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Reports, Analysis, Recomendations

ფონდი „ღია საზოგადოება-საქართველო"
OPEN SOCIETY GEORGIA FOUNDATION

ANALYSIS AND RECOMMENDATIONS OF ECONOMIC CHALLENGES OF GEORGIA AND GOVERNMENTAL STRATEGY AGAINST CRISIS

TFAG
TRANSPARENT FOREIGN AID TO GEORGIA

Present report was prepared with financial support of "Open Society Georgia Foundation" within the framework of "Transparent Foreign Aid to Georgia" Coalition

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ABOUT THE PROJECT

Present report was prepared by the experts of "Open Society Georgia Foundation" and the "Economic Policy Research Center". The project was implemented from November 2008 until February 2009 and was carried out within the framework of "Transparent Foreign Aid to Georgia" Coalition.[1] The Coalition aims at promoting the efficiency and transparency of financial aid pledged by donor states and organizations to Georgia.

In the aftermath of military operations in August 2008, donor states and organizations pledged at the donors' conference held in Brussels in October to allocate to Georgia in 2008-2010 aid worth 4,5 billion USD. This decision coincided with further deterioration of global financial crisis. Therefore, future actions of the Government of Georgia may not be limited to eradicating post-war consequences only, as the global financial and economic crisis poses even further threat to the prospects of country's economic development.

Obviously, aid allocated by the donors can not be sufficient for resolving large-scale tasks of modernizing the economy. Yet, rational distribution and transparent disposal of the donors' aid by the state will display as to how adequate are the authorities' evaluations of economic threats that Georgia faces and how seriously do they intend to fight to liquidate those threats.

Present report analyses as to how does the Government of Georgia evaluate challenges existing in the economy and how efficient is its approach to solution of problems.

"Open Society Georgia Foundation" extends its gratitude to the experts of "Economic Policy Research Center" for the expert work carried out within the project framework.

KEY FINDINGS OF THE PROJECT

Undertaken analysis demonstrated that the global financial crisis contains more than enough risks for Georgia to experience serious problems with respect to maintaining economic well-being.

The report examines existing local or global risks and specific threats that the country faces, and analyses as to how adequately the Government of Georgia evaluates these risks in its "Strategy against Global Economic Crisis", as well as during allocation of funds provided by the donors.

In the first place, it is noteworthy that the "Strategy against Global Economic Crisis", which was drafted in December 2008, does not contain any strategic vision in respect of examining negative or positive opportunities created by the global financial crisis.

The analysis outlined major threats, prevention of which in the short and mid-term perspective is crucial for protecting the country from a deepening crisis.

Majority of outlined threats already exists in this or that form and not taking counter steps will aggravate the situation even further. Out of these, emphasized may be the **difficulties that significantly hinder country's economic development and growth, namely**:

THREAT OF SLOWING DOWN THE GROWTH OF GEORGIA'S ECONOMY

In recent years Georgia achieved a high speed of economic growth. In last five years increase in average nominal GDP exceeded 20%, provoked mainly by the consumption boom. Against the background of global economic crisis, the in-flow of direct and portfolio investments as well as single transfers, which provided Georgian market with abundant liquidity, will decrease in a nearest future. If the consumption speed is not restrained, the country will have to either

1 Founders and member organizations of the Coalition are: "Eurasia Partnership Foundation", "Economic Policy Research Center", "Civitas Georgica", "Green Alternative", "Transparency International Georgia", "Georgian Young Lawyers' Association", "Open Society Georgia Foundation".

take private debts with higher interest rates, or to take the state credits, which will substantially aggravate country's economic state.

A permanent change of the country's export-import structure in favor of import demonstrates that the terms of Georgia's trade are permanently deteriorating also: prices on Georgia's chief export goods are reduced, and a majority of enterprises producing them is either closed down or operates in a slow mode.

In recent years, structure of Georgia's export witnessed an increase not in the type of exported production, but in the portion of specific good category, thus making the country's export potential highly dependable on several goods only (ferroalloys, scrap metal, copper mines, fertilizers, hazel nut).

Potential unpredictable development of both foreign and domestic conjuncture, or hypothetic delay in the donors' aid may create gravest problems to the economic system of Georgia, a number of sectors of which is significantly dependant on the availability of cheap liquid funds and a positive dynamics of consumers' income (trade, services, construction).

THREAT OF TERMINATION OR REDUCTION OF INVESTMENT FLOWS

"Cheap money" policy pursued in leading world economies provided an opportunity to global investors to invest capital in high-risk states, which could have been much more difficult in case of strict monetary policies in the developed states. Apart from this, financial institutes of leading states created an opportunity of investing intense liquidity profitably themselves, by investing in the high-risk assets of developing states.

In conjunction with these two factors it is remarkable that in recent years a volume of foreign, and particularly direct investments increased in Georgia. Although a part of investments was provoked by liberalization of economy and successful measures taken with respect to pursuing strict budgetary policy, rapid growth of foreign investments was still provoked more by the above-mentioned factors. This opinion is further upheld by the fact that an increase in foreign investments higher than in Georgia was established in relatively less developed countries of Asia and Africa.

Global financial crisis has already led to restriction of international capital flows. On a massive scale, funds are transferred from securities and assets to cash, and in most cases capital abandons risk markets. For investors, developing countries in general including Georgia still do not represent a portfolio of high-class capital investments. Therefore, against the background of more expensive capital and stricter regulations in the near future, maintenance of existing level of in-flow of foreign resources in our country should not be expected longer in nearest several years.

Hence, as a result of global financial crisis Georgia may lose one of the chief sources of capital formation and maintenance of stability of balance of payment. This is even further alarming as foreign savings play a key role in the formation of country's gross capital. As a result of their reduction, Georgia will become much more vulnerable to foreign shocks and its undesirable condition as it is will worsen in respect to international financial position.

RISKS IN THE BANKING SECTOR AND DEPENDENT ON FOREIGN FACTORS

Georgian banks have already felt negative impact of the August war and a global financial crisis: interest rates increased sharply, loan terms were made significantly harsher, and a volume of "bad loans" increased, which was reflected in a growing number of written-off loans. Due to the mentioned, entire banking system saw the first significant loss in last 10 years - worth 215 million GEL.

Problem of lack of savings within the country will become especially acute when a global economic crisis reaches its peak. Unfortunately, Georgian financial system is quite vulnerable to it, as it is undesirably dependent on the dynamics of international capital markets.

Negative balance between the deposits and loans of the banking system by the end of 2008 constituted approximately 13% of GDP. In such conditions, banks will hardly maintain balance if the capital starts flowing out of the country. Moreover, serious problems will arise even if the in-flow of international capital in the country is suspended, which seems to be a rather realistic scenario in light of hardest ongoing worldwide crisis.

Big inconsistency between the average volume of deposits and loans is especially dangerous. Average loan exceeds an average deposit by almost three times. In such instance banks will have to announce banking holidays or restrict withdrawal of deposits.

THREAT OF REDUCING THE VOLUME OF TRANSFERS

In 2009 it is expected that a volume of money remittances that constantly grew until recently will reduce. Global crisis already had its impact on all states, which secured largest monetary in-flows in Georgia by transfers.

Increasing migration from the country and rather rapid development of economies in the countries of the migrants' settlement might have been a chief pre-requisite for growing volume of transfers. This is particularly applicable to Russia, where in parallel with speedily growing global prices on oil and raw materials, the incomes of both local population as well as economic migrants increased. Global economic crisis has already exerted negative impact on Russia's economy, which is a primary source of transfers made to Georgia. Unfavorable environment is in other states of settlement of Georgian migrants also (EU, USA). In view of this, volume of net transfers is expected to decrease in 2009, thus creating a quite heavy pressure on national currency, as well as population and the banking sector.

Further, described source of income may significantly decrease not only due to a global crisis only, but owing to activation of non-economic factors also (for instance, more strenuous political relations with Russia), which will be directly reflected in the scale of economic activities in the country.

RISKS ASSOCIATED WITH INCREASING FOREIGN DEBT

Due to structural and other type of problems existing in the economy, Georgia might be obliged to take loans under much more severe terms, which will further deteriorate country's foreign economic state, especially as tendency of accelerating foreign debt is recurring since 2008.

Assuming that moneys transferred to Georgia by donors are spent in entirety for its development and approximately 2 billion USD from these funds are loans, the rate of country's debt increase will considerably exceed the rate of GDP growth. The ratio of foreign debt to GDP by the end of 2009 will reach approximately 30%. Yet, this does not necessarily imply that Georgia's foreign debt will definitely become a serious macroeconomic problem. On the other hand, it is obvious also that the dynamics of international conjuncture and our country's foreign debt already include tangible signs of such threat.

Based on the mentioned, the Government has to clearly apprehend existing environment and above-described real or expected risks, so that necessary steps for changing the environment are made effectively to a maximum extent and a set of preventive measures is applied to alleviate shocks caused by a recession.

