

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT AND FINANCE

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. The Georgian economy grew at an annual average of 5.6% from 2004 to 2015, reflecting reforms to liberalize the economy and remove bureaucratic barriers, while strengthening transparency and accountability.¹ Although governance and the business environment have improved substantially, significant barriers constrain private activity, such as limited finance for investment. Also, an unemployment rate of 12.4% and an incidence of absolute poverty that still stood at 21.4% of the population in 2014 illustrate the weak inclusiveness of growth. The recent economic downturn in the Central and West Asia region, which caused Georgia's gross domestic product (GDP) growth to slow to 2.8% in 2015, and moderate GDP growth of 3.0% expected for 2016 are likely to undermine the government's poverty reduction efforts.

2. **Public sector management.** The government has made significant progress in public financial management since 2010, including introducing a medium-term budget framework, program-based budgeting, a treasury single account, and electronic budget management and procurement systems. However, weaknesses remain that reduce the efficient use of public resources, pose fiscal risks to macroeconomic stability, and hurt the business environment. Also, public financial management capacity needs to be further improved. The Ministry of Finance (MOF) has a small fiscal forecasting department that is endeavoring to make fiscal forecasting more effective. Strengthening public sector management can increase national savings; improve the legal, regulatory, and institutional framework for private sector development; and help increase domestic resource mobilization.

3. Georgia's public debt to GDP increased to 41.5% of GDP in 2015 from 35.6% in 2014, partly reflecting 28.5% depreciation of the lari vis-à-vis the dollar in 2015. The fiscal deficit is expected to widen to 4.0% of GDP in 2016 from 3.8% in 2015. Georgia's public debt is largely denominated in foreign currency (77%) and its debt service is substantially exposed to exchange rate fluctuations. In the medium term, a transition from foreign-currency-denominated sources of finance to local-currency-denominated government securities will help mitigate the country's foreign exchange exposure, and will support the development of the Georgian bond and capital markets.

4. The management of public investment, and related monitoring and analysis of contingent liabilities for the government are relatively weak. Georgia has significant public infrastructure investment plans, such as in the transport and energy sectors. The government is increasingly promoting public-private partnership (PPP) investment projects to compensate for donor financing that is expected to drop as Georgia approaches middle-income status. Many infrastructure projects currently being developed have PPP characteristics and hence contain contingent liabilities for the government. At present, such liabilities are neither disclosed nor properly managed. Under subprogram 3, the Asian Development Bank (ADB) is supporting MOF in providing information on the debt and contingent liabilities of state-owned enterprises (SOEs) and PPPs in the state budget documents.

5. **Finance sector.** Georgia's finance sector is dominated by the banking industry, which accounts for over 90% of financial system assets. Domestic long-term capital to finance

¹ This summary is based on (i) Asian Development Bank (ADB). 2014. *Strengthening Domestic Resource Mobilization*. Manila; and (ii) updated reports, finance sector assessment, and public sector management assessment linked to ADB's country partnership strategy, 2014–2018 for Georgia.

investment and growth is limited because local capital markets are underdeveloped. The securities market is also at an early stage of development, with a narrow investor base and shallow market liquidity. The depreciation of the lari against the US dollar in 2015 was mainly due to a decline in foreign currency inflows, particularly remittances and export receipts. This undermined credit demand and the debt service capacity of borrowers of loans denominated in foreign currencies, which represented about two-thirds of bank credit in 2015. A resilient and stable finance sector, and a supportive environment for entrepreneurial development, capital market development, and savings mobilization are positively associated with economic growth and poverty alleviation.

6. **Capital market development.** The securities market in Georgia is at an early stage of development. The market infrastructure consists of the Georgia Stock Exchange (GSE) and Georgia Central Securities Depository, and three independent securities registries. Five brokerage companies are active. As of May 2016, one security was listed on the GSE's A listing tier and 6 securities were on the B tier. A further 128 companies were "admitted" to trade on the GSE; 118 of these had been admitted in 2000 as part of the mass privatization program but were not listed. The government securities market auctions registered a net increase of \$510 million of treasury securities in 2014, although trading was modest at \$36 million. MOF issues government securities with maturities of up to 10 years. Commercial banks are the key investors.

