# ANNUAL REPORT

NATIONAL BANK OF GEORGIA

# 2010 ANNUAL REPORT

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### INTRODUCTION

The present Annual Report is prepared in line with Articles 60 and 61 of the Organic Law of Georgia "On the National Bank of Georgia". It comprises the "Report on Implementation of Monetary, Exchange Rate and Supervision Policies" and the "Financial Report Certified by Auditors". The Report discusses priority directions guiding the activities of the National Bank of Georgia (NBG) in the accounting period. In addition, the Report contains the NBG's analysis of the developments taking place within the country and abroad, which exerted an essential influence on the Georgian economy and the accomplishment of goals set by the NBG.

The NBG has been conducting the 2010 monetary policy in line with the main goals and functions stipulated in Article 3 of the Organic Law of Georgia "On the National Bank of Georgia", which defined the main goal of the NBG as ensuring price stability. At the same time, the NBG should ensure stability and transparency of the financial system and promote sustainable economic growth unless the latter jeopardizes accomplishment of the main goal.

During 2010 the NBG conducted its monetary policies in line with the inflation targeting regime. The medium-term inflation target stood at 6%. During the first half of 2010 the annual inflation oscillated within an acceptable band of the targeted level. However, starting from July the inflation rate rose significantly, owing to a number of factors. On the one hand, unfavorable climatic conditions in 2010 conditioned bad harvests in the whole Caucasian region, leading to supply shortages of agricultural production and, hence, exerting an upward pressure on prices. As a result, the demand for agricultural products increased not only in Georgia, but also in the other regional countries (Azerbaijan, Armenia) stimulating growth of agricultural exports. Being a positive fact per se, higher agricultural exports moved up domestic prices. In addition, in 2010 the developments in the international markets essentially influenced domestic consumer prices. Regional droughts and fires in Russia occurred in summer 2010 spoiled a considerable share of wheat harvest. As a response to that, the wheat exporting countries - Russia, Ukraine, and Kazakhstan - banned or significantly restricted wheat exports, conditioning sharp increase in wheat prices. Taking into account Georgia's dependency on wheat imports from the neighboring countries, a forced reorientation to other markets led to an increase in transportation and logistical expenses. The situation was exacerbated by the floods in Australia and Brazil, further affecting wheat harvest. As a result, wheat prices hit record high levels in the international markets, accompanied with a considerable increase in sugar prices. Besides, the upswing in wheat prices lead to price growth for its substitutes and complements (cereals, sunflower, beef and poultry meat, eggs, etc.).

In parallel, high economic growth in the Asian countries boosted demand for fuels, which resulted not only in an immediate increase in prices for fuel but also conditioning additional pressure on food prices.

The above-mentioned developments were duly reflected in the Georgian consumer market, posting significant upturn in prices for food and petroleum products. The annual inflation rate soared from 3.7% to 11.2% at end-year. It should be noted that the food price increases accounted for 9.5 pps in the annual inflation. The inflation rates for the other components of the consumption basket were moderate. Thus, growth rate of prices on services was only 1.5%, indicating weak demand pressure on prices.

In 2010 the inflation rate was mainly conditioned by exogenous factors. The influence of monetary

policies on such factors is weak, underlying the decision of central banks not to address such shocks, since social costs of reducing this type of inflation exceed social benefits therefrom. However, if the effect of such shocks is large enough to affect the existing fundamental factors, it becomes necessary for the central bank to take adequate measures. Despite the fact that in the second half of the year the rise in inflation was largely due to exogenous factors, high inflation, and especially growth of food prices, creates inflationary expectations which represent one of the primary determinants of inflation. Thus, high food inflation was capable of strengthening inflationary pressure through increased expectations.

In order to curb inflationary expectations and to avoid additional demand pressure on prices, starting from June 2010 the NBG switched to monetary policy tightening. For this purpose the NBG used a twofold approach. On the one hand, by means of policy rate hiking, the monetary policy tightening is transmitted to lari denominated loans. Accordingly, from June 2010 to end-2010 the NBG increased the policy rate from 5% to 7.5%. On the other hand, due to a high level of dollarization in the country, the NBG uses reserve requirements and macro-prudential instruments in order to affect foreign currency denominated loans. Therefore, at the first stage in September 2010 amendments were introduced to the "Regulation on Calculation and Observance of Minimum Reserve Requirements" stipulating compulsory provisioning of external borrowings by commercial banks. This was followed by the decision of the NBG's Monetary Policy Committee (MPC) to gradually increase the reserve requirements for funds attracted in foreign currency from 5% to 15%.

In 2010 the main priority of the MPC consisted in increasing the efficiency of the monetary policy transmission mechanism. Monetary policy effectiveness is crucial for development of domestic financial markets. In 2010 the efforts related to money market development were focused on increasing money market liquidity and forming a long-term market yield curve.

Recovery of interbank markets and restoration of monetary policy transmission mechanism was among top priorities for central banks in many developing countries during 2009-2010. As opposed to the situation in the developed countries striving to enhance economic recovery, the NBG's reforms were directed to formation of the money market. In 2010 the NBG took a number of important steps with the purpose of promoting monetary policy effectiveness. The lari's reserve requirements were increased to the extent that they would not impose an additional burden on commercial banks and that the banks would be in a better position to forecast short-term liquidity; In order to stabilize short-term interest rates permanent overnight facility was introduced with the interest rate band of +/-2 pps with respect to the policy rate. The band was later narrowed to +/- 1.5 pps, with the further reduction possible along with the development of the interbank market. The collateral base for monetary operations has been expanded, and permanent refinancing loans have been introduced. A new system for accounting and securities registration was put into operation; a fully integrated online trading floor was created on the platform of the "Bloomberg" trading system. Relevant legislative basis for interbank trade was elaborated. As a result of all these measures, the settlement risk and transaction costs in the interbank money and securities markets were practically reduced to zero.

Carried out reforms quickly brought first results, as short-term interest rates stabilized and banks reduced their excess liquidity, implying an improvement in effectiveness of the system. This allowed banks to expand economy crediting starting from the second quarter of the year, enhancing an annual economic growth. The differential between interest rates on long-term and short-term securities gradually narrowed, bringing down government expenses on deficit financing and increasing availability of long-term lari resources.

In 2010 the NBG conducted its exchange rate policy under the floating exchange rate regime. The NBG's interventions were aimed at avoiding drastic exchange rate fluctuations rather than at reversing the existing trends or attaining a specific exchange rate level. The average GEL /USD exchange rate in 2010 equaled 1.7846 lari, depreciating 6.83% (from 1.6705). In terms of end-period data, the exchange rate depreciation amounted to 5.16% (from 1.6858 GEL /USD to 1.7728 GEL /USD). In the reporting period, the nominal effective exchange rate depreciated 2.2%, while the real effective exchange rate posted a 2.8% appreciation.

In 2010 the current account deficit stood at 9.6% of GDP (USD 1,116.5 million), down from 11.3% in 2009. The favorable downtrend in current account deficit occurred during the last three years, conditioned by a more rapid expansion of exports with respect to imports (26.6% vs. 15.7%, respectively). In addition, in the post-crisis period the external remittances recovered, while a remarkable 56% growth of tourism revenues was posted in 2010.

Improvement in the current account enhances external sustainability of a country. Besides, the primary source of financing of Georgia's current account deficit remains foreign direct investments, which further reduces risks of the country's external sustainability.

In 2010 the NBG's international reserves were on the rise: as of December 31, their volume totaled USD 2,263.9 million, up 7.4% year-on-year. The annual growth of international reserves was due an IMF tranche (USD 296.7 million), a World Bank loan (USD 125.3 million), and other loans and grants received from international financial institutions and donor countries.

The level of Georgia's official international reserves is considered to be adequate for ensuring external sustainability, according to the evaluations of different authoritative international organizations. The ratio of total international reserves to broad money, foreign currency denominated deposits, and short-term debt is higher than 100%, which is a fully appropriate level, according to the IMF estimates. Another important indicator represents a ratio of international reserves to months of imports. According to the IMF, the level of international reserves is considered sustainable, if it exceeds the value of 3 months of imports. In Georgia this indicator equaled 4.9 by end-2010 showing signs of a further increase.

In 2010 the Georgian financial sector was characterized with considerable revitalization. During the year the banking sector's credit portfolio expanded 21%, constituting 30% of GDP. The total banking assets equaled GEL 10.6 billion by end-2010, or 51% of GDP.

The banking profitability ratios significantly improved. Return on equity (ROE) equaled 9.6%, while the return on assets (ROA) stood at 1.7%. The recovery of the banking sector is reflected in the fact the share of non-performing loans in the total credit portfolio shrank from 18.8% in June 2009 to 12.5% on December 31, 2010.

The capital adequacy ratios of the banking sector showed certain fluctuations in 2010, still considerably exceeding the minimum required level. Therefore, it can be said that the banking system remains adequately capitalized and has large capacity to absorb systemic shocks and/or to expand credit activity.

Taking into account best international practices and accumulated domestic experience, the NBG actively implements changes in supervision in order to ensure financial stability in the country. In 2010 the NBG strengthened both micro- and macro-prudential supervision of the banking sector. Along with more intensive application of risk-based supervision, the activities related to improving the supervisory framework were initiated. Aimed at deeper risk analysis significant steps were taken in terms of specialization of resources, namely, in the areas of credit, market, and macro-prudential risks. The data processing

information system was created, allowing for improved effectiveness of supervision through flexible and diversified analytical data processing.

In addition, in 2010 the activities were started with the view of protecting consumers' interests in the financial market. For this purpose appropriate regulations were elaborated and a special structural unit was set up at the NBG.

In 2010 the adoption of counter-cyclical liquidity requirement policies continued, and the minimum requirements were back to the pre-crisis level. The NBG restored the capital adequacy requirements lowered during the 2008-2009 recession. As a result, starting from January 2011 the exchange rate risk-weighted ratio stands at 75%, up from 50%.

In terms of ownership structure, the banking sector is represented by strategic investors with large financial capacity. It should be noted that an increased share of international investors contributes to development of a sustainable and competitive domestic market. At end-2010 the share of non-residents, by final ownership, constituted 84.4% of the banks' paid-in capital.

The NBG has been conducting supervision activities since 2009. In 2009-2010 the improvement of the legal basis was continuing. At end-2009 significant amendments were made to the normative acts regulating insurance market, and the functions of the NBG as the state organ conducting supervision over insurance activities were expanded and described in detail.

As of end-2010, there were 16 insurance companies operating in the Georgian insurance market. Two of those were registered in 2010. The insurance market concentration in terms of raised premiums (top 5 insurers) decreased from 83.6% to 78.3%, indicating expansion in activities of relatively small companies.

In 2010 the Stock Exchange registered 1.71 times more transactions in annual terms, although still remaining at a low level in value terms. In the accounting period the NBG elaborated a new regulation, according to which it became possible in Georgia to trade securities of those issuers which are listed at the internationally accepted stock exchanges without additional registration. In addition, on June 18, 2010 the NBG became a partner of the Association of National Numbering Agencies (ANNA), which makes it possible to assign an International Securities Identifying Number (ISIN) to securities issued in Georgia.

With the purpose of improving payment systems, in 2010 the NBG carried out three important reforms. The existing real-time settlement system was replaced with a modern and sophisticated RTGS system, a completely new Central Securities Depository (CSD) system for settlement of state-issued securities was implemented, and transition of the banking settlement system to the IBAN format was completed.

The new RTGS system will ensure provision of effective and comprehensive banking services to customers. The operational risks are minimized, and processing of interbank money transfers will be carried out in a continuous, prompt, and secure manner. Along with installation of modern software the relevant procedures and legal basis was elaborated.

With the implementation of the CSD system, the NBG moved to a modern high-technology model of managing government securities. All transactions related to government securities are now processed electronically, no longer using paper documents. Overall, the system ensures prompt and risk-free management of transactions related to government securities. The CSD system is fully integrated into the RTGS system, which makes it possible to simultaneously transfer securities and perform all necessary monetary settlement procedures in line with the Delivery vs. Payment (DvP) principle; this fully eradicates securities settlement risk.

Using this system, the banks are capable of applying a completely new mechanism of liquidity manage-

ment, such as intraday loans. Availability of the latter will reduce banks' transaction demand and increase efficiency of the banking system.

Introduction of IBAN accounts reduced operational risk. In particular, this format excludes the possibility of indicating an account incorrectly, providing for use of the straight through processing (STP) system of interbank transfer processing. The use of IBAN no longer obliges a beneficiary bank to perform verification activities, decreasing bank's operational costs.

As a result of introducing a new optimal adjusting and sorting criterion for money processing system, in 2010 the visual and esthetic side of banknotes in circulation considerably improved, serving as one of the factors contributing to a reduction in faked banknotes compared to 2009.

In 2010 the construction of a cash center equipped with modern security and money processing technologies, in line with international standards, was initiated. After its startup high-tech processes related to operations recording and centralized control of cash and other valuables will be implemented. The cash center will essentially improve provision of banknotes and coins to the whole country and enhance servicing of commercial banks.

Improvement of the legal basis regulating activities of the NBG and the financial sector was under way. In the accounting period the NBG abolished approximately 90 normative acts and replaced them with new ones, in line with current requirements of the financial market.

In the accounting period elaboration of the draft Law "On Payment Systems" and the package of respective amendments to the existing legislation was initiated. These legal acts will settle a number of issues related to payment systems, such as regulation of e-money and its issuers, financial collateral, etc.



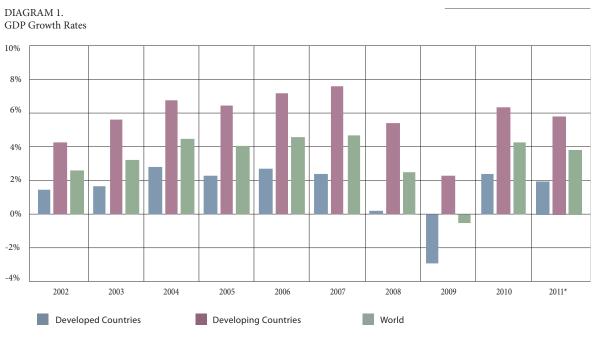
### MACROECONOMIC ENVIRONMENT

#### 1.1. WORLD ECONOMY

The post-crisis recovery of the world economy continued in 2010. However, in most developed countries this process turned out slower than expected.

According to the IMF forecasts, the 2010 world economic growth amounts to 4.8%, pointing to a considerable increase in economic activity compared to the two preceding years. The volume of household indebtedness remains large in the developed countries, hampering private demand and keeping the unemployment rate high. On the other hand, those developed and developing countries which had a sound financial sector before the crisis returned to the growth path. In line with the IMF estimates, in 2010 the real GDP growth in the developed and developing countries will equal 2.7% and 7.1%, respectively. The forecasted inflation rate will stand at 1.4% in the developed countries and at 6.2% in the developing countries.

In 2010 the central banks of Australia, Canada, Israel, Korea, New Zealand, Norway, and Sweden tightened monetary policy, although still keeping their policy rates at a low level. However, most developed countries used monetary policy to stimulate economic activity, with the monetary policy rates almost equaling 0%. In the same period the effect of fiscal stimulus packages on the economy weakened, conditioning the necessity to bring state budget deficits to a sustainable level. Growth of fiscal problems and sovereign debt risks in Greece, Ireland, Portugal, and Spain seriously affected the global financial stability, bringing down stock prices of financial companies and putting the economic recovery in jeopardy. Calming financial markets was possible only by purchasing state debt through the European Central Bank (ECB's Securities Market Program) and reaching agreement among the Euro area governments on the "European Stabilization Mechanism".



Source: IMF WEO, October 2010

<sup>&</sup>lt;sup>1</sup> Source: IMF WEO. October 2010

Economic activity was slackened in the second half of 2010, largely affected by the Greece's sovereign debt crisis and its spread to other countries. According to the IMF forecasts, an upturn in economic activity in the leading countries will occur in the second half of 2011, accompanied with low level of inflation and high unemployment.

Despite the fact that in 2010 the US economy returned to the pre-crisis level, the recovery process is not yet sustainable. After a 2.6% economic contraction in 2009, the real GDP forecast for the US economy stands at 2.8%. The main obstacle to growth of private consumption in the US still remains a drop in real estate prices and high level of unemployment. During the last three years the residential housing prices declined 30%, while the unemployment rate was on the rise reaching 9.7% by end-2010. Under these circumstances the inflation rate remained low, with the CPI level equaling 1.4% in 2010. Despite government's efforts to restore financial stability and economic recovery, the banking sector is still in need of additional capital. With the purpose of improving supervision of the financial sector, in July 2010 the US Congress adopted the "Doll-Frank Act on Wall Street Reform and Consumer Protection". The document envisages tightening of supervision over systemically important financial institutions and markets for derivatives, creation of the Financial Protection Bureau and the Financial Stability Oversight Council. It is remarkable that in the event of identifying signs of risks to financial stability, the Council shall be entitled to split complex institutions. According to the Fed's Monetary Policy Committee, slack use of resources, low inflation, and stable inflationary expectations are likely to maintain the federal funds rate at an essentially low level. On the other hand, the 2010 budget deficit is projected at 10% of GDP, underlining the necessity of maintaining state debt sustainability and tightening fiscal policy. The IMF projects the US real GDP growth at 2.3% and the inflation rate at 1% in 2011.

The economic recovery in Europe was seriously affected in summer 2010, when the large budget deficit in Greece turned into a sovereign debt crisis. The crisis was spread to other countries with weak fiscal stance, jeopardizing the financial system at the international level. However, as a result of strong EU support, the evolution of the crisis was precluded at an early stage, and its adverse effect was brought to minimum. In 2010 it is projected that the real GDP will grow 1.7% in the Euro area, while the unemployment rate will rise from 9.4% to 10.1%, although the economic situation varies for different EU member countries.

Growth of exports powered Germany's GDP growth to 3.3%, while relatively high level of unemployment hindered economic recovery in France, with the economic growth equaling only 1.6% in 2010. Significantly lower growth rates are expected in Greece, Ireland, Portugal, Spain, and Italy, as these countries experience adverse effects of large fiscal deficits. The inflation target in the EU area equals 1.7% in 2010, as the inflation risks remain low. The ECB refinancing rate was unchanged at 1% throughout 2010.

High growth rates were registered in the emerging European countries where global crisis had a weaker impact. In 2010 the real GDP growth in Turkey and Poland amounted to 7.8% and 3.4%, respectively. On the other hand, the recovery in those countries which were hit most during the global crisis – Latvia, Bulgaria, Romania (economic contraction in these countries amounted to 18%, 5%, and 7.1%, respectively, in 2009) – is expected to be slower. Identification of banking sector weaknesses in the European countries is done through stress-testing. In this regard an important step forward represent a creation of the European Systemic Risk Board, responsible for ensuring financial stability in the EU.

Slackened demand and budget contraction also affected the economic recovery process in the UK. In 2010 the economic growth amounted to 1.7%, while the inflation rate rose 3.7%. The Bank of England's

monetary policy remains loose, although in case of increasing inflationary risks it is expected that the monetary policy rate will be raised.

Economic recovery in the post-Soviet countries was conditioned by increasing prices on raw materials and food, expansion of trade volumes, and gradual return of foreign capital. The real GDP growth in 2010 amounted to 4.3%, while the inflation rate equaled 7.0%. On the other hand, serious problems in the financial sector related to a low level of capital and a high level of non-performing loans are still unresolved, pointing to the necessity of supervision reforms in Kazakhstan and Ukraine. It should also be noted that in most post-Soviet countries there is a fixed exchange rate regime, which precludes these countries from using one of the effective shock-absorbing instruments. According to the IMF's World Economic Outlook of October 2010, more exchange rate flexibility is desirable. Monetary policy loosening was suspended, and in some cases central banks applied policy tightening to combat inflation growth.

The expansion of global trade significantly enhanced the restoration of the Asian economies to the pre-crisis production level and conditioned fast economic progress. Capital inflows stimulated production growth in China and India, which, along with Singapore, posted high economic growth rates in 2010. The economic growth in Asian countries was powered by exports as well as by a boost in domestic demand. China's real GDP grew 10.3% and India's GDP rose 9.7% in 2010, mainly conditioned by a high level of investments and companies' profitability. Along with the increase in economic activity these countries registered growth of inflation, largely explained by the food price gains. The average annual inflation in China rose by 3.5 pps from 0.7% in 2009, while the average annual inflation rate in India amounted to 13.2%. The economic recovery in Japan proved to be slow due to its high dependency on exports and slack domestic demand. The real GDP growth equaled 2.8%.

Along with fast economic recovery, the majority of Asian countries brought their monetary policies to the pre-crisis level reversing economic stimulus measures which was manifested in rising policy interest rates and minimum reserve requirements. The Bank of China restored quantitative restrictions in crediting, while Singapore introduced the nominal effective exchange rate target.

The global trade returned to the pre-crisis level, posting an 11.4% annual increase in 2010, benefiting from increased demand and commodity price increases. In 2010 the IMF's commodity price index rose 20%, while the price index excluding fuel grew 17%. Along with the continuation of global economic recovery and restoration of global demand, the uptrend in commodity prices will be maintained. In 2011 the volume of global trade is projected to rise 7%.

#### 1.2. GROWTH OF THE ECONOMY

In 2010 the Georgian economy not only exited recession, but even posted a positive growth compared to the pre-crisis period.

The annual growth rate of real GDP equaled 6.4%. Expansionary fiscal and monetary policies should be pointed out, as they allowed the economy to post a positive growth rate in the fourth quarter of 2009 and largely conditioned favorable outcomes in 2010.

In every quarter of 2010 the economy registered a positive real growth. High economic growth was manifested in Q2, when the economy expanded 8.7% in real terms.

On the other hand, excluding seasonal factors which affect the GDP, the economy contracted 1% in Q3. Using seasonally adjusted data, the GDP was posting high quarterly growth rates in the range of 2-3%.

In 2010 the nominal GDP expanded 15.6% year-on-year, following a 5.7% decline in 2009. In the reporting period the GDP deflator rose 8.7%.

TABLE 1.
Real GDP and Sectoral Contributions (%), 2008-2010

	20	008	20	2009		2010	
	Growth	Contribution	Growth	Contribution	Growth	Contribution	
Agriculture, hunting and forestry; fishing	-4.4%	-0.4%	-6.8%	-0.6%	-1.73%	-0.14%	
Mining and quarrying	16.7%	0.1%	9.4%	0.1%	4.74%	0.03%	
Manufacturing	-1.5%	-0.1%	-8.5%	-0.7%	20.31%	1.43%	
Electricity, gas and water supply	3.7%	0.1%	6.2%	0.1%	2.10%	0.06%	
Processing of products by households	-4.5%	-0.1%	-1.8%	0.0%	-3.72%	-0.11%	
Construction	-11.1%	-0.7%	-3.1%	-0.2%	7.60%	0.42%	
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	11.8%	1.5%	-16.3%	-2.3%	14.14%	1.84%	
Hotels and restaurants	4.9%	0.1%	-4.4%	-0.1%	12.95%	0.25%	
Transport	-9.5%	-0.7%	0.5%	0.0%	13.12%	0.83%	
Communication	15.8%	0.5%	-3.4%	-0.1%	6.54%	0.22%	
Financial intermediation	4.3%	0.1%	1.5%	0.0%	14.70%	0.37%	
Real estate, renting and business activities	2.4%	0.1%	-4.1%	-0.1%	8.56%	0.30%	
Imputed rent of own occupied dwellings	3.2%	0.1%	2.8%	0.1%	2.58%	0.08%	
Public administration	9.9%	1.3%	1.2%	0.2%	0.84%	0.11%	
Education	13.1%	0.4%	4.7%	0.2%	2.33%	0.10%	
Health and social work	6.8%	0.3%	8.7%	0.4%	3.13%	0.18%	
Other community, social and personal service activities	1.6%	0.1%	-13.0%	-0.5%	10.41%	0.35%	
Private households employing domestic staff and undifferentiated production activities of households for own use	5.8%	0.0%	2.7%	0.0%	9.54%	0.01%	
Financial Intermediation Services Indirectly Measured (FISIM)	26.3%	-0.3%	-1.0%	0.0%	9.62%	-0.12%	
(=) GDP at basic prices	2.6%	2.3%	-4.1%	-3.5%	7.19%	6.21%	
(+) Taxes on products	0.6%	0.1%	-1.7%	-0.2%	1.27%	0.18%	
(-) Subsidies on products	8.2%	0.0%	4.0%	0.0%	4.30%	0.02%	
(=) GDP at market prices	2.3%	2.3%	-3.8%	-3.8%	6.37%	6.37%	

Source: Geostat

As shown in the sectoral dynamics of the GDP, the 2010 economic growth was driven by the sectors which registered large contractions in 2009, namely, trade, manufacturing, and construction sectors. In addition, a significant growth in transport and financial intermediation should be pointed out (13.1% and 14.7%, respectively) as well as a large contribution of these sectors to the overall GDP growth (0.8 and 0.4 pps).

As it is seen from Table 1, the following sectors registered high growth rates and, accordingly, made a significant positive contribution to the economic growth: "community, social, and personal services", "real estate operations, renting and commercial activities", "hotels and restaurants", and "communication".

In the remaining sectors the real growth of value-added was relatively moderate. However, none of the sectors posted real decline.

The positive contribution of sectors dependent on state budget financing<sup>2</sup> was essential in 2008 and crucial in 2009. One the other hand, the 2010 economic growth was largely driven by the business sector.

<sup>&</sup>lt;sup>2</sup> Includes public administration, health care and social work, and education sectors.

#### **DEMAND**

In 2010 the nominal GDP growth of 15% was mainly powered by gross capital formation and exports. The gross capital formation that almost halved in 2009 relative to 2008, posted a significant (73%) growth in 2010. Exports rose 35%, partly due to price effects.

TABLE 2. GDP by Main Categories of Use (in current prices, GEL millions)

	2003	2004	2005	2006	2007	2008	2009	2010³
GDP at market prices	8,564	9,824	11,621	13,790	16,994	19,075	17,986	20,791
Final Consumption Expenditures	7,029	8,574	9,794	12,972	15,732	19,596	19,075	20,163
Households	6,130	7,149	7,720	10,804	11,953	14,582	14,600	15,703
Government	836	1,379	2,014	2,116	3,718	4,936	4,399	4,371
NPISH	63	46	61	52	61	77	75	89
(+) Gross Capital Formation	2,682	3,135	3,892	4,255	5,448	4,952	2,343	4,061
Gross Fixed Capital Formation	2,284	2,697	3,261	3,524	4,370	4,099	2,755	3,592
Changes in Inventories	399	437	630	731	1,077	853	-412	469
(+) Exports of Goods and Services	2,727	3,100	3,922	4,532	5,303	5,459	5,349	7,235
Exports of goods	1,777	2,073	2,666	2,956	3,479	3,587	3,163	4,385
Exports of Services	949	1,027	1,256	1,576	1,824	1,873	2,185	2,849
(-) Imports of Goods and Services	3,976	4,734	5,993	7,863	9,848	11,140	8,801	10,871
Imports of Goods	3,142	3,814	4,861	6,574	8,295	9,304	7,173	8,971
Imports of Services	834	920	1,131	1,289	1,553	1,837	1,628	1,901
Statistical Discrepancies	102	-251	6	-107	359	209	20	205
(=) GDP at market prices	8,564	9,824	11,621	13,790	16,994	19,075	17,986	20,791

Source: Geostat

Table 2 shows, that expenditures on final consumption grew 5.7%, indicating that in real terms this category posted a small decline. The decline is explained by the fact that the nominal growth of total final consumption fell behind the average inflation rate (7.1%). The real contraction of total consumption is the result of a 0.6% decline in government consumption due to the government policies oriented to deficit reduction.

The nominal growth of final consumption in 2010 was the result of a 7.6% growth of its largest components – household consumption<sup>3</sup>.

In 2010 the value of imports also manifested a high growth rate (23.5%), which, similar to exports, was partly conditioned by price gains for tradable goods.

The growth of inventories and investment in fixed capital made approximately the same contribution to the 73% growth of gross capital formation. Enterprise inventories showed a steady increase, although their growth rates were lagging behind the pre-crisis level. It should also be noted that the annual stock of inventories (in current prices) only slightly exceeded the 2008 level, indicating the fact that the real stock of inventories relative to 2008 did not grow.

In 2010 investment in fixed capital grew 30%, although the growth was uneven during the year. In the beginning of the year there was a contraction of fixed capital investments, while in Q3 and Q4 an annual

<sup>&</sup>lt;sup>3</sup> The share of final household expenditures in 2010 accounted for 77.9% of total final consumption.

growth of more than 40% was registered. Overall, the level of fixed capital formation (in nominal terms) significantly fell behind the pre-crisis level.

As it was already mentioned, a significant growth of the nominal GDP was conditioned by relative revitalization of exports and expansion of gross capital formation. As a result of a slight decrease in government consumption, the final consumption expenditures posted a low growth, which to a certain extent slowed down the nominal GDP growth.

#### 1.3. CHANGES IN CONSUMER PRICES

Starting from July 2010 the uptrend in annual inflation was maintained throughout the year, largely conditioned by abrupt price increases in the world markets. In December 2010 the inflation rate equaled 11.2%, while the average annual inflation amounted to 7.1%.

The share of food in the Georgian consumer basket is relatively high, accounting for 40.5%. Accordingly, the sensitivity of the inflation rate to changes in food prices is significant. Food prices are very volatile in the international markets, affecting the inflation rate, i.e. a large share of inflation volatility is conditioned by food price changes. During 2006-2009 the impact of food prices on the overall inflation averaged 50%. Against the backdrop of drastic food price gains in the international markets, starting from the second half of 2010 the contribution of food price gains to the overall inflation rate rose to 90%.

In 2010 the inflation was on the rise. Particularly high growth was registered after June, which, in parallel to world market developments, was conditioned by the base effect. As it was noted above, the influence of exogenous factors on price dynamics was significant throughout the year. In the second half of 2010 the inflationary pressure was stemming from imported goods. Price increases for petroleum products essentially conditioned a rise in inflation. Spoiled harvest due to droughts and fire strongly affected international grain prices, including wheat, sunflower, and buckwheat. Due to the fact that grains represent one of the main components for poultry and animal husbandry, prices on meat and dairy products grew accordingly. Against the backdrop of natural calamities, production of sugar sharply declined leading to unprecedented price increases. Significant price growth was registered for corn flour caused, on the one hand, by droughts and bad harvests in Georgia and, on the other hand, by the substitution effect. The increase in consumer prices was also affected by a rise in regulated prices, namely, utilities and transport fees. As a result of all these processes, the actual inflation in 2010 turned out much higher than the inflation target (6%).

In 2010 high inflation was registered in Georgia's main trading partner countries. It should be noted that a significant part of the Georgian consumer basket includes imported commodities. Therefore, price dynamics in trading partners represented an important factor affecting inflation in Georgia. In the accounting period the food price fluctuations in the neighboring countries made a large impact on the Georgian price level. During the year more than 70% of food imports were received from Ukraine, Russia, Turkey, Brazil, Kazakhstan, and Azerbaijan. These countries were also significantly affected by food price gains in the international markets, although registering lower inflation compared to Georgia by end-year. In particular, the inflation rate equaled 6.4% in Turkey, 9.1% in Ukraine, and 7.9% in Kazakhstan. However, if we compare price growth for the last 2 year, the general price level in Georgia increased 14.5%, whereas it went up 22.8% in Ukraine, and 14.7% in Kazakhstan.

The analysis of price dynamics for tradable<sup>4</sup> and non-tradable goods is also important. During the

<sup>&</sup>lt;sup>4</sup> Goods and services sold away from production location.

recent years prices on non-tradables rose at a faster rate, than prices on tradable goods. This tendency is peculiar to developing countries. Significant capital inflows increased disposable income of population boosting aggregate demand. Other things being equal, this conditions an increase in prices on non-tradable goods, since prices on tradables are largely determined by the international markets, and a small open economy like Georgia in not in a position to affect world prices. Therefore, expansion of aggregate demand primarily affects prices on non-tradables. After the second half of 2008 this tendency weakened, since the general macroeconomic environment does not provide for a large growth of aggregate demand. By end-2010 the prices on non-tradable goods increased 3.2%, while the prices on tradables grew 16.8%. Such a drastic price growth for tradables, as it was already mentioned, represented the result of price increases in the international commodity markets.

Unlike in 2009, the annual core inflation rates were on the upturn in 2010. It is remarkable that these indicators were negative in early 2010, posting sharp increases later in the year. However, by the end-year the downward tendencies in core inflation rates were manifested. By end-December, the core inflation rates for the products within two and one standard deviations amounted to 7.2% and 7.6%, respectively. The dynamics of core inflation better describes general inflation trends and partly excludes one-time and seasonal factors.

Analysis of commodity groups shows that in 2010 a 22.8% growth was registered for "food and non-alcoholic beverages", while price increases for "alcoholic beverages and tobacco" and "other goods and services" amounted to 12.4% and 9.1%, respectively. By the end of the reporting period, consumer prices on transport<sup>5</sup> grew 7.2%, while prices for "hotels, cafes, and restaurants" and "healthcare" posted respective growth rates of 6.1% and 4.3%. Prices increased 0.6% for "education" and 0.9% for "clothing and footwear", A decrease in consumer prices was registered for "communication" and "recreation and culture" at 6.9% and 0.4%, respectively.

In terms of consumption durability the inflation rate was high for non-durable goods, increasing 16.0%. The annual inflation rate equaled 0.8% for semi-durable goods and 4.3% for durable goods. Prices of services posted an annual 1.5% increase.

<sup>&</sup>lt;sup>5</sup> In addition to intracity bus and subway transportation prices, the average growth of transportation prices is included. These also comprise other means of transport such as intracity taxi, micro bus, and suburban and intercity transport, etc.

TABLE 3. Inflation Rates (CPI) by Components (%), Their Weight in the Consumer Basket (%) and Contribution to the CPI (pps)

	December 2009	Dec10	/Dec10	Jan10-Dec10	/Jan09-Dec09
	weights	Inflation	Contribution	Inflation	Contribution
Total	100.0%	11.2%	11.2%	7.1%	7.1%
Food and Nonalcoholic beverages	40.1%	22.8%	9.5%	11.7%	4.9%
Food	40.5%	23.1%	9.4%	11.9%	4.8%
Bread and bakery	11.7%	19.8%	2.3%	7.4%	0.9%
Meat and meat products	6.8%	10.7%	0.7%	3.9%	0.3%
Fish products	1.3%	7.4%	0.1%	-0.5%	0.0%
Milk, cheese, and eggs	4.8%	14.5%	0.7%	7.0%	0.3%
Oils and fats	3.5%	34.7%	1.2%	9.4%	0.4%
Fruits, grapes	1.8%	32.6%	0.6%	24.0%	0.4%
Vegetables, watermelons, potatoes and other tubers	7.8%	44.3%	3.4%	18.8%	1.5%
Sugar, jams, honey, syrups, chocolate, pastry	2.3%	10.9%	0.3%	24.0%	0.5%
Other food products	0.4%	7.3%	0.0%	4.5%	0.0%
Nonalcoholic beverages	1.3%	12.1%	0.2%	4.7%	0.1%
Alcoholic beverages, tobacco	2.9%	12.4%	0.4%	7.7%	0.2%
Clothing and footwear	4.3%	0.6%	0.0%	-6.6%	-0.3%
Housing, water, electricity, gas and other fuels	13.8%	2.4%	0.3%	0.4%	0.1%
Furnishings, household equipment, routine house maintenance	3.6%	3.9%	0.1%	-0.1%	0.0%
Healthcare	9.0%	4.3%	0.4%	2.3%	0.2%
Transport	10.4%	7.2%	0.7%	9.5%	0.9%
Communication	4.2%	-6.9%	-0.3%	-2.2%	-0.1%
Recreation and Culture	2.2%	-0.4%	0.0%	-0.1%	0.0%
Education	5.2%	0.9%	0.0%	28.8%	1.1%
Hotels, cafes and restaurants	1.8%	6.1%	0.1%	4.1%	0.1%
Miscellaneous goods and services	2.5%	9.1%	0.2%	3.8%	0.1%
Non-durable goods	67.9%	16.0%	10.9%	9.1%	6.2%
Semi-durable goods	5.8%	0.8%	0.0%	-4.7%	-0.3%
Durable goods	3.4%	4.3%	0.1%	3.1%	0.1%
Services	22.8%	1.5%	0.3%	4.7%	1.1%

DIAGRAM 2. Annual CPI and Core Inflation (by 266 Components of the December 2009 Consumer Basket)

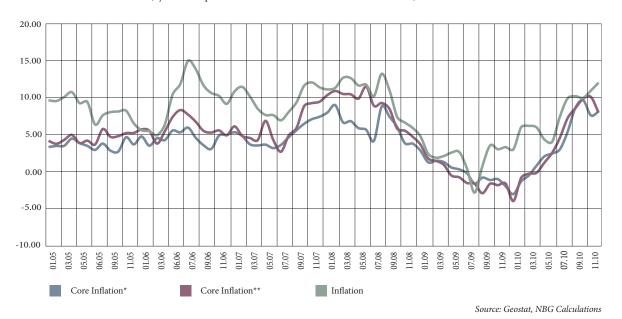


DIAGRAM 3. Contribution of Food to Annual Inflation (2006-2010)

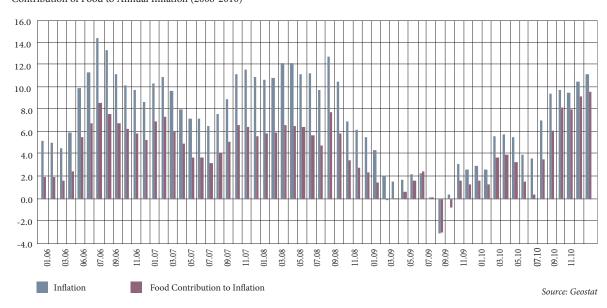
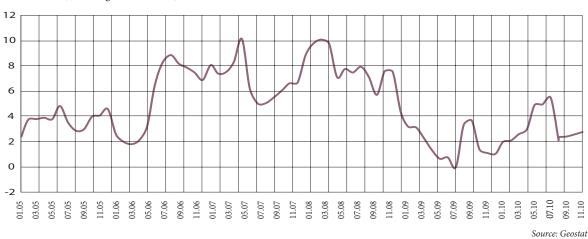


DIAGRAM 4. Core Inflation (Excluding Food and Fuel)



 $<sup>^{\</sup>star}$  For products within one standard deviation

<sup>\*\*</sup> For products within two standard deviations NATIONAL BANK OF GEORGIA / ANNUAL REPORT / 2010

DIAGRAM 5.
Dynamics of Price Indices for Tradable and Non Tradable Goods (2009=100)



Source: Geostat, NBG Calculations

DIAGRAM 6. Changes in Annual Inflation for Goods with Different Consumption Durability and Servicies

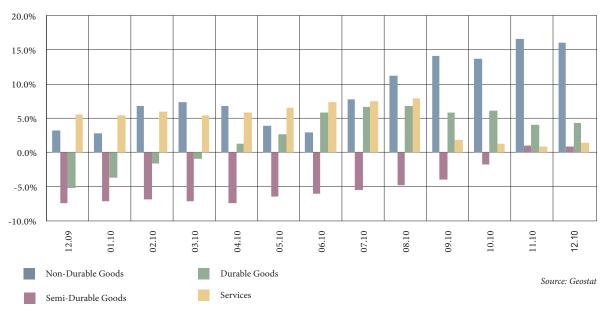
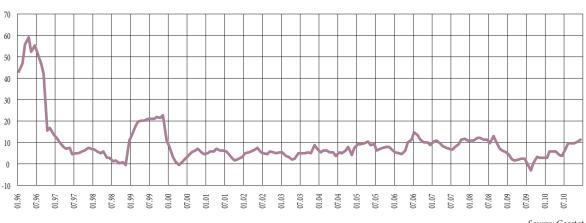


DIAGRAM 7. Annual Inflation in 1996-2000



Source: Geostat

#### 1.4 GOVERNMENT FINANCES

The process of recovery from the global financial and economic crisis began in 2010. The revitalization of the economy was reflected in a 6.4% growth of real GDP and a 10.9% increase in tax revenues of the consolidated budget. Government expenditures rose as well, although at a smaller rate (6%) than revenues. This resulted in a reduction of budget deficit from 9.3% in 2009 to 6.8% in 2010. The effect of fiscal stimulus policies subsided in parallel with the growing business activity.

The 2010 consolidated budget revenues and grants amounted to GEL 5.9 billion, up GEL 600 million year-on-year. It should be noted that in the beginning of 2010 the budget revenues were projected at GEL 6.2 billion, but along with the upward revisions of economic growth throughout the year, the budget revenue projections increased as well.

Until 2008 the tax burden (ratio of tax revenues to GDP) had been constantly growing. However, due to the August 2008 war and the financial crisis the tax revenues grew in 2008 and 2009 at a lower rate than the GDP, leading to a decrease in the tax burden. This tendency maintained in 2010 as well: the growth of tax revenues (10.9%) was lower than that of the nominal GDP (15.6%). As a result, the tax burden fell by 1 pp to equal 23.4%.

In terms of macroeconomic analysis, it is important to consider the real change in budget revenues (with respect to average inflation). A nominal increase in revenues and grants in 2010 amounted to 11.4%, while the real growth equaled 4%. The real growth of tax revenues equaled 3.6% against the 6.4% growth of real GDP. The difference points to a reduction in tax burden.

Similar to the preceding year, in 2010 the share of indirect taxes in the tax revenue structure equaled 58%, and the direct taxes account for the remaining 42%. The indirect taxes grew at a higher rate than direct taxes (12% vs. 9.4%, respectively), implying that in 2010 the tax burden was laid more on consumers than on producers.

The consolidated budget expenditures grew by GEL 335 million (4.8%) in 2010, totaling GEL 7.3 billion. The state budget expenditures also increased (by GEL 395 million), reaching GEL 6.8 million or 98% of the final annual plan. The initial projections of budget expenditures stood at GEL 6.5 million, although a better than expected economic performance in the country led to an upward revision of government expenditures to GEL 6.8 million. In 2010 the ratio of consolidated budget expenditures to GDP constituted 35%, down 3.6 pps year-on-year.

In terms of functional classification, the 2010 state budget expenditures were primarily used for the purposes of general government services, social protection, public order, security, and economic activities. These sectors accounted for approximately 72% of the total budget.

The amount of state budget deficit was initially planned at GEL 1.36 billion, later being increased to GEL 1.38 billion. The actual deficit was in line with the plan, constituting 6.3% of GDP. The consolidated budget deficit equaled Gel 1.41 million (6.8% of GDP). In 2009 the consolidated budget deficit stood at 9.3% of GDP, reflecting the expansionary fiscal policies<sup>6</sup> during the crisis year. The financial consolidation, namely, reduction of deficit to a sustainable level, is crucial for the purposes of ensuring macroeconomic stability. In 2010 the economic recovery began, and the government responded with cutting budget deficit. In the following years further reduction of deficit is planned. In line with the Economic Freedom Act adopted by the Parliament of Georgia, starting from 2012 the budget deficit should not exceed 3% of GDP.

<sup>&</sup>lt;sup>6</sup> Economic stimulation through deficit growth.

In 2010 the balances on government deposits grew by GEL 224 million (38%). The primary source of budget deficit financing represented the IMF's budget support credits (USD 297 million), the EU grant (USD 68 million), ADB's and World Bank's program loans (USD 151 million), and funds mobilized through issuance of Treasury bills (GEL 172 million).

The volume of state and state-guaranteed external debt of Georgia grew by GEL 1.28 billion, totaling GEL 6.98 billion as of December 31, 2010. The debt liabilities to the World Bank, the IMF, and the ADB rose significantly; the bilateral debt increased in favor of Germany as the latter provided the government of Georgia concessional loans at low interest. In 2010 the state external debt constituted 33.6% of GDP, up 1.9 pps year-on-year. It should be noted that the downtrend in the debt-to-GDP ratio was reversed in 2008 and the ratio increase continued in 2009, triggered by contraction of a large volume of debt over the last two years both from international financial organizations (the IMF, the World Bank, the EBRD, the ADB, etc.) and donor countries (EU countries, etc.).

In 2010 the Ministry of Finance continued issuance of Treasury bills and Treasury notes. Use of these instruments was aimed at financing budget deficit, developing securities market, and improving debt management. In 2010 the issuance of T-bills totaled GEL 608 million, while the repayment amount equaled GEL 422 million. In annual terms the share of domestic debt in GDP declined by 0.6 pps to 8.9%. The total state debt reached 42.5% of GDP, still being much lower than the critical level for debt sustainability (60% of GDP).

Issuance of state securities enhances market development, promoting demand for state securities in the future and, accordingly, reducing the maturity spread (interest rate differential between government securities and 1-week refinancing loans). As a result, the government will be in a position to sell T-bills and T-notes at lower interest and in larger volumes, issue securities with longer maturity, thus reducing interest and refinancing risk. Increased volumes of securities and longer maturity period will increase the share of domestic debt in the total debt, lowering the exchange rate risk and enhancing state debt sustainability. The current processes related to development of state securities market are described in Subchapter 2.2 on Monetary Instruments.

