14. GEORGIA

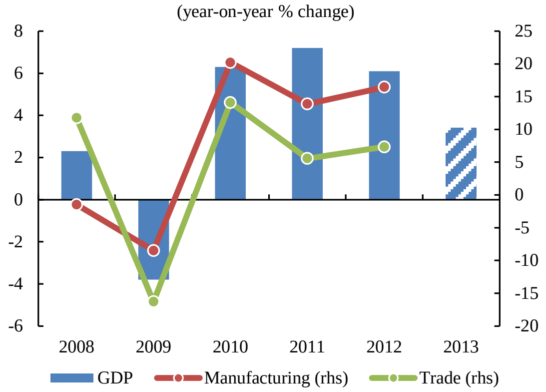
- ***Signs of economic weakening emerge as of end-2012 due to uncertainty associated with political transition and an unfavourable global environment.***

- ***New government maintains cautious fiscal stance, but some flexibility might be needed in view of weak economic performance in early 2013.***

- ***External position remains a major source of vulnerability due to a high current account deficit and declining FDI.***

Graph IV.14.1: **Georgia - GDP**

(year-on-year % change)



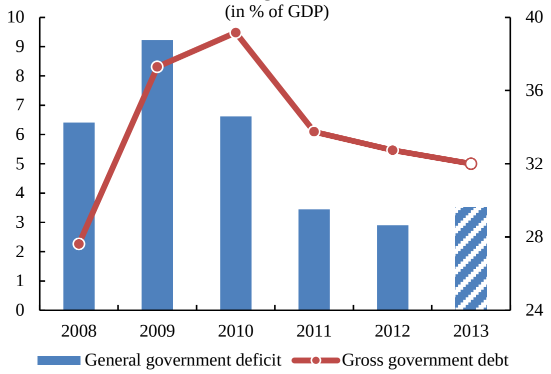
Sources: Geostat; Commission Staff forecast for 2013

Macroeconomic and financial developments

Georgia's economy demonstrated a remarkable recovery after the 2008-09 dual shock, ([94]) recording a 6.5% annual average growth in 2010-12. This was underpinned by sound macroeconomic policies and market-oriented reforms. Significant donor assistance pledged in the aftermath of the conflict with Russia was also instrumental to that end. However, economic activity moderated significantly in the final quarter of 2012, reflecting a worsening global environment, but also uncertainty arising from the unexpected change of power following the October parliamentary elections. The latter was accompanied by the 'wait-and-see' approach by both businesses and households. As a result, GDP growth slowed down to 6.1% in 2012 from 7.2% a year earlier.

Graph IV.14.2: **Georgia - General government balance and gross debt**

(in % of GDP)

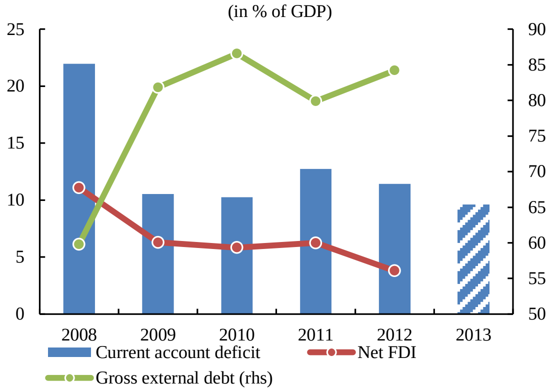


Source: Ministry of Finance; IMF; Commission Staff forecast for 2013

The main growth driver in 2012 remained buoyant investment activity driven by large-scale infrastructure projects financed by the state and through borrowings from IFIs. Household demand also had a positive contribution, reflecting growth in real incomes (a combination of further wage increases and a steep inflation slowdown), rising remittances, robust lending activity as well as high consumer confidence for most of the year. The booming tourist sector was also supportive of the good economic performance in 2012. On the other hand, net merchandise trade had a negative impact on GDP dynamics as imports rose at a high pace to

Graph IV.14.3: **Georgia - Current account and debt**

(in % of GDP)



Sources: National Bank of Georgia; Commission Staff forecast for 2013

([94]) The shocks from the August 2008 military conflict with Russia and the 2009 global recession.

finance robust investment demand. On the supply side, manufacturing, construction and financial intermediation recorded a rapid expansion. At the same time, agriculture witnessed a slight contraction following the bumper harvest in 2011.

The economic weakening, which started with the elections, continued in early 2013, with GDP growth moderating to only 2.3% in the first five months of the year. The reasons include elevated political tensions (highlighted by the incessant verbal attacks between the President and the Prime Minister), which hinder investment activity, but also delay with the implementation, and poor communication, of some of the economic measures announced by the new government ([95]). Furthermore, the authorities put a brake on capital expenditures, which led to a sharp contraction in construction activity in early 2013. Investment spending is expected to gradually pick up speed throughout the year but to be overall downscaled from the previous very high levels in line with the welcome policy shift by the new government towards social policy. Political tensions are expected to gradually subside, contributing to a rebound in economic activity in 2014.

