Georgia

Growth slowed to 6.1% from 7.2% in 2011, reflecting uncertainties in an election year that brought in a new government. Planned fiscal consolidation and continuing uncertainty in the political and investment climate are expected to limit growth to 5.5% in 2013, but growth should rise to 6.0% in 2014. The current account deficit is expected to narrow as fiscal consolidation reduces imports and as structural reforms gradually raise exports.

Economic developments

Another year of strong growth nevertheless saw the rate decrease to 6.1% from the 7.2% of 2011, reflecting uncertainties surrounding the October 2012 parliamentary elections and the subsequent transition to a new government administration. Unemployment remains very high, at 15.1% as of 2011, with two-thirds of the labor force engaged in low-productivity subsistence farming. Youth unemployment, at 35%, is particularly high.

Georgia experienced a peaceful political transition in 2012. The new government has committed to promoting more inclusive growth with additional support for agricultural, rural, and small town development and increased social spending. The government aims to improve trade ties with the Russian Federation. While differences remain, a resumption of these ties should increase Georgia’s exports in agriculture, light manufacturing, and services.

On the supply side, industry expanded by 9.9%, up from the 9.4% rise in 2011, led by construction and manufacturing (Figure 3.3.1). Agriculture contracted sharply in 2012, shrinking by 3.3% after the 8.0% growth in 2011 and reflecting smaller harvests of crops and livestock. Services grew by 5.8%, up from 5.7% in 2011, because of better performance in the financial sector, tourism, transport and communications, and wholesale and retail trade.

On the demand side, consumption expanded by 5.5%, less than half the 12.8% rise in 2011. Private consumption grew by 4.3%, versus 16.0% in 2011, possibly reflecting consumer uncertainty in the run-up to the October 2012 parliamentary elections. Public consumption rose by 10.8%, eight times the 1.4% rate in 2011. Spending on public salaries and social expenditure increased somewhat but still comprised only 42% of total outlays. Investment expanded by 28.8%, compared with 42.2% in 2011, driven by public spending on infrastructure in the run-up to the elections. Net exports declined by 22.0% from the 2011 figure.

Consumer prices fell by 0.9% in 2012, reversing the 8.5% rise in 2011 (Figure 3.3.2). Deflation reflected a 2.0% decline in prices for imported...
food and fuel and efforts to contain price increases for certain utilities, along with slower credit growth. Deflation was greatest for food and fuel but also affected other items such as clothing and footwear, furnishings, and recreational and cultural activities. Inflation during the 12 months ending in December was –1.4%, down from 2.0% in 2011.

Fiscal policy remained expansionary (Figure 3.3.3). The consolidated budget deficit narrowed to 3.0% of GDP from 3.6% in 2011. Revenues totaled 28.9% of GDP, slightly above the 28.2% of 2011, as larger nontax revenues supplemented higher receipts from value-added and corporate profits taxes. Total expenditure was 31.9% of GDP, up from 31.8% in 2011, despite higher public investment spending and continuing large outlays on untargeted subsidies, including the general food and energy voucher program initiated in 2011. Total government debt, mainly concessional external borrowing, declined marginally to 33.8% of GDP from 33.9% in 2011.

Monetary policy was relaxed, to combat deflation and support growth, as the authorities lowered the policy rate from 6.50% in January to 5.25% by the end of December and again in February 2013 to 4.75%, the lowest rate since 2008. However, the banking system remains highly dollarized, with foreign exchange deposits exceeding 60% of all deposits in 2012, so the decline in the policy rate had little impact on market rates. Average aggregate lending and deposit rates slipped only marginally, to 18.6% and 8.6%, respectively. The spread remained among the highest in the South Caucasus because of a shallow financial market, low saving, and lack of confidence in the domestic currency (Figure 3.3.4). Moreover, credit growth slowed from 20.5% in 2011 to 13.3% in 2012, reflecting a pre- and post-election slowdown in loan demand. The financial sector weakened, as bank profits fell by more than two-thirds, reflecting losses at several smaller, less-competitive banks. Nonperforming loans rose by about 1% to 9.3% at the end of 2012.

Given excess liquidity in banks, demand for refinancing loans fell in early 2012, weakening the interest rate transmission mechanism. Broad money growth slowed to 11.4% in 2012 from 14.5% in 2011, reflecting slow growth in domestic currency deposits that offset higher growth in foreign currency deposits (Figure 3.3.5). The exchange rate remained steady at about GEL1.7 = $1, but the real exchange rate saw the Georgian lari depreciate slightly because of deflation (Figure 3.3.6).

The current account deficit rose to 13.5% of GDP from 12.8% in 2011, reflecting a worsening trade deficit that was partly offset by a rise in net services (Figure 3.3.7). Exports grew by 8.1%, versus 32.2% in 2011, reflecting increases in vehicle re-exports, ferroalloys, minerals, and mineral fertilizers. Imports grew by 15.0%, versus 33.6% in 2011, fueled by heavy public spending on infrastructure and continued strong remittances. Services rose by 37.9%, following growth of 45.6% in 2011, as weaker performance in transportation, insurance, finance, and computer services offset strong gains in tourism. The deficit in the income account narrowed, reflecting lower interest payments and profit repatriation. Current transfers remained steady, with workers’ remittances rising by 8.8% to $0.6 billion. Transfers from the Russian Federation, comprising 58.1% of all transfers, increased by 14.3%.

