

Key developments and challenges

To improve banking sector stability and public confidence in banks, banking supervision needs to be further strengthened, focusing in particular on banks' risk management practices.

Further improvements in physical infrastructure and services of municipal utilities remain important challenges. A successful implementation of the reforms in the municipal utilities sector, including investment to modernise the infrastructure, is crucial to ensure the long-term financial sustainability of this sector.

Recent economic growth was largely driven by the financial services and construction sectors and the global financial crisis has emphasised the need for further economic diversification. The successful implementation of the government's programme to improve quality standards and competitiveness in the agricultural sector will contribute towards this goal, and similar initiatives are needed for other tradeable sectors.

Country data

Population (in millions)	4.4
Area ('000 sq km)	70.0
GDP (in billion US\$, 2008)	12.9
Average transition score (scale: 1 to 4.33)	3.11

Progress in structural reform

Business environment and competition

The August 2008 military conflict with Russia and the international financial crisis have negatively affected the business environment. According to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), a larger percentage of companies identified transport and access to finance as obstacles to doing business than in the previous 2005 survey. The conflict with Russia also had an impact on the functioning of state institutions, and almost 80 per cent of Georgian firms in BEEPS IV report political instability as an obstacle to their day-to-day operations.

In order to facilitate foreign investment, the government has allowed the establishment of two Free Economic Zones (FEZ). During 2008 the RAK Investment Authority (an investment vehicle of Ras Al Khaimah of United Arab Emirates) acquired full ownership of the Poti Seaport. The investor also acquired over 3 million square metres of nearby land to construct a new sea port and to establish a FEZ, the first stage of which is expected to be completed by the end of 2009. In April 2009 Egypt's Fresh Electric Company, together with a local company, created the Fresh Georgia company, which aims to establish a FEZ in Kutaisi. Fresh Georgia is expected to invest about US\$ 1.2 billion over the next two years and contract 12 manufacturing factories.

The government has recently prepared a Strategy for the Agricultural Development of Georgia that focuses on improving competition and quality standards. The government also launched a state programme of "Cheap Credit" aimed at supporting farms and other agricultural businesses. Companies can also purchase state-owned agricultural land at concessional prices.

Infrastructure

With the help of the United States Agency for International Development (USAID) the government has designed and is currently implementing a reform agenda for the municipal water sector aimed at improving water infrastructure and, ultimately, water quality. An independent water regulator was established in mid-2008 and parliament has approved a tariff policy based on cost recovery. Current tariffs are about 20 per cent below cost recovery levels and the collection rate for the population is below 40 per cent. Following the passing of a resolution in June 2009 on the merger of various state-owned water-distributing companies, the government has created two regional companies covering western and eastern Georgia. The merger consolidated the 29 and 33 regional water-distributing companies and sewerage systems in west and east Georgia, respectively, and is intended to improve management and attract investment.

Competition in telecommunications has increased in the fixed-line and mobile operator market, resulting in lower tariffs and better services. The fixed-line market continues to be dominated by United Telecom (with a 70 per cent market share) although a number of smaller operators provide some competition. Competition has increased in particular in the mobile operators market with the entry of a third operator, Mobitel (Beeline), in 2007. Mobile penetration had increased from about 53 per cent in 2007 to about 93 per cent by mid-2009. Mobile networks now cover virtually the whole of Georgia while the fixed-line networks remain outdated in many places.

Financial sector

Domestic credit to the private sector doubled from 15 per cent of GDP in 2005 to 30 per cent of GDP in 2008. The August 2008 conflict and the international financial crisis have resulted in a fall in deposits and a dramatic slow-down in bank lending dropping by 4 per cent on annual terms at the end of August 2009. At the same time dollarisation of banks' portfolios increased from 65 per cent in July 2008 to more than 77 per cent at the end of July 2009. This has increased the credit risk for banks as foreign exchange risks have been passed on to unhedged borrowers. Non-performing loans had also increased to more than 18 per cent of total loans by August 2009.

The National Bank of Georgia (NBG) took a number of emergency measures to ease liquidity in the banking sector, including reducing the refinancing rate, lowering reserve requirements and supporting banks with liquidity. A new law is currently under discussion which proposes the merger of the Financial Supervisory Authority (established in 2008) with the NBG in autumn 2009. It is hoped this will give the NBG more influence in financial sector supervision and regulation so that it can strengthen financial stability. At the same time the authorities are working on a contingency plan for bank rescues to boost confidence in the banking sector and increase lending. To clarify the role of parent banks in case of crisis, the NBG has signed a Memorandum of Understanding with home country supervisors.

