

Georgian-European Policy and Legal Advice Centre (GEPLAC)

GEPLAC was established in 1997. It is an EU-funded project to facilitate the closer relations between Georgia and the European Union. In providing its recommendations to the Georgian Government, GEPLAC follows the provisions of the EU-Georgia Partnership and Cooperation Agreement.

The fifth phase of the project is being implemented by Altair Assesores, the British Council, the European Social and Legal Economic Projects (ESTEP) and the Georgian Foundation for Strategic and International Studies (GFSIS).

GEPLAC issues two quarterly publications in Georgian and English languages – Georgian Economic Trends and Georgian Law Review. Although these publications are issued within the framework of the EU Technical Assistance programme, they represent the views of the authors and do not represent any official opinion of the European Union.

GEORGIAN ECONOMIC TRENDS

Quarterly review

June

2006



This project is funded by
the European Union

GEORGIAN ECONOMIC TRENDS

Georgian Economic Trends (GET) is a quarterly publication of the Georgian-European Policy and Legal Advice Centre (GEPLAC), which aims at providing all interested readers with a review of developments in the Georgian economy and analysis of economic reform and policy pursued by the government. GET is issued in both Georgian and English languages and is available on the internet.

GET is an independent publication. The materials represent the views of the authors and do not represent any official opinion of the European Commission, the Georgian-European Policy and Legal Advice Centre, or the Georgian Government.

For further information please contact:

Georgian-European Policy and Legal Advice Centre,

3a, Chitadze Street, Tbilisi, 0108, Georgia

Tel: (095 22) 243555

Fax: (095 22) 921371

E-mail: get@geplac.ge

www.geplac.org

Editorial Board:

Christophe Cordonnier,

Kakha Gogolashvili,

Merab Kakulia,

Vladimer Papava,

Alexei Sekarev,

Ivan Samson.

Separate chapters were prepared by the following experts:

Lela Bakhtadze

Nata Kakabadze

Veronika Schneider

Gross Domestic Product and Real Sector, Public Finance

Money and Banking, External Sector, EU-Georgia Economic Relations

Labour Market and Households Budgets

CONTENTS

Editors' Comments	7
-------------------	---

PART I. OVERVIEW OF THE GEORGIAN ECONOMY

Main Economic Events	9
Summary Macroeconomic Indicators	17
1. Gross Domestic Product and Real Sector	19
2. Public Finance	25
3. Money and Banking	29
4. Labour Market and Household Budgets	35
5. External Sector	40
6. EU-Georgia Economic Relations	45

PART II. ECONOMIC TRENDS AND POLICY ANALYSIS

1. Monetary Developments in Georgia: Recent Trends and Policy Implications	49
<i>Apostolos Papaphilippou, PhD in Economics, GEPLAC Economic Expert</i>	
2. Georgia in the context of EU energy policy	59
<i>Teimuraz Gochitashvili, Professor;</i>	
<i>Mindaugas Krakauskas, GEPLAC expert on energy issues;</i>	
<i>George Abulashvili, GEPLAC expert on energy issues</i>	

PART III. ECONOMIC REFORM AGENDA

Tax Administration Reform in Georgia	67
<i>Bill Curnow, Team Leader, the EU funded project "Support to the Georgian Tax Department"</i>	

EDITORS' COMMENTS

Georgia's economy in the first months of 2006: growth amid risks

Georgia's economy continued to perform well in the first months of 2006. In January-March, GDP is expected to have grown by 8.4 percent year on year, an improvement by 2.4 percentage points against Q1 2005. Trade, transport and communications as well as other services were the main driving force of growth. These sectors increased their contribution to GDP in the year-on-year comparison. As shown in chapter 1 of this issue, labour productivity (value added per employee, measured in 1996 basic prices) has grown significantly, indicating a better allocation of resources in the economy. Buoyant domestic demand, manifested by an increase in households' disposable income, expanding domestic trade and a strong increase of the volume of credits have supported economic growth.

The external environment for the country's economic development, however, has deteriorated recently, owing mainly to disruptions in energy supplies and Russia's ban on imports of wine and mineral water from Georgia. The effect of these developments is gradually becoming visible. As shown in the chapters below, the growth rate in industry dropped sharply in Q1 2006, both year on year and quarter on quarter. This was attributable to a significant decline in the sub-sector "electricity generation and distribution, gas and water supplies" caused by energy disruptions in the beginning of the year. The shortfall of export revenue from the Russian embargo, estimated by the government at around 0.5 to 1.0 percent of GDP, will obviously weaken the economy's external position in the short run.

Despite moderate growth of consumer prices in Q1, inflationary risks have been increasing, originates from several processes taking place simultaneously. Reaping the benefits of fiscal consolidation in 2005, the government has somewhat loosened expenditure in recent months, in order, among other things, to meet social protection obligations and finance projects in infrastructure. Another process was the continuing inflow of workers' remittances from abroad that increased consumption, but at the same time put pressure on the Lari's nominal exchange rate. In Q1 2006, base money increased by 21 percent year on year. According to preliminary estimates, 12-month consumer price inflation exceeded the 10-percent threshold in January-June 2006.

Policy responses to these challenges seem to have been adequate so far. To keep inflationary risks under control and avert possible imbalances, the National Bank announced the issuance of certificates of deposits to wrap up excessive liquidity. Obviously, in the longer run this approach can only be efficient if underpinned by measures to strengthen the independence of NBG – a contribution to stronger independence has been a recent amendments to the law prohibiting direct government borrowing from the central bank – as well as the continued development of the financial market in the country, through the securitisation of the existing government debt to NBG.

Attempts to explore new foreign markets for wine proved difficult so far, mainly for reasons related to technical aspects of trade. Adherence to international standards will be a major issue for wine traders, but also for the state authorities, which now recognize the necessity to create an internationally compatible regulatory framework. The government is on the way to reach an agreement with the EU on geographical indications of wine origin. In a broader effort, convergence of the regulatory framework with the European Union, as stipulated in the forthcoming EU-Georgia Action Plan, will allow increased access to EU markets and thus create clear advantages for the economy.

Georgia's proximity to alternative energy sources in the region is an important pre-requisite for diversification and sustainability of energy supplies in the long-term perspective. The country has entered negotiations to have the right to purchase around 1.5bn cubic meters of natural gas (more than a half of the yearly gas consumption) from the South Caucasus Gas Pipeline, due to be launched later in 2006. There is a growing understanding among economists that a diversification of energy supplies can be achieved within a 3-year period.

This issue of Georgian Economic Trends offers an in-depth analysis of some of these policy issues. The section “Economic trends and policy analysis” has papers on recent monetary developments, discussing appropriate policy options, as well as on Georgia’s energy situation in the European perspective.

Looking into the recent monetary developments, Dr. Apostolos Papaphilippou discusses the definition of inflation, its measurement, costs and re-distribution effects, as well as the inter-relationship between inflation and growth. The paper analyses price and monetary developments over the period 2001 – 2005, examines monetary and exchange rate policy in Georgia, with a focus on its current priorities and constraints. It then offers a short- to medium-term outlook and concludes with concrete recommendations on the design and conduct of monetary and related economic policies.

The contribution by Teimuraz Gochitashvili, Mindaugas Krakauskas and George Abulashvili gives a comparative analysis of EU and Georgia’s energy policies and legislation, identifies main problems in the harmonization, specifies EU instruments for the implementation of energy projects and offers recommendations to the government when implementing the EU-Georgia Action Plan. The paper also looks at possibilities of implementing EU energy policy objectives and goals in Georgia and discusses possible consequences.

In the last section, “Economic reform agenda”, we publish a critical overview of the tax administration reform in Georgia by Bill Curnow, who joined the Inland Revenue UK in 1967 and has worked continuously for tax administrations since, in UK, Thailand, Jamaica, Latvia, Kazakhstan and Uganda, before coming to Georgia in 2005. The paper looks into cultural traditions of Georgia from the perspective of the establishment of an efficient taxation system, considers the tax culture, explains the scope of tax administration (drawing the distinction with tax policy), and looks at the recent history of Georgia’s tax administration. The article then examines the structure and on-going tax administration reform issues.

Alexei Sekarev
GEPLAC Team Leader

PART I. OVERVIEW OF THE GEORGIAN ECONOMY

MAIN ECONOMIC EVENTS

2006

April 4

Georgian Prime Minister Zurab Nogaideli said that **Georgian wine**, the import of which was banned by Russia on March 27, “will return to the Russian market, by all means.” Nogaideli said that Georgia wants to organize an exhibition of its wines in Russia, Ukraine and Kazakhstan. The government will grant wine producing companies tax exemptions for three months due to Russia’s ban on Georgian wine imports.

April 10

The Board of Directors of the American Chamber of Commerce in Georgia (AmCham) hosted a US Congressional delegation led by Arizona Congressman Jim Kolbe for a discussion on the **investment climate in Georgia**. During the meeting the AmCham Board noted “the successful reform efforts of the Georgian Government in the areas of tax, customs, deregulation, liberalization of trade, credit access, improvements in infrastructure, and anti-corruption and anti-smuggling measures,” an AmCham representative reported. However during the meeting they noted “areas that still are in need of attention from both US and Georgian policy makers - namely the lack of an independent judiciary and the selective harassment of businesses.” “The Board stressed to the delegation that the great strides made by the government to date will be futile if the legal system is not free from outside pressure,” the AmCham press statement reads.

April 11

Parliamentary Chair Nino Burjanadze hinted that **Georgia may consider withdrawing from the Commonwealth of Independent States (CIS)** amid the deterioration of economic ties between Georgia and Russia, due to Moscow’s ban on imports of Georgian wine and spirits. We have spoken many times about whether we should be members of the CIS or not, and economic aspects have always been major arguments in favour of our CIS membership. We still adhere to this position, but at the same time we ask one very serious question: if we are the only CIS country with whom Russia has visa requirements; if we are the only country from whence imports of wine, citrus, tea and maybe tomorrow Borjomi [mineral water] as well are banned, then why should we remain in this organization? Burjanadze said. She also complained about the lack of solidarity among CIS member states and cited Tajikistan’s recent statement about its readiness to replace Georgian wines with its own on the Russian market. Georgian Prime Minister Zurab Nogaideli stated that leaving the CIS is not yet on the agenda.

April 12

Visiting Georgian President Mikheil Saakashvili held talks with his Chinese counterpart Hu Jintao in Beijing to discuss bilateral relations, as well as international and regional problems. During the talks, the Chinese President expressed his country’s readiness to expand economic cooperation with Georgia, adding that his government would **encourage Chinese companies to increase investment in Georgia**. In response, Saakashvili expressed his hope that the cooperation would turn the two countries into “reliable and good partners.” Following the talks the two Presidents signed a joint statement on the further development of friendship and cooperation.

April 17

Five **business support organizations have been set up** in Tbilisi and in four other towns throughout Georgia to help promote small and medium-sized enterprises (SME) under a SME Support Project implemented by the International Executive Service Corps (IESC) and supported by USAID. The network of business support organizations in Tbilisi, Zugdidi, Kutaisi, Batumi and Telavi is designed to provide business consultations on regulatory and legislative issues, management, business planning and borrowing, informational services, investment and trade promotion services, relevant training, agribusiness support and any other business development assistance as required.

April 18

The Russian consumer protection agency announced that it has found a large number of **falsified and low quality Georgian mineral water Borjomi** on the Russian markets. Despite this announcement, the Russian consumer protection agency has not yet banned the import of these products. Eighty percent of Georgia’s most prominent mineral water Borjomi is exported abroad and more than half of this amount to Russia, while 40 percent goes to 27 other countries around the world, according to the Georgian Glass & Mineral Waters Company, which produces Borjomi. Russia banned the import of Georgian wine on March 27, claiming that they were contaminated with pesticides.

April 18

Draft amendments to the tax code submitted to Parliament envisage a significant simplification of the registration procedures for taxpayers, a decrease of the excise tax on tobacco, as well as a number of initiatives aimed

at boosting tourism and supporting the energy system the Finance Ministry reported. According to the amendments, starting from July 1, 2006 foreign citizens will be able to collect the value added tax (VAT) paid for goods purchased in Georgia from customs authorities. The initiative aims at promoting tourism and export, the Finance Ministry stated. The Ministry said that to support the energy sector VAT exemptions will be given for the import of materials and goods purchased under soft credits provided for the rehabilitation of electricity facilities. VAT exemptions will also be provided for gas imported solely for generating electricity. The excise tax on imported tobacco will be reduced from the current 90 Tetri (49.4 cents) to 60 Tetri (32.9 cents) and on locally produced tobacco from the current 70 Tetri (38.4 cents) to 40 Tetri (21.9 cents), according to the draft amendments.

April 22

The EU Troika delegation, which visited Georgia, said energy security was among the issues discussed during their talks with Georgian officials. Hans Winkler, State Secretary of the Austrian Foreign Ministry and the head of the EU Troika delegation, said at a news conference on April 21 that “there is an increased European Union interest in the region” and one of the reasons behind this is related with the EU’s desire to diversify energy supplies and transits. He said that the EU is actively engaged in discussions over these issues with Russia, Central Asian and South Caucasus states. Georgia’s EU Neighbourhood Policy Action Plan was also discussed during the visit.

April 22

The Foreign Minister of Kazakhstan Kasymzhomart Tokayev stated that **Kazakhstan is considering the possibility of joining Trans-Caspian gas pipeline**, which will enable the transit of Central Asian gas to the west, bypassing Russia. Construction of a Trans-Caspian gas pipeline is now under consideration, including in the European Union, which has recently developed a Green Paper (European Strategy for Sustainable, Competitive and Secure Energy). Kazakhstan is currently only studying this issue, as the document contains a number of significant geopolitical elements. However, actually, it is better for us if there are many possibilities for the export of our energy resources, Kazakh Foreign Minister Kasymzhomart Tokayev stated. The EU Green Paper on energy policy says that Caspian oil and gas will be important for the EU’s energy security by increasing the geographical diversification of external energy supplies.

April 24

The government will request that Parliament approve **amendments to the 2006 state budget** that envisage an increase of expenditures by GEL 162 million (USD 89 million), according to the Georgian Prime Minister’s press office. This increase is possible as a result of tax and non-tax revenues that have increased by GEL 48.1 million (USD 26.6 million) and GEL 41.5 million (USD 22.9 million), respectively. According to the Finance Ministry, the remaining GEL 72 million is a holdover from the 2005 state budget.

April 25

President Saakashvili said that by **increasing the gas price**, which eventually will lead to an increase of electricity prices as well, Russia aimed at creating problems for each Georgian family. At a session of the government’s energy commission on April 25, Saakashvili instructed the government to subsidize the increased price of electricity for the most socially vulnerable citizens. Although neither the date of the planned increase nor the new rate for electricity tariff is known yet, Finance Minister Lexo Alexishvili said that about GEL 10-11 million will be needed to subsidize the increased tariffs. He said that the government should also partially subsidize electricity tariffs for those citizens who consume small amounts of electricity.

April 25

Argotex will pay GEL 20 million (USD 11 million) for a third **general cell communication frequency license**, the Georgian National Communications Commission (GNCC) reported. Argotex - which has never operated in the Georgian telecommunication market - and Geocell, which along with MagtiCom is a leading cell operator company in Georgia, participated in the auction held by the GNCC on April 25. The initial bidding price was set at GEL 8.4 million (approximately USD 4.6 million).

April 26

Energy Minister Nika Gilauri said that Georgia wants **the right to purchase more gas shipped through the Baku-Tbilisi-Erzrum pipeline** at a reduced price than is envisaged by the current contract. After construction of the pipeline, Georgia will receive 5 percent of the natural gas transported from Azerbaijan to Turkey as a transit country. Georgia will also purchase an additional half billion cubic meters of gas per year at a reduced price USD 55 per 1000 cubic meters for the next 20 years.

April 26

Georgian Prime Minister Zurab Nogaideli said that the government is considering several **investment bids regarding the privatization** of Chiaturmanganumi, a manganese-mining factory in Chiatura. In February, the British company Stemcor, which owns Zestaponi Ferro Alloy Plant in western Georgia, expressed interest in purchasing Chiaturmanganumi and the Vartsikhe hydro power plant. Economy Minister Irakli Chogovadze said that the British company’s interest in Chiaturmanganumi is natural, because it is more profitable if one company

owns these two interlinked enterprises. Last January Russia's EvrAzHolding bought shares in Chiaturmanganumi and the Vartsikhe hydro power plant, but pulled out from a privatization deal in June 2005, reportedly because of falling manganese prices.

April 28

Azerbaijan, Georgia and Kazakhstan are negotiating over an **extension of the Poti-Baku-Aktau-Alma-Aty cargo train route** to the Dostlug station at the Kazakh-Chinese border, Interfax news agency reported quoting chief of the Azeri Railway Company Arif Askerov. Currently we are working on attracting sufficient amounts of cargo that should be transported from Europe into China, Askerov said. The first cargo train left Poti to deliver cargo to Kazakhstan's port of Aktau and further to Alma-Aty via Baku on December 24.

April 29

Media magnate Rupert Murdoch's **News Corporation will buy shares in Imedi**, which unites the Tbilisi-based television and radio station owned by tycoon Badri Patarkatsishvili, Imedi TV reported. A preliminary agreement was signed by Rupert Murdoch and Badri Patarkatsishvili in New York. Imedi TV reported that News Corp bought a significant part of the shares of Imedi Holding but the details of the deal remain confidential. Some other media sources, including Rustavi 2 TV, which is Imedi's major competitor, reported that Badri Patarkatsishvili sold 30 percent of his shares.

May 1

The price for one cubic meter of gas in Tbilisi increased from 27 Tetri (approximately 15 cents) to 34 Tetri (approximately 18 cents), while in the regions - from 30 Tetri (approximately 16 cents) to 36 Tetri (20 cents) starting from May 1, 2006. This increase became necessary after **Gazprom increased gas prices for Georgia** from USD 63 per 1000 cubic meters to USD 110 per 1000 cubic meters starting from January, 2006. Last year the government allocated USD 19 million to subsidize the increased price of gas for the population until May 1.

May 1

The U.S. **Millennium Challenge Corporation disbursed USD 3.1 million** to the Millennium Challenge Georgia Fund (MCG) as part of the USD 295.3 million, five-year aid program Millennium Challenge Account (MCA), MCG reported. The funds disbursed are intended to fund MCG's operations through June 30 and will mainly be used for regional infrastructure projects, management of road rehabilitation activities in Samtskhe-Javakheti, establishment of an agricultural grant facility and for certain emergency repairs to Georgia's trunk gas pipeline.

May 2

Latvian AirBaltic will start the first direct flight between Riga and Tbilisi, the Georgian Civil Aviation Department reported. Flights from Riga to Tbilisi will be on Tuesdays and Thursdays and return flights are scheduled for Wednesdays and Fridays. Economy class tickets will cost about USD 206 and business class tickets - about USD 390.

May 2

Prime Minister Zurab Nogaideli said after the government's session that the government is currently discussing the **issue of possible withdrawal from the Commonwealth of Independent States (CIS)**. State Minister for Economic Reforms Kakha Bendukidze stated, "that a number of bilateral agreements should be reached to replace one multilateral agreement." He was referring to the agreements on free trade and on free movement which have been signed within the framework of the Commonwealth of Independent States.

May 4

The Georgian, Azerbaijani and Turkish sides are holding talks in Ankara, Turkey to discuss the construction of a **railway link between the eastern Turkish city of Kars and the southern Georgian town of Akhalkalaki**, the Georgian Railway Company reported. According to the preliminary calculations, construction of a 160-km long railway, which will also enable Azerbaijan to gain access to its strategic partner, Turkey, via Georgia, will cost about USD 400 million.

May 4

The European Bank for Reconstruction and Development (EBRD) is interested in **participating in the rehabilitation of Georgia's major gas pipeline system**, the prime minister's press officer reported, after talks in London on the sidelines of the business forum Invest in Georgia. No other details of the talks were reported. The U.S. funded aid program Millennium Challenge Account has already pledged USD 49.5 million to rehabilitate Georgia's North-South Gas Pipeline, which delivers gas from Russia and which is also used for transit to Armenia.

May 5

Kazakhstan supports a proposal to construct a seabed **Trans-Caspian gas pipeline** to transport its gas to Europe via Azerbaijan, Georgia and Turkey bypassing Russia, Kazakh Energy Minister Baktykozha Izumkhambetov said after talks with visiting EU Energy Commissioner Andris Piebalgs on May 4, Reuters reported. The minister said

that Kazakhstan will send a proposal to the EU about a feasibility study for a Trans-Caspian pipeline. One of the options of transporting Kazakh gas is through a Trans-Caspian pipe via Azerbaijan, Georgia and Turkey by using the Baku-Tbilisi-Erzrum gas pipeline. But considerations are already underway to construct another seabed gas pipeline across the Black Sea linking Georgia with Ukraine, also bypassing Russia. It is expected that Russia will oppose both of these potential gas pipeline projects

May 5

Russia has banned the import of the Georgian mineral water “Borjomi,” Russian chief sanitary inspector Genady Onishchenko announced. “The reason for this very difficult decision was the fact that an inspection carried out recently in the regions - especially in the Moscow region - showed that these waters, which are being advertised as ‘Borjomi’ water, do not, in reality, correspond to the specifications of this water,” Onishchenko said. The decision to ban Borjomi comes five weeks after Russia banned Georgian wines and spirits. Eighty percent of Georgia’s most prominent mineral water Borjomi is exported abroad. Sixty percent of this is exported to Russia while the remaining 40 percent goes to 27 other countries around the world, according to the Georgian Glass & Mineral Waters Company, which produces “Borjomi.”

May 6

Mikheil Saakashvili spoke at a ceremony to launch the construction of **a new airport in Batumi**, Adjara Autonomous Republic. On March 14 the Georgian and Turkish sides signed an agreement that envisages the transformation of Batumi airport into part of Turkey’s network of internal flights. The Turkish company TAV pledged last September to invest USD 15 million in reconstructing the airport. TAV is also reconstructing Tbilisi International Airport.

May 6

One day after banning Borjomi mineral water, Russian chief sanitary inspector banned the import of another Georgian mineral **water brand Nabeglavi**, the Russian consumer protection agency reported. 100 percent of the 175,560 bottles of Nabeglavi that were inspected failed to meet standards in the Moscow region, the Russian consumer protection agency said.

May 12

A Mission of the International Monetary Fund (IMF) will pay a working visit to Georgia on May 12-19. The Mission’s visit aims at assessing the current economic situation in the country and discussing performance under the Poverty Reduction and Economic Growth Program (PREGP), through which Georgia has already received USD 80 million between 2004-2006. The IMF’s Executive Board approved a three-year arrangement in June, 2004. The total sum of this arrangement will total USD 141 million.

May 12

Greenoak Group won a tender for Batumi Sea Port in the Adjara Autonomous Republic. The company would pay USD 92 million for the Batumi port. The Economy Ministry announced a tender in April for the transfer of 100 percent of the shares of the Batumi port for management for 49 years. The initial bid price for Batumi Sea Trading Port Ltd was USD 35 million. Economy Minister Irakli Chogovadze, who publicly opened the envelopes with applicants’ proposals, said that four other companies were also bidding for the port.

May 12

The Kazakh state-run KazTransGaz company won **a tender for the Tbilisi gas distribution company** Tbilgazi on May 12. KazTransGaz was the only company that bid for Tbilgazi. However, the amount of the deal remains unknown. A tender on privatization of Tbilgazi with initial bid price at USD 12.5 million was announced in April. Last December the economy minister and a top executive of the Kazakh state-run KazTransGaz company signed a memorandum in Tbilisi stating that the Kazakh company would buy 100 percent of shares of TbilGazi. However, the amount of the deal was not indicated in the memorandum

May 12

The **Kazakh bank TuranAlem will pay USD 90 million** for the Georgia’s largest local and international telephone operator company - the United Telecommunication Company of Georgia (UTCG), after having won a tender. The U.S. company Metromedia International Group, Inc. was also bidding for the company’s shares. The Economy Ministry announced on April 12 that it would be accepting privatization bids for the country’s largest telephone operator company for an initial price of USD 50 million. Kazakh Bank TuranAlem (BTA), whose assets exceed USD 5.5 billion, implementing the reconstruction of the hotel Iveria, in downtown Tbilisi, into a five-star hotel, as well as renovating of 21 hotels in Adjara. The BTA shareholders are EBRD, Austrian Raiffeisen Zentralbank (RZB), IFC and the Netherlands Development Finance Company (FMO).

May 15

Georgian Prime Minister Zurab Nogaideli said that **Russian investments pose no threat to Georgian security** and added that the authorities do not intend to impose “artificial restrictions” on the Russian state or private companies which will participate in the privatization process in Georgia. “Any kind of investment, whether it is Russian or from another country, whether it is private or state investment, creates additional jobs, strengthens

Georgia's economy, increases income for the state budget - thereby strengthening the country. So we will continue this policy in the future as well," PM Nogaideli said on the political talk show on Imedi television. "Imposing artificial restrictions for representatives of a certain country during the privatization process will never be on the agenda, whether it is Russia, or another country. It makes no sense and it will bring no results and we are not going to follow this path. And this represents no threat to Georgia's security," the Prime Minister stated. He noted that in June the government will privatize power facilities, including three electricity distribution companies and six hydro power plants, except of country's largest Enguri hydro power plant.

May 17

A third round of talks over Georgia's Action Plan within the **EU Neighbourhood Policy** (ENP) was held in Tbilisi between Valery Chechelashvili, the Deputy Foreign Minister and Hugues Mingarelli, European Commission Director for Eastern Europe, Southern Caucasus and Central Asian Republics. Details of the 35-page document, which, according to the officials, is close to finalization, have not yet been revealed. Two out of the five chapters of the document will focus on the EU's role in conflict resolution issues Both Chechelashvili and Mingarelli noted at a news conference after the talks that only details related to trade relations remain to be negotiated.

May 17

The International Financial Corporation (IFC) and European Bank for Reconstruction and Development (EBRD) will provide a loan of USD 54 million to TAV Urban Georgia LCC, which is a subsidiary of the Turkish company TAV that is engaged in **reconstructing Tbilisi and Batumi airports**. The IFC and ERDB each pledged USD 27 million, according to the IFC. The agreement was signed in Istanbul. TAV Airports Holding, in conjunction with its joint-venture partner Urban - a Turkish construction company - took over the operations of Tbilisi International Airport in November 2005. Construction of a new terminal in Tbilisi began in January 2006 and construction of Batumi International Airport was launched in May 2006. Total investment for both projects is expected to be about USD 77 million. Planned opening of the new Tbilisi airport terminal is scheduled for November 2006 and, when completed, is expected to serve 1 500 departing and arriving passengers per hour.

May 19

Representatives of 15 U.S. companies visited Georgia in an attempt to **promote trade and investment** in various agricultural fields, the American Chamber of Commerce in Tbilisi reported. The trade and investment mission was sponsored by the U.S. Department of Agriculture's (USDA) Foreign Agricultural Service (FAS) and was led by Kirk Miller, the General Sales Manager of the FAS. During the visit the mission met with about 100 business representatives. Some of the companies were able to establish business links with their potential partners in Georgia, according to AmCham.

May 21

Prime Minister Zurab Nogaideli held talks with President of the European Bank for Reconstruction and Development (EBRD) Jean Lemierre. During the talks Jean Lemierre said that the **EBRD plans to increase investments in Georgia** from the current Euro 85 million to Euro 150 million per year. The sides decided to set up an investment council in Georgia with the participation of the representatives from the EBRD, the government and the private sector to promote investment climate in the country. The EBRD President confirmed that the Bank will participate in the rehabilitation of the Inguri hydro power plant and Georgia's North-South Gas Pipeline, which delivers gas from Russia into Georgia and which is also used for transit of Russian gas to Armenia via Georgia.

June 1

An increased three-step electricity tariff was introduced in Georgia starting from June 1. This tariff is a result of a May 11 decision by the Georgian National Energy Regulation Commission (GNERC). Those residents of Tbilisi who consume less than 100 kilowatts of electricity per month will have to pay 13.48 Tetri (approximately 7.4 cents) per kilowatt instead of 12.8 Tetri (approximately 7.03 cents). Consumers using between 100 to 300 kilowatts per month will pay 16 Tetri (approximately 8.79 cents) and those consuming more than 300 kilowatts per month will pay 17.69 Tetri (approximately 9.7 cents). Consumers living outside Tbilisi, who use less than 100 kilowatt per month will pay 12.98 Tetri (approximately 7.1 cents) instead of 8 Tetri. Residents in the country's regions who consume between 100 and 300 kilowatts - 16.52 Tetri (approximately 9.07 cents) and residents in the regions who consuming more than 300 kilowatts per month will pay 17.49 Tetri (approximately 9.6 cents). Officials say that Russia's decision to increase the gas price triggered this hike in the electricity rate. According to the GNERC, the share of gas-generated electricity in Georgia will total about 28 percent, while the rest will be generated by hydro power plants.

June 5

The first cargo of oil transported through the Baku-Tbilisi-Ceyhan (BTC) pipeline was exported from the Ceyhan marine terminal on the Turkish Mediterranean coast, BP, operator of the BTC pipeline. A cargo of around 600,000 barrels of crude oil from Azerbaijan was loaded onto the BP tanker. The loading process followed the completion of testing, commissioning, and filling of the BTC pipeline along its entire route across Azerbaijan, Georgia and Turkey, from the Sangachal terminal on the Caspian coast near Baku to the Ceyhan terminal in Turkey. A total of 10 million barrels of oil from the Azeri-Chirag-Gunashli (ACG) fields in the Azerbaijani sector

of the Caspian Sea were required to fill the 1 768-kilometre pipeline, a process that began in May 2005. "The pipeline currently serves only the ACG fields but is expected, in the longer term, to attract volumes from other parts of the region," BP said.

June 6

Officials from Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Turkey, and Ukraine signed a declaration on cooperation at the **Black Sea Forum for Dialogue and Partnership summit**, held in Bucharest. The Presidents of Romania, Armenia, Azerbaijan, Moldova and Ukraine, as well as high ranking officials from NATO, OSCE, UN and Council of Europe were present at this summit. Officials from the Russian Federation attended the Forum as observers. "The Black Sea Forum is not designed as an organization, but rather as a forum which aims to foster synergy in the region with the view of achieving regional projects that address genuinely regional needs," a press release from the Georgian Foreign Ministry stated.

June 10

The Parliament decided to postpone of the government's proposal to reduce **number of customs tariffs** from the current 16 to 3. The proposal also envisaged reduction of customs tariff rates to zero percent, 5 percent and 12 percent on the remaining three tariffs. Custom tariff rates currently range from 6 percent to 30 percent. The government says the liberalized customs tariffs mean lower prices for consumers and will assist investment. But some influential lawmakers - Nino Burjanadze, the Parliamentary Chairperson and Jemal Inaishvili, the Vice-Speaker and the President of the Georgian Chamber of Trade and Commerce fear that the reduction of customs tariffs on imported agricultural products will hit local producers in the agricultural sector. But some lawmakers from the ruling National Movement, including parliamentary majority leader Maia Nadiradze, support the government's proposal. Parliamentarians from the opposition Industrialists party is also against of the proposal.

June 13

Georgia's defence spending will increase and reach USD 220 million in 2006, Georgian Deputy Defence Minister Mamuka Kudava stated. Georgia increased its arms spending by 143 percent - up to USD 146 million - in 2005, which is the largest increase worldwide according to the Stockholm International Peace Research Institute (SIPRI) in its latest yearbook. "There is nothing extraordinary in this increase. The information which was revealed by SIPRI was provided by the [Georgian] Ministry of Defence," Davit Kodua said. "This increase in spending aims at getting closer to NATO standards and integrating into the Euro-Atlantic structures," he added.

June 13

In their short remarks made during a press conference before talks in St. Petersburg the **Russian and Georgian Presidents stressed** the importance of economic ties between the two countries. President Saakashvili expressed hope that Russia will remain Georgia's major economic and trade partner. Putin said that Russian investments in Georgia have increased fivefold in 2005; as a result Russia has become the number one investor in the Georgian economy. Putin hopes that Russia has largely contributed to the development of Tbilisi and other regions of Georgia though its investment projects.

June 15

Donor countries from the OSCE pledged **more than EUR 10 million for economic and infrastructure rehabilitation in the South Ossetian conflict zone** at a conference in Brussels. The pledges were: the European Commission (Euro 2 million), the United States (USD 2 million), Sweden (Euro 1 million), Belgium (Euro 1 million), Germany (Euro 500 000), the Netherlands (Euro 500 000), Norway (about Euro 250 000), Spain (Euro 200 000) and Finland (Euro 200 000). Estonia, Turkey, France, Hungary, the United Kingdom, Lithuania, Italy, the Czech Republic, Croatia, Poland and Andorra pledged amounts of up to Euro 150 000, according to the OSCE press office. The list of package proposals on rehabilitation projects was put together based on a needs assessment study carried out in 2005-2006 by international, Georgian and South Ossetian experts. Representatives from the Georgian, South Ossetian, Russian and Russia's North Ossetian sides, which make up the main negotiating body over the conflict - the Joint Control Commission (JCC) - were also present at the conference. Georgian Prime Minister Zurab Nogaideli and OSCE Chairman-in-Office, Belgian Foreign Minister Karel De Gucht also addressed the conference. On top of its pledge to the 2006 budget, the European Commission indicated that it was ready to support the package proposal with a similar effort in 2007, provided that the conditions in the field are conducive and the implementation of the projects goes well, according to the OSCE. Russia has said it is going to support the economic development of the region with the equivalent of about three million euros. It also foresees the possibility that part of this amount would be allocated to specific projects coordinated with the OSCE, including those contained in the package proposals.