Portfolio inflows rose nearly sixfold to $847 million due to Eurobond issues, which helped finance the current account deficit. Foreign direct
Investment amounted to an estimated $865.2 million, about 23% less than that in 2011, as inflows slowed, particularly in latter half of 2012, deterred by pre- and post-election uncertainties. Gross reserves rose to $2.9 billion.

**Economic prospects**

Growth is forecast to decelerate to 5.5% in 2013 and then increase to 6.0% in 2014, as planned fiscal consolidation and uncertainty in the political and investment climate slow domestic demand, despite anticipated growth in private consumption (Figure 3.3.8).

On the supply side, industry is forecast to expand, as structural reforms designed to achieve higher-quality public investment are expected over time to boost productivity, catalyzing growth in manufacturing and other tradable goods. Agriculture is expected to grow, reflecting improved expectations for key crops and livestock, assuming normal weather. Services are projected to expand, with strong growth in transport, communication, and financial intermediation. On the demand side, investment, net exports, and to a lesser extent consumption are all expected to expand in both years.

Inflation is projected to accelerate to 3.0% in 2013 and rise further to 4.0% in 2014, as higher social expenditure, including growth in pensions and teachers’ salaries, create demand-side inflationary pressures.

Over the next 2 years fiscal policy is expected to tighten. The consolidated budget deficit is projected to shrink to 2.8% of GDP in 2013 and 2.5% in 2014. This reflects further cuts in government expenditure alongside a shift in spending toward social programs. Revenues are forecast to decline slightly as a share of GDP to 26.6% in 2013 before rising again to 27.4% in 2014. Total expenditure is forecast at 29.4% of GDP in 2013 and 29.9% in 2014, as the government implements measures intended to improve the quality of fiscal spending. Total government debt is projected to decrease to 32.1% of GDP in 2013 and 32.0% in 2014 as external debt declines (Figure 3.3.9).

Over the next 2 years, monetary policy is expected to support growth while achieving the central bank’s medium-term inflation target. Broad money growth is projected to rise sharply, to 21.2% in 2013, and then fall again to 18.5% in 2014, reflecting higher growth in credit to the private sector. Exchange rate policy, while allowing some flexibility, is expected to focus on the stability of the national currency.

The current account deficit is forecast to narrow to 11.9% of GDP in 2013 and 10.7% in 2014, as slower growth resulting from fiscal consolidation and other factors reduce demand for imports, and exports rise as structural reforms in agriculture and other sectors begin to take hold. Exports are projected to grow by 11.5% in 2013 and 14.8% in 2014, while imports expand by 7.0% in 2013 and 7.5% in 2014. Services should be in surplus due to the continued strong performance of financial and computer services. The income account deficit is expected to narrow, reflecting a decline in profit transfers and higher portfolio investment income. Current transfers are forecast to increase to $1.3 billion in 2013 and $1.4 billion in 2014 on the back of higher worker remittances. Expected strong inflows of foreign direct investment, in excess of $1 billion each year, will help finance the current account deficit. Gross reserves are...
projected to decline slightly to $2.6 billion in 2013 before recovering to $2.7 billion in 2014 (Figure 3.3.10).

Risks to the projections include slackening activity in the Russian Federation and the euro area, and possible problems in managing quasi-sovereign funds outside the state budget. Moreover, the high current account deficit remains a source of vulnerability and a risk to growth, given large external financing needs in a sluggish global environment.

Policy challenge—inclusive growth

Georgia’s impressive growth has fallen short in achieving poverty alleviation, job creation, and balanced regional development. A key development challenge is to make growth more inclusive, which would generate productive employment opportunities of particular benefit to subsistence farmers and others in Georgia’s poorer rural regions. Inclusive growth could also ease the current account deficit if it boosted domestic savings and exports. Future policies should tackle Georgia’s infrastructure deficit, improve connectivity, make basic services more widely available and sustainable, and enhance the productivity and skills of labor.

Ultimately, raising domestic savings is essential to address external imbalances. Policies that reduce tensions between Georgia and the Russian Federation may boost investor confidence and respond to perceptions of country risk. Better protection of property rights through fair and impartial judicial processes is also essential, as are measures that discourage dollarization and reduce financial market risks. Despite Georgia’s overall progress in various business climate surveys, progress in sectoral reform has lagged. Agricultural policies can be improved to promote economies of scale, enhance productivity, and spur value-chain development. Policy reform in the power sector is essential to foster the sustainable exploitation of Georgia’s hydropower potential, enable efficient cross-border power trade, improve energy security, and generate sufficient government resources. Education policies should address pronounced skills gaps in key job-generating sectors.

The government aims to enhance development by instilling stronger planning and results orientation, including monitoring progress toward achieving targets. The government plans to increase investment in agriculture and industry, partly by establishing investment funds to attract private sector financing. Planned higher investment in social capital includes doubling the health-care budget, extending health insurance to uninsured citizens, and raising teachers’ salaries.