EPRC
Economic Policy Research Center

Georgian Economic Outlook

Annual Review 2011

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Preface

In the framework of the Core and Institutional Support Project for EPRC and with the financial support of the Think Tank Fund of the Open Society Foundations, we present the fourth report: Georgian Economic Outlook – 2011.

The paper covers major economic developments of the country for the past year; it highlights ongoing challenges that need to be addressed with due diligence by economic policymakers and other relevant institutions. The data used for preparing this report was obtained mainly from official websites of the National Statistics Office of Georgia, the National Bank of Georgia, the Ministry of Finance of Georgia, as well as the International Monetary Fund. Some limitations observed are the following: part of the data is either preliminary information or projection and might be subject to change, it is marked with a star (*).

Introduction

The world economy is believed to be in a dangerous new phase with the projections made regarding slower growth and further economic shocks.

2011 was characterized by some unexpected events that affected the global economic atmosphere, major surprises being the Japanese Tsunami and the unrest in the Middle East that affected the oil prices. This increase was partially responsible for record high global food prices as well. Highlights for the world economy were sovereign debt and banking sector problems in the Euro area that economists fear might get out of control of the policymakers, and the economic activities in the United States that are already slow and might suffer additional shocks.

For Georgia 2011 was a recovery from the global financial crisis with GDP growth of 6.8% which is less than a pre-crisis indicator of around 10%, headline inflation picked up through early 2011 and eased starting from fall 2011. For suppressing inflationary expectations and potential widening of the price pressures, the National bank of Georgia (NBG) tightened the monetary policy in the beginning of the year, and with the inflation decreasing to tolerable levels eased the monetary policy from mid-2011. Current account deficit remained elevated during this year, while foreign direct investments (FDI) have not yet recovered to pre-crisis levels, while remittance inflow has been quite stable. For Georgia as well as for the Caucasus and Central Asia region, continued growth in Russia was beneficial through remittance channels and is expected to continue in 2012[1]. External debt still remains high, which has risen considerably during the global crisis. As for a country that imports oil and gas products major challenge remains fiscal consolidation and addressing external vulnerabilities, as well as combating both exogenous and endogenous inflationary pressures. The key threat for Georgia is the ongoing fiscal and current account deficit that questions the future external sustainability.

Below we shall discuss some major economic indicators in a more detailed manner. The topics that we shall tackle comprise and are not limited to the following: Gross Domestic Product (GDP), Foreign Direct Investments (FDI), Consumer Price Index (CPI), monetary and fiscal policies.

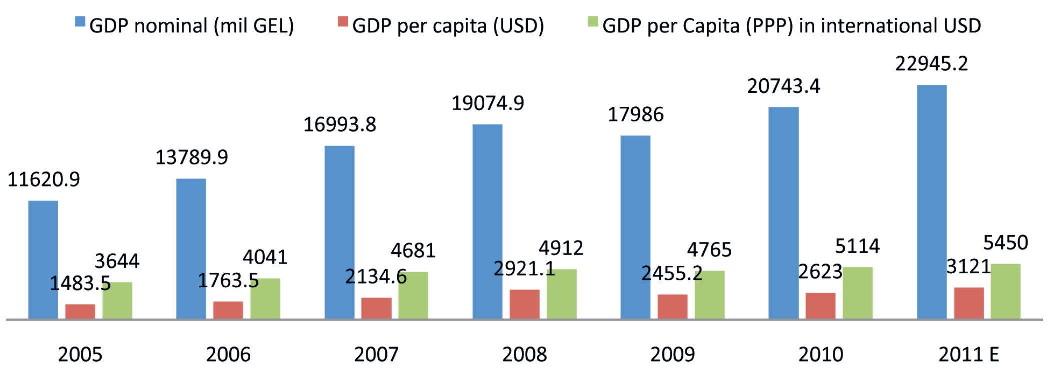
1 On the topic of the Role of Remittance in Georgian Economy, please refer to the third report of EPRC available at www.eprc.ge

Gross Domestic Product (GDP) and Economic Growth

For the year of 2011 an estimated amount of nominal GDP of Georgia in Georgian Lari amounts to 22,945.2 mil. GEL, a 10% increase as compared to the last year (f.1). The real annual growth rate, i.e. growth rate adjusted for inflation estimate for 2011 is 6.8%. As to GDP deflator indicator we currently do now have a year estimate, although it was the highest in the first quarter of 2011 (13.6%), in line with the ongoing two digit inflation, but decreased to 7.7% in the third quarter due to a decrease in overall inflation rate caused by seasonal price changes on food (f.2). Moreover, GDP growth for the third quarter of 2011 was the highest since the second quarter of 2010 when the real growth rate was 8.3%. However, the economy is still recovering for reaching the pre-crisis annual growth rate of around 10% (f. 2).

As can be observed from figure 1, in line with the real GDP growth, the GDP per capita is also taking up the growth pace; currently an estimate for 2011 is 3,121 USD. The indicator represents 18% growth as compared to the last year. Despite an increase in overall figure, we believe that this indicator is somewhat eroded by the inflationary pressure. Having demonstrated impressive economic growth during past decade, Georgia still lacks progress in some key development areas. For example, Georgia currently ranks 75th out of 187 countries[2] according to the human development index. At the same time, when conducting a worldwide survey on "quality of living" and taking into account some political, economic, and socio-cultural situation in various cities, Tbilisi was the lowest-ranking European city, and ranked 214 on the world scale of around 400 cities[3].

FIGURE 1
GDP and GDP per capita, PPP *(www.geostat.ge, www.imf.org)*



2 UN Human Development Reports. 2011. http://hdr.undp.org/en/media/HDR_2011_EN_Table2.pdf
3 www.mercer.com

FIGURE 2
Real GDP growth rate and GDP deflator
(www.geostat.ge)

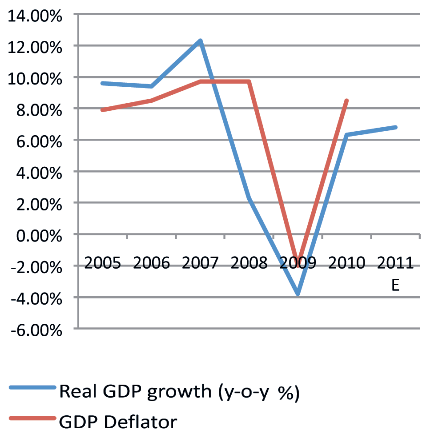
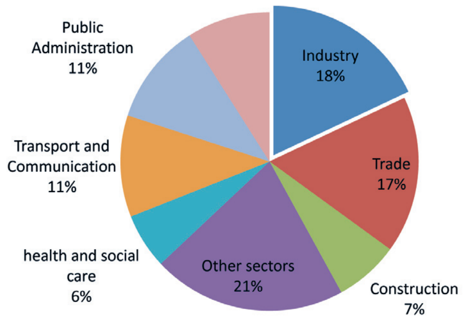


FIGURE 3
GDP by Sectors as of third quarter 2011
(www.geostat.ge)

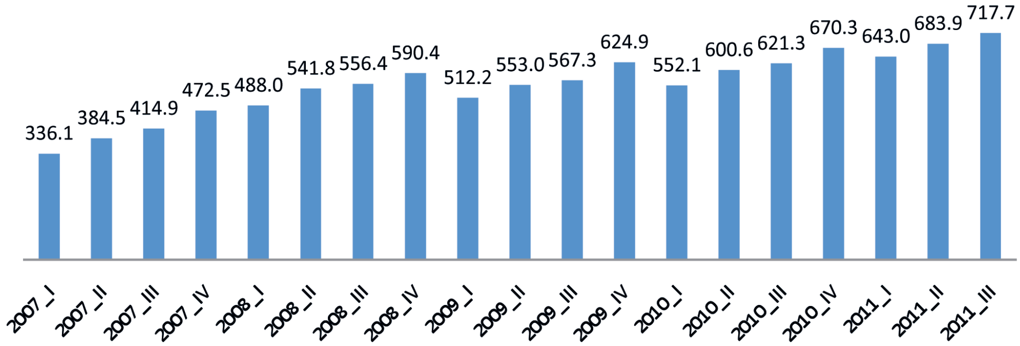


For international comparison of standard of living, a GDP per Capita (PPP) figure is often used. Purchasing Power Parity rate explores how much money is needed to buy the same amount of goods and services in a different country. Thus, PPP is a less biased measure for comparing differences in living standards of different countries, since the measure takes into account relative costs of living and the inflation rates in a country, rather than using exchange rates that may not be a representative measure for checking real differences between incomes. GDP per capita (PPP) is measured in a so-called international dollar for making comparisons between countries. As of 2011 with 5,450 GDP per capita (PPP) (f.1) Georgia ranks 111th among 181 countries[4], the indicator is way below the World Average GDP (PPP) per capita that currently amounts to 10,700 international USD. In other words, standards of living in Georgia are below the world average.

By looking at the sectors contributing to GDP growth (as of the third quarter), we observe (f.3) that the largest share is held traditionally by industry (18.3%) followed by trade (17.2%), the third place is taken up by transport and communications sector that contributes 11% to the country's GDP. Considerate growth was seen in the sectors of financial intermediation (24.9%) processing industry (16.6%), and other social and personal services (11.3%), hotels and restaurants (10.9%), trade (9.2%), household production (8.5%), communication (8.2%). Although it is noteworthy that the share of the above-mentioned sectors in the GDP figure is small, therefore this growth had a small effect on the overall growth of GDP. It is noteworthy that for the first time since 2007, we observe a 6.1% growth in the field of agriculture, forestry and fishing. The only category with a decrease in the third quarter was mining (-6.2%).

