November 2001
IMF Country Report No. 211

Georgia: Recent Economic Developments and Selected Issues

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GEORGIA

Recent Economic Developments and Selected Issues

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Approved by European II Department

October 10, 2001

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Area	69,700 sq. km
Population density (2000)	73.2 per sq. km
Population (estimated 2000)	5.1 million
Of which: percent urban	57.7 percent
Rate of population growth (2000)	-0.13 percent
Life expectancy at birth 1/	72.5 years
Infant mortality rate (per 1,000 live births—2000)	14.9
Hospital beds (per 1,000 people—2000)	4.8
GDP per capita, 2000	
In lari	1,168
In U.S. dollars	591.2

	1997	1998	1999	2000	2001	
					Q1	Q2
II. Economic Indicators						
	(Annual percent change)					
Real sector						
GDP volume	10.6	2.9	3.0	1.9	1.7	8.6
Consumer prices						
Period average	7.0	3.6	19.1	4.0	5.6	6.6
End-of-period	7.2	10.7	10.9	4.6	5.9	6.2
	(Percent of GDP)					
Government finances						
Revenue and grants	14.4	15.6	15.4	15.3	16.0	15.7
Of which: Revenue	14.1	14.7	14.6	15.1	15.8	15.4
Expenditure and net lending	21.2	21.8	22.1	19.4	18.9	16.9
Balance (commitments)	-6.8	-6.1	-6.7	-4.1	-2.9	-1.2
Balance (cash)	-6.1	-4.9	-5.0	-2.6	0.0	-1.5
	(Percent change, end-of-period) 3/					
Money and credit 2/						
Net domestic assets of the NBG	82.2	69.9	15.3	6.9	-1.4	-1.0
Credit to the rest of the economy	63.4	40.3	34.3	30.9	0.7	4.0
Broad money						
Including foreign currency deposits	45.5	-1.2	20.7	39.0	-3.7	2.7
Excluding foreign currency deposits	35.4	-11.5	9.6	33.5	-9.7	-5.1
	(In millions of U.S. dollars)					
External Sector						
Exports (goods)	493.5	478.3	477.0	645.5	107.0	n.a.
Imports (goods)	-1,052.4	-1,163.7	-1,026.3	-1,006.5	-227.7	n.a.
Trade balance	-558.9	-685.4	-549.3	-361.0	-120.6	n.a.
Current account (including transfers)	-374.9	-388.5	-238.0	-161.7	-71.8	n.a.
Official reserves, end-of-period						
(in millions of U.S. dollars)	173.3	118.4	132.4	109.4	116.9	118.7
(in months of imports)	1.5	1.0	1.2	0.9	1.1	n.a.
Memorandum items:						
GDP, current prices (in millions of lari)	4,639	5,041	5,665	5,955	1,444	1,637
Exchange rate, lari/U.S. dollar						
Period average	1.30	1.39	2.02	1.98	2.05	2.06
End-of-period	1.30	1.79	1.96	1.98	2.07	2.06

Sources: Georgian authorities, World Bank, World Development Indicators, 1999; and Fund staff estimates.

1/ Life expectancy at birth has not been surveyed since 1990.
2/ Valued at end-of-period actual exchange rates.
3/ Growth rates in 2001 are changes from end-2000

I. Recent Economic Developments

A. Real Sector

Output

1. **Real GDP growth in Georgia has been slow since the Russian crisis, but there are signs of more vigorous growth in the first half of 2001, despite weak external demand.** After several years of double-digit output growth in the mid-90s, growth slowed to about 3 percent in 1998 and 1999 and less than 2 percent in 2000. This reflected the Russian crisis of 1998, droughts in 1998 and 2000, increasingly severe energy supply problems, and underlying structural problems, particularly in the fiscal and governance areas. However, growth in the first half of 2001 was over 5 percent, reflecting a rebound in agriculture and strong growth in some services, particularly communications, hotels and restaurants (Figure I-1 and Table A-1).

Box I-1. Revised GDP Estimates

In early 2001, the authorities published revised GDP estimates for the period 1996 to 2000. The changes consisted of an upward revision of spending on education and health and a downward revision of spending on financial intermediation. A technical assistance mission by the IMF's Statistics Department found the data methodology to be basically sound, although some refinements were recommended. The largest change that was made in the context of this revision was a 3.6 percent upward adjustment to 1998 GDP. This is a much smaller change than the 34 percent downward revision of GDP undertaken in early 2000, and may suggest an increasing reliability of the GDP figures produced by the Georgian State Department of Statistics. However, many problems persist, including with measuring financial intermediation.

2. **Agriculture was hit by droughts in 1998 and 2000, but is expected to grow strongly in 2001.** The expectation of recovery in 2001 is based on very favorable weather conditions through end-July and on the availability of high quality seeds brought into the country through international aid following last year's drought. However, a lack of irrigation systems, poor infrastructure in rural areas, the lack of a well-developed land market, and limited access to credit continue to constrain the sector. The share of agriculture in GDP has fallen from about a third of GDP in the mid-90s to under a quarter today (Table A-1).

3. **After a drop of industrial output in 1998, industry grew by nearly 3½ percent in 1999 and by 3¼ percent in 2000.** More recently, energy supply interruptions were the main

factor behind a sharp decline of industrial output in the first quarter of 2001, but there was a rebound in the second quarter as continuous energy supply resumed.[1] Nonetheless, industrial output fell by ½ percent in the first half 2001 compared to a year earlier. In recent years, industry's share of GDP has been stable at 13-14 percent, but performance has been uneven across industries, with mining and food-processing performing better than the industrial average. In large parts of heavy industry, privatization and restructuring have been slow, leading to relatively weak performance (Tables A-1 and A-2).

4. **Construction output has been volatile in recent years, partly reflecting the influence of pipeline construction**. The Baku-Supsa pipline project boosted construction in 1997 and 1998. After the pipeline had been completed in 1998, a decline in construction followed in 1999. The sector grew moderately during 2000, but slowed in the first half of 2001. Construction accounts for about 4 percent of GDP.

5. **Privately-supplied services have shown above-average growth in recent years.** The combined share in GDP of services delivered in the areas trade, hotels and restaurants, transport, communications and financial intermediation has steadily increased from 21 percent in 1996 to 30 percent in the first half of 2001. Transport and communications have been the strongest sectors, both more than doubling their shares of GDP since 1996. By contrast, trade has shown only a small gain in share of GDP.

Labor market developments

6. **Total employment grew by only 1 percent between 1998 and 2000, but private sector employment is recovering strongly, while state sector employment has declined steadily** (Table A-4). The unemployment rate on the ILO definition increased from 7¾ percent in 1997 to a peak of 12¾ percent in 1999 and then fell back to 10½ percent in 2000 (Table A-5). After registering substantial gains in 1997 and 1998, real wage growth slowed to 2 percent in 1999 in the aftermath of the Russian crisis but recovered to 12 percent in 2000 (Table A-6 and Figure I-2).[2]

Prices

7. **After an inflationary spike due to the Russian crisis, inflation continued its downward trend and has been stable at around 5 percent since mid-2000** (Table A-8). The decline in inflation that started in 1995 was interrupted in late 1998 by the depreciation

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[1] On the energy sector, see Chapter VI.

[2] Labor market data should be used with caution due to weak incentives for the unemployed to register, inadequate coverage of informal activities, and the practice of counting all those who own a small piece of land as self-employed. Unemployment may well be higher than shown in the official data.

of the lari in the wake of the Russian crisis, and the annual inflation rate rose to over 20 percent during much of 1999. However, inflation dropped back to 4½ percent by end-2000, reflecting firm monetary policy, a more stable exchange rate, and the absence of demand side pressures. It remained at about that level in the 12 months to August 2001.

B. Fiscal Sector

8. **Fiscal performance improved significantly in 2000.** While total revenues and grants remained stable compared to 1999 as a percentage of GDP, tax revenues increased by ½ percent of GDP (Table A-9 and Figure I-3).[3] This was offset by a sharp decline in grants. Total expenditure and net lending fell by 3 percent of GDP to the lowest level since 1995. This was accounted for by cuts in both primary current expenditure and capital expenditure (partly reflecting lower external project financing), while interest payments increased slightly. The deficit on a commitment basis declined by 2½ percent of GDP, to 4 percent. The accumulation of expenditure arrears, mainly in the first half of the year, remained high and contributed to limiting the deficit on a cash basis to 2½ percent of GDP, half the level of 1999. The improvement in the fiscal stance occurred in the second half of the year and, in particular, in the fourth quarter. It reflected both a strengthening of the tax and customs administrations, and a revised budget in mid-year, following the presidential election, which sharply reduced expenditure commitments.