DIAGRAM 8. Ratio of Consolidated Budget Tax Revenues to GDP, 2004-2010

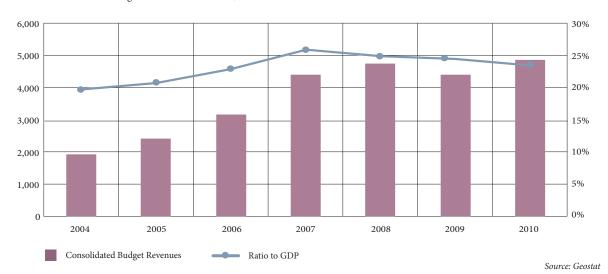


DIAGRAM 9. Consolidated Budget Revenues by Types of Taxes, 2010

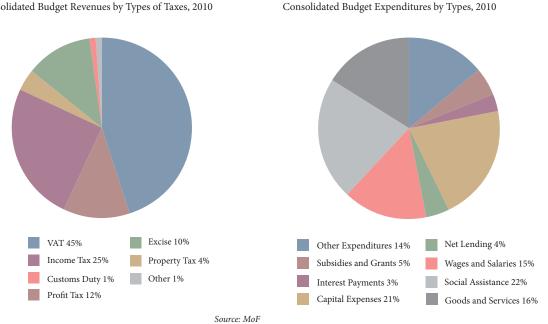
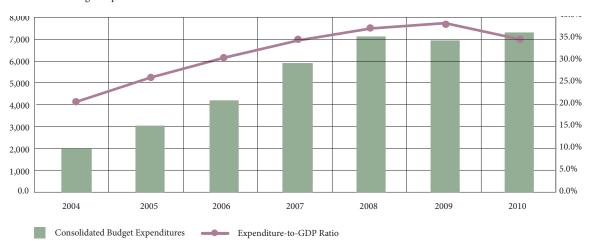


DIAGRAM 10.

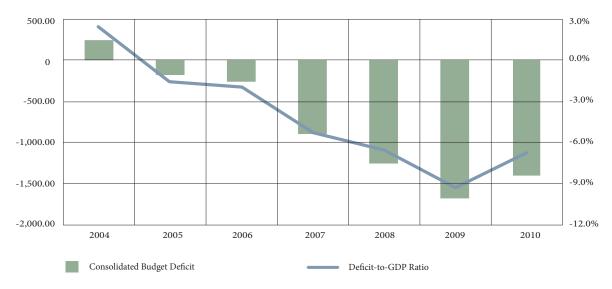
DIAGRAM 11. Consolidated Budget Expenditures and Their Ratio to GDP



Source: MoF

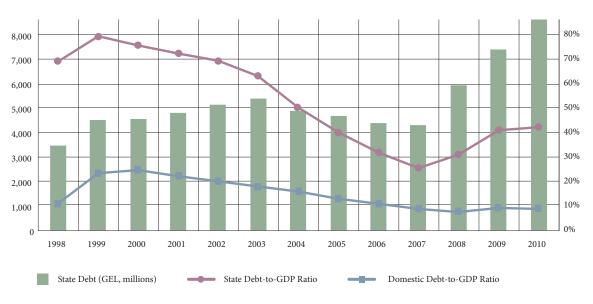
Source: MoF

DIAGRAM 12. Consolidated Budget Deficit and its Ratio to GDP



Source: MoF

DIAGRAM 13. External Debt and its Ratio to GDP

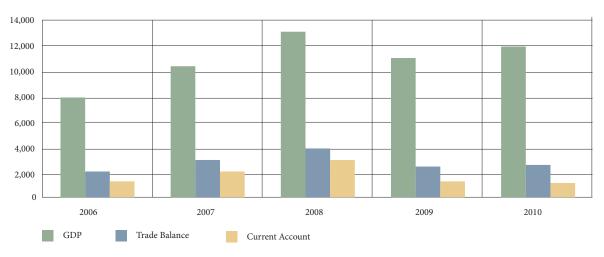


Source: NBG

#### 1.5. EXTERNAL SECTOR AND BALANCE OF PAYMENTS

In 2010 the current account deficit of the balance of payments totaled USD 1,116.5 million, or 9.6% of GDP, declining 7.7% year-on-year. The current account deficit was not only fully financed, but the accumulation of reserve assets took place.

DIAGRAM 14. GDP, Current Account and Trade Balance (USD millions)



Source: NBG, Geostat

The 2010 current account deficit was traditionally determined by the trade deficit. A detailed overview of external merchandise statistics is given below, which is largely based on registered goods data from the customs service<sup>7</sup>.

In 2010 Georgia's external trade turnover totaled USD 6,678.5 million, up 21.1% year-on-year. The trade deficit reached USD 3,511.7 million, exceeding the 2009 level by 8.3%. The registered export of goods rose 39.5% to equal USD 5,095.1 million, while the respective figures for the import of goods were 16.4% and USD 5,095.1 million.

In the total Georgian imports consumer goods accounted for 48.9%, investment goods for 12.4%, and intermediate consumption goods for 38.4%. The structure of imports remained quite stable in the recent years. Petroleum products accounted for 27.9% of total consumer goods imports, while motor cars accounted for 12.4%, medicaments for 7.6%, tobacco products for 3.2%, and meat and meat products for 1.9%.

Georgia's external trade turnover has been permanently increasing since 2009, reaching the maximum level in 2008. As a result of the August military hostilities and the followed global financial crisis, starting from the second half of 2008 both exports and imports started to decline. Along with the economic recovery and an increase in global demand, Georgia's external trade activity was picking up as well. Meanwhile, the growth rate of exports exceeded that of imports. As a result, the registered exports posted a 5.8% growth with respect to the 2008 level, whereas the imports and trade deficit were, respectively, 19.2% and 27.0% lower than in 2008.

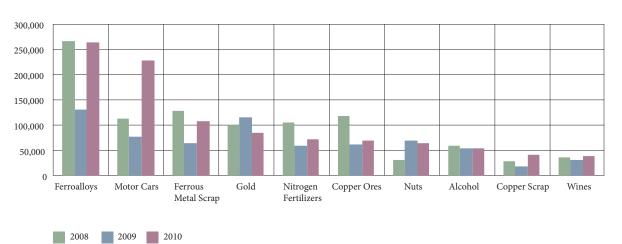
<sup>&</sup>lt;sup>7</sup> External merchandise statistics mainly relies on border crossing principle, while the goods trade component of the balance of payments is based on transfer of property rights between residents and non-residents. There are also other methodological differences.

TABLE 4. Annual Growth Rates

	2006	2007	2008	2009	2010
Exports	8.2%	31.6%	21.4%	-24.1%	39.5%
Imports	47.7%	41.8%	20.9%	-30.6%	16.4%
Trade Deficit	68.8%	45.3%	20.7%	-32.5%	8.3%

Starting from the second half of 2009 signs of global economic recovery and demand expansion emerged, leading to a gradual increase in international prices. These tendencies affected Georgia's external trade as well. As a result, in 2010 prices on principal Georgian export commodities, such as ferrous and non-ferrous metals, rose significantly after a drastic drop in 2009. In the reporting period the price effect was considerable for growth rates of both exports and imports.

DIAGRAM 15. Main Export Commodity Groups, USD Millions

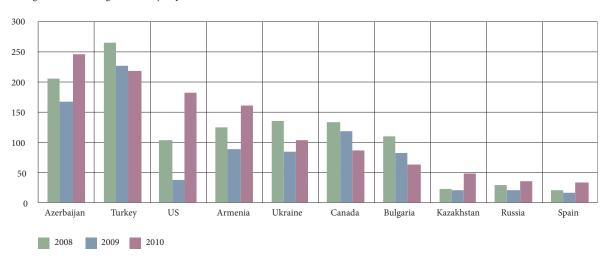


Source: Geostat

In 2010 the structure of Georgian exports did not undergo significant changes. The top position was traditionally held by ferroalloys, with their exports doubling to equal USD 263.9 million. Both physical volumes and prices of ferroalloys went up, as the export price grew 43.6%. The re-export of motor cars followed in the list<sup>8</sup>. The annual growth rate of metal scrap export equaled 71.9%, totaling USD 109.4 million. The export of gold declined 26.2%, moving down to the fourth position. The export of mineral fertilizers followed with a 19.8% annual growth, while the export of natural wines posted a 22.7% annual growth, totaling USD 39.3 million. In 2010 the export of electricity significantly increased due to production growth as a result of hydro power plants' reconstruction, posting an 82.1% annual growth. The export of one of the important industrial commodities, bars and rods of iron or non-alloy steel, amounted to USD 35.5 million, exceeding the 2009 level 14 times.

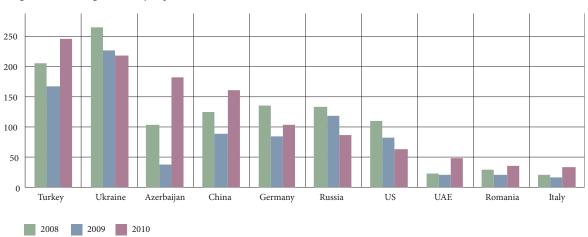
<sup>8</sup> Registered trade did not include cars under warehouse regime, a part of which was later reexported. Starting from 2010 this type of exports is registered, which artificially raises the growth rate of export. Meanwhile, the same cars are not accounted for in imports, decreasing trade deficit.

Diagram 16. Georgia's Main Trading Partners by Exports, USD Millions



Georgia's top 10 trading partners for exports in 2010 accounted for 73.8% of total exports and were ranked as follows: Azerbaijan, Turkey, the USA, Armenia, Ukraine, Canada, Bulgaria, Kazakhstan, Russia, Spain. In terms of imports the top 10 list looked as follows: Turkey, Ukraine, Azerbaijan, China, Germany, Russia, the USA, the UAE, Romania, Italy. The share of these countries in total registered imports equaled 67.9%.

DIAGRAM 17. Georgia's Main Trading Partners by Imports, USD Millions



Source: Geostat

TABLE 5. Distribution of Largest Export Commodity Groups by Countries, %

	Ferroalloys	Motor cars	Ferrous Metal Scrap	Gold	Mineral Fertilizers	Copper Ores	Nuts	Alcohol	Copper scrap	Wines
United States of America	62.2	0.5	0.3	-	6.0	-	0.5	0.1	8.1	2.5
Turkey	9.2	7.3	81.3	-	23.5	-	0.2	-	15.1	0.5
Azerbaijan	1.4	45.9	-	-	-	-	6.2	11.0	-	2.6
Canada	-	-	-	100.0	-	-	0.2	-	-	0.6
Ukraine	5.8	0.6	-	-	-	-	4.1	46.5	-	45.8
Bulgaria	-	0.1	-	-	14.2	71.7	0.2	-	-	0.2
Armenia	-	23.9	-	-	3.7	-	1.0	1.7	-	0.8
Kazakhstan	-	9.9	-	-	-	-	0.2	9.5	-	15.1
Spain	-	-	1.5	-	10.6	28.3	2.8	0.2	0.4	-
United Arab Emirates	-	1.1	9.6	-	-	-	0.4	-	18.5	-
Germany	1.6	0.1	0.7	-	-	-	20.6	-	0.4	1.4
Belgium	-	8.3	0.1	-	-	-	1.5	-	1.6	-
China	-	-	0.6	-	-	-	6.2	0.1	27.4	1.8
Belarus	2.7	-	-	-	-	-	0.2	9.0	-	10.0
Netherlands	2.5	-	0.7	-	-	-	1.7	7.6	1.4	1.1
Italy	1.2	-	-	-	3.4	-	9.5	-	2.9	-
Egypt	3.8	-	-	-	-	-	0.1	-	-	-
Japan	2.8	-	-	-	-	-	-	-	-	0.4
France	-	-	-	-	8.0	-	2.6	-	-	-
Iraq	-	-	-	-	-	-	10.7	-	-	-
Other	6.6	2.2	5.1	-	30.6	-	31.2	14.4	24.3	17.2
Total	100	100	100	100	100	100	100	100	100	100

In 2010 a significant part of Georgian imports was still held by petroleum products, as the latter registered a 25.1% annual growth rate. The growth was largely conditioned by an increase in international prices. The petroleum products accounted for 13.6% of total imports. The import of motor cars, occupying the second position and accounting for 6.1% of imports, posted an annual growth of 21.6%.

In 2010 the import of food products constituted 14.5% registered imports of goods. Wheat and other grains accounted for 24.9% of food products (3.6% of total imports). The expenses on food import grew 64.9% per annum, triggered by world price gains. In the list of food import the wheat was followed by sugar and confectionery (12.1% of food imports) with a 42.8% annual growth rate, and by meat products (10.0% of food imports). The import of tobacco and alcoholic beverages accounted for 1.9% of total registered imports, posting a 23.8% year-on-year growth.

DIAGRAM 18.

Dynamics of Largest Import Commodities, USD Millions

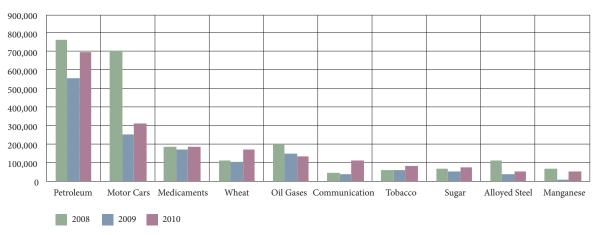


TABLE 6. Distribution of Largest Import Commodity Groups by Countries, %

	Petroleum Products	Motor Cars	Medicaments	Wheat and Meslin	Petroleum Gases	Transmission Apparatus for Radio-telephony	Nuts	Alcohol	Copper scrap	Wines
Azerbaijan	42.9	0.2	0.3	-	58.3	-	-	13.2	-	-
Ukraine	1.4	0.1	5.6	11.2	0.8	0.1	84.3	-	89.2	3.1
Russian Federation	3.8	0.3	2.0	38.9	33.2	0.6	1.1	-	-	-
Romania	17.1	-	1.0	1.9	-	2.8	-	-	-	-
Germany	0.8	23.1	8.8	-	-	12.8	3.5	0.3	0.2	-
Bulgaria	12.4	0.4	4.2	-	-	-	4.5	-	-	-
United States	0.1	27.1	3.1	0.8	-	1.5	-	-	-	-
Kazakhstan	0.1	0.1	0.3	40.5	0.7	-	-	-	-	6.8
Turkey	1.2	1.2	20.2	1.9	1.6	8.3	-	-	10.2	1.0
Japan	-	22.0	0.1	-	-	-	-	-	-	-
Turkmenistan	8.3	-	-	-	-	-	-	-	-	-
Brazil	-	-	-	-	-	-	-	60.9	-	3.5
United Arab Emirates	-	5.7	-	-	0.1	26.0	-	-	-	-
Greece	6.0	0.2	0.2	-	-	-	0.3	-	-	-
Italy	4.1	0.9	0.9	-	-	-	-	-	-	-
Australia	-	-	-	-	-	0.1	-	-	-	53.8
China	-	0.1	0.1	-	-	23.5	-	-	-	0.3
Netherlands	0.3	3.5	3.6	-	-	3.2	0.2	-	-	-
France	-	1.0	7.5	-	-	0.2	-	1.4	-	-
Belgium	0.1	3.7	3.1	-	-	0.1	-	-	-	-
Other	1.4	10.4	38.9	4.7	5.4	20.9	6.0	24.2	0.4	31.4
Total	100	100	100	100	100	100	100	100	100	100

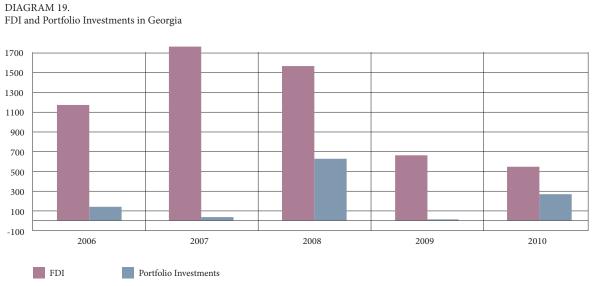
Source: Geostat

The level of current account deficit in 2010 (9.6% of GDP) is the lowest since 2005. Despite the fact that the trade deficit deteriorated by 7.0% in annual terms, larger increases in positive balances of services and current transfers overweighed that adverse effect. The trade balance manifested an increase in both exports and imports, although the growth rate of exports was higher than that of imports. Compared to 2009, the export/import coverage ratio increased 10.9%, amounting to 48.9%. Meanwhile, the balance of services, which has always played a significant role in financing trade deficit, equaled USD 534.4 million in the accounting period. Tourism should be noted particularly, posting an annual growth of 56.3% and totaling USD 460.2 million.

The income balance has been negative since 2008, as its negative component, investment revenues (expenses), exceeded the positive component – labor income. In 2010 the deficit of income balance widened by 55%, reaching USD 182.9 million. This included an 8.0% decline in labor income and a 7.6% rise in investment revenues (expenses).

The current transfers represent the largest positive component of the current account. In 2010 the positive balance of current transfers covered 42.8% of trade deficit. The annual growth of current transfers equaled 13.7%, totaling USD 1,099.2 million. The government transfers accounted for 15.9%.

In 2010 the positive balance of the capital and financial account equaled USD 1,079.5 million, down 6.9% year-on-year. The financial account declined by USD 103.0 million, while the capital account showed a modest growth equal to USD 23.2 million. The financial account balance dropped 10.5% in 2010 to USD 873.8 million due to a contraction of foreign inflows. The foreign direct investments in Georgia declined 17.7% in 2010, totaling USD 542.9 million. Agriculture accounted for 1.9% of FDI, industry for 16.4%, while different types of services accounted for the remaining part, of which transport and communication enjoyed the largest share of 35.1%.In 2010 the portfolio investment liabilities grew by USD 267.7 million, of which the Georgian Railway-issued bonds accounted for 97.5%.



Source: NBG

The net value of other investment decreased by 70.6% in 2010 and amounted to USD 271.0 million. Other investment assets grew by USD 371.9 million in the accounting period. This included a USD 288.7 million increase in cash and deposits, largely representing receipts from issuance of Georgian Railway bonds. The growth of trade credits and other investment assets amounted to USD 41.9 million.

Operations related to other investments' liabilities and FDI loans conditioned a rise in external debt. The latter grew by USD 1,003.9 million in the accounting period, reaching USD 9,664.9 million as of December 31, 2010. The volume of official international reserves grew by USD 208.0 million.

TABLE 7. Georgia's Balance of Payments in 2006-2010, USD millions

	2006	2007	2008	2009	2010
Current Account	-1,175.2	-2,009.9	-2,912.4	-1,210.1	-1,116.5
Goods	-2,019.4	-2,895.8	-3,833.2	-2,399.0	-2,567.1
Credit	1,666.5	2,088.3	2,428.0	1,893.6	2,459.8
Debit	-3,685.9	-4,984.1	-6,261.2	-4,292.6	-5,026.9
Services	157.8	161.2	21.0	339.7	534.4
Credit	885.1	1,094.1	1,260.5	1,313.6	1,601.6
Debit	-727.2	-932.9	-1,239.4	-973.9	-1,067.2
Income	162.4	36.3	-160.5	-117.6	-182.9
Credit	341.2	481.6	494.2	422.7	416.1
Debit	-178.8	-445.4	-654.7	-540.3	-599.0
Current Transfers	523.9	688.5	1,060.4	966.8	1,099.2
Credit	587.0	768.5	1,142.0	1,037.9	1,184.5
Debit	-63.0	-80.0	-81.7	-71.0	-85.4
Capital and Financial Account	1,239.8	2,045.0	2,948.6	1,159.3	1,079.5
Capital Account	171.2	127.9	112.3	182.5	205.7
Credit	172.2	128.3	112.4	182.6	205.8
Debit	-1.0	-0.3	-0.1	-0.1	-0.2
Financial Account	1,068.7	1,917.1	2,836.3	976.8	873.8
Direct Investment	1,185.9	1,673.9	1,494.1	659.5	542.9
To abroad	15.8	-76.3	-70.0	1.1	-5.9
From abroad	1,170.1	1,750.2	1,564.0	658.4	548.8
Portfolio Investment	140.3	21.0	626.6	12.1	267.1
To abroad	-2.2	-12.7	0.7	-1.1	-0.6
From abroad	142.5	33.6	625.9	13.2	267.7
Financial Derivatives	0.0	1.1	7.8	0.6	0.8
Assets	0.0	1.2	11.1	1.1	1.7
Liabilities	0.0	-0.2	-3.3	-0.5	-1.0
Other Investment	181.1	598.2	838.6	921.1	271.0
Assets	-56.5	-202.1	-266.5	191.5	-371.9
Liabilities	237.6	800.2	1,105.2	729.7	642.9
Reserve Assets	-438.6	-377.0	-130.7	-616.4	-208.0
Net errors and omissions	-64.6	-35.1	-36.3	50.7	37.0
Total Exceptional Financing	116.2	179.1	1,015.5	388.9	496.6

Source: NBG

#### 1.6.1. CAPITAL MARKET

The securities market in Georgia is represented by the Georgian Stock Exchange, which has been operating since 1999 and providing investment opportunities to domestic and foreign investors. As of December 31, 2010, daily trade turnover averaged GEL 16.6 thousand, whereas the complete market capitalization of securities totaled GEL 1.9 billion. The Georgian Stock Exchange index (GSX) ended the year at the 121.7 mark, up by 47.0 points relative to the beginning of the year. It should be noted that following a 2008 downturn the index has been on the uptrend. This is partially due to a higher level of activity in the market, with the number of transactions increasing by 1331 to equal 3207. The total value of these transactions reached GEL 101.2 million, up GEL 2.76 million compared to 2009. Commercial banks' active participation in trading sessions should be pointed out; in particular, "VTB Bank", "Bank of Georgia", and "Liberty Bank" accounted for 92.6% of total transactions value. However, the share of fixings (transactions concluded outside trading sessions) still remains high at almost 95%.





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Similar to the GSX index, the ratio of securities market capitalization to GDP continues to rise, amounting to 9.2% of GDP by end-2010 (vis-à-vis 6.8% in 2009). This is higher than in some countries within the region but much lower than in the developed EU countries (60% on average) and emerging Asian countries (150% on average).

<sup>&</sup>lt;sup>9</sup> Securities capitalization is the product of the current securities price (closing price at the last trading session) and the total amount of issued or placed securities.

TABLE 8. Ratio of Market Capitalization to GDP in Georgia, %

2005	2006	2007	2008	2009	2010
5.5	8.6	13.7	2.6	6.8	9.2

Source: GSE

#### 1.6.2. DOMESTIC FX MARKET

In 2010 commercial banks purchased USD 6.738 million and sold USD 6.487 million. The euro trading operations were relatively modest: EUR 1.379 million and EUR 1.372 million, respectively. At the FX auctions, representing the only means for the NBG to intervene in the interbank FX market, the annual turnover totaled USD 457.2 million, falling behind the 2009 level by almost USD 45 million. Meanwhile, the NBG tended to sell foreign currency in the first half of the year but largely purchased foreign currency in the second half (See Diagram 21).

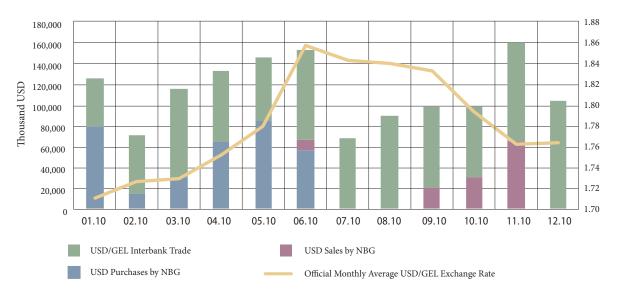
The interbank operations in the FX market have been conducted through the Bloomberg international trading system since 2009. The system proved to be a modern reliable electronic platform, through which banks conducted FX transactions in a simple and riskless way. During 2010 97% of total interbank FX transactions were conducted through the Bloomberg trading system. The number and volumes of interbank FX transactions increased. Participation of the NBG was still limited to periodical FX auctions, also conducted through the Bloomberg trading system. In addition, in 2010 the Bloomberg company considerably improved the software for the purposes of the Georgian FX market.

In FX trading between commercial banks and other economic agents a significant share is traditionally held by operations related to legal entities<sup>10</sup> (46.5% of purchases and 51.9% of sales). A particular attention should be paid to USD/GEL transactions between commercial banks, playing an important role in determining an official daily exchange rate. In particular, determination of the lari's exchange rate against other foreign currency the NBG takes into account transactions registered in the Bloomberg trading system. Determination of the official exchange rate is effected through calculating an average weighted value of spot USD/GEL transactions only. The exchange rate with respect to other currencies is established through existing cross-rates in the international markets of in the domestic FX markets of issuer countries.

During 2010 the trading system registered 2,671 transactions on the USD/GEL currency pair in the value of USD 906.3 million, accounting for approximately 80% of the total interbank FX currency turnover. To compare, in 2009 the latter indicator equaled 69.6%. In addition, the intensity of daily transactions increased from 5-6 to 7-8. All these facts indicate that the interbank FX market assumes higher importance in foreign currency trading. This tendency is fully in lines with the NBG's objective to ensure a dominant role of market mechanisms in exchange rate determination.

<sup>10</sup> Excluding commercial banks.

DIAGRAM 21. Dynamics of USD/GEL FX Trade in 2010



Source: NBG

After introduction of the FX auctions the NBG's participation in the FX market essentially declined and the exchange rate flexibility increased. A short-term exchange rate became unpredictable playing a positive role in reducing speculative expectations. Further development of the FX market requires development of FX risk hedging mechanisms. Low development level of FX risk hedging instruments, financial derivatives and other market attributes is the result of low consumer demand. Thus, development of financial derivatives market requires dissemination of information among market participants with respect to risk hedging mechanisms – the area in which commercial banks along with the NBG play an important role. The NBG's goal for the following years consists in developing the forward FX market.



# MONETARY AND EXCHANGE RATE POLICIES

#### 2.1. MONETARY POLICY

In designing the 2010 monetary policy the NBG followed the main objectives and functions stipulated in Article 3 of the Organic Law of Georgia "On the National Bank of Georgia", according to which "the primary objective of the NBG shall be to ... maintain price stability". The NBG's focus on price stability is based on a widely recognized fact that low and predictable inflation is a necessary prerequisite for long-run economic growth. At the same time, it should be noted that the Organic Law assigns the NBG to ensure stability and transparency of the financial system and promote sustainable economic growth in the country unless it jeopardizes accomplishment of the primary objective. Thus, in 2010 the monetary policy was again focused on price stability, while also serving to improve investment environment, protect population's incomes from losing purchasing power, and promote long-term potential GDP growth.

The NBG conducted the 2010 monetary policy in conformity with the resolution of the Parliament of Georgia "On Main Directions of 2010-2012 Monetary and Exchange Rate Policies". Starting from 2009 the NBG moved to a new monetary policy regime – inflation targeting. This regime implies announcement of a clear inflation target, representing a desirable level of inflation for the economy. For 2010-2012 the NBG set the medium-term target at 6% growth of consumer price index. In case the actual inflation exceeds the target, the NBG will tighten monetary policy, while monetary policy loosening will be applied in the opposite case.

As it was already mentioned, at the current stage of economic development the annual level of the medium-term inflation target for 2010-2012 was set at 6%. The NBG took into account that in case of exogenous factors (independent from monetary policy), it was possible for the actual inflation to deviate from the inflation target. Meanwhile, if the deviation level was significant enough to potentially affect such a fundamental factor as inflationary expectations, the NBG would respond with monetary policy loosening (or tightening).

In 2010 the NBG's monetary policy was based on the analysis of macroeconomic environment, processes taking place in the international markets, and political and economic situation within the country. Price dynamics and government policies in trading partner countries, existing tendencies in the financial and FX markets, prices movements in the international commodity markets, peculiarities of the CPI basket and monetary transmission mechanisms were taken into consideration, conditioning formation of inflationary expectations and increasing population's trust of the domestic currency.

In early 2010 the annual inflation oscillated in the targeted range. However, starting from July the inflation rate rose significantly as a result of a number of factors. First of all, due to bad weather conditions the last year's crops were particularly unfavorable in the whole region, essentially limiting supply of agricultural products to the market and pushing the price level upwards. The supply shortage increased demand for Georgian agricultural products on the part of the other regional countries (Armenia, Azerbaijan). This stimulated Georgian export of agricultural products, which is a clearly positive fact, but, on the other hand, an increased demand led to price gains on agricultural products. In addition, the developments in the international markets exerted a significant impact on consumer prices. In summer 2010 regional

droughts and fires in Russia spoiled a large share of wheat harvest. In response to that the wheat exporter countries – Russia, Ukraine, and Kazakhstan – fully banned or essentially limited wheat export, conditioning a drastic price increase in the region. It should be pointed out that Georgia being largely dependent on wheat import used to fully purchase wheat within the region. A forced change of markets increased transportation and logistical expenses. This coincided with spoiled wheat harvests in Brazil and Australia due to floods. As a result, wheat prices reached a record high level in the world market, accompanied with significant price gains for sugar. The wheat price gains in turn pushed up international prices on wheat substitutes and complements (cereals, sunflower, beef, chicken eggs, etc.)

In parallel to high economic growth in the Asian countries, demand for fuel was increasing, conditioning fuel price gains and exerting additional pressure on food prices.

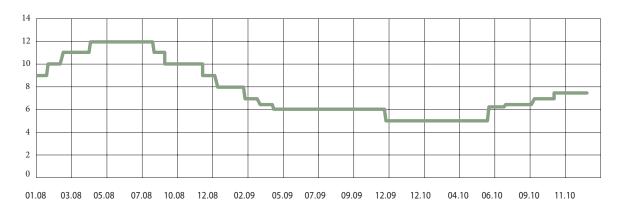
The processes described above were accordingly reflected in the Georgian consumer market, conditioning a significant increase in food prices from August 2010. As a result, the annual inflation rate grew from 3.7% in June to 11.2% at end-year. It should be noted that the impact of food products accounted for 9.5 pps in the annual inflation. Inflation rate for other components of the consumer basket oscillated in a moderate range, with the exception of alcoholic beverages and tobacco products, where large price increases were caused by raised excise taxes. At the same time, the prices on services rose only 1.5%, indicating weak demand pressure on prices.

It is remarkable that in the second half of the year the growth of inflation was caused by factors independent from monetary policy. The impact of monetary policy on such factors is limited, and central banks therefore do not react to such shocks. However, if the effect of these shocks is large enough to affect fundamental factors of inflation, in this case it is necessary to make an appropriate response. Although the increase in inflation taken place in the second half of the year was mainly the result of exogenous factors, high inflation, and especially food price gains, creates inflationary expectations among the population, which represents one of the primary determinants of inflation. Thus, high food prices may induce strengthening of inflationary pressure due to increased expectations.

With the purpose of curbing inflationary expectations and avoiding additional demand pressure on prices, the NBG started monetary policy tightening from June 2010. The monetary policy rate stood at 5% at that time. The Monetary Policy Committee at the June 24 meeting decided on a policy rate hike by unprecedented 125 basis points, raising the policy rate by additional 25 basis points at the next meeting up to 6.5%. It should be noted that a policy rate hike has a certain time lag before it is reflected in the loan interest rates. In these circumstances the effect of monetary policy tightening on the real economy was visible around August, when lari-denominated loan interest rates began to rise. In the same period the growth rate of loans in domestic currency declined.

The global developments occurred in August and September, price gains for food and fuel, increased medium-term risks affecting inflation in the world as well as in our region and in Georgia. Owing to this fact, the necessity of further monetary policy tightening arose, and the NBG increased the policy rate in September and October to the ultimate level of 7.5%. This policy change after a certain period was translated into a decline in lari-denominated loan interest rates and a slowdown in the growth rate of lari-denominated loans.

DIAGRAM 22. Monetary Policy Rate



It should be pointed out that by altering the monetary policy rate the NBG affects only prices related to lari-denominated assets. At the same time, the largest part of banks' crediting is effected in foreign currency. Thus, a policy rate hike made the lari-denominated loans more expensive, but this practically did not affect loans denominated in foreign currency. As a result, the interest rate differential for loans extended in domestic and foreign currency widened. Commercial banks stopped crediting in lari but started to expand their foreign currency denominated credit portfolio. Thus, it became necessary to spread the policy tightening measures to foreign currency loans as well.

In order to regulate interest rates on foreign currency loans, the minimum reserve requirements should be pointed out from the list of instruments available for the NBG. The increase in reserve requirements for funds mobilized in foreign currency makes resources in foreign currency more expensive and, consequently, induces an increase in loan interest rates. In order to extend the effect of policy tightening to foreign currency loans, starting from September 2010 the amendments to the "Rule on Calculation and Observance of Minimum Reserve Requirements of Commercial Banks" became effective, according to which funds borrowed from non-residents become subject to reserve requirements. Prior to that non-resident borrowings were exempt from reserve requirements. By the end of 2010 along with the existing inflation risks and expansion of foreign currency loans, the further policy tightening with respect to foreign currency loans became necessary. As a result, in December the Monetary Policy Committee made a decision on gradually increasing the reserve requirements for foreign currency liabilities from 5% to 15%. This regulation became effective since 2011. It should be noted that prior to the 2008 crisis foreign liabilities (except funds borrowed from non-resident banks) were subject to 13% of reserve requirements.

Similar to the preceding years, in 2010 one of the main directions of the NBG's activities represented an increase of monetary policy efficiency, for which the main hindering factor was high dollarization of the Georgian economy. Under high dollarization the interest rate transmission mechanism is weak, since a significant part of money supply is given in foreign currency, for which the interest rates are defined by central banks of other countries bypassing the NBG's sphere of influence. High dollarization increases exchange rate transmission to inflation, limiting exchange rate flexibility; in particular, the nominal exchange rate depreciation is transmitted to prices and, as a result, the real exchange rate remains unchanged. In

addition, the exchange rate risk should be indicated, which always accompanies high dollarization, especially for bank borrowers who took a loan in foreign currency while having their incomes in domestic currency. In this case changes in the lari's exchange rate can affect commercial banks' credit portfolio. Thus, a reduction in dollarization was one of the primary objectives of the NBG in 2010. However, a dollarization decline represents a long-term goal, and its resolution in a one-year period is impossible. Accordingly, the NBG's efforts were focused on developing the lari money market and providing incentives for crediting in lari, which should play an important role in reducing dollarization in the future.

With the purpose of increasing efficiency of monetary policy the NBG conducted a number of activities. These included:

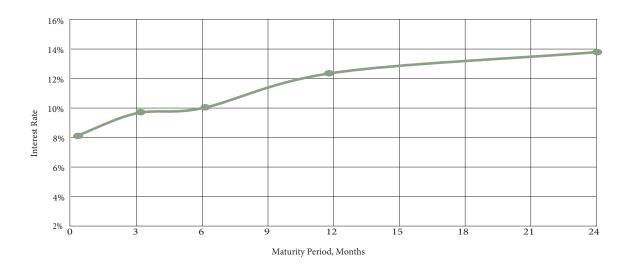
- An increase of reserve requirements on lari-denominated funds from 5% to 10%. This resulted in higher demand for short-term liquidity enhancing interbank money market activity. Besides, the monetary policy rate is accrued to the increased reserves. Accordingly, it does not represent additional burden for commercial banks.
- With the purpose of increasing the banking sector's confidence in refinancing loans and stimulating their use, the NBG introduced a new instrument standing refinancing loans. Banks can take these loans without auction procedures at the monetary policy rate + 1 pp. This instrument reduced loan refinancing risk for banks, and the use of refinancing loans grew more active. To a certain extent this supported lari-denominated loans as well. Increased demand for lari denominated loans gives incentives to commercial banks to be more active in the domestic market in terms of attracting deposits in domestic currency, conditioning decline in dollarization.
- The minimum reserve requirements for foreign currency denominated loans increased as well. At the
  first stage in September 2010 the NBG obliged banks to provision for external borrowings, while by the
  end-year it decided to raise the reserve requirements for foreign currency liabilities from 5% to 15%.
  The latter measure became effective in January-February 2011.
- In order to reduce fluctuations of the market interest rates, overnight loans and deposits were introduced with the interest rate band equaling the policy rate +/- 1.5 pps. One of the factors hindering money market development represents volatile interest rates. When market interest rates are characterized with high volatility, banks struggle to forecast expected interest rates and rely less on money market for the purposes of short-term liquidity management. Therefore, in order to promote money market development the NBG found it important to reduce interest rate volatility at the interbank money market. After introduction of these changes the interest rate volatility in the interbank market declined, and the interbank interest rate moved closer to the policy rate.
- A collateral base used for refinancing loans was expanded with commercial banks' loan portfolio and/ or guarantees of international organizations.
- New payment and state securities settlement systems were put into operation. This reduced operational
  risks related to payments and completely eliminated them in the case of state securities settlement, enhancing development of money and securities markets. Exchange rate policy oriented to free floating
  regime hampers formation of short-term expectations, reducing speculative pressure on the FX market
  and supporting medium- and long-term stability of the lari.
- In terms of securities market development an important step represented issuance of 2-year Treasury notes by the government.

More detailed description of these instruments is given in Subchapter 2.2 on Monetary Policy Instruments.

Money market development is crucial for improving the monetary policy transmission mechanism. By introducing the above-mentioned changes aimed at promoting lari-denominated loans, the money market showed demand for short-term liquid funds. Emergence of demand stimulated the short-term interbank money market, registering an increase in the number and volume of transactions. The interbank interest rate moved closer to the policy rate, ultimately allowing the NBG to be in control of short-term interest rates, as the latter represent a necessary prerequisite for the effectiveness of the monetary transmission mechanism.

Changes in short-term interest rates should be transmitted to longer-term interest rates and, ultimately, to loan interest rates. The relationship between interest rates with different maturity is expressed by the yield curve.

DIAGRAM 23. Yield Curve



Source: NBG

In a developed money market the interest rate differential reflects only the interest rate risk. In early 2010 the Georgian yield curve was steep, as the interest rate difference included not only short-term expectations, but also operational and liquidity risks. The monetary policy tightening applied by the NBG was duly reflected in the yield curve. As a result of introducing refinancing loans and expanding the securities market (through Certificates of Deposit, as well as Treasury bills and Treasury notes), the money market liquidity risk decreased, leading to yield curve flattening. At the same time, moderate changes in the monetary policy rate reduced expectations of abrupt movement of short-term interest rates, also contributing to a yield curve flattening. Despite the fact that in September and October 2010 the NBG increased the refinancing rate as the measure of monetary policy tightening, money market development and market risk mitigation caused the long-term interest rates to decline in the second half of the year. This resulted

in a yield curve flattening, indicating an increased effectiveness of the monetary transmission mechanism.

In 2010 the respective growth of M2 and M3 multipliers equaled 13.9% and 19.9%. The economy monetization rate also increased. In particular, the monetization rate with respect to GDP amounted to 30.2% and 13.2% for the M2 and M3 aggregates, respectively. The economy monetization was driven by the budget deficit, on the one hand, and banks' crediting, on the other. The ratio of budget deficit to GDP in 2010 equaled 6.8%. Income growth of the population dependent on government finances contributed to the rising monetization. Banks' crediting of the economy during the year expanded approximately 20%.

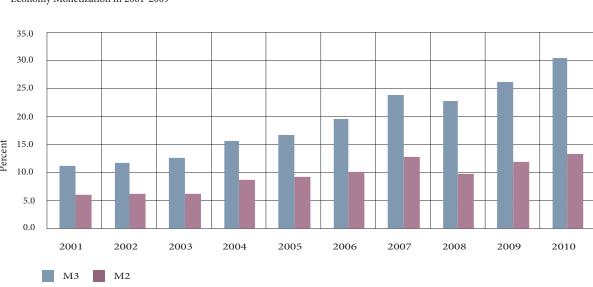


DIAGRAM 24. Economy Monetization in 2001-2009

Source: NBG

As it was already mentioned, in 2010 the dynamics of inflation was essentially affected by exogenous factors, mainly reflected in price gains for food and fuel. Due to the above, the NBG calculated core inflation indices by excluding different components from the consumer basket. These indices indicated weak demand pressure on prices.

Thus, it can be said that in early 2010 the NBG's primary concern was related to pulling the economy out of recession and increasing the monetary policy efficiency. In the second half of the year the inflation rate rose significantly, largely due to external factors on which the NBG's influence was limited. Therefore, the NBG's task was to neutralize second-round inflation effects and avoid inflationary spiral. To tackle this challenge the NBG applied monetary policy tightening to curb inflationary expectations.

### 2.2. MONETARY POLICY INSTRUMENTS

In 2010 the monetary policy of the NBG was conducted in conformity with the decisions of the MPC. The monetary policy rate defined by the MPC represented an operational target – short-term interest rate, attainment of which is necessary for maintaining price stability. The operational framework was used for this purpose, representing a unity of monetary instruments and guidance related to their use. The operational framework determines the possibility of attaining the desired interest rate level through the

available instruments. In 2010 the NBG's operational framework included the following monetary instruments: refinancing loans, overnight loans, overnight deposits, certificates of deposits and minimum reserve requirements.

As a result of the NBG's policies the efficiency of the interest rate transmission mechanism increased in 2010. The excess liquidity in the banking sector declined, leading to an increased activity in the money market. Starting from the second half of the year, daily turnover and interest rates at the interbank market increased. The overnight interest rate TIBR1 oscillated within 2-4% in January-May 2010, rising to 6-7.5% in the following part of the year. Concurrently, demand for refinancing loans was increasing, and the market interest rate moved closer to the monetary policy rate.

Based on short-term liquidity forecast in the banking system and in line with the MPC decisions, the NBG determined the volume of weekly issuance of refinancing loans with the view of bringing the average interbank interest rate closer to the monetary policy rate.

#### 2.2.1. REFINANCING LOANS

In order to supply the banking system with short-term liquidity, the NBG introduced the refinancing loan instrument from 2008. Through refinancing loans the banking sector received access to a reliable and low-risk source of short-term liquidity, which positively affected the money market and financial stability. By means of auctions the minimum interest rate on refinancing loans represented the monetary policy rate.

In early 2010 banks' confidence of this instrument was weak, as banks feared that they might not receive a desired amount through the auctions and preferred to accumulate excess liquidity instead. To address this problem the NBG put into operation a new instrument, standing refinancing loans, allowing the banks to obtain a guaranteed refinancing loan against proper collateral. The interest rate on this type of loans is defined as the policy rate + 1 pp. By introduction of this instrument the NBG practically created a guaranteed mechanism for banks to finance short-term liquidity needs through refinancing loans, implying that the banks were still guaranteed to obtain a refinancing loan even they fail to obtain one through the auction, albeit at a higher (penalty) interest rate. At the same time, it was expected that there would not be high demand for this instrument, as banks would satisfy their short-term liquidity requirements through refinancing loan auctions, and the permanent refinancing loans would represent a certain insurance mechanism. These expectations proved to be true, as the introduction of the new instrument led a an increased demand at the refinancing loan auctions, while the standing refinancing loans were used by banks only in rare cases.

The maturity period of standing refinancing loans is identical to the ordinary refinancing loan extension and repayment period. Refinancing loans were extended at collateral in the form of NBG's Certificates of Deposit, T-bills and T-notes of the Ministry of Finance.

DIAGRAM 25. Liquidity Supply through Refinancing Loans in 2010



#### 2.2.2. OVERNIGHT LOANS AND OVERNIGHT DEPOSITS

In order to enhance money market development, reduce interest rate volatility, and increase money market activity, starting from April 2010 the NBG introduced an interest rate band in the interbank market, bringing the interbank market interest rate within a stable range. The interest rate band was defined as an equal deviation from the monetary policy rate with the view of forming lower and upper interest rate limits. The upper limit was used by the NBG for overnight loans, while the lower limit – for overnight deposits. In April 2010 the band length equaled 4 pps, (monetary policy rate +/- 2 pps), while starting from December 2010 it was narrowed to 3 pps (monetary policy rate +/- 1.5 pps). The interest rates on overnight loans and deposits were changing in line with policy rate change, accounting for the existing length of the interest rate band. After these changes the interest rate volatility in the interbank market decreased considerably and the interbank interest rate moved closer to the policy rate.

The NBG's overnight loans represented the swiftest way of obtaining instant liquidity for the banking sector. However, it was available at a price higher than the existing market interest rate, which in turn encouraged banks to seek financial resources at lower cost. To a certain extent this played a positive role in further stabilizing short-term interest rates in the money market, although demand for these instrument remained low. The reason of that represented popularity of refinancing loans, which became a much more flexible and comprehensive means of short-term liquidity management in the banking sector. In 2010 the number of overnight loan transactions equaled 14.

Introduction of overnight deposits allowed commercial banks to place excess lari liquidity (available on correspondent accounts) on the NBG's overnight deposits. These funds returned back to correspondent accounts the next day. This instrument played an essential role in stabilizing interbank interest rates.

# 2.2.3. EXPANSION OF COLLATERAL BASE FOR MONETARY OPERATIONS

In 2010 legislative changes were made, according to which the NBG expanded the collateral base for monetary operations, further enhancing effectiveness of its monetary policy instruments. In taking a loan from the NBG, the banking sector representatives can now use as collateral, in addition to securities, their loan portfolio and/or guarantees given by international organizations. The appropriate criteria for using collateral were defined by the NBG.

# 2.2.4. CERTIFICATES OF DEPOSIT

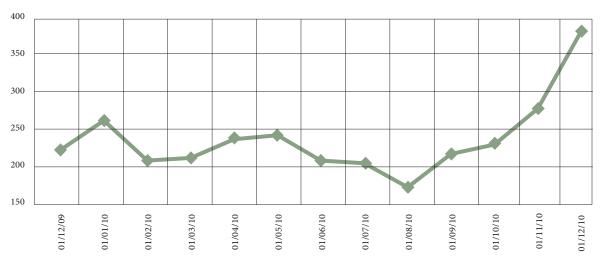
In 2010 the NBG continued issuance of Certificates of Deposits. These securities enjoyed high demand along with the T-bills and T-notes of the Ministry of Finance. The CDs circulated in the 3-month maturity segment, while the government securities had maturity period from 6 to 24 months. These securities contributed to formation of a stable yield curve. The yield curve provided important information on interest rates for different maturity periods as well as on expectations of market participants. According to the yield curve, spreads on long- and short-term interest rates were narrowing during the year, indicating an increase in market efficiency.

