# 2012
# Economic Outlook

## Annual Overview of Georgia's Economy

EPRC
Economic Policy Research Center

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March 2013

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# Preface

*Within the framework of the Core and Institutional Support Project for the EPRC, and with the financial support of the Think Tank Fund of the Open Society Foundations, we present the sixth report: Georgian Economic Outlook – 2012.*

This paper covers the major economic developments in the country over the past year and highlights ongoing challenges that need to be addressed with due diligence by economic policymakers and other relevant institutions. The majority of the data used in this report was obtained from the official web-sites of the National Statistics Office of Georgia, the National Bank of Georgia, the Ministry of Finance of Georgia, and the International Monetary Fund.

The report's presents a new *Issue in Focus*: "Understanding Georgia's Foreign Direct Investment Trends".

# Key Findings

- Projected average GDP growth for the year 2012 was 5.5%

- After its 2011 peak, Georgia's headline inflation eased in 2012 and was maintained below the targeted 6%. The annual inflation rate equaled as low as 0.6%; NBG is trying to stimulate the economy by easing the refinancing rate to 4.75% as of February 2013;

- Foreign Direct Investment (FDI) inflows to Georgia fell significantly closing the year 252 million USD down from 2011;

- Alongside the decrease in the availability of FDI stock on the global market, uncertainty regarding Georgia's political future caused by 2012's eventful elections, caused a decrease in FDI inflows;

- The new government faces the challenge of mobilizing private sources of financing, since the availability of an external pool of resources is limited;

- Out of the total loans issued by Georgia's commercial banks in 2012, 40% were directed towards households and the rest (60%) where directed towards sectors that bring little or no long-term economic growth;

- A major cause of the absence of serious rural credit is the dysfunctional land market. Agricultural land is rarely used as collateral, and therefore is not capitalized. Thus, a huge amount of wealth is out of productive use;

- A record high inflow of remittances 1,334.17 thousand USD was detected in 2012, in that particular year remittances outpaced FDI inflow by as high as 64%;

- Reducing Georgia's persistently high current account and fiscal deficit still remains a major macroeconomic challenge, as of 2012 the consolidated budget deficit amounted to 2.9%; current account deficit is mainly caused by the trade deficit equaling 24.9% of the country's GDP;

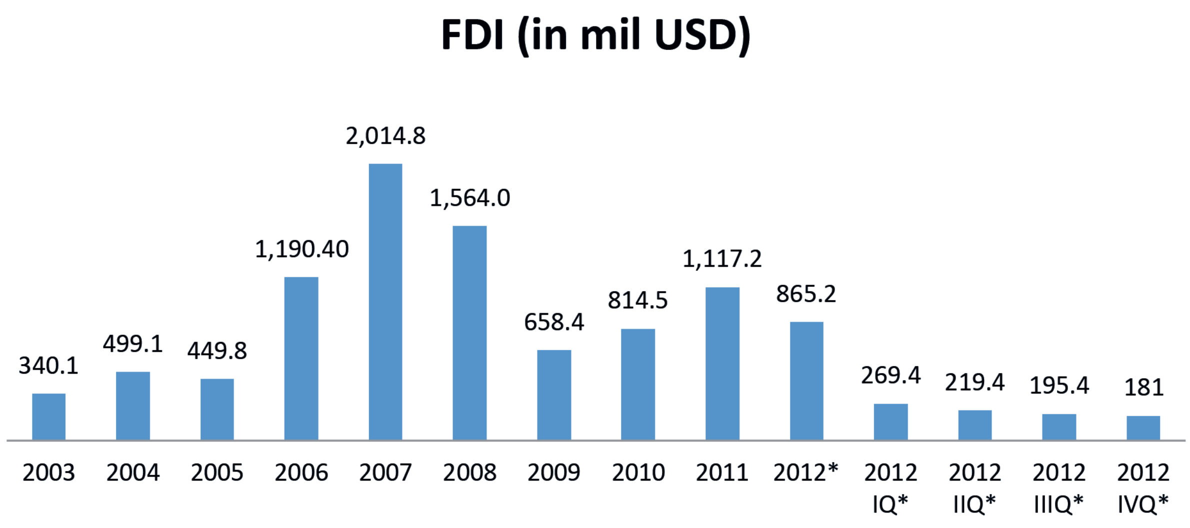
- The 2013 draft budget resembles the pre-election promises of the government and clearly prioritizes social expenses that will consume up to 44% of the total budget;

# Issue in Focus

## Understanding Georgia's Foreign Direct Investment Trends

Foreign Direct Investment (FDI) inflows to Georgia fell significantly from the second quarter of 2012, closing the year 252 million USD down from 2011 (f. 1).[1] After several years of steady recovery, this is a serious concern for policy makers. Georgia's domestic capital market is still underdeveloped, leaving economic growth substantially dependent on external sources of finance, particularly including FDI. FDI is especially important for long-term growth, as it can be directed towards financing large infrastructural projects that would otherwise be impossible to fund through the domestic banking sector.

**Figure 1 Foreign Direct Investment (mil. GEL) www.geostat.ge**

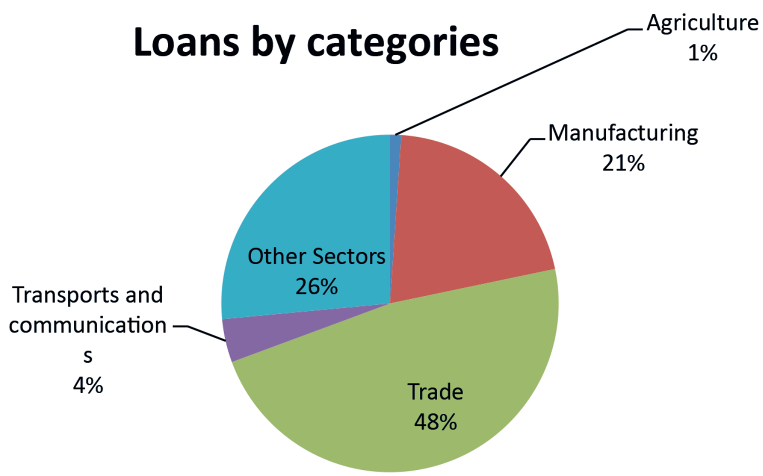



1 The National Statistics Office of Georgia (2013), Foreign Direct Investments, accessed 19 March 2013, <http://www.geostat.ge/index.php?action=page&p_id=140&lang=eng>

Out of the total loans issued by Georgia's commercial banks in 2012, 40% were directed towards households and the rest (60%) where directed towards sectors that bring little or no long-term economic growth. As can be seen from the chart below (f.2), almost half of the total loans issued in the economy go to trade (48%) – a trend that has deviated little from previous years. Traditionally, agriculture – which policymakers believe is crucial for the country's economic development – only receives 1% of total loans, while finances are heavily tilted towards sectors with fairly limited scope for generating fresh job opportunities. This particularly concerns trade, which can be regarded as proxy consumption. In the meantime, Georgia imports more and more goods, which are absorbed by foreign loans, whilst those branches of economy which have the highest import-substitution potential remain without bank financing (as we saw in the example of agriculture).

We believe that a major cause of the absence of serious rural credit is the dysfunctional land market. Agricultural land is rarely used as collateral, and therefore is not capitalized. Thus, a huge amount of wealth is out of productive use. Moreover, the loan maturity is very limited; the average maturity of a loan denominated in the national currency is 14.2 months, which restricts the possibility of investing in long term projects and initiatives. Georgia still lacks indigenous engines of economic growth that could potentially absorb capital from banks as well as stimulate saving, and hence more foreign and domestic investment.

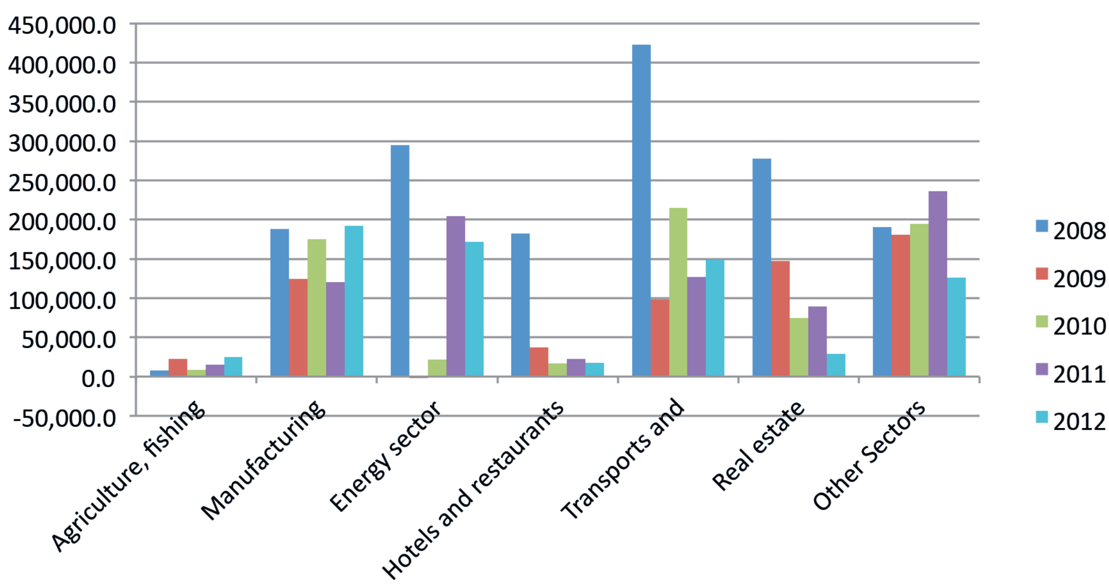
**Figure 2 Total loans issued by the commercial banks in 2012 by sectors (www.nbg.ge)**




Unlike remittances, FDI is vulnerable to shocks and economic downturns. The global financial and economic crisis that emanated from the west in 2008 was – according to the majority of international sources – the most severe for over 70 years.[2] In terms of global growth loss, it was significantly worse than the 1980's Latin-American debt crisis, the 1990's Asian financial crisis, and the decline that swept through the markets in the wake of 9/11. Amid the effects of the recession that followed was a substantial world-wide slump in FDI. Economic growth is one of the most important determinants of external investment – the slowdown of the world economy that proceeded 2008 reduced the attractiveness of crucial markets to foreign investors, which consequently reduced FDI flows.