9. **In 2001, the fiscal situation deteriorated during January-April but has since recovered.** The budget for 2001 envisaged a further increase in tax revenues of about ½ percent of GDP, further reductions in current expenditure commitments, a commitments deficit of 2 percent of GDP, and repayment of expenditure arrears of just over 1 percent of GDP. In the early months of the year, tax collections fell short of the budget target. Possible reasons include weaker than expected economic activity during the winter; the introduction of a visa regime by Russia that reduced migrant workers' remittances; reductions of excise rates on domestic tobacco products and car property fees, approved by parliament in December 2000; and increased smuggling of cigarettes and oil and petroleum products.[4] Domestic financing also turned out lower than assumed, partly because of difficulties in selling Treasury bills. The resulting shortfalls led to expenditure arrears accumulation. However, from May to August tax collection recovered, helped by stronger economic activity, allowing the clearance of the arrears that had been accumulated in the first quarter.

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[3] All the data given as percentages of GDP are calculated considering the nominal GDP assumed in the revised program.

[4] A reduction of the "incentive fund" for customs and other tax administration officers from 3 percent to 1 percent of collections may have contributed to the weak performance of the customs in 2001. The reduction, which took effect in January 2001, reduced the incomes of customs officers to half of their former level.

10. **The reform of fiscal institutions continued in 2000 and 2001.** The Ministry of Revenue's Large Taxpayers' Inspectorate (LTI) closed its "Social Fund Department" in order to strengthen tax administration. The department's duties were attributed to the functional areas of the Inspectorate. In the area of expenditure control and management, the Ministry of Finance assumed the sub-treasury accounts that were previously controlled by the Ministries of Defense and the Interior; introduced a system of recording contracts that exceed a defined threshold; audited the pre-2001 stock of expenditure arrears; revised the regulations on customs exemptions; and introduced an administrative unit to strengthen controls on exempted imports. The collection capacity of the tax and customs administration was, however, adversely affected by high turnover of senior staff of the State Customs Department and by a Ministry of Revenue decree of April 2001 that, inconsistently with the identification criteria, removed some large taxpayers from the Large Taxpayers' Inspectorate.

Box I-2. Fiscal Institutional Setting

In 2000-01, there were no major changes to the institutional structure of the general government, which comprises central and local government and extrabudgetary funds. The local government accounts include the autonomous republic of Adjara, but South Ossetia and Abkazia do not have fiscal relations with the central budget. There are 10 administrative regions and 53 administrative districts. There are three extrabudgetary funds, the Social Security Fund, the Road Fund, and the Employment Fund (for details see Chapter III). The central government, together with these funds, is referred to as the state government.

Local government budgets, unlike the state budget, are not subject to parliamentary approval but are heavily influenced by the state government. Local governments do not have the legal authority to levy their own taxes. Instead, they receive a portion of revenues from the various state taxes, with the share varying according to the region and type of taxes. In 2000, local government budgets received 31.2 percent of the total tax revenues (about 1 percentage point more than in 1999).

C. Monetary Policy and Financial Markets

11. **The Russian crisis and a weak fiscal position have been important challenges for the financial sector.** Concerns about the unsustainable fiscal situation and the onset of the Russia crisis in the latter part of 1998 brought about a sharp contraction of lari money demand. The treasury bill market was curtailed, the banking system came under significant pressure, and there was a loss of confidence in the lari, culminating in a sharp depreciation in December 1998.

12. **Since the crisis, money demand has increased substantially and financial intermediation has resumed, but confidence in the lari seems to remain weak.** Broad

money (including foreign exchange deposits) increased by 43 percent from end 1999 to June 2001. This reflected a sharp increase in commercial banks' deposit liabilities of 67 percent. Over the same period, the money multiplier rose from 1.44 to 1.66, and M3-velocity fell from 13.7 to 9.6. However, dollarization increased significantly in the wake of the Russia crisis, rising from 69 percent at end-1998 to 79 percent at end-1999.[5] Since then, dollarization has failed to decline in spite of more favorable macroeconomic developments, suggesting that confidence in the lari remains low. (Figures I-4 and I-5 and Tables A-15 to A-24).

13. **Prudent monetary policy has contributed to low inflation and a stable exchange rate within a floating exchange rate regime.**[6] Following a tight monetary stance in the wake of the events in 1998, fiscal pressures exerted considerable strains on monetary policy in the late1999 and the first half of 2000. This led to a sizeable expansion of net credit to government that contributed to pressures in the foreign exchange market, leading to a significant deterioration in net international reserves. During the second half of 2000, the fiscal situation improved and the NBG was able to rein in credit to the government. It was also able to ease reserve requirements by two percentage points in June 2000.[7] At the same time, the NBG began to step up its purchases of foreign exchange in order to bolster reserves. During 2000, due to favorable balance of payments developments, purchases amounted to US$75 million. Since most of these purchases occurred toward the end of 2000, reserve money growth began to accelerate sharply at the end of the year. However, this did not have a significant impact on inflation in 2001, as the central bank maintained a tight rein on government credit, and reserve money fell back during the first half of 2001.

14. **In the banking sector, prudential regulations have been strengthened, but confidence remains low.** The Russian crisis and the loss of confidence in financial markets put a significant strain on the banking system, but a full-scale crisis was averted, in part because the NBG extended liquidity support to some larger banks. The strengthening of prudential requirements and improved supervision have revealed weaknesses in the sector. In the past two years, additional prudential requirements were put in place, including higher minimum capital requirements, revised asset classification and provisioning requirements, and international accounting standards (Table A-24). In addition, technical assistance has improved the NBG's supervisory ability.[8]

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[5] Dollarization is defined here as the share of foreign currency deposits in total deposits. Chapter V examines the factors driving dollarization and policy implications.

[6] Under this policy, the central bank does not intervene to support the exchange rate, but purchases foreign exchange in order to bolster the reserves.

[7] Reserve requirements were raised from 12 to 16 percent in 1998.

[8] See Chapter IV for a discussion of the banking sector.

15. **The treasury bill market remains very thin, thereby limiting the development of indirect monetary instruments.** In December 1998, the entire stock of treasury bills was retired, after a peak stock of outstanding bills of lari 23 million had been reached in mid-1998. Auctions resumed in August 1999, but continued lack of confidence in fiscal policy limited sales. In addition, the government resorted to direct borrowing from the banking system, thereby undermining the treasury bill market. Conditions improved somewhat in the latter part of 2000, as the fiscal situation improved and the practice of direct borrowing was stopped, although the stock of treasury bills at end-2000 was only lari 3 million. During 2001, some further progress was made, and the stock reached 6 million by June 2001. A secondary market for treasury bills exists but the small size of the primary market limits its development.

16. **Nominal interest rates have generally declined since 1999, reflecting in part the decline of inflation, although the Turkish crisis adversely affected rates at the beginning of 2001.** The interest rate for 30-day maturity loans in the interbank credit auction fell from 29 percent at end-1999 to 14 percent as of end-June 2001 (Table A-22). Treasury bill yields edged downward from 12 percent at end-1999 to 7 percent in November 2000.[9] They rose again in early 2001, possibly influenced by concerns surrounding events in Turkey as well as a weakening of the fiscal situation. However, since May 2001 they have eased downward again.

D. External Sector

17. **The external current account strengthened in 2000 but was adversely affected by the Turkish crisis in the first half of 2001.** The current account deficit declined from 8½ percent of GDP in 1999 to 5½ percent of GDP in 2000 (Table A-25).[10] Customs data, covering only recorded trade, point to a strong increase of exports by 39 percent and a moderate increase of imports by 8 percent in 2000. However, the current account improvement has been reversed in the early months of 2001. Exports declined sharply, reflecting the lower industrial production in early 2001 and the Turkish crisis, while imports increased moderately.

