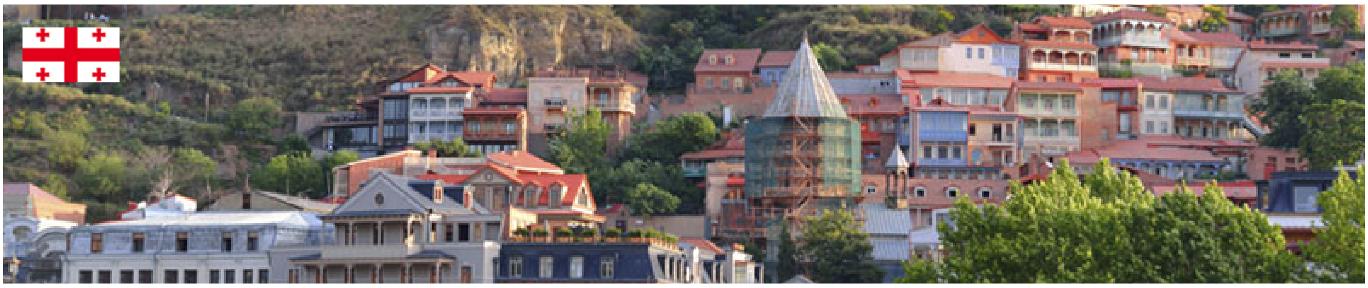

GEORGIA

Highlights

- **Economic growth is accelerating.** In the first half of 2017, strong export performance and burgeoning tourism helped to lift GDP growth to an estimated 4.9 per cent year-on-year, up from 2.7 per cent in 2016.
- **The banking sector demonstrated resilience in the face of exchange rate volatility.** Despite volatility in the lari-US dollar exchange rate and high dollarisation of the economy, non-performing loans remained under control and efforts to incentivise usage of the local currency for economic transactions continued.
- **The government has adopted a new reform agenda.** A Four Point Reform Plan is in place, and measures to accelerate economic growth and implement well-coordinated macroeconomic policies are important priorities under the programme, which is also supported by a new IMF arrangement.

Key priorities for 2018

- **Public investment needs to be stepped up without compromising fiscal sustainability.** Scaling up implementation of competitiveness-enhancing public infrastructure projects will help to realise Georgia's potential as a regional hub economy and to reap greater benefits from its business-friendly environment and extensive network of free trade arrangements.
- **Public-private partnerships (PPPs) should be structured in line with the new PPP framework.** A new PPP law has been developed in conformity with modern PPP best practices and internationally accepted standards. Adoption of this law by the parliament will promote fiscally responsible implementation of the PPP structures for infrastructure projects.
- **Commercial dispute resolution capacity should be enhanced.** The ability of the judiciary system to mediate commercial disputes in a competent and impartial manner needs to be strengthened. Steps should be taken to rebuild investor confidence in the judiciary and improve the qualifications of judges dealing with business disputes.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.4	4.6	2.9	2.7	4.5
Inflation (average)	-0.5	3.1	4.0	2.1	6.0
Government balance[1]/GDP	-2.6	-3.2	-3.7	-4.2	-4.1
Current account balance/GDP	-5.8	-10.7	-12.0	-12.8	-11.9
Net FDI/GDP [neg. sign = inflows]	-5.1	-8.2	-9.1	-9.3	-9.4
External debt/GDP	81.7	83.8	107.8	108.1	n.a.
Gross reserves/GDP	17.5	16.4	18.0	19.2	n.a.
Credit to private sector/GDP	39.0	44.5	50.4	55.7	n.a.

[1] According to the definition by the Ministry of Finance (GFS 1986).

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Macroeconomic performance

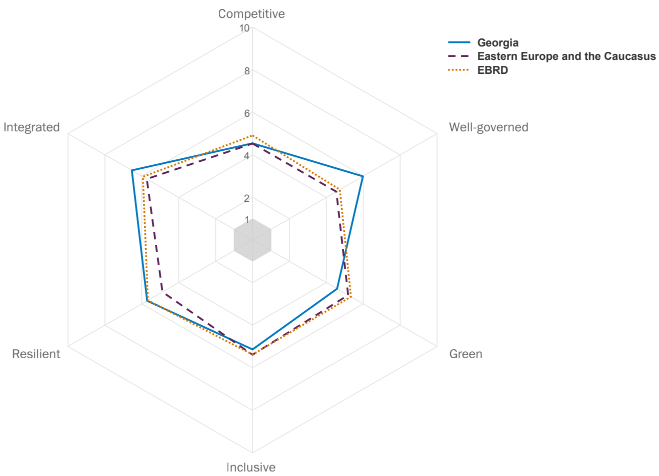
Output growth has accelerated in 2017 on the back of an improving external environment. GDP growth averaged close to 6.0 per cent in 2010-14, but then fell below 3.0 per cent in 2015 and 2016 mainly due to a difficult external environment and a slow-down in key trading partners. In 2016, robust growth in the hospitality industry, construction and financial intermediation bolstered the economy. Growth picked up to an estimated 4.9 per cent year-on-year in the first half of 2017, supported by a 30.1 per cent year-on-year increase in exports and a 15.1 per cent increase in tourist arrivals in the same period.

