Georgia

The economy fell into recession in the wake of the 2008 conflict with the Russian Federation and the global downturn. But aided by a strong fiscal response and sizable external inflows, the contraction bottomed in June and recovery is, apparently, under way. The outlook is for modest but gradually strengthening growth on the assumption that exports, foreign investment, and credit to the private sector continue to pick up. Reducing the fiscal stimulus is the immediate priority, but efforts to diversify production and trade are needed for the longer term.

Economic performance

The several years of high growth rates from 2005 through the first half of 2008 were underpinned by general macroeconomic stability, strong revenue performance, and a liberal business environment that attracted large inflows of foreign direct investment (FDI). But the armed conflict with the Russian Federation in August 2008 pummeled the economy, leading the authorities to seek an International Monetary Fund (IMF) standby arrangement the following month and emergency financing from donors. The September global financial crisis and subsequent recession then made a dire situation worse.

GDP contracted by 3.9% in 2009, well below the truncated 2.3% outturn in 2008 and far away from the 12.3% expansion in 2007 (Figure 3.3.1). The shrinkage reflected a 50% decline in FDI, which had provided real impetus to private investment and growth; a huge drop in demand for exports; and the conflict's dislocation of normal economic activity.

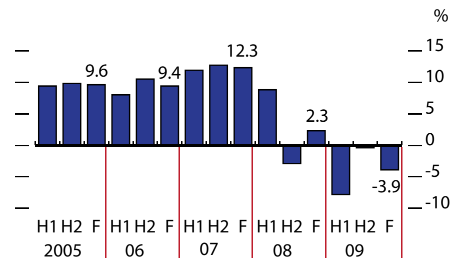
For the year, nearly all sectors of the economy were hit. Wholesale and retail trade saw double-digit declines while manufacturing and agriculture fell by more than 5%.

Large fiscal spending, however, put a floor on the decline in economic activity, and the downdraft appears to have bottomed in the second half of 2009, with a slight pickup in activity in the fourth quarter as investor and consumer confidence strengthened.

Inflation pressures were contained due to weak domestic demand and a drop in prices for major import items. Inflation, which had peaked at 12.7% in August 2008, steadily declined to 3.0% by December 2009 (Figure 3.3.2). It picked up somewhat in February 2010, mainly reflecting a seasonal increase in food prices. Average inflation dropped to 1.7% in 2009 from 10.0% in 2008.

In other measures to help stabilize the economy, the National Bank of Georgia, the central bank, shifted policy to monetary easing. It cut its key refinancing rate from 12% before August 2008 to 5% in November (where it stays). Moreover, it launched foreign exchange swaps and expanded

3.3.1 GDP growth

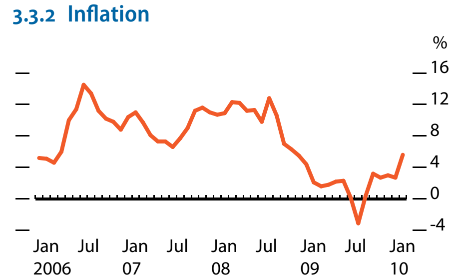


F = full year.

Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 31 March 2010).

Click here for figure data

3.3.2 Inflation



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 31 March 2010).

Click here for figure data

This chapter was written by George Luarsabishvili of the Georgia Resident Mission, ADB, Tbilisi; and Nariman Mannapbekov of the Central and West Asia Department, ADB, Manila.

uncollateralized loans to commercial banks as part of emergency lending. These changes had little impact on bank lending rates and on bank credit to the private sector, which dropped by nearly 12% in 2009. Still, the decline in private credit appeared to stabilize in the fourth quarter. New lending picked up in early 2010, though credit remained well below year-earlier levels.

Broad money contracted by around 14% in the first half of 2009 from a year earlier, though it rebounded to grow by around 8% by year-end (Figure 3.3.3).

