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Georgia

Economic Update
No.2 | Fall 2015

WORLD BANK GROUP

Macroeconomics
& Fiscal Management
Global Practice

GEORGIA:

Absorbing External Shocks

Georgia Economic Update, No. 2

Fall 2015

WORLD BANK GROUP
Macroeconomics & Fiscal Management

Government Fiscal Year:	January 1-December 31
Currency Unit:	Georgian Lari (GEL)
Currency Equivalent:	Exchange Rate as of September 18, 2015 US$1.00=GEL2.44
Weights and Measures:	Metric System

Abbreviation and acronyms

Geostat	National Statistics Office of Georgia
CAD	Current Account Deficit
CIS	Commonwealth of Independent States
DCFTA	Deep and Comprehensive Free Trade Areas
ESCO	Electricity System Commercial Operator
ETA	Electricity Transmission Agreement
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEL	Georgian Lari
GSE	Georgian State Electricity System
HPP	Hydropower Plant
IMF	International Monetary Fund
MOF	Ministry of Finance
MoU	Memorandum of Understanding
MW	Megawatts
NBG	National Bank of Georgia
NPL	Nonperforming Loan
PPA	Power Purchasing Agreement
PPP	Purchasing-Power Parity
VAT	Value-Added Tax

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Foreword

This report is the second edition in series of economic updates designed to monitor and assess recent developments in Georgia. It presents a concise overview of macroeconomic, political and structural indicators during the first half of 2015 and situates them in the context of Georgia's evolving external environment. This edition's authors are Mariam Dolidze and Mona Prasad (Senior Country Economists for Georgia). Cesar Cancho (Poverty Economist) and Archil Mamatelashvili (Consultant) provided valuable contributions to the poverty analysis and the focus section. The report was prepared under the supervision of Miria Pigato, Practice Manager and edited by Sean Lothrop (Consultant). Valuable comments were received from Rashmi Shankar (Lead Economist and Program Leader), Joseph Melitauri (Senior Operations Officer) and Naoko Kojo (Senior Economist). The team would like to thank Mercy Tembon (Country Director for South Caucasus) and Henry Kerali (the former Georgia Country Director) for their guidance. Tamuna Namicheishvili, Sarah Nankya Babirye and Zakia Nekaien-Nowrouz provided excellent support in the preparation of the report.

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Overview

Georgia's GDP growth rate slowed to 2.8 percent during the first half of 2015. Weak export demand and a slower-than-expected adjustment in imports caused a contraction in the trade and manufacturing sectors. Net exports fell as the Georgian lari (GEL) depreciated and consumption growth slackened. Remittances also fell sharply due to worsening labor market conditions in Russia, Greece and other major destinations for Georgian migrants. International tourist arrivals, however, have so far remained stable despite regional turbulence, though a rising share of transit passengers appears to be offsetting a decrease in longer-term visitors. The current-account deficit widened to 12 percent of GDP in the first half of 2015, up from 10.7 percent in the same period of 2014. Almost half of the deficit was financed by borrowing and a drawdown of commercial bank reserves. Foreign direct investment (FDI) recovered rapidly in the second quarter following a steep decline earlier in the year and covered about 53 percent of the deficit.

The fiscal accounts remained stable through the first half of 2015, though countercyclical policies may increase pressure on the budget. Improved tax administration coupled with an increase in imports in the wake of the lari's depreciation boosted trade-related value-added tax (VAT) collection. As a result tax revenues rose by 12 percent in the first half of 2015, while expenditures remained in line with the budget. However, due to the ongoing slowdown in economic growth total revenue for 2015 is likely to be lower than originally budgeted. The authorities revised the budget downward in July 2015, and the fiscal deficit is now projected to reach 3 percent of GDP. Despite the government's efforts to contain the fiscal deficit the public debt stock is expected to increase to 46 percent of GDP in 2015, up from 36 percent in 2014. This is primarily due to the composition of the public debt, 80 percent of which is denominated in foreign currency.

Georgia's flexible exchange rate has enabled its economy to adapt to worsening external conditions. The lari has depreciated by about 36 percent in nominal terms since end-October 2014, highlighting important weaknesses in Georgia's highly dollarized financial sector. Yet even sharper simultaneous depreciations among the country's major trading partners caused its real effective exchange rate to decline far more modestly, facilitating a slower adjustment in the trade deficit. Nevertheless, nominal depreciation pushed the inflation rate to 5.4 percent in August 2015, exceeding the central bank's target of 5 percent. This prompted the central bank to gradually raise the policy rate from 4 percent in January 2015 to 7 percent in September. Monetary policy continued to be geared towards price stability within an inflation-targeting framework.

The Economy is expected to accelerate in 2016 as external conditions improve. Under the baseline scenario a modest recovery among the country's main trading partners and the consolidation of stability in the euro zone will improve Georgia's GDP growth rate to 5 percent by 2018. Stronger export markets, rising FDI inflows, reforms designed to bolster competitiveness, and the recent signing of a Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union will drive an export-oriented expansion. No major fiscal policy shifts are anticipated over the medium term, and the fiscal deficit is projected to remain at around 3 percent of GDP. However, significant downside risks remain. Slower-than-expected growth could depress revenues, potentially requiring a further consolidation of current expenditures and/or significant efficiency improvements in public investment management. The fiscal deficit is expected to decline by about 0.4 percentage points of GDP over the next 3 years, reaching 2.6 percent of GDP by 2017.

A. Recent Political Developments

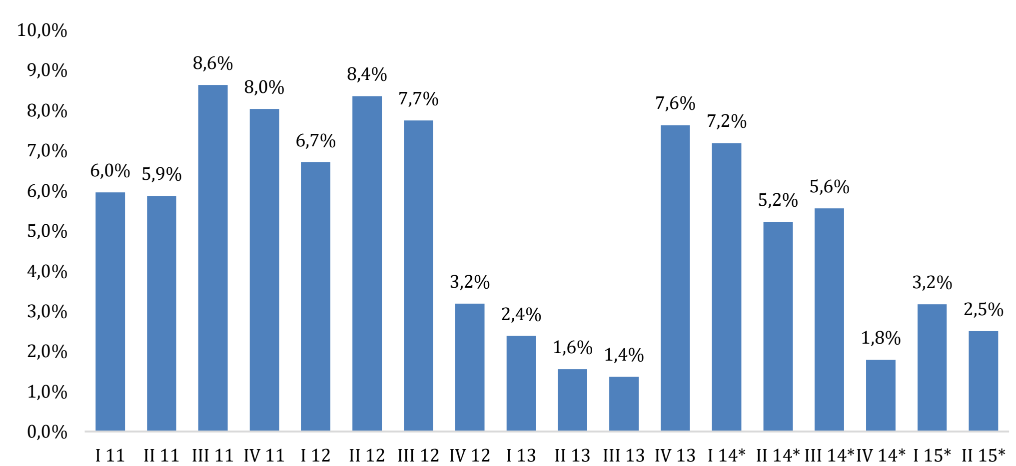
The Georgian government was subject to a Parliamentary vote of confidence in late April, 2015. Under the Georgian Constitution the replacement of 7 or more Cabinet members (one-third of the total) triggers an automatic vote of confidence. This occurred on April 29th following the resignation of three ministers from the Free Democrats Party: the Defense Minister, the Minister of Foreign Affairs and the State Minister for Euro-Atlantic Integration. Despite the withdrawal of the Free Democrats from the ruling coalition, Georgian Dream Party maintained its Parliamentary majority as 12 members of the United National Movement joined the coalition. The new Cabinet was approved by Parliament in early May. The administration's economic team remained unchanged, including the Minister of Economy, the Minister Finance and the sector ministers.