Taking into account inflationary trends and the existing situation in the money market, in line with the MPC's decisions, the maximum interest rate was established for the CDs. In 2010 the latter equaled the monetary policy rate +3 pps. In the second half of the year interest rates established at the CD auctions increased moving closer to the maximum interest rate. The weighted average interest rate on the CDs amounted to 7.64%. The CD placement ratio showing the proportion of actual placement to planned issuance equaled 0.88 (at 12 auctions placement was lower than the announced issuance), while the demand rate, showing the ratio of demand to announced issuance equaled 1.79.

In 2010 the purchases of CDs were positive at each of 52 announced auctions. The total placement value of CDs equaled GEL 946 million, while the repayment value amounted to GEL 806 million. As a result, the volume of securities in circulation grew from GEL 220 million to GEL 360 million. The average number of commercial banks participating in the CD auctions equaled 5.

In the accounting period 8 transactions with CDs were registered in the secondary market in the total value of GEL 12.5 million.





Source: NBG

# 2.2.5. TREASURY BILLS AND TREASURY NOTES

In order to promote money market development it was crucial to continue issuance T-bills of the Ministry of Finance. Starting from 2010 the Ministry of Finance resumed issuance of Treasury bills, 6-month and 1-year discounted securities, and started issuance of 2-year Treasury notes, medium-term coupon securities.

T-bills and T-notes are sold through the NBG's auctions using a multiple price method by means of the Bloomberg trading system. All licensed commercial banks and any legal entities or individuals through these banks are eligible to participate in the auctions. The securities may have a nominal holder – market intermediary, who received the right to dispose of, purchase, sale, and pledge these securities on the basis of a written agreement with the owner recorded in the T-bill registrar. The face value of a T-bill is GEL 1,000.

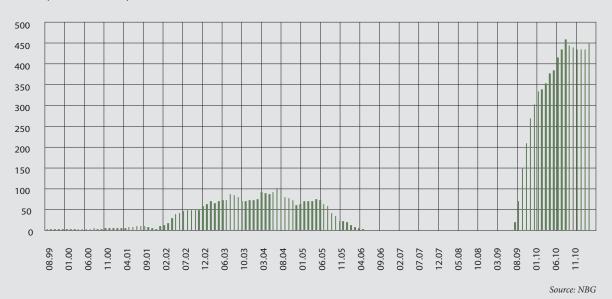
The overall face value of securities issued by the MoF equaled GEL 608 million, including GEL 160 million worth of long-term securities. During the year the nominal repayment value of securities totaled GEL 422 million, increasing the stock of Treasury securities in circulation to GEL 456 million. The weighted average interest rate equaled 7.49% for 6-month T-bills, 10.31% for 1-year T-bills, and 13.94% for 2-year T-notes. In 2010 14 transactions worth of GEL 81 million were concluded in the secondary securities market between commercial banks, of which 3 transactions in the amount of GEL 4.5 million involved T-bills.

The total portfolio including T-bills, T-notes, and CDs reached GEL 816 million, or 3.9% of GDP. It should be noted that the value of securities relatively to the size of economy is quite small. In order to increase market liquidity it is important to expand issuance of Treasury securities, as that would also decrease risks related to contraction of external debt for deficit financing purposes.

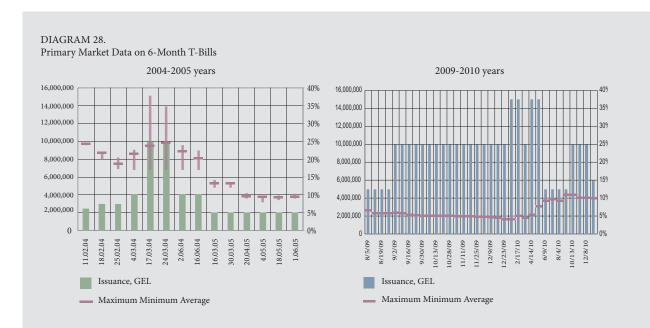
# BOX 1. DEVELOPMENT OF SECURITIES MARKET

After halting emission of securities in June 2005, the government of Georgia resumed issuance of T-bills with up to 1-year maturity in 2009, introducing 2-year Treasury notes in 2010. In terms of securities market development significant positive changes were made in 2009-2010. By end-2010 there were 6-month and 1-year T-bills and 2-year T-notes in circulation. The average maturity of T-bills and T-notes by end-2010 was 10 months. To compare, the same indicator equaled 6 months in 2005, as there were only T-bills with less than one year maturity in circulation. The volume of T-bills and T-notes in circulation exceeds the pre-July 2005 level 4.5 times.

DIAGRAM 27. Treasury Bills and Treasury Notes, GEL Millions



In 2010 banks' interest in purchasing securities was high, showing demand for securities at the auctions to exceed supply more than 2 times. Due to high demand relative to 2004-2005, the interest rates on 6-month T-bills at the primary market were more predictable and thus interest rate drastic volatility was avoided. It should also be noted along with a decline in interest rate volatility the average interest rates on 6-month and 1-year Treasury bills were significantly lower than in 2004-2005.



With the purpose of further development of securities market, at the initiative of the NBG, in 2010 all Georgian commercial banks agreed on and signed the "Master Repo Agreement", in line with international practice. In addition, the development of infrastructure related to primary and secondary securities markets continued through installation of the Bloomberg e-trading system and the new high-technology CSD system for securities settlement. The latter made possible to perform riskless and real-time DvP (Delivery vs. Payment) operations and conduct repo transactions in a swift and automated manner, representing an extremely important component for the secondary market development.



Maximum Minimum Average

DIAGRAM 29.

Maximum Minimum Average

In order to increase effectiveness of monetary transmission mechanism, the existence of a liquid secondary securities market is crucial. Despite high demand registered at the T-bill auctions, there was virtually no activity in the secondary market. One of the factors obstructing development of the secondary market consists in the lack of trust among market participants. To address this problem in November 2010, at the initiative of the NBG, commercial banks and the NBG signed an agreement on repo operations framework, allowing banks to use the Bloomberg trading system in conducting repo operations. In line with this agreement, settlement between a buyer and a seller will be effected electronically and recorded in the NBG's registrar, serving as a certain transaction guarantee. After signing of this agreement the secondary market activity remains weak, but promotion of repo operations represents a foundation for development of the secondary securities market, which should be followed by an increase in market liquidity through additional issuance of securities.

# 2.2.6. MINIMUM RESERVE REQUIREMENTS

Through minimum reserve requirements the NBG was in a position to control the money multiplier, develop interbank money market, while commercial banks were able to better manage their liquidity. The reserve requirement instrument was a prerequisite for effective use of other NBG's monetary policy instruments. After the August 2008 development the NBG reduced the minimum reserve requirements from 13% to 5% in order to avoid liquidity deficit in the banking system. This level of reserve requirements was lower than it was needed for banks' transactional demand. This implied that reserve requirements were practically inexistent for commercial banks. As a result, banks' demand for liquidity declined, leading to a decrease in lending and in interest rates in the money market. The interbank interest rate significantly moved away from the policy rate, indicating a break in the relationship between interest rates.

In order to promote development of the interbank money market and restore the relationship between interest rates, the NBG increased the reserve requirements for lari-denominated funds to 10% starting from April 2010. This level of reserve requirements was higher than banks' transactional demand, allowing banks to better forecast liquidity and ultimately increasing system efficiency.

At the same time, observance of minimum reserve requirements allowed banks to receive additional income, as the NBG started to accrue the policy interest rate on the increased part of commercial banks' reserves (i.e. on the part of reserves above 5% level). Prior to that there was no policy rate accrual on lari reserves. This decision was another step towards implementation of market-based monetary operations and improvement of interest rate transmission mechanism.

Starting from September 2010 the base for calculating funds attracted in foreign currency was expanded; in particular, borrowings from non-residents were added to external borrowings, resulting in establishing equal conditions for funds attracted from external sources and from the domestic market. This measure was aimed at promoting larization (de-dollarization) of the banking system, being a crucial condition for effective monetary policy and stable economic environment. At the second stage the NBG gradually increased reserve requirements for foreign liabilities from 5% to 15%, the regulation entering into force from January-February 2011. Along with monetary policy tightening, this change also serves to a long-term task of reducing dollarization.

#### 2.2.7. CENTRAL SECURITIES DEPOSITORY SYSTEM

In parallel to implementing the Real Time Gross Settlement (RTGF) system, starting from December 17, 2010 the NBG successfully implemented the Central Securities Depository (CSD) system. By putting into operation the CSD system the NBG moved to a modern high-technology model of state securities management, as the securities operations became fast and riskless. Any operation related to trading state securities is conducted electronically and no longer through document forms. Overall, the system ensures swift, secure, and continuous processing of interbank transfers related to state securities.

The CSD system comprises operations related to securities issued by the Ministry of Finance and the NBG: automated settlement related to issuance, coupon payment, and redemption of securities; electronic registrar of securities; sales and purchases; repo operations; pledges; financial collateral repossession.

The CSD system includes buying and selling operations related to the secondary securities market. The system is integrated with the Bloomberg trading system, allowing for automatic sending of securities operations from the Bloomberg trading system to the CSD system for completion. Through this infrastructure securities trading and settling procedures are completed within a few minutes. Such infrastructure is available only in a few countries with developed financial markets.

A second important function of the CSD system represents automation of the NBG' monetary operations. Through the system banks pledge securities in their portfolio as collateral with the purpose of taking a refinancing loan. The integration with the Bloomberg trading system allows the NBG to conduct refinancing and securities trading operations automatically, which reduces operational risks and increases effectiveness of monetary operations.

Implementation of new payment and securities settlement systems in the NBG promotes development of the Georgian financial market and improves promptness and security of operations.

# 2.3. EXCHANGE RATE POLICY AND MANAGEMENT OF INTERNATIONAL RESERVES

In 2010 the objective of the NBG's exchange rate policy consisted in switching to the free floating exchange rate regime by gradually decreasing the scope of FX market interventions. Flexible exchange rate is important for mitigating external shocks and ensuring macroeconomic stability. At the same time, in the short run a fluctuating exchange rate hinders formation of expectations, reducing speculative pressure and risks to financial stability. Concurrently, the main priority of the exchange rate policy remained enhancement of market-based principles of exchange rate formation and development of the FX market, preclusion of real effective exchange rate appreciation, and maintenance of international reserves at an adequate level.

In 2010 the NBG's exchange rate policy was conducted under the managed float regime. The goal of the NBG's FX interventions was to avoid drastic fluctuations of the exchange rate and not to affect the general trend or to achieve a certain target level. Similar to the preceding years, in 2010 the capital account remained liberalized allowing any economic agent to convert money into any foreign currency or to open a deposit in any foreign currency both in Georgia and abroad.

In early 2010 against the background of slack capital inflows the NBG remained the primary supplier of the US dollars. As it is known, after the 2008 military hostilities the international community provided significant financial assistance to Georgia, expressed in loans and grants from international financial institutions and donor countries. Obviously the accumulation of received loans and grants occurred in the NBG's foreign exchange reserves. Similar to the preceding year, supply of foreign currency to the FX mar-

ket was made through the FX auctions.

Exchange rate pressure was manifested in the first months of the year due to seasonal factors. The speculative pressure was particularly increased in May. Commercial banks increased their long FX positions, further aggravating depreciation risks. In order to avoid short-term abrupt fluctuations of the exchange rate, the NBG supplied a large amount of foreign currency to the FX market through the FX auctions. Overall, in the first half of the year the NBG sold USD 331.2 million in the FX market.

In the following period the situation in the FX market stabilized. Demand for imports was largely financed through FX proceeds from tourism and exports, freeing the NBG from intervening into the FX market. As a result, during 3 months the NBG did not make any FX market interventions. Starting from September the FX supply was growing in the market. Apart from tourism revenues, there was an increase in non-residents' deposits. In the same period the international markets registered depreciation of the US dollar against other currencies, creating dollar's depreciation expectations in the domestic market. As a result, commercial banks started to supply the US dollars to the FX market. These factors conditioned tendencies of the lari's appreciation starting from September 2010. The NBG considered this dynamics of exchange rate as temporary, since there were no FDI inflows taking place at that period. Therefore, in order to avoid drastic appreciation of the exchange rate, which could be followed by depreciation of the same scale, and to eradicate temporary misbalances in the exchange rate factors the NBG actively purchased the US dollars in the FX market since September 2010, with the total purchases equaling USD 116 million. Overall, throughout the year the NBG's net sales of foreign currency equaled USD 205.2 million.

The average exchange rate of the US dollar against the lari in 2010 averaged 1.7846, depreciating 6.83% in average terms (from 1.6705 to 1.7846). In end-period terms, the exchange rate depreciation equaled 5.16% (GEL/USD exchange rate grew from 1.6858 to 1.7728).

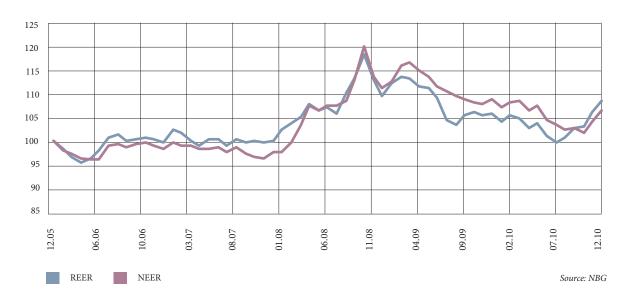




Until November 2010, apart from few exceptions, the lari's nominal effective exchange rate tended to

depreciate (meaning nominal depreciation of the national currency<sup>11</sup>). However, in the last two months of the year the NEER index grew by 10.5 points to ultimately settle at 225.6 points, or 2.2% less in annual terms. The situation was almost similar in the case of the lari's real effective exchange rate. However, unlike the NEER's depreciation tendencies in July-October, the REER was appreciating, which was caused by the fact that the inflation rate in Georgia's trading partner countries was lower than in Georgia. In that period the inflation rate in Georgia was significantly affected by price increases on wheat flour and bread as a result of regional wheat price gains. Compared to 2009, the lari's REER index grew 2.8%.



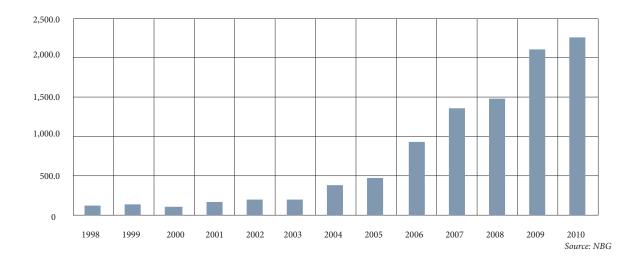


# DYNAMICS OF INTERNATIONAL RESERVES

In 2010 the NBG's priority consisted not in accumulating reserves but in maintaining them at a desired level. As of December 31, 2010, the volume of the NBG's international reserves totaled USD 2.26 billion, registering a USD 155 million (7.4%) increase year-on-year.

DIAGRAM 32. Official Reserve Assets (USD Millions, End-period Data)

<sup>&</sup>lt;sup>11</sup> The NEER index is calculated as a weighted average of the exchange rates of 12 trading partners. An increase in the index means appreciation of the domestic currency, and vice versa.



Changes in the volume of the NBG's international reserves in 2010 were traditionally affected by a few primary factors, including the NBG's FX auctions, government expenditures, and loans and grants received from international organizations. During the year the net FX sales by the NBG totaled USD 205 million. Despite this fact, as it was already mentioned, the volume of international reserves grew by approximately USD 155 million during the year. The growth was largely conditioned by loans and grants received from international financial organizations and donor countries. The IMF loan equaled USD 297 million, the World Bank loan – USD 140 million, the EU loan – USD 68 million, and the ADB loan – USD 125 million.

TABLE 9. Georgia's International Reserves

	2006	2007	2008	2009	2010
Ratio of gross international reserves to:					
Months of Imports	2.5	2.8	2.4	4.8	4.5
Broad Money (M2)	115	101	132	166	147
FX Deposits	123	115	101	141	113
Short-Term External Debt	182	151	118	181	164
Gross International Reserves (USD millions)	931	1,361	1,480	2,110	2,264

Source: NBG

According to different assessment methods, the level of Georgia's official international reserves is sufficient for ensuring external sustainability. As shown in Table 9, the ratios of gross international reserves to broad money, foreign currency denominated deposits, and short-term debt exceed 100%, indicating a sufficient level of international reserves. Another important indicator is the ratio of international reserves to months of imports. According to the IMF estimates, the level of reserves is considered to be sustainable if the latter ratio is higher than 3. At end-2010 this ratio for Georgia equaled 4.9, showing upward tendencies.

During 2010 the consequences of the financial crisis were still present, while the situation was aggravated by the fiscal crisis in the countries of the EU area. The world's leading central banks, and the Fed in the first place, continued expansionary policies, manifested in the growth of money mass through asset purchases and in further decreases of interest rates. The debt crisis in Greece and budgetary problems in a number of the EU countries such as Spain, Portugal, and Ireland, essentially shattered investors' trust towards euro-denominated assets. Against the background of increased credit risks it became even more difficult to make secure investments, raising demand for less risky assets and further reducing asset profitability. Under these circumstances the NBG's investment policy remained conservative, oriented to a reduction of credit risk.

The NBG's international reserves were placed in highly liquid financial securities issued by the US, EU area countries, and supranational financial institutions. During 2010 the NBG's revenues from managing international reserves amounted to GEL 25.2 million, which was lower than the revenues received in 2009. At the same time, the NBG limited or fully stopped to invest into those countries, whose solvency during the fiscal crisis was even slightly questioned.

In 2010 the NBG continued its cooperation with the World Bank within the framework of the Sovereign Investment Partnership Program, whose member the NBG became in 2009. The duration of the program is three years, and it is aimed at providing technical assistance with the purpose of further developing international reserve management through creation of appropriate infrastructure and accumulation of knowledge. The program stipulates transfer of knowledge accumulated from the World Bank's experience to the NBG in the areas of portfolio and risk management, accounting and reporting, legislation, and information technologies. Within the framework of the program sharing of experience among the NBG personnel was taking place. The activities related to Strategic Assets Allocation were conducted and the plan of gradual implementation of new approaches and instruments in reserve management was designed.

Within the framework of the same program, with the World Bank support and the USAID co-financing the NBG initiated implementation of a modern integrated system for reserve management. Analogous systems operate in about 30 central banks, including Germany, France, Finland, Poland, and the ECB. The system ensures automation of all investment processes, enhances efficiency of the reserve management process, and reduces operational risks. The new system will also allow the NBG to invest funds in new financial instruments. The main system configuration activities were finished during 2010. After successfully testing the system in a trial mode, completion of the implementation phase is scheduled for the first half of 2011.



# **BANKING SECTOR**

# 3.1. INTERNATIONAL ENVIRONMENT AND TRENDS IN SUPERVISION REFORM

In 2010 the international banking sector was influenced by the gradual recovery of the real economy from the global financial crisis, increased risks of external debt crisis in the EU, and elaboration of new supervision principles (Basel III) based on the consequences of the financial crisis.

According to the IMF statement made at the G-20 Finance Ministers meeting, there still exist economic downturn risks in the developed countries, while economy overheating risks represent a primary concern in the developing nations<sup>12</sup>. These misbalances are further aggravated by investors' decisions in favor of emerging economies directing capital flows towards developing countries. Speculative capital flows jeopardize macroeconomic and financial stability, leading to excessive credit growth and creative price bubbles at the local level. Therefore, in order to neutralize such risks, countries should pay attention to macroeconomic and prudential instruments.

Analysis of a three-year fight with the consequences of the financial crisis reveals a number of fundamental deficiencies in the existing supervision framework and risk management practices which could have a potential impact on any country or banking system. The Basel III document<sup>13</sup> disseminated by the Basel Committee on December 16, 2010 is exactly targeted at eradicating such deficiencies. The drawbacks peculiar to the recent global financial crisis which represent the target for Basel III include the following<sup>14</sup>:

- Poor liquidity management and insufficient liquidity buffers, despite a global glut in liquidity;
- Too much leverage in the banking system, combined by weak credit underwriting;
- Banks capital that was of inadequate levels and insufficient quality;
- Serious shortcomings in corporate governance, risk management and market transparency.

The crisis was also deepened by a disorderly deleveraging process and by the interconnectedness among institutions. These two dynamics – procyclicality and systemic risk – illustrate the imperative of taking account of bank-specific weaknesses as well as the risks that build up in the banking and financial system. Ultimately, the effects of the crisis were transmitted in ways and to regions that were not previously envisaged.

- Accordingly, the Basel Committee's response is designed to ensure that all banks and banking systems are better prepared for the next crisis, whatever its source or nature. The central response of the Basel Committee is the introduction of Basel III framework<sup>15</sup>. Basel III is not an overhaul of Basel II or replaces Basel II or Basel I, but it complements the Basel II and Basel I framework. It simplifies and strengthens the numerator of the capital ratio and introduces some macro prudential components to the regulatory framework. Among the main new components of the framework are: Raising the quality of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis;
- Increasing the risk coverage of the capital framework, in particular for trading activities, securitizations, exposures to off-balance sheet vehicles and counterparty credit exposures arising from derivatives;

<sup>&</sup>lt;sup>12</sup> February 2011. The IMF and G20: Global Economic Perspectives and Policy Challenges.

<sup>&</sup>lt;sup>13</sup> BIS (2010) "Basel III: A global regulatory framework for more resilient banks and banking systems", Basel Committee on Banking Supervision, Bank for International Settlements.

Address of the Chairman of the Basel Committee on Banking Supervision. January 27, 2011. New Framework of Banking Supervision. Cape Town, RSA.

<sup>&</sup>lt;sup>15</sup> BCBS, December 2010, "Basel III: a global regulatory framework for more resilient banks and banking systems".

- Raising the level of the minimum capital requirements, including an increase in the minimum common equity requirement from 2% to 4.5% and a capital conservation buffer of 2.5%, bringing the total common equity requirement to 7%;
- Introducing an internationally harmonized leverage ratio to serve as a backstop to the risk-based capital measure and to contain the build-up of excessive leverage in the system;
- Raising standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3), together with additional guidance in the areas of sound valuation practices, stress testing, liquidity risk
  management, corporate governance and compensation;
- Introducing minimum global liquidity standards consisting of both a short term liquidity coverage ratio and a longer term, structural net stable funding ratio; and
- Promoting the build-up of capital buffers in good times that can be drawn down in periods of stress, including both a capital conservation buffer and a countercyclical buffer to protect the banking sector from periods of excess credit growth.

The new framework will take effect in the G20 countries from the beginning of 2013 and will be progressively phased in by 2019. Irrespective of these transitional arrangements, implementation of Basel III is expected to be a very difficult and challenging exercise. According to McKinsey & Company's publication¹6 on this regulatory initiative, Basel III will have significant impact on the European & US banking sectors: "by 2019 the industry will need about €1.1 trillion of additional Tier 1 capital, €1.3 trillion of short-term liquidity, and about €2.3 trillion of long-term funding, absent any mitigating actions". The impact on the US banking sector is expected to be similar McKinsey & Company estimates that "[t]he capital need is equivalent to almost 60 percent of all European and US Tier 1 capital outstanding, and the liquidity gap equivalent to roughly 50 percent of all outstanding short-term liquidity." Considering above, implications of Basel III implementation may have significant impact on the business models prevalent in the banking sector. However, the Basel Committee expects that the long transition period will ensure that the banks have sufficient time to adjust their balance sheets to the new framework and that it can be implemented without impeding economic recovery. During the transition period the convergence towards the new requirements will be monitored by the Basel Committee. If it turns out that the new requirements have unwanted side-effects the requirements or the transition period will be reevaluated.

In addition to Basel III the Basel Committee stresses the importance of strengthening risk management and supervisory practices. The efforts in this field go beyond minimum standards for liquidity and capital but include for example the issuance of "Principles for Enhancing Corporate Governance" and "Compensation Principles and Standards Assessment Methodology". Other examples include work on stresstesting, operational risk and the joint work with the Financial Stability Board on systemically important banks. Last but not least, the use of sound provisioning methods based on expected rather than incurred losses is also a topic of high interest.

Most of these topics are also relevant for the Georgian situation. Especially the new quantitative metrics introduced for liquidity risk, the ideas for handling (local) systemic relevant banks and counter cyclical capital buffers are of interest for the Georgian situation. These topics will be taken into consideration for the further development of the local regulatory framework, just as the gradual convergence towards Basel II and Basel III.

 $<sup>^{16}</sup>$  November 2010. Basel III and European banking: Its impact, how banks may react and challenges of implementation.

<sup>&</sup>lt;sup>17</sup> BIS (2010) "Consultative document: Pillar 3 disclosure requirements for remuneration", Basel Committee on Banking Supervision, Bank for International Settlements.

BIS (2010) "Consultative Document: Pillar 3 disclosure requirements for remuneration", Basel Committee on Banking supervision, Bank for International Settlements.

Although sound regulation is important its effectiveness depends heavily on support by strong supervisory practices. Therefore, on the short term horizon the main focus of the Banking Supervision will be on further improving and bringing to international standards of the current supervisory practices. To this end the adopted approach of Risk Based Supervision will be further strengthened in 2011.

#### 3.2. SUPERVISION REFORM

The NBG's objective in the field of supervision is to ensure public trust towards the banking system and protect stability in the banking sector. In addition, an increasing focus is made on macro-prudential supervision methods.

In order to increase efficiency of macro-prudential measures, in 2010 the NBG has initiated the transition towards risk-based supervision. At the initial stage supervisory resources were reallocated in line with bank's risk profile and systemic importance. The integration of on- and off-site supervision processes resulted in increased efficiency of the supervisory cycle. Various activities were conducted with the purpose of identifying various banking risks and improving the micro-prudential risk assessment framework:

- With the view of credit risk analysis at a micro level, a unified form for corporate loan assessment was prepared. The form provides for evaluation of the financial situation of corporate clients both at an individual and at a consolidated level by using various corporate financial indicators. It also supports consolidation of financial indicators of individual financial clients at a sectoral level. As a result, a complete picture on riskiness of a sector or an individual bank becomes available.
- With the purpose of assessing industrial risks, a matrix was created, evaluating external risks for companies. The primary focus is made on cyclicality of an industry, competition level, maturity period, FX risk, and other significant factors, which could affect solvency of companies in a particular industry.
- The approach to risk assessment of retail portfolio differs from the corporate portfolio, since retail loan amounts are small and their number is so large, that individual assessment of these loans becomes inefficient. Accordingly, the NBG actively introduced the methodology of selecting and assessing retail loans, based on statistical inference techniques. This methodology provides for creating a sample from the total portfolio with similar risks properties. The next stage involves credit quality assessment in a sample (loan loss provisioning) and testing of obtained results. In case of statistically significant differences with respect to preceding risk quality indicators, the obtained results are extrapolated to the total credit portfolio.
- During 2010 the NBG also carried out a number of important projects, aimed at further development of market and liquidity risk management framework. In this context a new project on liquidity management was started. The project consists in implementing the Basel III liquidity principles and approaches and improving supervision quality of the existing static liquidity framework.
- In 2010 the NBG implemented the interest rate risk framework based on Pillar 2 of Basel II. Taking
  into account the local characteristics of the banking environment, an up-to-date draft methodology on
  interest risk assessment was elaborated.
- At the end of 2010 the NBG conducted numerous activities with the view of detailed analysis of operational risks and enhancing efficiency of the supervisory framework in this area. In particular, at the initial stage the NBG elaborated a questionnaire on operational risks, which was circulated among the commercial banks. The questionnaire is based on the Basel II principles of operational risks and its goal consists in identifying operational risks of each banking institution and analyzing their operational risks.
- The Georgian banking system actively implements innovative operations, the e-banking sphere tends to develop. Therefore, the issue of efficient operational risk management comes to the forefront. The

NBG plans to develop operational risk management framework and enhance implementation of best practices of operational risk management within the country. This implies introduction of effective standards on operational risk management in the banking system and, in general, raising awareness of operational risks.

• In November 2010 the NBG prepared and implemented a new reporting system for banking supervision. Meanwhile, there was an essential improvement in the automated system of quality data verification.

Taking into account the advantage of a single umbrella principle, merger of the NBG and the Financial Supervision Agency conditioned a significant increase in efficiency related to solving problems in common. As a result, it became easier to perform exchange of information between structural units responsible for macroeconomic policy and supervision of financial institutions, avoid duplication of work, and carry out optimal policies for ensuring financial stability. The cooperation framework was established, in line with which parties inform one another about financial stability-related significant tendencies, policy objectives, and plans for their accomplishment. The analysis includes such issues as to what impact is produced, on the one hand, by monetary policy instruments on financial institutions and users, and by supervision policy norms on general economic indicators and monetary transmission mechanisms, on the other. As a result, it becomes possible to avoid opposite and incompatible monetary and supervisory policies and carry out an optimal macro-prudential policy.

An example of such cooperation represents a situation when a structural unit responsible for macro-economic policy uses results of real policy analysis for macro-prudential regulation objectives. The information – such as revealed sectoral tendencies, unsustainable growth (bubbles) in different markets, risks related to external misbalances – is very useful for analysis of sectoral risks. Such information is important for sectoral (beta) coefficients and estimation of financial institutions' risks, leading to implementation of adequate regulatory norms.

At the same time, flows of opposite information are crucial for increasing efficiency of monetary policy. For instance, supervisors of financial institution possess significant information about different companies related to their capacity utilization levels, price formation policies, employment level, etc. Such information represents an essential source for forecasting price stability and inflation processes. Cooperation in this and other areas leads to increased efficiency in monetary and supervisory policies, which in turn underlies macroeconomic stability in the country.

With the purpose of protecting consumers, establishing a competitive environment, and reducing credit risks in the retail market of the Georgian financial sector, the NBG elaborated the "Regulation on Provision of Necessary Information to Consumers of Banking Services".

In the recent years a significant deterioration of consumer loan portfolio due to the crisis points to the necessity of a deeper analysis related to solvency of borrowers. At the same time, reduction in the number of retail consumer products partly indicates a fall of confidence in the financial institutions. Based on various sources of information, the reasons of consumers' displeasure often included hidden costs related to retail products, possibility of unilateral changes without informing the customer, limited control over amounts on different bank accounts, etc. In order to promote informed economic activity of consumers, it is important to raise financial awareness and trust of the public, strengthen banks' responsible approach in providing banking services, and introduce minimum regulation norms related to standardizing essential features of retail products.

In 2010 within the context of strengthening consumers' protection, at the initial stage the NBG elaborated the "Regulation on Provision of Necessary Information to Consumers of Banking Services". The regulation will cover all types of agreements related to granting consumer loans to individuals, when the

total loan amount is within the range of GEL 300 – 50,000. The same requirements are set for all types of deposit agreements of individuals, where the first deposit is less than GEL 50,000. According to the regulation, the banks shall indicate all financial costs in the contracts related to use of a loan or a deposit, include the effective interest rate of the product, information on FX risk, rules for changing terms of an agreement, etc. Consumer contracts shall necessarily include a preface stating the most important terms of the contract. Banks shall be ordered to prepare standard written procedures for submitting claims and report this information periodically to the NBG.

In parallel to preparing the regulation, the NBG set up a structural unit for protecting consumers' rights. The latter will monitor protection of consumers' rights in the consumer market of the financial sector, analyze and disseminate relevant statistical data, respond to similar issues through the hotline (406 406) and provide qualified recommendations. The unit will also administer the special information webpage for consumers (http://nbg.gov.ge/cp), designed to raise financial awareness of consumers and to disseminate innovations related to consumers' protection to wide audience.

At the following stages the action plan related to strengthening consumers' rights shall cover regulation of pre-contract relations between a commercial bank and a client, toughening sanctions against aggressive business behavior, developing verification mechanisms for enforcement of correct and comprehensive information provision to customers and performing other activities recognized by best international practices. It is important that the unit identifies essential problems of consumers through active interaction with the public, and such problems, based on their importance, are quite likely to be included in the future legislative initiatives. The existence of communication framework between the structural units in the areas of consumers' protection, credit, and operational risk is crucial for increasing efficiency in the process of identifying risks.

In 2010 the NBG continued to work on approximation of banks' financial reporting to the international standards. The "Regulation on External Auditing of Commercial Banks" became effective: being in full compliance with the international auditing standards and regulating the relationships between the supervision and banks' external auditors, the regulation also stipulates submission of detailed financial reports by commercial banks to the NBG in line with IFRS.

#### 3.3. BANKING SECTOR RISKS

# 3.3.1. OWNERSHIP STRUCTURE

As of December 31, 2010, the Georgian banking system comprised 19 banks. The total assets of the banking system constituted 50.8% of GDP. With regard to foreign capital participation, in terms of final ownership, there were 15 Georgian banks and two branches of foreign banks. The share of non-residents in the banks' paid-in capital equaled 84.4%. These banks also control 93% of total banking assets and 98.4% of non-banking deposits.

It should be noted that in terms of ownership structure, the banking sector is represented by powerful strategic investors, including large European and regional banking and international financial institutions. These institutions are in a position to provide additional capital liquidity, if required. It should be pointed out that an increased share of foreign capital participation in the banking sector promotes development of a sustainable and competitive domestic market.

#### 3.3.2. CREDIT RISK

Starting from the second half of 2009, against the background of essential revitalization of the economy and existence of excess liquidity in the banking system, the credit portfolio started to expand. As a result, the latter reached the maximum pre-crisis level, calculated at the exchange rate of June 2008. During 2010 the total nominal credit portfolio grew 20.7%. However, it should be pointed out that taking into account written-off loans and repossessed property, the growth of the nominal credit portfolio was even higher. The portfolio growth amounted to 22.6%, adding the effect of written-off loans, and to 23.7%, including the effect of repossessed property. In 2010 the net amount of written-off loans totaled GEL 171 million, while the value of repossessed property equaled GEL 58 million. It is remarkable that in 2009 the analogous amounts were much larger, equaling GEL 195 million and GEL 141 million, respectively.

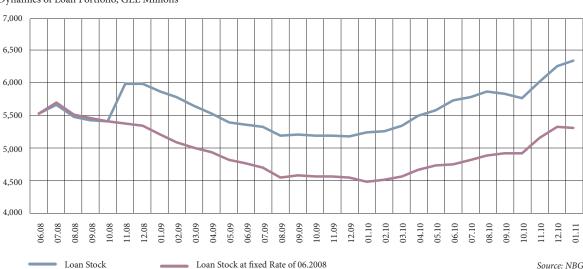


DIAGRAM 33. Dynamics of Loan Portfolio, GEL Millions

The revitalization of the banking sector is manifested in the fact that the share of non-performing loans in the total portfolio decreased from 18.8% in June 2009 (the historical maximum) to 12.5% as of December 31, 2010. Including the effects of written-off loans and repossessed property the same indicators equaled 20.7% and 18.6%, respectively.

In 2010 the expansion of the credit portfolio was initially fueled by the buildup of inventories in corporate clients, followed by an increased level of activity on the part of investment and retail banking.

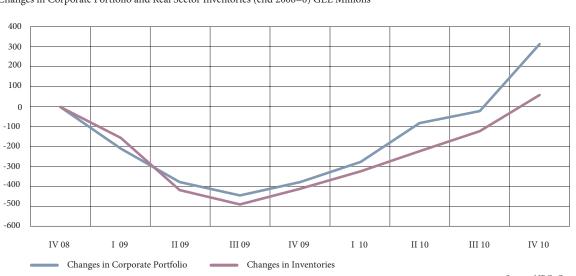
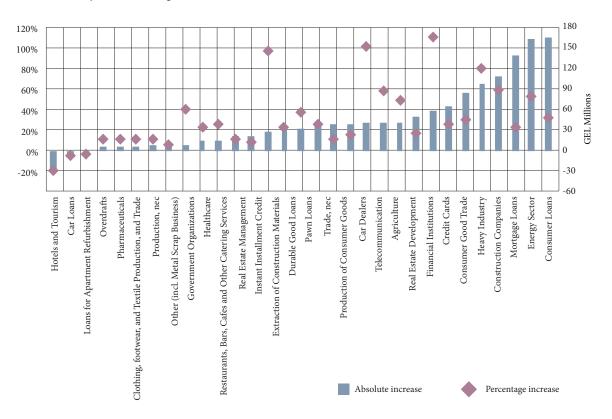


DIAGRAM 34. Changes in Corporate Portfolio and Real Sector Inventories (end 2008=0) GEL Millions

Source: NBG, Geostat

DIAGRAM 35. Growth of Loans by Sectors Including Write-offs, 2010



At the same time an expansion of the portfolio was registered in real estate and durable goods for both corporate and retail clients.

The real estate development represents a sector, where the largest loan quality deterioration took place. In this sector the share of provisions with respect to the portfolio equaled 34% in November 2009, a record high level. Due to the effects of significant loan write-offs and extension of new loans (largely within the framework of the Old Tbilisi New Life project), the level of loan loss provisions fell significantly below the historical maximum, settling at 22% in December 2010.

TABLE 10. Loan Portfolio by Risk Sectors

	As of December 31, 2010 (GEL millions)					
Risk Sectors	Sectoral share in total portfolio	Loan Stocks	Loan Reserves	Loan reserves/Portfolio		
Public Entities	0.50%	30.6	0.6	2.00%		
Financial Institutions	1.80%	110.1	2.6	2.40%		
Pawn loans	2.80%	172.8	3.5	2.00%		
Real Estate Development	5.00%	314.5	71.3	22.70%		
Real Estate Management	4.60%	290.4	37.5	12.90%		
Construction Companies (excluding Developers)	4.40%	278.2	38.8	14.00%		
Extraction, Production and Trade of Construction Materials	2.60%	164	29.3	17.80%		
Trade of Consumer Goods	5.60%	348	22.1	6.30%		
Production of Consumer Goods	4.50%	280.6	42.7	15.20%		
Production and Trade of Durable Goods	1.70%	105.3	13.2	12.50%		
Production and Trade of Footwear, Clothing, and Textile	0.90%	56.5	3.8	6.70%		
Trade, nec	5.20%	327.3	18.2	5.60%		
Production, nec	1.20%	76.6	15.7	20.40%		
Hotels and Tourism	1.90%	119.2	10.8	9.00%		
Restaurants, Bars, Cafes and Other Catering Services	1.30%	80.9	5.1	6.30%		
Heavy Industry	3.50%	219.2	10.8	4.90%		
Loans to Gas-Filling Stations and Gasoline Importers	3.60%	224.9	29.2	13.00%		
Energy	3.80%	235.2	15.4	6.50%		
Car Dealers	1.30%	79.5	8.4	10.60%		
Healthcare	1.20%	75.3	4.7	6.30%		
Pharmaceuticals	0.90%	55.1	4.8	8.60%		
Telecommunication	1.80%	109.8	6.4	5.80%		
Services	3.90%	242.4	16.3	6.70%		
Agriculture	2.00%	122.5	10.5	8.60%		
Other (including Scrap Businesses)	2.90%	183.2	14.5	7.90%		
Retail Products	31.20%	1,954.30	125.8	6.40%		
Car Loans	1.50%	94.8	7.4	7.80%		
Consumer Loans	10.20%	640.1	29.7	4.60%		
Instant Installment Loans	0.90%	54.6	5.2	9.50%		
Overdrafts	0.90%	58.6	2.8	4.80%		
Credit Cards	4.30%	271.4	28	10.30%		
Loans for Apartment Refurbishment	1.60%	102.7	4.6	4.50%		
Mortgage Loans	11.70%	732	48.2	6.60%		
Total	100.00%	6,256.30	562.2	9.00%		

The expansion of credit extended to construction (non-developing) companies was largely due to the government investments in infrastructure development and, in particular, in road construction. It should be noted that while at end-2008 and throughout 2009 loan conditions were tightened, which was primarily manifested in low payment to income and "loan to value" ratios, in Q1 2010 the decrease in interest rates along with a significant easing of the above ratios, allowing the banks to expand their portfolio.

DIAGRAM 36. Ratio of Loan Loss Provisions to Total Loans

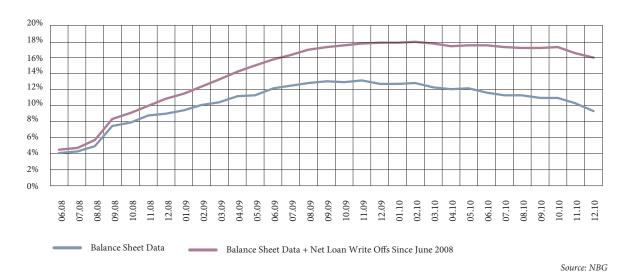


DIAGRAM 37.

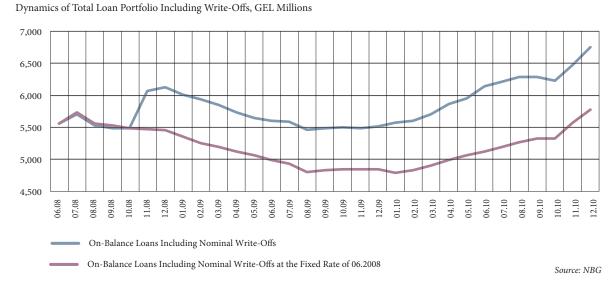


DIAGRAM 38. Loan Write-Offs and Recovery, GEL Millions

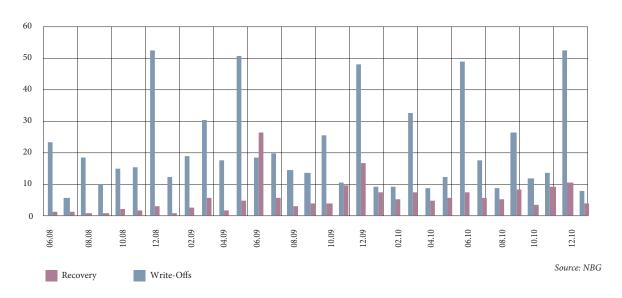
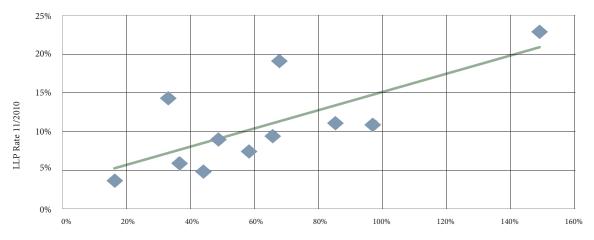


DIAGRAM 39. Correlation Between LLPs and Annual Portfolio Growth (for 96% of Banks Portfolio)

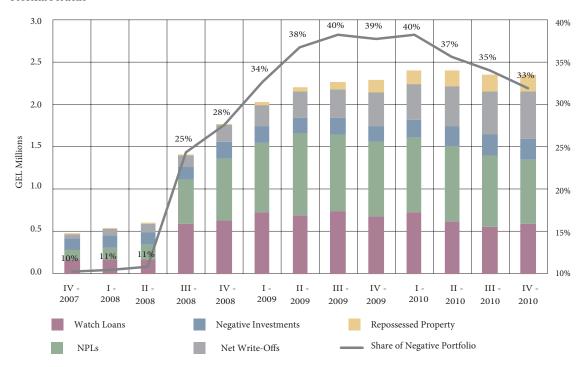


Average Annual Growth of Credit Portfolio6/2005 - 6/2008

Source: NBG

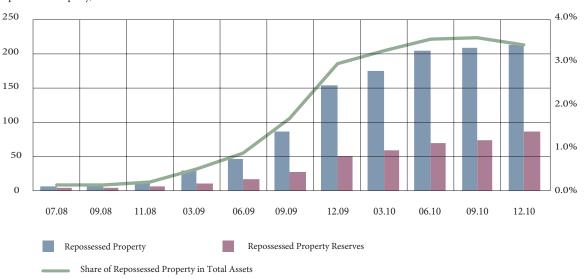
A rapid expansion of credit portfolio in Georgia occurred during the economic boom. In this period the credit portfolio quality seemed to be very high due to high proportion of newly issued loans, which was expressed in a low ratio of NPLs and LLPs with respect to total portfolio. Crediting of pro-cyclical sectors of the economy, along with rapid expansion of loans determined high cost of risk.

DIAGRAM 40. Problem Portfolio



Source: NBG

DIAGRAM 41. Repossessed Property, GEL Millions



In the post-recession period, the volume of repossessed properties soared, as the latter was used by banks to recover bad and written-off loans. As of December 2010 the provisions for repossessed property totaled GEL 89 million, or 41.4% of total repossessed property. Selling a significant part of repossessed property represents a difficult task for banks due to its size and low liquidity. It is likely that repossessed property provisions will increase, as it is conditioned by the NBG's regulations. According to these regulations, the level of repossessed property provisions equals 30% for less than a 1-year period, 50% for a 1-to-3-year period, and 100% for over 3-year period repossessions. Taking into account the fact that a sharp increase in banks' provisions for repossessed property occurred in June 2009, during 2011 the volume of such provisions is expected to increase by approximately GEL 30 million. This, after adding up to the existing repossessed property provisions, will increase the provisions' level to 57% of total repossessed property.

DIAGRAM 42.
Distribution of Repossessed Property by Types (As of June 30, 2010)

DIAGRAM 43. Repossessed Property by Value (As of June 30, 2010)

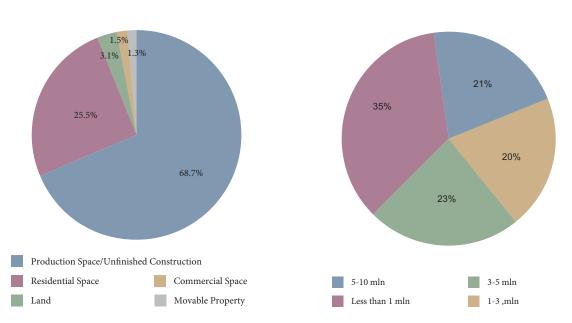
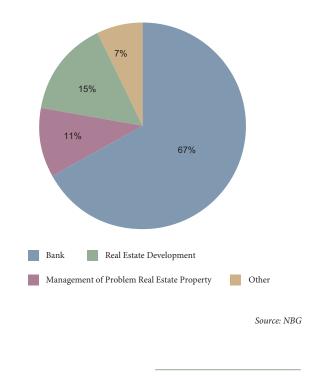


DIAGRAM 44. Problem Investments by Sectors (as of December 2010)



The volume of banks' problematic investments is also important, as the latter rose significantly along with other problematic assets as a result of the global financial crisis. As of December 2010, the volume of total banking investments stood at GEL 445 million, with the share of problematic investments equaling 59%. Investments abroad accounted for 67% of total problematic investments. It should be noted that in conformity with the NBG's capital adequacy regulations, investments in daughter companies are subject to deduction from supervisory capital. It is precisely these investments which account for 97% of total problematic investments and, accordingly, are deducted from the supervisory capital.