Even though the banking sector continued to face difficulties, commercial banks began to show signs of improvement by a return to profitability in the third quarter of 2009. The share of nonperforming loans has increased since 2008 in part due to high levels of unhedged foreign borrowing. However, the nonperforming loan ratio at 6.8% in January 2010 was fully provisioned. "Dollarization" of deposits increased by about 10 percentage points in the last quarter of 2008 to 75.8%, but eased to 73.4% by end-2009, indicating strengthening public confidence.

The authorities' proactive policy response to the crisis helped the economy weather the contagion effects of the global crisis, and was the main stabilizing force in the domestic economy. As part of the fiscal stimulus package, the government reduced income tax (from 25% to 20%) and dividend tax (from 20% to 15%). Tax collection declined by 7.7% in 2009. The decline in overall budget revenue, however, was larger, at 10.1%, attributed to a steep fall in grant assistance as the large grants—for those displaced by the conflict and for emergency infrastructure repairs—slowed.

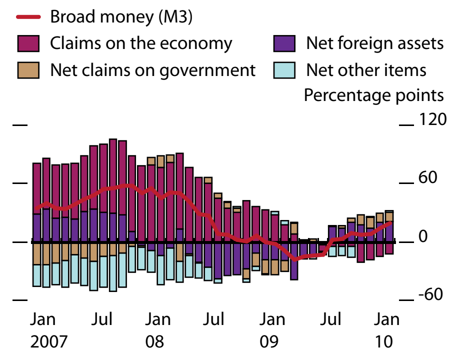
Current expenditure was essentially maintained at the 2008 level, though social welfare spending was significantly increased and defense outlays reduced. Total expenditure fell by 2.1% on a reduction in capital outlays (of about 8%). The fiscal deficit reached 9.2% of GDP in 2009, in line with the government's plan and the program with the IMF (Figure 3.3.4). Public external debt rose to $3.4 billion (or 31.8% of GDP) at year-end.

In light of lower than expected privatization revenue, weaker tax collection, and (to a lesser extent) a gap in external financing, sales of treasury bills were reintroduced in August 2009 and net issuance funded about 16% of the fiscal deficit in 2009. The bills were well received and will be used in financing the 2010 budget.

The current account deficit narrowed sharply to 11.9% of GDP ($1.3 billion) in 2009 (Figure 3.3.5), from 22.8% in 2008. The improvement was mainly due to a 31% drop in imports. The fall reflected weak domestic demand (in good part owing to a marked decline in investment), lower commodity prices, and devaluation of the lari, the domestic currency. Exports fell by 22% on slumping demand. Net invisible receipts increased by 22% to $1.1 billion, as remittance inflows (equaling $0.95 billion or around 9% of GDP) stayed strong.

The authorities devalued the lari by around 17% against the dollar in November 2008 after sustaining reserve losses after August. By February 2009, downward pressure on the lari had eased and from May 2009 interventions were conducted only through foreign exchange auctions, in effect adopting a market-determined exchange rate. The rate was relatively

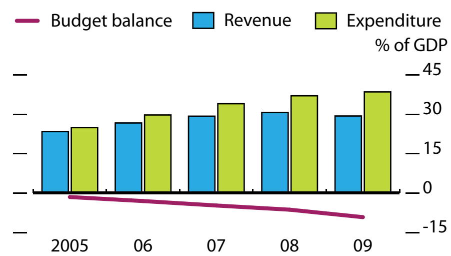
3.3.3 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 31 March 2010).

Click here for figure data

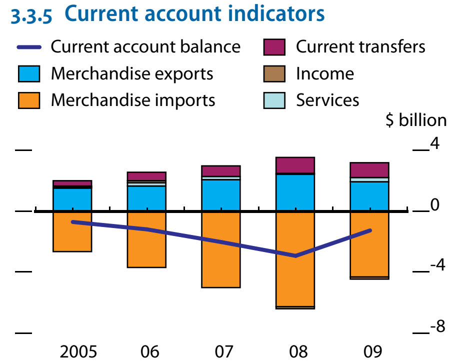
3.3.4 Fiscal indicators



Sources: International Monetary Fund. 2008. *Request for Stand-By Arrangement—Staff Report*. October; 2009. *Third Review Under the Stand-By Arrangement*. August; 2009. *Fourth Review Under the Stand-By Arrangement*. December. http://www.imf.org; Ministry of Finance of Georgia. http://www.mof.ge

Click here for figure data

3.3.5 Current account indicators



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 31 March 2010).

