Georgia:
Winds of Optimism

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Georgia: Winds of Optimism

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Currency Unit = Georgia Lari (GEL)
US$1.00 = GEL 1.7560
Weights and Measures: Metric System

Abbreviations and Acronyms

AA Association Agreement
BDD Basic Data and Directions
CIS Commonwealth of Independent States
DCFTA Deep and Comprehensive Free Trade Area
DSA Debt Sustainability Analysis
EBRD European Bank of Reconstruction and Development
eHRMS Electronic Human Resource Management System
EU European Union
FDI Foreign Direct Investment
GD Georgian Dream party
GDP Gross Domestic Product
GEL Georgian Lari
IDP Internally Displaced Person
IMF International Monetary Fund
MOF Ministry of Finance
NBG National Bank of Georgia
NPL Non-Performing Loans
PPP Public Private Partnership
REER Real Effective Exchange Rate
SME Small and Medium-size Enterprises
STA Single Treasury Account
TSA Targeted Social Assistance
UHC Universal Health Care
VAT Value Added Tax
WTO World Trade Organization
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Overview

The signing of the Association Agreement with the European Union in June 2014 and the coming into effect of the Deep and Comprehensive Free Trade Area in September are landmark achievements for Georgia. The Association Agreement (AA) is focused on improvements in the areas of democracy and the rule of law, human rights, good governance, and economic development. The Deep and Comprehensive Free Trade Area (DCFTA) is likely to enhance Georgia's trade prospects and boost economic growth by enhancing the country's export potential, especially to developed markets. This will be facilitated through improvements in quality standards and by bringing Georgia's legislation closer to that of the European Union (EU). The DCFTA will also remove the existing barriers on the trade of goods and services with the EU. While Georgia can now export duty-free to the EU, Georgian products will have to meet certain EU requirements not only when exported but also when being consumed within the country. This marks the beginning of a long process to improve sanitary and phyto-sanitary standards, intellectual property rights protection, competition, technical regulations on industrial products, and customs and trade facilitation and this process will involve short- to medium-term costs.

With greater policy certainty, there was an uptick in business and consumer confidence leading to an output expansion of 6.0 percent year-on-year in the first half of 2014, up from 3.2 percent in 2013 as a whole. The position of the ruling Georgia Dream party was further strengthened by the absolute majority the party won in the local elections in July 2014. Favorable domestic conditions and strong external demand supported economic growth in the first half of this year, demonstrating that regional economic tensions have not yet adversely affected Georgia. The large Russian market which opened up for Georgian products in July 2013 helped increase exports, particularly of wine. Greater consumer and business confidence gave a boost to manufacturing and trade. In addition, the construction sector benefited from renewed public infrastructure projects and resumption in business related investments. The agricultural sector grew at a relatively modest pace compared with industry and services. While growth was generally buoyant in the first half of the year, Georgia continues to face downside risks from an escalation of regional tensions and a slowdown in the EU. There is also a possibility of counter actions by Russia to limit trade with Georgia in light of the signing of the AA.

Buoyant revenue performance limited the fiscal deficit to 1.4 percent of GDP during the first 6 months of the year. Both current and capital spending picked up during January-June 2014 compared with the previous year. The prioritization of expenditures in the areas of pensions, healthcare and targeted social programs along with an increase in the wage bill raised current expenditures by 20 percent in the first half of 2014, year-on-year. Public investment also picked up, although, only in the second quarter of 2014. Despite the increase in expenditures, the fiscal deficit was contained because of a strong revenue performance. Government revenues in the first half of 2014 exceeded last year’s collections by 7.9 percent, year-on-year, driven by VAT and excise duty which increased by 30 percent and 15 percent, respectively.

The unemployment rate improved marginally in 2013 to 14.6 percent as a result of declining labor force participation. The overall labor force participation rate stood at 66.2 percent in 2013 and nearly 17,000 people in the working age population decided to opt out of the labor force during the year. Both urban and rural unemployment declined, albeit, slightly. Youth unemployment, however, increased to 29 percent in 2013, up by 1 percentage point from last year.
A. **Political Developments**

Following a landslide victory in the presidential elections of October 2013, the Georgia Dream Party also won a majority in the local elections in July 2014. After the presidential elections, Irakli Gharibashvili was appointed the new Prime Minister, and under the new constitution that shifted power from the Presidency, he has full executive authority over domestic and foreign policy. The Georgia Dream Party further consolidated its position after it won convincing victories in the July 12 run-off elections in 8 cities and 12 provincial municipalities, gaining control over all the executive branches of local self-governing bodies across the country. Despite these wins, a recent public opinion survey conducted by the National Democratic Institute shows that the government no longer enjoys the overwhelming support it had compared to previous polls. Jobs, poverty and territorial integrity remain the most important public issues and the new government’s policies have not made a particular dent in any of these areas.