4 www.imf.org

FIGURE 4
Average Monthly Nominal Salary of employees in business sector (in GEL)
www.imf.org

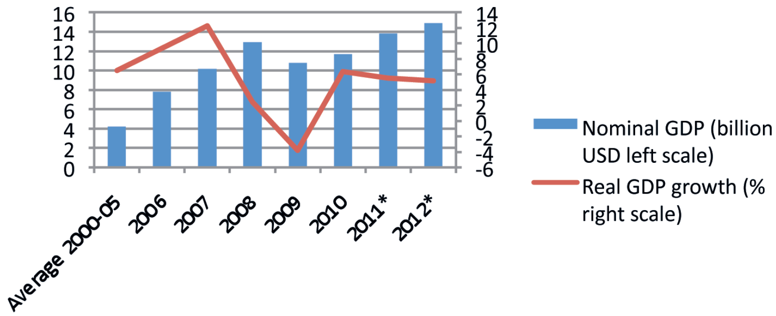


Why is it that in the conditions of economic growth the unemployment or underemployment still remains a number one issue in the country? International Monetary Fund (IMF) attracts its attention towards this peculiar phenomenon of so-called "jobless" economic growth in some countries, Georgia among them. Official unemployment figure given by the National Statistics Office of Georgia for the year of 2010 is 16.3%[5], while IMF publishes an unofficial/alternative figure of as high as 30%[6]. Mainly this paradox of constantly high figures in unemployment is due to the fact that there is a low growth in labor intensive sectors as can be seen from graph 3. More precisely, agriculture that according to official statistics employs around 50% of the population contributes to only 9% of the total GDP[7]. Unfortunately, Georgia is not successful in creating off-farm employment as well. Moreover, we observe a constant increase in real wages, thus making it impossible for the companies to hire, since an increased profit is directed towards increasing the wages of those who are already employed. IMF also highlights the issue of increased working hours for those who are employed. Unfortunately, we could not get the information regarding the change in working hours of the employed in Georgia, although we did look at the tendency of increasing wages. Surprisingly, in 2009 in the conditions of negative GDP growth and an ongoing deflation, we observe an increase in nominal wages by 4% (f. 4), while the unemployment grew to 16.9% during that period. We believe that this topic is rather interesting and is worth looking at; at the moment it is beyond the scope of this paper.

According to the IMF prognosis, the nominal GDP in Georgia shall increase by 1 billion USD in 2012 and amount to 14.9 billion. At the same time, annual real GDP growth is expected to experience a slight decrease in 2012 by 0.3% to 5.2%. This discrepancy between an increase in nominal figure and a decrease in real growth is due to the GDP deflator (f. 5).

5 National Statistics Office of Georgia.Employment and Unemployment.http://geostat.ge/index.php?action=page&p_id=146&lang=eng
6 IMF Regional Economic Outlook. OCT 11
7 The second report of EPRC was dedicated to Employment and Unemployment Trends in Georgia. The report addresses this topic in further details and is available at www.eprc.ge

FIGURE 5
nominal GDP and real GDP growth.
www.imf.org



In January 2012 European Bank for Reconstruction and Development (EBRD) has decreased the economic growth forecasts for the coming year due to the expected further euro zone deterioration. They believe that there is a substantial evidence to think that the baseline scenario shall change. This shall be due to a heavy integration of Eastern Europe and other countries within the region with euro zone-based banks, negative possible decrease in remittances, regional spillovers, as well as overall decrease in commodity prices. Thus, turmoil in euro zone might negatively affect output levels in other countries in transition through financial, trade and remittance channels. Moreover, if we take into account that Georgia receives a substantial number of foreign direct investment from European Union countries (roughly 60% of all FDI), the forecasted negative situation in the euro zone might cause capital outflows or decrease in capital inflows to Georgia. Georgia, although less integrated in European market, might not see so much of terms of trade pressure, rather than remittance volatilities (around 21% of all remittances send to Georgia originate from the euro zone countries). Thus, the predictions given initially by the IMF are likely to change and not picture the reality of 2012.

Foreign Direct Investment (FDI)

In all three quarters of 2011 Georgia received FDI of 643 million USD, annual estimate for 2011 is around 798 million USD. The major investor countries as of now are Denmark, the Netherlands, and Turkey. For all three quarters the Netherlands is the largest investor, 21% of all investment are originated from that country. If we look at FDI from the viewpoint of sectors mining and manufacturing received 22% of all investments for 9 months of 2011 (figure 6), the least popular sectors were agriculture and fishing, real estate and hotel and restaurants together with construction. Energy sector is the largest recipient of all foreign direct investments in the third quarter. That sector has received 32% of all investments in the third quarter that is 86 million USD. Investments were mainly directed towards small-medium hydropower plant building/rehabilitations. If we conduct a quarter to quarter comparison, FDI in Georgia amounted to USD 266 million in the third quarter of 2011, the indicator is a 18% increase as compared to the same period last year, and a 30% increase as compared to the second quarter of the same year. In spite of the gradually rising FDI inflow, the country is still far from its pre-crisis indicator. The largest amount of FDI inflow was seen in 2007 as given in the graph (f.7).

By looking at the FDI sector tendencies we observe that there has been a considerable investment in the energy sector, which has not been a popular sector for investment in the previous years. Although it is worth noting that due to a net direct outflow of investments in this sector in the second quarter of 2011, the effect of 2011 third quarter investment was somewhat eroded on the graph. At the same time, previous leaders in attracting investments such as transport and communications and construction lost their positions during and after the crisis. Although a considerable number of investments are still directed towards the financial sector that saw a drastic decrease in investments during the global financial crisis in 2009.

FIGURE 6
FDI by years (thousand USD) www.geostat.ge, *www.mof.ge*

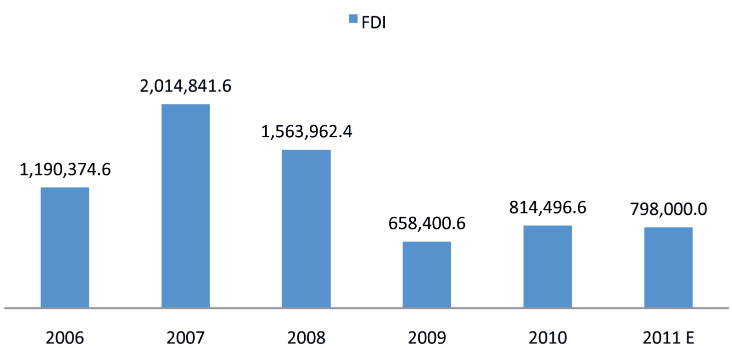
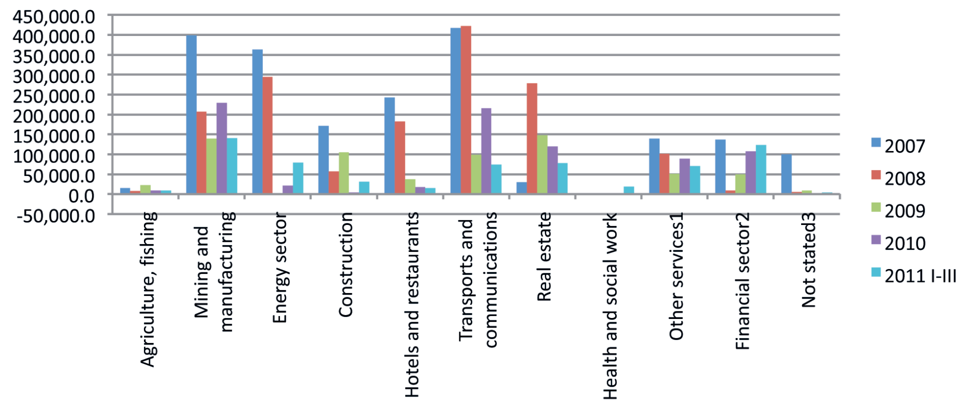


FIGURE 7
FDI sector tendencies (thousand USD)
www.geostat.ge
www.mof.ge



When talking about the attractiveness of a country for investors, something that investors look at when planning to invest in a country is return on assets that indicates the efficiency of management in transforming assets to generate earnings. It is calculated by dividing earnings by its total assets, the higher the number the better, because the company is earning more money on less investment. As can be seen,(figure 9) the country was doing better at converting its investment into profit in 2011, although is currently worse off compared to the pre-crisis period, with a ROA ratio of 2.2%.

