ASIAN DEVELOPMENT BANK

REGIONAL-CAPACITY DEVELOPMENT TECHNICAL ASSISTANCE (R-CDTA)

STRENGTHENING KNOWLEDGE MANAGEMENT IN CENTRAL AND WEST ASIA

RESPONDING TO EXTERNAL SHOCKS HITTING THE ECONOMY OF GEORGIA

23 March 2017

This report has been prepared under the Region-wide Study, *"Good Jobs for Inclusive Growth in Central and West Asia."* The study is undertaken under R-CDTA-8936, *"Strengthening Knowledge Management in Central and West Asia."* This report has been prepared by study consultant Eva Bochorishvili. The overall Study task manager is Giovanni Capannelli, Country Director, KARM, ADB.

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Executive Summary

1. The Georgian economy has performed relatively well, notwithstanding recent and potentially long-lasting external shocks related to oil price slump, currency depreciations, geopolitical tensions and related weakness in external markets. A reduction in exports and remittances and decrease in capital flows weighed on economic activity. However, tourism remained resilient with tourist arrivals increasing markedly during 2015-16. As a result growth slowed to 2.9% in 2015 and remained subdued in 2016.

2. Reduced foreign earnings and slowly adjusting imports resulted in significant depreciation of the GEL during 2015. With limited interventions to defend the local currency, central bank allowed the GEL to absorb most of the shocks to the economy minimizing negative impact on the real sector. As a consequence, Georgia maintained macroeconomic stability and inflation has been contained.

3. Despite the growth below potential, some country specific characteristics, stronger institutions and prudent policies of recent years helped Georgia to weather shocks better than regional peers. Nevertheless, Georgia's exposure to external shocks posed important challenges to the authorities in the face of Georgia's high current account deficit, high dollarization of the Georgian economy, and wider fiscal deficits of recent years.

4. To revive growth in the face of regional headwinds the government put forth a 4-point reform program. The program includes new tax incentives, infrastructure schemes, governance reforms and a reform of the education system to comply with labor market demands. Measures to further liberalize tax and customs procedures, amongst others, included the introduction of the Estonian model, which envisages the application of corporate income tax to only distributed profits; undistributed profits, reinvested or retained, are exempted starting January 1, 2017.

5. Other reform measures, amongst others, include creating a single window principle for the provision of government services to legal persons and speeding up the implementation of strategic infrastructure projects. Under new infrastructure schemes, government plans to implement those projects that would enhance country's tourist and transit potential, as well as support private sector investments and create new jobs.

6. Faced with higher expenditures and lower corporate income tax revenues under the 4-pillar reform program, government introduced revenue generation as well as expenditure consolidation measures in 2017 budget document in an effort to put fiscal accounts on a sustainable path.

7. For fiscal sustainability purposes government is faced to elaborate legislative changes for better managing public sector employment benefits, further cut non-essential expenditures, consider further consolidation of public sector institutions, make social and healthcare spending more targeted, and increase capital expenditure efficiencies.

8. Flexible exchange rate regime in Georgia proved to be effective and acted as a shock absorber, however needs emerged to address high dollarization of the economy, as well as to minimize potential negative impact on financial sector from large and unexpected currency depreciation. As a consequence, NBG introduced 10-point de-dollarization action plan, including reforms to expand the use of the local currency in the economy, voluntary conversion of US$-denominated loans issued before 1 January 2015 into GEL, as well as threshold on issuing US$-denominated bank loans to retail customers equivalent of up to GEL 100 thousand only in local currency. While addressing dollarization problem in Georgia is critical, mismatch between US$-

denominated bank liabilities and US$-denominated bank assets may present a serious risk to financial system in case of exchange rate depreciation.

9. IFIs support will be crucial to strengthen the effectiveness of social spending and the line ministries capacity for managing accelerating capital spending. On top of these, IFIs policy advice and support in analysis on outcomes of the new reforms can feed further trust in authorities' economic policy. In this context, right mix of coordinated activities of authorities and IFIs could benefit the country's long term economic prospects.

1. Introduction and Background

1. With remarkable progress in governance and business reforms, Georgia has generated strong GDP growth rates averaging 6.3% annually from 2003 to 2014. However, growth was accompanied by high unemployment, even in double digit growth years. While Georgia managed to weather the multiple crises faced on its path of economic transition process - domestic and global crises and the 2008 conflict with Russia - the most recent and potentially long-lasting external shocks related to oil price slump, currency depreciations, regional geopolitical tensions and increased uncertainties, raised concerns on the effectiveness of Georgia's growth model again. As a result, headwinds pressured policymakers to develop and implement policy changes to sustain high future growth rates. In this context, right mix of coordinated activities of authorities and IFIs could benefit the country's long term economic prospects.

2. Georgia's liberal economic reforms, favorable international rankings of business environment, and low levels of corruption supported to substantial FDI over the past decade. These capital flows boosted productivity and accelerate growth. At the same time, public infrastructure projects financed by IFIs were instrumental in driving growth, as well as providing critical services to citizens and better realizing country's potential in logistics, transport and tourism.

3. Faced with low domestic savings, FDI is an important source of financing growth in Georgia, as well as reliable source of Georgia's persistently high current account deficit funding. One important aspect of FDI is that it is directed mainly to non-tradable sectors. It is vital for Georgia to attract FDI in export-generating sectors important also for sustainable job-creation. Despite the fact that many countries faced reduced capital flows during recent shocks, FDI in Georgia was relatively secured thanks to business friendly environment as well as strategic infrastructure projects - BP gas pipeline construction project and railway project connecting Azerbaijan- Georgia-Turkey.

4. The Global and regional economic environment has become more challenging for Georgia in late 2014 and 2015. Georgia's all major trading partners were hit hard by falling oil prices, related currency depreciations and negative repercussions of the recession in Russia. Being small and open economy, problems of its major trading partners had a negative impact on the Georgian economy, despite being an oil importer country and related positive impact on current account from lower oil import bill. This positive impact was outweighed by second round effects on Georgia's commodity exports and migrant remittances, which led to widening current account deficit. The resulting depreciation of the GEL against the US$ acted as a shock absorber, however raised concerns about those who borrowed in the dollar as economy is highly dollarized. Furthermore, depreciation induced inflationary pressures due to pass through effect.

5. As a result of challenging external environment, the GDP growth slowed to 2.9% in 2015 from 4.6% a year earlier. Despite this slower growth by Georgian standards, some country specific characteristics, stronger institutions and prudent policies helped Georgia to weather shocks better than regional peers. But, increased uncertainty worldwide challenged policymakers how to cope with external vulnerabilities, ensure macroeconomic stability and revive growth in the face of continues weakness in external markets, as well guaranteeing social assistance to the poor without jeopardizing fiscal accounts.

6. Despite slower growth, unemployment rates fell significantly in Georgia in 2014 and 2015, as Georgia's flexible exchange rate acted as a shock absorber minimizing negative impact on real sector. Reasons of reduced unemployment reflected also changes in population dynamics as well as slight shift of employment from agriculture away to services. According to the latest 2014 census, Georgia's total population shrank to 3.7 million persons from 4.4 million in 2002, when the last census was conducted. One of the major reasons of population decline is migration. High poverty rates and a continued lack of paid jobs mostly in rural areas push workers to oversee employment.

7. Determining the right macroeconomic policy responses during shocks becomes very important because the policy reaction to these shocks may change economies for years to come. Against a backdrop of adverse global and regional developments the prospects of many economies are for weak growth as world commodity prices may stay low for long.

8. The collapse in commodity export revenues and remittances compounded by continued weakness in external markets, task the governments to a coordinated crisis response. Adjustment to these shocks requires Georgian authorities' to implement new policies to revive growth, continue prudent monetary policy making, and address dollarization problems of the economy as well as implement fiscal reforms that put government finances on a sustainable path. Further improvement in institutions and governance has to be utmost importance to stay attractive to foreign investors, raise competitiveness and enhance productivity.

9. In years to come, Georgia's growth prospects are related to improved economic ties with the EU as the Deep and Comprehensive Free Trade Agreement (DCFTA) is likely to improve market access and encourage FDI. In the short term, transitional process could pose certain costs as Georgian producers will face to meet the desired EU quality standards. Georgia will also benefit from ongoing infrastructure projects and maintain capital flows, particularly the BP financed gas pipeline, the Anaklia deep sea port and hydro power projects.

10. With right policy measures Georgia has a potential to transform itself into the transport and logistics hub for the region due to its geographic advantages, increase electricity generation and transmission capacity due to its abundant hydro recourses and further enhance its tourist sector and utilize benefits of EU DCFTA.

11. In the present paper we look at the sources of the recent external shocks, transmission channels to the Georgian economy, macroeconomic policy response to the shocks, the support from IFIs, as well as adequacy of policy responses for achieving long-term sustainable growth.

2. The Impact of External Shocks on the Economy of Georgia

12. In this section we discuss global and regional economic environment in 2014 and 2015 and the effect of these developments on the economy of Georgia throughout 2016. We consider two immediate transmission channels of the shocks to the economy - trade and remittances, as well as further effect on real sector, financial sector and fiscal accounts.

2.1 Economic environment in 2014 and 2015

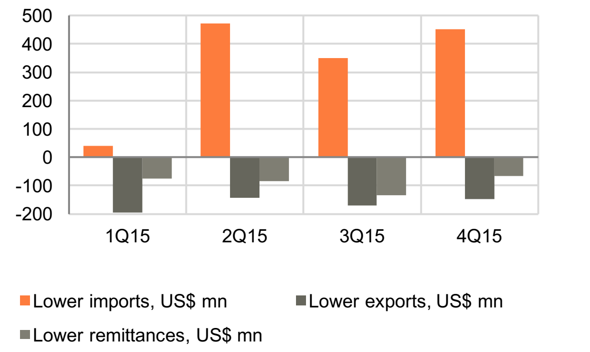
13. Global economic activity was marked by significant fluctuations in 2014. Price reductions of oil, metals and food commodities on international markets, geopolitical tensions and the legacy of the global financial crisis have significantly influenced both developed and emerging market economies. In early 2014, the US$ started to appreciate globally amid US Federal Reserve (FED) tapering the quantitative easing started in 2008. As a consequence, world currencies significantly depreciated against the US$. These processes transferred to the Georgian economy later through balance of payments pressures resulting from the depreciation of partner countries' currencies. As a result of weak external demand Georgia's goods exports and remittances decreased and the growth rate of tourism revenues slowed. These developments reflected on the GEL towards the end-2014, as foreign currency inflows were secured in the first half of the year. Georgia's growth was affected negatively in last quarter of 2014 with growth rate slowing to 1.7%

14. Falling oil and world commodity prices and volatility in financial markets continued to weigh on global and regional economic activity in 2015. Weak capital flows further aggravated depreciation pressures leading to volatility in financial markets and rising sovereign risks. As was broadly anticipated, the US FED increased its key rate in December 2015 and many developing and emerging markets faced further currency depreciations, leading to inflationary pressures. Geopolitical tensions and slow growth of global trade due to China's rebalancing were another factors negatively affecting expectations and deepening uncertainties in 2015.