In June 2014, Georgia signed the **Association Agreement with the European Union, reaching an important milestone under the EU Eastern Partnership Program**. The Agreement, which includes a Deep and Comprehensive Free Trade Area (DCFTA), marks years of cooperation between Tbilisi and Brussels under the Eastern Partnership program. It envisages the gradual improvements needed in areas such as trade, environment, agriculture, tourism, energy, transport, and education to bring Georgia in line with EU standards. Overall, the process is focused on democracy and the rule of law, human rights, good governance, and economic development. The DCFTA is likely to enhance Georgia’s trade prospects and boost economic growth by bringing its legislation closer to that of the EU. It will also remove the existing barriers on the trade of goods and services with the EU.

The Georgia-EU Association Agreement came into force on September 1, 2014, enabling Georgia to export duty-free to the EU. However, certain regulations on Georgian products will remain. Certain agricultural and industrial products will be duty free but subject to quotas. Moreover, Georgian products will have to meet certain EU requirements not only for export, but also when consumed within the country. This marks the beginning of a long process to improve sanitary and phyto-sanitary standards, intellectual property rights protection, competition, technical regulations on industrial products, and customs and trade facilitation and this process will involve short- to medium-term costs.

Despite improvements in the political relations between Georgia and Russia, economic ties between the two countries remain fragile. Following the signature of the AA, Russia threatened to suspend the free trade agreement with Georgia (in place since February 1994) because Georgia is neither a member of the Eurasian Customs Union, nor a part of the Commonwealth of Independent States (CIS). This could adversely impact Georgia’s wine exports since Russia is the largest market for Georgian wine. While there was no impact of the Russia-Ukraine crisis on Georgia in the first half of 2014, the country could face headwinds from a further escalation of tensions in the region.

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1 Under the Generalized System of Preferences (GSP+), Georgia already enjoys low or zero tariffs for two-thirds of its exports to the EU.
B. Recent Economic Developments

Demand and Output

With greater policy certainty and signing of the Association Agreement, there was an uptick in business and consumer confidence leading to an output expansion of 6.0 percent year-on-year in the first half of 2014. The position of the ruling Georgia Dream party was further strengthened as they won a majority in the local elections in July 2014. Favorable domestic conditions and strong external demand, especially from Russia, supported economic growth in the first half of this year, demonstrating that regional economic tensions did not adversely affect Georgia.

The sectoral decomposition of growth reveals that the expansion was primarily driven by manufacturing and construction. These sectors grew by 16.5 percent, 11.1 percent from a year earlier. While greater consumer and business confidence gave a boost to manufacturing and trade, the construction sector benefited more from renewed public infrastructure projects. Industry grew by 9 percent while the services sector, in general, showed robust growth and expanded by 6 percent, year-on-year. The agricultural sector grew at a relatively modest pace of 1.8 percent after expanding by almost 9.7 percent in 2013. Agriculture received a major boost last year from the Agriculture Development Fund, which provided farmers with vouchers for buying material and equipment and subsidized credit. While these incentives continue, the main impact was felt in 2013 and this year’s agricultural growth is likely to be comparatively modest. The only sector to clock a decline was mining and quarrying which contracted by 10.6 percent because of declining production in the mines since 2013 (Figure 1). A part of the output increase is, however, also attributable to the base effect – economic growth had moderated to 3.2 percent in 2013.

The relative contribution of the various sectors to GDP in H1 2014 did not show a marked change from 2013. Agriculture lost 0.5 percentage point of its share in total GDP since H1 2014,
the largest change over the last year. On the other hand, construction and financial intermediation gained 0.5 and 0.4 percentage points respectively. Growth rate variations in other sectors have not markedly changed the overall composition of GDP (Figure 2).

**The growth in aggregate demand – available only for the first quarter – was led by investments, particularly, capital expenditure undertaken by the government.** Gross fixed capital formation increased by 30.8 percent in Q1 2014 (year-on-year) and was led by public investments. Greater policy certainty and the low base of 2013 resulted in the significant rise in investments. Businesses which had adopted a wait-and-watch approach during 2013 due to political uncertainty were reassured with the new government in place and also increased their investments. This resulted in a significant rise in the import of capital goods which were mostly financed through foreign direct investments and external borrowings. The renewed focus on inventory build-up also contributed to GDP growth.

**Exports, primarily to Russia, and public consumption also boosted aggregate demand.** The export of goods and services expanded by 18.2 percent in Q1 2014 compared with the first quarter of 2013. The large Russian market was reopened for Georgian exports after Russia lifted its trade embargo in mid-2013. This resulted in a significant increase in exports to Russia, mainly of wine and mineral water, which continued in the first quarter of this year. The improved political environment also boosted private and public consumption which increased by 5.5 percent and 10.8 percent, respectively, in Q1 2014 (year-on-year). In comparison, government consumption had dropped by 10 percent in Q1 2013, year-on-year.

