GEORGIA

Highlights

- **Economic growth is slowing.** This is primarily due to external shocks which are translating into lower exports, remittances and investment flows, as well as a significant depreciation of the currency against the dollar. Weaker business and consumer sentiments are also weighing on economic performance.
- **The supervisory functions of the National Bank of Georgia (NBG) are being removed.** A new law, which was approved by parliament in July 2015, envisages the creation of a Financial Supervisory Agency to regulate the banking sector, with board members to be approved by the parliament. The application of legislation was, however, suspended in October 2015 by the constitutional court. The law, if implemented, may undermine confidence in the banking sector and independence of supervision, weakening the quality of what was internationally perceived as proper bank regulation.
- **Electricity tariffs have been increased.** The tariffs were raised for more than one million customers in the regions of Georgia in August 2015, followed by another increase in the capital city, Tbilisi, announced in September 2015. The government plans to subsidise the rate hike by providing support for socially vulnerable households. The overall tariffs, however, still remain below cost recovery levels.

Key priorities for 2016

- **Financial sector stability and strong banking supervision need to be preserved in light of increasing pressure stemming from both economic and political factors.** Steps need to be taken to strengthen the credibility of the newly created banking supervisory body and national currency. Efforts should be accelerated to reduce dollarisation in the banking sector, which exceeds 60 per cent in both loans and deposits.
- **Enhancement of the energy sector remains a key priority.** Important provisions regarding the energy sector (pricing, transport, transit of energy and the establishment of an independent energy regulator) have been included in the Deep and Comprehensive Free Trade Agreement (DCFTA), and these and other energy sector reforms should be implemented promptly.
- **Efforts by the authorities aimed at decreasing political uncertainty and improving the business environment need to be stepped up.** The latter, combined with concrete steps aimed at improving the business environment will contribute to the enhanced quality of economic institutions and the attractiveness of Georgia as an investment location.

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Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	7.2	6.4	3.3	4.8	2.5
Inflation (average)	8.5	-0.9	-0.5	3.1	3.5
Government balance/GDP	-3.6	-2.9	-2.6	-2.9	-3.0
Current account balance/GDP	-12.7	-11.7	-5.7	-10.5	-10.7
Net FDI/GDP [neg. sign = inflows]	-6.2	-3.9	-5.1	-8.1	-6.6
External debt/GDP	80.2	83.7	82.1	82.9	n.a.
Gross reserves/GDP	19.5	18.1	17.5	16.3	n.a.
Credit to private sector/GDP	30.6	32.0	37.7	42.8	n.a.

Macroeconomic performance

Economic growth moderated significantly to 2.6 per cent in the first half of 2015, after reaching 4.8 per cent in 2014. The slow-down in 2015 reflects the spillovers from the economic downturn in the region, lower cross-border trade, declining remittances inflows, lower investments and a slow-down in the tourism sector. External trade turnover shrank by 13 per cent, with exports down by 24 per cent and imports down by 9 per cent in the first half of 2015 year-on-year. Remittances dropped by 23 per cent in the first half of 2015 year-on-year due to sharply declining money transfers from Russia and Greece. Foreign direct investment (FDI) was also negatively affected, with a significant drop of 34 per cent in the first quarter of 2015 year-on-year.

The currency weakened significantly in late 2014 and into 2015. The NBG largely kept to its floating exchange rate policy, selling relatively modest amounts of foreign exchange reserves, and later raising interest rates in line with the requirements of its inflation target. The Georgian lari depreciated by around 21 per cent between January and September 2015, primarily due to currency devaluations of trading partners, a decline in remittances and FDI inflows, and domestic political uncertainty. Competitiveness gains have been much less, with the nominal effective exchange rate depreciating by around 7 per cent in January to September 2015. In response the NBG gradually raised the monetary policy rate from 4 per cent in 2014 to 7 per cent in September 2015. Interventions in the currency markets lowered international reserves to US$ 2.5 billion in September 2015, or the equivalent of around three months of imports. Inflation began rising in 2015, reaching 5.2 per cent in September 2015 year-on-year, after averaging 3.1 per cent in 2014.

The banking sector remains resilient and well capitalised, but risks are increasing. The loan portfolio grew by 14.7 per cent, while deposits increased by 6.5 per cent in June 2015 year-on-year. The banking sector remains profitable with returns on equity (RoE) reaching 15.9 per cent, while non-performing loan (NPL; more than 90 days overdue) levels remain low at 3.4 per cent as of the end of June 2015. However, there is a risk for the potential growth of NPLs due to currency depreciation. Dollarisation rates are high both in credits and deposits, at 63.1 per cent and 65.3 per cent, respectively, as of the end of June 2015.

Fiscal and external balances are under pressure. In July 2015, the government amended the 2015 budget law, reducing tax revenues by 2.7 per cent (GEL 200 million) and targeting a fiscal deficit of 3 per cent. The government is maintaining a fiscal stimulus, backed by international financial institution (IFI) lending, pushing up the public debt-to-GDP ratio to around 45 per cent in 2015, with a significant part of the increase attributed to exchange rate depreciation. The current account deficit widened to 10.5 per cent of GDP, with total external debt at 82.9 per cent in 2014, putting further pressure on the currency and making the country vulnerable to domestic and external shocks.