A two-day summit with the Eastern Partnership countries held in Riga, Latvia in May 2015 confirmed Georgia's progress on the Visa Liberalization Action Plan. A progress report by the European Commission praised Georgia's achievement of reform targets required to become eligible for a short-term visa-free regime in the Schengen Area. It also identified areas where further progress will be needed ranging from document security and improved border processes to migration management, external relations and human rights. The next assessment is scheduled for the end of 2015.

B. Recent Economic Developments

A worsening external environment caused GDP growth to slow to 2.5 percent, year-on-year, in the second quarter of 2015, pulling the first-semester average down to 2.8 percent (Figure 1:**).** Weakening export demand, a slower-than-expected adjustment in imports and a decline in remittances widened the current-account deficit. However, it should be noted that the slowing year-on-year growth rate is influenced by "base effects", as GDP growth reached a robust 6.2 percent in the first half of 2014.

Figure 1:GDP growth is increasingly volatile since 2012
(Quarterly GDP growth rates, %)



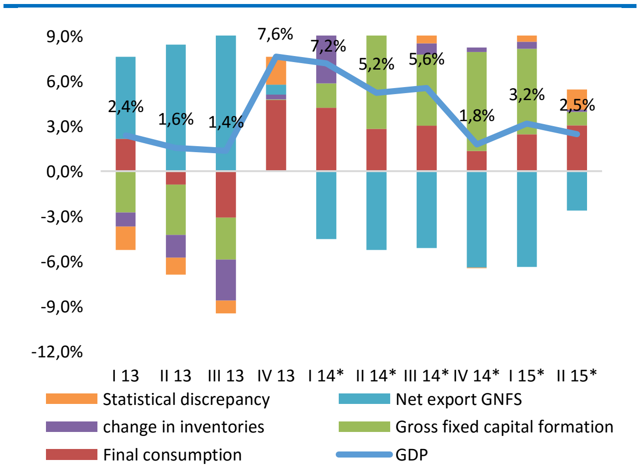
Source: Geostat.

Domestic demand contributed positively to growth, expanding by 5.4 percent in real terms during the first half of 2015. Investments grew by 12.3 percent, as the government accelerated the implementation of road, energy, municipal infrastructure and regional development projects. Overall public investment grew by about 70 percent, year-on-year, in real terms. Meanwhile private investment expanded by about 6 percent in the same period. Net foreign transfers including workers' remittances increased by 30 percent, though just by 6 percent in dollar terms. An increase in official transfers partially offset a sharp drop in private remittances. This increase in net foreign transfers, combined with a 12 percent expansion in the credit supply, caused consumption to grow by 3.2 percent. However, an 8 percent rise in imports absorbed some of the demand, and consumption of domestic output expanded by just 2.3 percent.

Weakening external demand impacted the export sector during the first half of the year. The depreciation of the lari smoothed out the impact of the external shock and led to mere 1.3 percent year-on-year increase in exports of goods and services. Exports to the European Union rose in both lari- and dollar-denominated terms driven by tourism services, which registered an especially robust increase in lari terms. However, deteriorating terms of trade with Russia, Azerbaijan, Turkey and Ukraine caused goods and services exports to drop by 14 percent, year-on-year, in dollar terms.

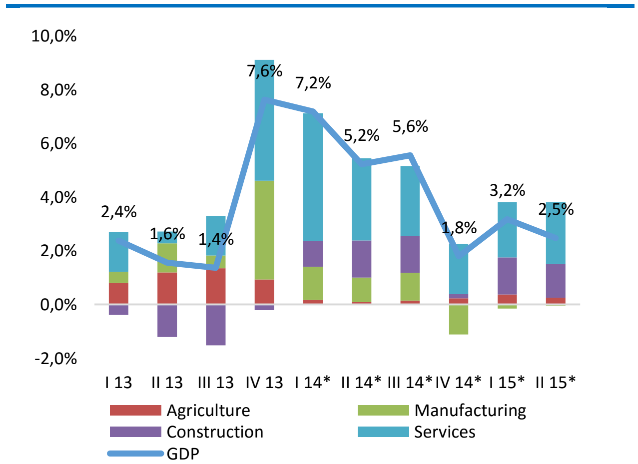
A breakdown of GDP growth by sector reveals the weak performance of manufacturing and wholesale trade in the first half of 2015. Growth was primarily driven by residential construction, pipeline transportation, financial intermediation and the agricultural sector, which expanded by an aggregate 8.4 percent. The tertiary sector as a whole also performed above average. However, the poor performance of the manufacturing and wholesale trade sectors detracted from overall growth.

Figure 2: Investment drove growth in H1 2015
(Contribution to growth, %)



Source: Geostat and WB staff estimates.

Figure 3: Performance of manufacturing and wholesale trade weakened in H12015
(Contribution to growth, %)



Labor Market Trends

Conditions in the Georgian labor market improved substantially during 2014 and 2015 despite slowing GDP growth and the return of migrant workers. The total size of the employed labor force increased by 1.9 percent, year-on-year, in 2014.[1] Employment growth in the urban service sector drove this trend, though the rural unemployment rate also fell. National enterprise surveys[2] measuring employment in the formal sector indicate that employment increased by 11 percent, year-on-year, led by agriculture and services.

The unemployment rate fell from 14.6 percent in 2013 to 12.4 percent in 2014. Demographic trends drove the decline in unemployment, as a large number workers are approaching retirement age. However, high rates of youth unemployment continue to pose a significant challenge. National business surveys indicate that the unemployment rate kept falling through the first half of 2015.