In addition, it should be noted that starting from 2008 banks established problematic asset management companies, whose primary objective consisted in removing problematic assets from banks' balance sheets and improvement management of such assets. Taking into account fragile recovery of the real estate market, it is important to accomplish problematic asset management programs, which will stimulate demand saide of the market(for example, "Old Tbilisi New Life" project).

# 3.3.3. LIQUIDITY RISK

Wholesale fundingThe credit boom of recent years was significantly financed through external borrowings, which increased refinancing risks and deteriorated the liquidity position of the banking system. However, the situation after the crisis considerably improved, manifesting a reduction in the ratio of loans to non-banking deposits.

As of December 2010, the volume of external borrowings in the banking system totaled GEL 1,492 million<sup>17</sup>, or only 7.2% of GDP. International financial institutions and parent companies account for 69% of external borrowings, while the remaining 31% is due to other private sources.

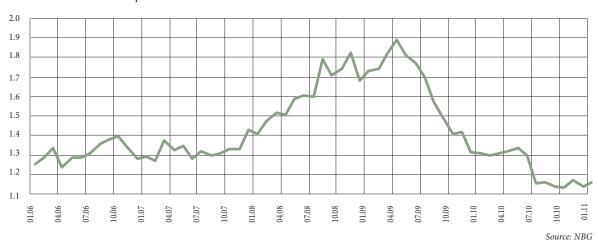
Taking into account a considerable share of parent companies and international financial institutions in non-subordinated loans, the repayment schedule is characterized with a less risky distribution.

<sup>&</sup>lt;sup>17</sup> Does not include subordinated liabilities (GEL 927 million), short-term funds received through operations with the NBG (GEL 190 million) and government loans (GEL 13.9 million).

TABLE 11. Repayment Schedule of External Borrowings

As of December 31, 2010						
	2011	2012	2013	2014	2015	2016
Repayment of Principal	34%	36%	10%	7%	3%	9%
of which: to Parent Company	14%	3%	2%	4%	1%	3%
of which: to international financial Institutions	14%	10%	7%	3%	2%	6%
of which: to other private sources	6%	23%	1%	0%	0%	0%

DIAGRAM 45. Ratio of Loans to Non-Bank Deposits



The schedule of servicing external borrowings similar to the situation in the first half of 2009 is not expected in 2011-2015. Despite the fact that the repayment schedule for long-term external financing is predictable and the risk of fund outflows due to repayment acceleration conditions is very low, the global financial crisis represents another example proving that banks should be limited through the compulsory loan-to-deposit ratio and that periods of high repayment concentration should be avoided to the extent possible, both at an individual and at a systemic level. In 2010 bank financing was mainly accomplished through local sources, which are traditionally considered less risky compared to external financing. Starting from 2010 the NBG began preparation of a new liquidity framework, which will take into account the refinancing risk of external borrowings. Banks for which the ratio of loans to non-banking deposits will exceed a specified level will be required to keep more liquid funds. Besides, it should be stressed that the ratio of loans to non-banking deposits is important not only with respect to liquidity risk, but also to credit risk. It is wholesale financing which allows for a rapid expansion of loans (See. Diagram 39 in Chapter on credit risk).

# **Retail Financing**

In 2010 the volume of non-banking deposits drastically increased. In particular, as of December 31, 2010, the annual growth of non-banking deposits amounted to 34.3% (compared to 9.87% a year before), largely caused by the improvement in general economic environment and, to a certain extent, by an increase in non-residents' deposits.

<sup>18</sup> Exchange rate is fixed at December 2008 level.

DIAGRAM 46.
Deposits of Legal Entities and Individuals, GEL Millions

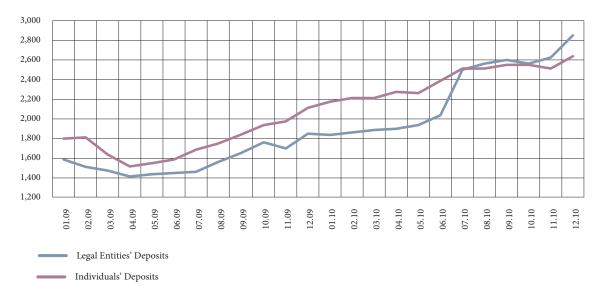
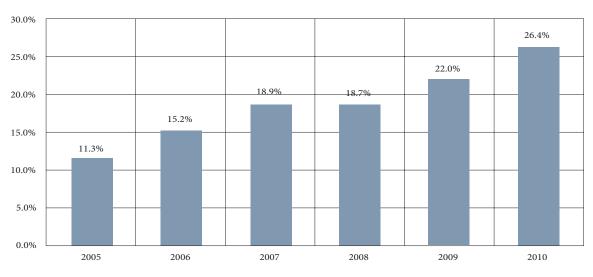


DIAGRAM 47. Ratio of Non-Banking Deposits to GDP



Source: NBG

The NBG also pays attention to the concentration of non-residents' deposits in the deposits' database. The share of this type of deposits soared in 2010, amounting to 10.2% by December 2010. At the same time, the share of time deposits also rose significantly. On the other hand, due to the fact that contract terms allow for time deposits' withdrawal at any time, the higher share of the latter does not ensure stability of non-residents' deposits. The increase in the share of non-residents' time deposits is caused by high interest rates in the country.

The results of the NBG's analysis of 2008-2010 data show that there is no evidence proving that this type of deposits is characterized with large fluctuations in Georgia. Despite this, the NBG considers that the non-residents' deposits potentially carry more outflow risks compared to the residents' deposits. Non-residents deposits are necessary for diversification of financing and enhancement of economic growth given scarce domestic financing. However, excessive dependence on this type of financing may consider-

ably increase liquidity risk. Accordingly, the NBG's new liquidity framework will take into account the non-residents' deposit risk. In the event that the share of non-residents' deposits exceeds a certain level, a bank will be required to keep more liquidity.

DIAGRAM 48. Share of Non-Resident' Deposits in Non-Banking Deposits

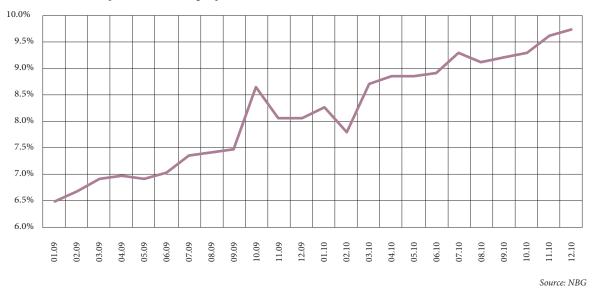
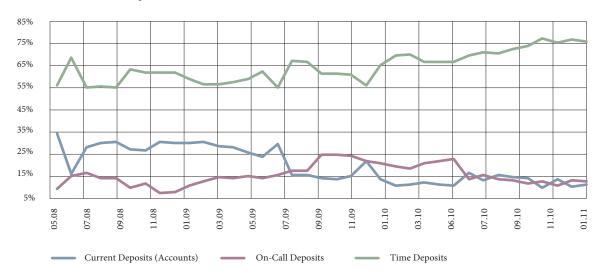


DIAGRAM 49. Share of Non-Residents' Time Deposits in Total Time Deposits

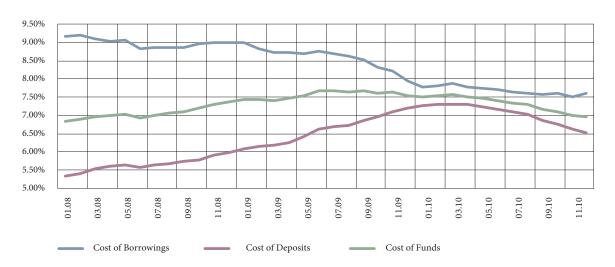


DIAGRAM 50. Structure of Non-Residents' Deposits



The expanding deposit base resulted not only an increase in credit activity, but also a decrease in cost of funds. The latter<sup>19</sup> gradually declined throughout 2010 to the level of early 2008. Unlike in 2009, when the increase in cost of funds was halted due to lower cost of external borrowings, the 2010 cost of funds declined due to lower deposit costs.

DIAGRAM 51. Cost of Attracted Funds and Their Components



Source: NBG

In accordance with the counter-cyclical policy, in October 2010 the NBG restored the minimum average liquidity requirement from 20% to the pre-crisis level of 30%.

<sup>19</sup> Calculated as last 12-month interest expenses/last 12-month average liabilities - other liabilities - accrued interest.

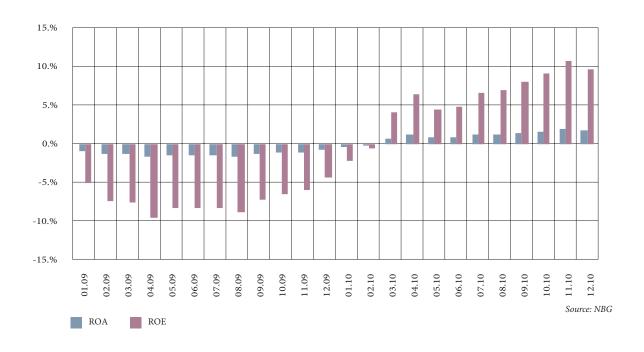
DIAGRAM 52. Liquidity Requirements and Average Liquidity Ratio



# 3.3.4. PROFITABILITY OF THE BANKING SECTOR

In 2010 the banking sector's profitability considerably improved, with the return on assets (ROA) and the return on equity (ROE) amounting to, respectively, 1.7% and 9.6% at end-year. The increase in profitability was caused, on the one hand, by a decline in credit cost and, on the other hand, by a rise in the operating profit of the banking sector.

DIAGRAM 53.
Profitability Ratios (Cumulative/Annualized Data from the Beginning of a year)



The 2008-2009 economic crisis led to deterioration of banking loan quality, increasing loan provisioning costs. Concurrently, the costs related to attracting deposits and the share of liquid assets went up, adversely affecting the banking sector's profitability. Starting from 2010 the situation reversed. The costs related to loan loss provisioning in 2010 totaled GEL 151.6 million, compared to GEL 359.6 million in 2009. The NBG paid particular attention to such indicators of loan soundness as interest capitalization and loan refinancing. In a number of cases, if accrued loan interest accounts for more than 1% of the credit portfolio, the bank is obliged by the NBG to fully provision for the extra amount.

By end-2009 the liquid assets held a significant share in the total assets of commercial banks. In 2010 banks experienced a faster credit than liquid assets growth and also as a consequence the profitability rate increased.

In 2010 the loan profitability rate remained practically unchanged, oscillating around 18% per annum. In parallel to reduction in interest rates on new loans, the interest rates on attracted funds were decreasing at a faster rate. As a result, the net interest spread was on the uptrend. Ultimately, the 2010 operating profit of the banking sector amounted to GEL 345.5 million, much higher than GEL 276.4 million posted in 2009.

DIAGRAM 54. Interest Rate Spread



Source: NBG



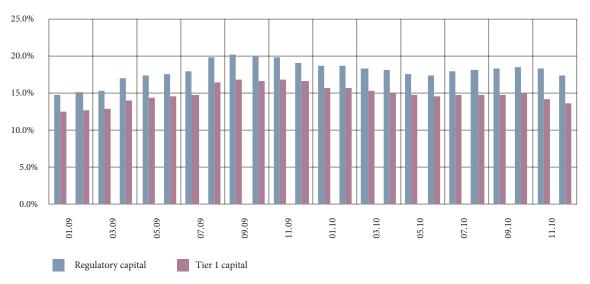
Source: NBG

#### 3.3.5. CAPITAL ADEQUACY

The banking sector remains adequately capitalized. During the 2008-2009 economic recession the regulator lowered the capital adequacy requirements twice, in line with the counter-cyclical policy. In particular, the FX risk-weighted factor was cut from 100% to 75% and then to 50%, allowing the banking system to absorb losses of GEL 365 million without additional capital injection. In 2010, along with the economic recovery, the banking sector resumed more aggressive lending strategies, which heightened the probability of funding more risky projects by commercial banks. Therefore, following its counter-cyclical approach, the NBG increased the FX risk factor to 75% (effective since January 2011).

In 2010 the capital adequacy ratios of the banking sector manifested slight fluctuations, still largely exceeding the minimum required level. It can be said that the banking system has a vast capacity for shock absorption and/or expansion of credit activity.

DIAGRAM 56. Regulatory and Tier 1 Capital Ratios



Source: NBG

DIAGRAM 57.

Actual Regulatory Capital Adequacy vs. Regulatory Capital Adequacy with Risk Weights Existing Before Introduction of Counter-Cyclical Policies



## 3.4. LIQUIDATION

In 2010 the liquidation process was completed in one commercial bank: based on Decree #1238 of the President of the NBG dated November 30, 2010 the "Iberiabank, Itd" was liquidated and removed from the bank register. By end-year the list of banks under liquidation still included the joint-stock companies "Georgian Post Bank", "Georgian Maritime Bank", "Ivertbank" and "Agroinvestbank", for which the liquidation activities are practically completed. The year of 2011 will be remarkable by the fact that it is for the first time since 1994 when the Georgian banking system will not have a bank under liquidation. The NBG intends to prepare a special publication in this regard.



## NON-BANKING SECTOR

#### 4.1. INSURANCE

The insurance market has been supervised by the National Bank of Georgia since 2009. With the purpose of improving regulation, in 2009-2010 the legal basis was refined. At the end of 2009 significant changes were introduced to the legal acts regulating the insurance market. The functions of the NBG as the state institution exercising control over insurance activities were expanded and described in detail. Essential amendments were entered into the Law of Georgia "On Insurance":

- The conditions/procedures for granting and revoking a license to an insurance institution were formalized, being regulated before that only on the basis of general legislation in the licensing area. These
  amendments brought into one legal act such important specification for insurance licensing as minimum capital requirement of an insurer and possibility for the regulator to identify beneficiary owners
  of the companies, possessing significant shares;
- Articles related to insurer's financial soundness preserving were amended, representing an important step towards ensuring solvency of an insurer and its ability to fulfill its obligations;
- An article on violations and sanctions was added, allowing the regulator to use a number of consistent
  sanctions against an insurance institution in case of violation of insurance legislation by an insurer or
  its administrator, or to apply discretionary sanctions based on the seriousness of violation and potential risks associated.
- Further important amendment, worth mentioning is a special Chapter of the Law dealing with the issues of forced administration, winding up, and bankruptcy procedures. The stipulations of the above clauses allow the regulator to fully monitor "non-sound"/perilous insurers, perform forced administration, winding up or bankruptcy procedures, and protect consumers' interests.

Improvements of the Law of Georgia "On Insurance" continued in 2010. In particular, fit and proper credentials, as effective means for reducing expected risks were elaborated for administrators and owners of significant shares of insurance companies. An Article related to establishment of a branch or a subsidiary abroad by an insurer was added. This change played an important role in insurance legislation with respect to prevention of illicit income legalization and combating terrorism financing as well as harmonization with the recommendations of the Financial Action Task Force (FATF).

Significant changes were made with regard to improving secondary legislation:

- The "Regulation on Determining, Imposing, and Enforcing Pecuniary Penalties on Insurers" should be
  noted, which became an important tool for effective supervision of the insurance market, as it contains
  detailed information about penalty amounts and procedures for imposing pecuniary sanctions for
  violating general insurance legislation as well as the Law "On Enhancement of Prevention of Illicit
  Income Legalization".
- The "Regulation on Forced Administration, Winding up, and Bankruptcy of Insurers" is no less important, serving the same goal. The regulation consistently describes procedures related to these special regimes, including an insurer's winding up and bankruptcy proceedings.
- The "Regulation on Determining Minimum Capital Requirements for Conducting Insurance Activi-

- ties on the Territory of Georgia" was adopted defining the amounts of minimum capital and minimum guarantee fund for different types of insurance.
- Elaboration and adoption of the "Rule on Insurers' Financial Reporting Forms and Their Submission to the National Bank of Georgia" is of particular importance, providing possibility of implementation of single accounting principles by means of new compliant electronic reporting formats.
- The "Rule on Insurers' Statistical reporting forms and their submission to the National Bank of Georgia" was elaborated and adopted. The rule provides a detailed reporting format for health insurance, since this type of insurance accounts for the largest share of the insurance market. Besides, other quarterly reporting formats were prepared, allowing the supervisors to obtain detailed information on participating reinsurers and the outstanding legal proceedings against insurers.
- The Rules "On Defining and Creating of Insurance technical provisions" and "On Determination of Assets Eligible for Covering Insurance technical provisions" were amended.
- Elaboration and adoption of the "Rule on Registration and Cancellation of Registration of Insurance
  Brokers" facilitates the regulation of intermediary activities on the insurance market, defining necessary registration conditions for both resident and non-resident insurance brokers/representatives to
  start their activities in Georgia.

Thus, based on the supervision practice in 2010, a number of rules were improved and new regulations were adopted.

As of December 31, 2010, the Georgian insurance market comprised 16 insurance companies. These included two insurance companies registered in 2010. 12 insurance companies perform both non-life and life insurance, while 4 remaining companies are involved only in non-life insurance activities. The founding structure of the companies is quite diversified. One insurer represents a branch establishment of an insurance company registered in the OECD member country, 2 insurance companies have a 100% foreign ownership, 4 insurance companies are partially owned by non-residents, while 9 insurance companies are fully owned by resident investors.

In 2010 the number of issued policies equaled 2.6 million, significantly exceeding the 2009 level. Meanwhile, increase in the number of policies issued to individuals (361 thousands) is notable, reflecting the development of the insurance retail market.

The gross insurance premium received by insurance companies in 2010 totaled GEL 372.5 million. In terms of gross written premiums, the concentration of the insurance market (5 largest insurers) declined from 83.6% to 77.9% in 2010 compared to 2009, indicating an increase in the activity of smaller insurance companies. Concurrently, it should be noted that in terms of insurance types Health Insurance accounts for 66.3 % of gross premium received.

DIAGRAM 58. Insurance Market Structure by Written Premiums in 2010

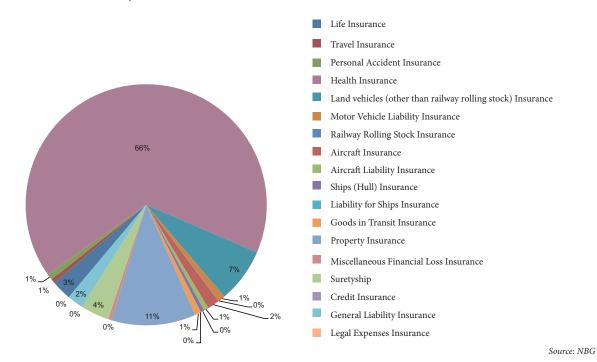
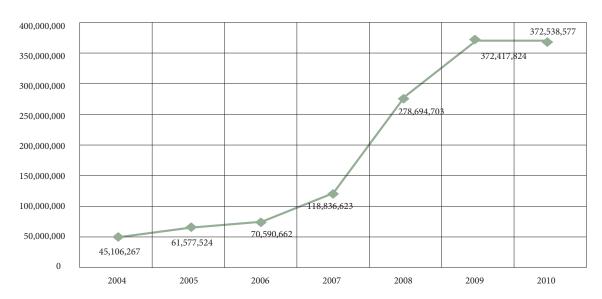


DIAGRAM 59. Dynamics of Gross Written Premiums (GEL)

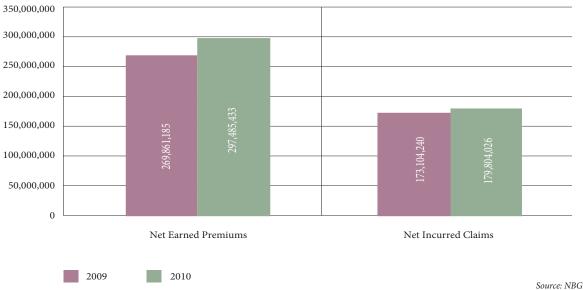


Compared to 2009, the companies' net earned insurance premiums increased by 10% reaching the amount of GEL 297.5 million. In annual terms, most types of insurance, health insurance in particular, posted revenue increases. Only a few areas, such as property insurance and motor vehicle liability insurance, registered a reduction in insurance earned premiums.

Based on the 2010 results, the reinsurance premium totaled GEL 63.0 million, while the share of reinsurers in the insurance liabilities, as of December 31, 2010, exceeded 79%.

In the accounting year net incurred claims amounted to GEL 179.8 million, while the main part of the actual losses, namely 91.3%, belongs to health insurance. By the end of 2010 the loss ratio in health insurance equaled 69.6%, descending by 4.2 pps compared to 2009. The overall loss ratio of the insurance companies equaled 60.4%.





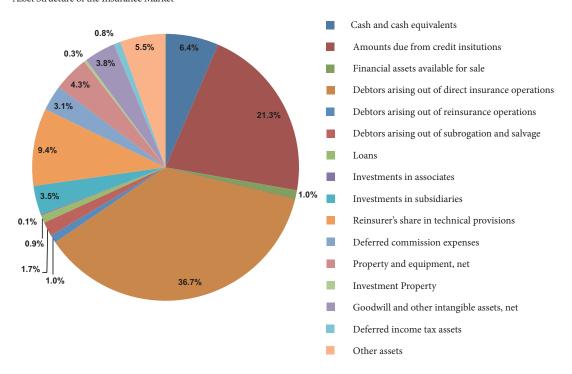
In the accounting period the net insurance profit increased by 90.1 % reaching the amount of GEL 34.0 million. The growth was largely due to an improvement in loss ratio, declining by almost 3.7 pps.

In 2010 the operating ratio improved by 2.3 pps, equaling 77.8% The parameters used for calculating the operating ratio include loss ratio 60.4%, expense ratio 30.7% and return on investment - 13.3%

Along with increased profitability, other financial ratios improved as well. In the accounting year the insurance companies' return on equity was 45.7%, return on assets – 8.7% and return on revenue – 11.4%.

The total volume of insurance companies' assets grew by GEL 116.9 million, amounting to GEL 448.4 million as of December 31, 2010, increased by 35.3% compared to 2009.

DIAGRAM 61. Asset Structure of the Insurance Market

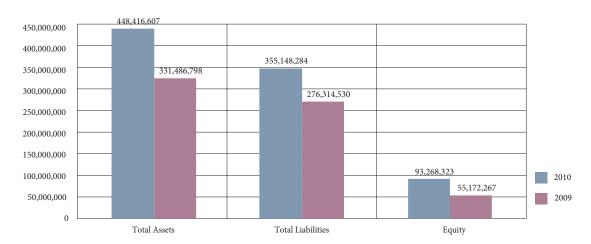


Source: NBG

The total volume of insurers' balance sheet liabilities at the end of 2010 equals GEL 355.1 million, exceeding the 2009 level by GEL 78.8 million. The gross insurance technical provisions hold a significant share in the liabilities of insurance companies, amounting to GEL 239.9 million as of December 31, 2010, almost 14% more than in 2009.

The total capital of insurance companies stood at GEL 93.3 million at the end of 2010, increased by 69.1% compared to 2009. Capital increase was due to growth of net profit as well as expansion of equity capital. Equity capital increased by GEL 5.1million resulting from establishment of two new companies and extra capitalization of the existing ones.

DIAGRAM 62. Insurers' Balance Sheet Items as of 31.12. 2009 vs 31.12.2010 (GEL)



As a result of measures taken by the NBG in 2010 the problem related to the lack of liquid assets was practically eradicated, as the insurance companies possess sufficient financing resources to cover the insurance technical provisions.

#### 4.1.1. PENSION SCHEMES

In 2010 essential changes were made in the area of non-state pension insurance, expressed in the amendments to the Law of Georgia "On Non-State Pension Insurance and Security" as well as in approved secondary legal acts such as the rules "On Determining Minimum Requirements for Non-State Pension Insurance and Security Agreements" and "On Determining, Imposing, and Enforcing Pecuniary Penalties on Non-State Pension Scheme Founders, Asset Management Companies, and Specialized Depositories". The latter rule represents an effective tool of supervision policy.

Another important change is related to lifting legislative limitations on investment activities of pension scheme founders. This issue became a matter of agreement exclusively between the founder and the participant, as well as the reflection of results of such investment activities (profit/loss) on the participant's savings. The rule adopted by the NBG imposed minimum disclosure requirements on founders of pension schemes with the view that their activities were as transparent as possible for the pension schemes' participants.

Changes affected pension schemes founded by banks and other legal entities. In particular, the banks were allowed to conduct activities related to non-state pension insurance and security only through subsidiaries established or acquired for this purpose; the latter in turn are precluded from investing pension savings into the assets of such founders of pension schemes, their parent companies, and the founders or affiliated persons of parent companies. All of the above served the interests of pension scheme participants.

As of 2010, there were six pension schemes founded by insurance companies, of which only three pension schemes actively performed pension insurance. The number of participants to these pension schemes at the end of 2010 amounted to 16,879 while the amount of pension scheme contributions totaled GEL 2.4 million, increased by 18.7% compared to 2009. The total liabilities of the pension schemes to their participants on December 31, 2010 stood at GEL 7.9 million.

#### 4.2. SECURITIES MARKET

In 2010, important activities related to the securities market included creation of main directions of the market development and renewal of the appropriate regulatory framework. All market participants submit their reports in line with international standards, which represented another step towards bringing market participants closer to international investors and partners. In addition, reporting of the market participants became available for public as well – the reporting forms of broker companies uploaded to the NBG's website allow users to get familiar with each company's financial standing and make an optimal decision with respect to an individual company.

The NBG prepared a new rule, which allowed for trading of securities listed on internationally recognized stock exchanges and of other securities issued by the companies listed at the internationally recognized stock exchanges without additional regulation. The rule included a detailed list of stock exchanges for which the above privileges were allowed. Since approval of the prospectus is a relatively long process, this rule provides certain incentives for foreign companies to place their securities in the Georgian market.

On June 18, 2010 the NBG became a partner organization of the Association of National Numbering

Agencies (ANNA), which made possible to assign an International Security Identification Number (ISIN) to securities issued in Georgia. This number is unique and includes quite voluminous information on characteristics of the securities. The number assigned by the NBG became globally identifiable; implying that securities issued and numbered in Georgia can be placed in the international markets as well.

The joint-stock company "Georgian Stock Exchange" introduced a stock index – GSX. The index represents an official indicator of the trading system at the stock exchange and its calculation and announcement is performed in line with the stock exchange rules. The index portfolio (base) mainly includes securities listed in the trading system; although according to GSE decision other securities of trading system may be allowed. The baseline period was defined as September 1, 2006.

In 2010 the Georgian Central Securities Depository made some changes to the rules, triggered by an interest of a large international custodian to enter the Georgian market. In particular, changes were made to the "Rule on Members of Central Securities Depository" and the "Rule on Operations and Procedures of the Central Securities Depository". As a result, the structure of Depository members and system of accounts were changed and the accent was made on servicing of custodians. The changes were effected in intensive consultations with the experts of the international custodian, and their demands were taken into account to the extent possible. Thus, favorable conditions are created in the Central Depository for expanding and improving the set of custodians' operations. The entering of the international custodian to the country in turn creates real perspectives for attracting institutional investors to the Stock Exchange.

Compared to the preceding year, trading of securities has expanded. In 2010, the number of transactions registered at the Stock Exchange grew 1.71 times. The value of transactions rose by 2.3%, amounting to GEL 101 million.

#### 4.2.1. MARKET PARTICIPANTS

The Georgian securities market was represented by the following licensed participants: a Stock Exchange, a Central Securities Depository, 9 brokerage companies, and 6 registrars.

#### 4.2.2. BROKERAGE COMPANIES

As of December 31, 2010, the Georgian securities market comprised 9 brokerage companies. Only one of these companies - "Abbey Asset Management, Ltd" was not the member of GSE.

In the accounting year the brokering license of the JSC "DBL Capital" was revoked (the merger with the JSC "BG Capital" was completed). As of December 31, 2010 the total volume of assets of broker companies equaled GEL 35.3 million, showing an insignificant 0.1% increase year-on-year. The liabilities totaled GEL 11.8 million, down by 0.7%. The total volume of equity amounted to GEL 23.5 million, up by 0.4%. The main part of the companies posted profits in the accounting period. Only three companies reported period losses.

TABLE 12. Activities of Brokerage Companies

Brokerage Company	Number of Transactions	Volume of Securities (Units)	Value (GEL)
JSC BG Capital	1,253	15,848,575	11,929,019
LLC Tbilintercapital	996	9,981,978	492,915
LLC Georgian Investment Group +	127	4,270,719	182,362
JSC Caucasus Capital Group	412	6,347,883	519,960
JSC Liberty Securities	2,258	377,478,746	8,420,942
LLC TBC Broker	138	3,046,044	131,031
LLC Caucasus Financial Services	42	799,048	36,516
LLC Cartu Broker	55	781,171	45,962
JSC DBL Capital	-	-	-
JSC Abbey Asset Management	-	-	-
Total	5,281	418,554,164	21,758,707

Source: NBG

## 4.2.3. REGISTRARS

As of December 31, 2010, the Georgian securities market comprised 6 licensed securities registrars. During the accounting year 2 licenses of securities registrars ("Georgian Registration Bureau, Ltd" and "Capital Register, Ltd") were revoked. These registrars kept stock records of 864 joint-stock companies. The activities of securities registrars are given in Table 13.

TABLE 13. Activities of Securities Registrars

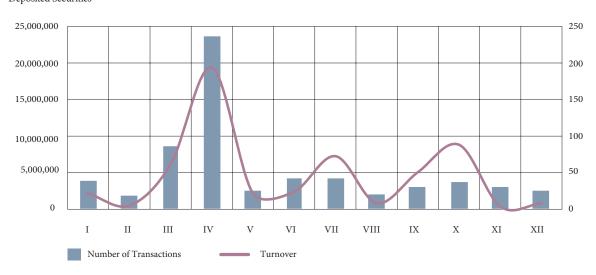
Registrar	Number of Issuers	Number of Transactions	Volume of Securities (Units)	Value (GEL)
JSC Kavkazregister	125	87	1,326,223,750	81,415,585
LLC Capital - Register	83	11	193,604	794,315
LLC Tbilisis Reestri	28	6	5,512	156,721
JSC United Securities Registrar of Georgia	376	179	685,566	870,275
LLC Registri	84	38	37,742	71,427
LLC National Registry	168	12	1,856,538	1,242,246
Total	864	333	1,329,002,712	84,550,569

Source: NBG

#### 4.2.4. DEPOSITORY

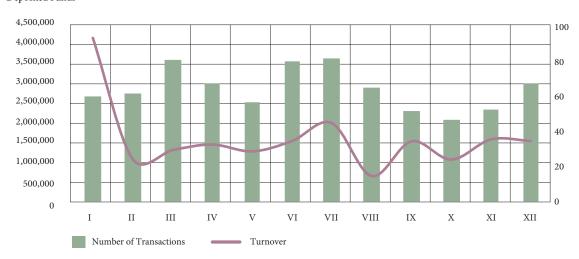
As of December 31, 2010, the Central Depository members included eight brokerage companies. The Central Securities Depository stored securities worth GEL 55.4 million and monetary funds equal to GEL 19.2 million.

#### DIAGRAM 63. Deposited Securities



Source: NBG

DIAGRAM 64. Deposited Funds



Source: NBG

TABLE 14. Financial Indicators of the Central Securities Depository in 2009-2010

Year	Assets	Liabilities	Equity	Period Outcome
2010	401,635	18,344	383,291	17,617
2009	380,524	14,849	365,675	(6,463)

#### 4.2.5. STOCK EXCHANGE

DIAGRAM 65.

As of December 31, 2010, 128 companies were allowed to trading system of GSE. In the accounting period the total number of securities transactions equaled GEL 101.2 million (1.7 billion units). The value of transactions made at the stock exchange amounted to GEL 5.1 million, while the transactions made OTC valued at GEL 96.1 million. In the overall volume of registered transactions, the registrars account for 80% of transactions in terms of numbers, and for 88% in terms of value (1.3 billion transactions worth GEL 84.6 million). The value of transactions concluded and registered through brokerage companies amounted to GEL 21.8 million.

The value of securities transactions remained practically unchanged, despite a 1.74-time decrease in the number of transactions.

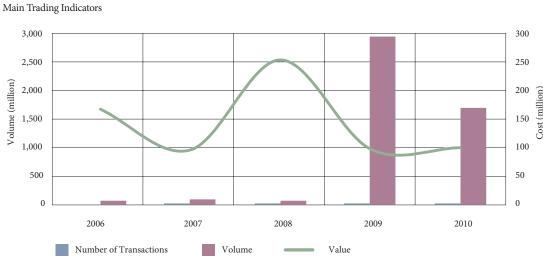


TABLE 15.
Consolidated Information on Main Trading Indicators at Georgian Stock Exchange in 2009-2010

	Number of	Transactions	Volume of	Securities	Value of Secu	rrities (GEL)
Year	2010	2009	2010	2009	2010	2009
At GSE	2,372	1,304	41,641,272	12,667,601	5,117,755	3,112,576
Outside GSE	835	572	1,663,935,776	2,954,953,076	96,051,895	95,757,904
Total	3,207	1,876	1,705,577,048	2,967,620,677	101,169,650	98,870,480

#### DIAGRAM 66. Main Monthly Indicators

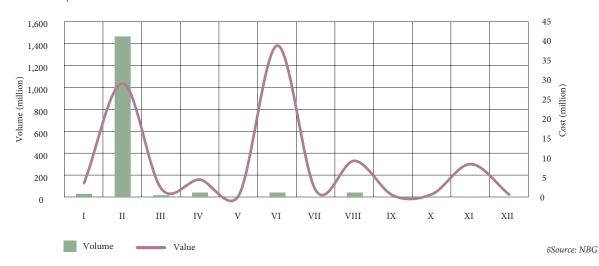


DIAGRAM 67. Consolidated Data on Transactions' Value by Issuers in 2010

DIAGRAM 68.
Distributions of Transactions' Value by Issuers at the Trading Sessions in 2010

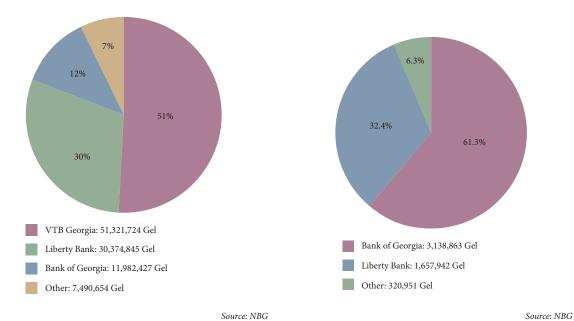


DIAGRAM 69.
Distribution of Transactions' Value by Issuers Outside the GSE in 2010

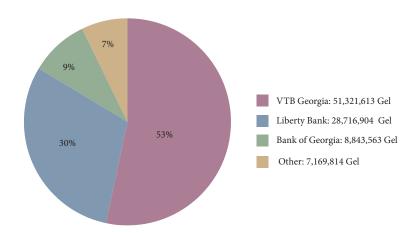


TABLE 16. Financial Indicators of the Georgian Stock Exchange

Year	Assets	Liabilities	Equity	Period Outcome
2010	1,531,081	62,883	1,468,198	98,882
2009	1,421,634	52,319	1,369,315	91,034

Source: NBG

#### 4.2.6. REPORTING COMPANIES

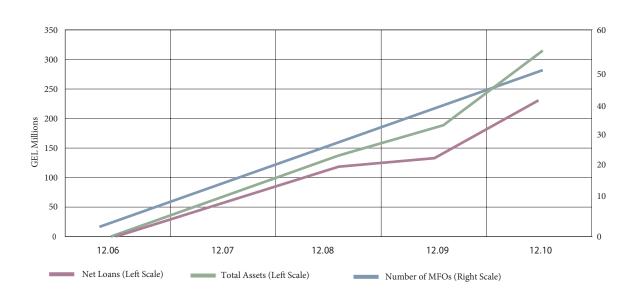
In 2010 the NBG assessed the status of 316 reporting companies and defined the list of those enterprises which were to submit an annual report. The NBG analyzed 71 annual, 69 semi-annual, and 27 current reports submitted by the enterprises. The majority of submitted reports did not satisfy the existing requirements, being prepared with a number of deficiencies. In active cooperation and consultations with the NBG, a large number of enterprises corrected and resubmitted their reports. The NBG remains in intensive consultations with the enterprises, helping them in submitting reports in conformity with the existing standards and legislative norms.

During 2010 the NBG reviewed and approved an equity prospectus of the JSC "VTB Bank Georgia" with the face value of GEL 43,500,000.

#### 4.3. MICROFINANCE INSTITUTIONS

In 2010 "light-touch" supervision policy of the NBG in the microfinance sector continued. As of December 31, 2010, the market included 18 credit unions, 49 microfinance organizations (MFOs), 1623 foreign exchange bureaus, and 37 money remittance units. In 2010 the number of MFOs increased by 29%, evidently promoted by a more liberal supervisory environment. The assets of MFOs grew by 67%, the asset portfolio expanded by 77%, while the equity capital increased by 44%. The respective numbers of the above indicators, as of December 31, 2010, stood at GEL 309.5 million, GEL 229.5 million, and GEL 81.6 million. The total assets of credit unions still remain at a low level of GEL 2.8 million, despite a 51% annual growth.







## PAYMENT SYSTEMS

In 2010 the NBG implemented a new payments and settlement system (GPSS) with the financial support of the World Bank and the USAID. The system software was developed by the US company "Montran", one of the main global suppliers of payment systems.

#### 5.1. THE REAL TIME GROSS SETTLEMENT SYSTEM (RTGS)

The new Georgian Real Time Gross Settlement (RTGS) system, which is operated by NBG, went live on 3rd of December 2010. The RTGS system is the main system in Georgia of interbank payments in GEL. The system processes low and high value payments. Transactions are carried out by both bulk and individual payments. Participants can transfer to the system low value transactions (less than 10 000 GEL) in bulk payments.

New RTGS system offers effective and reliable bank service to direct consumers of the banking sector. Operational risks are minimized; payment processing is significantly improved; during operational hours, interbank payments are processed rapidly and safely, supporting Straight-Through-Processing simultaneously.

The transaction management tools have become more flexible for participants. This includes assignment of transaction priorities as well as the option of changing it. Gridlock resolution mechanism is integrated into the RTGS system. Monitoring and reporting functions are also improved.

New RTGS and CSD (Government and NBG securities settlement system) systems are independently functioning, but at the same time mutually integrated systems. Through these systems banks are able to use liquidity management mechanism, such as the Intraday Liquidity Facility (ILF) in case of lack of funds on their settlement accounts. ILF can be used by banks only in case the collateral is duly registered in the CSD system. If at the end of the day the bank is unable to fully repay the ILF, it will be automatically transformed into the overnight loan using the same collateral. The commercial banks are to make the decision on ILF usage.

In terms of security the new RTGS system is safer. In particular, the system provides modern mechanisms of user management and access control, which significantly reduces risks of unauthorized access. Automatic switching to the disaster recovery site is also provided for contingency situations.

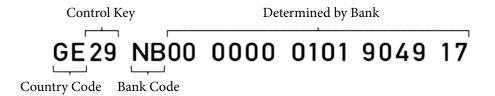
#### 5.2. GOVERNMENT AND NBG SECURITIES SETTLEMENT SYSTEM (CSD) SYSTEM

On 17<sup>th</sup> of December 2010, a CSD (Central Securities Depository) system was successfully introduced by NBG for the management of Government and NBG Securities.

By introducing the CSD system the NBG switched to a modern high-technology model of state securities management. All the operations that are being handled at this moment electronically in the CSD system were previously conducted manually, usually requiring paper document circulation. In overall, through STP the system ensures fast and safe processing of securities transactions and interbank transfer. Detailed information regarding the system is given in Chapter 2.2 on Monetary Instruments.

#### 5.3. INTERNATIONAL BANK ACCOUNT NUMBER (IBAN)

In 2010, bank account standardization was performed in the Georgian banking system. Starting from May 3, 2010 all bank accounts have to be opened in IBAN format.



The NBG has officially registered Georgian IBAN account format (22 symbols) in SWIFT. In addition, Georgian banks are registered in the international bank registry (BICplusIBAN), whose users can identify receiver bank details (BIC code, address, etc.) through the IBAN beneficiary account and make necessary transfers.

As a result of introducing IBAN account the operational risks are reduced. In particular, this format excludes the possibility of indicating an account incorrectly, providing for support of introducing the straight through processing (STP) method in interbank payments. The use of IBAN account exempts a beneficiary bank from the additional verification, therefore decreasing the bank's operational costs.

#### STATISTICS ON RTGS SYSTEM PERFORMANCE

In 2010, 7.3 million transactions were processed through RTGS system, with a value of 75.3 billion GEL. A daily average volume of processed transactions equaled 29,071 with an average daily value of GEL 301.4 million. Compared to 2009, the volume has been increased by 1.5 million which represents the 26% of growth, and the value of transactions by 41.4 billion GEL, i.e. 122 %. This was basically caused by the NBG reforms which resulted increasing of monetary operations (refinancing loans, overnight loans and deposits) and interbank money market.

The 2002-2010 statistical data on the RTGS system performance are given below in diagrams 71 and 72:

DIAGRAM 71. Transfers through RTGS System (Monthly Data, 2010)

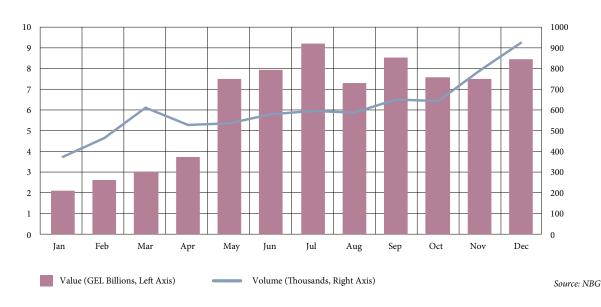
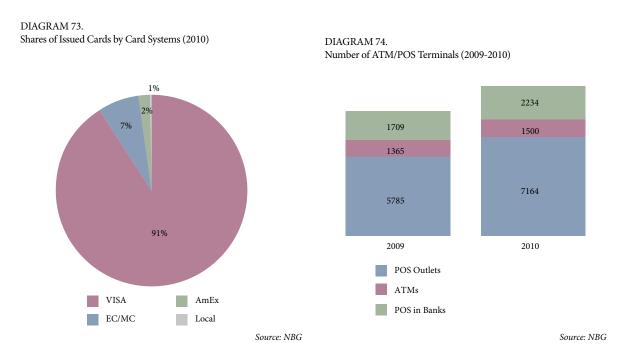


DIAGRAM 72. Transfers through the RTGS System (2002-2010 Annual Data)



#### 5.4. PLASTIC CARDS

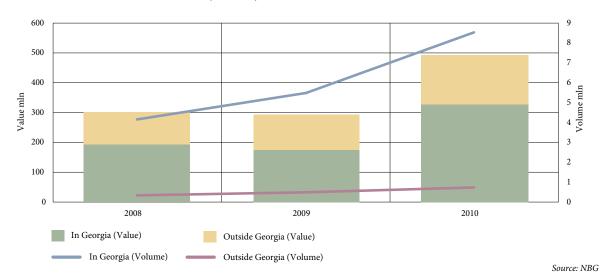
At the end of the reporting period the number of issued plastic cards in Georgia reached 3.1 million. During 2010 there were 7 cards per 10 capita on average. VISA cards covered the largest part of the market. MasterCard cards were also present in circulation, while issuance of American Express cards significantly increased.



Number of payment cards service units was also increased. At the end of 2010, the number of ATMs in Georgia was 1500 (by 135 ATMs more than the previous year), and the number of POS-terminals at the merchants outlets was 7164 (by 1 379 more terminals as compared to previous year).

The use of payment cards as means of payment is increasing. Throughout the analyzing year, the value of transactions conducted with Georgian cards per POS terminal of merchants outlets approximately doubled compared to 2009.

DIAGRAM 75. Card Transactions in Merchant/Service Outlets (2008-2010)



Card usage via internet as a payment instrument has been increased (utility payments, online-shops, taxes and etc.). In 2010 volume of internet transactions was increased 1.9 times compared to the previous year.

The use of payment cards is more secure relative to cash transactions but still is accompanied with fraud, lost/steal and other risks. Regarding this fact, a relevant work was done by issuer banks as well as processing centers. The most of the banks started to issue chip based cards, which increased the security of card payments. E-commerce Security technologies (Verified by Visa and MC Secure Code) also have been developed. All Processing Centers in Georgia are working in order to comply with international card system standards (PCI DSS). For the customers of the American Express, mandatory insurance was introduced, which is an additional security mechanism. In October 2010 at the initiative of MasterCard and with the participation of the NBG the seminar on security and fraud prevention was conducted.

In 2010 a new product was introduced at the Georgian market. Commercial banks started issuance of limited prepaid cards.