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[9] Rates during 1999 were not market determined due to a technical change in reserve requirements in July 1999, which allowed banks to hold one eighth of required reserves in treasury bills. As the remuneration on required reserves was 10 percent, average Treasury bill interest rates above this rate were attractive to banks.

[10] In 2000, the NBG started to estimate the BOP using its own method. Thus, BOP data from 2000 onward, which include estimates of unrecorded trade, are not consistent with data prior to 2000.

18. **Turkey became the largest importer of Georgian goods in 2000, but exports to Russia were also strong.** Russia's share of Georgia's exports dropped sharply in the wake of the Russian crisis. Although exports to Russia grew strongly in 2000, reflecting a real depreciation of the lari against the ruble and the strong growth of the Russian economy, Turkey became Georgia's largest export market in 2000 (Table A-26). In part, this reflected a strong increase of exports of scrap metal, following the elimination of an export tax on scrap metal in 1999 (Table A-27).

19. **The nominal exchange rate was stable during 2000 but depreciated moderately in early 2001, following the crisis in Turkey.** Since then, the nominal rate has been stable. The real effective exchange rate showed little overall change in 2000, in spite of a real depreciation against the ruble. In the first half of 2001, however, it appreciated, mainly because of the sharp depreciation of the Turkish lira (Figure I-6 and Table A-31).

20. **The external capital account remained weak in 2000, with lower concessional loan disbursements offsetting larger foreign direct investment.** Disbursements of medium- and long-term loans decreased to US$35 million, as World Bank structural adjustment lending was delayed. Principal falling due rose to US$110 million. However, foreign direct investment increased to US$153 million, mainly due to the investment by the US-based electricity utility AES in rehabilitation and upgrading of their Georgian assets.

21. **Despite strong current account developments, low loan disbursements and high debt service obligations led to a fall in official reserves and accumulation of external arrears.** Gross international reserves fell by US$23 million to US$109 million (0.9 months of import cover) at end-2000. Exceptional financing in 2000 included arrears on debt service of US$68 million, partly offset by net repurchases to the IMF of US$27 million. Georgia paid US$12 million to Turkmenistan (of the US$79 million due in principal) through an in-kind transaction. Georgia received no loans from the IMF during 2000. However, in January 2001, the IMF approved a three-year arrangement under the PRGF amounting to SDR108 million (72 percent of quota), and SDR18 million were drawn in the first quarter of 2001. The gross reserves rose to US$128 million by end-August 2001.

22. **Georgia's external debts remain very high.** At end-2000, external debt stood at US$1.6 billion (53 percent of GDP), of which about 50 percent was debt to bilateral creditors (Table A-29). Of the bilateral debt, about 90 percent was incurred prior to December 1994 and had been rescheduled previously.[11] In 2000, Georgia started to make principal repayments to Russia, China, and Ukraine, as agreed during previous bilateral rescheduling.

[11] Georgia signed rescheduling agreements on pre-December 1994 bilateral debt during 1996 to 1998 with Armenia, Austria, Azerbaijan, China, Iran, Kazakhstan, Russia, Turkmenistan, Turkey, Ukraine and Uzbekistan. Other creditors such as Germany, Japan and the U.S. provided credit later.

Principal repayment to Turkmenistan started in 1998, but Georgia, while remaining current on interest payments, has had continuing difficulties in making these principal payments. By end-2000, arrears to Turkmentistan amounted to US$179 million.

23. **Georgia successfully concluded a rescheduling of bilateral debt with Paris Club creditors in March 2001.** The agreement involves a rescheduling of principal payments falling due during 2001 and 2002 on medium- and long-term government debt contracted before November 1, 1999. Under this agreement, all of the previously rescheduled debt is subject to new rescheduling. Payments will be rescheduled over 20 years, with a 3-year grace period and a graduated repayment schedule. Creditors agreed to apply an interest rate no higher than that already applied to previously rescheduled debt (4 percent). The agreement includes a good will clause in which creditors agreed in principle and in case of a financing need to consider an extension of the consolidation period through end-2003.

24. **Georgia maintains an open and liberal trade regime and acceded to the WTO in June 2000.** The IMF's trade restrictiveness index for Georgia is currently 2 on a scale of 1 to 10. In line with commitments to the WTO, the authorities intend to change the import tariff schedule from 0, 5, and 12 percent to 0, 4, 9, and 12 percent. The simple average tariff rate, which currently stands at 10.9 percent, can be expected to decline further. However, the parliament passed a resolution in July 2001 to introduce a temporary ban on the export of timber through end-December 2001.

E. Structural Reform

25. **After significant strides since 1995, the pace of structural reform has slowed.** Progress has been made in privatization, regulatory reform, banking sector restructuring, trade liberalization, judicial reforms, and health sector reforms. However, recently the pace of reform has been affected by uneven commitment in implementation, weak institutional capacity, and poor governance, and much still needs to be done to complete the market reform agenda. Priorities include the completion of initiated reforms, particularly in the areas of governance, privatization, and energy sector reform;[12] a substantial improvement in the environment for business; and investments in public infrastructure and services.

26. **The government has intensified its privatization efforts, but no significant sales have been completed in the past two years.** Under the government's plan, infrastructure is to be offered to strategic investors via a competitive tender process, either through outright sales to strategic investors of a controlling majority of shares (e.g. telecom and energy generation/distribution), or through long-term concessions for commercial activities (e.g. water and port concessioning).The highlight so far has been the privatization of Tbilisi's Telasi Power Company at end-1998, when 75 percent of the shares were sold to a U.S.

[12] See Chapter VI for a discussion of energy sector reform.

investor, AES. Georgia has also sold productive assets at the thermal power plant Tbilsresi, and concessioned two major hydropower plants to the same investor. The government is currently working with IFC to privatize the remaining distribution and generation companies, and under the IDA-supported Electricity Market Support Project, the government is hiring a private international management contractor to manage the electricity transmission and dispatch companies and the wholesale electricity market. The government has also requested World Bank assistance to lease Tbilisi's water utility, and plans to replicate this approach in other urban areas. The government has designed a development strategy and regulatory framework for Poti Port that entails the creation of a new Port Authority, and granting of concessions to private operators; bidding documents to concession one berth have already been completed. In 2001, a tender for privatization of the telecommunications sector was issued. Lack of investor interest, powerful vested interests and corruption in the energy sector have impeded progress in privatization of infrastructure to strategic investors.