Data on wages and unit labor costs reveal rising wage pressures consistent with the increase in employment. Wages rose by 8 percent in 2014, and wage growth in the enterprise sector remained exceptionally strong at 7.6 percent in the first quarter of 2015. Rising unit labor costs did not reflect a commensurate increase in labor productivity. This is particularly true in the agricultural sector, where an increase in subsidies since 2103 caused employment to rise by more than 20 percent in the first half of 2015, while average wages grew by 10 percent. Yet agricultural output expanded by just 1.5 percent in 2014 and 3.9 percent in the first quarter of 2015.[3]

Poverty Rates

Poverty continued to decrease in 2014. The moderate poverty rate fell from 73.3 percent in 2013 to 69.4 percent in 2014, while the extreme poverty rate fell from 36 percent to 32.3 percent (Figure 4).[4] Social transfers were responsible for around half the reduction in poverty observed over the period (Figure 5:), as the government raised pension benefits and targeted social assistance. The other half was due to increased income from agricultural sales, rising employment and higher wage rates. During 2010-2014, when extreme poverty declined from 47 percent to 32 percent, wages and social assistance were the most important contributors to poverty reduction, while employment growth and agricultural income played a much less important role.

Despite the continuous decline in poverty observed over the past decade large urban-rural disparities persist. In 2014 the rural poverty rate of 41 percent was more than double the urban rate of 21 percent. The lack of income opportunities in rural areas, where two-thirds of the country's working poor are engaged in semi-subsistence farming, presents a major challenge, as does the high rate of urban unemployment, especially among younger workers. Addressing these issues will be critical to sustaining poverty reduction over the medium and long term.

[1] Geostat (2014) Annual Integrated Household Survey.
[2] Geostat (2015) Quarterly Business Survey.
[3] Geostat (2015).
[4] Moderate and extreme poverty are measured at US$2.50 per day and US$5.00 per day, respectively, in 2005 purchasing-power parity terms.

Figure 4: Poverty rates have fallen consistently over the past decade
(2005 US$ PPP)

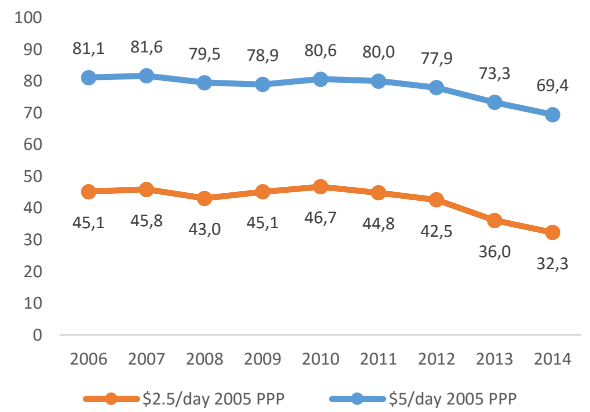
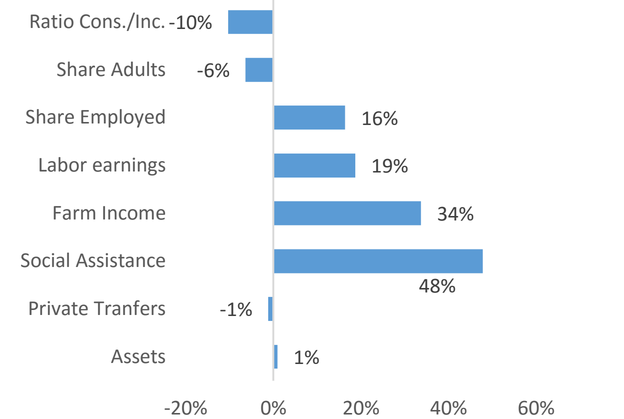


Figure 5: Social transfers and agricultural income drove poverty reduction in 2013-14.
(Contribution to poverty reduction)



Source: World Banks estimates.

Fiscal Policy and Public Debt Dynamics

Strong revenue performance bolstered the government's fiscal stance in the first half of 2015. Tax collection rose by 12 percent, year-on-year, and exceeded the budget forecast by 3.7 percent. A combination of improved administration and gains in import-related VAT spurred by the depreciation of the lari drove the increase in tax revenue. Nontax revenue also rose by 24 percent, year-on-year, as the depreciation of the lari increased the relative value of foreign assistance. The issuance of 4G licenses in the second quarter further boosted nontax revenue.

Public spending remained broadly in line with the budget, and the execution rate exceeded 96 percent. Current expenditures were executed at a rate of 97 percent. Capital expenditures were executed at 88 percent as implementing agencies still struggled to keep pace with the acceleration of the public investment program. This is still an improvement as compared to 74 percent execution rate last year. Only the health sector exceeded its budget, overspending by 1 percent as of end-June 2015 with substantial progress in the roll-over of the universal health care program in the third year of implementation.

Strong revenue performance and expenditure discipline caused the fiscal deficit to narrow to about 0.8 percent of GDP. Similar deficits have been observed in recent years, and the deficit reached just 1.2 percent of GDP in 2014, but these were largely attributable to the under-execution of the capital budget rather than improving revenue performance. However, slowing growth is expected to cause total annual revenue to fall below budget forecasts going forward.

Parliament recently approved amendments to the 2015 budget designed to reflect slowing growth and the expected decline in revenues. The revised budget cut the tax revenue forecast by about 2.5 percent (GEL 200 million or 0.6 percent of GDP), but this was partially offset by a projected rise in nontax revenues. The government is expected to receive an additional GEL 150 million (or 0.4 percent of GDP) from the sale of 4G licenses to telecommunications firms. The government also expects to receive grants from the World Bank, the Asian Development Bank and the EU as part of the implementation of the DCFTA. Meanwhile, expenditures were revised upward by GEL 40 million due to post-flood reconstruction projects in Tbilisi. The remaining GEL 160 million allocated for flood reconstruction will be spent in subsequent fiscal years. The government also targeted a potential savings of about GEL 160 million across various categories of both the current and capital budgets. Part of these resources will be transferred to a temporary national savings fund, and the rest will be redirected to various infrastructure projects designed to support growth. As a result, the fiscal deficit is projected to decline to about 3 percent of GDP, down slightly from the 3.4 percent deficit anticipated in the original budget

Figure 6: Social benefits and wages are the largest public expenditure categories
(Public spending, H1 2015)

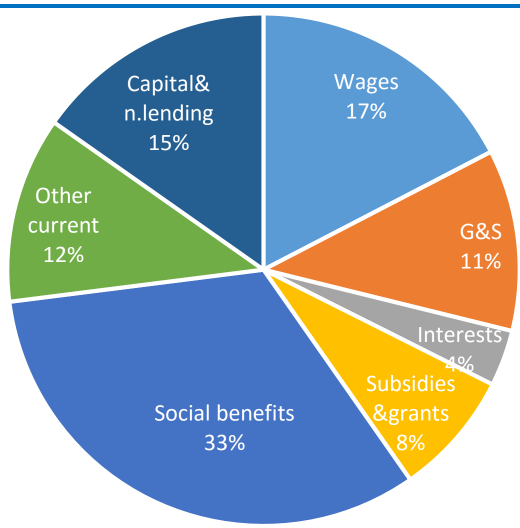
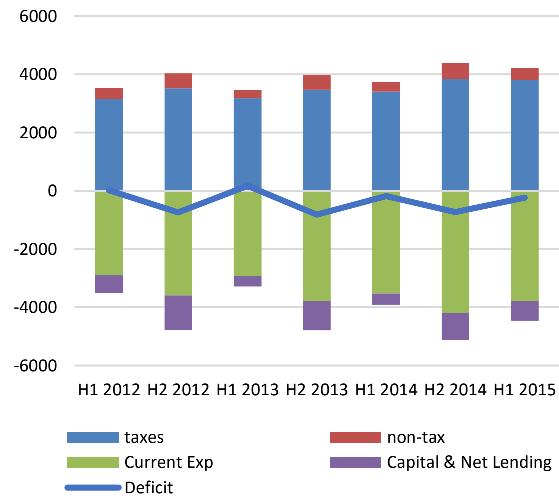


Figure 7: The low fiscal deficit is due to seasonality in H1 2015.
(GEL millions)



Source: MOF.

