Georgia

On the back of stronger trade demand and remittances, as well as a fiscal stimulus, the economy bounced back to solid growth in 2010, though inflation also accelerated, largely on global price pressures. The outlook is for measured growth with increased reliance on the private sector (including remittances from abroad) and for continued inflation pressures. Major risks relate to a weak recovery in foreign investment and other capital flows.

Economic performance

The economy recovered from the sharp contraction in the second half of 2008 and in 2009 to grow at 6.4% in 2010 (Figure 3.3.1). The broad-based recovery was underpinned by a marked pickup in export demand and robust remittances, strong government investment, and a rebound in credit to the private sector. A striking revival in gross fixed capital formation of 22.5%, after a 32.8% drop in 2009, was the main impetus.

On the production side, industry and services grew steadily at about the same pace. Industry advanced by 9.7%, led by high growth in manufacturing due to the rebound in export demand and to strengthening consumer demand. Services picked up by 7.1% on account of high growth in trade, transport, and tourism as Georgia's west coast tourist venues bounced back to a highly successful season. By contrast, agriculture contracted marginally. Once a strong exporter, it has become a low-profit sector as it cannot compete with grain and livestock imports.

Headline inflation accelerated from around mid-2010 to 13.7% by February 2011 (Figure 3.3.2). The uptick was largely attributable to food items (with a weight of 40.5% in the index), which rose by 28.4% owing to mounting global food prices. Price increases in other sectors were moderate, pointing to limited pressures from the demand side.

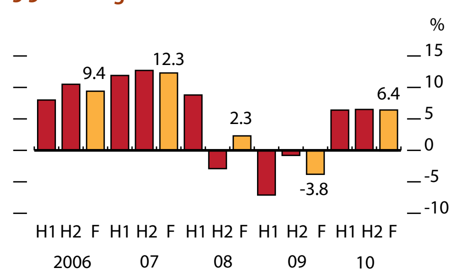
In light of the renewed inflation pressures and economic recovery, the National Bank of Georgia switched to monetary tightening in the second half of 2010, raising the policy rate in steps to 8% by February 2011. It also doubled the reserve requirements to 10% on lari-denominated deposits in April 2010 and on deposits in other currencies to 15% in February 2011.

Despite these policies, credit to the economy grew by 20.4% in 2010 owing to rising business and bank confidence. The M3 broad money aggregate rose by 34.8% as both local and foreign currency deposits climbed (Figure 3.3.3). Dollarization of deposits declined by 1.3 percentage points to 72.1%.

Interest rates on both deposits and lending decreased during 2010, by 150 and 300 basis points, respectively (Figure 3.3.4). As with the reduction in dollarization, the change appears due to a lower risk perception, as the high uncertainty associated with the global downturn fades.

This chapter was written by George Luarsabishvili of the Georgia Resident Mission, ADB, Tbilisi.

3.3.1 GDP growth

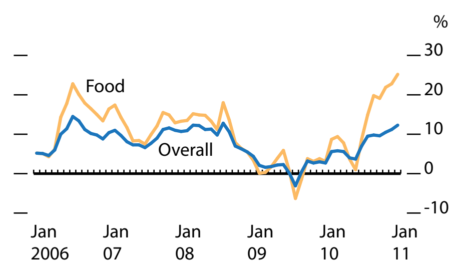


F = full year.

Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

Click here for figure data

3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

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The change in the monetary policy stance is expected to have a greater impact on the economy in 2011. The upward revision in the policy rate has narrowed its gap with deposit rates, making it less attractive to use the refinancing facility. Increases in reserve requirements have reduced excess bank reserves, as apparently reflected in slowing loan volumes in early 2011, to a level that will make monetary control more effective.

The main prudential ratio in the financial system is well above the minimum requirement: the average risk-weighted capital adequacy ratio was 17.4% at end-2010. Moreover, the ratio of nonperforming loans to total loans declined to 11.6% at year-end and banks made an aggregate profit (after 2009's loss).