June 16

Kazakhstan has officially joined the Baku-Tbilisi-Ceyhan oil pipeline after the Kazakh and Azeri Presidents Nursultan Nazarbayev and Ilham Aliyev signed an agreement in Almaty. Kazakhstan has pledged to transport BTC 7,5 million tones of oil annually. The first cargo of oil transported through the BTC pipeline was exported from the Ceyhan marine terminal on the Turkish Mediterranean coast on June 4. An official inaugural

ceremony of the BTC is planned in Turkey for July 13. President Saakashvili is also expected to participate in the ceremony.

June 20

Speaking at an international **conference on Eurasian Energy Security** in Tbilisi, President Saakashvili called for active development of new energy transit routes. He stressed the importance of the development of the Trans-Caspian and Black Sea-bed pipeline projects to ship Central Asian hydrocarbons to western markets via the Caucasus and Ukraine. Officials from Azerbaijan, Ukraine, Moldova, Turkey, United States, as well as representatives of BP, Shell and other companies gathered in Tbilisi to participate in the conference - Eurasian Energy Security - Market Access and Investment Policy - which was held on June 20-21.

June 20

The **Czech Energo-Pro has bought two electricity distribution companies and all six hydro power plants**, while the Georgian company TBC-Energy took over one electricity distribution company in a major privatization deal totalling USD 317 450 000, Georgian Prime Minister Zurab Nogaideli said. The Czech company bought United Energy Distribution Company (UDC) and Energy Distribution Company of Adjara, as well as hydro power plants: Lajanuri, Rioni, Gumati, Shaori, Dzevrula and Ats for a total of USD 312 million 350 thousand, according to the Economy Ministry. TBC-Energy, which is part of the Georgian TBC Group, paid USD 5.1 million for the Electricity Distribution Company in Kakheti, an eastern region of Georgia. A total of three electricity distribution companies and six hydro power plants were put up for sale. The initial total price for all these facilities was USD 119 million. Eight companies were competing for these energy facilities, including the Russian giant United Energy Systems (UES), which made its bid for two hydro power plants - Ats and Dzirula - and was ready to pay USD 4.5 and USD 20 million, respectively. UES was also bidding for Adjara Electricity Distribution Company, offering USD 6 million.

June 21

With the launch of the South Caucasus Gas Pipeline (SCP) less than five months away **Georgia is now striving to gain the right to purchase more gas** from this pipe at a reduced price than is envisaged by the current contract. Experts from Azerbaijan, Georgia and Turkey gathered in Tbilisi to negotiate Georgia's request on a sidelines of the Eurasian Energy Security conference. Initially it was agreed that after construction of the SCP - also known as Baku-Tbilisi-Erzrum, or Shah-Deniz gas pipeline - Georgia will receive 5 percent of the natural gas transported from Azerbaijan to Turkey as a transit country. Georgia will also purchase an additional half billion cubic meters of gas per year at a reduced price - USD 55 per 1000 cubic meters (with annual 1.5 percent price escalation) for the next 20 years. The SCP has an initial capacity to ship 8 billion cubic meters of gas. After 2012, capacity is expected to increase up to 20 billion cubic meters. Georgia now wants to receive at least 1.5 billion cubic meters of gas at reduced price starting from 2007. Officials in Tbilisi are optimistic about the outcome of talks with the Azerbaijani and Turkish sides. The 690-km long BP-led SCP is the only real alternative source of energy supply for Georgia, whose increasing gas consumption currently totally depends on Russia. Georgia purchases gas from Russia at the price of USD 110 per 1000 cubic meters.

June 22

President Saakashvili said that **customs tariff rates will not be reduced to a zero percent on imported agricultural raw products** in order not to harm local production. "I have categorically prohibited abolishing custom dues in the field of agriculture... because we should stimulate processing of local agricultural products as much as possible," Saakashvili said while meeting with top executives of the food producing companies. In early June, Parliament postponed its second hearing on the government's proposal to reduce both the number and rates of customs tariffs. The parliamentary majority was at odds, as some lawmakers including Parliamentary Chairperson Nino Burjanadze were against the zero percent tariff on imported agricultural raw products. The president stated that the government plans to invest over USD 100 million in the agrarian sector. Saakashvili also said that the government is ready to introduce profit tax exemptions in cases of reinvesting in the agricultural sector. He noted that a positive tendency was observed in 2005-2006, since several new processing enterprises were opened in the country.

June 24

Parliament decided to launch discussion of the government's proposal, envisaging an **increase of budgetary expenditures** by GEL 77 million (USD 42.7 million). According to the government this increase of expenditures was made possible as a result of tax and non-tax revenues that have increased by GEL 63 million and GEL 14, respectively. As a result of this increase, additional funds will be allocated for the Defence Ministry - GEL 17 million; as well as for infrastructure rehabilitation in the capital Tbilisi - GEL 14.5 million; GEL 9 million for infrastructure rehabilitating in the regions; GEL 3 million for construction of roads. In May, budgetary expenditure was increased by GEL 200 million. Parliament is expected to approve budgetary amendments at a special session in late July.

June 25

President Saakashvili announced a **National Presidential Program to boost tourism infrastructure** in order to attract at least 2.5 million people to Georgia's resorts annually. Mikheil Saakashvili was speaking at a meeting with regional governors to discuss what is being done in the country's regions to boost tourism through infrastructure development. He said that at an initial stage two schools of tourism will be set up - one in Tbilisi and another one in Kobuleti - to train qualified staff who can provide high quality service in tourism centres including in hotels and restaurants. A third school of this kind will be established in Borjomi later. Saakashvili said that the creation of tourism infrastructure at historic and cultural centres throughout Georgia is another part of the National Presidential Program to boost tourism. "We need well-equipped museums of high standard," Saakashvili added. Saakashvili also said that starting from August, TV advertisements promoting Georgia will appear on CNN and EuroNews. In early June the government allocated USD 175 000 for this purpose.

SUMMARY MACROECONOMIC INDICATORS

		2000	2001	2002	2003	2004	2005	2006**
GDP and real sector								
Nominal GDP	mIn GEL	6043.1	6674.0	7456.0	8564.1	9824.1	11591.8	13 080.0
Real GDP	mIn GEL, 1996	4618.2	4840.1	5105.0	5669.6	6001.8	6562.8	7055.0
Nominal GDP per capita	GEL	1298.6	1445.0	1625.9	1880.0	2166.2*	2563.7	-
	USD	657.5	697.0	741.4	876.9	1139.1	1415.6	-
Real GDP per capita	GEL, 1996	992.4	1047.9	1113.2	1244.5	1323.3	1452.2*	-
GDP by sectors								
Industry	% of nominal GDP	17.3	16.6	17.6	17.7	16.1	15.6	-
Agriculture	% of nominal GDP	20.6	21.0	19.2	19.3	16.4	14.8	-
Construction	% of nominal GDP	3.7	3.9	5.1	6.4	8.1	8.8	-
Real GDP growth	% over prev. year	1.8	4.8	5.5	11.1	5.9	9.3	7.5
Real growth by sectors								
Industry	% over prev. year	3.2	-2.5	8.4	7.7	4.0	11.4	-
Agriculture	% over prev. year	-12.0	8.2	-1.4	10.3	-7.9	12.0	-
Construction	% over prev. year	4.0	10.3	43.1	46.6	36.1*	22.3	-
Price indexes								
GDP deflator	1996=100	130.5	137.5	145.8	150.6	163.2	175.9	184.7
Consumer prices (year average)	2000=100	100	104.7	110.5	115.8	122.4	132.5	140.6
Producer prices (year average)	2000=100	100	103.6	110.8	113.9	119.2	128.0	-
Investments								
GFCF ¹	% of nominal GDP	25.4	27.2	24.5*	26.7	27.5	26.3	-
Net FDI ² inflow	mIn USD	131.7	109.9	163.3	336.3	489.5	539.3*	-
Labour market								
Population	mIn	4.63	4.60	4.57	4.54	4.52	4.52	-
Labour force	mIn	2.05	2.11	2.10	2.05	2.04	2.02	-
Unemployment rate	%	10.3	11.1	12.6	11.5	12.6	13.8	-
Wage								
Average nominal wage	GEL	72.5	82.6	99.1	101.5	116.4	149.3	-
	%, over prev. year	7.1	13.9	20.0	2.4	14.7	28.3	-
Living standard								
Level of poverty	% population	51.8	51.1	52.1	54.5	35.7*	39.4	-
Depth of poverty		20.2	19.3	19.8	21.1	12.2*	13.5	-
Severity of poverty		10.7	9.9	10.3	11.2	6.1*	6.6	-
National accounts								
Household consumption	% of nominal GDP	89.4	78.6	77.0	71.6	72.8	66.8*	75.1
Government consumption	% of nominal GDP	8.5	9.6	9.8	9.2*	14.9*	12.6*	11.7
Gross capital formation	% of nominal GDP	26.6	28.3	25.5*	27.7*	28.3	26.9*	31.0
Net exports	% of nominal GDP	-16.7	-14.4	-13.2	-14.6	-16.6	-17.8	-17.9
Government finance								
Revenue	mIn GEL	639.4	740.3	816.1*	956.0*	1773.0*	2607.5	3207.5
Expenditure	mIn GEL	833.9	906.4	1040.7*	1118.5*	1923.6*	2616.5	3496.7
Deficit(-) or Surplus (+)	mIn GEL	-194.5	-166.1	-224.6*	-162.5*	-150.6*	-9.0	-289.2
Financing of deficit								
Domestic	% of deficit	77.4	13.5	40.0*	31.9*	11.0*	398.0	37.9
Foreign	% of deficit	22.6	86.5	60.0*	68.1*	89.0*	-298.0	62.1
Total Debt	mIn GEL	4192.5	4449.5	4843.3	4608.0	4306.6	4076.1*	4611.1
Domestic	% of debt	35.7	33.5	31.4	34.0	36.6	37.7	32.9
Foreign	% of debt	64.3	66.5	68.6	66.0	63.4	62.3	67.1
Monetary indicators								
M2 (year end)	mIn GEL	382.1	403.8	462.3	527.4	846.1	1069.9	1323.5
Velocity of money (M2)		19.53	17.89	17.78	16.23	11.78	10.83	9.90
Deposit rate***	% per annum	12.2	11.1	11.4	10.6	9.5	8.7	-
Lending rate****	% per annum	25.3	24.0	23.1	21.6	20.2	17.9	-
Treasury bill rate	% per annum	17.14	29.93	43.42	44.26	19.66	12.57	-

		2000	2001	2002	2003	2004	2005	2006
Balance of payments								
Current account	mIn USD	-161.2	-211.4	-197.6	-369.5	-346.9	-692.9*	-760.4
Capital account	mIn USD	-4.8	-5.2	17.6	19.9	40.8	58.7*	-
Financial account	mIn USD	92.1	218.7	222.2	356.3	483.3	731.5*	-
Net errors and omissions	mIn USD	53.9	44.8	-3.7*	-24.3*	1.3	14.3*	-
Overall balance	mIn USD	20.0	-46.9	-38.5	17.6	-178.5	-111.6	-
External economic position								
Gross international reserves	mIn USD	109.7	159.9	198.4	191.6	383.7	474.1	-
	Import. coverage (month)	1.4	1.8	2.3	1.6	2.3	2.1	
Exchange rate (year average)	USD/GEL	1.9759	2.0723	2.1945	2.1459	1.9168	1.8126	1.8200
Real effective exchange rate	%, 1995=100	110.2	108.2	102.7	94.9	107.0	110.3	-
Terms of trade (year end)	1995=100	99.5	97.8	96.0*	77.0*	72.0*	75.0	-
NPV ³ of external debt	% of nominal GDP	38.9	36.8*	36.6*	32.2*	25.0*	20.3	-
Foreign debt service	% of total exports	9.1	6.3	5.0	4.6	6.5	5.0	5.9

Source: Georgian Government. Basic Data and Directions 2007-2010; Department for Statistics, Ministry of Economic Development; Ministry of Finance; National Bank of Georgia (NBG) and IMF

Note: * revised data

** forecast

*** the numbers of deposit rate reflect weighted average rates on time deposits denominated in domestic and foreign currency

**** the numbers of credit rate reflect weighted average rates on short term (up to one year) and long term (over the one year) credits denominated in domestic and foreign currency

Acronyms used:

1.GFCF -Gross Fixed Capital Formation

2.FDI - Foreign Direct Investments

3.NPV- Net Present Value

Georgian economy compared with EU25

	Georgia							EU-25
	2000	2001	2002	2003	2004	2005	2006*	2005**
Real GDP growth, % over prev. year	1.8	4.8	5.5	11.1	5.9	9.3	7.5	1.6
GNI per capita (PPP, Euro)	-	-	-	2 308.0	2 331.0	-	-	20 098.0 ²
in % of EU-23 ¹ (PPP)	-	-	-	11.7	11.6	-	-	-
GDP per capita (nominal USD)	657.5	697.0	741.4	876.9	1139.1	1415.6	1599.0	29 247.0
Inflation (year average)	4.0	4.7	5.6	4.8	5.7	8.2	5.0	4.7
end of year	4.6	3.4	5.4	7.0	7.5	6.2	6.0	-
Lending rate (year average) ³	25.3	24.0	23.1	21.6	20.2	17.9	-	4.0
Fiscal balance, % to GDP	-3.2	-2.5	-1.9	-3.2	-2.3	-0.1	-3.1	-2.3
Public debt, % to GDP	69.4	66.7	65.0	53.8	43.8	35.2	35.3	63.4
of which:								
domestic	24.8	22.3	20.4	18.3	16.0	13.3	11.6	-
foreign	44.6	44.4	44.6	35.5	27.8	21.9	23.7	-
Current account, % to GDP	-5.3	-6.9	-5.8	-9.3	-6.8	-10.8	-10.6	-0.9
Net FDI inflow, mln USD	131.7	109.9	163.3	336.3	489.5	539.3	-	-140 462.0
Memorandum items:								
Nominal GDP								
mln GEL	6043.1	6674.0	7456.0	8564.1	9824.1	11 591.8	13 080.0	-
mln USD	3058.4	3220.6	3397.6	3990.9	5125.3	6395.2	7186.8	13 491 662.0
mln Euro	3310.7	3594.0	3591.2	3523.7	4119.0	5139.2	-	10 841 913.0
Exchange rates (nominal, year average)								
USD/GEL	1.9759	2.0723	2.1945	2.1459	1.9168	1.8126	1.8200	-
Euro/USD	0.9238	0.8961	0.9461	1.1326	1.2443	1.2444	-	-

Source: Georgian Government. Basic Data and Directions 2007-2010; Department for Statistics, Ministry of Economic development; NBG; World Bank; IMF; European Central Bank and Eurostat

Note: * forecast

**partly preliminary numbers

1. EU23 (excludes Cyprus and Malta)

2. 2004

3. the numbers for Georgia reflect weighted average rates on short term (up to one year) and long term (over the one year) credits denominated in domestic and foreign currency; the number for the EU refers to the euro zone (EU12) only and reflects the rate on new loans in Euro with duration of up to one year

1. GROSS DOMESTIC PRODUCT AND REAL SECTOR

Table 1: Nominal and Real Gross Domestic Product (GDP)

	Nominal GDP (mln GEL)	Share of labour cost (%)	Share of operating surplus (%)	Share of net taxes (%)	GDP deflator (1996=100)	Real GDP (in 1996 prices, mln GEL)	Change in real GDP compared to last year's corresponding period (%)	Real GDP per capita (in 1996 prices)
2000	6043.1	27.6	64.9	7.5	130.5	4618.2	1.8	992.4
2001	6674.0	25.2	66.9	7.9	137.5	4840.1	4.8	1047.9
2002	7456.0	22.3	69.6	8.2	145.8	5105.0	5.5	1113.2
2003	8564.1	20.3	72.1	7.6	150.6	5669.6	11.1	1244.5
2004	9824.1	20.7	69.5	9.9	163.2	6001.8	5.9	1323.3
Q 1	2021.5	24.9	67.2	7.9	154.8	1302.5	6.3	286.9
Q 2	2431.0	20.5	70.1	9.4	163.4	1487.0	7.3	327.8
Q 3	2575.2	19.7	69.5	10.7	166.0	1551.3	5.2	342.1
Q 4	2796.6	18.7	70.5	10.8	168.4	1661.0	4.9	366.5
2005	11591.8	19.8	68.3	11.9	175.9	6562.8	9.3	1451.5*
Q 1	2414.1	21.6	67.1	11.3	175.0	1375.3	5.6	304.1*
Q 2	2820.2	21.6	66.5	12.0	171.0	1644.0	10.6	363.7*
Q 3	3057.4	19.4	68.0	12.6	175.7	1734.7	11.8	383.9*
Q 4	3300.1	17.3	70.9	11.8	181.9	1808.8	8.9	400.5*
2006								
Q 1**	2744.8	20.4	66.8	12.8	183.4	1491.2	8.4	330.2

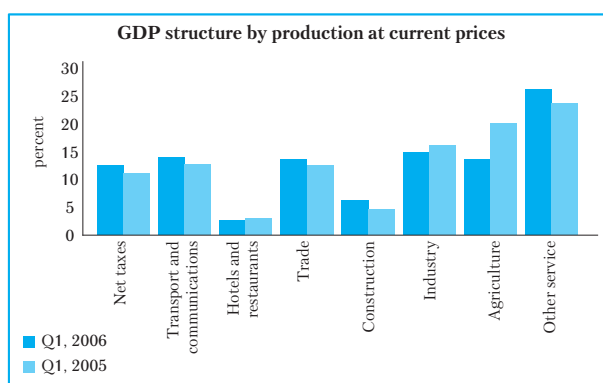
Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * verified data

** preliminary assessment

According to preliminary assessments, GDP continued its high rate growth in Q1, 2006. It exceeded the previous years same indicator by 2.8 percentage point. This was mainly due to the increase in domestic demand from households and the government as well as an increase in external demand. At the same time, economic activity significantly slowed down in the accounting period compared to the previous quarter, mainly due to seasonal changes.

Q1, 2006 saw a further increase in labour productivity (added value per employee), as a resource to meet increased total demand. This indicator showed a 26.2 percent annual increase. Labour productivity (in 1996 basic prices) was high in the spheres of financial intermediation (GEL 6730), real estate (GEL 4340), hotel and restaurant (GEL3170), construction (GEL 1610), industry (GEL 1430) and trade (GEL 1220). It was much lower in such important by number of employees sectors as agriculture (GEL 310), health care (GEL 380), and education (GEL 170).



Source: Department for Statistics, Ministry of Economic Development

In Q1, 2006, the share of net taxes on goods and imports in GDP structure by production continued with its upward trend, which had been observed over recent years. The annual increase was 1.4 percentage point and reached 12 percent. As regards various economic activities in basic prices, the share of food processing by agriculture and households significantly decreased, whereas the share of construction, trade, transport and real estate transactions significantly increased.

Table 2: Contribution of selected sectors of the economy to GDP real change 2006, Q1*

	Change to last year corresponding period (%)	Contribution to GDP real change (percentage points)
Agriculture	-8.3	-1.2
Mining	1.6	0.0
Manufacturing	2.5	0.2
Energy	-8.7	-0.2
Household production	2.5	0.1
Construction	25.9	2.3
Trade	13.8	1.6
Hotels and restaurants	8.5	0.2
Transport	37.7	3.2
Communications	19.5	0.8
Financial intermediation	56.7	1.1
Real estate	11.4	0.3
Rent	-1.6	0.0
Public administration	-6.2	-0.4
Education	9.6	0.3
Health care	3.3	0.1
Other social services	17.2	0.5
Hired employment in household	29.4	0.0
FISIM	2.8	0.0
GDP at Basic Prices	9.9	8.9
Taxes	-6.8	-0.7
Subsidies	-12.0	0.1
GDP at Market Prices	8.4	8.4

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

As the GDP structure shows, 63.4 percent of economic activity was concentrated in 6 fields. The highest shares among them accounted for industry, agriculture and trade. An impressive upward dynamic was again observed in the fields of financial intermediation, transport and construction. High annual growth in financial intermediation over the past few years developed into a stable trend, which was determined by the increase in the net percentage income resulting from the credit boom. The growth rate of communications, trade, real estate transactions and education was higher compared to the GDP annual growth rate.

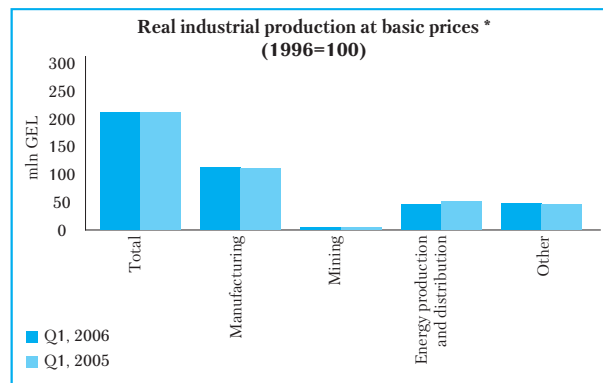
Table 3: Indicators of industry

	Value added in industry at current basic prices (mln GEL)	Index of industry (1996=100)	Real value added in industry at basic prices (% changes over the same period of the previous year)	Share of value added in industry at current basic prices (%)			
				Mining	Manufacturing	Energy production and distribution	Other
2000	1044.2	107.9	3.2	3.9	49.5	25.2	21.4
2001	1111.0	105.2	-2.5	3.4	46.4	23.1	27.1
2002	1315.8	114.0	8.4	3.8	47.5	23.7	25.0
2003	1515.3	122.8	7.7	5.0	49.2	21.4	24.4
2004	1581.8	127.8	4.0	4.9	50.8	19.2	25.1
Q1	328.3	103.2	14.1	4.9	46.5	27.0	21.6
Q2	371.3	119.7	6.0	5.0	56.1	18.7	20.1
Q3	407.2	129.1	-3.1	5.1	51.8	14.1	29.0
Q4	475.0	159.1	2.8	4.5	48.8	18.7	28.0
2005	1809.1	142.4	11.4	4.7	54.8	18.0	22.5
Q1	376.2	111.4	8.0	5.0	51.5	24.2	19.3
Q2	416.6	130.3	8.9	4.8	58.3	18.4	18.5
Q3	475.1	145.8	12.9	4.7	55.7	14.2	25.3
Q4	541.2	181.9	14.3	4.5	53.6	16.7	25.2
2006							
Q1*	392.1	112.0	0.5	5.9	57.7	22.1	14.3

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

The real growth rate of industry sharply dropped in the reviewed period both in annual and quarterly terms. This can be mainly explained by difficulties that emerged in the energy sector because of the accident on the trunk gas pipeline and problems with delays in imports. As a result, electricity generation-distribution and gas and water supplies experienced a significant decline, followed by a drop in the growth rate of the main industrial sectors.



Source: Department for Statistics, Ministry of Economic Development

Note: *The aggregated indicator of industry in this chart are calculated in 1996 prices, while in the above table the aggregated real growth rate of industry is calculated in 2005 average current prices and not in 1996 prices. Therefore, in contrast to the 0.5 percentage real growth reflected in the table the chart shows 0.2 percent real decrease

Annual growth in the processing industry and processing in households made up 2.5 percent each, while the same indicators for the previous quarter were, respectively, 22 and 10.8 percents. The mining industry showed some growth, thus reversing an apparent downward tendency in this sector, which can be explained by the increase in manganese extraction and in the production of non-ore construction materials.

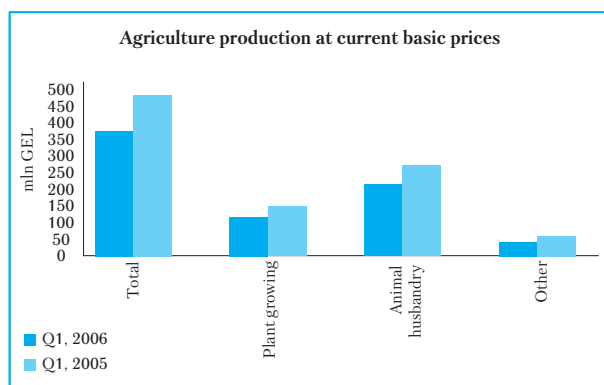
Table 4: Indicators of agriculture

	Value added in agriculture at current basic prices (mln GEL)	Index of agriculture (1996=100)	Real value added in agriculture at basic price (% change over the same period of the previous year)	Share of value added in agriculture at current basic prices (%)		
				Plant growing	Animal Husbandry	Other
2000	1245.0	91.3	-12.0	43.2	45.6	11.2
2001	1399.0	98.8	8.2	46.7	44.2	9.1
2002	1434.6	97.3	-1.4	46.7	47.3	6.0
2003	1653.0	107.4	10.3	46.9	41.0	12.1
2004	1610.7	99.0	-7.9	44.4	46.6	9.0
Q1	344.1	84.7	-21.8	29.2	52.6	18.2
Q2	471.5	114.7	0.1	48.4	42.1	9.5
Q3	420.7	100.0	1.8	50.8	46.0	3.2
Q4	374.4	96.4	-11.2	45.9	47.5	6.6
2005	1717.7	110.8	12.0	46.9	45.3	7.8
Q1	465.2	101.0	19.2	31.0	56.5	12.5
Q2	461.6	117.8	2.7	50.2	40.5	9.3
Q3	382.1	117.2	17.2	62.5	33.8	3.7
Q4	408.9	107.4	11.4	46.8	48.8	4.4
2006						
Q 1*	361.6	92.6	-8.3	31.5	57.3	11.2

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

Q1, 2006 saw a sharp drop in agricultural activity. Production indicators largely lagged behind the level attained in the previous year's corresponding period and the previous quarter, which was mainly due to unfavourable weather conditions, namely, late frosts. The result was a significant damage to crops including spring wheat, legumes, potato and vegetables. Vegetable and fruit output decreased significantly, causing a rise in their prices.



Source: Department for Statistics, Ministry of Economic Development

Compared to plant growing, the situation was better in animal husbandry. A significant increase was seen in swine and sheep rearing as well as in meat production. Demand for meat and meat products increased in the reporting period compared to Q1 2005, which resulted from almost a halving of poultry and 40 percent drop in egg production because of bird flu fears.

Table 5: Indicators of transport and communications

	Value added in transport and communications at current basic prices (mln GEL)	Index of transport & communication (1996=100)	Real value added in transport & communications at basic prices (% changes over the same period of the previous year)	Share of value added in transport and communications at current basic prices (%)	
				Transport	Communication
2000	858.8	239.9	13.1	82.4	17.6
2001	911.1	243.3	1.4	79.6	20.4
2002	1057.4	264.6	8.7	79.3	20.7
2003	1187.5	286.9	8.4	74.2	25.8
2004	1313.2	303.6	5.8	71.0	29.0
Q1	281.4	260.7	5.8	69.6	30.4
Q2	312.2	286.1	-1.5	70.0	30.0
Q3	365.6	339.1	11.4	71.5	28.5
Q4	353.9	328.6	7.3	72.3	27.7
2005	1462.5	333.6	9.9	67.7	32.3
Q1	296.9	272.1	4.4	66.0	34.0
Q2	359.6	335.5	17.3	68.8	31.2
Q3	400.5	363.5	7.2	67.7	32.3
Q4	405.6	363.3	10.5	68.1	31.9
2006					
Q 1*	370.8	358.7	31.8	71.2	28.8

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

The real annual growth rate in transport and communications in Q1, 2006 was 27.4 percentage point higher than the previous year's corresponding indicator, reflecting dynamic development in these sectors. Along with the enhancement of the country's transit function, annual transport growth accelerated. A significant increase was observed in land, sea and pipeline transportation volumes, accordingly increasing passenger, rail and seaport cargo turnovers. Business and personal tourism was on an upward trend again. Communications also showed a high annual growth rate (though it was lower than the transportation growth rate), resulting from a significant decrease in prices thanks to the introduction of new technologies and a decrease in input costs.

Table 6: Indicators of construction

	Value added in construction at current basic prices (mln GEL)	Index of construction (1996=100)	Real value added in construction at basic prices (% changes over the same period of the previous year)
2000	224.7	167.3	4.0
2001	259.6	184.6	10.3
2002	379.5	264.2	43.1
2003	547.4	387.3	46.6
2004	793.2	526.3	35.9
Q1	151.6	419.0	126.0
Q2	170.1	437.5	20.8
Q3	223.5	592.0	40.0
Q4	248.0	656.8	13.5
2005	1015.3	643.7	22.3
Q1	105.1	278.6	-33.5
Q2	228.5	628.6	43.7
Q3	346.1	878.4	48.4
Q4	335.7	789.0	20.1
2006			
Q1*	165.0	350.7	25.9

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

The high construction growth rate in the reviewed period was mainly due to increased domestic demand. The main reason of the annual growth was public sector construction with significant sums from state and local budgets spent on infrastructure. Individual housing development and increased investments in fixed assets determined activity in the private sector. Despite increasing legalization of this business, the share of the informal sector was still high, comprising 31.2 percent of construction output. It is noteworthy that Q1, 2006 saw less activity in pipeline construction due to the seasonal nature of the construction works, on the one hand, and the completion of the Baku-Tbilisi-Ceyhan pipeline, on the other.

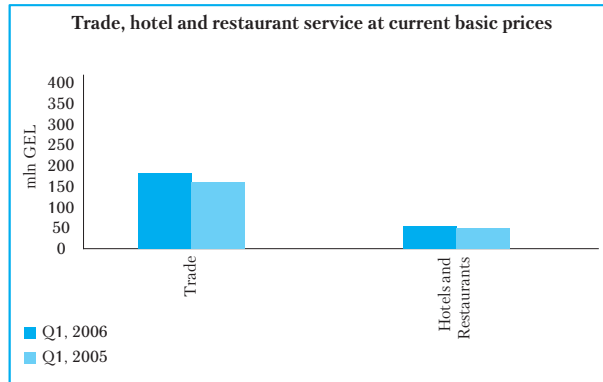
Table 7: Indicators of trade, hotels and restaurants

	Value added in trade at current basic prices (mln GEL)	Index of trade (1996=100)	Real value added in trade at basic prices (% changes over the same period of the previous year)	Value added in hotels & restaurants at current basic prices (mln GEL)	Index of hotels & restaurants (1996=100)	Real value added in hotels & restaurants at basic prices (% changes over the same period of the previous year)	Structure of value added in hotels & restaurants at current basic prices (%)	
							Hotels	Restaurants
2000	762.3	119.4	10.8	141.1	165.1	8.2	19.7	80.3
2001	871.0	129.9	8.8	192.1	220.9	33.7	46.2	53.8
2002	956.2	135.0	3.9	218.6	237.5	7.6	35.2	64.8
2003	1137.6	151.3	12.1	244.9	271.2	14.2	30.9	69.1
2004	1247.2	163.6	8.2	266.2	279.8	3.2	24.5	75.5
Q1	247.6	131.4	1.9	67.3	286.4	25.9	31.4	68.6
Q2	309.3	164.3	10.1	61.1	254.7	23.0	18.7	81.3
Q3	317.1	171.3	9.2	64.6	269.2	-25.0	23.1	76.9
Q4	373.2	187.6	10.3	73.2	308.9	6.1	24.2	75.8
2005	1315.7	169.2	3.4	328.2	325.7	16.4	29.5	70.5
Q1	292.6	148.3	12.9	69.8	303.9	6.1	29.9	70.1
Q2	327.5	180.7	10.0	85.8	369.2	45.0	31.7	68.3
Q3	336.0	167.3	-2.3	83.5	303.2	12.6	23.6	70.4
Q4	359.5	180.6	-3.7	89.0	326.6	5.7	27.1	72.9
2006								
Q 1*	359.3	168.2	13.8	70.1	329.8	8.5	34.8	65.2

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * Preliminary assessment

As a consumer demand grew in the accounting period, the trade sector showed quite high annual growth rates after significant decreases in the two previous quarters. Moreover, unlike the previous quarter, an upward trend in both wholesale and retail trade took place. Positive changes were observed in the trade structure. In particular, the amount of goods sold through organized retail trade networks exceeded that sold at market places. Moreover, restrictions imposed on open-air trade and the introduction of cash registers led to a decrease in the informal trade share by 5.1 percentage point compared to the previous year.



