

# GEORGIA

Country Economic Update  
February 2018



**Making the Recovery Sustainable**



**WORLD BANK GROUP**

Macroeconomics, Trade and  
Investment Global Practice



# **GEORGIA:**

## ***Making the Recovery Sustainable***

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Country Economic Update

February 2018



Government Fiscal Year	January 1 – December 31
Currency Equivalents	Exchange Rate Effective as of February 5, 2018
Currency Unit	Georgian Lari (GEL)
US\$1	GEL2.4638
Weights and Measures	Metric System

## Abbreviations and Acronyms

GEUAA	Georgia EU Association Agreement	IFC	International Finance Corporation
ADB	Asian Development Bank	IFI	International Financial Institution
BP	British Petroleum	IMF	International Monetary Fund
CAD	Current Account Deficit	MoF	Ministry of Finance
CAR	Capital Adequacy Ratio	MLT	Medium and Long Term
CEU	Country Economic Update	MOLHSA	Ministry of Labor, Health and Social Affairs
CIT	Corporate Income Tax	MPs	Members of the Parliament
CPI	Consumer Price Index	NBG	National Bank of Georgia
DCFTA	Deep and Comprehensive Free Trade Area	NDI	National Democratic Institute
DIS	Deposit Insurance System	NPL	Non-Performing Loans
EBRD	European Bank for Reconstruction and Development	PIM	Public Investment Management
ECA	Europe and Central Asia	PER	Public Expenditure Review
ECOPA	European Consensus-Platform for Alternatives	PIT	Personal Income Tax
EU	European Union	PPAs	Power Purchasing Agreements
FDI	Foreign Direct Investment	PPP	Public Private Partnership
FIZ	Free Industrial Zone	PPT	Percentage Point
FSI		ROA	Return on Assets
FSAP	Financial Sector Assessment Program	ROE	Return on Equity
FX	Foreign Exchange	SOEs	State Owned Enterprises
GDDG	Georgian Dream Democratic Georgia	SMEs	Small and medium enterprises
GDP	Gross Domestic Product	UHC	Universal Healthcare
GEL	Georgian Lari	USAID	United States Agency for International Development
Geostat	State Department of Statistics of Georgia	VAT	Value Added Tax
GR	Georgian Railway	UNM	United National Movement
GOGC	Georgian Oil and Gas Corporation	WB	World Bank
HH	Household	WDI	World Development Report

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## **Foreword**

This edition of Georgia's Country Economic Update (CEU) is part of a semi-annual series designed to monitor socio-economic developments in Georgia. It presents a concise analysis of political, economic and social developments, as well as the progress achieved with the implementation process of structural reforms during 2016. It also includes a focus note on Georgia's foreign direct investment (FDI). This edition of the Georgia Economic Report was prepared by the World Bank economic team working on Georgia—Mariam Dolidze (Senior Economist), with input from David Keshelava (Consultant), Natalia Tsivadze (Financial Sector Specialist) Inga Paichadze (Senior Communications Officer), under the guidance and supervision of Genevieve Boyreau (EFI Program Leader) and Maria Gonzalez-Miranda (Practice Manager), and Tamuna Namicheishvili (Program Assistant) provided administrative support. Photo on the cover page is a courtesy of Mr. Vakhtang Kuntsev-Gabashvili.

Maria Gonzalez-Miranda  
Practice Manager  
Macroeconomics, Trade and Investment Global Practice



## Overview

**A pickup in global growth coupled with strengthening business and consumer confidence have supported a notable recovery in Georgia.**

**The growth drivers shifted from public spending in 2016 to net exports in 2017.**

**The government accelerated the implementation of structural reform along with the improved macro-fiscal stance in 2017.**

The country benefited from the improved external demand in 2017. Global growth is estimated to have picked up in 2017 to 3.0 percent from 2.4 percent in 2016, reflecting gradual recovery in the euro area, China, emerging Europe, and Russia as commodity prices and financial markets continued to stabilize. With growth outcomes in 2017 generally stronger than expected, Georgia's annual growth estimate was revised to 4.2 percent, compared to an earlier projection of 3.5 percent. Higher growth is likely to have improved population incomes, following adverse social outcomes in 2016 (figure 1). In 2016, poverty indicators deteriorated to 25.6 percent from 25.3 percent in 2015 (at US\$3.2 a day in 2011 PPP terms).

The recovery in the first three quarters of 2017 was driven by a sharp increase in net exports, and—to a smaller extent—by private consumption; on the flipside, this was accompanied by a slight decline in overall gross investment (largely due to weakened inventories) and a considerable drop in public consumption. The benefits of a well-managed monetary policy and adequate exchange rate flexibility on Georgia's competitiveness were further supported by a firm economic recovery in its main trading partners, helping the current account deficit narrow significantly; a reduction to 9 percent of GDP is estimated as of end-2017.

Fiscal consolidation measures implemented under the 2017 budget and stronger than expected growth ensured a considerably improved fiscal stance, with the fiscal deficit at 3.4 percent of GDP by end-year. Key structural measures have been taken: (i) a new remuneration law for the civil service was approved by the Parliament as envisaged by the recently enacted Civil Service Law—it sets the salary ceilings and provisions to ensure that the public wage bill is consistent with the medium-term projections under the government's fiscal framework; (ii) a new PPP law that is integrated with the overall investment plan and budget cycle was prepared and submitted to the parliament; also, a PPP unit has been established at the Prime Minister office; (iii) a Public Investment Management (PIM) framework was established in order to strengthen the monitoring of public investment; a dedicated Public Investment Unit was established at the Ministry of Finance (MoF); (iv) in the 2018 Budget, the fiscal risk annex includes a quantitative reporting of quasi-fiscal relationships, and expands the analysis of contingent liabilities associated to SOEs.

**The gradual recovery is expected to continue on the back of prudent macroeconomic and fiscal policies and structural reform.**

GDP growth is expected to rebound to 5 percent by 2020. The external sector will recover through a robust increase in net exports, with the main growth driver shifting to the external demand. The government has committed to contain its administrative expenses based on the package of fiscal consolidation measures, and expand the capital budget instead, helping address the remaining infrastructure bottlenecks. As a result, a gradual reduction in the fiscal deficit is expected to come from the robust GDP growth and a careful management in public spending. In addition, reforms in the non-banking financial sector, capital markets and pension system will be major steps towards strengthening the financial system and positioning it to support the recovery. Upside risks stem from a stronger-than-expected domestic demand and/or a sustained improvement in the external environment. Downside risks include inward-looking policies in advanced countries and weaker-than-expected growth in both advanced and emerging economies, as a possible tightening in global financial conditions could threaten the growth momentum. However, an improved macro-fiscal stance, a flexible exchange rate, and well-capitalized, liquid banking system are in place in Georgia to help the country cope with negative shocks.

## A. Recent Socio-Economic Developments

### Recent Political Events

**Following the 2016 October parliamentary elections, the ruling party initiated a process of much-debated and wide-ranging constitutional amendments.**

The Parliament of Georgia approved the draft Constitution on September 26, owing to a majority vote by the ruling party. The draft did not obtain the support of the opposition parties, the President, nor civil society representatives, because of the lack of consensus on critical issues such as the electoral system and the presidential elections. The Georgian Dream recently initiated a new round of the constitutional amendment process to incorporate the Venice Commission recommendations in the newly-adopted Constitution. According to the amendments, parties will be allowed to form election blocs for the next parliamentary election in 2020. Also, the so-called bonus system, which entails transfer of votes of the parties that

fail to cross the parliamentary threshold entirely to the winner, will be scrapped. Amendments will also be introduced to the provisions related to the Constitutional Court. The constitutional bill includes other changes as well, which have not been agreed with the Venice Commission<sup>1</sup>, including to Article 5 of the new constitution, which defines the principles of a social state. The new constitution will enter into force following the next presidential election in fall of 2018<sup>2</sup>.

#### Box 1. Key Constitutional Amendments

Under the new Constitution, direct presidential elections are to be abolished in 2024, and the country will transfer to fully proportional parliamentary representation; electoral blocs will no longer be allowed and the 5 percent threshold will remain intact.

- Georgia will switch to fully proportional elections in 2024.
- The 2020 parliamentary elections will be held using the current mixed electoral system, where voters elect 73 MPs in majoritarian, single-seat constituencies, while the remaining 77 seats are distributed proportionally in the closed party-list contest; The threshold for entering the Parliament will be reduced to 3 percent and parties will be allowed to form electoral blocs.
- The President will no longer be elected through direct ballot, transferring the mandate to the college of electors composed of 300 members, including MPs, local and regional government representatives. The 2018 presidential election, however, will still be held directly;
- Selling agricultural lands to foreign nationals will be prohibited.
- The opposition rights in parliament will be boosted, including by permitting them to create investigative commissions.

<sup>1</sup> The Venice Commission is the Council of Europe's advisory body on constitutional matters. Its role is to provide legal advice to its member states and, in particular, to help states wishing to bring their legal and institutional structures into line with European standards and international experience in the fields of democracy, human rights and the rule of law.

<sup>2</sup> Exact date will be defined later.

**On October 21, 2017, Georgian citizens headed to polls to elect 2058 members of 64 city councils (Sakrebulo) and 64 municipal mayors.**

Tbilisi, the country's capital and home to one third of its voters, elected the Mayor and its 50-member Sakrebulo. While the ruling Georgian Dream – Democratic Georgia won in all 73 electoral districts in the party list contest, the runner-ups offered a less homogenous picture. According to the national democratic institute (NDI), the legislative and electoral framework largely meets mostly international standards and is conducive to the conduct of democratic elections. NDI also noted that with the further consolidation of power in one party, prospects for a vibrant and pluralistic democracy are at risk and the responsibility lies with the country's leadership to create an environment that promotes a genuinely inclusive governing process and strengthens democratic checks and balances.

## Growth and Inflation

**The Georgian economy performed well in 2017, and GDP growth improved markedly, led by a stronger external environment, higher private consumption and supported by the macro-fiscal policy framework.**

The external environment improved in 2017, as the recovery of the Russian economy and better prospects for the EU generated strong external demand for Georgia's exports. GDP growth in the Europe and Central Asia region is expected to reach 2.2 percent in 2017, its strongest growth in six years (figure 2). In Georgia, driven by the solid recovery in exports (which rose by 21.3 percent in real terms), the economy grew by 4.8 percent in the first three quarters of 2017<sup>3</sup>. Exports of goods and export of services both picked-up strongly. Tourism proceeds remained especially robust with a strong positive contribution to export of services. Import increased as well, but at much lesser pace, with the trade balance improving considerably and net exports contributing up to 4.7 ppt to overall growth during the first three quarters of 2017. The fiscal consolidation reforms and flexible exchange rate policy supported smooth external adjustment.

**The contribution of investment to growth moderated in the first three quarters of the year.**

The share of gross investments declined to 29.5 percent of GDP or 1.2 ppt lower than in the first 9 months of 2016. Total investment growth decelerated to 0.7 percent in the real terms because of a weaker accumulation of inventories. This might be associated with the postponement of investor decisions to build the stock in the pre-election period. Meanwhile, total fixed investments grew by 2.2 percent year-on-year in the first 9 months of 2017 (compared to 4 percent in the same period in 2016). Based on the FDI composition in the same period, investments predominantly were directed to the transport, construction, and real estate sectors. Public investment has been strong throughout the year and it is estimated to have accelerated in the last quarter of 2017. This was driven by the government decision to increase capital budget al-

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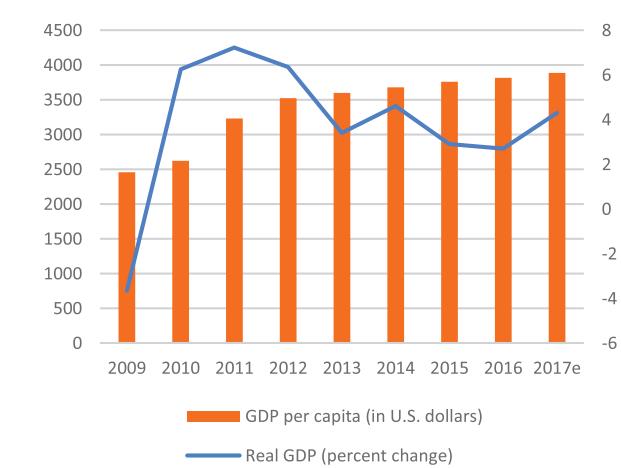
<sup>3</sup> Geostat's flash growth estimates 2017 is 4.8 percent.

location through the end-year state budget amendment for 2017. It is expected that annual growth outcomes will demonstrate a strong contribution from total investment, given the greater certainty following the local election and the accelerated pace of the public investments in the last part of the year.

