INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/215

GEORGIA

September 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR GEORGIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Georgia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 15, 2021 consideration of the staff report that concluded the Article IV consultation with Georgia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 15, 2021, following discussions that ended on July 19, 2021, with the officials of Georgia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 30, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Georgia.

The documents listed below will be separately released.

Financial Stability System Assessment

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Washington, D.C.

PRESS RELEASE

PR21/270

IMF Executive Board Concludes 2021 Article IV Consultation with Georgia

FOR IMMEDIATE RELEASE

Washington, DC – September 21, 2021: On September 15, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Georgia.[1] This year the consultation also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for Georgia.[2]

The COVID-19 crisis took a heavy toll on Georgia's economy. Domestic mobility restrictions necessary to control the pandemic and a slowdown in tourism drove the largest output contraction since the 1990s with the economy shrinking by 6.2 percent in 2020. Poverty and unemployment also rose, undoing much of the progress of recent years. The authorities appropriately responded by strengthening healthcare and providing substantial assistance to vulnerable households and businesses, aided by sizeable donor support. COVID-19 case numbers rose sharply in August before declining while vaccinations have accelerated.

The recovery has recently gained momentum with growth now expected to reach 7.7 percent in 2021. This is a significant upgrade from earlier expectations, and implies that output will exceed its 2019 level this year. Robust growth in remittances and exports, and early signs of a faster than expected rebound in tourism have supported the recovery and should contribute to a narrowing of the current account deficit compared to its elevated 2020 level. Inflation accelerated to 12.8 percent year-on-year in August, largely reflecting utility price increases, higher commodity and food prices, and elevated input costs, but is expected to decline rapidly in 2022 as these temporary effects fade.

Significant risks remain and contribute to an outlook that is more uncertain than usual. Chief among risks, COVID-19 variants or vaccination delays could derail the recovery by requiring new lockdowns and reducing external demand.

The Financial Sector Assessment Program (FSAP) found that the authorities' regulatory reforms in recent years and the policy actions taken following the COVID-19 shock have helped support financial

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion.

sector resilience, including on account of strong pre-pandemic bank capital and liquidity buffers and profitability.

The authorities' macroprudential toolkit is comprehensive and includes measures to address the key risk from high dollarization, which complicates monetary policy and exposes Georgia's banks to credit risk from exchange rate shocks. These measures also aim to limit bank risks and reduce incentives for lending in foreign currency. Over the medium term, the authorities should consider tightening de-dollarization measures gradually, with the choice of measures and calibration informed by impact assessments.

The authorities follow a prudent supervisory approach. They have taken significant steps to strengthen the quality of supervisory oversight and financial safety net arrangements since the last FSAP in 2015. These include adoption of Basel III and a comprehensive update of the legal and regulatory framework for banking resolution and crisis management. Looking ahead, there is some scope to formalize internal procedures, including for bank resolution and crisis management.

Executive Board Assessment[3]

Executive Directors agreed with the thrust of the staff appraisal. Given the heavy toll of the pandemic, Directors emphasized that sustaining a strong pace of vaccinations is needed to bolster the ongoing recovery against further pandemic risks.

Directors supported shifting fiscal policy toward bringing down the deficit and debt, anchored by Georgia's fiscal rule. They noted that the better-than-expected recovery has helped finance additional healthcare services, and stressed saving further windfalls to provide a buffer against risks. Directors agreed that the authorities should seek to expand fiscal space and reduce fiscal risks by reviewing tax expenditures, strengthening tax administration and public investment management, and advancing SOE governance reform.

Directors welcomed recent monetary policy rate increases, which should help keep inflation expectations anchored. With inflation risks tilted to the upside, Directors supported further rate hikes if there are signs of high inflation becoming entrenched. They encouraged continued prudent use of foreign exchange intervention to prevent disorderly market conditions given risks from financial dollarization.

Directors commended the NBG's prudent supervisory approach, including financial sector reforms since the last FSAP and decisive actions during the pandemic. They urged formalization of internal supervisory processes and continued strengthening of assessments of banks' risk management and governance. They noted that any further tightening or recalibration of de-dollarization measures should follow a gradual approach informed by thorough impact assessments.

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[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed the FSAP's findings that banks have sufficient capital to absorb credit losses from the pandemic under a baseline scenario, and that capital shortfalls in possible stress scenarios are expected to remain manageable. They agreed that the NBG should encourage banks to retain earnings until pandemic-related uncertainties subside and capital buffers are fully restored. Directors commended progress in upgrading the bank resolution and crisis management framework, and urged the authorities to implement a prompt corrective action framework for banks, and to stand ready to implement a bridge bank if needed. Directors noted consideration of a central bank digital currency, and underlined plans for a controlled testing environment that could uncover potential unintended consequences and economic and regulatory issues. They also stressed the need to address AML/CFT vulnerabilities.

Directors agreed that reinvigorating structural reforms is needed to sustain growth and make it more inclusive. They urged actions to tackle high unemployment and inequality including education reforms, a social protection review, and strengthened active labor market policies. Directors welcomed implementation of the new insolvency framework and stressed continued structural fiscal and judiciary reforms to improve the business environment.

Georgia: Selected Economic and Financial Indicators, 2019-2022

	2019	2020	2021	2021	2022
	Actual		Country Report 21/79 1/	Projections	
National accounts and prices	(annual percentage change; unless otherwise indicated)				
Real GDP	5.0	-6.2	3.5	7.7	5.8
Nominal GDP (in billions of laris)	49.3	49.4	53.3	57.5	64.5
GDP per capita (in thousands of U.S. dollars)	4.7	4.3	4.4	4.8	5.3
CPI, Period average	4.9	5.2	3.8	9.3	5.4
CPI, End-of-period	7.0	2.4	5.0	13.1	3.2
Consolidated government operations	(in percent of GDP)				
Revenue and grants	27.1	25.1	25.2	25.7	26.1
o.w. Tax revenue	23.7	22.2	22.6	22.9	23.6
Expenditures	28.9	34.4	32.6	32.2	29.7
Expense	21.4	26.2	25.2	25.0	22.7
Net acquisition of non-financial assets	7.6	8.1	7.4	7.2	7.0
Capital spending	8.0	8.6	7.9	8.0	7.4
Privatization proceeds	-0.4	-0.4	-0.5	-0.8	-0.4
Net Lending/Borrowing (GFSM 2001)	-1.8	-9.2	-7.4	-6.5	-3.6
Budget lending	0.2	0.1	0.2	0.2	0.3
Augmented Net lending / borrowing (EFF definition)2/	-2.1	-9.3	-7.6	-6.6	-3.9
General government debt3/	40.4	60.0	60.8	54.2	53.6
o.w. Foreign-currency denominated	32.0	47.5	49.6	43.9	42.1
Credit growth	(annual percentage change; unless otherwise indicated)				
Credit to the private sector	20.7	22.4	6.4	10.5	11.8
In constant exchange rate	16.1	9.0	5.5	14.0	8.5
Broad money	17.6	24.6	16.9	14.1	19.7
External sector	(in percent of GDP; unless otherwise indicated)				
Current account balance	-5.5	-12.5	-10.9	-10.0	-7.6
Gross international reserves (billions of US$)4/	3.5	3.9	3.6	3.8	4.0
In percent of IMF Composite measure (floating)	98.3	107.6	97.8	98.5	98.5
Gross external debt	106.6	129.5	133.9	116.8	111.8

Sources: Georgian authorities; and Fund staff estimates.

1/ Please refer to this link for details https://www.imf.org/en/Publications/CR/Issues/2021/04/16/Georgia-Eighth-Review-Under-the-Extended-Fund-Facility-Arrangement-Press-Release-and-Staff-50358

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

3/ Excludes domestic legacy debt of 1.2 percent of GDP.

4/ Includes IMF SDR allocation of $286 million approved in August 2021.

INTERNATIONAL MONETARY FUND

GEORGIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

August 30, 2021

KEY ISSUES

Context. High frequency estimates suggest a V-shaped recovery with output now poised to return close to 2019 levels already this year, much earlier than expected. Recently COVID-19 case numbers have risen sharply to new highs while vaccinations have also accelerated significantly after a slow start. The recovery has improved the fiscal outlook and the authorities submitted to Parliament a supplementary budget, with GEL 1.2 billion in additional spending roughly equivalent to the expected increase in revenues. The National Bank of Georgia (NBG) has increased the policy rate by 200 basis points to deal with high inflation driven by lagging effects of depreciation, commodity and food price increases, and supply side constraints.

Policy Priorities. The consultation focused on policies to respond to the pandemic and strengthen growth and resilience.

Key Recommendations.

- As the economy recovers, fiscal policy should seek to unwind crisis support measures and reduce the deficit and debt. A mildly contractionary fiscal policy stance in 2021 remains appropriate, and if further additional revenue materializes, it should be saved to reduce the deficit, given the large medium-term adjustment needs. If downside risks materialize in 2021, further support should be deficit neutral.

- Medium-term fiscal consolidation is needed to comply with the fiscal rule and rebuild buffers. The authorities should review tax expenditures, improve tax administration, strengthen public investment management, and implement a comprehensive state-owned enterprise (SOE) reform strategy to manage and mitigate fiscal risks.

- If evidence emerges that higher inflation expectations are becoming entrenched, the NBG should further tighten the monetary policy stance to achieve the inflation target.

- Maintaining adequate buffers and provisions for the financial sector is critical as the recovery solidifies. The authorities should use available policy tools to preserve capital in the banking system. Effective ways to deal with NPLs will be important to reduce any lingering pandemic-related uncertainty about the health of balance sheets and restore profitability.

- Comprehensive education reform should be complemented with cost-effective active labor market policies to deal with entrenched unemployment, as well as renewed attention to actions to attract foreign direct investment, diversify exports, and increase productivity.

Approved By
Subir Lall (MCD) and Craig Beaumont (SPR)

An IMF team consisting of J. John (head), S. Khan, S. Saksonovs (all MCD), A. Lagerborg (FAD), M. Leika (MCM), Y. Zhao (SPR), S. Cakir (Resident Representative) and N. Sharashidze (Local Economist) held discussions with the Georgian authorities by videoconference during June 28 – July 19, 2021. N. Reyes, B. Laumann, and S. Zolotareva (all MCD) and K. Danelia (Tbilisi Office) assisted in the preparation of this report. Discussions were led on the authorities' side by Governor K. Gvenetadze, Minister of Finance L. Khutsishvili, Minister of Economy N. Turnava and other senior officials. M. Saiyid (MCM, FSAP mission chief) and Z. Zedginidze and S. Tsur (OED) participated in the discussions.

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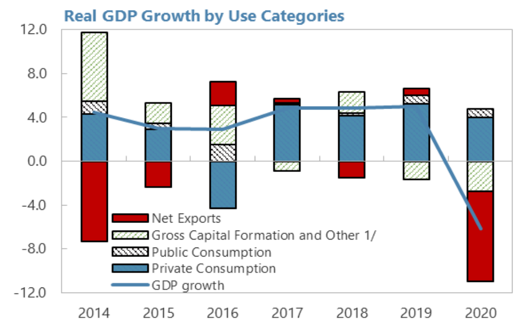
CONTEXT

1. **Before the COVID-19 crisis, the Georgian economy was growing robustly.** Real GDP growth averaged 4.9 percent between 2017 and 2019 (compared to 3.5 percent between 2014 and 2016), driven largely by domestic demand. The current account deficit improved steadily from 12.5 percent of GDP in 2016 to 5.5 percent of GDP in 2019 reflecting an increase in tourism revenues. Strong policy frameworks including a fiscal rule, an inflation-targeting regime, and robust financial sector regulation and supervision, as well as continued reforms (Annex I) facilitated macroeconomic and financial stability and enhanced resilience to shocks.



Source: Geostat, and IMF staff calculations.
1/ Includes statistical discrepancy

2. **The COVID-19 crisis took a heavy toll on growth, jobs and household incomes, and increased poverty.** Real GDP declined by 6.2 percent in 2020, the largest decline since the 1990s, owing to sharply lower net exports and investment. The government provided substantial support to vulnerable households and businesses (3.8 percent of GDP in 2020), contributing to a sharp rise in the fiscal deficit and public debt, to 9.2 and 60 percent of GDP respectively. Sizeable external assistance helped meet expanded financing needs. The unemployment rate increased from 16.6 percent in 2019Q4 to 22.1 percent in 2021Q2[1] even as labor force participation increased from 50.5 to 51.4 percent.[2] The pandemic-related downturn lowered average household incomes by 4.5 percent in 2020, and the share of the population below the national poverty line[3] increased for the first time since 2016, from 19.5 percent in 2019 to 21.3 percent in 2020.

3. **Recently COVID-19 case numbers have risen sharply while vaccinations have also picked up significantly.** After a slower start than in neighboring countries and EM Europe, the pace of vaccinations rose in the beginning of May when the age limit was lowered and Chinese-manufactured vaccines were approved, and accelerated again recently with the arrival of additional vaccines (around 11 percent of the target population has been fully vaccinated and 25 percent has received at least one dose). New cases of COVID-19 have reached all-time highs and sustaining a high rate of vaccinations will be needed to meet the government's goal of inoculating more than half of the population by the end of the year.

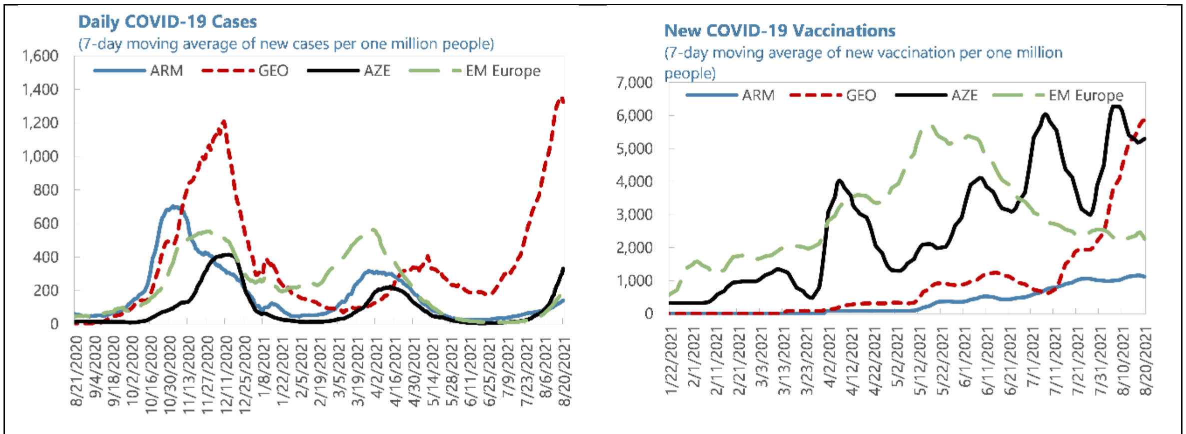
4. **The political environment is contributing to higher than usual uncertainty.** Following parliamentary elections in 2020, opposition parties refused to enter Parliament for more than six

[1] New ILO standards, including regarding individuals working in households, were adopted by Georgia in 2020. The new methodology accounts on average for an 8-percentage point increase in the unemployment rate in 2010–19.

[2] Labor force participation had declined to 48.3 percent through 2021Q1, but it picked up in 2021Q2.

[3] The national poverty line is defined as the amount of money needed to meet the basic needs of one able man (the numerical value of this indicator is not publicly available).

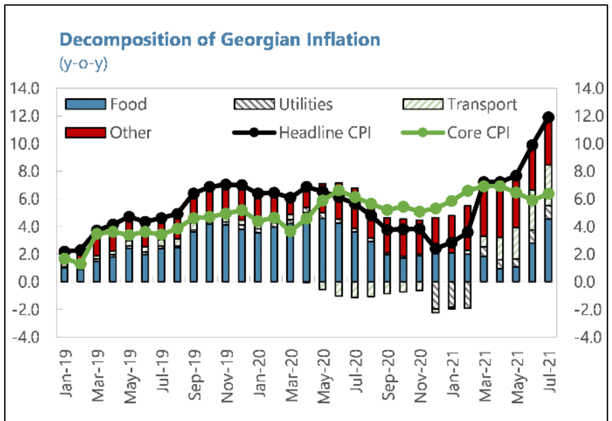
months until an agreement was reached in April 2021 to end the boycott. The ruling party has recently rejected the agreement, which was also unsigned by the leading opposition party. A provision of the agreement stipulated that if the ruling party receives less than 43 percent of the votes in local elections in October 2021, an early parliamentary election will be called for 2022.



Source: European Centre for Disease Prevention and Control, Haver (Oxford University) and IMF staff calculations.

RECENT ECONOMIC DEVELOPMENTS

5. **The recovery has gained impressive momentum (Table 1, Figure 1), but inflation has also accelerated.** Pent-up demand and strong base effects resulted in exceptionally high and broad-based growth in the second quarter of 2021 (29.8 percent y-o-y resulting in a 2021H1 growth rate of 12.7 percent). Growth is projected to reach 7.7 percent, implying that output will exceed its 2019 level in 2021. Higher tax revenues also suggest that recovery in 2021 is more likely to be V-shaped than was previously anticipated. Inflation has accelerated to 11.9 percent y-o-y in July (17.4 percent m-o-m annualized)—well above the National Bank of Georgia's 3 percent target, largely reflecting exchange rate depreciation[4], utility price increases, and higher global commodity and food prices with the latter contributing to diversion of some types of food for exports. Core inflation remained much lower than headline and broadly stable at 6.4 percent y-o-y in July.



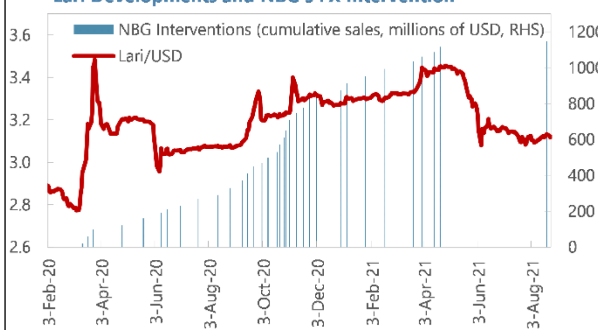
Source: Geostat, and IMF staff calculations.

[4] Staff analysis suggests that for Georgia, forward inflation expectations and changes in the NEER are the main determinants of headline inflation (see detailed discussion in Annex III of IMF Country Report No. 20/322). In particular, short-term dynamics are driven by changes in the NEER. Thus, exchange rate depreciation has increased the impact on inflation from recent increases in fuel and commodity prices.

6. Strong growth in remittances, resilient exports, and a pick-up in tourism further supported the economic recovery (Figure 2, Table 2). Net money transfers increased by 35.8 percent (y-o-y) in January through July. High frequency data on goods trade showed that for January through July exports grew 27.8 percent (in dollar terms, y-o-y, driven by copper ores and motor cars), although import growth of 19.3 percent (mostly driven by imports of industrial supplies and capital goods) led to the trade deficit increasing by 13.3 percent. The tourism sector also showed signs of faster-than-expected recovery, driven not only by foreign but also domestic tourists.

7. Recently, the lari has appreciated against the US dollar and the NBG paused interventions. Given high dollarization, the exchange rate against the US dollar remains a key indicator of threats to financial stability and inflation expectations. Between February 2020 and April 2021, the lari depreciated by 20.5 percent against the US dollar, before appreciating 9.0 percent in May-July 2021. Having sold US$ 248.1 million in January – April 2021, the NBG intervened only a few times since then, including selling US$ 30 million in August. As of end-July 2021, gross international reserves stood at a relatively high US$ 3.9 billion, reflecting among other factors significant donor support that more than offset interventions. A USD 500 million Eurobond was refinanced in April at a historically low rate (2.75 percent for 5 years compared to 6.875 percent for the previous 10-year bond), helping to contain interest costs and reduce pressure on reserves. Since February 2020, the lari has depreciated by 2.5 percent in nominal effective terms and appreciated by 0.8 percent in real effective terms.[5]

Lari Developments and NBG's FX Intervention



Source: NBG, Haver, and IMF staff calculations.
Note: NBG sales in 2020 amounted to USD 873 Million. Total sales in 2020 and 2021 were USD 1,146 million.

8. Stronger revenues are helping to finance higher spending, including for COVID-19 expenses (Text Table 1[6], Table 3, Figure 3). The initial 2021 budget was expected to deliver a deficit of around 7½ percent of GDP—a mildly contractionary stance but still providing around 2.2 percent of GDP in COVID-19 tax relief and spending measures. With the accelerating economic recovery, there has been strong growth in tax receipts since April.[7] Higher VAT refunds, which have risen since the automatic system was implemented in November 2020, have been more than offset by growth in other (gross) tax revenues (text chart).[8] Driven by higher revenues, the deficit in

[5] The NEER and REER changes are through July 2021. The depreciation against the US dollar has been offset by significant appreciation relative to the Turkish lira (23 percent) and the Russian ruble (5 percent).

[6] In Text Table 1, the adopted and amended budget (columns 4-8) reflect the authorities' numbers for GDP and revenues (rather than IMF staff projections).

[7] VAT revenues during April-July on average increased by 60 percent year-on-year (reflecting the lockdown a year earlier), and by around 14 percent relative to 2019.

[8] VAT refunds have averaged GEL 150 million over January-July, helping provide additional liquidity to the nonfinancial sector.

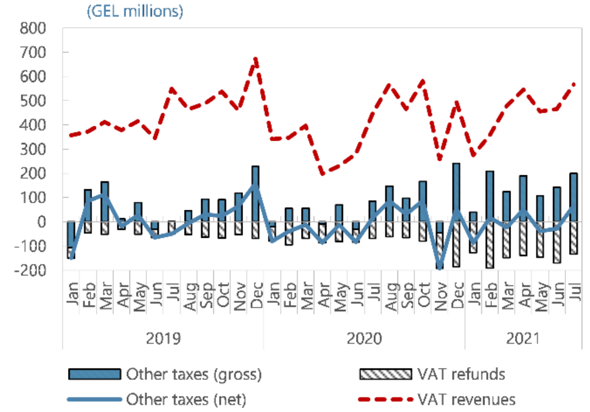
January-July 2021 declined by 0.6 percentage points of GDP compared to 2020, despite higher COVID-related spending, and would have fallen by 1.2 percentage points y-o-y (from -2.8 percent of GDP to -1.5 percent) in the absence of COVID-19 fiscal measures. A supplementary budget, totaling GEL 1.2 billion in additional spending, including for substantially higher COVID-related expenses,[9] and nearly equivalent to the expected increase in revenues, has been adopted by the Parliament. Two-thirds of the 2.9 percent of GDP pandemic support package envisaged for the year (including the supplementary budget) has been disbursed as of July 2021, with several temporary support schemes expiring in June 2021. Reflecting stronger growth, the deficit as a percent of GDP would fall to 6.5 percent.

Text Table 1: Budget Execution, Jan-Jul 2020/21

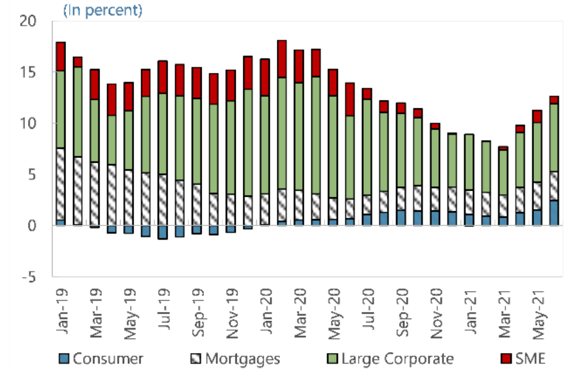
	Jan-Jul 2020		Jan-Jul 2021		MOF 2021 Budget: Adopted Budget		MOF 2021 Budget: Amended Budget	
	GEL mls	% of GDP	GEL mls	% of GDP	GEL mls	% of GDP	GEL mls	% of GDP
Revenues and grants	6,734	13.6	8,127	14.1	13,402	25.1	14,579	25.5
Taxes	5,982	12.1	7,144	12.4	12,045	22.5	12,922	22.6
of which: VAT revenues	2,537	5.1	3,187	5.5	-	-	-	-
of which: Other taxes (net)	-299	-0.6	-45	-0.1	-	-	-	-
of which: VAT refunds	-501	-1.0	-1,055	-1.8	-	-	-	-
of which: COVID-19 tax relief	-174	-0.4	-263	-0.5	-270	-0.5	-270	-0.5
Other revenues	689	1.4	763	1.3	1,000	1.9	1,200	2.1
Grants	63	0.1	219	0.4	357	0.7	457	0.8
Primary current spending	6,592	13.3	7,728	13.4	12,474	23.3	13,536	23.7
of which: COVID-19 fiscal measures	483	1.0	947	1.6	977	1.8	1,344	2.3
Interest expense	473	1.0	520	0.9	933	1.7	883	1.5
Net acquisition of non-financial assets	1,713	3.5	1,900	3.3	3,986	7.5	4,140	7.2
Capital spending	1,816	3.7	2,117	3.7	4,236	7.9	4,620	8.1
Privatization	-103	-0.2	-217	-0.4	-250	-0.5	-480	-0.8
Net budget lending	13	0.0	27	0.0	91	0.2	-55	-0.1
Augmented balance	-2,057	-4.2	-2,048	-3.6	-4,082	-7.6	-3,925	-6.9
Memo items:								
Nominal GDP					53,443		57,201	
Augmented balance excl. COVID-19	-1,399	-2.8	-838	-1.5	-2,835	-5.3	-2,311	-4.0
Primary current spending excl. COVID-19	6,109	12.4	6,781	11.8	11,497	21.5	12,192	21.3

Source: National authorities and IMF staff estimates.

VAT Revenues, Other Taxes and VAT Refunds
(GEL millions)



Decomposition of Credit Growth
(In percent)



Source: National authorities, NBG, and IMF staff calculations.

[9] Additional spending in the supplementary budget includes GEL 445 million in COVID-19 healthcare costs, GEL 177 million in support to agriculture, GEL 75 million in social benefits to vulnerable families with children, GEL 255 million in capital spending, and GEL 260 million in a range of other spending items.

9. The NBG has tightened monetary policy, putting downward pressure on the pace of credit growth. Since March 2021, the NBG has raised its policy rate by a cumulative 200 basis points (with the latest increase on August 4th), more than offsetting the 100 bps in rate cuts in 2020 and bringing the policy rate to10.0 percent, its highest level since 2008. Credit continued to grow through the crisis, but at constant exchange rates slowed to 7.7 percent (y-o-y) in March before picking up in the second quarter notwithstanding the tightening in rates.

10. The banking system appears to be weathering the aftermath of the COVID-19 shock well (Figure 4, Tables 4-5). In the first half of 2021, profits rebounded strongly and the capital adequacy ratio recovered to 19.2 percent. NPL provisioning stood at 80 percent, while the level of NPLs declined to 6.7 percent by July reflecting some improvement in retail and SME loan portfolios.[10] In an effort to reduce deposit dollarization, the NBG modified its minimum reserve requirements on FX deposits, implying a small relaxation.[11]

OUTLOOK AND RISKS

11. Near-term growth prospects have significantly improved, but output levels are expected to remain below their pre-pandemic trajectory. Assuming accelerating vaccinations and a continued rebound in tourism, a strong V-shaped recovery is expected to be sustained, supported by robust credit growth. The output gap is now expected to close by 2023, faster than previously forecast. Projected medium term growth rates, however, still imply that output will not reach its pre-pandemic trend.

12. Inflation pressures are expected to ease next year. Inflation at end-2021 is projected to be 13.1 percent—well above the NBG's target—due especially to the combined effect of past depreciation of the lari, the adjustment of utility prices earlier this year, and high commodity and food prices. It is expected to decline below the target by the end of next year as these temporary effects fade.

13. The current account deficit is expected to gradually narrow as tourism recovers. A gradual post-pandemic recovery in tourism is expected to help bring the current account deficit from 10 percent of GDP in 2021 to 5.5 percent by 2026 (the historically low level it attained in 2019), and it is expected to continue to be financed primarily by foreign direct investment (FDI). This would

[10] NPL figures reflect the NBG's more stringent definition. NPLs under the traditional IMF definition have remained below 3 percent (see Table 5).

