Georgia

The economy maintained robust growth in 2011, following its recovery in 2010 from the global recession, while annual inflation rose slightly. The current account deficit remained large, as nominal imports grew more than exports. In 2012 a weaker global environment will likely reduce growth by constraining exports, foreign direct investment, and remittances. A key policy challenge is to achieve more inclusive growth, particularly for rural areas.

Economic performance

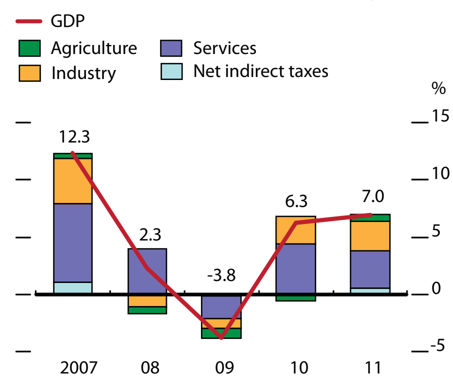
The economy continued to show robust growth, estimated by the government at 7.0% (Figure 3.3.1). Among the productive sectors, about half the growth came from services, which rose by 5.6% relative to the previous year, because of strong increases in the financial sector, tourism, and communications. Another two-fifths came from industry, which rose by 9.7% during 2011, as strong external demand and continued structural reforms boosted manufacturing, although mining declined due to reduced production of coal, lignite, and peat. The small balance came from agriculture, which, after 3 years of decline, rose by 5.5% during the year, reflecting higher crop production as a result of good weather and favorable prices.

On the demand side, private investment and private consumption are both estimated to have contributed to growth, with consumption benefiting from higher remittance inflows, aided by the Russian Federation's healthy economy. Government consumption and investment had little impact, as fiscal consolidation held back government spending, while net exports had a negative impact (real imports grew far more than real exports).

Although average inflation rose to 8.5% from 7.1% in 2010, the 12-month rate slowed to 2.0% in December, after peaking at 14.3% in May 2011 (Figure 3.3.2), as the moderation in prices of food (domestic and imported) and other imports during the second half of the year outweighed price hikes for transport and utilities stemming from price liberalization.

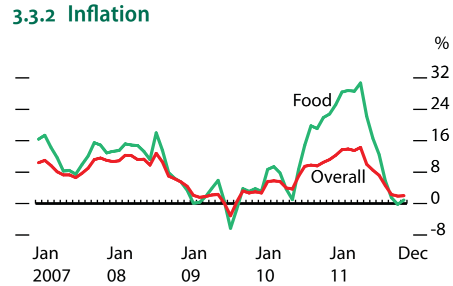
The fiscal deficit narrowed to 2.9% of GDP from 6.6% of GDP in 2010, consistent with the adjustment program supported by the International Monetary Fund. Tax revenue rose by 26.0%, reflecting a new tax code, enforcement of new revenue measures, and simplification of tax compliance and reporting requirements, all of which took effect at the start of the year. Relative to GDP, however, total revenue rose only slightly, to 28.4% from 28.3% in 2010, because of declines in grants and nontax revenue as a share of GDP.

3.3.1 Contributions to growth (supply)



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 20 March 2012).

3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 9 March 2012).

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

Spending growth was kept to 4.7%, reflecting compression in capital expenditure as well as tighter spending limits on public salaries and defense. Total expenditure fell to 31.3% of GDP from 34.9% in 2010.

Treasury securities, foreign financing, and privatization receipts all contributed to budget financing. Treasury securities—funding 28.4% of the budget deficit in 2011—have emerged in recent years as an important source of deficit coverage, and successful issues of treasury notes of up to 10 years' maturity have become an important step for developing the secondary market for tradable domestic debt. In addition, the successful issue of a second sovereign Eurobond (the first was in 2008) reduced the rollover risk from external liabilities falling due in 2012 and 2013. Total government debt was estimated at 36.8% of GDP at end-2011.