FIGURE 8
FDI by Sectors (Jan-Sep 2011)
www.geostat.ge

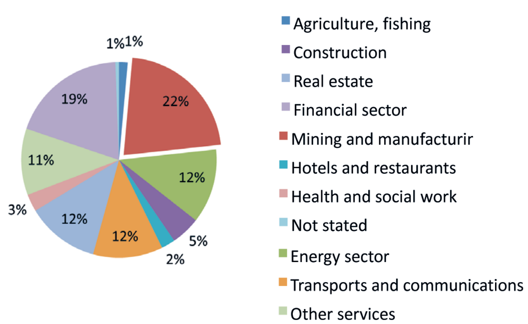
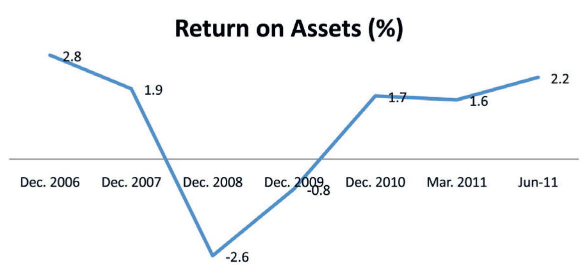


FIGURE 9
Return on assets (2006-2011)
www.imf.org



Foreign Trade Tendencies

As per preliminary data for the year of 2011 total foreign trade turnover for Georgia amounted to 9,244 million USD, a 35% increase compared to the last year. Out of the total trade 2, 189 million USD was comprised by export category, a 39% increase in comparison to the last year, and import comprised of 7,055 mln USD, a 34% increase compared to 2010. Top trading partners by turnover were Turkey, Azerbaijan and Ukraine. Azerbaijan is the largest export partner with 19.5% of total exports and Turkey being the largest partner in imports, with 18.0% of total imports coming from there. The commodity positions by exports are motor cars (20.6%), ferro-alloys (11.6%), mineral and chemical fertilizers (6.6%). It must be noted that a drastic increase in automobile exports in the first half of 2011 was caused by an expected change in the customs legislation in Kazakhstan, a major trade partner for Georgia when it comes to automobiles. Commodity position by imports is the following: oil and oil products (12.9%), motor cars (7.2%), petroleum and other gases (3.4%).

As we can observe around 75% of the total trade is comprised of imports, thus causing a negative trade balance that as of 2011 has reached 4,865 million USD, this represents a 32% increase as compared to 2010 and is record high. A similar trade deficit was observed once in 2008 (figure 10). However, it must be taken into account that economic growth was higher during that time, thus partially balancing this deep deficit.

As can be seen from the graph, there is an increasing tendency for both import and export categories, although the growth in imports is taking a quicker pace and outreaches the growth in exports. This substantial increase in imports figure was caused by drastic price increase on the import products; these are mainly oil and oil products as well as food. As we shall discuss later on in the paper during the first half of 2011, the world has observed a drastic price increase in both food and oil products,

FIGURE 10
Foreign Trade Tendencies (2006-2011)
www.geostat.ge

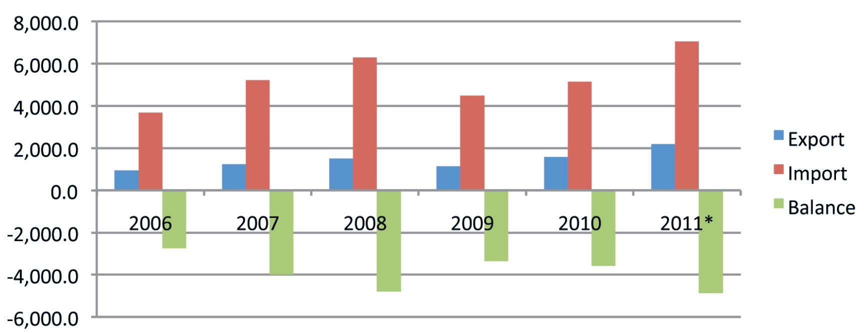


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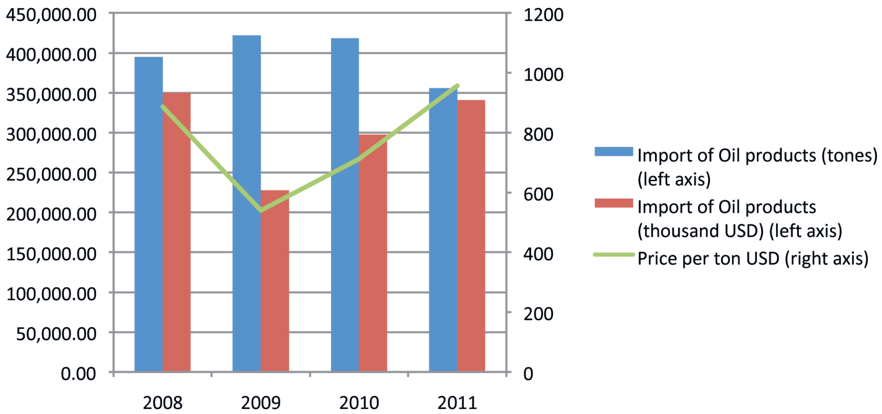
FIGURE 11
Oil and oil product imports from Azerbaijan (2008-2011)
www.geostat.ge

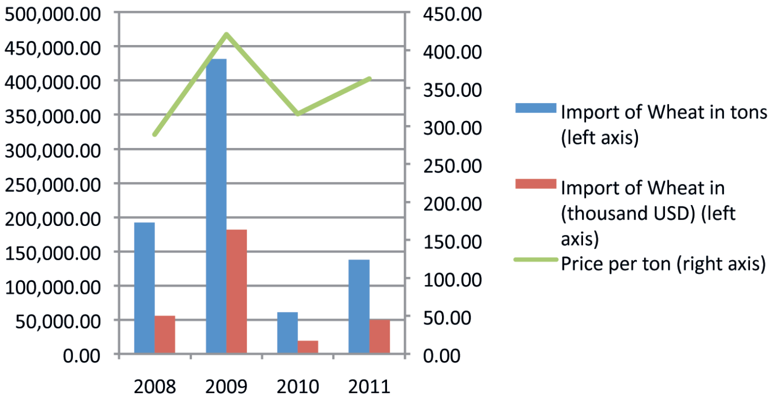


thus resulting in higher trade deficit for Georgia. The imports have not increased in volume terms as such, this increase was mainly due to an increase in monetary terms. Moreover, volumes of imports of oil and oil products from Azerbaijan have decreased as compared to 2010, but have increased in monetary terms due to an increase in unit price. In order to understand the reasons for trade balance deterioration we shall analyze two major import products for Georgia (these are oil and oil products and wheat) and a major export product that is domestically produced rather than re-exported, this is ferro-alloys.

The figure 11 presents oil and oil product import tendencies from Azerbaijan over the period of 2008-2011. Interestingly enough, the volumes have decreased in 2011 by 14%; supposedly domestic demand was satisfied through other means, such as exports from other countries, it is also possible that due to an increase in price decrease in demand was observed. This issue is not of relevance at the moment. A more important factor is that a unit price has increased from 711 USD per ton in 2010 to 957 USD per ton in 2011, this represents a 34% increase.

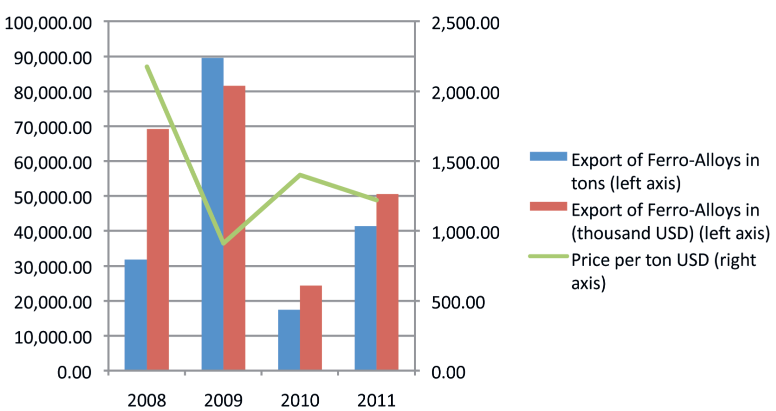
On the other hand, the import of wheat from the Ukraine has increased in both monetary and volume terms. The chart might be a little biased, since in the years of 2008-2009 major imports of wheat were conducted from the Russian federation, while in the last two years the Ukraine is the largest provider of wheat. Although the graph can be used for depicting an increase in the unit price of wheat, once again proving the assumption that the deterioration of terms of trade for Georgia was caused by the price increase on its import products, rather than drastic changes in volumes consumed. Prices on wheat went up from 316 USD per ton to 362 USD per ton (a 14% increase) (f.12), this together with an increase in the volumes (by more than 100%) imported deepened the trade deficit.

FIGURE 12
Import of Wheat (2008-2011)
www.geostat.ge



On the other hand, the price on raw materials have suffered because of concerns regarding the debt crisis in euro area, which caused a global downturn and caused reduction in demand for things such as metal, one of the major export items for Georgia. Opposite can be assumed regarding 2008 trade deficit, since 2008 was accompanied by stronger economic growth that might have caused increase in demand for imports , so the mentioned deficit might had been caused by increase in imports in terms of volumes. The figure depicts the tendency of exports for one of the major export products for Georgia that is ferro-alloys to Turkey. As we have mentioned the prices per unit went down for this product in 2011 (by 14% as compared to 2010), although the export of ferro-alloys in monetary terms has increased due to an increase in volumes, that more than doubled as compared to 2010 (f. 13). In short, the events taking place on global markets in 2011 caused deterioration of terms of trade for Georgia.