ABOUT THE AID OF DONORS

In the aftermath of military operations in August 2008, Georgia had to face extremely difficult political, economic, and social challenges. In order to timely overcome damage inflicted by the war and ensure irrevocability of economic and political development of Georgia, donor states and organizations pledged to allocate to our country aid worth approximately 4.5 billion Dollars. 2 billion out of this aid are loans, and the remaining amounts are grants. Funds should be allocated in 2008-2010. Together with donors, Government of Georgia has developed the aid plan of main priorities, which should be distributed by certain proportions to several priority fields. A product of a two-month work of the Government of Georgia and the donor society was made public on 22 October 2008 at the donors' conference in Brussels. At this conference, total volume and major fields of the aid, and activities to be carried out by concrete donors in each field were determined. Pursuant to the statement of Benita Ferrero-Waldner, the Commissioner for External Relations and European Neighborhood Policy, made at the Brussels conference, donors' aid should be distributed to three chief priorities: 1) restoration of sustainability of Georgia's economy, 2) growth of investments in major infrastructure, including energy sector, and 3) assistance of persons suffering from the conflict through providing them with residential space, food, and basic social services. Under the "Joint Needs Assessment" document developed by the UN and the World Bank in partnership with various donor organizations (Joint Needs Assessment, The United Nations – The World Bank, October 9, 2008), a total approximate volume was determined of funds to be allocated to sectors in 2009-2011: budgetary assistance – 930 million USD, social sector – 1248 million USD, infrastructure – 1273 million USD, city and municipal services – 257 million USD, environmental protection – 7 million USD, and assistance to banking sector – 700 million USD.

METHODOLOGICAL APPROACH OF THE STUDY

Obviously, aid allocated by the donors will not be fully sufficient for solving the large-scale tasks of modernizing the economy. Yet, rational distribution of the donors' aid by the state will demonstrate as to how realistically do the country's authorities assess economic challenges that Georgia faces and how seriously do they intend to fight against these challenges. In December 2008 the Government developed the "Strategy against Global Economic Crisis". Present report was drafted based on this very document, as well as the "Joint Needs Assessment" document, document of the Government of Georgia "United Georgia without Poverty", and the statistical data of the National Bank of Georgia, Department for Statistics, and international sources. The report analyses as to how does the Government of Georgia evaluate existing economic challenges and how efficient is its approach to solution of problems. Further, assessment of threats provided below foresees the macroeconomic scenarios (basic, moderate impact of the world crisis, and strictly negative impact of the crisis) set in the "Joint Needs Assessment" document also. Next chapters will present separate macroeconomic threats, assessment of rightness of Government's vision, and the recommendations.

GENERAL CONTEXT OF THE DONORS' AID AND IMPACT OF THE GLOBAL FINANCIAL CRISIS ON GEORGIA

Remarkably, the Brussels donor's conference coincided with further deterioration of a global financial crisis. At this time the tendency of shifting the problems of global financial sector to real economy has clearly revealed. In the opinion of international financial organizations and leading analysts, negative aspects of a financial crisis are already reflected in a real sector of global economy, which ha already displayed deepest recession since 1981-82.

According to the prognosis of IMF, under a best scenario, growth of a global economy in 2009 will be most modest since the II World War and, presumably, will constitute 0,5% (prognoses of other international and think-tank organizations are more pessimistic and predict zero growth, and sometimes even fall).

Unfortunately, it is not excluded that a global depression takes hold of global economy. Therefore, Georgia may not limit itself to liquidation of the war consequences only, as a global financial and economic crisis poses even larger threats to the prospects of country's economic development.

In light of weak development of financial markets in our country, consequences of a global financial crisis were less acute so far, however, this should not create illusion that the crisis will not occur later and the country will overcome grave situation without serious and large-scale state measures. Georgia's economy currently is rather integrated in the world economy in respect of trade, direct foreign investments, transfers received from abroad, and the funds raised by a banking sector. Apart from this, cheap monetary policies pursued in developed states in recent years, which have unprecedentedly increased the mobility of international capital, significantly preconditioned financing of Georgia's economy through direct foreign investments and funds raised by Georgian banks from foreign financial markets.

Taking into account these factors, due to a very relatively weak development of financial markets, in a mid and short term period Georgia may find itself in a harder condition than developed states, if a real sector crisis becomes durable as worldwide, as well as in Georgia.

Period of emerging from the crisis will be more difficult for Georgia due to very underdevelopment of financial markets. In such conditions, priority tasks of the Government of Georgia and the National Bank should be a liquidation of urgent threats facing country's economy and maintenance to a possible extent of dynamism of durable economic growth.

Examination of priority tasks of the Government of Georgia and the National Bank has to take into consideration that economic growth of Georgia in recent years, despite certain successes, was accompanied by serious structural imbalances. This implies alarming growth of a negative balance between foreign trade and current balance, rapid expansion of bank credits, spending of budgetary funds and rapid salary growth, possible "financial bubble" in a construction sector and chronic dependence on foreign sources of funding (transfers, foreign investments mostly in the banking sector), which raises expectations of devaluation of GEL and other risk factors. Without measures aimed at eradicating such imbalance it will be difficult to maintain the results achieved in recent years and the country will face grave economic challenges without significant leverages.

Primary consequences of a global economic crisis in Georgia are already apparent and their worsening is inevitable. Expected reduction of a volume of foreign investments and bank credits in 2009 will serve as important factors of slowing down economic growth. Investing from the governmental package of economic stimulation into infrastructure will considerably increase the share of gross domestic product consumption and state procurements, while the investment component will be decreased, thus finally leading to unfavorable redistribution of resources.

Further hindrance of production will increase negative trade balance and decrease export volume. 2009 will be a difficult year for a banking sector also, and especially in the first half of the year significant changes in the conjuncture are not expected. Respectively, increasing problems are expected in the construction companies also (several of them are already under bankruptcy regime), where a volume of constructions and number of jobs will be reduced further. Due to increasing unemployment and high prices on consumer goods, a poverty rate is expected to grow in 2009.

THREAT OF SLOWING DOWN THE GROWTH OF GEORGIA'S ECONOMY

Next chapters examine risks that the country faces, and assess as to how objectively the Government of Georgia evaluates these risks in its "Strategy against Global Economic Crisis", as well as during allocation of funds provided by the donors.

Table 1.
Georgia's GDP under market prices, by costs (in million GEL)

	2003	2004	2005	2006	2007	2008 (three quarters)
Costs on final consumption	7028.84	8573.83	9794.15	12971.97	15731.90	13650.90
Formation of gross capital	2682.33	3134.75	3891.54	4255.31	5447.51	3810.71
Net export	1249.03	-1633.44	-2070.79	-3330.42	-4544.96	-3923.08
Total	8462.14	10075.14	11614.90	13896.86	16634.44	13538.53

Source: Department for Statistics

Information provided in Table #1 above is quite impressive at a single glance, as it depicts the speed of high economic growth in recent years. In last five years average growth of nominal GDP exceeded 20%. Analysis of a table reveals a rather negative tendency, which poses significant threat to a rapid development of Georgia's economy.

CHART 1. COMPOSITION OF GEORGIA'S GDP BY MAJOR CATEGORIES INCLUDING 2003 - THREE QUARTERS OF 2008

Source: Department for Statistics

Data depicted in Chart #1 demonstrate that economic growth of Georgia in recent years was mostly preconditioned by a consumption boom. Despite rapid growth of foreign and local capital investments in the economy, it is clear that maintenance of existing speed of economic growth will become difficult without decreasing the speed of import growth. In the course of time Georgia will have to raise more and more capital from abroad in order to ensure parity in payment balance. Although a certain progress is achieved currently in attracting direct foreign investments, speed of formation of gross capital is clearly not sufficient for satisfying the "increased appetite" of consumers. Against the background of global economic crisis, the in-flow of direct and foreign portfolio investments as well as single transfers, which provided Georgian market with abundant liquidity, will relatively decrease in a nearest future.

If the consumption speed is not substantially restrained, the country will have to either take private debts with higher interest rates, or to take the state credits, which will considerably aggravate country's economic state. Due to the fact that export as such depends on the dynamics of demand of foreign economic agents, which in itself is determined by the revenues of the latter, hoping on a speedy growth of export during a global economic crisis will be rather difficult. This in itself will reduce the growth of Georgia's economy as a minimum. In addition, the US expansionist monetary policy pursued in recent period has to be taken into account, which reduced the rate of refinancing a federal reserve system to 0.25%.

Against the background of restricted capital flows, practically "free of charge" US Dollar in a short-term period poses to Georgia's economy threats of further increasing the import and decreasing the export. At the same time, in nearest several months it is possible to import relatively more capital goods by means of a cheap Dollar, which will alleviate potential threats to our country's economy.

Chart 2 illustrates how dangerous is the dependence of Georgian economy on consumption and import.

Analysis of country's export-import balance and structure clearly demonstrates the risks arising from a foreign trade.

In 2008, Georgia's foreign trade turnover (without unorganized trade) constituted 7 billion 556 million USD, which exceeds previous year by 17,2%.

Out of this, export constitutes 1 billion 498 million USD (respectively more by 21,5%), while import – 6 billion 58 million USD (more by 16,2%). In 2008 Georgia's negative trade balance exceeded 4 billion 560 million USD, and the import exceeded export 4 times.

