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Georgian Economic Outlook

The First Half of 2011

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Preface

The Report gives an overview of Georgian Economy for the first half of 2011. The paper starts with a special segment "issue in focus," which highlights a specific topic that has been chosen based on its significance in the economic life of the country. The report also covers such crucial aspects of the economy as: GDP, GNI, CPI, inflation and unemployment, foreign trade and FDI, the country's budget and the implementation of fiscal and monetary policies, banking sector of the country, as well as Georgian economy from the world economic perspective. Finally, the report gives conclusions and recommendations to address some of the identified challenges.

The research method used for the report was a secondary data collection from internet resources, including the web-sites of the various state agencies in Georgia: the National Statistics Office, the National Bank, the Ministry of Finance, and the Ministry of Economy and Sustainable Development. Moreover, the Report has used data provided by the relevant international organizations, such as the International Monetary Fund and the European Bank for Reconstruction and Development.

However, certain limitations to the study need to be mentioned. First, the authors of the report had to cope with the scarcity of up-to-date information, since the available data mainly covers the first quarter of the year, while the rest of the information is projections made by experts. At the same time, most of the information from 2010 and 2011 is preliminary and might be subject to change.

Abbreviations

CIS – Commonwealth of Independent States
EBRD – European Bank for Reconstruction and Development
EU – European Union
FDI – Foreign Direct Investment
GDP – Gross Domestic Product
GNI - Gross National Income
GoG – Government of Georgia
IMF – International Monetary Fund
NBG – National Bank of Georgia
SME – Small and Medium Enterprise
VAT – Value Added Tax

Issue in Focus

Inequality and Gini Coefficient

In the current discourse on the health of Georgian economy and the prospects of its future growth, the authorities often focus on such concepts as income, both national and per capita, overlooking other important indicators, such as the economic inequality, which is indispensible for a realistic assessment of the standard of living and the level of poverty in the country. It is precisely the inequality in the income growth across the country's population that represents one of the major challenges for improving the standard of living in Georgia, and as such, deserves a heightened attention from the experts as well as the relevant state institutions.

The growth of income inequality is of course neither new nor limited to Georgia – it has been a trend in market economies since 1970s. According to one point of view, inequality is inherent to the free market system, resulting directly from the rewards associated with hard work and risk-taking. Put simply, the more a person works the more he/she gets paid, since citizens receive income by selling their own labor. However, the drawback of this system is that some people who do succeed end up with vast amount of money, while others who fail cannot even afford the basics (McDowell, Thom, Frank & Bernanke, 2006). In this case we are faced with a society built on exploitation of some groups by others, or by an unequal access to resources, which in turn feeds social discord, lowers the levels of trust and civic engagement, and can lead to higher crime rates. Moreover, substantial part of economic literature demonstrates negative relationship between inequality and human development, (http://hdr.undp.org), as well as between inequality and social cohesion (Putnam, 2000). Conversely, the basic economic experience dictates that flattening of the equality indicator might be directly associated with improvements in the overall health and education outcomes, as well as economic growth. Moreover, there is a negative relationship between inequality and human development (http://hdr.undp.org). Therefore, a high indicator of income inequality is troubling.

Official statistics of Georgia measures two indicators in this direction, that is a share of population under 60/40% of the median consumption, and the percentage of population living below poverty line. Although official statistics does not measure the Gini coefficient, one of the most widely used methods for measuring income inequality. In this case we shall use information provided by international organizations that conduct such studies in various countries.

However, not neglecting the information given by the office of National Statistics of Georgia we start from presenting it first. According to the latest information from 2009, 21% of the population of Georgia lives under 60% of the median consumption, while 8.8 % of the population below 40% of the median consumption (fig. 1&2). If we examine the figures over the specified period of time from

2004 to 2009, we observe a slight decrease in figures till 2007, an increase in 2008 and once more a decrease in 2009. Identical trend is seen in both rural and urban indicators, with rural indicators being slightly higher as compared to the urban ones.

We assume that an increase in inequality indicators might be connected with the growth rates of Gross Domestic Product (GDP) in the country, which fell considerably in 2008 due to the Russia-Georgia war and the global economic crisis. To strengthen our assumptions we can observe in the figure below (f. 3) that a radical decrease in real GDP growth rate in 2008 (2.3%) gave an increase (a positive change) in the shares of population living below 60/40% of the median consumption. However, in spite of a negative real GDP growth rate of -3.8%, there was a decrease (a negative change) in the shares of population living below 60/40% of the median consumption. The letter is hard to

FIGURE 1
Share of population under 60% of the median consumption (2004-2009) *www.geostat.ge*

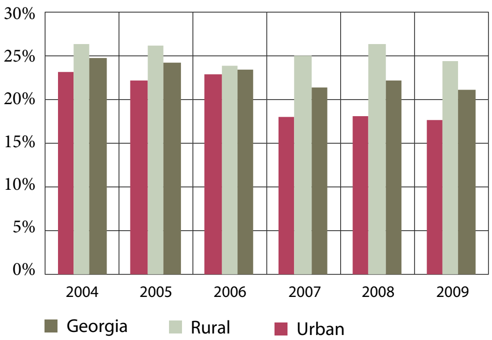


FIGURE 2
Share of population under 40% of the median consumption (2004-2009) *www.geostat.ge*

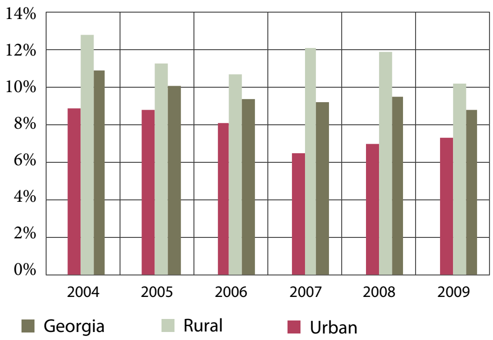


FIGURE 3
GDP Growth Rate and Changes in Inequality indicators (2005-2009) *www.geostat.ge*

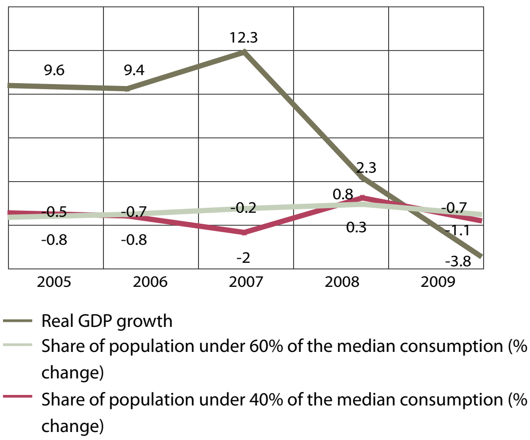
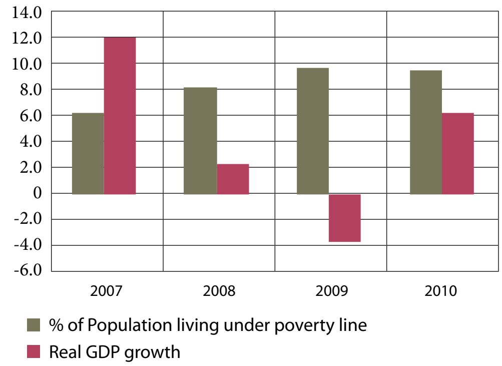


FIGURE 4
Real GDP Growth and Poverty (2007-2010)
www.geostat.ge



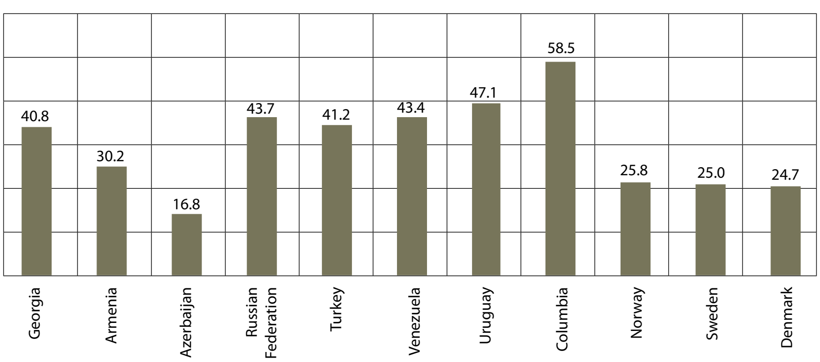
interpret; by and large inequality is not solely dependent on the real GDP growth, but rather on other factors as well such as, the labor markets, development tendencies, wealth condensations, etc.

