ECONOMIC ANALYSIS (SUMMARY)[1]

A. Context

1. After gaining independence in 1991, Georgia's gross domestic product (GDP) fell by 50%. Entrenched corruption, poor governance, and deficient public infrastructure severely undermined the prospects of a recovery. Since the Rose Revolution in 2003, the government has initiated a structural reform program that sought to liberalize trade, upgrade infrastructure, improve the business environment, strengthen public financial management, and combat corruption. By 2007, Georgia's real GDP growth had reached 12.3% and real per capita incomes had risen to $2,316, from $919 in 2003 (in constant prices). However, Georgia's strong growth performance was not matched by commensurate declines in unemployment and poverty.

2. In 2008, real GDP growth dropped sharply following the August 2008 armed conflict with the Russian Federation, and the global financial crisis. However, the impact of these crises was short-lived; the successful implementation of a countercyclical fiscal stimulus rapidly restored consumer and investor confidence. Despite Georgia's economic recovery, public disenchantment with poverty and inequality, rising unemployment, and inadequate social welfare increased. This culminated in the election of a new government in the October 2012 parliamentary elections. While the transition to the new government was orderly, Georgia experienced political tension and policy uncertainty throughout 2013.

3. World Bank data show that Georgia remains one of the only countries in the South Caucasus and Central Asia that has not reached its pre-independence real GDP level. The new government has committed to a stronger, more inclusive growth process. In its Socio-economic Development Strategy of Georgia (Georgia 2020), the government prioritizes (i) macroeconomic stability, (ii) private sector competitiveness, (iii) human capital development, and (iv) improved access to finance.[2] The strategy supports welfare improvements through job creation, complemented by targeted measures to strengthen Georgia's social support system. The government is also strengthening its engagement with the European Union. In June 2014, Georgia and the European Union signed an Association Agreement, including agreement on a Deep and Comprehensive Free Trade Area.

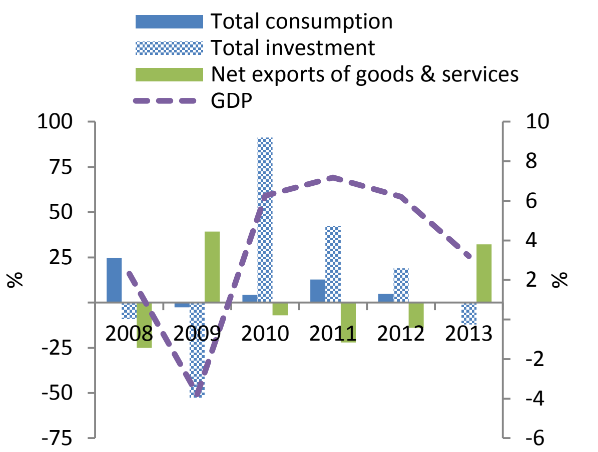
B. Recent Economic Developments

4. **Economic growth.** Real GDP growth slowed significantly to 3.2% in 2013, from 6.2% in 2012. The slowdown reflected a political-transition-related deceleration that prompted investor caution, continued fiscal consolidation, weak domestic demand, and slower global growth. A strong recovery in the agriculture sector and some resilience in trade and financial services helped avert a further decline. On the demand side, growth was supported by a 32.2% rise in net exports in 2013, compared with a 14.0% decrease in 2012 (Figure 1). Investment contracted by 12.2% in 2013, compared with a 19.0% expansion in 2012, due to reduced public spending on infrastructure stemming from the rationalization of public outlays and auditing of existing contracts. Consumption increased slightly by 0.1% from 2012. On the supply side, growth was led by agriculture, financial intermediation, domestic trade, and tourism. Services grew by 3.1% in 2013, compared with 6.2% in 2012, due to growth in financial services, real estate, wholesale

[1] This summary draws on ADB. 2013. *Asian Development Outlook* 2013. Manila (with additional country team inputs).
[2] Government of Georgia. 2014. *Socio-economic Development Strategy of Georgia (Georgia 2020)*. Tbilisi.