Macroeconomic performance

The Georgian economy suffered a deep contraction of 10.7 per cent in annual terms in the second quarter of 2009 after a contraction of 5.9 per cent in the first quarter. This contrasts sharply with positive real GDP growth of 8.3 per cent in the second quarter of 2008 (and 2.1 per cent growth during 2008 as a whole). This sharp slow-down is mainly due to lower investment, both foreign and domestic, and very limited bank lending. The construction, services and manufacturing sectors all experienced significant falls in activity during the first half of 2009.

Exports decreased by 37 per cent in the first half of 2009 compared with a year earlier due to lower external demand and metal prices. However, imports – especially of services – decreased by 43 per cent, contributing to a fall in the current account deficit to 10 per cent of GDP (compared with 22.7 per cent of GDP in 2008 as a whole). During the first half of 2009 foreign investment flows fell by about 80 per cent relative to the same period in 2008, and remittances declined by about 20 per cent at the end of July due to the economic slow-down in Russia.

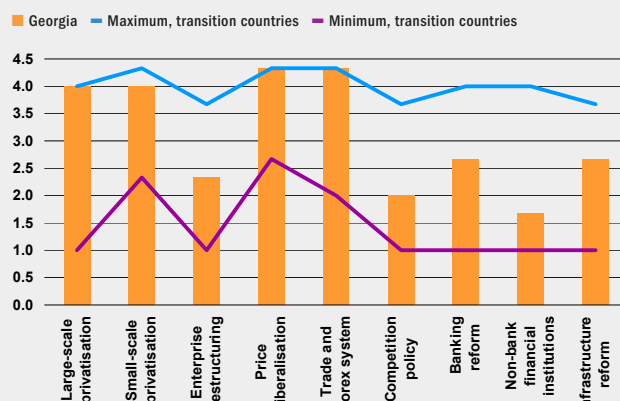
The conflict and intensification of the international financial crisis put pressure on the lari, which depreciated by 17 per cent during early November 2008. The exchange rate has remained relatively stable since then, at about 1.67 to the dollar, despite a decision by the NBS to increase exchange rate flexibility since May 2009. Inflationary pressures have eased as demand has weakened and the annual rate of inflation was negative at -3.1 per cent in August 2009 compared with 10 per cent at the end of 2008.

Although the crisis has negatively affected fiscal revenues, the government has recently amended the budget with public investment focused on conflict-related reconstruction and infrastructure, along with social spending. The expected increase of fiscal deficit to some 9 per cent of GDP is likely to be funded by donor funds.

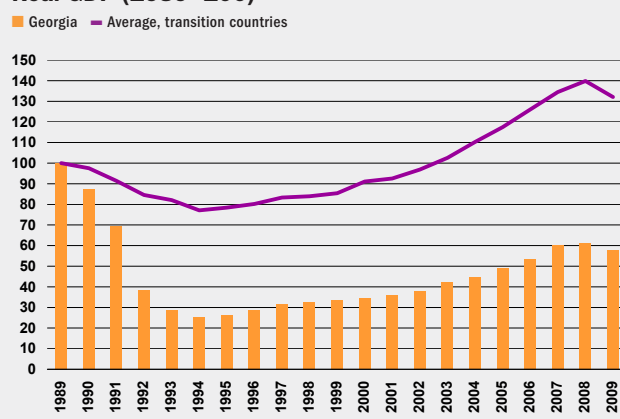
Outlook and risks

After the economic contraction in 2009, Georgia is likely to experience only a modest recovery in 2010, reflecting relatively low levels of domestic and foreign investment and limited bank lending. The large fiscal stimulus, mainly financed from international financial support, will provide some counter-cyclical effect. Remittances, although significant, are expected to decline further due to the recession in neighbouring countries, in particular Russia, which in turn will affect consumption. International financial support for the banking sector will help to limit the shrinking of banks' balance sheets and improve their lending capacity. However, non-performing loans may increase further due to the economic slow-down and the malaise in the real estate sector, while foreign currency risks remain large due to the dollarisation of bank assets. Risks to this already negative outlook include the possibility of an even sharper decline in foreign direct investment (FDI) flows and remittances, which could lead to pressures on the currency and banks' balance sheets.

