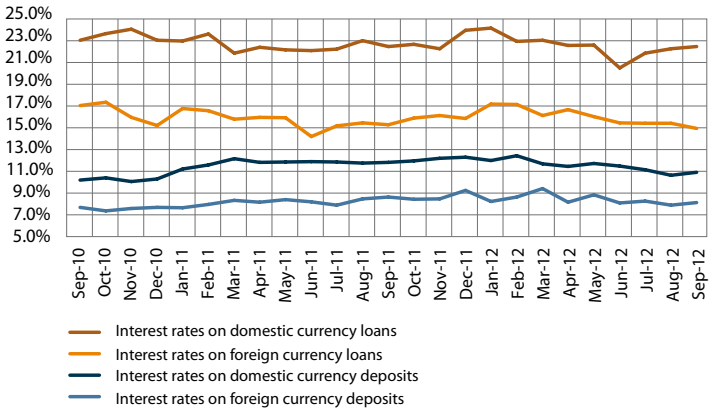
Source: NBG

DIAGRAM 3.6
Structure of Loans



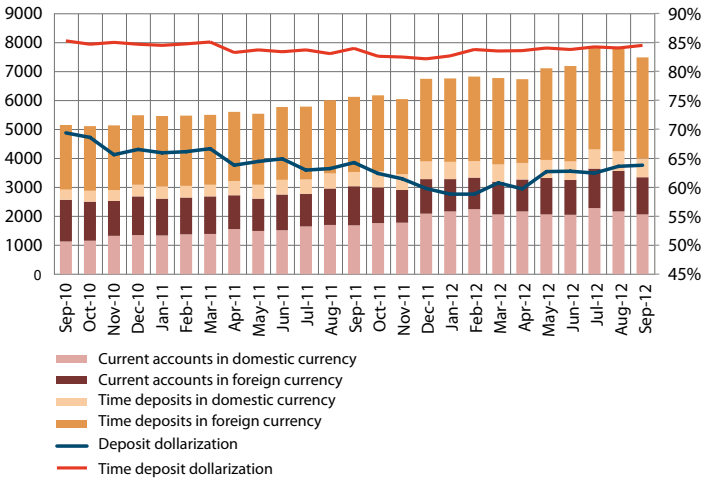
Source: NBG

DIAGRAM 3.7
Market Interest Rates on Loans and Deposits by Currencies



Source: NBG

DIAGRAM 3.8
Deposits, GEL millions



Source: NBG

In Q3 the structure of loans did not change, with business loans still accounting for approximately 60% of total loans (See Diagram 3.6). Three large sectors in turn are important for the business loans: trade and services (26%), mining and manufacturing (7%) and construction (5%). The loans to individuals account for 39%, while the loans to government do not exceed 1%.

The loan interest rates remained largely unchanged in Q3 (See Diagram 3.7). It should be noted that in September 2012 the interest rates on domestic currency denominated loans fell by 1.7 pps with respect to January 2012, while decreasing more significantly (by 2.2 pps) for foreign currency loans in the same period. The latter fact to a certain extent hindered the larization process.

In September the annual growth of deposit liabilities equaled 22.4%, as the volume of deposits reached GEL 7.5 billion (See Diagram 3.7). However, it is important to note that the deposits dropped 4% during August-September. The reduction in deposits was partly caused by the existing uncertainties with respect to future period.

In order to attain monetary policy objectives, it is crucial that financial intermediation be performed largely with funds attracted in domestic currency. As of September 2012, the dollarization rate of deposit liabilities still remains high at 63.8%. Despite a 1 pp quarter-on-quarter increase, the annual deposit dollarization fell by 0.4 pps in September. The rise in deposit dollarization was caused to a certain extent by issuance of USD 250 million worth of eurobonds by the Georgian Railway, affecting the growth of deposit certificates in foreign currency. Traditionally, the dollarization of time deposits remains high at 84.2%, with the primary reason still consisting in

low population's trust in the domestic currency. The interest rate on domestic currency deposits fell by 1.1 pps, while remaining unchanged for foreign currency deposits. The latter fact also hindered the deposit larization.

The banking sector remained profitable, with the net profit totaling GEL 138.62012 million, as of September 2012. The ROA was 1.4%, while the ROE equaled 8.1%, down by 7.7 pps in annual terms. The Tier 1 capital adequacy ratio stood at 13.1%, and the regulatory capital adequacy ratio posted an annual increase of 0.6 pp, reaching 16.8%. The average liquidity ratio did not change considerably in the reporting month, although rising by 5.2 pps in annual terms to 39.9%.

The share of non-performing loans in total loans (accounting for the exchange rate effect) remained unchanged at 7.8%. It should be noted that the share of NPLs increased by 0.9 pps for domestic currency loans, while dropping by 0.4 pps for foreign currency loans to 8%.

BOX 2 THE LAW OF GEORGIA ON PAYMENT SYSTEM AND PAYMENT SERVICES

The payment and settlement systems play an important role in ensuring stability and efficiency of the financial sector and the country's economy in general. The payment system represents the means for transfer of monetary funds. A risk-free effective payment system is decisive in ensuring effective functioning of the financial system.

The Law aims at ensuring stability of the Georgian financial sector and risk-free, sustainable and effective functioning of its payment system.

The Law empowers the NBG to register and supervise providers of payment services and payment system operators, define a payment system and a payment service provider of systemic importance and impose additional requirements on those. The Law envisages a comprehensive and flexible legal base for agreements involving financial collateral.