#### 5.5. LEGISLATIVE REFORMS RELATED TO PAYMENT SYSTEMS AND PAYMENT SERVICES

In the reporting period, improvement of the legislative base related to payment system was under way, which aimed to provide safety and soundness of payment systems in Georgia and raise their efficiency. Real-time Gross Settlement System Rules and Procedures have been elaborated and put in place. Amendments to the existing "Regulation on Bank Cards" have been introduced, which mainly were related to personalized and non-personalized prepaid cards and also established restrictions on certain types of operations provided by non-personalized cards.

In 2010, NBG has started working on the draft "Law on Payment Systems and Payment Services", as well as on the "Regulation on Supervision of Payment Systems" with support and legal assistance of the International Monetary Fund Mission. After adoption of the mentioned legal acts will empower the NBG to regulate and oversee payment systems, as well as activities of the payment service providers, that will promote the development of the non-banking sector and will enhance the public confidence towards electronic payment services.



## INTERNAL AUDIT AND ACCOUNTING

In early 2010 the NBG updated the internal audit methodology for risk-based planning. The updated document reflected results related to restructuring of the NBG's individual organizational units, changes in general business risk profiles, deployment of new system projects, and decomposition of certain auditees. An updated assessment was prepared with respect to particular risk profiles of auditees and adequacy of internal control. Auditees were grouped by risk categories, audit cycles were defined, and the action plan was elaborated.

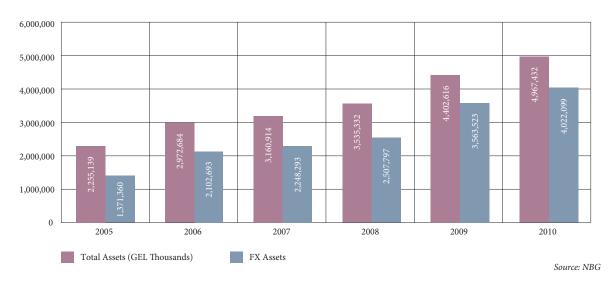
In line with International Standards for the Professional Practice of Internal Auditing, the "Quality Assurance and Improvement Policy of the Internal Audit Service" and the "Quality Assurance and Improvement Program of the Internal Audit Service" were elaborated. The Program allowed permanent quality control of internal audit engagements. In line with the Program, for the purpose of controlling internal audit engagement process, the regular usage of a checklist with compulsory procedures was mandatory. In addition, after each internal audit engagements a survey of audit client was conducted. The Program also envisaged an annual monitoring of the performance indicators of internal audit activities using the benchmarking system. It should be noted that the benchmarks defined by the Program were fully attained in the reporting period. The Program also defined necessity and periodicity of internal and external assessments. The first external assessment of the Internal Audit Service activities was done 2010.

Taking into account the existing practices and new requirements, in the reporting period the NBG reviewed certain procedures and prepared new documents related to internal audit. These documents included, in particular: "Description of Procedures Related to Planning of Internal Audit Engagement, Preparation and Implementation of Audit Process", "Policy and Procedures with Respect to Implementation of Recommendations of External Auditors", "General Methodology for Quality Assessment of the Internal Audit Service Activities", and methodological reference "Assessment of Fraud Risks". In addition, the International Standards for the Professional Practice of Internal Auditing and Code of Ethics, issued by the Institute of Internal Auditors, were translated for internal purposes.

In 2010 the "Internal Auditor's Manual" was prepared in a consolidated form based on accumulated experience in the field of internal audit, the NBG's existing methodological documentation, policies and procedures.

In the accounting period activities related to improving financial reporting and accounting were under way. In particular, in 2010 the RTGS and CSD systems were implemented. Along with the integration of the system with the main banking system, additional modules for recording CDs and refinancing loan transactions were put into operation.

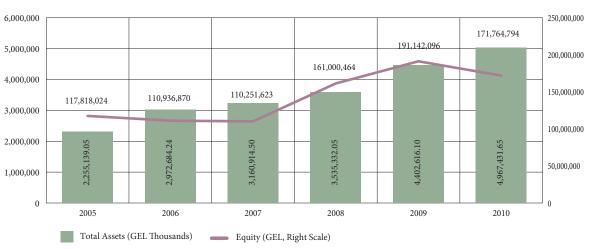
DIAGRAM 76. Assets in Foreign Currency and Total Assets (GEL Thousands)



In the accounting period preparatory activities were conducted with the view of implementation of the international reserve management system. The NBG's Finance and Accounting Department collaborated with the World Bank experts and the central bank of Australia. Sharing of experience in the area of recording financial instruments was particularly important.

In 2010 activities related to improvement of internal procedures continued. In particular, in 2010 the "Methodic Instructions on Using the Main Banking System of the NBG" and the "Manual on Accounting and Financial Reporting in the NBG" were updated.

DIAGRAM 77. Equity and Total Assets





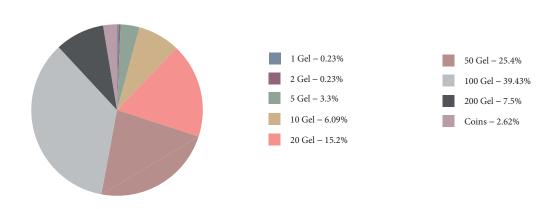
## ORGANIZATION OF CASH EMISSION ACTIVITIES

In order to fully satisfy the economy's demand for cash, in the accounting period the following activities were conducted: production, import, storage, and emission of notes and coins, quality improvement of notes and coins in circulation, appropriate processing of cash withdrawn from circulation, destroying of worn out bank notes, and improvement of legal basis.

In 2010 the NBG began construction of a modern cash centre in line with international standards, equipped with up-to-date security and money processing technologies. Putting into operation of the cash centre will allow the NBG to implement high-tech programs related to operations recording and ensure centralized control of cash and other valuables. The cash centre will significantly improve provision of notes and coins to the whole territory of the country and enhance the process of bank servicing.

As of December 31, 2010 the volume of cash in circulation equaled GEL 1,618.2 million, where the value of bank notes was GEL 1,575.8 million and the value of coins – GEL 42.4 million (Diagram 78).



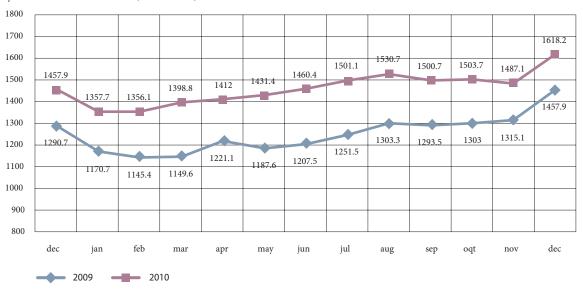


Source: NBG

The volume of cash in circulation increased by GEL 160.2 million, or 10.9%, during the year. The value of banknotes increased by GEL 156 million, with its share reaching 97.4% of total cash in circulation. In the same period the value of coins grew by GEL 4.2 million (Diagram 79).

DIAGRAM 79.

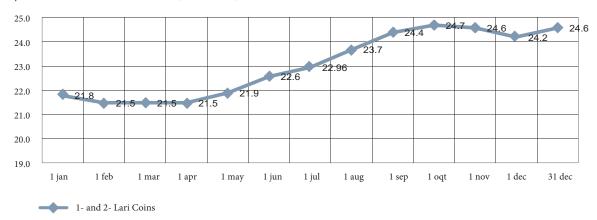
Dynamics of Cash in Circulation (GEL Millions)



Source: NBG

In 2010 the volume of low-denomination bank notes (1, 2, and 5 lari) increased 2.5%, while the volume of higher-denomination notes grew 11.5%. In the accounting period an increase of 1- and 2-lari coins should be pointed out, indicating their full acceptance by the population. In particular, the volume of coins in circulation equaled GEL 21.8 million in the beginning of 2010, increasing 13.1% during the year and amounting to 24.6% at end-2010 (Diagram 80).

DIAGRAM 80. Dynamics of 1- and 2- Lari Coins in 2010 (GEL Millions)



Source: NBG

An 8.9% increase of small coins, tetri, is also remarkable, owing to higher demand for transaction purposes in public transport and trading outlets. The NBG actively supplied small coins to the market, on the one hand, fully satisfying demand on the part of commercial banks, and, on the other hand, obliging commercial banks to provide small coins to any individual or legal entity irrespective of the fact whether these persons had an open account with the concrete bank or not.

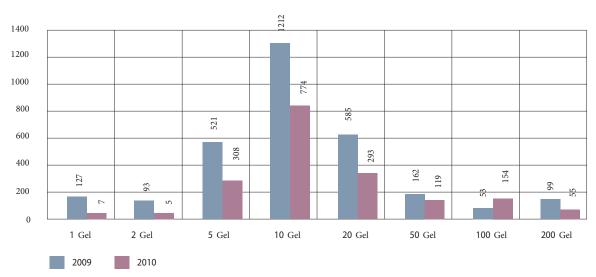
In order to improve money counting and sorting processes, the counting cash-desk of the Tbilisi cash center introduced a new machine produced by "Giesecke & Devrient", capable of sorting and ordering bank notes and coins in line with international standards, while the Kutaisi cash center installed 2 new money sorting and ordering machines of "Cobra 4004" type, produced by the company "De La Rue". In addition, money counting machines "MSB-30" and cash detectors were purchased.

In order to detect chemical composition of coins for circulation, collection, and other purposes, as well as for identifying fake coins, the "FISHERSCOPE X- RAY XAN150" spectrometer was purchased, capable of identifying the composition of precious and base metals and the content of internal layers without damaging coins.

In 2010, the number of fake lari notes decreased 39.9% (Diagram 81), while the number of fake lari coins lowered 14.6%. This included a 37.3% decrease in the number of fake 1-lari notes, while the number of 50-tetri coins, emitted in 1993, dropped 26% (Diagram 82).

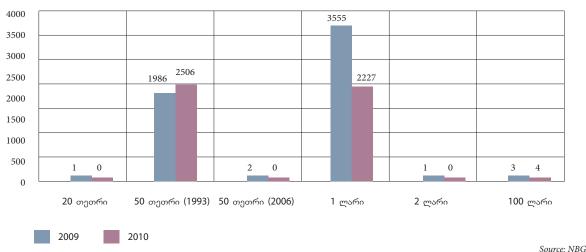
With respect to fake foreign currency notes and coins, the number of fake US dollars increased 8.4%, while identified fake Russian rubles increased 2.5 times. The number of fake euro notes in the accounting period remained at the 2009 level.

DIAGRAM 81. Number of Fake Lari Notes Detected



Source: NBG

DIAGRAM 82. Number of Fake Lari Coins Detected



300,00,112

As a result of introducing a new optimal adjusting and sorting criterion for money processing system, in 2010 the visual and esthetic side of banknotes in circulation considerably improved, serving as one of the factors which contributed to a reduction in fake banknotes compared to 2009 The decision of the NBG on withdrawing bank notes issued in 1995 and 1999 from circulation also played a positive role.

In the accounting period the NBG provided methodological guidance to commercial banks and currency exchange bureaus as well as to legal entities and individuals with respect to improving personnel qualifications.

In particular, special trainings were provided to 158 cashiers, which included the following issues: legal basis with

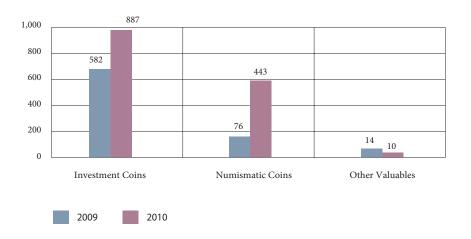
respect to combating spread of fake notes and coins and appropriate responsibilities of cashiers; protection features of notes and coins; identification of validity of the national currency; working with cash in general.

In order to familiarize the public with the history of Georgian money and the activities of the NBG, the Museum of Money at the NBG actively offered educational lectures.

In 2010 the Museum conducted 47 educational courses, which included overview of the Georgian numismatics and a guided display of the museum exhibits. The courses were attended by 674 people. In addition, the Museum of Money regularly conducted excursions for schoolchildren. In 2010 2,081 schoolchildren attended the excursions, while guided tours were offered to 2,260 persons.

In the accounting period the NBG, through the Museum of Money and the Kutaisi cash center, offered for sale investment and jubilee coins. The revenues from sales of coins in 2010 totaled GEL 1,339.5 thousand, exceeding the 2009 level by 99.3%. The receipts amounted to GEL 443.1 thousand from numismatic bank notes and coins, GEL 886.5 thousand – from investment coins, and GEL 9.9 thousand – from sales of the remaining products.

DIAGRAM 83. 2009 - 2010 Sales of Valuables



Source: NBG

In the accounting period the activities related to improvement in the legal basis regulating cash emission. In particular, on March 23, 2010 after introducing amendments to the Organic Law of Georgia "On the National Bank of Georgia", which also included the legal basis for production and sale procedures of lari bank notes and coins (including those for numismatic and other purposes), a resolution #5 of the NBG Board "On Approving the Mode of Production of Lari Bank Notes and Coins" dated June 10, 2010 was prepared and approved; with the purpose of raising the security level in those units of commercial banks, which directly conduct operations related to cash and other valuables, according to the Decree of the President of the NBG # 140/01 dated November 2010, amendments were introduced to the Rule "On Approving the Conduct of Operations Related to Cash and Other Valuables at Commercial Banks" approved by the President of the NBG through Decree # 7/01 dated January 29, 2010, etc.



# PUBLIC RELATIONS AND INTERNATIONAL COOPERATION

In order to ensure maximum transparency of the NBG's activities and to promptly provide information to the public on current processes in the banking system, public relations were conducted with the use of mass media as well as through other means of communication. In the accounting period the NBG promptly disseminated press releases and statistical data, regularly conducted press conferences, conferences, briefings, seminars, presentations and meetings on the relevant topics.

In order to provide adequate and comprehensive information to public about planned reforms, new financial products to the banking sector, the NBG's representatives held regular meetings with print and electronic media.

In 2010 the NBG's monetary policy was aimed to attaining price stability in the medium and long-term



period. The monetary policy was directed at managing inflationary expectations rather than actual inflation. Therefore, in order to ensure effectiveness of monetary policy it was crucial to establish adequate inflationary expectations among the population. For this purpose it was extremely important to ensure transparency of the monetary policy through active public relations policy of the NBG.

It is crucial for the public to understand the current economic processes and expected outcomes, as well as the NBG's policies and their impact on the economy. In this context, in line with the conventional practice used by central banks of the advanced countries, by means of electronic and print publications as well as other means of mass media the NBG made efforts to ensure maximum availability of information on the current tendencies in the money and FX markets, express its opinion with respect to these issues,

and explain the motives standing behind a particular decision. For these purposes the NBG published a "Monthly Survey", a quarterly "Inflation Report", promptly disseminated statistical data and press releases of the MPC. In addition, in 2010 the NBG prepared disseminated the following publications: "2009 Annual Report of the NBG", "2010 Financial Stability Report", "2009 Balance of Payments", Monetary and Fiscal Bulletin" (quarterly).

The Electronic versions of the NBG's publications are available at the official internet site of the NBG (http://www.nbg.ge).

In the accounting period along with intensification of international cooperation and with the purpose of sharing experience with other central banks in particular areas the NBG cooperated with various central banks in the world.

In 2010 the NBG organized a few international meetings. In April 2010 the NBG hosted an international conference titled: "Re-Starting Credit Expansion in Caucasus, Central Asia, and EU's Eastern Neighbors". The conference was attended by the representatives of Ministries of Finance and central banks of 12 countries.

On September 13, 2010 the NBG and the World Bank jointly organized an international conference. The conference focusing on contemporary problems of market risk management and their solutions was

attended by 40 representatives of 20 central banks. The participants heard about contemporary approaches to market risk and profitability assessments, instruments and practices. According to the World Bank representatives, Georgia is a clear regional leader in conducting reforms and that was the reason why Tbilisi was selected as the venue of such an important event.

In November 2010 the NBG hosted a conference titled "Responsibility in the Financial Sector",



which was organized with the support of the KfW Development Bank and the European Fund for Southeast Europe (EFSE). The aim of the conference was to promote responsibility in the financial sector and share experience of different central banks in this regard. Such activities with the participation of central banks are held in Europe on an annual basis. This conference was the fifth for Georgia.

One of the priorities of the NBG represents the field of education. In this regard, in 2010 the NBG and 9 institutions of higher education signed a Memorandum of Understanding. The latter provides for



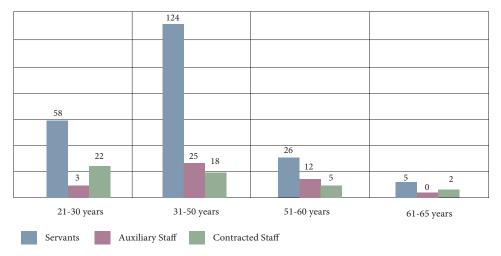
cooperation between the NBG and higher education institutions in the field of joint educational projects, professional training of young specialists, exchange of experts, joint preparation of educational and scientific publications. In the framework of the MoU the NBG representatives regularly conduct thematic lectures in various Georgian institutions of higher education. Besides the NBG staff, lectures in the higher education institutions were also given by international specialists.



## NBG PERSONNEL AND CAPACITY BUILDING

By end-2010 the number of the NBG personnel equaled 300. This included 213 office workers, 40 auxiliary and 47 contracted staff. The average age was 38 years for office workers, 45 years for auxiliary staff, and 35 years for contracted staff. 93% of staff had higher education. Women accounted for 47%.

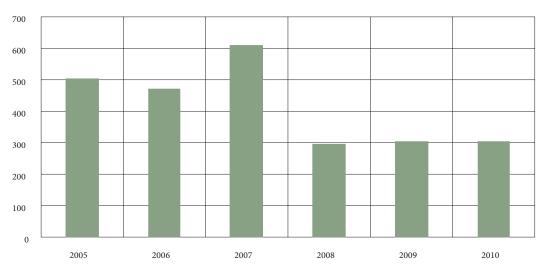




Source: NBG

In order to optimize the structure of the NBG, in the accounting period reorganization of certain structural units was performed. In particular, due to qualitative changes in activities, the department of banking supervision and the department of audit, as well as methodological and licensing and registration units underwent structural changes. As a result the departments of banking supervision, specialized groups and supervision policy, non-banking supervision as well as the money laundering inspection unit were formed.

DIAGRAM 85. Number of NBG Personnel (2005-2010)



The NBG installed the HR automated management system and elaborated the rule on HR management procedures and their automated recording.

In order to clearly define job responsibilities and identify required competences of staff, the NBG undertook analysis of the existing activities. As a result of these activities with the assistance of heads of structural units job descriptions were produced.

The process of receiving interns at the NBG was improved and systematized. Based on the MoU concluded with higher education institutions, 32 interns were accepted, 7 of which are now the NBG staff.



## DEVELOPMENT OF THE LEGAL BASIS

The improvement of the legal basis regulating the activities of the NBG and the financial sector continued throughout 2010. The NBG abolished approximately 90 legal acts and replaced them with 48 new legal acts reflecting the current requirements of the financial market.

Legal acts, adopted in 2010 defined such important issues as establishment of branches, divisions (service centers) and representative offices by commercial banks both on the territory of Georgia and outside of its country; external audit of commercial banks; operations related to cash and other valuables in commercial banks; use of the international bank account format - IBAN by commercial banks; licensing of securities registrars and broker companies, submission of financial reporting, definition of minimum capital requirements and reporting; financial and statistical reporting of insurance companies; formation of insurance reserves; registration and cancellation of registration of insurance brokers; enforced administration, liquidation, and bankruptcy of insurers, etc.

Amendments were introduced to cashless settlement rules and regulations on bank plastic cards, bringing these legal acts in conformity with international practice and modern requirements of payment system development.

Legal acts regulating the NBG's monetary operations were updated. The changes covered overnight loans and deposits, refinancing loans, forms of collateral used for receiving the NBG's loans, and issues related to the management of portfolio eligible to be used as collateral for monetary operations.

Legal acts were issued, which envisaged pecuniary sanctions for securities registrars and brokers, money remittance institutions and MFOs, insurers, founders of pension schemes, asset management companies, and specialized depositary, also comprising sanctions for violating the requirements of the Law of Georgia on Facilitation of Prevention of Legalization of Illicit income.

The rules for operation of the RTGS and the CSD systems were elaborated. In order to ensure conformity of legislative framework with the mentioned acts, draft changes in a number of legal acts were prepared by the NBG; In addition, internal procedures related to the operation of these two systems have undergone legal expertise.

In the reporting period preparation of the draft Law of Georgia "On Payment Systems", as well as relevant amendments in other legislative acts relating to the topic was initiated. This Law aims to design legal framework for important issues such as payment systems, payment services, and rights and obligations of service providers, electronic money and regulation of e-money issuers, financial collateral, etc. The draft Law defines main principles of registration and regulation of the payment system operators and payment service providers, as well as the NBG's regulatory authority in terms of imposing requirements on systemically important payment system operators and payment service providers.



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## 1. MAIN MACROECONOMIC AGGREGATES

	Unit value	2000	2005	2006	2007	2008	2009	2010
I.Real Sector								
Nominal Gross Domestic Product	Mln GEL	6043.1	11620.9	13789.9	16993.8	19074.9	17986.0	20791.3
GDP per capita	GEL	1362.5	2689.1	3133.1	3866.9	4352.9	4101.3	4686.5
Output of Industrial Production	Mln GEL	1793.4	3242.9	3952.7	4521.0	4884.9	4515.7	6079.0
Output of Agricultural Production	Mln GEL	1857.2	2585.4	2341.7	2390.2	2375.2	2228.9	2321.5
Growth Rate in Real GDP	%	101.8	109.6	109.4	112.3	102.3	96.2	106.4
2. Inflation								
Consumer Prices Index	%	104.6	106.2	108.8	111.0	105.5	103.0	110.7
Nondurable Goods	%	106.9	107.3	112.4	111.9	105.4	103.2	115.6
Semidurable Goods	%	102.1	103.5	98.8	96.4	98.4	92.6	100.9
Durable Goods	%	101.0	100.9	96.9	99.0	100.7	94.8	104.3
Services	%	101.9	104.2	107.3	113.1	107.7	105.5	100.6
3. State Budget**								
Cash Receipts from Operating Activities	Mln GEL	640.2	2607.5	3293.3	4293.6	5517.7	4917.0	5421.5
Cash Payments for Operating Activities	Mln GEL	833.8	2618.6	2669.4	3890.0	5554.7	5367.2	5466.5
Net Cash Inflow from Operating Activities	Mln GEL	-	-	623.9	403.6	-37.0	-450.2	-45.0
Net Cash Outflow from Investments in Nonfinancial Assets	Mln GEL	-	-	278.7	274.0	324.7	746.8	873.6
Cash Surplus (+) / Deficit (-)	Mln GEL	-193.6	-11.0	345.2	129.6	-361.7	-1197.0	-918.6
Percentage of GDP	%	-3.2	-0.1	4.5	0.8	-1.9	-6.7	-4.4
4. Employment								
Employment	Thousand employees	1840.7	1744.6	1747.3	1704.3	1601.9	1656.1	
Unemployment rate	%	10.3	13.8	13.6	13.3	16.5	16.9	
5. Social Indicators								
Money Monthly Income of Households	Mln GEL	149.4	272.6	305.5	351.6	454.4		
Money Monthly Expenditure of Households	"	246.7	309.1	333.7	373.0	452.7		
Nominal Wages	GEL	72.3	204.2	277.9	368.1	534.9	556.8	664.4*
Growth of Nominal Wages	%	107.1	130.2	136.1	132.5	145.3	104.1	105.5*
Growth of Real Wages	%	122.6	120.4	124.6	121.3	132.1	102.3	95.5*
Minimum Cost of Living for:								
Adult Male	GEL	114.5	98.3	120.3	115.9	130.7	126.1	149.6
Average consumer	GEL	100.4	87.1	106.5	102.7	115.8	111.7	132.5
Average family	GEL	199.2	164.9	201.7	194.4	219.3	211.5	250.9

 $\textbf{Source:} \ \textbf{National Statistics Office of Georgia; Ministry of Finance.}$ 

a) December of the previous year is a basis for the CPI of the next year.
b) Mismatch between household income and expenditure is caused by unwillingness of households to fully reveal their income.

<sup>\*) 4-</sup>th quarter.
\*\*) 2000–2005 – by old classification.

## 2. CONSUMER PRICE INDICES

(Over December of the Previous Year)

	20	005	20	06	20	07	20	08	20	09	20	010
	Price index	Monthly per-centage change										
January	102.1	2.1	101.2	1.2	102.7	2.7	102.5	2.5	101.4	1.4	101.1	1.1
February	102.4	0.3	101.4	0.2	103.5	0.7	103.4	0.9	100.0	-1.3	102.6	1.5
March	103.0	0.6	101.5	0.1	102.4	-1.1	103.5	0.1	99.6	-0.4	102.4	-0.2
April	103.5	0.4	103.3	1.8	102.7	0.3	103.8	0.3	100.1	0.5	102.7	0.2
May	102.1	-1.3	105.8	2.4	104.3	1.6	104.6	0.7	101.3	1.2	102.3	-0.4
June	100.6	-1.4	105.6	-0.2	104.1	-0.2	104.5	-0.1	101.3	0.0	102.0	-0.3
July	98.6	-1.9	106.4	0.8	104.3	0.1	103.2	-1.2	97.9	-3.4	101.8	-0.2
August	99.2	0.6	106.0	-0.4	104.9	0.6	106.7	3.4	97.9	0.0	104.1	2.3
September	101.1	1.9	106.0	-0.0	106.2	1.2	105.8	-0.8	100.7	2.8	107.4	3.1
October	102.9	1.7	106.8	0.8	109.2	2.8	105.3	-0.5	103.0	2.2	109.5	2.0
November	104.3	1.4	107.9	1.0	110.7	1.4	106.0	0.7	103.1	0.2	110.7	1.1
December	106.2	1.8	108.8	0.9	111.0	0.3	105.5	-0.4	103.0	-0.1	111.2	0.5

Source: National Statistics Office of Georgia.

## 3. ANNUAL INFLATION

	20	005	20	06	20	07	20	08	20	09	20	010
	12 month change	12 month average										
January	9.3	6.1	5.2	7.9	10.4	9.6	10.7	9.3	4.4	9.4	2.7	1.6
February	9.2	6.3	5.1	7.5	11.0	10.1	10.9	9.3	2.1	8.7	5.6	1.9
March	9.7	6.6	4.6	7.1	9.7	10.5	12.3	9.5	1.6	7.8	5.8	2.2
April	10.3	7.0	6.0	6.7	8.1	10.7	12.2	9.8	1.8	6.9	5.6	2.6
May	8.9	7.3	10.0	6.9	7.3	10.4	11.2	10.2	2.2	6.1	4.0	2.7
June	9.0	7.8	11.4	7.1	7.3	10.1	11.3	10.5	2.3	5.4	3.7	2.8
July	6.0	7.8	14.5	7.8	6.6	9.4	9.8	10.8	0.1	4.6	7.0	3.4
August	7.2	8.0	13.4	8.3	7.7	9.0	12.8	11.2	-3.1	3.3	9.5	4.4
September	7.7	8.1	11.2	8.6	9.0	8.8	10.6	11.3	0.4	2.5	9.8	5.2
October	7.8	7.9	10.2	8.8	11.2	8.9	7.0	10.9	3.2	2.2	9.6	5.7
November	7.9	8.3	9.8	8.9	11.6	9.1	6.3	10.5	2.7	1.9	10.5	6.4
December	6.2	8.2	8.8	9.2	11.0	9.2	5.5	10.0	3.0	1.7	11.2	7.1

**Source:** National Statistics Office of Georgia.

# 4. DYNAMICS OF RESERVE MONEY AND ITS STRUCTURE

(End of period; Thous. of GEL)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
						Reserve Mo	oney					
2005	802537	828791	822638	852874	845680	889438	907915	931555	939546	957768	969178	1007368
2006	989149	1009984	984685	1040715	1026383	1067290	1122798	1111354	1115394	1101880	1270883	1272099
2007	1236050	1239090	1157369	1282871	1407816	1409355	1468365	1561322	1579084	1595492	1615265	1781802
2008	1628390	1689865	1731215	1833538	1821662	1901146	1968946	1716703	1836932	1696369	1475989	1642081
2009	1509846	1469210	1450415	1600698	1629840	1660360	1878566	1863606	1823142	1850711	1794465	1874961
2010	1713536	1796689	1779993	1840471	1794175	1814726	1850494	1871817	1954729	1997837	1975036	2081129
					Cur	rency in Cir	culation					
2005	634171	656852	662785	693144	683123	698215	730838	744967	750005	767996	753594	811400
2006	752834	759693	778939	795955	785653	807495	833762	841546	856959	839255	823901	929538
2007	838393	843298	861359	899127	927130	972672	1030849	1070629	1085260	1113966	1143785	1310488
2008	1191848	1228063	1296336	1404910	1354789	1416852	1476249	1449647	1407612	1355782	1253630	1290703
2009	1170745	1145383	1149640	1221119	1187620	1207513	1251466	1303287	1293495	1303035	1315117	1457938
2010	1357686	1356142	1398806	1412001	1431384	1460407	1501064	1530686	1500695	1503652	1487064	1618180
				E	Balance on E	Banks Corre	spondent A	ccounts				
2005	57732	51950	58628	57843	50284	78568	64876	67520	67436	66100	85979	66135
2006	103132	112330	66412	101105	88771	86106	106278	71808	52954	54733	237092	118002
2007	178354	172144	64862	140216	174687	210549	191382	240580	236387	202729	208435	193061
2008	158104	173893	152157	145816	162319	188181	208115	116684	341116	237194	108216	230142
2009	208701	194900	175676	268577	335522	343687	516147	448446	407773	423279	350098	289732
2010	217510	299978	239217	164134	197181	132106	124090	91298	166772	214645	190543	157887
			ı			Required Re	eserves	T		· · · · · · · · · · · · · · · · · · ·		
2005	90488	94344	97725	101887	108768	109141	110988	118348	122067	123171	129101	129833
2006	133183	137960	139334	143655	151959	158689	162958	177646	202331	206242	209890	224559
2007	219303	223649	231147	243528	305999	226134	246134	250113	257437	278798	263045	278253
2008	278254	287724	282537	282811	304555	296113	284582	150372	88204	103394	114144	121236
2009	130401	128926	125099	111001	106698	109160	110953	111872	121873	124398	129250	127291
2010	138340	140570	141969	141836	140190	148473	153540	159678	242133	239590	234329	244750

# 5. DYNAMICS OF MONEY AGGREGATES

(End of period; Thous. of GEL)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
					Мо	ney Supply	(M3)					
2005	1443563	1484314	1512412	1601587	1599309	1643988	1697075	1781527	1824447	1883967	1921281	1924919
2006	1956061	1986757	2023117	2187069	2185567	2307293	2346359	2397622	2448024	2468322	2524549	2689887
2007	2613987	2753554	2705882	2895427	2999459	3281910	3442747	3650827	3748029	3836584	3931101	4027469
2008	4056922	3993356	4075932	4333892	4206603	4234084	4373549	3941205	4017809	3936563	3966082	4305126
2009	4045248	3921734	3725642	3553415	3571732	3646504	3802869	4020235	4153117	4287392	4264627	4656775
2010	4635119	4685610	4792026	4880979	4906868	5103377	5754689	5821978	5872447	5890780	5856348	6275726
					Мо	oney Supply	7 (M2)					
2005	787580	809440	818036	861120	847809	894495	921353	972659	987143	1018412	1043039	1071039
2006	1055535	1057217	1092520	1147523	1158490	1258674	1255728	1260433	1279668	1247729	1242778	1392849
2007	1304141	1316010	1372487	1464488	1544770	1655771	1791198	1874078	1937606	2003664	2089028	2149311
2008	2047754	2081520	2276128	2380826	2333668	2432518	2529779	2294428	2280434	2190228	1926785	1862498
2009	1721403	1644895	1650537	1703651	1679463	1723654	1796195	1850551	1932951	1966403	2004755	2139452
2010	2026739	2108243	2222580	2303195	2280475	2356083	2442874	2462680	2467855	2514414	2615904	2738628
					of which: M	Ioney outsi	de Banks (1	(0M				
2005	577768	601686	613121	644084	628246	640135	668163	686582	689614	702863	688231	736284
2006	685795	692108	712598	717900	715217	733341	749754	756053	776625	758866	743278	827357
2007	743861	755503	765376	786906	823848	856423	913705	949535	956649	993026	1012029	1152070
2008	1045934	1075495	1132136	1232825	1192990	1239022	1299023	1256293	1204893	1159088	1064777	1082554
2009	996266	966188	968646	1027410	1011613	1026754	1081585	1090988	1101248	1110999	1100696	1229436
2010	1132677	1142394	1186814	1219755	1234321	1269456	1315057	1334415	1306717	1302947	1280023	1372989
					Deposits	s in Nationa	al Currency	7				
2005	209812	207754	204915	217036	219563	254360	253190	286077	297530	315549	354807	334754
2006	369740	365109	379922	429622	443273	525333	505974	504381	503043	488863	499500	565491
2007	560281	560506	607111	677582	720923	799348	877494	924543	980956	1010638	1076998	997241
2008	1001820	1006026	1143992	1148001	1140678	1193496	1230757	1038134	1075541	1031140	862008	779944
2009	725137	678706	681890	676241	667850	696899	714610	759562	831702	855404	904059	910016
2010	894061	965848	1035765	1083440	1046155	1086627	1127817	1128266	1161138	1211467	1335881	1365639
					Deposit	s in Foreigi	n Currency					
2005	655983	674874	694376	740467	751501	749493	775722	808868	837303	865555	878242	853880
2006	900526	929540	930597	1039547	1027077	1048619	1090631	1137189	1168356	1220593	1281770	1297038
2007	1309845	1437544	1333396	1430939	1454688	1626139	1651548	1776749	1810423	1832919	1842074	1878158
2008	2009168	1911836	1799804	1953066	1872935	1801566	1843770	1646777	1737375	1746335	2039297	2442628
2009	2323845	2276839	2075106	1849764	1892269	1922850	2006674	2169684	2220166	2320989	2259872	2517323
2010	2608380	2577368	2569447	2577784	2626393	2747294	3311815	3359298	3404591	3376366	3240444	3537098

## 6. NATIONAL BANK SURVEY

(Thous. of GEL)

Net Foreign Assets		01.01.10	01.04.10	01.07.10	01.10.10	01.01.11
Gold         0	Net Foreign Assets	2033440	2327941	1886976	2226738	2479230
SDR holdings	Foreign Assets	3563048	3853715	3444034	3817471	4022093
Foreign Exchange   3188810   3464374   3050262   3408486   3618932   Other Foreign Assets   5347   6402   5718   5561   8624   Foreign Liabilities   -1529608   -1523774   -1557057   -1590733   -1542868   Claims on general government   -1529291   -1525657   -1556705   -1590733   -1542868   Claims on general government   177725   -186367   56583   -68422   -88701   Net claims on central government   177725   -186397   56383   -68422   -88701   Net claims on central government   -768375   -768874   748909   755129   719864   716402   Loans to central government   -3 3 3 3 3 3 3 3 3 3 3 3 3 3 3 3 3 3	Gold	0	0	0	0	0
Other Foreign Assets         5347         6402         5718         5561         8624           Foreign Liabilities         -1529608         -1522774         -1557057         -1590733         -1542863           Use of IMF resources         -1529291         -1532567         -1590705         -1590733         -1542863           Other Foreign Liabilities         -317         -117         -265         -568         -268           Net Domestic Assets         -158464         -547749         -71821         -2271893         -398088           Net claims on general government         177725         -186397         56383         -68422         -85701           Net claims on central government         177725         -186397         56383         -68422         -85701           T-bill holdings         768874         748909         735129         719864         716402           Loans from central government         0         0         0         0         0         0           Loans from central government         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0	SDR holdings	368890	382940	388054	403424	394538
Toreign Liabilities	Foreign Exchange	3188810	3464374	3050262	3408486	3618932
Use of IMF resources Other Foreign Liabilities Other Foreign Currency Other Foreign Liabilities Other Foreign Currency Other Geposts Other Geposts Other Foreign Currency Other Geposts Other Geposts Other Foreign Currency Other Geposts Other Foreign Currency Other Geposts Other Geposts Other Geposts Oth	Other Foreign Assets	5347	6402	5718	5561	8624
Other Foreign Liabilities         -317         -117         -265         -568         -268           Net Domestic Assets         -158464         -547749         -71821         -271893         -398088           Net claims on general government         177725         -186397         56383         -68422         -85701           Trbill holdings         760874         748909         735129         719864         716402           Loans to central government         3         3         3         3         3         3           Deposits of central government         -583152         -935308         -678749         -788289         -802106           Loans from central government         0         0         0         0         0         0           Net claims on local government         -0         -0         -0         -0         -0         -0           Deposits of local government         -0         0         0         0         0         0         0           Claims on public nonfinancial corporations         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0         0	Foreign Liabilities	-1529608	-1525774	-1557057	-1590733	-1542863
Net Domestic Assets         -158464         -547749         -71821         -271893         -398088           Net claims on general government         177725         -186397         56383         -68422         -85701           Net claims on central government         177725         -186397         56383         -68422         -85701           T-bill holdings         760874         748909         735129         719864         71602           Loans for central government         -583152         -935308         -678749         -788289         -802106           Loans from central government         0         0         0         0         0         0           Loans from central government         0         0         0         0         0         0           Loans from central government         0         0         0         0         0         0           Loans forcian central government         0         0         0         0         0         0           Loans fooleal government         0         0         0         0         0         0         0         0           Claims on bulk         0         0         0         0         0         0         0         0 </td <td>Use of IMF resources</td> <td>-1529291</td> <td>-1525657</td> <td>-1556792</td> <td>-1590165</td> <td>-1542596</td>	Use of IMF resources	-1529291	-1525657	-1556792	-1590165	-1542596
Net claims on general government         177725         -186397         56383         -68422         -85701           Net claims on central government         177725         -186397         56383         -68422         -85701           T-bill holdings         760874         748909         735129         719864         716402           Loans to central government         3 </td <td>Other Foreign Liabilities</td> <td>-317</td> <td>-117</td> <td>-265</td> <td>-568</td> <td>-268</td>	Other Foreign Liabilities	-317	-117	-265	-568	-268
Net claims on central government         177725         -186397         56383         -68422         -85701           T-bill holdings         760874         748909         735129         719864         716402           Loans to central government         3         3         3         3         3         3           Deposits of central government         -583152         -935308         -678749         -788289         -802106           Loans from central government         0         0         0         0         0         0           Net claims on local government         -0         -0         -0         -0         -0         -0           Loans to local government         -0         -0         -0         -0         -0         -0           Claims on bool coal government         -0         -0         -0         -0         -0         -0           Claims on bool coal government         -0         -0         0	Net Domestic Assets	-158464	-547749	-71821	-271893	-398088
T-bill holdings	Net claims on general government	177725	-186397	56383	-68422	-85701
Loans to central government	Net claims on central government	177725	-186397	56383	-68422	-85701
Deposits of central government	T-bill holdings	760874	748909	735129	719864	716402
Loans from central government	Loans to central government	3	3	3	3	3
Net claims on local government         -0         -0         -0         -0         -0           Loans to local government         0         0         0         0         0         0           Deposits of local government         -0         -0         -0         -0         -0         -0           Claims on public nonfinancial corporations of which loans in foreign currency         0         0         0         0         0           Claims on other nonfinancial corporations of which loans in foreign currency         0         0         0         0         0         0         0         0           Claims on individuals of which loans in foreign currency         0         <	Deposits of central government	-583152	-935308	-678749	-788289	-802106
Loans to local government	Loans from central government	0	0	0	0	0
Deposits of local government         -0         -0         -0         -0         -0         -0         -0         -0         -0         -0         -0         -0         0	Net claims on local government	-0	-0	-0	-0	-0
Claims on public nonfinancial corporations of which loans in foreign currency         0	Loans to local government	0	0	0	0	0
of which loans in foreign currency         0         0         0         0         0           Claims on other nonfinancial corporations         0         0         0         0         0         0           of which loans in foreign currency         0         0         0         0         0         0           Claims on individuals         3633         3414         3122         2844         2631           of which loans in foreign currency         0         0         0         0         0         0           Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938	Deposits of local government	-0	-0	-0	-0	-0
Claims on other nonfinancial corporations         0         0         0         0         0           of which loans in foreign currency         0         0         0         0         0         0           Claims on individuals         3633         3414         3122         2844         2631           of which loans in foreign currency         0         0         0         0         0           Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186	Claims on public nonfinancial corporations	0	0	0	0	0
of which loans in foreign currency         0         0         0         0         0           Claims on individuals         3633         3414         3122         2844         2631           of which loans in foreign currency         0         0         0         0         0           Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         14847	of which loans in foreign currency	0	0	0	0	0
Claims on individuals         3633         3414         3122         2844         2631           of which loans in foreign currency         0         0         0         0         0           Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         177993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           Of which: foreign currency         3753         4616	Claims on other nonfinancial corporations	0	0	0	0	0
of which loans in foreign currency         0         0         0         0         0           Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           Of which: foreign currency         289732         239217         132106         166772         157887           Other deposits         0         0	of which loans in foreign currency	0	0	0	0	0
Net claims on banks         -174005         -149176         27239         -7200         -165040           Claims on banks         45048         45040         217289         185073         190079           Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           Of which: foreign currency         127291         141969         148473         242133         244750           Other deposits         0         0         73740         45130         60312           Deposits         14         200         430 <td>Claims on individuals</td> <td>3633</td> <td>3414</td> <td>3122</td> <td>2844</td> <td>2631</td>	Claims on individuals	3633	3414	3122	2844	2631
Claims on banks       45048       45040       217289       185073       190079         Liabilities to banks       -219053       -194216       -190050       -192273       -355119         Liabilities to resident financial institutions       0       0       0       0       0         Other items, net       -165817       -215591       -158564       -199114       -149979         Reserve Money       1874961       1779993       1814726       1954729       2081129         Currency in circulation       1457938       1398806       1460407       1500695       1618180         Banks deposits       417023       381186       354319       454034       462949         Required reserves       127291       141969       148473       242133       244750         of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       2	of which loans in foreign currency	0	0	0	0	0
Liabilities to banks         -219053         -194216         -190050         -192273         -355119           Liabilities to resident financial institutions         0         0         0         0         0           Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           of which: foreign currency         127291         141969         148473         242133         244750           Correspondent account balances         289732         239217         132106         166772         157887           of which: foreign currency         3753         4616         5568         17087         13946           Other deposits         0         0         73740         45130         60312           Deposits         14         200         430	Net claims on banks	-174005	-149176	27239	-7200	-165040
Liabilities to resident financial institutions       0       0       0       0       0         Other items, net       -165817       -215591       -158564       -199114       -149979         Reserve Money       1874961       1779993       1814726       1954729       2081129         Currency in circulation       1457938       1398806       1460407       1500695       1618180         Banks deposits       417023       381186       354319       454034       462949         Required reserves       127291       141969       148473       242133       244750         of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Claims on banks	45048	45040	217289	185073	190079
Other items, net         -165817         -215591         -158564         -199114         -149979           Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           of which: foreign currency         127291         141969         148473         242133         244750           Correspondent account balances         289732         239217         132106         166772         157887           of which: foreign currency         3753         4616         5568         17087         13946           Other deposits         0         0         73740         45130         60312           Deposits         14         200         430         115         13           National Currency Deposits         14         199         429         115         12	Liabilities to banks	-219053	-194216	-190050	-192273	-355119
Reserve Money         1874961         1779993         1814726         1954729         2081129           Currency in circulation         1457938         1398806         1460407         1500695         1618180           Banks deposits         417023         381186         354319         454034         462949           Required reserves         127291         141969         148473         242133         244750           of which: foreign currency         127291         141969         148473         242133         244750           Correspondent account balances         289732         239217         132106         166772         157887           of which: foreign currency         3753         4616         5568         17087         13946           Other deposits         0         0         73740         45130         60312           Deposits         14         200         430         115         13           National Currency Deposits         14         199         429         115         12	Liabilities to resident financial institutions	0	0	0	0	0
Currency in circulation       1457938       1398806       1460407       1500695       1618180         Banks deposits       417023       381186       354319       454034       462949         Required reserves       127291       141969       148473       242133       244750         of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Other items, net	-165817	-215591	-158564	-199114	-149979
Banks deposits       417023       381186       354319       454034       462949         Required reserves       127291       141969       148473       242133       244750         of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Reserve Money	1874961	1779993	1814726	1954729	2081129
Required reserves       127291       141969       148473       242133       244750         of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Currency in circulation	1457938	1398806	1460407	1500695	1618180
of which: foreign currency       127291       141969       148473       242133       244750         Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Banks deposits	417023	381186	354319	454034	462949
Correspondent account balances       289732       239217       132106       166772       157887         of which: foreign currency       3753       4616       5568       17087       13946         Other deposits       0       0       73740       45130       60312         Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	Required reserves	127291	141969	148473	242133	244750
of which: foreign currency     3753     4616     5568     17087     13946       Other deposits     0     0     73740     45130     60312       Deposits     14     200     430     115     13       National Currency Deposits     14     199     429     115     12	of which: foreign currency	127291	141969	148473	242133	244750
Other deposits         0         0         73740         45130         60312           Deposits         14         200         430         115         13           National Currency Deposits         14         199         429         115         12	Correspondent account balances	289732	239217	132106	166772	157887
Deposits       14       200       430       115       13         National Currency Deposits       14       199       429       115       12	of which: foreign currency	3753	4616	5568	17087	13946
National Currency Deposits 14 199 429 115 12	Other deposits	0	0	73740	45130	60312
National Currency Deposits 14 199 429 115 12	Deposits	14	200	430	115	13
	*	14	199	429	115	12
	Foreign Currency Deposits	1	1	0	1	1

## 7. OTHER DEPOSITORY CORPORATIONS SURVEY

(Thous. of GEL)