The new draft annual budget law 2016 deepens its social orientation while slow growth raises fiscal sustainability concerns. The Medium term framework suggest that the 2016 budget assumes a 3 percent growth in 2016. At the same time, allocation for pensions, targeted social safety net and health care are proposed to be scaled up by 6.5, 7.7 and 22.0 percent respectfully. These programs only drove total expenditure 3.3 percent above the last year budget. Another substantial increase is proposed to take place in the education sector: general education funding will be up by 17 percent mostly for teacher salaries and also higher education will get 13 percent increase. The government also expects to expand number of staff and respective wage bill. There is almost no additional resources allocated for capital projects weakening counter-cyclical impact of the fiscal operations.

Despite the narrowing of the projected fiscal deficit the public debt stock is expected to increase from 35 to 46 percent of GDP in 2015 due to valuation effects caused by currency depreciation (Figure 8:**).** About 80 percent of Georgia's public debt is denominated in US dollars, and following the lari's 35 percent depreciation between January and August of 2015 the debt stock is projected to increase dramatically. However, because of the concessional nature of most of Georgia's external debt the ratio of debt service to exports is expected to decline slightly from 5 percent in 2014 to 4 percent in 2015. Meanwhile, domestic borrowing is expected to increase by 32 percent, rising from 9 to 11 percent of GDP. Treasury bills with 1, 2, 5 and 10-year maturities are the main instruments of domestic borrowing (Figure 9:). Due to the depreciation interest rates on T-bills have increased by an average of 4 percentage points since December 2014. The coupon rate for 2-year T-bills, the most popular Georgian securities, rose from 7 percent in December 2014 to 13 percent in August 2015.

Figure 8: Depreciation is having a major impact on the public debt stock
(% of GDP)

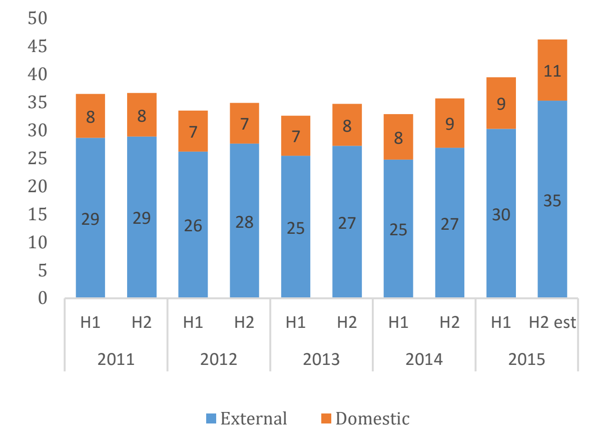
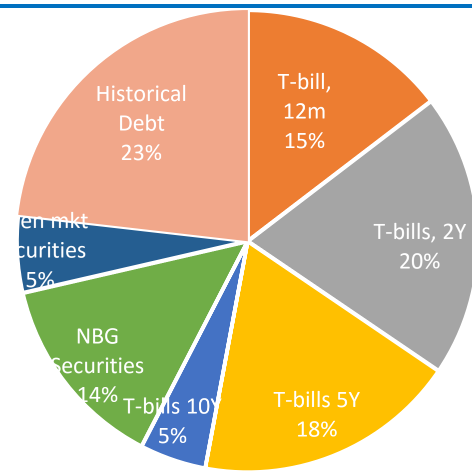


Figure 9: Treasury bills of varying maturity represent the largest share of domestic debt
(The domestic debt stock at end-June 2015)



Source: MOF.

The Balance of Payment and the External Sector

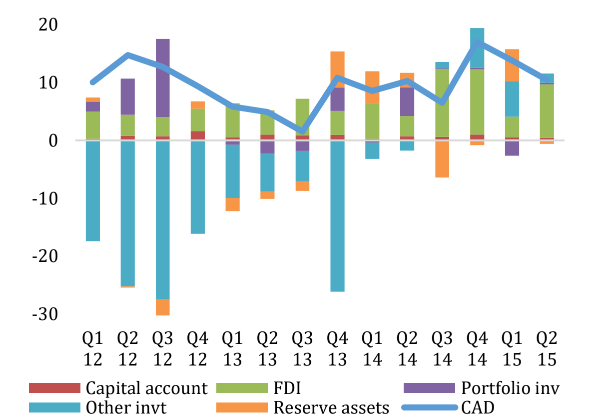
The current-account deficit widened to 12 percent of GDP in the first half of 2015, a year-on-year increase of 1.3 percentage points. The trade deficit for goods and services widened by 3.6 percent, as exports declined by 14 percent, year-on-year, and imports fell by 9 percent. Notable improvements were observed in the second quarter as the currency depreciation partially absorbed the impact of the shock. Meanwhile, private remittances dropped by about 18 percent, year-on-year, in the first half of 2015 as labor market conditions deteriorated in Russia, Greece, Ukraine and other destinations for Georgian migrants. However, official development assistance increased tenfold in the second quarter, driven by a donor-funded initiative to combat hepatitis C. This boosted net foreign transfers by 6 percent, year-on-year. International tourist arrivals remained stable during the first half of 2015 despite regional turbulence, though the share of transit passengers may be increasing at the expense of longer-term visitors. Nevertheless, tourism revenues increased by about 2 percent due to an uptick in business travelers, which offset a modest decline in revenue from personal travelers.

Total goods exports dropped by 14 percent, year-on-year, between January and August of 2015. A decline in exports to countries in the Commonwealth of Independent States (CIS) drove this trend. Exports to Azerbaijan fell by 55 percent, slashing total exports by 10 percent. Azerbaijan's share in Georgia's total exports fell from 20 percent in the first half of 2014 to 12 percent in the first half of 2015. New restrictions on used-car imports greatly exacerbated the decline in exports to Azerbaijan, and weakening demand in Russia and Ukraine trimmed another 10 percent from Georgia's total exports. Exports to EU countries, which represent 28 percent to total exports, remained stable in nominal terms. Imports also declined by 10 percent between January and August, as domestic consumption slackened, though this was insufficient to compensate for the drop in exports. Moreover, a surge in imports from Ireland reflected a large-scale purchase of hepatitis C medication as part of the government's campaign to eradicate the disease. This single transaction widened the merchandise trade deficit by 7 percent.