15. Regional economies were affected negatively by 2015 headwinds, which translated into unfavorable consequences for Georgia. The immediate effect of lower oil prices were lower oil imports bill bringing total of US$ 260mn savings (1.9% of GDP) for Georgia in 2015. This low oil prices also helped to ease price pressures. However second round effects through lower exports and reduced remittances outweighed the positive impact of low oil prices and Georgia's growth slowed to 2.9% in 2015 from 4.6% in 2014. The result of reduced external earnings was the GEL depreciation, as central bank interventions were limited to defend the currency and let the GEL to weaken 27% against the US$ over 2015.

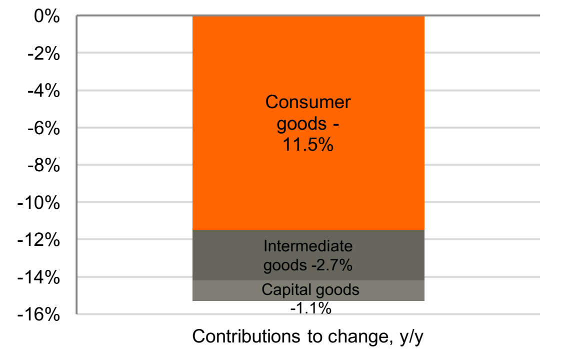
16. GEL depreciation acted as a shock absorber, as imports started to decrease supporting to external adjustment. Notably, reduction in imports was healthy as it came on the back of reduced consumer goods imports, while capital goods imports, inter alia, supported by FDI, and essential for economy's long term potential growth, fell modestly. A reduced money transfers was another reason of the GEL depreciation. However, the depreciation helped to preserve the GEL value of remittances supporting to private demand. Notably, there was little sign of imports adjusting to lower foreign earnings in the beginning of 2015. The resulting further depreciation of the GEL led significant adjustment in imports starting April 2015.

Figure 1: Exports, imports and remittances US$ mln change



Source: Geostat.
Note: Imports provided excluding donated C-hepatitis medication imports.

Figure 2: Contributions to imports change, 2015

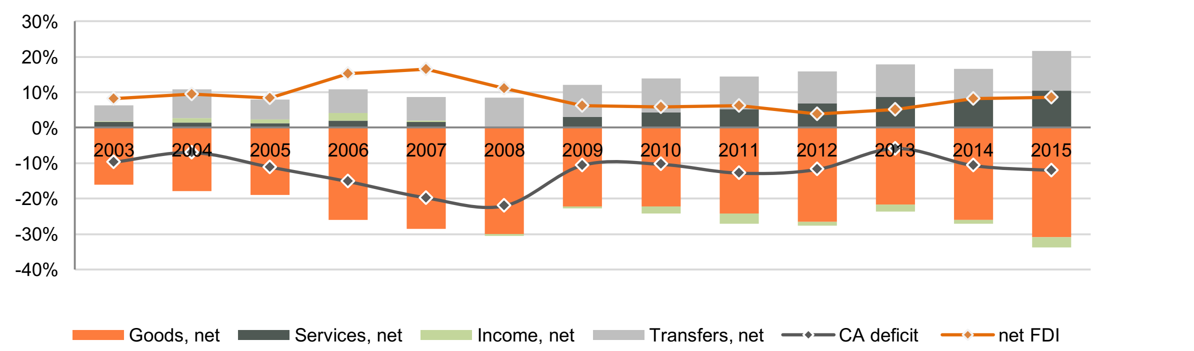


Source: Geostat.
Note: Imports provided excluding donated C-hepatitis medication imports.

17. As a result of reduced exports and remittances, current account deficit widened to 11.9% of GDP in 2015 from 10.6% of GDP in 2014, while deficit was down 4.9% y/y in nominal terms to US$ 1.7bn. Merchandize trade deficit, traditionally the major contributor to deficit creation, remained almost flat, as exports (-23.9% y/y) and imports (-10.7% y/y) both fell.

18. Positive balance in services and current transfers compensated about 70% of trade deficit. Among services, tourism had the largest positive balance, with tourism revenues increasing 8.3% y/y to US$ 1.9bn (13.9% of GDP). Net current transfers, another significant positive item of the current account, reflected the government sector transfers that increased due to commodity aid received for C-hepatitis elimination program, while workers remittances decreased 23.3% y/y to US$ 1.1bn. Net FDI, significant item for financing the current account deficit, amounted to US$ 1.3bn (9.0% of GDP). The largest investment inflows were directed to transport and communications sector for financing PB gas pipeline construction.

Figure 3: Georgia’s current account deficit to GDP



Source: GeoStat. NBG.

19. The main driver of growth in 2015 was the construction sector expanding 13.5% annually. Construction posted growth in both the public and private sectors, fueled by government infrastructure projects, while increased private sector activity was supported by BP gas pipeline construction as well as private residential construction. Low commodity prices and weak external demand weighed on the

largest sectors - manufacturing contracted 2.4% and growth in trade was flat. Agriculture expanded by a modest 1.5%, despite various government supported programs in the sector.

20. As economy maintained positive growth in 2015 and shock was absorbed mostly through exchange rate, jobs were secured in the real sector. The unemployment rate fell to 12.0% in 2015 from 12.4% in 2014, with jobs shifting slightly toward services and away from agriculture.

Figure 4: Employment dynamics

Source: Geostat.

Figure 5: Employment by sectors, share in total %

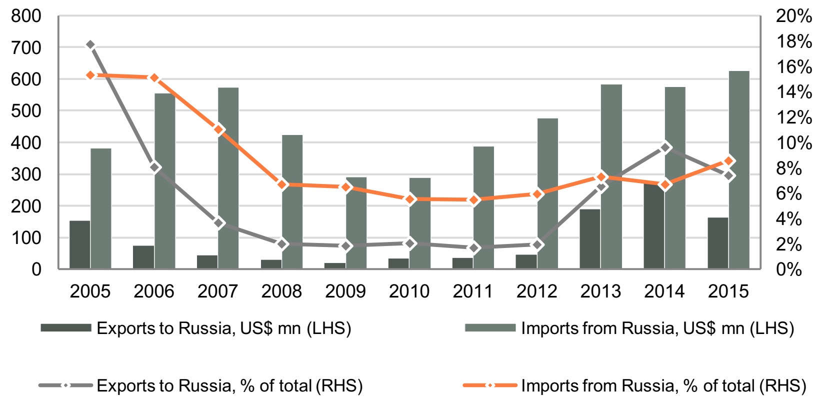
Source: Geostat.

BOX 1: Georgia's exposure to Russia

Georgia is less exposed to Russia via exports, FDI and remittances, than other countries of Caucasus and Central Asia. Georgia's largest exposure to Russia is through remittances, however Russia accounted for significantly lower share in Georgia's total remittances during 2015-2016 compared to previous years. Currently, tourism sector increasingly benefits from increased Russian arrivals, with Georgia likely being re-discovered by Russian as well as other visitors from regional countries.

Trade: In 2015, Russia accounted for 7.4% of Georgia's exports and 8.6% of imports. Despite reopening of Russian market in 2013, Russia's share in Georgia's total exports remains far below pre-embargo level of about 20% of total. In 11M16, exports to Russia started to increase amid lower base and accounted for 9.5% of total, while imports accounted 6.7% of total

Figure 6: Georgia's foreign trade with Russia

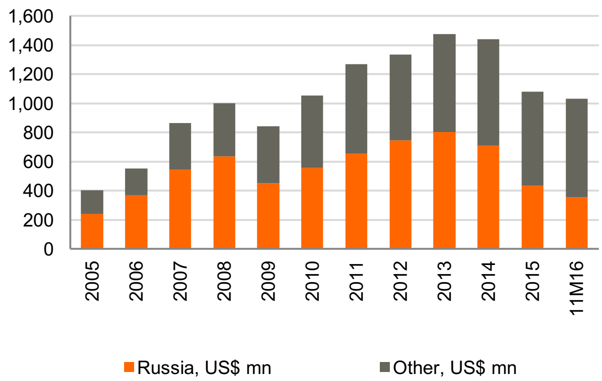


Source: GeoStat.
Note: In 2015 total imports excludes donated hepatitis C-medication imports.

FDI: Russia accounted for just 4.1% of cumulative FDI over 2004–2015.

Remittances: Migrant remittances are an important source of consumption and hard currency inflows to Georgia and account about 8–9% of GDP annually. Majority of Georgian emigrants are employed in Russia, which traditionally accounted for more than half of money transfers to Georgia. In 2014 money transfers from Russia decreased 11.5% y/y and fell further by 39.0% in 2015. As a result, Russia's share in total remittance fell to 40.0% in 2015 from 50.0% in 2014. In 11M16 money transfers increased 5.5% y/y to US$ 1.0bn, while remittances from Russia were still down by 9.8% y/y and accounted for 34.1% of total.

Figure 7: Remittances from Russia and other countries



Source: NBG.

Tourism: Visitors from Russia accounted for 15.7% of total international visitors in 2015 increasing 14.0% y/y. in 11M16, arrivals from Russia increased further by 12.0% y/y accounting for 16.3% of total.

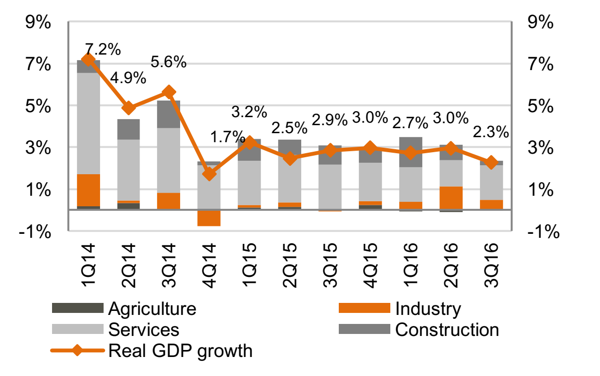
2.2 Economic Developments in 2016

21. Exports and remittances declined in the first half of 2016 reflecting weakness in external markets marked again by low commodity prices. Meanwhile, the construction, manufacturing and hotels and restaurant sectors supported economic activity, pushing the GDP growth rate to 2.9% in 1H16.

22. Despite increase in external earnings in 3Q16, growth slowed to 2.2% in the quarter compared to the first half of 2016. Slower growth mainly reflected slowdown in construction sector increasing by just 2.4% y/y in 3Q. This is explained by last year's high base posted in public investment spending as well as BP gas pipeline construction. Hotels and restaurants sector continued robust growth expanding by 13.4% y/y supported by tourism, while agriculture (-0.1%) and transport and communication sectors (-3.0%) were in downturn. Importantly, in 3Q16 positive growth was recorded in two largest sectors of Georgian economy - manufacturing and trade.