M3 broad money grew by 17.2% (Figure 3.3.3), reflecting a 19.5% rise in bank credit to the private sector. The central bank's switch to a more accommodative monetary policy in July lowered the policy rate in steps from 7.5% to 6.5% by January 2012, although heavy dollarization of the banking system limits monetary policy effectiveness. Interest rates declined on long-term loans, despite strong growth in lari-denominated loans and higher credit risk premiums, although the lending rate remained high at 19.2%. Deposit interest rates rose slightly to 9.4%, as banks moved to increase deposits by offering competitive interest rates (Figure 3.3.4).

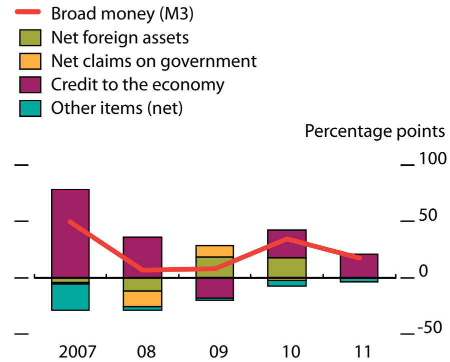
Banking stability improved, reflecting a near doubling of banks' returns on assets and on equity in light of wider profit margins and a continued high capital-adequacy ratio of about 17%. The ratio of nonperforming loans to total loans decreased to 8.6%, partly due to rising credit volumes.

The current account deficit worsened to an estimated 13.3% of GDP from 11.5% in 2010. The trade deficit widened by an estimated 25% to $3.6 billion (Figure 3.3.5). Exports shot up by 42.3%, reflecting rapid growth in vehicle reexports to Kazakhstan (in advance of higher customs duties, as Kazakhstan—a traditional major market—entered a customs union with Belarus and the Russian Federation in January 2012) and a near doubling of sales of nitric fertilizers due to heavier global demand associated with high food prices. Imports surged by 39.8% (from a larger base than exports), mainly reflecting increased imports of intermediate goods and petroleum products.

Strong remittances and continued surpluses in services—mainly from tourism (which rose by nearly 39% to $2.5 billion) and transport—offset some of the deterioration in the trade balance. A 21% rise in foreign direct investment (FDI) inflows to an estimated $981 million helped finance the larger current account deficit. Gross international reserves climbed by 23.5% to $2.8 billion, equivalent to around 4 months of imports. Total external debt, including private debt, fell to an estimated 57.5% of GDP at end-2011 from 61.6% the previous year.

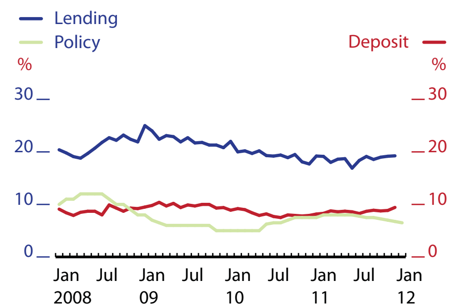
The flexible exchange rate regime continued to provide relative stability for the external sector. The lari appreciated by 12.2% in nominal effective terms and by 8.4% in real effective terms during 2011 (Figure 3.3.6).

3.3.3 Contributions to money supply (M3) growth



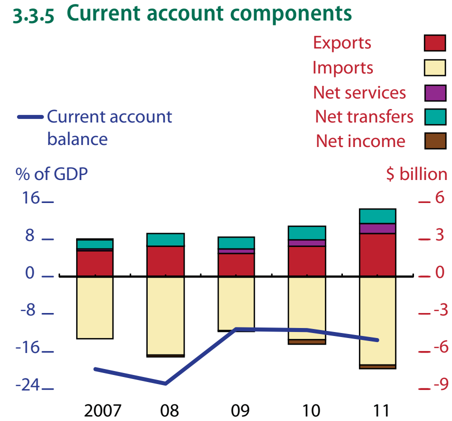
Source: International Monetary Fund. International Financial Statistics online database (accessed 15 March 2012).

