Georgia

Economic growth in the Asian Development Bank's newest member has been robust in recent years, supported by strong domestic demand and supply-side reforms. Investment activity has been buoyed by large foreign direct investment inflows. Revenue collections have soared but so too has public spending. Near term, the large current account deficit has to be managed while macroeconomic imbalances are unwound; further out, more jobs are needed. The outlook for rapid growth is positive.

Economic performance

Resilient to shocks, growth accelerated to 12.0% from an average of 8.3% in 2004–2006 (Figure 3.3.1). Rising domestic demand, particularly consumption, as well as buoyant investment underpinned the spurt. Consumption growth was supported by rising real wages and surging workers' remittance inflows.

The investment activity was bolstered by foreign direct investment (FDI) amounting to $1.4 billion (13.8% of GDP) in 2007, up from $1.1 billion the previous year (Figure 3.3.2). The increase in FDI reflects continued government reforms to improve incentives for private sector development, including extensive privatization. FDI also helped cushion the adverse impact of the loss of large bilateral trade flows due to a Russian trade and transit embargo imposed in 2006.

Industry, led by mining and manufacturing, grew by 12.8%, reflecting in part a favorable external environment for such export-oriented products as ferrous alloys and copper ore. Higher industrial growth may also reflect the crossover of enterprises to the formal from the informal sector, as reforms have made staying informal less attractive. Another factor could be progress in industrial restructuring, with the exit of older, more inefficient firms and the entry of new, more productive firms.

Services continued to grow strongly, by 14.4% in 2007, led by the subsectors of wholesale and retail trade, hotels and restaurants, and transport. Buttressing recent strong performance are reforms in policies toward infrastructure development, especially in energy, transport, telecommunications, and financial services.

Agriculture showed signs of recovery beginning in the second quarter from the slump in 2006 to expand by 3.8%. However, the trend in growth in recent years has been weak due to the incomplete transition from subsistence to commercial agriculture.

Differences in sector growth rates over the years have led to large changes in the composition of GDP, with services accounting for some three fifths and industry around one fourth (Figure 3.3.3). Despite agriculture's dwindling share in GDP, its impact on food prices is substantial.

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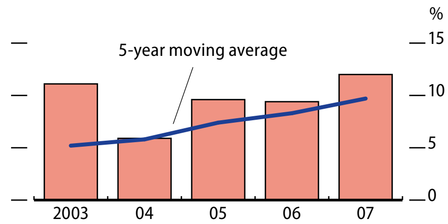
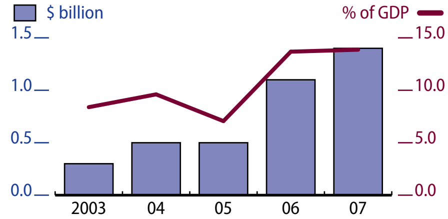
3.3.1 GDP growth



Sources: Department of Statistics, available: http://www.statistics.ge, downloaded 18 March 2008; staff estimates.

Click here for figure data

3.3.2 Foreign direct investment



Sources: International Monetary Fund, *International Financial Statistics* online database, downloaded 14 March 2008; staff estimates.

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Surging foreign exchange inflows have underpinned recent growth, but have also complicated the task of containing internal and external imbalances. Inflation rose to double digits in the second half of 2007 (Figure 3.3.4). The 12-month end-of-period inflation for 2007 stood at 11.0% and the period average at 9.2%.

In the consumer price index basket, the largest increases were registered in the categories of gas, fuels, and electricity (23.9%); transport (15.6%); and food (12.9%). Increased world prices for energy and food (particularly cereals) were a contributory factor. The domestic prices of most tradable goods are likely to have been pushed up by the depreciation of the local currency, the lari, on a trade-weighted basis over recent months. The nominal effective exchange rate depreciated by 0.7% year on year in December 2007. The real effective exchange rate appreciated marginally by 0.5%. The growth rate of average wages outstripped growth of real value added per employee in the first half of 2007.

Added to this mix was a marked expansion in credit to the private sector, which boosted broad money growth (M3) to 49.7% (Figure 3.3.5), stoking accelerating inflation pressure during the year.

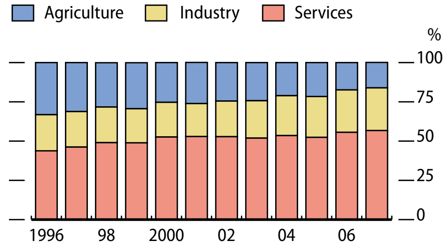
The National Bank of Georgia (NBG) has so far followed a hybrid approach aimed at inflation control and smoothing fluctuations in the exchange rate, but has encountered inherent tensions between these two aims. In fact, its preference seems to have been to slow exchange rate appreciation and, more recently, to induce nominal exchange rate depreciation, as concern to control inflation gave way to worries over competitiveness (as export growth appeared to wane). The monetary instruments used were foreign exchange interventions and open-market operations (using NBG certificates of deposit and sale of its holdings of government securities), the latter on a limited scale given the underdeveloped financial sector.