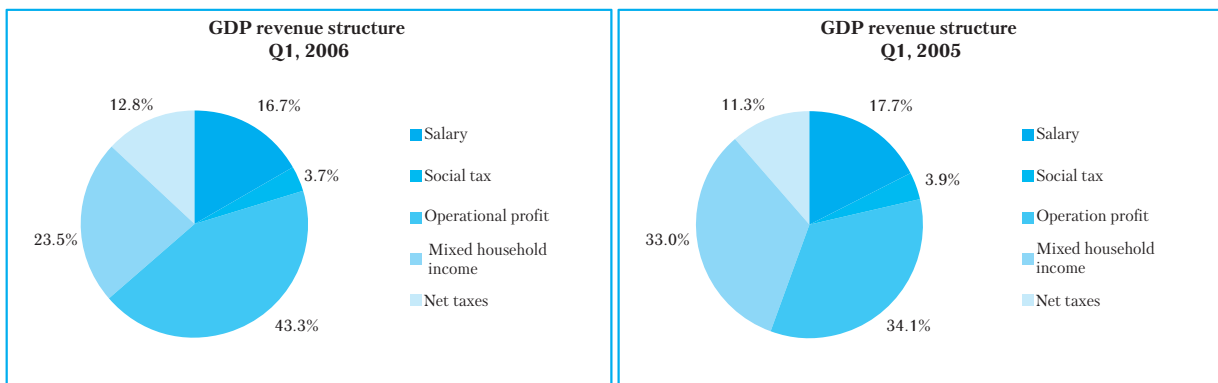
Source: Department for Statistics, Ministry of Economic Development

Growth in hotel and restaurant service volumes in Q1, 2006 was determined by a rise in service prices in the context of largely stable demand. At the same time, the higher increase in added value in the hotel service, compared to the restaurant service, continued in the accounting period. Although improvements in registration and legalization resulted in a 10 percentage point decrease in the share of the unregistered segment compared to the previous year, it still remained high (33.5 percent).

It is worth mentioning that the increase in dependence of the economy on imports (58.1 percent of GDP accounted for imports and 37.5 percent of exports). A focus on consumption (91.4 percent of GDP) continued in the reporting period, which was mainly attributed to the increase in disposable income.

Q1, 2006 saw a decrease in capital formation both in annual and quarterly terms by 5.1 and 32.44 percent respectively. Taking into account significant statistical differences between GDP volumes calculated by production and expenditure methods, which is expressed in lower GDP indicators calculated by expenditure methods, the amount of investments in reality might be higher.

As a result of further improvements in tax and customs administration, the share of net taxes in the structure of GDP structure kept on increasing in the accounting period. However, the share of salaries in GDP, despite a rise in average salaries, significantly lagged behind the profit and mixed income indicator, which can be explained by sharp staff cuts in the public sector.



Source: Department for Statistics, Ministry of Economic Development

Gross National Income (GNI), Net National Income (NNI) and Net Disposable Income were again on an upward trend in Q1, 2006, showing 12.9 , 12.7 and 15.7 percents annual growth, resulting from increased transfers received from abroad. The economy mainly remains a borrower, which is expressed in much higher volumes of investments than internal savings.

2. PUBLIC FINANCE

Table 8: Total Consolidated Budget Revenues

	Total revenues (mln GEL)	Total tax revenue (mln GEL)	GDP %							
			Total revenues	Total tax revenue	VAT	Profit tax	Excise duty	Income tax	Customs duty	Social tax
2000	905.2	854.3	15.0	14.1	4.6	1.3	1.5	1.8	0.9	2.1
2001	1033.9	954.7	15.5	14.3	5.2	1.0	1.3	2.0	0.8	2.1
2002	1135.3	1054.7	15.2	14.1	5.4	1.1	1.2	1.9	0.8	1.7
2003	1272.7	1186.6	14.9	13.9	4.8	1.2	1.2	1.8	0.8	2.1
2004	2102.0	1827.6	21.4	18.6	6.4	1.6	1.6	2.7	1.0	3.0
Q1	391.2	328.6	19.4	16.3	5.1	1.7	1.4	2.6	0.7	2.9
Q2	511.5	445.2	21.0	18.3	6.1	2.0	1.6	2.6	1.0	2.8
Q3	562.8	501.0	25.0	19.5	7.0	1.5	1.7	2.6	1.1	3.0
Q4	636.5	552.8	22.8	19.8	7.0	1.4	1.8	3.0	1.2	3.3
2005	3152.7	2411.5	27.2	20.8	8.5	1.8	2.4	2.5	1.1	3.7
Q1	618.2	471.1	25.6	19.5	8.1	1.8	2.2	2.8	1.0	3.1
Q2	831.3	566.0	29.5	20.1	8.2	2.1	2.7	2.4	1.0	3.1
Q3	784.6	655.2	25.7	25.7	8.4	2.1	2.7	2.4	1.2	3.9
Q4	918.6	719.2	27.8	21.8	9.2	1.4	2.3	2.6	1.1	4.5
2006										
Q1*	827.7	609.7	30.2	22.2	9.3	2.5	2.2	2.8	1.2	3.5

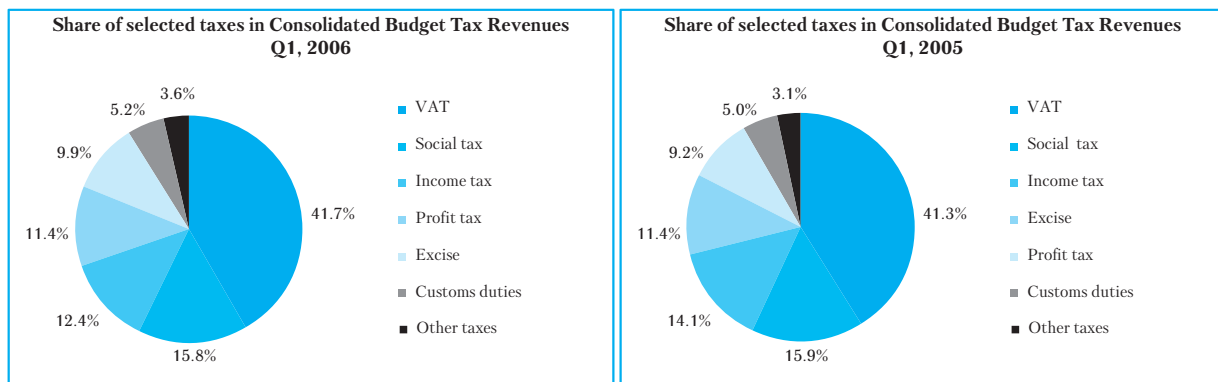
Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * preliminary assessment

Thanks to further improvements in mobilizing tax and non-tax revenues, consolidated budget revenues in Q1, 2006, exceeded revenue and grant targets by 24.3 percent. The amount raised in capital revenues was 14 percent lower than the target, while the grants received were 50 percent lower, thus reflecting persisting shortcomings in the planning process.

In the reporting period the upward trend in budget revenues from domestic sources continued. Total consolidated budget revenues exceeded the target by 26.5 percent. Its annual growth was 33.2 percent. At the same time, compared to the previous quarter, total revenues decreased by 14.4 percent due to seasonal factors.

Taxes still continued to be the main source of consolidated budget revenues. As a result of further improvements in tax and customs administration, tax revenues in Q1, 2006 were 17.5 percent higher than the target. Its annual growth was 29.4 percent. High growth rate was observed in profit tax (59.3 percent), customs duties (33.8 percent) and VAT (30.6 percent). It is worth noting that except for the profit tax, the amount collected in other taxes was lower than in the previous quarter, which can be explained by a high base indicator for Q4, 2005.



Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

VAT remained the main source of tax revenues in the accounting period. The level of VAT collection was 30.6 percent higher compared to the same period in 2005, though 16.6 percent lower compared to the previous quarter. VAT mainly came from imports of fuel, electricity, computer equipment, and ready-made food products.

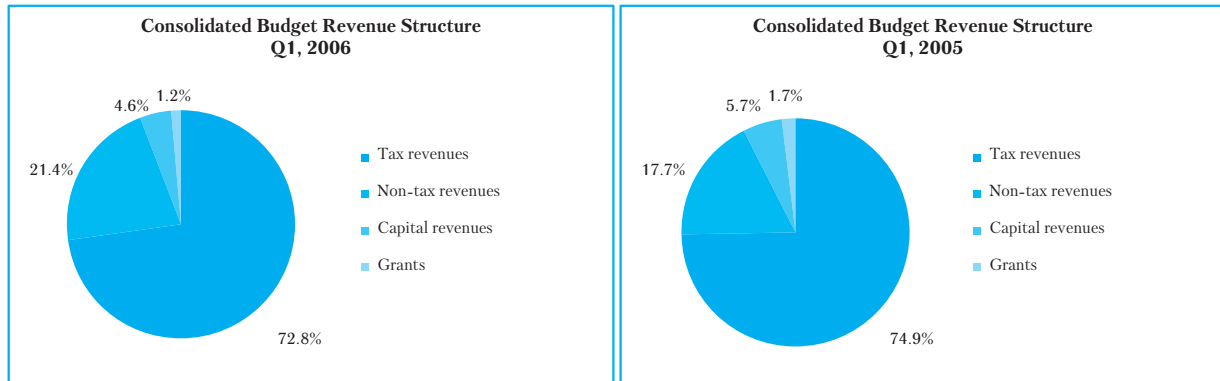
Revenues from the social tax were among largest tax revenues in Q1, 2006 showing an annual increase of 29.3 percent. However, compared to the previous quarter it dropped by 34.6 percent due to a seasonally high base indicator. The main part of these revenues was received in the form of social insurance paid by private sector employees.

The reviewed period saw a 14.3 percent annual increase in income tax. However, income tax decreased by 11.2 percent compared to the previous quarter. It is noteworthy that non-budget sector revenues were 2.3 times higher than the revenues from budget organizations.

As a result of improvements in administering profit tax following the transfer of its collection from local to state budgets, there was a high growth rate both in annual and quarterly indicators (respectively, 45.6 and 51.8 percents) in Q1, 2006.

In the reviewed period, excise revenues increased by 75.6 percent compared to last year's corresponding indicator. This can be explained by an increase in filtered cigarette output, automobile imports and diesel consumption. However, the amount of excise revenues decreased by 20.5 percent compared to the previous quarter, resulting from a drop in filtered cigarette imports and also from a rise in petroleum prices.

In Q1, 2006 annual growth in customs duties comprised 37 percent mainly thanks to an increase in computer equipment, arms and military related imports. At the same time, revenues from customs duties went down by 14 percent compared to the previous quarter due to a decrease in imports of clothes, footwear, ready-made food products and ferrous metal products.



Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

The consolidated budget, in the accounting period, received 2.3 and 1.6 times more revenues compared to the previous quarter and last year's corresponding period, respectively. This resulted mainly from an increase in communications and post license, and permit and gambling business fees.

Due to small-scale privatization in Q1, 2006, revenues from capital transactions showed a significant – 3.1 times - decrease compared to the previous quarter; but compared to the previous year's corresponding period, they showed an insignificant increase (7.5 percent). USD 17 million of state assets was privatized in the reporting period, supplying the consolidated budget with GEL 11 million.

A positive downward annual and quarterly trend was observed in grants in the accounting period. The largest part of grants was received in the form of current grants from foreign governments.

Table 9: Consolidated Budget Expenditures

	Total expenditure, (mln GEL)	GDP %						
		Total expenditures	General state service	Defence, public order and security	Foreign debt service	Education	Health care	Social safety and social security
2000	1126.5	18.6	2.2	1.7	-	2.2	0.6	3.4
2001	1237.9	18.5	3.1	2.0	-	2.1	0.8	2.9
2002	1409.5	18.9	3.5	2.0	0.9	2.2	0.9	3.0
2003	1522.1	17.8	3.1	1.9	0.9	2.1	0.4	4.0
2004	2412.2	24.6	3.6	4.4	0.5	2.9	1.0	4.7
Q1	417.5	20.7	4.4	2.9	0.6	2.1	0.4	4.2
Q2	516.9	21.3	3.0	3.1	0.6	3.2	0.5	5.1
Q3	576.1	22.4	3.4	4.0	0.4	2.5	0.9	4.5
Q4	901.7	32.2	3.7	6.8	0.4	3.1	1.9	5.0
2005	3280.8	28.3	3.1	5.9	0.3	2.5	1.8	5.4
Q1	621.2	25.7	3.2	5.5	0.5	2.2	1.4	6.4
Q2	773.4	27.4	2.5	5.4	0.3	2.1	1.7	6.0
Q3	827.8	27.1	2.8	5.7	0.2	2.4	1.8	4.8
Q4	1058.4	32.1	4.8	6.8	0.4	3.1	2.0	4.6
2006								
Q1*	766.7	27.9	3.3	6.4	0.3	2.5	1.3	5.2

Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Note: * preliminary assessment

Consolidated budget expenditure in Q1, 2006 was 23.4 percent higher than last year's same indicator, though 27.6 percent lower than in the previous quarter due to a high base indicator. Consolidated budget expenditures were mainly used to finance ongoing operations. The state budget spent only 7 percent of its total financing on capital costs in the accounting period.

In the reporting period, the top budget priority remained in the social sphere, with 18.6 percent of total costs spent on it. However, expenditures on social and health care programmes were lower than in last year's corresponding period and the previous quarter by, respectively, 9.8 and 6.7 percent.

Annual growth in defence expenditure comprised 27 percent in Q1, 2006. However, compared to the previous quarter, it dropped by 26.8 percent. It is noteworthy that 28.9 percent of expenditure allocated for defence from the state budget, accounted for capital expenditure and was used mainly for upgrading military infrastructure.

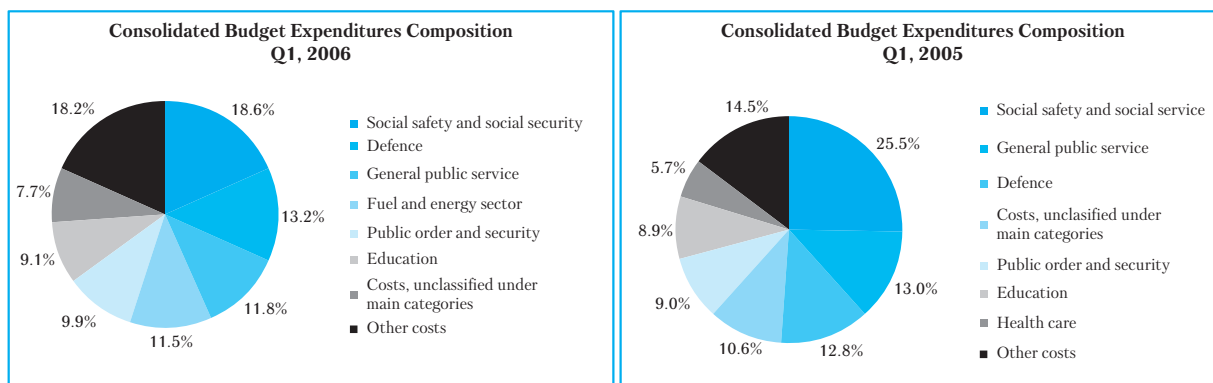
General state service expenditure was up by 12.5 percent in the accounting period as compared with the corresponding period last year and down by 22 percent compared with the previous quarter. Most of this expenditure was channelled into the rehabilitation of the penitentiary system infrastructure and reform in public administration.

A sharp annual growth (2.6 times) was observed in the fuel and energy sector in Q1, 2006, which was caused by an increase in spending to tackle the energy crisis. The main part of costs was used for financing subsidies and rehabilitation efforts.

Annual growth of expenditure on maintaining public order and security was also significant in Q1, 2006, comprising 87.1 percent. It should be noted that 12 percent of the allocations from the budget was used for financing investment projects in law enforcement agencies.

In Q1, 2006, financing in the education sector went up by 25.3 percent compared to the previous year's same period and down by 31.4 percent compared to the previous quarter due to a high base indicator. A large portion of the sum was allocated to programmes in secondary and higher education as well as on measures towards the integration towards European standards.

In the reviewed period, the costs which do not fall under main categories showed a downward trend both in annual and quarterly terms decreasing by 10.2 and 39.1 percents, respectively, which mainly resulted from improved transparency in costs and increased ability of local budgets to sustain themselves through their own revenues.



Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

In the accounting period, GEL 23 million was allocated for public debt service, comprising 3 percent of consolidated budget expenditure. State debt totalled GEL 4 120.6 million at the end of the first quarter. 63.1 percent of it represented a long-term foreign liability, while 36.9 percent was indebtedness to the National Bank and other entities.

Table 10: Budget Balance

	Balance deficit (-) profit (+)	Balance (expenditure %)	Balance (GDP %)
2000	- 207.0	18.4	3.4
2001	- 155.9	12.6	2.3
2002	- 251.6	17.9	3.4
2003	- 201.3	13.2	2.4
2004	- 288.4	12.0	2.9
Q1	- 25.0	6.0	1.2
Q2	- 5.1	1.0	0.2
Q3	+ 3.4	0.6	0.1
Q4	- 261.7	29.0	9.4
2005	- 24.0	0.7	0.2
Q1	+ 7.5	1.2	0.3
Q2	+78.8	10.2	2.8
Q3	- 29.7	3.6	0.1
Q4	- 80.6	7.6	2.4
2006			
Q1*	+70.6	9.2	2.6

Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations
Note: * preliminary assessment

The imbalance between revenues and expenditures was overcome in the reporting period. Consolidated budget revenues exceeded expenditure by GEL 70.6 million and the deficit comprised 2.6 percent of the GDP.

3. MONEY AND BANKING

Table 11: NBG accounts (thousand GEL, end of period)

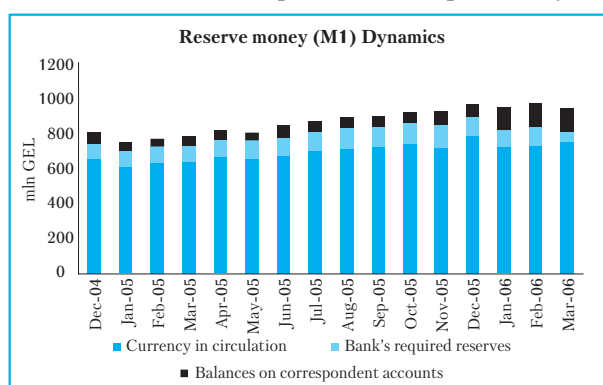
	NBG international reserves	NBG Claims on General Government	Reserve money (M1)	Currency in circulation	Banks' deposits		Real Cash Balances Index (1995=100)*
					Required reserves	Balances on correspondent accounts	
2000	217 058	760750	391 737	329 157	38943	23636	2100
2001	332 861	749415	429 857	365 669	53300	10888	2256
2002	414573	766681	508969	417178	72228	19525	2442
2003	397636	795572	579912	473242	81405	25214	2590
2004	700174	841414	836536	676158	92334	68045	3442
Q1	424325	815639	594008	466212	89946	32550	2527
Q2	527641	811349	655670	504188	74223	71259	2781
Q3	671522	816652	747390	600225	75342	71793	3252
Q4	700174	841414	836536	676158	92334	68045	3442
2005	851599	832849	1001451	811400	129833	60218	3890
Q1	699838	841691	809154	658218	97725	53211	3253
Q2	794216	841972	879314	694576	109141	75597	3513
Q3	802746	836230	933404	746508	122067	64829	3757
Q4	851599	832849	1001451	811400	129833	60218	3891
2006							
Q1	877952	832849	978908	775443	139334	64132	3664

Source: NBG and GEPLAC calculations

Note: * The real cash balance is derived from dividing the indicator for currency in circulation by CPI for the corresponding period (December 1995=100)

In Q1, 2006, the dynamics of the National Bank's (NBG) international reserves was still on the upward trend. Their quarterly growth comprised 3 percent, while the annual growth was 25.5 percent. The annual increase in international reserves in the reviewed period mainly resulted from currency inflows from the privatization of state property and the sale of a cellular communication license. Foreign currency purchases by the NBG at TICEX also increased sharply compared to Q1, 2005, though they were still lower than NBG's foreign currency sales at TICEX, due to seasonal factors.

The government's debt to the NBG did not change in the accounting period. Although actual budget revenues exceeded the target by 8 percent and expenditure comprised 91 percent of the target, the downward trend in government debt, which was observed over the last two quarters of the previous year, did not persist.



Source: NBG and GEPLAC calculations

Money supply in circulation decreased by 4.4 percent in Q1, 2006. This can be explained by the increase in banks' deposit liabilities and transfer of cash into bank channels. Although commercial banks' required reserves and amounts on commercial banks' correspondent accounts in the NBG increased, reserve money (M1) decreased. As the money supply in circulation decreased, so did the index of real cash balances.

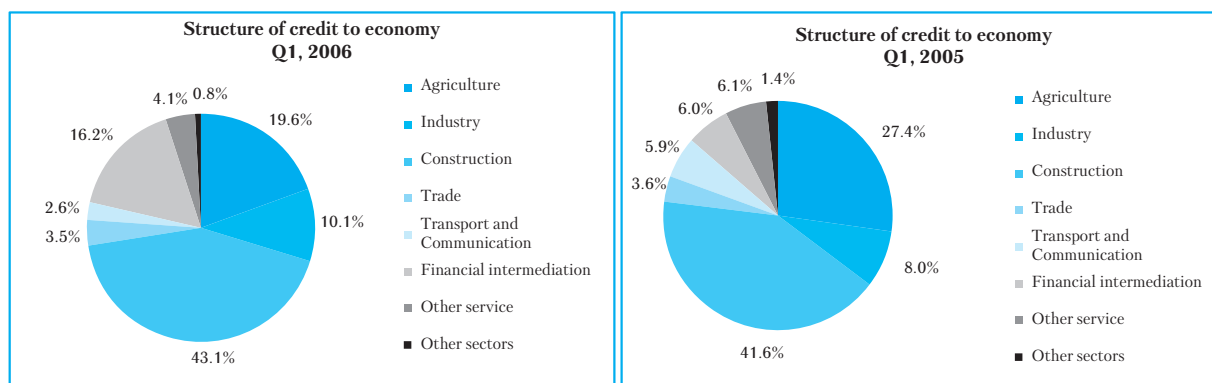
Table 12: Commercial banks' accounts (thousand GEL, end of period)

	Commercial banks' credits to economy	Share of credits to non-budgetary sector (%)	Net foreign assets	Deposits		Share of households in deposits (%)
				in national currency	in foreign currency	
2000	430315	100.00	-12610	67094	235868	-
2001	489783	99.51	3708	54989	328606	42.5
2002	629486	98.93	25040	71478	401301	53.5
2003	785923	98.42	42456	85863	532989	60.3
2004	964917	99.97	54595	230104	665836	50.5
Q1	726407	99.33	85595	115454	570494	57.0
Q2	739842	99.74	66743	127018	589566	58.3
Q3	875977	99.92	19311	173273	610244	54.8
Q4	964917	99.97	54595	230104	665836	50.5
2005	1730466	100.00	-231480	333611	841285	54.7
Q1	1070710	99.98	20984	203870	684471	57.2
Q2	1229399	99.98	-18482	253233	738697	58.2
Q3	1431937	99.98	-22138	296225	825201	54.0
Q4	1730466	100.00	-231480	333611	841285	54.7
2006						
Q1	1948496	99.99	-269532	378414	915702	55.0

Source: NBG and GEPLAC calculations

The higher growth of deposits in the national currency compared to those in foreign currencies continued into the reviewed period in both quarterly and annual terms. Moreover, while the quarterly growth of Lari denominated deposits was slightly higher than the same indicator of foreign currency deposits, the annual growth rate was 2.5 times higher. As a result, the dollarization of deposits kept decreasing showing a 8.2 percentage point annual decrease and 1.2 percentage point quarterly decrease in Q1, 2006.

The steady growth of deposits in commercial banks was determined by the increase in their loan resources. Loans to the economy in Q1, 2006, increased by 12.6 percent as compared to the previous quarter and by 82 percent as compared to the corresponding period of the previous year. In annual terms, a further increase was observed in the share of loans to trade, services and construction. At the same time, the share of loans to such sectors as industry and agriculture kept decreasing in the reporting period.



Source: NBG and GEPLAC calculations

As regards quarterly changes, the accounting period saw a significant decrease in trade due to seasonal factors, while loans to the service sector showed a sharp increase and to agriculture a significant increase compared to the previous quarter.

Table 13: Money aggregates (thousand GEL, end of period)

	Money outside banks (M0)	Reserve money (M1)	Broad money (M2)	Broad money (M3)	Money multiplier		Money Velocity	
					M2	M3	M2	M3
2000	315007	391 737	382101	617969	0.98	1.58	19.53	11.67
2001	348850	429 857	403839	732445	0.94	1.70	17.89	10.23
2002	390787	508931	462265	863566	0.91	1.70	17.78	9.54
2003	441536	579912	527398	1060388	0.91	1.83	16.23*	8.07*
2004	615993	836536	846097	1511933	1.01	1.81	11.78	6.59
Q1	431144	594008	546598	1117092	0.92	1.88	18.24	8.92
Q2	467749	655670	594768	1184334	0.91	1.81	16.76	8.42
Q3	537663	747390	710937	1321181	0.95	1.77	14.02	7.55
Q4	615993	836536	846097	1511933	1.01	1.81	11.78	6.59
2005	736284	1001451	1069895	1911181	1.07	1.91	10.83	6.07
Q1	608555	809154	812425	1496897	1.00	1.85	14.27	7.74
Q2	636495	879314	889728	1628425	1.01	1.85	13.03	7.12
Q3	686116	933404	982341	1807542	1.05	1.94	11.80	6.41
Q4	736284	1001451	1069895	1911181	1.07	1.91	10.83	6.07
2006								
Q1	709102	978908	1087516	2003218	1.11	2.05	12.03	6.53

Source: NBG

Note: *verified data

Along with the decrease in money supply outside banks and in reserve money and the increase in commercial banks' deposit liabilities, broad money (M2) aggregates showed a significant increase with annual growth of 33.9 percent. The quarterly increase of this indicator was more modest. Almost the same holds true for broad money (M3) aggregates, which showed a 33.8 percent increase compared to the same period last year but there was a slow down in growth in quarterly terms.

Table 14: Change in prices

	Consumer Price Index December 1995=100 (the latest month of period)	Change in Consumer Price Index (%, as compared with the latest month of previous period)	Change in Core Inflation (% as compared with the latest month of previous period)*	Producer Price Index December 2000=100 (the latest month of period)
2000	156.7	4.6	0.9	100.0
2001	162.1	3.4	1.3	108.9
2002	170.9	5.4	0.5	111.3
2003	182.7	7.0	2.3	118.7
2004	196.5	7.5	2.2	120.1
Q1	184.5	1.0	0.2	119.5
Q2	181.3	-1.7	-0.3	118.3
Q3	184.6	1.8	0.9	119.4
Q4	196.5	6.4	1.4	120.1
2005	208.6	6.2	3.0	130.1
Q1	202.4	3.0	0.6	129.8
Q2	197.7	-2.3	0.0	128.3
Q3	198.7	0.5	1.1	127.4
Q4	208.6	5.0	1.2	129.2
2006				
Q1	211.6	1.5	0.6	133.9

Source: Department for Statistics, Ministry of Economic Development and NBG

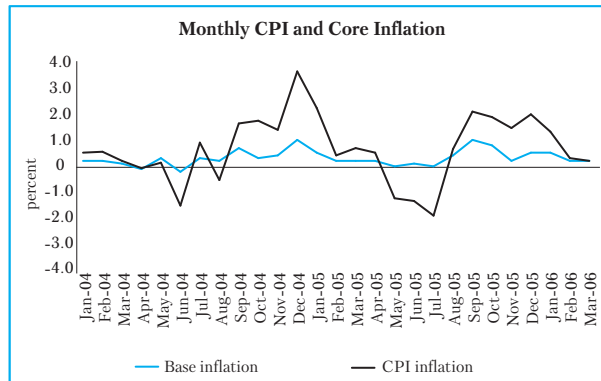
Note: * The core inflation indicator no longer includes exogenous factors and mainly reflects the impact of monetary policy on the price developments. A stable core inflation reflects the fact that the pursued monetary policy did not induce sharp change in consumer prices

The consumer price index in Q1, 2006 increased by 1.5 percent, which is 3.5 percentage point lower than the previous quarter indicator and 1.5 percentage point lower than the corresponding indicator of the previous year. This resulted from relatively lower monthly inflation, which showed a downward trend in the accounting period.

The dynamics of consumer prices is mainly determined by non-monetary, exogenous factors, the proof of which is a moderate change in the base inflation indicator.

The CPI increased by 1.2 percent in January 2006, mainly due to seasonal increases in prices on some food products, namely fruit and vegetable, on wood and kerosene, as well as on imported cigarettes. In February, because of contradictory dynamics in food prices, inflation increased by just 0.2 percent. This time, the increase in world prices affected sugar. The price also increased on meat and fish, but prices on other food products and service were either stable or showed a decrease. The downward trend in general price levels continued in March, when monthly inflation dropped to 0.1 percent, although a significant increase in some food products, namely vegetable and sugar, was apparent.

It is noteworthy that a steady drop in annual inflation, which started in December 2005, was quite apparent in the accounting period. In January-March, 2006, this indicator went down from 5.2 percent to 4.6 percent, thus suggesting that a significant increase in consumer prices in 2005, which was largely caused by exogenous factors, did not translate into a sustainable trend. This suggestion is also supported by average annual inflation dynamics that showed a decrease from 7.9 percent to 7.1 percent over the period between January and March.



Source: Department for Statistics, Ministry of Economic Development and NBG

Q1, 2006 showed a significant increase in producers' prices being more impressive than the growth of consumer prices. The upward dynamics in producers' prices was mainly influenced by a significant increase in the cost of electricity and natural gas generation and distribution, and also of water collection, treatment and distribution.

Table 15: Interest rates

	Money Market Rate* (GEL)	Money Market Rate (Foreign currency)**	Commercial banks' interest rates (annual weighted average)							
			on loans				on deposits			
			GEL		Foreign currency		GEL		Foreign currency	
			short-term	long-term	short-term	long-term	short-term	long-term	short-term	long-term
2000	-	-	22	17	30	20	11	2	11	13
2001	-	-	24	17	27	21	8	3	11	12
2002	24	16	25	16	25	20	11	12	11	12
2003	12	13	25	19	23	19	10	12	10	11
2004	8	8	27	20	22	17	8	12	9	11
Q1	17	11	27	20	23	18	10	13	9	11
Q2	16	8	29	19	23	18	8	13	9	11
Q3	6	7	27	20	22	17	7	12	9	11
Q4	6	7	25	21	22	17	7	12	8	11
2005	8	7	22	21	20	16	9	12	8	10
Q1	9	5	23	21	22	16	8	11	8	10
Q2	7	7	22	22	21	16	9	11	8	10
Q3	8	8	21	21	20	16	8	12	7	10
Q4	10	8	21	20	20	15	9	13	8	11
2006										
Q1	7	11	21	20	19	15	10	13	8	11

Source: NBG and GEPLAC calculations

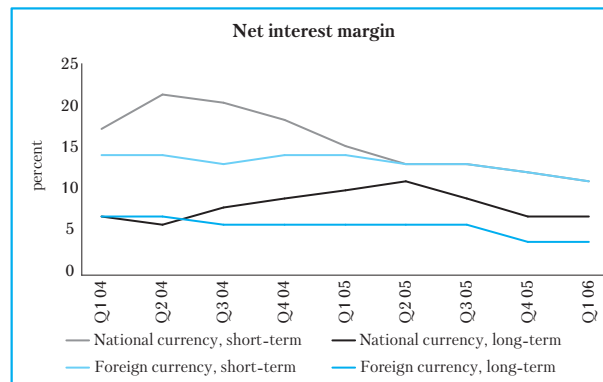
Note: * The money market interest rate in national currency includes an annual weighted average interest rate on up to 1-year maturity loans issued through Interbank Credit Auctions and bank to bank market

** The money market interest rates in foreign currency include an annual weighted average interest rate on up to 1-year maturity loans issued directly at the bank to bank market

Despite a stable growing trend in Lari denominated deposits in the accounting period, significant quarterly changes in interest rates on deposits, disregarding a slight increase in short-term Lari denominated deposit interest rates, did not take place. The increase in Lari denominated deposit interest rates was noticeable in annual terms, which reflected a steady process of financial mediation enforcement. More stable were interest rates on foreign currency deposit both in quarterly and annual terms.

Interest rates on national currency loans, set by commercial banks were almost the same in Q1, 2006 compared to the previous quarter. However, they dropped significantly compared to the corresponding period in 2005. The same dynamic was observed in loans in foreign currency. The downward trend in loan interest rates is a clear reflection of a sharp increase in credit resources on the one hand, and on the other, the increase of competition between banks.

As the deposit and loan interest rates decreased, the process of net interest margin decrease was observed in the accounting period. It is also noteworthy that the net interest margin between short-term deposits and loans in national currency, since Q2, 2005, has leveled with the same indicator of deposits and loans in foreign currency.