**Meanwhile, total consumption slightly undermined the growth recovery in the first 9 months of 2017.**

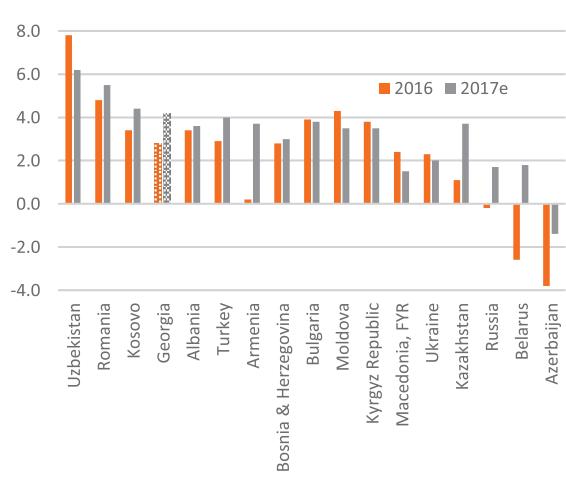
Total consumption in real terms almost stagnated with limited contribution to growth in the first three quarters of the year (figure 3). In contrast, the private consumption grew at almost 2 percent year-on-year driven by a credit growth and recovery in remittances. Domestic credit growth exceeded 18 percent on average in 9 months over the same period of 2016; in particular, loans to the households expanded by 23 percent year-on-year. In addition, a continued recovery in remittances also stimulated private consumption. However, public consumption in real terms declined by 6 percent in the same period in-line with the implementation of envisaged fiscal consolidation measures, such as an introduction of wage- and hiring-related constraints for civil servants and stricter approach for purchase of goods and services in public sector.

**Figure 1. Georgia GDP Growth and Per Capita GDP bottomed up in 2017**  
(Percent)<sup>1</sup>



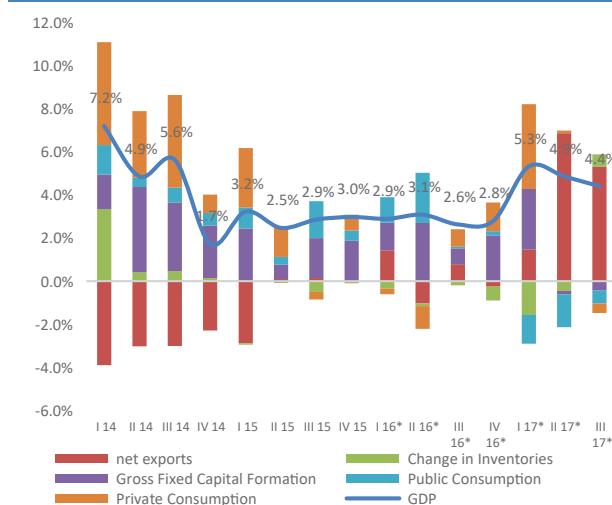
Source: Estimates based on Geostat statistics.

**Figure 2. Georgia performed better than many ECA countries, 2016-2017e**  
(%, \$US)

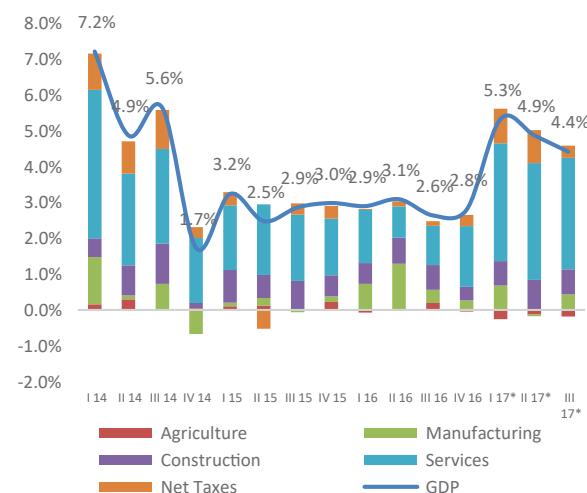


Source: WDI, Bank staff calculations.

**Figure 3. Consumption has moderated**  
(Contributions, growth %)



**Figure 4. Growth concentrated in services**  
(Contributions, growth %)



Source: Geostat and WB staff estimates.

**Construction and trade were the top two sectors driving growth in the first three quarters of 2017.**

The stronger performance in the construction sector is well aligned with the trends observed in FDI, (which generally dominated construction) as well as with the public investments in roads and municipal infrastructure. Trade benefited strongly from the enhanced external transactions, especially export of wine, mineral waters and beverages and contributed 0.9 ppt to 4.8 percent growth. Other service-related sectors, such as transport, communication, restaurants grew strongly as well by the rate above GDP growth (figure 4). These sectors highly benefit from the growing number of tourists traveling to Georgia. Although tourism generates demand for agricultural products too, the sector still contracted by 2.7 percent annually, affected by a series of one-off shocks, including the unfavorable weather conditions and insect epidemic that severely hit the harvest of walnuts – one of the key export products. The share of agriculture sector in GDP dropped to 6.9 percent in the first 9 months of 2017 from 8 percent in the same period of 2016. This production shock adds to the striking trend of productivity decline in the agriculture sector, in a context in which the agri-sector holds about 50 percent of total employment.

**Annual inflation was at 6.7 percent in 2017, exceeding NBG's target.**

Apart from one-time factors, such as the sharp increase in excise taxes on fuel and tobacco early in the year, the rising global oil prices, especially in the second half of the year were passed through to the economy. As a result, headline inflation stood significantly above the NBG's target of 4 percent. Inflation as expected decreased considerably in the beginning of 2018 once the impact of one-time factors is fading out. Inflation expectations also increased in the last months of 2017, partially driven by the depreciation of Lari in the last quarter of the year as trade

balance slightly deteriorated due to higher import of goods. In addition, the demand-driven inflation pressure emerged because of the better than expected economic performance. Annual inflation of 6.7 percent was much higher than 1.8 percent in December 2016, in response to which the NBG raised its policy rate by 0.75 ppt to 7.25 percent. The NBG increased its policy rate three times (on 25 January, 2 May and 13 December) by 0.25 ppt every time during 2017 (figure 15).

## External sector

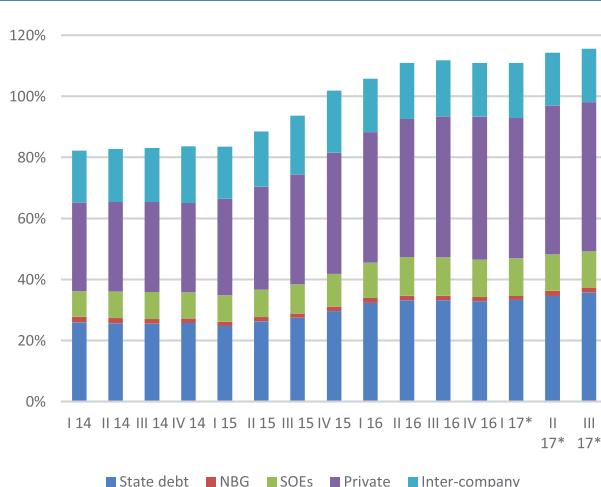
**Georgia's external position strengthened considerably, with the current account deficit narrowing.**

An improvement in the trade balance arising from higher exports and muted imports resulted in the current account deficit falling to 7.1 percent of GDP in the first three quarters of 2017 from 11.2 percent in the same period of 2016 (figure 5). Exports of goods expanded by 22 percent on the back of strong external demand from Russia, Azerbaijan, Ukraine, China, and the US. Tourism proceeds rose by 29 percent as the number of foreign visitors in 2017 reached 7 more than 2 visitors per capita. The recovery in external demand boosted worker's remittances by 17 percent year-on-year in the first three quarters of 2017. By contrast, the factor income balance weakened further due to the increased income profit repatriation by FDI shareholders, while a considerable part of it was reinvested, counting as an inflow in the capital and financial account. Net FDI inflows increased in the first three quarters of 2017 to 10.6 percent of GDP year-on-year (compared to 9.1 percent of GDP a year earlier), which exceeded the current account deficit and along with other financial and capital inflows strengthened the international reserve position of the country.

**Figure 5. Current Account Deficit further improved along with trade balance in 2017**  
(% of GDP)



**Figure 6. Public, Private Debt slightly increased**  
(% of GDP)

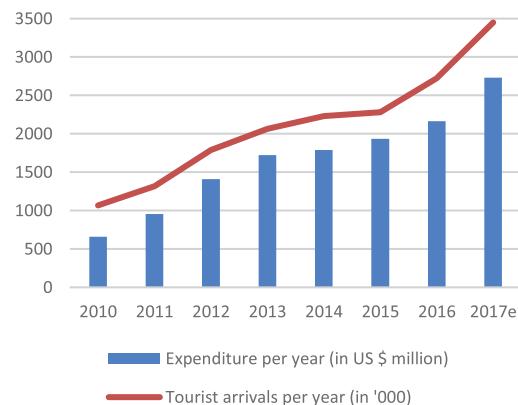


Source: National Bank of Georgia.

**External proceeds from tourism and workers' remittances continued to improve through 2017.**

The number of all types of visitors in 2017 increased by 18.8 percent year-on-year and reached 7.6 million people, out of which 46 percent were classified as tourists (figure 7), with their number increased by 28 percent. Top countries of origin were Armenia, Azerbaijan, Russia, Turkey and Iran. Money transfers registered through the banking system rose by 20 percent in 2017 driven by remittances from Israel and EU countries, such as Italy, Greece, Germany. Russia traditionally is the top country of origin for such transfers and inflows from this country increased by 15.5 percent reaching 33 percent of total.

**Figure 7: Tourism is the fastest growing sector (# of persons, m GEL)**



Source: Ministry of Economy of Georgia and Staff calculations.

**External financing requirements fell in-line with the positive developments of the current account.**

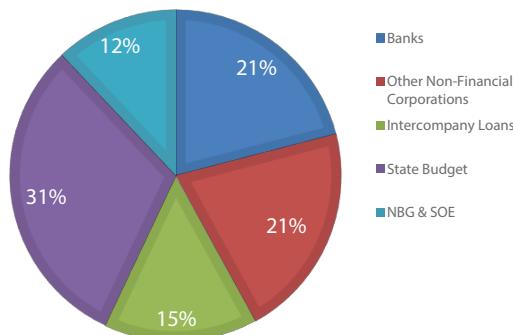
Net FDI inflows increased in the first three quarters of 2017 to 10.6 percent of GDP year-on-year (compared to 9.1 percent of GDP a year earlier), which exceeded the current account deficit and added to the international reserves. Net inflows of FDI largely originated from Azerbaijan, Turkey, and the UK (see the Focus Note). FDI inflows were directed into the transport, construction and real estate sectors. In addition to FDI, new borrowings were disbursed from the IFIs and other development partners to the public sector. Donor concessional funding exceeded 3.3 percent of GDP. At the same time, debt repayments of the private sector exceeded the new external borrowings in the first three quarters of 2017; as a result, net borrowing was negative. During this 9-month period, the NBG accumulated gross international reserves of about \$269m or 2.2 percent of GDP, comfortably meeting the target established under the new IMF program<sup>4</sup>.

<sup>4</sup> The IMF Executive Board Approved US\$285.3 million Extended Arrangement under the Extended Fund Facility for Georgia on April 12, 2017.

**Georgia is highly dependent on external financing, which has resulted in the accumulation of a large stock of external debt.**

Total external debt reached \$16.7 billion as of end-September 2017, and 112.3 Percent of GDP (was 109.6 percent of GDP by end-September 2016) (figure 6). During the first three quarters of 2017 the debt stock increased by \$932m, out of which \$518m represented newly contracted debt. The central government external debt reached 34.6 percent of GDP by the end of September, while public sector debt (including the NBG and public enterprises, in addition to the general government) held 48 percent of GDP, equivalent to 43 percent of total debt (Figure 8). Debt of public corporations includes the Georgian Oil and Gas Corporation (Eurobond of US\$250 million), the Georgian Railways (Eurobond of \$670 million), Marabda-Kartsakhi Railway (US\$560 million). The short-term debt, which amounted to about 22 percent of total debt by the end of September 2017, 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.

**Figure 8: Composition of external debt reveal vulnerabilities, end-September 2017**  
(% of total)



Source: Ministry of Economy of Georgia and Staff calculations.

## Financial sector

**The banking sector is well capitalized, profitable and the level of NPLs is not concerning, but structural vulnerabilities remain high.**

The credit issued by commercial banks to the national economy expanded by 18 percent, and total banking sector assets increased by 22 percent in 2017(figure 9). The capital adequacy of the banking sector (CAR) stood at 19.1 percent in December 2017, exceeding the NBG regulatory required ratio of 10.5 percent. The liquid-to-total assets ratio was at 21.3 percent. Profitability remains high, with a return on equity (ROE) and return on assets (ROA) at 20.7 percent and 2.8 percent, respectively. Nonperforming loans (NPLs) are lower than in neighboring countries, and on a declining trend—falling to 6.0 percent in December 2017, compared with 7.3 percent in 2016. NPLs under the IMF FSI methodology were reported at about 3.5 percent. Strict banking supervision, reasonable underwriting standards of the banks and continued credit growth have added to solid performance of the sector. At the same time, systemic financial sector vulnerabilities are high - the market share of the top 2 banks, retail loan growth, and, high dollarization – against the backdrop of weak financial safety nets and a deficient crisis preparedness framework.