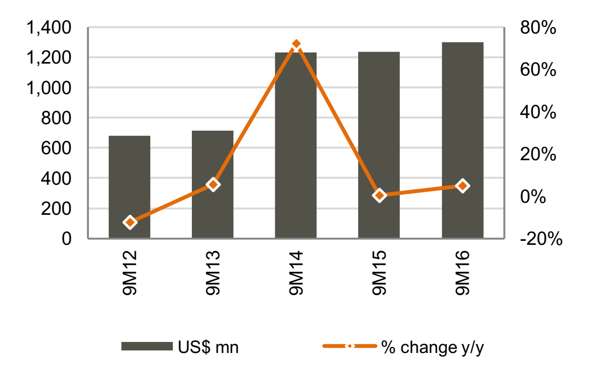
23. Last year's low base, as well as better than expected performance in Georgia's trading partners, positively affected export growth later in the year, increasing for the first time in last two years by 8.3% y/y in September 2016. In the first half of 2016 increased FDI and public infrastructure projects supported to capital goods import growth. Consumer goods imports also started picking up from September 2016 driven by seasonal factors.

Figure 8:Real GDP growth and sectoral contributions to growth



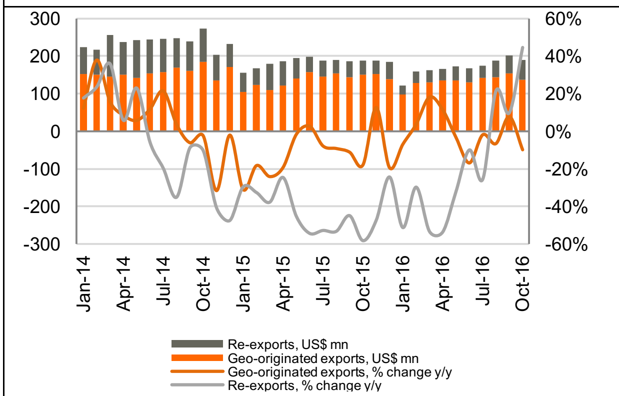
Source: GeoStat.

Figure 9: FDI in Georgia



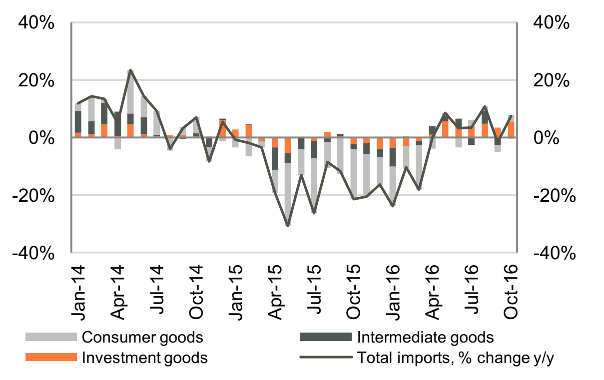
Source: GeoStat.

Figure 10: Exports



Source: GeoStat.

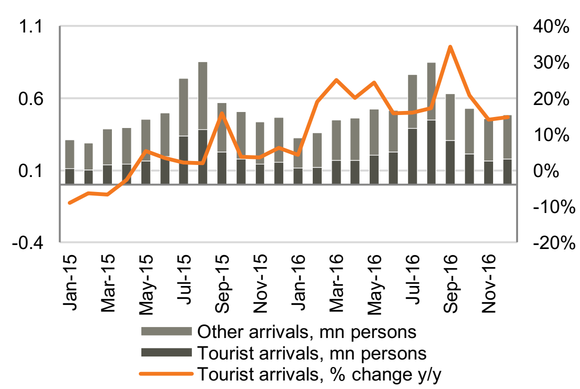
Figure 11: Contributions to import growth, %



Source: GeoStat.

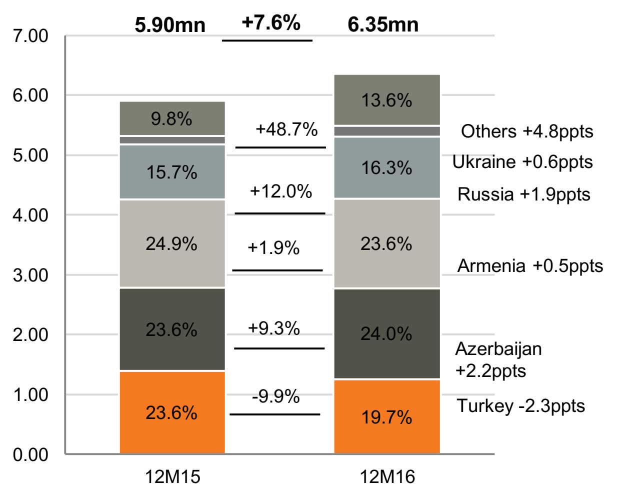
Note: Imports provided including donated C-hepatitis medication imports.

Figure 12: International arrivals



Source: GNTA.

Figure 13: Arrivals by country



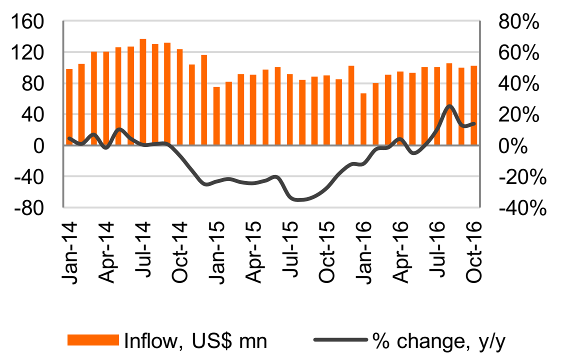
Source: GNTA.

24. Throughout 2016 tourism remained one of the main drivers of growth with total international arrivals increasing 7.6% y/y to 6.4mn visitors. Growth in total arrivals was predominantly fueled by tourist arrivals, posting spectacular growth at 19.1% to 2.7mn arrivals in 2016. Arrivals were up not only from neighboring countries (Armenia, Azerbaijan, Russia, Turkey, Ukraine, and Iran) but also from the EU and other distant countries such as India, Philippines, UAE, Israel, and Saudi Arabia. A series of entertainment events sponsored by the government across Georgia in 2016, plus safety and cheap services Georgia offers were the major factors attracting more visitors. Eased visa regulations in June 2015 and in February 2016 (on Iranian visitors) also supported to increased tourist arrivals.

25. Declining trend in money transfers continued until mid-2016, however remittances bottomed-out since June 2016 and were up 5.5% y/y to US$ 1.0bn in 11M16. Starting from November 2016 remittances growth from Russia turned positive after two years of slump, and transfers from other major remitting countries (USA, Greece, Italy, Turkey, Israel, Spain and Germany) posted significant increases.

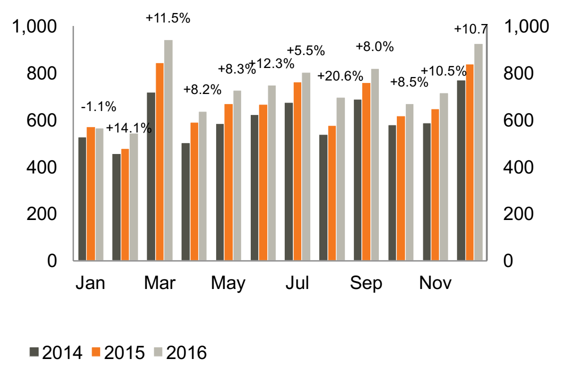
26. With significant increase in government current and capital spending to boost growth in the face of external shocks, fiscal deficit remained elevated and is estimated to widen to 4.6% of GDP in 2016 from 3.7% in 2015. Despite slower growth and inflation lower than budgeted, consolidated budget tax revenues were above the budgeted figure in 2016 and accounted for 100.5% of upward revised plan in December 2016.

Figure 14: Remittances



Source: NBG.

Figure 15: Consolidated budget tax revenues



Source: MOF.

27. Georgia's current account deficit expected to be close to 12% of GDP in 2016, reflecting weakness in GEL which lost another 9.5% of its value against US$ in 2016 after 27% depreciation in 2015. Despite nominal depreciation, Inflation has been contained in 2016, with annual inflation at 1.8% in December - well below the NBG's target of 5.0%.

2.3 Financial Channel

Banking sector

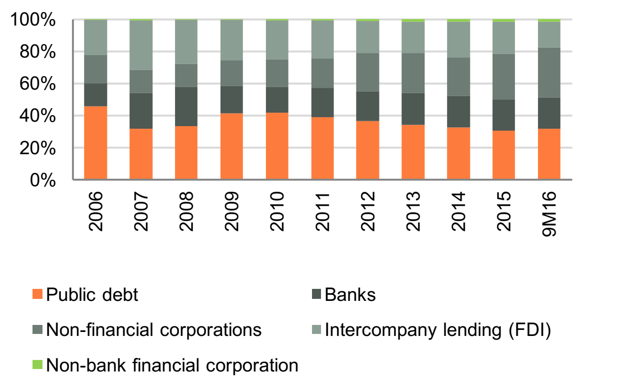
28. One of the major concerns of external shocks and related currency depreciation is high dollarization of the Georgian economy. Notably, despite the depreciation of the GEL and high rates of dollarization, the financial sector was on a solid footing in 2015 and 2016. The average capital-adequacy ratio remained above 16% (Basel III) in 2015 and 9M16. Despite a pickup in loan-dollarization over 65% the share of NPLs fell to 2.7% in 2015 from 3.0% in 2014 before increasing slightly to 3.8% in 9M16. Conservative banking supervision and prudent management by the

regulator, higher share of GEL-denominated retail loans in recent years as well as informal savings practices are likely reasons supporting financial sector stability. However, dollarization remains a problem in the economy raising concerns on fragility of banking sector, effectiveness of monetary transmission mechanism as well as eroding purchasing power of consumers in the face of large depreciation.

External debt

29. Faced with low domestic savings, Georgia's growth model heavily relied on foreign savings and resulted in rapid accumulation of external debt mostly in private sector. In 2015 gross external debt increased to 107.9% of GDP from 83.9% of GDP in 2014. This reflected both GEL depreciation related decrease in nominal GDP in US$ terms as well as debt growth in nominal terms. Excluding inter-company lending (which accounted for 21.5% of GDP and generally carries lower repayment risks) Georgia's external debt stood at 86.3% of GDP. About 95% of external debt is in foreign currency. As of 2015, external debt of Georgian corporations stood at US$ 4.3bn, increasing 26.9% y/y and accounting for 28.3% of Georgia's gross external debt. Growth of real sector corporation's debt in 2015 was mainly driven by increased borrowing from IFIs. Corporations leverage accelerated during 2008-2012 from US$ 0.8bn in 2007 to US$ 3.3bn in 2013 with significant growth of trade credits, Eurobonds (GRAIL and GOGC) and IFIs loans. Faced with insufficient international reserves, which cover slightly above three months of imports, Georgia's external debt is a source of external vulnerability stemming from large exchange rate depreciation. In years to come, authorities' efforts should be directed to enhance country's export potential in goods and services and stimulate savings for structural reduction in current account deficit and external debt.

Figure 16: Composition of gross external debt (share in total %)



Source: NBG.