In 2008 Georgia had a negative trade balance with 107 partner states, with who a trade deficit constituted 4 billion 790 million USD (instead of 100 states and 4 billion 128 million USD in 2007).

In 2008 the country had a positive trade balance with 21 states with 230 million USD of positive balance, instead of 23 states and 146 million USD in 2007.

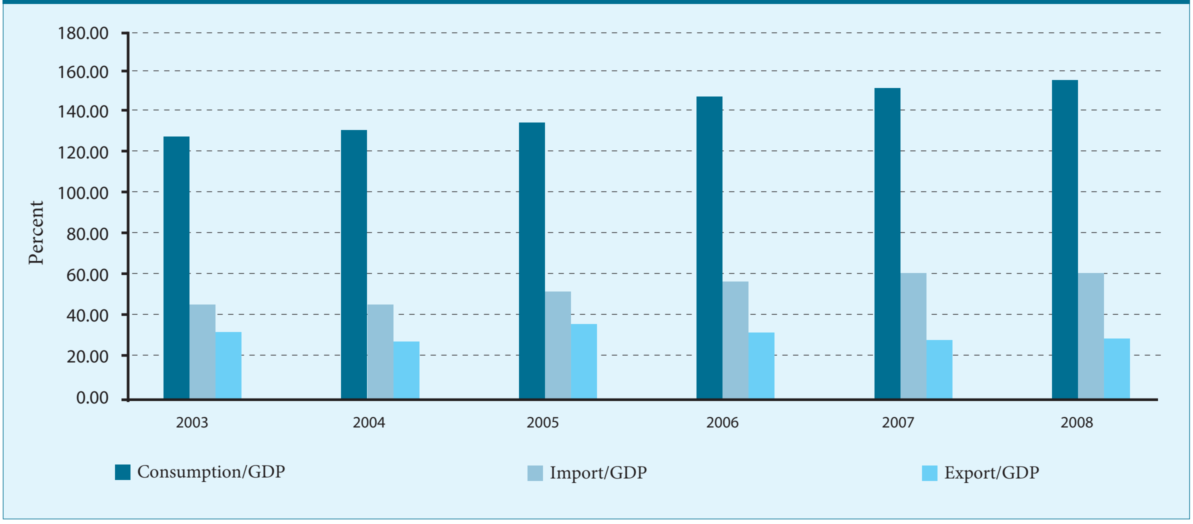
Remarkably, this is not a tendency characteristic to 2008 only: dominant position of import and limitation of export in Georgia's foreign trade becomes more and more apparent annually.

Further, terms of trade of Georgia have deteriorated also, as prices on Georgia's chief export goods (scrap metal, nonferrous metals) reduced further than on energy carriers. In near future, after the leading states overcome a global economic crisis, it is expected that prices on energy carriers will become soaring, which is not expected in respect of other raw materials (interestingly, a list of Georgia's export goods becomes more dependant on these groups. For instance, recently, despite abrupt fall of demand on ferroalloys, ferroalloys still top the list of export goods of Georgia. According to official statistics, in 2008 its share in gross export is 17,8% and its value exceeds 276 million USD).

In recent years, structure of Georgia's export witnessed an increase not in the type of exported production, but in the portion of specific good category, thus making the country's export potential highly dependable on several goods only (ferroalloys, scrap metal, copper mines, fertilizers, hazel nut).

Index of use of the EU Generalized System of Preferences (GSP+) illustrates also the scarcity of export potential and non-utilization of existing resources – out of 7,200 products, which may enter European markets without customs fees, practically only up to ten types of goods benefit from this exemption.

CHART 2. DYNAMICS OF CONSUMPTION, IMPORT, AND EXPORT WITH RESPECT TO GDP INCLUDING 2003 - THREE QUARTERS OF 2008



Source: Department for Statistics

Potential unpredictable development of both foreign and domestic conjuncture, or hypothetic delay in the donors' aid may create gravest problems to the economic system of Georgia, a number of sectors of which is significantly dependant on the availability of cheap liquid funds and a positive dynamics of consumers' income (trade, services, construction).

Presumably, already established tendency will not change in short-term. Therefore, Government's policy should be oriented on avoiding a negative shock on consumption to a maximum extent. Simultaneously, a vision has to be formulated on how the country's economy should reorient in a mid and long-term period from consumption and import to savings and export.

To illustrate one of the possible mechanisms of impact of global financial and economic crisis on Georgia, we examined the foreign and financial sectors of our country's economy. Truly, a developed capital, especially the stock market, is still absent in Georgia.

A belief that global financial crisis will not affect Georgia is wrong due to the following judgments:

Foreign, especially direct foreign investments, activities of which are driven mostly by foreign factors, have considerably grown in recent years in Georgia;

Georgia should be considered as a country of incomplete mobility of capital and a non-autarchic (totally closed for international financial flows) state, which means that a country is sensitive to the flows of international capital in the banking field;

Georgia sufficiently depends on factual revenues from abroad, i.e. transfers of migrants, which is one of the most significant article of our country's payment balance;

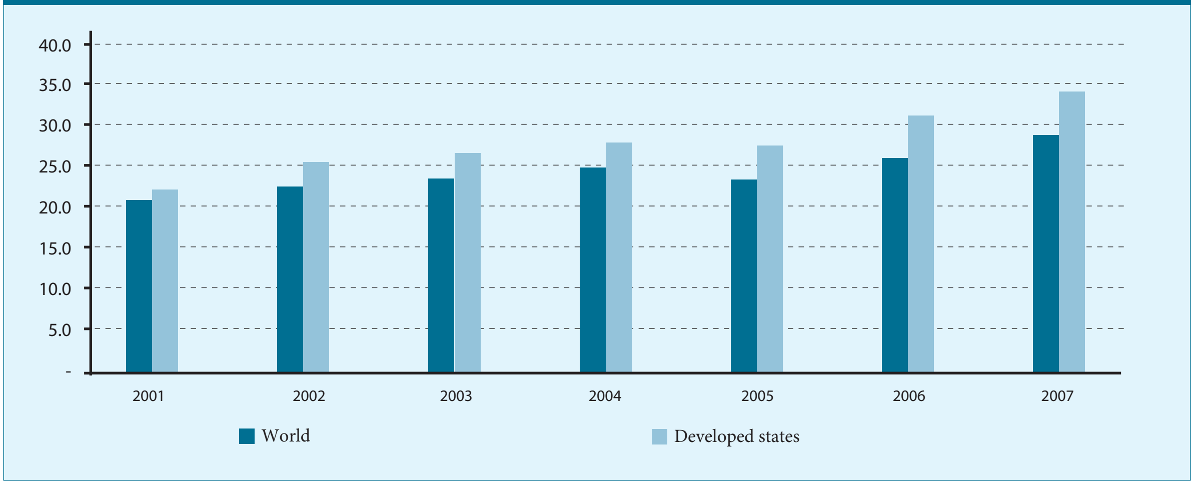
Georgia receives donors' aid for almost two decades, efficiency of which also largely depends on international conjuncture. Even in current situation there is a risk (although this risk is ignored in the presented materials) that a certain portion of funds pledged by the donors to Georgia may not reach addressee if a global economic crisis deteriorates further. This may create challenges to Georgia, reflected in a problem of abrupt growth of a foreign debt (Debt Overhang).

Risk of devaluation of Georgia's national currency, which will occur under increasing pressure of abovementioned factors on national currency in case of pursuit of expansionist fiscal policy.

Unity of all above-listed factors exerts enormous influence on the state of Georgia in respect of its foreign liabilities, investment position, and solvent capacity in general.

Global financial crisis contains more than enough risks for Georgia to encounter serious problems in terms of maintenance of economic wellbeing.