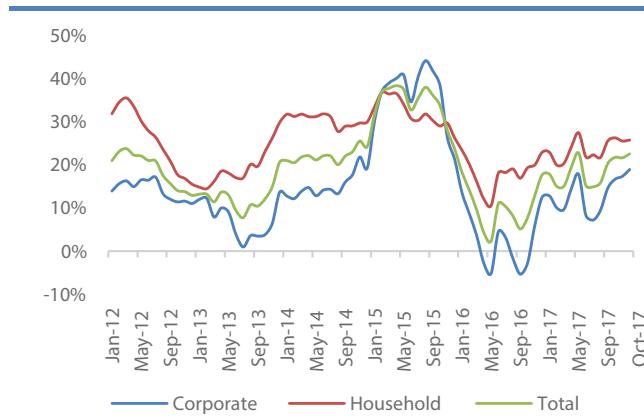
**High dollarization is a crucial challenge for Georgia's economy as it weakens effectiveness of the monetary policy transmission under the inflation targeting regime.**

**The top banks in Georgia became both larger as a proportion of GDP and more concentrated in terms of market share.**

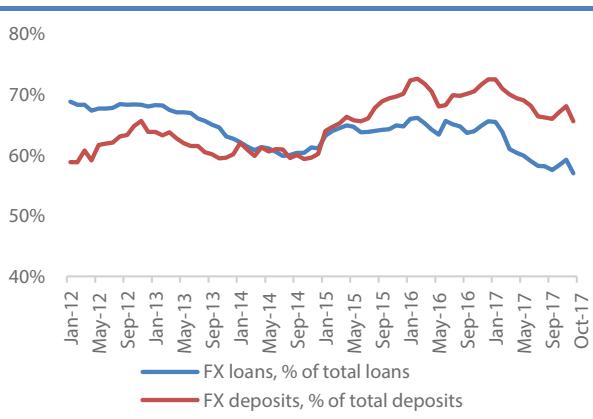
About 65 percent of the banking deposits were in foreign currency in the end of 2017, including 77 percent dollarization for individual depositors. The banking sector's long-term and short-term external debt is about 24 percent of GDP. On the asset side of the balance sheet, about 57 percent of banks' loans are foreign currency denominated (down from 65 percent in December 2016), including 69 percent of corporate loans and 46 percent of household loans (figure 10). High dollarization increases foreign exchange risk for borrowers, especially for non-exporting, small and medium enterprises (SMEs) and households that rely on income in local currency and are unhedged against the depreciation of the Lari.

The combined assets of the two largest banks in Georgia were equivalent to 65 percent of GDP as of 2017, rising from 29.3 percent in 2010; and their share over the same period increased to 71 percent of total banking sector assets from 58 percent. The top two banks<sup>5</sup> also represent large financial-industrial groups. Their size brings scale benefits, greater risk diversification that helps sustain profitability, and access to international financing at an advantageous funding cost; but, if one of these banks were to fail, the impact on the financial system would be potentially substantial. The FSAP 2014 Update recommended the enhancement of the bank resolution framework and the introduction of an explicit deposit insurance system to strengthen existing financial stability and safety net framework. Law on Deposit Insurance was adopted in June 2017. Deposit insurance coverage for household deposits came into effect on January 1, 2018.

**Figure 9. Credit growth recovered in 2017 (percent)**



**Figure 10. Dollarization of loans declined in 2017 (percent)**



Source: National Bank of Georgia.

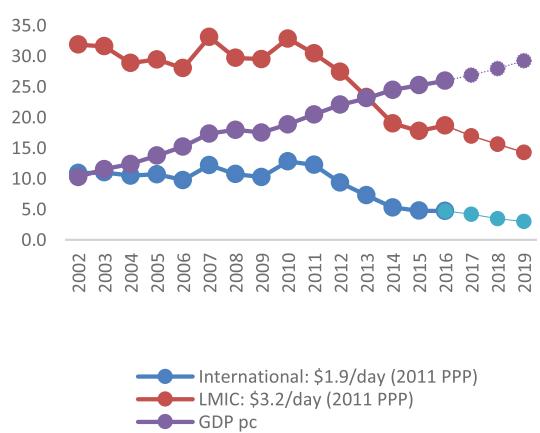
<sup>5</sup> Both of these commercial banks are domestic (owned by local investors).

## Social sector

**Net job creation stagnated in 2016 and important challenges remain.**

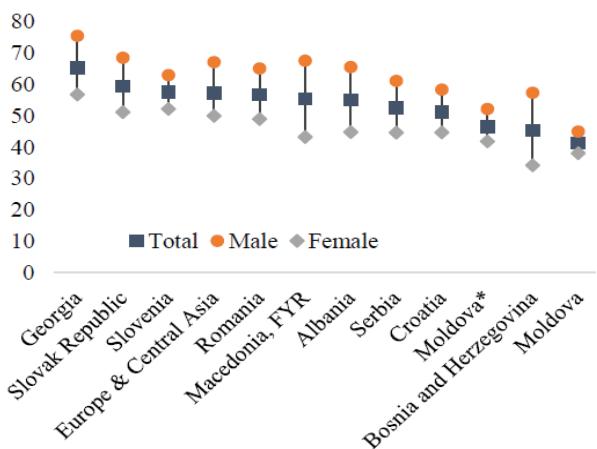
According to the household survey data that covers both formal and informal sectors, the overall unemployment rate declined to 11.8 percent in 2016 from 14.6 percent in 2013. Nevertheless, this level is one of the highest in the Europe and Central Asia (ECA) region. The government's success in attracting foreign investors through significant improvements in the business environment was not sufficient to improve employment outcomes in the country. New growth sectors, especially tourism and other services, have not been able to generate sufficient employment vis-a-vis those sectors that shed jobs. In addition, the existing educational system is not in line with the demands of the private sector, and student performance ranks low, generating a skills gap. Low net job creation (even during high-growth periods) led to high and sustained unemployment levels in the country which, in turn, have had a negative impact on poverty and shared prosperity. The currently unemployed and inactive population is close to 45 percent of the poor "bottom 40" population.<sup>6</sup> In addition, the problem of low female participation at 57 percent currently (77 percent for male) remains yet to be addressed.

**Figure 11. Poverty Indicators improved (2003-2019)**



Source: WB staff estimates based on Geostat HIS data.

**Figure 12. Labor force participation rate (2016)**



Source: World Bank database.

<sup>6</sup> This refers to the 40 percent of population with the lowest income.

**The slowdown in employment creation had an adverse impact on poverty reduction which stalled in 2016.**

The stagnation in poverty reduction breaks a declining trend that started in 2010, which was propelled mainly by employment opportunities and social assistance. The slight reduction in employment observed in urban areas translated into an increase in poverty in urban areas, though extreme poverty remained at the same level. Poverty at \$3.2/day (2011 PPP) was estimated at 18.7 percent in 2016, almost one percentage point higher than in 2015. The positive outcomes from labor markets in 2017, especially among the less-skilled, suggest poverty will start again to decline, but also highlights the vulnerability of the population just above the poverty line to labor market fluctuations. Inequality, as measured by the Gini coefficient, has fallen from a peak of 42 points in 2010 to close to 39 in 2016 (using the consumption aggregate used for international poverty comparison). Nonetheless, inequality is still among the highest in the ECA region and is evident along geographic dimension. For instance, regions located in the eastern parts of the country surrounding Tbilisi have poverty rates considerably higher than in the western regions or in Tbilisi. Similarly, along the urban-rural divide, the gap between rural and urban poverty rates has broadly been stable over the past decade, at an average of around 8 percentage points. While some differences in welfare across space are to be expected in any country, persistent gaps potentially signal chronic lack of economic opportunities in lagging regions.

## B. Macroeconomic Policies and Structural Reforms

### Assessment of fiscal and debt policies

**Fiscal pressures from the expenditure side remained elevated in 2017, while the risks to sustainability diminished with a solid revenue performance and expenditure reshuffle.**

The fiscal deficit in 2017 narrowed from 4.1 observed in 2016 to the estimated 3.4 percent of GDP (figure 13). The composition of expenditure was considerably rationalized to enhance fiscal sustainability. In order to prioritize social and infrastructure funding the authorities introduced ceilings on the wage bill and on the purchase of goods and services in the 2017 budget law. Savings for about 0.8 percentage points of GDP were generated in 2017 from reduced administrative costs. This helped—on one hand—to ease the fiscal pressure on social spending (which increased in nominal terms but declined by 0.5 percentage points as a ratio to GDP); and on the other hand, allowed the government to stimulate capital expenditures by 1.9 percentage points of GDP (figure 14). With the overall deficit at 3.4 percent of GDP the government freed-up more fiscal space than initially envisaged according to the annual fiscal target (4.1 percent of GDP). The government took an advantage of the revenue windfall to advance payments for infrastructure projects in 2018.

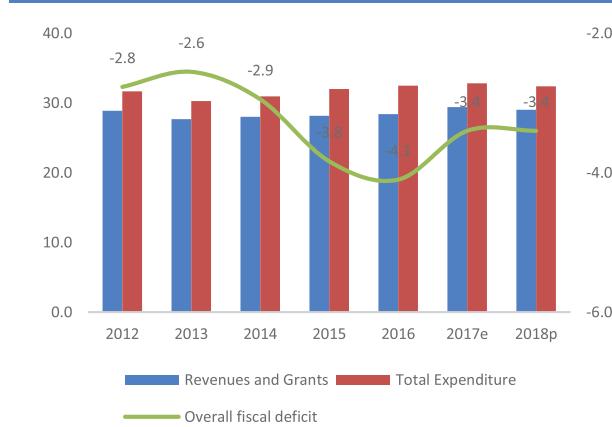
**Both tax and non-tax revenues of the general government had solid outcomes.**

Despite earlier concerns over the possible losses from the PIT reform (applying the Estonian model starting in early 2017), collections from the corporate tax were strong. The profit tax exemption retained by the private sector as a result of the reform is estimated at GEL368m (1.3 percent of nominal GDP) in the first 9 months of 2017, which was slightly lower than budgeted (by about GEL46m), reducing the public revenue loss from the reform. Overperformance against the planned collections was particularly strong for the value-added tax (an additional GEL300m or 11 percent higher) although this is partially explained by the inaccurate information about the actual VAT collections in 2016.<sup>7</sup> Excise collections suffered despite the sharp increases in their rates. This was mainly attributable to the 3-month payment delay introduced for car importers and accumulation of inventories by the tobacco importers at the end-of-year in anticipation of spike in excise rates for tobacco from January 1, 2017.

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<sup>7</sup> Around GEL300m in VAT collected in 2016 remained unidentified as a particular type of tax and considered as overpayment due to temporary technical issues following the introduction of treasury single taxpayers' account. As a result of the inaccurate baseline of 2016, VAT collections were underestimated in the 2017 budget.

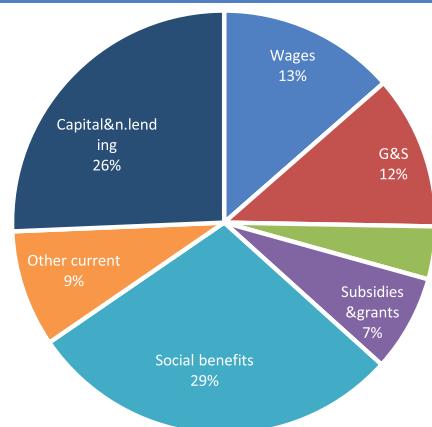
**Figure 13. A Fiscal Consolidation has started**  
(% of GDP)



Source: MOF and bank staff estimates.

**Georgia's public debt remained sustainable at 45 percent of GDP<sup>8</sup> as of end 2017.**

**Figure 14. Social spending is the largest component, 2017**  
(expenditure composition, % of GDP)



A sharp increase in public debt in 2015 and 2016 was primarily driven by the depreciation of the Lari against the USD, while the increase in 2017 is attributable to operational borrowings and further (but more moderate) currency depreciation. About 79 percent of public debt in 2017 was external and dominated by long-term multilateral and bilateral debt. Given the concessional nature of public debt, interest payments are low and average at around one percent of GDP a year. Nearly 75 percent of external public debt is at fixed interest rates, thereby reducing interest rate risk. In addition, less than 5 percent of public debt is short-term, helping maintain rollover risks well contained. Georgia's public debt is likely to decline to about 40 percent of GDP over the medium-term by 2022, supported by a gradual reduction in the fiscal deficit. Alternative scenarios confirm the need to reduce the fiscal deficit to stabilize the debt to GDP ratio in case of additional shocks, like further exchange rate depreciation<sup>9</sup>.