3. Policy Response

30. In this section we consider monetary, fiscal and structural policy responses to the shock.

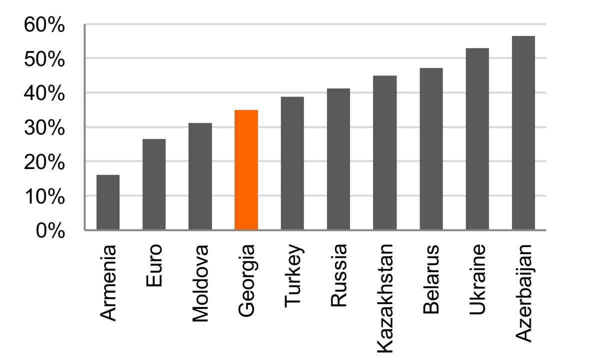
3.1 Monetary and exchange rate policy

31. During recent external shocks, falling world commodity prices, depreciating currencies and fixed exchange rate regime complicated tasks for monetary authorities. In highly dollarized financial markets sharp depreciations raised concerns about defaults and fragility in the banking sector. In the new reality of necessary shift toward flexible exchange rates, oil exporting countries faced more severe difficulties than oil exporting countries. Consequences of external shocks pressured the GEL; pass-through effect from nominal depreciation resulted in higher inflation

expectations and related tightening of monetary policy in 2015 raised concerns about efficiency of monetary transmission mechanism due to high level of dollarization of Georgia's banking sector.

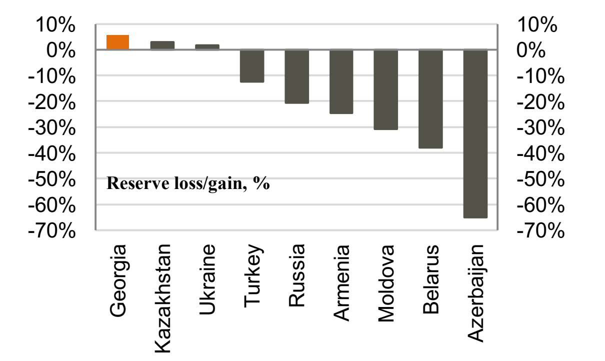
32. Currency in Georgia is free floating, which is seen as an optimal regime for a small and open economy. In an effort to cope with currency depreciation pressures, the depth of crisis and policy responses in regional economies differed. With their different exchange rate regimes, central banks in Armenia, Moldova, Russia, Ukraine, Azerbaijan, and Belarus lost a significant share of their reserves, in attempts to support their currencies. But success was limited due to long-lasting external shocks affecting economies negatively. Georgia's floating exchange rate policy enabled the central bank to pursue limited interventions to defend the GEL. As a result, Georgia's international reserves fell far less, while the reserve losses of the other regional economies were substantial. Application of more advanced monetary policy tools and inflation targeting since 2009, supported to better manage depreciation related pass-through effect on prices in Georgia compared to regional economies. As a result, depreciation acted as a shock absorber in Georgia minimizing negative impact on real economy, supporting to maintain positive growth and jobs in private sector.

Figure 17: Currency weakening vs. US$



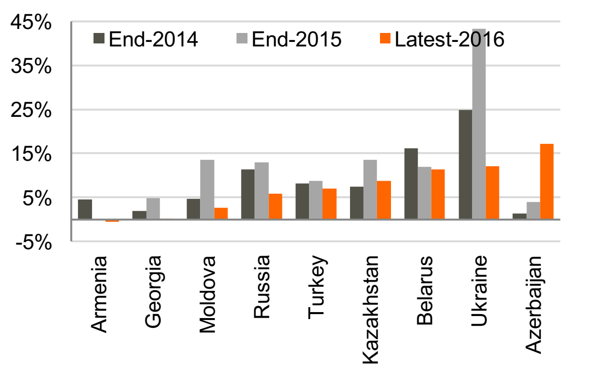
Source: Bloomberg.
Note: US$ per unit of national currency. Aug 2014–Dec 2016.

Figure 18: Change in central bank reserves



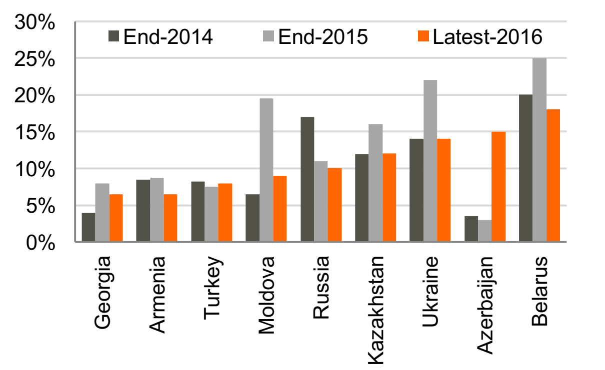
Source: IMF.
Note: From Aug-2014 to Sep-2016. Armenia's reserves exclude a US$ 500mn Eurobond issued in Mar-2015.

Figure 19: Inflation, Georgia vs. regional economies



Source: National Statistics Offices.

Figure 20: Monetary policy rate, Georgia vs. regional economies



Source: Central Banks.

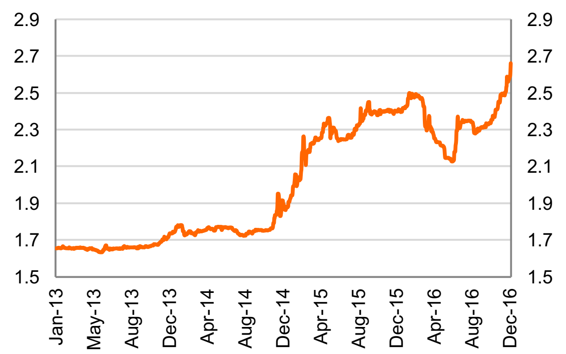
33. Stronger US$ globally affected the GEL relatively late, at end-2014 through reduced exports and remittances. The central bank's commitment to exchange rate flexibility absorbed most of the shocks through exchange rate. With limited interventions central bank allowed the GEL to depreciate by 27% against US$ over 2015. In the beginning, imports were slow to adjust resulting in wider trade deficit. But GEL's real depreciation since May 2015 supported to external adjustment. As depreciation helped to necessary adjustment in the external imbalances, Georgia maintained macroeconomic stability with minimum possible negative impact on the real sector.

GEL started to weaken further at the beginning of 2016, which was reversed starting end-March 2016. However Georgia's major trading partners' currencies remained weak. This resulted in the nominal effective exchange rate to strengthen 17.7% y/y in May 2016. The real effective exchange rate also gained 15.8% y/y, undermining the competitiveness of local producers. These developments prompted the regulator to actively intervene in the FX market to forestall any further appreciation of GEL, purchasing a total of US$ 258.4mn in March-June 2016.

34. To cope with depreciation related consequences, in May 2016, the NBG introduced a combination of various measures, which were communicated in the framework for its de-dollarization policy actions and for enhancing monetary transmission mechanism. These included: 1) reducing the reserve requirements for GEL funds from 10% to 7%, and increasing those for FX deposits from 15% to 20%; 2) allowing commercial banks to pledge GEL-denominated corporate debt securities at the NBG, provided that such securities have an acceptable credit rating; and 3) introducing stimulus for banks to convert FX loans into GEL.

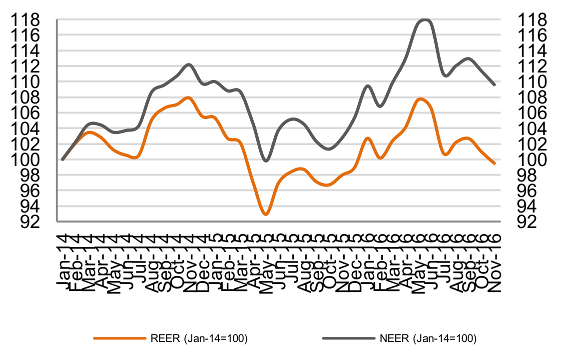
35. Established expectations for the weaker GEL toward the end of the year (the GEL was losing its value against the US$ at end-year in three years in a row since 2013) and other one-off factors resulted in a further GEL weakness by end-2016. As a result, the GEL lost another 9.5% value against US$ over 2016.

Figure 21: GEL/US$ exchange rate



Source: NBG.

Figure 22: GEL NEER and REER

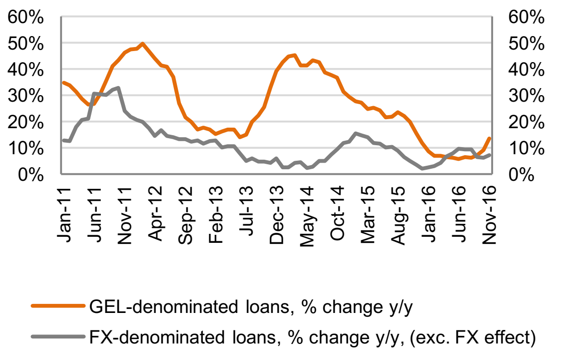


Source: NBG.
Note: Index growth means GEL appreciation, decline means GEL depreciation.

36. While GEL's depreciation supported to external adjustment and macroeconomic stability, pass-through affect from nominal depreciation and related increase in inflation expectations raised concerns on price pressures. The National Bank of Georgia follows inflation targeting regime since 2009, with inflation target of 5% in 2015 and 2016. Annual consumer price inflation was 2.0% in December 2014. In 2015 the decline in global oil and food prices put downward pressure on prices; however GEL's depreciation translated into increased inflation expectations in 2015. Pass-through effects from the nominal depreciation as well as one-off increase in electricity price reflected supply side factors affecting inflation dynamics in Georgia. This pushed the inflation rate to 5.2% in September 2015, which inched up further to 6.3% in November, before retreating toward 4.9% at end 2015.

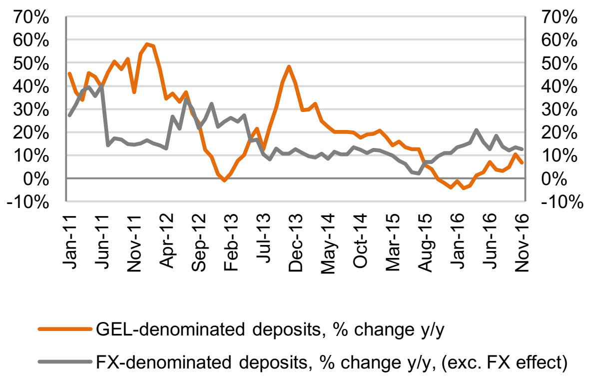
37. In an effort to stabilize inflation expectations the central bank gradually increased its policy rate from 4.0% in January 2015 to 8.0% in December 2015. Despite high dollarization, monetary transmission mechanism turned out to be more efficient than in previous years as resulting increase in GEL-denominated lending rates slowed credit growth since April 2015 from about 20% y/y growth in previous months to below 10% y/y growth onward. However, lower interest rates for US$-denominate loans supported to credit portfolio expansion in FX, leading to an increase in loan dollarization and related risks of GEL's further weakness.

Figure 23: Banking sector loan portfolio growth



Source: NBG.

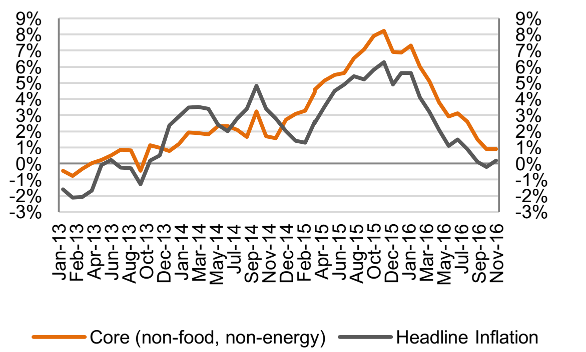
Figure 24: Bank deposits growth



Source: NBG.