[11] Effective July 1, 2021 the minimum reserve requirements will vary between 25 percent (for banks with deposit dollarization above 70 percent) and 10 percent (for those with deposit dollarization below 40 percent). Between the maximum and minimum thresholds, the requirement will be reduced by one percentage point for every two percentage point reduction in deposit dollarization. Previously the reserve requirement was 25 percent regardless of the dollarization level.

ensure that foreign exchange reserves remain near or above 100 percent of the ARA metric throughout the forecast horizon and reach 109 percent by 2026.[12]

14. While risks to the outlook are balanced, they are significant and contribute to greater than usual uncertainty (Annex II). COVID-19 variants or vaccination delays could derail the recovery by requiring new lockdowns and reducing external demand. Renewed political uncertainty could increase lari volatility, undermine investment and confidence, and hinder structural reform efforts. Significant external vulnerabilities remain. Further lari depreciation could increase inflation pressure and threaten financial stability given high dollarization. Depreciation could also pose vulnerabilities for public debt, given the high share that is denominated in foreign currency (Annex III). Large current account deficits leave Georgia vulnerable to unexpected shortfalls in financial inflows. On the upside, if efforts to control COVID-19 are successful, the recovery could be stronger than expected due to still sizeable fiscal support, pent-up demand, and faster than expected growth in tourism.

POLICY DISCUSSIONS

The consultation focused on policies to respond to the pandemic and strengthen growth and resilience. Staff recommended: (i) continued focus on policies to address challenges from the pandemic and reduce risks; (ii) clarifying adjustment plans to comply with the fiscal rule and build resilience; (iii) maintaining an appropriately tight monetary stance to address inflation risks; (iv) addressing fiscal risks as crisis support is unwound; and (v) structural measures to strengthen growth and inclusiveness.

A. Rebuilding Fiscal Buffers and Controlling Risks

Achieving Compliance with the Fiscal Rule

15. As the economy recovers, fiscal policy should seek to unwind crisis support measures and reduce the deficit and debt. Notwithstanding the supplementary budget, the fiscal policy stance in 2021, relative to 2020, remains mildly contractionary, which is appropriate and consistent with the V-shaped recovery. In the authorities' supplementary budget, expected new revenues[13] will largely finance additional spending (see ¶8). Staff had advised saving at least half of the expected revenue increases due to the better outlook, which would have enabled somewhat faster progress on the fiscal consolidation required to comply with the fiscal rule by 2023 and provided a buffer against risks while maintaining a mildly contractionary stance. The new spending limits room for maneuver in case downside risks materialize. Staff therefore advised that should additional outlays be needed, for example if the pandemic intensifies, these should be offset through spending

[12] The baseline projections include the impact of an SDR allocation of US$ 286 million approved in August 2021. The authorities have indicated that they do not intend to use the additional SDRs in the near term and will include them as reserves.

[13] Higher revenue projections result chiefly from increased tax revenues, consistent with the economic recovery, as well as non-tax revenues (e.g., interest, dividends, and revenue from legal entities of public law (LEPLs)). Higher privatization proceeds (GEL 230 million) will also partially help create space for additional capital spending.

reprioritization to avoid a more abrupt consolidation in 2022-23.[14] Conversely, if there is further revenue overperformance, extra revenues should be used to reduce the deficit. Staff welcomed that the supplementary budget prioritized the COVID-19 health response, social transfers to vulnerable families with children[15], and some existing development needs (e.g., capital spending), but noted that some permanent measures will add to medium-term spending pressures. Staff also encouraged assessing the performance of social safety nets during the crisis and the scope to improve targeting and automatic stabilization properties.

16. The authorities remain committed to complying with the fiscal rule but medium-term consolidation plans backload new adjustment measures. Staff welcomed the commitment to the fiscal rule, which is essential as an anchor for the credibility of fiscal policy and macroeconomic stability. Accordingly, staff broadly supported the authorities' intention to bring the deficit down by unwinding temporary COVID-19 support measures as the economy recovers, containing current spending pressures, and if needed until additional fiscal space is created, reducing capital spending in the medium run from a record-high level in 2020 as major infrastructure projects are completed. The baseline scenario assumes a gradual fiscal consolidation path starting in 2021, with the deficit narrowing to 6.5 percent of GDP (from 9.2 percent in 2020), and reaching 3.6 and 2.6 percent in 2022 and 2023, in compliance with the fiscal rule requirements. Since approximately 2.4 percent of GDP in temporary COVID-19 fiscal support should end in 2022, more of the remaining adjustment is focused on 2023 (Text Table 3). Staff therefore advised faster deficit reduction in the 2022 budget to smooth the need for new fiscal measures over the next years to safeguard compliance with the fiscal rule, which would help create future policy space.

Text Table 2: Key Fiscal Indicators, 2020-23

(Percent of GDP)

	Actual	Proj.		
	2020	2021	2022	2023
Revenues and grants	**25.1**	**25.7**	**26.1**	**26.1**
of which: Covid-19 tax exemptions	*-0.7*	*-0.5*	*0.0*	*0.0*
Primary current spending	**24.7**	**23.5**	**21.4**	**21.3**
of which: Covid-19 spending	*2.9*	*2.3*	*0.5*	*0.2*
Health-related	*0.7*	*1.4*	*0.5*	*0.2*
Support to households and businesses	*2.2*	*0.9*	*0.0*	*0.0*
Interest expense	**1.6**	**1.5**	**1.3**	**1.4**
Net acquisition of non-financial assets	**8.1**	**7.2**	**7.0**	**6.1**
Capital spending	8.6	8.0	7.4	6.4
of which: Covid-19 health equipment	*0.1*	*0.1*	*0.0*	*0.0*
Privatization	-0.4	-0.8	-0.4	-0.4
Net lending/borrowing	**-9.2**	**-6.5**	**-3.6**	**-2.6**
Memorandum items:				
One-off Covid-19 fiscal measures	3.8	2.9	0.5	0.2
Change in NLB	-7.4	2.7	2.9	1.0
Change in one-off Covid-19 measures	-3.8	0.9	2.4	0.3
Other fiscal adjustment	-3.6	1.8	0.5	0.7
General government gross debt	**60.0**	**54.2**	**53.6**	**52.1**

Source: National authorities and IMF staff estimates.

17. Additional fiscal policy space will be needed to meet the authorities' medium-term objectives. Ambitious capital spending plans to address development needs including

[14] In the event of a downside scenario, staff estimates an additional 0.5 percent of GDP in targeted cash transfers to vulnerable households could be offset by spending reprioritization (including capital spending).

[15] The social assistance to vulnerable families with children was doubled to GEL 100 per child per month and the threshold increased to 120,000. This measure will cost the budget GEL 75 million in 2021 (for six months) and GEL 150 million per year afterwards.

infrastructure[16], current spending pressures (including for education, pension, and health outlays[17]) which could increase also due to recent high inflation, and fiscal risks – stemming from state-owned enterprises (SOEs), public-private partnerships (PPPs) and power purchase agreements (PPAs) – could further increase adjustment needs and add to medium-term fiscal policy challenges (Annex IV). Staff supported the authorities' plans to postpone the introduction of an education spending floor of 6 percent of GDP (which would increase education spending by about 50 percent), and argued for a more gradual increase to reflect capacity constraints and the evolution of key education needs. Staff also welcomed the authorities' plans to comprehensively review tax expenditures by end-2021 including VAT and income tax expenditures. Strengthening tax administration (including by enhancing tax compliance, Annex IV), streamlining tax incentives and expenditures, and addressing distortions in the current system, would help create additional fiscal space.[18] Over the medium term, a more comprehensive tax policy review, including with the help of IMF TA, could be considered to identify options for revenue mobilization. Any tax policy changes should be carefully calibrated and accompanied by targeted social support to cushion the impact on vulnerable segments of the population, given the already regressive current flat-tax system.

Authorities' Views

18. The authorities broadly agreed with the need for gradual fiscal consolidation and creating additional fiscal space. However, they did not see scope to save more of the currently expected revenue increases in the supplementary budget, noting that close to 40 percent of additional spending was due to higher-than-envisioned COVID healthcare costs. The authorities agreed with staff's recommendation to save revenue increases beyond those projected in the supplementary budget in an upside scenario and to reprioritize spending in a downside scenario. The authorities agreed that additional fiscal space will be needed to meet the government's medium-term objectives, including by raising revenues through improved tax administration, but saw more scope to contain current spending to make space for higher capital expenditures.

Controlling Fiscal Risks

19. Building on substantial progress in disclosing SOE fiscal risks, the authorities should continue to advance efforts to manage and mitigate them through SOE reform. The unsatisfactory financial performance of SOEs, as highlighted by successive Fiscal Risk Statements, has led the authorities to seek a comprehensive reform strategy. To improve transparency and accountability, the authorities carried out a sectorization exercise of SOEs (becoming the first country in Central Asia and Eastern Europe to do so), and plan to include all non-market SOEs in

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[16] The December 2020 government program indicates its objective to maintain capital spending at 8 percent of GDP in the medium term.

[17] COVID-19 healthcare spending is projected to fall from 1.4 percent of GDP in 2021, to 0.5 percent in 2022, and remain at 0.2 percent thereafter, covering (single dose) vaccination costs each year. Additional healthcare costs are expected due to population aging.

[18] For example, the tax rate imbalances between the self-employed and wage earners make the system difficult to administer and negatively affect tax compliance.

general government fiscal reporting starting in 2021. The authorities also plan to reform governance of public corporations (PCs) in line with OECD principles.[19] Staff encouraged the authorities to publish the strategy, pilot it in additional SOEs, and adopt a framework PC law.

20. Strengthening control over other fiscal risks is also essential. To this end, staff highlighted the importance of strengthening the public investment management (PIM) framework, which does not cover all the projects, and better integrating off-budget investments (PPPs, PPAs and PCs) into the budget process. As an example, external independent reviews could be undertaken before major infrastructure projects over a defined threshold amount are considered for implementation. Further expanding annual Fiscal Risk Statements (FRS) by disclosing risks from individual PPA projects as well as covering environmental, social (e.g., demographics), and governance (ESG) risks would help improve decision-making. To contain fiscal risks in the power sector, clear criteria should be specified in advance for any deviations from the feed-in premium scheme. Staff continued to argue for dismantling the Partnership Fund given its non-commercial objectives.

Authorities' Views

21. The authorities reiterated their determination to contain fiscal risks. They plan to further enhance the annual FRS and are determined to continue SOE governance reform in line with OECD principles. The authorities plan to publish the SOE governance reform strategy, increase the number of pilot cases, and adopt a PC framework law. They are committed to improving public investment management. The authorities also committed to refrain from exceptions to the feed-in premium for new PPAs until criteria for exceptions are clearly defined. The authorities remain committed to limiting the operations of the Partnership Fund, and plan to incorporate it in the general government.

B. Achieving the Inflation Target

22. A moderately tight monetary policy stance is essential to keep inflation expectations anchored. Staff supported recent policy rate increases, which constrained credit growth and kept the monetary policy stance moderately tight. The drivers of the recent inflation increase (see ¶s 5 and 9) appear to be temporary and core inflation has been contained relative to headline prices. The NBG's current stance is appropriate and along with recent exchange rate appreciation should help ensure that the effects of these temporary factors are indeed transitory. With the faster than expected economic rebound, strong imports could lead to reemergence of depreciation—a key driver of inflation pressures. On the other hand, a recovery in tourism—the collapse of which was a

[19] A draft strategy has been finalized with IMF TA support in May 2021 and is being implemented in pilot form at Georgian State Electrosystem (GSE), where an independent and merit-based Board has been appointed. The strategy requires PCs to (i) operate with commercial objectives and on a competitively neutral basis, (ii) comply with good corporate governance practices (e.g., independence of board members), (iii) define the financial and non-financial objectives to be achieved within specified risk thresholds, serving as a performance framework, and (iv) be supervised in line with an ownership policy statement to be developed and published by government authorities.

key factor in the widening of the current account deficit and earlier depreciation pressure—could push in the opposite direction. Risks to inflation are tilted to the upside, and the NBG should continue to increase rates if inflation expectations and/or core inflation do not decrease in line with expectations. Otherwise, there would be a risk of higher inflation expectations becoming entrenched and sharper tightening later being necessary with a more adverse impact on the economy.

23. Inflation-targeting and exchange rate flexibility have helped Georgia adjust to the crisis. Georgia's external position in 2020 was broadly in line with the level implied by fundamentals and desirable policies. However, external vulnerabilities have increased relative to 2019 given the massive hit to tourism, the expectation that recovery in the sector will take a few years, and the build-up of external debt (Annex V). Gross international reserves are expected to decline from 108 to 99 percent of the ARA metric in 2021 as exceptional donor support moderates before rising to 109 percent at the end of the forecast horizon. With still considerable financial dollarization, the NBG should continue prudent use of foreign exchange intervention as needed to avoid disorderly market conditions.

24. The authorities agreed with the assessment of the monetary policy stance and the external sector assessment. The NBG remains ready to increase rates as needed, although officials noted that in a dollarized financial system the effectiveness of further monetary policy tightening may be limited as too high rates on lari loans may incentivize borrowing in dollars. The authorities agreed that FX sales should be used judiciously if needed to prevent disorderly market conditions.

C. Ensuring a Resilient Financial Sector

25. Stress tests conducted for the recent Financial Sector Assessment Program (FSAP) confirmed that banks are adequately capitalized. All credit losses stemming from the pandemic under a conservative baseline scenario over the next three years can be absorbed. Under the stress scenario of an extended pandemic and an adverse external financial environment, capital shortfalls are not deemed substantial and are assessed to be manageable from a systemic perspective. The FSAP also found that banks are sufficiently liquid, including in a stressed scenario of high deposit withdrawals. The resilience of the banking sector has benefited from the NBG's prudent supervision and comprehensive financial sector reforms (implementing the Basel III framework, introducing responsible lending regulations, and measures to address foreign exchange-related financial stability risks).

26. Financial sector policies should now aim to maintain adequate buffers and provisions in the banking sector, amidst signs of recovery. Precautionary provisioning in April 2020 sharply reduced bank profitability and capital buffers were subsequently released, although all banks remained above the minimum capital and liquidity requirements. In 2021, income from strong loan portfolio growth, reversal of provisions, and lari appreciation have all contributed to higher profitability and capital ratios. Some of these factors (appreciation, provisions) could be reversed in a downside scenario, e.g., if new lockdowns are needed. Therefore, staff urged the authorities to use available policy tools to preserve capital in the banking system, for example, by asking banks to minimize dividends and bonuses until recovery is more certain.

27. The authorities agreed that banks should consider the possibility that the pandemic deteriorates but did not see the need to restrict bank payouts as long as banks meet pre-COVID capital requirements. The authorities highlighted that banks made substantial ex ante loan loss provisions under the assumption that NPLs would peak at up to 10 percent, yet NPLs have declined from a peak of 8.5 percent in March 2021 and have been adequately provisioned. They attributed sustained credit growth and healthy bank profitability to government support to vulnerable households and businesses, loan moratoria, inflation, lari appreciation, and the rebound of economic activity. Inflation drove higher corporate turnover and therefore trade finance demand. Demand for mortgages did not drop even after the government interest rate subsidies expired in January 2021. The authorities therefore saw the current framework, under which payouts are restricted only for those banks that have not fully rebuilt capital buffers, as sufficiently prudent. They argued that further restrictions on dividends and bonuses would reduce the attractiveness of Georgian banks to investors, especially vis-à-vis peer countries that are relaxing restrictions.

28. Staff called for further strengthening the financial system by promptly dealing with problem loans. The recovery from the pandemic might drag on banks' profitability until risks from non-performing loans (6.7 percent of loans) and restructured loans (19 percent) are addressed.[20] Staff emphasized *ex ante* preparedness to deal with problem loans via effective implementation of the insolvency framework, and creation of a market for bad loans. Effective ways to deal with NPLs, such as prompt write-downs, and full provisioning without relying on real estate collateral would be important in reducing pandemic related uncertainty. Finalizing procedures for bank recovery and resolution, establishing early intervention arrangements for banks including preparations for a bridge bank, and ensuring backup funding arrangements for the deposit insurance scheme are also important.

29. The authorities plan to further strengthen financial safety nets in line with the FSAP recommendations. The NBG is developing a prompt corrective action framework for banks and taking steps to be able to swiftly implement a bridge bank. The operational framework for the bridge bank will be agreed with the Ministry of Finance (MOF) and implemented within the suggested time horizon of 2-3 years. The NBG will also seek to develop legislation on minimum required eligible liabilities (MREL) with the help of the IMF.

30. Staff discussed NBG plans to reduce dollarization and noted that the recent modification to the differentiated reserve requirements for FX deposits could be a useful step. The authorities have put in place a nearly complete arsenal of measures to reduce dollarization, which has declined slowly but steadily.[21] Staff and the authorities agreed that high levels of loan and

[20] Figures are as of July 2021.

[21] These include more stringent LTV and PTI requirements for unhedged borrowers in FX; the introduction of a currency-induced credit risk (CICR) pillar 2 capital buffer; an outright ban on FX loans below 200,000 GEL for

(continued)

deposit dollarization, although common in many emerging markets, continue to complicate monetary policy and increase financial stability risks. In line with the FSAP conclusions, staff argued that further measures to reduce loan dollarization should be informed by a thorough impact assessment and dependent on progress in reducing deposit dollarization.

31. Policies to develop fintech and digital currencies should balance benefits with risks. The NBG is moving ahead with its central bank digital currency (CBDC) project and aims to choose a technology provider by the end of this year. The implementation and the timeline of the project will depend on the outcomes of the trial phase. If implemented, CBDC could help reduce transaction costs by offering an alternative to relatively expensive global card payment systems, and increase payment speed and efficiency, especially for SMEs in rural areas. As a side benefit, CBDC could encourage further development of fintech products and a wider fintech ecosystem in Georgia. Staff noted risks such as those related to liquidity for banks from deposit outflows, privacy concerns, and cybersecurity issues. Also, cryptocurrency is an unregulated sector and hence not currently subject to AML/CFT rules. Staff stressed the importance of adopting legal and regulatory framework for licensing and AML/CFT supervision[22] of virtual asset service providers.

32. The NBG noted that safeguards for virtual asset service providers (VASPs) will be in place and that AML/CFT regulation will be strengthened. The NBG has developed a draft AML/CFT regulation for virtual asset service providers and plans to publish it for public consultations. After the legislative amendment on AML/CFT regulation and supervision of VASPs is in force, the NBG will start working on ensuring implementation of AML/CFT preventive measures including the so-called "travel rule" requiring that VASPs obtain, hold, and exchange information about the originators and beneficiaries of transfers, which so far is not widely implemented internationally.

D. A Stronger and More Inclusive Recovery

33. Staff called for a renewed structural reform agenda to attract foreign direct investment and diversify exports, increase productivity, and address high unemployment and inequality. Georgia has made significant progress in strengthening its business environment and improving governance. For example, procedures for starting a business, registering property, or paying taxes, have been modernized and simplified. The most recent Public Investment Management Assessment highly rates institutional design and effectiveness of public procurement. There likely are no "quick wins" in the near-term. However, reforms are still needed to expand economic opportunities and increase potential growth, as well as to foster the creation of more (and more productive) jobs to lessen outward migration of skilled human capital.

households, corporates and SMEs; an LCR requirement for banks in FX; higher reserve requirements on bank FX liabilities and associated penalty rates of remuneration.

[22] Staff also encouraged the authorities to improve the effectiveness of AML/CFT system, especially in macro-critical areas such as targeted financial sanctions and beneficial ownership in line with the FSAP recommendations.

34. Education reform coupled with active labor market policies would help tackle entrenched unemployment and foster a more inclusive recovery. Unemployment in Georgia has been high by international standards and a large share of the labor force is employed in the agricultural sector, which contributes little to GDP (Annex VI). Staff and the authorities agreed that skills mismatches are a key driver of unemployment. Staff called for increasing access to quality education that is grounded in strong primary education, and more active labor market policies (ALMPs), particularly targeted vocational training, which would help bridge the skills gap, and assist the long-term unemployed by reducing information asymmetries and encouraging entry into the formal labor market.

35. Taking full advantage of trade opportunities requires continued investment in infrastructure. Addressing infrastructure gaps is a necessary element if Georgia is to realize its ambitions of becoming a transit hub, unlock additional tourism potential in less accessible regions, and facilitate exports, including of agricultural products. The authorities are committed to expanding Georgia's road and transportation infrastructure and have made substantial progress on the key East-West highway. Strengthening the PIM process (¶20) should help to maximize the impact on potential growth of capital spending. The authorities are also conducting a feasibility study for a cable under the Black Sea to strengthen regional electricity and internet connectivity.

36. Structural fiscal measures are important for enhancing governance. In addition to strengthening PIM, regular Fiscal Risk Statements, the recent sectorization exercise for SOEs as well as SOE reforms, and commitments under the EFF arrangement to continue to limit the operations of the Partnership Fund will help control risks and support further governance improvements.

37. Legal and judiciary reforms are important for resource reallocation in the aftermath of the crisis and for strengthening governance and the business environment. The law on Rehabilitation and Collective Satisfaction of Creditors, which recently came into effect, significantly modernized and strengthened the insolvency framework. To support the implementation of the new framework, the authorities have introduced regulations for insolvency professionals and started training and certification of insolvency practitioners in April 2021 with the first graduates expected to be certified by October 1st. More broadly, staff noted that a transparent and efficient judiciary system is essential for good governance and the business environment, and underscored the importance of judiciary reforms. The authorities have taken a number of steps to modify and make more transparent processes for judicial appointments, drawing on Venice Commission recommendations, although the Venice Commission and some development partners have signaled scope for further improvements.

38. The authorities broadly agreed with the key priorities for structural reform. They are preparing a 10-year Development Plan touching on a wide range of structural reform priorities, which is expected to be released soon. The authorities noted that ongoing work on education reform has been delayed by the need to focus on the COVID-19 pandemic, but they are engaging with development partners in this area. Furthermore, the authorities, in cooperation with international donors, are currently engaging in a comprehensive review of social and labor policies, which should consider the need for and modalities of additional ALMPs. The authorities pointed to important reforms in the energy sector such as continued progress in liberalizing the energy market and unbundling of energy generation from transmission. Capital market development was acknowledged as another priority. Finally, the authorities noted that they continue working on free trade agreements with South Korea, Israel and other countries, which should further increase opportunities for private sector development.

STAFF APPRAISAL

39. The COVID-19 crisis took a heavy toll on the economy. After growing strongly in the years before the crisis, the economy suffered its largest output contraction since the 1990s reflecting domestic mobility restrictions necessary to control the pandemic and a slowdown in tourism. Poverty and unemployment also rose, undoing much of the progress of recent years. The authorities appropriately responded by strengthening healthcare and providing substantial assistance to vulnerable households and businesses, aided by sizeable donor support**.**

40. The economy is now bouncing back in a V-shaped recovery. Recent impressive momentum has been supported by robust growth in remittances and exports, early signs of a faster than expected rebound in tourism, and pent-up demand. COVID-19 case numbers are rising sharply and the pandemic remains a key risk. The recovery will be secure, only if a strong pace of vaccinations is sustained.

41. As the recovery proceeds, fiscal policy should shift toward unwinding crisis support measures and bringing down the deficit and debt. The pandemic led to sharp rises in the fiscal deficit and debt reflecting the cost of fiscal support and declines in revenues. Fiscal policy should remain anchored by Georgia's fiscal rule, which has been a source of policy credibility. With new revenues from the improved outlook for 2021 largely financing additional healthcare costs as well as capital and other spending, it is critical that any further revenue increases are saved to speed progress on fiscal consolidation to comply with the fiscal rule by 2023 and provide a buffer against risks. Some of the new adjustment needed to comply with the fiscal rule (beyond the unwinding of COVID-19 measures) should be included in the 2022 budget to avoid backloading new measures to 2023.

42. Rising spending pressures and fiscal risks require efforts to expand fiscal space, further strengthen the fiscal framework, and continue with comprehensive SOE reforms. Ambitious capital spending plans, rising current spending pressures including for education, pension, and health outlays, along with fiscal risks stemming from SOEs and PPAs could further increase fiscal adjustment needs and add to medium-term fiscal policy challenges. Strengthening the public investment management framework would help boost the efficiency of capital spending and maximize growth benefits. Additional revenue could be generated by undertaking a comprehensive review of tax expenditures and further strengthening tax administration. Efforts to manage and mitigate risks should continue with comprehensive reform of SOE governance essential.

43. Monetary policy should guard against temporarily high inflation becoming entrenched. The recent increases in the monetary policy rate were appropriate to help ensure that the temporary effects of commodity price increases and supply constraints remain transient and that inflation expectations stay anchored. With recovery now faster than expected, risks to inflation are tilted to the upside, and the NBG should hike rates further if inflation expectations or core inflation suggest high inflation risks becoming entrenched.

44. Overall, the inflation targeting framework and floating exchange rate regime have helped Georgia adjust to the COVID-19 shock and remain appropriate. Georgia's external position in 2020 was broadly in line with the level implied by fundamentals and desirable policies. However, external vulnerabilities have increased relative to 2019 given the massive hit to tourism and recovery only over a few years, and the build-up of external debt. Considering risks, including due to financial dollarization, the NBG should continue prudent use of foreign exchange interventions to prevent disorderly market conditions. The recent introduction of differentiated reserve requirements on foreign exchange liabilities of banks could be a useful step to reduce deposit dollarization.

45. The NBG's prudent supervisory approach pre-crisis and decisive actions afterwards contributed to financial sector resilience and the banking system remaining adequately capitalized and liquid. Stress tests conducted for the recent Financial Sector Assessment Program (FSAP) mission confirmed that banks have sufficient capital to absorb credit losses stemming from the pandemic under a conservative baseline scenario over the next three years. Under the stress scenario of an extended pandemic and an adverse external financial environment, capital shortfalls are not deemed substantial and are assessed to be manageable from a systemic perspective. The FSAP also found that banks are sufficiently liquid, including in a stressed scenario of high deposit withdrawals.

46. Preserving sufficient retained earnings and dealing with problem loans are key priorities for the financial sector in the near-term. Given the larger than usual uncertainty about the outlook, the NBG should ask banks to preserve sufficient retained earnings until significant downside risks to the economy recede. Identifying effective ways to resolve non-performing loans including through utilizing the new insolvency framework or NPL sales should ensure that the crisis does not leave a legacy of bad loans.

47. The medium-term agenda for financial sector policies should build on the considerable progress of recent years. The FSAP suggested medium-term priorities for financial sector policies include implementing Basel regulations on banks' large exposures as planned; formalizing and enhancing supervisory processes; developing a prompt corrective action framework for banks; and taking steps to be able to swiftly implement a bridge bank if needed. Beyond financial stability, development of CBDC could offer opportunities to increase financial efficiency and inclusion, assuming that risks are addressed and a sound regulatory framework is developed.

48. Reinvigorating the structural reform agenda is vital to enhancing economic growth and making it more inclusive. Implementation of the recently adopted insolvency framework and training of insolvency professionals will help facilitate resource reallocation in the wake of the crisis. High unemployment levels and the associated inequality are longstanding challenges for Georgia exacerbated by the crisis. Renewed efforts to improve education and vocational training would help address skills mismatches in the labor market, and the authorities' planned review of the social protection system could complement these actions with strengthened active labor market policies aimed at tackling entrenched unemployment. Finally, continued structural fiscal and judiciary reforms are important to further strengthen governance and the business environment.

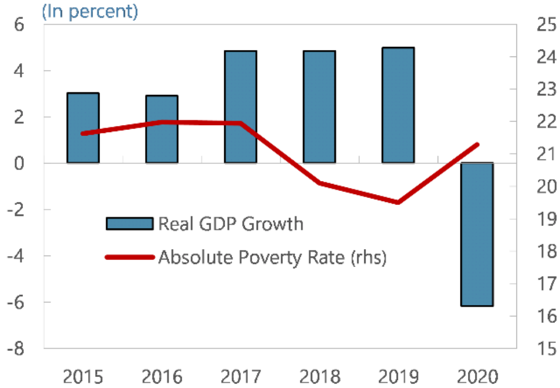
49. Staff recommend initiation of a Post Financing Assessment (PFA). Georgia's credit outstanding is 230 percent of quota, which triggers the expectation of PFA. While the authorities have indicated interest in a new Fund-supported program, the timing of a potential program is unclear.

50. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Georgia: Real Sector Developments

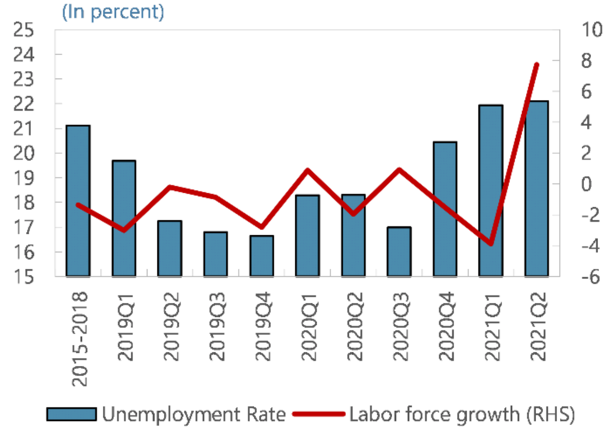
The COVID-19 crisis increased absolute poverty…

Real GDP Growth and Absolute Poverty Rate
(In percent)



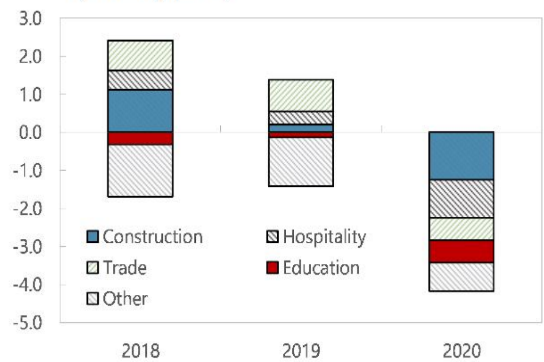
… and reduced employment and labor force participation.

Unemployment Rate and Labor Force Growth
(In percent)



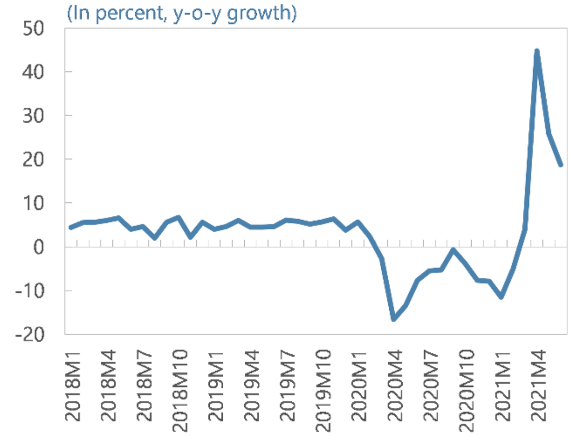
The loss in employment was driven by construction, hospitality and trade industries hurt by COVID-19.

Employment Growth by Economic Activity
(Percentage points)



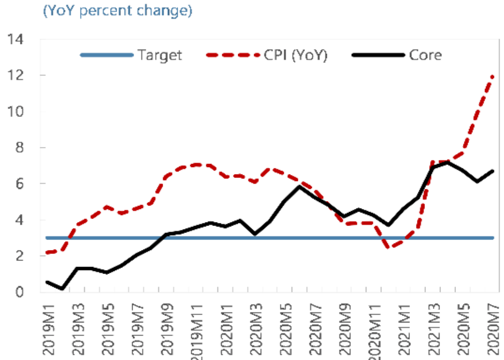
However, flash estimates now suggest a dramatic rebound in GDP growth.

Rapid Estimates of Real GDP Growth
(In percent, y-o-y growth)



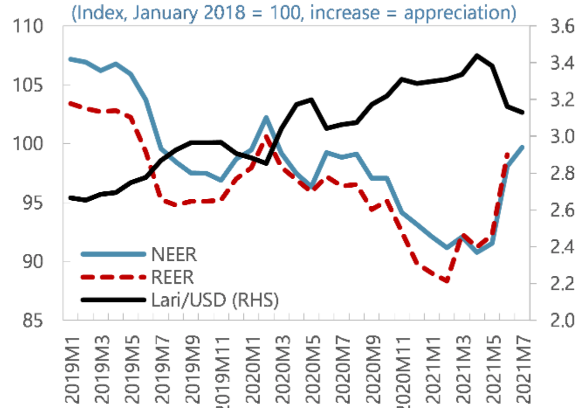
Headline inflation accelerated sharply, partly reflecting the removal of utility subsidies, and rising food and commodity prices…

Inflation: Headline and Core Inflation
(YoY percent change)



…plus lari depreciation against the dollar as well as in effective terms. .

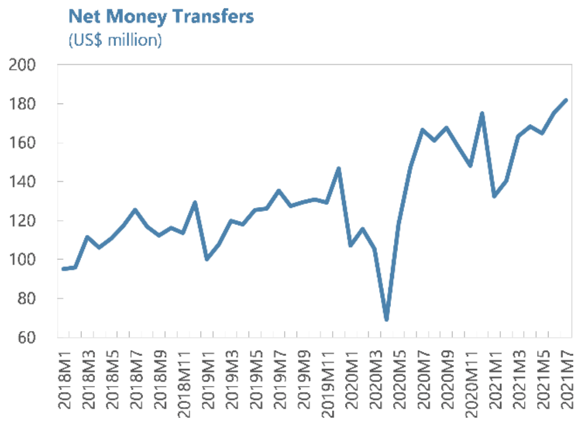
Nominal and Real Effective Exchange Rates
(Index, January 2018 = 100, increase = appreciation)



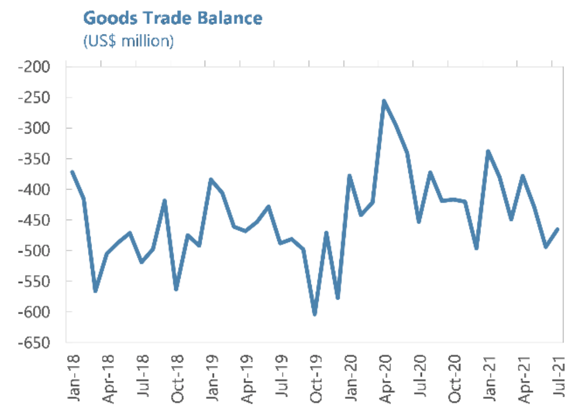
Source: National authorities, Haver, GEOStat, and IMF staff calculations.

Figure 2. Georgia: External Sector Developments

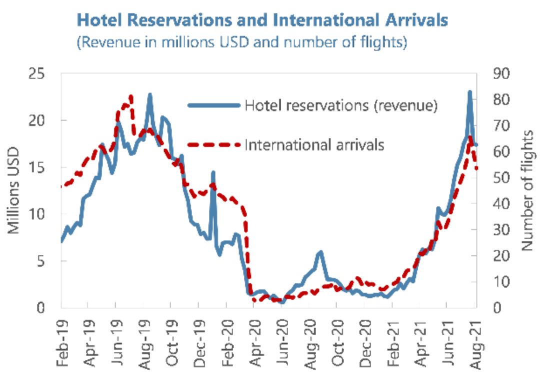
The increase in net money transfers has been sustained…



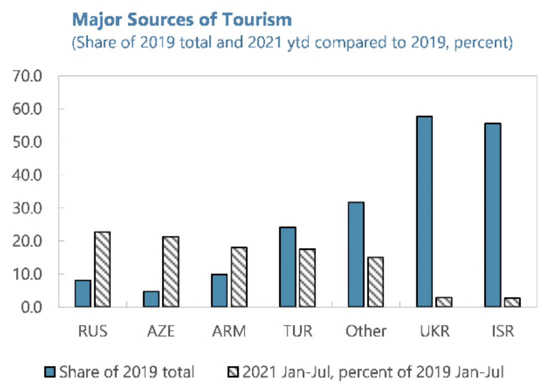
…as has much of the improvement in the goods trade balance.



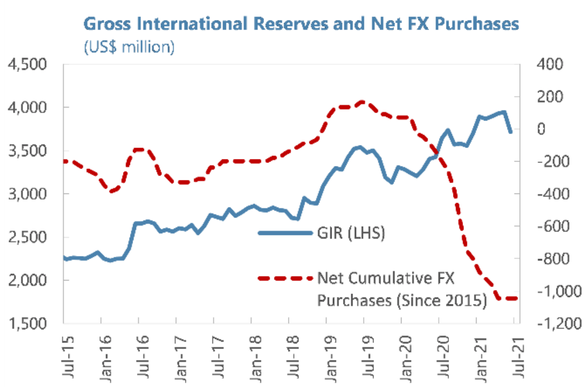
Hotel reservations and the number of flights rebounded before weakening again recently…



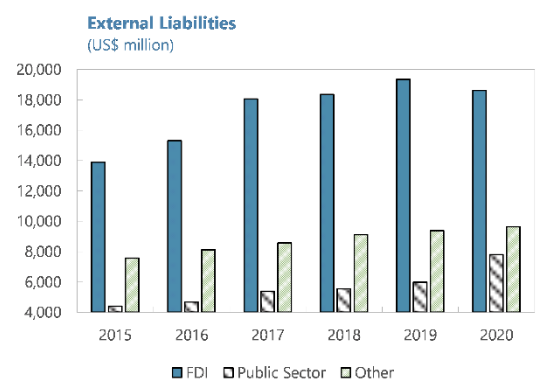
…and the major sources of tourism remain well below pre-COVID-19 levels.



Gross international reserves reached a record high, even as the NBG sold FX in 2020-2021…



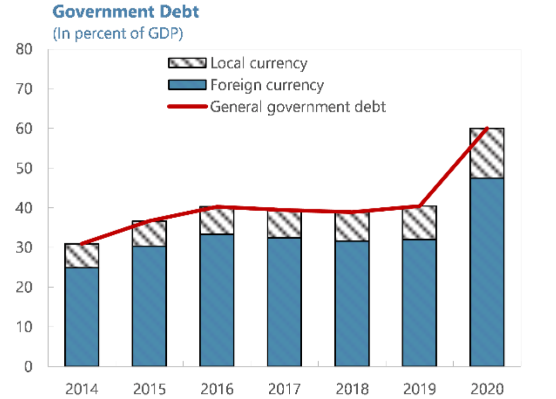
… supported by external borrowing (including IMF and donor financing).



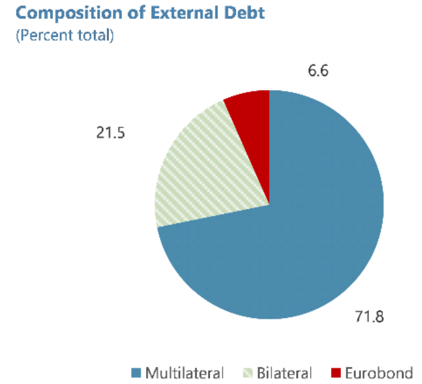
Source: National authorities, Haver, GeoStat, and IMF staff calculations.

Figure 3. Georgia: Fiscal Sector Developments

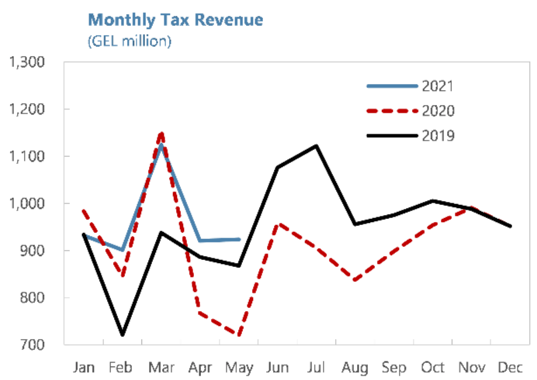
The COVID-19 crisis increased general government debt, which remains primarily FX denominated.



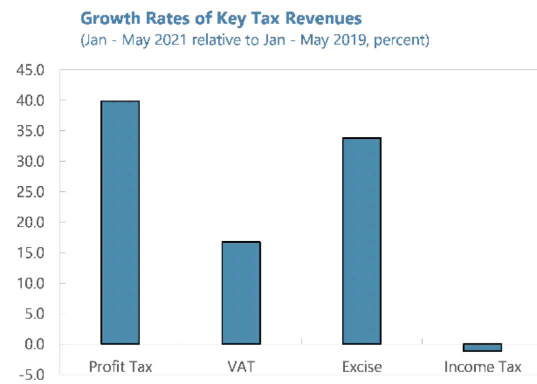
Most of the external debt is to bilateral and multilateral official creditors.



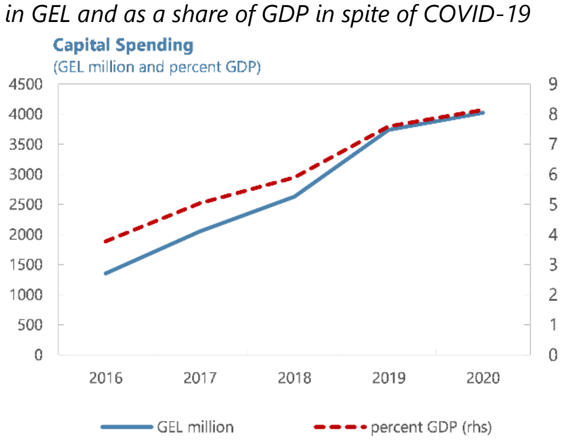
Revenue performance in 2021 has been strong so far…



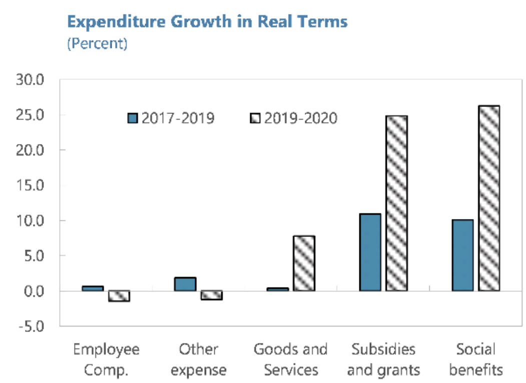
…driven by profit tax as well as VAT and excises (due to higher import prices).



Capital spending reached a record high in 2020 both in GEL and as a share of GDP in spite of COVID-19



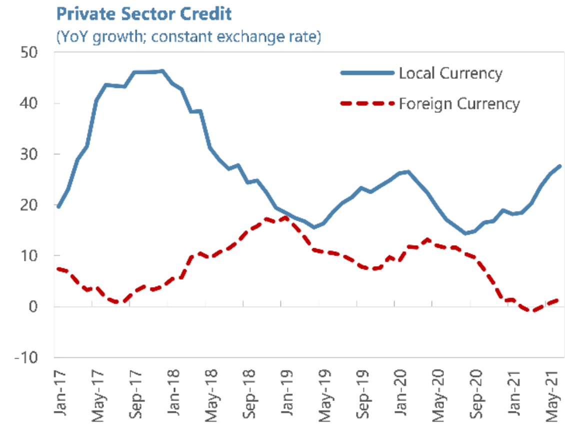
For current spending, the COVID-19 crisis increased real spending on subsidies and social benefits.



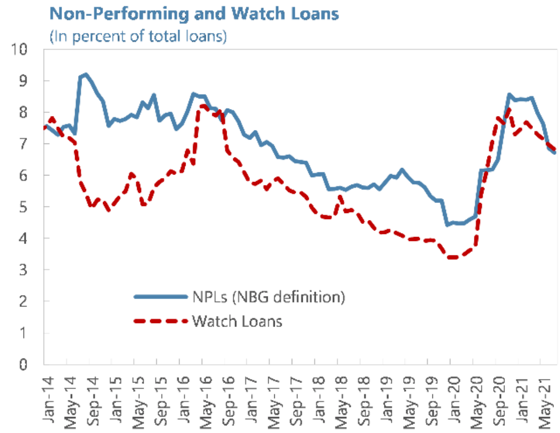
Source: National authorities, and IMF staff estimates.

Figure 4. Georgia: Financial Sector Developments

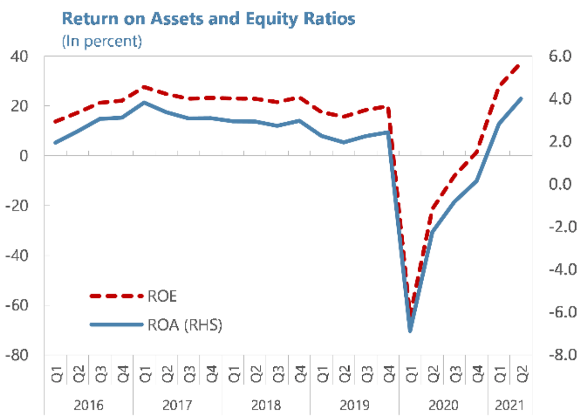
Private sector credit growth remained robust on account of local currency credit.



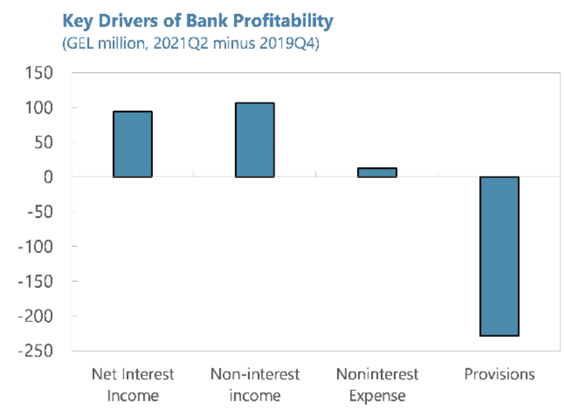
NPLs and watch loans have stabilized at levels close to those observed during the previous crisis.



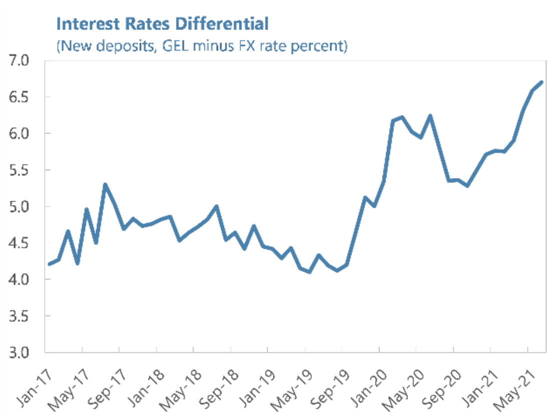
Bank profitability has recovered to pre-crisis levels….



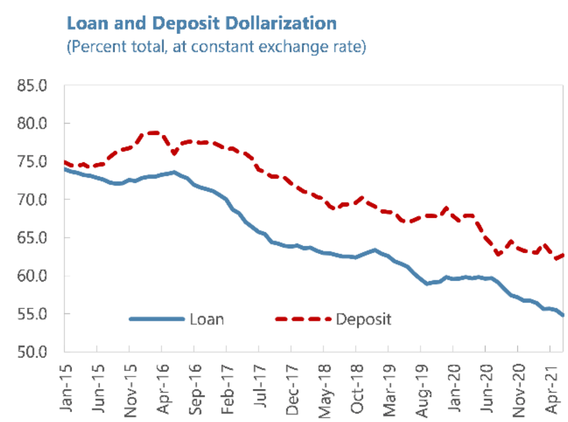
…owing to higher net interest income and lower provisions.



The interest rate differential between lari and FX deposits is at its highest level



Loan dollarization resumed its decline in the aftermath of COVID-19 shock, while deposit dollarization was more persistent.



Source: National Bank of Georgia, and IMF staff calculations.

Table 1. Georgia: Selected Economic and Financial Indicators, 2019–26

	2019	2020	2020	2021	2021	2022	2023	2024	2025	2026
	Actual	EFF 8th Review	Est.	EFF 8th Review			Projections			
National accounts and prices 1/			(annual percentage change; unless otherwise indicated)							
Real GDP	5.0	-6.2	-6.2	3.5	7.7	5.8	5.5	5.2	5.2	5.2
Output Gap	-0.6	-3.9	-3.9	-2.8	-1.0	-0.4	0.0	0.0	0.0	0.0
Nominal GDP (in billion of laris)	49.3	49.4	49.4	53.3	57.5	64.5	70.2	76.0	82.4	89.3
Nominal GDP (in billion of U.S. dollars)	17.5	15.9	15.9	16.2	17.8	19.7	21.6	23.6	25.8	27.9
GDP per capita (in thousand of U.S. dollars)	4.7	4.3	4.3	4.4	4.8	5.3	5.8	6.3	6.9	7.5
GDP deflator, period average	4.9	6.9	6.9	5.2	8.3	6.1	3.0	3.0	3.0	3.0
CPI, Period average	4.9	5.2	5.2	3.8	9.3	5.4	3.0	3.0	3.0	3.0
CPI, End-of-period	7.0	2.4	2.4	5.0	13.1	3.2	3.0	3.0	3.0	3.0
Core CPI, End-of-period	3.8	3.7	3.7	...	...	...	...	...	...	...
Investment and saving				(in percent of GDP)						
Gross national saving	19.8	14.6	13.7	13.2	15.6	17.0	17.2	17.2	16.9	16.7
Investment	25.3	26.9	26.2	24.1	25.6	24.6	23.4	22.9	22.4	22.2
Public	8.0	8.6	8.6	7.9	8.0	7.4	6.4	6.1	5.7	5.6
Private	17.3	18.4	17.6	16.2	17.5	17.2	17.0	16.9	16.7	16.6
Consolidated government operations				(in percent of GDP)						
Revenue and grants	27.1	25.1	25.1	25.2	25.7	26.1	26.1	26.0	25.9	25.8
o.w. Tax revenue	23.7	22.2	22.2	22.6	22.9	23.6	23.7	23.8	23.8	23.8
Expenditures	28.9	34.4	34.4	32.6	32.2	29.7	28.7	28.4	28.3	28.0
Expense	21.4	26.2	26.2	25.2	25.0	22.7	22.6	22.7	22.9	22.7
Net acquisition of non-financial assets	7.6	8.1	8.1	7.4	7.2	7.0	6.1	5.7	5.4	5.3
Capital spending	8.0	8.6	8.6	7.9	8.0	7.4	6.4	6.1	5.7	5.6
Privatization Proceeds	-0.4	-0.4	-0.4	-0.5	-0.8	-0.4	-0.4	-0.3	-0.3	-0.3
Net Lending/Borrowing (GFSM 2001)	-1.8	-9.2	-9.2	-7.4	-6.5	-3.6	-2.6	-2.4	-2.3	-2.2
Budget Lending	0.2	0.1	0.1	0.2	0.2	0.3	0.3	0.2	0.3	0.2
Augmented Net lending / borrowing (EFF definition) 2/	-2.1	-9.3	-9.3	-7.6	-6.6	-3.9	-2.9	-2.7	-2.6	-2.5
General government debt 3/	40.4	60.0	60.0	60.8	54.2	53.6	52.1	50.7	49.3	48.1
o.w. Foreign-currency denominated	32.0	47.5	47.5	49.6	43.9	42.1	39.3	36.8	34.1	31.1
General government debt net of government deposits 3/	37.5	53.6	53.6	57.5	50.7	50.9	49.4	47.9	46.5	45.4
Money and credit			(annual percentage change; unless otherwise indicated)							
Credit to the private sector	20.7	22.4	22.4	6.4	10.5	11.8	8.7	8.4	8.4	8.3
In constant exchange rate	16.1	9.0	9.0	5.5	14.0	8.5	8.8	8.6	8.6	8.2
Broad money	17.6	24.6	24.6	16.9	14.1	19.7	10.3	9.9	9.9	10.9
In constant exchange rate (estimate)	14.3	14.4	14.4	15.8	18.7	15.2	10.7	10.3	10.3	10.8
Broad money (excl. fx deposits)	18.8	18.8	18.8	17.7	16.8	19.5	11.5	11.1	11.1	12.0
Deposit dollarization (percent of total) 4/	64.0	67.5	61.4	67.0	66.7	66.2	65.6	65.0	64.4	63.5
Credit dollarization (percent of total)	55.4	55.7	55.7	55.0	55.0	54.9	53.9	52.9	51.9	50.9
Credit to the private sector (percent of GDP)	62.8	76.6	76.6	75.5	72.6	72.4	72.4	72.4	72.4	72.4
External sector				(in percent of GDP; unless otherwise indicated)						
Current account balance (in billions of US$)	-1.0	-2.0	-2.0	-1.8	-1.8	-1.5	-1.3	-1.4	-1.4	-1.5
Current account balance	-5.5	-12.3	-12.5	-10.9	-10.0	-7.6	-6.2	-5.7	-5.6	-5.5
Trade balance	-21.3	-19.8	-19.8	-18.9	-19.1	-18.1	-17.6	-17.1	-16.5	-15.9
Terms of trade, goods (percent change)	-0.7	5.2	5.8	-9.2	-2.1	0.5	2.2	2.1	0.8	-0.1
Gross international reserves (in billions of US$) 5/	3.5	3.9	3.9	3.6	3.8	4.0	4.3	4.7	5.0	5.2
In percent of IMF Composite measure (floating)	98.3	111.0	107.6	97.8	98.5	98.5	100.3	103.8	108.5	109.2
Gross external debt	106.6	124.8	129.5	133.9	116.8	111.8	108.4	104.1	99.9	93.2
Gross external debt, excl. intercompany loans	87.7	104.1	109.0	110.3	95.9	91.7	87.6	83.7	79.7	73.0
Laris per U.S. dollar (period average)	2.82	3.1	3.11	...	...	...	...	...	...	
Laris per euro (period average)	3.15	3.6	3.55	...	...	...	...	...	...	
REER (period average; CPI based, Jan 2010=100)	100.5	97.5	97.5	...	...	...	...	...	...	

Sources: Georgian authorities; and Fund staff estimates.

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

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

3/ Excludes domestic legacy debt amounting to 1.2 percent of GDP.

4/ Includes nonresident deposits.

5/ Includes IMF SDR allocation of $286 million approved in August 2021.

Table 2. Georgia: Balance of Payments, 2019–26

	2019	2020	2020	2021	2021	2022	2023	2024	2025	2026
	Actual	EFF 8th Review	Proj.	EFF 8th Review	Projections					
	(in millions of U.S. dollars)									
Current account balance	-957	-1,962	-1,984	-1,766	-1,778	-1,502	-1,338	-1,355	-1,434	-1,541
Trade balance	-3,726	-3,141	-3,153	-3,056	-3,404	-3,562	-3,794	-4,024	-4,249	-4,455
Exports	4,990	4,375	4,375	4,783	5,059	5,282	5,757	6,260	6,556	6,786
Imports	-8,716	-7,515	-7,528	-7,840	-8,463	-8,844	-9,552	-10,284	-10,805	-11,240
Services	2,169	135	135	347	513	1,005	1,551	1,831	2,014	2,405
Services: credit	4,586	1,583	1,583	2,273	2,638	3,688	4,965	5,925	6,530	7,189
Services: debit	-2,418	-1,449	-1,449	-1,926	-2,125	-2,682	-3,413	-4,093	-4,516	-4,784
Income	-775	-765	-775	-843	-844	-844	-1,059	-1,241	-1,376	-1,538
Of which : interest payments	-608	-565	-575	-582	-582	-628	-673	-720	-771	-821
Transfers	1,375	1,809	1,809	1,786	1,957	1,899	1,965	2,079	2,177	2,047
Of which : remittances (net)	915	1,167	1,167	1,201	1,383	1,314	1,366	1,421	1,477	1,536
Capital account	48	38	41	40	40	39	38	38	37	36
General government	42	25	28	40	40	39	38	38	37	36
Financial account	1,006	877	973	719	828	1,697	1,609	1,658	1,754	1,638
Direct investment (net)	1,029	594	594	735	693	887	1,076	1,403	1,679	1,737
Portfolio investment (net)	698	-173	81	-87	-106	300	206	240	271	5
Equity	-50	-15	-15	0	-19	0	0	0	0	0
Debt securities	748	-158	96	-87	-87	300	206	240	271	5
Loans (net)	-135	230	239	486	313	391	425	367	359	447
Short-term loans (net)	40	131	138	-24	-23	4	3	4	5	6
Public	-1	-5	-5	-5	-5	-5	-5	-5	-5	-5
Private	41	136	143	-19	-18	9	8	9	10	11
Medium and long-term loans (net)	-175	99	101	510	336	387	422	363	354	441
Public 1/	91	220	220	214	236	218	207	188	202	245
Private	-266	-121	-118	296	100	169	216	175	152	195
Bank	-73	118	118	403	50	176	225	186	162	144
Non-bank	-193	-239	-236	-108	50	-7	-10	-11	-10	51
Others (net) 2/	-585	227	59	-415	-72	119	-98	-352	-554	-551
Errors and omissions	-20	9	-67	0	0	0	0	0	0	0
Overall balance	77	-1,038	-1,038	-1,007	-910	234	310	340	357	133
Financing	-324	-179	-179	261	110	-234	-309	-340	-357	-133
Gross International Reserves (-increase)	-202	-315	-315	261	110	-234	-309	-340	-357	-133
Rescheduled debts and arrears clearance	-122	136	136	0	0	0	0	0	0	0
Financing gap	247	1,217	1,217	746	800	0	0	0	0	0
Use of Fund Resources	35	315	315	106	107	0	0	0	0	0
IMF EFF	83	315	315	109	111	0	0	0	0	0
Repayment 3/	-48	0	0	-4	-4	0	0	0	0	0
Official creditors	212	903	903	641	693	0	0	0	0	0
Memorandum items:	(in percent of GDP)									
Current account balance	-5.5	-12.3	-12.5	-10.9	-10.0	-7.6	-6.2	-5.7	-5.6	-5.5
Trade balance	-21.3	-19.8	-19.8	-18.9	-19.1	-18.1	-17.6	-17.1	-16.5	-15.9
Financial account	5.8	5.5	6.1	4.4	4.6	8.6	7.5	7.0	6.8	5.9
Foreign direct investment (net)	5.9	3.7	3.7	4.5	3.9	4.5	5.0	5.9	6.5	6.2
External financing requirement	29.3	37.5	37.6	33.5	34.1	25.5	20.4	17.5	15.2	12.8
Gross international reserves (in million of USD) 4/	3,506	3,911	3,911	3,650	3,801	4,034	4,343	4,683	5,041	5,173
in months of next year GNFS imports	4.7	4.8	4.4	4.3	4.0	3.7	3.6	3.7	3.9	3.2
in percent of short-term debt at remaining maturity	90	110	93	98	95	99	101	104	106	107
in percent of broad money and non-resident deposits	34	36	36	29	29	27	26	26	25	24
in percent of IMF Composite measure (floating)	98	111	108	98	99	99	100	104	108	109
in percent of short-term external debt (remaining maturity)	90	110	93	98	95	99	101	104	106	107
Reserve cover (percent) 5/	53.7	53.0	51.5	50.4	49.6	51.9	53.6	54.2	54.3	53.4

Sources: National Bank of Georgia, Ministry of Finance; and IMF staff estimates.