3.3.4 Interest rates



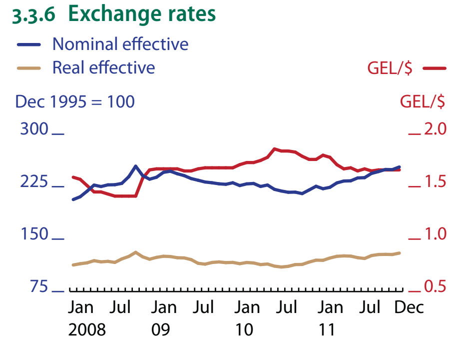
Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 9 March 2012).

3.3.5 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 9 March 2012).

3.3.6 Exchange rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 15 March 2012).

Economic prospects

For a small economy that relies heavily on trade and remittances, economic prospects will depend heavily on the external economic environment, in particular developments in the European Union (EU) and neighboring countries such as Azerbaijan, Kazakhstan, the Russian Federation, and Turkey. The expected slowdown in the eurozone and the Russian Federation will likely limit exports, FDI, and remittances, while continued fiscal restraint will curtail the government's ability to augment growth. Thus growth is projected to slow to 6.0% in 2012, recovering somewhat to 6.3% in 2013 with the assumed improvement in the world economy.

Year-average inflation is projected to slow to 4.8% in 2012, reflecting the expected moderation in global food prices. A return to modest increases in global commodity prices should cause only a slight rise in inflation to 6.2% in 2013, predicated on limited supply-side pressures and the absence of wage-price spirals.

The high level of dollarization will continue limiting the scope for monetary policy such that the authorities will need time to push through with their desired move to inflation targeting. Consistent with its adjustment program, the government aims to reduce the budget deficit further to 3.3% in 2012 and to 2.9% in 2013 (Figure 3.3.7). Fiscal consolidation will include both current and capital expenditure, with a careful review of subsidies. Total government debt is forecast to nudge up to 38.0% of GDP at end-2012 and to 38.2% the following year (Figure 3.3.8).

The current account deficit is projected to narrow to 12.5% of GDP in 2012, with slowing growth expected to reduce imports more than exports. Both sides of the trade account are, however, expected to rise in 2013 with a recovery in the world and domestic economies. As nominal GDP is forecast to grow more than the current account deficit, the current account deficit as a share of GDP will narrow further in 2013, to about 12.0%.

Negotiations for a long-awaited free trade agreement with the EU were launched in early 2012. An agreement would give Georgia extended access to the EU's single market, which should improve trade and investment.

While sound macro-prudential policies and fiscal restraint have reduced the chances of overheating and speculative bubbles, downside risks remain. These include a continuing large current account deficit; a limited export base with high import content and FDI focused more on the nontradable sector than on exports; heavy dependence on foreign aid and borrowing (despite high levels of official borrowing at concessional rates); and low private savings.

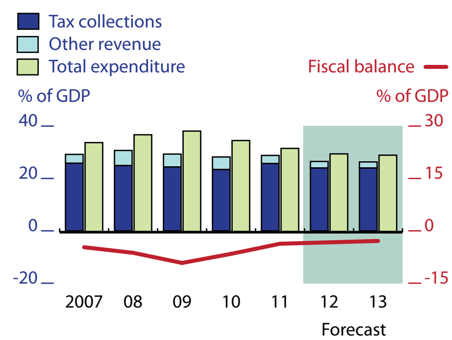
Policy therefore needs to promote capital inflows toward productive investment, particularly in the export sector. Similarly, the government needs to better leverage the country's investment resources and to maximize the efficiency and effectiveness of public spending. These measures are even more essential given current risks in the international financial markets, which may hinder availability of private investment and concessional financing from development partners.