The current-account deficit was financed by private external borrowing and other short-term inflows combined with FDI, which covered 53 percent of the deficit in the first half of 2015. FDI weakened in the first quarter but recovered in the second. As a result FDI was sufficient to cover just over half of the current-account deficit, down from 77 percent in 2014. New borrowing by the private sector covered almost 27 percent of the deficit, and the remainder was financed by a drawdown of commercial bank reserves. The central bank largely refrained from intervening in the foreign-exchange market, and gross reserves remained broadly unchanged at US$2.5 billion (or 3.5 months of imports) as of end-June.

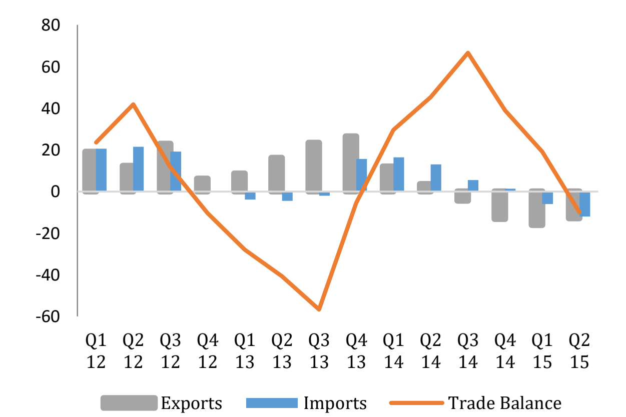
Georgia's total external debt remained stable in dollar terms during the first half of 2015, yet in lari terms it increased from 80 percent to 102 percent of GDP. The depreciation caused a sharp decline in dollar-denominated GDP, driving up the external debt-to-GDP ratio. Meanwhile, the total debt stock increased by US$774 million (or about 5.5 percent of GDP[5]), year-on-year, to reach US$14.1 billion at end-June 2015. This increase was driven by the private sector, especially commercial banks, while the public debt stock increased by only US$$50 million, year-on-year, in dollar terms. This figure does not include contingent liabilities of state-owned enterprises, which are estimated to have increased significantly due to new borrowing. Both the widening external debt-to-GDP ratio and the rising debt stock were largely caused by the reduction in dollar-denominated GDP, while nominal values experienced relatively moderate changes over the first half of the year.

Figure 10: Foreign investment has partially financed the current-account deficit
(% of GDP)



Source: NBG.

Figure 11: The trade balance is improving slowly
(Goods and Services % growth, year-on-year)



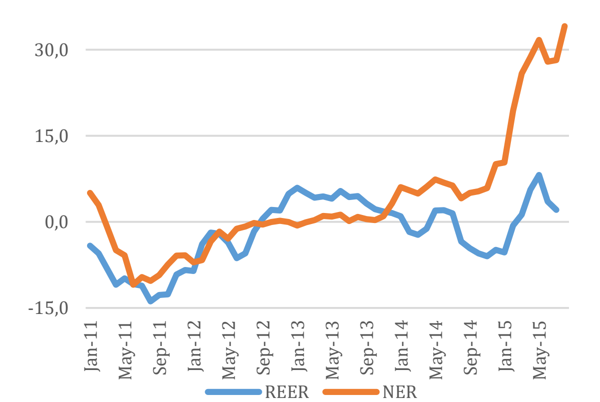
The nominal depreciation of the lari was largely caused by worsening external conditions. The central bank's limited interventions in the foreign-exchange market facilitated the adjustment in relative currency values. The last intervention took place in September 2015, when the central bank sold US$27 million on the foreign-exchange market. As of end-August the total value of interventions in 2015 amounted to just US$227 million, or 8 percent of the central bank's gross international reserves. The lari stabilized during the summer, supported by a steady inflow of tourism revenue. However, depreciation pressures resumed in mid-August, coupled with a decline in tourist arrivals at the end of the summer season.

[5] Based on estimated GDP for 2015.

Despite the large nominal depreciation the real effective exchange rate depreciated by just 6.6 percent, year-on-year, during the first half of 2015. This difference was due to the concurrent depreciation experienced by most of Georgia's main trading partners, including the CIS countries and Turkey. The modest degree of real depreciation against major regional currencies limited the extent to which Georgian exports were able to benefit from the nominal depreciation. Nevertheless, Georgia's terms-of-trade balance improved significantly vis-à-vis the EU and other non-CIS countries.

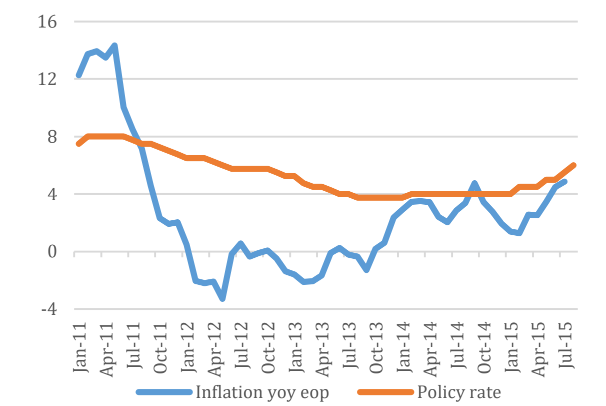
Pass-through effects from the nominal depreciation pushed the inflation rate to 5.2 percent in September 2015, slightly exceeding the central bank's target rate of 5 percent. The decline in global oil prices put downward pressure on inflation, while the lari's modest real appreciation against the Turkish lira, Russian ruble and Ukrainian Hrivnya helped to keep food prices stable. Rising inflation rates among Georgia's trading partners are taking toll on business profit margins briefly affecting domestic prices so far. Food-price inflation rose to 4.2 percent by end-September, contributing about one-fourth to headline inflation. In an effort to stabilize inflation expectations the central bank gradually increased its policy rate from 4 percent in January 2015 to 7 percent in September (Figure 13:).

Figure 12: Nominal depreciation substantially exceeded real depreciation
(% change, year-on-year)



Source: NBG.

Figure 13: The NBG has increased the policy rate to contain inflation expectations
(% change, year-on-year)



Source: Geostat.

Despite the depreciation of the lari and high rates of dollarization the financial sector continues to appear broadly stable. The average capital-adequacy ratio remains above 16 percent, the share of nonperforming loans (NPLs) is low at around 3 percent,[6] and the overall liquidity ratio is high at close to 40 percent. Year-on-year credit growth remained robust at 20 percent at end-2014, but has since tapered off. Despite a loan-dollarization rate of over 65 percent the share of NPLs mproved slightly from 2.6 percent in 2014 to 2.0 percent in July 2015. A rescheduling of dollar-denominated loans to extend maturities, strict banking supervision, proactive management of dollarization and informal savings practices have helped maintain financial sector stability. However, conditions are still likely to deteriorate somewhat over the medium term.