1/ Including general government and monetary authorities

2/ Including currency and deposits from banks and other financial instruments

3/ Repayment of principals for exisitng Fund resources over 2017-21 will be recorded as a part of financing gap.

4/ Includes proposed IMF SDR allocation of $287 million (specific amount subject to change), which is expected to be approved later in 2021.

5/ Gross international reserves in percent of total short-term liabilities plus the current account deficit.

Table 3a. Georgia: General Government Operations, GFSM2001 2019–26

(In millions of GEL)

	2019	2020	2020	2021	2021	2022	2023	2024	2025	2026
		EFF 8th		EFF 8th						
	Actual	Review	Est.	Review			Projections			
Revenue	13,350	12,422	12,422	13,419	14,810	16,863	18,302	19,756	21,367	23,050
Taxes	11,860	10,979	10,979	12,064	13,161	15,254	16,658	18,075	19,648	21,288
Taxes on Income, profits and capital gains	4,349	4,246	4,246	4,610	4,861	5,731	6,232	6,777	7,403	8,020
Payable by individuals	3,483	3,327	3,327	3,677	3,928	4,635	5,039	5,461	5,919	6,413
Payable by corporations	866	919	919	933	933	1,097	1,193	1,315	1,483	1,607
Taxes on property	474	434	434	451	466	573	623	675	732	793
Taxes on goods and services	6,746	6,457	6,457	6,986	7,680	8,742	9,578	10,380	11,250	12,189
General taxes on goods and services (VAT)	5,239	4,837	4,837	5,338	5,840	6,678	7,334	7,948	8,615	9,334
Excises	1,507	1,619	1,619	1,648	1,840	2,063	2,244	2,432	2,635	2,855
Taxes on international trade	79	74	74	82	84	89	96	104	112	122
Other taxes 1/	212	-232	-232	-65	70	119	129	140	151	164
Social contributions	34	0	0	0	0	0	0	0	0	0
Grants	422	405	405	285	304	349	347	344	341	342
Other revenue	1,067	1,038	1,038	1,070	1,345	1,260	1,298	1,337	1,378	1,420
Total Expenditure	14,257	16,981	16,981	17,389	18,546	19,171	20,134	21,619	23,283	25,038
Expense	10,518	12,960	12,960	13,433	14,406	14,646	15,884	17,269	18,833	20,288
Compensation of employees	1,785	1,851	1,851	1,955	1,977	2,190	2,381	2,581	2,797	3,030
Use of goods and services	1,659	1,881	1,881	2,070	2,240	2,182	2,232	2,419	2,622	2,841
Interest	611	769	769	933	870	836	970	1,111	1,333	1,374
External	324	337	337	394	330	262	262	260	260	252
Domestic	287	433	433	539	539	574	707	852	1,074	1,122
Subsidies	990	1,452	1,452	1,325	1,595	1,660	1,806	1,908	2,045	2,153
Grants	126	237	237	177	214	255	277	300	326	353
Social benefits	4,198	5,575	5,575	5,571	5,915	5,882	6,449	7,044	7,659	8,328
Other expense 2/	1,150	1,196	1,196	1,402	1,595	1,640	1,770	1,905	2,051	2,209
Net acquisition of nonfinancial assets	3,739	4,022	4,022	3,956	4,140	4,525	4,250	4,350	4,450	4,750
Increase (capital spending)	3,945	4,229	4,229	4,206	4,620	4,775	4,500	4,600	4,700	5,000
Decrease (privatization proceeds)	-206	-208	-208	-250	-480	-250	-250	-250	-250	-250
Net lending / borrowing before adjustment	-907	-4,559	-4,559	-3,970	-3,735	-2,308	-1,832	-1,862	-1,916	-1,988
Unidentified measures	0	0	0	0	0	0	0	0	0	0
Net lending / borrowing	-908	-4,559	-4,559	-3,970	-3,735	-2,308	-1,832	-1,862	-1,916	-1,988
Change in net financial worth, transactions	-908	-4,559	-4,559	-3,970	-3,735	-2,308	-1,832	-1,862	-1,916	-1,988
Net acquisition of financial assets ("+": increase in assets)	456	1,773	1,773	-1,383	-1,030	-110	338	369	392	345
Domestic	456	1,773	1,773	-1,383	-1,030	-110	338	369	392	345
Budget lending	111	57	57	91	91	185	185	185	221	200
Deposits (NBG and commercial banks)	346	1,736	1,736	-1,474	-1,121	-295	95	184	171	145
Financial privatization	0	-21	-21	0	0	0	0	0	0	0
Net incurrence of liabilities ("+": increase in liabilities)	1,364	6,332	6,332	2,587	2,705	2,198	2,170	2,231	2,308	2,333
Domestic	898	1,970	1,970	-244	-244	1,510	1,510	1,640	1,910	2,660
Securities other than shares	898	1,970	1,970	-244	-244	1,510	1,510	1,640	1,910	2,660
Loans	0	0	0	0	0	0	0	0	0	0
Foreign	467	4,362	4,362	2,831	2,949	688	660	591	398	-327
Loans	467	4,362	4,362	2,831	2,949	688	660	591	398	-327
Memorandum items:										
Nominal GDP	49,253	49,407	49,407	53,315	57,549	64,520	70,156	76,031	82,405	89,281
Government debt 3/	19,916	29,654	29,654	32,390	31,218	34,605	36,559	38,554	40,621	42,954
End-year government deposits	1,454	3,190	3,190	1,716	2,069	1,774	1,927	2,110	2,282	2,426
Operating balance	2,831	-538	-538	-14	405	2,217	2,418	2,488	2,534	2,762
Net lending / borrowing (excluding privatization)	-1,114	-4,767	-4,767	-4,220	-4,215	-2,558	-2,082	-2,112	-2,166	-2,238
Augmented Net lending / borrowing (EFF definition) 4/	-1,019	-4,617	-4,617	-4,061	-3,826	-2,493	-2,017	-2,047	-2,137	-2,188
Cyclically-adjusted primary balance (EFF definition)	-329	-3,367	-3,367	-2,754	-2,807	-1,587	-1,047	-936	-803	-815

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes cash outflows due to tax credit refunds.
2/ Includes wages and salaries in the education sector.
3/ Excludes domestic legacy debt amounting to 1.2 percent of GDP.
4/ Augmented Net lending / borrowing (EFF definition) = Net lending / borrowing - Budget lending.

Table 3b. Georgia: General Government Operations, GFSM2001 2019–26

(In percent GDP)

	2019	2020	2020	2021	2021	2022	2023	2024	2025	2026
		EFF 8th		EFF 8th						
	Actual	Review	Est.	Review			Projections			
Revenue	27.1	25.1	25.1	25.2	25.7	26.1	26.1	26.0	25.9	25.8
Taxes	24.1	22.2	22.2	22.6	22.9	23.6	23.7	23.8	23.8	23.8
Taxes on Income, profits and capital gains	8.8	8.6	8.6	8.6	8.4	8.9	8.9	8.9	9.0	9.0
Payable by individuals	7.1	6.7	6.7	6.9	6.8	7.2	7.2	7.2	7.2	7.2
Payable by corporations	1.8	1.9	1.9	1.7	1.6	1.7	1.7	1.7	1.8	1.8
Taxes on property	1.0	0.9	0.9	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Taxes on goods and services	13.7	13.1	13.1	13.1	13.3	13.5	13.7	13.7	13.7	13.7
General taxes on goods and services (VAT)	10.6	9.8	9.8	10.0	10.1	10.4	10.5	10.5	10.5	10.5
Excises	3.1	3.3	3.3	3.1	3.2	3.2	3.2	3.2	3.2	3.2
Taxes on international trade	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes 1/	0.4	-0.5	-0.5	-0.1	0.1	0.2	0.2	0.2	0.2	0.2
Grants	0.9	0.8	0.8	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Other revenue	2.2	2.1	2.1	2.0	2.3	2.0	1.9	1.8	1.7	1.6
Total Expenditure	28.9	34.4	34.4	32.6	32.2	29.7	28.7	28.4	28.3	28.0
Expense	21.4	26.2	26.2	25.2	25.0	22.7	22.6	22.7	22.9	22.7
Compensation of employees	3.6	3.7	3.7	3.7	3.4	3.4	3.4	3.4	3.4	3.4
Use of goods and services	3.4	3.8	3.8	3.9	3.9	3.4	3.2	3.2	3.2	3.2
Interest	1.2	1.6	1.6	1.7	1.5	1.3	1.4	1.5	1.6	1.5
External	0.7	0.7	0.7	0.7	0.6	0.4	0.4	0.3	0.3	0.3
Domestic	0.6	0.9	0.9	1.0	0.9	0.9	1.0	1.1	1.3	1.3
Subsidies	2.0	2.9	2.9	2.5	2.8	2.6	2.6	2.5	2.5	2.4
Grants	0.3	0.5	0.5	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	8.5	11.3	11.3	10.4	10.3	9.1	9.2	9.3	9.3	9.3
Other expense 2/	2.3	2.4	2.4	2.6	2.8	2.5	2.5	2.5	2.5	2.5
Net acquisition of nonfinancial assets	7.6	8.1	8.1	7.4	7.2	7.0	6.1	5.7	5.4	5.3
Increase (capital spending)	8.0	8.6	8.6	7.9	8.0	7.4	6.4	6.1	5.7	5.6
Decrease (privatization proceeds)	-0.4	-0.4	-0.4	-0.5	-0.8	-0.4	-0.4	-0.3	-0.3	-0.3
Net lending / borrowing before adjustment	-1.8	-9.2	-9.2	-7.4	-6.5	-3.6	-2.6	-2.4	-2.3	-2.2
Unidentified measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending / borrowing	-1.8	-9.2	-9.2	-7.4	-6.5	-3.6	-2.6	-2.4	-2.3	-2.2
Change in net financial worth, transactions	-1.8	-9.2	-9.2	-7.4	-6.5	-3.6	-2.6	-2.4	-2.3	-2.2
Net acquisition of financial assets ("+": increase in assets)	0.9	3.6	3.6	-2.6	-1.8	-0.2	0.5	0.5	0.5	0.4
Domestic	0.9	3.6	3.6	-2.6	-1.8	-0.2	0.5	0.5	0.5	0.4
Budget lending	0.2	0.1	0.1	0.2	0.2	0.3	0.3	0.2	0.3	0.2
Deposits (NBG and commercial banks)	0.7	3.5	3.5	-2.8	-1.9	-0.5	0.1	0.2	0.2	0.2
Financial privatization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities ("+": increase in liabilities)	2.8	12.8	12.8	4.9	4.7	3.4	3.1	2.9	2.8	2.6
Domestic	1.8	4.0	4.0	-0.5	-0.4	2.3	2.2	2.2	2.3	3.0
Securities other than shares	1.8	4.0	4.0	-0.5	-0.4	2.3	2.2	2.2	2.3	3.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.9	8.8	8.8	5.3	5.1	1.1	0.9	0.8	0.5	-0.4
Loans	0.9	8.8	8.8	5.3	5.1	1.1	0.9	0.8	0.5	-0.4
Memorandum items:										
Nominal GDP (in millions of GEL)	49,253	49,407	49,407	53,315	57,549	64,520	70,156	76,031	82,405	89,281
General government debt 3/	40.4	60.0	60.0	60.8	54.2	53.6	52.1	50.7	49.3	48.1
End-year government deposits	3.0	6.5	6.5	3.2	3.6	2.7	2.7	2.8	2.8	2.7
Operating balance (before adjustment)	5.7	-1.1	-1.1	0.0	0.7	3.4	3.4	3.3	3.1	3.1
Net lending / borrowing (excluding privatization)	-2.3	-9.6	-9.6	-7.9	-7.3	-4.0	-3.0	-2.8	-2.6	-2.5
Augmented Net lending / borrowing (EFF definition) 4/	-2.1	-9.3	-9.3	-7.6	-6.6	-3.9	-2.9	-2.7	-2.6	-2.5
Cyclically-adjusted primary balance (EFF definition)	-0.7	-6.8	-6.8	-5.2	-4.9	-2.5	-1.5	-1.2	-1.0	-0.9

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes cash outflows due to tax credit refunds.
2/ Includes wages and salaries in the education sector.
3/ Excludes domestic legacy debt amounting to 1.2 percent of GDP.
4/ Augmented Net lending / borrowing (EFF definition) = Net lending / borrowing - Budget lending.

Table 4. Georgia: Monetary Survey, 2019–21

	2019	2020		2021	
				Projections	
		June	Dec	June	Dec
Central Bank			(In billions of lari)		
Net foreign assets	8.8	9.7	10.9	11.5	9.7
Gross international reserves	10.1	11.0	12.8	13.6	11.9
Foreign liabilities	1.3	1.4	1.9	2.2	2.2
Of which : use of Fund resources	0.7	0.8	1.2	1.5	1.5
Net domestic assets	0.2	-0.2	-0.1	-0.3	1.9
Net claims on central government	-0.4	-0.3	-0.1	0.8	0.4
Claims on general government (incl. T-bills)	1.0	1.2	1.4	1.5	1.5
Nontradable govt. debt	0.2	0.2	0.2	0.2	0.2
Debt securities (tradable)	0.8	1.0	1.2	1.4	1.4
Deposits	1.5	1.5	1.5	0.7	1.1
Net claims on banks (excl. reserves)	3.1	2.8	3.2	2.1	4.7
Bank refinancing (incl. swap lines)	3.1	2.8	3.2	2.2	4.8
Certificates of deposits and bonds	0.1	0.1	0.1	0.1	0.1
Other items, net	-2.5	-2.7	-3.2	-3.3	-3.3
Reserve Money	8.9	9.5	10.8	11.1	11.6
Banking System			(In billions of lari)		
Net foreign assets	-0.4	-1.0	0.9	0.5	-0.9
NBG	8.8	9.7	10.9	11.5	9.7
Commercial banks	-9.1	-10.7	-10.0	-10.9	-10.6
Net domestic assets	24.7	26.6	29.4	30.2	35.6
Domestic credit	33.3	36.2	40.2	41.8	45.1
Net claims on central government	1.6	2.0	1.5	1.4	2.4
Of which : government deposits at NBG	1.5	1.5	1.5	0.7	1.1
Of which : T-bills at commercial banks	0.8	1.6	2.8	3.0	2.0
Claims on Other Sectors	31.7	34.2	38.7	40.4	42.7
Other items, net	-8.6	-9.6	-10.7	-11.6	-9.5
Broad money (M3)	24.4	25.6	30.4	30.8	34.7
Lari Broad money (M2)	11.5	12.1	13.7	12.8	16.0
Currency held by the public	3.2	3.5	3.7	3.8	4.3
Lari resident deposits	8.3	8.6	9.9	9.1	11.6
Resident foreign exchange deposits	12.9	13.5	16.7	17.9	19.1
Sources of funds of commercial banks	39.8	42.9	49.7	49.2	55.6
Resident deposits	22.0	24.2	29.7	30.3	33.1
Non-resident deposits	5.0	5.3	5.6	5.6	6.0
Other resident liabilities	3.7	3.4	3.9	2.9	5.5
Other foreign liabilities	9.1	10.1	10.4	10.3	11.1
Uses of funds of commercial banks	39.8	42.9	49.7	49.2	55.6
Claims on Central Bank	5.7	6.1	7.1	7.6	7.8
Credit to the Private Sector	31.7	34.2	38.7	40.4	42.7
National currency	14.1	14.7	17.1	18.2	19.3
Foreign currency	17.6	19.5	21.5	22.2	23.5
Other foreign assets	5.0	4.6	6.1	5.0	6.4
Other items, net	-2.6	-2.0	-2.2	-3.8	-1.3
			(In percent of GDP)		
Broad money (M3)	49.5	51.8	61.5	53.5	60.2
Lari Broad money (M2)	23.3	24.4	27.6	22.3	27.7
Currency held by the public	6.6	7.0	7.6	6.6	7.5
Non-resident deposits (percent of total deposits)	18.5	18.0	16.0	15.6	15.3
Credit to the Economy	64.4	69.2	78.3	70.3	74.3
Nominal GDP (billions of lari)	49.3		49.4		57.5
			(year-on-year growth)		
Reserve Money	13.4	5.1	20.8	17.4	7.9
Broad money (M3)	17.6	14.4	24.6	20.3	14.1
NBG Claims on Banks	61.3	102.5	2.3	-21.8	48.7
Credit to the Economy (Percent change, year on year)	19.7	19.0	22.0	18.3	10.5

Sources: National Bank of Georgia; and Fund staff estimates.

Table 5. Georgia: Financial Soundness Indicators, 2018–21

	2018	2019	2020				2021	
		Dec	Mar	Jun	Sep	Dec	Mar	Jul
Capital Adequacy								
Capital to risk-weighted assets 1/	18.4	19.5	17.0	18.0	17.6	17.6	18.2	19.2
Nonperforming loans net of provisions to capital	6.4	5.2	7.8	7.6	7.9	7.3	7.3	6.5
Leverage ratio 2/	18.5	19.0	16.2	16.6	16.3	16.3	17.1	18.6
Asset Quality								
Nonperforming to total gross loans (IMF) 3/	2.7	1.9	2.2	2.4	2.3	2.3	2.4	2.2
Nonperforming to total gross loans (NBG) 4/	5.5	4.4	4.4	5.5	6.3	8.2	8.3	6.7
Substandard and restructured loans to total gross loans 5/	15.3	12.9	27.0	20.5	26.9	34.5	36.0	32.8
Specific provisions to total loans	2.5	1.9	2.1	2.6	2.6	3.2	3.2	2.7
Sectoral distribution of loans to total loans								
Residents	97.4	97.4	95.4	96.1	96.3	96.4	96.5	96.3
Deposit-takers	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.0
Other financial corporations	0.7	0.0	0.6	0.0	0.0	0.0	0.0	0.0
Nonfinancial corporations	46.3	49.8	46.3	46.2	46.2	47.1	47.0	46.4
Other domestic sectors 6/	50.5	47.5	48.4	49.7	49.9	49.1	49.3	49.9
Non-residents	2.6	2.6	4.6	3.9	3.7	3.6	3.5	3.7
Earnings and Profitability								
Return on assets (ROA)	3.0	2.5	-7.1	-2.4	-0.9	0.2	3.1	4.0
Return on equity (ROE)	23.3	20.3	-64.4	-21.7	-8.1	1.4	29.4	37.3
Interest margin to gross income	61.0	58.1	56.5	58.1	58.8	58.4	59.9	57.1
Non-interest expenses to gross income	49.6	52.9	55.0	56.5	55.4	54.3	49.1	46.8
Liquidity								
Liquid assets to total assets ratio	21.6	19.6	20.0	21.4	21.5	21.1	22.5	20.9
Liquid assets to total short-term liabilities 7/	27.1	24.2	24.0	25.6	25.6	25.2	27.3	26.8
Loan-to-deposit ratio (in percent) 8/	115.6	121.7	121.5	113.2	110.9	110.6	108.0	113.6
Foreign Currency Position and Dollarization								
Deposit dollarization (total non-bank deposits)	62.1	64.0	66.3	61.4	61.6	61.4	63.5	…
Loans in foreign exchange to total loans	57.1	55.2	58.9	57.3	57.5	55.7	55.6	52.8
Net foreign assets to total assets	-18.3	-18.9	-19.3	-22.1	-19.4	-17.6	-16.7	-19.5
Net open foreign exchange position to regulatory capital	9.8	-1.4	1.8	-2.6	1.0	3.1	-3.7	-0.4
Borrowed funds from abroad-to-GDP ratio 9/	16.2	19.1	17.2	17.7	18.9	18.0	18.5	16.5
Other								
Loans collateralized by real estate to total loans	62.0	64.9	65.5	65.7	65.5	53.5	64.8	65.4
Memorandum items								
Georgia EMBIG Sovereign Spread	252	157	241	680	495	407	232	202
Georgia EMBIG Sovereign Yield	5.4	3.2	3.5	7.0	5.1	4.2	2.4	2.4

Source: National authorities and IMF staff calculations.

1/ Basel III definition.

2/ Defined as the ratio of total capital to total liabilities; an increase in the ratio indicates an improvement.

3/ IMF definition for NPLs: includes loans in doubtful and loss categories (categories overdue 90 days or more).

4/ National definition: NPLs are defined as loans in substandard, doubtful, and loss loan categories.

5/ Includes watch, non-standard, doubtful, bad, and restructured loans.

6/ Includes households and individual entrepreneurs.

7/ Ratio of liquid assets to 6-month and shorter maturity liabilities.

8/ Loans and deposits from the banking sector.

9/ Borrowed funds include subordinated debt.

Table 6. Georgia: External Vulnerability Indicators, 2019–26

	2019	2020	2021	2022	2023	2024	2025	2026
		Prel.			Projections			
Value of exports of goods and services, percent change	7.2	-37.8	29.2	16.5	19.5	13.6	7.4	6.8
Value of imports of goods and services, percent change	3.1	-19.4	18.0	8.9	12.5	10.9	6.6	4.6
Terms of trade, goods (deterioration -)	-0.7	5.8	-2.1	0.5	2.2	2.1	0.8	-0.1
Current account balance (percent of GDP)	-5.5	-12.5	-10.0	-7.6	-6.2	-5.7	-5.6	-5.5
Capital and financial account (percent of GDP)	7.2	12.1	8.7	8.8	7.6	7.2	6.9	6.0
External public debt (percent of GDP)	34.5	49.3	42.8	39.8	37.2	34.5	31.9	28.8
(in percent of exports of goods and services)	63.0	131.5	99.3	87.5	74.8	66.9	62.9	57.6
Debt service on external public debt								
(in percent of exports of goods and services)	4.8	7.2	5.5	5.2	4.6	4.3	4.0	3.6
External debt (percent of GDP) 1/	87.7	109.0	95.9	91.7	87.6	83.7	79.7	73.0
(in percent of exports of goods and services)	160.0	290.8	222.3	201.3	176.4	162.0	157.0	145.9
Debt service on MLT external debt								
(in percent of exports of goods and services)	19.3	27.8	24.2	17.1	13.4	11.8	11.0	10.1

Source: Fund staff estimates and projections.

1/ Excluding intercompany loans.

Table 7. Georgia Gross External Financing Requirement, 2019–2026
(In millions of USD)

	2019	2020	2021	2022	2023	2024	2025	2026
				Projections				
Total financing requirement	2,134	2,998	3,298	2,089	2,070	2,265	2,471	2,751
Current account deficit	957	1,984	1,778	1,502	1,338	1,355	1,434	1,541
Medium and long-term debt	1,289	1,153	1,342	1,006	840	797	754	664
Private	1,004	847	1,041	653	460	379	330	254
Banks	713	450	596	469	393	303	247	158
Corporates	291	397	445	184	67	76	83	96
Public	285	306	300	353	379	418	425	410
Others (net)	-113	-139	178	-419	-108	112	283	546
Total financing sources	2,230	2,028	2,388	2,323	2,379	2,605	2,829	2,884
Capital transfers	48	41	40	39	38	38	37	36
Direct investment, net	1,029	594	693	887	1,076	1,403	1,679	1,737
Medium and long-term debt	1,114	1,254	1,678	1,392	1,262	1,160	1,108	1,105
Private	738	728	1,141	822	676	554	482	449
Banks	639	567	646	645	619	489	409	302
Corporates	99	161	495	177	58	65	73	147
Public (only project loans)	376	526	537	570	586	606	626	655
Short-term debt (net)	40	138	-23	4	3	4	5	6
Increase in gross reserves	202	315	-110	234	309	340	357	133
Rescheduled debt and arrears clearance	122	-136	0	0	0	0	0	0
Errors and omissions	-20	-67	0	0	0	0	0	0
Total financing needs	247	1,217	800	0	0	0	0	0
Official financing	247	1,218	800	0	0	0	0	0
IMF	35	315	107	0	0	0	0	0
Prospective purchases	83	315	111	0	0	0	0	0
Repurchases	-48	0	-4	0	0	0	0	0
Official creditors	212	903	693	0	0	0	0	0
Memorandum items:								
Gross international reserves	3,506	3,911	3,801	4,034	4,343	4,683	5,041	5,173
in months of next year GNFS imports	5	4	4	4	4	4	4	3
in percent of short-term debt at remaining maturity	90	93	95	99	101	104	106	107
in percent of IMF Composite measure (floating)	98	108	99	99	100	104	108	109
EFF in percent of total official financing	14	26	13	…	…	…	…	…

Sources: National Bank of Georgia, Ministry of Finance; and IMF staff estimates.

Table 8. Indicators of Fund Credit, 2019–26
(In millions of SDR)

	2019	2020	2021	2022	2023	2024	2025	2026
	Actual	Actual			Projections			
Existing Fund credit								
Disbursements (EFF)	60.0	226.0	78.0	0.0	0.0	0.0	0.0	0.0
Stock 1/	180.0	406.0	481.5	469.0	446.5	404.3	330.1	249.4
SBA and EFF	180.0	406.0	481.5	469.0	446.5	404.3	330.1	249.4
Obligations	38.1	4.2	6.0	19.2	28.8	47.9	78.4	84.0
SBA and EFF	38.1	4.2	6.0	19.2	28.8	47.9	78.4	84.0
Principal (repurchases)	35.0	0.0	2.5	12.5	22.5	42.3	74.2	80.7
Interest charges	3.1	4.2	3.5	6.7	6.3	5.6	4.3	3.3
Prospective purchases								
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stock 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Obligations 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Principal (repurchases)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stock of existing and prospective Fund credit 1/	180.0	406.0	481.5	469.0	446.5	404.3	330.1	249.4
In percent of quota 3/	85.6	193.0	228.8	222.9	212.2	192.1	156.9	118.5
In percent of GDP	1.4	3.6	3.9	3.4	3.0	2.5	1.9	1.3
In percent of exports of goods and nonfactor services	2.6	9.5	9.0	7.6	6.1	4.9	3.7	2.7
In percent of gross reserves	7.1	14.5	18.2	16.8	15.0	12.7	9.7	7.2
In percent of public external debt	4.1	7.2	9.0	8.7	8.1	7.3	6.0	4.6
in percent of total government revenues and grants	5.9	16.2	18.0	16.1	14.3	12.2	9.3	6.5
Obligations to the Fund from existing and prospective	38.1	4.2	6.0	19.2	28.8	47.9	78.4	84.0
In percent of quota	18.1	2.0	2.8	9.1	13.7	22.7	37.3	39.9
In percent of GDP	0.3	0.0	0.0	0.1	0.2	0.3	0.5	0.4
In percent of exports of goods and nonfactor services	0.5	0.1	0.1	0.3	0.4	0.6	0.9	0.9
In percent of gross reserves	1.5	0.2	0.2	0.7	1.0	1.5	2.3	2.4
In percent of public external debt service	11.5	1.4	2.0	5.9	8.5	13.4	22.1	24.7
in percent of total government revenues and grants	1.2	0.2	0.2	0.7	0.9	1.4	2.2	2.2

Source: Fund staff estimates and projections.