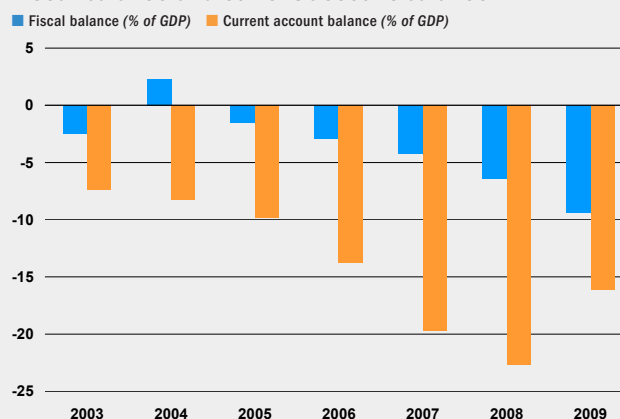
Transition indicators 2009



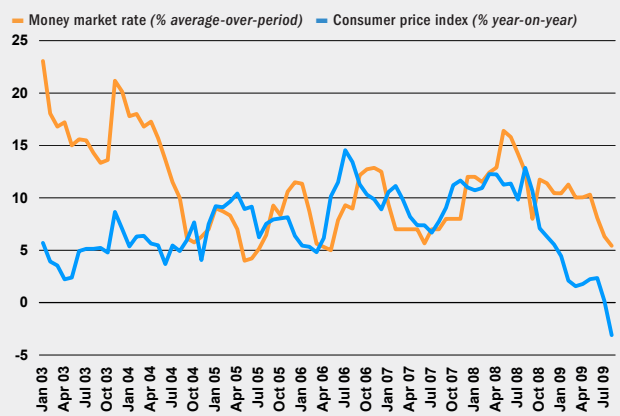
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility - full	Competition office - yes	Telecoms regulatory assessment compliance - high	Capital adequacy ratio - 12 per cent	Share of population living in poverty - 30.4 per cent (2005)
Controls on inward direct investment - no	Quality of insolvency law - low	Independence of the electricity regulator - partial	Deposit insurance system - no	Government expenditure on health - 1.6 per cent (2008)
Interest rate liberalisation - full	Secured transactions law - under development	Separation of railway infrastructure from operation - no	Private pension funds - yes	Government expenditure on education - 2.9 per cent (2008)
Exchange rate regime - managed float		Independence of the road directorate - partial		Household expenditure on power and water - 11.0 per cent
Wage regulation - no				
Tradeability of land - unlimited				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	23.6	24.5	28.1	32.9	38.1	41.8	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	70.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	77.3	77.9	77.7	79.0	79.0	80.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	2.4	7.5	9.3	6.6	na	na
Share of industry in total employment (in per cent)	5.9	6.4	6.8	6.0	6.5	6.5	na
Change in labour productivity in industry (in per cent)	23.4	5.4	8.3	31.9	8.8	na	na
Investment/GDP (in per cent)	24.4	26.6	26.3	25.6	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.7	3.7	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	5.5	5.4	5.4	12.4	12.4	12.4	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	64.0	55.4	50.3	61.5	na	na	na
Share of trade in GDP (in per cent)	51.6	62.7	64.9	68.8	69.5	68.3	na
Tariff revenues (in per cent of imports)	6.8	8.0	8.4	7.2	5.4	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	24 (6)	21 (7)	19 (10)	17 (10)	19 (14)	20 (16)	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent) ¹	34.9	58.1	75.9	86.9	90.6	90.8	na
Non-performing loans (in per cent of total loans)	7.5	6.2	3.8	2.5	2.6	12.8	na
Domestic credit to private sector (in per cent of GDP)	8.7	9.7	14.8	19.7	27.1	30.2	na
Domestic credit to households (in per cent of GDP)	3.0	2.8	4.1	5.6	8.8	13.2	na
- Of which mortgage lending (in per cent of GDP)	0.5	1.0	1.1	1.4	2.6	3.5	na
Stock market capitalisation (in per cent of GDP)	5.3	3.8	5.5	8.3	13.0	2.9	na
Stock trading volume (in per cent of market capitalisation)	0.5	11.6	13.6	18.6	4.4	1.0	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	2.0	5.0	na
<i>EBRD index of banking sector reform</i>	2.3	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	14.6 (15.6)	15.1 (18.6)	12.8 (26.3)	12.5 (38.6)	12.8 (59.7)	12.8 (59.7)	na
Internet users (per 100 inhabitants)	2.6	3.9	6.1	7.5	8.3	8.3	na
Railway labour productivity (1989=100)	72.6	68.6	93.4	118.4	110.9	101.5	na
Residential electricity tariffs (USc kWh)	4.1	4.2	4.9	7.5	9.8	10.3	na
Average collection rate, electricity (in per cent)	33	37	58	81	95	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	4.9	4.9	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7
- Electric power	3.0	3.0	3.0	3.0	3.3	3.3	3.3
- Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
- Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
- Telecommunications	2.3	2.3	2.3	2.7	2.7	2.7	2.7
- Water and wastewater	2.0	2.0	2.0	2.0	2.0	2.0	2.3

¹ Data on bank ownership is based on the legal registration of ownership and not the beneficial ownership.