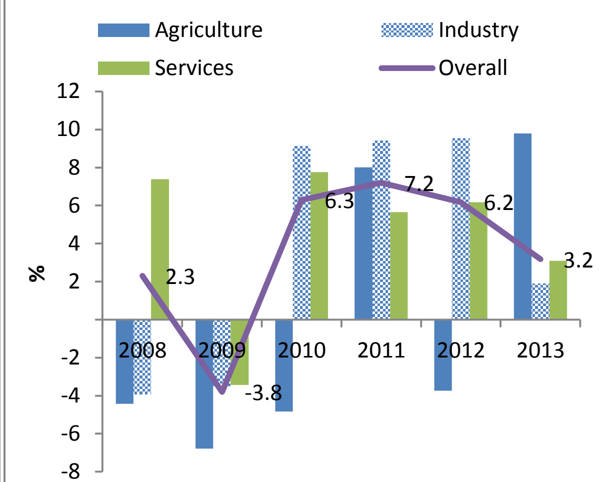
and retail trade, tourism, communication, and transport (Figure 2). Agriculture experienced a sharp expansion in 2013, growing by 9.8%, due to strong government support for the sector. According to preliminary data, the first half of 2014, real GDP growth amounted to 6.0%, compared to the same period in 2013.

Figure 1: Contributions to Growth (Demand)



GDP = gross domestic product
Source: National Statistics Office of Georgia. Gross domestic product. http//www.geostat.ge (accessed 16 September 2014).

Figure 2: Contributions to Growth (Supply)



Source: National Statistics Office of Georgia. Gross domestic product. http//www.geostat.ge (accessed 16 September 2014).

5. **Inflation.** Georgia experienced average annual deflation of 0.5% in 2013 compared with deflation of 0.9% in 2012 (Figure 3). Deflation resulted from (i) a sharp decline in global food and fuel prices; (ii) continued unit labor cost slowdowns in the communication, industry, trade, and transport sectors; (iii) a slight appreciation of the lari, stemming from high foreign direct investment (FDI), remittances, and tourism receipts, which lowered import prices; and (iv) base effects. The International Monetary Fund (IMF) projects inflation will increase to 4% by the end of 2014, as the impact of these temporary drivers dissipates. In August 2014, inflation rose to 3.4% due to higher food, healthcare, utility and transport prices.

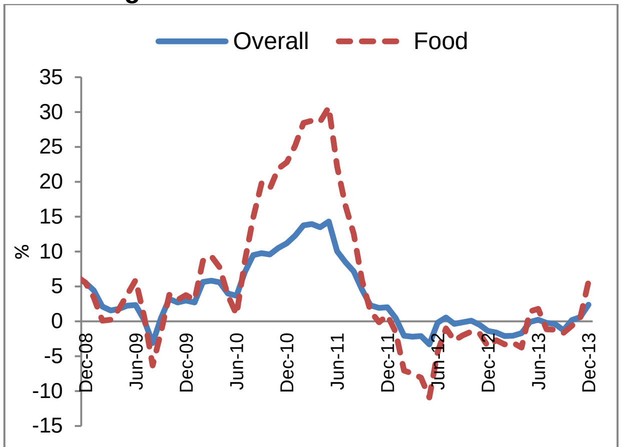
6. **Unemployment.** Unemployment and underemployment are high in Georgia. The official unemployment rate, which has averaged 14% since 2003, does not consider the large number of people who live off subsistence farming, work erratically in self-employment or live off other government benefits.[3] While the official unemployment rate decreased to 14.6% in 2013 from 15.0% in 2012 (Figure 4), the results of a February 2012 National Democratic Institute survey suggest the actual unemployment rate is around 33%.[4] Youth unemployment is also very high for both men and women in the 15–24 age group at 36%.[5]

[3] T. Waal. 2011. *Georgia's Choices—Charting a Future in Uncertain Times.* Washington, DC: Carnegie Endowment for International Peace. The International Fund for Agricultural Development estimates that subsistence farms consume approximately 70% of their output and collectively account for one-fifth of Georgia's GDP.

[4] The survey was financed by the Swedish International Development Cooperation Agency. Participating households were selected through random route-sampling, and individual respondents were chosen using a Kish table. In total, the survey results are based on 3,161 face-to-face interviews in Batumi, Kutaisi, Poti, Rustavi, Tbilisi, Telavi District, and other urban and rural areas. The average margin of error is reported at +/– 3%.