Strong economic growth in 2011-12 has positively affected labour market developments. The jobless rate fell by 1.3 percentage points to 15%, but more importantly, employment growth reached 6% in these two years. These developments came in contrast with the pre-2008 period, when very high growth rates were entirely due to productivity gains. Despite the recent positive dynamics, it should be noted that the labour market still manifests significant weaknesses, as indicated by the dominance of self-employed (more than 60%) and the very high unemployment rates in urban areas (26%). Furthermore, poverty rates remain high, in particular in the rural areas where people are predominantly occupied with subsistence farming. In this respect, the policy change by the new administration in favour of r a more inclusive growth model and higher social protection of the most vulnerable is welcome. However, these objectives should not compromise with the goal for continued fiscal consolidation.

In marked contrast with the high inflationary environment in the previous two years, there was an impressive disinflationary trend in 2012 that was mainly due to lower food prices worldwide. Demand-side pressures remained subdued as economic growth was largely driven by investment activity. The CPI was in the deflationary area for most of the year, with the average price decline reaching 0.9% in 2012. Inflation is expected to rebound in 2013 on growing food prices. However, the economic slowdown and a price cut of utility tariffs negotiated by the new cabinet will likely keep inflation well below the 6% target of the central bank. In the absence of any inflationary pressures in 2012, the Bank continued its easing cycle and reduced the key policy rate by cumulative 150 basis points to 5.25% at the end of the year. More cuts, to a record-low 4%, followed in the first half of 2013 as the central bank attempted to boost economic activity. However, the monetary policy transmission mechanism remains constrained by the high dollarization ratio.

On the fiscal front, the new cabinet put on a freeze capital spending after coming in power. This brought the general government deficit to only 2.9% of GDP in 2012, well below the 3.5% initial target. The 2013 budget envisages a further reduction of the deficit to 2.8% of GDP based on a streamlining of administrative costs and infrastructure spending. At the same time, social expenditures (for pension increases and universal health coverage ([96])) will be on the rise, which will limit room for a counter-cyclical fiscal policy in case of downside risks. In view of the weak economic activity in early 2013, and the plans of the cabinet to adhere to its expenditure-side commitments, there is a high probability that the 2.8% of GDP deficit target will be exceeded. Still, in the medium term prudent fiscal policies would be underpinned by the entry into force of the Economic Liberty Act in 2014. This law will introduce a set of fiscal thresholds, including a fiscal deficit ceiling of 3% of GDP, a public debt

([95]) Debates on the approval of a new Labour Code, which strengthens employees' rights, lasted nearly seven months and contributed to the uncertainty over the direction of economic policy. The ambiguity about the establishment of various funds to co-finance foreign and domestic investment projects acted in a similar way.

([96]) The basic pension for people aged up to 67 was raised in February 2013. There will also be a 20% across-the-board increase in September. In February, the cabinet started providing health insurance to the entire population. It widened the coverage of the insurance package in July.

cap of 60% and a government spending cap of 30% of GDP. The fiscal consolidation efforts in the last few years have allowed a reduction in the public debt ratio to approximately 34% of GDP at the end of 2012 from 40% of GDP two years earlier.

Turning to the external sector, the sizeable current account deficit remains a major source of vulnerability for the country. The gap amounted to 11.4% of GDP in 2012, fuelled by a widening merchandise trade deficit (at 26% of GDP) on the back of growing imports of investment goods. This was mitigated by further growth in proceeds from trade in services due to the booming tourist industry as well as a significant decline of the net income outflow (most likely the result of lower profitability by foreign companies operating in the country). Furthermore, workers' remittances continued growing, although at a weaker pace. The financing of the current account gap was ensured at the expense of rising debt capital inflows. ([97]) At the same time, net FDI fell by a third in 2012 and remains well below the levels before the conflict with Russia. As a result, the current account coverage by net FDI dropped to only 33% from about 100% in 2007. Growing reliance on debt financing also led to increase of the already high gross external debt of the country, which reached 85% of GDP at the end of 2012.

These external vulnerabilities are to some extent alleviated by recourse to considerable donor financing, a relatively favourable debt maturity structure as well as a two-year precautionary programme approved by the IMF in April 2012 (see Annex 1 in Part II). Also, the EU adopted in July 2013 a decision providing MFA to Georgia in the amount of up to EUR 46 million. Moreover, it should be noted that a considerable part of the external debt reflects intercompany financing, which is likely to be easily rolled over. The on-going increase of international reserves, which are close to four months of next year's imports, should also act as a cushion. However, in the future the authorities should seek a long-term solution to the high external imbalances, by allowing a greater flexibility of the local currency, encouraging export-oriented sectors and better utilising the comparative advantages the country could have in areas like agriculture, tourism and hydropower production.