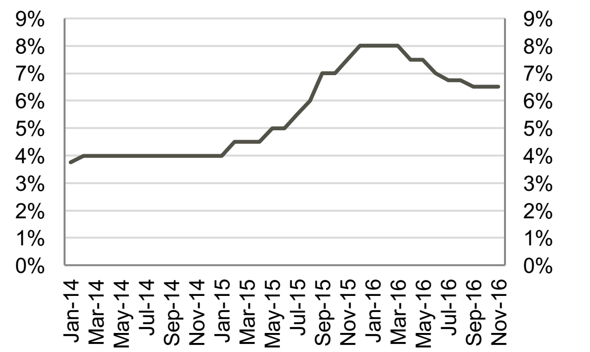
38. Weaker aggregate demand, low global oil and food prices, and last year's high base have caused overall price growth to decelerate since the end March 2016. Annual inflation fell by 1ppts per month in the four months from March to June, reaching 1.1% before increasing slightly to 1.5% in July, falling further over September - November. The NBG has reacted to the weak inflation and persistently low global commodity prices by gradually cutting its policy rate to 6.5% at end-2016 from 8.0% at the beginning of 2016. Annual inflation came in at 1.8% in December - well below the NBG's target of 5.0% in 2016.

Figure 25: Inflation dynamics in Georgia



Source: NBG.

Figure 26: Monetary policy rate



Source: NBG.

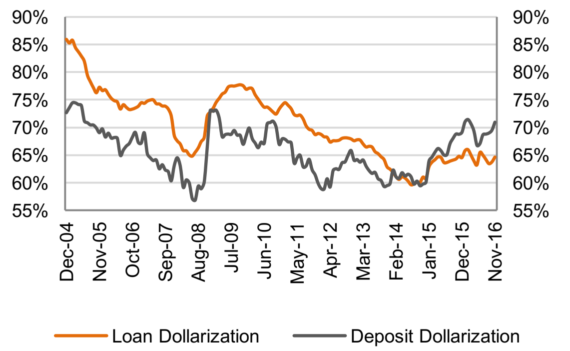
39. The major obstacle to monetary policy in Georgia is high level of dollarization, which impedes the efficiency of monetary transmission mechanism to the real economy. High dollarization is also seen as an obstacle to greater exchange rate flexibility due to its negative impact on inflation as well as on borrowers whose income is denominated in the local currency, while their debt is in a foreign currency.

40. In recent years, National Bank of Georgia implemented various policy measures to address dollarization problem in the economy. The process of loan de-dollarization was supported by NBG's policies to encourage GEL floating-rate loans as well as the government's scheme to hold long-term bank deposits. Deposit de-dollarization was supported by stable national currency, low rates of inflation and interest rate differential on Gel-denominated and FX- denominated deposits. As a result, dollarization of loans and deposits of the banking sector was on a declining trend for

the past decade and retreated from circa 85% for loans and circa 75% for deposits in 2004 to around 60% at end 2014.

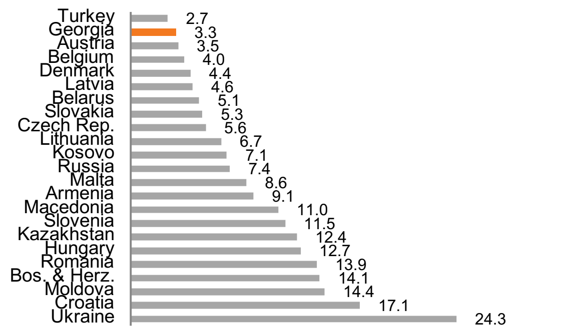
41. In 2015, the GEL depreciation pushed up dollarization of the banking sector to about 70% for deposits and 65% for loans, reflecting deteriorated moods toward national currency and higher interest rates on GEL funding as a result of tighter monetary policy. Dollarization raised concerns about defaults, however real sector performed well and NPLs stood at 3.3% at end-2015, thanks to positive GDP growth and NBG's prudent policies of recent years.

Figure 27: Dollarization in Georgia



Source: NBG.

Figure 28: NPLs to gross loans, %



Source: IMF.

42. During 2014-2015, in the framework of de-dollarization efforts, government domestic securities in the amount of GEL 272 .8mn (GEL 172.8mln in 2014 and GEL 100.0mn in 2015 respectively) was deposited in commercial banks. The mechanism was designed to create long GEL in the banking sector critical to reduce currency risks for borrowers, as GEL liabilities of commercial banks are mostly short term and are mainly used to provide short-term loans. These new mechanism allowed banks to place short-term resources in financial instruments and, in return, receive long-term liquidity in the form of unredeemable deposits.

43. For addressing GEL liquidity issues, the NBG expanded the collateral base used for refinancing operations. NBG encouraged the issuance of financial instruments in local markets by international financial institutions to facilitate local capital markets and secondary markets. In 2014 and 2015, the GEL-denominated bonds were issued for local markets by EBRD, ADB, IFC and BSTDB.

44. With dollar strengthening further related to US presidential elections, FED's decision to raise interest rate in December 2016, and economies facing potentially long-lasting external shocks than previously anticipated prompted central bank for further policy actions for decreasing dollarization of the Georgian economy and expanding the use of local currency.

45. At end November 2016 central bank and government communicated 10-point de-dollarization action plan, including 3 major sub-directions: 1) increase access to the long term local currency loans, 2) sharing of FX-risks and 3) pricing in local currency.

- Under the first direction (access to long term GEL resources), NBG plans to increase flexibility of the transmission mechanism and widen the list of eligible collateral for providing the commercial banks with sufficient liquid assets for transforming short term deposits into long term loans. According to IMF recommendation, NBG also plans to introduce the liquidity coverage ratio under Basel III, with the national currency treated preferentially.

- Other measures include developing capital markets for making easier for the companies to issue long term bonds and raise capital. A developed local government securities market

is seen as a necessary precondition for development of local capital market. In this front, government and NBG are considering implementing a combination of different measures, which envisage:
a) The issuance so called highly liquid “benchmark” bonds with predictable emission calendar for the next 5 years.
b) The introduction of the “primary dealers” institute, requiring the banks participating in the primary auctions of the government securities to ensure liquidity of the secondary market for every market participant.
c) The Implementation of Pension Reform is also seen to contribute to the economic growth by increasing the demand for long term instruments, as well as ensuring to create the long term local currency resources.

- The second direction (sharing of FX risks) includes: de-dollarization scheme of existing US$-loans jointly administered by government and NBG and new de-dollarization measures.

  The de-dollarization program of existing US$-loans envisages the voluntary conversion of US$-denominated retail loans collateralized by real estate into GEL issued before January 1, 2015. Outstanding amount of such loans is estimated at US$ 400mn and conversion will take place based on an agreement between a bank and its client. According to the government the program is a one-time targeted social measure for those borrowers who were most negatively hit by the depreciation of the exchange rate, and will have affect from January 17, 2017 and mature in 2 months’ time. Exchange rate for loan conversion will be official exchange rate at conversion date less GEL 0.2. This difference between exchange rates will be reimbursed to commercial banks from state budget (necessary budget subsidy estimated at GEL 65mn). The NBG will provide the commercial banks with the US$ necessary for loan conversion to GEL as well as with the sufficient GEL liquidity. Accordingly, this transaction will affect neither exchange rate nor banks’ foreign exchange position. The program does not imply additional costs for the commercial banks. All the clients will have a possibility to choose the bank that offers better conditions for conversion. For this purpose, the NBG will abolish loan prepayment fees. Authorities expect that that this program will ease pressure on GEL stemming from servicing the US$-loans by retail customers.

  Under new de-dollarization schemes, NBG and government submitted package of legislative amendments of the organic law on the National Bank of Georgia and other related laws to the parliament for discussion at end December 2016. The changes, already adopted by the parliament, *inter alia*, include: 1) mandatory quotation of prices in national currency for goods and services and advertisement on the territory of Georgia, 2) special rules for the provision of information to the customers when providing loans/credits, 3) mandatory issuance of retail loans of up to GEL 100,000 only in local currency, 4) and limits on interest rates and charges imposed by online credit operators.

- For the third direction (pricing in GEL), along with mandatory pricing of every goods and services in GEL, authorities plan to promote the implementation of safe service for real estate transactions - “escrow” account service. This measure aims at avoiding risks and reducing cost of real estate transactions both for the sellers and buyers. The service will be implemented in cooperation with the Georgia’s National Agency of Public Registry and be optional for the consumers. It is anticipated that this service will be additional stimulus for settlement of real estate operations in GEL.

3.2 Fiscal Policy

46. Economic Liberty Act plays significant role in designing Georgia's fiscal policy. Georgia adopted the Liberty Act in 2011, and it came into force in January 2014. The Act caps consolidated budget expenditure at 30% of GDP, public debt at 60% of GDP, and the fiscal deficit at 3% of GDP. The Act also requires approval via nationwide referendum of new taxes and increases in existing taxes (namely, personal income tax, corporate income tax, VAT, and custom duties), excluding excise taxes.

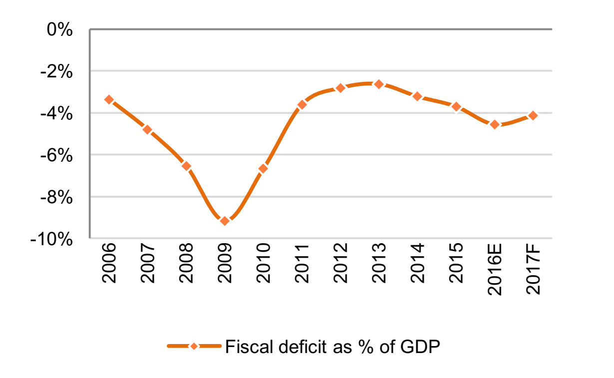
47. Since 2013, increased healthcare and other social spending (pensions, social benefits), as well as rising wages and goods and services categories, coupled with slow growth rates raised concerns on the fiscal sustainability. Notably, this increase in current expenditures was on the back of reduced capital spending and net lending, with its share in total expenditures averaging about 20% during 2013-2016 compared to about 25% of total in previous four years. To compensate for rising social expenditures, government raised excise taxes on tobacco since 2013 and introduced alcohol excises and an excise on international phone calls.

48. Faced with slower growth than projected and to reflect the expected decline in revenues, Government revised budget twice in 2015. Meanwhile, expenditures were revised upward reflecting overspending in healthcare expenditures as well as increased expenditures due to post-flood reconstruction activities in Tbilisi. Capital expenditures were also revised up by GEL 68mn. Despite better than expected tax revenues performance and GEL-depreciation related increase in the value of foreign support, overspending in both current and capital expenditures resulted in widening fiscal deficit at 3.7% of GDP compared to the budgeted 3% of GDP (according to GFSM 1986 methodology tracked by IMF and other IFIs. Georgian legislation uses GFSM 2001 methodology for computing fiscal deficit, which was in conformity of the cap introduced by Economic Liberty Act).