1/ End of period.

2/ Repayment schedule based on repurchase obligations and GRA charges. Includes service charges.

3/ Quota increased to SDR 210.4 million in February, 2016.

Annex I. Implementation of the 2018 Article IV Recommendations

1. The 2018 Article IV consultation (henceforth 2018 Article IV)[1] with Georgia took place in a favorable growth environment with discussions focusing on reforms to increase resilience and promote growth. Recommendations focused on policies to: (i) preserve fiscal sustainability while addressing bottlenecks to growth; (ii) strengthen monetary and financial policy frameworks; (iii) improve external stability; and (iv) implement structural reforms to promote private sector-led activity through economic diversification and job creation.

2. The 2018 Article IV occurred during the Second Review of the EFF program originally scheduled to expire in April 2020. In 2020, however, the program was extended by one year and augmented to help Georgia deal with the fallout of the COVID-19 pandemic. The last review of the augmented EFF was successfully concluded in April 2021 with program objectives largely achieved.[2]

Fiscal Policy

3. The 2018 Article IV recommended strengthening the fiscal rule and limiting fiscal risks from SOEs and PPAs. The consultation suggested that the fiscal rule should be less pro-cyclical and that it should promote fiscal transparency by increasing coverage and accountability by clarifying escape clauses. The consultation also stressed control over fiscal risks by strengthening supervisory powers over SOEs.

4. These recommendations have been implemented. The authorities reduced the procyclicality of the fiscal rule by abolishing expenditure ceilings (set as a share of GDP) and specifying escape clauses, which were utilized in 2020, due to the COVID-19 pandemic. Efforts to increase coverage are ongoing with the help of IMF TA. Control over fiscal risks has been strengthened through notable improvements in the annual Fiscal Risk statements. The authorities are also seeking to comprehensively revamp SOE governance.

Financial Sector

5. The 2018 Article IV recommended targeted and market-based prudential measures that would encourage prudent pricing of FX risk, as well as bringing the crisis management framework in line with best international practice.

6. These recommendations have been implemented. The authorities introduced payment-to-income and loan-to-value ratio caps with tighter limits on FX denominated loans in 2019, which turned out to be helpful in 2020, when the currency depreciated owing to the consequences of the COVID-19 pandemic. The authorities also developed emergency liquidity assistance and resolution

[1] See IMF Country Report 18/198.

[2] See Box 1 of the IMF Country Report 21/79.

frameworks and adopted a full set of implementing regulations by end-2020 in line with EFF program conditionality.

Structural Reforms

7. The recommendations of the 2018 Article IV on the structural front were broadly similar to the 2021 Article IV consultation. The 2018 Article IV emphasized reforming education and strengthening labor market policies, developing capital markets, and reforming the judiciary.

8. Progress in implementing these recommendations has been slow. The authorities began a comprehensive education reform in 2019 by improving teacher qualification requirements and offering retirement packages to teachers unwilling to meet the new requirements. Work on other elements of the education reform (e.g., strengthening vocational education) is ongoing but has been set back by COVID-19. On capital market development, the creation of the Pension Agency should help mobilize savings in domestic currency, but the Agency is in its initial phase and so far has invested only in bank deposits. More diversified investments are expected soon. There have been efforts to enhance mediation to offer an alternative to the judicial system.

Annex II. Risk Assessment Matrix[1]

Source of Risks	Likelihood	Expected Impact on the Economy if Risks Materialize	Policy Response
Conjunctural Shocks and Scenarios			
Unexpected shifts in the COVID-19 pandemic. • **Asynchronous progress.** Limited access to, and longer-than-expected deployment of, vaccines in some countries—combined with dwindling policy space—prompt a reassessment of their growth prospects (for some emerging and frontier markets, triggering capital outflows, depreciation and inflation pressures, and debt defaults).	Medium	High Capital outflows in context of high current account deficit and significant external financing requirements would threaten external stability, likely resulting in lari depreciation and accelerating inflation.	Maintain commitment to exchange rate flexibility, but utilize foreign exchange reserves to prevent a disorderly depreciation that would jeopardize financial stability. Tighten monetary policy to keep inflation expectations anchored.
• **Prolonged pandemic.** The disease proves harder to eradicate (e.g., due to new virus strains, short effectiveness of vaccines, or widespread unwillingness to take them), requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable. For countries with policy space, prolonged support—while needed to cushion the economy—exacerbates stretched asset valuations, fueling financial vulnerabilities. For those with limited space, especially EMs, policy support is insufficient.	Medium	High Insufficient policy support during prolonged pandemic would likely increase poverty among vulnerable populations in informal employment Lack of tourism recovery would reduce medium-term growth.	Extend targeted measures to support individuals and businesses by reprioritizing spending. To the extent that inflation expectations remain anchored utilize available monetary policy space to support demand.

[1] Prepared by S. Saksonovs. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Source of Risks	Likelihood	Expected Impact on the Economy if Risks Materialize	Policy Response
• **Faster containment.** Pandemic is contained faster than expected due to the rapid production and distribution of vaccines, boosting confidence and economic activity.	Medium	High Higher growth in trading partners would enable a faster recovery in Georgia.	Maintain prudent macroeconomic policies to build up buffers. Proceed with fiscal consolidation.
Widespread social discontent and political instability. Social tensions erupt as the pandemic and inadequate policy response cause socio-economic hardship (unemployment, poverty, and shortages and higher prices of essentials—often exacerbating pre-existing inequities), or due to unequal access to vaccines. Growing political polarization and instability weaken policymaking and confidence.	High	High Political polarization and social tensions could result in a disorderly lari depreciation. Social tensions would undermine the ability of policymakers to set a new agenda for structural reform. They could also threaten external financing flows from international financial institutions (IFIs) on which Georgia relies.	Strengthen the policy response and improve communication about economic policy – especially in terms of setting a medium-term reform agenda. Maintain commitment and ownership of reforms. As policies are being strengthened, utilize foreign exchange reserves to prevent a disorderly depreciation that would jeopardize financial stability.
Structural Risks			
Accelerating de-globalization. Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	Medium	Medium Accelerating de-globalization would put the merits of Georgia's efforts to become a logistics hub in doubt. The country would need to find a new source of	Allow the exchange rate to adjust to reflect the new fundamentals. Utilize monetary policy space to ensure that the output gap does not

Source of Risks	Likelihood	Expected Impact on the Economy if Risks Materialize	Policy Response
		future growth that relies less on the external environment.	stay negative for too long. Extend targeted measures to support individuals and businesses by reprioritizing spending.
Georgia-Specific Structural Risks			
Financial risks. As a result of one of the global shocks above, exchange rate could depreciate rapidly undermining confidence in the currency and increasing inflation expectations.	Medium	High Depreciation in a highly dollarized economy could hurt growth and threaten financial stability as households and firms struggle to repay loans. Higher inflation and depreciation expectations could result in a vicious cycle of loan conversions putting further pressure on the currency.	Maintain tight monetary policy to ensure confidence in the currency and keep inflation expectations anchored. Strengthen the resolution framework to ensure that financial stability challenges can be addressed. Adjust macroprudential measures to avoid an undue tightening of financial conditions.
Fiscal risks. Materialization of contingent liabilities/fiscal risks could put pressure on the deficit.	Medium	High The need to cover contingent liabilities could result in lower capital spending or lower current spending, which has already been significantly compressed.	Continue improving SOE governance and fiscal risk management practices. Utilize fiscal buffers accumulated due to capital markets development strategy.

Source of Risks	Likelihood	Expected Impact on the Economy if Risks Materialize	Policy Response
Political risks. Political instability or/and reform fatigue could undermine efforts to undertake structural reforms.	**High**	**Medium** Policy uncertainty could undermine confidence and hurt growth.	Maintain macroeconomic policy discipline. Strengthen social safety nets to protect the most vulnerable segments of the population and ensure that growth is sufficiently inclusive.

Annex III. Public Debt Sustainability Assessment[1]

Georgia's public debt is assessed as sustainable, with fiscal consolidation and higher growth expected to put the public debt-to-GDP ratio on a downward path, after a sharp rise in 2020 due to the COVID-19 pandemic. Expanding the coverage of fiscal reporting to include non-market SOEs into the general government, starting in 2021, will add to the projected stock of debt subject to the fiscal rule limit. Taking this into account, the debt-to-GDP ratio is projected to have peaked at the limit in 2020, and to gradually fall to 52 percent of GDP by 2023, in compliance with Georgia's fiscal rule. The main risks to sustainability stem from the high share of foreign exchange denominated debt.

1. Public debt-to-GDP increased sharply in 2020 after an extended period of stability. Gross public debt stood at 40 percent of GDP at end-2019, having remained stable on average over 2016-19. Fiscal discipline, under the EFF arrangement, helped contain public debt and supported the buildup of government deposits. However, faced with the COVID-19 pandemic, debt increased by 20 percentage points of GDP in 2020, reaching the upper limit of the fiscal rule. This sharp increase reflects: (i) a widening of the fiscal deficit, as the pandemic shock triggered a drop in GDP and revenues, coupled with a rise in spending, including to finance the government's fiscal relief package in response to COVID-19 (3.8 percent of GDP), accelerated VAT refunds, and elevated capital spending; (ii) economic contraction; (iii) an accumulation of government deposits (which increased by 3.6 percent of GDP) to guard against downside risks, (iv) exchange rate depreciation; and (v) other residual debt-increasing factors.[2]

2. Public debt remains sustainable over the medium term. Under a realistic baseline medium-term fiscal path, the public debt-to-GDP ratio (excluding SOE debt) is expected to decline over the projection horizon starting in 2021, as one-off spending measures wane and growth resumes. In 2026, public debt is projected at 48 percent of GDP in gross terms and 45 percent of GDP measured net of government deposits, broadly in line with previous program commitments[3]. Gross financing needs are expected to average 7.1 percent of GDP over 2022-26.

3. Public debt is projected to comply with Georgia's Liberty Act. Georgia's fiscal rule imposes a 60 percent ceiling on gross general government debt to be attained by 2023 (within three years of the escape clause being triggered due to the pandemic). Georgia's public debt is currently projected at 52 percent of GDP in 2023 (approximately 54 percent including SOEs and PPPs), in compliance with the fiscal rule. Government deposits, projected at 2.7 percent of GDP, provide some additional cushion for adherence to the rule. However, fiscal risks arising from an uncertain impact of incorporating non-market SOEs into general government reporting, PPP liabilities, and contingent liabilities in the form of PPAs and SOEs, could further add to projected debt starting in 2021 and reduce space within the fiscal rule's limits. In this context, and to provide buffers to respond to

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[1] Prepared by A. Lagerborg. The public sector throughout this analysis is defined as the general government (i.e., excludes NBG debt to the IMF).

[2] The government responded to the COVID-19 shock in 2020 with temporary fiscal support measures (tax relief and increased spending) in addition to stepping up VAT refunds and capital spending. Donor grants/loans and domestic borrowing accommodated a higher deficit and accumulation of deposits to weather against downside risks.

[3] The EFF program target for public debt net of deposits was 45 percent of GDP, but included NBG debt.

shocks, the rule provides very little room for relaxing fiscal policy and underscores the urgency of commencing fiscal consolidation in 2021, to avoid a more abrupt consolidation path in 2022-23.

4. **Public debt remains sustainable in all standardized stress tests.** Public debt remains sustainable and below the high-risk thresholds in all standardized macro-fiscal stress tests, considering shocks to real GDP growth, the primary balance, the real interest rate, and the real exchange rate. While debt would not stabilize under the constant primary balance scenario (at 2020 levels), this scenario is not realistic, considering the unprecedented external shock related to the Covid-19 pandemic and the authorities' good past record of fiscal discipline. Under the combined macro-fiscal shock of low growth, inflation, a deteriorated primary balance, and high interest rates, debt levels stabilize at a level that breaches the benchmark threshold; such a scenario seems unlikely as it would also breach Georgia's fiscal rule, which imposes a 60 percent ceiling on the debt level.

5. **After a comfortable Eurobond rollover in April 2021, short-term risks associated with high gross financing needs remain low, while vulnerabilities stem mostly from a high share of FX-denominated debt.** A $500-million sovereign Eurobond maturing on April 12, 2021 was refinanced at a historically low interest rate (2.75 percent coupon rate for 5-year maturity). While the pandemic delayed plans to increase the share of domestic debt, the authorities remain committed to deepening the local capital market and reducing the share of FX-denominated share over the medium term. Currently, 80 percent of public debt is FX-denominated, causing debt dynamics to be vulnerable to exchange rate depreciation. On the other hand, the government has been successful in securing debt of long-term maturity (representing over 97 percent of outstanding debt), reserves are adequate, the public debt service profile is relatively smooth (averaging 5.9 percent of GDP over 2022-26), and much of the external debt service is owed to international finance institutions at concessional terms, mitigating risks to debt sustainability.

6. **The public debt analysis does not incorporate contingent liabilities to the general government.** Key fiscal risks stem from power purchasing agreements and SOEs. Under the EFF arrangement, the authorities took important steps to strengthen the assessment, monitoring, and transparency of those risks, including by disclosing them in their annual Fiscal Risk Statement (FRS). The completion of a comprehensive sectorization exercise of SOEs in 2020, the first among Central Asia and Eastern European countries, revealed 183 enterprises to be incorporated into the general government sector starting in 2021.[4] The 2020 FRS estimates that the hypothetical impact of this exercise on 2019 fiscal statistics would increase debt by 0.8 percent of GDP.[5] The impact of incorporating these SOEs in public finance statistics is yet to be estimated for 2021-26. The authorities are also committed to a comprehensive governance reform of SOEs which will help reduce fiscal risks.

[4] With support of IMF TA, pilot balance sheet compilations for 65 non-market SOEs (representing 84 percent of all non-market SOEs in terms of annual turnover), estimated debt liabilities totaling 3.1 percent of GDP in 2019.

[5] IMF TA provided in June 2021 estimates a higher impact whereby 2019 debt would increase by 1.1 percent of GDP based on GFSM 2014 (considering 84 percent of SOEs in terms of annual turnover).

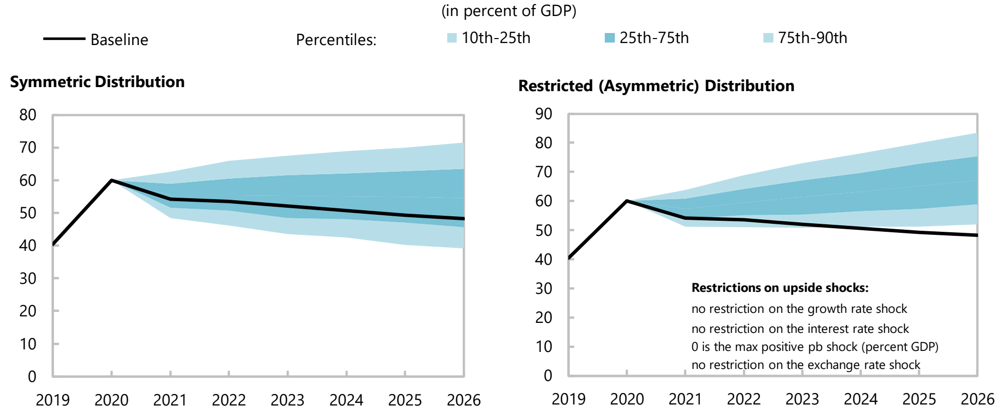
Figure 1. Georgia: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

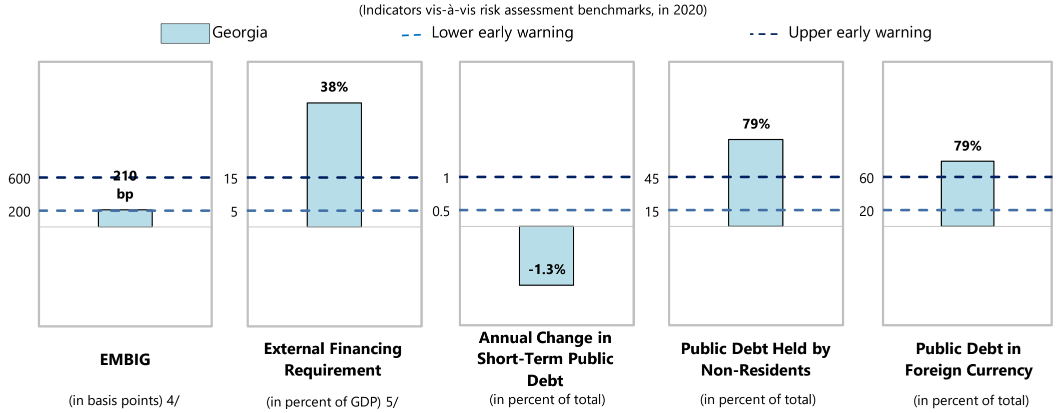
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, .

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Georgia: Public DSA – Baseline Scenario

(in percent of GDP unless otherwise indicated)

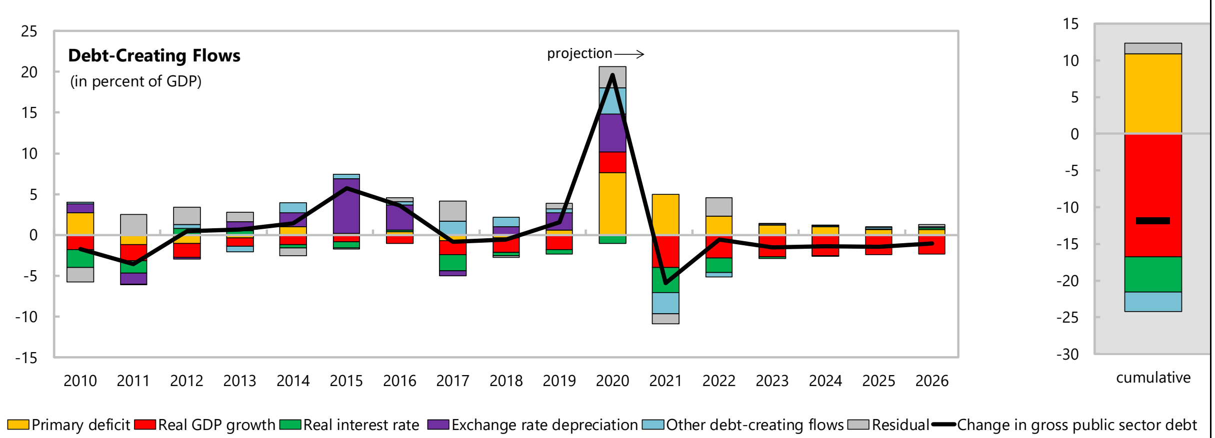
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	33.9	40.4	60.0	54.1	53.5	52.0	50.7	49.2	48.2
Public gross financing needs	4.2	6.5	14.3	13.9	7.6	6.3	6.3	6.9	8.2
Real GDP growth (in percent)	4.8	5.0	-6.2	7.7	5.8	5.5	5.2	5.2	5.2
Inflation (GDP deflator, in percent)	5.1	4.9	6.9	8.3	6.1	3.0	3.0	3.0	3.0
Nominal GDP growth (in percent)	10.4	10.4	0.3	16.5	12.1	8.7	8.4	8.4	8.3
Effective interest rate (in percent) [4/]	3.4	3.5	3.9	3.0	2.7	2.8	3.1	3.3	3.6

As of June 03, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		150
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB	BB
Fitch	BB	BB

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [10/]
Change in gross public sector debt	0.6	1.6	19.6	-5.9	-0.6	-1.5	-1.4	-1.4	-1.1	-11.9	
Identified debt-creating flows	0.0	0.9	17.0	-4.7	-2.8	-1.5	-1.4	-1.5	-1.4	-13.3	
Primary deficit	0.1	0.6	7.7	5.0	2.3	1.2	1.0	0.7	0.7	10.9	-2.1
Primary (noninterest) revenue and grants	27.1	27.1	25.1	25.7	26.1	26.1	26.0	25.9	25.8	155.7	
Primary (noninterest) expenditure	27.1	27.7	32.8	30.7	28.4	27.3	27.0	26.6	26.5	166.6	
Automatic debt dynamics [5/]	-0.7	-0.3	6.1	-7.0	-4.6	-2.9	-2.6	-2.4	-2.2	-21.6	
Interest rate/growth differential [6/]	-2.1	-2.3	1.4	-7.0	-4.6	-2.9	-2.6	-2.4	-2.2	-21.6	
Of which: real interest rate	-0.6	-0.6	-1.1	-3.1	-1.8	-0.2	0.0	0.1	0.2	-4.8	
Of which: real GDP growth	-1.4	-1.8	2.5	-4.0	-2.8	-2.7	-2.5	-2.4	-2.4	-16.8	
Exchange rate depreciation [7/]	1.4	2.1	4.6	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.6	0.5	3.2	-2.6	-0.6	0.1	0.2	0.2	0.1	-2.6	
GG: Privatization and Drawdown of deposits (negative)	-0.6	0.3	3.1	-2.8	-0.8	-0.1	-0.1	-0.1	-0.1	-4.1	
GG: Net acquisition of financial assets: Budget lending [8/]	1.2	0.2	0.1	0.2	0.3	0.3	0.2	0.3	0.2	1.4	
Residual, including asset changes [9/]	0.6	0.7	2.6	-1.2	2.3	0.0	0.1	0.0	0.3	1.5	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes net budget lending.

9/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

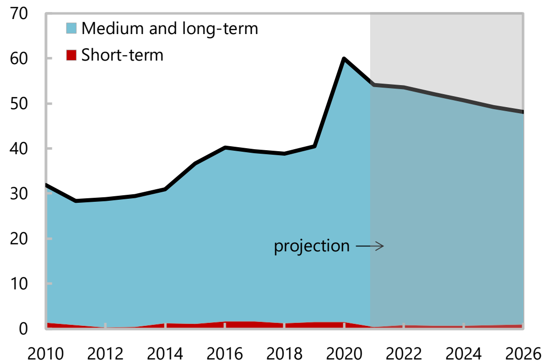
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Georgia: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

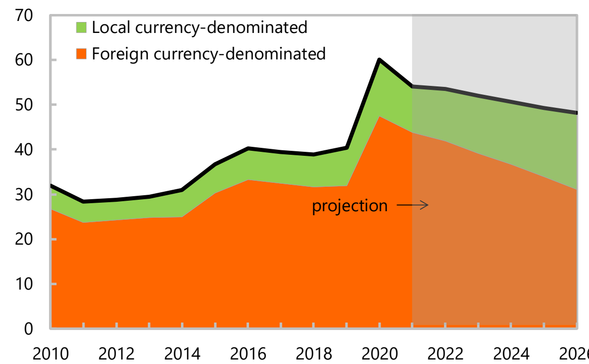
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

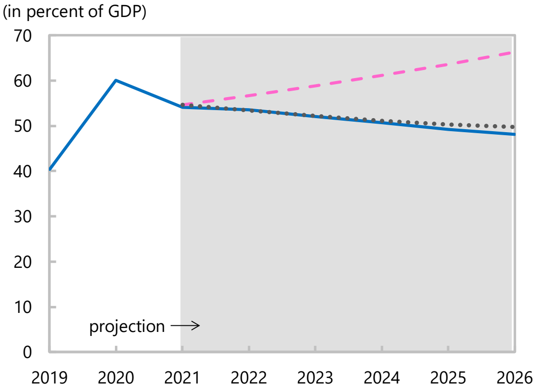


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

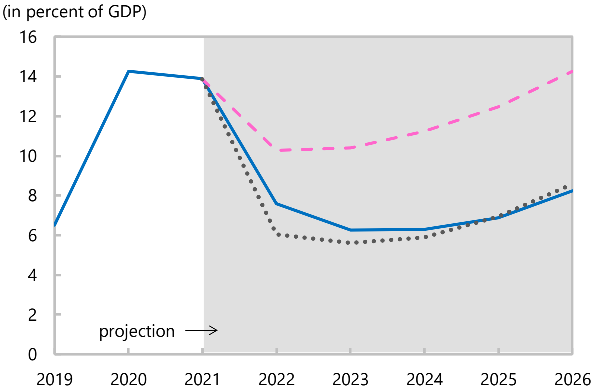
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

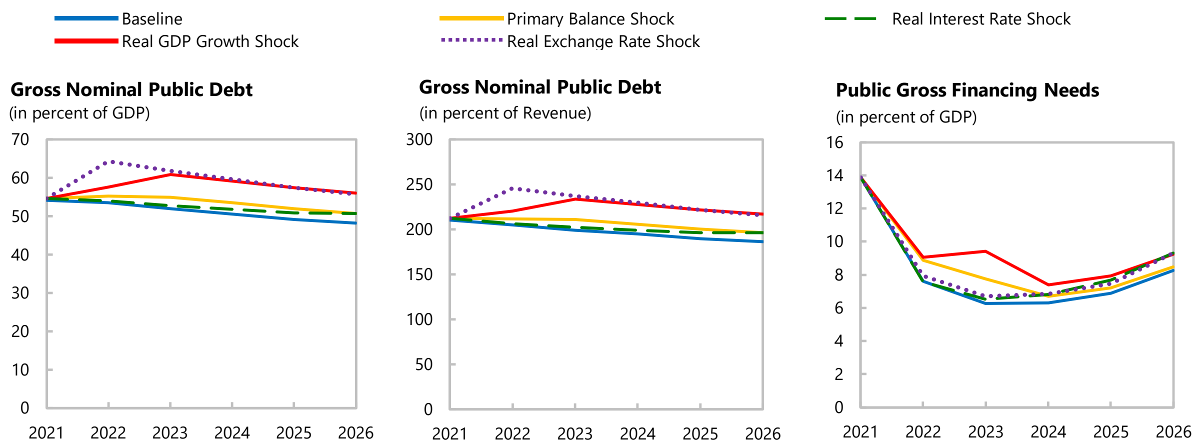
Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	7.7	5.8	5.5	5.2	5.2	5.2
Inflation	8.3	6.1	3.0	3.0	3.0	3.0
Primary Balance	-5.0	-2.3	-1.2	-1.0	-0.7	-0.7
Effective interest rate	3.0	2.7	2.8	3.1	3.3	3.6
Constant Primary Balance Scenario						
Real GDP growth	7.7	5.8	5.5	5.2	5.2	5.2
Inflation	8.3	6.1	3.0	3.0	3.0	3.0
Primary Balance	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Effective interest rate	3.0	2.7	2.9	3.2	3.5	3.9

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	7.7	3.6	3.6	3.6	3.6	3.6
Inflation	8.3	6.1	3.0	3.0	3.0	3.0
Primary Balance	-5.0	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	3.0	2.7	2.7	3.0	3.2	3.5

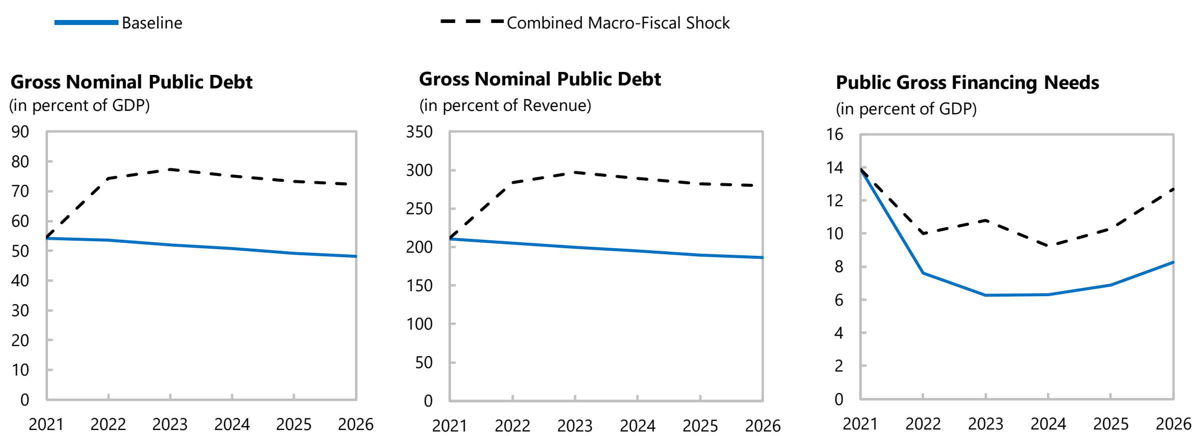
Source: IMF staff.

