Part II. Economic Trends and Policy Analysis

1. RISKS FOR THE SUSTAINABILITY OF GEORGIA'S ECONOMIC GROWTH

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The aim of this paper is to provide an assessment of the risks for the sustainability of Georgia's growth and economic development as well as to formulate tentative recommendations for the design and implementation of economic policy in Georgia.

Following a brief discussion of the disaggregation of economic growth and its sustainability and the Georgian economy's areas of comparative advantage, this paper will proceed to discuss the evolution of selected macroeconomic, monetary and Foreign Direct Investment indicators. The subsequent section provides a brief analysis and recommendations for a number of selected issues including the effect of the international liquidity crisis upon the Georgian economy, trade and investment promotion, exchange rate and competitiveness, fiscal and monetary policy co-ordination, issues of banking supervision and accounting and auditing reforms, judicial reforms and enforcement.

Disaggregation of Economic Growth and the Areas of Comparative Advantages

The rapid growth that the Georgian economy has experienced over the last few years has been largely fuelled by capital inflows (mostly Foreign Direct Investment, but also remittances) as well as private household consumption and government spending on goods and services. A sustainable model of growth in the medium to longer term should be one that is largely based upon investment (which adds to the economy's production capacity and its ability to grow in the future) and exports (which allows the economy to avoid the limitations of a relatively small internal market and reap the efficiency benefits of specialisation). Strengthening the sustainability of Georgia's growth and economic development entails:

1. Minimising the risks of a potential deceleration of capital inflows and
2. Gradually shifting from the current and largely consumption-based growth paradigm towards one that increasingly relies upon the growth of investment as well as exports in the areas wherein the country has a comparative advantage.

There are indications that the existing export structure reflects, at least to some degree, the areas where the country has a comparative advantage. This co-exists, however, with components which are not sustainable in the longer run such as the export of scrap metal. In more detail the Georgia's economy's endowments include a soil and climate which is favourable for agricultural, some raw materials (such as copper and manganese) and a competent labour force earning internationally competitive wages. A study on Georgia's areas of revealed comparative advantage suggests that these may include the following sectors (in order of importance): processed food, minerals, fresh food and, possibly, basic manufactured items. The Georgian export structure lacks the labour-intensive manufactures, as suggested by the results of the revealed comparative advantage study, possibly because the country is surrounded by similar low-wage economies [1].

The Evolution of Selected Indicators

Table 1 below provides the evolution of a number of indicators over the period 2001-06. In short, the economy registered relatively high rates of growth largely fuelled by capital inflows. From 2002 onwards, the nominal exchange rate has appreciated. As analysed in the relevant section of *Georgian Economic Trends*, the Central Bank has accumulated reserves over the period which has brought the Gross International Reserves to the equivalent of 3.1 months of imports by the end of 2006. A large number of these purchases were unspecialised which gave rise to a strong growth of monetary aggregates.

The increase in the external sector deficit is a source of concern especially if the inflow of capital in the economy decelerates or reverses. Another area of concern is the relatively high rate of growth of prices.

Table 1: Selected Output and External Sector Indicators

	2001	2002	2003	2004	2005	2006
Nominal GDP (mln GEL)	6674.0	7456.0	8564.1	9824.3	11621.0	13783.9
Nominal GDP (mln USD)	3224.2	3404.6	3983.3	5116.8	6420.4	7743.8
Real GDP growth rate	4.8	5.5	11.1	5.9	9.6	9.4
CPI growth rate (pa)	4.7	5.6	4.8	5.7	8.3	9.2
Fiscal Balance (% of GDP)	-2.3	-3.4	-2.4	-2.9	-0.2	-0.3
Exchange Rate (USD/GEL, pa)	2.07	2.19	2.15	1.92	1.81	1.78
Real Effective Exchange Rate (1995=100)	108.2	102.7	94.9	107.0	110.3	109.4
Trade Balance (% of GDP)	-14.6	-13.1	-14.5	-16.6	-17.7	-23.8
Current Account Balance (% of GDP)	-6.6	-6.1	-9.4	-6.7	-10.9	-14.8
Net Foreign Direct Investment (mln USD)	109.9	156.1	330.9	482.8	542.3	1075.6
Gross Int. Reserves (mln USD)	161.9	202.2	196.2	386.6	478.6	930.8
Gross Int. Reserves (months of imports)	1.8	2.3	1.7	2.3	2.2	3.1
Foreign debt (% of GDP)	50.0	51.5	45.9	34.2	27.1	21.3

Source: Department for Statistics, Ministry of Economic Development; NBG and expert assessments

Table 2 presents a selection of monetary indicators. Monetary indicators and the money multiplier registered growth over the analysed period. Rapid money expansion continued with the end-September 2007 12-month rate of growth in the M3 aggregate being of the order of 53 percent. In addition, the rate of growth of credit to the economy grew significantly as did the commercial banking sector's assets.

