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Georgia – Assessment Letter for the Asian Development Bank

April 27, 2020

Recent Developments, Outlook, and Risks

1. **The Covid-19 outbreak has hit the Georgian economy hard.** The authorities declared a state of emergency on March 20th, imposing sweeping mobility restrictions and closure of non-essential shops, which helped limit the number of confirmed cases to below 300 as of mid-April. Tourism and travel, representing 20 percent of GDP in 2019 in the BOP, has stopped, hurting the hospitality sector (accounting for 7⅔ percent of GDP in value added in 2019). The lari depreciated by around 20 percent vis-à-vis the dollar in March but has since recovered about half of this and remains around 10 percent down since the beginning of the year. The NBG has sold $100 million to prevent excessive volatility. Rising risk aversion prompted some non-residents to sell domestic government securities. Facing lari liquidity pressures, the NBG started operating FX swap lines with banks.

2. **Growth prospects for 2020 have weakened sharply.** The pandemic and ensuing containment and behavioral responses are dampening potential GDP and growth, lowering tax revenues, and putting pressure on the lari. Lower growth in trading partners is expected to significantly lower exports and remittances. Heightened global uncertainty will hamper confidence, reduce capital inflows, and delay investment. A sharp contraction in economic activity is expected to bring growth to -4 percent in 2020, with a rebound starting only in 2020Q4. Growth in 2021 is projected at 4 percent, supported by the lift in containment measures and the pickup in trading partners' growth. Nominal depreciation will sustain inflationary pressures in 2020 but lower commodity prices, subdued domestic demand, and fading one-offs should help inflation converge to the 3-percent target by end-2021.

3. **Staff projects BOP gaps of $1.4 billion in 2020 and $0.4 billion in 2021, both to be financed with external assistance.** The current account deficit is expected to widen to 11⅓ percent of GDP in 2020, reflecting lower exports and remittances. Imports would decline driven by lower commodity prices and weaker domestic demand. The financial account is projected to deteriorate by 5.1 percent of GDP to 0.4 percent of GDP in 2020, as outflows are only expected to be partially mitigated by additional IFI loans to help cope with the COVID-19 shock. BOP gaps are expected to be closed with Fund and donor financing. The external position was assessed to be broadly consistent with fundamentals and desired policy settings in 2019, it is expected to deteriorate in 2020.

4. **The outlook is subject to significant downside risks.** A more protracted shock could weaken aggregate demand for longer, increase the BOP needs and the fiscal deficit, worsen bank asset quality and liquidity conditions, and weaken any subsequent recovery. Market pressures and further lari depreciation could increase headline inflation and dollarization. Depending on the nature of risks, policies must be proactive to limit their effects on the economy and financial stability. A more protracted outbreak and growth slowdown would require additional fiscal spending and a more accommodative monetary stance, while market pressures would need to be dealt with a combination of continued exchange rate flexibility and use of reserves, as well as proactive measures to maintain financial stability. The authorities have mobilized donor assistance to build external and fiscal buffers that would support additional policy response and strengthen confidence. Election-related uncertainty, with Parliamentary elections in October, could interfere with the aftermath of the shock and delay reform efforts.

Economic Policies

5. The authorities are appropriately loosening the fiscal stance in 2020 to address the COVID-19 pandemic. The augmented deficit is projected to reach 8½ percent of GDP in 2020. Revenues are projected to fall by 2.8 percent of GDP.[1] The government has taken measures to quarantine and treat the sick, and plans to provide immediate support to the most affected sectors and the population, including through direct transfers to the most vulnerable, employees who have lost their jobs, and businesses (contingent on retaining jobs) for up to six months. The fiscal relief package (4.0 percent of GDP) would be partly financed by reprioritizing spending but will raise total expenditure by 3.0 percent of GDP (compared to the projection at the time of the Fifth Review under the EFF arrangement). Public debt is expected to remain sustainable in 2020, it is projected to increase to 62.8 percent of GDP, about 80 percent denominated in foreign currency.

6. External assistance is expected to finance BOP gaps and a widening fiscal deficit. The authorities' financing strategy combines higher borrowing (by 14.4 percent of GDP), mostly from external donors. The BOP is fully financed for 2020. The higher financing would help buildup government deposits (5.9 percent of GDP), to be used if the crisis gets worse. Fiscal buffers could also be used to address liquidity pressures in 2020-21. To cover expected liquidity shortfalls in mid-2020, part of the envisaged IMF financing (see below) would take the form of budget support (70 percent of quota).

7. Medium-term fiscal consolidation would bring public debt (net of government deposits) below 45 percent of GDP by 2024. The authorities plan for a gradual fiscal consolidation starting in 2021 as one-off spending expires and revenues recover, to bring debt to the fiscal anchor under the EFF arrangement. The authorities continue to monitor fiscal risks, including from power purchasing agreements and state-owned enterprises, disclosing them in their fiscal risk statement.

