Office Memorandum

To: Members of the Executive Board May 27, 2014

From: The Secretary

Subject: **Georgia—Assessment Letter for the World Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in Georgia, which was requested by the World Bank.

If the authorities of Georgia consent to the publication of this assessment, it may be published by the World Bank.

Questions may be referred to Mr. Griffiths (ext. 35354) and Mr. Ljungman (ext. 38697) in MCD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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GEORGIA—ASSESSMENT LETTER TO THE WORLD BANK

May 27, 2014

This letter updates the assessment of Georgia's economic conditions and policies included in the 2013 Article IV report for Georgia, which was discussed on July 10, 2013 (Country Report 13/264), the most recent report on Georgia considered by the IMF Executive Board.

Recent Developments, Outlook, and Risks

1. **Georgia's economy is recovering from the economic slowdown of late 2012 and early 2013.** Supported by strengthened business confidence, a rebound in credit and accommodating fiscal and monetary policies, growth has increased to over 7 percent year-on-year in the first quarter of 2014. In part due to the strong base effect at the end of last year, GDP growth is projected to reach 5 percent this year, up from 3.1 percent in 2013. Continued structural reforms supported by prudent macroeconomic policies should return growth to its potential of 5–6 percent by next year. Inflation, which had been at around zero for much of 2012–13, rose to 3.5 percent year-on-year in March. Given the economic recovery and the exchange rate depreciation at the start of the year, inflation should come close to the National Bank of Georgia's (NBG) 6 percent target by the end of the year.

2. **The external account improved in 2013, but the current account deficit will widen in 2014 as imports rebound along with growth and a more expansionary fiscal policy.** The current account deficit fell sharply—to below 6 percent of GDP in 2013 from close to 12 percent of GDP in 2012—helped by the economic slowdown and fiscal tightening throughout most of last year. However, staff estimates that only about half of the improvement was structural, and so the current account deficit will widen to around 8.5 percent of GDP in 2014 as imports recover and the growth rate of exports to some major trading partners (Turkey, Russia, and Ukraine) falls. Following exchange rate intervention in support of the lari at the end of last year, it will be important to re-build reserves over the medium-term, including through continued support from IFIs.

3. **Despite the increase in the budget deficit this year, public finances should be sustainable.** Since 2011 the general government deficit has come down from 3.6 percent of GDP to 2.6 percent of GDP in 2013, stabilizing debt at around 34 percent of GDP. While the deficit is projected to increase to 3.7 percent of GDP in 2014, public finances remain sustainable provided that medium-term consolidation objectives are achieved. However, the

in-year spending profile in 2013—with a surplus through the first three quarters followed by a 3 percent of GDP deficit in the fourth quarter—added to economic volatility. The authorities are committed to improving coordination of fiscal and monetary policies.

4. **Faced by an increasingly uncertain external environment, downside risks to the outlook have increased.** The sharp slowdown in Russia, the political and economic crisis in Ukraine and the slowing of Turkey's economy create risks for Georgia's recovery. Lower demand for Georgia's exports (both through subdued growth and exchange rate depreciation in partner countries), falling remittances, and the risk that foreign direct investment (FDI) might fall short of forecast may impact growth. So far, however, there have been few signs, save for some recent decline in remittances, that the more unsettled external environment is affecting the Georgian economy.

5. **External vulnerabilities remain high, but should not pose immediate risks.** Successive current account deficits have increased net foreign liabilities to about 100 percent of GDP. Although foreign currency denominated, a large part of these liabilities are long-term concessional public debt, FDI and intercompany loans that do not require frequent rollover. External financing needs are sizeable, but in the past these have been easily met by official inflows and FDI. Georgia's banking sector is well capitalized and liquid. While still highly dollarized—leaving banks exposed to currency-induced credit risk—the share of credit and deposits in foreign currency have both fallen over the past year in response to policies supporting greater use and flexibility of the lari and greater macroeconomic stability.

Macroeconomic Policies

6. **The new government has taken steps to strengthen economic decision-making and improve communication.** An Economic Council under the Prime Minister has been established to facilitate decisions, coordinate policies, and follow up on their implementation. The government has prepared a long-term development strategy—Georgia 2020—which identifies, in general terms, reforms critical for macroeconomic stability and sustainable and inclusive growth.