The Law also provides for expanding the supervision function of the NBG in terms of payment services as well. These supervisory powers are related to issuance of modern payment instruments (such as e-money) as well as to payment services for consumers. The Law defines and lists the types of payment services.

The Law envisages introduction of new terms and explanation of certain terms used in the Georgian legislation with respect to payment systems and payment services. This, on the one hand, will streamline the terminology of payment legislation, while helping to avoid different interpretation of the existing terms, on the other. The list includes such terms as settlement, payment, clearing, financial instrument, payment system, electronic money, payment system operation, payment service provider, etc.

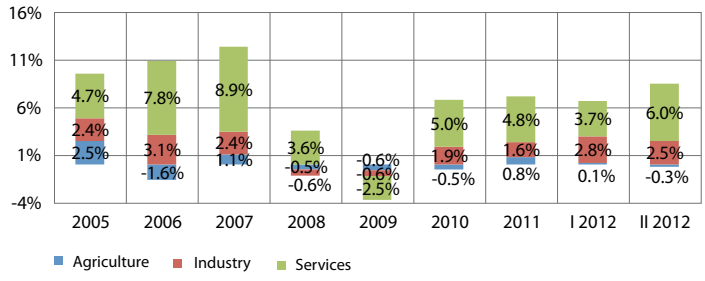
Popularization of electronic money is crucial for trade development. The e-money represents a convenient means for transactions. A customer does not need to go to a bank and wait in a queue, being able to make a transaction through a personal computer at home. The transaction time also decreases. In addition, e-money allows small businesses to access global markets.

3.3 PRODUCTION AND DEMAND

In Q2 2012 the real economic growth equaled 8.2% in annual terms, reaching the regional high level. In the same period the GDP deflator grew 0.5% year-on-year.

The quarterly growth of real GDP was fueled by the service sector, contributing 6 pps to the overall 8.2% expansion. The largest impact on service growth was in turn produced by trade, which grew 11.6%. The largest impact of the service sector (and trade, in particular) on the economic growth was evident in the whole post-crisis period.

DIAGRAM 3.9
Value-Added Growth in the Largest Sectors (2006 – Q2 2012)



Source: Geostat, NBG

DIAGRAM 3.10
Real Growth of the Largest Economic Sectors, 2007 – Q2 2012

Source: Geostat, NBG

The real growth of industry equaled 15.5%. Despite such impressive growth, the contribution of the industry to the GDP growth (2.5 pps) was relatively lower than that of services. High growth rates in manufacturing and construction need to be pointed out, equaling 20.9% and 19.4%, respectively.

In Q2 the value-added in agriculture (accounting for 10% of the GDP) contracted 2.4% in annual terms. It should be noted that after an 8% growth in 2011, the agriculture shrank again.

Sectoral analysis of the economy shows that in Q2 2012 the real value-added grew in every large sector, except agriculture. However, in the recent years the largest sectors displayed different trends of real value-added growth. In the long-term the most important contributions were produced by the trade and tourism[2] among the service sectors and by the manufacturing and construction among the industry sectors. These sectors manifested a relatively stable real growth from early 2010 which was sustained in Q2 2012.

The sectoral analysis of seasonally adjusted data shows that the financial intermediation of the service sector and the manufacturing of the industry sector produced strong positive contributions to economic growth in the last two-year period.

[2] The System of National Accounts does not differentiate a tourism sector separately. The estimation of the latter involves summing of real value-added produced in tourism-related sectors, such as hotels and restaurants, activities of travel bureaus and tourism agencies, etc.

3.3.1. AGGREGATE DOMESTIC DEMAND

As it was noted, in Q2 2012 the real GDP grew 8.2% year-on-year, while the nominal growth amounted to 8.8%.

Similar to Q1, the GDP growth was powered by an increase in capital expenditures. It is expected that the investment growth will promote long-term growth.

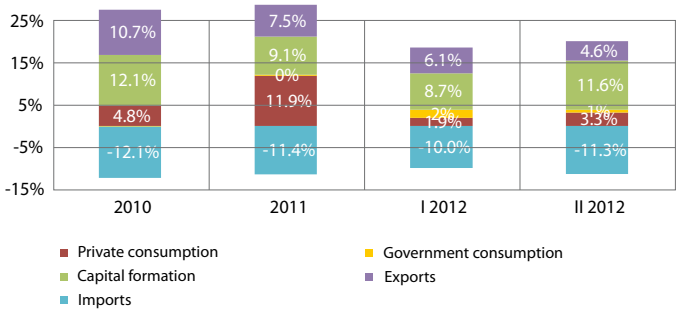
The growth rate of capital formation accelerated from the beginning of 2012, amounting to an annual 51.5% in Q2 2012. Such expansion largely represented the result of increasing investment in fixed capital. The private investments accounted for the biggest part thereof.

The capital growth occurred mainly at the expense of an increase in national savings, while the contribution of foreign capital inflows was relatively low. The saving rate with respect to GDP stood at 16.8% in Q2 2012, up from 10.6% a year before. It should be noted that in the post-crisis period both the investments and national savings displayed a pronounced uptrend.

The annual growth rate of private consumption increased in Q2 2012, equaling 4.3%. It should be noted that in the first half of 2012 the share of private consumption in the GDP was lower than in the previous years, which resulted from a deceleration in consumption growth rates. No considerable growth of private consumption is either expected in the second half of the year.