8. The moderately tight monetary policy stance is suitable for the moment. The National Bank of Georgia (NBG) is closely monitoring inflationary expectations, as the economy deals with the impact of the COVID-19 pandemic. In deciding policy rates, the NBG will need to balance the impact of the lari depreciation (which calls for keeping the rate high for longer) with a sharp weakening in demand (which would allow for reducing rates). Inflation is expected to decline to the 3-percent inflation target by end-2021.

9. A flexible exchange rate regime remains the first line of defense against external shocks like COVID-19. In a dollarized economy like Georgia, excessive lari volatility could become disruptive to financial stability. However, foreign exchange (FX) interventions should be limited to prevent disorderly market conditions. The NBG will continue to primarily rely on ad-hoc discretionary interventions; but they will be complemented with smaller FX sales triggered by lari volatility and the need to support FX market liquidity. Following the shock, the NBG is committed to upgrade its FX intervention policy, and strengthen NBG's communication.

10. The NBG has relaxed capital requirements and released liquidity buffers to safeguard financial stability. The release of the capital conservation buffer (2½ percent, about GEL1½ billion) should cover additional provisioning due to the expected deterioration in bank portfolios as a result of the COVID-19 shock. The NBG has scaled up access to lari liquidity, and will coordinate with the MoF on the

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[1] This is calculated as the difference in revenues between current scenario and the scenario before the shock as a ratio to revised GDP projections for 2020.

issuance of up to GEL600 million government securities, with receipts being placed in long-term bank deposits, to further provide GEL liquidity to banks. Banks, in turn, could use the government as collateral to secure NBG funding. The introduction of prudential limits on large exposures is postponed until June 2021.

11. The authorities are considering measures to support lending to the private sector. The authorities are evaluating how to revamp the credit guarantee scheme to support credit to the business community and the economic recovery. Additional support, during the containment period, may be needed for business, especially SMEs, to absorb the shock and remain operational.

12. Advancing structural reforms would help support the recovery after the COVID-19 pandemic. The authorities should implement promptly a new corporate insolvency framework. Adopting an indexation rule for the basic public pension will help protect the real income for pensioners and reduce old-age poverty. The implementation of the resolution framework is advancing as planned.

Relations with the IMF

13. Georgia has been engaged with the IMF under an Extended Fund Facility (EFF) arrangement since April 2017. On April 14, 2020, IMF team reached a staff–level agreement with the Georgian authorities for the completion of the Sixth Review and an augmentation of access (130 percent of quota, or about $375 million). Pending Executive Board approval, about $200 million would be made available immediately to the budget to help the authorities address containment costs and implement measures to compensate those most affected by the COVID-19 pandemic.