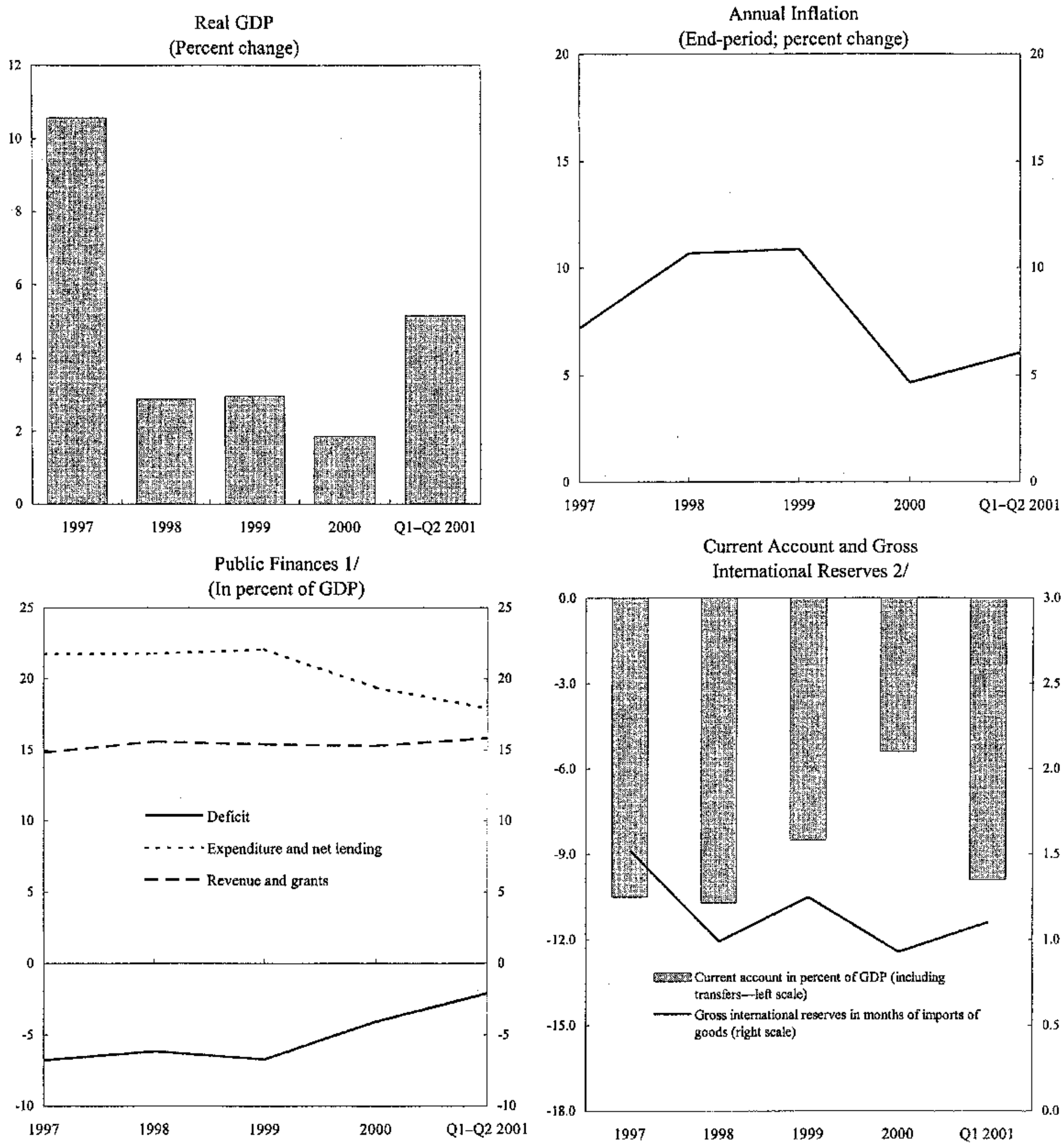
27. **Progress has been made in agricultural land privatization.** The agricultural land privatization program started in 1992 and involved the distribution of individual land plots (850,000 hectares) to private farmers. In 1996, the Government instituted a land lease program involving about 750,000 hectares. To date, nearly 900 land parcels have been privatized. The government's reform program envisages the creation of a land registration system that would be the basis for the development of a land market by allowing land to serve as bank collateral.

28. **Corruption remains a major constraint on economic growth, development, and poverty alleviation efforts.** In mid-2000, President Shevardnadze established an anti-corruption advisory body, including representatives from the three branches of the government and from civil society, to develop a strategy for combating corruption. The commission prepared a paper that was endorsed by the President and published in November 2000. It lays out a broad strategy to combat corruption, including measures in six main areas: liberalization of the business environment; improving the effectiveness of the state management system; strengthening law enforcement bodies and judiciary; development of representative democracy; and reform in education. However, implementation is proceeding slowly. In March 2001, presidential decree No. 95 identified specific short-term measures to be implemented, including measures to broaden financial disclosure, clarify the role of regulatory agencies, introduce audits in government agencies and require publication of their expenditures. An anti-corruption council was established comprising representatives from government and civil society in order to monitor progress. A recent report issued by the council, following up on the implementation of decree No. 95, was critical of progress made, indicating that a number of measures were not fully implemented. In July, another presidential decree was issued (No. 758) that aims at increasing fiscal transparency, including through proposals for a draft budget code, monitoring of state debt, the establishment of a code of ethics for civil officials, and elimination of revenue transit accounts.

29. **The government has also embarked on initiatives aimed at reducing administrative interference via public procurement and licensing reforms.** The public

procurement law was amended in April 2001 to address problems with the 1998 law, on the basis of a review carried out in collaboration with the World Bank. The law on licensing was enacted in 1999 and regulations were issued by the various licensing agencies. In April 2001, the Government decided to substantially amend the current law. The revised law will provide the legal instrument to repeal the various licenses (and permits) that have proliferated at the central and local levels, include general principles for issuing licenses, and provide for the establishment of a monitoring unit within the Ministry of Justice to ensure the proper implementation of the licensing reforms.

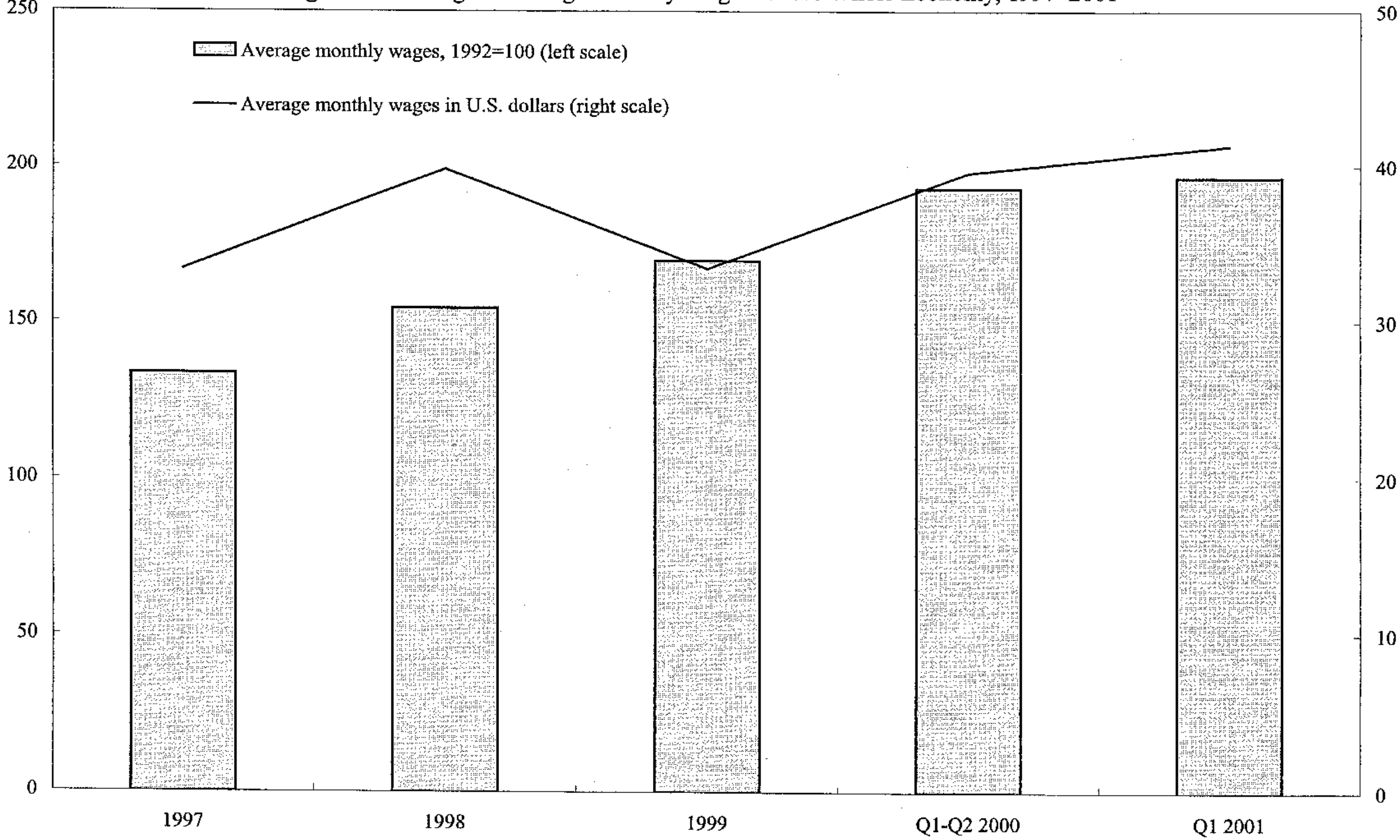
Figure I-1. Georgia: Macroeconomic Indicators, 1997–2001



Sources: Georgian authorities; and Fund staff estimates.