Source: NBG and GEPLAC calculations

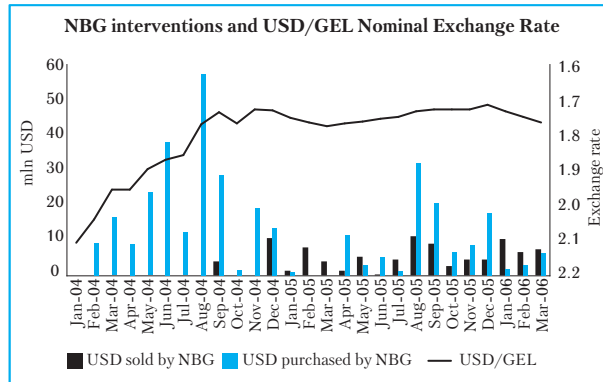
The formation of money market interest rates in the national currency was still largely influenced by bank-to-bank credit auctions. Due to the increase in liquidity of the Lari, an excess supply was created on the money market late February and March. Accordingly, the price of loans up to one-month maturity decreased on inter-bank auctions. A somewhat opposite tendency was observed on the foreign currency market, where along with a sharp decrease in transactions, interest rates significantly increased, reflecting an increased demand on foreign currency at the bank-to-bank market.

Table 16: Exchange Rates and net NBG Net Interventions

	Nominal Exchange Rate (average for the period)		USD/GEL Banknote Rate (average for the period)	Real Effective Exchange Rate December 1995=100 (end of period)	NBG Net interventions (thousand USD)
	USD/GEL	EURO/GEL			
2000	1.9759	-	-	110.2	-71416
2001	2.0723	1.8473	2.0816	108.2	-35448
2002	2.1945	2.0714	2.3822	102.7	-40459
2003	2.1459	2.4243	2.1502	94.9	-42685
2004	1.9168	2.3814	1.9160	107.0	-182662
Q1	2.0589	2.5753	2.0587	97.3	-21982
Q2	1.9506	2.3513	1.9475	100.7	-60226
Q3	1.8484	2.2582	1.8455	108.5	-80379
Q4	1.8094	2.3409	1.8124	107.0	-20075
2005	1.8126	2.2601	1.8154	110.3	-42919
Q1	1.8272	2.3995	1.8302	103.6	10600
Q2	1.8250	2.3032	1.8276	104.1	-10885
Q3	1.8046	2.2039	1.8068	104.6	-24652
Q4	1.7936	2.1338	1.7960	110.2	-17982
2006					
Q1	1.8148	2.1810	1.8131	105.5	11323

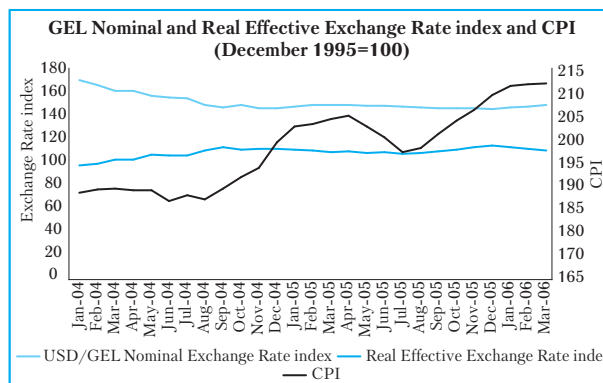
Source: NBG and GEPLAC calculations

In the accounting period the domestic currency market conjuncture was determined by stable high world prices on oil and increased imports of energy resources due to an energy crisis, on the one hand, and on the other, by a seasonal low demand on the Lari at the beginning of this period. The demand on foreign currency became apparent on the market. In order to avoid a sharp fluctuation of the Lari nominal exchange rate, the NBG continued with its bilateral interventions at the TICEX. However, this time the total foreign currency sold by NBG far exceeded the amount of purchased foreign currency.



Source: NBG

Net sales of foreign currency by NBG were relatively large-scale in January, when the national currency devaluated by almost 1 percent in nominal terms. In February and especially in March this trend slowed and the pressure on the exchange rate abated. Overall, in Q1, 2006, the nominal average monthly devaluation comprised 1.2 percent, which is slightly higher than the corresponding indicator for Q1, 2005.



Source: NBG

The real effective Lari exchange rate index decreased by 4.3 percent in the reviewed period compared to the previous quarter, reflecting a moderate devaluation in the Lari nominal exchange rate as well as a moderate inflation rate in Georgia compared to its partner countries. In annual terms, compared to Q1, 2005, the real exchange rate significantly strengthened. It is true that a year before the real exchange rate showed a quarterly decrease, but the process reversed in the following quarter.

4. LABOUR MARKET AND HOUSEHOLD BUDGETS

Table 17: Population and Employment (thousand persons)

	Total population over 15 years old	Economically active population *		Employed					Total employment rate (%)
		Total	Labour force participation rate (%) *	Total	Hired	Self-employed	Employment rate among people of working age (%)	Employment rate among people older than working age (%)	
2000	3 148.1	2 051.6	65.2	1 839.3	684.3	1 043.9	79.2	20.8	58.4
2001	3 191.1	2 113.3	66.2	1 877.7	654.6	1 135.9	80.2	22.0	58.8
2002	3 239.5	2 104.2	65.0	1 839.2	650.9	1 184.9	80.0	20.1	56.8
2003	3 104.9	2 050.8	66.1	1 814.9	618.5	1 195.2	79.8	18.9	58.5
2004	3 151.1	2 041.0	64.8	1 783.3	600.9	1 180.8	77.9	19.2	56.6
Q1	3 142.6	2 006.7	63.9	1 746.4	619.8	1 125.4	83.4	20.6	55.6
Q2	3 121.7	2 053.9	65.8	1 809.0	608.1	1 200.6	87.1	20.7	57.9
Q3	3 180.9	2 093.1	65.8	1 819.2	577.5	1 239.3	86.2	22.1	57.2
Q4	3 159.3	2 010.2	63.6	1 758.6	598.1	1 158.1	84.2	20.5	55.7
2005	3 162.3	2 023.9	64.0	1 744.6	600.5	1 143.3	82.0	18.8	55.2
Q1	3 177.9	1 999.4	62.9	1 705.1	595.1	1 108.7	80.3	19.7	53.7
Q2	3 148.7	2 035.5	64.6	1 763.2	604.5	1 158.0	82.9	17.1	56.0
Q3	3 131.5	2 011.8	64.2	1 744.9	587.4	1 156.7	81.2	18.8	55.7
Q4	3 191.1	2 048.8	64.2	1 765.1	614.8	1 149.9	83.9	19.4	55.3

Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development
Note: * ILO "strict" methodology

In Q4 2005, the labour market started showing certain signs of revival, though unemployment and under-employment is still widespread among the working age population. As the labour force participation rate starts growing, if even insignificantly, there is hope that more people will be engaged in actively in seeking work, and therefore, unemployment should reduce. Hired employment is on the rise, while self-employment has shrunk, though, it still dominates total employment. Subsistence self-employment in agriculture and unofficial, unregistered and low-paying non-agricultural activities still remain the chief components of self-employment. The share of the population of the working age that were in waged or salaried employment was about 19 percent. Being employed does not, however, always save workers and their families from hardship. While, the average nominal monthly salary across the economy rose in H2 2005, many salaries remain quite modest. The labour force participation rate grew, as did the unemployment rate.

During the period under consideration, the labour force participation rate grew by 0.6 percentage points in annual terms. Though it might be premature to talk about a reversal in the downward trend, the rise in the labour force participation rate is a positive sign in itself. The labour force participation rate, as a deviation from a regular trend, where in Q4 it is usually lower than in Q3, remained unchanged in quarterly terms. The participation rate is relatively high in Georgia and suggests that the extremely hard household income situation urges those outside the labour force to seek employment again. Therefore, the labour force should be growing, as re-entrants join the ranks of active job seekers.

The size of hired employment remained virtually unchanged on average in 2005, compared to 2004. This is another positive sign after it shrank in 2004 compared to 2003. In Q4 2005, hired employment grew in annual terms continuing the annual growth trend of Q3, after having decreased in the first two quarters of the year. This gives grounds for assuming that more jobs are being created (primarily in the private sector) to offset, if only to a certain extent, the massive job cuts that took place in the public sector since late 2003. The stability of the jobs that are being created depends largely on the overall developments in the economy. It also grew in quarterly terms in Q4 2005, however, this was in line with seasonal trends.

The share of hired employment in total employment also grew during the period under consideration in annual terms, as total employment figures grew and self-employment showed signs of decline. Although it was just a 1.1 percentage points growth, it suggests that positive developments are likely to be underway, and, hopefully on-going, that would support further job-creation to give more possibilities for those that either lost their job or fell out of self-employment.

Self-employment annual average figures have been on a downward trend since 2003. In quarterly terms it has been fluctuating, which was preconditioned by seasonal changes. In Q4 2005, self-employment decreased both in quarterly terms, reflecting usual seasonal patterns, and in annual terms, following the above-mentioned trend. The annual decrease in the share of self-employment in total employment was 0.7 percentage points this time, whereas the decrease against 2003 was 3.6 percentage points.

In Q4 2005 self-employment accounted for 65.2 percent of total employment and 56.1 percent of the labour force. Although self-employment has been shrinking for several years, it still dominates total employment, however, its share in the labour force has decreased considerably.

Table 18: Unemployment (thousand persons)

	Total population over 15 years old	Unemployment *		Unemployment rate (%) *		Non-active population of 15-70 years old *		
		Total	Unemployment Rate (%) *	Among people of working age **	Among people older than working age **	Total	Employed in household	"Discouraged" workers
2000	3148.1	212.2	10.3	12.2	2.6	898.8	265.0	117.7
2001	3191.1	235.6	11.1	13.4	1.8	872.4	250.5	116.3
2002	3239.5	265.0	12.6	14.9	2.2	910.0	280.2	70.4
2003	3104.9	235.9	11.5	13.4	2.3	847.1	257.3	61.9
2004	3151.1	257.6	12.6	14.9	1.8	895.4	257.1	62.9
Q1	3142.6	260.2	13.0	15.3	1.8	923.2	268.5	82.1
Q2	3121.7	244.9	11.9	14.0	1.7	861.5	242.2	52.6
Q3	3180.9	273.8	13.1	15.5	2.2	868.9	254.2	53.2
Q4	3159.3	251.6	12.5	14.8	1.6	927.9	263.3	63.6
2005	3162.3	279.3	13.8	16.3	0.9	913.6	248.5	56.0
Q1	3177.9	294.3	14.7	17.3	2.3	941.5	258.8	72.1
Q2	3148.7	272.3	13.4	15.9	1.3	902.5	241.0	55.4
Q3	3131.5	266.9	13.3	15.7	0.8	911.7	244.9	41.9
Q4	3191.1	283.7	13.8	16.1	2.7	898.6	249.4	54.7

Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

Note: * ILO "strict" methodology

** Working age is given as 15-60 for women and 15-65 for men

While the labour force participation rate was falling until Q4 2005, the unemployment rate has been growing for several years. The national unemployment rate calculated by the ILO "strict" methodology grew in Q4 2005 by 1.3 percentage points in annual terms and by 3.1 percentage points compared to two years ago. It also grew in quarterly terms by 0.5 percentage points. According to the generally established pattern, the rural unemployment rate of 4.4 percent was in no way comparable to the urban one of 27.2 percent, which distorts the national unemployment rate figures. The highest unemployment rate was, as usual, in Tbilisi, 30.4 percent this time.

Table 19: Wages (GEL)

	Average monthly wages and salaries			Average nominal monthly wages and salaries share in minimum subsistence		Nominal monthly wages and salaries		Wage arrears (GEL thousand)
	Nominal	Real		of a working man (%)	of a family of four (%)	Public sector including Budgetary organisations	Private sector	
		Absolute terms*	1997=100 (%)					
2000	72.5	56.5	119.3	62.9	35.9	54.0	106.1	
2001	82.6	61.4	129.7	70.0	39.9	63.0	120.6	50524.7
2002	99.1	69.8	146.8	79.0	45.0	77.6	139.4	38074.9
2003	101.5	68.3	143.4	77.7	44.3	79.3	145.8	43298.1
2004	116.4	60.8	156.0	84.9	48.4	93.7	160.0	23032.7
Q1	109.5	69.3	170.6	80.6	45.9	86.6	159.8	
Q2	112.8	72.8	161.1	84.1	47.9	88.9	155.9	
Q3	121.8	77.6	155.1	91.1	51.9	98.9	165.7	
Q4	121.6	76.7	140.9	84.0	48.3	101.3	158.4	
2005	149.3	87.9	184.9	98.0	56.1	130.9	184.0	
Q1	128.0	74.1	182.4	84.2	47.9	108.3	162.9	
Q2	146.1	86.2	190.7	96.5	55.0	124.0	182.4	
Q3	156.4	93.2	186.2	102.4	58.9	142.9	184.8	
Q4	166.7	98.0	180.2	109.1	62.7	148.3	206.1	

Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

Note: * Nominal Wages deflated by CPI

The average monthly nominal salary of hired employees across the economy grew substantially in H2 2005. The average monthly salary in absolute terms grew accordingly as well. Though salaries in the public sector are still substantially lower than those in the private sector, the growth rate of the former has been much higher than that of the latter, during the last year. If in Q4 2005, the average nominal monthly salary in the public sector grew by 46.4 percent, compared to a year ago, in the private sector it grew by 30.1 percent only.

The increase in salaries and wages found its reflection in the growing share of salaries in minimum subsistence. In Q4 2005, the share of the average monthly salary in the minimum subsistence of a family of four grew compared to a year ago by 14.4 percentage points and in the minimum subsistence of a working man – by 25.1 percentage points. In Q3 and Q4 2005, the average monthly salary surpassed the minimum subsistence for a working man by 2.4 and 9.1 percentage points accordingly – an unprecedented case. Therefore, while the salaries of both public sector employees and the majority of private sector employees remained predominantly way below the subsistence minimum for a family of four¹, the salaries and wages of private sector employees exceeded the subsistence minimum for both a working man and an average consumer in Q3 and Q4 2005. This is significant as quite often those salaries are the major if not the only source of income for many households, as many households have only one breadwinner.

It should be mentioned, however, that while these comparisons are based on the minimum subsistence levels calculated by the Department for Statistics (DS) based on the methodology that has been applied for a number of years, the DS started recently to calculate those levels using another methodology. The comparisons against the minimum subsistence levels that the DS is introducing are still to be made, as the adjusted data series become available from the DS.

During the period under consideration, 75.1 percent of all public sector workers (52.3 percent of all hired workers) - budgetary organisations² employees – were earning salaries of GEL 141 per month on average. Salaries of another 17.3 percent of hired workers, represented by employees of public enterprises and organisations, were on average GEL 176.4 per month in Q4 2005. Private sector employees, accounting for over 25.6 percent of all hired workers in Q4 2005, were getting an average monthly remuneration of GEL 174.5. Workers of foreign organisations or joint ventures comprising 4.8 percent of those engaged in hired labour were paid an average monthly salary of GEL 397.7.

H2 2005 saw an increase in average monthly salaries and wages across the economy. Salaries increased not only in nominal but also in real terms. The most likely reason for the increase in the remuneration for hired labour is staff cuts of civil servants and substantial rises in public sector wages, though private sector salaries also grew in H2 2005. Raising salaries of senior government officials was meant to make such posts attractive for highly professional bureaucrats on the one hand and to contribute to reduce corruption on the other. The salaries of many lower ranked bureaucrats went up, however, the majority of civil servants and public sector employees' salaries are still quite low, therefore, obliging them to seek alternative activities to support the family. (The minimum remuneration of civil servants was fixed at GEL 115 starting from January 2005). Wages and salaries remain the primary source of income for urban households, for whom any source of household income still remains largely unstable. The average monthly nominal salary accounted for 54.6 percent in the total monetary household income and for 44.2 percent in the total household income in Q4 2005.

Table 20: Monthly Household Monetary Income (GEL)

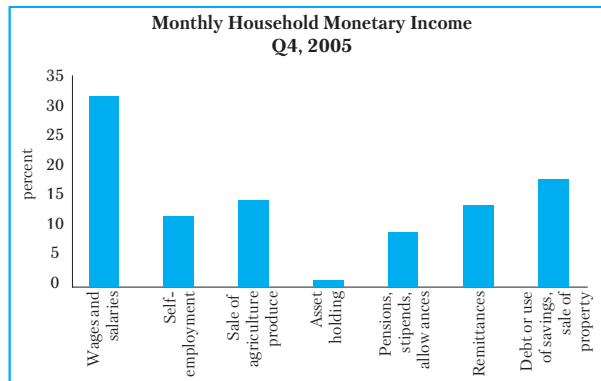
	Nominal									Real income (1997=100)	Monetary income per capita	Real monthly monetary income per capita (1997=100)
	Wages and salaries	Self-employment	Income from sale of agricultural produce	Income from asset holdings	Pension, stipends, family allowances, benefits	Remittances	Debt or use of savings, sale of property	Total monetary income	Wages (% of total income)			
2000	43.9	21.6	20.9	1.3	8.5	11.9	26.9	135.0	32.5	105.2	36.0	28.0
2001	52.7	24.3	21.4	1.6	12.3	18.1	18.6	149.0	35.4	110.9	38.8	28.9
2002	57.5	28.9	28.9	1.0	12.2	23.6	44.4	196.5	29.3	138.5	52.7	37.1
2003	60.4	32.2	30.8	1.6	8.3	38.6	41.7	213.7	28.3	143.7	57.0	38.3
2004	67.4	36.6	34.3	2.3	15.6	34.1	42.7	232.9	28.9	132.1	61.6	35.2
Q1	62.0	33.5	36.5	2.3	8.0	31.3	40.6	214.1	29.0	135.6	56.9	36.0
Q2	65.6	34.9	30.5	2.3	15.6	31.4	46.0	226.2	29.0	146.1	60.1	38.8
Q3	72.4	37.0	30.6	2.0	19.6	35.0	42.5	239.2	30.3	152.3	62.9	40.1
Q4	69.5	41.0	39.5	2.7	19.4	38.6	41.8	252.5	27.5	159.2	66.3	41.8
2005	87.5	39.5	32.1	3.3	25.6	36.6	43.1	267.6	29.7	157.4	71.3	34.4
Q1	73.9	41.1	31.1	3.6	22.2	34.7	40.5	247.0	29.9	143.0	65.0	37.6
Q2	87.3	41.5	24.5	3.1	26.8	32.7	36.9	252.7	34.6	149.1	67.2	39.6
Q3	90.6	39.7	28.6	3.1	25.5	37.5	40.2	265.2	28.1	157.9	70.8	42.2
Q4	98.0	35.7	44.2	3.4	27.8	41.4	54.9	305.4	26.0	179.5	82.0	48.2

Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

¹ An average household in Georgia consists of four members.

² A budgetary organisation is a public organisation fully financed by the state budget.

The average monthly household income nationally was GEL 377.5 in Q4 2005. A very important role in the budgets of many Georgian households belongs to non-monetary income - 19.1 percent of the total monthly household income in Q4 2005. Non-monetary income is especially important for rural households, where its share in the total household income is usually nearly three times as high as that for urban households. At the same time, the non-monetary income share in total household incomes in Tbilisi, compared to the national proportion, is usually close to marginal.



Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

During the reporting period, salaries and wages accounted for the largest share in total monetary household income – 32 percent, an annual increase and a decrease compared to the previous quarter. The second largest item in the total monetary income - 18 percent – was debt, use of savings and sale of property. Its share in total income increased in both in annual and quarterly terms. The next biggest share in the total monetary household income belonged this time to monetary income from the sale of agricultural produce and equalled 14.5 percent. This was a smaller share than a year before and much higher compared to the previous quarter. This was no surprise taking into consideration the seasonal effect, especially at the end of the year and the special susceptibility of this household income item to this effect. Assistance from relatives and friends and their remittances from outside Georgia accounted for 13.6 percent of total monetary household income, however, though it moved up on the list, this happened because certain other items' shares reduced. This item showed both an annual and quarterly decrease. In the situation where the majority of monetary household income items are quite unstable, this one traditionally represents an important source of income. Another source of monetary income, though having moved down on the list, still had a substantial impact on the total household income was income from self-employment at 11.9 percent. However, it was smaller in both annual and quarterly terms. Pensions, stipends and allowances accounted for 9.1 percent in total monetary household income. The share of this item in total monetary income increased in annual terms and shrank compared to the previous quarter. The overall pattern of household income structure always reflects seasonal peculiarities, although, certain items are more driven by the seasonal factor than others. Therefore, annual changes are much more instrumental in tracing trends than quarterly ones.

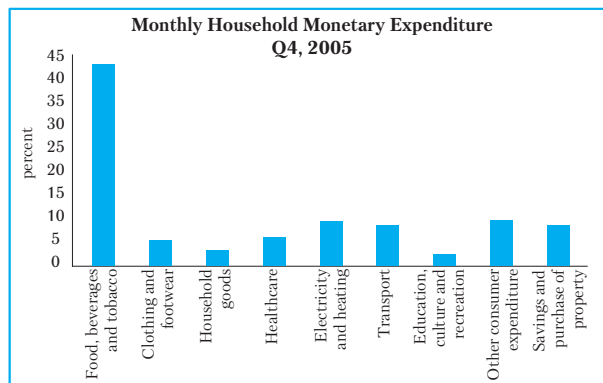
Table 21: Monthly Household Monetary Expenditure (GEL)

	Total Monetary Expenditures *	Consumer expenditure (purchase of goods and services)	Food, beverages, tobacco	Clothing and footwear	Household goods	Health care	Electricity and heating	Transport	Education, culture and recreation	Other consumer expenditure	Savings and purchase of property	% of monetary income		Real consumption 1997=100
												Purchase of goods and services	Total savings	
2000	217.0	197.0	100.9	12.7	27.1	10.2	15.8	13.6	7.0	9.7	20.0	88.4	8.9	173.7
2001	222.6	201.8	106.7	12.2	25.6	11.5	17.1	12.4	7.3	9.2	20.6	88.1	9.0	170.4
2002	240.0	216.7	113.0	12.4	7.6	15.7	20.0	25.7	13.3	9.1	23.2	81.2	8.7	188.0
2003	245.9	219.8	116.8	13.3	7.6	13.8	20.0	22.2	6.2	19.9	26.1	81.6	9.7	181.3
2004	268.2	245.7	131.6	14.5	9.1	15.3	21.8	23.5	6.6	23.1	22.7	84.2	7.8	185.6
Q1	261.6	233.0	124.4	14.0	10.1	14.5	22.0	20.9	6.8	20.3	28.6	82.7	10.1	178.3
Q2	256.3	232.8	128.0	12.5	8.8	15.1	18.0	22.4	7.7	20.4	23.4	82.0	8.3	183.3
Q3	257.1	238.1	131.4	12.4	8.0	16.0	18.1	24.3	4.6	23.2	19.1	84.4	6.8	179.7
Q4	298.6	278.9	142.8	19.2	9.7	15.8	29.2	26.4	7.3	28.6	19.6	87.4	6.1	201.2
2005	287.0	265.5	133.9	14.9	9.8	19.5	26.1	27.0	7.9	26.5	21.5	87.5	4.5	178.5
Q1	279.5	261.1	131.7	15.0	10.2	18.4	27.1	26.5	8.6	23.5	18.5	89.1	4.3	169.6
Q2	273.7	257.4	132.0	12.9	8.7	20.3	22.9	27.3	9.0	24.2	16.4	88.4	3.9	171.9
Q3	272.2	250.0	128.6	13.3	9.2	18.8	22.7	25.5	5.8	26.1	22.2	85.5	4.4	174.2
Q4	322.3	293.3	143.3	18.2	10.9	20.3	31.7	28.6	8.1	32.2	29.0	87.0	5.4	198.1

Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

Note: *Total expenditures in this table do not include agricultural expenditures and transfers

82.4 percent of average monthly household expenditure was accounted for by monetary expenditure in Q4 2005. The share of monetary consumer expenditure, i.e., money spent for the purchase of goods and services equalled 91 percent of total monetary expenditure, and was smaller than a year before. However, it showed an insignificant decrease compared to the previous quarter. In line with the general pattern, spending on food, beverages and tobacco represented the biggest item in consumer household expenditure – 48.9 percent of total household monetary expenditure. Its share in total monetary expenditure was higher both a year before and in the previous quarter.



Source: Integrated Household Survey, Department for Statistics, Ministry of Economic Development

Among the remaining household monetary expenditure items the largest one - 9.8 percent – was represented by money paid for electricity and gas (this item grew in quarterly terms, while remaining unchanged in annual terms). The next largest share in household monetary expenditure was accounted for by total savings and purchase of property taken together - 9 percent – it grew in both quarterly and annual terms. (The share of this item in total household expenditure was 7 percent). Another 8.9 percent of household monetary expenditure belonged to spending on transportation, and its share appeared smaller than in the previous quarter, and unchanged compared to the year before. Payments for healthcare services and purchase of medicines accounted for 6.3 percent of households’ spending (an annual increase and quarterly decrease).

5. EXTERNAL SECTOR

Table 22: Main components of external economic relations (million USD)

	Trade balance of goods and services	Current account balance	Current account balance (GDP %)	Net foreign direct investments	Portfolio investments	Change in gross international reserves	International reserves by import months	Total Foreign debt (GDP %)
2000	-533.7	-161.2	-5.3	131.7	2.7	-23.3	1.4	50.9
2001	-479.6	-211.4	-6.9	109.9	2.0	50.2	1.8	50.0
2002	-447.5	-197.6	-5.8	163.3	0.0	38.5	2.3	51.5
2003	-582.0	-369.5	-9.3	336.3	0.0	-6.7	1.6	46.3
2004	-858.6	-346.9	-6.8	489.5	-13.1	192.0	2.3	34.2
Q1	-181.7	-100.5	-10.2	117.5	0.0	20.0	1.3	38.6
Q2	-159.3	-58.5	-4.7	117.1	0.0	63.2	1.6	36.2
Q3	-238.8	-98.3	-7.1	131.3	0.0	90.1	2.2	33.9
Q4	-278.7	-89.6	-5.8	123.6	-13.1	18.7	2.3	34.2
2005	-1143.5*	-692.9*	-10.8	539.3*	15.5	91.4*	2.1	26.8*
Q1	-195.9	-117.8	-8.9	86.7	5.6	-2.1	1.7	28.9
Q2	-216.1	-134.0	-8.7	198.1	2.9	56.6	2.0	27.5
Q3	-321.6	-181.8	-10.7	75.6	7.0	9.6	2.0	27.3
Q4	-409.9	-259.3	-14.1	178.9	0.0	27.3	2.1	26.8
2006								
Q1	-318.9	-193.5	-12.8	133.8	0.0	5.5	2.0	27.1

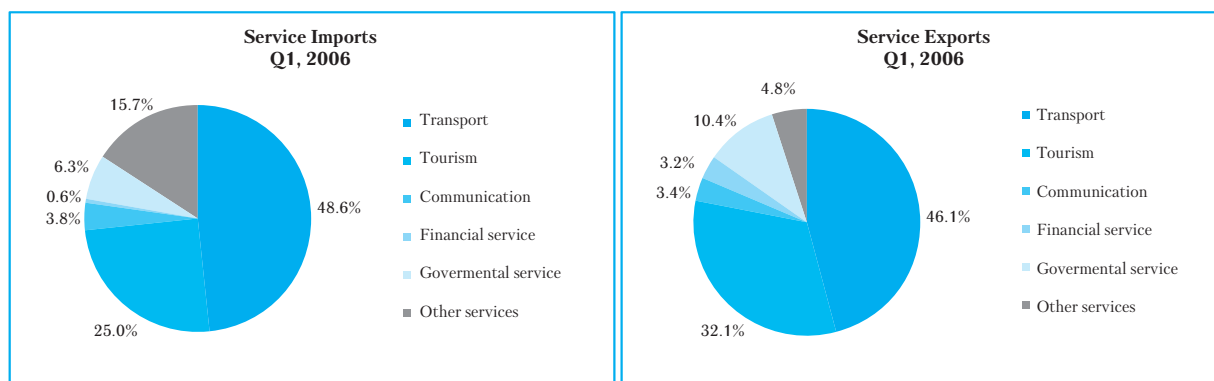
Source: Department for Statistics, Ministry of Economic Development

Note: * verified data

The current account deficit in Q1, 2006 almost doubled compared to the corresponding period in 2005. Estimates suggest that imports increased by 46 percent, whereas export growth somewhat slowed down and comprised 32 percent. As a result, the trade balance of goods deteriorated by 7 percentage points. Despite the 63 percent improvement in the balance of service, revenues and transfers, the merchandise trade component proved to be decisive for a total current account balance. The role of grants was also very important, showing a 74 percent increase.

According to data reflected in the Balance of Payments, the import growth rate was high yet again in the accounting period, reflecting a significant growth in domestic demand. As a result, imports, compared to the same period last year, increased by 10.4 percentage points of GDP and comprised USD 726 million. At the same time, exports grew by 3.4 percentage points, reaching USD 376.6 million. Apart from raw materials, the country's export potential was mainly realized through wine and hazelnut production. Twenty percent of exports went to Russian market. Therefore, high economic growth rates of Russia's economy was stimulating its external demand, having a positive impact on the sales of Georgian products.

Although the service sphere is seasonally less active at the beginning of the year, it showed quite a high growth rate in Q1, 2006 compared to the same period in the previous year. Service revenues from exports were up by 32.7 percent. Passenger and cargo transportation, and tourism, grew, respectively, by 31 and 48 percent. Meanwhile, the use of foreign services by Georgia enhanced. In total, service turnover increased by 79 percent, while its balance was USD 13.5 million.



Source: Department for Statistics, Ministry of Economic Development

In the reporting period, the total turnover of goods and services in Georgia increased by 38 percent, whereas the total balance went down by 63 percent, which is 21.2 percent of GDP.

In Q1, 2006, the income account improved by USD 6.4 million (28.2 percent), again due to remittances received from Georgian residents abroad or other external sources. The revenue balance, therefore, made up USD 29 million. As foreign investment inflows increased, the out flow of interests accrued on them also went up, although it did not have a significant adverse effect on the income balance. Net government grants¹ almost tripled in the reviewed period as compared with last year's same period and reached USD 20 million. Workers' remittances also grew by 57 percent. As a result, the income balance improved by 73.4 percent, comprising USD 96.2 million in the first quarter of 2006.

Current and financial accounts imbalance was smoothed by foreign direct investments, which made up USD 133.8 million in the reporting period. 31.4 percent of them were through the sale of cell communication frequency (USD 40 million) and a number of other state assets, while 27 percent was invested in private enterprises. Investments in the Shah Deniz gas pipeline construction continued. They are of a seasonal nature and therefore less active during the winter. There was significant foreign direct investment (USD 12.3 million) in the banking sector, reflecting increasing capacity in the sector. At the same time, the banking system took long-term loans from foreign sources, which in Q1, 2006 made up USD 160 million, exceeding even the annual indicator of the previous year. At the same time, USD 78 million of loans paid back partially offset that amount. Finally, the capital and financial account balance made up USD 199.3 million. As a result, reserve assets increased by USD 28.5 million.

Table 23: Imports structure by commodity groups

	Total imports		Oil products		Motor cars		Natural gas		Medication		Wheat and meslin		Sugar		Electricity		Other	
	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%
2000	709.4	100	71.8	10.1	15.5	2.2	50.3	7.1	45.8	6.5	29.2	4.1	25.4	3.6	14.5	2.0	457.0	64.4
2001	753.2	100	87.7	11.6	13.1	1.7	48.8	6.5	53.6	7.1	14.4	1.9	24.1	3.2	15.6	2.1	495.8	65.8
2002	795.6	100	88.9	11.2	21.9	2.8	52.4	6.6	62.0	7.8	20.1	2.5	34.7	4.4	17.7	2.2	498.0	62.6
2003	1141.2	100	104.8	9.2	46.5	4.1	66.0	5.8	62.9	5.5	28.0	2.4	53.0	4.6	26.4	2.3	753.6	66.0
2004	1847.9	100	186.3	10.1	116.3	6.3	80.1	4.3	78.0	4.2	75.0	4.1	50.8	2.8	32.3	1.7	1229.1	66.5
Q1	328.7	100	28.3	8.6	18.1	5.5	26.0	7.9	17.3	5.3	10.5	3.2	6.2	1.9	17.1	5.2	205.1	62.4
Q2	438.5	100	41.1	9.4	21.1	4.8	14.4	3.3	17.9	4.1	20.2	4.6	16.5	3.8	4.7	1.1	302.5	69.0
Q3	490.0	100	56.9	11.6	30.4	6.2	12.2	2.5	15.3	3.1	27.9	5.7	13.3	2.7	0.3	0.1	333.7	68.1
Q4	590.7	100	60.0	10.2	46.7	7.9	27.5	4.7	27.4	4.6	16.4	2.8	14.7	2.5	10.2	1.7	387.8	65.7
2005	2490.9	100	336.3	13.5	178.5	7.2	90.8	3.6	92.5	3.7	45.1	1.8	78.2	3.1	40.1	1.6	1629.2	65.4
Q1	454.5	100	56.8	12.5	28.6	6.3	28.4	6.2	23.3	5.1	8.2	1.8	16.7	3.7	17.5	3.8	275.0	60.5
Q2	527.3	100	74.0	14.0	36.5	6.9	19.2	3.6	28.0	5.3	9.9	1.9	13.1	2.5	3.4	0.6	343.3	65.1
Q3	687.6	100	104.1	15.1	48.1	7.0	14.4	2.1	18.4	2.7	12.3	1.8	19.6	2.9	1.6	0.2	469.2	68.2
Q4	821.4	100	101.4	12.3	65.3	7.9	28.9	3.5	22.8	2.8	14.8	1.8	28.7	3.5	17.7	2.2	541.8	66.0
2006																		
Q1	682.4	100	80.8	11.8	65.5	9.6	56.8	8.3	25.4	3.7	16.9	2.5	11.0	1.6	10.9	1.6	415.1	60.8

Source: Department for Statistics, Ministry of Economic Development

According to initial foreign trade data, the trade balance of Georgia deteriorated almost two times in Q1, 2006 compared to last year's same period, which was mainly determined by a sharp, 50 percent, increase in the value of imports. This was still partially determined by increasing world oil prices, although the increase in imports was also largely stimulated by a significant growth of economic activity and domestic demand.