CHART 3. DIRECT INVESTMENTS ABROAD WITH RESPECT TO GDP OF INVESTING COUNTRY IN PERCENT

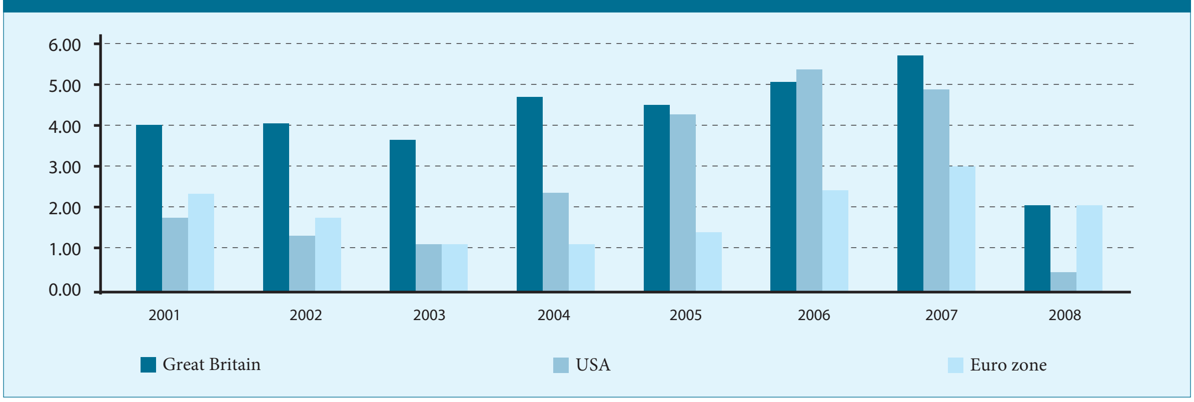


Source: UN Trade and Development Conference

The above Chart well displays consequences of financial globalization underway in the beginning of the 21st Century in terms of growth of capital flow from main supplier states of capital to a rest of the world. Here developed states are represented by the OECD states, which in general pursued rather liberal fiscal policies throughout this period. Although mobility of capital increased in the rest of the world also, particularly in countries rich with oil, in 2001-2007 still the western states, and especially the United States of America held leading position. Unprecedented accumulation of abundant liquidity and inflation of prices on assets became a continuation of technological boom of the 1990s. From the same period, current balance deficit started growing rapidly in the United States against the background of accrual of debts of household economies. Maintenance of existing consumption rate in the US was made possible through a cheap monetary policy, while financing of current balance deficit was possible until American securities were treated as optimum means for investing of funds available to investors in the rest of the world. Evidently, in western states including the US, rates of capital revenues were not so high, thus enhancing the stimuli to invest in the high-risk assets of developing states with abundant liquidity. As a price of portion of the investors' money was quite low, direct and portfolio investments in developing states grew particularly rapidly. In one of the three major centers of capital supplies (US, Great Britain, Euro zone), basic nominal rate of monetary policy exceeded 5% only twice, which in itself is a rather low indicator (refer to Chart 4).

Cheap money policy provided an opportunity to investors to invest capital in high-risk states, which could have been much more difficult in case of strict monetary policies in the developed states. Apart from this, financial institutes of leading states created an opportunity of investing intense liquidity profitably themselves, by investing in the high-risk assets of developing states.

CHART 4. MAIN INTEREST RATE BY THE END OF REPORTING PERIOD



Source: Web pages of Central Banks of respective states

In conjunction with these two factors it is remarkable that in recent years a volume of foreign, and particularly direct investments increased in Georgia. Although a part of investments was provoked by liberalization of economy and successful measures taken with respect to pursuing strict budgetary policy, rapid growth of foreign investments was still provoked more by the above-mentioned factors. This opinion is further upheld by the fact that an increase in foreign investments higher than in Georgia was established in relatively less developed countries of Asia and Africa (refer to annual report of the UN Trade and Development Conference).

Global financial crisis has already led to restriction of international capital flows. On a massive scale, funds are transferred from securities and assets to cash, and in most cases capital abandons risk markets. For investors, developing countries in general including Georgia still do not represent a portfolio of high-class capital investments. Therefore, against the background of more expensive capital and stricter regulations in the near future, maintenance of existing level of in-flow of foreign resources in our country should not be expected longer in nearest several years.

Hence, as a result of global financial crisis Georgia may lose one of the chief sources of capital formation and maintenance of stability of balance of payment. This is even further alarming as foreign savings play a key role in the formation of country's gross capital. Although interest rate is lower currently in the developed states, including the US compared to pre-crisis period, such policy is temporary and aims to break the deadlock of economy through its stimulation. Following the fulfillment of this task, tendency of growth interest rates will occur, upheld by the necessity to fill in the budgetary deficits existing in leading states. Thus, Georgia will become much more vulnerable to foreign shocks and its undesirable condition as it is will worsen in terms of international financial position (latter is provided in the present chapter, as a concluding position on foreign risks).

RISKS IN THE BANKING SECTOR AND DEPENDENT ON FOREIGN FACTORS

Dynamics of economic development substantially depends on the soundness of country's banking system. It is practically impossible to maintain durable economic growth without sustainability of a banking system. Georgian banks have already been affected by a negative impact of the August military hostilities and a global financial crisis. Interest rates significantly increased, lending terms became considerably stricter, and a number of non-quality loans grew, reflected in an increased volume f written-off loans. Described tendency was first reflected in a net loss of entire banking system during a last decade.

Despite a success achieved in recent years and substantial growth of foreign capital investments, unfortunately Georgian banking system had not been formed as a sustainable institute that would fully tackle the task of ensuring country's economic growth. This was preconditioned by numerous objective internal or foreign, as well as conjuncture reasons, examination of which represents a much broader task. In fact, the country is chronically affected by a lack of capital, which used to be filled in by funds attracted from foreign markets.

Unfortunately a deposit base is not sufficient for ensuring local economy with loans. Obviously, achievement of this task by its own efforts only is extremely difficult for a small country. Further, it has to be taken into account that Government of a country, which until recently planned to transform Georgia into international financial center (part of the 50-day program of the Government of Georgia), has to be well aware that transforming a country into a serious financial center is impossible until local finance, including a banking system is not so stable as to enjoy opportunities of investing intense liquidity abroad (here of course we do not mean off-shore zones and microstates, as financial centers, development models of which are absolutely unacceptable and unrealistic for Georgia).

Unfortunately, attraction of foreign investments still remains as a central target of Georgia's economic policy, whereas it is much more important to ensure emergence of alternative means of internal savings and capital mobilization. Foreign direct and portfolio investments should be viewed only as a source for filling in the internal savings deficit and not a driving force of economic development.

Problem of lack of savings within the country will become especially acute when a global economic crisis reaches its peak. Unfortunately, Georgian financial system is quite vulnerable to it, as it is undesirably dependent on the dynamics of international capital markets.

Banking sector finished the year of 2008 with a loss of 215 million GEL, while a total profit at the same time last year exceeded 109 million GEL. According to the banks, established loss was preconditioned by establishment of increased reserves on credit portfolios, as a result of financial crisis.

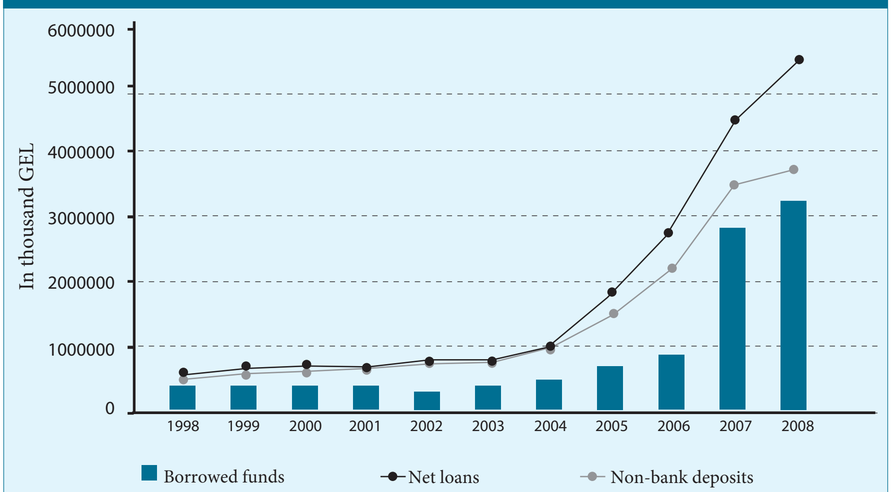
Currently, the banks possess cash in face of reserves. Despite increased risks, index of ratio of share capital to liabilities reaches 21%, which guarantees sustainability of the sector during the crisis. Currently, banking sector is represented with 20 commercial banks, total assets of which, at this point in time exceed 8 billion 865 million GEL.

Existing situation is deteriorated further by the fact that Georgian banks reached a point in time when they have to start paying off credit liabilities towards foreign financial institutes. Just only two leading banking institutions have to spend more than 200 million USD on foreign credit liabilities in a first quarter of the year.

Another problem persists also: as of 1 January 2009, a volume of overdue loans in the banking sector constituted 159 million 245 thousand GEL. At this point in time, "bad loans" in the banking sector constitute 3% of total loans and 1,8% of total assets. Volume of "bad loans" reached 100 million GEL before August and did not exceed 1,2% of total assets of banks operating on the market. Following the August war, repayment of loans has become difficult and reached a peak in December, when a gross volume of overdue loans increased up to 209 million GEL.

	Overdue Loans
August 2008	100 mln.
November 2008	141 mln.
December 2008	209 mln.
January 2009	159 mln.