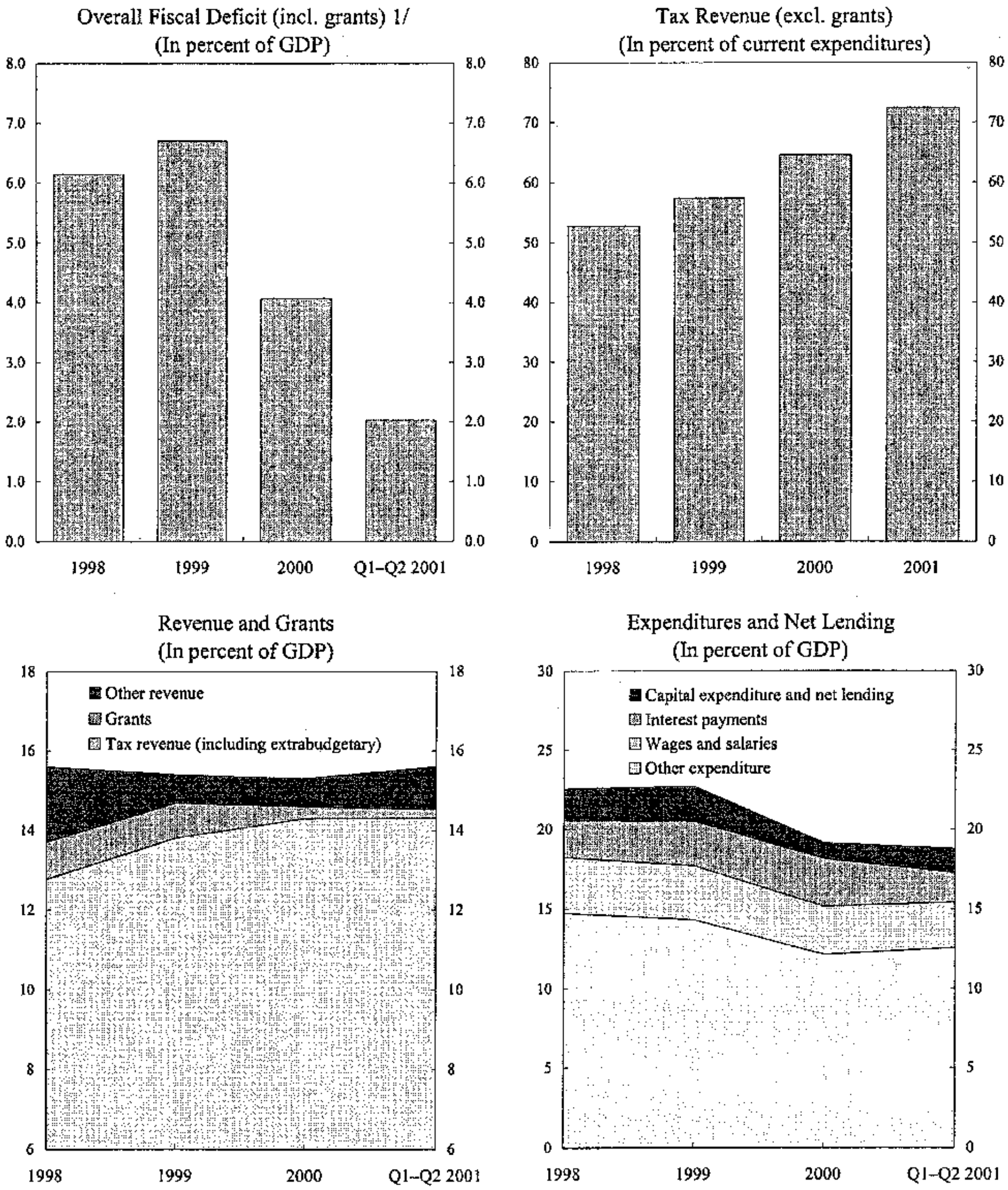
1/ Commitment basis.
2/ Excluding official transfers.

Figure I-2. Georgia: Average Monthly Wages for the Whole Economy, 1997–2001



Sources: Georgian authorities; and Fund staff estimates.

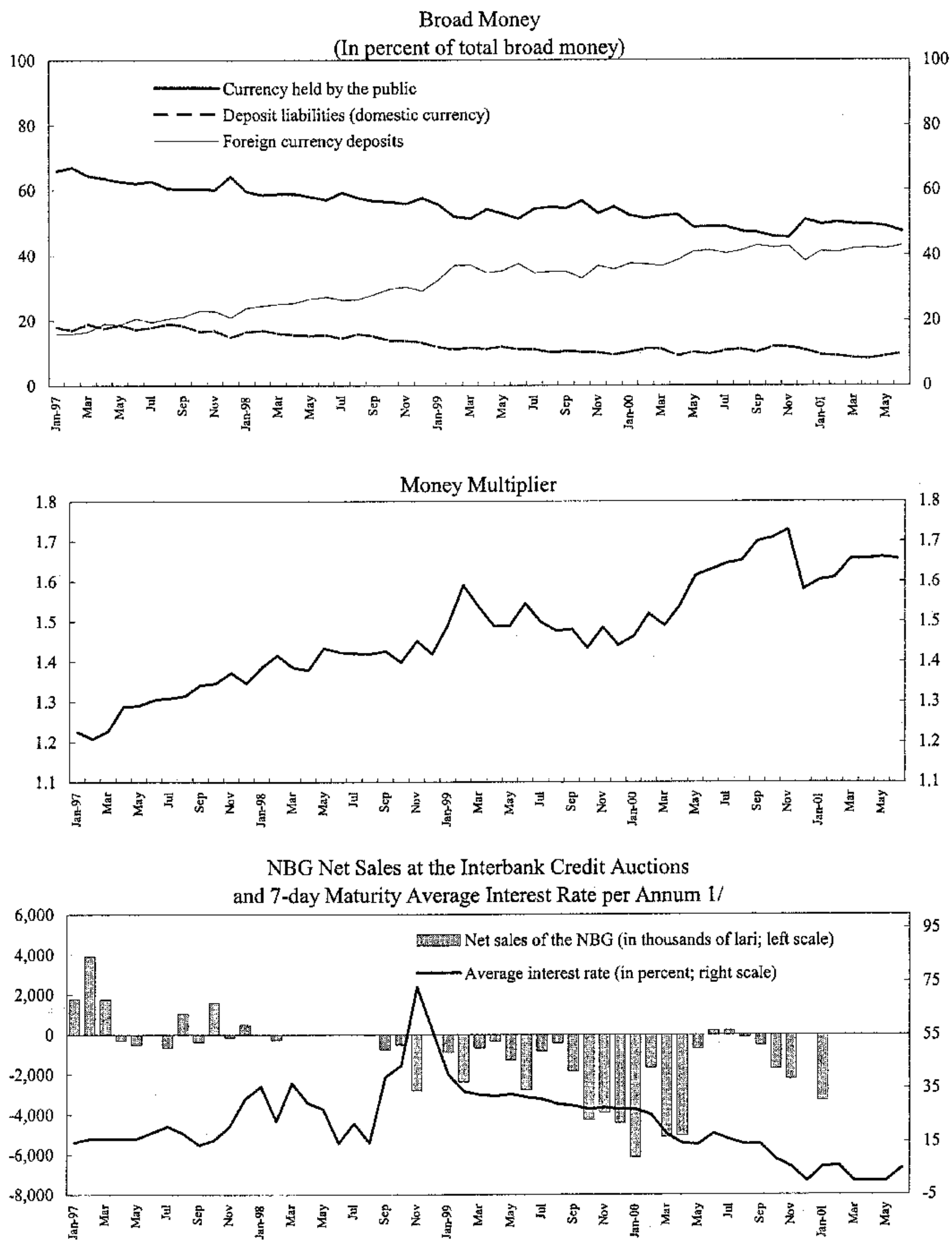
Figure I-3. Georgia: Public Finances, 1998–2001



Sources: Georgian authorities; and Fund staff estimates.

1/ Commitment basis.