Table 1. Georgia: Selected Economic and Financial Indicators, 2018–25

	2018	2019	2019	2019	2020	2020	2020	2021	2022	2023	2024	2025
	Actual	EFF 5th Review	EFF 5th Review New GDP		EFF 5th Review	EFF 5th Review New GDP			Projections			
National accounts and prices 1/				(annual percentage change; unless otherwise indicated)								
Real GDP	4.8	4.6	4.6	5.1	4.3	4.3	-4.0	4.0	6.0	5.8	5.5	5.2
Output Gap	-1.5	-1.0	-1.0	-0.5	-1.0	-1.0	-1.5	-1.7	-0.5	0.0	0.0	0.0
Nominal GDP (in billion of laris)	44.6	45.2	49.0	50.0	49.2	53.4	50.3	54.5	59.4	64.7	70.3	76.1
Nominal GDP (in billion of U.S. dollars)	17.6	16.1	17.5	17.7	17.2	18.7	15.1	17.7	20.1	22.0	23.9	25.8
GDP per capita (in thousand of U.S. dollars)	4.7	4.3	4.7	4.8	4.7	5.1	4.1	4.8	5.4	5.9	6.5	7.0
GDP deflator, period average	4.3	4.9	4.9	6.4	4.7	4.7	5.1	4.0	3.0	2.9	3.0	2.9
CPI, Period average	2.6	4.9	4.9	4.9	4.5	4.5	4.7	3.6	3.0	3.0	3.0	3.0
CPI, End-of-period	1.5	7.2	7.2	7.0	3.0	3.0	3.5	3.0	3.0	3.0	3.0	3.0
Core CPI, End-of-period	0.5	…	…	3.8	…	…	…	…	…	…	…	…
Investment and saving						(in percent of GDP)						
Gross national saving	26.5	28.4	26.2	28.7	28.4	26.2	20.3	25.5	27.4	26.8	26.1	25.7
Investment	33.3	33.8	31.2	33.8	33.7	31.1	31.6	33.0	33.4	32.6	31.7	31.0
Public	6.4	7.8	7.2	7.9	7.2	6.6	6.4	6.4	4.9	4.5	4.1	3.8
Private	26.9	26.0	24.0	25.9	26.5	24.4	25.2	26.6	28.5	28.2	27.6	27.2
Consolidated government operations						(in percent of GDP)						
Revenue and grants	26.4	28.6	26.4	26.7	27.6	25.4	24.1	24.7	25.1	25.3	25.4	25.4
o.w. Tax revenue	23.4	25.5	23.5	23.7	24.9	23.0	21.4	22.2	22.7	22.9	23.0	23.1
Expenditures	29.2	31.3	28.8	29.1	30.7	28.3	32.9	29.9	28.6	28.2	28.0	27.8
Current expenditures	21.3	23.1	21.3	21.0	23.2	21.4	26.2	23.2	23.4	23.5	23.6	23.7
Capital spending and budget lending	7.9	8.2	7.6	8.1	7.5	6.9	6.7	6.8	5.2	4.8	4.4	4.1
Net Lending/Borrowing (GFSM 2001)	-0.8	-1.9	-1.8	-1.8	-2.4	-2.2	-8.2	-4.4	-2.7	-2.3	-2.0	-1.8
Augmented Net lending / borrowing (Program definition) 2/	-2.3	-2.3	-2.1	-2.0	-2.7	-2.5	-8.5	-4.8	-3.0	-2.6	-2.2	-2.1
Public debt 3/	41.3	47.9	44.1	42.7	48.3	44.5	62.8	59.6	55.5	53.6	52.1	51.1
o.w. Foreign-currency denominated	32.5	37.2	34.3	32.9	36.6	33.7	50.6	45.6	41.0	38.6	36.4	34.5
Public debt net of government deposits 3/	38.8	44.4	40.9	39.8	44.4	40.9	54.0	51.2	48.2	46.6	45.1	43.8
Money and credit					(in percent; unless otherwise indicated)							
Credit to the private sector (annual percentage change)	19.3	17.3	17.3	19.9	8.5	8.5	5.9	3.6	9.9	6.5	8.4	8.2
In constant exchange rate	17.0	11.5	11.5	15.2	7.5	7.5	-2.3	8.2	10.0	8.8	8.6	8.2
Broad money (annual percentage change)	14.0	14.7	14.7	16.1	9.2	9.2	3.6	11.5	8.2	10.4	10.4	10.2
Broad money (incl. fx deposits, annual percentage change)	13.3	14.9	14.9	16.0	8.1	8.1	3.1	8.3	7.0	9.6	9.8	9.8
In constant exchange rate	11.9	9.2	9.2	11.8	8.1	8.1	-4.6	16.7	10.6	10.7	10.4	10.1
Deposit dollarization (in percent of total)	62.1	62.9	62.9	61.9	62.7	62.7	62.4	58.4	54.3	53.3	52.4	51.5
Credit dollarization (in percent of total)	55.8	53.7	53.7	54.4	51.3	51.3	51.6	49.2	48.3	47.4	46.5	45.6
Credit to GDP	58.8	68.1	62.8	62.9	67.8	62.5	66.2	63.3	63.8	62.4	62.3	62.2
External sector					(in percent; unless otherwise indicated)							
Current account balance (in billions of US$)	-1.2	-0.9	-0.9	-0.9	-0.9	-0.9	-1.7	-1.3	-1.2	-1.3	-1.3	-1.4
Current account balance	-6.8	-5.4	-5.0	-5.1	-5.3	-4.9	-11.3	-7.5	-6.0	-5.8	-5.6	-5.3
Trade balance	-23.4	-22.7	-20.9	-21.0	-22.2	-20.5	-20.4	-19.8	-19.3	-18.9	-18.5	-18.0
Terms of trade (percent change)	-5.1	0.2	0.2	2.6	-1.8	-1.8	1.8	3.9	2.0	1.4	1.9	1.4
Gross international reserves (in billions of US$)	3.3	3.3	3.3	3.5	3.4	3.4	3.5	3.6	3.8	4.1	4.4	4.6
In percent of IMF Composite measure (floating)	95.4	96.4	96.4	99.0	95.9	95.9	103.9	98.5	98.4	101.3	103.3	105.5
Gross external debt	100.3	118.6	109.3	103.4	117.2	108.1	136.3	124.1	114.7	111.1	106.9	103.1
Gross external debt, excl. intercompany loans	82.2	95.2	87.7	85.0	94.0	86.7	111.4	102.2	94.2	90.0	86.2	82.6
Laris per U.S. dollar (period average)	2.53	…	…	2.82	…	…	…	…	…	…	…	…
Laris per euro (period average)	2.99	…	…	3.15	…	…	…	…	…	…	…	…
REER (period average; CPI based, 2010=100)	104.1	…	…	98.1	…	…	…	…	…	…	…	…

Sources: Georgian authorities; and Fund staff estimates.

1/ National accounts numbers include the impact of GDP rebasing, which increased GDP levels while leaving growth rates unchanged.

2/ Augmented Net lending / borrowing (Program definition) = Net lending / borrowing - Budget lending.

3/ Public debt includes central government and NBG.