Georgia

A reduction in budget spending, and low private investment attributable to political uncertainty, slowed growth to an estimated 3.2% in 2013, while the current account deficit narrowed substantially to about 6% of GDP. Greater political stability, better trade links, reforms to boost competitiveness, and improved investor sentiment are expected to raise growth to 5.5% in 2014 and 6.0% in 2015, though the current account deficit will likely widen.

Economic developments

Growth slowed to an estimated 3.2% in 2013 from 6.2% in 2012. On the demand side, a 16.7% decline in public investment offset improvement in net foreign trade and services. Public investment declined because of audits of ongoing projects, while private investment fell because of political uncertainty. The drop in investment reduced construction by 10.6% (versus 13.6% growth in 2012), slowed manufacturing growth to 8.4% from 13.6% in 2012, and cut growth in industry overall to 1.9% from 9.5% (Figure 3.3.1). Partly offsetting these steep slowdowns were 9.8% growth in agriculture, reversing a 3.7% decline in 2012, and 3.1% growth in services, down from 6.2% in 2012, as domestic trade, financial intermediation, and tourism all expanded by less than in the previous year. Growth accelerated toward the end of 2013, reflecting greater political certainty and increased public investment.

Deflation persisted in 2013. Consumer prices fell by 0.5%, about half the 0.9% decline in 2012, reflecting both supply and demand factors (Figure 3.3.2). Lower international food and fuel prices, together with cuts in electric and gas utility charges, contributed to deflation from the supply side, while slower growth helped lower prices from the demand side. Inflation accelerated to 2.9% in January 2014 with higher food and utility prices.

The fiscal deficit narrowed slightly to 2.7% of GDP in 2013 from 2.8% in 2012 (Figure 3.3.3). With slower growth, revenues fell by 2.1% to the equivalent of 27.6% of GDP, from 28.9% in 2012. Tax revenues declined slightly (against a 4.3% projected increase), and nontax revenues fell by 13.3%. Total expenditure decreased by 3.1% to the equivalent of 30.3% of GDP from 31.7% in 2012. Increases of 23.5% in social spending and 16.0% in salaries were offset by two large declines: 20.8% in capital expenditure and 22.1% in spending on goods and services. At the end of 2013, total government debt rose to 32.9% of GDP from 32.3% a year earlier.

In response to the slowdown, the National Bank of Georgia, the central bank, progressively cut the policy rate from 5.25% to 3.75% during 2013 before restoring it to 4.00% in February 2014 (Figure 3.3.4).
Growth in broad money (M3) rose to 24.5% in 2013 from 11.4% in 2012. Bank credit to the economy grew by 18.7% during 2013 (compared with 20.6% in 2011 and 13.3% in 2012), reflecting revived economic activity, increasing demand for bank loans, and less risk aversion among banks (Figure 3.3.5).

The average lending rate dropped to 15.6% from 18.6% in 2012, and the average deposit rate to 6.2% from 8.5%, as constrained credit growth and excess liquidity persisted in the banking sector. Dollarization remained high, though the share of foreign exchange deposits in total deposits declined to 55.7% from 60.4% in 2012. Nonperforming loans eased to 7.5% of total loans at the end of 2013 from 9.3% a year earlier, as overdue loans and provisions for loan losses decreased.

The current account deficit nearly halved to 6.0% of GDP in 2013 from 11.4% in 2012 (Figure 3.3.6). The trade balance improved substantially with a strong, 27.6% recovery in exports and a 0.5% decrease in imports. Improved trade relations prompted a fourfold rise in exports to the Russian Federation. Exports to other markets in the Commonwealth of Independent States rose by 19.2%, and those to the European Union by 72.2%. The reduction in imports largely reflected the economic slowdown and lower imports of investment items.

Gains in tourism generated a surplus in the services account, as the number of tourists including those in transit rose by 21.1% in 2013 and earnings related to tourism increased by 6.0%. Total remittances rose by 7.8% to $1.3 billion (8.0% of GDP), including a 5.0% increase in remittances from the Russian Federation.

The current account deficit was largely financed by inflows of foreign direct investment, which slightly increased to $914 million from $912 million in 2012. The Georgian lari weakened by about 5% vis-à-vis the US dollar in 2013, reflecting rising imports and faster economic growth at year-end, along with market sentiment that the lari was overvalued. Over the year, it depreciated by 1.5% in real effective terms.

In response to outflows of short-term capital, the central bank sold $240 million in foreign exchange near the end of 2013 to stabilize the exchange rate, following purchases of $575 million during the first three quarters.Official reserves decreased by $50 million to $2.8 billion in 2013, equivalent to 4.4 months of merchandise imports. Gross external debt declined to 62.8% of GDP at the end of 2013 from 63.5% a year earlier, in part reflecting Georgia’s repayment of $377 million in loans from the International Monetary Fund.

**Economic prospects**

Growth is expected to accelerate to 5.5% in 2014 and 6.0% in 2015, reflecting higher public investment and improved investor sentiment (Figure 3.3.7). Anticipated improvement in the external environment, coupled with rising consumer confidence, should also support growth. Reduced political uncertainty will help revitalize the banking sector and credit activity, aiding growth.