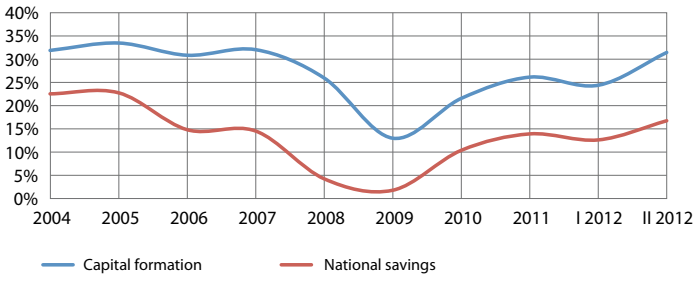
In the first half of 2012 the total (private and government) real expenditures on final consumption grew 5.4% in annual terms. Relatively slower growth of final consumption compared to the overall real GDP growth (7.4%) shows that, similar to the preceding year, the inflationary pressure of private consumption in 2012 still remains insignificant.

DIAGRAM 3.11
Contributions of GDP Categories of Use to Overall GDP Growth, 2010 – Q2 2012



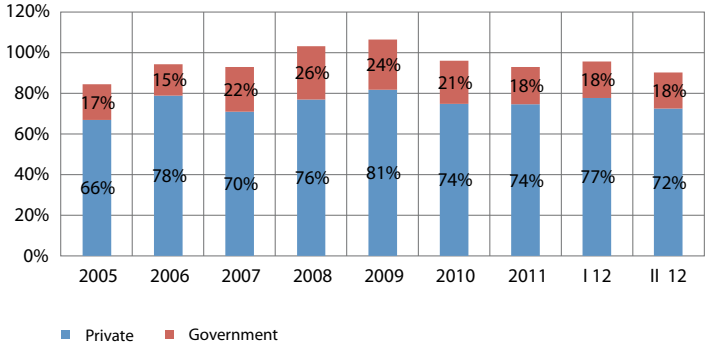
Source: NBG

DIAGRAM 3.12
National Savings and Investments, 2003 – Q2 2012 (with respect to GDP)



Source: Geostat, NBG

DIAGRAM 3.13
Final Consumption, 2003 – Q2 2012 (with respect to GDP)



Source: Geostat

3.3.2. GDP FORECAST

The Q2 GDP forecast published in the previous report slightly different (lower by 0.2 pps) from the actual figure.

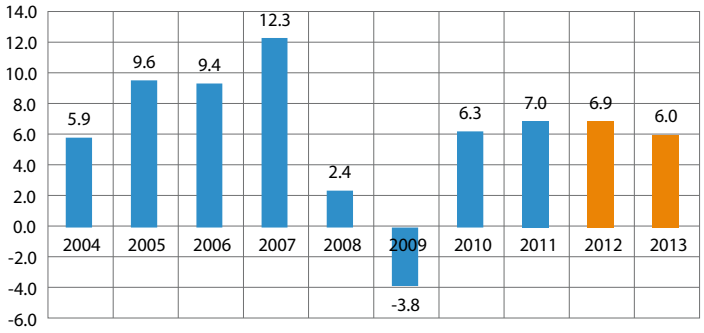
In Q3 2012 an important indication for GDP estimations was a 15% annual increase in VAT taxpayers' turnover (accounting for more than 80% of total turnover in the economy). Under practically constant prices, such turnover growth is quite high, but the expectations of high growth were to a certain extent mitigated by a decline in the share of non-observed economy. Also taking into account sectoral forecasts, the Q3 economic growth was projected at 7.4% in real terms and 8.2% in nominal terms.

The economic growth will continue to be driven by the services and industry, with the growth rate of industries still remaining higher (approximately 12%) than that of services (approximately 7%). The agriculture is expected to contract again.

With respect to projections of value-added in individual sectors, the industry is forecasted to expand at the expense of manufacturing and construction, while the service sector growth will be driven by trade and transport.

Overall, the 2012 real economic growth is forecasted to equal 6.9%. The growth contributions equal 4.5 pps for services and 2.5 pps for industry. At the same time, the annual contraction of agriculture is projected. In sectoral terms, similar to Q3, the main driving forces of the economic growth will represent the manufacturing, construction, trade, and transport sectors.

DIAGRAM 3.14
Real GDP Growth in Georgia, 2003-2012[3] (%)



Source: Geostat, NBG calculations

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

BOX 3 ESTIMATION OF CAPACITY UTILIZATION AND POTENTIAL OUTPUT FOR THE GEORGIAN ECONOMY

Capacity Utilization represents an important factor for estimating the current economic activity. Total output exceeding the potential level creates inflationary pressure. Short-term shocks, peculiar to the business cycles, are well explained by estimations of capacity utilization. However, it is necessary to determine a difference between utilization of industrial capital and utilization of economic capital. The former estimates potential output feasible at full employment. Utilization of economic capital/capacity utilization has no assumption about full employment and represents a variable which is extremely important for economic analysis, as it measures output which is desirable for the current level of capital, i.e. output with desirable results under minimization of costs[4].

For this purpose a capacity utilization model was used, simultaneously measuring potential output. The model is based on the identity $Y(t) = \frac{Y}{Y^*} * \frac{Y^*}{K} * K$ and estimating equation $\log u(t) = e_u(t)$[5] $\log v(t) = b_0 + b_1 t + b_2 \log K(t) + e_v(t)$; where $Y(t)$ is output in period t, $K(t)$ is capital stock in period t $v = \frac{K}{Y^*}$, $u = \frac{Y}{Y^*}$ while $e_v(t)$ and $e_u(t)$ are random errors.