According to the data from 2010, 9.7% of the population of Georgia lives below the poverty line. Likewise, we can detect a negative correlation between the real GDP growth and the levels of poverty in the country (f.4), with the growth of real GDP, percentage of population living below the poverty line decreases and the other way around. Although, once again GDP growth is not the only determinant of the well-being of the nation, we have argued about the importance of equality of income distribution.

As we have mentioned above, the most common and easily understood measure is the so-called Gini coefficient (after an Italian statistician Corrado Gini), which is not measured in Georgia by local statistics office. The Gini coefficient represents a mathematical concept that measures inequality in the range from 0 to 1, and is often expressed as a percentage between 0 and 100. A lower Gini coefficient points to a higher equality in distribution, with 0 corresponding to complete equality. Conversely, a higher Gini coefficient corresponds with more unequal distribution, with 1 indicating complete inequality. In other words, the most unequal society will be one in which a single person receives 100 percent of the total income and the remaining people receive none (Gini coefficient of 1); and the most equal society will be one in which every person receives the same income (Gini coefficient of 0). In reality, the indicator is always somewhere in between 0 and 1, since the perfect equality/inequality is hypothetical (McDowell et al., 2006).

So, where does Georgia stand? Generally speaking, income equality has followed a declining trend in the countries of former Soviet Union that initially started out with relatively low inequality. The cause was the elimination of state employment, job security and other social benefits provided in

FIGURE 5
Gini Coefficients for various countries
(http://hdr.undp.org)



Soviet times. Currently, Georgia's Gini coefficient equals 40.8. A comparison helps better assess the picture: Scandinavian countries have an indicator of around 25, while the continent of Africa is characterized by a relatively high indicator (around 70). Even within the region, where the post-Soviet countries likewise have high indicator, Georgia still outweighs some of its neighbors in terms of inequality: Armenia's Gini coefficient is 30.2, while Azerbaijan's 16.8. However, has a lower inequality as compared to Russian Federation (43.7), and Turkey (41.2) (http://hdr.undp.org). The Georgian indicator closely resembles the coefficients of Latin American countries (Venezuela 43.4, Uruguay 47.1, Columbia 58.5), characterized by the absence or a small size of middle class (f.5).

In short, Georgian Gini coefficient is significantly higher than that of the most advanced economies, especially compared to the European indices, pointing to a serious social and economic challenge in the country. Notwithstanding one existing point of view that a high level of inequality might give people incentive to work harder and foster entrepreneurial activities, the wealth of international experience shows that the costs related to high level of income inequality far exceed any benefits that it may bring about in the country. We shall illustrate this point below based on the information provided by World Bank (www.worldbank.org).

First, high levels of inequality might lead to lower social cohesion and civic engagement, which eventually translates into higher political instability. Numerous studies have found a direct correlation between the level of inequality and such important indicators of social cohesion as crime rate (especially homicides), mental health problems, and the incidence of teenage pregnancy, both within and across countries (Wilkinson and Pickett, 2009). Serious inequality also constrains government's ability to use important market mechanisms, such as changes in prices for public service or fines, since it may lead to even deeper inequality by causing overwhelmingly stronger deprivation among the poor citizens. Furthermore, a recent study has found a strong correlation between the levels of equality and tolerance in 35 democracies around the world (Andersen and Fetner, 2008).

Even though a successful market economy cannot function and develop without incentives that imply some inequality of income (McDowell et al., 2006), we have argued that a high level of income inequality also poses a problem to economic development. We believe that the problem of income inequality needs to be addressed with due diligence. The government bodies should carefully assess this issue and decide whether or not the distribution of income deemed to be sub-optimal. If so, special polices should be directed towards ameliorating the inequalities. There are two basic approaches to address the issue – changing the underlying factors that produced the observed distribution, or compensating the observed outcomes (McDowell et al., 2006). In Georgia, we mostly observe the second type of form for addressing the issue, when the government makes direct payments or transfers benefits in kind (payments made in the form of providing "free" goods and services) to less privileged households. This has largely been ineffective – the payments are very minimal and rarely change anything in the lives of these households. On the other hand, policymaking that targets the underlying factors of inequality has not been attempted. In practice, governments around the world have employed various initiatives to mitigate the rising inequalities. For example, it is a common knowledge that children of poor families have significant difficulties with accessing quality education and consequently have far less lucrative employment opportunities than those coming from rich families. A significant barrier to the access to quality education are tuition fees, which makes them effective targets for policymakers committed to addressing the roots of the growing socio-economical inequalities.

Other economic policy choices that may be taken with the view towards decreasing inequalities are the progressive taxation – taxing the rich proportionally more than the poor to reduce the amount of income inequality in society; and instituting minimum wage legislation to raise the income of the poorest workers. Whatever the combination of policy options that the government chooses, it is important to keep in mind that fighting the causes is always more effective than trying to directly mitigate the outcomes through various subsidies. The key, therefore, lies in identifying policy options, as well as putting the institutions in place, in order to find a balance between the need to distribute income equitably and the need to stimulate the economy by maintaining a competitive environment.

Introduction

In 2008 Georgian economy faced two negative shocks: one in the face of the Russia-Georgia war, and the second one in the global economic crisis. These two factors had a negative influence on the Foreign Direct Investment (FDI) of the country, which is one of the driving forces in the country's economic growth. At the same time, due to the political instability and uncertainty, the banks faced a drastic outflow of deposits and there was a risk of bankruptcy. During the period of 2008-2011 Georgia received international aid in the forms of loans and grants that amounted to approximately 4.5 billion USD; part of this amount had already been transferred and the rest is still under way. This aid was directed towards covering a possible budgetary imbalance, and increasing trust in the financial system, as well as other sectors of crucial importance such as: internally displaces persons, transport, energy, urban and municipal infrastructures, environment and agriculture.

Since, the aid funds from different donors that were provided during the crisis years to Georgia began to run out, the GoG had directed a number of reforms in order to help the economy climb out of the recession. The reforms have paid back in some crucial areas, such as the ones directed towards creating a favorable business environment and elimination of corruption in the country. Georgia is among the leaders in ease-of-doing business measure in the region. At the same time, simplification of tax system and fighting of petty corruption was reflected in the Transparency International Corruption Perception Index, where Georgia is ranked above the Commonwealth of Independent States (CIS) margin (www.ebrd.com). However, there are a number of negative tendencies in the economy that stagnate growth and development, such as high levels of unemployment and inflation, as well as negative trade balance and slow growth in the sectors of industry and agriculture. Moreover, Georgia continues to be heavily dependent on the aid coming from international donor organizations and money transfers by the citizens of Georgia employed abroad.

In short, the world economy, as well as that of Georgia, is fighting to overcome the biggest economic contraction since 1930s (www.europeanbusinessreview.com), and to at least reach the pre-crisis economic growth, the prognosis is optimistic for the near future with a gradual but sustainable development. Output in most of the emerging economies has already reached its pre-crisis levels. According to IMF, expected growth of emerging and developing countries in 2011 and 2012 is 6.5%. Major challenges for these countries are unemployment and inflation (www.imf.org).

1. Economic Growth

Economy of a country is influenced by a number of factors. It is generally regarded that some of the conducive factors to the economic growth are increase in productivity, brought about by an increase in employment and/or population, and therefore output; similarly, educated and healthy workforce also results in the increase of output. At the same time, ease of doing business fostering small and medium enterprises (SMEs) and entrepreneurship, as well as the favorable investment environment for investors, play a major role in speeding up the economic growth of a country.

1.1 Gross Domestic Product (GDP)

The real GDP, i.e. the value of economic output of a country adjusted for price changes, amounted to 5,151.8 mil GEL for the first quarter of 2011 — a 20% increase as compared to the same quarter last year. The real GDP growth rate for this year's first quarter increased to 5.8%. As we can see from the graphs below (f. 6 & 7), the GDP rate is slowly increasing after the crisis in previous years, and it has outreached the pre-crisis annual indicator. The growth rate is still below the pre-crisis level of 12,3%, reached in 2007.

Significant growth was marked in the sectors of financial intermediation (24.0%), electricity, gas and water supply (12.4%), real estate, renting and business activities (9.5%), transport (9.1%), industry (8.6%), hotels and restaurants (8.6%), and communication (7.6%) (www.geostat.ge).