Banking supervision was removed from the Central Bank and made into an independent agency with effect from September 2015. Despite the open disapproval of this move by the market, international financial institutions and the President of Georgia (who vetoed it), the Parliament was able to over-ride the veto and establish the agency. The new agency, called the Financial Supervision

[6] The central bank defines NPLs as being 90-120 days overdue.

Agency, will be staffed by a Board of 7 members which will include the President of the National Bank and a member of the Board of the National Bank along with 5 candidates nominated by the government and ratified by the Parliament. In this new arrangement there are concerns on the independence and integrity of the new agency and potential distortions and costs of transition at a time when financial and external vulnerabilities are high. Many of these concerns have already been communicated to the government.

Macroeconomic Outlook and Debt Sustainability

Economic growth is projected to average 3.6 percent a year over the medium-term but downside risks to growth remain. The contraction in the Russian economy, the collapse of the ruble and the impact of the decline in oil prices on Georgia's resource dependent neighbors has had spillover effects in the region. It has lowered export demand for Georgian goods while lower remittances from Russia and Greece have moderated consumption growth. In addition, the lackluster performance of EU countries has also dampened export demand. Although FDI inflows, which primarily originate in the EU countries, have grown moderately in the first half of 2015, they are likely to reduce going forward. Hence, output expansion is projected at 2 percent in 2015, followed by an increase to 3 percent in 2016. However, downside risks remain, especially, if Georgia's export markets see a protracted period of slowdown. In addition, with Parliamentary elections due in 2016, the efforts at structural reforms could take a backseat. In the outer years, growth prospects factor in improved economic ties with the EU and the reform program outlined in the government's development strategy, which will support growth in private investment. The Deep and Comprehensive Free Trade Area (DCFTA) and the AA with the EU is likely to improve market access and encourage FDI. However, in the short-term, this transitional process could involve certain costs as producers upgrade their facilities and methodologies to meet the desired quality standards. Gross investment is likely to average 30 percent of GDP a year during 2015-18, supported by public and private investment, particularly in the areas of the British Petroleum financed gas pipeline, hydro power projects and the Anaklia sea port (Table 1).

Rising social expenditures and some recent policy announcements raise concerns on the fiscal front. With the revision in the budget for 2015 and strong revenue performance in the first half of the year, the fiscal deficit is expected at 3.0 percent of GDP. In 2016, the main increases that are being budgeted for include TSA and health spending, electricity subsidies for all those who have a means-tested score of 70,000 and below, and additional spending from the recently adopted High Mountainous Regions law. In addition, a further increase in pensions is under consideration. Education expenditures will also go up as teacher salaries will increase again in April 2016 (they increased in September 2015) while the budgeted increase in wages would finance the central election committee and the salaries of the rescue mission contingency in the municipalities. In the run-up to the elections, some additional increases cannot be ruled out. With all these increases in current spending, capital expenditures are likely to go down to 5.7 percent of GDP in 2016. On the revenue side, a further increase in excise has been budgeted for in 2016. Post 2016, the government intends to consolidate its fiscal stance with increased expenditure efficiencies, reforms in public investment management, and limits on other non-essential expenditures. The government has an efficient tax administration and cannot easily increase tax rates. Hence, the fiscal consolidation process falls proportionately more on the expenditure side. The level of revenues is expected to be maintained at about 27.7 percent of GDP while the fiscal deficit is likely to vary in the range of 2.6-3.1 percent (Table 2). Fiscal consolidation is a key element of the International Monetary Fund (IMF) Stand-By Arrangement with Georgia. To achieve the desired fiscal outcomes, strengthening the effectiveness of social spending and supporting the government in developing the institutions and capacity for program implementation will be crucial.

Table 1: Macroeconomic Trends and Projections

	2011	2012	2013	2014	2015p	2016p	2017p	2018p
	Actuals				Projections			
	(Percent change, unless otherwise indicated)							
National Accounts								
GDP nominal (in billions of GEL)	24.3	26.2	26.8	29.2	31.6	34.1	37.4	41.3
Real GDP growth	7.2	6.4	3.3	4.8	2.0	3.0	4.5	5.0
Consumer price index	8.5	-0.9	-0.5	3.1	4.0	5.0	4.0	4.0
GDP per capita (in U.S. dollars)	3,231	3,523	3,600	3,681	3,547	3,650	3,884	4,157
Gross investment (in percent of GDP)	26.2	28.9	24.8	29.8	29.9	29.8	30.1	30.7
Gross national saving (in percent of GDP)	13.5	17.2	19.1	19.2	18.9	20.0	21.6	22.6
	(In percent of GDP, unless otherwise indicated)							
General Government Operations								
Revenues and grants	28.3	28.9	27.7	27.8	28.0	27.5	27.6	27.8
Tax revenues	25.2	25.5	24.8	24.8	25.0	25.0	25.2	25.2
Expenditure and net lending	31.8	31.7	30.2	30.8	31.1	30.6	30.5	30.4
Current expenditure	23.0	24.9	24.1	25.3	24.9	24.9	24.7	24.6
Capital expenditure and net lending	8.8	6.8	6.1	5.5	6.2	5.7	5.8	5.8
Overall fiscal balance	-3.6	-2.8	-2.6	-3.0	-3.1	-3.1	-2.9	-2.6
Total public debt	33.6	32.3	32.2	33.3	42.3	42.5	41.9	40.1
	(In percent of GDP, unless otherwise indicated)							
External Sector								
Current account balance	-12.7	-11.7	-5.7	-10.5	-11.0	-9.8	-8.5	-8.1
Exports of goods and services	36.3	38.0	44.5	42.6	41.8	42.0	43.1	44.2
Imports of goods and services	55.3	57.6	57.4	60.6	59.6	58.1	58.0	59.7
FDI (net)	6.2	3.9	5.1	8.1	7.5	7.6	7.6	7.7
Foreign exchange reserves								
(Months imports of goods and services)	3.7	3.7	3.4	4.1	3.8	3.8	3.8	3.8
(In millions of dollars)	2,818	2,873	2,823	2,699	2,506	2,663	2,895	3,145

Source: Georgian authorities; and Bank and IMF staff estimates and projections.