By transformation we obtain a model having a cointegrating relationship between output and capital stock.

$$\log Y(t) = a_0 + a_1 t + a_2 \log K(t) + e(t) \quad (4)$$

where $a_0 = -b_0$, $a_1 = -b_1$, $a_2 = 1 - b_2$, and $e(t) = e_u(t) - e_v(t)$ is a standard error. The model assumes that in the long-run utilization of economic capacity reaches 100% and output approaches its potential level (Y=Y*). It is precisely this assumption which makes it possible to estimate potential output and capacity utilization for each t period.

In turn, the capital stock is described by the following dynamic equation: $K_{t+1} = K_t(1 - \delta) + I_t$

where δ is the depreciation rate, and I_t are investments in period t. The baseline level of K_0 is taken for 1996.[6]

Capital estimation was made. It was found that time-series for capital stock and output are I(1) cointegrated. The cointegrating vector for output and capital was estimated using 3 exogenous variables (ROE in the banking sector, quarterly inflation, and a dummy variable for the 2008 war and financial crisis).

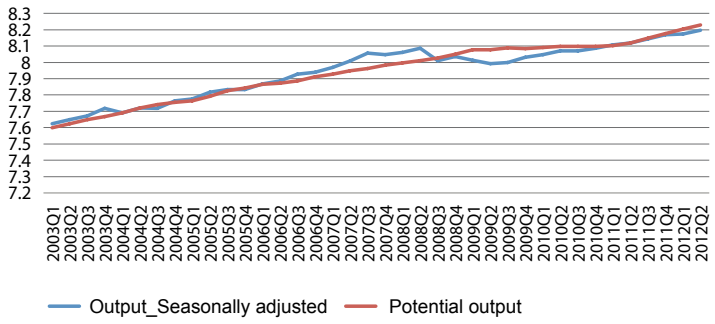
Diagram 3.15 shows actual and potential output. A significant deviation of actual output from the potential output starts in 2006. In this period capacity utilization exceeds the potential level. The 2008 Russian aggression and financial crisis reduced utilization of industrial capacity which fell below the natural level until 2010.

[4] A, M Shaikh, J, K Moudud, "Measuring Capacity Utilization in OECD Countries: A Cointegration Method" The Levy Economics Institute of Bard College, Working paper No. 415 (November 2004)

[5] In the long run, utilization u=Y/Y^* oscillates around the desired level (u^*=1).

[6] K_0 is calculated from the share of capital rent, α and r are calibrated: α=0,3; r=20%, while δ=5%.

DIAGRAM 3.15
Actual and Potential Output

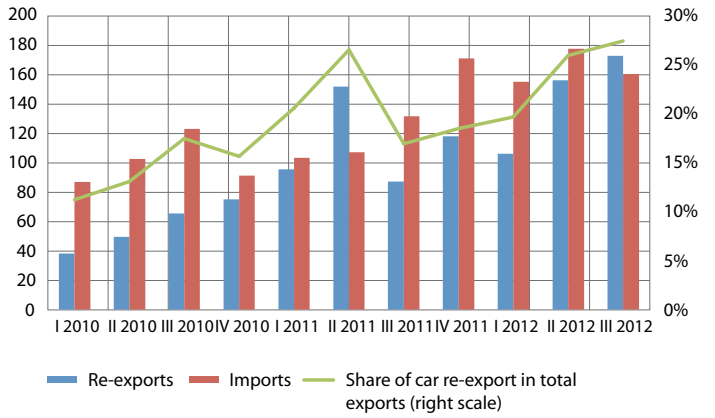


Source: NBG

DIAGRAM 3.16
Registered Exports, Imports, and Trade Deficit, 2009-2012 (GEL millions)

Source: Geostat

DIAGRAM 3.17
Imports and re-exports of cars



Source: Geostat

The level of utilization of economic capital is a significant indicator for estimatng the current economic activity and potential output. In assessing potential output different statistical methods are used, which, through trend identification, ensure data filtering in a relatively simple manner; however, methods based on structural models provide more ample opportunities for economic analysis and forecasting.

3.4 EXTERNAL TRADE AND BALANCE OF PAYMENT

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 balance of goods trade represents a significant negative component of the trade balance. The data for 9 months of 2012 shows that the (See Diagram 3.16). In the meanwhile, an uptrend is manifested for the balance of services, which has a positive contribution to the trade balance, albeit at a smaller scale compared to goods trade.

High growth rates of registered[7] exports of goods (even in comparison to registered imports) which were recorded in the previous year discontinued in 2012. However, the growth rates of registered imports also decelerated. Accordingly, the rate of trade deficit deterioration declined.

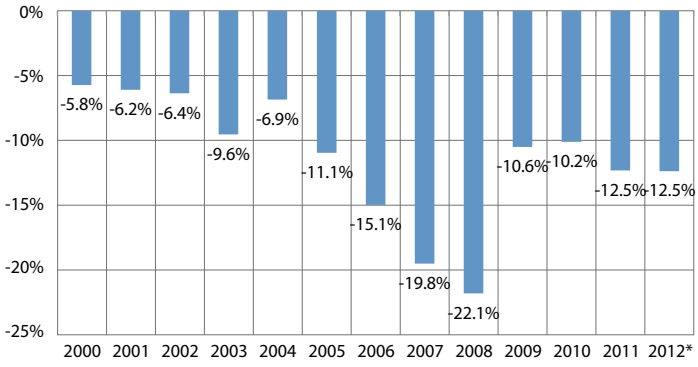
[7] The statistics of goods trade mainly relies on the principle of border crossing, while compilation of the goods trade component of the balance of payments is based on the transfer of ownership rights between residents and non-residents. There are also some other methodological differences between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

In the 9 months of 2012 the exports of goods by end-use categories was distributed as follows: investment goods – 6.7%; intermediate consumption goods – 46.2%; and final consumption goods – 46.4%. In comparison to the same period of 2011 the share of investment goods is significantly increased. The export growth of consumer goods was largely contributed by export of spirituous beverages. The re-export of medicaments and motor cars was also important. The latter, being the primary determinant of export growth, remains in the top of the export item list since 2011 and displays high growth rates (See Diagram 3.17). In the first 9 months of 2012 the motor car re-export accounted for 88.2% of imported cars. Unlike exports of investment and consumer goods, the share of intermediate consumption goods in total exports decreased.