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Economic growth is expected to moderate significantly to 2.5 per cent in 2015, reflecting a deteriorating external environment and the economic slow-down of regional trading partners. Increased domestic political tensions during 2015 are also putting pressure on confidence and growth. In 2016, growth is expected to remain subdued, projected at 2.6 per cent, affected by a negative external environment and a potential increase in NPLs, as the effects of the slide of the Georgian lari in 2014-15 and the downturn in the economy will begin to crystallise.

Major structural reform developments

Georgia's business environment remains favourable, having undergone significant structural reforms over the past several years, as recognised by the World Bank's *Doing Business 2016* report in areas such as business entry, deregulation, construction permits, tax and customs reforms. The country ranked 24th out of 189 countries in the *Doing Business 2016* report.

Parliament has approved the banking supervision bill; however, its application has been delayed by the constitutional court. The new law, approved by parliament in July 2015, removes from the NBG its supervisory functions by creating a financial supervisory agency for regulating Georgia's banking sector. The agency will be governed by seven board members, a majority of which are nominated by the government and approved by the parliament. The law has drawn widespread criticism from IFIs, business associations and the President of Georgia, who vetoed the bill in July 2015; the veto was overturned by the parliament in September 2015. In October 2015, the constitutional court suspended the application of the legislation dealing with operation of the banking supervisory agency. The new structure of banking supervision, if implemented, may weaken confidence in the banking sector.

Georgia continues to implement its commitments under the DCFTA. In the past year, Georgia made progress in the liberalisation of trade and trade-related issues by introducing necessary amendments in food safety, veterinary and customs legislation during 2014. Two agencies – for entrepreneurship development and for innovation and technology – were created to provide entrepreneurship and consultancy services to small and medium-sized enterprises (SMEs). It is critical that the country continues with effective implementation of the reform agenda under the DCFTA framework, including the elimination of technical barriers to trade, enhancing the regulation of public procurement and enacting a more robust competition policy.

Visa and migration rules were eased. Parliament passed a package of legislative amendments aimed at easing visa and migration regulations in May 2015, which had been tightened in September 2014. The bill envisages the extension of the visa-free stay in Georgia for citizens of some countries from 90 to 360 days, as it was previously.

Regulations for selling and buying agricultural land by foreign citizens have been changed. The government adopted amendments to the Law on Ownership of Agricultural Land in September 2014. The regulations remain quite restrictive. According to the amendments, foreign citizens and legal entities founded abroad are not allowed to purchase agricultural land in Georgia. However, a foreigner could become the owner of the land if he/she inherits it. Also, in the case of a marriage partnership between a Georgian and a non-Georgian, agricultural land may be in joint-ownership. A company is also allowed to become a land owner only if it has five years of working experience in the agricultural sector in Georgia; while in the case of physical persons, they need to have permanent residence or an investor's residence permit to live and work in the country.

Electricity tariffs have been increased. In August to September 2015, the tariffs were raised by around 1.5-2 US cents (3.5-4.5 tetri) per kilowatt-hour – from 4-7.5 US cents (9-17.7 tetri) to 5.75-9 US cents (13-21.5 tetri) depending on the electricity consumption level – for more than one million customers in the regions of Georgia and for customers in the capital city, Tbilisi. The government plans to subsidise the rate hike in the regions by providing GEL 20 million (around US$ 8.9 million) for socially vulnerable households; more subsidies are expected to be earmarked for customers in Tbilisi. The overall electricity tariffs, however, still remain below the cost recovery levels.

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The Competition Agency, established in April 2014, has made its first decisions. The Agency fined Georgia's five largest petrol and diesel fuel retailers a total of GEL 51.6 million (around US$ 22.7 million) in July 2015 for alleged price-fixing. The companies rejected the price-fixing allegations and the dispute is expected to continue in court. The decision is an important milestone for establishing the credibility of the agency; however, its impact will depend on how the dispute between the agency and companies is resolved in court.

Details of the Nenskra hydropower project, the largest project of its kind since Georgia's independence, have been finalised. The implementation package was signed between Georgia's state Partnership Fund, South Korea's K-Water and Italy's Salini Impregilo on 31 August 2015 to launch construction of the 280MW Nenskra hydropower plant in the northwest region of the country. The total cost of the project is around US$ 1 billion, with financing to come from the EBRD, ADB and Export-Import Bank of Korea, with construction to be completed in five years. Nenskra is expected to generate sufficient energy supply during the winter season and increase the export capacity in the summer.

The government announced privatisation plans in March 2015, under which about 20 state-owned assets are to be sold in 2015, generating US$ 300-350 million to help stabilise the national currency and finance infrastructure projects. The list of assets to be privatised includes buildings of the National Bank and Ministry of Economy, presidential and government residential buildings in the regions, and so on. However, there has been little progress with privatisations to date.