**Poverty and Unemployment**

**A micro-decomposition of poverty change using sources of household income confirms the importance of social transfers for poverty reduction.** Poverty declined to 14.8 percent in 2012 from 17.7 percent in 2011 while extreme poverty fell from 5.5 percent to 3.7 percent over the same period (Figure 3). Universal, non-contributory old age pensions are the largest social assistance program covering more than 50 percent of the population. As these pensions are not poverty targeted and non-contributory, they do not alter the distribution of consumption as much as they help to bring down poverty. The government’s well-targeted TSA program has also helped the poor. In addition, consumption growth among the bottom 40 percent of the population, the World Bank’s indicator of shared prosperity, was 5.4 percent during 2010-12, higher than the 3.6 percent growth for the population as a whole. Inequality in Georgia is high compared to other countries in the region. However, since 2010, there has been a steady, albeit marginal, reduction in the Gini coefficient indicating that the poor benefited more from growth in recent years. Inequality stood at 38.8 percent in 2012 (Figure 4).

**Poverty is concentrated in rural areas.** In 2012, nearly 66 percent of all poor lived in rural areas. In addition, about 18.8 percent of rural residents and 10.5 percent of urban residents were poor with 5.34 percent of rural residents facing extreme poverty as compared to 1.96 percent of urban residents. These patterns represent a notable decline in urban poverty which was as high as 16.6 percent in 2006. Rural poverty is deeper and more severe than urban poverty.

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2 The population is split evenly across rural and urban areas.
Nearly all regions in the country registered a decline in poverty levels between 2010 and 2012 with the exception of Kvemo Kartli. Kakheti stands out as the best performing region with poverty falling from 32 percent in 2010 to 20 percent in 2012, such that it is no longer the poorest region in the country. In 2012, the regions with highest poverty incidence are Kvemo Kartli and the northern mountain arc (Shida Kartli, Mtsheka-Mtianeti, Kakheti). The harsh terrain and physical isolation in the northern mountain arc make living conditions extremely difficult in this region (2009 Poverty Assessment). The regions with the lowest poverty incidence are Tbilisi and Samtskhe-Javakheti.

While internationally comparable poverty indicators for 2013 are yet to be released, the national measure indicates a continuation in the trend of falling poverty. The national poverty level, measured as the percentage of the population living on an amount that is less than 60 percent of median consumption, declined further in 2013.

The unemployment rate improved marginally in 2013 to 14.6 percent as a result of declining labor force participation. The overall labor force participation rate stood at 66.2 percent in 2013. Nearly 17,048 people in the working age population decided to opt out of the labor force during the year. As a result, the rate of unemployment improved by 0.4 percentage point to 14.6 percent.

Both urban and rural unemployment declined in 2013, albeit, slightly. Rural unemployment in Georgia has traditionally been low because of self-employment in agriculture which is characterized by family-based subsistence farming. In 2013, rural unemployment fell to 6.5 percent from 7 percent a year back. A part of this decline in unemployment can be explained by migration to urban areas–there was a decline in the rural population by about 40,000 and an increase in urban population by about 31,000 dwellers. Urban unemployment is more than four-times rural unemployment, primarily because of limited job opportunities in the cities. Urban unemployment reduced from 26.2 percent in 2012 to 25.6 percent in 2013, primarily because of a decline in the labor force participation rate (Figure 5).
Youth unemployment increased to 29 percent in 2013, up by 1 percentage point from last year. The economic moderation of 2013 appears to have taken a bigger toll on the nation’s youth (age 20-29). This cohort is possibly concentrated in the urban areas where unemployment levels are high and net job creation is low. The population above the age of 40, on the other hand, saw high labor force participation rates and low unemployment—pointing to the possibility that they are clustered in the rural areas (Figure 6).

Figure 5. Number of employed and unemployment

(Thousand persons, Percent)

Source: Geostat.

Figure 6. Unemployment and participation rates by age groups, 2013

(Percent)

Source: Geostat.

Foreign Trade, Balance of Payments and External Debt

The regional economic tensions had a limited impact on Georgia’s export of goods but downside risks remain. With the opening up of the large Russian market in mid-2013, exports to Russia continued to grow and increased three-fold in H1 2014 (year-on-year). Goods exports reached US$5.4 billion during the first 6 months of 2014 (15.5 percent more than the previous year). However, weak growth prospects in Russia will impact Georgian exports over time. Simultaneously, the uptick in economic activity increased imports by nearly 16 percent during January-June 2014, year-on-year.

The growth in export of goods was driven by black metals, wine and mineral water, and manganese ore which rose by 20 percent, 67 percent, and 173 percent, respectively, in H1 2014, year-on-year. The re-export of used cars, however, fell because of the trade restrictions imposed by Armenia and the more stringent requirements on used cars introduced by Azerbaijan (Figure 7).