Moderate real growth was recorded in education (3.8%), trade (2.5%), public administration (1.9%), agriculture, forestry, and fishing (1.7%). Fields that have been decreasing in the course of last year and the first quarter of 2011 were construction and products by households. Areas of recent growth in the country are construction, banking and mining sectors, although due to the scarcity of funds

FIGURE 6
GDP at Market Prices (2006-2011)
www.geostat.ge

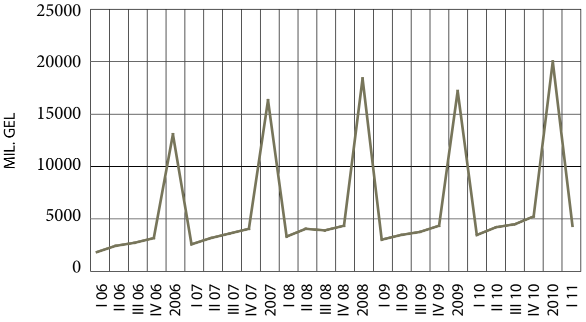
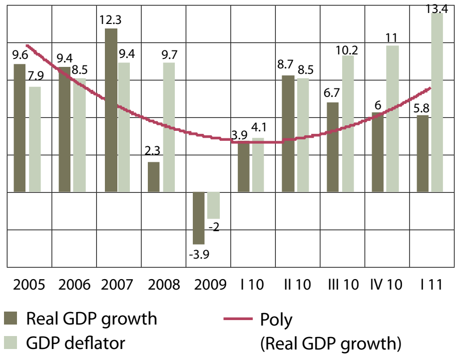


FIGURE 7
GDP growth and deflator (2005-2011)
www.geostat.ge



and difficulty of attracting external investments, there is a risk of further economic slowdown in those fields.

Furthermore, it is worth noting that the deflator grew to 13.4 % up from the last year first quarter's 4.1%, and a record high since 2005, which in its turn highlights the on-going inflation in the country (f.7). It is notable that in the year of 2009 there was a negative deflator, i.e. deflation, possibility due to the crisis that resulted in the decreased demand for commodities.

Interestingly enough GDP growth rate outreached GDP deflator rate during the pre-crisis period, whilst it's the other way around at the moment. GDP growth rate is slowly climbing up, although has not reached the pre-crisis level of around 10%.

In line with the real GDP growth, GDP per capita, determinant of a country's standard of living, has also taken up the growth pace, it amounted to 1,152.7 mil GEL in the first quarter of 2011 (f.8), a 19% increase compared to the same period last year, although a decrease from the fourth quarter of 2010, the letter might be due to the fact that the economy is growing slower in the beginning of the year, at the same time due to the seasonality of agricultural sector. Moreover, the per capita GDP might not be a representative figure to actually measure the standard of living of a household due to the inequality in income distribution. Gini coefficient of Georgia that measures the equality of income distribution is quite high and hits 40.8 (0 being the perfect equality and 100 perfect inequality) (www.cia.org).

An increase in GDP in the first quarter of 2011 is likely due to an increase in the fields of "final consumption" and "export". However, we assume that the economic growth mostly comes from the growth in "consumption" field rather than from the growth in investments and export. This statement shall be further proved in the foreign trade section further in the paper that depicts the faster growth in imports in comparison with the exports of the country. The increase in GDP is forecasted to be less than in 2010 due to a tight monetary policy and a slow increase in the employment sector (www.nbg.ge). Tightening of the monetary policy shall decrease the "consumption" sector, whilst the slow growth in the employment shall

FIGURE 8
GDP per capita (mil GEL) (2009-2011)
www.geostat.ge

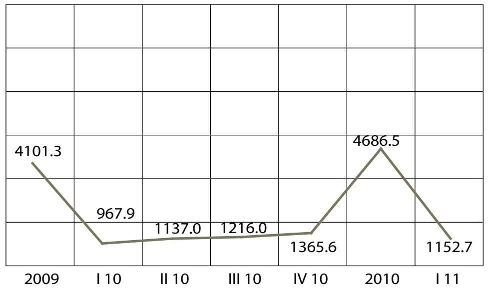
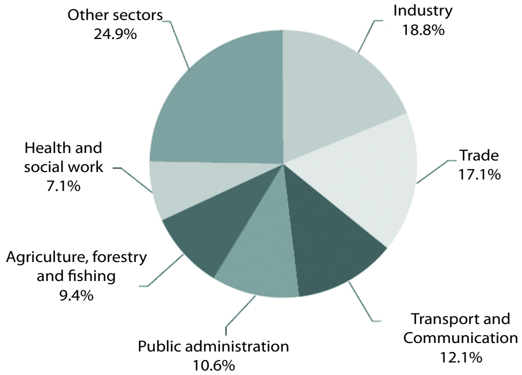


FIGURE 9
GDP distribution by Sector (1st Q.2011)
www.geostat.ge



result in a decrease/slower increase of the "output" field. At the same time, current growth in GDP, which now largely depends on consumption and government spending, could be due to an increase in national debt, which was the case in Georgia in the course of an on-going economic crisis.

It is noteworthy that the largest share of GDP comes for Tbilisi, whilst the role of the regions in the process of the economic growth is decreasing. Due to the even poorer employment opportunities in the regions as compared to the capital, we observe a massive outflow of the population - especially this concerns the mountainous regions.

As to the main contributors to the country's GDP, we can see from the graph above (f.9) that industry makes up the largest chunk of the GDP of Georgia (18,8%), followed by trade (17.1%), transport and communication (12.1%). Export of Ferro-alloys and scrap material does represent the biggest part of total exports; therefore it is one of the driving forces of GDP growth in the country.

Interestingly enough, agriculture is losing its share in the country's GDP, although historically cultivation of agricultural products (grapes, fruits and hazelnuts) represented a major part of Georgian economy. (www.cia.org). At the same time, official statistics ascribe around 50% of workforce in agriculture. If this is the case we are dealing with extremely poor productivity in agriculture. This fact possesses a great threat to the economy of the country were agriculture was historically considered as a major competitive advantage due to the fertile land and experienced workforce. Current trend is a quickly declining processed land area and declining productivity. It is paradoxical in the condition of increasing prices on agricultural products that the productivity is declining. Major assumption drown can be that there is a lack of investment and resources, thus the capital available in this field is inadequately low.

Moreover, irrigation and drainage systems are believed to be another hindering factor in agricultural development. If the problem is not addressed in the nearest future the country shall lose its competitive advantage in producing foodstuffs. As we can see in the upcoming sections, Georgia is becoming heavily dependent on imports of foodstuffs which is quite alarming since most of the products can be produced domestically whilst having a higher quality and lower prices. In case of correct organization of agricultural production, the country shall be able to save large volumes of currency reserves that are currently spent on import.

1.2 Gross National Income (GNI)

The Gross National Income (GNI), i.e. the value of goods and services produced within Georgia, equals 4,994.8 mil GEL for the first quarter of 2011, an increase from last year's 4,223.6 mil GEL of the same quarter, although a decrease compared to other quarters of the previous year (fig. 10). An increase in GNI for the first quarter of 2011 is approximately 18%, 2% less than that of GDP.

FIGURE 10
GNI (mil GEL, 2009-2011)
www.geostat.ge

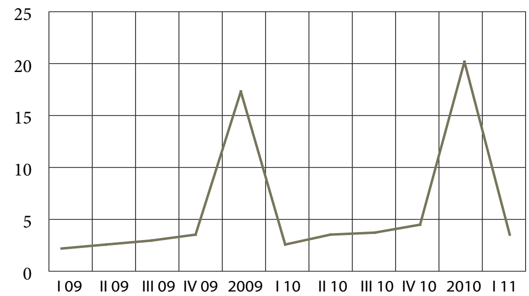
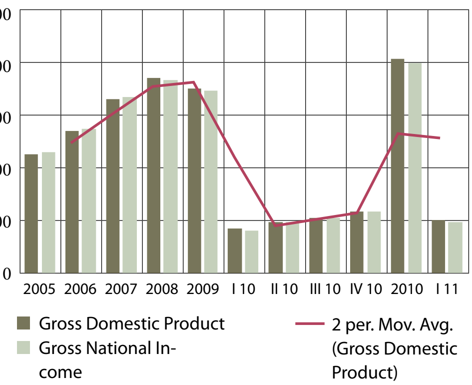


FIGURE 11
GDP vs GNI (2005-2011)
www.geostat.ge



GNI equals GDP plus net income receipts from the rest of the world. Therefore, a country that has an increase in debts, and spends these debts as income, shall have a high GDP, but a low GNI figure. Moreover, if a country sells off its resources to other countries, this shall also result in an increasing GDP, although a decreasing GNI. As we have mentioned above, Georgia has a growing tendency for foreign debt during the years following the war and the crisis. What we see in the graph above (fig. 11) is a more or less equal fluctuations in both GDP or GNI indicators, with GNI figure being mostly a little lower.