Compared to Q1, 2005, there was an increase of 42.2 percent in oil and oil product imports in the reporting period. Despite a 0.7 percentage point decrease of its share in imports overall, this commodity remained the largest import category. Moreover, oil and oil product imports were 5 and 3 times higher than the corresponding quarterly indicators in 2003 and 2004 respectively. This is a reflection of this sector moving towards further legalization and correspondingly shows a reduction in smuggling. The rise in demand for oil products was also caused by the interruption in the supply of natural gas from Russia in January 2006. The main suppliers remained Azerbaijan and Turkmenistan in the accounting period with a 70 percent share.

¹ The grants received by the Georgian government minus taxes paid from revenues received abroad by Georgian residents. The latter is derived by expert assessment.

The value of car imports more than doubled, which can be explained by a rise in unit costs, supported by significant growth in the volume and availability of consumer loans issued by banks.

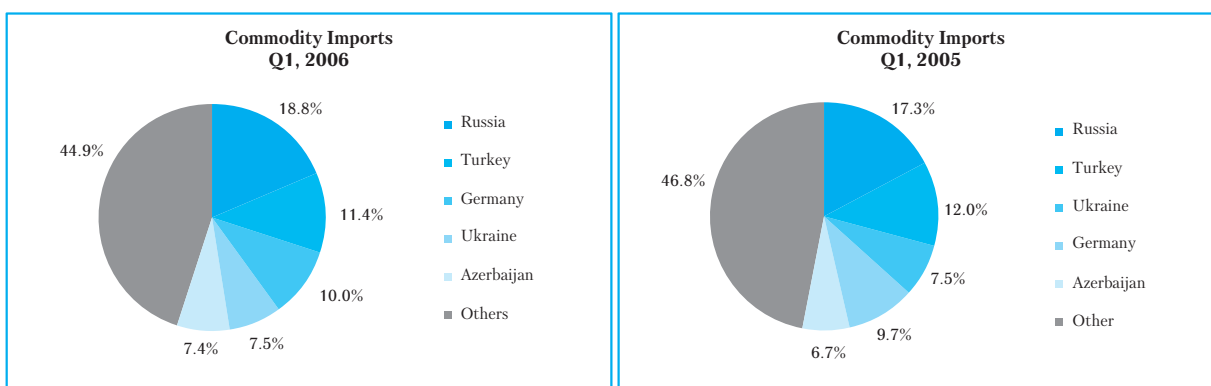
Although, as mentioned above, the first quarter of 2006 saw a disruption in natural gas supply from Russia, the almost doubling of natural gas prices in the same period increased the import value indicator. Due to the January crisis, Georgian purchased USD 2.4 million worth of Azeri and USD 585 thousand worth of Iranian gas.

Compared to the previous year, the import of wheat, which is mainly imported from Russia, increased sharply (2 times). Legalization is among the reasons for this increase.

The supply of sugar from main importer countries – Brazil and Britain was partially replaced by Swiss sugar. The import of sugar saw a 34.1 percent annual drop and its share in total imports decreased from last year’s 3.7 percent to 1.6 percent. This can be partially explained by a decrease in demand due to a sharp rise in world, and consequently, domestic prices on sugar.

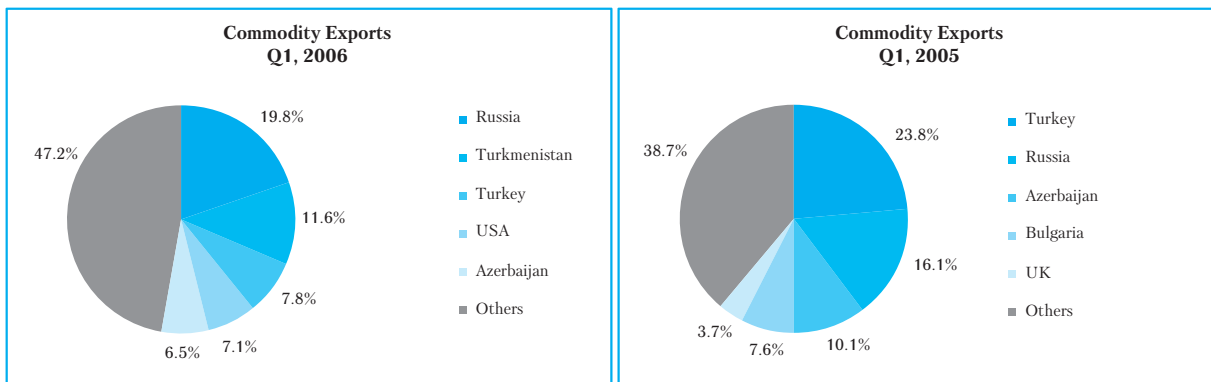
In Q1, 2006 the energy imports from abroad was dropped significantly - by 37.7 percent mainly due to accident on the trunk gas pipeline and disruptions in energy supply.

The share of top five trade partners in Q1, 2006 grew from 53 to 55 percent. The share of imports from Russia increased by 64 percent (USD 50 million) and from Azerbaijan by 65 percent (USD 20 million). Import inflows from Germany and Bulgaria more than doubled. At the same time, the diversification of imports by countries hardly occurred - compared to the same period last year the number of countries increased only by one, totalling 95.



Source: Department for Statistics, Ministry of Economic Development

According to initial foreign trade data, commodity exports growth significantly lagged behind (29.8 percent) import growth, which became the cause of a sharp deterioration in the trade balance.



Source: Department for Statistics, Ministry of Economic Development

The structure of export commodities somewhat changed, while its focus narrowed to some extent. Whereas in Q1, 2005 the total export of 7 main commodity categories comprised 53.3 percent, in Q1, 2006 the export of the same number of commodity categories comprised just 49.5 percent. This caused a decrease in the share of some large commodity groups in total exports. Such commodity groups were ferrous alloy and black metal scrap. The demand on scrap, mainly accounting for Turkey, gradually decreased throughout 2005. Therefore, the amount of scrap exported to Turkey in the accounting period decreased more than three times compared to the corresponding period last year due to a gradual depletion of this resource. The ferrous alloy market enhanced significantly and its largest consumer in the accounting period appeared to be the USA instead of Russia, although Russia was the second largest market for this commodity.

Table 24: Exports structure by commodity groups

	Total exports		Natural grape wine		Ferroalloy		Walnut fresh or dried, other		Flying apparatus		Black metal scrap		Mineral waters		Unprocessed gold		Other	
	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%
2000	322.8	100	29.0	9.0	13.6	4.2	19.3	6.0	7.1	2.2	39.0	12.1	9.4	2.9	-	0.0	205.3	63.6
2001	317.6	100	32.3	10.2	17.6	5.5	9.8	3.1	35.7	11.2	33.1	10.4	11.7	3.7	12.5	3.9	165.0	52.0
2002	345.9	100	33.2	9.6	15.5	4.5	6.8	2.0	41.1	11.9	36.5	10.5	17.3	5.0	28.6	8.3	167.0	48.3
2003	461.4	100	42.6	9.2	26.1	5.7	12.6	2.7	28.1	6.1	60.1	13.0	19.7	4.3	20.3	4.4	252.0	54.6
2004	647.0	100	48.7	7.5	42.5	6.6	17.7	2.7	84.0	13.0	95.9	14.8	19.3	3.0	18.8	2.9	319.9	49.5
Q1	95.5	100	8.2	8.6	10.1	10.6	0.5	0.5	-	0.0	18.4	19.2	1.7	1.8	-	0.0	56.5	59.2
Q2	199.8	100	12.7	6.3	11.7	5.9	0.2	0.1	46.2	23.1	22.6	11.3	5.3	2.6	10.5	5.2	90.6	45.4
Q3	157.9	100	13.2	8.4	6.9	4.3	5.4	3.4	20.6	13.0	21.5	13.6	5.5	3.5	4.7	3.0	80.1	50.7
Q4	193.8	100	14.6	7.5	13.8	7.1	11.5	5.9	17.3	8.9	33.4	17.3	6.8	3.5	3.6	1.9	92.7	47.8
2005	866.2	100	81.3	9.4	30.2	9.3	70.3	8.1	69.4	8.0	84.2	9.7	32.5	3.7	34.7	4.0	413.6	47.7
Q1	170.3	100	13.2	7.8	21.4	12.6	8.0	4.7	8.4	5.0	28.0	16.5	5.3	3.1	6.3	3.7	79.6	46.7
Q2	202.7	100	18.6	9.2	16.5	8.1	4.4	2.2	28.2	13.9	24.5	12.1	9.2	4.5	9.6	4.8	91.7	45.2
Q3	225.1	100	23.1	10.3	20.3	9.0	19.8	8.8	2.4	1.1	19.2	8.5	9.2	4.1	9.6	4.3	121.4	54.0
Q4	268.1	100	26.4	9.8	22.0	8.2	38.0	14.2	30.3	11.3	12.5	4.7	8.9	3.3	9.3	3.5	120.8	45.1
2006																		
Q1	221.0	100	21.5	9.7	19.6	8.9	17.0	7.7	15.5	7.0	13.5	6.1	11.2	5.0	11.1	5.0	111.6	50.5

Source: Department for Statistics, Ministry of Economic Development

Natural grape wine exports moved up to the first position. It should be noted that at the end of the accounting period Georgian wine encountered obstacles on the Russian market, however, this did not have an immediate impact on the quarter indicator. The share of wine in total exports comprised 9.7 percent, which is almost 2 percentage point higher than the corresponding indicator of the previous year.

Given the seasonality of walnut exports, it halved in Q1, 2006 compared to the end of the previous year, however, compared to Q1, 2005 the share of walnuts in total exports increased by 2 percentage points and comprised 7.7 percent. It was, therefore, the third largest export commodity after wine and ferrous alloy. Main consumers of walnut continued to be Italy, Russia and Germany.

The value of mineral waters exported to Russia doubled in the reviewed period compared to the previous year. Moreover, the export of this commodity to Ukraine increased significantly, which, from the export diversification standpoint, can be regarded as the beginning of a definitely positive trend and indicate to high competitiveness of Georgian waters.

Table 25: Georgia's foreign trade with CIS (million USD)

	Imports			Exports			Total balance		
	Total	CIS	Other countries	Total	CIS	Other countries	Total	CIS	Other countries
2000	709.2	229.3	479.9	322.6	128.3	194.3	-386.6	-101.0	-285.6
2001	753.0	253.9	499.2	317.6	144.3	173.3	-435.4	-109.6	-325.8
2002	795.5	292.3	503.2	345.9	168.7	177.2	-449.6	-123.6	-326.0
2003	1141.2	370.1	771.1	461.4	224.8	236.6	-679.8	-145.3	-534.5
2004	1847.9	657.2	1190.6	646.9	327.7	319.3	-1200.9	-329.5	-871.4
Q1	328.7	123.0	205.7	95.5	35.5	60.0	-233.2	-87.5	-145.7
Q2	438.5	142.3	296.2	199.8	119.8	80.0	-238.7	-22.4	-216.3
Q3	490.0	168.7	321.3	157.9	81.5	76.4	-332.1	-87.2	-244.9
Q4	590.7	223.3	367.4	193.8	90.9	102.9	-396.9	-132.4	-264.5
2005	2490.9	997.7	1493.2	866.7	408.4	458.4	-1624.2	-589.3	-1034.9
Q1	454.5	181.0	273.5	170.3	62.4	107.9	-284.2	-118.5	-165.6
Q2	527.3	210.3	317.0	202.7	110.1	92.6	-324.6	-100.3	-224.3
Q3	687.7	287.1	400.5	225.3	97.9	127.4	-462.3	-189.2	-273.1
Q4	821.5	319.3	502.2	268.4	138.0	130.4	-553.1	-181.3	-371.8
2006									
Q1	682.4	265.9	416.5	221.0	113.1	107.9	-461.3	-152.8	-308.6

Source: Department for Statistics, Ministry of Economic Development

As the table above indicates, the CIS remains the main market for the sale of Georgian products. The share of exports to CIS countries comprised 52 percent of total exports in the accounting period. The largest part of CIS exports went to Russia. It should be noted that the share of exports to Turkey in Q1, 2006, compared to Q1, 2005, went down from 24 percent to 8 percent, which is mainly due to a decrease in scrap metal exports. It is also noteworthy that the export geography enhanced to include six more countries compared to the previous year.

The commodity volume from the CIS in total imports decreased by 4-6 percentage point since 2005 and varied between 60 and 61 percents. Here, the main importer was Russia again, which, together with Ukraine and Azerbaijan, comprised 86 percent of commodities from CIS countries.

The government's debt in Q1, 2006 decreased by 7.4 million, though, during this period, the amount of debt in GEL increased by GEL 48 million due to a strong depreciation of the Lari against the dollar. Of this amount, as on 31 March 2006, the debt to 16 creditor countries under bilateral agreements made up USD 617.8 million, while to multilateral creditors – USD 1025.7 million. At the same time, a new loan of USD 17.4 million was received in the first quarter, 2006, of which USD 12.9 million was used for financing World Bank investment projects and the rest was mainly received as a result of bilateral agreement or restructuring. As regards payments, they comprised USD 38.1 million, exceeding Q1, 2005 payments by USD 12.7 million.

6. EU-GEORGIA ECONOMIC RELATIONS

Table 26: Main indicators of economic relations between EU and Georgia*

	Trade						DFI by EU countries	
	Turnover (thousand USD)	Exports (thousand USD)	Share in total exports (%)	Imports (thousand USD)	Share in total imports (%)	Balance (thousand USD)	Volume (thousand USD)	Share in Total FDI (%)
2000	264 559	76 389	24	188 170	22	-111781	39780	30
2001	302 451	61 605	19	240 846	34	-179241	69812	64
2002	295 474	63 220	18	232 254	29	-169034	58446	35
2003	512 749	81 590	18	431160	38	-349570	95823	28
2004	728 912	111 363	17	617549	33	-506185	195622	39
Q1	127 846	15 414	16	112 431	34	-97017		
Q2	199 630	31 543	16	168 087	38	-136544		
Q3	184 268	28 717	18	155 551	32	-126834		
Q4	217 168	35 689	18	181 479	31	-145790		
2005	836 655	165 270	19	671385	27	-506116	243 710**	54
Q1	155 123	32 483	19	122 640	27	-90157	38 673	43
Q2	175 994	23 956	12	152 038	29	-128082	44 246	42
Q3	233 099	52 247	23	180 852	26	-128605	49 841	66
Q4	272 439	56 584	21	215 855	26	-159271	110 949	62
2006								
Q1	209 292	34265	16	175 027	26	- 140 762	29 352	22

Source: Department for Statistics, Ministry of Economic Development

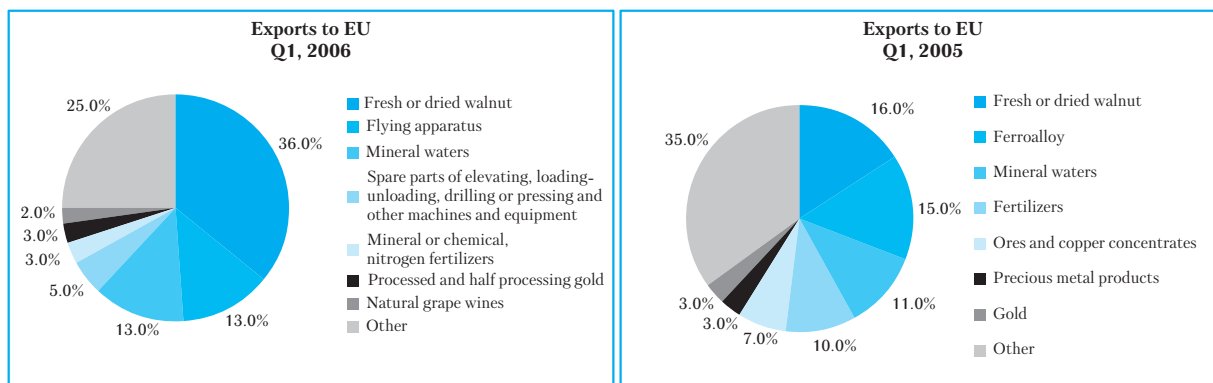
Note: *To avoid possible discrepancy, the data for all the periods include indicators of 25 current EU member states

** verified data

In Q1, 2006 the annual growth rate of imports from EU countries was higher than that of Georgia's exports to the same countries. Compared to the corresponding period in 2005, exports grew by 5.5 percent whereas imports increased by 42.7 percent. It is noteworthy that compared to Q4, 2005, the accounting period saw a drop both in exports to EU (39.4 percent) and imports from EU (19 percent), which can be explained by seasonal factors. As a result, the trade turnover decreased notably in quarterly terms and increased significantly in annual terms.

Georgia's largest export category to the EU in the accounting period, alike Q1 and Q4 2005, was walnuts, which more than doubled compared to Q1, 2005 reaching USD 12.3 million. However, it decreased three times compared to Q4, 2005, which can be explained by seasonal factors. The share of walnuts decreased in total exports as well.

Q1, 2006, compared to last year's same period, saw a notable increase in mineral water exports, worth USD 4.5 million. Accordingly, its share in total exports increased. Despite a sharp increase of this commodity share, the absolute indicator of imports did not change compared to Q4, 2005.



Source: Department for Statistics, Ministry of Economic Development

The reviewed period saw a drop in fertilizer exports both in annual and quarterly terms. Its share in total exports, consequently, decreased.

The export of gold tripled in Q1 2006 as compared with the first quarter of the previous year, though its percentage share in total exports remained unchanged.

The export of natural grape wines to EU countries also tripled in annual terms in the reporting period, however, in quarterly terms it fell 1.5 times. As regards its share in total exports, it increased in the accounting period compared to Q1, 2005, but remained unchanged compared to the previous quarter.

In Q1, 2006, copper ore exports decreased as many as 7 times compared to the same period in 2005.

The export of aircraft to the EU happened for the first time in the accounting period.

Table 27: Exports from Georgia to EU countries (thousand USD)

	2005				2006
	Q 1	Q 2	Q 3	Q 4	Q 1
Total exports to EU	32 483	23 956	52 247	56 584	34 265
Of which:					
Austria	-	244	180	621	1 344
Belgium	705	1 248	1 815	1 307	929
Cyprus	22	81	31	108	40
Czech Republic	891	185	2 099	3 457	1 204
Denmark	43	-	1	175	556
Estonia	1 040	275	601	865	1 026
Finland	-	-	-	-	1
France	2 417	291	5 887	2 950	429
Germany	4 351	3 810	6 638	13 664	6 868
Greece	2 477	1 921	3 711	2 302	326
Hungary	-	-	24	7	-
Ireland	-	5	414	523	6
Italy	4 814	3 980	8 409	16 351	7 274
Latvia	201	229	248	1 067	347
Lithuania	119	343	254	256	253
Luxembourg	-	-	-	29	-
Malta	1	6	4	1	2
Netherlands	4 549	2 533	2 566	1 737	722
Poland	390	135	166	45	210
Portugal	188	2	22	-	155
Slovakia	216	166	892	1 625	484
Slovenia	-	-	3	16	-
Spain	3 786	1 742	6 621	2 089	2 662
Sweden	-	8	5	134	-
UK	6 272	6 749	11 656	7 253	9 429

Source: Department for Statistics, Ministry of Economic Development

The UK was the first among EU countries by Georgia's export volumes in Q1, 2006, with a share of 27.5 percent in total exports to the EU. The main commodity groups exported to this country were gold and mineral waters. A certain factor contributing to the upward dynamic in exports to the UK was the rise in world prices on gold. Besides, Georgia exported USD 4.6 million worth of aircraft to the UK. As a result, Georgia's exports to this country grew in annual as well as quarterly terms.

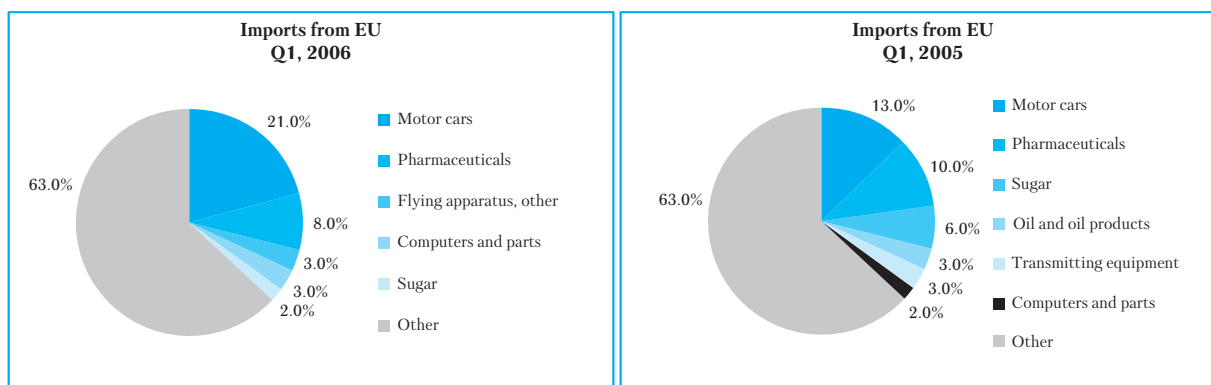
In the accounting period, Italy moved down from first to the second position by volume of Georgia's exports. Its share in total exports was 21.2 percent. Compared to last year's corresponding period, exports to Italy notably increased despite the fact that the export of fertilizers and ferroalloys did not take place this time. However, the decrease in Georgia's exports to Italy, if compared to the previous quarter, is mainly the result of a reduction in walnut export and the failure to export mineral fertilizers.

The third largest EU export market for Georgia was Germany again with a 20 percent share in total exports in the reviewed period. As in the case with Italy, annual exports showed a significant increase although in the last quarter there was a sharp drop. Although compared to last year's same period walnut exports to Germany increased 5 times, but compared to the previous quarter it decreased more than 4 times. Moreover, no fertilizers were exported to Germany in the reviewed period. All this translated into a quarterly downward dynamic in exports to this country.

The share of exports to Spain was 7.8 percent of total exports to the EU. Compared to Q1, 2005, exports to this country decreased significantly, resulting from a sharp drop in copper ore exports. Annual export volumes of chemical and nitrogen fertilizers also decreased. However, some increase was observed in quarterly terms.

Austria and the Czech Republic were also among significant countries by export volumes from Georgia in Q1, 2006. Their shares in total exports were 3.9 and 3.5 percents respectively. The rise in exports to Austria, compared to the previous quarter, was caused by the export of gold. It is noteworthy that no export was carried out to this country in the same period last year. Exports to the Czech Republic were mainly walnuts, it was influenced by the export of walnut, which increased in annual terms but notably decreased in quarterly terms.

A serious annual and quarterly decrease was observed in exports to such relatively significant trade partners as Greece, France and Netherlands in the reviewed period. Exports to Greece were affected by the failure to export ferroalloys and a decrease in walnut exports, especially as compared to Q4, 2005. The downward dynamics of exports to France was largely caused by a sharp decrease in fertilizer exports both in annual and quarterly terms. The largest commodity group to the Netherlands was copper ore, the export of which had not taken place since Q1, 2005, which, consequently, was expressed in decreased annual and quarterly indicators of export to this country.



Source: Department for Statistics, Ministry of Economic Development

The largest commodity group of imports from the EU again contained motor cars, the import of which doubled compared to the same period last year. Its share also notably increased in total imports from the EU. The increase of car imports in the total share of imports was less in quarterly terms, though in absolute terms it showed a significant decrease.

The import of pharmaceuticals also increased in the accounting period in annual terms, although its share in total imports decreased. It is noteworthy that the share of this commodity group was even lower in Q4, 2005.

The share of sugar sharply decreased in Q1, 2006 compared to the previous quarter as well as the previous year's same period. The annual import of this commodity from the EU decreased more than twice, while the quarterly import dropped more than 6 times.

Table 28: Imports to Georgia from EU countries (thousand USD)

	2005				2006
	Q 1	Q 2	Q 3	Q 4	Q 1
Total imports from EU	122 640	152 038	180 852	215 855	175 027
Of which:					
Austria	3 474	4 530	5 796	5 212	4 690
Belgium	4 651	6 101	6 216	8 612	8 362
Cyprus	572	196	669	297	203
Czech Republic	1 680	4 766	6 839	7 268	6 177
Denmark	1 192	2 770	1 417	1 685	1 221
Estonia	116	102	843	83	161
Finland	2 971	4 397	2 496	3 387	4 932
France	11 911	20 473	29 806	35 089	15 967
Germany	34 202	46 737	56 511	69 310	68 063
Greece	4 856	2 582	5 346	5 809	3 820
Hungary	1 480	4 423	4 752	3 685	4 595
Ireland	493	916	977	1 944	1 066
Italy	11 390	12 767	20 178	20 088	15 106
Latvia	1 268	1 282	2 459	1 186	1 288
Lithuania	1 182	882	1 337	1 613	901
Luxembourg	89	392	184	275	131
Malta	-	-	-	-	-
Netherlands	10 725	10 230	11 396	20 735	13 905
Poland	3 193	3 609	3 288	3 567	3 480
Portugal	643	1 075	677	748	731
Slovakia	888	391	455	1 216	978
Slovenia	616	1 179	643	1 616	1 009
Spain	1 173	2 190	2 356	2 732	2 877
Sweden	4 662	990	3 275	696	601
UK	19 214	19 059	12 938	19 002	14 763

Source: Department for Statistics, Ministry of Economic Development

In terms of import volume from the EU, Germany was the first in the accounting period with 38.9 percent of total imports. The import from this country doubled compared to the same period last year, but decreased compared to the previous period. This time the largest commodity category was again represented by motor cars, various machinery and pharmaceuticals.

France was again the second largest importer to Georgia in Q1, 2006. Its share was 9.1 percent of total imports. Imports from France notably increased in annual terms but sharply decreased in quarterly terms, which was the result of 18 times decrease in sugar and 3 times decrease in alcoholic beverages. It is noteworthy that compared to Q1, 2005 the import of these commodity groups increased significantly.

The share of imports from Italy in total EU imports was 8.6 percent in the accounting period. Compared to last year's same period, the volume of goods imported from this country increased significantly, however, compared

to the previous quarter it notably decreased, which was mainly due to a 25 percent drop in unloading and food processing equipment imports.

The share of Britain in total EU imports was 8.4 percent. Imports from the UK decreased both in annual and quarterly terms. One of the reasons of the decline was a drop in imports of various industrial metal constructions and fittings. The volume of sugar imported from the UK decreased as many as 6 times compared to the corresponding period last year.

The share of the Netherlands was almost 8 percent in the reviewed period. Compared to Q1, 2005 the share of imports from this country notably increased, while compared to the previous quarter it decreased. Annual growth was determined by an increase in computer and motor car imports with the latter showing a 4 times growth. As regards the quarterly decrease, it was caused, among other factors, by a sharp drop in the export of pharmaceuticals.

Table 29: Direct investments by EU countries in Georgia (thousand USD)

Countries	2003	2004	2005					2006 Q1
			Q1	Q2	Q3	Q4	Total*	
Total	340 070	499 107	89 366	105 944	75 618	178 857	449 785	133 833
EU	95 823	195 622	38 673	44 246	49 841	110 949	243 710	29 352
Austria	18 108	23 157	4 563	3 046	618	6 505	14 732	3 662
Czech Republic	250	277	57	38	620	565	1 280	1 097
Denmark	0	0	0	0	319	0	319	133
UK	37 670	87 875	11 779	20 989	24 593	75 591	132 952	8 823
Germany	4 145	5 141	945	631	1 234	2 222	5 032	1 552
Ireland	37	41	9	6	317	262	592	343
Italy	15 896	32 480	3 858	6 469	6 770	5 742	22 838	1 933
Cyprus	676	21 333	14 538	9 705	9 028	14 265	47 537	8 499
Luxembourg	250	277	57	38	214	244	553	116
Netherlands	0	0	0	0	275	217	492	732
Poland	0	0	0	0	164	130	294	246
Greece	1 967	2 178	449	299	490	979	2 217	522
France	16 709	22 863	2 418	3 025	5 040	3 901	14 383	1 301
Sweden	81	0	0	0	160	0	160	152
Hungary	34	0	0	0	0	327	327	242
EU share (%)	28	39	43	42	66	62	54	22

Source: Department for Statistics, Ministry of Economic Development

Note: * verified data

The share of direct foreign investments from the EU in Q1, 2006 sharply dropped in total FDI in annual and in quarterly terms, which, assumedly, resulted from a seasonal slowdown in the construction of the Shah-Deniz pipeline. The decrease in FDI was mainly reflected by pipeline and associated infrastructure construction.

The UK retained the status of the largest EU investor in Georgia. There has been a steady quarterly DFI growth from this country since 2005, but the volume of investments in Q1, 2006, compared to the previous quarter dropped by 88 percent while compared to the same period in 2005 it dropped by 25 percent. The same holds for investment from Italy and France. Investment inflows from Italy in the accounting period decreased by 66 percent and from France by 67 percent. Compared to the previous year's corresponding period the decrease was more modest comprising 50 percent for Italy and 46 percent with France. Investment inflows from Cyprus are related to the Kulevi oil terminal construction. Investment from this country was almost equal in Q1 and Q2, 2005; accordingly the investment in the reviewed period, as compared to the previous year, dropped by 40.4 percent and as compared to last year's same period by 41.5 percent.

1. MONETARY DEVELOPMENTS IN GEORGIA: RECENT TRENDS AND POLICY IMPLICATIONS

Apostolos Papaphilippou, PhD in Economics, GEPLAC Economic Expert

1. Introduction and overview

Over the last few years Georgia's economy has experienced a period of relatively high growth in an environment of low inflation. The aim of the paper is to provide an assessment of price, monetary and external sector developments, as well as provide recommendations for the design and conduct of economic policy in Georgia.

The paper is organized as follows: Section 2 provides a brief analysis of inflation. It discusses the definition of inflation and its measurement, the causes of inflation in the short and longer term, costs and re-distribution effects, and the inter-relationship between inflation and growth. Section 3 gives an overview on the conduct of monetary policy in Georgia, and the structure of its financial markets. The section notes the priorities of monetary and exchange rate policy in Georgia, and analyses briefly the limitations in the conduct of monetary policy. These limitations stem from the evolving structure of the Georgian economy in general, and its financial and capital market characteristics in particular. Section 4 contains an assessment of the price and monetary developments over the period 2001 – 2005. Section 5 proceeds to analyse the evolution of key external sector and competitiveness indicators, drawing upon the existing studies and surveys. Finally, section 6 offers a short- to medium-term outlook and concludes with concrete recommendations on the design and conduct of monetary and related economic policies in Georgia.

2. Inflation: key concepts

Definition and measurement

Inflation is a dynamic phenomenon. It usually refers to persistent increases in the level of a price index of goods and services. Such indices include:

1. The Consumer Price Index, which is the most widely quoted index. Its evolution over the time provides a characterization of the increase in the price of the basket of goods and services of an average household in the economy.

2. The Producer Price Index: its evolution measures an average change in prices received by domestic producers for their output. As there is usually a time lag, by which an increase in producer prices feeds through consumer prices, the evolution of the producer price index is frequently used as a precursor of future consumer price inflation.

3. The GDP deflator: its evolution provides a broad indication of inflationary developments in the domestic economy. It is the index, by which the nominal GDP figure is deflated in order to arrive at a real GDP estimate.

4. Index of so-called “core inflation”, which excludes from the price index a number of highly volatile items, and which is used to assess the underlying longer-term inflationary tendencies in the economy.

The costs of inflation

The costs of inflation are a subject of some controversy. These costs are clearly a function of the inflation rate itself, with substantial agreement that high levels of inflation are disruptive to economic efficiency and social welfare. Intuitively it is useful to distinguish between the costs of anticipated inflation versus the costs of unanticipated inflation. The costs of (low) anticipated inflation are relatively small. They include the so-called “shoe-leather cost”. This refers to the shoe leather that economic agents allegedly destroy due to their frequent trips to the bank in order to deposit their (excess) currency in interest earning deposits. It arises from the need of economic agents to save on their currency holdings (which earn no interest, and whose real value is eroded by inflation). An additional cost of anticipated inflation is the so-called “menu costs”, i.e. costs arising from the need to change prices more frequently in a high inflation environment.