Macroeconomic indicators

	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	11.1	5.9	9.6	9.4	12.4	2.1	-5.5
– Private consumption	3.2	7.6	0.1	29.1	9.8	na	na
– Public consumption	4.1	64.2	27.2	-3.6	7.8	na	na
– Gross fixed capital formation	20.9	9.0	12.0	-0.4	14.8	na	na
– Exports of goods and services	na	na	na	na	na	na	na
– Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output	14.0	12.2	13.0	16.2	15.0	na	na
Agricultural gross output	10.3	-7.9	12.0	-9.6	6.0	-2.1	na
Employment¹	<i>(Percentage change)</i>						
Labour force (end-year)	-2.5	-0.5	-0.8	-0.1	-2.8	-2.4	na
Employment (end-year)	-1.3	-1.7	-2.2	0.2	-2.5	-6.0	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	11.5	12.6	13.8	13.6	13.3	16.5	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	4.9	5.7	8.4	9.2	9.3	10.0	1.2
Consumer prices (end-year)	7.0	7.5	6.4	8.8	11.0	10.0	3.0
Producer prices (annual average)	2.3	3.8	7.2	9.6	10.2	12.0	na
Producer prices (end-year)	5.4	0.7	8.2	10.9	16.9	1.4	na
Gross average monthly earnings in economy (annual average)	10.4	24.5	30.2	36.1	29.5	40.3	na
Government sector²	<i>(In per cent of GDP)</i>						
General government balance	-2.5	2.3	-1.5	-3.0	-4.2	-6.4	-9.4
General government expenditure	18.7	19.4	24.9	29.2	33.5	37.1	na
General government debt	61.5	47.0	36.6	28.9	22.9	na	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M3, end-year)	22.7	42.6	26.4	39.3	50.3	14.0	na
Domestic credit (end-year)	14.7	7.4	39.8	34.5	28.8	34.0	na
	<i>(In per cent of GDP)</i>						
Broad money (M3, end-year)	12.4	15.2	16.4	19.3	23.5	23.9	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Money market rate	16.9	11.9	7.7	9.5	7.8	na	na
Treasury bill rate (3-month maturity) ³	44.3	19.2	na	na	na	na	na
Deposit rate (3-month) ⁴	9.3	7.2	7.6	11.4	9.5	10.4	na
Lending rate (3-month)	32.3	31.2	21.6	18.8	20.4	21.2	na
	<i>(Laris per US dollar)</i>						
Exchange rate (end-year)	2.1	1.8	1.8	1.7	1.6	1.7	na
Exchange rate (annual average)	2.1	1.9	1.8	1.8	1.7	1.5	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-294.0	-430.0	-628.0	-1,069.0	-2,005.8	-2,904.6	-1,720.7
Trade balance	-598.0	-719.0	-1,214.0	-2,019.0	-2,895.7	-3,894.4	-2,669.6
– Merchandise exports	730.0	1,272.0	1,472.0	1,667.0	2,088.3	2,420.3	1,933.9
– Merchandise imports	1,328.0	1,991.0	2,686.0	3,686.0	4,984.0	6,314.8	4,603.5
Foreign direct investment, net	335.0	420.0	529.0	1,115.0	1,740.1	1,561.1	887.1
Gross reserves, excluding gold (end-year)	190.9	383.0	473.9	881.0	1,361.0	1,480.0	na
External debt stock	1,954.0	2,039.0	2,137.0	2,000.0	3,136.0	4,555.2	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.3	1.8	1.8	2.5	2.9	2.6	na
	<i>(In per cent of current account revenues, excluding transfers)</i>						
Debt service	10.0	10.2	5.6	10.5	9.0	14.4	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	4.6	4.5	4.5	4.5	4.4	4.4	na
GDP (in millions of laris)	8,565.0	9,969.8	11,621.0	13,789.9	16,998.6	19,069.6	17,925.4
GDP per capita (in US dollars)	877.0	1,155.9	1,419.5	1,722.2	2,312.7	2,908.1	na
Share of industry in GDP (in per cent)	17.7	16.1	15.7	14.9	14.2	13.5	na
Share of agriculture in GDP (in per cent)	19.3	16.4	14.8	11.3	9.2	8.9	na
Current account/GDP (in per cent)	-7.4	-8.3	-9.8	-13.7	-19.7	-22.7	-16.1
External debt – reserves (in US\$ million)	1,763.1	1,656.0	1,663.1	1,119.0	1,775.0	3,075.2	na
External debt/GDP (in per cent)	49.0	39.2	33.3	25.7	30.8	35.6	na
External debt/exports of goods and services (in per cent)	151.7	111.4	106.9	77.8	106.0	127.9	na

¹ Figures consistent with ILO methodology.

² General government includes the state, municipalities and extra-budgetary funds.

³ Data relate to the average auction rates during the year.

⁴ Data refer to average rates for local currency from international financial statistics.