CHART 5. BORROWED FUNDS, NET LOANS AND NON-BANK DEPOSITS

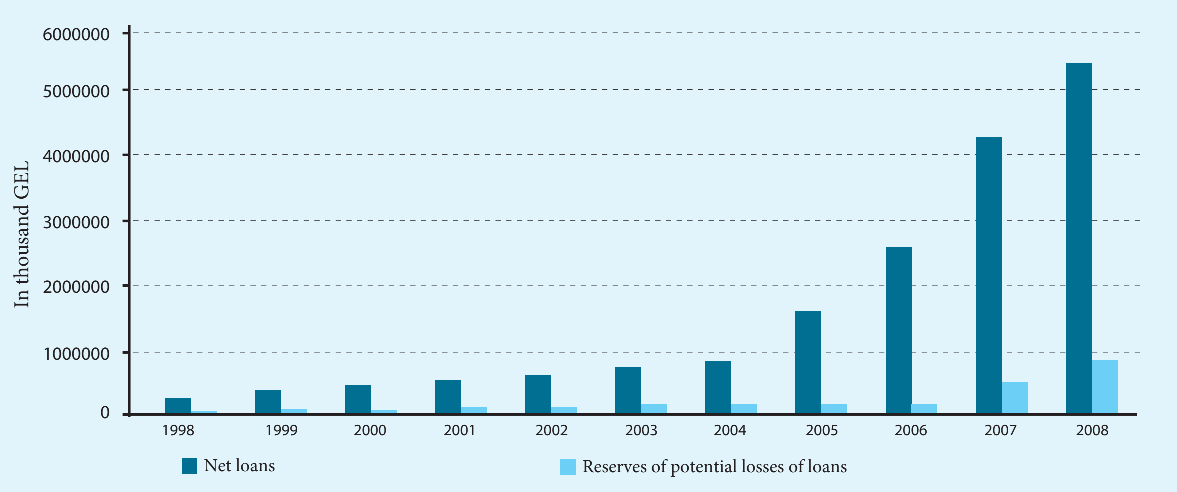


Source: National Bank of Georgia

Chart provided above clearly demonstrates that funds borrowed from the very foreign capital markets, so-called "on-landing" is the sole source of funding the difference between net loans and non-bank deposits (household economies) of Georgian banking system, as deposits of the depositors. Interestingly, speedy growth of net loans of Georgian banking system coincides with softening of monetary-credit policies by leading western states, which was already reflected in an abrupt increase in the volume of borrowed funds within the liabilities of Georgian banking sector. At the same time, until 2006 non-bank deposits would almost fully fund the net loans. Since 2006, this deficit has increased sharply, caused presumably by already described cheap money policies in foreign countries and inflation expectations existing in Georgia, reflected in weakened deposit base. Simultaneously, year 2008 provided in the above Chart comprises also the October data, when the out-flow of part of deposits from the banking sector occurred.

2008 was marked also with a speedy growth of reserves of potential loan losses, displayed in a Chart below. Abrupt growth of "bad loans" is presumably is caused presumably by serious problems affecting the construction sector, which deteriorated particularly in the second half of 2008.

CHART 6. TOTAL NET LOANS AND RESERVES OF POTENTIAL LOSSES OF COMMERCIAL BANKS



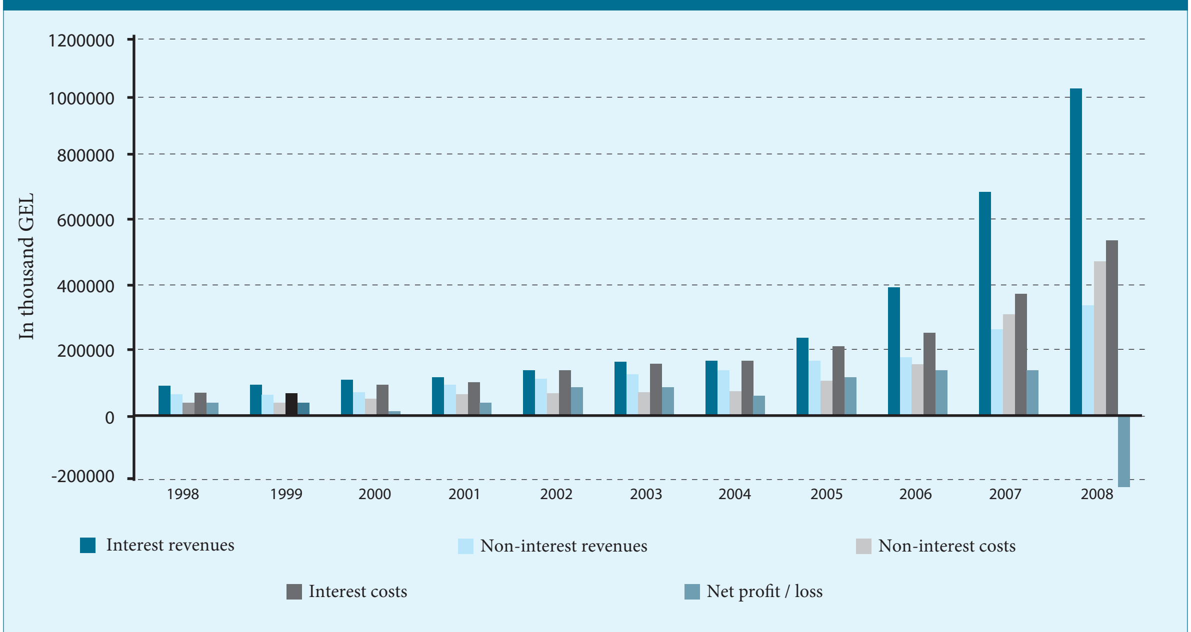
Source: National Bank of Georgia

Examination of dynamics of total indices of Georgian banking system in 1998-2008 clearly reveals a tendency of acceleration of banking activities in recent years, which at a first glance is a rather positive tendency, but it has to be taken into account, that in general economy such a speedy growth of crediting level, i.e. generating money creates rather complex macroeconomic risks, which may be reflected in an abrupt fall in loans issued by the banks and a quality of pledged property. Such developments occurred in states with established financial systems, such as Sweden and Japan at the crossover of 80s and 90s of last century. Huge dependence of Georgia on international capital markets makes its banking system too vulnerable in terms of sustainability of liquidity and profitability. Remarkably, both non-interest revenues and non-interest costs grow abruptly in the banking system. However, the latter grew so rapidly in 2008 that preconditioned net loss of entire banking system in the value of approximately 215 million GEL.

In nearest several months interest payments on borrowed funds will become due for Georgian banks, while terms of accessibility to new loans on international capital markets will be made stricter.

Hence, ensuring Georgian banking system with liquidity will be an urgent priority task for the country during the mentioned period of time.

CHART 7. TOTAL OPERATION INDICES OF THE BANKS



Source: National Bank of Georgia

Table 2.
Total Indices of Banks with respect to Gross Revenues

	Interest revenues	Non-interest revenues	Interest costs	Non-interest costs	Net profit/loss
1998	66.21	33.79	18.53	42.45	24.08
1999	63.95	36.05	18.96	45.91	20.67
2000	66.27	33.73	22.36	48.25	2.63
2001	58.36	41.64	17.39	52.00	6.69
2002	63.50	36.50	17.23	50.36	21.55
2003	62.85	37.15	16.70	51.46	19.72
2004	56.21	43.79	15.59	58.74	9.94
2005	56.29	43.71	16.12	55.58	15.60
2006	68.84	31.16	26.71	44.91	16.16
2007	72.73	27.27	31.79	40.17	11.51
2008	74.75	25.25	33.17	38.41	-15.70

Source: National Bank of Georgia

Table 3 exploits our belief further that Georgian banking system does not possess sufficient loan resource for ensuring country's economic development. Out of major GDP components, only trade is funded adequately. To illustrate this, we elaborated the index for payment of sectoral GDP by bank loans, in order to demonstrate which branches of economy are mostly served by a banking sector.

Table 3.
Payment of Sectoral GDP by Bank Loans in percent for Loans Issued in National and Foreign Currencies

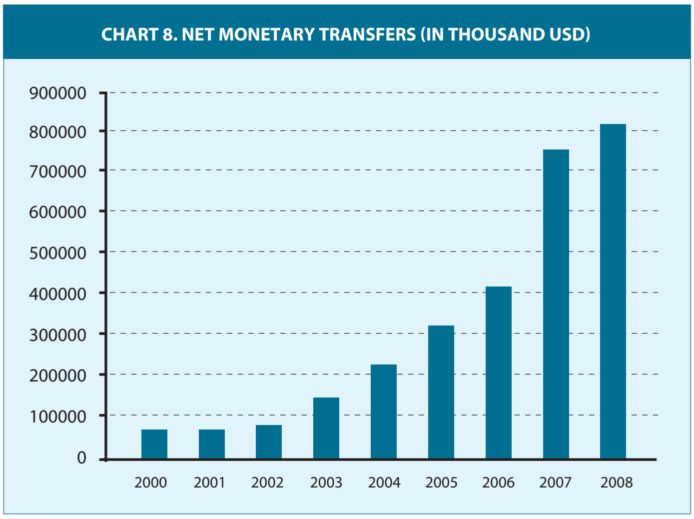
	Agriculture, forestry, fishing	Industry	Construction	Trade
2003	0.96	28.25	14.57	44.81
2004	0.85	30.54	12.37	43.60
2005	0.76	35.33	21.54	78.76
2006	1.32	41.99	40.48	99.16
2007	5.14	46.58	43.50	121.57
	Hotels and restaurants	**Transport and communication**	**Financial mediation**	**Real estate operations, studies, commercial activities**
2003	3.83	3.16	62.31	1.08
2004	8.34	3.41	58.96	1.33
2005	5.96	4.31	93.19	5.50
2006	7.51	5.62	54.12	8.53
2007	14.66	3.81	22.26	10.35