Recovery in economic activity along with improved tax administration brought about a revival in tax receipts and general government income (excluding grants). Total revenue increased by 11.4% year on year. On the expenditure side, the government raised social spending and salaries, adjusting largely by containing other current expenditure items such as spending on goods and services for public administration. Capital spending and net lending rose somewhat more than planned in the original program. Still, the deficit narrowed to 6.5% of GDP in 2010 from 9.2% a year earlier (Figure 3.3.5).

Foreign financing was much higher than a year earlier and provided more than 80% of the deficit financing, although Treasury bills remained important.

External public and publicly guaranteed debt increased from 31.4% of GDP in 2009 to 37.4% in 2010. The debt repayment burden will become very heavy in 2013, when a large Eurobond issue matures and significant repayment obligations to the International Monetary Fund fall due. Rapid fiscal consolidation is essential in preparing to make these payments.

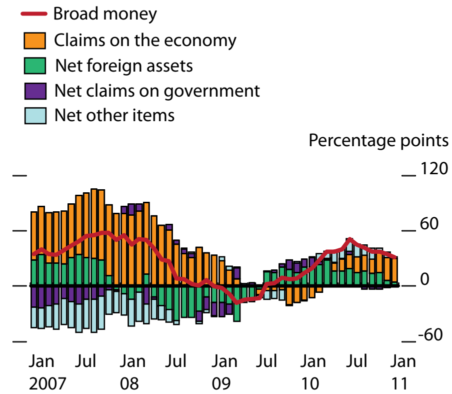
A recovery in global demand and higher prices of ferroalloys and nonferrous metals—the country's leading export commodities—helped to boost exports by 23.5%; imports grew by 15.8%. The trade deficit widened to $2.6 billion, though this was largely offset by stronger net remittances and services exports.

The current account deficit amounted to an estimated 11.4% of GDP in 2010, up from 11.2% in 2009 (Figure 3.3.6). Inflows of foreign direct investment (FDI), however, were disappointing. They had been expected to come back as the main source of growth, but missed the $600 million target.

The lari depreciated against the US dollar by about 5% in 2010. Weaker inflows in the first half of the year and banks' buildup of foreign exchange balances led to a larger depreciation in this period, but the currency subsequently strengthened (Figure 3.3.7) on improved earnings and capital inflows. Because of the steeper increase in domestic prices than in major trade partners, the real effective exchange rate appreciated by 2.8%.

Gross international reserves gained about $155 million, rising to $2.3 billion at end-2010, equivalent to about 4 months of 2011 estimated imports. Reserves were bolstered by drawing on funds from the International Monetary Fund made available under stand-by arrangements originally approved in 2008 and augmented in 2009 to a cumulative amount of about $1 billion.

3.3.3 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 17 March 2011).

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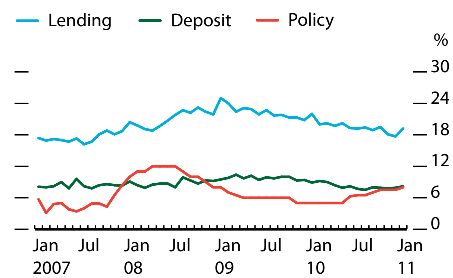
3.3.4 Interest rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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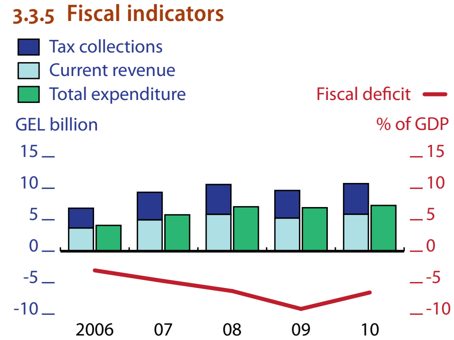
3.3.5 Fiscal indicators



Sources: International Monetary Fund. 2008. *Country Report* No. 08/328. October; 2009. *Country Report* No. 09/267. August; 2009. *Country Report* No. 09/331. December; 2011. *Country Report* No. 11/31. January. http://www.imf.org; Ministry of Finance of Georgia. http://www.mof.ge/en (accessed 17 March 2011).