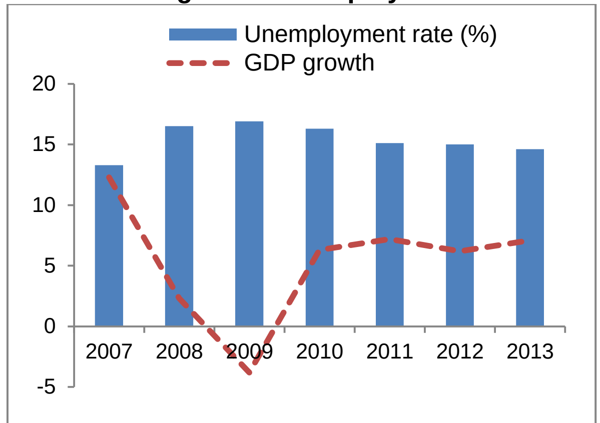
[5] National Statistics Office of Georgia. Employment and Unemployment. http://www.geostat.ge/index.php?action=page&p_id=146&lang=eng (accessed 18 October 2014).

Figure 3: Contributions to Inflation



Source: National Statistics Office of Georgia. CPI (Inflation). http//www.geostat.ge (accessed 16 September 2014).

Figure 4: Unemployment



GDP = gross domestic product
Source: National Statistics Office of Georgia. Employment and Unemployment. http//www.geostat.ge (accessed 18 October 2014).

7. **Wages.** Georgia's sustained economic growth has fuelled a sharp increase in real wages, which have risen by an annual average of 14% (compared with the global average of 3%) since 2004. In 2013, average monthly nominal wages increased to GEL773 (compared with GEL717 in 2012).[6] There is significant sector variation in wages: financial intermediation is the highest-paid sector, with average monthly nominal wages of GEL1,505; followed by public administration at GEL1,132 per month. The lowest-paid sectors are education, at GEL423 per month, hotels and restaurants at GEL437, and agriculture at GEL495. Women earn less than their male counterparts in all sectors; in 2013, women's monthly wages were on average 36% lower than men's. This pay gap may reflect (i) the high concentration of women in lower paid sectors, such as education, health, and social work; (ii) cultural norms that require women to bear a greater proportion of household responsibilities, thereby limiting their ability to seek full-time work; and (iii) gender stereotyping by employers.[7]

8. **Monetary policy.** The National Bank of Georgia (NBG) has steadily eased monetary policy since the twin crises of 2008. Sustained deflation, coupled with continued uncertainty in the global economic outlook, prompted the NBG to lower the refinancing rate progressively from 5.25% in December 2012 to 3.75% in December 2013 (150 basis points), before restoring it to 4.00% in February 2014. In 2013, the NBG purchased $335 million (net) in foreign exchange auctions; its gross international reserves declined slightly to $2.8 billion, representing 3.9 months of merchandise imports.

9. **Fiscal balance.** The government has affirmed its commitment to fiscal consolidation in its Georgia 2020 strategy. There has been a sharp reduction in the fiscal deficit, from 9.2% of GDP in 2009 to 2.6% of GDP in 2013. In 2013, government revenue (including grants) declined to 27.5% of GDP from 28.8% of GDP in 2012, reflecting lower value-added tax and corporate tax receipts. Total expenditure also decreased to 30.1% of GDP in 2013, from 31.8% in 2012, due to reduced spending on public infrastructure.

[6] National Statistics Office of Georgia. Wages. http://www.geostat.ge/?action=page&p_id=149&lang=eng (accessed 18 October 2014).

[7] D. Harmsen. 2012. Wages in Georgia. *Financial Headline News & Analysis*. 24 December. http://gcedu.org/wp-content/uploads/2013/03/Wages-in-Georgia-by-Daan-Harmsen-The-Financial-24.12.2012.pdf

10. **Taxation.** Georgia continues to have one of the world's most attractive tax regimes. Following major tax reforms in 2004, the number of taxes was reduced from 21 to 6. Value added tax, at 18%, is competitive with that applied in neighboring countries, while income tax peaks at 20% and corporate tax at 15%.