	01.01.10	01.04.10	01.07.10	01.10.10	01.01.11
Net Foreign Assets	-1239134	-1276812	-1146137	-609219	-867393
Foreign exchange reserves	904053	870466	1134333	1500149	1405866
Foreign securities	0	0	15	89	174
Foreign shares	44763	19625	2445	3861	3140
Loans to nonresidents	4215	4374	4611	4516	4432
Foreign liabilities	-2199128	-2177746	-2282981	-2108720	-2264862
Other foreign assets, net	6963	6470	-4560	-9114	-16143
Net Domestic Assets	4666458	4881824	4979628	5174833	5770118
Net claims on general government	85359	176719	175204	276394	247126
Net claims on central government	174117	262471	318883	384416	371987
T-bill & bond holdings	252515	332101	376351	444230	448088
Loans to central government	25809	27558	36203	38902	29068
Deposits of central government	-89124	-81970	-78389	-85029	-91220
Loans from the MOF to finance private business development	-15083	-15218	-15283	-13686	-13950
Net claims on local government	-51348	-46354	-104636	-65637	-70908
Loans to local government	0	0	0	0	0
Deposits of local government	-51348	-46354	-104636	-65637	-70908
Accrued tax liabilities	-37410	-39398	-39042	-42385	-53954
Claims on public nonfinancial corporations	36248	37797	47273	54577	52681
of which loans in foreign currency	22801	18591	21018	31051	36948
Claims on other nonfinancial corporations	3356675	3507013	3764000	3780172	4099673
of which loans in foreign currency	2649508	2729963	2867294	2870806	3209483
Claims on individuals	1863732	1876086	1998788	2078462	2185396
of which loans in foreign currency	1364885	1360335	1385502	1399929	1437147
Other claims on private sector	376959	420850	454201	444107	448251
Bank reserves	645310	592552	469247	603268	647518
Lari holdings	228502	211992	190950	193978	245191
Required reserves	127289	141984	148472	242216	244750
Correspondent account balances	289519	238577	129825	167075	157577
Net claims on banks	-242016	-249392	-397703	-416626	-229716
Claims on ODCs	138852	123131	213488	237007	298647
Liabilities to ODCs	-564806	-521739	-657980	-706036	-753632
Claims on NBG	228938	194216	263790	237403	415269
Liabilities to NBG	-45000	-45000	-217000	-185000	-190000
Other items, net	-1455807	-1479802	-1531382	-1645522	-1680811
Other assets	1318667	1395833	1423776	1430544	1461103
Other liabilities	-2774474	-2875634	-2955158	-3076066	-3141914
Loans from other resident financial corporations	-234548	-243576	-256276	-251132	-246121
Money market instruments	0	0	-3651	-3717	-40760
Other liabilities	-2539927	-2632058	-2695232	-2821216	-2855032
Deposits	3427324	3605012	3833491	4565615	4902725
National Currency Deposits	910002	1035566	1086198	1161024	1365627
Foreign Currency Deposits	2517322	2569446	2747293	3404591	3537098

## 8. DEPOSITORY CORPORATIONS SURVEY

(Thous. of GEL)

	01.01.10	01.04.10	01.07.10	01.10.10	01.01.11
Net Foreign Assets	794306	1051130	740839	1617519	1611837
Net Foreign Assets (NBG)	2033440	2327941	1886976	2226738	2479230
Net Foreign Assets (ODC)	-1239134	-1276812	-1146137	-609219	-867393
Net Domestic Assets	3862469	3740897	4362538	4254927	4663889
Domestic credit	5900330	5835483	6498970	6568134	6950056
Net claims on general government	263084	-9677	231587	207972	161425
Net claims on central government (NBG)	177725	-186397	56383	-68422	-85701
Net claims on central government (ODC)	174117	262471	318883	384416	371987
Net claims on local government (NBG)	-0	-0	-0	-0	-0
Net claims on local government (ODC)	-51348	-46354	-104636	-65637	-70908
Accrued tax liabilities (NBG)	0	0	0	0	0
Accrued tax liabilities (ODC)	-37410	-39398	-39042	-42385	-53954
Claims on public nonfinancial corporations	36248	37797	47273	54577	52681
Claims on public nonfinancial corporations(NBG)	0	0	0	0	0
Claims on public nonfinancial corporations(DMB)	36248	37797	47273	54577	52681
Claims on other nonfinancial corporations	3356675	3507013	3764000	3780172	4099673
Claims on other nonfinancial corporations(NBG)	0	0	0	0	0
Claims on other nonfinancial corporations(DMB)	3356675	3507013	3764000	3780172	4099673
Claims on individuals	1867365	1879500	2001910	2081305	2188027
Claims on individuals(NBG)	3633	3414	3122	2844	2631
Claims on individuals(DMB)	1863732	1876086	1998788	2078462	2185396
Other claims on private sector	376959	420850	454201	444107	448251
Other claims on private sector (DMB)	376959	420850	454201	444107	448251
Other items, net	-2037861	-2094587	-2136432	-2313206	-2286167
NBG, other items	-756846	-745953	-485645	-660349	-777968
Net claims on banks (NBG)	-174005	-149176	27239	-7200	-165040
Liabilities to resident financial institutions (NBG)	0	0	0	0	0
Banks deposits (NBG)	-417023	-381186	-354319	-454034	-462949
Other items, net (NBG)	-165817	-215591	-158564	-199114	-149979
ODC, other items	-1281015	-1348634	-1650787	-1652857	-1508199
Required reserves (ODC)	127289	141984	148472	242216	244750
Correspondent account balances (ODC)	289519	238577	129825	167075	157577
Net claims on banks (ODC)	-242016	-249392	-397703	-416626	-229716
Other items, net (ODC)	-1455807	-1479802	-1531382	-1645522	-1680811
Money Supply (M3)	4656775	4792026	5103377	5872447	6275726
Money supply (M2)	2139452	2222580	2356083	2467855	2738628
Money supply (M1)	1859325	1935658	2049132	2107206	2325877
Money outside Banks (M0)	1229436	1186814	1269456	1306717	1372989
Transferable Deposits in national currency	629889	748844	779676	800489	952888
Term Deposits in national currency	280127	286922	306951	360649	412751
Deposits in foreign currency	2517323	2569447	2747294	3404591	3537098

## 9. DYNAMICS OF MONETARY RATIOS

(End of Period)

	Required Reserves	Com.Banks Correspon- dent Accounts in NBG	Cash in Com. Banks	Total Com. Banks Reserves	Dollariza- tion Ratio	Money Multiplier (M2)	Money Multiplier (M3)	Velocity of Circulation (M2)	Velocity of Circulation (M3)
	Perce	ntage of CBs D	eposits Li	abilities					
				20	09		l		l
January	4.28	6.84	5.72	16.84	76.22	1.14	2.68		
February	4.36	6.59	6.06	17.02	77.04	1.12	2.67		
March	4.54	6.37	6.56	17.47	75.27	1.14	2.57	10.90	4.83
April	4.39	10.63	7.67	22.70	73.23	1.06	2.22		
May	4.17	13.11	6.87	24.15	73.91	1.03	2.19		
June	4.17	13.12	6.90	24.19	73.40	1.04	2.20	10.43	4.93
July	4.08	18.97	6.24	29.29	73.74	0.96	2.02		
August	3.82	15.31	7.25	26.38	74.07	0.99	2.16		
September	3.99	13.36	6.30	23.65	72.75	1.06	2.28	9.30	4.33
October	3.92	13.33	6.05	23.29	73.07	1.06	2.32		
November	4.09	11.07	6.78	21.93	71.43	1.12	2.38		
December	3.71	8.45	6.67	18.83	73.45	1.14	2.48	8.41	3.86
				20	10				
January	3.95	6.21	6.42	16.58	74.47	1.18	2.71		
February	3.97	8.47	6.03	18.47	72.74	1.17	2.61		
March	3.94	6.64	5.88	16.45	71.27	1.25	2.69	9.35	4.34
April	3.87	4.48	5.25	13.61	70.41	1.25	2.65		
May	3.82	5.37	5.37	14.55	71.51	1.27	2.73		
June	3.87	3.45	4.98	12.30	71.66	1.30	2.81	8.82	4.07
July	3.46	2.80	4.19	10.44	74.60	1.32	3.11		
August	3.56	2.03	4.37	9.97	74.86	1.32	3.11		
September	5.30	3.65	4.25	13.20	74.57	1.26	3.00	8.42	3.54
October	5.22	4.68	4.37	14.28	73.59	1.26	2.95		
November	5.12	4.16	4.52	13.81	70.81	1.32	2.97		
December	4.99	3.22	5.00	13.21	72.15	1.32	3.02	7.59	3.31

### 10. MONETARY POLICY INTEREST RATE

Date	Interest Rates,%
1/23/2008	10.00
2/20/2008	11.00
3/19/2008	11.00
4/16/2008	12.00
5/14/2008	12.00
6/25/2008	12.00
7/23/2008	12.00
8/20/2008	11.00
9/10/2008	10.00
9/17/2008	10.00
10/15/2008	10.00
11/26/2008	9.00
12/24/2008	8.00
1/21/2009	8.00
2/18/2009	7.00
3/18/2009	6.50
4/15/2009	6.00
5/13/2009	6.00
6/24/2009	6.00
7/22/2009	6.00
8/19/2009	6.00
9/16/2009	6.00
10/13/2009	6.00
11/25/2009	5.00
12/23/2009	5.00
1/20/2010	5.00
2/17/2010	5.00
3/17/2010	5.00
4/14/2010	5.00
5/25/2010	5.00
6/16/2010	6.25
7/7/2010	6.25
7/21/2010	6.50
8/18/2010	6.50
9/15/2010	7.00
10/27/2010	7.50
11/24/2010	7.50
12/22/2010	7.50

 $\textbf{Note:} \ \textbf{Until the August 20, 2008 7-day CD (Certificate of Deposit) rate was used as a Monetary Policy rate.} \\ \textbf{Since then the 7-day Refinancing instrument w}$ 

## 11. ASSETS AND LIABILITIES OF COMMERCIAL BANKS

(Thous. of GEL)

	1.01.10	1.04.10	1.07.10	1.10.10	1.01.11
Cash	441841	412512	418563	400629	458145
Balances on Correspondent Accounts	1257041	1184331	1473457	1982039	1952469
Securities for Dealing Operations	5456	5297	3191	4166	3198
Investment Securities	506453	551183	591289	637907	801706
Net Loans	4524437	4683086	5064319	5199049	5673214
Loans to State Sector	0	0	0	0	0
Loans to Private Sector (excluding Interbank Loans)	5181122	5339164	5729971	5839832	6256273
Interbank Loans	4215	4389	4611	4516	4432
Loan Loss Reserves (-)	660899	660467	670263	645298	587491
Accrued Interest and Dividends Receivable	74589	81374	78296	76668	81011
Equity Investments	388906	406980	421827	422237	436274
Fixed Assets	837010	817793	817887	825868	885147
Other Assets	256812	330447	345918	320605	273052
Total Assets	8292546	8473004	9214747	9869169	10564217
Liabilities	6775558	6923504	7638792	8172647	8776570
Deposits of Banks	223740	191389	276461	232861	328925
Non-bank Deposits	3950156	4092427	4415696	5144787	5488728
Demand Deposits	1711390	1719880	1835003	2418242	2523579
Term Deposits of Enterprises	480673	488538	510808	562118	728956
Term Deposits of Individuals	1617782	1756207	1887510	2014665	2074146
General Government Deposits	140311	127802	182376	149761	162048
Accrued Interest and Dividends Payable	90427	79636	106704	101822	112415
Borrowed Funds	2367454	2379893	2656377	2511645	2623219
Other Liabilities	143780	180159	183555	181532	223283
Equity Capital	1516988	1549500	1575954	1696523	1787647
Paid-in Capital	611340	620337	665326	714173	722563
Capital Reserves	890516	899745	898124	908771	927042
Retained Profits	15132	29418	12505	73579	138042
Total Liabilities and Equity Capital	8292546	8473004	9214747	9869169	10564217

## 12. VOLUME AND ANNUAL WEIGHTED AVERAGE INTEREST RATES ON COMMERCIAL BANKS' CREDITS AND DEPOSITS

		1.01.10	1.04.10	1.07.10	1.10.10	1.01.11
			,	Thous. of GEL		
	Total	1145154	1198017	1429343	1521463	1566808
Loans in national currency to Enterprises and Households	Short-term	483326	466286	574470	638288	692174
and Households	Long-term	661828	731731	854873	883175	874634
	Total	3876174	3924008	4099493	4115911	4515498
Loans in foreign currency to Enterprises and Households	Short-term	704880	686840	792600	774294	842117
and Households	Long-term	3171294	3237168	3306893	3341616	3673381
	Total	273309	279298	298405	351359	405371
Term deposits in national currency	Short-term	225030	224866	238294	286699	337440
	Long-term	48280	54432	60111	64659	67931
	Total	1825146	1965447	2099913	2225425	2397731
Term deposits in foreign currency	Short-term	1414083	1508833	1579047	1662046	1789097
	Long-term	411063	456614	520865	563379	608634
			Iı	nterest Rates, %	6	
T	Total	23.6	23.3	22.2	22.2	22.9
Loans in national currency to Enterprises and Households	Short-term	24.6	25.4	24.3	24.6	25.7
and riouseholds	Long-term	22.9	21.9	20.8	20.4	20.6
	Total	18.1	17.9	17.4	16.8	15.9
Loans in foreign currency to Enterprises and Households	Short-term	22.5	22.1	20.8	19.5	17.5
and Households	Long-term	17.1	17.0	16.6	16.2	15.5
	Total	9.3	9.0	8.8	8.7	8.2
Term deposits in national currency	Short-term	8.3	7.9	7.7	7.8	7.2
	Long-term	13.6	13.5	13.2	13.0	13.0
	Total	10.0	9.5	8.9	8.5	8.2
Term deposits in foreign currency	Short-term	9.6	9.0	8.2	7.7	7.5
	Long-term	11.5	11.4	11.1	10.7	10.3

## 13. COMMERCIAL BANKS TERM LOANS

(Thous. of GEL)

	m . 11	of w	hich:
	Total Loans	In National Currency	In Foreign Currency
1.01.10	4865749	1093131	3772618
1.02.10	4819207	1053057	3766151
1.03.10	4847709	1059319	3788390
1.04.10	4909275	1109283	3799992
1.05.10	5065514	1183986	3881527
1.06.10	5153977	1254639	3899337
1.07.10	5332311	1349649	3982662
1.08.10	5393394	1349847	4043546
1.09.10	5412173	1390819	4021354
1.10.10	5439432	1452806	3986625
1.11.10	5367626	1454258	3913368
1.12.10	5619453	1472237	4147216
1.01.11	5912771	1508952	4403819

## 14. COMMERCIAL BANKS OVERDUE LOANS

(Thous. of GEL)

	O	of w	hich:
	Overdue Loans, Total	In National Currency	In Foreign Currency
1.01.10	159793	52023	107770
1.02.10	210941	73171	137770
1.03.10	211658	75834	135825
1.04.10	217139	88750	128389
1.05.10	216310	91364	124945
1.06.10	217757	90204	127552
1.07.10	201136	79694	121441
1.08.10	201599	86839	114759
1.09.10	226863	87254	139609
1.10.10	202458	68657	133801
1.11.10	204307	68404	135903
1.12.10	203101	67009	136092
1.01.11	173967	57856	116111

## 15. TRANSACTIONS WITH USD AT THE FOREIGN EXCHANGE MARKET

			Purcha	sed USD by t	he Commercia	ıl Banks		
					of which:			
			at the		outside foreign exchange auction			
	Total	at Tbilisi Inter- bank Currency Exchange	Foreign Exchange Auction of the NBG	from NBG	from Georgian commercial banks	from foreign banks	from legal entities	from individuals
			•	Thous	of USD			
2009	5290256	265810	116700	344615	860325	505238	2344307	969962
January	460890	89490	-	83230	47069	30802	140793	69506
February	463203	82465	-	73985	52453	35096	138746	80458
March	552384	64140	19000	76485	43104	102315	188897	77442
April	387259	17605	9700	22915	66836	45497	171365	63041
May	368124	12110	17000	17000	91011	25229	170610	52165
June	413101	-	25000	25000	76220	56133	172356	83392
July	346934	-	6000	6000	55058	31586	155767	98523
August	426496	-	19000	19000	73052	21456	221322	91667
September	465284	-	6000	6000	86791	43212	246255	83025
October	442145	-	2000	2000	83870	27452	237555	91269
November	438209	-	13000	13000	80593	57148	206817	80652
December	526226	-	-	-	104268	29311	293823	98824
2010	6794978	-	331200	331200	1330879	747139	3137430	1248329
January	409175	-	79000	79000	79067	20493	174318	56298
February	414531	-	15200	15200	93492	28720	204260	72859
March	523992	-	30000	30000	116858	60968	211945	104221
April	518726	-	65000	65000	100909	39729	232158	80930
May	475508	-	85000	85000	107116	40425	174842	68125
June	598596	-	57000	57000	122369	60468	254692	104067
July	639285	-	-	-	125378	49638	268500	195769
August	756228	-	-	-	99424	69210	463024	124570
September	615844	-	-	-	104473	79893	291745	139734
October	322129	-	-	-	76416	20493	169011	56210
November	529160	-	-	-	88025	64793	273839	102504
December	991801	-	-		217352	212309	419097	143043

### 15. TRANSACTIONS WITH USD AT THE FOREIGN EXCHANGE MARKET

**CONTINUE** 

			Sold US	SD by the Com	mercial Banl	ΣS.		
				of	which:			
		at the			ou	tside foreign	exchange auct	ion
	Total	at Tbilisi Inter- bank Currency Exchange	Foreign Exchange Auction of the NBG	to NBG	to Geor- gian com- mercial banks	to foreign banks	to legal entities	to individuals
				Thous.of U	SD			
2009	5089232	189030	5000	156135	865935	639662	2446181	792289
January	358683	32740	-	26480	37141	32101	173010	57211
February	334557	8480	-	-	94066	16900	162932	52179
March	555804	66810	5000	65155	66527	98858	178893	79562
April	467004	60880	-	56490	63421	55546	167055	63612
May	330374	20120	-	8010	56993	32419	156649	56183
June	375067	-	-	-	72244	48573	185701	68550
July	349229	-	-	-	62616	40134	181750	64729
August	411526	-	-	-	90962	40530	213032	67002
September	433928	-	-	-	98017	36390	222694	76827
October	479757	-	-	-	66494	84906	254463	73893
November	446274	-	-	-	51500	93877	245370	55527
December	547030	-	-	-	105955	59428	304632	77015
2010	6487525	-	126000	126000	1126123	1089581	3367317	778504
January	408600	-	-	-	62729	73799	217871	54202
February	384920	-	-	-	67560	56577	212460	48323
March	491941	-	-	-	89001	54915	281154	66871
April	500023	-	-	-	83136	104766	254693	57427
May	460672	-	-	-	75438	61775	250467	72993
June	454851	-	10000	10000	81624	37855	275212	50160
July	559359	-	-	-	121371	54997	298676	84315
August	748808	-	-	-	112533	287110	292566	56599
September	608481	-	21000	21000	90364	60588	344672	91858
October	431685	-	30000	30000	57110	73799	214695	56081
November	566038	-	65000	65000	84229	69085	281196	66528
December	872147	-	-	-	201029	154316	443656	73146

 $<sup>^{\</sup>ast}$  From March to June 2009 Tbilisi Interbank Foreign Exchange and Foreign Exchange Auction of the National Bank of Georgia functioned simultaneously, from June 2009 trade at Tbilisi Interbank Foreign Exchange was temporarily suspended.

### 16. TRANSACTIONS WITH EURO AT THE FOREIGN EXCHANGE MARKET (Thous.of EURO)

			Pu	rchased EURO				
				of which	h:			
		At Tbilisi		of which:				
	Total	Interbank Cur- rency Exchange by commercial banks	Outside Tbilisi Interbank Cur- rency Exchange	from Georgian commercial banks	from foreign banks	from legal entities	from individuals	
2009	1196547	55	1196492	176611	371559	357582	290740	
January	81527	-	81527	11860	16122	33727	19818	
February	106118	55	106063	56848	10561	20152	18502	
March	131174	-	131174	5290	72264	24819	28801	
April	113272	-	113272	8536	34191	46754	23791	
May	80871	-	80871	6615	15306	24635	34315	
June	107740	-	107740	11699	32025	37005	27011	
July	89261	-	89261	6293	22496	30537	29934	
August	75229	-	75229	6964	23532	19649	25084	
September	83894	-	83894	22551	15867	20263	25213	
October	90984	-	90984	8805	42917	21193	18069	
November	116767	-	116767	16745	35603	47517	16902	
December	119710	-	119710	14406	50674	31330	23300	
2010	1379401	-	1379401	259350	499403	354936	265711	
January	84465	-	84465	12856	36752	24380	10477	
February	86992	-	86992	12435	28961	29306	16291	
March	117953	-	117953	19330	26085	50581	21958	
April	128296	-	128296	13989	67207	27623	19477	
May	103174	-	103174	16128	32933	32060	22051	
June	137855	-	137855	13252	74087	29155	21361	
July	109021	-	109021	20142	22558	33139	33183	
August	92079	-	92079	31158	16346	22169	22406	
September	142857	-	142857	39403	41466	33113	28876	
October	100356	-	100356	12239	38666	23489	25962	
November	103178	-	103178	12155	38666	26096	26262	
December	173175	-	173175	56264	75677	23826	17407	

## 16. TRANSACTIONS WITH EURO AT THE FOREIGN EXCHANGE MARKET

(Thous.of EURO) CONTINUE

			So	ld EURO			
				of which	:		
		At Tbilisi Inter-			of w	hich:	
	Total	bank Currency Exchange by commercial banks	Outside Tbilisi In- terbank Currency Exchange	from Georgian commercial banks	from foreign banks	from legal entities	from individuals
2009	1221560	55	1221506	203483	324780	554228	139015
January	80912	-	80912	15260	18932	31817	14903
February	107415	55	107361	29011	21351	34516	22483
March	131303	-	131303	7126	76196	35527	12455
April	116978	-	116978	21905	36798	45706	12568
May	79099	-	79099	18386	11126	41470	8116
June	110403	-	110403	17840	34123	46023	12416
July	86251	-	86251	9253	21299	45880	9820
August	68748	-	68748	12904	13671	35309	6864
September	89236	-	89236	28693	14757	36610	9176
October	86601	-	86601	12026	15764	50095	8716
November	122620	-	122620	12935	21732	77608	10345
December	141993	-	141993	18144	39031	73666	11153
2010	1372652	-	1372652	213308	363647	687247	108450
January	78458	-	78458	9145	10530	49276	9507
February	82359	-	82359	10049	14668	49399	8243
March	129846	-	129846	18880	41400	61472	8094
April	133290	-	133290	14812	25676	82935	9867
May	106151	-	106151	14291	26654	54332	10873
June	95648	-	95648	13836	12495	58737	10580
July	104552	-	104552	21143	29051	45208	9150
August	101901	-	101901	22201	18155	53658	7887
September	143918	-	143918	26574	60049	49733	7562
October	105374	_	105374	5679	38847	52511	8337
November	108613	_	108613	5494	38851	56786	7482
December	182541	_	182541	51204	47272	73199	10867

 $<sup>^{\</sup>ast}$  From June 2009 trade at Tbilisi Interbank Foreign Exchange was temporarily suspended.

## 17. EXCHANGE RATES: GEL/USD

	End of Month	Monthly average
2009		
January	1.6670	1.6677
February	1.6840	1.6739
March	1.6700	1.6729
April	1.6501	1.6650
May	1.6450	1.6489
June	1.6579	1.6540
July	1.6746	1.6667
August	1.6858	1.6773
September	1.6771	1.6827
October	1.6790	1.6766
November	1.6743	1.6810
December	1.6858	1.6791
2010		
January	1.7415	1.7097
February	1.7360	1.7255
March	1.7494	1.7288
April	1.7738	1.7517
May	1.7847	1.7800
June	1.8442	1.8579
July	1.8391	1.8429
August	1.8330	1.8399
September	1.8064	1.8325
October	1.7780	1.7935
November	1.7593	1.7625
December	1.7728	1.7632

## 18. EXCHANGE RATES:GEL/EURO

	End of Month	Monthly average
2009		
January	2.1504	2.2290
February	2.1308	2.1414
March	2.2034	2.1844
April	2.1752	2.1985
May	2.3196	2.2458
June	2.3293	2.3206
July	2.3565	2.3463
August	2.4034	2.3911
September	2.4405	2.4483
October	2.4920	2.4837
November	2.4976	2.5045
December	2.4195	2.4587
2010		
January	2.4313	2.4429
February	2.3632	2.3597
March	2.3589	2.3468
April	2.3494	2.3507
May	2.2141	2.2496
June	2.2484	2.2706
July	2.3897	2.3510
August	2.3296	2.3740
September	2.4585	2.3865
October	2.4595	2.4910
November	2.3223	2.4179
December	2.3500	2.3308

## 19. BALANCE OF PAYMENTS

(Thous. of USD)

	2005	2006	2007	2008	2009	2010
Current account	-709,208.2	-1,175,198.9	-2,009,926.1	-2,912,366.8	-1,210,052.5	-1,116,512.8
A. Goods	-1,213,903.4	-2,019,354.3	-2,895,825.2	-3,833,225.4	-2,398,993.0	-2,567,149.5
Credit	1,472,437.3	1,666,525.9	2,088,284.8	2,427,979.4	1,893,602.4	2,459,778.3
Debit	-2,686,340.7	-3,685,880.2	-4,984,110.0	-6,261,204.8	-4,292,595.3	-5,026,927.8
B. Services	83,591.0	157,837.7	161,189.4	21,029.6	339,725.8	534,371.0
Credit	715,043.4	885,085.8	1,094,109.4	1,260,454.0	1,313,609.0	1,601,569.2
Debit	-631,452.4	-727,248.1	-932,920.0	-1,239,424.4	-973,883.3	-1,067,198.2
C. Income	62,066.5	162,374.2	36,255.9	-160,525.9	-117,623.1	-182,893.5
Credit	263,325.2	341,206.8	481,606.7	494,181.3	422,686.9	416,070.9
Debit	-201,258.6	-178,832.6	-445,350.8	-654,707.2	-540,310.0	-598,964.4
D. Current transfers	359,037.6	523,943.4	688,453.8	1,060,354.9	966,837.9	1,099,159.2
Credit	413,435.0	586,956.8	768,455.9	1,142,020.1	1,037,857.1	1,184,546.6
Debit	-54,397.4	-63,013.4	-80,002.1	-81,665.2	-71,019.3	-85,387.4
Capital and financial account	683,253.3	1,239,846.9	2,045,014.6	2,948,627.1	1,159,304.8	1,079,507.9
Capital account	58,644.3	171,156.2	127,945.8	112,284.0	182,504.2	205,686.9
Credit	61,571.4	172,194.8	128,250.9	112,422.7	182,614.6	205,841.2
Debit	-2,927.1	-1,038.6	-305.1	-138.7	-110.5	-154.3
Financial account	624,608.9	1,068,690.6	1,917,068.8	2,836,343.1	976,800.6	873,821.0
A. Direct investment	542,229.6	1,185,908.8	1,673,898.6	1,494,068.4	659,463.5	542,936.2
To abroad	89,477.3	15,831.4	-76,344.0	-69,962.0	1,062.9	-5,890.4
From abroad	452,752.3	1,170,077.4	1,750,242.6	1,564,030.3	658,400.6	548,826.6
B. Portfolio investment	15,473.6	140,320.1	20,971.9	626,590.9	12,067.5	267,095.7
Assets	13,064.1	-2,188.5	-12,662.6	675.6	-1,130.9	-617.4
Liabilities	2,409.5	142,508.6	33,634.5	625,915.3	13,198.4	267,713.1
C.Financial derivatives, net	0.0	0.0	1,066.8	7,778.8	567.4	764.3
Assets	0.0	0.0	1,247.8	11,079.7	1,105.8	1,723.4
Liabilities	0.0	0.0	-181.0	-3,300.9	-538.5	-959.1
D. Other investment	177,475.8	181,098.9	598,158.6	838,610.2	921,124.6	271,004.4
Assets	-15,798.2	-56,457.2	-202,060.4	-266,547.3	191,451.6	-371,923.7
Liabilities	193,274.0	237,556.1	800,219.0	1,105,157.4	729,673.0	642,928.0
E. Reserve assets	-110,570.1	-438,637.1	-377,027.1	-130,705.1	-616,422.3	-207,979.6
Net errors and omissions	25,955.0	-64,647.9	-35,088.5	-36,260.3	50,747.7	37,004.9
Total exceptional financing	142,513.8	116,211.2	179,073.5	1,015,499.3	388,936.2	496,627.8

## 20. INTERNATIONAL INVESTMENT POSITION

(End of period; Thous. of USD)

	2005	2006	2007	2008	2009	2010
International Investment Position, net	-4,023,605.0	-5,177,520.1	-7,325,751.2	-10,113,512.6	-11,099,752.4	-11,900,037.9
Assets	1,017,388.1	1,535,662.0	2,291,839.3	2,730,471.0	3,178,311.9	3,748,284.9
Direct investment abroad	21,172.3	5,447.1	89,051.0	152,738.7	151,281.3	155,405.5
Portfolio investment	12.5	2,203.1	7,739.5	245.4	1,433.5	2,005.9
Financial derivatives	0.0	0.0	57.9	158.2	745.1	1,346.9
Other investment	517,729.5	597,161.9	833,834.6	1,097,171.4	914,445.3	1,325,595.8
Reserve assets	478,473.8	930,849.9	1,361,156.3	1,480,157.2	2,110,406.8	2,263,930.8
Liabilities	5,040,993.1	6,713,182.1	9,617,590.5	12,843,983.6	14,278,064.3	15,648,322.7
Direct investment in reporting economy	2,373,600.3	3,559,201.4	5,356,064.5	6,762,493.0	7,361,711.5	7,821,129.3
Portfolio investment	15,015.4	181,231.9	277,897.8	893,670.4	901,508.6	1,162,346.8
Financial derivatives	0.0	0.0	9.3	108.5	335.2	218.0
Other investment	2,652,377.4	2,972,748.8	3,983,618.8	5,187,711.6	6,014,508.9	6,664,628.6

## 21. GROSS EXTERNAL DEBT

(End of period; Thous. of USD)

	2006	2007	2008	2009	2010
General Government	1,439,414.4	1,583,333.5	2,260,951.3	2,739,646.6	3,322,172.4
Short-term	112,233.1	77,659.4	73,879.6	70,937.2	61,371.8
Long-term	1,327,181.2	1,505,674.1	2,187,071.7	2,668,709.4	3,260,800.5
Monetary Authorities	294,690.8	254,221.4	460,954.0	913,928.6	876,441.0
Short-term	18.3	19.4	782.9	1,034.6	1,323.3
Long-term	294,672.6	254,202.0	460,171.1	912,894.0	875,117.7
Banks	548,668.1	1,295,028.4	1,874,812.9	1,498,722.2	1,581,976.6
Short-term	221,317.5	399,973.2	565,556.5	353,749.3	439,459.3
Long-term	327,350.6	895,055.2	1,309,256.4	1,144,972.9	1,142,517.3
Other Sectors	689,975.5	851,035.5	1,098,805.9	1,370,024.1	1,664,906.9
Short-term	219,896.3	224,736.8	390,203.2	490,727.5	584,969.8
Long-term	470,079.1	626,298.8	708,602.7	879,296.5	1,079,937.0
Direct Investment: Intercompany Lending	826,723.9	1,798,723.3	2,102,244.0	2,138,735.0	2,219,434.4
Gross External Debt	3,799,472.7	5,782,342.1	7,797,768.1	8,661,056.4	9,664,931.2

## 22. FOREIGN TRADE

 $(Excluding\ Nonregistered\ Trade;\ Thous.of\ USD)$ 

	Total	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
	Exports (FOB)												
2005	865456	52696	48766	68501	75741	57852	69134	72308	78464	73906	76089	108972	83027
2006	936375	67665	60390	86058	87853	74352	67723	75033	76934	80899	67519	88450	103497
2007	1232110	69474	67470	86485	99579	112612	107918	114501	111127	97184	130414	110998	124349
2008	1495345	96157	101214	131397	135533	144223	187019	160785	112046	170475	110824	71227	74444
2009	1133622	61993	73883	81964	90575	98334	106637	102008	112227	92627	103822	97243	112309
2010	1583397	106608	109820	125161	127095	138846	113151	143579	112325	121438	129947	166810	188616
						Import	s (CIF						
2005	2487548	132829	139371	181483	176782	175254	174886	231116	223586	232598	243876	302745	273023
2006	3674832	190831	223706	267200	285174	294324	306342	309216	363445	350177	341398	333289	409731
2007	5212158	328137	334460	381546	364408	438345	375920	429942	463469	424059	522268	445391	704213
2008	6301540	402575	473805	527727	579390	610953	600701	629238	438215	543482	553710	442400	499343
2009	4366106	305837	300314	353622	317562	316824	383780	386032	366643	376914	417351	381661	459565
2010	5095073	277874	320251	420387	382440	424381	403582	411336	431822	438510	492087	486296	606107
						Turn						1	
2005	3353004	185525	188136	249984	252523	233106	244020	303424	302050	306504	319964	411716	356051
2006	4611207	258496	284096	353258	373027	368677	374065	384250	440379	431076	408917	421739	513228
2007	6444269	397611	401929	468031	463987	550958	483838	544444	574596	521243	652682	556388	828562
2008	7796886	498732	575020	659124	714923	755177	787720	790023	550261	713958	664534	513627	573787
2009	5499728	367830	374197	435586	408138	415158	490417	488040	478870	469541	521173	478904	571874
2010	6678470	384482	430072	545548	509535	563227	516734	554915	544147	559948	622033	653106	794723
						Bala							
2005	-1622093	-80133	-90605	-112982	-101040	-117402	-105752	-158808	-145122	-158692	-167787	-193773	-189996
2006	-2738458	-123166	-163316	-181142	-197321	-219972	-238620	-234183	-286510	-269277	-273879	-244838	-306233
2007	-3980048	-258664	-266990	-295060	-264829	-325733	-268001	-315441	-352343	-326875	-391854	-334393	-579864
2008	-4806195	-306418	-372591	-396330	-443858	-466730	-413681	-468454	-326168	-373007	-442887	-371173	-424899
2009	-3232483	-243845	-226432	-271658	-226987	-218491	-277143	-284023	-254417	-284287	-313529	-284417	-347255
2010	-3511676	-171266	-210431	-295226	-255345	-285535	-290431	-267756	-319497	-317072	-362140	-319486	-417491

Source: National Statistics Office of Georgia.

## 23. MAJOR FOREIGN TRADE PARTNERS

(Thous.of USD)

				Turnove	r
	Exports (FOB)	Imports (CIF)	Balance	Total	%
			2009		
Turkey	225768.7	787616.7	-561848.1	1013385.4	18.4
Azerbaijan	165633.8	376432.9	-210799.1	542066.7	9.9
Ukraine	83955.0	418313.8	-334358.8	502268.9	9.1
Germany	23025.4	301382.5	-278357.1	324407.8	5.9
Russia	21146.2	285553.9	-264407.7	306700.0	5.6
USA	36933.9	223725.2	-186791.3	260659.1	4.7
Bulgaria	82290.6	152840.0	-70549.4	235130.7	4.3
China	5965.5	174669.1	-168703.5	180634.6	3.3
Italy	23282.1	127686.4	-104404.2	150968.5	2.7
Canada	117224.1	14148.5	103075.7	131372.6	2.4
Total	785225.4	2862368.9	-2077143.4	3647594.3	-
Foreign Trade, total	1133622.4	4366105.7	-3232483.3	5499728.1	100.0
Ratio,%	69.3	65.6	64.3	66.3	-
			2010		
Turkey	216049.4	888644.6	-672595.2	1104694.0	16.5
Azerbaijan	243989.3	464112.5	-220123.2	708101.8	10.6
Ukraine	103334.4	558900.6	-455566.2	662235.0	9.9
Germany	31762.0	330018.5	-298256.5	361780.5	5.4
China	24250.5	334318.6	-310068.1	358569.1	5.4
USA	180498.8	173401.5	7097.3	353900.3	5.3
Russia	34298.3	279672.9	-245374.6	313971.2	4.7
Armenia	160289.7	45547.6	114742.1	205837.3	3.1
Bulgaria	62105.9	131723.1	-69617.2	193829.0	2.9
UAE	27793.5	159229.6	-131436.1	187023.1	2.8
Total	1084371.8	3365569.5	-2281197.7	4449941.3	-
Foreign Trade, total	1583397.0	5095072.8	-3889800.2	6678469.8	100.0
Ratio,%	68.5	66.1	58.6	66.6	-

**Source:** National Statistics Office of Georgia.

## 24. MAJOR COMMODITY GROUPS OF GEORGIAN EXPORTS

	2009		20	10
	Thous.of USD	%	Thous.of USD	%
Exports, Total	1133622.4	100.0	1583397.0	100.0
of which:				
Ferrous Metals	130081.3	11.5	263937.8	16.7
Automobiles	78461.6	6.9	227296.8	14.4
Scrap Black Metals	63616.0	5.6	109370.9	6.9
Gold Unwrought or in Semi-Manufactured Forms	116189.3	10.2	85788.3	5.4
Fertilizers	60213.6	5.3	72113.4	4.6
Copper Ores and Concentrates	61868.0	5.5	70675.6	4.5
Other Nuts, Fresh or Dried, Whether or not Shelled or Peeled	69955.8	6.2	64035.9	4.0
Alcohol and other Spirituous Beverages	54019.4	4.8	54573.3	3.4
Copper Waste and Scrap	19013.2	1.7	41666.7	2.6
Wine	31997.0	2.8	39269.0	2.5
Other	448207.2	39.5	554669.3	35.0

## 25. MAJOR COMMODITY GROUPS OF GEORGIAN IMPORTS

	2009		20	10
	Thous.of USD	%	Thous.of USD	%
Imports, Total	4366105.7	100.0	5095072.8	100.0
of which:				
Crude Oil and Petroleum Products	555311.7	12.7	694568.1	13.6
Automobiles	254701.9	5.8	309599.7	6.1
Medicines	175162.0	4.0	188384.5	3.7
Wheat	104123.1	2.4	171715.4	3.4
Petroleum Gases and Other Gaseous Hydrcarbons	151930.8	3.5	133645.0	2.6
Electrical Apparatus for Line Telephony or Line Telegraphy	78559.8	1.8	110445.3	2.2
Cigarettes	57424.7	1.3	78991.8	1.6
Sugar	50407.8	1.2	74233.1	1.5
Other Bars and Rods of Iron	35073.1	0.8	56432.6	1.1
Manganese Ores and Concentrate	8006.3	0.2	55934.4	1.1
Other	2895404.5	66.3	3221122.9	63.2

 $\textbf{Source:} \ \textbf{National Statistics Office of Georgia}.$ 

## **26. FINANCIAL INSTITUTIONS**

(End of Period)

	2005	2006	2007	2008	2009	2010
Number of Commercial Banks	19	17	19	20	19	19
of which:						
Foreign controlled	12	12*	14*	17*	15*	16*
per 100 000 inhabitants	0.43	0.39	0.43	0.46	0.43	0.43
branches	159	122	124	124	120	119
service centers	187	298	416	559	513	522
Authorized Capital of Commercial Banks, thous.of GEL	296443	344844	524576	625616	673419	805147
Equity Capital of Commercial Banks, thous. of GEL	479488	898373	1471046	1517250	1516987	1787647
Exchange Bureaus	556	655	806	1030	1352	1624
per 100 000 inhabitants	12.63	14.90	18.34	23.50	30.83	36.61
Non-Bank Depository Institutions	40	38	24	18	18	18
Micrifinance organizations	X	3	15	27	38	49
Stock Exchanges	1	1	1	1	1	1
Insurance Companies	16	14	15	13	14	16
Pension Schemes	3	3	4	7	6	6

<sup>\* -</sup> Including 2 Branch of Non-Resident Banks.

# 27. LIST OF COMMERCIAL BANKS OPERATING IN GEORGIA AS OF JANUARY 1, 2011

N	Bank	License Date	License- Number	Number of Branches	Number of service centers
1	JSC Bank Republic	04.02.1992	5	8	30
2	JSC PrivatBank	25.02.1992	10	-	68
3	JSC TBC Bank	20.01.1993	85	13	32
4	JSC Bank of Georgia	15.12.1994	86	1	142
5	JSC Liberty Bank	10.02.1993	96	72	123
6	JSC Basisbank	04.11.1993	173	-	18
7	JSC VTB Bank Georgia	07.05.1995	226-a	13	1
8	JSC Cartu Bank	09.01.1997	229	3	5
9	JSC ProCredit Bank	13.05.1999	233	7	51
10	JSC KOR Standard Bank	25.01.2008	0110245	-	22
11	JSC BTA Bank	13.03.2001	238	1	6
12	JSC Investbank	29.09.2003	241	-	1
13	T.C. Turkish Ziraat Bank A.S. Tbilisi Branch	31.03.1998	231-1	-	-
14	OJSC Transcaucasus Development Bank Tbilisi Branch	02.12.1999	234-1	-	-
15	JSC The International Bank of Azerbaijan - Georgia	07.02.2007	0110242	-	-
16	JSC HSBC Bank Georgia	30.07.2007	0110226	-	-
17	JSC Progress Bank	31.12.2007	0110244	-	1
18	JSC Halyk Bank Georgia	29.01.2008	0110246	1	-
19	JSC Bank Constanta	03.07.2008	130	-	22

### 28. PAID-IN CAPITAL OF COMMERCIAL BANKS AS OF JANUARY 1, 2011

From 5 to 10 mln of GEL	10 mln of GEL and above
JSC Basisbank	JSC Cartu Bank
T.C. Turkish Ziraat Bank A.S. Tbilisi Branch	JSC ProCredit Bank
OJSC Transcaucasus Development Bank Tbilisi Branch	JSC VTB Bank Georgia
	JSC Bank of Georgia
	JSC Bank Republic
	JSC Kor Standard Bank
	JSC Investbank
	JSC BTA Bank
	JSC Liberty Bank
	JSC TBC Bank
	JSC PrivatBank
	JSC The International Bank of Azerbaijan - Georgia
	JSC HSBC Bank Georgia
	JSC Progress Bank
	JSC Halyk Bank Georgia
	JSC Bank Constanta

# 29. LIST OF MICROFINANCIAL ORGANIZATIONS OPERATING IN GEORGIA AS OF JANUARY 1, 2011

N	Name	License Date	License Number
1	LLC "Georgian Credit"	04.10.2006	1006-1/da
2	LLC "Allians Group "	09.10.2006	1006-1/db
3	LLC "Tbilbusiness"	30.11.2006	1106-2/da
4	JSC "Alfa Express"	01.10.2007	40107
5	LLC "Alfa Credit"	12.02.2007	50207
6	LLC "TAM Credit"	06.03.2007	60307
7	LLC "Intel Express Georgia"	23.03.2007	70307
8	LLC "Rico Express"	11.04.2007	80407
9	JSC "Cristal"	18.09.2007	90907
10	JSC "Finagro"	30.11.2007	101107
11	LLC "Credo"	06.12.2007	111207
12	JSC "Caucasuscredit"	13.12.2007	121207
13	LLC "Imercredit"	18.12.2007	131207
14	LLC "Credit Service"	20.12.2007	141207
15	JSC "Finca Georgia"	28.12.2007	151207
16	LLC "Express Credit"	10.01.2008	160108
17	JSC "Lazika Capital"	21.01.2008	170108
18	LLC "Creditservice+"	06.02.2008	180208
19	LLC "Cristal Credit"	03.04.2008	190408
20	LLC "Moneta Express Georgia"	13.06.2008	210608
21	LLC "Intelnet"	01.07.2008	220708
22	LLC "Tbilmicrocredit"	17.10.2008	241008
23	LLC "Amigo+"	30.10.2008	251008
24	JSC "Nyke Kredit"	30.10.2008	261008
25	LLC "CaucasusCredit"	19.11.2008	271108
26	LLC "X Credit"	27.01.2009	280109
27	LLC "EasyCred Georgia"	20.02.2009	290209
28	LLC "VAM Credit"	05.05.2009	300309
29	LLC "MicroCredit"	30.03.2009	310309
30	JSC "Georgian Capital"	28.05.2009	320509
31	LLC "Markline"	22.06.2009	330609
32	LLC "New Credit Office"	14.07.2009	340709
33	LLC "Credit Plus"	03.08.2009	350809
34	LLC "B Credit"	04.09.2009	360909
	LLC "Agrocredit"		
35		06.11.2009	371109
36	LLC "Microinvest"	25.11.2009	381109
37	LLC "City Credit"	15.12.2009	391209
38	LLC "B.I.G."	01.02.2010	400110
39	JSC "Invest Georgia"	31.08.2010	410810
40	LLC "Realcredit"	11.10.2010	421010
41	LLC "Smart Finance"	18.10.2010	431010
42	LLC "Financial Alliance for Bussiness"	18.10.2010	441010
43	LLC "Swis Capital"	18.10.2010	451010
44	LLC "Capital Credit"	27.10.2010	461010
45	JSC "IMG"	10.11.2010	471110
46	LLC "G Credit"	16.11.2010	481110
47	LLC "Bonaco"	19.11.2010	491110
48	LLC "Inter- Credit"	17.12.2010	501210
49	LLC "Nova Credit"	29.12.2010	511210



# FINANCIAL STATEMENTS

## NATIONAL BANK OF GEORGIA

**Financial Statements** 

For the Year Ended 31 December 2010

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## STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

Management is responsible for the preparation of the financial statements that present fairly the financial position of the National Bank of Georgia (the "Bank") as at 31 December 2010, the results of its operations, cash flows and changes in equity for the year then ended, in accordance with International Financial Reporting Standards ("IFRS").