Figure 4. Georgia: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests

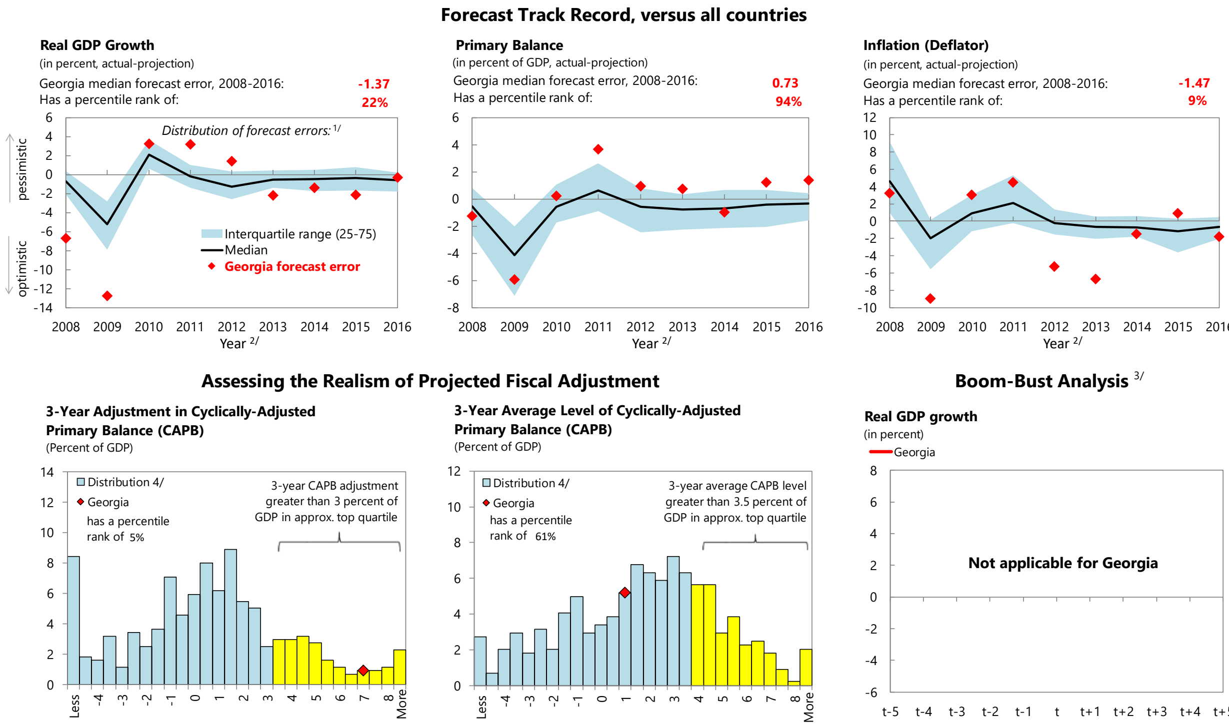


Underlying Assumptions
(in percent)

Primary Balance Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	7.7	5.8	5.5	5.2	5.2	5.2
Inflation	8.3	6.1	3.0	3.0	3.0	3.0
Primary balance	-5.0	-3.6	-2.5	-1.0	-0.7	-0.7
Effective interest rate	3.0	2.7	2.9	3.2	3.4	3.7
Real Interest Rate Shock						
Real GDP growth	7.7	5.8	5.5	5.2	5.2	5.2
Inflation	8.3	6.1	3.0	3.0	3.0	3.0
Primary balance	-5.0	-2.3	-1.2	-1.0	-0.7	-0.7
Effective interest rate	3.0	2.7	3.3	4.0	4.7	5.5
Combined Shock						
Real GDP growth	7.7	2.1	1.8	5.2	5.2	5.2
Inflation	8.3	5.2	2.1	3.0	3.0	3.0
Primary balance	-5.0	-3.6	-3.7	-1.0	-0.7	-0.7
Effective interest rate	3.0	3.0	3.0	3.8	4.4	5.2

Real GDP Growth Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	7.7	2.1	1.8	5.2	5.2	5.2
Inflation	8.3	5.2	2.1	3.0	3.0	3.0
Primary balance	-5.0	-3.5	-3.7	-1.0	-0.7	-0.7
Effective interest rate	3.0	2.7	2.9	3.3	3.5	3.7
Real Exchange Rate Shock						
Real GDP growth	7.7	5.8	5.5	5.2	5.2	5.2
Inflation	8.3	15.6	3.0	3.0	3.0	3.0
Primary balance	-5.0	-2.3	-1.2	-1.0	-0.7	-0.7
Effective interest rate	3.0	3.0	2.4	2.7	2.9	3.2

Figure 5. Georgia: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Georgia, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex IV. Georgia's Medium-Term Fiscal Path and Risks[1]

Medium-term fiscal adjustment is needed to comply with Georgia's fiscal rule, which is essential for credibility, as well as to build resilience. Reining in fiscal risks, particularly those stemming from state-owned enterprises, will be important.

1. **A sound fiscal position leading up to the pandemic created space for a strong fiscal response.** During 2015-2019, small fiscal deficits (averaging 1.3 percent of GDP), an adequate deposit buffer (averaging 2.7 percent of GDP), and low gross debt (below 40 percent of GDP) placed Georgia in a sound fiscal position, even after boosting capital spending substantially. Numerous structural reforms have further strengthened the fiscal framework. This laid the ground for a proactive fiscal response to the COVID-19 pandemic, including 3.8 and 2.9 percent of GDP in 2020 and 2021 in measures to support the health sector, vulnerable households, and viable businesses. In view of high uncertainty in early 2020, the authorities also mobilized international support to attract concessional financing in preparation for downside risks. As a result, by end-year, the budget deficit reached 9.2 percent of GDP and public debt widened by 20 percentage points of GDP. Deposit buffers reached a historic high of 6.5 percent of GDP.

2. **As the economy recovers, fiscal adjustment is needed to comply with the fiscal rule and rebuild buffers for macro policy management.** Georgia's Liberty Act, which was reformed in 2019, prescribes ceilings on the general government deficit and gross debt of 3 and 60 percent of GDP. An escape clause triggered in 2020 due to the pandemic allows for temporary deviation from this rule for up to three years, making the rule binding again in 2023. Under the baseline, compliance with the fiscal rule is expected, with a deficit projected at 2.6 percent of GDP while the stock of debt (including PPPs and non-market SOEs[2]) is projected at 52 percent of GDP (Figure 1). While this path would comply with the fiscal rule, somewhat faster fiscal consolidation in 2022, when COVID-19 relief measures are expected to roll off, could deliver a smaller deficit and achieve a smoother path of new adjustment measures across 2022 and 2023. In the medium run, fiscal policy space should be built to cope with potential macroeconomic shocks and/or materialization of fiscal risks. Stochastic simulations of shocks for Georgia suggest a sizeable fiscal buffer should be maintained, to ensure compliance with the fiscal rule and provide space for countercyclical fiscal policy (Figure 2). Based on past shocks in Georgia, targeting a debt anchor of 50-53 percent of GDP would be appropriate for debt to exceed the fiscal rule limit only with a 5-10 percent probability over a 6-year forecast horizon.

3. **The baseline fiscal consolidation path is predicated on unwinding COVID-19 crisis support, containing medium-term current spending pressures, and lowering capital spending**. Fiscal space is constrained by higher current spending (driven by the recent pension indexation reform). Tax revenues (measured after VAT refunds) are projected to recover to close to 2019 levels (as a share of GDP), and a higher level of VAT refunds under the newly implemented system is compensated by growth in other (gross) tax revenues (Figure 3). Withdrawal of COVID-19 support

[1] Prepared by A. Lagerborg.

[2] Georgia's fiscal rule applies to the general government including non-market SOEs (classified as general government entities under the 2020 sectorization exercise) as well as outstanding PPP commitments.

measures in 2022 is expected to bring current spending below pre-pandemic levels as a share of GDP, after accounting for the rise in basic pension benefits (Figure 4). However, medium-term spending pressures are rising from the indexation of state pensions and subsidies to PPAs.[3] Education spending is projected to remain close to 4 percent of GDP; the education spending floor of 6 percent of GDP originally targeted for 2022 is expected to be delayed due to limited fiscal space.[4] Capital spending is assumed to gradually decline from record levels in 2020, converging to 5.6 percent of GDP in the medium run, in line with average spending during 2013-2018 but below the government's target of 8 percent of GDP under the Government Program for 2021-24 described in greater detail below (Figure 5). Reaching the authorities' ambitions for education reform, infrastructure investment, and other priority spending, while ensuring essential buffers, would require additional fiscal space.

4. The challenges the authorities face in achieving spending priorities while staying safely under fiscal rule ceilings would be exacerbated if fiscal risks materialize. The authorities produce a detailed Fiscal Risk Statement annually that identifies key vulnerabilities. In 2019, PPP liabilities and non-market SOE debt were estimated to add 1.6 percent of GDP to the stock of debt subject to the fiscal rule.[5] The negative impact of the pandemic on the financial results of SOEs in 2020 remains to be fully assessed and the impact on fiscal parameters in future years is still unknown.[6] The materialization of adverse macroeconomic shocks and fiscal risks could further burden the state budget, manifesting in capital injections and accumulated losses transitioning into government debt.[7] Poor financial performance of SOEs has given rise to net losses, negative return on assets and on equity, and rising debt-to-equity leverage during 2013-19 (Figure 7). As of 2018, the recapitalization needed to restore adequate levels of equity (assumed to be 40 percent

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[3] A steep rise in fiscal costs associated with PPAs expected in 2025 may be delayed by 2-3 years due to Nenskra's construction delays.

[4] Increasing spending to meet this floor would amount to a sharp rise in the education budget in one year. A more gradual pace for increasing education spending is expected. As part of increasing teachers' remuneration, gradual salary hikes are expected to cost GEL 100 million per year. Salaries for kindergarten teachers were raised in September 2020 and for school teachers in January 2021. The authorities have committed to revisiting the comprehensive education reform agenda after the pandemic.

[5] The 2020 Fiscal Risk Statement estimated PPP liabilities at GEL 390 million (0.8 percent of GDP), including the Nenskra Hydro Power Plant (GEL 267 million) and Tbilisi Shota Rustaveli International Airport (GEL 122 million). The hypothetical impact of including non-market SOEs as part of the general government sector was estimated to increase state debt by another 0.8 percent of GDP (and reduce the fiscal deficit by 0.22 percent of GDP) according to the 2020 FRS. More recent IMF TA estimates based on GFSM 2014 methodology suggest a larger impact (increase of 1.1 percent and 0.6 percent respectively) on government debt and deficit.

[6] Support to SOEs totaled GEL 67 million in 2020 in the form of on-budget subsidies. SOEs are estimated to have lost revenues totaling about GEL 130 million (0.3 percent of GDP) due to the pandemic in 2020, while operating expenses remained constant, adding to risks in terms of possible capital injections. Most of the revenue losses were by SOEs in the transport and aviation industry, e.g., Tbilisi Transport Company (GEL 40 million), Georgian Railway (GEL 30 million), and United Airports of Georgia (GEL 47 million).

[7] Fiscal risks from SOE loan liabilities (estimated at a 78 percent debt-to-asset ratio) are amplified by a high share of FX-denominated debt and on-lending practices based on the government's external financing practices, making improving debt management of SOEs imperative. Adverse macroeconomic shocks, especially FX risks, could substantially decrease SOE profitability and net worth, and increase their debt-to-asset ratio and gross financing needs.

debt/total liabilities) was estimated at around 7 percent of GDP[8]; the authorities' commitment not to take over any SOE debt or provide equity injections until SOE reform is finalized somewhat mitigates these risks. Contingent liabilities from SOEs, stemming largely from PPA contracts such as ESCO's guaranteed purchase agreements, could also materialize if market prices available for imports into the region significantly fall below the guaranteed purchase price.[9] Under the baseline, fiscal costs associated with PPAs are estimated to peak at 0.17 percent of GDP in 2025 and amount to US$ 883 million over 2020-2043, but could be 3.5-4.8 times larger (peaking at 0.4-0.6 percent of GDP in 2025) under downside scenarios where market prices are lower by 10-30 percent (Figure 6).[10] The authorities' measures to limit fiscal risks are welcome, including by establishing a new feed-in premium mechanism for new PPAs, a new PPP framework, and constraining activities of the Partnership Fund, which has been operating on a non-commercial basis. Comprehensive SOE reform will be key to limiting fiscal risks going forward.

5. **Continued fiscal reforms are needed to create fiscal space, reduce risks, and enhance resilience to future shocks.** Priority reform areas should include strengthening public financial management to optimize expenditures, improving the efficiency of public investment management (PIM) including by standardizing project appraisal and selection[11], and wide-scale reform of SOEs. The COVID-19 crisis has further highlighted the importance of building resilience to shocks and having the fiscal firepower and systems to provide targeted support. Enhancing social safety nets could improve targeting of fiscal support to vulnerable households and reduce fiscal costs associated with broader and more ad hoc approaches.

6. **The authorities' ambitious agenda for infrastructure investment will require additional fiscal space.** The authorities' medium-term capital spending target of 8 percent has an ambitious set of goals, including large infrastructure projects focused on strategic highways, water, education, and urban transport. Establishing Georgia as a regional hub and transport corridor as the government aims to do would require substantial further investments to develop its infrastructure, logistics, communications, energy, and technology.[12] Other strategic infrastructure plans include developing the national water supply and diversifying energy supply, from mainly hydro to include wind and solar power plants to provide year-round energy security, as well as constructing power transmission lines. Digital infrastructure development, including expanding broadband networks, will help grow the country's digital economy and increase competitiveness. A strategic plan to further develop the tourism sector also includes developing ski resorts among other investments. Given

[8] See the "Public Sector Balance Sheet and State-Owned Enterprises" IMF Technical Assistance Report, 2020.

[9] Under ESCO's Guaranteed Purchase Agreement, it undertakes to purchase a pre-agreed amount of electricity at a pre-agreed guaranteed price.

[10] These estimates are taken from the Ministry of Finance's December 2020 Fiscal Risk Statement.

[11] The new PIM methodology still remains to be implemented and the responsibilities of the MOF in project appraisal should be defined.

[12] Ongoing development projects include: the Poti port and Anaklia deep-sea port infrastructure, modern logistic centers in Tbilisi and Kutaisi, a cargo terminal in Kutaisi international airport, the Baku-Tbilisi-Kars Railway which will reduce the time for cargo transportation between Asia and Europe, and construction and rehabilitation of roads of national and international significance such as the East-West highway connecting Tbilisi to Batumi.

these public investment goals, narrowing the efficiency gap in public investment (estimated at 15-20 percent in 2018[13]) will be particularly important.

7. **There is limited room to cut current spending to create fiscal space.** Under baseline projections, primary current spending rises remains above pre-pandemic levels due to spending pressures, while capital spending is reduced. While the pension bill and education spending are rising as a share of GDP, other current primary spending is compressed below pre-pandemic levels by 0.8 percent of GDP in the medium run (Figure 3). The interest bill is expected to fall in 2022 but then rise again as the share of domestic debt financing increases (which reduces fiscal risks but at the cost of higher interest rates) and the debt stock, while falling, remains higher than pre-pandemic levels. Altogether, this leaves little room for further current spending cuts.

8. **Additional fiscal space could be created by mobilizing revenue.** Georgia has a simple flat tax system and low tax burden that is known for being business-friendly but is also highly rigid, regressive, and subject to loopholes. Georgia's Economic Liberty Act allows for temporary changes in tax rates (for a maximum of three years) but prevents any new state taxes or increases in top tax rates (except for excise taxes) without a referendum. This rigidity prevents mobilizing revenue by raising top tax rates, which would make the current system more progressive; Georgia's 20 percent flat personal income tax (PIT) rate is a disproportionately high burden for low-income earners. Still, there is scope to increase tax revenue and competitiveness under Georgia's current tax system. Georgia's tax administration has been strengthened substantially during 2016-20[14], but additional measures could be taken to improve tax compliance.[15] A long and growing list of tax expenditures (e.g., VAT exemptions and tax incentives) that distort production decisions could be revisited to broaden the tax base and create a more competitive environment. Small businesses (with turnover below GEL 500,000) enjoy a 1 percent turnover tax compared to the 20 percent PIT rate, creating incentives to shift from formal employment to sub-contracting as "entrepreneurs". Property tax rates, at less than 1 percent, rely on self-declared property values and are linked to household income rather than wealth (favoring foreign owners).

9. **A broader revenue strategy might be considered.** Although progress can be made under the current tax system, there could also be merit over the medium term in considering a more far-reaching revenue mobilization strategy, based on a comprehensive tax policy review that takes into account the specificities of Georgia's tax system. It might seek to raise additional revenue while avoiding undermining competitiveness and aiming for a more balanced tax burden with careful attention to distributional implications.

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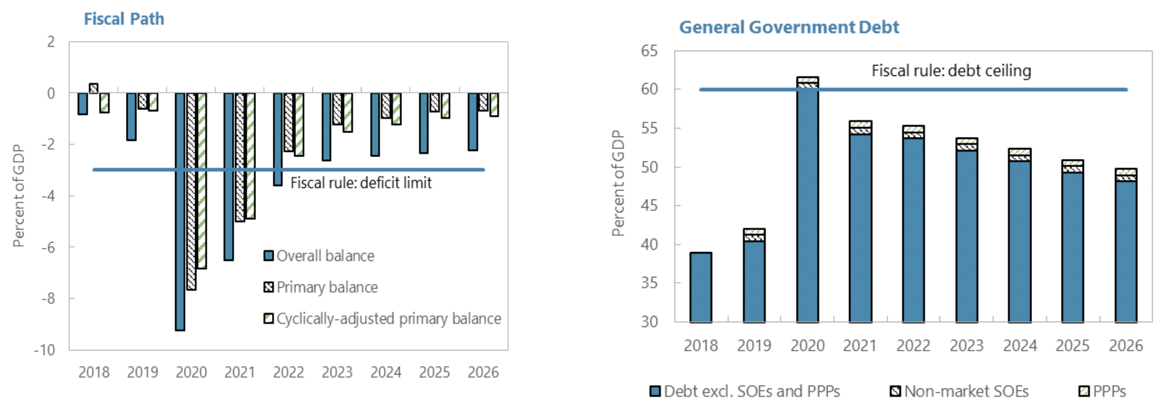
[13] See the "Public Investment Management Assessment" IMF Technical Assistance Report, 2018.

[14] A four-year revenue administration reform program (RMTF) was completed in April 2021 and TADAT assessments attest to the significant improvements made over 2016-2020. For example, these have included the creation of a new taxpayer register, improved use of third-party data and analytical capability to identify and assess compliance risks, creation of a large taxpayer unit within the GRS, and establishment of good practices for new VAT refund claims under an automatic payment system.

[15] For example, this could include developing and implementing compliance improvement plans for different segments (e.g., large taxpayers, high-income self-employed, high-wealth individuals, and a payroll audit program) and better monitoring of bulk data to identify unregistered businesses.

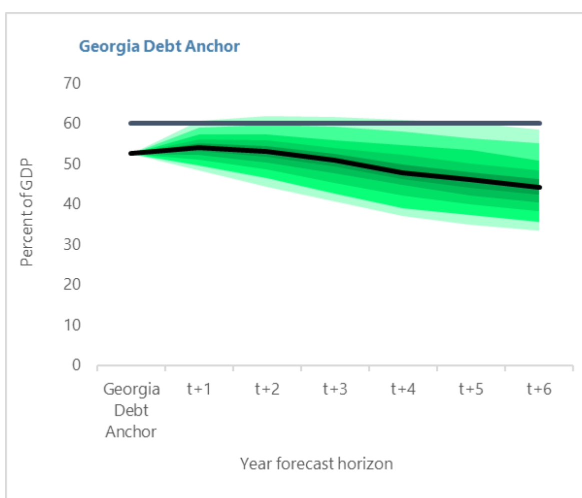
10. A strong focus on fiscal policies will be needed to restore buffers, create fiscal space for priority outlays, and control risks. To comply with the fiscal rule, which is essential for credibility, the fiscal deficit needs to be reduced by around 4 percent of GDP in the next two years. To also provide a buffer and fund priority spending the necessary adjustment is even larger. These already challenging objectives would be jeopardized if fiscal risks materialize, underscoring the importance of reforms to control risks, especially from SOEs, PPPs, and PPAs.

Figure 1. Fiscal Adjustment



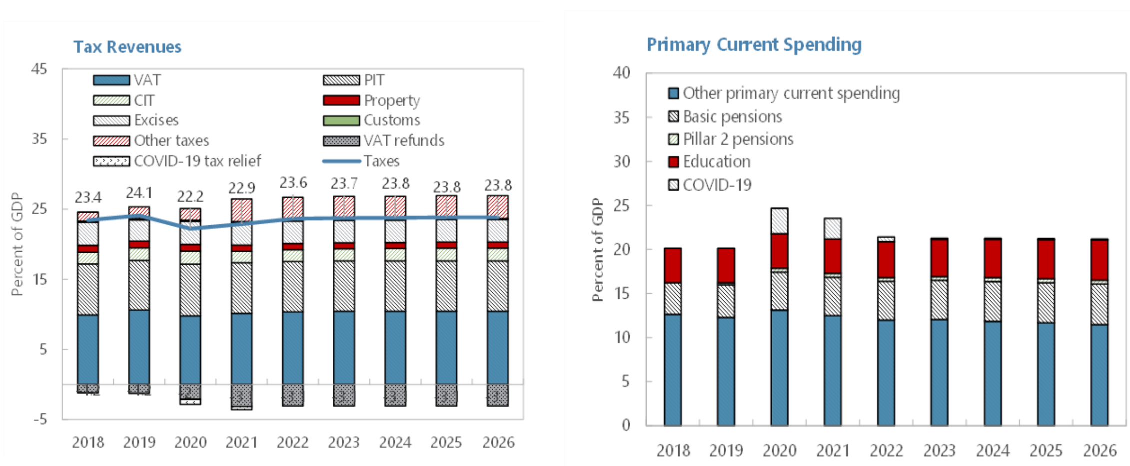
Sources: National authorities, and IMF staff calculations

Figure 2. Debt Limit and Implied Anchor



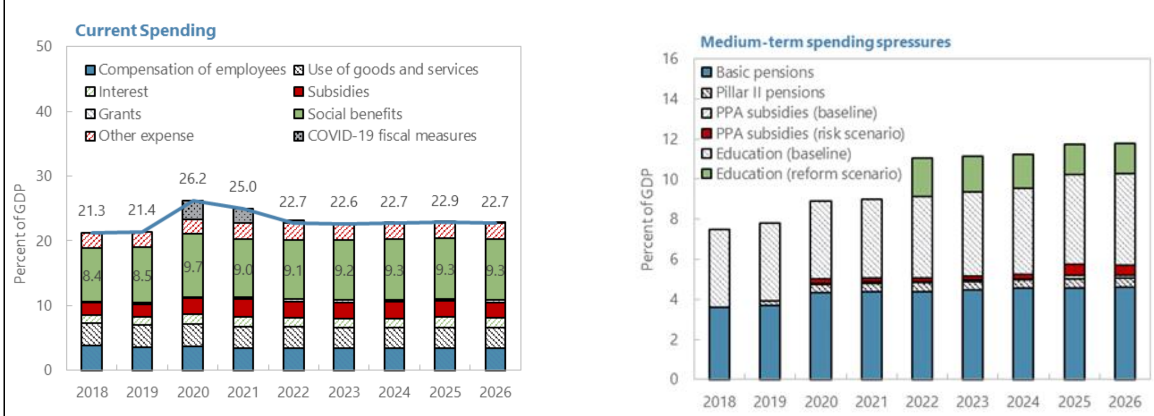
Sources: National authorities, and IMF staff calculations

Figure 3. Tax Revenues and Primary Current Spending



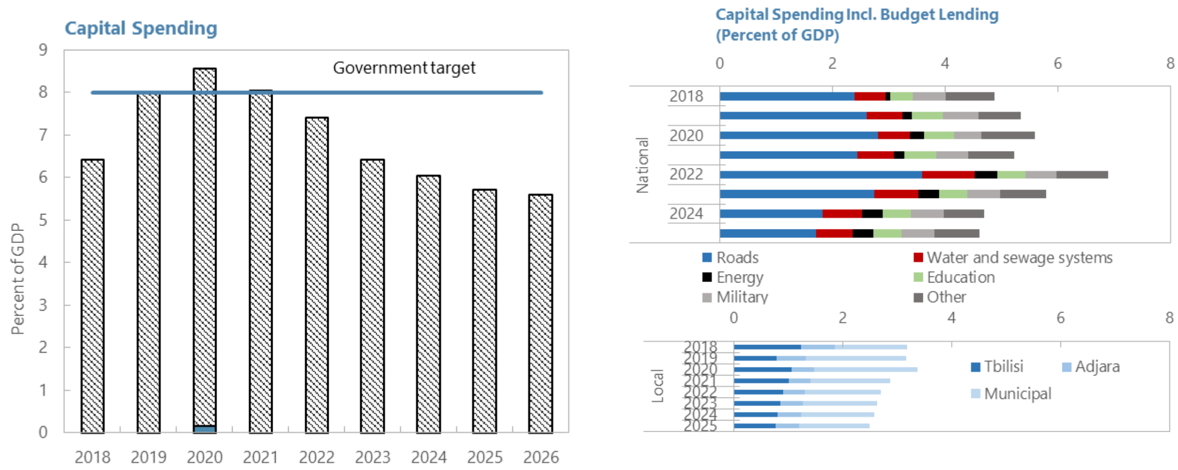
Source: National authorities, and IMF staff calculations.

Figure 4. Current Spending – Additional Details



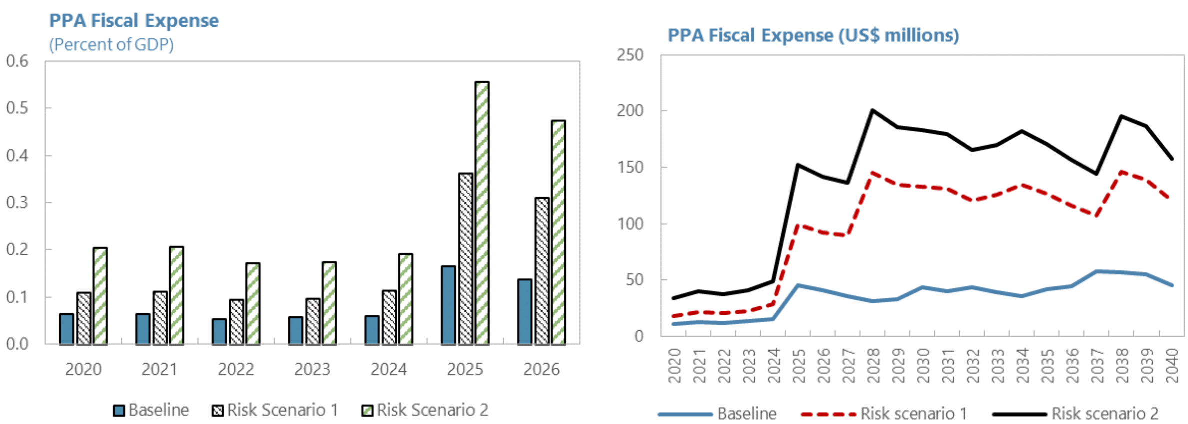
Sources: National authorities, and IMF staff calculations.

Figure 5. Capital Spending



Sources: National authorities, and IMF staff calculations.

Figure 6. PPAs



Sources: National authorities, and IMF staff calculations.

Figure 7. SOE Financial Statements

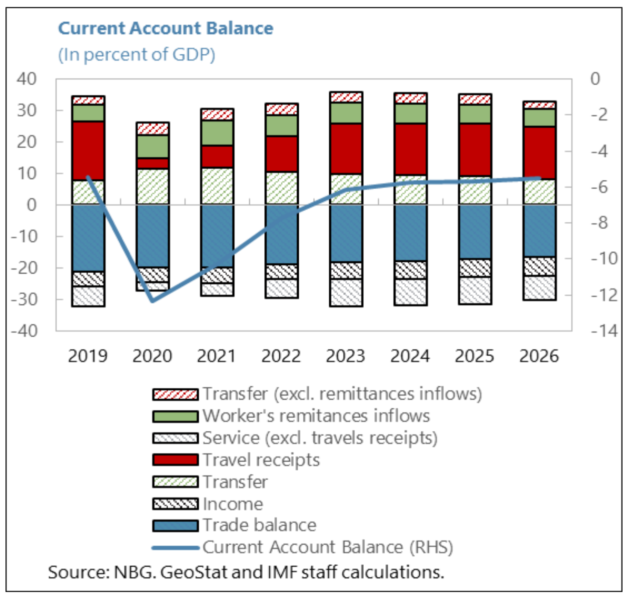
Sources: National authorities, and IMF staff calculations.