In 2011, however, the United Nations Conference on Trade and Development (UNCTAD) reported an improvement in global trends: FDI rose by 17%[3], causing both UNCTAD and other International Economic Organizations (IEOs) to tentatively predict that the end of the global recession was on the horizon. Georgia followed this trend with FDI inflows growing 27% from the previous year.[4] In 2012, however, global FDI inflows fell again by 18%, while the transition economies of Eastern Europe, the Commonwealth of Independent States (CIS) and Georgia suffered a decline in FDI flows of 28%.[5]

**Figure 3 FDI by sector (mil. GEL) www.geostat.ge**




2 Onwuamaegbu, U; Sauvant, P (2011), "FDI, the Global Crisis and Sustainable Recovery", Transnational Corporations, UNCTAD: 20(1)
3 UNCTAD (2012), World Investment Report 2012: Towards a New Generation of Investment Policies;
4 The National Statistics Office of Georgia (2013), Foreign Direct Investments, accessed 19 March 2013, <http://www.geostat.ge/index.php?action=page&p_id=140&lang=eng>
5 UNCTAD (January 2013), Global Investment Trends Monitor, No.11

Not all sectors of the Georgian economy have been affected equally by the recent drop in FDI inflows. Figure 3 shows a significant increase in the *transport and communications*, and *manufacturing sectors*, up 18% and 59% respectively. Manufacturing maintained inflows throughout the post-crisis period, but FDI to the transport and communications sectors in 2012 was at just 35% of the level recorded in 2008. The *mining*, *real estate* and *consultancy* sectors have experienced the most significant drops, with each recording a more than 50% reduction in FDI from 2011 to 2012. Meanwhile, FDI directed towards the *real estate* sector in 2012 was just 10% of the figure recorded in 2008.

Given the sensitivity of FDI to global shocks and economic downturns, it would thus be easy to conclude that Georgia's declining FDI is the result of global trends; that, as UNCTAD proposes, as the more developed nations increasingly struggle, the transition economies have simply suffered from weak external demand.[6] One must not forget, however, that throughout the post-crises period, the impact of the downturn has been felt differently in developing, developed, emerging and transition economies. Growth in 2011 was largely universal, but 2012's FDI decline was unevenly spread. The reduction in global FDI inflows was largely isolated to the United States and those European countries most affected by the Eurozone crisis, which combined were significantly great alone to reduce the global aggregate figures. Meanwhile, and for the first time, the developing world's share of global FDI inflows exceeded that of the developed, and Georgia's neighbor, Turkey – the source of a large proportion of total remittances to Georgia – has recorded consistent increases in FDI inflows.[7]

Although the effect of global trends cannot and should not be dismissed, key influences remain unaccounted for: local and regional effects. A decade ago, IEOs including the International Monetary Fund (IMF) reported that despite strengthening its macroeconomic performance, low FDI inflows to Georgia and the Caucasus region reflected a weak investment climate due to a lack of structural reforms.[8] Of particular concern were the region's demanding tax systems, widespread corruption, unnecessary state intervention, poor regulatory framework, and weak legal structures. According to the World Bank and International Finance Corporation's (IFC) *Ease of Doing Business Index*, however, Georgia has made remarkable improvements in all the above over the last ten years.[9] Although Georgia would benefit from further institutional improvements, we must look elsewhere to understand why the economy experienced a drop in FDI during 2012.

While many empirical analyses have established (by and large[10]) that institutional factors such as those mentioned above greatly influence FDI inflows, less attention has been given to the literature that concentrates on

6 Ibid
7 Ibid
8 Campos, N; Kinoshita, Y (2003), "Why Does FDI Go Where it Goes? New Evidence from the Transition Economies", IMF Working Paper, No.228; Shiells, C (2003), "FDI and the Investment Climate in the CIS Countries", IMF Policy Discussion Paper, No.5
9 The World Bank; IFC (2013), Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises, Washington, DC: World Bank Group
10 For a critique of the literature, see: Blonigen, B; Piger, J (2011), "Determinants of Foreign Direct Investment", NBER Working Paper, No.16704

the relationship between *political risk* and *investment decisions*.[11] Several of the transition economies of Eastern Europe and the CIS have experienced a great improvement in FDI inflows throughout the past decade. Meanwhile, other countries in the region – specifically those whose democratic evolution has remained unsettled, bringing into doubt the stability and effectiveness of their governments and the prospect of social unrest – have been generally ignored by foreign investors.

All investment, FDI included, is a forward-looking activity, and is founded on investors' expectations about future returns and the confidence that they can place on those returns. Therefore, the decision to invest in an economy almost always involves an evaluation of the political future of the country in question. Political instability in the host country means that there are two principle risks that an investor will have to factor into their cost-benefit analysis, each of which is particularly important in transition economies.[12] The first is that internal instability or regional conflict may reduce the profitability of operating in an affected country, either because sales and exports are in danger, production is disrupted, or resources are damaged. The second result is that political instability is likely to decrease the value of the affected country's domestic currency, consequently reducing the value of the assets invested in the country's economy as well as of any future profits that the investment could be expected to produce.

Thus it can be concluded that alongside the decrease in the availability of FDI stock on the global market, uncertainty regarding Georgia's political future caused by 2012's eventful elections and unfriendly relations with Russia, has made potential investors more cautious. The assumption becomes even more accurate if we take into account that the FDI inflow has particularly decreased in the third and fourth quarters of 2012. Given that, according to UNCTAD, international investors are holding back huge sums of cash holdings,[13] it can be assumed that FDI inflows will be gradually restored after October's presidential election – assuming that further political instability is not provoked, and that investors are given no reason to doubt the competency of the new regime and thus the future strength of the Georgian currency.

However, international investors are unlikely to convert available cash into new and sustained FDI while the international financial markets remain unstable and Georgia's future remains uncertain. FDI inflows will largely depend on how soon the global economy recovers from recession and how successfully the government maintains and strengthens Georgia's hitherto effective investment policies. Fortunately, the newly elected government has recognized the role of FDI in the economic development of the country and has expressed

11 For example: Haksoon, K (2010), "Political Stability and Foreign Direct Investment", International Journal of Economics and Finance, 2(3); Busse, M; Hefeker, C (2007), "Political Risk, Institutions and Foreign Direct Investment", European Journal of Political Economy, 23(2); Carmignani, F (2003), "Political Instability, Uncertainty, and Economics", Journal of Economic Surveys, 17(1)

12 Brada, J; Kutan, A; Yigit, T (2005), "The Effects of Transition and Political Instability on Foreign Direct Investment in ECE Emerging Markets", UNECE Publications

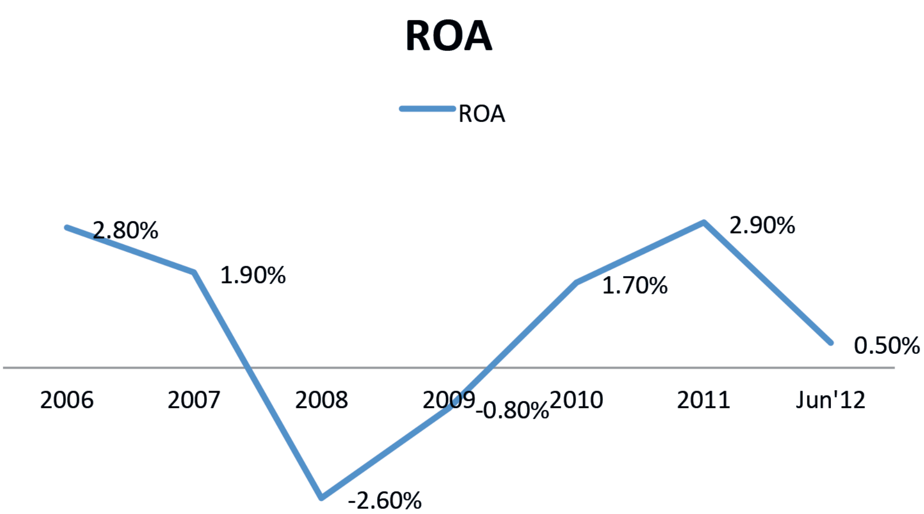
13 UNCTAD (2012), World Investment Report 2012: Towards a New Generation of Investment Policies

14 Cabinet of Georgia (2012), The Government Program, accessed 20 March 2012, <http://government.gov.ge/files/68_35092_403443_programa.pdf>

its readiness to provide support through investment protection measures and the creation of a stable and predictable business environment.[14]

Something that investors look at when planning to invest in a country is return on assets, which indicates the efficiency of management in transforming assets to generate earnings. It is calculated by dividing earnings by its total assets; the higher the number the better, because the company is earning more money on less investment. As can be seen (f. 4), the country was doing better at converting its investment into profit in 2011, although is currently worse off compared to previous years, with an ROA of 0.5%.

**Figure 4 Return on Assets (12%) www.imf.org**

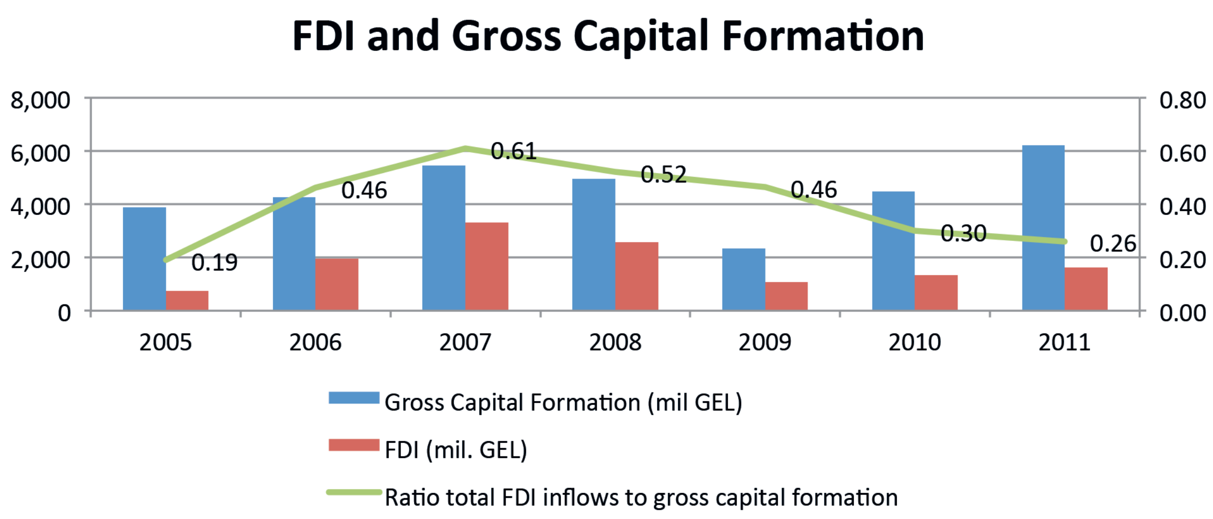



The Georgian Ministry of Finance has given a very positive prognosis regarding future FDI inflows into the country; according to the Minister, FDI inflow will equal around 2 billion USD[15], gradually converging to the level recorded in 2007 – i.e. more than double compared to 2012. Attainment of the pre-crises peak level of FDI will largely depend on how soon the global economy recovers from recession and how successfully Georgia continues its open-door policy towards FDI.