In preparing the financial statements, management is responsible for:

- Properly selecting and applying accounting policies;
- Presenting information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- Providing additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Bank's financial position and financial performance; and
- Making an assessment of the Bank's ability to continue as a going concern.

Management is also responsible for:

- Designing, implementing and maintaining an effective and sound system of internal controls, throughout the Bank;
- Maintaining adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank, and which enable them to ensure that the financial statements of the Bank comply with IFRS;
- Maintaining statutory accounting records in compliance with legislation and accounting standards of Georgia;
- Taking such steps that are reasonably available to them to safeguard the assets of the Bank; and
- Preventing and detecting fraud and other irregularities.

The financial statements for the year ended 31December 2010 were authorized for issue on 30 March 2011 by the Management Council of the Bank.

On behalf of the Council of the Bank:

Chairman of the Council Giorgi Kadagidze

30 March 2011 Tbilisi, Georgia Head of Finance and Accounting Department Salome Skhirtladze

30 March 2011 Tbilisi, Georgia

## Deloitte.

Deloitte & Touche LLC 36 a Lado Asatiani Street Tbilisi, 0105 Georgia

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#### INDEPENDENT AUDITORS' REPORT

To the Council of the National Bank of Georgia:

#### Report on the financial statements

We have audited the accompanying financial statements of the National Bank of Georgia (the "Bank"), which comprise the statement of financial position as at 31 December 2010, the statements of comprehensive income, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

#### Management's responsibility for the financial statements

Management of the Bank is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### Auditors' responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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## Deloitte.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2010, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

#### Other matter

The financial statements of the Bank as at 31 December 2009 and for the year then ended were audited by another auditor, who expressed an unmodified opinion on those statements on 1 April 2010.

Deloite a Touche

30 March 2011 Tbilisi, Georgia

## STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2010

(in thousands of Georgian Lari)

	Notes	Year ended 31 December 2010	Year ended 31 December 2009
Interest income			
Investments held-to-maturity		38,925	42,027
Due from resident financial institutions		9,941	16,032
Due from international financial institutions		6,380	5,559
Other		1,352	627
		56,598	64,245
Investments available-for-sale		29,947	39,812
Trading securities		1,863	381
Interest expense		88,408	104,438
Interest expense Debt securities issued		(13,706)	(9,966)
Due to international financial institutions		(16,230)	(6,979)
Due to resident financial institutions		(5,285)	(314)
		(35,221)	(17,259)
NET INTEREST INCOME BEFORE RECOVERY OF		(33,221)	(17,237)
PROVISION/(PROVISION) FOR IMPAIRMENT LOSSES ON			
INTEREST BEARING ASSETS		53,187	87,179
INTEREST BEAMING ASSETS		23,107	07,177
Recovery of provision/(provision) for impairment losses on other			
assets	16	197	(338)
NET INTEREST INCOME		53,384	86,841
Net gains/(losses) from foreign currencies:			
-translation differences, net		29,473	20,362
-dealing, net		(6,556)	808
Fee and commission income	4	496	671
Fee and commission expense	4	(732)	(489)
Net losses from trading securities		(1,028)	(319)
Other income	5	1,237	1,736
NON-INTEREST INCOME		22,890	22,769
Personnel expenses	6	(9,595)	(7,681)
General and administrative expenses	6	(4,527)	(7,225)
Losses on disposal of property, plant and equipment	6	(4,120)	(5,059)
Depreciation and amortization	6	(2,366)	(1,971)
Money printing expenses		(1,044)	-
Other expenses		(1,163)	
NON-INTEREST EXPENSES		(22,815)	(21,936)
NET PROFIT FOR THE YEAR		53,459	87,674
Other comprehensive income			
Net unrealized (loss)/gain on investments available-for-sale		(5,527)	1,374
Net realized losses on investments available-for-sale reclassified to the statement of comprehensive income		<u> </u>	(1)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		47,932	89,047

On behalf of the Council of the Bank:

Chairman of the Council Giorgi Kadagidze Head of Finance and Accounting Department Salome Skhirtladze

30 March 2011 Tbilisi, Georgia

30 March 2011 Tbilisi, Georgia

## STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2010

(in thousands of Georgian Lari)

	Notes	31 December 2010	31 December 2009
ASSETS:			
Foreign currency assets			
Cash and cash equivalents	7	1,904,779	1,800,367
Due from financial institutions	8	7,674	5,347
Special Drawing Rights holdings with the International			
Monetary Fund	9	394,538	368,890
Trading securities	10	177,631	167,725
Investments available-for-sale	11	1,456,563	1,074,285
Investments held to maturity	12	79,960	146,441
Other assets	16	954	467
National currency assets			
Investments available-for-sale	11	113,895	118,254
Due from financial institutions	8	190,039	45,000
Investments held to maturity	12	602,547	642,660
Property, plant and equipment held for sale	13	329	-
Property, plant and equipment	14	28,038	27,848
Intangible assets	15	1,410	185
Other assets	16	9,072	5,146
TOTAL ASSETS		4,967,429	4,402,615
LIABILITIES AND EQUITY:			
LIABILITIES:			
Foreign currency liabilities			
Due to resident financial institutions	17	258,696	131,044
Due to the Ministry of Finance	18	96,489	147,093
Due to the International Monetary Fund	9	1,543,630	1,529,267
Other liabilities	16	1,369	212
National currency liabilities			
Money issued in circulation	19	1,618,180	1,457,938
Due to resident financial institutions	17	204,252	285,979
Due to the Ministry of Finance	18	712,660	438,149
Due to customers	20	280	332
Debt securities issued	21	355,119	219,053
Other liabilities	16	4,991	2,405
Total liabilities		4,795,666	4,211,472
EQUITY:			
Capital	22	15,000	15,000
Reserve fund	22	60,692	60,692
Foreign currency revaluation reserve	22	59,659	30,186
Revaluation reserve of investments available-for-sale	22	12,426	17,953
Retained earnings		23,986	67,312
Total equity		171,763	191,143
TOTAL LIABILITIES AND EQUITY		4,967,429	4,402,615

On behalf of the Council of the Bank:

Chairman of the Council Giorgi Kadagidze Head of Finance and Accounting Department Salome Skhirtladze

30 March 2011 Tbilisi, Georgia 30 March 2011 Tbilisi, Georgia

## STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2010

(in thousands of Georgian Lari)

	Capital	Reserve fund	Foreign currency revaluation reserve	Revaluation reserve of investments available- for-sale	Retained earnings	Total equity
31 December 2008	15,000	119,597	9,824	16,580	-	161,001
Total comprehensive income for the year Transfer to the Ministry of Finance (Note 22) Transfer to foreign	-	(58,905)	-	1,373	87,674 -	89,047 (58,905)
currency revaluation reserve (Note 22)			20,362		(20,362)	
31 December 2009	15,000	60,692	30,186	17,953	67,312	191,143
Total comprehensive income/(loss) for the year Transfer to the Ministry of	-	-	-	(5,527)	53,459	47,932
Finance (Note 22) Transfer to foreign currency revaluation	-	-	20.472	-	(67,312)	(67,312)
reserve (Note 22) 31 December 2010	15,000	60,692	29,473 <b>59,659</b>	12,426	(29,473) 23,986	171,763

On behalf of the Council of the Bank:

Chairman of the Council Giorgi Kadagidze

30 March 2011 Tbilisi, Georgia **Head of Finance and Accounting Department Salome Skhirtladze** 

30 March 2011 Tbilisi, Georgia

#### STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2010

(in thousands of Georgian Lari)

	Notes	Year ended 31 December 2010	Year ended 31 December 2009
CASH FLOWS FROM OPERATING ACTIVITIES:			
Interest received		79,392	96,924
Interest received		(30,371)	(24,327)
Fees and commissions received		496	671
Fees and commissions paid		(732)	(489)
Net losses from investment securities		(732)	(409)
Net realized (gains)/losses from dealing in foreign currencies		(6,556)	808
Other income received		1,303	1,510
Personnel expenses paid		(9,595)	(9,166)
Cash paid for printing money		(366)	(1,244)
Other general and administrative expenses paid		(3,796)	(7,232)
Cash flow from operating activities before changes in operating assets			
and liabilities		29,775	57,456
Net (increase)/decrease in operating assets:			
Due from financial institutions		(147,144)	200,417
Special Drawing Rights holdings with the International Monetary		(117,111)	200,117
Fund		(12,935)	(348,414)
Trading securities		(1,464)	(166,732)
Other assets		(4,413)	(166,732) $(168)$
Net increase/(decrease) in operating liabilities:		1.60.040	165.005
Money issued in circulation		160,242	167,235
Due to financial institutions		46,805	64,858
Due to the Ministry of Finance		230,107	(296,480)
Due to customers		(52)	(4,214)
Other liabilities		1,343	(1,228)
Net cash inflow/(outflow) from operating activities	_	302,264	(327,270)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from disposal of property, plant and equipment		94	43
Purchase of property, plant and equipment		(7,394)	(4,011)
Purchase of intangible assets		(1,301)	(81)
Purchase of investments held to maturity		<u>-</u>	(95,820)
Proceeds from redemption of investments held to maturity		63,887	18,054
Purchase of investments available-for-sale		(1,613,093)	(1,381,516)
Proceeds from redemption of investments available-for-sale	-	1,247,967	1,313,909
Net cash used in investing activities		(309,840)	(149,422)

# STATEMENT OF CASH FLOWS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2010

(in thousands of Georgian Lari)

	Notes	Year ended 31 December 2010	Year ended 31 December 2009
CASH FLOWS FROM FINANCING ACTIVITIES:  Transfer of distributable profit to the Ministry of Finance Debt securities issued Debt securities redeemed Increase in borrowings from the International Monetary Fund Repayment of amounts due to the International Monetary Fund	-	(67,312) 928,217 (794,925) - (38,536)	(58,905) 626,284 (483,773) 774,228 (46,133)
Net cash inflow from financing activities	_	27,444	811,701
Effect of exchange rates changes on cash and cash equivalents	-	84,544	30,768
NET INCREASE IN CASH AND CASH EQUIVALENTS		104,412	365,777
CASH AND CASH EQUIVALENTS, at the beginning of the year	7 _	1,800,367	1,434,590
CASH AND CASH EQUIVALENTS, at the end of the year	7	1,904,779	1,800,367

On behalf of the Council of the Bank:

Chairman of the Council Giorgi Kadagidze

30 March 2011 Tbilisi, Georgia **Head of Finance and Accounting Department Salome Skhirtladze** 

30 March 2011 Tbilisi, Georgia

#### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2010

(in thousands of Georgian Lari, unless otherwise indicated)

#### 1. ORGANIZATION

The National Bank of Georgia (the "Bank") is the central bank of Georgia and the banker and fiscal agent of the Government of Georgia. It acts in accordance with the Organic Law of Georgia "On the National Bank of Georgia" enacted effective from 1 December 2009 (the "Law"), which fully replaced previous law dated 24 October 1995.

Article 3 of the Law sets out the goals and functions of the Bank as follows:

- The primary goal of the Bank's activity is to ensure price stability;
- Ensure stability and transparency of the financial system and assess stable economic growth of Georgia. To the extent possible, it should be done in a way that the implementation of the Bank's major objective is not hindered;
- Develop and implement monetary and foreign exchange policies, in accordance with the main directions defined by the Parliament of Georgia;
- Hold, maintain and manage official international reserves;
- Act as a banker and a fiscal agent of the Government of Georgia;
- Ensure efficient operation of the payments system;
- Carry out emission of Georgia's monetary units;
- Carry out and disseminate information on the financial and external statistics of Georgia based on international standards and methodologies;
- Carry out supervision of the financial sector;
- Support prevention of anti-money laundering and financing of terrorism, pursuant to the Law through the legal entity under public law, the Georgian Financial Monitoring Office;
- Other functions, as stipulated by the Law.

Pursuant to the legislation of Georgia and the international treaties acceded to by Georgia, the Bank represents Georgia in relations with the central banks of foreign states, as well as international financial and credit institutions in matters relating to the Bank's responsibilities and functions.

The Bank may conclude agreements in cooperation with the central banks of foreign countries concerning various areas of its activities. It may also conclude clearing and settlement agreements and other agreements with foreign public and private clearing agencies, on its own behalf and on behalf of Georgia, if appropriately empowered.

The Bank may participate in the capital and activity of international organizations for the purpose of cooperation in monetary, foreign currency and banking areas.

As at 31 December 2010 and 2009, the members of the Council of the Bank are:

Position	Name
Chairman	Mr. Giorgi Kadagidze (Governor)
Member	Mr. Temur Shengelia
Member	Mr. Mikheil Tokmazishvili
Member	Mr. Simon Gelashvili
Member	Mr. Archil Mestvirishvili
Member	Mr. Otar Nadaraia
Member	Mr. Lasha Jugeli

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The Bank's main office is located at 3/5 Leonidze Street, Tbilisi, 0105, Georgia. In 2010 and 2009 the Bank has one cash service center. It has 303 and 296 personnel as at 31 December 2010 and 2009, respectively.

These financial statements were authorized for issue by the Council of the Bank on 30 March 2011.

#### 2. BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

#### Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board ("IASB") and Interpretations issued by the International Financial Reporting Interpretations Committee ("IFRIC").

#### Other basis of presentation criteria

These financial statements have been prepared on the assumption that the Bank is a going concern and will continue its operations for the foreseeable future.

These financial statements are presented in thousands of Georgian Lari ("GEL"), unless otherwise indicated. These financial statements have been prepared on the historical cost basis, except for the measurement at fair value of certain financial instruments and property held for sale, as explained in the accounting policies below. Historical cost is generally based on the fair value of consideration given in exchange for assets.

The Bank is required to maintain its records and prepare its financial statements in Georgian Lari and in accordance with IFRS.

Georgian Lari is the reporting and functional currency of the Bank as it is the currency of the economic environment in which the Bank operates. Transactions in other currencies are treated as transactions in foreign currency.

The Bank presents its statement of financial position broadly in order of liquidity. An analysis regarding recovery or settlement within 12 months after the statement of financial position date (current) and more than 12 months after the statement of financial position date (non-current) is presented in Note 25.

#### 3. SIGNIFICANT ACCOUNTING POLICIES

#### Recognition and measurement of financial instruments

The Bank recognizes financial assets and liabilities in its statement of financial position when it becomes a party to the contractual obligations of the instrument. Regular way purchases and sales of financial assets and liabilities are recognized using settlement date accounting.

Financial assets and liabilities are initially recognized at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs directly attributable to the acquisition of financial assets or financial liabilities at fair value through profit or loss are recognized immediately in profit or loss. The accounting policies for subsequent remeasurement of these items are disclosed in the respective accounting policies set out below.

#### Derecognition of financial assets and liabilities

#### Financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognized where:

- the rights to receive cash flows from the asset have expired;
- the Bank has transferred its rights to receive cash flows from the asset, or retained the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass-through' arrangement; and
- the Bank either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

A financial asset is derecognized when it has been transferred and the transfer qualifies for derecognition. A transfer requires that the Bank either: (a) transfers the contractual rights to receive the asset's cash flows; or (b) retains the right to the asset's cash flows but assumes a contractual obligation to pay those cash flows to a third party. After a transfer, the Bank reassesses the extent to which it has retained the risks and rewards of ownership of the transferred asset. If substantially all the risks and rewards have been retained, the asset remains in the statement of financial position. If substantially all of the risks and rewards have been transferred, the asset is derecognized. If substantially all the risks and rewards have been neither retained nor transferred, the Bank assesses whether or not it has retained control of the asset. If it has not retained control, the asset is derecognized. Where the Bank has retained control of the asset, it continues to recognize the asset to the extent of its continuing involvement.

#### Financial liabilities

A financial liability is derecognized when the obligation is discharged, cancelled, or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognized in the statement of comprehensive income.

#### Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, unrestricted balances on correspondent and time deposit accounts including overnight deposits and amounts due from financial institutions that mature within ninety days from the date of origination and are free from contractual encumbrances.

#### **Precious metals**

Gold commemorative coins are recognized at cost, including expenses on minting, transportation and other direct costs. When commemorative coins are sold, gain or loss is recorded in the statement of comprehensive income. Expenses on other commemorative coins are recognized as current expenses when produced and reflected in the statement of comprehensive income.

#### Due from financial institutions

In the normal course of business, the Bank maintains loans, advances and deposits for various periods of time with financial institutions. Due from financial institutions are non-derivative financial instruments that are not quoted in an active market. They are not entered into with the intention of immediate or short-term resale and are not classified as trading securities or designated as available-for-sale investments. Due from financial institutions are initially recognized at fair value and subsequently measured at amortized cost using the effective interest method. Amounts due from financial institutions are carried net of any allowance for impairment losses. Gains and losses are recognized in the statement of comprehensive income when the loans and receivables are derecognized or impaired, as well as through the amortization process.

## Membership in the International Monetary Fund (the "IMF") and other international financial institutions

Based on the provision of Article 5 of the Law, the Bank acts as an intermediary of the Government of Georgia on transactions related to the membership of Georgia in international financial organizations (i.e. the IMF, World Bank), including payment of membership fees to such organizations.

The International Monetary Fund (the "IMF") is an international organization established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payment adjustments. Quotas (capital subscriptions) are the primary source of the IMF resources. The IMF receives its resources from its member countries. Each country's subscription, or quota, is determined broadly on the basis of the economic size of the country, and taking into account quotas of similar countries. A member's quota delineates basic aspects of its financial and organizational relationship with the IMF.

Membership fees payable to the IMF are denominated in Special Drawing Rights (SDRs) and are revalued in GEL at the rate of exchange set by the IMF at the financial year-end of the IMF. Membership quota and securities issued by the Ministry of Finance of Georgia in respect of the IMF quota are not presented on the statement of financial position as they do not represent the assets and liabilities of the Bank, but are considered as off-balance sheet and are accordingly disclosed in the financial statements.

Moreover, the IMF has the authority under its Articles of Agreement to create unconditional liquidity through general allocations of SDRs to participants in its SDR Department in proportion to their quotas in the IMF. General allocations of SDRs should meet a long-term global need to supplement existing reserve assets in a manner that will promote the attainment of the IMF's purposes and avoid economic stagnation and deflation, as well as excess demand and inflation. Under the Fourth Amendment of the Articles of Agreement, the IMF also provided for a special allocation of SDRs to raise the ratios of members' cumulative SDR allocations relative to quota to a common benchmark ratio as described in the amendment.

The IMF pays interest to each holder of SDRs, and it makes charges at the same rate on each participant's net cumulative SDR allocations. The Articles of Agreement do not prescribe the accounting treatment of SDRs by members. As a matter of practice, the Bank records the SDR position in its books though obligations and rights arising under the Articles of Agreement from members' participation in the SDR Department – including those related to the use of SDR allocations – are obligations and rights of the relevant member. A member country would be required to repay its allocation of SDRs in certain circumstances such as upon termination of its participation in the SDR Department or upon liquidation of the SDR Department.

General and special allocations received from the IMF to boost the liquidity of member countries are taken up by the Bank as a foreign currency asset under SDR holdings with the IMF and a foreign currency liability under amounts due to the International Monetary Fund.

#### Financial assets and liabilities at fair value through profit or loss

Financial assets are classified as at fair value through profit or loss ("FVTPL") when the financial asset is either held for trading or it is designated as at FVTPL.

A financial asset is classified as held for trading if:

- It has been acquired principally for the purpose of selling it in the near term; or
- On initial recognition it is part of a portfolio of identified financial instruments that the Bank manages together and has a recent actual pattern of short-term profit-taking; or
- It is a derivative that is not designated and effective as a hedging instrument.

A financial asset other than a financial asset held for trading may be designated as at FVTPL upon initial recognition if:

- Such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise; or
- The financial asset forms part of a group of financial assets or financial liabilities or both, which is managed and its performance is evaluated on a fair value basis, in accordance with the Bank's documented risk management or investment strategy, and information about the grouping is provided internally on that basis; or
- It forms part of a contract containing one or more embedded derivatives, and IAS 39 "Financial Instruments: Recognition and Measurement" permits the entire combined contract (asset or liability) to be designated as at FVTPL.

Financial assets at FVTPL are stated at fair value, with any gains or losses arising on re-measurement recognized in profit or loss presented in net losses from trading securities line item in the statement of comprehensive income. Fair value is determined in the manner described in Note 25.

#### **Derivative financial instruments**

In the normal course of business, the Bank enters into various derivative financial instruments including forwards and swaps, to manage currency and liquidity risks and for trading purposes. Derivative financial instruments entered into by the Bank are not designated as hedges and do not qualify for hedge accounting. Derivatives are initially recognized at fair value at the date a derivative contract is entered into and are subsequently re-measured to their fair value at each reporting date. The fair values are estimated based on quoted market prices or pricing models that take into account the current market and contractual prices of the underlying instruments and other factors. Derivatives are carried as assets when their fair value is positive and as liabilities when it is negative.

Derivatives are included in financial assets and liabilities at fair value through profit or loss in the statement of financial position. Gains and losses resulting from these instruments are included in net gain or loss from financial assets and liabilities at fair value through profit or loss in the statement of comprehensive income.

#### Investments available-for-sale

Investments available-for-sale represent debt and equity investments that are intended to be held for an indefinite period of time. Investments available-for-sale are initially recorded at fair value and subsequently measured at fair value, with such re-measurement recognized directly in equity, except for impairment losses, foreign exchange gains or losses and interest income accrued using the effective interest method, which are recognized directly in the statement of comprehensive income. When sold, gain or loss previously recorded in equity is recycled through the statement of comprehensive income. The Bank uses quoted market prices to determine fair value of the Bank's investments available-for-sale. If the market for investments is not active, the Bank establishes fair value by using discounted cash flow analysis and other relevant valuation techniques. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the Bank uses that technique.

#### **Investments held to maturity**

Investments held to maturity are debt securities with determinable or fixed payments, and where the Bank has a positive intent and the ability to hold them to maturity. Such securities are carried at amortized cost using the effective interest method, less any allowance for impairment. Amortized discounts are recognized in interest income over the period to maturity using the effective interest method.

#### Write-off of loans and advances

Loans and advances are written off against the allowance for impairment losses when deemed uncollectible. Loans and advances are written off after management has exercised all possibilities available to collect amounts due to the Bank and after the Bank has sold all available collateral. Subsequent recoveries of amounts previously written off are reflected as an offset to the charge for impairment of financial assets in the statement of comprehensive income in the period of recovery.

## Allowance for impairment losses on financial assets

The Bank accounts for impairment of financial assets not recorded at fair value when there is objective evidence of impairment of a financial asset or a group of financial assets. The impairment of financial assets represents a difference between the carrying value of the asset and current value of estimated future cash flows including amounts which can be received on guarantees and security discounted using an initial effective interest rate on financial assets recorded at amortized value. If in a subsequent period the impairment amount decreases and such a decrease can be objectively associated with an event occurring after recognition of the impairment then the previously recognized impairment loss is reversed with an adjustment of the provision account.

For the financial instruments recorded at cost the impairment represents the difference between the carrying value of the financial asset and current value of the estimated future cash flows discounted using the current market interest rate for a similar financial instrument. Such impairment losses are not reversed.

The impairment is calculated based on the analysis of assets subject to risks and reflects the amount sufficient, in the opinion of the management, to cover relevant losses. The provisions are created as a result of an individual evaluation of assets subject to risks regarding financial assets being material individually and on the basis of an individual or joint evaluation of financial assets not being material individually.

The change in the impairment is included into profits using the provision account (financial assets recorded at amortized cost) or by a direct write-off (financial assets recorded at cost). Assets recorded in the statement of financial position are reduced by the amount of the impairment. The factors the Bank evaluates in determining the presence of objective evidence of occurrence of an impairment loss include information on liquidity of the debtor or issuer, their solvency, business risks and financial risks, levels and tendencies of default on obligations on similar financial assets, national and local economic tendencies and conditions, and fair value of the security and guarantees. These and other factors individually or in the aggregate represent, to a great extent, an objective evidence of recognition of the impairment loss on the financial asset or group of financial assets. It should be noted that the evaluation of losses includes a subjective factor. The management of the Bank believes that the amount of recorded impairment is sufficient to cover losses incurred on assets subject to risks at the reporting date, although it is probable that in certain periods the Bank can incur losses greater than recorded impairment.

#### Non-current assets held for sale

A non-current asset is classified as held for sale if it is highly probable that the asset's carrying amount will be recovered through a sale transaction rather than through continuing use and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification of an asset as held for sale.

Non-current assets held for sale are measured at the lower of its carrying amount and fair value less costs to sell. If the fair value less costs to sell of an asset held for sale is lower than its carrying amount, an impairment loss is recognized in the statement of comprehensive income as loss from non-current assets held for sale. Any subsequent increase in an asset's fair value less costs to sell is recognized to the extent of the cumulative impairment loss that was previously recognized in relation to that specific asset.

## Property, plant and equipment

Property, plant and equipment are carried at historical cost less accumulated depreciation and any recognized impairment loss, if any.

Depreciation is charged on the carrying value of property, plant and equipment and is designed to write off assets over their useful economic lives. Depreciation is calculated on a straight line basis at the following annual prescribed rates:

	%
Buildings	2
Computers, office equipment and fixtures	10-20
Vehicles	20
Other	20

Expenses related to repairs and renewals are charged when incurred and included in operating expenses unless they qualify for capitalization.

The carrying amounts of property, plant and equipment are reviewed at each reporting date to assess whether they are recorded in excess of their recoverable amounts. The recoverable amount is the higher of fair value less costs to sell and value in use. Where carrying values exceed the estimated recoverable amount, assets are written down to their recoverable amount; impairment is recognized in the respective period in the statement of comprehensive income. After the recognition of an impairment loss the depreciation charge for property, plant and equipment is adjusted in future periods to allocate the assets' revised carrying value, less its residual value (if any), on a systematic basis over its remaining useful life.

# **Intangible assets**

Intangible assets include computer software and licenses.

Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses. The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortized over the useful economic lives of five years and assessed for impairment whenever there is an indication that the intangible asset may be impaired. Amortization periods and methods for intangible assets with finite useful lives are reviewed at least at each financial year-end.

#### **Taxation**

Assets, property and income of the Bank, as well as its activities and operations are exempted from all taxes and other levies.

# Money issued in circulation

Money issued in circulation represents banknotes and coins issued by the Bank in accordance with the Law and its function as the central bank. Banknotes and coins in circulation are recorded in the statement of financial position at their nominal value net of cash in the Bank's cash offices.

The expenses for the production of notes and coins are expensed as incurred.

When notes are returned to the Bank by the commercial banks they are removed from money in circulation and depending on their condition or legal tender status, are either sent for destruction or held as cash by the Bank.

## Due to financial institutions, customers, the Ministry of Finance and debt securities issued

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity instruments. Such instruments include amounts due to the Government, amounts due to resident financial institutions, amounts due to customers, debt securities issued and liabilities to the International Monetary Fund. These are initially recognized at fair value of the consideration received less directly attributable transaction costs. After initial recognition, these financial instruments are subsequently measured at amortized cost using the effective interest method.

#### **Provisions**

Provisions are recognized when the Bank has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the obligation can be made.

## **Contingencies**

Contingent liabilities are not recognized in the statement of financial position but are disclosed unless the possibility of any outflow in settlement is remote. A contingent asset is not recognized in the statement of financial position but disclosed when an inflow of economic benefits is probable.

## Retirement and other employee benefit obligations

As at 31 December 2010 and 2009 the Bank does not have any active pension arrangements and no significant post-retirement benefits. As at 31 December 2010 and 2009 the Bank has pension scheme liabilities in the amount of GEL 760 and GEL 897 (Note 16), respectively, that represent the payables under pension arrangement cancelled on 29 May 2009, according to which the Bank had been collecting contributions from its employees and paying aggregated contributions to the employees after they reached the pension age according to pre-agreed schedule.

## Recognition of income and expense

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured.

*Interest and similar income and expense* 

For all financial instruments measured at amortized cost and interest bearing securities classified as trading, interest income or expense is recorded at the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument (for example, prepayment options) and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective interest rate, but not future credit losses. The carrying amount of the financial asset or financial liability is adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate and the change in carrying amount is recorded as interest income or expense.

Once the recorded value of a financial asset or a group of similar financial assets has been reduced due to an impairment loss, interest income continues to be recognized using the original effective interest rate applied to the new carrying amount.

Fee and commission income and expense

The Bank earns fee and commission income from a diverse range of services it provides to its counterparties. Fee and commission income includes cash operations fees and fund transfer fees, which are recognized as revenue as the services are provided. Fee and commission expense consists of cash operation, settlement fees and fees paid to the external manager.

#### Foreign currency translation

The financial statements are presented in Georgian Lari, which is the Bank's functional and presentation currency. Transactions in foreign currencies are initially recorded in the functional currency, converted at the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated at the functional currency rate of exchange ruling at the end of reporting date. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Gains and losses resulting from the translation of foreign currency transactions are recognized in the statement of comprehensive income as gains less losses from foreign currencies - translation differences, which are transferred by the Bank to the foreign currency revaluation reserve, which may only be used to offset future net revaluation losses as described in Note 22.

Differences between the contractual exchange rate of a transaction in a foreign currency and the Bank's exchange rate on the date of the transaction are included in gains less losses from dealing in foreign currencies.

#### Rates of exchange

The exchange rates used by the Bank in the preparation of the financial statements as at year-end are as follows:

	31 December 2010	31 December 2009
GEL/1 US Dollar	1.7728	1.6858
GEL/1 Euro	2.3500	2.4195
GEL/1 Pound Sterling	2.7393	2.6735
GEL/1 Special Drawing Right	2.7302	2.6428

## Offset of financial assets and liabilities

Financial assets and liabilities are offset and reported net in the statement of financial position when the Bank has a legally enforceable right to set off the recognized amounts and the Bank intends either to settle on a net basis or to realize the asset and settle the liability simultaneously. In accounting for a transfer of a financial asset that does not qualify for de-recognition, the Bank does not offset the transferred asset and the associated liability.

#### Reclassification of financial assets

If a non-derivative financial asset classified as held for trading is no longer held for the purpose of selling in the near term, it may be reclassified out of the fair value through profit or loss category in one of the following cases:

- a financial asset that would have met the definition of loans and receivables above may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity;
- other financial assets may be reclassified to available-for-sale or held to maturity categories only in rare circumstances.

A financial asset classified as available-for-sale that would have met the definition of loans and receivables may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity.

Financial assets are reclassified at their fair value on the date of reclassification. Any gain or loss already recognized in profit or loss is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable.

## Areas of significant management judgment and sources of estimation uncertainty

The preparation of the Bank's financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities at the reporting date and the reported amount of income and expenses during the period ended. Management evaluates its estimates and judgments on an ongoing basis. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The following estimates and judgments are considered important to the portrayal of the Bank's financial condition.

## Valuation of financial instruments

Financial instruments that are classified at fair value through profit or loss or available-for-sale, and all derivatives, are stated at fair value. The fair value of such financial instruments is the estimated amount at which the instrument could be exchanged between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. When valuation parameters are not observable in the market or cannot be derived from observable market prices, the fair value is derived through analysis of other observable market data appropriate for each product and pricing models which use a mathematical methodology based on accepted financial theories. Pricing models take into account the contract terms of the securities as well as market-based valuation parameters, such as interest rates, volatility, exchange rates and the credit rating of the counterparty. Where market-based valuation parameters are missed, management will make a judgment as to its best estimate of that parameter in order to determine a reasonable reflection of how the market would be expected to price the instrument. In exercising this judgment, a variety of tools are used including proxy observable data, historical data, and extrapolation techniques. The best evidence of fair value of a financial instrument at initial recognition is the transaction price unless the instrument is evidenced by comparison with data from observable markets. Any difference between the transaction price and the value based on a valuation technique is not recognized in the statement of comprehensive income on initial recognition.

Subsequent gains or losses are only recognized to the extent that it arises from a change in a factor that market participants would consider in setting a price.

The Bank considers that the accounting estimate related to valuation of financial instruments where quoted markets prices are not available is a key source of estimation uncertainty because: (i) it is highly susceptible to change from period to period because it requires management to make assumptions about interest rates, volatility, exchange rates, the credit rating of the counterparty, valuation adjustments and specific feature of the transactions and (ii) the impact that recognizing a change in the valuations would have on the assets reported in the statement of financial position as well as its profit or loss could be material.

Had the management used different assumptions regarding the interest rates, volatility, exchange rates, the credit rating of the counterparty and valuation adjustments, a larger or smaller change in the valuation of financial instruments where quoted market prices are not available would have resulted that could have had a material impact on the Bank's reported net income.

Allowance for impairment losses on loans and advances

The Bank regularly reviews its loans and advances to assess for impairment. The Bank's loans and advances impairment provisions are established to recognize incurred impairment losses in its portfolio of loans and advances. The Bank considers accounting estimates related to allowance for impairment of loans and advances a source of estimation uncertainty because (i) they are highly susceptible to change from period to period as the assumptions about future default rates and valuation of potential losses relating to impaired loans and advances are based on recent performance experience, and (ii) any significant difference between the Bank's estimated losses and actual losses would require the Bank to record provisions which could have a material impact on its financial statements in future periods.

The Bank uses management's judgment to estimate the amount of any impairment loss in cases where a debtor has financial difficulties and there are few available sources of historical data relating to similar counterparties. Similarly, the Bank estimates changes in future cash flows based on past performance, past debtor behavior, observable data indicating an adverse change in the payment status of debtor in a group, and national or local economic conditions that correlate with defaults on assets in the Bank. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the group of loans. The Bank uses management's judgment to adjust observable data for a group of loans to reflect current circumstances not reflected in historical data.

The allowances for impairment of financial assets in the financial statements have been determined on the basis of existing economic and political conditions.

Useful lives of property, plant and equipment and intangible assets

Items of property, plant and equipment and intangible assets are stated at cost less accumulated depreciation/amortization and less any accumulated impairment losses. The estimation of the useful life of an item of property, plant and equipment and intangible assets is a matter of management judgment based upon experience with similar assets. In determining the useful life of an asset, management considers the expected usage, estimated technical, legal obsolescence, physical wear and tear and the environment in which the asset is operated. Changes in any of these conditions or estimates may result in adjustments to future depreciation and amortization rates.

#### Adoption of new and revised standards

In the current year, the Bank has adopted all of the new and revised Standards and Interpretations issued by the IASB and IFRIC of the IASB that are relevant to its operations and effective for annual reporting periods ending on 31 December 2010. The adoption of these new and revised Standards and Interpretations has not resulted in significant changes to the Bank's accounting policies that have affected the amounts reported for the current or prior years. These new and revised standards are:

Amendments to IFRS 5 "Noncurrent Assets Held for Sale and Discontinued Operations" (as part of Improvements to IFRSs issued in 2009)

The amendments to IFRS 5 clarify that the disclosure requirements in IFRSs other than IFRS 5 do not apply to non-current assets (or disposal groups) classified as held for sale or discontinued operations unless those IFRSs require (i) specific disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations, or (ii) disclosures about measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of IFRS 5 and the disclosures are not already provided in the financial statements. Disclosures in these financial statements have not been affected by the above clarification.

Amendments to IFRS 7 "Financial Instruments: Disclosures" (as part of Improvements to IFRSs issued in 2010)

The amendments to IFRS 7 clarify the required level of disclosures about credit risk and collateral held and provide relief from disclosures previously required regarding renegotiated loans.

Amendments to IAS 1 "Presentation of Financial Statements" (as part of Improvements to IFRSs issued in 2009)

The amendments to IAS 1 clarify that the potential settlement of a liability by the issue of equity is not relevant to its classification as current or noncurrent. This amendment has no effect on the amounts reported because the Bank has not issued instruments of this nature.

Amendments to IAS 1 "Presentation of Financial Statements" (as part of Improvements to IFRSs issued in 2010)

The amendments to IAS 1 clarify that an entity may choose to present the required analysis of items of other comprehensive income either in the statement of changes in equity or in the notes to the financial statements. The Bank has applied the amendments in advance of their effective date (annual periods beginning on or after 1 January 2011). The amendments have been applied retrospectively.

Amendments to IAS 7 issued in 2009)

The amendments to IAS 7 specify that only expenditures that result "Statement of Cash Flows" (as in a recognized asset in the statement of financial position can be part of Improvements to IFRSs classified as investing activities in the statement of cash flows. The application of the amendments to IAS 7 has not resulted in a change in the presentation of cash outflows.

Amendments to IAS 24 "Related Party Disclosures" (as part of Improvements to IFRSs issued in 2009)

The IASB revised IAS 24 in 2009 by (i) simplifying the definition of a related party, clarifying its intended meaning and eliminating inconsistencies from the definition; and (ii) providing a partial exemption from the disclosure requirements for governmentrelated entities (effective for the annual periods beginning on or after 1 January 2011 with earlier application permitted). The Bank applies this Standard retrospectively.

## Standards and interpretations in issue and not yet effective

At the date of authorization of these financial statements, other than the Standards and Interpretations adopted by the Bank in advance of their effective dates, the following Standards and Interpretations were in issue but not yet effective.

- Amendments to IFRS 7 "Financial Instruments: Disclosures" "Transfers of Financial Assets", effective for annual periods beginning on or after 1 July 2011;
- IFRS 9 (as amended in 2010) "Financial Instruments", effective for annual periods beginning on or after 1January 2013, with earlier application permitted;
- Amendments to IFRIC 14 "Prepayments of a Minimum Funding Requirement", effective for annual periods beginning on or after 1 January 2011;
- IFRIC 19 "Extinguishing Financial Liabilities with Equity Instruments", effective for annual periods beginning on or after 1 July 2010;
- Improvements to IFRSs issued in 2010 (except for the amendments to IFRS 3 (2008), effective for annual periods beginning on or after 1 July 2010 and 1 January 2011, as appropriate.

The Bank's management does not anticipate that these amendments to IFRS will have a significant effect on the Bank's financial statements, except for IFRS 9. The management anticipates that IFRS 9 that will be adopted in the Bank's financial statements for the annual period beginning 1 January 2013 and that the application of the new Standard will have a significant impact on amounts reported in respect of the Bank's financial assets and financial liabilities. However, it is not practicable to provide a reasonable estimate of that effect until a detailed review has been completed.

Exposure draft IFRS 9, "Financial Instruments" issued in November 2009 and amended in October 2010 introduces new requirements for the classification and measurement of financial assets and financial liabilities and for derecognition.

- IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 "Financial Instruments: Recognition and Measurement" to be subsequently measured at amortized cost or fair value. Specifically, debt investments that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other debt investments and equity investments are measured at their fair values at the end of subsequent accounting periods.
- The most significant effect of IFRS 9 regarding the classification and measurement of financial liabilities relates to the accounting for changes in fair value of a financial liability (designated as at fair value through profit or loss) attributable to changes in the credit risk of that liability. Specifically, under IFRS 9, for financial liabilities that are designated as at fair value through profit or loss, the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is recognised in other comprehensive income, unless the recognition of the effects of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Previously, under IAS 39, the entire amount of the change in the fair value of the financial liability designated as at fair value through profit or loss was recognised in profit or loss.

# 4. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

	Year ended 31 December 2010	Year ended 31 December 2009
Fee and commission income:		
Funds transfer	490	377
Cash operations	2	283
Other	4_	11
Total fee and commission income	496	671
Fee and commission expense:		
Fees paid to external manager	(538)	(84)
Settlement operations	(169)	(135)
Cash operations	(25)	(223)
Fees to Tbilisi Interbank Currency Exchange	<del>-</del>	(47)
Total fee and commission expense	(732)	(489)

# 5. OTHER INCOME

Other income comprises:

	Year ended 31 December 2010	Year ended 31 December 2009
Gain on sale of commemorative coins	808	204
Revenue from fines	28	20
Revenue from liquidated local commercial bank	-	1,270
Other	401	242
Other income	1,237	1,736

The Bank has recovered GEL 1,270 from the assets of a liquidated local commercial bank during the year ended 31 December 2009.

## 6. OPERATING EXPENSES

Operating expenses comprise:

	Year ended 31 December 2010	Year ended 31 December 2009
Salaries and bonuses	9,130	6,909
Paid vacation and sick leaves	465	391
Pension cost		381
Total personnel expenses	9,595	7,681
Expenses related to financing of public legal entities	1,308	4,158
Subscription to information services	679	472
Security	526	546
Utilities	431	465
Employee insurance expense	296	272
Legal and consultancy	158	279
Personnel training	143	121
Business travel and related expenses	117	111
Repairs and maintenance	96	82
Communications	80	121
Office supplies	27	50
Software maintenance fees	1	39
Other	665	509
Total general and administrative expenses	4,527	7,225
Losses on disposal of property, plant and equipment	4,120	5,059
Depreciation charge (Note 14)	2,292	1,858
Amortization charge (Note 15)	74	113
Total depreciation and amortization	2,366	1,971

Expenses related to public legal entities financed by the Bank, represent expenses related to the Georgian Financial Monitoring Office and the Financial Supervisory Agency (the "FSA"), which were separate entities financed by the Bank. According to the Law, the FSA was liquidated on 1 December 2009 and it became a structural unit of the Bank.

Losses on disposal of property, plant and equipment for the years ended 31 December 2010 and 2009 include losses from the transfer of the buildings to the Ministry of Economy and Sustainable Development of Georgia for free in the amounts of GEL 3,670 and GEL 4,877, respectively.

# 7. CASH AND CASH EQUIVALENTS

	31 December 2010	31 December 2009
Cash on hand in foreign currency Current accounts	157,398 28,066	152,781 40,533
Time deposits with financial institutions up to 90 days	1,719,315	1,607,053
Total cash and cash equivalents	1,904,779	1,800,367

As at 31 December 2010 and 2009, GEL 1,294,101 and GEL 781,881, respectively, was placed in current accounts and time deposits up to ninety days with five internationally recognized Organization of Economic Co-operation and Development (OECD) banks and central banks.

As at 31 December 2010 and 2009, annual interest rate range of time deposits with financial institutions up to ninety days was 0.22%-4.65% and 0.12%-3.80%, respectively.

#### 8. DUE FROM FINANCIAL INSTITUTIONS

Due from financial institutions as at 31 December 2010 and 2009 comprise:

	31 December 2010	31 December 2009
<b>Due from financial institutions in foreign currency:</b> Due from non-resident financial institutions		
Deposits	7,674	5,347
Total due from financial institutions in foreign currency	7,674	5,347
<b>Due from financial institutions in national currency:</b> Due from resident financial institutions		
Refinancing loans	190,039	-
Last resort loans to commercial banks		45,000
Total due from financial institutions in national currency	190,039	45,000

As at 31 December 2010 and 2009, annual interest rate on time deposits with financial institutions with maturity of more than ninety days range was 0%-0.24%.

Restricted deposits as at 31 December 2010 relate to letters of credit for government related contracts and bear interest of 0.24% (2009: 0%) per annum on EUR denominated deposits and 0% (2009: 0%) on USD denominated deposits due to low remuneration indexes. Restricted deposits will be released by 30 March 2012 upon maturity of the related letters of credit.

As at 31 December 2010 and 2009, the Bank had a concentration of refinancing loans in the amount of GEL 190,039 due from seven resident commercial banks and last resort loan of GEL 45,000 due from one resident commercial bank at annual interest rate of 7.5%-7.8% and 13%, respectively.

# Collateral and other credit enhancements

The eligible type of collateral and criteria for each type of collateral is defined by the Council of the Bank. The accepted types of collateral are a) Securities issued by the Bank and by the Government of Georgia, b) Eligible International Bank Guarantees; c) Claims to eligible loan assets of commercial banks; haircuts to each type of collateral is periodically defined by the Monetary Policy Committee (MPC) of the Bank. In special cases defined by the Law, Council of the Bank can grant the last resort loan without collateral. National Bank of Georgia has the first lien on borrowers' assets according to the Law.

The main types of collateral obtained on refinancing loans are Government securities and/or debt securities issued by the Bank.

The Bank monitors the value of collateral, requests additional collateral in accordance with the underlying agreement, and monitors the value of collateral obtained during its review of the adequacy of the allowance for loan impairment.

# 9. SPECIAL DRAWING RIGHTS HOLDINGS WITH THE INTERNATIONAL MONETARY FUND (THE "IMF")

	31 December 2010	31 December 2009
Assets: Special Drawing Rights ("SDR") holdings	394,538	368,890
Liabilities:		
IMF current accounts Current account # 1	1,007	929
Current account # 2	27	25
Current decount // 2	1,034	954
Borrowings from the IMF		
Under Stand-by Arrangement Facility (SBA)	865,498	833,776
Under the Poverty Reduction and Growth Facility (PRGF)	283,826	313,925
General SDR allocation	304,451	294,650
Special SDR allocation	88,821	85,962
	1,542,596	1,528,313
Total due to the IMF	1,543,630	1,529,267
Off-balance sheet balances:		
IMF Quota	401,619	371,477
Security held in custody in respect of the IMF quota and as collateral of the IMF granted facilities	(1,948,703)	(1,315,899)

# **SDR Holdings**

SDR holdings represent the current account of the Bank with the IMF used for borrowings and settlements with the IMF. SDR holdings are primarily obtained from the general and special SDR allocations provided by the IMF under its Articles of Agreement. Interest accrued in respect of SDR holdings is calculated using the rate set by the IMF weekly on the basis of short-term market rates in major money markets. Average rate charged during 2010 and 2009 is 0.29% and 0.30% per annum, respectively.

#### IMF current accounts

The Bank is required to maintain two separate accounts: IMF current account number 1 and IMF current account number 2. IMF current account number 1 is for settlement of the IMF's operational transactions, whereas IMF current account number 2 is used for operational expenses incurred by the IMF in Georgian Lari.