FIGURE 13
Export of Ferro-Alloys (2008-2011)
www.geostat.ge

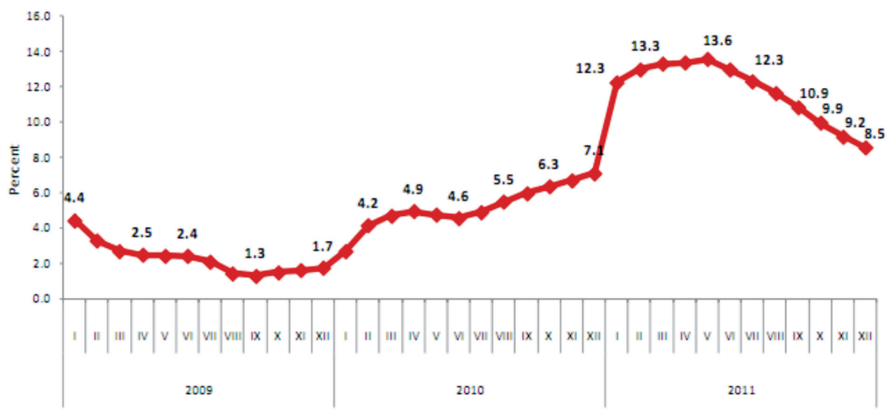


Consumer Price Index

Inflation has been a major challenge for Georgia in 2011. According to the National Statistics Office of Georgia, average annual year on year inflation rate for 2011 was 8,5%. Since the second half of 2010 inflation has taken up the growing tendency and equaled a two digit figure for most of the year 2011. Inflation peaked in May 2011 with 13.6% average inflation as compared to the same period of the previous year (f.14).

Inflation characteristics of Georgia are very similar to those of other small open economies, i.e. with large food shares in national consumption baskets. Therefore, there is a positive correlation between headline inflation and international oil and food prices for Georgia. At the same time, there is a positive correlation between international food prices and domestic food inflation. Lastly, food inflation in Georgia is higher, more volatile and more persistent than nonfood inflation; thus, causing headline or overall inflation to be higher than core inflation (that is inflation that excludes food and energy)[8]. Food share in national consumption basket equaled 40% till December 2011, starting from January 2012 the share of food has decreased to 30%. . We believe that a decrease in share of food in the national consumption basket shall influence the overall headline inflation figure, and in case of low core inflation, show a slight decrease in headline inflation as well.

FIGURE 14
Average Inflation (y-o-y 2009-2011)
www.geostat.ge



8 IMF Regional Economic Outlook. OCT 11

In the figure 15 we compare and contrast the tendencies for core vs. headline inflation in Georgia over the past years. The numbers are given as year average in percentage. As it can be seen a large gap between core and headline inflation is observed in 2011 (f.15), while in previous years headline and core inflation were more or less convergent. The reason for this being drastic changes in prices of food and oil and oil products that are not included in core inflation. We discussed this price change when analyzing the foreign trade tendencies and have visualized the unit price increase on imported wheat and oil products, and have also argued that there is a positive correlation between the prices of imported and domestic food. In 2012, it is projected that headline and core inflation shall more or less converge, with a decrease in headline inflation and a slight increase in core inflation. Generally, in developed countries core inflation is believed to be a good predictor of future headline inflation and a good indicator of overall inflation, although this argument might not be valid in food consumption dominated countries, since emphasizing on core inflation only, may harm the purchasing power of poor households and adversely affect the income distribution[9].

In order to further strengthen the assumption that 2011 inflation was caused by global price changes on food rather than pressures from the demand side we present a picture showing food price indices in the years of 2007 to 2011. As we can see increases in price was observed in spring 2011 and eased by summer 2011 after which a decreasing tendency is marked (f.16).

Price increase on food in 2011 was believed to be the steepest in 36 years[10].Increase in prices on food was caused by increase in energy prices. These two are positively correlated. 2011 was characterized by overall increase in oil prices by 19% as compared to 2010. Major disruptions in prices were seen in February after rebellion began in Libya and international companies pulled out their employees

FIGURE 15
Core and headline inflation (% year average)
www.imf.org

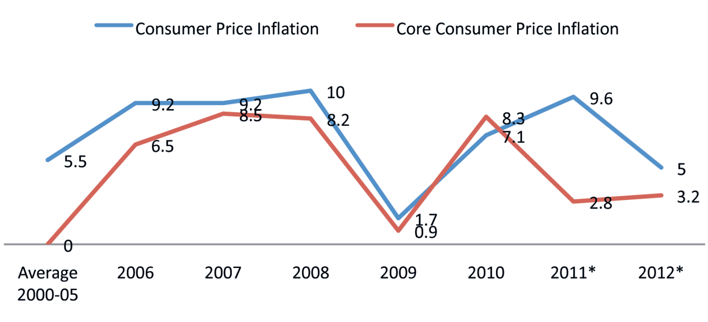


FIGURE 16
Food price indices
www.fao.org

9 IMF Regional Economic Outlook. OCT 11
10 http://www.cbsnews.com/stories/2011/03/16/business/main20043737.shtml

from the country and when oil production was halted for several months[11]. Moreover, the Middle East unrest caused oil prices to peak in April, while Georgia's headline inflation peaked in the month of May. We have highlighted a clear connection between the world prices on food and energy and their effect on prices in Georgia.

As for 2012, food price inflation is expected to abate from 2011 levels but is projected to be slightly above the historical average for the past two decades. Food prices are projected to increase by 2.5 to 3.5% over 2011 levels, more specifically prices on food in grocery stores are expected to increase by 3-4% while food prices at the restaurants are expected to increase by 2 to 3%. Although, price levels for food in 2012 are heavily dependent on other macroeconomic factors as well that are hard to be predicted such as weather conditions, fuel prices, etc.[12] Some unexpected political decisions as we have seen made by Russian and Ukraine side by having an embargo on wheat exports, can also drastically influence the prices for bread and bread products in this instance. According to the UN food agency, food prices are most probably going to stay volatile[13].

To sum up, according to IMF, average annual inflation in 2011 equaled 9.6%, 2.5% up from the last year's indicator. In 2011 core inflation decreased to 5.5% to 2.8%. It is projected that in 2012 average annual inflation would equal 5.0%, and core inflation shall increase to 3.2%.

In case of oil and oil products Georgia has no alternative but to import, although when it comes to food, we strongly believe in Georgia's potential to pursue import-substitution mechanism by fully exercising its comparative advantage especially in vegetable, nut and fruit production. Despite this fact Georgia imports almost four times as much agricultural products than it exports.

11 http://finance.yahoo.com/news/oil-price-ending-2011-near-185006420.html
12 http://www.ers.usda.gov/briefing/cpifoodandexpenditures/consumerpriceindex.htm
13 http://www.economist.com/blogs/graphicdetail/2012/01/focus-3

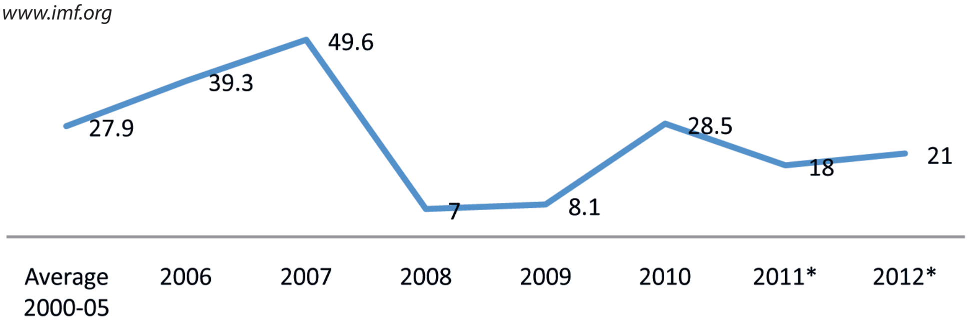
Monetary Policy

Above we have argued that the inflation in Georgia is caused mainly by exogenous factors. This type of inflation is temporary and the central banks do not react by adjusting their policies to it, since costs of such actions exceed the benefits. Although it is once again important to understand that food comprises the largest share in consumer expenses in Georgia, therefore the increase in prices on food creates further expectations of price increase which negatively affect the headline inflation as well. Thus starting from January 2011, that was when the annual inflation hit 12.3%, that the Georgian National Bank (NBG) started pursing the "tightening the belt" (that is strict) monetary policy. In January 2011 interest rate equaled 8%. At the same time, starting from 2011 the broad money aggregate was reduced in volumes mainly caused by the seasonal factors, as well as in annual growth rate. According to the existing prognosis broad money growth shall be around 20-25%[14], which together with the economic growth prognosis and the inflation indicator is close to the reasonable levels. As can be observed from the graph broad money growth has decreased by around 10% in 2011 due to the contractionary monetary policy, while the prognosis represents a 3% increase in broad money growth accompanied by an expansionary monetary policy (f.17 & 18).

Together with the interest rate the minimum reserve requirement for attracted foreign currency means was increased. Given restrictions gradually influence the amount of loans issued in both local and national currencies (f.19). As can be seen loans issues started increasing in the second half of the year, when the monetary policy was relatively loose. Even though total volume of loans issued are predominantly in foreign currency, an increasing trend was observed in national currency, due to the favorable conditions on those loans directed towards achieving de-dollarization in the country.