7. The low levels of corporate securities issuance and the fragmented nature of trading are partly a result of the 2007 amendments to the legislation, which deregulated the securities markets. This led to minimal price discovery and low issuer transparency, encouraging issuers to raise capital outside the country. The demand for capital by the Georgian private sector is healthy, but the capital market, constrained by the current legal and regulatory regime, is unable to meet the demand. The introduction of the supplementary pension savings scheme should act as a driver for reforms. Support to the Ministry of Economy and Sustainable Development (MOESD) through subprogram 3 to complete a review on laws and regulations on investment, and approve accounting and prudential regulations for repos and securities lending, is expected to improve the legal framework for the securities market.

8. **Issuance of bonds in local currency by international financial institutions.** ADB, in 2015, raised GEL100 million from its first sale of bonds denominated in Georgian lari to support development of the local capital markets and smaller businesses in Georgia. The proceeds of the 3-year bond were lent to TBC Bank to provide investment and working capital loans to small and medium-sized enterprises. The European Bank for Reconstruction and Development (EBRD), in 2015, issued a 2-year bond totaling GEL50 million to help develop the local capital markets. The local currency loan products of international financial institutions (IFIs) alleviate currency mismatches and complement the development of the local financial system and capital markets through interest rate and currency risk sharing and, importantly, provide local banking institutions with capital that can be targeted to widen access to local currency credit for SMEs.

9. Local currency bond issuance by IFIs in emerging markets can build a "confidence factor" for domestic and international investors, and contribute to the integrity and stability of the domestic government debt market. Attracting foreign investors through an IFI issuance in local currency generally broadens the domestic investor base. Their emergence in the local market may lead to investments in a wider range of assets, such as lari-denominated government securities, corporate debentures, and bank bonds, and thereby contribute to cost-effective funding by the government, local capital market development, and diversity. Local currency bond issues by ADB and EBRD in June and July 2016 are further expected to help improve access to finance in local currency and boost capital market development.

10. **Pensions and contractual savings.** The government-financed universal pension is the main component of the current pension landscape. It entitles all citizens to receive pension benefits after the age of 60 for women and 65 for men. It is an important instrument of poverty reduction and old-age security. The pension amount has doubled from GEL80 per month in 2010 to GEL160 per month in 2015, but it still only marginally exceeds the subsistence level of income, which is currently GEL143.9 per month. On 18 March 2016, the cabinet approved the indexation mechanism for the universal pension to maintain the value of the pension over time, and thereby guarantee an adequate minimum income floor for pensioners.

11. Financing of the universal pension constitutes the largest social spending item in the state budget, accounting for 16.0% of public expenditure in 2015 and 4.1% of GDP. The government's social expenditure will constantly increase because of the aging population and public pension financing, raising the question of long-term fiscal sustainability. The introduction of an additional private pension savings scheme, supported under the program and associated technical assistance (TA), is therefore necessary. It will reduce the fiscal pressure from the universal pension on the state budget, and enable employees to build a pension with an adequate replacement rate, especially for those at or above the average wage. The introduction of a contributory pension will facilitate the growth of savings in the country and will create an additional source of funds for investment. These long-term pension funds could be invested to stimulate development of capital markets and resource mobilization, which will be necessary to absorb pension inflows and generate reasonable returns.

12. **Micro, small, and medium-sized enterprises.** Georgia's economy is dominated by micro, small, and medium-sized enterprises (MSMEs). Of 370,000 businesses registered in Georgia, only 40,000 are active. These businesses are not reaching their economic potential because of weaknesses in the legal, regulatory, and institutional business environment, and inadequate levels of business management skills and financial literacy. Reforms under subprogram 3 have provided better access to finance for MSMEs (through the Entrepreneurship Development Agency, and the Georgia Innovation and Technology Agency). Improving the business and investment climate will not only bolster investor confidence but will also attract foreign direct investment that can lead to private sector-driven growth.