The registered imports of goods comprised 16.4% of investment goods, 41.3% of intermediate consumption goods, and 41.8% of consumer goods. The petroleum products (largely motor car fuel) and motor cars, occupying, respectively, the first and the second position in the import list, are classified as consumer goods. The annual growth rate of petroleum product import equaled 8.6%, mainly due to the volume effect[8]. The annual growth rate of motor car imports grew significantly, although, as mentioned above, the largest part of imported cars goes to neighboring countries in the form of re-exports. The import of petroleum gases, making part to the intermediate consumption goods, declined in annual terms. Despite positive growth in the 9 months of 2012, the share of food imports shrank, constituting 15.6%. The expenditures on food imports rose only 5.0% per annum, with wheat expenditures being the largest. The latter rose approximately 19% year-on-year. Other significant shares in the list of food imports were held by meat products, sugar and confectionery.

The balance of goods trade clearly predetermines the current account balance. Widening of the current account deficit started in Q2 2010 continued in 2011. The same tendency was registered in the 9 months of 2012 as well, with no reversal forecasted until end-2012. In 2011 the current account deficit constituted 12.5% of GDP. The NBG's projections give an analogous figure for 2012 (See Diagram 3.18).

DIAGRAM 3.18
Current Account Deficit, % of GDP

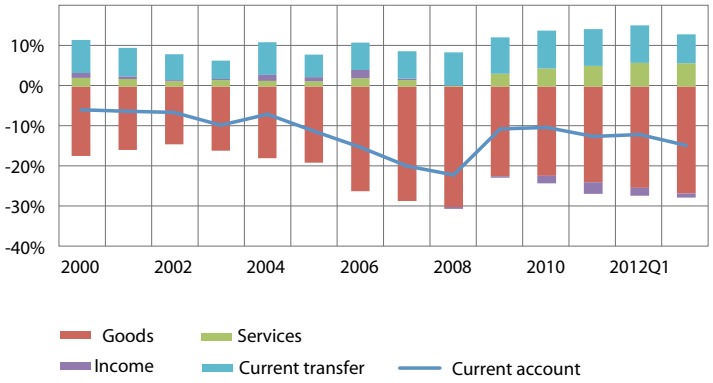


* NBG forecast

Source: Geostat

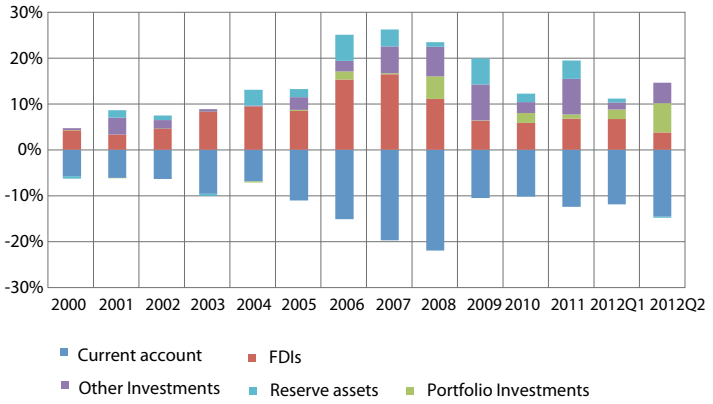
[8] According to the IMF forecast, oil price risks are mitigated for 2012, with oil prices projected to remain stable in near future. World Economic Outlook Update, October, 2012, International Monetary Fund

DIAGRAM 3.19
Current Account, 2000 – Q2 2012 (% of GDP)



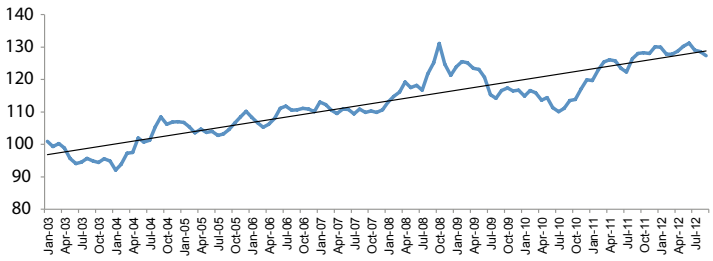
Source: NBG

DIAGRAM 3.20
Financing of Current Account Deficit, 2000 – Q2 2012 (% of GDP)



Source: NBG

DIAGRAM 3.21
REER Index



Source: NBG

As mentioned above, the balance of services is positive, partly ofsetting the defitic of goods trade and thus, improving the current account deficit (See Diagram 3.19). A remarkable increase in tourism revenues needs to be pointed out. Similar to 2010-2011, in the first half of 2012 the growth rates of tourism export reached 50%. The revenue growth for transport services is also important for the balance of services.

Historically positive balance of income grew negative in 2008 (See Diagram 3.19). This is explained by a sharp increase in foreign investments in the preceding years. Along with an increase in foreign liabilities, the capital services expenses grew as well.

