# GEORGIA

## Highlights

- **Economic growth remains strong.** The economy expanded by 4.7 per cent year-on-year in the first half of 2019, but the inflow of foreign investments (relative to gross domestic product) slowed substantially, although this number remains among the highest in the EBRD regions.
- **The fiscal framework was improved.** The fiscal rule was revised to ensure counter-cyclicality, provide more clarity and allow for a broader coverage of fiscal risks, and efforts to strengthen the value added tax (VAT) system continued.
- **Important structural reforms have advanced.** Notable reforms in the past year include the central bank's implementation of new regulations on responsible lending to individuals, the approval of a corporate governance code for banks and the launch of a credit guarantee scheme.

## Key priorities for 2020

- **Governance standards need to be improved.** This includes ensuring the impartiality of the justice system, continuing to advance the quality and transparency of public services and safeguarding the independence of economic institutions from undue political influences.
- **To make full use of Georgia's strategic geographic location, efforts to implement multimodal infrastructure development projects need to be deepened.** There is a need to advance with core public infrastructure projects, in particular the East-West highway and the North-South corridor.
- **Comprehensive reform of the education sector is needed to address labour market shortcomings.** The authorities' initial efforts to tackle inefficiencies in the sector need to be followed by an encompassing reform plan and decisive implementation.

Main macroeconomic indicators %

| | 2015 | 2016 | 2017 | 2018 | 2019 proj. |
|---|---|---|---|---|---|
| GDP growth | 2.9 | 2.8 | 4.8 | 4.7 | 4.5 |
| Inflation (average) | 4.0 | 2.1 | 6.0 | 2.6 | 4.3 |
| Government balance[1]/GDP | -1.1 | -1.3 | -0.9 | -0.8 | -2.2 |
| Current account balance/GDP | -12.6 | -13.1 | -8.8 | -7.4 | -5.9 |
| Net FDI/GDP [neg. sign = inflows] | -10.2 | -8.6 | -11.2 | -5.7 | -5.6 |
| External debt/GDP | 109.4 | 110.7 | 114.7 | 109.8 | n.a. |
| Gross reserves/GDP | 18.0 | 19.2 | 20.1 | 20.3 | n.a. |
| Credit to private sector/GDP | 47.6 | 52.5 | 56.2 | 61.7 | n.a. |

[1] According to the definition by the Ministry of Finance (GFS-2001).

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## Macroeconomic performance

**Georgia's economic performance remains strong.** Economic output increased by 4.7 per cent in 2018. The growth was broad-based; all sectors expanded, apart from construction. Trade was up by nearly 6.0 per cent, followed by real estate, transport, financial intermediation and other sectors, such as social and personal service activities. The negative growth rate in the construction sector is largely explained by delays in public infrastructure spending and completion of the landmark gas pipeline project. Tourism continued to boom. Gross domestic product (GDP) grew by an estimated 4.7 per cent year-on-year in the first half of 2019. Exports of goods in nominal US dollar terms increased by 11.5 per cent year-on-year in the first half of 2019, down from 22.7 per cent growth in 2018. Inflows of money transfers are growing for the fourth consecutive year and credit growth remains robust despite the slowdown, supporting private consumption.

**The inflow of foreign direct investments decelerated after reaching a peak in 2017**. The current account deficit shrank further in 2018 on the back of thriving tourism and a strong increase in the exports of goods, benefiting from ongoing geographical diversification as the network of free trade agreements grows. At the same time, following an all-time high in 2017, foreign direct investment (FDI) into Georgia decreased by 35.3 per cent in 2018, hitting a five-year low. The drop is mainly explained by the completion of the South Caucasus Pipeline Expansion (the gas pipeline connecting Azerbaijan and Turkey), the transfer of several enterprises to domestic ownership and debt repayments between connected companies. Despite the decline, FDI remained the main source of currency inflows, nearly offsetting the current account deficit. Similar trends have continued in the first half of 2019.

**The Georgian lari came under renewed pressure.** Helped by the high degree of trade diversification, the currency has demonstrated resilience to adverse developments in large trading partners in the recent past. However, the currency came under renewed pressure on the back of domestic political uncertainties and negative expectations, based on anticipated movements in the balance of payments, stemming from the deterioration in Georgian-Russian relations in mid-2019. A Russian ban on direct flights to and from Georgia has been in force since July 2019, and the import of wine from the eight largest Georgian wineries has been prohibited since the end of June 2019. In 2018, Russian tourists accounted for approximately one-fifth of all international visitors and a significant portion of foreign exchange inflows from tourism. Coupled with domestic political uncertainties, this has influenced expectations, leading to currency depreciation of more than 9.0 per cent in the first nine months of 2019. Inflation has risen from 2.6 per cent in 2018 to 6.4 per cent in September 2019 due to pass-through from nominal exchange rate depreciation and the increase in excise taxes earlier in the year. This prompted the National Bank of Georgia (NBG) to intervene on the foreign exchange market and raise the monetary policy rate by 200 basis points to 8.5 per cent in October. Official international reserves increased by 9.5 per cent since the beginning of 2019 and stood at US$ 3.6 billion in August 2019, providing around four months of import coverage.