49. In 2016, the main increases in budget expenditures were again driven by social benefits and healthcare spending, reflecting further increase in pension and teachers' salaries, and additional spending stemming from "High Mountainous Regions Law" adopted in 2015, as well as the October 2016 parliamentary elections related spending. In 2016, based on new law of self-governance certain items of personal income tax revenues were redirected from the central government budget to local governments. In order to ensure efficient spending of these funds, the government has initiated changes, which require local governments to use these revenues for infrastructure projects only. This new norm will remain in force through 2021.

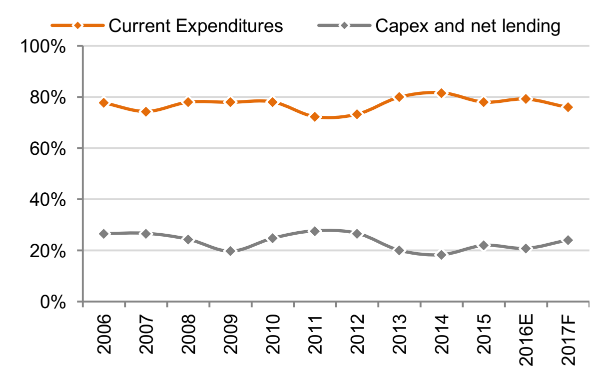
50. Despite better than expected performance in tax revenues government was again faced to revise budget at end 2016. Tax collection rose by 9.7% in 2016, exceeding the initial budgeted figure by GEL 101mn. The shortfall in getting foreign assistance due to delays in receiving budget support credits from the WB and the EU (GEL 240mn and GEL 35mn respectively, which were moved to 2017 budget document) was mitigated by disbursement of ADB's budget support credit at end 2016 in the amount of GEL 250mn (initially planned at GEL 120mn). Meanwhile, current expenditures were revised upward by GEL 287mn compared to initially budget figure for 2016. Higher current spending mainly reflected increases in goods and services category (GEL 180mn), public sector wages (GEL 90mn) and social spending (GEL 40mn). Capital expenditures and net lending were also revised upward by GEL 255mn compared to initial plan. As a result, fiscal deficit expected to widen to 4.6% of GDP in 2016 compared to initially projected 3.0%. Increased spending was financed by domestic borrowing, rising from initially planned GEL 190mn to GEL 409mn as well as deposit drawdown (reduction by GEL 111mn compared to initially planned increase in the amount of GEL 100mn).

Figure 29: Fiscal deficit as % of GDP



Source: MOF. GeoStat.

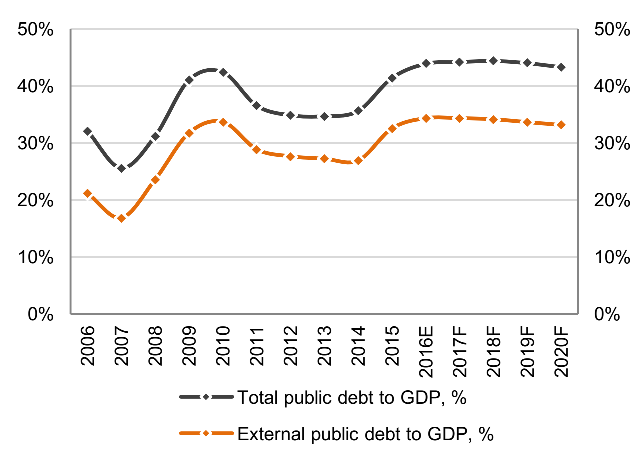
Figure 30: Current and capital expenditures of consolidated budget



Source: MOF.

51. One of the concerns of fiscal sustainability stemming from rising fiscal deficit is Georgia's public debt. About 80% of public debt is denominated in FX. Due to large share of external debt, depreciation pushed up the public debt to GDP ratio to 41.5% in 2015 from 35.6% in 2014, as external public debt stock rose to 32.5% of GDP in 2015 from 26.8% of GDP in 2014. Meanwhile, domestic debt to GDP rose by just 0.1ppts to 8.9% of GDP in 2015 and expected to reach 9.7% of GDP in 2016. The concessional nature of most of external public debt lessens the concern. However with the intension of government to increase public infrastructure spending to support growth in coming years as laid out in 4-pillar reform program, debt level will increase further. In these circumstances, consolidation of current expenditures and targeting social spending for most vulnerable becomes more crucial.

Figure 31: Public debt to GDP



Source: MOF. GeoStat.

52. To revive growth in the face of regional headwinds the government put forth a 4-pillar reform program in February 2016. The program focuses to bring structural changes in Georgian economy for boosting growth and raising welfare of the population through creating new jobs. Under 4-point program, the government plans to implement:

i. **Economic reform**, which will be focused to further support private sector in driving growth. In this regard, reform measures will be directed to further improve business environment and introduce significant tax incentives.

   Measures to further liberalize tax and customs procedures, amongst others, include the introduction of the Estonian model, which envisages the application of corporate income tax to only distributed profits; undistributed profits, reinvested or retained, will be exempt starting January 1, 2017 (changes to the tax code of Georgia were adopted by the parliament in May 2016). This measure is expected to generate additional private sector investments and to create of new jobs, in the medium term. According to USAID's assessment corporate income tax reform will add 1.5% to growth. The government also plans to continue and expand programs that support entrepreneurship, innovation, and business start-ups.

ii. **Education reform** is proposed to ensure the development of human capital and its effective involvement in the country's development process. Government plans to introduce dual system in professional education, which implies the work-based learning approach through public-private partnership. In this approach, education institutions and employers will jointly implement the training programs. Higher education will be based on the needs and demands of the economy, priority disciplines will be determined based on labor market analysis, and efforts will be directed to enhance labor force effectiveness and readiness for labor market demands.

iii. **Infrastructure schemes** envisages development of the spatial plan, which will establish major framework to respond to demands of the economy to better realize Georgia's geographic advantages in transit and logistics and tourism sector. Spatial planning targets to develop urban and rural development regulation plans to restrict chaotic development, enhance Georgia's benchmark in four season tourism location, improve connectivity of different regions, with an aim to enhance their untapped potential in tourism and agriculture.

   Spatial planning expected to improve the relationships between towns and villages, to promote high-quality sustainable tourism development, as well as to transform Georgia into transport and logistics hub connecting Europe and Asia. Government plans to develop special plan for the entire country as well as for municipalities, villages and coastal regions, including master plans for established tourist destinations and for places of untapped tourism potential.

   Under infrastructure development component of spatial planning government plans to construct more than 800km road infrastructure, with construction costs estimated at US$ 3.5bn, including finalization of east-west highway construction by 2020. Other priority directions are water supply, sanitation, and solid waste management projects. On top of these, government plans to provide internet infrastructure for additional 800 thousand persons. With this measure, more than 90% of country's population will have an access to the internet. Infrastructure schemes are expected to enhance Georgia's importance in the region and its transit and logistics hub potential.

iv. **Governance reform** envisages the development of a public service policy, improvement of quality of public service and efficiency of public institutions. For achieving reform goals government plans to establish "Business House", where businesses will receive services based on a single window principle, similarly to how ordinary citizens currently receive services at public service halls. The single window principle expected to save time and resources of businesses while their interactions with the governmental agencies. Government also plans to enhance existing online public services as well as introduce new distant services and optimize fees.

53. In order to achieve fiscal sustainability faced with reform-related lower corporate income tax revenues in 2017 (corporate income tax revenues estimated to be GEL 500-600mn lower compared to 2016 budgeted figure) along with ambition plan of increasing public investments, the government faced needs to cut non-essential expenditures, consider consolidation of public sector institutions, make social and healthcare spending more targeted, and increase capital expenditure efficiencies. Government also faces increased needs to enhance implementing agencies' capacity to keep pace with the acceleration of public investment spending projects.

54. 2017 budget document (approved by the parliament on 14 December 2016), reflects increased spending for measures outlined in 4-point reform program. The 2017 budget framework is based on 4.0% GDP growth and 4.0% deflator projections and sets the fiscal deficit at 4.1% of GDP.

55. To put fiscal accounts on a sustainable path, government introduced revenue generation as well as expenditure consolidation measures in 2017 budget document. In case of unchanged policy, reform initiatives under 4-point reform program expected to widen fiscal deficit to 6.0% of GDP. As a result, government implemented legislative changes in Budget Code, Code on Local Self-governments and introduced a number of new regulations in the 2017 state budget law. According to the new regulations additional restrictions were imposed on payments from state to local budgets to ensure compliance with fiscal rules under Economic Liberty Act, authorizing the parliament of Georgia to limit payments to the budgets of municipalities as well as imposing the obligation of reduction in administrative costs and optimization of expenses of both the central and local governments. On top of these, municipalities are obliged to consider the information about tax revenue projections provided from the Ministry of Finance during budget planning process.

56. Government estimated a drop in revenues from corporate profit tax from GEL 980mn of 2016 target to GEL 681mn in 2017 due to reform.

57. To compensate this shortfall, based on consultations with IMF and taking into account limitations under Economic Liberty Act, government plans to generate additional revenues from increased excise taxes. Namely:

- Additional GEL 200mn revenues from excise tax increase on tobacco in the range of GEL 0.3-0.6. This increase is also in line with the obligations Georgia has toward World Health Organization in reducing cigarette consumption as well as EU-Georgia Association Agreement (2011/64/ EU directive - manufactured tobacco excise tax structure and rates). In coming years government plans to further increase excise tax on cigarettes to bring it to the minimum of EUR 1.8 per 1 pack, taking into consideration impact on businesses in this sector as well as potential danger of illegal trade. Currently, tobacco consumption is one of the major public health problems in Georgia. According to the World Health Organization and various research data, tobacco consumers account for 40% of population. In recent years, as a result of excise tax increases on tobacco, consumption fell by 5% and government estimates further 8-11% drop in tobacco consumption due to proposed measure.
- Additional GEL 45mn revenues from excise tax increase on cars. Revised excise tax scale takes into consideration environmental issues also, with excise tax on environmentally friendly hybrid cars reduced by 60% and zero tax on electric car imports.
- Additional GEL 250mn from excise tax increase on fuels, which expected to reduce imports of petroleum and petroleum products. In 2015, oil and oil products imports to Georgia stood at US$ 660mn representing the largest import category. In volume terms, petroleum imports post continues increases year on year. Combination of measures related to excise tax increase on fuels and cars, preferential taxation of hybrid/electric cars as well as plans targeting enhancing public transportation are seen by the government to positively affect environmental and traffic issues in Georgia as well as having positive impact on reducing current account deficit.

58. On revenue generation measures, government also increased gambling fees (additional revenues estimated at GEL 20mn in 2017) and introduced property tax on cars if a person's/family's income exceeds GEL 40,000 (threshold already existing in tax code for property taxation of real estate, additional revenues estimated at GEL 3mn in 2017). Government also introduced VAT advances for goods and services with an aim to harmonize VAT rules with EU directive 2006/112 (according to article 285 and annex 22 of EU-Georgia Association Agreement).

59. As a result of above mentioned changes in Tax Code, tax revenues of consolidated budget are set at GEL 9.5bn (+9.2% y/y) in 2017, accounting for 26.5% of projected GDP.