7. **For 2014, fiscal policy targets a 3.7 percent of GDP deficit.** The 2014 budget does not propose major new revenue reductions or new social commitments. However, the deficit is expected to increase by just over 1 percentage point of GDP as a result of the full year impact of social commitments introduced in 2013 (higher pension transfers and universal healthcare insurance), lower personal income taxes (effective for 2013 but only paid out in 2014), and a lower revenue base due to the 2013 slowdown, which was more severe than the government had expected. The deficit will be financed from domestic and official sector sources, in roughly equal proportions. The authorities are committed to reducing the fiscal deficit to 3.0 percent in 2015 and to no more than 2.5 percent of GDP in the medium term, while preserving pro-poor social policies and retaining an adequate level of public

investment. Meeting these commitments will be important to preserving fiscal sustainability and correcting economic imbalances.

8. **Monetary policy is geared towards meeting the inflation target**. The NBG responded to last year's deflation by loosening monetary policy in 2013, cutting its refinancing (policy) rate by a total of 150 basis points. Higher food prices and increased activity pushed inflation up to 2½ percent by end-2013. Reacting to projected further increases in inflation closer to its 6 percent target—partly due to the expected pass-through from the lari's recent depreciation—the NBG raised its policy rate in February for the first time since early 2011, by 25 bps to 4 percent. With inflation still below target, monetary policy remains (appropriately) slightly accommodative.

9. **The authorities' initiative to establish a Development Bank is a concern, and strong safeguards will be needed to ensure that such an institution does not create large fiscal risks or generate distortions.** Before proceeding with a Development Bank, a thorough assessment of the market failure that needs to be addressed should be made, including an analysis showing why the proposed Bank is the appropriate solution. A public financial corporation providing credit to the economy runs the risk of creating implicit or explicit contingent liabilities for public finances, highlighting the need for putting in place stringent safeguards, including limits on the size and nature of liabilities. Should the government continue with its decision to establish a Development Bank, it will be important to establish a comprehensive framework that addresses all concerns regarding governance, fiscal risks, financial sector distortions and competition.

10. **Economic recovery and the pickup in inflation have allowed the central bank to bring its three-year loosening cycle to an end.** In February the NBG raised its policy rate by 25 basis points (to 4 percent). Recent fluctuations in the lari/US$ exchange rate, which for the last 2–3 years had been relatively stable, demonstrate the NBG's commitment to exchange rate flexibility and inflation targeting. To further strengthen its inflation-targeting framework, the NBG is improving the transmission mechanism, its communications strategy and strengthening accountability for inflation targeting.

11. **The Georgian authorities are working to meet the medium-term challenge of generating sustained growth and to make it more inclusive.** The government's Georgia 2020 strategy recognizes the importance of structural reforms aimed at improving public sector efficiency, access to financing, private sector competitiveness and human capital development. These can contribute to private sector investment, productivity gains and growth. Support from development partners and the momentum created by the recently initialed EU-Georgia Association Agreement should facilitate these reforms.

Relationship with the Fund

On April 11, 2012, the IMF Board approved the request for a Stand-By Arrangement (SBA) and an arrangement under the Standby Credit Facility (SCF).

On March 13, 2013, the IMF Board approved the 1st and 2nd review under the SBA/SCF.

On July 10, 2013, the IMF Board concluded the 2013 Article IV Consultation.

The 24-month SBA/SCF expired on April 10, 2014 without completion of the 3rd or 4th reviews due primarily to fiscal policy slippages.

Fund staff is currently in discussions on a new 36-month program with the Georgian authorities.