Source: National Bank of Georgia

Except for industry, construction, and particularly trade, bank credits in fact almost do not cover sectoral GDP. This applies in particular to agricultural sector, which remains as a most depressive part of the Georgian economy. Economic and institutional changes almost have not affected it. It will be difficult to maintain a speed of growth of Georgia's economy without commercialization of agricultural sector and allocation of credits for it, as approximately 50% of country's population accounts for this sector. Remarkably also, a trade sector, which almost entirely accounts for import, is even over-covered by a bank credit (funds borrowed by a sector significantly exceed its sectoral GDP), which makes it vulnerable to potential shocks of foreign trade. At the same time, these tables highlight one **interesting fact: practically we have a situation, when Georgia borrows funds from abroad to finance its own import, which is concerning. A vicious circle is made: Georgia imports more and more import goods, and more and more foreign loans are used to absorb these goods. At the same time, branches of economy, which have highest import-substitution and export potential, remain without bank financing (for instance, agriculture and agro-business). Non-funding of transport sector is surprising when Georgia is viewed as a corridor linking eastern and western states.**

THREAT OF REDUCING THE VOLUME OF TRANSFERS

Factual revenues, net monetary transfers remitted to the country annually represent one of the most significant components of Georgia's foreign sector. Until present, their dynamics used to grow gradually. Until 2004, mentioned indicator was mainly not registered. Nevertheless, despite of this, tendency of growth of absolute, as well as relative indicator is notable for Georgian economy (refer to Chart 8, Table 4).



Source: National Bank of Georgia

Table 4.
Fraction of Net Monetary Transfers in GDP (%)

2000	2001	2002	2003	2004	2005	2006	2007	2008
3,1	2,7	2,2	1,6	4,3	4,0	6,1	6,3	7,0

Source: National Bank of Georgia

Increasing migration from the country and rather rapid development of economies in the countries of the migrants' settlement might have been a chief pre-requisite for growing volume of transfers. This is particularly applicable to Russia, where in parallel with speedily growing global prices on oil and raw materials, the incomes of both local population as well as economic migrants increased. Global economic crisis has already exerted negative impact on Russia's economy, which is a primary source of transfers made to Georgia. Unfavorable environment is in other states of settlement of Georgian migrants also (EU, USA). In view of this, volume of net transfers is expected to decrease in 2009, thus creating a quite heavy pressure on national currency, as well as population and the banking sector.

In 2008, 1 billion 2 million USD were sent to Georgia as remittances, which exceeds the 2007 indicator by 16%. 92% of remittances from abroad to Georgia account for nine largest donor states, including Russia with 63%. Second on the list is Ukraine with 7%, and the United States with 6,4%. Greece with 4,7% and Italy with 3,7% are in the top five.

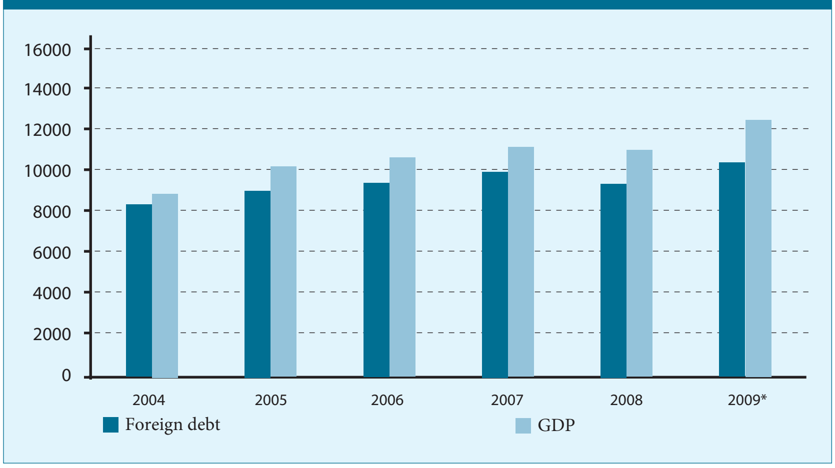
Due to a global crisis, as well as activation of apparently non-economic factors (for instance, more strenuous political relations with Russia), a source of described income may significantly reduce.

RISKS ASSOCIATED WITH INCREASING FOREIGN DEBT

Although country's foreign debt with respect to GDP has not yet reached an alarming point, owing to negative foreign conjuncture and structural problems existing in Georgia's economy (dominance of consumption, weakness of export potential, etc.), as well as due to the fact that allocation of funds by the donors will significantly depend on existing situation in these countries, Georgia might be obliged to take loans under much more severe terms, which will further deteriorate country's foreign economic state. It is noteworthy also that reducing dynamics of a foreign debt achieved in recent years must be regarded as country's success. Following 2004, the country has practically resolved a problem of dependence on a foreign debt. By 2007, a foreign debt fluctuated within the range of 15-20% of a gross domestic product, which may even be considered as an optimum indicator.

Nevertheless, a tendency of accelerating foreign debt is recurring since 2008. In the first place, Euro bonds worth 500 million USD were issued in the first half of the year. We critically assess this measure based on several reasons. Afterwards, already in the second half of the year, foreign debt started increasing against the background of aid rendered by the donors to Georgia, part of which are loans. Obviously, foreign debt with respect to GDP is still at a rather low point, but a serious risk persists already that a foreign debt will start accruing rapidly. Chart #9 calculates GDP of 2008 with a 20% growth of nominal 2007 indicator. Same procedure was applied to a predicted index of 2009. Even under such relatively optimistic estimations, assuming that moneys transferred to Georgia are spent in entirety for its development and approximately 2 billion USD from these funds are loans, the rate of country's debt increase will considerably exceed the rate of GDP growth.

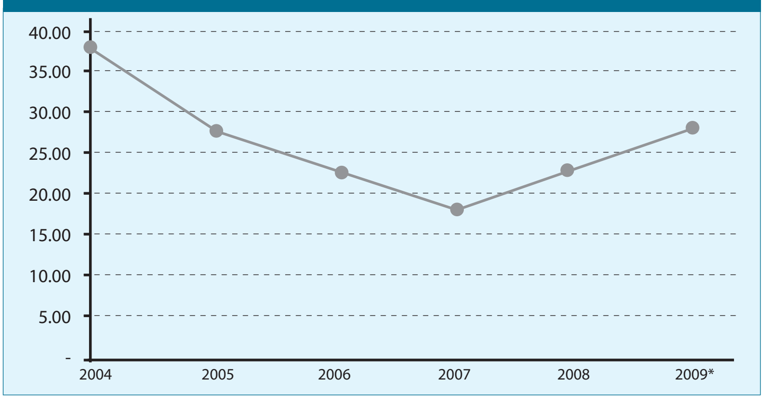
CHART 9. GEORGIA'S GDP AND FOREIGN DEBT IN USD



*Source: Ministry of Finance of Georgia, * our prognosis*

Chart #10 shows that a ratio of foreign debt to GDP by the end of 2009 will reach approximately 30%. This does not imply directly that Georgia's foreign debt will definitely become a serious macroeconomic problem. On the other hand, it is obvious also that the dynamics of international conjuncture and our country's foreign debt already include tangible signs of such a threat.

RATIO OF FOREIGN DEBT TO GDP IN PERCENT



*Source: Ministry of Finance of Georgia, * our prognosis*

Numerous developing states faced a similar problem in 70s-80s of the last century. Their problems emerged as a result of foreign trade shocks and a sharp rise in prices on capital on international markets. Subsequently, countries with much more voluminous markets and diversified export than Georgia, such as Brazil, Argentina, and Venezuela, suddenly, just in merely several years have turned into highly indebted states. From 1976 till 1981 ratio of foreign debt of these states to GDP increased by 10-15% and exceeded 30%. Accordingly, a problem of debt overhang emerged in these states, which substantively slowed down the speed of economic development in these countries for approximately 15 years.

Unfortunately, current global crisis is much more comprehensive and deep than the shocks of 70s and 80s of the last century, and Georgia's position is weaker than that of abovementioned countries in 1970s-1980s.

CURRENCY RISKS AND GEORGIA'S NET INTERNATIONAL INVESTMENT POSITION

Table provided below depicts Georgia's net international investment position (Table #5), which represents a sum of country's international assets and liabilities. Worth noting is the increase of negative international investment position at a much higher speed than GDP, driven mainly by direct investments carried out in our country. At a glance, this Table does not draw a too dangerous situation. In the first place, National Bank of Georgia is rather well in control of situation from the standpoint of reserve assets.

In spite of panicky state existing on a currency market, the National Bank addressed the problems and maintained more or less stable rate of a national currency. In terms of non-changing major macroeconomic parameters, no threat will be posed to the Lari rate in a short-term perspective. However, in a mid and long-term perspective, we believe maintenance of status quo in this regard will be extremely difficult due to increasing current balance deficit, deteriorating trade conditions, and a high rate of state sector consumption.

Country's net international investment position indicates also that if in nearest future international mobility of capital is restricted and a flow of direct foreign investments decreases in Georgia (signs of which are apparent already), international investment position of the country will witness a tendency of capital outflow, reflected in repatriation of profit on foreign capital investments. In the future, this factor will exert additional pressure on the economy, including the Lari rate.