2. External Trade

General tendencies of external trade of Georgia are presented in the graph below (f. 12),which points to a gradual increase in the country's exports over the years. However, this increase is far outweighed by the growth in imports, resulting in a persisting trade deficit, which reached its second highest indicator in 2011 (after -1986 mil. USD in 2008), and amounted to -1614 mil. USD.

Total foreign trade turnover for January-May 2011 amounted to 3.328 mil USD, which exceeds last year's indicator (2434 mil. USD) by 37%. The increase was mostly reflected by an increase in the import's figure. Out of the total trade turnover, exports figure is 857 mil USD (a 41% increase compared to the last year's indicator). On the other hand, import comprises 65% of total trade, i.e. 2471 mil

FIGURE 12
External Trade (2006-2011)
www.geostat.ge

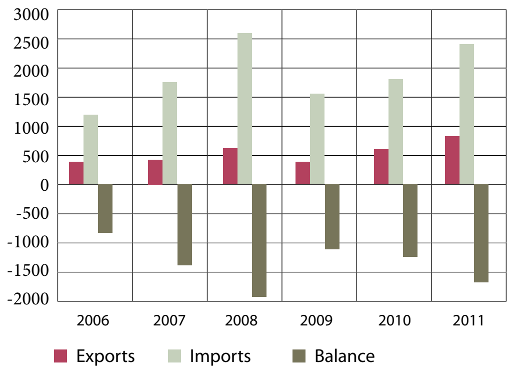
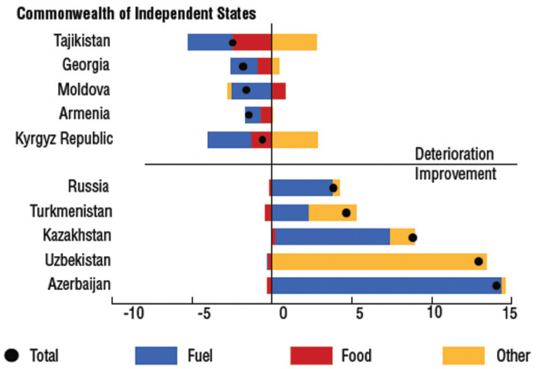


FIGURE 13
Impact of Commodity Price Changes on Trade Balances
www.imf.org



USD (a 35% increase compared to the last year). Therefore, the trade deficit comes to - 1614 mil USD, which is 32% higher compared to the last year's indicator.

Trade balance deterioration (f. 12 & 13) is mostly due to an increase in imports and of high prices on the import products, and since a country is a net importer of most of its oil and gas supply needs, prices for which have drastically increased during the first quarter of 2011, this resulted in a higher trade deficit (fig. 12), which has to be covered from official sources. At the same time, due to the inflation on commodity prices, emerging Europe is expected to have deterioration in the terms of trade due to a high dependency on imports (www.imf.org). If the negative trade balance is further observed in the upcoming years, GoG shall be forced to further increase foreign liabilities in order to cover the trade deficit, i.e. more money shall be dragged from the industry sector for fulfilling the foreign obligations that in its turn shall stagnate the economic development of the country.

Commodity exporting economies are boosting production and thus the unemployment is going down in these countries; whilst, net importer countries do not gain from commodity price rise in any way. Since Georgia imports nearly all the needed supplies of natural gas and oil products (www.cia.org), an increase of the price of these products further deteriorated the trade balance of Georgia, whilst we see an improvement in trade for fuel exporting countries such as Russia, Azerbaijan, and Kazakhstan (f. 13).

As to the major trading partners (f. 14), trade with European Union (EU) countries increased and now amounts to 25% of total trade turnover (32% more than last year), while the CIS countries comprise 35% of total trade turnover and amount to 1150 mil GEL, 47% increase since last year (www.economy.ge). Overall, Turkey is the country's major trade partner when it comes to imports, whilst Azerbaijan being the major trade partner in exports.

FIGURE 14

Trading Partners (million US dollars) (2011)

www.geostat.ge

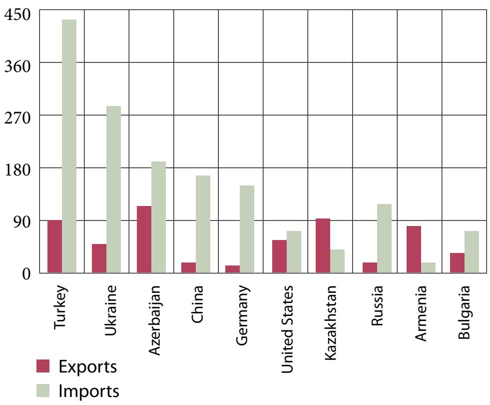
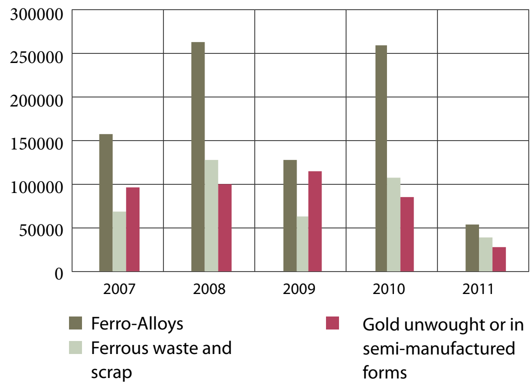


FIGURE 15

Income from main exports (2007-2011)

www.geostat.ge



Georgia mainly imports petroleum, and petroleum oils, motor cars, gases, wheat, and pharmaceutical products; the country mainly exports motor cars (re-export), Ferro-alloys, fertilizers, ferrous waste and scrap materials. Traditionally Ferro-alloys were Georgia's major export, currently on the second place, the export volume has decreased by 4.6% as compared to the same period last year, whilst the prices went up by 33.9%. At the same time, a 22% decrease in the price of gold is observed, while the volume exported for the first half of 2011, equals the volume that had been exported for the entire year of 2010 (www.nbg.ge). Above (f. 15) we can find income coming from major exports in the monetary terms; unfortunately we could not obtain the data depicting quarterly figures nor physical volumes of these exports. Still the figures give us a general idea of the trend, main income comes from the export of Ferro-alloys, followed by metal waste/scrap, and gold.

Increase in Georgian trade turnover is due to the liberal trade regime, implemented by the GoG such as low import tariffs, few export/import licenses and permits, no quantitative restrictions on import/export, no customs tariff on export/re-export, no value added tax (VAT) on export, and simplified export/import procedures (www.mof.ge). Although, these simplified regimes just concern CIS countries, whilst exporting foodstuffs without proper laws of food safety and quality control mechanisms in place, is not possible to European markets. These mechanisms are still under implementation in Georgia. Moreover, it seems that the liberal trade regimes have fostered mostly growth in imports, whilst the major target was increase in exports.

3. Foreign Direct Investment (FDI)

Attracting Foreign Direct Investment (FDI) still remains one of the major challenges for the GoG after the crisis. The country is struggling to reach the pre-crisis indicators for FDI. Georgia is heavily dependent on FDI which in its turn is a pretty unstable source of economic growth; we have observed how a declining FDI indicator resulted in major macroeconomic disruptions for a large number of countries. After the crisis the competition for attracting foreign investments became even fiercer, furthermore, the availability of free capital had declined due to the fact that the countries with developed capital markets became heavily indebted.

For the 1st quarter of 2011 FDI amounted to 174 mil. USD which exceeds the same data of 2009 and 2010 by 1.5, 2.3 times respectively. Out of total investments, 67% came from the EU countries, whilst Industry and financial sector were the largest targets of FDI (www.economy.ge). Furthermore, from the graphs below (f. 16 &17), it can be seen that the annual FDI has been decreasing since 2009, i.e. from 658,400.6 in 2009 to 553,056.1 in 2010.