15 http://24saati.ge/index.php/category/news/2013-03-13/36432.html
16 UNCTAD (2012), World Investment Report 2012: Towards a New Generation of Investment Policies

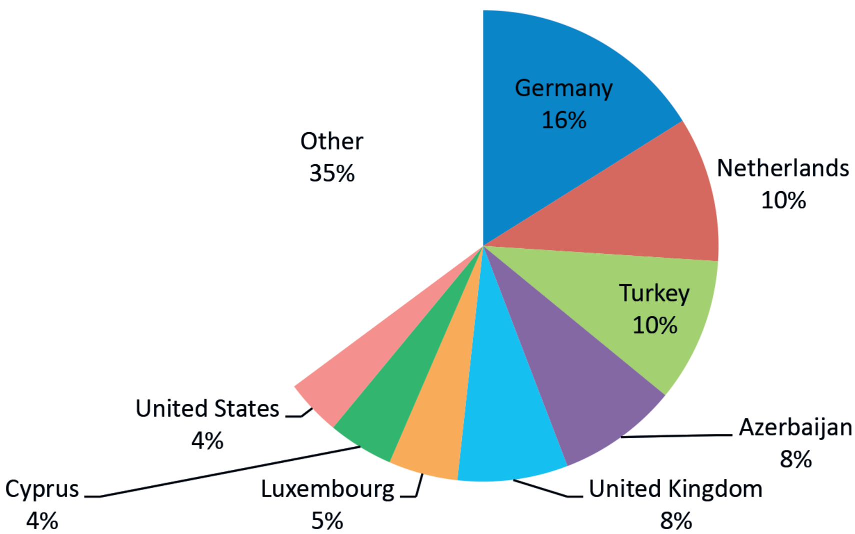
We should not be too quick, however, to assume that the historic 2007 pre-crises peak (see f.1) can be recreated. According to UNCTAD[16], ever greater numbers of less-developed states are implementing FDI-friendly policies, significantly increasing the degree of competition among countries striving to increase FDI inflows. Georgia will thus have to apply significantly more aggressive investment promotion policies; there is still no guarantee, however, that FDI can be restored whilst the west remains in recession. In the meantime, the lower level of FDI might encourage an increase in domestic savings to supplement gross capital formation, which is positively correlated with the volume of FDI in the economy (f.5). If the capital inflow decreases and the aggregate demand on money holds or increases, the price will increase in turn, incentivizing domestic savers.

**Figure 5 FDI and Gross Capital Formation. www.geostat.ge**




Furthermore, Georgian FDI is heavily reliant and one-off, large-scale investments. Figure 6 suggests that Germany is a principle contributor of FDI, but this has not been the case in previous years. Between 2005-2011, Germany's yearly average investment in the Georgian economy was 26mil. USD, just 18% of the 142mil. USD of German FDI recorded in 2012. In 2011, 50% of FDI originated from just 4 sources, in 2010 49% originated from 5, and in 2009 56% originated from 4. In each case a single large-scale investment made up a substantial amount total FDI inflows. For example, in both 2011 and 2009, just one country of origin accounted for 22% of total FDI inflows, Netherlands and United Arab Emirates respectively. The Netherlands, Azerbaijan, Turkey and the United Kingdom are all relatively consistent sources of FDI, but although the contribution of each has rarely dipped below 5% of the total, their contributions vary wildly from year to year. For example, FDI originating from the UK has followed the general trend, hitting its peak in 2006 with investments to the value of 187mil. USD, before a sharp drop in 2009, and settling to a steady average of 59mil.USD between 2010-2012. Meanwhile, the quantity of FDI inflows originating from the Netherlands follows no such observable trends, with contributions in excess of 250mil.USD dollars in both 2007 and 2011, and an incoherent spread ranged between 18mil. and 136mil.USD in all other years from 2006 until the present.[17]

**Figure 6 FDI by country of origin (mil. GEL) 2009-2012 www.geostat.ge**




On the one hand, these large-scale investments leave the statistics vulnerable to fluctuations due to the impact the loss of a single large investment could have. On the other hand, they have largely resisted the declining trend, suggesting that it is the smaller, more consistent investments that Georgia has failed to attract in this and recent years.

17 The National Statistics Office of Georgia (2013), Foreign Direct Investments, accessed 19 March 2013, <http://www.geostat.ge/index.php?action=page&p_id=140&lang=eng>

# Overview of Georgia's Economy

## Gross Domestic Product

The economic outlook of Georgia and the region as a whole remains favorable, in line with the slow recovery from the global financial crisis. Macroeconomic developments have been positive and inflation has subdued. Economic slow-down paired with a decrease in investments was observed due to post-election uncertainty. Therefore, the new government faces the challenge of mobilizing private sources of financing, since the availability of an external pool of resources is limited. In order to mitigate the uncertain external environment the government of Georgia has signed a precautionary agreement with the IMF enabling the country to have access up to 400 million USD in the case that there is a sudden necessity for funds[18]. Reducing Georgia's persistently high current account and fiscal deficit still remains a major macroeconomic challenge. A number of international financial institutions have recommended that the government undertakes fiscal consolidation and structural reforms to increase the country's competitiveness and thus overcome the aforementioned challenges. The process of fiscal consolidation has started: as of 2012 the consolidated budget deficit amounted to 2.9%, and it is promised that the deficit will further decrease to 2.8% in 2013[19].

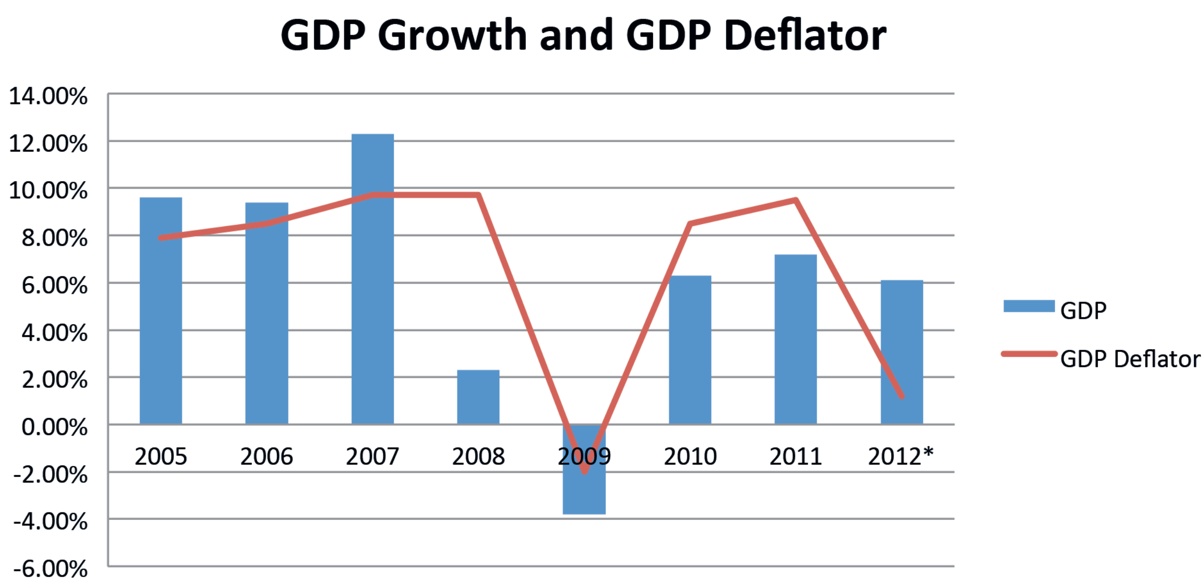
At the same time, in order to meet its pre-election promises the government has increased social spending for the most vulnerable. The government also plans to foster agricultural development in order to provide more inclusive growth; in order to fulfill this plan, however, an increased investment in the field is needed. This paired with the renewed social obligations might mean that the government will need to increase budgetary revenues. In light of the promise of a possible normalization of trade relations with Russia, an increase in exports might take place. Although, the ongoing Eurozone crisis, as anticipated, has had negative spillovers to Georgia, expressed mostly in the decreasing growth rates of exports.

Projected average growth for the year 2012 was 5.5%[20]; according to the preliminary data provided by the National Statistics Office of Georgia (GeoStat), however, real GDP growth for 2012 was 6.1%, with a low 1.2% GDP deflator. Nominal GDP for 2012 was 26,138.9 million GEL, which in nominal terms represents a 7.4% increase compared to the previous year. GDP growth is slightly the 6.5% growth for the year 2012 initially projected by the IMF. Real GDP growth is expected to be 5.5% in 2013.

18 http://www.imf.org/external/np/sec/pr/2013/pr1375.htm
19 www.mof.ge
20 IMF Regional Economic Outlook. Nov. 2012

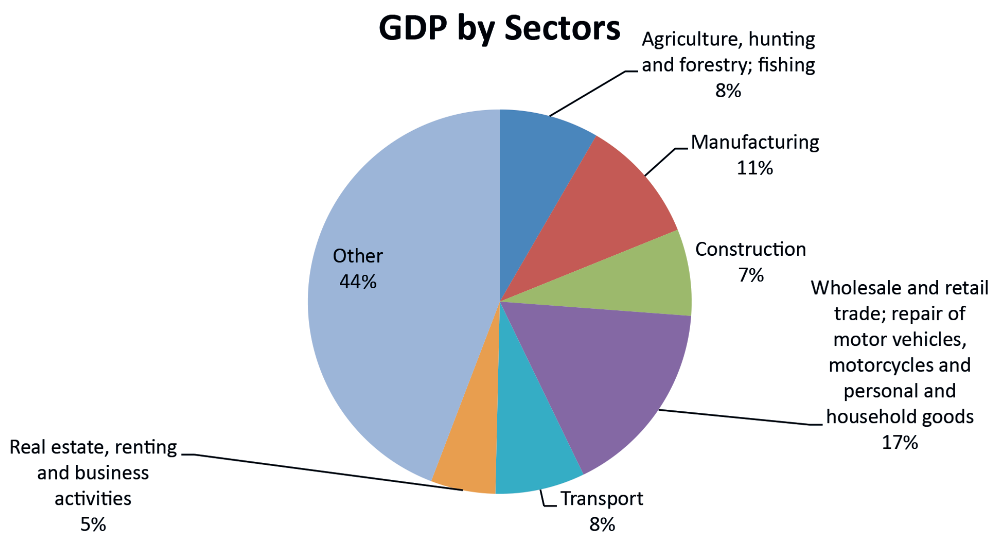
In terms of contributing sectors, the structure of Georgia's GDP is basically unchanged from previous years. The largest contributor (with 17% of total GDP) is still trade, followed by the manufacturing sector. In nominal terms, the largest growth was observed in the sectors of financial intermediation (18.1%), construction (16%), and manufacturing (13,1%). Agriculture is the largest employer but it still only comprises 8% of GDP. Agricultural production accounts for 45% of rural household income, and subsistence agriculture accounts for 73% of rural employment. The poor performance of the sector has been reflected in the deepening of the agricultural trade deficit. Major problems in the sector include low investment due to highly fragmented land, high transport costs, poor road connectivity to markets and poor infrastructure[21].