The exchange rate volatility persists. Following in the footsteps of other regional currencies, the lari depreciated by approximately 34.4 per cent against the US dollar between 2014 and 2016. This exchange rate trajectory was reversed in the first nine months of 2017, with the lari appreciating by approximately 6.9 per cent against the US dollar. This was supported by foreign exchange inflows from increased merchandise exports, tourism receipts, tightening of monetary policy, and a recovery in remittances which increased by approximately 19.7 per cent in the first nine months of 2017. The exchange rate pressures have since reemerged. Between the beginning of October and 15 November the lari lost approximately 7.7 per cent of its value against the US dollar. Inflation accelerated to 6.2 per cent year-on-year in September 2017 from an average of 2.1 per cent in 2016 reflecting earlier depreciation of the lari, a spike in excise taxes and higher commodity import prices. The National Bank of Georgia (NBG) increased the refinancing rate two consecutive times from 6.5 per cent in September 2016 to 7.0 per cent in May 2017.

External and fiscal deficits are sizeable but sustainably financed. The high current account deficit, at 12.8 per cent of GDP in 2016, remained mostly financed by an inflow of net foreign direct investment which stood at approximately 9.3 per cent of GDP in 2016. Official international reserves remained steady in the first nine months of 2017, providing approximately three and a half months of import coverage (US$ 3.0 billion at the end of September 2017). The fiscal deficit widened to 4.2 per cent of GDP in 2016 and is planned at 4.1 per cent of GDP in 2017, reflecting high infrastructure spending supported mainly by borrowing from international financial institutions on favourable terms.

Growth is set to remain vigorous. A recovery in consumption, investment in infrastructure and strong performance of the hospitality sector are expected to fuel short-term growth. The free trade agreement signed with China in May 2017, which abolishes approximately 95 per cent of import taxes on Georgian goods, and realisation of DCFTA benefits in the medium term are expected to stimulate exports. GDP growth is forecast at 4.5 per cent of GDP in 2017 and 2018. Weaker-than-expected regional recovery and geopolitical tensions could, however, affect growth on the downside.

Assessment of transition qualities (1-10)



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Major structural reform developments

Georgia has introduced a new Reform Plan. The Four Point Reform Plan, introduced in February 2017, aims to improve the investment climate and generate higher and more inclusive economic growth. The plan's structural reform agenda focuses on, among other things, upgrading the education system, streamlining implementation of infrastructure projects to leverage Georgia's position as a transit and tourism hub, increasing efficiency and improving governance in the public administration, and further improving the business environment.

A new IMF programme is supporting fiscal and monetary discipline. A three-year US$ 285 million Extended Fund Facility was approved by the IMF Board in April 2017, providing additional shock absorption capacity against exogenous economic risks. The main policy areas under the new programme include fiscal consolidation and improvements in public financial management, pension reform, development of a new PPP law with an emphasis on minimisation of contingent fiscal risks, measures to enhance the NBG's liquidity management framework, and financial sector reforms to strengthen banking regulation and supervision, improve the bank resolution framework and enhance overall resilience of the financial sector. Staff-level agreement between the IMF and Georgian authorities for completion of the first programme review was reached in October 2017.

Fiscal reforms are creating more space for growth-enhancing public infrastructure projects. Efforts were made in the past year to increase revenues and to shift fiscal resources from current expenditures to public investment spending. The tax model introduced in 2016 applies corporate income tax only to distributed profits, and to offset the resulting shortfall, the authorities raised excise taxes on tobacco, gambling, cars and fuels effective from January 2017. Current expenditure optimisation measures include reduction of the wage bill through rightsizing the headcount in public administration and reforms to the remuneration system. Universal healthcare insurance, launched in 2013, was modified to apply only to more vulnerable groups whose income is below the specified threshold. Legislative amendments were made to allow better state control over local government spending in order to ensure compliance with general government deficit limits. Work has also been initiated on designing a new pension system.

Incentives to use local currency are in place but with limited impact so far. A 10-point "larisation" plan was developed jointly by the NBG and the government of Georgia and rolled out in January 2017. As part of the plan, the authorities offered one-time subsidised conversion of dollar-denominated mortgage loans (issued before January 2015 and up to approximately US$ 40,000 per loan) into local currency at the beginning of 2016. Only a quarter of eligible loans participated in the conversion opportunity. Small new loans (up to approximately US$ 40,000) have been required to be issued in local currency only since January 2017. Other measures under the larisation plan include regulatory incentives to issue local currency corporate bonds, preferential treatment of local currency under the NBG's prudential regulations and the requirement to quote all prices in lari, including for real estate. As of August 2017, these measures have had limited cumulative impact. Dollarisation decreased somewhat but remained high with 57.6 per cent of loans and 66.0 per cent of deposits denominated in foreign currency as of 1 October 2017.

Safeguards have been added to the banking sector. Despite lari depreciation, non-performing loans remained low at approximately 3.1 per cent of total loans in the third quarter of 2017. In May 2017, the NBG increased the minimum capital requirement for Georgian banks more than four times, to approximately US$ 20.4 million. Banks are expected to increase their capital in three stages until 2018. In May 2017, the parliament adopted a Law on Deposit Insurance System which provides for setting-up mandatory insurance for deposits up to 5,000 lari (US$ 2,000), starting from January 2018. The scheme is to be fully funded by banks providing insurance contributions to the Deposit Insurance Fund, which will be governed by high-ranking officials from the ministries, NBG and independent members.