In order to increase FDI, the GoG has passed a law on the creation of Free Industrial Zones (FIZ), where businesses can enjoy a business-friendly climate, strategic geographical location, liberal trade regimes on exports, educated workforce, and at the same time be exempt from taxes. Currently, there are three FIZs in Georgia –in Poti, Kutaisi and Tbilisi (www.investingeorgia.org, www.mof.ge). These FIZs are still in the process of attracting investors and setting up businesses mostly in the field of industry. Therefore, the influence of FIZs on the GDP/FDI of the country is currently unknown. From our point of view, creation of these zones as a means for fostering FDI is irrelevant and less effective.

In the figures below (f.17 &18) we present distribution of FDI in the years of 2007-2010 and the 1st quarter of 2011 according to various sectors.

We observe a drastic decrease in all sectors during 2009, due to the global and local economic crisis, the situation does not change much in 2010 either. FDI is mostly tilted towards transport and communications, as well as mining and manufacturing sectors, whilst agriculture is one of the least popular sectors for investors.

The situation is similar for the first quarter of 2011, where the leading sectors for FDI are mining and manufacturing (47% of total investments), and construction sectors (23%), although transport and communications sector is not so attractive in this quarter. Agriculture and fishing has only managed to attract 1% out of total foreign investments, the sector needs further popularization and first of all improvement for it to become more attractive for investors.

FIGURE 16
FDI by Quarters (Million US Dollars, 2009-2011)
www.geostat.ge

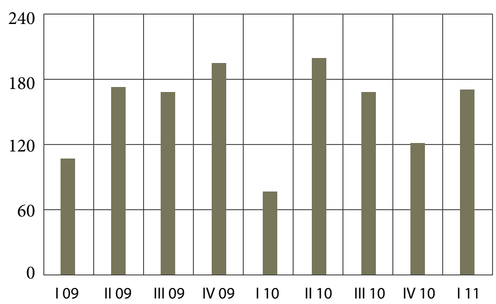


FIGURE 18
FDI by Sectors I 2011
www.geostat.ge

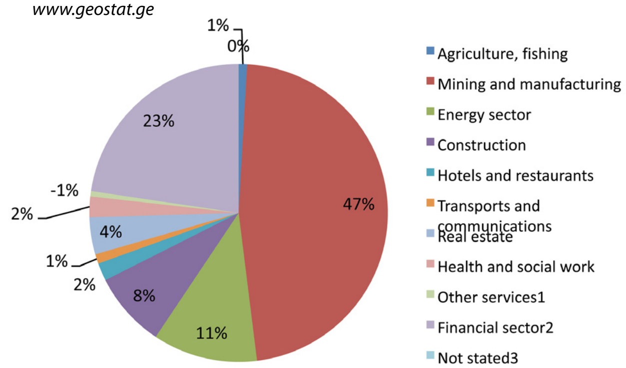
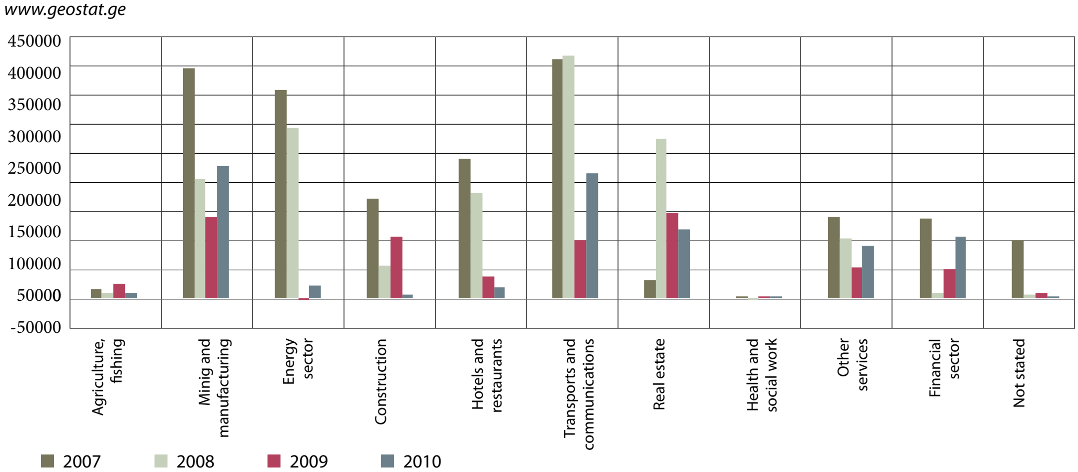


FIGURE 17
FDI by economic Sectors (Thousand USD, 2007-2010)
www.geostat.ge



4. Consumer Price Index (CPI) and Unemployment

Consumer Price Index (CPI) that measures the change in prices on household goods and services has been rising in Georgia; inflation has been a major challenge for the county this year. Inflation is high across the CIS region, reduced grain harvest in 2010 has increased food prices, that comprise about 30-50% of the CPI in the region (www.imf.org). According to the National Statistics Office of Georgia, by the end of March 2011, the annual inflation hit 13.9 %, a record high for the past three years. The increase in prices mainly affected foodstuffs, which according to the National Bank of Georgia (NBG) was due to the low productivity and natural disasters that took place in 2010 globally. This assumption is strengthened by a lower inflation rate (2.1 % in March) in the service sector, which means that the inflation is not due to an increase in demand, rather it is due to a price increase on the global markets. Due to an increase on the price of wheat in the world, we saw an increase on the prices of bread and meat products in Georgia, which represents a major part of the consumption. It is important to note that 15.8% out of total imports are foodstuffs. According to the information received from the Ministry of Economy and Sustainable Development of Georgia, the price of wheat for one ton in 2010 equaled 238 USD, whilst we observe a 52% increase in the first quarter of 2011 to 363 USD for one ton. This fact strengthens the assumption that the price increase of wheat had taken place and therefore affected the basket of goods of Georgia.

At the same time, because of the seasonal factors, the prices also went up on fruit and vegetables. Furthermore, as in most of the developing countries, foodstuffs comprise the biggest share (40.5%), (f.19) of the basket of goods in Georgia the share of inflation on foodstuffs comprised of almost 86%

FIGURE 19
CPI weights for Food for some CIS countries (%)
www.imf.org

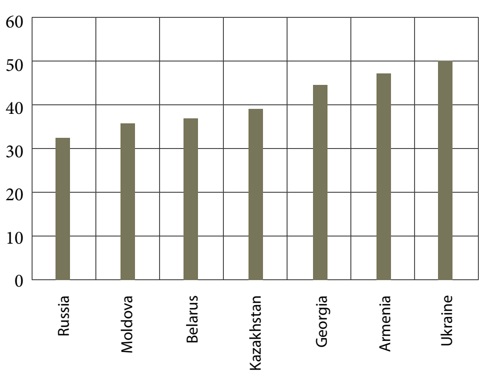
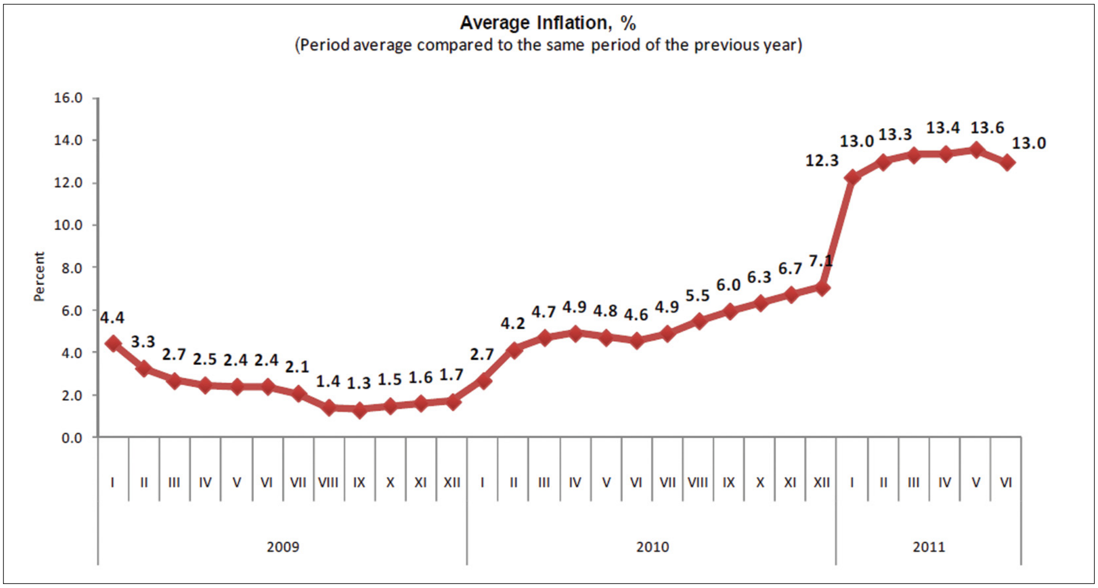


FIGURE 20
Average Inflation (2009-2011)
www.geostat.ge



of total inflation (www.nbg.ge), meaning that this increase in prices for foodstuffs heavily affects the CPI, and is a heavy burden on the population. Challenges of inflation are higher in emerging economies, since the consumption share of food (f. 19) and fuel are higher and the credibility of the monetary policy is weak (www.imf.org).