**Georgia's quasi-fiscal risks emanating from the contingent liabilities of the State-Owned Enterprises (SOEs) are estimated to be substantial.**

According to the Fiscal Risks Annex to the 2018 Budget Law prepared by the MOF, liabilities of the 43 high-risk SOEs reached 12.8 percent of GDP by the end of 2016, 87 percent of which were concentrated in 3 companies: Marabda-Kartsakhi Railway Company (44 percent of total), Georgian State Electrosystem (27 percent) and Georgian United Water Company (16 percent). The liabilities of the 33 medium-risk SOEs were about 7.4 percent of GDP concentrated in companies such as Georgian Railway (GR), Georgian Oil and Gas Corporation (GOGC), Commercial Operator of Electro-power System. The government is committed to monitor and manage quasi-fiscal liabilities and operations under the IMF program. In

<sup>8</sup> Includes external and domestic debt plus soviet times historical non-interest debt of about 1.9 percent of GDP.

<sup>9</sup> Debt Sustainability Analysis, WB and IMF estimates.

addition, the government (together with the IMF and the WB) closely monitors contingent liabilities generated by the government's Power Purchasing Agreements (PPAs). Under these PPAs the state issues guarantee to purchase excess electricity from the operators on a seasonal basis. As of end 2017 there were 72 signed PPAs, of which 18 are linked to power plants that are already operational, 16 are under construction, 19 are awaiting the licenses and another 19 are at the assessment stage. While the fiscal risks of PPAs are high, the needs for additional power capacity are also evident from the consumption growth trend. Therefore, the Government is committed to review carefully its decisions going forward and ensure compliance of the new PPAs with the recently adopted Law on Public Private Partnerships. The latter will be enacted on March 31, 2018.

## Assessment of monetary and exchange rate policies

### **Georgia's floating exchange rate policy is consistent with its inflation targeting regime.**

This regime allowed the NBG to conduct of an independent monetary policy, facilitated the economy's adjustment to the shock, and prevented exchange rate misalignments. Under the floating exchange rate regime, in 2017 the NBG opted to buy foreign exchange to improve its international reserves position. Gross international reserves reached US\$3.0 billion as of end 2017 (which is about 4 months of import of goods and services), the first time since 2013. In Georgia, the Lari-dollar exchange rate fluctuated between GEL2.77 per dollar in January 2017 to GEL2.38 in April, ending the year at around GEL2.55 per dollar and triggering higher inflation expectations (figure 16). In real terms, the exchange rate was volatile as well. It appreciated by 10 percent through January-April. The real effective exchange rate depreciated by 11 percent during May-November, impacting positively on export competitiveness. The NBG believes that a higher volume in the foreign exchange forward market could help smooth exchange rate seasonality.

### **Monetary policy is geared towards maintaining price stability within the inflation targeting framework.**

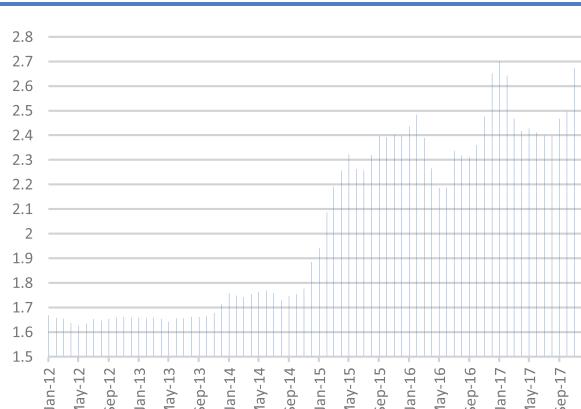
The NBG's inflation target is 4 percent in 2017 and 3 percent for the medium-term. As the annual inflation spiked to 6.7 percent in 2017, the NBG increased the policy rate from 6.50 in January to 7.25 percent in December (figure 15) in response to the emerging inflation expectations caused by the significant increase in excise taxes on tobacco and fuel in 2017. The NBG appropriately considers it as a one-off spike which will expire in early 2018 and further monetary policy tightening will likely not be necessary. Inflation expectations also increased in the recent months driven by the depreciation of Lari in the last quarter of the year. In December 2016, the NBG introduced a new monetary policy instrument—a one-month open market refinancing loan. Through this policy instrument, the NBG supplies short-term liquidity to the banking system when needed.

**Figure 15: NBG tightened monetary policy**  
(percent)



Source: Geostat, NBG.

**Figure 16: Nominal exchange rate remains volatile**  
(GEL/\$)



Source: NBG.

## Ongoing structural reforms

**The government that took office in late 2016 outlined a Four-Point-Program consistent with the main objective of the Socioeconomic Development Strategy of Georgia, “Georgia 2020”.**

This assumes that structural reforms will support rapid growth in investment, employment, and firm productivity, while also ensuring the realization of potential benefits associated with the DCFTA in terms of higher exports and FDI. The following top priority reforms were initiated or launched in recent years.

- A new remuneration law for the civil service was approved by the Parliament as envisaged by the recently enacted Civil Service Law. The salary ceilings and provisions set by the remuneration law will ensure that public wage bill is consistent with the medium-term wage bill projections under the IMF program;
- A Public Investment Management (PIM) framework was set up to strengthen the monitoring of public investment; a dedicated public investment unit was established at the MoF; and the Tbilisi Municipality has begun using the PIM Guidelines as part of a pilot involving 5 other municipalities. Following training of municipality staff, a project concept note was prepared in the appropriate. A new PPP law that is integrated with the overall investment plan and budget cycle was prepared and endorsed by the government, and a PPP Unit has been created at the Prime Minister Office;

- *In the 2018 Budget Law, the Fiscal Risk Annex* includes a quantitative reporting of quasi-fiscal relationships, and expands the analysis of contingent liabilities associated to SOEs;
- *Pension reform* has been moving forward supported by the WB, ADB and other development partners. A roadmap was completed and published as part of the pension reform strategy published in March 2016. The draft law was approved by the Cabinet for public consultation in March 2017 and was presented to Parliament for discussion in December 2017. It is expected to be approved during 2018 spring session to start implementation from July 2018;
- *Deposit insurance system (DIS)*: To foster savings in the economy and enhance the financial and social safety net, the authorities committed to develop a. The government approved the Strategy and Action Plan on Introduction of DIS in Georgia on March 2, 2017 and the Parliament adopted the Law on DIS on May 17, 2017. This key recommendation of the 2014 FSAP will help Georgia to meet the related EU AA commitments on the DIS.

## C. Economic Outlook and Risks

### Baseline scenario

**Positive external developments have helped to accelerate growth in Georgia, benefiting from the resilience demonstrated during the recent crisis.**

Georgia's growth of 4.8 percent in the three quarters of 2017 was higher than expected in the beginning of the year and the annual estimates were upgraded to 4.2 percent for 2017 driven by a strong recovery in exports and growth in private consumption. Steady implementation of the reform program will result in a gradual acceleration of growth over the medium-term to 5 percent by 2020. The annual CPI inflation is expected to converge to the NBG's target of 3 percent by year-end 2018, and the current account deficit will narrow to 9 percent of GDP by 2020.

**Table 1. Selected Macroeconomic and Social Indicators, 2013-2020p**

	2013	2014	2015	2016	2017e	2018p	2019p	2020p								
	Actuals				Projections											
(Percent change, unless otherwise indicated)																
<b>National Accounts</b>																
Real GDP (percent change)	3.4	4.6	2.9	2.7	4.2	4.3	4.6	5.0								
GDP nominal (in billions of U.S. dollar)	16,140	16,508	13,988	14,333	15,150	16,350	16,350	18,960								
GDP per capita (in U.S. dollars)	3,600	3,676	3,767	3,853	4,120	4,373	4,671	4,980								
Consumer price index	-0.5	3.1	4.0	2.1	6.7	3.1	3.0	3.0								
(In percent of GDP, unless otherwise indicated)																
<b>Investment and saving</b>																
Gross investment (in percent of GDP)	24.8	29.8	31.5	32.4	31.5	33.1	33.5	33.7								
Public	5.9	5.6	5.6	5.1	6.2	6.5	7.2	8.0								
Private	18.9	24.2	25.9	27.3	25.3	26.6	26.3	25.7								
National Savings	19.1	19.2	19.6	19.5	22.0	23.7	24.2	24.7								
<b>General Government Operations</b>																
Revenues and grants	27.5	28.0	28.1	28.4	29.4	29.0	28.7	28.5								
Of which: Tax revenues	24.8	25.1	25.1	25.8	26.5	26.0	26.0	25.9								
Grants	1.0	1.0	1.0	0.8	0.9	1.0	0.9	1.0								
Expenditure and net lending	30.1	31.0	31.9	32.5	32.8	32.4	32.0	31.5								
Current expenditure	24.3	25.4	24.9	26.1	24.5	24.0	23.3	22.4								
Of which: interest payments	0.9	0.9	1.0	1.2	1.3	1.4	1.2	1.5								
Capital expenditure and net lending	5.9	5.6	7.0	6.4	8.3	8.5	8.7	9.1								
Primary balance	-1.7	-2.1	-2.8	-2.9	-2.1	-2.1	-2.1	-1.6								
Overall fiscal balance	-2.6	-2.9	-3.8	-4.1	-3.4	-3.4	-3.3	-3.0								
(In percent of GDP, unless otherwise indicated)																
<b>External Sector</b>																
Current account balance	-5.8	-10.6	-11.9	-12.8	-9.5	-9.4	-9.3	-9.0								
Exports of goods and services	44.5	42.6	44.6	43.8	50.0	50.6	50.2	49.8								
Imports of goods and services	57.4	60.6	62.3	59.5	61.8	62.6	62.1	61.7								
Remittances	4.7	4.6	4.2	4.3	4.8	4.7	4.8	5.0								
FDI (net)	5.1	8.1	9.0	9.3	9.2	9.0	9.1	9.2								
Gross International Reserves (in months of total imports)	3.4	3.4	3.3	3.6	4.0	3.9	3.9	4.0								
(in billions of dollars)	2.8	2.7	2.5	2.8	3.0	3.4	3.7	4.2								

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

**Fiscal operations will continue to gradually shift from current to capital spending in the medium-term.**

Considerable consolidation of administrative spending, streamlining of the subsidies and a more efficient social safety net will help to achieve medium-term fiscal consolidation while providing space for capital spending. The fiscal deficit of the general government will be gradually reduced to 3 percent of GDP by 2020, helping stabilize public debt at around 40 percent of GDP. Increasing public investment to reduce infrastructure bottlenecks will be made possible by reducing current spending from 24.5 percent of GDP in 2017 to 22.4 percent in 2020. This will be achieved primarily by improving the efficiency of public spending: containing the wage bill and administrative expenses which were increasing steadily and steeply for at least last 4-5 years, better targeting subsidies and social assistance programs.

**The 2018 approved Budget is consistent with the government medium-term plan to enhance revenue measures and contain current spending.**

The 2018 State Budget Law outlines continued consolidation path to maintain the deficit at 3.4 percent of GDP. Such outcome will not be automatic – it will require continued rationalization of current spending, including (i) further containing the wage bill and administrative expenses consistent with the new civil service law; (ii) improving the targeting of subsidies and of social assistance programs, (iii) reducing transfers and privatizing loss-making state-owned enterprises (SOEs); and (iv) improving performance-based budgeting.

**Table 2. Fiscal accounts, 2013-2020**

(In percent of GDP)

	2013	2014	2015	2016	2017e	2018p	2019p	2020p
	Actuals				Projections			
<b>Overall fiscal balance</b>	-2.6	-2.9	-3.8	-4.1	-3.4	-3.4	-3.3	-3.0
<b>Primary Balance</b>	-1.7	-2.1	-2.8	-2.9	-2.1	-2.1	-2.1	-1.6
<b>Revenues and grants</b>	27.5	28.0	28.1	28.4	29.4	29.0	28.7	28.5
Taxes	24.8	25.1	25.1	25.8	26.5	26.0	26.0	25.9
Non-tax revenues	2.7	2.9	3.0	2.6	2.9	3.0	2.6	2.6
<b>Total expenditure and net lending</b>	30.1	31.0	31.9	32.5	32.8	32.4	32.0	31.5
Current expenditure	24.3	25.4	24.9	26.1	24.5	24.0	23.3	22.4
Wages and salaries	5.3	5.2	5.0	5.2	4.4	4.4	4.2	4.0
Goods and services	3.8	3.9	3.8	4.1	4.1	3.8	3.4	3.2
Interest payments	0.9	0.9	1.0	1.2	1.3	1.3	1.3	1.4
Subsidies and grants	2.1	2.2	2.4	2.3	2.3	2.2	2.1	2.0
Social expenses	8.5	9.6	9.6	10.1	9.6	9.5	9.4	9.3
Other expenses	3.7	3.6	3.1	3.2	2.8	3.0	2.9	2.5
Capital expenditure and net lending	5.9	5.6	7.0	6.4	8.3	8.5	8.7	9.1
<b>Government Financing</b>								
External	0.6	1.7	2.1	2.2	1.8	2.5	2.6	2.2
Domestic	1.5	0.8	0.6	0.8	0.9	0.5	0.5	0.6
Privatization	0.5	0.4	1.1	1.1	0.7	0.4	0.2	0.2

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

**Monetary policy will continue to operate within the framework of inflation targeting with exchange rate flexibility.**

NBG targets inflation at 3 percent from 2018 onwards. Inflation is forecasted to remain above 4 percent target in 2017, mainly a result of a hike in excises. With the effects of temporary factors expiring in 2018, inflation will converge towards target by the year-end. Foreign exchange interventions will be limited to smoothing excessive volatility of the exchange rate. The level of gross international reserves, currently below the level recommended by the IMF's Assessing Reserve Adequacy (ARA) metric, will be raised throughout the program. The monetary policy transmission mechanism will be strengthened by promoting liberalization of loans and deposits.