The group of CIS countries continued to be Georgia’s largest trading partner in the first half of 2014. However, Georgia’s exports to the EU countries expanded as well, particularly to Bulgaria (Figure 8). Like before, Georgia’s main export destinations continued to be Azerbaijan (accounting for 20.4 percent of Georgian exports), Armenia (11.0 percent), Russia (9.4 percent), and Turkey (7.9 percent).
Import growth, at 16 percent in H1 2014, was spurred by a stronger demand for intermediate goods in manufacturing and an increase in investments. The strong performance in the manufacturing sector raised the demand for intermediate goods, while the significant increase in gross capital formation increased investment related imports. There was, however, no change in the composition of imports. The most important commodity groups in Georgia’s imports included crude oil and oil products (16.3 percent of total imports), motorcars (10.5 percent), mechanical appliances (10.4 percent), electrical equipment (7.6 percent), and pharmaceuticals (4.3 percent). Majority of the imports were sourced from Turkey (20.5 percent of total imports), China (8.7 percent), Azerbaijan (7.3 percent), and Ukraine (6.1 percent).

With a relatively slower growth in the export of services and a rapid increase in imports, the trade deficit deteriorated to 17 percent of GDP in Q1 2014, from 14 percent a year ago. The trade in services sector, which is dominated by tourism, contracted by 12 percent in Q1 2014, year on year (Figure 9). The slower growth was primarily because of a decline in tourist arrivals from Turkey and Iran by 15 percent and 42 percent, respectively, and a contraction in the export of railway services, particularly to Azerbaijan.

The higher trade deficit and lower transfers widened the current account deficit to 10 percent of GDP in Q1 2014 compared with 6 percent a year ago. The income account was in deficit due to dividends and interest paid out to foreign investors and reinvested earnings. Current transfers also recorded a year-on-year decline in Q1 2014 because of a 42 percent reduction in official transfers. However, remittances grew to US$358 million in the first quarter of 2014 (8 percent more than the previous year). While remittances from Russia and Ukraine declined by 5 and 6 percent, respectively, there was an increase in remittances from Greece, Turkey, Italy and Germany. Despite the decline, remittances from Russia represent almost 50 percent of total transfers from abroad while Greece is a distant second with 15 percent.  

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3 Source: NBG statistics on the electronic money transfers.
Net inflow of foreign direct investment in the first quarter of 2014, at 3.6 percent of GDP, only partially financed the current account deficit during the period. During Q1 2014, net FDI inflows grew by 0.6 percent, year-on-year. The main sectors receiving FDI included financial intermediation, manufacturing, and transport and communication, and most of it came from the Netherlands, the United Kingdom, Turkey, and Azerbaijan (Figure 10). In addition because of significant repayment of external debt, international reserves of the National Bank of Georgia declined from US$2.8 billion in end-2013 to US$2.6 billion in end-Q1 2014. These debt repayments were made by the NBG (about US$40 million), the government (US$50 million), and the private sector including banks (US$200 million).

Gross external debt, including inter-company loans, continues to be high and stood at 85.6 percent of GDP in June 2014. Most of this debt is owed by the private sector with the public sector accounting for 23 percent of GDP. A large part of the public sector debt is also concessional and is owed to multilateral and bilateral institutions, reducing the risk of external public debt distress.
C. Economic and Structural Policies

Fiscal Policy

The fiscal deficit was 1.4 percent of GDP in the first half of 2014 and is expected to widen to 3.7 percent by the end of the year. Both current and capital spending picked up during January-June 2014 compared with the previous year. The prioritization of expenditures in the areas of pensions, healthcare and targeted social programs along with an increase in the wage bill raised current expenditures by 20 percent in the first half of 2014, year-on-year. The spike in intergovernmental fiscal transfers also contributed to this rise. Public investment picked up, although, only in the second quarter of 2014. It rose by 35.5 percent compared with the first half of 2013, but it represents only a quarter of the annual budgeted public investment expenditures. Despite the increase in expenditures, the fiscal deficit was contained because of a strong revenue performance in the first half of the year (Figure 11). For 2014 as a whole, the fiscal deficit is expected to widen to 3.7 percent of GDP. This is because nearly 75 percent of the budgeted capital expenditures will take place in the second half of 2014 along with the higher social expenditures.

**Figure 11. General government operations**

(Percent of GDP)

![Graph showing general government operations](image)

**Source:** MOF.

**Figure 12. Composition of taxes**

(Percent of Total)

![Pie chart showing composition of taxes](image)

**Source:** MOF.

Government revenues in the first half of 2014 exceeded last year’s collections by 7.9 percent, year-on-year, driven by VAT and excise duty. Revenue collections were in line with the budgeted numbers. Tax revenues were higher by 7.2 percent over the same period and were driven by VAT collections which increased by 30 percent and excise duty which rose by 15 percent. VAT also accounts for the largest share of tax revenues in Georgia (Figure 12). However, income and profit tax collections were lower by 3 percent in the first half of this year. This is primarily because of the enactment of the minimum income tax exemption in 2014 which refunded income tax which was paid by households with an income below GEL6,000 in 2013. Weaker profitability expectations
early in the year also resulted in lower advance tax payments by corporates. Non-tax revenues accounted for 8.7 percent of the total and exceeded last year’s collections by lari 43 million.