**Figure 7 GDP and GDP deflator www.geostat.ge**




21 World Bank – Georgia Partnership Country Program Snapshot. October 2012. http://www.worldbank.org/content/dam/Worldbank/document/Georgia-Snapshot.pdf

**Figure 8 GDP by Sectors (2012) www.geostat.ge**




Recently, the size of the unobserved economy has generated interest among policymakers. According to the IMF, as of 2008 the size of Georgia's informal economy was equivalent to almost 30% of GDP, although the figure is believed to have decreased to 20%. Naturally, the large size of the unobserved economy harms public finances, since the activities are informal and thus evading taxation. The principle reasons for the existence of the informal economy in Georgia are believed to be the regulatory burden surrounding the financial and goods markets, and in particular difficulties in the credit market and the registration of property. Other determining factors identified by IMF include existing monopolies, lack of free competition, and market dominance. These drivers are believed to be responsible for more than 40 % of the size of the informal economy[22].

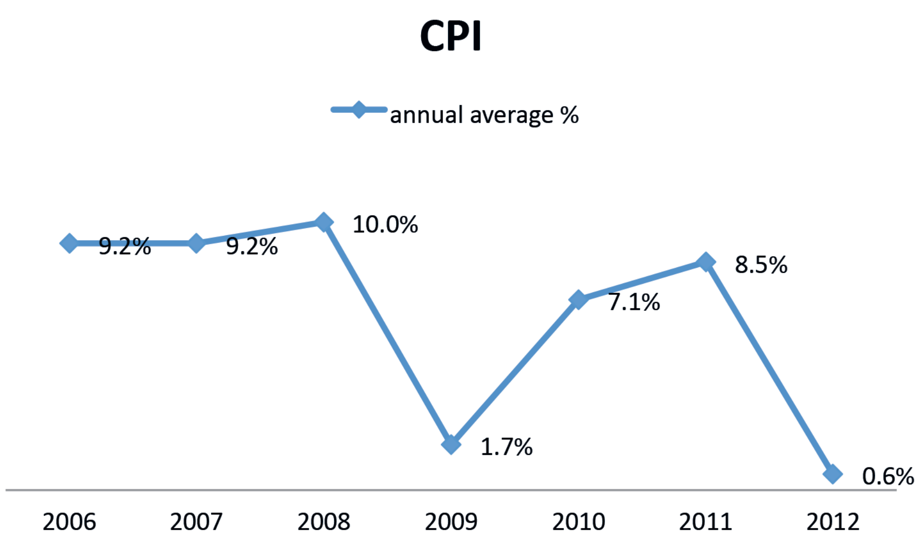
In order to decrease the barriers to businesses, recommendations provided by IMF include not only creating simplified and less costly business and tax regulations, but also establishing a fair environment for enforcing these regulations, i.e. overcoming favorable treatment to particular businesses, providing a fair playing-ground for all. Recently, the lack of the above has been a major issue of discussion in Georgia; in their pre-election campaign, the newly elected government highlighted the problem of elite corruption and the country's unfair and uncompetitive business environment. Therefore, allowing all firms and workers to compete on a level playing-field will not only foster growth in domestic businesses, but will also be conducive to attracting further investment.

22 IMF Regional Economic Outlook. April 2012.

## Consumer price index

After its 2011 peak, Georgia's headline inflation eased in 2012 and was maintained below the targeted 6%. The annual inflation rate equaled as low as 0.6% (f.9). According to NBG and the IMF this was due to the supply factor, such as abundant local harvests in 2011 and a decrease in global food prices in the first half of 2012 (f.10)[23][24]. At the same time, weakened economic activity in 2012 created no demand side pressures, thus bringing inflation further down. Average inflation is projected to rebound in 2013, as a result of a forecasted increase in global food prices that will eventually spill over to local food prices. Georgia is characterized by a high pass-through of global commodity prices. Food inflation in Georgia peaked at 30.7% (year-on-year) in May 2011, which was among the highest in the world[25].

**Figure 9 annual inflation rates (2006-2012) www.nbg.ge**




23 IMF Regional Economic Outlook. Nov. 2012
24 NBG Inflation Report. February 2013. http://www.nbg.ge/uploads/publications/inflationreport/2013/ir_2013q1_publish_eng.pdf
25 World Bank – Georgia Partnership Country Program Snapshot. October 2012. http://www.worldbank.org/content/dam/Worldbank/document/Georgia-Snapshot.pdf

**Figure 10 FAO food price index (2009-2012) www.fao.org**


NBG projects that inflation will be maintained below the target level of 6% in the beginning of 2013 in line with the decreased prices on utilities. Starting from the second half of 2013, however, increased economic activity means that the inflation rate will gradually increase and eventually converge with the target level in the second half of 2014[26]. Due to weakened economic activity, and based on its prognosis and macroeconomic analysis, NBG is trying to stimulate the economy by easing the refinancing rate to 4.75% as of February 2013.

26 NBG Inflation Report, February 2013. http://www.nbg.ge/index.php?m=349

Refinancing rate is the primary tool of the monetary policy. The change in the interest rate is transmitted into the economy through market rates, exchange rate and credit activity, thus influencing the aggregate demand. Changes in the monetary policy are transmitted to the economy with a certain time lag, therefore full effects have not been reflected yet.

Inflation had a decreasing trend in most of the Eurozone and Organization for Economic Co-operation and Development (OECD) countries, and thus central banks have pursued accommodative monetary policies and maintained low interest rates, together with experimental programs designed to decrease rates in particular markets, and to help particular categories of borrowers or financial intermediation in general[27]. Oil prices have not changed dramatically from the end of 2012 up to the beginning of 2013. Notwithstanding unrest in the east, the overall oil supply has increased due to an increased supply coming from the USA and Canada.

## External Sector

Overall, international organizations have given positive economic projections for 2013. The large current account deficit (f.13 - currently equal to 21.1% of GDP), however, and uncertainties associated with the political transition are identified as the strongest risks for the country. According to the IMF, Georgia's elevated current account deficit is partially due to an appreciation of GEL exchange rate (f.11) which has caused a surge in imports and further deteriorated the country's trade balance to -5465 million USD (f.12) – equal to 24.9% of the country's GDP (f.13), the highest recorded since 2007. Demand for the local currency may have increased due to a record high growth in the volume of remittance inflows, which are eventually exchanged into the local currency for consumption. With the limited availability of FDI, these financing gaps will be covered by increasing external liabilities, which are already quite high; as of now state debt of Georgia is equal 36.3% of GDP (f.13).

On the other hand, the corporate sector initiated three Eurobond issuances in 2012: 250 million USD by Georgian Oil and Gas Company, 500 million USD by Georgian Railway Company, and 250 million USD by the Bank of Georgia. As a result, the total external debt is expected to reach 9.7 billion USD in 2012, 59.1% of GDP[28].

A future deterioration of the global economic outlook could be negatively reflected in exports, FDI and other capital inflows that support growth in Georgia. Therefore, fiscal consolidation is believed to be necessary for creating additional fiscal space for repayments in response to a wider global shock. Implementation of further fiscal consolidation will require skillful management to correctly balance infrastructural development and social expenditure needs.

27 IMF. World Economic Outlook. October 2012. http://www.imf.org/external/pubs/ft/weo/2012/02/index.htm

28 World Bank – Georgia Partnership Country Program Snapshot. October 2012. http://www.worldbank.org/content/dam/Worldbank/document/Georgia-Snapshot.pdf