As for the costs of unanticipated inflation, these are likely to be much more significant than the costs of anticipated inflation. Firstly high and variable inflation has the undesirable effect of increasing the risk associated with investment decisions. This higher risk leads to lower investment flows and thus lower output growth and employment in the economy. Secondly high and, especially, variable inflation makes it difficult for economic agents to distinguish changes in relative prices (which act as a signal and facilitate the efficient allocation of resources in a market economy) from changes in the overall price level. Thirdly, high inflation has sometimes resulted in the imposition of inefficient (administrative) controls on the evolution of prices and/or wages. And, again, these wage and/or price distortions destroy the in-built efficiency of a market economy – that is, the ability of the system of

free prices to reflect the inter-play of demand and supply and, through changes in relative prices, guide the efficient allocation of resources among alternative uses in the economy.

Redistribution effects

Inflation has also redistribution effects. It is well-known that, other things being equal, [1] inflation has undesirable social consequences and hits particularly hard the vulnerable groups of the population. These groups are less able to safeguard their real income from inflation, and are frequently relying on incomes which are fixed in nominal terms. This effect is likely to be of significance in a transition economy, where poverty is widespread; [2] inflation favours debtors at the expense of creditors; [3] in a progressive taxation system, inflation induces a shift to higher tax brackets; [4] inflation reduces the real value of government debt; [5] inflation acts as an implicit tax on the holdings of currency.

Causes of inflation in the short and longer term

In the long run there is substantial agreement among economists that inflation is a monetary phenomenon caused by too much money chasing too few goods. Of paramount importance for the evolution of inflation in the medium to longer term is the stance of the monetary authorities, in particular, whether or not they will accommodate an initial price increase by providing liquidity. A very important determinant of the actual evolution of inflation is the inflation expectations of economic agents in the economy. These are highly volatile but are closely connected with the perceived credibility and confidence in the conduct of economic policy by the authorities.

In the short term, however, an increase in the price level may be due to any combination of “demand-pull”, “cost-push” and “structural-inertial” factors. By “demand-pull” we refer to a situation where there is an excess demand, at current prices, for the available supply of goods and services. This excess demand will tend to raise the overall price level. By “cost-push” we refer to a situation where the initial increase in the price level is largely due to an increase in the costs of inputs to the production process. An example is an increase in raw materials and/or wages, which represent important costs in the production process. By “structural-inertial factors” we refer to characteristics in the structure of the economy which may propagate an initial increase in the level of prices to further increases in subsequent periods. An example is an economy with wide indexation of prices (including wages) to the inflation rate. In such an economy an initial price increase will automatically lead to higher prices and wages in the next period, which may set in motion a wage-price spiral. This will be especially pronounced in economies with limited competition and where price setting follows a cost-plus rule.

Inter-relationship between inflation and growth

As noted already, there is substantial agreement among economists that inflation has an adverse effect on medium and long-term economic growth. The natural issue that arises concerns the threshold level of inflation, above which inflation significantly reduces economic growth in a particular economy. This is obviously a policy-relevant issue, as it provides an indicative estimate of the target level (or ceiling) of inflation for that economy.

The determination of the threshold level of inflation is largely an empirical issue, which is linked to the structure of the economy at a particular point in time. A relevant econometric study was undertaken by Khan and Senhadji (2001). The study also surveyed earlier related empirical studies, and provided evidence suggesting that the threshold level of annual inflation above which it significantly slows growth is within the range 1-3 percent for industrial countries, and 7-11 percent for developing countries [1]. An earlier study by Christoffersen and Doyle (1998) estimated the inflation threshold at 13 percent for transition economies [2].

3. Monetary policy and the structure of Georgia’s commercial banking and financial system

Following the theoretical and empirical issues analysed in the previous section we now turn to a brief discussion of the conduct of monetary policy in Georgia. The aim of this section is threefold: 1) to summarise briefly the objectives and limitations in the conduct of monetary policy in Georgia; 2) provide an overview of the developments in Georgia’s banking and financial sector; and 3) refer explicitly to the existing theoretical and empirical studies. This section provides the background for the assessment of price, monetary and external sector developments, which follow below. It also constitutes the starting point for the policy recommendations.

Monetary and exchange rate policy priorities in Georgia

The central bank, the National Bank of Georgia (NBG), has as its primary objective the maintenance of price stability [3]. At the same time the NBG promotes the financial sector’s stability through effective banking regulation and supervision of commercial banks, and promotes the maintenance of a secure and efficient payment system.

The exchange rate in Georgia is market-determined since 1999. In other words, it reflects the demand for and supply of foreign currency in the foreign exchange market. Other things being equal, a floating exchange rate policy is a sensible policy option for a small open economy such as Georgia, as it is well-known that: [1] a floating system avoids the possible divergence between an exchange rate reflecting market conditions and the official/targeted exchange rate, which would be possible in a fixed exchange rate system; [2] a floating exchange rate provides an in-built, flexible and appropriate process, which tends to automatically correct external imbalances

and external shocks to the economy; and [3] a floating rate frees monetary policy to pursue objectives other than the maintenance of the exchange rate itself (such as the domestic price stability objective). In theory the NBG's regular intervention at the Tbilisi Interbank Foreign Exchange aims at smoothing out the fluctuations in the exchange rate. In actual fact the NBG's interventions do not cancel out over time: in the presence of significant capital inflows, the NBG has been purchasing foreign currency on the foreign exchange market. This has led to some increase in money supply. At the same time, foreign reserves have also been growing, however, remain low in relative terms.

Constraints to the conduct of monetary policy

As is typical in any transition economy the design and conduct of monetary policy in Georgia has been hampered by: 1. data limitations regarding the length, coverage, and quality of statistics and economic indicators; 2 the severe difficulties involved in estimating behavioural equations, such as the demand for money (due to the mentioned data limitations, ongoing structural changes in the economy, the continuing presence of a significant shadow economy, the high dollarization of the economy and the ongoing monetization process), 3. a relatively under-developed banking sector, and limited and thin capital markets; 4. shocks to the economy (such as energy, weather and internal conflicts) which Georgia experienced over the transition period, and 5. institutional reasons, related to the changing roles of the state in the transition economy, and the relatively poor design and co-ordination between the monetary, fiscal and structural reform policies. It should be noted here, however, that this largely holds for the early stages of the transition process. In particular in Georgia the NBG is largely independent, with a recent amendment prohibiting the direct crediting of the Government by the NBG.

Data-related issues

With regard to statistics there has been an enormous improvement over the transition period. Nevertheless a recent IMF report concludes that, while the existing data are adequate for surveillance and programme monitoring, real sector data, fiscal and balance of payments data require further enhancements [4].

Table 1: Selected Monetary Sector Indicators

	2001	2002	2003	2004	2005
Dollarization ratio (%)	85.7	84.9	86.1	74.3	71.6
Monetization (M3) (%)	11.0	11.6	12.4	15.4	16.5
Total banking sector's assets (% of GDP)	13.2	15.0	15.6	17.3	22.0
Money multiplier (M2)	0.9	0.9	0.9	1.0	1.1
Money multiplier (M3)	1.7	1.7	1.8	1.8	1.9
Nominal interest rate spread	12.9	11.7	11.0	10.7	9.2

Source: NBG and Georgian Economic Trends, Quarterly Review, March 2006

Dollarization, monetization and shadow economy evolution

The definition and evolution of the dollarization ratio and monetization in Georgia over the period 200-05 is portrayed in table 1. There has been a decrease in the share of deposits in foreign currency over the period. However the dollarization of deposits still remains high and accounts to slightly over 70 percent at the end of 2005. The share of loans in foreign currency accounted for 76.2 percent at the end of 2005. The monetization ratio, i.e. the ratio between the broadest monetary aggregate (M3) and GDP, has followed an upward trend throughout the period, but still remains relatively low. The shadow economy remains significant, though it is likely to have decreased [5].

The commercial banking sector

The importance of a well-capitalised, stable and competitive commercial banking sector is well-known. It largely stems from the ability of the commercial banking system to efficiently intermediate between savers and borrowers in the economy. In short, commercial banks mobilise and attract the available savings in an economy, and, after effectively assessing loan proposals, efficiently allocate these savings into productive investment. Furthermore in an economy in transition the importance of commercial bank's is enhanced. This is because [1] the undeveloped or non-existent capital markets imply that commercial bank financing is frequently the only available external financing source for firms, and [2] in an environment characterised by weak property rights, commercial banks in transition economies perform the useful role of acting as monitors of firms activities after the provision of loans.

As table 1 indicates, the total assets of the commercial banking sector in Georgia have grown significantly over the period, but still account for only 22 percent of GDP at the end of 2005. The commercial banking sector of Georgia comprises 19 commercial banks, the largest 6 of which account for around 87 percent of the assets of the banking system. Around half of the gross capital of the banking sector at the end of 2005 accounted for investments by foreign financial and non-financial organisations in the capital of resident commercial banks [6]. The foreign participation in Georgia's commercial banking sector is likely to increase. Furthermore the development of the commercial banking system is likely to lead to some more consolidation in the number of banks. Table 1

shows that money creation is limited, with the money multiplier remaining very low (though slightly growing through time). The spread between the deposit and lending rate, which provides an indication of the banking sector's efficiency and competitiveness, has followed a downward trend throughout the period. It, however, remains significant.

Capital markets and monetary policy instruments

The stock market is extremely small and is unlikely to develop significantly in the near future. Currently there are no treasury bills auctions and no repo auctions. In fact, the last treasury bills and repo auctions were held on 8 June 2005 and on 28 June 2005 respectively. A very limited amount of credit is transacted in interbank credit auctions. The receipt of overnight deposits from commercial banks by the NBG has been suspended since 3 August 2004.

As noted already, the NBG intervenes in the Tbilisi Interbank Foreign Exchange market with the aim to facilitate an orderly market and smooth out the fluctuations in the exchange rate. As discussed briefly in section 5 below, and in more detail in the relevant section of Georgian Economic Trends, over the last few years the NBG has purchased foreign exchange, leading to an increase the country's gross international reserves. In an environment of foreign currency purchases a policy decision is the extent by which the NBG's interventions in the foreign exchange market are sterilized (and, therefore, do not influence the evolution of domestic monetary aggregates). To date most of the interventions were unsterilized. The reserve requirement is currently 13 percent on foreign currency deposits and 2 percent on Lari deposits.

Looking forward, the recent agreement between the Ministry of Finance and the NBG on the phased securitization of most of the Government's debt to the NBG will, in time, create the conditions for the conduct of monetary policy primarily through open market operations (i.e. the buying and selling by the central bank of government bonds on the market, which influences short term interest rates and liquidity conditions). The NBG is planning the issuance of Certificates of Deposit in the near future. These changes will, eventually, lead to the broadening of the monetary policy instruments under the control of the monetary authorities.

A note on limitations of econometric work in transition economies

It is well worth emphasising that a combination of factors renders empirical work in transition economies of limited reliability for the conduct of policy. These limitations include the inter-play of three factors: 1. data limitations. These comprise an incomplete data set, which, furthermore, is too short for efficient econometric inferences; 2. the fact that transition economies experienced severe shocks through the transition period; and 3. the fact that the structure of transition economies underwent significant changes over the transition period. And, furthermore, the structure of transition economies, continues to evolve through time.

In short the researcher and policy maker should treat empirical findings as indicative and highly uncertain. They should be on their guard, especially when using past statistical regularities as predictors of future developments. Our view is that empirical, including econometric work, is clearly useful to a policy maker. But, at the same time, policy will have to rely on a balanced assessment of every available piece of information. This assessment will incorporate a judgement on the combined effect of a number of inter-related factors such as trends in a number of key indicators, and the insights from economic theory and the available empirical evidence, both national and international.

On monetary policy lags in transition

Time lags by which a change in a monetary instrument affects the economy tend to be significantly shorter in transition economies, while in fully-fledged market economies they are typically between one-and-a-half and two-and-a-half years. The available evidence suggests that time lags of the order 3 – 6 months may be typical for a number of CIS countries for a complete pass-through of the effect of a change in monetary aggregates to the price level. Keller and Richardson (2003) even argue that, in transition countries, most of the price effect of a change in monetary aggregates may be felt within a matter of weeks, with the effect of the change in monetary aggregates on the exchange rate felt within a matter of days [7]. Behavioural equations crucial for guiding policy, such as the demand for money, are likely to be highly volatile and uncertain. The instability in the behaviour of money demand is frequently compensated in practice by frequent small adjustments in monetary policy instruments [8].

Existing empirical studies for the Georgian economy, which provide insights useful for the conduct of monetary policy in the country, include econometric studies of inflation and the demand for money. An econometric study of inflation in Georgia by Maliszewski (2003) provided evidence supporting the dominant role of the changes in the exchange rate in determining the evolution of prices. The inter-relationship between the exchange rate and inflation is briefly analysed below. The Maliszewski (2003) study also indicates that there is a low persistence of inflation in the Georgian economy [9]. A study by Gigineishvili (2002) provided evidence for the importance of the exchange rate on inflation developments in the Georgian economy [10]. A paper by Jarocinski and Jirny (1998) included an econometric investigation of the demand for money in Georgia [11].

4. An assessment of price and monetary developments in Georgia

Table 2 portrays the joint evolution, over the period 2001-2005, of the rate of growth of real GDP in Georgia and the rate of growth in the price indices.

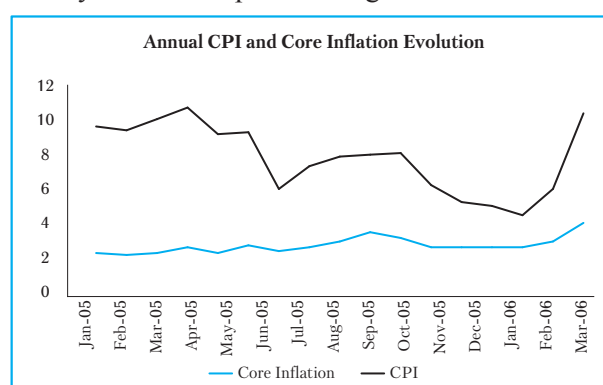
Table 2: Rate of Growth of Output and Prices

	2001	2002	2003	2004	2005
Real GDP	4.8	5.5	11.1	5.9	9.3
Consumer Price Index (pa)	4.7	5.6	4.8	5.7	8.3
Consumer Price Index (eop)	3.4	5.4	6.9	7.6	6.2
Producer Price Index (pa)	3.6	6.3	3.2	4.6	7.4
Producer Price Index (eop)	8.9	2.2	6.6	1.2	8.3
GDP deflator	5.4	6.0	3.3	8.4	7.8
Core Inflation (eop)	1.3	0.5	2.3	2.2	3.0

Source: Department for Statistics; Ministry of Economic Development and NBG
Note: pa: period average; eop: end of period

Over the period the economy experienced relatively high rates of real growth in an environment of relatively stable prices. There is some indication of a slight acceleration of the inflationary process in the recent evolution of the producer price index (which, as noted above, may provide an indication of a likely evolution of future consumer price inflation) and the evolution of the core inflation index (which excludes volatile items, including the price of energy and tobacco, and provides an indication of the underlying longer-term inflationary tendencies in the economy).

The graph portrays the 12-month rate of growth in the consumer price index and the core inflation index over the period January 2005 – May 2006. It indicates a slight acceleration of the inflationary process in the last few months. In particular the 12-month rate of growth in the consumer price index in May 2006 was 10 percent, up from 6 percent in April 2006 (while the May 2005 and April 2005 figures were 8.9 percent and 10.3 percent respectively). The 12-month rate of growth in the core inflation index in May 2006 was 4.2 percent, up from 3.2 percent in April 2006 (while the May 2005 and April 2005 figures were 2.6 and 2.9 percent respectively).



Source: Department for Statistics; Ministry of Economic Development and NBG

The increase in monetary aggregates was closely connected with the (largely un-sterilised) NBG's intervention in the foreign exchange market in the presence of significant inflows of foreign currency in Georgia, including remittances. The recent significant increase in the credit to the economy was accompanied by lower lending rates, a slight reduction in the share of loans in foreign currency and longer loan maturities. In relative terms credit still remains low, however, corresponding to 15 percent of GDP at the end of 2005.

Table 3: Rate of Growth of Selected Money and Credit Aggregates

	2001	2002	2003	2004	2005
Reserve Money	9.8	18.4	14.0	44.3	19.7
Broad Money, (M2)	5.7	14.5	14.1	60.4	26.5
Broad Money, (M3)	18.5	17.9	22.8	42.6	26.4
Credit to the economy	13.8	28.5	24.9	22.8	79.3

Source: NBG

The significant increase in monetary aggregates did not give rise to a significant growth in the price level. The reason for the apparent stability in the inflation rate is due to a combination of four inter-related developments:

- The first reason is the increase in the demand for money over the period, which reflects the increase in confidence. This increase in the demand for money is reflected in a drop in the velocity of circulation, and an increase in monetization, i.e. the ratio of broad money, over GDP.

Table 4: Monetization

	1998	2000	2002	2004	2005 Est
Georgia	7.3	10.3	11.6	15.2	16.5
Kazakhstan	8.6	15.4	20.3	29.5	30.3
Caucasus ^{1/}	10.5	12.9	14.3	16.5	16.5
CIS-7	12.0	12.9	14.9	18.2	15.8
Selectd CEE ^{2/}	48.0	51.1	53.6	53.3	55.4
Baltics	23.6	28.9	33.6	38.7	47.6

Source: International Monetary Fund

Note: The table reports the ratio between broad money and GDP; broad money refers to the monetary aggregate M3 (which includes foreign currency deposits) where this is available, or M2 otherwise

1/ Includes Armenia and Azerbaijan, excludes Georgia; simple average

2/ Includes Poland, Czech Republic, Hungary; simple average

3/ Includes Estonia, Latvia, Lithuania; simple average

- A second reason limiting the rate of growth of prices in Georgia is the fact that the economy probably continues to operate well within its production capacity. It is well-known that inflation accelerates the closer the economy is to a full employment of its productive resources. For Georgia, however, the available evidence suggests that there are still spare capacities, both with regard to the utilization of the existing stock of capital and of labour resources in the economy [12]. The availability of spare capacities seems to hold both at the macroeconomic level and in sectors where Georgia is likely to have comparative advantages. The latter include manufacturing and agro-processing sectors, whose growth will be critical for the successful growth and development of the whole economy.

- A third reason is closely related to the economy's openness to trade. The liberal trade regime implies that the competition from imports of (tradable) goods limits price increases of domestically produced output.

- A fourth reason is closely connected with the nominal appreciation of the national currency over the period. This appreciation was due to the significant inflows of foreign currency, including remittances. There is no doubt that the appreciation of the exchange rate has had a dampening effect on inflation: the evolution of the exchange rate is a crucial determinant of the actual path of inflation, through 1. its direct effect on the import content of the consumption basket, and 2. its effect on the inflationary expectations of economic agents.

5. An assessment of external sector developments and competitiveness

Table 5 portrays the evolution of selected external sector indicators over the period 2001-2005. As noted already, the period was characterised by strong capital inflows. The period was also characterised by a growing external (and especially trade) deficit. It is notable that both the volume of exports and the volume of imports have grown over the period. Nevertheless, imports have grown evidently faster than exports. A large part of the Foreign Direct Investment inflows financed the import of capital equipment in Georgia, with the largest part of remittances fuelling consumption, a big part of which financed the import of consumption goods.

Table 5: Selected External Sector Indicators (million USD, unless otherwise indicated)

	2001	2002	2003	2004	2005
Trade Balance of Goods and Services	-479.6	-447.5	-582.0	-858.6	-1142.3
Current Account Balance	-211.4	-197.6	-369.5	-346.9	-688.8
Current Account Balance (% of GDP)	-6.9	-5.8	-9.3	-6.8	-10.8
Gross International Reserves	159.9	198.4	191.6	383.7	474.1
Import coverage (month)	1.8	2.3	1.6	2.3	2.1
USD Exchange Rate (pa)	2.07	2.19	2.15	1.92	1.81
Real Eff. Exchange Rate, (1995=100)	108.2	102.7	94.9	107.0	110.3
Terms of Trade (1995=100)	97.8	96.9	97.7	99.0	-

Source: Georgian Economic Trends, Quarterly Review, March 2006; Department of Statistics, Ministry of Economic Development; NBG and expert assessments

An inter-related development has been the appreciation of Lari in the nominal and real effective terms, which also tends to deteriorate the external deficit. The NBG's purchases on the foreign exchange market have resulted in an increase in international reserves. In relative terms, however, these remain low, covering around 2.1 months of imports. Capital inflows are likely to persist in the medium term, although the revenues from privatization receipts may fall. Debt indicators are low, and, looking forward, there is only a moderate risk of debt distress [13].

Medium-term development path and export sustainability

A source of some concern, however, is the composition and sustainability of export volumes. This is because growth and development of a small open economy, such as the Georgian economy, has to rely on sustainable increases in investment and exports. Increases in investment add to the productive capacity of the economy and its ability to grow in the future. And increases in exports allow the economy to: 1. avoid the limitations of the small internal market and reap the economies of scale inherent in larger volumes of production; 2. reap the benefits of trade through specializing in areas where the country has comparative advantage; and 3. help in maintaining a sustainable and balanced external payments position, which does not lead to increases in debt indicators.

The concern regarding the sustainability of exports becomes apparent when one looks at the composition of exports of goods. In 2005 scrap metals accounted for around 15 percent of the total, parts for the aircraft industry account for around 13 percent, wine - 8 percent, ferrous metals - 7 percent, sugar - 5 percent, copper ores and concentrates - 5 percent, fertilizers - 4 percent, other 43 percent.

Of these, however: 1. scrap metal exports cannot be sustainable in the long term, 2. the aircraft production stems from a barter deal to repay debt to Turkmenistan, and its longer-term sustainability is questionable; and 3. around 90 percent of wine exports go to Russia. This implies that the sector is highly vulnerable to changes in bilateral trade conditions. The ban on exports of a number of Georgian goods to the Russian market, which includes wine and mineral waters, is a significant adverse development.

Export figures for the period January – April 2006 display an encouraging sign that exports have grown by just under 22 percent over the respective period of 2005. There is, however, a significant reduction in scrap metals exports and only a slight reduction in the share of exports of wine in total exports. The latter is not surprising as the ban on the export of Georgian wine to Russia was only proposed towards the end of March and is likely to have been implemented with a time-lag. Further study is warranted to: 1. assess the sustainability of the volume of exports, and 2. assess, whether the changes in its structure over a period lead to a more efficient and competitive allocation of resources in the economy, reflecting Georgia's areas of comparative advantage.

Some remarks on competitiveness

A related policy-relevant issue of importance is whether the real appreciation of the Lari poses a threat to the external competitiveness of the economy. A recent IMF report argued that the real exchange rate was likely undervalued in the past [14]. The report refers to two recent competitiveness studies suggesting that the productivity of the Georgian economy has improved in 2004-2005. It also notes that USD wages are the lowest in the region according to the latest available figures for 2004. On the other hand the study noted that Georgian exports have started losing ground in their main trading partners' import markets.

The USD wage is a useful indicator of relative competitiveness among countries in the region. At the same time the evolution of the nominal wage helps to assess price developments in an economy: while wages are part of the production costs, they are at the same time a major determinant of households' nominal disposable income. The evolution of the nominal wage, therefore, determines consumption demand in an economy: other things being equal, an increase in nominal wages is likely to lead, with a time lag, to an increase in aggregate demand and some upward pressure on prices. As the IMF notes, the USD wages in 2004 in Georgia were indeed the lowest among the economies examined in the report. At the same time, however, it is notable that, for all the countries surveyed, there has been an increase in the ratio between the nominal USD in Georgia and the nominal USD wage in the other economies. Thus it is clear that over the period 2003-2004 competitiveness has been eroded. Furthermore, the latest available figures suggest that the significant increase in nominal wages in Georgia is likely to have persisted in 2005, thus possibly further eroding competitiveness. There is statistical evidence that the growth of the average nominal wage in the period January – September 2005 was close to 27 percent, while the nominal exchange rate over the period has appreciated.

6. Outlook and policy recommendations

Recent developments and outlook

When the 2006 monetary programme was designed in 2005, the indicative target for the end-of-year rate of growth in the consumer price index was set at 5 percent. Recent developments, which are largely outside the control of Georgian authorities, indicate that there may be some acceleration of inflation in Georgia.

These developments include: 1. An acceleration of inflation internationally. This was caused by the continuing high prices of inputs to the production process, including energy, upon which Georgia is dependent; and 2. The ban on exports of a number of Georgian goods to Russia. The latter is likely to have an adverse effect on the growth of Georgia's exports and lead to deterioration in the economy's external balance.

Monetary policy recommendations

1. The primary objective of monetary policy is, rightly in our view, the maintenance of price stability. In practice in any country the conduct of monetary policy is pragmatic. And it is based upon an assessment of developments in a number of sectors in the economy. Policy also seeks to achieve a number of goals which are of para-

mount importance for the economic system's efficient operation. As noted above, these include: 1. the safeguard of the financial sector's stability, through effective banking regulation and supervision of commercial banks; and 2. the promotion and the maintenance of a secure and efficient payment system, including orderly servicing of both domestic and international payments.

2. The NBG is well aware of the need for transparency and credibility in the design and conduct of monetary policy. It has made a significant effort to communicate and explain its policies to the public at large. This effort encompasses the production of a number of periodic publications and the wide dissemination of information through its internet website. The forthcoming quarterly Inflation Report is a welcome addition to these initiatives. At the time that this article was being written there was no draft of the report available for review. Our recommendation would be to keep the discussion simple and accessible to interested readers. One possible variant may be a report with a main section which is relatively short, analytical (rather than simply descriptive), and forward looking.

3. At the same time the temptation to incorporate in the Inflation Report, and in official pronouncements in general, a precise future path of the price level, or of monetary variables, should be avoided. This is because the path is likely to be rather volatile, even in the absence of disturbances, including external shocks. On the other hand an indicative future target of inflation, based on the consumer price index, should be included. The target may be an average, in order to average out the short-term volatility in any particular month of the year. This volatility is unavoidable in a consumer price index. This is especially so in an economy in transition, such as the Georgian economy. In Georgia the weight of the food component in the consumer price index is dominant, and the seasonal variation in the index pronounced.

4. It is worth remembering that the forecast itself acts as both an anchor for the inflation expectations of agents in the economy and as a benchmark upon which actual policy will be assessed in the future. Success in achieving the indicative target (or, rather, minimizing the actual deviations from the target) builds credibility and promotes the maintenance of an orderly and efficient macroeconomic environment. The costs of a (low) level of anticipated inflation may well be negligible: a credible anticipated low rate of inflation can be incorporated into the economic agent's actions and forecasts. While, on the other hand, unanticipated inflation increases the level of uncertainty in the economy and is detrimental to efficiency, investment and growth.

5. The value of the indicative inflation target is a subject of some controversy. In short, our view is that more work is needed in order to arrive at an appropriate estimate. One may argue that in an economy with Georgia's characteristics a single-digit inflation (in any case below the psychologically important 10 percent figure) would be preferable. On the other hand, the empirical study cited in section 2 mentions that this figure will lie within the 7–11 percent range, typical to development economies. We should add that our preference for a slightly higher rate of inflation has less to do with providing some leeway to facilitate meeting the target in the presence of uncertainty in the economy, and thus build credibility through time. The reason is the relevance for a transition economy of the argument suggesting that, in the presence of downward rigidities in the evolution of nominal prices, a low and stable inflation rate facilitates the adjustment of relative prices in the economy.

6. The process by which a central bank assesses developments in the economy in general, and forecasts the inflation rate in particular, merits thought and organization. Both the overall economic assessment and the setting of policy instruments require judgement in any economy. And the importance of informed judgement is enhanced in a transition economy. It makes sense to rely upon monitoring a broad set of indicators to inform policy decisions. These indicators should encompass monetary and credit aggregates, real sector developments, labour market developments, regional development indicators, and international developments, especially with regard to main partners. Empirical work is clearly useful. But, as noted in section 3 above, econometric results are bound to be less reliable within the context of a transition economy. Without compromising its independence the NBG should consult widely with both the government and the private sector. The latter is of particular importance in Georgia as forward-looking indicators useful for forecasting, such as expectations, currently do not exist. With regard to the internal organization in the NBG to support the efficient assessment of developments and forecasting it is worthwhile to devise a system to pull resources and expertise across departmental lines in order to facilitate: 1. the information gathering process and the utilization of departmental areas of comparative advantage; 2. the further development of data monitoring and empirical investigation; 3. a sound communication strategy to reinforce reputation and credibility in policy, and 4. learning through time from evaluating past assessments and actual performance. A recent paper provides a useful summary of setting the operational framework for producing inflation forecasts in a number of market economies [15].

7. The demand for money is likely to continue exhibiting volatility. The NBG should consider moving from its current monetary programme, which is largely based on monitoring and estimating monetary aggregates, to one that places more emphasis on inflation. We consider, at the same time, that the discussion on the possible introduction of formal inflation targeting in Georgia is premature. And that the successful introduction under current conditions in the country is simply not feasible. In short, the preconditions for that are currently not satisfied: On the positive side, the central bank's independence is growing and the NBG is committed to accountability, transparency and an active communication of its policy to the public at large. On the other hand, however, the available set of monetary policy instruments is currently very limited. Besides, although the NBG is currently

upgrading its economic modelling efforts, reliable and stable econometric results are unlikely to hold, and thus effectively inform policy decisions. The latter limitation will probably persist for some time, stemming from limitations of empirical work in a transition economy. In the meantime placing more emphasis on achieving an (informal) inflation target will provide the central bank with very valuable experience. It will facilitate a possible switch to formal inflation targeting sometime in the future when the preconditions are satisfied and the introduction of inflation targeting may prove to be both meaningful and credible.

8. The importance of the emergence of a well-capitalised, active and competitive banking system for the successful development of Georgia cannot be over-emphasised. Commercial banks are instrumental in mobilizing savings (including savings held in the form of currency, including foreign currency, which is currently outside the banking sector in Georgia), and transforming these into productive investment. For the foreseeable future aggregate demand will continue to be fuelled by inflows, including remittances from abroad. And the commercial banking sector may provide the means by which a part of this income may be channelled into productive investment, rather than remaining idle, as cash outside the banking system, or financing only consumption, including imports¹. Furthermore, in a transition economy the role of commercial banks is enhanced as: 1. the undeveloped capital markets imply that commercial bank financing is frequently the only available external financing source for firms; and 2. in an environment characterised by weak property rights, commercial banks perform the useful role of acting as monitors of firms activities after the provision of loans. The challenge for policy is to sustain the increase in intermediation and build upon the recent significant increase in the provision of credit to the emerging private sector. This should be done in the way sustainable for the system, which would not lead to an adverse increase in risks in the commercial bank's credit portfolios.

9. To this end we consider that the operation of the central bank as an effective regulator and supervisor of the commercial banking system to be of paramount importance. The recent Georgian Banking System Development Strategy 2006-2009, provides a good framework for medium-term development needs. It rightly places emphasis on transparency, further consolidation of the commercial banking sector, and increased competition. And the continuing adherence to international standards is an important guide to policy in the sector.

10. The proposed broadening and deepening of financial markets will, eventually, provide the monetary authorities with a larger set of instruments with which to influence short-term liquidity. Time is, however, required for the emergence of an orderly and efficient market.

Other policy recommendations

11. An efficient co-ordination of monetary policy with fiscal policy is a prerequisite for the emergence of a policy mix which is appropriate for the country's development needs in general, and supports the maintenance of a stable macroeconomic environment in particular. It is worth emphasising the importance of the size of the fiscal deficit relative to GDP. In a transition country such as Georgia, even a rather small number may be very significant, as it corresponds to a very large share of the stock of reserve money. Other things being equal, a small fiscal deficit supports the stable price objective and limits the possible crowding out of the private sector by the public sector borrowing requirement needs.

12. The country's competitiveness in the longer term is primarily determined by the introduction of structural reforms aiming at efficiency and productivity gains. The recent deterioration of competitiveness is a cause of some concern and merits further study. The country's relative competitiveness indicators – which include the evolution of bilateral exchange rates, price levels and relative production costs, export growth and market penetration, transportation costs and the costs of doing business – should be monitored periodically.

References:

1. Khan M.S., Senhadji A. S. Threshold Effects in the Relationship Between Inflation and Growth, IMF Staff Papers, 2001, Vol. 48, No. 1.
2. Christoffersen P.F., Doyle P. From Inflation to Growth: Eight Years of Transition, IMF Working Paper Series, 1998, No. 98/99.
3. Kakulia M., Gigineishvili N. The Primary Objectives and Priorities of Monetary Policy in Georgia, Problems of Economic Transition, 2005, Vol. 48, No.4.
4. International Monetary Fund. Georgia: 2006 Article IV Consultation, Third Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria-Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director of Georgia, IMF Country Report No. 175, 2006.
5. International Monetary Fund. Georgia: Selected Issues, IMF Country Report No. 06/170, 2006.
6. National Bank of Georgia. Georgian Banking System Development Strategy 2006-2009, 2006.

¹ It is worthwhile noting here that a part of remittances were channelled to purchases of real estate, leading to increases in prices of apartments. These prices in Georgia, as in other transition countries, are expressed in foreign currency. Incidentally the evolution of the price of assets, as a proxy for the evolution wealth in the economy, is another indicator that the central bank should monitor.