Table 2: Selected Monetary Indicators

	2001	2002	2003	2004	2005	2006
Rate of growth of broad money M3 (%)	18.5	17.9	22.8	42.6	26.4	39.3
Monetisation (M3), (%)	11	11.6	12.4	15.4	16.5	19.3
Dollarisation ratio (%)	85.7	84.9	86.1	74.3	71.6	69.4
Money multiplier (M3)	1.7	1.7	1.8	1.8	1.9	2.2
Rate of growth of credit to the economy (%)	13.8	28.5	24.9	22.8	79.3	55.0
Credit to the economy as a share of GDP (%)	7.3	8.4	9.2	9.8	14.9	19.5
Total banking sector's assets (% of GDP)	13.2	15.0	15.6	17.3	22.0	30.7
Nominal interest rate spread	12.9	11.7	11.0	10.7	9.2	9.9

Source: NBG

Notes: M3 is the broadest monetary aggregate (which includes foreign currency deposits). Monetisation refers to the ratio between broad money M3 (which includes foreign currency deposits) over GDP; The dollarisation ratio refers to the ratio between deposits in foreign currency over total deposits; The money multiplier refers to the ratio between the broad monetary aggregate M3 over reserve money; Credit to the economy refers to the aggregate credit provide by commercial banks to the economy; The nominal interest rate spread refers to the difference between the average weighted lending and deposit rates

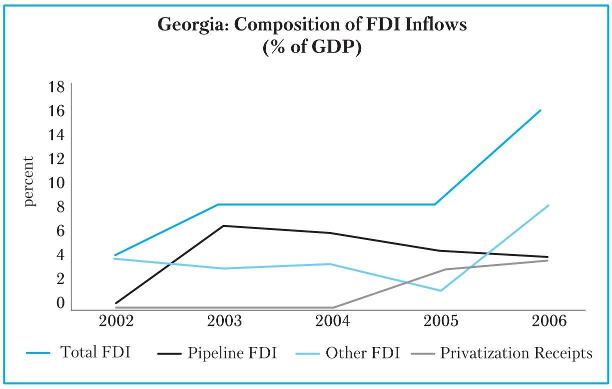
The growth of the banking sector in a transition economy is an expected development. In any economy, commercial banks efficiently intermediate between savers and borrowers. In short, commercial banks: 1. mobilise and attract the available savings in an economy and 2. after effectively assessing loan proposals, efficiently allocate these savings into productive investment. Commercial banks' activity is particularly important given that they may be the only external supply of finance for firms with the relative underdevelopment of the capital market in a transition economy.

A risk factor is that the very high rate of growth of loans, which is associated with high economic growth and expectations of further expansion, may become a dynamic process feeding upon itself whilst masking vulnerabilities and risks. These risks usually become apparent only when the expectations fail to materialise. Of critical issue is, therefore, the adherence to prudential standards for loans and effective banking supervision. Risks are also inherent due to the relatively high dollarisation in an economy in transition and the mismatch between assets and liabilities. A relevant recent paper has provided evidence that the currency mismatch has fallen and that liquidity problems are unlikely [2]. There is also evidence that the level of financial stability has improved in June 2007 as compared to the year before [3]. Given, however, the very high credit growth rate to date and the recent international and domestic uncertainty on the financial markets, financial stability, in general, and effective banking supervision, in particular, remain an important issue for the economy of Georgia.

Besides the institutional design of an efficient banking supervision, a related area for a policy effort in an economy in transition is the improvement in accounting and auditing which will allow for a more efficient assessment of loan applications by commercial banks. I will return to the issues of banking supervision and accounting and auditing standards in the policy section below.