To further strengthen the assumption made on the seasonal factors, we can observe a decrease in prices for foodstuffs in June 2011, which was mainly presented by a drop in prices in the subgroups of fruits, grapes, and vegetables. Overall, the monthly inflation rate has decreased by 4.0% in June 2011. The graph above (f.20) shows an average inflation rate by quarters since 2009.

We can observe low inflation rates in 2009 which was probably due to a decrease in demand amidst the ongoing economic crisis, and therefore a low purchasing power of the costumers.

Increase in commodity prices was detected in other developing countries as well; that was due to an increase in oil prices in the first half of the year, as to the food, the main factor was weather-related supply shocks. A hindering factor to world economic growth is feared to be even higher prices on oil due to the supply disruptions.

Generally it is believed that inflation is due to the currency devaluation, which was not the case in Georgia. NBG believes that the tendency of appreciation of Georgian currency in the first quarter of 2011 could be due to the income coming from tourism, money transfers from abroad, and depreciation of the

USD on the international financial markets (www.nbg.ge). There is a tendency of increasing migration from the country mostly due to high levels of unemployment (that we shall discuss further), that is a chief cause for growing volume of transfers. Therefore, volume of money transfers is heavily dependent on the economic situation of the country from where the transfers come from, i.e. during the global crisis we saw a decrease in money transfers. So that for the first quarter of 2011 money transfers from abroad amounted to 208.9 million USD, a 15% increase compared to the same period last year (www.nbg.ge).

Moreover, inflation and unemployment are inversely related, i.e. when the inflation is high unemployment is low and vice versa. This does not hold true for Georgia, we observe an increase both in inflation and unemployment rates (f. 21). An explanation to this fact can be high money transfers from abroad, which holds the demand rates up, therefore the prices.

As we can observe from the figure below (f.21) there is a well-established declining trend of the number of people employed with 16.3% of unemployment according to the latest data of 2010. During the recent years we witnessed a wide range of redundancies occurring in the governmental sectors of the country, maybe the decreasing number of employees made it possible for the wages to increase for the remaining staff.

At the same time, among those who are listed as employed, majority of them are self-employed, this category is largely concentrated in agriculture, as mentioned above. That is why job creation cannot be accomplished without full utilization of Georgia's agricultural and food processing capacity. Therefore, the number of people who are officially employed are even lower than the figure presented by the official statistics. This means that the number of social tax payers is quite low; therefore the self-employed workforce cannot be considered stable enough or cannot generate the income enough for decreasing the poverty level in the country. Shortly, lack of formal job opportunities represents a serious constraint to economic development of Georgia.

Furthermore, inflation and unemployment indicators of Georgia outreached that of neighboring Armenia and Azerbaijan for the year of 2011 (f. 22).

FIGURE 21
Unemployment rate (%) (1998-2010)
www.geostat.ge

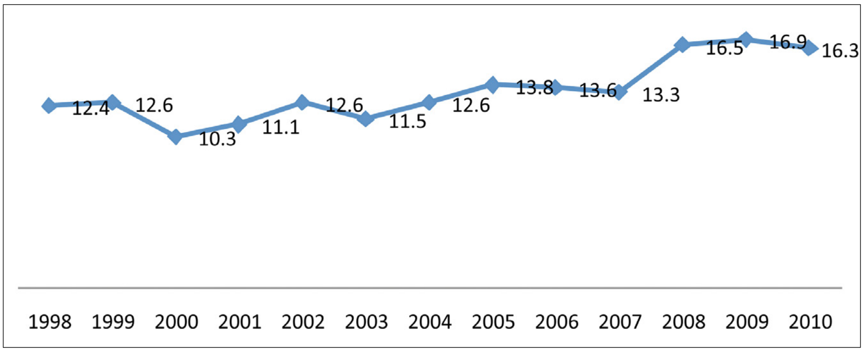
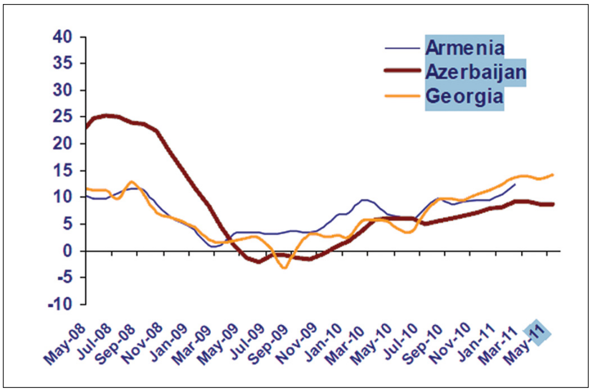


FIGURE 22
Inflation and Unemployment Indicators
www.ebrd.com



At the same time, Georgia's inflation and unemployment indices are higher compared to other countries in the region (f. 23). Furthermore, Azerbaijan as an oil exporter country suffered from high inflation during the pre-crisis period compared to the neighboring countries, whilst the situation changes radically during and after the crisis in the course of increasing oil prices.

FIGURE 23
CIS country indicators
www.imf.org

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Commonwealth of Independent States (CIS)[4]	**4.6**	**5.0**	**4.7**	**7.2**	**9.6**	**8.1**	**3.8**	**4.7**	**3.2**	...	...	...
Russia	4.0	4.8	4.5	6.9	9.3	8.0	4.9	5.6	3.9	7.5	7.3	7.1
Ukraine	4.2	4.5	4.9	9.4	9.2	8.3	−1.9	−3.6	−3.8	8.1	7.8	7.2
Kazakhstan	7.0	5.9	5.6	7.4	9.1	6.4	2.5	5.8	4.2	5.8	5.7	5.6
Belarus	7.6	6.8	4.8	7.7	12.9	9.7	−15.5	−15.7	−15.2	0.7	0.7	0.7
Azerbaijan	5.0	2.8	2.5	5.7	10.3	7.5	27.7	28.4	24.2	6.0	6.0	6.0
Turkmenistan	9.2	9.0	6.4	4.4	6.1	7.3	−11.4	−4.7	−3.9	...	...	...
Mongolia	6.1	9.8	7.1	10.2	16.4	16.0	−15.2	−13.3	−14.0	3.3	3.0	3.0
Low-Income CIS	**6.0**	**5.0**	**4.8**	**7.4**	**11.4**	**9.2**	**11.0**	**13.1**	**10.3**	...	...	...
Uzbekistan	8.5	7.0	7.0	9.4	11.6	12.3	6.7	10.0	6.7	0.2	0.2	0.2
Georgia	6.4	5.5	4.8	7.1	12.6	7.9	−9.8	−13.0	−12.0	16.8	16.7	16.5
Armenia	2.6	4.6	4.3	8.2	9.3	5.5	−13.7	−12.4	−11.3	7.0	7.0	7.0
Tajikistan	6.5	5.8	5.0	6.5	13.9	9.7	2.2	−4.1	−7.2	...	...	...
Kyrgyz Republic	−1.4	5.0	6.0	7.8	18.8	9.3	−7.4	−6.7	−7.8	5.8	5.6	5.5
Moldova	6.9	4.5	4.8	7.4	7.5	6.3	−10.9	−11.1	−11.2	7.4	6.5	6.0
Memorandum												
Net Energy Exporters[5]	4.4	5.0	4.6	6.9	9.4	8.0	5.3	6.3	4.5	...	...	...
Net Energy Importers[6]	5.1	5.3	4.9	8.7	10.7	8.7	−6.5	−7.9	−8.0	...	...	...