11. **Current account.** In 2013, the current account deficit narrowed to 5.9% of GDP, as the merchandise trade deficit shrank, owing to significant growth in exports and a slowdown in real GDP growth. The merchandise trade deficit narrowed by 17.2% to $3.5 billion. Merchandise exports in nominal terms increased significantly, by 21.2%, while merchandise imports fell marginally. The income deficit widened substantially in 2013, due to a 14.4% decrease in income credits, and a 2.7% increase in income debits. The merchandise trade and income account deficits were partially offset by surpluses in the services account and current transfers. The services surplus grew by 28% to $1.4 billion in 2013; service exports rose by 16.5% to $2.96 billion, while imports rose by 8.0% to $1.6 billion. This surplus is one of the highest levels recorded in the last decade, and represents 8.7% of GDP in 2013. Current transfers, which are the largest positive component of Georgia's current account, increased to $1.5 billion in 2013.

12. **Balance of payments.** The current account deficit was more than offset by surpluses in the capital and financial accounts, ensuring that the balance of payments remained in surplus in 2013. FDI inflows—comprising equity capital, reinvested earnings, and other capital—rose by 3% to $942 million in 2013. The increase mainly reflected higher investment in energy, transport and communication, and mining and agriculture. The Netherlands, Luxembourg, the People's Republic of China, Azerbaijan and Turkey were Georgia's major investors in 2013. A sharp rise in other private inflows reinforced the positive impact of Georgia's FDI inflows on the balance of payments.

13. **Debt.** Georgia successfully issued sovereign Eurobonds in 2008 and 2011 and corporate Eurobonds (Georgian Railways and Georgian Oil and Gas Corporation) in 2012, which has supported the diversification of external financing sources. Georgia's net external debt to GDP ratio has fallen slowly over the past decade, reaching 51.3% in 2013. The terms of Georgia's external debt are favorable: the weighted average interest rate is approximately 2%, given that approximately 90% of the loan portfolio comprises concessional bilateral and multilateral loans. According to the IMF's 2014 Debt Sustainability Analysis, Georgia's relatively high level of gross external debt to GDP (excluding intercompany loans) is projected to decline from 64.0% in 2014 to 56.5% by 2019, based on an anticipated reduction in Georgia's gross external financing requirements from 2015 onward.[8]

14. **Competitiveness.** Georgia's ranking in the World Economic Forum's 2014–2015 *Global Competitiveness Report* improved from 72nd to 69th,[9] driven by a higher score under the Basic Requirement subindex and stable scores under the Efficiency Enhancers and Innovation and Sophistication Factors subindexes. Among other efficiency-driven economies,[10] Georgia's main competitive advantages lie in goods and labor market efficiency, as well as institutions and macroeconmic environment. The survey shows that Georgia performs more favorably in (i) the extent and effect of taxation, (ii) number of days and procedures required to open a business, (iii) application of trade barriers and tariffs, (iv) simplicity of customs procedures, (v) flexibility of wage determination, (vi) redundancy costs, and (vii) burden of government regulation. Areas

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[8] International Monetary Fund. 2014. *Georgia: Request for a Stand-By Arrangement. Country Report No. 14/250.* Washington, DC.

[9] World Economic Forum. 2014. *The Global Competitiveness Report 2014–2015.* Geneva.

[10] Based on the World Economic Forum's categorization of the stages of economic development.

requiring improvement include innovation and business sophistication. Industrial competitiveness is constrained by the size of the domestic market and labor skills mismatch. More broadly, Georgia's economy and private sector would become more competitive through more diversification exports, stronger enforcement of property rights, and continued efforts to stop anticompetitive practices.

C. Economic Prospects

15. While Georgia's growth performance in 2013 was weak, the country's overall economic outlook remains positive. ADB forecasts GDP growth of 5.5% in both 2014 and 2015.[11] On the demand side, investment, private consumption and, to a lesser extent, current government spending, are all forecast to expand. On the supply side, structural reforms targeting higher quality public investment are expected to boost productivity, catalyzing growth in manufacturing and other tradable goods. The agricultural sector is expected to expand (assuming normal weather conditions), reflecting increased government support to the sector. Services are also projected to grow, fueled by projected expansions in the transport, communication, and financial intermediation sectors. Inflation is forecast at 4.0% in 2014 and 5.0% in 2015, as higher pensions and teachers' salaries are expected to generate demand-side inflationary pressures.