**Figure 11 Official Exchange rate. www.nbg.ge**

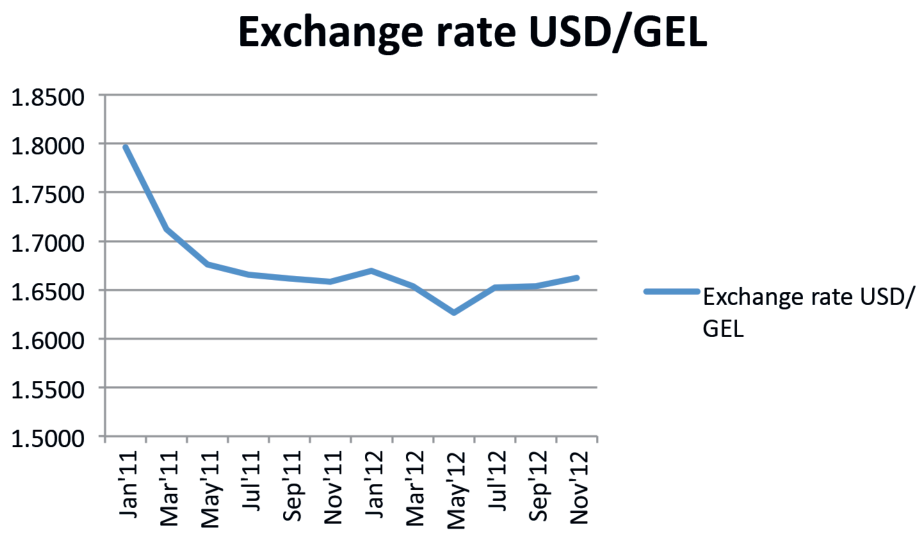



**Figure 12 Trade Tendencies 2007-2012 www.geostat.ge**

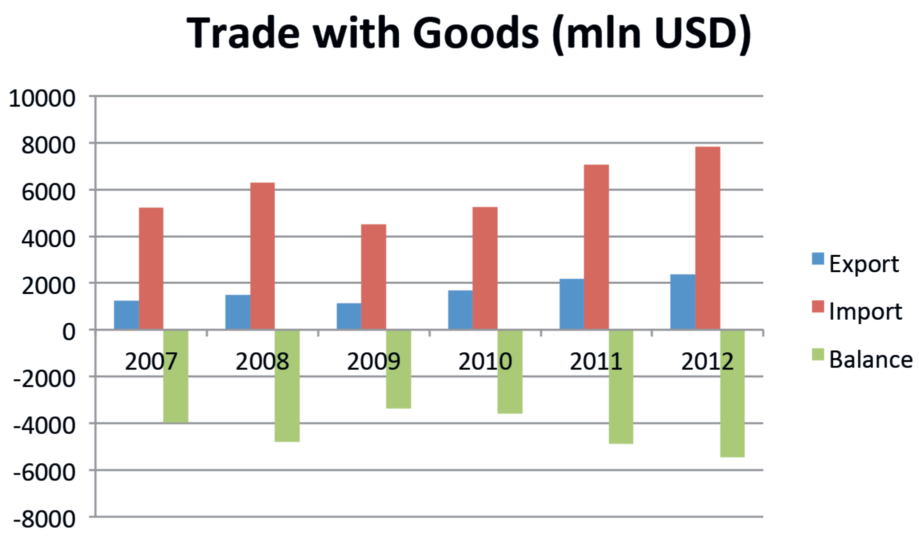
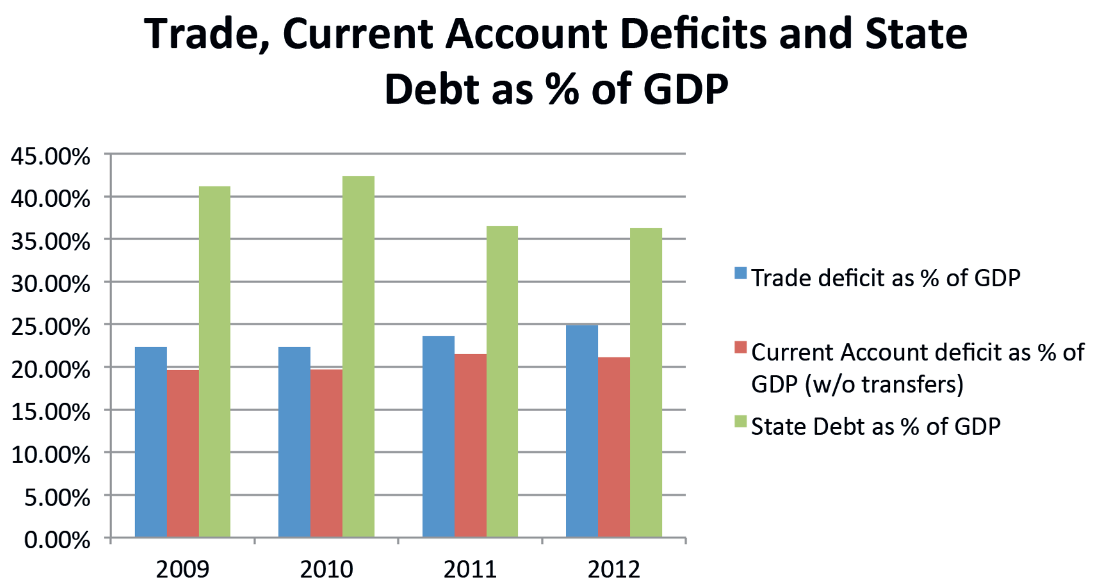
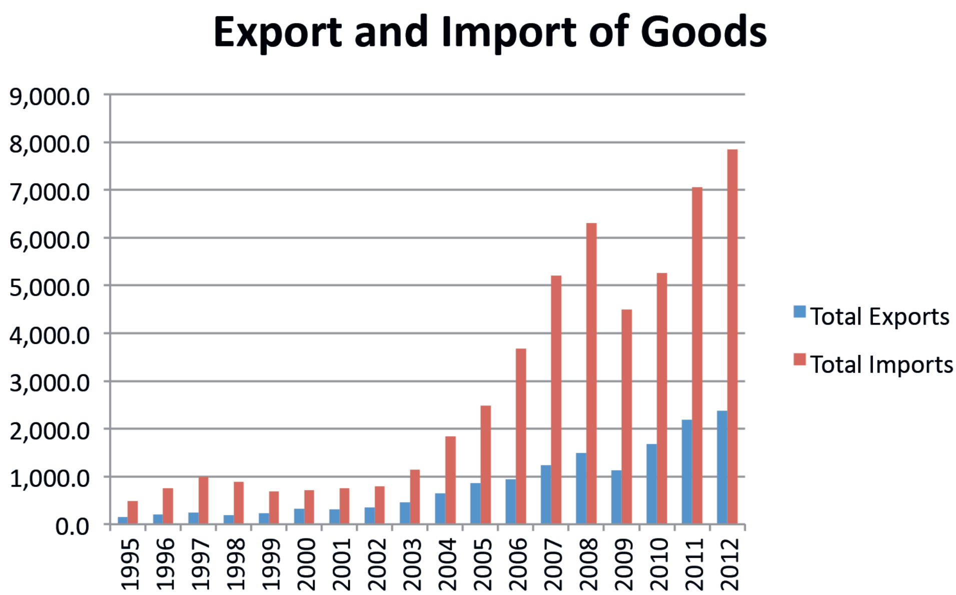


**Figure 13 Trade, Current Account Balance Deficits and State Debt as % of GDP www.mof.ge**




In 2012, both imports and exports continued their trend of recovery after the 2008/2009 economic downturn (f.14). The balance of Georgia's current account (the difference between exports and imports), however, continues to be in substantial deficit, suggesting that – remittances aside – significantly more value may be flowing out of the country than flowing in. Although Georgian exports have increased sevenfold since 2000 in line with the country's remarkable GDP growth, the disparity between total exports and total imports has increased fourteen-fold over the same period. In 2012, inflows of goods and services were 5464mil.USD greater in value than outflows (2377 mil. USD exports vs. 7842 mil. USD imports), representing a significant economic burden.

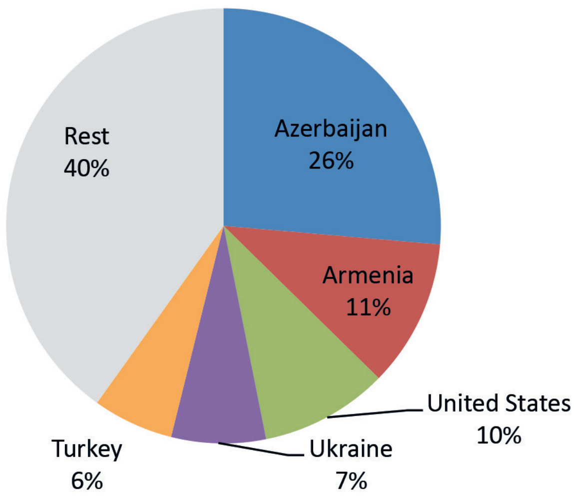
**Figure 14 Total exports and Imports (mln. USD) 1995-2012 (www.geostat.ge)**




Georgia has made some progress in the last 4 years to find new markets for its exports, but continues to largely rely on a handful of local countries. In 2012 (f.15), 54% of Georgian exports were destined for just 5 countries (Azerbaijan, Turkey, Armenia, Kazakhstan, and the United States), only one of which (the United States) was from outside the local region. This is only a single country better than in 2009, when 53% of Georgian exports were transferred to just 4 countries (Turkey, Azerbaijan, Canada, and Armenia). Azerbaijan and Turkey have remained Georgia's most significant trade partners, together accounting for on average of 28% of Georgia's exports since 2005. Exports to Turkey as a percentage of the total have dwindled in recent years from a height of 20% in 2009, down to just 6% in 2012, whilst exports to Azerbaijan have followed a reverse trend – accounting for 26% of Georgian exports in 2012, up from just 4% in 2005.

A portion of Georgia's export growth between 2009 and 2012 came from an increase in exports to established trade partners such as Azerbaijan, but the majority of the rise has been due to expansion into new markets. The number of countries receiving 1-4% of Georgia's total trade outflows has increased significantly – just 3 in 2009, and 9 in 2012 (f.15) – while the absolute value of exports to the majority of Georgia's established trade partners has remained relatively stable.

**Figure 15 Exports by country 2012 (www.geostat.ge)**




While some success has been achieved in this regard, Georgia must radically diversify and expand its export portfolio if the remarkable growth levels it has recorded over the last decade are to be sustained, the intrinsic value of Georgia's economy is to be solidified, and a greater equilibrium in the credit account is to be achieved. Various policies and improvements could and should be investigated for their feasibility in the Georgian context. To enable the expansion of Georgian exports into new markets, particularly large and wealthy importers in the west, strict controls should be introduced to improve the quality of Georgian exports relative to the international standard. Due to financial constraints, however, in many cases entrepreneurs are not able to set up their own means of quality control. India has had great success establishing regional testing centers in economically key geographical areas to provide general and product-oriented testing facilities for mechanical, chemical and electrical products.

When it comes to exporting agricultural produce lack of standards, phyto-sanitary and plant protection measures, livestock disease controls are a major challenge that limit the export potential of the country. The government's initiatives to revive this sector by directing additional finances might have a positive impact– it is important to ensure public investment in commercial activities to stimulate rather than crowd-out private investments.

Exports to Russia (f.16) have begun to pick up in recent years after their slump from 2006 (8% of total exports, down from 18% in 2005). This trend continued through to 2012 in absolute numbers, but trade embargos and frosty relations prevent Georgia from fully utilizing this potentially significant market. The 46mil.USD worth of exports to Russia in 2012 is still far away from the 154mil.USD achieved in 2005. In December 2012, Russian President Vladimir Putin said that trade ties between Georgia and Russia should be "de-politicized", and that the re-entry of Georgian products to the Russian market was now only a matter of technical procedure. Little progress has been made since, however, despite talks at the beginning of February of this year indicating that Russia may soon lift its ban on Georgian wines and mineral waters.

**Figure 16 Exports to Russia in mln USD 2000-2012 (www.geostat.ge)**

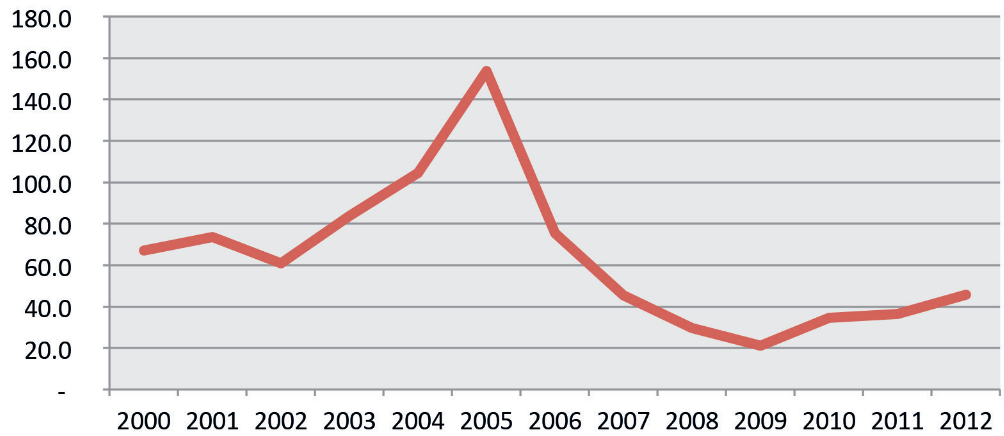
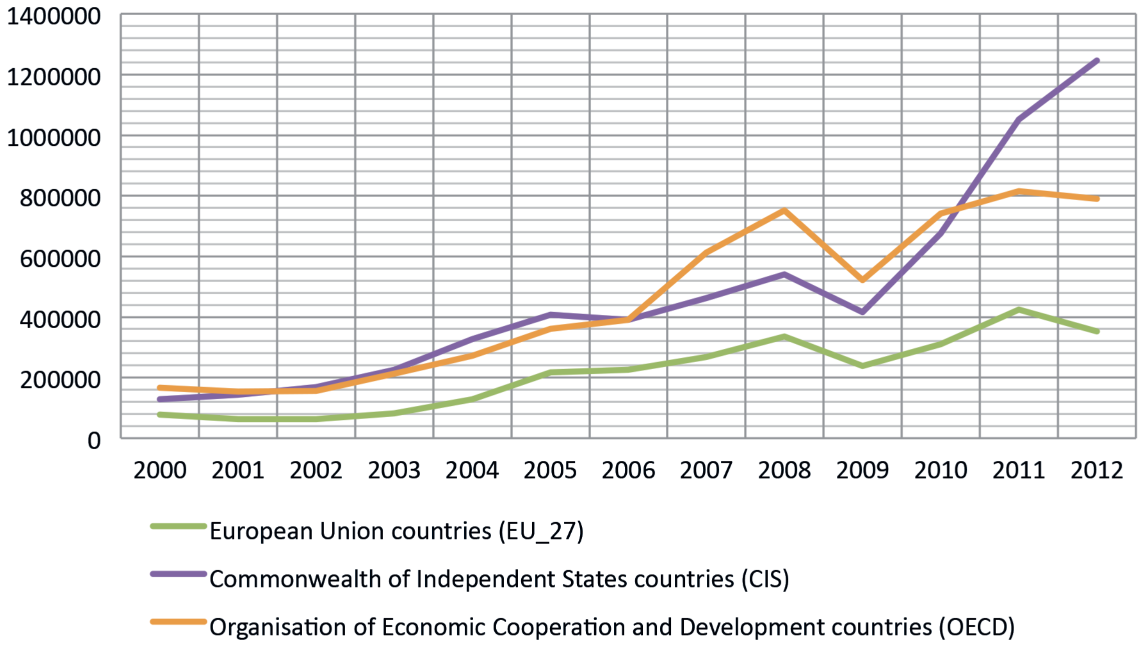



Figure 17 shows a decline in exports to the EU and OECD countries between 2011-2012. The pronounced decline in exports to countries of the EU in particular (and the OECD more generally) is the result of the Eurozone crisis, which through declining imports and investment has affected the growth of numerous developing and emerging economies. Despite repeated interventions by the European Central Bank (ECB) to recapitalize the banking systems of the affected economies of Italy, Spain, Ireland, France and Greece, the last quarter of 2011 saw the crisis enter a new and particularly dangerous phase.