7. Keller P.M., Richardson T. Nominal Anchors in the CIS, IMF Working Paper Series, 2003, No. 03/179.
8. Stone M. Inflation Targeting Lite, IMF Working Paper Series, 2003, No. 03/12.
9. Maliszewski W. Modeling Inflation in Georgia, IMF Working Paper Series, 2003, No. 03/212.
10. Gigineishvili N. Pass-through from Exchange Rate to Inflation: Monetary Transmission in Georgia, Proceedings of the Georgian Academy of Sciences – Economic Series, 2002, Vol. 10, Nos. 3-4.
11. Jarocinski M., Jirny A. Monetary Policy and Inflation in Georgia (1996-1998), Centre for Social and Economic Research CASE - Studies and Analyses, , 1998, No.114.
12. Cordonnier C. Georgia's Economic Growth: How to Avert Possible Risks in the Future, Georgian Economic Trends, Quarterly Review, March, 2006.
13. International Monetary Fund. Georgia: Statistical Issues, IMF Country Report No. 06/171, 2006.
14. International Monetary Fund. 2006, Georgia: Selected Issues, IMF Country Report No. 06/170, 2006.
15. Canales-Kriljenko J.I., Kisinbay T., Maino R., Parrado E. Setting the Operational Framework for Producing Inflation Forecasts, IMF Working Paper Series, 2006, No. 06/122.
16. National Bank of Georgia. Bulletin of Monetary and Banking Statistics, various issues.

2. GEORGIA IN THE CONTEXT OF EU ENERGY POLICY

Teimuraz Gochitashvili, Professor; Mindaugas Krakauskas, GEPLAC Expert on energy issues; George Abulashvili, GEPLAC Expert on energy issues

Integration into the European Union is one of Georgia's top priorities. Given a large-scale international support, expressed in providing the country with much needed financial and technical assistance, it is of paramount importance to detect impeding factors towards this goal and to identify appropriate activities that should help develop the government's proper strategies, including the harmonization of legislative and institutional framework with European ones. This process in Georgia started with the signing of the Partnership and Cooperation Agreement in 1996 and entered a new phase in 2004 by joining the European Neighbourhood Policy [1]. Currently special attention is paid to the so-called second generation reforms, which include the harmonization of energy policy, as one of main pillars for ensuring the country's and the region's security and economic stability, with an European Green Paper of Strategy for Sustainable, Competitive and Secure Energy [2].

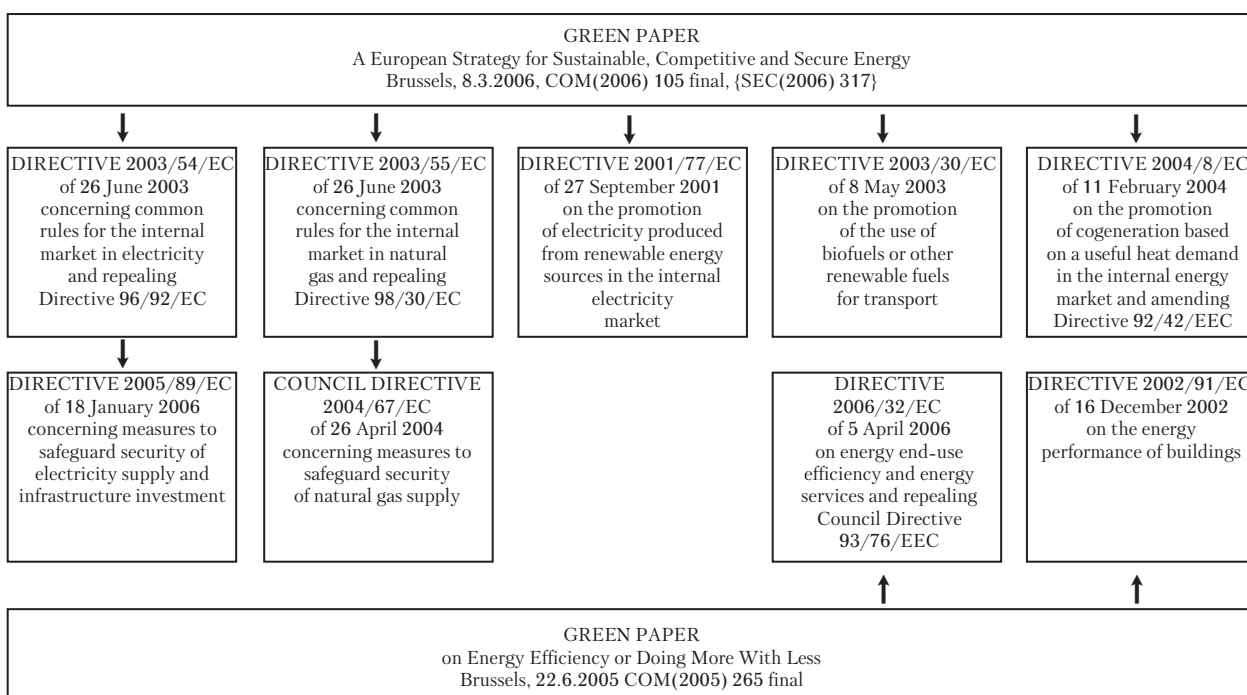
At this initial stage of the harmonization process towards EU energy policy and legal framework, it is important to identify formal (structural) and substantial (essential) differences between the relevant documents, to outline reasonable ways of their harmonization, taking into account Georgian national interests and characteristics. A stage-by-stage harmonization should be focused on the adaptation of the main principles of EU energy policy to Georgia in order to facilitate the establishment of such rules of economic activity that would eventually lead to a liberal market environment and maximum efficiency.

This paper provides a comparative analysis of EU and Georgian energy policies and legislation, identifies main problems in the harmonization, specifies EU instruments for the implementation of energy projects and offers recommendations to the government when implementing the action plan within the framework of the European Neighbourhood Policy. The paper also looks at possibilities of implementing EU energy policy objectives and goals in Georgia and some expected consequences.

Compliance of Georgian energy legislation and strategy with the EU Green Papers

Overall, the hierarchy of Georgia's energy legal and regulatory acts does not comply with those in Europe. Legal power is not proportionally distributed among policy papers, laws and sub-laws. One and the same provision is often repeated in legal documents at various levels, while these documents themselves are poorly harmonized. Instead of norms one can often see declarations with no measures defined to ensure their implementation. For example, the Law on Electricity and Natural Gas declares support for competition but it is not supported by a single norm.

Georgia's energy legislation does not provide for such a transparent structure as European Directives. For example, the Law on Electricity and Natural Gas gives huge powers to the Georgian National Energy Regulatory Commission (GNERC). The Commission is entitled to issue and approve basic rules for technical and economic operation of the system and to control compliance. GNERC is also entitled to establish license rules and conditions and control their compliance. Such rules in the EU are specified in the legislation itself or endorsed by sub-laws that are enforced under a relevant ministry's decree, while the powers of the regulatory commission are limited to monitoring and control of compliance of energy market participants with these rules.



The Law does not specify norms and rules for the system's operation and, instead, contains lots of provisions about the ministry, GNERC and the wholesale energy market. Most provisions describe issues related to the establishment of these institutions and their operation. There is only one clause in the law, which covers rules and conditions for licensing, where a few provisions can be found concerning the system operator and operation, but they mainly have a declarative nature and do not build a normative basis for the management of the system. The law also leaves ample room for interpretation. In particular, the Law does not clearly specify the rules for generation facilities to enter the market and access to the grid, which is necessary to prevent discrimination and ensure transparency. Under EU requirements, energy generation facilities are free from any regulation and license and need authorization only for connection to the grid, which promotes the establishment of a secure and competitive market. Georgia's energy law refers to competition in general provisions only, saying nothing about it in the law itself. Instead, it provides a detailed definition of a strong, regulated wholesale trade mechanism. The wholesale electricity market, being the only buyer, is a privileged player in the energy market. Moreover, technical safety, reliability and commercial issues are intermingled, while trade in energy resources is a strictly regulated process.

Due to such fundamental differences in legislative and regulatory frameworks, there is an essential difference between the Georgian and EU energy markets in terms of organization and operation. As a result, the participants in Georgia's energy market are oriented on regulatory bodies rather than consumers. The impression is that the law was created for ensuring strict supervision of a system operator by the ministry and the GNERC, which runs counter with the European vision of creating a business environment within the energy market.

Clear-cut goals to attain sustainable development and create a competitive environment are not seen among the objectives set out in the main directions of Georgia's state energy policy. Only one of these objectives, which concerns energy security, is fully in line with EU energy policy requirements. Of course, every country is free to make its own choice and considering its national characteristics, reflect its own vision in a policy document, but if a country, in this particular case - Georgia, is, after all, striving to integrate into Europe, it should make sure that the main objectives of its energy policy are harmonized with Europe. It is true that the concluding part of the document on Georgia's energy policy provides for an energy regulation format and privatization principles, but it says nothing about creating a competitive environment, which is indispensable for tackling reliability, efficiency and safety issues. Most of the measures set out in the document are just limited to a description of various energy resource potential, but they do not specify the scope of their utilization and, more importantly, do not define their role in achieving energy policy goals. If Georgia shares EU energy strategy objectives, it will easily, or even automatically, attain the goals set out in its energy policy document.

It is impossible to sustain electrical energy market stability and reliability at an appropriate level unless reserves and auxiliary services in the system are developed as separate market products in the restructured and liberalized energy sector. Under current conditions it is very difficult to consider public service obligations, to render service to vulnerable groups of population and to support market players.

After comparing Georgian and European legislation and policy objectives, it can be concluded that Georgian legislation:

- does not draw a clear line between competitive and monopolistic activities;
- does not define the full spectre of market products and services;
- does not differentiate types of system and auxiliary services needed for the safe operation of the system;
- does not define public service obligations for the protection of society's interests;
- does not establish an effective mechanism for the regulation of monopolistic activity;

To harmonize the Georgian energy legislation with Europe, it is necessary:

- to update the national energy policy in accordance with the standards and objectives of the European Green Paper called a Strategy for Sustainable, Competitive and Secure Energy;
- to amend the Law on Electricity and Natural Gas, to develop the regulatory structure with a more flexible law and sub-laws in accordance with EU directives;
- to create a strong system operator on the basis of a high-voltage network and dispatch service;
- to separate supply (commercial) and distribution (technical) operations and, accordingly, operators;
- to gradually increase the share of power sold through direct contracts with customers and to liberalize this service;
- to set balance energy as a separate product;
- to develop system services and reserves into separate services;
- to steadily increase the number of direct customers on the electricity market;
- to draw up policy and regulations promoting energy efficiency and the application of renewable energy resources.

The EU Green Paper on Energy Efficiency

The EU views the consumption and the supply of energy resources as equally important issues. Therefore, the Green Book adopted following long consultations in June 2005, pays much attention to energy efficiency by sectors and resources. It sets out strategic objectives for promoting energy efficiency and formulates provisions for the development of corresponding directives (laws).

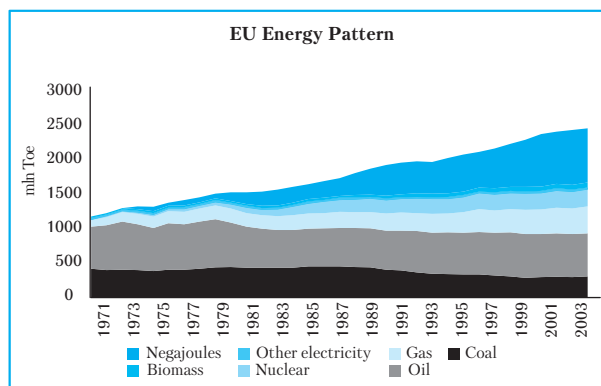
The Book emphasizes the adverse effect of increasing energy prices in terms of economic growth and the importance of improved energy efficiency for EU countries. In this context, it singled out three main objectives:

1. To improve European economy's competitiveness and employment rate. A decrease in energy intensity leads to a decrease in production costs and to the provision of a qualitatively new energy service, making it possible to create about a million additional jobs by 2002.

2. To implement environmental requirement, namely Kyoto Protocol obligations. Energy efficiency is regarded as the least investment-intensive mechanism for limiting emission of greenhouse gases and cleaning the atmosphere.

3. To improve energy security. Given current demographic and economic growth rates of developing countries, prices on energy resources in the medium and long terms are totally unpredictable. According to estimates, by 2030, 80 percent of natural gas and 90 percent of oil products consumed by the EU will be imported from other regions. Therefore, the efficient consumption of energy is one of those tools, which affects Europe's energy security and sustainable development.

The chart below reflects the supply of primary energy resources of 25 European countries and the so-called negajoules. Negajoule refers to the amount of energy, which would have been consumed in a concrete historical time period had the energy intensity indicator remained unchanged since the beginning of the time period¹.



Source: EU Green Paper on Energy Efficiency

The chart shows that had EU countries not started improving their energy efficiency since 1970s, they would have consumed about 1 billion tons of oil equivalent (toe) more energy resources by 2003.

The Green Book stresses the importance of increased energy efficiency at an international level, especially for that group of countries, which fall within the sphere of EU's political and strategic interests. The three Caucasian countries also belong in this group and this is proved by the inclusion of Georgia, Azerbaijan and Armenia in the European Neighbourhood Policy.

European Commission instruments for the implementation of energy projects

Both, the above-mentioned Green Paper and the European Neighbourhood Policy consider Intelligent Energy, the European Commission's long-term programme, as a specialized instrument for the implementation of projects in the sphere of energy. This programme is mainly designed to weaken the dependence of EU countries on imports through the international sub-programme, Coopener. This sub-programme, like whole Intelligent Energy, is focused on energy efficiency and the application of renewable energy resources.

Since 1999, the regional programme INOGATE, another important instrument of energy cooperation, has been operational in Georgia and other countries of the Black Sea and Caspian Sea basins. Initially the programme was only focused on facilitating the transportation of oil and gas towards Europe. However, its format has been enhanced in accordance with the declaration adopted at a meeting of energy ministers of the EU and Black Sea and Caspian Sea basin countries held in Baku in 2004 (Baku Initiative). The INOGATE Secretariat was tasked, considering new realities to draw up an Energy Road Map before the next meeting of energy ministers of the EU and Black and Caspian Sea basin countries scheduled for November 2006 in Kazakhstan. This document is to provide a long-term view of the integration of energy markets of EU, South Caucasus and Central Asian

¹ Energy intensity is a macroeconomic indicator, which represents the amount of energy consumed for the production of one dollar worth of GDP, expressed in oil equivalent (toe) units.

countries, envisaging a stage-by-stage harmonization of effective policies, legislation and standards regarding the trade in energy resources, their transportation and related environmental issues.

To this end, the Secretariat, together with representatives of target countries, set up working groups on four main issues of energy market integration. Tasks for the groups were defined as follows: the first group – harmonization of policies, legislation and institutional arrangement for achieving absolute liberalization of the market; the second group – measures for ensuring transportation of energy resources and reliability and security of infrastructure; the third group – facilitation of sustainable development, in particular, promotion of energy efficiency and application of renewable energy resources and settlement of related environmental issues; and the fourth group – attraction of investments and implementation of energy projects with the assistance of international financial institutions.

Considering the vast experience of the EU in promoting energy efficiency and application of renewable energy resources, it is recommended that the Georgian government start working on the policy document, to develop an appropriate legislative and regulatory framework and meet existing international obligations to increase the country's economic competitiveness. To this end, Georgia's action plan developed within the framework of European Neighbourhood Policy should fully and precisely reflect the EU's role in overcoming the country's energy problems. In particular, the instruments offered by the European Commission should be used to the maximum extent possible and this requires more intensive cooperation with the INOGATE Secretariat in the process of developing the Energy Road Map, even more so that this program may in the nearest future, November 2006, become the main instrument of EU towards the South Caucasus energy markets.

This is particularly apposite because by even more so that this program may in the nearest future, November 2006 it will become the main instrument of the EU towards the South Caucasus energy markets.

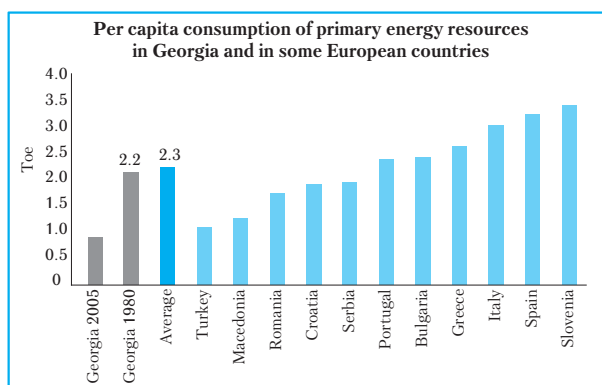
Georgia's energy balance: reality and prognosis

EU energy policy and relevant directives single out the main problems in the development of the energy sector, define the aims of their resolution and identify priorities of action, which also fully correspond to Georgian reality. Among the universal problems in the development of energy sectors are:

- a) increasing demand on investments;
- b) increasing dependency on imported energy resources;
- c) increasing oil and gas prices (in fact, doubling of prices over the last two years) and consequently, increasing electricity prices and other commodities;
- d) global warming;
- e) insufficient liberalization of energy market.

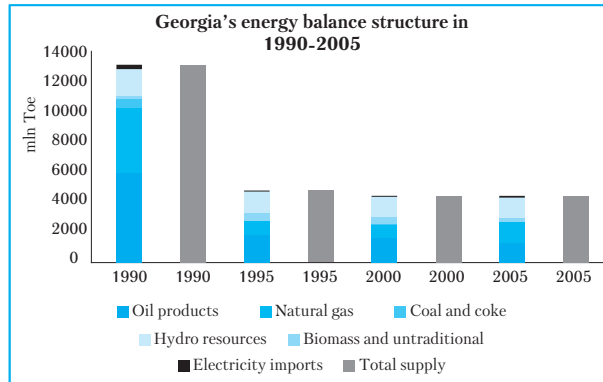
Taking this into account, it is urgent to consider issues of formation of Georgia's energy balance and energy security in the context of the requirements of the EU strategy and legal directives.

In the second half of 1980-es, consumption of primary energy resources per capita in Georgia was about 2.1-2.3 tons of oil equivalent [3], which totals a current average indicator for the European countries, located in comparable climatic zones and geographic environments (see the chart below). Since the break-up of the Soviet Union in 1999 and the demise of traditional centralized energy supply system, the energy consumption in Georgia has sharply dropped and at present it is almost 3 times lower than the world average indicator [4].



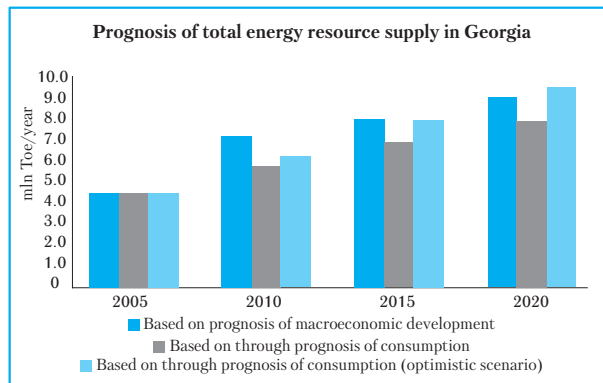
Source: Natural gas strategy for Georgia, May, 2006 and Key World Energy Statistics, IEA, 2005

The following chart shows the structure of Georgia's energy balance and changes between 1990-2005 (it is noteworthy that 1995, 2000 and 2005 data differs from official statistics. The revisions are based on expert assessments, which suggest that the annual consumption of wood in Georgia is around 500 000 tons of oil equivalent and that of oil products - 1 000 000 tons of oil equivalent; HPP generation is revised by applying the equation 1 tons of oil equivalent = 4.5 GWh).



Source: expert assessments

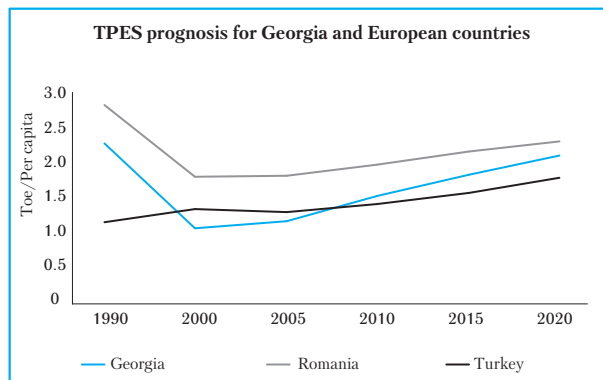
The prognosis for total supply of energy resources up to 2020 (see the chart below), estimated by the authors of this paper, is based on such methods of analysis, which consider various scenarios of the country's macroeconomic development and the impact of energy intensity of output on estimated total energy consumption [5] and/or is based on a detailed analysis of energy demanded by various energy-consuming sectors to arrive at an expected total consumption figure. The core scenario of the country's macroeconomic development is based on an upward GDP growth trend observed over the last decade, while an optimistic scenario is based on that over the last 5 years.



Source: expert assessments

An expected decrease in energy intensity indicator was calculated following the prognosis of the US Energy Information Agency (EIA), which suggests an annual 3.3 percent decrease in this indicator in Georgia and other transitional countries until 2010 and 1.85 percent decrease on average during the next decade. Energy intensity in Georgia today equals 0.65 kg of oil equivalent and under the prognosis it will decrease to 0.35 kg of oil equivalent/USD by 2020.

Based on a comparative analysis conducted by the authors of this paper, it was established that the total primary supply of energy resources (TPES) will significantly increase in Georgia by 2020 and will come very close to the average indicator of Turkey, Romania and other south-east European countries of similar climatic and geographic conditions (Spain, Portugal, Italy, Slovenia, Greece, Bulgaria), which, on the other hand, comprises 60 percent of the average indicator [6] for 30 European countries (see the next chart).



Source: expert assessments

The study suggests that the growth of energy consumption and the formation of energy balance in Georgia should be planned on the basis of rational utilization of domestic, mainly hydro energy resources. According to existing assessments, the hydro energy potential of the country can ensure 135 TWh electricity annually, includ-

ing 32 TWh economically expedient electricity². Now only 10-12 percent of an economic hydro potential has been utilized. The study also identifies prospects and economic expedience for the rehabilitation of existing hydro power plants and the construction of new capacity [7].

Vast possibilities of using in Georgia other renewable energy sources, first and foremost wind and sun energy, have been identified [8]. The total energy potential of the country on the basis of biomass (wood) and waste utilization is estimated at 400 000 tons of oil equivalent/year, which can significantly contribute to a rational formation of the country's energy balance. The energy potential of geothermal spas is also significant [9].

Georgia's sub-bitumen coal reserves are about 350 million tons, while lignite reserves – 76 million tons. However, domestic coal is not regarded as a serious source for the formation of energy balance in the short-term because of its relatively low quality and difficult geological laying-out coal layers, which makes it complicated and expensive to generate energy. Moreover, the economic significance of coal utilization may largely increase in case of using underground coal gasification and modern clean technologies for energy generation.

It is planned to increase significantly oil and gas extraction from domestic, including deposits in the Black Sea offshore. However, the prospects and the scale of the development depend on estimated parameters to be derived on the basis of ongoing geophysical investigations [10]. By expert assessments, it is expected to discover a deposit with the capacity of 2-2.5 million tons a year in eastern Georgia in the nearest future, while in 7-10 years oil extraction from the Black Sea shelf may reach 3-3.5 million tons a year [11].

The consumption of energy in Georgia is characterized by very low efficiency. Economic potential gained in Georgia, as well as in southeast European countries; through energy saving is estimated at 30-50 percent of current consumption. Crude calculations suggest that the increase of energy efficiency in supply and consumption sides by just 10 percent, will lower the dependence of the country on imported energy resources by approximately 20 percent.

Through a survey, conducted in compliance with the requirements of EU strategy and directives, it was established that for the development of Georgia's energy sector and rational formation of the energy balance, the following aspects should be regarded as main priorities in the short and medium terms:

- 1.Rehabilitation/modernization of existing energy capacity and construction of new hydro power plans;
- 2.Regional integration of power systems by means of constructing internal high-voltage lines as well as high-voltage lines connecting to other countries in the region, and by using exports for peak energy instead of basic one;
- 3.Diversification of natural gas supply sources and routes, promotion of the development of international transit routes;
- 4.Ensuring strategic energy reserves through building storage in the country or using existing storage outside the country, as defined by the EU energy security strategy;
- 5.Significant improvement in utilization of energy resources in every unit of generation, supply and consumption sectors;
- 6.Significant increase in the extraction of coal, oil and gas and the development of local processing industry on the basis of vast utilization of local fossil fuels;
- 7.Development of legislative framework and improvement of investment climate by promoting utilization of renewal energy sources, mainly wind and solar energy.

Prospects for diversification of natural gas transit routes and market

According to prognosis, natural gas, for its ecological advantage, simplicity of consumption and economic expedience compared to other fossil fuels, will be a leading resource in the formation of world energy balance in the 21st century. The consumption of natural gas in Europe is expected to increase from 371 billion m³ in 2000 to 750-800 billion m³ by 2020 [12], 60 percent of which will be imported from other regions.

At the same time, the limitations of traditional sources of supply and transport infrastructure, also inadequate behaviour of one of the main importers, Russia, during the gas crisis in Ukraine and Georgia last winter, which affected the gas supply of some European countries too, made it apparent that it is necessary to diversify the international energy market through the development of new sources and routes. An attempt by Russia to use the export of energy resources as a tool for exerting political pressure on neighbouring countries and blackmailing the EU made it apparent to the international community that active actions are needed to support new international projects.

Under these circumstances, the Caspian Sea basin countries and South Caucasus, which Europe considers prospective regions for additional gas supply and relevant transit infrastructure development can play a strategic role. Estimated natural gas resources in Azerbaijan, Turkmenistan, Kazakhstan and Uzbekistan stand at 10 trillion

² *The assessment is subjective to some extent, because it does not consider possibility of significant change in overall economic situation and changes of market conjuncture.*

m³, while additional resources at 32 trillion m³ [13], which is 75 times more than current import of Europe. The utilization and transportation of these resources is a problematic issue because, at present, Caspian natural gas transit routes are completely monopolized by Russia together with Iran. This factor increases the dependence of producing countries and the European market on a monopolist supplier (Gasprom) to a dangerous level. Gasprom permanently neglects liberal market rules acknowledged in the world gas industry, including the rules on third party access to available capacities, which is one of the main requirements Energy Charter Treaty³.

Efforts have been taken within the framework of INOGATE and other international energy projects to reanimate the Trans-Caspian gas pipeline project, developed some time ago. The project envisages the supply of gas from eastern Turkmenistan and Kazakhstan to the international market through Trans-Caspian pipeline (TCP) and a pipeline through the South Caucasus. The installed capacity of the pipeline is 21 billion m³/year; the length across the Central Asian countries is 780 880 km and across the Caspian Sea offshore segment – 290 km [14]. The investment needed for the project is estimated at USD 3.3 billion.

According to recent information, it is also planned to start the second phase of the utilization of Shah-Deniz oil deposit in Azerbaijan and to load the South Caucasus Pipeline (SCP) with a corresponding capacity (18-22 m³/y) in 2009-2010 instead of loading it as originally planned in 2011-2014. The reason for that change is the fact that searches have not only proved the existence of resources but also showed more optimistic results on the one hand, and on the other, the demand of the European market for additional gas supplies through alternative routes have increased.

At the end of June, the energy ministers of Austria, Bulgaria, Hungary, Romania and Turkey and the EU energy commissar signed in Vienna a Ministerial Statement in support of the Nabucco gas pipeline project. For the first time ever, this agreement specified that the pipeline is designed for the supply of Caspian and Iranian gas to Europe for the purpose of diversification. The 1420 mm diameter, 3400 km long pipeline will connect the junction of SCP and Iran-Turkey pipelines with Erzerum (Turkey) and the Austrian Baumgarten, which is one of the international gas trade hubs in Europe. The initial design stage of designing the Nabucco pipeline project will be financed by the EU and from 2007 a newly established consortium (Nabucco Gas International) will launch the construction, which is to be completed by 2010. The planned initial throughput of the pipeline is 8 billion m³/y (under optimistic scenario - 13 m³/y) and will increase to 25 m³/y (under optimistic scenario - 31 m³/y) by 2020. The construction cost varies between USD 4.6 – 5.8 billion. According to expert assessments, the Nabucco pipeline can be best supplied from Azerbaijan's Shah-Deniz gas field through SCP network [15]. Because of the Iranian government's policy, prospects of Iranian gas supply are lower and Turkmen and Kazakh gas seems to be more feasible option for the Nabucco pipeline supply through TCP and/or SCP networks.

Possibilities of extending TCP to include the South Caucasus segment (about 900-km-long arm across Azerbaijan and Georgia) and the Black Sea offshore segment (about 500-600-km-long arm from Poti or Sukhumi to Ukraine's Feodosia) is being also discussed. It is planned to connect to the main gas route and transit pipeline system of Europe. The Central Asia-Ukraine (CAU) pipeline's total length is about 2600 km, expected annual throughput – minimum 30 m³/y, the amount of investments - USD 5.5 billion. An alternative option envisages the use of IGAT-3 pipeline in Iran carrying gas from the rich Pharsi deposit in southern Iran to the Azerbaijani border and further through the South Caucasus and Black Sea segments to Ukraine. Investments needed for the construction of the North Iran-Ukraine (NIU) pipeline is estimated at USD 6 billion.

Experience shows that geopolitical factors should be given serious attention when assessing the probability of realizing alternative gas routes. Alternative routes for Caspian gas initiated by Russia – the existing Blue Stream, South European Gas Pipeline agreed by President Putin with the Hungarian government during his visit to this country in March 2006, Central Asia – China and Trans-Afghanistan pipeline (TAP) projects – may prove to be a serious impeding factor in the implementation of projects on delivering Caspian and Iranian gas to the European market via Georgia [16]. In general, the competitiveness of alternative routes for the delivery of additional gas to international markets primarily depends on transportation costs and transit fees. Analysis suggests that the Shah-Deniz Phase II project and SCP and TCP pipeline projects [3] are the most competitive for the delivery of about 30 billion m³ (with the prospect of increasing to 50 billion m³) Azeri and Caspian gas to the European energy market, provided that their development is consolidated (thus saving about USD 1 billion investment) and they are connected to the Nabucco pipeline.

It can be concluded that the current situation on the international energy market adds a global strategic dimension to the issue of constructing alternative gas routes that will run through Georgia and be free of Russian influence. The implementation of these transit pipeline projects will ensure the diversification of the European energy market, successful integration of Georgia and GUAM, Central Asian and East European countries into global economic structures and sustainable development of the region, and will put an end to the monopoly of a single company on the supply of strategic resources to the international energy market.

³ An example of Gasprom's behaviour is the fact of blocking the supply of Kazakh gas to Georgia last year when the corresponding section of Makati-North Caucasus main route (Aturau-Grozno section) was actually unloaded.

References:

1. Samson Ivan. The search for a development path: challenges for Georgia. Georgian Economic Trends, Georgia, Quarterly Review, March, 2005.
2. Green Paper, A European Strategy for Sustainable, Competitive and Secure Energy. Commission of the European Communities, Brussels, 8.3.2006.
3. Natural gas strategy for Georgia, Part 2. Economic and Geopolitical Context, prepared by T. Gochitashvili in frames of contract with “CORE International Inc”, USAID, Project: Advisory Assistance to the ministry of Energy of Georgia, May, 2006.
4. Key World Energy Statistics, IEA, 2005.
5. World Energy Model. World Energy Outlook 2005, worldenergyoutlook@iea.org
6. European energy and transport trends to 2030. Summary Energy Balances and Indicators, EC, January, 2003.
7. Gilauri N. Investment opportunities in the energy sector of Georgia, Presentation at GIOGIE 2006 Conference, Tbilisi, March, 2006 and Invitation on Expression of Interests. The Energy Ministry of Georgia, March 29, 2006, www.minenergy.gov.ge
8. IFC/CFF Market Assessment of SME activities: energy efficiency and renewable energy in Georgia, Winrock International with contribution of EEC Georgia and ABCO, Report, 2005.
9. Georgian thermal waters, Georgian Geothermal association, 1988.
10. Extractive and Energy Transit industries in Georgia, Open Society Georgia Foundation, Background Report, Tbilisi, 2006.
11. Varshalomidze G. Prospects of Hydrocarbon Exploration, Extraction and Production in Georgia, Georgian Oil and Gas, , 2005, No. 12.
12. Study of Mediterranean de L’Energie Institution, OME Report, 2002.
13. Center for Global Energy Studies, Study Report, 2002.
14. Feasibility Study for the oil and gas pipelines through Caspian Sea, INOGATE, Project N 9601, Snamprogetti/ILF/Partex, September, 1999.
15. Socor V. Nabucco Pipeline Project to Diversify Europe’s Gas Supplies, Austria Presse Agentur, ORF, Der Standart, June 26-28, 2006.
16. Socor V. Gazprom SEGP Project, RosUkrEnergo conflict with EU in Hungary, Newsweek International, July 3, 2006.

PART III. ECONOMIC REFORM AGENDA

TAX ADMINISTRATION REFORM IN GEORGIA

Bill Cumow

Team Leader, the EU funded project "Support to the Georgian Tax Department".