2. Government's Sector Strategy

13. The Socio-Economic Development Strategy of Georgia (Georgia 2020), approved by the government in June 2014, establishes policy directions for sustainable and inclusive economic growth, macroeconomic stability and effective public administration, human capital development, access to finance, and private sector competitiveness.² It calls for enhancement of public management, strengthening of human resource management in the public sector, and improved public service delivery.

14. The government has initiated a pension reform program to boost the adequacy, fairness, and sustainability of old-age income planning in Georgia. A Pension Reform Unit was established and staffed in MOESD in 2014, tasked to design a new contributory pension system, and is being further strengthened to develop the legal and operational frameworks. On 18 March 2016, the cabinet approved the pension reform policy with the following design features: (i) initial contribution rate of 2% each from employer, employee, and government; (ii) participation in the system to be quasi-mandatory for all employed people, with an opt-out principle; (iii) defined contribution system, whereby the pension depends on the contribution and a proportionate share of the return on investment of the pension fund; (iv) contribution, returns, and pension benefits to

² Government of Georgia. 2014. *Socio-Economic Development Strategy of Georgia, 2020*. Tbilisi.

be tax-free; (v) asset management to be done through a not-for-profit fund independently managed by professional fund managers; and (vi) investments targeting both domestic and international opportunities. During a parliamentary committee hearing on the proposed pension reform, the majority of the members showed strong support.

15. In a parallel effort, the government, with ADB's assistance, undertook a comprehensive review of the capital markets, aimed at developing and executing a multifaceted, time-bound road map for improving market participation. Cabinet approved the capital market development strategy on 11 May 2016. It aims to support the development of corporate and government securities markets. This will be achieved by creating enabling conditions for the development of money markets; expanding the investor base; increasing the availability of investment resources; strengthening custody and settlement systems, and de-dollarization; increasing the resistance of the financial sector against shocks; and improving debt market regulation.

3. ADB Sector Experience and Assistance Program

16. ADB has been active in providing loans and TA for public management and finance sector development in Georgia since the country became an ADB member in 2007. In 2010, a loan of \$100 million was provided to support social services delivery,³ and \$250 million was approved in 2014–2016 for the domestic resource mobilization program loan. Seven nonsovereign loans were provided to commercial banks (Bank of Georgia, TBC Bank, Finca Bank Georgia), and to Credo Microfinance Organization for a total of \$255 million to support lending to MSMEs. TA was provided to (i) strengthen domestic resource mobilization with regard to public sector management and finance sector issues;⁴ (ii) bolster supervision and regulation at the National Bank of Georgia; (iii) streamline the lending processes of TBC Bank, Finca Bank, and Credo with regard to its MSME clients; and (iv) improve the business and financial literacy of MSMEs through TBC Bank's in-house training academy. ADB has engaged in knowledge work in the pension industry and prepared a finance sector assessment on capital market development and agricultural finance.⁵

17. Lessons from ADB's sector experience include the importance of long-term engagement with the government on pension reform, and securities and money market development; and the need to raise government awareness of fiscal risks and contingent liabilities to better assess and manage fiscal risks arising out of PPP projects and SOE operations. These lessons were incorporated into the proposed program and associated TA. ADB's strategic interventions in the sector will be closely aligned and coordinated with those of other development partners.

18. ADB's future planned support to Georgia's finance sector during the country partnership strategy, 2014–2018 is a continuation of its ongoing assistance in improving domestic resource mobilization. ADB nonsovereign assistance is planned to provide finance to underserved regions and help develop products to improve access and use of finance for MSMEs. ADB's efforts to enhance access to financial services will build on sector development achievements to date, for a more viable, effective, and sustainable financial system.

³ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Social Services Delivery Program in Georgia*. Manila.

⁴ ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization*. Manila.

⁵ ADB. 2011. *Pensions and Pension Reform in Georgia*. Manila.

Problem Tree for Public Sector Management and Finance Sectors in Georgia

