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IMF Executive Board Concludes 2009 Article IV Consultation with Georgia

On March 23, 2009 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Georgia.[1]

Background

With the double impact of the August 2008 armed conflict and the global crisis, real economic growth suffered a dramatic decline from 12½ percent in 2007 to an estimated 2 percent in 2008, after a sharp contraction in the second half of the year. Inflation slowed to 5½ percent at end-2008 as global food and energy prices receded and demand weakened. The external current account deficit is estimated to have reached 22½ percent of GDP in 2008 but narrowed substantially in the second half of the year. Private capital inflows, which had been financing the current account deficit, dropped from $1.7 billion during the first half of the year to an estimated $450 million during the second half. Gross official reserves fell immediately after the conflict but recovered later, aided by donor support, borrowing from the Fund under the Stand-By Arrangement approved last September, and transfers from the sovereign wealth funds to government accounts in the central bank.

The fiscal deficit widened markedly in 2008 but the composition of spending improved from high defense and election outlays in the first half of the year to infrastructure and social spending in the second half. Monetary policy, which focused on resisting inflationary pressures until the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

conflict, had to deal the impact of declining demand for local currency on bank liquidity. The central bank intervened heavily in the foreign exchange market to support the lari, and banks stopped new lending despite central bank liquidity injections, reduced reserve requirements and policy rate cuts.

The tightening of credit conditions and weakening of the economy exposed vulnerabilities in the banking sector. Liquidity and solvency ratios deteriorated. The level of nonperforming loans increased sharply and the need for loan-loss provisioning together with higher funding costs and lost interest income have affected profitability.

The government introduced important structural reforms in the first half of 2008 , including a gradual reduction of income and dividend taxes, and the introduction of rules to guide fiscal and monetary policies in the medium term while ensuring public sector discipline and price stability.

Executive Board Assessment

Executive Directors observed that, following a long period of strong performance owing to the implementation of sound economic policies and structural reforms, the Georgian economy has been seriously affected by the August 2008 armed conflict, and now by the global downturn. The combined shocks to the current and capital accounts are likely to be larger and more prolonged than originally expected, increasing the external adjustment challenge and diminishing near-term growth prospects. Directors endorsed the authorities' economic strategy, which assigns fiscal policy to support domestic demand and exchange rate flexibility to achieve external stability. Structural reforms aim to secure sustained economic growth over the medium term. Directors saw considerable downside risks to the economic outlook and recommended that the authorities should stand ready to adapt their economic policies as warranted.

Directors supported the authorities' plans to contain the economic slowdown through a donor-financed fiscal stimulus and a reorientation of expenditures. The authorities have reduced the targeted 2009 fiscal deficit in line with a downward revision in expected official external financing, and have switched expenditure from imported defense goods toward essential productivity-enhancing infrastructure investment and better targeted social spending. Directors welcomed the planned expenditure management reforms.

Directors welcomed the move to foreign exchange auctions as an important step to achieving greater exchange rate flexibility and protecting international reserves, which are relatively low. They agreed with the authorities that exchange rate flexibility needed to be managed so as to preserve confidence in the financial sector. Directors took note of the staff assessment that the real effective exchange rate is overvalued. Over the medium term, the authorities' commitment to exchange rate flexibility and structural reforms to enhance competitiveness should help correct the overvaluation, and reduce vulnerabilities posed by the large underlying current account deficit.

Directors recommended that all instruments of monetary policy, including the interest rate and reserve requirements, be employed in support of the authorities' more cautious liquidity management, which would ease pressures on the foreign exchange market. They welcomed the planned improvement of the central bank's liquidity framework, which should strengthen the effectiveness of interest rate policy. Directors stressed the importance of closely coordinating fiscal and monetary policies in order to contain pressures in the foreign exchange market.

Against the background of deterioration in banks' loan portfolios and profitability, Directors emphasized that close supervision will be crucial. They welcomed the Financial Supervisory Agency's actions to increase provisioning based on bank-by-bank assessments, and the upcoming technical assistance from the Fund to strengthen its stress-testing capability. Directors endorsed the authorities' measures to bolster depositor confidence through increased transparency and adequate safety nets. Directors welcomed the authorities' commitment to developing a financial stability plan to respond to potential situations of stress.

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Georgia: Selected Economic Indicators, 2004–2008

	2004	2005	2006	2007	2008
Real Sector					
Real GDP growth (percentage change)	5.9	9.6	9.4	12.4	2.0
GDP (in millions of U.S. dollars)	5,126	6,411	7,768	10,227	12,870
GDP per capita (in U.S. dollars)	1,188	1,486	1,800	2,324	2,925
Inflation (in percent)					
Period average	5.7	8.3	9.2	9.2	10.0
End-of-period	7.5	6.2	8.8	11.0	5.5
Central government operations (in percent of GDP)					
Revenue and grants	23.1	24.4	26.7	29.3	30.7
Expenditure and net lending	20.7	26.0	29.7	34.0	37.1
Overall balance (cash basis)	2.4	-1.6	-3.0	-4.7	-6.4
Monetary indicators					
Reserve money (end-of-period growth rate, in percent)	44.3	19.7	19.2	25.6	-4.5
Broad money (end-of-period growth rate, in percent)	42.6	26.4	39.3	49.6	7.0
Broad money velocity	7.64	6.79	5.18	4.27	4.48
External Sector					
Current account balance (including transfers)					
In millions of U.S. dollars	-344	-701	-1,174	-2,006	-2,911
In percent of GDP	-6.7	-10.9	-15.1	-19.6	-22.6
External debt					
In millions of U.S. dollars	2,138	2,095	2,328	3,136	4,581
In percent of exports of goods and services	41.7	32.7	30.0	30.7	35.6
Gross official international reserves					
In millions of U.S. dollars	352	474	881	1,361	1,480
In months of imports of goods and services	1.3	1.3	1.8	2.2	3.0
Exchange rate, lari/dollar, period average	1.92	1.81	1.78	1.66	1.48

Sources: Georgian authorities; and IMF staff estimates.