The government significantly increased the share of domestic debt in financing the budget deficit during the first half of 2014. The volume of T-bills and T-notes issued during January-June 2014 added GEL330 million to the stock of government securities and were almost fully utilized to finance the fiscal deficit of 1.4 percent of GDP. As a result, domestic debt increased by 14.7 percent from December 2013 (Figure 13). According to the planned budget, the government will need to borrow over 1 billion lari from external sources in the second half of the year to cover the deficit.

The draft medium-term fiscal framework of the Government (2015-2018) envisages an ambitious plan to reduce the fiscal deficit from 3.7 percent of GDP in 2014 to 1.4 percent in 2018. In order to achieve this target, the average annual nominal growth of revenues is assumed at 10.5 percent a year and expenditures at 8.5 percent a year for the next 4 years. The main priorities outlined in the draft document include the following: (i) ensuring sufficient funding for old-age pensions, social safety nets, healthcare and education, agriculture, investment in infrastructure and employment; (ii) achieving the level of fiscal deficit that would support economic stability in the country; and (iii) further strengthening of public finance management systems.4

Prices and Monetary Policy

Driven by larger increase in prices for food, the year-on-year inflation reached 3.4 percent in August 2014. The price of food and non-alcoholic beverages increased by 6.4 percent and contributed to an increase in price levels by almost 2 percentage points (Figure 14). Within this category, the main increases came from vegetables (14.4 percent), fruits and grapes (12.2 percent), and milk, cheese and eggs (9.6 percent). There was also an increase in transport prices (2.8 percent) and tobacco (9.9 percent).

The NBG raised its policy rate by 25 bps to 4 percent in February 2014 over concerns of rising inflation. A further increase in inflation was expected because of rising food prices and a depreciating lari in late 2013 and early 2014. The policy rate has been maintained at 4 percent since February 2014 and inflation has been contained because of a strengthening of the nominal effective exchange rate. The year-on-year inflation was 3.4 percent in August 2014, below the target of 6 percent. The 2015 inflation target is 5 percent. Monetary policy is geared towards maintaining price stability within an inflation targeting framework. However, in the context of a highly

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dollarized economy and weak capital markets, there is limited transmission of interest rate
changes.

**Figure 14. Consumer prices**

![Graph showing consumer prices](image)

**Source:** Geostat.

**Figure 15. NBG Policy rate**

![Bar chart showing NBG policy rate](image)

**Source:** NBG.

The introduction of some new financial instruments by the NBG helped reduce loan
dollarization. It declined by 5.5 percentage points to 59.6 percent on September 1, 2014, but
deposit dollarization increased by 1 percentage point to 61.8 percent from a year ago. The NBG
increased the volume of long-term lari-denominated resources through the introduction of various
instruments such as refinancing loans, deposit certificates, and repo operations. In addition, in
March 2014, the EBRD issued lari-denominated bonds with a 2-year maturity in the amount of GEL
50 million.

The new lari-denominated instruments, particularly refinancing by the NBG, boosted lari-
denominated credit growth. This refinancing by NBG was available for mortgages and SME loans
and attracted lower interest rates. As an instance, fixed mortgages are offered at 15 percent, while
the refinanced mortgages are available at about 9-10 percent. As a result, the stock of Lari
denominated loans issued by the commercial banks expanded by 48 percent, while foreign
currency loans grew by 10 percent during January-July of 2014. The 12 month moving average of
weighted interest rates on loans declined from 18.4 percent to 17.1 percent over a year as of July
2014. The ratio of non-performing loans (NPLs) improved from 9.3 percent to 7.4 percent in July
2014, year-on-year.5

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5 For all loan categories (>30 days past due).
The Lari depreciated by 2 percent against the dollar in the first half of 2014, with limited intervention by the NBG in the foreign exchange market. During this period, the NBG has intervened in the foreign exchange market only twice, in January when it sold US$220 million and in February when it bought US$80 million. This is a significant departure from 2013 when the NBG intervened in the foreign exchange market every month. The new development signals greater willingness on the part of the NBG to maintain exchange rate flexibility. The movement in the real effective exchange rate has broadly followed the nominal rates. The real effective exchange rate in June 2014 was maintained at the end-2013 level (Figure 16).