**The current account deficit is projected to fall below 10 percent of GDP in 2018 and 2019, supported by export growth and tourism.**

The deficit will continue to be financed by the FDI, as new projects develop and BP pipeline project financing fades out (Table 3). Meanwhile, the Government program is expected to improve external competitiveness. Ambitious structural reforms, together with the continued implementation of the EU-Georgia Association Agreement and free trade agreements with China and other countries, will support access to new markets and economic diversification. Improving further the business environment will help mobilize FDI in tradable sectors, improve competitiveness and reduce external vulnerabilities.

**Table 3. External Financing Requirements and Sources**  
(percent of GDP)

	Outturn		Projections			
	2017	2018	2019	2020	2021	2022
<b>Overall fiscal balance</b>	17.3	17.8	17.0	16.7	16.8	17.1
<b>Requirements</b>	9.5	9.5	9.3	9.0	9.0	8.7
Current Account Deficit	6.4	6.8	6.9	7.2	7.2	7.8
Medium and long-term debt	5.4	5.5	5.3	5.4	5.3	5.7
Private	1.8	2.0	1.7	1.7	1.5	1.7
Banks	3.6	3.5	3.6	3.7	3.8	4.0
Corporates	1.1	1.3	1.6	1.8	1.9	2.1
Public	1.2	1.5	0.8	0.5	0.6	0.6
Others (net)	18.0	17.9	17.8	18.0	18.2	17.7
<b>Sources</b>	9.2	9.0	9.1	9.2	9.2	9.1
Foreign Investment (net)	0.6	0.4	0.3	0.3	0.3	0.2
Portfolio Investment (net)	8.0	8.3	8.2	8.3	8.5	8.2
MLT Disbursements	5.5	5.5	5.0	5.0	5.0	4.7
Private	2.5	2.4	2.0	2.0	2.0	2.0
Banks	3.0	3.1	3.0	3.0	3.0	2.7
Corporates	2.5	2.8	3.2	3.3	3.5	3.5
Public (only project loans)	0.2	0.2	0.2	0.2	0.2	0.2
Short-term & other capital (net)	0.5	0.4	1.1	1.1	0.7	0.4

Source: DSA, IMF and WB staff estimates.

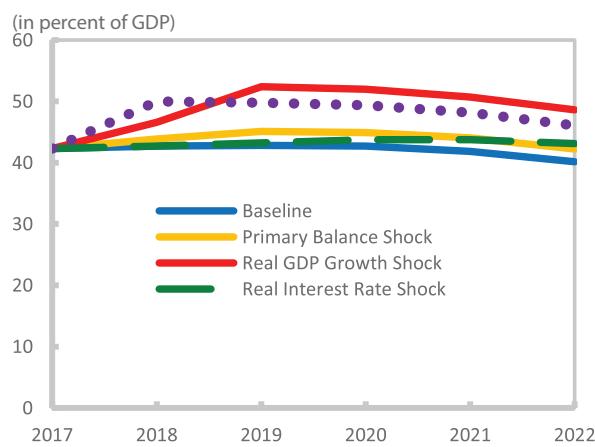
**Georgia's public debt is projected to decline to 40 percent of GDP by 2022.**

**Total external debt excluding intercompany loans, is projected to decline to about 90 percent of GDP in the medium term.**

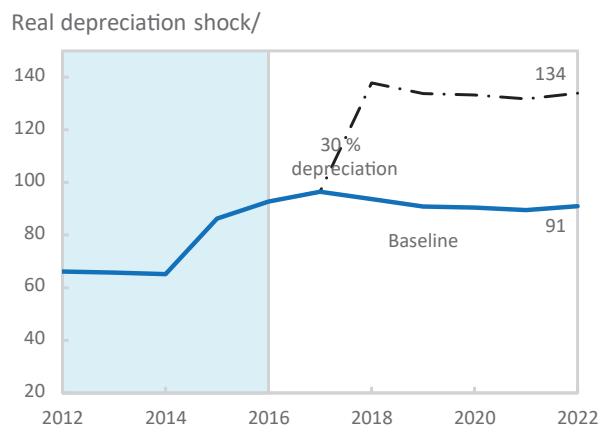
The downside risks to the baseline scenario are associated with (i) further tightening of US monetary policy and Lari depreciation; (ii) deterioration in the external environment including a weaker EU outlook and regional geopolitical tensions; and (iii) potential delays in implementation of consolidation measures, or accumulation of new liabilities or materialization of contingent liabilities. Given the large part of the debt is denominated in US dollars, a 37 percent<sup>10</sup> Lari depreciation would push public debt to 46 percent of GDP by 2022, while with higher real interest rates<sup>11</sup>, public debt would grow to close to 43 percent of GDP. Under a lower GDP growth scenario public debt would rise above 48 percent by 2022, while combined risks would push public debt to 63 percent of GDP by 2022.

However, projections remain highly sensitive to changes in macroeconomic assumptions. Deterioration of non-interest current account gap and lower growth shock would push external debt to 103 percent and 100 percent of GDP, respectively. Yet, external debt is most sensitive to the 30 percent exchange rate depreciation shock which would push the debt to 134 percent of GDP by 2022.

**Figure 17. Public Debt Sustainability**



**Figure 18. External Debt Sustainability**



Source: IMF DSA framework and WB staff calculations.

<sup>10</sup> Estimate of overvaluation or maximum historical movement of the exchange rate.

<sup>11</sup> Higher by 25 basis points.

## Risks and Mitigation

**Fragile growth, continued fiscal pressures, a large current account deficit, and high external debt are the main risks to the economy.**

- *Georgia remains vulnerable to regional developments given its high current account deficit, and the risks of low export demand and remittances.* More inward-oriented policies and weaker economic growth in key advanced and emerging economies could undermine efforts to promote trade. Spillover effects from geopolitical uncertainties and potentially slower-than-expected recovery in the EU, could potentially dampen investment inflows to Georgia and increase external imbalances. At 95 percent of GDP in 2017 (or 112 percent including intercompany loans), external debt is very high and tighter global financial conditions and a stronger U.S. dollar could deteriorate debt dynamics further. Loan dollarization at 65 percent in 2017 increases the vulnerability of the financial sector to exchange rate risks as well. Mitigating factors include a flexible exchange rate policy, the new program with the IMF, and market access;
- *With growth prospects improving in the economies of key trading partners, the output expansion in Georgia is likely to be improved as well.* However, the banking sector remains fragile in many countries, and exposures have grown in countries that depend on commodity exports. This risk is mitigated, to an extent, by the structural reforms being undertaken by the government to improve competitiveness and the investment climate in the country. Relative price changes have opened up the opportunity for increased exports, but in most cases structural reform is needed to realize these opportunities;
- *Fiscal risks largely emanate from pressures to further increase social spending on pensions, social protection and health programs, as well as PPPs and PPAs.* Fiscal space from efficiency improvements in social areas should play a crucial mitigating role in overall fiscal management and prudence deficit over the medium-term. In addition, public contingent liabilities also pose a risk, especially, those arising from power purchase agreements (PPAs) signed by the government and from quasi-fiscal activities by state-owned enterprises. These contingent liabilities need to be monitored and managed steadfastly to avoid the devolution of additional liabilities on the budget. Mitigating factors include the SOE and public investment management reforms, government's commitment to fiscal consolidation as evidenced by the 2018 Budget.

## D. Focus Note: FDI and Economic Performance in Georgia

### Overview

**Georgia has embedded remarkable improvements in its business climate over the last decade.**

**At the same time inflows of FDI have increased considerably since 2004.**

The government implemented number of important institutional reforms to this end, including a simplified and streamlined taxation system, a transparent and open governance structure, better legal system, enhanced property rights and sound prudential regulation and supervision of the banking system. Georgia improved its ratings in Doing Business survey to top ten. Other cross-country surveys suggest that impressive progress has been achieved in economic freedom (#13 out of 180 countries), trade openness (#41 out of 160 countries), and fighting corruption (#44 out of 176 countries).

Gross FDI inflows reached its peak in 2007 at about 18 percent of GDP and remained relatively high (in a range of 6-10 percent of GDP) since then, despite of several external and domestic shocks. It is important to understand whether these FDI inflows contribute to growth and meet expectations of policy makers, which relate to FDI fulfilling insufficient capital inflows, encouraging export growth, decreasing unemployment, intensifying the economic development, raising the main macroeconomic parameters (GDP and GDP per capita) and the country's international economic competitiveness.

This chapter aims to assess the factors that define FDI structure and composition in the country and its impact on the Georgian economy. It reviews country and sector composition of FDI and identifies drivers and constraints associated with the FDI inflows. Based on the findings of this analysis possible solutions and recommendations are suggested.

#### Key findings:

- There is a significant concentration of FDI in the large transport-related projects in Georgia;
- A skills mismatch, inadequate infrastructure and limited access to finance constrains foreign firms;
- The empirical relationship between employment and FDI seems tenuous at best;

- There is a significant concentration of FDI in the large transport-related *projects* in Georgia. Further analysis will be critical to understand why this sector has become particularly attractive, and how its positive impact can be maximized into the domestic economy;
- A skills mismatch, inadequate infrastructure and limited access to finance *constrains* local as well as foreign firms despite favorable business climate and relatively resilient macroeconomic environment;
- While theoretically FDI has a positive effect on employment, in the case of Georgia the empirical relationship between employment and FDI seems tenuous at best; at the same time, there is a strong positive correlation between employment in different sectors and *investments* in fixed assets almost for all the sectors. Further detailed analysis is needed to understand how different investment projects have been linked to direct impacts on employment, and whether there have been any spillovers or second-round effects;

- FDI may generate large outflows or repatriation of profits in the medium to long-run.

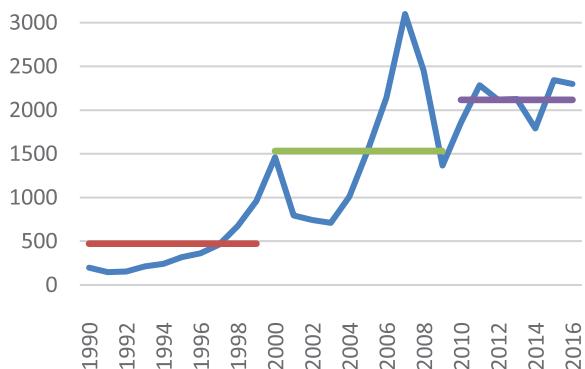
**Way forward for the FDI attraction requires improved legal framework, educated and skilled work force, transparent and simple tax system and comprehensive statistical information.**

- FDI has largely financed the current account gap in recent years; however, it may *generate* large outflows or repatriation of profits in the medium to long-run if productivity of firms is not improved over time and does not generate exports;
- Improve FDI statistics to allow policy makers better to identify FDI inflows that are related to the mergers/acquisitions and greenfield investment, as well as their direct and indirect impact on output and employment in different sectors and at the macro level;
- Improve the legal framework, identify existing deterrents to FDI still present in the economy, and implement public policies to encourage investments in a diverse set of sectors (such as agriculture, mining, light manufacturing, ect.), and attract responsible investors;
- Ensure that the level of educational attainment, provision of infrastructure services, local technological capabilities and development of domestic financial markets capture full benefits associated with the FDI;
- Maintain a level playing field and a stable, certain, simple and transparent tax system.

## 1. Introduction and Literature Review

**With FDI rising worldwide over the last decade (Figure 19), there are ongoing discussions related to the impact it has on the economy of the host country.**

**Figure 19: Global FDI flows increased (1990-2016)<sup>12</sup>**  
(billion\$)



Source: International Monetary Fund, Balance of Payments database.

<sup>12</sup> Horizontal lines on the graph represents average FDI per decade.

In neoclassical growth models, FDI promotes the accumulation of capital stock that eventually contributes to economic growth. These models are based on the assumption that the efficiency of domestic capital is the same as that of foreign capital. Therefore, FDI inflow has no spill-over effect on the host economy through technological transfer, but only through the increase in an input of production.