Table 5.

	12/31/2005	12/31/2006	12/31/2007
International investment position, net	**-3,923,402.8**	**-5,050,947.2**	**-7,139,448.9**
Assets	**885,210.1**	**1,399,719.6**	**2,143,379.9**
Direct investments abroad	21,172.3	5,447.1	87,164.2
Portfolio investments	14.4	2,203.1	7,593.0
Financial derivatives	0.0	0.0	57.9
Other investments	385,549.6	461,219.5	687,408.5
Reserve assets	478,473.8	930,849.9	1,361,156.3
Liabilities	**4,808,612.9**	**6,450,666.8**	**9,282,828.8**
Direct investments in Georgia	2,379,930.3	3,559,201.4	5,388,724.5
Portfolio investments	14,934.3	181,142.2	261,986.7
Financial derivatives	0.0	0.0	9.3
Other investments	2,413,748.3	2,710,323.2	3,632,108.3

Source: National Bank of Georgia

ASSESSMENT OF STRATEGY OF GOVERNMENT OF GEORGIA AGAINST GLOBAL ECONOMIC CRISIS

During the analysis of Georgia's economic risks, only the most obvious and easily identifiable threats have been highlighted. Therefore, we assumed, that Government of the country would have drawn attention to at least one of them in its "Strategy against Global Economic Crisis", which was published in December 2008.

Firstly, it is worth noting that the mentioned strategy of the Government, which consists of several slides, does not contain any kind of strategic vision in terms of examination of negative and positive opportunities produced as a result of global financial crisis. Although individual tactical measures provided in the strategy may be assessed as positive, it is totally unclear as to why is this presentation called as a strategy against crisis, when it does not set strategic tasks, does not identify existing threats on the way to fulfilling these tasks in light of the crisis, and doe not convey a strategic vision on problem solution.

In the first place, the Strategy does not anywhere mention the role of the National Bank, in absence of which it is impossible to pursue expansionist fiscal policy (majority of offered activities belongs to this very category), as well as to define and fulfill the strategy of priority macroeconomic parameters (money supply, credit, currency rate). Any economic policy simply does not exist without the latter.

Government of Georgia intends to develop three strategic directions: investing in local infrastructure, social protection, and boosting attractiveness of Georgia before international investors.

In light of the existing situation and due to a threat of deterioration of external or internal risks, we find it necessary that the Government elaborates more or less adequate counter-measures against unfavorable development of events and does not hold to the strategy, which in a declaratory tone relates only about the Government's wishes and hypothetic plans.

Thus, the Government has to precisely realize a current situation and the abovementioned occurred or expected risks, so that measures necessary for overcoming the situation are taken timely and effectively to a maximum extent, and a set of preventive measures that would mitigate shocks caused by recession is carried out.

Conclusions / Recommendations

Without immediate implementation of sectors and activities highlighted in the Conclusions / Recommendations section, it is hardly imaginable to pull country out of the existing crisis.

BANKING SECTOR

To mitigate the problems of a banking sector it is necessary to carry out urgent measures in order to avoid a bank panic, which may inflict a huge damage on still developing Georgian banking system by creating a systemic crisis, especially when Georgian banks already experience solvency problems. Currently, the country has an extremely weak mechanism of long-term savings and their transformation into loans. The society still does not trust the banking system, and therefore the latter has to rely on foreign sources to fund the assets. Big share of the banks' liabilities falls on short-term deposits, whereas in recent period long-term crediting (mortgage and consumption boom) has rapidly grown mainly at the expense of international capital. According to the data of the National Bank of Georgia, a negative balance between the deposits and loans of the banking system by the end of 2008 constituted approximately 13% of GDP. In such conditions, banks will hardly maintain balance if the capital starts flowing out of the country. Moreover, serious problems will arise even if the in-flow of international capital in the country is suspended.

This seems to be a rather realistic scenario in light of hardest ongoing worldwide crisis, which was called by the former Chairman of the US Federal Reserve System Alan Greenspan as “the crisis, which occurs once in 50 years, or possibly, once in a century”.

Banking system, in which there is a significant imbalance between terms of deposits and loans, is especially inclined towards a banking panic described by the so-called Diamond-Dibvig model. Unfortunately, this is a very evident disadvantage of Georgian banking system (refer to table 6).

In view of fact that by the end of last year approximately 2 million 170 thousand deposits of natural persons and legal entities were registered in Georgia, out of which a number of deposits up to one month constituted 99% of a gross number, it is easy to guess that a long-term savings mechanism does not practically operate in the country. Total number of loans is approximately the same and exceeds 1 million 260 thousand. Although a volume of deposits up to one year in a gross volume of deposits is only 54%, in case of a banking panic the system will be practically left without attracted funds.

Big inconsistency between the average volume of deposits and loans is especially dangerous. Average loan exceeds an average deposit by almost three times.

Pursuant to the Diamond-Dibvig model, in such case the banks will have to announce banking holidays or restrict withdrawal of deposits. Overall, under the model, such action will inflict further damage on the banking system and may well become a reason for apparent banking crisis. **Introduction of institute of deposit insurance, which exists in many countries worldwide, is a way to avoid crisis development of events**. Apart from a fact that such a scheme is a rather effective means of protection from the banking panic, empirical studies confirm that countries having schemes for insuring deposits enjoy relatively more direct foreign investments.

As pursuant to the Government’s calculations a volume of aid to be provided to a banking sector exceeds 1,1 billion Dollars, we find it reasonable to start working on the scheme for insuring deposits. Such a scheme should insure at least a portion of the most short-term deposits by the terms. Having into consideration that an average volume of such deposits does not exceed 1,000 GEL, it is obvious that these funds are necessary consumption means for the average and poor classes of population. Moreover, it is necessary to design such a scheme for insuring deposits, which stimulate bank’s clients to make long-term savings. The following mechanism may be developed for this: depositors, which request immediate withdrawal of monies from the bank, will have their deposits insured less portion-wise compared to those who trust the banks more.

It is apparent that last year the banks incurred serious losses and a portion of the state assistance should be spent on their recapitalization. Large amounts are needed also for paying off pending liabilities accumulated on on-landing means, but the strategic document of country’s development should definitely talk about the scheme for insuring deposits, especially when international financial institutions have provided Georgia with numerous recommendations about this issue.

With respect to assisting the banking sector itself it is notable that unfortunately nothing is said about the purpose and the types of mechanisms of allocating funds to the banks. Non-clarification of these two components transparently and clearly will provoke further uncertainty, damaging the as it is vulnerable financial system even more.

Table 6.

Difference between deposits and loans by the terms by the end of 2008 (in thousand GEL)		Average volume of deposits (in thousand GEL)	Average volume of loans (in thousand GEL)
Up to one month	1,993,650	0.97	0.60
From 1 to 3 months	82,000	17.95	0.97
From 3 to 6 months	-25,840	7.47	4.23
From 6 to 12 months	-316,557	12.10	2.10
Over 12 months	-3,881,310	5.22	11.91
Total	-2,148,056	1.61	4.75

Source: National Bank of Georgia

PENSION REFORM

Unfortunately, the Strategy against Global Economic Crisis of the Government of Georgia does not mention such a crucial instrument of operation of financial field, as a pension reform. Population of Georgia, just like the population of majority of developed part of the world, grows old. Although a ratio of capable and incapable part of population is still stable and according to the data of the Department for Statistics this figure in 2003-2008 falls approximately within the 1.4-1.5 range, a process of speedy growth of pension-age population is already evident. For instance, ratio of number of capable population with a number of pension-age population reduced from 4.37 in 2003 to 4.08 in 2008. In light of birth-rate stagnation, this process will aggravate further especially in the rural areas. Foundation should be immediately laid for the pension sector reform through private-state partnership, which should start with identification of exact number of pensioners and relevant modification of taxation system. Otherwise the country will soon end up in a gravest situation in respect of fulfillment of social protection obligations. Obviously, pension reform is a time-consuming process, but funds allocated by the international community should be utilized in this area right now, as in the future it will be extremely difficult to attract cheap funds for funding the social protection mechanisms.

We recommend the Government to accumulate allocated funds for launching the transition period and gradually transferring from existing ineffective scheme (when high-income employees pay large taxes to receive much less pension in the future) to a more effective system based on personal savings. Clearly, transition period will be associated with losses of certain social groups, but their compensation will be possible from the funds allocated by the donors. It has to be taken into account that the crisis events make it easier to carry out unpopular, but needed reforms. Postponement of this reform will hinder its implementation in the future.

INVESTMENTS IN TRANSPORT INFRASTRUCTURE

Decision of the Government to invest in transport infrastructure as such may be assessed positively. This is particularly applicable to rehabilitation of rural roads. To this end, the authorities plan to receive from the donor aid only in 2009 approximately 136 million GEL. Rehabilitation of rural roads and ensuring connection of isolated regions with the center is crucial for normal operation of Georgia's economy and social area. Nevertheless, it has to be taken into account that **capital invested in the roads generally in a short-term period fosters even speedier growth of import rather than export. This sentiment is confirmed as theoretically, as well as by numerous empirical studies**. Rehabilitation of transport infrastructure in Georgia is a rather import-loaded field, as a major portion of required capital for this and the current assets are not produced locally. Besides, it is suspected that the income of the employed in road-construction sector will be still spent on import. In the first place, only 9% of GDP is generated in this field and a portion of the employed in this sector is small compared to gross employment rate. Secondly, roads and major transport infrastructure belong in general to the state and a private sector may have only indirect motivation to invest in this field.