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Percent. National definitions of unemployment may differ.
[4]Georgia and Mongolia, which are not members of the Commonwealth of Independent States, are included in this group for reasons of geography and similarities in economic structure.
[5]Net Energy Exporters comprise Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.
[6]Net Energy Importers comprise Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, and Ukraine.

Figure 23 above gives some projections (annual % changes) for real GDP, price indices, account balances, and unemployment for CIS region. Georgia is presented as a CIS country on the graph, due to the geographical location and similarities in the economic structure. GDP growth is expected to be 5.5% in 2011 –less than the indicator for 2010, and to further decline to 4.8% in 2012. We see a 12.6% increase in CPI in 2011 a considerable increase after 7.1% in 2010, the figure is forecasted to drop to 7.9% in 2012 projections. General trend of inflation is also pretty high among other CIS countries. Current account balance is expected to increase in Georgia to -13.0% in 2011, after -9.8 % in 2010, with only one percent decline expectations in 2012. Current account balance deficit is a common trait of CIS countries. Unemployment in Georgia is record high among CIS countries with 16.8% in 2010 and only 0.1% decline expectations in 2011. The situation is not expected to change much in 2012 either.

5. Banking Sector

The problem of lack of savings in the country makes economy so much dependent on FDI, which we have discussed above to be very volatile. There is a negative balance between the deposits and loans of the banking system which is especially troublesome, since average loan exceeds an average deposit by almost 2.5 times. The volume of deposits for the first quarter of 2011 has increased, but this increase is moderate in comparison with an increase in loans (www.nbg.ge). Moreover, the deposits are mostly short-term, which reflects the perception of political and economic instability, unpredictability of the future among the population. On the contrary, long-term crediting has rapidly grown and comprises roughly 70.9% of total credit portfolio mainly at the expenses of international capital. The fact that there is a lack of trust among the population as well as among commercial banks is further proved by the dollarization of 72.1% of total deposits, and 73.2% of total credits. In line with the dollarization, level of nonperforming loans is also quite high with 11.8% for the first quarter of 2011 (www.nbg.ge).

A sound working banking system is a key to economic development; unfortunately Georgian banking system has not been formed as a sustainable institute that would have the possibility to ensure economic growth. Banking sector is a relatively new field for the country that is why the fact that it is underdeveloped is quite understandable. That is the reason why attraction of FDI is viewed as a central issue of country's economic policy, whilst the emergence of alternative means of internal savings and capital mobilization is more important. FDI should be viewed as a source of filling in the internal savings deficit rather than the driving force of economic development.

Due to the lack of deposits, Georgian banking system does not possess sufficient loan resource for ensuring country's economic development. Small volume of deposits might be due to the lack of trust among society, therefore the bank has to rely on foreign resources to fund the assets. Introduction of a deposit insurance institute existing in many countries worldwide is a way to attract deposits and increase trust among the population.

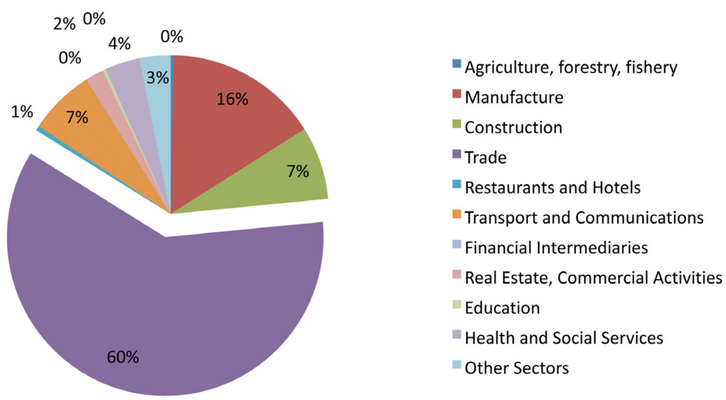
According to the information from NBG, for the first quarter of 2011 only the credit portfolio of the banks amounted to 6,428.9 mil GEL which is a considerable increase (around 19%) compared to the last year. At the same time, dollarization of credits is about 73.2%, the figure indicates that national currency is viewed as relatively volatile and unreliable, the population lacks trust in GEL and believes that USD is more predictable and secure currency. The same holds true for the banks who offer a better interest on deposits hold in GEL. In the conditions of low demand for national currency it might be difficult for NBG to maintain the exchange rate.

Below we demonstrate the loans issued by banks according to various activities.

As can be seen from the figure below (f.24) agriculture that we have discussed to be crucial in the country's economic development only receives 1% of total loan, whilst finances are heavily tilted towards sectors with fairly limited job opportunities available. This notably concerns trade, which can be regarded as proxy consumption. In the meantime, Georgia imports more and more goods, that are absorbed by foreign loans, whilst branches of economy which have highest import-substitution potential, remain without banking financing, as we saw in the example of agriculture. We believe that the major cause of absence of serious rural credit is due to a dysfunctional land market. Agricultural land is rarely used as collateral, and therefore is not capitalized. Thus, a huge amount of wealth is out of productive uses.

To conclude, we believe that Georgia still lacks indigenous engines of economic growth that could potentially absorb capital from banks as well as stimulate more savings, and hence, more investments.

FIGURE 24
Loans issued to legal entities in USD as of 06-2011
www.nbg.ge



6. Consolidated Budget

Consolidated budget revenues for the first quarter, including incomes and grants, amounted to 1,764.1 mil GEL. Major source of income comes from taxes 1,559 mil. GEL. It is worth noting that the income coming from taxes has drastically increased over the last two years (f. 25), although as we shall discuss in the upcoming section, there has been a considerable decrease/elimination of taxes in the country. According to the Ministry of Finance of Georgia (MOF), this increase is due to a better administration/collection of taxes and a considerable drop in petty corruption (www.mof.ge). At the same time, this increase might as well be due to the favorable business environment that helps the existing businesses to expand and the new ones to start-up, therefore creates more tax payers in the country.

Grants make up another important source of income for Georgia with 78,2 mil GEL. Revenues mobilized in the first quarter amount to 34.4 % of GDP, 3.7 % more than that of the last year. In the first quarter of 2011, total budgetary expenses amounted to 1,231.5 mil. GEL, that is around 2% an increase compared to the same quarter last year. Total expenses are 30.6% of total GDP, 2.7% less than during the same period last year. In the first quarter of 2011 reserve funds of the National Bank decreased by 15.9%. The first quarter was characterized by a tight monetary policy, for decreasing the ongoing inflation (www.nbg.ge). The graph below (f.26) shows a correlation between the state revenue and expenses since 2009. The general trend is a gradual increase in revenues since 2009, and a slight decrease in expenditures compared to 2009. Overall, the changes in figures are very moderate, the GoG is pursuing a tight fiscal policy, i.e. there is a budgetary surplus in the country (198 mil. GEL) that comprises 3.9% of GDP.

The chart below (f. 27) shows the main direction for expenses. Since poverty reduction is the main priority for the GoG (www.mof.ge), social benefits comprise the biggest part of the country's expenses. This sphere includes pensions, and help to the less privileged households.