**In practice, FDI has added benefits, as the efficiency of foreign capital tends to be significantly higher than that domestic capital.**

FDI is typically carried out by multinational corporations that invest a large amount of money in R&D to improve their technological capabilities. Indeed, Yu et al. (2011) claim that FDI is one of the most important channels for technological dissemination. As a result, FDI not only increases the amount of capital goods in the host country, but also improves the quality and variety of production technologies (Melnyk et al., 2014). In addition, the transfer of advanced technologies leads to “technological diffusion” – the presence of technologically advanced foreign companies makes it easier for domestic producers to adopt new technologies and improve the efficiency of their business activities (Neuhaus, 2006).

**In sum, FDI also has a number indirect spillovers, including:**

(1) increased competition in the host economy and improved quality of domestic firms; (2) the sharing of technologies and experience to domestic suppliers and building more efficient sales networks; and (3) transferred knowledge by sharing technical and managerial know-how to local employees through labor force training (Blomstrom & Kokko, 1997).

**Nevertheless, in some cases, FDI might pose risks for the domestic economy.**

According to Schoors et al. (2002), when the host country is in the early stage of development, FDI might weaken the market position of local producers (even productive ones) and cause structural unemployment. Moreover, profit repatriation and increased dependence on foreign investors are considered as other channels for a negative contribution.

## 2. Dynamics of FDI

**FDI is an important macroeconomic indicator for policymakers in Georgia despite problems with its reliability.**

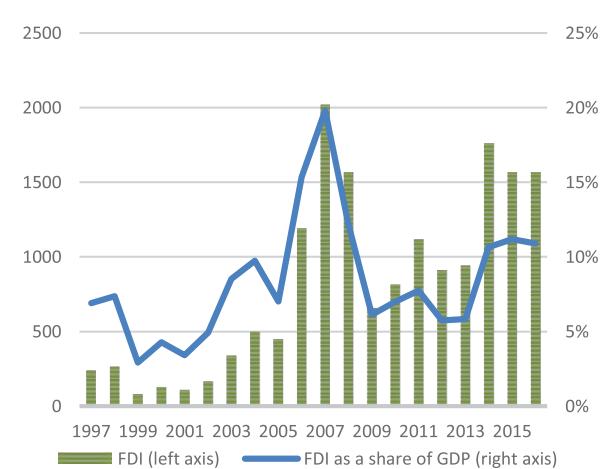
**The dynamics of FDI in Georgia reflect three distinct phases in the country's economic and political development.**

Often officially available data on Foreign Direct Investment (FDI) fails to consistently reflect a country's business environment and attractiveness for foreign investors. Thus, using FDI numbers for economic analysis could lead to misleading results due to a lack of background information on the nature of a particular investment and its calculation methodology, (Mosiaishvili & Pkhakadze, 2015).

Until 2003, both foreign and domestic investments in the country were limited by an absence of sustainable economic and political institutions, the lack of regulatory frameworks and a high level of corruption. From 1997 to 2002, FDI in Georgia amounted to US\$166 million per year on average, which constituted 5 percent of GDP. From 2003, as a result of

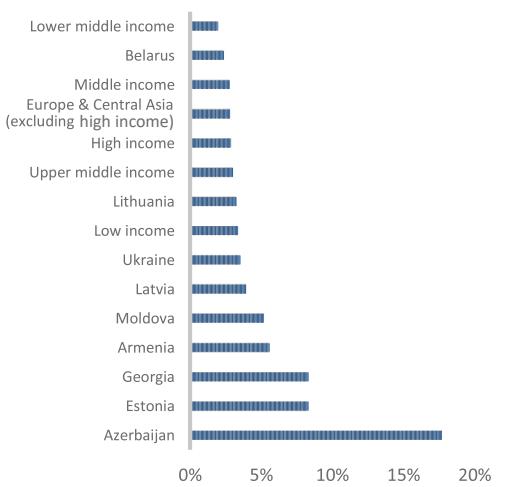
successful structural reforms implemented by the new political regime, FDI started to pick up. This period also coincided with the accelerated growth of the global economy, but it ended in 2008 as a result of the global financial crisis and the Russian military invasion of Georgia. During the period 2003-2008, net FDI inflow to Georgia reached record levels – amounting to US\$1 billion per year on average, which constituted 12.1 percent of GDP. In the post-war and post-crisis period, FDI to Georgia and its share in GDP fell sharply; however, in 2014, as a result of the large infrastructure projects launched by BP and Azerbaijan, net FDI inflows increased once more amounting to an average of US\$1.2 billion per year (8.1 percent of GDP).

**Figure 20: Overall dynamics of FDI in Georgia is positive**  
(million\$, % of GDP)



Source: Geostat, World Bank.

**Figure 21: Georgia's FDI performed better than many ECA countries**  
(1997-2016 average, % of GDP)



Source: World Bank.

**The structure of top source countries by share of total FDI has remained relatively stable over the last two decades.**

This low diversification can be explained by the large investments made in the construction of oil and gas pipelines connecting Azerbaijan and Turkey (and later Europe), by BP, the State Oil Company of Azerbaijan (SOCAR), Chevron, etc. The share of net FDI inflows from the top ten countries always exceeded 70 percent of the total during the three phases distinguished in Table 1. Azerbaijan, the United States, the United Kingdom and Turkey are countries which have regularly invested in Georgia

**Table 4: The structure of FDI by country**

Share, %

1997-2002			2003-2008		2009-2016	
	Country	Share (%)	Country	Share (%)	Country	Share (%)
1	United States	40.5	United Kingdom	12.2	Azerbaijan	19.5
2	United Kingdom	8.7	United States	10.0	Netherlands	12.5
3	Turkey	8.6	Turkey	7.6	United Kingdom	10.2
4	Russia	6.2	Netherlands	7.5	Turkey	7.8
5	Australia	5.7	United Arab Emirates	7.2	Luxembourg	5.9
6	Austria	3.8	Virgin Islands, British	7.0	United States	5.3
7	Germany	2.7	Azerbaijan	5.1	China	4.9
8	Azerbaijan	2.6	Kazakhstan	5.1	United Arab Emirates	4.3
9	Cyprus	2.5	Cyprus	4.7	Czech Republic	3.2
10	Norway	2.5	Czech Republic	4.6	Russia	3.1

Source: Geostat.

**The sectoral distribution of FDI in Georgia is similarly highly concentrated.**

The transport and communications sector was dominated by large investment projects: in particular, the construction of the Baku-Tbilisi-Ceyhan (BTC) Pipeline, the South Caucasus Pipeline and its further expansion, and the Baku-Tbilisi-Kars railway, attracted nearly 25 percent of total foreign investment in 2007-2016. The energy and manufacturing sectors received 13.4 percent and 12.3 percent of total FDI in that period, respectively. Agriculture and fishing – a sector that, according to Geostat, employed about 870,000 people (about 50 percent of the labor force) in 2016 – has not been popular with foreign investors. Only 1.2 percent of net FDI inflows ended up in this sector during 2007-2016.

**Statistical analysis of FDI data by country and by sector shows that Georgia is highly dependent on large multinational companies and their investment interests.**

In 2015, around 70 percent of entire FDI to Georgia could be attributed to six large-scale projects, which were dominated by infrastructure investments (Movchan & Saha, 2016). The largest single investor company was BP, and its interests in the region brought a significant part of FDI to Georgia. According to Geostat data, BP was the biggest FDI source for Georgia in four consecutive years (2013-2016), with more than \$2 billion invested in country during 2014-2017 in the South Caucasus Pipeline Expansion (SCPX) project alone. Another example of the importance of large foreign investors is the Hualing Group, which brought more than \$500 million into Georgia since 2007, most of which was invested in 2013-2015 (Larsen, 2017).

### 3. Drivers and Constraints for FDI

**According to the empirical literature, several factors determine the investment**

Market size, a stable economic and political situation, together with favorable investment environment and efficient domestic markets create good starting point for foreign investors to think about making

**climate in a country and define the level of competitiveness of the domestic economy.**

**However, the interaction between host countries' characteristics and FDI might vary across countries' level of development and resource abundance.**

large investments in a developing country. Therefore, development of human capital, quality of infrastructure, access to financing, stable tax system, legal framework and government policy, macroeconomic stability and economic conditions of the main partner countries are main determinants of the country's attractiveness for foreign investors.

Research has identified four types of foreign direct investment in terms of investors' motivation: natural-resource-seeking FDI, market-seeking FDI, efficiency-seeking FDI and strategic-asset-seeking FDI (USAID, 2005). Each type of FDI needs a different treatment from domestic policymakers. Georgia has a potential to attract efficiency-seeking FDI and use its favorable geographic location and exploit investment potential in the transit sector. Investments in this sector (for example, the large BP investment) require political stability; in addition, efficiency-seeking FDI needs competitively-priced inputs and labor, and fast technological development. Sectorial and country diversification achieved by focusing on the different type of investments will make FDI inflows more sustainable and will further contribute to the sustainable development.

### ***3.1 Human Capital and Inadequately Educated Workforce***

**Literature shows that the level of human capital is important determinant of attracting FDI, especially in the capital-intensive sectors that are the most FDI intensive sectors for Georgian reality.**

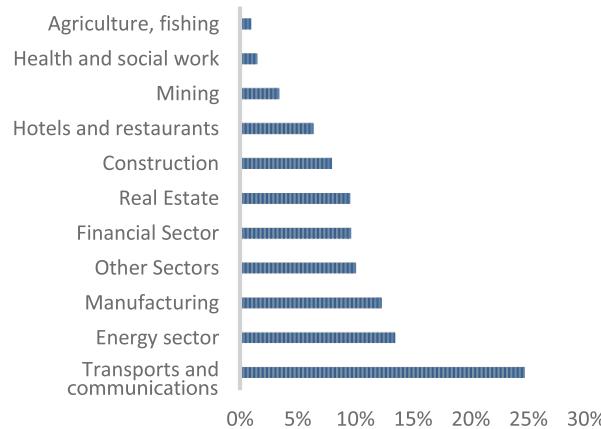
**According to the Global Competitiveness Report (2017-18), an inadequately educated workforce is the most problematic factor for doing business (see Figure 23).**

Therefore, it is important for the domestic government to implement effective education policies that directly enhance the domestic skill base and serve other two important functions: i) attracting FDI, as foreign investors are mainly seeking a new location with pre-existing human capital (Noorbakhsh et al., 2001); and ii) ensuring that the local workforce has enough capacity to absorb skill spillovers from the activities of the transnational corporation in the host country (Blomström et al., 2003).

Given Georgia's economic structure relatively few jobs require tertiary education. The majority of the population is working in the relatively low-productivity agricultural and trade sectors, where demand on the college graduates is quite limited. Therefore, the supply of the educated workforce exceeds its demand. Moreover, some workers with tertiary education may have knowledge that is far from that required when high-skills jobs are created. This phenomenon in the economic literature is known as "skills mismatching". According to the World Bank's article: "Georgia: Skills Mismatch and Unemployment, Labor Market Challenges", if all of the unemployed in Georgia were employed and new jobs require the same education profile as the existing ones, 22 percent of people with a tertiary education would not be able to find a job and 31 percent of the jobs requiring vocational skills would not be filled by workers with vocational education. Nowadays, many people with tertiary education are working on positions that require vocational

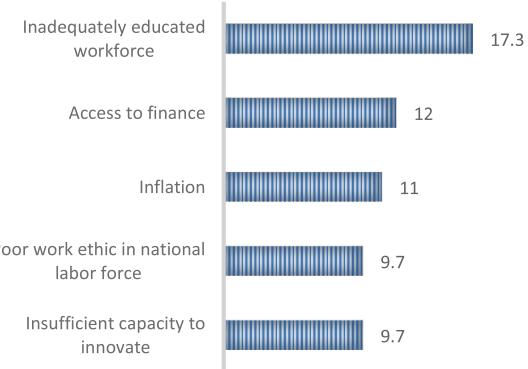
skills. At the same time, employers have difficulties to find people with specific professional education, such as IT technicians, production line workers, tractor operators, and hotel management personnel (Livny and Biermann, 2016). In addition, Georgia is ranked 107th country in the world by the quality of its education system with a relatively low score of 3 out of 7 (Global Competitiveness Report (2017-18)). Therefore, despite high literacy rate and high demand on higher education, the quality of education (evaluated by international scores e.g. Pisa Score or TIMMS Score) still remains an important constrain.

**Figure 22: FDI by economic sectors, 2007-2016**  
(share in total, %)



Source: Geostat.

**Figure 23: Top 5 problematic factors for doing business in Georgia**  
(%)



Source: The Global Competitiveness Report 2017-18.