On Foreign Investment Inflows and Projections

The graph below summarises the composition of Foreign Direct Investment inflows into its constituent components as a share of Georgia's GDP.



Source:IMF; NBG and Department for Statistics, Ministry of Economic Development

Over 2002 to 2006, Foreign Direct Investment averaged 9 percent of GDP with much of the inflows channelled to the construction of the Baku-Tbilisi-Ceyhan oil pipeline and the South Caucasus gas pipeline. In 2006, the share of pipeline investment diminished as a function of total Foreign Direct Investment with more than half going to the banking, manufacturing and tourism sectors [4 , p.7].

Table 3 provides a breakdown of FDI by sectors in the second quarter of 2007.

Table 3: Breakdown of FDI by Sectors in Q2, 2007* (thousands USD)

Total	370472.0	100
	of which	%
Agriculture	9.7	0.0
Production	53604.7	14.5
Energy	136447.9	36.8
Construction	72791.7	19.6
Services	95883.2	25.9
Other**	11734.7	3.2

Source: Department for Statistics, Ministry of Economic Development
*Note: * The Department for Statistics launched the survey of FDI by sectors in the second quarter of 2007*
*** Assets purchased through the privatisation process whose sectoral profile are not yet determined*

The projection contained in the latest IMF report suggests that the current account balance will follow a slight downward trend from a projected 16 percent to 11.5 percent of GDP in 2010 [4, p. 16]. Capital inflows in 2007 are projected to be in the order of USD 2.1 billion. Capital inflows are projected to remain in the order of USD 1.8 billion per year with a steady increase in the share of net private capital inflows in this aggregate figure at the expense of Foreign Direct Investment including privatisation receipts. At the time of the writing of this paper, it seems that the 2007 projection will not be realised given the actual capital inflows to date and the increase in both external and internal uncertainty.

Analysis and Policy Recommendations

The purpose of this section is to provide analysis to support tentative recommendations for policy design and implementation. The issues analysed below are inter-connected. They are, however, presented in a sequential manner, moving from external to internal factors, and from the more general to the more specific.

On the Effect of the International Liquidity Crisis

The recent turbulence will have some effect upon domestic money market conditions and increase the overall uncertainty with regards to the (expected) external flows. Furthermore, the effect upon the Georgian economy will be a function of the banking sector's dependence upon external funding. In relative terms, however, the effect is likely to be small given current domestic market conditions. As argued by Erik Berglof, the EBRD's Chief Economist, one might distinguish between short-term liquidity effects (where the regional effect will be minimal) and longer term consequences in terms of increased borrowing costs [5]. Looking at the region as a whole, there is a very slight downgrade on projected growth with most affected economies – most notably Kazakhstan – but also others such as Latvia, Hungary, Bulgaria, Romania and, to a lesser extent, Serbia.

In any case, from a practical point of view it is an exogenous event and, whilst being important to monitor and assess, it is beyond the control of the Georgian authorities.

Trade and Investment Promotion

Georgia's export basket and its trade orientation are slowly adjusting towards those which may be expected upon the basis of the country's areas of comparative advantage and geographical location. Policies which may facilitate the export-orientation of the economy include efforts to maximise the market access for exports through:

- a fuller use of GSP + provisions (which should be undertaken with an assessment of the investment required to adjust quality standards allowing the economy to benefit more from these provisions);
- possibly signing new Free Trade Agreements after assessing the related costs and benefits. Other things being equal, and given the high degree by which the economy's external sector is already liberalised, this may increase the market access of its exports industry and is not likely to have much of an effect on the domestic economy;
- a provision of export promotion services, mostly informational (targeted to exporters, in general, and the SME sector, in particular).

With regards to achieving the projected capital inflows in the medium-term, the recommendations are similar for any economy in transition:

- to retain the liberal payments regime which includes the critical area of attracting Foreign Direct Investment. Regularly updating the survey cited under table 3 will allow, in time, for a more thorough analysis of the effect of FDI flows and
- to increase the transparency of the privatisation process so as to facilitate interest amongst investors, maximise the revenue generated and minimise the overall uncertainty and the probability of retro-active actions annulling previous privatisations which have an adverse effect upon the business climate.