Table 2: Fiscal Indicators

	2011	2012	2013	2014	2015p	2016p	2017p	2018p
	Actuals				Projections			
	(In percent of GDP)							
Overall fiscal balance	-3.6	-2.8	-2.6	-3.0	-3.1	-3.1	-2.9	-2.6
Revenues and grants	28.2	28.9	27.7	27.8	28.0	27.5	27.6	27.8
Taxes	25.2	25.5	24.8	24.8	25.0	25.0	25.2	25.2
Non-tax revenues	3.0	3.4	2.9	3.0	3.0	2.5	2.4	2.5
Total expenditure and net lending	31.8	31.7	30.2	30.8	31.1	30.6	30.5	30.4
Current expenditure	23.0	24.9	24.1	25.3	24.9	24.9	24.7	24.6
Wages and salaries	4.7	4.6	5.2	5.2	5.2	5.3	5.2	5.1
Goods and services	5.0	5.0	3.8	3.9	3.7	3.7	3.6	3.6
Interest payments	1.2	1.0	0.9	0.9	1.2	1.3	1.3	1.2
Subsidies and grants	1.8	2.0	2.0	2.1	2.2	2.0	2.0	2.0
Social expenses	6.8	7.1	8.5	9.6	9.6	9.8	9.6	9.5
Other expenses	3.5	5.2	3.7	3.6	3.0	2.8	3.0	3.2
Capital expenditure and net lending	8.8	6.8	6.1	5.5	6.2	5.7	5.8	5.8

Source: Georgian authorities; and Bank and Fund staff estimates and projections.

Lower export demand, the decline in remittances, and the moderate impact on imports of the large depreciation of the lari is likely to widen the current account deficit in 2015. Georgia's exports are expected to remain subdued in 2015 because of lower demand from its key trading partners. In addition, remittances have declined while the adjustment in imports has been slower than expected. As a result, the current account deficit is likely to widen to 11 percent of GDP in 2015. In 2016, some improvement in the current account is likely with a pick-up in export demand. From 2017 onwards, external sustainability will be supported by a larger recovery in export markets and some gains from the continued focus on competitiveness, especially in the context of the DCFTA. The full impact of the improvements on the export front as a result of the DCFTA and other structural reforms will be visible only over the medium- to long-term. Given the high level of external liabilities, a more ambitious reduction in the current account deficit (CAD) is desirable but not very likely with the low domestic savings. More than two-thirds of the CAD will be financed from FDI and the rest from loans. Portfolio investments are relatively small in Georgia. Georgia receives most of its FDI from the EU countries and has limited dependence on Russia and Ukraine for direct investment. In recent months, it has also started receiving FDI from China. However, spillover effects from geopolitical uncertainties and potentially longer-term stagnation in the EU could dampen investment inflows to Georgia.

Georgia's public debt is likely to increase substantially in 2015 because of the impact of the depreciation of the lari on the large share of external debt. Total public sector debt is likely to increase from 33.3 percent of GDP in 2014 to 42.3 percent in 2015, largely because of the depreciation of the Lari against the USD (Table 3). About 80 percent of public debt in 2014 was external and was dominated by long-term multilateral (70 percent) and bilateral (20 percent) debt. Given the highly concessional nature of public debt, interest payments average at around 1 percent of GDP a year. Nearly 75 percent of external public debt is at fixed interest rates, thereby, reducing interest rate risk. The Ministry of Finance (MOF), with support from international financial institutions, including the World Bank, has developed a draft debt management strategy which is under discussion within the government. It is likely to be finalized by December 2015.

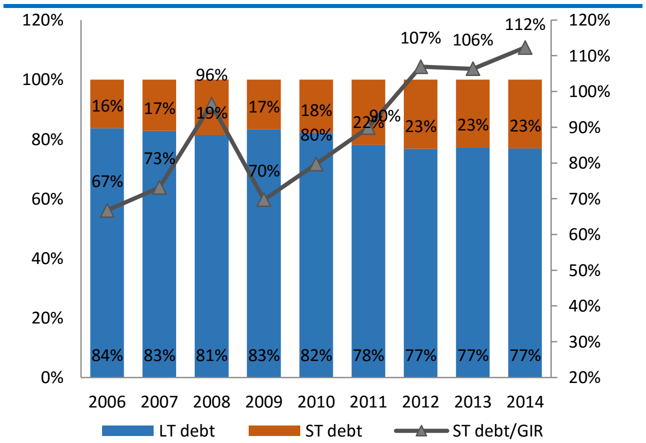
Table 3: Debt Sustainability Analysis

	2011	2012	2013	2014	2015p	2016p	2017p	2018p
	Actuals				Projections			
	(In percent of GDP)							
Total public sector debt	33.6	32.3	32.2	33.3	42.3	43.5	43.3	42.9
External public sector debt	29.1	27.5	27.2	26.8	35.9	36.3	35.9	35.4
Domestic public sector debt	4.5	4.8	5.0	6.5	6.4	7.2	7.4	7.5
Gross external debt (including inter-company loans)	77.8	82.2	82.06	82.9	103.0	99.6	97.3	92.7

Source: Georgian authorities; and Bank staff estimates and projections.

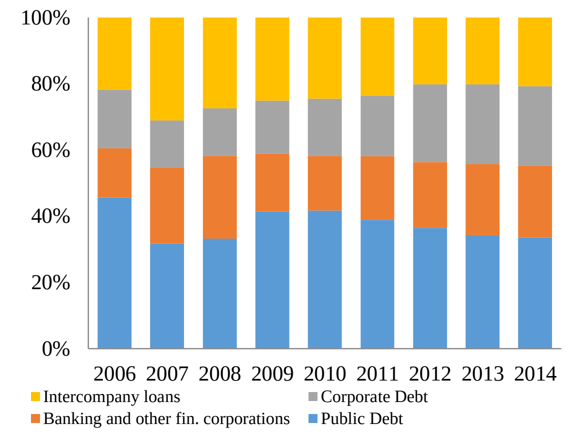
Total external debt is however a source of vulnerability. The high reliance on foreign savings to fuel growth resulted in rapid accumulation of external debt which stood at 83 percent of GDP in 2014. About 77 percent of external debt is long-term and nearly two-thirds of external debt is held by the private sector (Figures 1 and 2). Inter-company external loans account for nearly 20 percent of GDP and generally carry lower repayment risks. In addition, 6 percent of the external debt is denominated in local currency. The main holders of Georgia's private external debt include financial institutions (Bank of Georgia and TBC Bank) and non-financial corporations like the Georgian Oil and Gas Corporation (Eurobond of $200 million), the Georgian Railways (Eurobond of 670 million), and Marabda-Kartsakhi Railway ($560 million highly concessional loan from Azerbaijan). Banking supervision norms require banks to keep their positions closed. However, the banks' debtors could face currency mismatches in their revenue streams. The short-term debt mostly consists of trade credits owned by non-financial corporations, deposits of non-residents in the banking sector of Georgia, and short-term intercompany loans by foreign direct investors. For non-resident deposits, banking supervision norms require that if such deposits exceed 10 percent of total deposits of the bank, then the liquidity requirements are much higher (close to 100 percent of the deposits). However, reserves cover only about three months of imports and short-term debt amounted to more than 100 percent of reserves in 2014. This makes Georgia highly vulnerable to exchange rate depreciation. Gross external debt, including inter-company loans, is likely to go down in the medium-term with a decline in the current account deficit.