Given the number of established tax administrations in advanced economies, the question is often asked why one of these administrations cannot be simply replicated in a country like Georgia. There are cultural, different political and administrative structures and practices, unique historical reasons etc why democracies and taxation systems cannot simply be replicated. This article establishes a link between democracy and taxation, considers 'tax culture', explains the scope of a tax administration drawing the distinction with tax policy, and looks at the recent history of the Georgian Tax Department before examining the structure and on-going reform issues.

Changing a Tax Culture

Cultural changes are amongst the most difficult to make. Changing long-held, deep-rooted attitudes, beliefs and practices is difficult for those making and those accepting cultural change. What is tax culture? There have been many attempts to define it – but a general consensus is that it is a common attitude in a particular society towards taxation. A poor tax culture involves an attitude among taxpayers that avoids or evades taxation and a tendency amongst tax officials to collude with this attitude for personal gain. By contrast a good tax culture is an acceptance that taxes should be paid, a feeling of obligation by taxpayers towards the rest of society and a sense of public service among tax officials. That is not to say that, even in a good tax culture, taxpayers enjoy paying taxes. It is more an acceptance that it is the right thing to do.

However, tax culture is fragile. History is littered with examples of previously tax-compliant societies objecting to tax policies it sees as extortionate or inequitable often with serious consequences (an example is the UK revolt against a poll tax in 1990, which finally brought down the Thatcher government – a repeat of the Peasant's Revolt over 600 years earlier against a previous attempt to introduce a poll tax).

Transition economies have to undergo a cultural change. Less than twenty years ago, paying taxes was not something about which Georgians had to concern themselves. After 70 years of Soviet rule, keeping tax records and filing returns were not activities familiar to the citizens of Georgia, and tax appeals, arrears, enforcement or tax audits were not disciplines familiar to government officials. Whilst far from perfect, it is remarkable how far Georgia has come.

Of course, some aspects of market economics have been more easily accepted and understood than others. Georgians have eagerly taken the opportunity to exercise entrepreneurial skills to make a profit as the number of small businesses demonstrates. However, less easily accepted has been the obligation to part with some of those profits in order to pay taxes for the services provided by government. As democratic principles take root, the fundamental link between democracy and taxation will strengthen. Governments are elected on mandates from the citizens to follow policies, and provide services, for which the citizens will pay in the form of taxation, and in established democracies, the debate is about how much the citizens are willing to pay for particular services and how that burden of taxation is distributed. The poll tax revolt in the UK was a groundswell of objections to how the tax burden was being distributed and it reached such proportions that the policy had to be withdrawn. As we shall see, an important element of Tax Administration Reform is the constant need to keep the public informed – not just of their rights, and their responsibilities under the law, but also why they are paying taxes and what they are receiving in return.

Scope of Tax Administration

Tax policies are designed to raise the revenue to pay for government services, but it is important to make the distinction between tax policy, decided by politicians and tax administration, the responsibility of civil servants. The core activity of the Tax Department is to administer tax legislation and regulations. That legislation gives taxpayers rights and responsibilities, and makes the Tax Department accountable for protecting taxpayers' rights but also gives them powers to enforce taxpayers' responsibilities.

Tax Administration Reform is all about how the Tax Department is made accountable for protecting taxpayers' rights, what powers they are given to enforce taxpayers' obligations, how they balance these two responsibilities and how they organise themselves to undertake both these tasks.

Recent Georgian Tax Administration History

A Tax Department for Georgia was first established on 31st March 1990 as part of the Ministry of Finance, but was made an independent State Tax Inspectorate in March 1992, before being incorporated once more into the

Ministry of Finance in June 1997. There have been various reorganisations since, but since June 2002 it has been an ancillary unit of the Ministry of Finance.

Formal independence of Georgia from the Soviet Union was declared on April 9th 1991, but was not immediately recognised by the United States or by the European Union. Tax Administration became a sorry casualty of the administrative chaos that ensued, and it was not an enviable situation. Politicians and administrators alike saw the tax system as easy pickings. Unfortunately, Georgia already had a reputation for corruption (it is said that even Russia, not without its own reputation for corruption, found the situation in Georgia embarrassing), and by 1999, Transparency International listed Georgia as the 16th most corrupt country out of the 99 it had examined. It is not necessary here to go into details of the levels of corruption in the collection of taxes, and the role of organised crime, often with political connections, which have been documented elsewhere. It is sufficient to report on the writer's discussion with a former tax official who revealed that his target for collection was several million GEL in taxation each month, for which his salary had been 36 GEL (say 18 euros) per month and he had a young family to support. He was surprised that anybody could blame him for being corrupt. "What did they expect?" he explained, and went on to say corruption was endemic and even expected, he thought, by senior managers. Never having been in that situation, it is difficult to condemn or condone his corruption, except to say that once corruption is part of the 'system', would the level of his salary have made any difference?

"Rose Revolution"

After the revolution of November 2003, the new Georgian Government committed to a nation-wide programme of reforms to combat corruption and promote economic development. The programme encompasses three aims:

1. To improve governance through administrative and civil service reform;
2. To reinforce public expenditure management through an enhanced process for the State budget preparation and execution; and
3. To fight widespread corruption through the reorganisation of some line Ministries (e.g. Interior and Office of the Prosecutors).

The fight against corruption would become manifest through the following means:

- Changes in the legislation (e.g. elimination of special revenues; re-focus the role of the financial police, etc.);
- Improved structure and function of the court system and the executive branches of government; and
- Enhanced transparency.

In addition, the Government pledged to improve the investment climate through a simplified system of business registration, building permits, tax and customs administration and standardisation, certification and control over business.

These Aims impact the Tax Department as follows.

Programme Aim 1 - Improving Tax Department Governance through Administrative and Civil Service Reform

Since the new Government took office, the Constitution was amended and a Law on Structure, Functions and Responsibility of the Government was enacted. The Constitution created the figure of the Prime Minister and a Cabinet of Ministers, reduced the number of Ministries from 18 to 14; and consolidated many semi-independent state departments in the line ministries. In addition, most Ministries received new mandates, were liquidated, re-organised and streamlined.

Tax Department Structural Reform

The Tax Department has already had several iterations of a new organisation, and more are expected. The trend in tax administrations is to organise along functional lines, as opposed to type of taxes or taxpayers. Staff are organized principally by functional groupings (e.g. registration, accounting, information processing, audit, collection, appeals, etc.) and generally work across taxes. This approach to organizing tax work enables greater standardization of work processes across taxes, simplifies computerization and arrangements for taxpayers, and generally improves efficiency. Compared to the tax type model, this model was perceived to offer many advantages and has facilitated many developments aimed at improving tax administration performance (e.g. providing single points of access for tax inquiries, unified system of taxpayer registration, common tax payment and accounting approaches, and more effective management of tax audit and debt collection functions). However, this model also is not without its weaknesses—fragmentation by function can lead to poor/inconsistent service while standardization (e.g. a "one size fits all" approach) may not be appropriate given the myriad of behaviours and varying attitudes to tax compliance to be addressed.

As part of the organisational reforms, Tax Administration staff was reduced by 44 percent in 2002. The structure of the Central Office of the Tax Department was changed, and the total number of inspectorates reduced from 73 district zone and rayon tax inspectorates to 8 tax inspectorates (excluding the Inspectorate for Large Taxpay-

ers and the Excise Tax Inspectorates). For example, the 5 district tax inspectorates in Tbilisi were merged into 1 central Tbilisi tax inspectorate in autumn 2004. Responsibilities within each inspectorate changed too, to include Taxpayer Registration, Return Processing, Audit, Tax Assessments, Legal and Appeals, and General Administration. As a part of the reorganisation of the Tax Department, the Taxpayer Service Unit has been maintained in each district to deal with taxpayers' requests, to provide answers on their questions and to supply information aiming at an enhanced public awareness and an increase of taxpayer compliance.

The current structure was established with the assistance of a USAID project. In principle, it follows a model widely used in other countries – with the head office dealing with policy and strategies and establishing working methodologies and processes, the regional offices is the executive level and deals with 'back office' processes such as audits and the local offices dealing with the 'front office' work including taxpayer service. However, in practice, there have been compromises. The establishment of a Large Taxpayer Inspectorate is an exception to the functional organizational principle, but is in line with the practice in most countries because of the significance to the economy of compliance and prompt payment by these taxpayers. Additionally, for example, registration, a taxpayer service function best dealt with at local level, is being done at regional offices because of the serious constraints of the IT network and equipment.

Many of the current problems of the Tax Department are being blamed on the organisational structure, but we should not confuse where a function is performed with how well it is done. Unfortunately the titles given to Divisions within the Tax Department sometimes lack clarity, and the mandates have to be studied in order to understand the structure. But the real problems have less to do with the structure than with the low levels of experience and training of most of the staff, particularly at middle management levels, and a management culture in transition economies, which typically lacks the confidence to delegate authorities and empower the staff.

The Tax Department (central office) consists of 9 Divisions

- The Chairman's Secretariat is a support unit for the Chairman, but is also responsible for public and international relations and all internal and external communications. This includes diverse activities such as the web site and international agreements. They are responsible for the Department's Plans, documentation management and the registry and also look after office security.
- Methods of Taxation and Tax Collection develops standards and monitors the development of procedures for all tax functions and the implementation of them at Inspectorate and local offices. They seek improvements in methods of working as well as the review and clarification of legislation. They design forms and the instructions for completing them and are responsible for taxpayer service insofar as they are the authority for dealing with taxpayer problems which cannot be dealt with at Inspectorate or local office level, and for management information and performance measurements.
- Legal and Appeals draft legislative proposals and review the legality of all procedures, normative acts and correspondence leaving the Tax Department. They provide legal support and court representation for Tax Appeals, for actions arising from enforcement and distraint activities and from violations of the Code of Administrative Offences and Tax Code.
- Taxpayer Audit and Indirect Taxes develop audit methodologies and procedures and the department's annual audit plan. They analyse audit reports and audit feedback for future audits and produce benchmarks for the purposes of risk assessment. They examine export-import transactions for evidence of, for example, transfer pricing transactions.
- Taxpayer Registration maintains the Register of Taxpayers and provides analyses and reports.
- IT maintains and develops the IT infrastructure including hardware and application software and provides system support to the Department.
- Account Reporting and Revenue and Arrears Analysis develop the procedures for maintaining taxpayer accounting data, (under the various heads of tax and including interest and penalties), accounting for remissions to the State Budget and for the statistical analysis of this data. They provide the forecasts for the State Budget, set targets for each office, monitor the flow of tax into the budget. They monitor the accumulation of arrears and their collection, negotiate the restructuring of tax debts and justify the writing off of bad debts.
- Tax Department Budget maintains the Department's accounts, estimates and negotiates the expenditure budget for all the Inspectorates, manages payrolls and incentive payments, controls the Department's running costs centrally and for Inspectorates and maintains the property of the central Tax Department.
- HR Management maintains personnel records, develops job descriptions and supervises the appraisal and promotion procedures, coordinates the training of staff with the Training Centre, and manages staff disciplinary processes.

The Tax Inspectorates

A Tax Inspectorate has 5 Departments.

- The Taxpayer Service Department is responsible for registration of taxpayers and their cash registers and the entry of businesses into the Entrepreneurial Register, receipt, examination and computer entry of tax returns.

They also maintain and manage taxpayer documentation, receive information from treasury on taxes paid, and maintain the taxpayer account, provide reporting of receipts and arrears to the Tax Department and arrange for overpayments to be set off against other liabilities or refunded. They report violations of the Tax or Administrative Code to the Tax Department and provide advice and support to taxpayers.

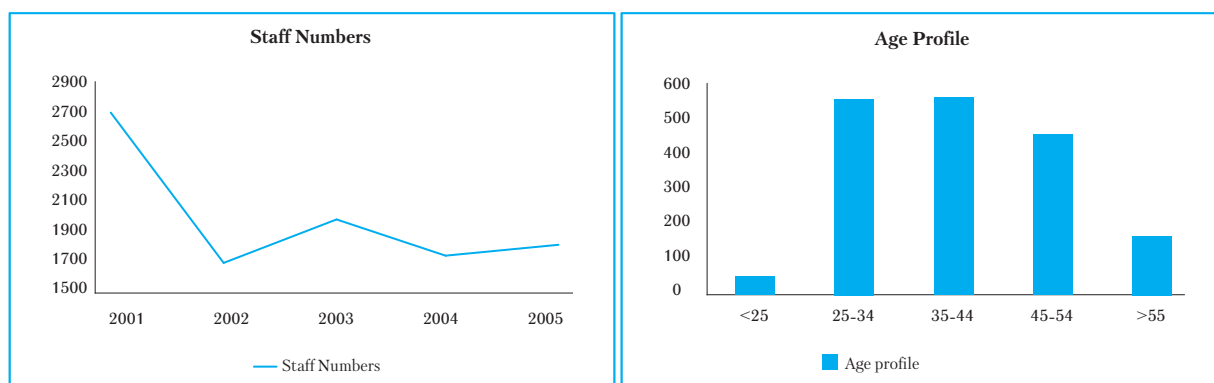
- The Tax Audit Department produces an annual audit plan, and conducts audits.
- The Tax Administration Department manages arrears, restructuring debts and writing off irrecoverable arrears, and undertakes enforcement activities, seizing and selling property. They also investigate tax avoidance and non-compliant activities.
- Legal and Appeals Department gives legal advice on the Tax Code and normative acts and handles tax appeals and cases of tax or administrative violations, representing the Inspectorate in court when necessary.
- The Administration is responsible for the office budget and accounts, communications including documentation management, archiving and mail, and local personnel work.

Staffing

After a significant ‘shake-out’ of staff in 2002, and another minor one in 2004, staff number have stabilised as the chart below demonstrates. Over 65 percent of current staff are under the age of 45.

Civil servants have been, or still are, in the process of being appointed on the basis of new curricula and tests. The current recruitment system of internships and examination should ensure a better-educated generation of tax officials, and therefore one of higher management potential, than hitherto. It would be helpful if this testing was competency-based, focused on looking at each area of aptitudes, skills and knowledge required for the job of a tax inspector. These competencies for the jobs need to be defined. Nevertheless, progress has been made and will continue.

The problem, of course, is the relatively low level of experience within the administration, putting a high level of responsibility for day-to-day decision-making on the more experienced senior managers, but during 2004, there was an almost 100 percent turnover of senior staff occupying key positions within the Ministry of Finance (MoF), and the Tax and Customs Departments.



Source: Tax Department, Ministry of Finance

Recruitment is only the first of the Human Resource Management (HRM) building blocks that are required. Finding square pegs for square holes is important, but retaining the best tax officials is a problem for every country, and each has its own method of dealing with it. Remuneration is an important factor, but it has to be accepted that the accountancy profession and financial services industries will always be able to offer greater incentives for the best tax auditors than government, and no government can afford to enter a competitive bidding process for the available talents. There has to be other means of retaining staff, such as greater security of tenure, better training opportunities, more interesting work, a better career path with the potential for high public office. This would make the Tax Department a desirable place to work, by giving a corporate image for the Tax Department of which officials can be proud and which instils a sense of public service. Of course a remuneration system, which is seen as adequate, is important, and the incentive here is to make it performance-based, so that officials can always see the prospect of earning more if they perform well. Performance Pay of course has to be based on an Appraisal System, which is seen as fair and objective by all employees.

All these are the building blocks of an HRM system, which are sadly missing from the Tax Department so far.

Programme Aim 2 - Reinforce public expenditure management

This aim has no major impact on the Tax Department. As a broad rule, government consists of revenue and spending departments, and the revenue departments are often made to feel like poor relations to the spending departments, despite their importance to the economy. Politicians usually feel they win more votes by promising enhanced social benefits – health, education, pensions, transport and roads etc than they do by promising reforms

to the tax system, so they take a greater interest in the performance of spending departments. The only votes they might win by promising tax cuts may include downsizing of the revenue departments.

To a Tax Administration, Public Expenditure Management usually means job cuts. Actual expenditure on the Tax Administration in 2005 amounted to 14,751.1 thousand GEL. This is an important piece of information, because it tells us that the cost of raising each lari is 1 tetri, which is absolutely on a par with developing and transitional economies. At present, the Tax Department Annual Report includes a breakdown of its expenditures, without making the direct relationship to revenues collected. This would be a key indicator of its performance – demonstrating its commitment to meeting revenue targets at an acceptable cost to the taxpayer.

Programme Aim 3 – Fighting Widespread Corruption

As Staffing Charts above illustrate, the significant reduction of staffing took place in 2002. The belief is that these dismissals were almost entirely associated with corruption allegations, but no analysis of the reasons for dismissal, or of prosecutions for corruption, has been made available. Since November 2003, 41 employees have been dismissed of whom there were 9 court decisions declaring them guilty of corruption, but it is not known what their punishment was, how many of the 41 were dismissed for corruption reasons (likely to be most of them) nor why only 9 were found guilty of corruption.

There is no doubt that corruption still exists, albeit at a much lower level than previously, and at much higher risk to the perpetrators. So soon after a period when corruption was all prevailing, it would be unwise to suppose it has suddenly been eliminated. There is probably a “wait-and-see” attitude among some who expect the current anti-corruption commitment to be relaxed, so continuous vigilance is essential. It would help public perception and confidence if there were more transparency in the prosecution of corrupt officials, with figures published of prosecutions and sentencing. The system of plea-bargaining is not helpful – light sentences given for admissions of guilt and for implications of other officials, does not make corruption such a high-risk activity. Experience in advanced economies suggests that it is possible to prosecute cases of corruption successfully. The Georgian authorities need to be more thorough in the identification and presentation of appropriate evidence.

Programme Aim 4 – Changing Legislation

Tax Code 2004

In December 2004, a new Tax Code was adopted, effective as from 1 January 2005. The new Tax Code constitutes a comprehensive reform of tax legislation in Georgia. It has substantially simplified the tax system by reducing the type of taxes from 21 to 7 (income tax, profits tax, social tax, value added tax, excise tax, property tax and gambling tax) and the tax rates have been reduced considerably. For example, the rates of the income tax went down from 20 to 12 percent, the social tax from 33 to 20 percent, and the VAT from 20 to 18 percent, while the profits tax rate remained unchanged (i.e. 20 percent). The rationale of this reform is to reduce the tax rates, to broaden the taxable base of various taxes (partly by abolishing a wide range of exemptions and incentives which were granted under the previous tax code and which – in itself – constituted a source of corruption), to curb tax evasion by simplifying the system and tax administration procedures and by extending the powers of the tax administration to enforce compliance, in order to ensure constant or increasing budget revenues for the future. However, due to late moment of adoption of the Tax Code (less than 10 days before the entry-into-force), measures to ensure proper implementation and application and to build adequate capacity for the administration of taxes in line with the provisions of the new Tax Code were either taken too late or not at all. The same applies to public awareness and taxpayer compliance.

Three of the major challenges for the Tax Department now are:

- a. the development of detailed procedures for each of the functions of the Department;
- b. training of tax officials in those functions as well as in the Tax Code and management;
- c. developing public awareness of their rights and responsibilities under the Tax Code as part of a wider improvement of Taxpayer Services.

The haste, with which the new code was adopted, inevitably meant that there were many imperfections – contradictions and lack of clarity. Subsequent and ongoing legislation is gradually removing some of these imperfections. Recent changes, for example, have included:

- Reductions in elapsed time to register businesses from 8 to 3 days, individuals from 6 to 1 day and associations and funds from 20 to 5 days;
- Individuals making single transactions need not register as a taxpayer, they only need a passport ID;
- Clarification of the crediting of overpayments of tax against other tax liabilities or making refunds within 3 months (reduced from 6 months);
- Assets being leased to be regarded as fixed assets, and lease payments to be subject to VAT on the day of lease payments according to the leasing contract;

- Communications services rendered to foreign purchasers will be exempt from VAT;
- VAT paid by foreigners for goods and services will be reimbursed at the borders;
- Imported goods used to maintain the energy sector and the import and supply of natural gas to generate electricity will be exempt from VAT;
- Property tax compliance procedures have been simplified.

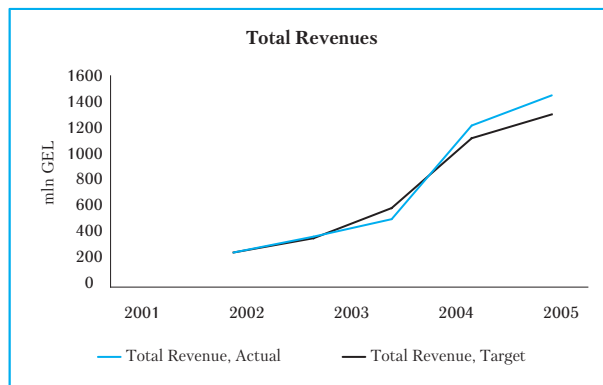
Impact of the reforms on revenue

The following chart illustrates the growth of tax revenues of the central government. Revenues include those taxes which are the responsibility of the Tax Department (Income Tax, Profit Tax, Value Added Tax, Excise, Social Tax, Property Tax, Gambling Tax and various arrears of subsequently revoked taxes). They exclude Customs Duties.

Table 1: Total Revenues (thousand GEL)

	2001	2002	2003	2004	2005		
					Actual Revenue	Percentage to	
						Forecasted Figure	Relevant Figure of Previous year
Total tax revenues	696 000.0	772 459.7	853 066.6	1 299 837.1	1 441 817.1	106.6	110.9
State Budget	-	466 290.1	509 377.1	784 693.4	866 429.7	107.9	110.4
Local Budget	-	306 169.6	343 689.5	515 143.7	575 387.5	104.7	111.7

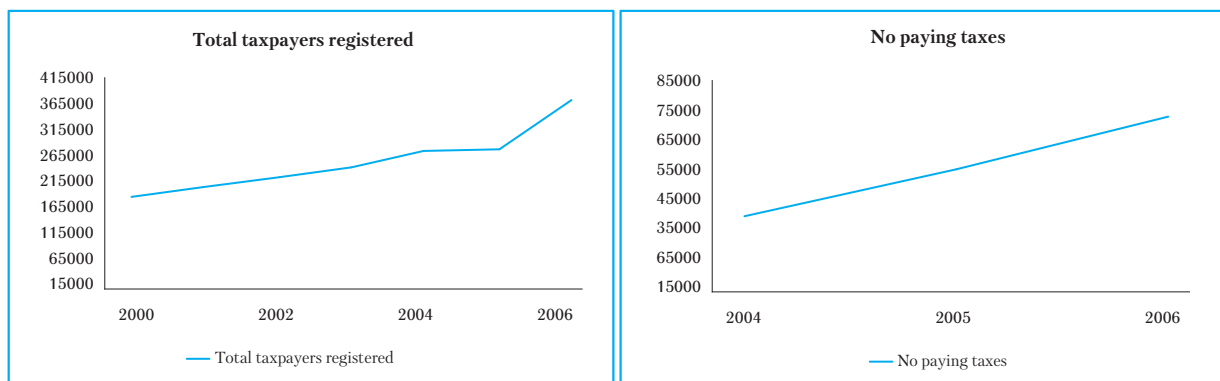
Source: Tax Department, Ministry of Finance



Source: Tax Department, Ministry of Finance

Total revenues for 2005 were almost 11 percent higher than in 2004 which were 52.4 percent higher than 2003 and 107 percent higher than 2001.

It is significant that the major improvement began in 2004 – so had nothing to do with the adoption of a new Tax Code. This extraordinary performance in 2004 (according to the IMF tax increased from 14.5 percent of GDP to 18.2 percent) is generally attributed to a much more vigorous approach to investigations and audit. The resulting increase in the number of registered and ‘active’ taxpayers during the period is indicated in the charts below. Unfortunately, the number of ‘active’ taxpayers is not known for the period prior to 2004. The figures of number of taxpayers generally are unreliable – due to the vagaries of the tax registration system, which is not computerised in some of the more remote regions and the difference between ‘active’ and ‘inactive’ registered taxpayers, and issues such as a taxpayer being ‘active’ even though he only makes a single payment in a year, etc. All these registration problems will hopefully be resolved when the new registration system is introduced.



Source: Tax Department, Ministry of Finance

However revenue improvements have continued into 2005, but in spite of this success, there is still some doubt about whether the success is due to the structural reforms and whether these are sufficiently comprehensive, to be sustainable. In particular, as already discussed, the problems of inexperienced staff, inadequate training and the absence of standards, methodologies and detailed procedures are still influencing at large the tax administration and its public perception. The introduction of the new Tax Code requires additional efforts to develop new regulations and procedures.

Although, during the last 18 months, the Georgian Government has taken many steps towards substantive institutional reforms in order to promote good governance, a lot still need to be done to accomplish a real change in the country. During its visit to Georgia in November 2005, the IMF expressed concerns that despite the reforms that had taken place and the remarkable improvement of revenues, there were still underlying weaknesses especially in the areas of Taxpayer Service, management of tax arrears, and audit. They also thought that the Large Taxpayer Inspectorate (LTI) should increase its tax base in order to collect about 60 percent of total tax revenues. In 2005, the figure was less than 40 percent. The LTI should assess the feasibility of meeting the IMF target.

Programme Aim 5 – Improved Structure of the Court System

Apart from the prosecution of officials for corruption (discussed elsewhere) the main use of the court system by the Tax Department is for the hearing of appeals against tax liabilities by taxpayers. The Appeals system is a major source of complaints from taxpayers. Georgia briefly set up an independent tax tribunal to hear taxpayer appeals. This is in line with most international practice. However, much to the dismay of taxpayers and their representatives, the independent tribunal was abandoned and the only recourse for taxpayers is to the courts.

Interviews with taxpayers and their representatives suggest they believe the tribunal was abandoned because too many cases were being decided in favour of the taxpayer, compared with now, when the courts rarely, if ever, decide in favour of the taxpayer. The latter perception is not borne out by the facts. For 2005 the Tax Department reports that of the 26 cases concluded by the courts during the year, 15 cases were decided in favour of the Tax Department and 11 (42 percent) in favour of the taxpayer.

Table 2: Appeals Court Cases, 2005

	Number	Amount of tax at risk GEL thousand
Cases referred to Courts	425	251 654.1
Completed	26	51 544.4
Decisions in favour of the Tax Department	15	10 165.0
Decisions in favour of the Taxpayer	11	41 379.4

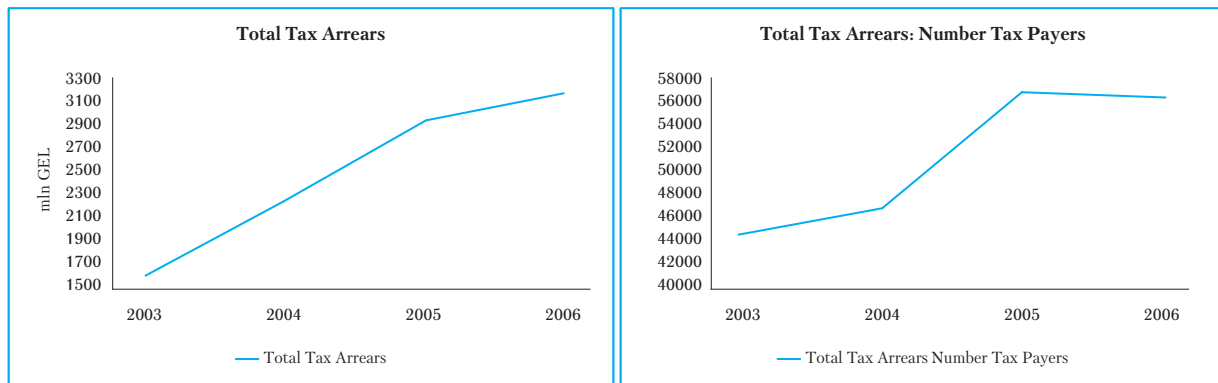
Source: Tax Department, Ministry of Finance

However this tells only part of the story. There were a total of 425 appeals referred to the court, so presumably there are at least 400 cases still waiting to be heard, suggesting unacceptable delays in settling appeals. In addition, the Tax Department received another 799 appeals during the period. What happened to these, and how many were decided in favour of the taxpayer, is not reported.

The Appeals process needs to be made more transparent and taxpayer-friendly. In the UK, it was not unknown for the Inland Revenue, having listened to the taxpayer’s arguments, to agree that there was a good case to be made by the taxpayer, and although Inland Revenue did not agree with that case, they encouraged the taxpayer to take them to court, and win or lose, would pay the costs. The reasoning was that it is in the interests of the tax administration to have the law clarified and a precedent set to be used in future. In terms of the relationship between tax official and taxpayer, Georgia has some way to go before this stage is reached. However, the process for a taxpayer to make an appeal could be simplified and speeded up, and the court decisions put in the public domain and published quickly so that taxpayers and their representatives are made aware of the court’s interpretations of the legislation.

Arrears

One of the issues raised by the IMF in their latest mission is the state of tax arrears in Georgia, which are very high and continue to grow at an unacceptable rate, as the charts below indicate.



Source: Tax Department, Ministry of Finance

The imposition of interest charges and penalties on tax debtors is a major reason for this continued growth, accounting for 64 percent of the total arrears. Work on restructuring these debts and recovering these arrears is ongoing.

Compliance and Taxpayer Service

The Tax Department has powers to enforce the fulfilment of taxpayer's obligations and has been using those powers recently. Together with the Financial Police, they have closed businesses and seized financial records for auditing in some well-publicised compliance actions. The growth in revenues and in the number of registered taxpayers suggests that these actions have, in general, been justified. Unfortunately, compliant and innocent taxpayers have been caught up in these actions and the Tax Department must ensure they target tax evaders more specifically using better risk criteria. Faced with widespread tax evasion, this approach is necessary to reinforce the message that taxpayers have obligations under the law. However in the long term, it may produce a resentful and ever more devious business climate.

Alongside this enforcement activity, tax authorities see improvements in taxpayer service as having an important role to play in improving tax compliance, and the Tax Department has identified Taxpayer Service as one of its priorities - helping taxpayers to understand their rights under the Tax Code of Georgia, and facilitating the fulfilment of taxpayers' obligations, in a manner which is both efficient and effective for both taxpayers and tax administrators. Encouraging voluntary compliance through better taxpayer service, and reducing the costs to the taxpayer of complying with tax laws, in the long term, may be more effective and efficient than enforcement.

Making the public aware of their rights and responsibilities and making the operation of the Tax Department transparent, is fundamental to Taxpayer Service. The recent publication of leaflets on tax registration, and of the annual report and quarterly revenue statistics are efforts to improve public awareness, and there is much more effort being made to make these communications taxpayer friendly in both the language they use (less legalese) and in the information they provide. These publications will be made widely available at every local tax office as well as on the Department's internet web site.

Efforts are also being made to simplify tax forms and making the payment of taxes more convenient for the taxpayer. As with most other countries, the internet is seen as a tool to provide better taxpayer service, and the Tax Department is developing tools to assist taxpayers to calculate their obligations and, in the longer term, to file their tax returns.

Donor Support

The Tax Department is being supported by the European Union TACIS programme, USAID Georgian Business Climate Reform project, the US Treasury and UNDP. USAID have been advising on the production of Departmental Strategies and Plans, and more recently on the documentation of processes, and in particular with the development of the new integrated registration process. US Treasury have a team of advisors who have been visiting the Tax Department for short periods over a number of years advising on tax audits and collection and enforcement processes. UNDP have also been giving long term assistance particularly supporting training. The EU project is for two years, and is supporting the Department in 3 areas – strengthening structural reform, capacity building and public awareness.

On structural reform, the EU project is concentrating on the area of Taxpayer Service as well as assisting in the production of procedures. For example the project has drafted some procedures to help with the implementation of the recent adjustment to the legislation to allow VAT to be refunded to foreigners on leaving Georgia. They have also funded the training of new recruits in administrative procedures and of junior managers in basic management principles. More training is planned as well as a study tour to a European tax administration. For public awareness, the project has helped the Department develop information leaflets, edited the annual report and quarterly statistics and funded the printing of them all, and has recently conducted a public awareness survey. The results will be published soon and will be the basis for a Departmental Communications Strategy.

As the result of the work of all the donor projects, and the eagerness of Tax Department management to seek advice, consult and embrace reform, augurs well for the continuing success of the tax administration reform process.

References:

1. Asian Development Bank. Key Issues in Income Tax: Challenges of Tax Administration and Compliance, Tax Conference, Neil Brooks, September 2001.
2. Handbook for Tax Administrations, Inter-American Centre of Tax Administrations, 2000.
3. Modernising Tax Administration: Towards Sustainable Reform, IMF Report, February 2006.
4. Munk Knud J. Tax-tariff reform with Costs of Tax Administration, University of Aarhus, 2005, <http://ideas.repec.org/p/aah/aarhec/2005-21.html#download>
5. Nerré Birger. The Concept of Tax Culture, University of Hamburg, Germany, Annual Meeting of the National Tax Association, November 8-10, Baltimore, MD, USA, 2001.
6. Nogaideli Zurab. Vision of Structural Reforms in the Financial Sphere, Donor Conference for Georgia, 1 March 2004.
7. Tax Department, Ministry of finance of Georgia. Annual Report, 2005, www.taxdep.ge
8. Tax Department, Ministry of finance of Georgia. Tax Revenue Statistics, 2005, www.taxdep.ge