The slight leveling off of the steep rate of growth of exports to CIS and BSEC countries experienced after 2009 can also be explained by the Eurozone crises. Bank funding evaporated in the Eurozone in the first quarter of 2012, causing lending conditions to deteriorate across a number of advanced economies which in turn affected the capital flows to emerging and developing countries in general – including CIS and BSEC countries – significantly depreciating the currencies of many emerging markets. Even though it's relative importance has declined over time with the rapid increase in export shares to Brazil, Russia, India and China (the BRICs), the EU remains one of the largest single trading partners for lower, lower middle, and middle-income countries.

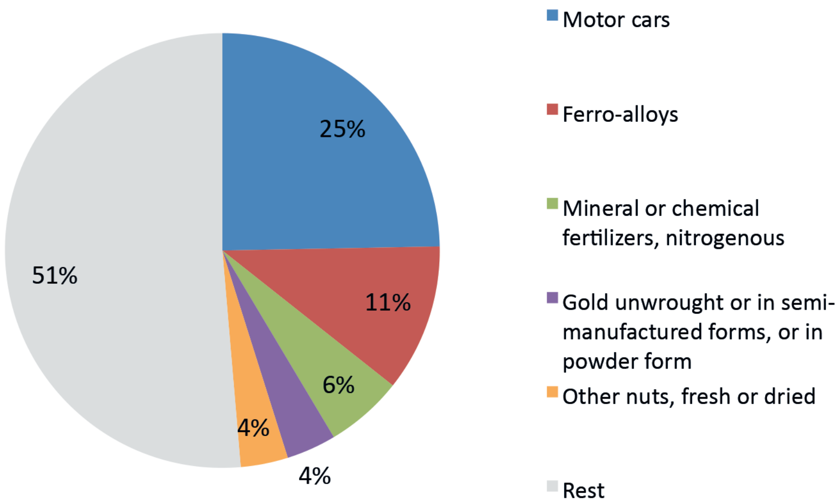
**Figure 17 Exports by country group thsd USD 2000-2012 www.geostat.ge**




That the Georgian economy has not been more affected by the crisis is a testament to the country's reliance on a small number of local economies for the majority of its exports, and relatively low dependence on trade as a source of growth. Nevertheless, Georgia would be extremely vulnerable to a downturn in the Caucasus and the immediately surrounding region. If through its trade relations within the Eurozone, Turkey (for example) finds itself adversely affected by the crisis, this could have serious ramifications for Georgia's current account and over-all growth.

It is difficult to predict how future fluctuations in consumer demand will affect Georgian exports. Products with a low degree of elasticity to consumer demand, such as necessities, may experience less of a slow-down relative to more luxury types of goods which have a higher elasticity. The majority of Georgia's most significant exports (f.18), however, reside on the border between "necessity" and "luxury", which while on the one hand imbues Georgian exports with a degree of strength, they are by no means invulnerable to further downturns in demand.

**Figure 18 Exports by Product 2012 (www.geostat.ge)**

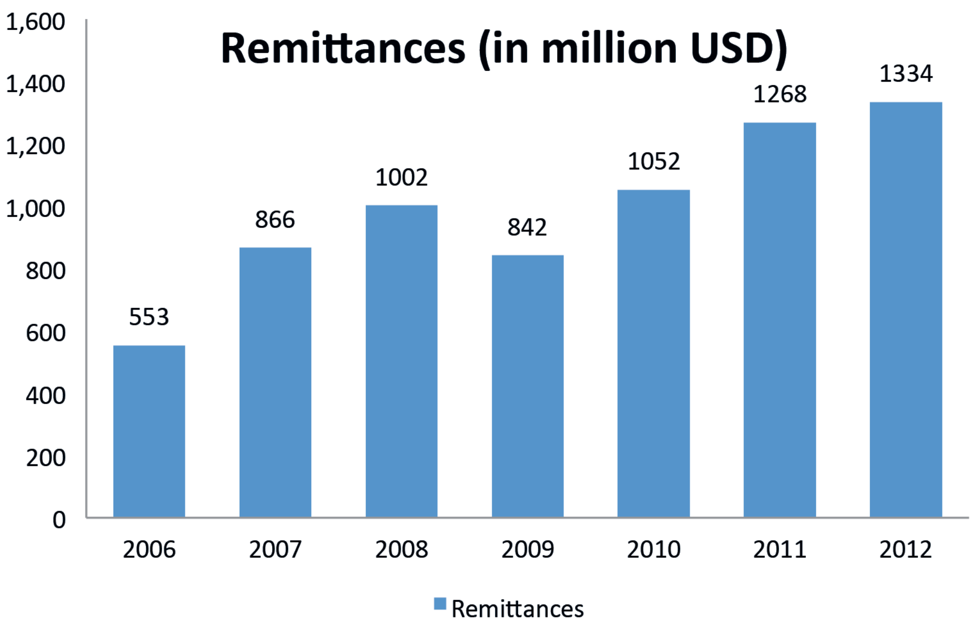



Perhaps Georgia's greatest weakness in regards to exports is its heavy reliance on a few key product sectors. In 2012, motor cars and ferro-alloys continued to be far and away Georgia's largest exports; the exportation of motor cars, ferro-alloys and ferrous waste and scrap has accounted for around 1/5$^{th}$ of Georgia's annual exports since 2009. In 2012 the exportation of motor cars alone accounted for a quarter of all exports, to the value of 588mil.USD. This figure is, however, expected to drop substantially in 2013. Georgia does not have a car manufacturing industry, instead its automobile export figures represent the re-exportation of cars bought in Europe and elsewhere and then sold on to countries in the local region where demand for quality vehicles is high. In 2011, Kazakhstan – where re-exported cars are particularly sought after – strengthened its customs regulations to prevent the massive influx from Georgia, which were seen as a burden on the Kazakhstani economy. In response to the impending increase in import tax, demand in Kazakhstan soared; automobile exports will only maintain the levels achieved in 2012 until the regulations come into effect.

Although the re-exportation of cars requires little startup capital and minimum overheads, profit margins are substantially smaller and job creation minimal. Therefore, the figures given for car exports may paint and exaggerated picture of the industry's contribution to Georgia's economy. Georgia's negative current account balance may, therefore, represent an even more substantial burden on the economy that figures initially suggest.

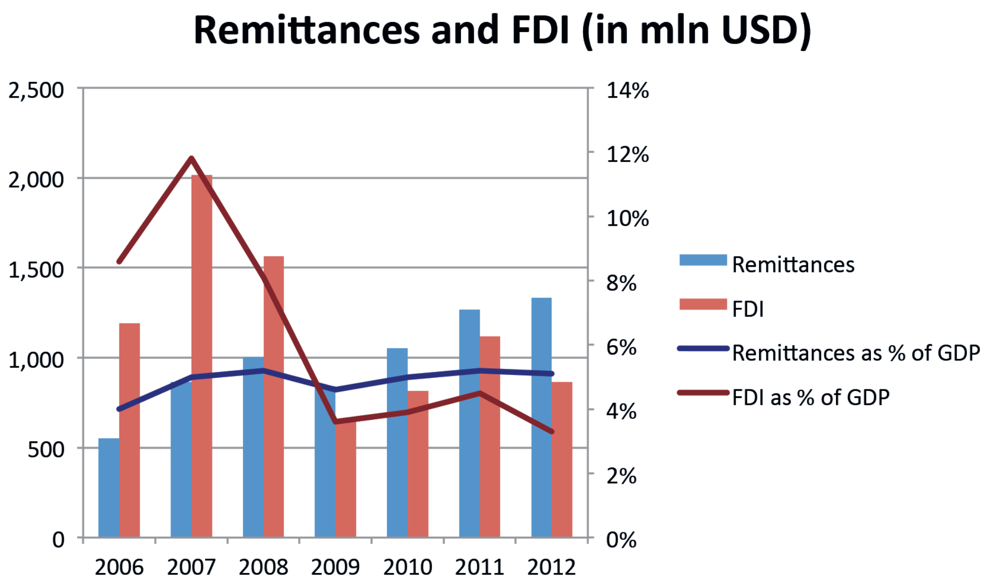
Remittances still remain one of the most stable external sources of financing. Unlike FDI, remittances are believed to be resistant to economic slowdowns and are far more stable sources of external financing. In the graph (f.19) we can observe a slight decrease in the volumes of remittances in 2009, although it was temporary and the volumes are now recovering. A record high inflow of remittances 1,334.17 thousand USD was detected in 2012, in that particular year remittances outpaced FDI inflow by as high as 64%. Absolute majority of remittances, i.e. 747.4 million USD (60%) comes from the Russian federation. Notwithstanding the Eurozone crisis, Greece and Italy are still second and third largest remittance senders, with the share of 10% of total remittance inflow.

**Figure 19 Remittances www.nbg.ge**




In the conditions of declining FDI, remittances provide a steady stream of foreign currency to Georgia, as a matter of fact, the tendency observed up to 2009, has reversed, and remittances outpace FDI for the last 4 years already, moreover, the largest gap between them was seen in 2012 (f.20). Even though 2012 was characterized by the record high inflow of remittances, their share as a percentage of GDP has actually declined slightly, the share ranges steadily between 4-5%. The same cannot be said about FDI, which is far more volatile when it comes to its share to GDP this year hits at record low – 3.3%, whereas in 2007 FDI was as high as 11.8% of the country's GDP.