As a complementary sterilization measure, government deposits have been accumulated with NBG, made possible by significant privatization proceeds that have exceeded the overall deficit. Georgia faces the classic problem of the "incompatible trinity": with free capital mobility, monetary policy can be oriented toward an external objective (exchange rate) or an internal objective (price level), but not both at the same time. It is now seeking to get out of this bind and in legislation approved in February 2008 NBG's main objective is stated to be price stability.

At a time when the economy shows signs of overheating, the fiscal deficit widened in 2007 as record revenue collections were outweighed by a record level of public spending. Budgetary revenues (excluding privatization receipts) rose sharply to an estimated 29.4% of GDP, from 26.3% the previous year, on the back of tax revenue collections that rose by 40.0%. The main sources of recent growth in receipts have been value-added tax, profit tax, income tax, and excise duty. Major reforms in tax policy and administration have sustained the upward trend in budgetary revenues, in particular, flat-rate taxes (on income and profit) on a broader tax base, together with substantially improved tax compliance.

Budget expenditures grew by 36.6%, with the expenditure-to-GDP ratio now at 32.5%. The higher spending was mainly on defense, infrastructure development, and social sectors. The fiscal outturn for 2007 (a deficit of 3.1% of GDP) is wider than originally planned (2.6%) and

3.3.3 Sector shares in GDP



Sources: Department of Statistics, available: http://www.statistics.ge, downloaded 18 March 2008; staff estimates.
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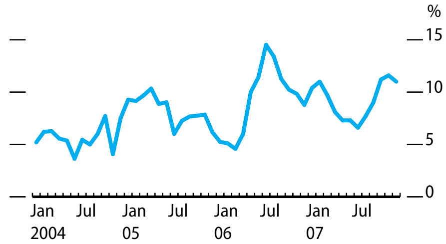
3.3.4 Inflation



Source: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 18 March 2008.
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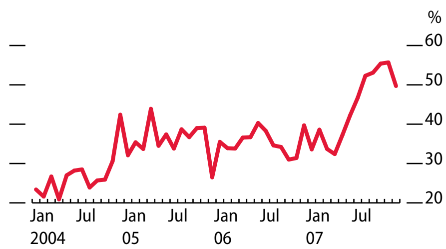
3.3.5 Money supply (M3) growth



Sources: National Bank of Georgia, available: http://www.nbg.gov.ge; International Monetary Fund, *International Financial Statistics* online database; both downloaded 10 March 2008.
Click here for figure data

slightly higher than the 2006 outturn of 3.0% (Figure 3.3.6). The deficit was, however, more than covered by privatization receipts, estimated at 3.8% of GDP in 2007.

Public debt ratios, both external and domestic, have been falling. Total government debt stood at 22.0% of GDP for 2007 (down from 35.7% in 2005) and of this, the external share is estimated at around 17%, down from 27.0% in 2005 (Figure 3.3.7). Debt-reducing factors include the effect of higher GDP growth on the debt-to-GDP ratio, debt-reduction operations, prepayment of debt owed, and a conservative external borrowing policy. The relatively low public debt and strong GDP growth point to a sustainable fiscal deficit.

Nonetheless, with limited effectiveness of monetary policy, fiscal policy should be developed into a more effective instrument for managing the large foreign exchange inflows. Saving the receipts from overperformance (relative to the original budget) rather than ratcheting up public spending would help sterilize foreign exchange inflows and thus lessen the risk of the economy overheating. At some time in the future, the Government envisages eliminating fiscal deficits altogether. The February 2008 legislation includes a directive to make fiscal surpluses mandatory and to establish a "future generations fund" and a "stable development fund" to absorb both the surplus and privatization proceeds.

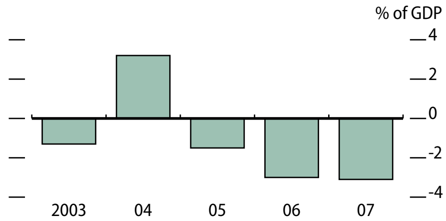
The current account deficit is large and growing (14.7% of GDP in 2007, from 9.8% in 2005). The trade balance has been deteriorating, with particularly sharp downturns in 2006–2007 as import growth outpaced export growth (Figure 3.3.8). The deteriorating trade balance has been partially offset by growing surpluses in other components of the current account, notably nonfactor services, income, and transfers.

Whether such a large deficit is sustainable requires a view of the other side of the coin, namely the savings-investment gap. The gap is mainly in the private sector account—the recent private investment boom has been covered by FDI while private saving has fallen. The contribution of the public sector to the savings-investment gap is less significant. The potential risk presented by the widening of the savings–investment gap stems from the expected slowdown in FDI from its current high levels. Such a slowdown will require an adjustment in the savings-investment gap either through a painful retrenchment in investment or, preferably, through higher private saving to finance expanding domestic private investment.

Structural reforms have affected growth and private investment. Governments have vigorously pursued business regulatory reforms since 2004, and licensing reforms stand out as a key area that has transformed the business environment. Other "business-friendly" policies include labor regulations, property registration, and tax reform. Consequently, the cost of doing business has fallen appreciably—the country's global rank in the World Bank's *Doing Business* index is now 18 and inward FDI has surged. Public sector reform is moving apace. The program for privatizing large-scale enterprises is now nearly complete. Public finance reforms on both the revenue side (such as tax reforms) and the expenditure side (such as improved allocative and operational efficiency of public spending) have contributed to fiscal sustainability.