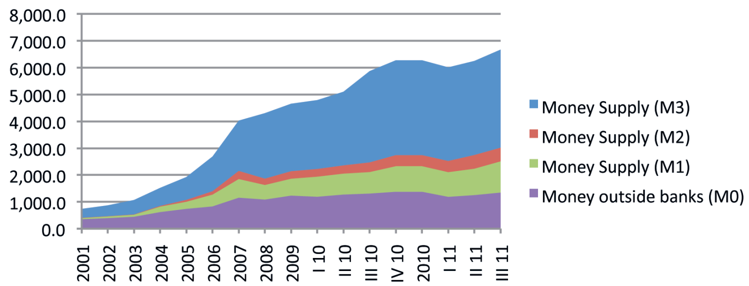
In June 2011, NBG has decreased the interest rate to 7.75%, and later to 7.5 % even though the annual inflation was 10%, later 8.5% (in July) above the target rate (that is 6%), the committee has decided to ease the monetary policy due to further expectations in decrease of oil and food prices on international markets. These reductions in interest rate for stimulating demand were caused by expected risks in the USA eco-

FIGURE 17
Broad money Growth (%)
www.imf.org



14 www.nbg.ge

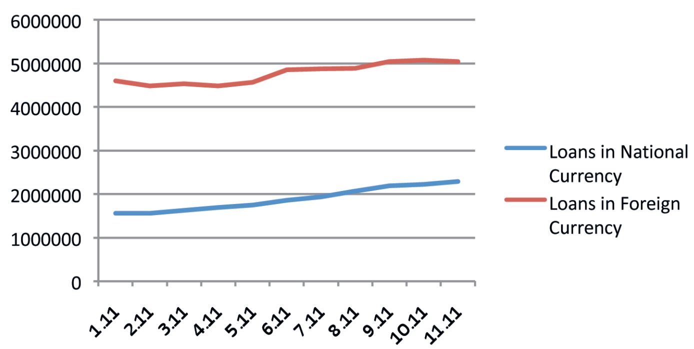
FIGURE 18
Money Supply (2001-2011)
www.geostat.ge



nomic slowdown, projected increase in the eurozone crisis that could have further brought down the prices on international markets, and influenced the demand on the Georgian market as well, therefore further decreasing the inflation rate. Furthermore, for promoting long-term financing the committee made a decision to decrease the minimum reserve requirement on long-term loans. More clearly, the loans above 1 year in national currency and 2 years in foreign currency were exempted from the reserve requirements, at the same time for foreign loans from 1 to 2 years the reserve requirement was decreased to 5%.

In September, October 2011, the decreasing tendency of inflation rate was maintained and equaled annual 4.6% and 2.3% respectively. The NBG committee has further decreased the interest rate to 7.25% and later to 7%. Increase was observed in activities of commercial banks; this mainly concerned the loans issued in national currency which is less risky to the economy therefore reducing the dollarization as well. This increase in loans is not supposed to carry inflationary risks. In November, in the conditions of decreasing inflation (1.9% annual) and a decrease in landing speed by the banks caused by a decrease from the side of domestic demand. Thus, the NBG committee has decided to further decrease the interest rate to 6.25%. This decrease in interest rate shall first be resembled in the interest rates of commercial banks and finally affect the market interest rate thus encouraging demand. The process of monetary easing should proceed cautiously, especially in the conditions of strong credit growth that is observed in the country.

FIGURE 19
Loans 2011 (thousand GEL)
www.nbg.ge



Banking Sector

Net profit of banking sector for 2011 constituted to 323,0 million GEL. According to the information provided by NBG, the volume of lending by commercial banks (including loans to non-residents) in December, 2011, compared to the previous month, increased by 201.8 million GEL (2.7 percent) and exceeded 7.7 billion GEL by January 1, 2012. The volume of loans provided in the national currency increased by 47.4 million GEL (2.0 percent) and the volume of loans in a foreign currency increased by 154.4 million GEL (3.0 percent).

By the end of December 2011, commercial banks issued to resident legal entities 824.2 million GEL worth of national currency-denominated loans (0.2 percent or 1.5 million GEL less compared to the previous month) and 3.5 billion GEL worth of loans in a foreign currency (2.7 percent or 93.1 million GEL more, respectively). Out of the total loans issued 54% were directed towards the legal entities, while 42% to households.

Out of the total volume of lending to legal entities, the biggest share falls on trade – 48.5 percent. Compared to the previous month, in December the volume of loans provided for trade increased by 1.3 percent or 26.9 million GEL and reached 2.1 billion GEL.

Share of loans provided to the industrial sector constituted 20.8 percent of all loans to legal entities and amounted to 895.1 million GEL by January 1, 2012 (7.4 percent or 61.9 million GEL more compared to the previous month). 10.3 percent fell on construction, amounting to 441.9 million GEL (8.4 percent or 40.8 million GEL less, respectively). Therefore, 79.5 percent of the total volume of lending to the legal entities falls only on three sectors – trade, industry, and construction. As we have

FIGURE 20
Loans per categories
www.nbg.ge

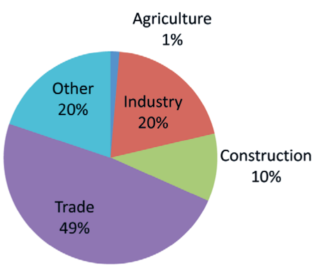


FIGURE 21
Loans and deposits 2011
www.nbg.ge

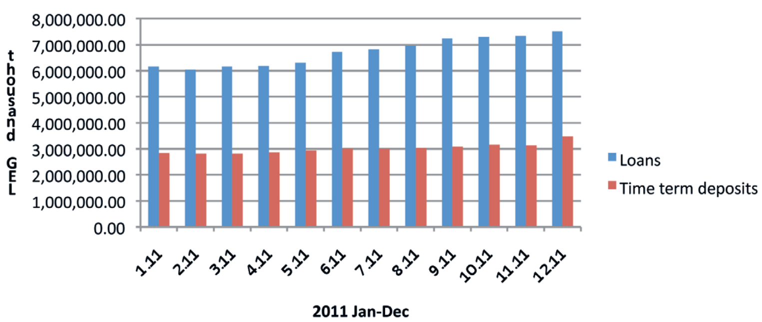
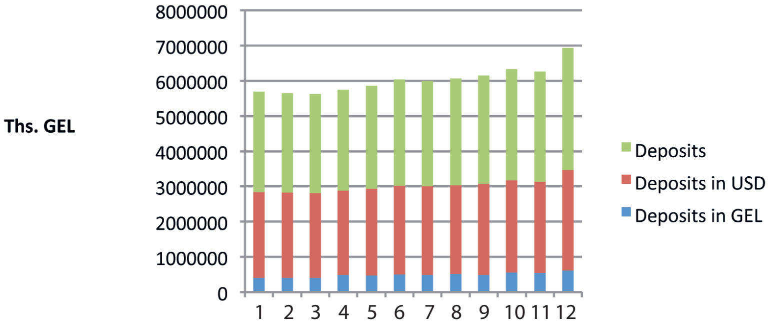


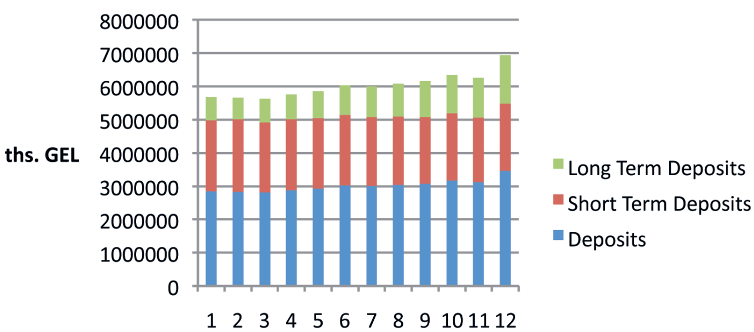
FIGURE 22
Deposits by Currency 2011.
www.nbg.ge



mentioned in our previous work, the fact that the finances are heavily tilted towards the sectors with limited job opportunities (such as trade), hinders employment growth. At the same time sectors with import substitution potential such as agriculture receives the least amount in total loans issued (around 1.35% of total loans) (f. 20).

When it comes to comparing the volumes of deposits to loans, it is noteworthy that the amount of loans exceeds deposits by almost three times, and absolute majority of the deposits are denominated in the US dollar, which highlights uncertainty towards the national currency (f. 21&22). Moreover, the amount of long-term deposits is little as compared to the short-term ones (f.23). Therefore, Georgian banks are heavily depended on foreign sources of lending, which in the conditions of negative global tendencies and the ongoing debt crisis in the euro area might become very unstable and expensive source of financing. Therefore, emphasis should be put on promoting domestic saving.

FIGURE 23
Deposits by Time 2011
www.nbg.ge



Government Operations

According to the preliminary information for the year of 2011 total revenues of the consolidated budget amounted to 6,960 million GEL 18% increase as compared to 2010 and constitute to 29.3% of GDP. As to total expenses projected figure is 5,553 million GEL, a considerable increase from the last year and comprise of 26.4% of GDP. The government of Georgia is maintaining the expenses GDP share not to exceed 30%, the trend shown in figure 25 is a gradual decrease in expenses as % of GDP, and an increase of revenues as % of GDP. In theory, as well as according to empirical literature, the total volume of government operations, reaches its maximum efficiency level at around 13-14 as a percentage of GDP. Afterwards incremental percentage of government expenses as a percentage of GDP results in 0,1-0,4% deceleration of economic growth rate. After budget expenditures reach 30% of GDP, the implications for growth are negative, i.e. marginal increase of government expenses does not affect positively the growth. Moreover, even decrease the growth pace. Budgetary expenses per se are the products of economic growth, since the government raises finances through taxation, which is derived from the private sector.