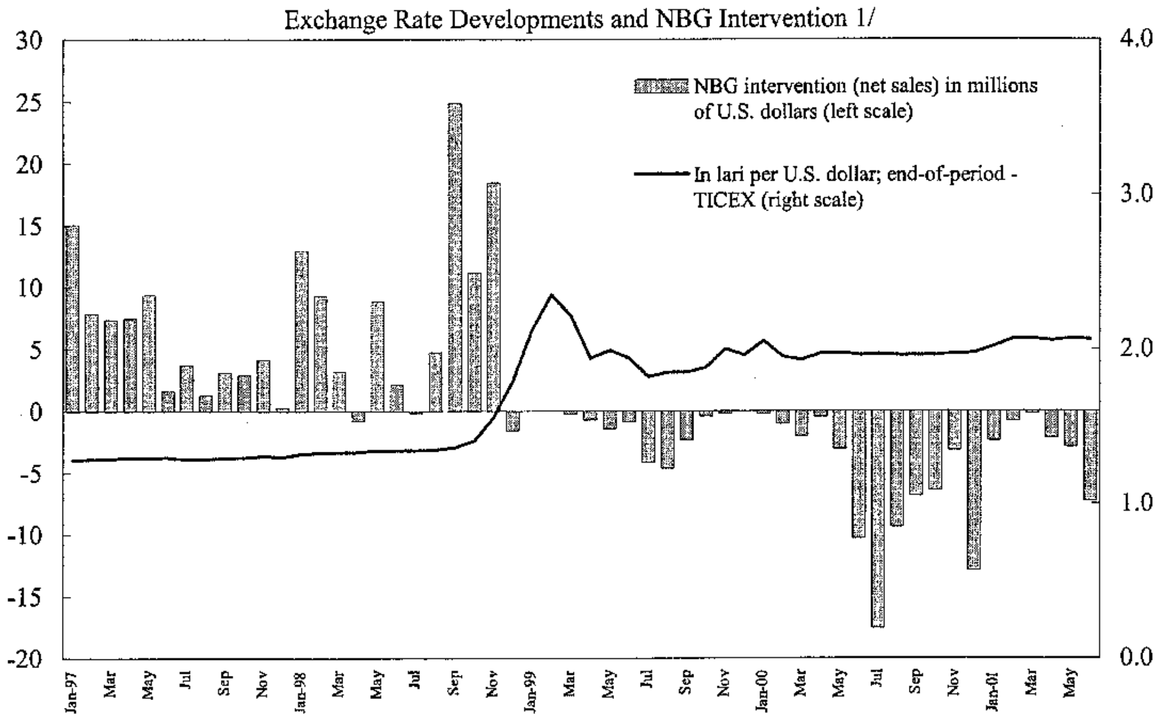
Figure I-4. Georgia: Monetary Indicators, 1997–2001

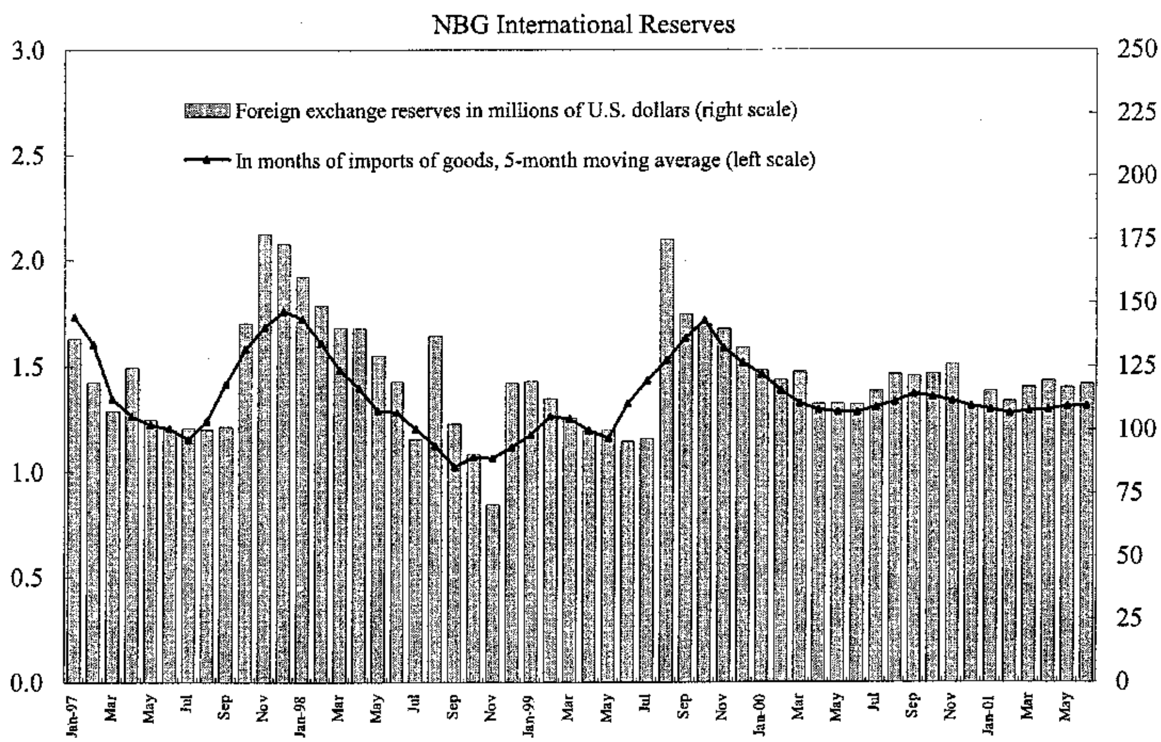


Source: National Bank of Georgia.

1/ Difference between amount sold and amount purchased.

Figure I-5. Georgia: Foreign Exchange Market and International Reserves, 1997–2001

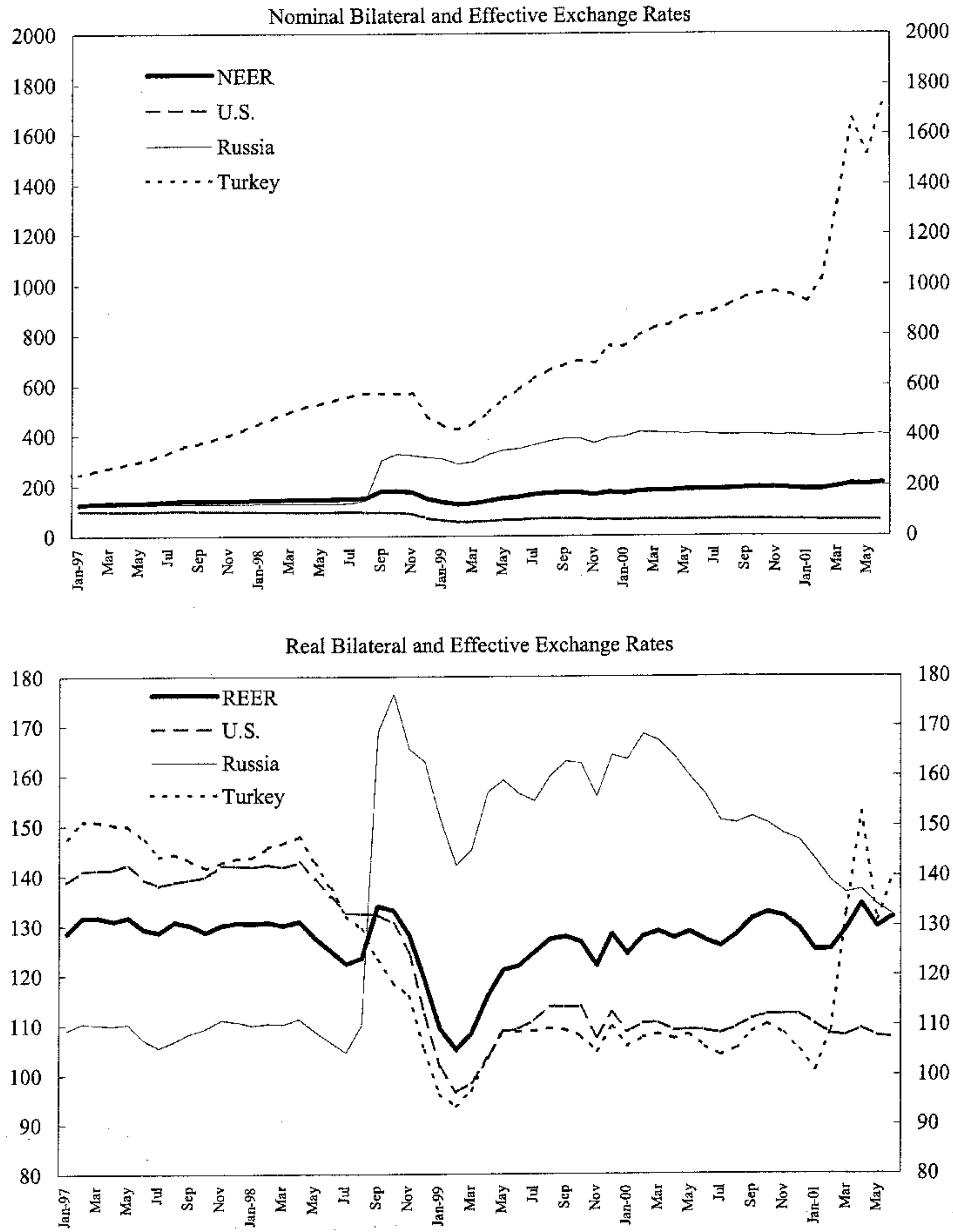




Source: National Bank of Georgia.