Current transfers comprising budget grants and money remittances to other sectors also produce a positive contribution to the current account (See Diagram 3.19). High growth was recorded for labor remittances, representing an important part of total transfers.

In addition to full financing of the current account deficit, largely at the expense of long-term capital (namely FDI), the stock of reserve assets is growing. It should be noted that in the first half of 2012 portfolio investments became significant, clearly conditioned by the issuance of eurobonds in the amount of USD 250 million (See Diagram 3.20).

An important indicator of competitiveness is a change in the real effective excxhange rate. In September the REER depreciated at an annual 0.5%. It should be noted that in the recent years the real exchange rate tends to appreciate at 3% per annum. At present the deviation of the real exchange rate from the trend is close to zero, pointing to the lack of risks related to economy overheating and inflationary pressure.

3.5 GOVERNMENT OPERATIONS

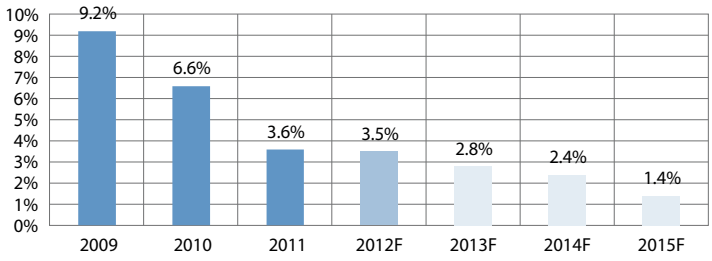
The trade balance (trade in goods and services) of the balance-of-payments of Georgia remains negative, producing a negative impact on the GDP growth. The balance of goods trade represents a significant negative component of the trade balance. The data for 9 months of 2012 shows that the (See Diagram 3.16). In the meanwhile, an uptrend is manifested for the balance of services, which has a positive contribution to the trade balance, albeit at a smaller scale compared to goods trade.

High growth rates of registered[7] exports of goods (even in comparison to registered imports) which were recorded in the previous year discontinued in 2012. However, the growth rates of registered imports also decelerated. Accordingly, the rate of trade deficit deterioration declined.

In line with the 2012 budget plan, the consolidated budget deficit totals GEL 943 million. In the 9 months of 2012 the budget deficit equaled GEL 315 million. The remaining portion is mainly aimed at financing capital expenses (infrastructure projects).

In the recent period the budget structure saw a considerable increase in social and wage expenditures; however, the share of these expenditures is not high, amounting to approximately 38% in the 2012 budget plan. A large share of capital expenses should also be noted, oscillating between 20-25% in the recent period. Such structure of expenditures, on the one hand, makes fiscal policies more flexible for neutralizing different types of shocks, while also promoting economic growth, on the other.

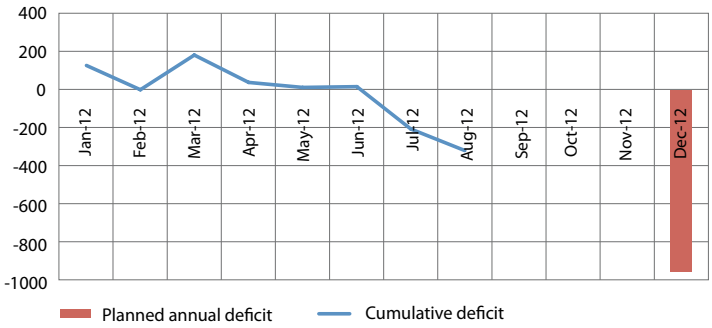
DIAGRAM 3.22
Ratio of Consolidated Budget Deficit to GDP, 2009-2015



F -forecast

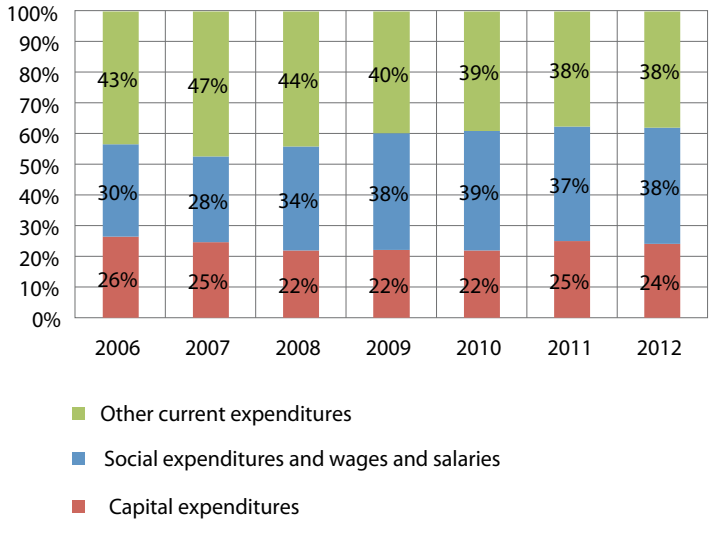
Source: Ministry of Finance

DIAGRAM 3.23
2012 Consolidated Budget Deficit (GEL millions)