60. On the expenditure side of 2017 budget document, the government implemented the following fiscal consolidation measures:

- 10% cut in payroll and administrative expenses in almost all budgetary organizations, generating GEL 100mn savings compared to 2016 budget document.
- Reduction of funding and/or abolishing part of budgetary programs based on appropriate economic analysis.
- Limiting the state auto park and reduce fuel expenses.
- Reduction or termination of state budget funding for various budgetary organizations (e.g. closure of National Investment Agency and moving its functions to Entrepreneurship Development Agency of the Ministry of Economy and Sustainable Development).

61. Based on fiscal consolidation measures current expenditures are set to increase 3.1% y/y to GEL 9.1bn. The 2017 current expenditures reflect 1) full year effect of increase in old-age pension introduced from July 2016 (from GEL 160 to GEL 180 per month); 2) full year effect of GEL 200 monthly pension for mountainous region population introduced in September 2016; 3) GEL 65mn one-off subsidy for funding the voluntary conversion of US$-denominated bank loans of individuals secured by real estate into GEL; 4) 10% cuts in salaries and administrative expenditures generating GEL 100mn savings; 5) abolishment or reduction various budget programs, and 6) dissolution or reorganization of some budgetary organizations.

62. To guarantee efficient use of fiscal resources, government plans to consider international best practices for increasing efficiency of healthcare program while providing quality assistance to most vulnerable. In this front, government plans to limit coverage of healthcare costs of employed people under the universal healthcare program. Other measures for sustaining fiscal stability in coming years as well as guarantee for decent living conditions in pension age, government plans to implement cumulative pension system from 2018, which envisages co-financing scheme by employee, employer and state budget. For enhancing education outcomes, government increased funding for the Ministry of Education and Science by GEL 144.8mn to GEL 1.1bn in 2017. The increased funding reflects higher salaries for teachers as wells as increased funding for professional (GEL 29.6mn) and tertiary education (GEL 128.9mn). State funding for priority scientific directions will be identified and supported taking into consideration the requirements of country's economic development priorities and the needs of society. Significant investments are also scheduled for development of school infrastructure, including construction of new schools with the support of Millennium Challenge Compact, EU and Council of Europe.

63. To strike balance between social justice and fiscal sustainability, government plans to reduce current expenditure ratio to GDP from 26.5% in 2016 to 21.4% by 2020 on the back of reduced costs on salaries and administrative expenditures from 5.3% of GDP in 2016 to 4.7% in 2017 and further to 3.9% by 2020, while making social and healthcare expenditures more targeted to assist most vulnerable.

64. The government plans to raise GEL 1.8bn in loans, of which GEL 400mn constitute net domestic borrowing and the rest in the form of long-term concessional borrowing from IFIs. Total public debt to GDP ratio for 2017 is projected to reach 44.2% (+0.3ppts y/y), of which external public debt is projected at 34.3% of GDP (unchanged y/y). Consolidated budget capital

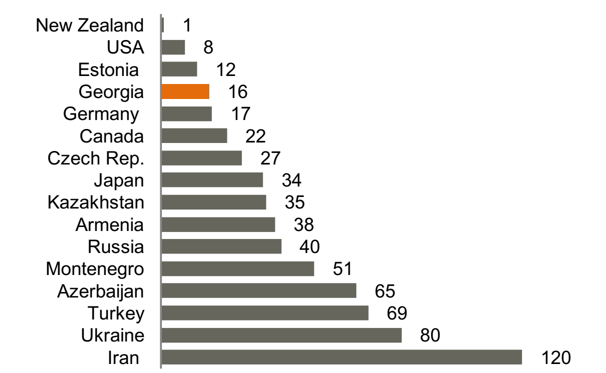
expenditures (including net lending) are set to increase 24.5% y/y to GEL 2.9bn, reflecting enhanced spending on infrastructure as outlined in government's 4-point reform program.

3.3 Structural Policies

65. Since 2003, Georgia has made outstanding progress in institutional development, fighting against corruption and strengthening public finances. These institutionalized structural improvements in Georgia have been one of the reasons that economy weathered recent external shocks relatively better than other regional economies. The results of these reforms are reflected in favorable and persistently improving international rankings: 16th out of 189 countries in the World Bank's 2017 Ease of Doing Business, with latest report naming Georgia top-performer globally over the past 12 years. Only 7% of people admitted to paying a bribe according to Transparency International's latest Global Corruption Barometer, putting Georgia on a par with EU member states.

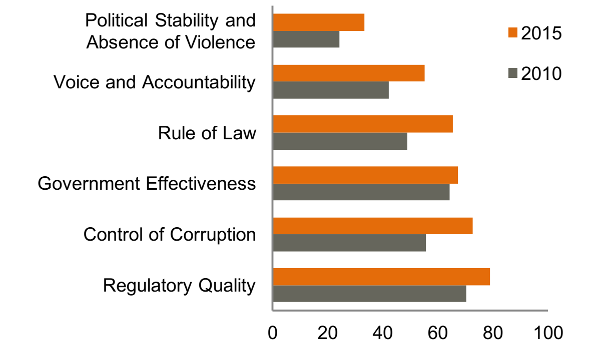
66. Georgia made remarkable progress in governance and scored higher in most of the indicators in the 2015 Worldwide Governance Indicators report by the World Bank. The report captures six key dimensions of governance - voice and accountability, political stability and lack of violence, government effectiveness, and regulatory quality, rule of law and control of corruption. In three out of these six indicators Georgia is ahead of some EU members and all five EU candidate countries. In the control of corruption indicator, Georgia is ahead of 13 EU member countries and all five candidate counties.

Figure 32: Doing Business ranking, 2017



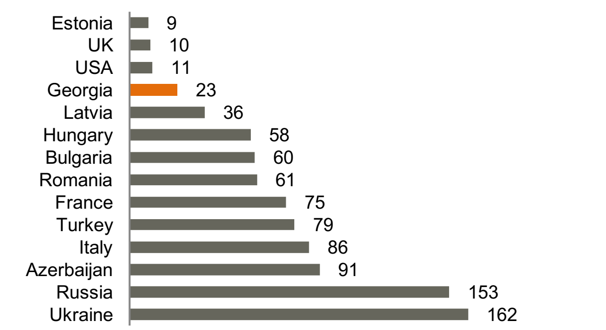
Source: WB.

Figure 33: Georgia's progress in Worldwide Governance Indicators, 2010 vs. 2015



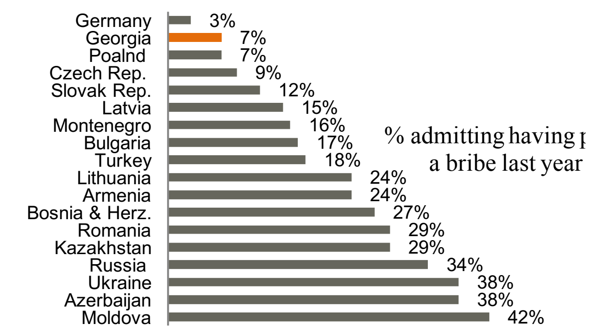
Source: WB.

Figure 34: Economic Freedom Index, 2016 ranking



Source: Heritage Foundation.

Figure 35: Global Corruption Barometer 2016



Source: Transparency International. 2016.

67. Recent external shocks demonstrated that Georgian economy is still exposed to external disturbances and further resilience is conditional upon successful implementation of various structural measures.

68. During 2015-2016, authorities' reaction was directed to enhance and sustain external flows to the economy as well as to implement structural reforms to revive growth, strengthen external sustainability, enhance private sector, mobilize domestic savings, expand the use of local currency and put public finances on a sustainable path.

69. To revive growth in the face of regional headwinds the government put forth a 4-point reform program. The program includes new tax benefits, infrastructure schemes, governance reforms and a renewal of the education system to comply with labor market demands. Measures to further liberalize tax and customs procedures, amongst others, included the introduction of the Estonian model, which envisages the application of corporate income tax to only distributed profits; undistributed profits, reinvested or retained, will be exempt starting January 1, 2017. This measure is expected to generate additional private sector investments, in the medium term, and based on USAID's assessment it will add 1.5% to growth. Other reform measures, amongst others, include creating a single window principle for the provision of government services to legal persons and speeding up the implementation of strategic infrastructure projects. Under new infrastructure schemes, government plans to implement those projects (roads, airports, tourist infrastructure, water and sanitation projects, etc.) that would raise economic activity in the regions of Georgia, enhance country's tourist and transit potential, as well as support private sector investments and create new jobs.

70. Government reforms expected to have positive affect to enhance Georgia's role as a transit hub of the region by increasing its potential in transport, logistics, and tourism. Reforms in education system expected to generate productivity improvements, as workers expected to move from agriculture to more productive, export-generating services sectors.

71. With persistent overspending in current expenditures in the face of slower growth and related widening in fiscal deficit, government faced needs to put public finances on a sustainable path. In this regard, successful implementation of fiscal consolidation and revenue generation measures proposed under 2017 budget document expected to have positive impact on external debt and budget deficit for the medium term. Excise tax increases on tobacco, cars and fuels also expected to reduce current account deficit.

72. To cope with high dollarization of the economy, monetary authority together with the government put forth 10-point de-dollarization action plan to address de-dollarization of banking sector loan-book, enhance effectiveness of monetary transmission mechanism, and support stability in the financial sector as well as measures to expand usage of local currency in the economy and mobilize domestic savings.

73. EU-Georgia Association Agreement and related Deep and Comprehensive Free Trade Agreement signed in June 2014, is also seen as significant roadmap for harmonizing Georgia's economic policy with European standards and benefit from deeper integration with the EU. This will bring potential to promote the reallocation of capital and labor to more productive industries, benefit from access to the EU market without customs duties and attract FDI. In this font, Government's plans to harmonize Georgia's legal and regulatory frameworks with the EU, to improve trade facilitation, protect intellectual property rights and develop country's human capital.

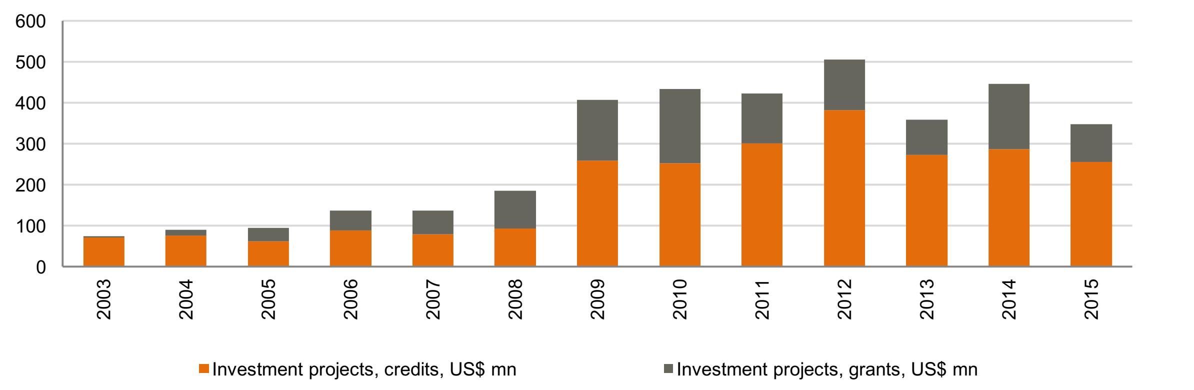
74. Imminent free trade agreement with China (negotiations completed in 2016), ongoing negotiations on free trade agreement with Hong-Kong, and the negotiations on expanding existing free trade agreement with Turkey expected to positively affect Georgian exports and further diversify export markets.