1/ No interventions occurred in January nor February 1999.

Figure I-6. Georgia: Bilateral and Real Effective Exchange Rates, 1997–2001 1/
(1995=100)



Source: IMF, Information Notice System; and Fund staff estimates.

1/ Increase indicates appreciation.

II. Administrative Corruption, State Capture, Influence and Tax Policy Formulation[13]

A. Summary and Introduction

- Several surveys indicate that domestic enterprises and the public believe that Georgia has high levels of administrative corruption both in terms of the spread of institutions affected and relative to perceptions of administrative corruption in a majority of other CIS countries. A significant proportion of firms perceive that the policy process in Georgia is captured by narrow interests.

- An analysis of changes to the Georgian tax code since its passage into law in 1997 indicates that some sectors, particularly excisable goods, have had frequent changes of tax legislation that have served to narrow the tax base, reduce effective rates and complicate the administration of tax policy. A detailed case study of tobacco excises is presented.

- Tentative conclusions are that corporate interests substantially influenced the policies for taxation of excisable goods, particularly tobacco products, and that firms clearly influenced VAT policy by lobbying for tax preferences in the areas of energy exploration, agriculture and utilities, although there is no evidence of direct payments to purchase policy change in any of these cases.

- The central policy lessons are: proposals to change tax policy legislation should include a clear indication of the likely revenue impact, preferably by an independent authority, so that policymakers can have access to information that will enable them to make an accurate assessment of the claims of sectoral interests; and, in the interests of fiscal and legislative stability, that tax policy amendments only be made in conjunction with presentation of the budget or amendments to the budget, to avoid inconsistencies between tax legislation and budget revenue estimates.

30. Studies of corruption in transition economies identify several types of interaction between firms and the state: administrative corruption where illegal or informal payments are made to public officials to obtain a particular administrative or regulatory outcome; state capture where payments are made to "purchase" laws and regulations and alter the rules for commercial activity; and finally, cases where firms influence policy making without recourse to illicit payments to officials. This chapter considers the extent of administrative corruption and state capture in Georgia and the extent to which the latter might affect the formulation of tax policy in the areas of VAT and excises.

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[13] Prepared by Christopher Lane, drawing on a review of Georgia's tax policy by Thomas Baunsgaard.

B. Administrative Corruption and State Capture in Georgia

31. The analysis of economic performance in transition economies has increasingly focused on the impact of pervasive corruption in inhibiting investment, deterring competition, reducing fiscal revenues and more broadly in restraining economic growth and poverty reduction.[14] As indicated by Kaminski and Kaminski: "Corruption belongs to the broad category of phenomena when formal institutional rules become inactive and people's activities become guided by concerns external to the organizational mission."[15]

32. Surveys in Georgia, and in most transition economies, indicate that administrative corruption involving side payments is widespread and that the public and enterprises view state institutions as having a high level of dishonesty. Cross-country surveys place Georgia in a group of "high corruption" countries within the post-Soviet space, particularly in terms of administrative corruption.

33. An empirical enterprise perception survey (EBRD/WB Business Environment and Enterprise Performance Survey—BEEPS; EBRD,1999) attempts to distinguish between small scale administrative corruption and high level grand corruption. The BEEPS survey draws a distinction between administrative corruption where firms pay bribes to circumvent bureaucratic and regulatory procedures, including kickbacks on public procurement contracts, and "state capture" where firms extract rents from the state by "purchasing" laws, rules and regulations from state actors.

34. The Georgian sample of 129 enterprises in the 1999 BEEPs survey indicated above average severity of both administrative corruption and state and judicial capture (Figure II-1).

35. As regards administrative corruption proxied by average bribe payments as a share of firm revenues, Georgia is above both CIS and CEE averages with over 4 percent of revenue paid as bribes to public officials (Figure II-2). Enterprise managers were asked "what percentage of revenues do firms like yours pay per annum in unofficial payments to public officials?"

36. Another survey undertaken with the agreement of the Government of Georgia assessed perceptions of corruption by 1,350 businesses, households and public employees (World Bank and USAID, 1998, unpublished). All three groups of respondents ranked police and traffic police, tax and customs authorities and energy sector companies as the most dishonest institutions from a list of 22 public and civil society structures. This survey

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[14] Bardhan, P., Journal of Economic Literature vol XXXV 1997 pp. 1320-1346 reviews the literature on corruption and economic development.

[15] P3, Kaminski, A.Z., and Kaminski, B. "Governance and Corruption in Transition: The Challenge of Subverting Corruption" mimeo May 2001 for UNECE.

quantified the degree of administrative corruption in terms of bribes paid by those admitting the need to pay bribes. Businesses reported the highest average bribes paid for tax inspections, building permits, import permits or licenses, and customs clearance.

37. As revenue collection agencies are widely associated with administrative corruption in transition countries, it is not surprising that there is a negative correlation between an index of the level of perceived corruption and the level of tax collections as a share of GDP. This correlation is shown in Figure II-3 and is statistically significant from zero at the 95 percent confidence level.

38. State capture is analogous to the existence of vested interests which influence public policy in order to further private, group or clan interests without reference to stated public policy goals. In practice, the distinction between the articulation of vested interests seeking to capture the state and the legitimate operation of pressure and lobby groups in a democratic system is often hard to determine. One criterion to distinguish between state capture and more democratic bargains is based on whether or not financial transfers are used as a tool to achieve policy change, although this is rarely documented. A second, weaker, criterion is the specificity of policy change—whether it channels benefits to a single or small group of economic interests, with costs—such as loss of tax revenue—spread more widely.

39. Aside from the practical problem of distinguishing state capture from legitimate democratic processes, the perception of its impact may be very difficult to assess as the benefits or rents accrue to relatively few interests while the costs may be very widely spread.

40. A significant proportion of surveyed firms in Georgia reported that they were affected by decrees, laws, criminal and commercial court actions that they classed as reflecting state capture. A composite index of state capture reflecting the proportion of firms affected by different types of state capture placed Georgia in the second worst quintile of 22 CEE and CIS countries, with greater impact of state capture reported in Azerbaijan, Bulgaria, Croatia, Kyrgyzstan, Latvia, Moldova, Russia and Ukraine (Table II-1). State capture in Georgia was most widely perceived to have affected Parliamentary legislation, presidential decrees and central bank actions.

41. More broadly, the relationship between the impact of state capture in the EBRD/WB survey and economic or fiscal variables is less clear than for administrative corruption. For example, the relationship between revenue yield and state capture is statistically weak. This is not surprising as the index of state capture includes many variables that are not directly related to tax collection, such as procedures in civil and criminal courts and party political finance (Figure II-4).

Table II-1. Direct Impact of State Capture on Firms

(Percent of firms reporting a significant or very significant impact of state capture, unless otherwise indicated)

	Parliamentary Legislation	Presidential Decrees	Central Bank	Criminal Courts	Commercial Courts	Party Finance	Capture Index 1/
Georgia	29	24	32	18	20	21	24
Average (of 22 CIS and CEE countries)	21	18	23	18	18	20	20
Georgia Rank of 22 (Highest to lowest)	6	7	7	11	7	11	9

1/ Calculated as the unweighted average of the six component indices.
Source: "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," p. 9 (World Bank PRWP 2444, http://www.worldbank.org/wbi/governance/).