**Economic growth is expected to stay at similarly strong levels.** We currently forecast real GDP to grow by 4.5 per cent in both 2019 and 2020. Downside risks to the outlook stem from potential external shocks that would hit the Georgian economy through trade, investment, tourism or remittances channels and geopolitical vulnerabilities, recently intensified by the deterioration in Georgian-Russian relations.

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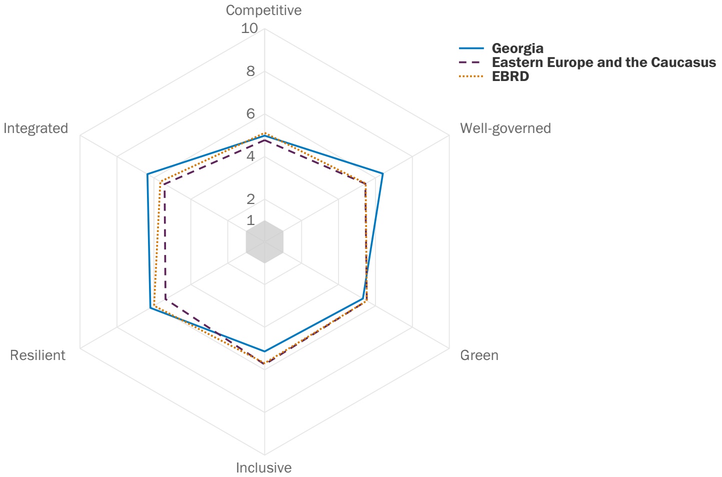
Assessment of transition qualities (1-10)




## Major structural reform developments

**Implementation of reforms under the International Monetary Fund (IMF) programme advanced.** In June 2019, Georgia completed the fourth review under the three-year Extended Fund Facility arrangement signed in April 2017. The completion of the review enabled the release of US$ 41.4 million, bringing total disbursements under the arrangement to US$ 207.2 million. Measures implemented under the IMF programme so far include the enhancement of financial supervision and regulation, improvements to the fiscal framework and administration, advances in setting up the public-private partnership (PPP) framework and pension reform. The authorities have been able to maintain fiscal prudence and create space for increasing social and capital spending.

**A new credit guarantee scheme aims to facilitate access to finance for entrepreneurs.** Eligibility for the scheme, which was launched in April 2019, is limited to entrepreneurs whose average total turnover is below GEL 20,000 (US$ 7,000) in the three years preceding the application and whose loan liabilities do not exceed GEL 8,000,000 (US$ 2,800,000). The guarantee can be issued on loans in Georgian lari worth between GEL 50,000 (US$ 17,000) and GEL 2,000,000 (US$ 700,000), with the maximum term of the guarantee at 10 years. The scheme will receive direct budget allocation of GEL 20 million in each of the next five years, which will cover up to 15 per cent of the loan portfolio under the scheme in each participating bank. Loan selection is carried out by the banks and the scheme will be subject to internal and external audits as well as a report on requirements regarding activities and financial outcomes.

**The fiscal rule was revised.** The Economic Liberty Act, in force since 2014, stipulates that public debt must not exceed 60 per cent, public expenditures must be contained to 30 per cent and the fiscal deficit needs to be lower than 3 per cent, all as a share of GDP. The revised rule removes the restriction on expenditures, clarifies the scope of the public debt and deficit definitions and defines escape clauses. Liabilities stemming from PPPs are included under the debt ceiling, helping to better track and contain fiscal risks.

**The NBG continues to strengthen its financial stability and monetary policy frameworks.** At the end of September 2018, a corporate governance code for banks was approved. The code sets out principles for introducing supervisory boards in the commercial banks and supporting committees, such as risk management, internal audit and remuneration. According to the code, at least one-third of supervisory board members need to be independent and a minimum of 20 per cent or one member needs to be female. To facilitate sound banking and retail lending, a new regulation on responsible lending to individuals was adopted in December 2018. The regulation sets out threshold levels for loan-to-value ratios and debt service payments-to-income levels,

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differentiated by the currency of the loan and by income brackets. In force since the beginning of 2019, the new regulation helped curb mortgage lending: the growth of loans secured by real estate decreased from 31.7 per cent in 2018 to 11.2 per cent in the first seven months of 2019. In addition, to help address risks related to foreign currency, the NBG further increased reserve requirements on deposits in foreign currency by 5 percentage points to 30.0 per cent, while keeping the reserve requirements on local currency deposits unchanged at 5.0 per cent. The threshold under which loans can be issued only in local currency was doubled to GEL 200,000 (US$ 70,000) and expanded to include legal entities as well. Lastly, the NBG's arsenal of regulatory and supervisory tools was expanded in early 2019 to include foreign exchange options, with the primary goal of using the instrument to boost international reserves.

**Further business-friendly reforms have been introduced.** From January 2019, assessments of all new VAT declarations are automated and the authorities are planning further improvements, including risk-based auditing. Energy market deregulation is also being gradually implemented. Since May 2019, household and industrial consumers are separated and industrial consumers are buying electricity at market prices.