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Economic prospects

Growth in 2011 will be measured because of the cyclical revival of 2010 and a phased withdrawal of fiscal stimulus in view of the need for consolidation. Hence more modest growth of 5.5% is projected. With greater reliance on the private sector as a driver, growth is forecast to be sustained at 5.0% in 2012.

Even though the growth of broad money is seen slowing to 20%–25% in 2011, the central bank's monetary program calls for a 15%–20% increase in credit to the private sector, which it perceives as appropriate for the growth target. The central bank is committed to a flexible exchange rate regime, and is moving to adopt inflation targeting.

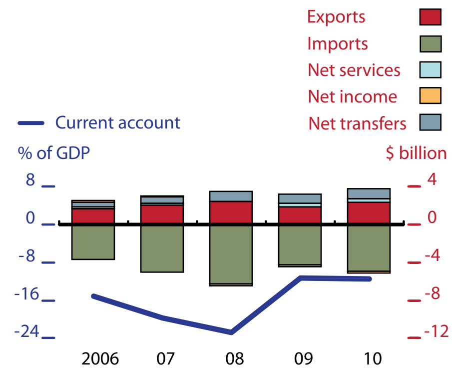
Inflation is expected to be high in 2011 at 9.5% given the ongoing surge in global food and oil prices. It should edge down in 2012 on the view that food price rises will be largely over and that oil and other import prices increase only moderately.

A new tax code that was passed in September 2010 (effective 1 January 2011) should boost government revenue. Its impact, along with the government's continued commitment to containing current spending, is seen narrowing the fiscal deficit to 4.0% of GDP in 2011 and to 3.4% in 2012. Special measures to protect low-income families from high inflation, such as electricity vouchers introduced in February 2011 and food vouchers the following month, will require cuts in budgeted expenditure to maintain the 2011 deficit target. Fiscal adjustment, unlike in 2010, will involve holding back capital spending.

The current account deficit is expected to widen slightly to 12.6% of GDP in 2011 as rising food and oil prices add to the import bill. A steady stream of remittances and services surpluses as well as growing export revenue from a sustained global recovery will help to rein in the deficit. It is projected to narrow to 11.4% of GDP in 2012, largely reflecting a further narrowing of the trade gap. External financing requirements of the current account deficit will increasingly rely on private inflows, such as FDI, as official development assistance slows.

External risks associated with this outlook include a setback in the global recovery, higher than expected global commodity prices, and weaker FDI inflows. On the domestic front, the most significant risk is slow fiscal consolidation.

3.3.6 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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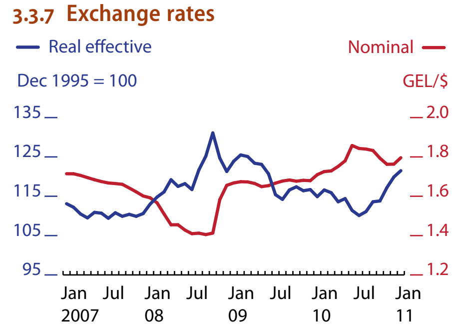
3.3.7 Exchange rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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Development challenges

A key challenge is to make growth sustainable over the medium term. The country therefore needs to diversify its production structure and exports from traditional products. The current limited physical, financial, and human capital are key bottlenecks.

Further efforts are needed to improve the fiscal deficit and to continue implementing reforms so as to prevent systemic risks from developing in the private sector.

3.3.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	5.0
Inflation	9.5	6.0
Current account balance (share of GDP)	-12.6	-11.4

Source: ADB estimates.