Structural reform challenges

Georgia is among the leading reformers in the economic field worldwide, which has contributed to the growing investor appeal of the country. This is also recognized by the World Bank, which estimated the country was a frontrunner in terms of improving its business environment since 2005 (see Box II.2.1 in Part II). The Bank ranks Georgia 9th among 185 economies in its 'Doing Business 2013' report. The country scores among the top ten in areas such as registering a property, launching a business, dealing with construction permits and getting credit. Reforms were also successful in the areas of taxation and public finance management. Significant progress was achieved in trade deepening, as Georgia is advancing at a fast pace with negotiations on the establishment of a DCFTA with the EU. The new government plans to fight oligopolistic structures and to encourage competition. It also intends to set up various investment funds (including in the agriculture sector) in order to boost investment activity although, as noted, there is still insufficient information about these funds.

Future policies should focus on stimulating export industries and promoting job creation, including through supporting the SMEs. Despite strong growth for most of the last decade, unemployment and poverty remain at high levels. It should be also noted that the real picture of the labour market is disguised by high employment in agriculture (about half of the total), which reflects mainly subsistence farming. Further fiscal consolidation and reforms to strengthen the efficiency and credibility of the central bank's policies are required in view of the significant external imbalances and the unsettled global environment.

Risks and outlook

The main short-term risks for the Georgia's economy stem from high political tensions and possible instability due to the difficult co-habitation between the President and the new government, but also to policy uncertainty and an inconsistent implementation of reform measures.

([97]) This reflects mainly USD 750 million (or 4.7% of GDP) Eurobond placements by the state railway company and the state oil and gas corporation. Another factor was a steep rise in non-resident deposits due to high interest rates on savings

Table IV.14.1: **Georgia - Main economic indicators**	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	-3.8	6.3	7.2	6.1	3.4
GDP nominal (USD, billion)	10.8	11.6	14.4	15.9	16.6
GDP per capita (USD)	2,455	2,623	3,231	3,520	3,689
Inflation (%, period average)	1.7	7.1	8.5	-0.9	-0.6
Inflation (%, end-year)	3.0	11.2	2.0	-1.4	1.8
Social indicators					
Population (million)	4.4	4.4	4.5	4.5	4.5
Unemployment rate (%, ILO definition)	16.9	16.3	15.1	15.0	14.8
Poverty ratio, %*	21.0	22.7	23.0	22.4	22.0
Fiscal sector					
Total revenue (% GDP)	29.3	28.3	28.2	28.8	28.2
Total expenditure (% GDP)	38.5	34.9	31.8	31.8	31.7
General government balance (% GDP)	-9.2	-6.6	-3.6	-3.0	-3.5
Gross government debt (% GDP)	37.3	39.2	33.8	32.3	32.1
Monetary and financial sectors					
Key policy rate, end-year	5.0	7.5	6.8	5.3	3.5
Domestic credit to private sector (% change, end-period)	-13.4	20.8	23.9	12.4	13.5
Broad money (M3, % change)	7.7	30.1	14.5	11.4	13.0
Non-bank deposit dollarisation, end-year	68.5	68.0	59.0	64.1	61.0
External sector					
Current account balance (% GDP)	-10.5	-10.2	-12.7	-11.4	-9.6
Trade balance (% GDP)	-19.1	-17.8	-19.0	-19.6	18.5
Net remittamces (% GDP)	6.6	6.9	7.8	8.6	8.6
Net FDI (% GDP)	6.3	5.8	6.2	3.8	n.a.
Gross external debt (% GDP)	81.8	86.6	79.9	84.2	86.0
Gross reserves (USD billion)	2.1	2.3	2.8	2.9	3.2
Import cover of reserves (months)	4.1	3.4	3.8	3.8	3.9
Exchange rates					
Exchange rate (lari per EUR, average)	2.3	2.4	2.3	2.1	2.2
Exchange rate (lari per USD, average)	1.7	1.8	1.7	1.7	1.7
Real effective exchange rate (% change, + is appreciation)	0.0	-4.6	9.8	1.9	n.a.

* - share of population under 60% of median consumption

Sources: National authorities; IMF, Commission staff estimates for 2013

In fact, these risks seem to have been already materialising in the weakening investment and credit activity at the end of 2012 and in early 2013. Another risk comes from the weak global environment that could affect the economy through various channels such as trade and capital flows, remittances and tourism. At the same time, signals for improved cooperation with Russia, while retaining the path for further strong integration with the EU, reduce geopolitical risks and open opportunities for new export destinations.

The IMF agreement should serve as a buffer that could absorb a potential negative shock for the country, while contributing to ensure that the economic policy strategy remains prudent. Macroeconomic risks stem, as noted, from the high external vulnerabilities manifested by the double-digit current account deficit and very high, and growing, external debt. Efforts should be focused to address these weaknesses through continuation of the sound macroeconomic policy mix, but also reforms that will support the development of the export base. Diversifying exports, while strengthening competitiveness in areas where Georgia has competitive advantage, should enable the country to benefit from its policy course for deepening trade integration, including through the establishment of a DCFTA with the EU. This could also lead to more inclusive growth, which is needed to address the country's relatively high level of economic inequality.