#### IMF granted facilities

Facilities received from the IMF include the PRGF loan with original maturity of 10 years bearing initial interest of 0.5% per annum issued for the purpose of poverty reduction and macroeconomic stability. The PRGF-ESF (Exogenous Shocks Facility) Trust borrows resources from central banks, governments, and official institutions generally at market-related interest rates, and lends them on a pass-through basis to PRGF-eligible countries. There is no such trust for other IMF granted facilities. Effective 7 January 2010 interest on PRGF-ESF loans has been waived through 31 December 2011. The IMF will review interest rates for PRGF-ESF facilities in late 2011 and every two years thereafter. After 2011, projected interest charges are based on 0.25% percent per annum for the PRGF-ESF facilities.

SBA facility with original maturity of five years bearing floating interest rate issued to rebuild gross international reserves and strengthen investor confidence.

The annual interest rate range on the SBA facility in 2010 and 2009 is 1.22%-1.41% and 1.23%-1.82%, respectively. The repayment of the borrowings under the SBA facility will commence in 2011.

All facilities received from the IMF are denominated in SDR. PRGF borrowing is expected to be fully repaid by 2017 and SBA borrowing is expected to be fully repaid by 2014.

#### SDR allocations

The SDR allocation is an unsecured, interest bearing distribution of SDRs by the IMF through general and special allocations. General allocation is made by the IMF according to the Articles of Agreement to all participants in its SDR Department in proportion to countries' quotas in the IMF. On 10 August 2009, the Fourth Amendment to the IMF Articles of Agreement providing for a special one-time allocation of SDRs entered into force to boost global liquidity. According to the amendment dated 9 September 2009, the special allocation was made to the IMF members, which includes Georgia. Members and prescribed holders may use their SDR holdings to conduct transactions with the IMF. The Bank treats the allocation as a foreign currency liability to the IMF. Georgia, as a member country of the IMF and recipient of the allocations, is obliged to pay to the IMF an amount equal to its net cumulative allocation and any other amounts that may be due and payable because of the membership termination or liquidation of the IMF's SDR Department.

The annual interest rate range on the SDR allocation in 2010 and 2009 is 0.22%-0.40% and 0.23%-0.31%, respectively.

## **IMF Quota**

The IMF Quota, in the amount of Special Drawing Rights of 150.3 million, represents the membership subscription of Georgia with the IMF, and is non-interest bearing.

# Security held in custody in respect of the IMF Quota and as collateral of the IMF granted facilities

Security held in custody comprises GEL 401,619 in respect of the IMF Quota and GEL 1,948,703 held in custody as collateral for the IMF granted facilities. Security was issued by the Government of Georgia in 1992 in settlement of the IMF Quota. The Security used as collateral includes the total nominal value of the IMF granted facilities to Georgia: to the Bank and to the Government. Nominal value of the security is changed annually according to the revaluation and at the time of facility receipt from the IMF General Resources Account by the facility amount. As this security is held by the Bank in Custody, it is accounted for as an off-balance sheet item and presented at nominal value.

#### 10. TRADING SECURITIES

Trading securities comprise:

	31 December 2010	31 December 2009
Government bonds:		
US Treasury Notes	107,891	88,962
US Treasury Bills	35,594	61,870
Federal Home Loan	8,893	-
Fannie Mae	5,357	-
US Agency notes	-	8,450
	157,735	159,282
Corporate bonds:		
African Development Bank	8,877	8,443
Nordic Investment Bank	5,398	-
European Investment Bank	3,646	-
KfW International Finance	1,975	
<b>Total trading securities</b>	177,631	167,725

	31 December 2010		<b>31 December 2009</b>	
	Interest rate	Maturity	Interest rate	Maturity
	p.a.		p.a.	
	0.000/ 4.000/	2011 2012	0.00/.000/	2010 2011
Government bonds	0.09%-1.38%	2011-2012	0.8%-2.88%	2010-2011
Corporate bonds	0.41%-3.25%	2011-2013	0.41%	2012

# 11. INVESTMENTS AVAILABLE-FOR-SALE

	31 December 2010	31 December 2009
Investments available-for-sale in foreign currency:		
Government bonds:		
US Treasury Notes	505,140	146,740
French Treasury Bills	438,932	321,027
Belgian Treasury Bills	154,949	118,426
Dutch Treasury Bills	46,907	89,332
French Treasury Notes	33,244	-
US Treasury Bills	8,847	-
Spanish Treasury Bills	-	106,217
Portuguese Treasury Bills	-	91,666
	1,188,019	873,408
Corporate bonds:		
Bank for International Settlements	98,174	136,430
European Investment Bank	170,370	64,447
•	268,544	200,877
Total investments available-for-sale in foreign currency	1,456,563	1,074,285
Investments available-for-sale in national currency: Government bonds:		
Government of Georgia bonds	113,855	118,214
Equity investments:		
Shares of Tbilisi Interbank Foreign Exchange	40	40
Total investments available-for-sale in national currency	113,895	118,254

	<b>31 December 2010</b>		<b>31 December 2009</b>	
	Interest rate	Maturity	Interest rate	Maturity
	p.a.		p.a.	
US Treasury Notes	0.75%-4.88%	2011-2014	1.125%-5.75%	2010-2014
French Treasury Bills	0.53%-1.18%	2011	0.305%-1.05%	2010
Belgian Treasury Bills	0.44%-0.66%	2011	0.24%-1.57%	2010
Other foreign government bonds	0.23%-1.5%	2011	0.24%-1.57%	2010
Bank for International Settlements	3.00%-4.00%	2012-2014	3.00%-4.00%	2010-2014
European Investment Bank	2.5%-5.38%	2011-2013	3.625%-5.375%	2010-2013
Government of Georgia bonds	12%-13%	2011-2015	13.00%	2010-2014

## 12. INVESTMENTS HELD TO MATURITY

	31 December 2010		31 Decemb	er 2009
	Carrying value	Nominal value	Carrying value	Nominal value
Investments held to maturity in foreign currency: Government bonds:				
US Treasury Notes	18,444	17,728	18,171	16,858
Corporate bonds:	- 7	.,.	-, -	.,
Bank for International	61,516	58,750	128,270	123,159
Total investments held to maturity in foreign currency	79,960	76,478	146,441	140,017
Investments held to maturity in national currency:				
Government of Georgia bonds	602,547	600,846	642,660	640,846
Total investments held to maturity in national currency	602,547	600,846	642,660	640,846

	31 December 2010		<b>31 December 2009</b>	
	Interest rate	Maturity	Interest rate	Maturity
	p.a.		p.a.	
Foreign government bonds	4.63% - 4.88%	2011	4.63% - 4.88%	2011
Corporate bonds	3.80% - 4.60%	2011-2014	3.50% - 4.65%	2010-2014
Government of Georgia bonds	6.00%	2025	6.00%	2010-2025

Government bonds in national currency represent fixed interest bearing securities issued by the Ministry of Finance of Georgia according to the agreement formed between the Government of Georgia and the Bank in March 2006 converting borrowings of the Government of Georgia into debt securities. Interest rate is subject to revision annually considering market rates.

# 13. PROPERTY, PLANT AND EQUIPMENT HELD FOR SALE

	31 December 2010	31 December 2009
Beginning balance	<u>-</u>	11,260
Additions	329	
Disposals		(11,260)
Ending balance	329	

# 14. PROPERTY, PLANT AND EQUIPMENT

	Buildings	Computers, office equipment and fixtures	Assets under construction	Vehicles and other	Total
At initial cost:					
31 December 2008	18,670	6,270	128	13,131	38,199
Additions Disposals Transfers from assets classified as held for sale	187	1,028 (1,190)	374 (4)	2,891 (840)	4,480 (2,034)
(Note 13)	6,383				6,383
31 December 2009	25,240	6,108	498	15,182	47,028
Additions Disposals Transfers to assets classified	(4,123)	571 (1,592)	3,697 (127)	2,762 (2,550)	7,030 (8,392)
as held for sale (Note 13)	(334)				(334)
31 December 2010	20,783	5,087	4,068	15,394	45,332
Accumulated depreciation:					
31 December 2008	(3,095)	(5,066)	-	(11,011)	(19,172)
Depreciation charge Disposals	(375)	(524) 1,084	<u> </u>	(959) 766	(1,858) 1,850
31 December 2009	(3,470)	(4,506)	-	(11,204)	(19,180)
Depreciation charge Disposals	(449) 115	(488) 1,541		(1,355) 2,522	(2,292) 4,178
31 December 2010	(3,804)	(3,453)		(10,037)	(17,294)
Net book value:					
As at 31 December 2010	16,979	1,634	4,068	5,357	28,038
As at 31 December 2009	21,770	1,602	498	3,978	27,848

# 15. INTANGIBLE ASSETS

Intangible assets comprise:

31 December 2008	2,736
Additions Disposals	81
31 December 2009	2,817
Additions Disposals	1,301 (618)
31 December 2010	3,500
Accumulated amortization	
31 December 2008	(2,515)
Charge for the year Eliminated on disposals	(117)
31 December 2009	(2,632)
Charge for the year Eliminated on disposals	(74) 616
31 December 2010	(2,090)
Net book value	
31 December 2010	1,410
31 December 2009	185

Intangible assets include computer software and licenses.

# 16. OTHER ASSETS AND LIABILITIES

Other assets comprise:

	31 December 2010	31 December 2009
Other assets in foreign currency: Prepayments	949	450
Other debtors  Total other assets in foreign currency	5 954	17 467
Other assets in national currency: Prepayments Loans to employees Commemorative gold coins Inventory Other debtors	4,882 2,631 2,173 530 672 10,888	13 3,633 2,577 509 438 7,170
Allowance for impairment of other assets	(1,816)	(2,024)
Total other assets in national currency	9,072	5,146

As at 31 December 2010 and 2009, other financial assets amount to GEL 1,492 and GEL 2,064, respectively.

Other liabilities comprise:

	31 December 2010	31 December 2009
Other liabilities in foreign currency: Amounts due to suppliers	1,369	212
Total other liabilities in foreign currency	1,369	212
Other liabilities in national currency:		
Deferred revenue	1,731	80
Amounts due to suppliers	1,271	981
Liability for realized banknotes and coins	1,219	-
Pension scheme liabilities	760	897
Other liabilities	10	447
Total other liabilities in national currency	4,991	2,405

As at 31 December 2010 and 2009, other financial liabilities amount to GEL 4,629 and GEL 2,537, respectively.

The movements in allowance for impairment losses on other assets were as follows:

	Allowance for impairment losses on other assets
31 December 2008 Provision for impairment Write-offs	(1,691) (338) 5
31 December 2009 Recovery of provision for impairment Write-offs	(2,024) 197 11
31 December 2010	(1,816)

Allowance for impairment losses on other assets represents allowance for impairment of loans to employees.

## 17. DUE TO RESIDENT FINANCIAL INSTITUTIONS

Due to resident financial institutions comprise:

	31 December 2010	31 December 2009
Due to resident financial institutions in foreign currency:		
Correspondent accounts of banks	13,946	3,753
Obligatory reserves of banks	244,750	127,291
Total due to resident financial institutions in foreign currency	258,696	131,044
Due to resident financial institutions in national currency:		
Correspondent accounts of banks	144,102	285,979
Overnight deposits	60,150	
Total due to resident financial institutions in national currency	204,252	285,979

As at 31 December 2010 and 2009 included in due to resident financial institutions is a balance with three largest local commercial banks in the amount of GEL 293,963 and GEL 202,121, respectively that exceed 15% of the total balance of due to resident financial institutions.

Resident financial institutions are required to maintain obligatory reserves with the Bank. As at 31 December 2010 the obligatory reserves are calculated as 5% of their eligible liabilities denominated in foreign currencies. As at 31 December 2010 and 2009 annual interest rate on USD and EUR denominated obligatory reserves is 0% and 0.5%, respectively.

# 18. DUE TO THE MINISTRY OF FINANCE

	31 December 2010	31 December 2009
Due to the Ministry of Finance in foreign currency:		
Current accounts	89,446	145,003
Restricted deposits to secure letters of credit	7,043	2,090
Total due to the Ministry of Finance in foreign currency	96,489	147,093
Due to the Ministry of Finance in national currency:		
Current accounts	712,072	434,761
Restricted deposits to secure letters of credit	588	3,388
Total due to the Ministry of Finance in national currency	712,660	438,149

# 19. MONEY ISSUED IN CIRCULATION

Money issued in circulation represents the amount of national currency of Georgia issued by the Bank. Movements during the year ended 31 December 2010 and 2009 are as follows:

	2010	2009
Balance as at 1 January	1,457,938	1,290,703
Banknotes issued into circulation	991,765	1,070,429
Coins issued into circulation	7,162	16,049
Cash on hand in national currency	(14,071)	(47,873)
Banknotes withdrawn from circulation	(822,577)	(869,257)
Coins withdrawn from circulation	(2,037)	(2,113)
Balance as at 31 December	1,618,180	1,457,938

# 20. DUE TO CUSTOMERS

Due to customers comprise:

	31 December 2010	31 December 2009
International financial institutions Other	267 13	317 15
Total due to customers	280	332

#### 21. DEBT SECURITIES ISSUED

	Interest rate p.a.	Maturity	Nominal value	Carrying value
Certificates of Deposit as at 31 December 2010	8.49% -9.95%	6 January - 31 March	360,000	355,119
Certificates of Deposit as at 31 December 2009	2.85% to 3.45%	6 January - 1 April 2010	220,000	219,053

#### 22. EQUITY

As stated in the Law, the Bank's capital is comprised of its subscribed and fully paid-up capital and reserve fund.

## **Authorized capital**

The authorized and fully paid-up capital of the Bank is GEL 15,000 thousand as at 31 December 2010 and 2009.

#### Reserve fund

According to the amended Article 25 of the Organic Law of Georgia "On the National Bank of Georgia" (the "Law") dated 1 December 2009 (N2186) the reserve fund should make up 15% of the reserve money, which comprises the national currency in cash put into circulation by the Bank together with the correspondent accounts of commercial banks in national currency, and are established by allocations from the realized profit for the year, which comprises net profit for the year excluding net foreign currency translation gain. The Council is entitled to determine the establishment of the reserve fund of less than 15% of the reserve money. The reserve fund may only be used to offset losses of the Bank. With the specific objective of maintaining stability of the financial system, as well as fostering sustainable economic growth in the country, the Council is entitled to take decision on the distribution of the reserve fund. Upon establishment of the reserve fund, the residual balance of realized profit of the Bank shall be transferred to the State Budget of Georgia.

## Foreign currency revaluation reserve

Based on the amended Article 25 of the Law, the Bank transfers net gains arising from unrealized foreign currency revaluation to the foreign currency revaluation reserve, which may only be used to offset future net revaluation losses.

The Bank transferred GEL 29,473 and GEL 20,362 net gains arising from foreign currency revaluation to the foreign currency revaluation reserve for the years ended 31 December 2010 and 2009, respectively.

#### Revaluation reserve for investments available-for-sale

This reserve records fair value changes of investments available-for-sale.

#### 23. COMMITMENTS AND CONTINGENCIES

In the normal course of operations, the Bank is a party to financial instruments with off-balance sheet commitments. The Bank uses the same risk management policies in undertaking off-balance sheet commitments as it does for on-balance operations.

## Capital commitments

As at 31 December 2010 the Bank's capital commitments in respect of constructing new cash vault amount to GEL 137.

## **Operating environment**

As an emerging market, Georgia does not possess a well-developed infrastructure that would generally exist in a more mature market economy. Operations in Georgia may involve risks that are not typically associated with those in developed markets. However, over the last few years the Government of Georgia has made a number of developments that positively affect the overall investment climate in Georgia, specifically implementing the reforms necessary for creating efficient banking, judicial, taxation and regulatory systems. This has resulted in a stable macroeconomic environment with higher real growth rates and inflow of foreign investments. In management's view, these steps contribute to mitigate the risks of doing business in Georgia. The existing tendency aimed at the overall improvement of the business environment is expected to persist. Future development of economy of Georgia is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the Government and the National Bank of Georgia.

#### **Operating lease commitments**

No material lease commitments were outstanding as at 31 December 2010 and 2009.

## Legal proceedings

The Bank is subject to legal actions and complaints. Management believes that the ultimate liability, if any, arising from such actions or complaints will not have a material effect on the financial position or the results of operations of the Bank. Management is of the opinion that no material unaccrued losses will be incurred and accordingly no provision has been made in these financial statements.

## Credit commitments and contingent liabilities

As at 31 December 2010 and 2009, the Bank's credit commitments and contingent liabilities comprised of letters of credit issued in the amount of GEL 7,631 and GEL 5,478, respectively.

#### **Insurance**

The Bank has not currently obtained insurance coverage related to liabilities arising from errors or omissions.

# 24. RELATED PARTY TRANSACTIONS

Related parties include shareholders, affiliates and entities under common ownership and control with the Bank and members of key management personnel.

In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form. The Bank had the following transactions outstanding with related parties:

	31 Dece	mber 2010	31 Dece	31 December 2009	
	Related party balances	Total category as per the financial statements caption	Related party balances	Total category as per the financial statements caption	
STATEMENT OF FINANCIAL POSITION				•	
ASSETS:					
Investments available-for-sale in national currency					
Government of Georgia	113,855	113,895	118,214	118,254	
Investments held to maturity in national currency					
Government of Georgia	602,547	602,547	642,660	642,660	
Loans to employees in national currency Key management personnel	429	2,631	638	3,633	
LIABILITIES: Due to the Ministry of Finance in foreign currency					
Government of Georgia	96,489	96,489	147,093	147,093	
Due to the Ministry of Finance in national currency					
Government of Georgia	712,660	712,660	438,149	438,149	
Credit commitments and contingent liabilities					
Government of Georgia	7,631	7,631	5,478	5,478	

		ended mber 2010	Year ended 31 December 2009	
	Related party transactions	Total category as per the financial statements caption	Related party transactions	Total category as per the financial statements caption
Key management personnel compensation: - short-term employee benefits	1,877	9,595	1,364	7,681
Total	1,877	9,595	1,364	7,681

	Year ended 31 December 2010		Year ended 31 December 2009	
STATEMENT OF COMPREHENSIVE INCOME	Related party transactions	Total category as per the financial statements caption	Related party transactions	Total category as per the financial statements caption
Interest income on investments  Government of Georgia	52,043	68,872	59,969	81,839
Interest income on other operations  Key management personnel	39	1,352	49	627
Losses on disposal of property, plant and equipment  Government of Georgia	3,670	4,120	4,877	5,059
Operating expenses related to financing of legal public entities  Other related parties	1,308	1,308	4,158	4,158

# 25. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is defined as the amount at which the instrument could be exchanged in a current transaction between knowledgeable willing parties in an arm's length transaction, other than in forced or liquidation sale. The estimates presented herein are not necessarily indicative of the amounts the Bank could realize in a market exchange from the sale of its full holdings of a particular instrument.

The fair value of financial assets and liabilities that are not carried at fair value in the statement of financial position compared with the corresponding carrying value in the financial statements of the Bank is presented below:

	<b>31 December 2010</b>		<b>31 December 2009</b>	
_	Carrying value	Fair value	Carrying value	Fair value
Financial assets:				
Cash and cash equivalents	1,904,779	1,904,779	1,800,367	1,800,367
Due from financial institutions	197,713	197,713	50,347	49,895
Special Drawing Rights holdings with the International Monetary				
Fund	394,538	394,538	368,890	368,890
Investments held to maturity	682,507	494,908	789,101	661,666
Other financial assets	1,492	1,492	2,064	2,064
Financial liabilities:				
Due to resident financial				
institutions	462,948	462,948	417,023	417,023
Due to the Ministry of Finance	809,149	809,149	585,242	585,242
Due to the International				
Monetary Fund	1,543,630	1,543,630	1,529,267	1,527,298
Due to customers	280	280	332	332
Debt securities issued	355,119	355,119	219,053	219,053
Other financial liabilities	4,629	4,629	2,537	2,537

## Assets for which fair value approximates carrying value

For financial assets and liabilities that have a short term maturity (less than 3 months), it is assumed that the carrying amounts approximate to their fair value. This assumption is also applied to demand deposits and savings accounts without a maturity.

## Investments available-for-sale

Investments available-for-sale include government bonds in local currency issued by the Ministry of Finance of Georgia. As there have not been any transactions in 2010 and 2009 providing evidence of the current fair value of the bonds of the Government of Georgia, discounted cash flow method is used for estimating fair value. The average yield of 13.82% and 7.45% for T-bills of the Government of Georgia is used for the estimation of fair value of the unquoted investments available-for-sale as at 31 December 2010 and 2009, respectively.

#### Fixed rate financial instruments

The fair value of fixed rate financial assets and liabilities carried at amortized cost are estimated by comparing market interest rates when they were first recognized with current market rates offered for similar financial instruments. The estimated fair value of fixed interest bearing deposits is based on the discounted cash flow using prevailing money-market interest rates for debt with similar credit risk and maturity. For quoted debt issued the fair value are calculated based on quoted market prices. For those notes issued where quoted market prices are not available, a discount cash flow model is used based on a current interest rate yield curve appropriate for the remaining term to maturity.

#### Financial instruments recorded at fair value

Financial instruments recognized at fair value are broken down for disclosure purposes into a three level fair value hierarchy based on the observability of inputs as follows:

- Quoted prices in an active market (Level 1) Valuations based on quoted prices in active
  markets that the Bank has the ability to access for identical assets or liabilities. Valuation
  adjustments and block discounts are not applied to these financial instruments. Since valuations
  are based on quoted prices that are readily and regularly available in an active market,
  valuations of these products do not entail a significant amount of judgment;
- Valuation techniques using observable inputs (Level 2) Valuations based on inputs for which
  all significant inputs are observable, either directly or indirectly and valuations based on one or
  more observable quoted prices for orderly transactions in markets that are not considered
  active;
- Valuation techniques incorporating information other than observable market data (Level 3) –
   Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The Bank's valuation approach and fair value hierarchy categorization for certain significant classes of financial instruments recognized at fair value is as follows:

		31 Decen	nber 2010	
	Quoted prices in active market (Level 1)	Valuation techniques based on observable market data (Level 2)	Valuation techniques incorporating information other than observable market data (Level 3)	Total
Trading securities Investments available-for-sale	177,631 1,456,563	113,895	- -	177,631 1,570,458
		31 Decem	nber 2009	
	Quoted prices in active market (Level 1)	Valuation techniques based on observable market data (Level 2)	Valuation techniques incorporating information other than observable market data (Level 3)	Total
Trading securities Investments available-for-sale	167,725 1,074,285	- 118,254	-	167,725 1,192,539

The following is a description of the determination of fair value of financial instruments which are recorded at fair value using valuation techniques. These incorporate the Bank's estimate of assumptions that a market participant would make when valuing the instruments.

# Trading securities and investment securities available-for-sale

Trading securities and investment securities available-for-sale are valued using a valuation technique or pricing models primarily consist of unquoted equity and debt securities. These securities are valued using models which sometimes only incorporate data observable in the market and at other times use both observable and non-observable data. The non-observable inputs to the models include assumptions regarding the future financial performance of the investee, its risk profile, and economic assumptions regarding the industry and geographical jurisdiction in which the investee operates.

The table below shows an analysis of financial assets and liabilities according to when they are expected to be recovered or settled.

		<b>31 December 2010</b>			31 December 2009	
	Within one year	More than one year	Total	Within one year	More than one year	Total
Financial assets:						
Cash and cash						
equivalents	1,904,779	-	1,904,779	1,800,367	-	1,800,367
Due from financial						
institutions	197,713	-	197,713	50,347	-	50,347
Special Drawing Rights						
holdings with the						
International Monetary	204 520		204.520	2.60.000		2.00.000
Fund	394,538	-	394,538	368,890	-	368,890
Trading securities	177,631	-	177,631	167,725	-	167,725
Investments available-	1 010 240	<i>E(</i> 0.110	1 570 450	924 (50	267.000	1 102 520
for-sale Investments held to	1,010,348	560,110	1,570,458	824,659	367,880	1,192,539
maturity	669,839	12,668	682,507	63,170	725,931	789,101
Other financial assets	846	646	1,492	1,260	804	2,064
Total financial assets	4,355,694	573,424	4,929,118	3,276,418	1,094,615	4,371,033
Financial liabilities:						
Due to resident financial						
institutions	462,948	-	462,948	417,023	-	417,023
Due to the Ministry of						
Finance	809,149	-	809,149	585,242	-	585,242
Due to the International	407.212	1.046.217	1 542 620	52.004	1 455 102	1.500.065
Monetary Fund	497,313	1,046,317	1,543,630	52,084	1,477,183	1,529,267
Due to customers	280	-	280	332	-	332
Debt securities issued	355,119	= -	355,119	219,053	-	219,053
Other financial liabilities	3,869	760	4,629	1,643	894	2,537
Total financial						
liabilities	2,128,678	1,047,077	3,175,755	1,275,377	1,478,077	2,753,454
NET FINANCIAL		(170 (70)	1 == 2 2 4	• 004 0 : :	(202.452)	4 (4
POSITION	2,227,016	(473,653)	1,753,363	2,001,041	(383,462)	1,617,579

All gains and losses included in other comprehensive income relate to investments available-for-sale and are reported as changes of revaluation reserve of investments available-for-sale.

#### 26. RISK MANAGEMENT

#### Introduction

The activities of the Bank are exposed to various risks. Risk management therefore is a critical component of its banking activities. Risk is inherent in the Bank's activities but it is managed through a process of ongoing identification, measurement and daily monitoring, subject to risk limits and other controls. Each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk, and market risk. It is also subject to operating risks.

The Council of the Bank is ultimately responsible for identifying and controlling risks; however, there are separate business units responsible for managing and monitoring the various risks.

#### The Council

The Council of the Bank has overall responsibility for the oversight of the risk management framework, overseeing the management of key risks and reviewing its risk management policies and procedures.

## Reserve Management Committee

The Reserve Management Committee (the "Committee") of the Bank is responsible for monitoring and implementation of risk mitigation measures and making sure that the Bank operates within the established risk parameters. Typical activities of the Committee are reviewing the monthly reports, approving the list of eligible counterparties, approving changes to the strategy before submitting them to the Council and occasionally making important tactical decisions on asset allocation.

#### Risk Management and Control Division

Risk Management and Control Division (the "Division") of the Bank is responsible for the overall risk management and compliance functions, ensuring the implementation of common principles and methods for identifying, measuring, managing and reporting risks. Main function of the Division is to identify, analyze and manage the risks faced by the Bank, to set appropriate risk limits and controls, and to continuously monitor risk levels and adherence to limits. Also the Division works on benchmarking and stress testing. The Division is responsible for monthly reports for the Reserve Management Committee.

#### Internal Audit

Risk management processes throughout the Bank are audited annually by the Internal Audit that examines both the adequacy of the procedures and the Bank's compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Chairman of the Council.

# Risk measurement and reporting systems

Depending on the structure of operations, the risk management in the Bank is conducted by centralized and non-centralized method. Financial risk management is conducted centrally whereas operational risk management is not centralized.

Risk management is conducted directly by various departments. There are also special committees and commissions within the Bank for conducting operations and control such as the Reserve Management Committee, Credit Committee and others.

The risk related to the Bank's foreign currency assets is a significant risk. Segregation of duties, procedures and reporting for risk management are regulated by the "Guidelines on Management of International Reserves of the National Bank of Georgia".

#### Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risks, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio.

#### Credit risk

The Bank is exposed to credit risk, which is the risk that one party will incur a loss because the other party failed to comply with its financial obligations. Credit risk is managed and controlled through proper selection of investment assets, credit quality of investment assets and setting limits on the amount of investment per investment asset. The Bank has developed policies and procedures for the management of credit exposures, including guidelines to limit portfolio concentration. Reserve Management Committee actively monitors the Bank's credit risk. The Bank's credit policy is reviewed and approved by the Council.

In order to decrease the credit risk exposure in foreign currency, the list of reliable counterparties having high long-term credit rating, established by the international rating agencies (Standard & Poor's, Moody's and Fitch) is selected by the Risk Management Division and approved by the Reserves Management Committee.

While selecting the Bank's counterparties, the counterparty's credit rating, the country of its residence, the volume of its assets and capital, the experience of working in international markets and with corporate clients and the spectrum of the services and instruments offered to clients are taken into consideration. In case of downgrade of the long-term credit rating of the Bank's counterparty by the above-mentioned rating agencies, the counterparty will be withdrawn from the list of counterparties. Minimum required credit rating must be at least AA by at least two of the three credit rating agencies. As to the current accounts and trading purposes, the Bank sees a lower credit risk and therefore, the minimum requirement stands at A by at least two of the three credit rating agencies.

The Bank also has limits for individual counterparties and sovereign limits as well.

The table below shows the maximum exposure to credit risk for the components of the statement of financial position. The maximum exposure is shown gross, before impairment allowances and the effect of mitigation through the use of master netting and collateral agreements.

		Maxii expos	
	Notes	31 December 2010	31 December 2009
Cash and cash equivalents (excluding cash on hand)	7	1,747,381	1,647,586
Due from financial institutions	8	197,713	50,347
Special Drawing Rights holdings with the International			
Monetary Fund	9	394,538	368,890
Trading securities	10	177,631	167,725
Investments available-for-sale	11	1,570,458	1,192,539
Investments held to maturity	12	682,507	789,101
Other financial assets	16	1,492	2,064
		4,771,720	4,218,252
Credit commitments and contingent liabilities	23	7,631	5,478
Total credit risk exposure		4,779,351	4,223,730

Where financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure, but not the maximum risk exposure that could arise in the future as a result of changes in values. For more detail on the maximum exposure to credit risk for each class of financial instrument, references shall be made to the specific notes. The table below represents information on credit rating of issuers of the financial instruments held by the Bank in foreign currency.

The table contains ratings of Standard & Poors, Fitch and Moody's international agencies. When different credit ratings are designated by the agencies for the asset, the lowest designated rating for this asset is used.

Total
1,747,381
197,713
394,538
177,631
1,570,458
682,507
1,492
Total
1 (47 59(
1,647,586
50,347
368,890
167,725
167,725 1,192,539
- 4 - - - 2 1

#### Credit quality per class of financial assets

As a central bank, the Bank ensures the stability of the country's financial system by granting short-term loans to banks having liquidity needs, as deemed appropriate. The table below shows the credit quality by class of asset for loan related lines in the statement of financial position, based on the Bank's credit rating system.

	As at 31 December 2010					
		Neither past due nor impaired				
	Notes	AAA grade	AA grade	B grade	Total	
Due from financial institutions	8		190,039		190,039	
Investments available-for-sale	11	1,456,563	113,895	-	1,570,458	
Investments held to maturity	12	-	602,547	-	602,547	
Loans to employees	16			2,631	2,631	
Total		1,456,563	906,481	2,631	2,365,675	

	As at 31 December 2009					
		Neither past due nor impaired				
	Notes	AAA grade	AA grade	B grade	Total	
Due from financial institutions	8	-	45,000	-	45,000	
Investments available-for-sale	11	1,074,285	118,254	-	1,192,539	
Investments held to maturity	12	146,441	642,660	-	789,101	
Loans to employees	16			3,633	3,633	
Total		1,220,726	805,914	3,633	2,030,273	

The Bank classifies its assets for loan-related lines in the statement of financial position as follows:

AAA grade – loans issued to borrowers with excellent financial performance, having no changes in the terms and conditions of loan agreements and no overdue in principal and interest.

AA grade – loans issued to borrowers with stable financial performance, having no changes in the terms and conditions of loan agreements and no overdue in principal and interest.

A grade – loans issued to borrowers with satisfactory financial performance, having changes in the terms and conditions of loan agreements and no overdue in principal and interest.

B grade – loans issued to borrowers with satisfactory financial performance, having changes in the terms and conditions of loan agreements and overdue in principal and interest.

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. The attributed risk ratings are assessed and updated regularly.

#### Impairment assessment

The main considerations for loan impairment assessment include whether any payments of principal or interest are overdue by more than ninety days or there are any known difficulties in the cash flows of the counterparties, credit rating downgrades, or infringement of the original terms of the contract. The Bank addresses impairment assessment in two areas: individually assessed allowances and collectively assessed allowances.

# Individually assessed allowances

The Bank determines the allowances appropriate for each individually significant loan on individual basis. Items considered when determining allowance amounts include the sustainability of the counterparty's business plan, its ability to improve performance once a financial difficulty has arisen, projected receipts should bankruptcy ensue, the availability of other financial support and the realizable value of collateral, and the timing of the expected cash flows. The impairment losses are evaluated at each reporting date, unless unforeseen circumstances require more careful attention.

## Collectively assessed allowances

Allowances are assessed collectively for losses on loans and advances that are not individually significant and for individually significant loans and advances where there is not yet objective evidence of individual impairment. Allowances are evaluated on each reporting date with each portfolio receiving a separate review.

# Loans granted to employees

Employees of the Bank have right to take a loan from the Bank during the time period of his/her work. When the employee leaves the Bank, a 100% allowance is made on the outstanding loan. Write-off is conducted according to the decision made by the management of the Bank.

# Loans granted to commercial banks

If a commercial bank fails to repay the loan within the fixed timeframe, the Bank is entitled to recover the unpaid loan from realization of the collateral, and in case of insufficient funds, from any assets of the commercial bank, in line with the requirements under Article 64 of the Law.

The geographical concentration of the Bank's monetary assets and liabilities is set out below:

	Georgia	31 December 2010 OECD	Total	Georgia	31 December 2009 OECD	Total
Financial assets:						
Cash and cash equivalents	157,398	1,747,381	1,904,779	152,781	1,647,586	1,800,367
Due from financial	,	,,	, ,	, , ,	,,	, ,
institutions	190,039	7,674	197,713	45,000	5,347	50,347
Special Drawing Rights						
holdings with the						
International Monetary		204.520	204.520		2.60.000	2.00.000
Fund	-	394,538	394,538	-	368,890	368,890
Trading securities	-	177,631	177,631	-	167,725	167,725
Investments available-for- sale	113,895	1,456,563	1,570,458	118,254	1,074,285	1,192,539
Investments held to	115,893	1,430,303	1,3/0,436	110,234	1,074,263	1,192,339
maturity	602,547	79,960	682,507	642,660	146,441	789,101
Other financial assets	1,492	-	1,492	1,597	467	2,064
	1,.,2	<u> </u>	1,.>2			
Total financial assets	1,065,371	3,863,747	4,929,118	960,292	3,410,741	4,371,033
Financial liabilities:						
Due to resident financial						
institutions	462,948	-	462,948	417,023	-	417,023
Due to the Ministry of						
Finance	809,149	-	809,149	585,242	-	585,242
Due to the International						
Monetary Fund	-	1,543,630	1,543,630	-	1,529,267	1,529,267
Due to customers	12	268	280	-	332	332
Debt securities issued	355,119	-	355,119	219,053	-	219,053
Other financial liabilities	4,629	<u> </u>	4,629	2,537	<u> </u>	2,537
Total financial liabilities	1,631,857	1,543,898	3,175,755	1,223,855	1,529,599	2,753,454
Net financial position	(566,486)	2,319,849	1,753,363	(263,563)	1,881,142	1,617,579

## Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due under normal and stress circumstances. Management of the liquidity risk by the Bank is based on keeping the liquidity at required level for meeting the requirements of the Bank in any condition.

In order to achieve the Bank's primary goals of maintaining price stability and control over monetary policy, the Bank maintains operational foreign currency assets which are a group of liquid assets from its foreign currency assets to ensure timely intervention when deemed necessary. Liquidity risk management consists of identifying the liquid assets and determining the minimum liquidity limits of foreign currency assets over its investment period.

The Bank's Monetary Policy and International Reserves Management Committees set limits on the minimum proportion of maturing funds available to cover cash outflows. The liquidity management policy of the Bank requires:

- Projecting cash flows by major currencies and considering the level of liquid assets necessary in relation thereto;
- Maintaining a diverse range of funding sources;
- Managing the concentration and profile of debts;
- Maintaining a portfolio of highly marketable assets that can easily be liquidated as protection against any interruption to cash flow; and
- Maintaining liquidity and funding contingency plans.

The Financial Markets Department receives information from business units regarding the liquidity profile of their financial assets and liabilities and details of other projected cash flows arising from projected future operations. The Department then provides for an adequate portfolio of short-term liquid assets to be maintained, largely made up of short-term liquid trading securities, loans to banks and other inter-bank facilities, to ensure that sufficient liquidity is maintained within the system as a whole.

The daily liquidity position is monitored by the stress testing under a variety of scenarios covering both normal and more severe market conditions is performed by the Financial Markets Department. Under the normal market conditions, liquidity reports covering the liquidity position of the Bank are presented to the senior management on a weekly basis. Decisions on the Bank's liquidity management are made by the Monetary Policy Committee and International Reserves Management Committee and implemented by the Financial Markets Department.

Analysis of financial liabilities by remaining contractual maturities

The table below summarizes the maturity profile of the Bank's financial liabilities as at 31 December 2010 and 2009 based on contractual undiscounted repayment obligations. Repayments which are subject to notice are treated as if notice were to be given immediately. However, the Bank expects that many counterparties will not request repayment on the earliest date the Bank could be required to pay and the table does not reflect the expected cash flows.

	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
31 December 2010					
Due to resident financial institutions	462,948	-	-	-	462,948
Due to the Ministry of Finance	805,988	3,161	-	-	809,149
Due to the International Monetary					
Fund	415,651	85,352	1,042,616	11,467	1,555,086
Due to customers	280	-	-	-	280
Debt securities issued	360,000	-	-	-	360,000
Other financial liabilities	3,869		148	612	4,629
Total undiscounted financial liabilities	2,048,736	88,513	1,042,764	12,079	3,192,092
31 December 2009					
Due to resident financial institutions	417,023	-	-	-	417,023
Due to the Ministry of Finance	585,242	-	-	-	585,242
Due to the International Monetary					
Fund	394,497	37,410	1,244,791	78,102	1,754,800
Due to customers	332	-	-	-	332
Debt securities issued	220,000	-	-	-	220,000
Other financial liabilities	1,200	447	5	885	2,537
Total undiscounted financial liabilities	1,618,294	37,857	1,244,796	78,987	2,979,934

The table below shows the contractual expiry by maturity of the Bank's credit commitments and contingent liabilities.

	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
31 December 2010	3,883	3,160	588	-	7,631
31 December 2009	1,240	-	4,238	-	5,478

## Market risk

Market risk is the risk that the value of financial instruments will fluctuate due to changes in market variables such as interest rates and foreign exchanges rates. Market risks comprise currency risk, interest rate risk and other price risk. Market risk arises from open positions in interest rate, currency and equity financial instruments, which are exposed to general and specific market movements and changes in the level of volatility of market prices.

#### Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The following table demonstrates the net effect of 1% change in interest rates, with all other variables held constant, on the Bank's statement of comprehensive income.

The sensitivity of the statement of comprehensive income is the effect of the assumed changes in the interest rates on the net interest income for the year, based on the floating rate non-trading financial assets and liabilities held at statement of financial position date.

	20	10	20	2009	
Currency	Increase in Sensitivity of interest rate income		Increase in interest rate	Sensitivity of net interest income	
USD	1%	20,763	1%	17,541	
EUR	1%	10,063	1%	10,434	
GBP	1%	452	1%	444	
SRD	1%	(8,715)	1%	(8,436)	
Other	1%	703	1%	564	

	20	10	20	009
Currency	Decrease in interest rate	Sensitivity of net interest income	Decrease in interest rate	Sensitivity of net interest income
USD	(1%)	(20,763)	(1%)	(17,541)
EUR	(1%)	(10,063)	(1%)	(10,434)
GBP	(1%)	(452)	(1%)	(444)
SRD	(1%)	8,715	(1%)	8,436
Other	(1%)	(703)	(1%)	(564)

The sensitivity of equity is calculated by revaluing fixed rate available-for-sale financial assets at 31 December 2010 and 2009 for 0.1% change in interest rates.

	20	10	2009		
Currency	ency Increase in Sensitiv interest rate equi		Increase in interest rate	Sensitivity of equity	
USD	0.1%	(585)	0.1%	(661)	
EUR	0.1%	(850)	0.1%	(490)	
GEL	0.1%	(112)	0.1%	(233)	

	201	.0	2009		
Currency	Decrease in interest rate	Sensitivity of equity	Decrease in interest rate	Sensitivity of equity	
USD	(0.1%)	585	(0.1%)	671	
EUR	(0.1%)	850	(0.1%)	448	
GEL	(0.1%)	112	(0.1%)	61	

## Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. Subject to the currency structure of assets, the value of assets of the Bank is exposed to risk of changes in exchange rates of main foreign currencies.

The table below indicates the currencies to which the Bank had significant exposure at 31 December 2010 and 2009 on its non-trading monetary assets and liabilities and its forecasted cash flows. The analysis calculates the effect of a reasonably possible movement of the currency rate against Georgian Lari, with all other variables held constant on the statement of comprehensive income. A negative amount in the table reflects a potential net reduction in the statement of comprehensive income, while a positive amount reflects a net potential increase.

	31 December 2010						
-	GEL	USD	EUR	SDR	Other	Total	
Financial assets: Cash and cash							
equivalents Due from financial	-	1,554,311	234,772	-	115,696	1,904,779	
institutions Special Drawing Rights holdings with the International Monetary	190,039	6,834	731	-	109	197,713	
Fund	-	-	-	394,538	-	394,538	
Trading securities Investments available-	-	177,631	-	-	-	177,631	
for-sale Investments held to	113,895	599,485	857,078	-	-	1,570,458	
maturity	602,547	18,444	61,516	-	-	682,507	
Other financial assets	1,487	5				1,492	
Total financial assets	907,968	2,356,710	1,154,097	394,538	115,805	4,929,118	
Financial liabilities: Due to resident financial							
institutions Due to the Ministry of	204,252	217,770	40,894	-	32	462,948	
Finance	712,660	95,506	791	-	192	809,149	
Due to the International Monetary Fund	-	-	-	1,543,630	-	1,543,630	
Due to customers	280	-	-	-	-	280	
Debt securities issued	355,119	-	-	-	-	355,119	
Other financial liabilities	3,259	692	678			4,629	
Total financial							
liabilities	1,275,570	313,968	42,363	1,543,630	224	3,175,755	
NET FINANCIAL							
POSITION	(367,602)	2,042,742	1,111,734	(1,149,092)	115,581	1,753,363	

**31 December 2009** 

_			31 Decem	Der 2009		
<u>-</u>	GEL	<b>USD</b>	EUR	SDR	Other	Total
Financial assets:						
Cash and cash		1 457 576	241 001		100.010	1 000 277
equivalents	-	1,457,576	241,981	-	100,810	1,800,367
Due from financial	45,000	2.005	2 1 4 7		115	50.247
institutions Special Drawing	45,000	3,085	2,147	-	115	50,347
Rights holdings						
with the						
International						
Monetary Fund	_	_	_	368,890	_	368,890
Trading securities	_	167,725	_	-	_	167,725
Investments		107,720				107,720
available-for-sale	118,254	270,114	804,171	_	_	1,192,539
Investments held to	,	,	,			, ,
maturity	642,660	68,785	77,656	-	-	789,101
Other financial assets	1,597	15		450	2	2,064
Total financial	00##44	4.04.200	1 10 5 0 5 5	260.240	100.00	4.054.000
assets	807,511	1,967,300	1,125,955	369,340	100,927	4,371,033
Financial liabilities:						
Due to resident						
financial institutions	285,979	101,324	29,703	_	17	417,023
Due to the Ministry	200,575	101,02.	_>,, 00		-,	.17,020
of Finance	438,149	112,917	33,335	_	841	585,242
Due to the	,	,	,			Ź
International						
Monetary Fund	_	_	_	1,529,267	_	1,529,267
Due to customers	332	-	-	-,,	_	332
Debt securities issued	219,053	-	-	_	_	219,053
Other financial						
liabilities	2,325	206	6	_		2,537
-						
Total financial						
liabilities	945,838	214,447	63,044	1,529,267	858	2,753,454
NET FINANCIAL	(120.225)	1 550 050	1.072.011	(1.150.025)	100.070	1 (15 550
POSITION	(138,327)	1,752,853	1,062,911	(1,159,927)	100,069	1,617,579

# Effect on profit for the year ended 31 December 2010

_	31 Detember 2010					
-	GEL	USD	EUR	SDR	Other	Total
Increase in currency rate of 1%		20,427	11,117	(11,481)	1,156	21,219
Increase in currency rate of 5%		102,137	55,587	(57,407)	5,779	106,096
Increase in currency rate of 10%		204,274	111,174	(114,814)	11,558	212,192
Decrease in currency rate of 1%		(20,427)	(11,117)	11,481	(1,156)	(21,219)
Decrease in currency rate of 5%		(102,137)	(55,587)	57,407	(5,779)	(106,096)
Decrease in currency rate of 10%		(204,274)	(111,174)	114,814	(11,558)	(212,192)

# Effect on profit for the year ended 31 December 2009

	GEL	USD	EUR	SDR	Other	Total
Increase in currency rate of 1%		17,529	10,629	(11,599)	1,001	17,560
Increase in currency rate of 5%		87,643	53,146	(57,996)	5,003	87,796
Increase in currency rate of 10%		175,285	106,291	(115,993)	10,007	175,590
Decrease in currency rate of 1%		(17,529)	(10,629)	11,599	(1,001)	(17,560)
Decrease in currency rate of 5%		(87,643)	(53,146)	57,996	(5,003)	(87,796)
Decrease in currency rate of 10%		(175,285)	(106,291)	115,993	(10,007)	(175,590)

# Operational risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal implications, or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is expected to manage the risks. Controls include effective segregation of duties, access, authorization and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

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