3.3.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.0	6.3
Inflation	4.8	6.2
Current account balance (share of GDP)	-12.5	-12.0

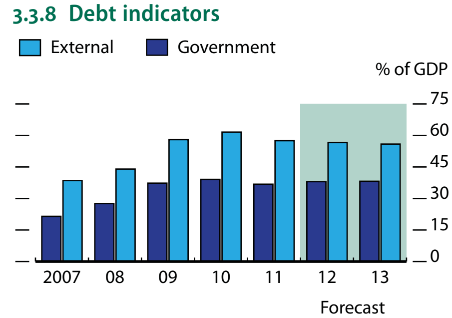
Source: ADB estimates.

3.3.7 Fiscal indicators



Sources: International Monetary Fund. 2010. *Country Report No. 10/219*. July; 2011. *Country Report No. 11/146*. June. www.imf.org; Ministry of Finance of Georgia, www.mof.ge (accessed 15 March 2012).

3.3.8 Debt indicators



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Asia Pacific*. October. http://www.imf.org; ADB estimates.

Policy challenge—securing inclusive growth

A major challenge over the medium to long run is to ensure economic growth that is more inclusive, with more equal access to economic opportunities and social welfare. One indication of income disparities is Georgia's relatively high Gini coefficient of 0.41, well above 0.31 for Armenia and 0.34 for Azerbaijan.

The government needs to step up its efforts to address structural unemployment, which stems from a mismatch between existing human capital and available jobs and which represents an important supply-side constraint. While skill inadequacies are an important part of the problem, so too is the limited range of well-paying jobs, in turn reflecting the small size of the tradable goods sector. Structural reforms to promote investment, particularly in export-oriented industries, could help create greater demand for employment while providing a way to reduce the chronic current account deficit in the medium term. At the same time, addressing high (35%) youth unemployment by improving skills through more vocational education, progress in secondary education, and on-the-job training (including the use of new technology) will help create a supply of employable workers to fill new jobs.

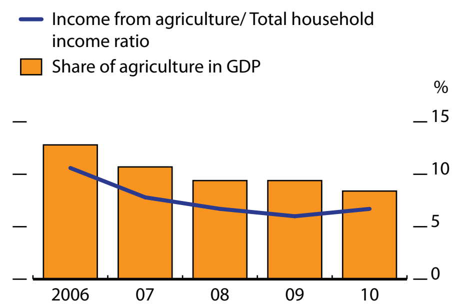
As job creation in the past was primarily skills-based and concentrated in finance and services, investing more in labor-intensive sectors such as industry and agriculture would enhance the inclusiveness of economic growth. About half the workforce is employed in agriculture, which contributes less than 10% of GDP (Figure 3.3.9). Surplus labor in urban areas, however, with low levels of labor absorption in agriculture, has made it extremely hard for the rural unemployed to move into other sectors.

The narrow base of the formal economy in rural areas, where self-employment is associated with subsistence income and low productivity in agriculture, contributes to rural poverty. Moreover, the prevalence of subsistence income limits the demand of the rural population for outputs from other sectors, constraining sectoral diversification of the economy and hindering development spillovers between agricultural and nonagricultural activity.

To help narrow differences between urban and rural development, the government has proposed a strategy to promote rural growth. This includes increasing investment in, among others, manufacturing, agriculture and renewable energy, in part through public–private partnerships. Well-designed public investment in infrastructure—whether in roads, power, water supply, or irrigation—would support private investment in agroprocessing and other industries, bolstering rural employment and reducing a persistent urban bias against agriculture. It would also promote the development of a more export-oriented agricultural sector, to draw on Georgia's favorable climate and natural resources.

Structural reforms, too, should focus on areas that could improve Georgia's attractiveness as a place to do business. Although the country has improved its standing in the 2012 Doing Business report from the World Bank—to 16 out of 183 countries (better than Malaysia, Thailand, Germany, and Japan)—it could still benefit by addressing issues in resolving insolvency, enforcing contracts, and trading across borders. In addition, improving governance and transparency in business would promote productivity and create greater job opportunities.

3.3.9 Agricultural indicators



Source: National Statistics Office of Georgia. http://www.geostat.ge