It is meant here that private sector in itself will not invest money in the roads unless the state authorities intend to modernize the roads and hire the private sector to fulfill this task. Unlike other types of infrastructure (energy infrastructure, irrigation, where the systems may be privatized in near future), involvement of private sector in road construction, at least in Georgia's current reality, will not be of full value as representatives of private sector are not appropriately stimulated.

Contrary to the above-mentioned, we believe that the energy or irrigation sectors rehabilitated by the state might be much more attractive for private capital in general, as it is quite possible to privatize these areas. Thirdly, if we assume that according to Georgian Government's calculations the country albeit slow speed will still grow economically, then the consumption of our population, including import, will only increase at the expense of improving infrastructure. It is widely known that consumption, and including import, is directly proportionate to incomes – if the income grows, consumption will grow, including the consumption of imported goods. Damaged roads and bad infrastructure generally hamper the functioning of sales, including imported goods sales market. Therefore, development of road infrastructure fosters import in a short-term period. As for the export growth, it should be viewed as a directly proportionate result of growth of revenues of Georgia's trading partner countries. Hence, improvement of Georgian infrastructure cannot affect them, especially when incomes and consumption are reduced worldwide in light of the global crisis.

Improvement of transport infrastructure will facilitate export in case the country will pursue policy seriously fostering supply stimulation, which will yield the results gradually. We do not have anything against rehabilitation of the transport system, but find that without serious steps facilitating national production, maximum utilization of road rehabilitation is quite low.

AGRICULTURAL SECTOR

Measures stimulating supply may include investing funds in rehabilitation of irrigation and drainage systems. In recent years only the production of Georgian food and agricultural products has demonstrated its real export potential along with several other products (processing of nonferrous metals, fertilizers, other). In addition, a potential to replace import in agricultural and food sectors is high as well. As in initial production entirely, as well as in food processing approximately 15% of the country's GDP is generated, whereas a number of the employed in rural areas is more than half of total number of the employed. In case of correct organization of agricultural production, the country will save large volumes of currency reserves that are spent today on import.

In 2008, Georgia's import of food and agricultural goods constituted 942 million 65 thousand USD, while export equaled only 250 million 508 thousand USD. Recently a number of crucial food products produced per capita has drastically reduced. For example, wheat production per capita reduced from 44 to 17 kilograms from 2005 to 2007, corn – from 98 to 68, vegetables – from 102 to 43, potato – from 101 to 52. From 1990 to 2007 area of sowed land plots reduced from 700 thousand to 297 thousand. Two-fold reductions were marked in the areas sowed with grain, sunflower, and melon crops.

One of the reasons of this unfavorable tendency, among others, is a failure of the irrigation and drainage system. Rehabilitation of system would give the country two types of direct income: 1) would return non-irrigated land into production, and 2) would increase income several times (2-3 times) by watering the irrigated land parcels. According to calculations of program AgVantage prepared in 2007, rehabilitation of irrigation and drainage systems would increase country's revenues by 500 million GEL annually. Pursuant to calculations of the same organization, approximately 55 million USD are required annually (this includes capital expenses and operation costs) for covering up to 250 thousand hectares of irrigation system. Approximately half of these funds should be allocated by farmers if the Government manages to develop optimum scheme for private-state partnership in this sector. Positive output of these measures is more than obvious. Moreover, IRR of such projects exceeds 30% annually even if calculated with respect to long-term period.

Unfortunately, Government's document mentions in relation to this crucial sector only that 21.2 million GEL are to be allocated in this area. It is not indicated whether this will be allocated directly from the state budget or from any of the donors. **We believe that irrigation and drainage systems require much more attention and should represent a key element of the Government's strategic vision, since its rehabilitation is significantly beneficial for the country**. Apart from this, this matter bears huge political importance as well, as rehabilitation of such systems will assist the population in depressive peripheral zones to stay there and will raise their well-being, which itself will reduce budgetary liabilities in terms of social obligations. We believe that it is possible to engage local authorities more actively in development and implementation of infrastructural projects, provided they are given more opportunities to collect land and real estate taxes on spot (i.e. by activating real leverages of financial decentralization).

FOREIGN TRADE

Government's document talks a lot about cancellation of double taxation and establishment of free trade regimes with individual countries. It is believed that by executing these treaties only Georgia will be provided an opportunity to penetrate markets of leading states. Unfortunately the reality is much more complex. Georgia enjoys free trade regime with the CIS states for a long time now, but the goods produced in Georgia do not play a decisive role even on the CIS markets.

Bringing Georgia's relevant legislation in compliance with the European standards is necessary for full utilization of preferences offered by the European Union. In particular, at the moment the effect of the Law on Food Safety and Quality is suspended in Georgia. Without this Law, it is impossible to export in large volumes the food and beverages produced in Georgia to the European market. Unfortunately, Government's document doe not mention this at all.

INCREASING THE ROLE OF NATIONAL BANK

Government's strategy did not pay due attention to the role of National Bank in stabilization of the country's economy. Pursuing expansionist policy declared by the Government is impossible without respective synchronization with the

National Bank. Implementation of several macroeconomic activities indicated in the Government's document only by means of fiscal instruments is impossible even theoretically. Clear examples of this are the initiatives of the Financial Center and Free Industrial Zones mentioned in the presentation, which, in our opinion, are totally unreasonable, unprepared, and out of place in Georgia's current context, especially in light of ongoing global crisis. Measures proposed by the Government imply in itself securing the stability of national currency and prices, which is a straightforward prerogative of the National Bank. If the Government plans expansionist policy, it is unclear how should the stable inflation rate be maintained if the National Bank has nothing to do in the presentation?

Back in the middle of the 20th Century, Dutch economist and Nobel Prize Laureate Jan Tinbergen demonstrated that fulfilling two or more macroeconomic policy tasks is impossible without at least two macroeconomic instruments. We find it extremely important that the Government's strategy for overcoming the crisis should have paid due attention to ways of maintaining national currency rate, as in case of devaluation of Georgian Lari it will be difficult not only to pursue expansionist policy, but to maintain the country's solvent capacity.

"EXPANSIONIST POLICY - 2009" OF THE GOVERNMENT

Interestingly, the Government of Georgia, which is a consistent advocate of free market economy, still intends to continue the cheap loan program and to distribute fertilizers and agricultural equipment to the farmers, when no one has yet assessed the efficiency of already completed similar programs. In these circumstances one has to ask why has not the Government opted for the policy of subsidizing individual fields of economy, especially when leading western states also do it in the crisis conditions? If the expansionist policy is talked about, why is not a more serious subsidizing of economy discussed? Besides, unreasonable use of the term 'expansionist policy' by the Government is unclear.

Overview of the expenditure section of the 2009 budget leaves impression that the country's authorities have substantially reduced only the costs of power structures and the defense (funding of the Ministry of Internal Affairs constituted 742 million GEL in 2008, and was reduced to 568 million in 2009; defense budget was reduced from 1 billion 547 million in 2008 to 942 million in 2009), while the established growth in other areas is less than nominal growth speed of economy in general. This is applicable to assignments in the health care (1,3 billion GEL in 2008, 1,494 billion - in 2009) and education (465 million in 2008, 538 million - in 2009) sectors.

Expansionist fiscal policy implies substantial growth of economic role of the Government, which often entails large budgetary deficit that the state sector in most cases covers with money borrowed from private and foreign sectors. In case of Georgia the expansionist policy, as the Government calls it, was not a choice for our country. Government of Georgia did not on its own intend to pursue such a policy. Fortunately for Georgia, following the August events and at the outset of a global crisis Georgia's friend states expressed free will and happened to have funds to render vast financial aid to the country. We believe that the Government's document has to emphasize real significance of aid received from western partners and a fact that most crucial areas of budgetary expenditures would have been left almost non-funded without their aid.

Finally, it could be mentioned that the Strategy against Global Economic Crisis presented by the Government does not address necessary requirements of a strategic document. It does not clearly establish the authorities' real plans in terms of avoiding potential threats of a global crisis (our report examines most apparent threats that are characteristic not only to Georgia but states that are much more financially sustainable than Georgia). Unfortunately, Government's strategic document does not mention real threats, overcoming of which would preserve dynamism to Georgia's economy. The document discusses only the unity of fragmentary measures that have to be contemplated mostly within the framework of tactical measures.

The draft 2009 state budget of Georgia is not sufficiently modified to take into account the crisis-driven reality. It mostly presents a reaction to the aid allocated by international donors, without good will of which country's authorities would not practically have its own plan and resources to withstand a global crisis.

www.transparentaid.ge
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Tbilisi, February 2009