Annex V. External Sector Assessment[1]

Georgia's external position in 2020 was broadly in line with the level implied by fundamentals and desirable policies. However, the COVID-19 shock dampened tourism revenues and widened the current account deficit significantly, and external vulnerabilities increased relative to 2019 in view of the slow recovery of tourism and the build-up of external debt. The net international investment position widened in 2020, although it is deemed sustainable according to the external sustainability approach. Despite moderately lower inflows, end-2020 gross international reserves coverage reached 108 percent of the ARA metric and the NIR target was met with a comfortable margin. This was mainly driven by large donor financing in 2020 and because the capital outflows projected at the Seventh Review did not materialize. In the aftermath of the COVID-19 shock, the current account deficit is projected to gradually narrow to 5.5 percent of GDP by 2026. Continued prudent fiscal policy, exchange rate flexibility, and structural reform implementation remain essential to safeguarding external sustainability over the medium term.

Current Account and Real Exchange Rate Developments

1. **The 2020 current account (CA) widened significantly due to the COVID-19 shock.** The 2020 CA deficit is estimated at 12.5 percent of GDP, 7.0 percentage points higher than in 2019. Although the (merchandise) trade deficit in 2020 narrowed due to a large decline in imports, it was more than offset by the sharp deterioration in the services account, with tourism revenue lower by 83 percent (y-o-y).

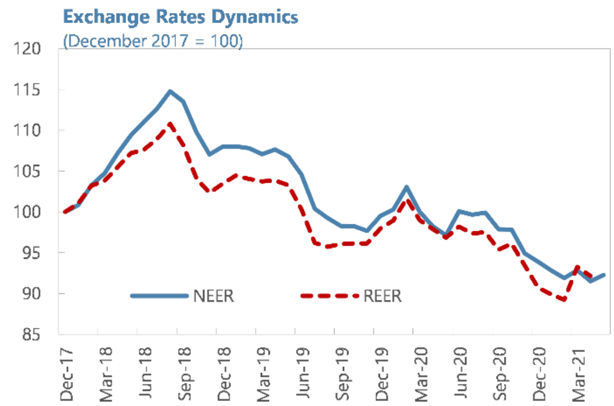


2. **The CA deficit is expected to narrow gradually in 2021 and beyond.** Partly driven by a gradual recovery in tourism revenue (by 111 percent in 2021 y-o-y largely due to the low base in 2020), the CA deficit is projected to narrow to 10 percent of GDP in 2021. However, due to potential scarring and high uncertainties around the vaccine rollout in Georgia and worldwide, tourism revenue is expected to recover to the 2019 level only in 2023. Accordingly, the medium-term CA deficit is expected to decline gradually to 5.5 percent of GDP (the historically low level of 2019), assuming a gradual recovery in exports and timely implementation of structural reforms to diversify the economy and increase competitiveness.[2]

[1] Prepared by Yunhui Zhao.

[2] With Georgia's product diversification relatively low, export growth is projected to be mostly sustained by enhanced export market diversification.

3. The lari depreciated sharply due to the COVID-19 shock. In 2020, the lari depreciated by 5.6 percent and 7.4 percent in nominal and real effective terms, respectively. The lari depreciation was attributable to the adverse effect of the COVID shock starting from the initial outbreak stage in March-May 2020. The NBG's FX sales to curb inflationary expectations helped limit pressures on the FX market, although renewed depreciation pressures emerged in November 2020 when Georgia's COVID cases surged. In spring 2021, along with some further FX intervention to prevent excess FX volatility, the NBG demonstrated its strong commitment to low and stable inflation by raising its policy rate. Following these policy actions, together with expectations of the COVID vaccine rollout domestically and abroad, depreciation pressures have abated: for example, the NEER appreciated by 0.8 percent m-o-m in May 2021, as opposed to the 3.0 percent m-o-m depreciation in November 2020.



Source: National Bank of Georgia and IMF staff calculations.
Note: An increase in the REER or the NEER means an appreciation of the currency.

4. The CA approach does not suggest a significantly negative CA gap in 2020. The CA approach of the IMF's External Balance Assessment (EBA-lite) methodology suggests a -1.0 percent of GDP CA gap in 2020, compared with the positive gap of 2.8 percent of GDP in 2019 at the Sixth Review. Despite the CA deficit being significantly higher in 2020 than in previous years, an additional cyclical adjustment (4.7 percent of GDP) is made to account for the temporary impact of the pandemic on tourism and the oil trade balance, in line with the updated EBA-lite template.[3] As a result, the CA approach implies an adjusted CA deficit of 7.9 percent of GDP, corresponding to a CA gap of -1.0 percent of GDP. In addition, compared with policy gaps, economic fundamentals play a larger role in driving the CA gap. Furthermore, the REER approach actually suggests a *positive* CA gap of 1.9 percent of GDP and an REER undervaluation of 5.1 percent.[4] In view of the results of these two approaches, staff assess that Georgia's external position in 2020 was broadly in line with fundamentals and desirable policies. However, given the caveats of both approaches, the results should be interpreted with caution, and the authorities are still advised to sustain their reform agenda to enhance external competitiveness and raise net private savings.

[3] The tourism adjustor equals 5.58 percent of GDP, and the oil trade balance adjustor equals -0.86 percent of GDP. The tourism adjustor accounts for medium-term scarring and is based on the comparison between the tourism revenue estimates/projections in 2020-2025 for Georgia in the current vintage and those in the January 2020 WEO, just before the pandemic. The tourism adjustor obtained using this method (5.58 percent of GDP) is close to the one obtained using an alternative method (5.37 percent of GDP) that builds on the WEO scenario and assumptions about the scarring effects.

[4] Although the REER approach is generally less accurate than the CA approach, it may be more suitable for a tourism-dependent economy such as Georgia (*Methodological Note On EBA-lite*, IMF, February 2016, Paragraph 28).

Table 1. Georgia: EBA Model Estimates for 2020
(in Percent of GDP)

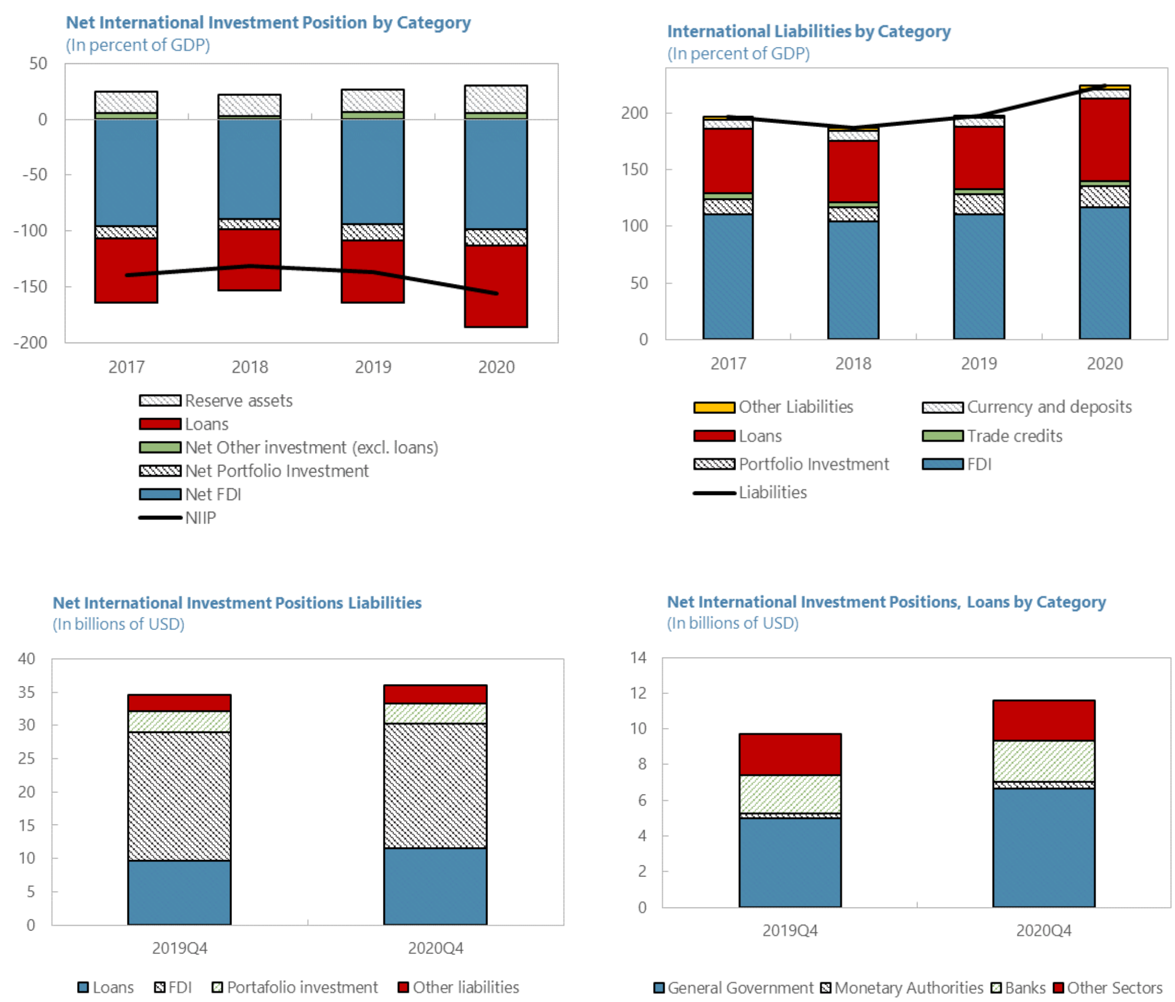
	CA model	REER model
CA-Actual	**-12.5**	
Cyclical contributions (from model) (-)	0.2	
COVID-19 adjustor (+) 1/	4.7	
Additional temporary/statistical factors (+)	0.0	
Natural disasters and conflicts (-)	0.0	
Adjusted CA	**-7.9**	
CA Norm (from model) 2/	**-6.9**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**-6.9**	
CA Gap	**-1.0**	**1.9**
o/w Relative policy gap	1.3	
Elasticity	-0.38	
REER Gap (in percent)	**2.7**	**-5.1**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic balances (-0.86 percent of GDP) and on tourism (5.58 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

Source: IMF staff calculations.

External Sustainability Approach

5. Georgia's net international investment position (NIIP) widened in 2020, and its external vulnerability increased relative to 2019. Under the current baseline scenario, the EBA-lite external sustainability approach assesses that the NIIP (i.e., gross foreign liabilities minus gross foreign assets) does not deteriorate in net present value terms, that is, the NIIP is sustainable based on this definition. However, this definition of sustainability is relatively narrow, and potential vulnerabilities associated with the current level of the NIIP or the composition of the NIIP require further analysis. By 2020, Georgia's NIIP stood at negative 156.8 percent of GDP, with FDI and loans accounting respectively for about 51.6 percent and 32.2 percent of total liabilities. Relative to end-2019, the NIIP widened by 20.1 percent of GDP, mainly driven by higher loan disbursements (by 17.4 percent of GDP), higher net FDI inflows (by 4.5 percent of GDP), and a lower nominal USD-denominated GDP. One potential mitigating factor is that an important contributor to the external debt stock build-up in 2020 was the increase in the government's concessional loans from IFIs (by around $1.0 billion); the private sector's external debt remained virtually unchanged in nominal terms.



Sources: National Bank of Georgia and IMF staff calculations.

Capital and Financial Flows

6. **The financial account balance in 2020 did not deteriorate, as the projected capital outflows did not materialize.** The financial account surplus is now estimated at 6.1 percent of GDP in 2020, slightly higher than that in 2019 and much higher than projected in the Seventh Review (by 3.5 percentage points). This reflects the fact that the projected capital outflows did not materialize (other net inflows were much higher), consistent with the lower-than-expected need for FX interventions by the NBG in 2020. Moreover, although the net FDI inflows and net portfolio inflows were much lower than 2019 (by 2.2 and 3.5 percent of GDP y-o-y, respectively), caused by the COVID shock, the net loan inflows were also much higher (by 2.3 percent of GDP y-o-y), reflecting the large inflows of donor financing.

7. **Financial flows are expected to stabilize over the medium term.** The financial account surplus is projected to gradually decrease to about 6 percent of GDP over the medium term (after a temporary increase in 2022), consistent with a gradually improving current account balance. In the aftermath of the COVID-19 shock, portfolio inflows are expected to stabilize. As the economic outlook improves domestically and abroad, and boosted by improved competitiveness from

structural reforms, FDI inflows are projected to gradually increase. The net loan inflows are expected to peak in 2021, as the COVID-related external borrowing gradually fades out. Over the medium term, the bulk of Georgian debt is expected to remain held by IFIs and related parties—mostly on concessional terms. External debt is also expected to remain dominated by medium and long-term debt.

Reserves

8. Gross international reserves (GIR) reached 108 percent of the ARA metric at the end of 2020, and the end-2020 NIR target for the eighth EFF review was met with a comfortable margin. Despite moderately lower program and project loans/grants, net international reserves (NIR) stood at $1,335 million (program exchange rate) and GIR at $3,911 million (market exchange rate) by end-2020, both higher than projected at the time of the Seventh Review. This was mainly driven by the lower-than-expected need for FX interventions by the NBG.

9. GIR in 2021 are expected to decrease relative to 2020 but the coverage ratio remains high. The protracted recovery in tourism in 2021, as well as further FX intervention (the NBG has sold around US$ 273 million so far in 2021), should lead to a decrease in GIR relative to 2020 in spite of continued donor financing and the SDR allocation. Staff project GIR coverage in 2021 of 99 percent of the ARA metric.

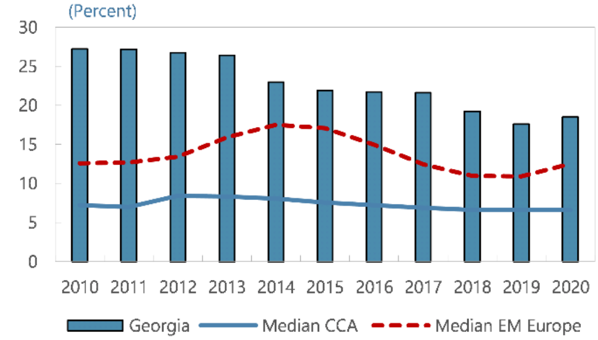
10. In conclusion, Georgia's external position in 2020 was assessed to be broadly in line with fundamentals and desired policy settings. This assessment was based on an additional cyclical adjustment accounting for the temporary impact of the pandemic on tourism and oil trade balance. However, external vulnerabilities increased with the protracted recovery in tourism, a gradually narrowing CA deficit, the large negative NIIP, a build-up in external debt, and pressures on reserves. Hence, strong and prudent macroeconomic policies are needed to maintain and strengthen external sustainability over the medium term.

Annex VI. Strengthening the Labor Market in Georgia: Key Facts and Policy Considerations[1]

Stylized Facts

1. Unemployment in Georgia has been persistently high and job creation slow. Although international comparisons are complicated by recent methodological changes[2], Georgia's unemployment is likely one of the highest in the CCA region and higher than in most EM European countries. Significant job creation matched by a reduction in the stock of unemployed or individuals outside the labor force was only observed in 2014-15 (together these two years accounted for 110,600 additional employed persons out of a total of 128,300 additional employed persons between 2010 and 2019). More recently, job creation has been anemic with the number of employed individuals declining by 12,600 between 2015 and 2019, suggesting that the reductions in unemployment rates during this period reflect individuals leaving the labor force, including by leaving the country. The COVID-19 pandemic has further strained the labor market, with the number of employed individuals declining by 81,300 between 2019 and 2021Q2.

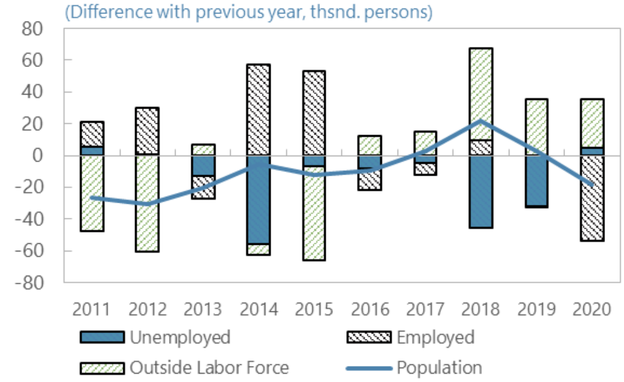
Unemployment Rate
(Percent)



Source: International Monetary Fund, World Economic Outlook April 2021, and IMF staff calculations.

2. There is a mismatch between the drivers of GDP growth and the drivers of employment. GDP growth averaged 4.7 percent between 2011 and 2019, but this has not translated into steady progress in reducing unemployment. The main drivers of growth over this period have been financial, insurance and real estate activities (FIREA) (0.9 percentage points total), as well as construction and manufacturing (0.4 percentage points each). More recently the growth drivers changed. Between 2017 (the

Changes in Labor Force Status and Population
(Difference with previous year, thsnd. persons)



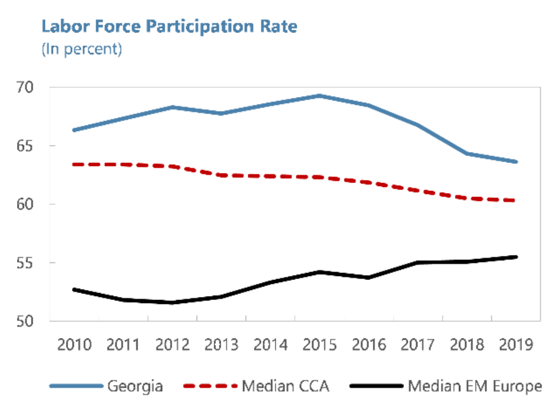
Source: Geostat

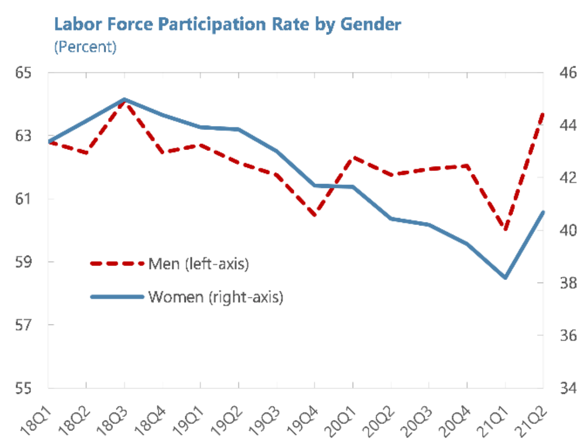
[1] Prepared by S. Khan, N. Reyes, S. Saksonovs and N. Sharashidze.

[2] In late 2020 GEOSTAT adopted new ILO standards for measuring unemployment. The main change is that individuals working in households are no longer considered employed if less than ½ of their produce was sold in the market. This affects many Georgians, who are engaged in subsistence agriculture and were previously considered self-employed. Many of these formerly self-employed individuals do not meet the requirements to be in the labor force as they are not looking for jobs. The change in methodology accounts on average for an 8 percentage point increase in the unemployment rate of Georgia each year in 2010-2019, the period for which the data is available in both methodologies.

first year for which the sectoral composition of employment is available) and 2019, growth averaged 4.9 percent, of which 0.7 percentage points was due to FIREA, 0.7 p.p. due to wholesale and retail trade and 0.6 p.p. due to accommodation and food service activities, reflecting the growing importance of tourism. However, these industries, which accounted for almost half of the GDP growth, only accounted for 20.5 percent of employment on average. FIREA created barely any jobs between 2017 and 2019. Only trade as well as accommodation and food services generated healthy growth in employment between 2017 and 2019, contributing an average 0.8 and 0.4 p.p., respectively, to the average annual growth in employment of 0.4 p.p. over this period; however, progress has been largely undone by the COVID-19 crisis.

3. Labor force participation rates, although higher than in peer countries[3], have been declining. Prior to the COVID-19 shock, the decline was similar for men and women. However, COVID-19 revealed a sharply different pattern with male labor force participation stabilizing, while female participation declined further reflecting possibly increased childcare responsibilities, in line with international experience.





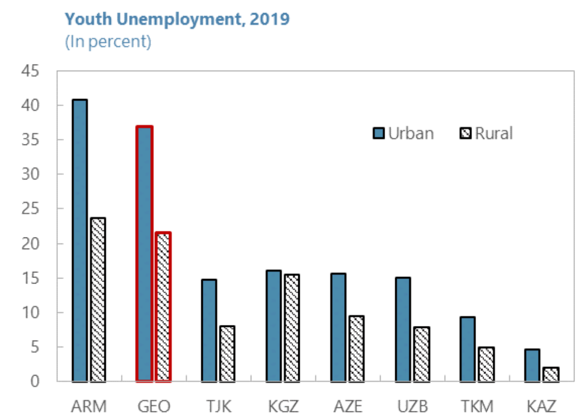
Source: Geostat.

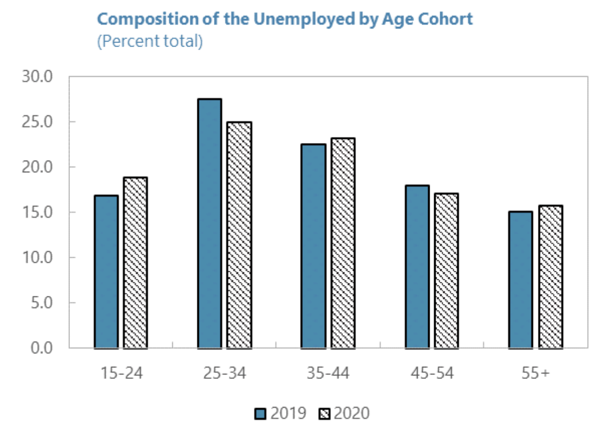
4. The COVID-19 crisis exacerbated the previous trends in labor market dynamics. Between 2019Q4 and 2021Q2, the number of employed shrunk by 62,000 people: about 90,000 people joined the ranks of the unemployed, while 27,000 joined the labor force.[4] Although the number of job losses was roughly equally split between women and men (33,000 and 30,000 people, respectively), women dropped out of the labor force (12,000 people) rather than be unemployed (21,000), while men entered the labor force (39,000) and continued to actively look for work

[3] IMF (2018) attribute higher labor force participation in Georgia to the relatively high share of workers age 65+ (8.4 percent of the total labor force), who may be compelled to participate in economic activity due to poverty, low savings and basic pension. In 2020, the basic pension was about USD 80 per month, roughly USD 20 higher than the subsistence minimum.

[4] Between 2019Q4 and 2021Q1, about 85,000 people dropped out of the labor force; however, labor force participation picked up significantly in 2021Q2.

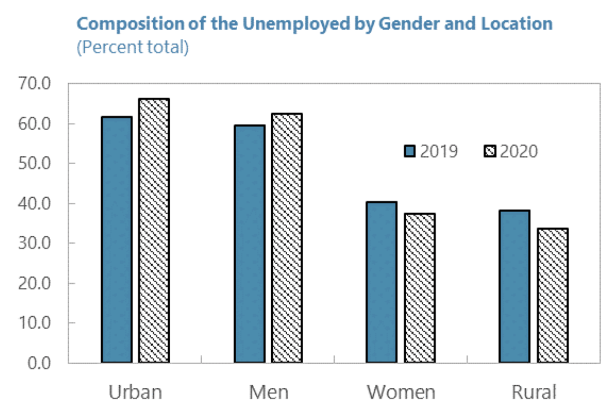
(68,000).[5] With the decrease in the labor force in 2020, the unemployment rate rose by less than one percent to 18.5 percent as the pandemic hit; however, in 2021Q2, the size of the labor force increased and, compared to 2019, the unemployment rate increased by about 5 percentage points, reaching 22.1 percent.





Source: Geostat, and International Labour Organization, (2019), Unemployment rate by sex, age and rural / urban areas, https://ilostat.ilo.org/topics/population-and-labour-force/

5. Youth unemployment is one of the highest in the region and almost half of the unemployed are less than 34 years old. Georgia's youth unemployment rates are the second highest in the region, behind only Armenia. However, unemployment rates may be misleading for younger cohorts as the labor force at that age is usually smaller. In 2019 the share of people below 34 among the unemployed was 44.4 percent, which decreased slightly in 2020 (43.9 percent).[6] Further, ILO data compiled by the World Bank[7] indicate that in 2019, 26 percent of Georgian youth were not in employment, education, or training (NEET), putting the country among those with higher NEET shares.



Source: Geostat.

[5] Note that the Labor Force Survey on which we rely, attempts to capture those who are informally employed (according to GEOSTAT 31 percent of the employed in 2020 were informally employed). According to ILO statistics, the informality of Georgian labor market decline from 51 percent in 2019 to 38 percent in 2020. This may reflect many people registering for the state compensation in 2020 as the state's COVID relieve measure (200 GEL per month for 6 months for the employed who lost jobs and GEL 300 one-time support for the self-employed). The new labor legislation requiring presence of a written contract in any labor relationship of longer than 1 month, might also have helped reduce the informality in the labor statistics.

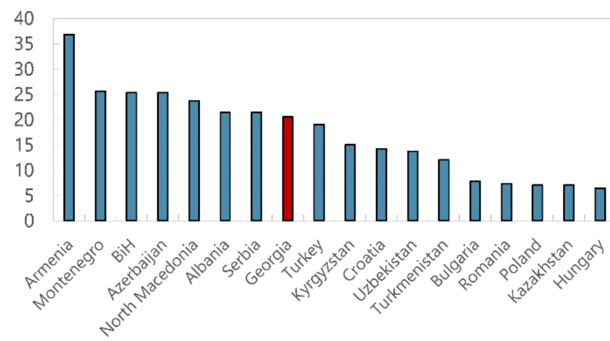
[6] On the other hand, among the people outside labor force those below 34 comprised only 26.4 percent in 2019, increasingly slightly to 28 percent in 2020. More than half of the individuals outside the labor force (51.7 percent) are ages 55 and above.

[7] https://data.worldbank.org/indicator/SL.UEM.NEET.ZS

6. The unemployed are mostly men and live in urban locations, a pattern that has become more pronounced after COVID-19. In 2020 around two thirds (63 percent) of the unemployed were men and, similarly, 66 percent were individuals who live in urban locations. The gender breakdown is driven in part by lower female labor force participation noted above.

7. A considerable share of labor resources is underutilized. The ILO composite measure of labor underutilization (LU4), defined as the ratio of the unemployed, underemployed[8] (people who are working part-time and would like to work more, which are not a large group in Georgia), and potential labor force[9] as a share of current plus potential labor force, puts Georgia approximately in the middle of the peer comparison at 20.5 percent.

Composite Rate of Labor Underutilization (LU4), 2019



International Labour Organization, (2019), Unemployment and labor underutilization, https://ilostat.ilo.org/topics/unemployment-and-labour-underutilization/

8. Along with high unemployment, Georgia also experiences relatively high inequality. While inequality, as measured by Georgia's GINI coefficient, has been improving in recent years and fell somewhat further in 2020, the country still has higher inequality than many of its peers.

Policy Considerations

9. Lack of labor market flexibility is unlikely to be a central issue for Georgia. Hiring and redundancy are considered easy, and the labor tax wedge is low (only in 2019 with the introduction of the Pillar II pension system do employers have to contribute 2 percent of salary for pensions). This flexibility nonetheless did not result in more job creation. The Labor Code was amended in 2020, as part of the EU accession roadmap to offer more protection to the employed. The latest changes to the labor code set standards for working hours, leave hours and break time, and remuneration for overtime; define rules for mediation on job-related disputes; ask employers to sign a written contract with the employee; determine the form, terms and content of the labor contract; and cover internships, night work, and identifying labor discrimination. Moreover, labor inspectors will now be authorized to inspect labor relations and assess compliance with labor rights and the requirements stated by the law. It remains to be seen whether the new code will constitute an additional obstacle to hiring.

10. Because the young comprise a substantial share of the unemployed, education reforms have consistently been proposed as a key element of the solution. For example, Badurashvili (2019) used a variety of skills mismatch indicators to conclude that there is a problem with the school-to-work transition in the Georgian labor market. Although levels of educational attainment

[8] Defined as people who are working part-time and would like to work more, which are not a large group in Georgia.