16. The budget deficit is projected to widen to 3.6% of GDP in 2014. It will be financed in part from domestic and foreign financing, including long-term investment credits (predominantly for infrastructure), and policy lending from the European Union and the World Bank. During 2014–2015, monetary policy is expected to focus on supporting growth while achieving the NBG's medium-term inflation target. Broad money growth is projected to rise by 21.5% in 2014 and by 18.5% in 2015, reflecting higher credit growth to the private sector. Gross international reserves are projected to decline to $2.7 billion in 2014 before rising to $3.0 billion in 2015. Total gross external debt (excluding intercompany loans) is forecast at 64.0% of GDP by the end of 2014 before declining to 63.5% by the end of 2015.

17. Georgia remains vulnerable to exogenous shocks, given its heavy reliance on FDI, high current account deficit (CAD), and high dollarization.

(i) **FDI serves as a critical lifeline for the Georgian economy.** According to the Organization for Economic Co-operation and Development *Competitiveness and Private Sector Development Report* (2011), Georgia has the highest per capita FDI in the Eastern Europe and South Caucasus region. While FDI has declined from its 2007 peak of $2 billion, it remains high compared to peers and is an important source of financing at 5.8% of GDP in 2013. Gross national savings declined sharply in 2008, but are showing signs of recovery.

(ii) **Georgia's current account deficit is among the highest in the Central and West Asia region.** The CAD is forecast to rise to 8.5% of GDP in 2014 and then fall to 7.5% in 2015, given lower demand for imports, driven in part by continued fiscal consolidation, and higher exports due to planned structural reforms in agriculture and other key sectors (footnote 11). The services account is expected to remain in surplus, while current transfers are forecast to increase in anticipation of higher worker remittances from the Russian Federation. At the same time, the income deficit is projected to narrow, as profit transfers decline and portfolio investment income rises. The IMF projects the CAD will decline

[11] ADB. 2014. *Asian Development Outlook 2014 Update.* Manila.

further to 5% of GDP by 2019, contingent on continued fiscal consolidation, maintenance of a flexible exchange rate regime, and implementation of structural reforms to enhance competitiveness.

(iii) **Heavy dollarization of Georgia's economy continues to undermine the effectiveness of monetary policy.** In 2013, foreign exchange deposits accounted for 56% of all deposits (compared with 60% in 2012). The NBG is promoting de-dollarization through specific prudential measures (e.g., through the application of differential reserve requirements to encourage banks to loan in local currency).

18. In August 2014, Moody's changed the outlook on Georgia's Ba3 sovereign rating to positive from stable and concurrently confirmed Georgia's Ba3 rating. Standard & Poor's and Fitch affirmed in November 2013 Georgia's long-term sovereign credit rating at BB– and affirmed Georgia's short-term debt ratings at B. In 2012, the IMF and Georgia agreed to the establishment of a 2-year stand-by credit facility and stand-by arrangement that provided a macroeconomic safety net. This agreement lapsed in April 2014, and a 3-year stand-by arrangement totaling SDR100 million (about $154 million) was approved in July 2014. The new IMF program aims to facilitate Georgia's external adjustment, reduce key macroeconomic vulnerabilities, rebuild fiscal space, and support growth.

D. Development Challenges

19. Georgia's impressive growth has inadequately addressed poverty alleviation, job creation, and balanced regional development. Making future growth more inclusive is a key development challenge. A more inclusive growth process would generate productive employment opportunities, which would be of particular benefit for farmers and others in Georgia's poorer regions. It could also ease the CAD if it boosts domestic savings and increases exports. Future policies must seek to address Georgia's infrastructure deficit, improve access to basic services, and enhance labor skills and productivity.

20. Ultimately, boosting domestic savings is essential to address external imbalances. Policies that reduce tensions between Georgia and the neighboring Russian Federation may boost investor confidence and reduce perceptions of country risk. Better protection of property rights, through fair and impartial judicial processes, is likewise essential, as are measures that reduce dollarization and address financial market risks. Despite Georgia's overall progress in various business climate surveys, more progress is needed to reform sector policies. Agricultural policies can be improved to promote economies of scale, enhance productivity, and spur value-chain development. Reform in power sector policies is essential to foster sustainable exploitation of Georgia's hydropower potential, enable efficient cross-border power trade, improve energy security, and generate sufficient government resources. Education policies should address pronounced skills gaps in key job-generating sectors.