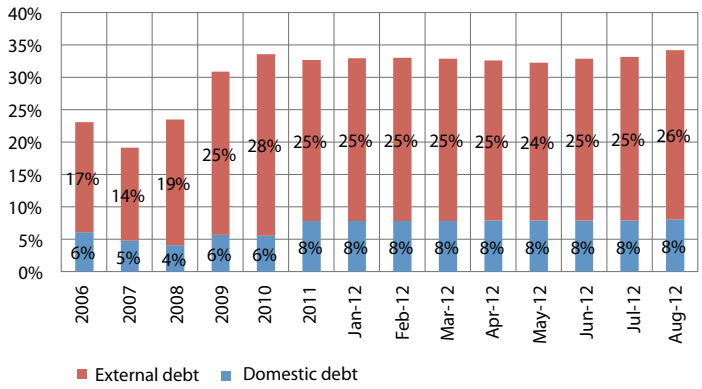
Source: Ministry of Finance

DIAGRAM 3.24
Structure of Consolidated Budget Expenditures, 2006-2012



Source: Ministry of Finance

DIAGRAM 3.25
Ratio of Government Debt to GDP, 2006 - 2012



Source: Ministry of Finance

Expansionary fiscal policies conducted after 2008 with the view to offset the consequences of the global financial crisis led to a considerable accumulation of government debt; however, the existing level of debt with respect to the economy size is quite low, not creating debt sustainability issues. It should also be taken into account that a large part of debt represents concessional loans from the World Bank and other international financial institutions with low interest risk. Overall, the size and structure of government debt currently do not contain risks capable of jeopardizing the fiscal stance.

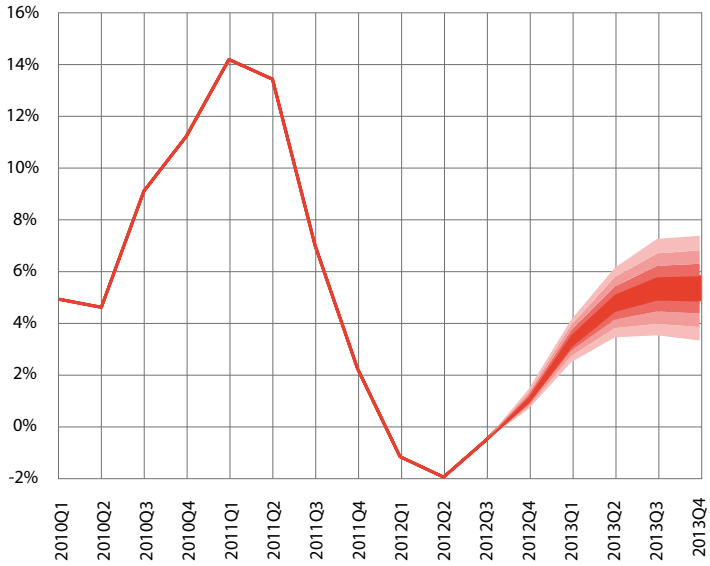
4. Inflation Forecast

In Q3 2012 the annual inflation stood at 0.03%, while equaling -0.1% at end-September. The low level of actual inflation compared to inflation forecasts was due to lower-than-forecasted oil prices, the latter factor being one of the causes of low inflation in the neighboring countries as well; the assumption on real economic growth was less optimistic; slack banking activity due to pre-election uncertainties also represented a cause of low inflation; at the same time, expansionary monetary policy helped to reduce deflationary pressure, although its effect was limited. In Q3 imported goods making part to the consumer basket registered significant price decreases; however, it should be noted that the deflation sharply declined in September compared to August. According to the NBG's forecasts, the inflation will start to grow moderately and reach the targeted level in the second half of 2013.

The short-term inflation forecast was obtained based on the following assumptions:

- The annual growth of broad money will equal 19% at end-2012 and 23% in Q3 2013
- Prices for fruits and vegetables will change following seasonality patterns for agricultural products;
- The oil price will average 95 USD/barrel
- The real GDP growth will equal 6.9% in 2012 and 6.7% in Q1 2012;
- The nominal effective exchange rate will not change

DIAGRAM 4.1
Annual Inflation Forecast



Source: NBG

The medium-term forecast predicts attainment of the targeted inflation level due to a number of factors, such as price increases for oil and imported products, loose monetary policy promoting commercial banks' activity and stimulating domestic demand. Forecasted economic growth in trading partner countries will lead to increased demand, promoting demand for the Georgian exports. In addition, growing inflation in the partner countries will trigger an inflation increase in Georgia, resulting in attainment of the targeted inflation level.

The Q3 economic activity indicators suggest high economic growth rates; however, risks related to de-

mand pressure on prices are not expected, since the deviation of the GDP from the potential level is close to zero.

In analyzing risks of inflation forecasting it should be mentioned that Georgia as a small open economy is largely dependent on external factors such as changes in international prices, demand for goods and services in the trading partners, economic growth and inflation rates in these countries.

Potential risks pushing prices upward include increased demand as a result of fiscal expansion and bad climatic conditions. On the other hand, factors producing a downward impact on prices are reduction in utility fees and decreased demand in trading partner countries.

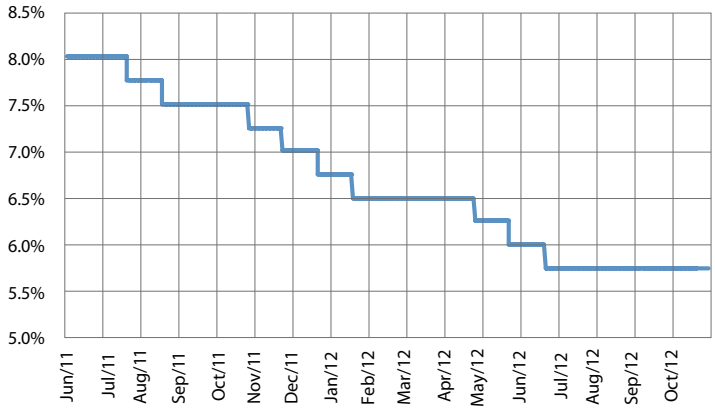
Due to the above, certain price fluctuations are possible in the short-term period. However, consistent monetary policies should mitigate these fluctuations and help to attain the targeted level of inflation in the medium- and long-term period.