[9] The ILO defines potential labor force as people, who are available to work, but not seeking employment (e.g., discouraged workers), and people who are seeking employment, but not immediately available (e.g., due to family care responsibilities).

appear to be high, World Bank surveys of firms report that an inadequately educated workforce is the third most significant constraint to doing business. It may be that despite good indicators in terms of years of schooling, students' skills are not well-matched to jobs available in the market. In some cases, over-education can be a problem with workers not taking jobs or taking jobs that do not require the level of education they have achieved; women and those with tertiary education but limited skills or skills less aligned with labor market demands are more likely to do so (Posadas, et. al. 2018). The government has embarked on a comprehensive reform of the education system, a key pillar of which has been strengthening teacher qualification requirements and increasing teacher salaries while at the same time reducing headcount. Importantly, efforts are underway to strengthen vocational education supported by a range of donors, e.g., through a KfW-financed Center of Excellence for construction and logistics[10]. Reform implementation slowed due to COVID-19, but it remains a priority of the government.

11. However, the positive effects of education reform will take time to materialize and should be complemented with additional focus on active labor market policies (ALMPs). Around 40 percent of the unemployed are between ages 35 and 54, and are unlikely to benefit from the education system reform (though they may find more options to gain additional skills through vocational education and training). ALMPs could play a constructive role in reaching this segment of the population. These measures include improving search and matching (e.g., reducing information gaps through employment services), subsidizing jobs directly or indirectly, and paying for training. There is a large literature on the effectiveness of ALMPs. Card et. al. (2015) review estimates from over 200 recent studies of active labor market programs and find that job search assistance programs appear to be relatively more successful for disadvantaged participants, whereas training and private sector employment subsidies tend to have larger average effects for the long-term unemployed. Public sector employment subsidies, on the other hand, have small or negative effects.

12. Georgia has been delivering ALMPs through a variety of public agencies. The most well-known agency is the State Employment Promotion Agency. Its tasks[11] include providing professional consulting and career planning services at the regional level and setting up internships. The government's strategy also includes supporting other entities involved in promoting employment such as the Agricultural and Rural Development Agency, which specializes in public employment projects, and the National Tourism Administration, which provides short-term training for those employed in the tourism industry as well as jobseekers.

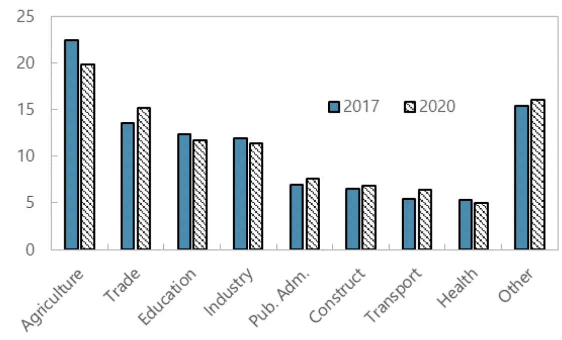
13. Existing ALMP efforts should be evaluated for cost-effectiveness with the most promising ones expanded. Although cross-country evidence provides some guidance (generally favoring private employment subsidies and measures targeting search and matching) it is difficult to know ex ante what combination of ALMPs will prove optimal for Georgia. Performing impact assessments would make it possible to scale up the most promising measures.

[10] The government recently launched a new portal on vocational education and training (VET) developments, data and statistics, best practices, government policies, and latest trends in the VET sector.

[11] Specified in the Action Plan 2019-2021 of the National Strategy for Labor and Employment Policy.

14. The sectoral composition of growth and employment dynamics suggests that ALMPs targeting labor supply (e.g., internships, public employment projects) may not be enough to tackle entrenched unemployment. As noted earlier, although Georgia had robust GDP growth, job creation has been weak. This is because the main drivers of growth were either not especially labor intensive (FIREA), or because they were growing from a low base and low initial employment stock (accommodation and food services). Only the trade sector has combined healthy contributions to GDP and employment growth in recent years (before COVID-19). Nearly 20 percent of the employed are in agriculture, which contributes only around 2 percent of GDP and only 0.1 percentage point to growth between 2017 and 2019. The employment composition has changed very little between 2017 and 2020 suggesting little reallocation across sectors.

Distribution of Employed Persons by Economic Activity
(In percent of total)



Source: Geostat.

15. Policies to boost employment should acknowledge sectoral constraints of the economy. There may be little scope to boost employment in FIREA activities, which are very productive, but not especially labor intensive. The growth of the services industry (notably tourism related services) could be more promising, but progress there will depend on domestic and external demand. Infrastructure development is especially important to facilitate the growth of tourism and to be able to provide other services remotely (e.g., call centers, IT outsourcing, etc.). Posadas et. al. (2018) suggest that there may be scope to address structural bottlenecks to the growth of firm size and employment by further developing infrastructure, setting up export promotion mechanisms, and attracting FDI.

16. There may be scope for measures to increase female labor force participation and avoid an unemployment trap. Expanding availability and access for childcare (for example, adding public kindergartens and simplifying access) could increase female labor force participation. The OECD (2017) provides evidence that in households receiving remittances, the labor supply of remaining members (typically women) is usually reduced. Individuals receiving remittances may have higher reservation wages and have limited incentives to join the labor market, which the authorities could address through fiscal policy. For example, the authorities could consider introducing measures similar to an earned income tax credit by effectively lowering income tax rates on low wages. Given the pressing fiscal adjustment needs, such measures could only be considered over the medium term, perhaps as part of a broader revenue-raising reform package. More generally boosting productivity (including in agriculture) to create higher paying jobs may make work more attractive than remittances or subsistence agriculture.

17. Dealing with the entrenched unemployment problem should help reverse the increase in poverty and emigration in the aftermath of the COVID-19 pandemic, and reduce inequality. Along with job destruction, poverty in 2020 increased to 21.3 percent, undoing all of the poverty reduction since 2017. While older people are somewhat shielded from the increase in poverty through state pensions, the prime age population lacks a developed safety net (except for the Targeted Social Assistance payments for the most vulnerable), making access to employment opportunities even more crucial.

INTERNATIONAL MONETARY FUND

GEORGIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 30, 2021

Prepared By

Middle East and Central Asia Department (In Consultation with Other Departments)

CONTENTS

RELATIONS WITH THE FUND

(As of July 31, 2021)

Membership Status

Date of membership: May 5, 1992, Article VIII.

General Resources Account

	SDR Million	Percent of Quota
Quota	210.40	100.00
Fund Holdings of Currency	694.38	330.03
Reserve Tranche Position	0.02	0.01

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	143.96	100.00
Holdings	145.28	100.92

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
Extended Arrangements	484.0	230.04

Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
EFF	April 12, 2017	April 11, 2021	484.00	484.00
Stand-By	July 30, 2014	April 11, 2017	100.00	80.00
Stand-By	Apr. 11, 2012	Apr. 10, 2014	125.00	0.00

Projected Payments to the Fund

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2021	**2022**	**2023**	**2024**	**2025**
Principal	2.50	12.50	22.50	42.25	74.17
Charges/Interest	3.46	6.74	6.32	5.60	4.26
Total	**5.96**	**19.24**	**28.82**	**47.85**	**78.43**

Safeguard Assessments

The most recent safeguard assessment was conducted in 2014. The assessment found a robust framework with strong control mechanisms and a good track record at the central bank. The NBG has implemented all recommendations from the last assessment. The NBG's latest audited financial statements are published for the year ending December 31, 2020.

Implementation of Multilateral Debt Relief Initiative (MDRI)

Not applicable.

Implementation of HIPC Initiative

Not applicable.

Implementation of Catastrophe Containment and Relief Initiative (CCR)

Not applicable.

Exchange Arrangements

The de jure and de facto exchange rate arrangements of Georgia are floating. The National Bank of Georgia (NBG) intervenes in the foreign exchange market through foreign exchange auctions, but does not make any explicit or implicit commitment with respect to an exchange rate target or path. Considering market conditions, interventions are aimed at accumulating international reserves or smoothing excessive volatility to avoid inflationary expectations. The amount bought/sold at NBG foreign exchange auctions and the average exchange rates are posted on the NBG website the same day, shortly after each auction.

Effective March 1, 2020, the NBG introduced a new foreign exchange trading system—Bloomberg's BMatch. This foreign exchange trading platform is based on the principle of automatic "matching" of transactions. Market participants will place foreign currency buying and selling applications on the BMatch platform, and if the exchange rates between the buyer and seller of the currency coincide, then the currency transactions between the parties will be concluded automatically.

Georgia accepted the obligations of Article VIII Sections 2(a), 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system free of multiple currency practices, and of restrictions on the making of payments and transfers for current international transactions. The official exchange rate for the US dollar is determined daily and may be used (not mandatory) for state budget and tax accounting and for payments between the government and businesses and other legal entities. The official exchange rates for other currencies are based on the cross-rates for the dollar and other currencies in the international market.

Program Engagement

A 36-month EFF was approved on April 12, 2017. In 2020, the arrangement was extended by one year and augmented by SDR 274 million (130 percent of quota) bringing total access to SDR 484 million (230 percent of quota). The last review of the EFF was completed on April 9, 2021.

Article IV Consultation

The 2018 Article IV consultation was concluded on June 27, 2018. The published Staff Report is available at https://www.imf.org/en/Publications/CR/Issues/2018/06/28/Georgia-2018-Article-IV-Consultation-Second-Review-under-the-Extended-Fund-Facility-46036

FSAP Participation

The 2021 FSAP took place during virtual missions in January-February and May-June 2021. The Financial Sector Stability Assessment is being considered by the Board in combination with the 2021 Article IV.

Technical Assistance

The IMF has provided considerable technical assistance (TA) including to support the objectives of the EFF program. Specific areas of TA included:

- **Fiscal**: public investment management assessment (PIMA), public financial and investment management (SOE reform, managing fiscal risks from power purchase agreements), tax administration reforms notably comprehensive reforms of Georgian Revenue Service (including through a long-term expert with support of the Revenue Mobilization Thematic Fund), accounting reform, and fiscal risks.

- **Monetary/Financial**: development of the government securities' market, implementing IFRS 9, central bank risk management, pillar 2 and consolidated supervision, monetary policy communication, non-bank financial institutions, and a top-down stress testing framework.

- **Legal**: banking resolution framework, insolvency framework, AML/CFT assistance, and capital market development.

- **Statistics**: government finance statistics (compiling *GFSM 2014* based data for non-market SOEs), quarterly national accounts, compilation of price indices (price scanner data for CPI, producer price index, property price index), labor market indicators, monetary and financial statistics, and financial accounts and financial soundness indicators.

- **Training**: macroeconomic programming and analysis; fiscal policy analysis at Ministry of Finance.

The JVI and the recently established CCAMTAC will be instrumental in capacity development and providing additional TA.

Resident Representative

The resident representative, Mr. Selim Cakir, took up his post in June 2019.

RELATIONS WITH THE WORLD BANK GROUP AND OTHER IFIS

(As of July 23, 2021)

Information about Georgia's relations with the World Bank Group and other international financial institutions can be obtained from the following webpages.

The World Bank Group	https://www.worldbank.org/en/country/georgia/overview#2
European Bank for Reconstruction and Development	https://www.ebrd.com/georgia.html
Asian Development Bank	https://www.adb.org/countries/georgia/main

STATISTICAL ISSUES

(As of July 30, 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings but is broadly adequate for surveillance. There is some room for improving the compilation and dissemination of price, national accounts, and external sector statistics. Improvements to price and economic activity indicators to facilitate assessment of underlying inflation and output trends would strengthen implementation of the inflation targeting framework. To support the authorities' effort to improve the compilation of macroeconomic statistics, the Fund has provided technical assistance (TA). The data module of the Report on the Observance of Standards and Codes (ROSC), published in March 2012, indicated that since the previous 2002 ROSC, the authorities have made significant institutional and methodological improvements in macroeconomic statistics. Georgia subscribed to the IMF's Special Data Dissemination Standard (SDDS) on May 17, 2010.
National Accounts: Since late 2019, national accounts statistics have followed the concepts and definitions of the *System of National Accounts 2008.* Annual and quarterly GDP estimates are compiled by both the production and expenditure approaches. Preliminary national accounts in current prices by the production approach are available after 80 days and final estimates after 11 months. A ROSC mission in 2012 found various shortcomings in source data. Since then GEOSTAT has made progress in updating the business register by using administrative sources (such as monthly and annual turnover data from the Revenue Service). The amendments to the Law on Statistics, which made reporting compulsory, led to significant improvement in business reporting. A better method is now used to benchmark quarterly national accounts (QNA) data to annual estimates. Following the comprehensive updates in 2019, GEOSTAT is now using the NACE rev. 2 classification of economic activities, and to align with the *2008* SNA, has also updated measures of owner-occupied dwellings, FISIM and insurance services, government non-market output and final consumption, changes in inventories, and research and development Since 2015 GEOSTAT started publishing volume estimates of GDP by the expenditure approach. These are available at annual frequency and cover the period 2010-20. During the national accounts TA missions in 2013-17, actions on several issues were either initiated or partly implemented (benchmarking of QNA in current and constant prices, new methodology for estimating volume of taxes on products, compilation of unit values for imports). TA missions have also been supporting GEOSTAT in improving statistics on the deflator of various components of aggregate demand. Via an EU twinning project with Statistics Denmark, GEOSTAT has developed a system of annual supply and use tables in current prices and has so far published results for 2019 and 2020.
Price Statistics: The scope of the consumer price index (CPI) is limited to urban areas. Owner-occupied housing is not covered by the CPI. The structure of the producer price index relies on output concept, and product-based indices are compiled on the lowest level of the overall PPI. Export price indices are available at monthly frequency from 2014, while import price indices are available at monthly frequency from January 2017. Implementation of the agricultural price index survey ceased. The imputation methods for both CPI and PPI are based on broadly accepted methods ensuring coherent long-term treatment of seasonal goods. GEOSTAT began disseminating the residential property price index in mid-May 2020 and expanded the coverage of the PPI to warehousing and storage services, telecommunications services, and travel agency and tour operator services.

Government Finance Statistics: The Ministry of Finance (MOF) is well advanced on a program of reform to their central and local government budget and accounting systems to fully adopt the *Government Finance Statistics Manual 2014 (GFSM 2014*) methodology and the International Public Sector Accounting Standards (IPSASs), including the staged introduction of accrual recording into transactions data, and the expansion of the range of items recorded in the balance sheet. The coverage of government finance statistics (GFS) until recently was limited to transactions of budgetary entities and local governments and the liabilities stock positions of budgetary entities. Following recent TA recommendations, new data series covering extrabudgetary entities (referred to as legal entities of public law (LEPLs)) were disseminated to the IMF's GFS database. The MOF continues to report timely annual and monthly GFS compiled on a cash basis in the *GFSM 2014* framework for publication in the *GFS Yearbook* and *IFS,* albeit with balance sheet data only limited to liabilities. The MOF has recently started working, with support from TA, on expanding GFS coverage to also include non-market state-owned enterprises (SOEs). Preliminary GFS including a statement of operations and balance sheet based on the *GFSM 2014* were compiled for a representative sample of non-market SOEs using data from the SOEs' database established by the MOF to facilitate the analysis and management of fiscal risks. Data compiled for non-market SOEs is expected to be added to existing central and local government data for a more comprehensive coverage of general government GFS.
Monetary and Financial Statistics: The NBG compiles monetary data in line with the recommendations of the *Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG).* Data are compiled based on STA's Standardized Report Forms and reported to STA on a regular and timely basis for publication in the *International Financial Statistics (IFS)*. A 2016 technical assistance (TA) mission supported the NBG in expanding the scope to include also the other financial corporations (OFC) sector; producing financial accounts; and working towards the compilation of flow-based monetary statistics for the central bank and other depository corporations. Since early 2017, the NBG is regularly reporting to STA quarterly data on OFCs for publication in *IFS*. The NBG reports data on some key series and indicators of the Financial Access Survey (FAS), including gender-disaggregated data on use of financial services and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial sector surveillance: Financial surveillance is conducted by the NBG, which supervises both banks and other entities such as credit unions, micro financial organizations, money remittance units, and currency exchange bureaus. Following the TA mission in 2017, the NBG improved the frequency of Financial Soundness Indicators (FSIs) reporting to STA from quarterly to monthly for dissemination on the IMF website. The NBG reports all core FSIs and 18 encouraged FSIs to STA.
External sector statistics: Over the past few years, GEOSTAT and the NBG continued to enhance external sector statistics (ESS). A 2019 TA mission supported GEOSTAT and the NBG in improving data collection and compilation for producing the financial account components, including foreign direct investment (FDI) statistics. GEOSTAT and the NBG worked together to eliminate discrepancies between FDI data disseminated by GEOSTAT and the balance of payments disseminated by the NBG. As a result, GEOSTAT established an integrated database on FDI and began publishing both transactions and positions. The reconciliation exercise also eliminated the discrepancies between the international investment position and Coordinated Direct Investment Survey data. The 2019 TA mission also supported GEOSTAT in developing a method to address issues with the coverage and valuation of cars within the trade in goods statistics.

II. Data Standards and Quality	
The country has subscribed to the SDDS since May 17, 2010.	Data ROSC was published on March 2012.

Georgia: Table of Common Indicators Required for Surveillance
(as of July 30, 2021)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8] Data Quality Methodological soundness[9]	Memo Items:[8] Data Quality – Accuracy and reliability[10]
Exchange Rates	07/30/2021	07/30/2021	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	07/30/2021	07/30/2021	D	D	M		
Reserve/Base Money	06/30/2021	07/26/2021	D	M	M	O, O, LO, O	LO,O,O,O,O
Broad Money	06/30/2021	07/26/2021	D	M	M		
Central Bank Balance Sheet	06/30/2021	07/12/2021	D	M	M		
Consolidated Balance Sheet of the Banking System	06/30/2021	07/26/2021	M	M	M		
Interest Rates[2]	06/30/2021	07/26/2021	M	M	M		
Consumer Price Index	June 2021	07/02/2021	M	M	M	O,LO,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2021	07/29/2021	M	M	M	O,O,LO,LO	O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	June 2021	07/29/2021	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	06/30/2021	07/21/2021	M	M	M		
External Current Account Balance	2021Q1	06/30/2021	Q	Q	Q	O,O,O,O	LO, O, LO ,O, LO
Exports and Imports of Goods and Services	2021Q1	06/30/2021	Q	Q	Q		

Georgia: Table of Common Indicators Required for Surveillance (concluded)
(as of July 30, 2021)

GDP/GNP	2021Q1	06/29/2021	Q	Q	Q	O,LO,LO,LO	LNO, O, LO, O, LO
Gross External Debt	2021Q1	06/30/2021	Q	Q	Q		
International Investment Position[6]	2021Q1	06/30/2021	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign and domestic banks, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] These columns should only be included for countries for which a Data ROSC (or a Substantive Update) has been published.
[9] This reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[10] Same as footnote 9, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. Rashkovan, Alternate Executive Director,
and Mr. Tsur, Senior Advisor on Georgia
September 15, 2021

The Georgian authorities thank staff for the dedicated and constructive engagement during the Article IV and the FSAP mission and for the well-written reports. They agree with the thrust of the staff appraisal in the Article IV and with the recommendations of the FSAP. Georgia's commitment to meet the entire EFF conditionalities and targets, frequently with large margins, has helped enhance Georgia's resilience to shocks, as demonstrated in the last year and during the COVID-19 crisis. Accordingly, market confidence has recently been reconfirmed in the decision of "Fitch" to revise Georgia's outlook on the long-term Foreign-Currency Issuer Default Rating (IDR) to stable from negative and reaffirmed the IDR at 'BB'. The agency is confident that the "Georgian authorities will continue implementing policies supporting macroeconomic stability and medium-term sustainability of public finances". The authorities reinforce their commitment for such policies and emphasize their remarkable track record. ***To maintain the reforms' momentum, the authorities requested a new IMF-supported program for Georgia, with anticipated commencement in early 2022.***

Recent developments

As staff well described, recent economic data illustrates a V-shaped recovery and the current projection is consistent with a return to 2019 levels already this year, much earlier than expected by the IMF and the authorities. The recovery has gained impressive momentum since April 2021, with a 29.8% y/y GDP growth in the second quarter, based on strong private sector activity and improved sentiments. An in-depth overview shows a well-balanced pattern of the recent growth, with a robust growth in remittances and exports, a faster than expected rebound in the hospitality sector, strong growth in the manufacturing sector and improved trade which is supported by the recovery in regional economies. Furthermore, public infrastructure spending supports the construction sector.

The sharp and quicker than expected recovery could have not occurred without the sound macroeconomic policies that Georgia have carried out before and during the COVID-19 crisis. The low debt-to-GDP ratio before the pandemic allowed the government to provide fiscal support to vulnerable firms and households, to bridge the hard economic period. The credible policy framework has allowed Georgia to obtain comfortable credit despite higher financing needs. Diligent implementation of the 2015 FSAP recommendations and the regulatory adjustments during the pandemic have strengthened the resilience of the financial sector, which maintained adequate capital and liquidity buffers despite the COVID-19 shock. The inflation targeting framework adopted in 2009 allows the NBG to curb inflation expectation with a moderate and gradual increase of its policy rate.

Recent measures imposed by the government have contributed to a recent reduction of the number of COVID-19 cases. The government is determined to further improve the health condition by enhancing its vaccination campaign. The progress is in line with the government's target to vaccinate 60% of the population by the end of the year. However, Georgia shares the most prominent risks to its outlook with many other benchmark countries as outlined in the last update of the World Economic Outlook: protracted spread of the COVID-19 variants and global divergence that creates contractionary effects due to worse financial conditions forced by advanced economies.

Fiscal policy

The supplementary budget, approved by the parliament in July 2021, reduces the deficit and debt already this year despite the challenging health conditions. As the number of COVID-19 cases rose sharply and unexpectedly due to the delta variant, expenditures are planned to increase in 2021 mainly to meet healthcare needs and to support vulnerable households. Nevertheless, owing to the revised growth projection (upward from 4.3% to 7.7% for 2021) the 2021 deficit is now projected to stand at 6.9% of GDP (down from 7.6% in the previous projection) and government net debt at 50.3% of GDP for 2021. The government is optimistic that further upward updates in the projection are possible and is committed to accelerate the reduction in deficit and debt if health conditions allow and if revenue increases faster than projected.

The government is committed to the fiscal rules with a fiscal consolidation of its framework within the next three years. The budget deficit is expected to return to 3.0% of GDP in 2023 and government net debt to 48.2% of GDP. In the longer term, the Ministry of Finance strives to reduce public debt back to its under 40% level by 2030. The Ministry of Finance is confident that the reform activism that allowed fiscal buffers before the pandemic will also be adequate in the next several years. The consolidation process will be supported by a development plan that includes a growth-oriented tax policy, friendly tax administration, a tax dispute reform, and a capital market reform.

The government intends to reform the tax administration based on the principle that the role of the private sector in driving growth is irreplaceable. At the same time, it is the government's duty to ensure stable and growth oriented macroeconomic conditions and pro-business environment. Accordingly, they plan to reduce the share of direct taxes in the total tax burden, and to incentive FDI to accelerate and diversify the growth of Georgia's export. On the administrative front, they plan to simplify taxation transactions by fully automizing the tax payment and return filling system. This reform will better serve the private sector while increasing revenues thanks to the more efficient system.

Monetary Policy and Inflation

The NBG performed contractionary monetary policy despite the transitory character of the recent inflation. The rise in global prices of oil and food products has transmitted to the local market and resulted in strong inflationary pressure. Annual inflation has also been affected by the government's utility bill subsidy program, which was introduced in 2020. After this program was initiated, headline inflation dropped at the end of last year; In addition, despite the recent appreciation of the local currency, imported inflation remains high under the influence of the depreciated Lari exchange rate in previous periods. These were accompanied by significant improvements in aggregate demand since Q2 of this year. Due to the aforementioned factors, the NBG forecasts that inflation for 2021 will be approximately 9%.

While a de-anchoring of inflation expectations poses a risk that might complicate the maintenance of price stability and the long-term trend of de-dollarization, the tight monetary policy adopted in the current period serves to avoid this risk. The NBG assesses that inflation will start to decline and then approach the target in the medium term. Rising inflation in Georgia is closely linked to rising prices for consumer goods around the world, and the most prominent monetary institutions and international organization perceive the current spike in food and energy prices to be temporary. Excluding food, energy, and tabaco (core inflation), annual inflation as of August is 6.8%, significantly lower than the 12.8% headline inflation. Moreover, the recent appreciation of the exchange rate will help push inflation further down.

Monetary policy rate and macroprudential policy instruments are the major tools to achieve price stability and financial stability. Nevertheless, the NBG ascribes risks to these primary objectives from foreign exchange fluctuations. The FX intervention strategy limits the interventions to the frequency and volume that is necessary to support these objectives. The interventions let the exchange rate adjust to new equilibria in a timely manner and provided appropriate incentives to avoid excessive risk taking in the market.

<u>The Financial Sector</u>

We highly appreciate the FSAP team for the insightful analysis, and convey the authorities' satisfaction that the banking system appears resilient under adverse scenarios. The 2020-21 crisis once again demonstrates the resilience of Georgia's economy against shocks. Despite the scale of the crisis, the NBG monetary and macroprudential policy instruments have served this resilience very well. The financial sector is sustainable, and the accumulated buffers helped the economy overcome this crisis more rapidly, and with fewer costs than in previous crises.

The authorities' welcome staff's insight that there is scope to formalize and enhance supervisory processes. The recommendation to formalize the internal supervisory processes meets the NBG's agenda in the "Supervisory Strategy 2020-2022". In response to the FSAP recommendation for strengthening supervision of banks' corporate governance and risk management, the NBG plans to communicate material supervisory findings with banks' supervisory boards on a regular basis.

Recent developments in the credit market supports the economic recovery. In June, the growth of the loan portfolio increased and stood at 12.6% relative to March (excluding the effect of exchange rate fluctuations), driven by an increase in loans to the construction, and agriculture and energy sectors. The banking sector also expects an increase in demand in retail loans. The growth of the loan portfolio in 2021 Q2 was driven by domestic currency loans: the annual growth rate of foreign currency-denominated loans was 1.3%, while the growth rate of loans in the domestic currency was 27.6%.

High dollarization remains a challenge that carries risks to Georgia's financial stability, and its gradual reduction is a long-term priority for the authorities. We concur with staff's recommendations both in the FSAP and in the Article IV. To encourage de-dollarization of liabilities, since July 6 the minimum reserve requirements for foreign currency funds are determined individually for each commercial bank according to their deposit dollarization. This reduces the reserve requirements for banks with less than 70% deposit dollarization.

<u>Macro-Structural Policies</u>

The government highly prioritizes educational reforms with special focus on early and pre-school education. Recognizing that the quality of teachers is the most important factor to improve educational outcomes has led to a recent improvement in teachers' professional training. This process is led by a committee of educational experts and with the involvement of teachers. Additional reforms in vocational education, by adopting the European standards of the certificating framework, will be implemented gradually within the next 5 years. As for higher education, the government is developing academic programs based on international accreditation, while striving to improve the inclusiveness of the academy to individuals with special needs, among others.

The continued close cooperation with international partners, based on Georgia's strong track record, aims to attract resources to help finance some of the reforms and infrastructure projects needed for Georgia's green, digital and inclusive development. The government's fiscal medium-term plan accommodates the construction of a full net of highways within 10 years, and electricity and water projects to ensure smooth and sustainable supply across the entire country. Georgia collaborates with the World Bank on promoting technological innovation and environmentally friendly industries and jobs. The World Bank also supports Georgia's National Broadband Development Strategy for 2020–25 to connect up to 500,000 people in over 1,000 villages in mountainous and remote regions to high-speed internet. This vital project will promote the overall digital transition of the country.

The government is committed to use the potential of SOEs more efficiently by reforming public corporations in line with OECD principles. Georgia became the first country in Central Asia and Eastern Europe to carried out a sectorization exercise of SOEs to improve transparency and accountability. The government plans to include all non-market SOEs in general government fiscal reporting already for 2021, and to reform governance of public corporations (PCs) in line with OECD principles. More generally, Georgia has made a prominent progress in recent years towards improving its governance and particularly the business climate.

The authorities look forward to continuing the fruitful dialogue and cooperation with the Fund. The continuation of close engagement between Georgia and the IMF, among others with a new IMF supported program, is a top priority of the authorities, to maintain the reforms momentum and the confidence of the markets in Georgia's economy.