Table 1. Georgia: Macroeconomic Framework, 2012–19

	Actual		Projections					
	2012	2013	2014	2015	2016	2017	2018	2019
National accounts	(annual percentage change; unless otherwise indicated)							
Real GDP	6.2	3.2	5.0	5.0	5.0	5.0	5.0	5.0
Nominal GDP (in billion of laris)	26.2	26.8	29.2	32.2	35.5	39.1	43.1	47.5
Nominal GDP (in billion of U.S. dollars)	15.8	16.1	16.1	17.5	18.9	20.4	22.1	23.8
GDP per capita (in thousand of U.S. dollars)	3.5	3.6	3.6	3.9	4.2	4.6	4.9	5.3
GDP deflator, period average	1.2	-0.7	3.5	5.0	5.0	5.0	5.0	5.0
Investment and saving	(in percent of GDP)							
Gross national saving	17.3	18.9	17.2	18.5	20.0	21.1	21.7	22.3
Investment	28.9	24.8	25.5	26.4	26.9	27.4	27.4	27.3
Public	7.5	5.1	5.7	6.5	6.5	6.5	6.5	6.5
Private	21.4	19.7	19.8	19.8	20.3	20.8	20.8	20.8
Inflation	(in percent)							
Period average	-0.9	-0.5	4.6	4.9	5.0	5.0	5.0	5.0
End-of-period	-1.4	2.4	5.0	5.0	5.0	5.0	5.0	5.0
Consolidated government operations	(in percent of GDP)							
Revenue 1/	28.8	27.5	27.1	27.3	27.3	27.2	27.1	27.0
o.w. Tax revenue	25.4	24.8	24.7	25.0	25.1	25.0	25.0	24.9
Expenditures	31.8	30.1	30.8	30.3	30.0	29.7	29.6	29.6
Current expenditures	23.1	24.3	24.8	23.3	23.1	22.9	22.8	22.8
Capital spending and net lending	8.7	5.9	6.0	6.9	6.9	6.9	6.8	6.8
Overall balance	-3.0	-2.6	-3.7	-3.0	-2.7	-2.5	-2.5	-2.5
Public debt	32.3	32.2	34.1	34.2	34.0	33.7	33.6	33.5
Of which: foreign-currency denominated	27.6	27.2	27.6	27.5	27.4	26.8	25.9	24.7
Money and credit	(annual percentage change; unless otherwise indicated)							
Credit to the private sector	12.8	19.5	21.6	17.7	15.1	15.1	15.1	15.1
Credit to the private sector (constant exchange rate from 12 month prior)	13.4	16.1	18.7	16.4	13.8	13.8	13.8	13.8
Broad money, incl. fx deposits	11.4	24.4	21.5	18.5	16.0	15.0	15.0	15.0
Broad money, incl. fx deposits (constant exchange rate from 12 month prior)	11.8	21.8	19.2	17.5	15.0	14.0	14.0	14.1
Deposit dollarization (in percent)	66.0	62.1	63.6	61.2	60.0	58.8	56.8	55.2
External sector	(in percent of GDP; unless otherwise indicated)							
Gross international reserves (in billions of US$)	2.9	2.8	2.7	3.0	3.4	3.7	4.3	4.8
In months of next year's imports of goods and services	3.7	3.3	3.0	3.1	3.4	3.5	3.7	3.9
In percent of broad money and non-resident deposits	51.9	42.5	35.5	33.9	34.5	33.7	34.4	34.8
Current account balance (in billions of US$)	-1.9	-1.0	-1.3	-1.4	-1.3	-1.3	-1.2	-1.2
In percent of GDP	-11.7	-5.9	-8.4	-7.9	-6.9	-6.3	-5.6	-5.0
Trade balance	-26.6	-21.7	-25.1	-24.7	-23.9	-23.4	-22.8	-22.2
Foreign direct investment (inflows)	5.8	6.3	6.4	6.5	6.5	6.0	6.0	6.0
Gross external debt	82.2	81.5	84.2	83.1	82.3	79.9	77.5	74.6
Gross external debt, excl. intercompany loans	63.7	62.3	64.0	63.5	63.4	61.7	59.3	56.4
Exchange rates								
Laris per U.S. dollar (period average) 2/	1.65	1.66	1.76	...	...	...	...	...
Laris per euro (period average) 2/	2.12	2.21	2.44	...	...	...	...	...
REER (period average; CPI based, 2005=100)	131.7	125.8	...	...	...	...	...	...

Sources: Georgian authorities; and IMF staff estimates.

1/ Includes grants.

2/ The 2014 value of the Lari/Dollar and the Lari/Euro exchange rate for 2014 is based on the value as of May 4th 2014.