Macroeconomic Outlook and Debt Sustainability

Economic growth is projected to average 5.5 percent a year over the medium-term based on greater policy certainty, improved market access to EU markets, and strong structural reform implementation. Medium-term growth prospects factor in improved economic ties with the EU and the robust reform program outlined in the government’s development strategy, which will support growth in private investment. The DCFTA and the Association Agreement with the EU will improve market access and encourage FDI. A trade sustainability impact analysis commissioned by the EU suggests a potential increase in GDP growth of 4.3 percent in the long-run. This will call for labor and capital reallocations to more productive sectors, involving capacity building on regulatory approximation particularly in trade facilitation, technical barriers to trade and intellectual property rights, and upgrading of and investment in human capital. However, in the short-term, this transitional process could involve certain costs as producers upgrade their facilities and methodologies to meet the desired quality standards. In recognition of the improved growth prospects, Moody’s Investors Service changed its outlook on Georgia’s Ba3 sovereign rating to positive from stable in August 2014. Moody’s expects that the DCFTA will attract further FDI and bolster the country’s export performance, which in turn would support an improvement in Georgia’s external position over the medium-term. However, downsides from an escalation of regional tensions and a slowdown from the EU remain.

While public investment will be maintained over the medium-term, private investment is expected to strengthen. Thanks to a better business environment and improved confidence, gross investment is likely to increase to an average of 27 percent of GDP a year during 2014-16. Even so, this will be lower than the 2004-07 average of 32 percent of GDP a year. The government is
committed to leverage more private investment through the PPP framework that is under discussion.

**Fiscal consolidation is a policy priority for the government, even with a wider deficit in 2014, and is supported by the IMF program.** The fiscal deficit is expected to widen to 3.7 percent of GDP in 2014 with a pick-up in social expenditures and relatively lower revenues due to the lagged impact of the growth slowdown in 2013. An increase in capital expenditures and tax refunds will also contribute to higher spending. Various measures are under consideration to narrow the deficit over the medium-term. These include increased expenditure efficiencies in social benefits, reforms in public investment management, the establishment of bonus limitations for public employees, and limits on other non-essential expenditures. The level of revenues is consistent with the current tax policy framework and is expected to be maintained at about 27 percent of GDP. With a planned decline in current expenditures and sustenance of capital expenditures at about 5-6 percent of GDP, the fiscal deficit is likely to come down to 2.7 percent of GDP by 2016. Fiscal consolidation is a key element of the IMF’s Stand-By Arrangement in Georgia. It should be noted that the draft medium-term framework of the government (2015-2018) envisages a more ambitious fiscal consolidation path with an anticipated deficit of 1.4 percent of GDP by 2018. To achieve the desired outcomes, strengthening the effectiveness of social spending and supporting the government on developing the institutions and capacity to support program implementation will be crucial.

**The renewed focus on competitiveness and fiscal consolidation will support external sustainability.** Higher economic activity and public spending in 2014 will cause the current account deficit to increase before improved competitiveness – driven by the government’s structural reforms, especially in the context of the DCFTA – and a narrowing fiscal deficit start narrowing the external deficit again. Net FDI is likely to amount to 6.3 percent of GDP on average while the national saving rate increases to 20.2 percent of GDP by 2016. Regional uncertainties could however dampen Georgia’s export performance and reduce remittances.

**Georgia’s public debt remains sustainable.** Total public sector debt fell from 38.7 percent of GDP in 2010 to 32.2 percent in 2013 due to continued fiscal consolidation efforts. It is estimated to increase to 34.5 percent of GDP in 2014 because of the widening of the fiscal deficit. About 80 percent of public debt in 2013 was external and was dominated by bilateral and multilateral debt. Gross external debt, including inter-company loans, continues to be high and is expected to remain at more than 80 percent of GDP over the medium-term. The 2014 Debt Sustainability Analysis (DSA) by the IMF confirms that debt indicators are within prudential thresholds.

**Total external debt is likely to fall from 84 percent in 2014 to about 75 percent in 2019 because of a narrowing of the twin deficits.** While external debt is being closely monitored by the authorities, its growth in recent years has mainly been due to commercial borrowings as the country’s access to international financial markets has strengthened. Most of this debt is of long-term maturity and therefore entails limited rollover risks.

**Structural Reforms and New Initiatives**

The government’s development strategy 2020 was approved in June 2014 and aims at inclusive growth. The strategy is based on four pillars: maintaining macroeconomic stability, strengthening competitiveness of the private sector, developing human capital, and enhancing access to finance. While the government has initiated a number of reforms towards its strategic
goals, the next step would be to develop an action plan for the systematic implementation of the strategy.

**Georgia is continuously implementing a number of important reforms in public financial management to improve transparency and accountability.** Some of the recently introduced initiatives include the following: (i) Assessment of fiscal risk associated with the wider public sector operations has been initiated along with IMF support; (ii) Preparation is in progress to integrate operations of all central and local budgets into the Single Treasury Account (STA); (iii) An action plan is under implementation to introduce a single taxpayers account to ensure rapid and accurate recording of taxes; (iv) Two new electronic systems were launched—“eDocuments” and “eHRMS”—in the central and local administrations to allow for efficient planning and execution of the budget and better management of payroll, pensions, and other money transfers.