### 3.2 Infrastructure

**The quality and availability of internal and international transport services in Georgia have improved significantly, according to the “Georgian Transport Sector Assessment, Strategy, and Road Map” (2014) according to the Asian Development Bank (ADB).**

**Georgia is characterized by an increasing trend of infrastructure investment in**

Furthermore, a contribution of the transport sector to gross domestic product (GDP) substantially increased from \$285 million in 1996 to \$2.1 billion in 2011, reaching 14 percent of GDP. However, authors identify bottlenecks in sector development: rural transport services that does not meet demand of economy, almost road-based passenger transport, inefficient distribution of tariffs and etc

In addition, according to the OECD statistics, Georgia spent more than 15 mln Euro on road maintenance in 2014. However, ADB concluded that annual expenditure on maintenance is not sufficient to keep entire

**road transport – from 124 mln Euro in 2008 (1.5 percent of GDP) to more than 224 mln Euro in 2014 (about 2 percent of GDP).**

road system in good condition. In addition to the poor maintenance, overburdened foreign trucks further aggravates this problem (ADB, 2009). This finding is confirmed by the Global Competitiveness Report (2016-17), as Georgia occupies 75<sup>th</sup> and 78<sup>th</sup> positions in the global ranking in terms of quality of infrastructure and quality of roads respectively

### 3.3 Global factors

**As a country with open economy with the high share of FDI, remittances and export of services and FDI, the Georgian economy is sensitive to episodes of economic crisis and recovery in the region.**

Table 2 offers a perspective on the linkages and dependencies of Georgia on other countries with respect to external factors in 2016. Darker colors correspond to stronger linkages and, consequently, stronger spillover effects. For example, Russia, Azerbaijan, Armenia, Turkey each absorbed between 7-10 percent of Georgian exports. Thus, the projected economic recovery in Russia and Azerbaijan after slowdown of economic growth in 2014-2016 will have positive influence on the Georgian economic parameters. While the country has pursued important Euro-Atlantic integration goals, AA and DCFTA with EU, Georgia's economic ties with neighboring countries and member of CIS were stronger than with EU in 2016. However, recent association and trade agreements and the Visa-free regime imposed in 2017 are expected to decrease dependence of Georgia on volatile CIS countries towards more stable EU and faster growing China.

**Table 5: Linkages with partners in 2016, percentage of total (%)**

Partner	Export	Import	FDI	Remittances	International Arrivals	GDP Growth Forecast, 2017-2019
Russia	9.8	9.3	1.9	34.3	16.3	1.4
Azerbaijan	7.2	6.8	35.6	1.3	24	0.2
Armenia	7.1	3	0.3	0.6	23.5	3.1
Turkey	8.2	18.6	13	7.6	19.7	3.8
EU	27.1	30.4	25.2	32	4.1	1.6
China	7.9	7.5	1.7	0.4	0.2	6.4
United States	3.2	2.9	3.4	11.1	0.5	2.1
CIS	34.9	27.2	38	39.9	68.4	-

Source: Geostat, Georgian National Tourism Administration (GNTA).

### **3.4 Legal framework and government policy**

**Georgia has a liberal and business-friendly legislative framework however the gaps on judicial independence undermines its attractiveness for foreign investors.**

According to Doing Business 2018, Georgia ranked 9th among 190 countries and highest in Europe and Central Asia Region. The result was achieved by implementing 47 reforms during last 15 years, which is the highest number among countries in the ECA region. In addition, the Georgian legal framework can be further improved by structural reforms in trading across borders and resolving insolvency. It is worth noting that according to the Global Competitiveness index (2017-2018) of the World Economic Forum, the legal framework in Georgia is behind best international practice with regard to (1) the efficiency in settling disputes and efficiency in challenging regulations; (2) the presence of favoritism in decisions of government officials and (3) the gaps on judicial independence that reduced the attractiveness of the Georgian legal framework for foreign investors.

### **3.5 Taxation**

**Georgia's tax system is based on sound foundations and by and large, the system follows international best practices.**

Georgia has a flat tax system considered to be rather efficient by regional standards. After a series of reforms in 2003-07 to simplify the tax system, eradicate border smuggling and enhance tax administration, Georgia's tax collections improved dramatically and reached 25 percent of GDP by 2007. Tax revenues have been a stable source of revenue at 24-26 percent of GDP since 2007 despite periods of high growth volatility in 2009, 2013 and 2015. Income tax in Georgia is collected at a flat rate of 20 percent, while the value-added tax (VAT) and corporate tax are levied at a flat rate of 18 percent and 15 percent respectively. As of 2017, the VAT constituted the largest single source of revenues at 40 percent of the total; income tax contributed 25 percent, profit tax 12 percent and excises 10 percent. Electronic filing is the norm and the tax administration is well-geared on modern lines with additional reforms under discussion. To preempt any reversal of the tax reforms and provide certainty, a Liberty Act was enacted in 2014 to ban new state tax or rate increase without a referendum for most taxes, which has limited potential tax revenue increases. Excise taxes are an exception to this rule and therefore has been raised frequently, with the last increase in January 2017

**In 2017, the Georgian government implemented an important initiative and introduced a new taxation scheme of corporate income (the “Estonian model”)**

Reinvested or retained profits are no more subject to income tax; only distributed profits will be taxed by 15 percent. This tax incentive is expected to boost reinvestment and overall investment level; the preliminary statistics suggest that the reform already had effect on investment decisions – the reinvestment component of FDI made in the first half of 2017, showed a record annual increase of 263 percent from \$97.8 million in previous year.

### **Box 2. The tax reform in Estonia**

With the tax reform, Estonia became the most competitive country among OECD members and one the largest stocks of FDI per capita among EU accession candidates in 2002. The reinvested corporate profits were no longer subject to income tax. Its income tax system, 20 percent flat income tax rate, at that time was considered as one of the simplest tax systems in the world. This simple and clear tax system contributed to confidence among businesses and helped promote capital investment. The competitive tax environment was vital in attracting foreign direct investments to Estonia. The Estonian corporate tax system has been conducive to economic growth. In fact, after Estonia enacted its cash-flow corporate tax in 2000, investment surged relative to its neighbors. Between 2000 and 2004, investment growth in Estonia was 39 percentage points faster than neighboring Latvia and Lithuania. The increase in FDI coincided with the exemption of reinvested earnings from corporate income tax since 2000, the model that Georgia adopted in 2017.

**In addition, Georgia exempts incomes from certain sources, as it aims to encourage investment from these sources.**

One of the important exemptions is for foreign source income. This is likely to be availed by individuals who are high income as low income individuals are not likely to derive their income from foreign sources. Similarly, capital gains accrue on capital ownership over a period of time. High income individuals would hold assets that accumulate capital gains over time. In the case of the exemptions for foreign source income and long-term capital gains, the beneficiaries are likely to be high-income taxpayers. The high-income taxpayers can be domestic or foreign depending upon the ownership structure of the industry in Georgia. These tax exemptions appear to be aimed at promoting private investment.

### **3.6 Macroeconomic stability**

**Achieving macroeconomic stability remains a necessary, but not sufficient, condition for attracting investments.**

It is widely recognized that the stable macroeconomic environment further reduces risk for FDI, allows better planning, ensures a robust domestic demand, and a good platform for exports. As mentioned before, the fall of commodity prices on world markets, global appreciation of dollar and weakened regional demand in 2014-2016 year put pressure on macroeconomic stability in Georgia. Taken together, these factors were the main contributors to the sluggish economic growth in 2015 and created further obstacles to attract foreign investments. The macro environment has generally been supportive to FDI during 2017 – with important efforts to contain inflation, maintain a floating, stable, fully convertible and transparent exchange rate regime. In addition, fiscal policy and the external sector have been supportive to growth but they do represent some important risks (increased debt burden on borrowers, for both private sector and the government; contingent liabilities) that the government is mindfully addressing. Overall, the macro environment does not seem to have acted as a deterrent for FDI, though the volatility in regional conditions and prospects inevitably plays a role.

## 4. FDI and Economic growth - Theory

### 4.1 FDI and Economic growth – Empirical Literature

**There is no consensus in the empirical literature about the direction of the causal relationship between FDI and economic growth.**

**Although much of the literature tests the causal relationship between FDI and economic growth for a country group, very few studies investigate this issue on the national level (and only one study does this for Georgia).**

According to the literature, there are four common outcomes of causality analysis: (1) the positive contribution of FDI in economic growth is clear and does not depend on any additional conditions/factors (e.g. Campos et al. (2002); Melnyk et al. (2014)); (2) FDI has a positive impact on real GDP growth, but only for countries that have a sufficient level of human capital, an appropriate trade policy, enough absorptive capability and/or a friendly business climate (e.g. Alfaro et al. (2008)); (3) FDI does not have any significant influence on economic growth (e.g. Lyroudi et al. (2004); Carkovic & Levine (2002); Herzer et al. (2007)); and (4) FDI has a negative impact on economic performance (e.g. Mencinger et al. (2003))

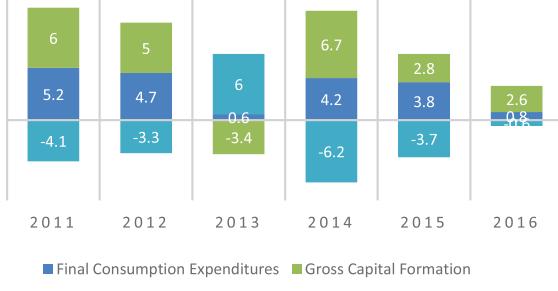
Guersoy and Kalyoncu (2012) studied the connection between FDI and GDP growth in Georgia over the period 1997-2010. The authors conducted Engel-Granger cointegration and Granger causality tests and found that these two variables are cointegrated and there is unilateral causality between them – it is only FDI that causes GDP growth and not vice-versa.

### 4.2 FDI, Gross Capital Formation and GDP growth

**According to the theoretical foundations, one of the most important channels FDI contributes to economic growth is through the acquisition of capital stock (real investment).**

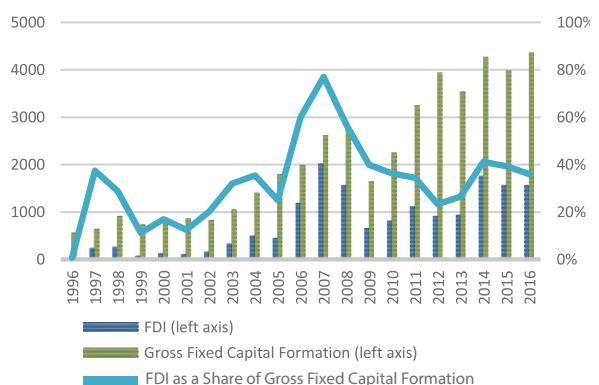
In recent years, investments have been the main source of economic growth for Georgia (see Figure 25). Especially after the regional crisis in 2014, growth in Gross Capital Formation (that measures total investment) was the main source of real GDP growth in Georgia, neutralizing the high negative contribution of the significantly deteriorated trade balance. Gross Capital Formation contains two components: Gross Fixed Capital Formation (GFCF) and change in inventories. The first measure can be used to evaluate fixed capital formation in the economy, which, according to the theoretical foundations, determines the short-run growth of the country. However, it is hard to determine the role of FDI in acquiring fixed capital. FDI can be used to finance fixed capital formation, but it can also be used to finance the deficit of a company and/or to pay off a loan. Therefore, the share of FDI in GFCF can only be approximated based on the part of the fixed capital that was acquired using FDI. The evolution of FDI as a share of GFCF has followed a similar pattern to the evolution of FDI. During the early years of transition, the share was relatively low, but after 2005 (during the global economic boom) it started to accelerate rapidly and reached a peak value of 77 percent. Following the 2008 financial crisis, the share fell rapidly to a low of 23 percent, and it now stands at 36 percent.

**Figure 24: Decomposition of real growth**  
(%, contributions)



Source: Geostat and staff calculations.

**Figure 25: FDI and Gross fixed capital formation**  
(million\$, %)



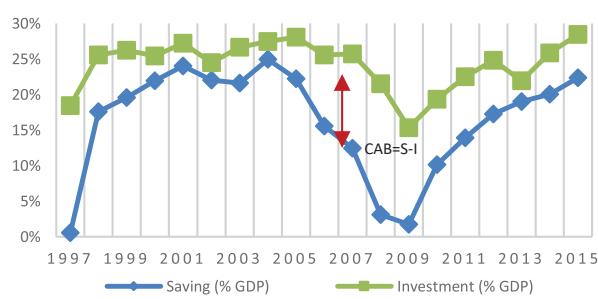
Source: Geostat, NBG and staff calculations.