Industry is projected to expand by 5.8% in 2014 and 6.5% in 2015, reflecting improved investor sentiment, while rising income is forecast to boost services by 5.1% in 2014 and 5.5% in 2015. Barring adverse
weather, agriculture is expected to expand further by at least 7.0% in 2014 and in 2015 as the government continues to promote higher productivity and technological advancement.

Inflation is projected to remain below the central bank’s 6.0% target but rise to 4.0% in 2014 and 5.0% in 2015, reflecting accommodative monetary policy, the pass-through effect of a weakening lari, and the diminishing impact of earlier utility price cuts. Demand-side inflationary pressures should intensify as economic activity picks up. However, delayed recovery in business activity and investment may keep inflation below current projections.

Higher expenditures are expected to widen the fiscal deficit to 3.6% of GDP in 2014, but increased revenues and a leveling off of spending should narrow it again to 3.0% in 2015. Revenues are expected to decrease to 27.2% of GDP in 2014 before rising to 27.5% in 2015. Expenditures are expected to reach 30.8% of GDP in 2014 and then decline to 30.5% in 2015. The ratio of government debt to GDP is forecast to rise to 33.6% of GDP in 2014 before declining to 33.0% in 2015, with the share of external debt expected to fall (Figure 3.3.8).

Monetary policy will pursue the twin objectives of low and stable inflation and higher employment as it remains accommodative to support growth. Broad money is projected to expand by 26% annually during 2014–2015 as credit growth accelerates, reflecting the central bank’s efforts to expand borrowers’ access to long-term loans in local currency.

Faster growth in consumption should, along with higher investment, boost imports and widen the current account deficit in 2014. The deficit is forecast to reach 8.0% of GDP in 2014, with exports projected to grow by 19.0% and imports by 21.5%. The deficit should narrow slightly in 2015 to 7.5%, as export growth accelerates to 22.0% and import growth eases to 17.4%. Exports will expand as additional productive public investment boosts output and productivity generally, while higher growth will further attract imports. The services balance should improve as service earnings expand with increased tourism. However, the income account deficit should widen, with higher profit transfers and lower portfolio investment income. Foreign direct investment is expected to remain strong at just under $1 billion in 2014 and 2015, as increased integration with the European market and improved infrastructure boost investor sentiment and project opportunities. Gross international reserves are forecast to dip to $2.7 billion in 2014 before increasing to $2.8 billion in 2015 (Figure 3.3.9). Total external debt is expected to decline to 60.4% of GDP in 2014 and further to 60.0% in 2015. In 2013, Georgia initialed an association agreement with the European Union that is expected to lead to a deep and comprehensive free trade agreement.

Downside risks to economic growth relate to fiscal and financial challenges and unexpectedly slow growth in major trading partners from such possible causes as regional tensions that diminish trade and investor confidence. Inflation could also be higher. A protracted recovery in the euro area and continued economic weakness in the Russian Federation may undermine growth prospects if exports, remittances, and capital inflows disappoint expectations.
Policy challenge—fiscal policy for inclusive growth

The government is pursuing fiscal policies that support inclusive growth while maintaining a sustainable fiscal position. Measures aim to improve the tax system, the business environment, and the quality and composition of public spending.

The tax environment is to be made more conducive for business through policy reform and better tax administration. Reform and easier tax compliance should encourage business activity, generating higher revenues that could fund additional benefits to the poor, particularly in health care, education, and social security. On the expenditure side, health care and social protection are rising priorities, reflecting a strong commitment to improving the health of the most vulnerable. Plans are under way to reshuffle spending to focus on the poor, expanding jobs to replace aid provision and offering reserve social assistance for the poorest groups, while cutting other expenditure to provide sufficient fiscal space to ensure sustainability.

To facilitate inclusion and social cohesion, the government has expanded social expenditure and upgraded the country’s social protection system with targeted social assistance and a basic pension. Spending on targeted social assistance has doubled, at a cost of 0.5% of GDP, while the basic pension was raised almost to the subsistence minimum, costing an additional 0.8% of GDP. Universal medical insurance, which extends coverage for basic care to every citizen, has also been introduced at a cost of about 1% of GDP, nearly doubling health care spending in 2013 to 2.7% of GDP. The new insurance system is expected to stay cost-effective and sustainable by using a common procurement mechanism for basic medical services. Further social reforms yet to be elaborated are expected to add about 1% of GDP annually to existing costs.

The government intends to index the basic pension to inflation, to protect the purchasing power of pension benefits and offer recipients an acceptable percentage of prior earnings. To lessen financial pressure arising from future pension increases for an aging population, the government is planning to supplement the current basic pension, funded solely from payroll taxes, with a private pension savings scheme under a defined contribution plan. This reform will support retirement needs while extending basic income security to those working outside the formal sector.

Better targeting of social benefits should promote social inclusion while making social spending more sustainable. Coverage of the poorest decile under the Targeted Social Assistance program is expected to increase to 60% by 2017 up from a baseline of 40% in 2013. At the same time, as the elderly use their pensions to supplement income for their extended families, higher pensions should benefit children living in such families and reduce the number of children living below the poverty line.