**Figure 20 FDI and Remittances (2006-2012) www.geostat.ge; www.nbg.ge**



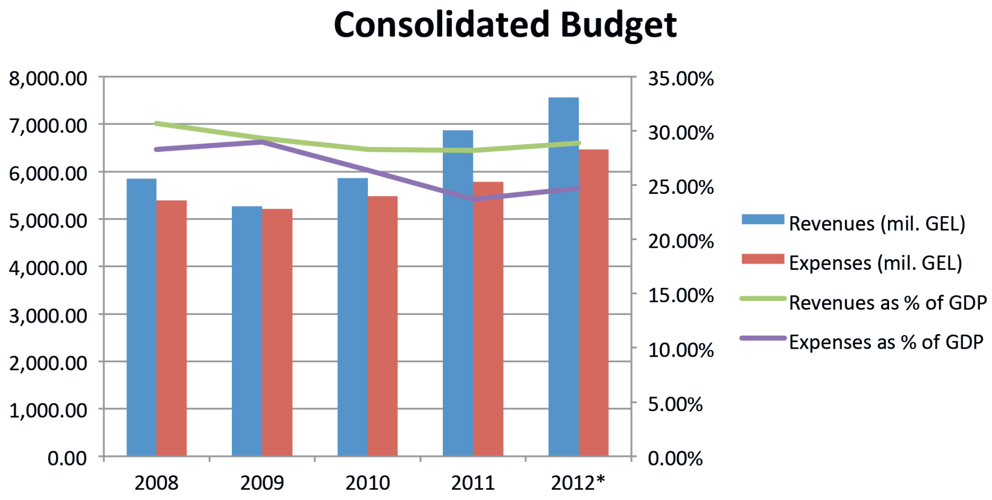

## The state budget in the context of economic development

According to preliminary information for the year of 2012, total revenues of the consolidated budget amounted to 7,565.7 million GEL, a moderate 10% increase compared to 2011 and equal to 28.9% of GDP (which represents just a 0.7% increase). The increase in budgetary revenues was more significant in 2011, when it constituted 17%. The projected figure for total expenditure is 6,462.8 mln GEL, a considerable increase compared to the last year (11%) and equal to 24.7% of GDP (1% increase) (f.21).

The government of Georgia is maintaining that expenses' share of GDP share will not exceed 30%. The trend shown in the figure below is a gradual decrease in expenses as a percentage of GDP, and an increase in revenues as a percentage of GDP (although 2012 is an exception in this case, when a slight increase in expenses as a percentage of GDP was observed). In theory, as well as according to the empirical literature, the total volume of government operations reaches its maximum efficiency level at around 13-14% of GDP[29]. Afterwards, each incremental percentage of government expenses as a percentage of GDP results in a 0.1-0.4% deceleration in economic growth rate. After budget expenditures reach 30% of GDP, the implications for growth are negative, i.e. a marginal increase of government expenses does not positively affect growth.

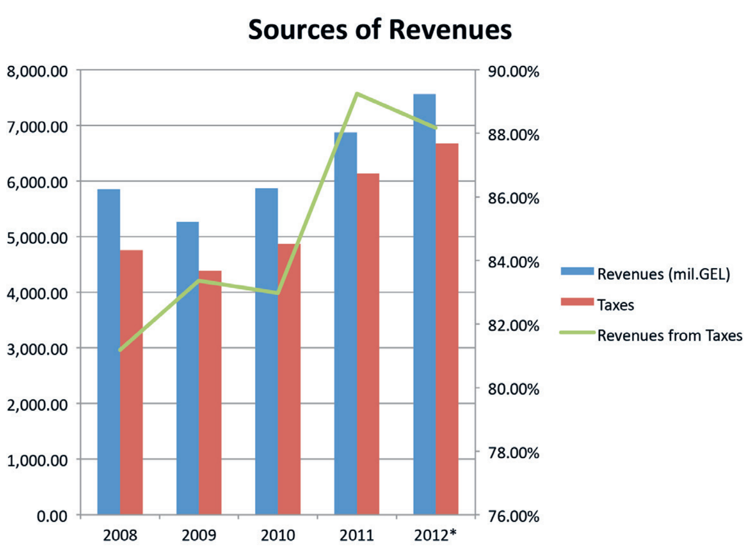
29 Pevcin, P., Government Activities and their Impact on Economic Growth
http://archive.scottish.parliament.uk/business/committees/enterprise/inquiries/bg/30%20Sup%20Evidence.pdf

**Figure 21 Consolidated Budget www.mof.ge**



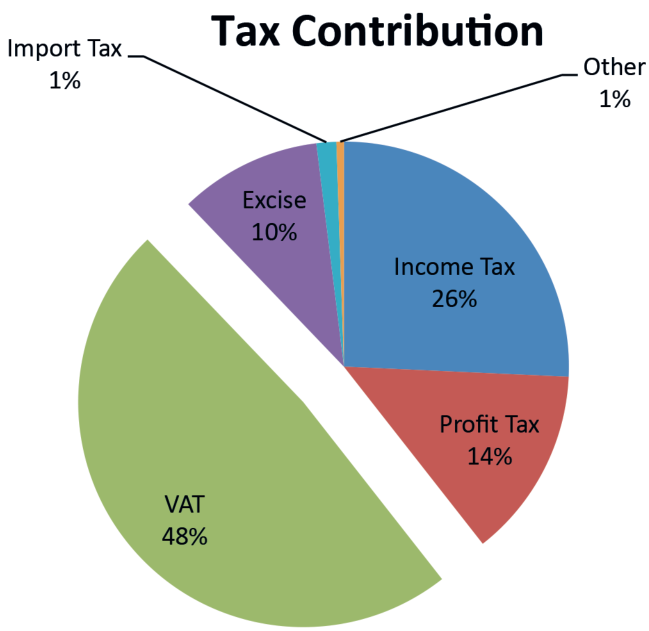

As to the sources of revenues for the consolidated budget 2012, roughly 88% of them derive from taxes (f.22). As we can see from the graph, the share of taxes as a percentage of total revenues has been increasing in Georgia since 2007, the year 2012 is an exception in this regard since a slight decrease of tax revenues are observed (roughly 1%), this tendency was due to an increase in the grants (24.9%) and non-classified tax categories (31.0%).

**Figure 22 Sources of revenue www.mof.ge**



The largest contributor in tax revenues is traditionally VAT, 48% of total taxes belong to the latter tax category (f.23). Income and profit taxes comprise 26 and 14% of tax revenues accordingly. Tax revenues have increased by 8.8% compared to 2011; the share of income tax in tax revenues has increased compared to the previous year by 12.8%, while the share of VAT has increased by 9.8%.

**Figure 23 Tax Contribution www.mof.ge**




In 2012 the government of Georgia further consolidated the budget and managed to reduce the fiscal deficit to 2.9% of GDP, as a comparison – the figure was 9.2% in 2009. The government plans to further decrease the fiscal deficit to 2.8% of GDP in 2013. The new government plans to make fundamental changes to the expenditure of the budget's various categories.

Unfortunately, the draft 2013 budget already reveals certain collisions between economic growth and social equality. We believe that the above collision should be solved in favour of the former, since the task of social equality cannot be achieved without economic growth. After analysing the budget, we urge the new government to become more realistic during next budget cycle and to admit that the rapid fulfilment of a major pre-election promise is not feasible, rather than throwing billions of GEL in unreasonable expenses.

According to the draft 2013 state budget, it financial resources are 8748.5 million GEL, which exceeds the corresponding figure for 2012 by 628.5 million GEL (f.24). 8425.5million GEL in financial resources falls on the sums mobilized from receipts (sum of all revenues to be accumulated in the budget) and the rest are available deposits (balance excluding grants and credits). In previous years, funds were mostly accumulated in the budget accounts (109 million GEL in 2010, 122 million GEL in 2012), or else their use was insignificant (11.5 million GEL in 2011). The draft budget for the coming year plans to spend 323.0 million GEL of funds existing in the budget accounts.

It is well known that the budget is an important tool for influencing the macroeconomic stability of the country and its impact on the economy is crucial. Therefore, such a large-scale use of funds from the budget account is potentially very risky given the on-going process of inflation management. Due attention should also be paid to budgetary expenditures. In 2012 it was suggested that 189.4million GEL would cover liabilities from the state budget, in 2013 the corresponding indicator has increased to 539.8 million GEL. The above indicates that, compared to 2012, out of the budget (which has been increased by 628.5 million GEL) 305.5 million GEL will not stay in the domestic market and therefore its influence on inflation will be rather insignificant. The above threat is not completely removed, however. At the beginning of the year budget revenues are much lower than at the end of the year, and yet the procurement procedures are carried out by the spending organizations from the very beginning of the year. Therefore, the balancing of state budget receipts and expenses on a quarterly basis will necessitate the utilization of such available deposits, which will eventually trigger the inflation processes.

**Figure 24 Financial resources of the state budget www.mof.ge**

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| I. Total Receipts | 7,447.7 | 8,242.0 | 8,425.5 |
| Revenues | 6,442.3 | 7,053.6 | 7,422.5 |
| Decrease of nonfinancial assets | 189.8 | 70.0 | 100.0 |
| Decrease of financial assets(excluding change in deposits) | 80.7 | 60.0 | 35.0 |
| Increase of liabilities | 734.9 | 1,058.4 | 868.0 |
| II. change in deposits +use /-accumulation | 11.5 | -122.0 | 323.0 |
| Financial resources | **7,459.2** | **8,120.0** | **8,748.5** |
| % GDP | 30.8 | 30.7 | 29.9 |

**Revenues** are given by the 2013 state budget as 7 422.5 million GEL, which exceeds the 2012 value by 368.9 thousand GEL (f.20).

**Figure 25 Revenues of the State Budget www.mof.ge**

| | 2011 | 2012 | 2013 | +/-change |
|---|---|---|---|---|
| Total receipts | **6,442.3** | **7,053.6** | **7,422.5** | **368.9** |
| Taxes revenues | 5,802.0 | 6,300.0 | 6,920.0 | 620.0 |
| Grants | 223.1 | 333.6 | 202.5 | -131.1 |
| Other revenues | 417.2 | 420.0 | 300.0 | -120.0 |

Revenue growth is related to an increase in tax revenues, which has increased by 620 million GEL compared to 2012. However, taking into consideration the fact that financial means received from grants and other revenues has reduced compared to 2012, total budget revenues have only increased by 368.9 million GEL.