On Exchange Rate Policy and Competitiveness

For a small open economy such as the Georgian one, a floating exchange rate policy is a sensible exchange rate policy option given that:

1. A floating system avoids the possible divergence between an exchange rate reflecting market conditions and the official/targeted exchange rate which would be possible in a fixed exchange rate system;
2. A floating exchange rate provides a built-in, flexible and appropriate process which tends to automatically correct external imbalances and external shocks to the economy. An external imbalance, therefore, will, other things being equal, lead to a depreciation. In turn, and under fairly non-restrictive assumptions, this will eventually have a beneficial effect upon the trade and external balance of an economy; and
3. A floating rate frees monetary policy to pursue objectives other than the maintenance of the exchange rate itself (such as domestic price stability).

On balance, the evidence suggests that the exchange rate appreciation has contributed to the erosion of competitiveness in Georgia. In relative terms, however, this is likely to have been modest given that neighbouring countries – and transition countries, more generally – have experienced similar exchange rate trends. Furthermore, a broad assessment of competitiveness will necessarily rely upon a judgment which takes into account the joint evolution in a multitude of indicators such as: the business climate in general and the costs of doing business, the evolution of bilateral exchange rates, bilateral price levels and relative domestic production costs, the growth in the volume of exports through time and the market penetration of Georgia's export industries. Reaching such an assessment is an issue which lies outside of the scope of this paper.

Furthermore, in the longer term, a country's competitiveness is primarily determined by the introduction of structural reforms aiming at efficiency and productivity gains. Effort should be given to track the country's relative competitiveness indicators through time and to periodically reach an assessment on the evolution of the country's competitiveness.

On Expenditure Policy

The effect of government expenditure is a function of its magnitude and finance. At the same time, the overall effect of government spending upon economic welfare is also related to its composition: the subdivision of the aggregate into areas critical for growth sustainability (such as investment) and development (such as health and education and the targeting of social assistance) as well as others which are needed such as law and order and defence (which seems relatively high in Georgia).

On Monetary Policy

An earlier paper discussed monetary developments in Georgia and related policy recommendations [6]. Whilst the primary objective of monetary policy is price stability, the conduct of policy in practice will be pragmatic and take fiscal and real developments into account.

Inflation is linked with the maintenance of macroeconomic stability, an increase in the uncertainty in the economy (which, other things being equal, reduces investment and growth) and tends to hit the vulnerable population groups the hardest. Inflation is an area of concern in Georgia. The conduct of monetary policy needs to take the government's fiscal stance into account together with the effect of capital inflows upon the exchange rate and domestic monetary conditions.

The issue of co-ordinating monetary policy and fiscal policy requires effective consultation. At the technical level, a useful co-ordinating mechanism may be a liquidity management committee which will convene upon a monthly basis in order to assess overall developments and to project the effect of the monthly income and expenditure flows.

On Banking Supervision

As noted in the previous section, effective banking supervision is essential for the efficiency of the economy and reduces related risks. Until recently, relevant European Directives incorporated a clear dividing line between deposit-taking institutions (which were to be supervised by the Central Bank) and all other financial institutions. Given capacity constraints, the importance of effective commercial banking supervision for the maintenance of the banking system – and the fact that the distinction between a commercial bank's liquidity and solvency is often blurred in a transition economy – there is a very strong case for an economy in transition, such as Georgia's, to retain banking supervision within the Central Bank whilst entrusting the overview of other financial institutions to an independent agency.

Strengthening banking supervision was a focus of the recently completed IMF programme and its institutional design is currently under discussion in Georgia. Whatever decision is taken, careful thought should be given to the institutional design of this regulator and its capacity, its funding and competence as well as its institutional relationship and exchange of information with the Central Bank.

Supporting pillars for the functioning of the financial sector and the economy as a whole involve: accounting and auditing reform issues where indicators of a reform agenda are provided in the recent Report on Standards and Codes [7] and the critical area of judicial reform and enforcement.

Conclusion

This article has analysed the nature of possible risks and recommended specific measures to introduce a country-driven analytical consultation process which will:

- improve the effectiveness and co-ordination of economic policy and possibly arrive at an improved policy mix given current challenges and
- inform policy making in general and act as an early warning system on the emergence of possible risks in the future.

With regards to the longer term, a challenge for Georgia is to build upon its liberalisation programme in a way which conforms to international best practice adapted to local conditions and is conducive to the country's sustainable socio-economic development.

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