5. Decisions of the Monetary Policy Committee

Starting from June 2011 the NBG applied monetary policy loosening, as the existing forecasts pointed to a considerable decline in inflation, largely due to the base effect. In the first half of the year considerably high economic activity was registered. The real GDP growth equaled 6.8% and 8.2% in Q1 and Q2 2012. However, taking into account the fact that the deviation of the GDP from its potential level was close to zero throughout the year, there were no risks related to demand pressure on prices. As expected, in September 2011 the annual inflation fell below the targeted level, turning negative in February 2012. Taking into account the existing inflation forecasts and factors affecting aggregate demand, in June 2012 the Monetary Policy Committee stopped monetary policy loosening, since moderate inflation growth was expected along with discontinuation of the base effect. Accordingly, the refinancing rate equaled 5.75% in July-December. In line with the existing forecasts, the inflation will remain low in 2012 and early 2013, attaining the target level in the second half of 2013.

The primary instrument of the monetary policy represents one-week refinancing loans, by means of which changes in the monetary policy affect inflation via monetary policy transmission channels. Commercial banks have the possibility to obtain refinancing loans through participation in the one-week auctions. The minimum interest rate represents the monetary policy rate. Banks use refinancing loans to efficiently manage short-term liquidity. The volume of auctioned one-week refinancing loans oscillated between GEL 168-400 million, while the interest rate was close to the policy rate.

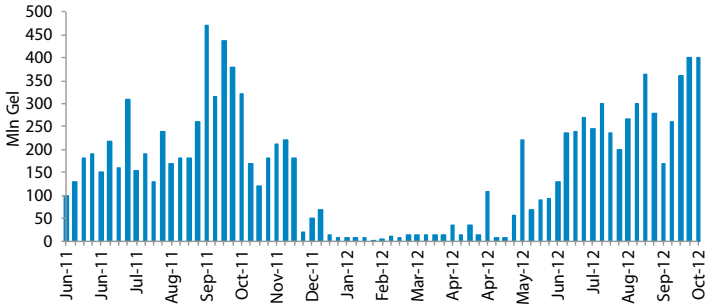
DIAGRAM 5.1
Monetary Policy Rate



Source: NBG

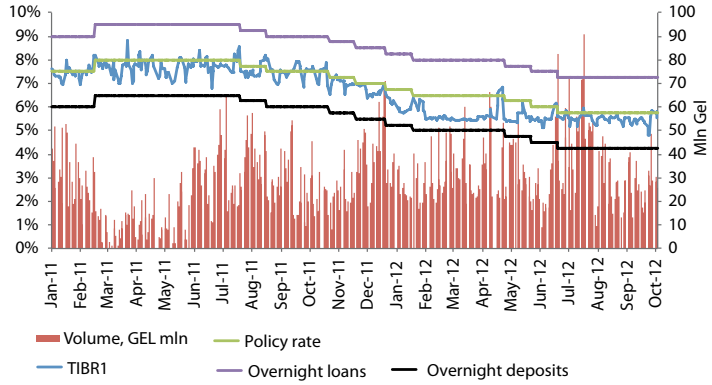
The use of refinancing loans by commercial banks is important for the NBG, as it conditions transmission of the monetary policy rate (refinancing loan rate) first to interbank market rates and then to market interest rates. Under increased liquidity the demand for refinancing loans declines, reducing efficiency of the monetary policy. On the other hand, liquidity deficit leads to increased demand for refinancing loans, improving the effectiveness of the monetary policy transmission mechanism. In early 2012 commercial banks' demand for refinancing loans was low due to large volumes of accumulated liquidity in the system. The latter fact was related to higher-than-expected expenditures incurred by the government at end-2011. In March, along with payment of profit tax the level of excess liquidity started to decline. In addition, the NBG put government bonds into circulation, further reducing medium-term excess liquidity. All these actions boosted demand for refinancing loans.

DIAGRAM 5.2
Refinancing Loans



Source: NBG

DIAGRAM 5.3
Interbank Money Market



Source: NBG

In case of accumulation of excess liquidity in the system the NBG withdraws medium-term liquidity through open market operations and promotes use of refinancing loans, thus stimulating the interbank market. For this purpose the NBG uses 3- and 6-month Certificates of Deposit. Since there was not necessity of withdrawing excess liquidity from the banking system, the NBG kept the volume of CDs in circulation unchanged: in July the volume of CDs decreased from GEL 590 million to GEL 570 million, remaining unchanged thereafter. According to the Q4 plan, the volume of CDs in circulation will not change until the end-year.

Existence of the money market is crucial for ensuring efficiency of monetary policy. Thus, the NBG strives to enhance deepening and development of this market. At the present stage the scope of the interbank money market in Georgia still remains quite small. The market largely involves lari denominated transactions. As already mentioned, the liquidity situation in the banking sector largely determines the level of activity of the interbank market. It is remarkable that along with reduction in excess banking liquidity the volume of transactions in the interbank market was increasing. It should be noted that in the pre-election period the level of liquidity rose. However, this can be considered as a temporary phenomenon and, with the end of the election period, a reduction in excess liquidity is expected.

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