### 4.3 FDI and the Current Account Deficit

**Georgia is a country with a low domestic savings rate. As a result, savings as a share of GDP are much lower than investment.**

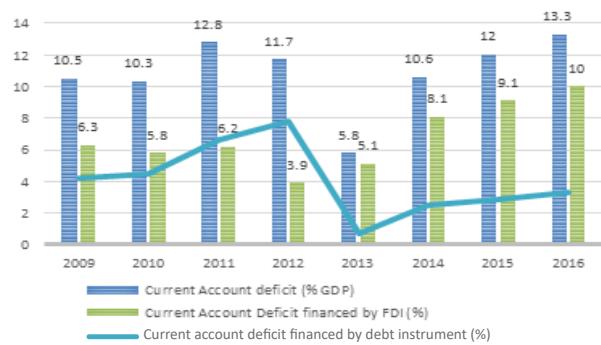
This leads to a large (yet sustainable) Current Account (CA) deficit (see Figure 27). The imbalance in the CA usually exceeds 10 percent of GDP and has been characterized by an increasing trend over the last three years that is just starting to reverse in 2017. In Georgia, FDI remains the main source of financing the CA deficit. For example, 75 percent of the deficit was financed by FDI in 2016 and this number was close to 70 percent for both 2014 and 2015 as well. Therefore, it is important to make productive investments that can be directed to closing the gap in the current account.

**Figure 26: Saving-Investment Balance**  
(% of GDP)



Source: NBG, Geostat.

**Figure 27: Current Account Deficit**  
(% of GDP)



Source: NBG.

#### 4.4 FDI and Trade

**FDI affects economic growth through different transmission channels, of which the trade channel is one of the most important, especially for countries like Georgia.**

**However, FDI affects not only exports, but also imports.**

FDI promotes exports by making country more competitive in price and quality, increasing productivity through capital accumulation, improving transport infrastructure and production facilities, attracting new technologies and know-how. In case of Georgia the effect should be even stronger – developing country with tiny domestic market and liberal trade regime with rest of the world should attract export oriented FDIs.

At the initial stage of investment phase, FDI negatively affects trade balance through increasing imports of machineries, equipment, other capital goods and services of foreign experts. In the later phases of the investment the effect on imports is dependent on input nature and output type of production. If FDI uses domestic raw materials and intermediary goods in production process, it will not have adverse effect on imports. If FDI is concentrated in industries which produces goods that are complementary to the imported products, it may encourage imports. However, if investments are made in sector which consists of import substituting industries, it would shrink import values.

**Table 6: Correlation coefficients of FDI to trade indicators (2007-2016)**

	Net FDI (flow)	Net FDI (stock)	FDI in transports and communications (flow)	FDI stock in transports and communications (stock)
Exports of goods	0.00	0.68	0.00	0.88
Imports of goods	0.19	0.69	0.15	0.55
Imports of Capital goods (except transport equipment)	0.32	0.74	0.34	0.66
Imports Transport equipment and parts	0.15	0.39	0.00	0.25
Exports of services	0.10	0.96	0.36	0.88
Exports of transport services	-0.03	0.90	0.19	0.79
Exports through pipeline transport and electricity transmission	-0.27	0.79	0.17	0.75

Source: Geostat.

**Nearly 25 percent of FDI in Georgia during last ten years went into transport and communications.**

For this reason, our analysis observes correlations between FDI in these sectors and trade indicators in 2007-2016. The results shown in table 5 suggest that:

- *Accumulated stocks of FDI have a stronger correlation with trade indicators than its flows.* It could be explained by the fact that investment needs time to affect production and exports.
- *Correlation between imports of capital goods and FDI indicators are positive, suggesting that FDI in Georgia is associated with increasing imports at the initial stage.*
- *Generally, there is no strong linkage between net FDI flows and trade indicators.* Georgian exports are dependent on various variables like regional demand, geopolitical situation in the region and trade relationship with neighbors.

**More generally, FDI in transport and communication (mainly made by BP) are expected to have a net positive impact on trade for the country in the long run.**

**To analyze the impact on trade of FDI in its second largest recipient sector of energy (with 13 percent share in total FDI) one could look at the exports and imports of electricity.**

The increased import of raw materials and intermediary goods in the initial stage production process will gradually be outweighed by benefits from transit of oil and gas through pipelines in the future. Furthermore, Georgia benefits from these projects in different ways. For example, two major regional oil pipelines – Baku-Tbilisi-Ceyhan (BTC) and South Caucasus pipeline Baku-Tbilisi-Erzurum (Shah-Deniz) significantly increase Georgia's export potential. According to the agreement made between Georgia and Azerbaijan around BTC pipeline<sup>13</sup>, Georgia will receive around US\$ 2.1 billion (as a transit fee) during the 40 years contract functioning time, which corresponds to the 62.5 million dollars per year. Also, per the agreement around South Caucasus pipeline Georgia is not only transit country but also a natural gas consumer country. Therefore, Georgia has an option to purchase 5% of gas exported from Azerbaijan to Turkey for a favorable price and get additional half a million cubic meter gas from the project investors at a special price (Georgian Oil and Gas Corporation).

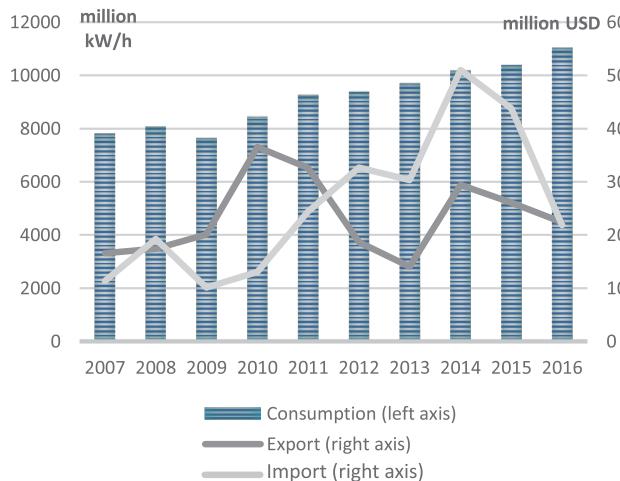
Georgia is a net importer of electricity, and domestic generation is usually less than domestic demand. Currently, FDI is ongoing in the energy sector, particularly to develop new HPPs and promising aspects of these investments include: First, increased domestic generation that will save significant part of electricity imports. The demand on electricity in the country rose significantly from 7,800 million kW/h in 2007 to 11,026 million kW/h in 2017, constituting a 41% increase. Therefore, investments in electricity generation saved for the country about 483.6 million USD on electricity imports during the last ten years compared to the scenario where generation powers freeze on 2007 level.<sup>14</sup> Second, investments in the electricity sector further increase the electricity export potential of the country especially in the summer time. Beyond this significant direct impact on trade, there is indirect positive effect on the whole economy through lower electricity prices.

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<sup>13</sup> The contact came into force in 2000.

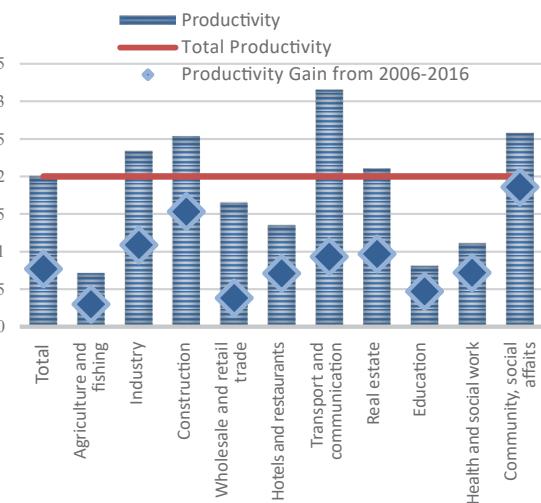
<sup>14</sup> The total amount is calculated based on average import price of 2016 and the total amount of electricity country would have to import in case of no increase in domestic generation.

**Figure 28: Trade and consumption of electricity**



Source: GeoStat, ESCO.

**Figure 29: Productivity-real value added per employed person, 2016 (GELm)**



Source: Geostat.

## 4.5 FDI and Productivity

**FDI affects economic growth through different spillover channels, including by bringing capital, new technologies, know-how marketing and management skills.**

**While there is no empirical literature that studies the impact of the FDI inflows**

While all of these benefits are considered as crucial ones for country's development, particular emphasis is placed on the contribution of FDI to the productivities of the domestic industries. According to the theoretical foundations, the transfer of technologies and knowledge resulting from FDI inflows goes beyond actual projects of foreign investors and benefits domestic firms. However, there is no empirical evidence that this positive spillover actually exists. The firm-level panel data and case study analysis show that the importance of these theoretical spillover channel is commonly exaggerated for developing countries<sup>15</sup>. There are more optimistic findings based on the industry-level studies that rely on cross-sectorial data, but the main disadvantage of this methodology is the difficulty in establishing the direction of causality (Javorcik, 2003).

Sectors that were the most attractive for foreign investors stand as the most productive sectors in the country. For example, top 3 the most productive sector<sup>16</sup>: transport and communication sector, construction

<sup>15</sup> Haddad and Harrison (1993) on Morocco, Aitken and Harrison (1999) on Venezuela, and Djankov and Hoekman (2000) on the Czech Republic doubt that there is any spillover effect of FDI on the productivity of industries. However, it worth noting that Haskel, Pereira, and Slaughter (2002) and Keller and Yeaple (2003) identified positive spillover in the United Kingdom and United States, respectively.

<sup>16</sup> Community, social and personal service activities could be considered as a high productive sector, but we should take into consideration the fact that small share of this sector in number of employed people and added value.

**on sectoral productivity in Georgia, data suggests that the sectors that were the most attractive for foreign investors experienced the highest productivity gain in the recent decade.**

**In addition, it is worth noting that the sectors which are the most attractive for foreign investors experienced the largest productivity gains in the last 10 years.**

sector, and industry, where real<sup>17</sup> value added per employed person even reaches 315, 253 and 233 thousand lari respectively<sup>18</sup>, have been the most attractive sectors for foreign investors in the recent decade. Furthermore, these sectors were characterized by large amount of investments in fixed assets. The least productive sectors, like agriculture and fishing and education sectors were the least attractive sectors for foreign investments as well (see the Figure 29). These findings are not surprising, as FDI is mainly made in capital intensive sectors that are distinguished by high productivity.

For example, top 3 fastest improving sectors in terms of productivity: construction, industry and real estate, where value added per employed person improved by 153, 109 and 97 thousand lari respectively, again has been the most active destinations for foreign direct investment. However, despite the fact that there is a strong correlation between FDI and sectorial productivity (and productivity gain), it is hard to conclude that there is causal relationship between these variables and what is the direction of causality.

#### **4.6 FDI and employment**

**While theoretically FDI have the positive effect on employment, in the case of Georgia the relationship between them is ambiguous.**

A high share of self-employed people in total employment in the country complicates this analysis even further. Theoretically, high FDI inflow causes moving self-employed people to formal employment in the corresponding sectors and this finding is confirmed by data. The share of self-employment in total employment varied between 66.2 percent (2004) to the 54.2 percent (1999), starting a gradual decline in the recent years to 57.3 percent in 2016. Yet, there are other objective factors that also incentivize people to involve into the formal employment – domestic investment, decreasing tax burden, tax system simplification, and negative net migration that puts this theoretical foundation into question. A simple correlation test between employment and FDI, which includes only officially hired people showed that the linkage between these two variables is statistically not significant and even negative in some economic sectors. However, there is a strong positive correlation between employment in different sectors and investments in fixed assets almost for all of sectors. In addition, there is a weak positive correlation between investment in fixed assets and FDI, and construction sector remains the only sector where these two variables are closely linked to each other (see the table 8). From this very simplistic comparison, one can conclude that without knowing details about every specific FDI inflow or outflow, FDI (as represented by BOP statistics) might lead to the misleading interpretations.

<sup>17</sup> Real value added is computed based on the sectorial GDP deflator.

<sup>18</sup> The source of this statistical data is business statistics, provided by Geostat and do not contain information about self-employed people and their contribution to the national economy. However, sectors that are dominated by self-employed workers (for example agriculture) are still the least productive sectors after taking into consideration of them (“Structural Transformation in Georgia – In the Right Direction at a Turtle’s Pace” (2016), Davit Keshelava).

**Table 7: correlation coefficients of employment to FDI and Investment in Fixed Assets**

Economic Sector	Investments in fixed assets	FDI
Total	0.89	0.13
Agriculture, hunting and forestry	0.78	-0.22
Fishing	0.55	-
Industry	0.50	-
Construction	0.72	0.29
Wholesale and retail trade; repair of motor vehicles and personal and household goods	0.66	-
Hotels and restaurants	0.62	-0.38
Transport and communication	0.33	0.52
Real estate, renting and business activities	0.95	-0.21
Education	0.33	-
Health and social work	0.68	0.39
Community, social and personal service activities	0.24	-

Source: Geostat and staff calculations.

**Table 8: Correlation coefficients of FDI to Investment in Fixed Assets**

Total	Agriculture, fishing	Construction	Hotels and restaurants	Transport and com- munication	Real estate, renting and business activ- ties	Health and social work
0.51	-0.09	0.67	0.19	0.37	0.00	0.44

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**WORLD BANK GROUP**

5a, Nino Ramishvili Street  
Tbilisi, 0179, Georgia

T: (99532) 229 6221

[www.worldbank.org.ge](http://www.worldbank.org.ge)