FIGURE 25
Revenue from Taxes (2009-2011)
www.geostat.ge

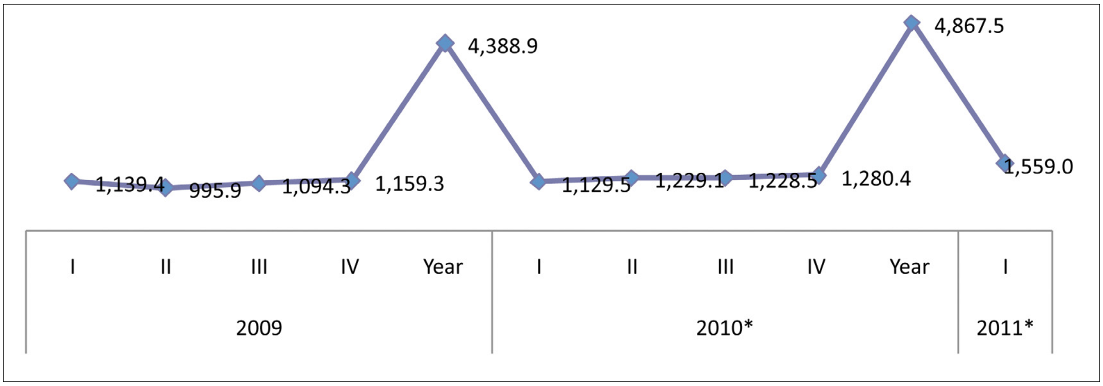


FIGURE 26
State Budget (mil. GEL, 2009-2011) *www.geostat.ge*

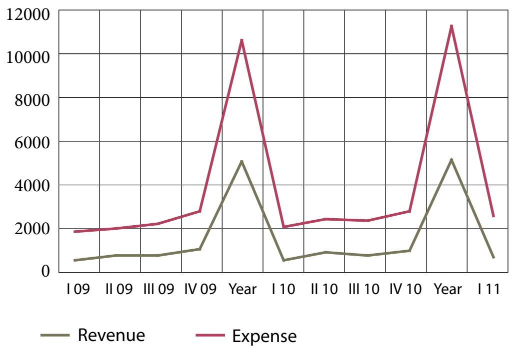
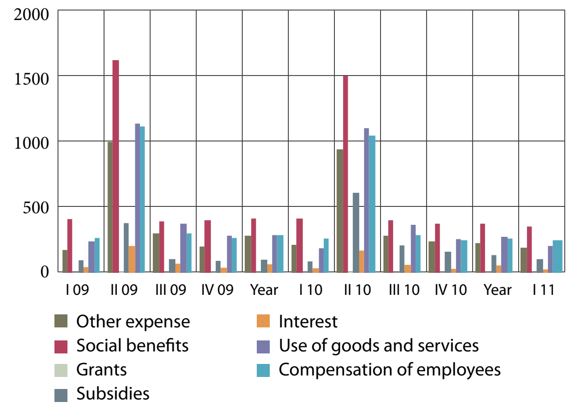


FIGURE 27
Expenses (2009-2011) *www.geostat.ge*

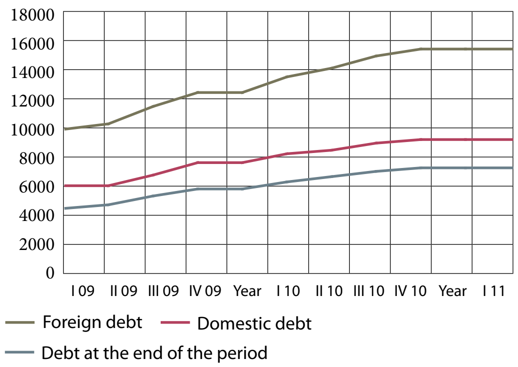


As we can observe the priority for the GoG is social benefits, at the same time compensation of employees and use of goods and services is another considerable portion of budgetary expenses. It is worth noting, that the social benefits are increasing over the past years, at the same time, IMF recommends to further increase help to targeted households due to the high inflation in the country (www.imf.org).

Country's debts have been rising gradually since 2009, and for the first quarter of 2011 amounted to 7,625.7 mil GEL, compared to 6,736.5 mil GEL of the same quarter in 2010. Out of the total debt foreign debt comprises most of it with 5,800.6 mil GEL. As we can see from the graph below (f. 28), an increase in foreign debt is higher than that of the domestic debt. Due to the economic downturn, the tax base has weakened, budgetary surplus has decreased and the needs for public borrowing have increased. Government debt has increased by 130 mil GEL compared to the last year and amounted to 9,3 bil GEL. Out of which foreign debt has increased by 115 mil GEL, whilst the domestic debt by 15 mil gel. Thus, debt in comparison with the GDP is roughly 45% (www.nbg.ge)

Even though country's foreign debt with respect to GDP has not yet reached an alarming point, due to other structural problems existing in the country such as dominance of consumption, and weak export potential, Georgia might be obliged to take loans under much more severe terms which will further deteriorate country's foreign economic state.

FIGURE 28
Debts (mil. GEL, 2009-2011) *www.geostat.ge*



7. Government operations

Poverty reduction is the priority of the Government of Georgia within the next few years. This should be done by putting the economy on the development track, decreasing unemployment, infrastructure development, providing high quality education and providing a conducive business environment. In order to attract the investors, the government should ensure macroeconomic stability, decrease budget deficit and flatten the inflation indicator. The GoG passed relative changes in the constitution and pursues a free economic policy. For fostering the business environment the tax legislation has been simplified, quality of tax administration has increased. At the same time, the policy of "free trade" should further improve foreign trade. The priority is to wisely use the foreign aid and create an environment for FDI inflow through developing infrastructure such as roads and water supply, railway projects,and so-called "open air policy" (www.mof.ge). The construction of the Baku-Tbilisi-Ceyhan oil pipeline, the Baku-Tbilisi-Erzerum gas pipeline, and the Kars-Akhalkalaki Railroad are part of a strategy to capitalize on Georgia's strategic location between Europe and Asia and develop its role as a transit point for gas, oil and other goods (www.cia.gov).

7.1 Fiscal and Monetary Policies

A significant part of the inflation process is an increase in the loans issued by commercial banks. In the first quarter of 2011 the loans increased by 91,8 mil GEL and amounted to 6,428.9 GEL. Due to this fact, NBG has tightened its control on the monetary policy and increased the necessary reserve norm to 15 % on the attracted foreign currency sources. In order to further control the inflation expectations, the monetary policy committee has increased the interest rate to 8% (www.nbg.ge). By this means the committee tried to contract the money supply indirectly, since the inflation is caused by exogenous factors, and not due to an increase in demand, thus monetary instruments would have only a temporary influence. Therefore, by increasing the interest rate, the amount of available money decreases, thus decreasing demand, which in its turn brings the prices down. Although this method can also cause unemployment; moreover, managed exchange rate regime limits the abilities of the monetary policy.

In order to give incentives to businesses, the government has used a fiscal policy to overcome recession, i.e. taxes have been reduced. This method should have brought employment up, increased output level, and enhanced demand, but the economic downturn in 2008-2009 has eroded the effects of this policy. The number of taxes has been reduced to 6, out of existing 21. At the same time, all of the taxes have been decreased, and there is a further forecasted reduction planned in 2013, the adjustments are going to concern the income tax, and dividend & interest income taxes. Although planned income tax reduction shall be postponed to satisfy budget revenue requirements. The GoG is planning on further reducing the taxes for micro and small businesses, such as elimination of the profit tax for those businesses. For further elimination of corruption, the board of auditors is planned to supervise the tax inspectors. Therefore, the government is directing their efforts to attracting FDI, tourism and agriculture. In order to maintain the business-friendly image of the country, the GoG has adopted a "fiscal responsibility law" that includes firms' limits on fiscal deficit and public debt, and thus makes the tax system more predictable (www.ebrd.com).

The Parliament of Georgia adopted a new law on "economic freedom" in July 2011, enforced from December 31, 2013. The law demonstrates that the GoG is keeping up with the liberal economic policy amidst the global economic crisis. The main principles of the law are the following: limiting the government power, maintaining low tax levels, and a conservative cutting edge macro-economic policy (www.mof.ge). One of the key principles of the new law is that any new state tax can only be introduced by means of a referendum; furthermore, expenditures of the consolidated budget should not exceed 30% of GDP, i.e. the executive government is restricted in its expenditures. Further restrictions include a correlation of a consolidated budget deficit with GDP (max. 3%), a correlation of public debt with GDP (max. 60%). These parameters are believed to develop a long-term macro-economic stability in the country, as well as increase the confidence of investors in the country, and thus increase FDI.

8. Conclusions and Recommendations

As we have shown in the paper, Georgia is struggling with high levels of unemployment and inflation that result in low output, and slower economic growth. The GoG is directing reforms towards fostering entrepreneurship in the country which is dragged back due to the lack of resources in forms of domestic and foreign investment. In line with the recommendations set out by EBRD there are certain concrete steps that the GoG can further take for escalating economic growth and ensuring macroeconomic stability.

Since one of the main challenges for Georgia after the crisis is attracting private investments, the government should emphasize on the reforms for encouraging domestic savings and investment (such as a creation of a privately funded pension system). Due attention is needed for the field of agriculture since it is the source of main employment as well as import substitution, we recommend taking care of irrigation and drainage systems as a start. Further reforms are necessary in the financial sector for ensuring the long-term stable growth, such as combating unemployment and inflation. The monetary policy should be targeted towards the inflation reduction, and deepening of the local capital market, that in its turn shall result in reducing the dollarization of the banking system in the country. Fiscal deficit is still at the high level and the public debt still needs stabilization, therefore, the government should concentrate on the implementation of a credible fiscal policy for recovering the market confidence.

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