**The government endorsed the amendments to the tax code in August 2014 to improve the business environment and streamline tax administration.** The main changes include the following: (i) VAT exemption to be introduced for local businesses that serve foreign companies operating in the goods processing industry; (ii) Certain long overdue tax arrears and fines to be written-off; (iii) Small businesses to be allowed to postpone tax obligations. These amendments aim at improving the business environment and streamlining tax administration.

**The parliament recently passed a law placing Georgia’s Financial Monitoring Service under the prime-Minister’s office instead of the NBG.** The objective of the Financial Monitoring Service is to facilitate the prevention of money laundering and terrorism financing. This step has raised some concerns on confidentiality and integrity of financial data, and the government is committed to consultation on this issue and to making possible amendments to the law if needed.

**The new local self-governance code came into effect in July 2014 with the completion of municipal elections.** Following local elections, the code, which was approved by the parliament a few months back, replaced the law on self-governance. The new code mainly focuses on the administrative set-up of the local governments and the division of responsibilities and powers between the central and the local authorities. The new code does not significantly change the division of expenditures with education and health continuing under the central government. The new system for revenue sharing and equalization grants are expected to be developed over time. In terms of the administrative set-up, 7 new cities were created taking the total to 12. In addition, the new code necessitated the direct election of Mayors by the public.
D. Special Topic: Labor Market and Social Protection

Labor Market

Georgia has faced persistent unemployment over the past few years despite a strong growth performance. Unemployment affects all Georgians, independent of their standard of living. According to the 2013 Welfare Monitoring Survey, 58 percent of the poorest quintile and 30 percent of the richest quintile reported unemployment of a household member to be the main problem facing the household (Figure 17).

Household responsibilities play an important role in reducing female labor force participation. Female labor force participation at 75 percent in 2012 (in the age cohort of 35-54) was much lower than the 90 percent for men. The presence of children is associated with a significant reduction in female labor force participation, while having grandparents living in the household (aged 65+ who all receive old age pensions) is associated with an increase in the labor force participation of women and men, suggesting that grandparents contribute to household chores including raising grandchildren and freeing up women’s time that is then allocated to the labor market. Interestingly, the negative effect of childcare responsibilities is large enough to dominate the positive effect of education on women’s labor force participation. This suggests that policies to lighten women’s time burden of care responsibilities will contribute to raise female labor force participation. In particular, and given the low wages prevalent in the labor market, the Government of Georgia should invest in good quality childcare provision and pre-school enrollment.

Unemployment results from queuing for good jobs, imperfect information about jobs and skill mismatches. Unemployed workers are searching for good jobs—permanent, full time, and with opportunities for career development—indepen dent of their living standards. In 2012, nearly 65 percent of the non-poor unemployed were searching for a permanent position and 58 percent were searching for a full time one. These figures were even higher among the long term unemployed: 70 percent were looking for a permanent position and 66 percent were searching for a full time position. This can be suggestive of queuing, which is more prevalent among unemployed

Figure 17. Evolution of the labor force participation and unemployment rates

(Percent)

Source: National Statistics Office of Georgia. Note: Notice that these statistics differ from those reported in the text since they cover the 15 and older population instead of the 20-64 (calculated using the Welfare Monitoring Survey 2013).
Although present, the queuing is less strong among the poor as they have less ability to do so given their limited resources.

As a result of queuing and information problems, long term unemployment is high. Nearly 45 percent of all unemployed were searching for a job for more than one year. In urban areas, this figure stood at 50 percent, with more women than men that were long-term unemployed. It was found that the problem was even more severe for youth transitioning from school to work, as it took school leavers 1.4 years, on average, to find a stable and permanent employment. While waiting for the right job, only some youth managed to work temporarily.

Skills are an important determinant of good labor market outcomes. The recent STEP study by the World Bank finds strong evidence that non-cognitive skills—socio-emotional and job-relevant—matter for leaving unemployment, accessing good jobs, and maintaining them over time. Moreover, the study finds that participation in training programs is associated with better skill profiles. Therefore, there is a need to put more emphasis on improving the quality of skills throughout the education system, on incentivizing workers and firms to raise the levels of on-the-job training and other forms of formal accreditation, and in helping the unemployed to acquire skills that are in-demand.

In Georgia, there are no policies to directly help the unemployed to cope with labor market shocks and there is limited effort on labor activation. If well designed, an unemployment insurance benefit can help households to cope with the loss of a job. However, such a benefit has to be designed so as not to aggravate queuing, especially among the non-poor. In parallel, there is a need to strengthen active labor market policies to help people in finding jobs, acquiring skills in high demand, and gain a better understanding of jobs and skills. All these policies should be coordinated among themselves as well as with those devoted to good job creation. It is imperative that the government takes a more active role in supporting the labor market.