Click here for figure data

stable in 2009, varying little around the average of GEL1.68/$, though this was about 11% weaker than 2008's average.

Gross international reserves increased to $2.1 billion by end-2009 from the prior year-end low level of $1.5 billion. About one-third of the increase was due to an allocation of special drawing rights by the IMF.

Economic prospects

The economic outlook remains challenging. As a small, open economy at the cross-roads of Europe and Asia, trade and economic growth heavily depend on developments in neighboring countries and major trade partners. Given the projected global and regional economic recovery and the return of investor confidence, as evidenced by strengthening momentum in the domestic economy in the final months of 2009, GDP growth is projected to increase to 2.0% in 2010 and 4.0% in 2011.

While government expenditure will remain the mainstay of the economy, private investment is expected to pick up owing to a mild strengthening of FDI and improved domestic financing conditions as confidence in the recovery reasserts itself. A revival in trade and commodity prices is seen bringing export activity up sharply. Consumer expenditure should improve, if only slightly, on some gain in remittances and a return to domestic growth.

During the last few months of 2009 tax revenue, remittances, and trade turnover began to perk up, and will likely continue doing so in the forecast period. The 2010 budget plans to ease spending from 38.5% in 2009 to 36.5% of forecast GDP, but it would still underpin much economic activity. Notably, there would be a shift toward domestic expenditure and donor-financed postconflict rehabilitation spending away from import-oriented defense spending at 8% of GDP in 2008 to 4% of 2010's forecast GDP.

In addition, the budget envisages no increase in social spending relative to 2009, while other public expenditure will be brought down across the board. While revenue as a share of GDP will be little changed, expenditure policy is expected to lower the budget deficit to 7.4% of GDP. The government's medium-term fiscal plan targets are to reduce the budget deficit to 2%–3% of GDP by 2013 to ensure debt sustainability.

Monetary policy will continue to be geared to expanding lending to the private sector. Although domestic demand will be subdued, increases in international prices will likely push inflation higher to around 6% in 2010–2011. The central bank will continue to let the exchange rate adjust to market conditions.

The current account deficit is projected to widen to about 14% of GDP. This mainly reflects an increased import bill, in part on higher commodity prices, both for hydrocarbons and food. The revival in economic activity and global price developments is projected to push imports higher by about 12% in 2010. Given the expected growth in major trade partners, exports are forecast to strengthen by about 12% in 2010 and 14% in 2011. These factors will push the trade deficit higher, and with relatively little foreseen improvement in workers' remittances and other invisible receipts, the current account deficit will rise.

3.3.1 Selected economic indicators (%)

	2010	2011
GDP growth	2.0	4.0
Inflation	6.0	6.0
Current account balance (share of GDP)	-14.0	-14.0

Source: ADB estimates.

3.3.1 Development challenges

To achieve a sustainable fiscal and external balance, the government will need to modernize and diversify the export structure, then promote exports more. (The list of leading Georgian exports of a decade ago is remarkably similar to now.)

Traditionally, the share of FDI in manufacturing and agriculture has not exceeded one-quarter of total FDI, even though these two sectors have large potential for growth. Tourism and transportation sectors could be attractive for foreign investors as the country has a potential to become a major commercial and logistical hub in the Caucasus via the Poti and Batumi ports. Moreover, the country's sizable hydropower potential should be better tapped.

To rebalance growth toward export-led strategy it is important to create a conducive environment for attracting FDI to the tradable sector. Additional measures and incentives are needed to channel funds into the above promising sectors.