As to the sources of revenue for the state budget, roughly 80-90% of them derive from taxes. As we can see from the graph, the share of taxes as a percentage of total revenues has been increasing in Georgia (f.25) . The government believes that this is due to a better tax administration and elimination of the petty corruption. In the fourth quarter of 2009, we observe a decrease of tax revenues to below 80% as a share of total revenues, this was mainly due to an increasing number of grants inflow in the country. Although, it must be also noted that since value added tax comprises 48% of the total tax collected, the increase in taxes must be also due to an increase in imports in monetary terms and in some cases in quantitative terms as well. At the same time, the fact that almost half of the tax revenues come from VAT tax indicates that the industry/manufacturing sector is not strong in Georgia and that the taxes derive mostly from

FIGURE 24
Consolidated budget
www.mof.ge

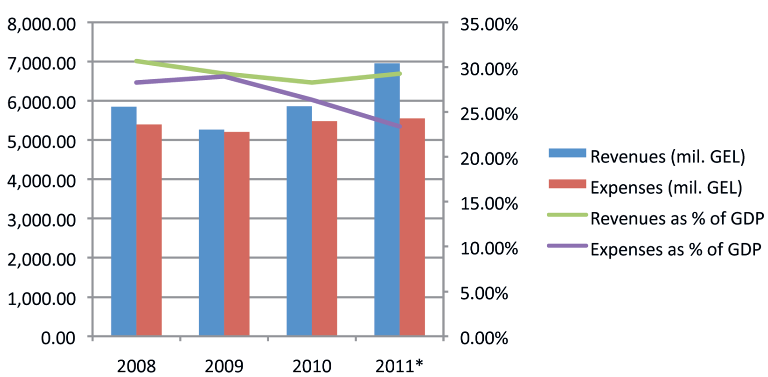


FIGURE 25
Revenue Sources (2009-2011)
www.mof.ge

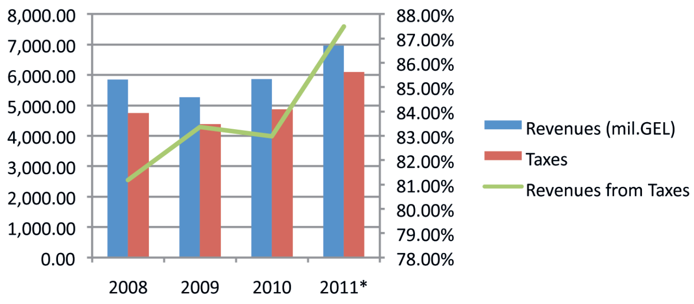
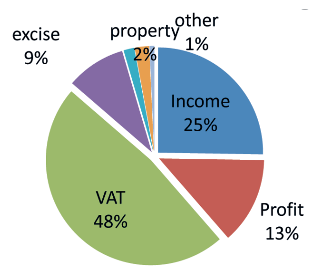


FIGURE 26
Tax contribution
www.geostat.ge



services and trade. Income and profit tax comprise only 25% and 13% of all taxes respectively (f.26).

By looking at the tax tendencies over the years, considerable increase is seen in the VAT tax, with an increase in income tax, somewhat volatile profit tax with annual increase, although volatile quarterly indicator (f.27).

If we look at the preliminary information regarding budgetary expenses for the year of 2011 (f.28), social benefits comprised the largest share of the expenses with 30%, goods and services on the second place with 21%, together with salaries of state employees that also comprised 21% of the total budgetary expenses. It is worth mentioning that as large as 15% is labeled as "other" expenses, we believe that labeling more than 833.0 million. GEL as miscellaneous expenses makes these sums untraceable and not transparent enough.

Moreover, the category of social expenses has been increasing over the past years (f.29). Dynamics indicates clearly that the budget is getting more and more burdened by the social obligations. Interestingly, social

FIGURE 27
Tax Tendencies (2009-2011)
www.geostat.ge

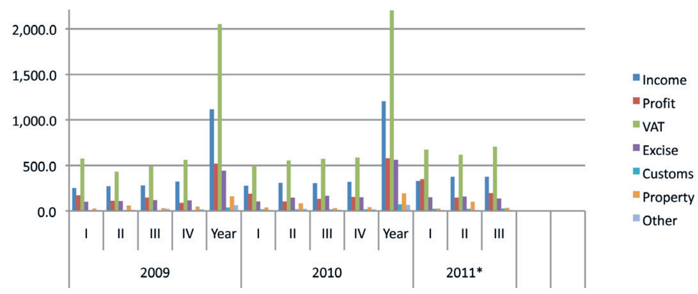
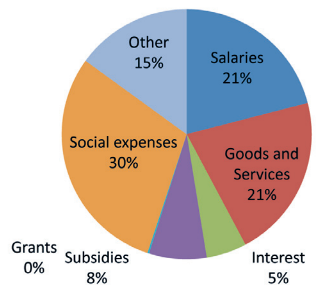


FIGURE 28
Budgetary Expenses 2011*
www.mof.ge



expense outlays growth rates almost always exceed the growth rates of nominal GDP. Since 2005 there is a very close correlation between the pace of increase of foreign debt and social outlays. This means that that the primary source for the social assistance programs is provided by the foreign debt facility. Plus, increases in social expenses appear to be driven by conjuncture factors and not by the careful planning process. Abrupt swings in this particular category of the budgetary expenditures can create inflationary pressure to the economy and might deteriorate the government's liquidity position. We fully appreciate the fact that in 2009 sharp increase of social spending was driven by the consequences of the War with Russia and need to meet the requirements of the poor strata of the population. Despite this, bringing more predictability and consistency in this particular area will pose a serious challenge to the GoG and the economy in general.

At the same time, budgetary expenses can positively affect economic growth if they are directed towards accomplishment of private sector development support roles such as basic infrastructure provision, basic health and basic education. While expenses directed mostly towards social benefits and wages do not bring about economic improvement and development. The letter is the case in Georgia where the largest chunk of the budgetary expenses is taken up by the social expenditures.

The achievement of a "genuine" positive fiscal balance remains a problem for all the Georgian governments since the collapse of the Soviet Union. Genuinely positive fiscal balance is the excess of budgetary revenues over expenditures not taking into consideration the privatization proceeds. Only in 3 years post Rose Revolution managed the Georgian government to maintain overall positive fiscal balance even taking into consideration the privatization proceeds. Currently, the potential for privatization of the state owned enterprises is much more limited than it used to be. Thus, subsequently, if the negative shock to the economy occurs, it will be very hard to the Government to maintain positive fiscal balance without incurring more of the domestic and foreign debt.

For 2010 state budget deficit comprised of 1.38 billion GEL (6.3% of GDP), and consolidated budget deficit equaled 1.41 billion. GEL. (6.8% of GDP), in 2011 as per preliminary information the ratio fell to 3.7% with the budget deficit not exceeding 878.6 million. GEL. As seen from the graph the largest budgetary

FIGURE 29
Expense Tendencies 2008-2011 (thousand GEL)
www.mof.ge

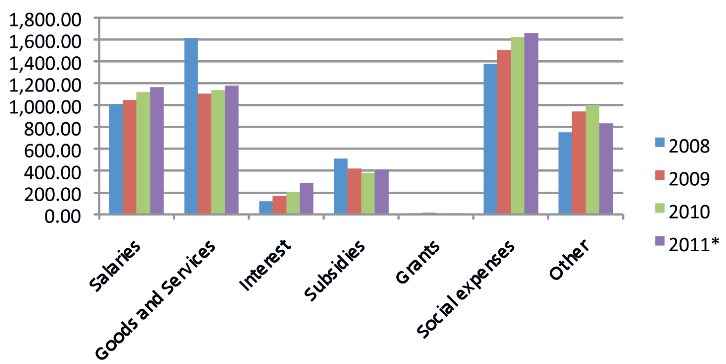
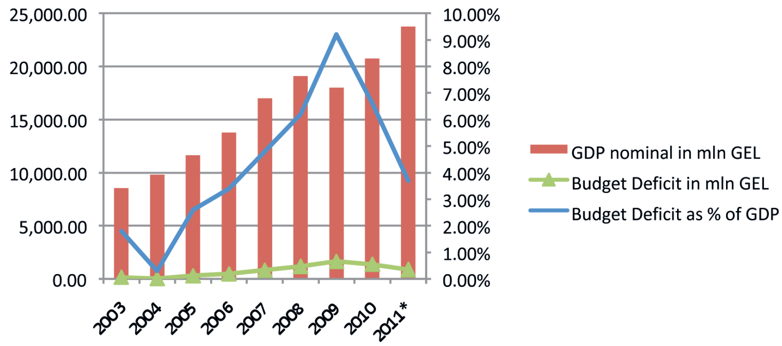


FIGURE 30
Budget Deficit and GDP
www.mof.ge

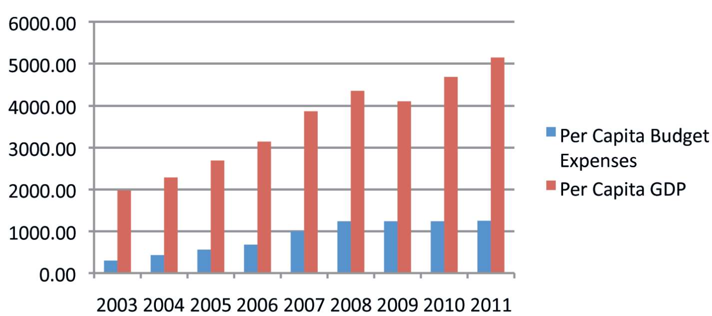


deficit as a share of GDP (that is 9.3%) was in 2009 due to a crisis period expansionary policy[15] (f.30). For ensuring macroeconomic stability fiscal consolidation is of upmost importance that is cutting budgetary deficit to tolerable levels. The government of Georgia is planning to reduce the deficit in line with the Law on Economic Freedom coming into force in 2013 and restricting the budgetary deficit-GDP ratio to 3%. We could not get hold of the information regarding 2011, although in 2010 primary sources of budget deficit financing were IMF's budget support credits, EU grants, World Bank's program loans and funds mobilized through issuance of Treasury bills.