Social Protection

Georgia has one of the highest social assistance expenditures in the Europe and Central Asia region. In 2013, social benefits accounted for nearly 6.1% of GDP (Figure 18). Most of the poverty reduction seen over the past 2-3 years is attributable to social assistance with the labor market playing a relatively limited role.

Social spending increased during 2013 with a full year impact becoming visible in 2014. The 2013 increases in pension and TSA benefits contributed to the growing social protection expenditure (Table 1). According to the 2014 budget law, old age pensions will absorb about 48 percent of the total social benefit expenditures. The TSA and health protection programs will consume about 22 percent each, while the remaining social protection budget will be managed by the other line ministries for case-by-case support to their employees or by local municipalities to supplement the centralized social assistance programs. The government has prioritized social expenditures, although, fiscal pressures demand greater efficiency in these expenditures.

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6 Queuing is essentially waiting for good jobs.
7 Fares, Montenegro and Orazem (2006).
8 Georgia: Education, skills, and labor market outcomes of 15- to 64-year old adults living in urban areas. World Bank Study 2014.
Old-age pensions, Georgia’s largest category of social spending, play a major role in reducing poverty. The existing old-age pension system, which is universal and non-contributory, lowers the poverty rate by almost 16 percentage points. However, this flat benefit does not provide adequate income replacement for middle- and high-income retirees. The current level of basic pension, set at GEL 150 per month, represents a replacement rate of around 20 percent of the average wage, an amount that is just below the subsistence level for a working age male (GEL 154). Implementing a retirement savings program that complements the public pension system is one of the priorities for the country, which is in the pipeline of the government.

The coverage of the TSA program in Georgia is the highest in the ECA region. The TSA is a proxy-means tested benefit aimed at providing income support and consumption smoothing among the very poor households in Georgia. It consists of GEL 60 monthly as a base transfer plus GEL 48
for each additional household member. Launched in July 2006, the program has improved over time in its three dimensions—coverage, generosity and equitability (Figure 19 and 20). For the level of poverty of the country, the coverage of the TSA is now among the highest in the ECA region (Figure 21). The generosity of the program for the lowest consumption quintile increased from 57.7 percent in 2009 to 80.8 percent in 2013 while its coverage almost doubled, both for the total population (from 8.2 percent in 2009 to 12.6 percent in 2013) and for the bottom 20 percent (from 16.6 percent to 33.3 percent). In terms of targeting, the percentage of the total TSA benefit received by the bottom 20 percent has increased from 39.6 percent to 53.6 percent. While the TSA program does a good job of supporting consumption among the extreme poor, more than 40 percent of the poorest quintile does not receive TSA and only 8 percent of those receiving transfers receive only TSA (Figure 22).

**With raised benefit levels, the TSA program might be generating work disincentives for women.** While the TSA did not discourage beneficiaries from work in 2007 (as reported in the World Bank PER of 2012), the expansion of the program—both in terms of coverage and generosity—might be responsible for the current work disincentives among women. A recent study comparing families around the TSA eligibility threshold finds that single women with children between 7 and 17 are more likely to remain inactive if benefiting from TSA. Women who receive TSA are 11 percentage points less likely to work (formally or informally) than women who live in households that do not receive the transfer. The authors do not find work disincentives among mothers of younger children (less than 7), a trend that needs further analysis. There appear to be no work disincentives among men.

**Figure 19. TSA registered applicants, beneficiaries, and benefits**

(People in million and benefits in GEL)

Source: ADePT SP using WMS 2013.

**Figure 20. Performance indicators of TSA, 2009-2013**

(Percent)

Source: ADePT SP using WMS 2013.

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In summary

The new government in Georgia has clearly prioritized social expenditures. However, there is a need to avoid work disincentives and achieve greater efficiency gains to avoid fiscal pressures in the future. In addition, sustained poverty reduction will require greater job creation and investments in human capital rather than continual increases in social assistance expenditures.
## Georgia: Winds of Optimism

### Appendix

### Economic and Social Indicators: Georgia 2007-16

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<td>Revenues</td>
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<td>Overall Fiscal Balance before grants</td>
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<td>Export real growth (% change, yoy)</td>
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<td>8.1</td>
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<td>Import real growth (% change, yoy)</td>
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<td>Merchandise exports</td>
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<td>2,428</td>
<td>1,894</td>
<td>2,462</td>
<td>3,254</td>
<td>3,502</td>
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<td>340</td>
<td>513</td>
<td>747</td>
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<td>1407</td>
<td>1430</td>
<td>1708</td>
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<td>as percent of GDP</td>
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<td>679</td>
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<td>614</td>
<td>903</td>
<td>1080</td>
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<td>Population Growth (annual %)</td>
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### Selected Indicators

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<td>15.2</td>
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### Other

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