Public administration has seen notable progress in implementing anticorruption measures and in streamlining administrative structures,

3.3.6 Budget balance



Sources: International Monetary Fund, *Country Report* Nos. 06/171 and 07/299, both available: http://www.imf.org; staff estimates.

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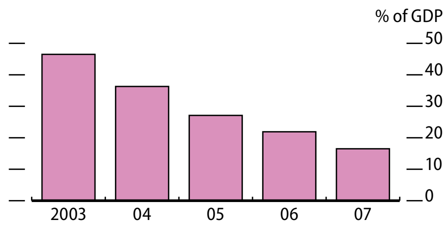
3.3.7 External debt



Source: International Monetary Fund, *Country Report* No. 06/171, available: http://www.imf.org.

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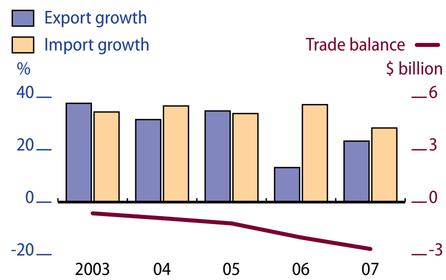
3.3.8 Trade indicators



Sources: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 10 March 2008; staff estimates.

Click here for figure data

3.3.1 Selected economic indicators

	2008	2009
GDP growth	6.5	7.0
Inflation	9.5	7.0
Current account balance (% of GDP)	13.6	11.5

Source: Staff estimates.

while significant consolidation of the banking system has taken place, with an increase in minimum capital requirements. The effectiveness of the private credit bureau has been strengthened by a broadening of the database of payment information collected and improvement of the means for distributing borrowers' debt profiles to creditors. Also, the law on insolvency procedure passed in May 2007 has reduced the time involved in closing a business and improved the debt-recovery rate. These reforms, together with a generally prudent macroeconomic policy, have boosted credit to the private sector from a very low base.

Economic prospects

Relative to 2005–2007, GDP growth in the forecast period is expected to fall to 6.5–7.0%, largely reflecting decelerating domestic demand. The expected growth easing stems from the following factors: investment growth may be pared back given an uncertain environment leading up to parliamentary elections to be held this May; the Government has committed to more restrained public spending on concerns of fueling inflation (thereby probably slowing demand growth); and the negative contribution of net exports will continue to affect growth, since foreign demand for exports is likely to be somewhat weaker as the impact of moderating eurozone expansion is likely to outweigh the effect of any depreciation in the lari-euro exchange rate.

GDP growth is projected to pick up to 7.0% in 2009 as private sector investment, particularly on the domestic side, responds to productivity-enhancing reforms. The balance of risks to projected GDP growth is on the upside. The postelection policy environment is likely to see deepening reforms and institution building. If promising signs of rapprochement with the Russian Federation do indeed materialize, then demand for Georgia's traditional exports to that country could recover, and the negative contribution of net exports to growth could ease somewhat.

Average consumer price inflation in 2008 is expected to stay at around 9.5%, reflecting high energy and food prices, as well as continued depreciation of the exchange rate on a trade-weighted basis, which will feed through to domestic production costs. In 2009, inflation is projected to fall back as energy and import prices moderate. There are both upside risks and downside potential to these projections: further upward pressure on world energy and food prices in 2008 will see double-digit inflation carry forward into 2009, while slower demand growth aided by substantial fiscal tightening may help reduce pressure on prices.

Export growth is likely to remain subdued in 2008 given the external environment. Import growth may also wane as domestic demand weakens. The services and income surpluses are expected to increase. The combination of these influences is likely to result in some narrowing of the current account deficit to 13.6% of GDP in 2008 and to 11.5% in 2009, aided by adherence to structural reforms leading to quality improvements in the export sector.

3.3.1 Development challenges

Recent strong growth has yet to translate into sustained trends in declining unemployment and falling poverty rates.

The overall unemployment rate edged up to 13.6% in 2006. The urban rate is five times that in rural areas (28% and 5.7%, respectively), and is mainly because the data reflect open unemployment in urban areas and substantial underemployment in rural areas.

The poverty incidence rose by an estimated 5.7 percentage points in 2004–2005 to 32.9%. According to recent World Bank estimates the poverty incidence fell in 2006 to 31%. At this point, firm evidence of a sustained downward trend in poverty incidence is lacking.

Unemployment is high, given the labor market rigidities. Job creation remains quite low, because enterprises are still being restructured and because new private businesses (as opposed to privatized enterprises that were once state owned) are still a relatively small share of the formal sector.

Conversely on the supply side, skills shortages in emerging growth sectors are constraining employment. With net new job creation highest among small private firms, a greater focus on creating an enabling environment for them is required. This calls for addressing their current obstacles, such as access to diverse sources of finance, limits on acceptable types of collateral, high costs of evaluating credit information, and ineffective systems for enforcing repayment of debts.