Achieving fiscal consolidation is crucial since budgetary expenses have been growing at upmost speed; to visualize, we see that the per capita budgetary expenses growth rate in Georgia substantially outpaced the growth rate of general economy (f.31).

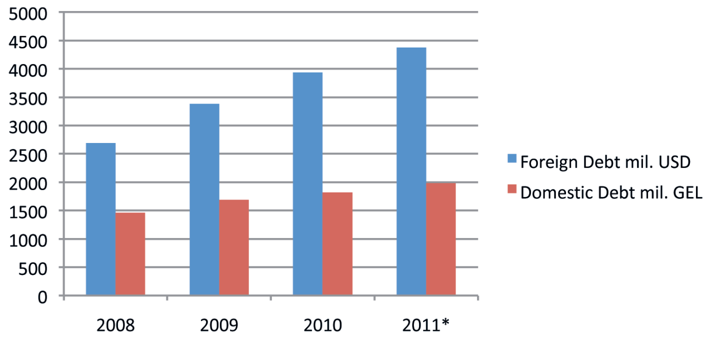
When government expenditure reaches certain level of GDP their marginal benefit inevitably go down. Another dangerous implication of uncontrolled growth of the state sector is accumulation of debt that naturally follows undesired growth of share of state expenditures in GDP.

FIGURE 31
Per Capita Budgetary Expenses and GDP 2003-2011 (in GEL)
www.geostat.ge



15 NBG.Annual Reports. 2010. http://nbg.ge/uploads/publications/annualreport/2010/annual_2010_web.pdf

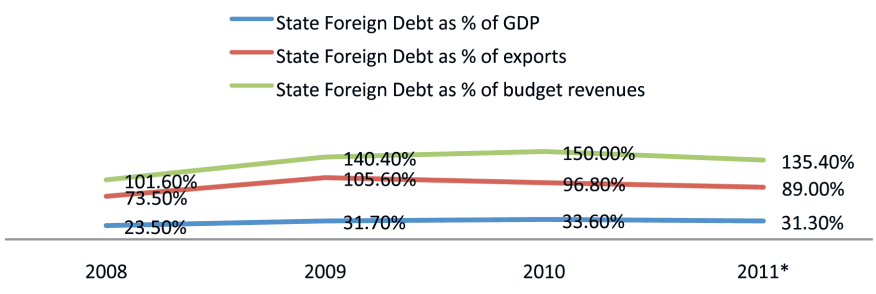
FIGURE 32
State Debt per origin.
www.mof.ge



As of today, state debt levels are way below the restricted level of 60% of GDP set by the Law on Economic Freedom. Despite this, it will be a serious challenge to keep the debt levels within the manageable margin, if the mentioned tendency continues. According to the preliminary information provided by the Ministry of Finance, as of 2011 the state foreign debt amounts to 4,375.7 million USD, while the domestic debt equals 1,983.3 million GEL. (f.32). To clearly understand the meaning of the figures, it is a general practice to show debts as a ratio of several indicators. This is as a percentage of GDP, exports and budgetary revenues. This is where the real danger exposed by debt can be found. Starting from GDP, once debt becomes significant fraction of GDP, and its growth rate substantially exceeds that of GDP, the economy will suffer a recession even if the debt to GDP ratio merely stabilizes. As to debt-to-exports ratio, it shows that total debt is growing faster than the country's basic source of external income, indicating that the country may have problems meeting its debt obligations in the future. As well as debt-to-revenue ratio that is a major source of internal income for a country that means it may have budgetary problems in servicing this debt. In such an adverse scenario the option is to resort to foreign lenders since almost 75% of the debt is foreign. In such a case the debt can grow quickly and further deteriorate growth prospects[16].

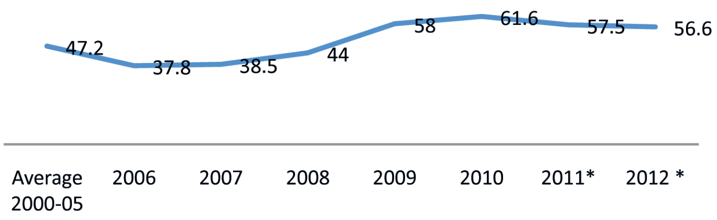
Looking at the situation in Georgia (f. 33), State debt to GDP ratio is maintained at tolerable levels at 31.3% as of 2011, debt-to-export ratio is currently set at 89.0%, while it exceeded a hundred percent in 2009. This means that the country's state foreign debt is almost as much as annual exports. As to debt-to budgetary

FIGURE 33
State Foreign Debt as % of GDP, exports and budget revenues
www.mof.ge



16 IMF.Debt Analysis. 2010. http://www.imf.org/external/pubind.htm

FIGURE 34
Foreign Debt as % of GDP
www.imf.org



revenues indicator, currently the ratio is 135%, it reached its highest in 2010 and equaled 150%.

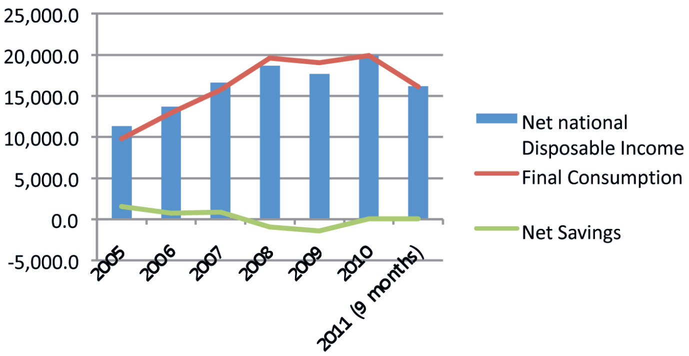
Even though the government has succeeded in maintaining the state debt levels below the 60% of GDP, according to the data from IMF, gross foreign debt of the country (that is both state and private debt) outreached the 60% of GDP restriction in 2010 and is currently 57.5% with a projection of a decrease in 2012 to 56.6% (f.34).

The mark 60% as a dangerous limit of the external debt to GDP ratio is the empirical threshold beyond which the country faces serious problems related to it solvency. In general, government debt can be analyzed through the prism of two key variables: its size and its pace of accumulation. Problem with the state debt is that it is exogenous variable, meaning that the economy cannot automatically correct its levels. Debt problems of the country affect all of its citizens even if they are personally not indebted. The large stock of debt is dangerous because its service consumes larger and larger portions of the state income and directs it to debt service instead of economic development. As of 2011 the foreign debt service amount is 14.6% of the budgetary revenues[17].

National saving represents a crucial factor in long term sustainable economic growth of a country, national saving is calculated as follows: net national disposable income minus final consumption. National saving is understood as a unity of private and public savings. These are resources available for investment for replacing or buying new and better capital goods. High savings and investment in a nation's capital are contributors to increased productivity and stronger economic growth[18]. Government deficits absorb large share of private saving and reduce the overall national saving available for investment. Thus, government savings is the most direct way for increasing national savings. For Georgia as depicted in the graph, final consumption in some cases even outreached the net national disposable income available (f.35). General trend is that if we look at the share of net savings as a share of net national disposable income, it is below 1%, while on average in the eurozone countries this percentage is above 19%, with Austrians being the biggest savers (25.0%) and Greek the smallest (4.0%)[19].

17 www.mof.ge
18 National Saving Answers to Key Qeustions.US Government Accountability Office.2001. http://www.gao.gov/new.items/d01591sp.pdf.

FIGURE 35
Savings vs Consumption (mln GEL)
www.geostat.ge



In Georgia national saving has been on a decrease since 2005 till 2009. During the course of the years private saving was a major contributor to the national savings figure. Therefore, the overall decrease in national saving is due to a relative decrease in private savings. In 2006-2008 a drastic increase was seen in final consumption (therefore a decrease in savings) this was mainly due to the easier access to loans issued by the banks to physical entities and positive expectations from the population regarding economic tendencies[20]. During this period bank credit portfolio was constantly increasing (annual 60-70%), while the increase in deposits was at least 10% less than those of credits. Such an increase in credit portfolio was mainly due to an increased inflow of FDI and volumes of foreign loans obtained for a relatively low interest rate. As a result by 2008 total volume of loans exceeded the total volume of deposits by almost 32%. This increase in loans directly influenced the amount of disposable income available for households thus resulting in an increase in final consumption. By the end of 2008 beginning of 2009 due to clearly known reasons the loan availability was reduced together with a 5% reduction in net national disposable income; this reduction was not answered by an adequate decrease in population's final consumption, thus resulting in a decrease in net savings as seen on the graph.

In 2010 together with an increase in overall income, an increase was observed in net savings, although in starting from the second half of 2011 there has been a considerable increase in loans issued to physical entities (due to a decrease in interest rate for loans denominated in national currency), thus once again resulting in a decrease in net savings. During this period the net saving was completely comprised of public savings. The tendency is believed to continue due to the expansionary monetary policy targeted at decreasing the interest rate and promoting demand.