Figure 14: Maturity of External Debt
(% of GDP)



Source: NBG, World Bank staff calculation.

Figure 15: Composition of External Debt
(%, share in total)



Source: NBG, World Bank staff calculation.

Georgia's overall macroeconomic policy framework is adequate. There are downsides to growth triggered by external disturbances but the government remains committed to sound macroeconomic management as evidenced by its commitment to a floating exchange rate regime, limited interventions in the foreign exchange market, an increase in policy rates in response to increased inflationary expectations and a limited increase in the fiscal deficit budgeted for 2016. Over the medium-to long-term, the DCFTA and the AA, structural reforms and continued macroeconomic stability will strengthen growth prospects and also reduce external vulnerabilities.

C. Focus Section: Benefits and Risks of Georgia's Energy Sector Development

Georgia's energy sector contributed 2 percent to GDP in 2014. The sector is governed by the 1999 Law on Electricity and Natural Gas (amended in 2005), the 2006 resolution "Main Directions of State Policy in the Georgian Energy Sector," and other secondary legislation. The Georgian National Energy Regulatory Commission is responsible for establishing tariffs and licensing firms in the energy and water sectors. The main public agencies in the energy sector are the Electricity System Commercial Operator (ESCO), which was established to carry out wholesale electricity trades, and the Georgian State Electrosystem (GSE) and its subsidiary "Energotrans," which are responsible for electricity transmission. Power generation and distribution are mostly performed by private firms.

The government has prioritized the development of the hydropower sector through various initiatives. The "Main Directions of State Policy" resolution incentivizes the development of

Hydropower Plants (HPP). The government signed an electricity trade agreement with Turkey to export hydroelectric power, and the authorities have pursued an active dialogue with the Energy Community. Investments in high-voltage transmission infrastructure will enable Georgia to export surplus hydroelectric power to Turkey during spring and summer.

To support the development of HPP the government has established standard rules and procedures for private investors. Under these rules a new developer must enter into a memorandum of understanding (MoU) with the government to secure the rights to develop a particular site. The prospective developer is obliged to sell 20 percent of its output to ESCO for the first 10 years of its operation at a fixed price defined in a power-purchase agreement (PPA)[7]. As of June 30th, 2015 the Georgian government has signed 48 MOUs with private developers representing a total installed capacity of about 2,300 megawatts (MW). To date, ESCO has signed PPAs for 32 HPPs with a total annual production potential of about 9 terawatt-hours (TWhs)[8] and part of it is contracted under PPAs and Electricity Transmission Agreements (ETAs).

Managing the very large volume of electricity represented by the PPAs poses substantial risks to state companies in the sector, which could become a major source of contingent liabilities for the government. These risks fall under three categories: (i) *volume risk*: all HPPs are required to sell 20 percent of their output to ESCO, and ESCO is obliged to buy their output regardless of whether it can efficiently transmit and sell it; (ii) *price risk*: if ESCO's sale price is lower than the purchasing price specified by the PPA, ESCO would bear the loss; (iii) *Capacity risk*: under the ETA the GSE and Energotrans are responsible for transmitting power to the export point, but the power produced by HPPs may exceed the transmission capacity of the grid, or there may be congestion at the export point. The seasonality of power generation contributes to these risks, as most HPPs reach peak capacity during the spring and early summer.[9]

Changes in relative currency values could pose additional financial risks, as domestic electricity sales are denominated in lari, while PPA's prices are denominated in US dollars. The GSE and domestic distribution companies already have dollar-denominated liabilities, while their revenues are in lari. The 22 percent nominal depreciation of the lari against the dollar from January to August 2015 increased real PPA purchase prices, as well as the debt-service costs of electricity companies. However, not all these costs have been passed on to the consumers. Electricity tariffs were increased by 12-16 percent in July 2015, but this has not been sufficient to cover the losses incurred by the GSE and ESCO as a result of the depreciation. Since the GSE and ESCO are public sector companies their debts are implicitly back by the government. These contingent liabilities may threaten fiscal stability if the price imbalance continues.

An assessment of the potential impact of newly developed HPPs indicates that from 2016 on, under the baseline scenario, the implementation of all projects with signed PPAs will generate substantial benefits to the energy sector and Georgian consumers. By reducing the need for thermal power and imported electricity HPPs will save the energy sector an estimated US$26.8 million in 2016 alone. The benefits to consumers will vary, but could reach as much as US$117 million in 2023 and continue to rise as consumption increases at a projected rate of 5 percent per year.

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[7] Prior to 2013 sales to ESCO during winter months were optional.

[8] Georgia's total electricity consumption is about 10 TWhs, very low by European standards.

[9] Output typically peaks in summer and declines in winter, while consumption is highest in the winter months and lowest in the summer. Georgia typically runs a surplus from April to August, and in the winter it relies on thermal power plants and energy imports. However, the increasing use of air conditioners during the summer is gradually flattening the consumption pattern.

The construction of HPPs would also create jobs and help narrow the current-account deficit. The construction of a single 100 MW HPP creates 334 new jobs during the 3.4 years when it is under construction and 28 jobs after it is commissioned. The construction of HPPs with a combined capacity of 2,225 MW during the next seven years is expected to create more than 7,400 temporary construction jobs and about 630 permanent jobs. Increased domestic electricity production will also improve both the import and export sides of the current-account balance. If all planned HPPs are constructed, the current-account balance could improve by US$24.8 million in 2016 (0.4 percent of the projected current-account deficit[10]) before gradually increasing to US$486.3 million by 2023.

However, these projections reflect the assumptions of the baseline scenario. Under an alternative worst-case scenario, in which electricity consumption declines by more than 19.2 percent from its current levels and does not grow over the next decade, ESCO would face a loss. However such a scenario is an outlier and is almost statistically improbable. There is a roughly 85 percent chance that ESCO will be able to replace all thermal energy with cheaper hydroelectric power. This would result in gains varying from US$8 million to US$117 million over the next 10 years. However, there is a 7 percent chance that the projected increase in power consumption of 3 percent per year will not occur and that unforeseen technical or political obstacles may disrupt exports. This could result in annual losses of between US$6.4 million and US$12.6 million over the next 10 years.

Georgia's hydropower development program could yield substantial fiscal and economic benefits, assuming that the risks are properly managed. The construction of new HPPs could create jobs, reduce electricity costs, narrow the current-account deficit and improve the financial health of the public utilities, while also strengthening Georgia's energy independence and reducing marginal greenhouse gas emissions. However, a range of technical and financial factors could result in the generation of contingent liabilities, and these risks must be carefully monitored.

[10] Asian Development Bank (2015) http://www.adb.org/countries/georgia/economy

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