4. Support from ADB and other IFIs

75. Georgian economy is benefiting from IFIs support for decades. Capital flows from IFIs were critical to develop country's infrastructure (roads, HPPs, water and sewage, tourism infrastructure) as well as social projects (support to IDPs). On top of these, IFIs play significant role in policy advice and provide financing to small and medium enterprises, where usually banking sector financing is weak.

76. ADB is one of Georgia's largest multilateral partners with over US$ 1.9 billion approved for development assistance since 2007. ADB's budget support to the government in the aftermath of 2008-2009 global financial crisis through program loans were critical as it addresses reforms necessary to strengthen institutional setting and apply international best practices in fiscal management and various fronts of public policy directions.

Figure 36: Public sector donor funded investment projects



Source: Ministry of Finance of Georgia.

77. Over 2015-2016 IFIs support in public sector were extensively directed to enhancing Georgia's critical infrastructure needs in transport, water supply and sanitation, solid waste management, energy and regional development. This assistance plays significant role to improve internal and regional market connectivity to better utilize Georgia's geographic advantages, enhance private sector competitiveness, provide reliable water, sewerage, and sanitation services in cities and towns having potential in agribusiness, tourism, and logistics/trade, to improve reliability of energy supply. Project financing for above mentioned directions envisaged in state budget stood at GEL 1.0bn during 2015-2016 and government plans to mobilize GEL 0.8mn donor financing for specific infrastructure programs based on 2017 budget law.

78. On top of these, budget support credits and grants are significant source to finance priority directions of the public policy. Disbursement of these funds, conditional upon favorable assessment of government progress in various policy directions, represents significant tool from IFIs to enhance reforms by the government in broad range of areas critical for Georgia's institutional and economic development. IFIs budget support credit and grants stood at GEL 0.9mn in 2015-2016, out of these amount ADB's budget support assistance stood at GEL 0.4mn. Budget support credits and grants are planned at GEL 0.6mn in 2017.

Table 1: Donor support reflected in State Budget of Georgia

#	State budget donor financing, GEL mn	2015 actual	2016 plan	2017 plan
1	***Credits***	***1,021.4***	***935.0***	***1,392.7***
	Budget support credits	*445.3*	*255.0*	*470.0*
	Water/ wastewater infrastructure rehabilitation and solid waste management	*112.0*	*146.4*	*190.6*
	HPPs and transmission lines rehabilitation/construction	*93.4*	*89.6*	*87.6*
	Road infrastructure construction/enhancement	*310.3*	*353.2*	*393.9*
	Regional development	*60.5*	*90.8*	*250.7*
2	***Grants***	***315.6***	***255.0***	***284.5***
	EU budget support grants	*121.6*	*125.0*	*130.0*
	Project grants from various donors	*194.0*	*130.0*	*154.5*
3	**Total (1+2)**	***1,337.0***	***1,190.0***	***1,677.2***

Source: MOF.

79. IFIs support also plays significant role for small and medium enterprise development, enhance access to finance and promote financial inclusion, particularly for micro, small, and medium-sized enterprises, where banking sector funding is weak.

80. International development partners were actively supporting government in elaborating Socio-Economic development Strategy of Georgia -Georgia 2020, which captures government development program, establishing policy directions regarding sustainable and inclusive economic growth, macroeconomic stability, and effective public administration, human capital development, access to finance, and private sector competitiveness.

81. IFIs support was also important in the process of promoting de-dollarization of the economy, facilitating local capital markets and secondary markets development as well as the development of a local corporate bonds market. In this regard, EBRD, IFC, ADB and BSTDB carried out lari-denominated bond emissions in 2014-2016.

5. Conclusion and Recommendations

82. The recent external shocks related to oil price slump, geopolitical tensions and spillover effects from the recession in Russia had a net negative affect on Georgian economy. While first round effect of lower oil prices had positive impact being Georgia an oil importer, second round effects through reduced exports and remittances and related depreciation of the GEL outweighed the initial positive impact. On top of these, concerns increased on fiscal front due to widening fiscal deficit, and high dollarization of the Georgian economy and Georgia's high external debt raised concerns about fragility of financial system and external sustainability of the country.

83. With limited interventions to defend the local currency, central bank allowed the GEL to absorb most of the shocks to the economy minimizing negative impact on real sector. As a consequence

Georgia maintained positive growth in 2015. However, pass through effect of GEL's depreciation led to rising inflationary pressures with inflation at 4.9% at end 2015. As a result, central bank responded with tightening of monetary policy in 2015. In 2016, weak aggregate demand along with lower world commodity prices eased price pressures enabling central bank to cut policy rate from 8% at the start of 2016 to 6.5% at-end-2016.

84. Flexible exchange rate regime in Georgia proved to be effective and acted as a shock absorber, however pointed to address high dollarization of the economy for increasing efficiency of monetary transition mechanism as well as minimizing potential negative impact on financial sector from large currency depreciation.

85. Dollarization has been issue in Georgia since the country gained independence in 1991. Large capital flows, better economic and exchange rate policies, as well as low inflation supported to improving consumer moods toward GEL. Dollarization was on a sustainable declining path before GEL's depreciation in 2015. NBG introduced various measures to address dollarization issue in recent years. However companies' greater exposure to US$-denominated debt and loss of confidence in GEL made it less likely that the move away from the dollar would continue without additional efforts from NBG.

86. As a consequence, NBG introduced 10-point de-dollarization action plan to address the problem, which inter alia, puts threshold on issuing US$-denominated bank loans to retail customers equivalent of up to GEL 100 thousand and voluntary conversion of US$-denominated loans issued before 1 January 2015 into GEL. While addressing dollarization problem in Georgia is critical, mismatch between US$-denominated bank liabilities and US$-denominated bank assets may present a serious risk to financial system in case of exchange rate depreciation.

87. International data since the global financial crisis suggests that de-dollarization has stopped and even reversed in many emerging market countries. There are very few cases of successful de-dollarization worldwide. Typically dollarization is very persistent and some countries never de-dollarize. But there are also successful exceptions, e.g. one found in case of Peru. Since de-dollarization action plan proposed by NBG has similarities as well as differences with Peruvian example, some key policy lessons may be relevant for Georgia to consider. In late 1990s about 85% of Peru's bank deposits and 80% of loans were dollar denominated; as a result of de-dollarization policy in Peru dollar loans are now less than 30%, while dollar deposits have grown marginally since 2012 at around 50%, reflecting global trends of stronger dollar.

88. In Peruvian experience, there are four main factors found for successful de-dollarization process (Catao and Terrones, 2016):

- Introduction of inflation targeting
- Regulations that make it more expensive for banks to manage dollar deposits and make dollar loans
- Persistent real exchange rate appreciation, and
- Favorable external conditions, such as high global commodity prices and low global risk aversion

89. While first three factors that mattered in Peruvian de-dollarization case are in place in Georgia and will likely affect the de-dollarization exercise positively, the forth component is totally opposite currently for Georgia. Higher commodity prices are seen to encourage a shift toward local currency loans and deposits for various reasons, including encouraged confidence in domestic

policies due to higher growth. At the same time it depends on the marginal costs of administering US$ and local currency accounts. In case interest rates in local currency increase, lower interest rates abroad might motivate firms to borrow abroad rather than domestically. This will reduce demand for domestic US$ borrowing and lower dollarization, but Georgian companies will be still exposed to exchange rate risk if external debt widens. In a nutshell, as external factors are out of control of the authorities, efforts and resources should be directed to increase confidence in domestic policies and revive growth for enhancing domestic firms' and consumers' moods toward holding domestic currency.

90. Fiscal policy was expansionary during 2014-2015, aiming to support the sluggish aggregate demand and supporting vulnerable population, however elevated fiscal deficit raised concerns on fiscal sustainability. Structural reforms put the most emphasis on reviving growth potential, further enhancement tax and customs administration, addressing skills mismatch, and enhancing public infrastructure spending and further supporting business environment.

91. For fiscal sustainability purposes government is faced to elaborate legislative changes for better managing public sector employment benefits, further cut non-essential expenditures, consider further consolidation of public sector institutions, make social and healthcare spending more targeted, and increase capital expenditure efficiencies.

92. The combination of revenue generating and expenditure consolidation measures expected to strengthen fiscal sustainability from 2017. However, in reforming public sector employment benefits, government should consider adequate remuneration schemes as decent salaries in public sector was one of the major reasons behind success in fighting against corruption in recent years. In this front, more emphasis should be attached to optimization of public sector institutions through abolishing parallel structures and/or duplicated tasks among budgetary organizations rather than cutting wages.

93. It is also desirable to reduce public sector dependence on domestic borrowing for leaving scarce local currency resources for private sector funding, which will help to natural de-dollarization of the economy.

94. IFIs support will be crucial to strengthen the effectiveness of social spending and the line ministries capacity for managing accelerating capital spending. On top of these, IFIs support in analyzing outcomes of the reforms can feed trust in economic policy.

95. Reforms related to capital market development, and pension reform, as well as reforms aiming at attracting FDI, increasing export potential and supporting productivity of labor force should gain increased attention. These reforms are expected to have positive impact on domestic savings, improve productivity and address structural change in the economy.

96. Continuation of business-friendly reforms and implementation of government 4-point reform program is expected to revive growth from 2017 and beyond. The reforms expected to enhance economy's ability to better utilize its advantages in transport and logistics and tourism sector.

97. To feed trust in new initiatives and Georgian economy, government needs to have intensive communication with market players and provide analysis of initiated measures and achieved

targets. Government also needs to revive trust in fiscal policy by meeting fiscal deficit target, which was persistently widening compared to initially projected figure during last two years.

98. Achieving rapid and sustainable growth also requires addressing productivity and growth of exports, for which infrastructure schemes and labor market reform under 4-point reform program can be seen as a proper tools for enhancing competitiveness, market access and improving logistics.

99. There is broad understanding that a sustained improvement in the current account balance would have to come from an improved trade balance. Excise tax increases on fuels, cars and tobacco from January 2017 expected to have positive impact on current account. At the same time, various measures deployed by government in recent years and as well as new measures under 4-pillar reform program expected to enhance structural improvement in the economy with positive impact on current account. On the other hand, low world commodity prices affect Georgian exports in a negative way as minerals and metals constitute a large part of Georgia's exports.

100. For expanding commodity exports, Georgia should deploy different possibilities. First, the trade enhancing reforms to be implemented under the EU DCFTA and 4-point reform program can be particularly important to gain EU market share as well as other markets. However to comply with EU standards producers will face additional costs. Second, attracting FDI in export generating sectors, including manufacturing is critical, as Georgia lacks capital and knowledge to produce and export more sophisticated commodities other than agricultural products and raw materials.

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