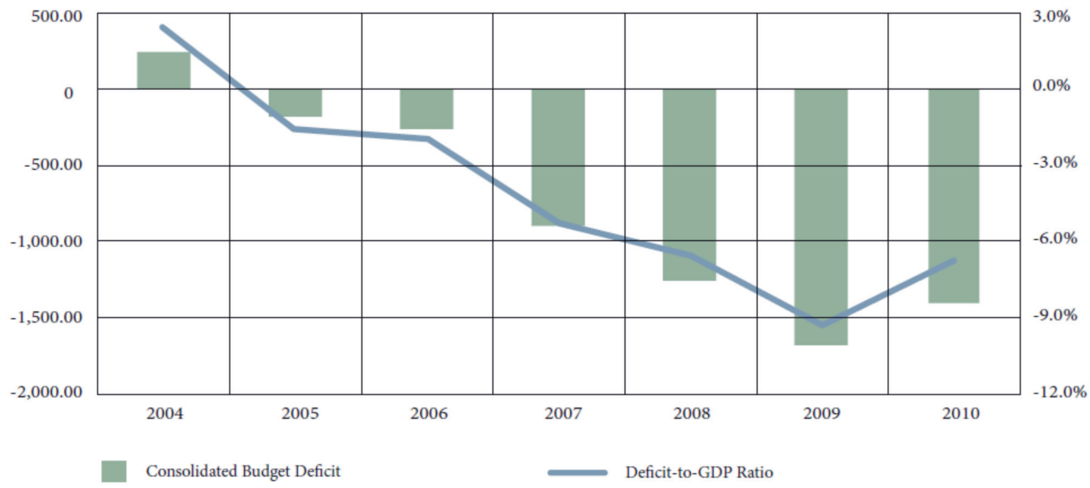
One of the major reasons for a relatively decreasing saving trend in Georgia might be the inflationary pressure that is usually one of the major reasons that reduces incentives of population to save. At the same time negative government saving proves to be the biggest disincentive to save in developing countries.

19 European Commission.Eurostat.National Accounts. 2011. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/National_accounts_%E2%80%93_GDP
20 National Bank of Georgia.Inflation Reports. 2011 Third Quarter. 2011. http://nbg.ge/uploads/publications/inflation-report/2011/saboloo_inflacia3q_27_12_11.pdf

Twin Deficit

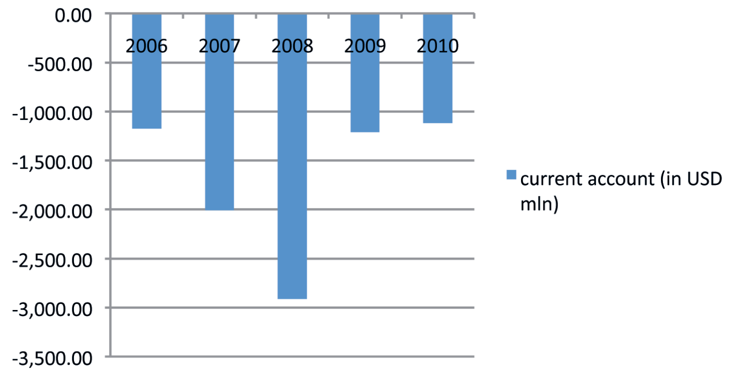
Twin deficit is a situation when a country's economy is running two deficits at the same time. These are fiscal deficit and a deficit on the current account of the balance of payments. According to the twin deficit hypothesis, persistent fiscal shocks which cause a deterioration of the government's budget also worsen a country's current account balance. Since, excess government spending is accompanied by excess private consumption as well, thus reducing national saving and making it necessary to borrow from abroad, thus fiscal deficit is accompanied by current account deficit[21] It is believed that fiscal consolidation is a necessary measure for correcting the account deficit[22]. As we have argued, constant or long-term government deficit decreases national savings that causes fall in the current account balance. By National Accounting – a fall in national saving due to a government deficit translates – other things equal – into a fall in the current account balance. This effect can be partially offset by private domestic saving which Georgia lacks. At the same time, loosening of fiscal policy raises interest rates (a fall in public saving) may also crowd out investment. With flexible exchange rates according to Mundell-Fleming model, fiscal deficit appreciates the currency; hence domestic goods are relatively higher in price that crowds out net export[23].

FIGURE 36
Budget Deficit as GDP Ratio
www.nbg.ge



21 European Central Bank Working Papers. Fiscal Policies, The Current Account and Ricardian Equivalence. 2008. http://www.ecb.int/pub/pdf/scpwps/ecbwp935.pdf
22 European University Institute. Twin Deficits: Squaring Theory, Evidence and Common Sense. 2006. http://www.eui.eu/Personal/corsetti/research/tdh.pdf
23 Corsetti, G., Muller, G.J., 2006. Twin Deficits: Squaring Theory, Evidence and Common Sense. European University Institute, Goethe University Frankfurt. http://www.eui.eu/Personal/corsetti/research/tdh.pdf

FIGURE 37
Current Account
www.nbg.ge



According to the Economic Freedom Act adopted by the parliament of Georgia, starting from 2013 the budget deficit should not exceed 3% of GDP. The consolidated budget deficit as of 2010 amounted to 1.41 billion GEL, thus constituting 6.8% of GDP, improvement from 2009, when the consolidated budget deficit stood at 9.3% of GDP, reflecting the expansionary fiscal policy stimulated through deficit growth (f.36). Since financial consolidation that is reduction in budget deficit is crucial for macroeconomic stability, further reductions are planned for bringing the budget deficit to tolerable levels[24].

In 2010 the current account deficit of the balance of payments totaled USD 1,116.5 million, or 9.6% of GDP, a 7.7% decline year-on-year. Current account deficit is mainly due to the trade deficit. In 2011 the account balance deficit must have deepened due to a record high trade deficit (f.37).

According to the working paper of European Central Bank, the relationship between fiscal policy and the current account changes depends on the government debt to GDP ratio, since this variable affects private sector expectations. The research concluded that in low debt and medium debt countries where state debt level is up to 44% of GDP (this is where Georgia stands at the moment) the relationship is positive, i.e. an increase in fiscal deficit leads to higher current account deficit. In this case for combating the current account deficit the government of Georgia has to consolidate fiscal policy by reducing the unnecessary spending. Government should be cautious regarding excessive spending, cut non-priority spending especially avoid increases in wages and pensions. Together with spending constraints, fiscal consolidation also requires authorities' commitment to enhancing the transparency, quality and efficiency of public spending[25].

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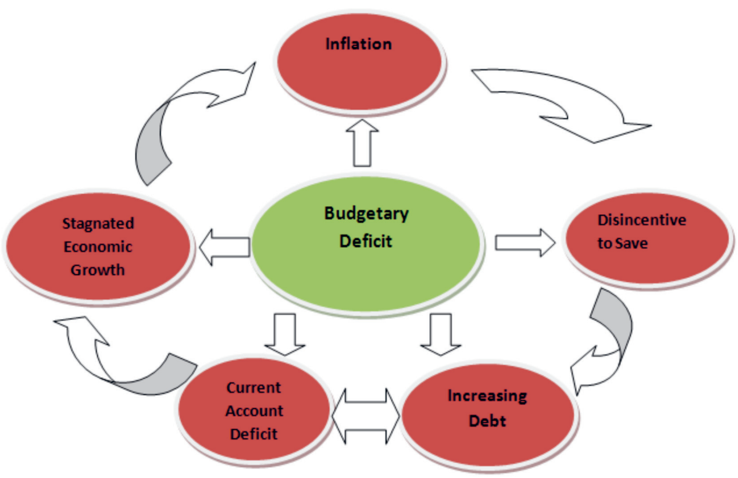
24 National Bank of Georgia.Annual Reports. 2010. http://nbg.ge/uploads/publications/annualreport/2010/annual.eng.veb_versia.saboloo2010.pdf
25 International Monetary Fund.Regional Outlook. 2011.http://www.imf.org/external/pubs/ft/reo/reorepts.aspx

Conclusions

2011 was mainly characterized by high inflationary pressure, global abrupt price increase in both food and oil products, thus resulting in higher trade deficit for Georgia. Prognosis for the coming year are not optimistic, economists believe that the euro zone crisis might negatively affect output levels in other countries as well through financial, trade and remittance channels. Since the country has exhausted its package of external financing provided by different donors, there is an uncertainty in external environment and large stock of non-performing loans in the financial sector. These are the fundamental vulnerabilities that the country shall face in the coming year. Georgian banks are heavily depended on foreign sources of lending, which in the conditions of upcoming projections regarding economic slowdown in the US and the ongoing debt crisis in the euro area might become very unstable and expensive source of financing. Therefore, emphasis should be put on promoting domestic saving.

One of the major reasons for not so impressive saving trend in Georgia might be the inflationary pressure that is usually one of the major reasons that reduces incentives of population to save. Constant fiscal deficit in the country has also contributed to decreasing savings. Since, excess government spending is accompanied by excess private consumption as well, thus reducing national saving and making it necessary to borrow from abroad. Therefore, fiscal deficit is accompanied by current account deficit. Interrelation of these factors is presented in a graph that sums up the conclusions/assumptions made in the paper (f. 38). In this case for combating the current account deficit the government of Georgia has to consolidate fiscal policy by reducing the unnecessary spending, especially in the forms of wage and pension increase.

FIGURE 38
Conclusion made by authors



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