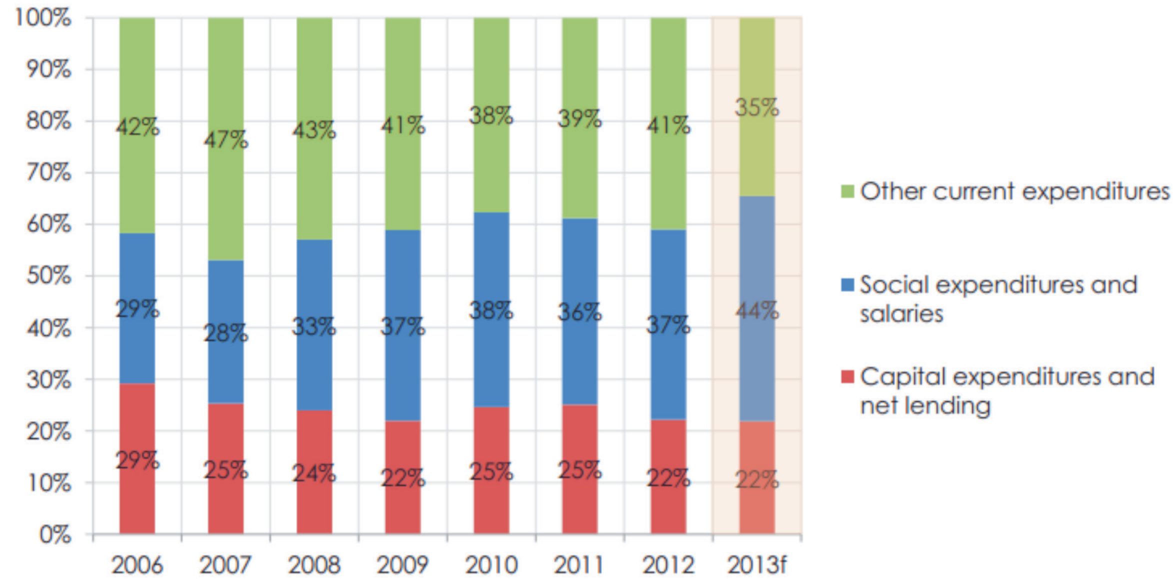
A key challenge in the process of fiscal consolidation in Georgia is to manage the pressure of social expenditure, and at the same time provide adequate pensions for the aging population and social assistance to the poor. Pensions represent the largest category of social spending, accounting for more than half of the total social protection expenditure. The World Bank states that the pension program will continue to be a heavy burden on the budget as long as the country's rapidly aging population continues to rely on the basic public pension benefit. The budget will face social expenditure pressures in the medium-term, and, therefore, without private saving for retirement, maintaining even the existing pension rates will lead to higher fiscal costs over time. As per their pre-election promises, however, the government plans to increase pensions in the near future. In order to address these challenges, policymakers should devise a retirement savings scheme, or identify financial instruments for long-term retirement saving[30].

At the same time, according to international research, a mandatory pension system might be premature for Georgia at the moment, since it requires greater regulation, supervision and the availability of investment instruments. An alternative approach, such as a voluntary/private pension funds, already exist in Georgia (three main ones), but there are fewer than 25.000 contributors. Therefore, it is necessary to find ways to encourage domestic savings. One possibility is to offer an interest rate for pension deposits at least equal to the annual inflation rate. That might not be so feasible in reality, however, given that in 2011 the annual inflation rate equalled 8.5% whilst in 2012 it equalled almost zero, which would have translated to a zero yield on deposits. In general, the lack of long-term savings reflects a low level of trust in domestic financial markets. In order to overcome this issue, long-term financial stability and long-term monetary policies for improvement of trust in Georgian currency are needed.

30 World Bank. Georgia Public Expenditure Review. Managing Expenditure Pressures for Sustainability and Growth. 2012. http://www-ds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/12/20/000333037_20121220015016/Rendered/PDF/NonAsciiFileName0.pdf

Since 2006, social expenditures and salaries have been kept below 40% of the total budget. The 2013 draft budget resembles the pre-election promises of the government and clearly prioritizes social expenses that will consume up to 44% of the total budget (f.26).

**Figure 26 Budgetary Expenditure Categories www.nbg.ge**



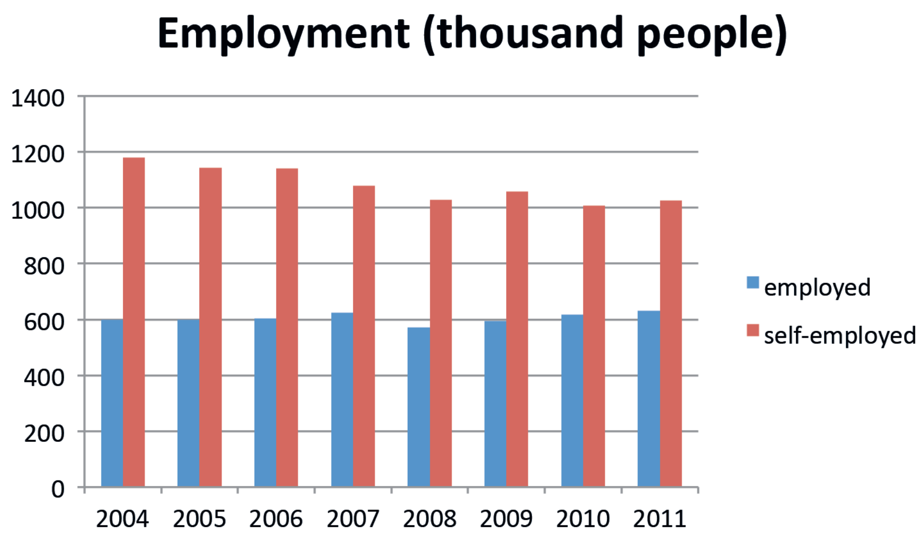

The state budget is the basic tool for directing the economic life of the country. Despite this, however, we must understand that the budget, as a mechanism for accumulating and distributing economic resources and facilitating economic growth, is characterized by certain restrictions. The resources contained within and distributed by the budget cannot permanently grow faster than the economy in general. In this context we need to consider that up until 2008 Georgia had already passed the peak period of budgetary consolidation, i.e. when the rate of revenues and expenditure growth achieved its maximum (f.27). This happened at the expense of both a quantitative and qualitative increase in tax administration. Furthermore, the degree of transparency has improved.

**Figure 27 GDP and budgetary revenues growth rate www.geostat.ge; www.mof.ge**


It should be noted that the economy rapidly developed against the background of an encouraging trend in budgetary consolidation. Obviously, the positive outcomes of economic growth cannot not be evenly distributed to all social groups, which characterizes all transitional economies at the early stage of their development, and Georgia is no exception. It should be considered as an unfortunate negative side-effect of the progress of Georgia.

Since 2008, after the war and the worst of the global financial crisis Georgia, has rapidly caught-up and even overpassed quite a number of countries in terms of GDP per capita. At the same time, social inequality has been further aggravated. This is important, since maintaining the rate of economic growth in the short and medium-term periods is more problematic in countries with medium development rates, compared to relatively less developed countries.  At his stage it is only possible in the context of a radical improvement of healthcare, education and infrastructure. In relation to Georgia – where the state has already achieved a certain amount stability in budgetary consolidation as opposed to social problems, and as a consequence social demand for income distribution is maintained – there is a threat of collision between the task of ensuring economic growth and the social demand for the equal distribution of wealth. We believe that a responsible government should not allow an economic slowdown for the purpose of wealth redistribution, especially when the outcome of such redistribution is more or less unknown and may be relatively ineffective. We would like to illustrate the above by looking at the dynamics of employment in Georgia at the time when the growth rate was at its highest.

**Figure 28 Dynamics of employment in Georgia 2004-2011 www.geostat.ge**




The situation is rather unfavourable in regards to employment growth in Georgia. At the same time, considering the decrease in economic growth rates we should not expect major positive changes in this direction, especially given that the formally employed (i.e. tax payers) on the above table do not reflect the total number of employed persons. What it means is that redistribution programs will be implemented at the expense of less than 600,000 tax payers approximately one third of which are employed by the state sector. We believe that the government should at least manage to retain an employment promoting tax climate so that more people are able to solve their own social problems through employment rather than expect state assistance.

The government should also be more responsible in relation to the management of internal and external debts. The volume of debts should in no means exceed established limit, even if it were necessary for solving important tasks in fields of education, healthcare, infrastructure and energy. Finally, during the development 2014 budget it will be necessary to efficiently prioritise the government's election promises in accordance with the reality of the situation.

# Conclusions and Recommendations

The economic outlook of Georgia as a whole remains generally favorable: macroeconomic developments have been positive and inflation has subdued, mirroring the world's slow recovery after the global financial crisis. The economy has, however, slowed-down in 2012 and a decrease in FDI was recorded due in part to the uncertainty surrounding Georgia's recent elections. The rippling effect of the Eurozone crisis has also caused a global downturn in investment, reducing the pool of external resources available to Georgia.

FDI is vital for long-term growth as it can be directed towards financing large infrastructural projects that would otherwise be impossible to fund through the domestic banking sector. Future FDI inflows, however, will largely depend on how soon the global economy recovers from recession and how successfully the government maintains and strengthens Georgia's hitherto effective investment policies. The newly elected government must, therefore, undertake the difficult task of mobilizing private sources of finance. Fortunately, the role of FDI in the economic development of the country has been recognized and the government has expressed its readiness to provide support through investment protection measures and the creation of a stable and predictable business environment.

In order to meet its pre-election promises the government has increased social spending to society's most vulnerable. The government also plans to generate more inclusive growth in the future by fostering agricultural development. In order to fulfill this plan, however, investment in the sector must be substantially increased. Paired with the government's renewed social obligations, it may therefore need to increase budgetary revenues or else face an increasing deficit.

Reducing Georgia's persistently high current account and fiscal deficit still remains a major macroeconomic challenge. A number of international financial institutions have recommended that the government undertakes immediate fiscal consolidation and structural reforms to increase the country's competitiveness and thus overcome the aforementioned challenges, a recommendation we strongly support.

While some success has been achieved in this regard, Georgia must radically diversify and expand its export portfolio if the remarkable growth levels it has recorded over the last decade are to be sustained, the intrinsic value of Georgia's economy is to be solidified, and a greater equilibrium in the credit account is to be achieved. Various policies and improvements could and should be investigated for their feasibility in the Georgian context. To enable the expansion of Georgian exports into new markets, particularly large and wealthy importers in the west, strict controls should be introduced to improve the quality of Georgian exports relative to the international standard.

The promise of a possible normalization of trade relations with Russia could increase exports and thus increase tax revenues, whilst simultaneously helping to address Georgia's dramatic current account deficit, and compensate for the ongoing Eurozone crisis' negative effect on the growth rate of exports. A trade agreement with Russia should thus be vigorously pursued.

A lack of standards, livestock disease controls, phyto-sanitary and plant protection measures are the major challenges limiting the export potential of the country's agricultural sector. Governmental initiatives to revive the sector might have a positive impact if sufficient resources and be redirected. It is important to ensure, however, that public investment in commercial activities stimulates rather than crowds-out private investment.

A key challenge in the process of fiscal consolidation will be to manage the pressure of social expenditure, while at the same time providing pensions for the Georgia's aging population and social assistance to the poor. Pensions represent the largest category of social spending, accounting for more than half of Georgia's total social protection expenditure. The World Bank states that the pension program will continue to be a heavy burden on the budget as long as the country's rapidly aging population continues to rely on the basic public pension benefit. The budget will face significant social expenditure pressures in the medium-term and, therefore, without private retirement savings, maintaining even the existing pension rate will lead to higher fiscal costs over time. The government's pre-election promises, however, included plans to increase pensions in the near future. In order to address these challenges, policymakers should devise a retirement savings scheme or identify financial instruments for long-term retirement saving.

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