C. State Capture, Influence and the Tax Policy Process in Georgia

42. Although survey evidence in transition economies indicates that a significant proportion of firms perceive that the policy process is captured by narrow interests and also perceive a direct impact effect from this capture, less attention has been focused on how state capture works in practice or the type of interests that influence the policy process. Cross-country analysis has focused on the links between indicators of perceived corruption and underlying weaknesses in public policies and institutions with various proxy indicators of political development and the depth of structural reforms.

43. To illustrate and analyze state capture in Georgia, we consider the tax policy process since the passage of a comprehensive Tax Code. The approval of the Tax Code of Georgia in June 1997 served to rationalize the tax system by bringing all tax legislation together into a single legislative document from 29 separate legal acts—the Georgian authorities worked closely with Fund staff legal experts in drafting the Code. The Code came into force progressively and by January 1998 was fully in force. The Code also broadened the tax base by eliminating some exemptions (although many remained, particularly under the VAT), defined taxpayer rights and obligations clearly, and reduced various excessive tax penalties introduced during an earlier period of high inflation.

44. The main taxes and rate structure of the Code are summarized in Box II-1.

Box II-1. Main Taxes and Tax Rates of 1997 Georgian Tax Code

- Single rate of VAT at 20 percent with a low registration threshold (US$2,300 at 1997 exchange rates). Exports zero-rated.
- Single rate of corporate income tax at 20 percent with allowable deductions broadly in line with international practice.
- A personal income tax with bands at 12, 15, 17 and 20 percent, with very modest progressivity as most incomes are taxed at the top marginal rate.
- Social tax on payroll of 28 percent (Tax Code does not govern payroll taxes payable to the medical insurance or employment funds).
- Withholding tax of 10 percent on interest and dividends.
- A limited number of ad valorem excises (alcoholic beverages, tobacco products, gasoline and a few minor excises).
- Taxes on property and land, vehicle ownership and inheritance tax.
- A wide range of natural resource taxes.
- Seven local taxes including a turnover tax of 1-2 percent depending on region.

Source: Tax Code of Georgia, 1997.

D. Tax Code Revisions

45. The tax code quickly became a focus for repeated legislative amendments.[16] Between mid-1997 and mid-2001, 27 individual packages of amendments were approved, comprising hundreds of specific amendments. A Fund staff paper prepared for the Georgian authorities (Georgia: Tax Policy Review, October 2000, unpublished) noted that:

> *"These [legislative] changes have been wide-ranging. Some amendments have been introduced by the authorities in an attempt to improve tax administration and collections, and others have been driven by the need to comply with conditionality under Fund programs or WTO obligations (e.g. increases in excise rates, harmonization of tariff classification, and removal of some exemptions). However,*

[16] Following passage of the Code virtually all tax policy changes are required to be approved by Parliament and signed into law by the President of Georgia. Executive orders or decrees cannot override Tax Code provisions unless expressly envisaged in the Code. Amendments to the Code can be proposed for discussion by executive powers or initiated by groups in the Parliament. Provisions of amendments come into force after they are published in the official Legal Gazette.

many new exemptions have been introduced to benefit special sectors or interest groups in the economy (e.g., natural gas companies, the agricultural sector, and energy enterprises) while some have been introduced to reduce the tax burden on poorer segments of society (e.g., in mountainous regions). ... The overall impact has been to narrow the tax base and complicate the tax legislation considerably." (p. 3)

46. During the period July 1997 to April 2001, 113 specific code amendments were passed relating to tax policy, i.e. rate changes, tax base narrowing or broadening, and temporary provisions relating to tax rates or bases (summarized in Figure II-5). This listing excludes all amendments which are primarily administrative in nature, and amendments to clarify the intent of Code. While many tax policy amendments were relatively minor, a good number had a significant revenue impact, particularly frequent and large adjustments to excise rates and the introduction of VAT exemptions.

47. Policy makers have focused their attention on amending the provisions of the two main indirect taxes which account for 78 percent of central government revenue. Value added tax (VAT) and excises account for 58 percent of the number of tax policy amendments to the Code. The two main direct taxes, corporate and personal income taxes account for 9 percent of the total amendments, and taxes on property and land account for a further 11 percent of total amendments, with the remainder accounted for by local taxes, resource taxes and minor taxes.

48. The following sections look in more detail at the nature of the amendments and the motivation behind policy changes for the VAT and excises.

E. Legislative Amendments to the VAT

49. The thrust of the 38 specific legislative amendments to the VAT rates and definition of taxable base was to introduce a significant number of exemptions and to narrow the tax base (Table II-2). The bulk of the exemptions were introduced or extended during 1998-1999, notably for primary agricultural production, wheat, imported fuel oil, natural gas and electricity, inputs for the oil and gas sector, imported cigarettes, newspapers and magazines. Only two exemptions were removed during the entire period (automobiles and primary agricultural production before processing, both in the context of IMF program conditionality). Three products were zero-rated, wheat (subsequently reversed as part of Fund program conditionality), domestically-produced cigarettes (also reversed) and electricity other than that supplied to the final consumer. One amendment reduced the VAT rate from 20 to 7 percent for bread, pasta and domestic production of flour. This was subsequently reversed, again as part of policy actions required for IMF financial support. A number of amendments narrowed the tax base, including an increase in the turnover threshold from very low levels (although mainly to simplify administration), and a variety of schemes to reduce VAT liabilities in respect of energy, water and sewerage services by levying VAT on cash receipts or a fixed proportion of supplied services rather than invoiced sales.

50. Although sector lobby groups promoted VAT exemptions, particularly in the case of agriculture, utilities, oil and gas, it is inherently difficult to find clear evidence of "state capture" in the form of transactions related to the purchase of legislative reform, even though sectoral ministries strongly articulated the case for exemptions on behalf of their constituencies.

51. In the case of utilities (water, sewage and electricity) much of the pressure for exemptions or cash treatment resulted from a deficiency in the Code, which did not provide for tax relief on bad debts. The utility companies had extremely poor collection rates, as well as below cost recovery tariffs, and VAT liabilities on services supplied were very high relative to cash payments, which compounded their severe financial problems. The authorities preferred to provide exemptions to introducing a bad debt provision, as they were not confident that the VAT administration could effectively audit fraudulent claims of non-payment.

52. Primary agriculture was granted a transitional and temporary VAT exemption when the Tax Code was introduced, for primary production from small firms. In 1998, the exemption was prolonged (until April 1999) and extended to all firms, regardless of size. In June 1999, the VAT threshold for primary agricultural producers was raised to nearly double the threshold for all other sectors. After extensive discussions with the Fund staff, the VAT exemption for primary agriculture was removed, effective January 1999. Although primary agriculture is in mid-2001 not VAT exempt, the 2002 budget is likely to remove a large group of small farmers from the tax net, primarily for reasons of administrative simplicity.

53. In primary agriculture, the case for exemptions was articulated mainly on the grounds of tax or subsidy competition from neighboring countries, especially Azerbaijan and Turkey, and tariff free trade with neighboring CIS countries. This was compounded by the inability of customs authorities to levy VAT on imported foodstuffs due to porous borders, tax privileges granted in 1995 to a small number of firms, and administrative corruption involving importers, tax and enforcement agencies.

54. As most farmers in Georgia are small scale and not organized as a political or commercial grouping, it is difficult to see how state capture could have been coordinated. Nonetheless the introduction of agricultural exemptions is and remains politically popular, as 40 percent of the labor force works in agriculture. This strongly suggests that, as in many other countries, exemptions were passed for reasons of political expediency rather than the result of direct pressure from vested interests.

55. The oil and gas sector has very broad VAT exemptions introduced in parallel with the 1999 Oil and Gas Law (which also provided a wide range of exemptions across most taxes). Industry concentration is much higher than in the agriculture sector (five oil and gas exploration firms), so collusive state capture is theoretically easier to coordinate and the potential benefits of state capture are similarly fairly concentrated. However, there is no evidence available to suggest that exemptions for the oil and gas sector were in any sense

"purchased." Nonetheless, tax policy was clearly influenced by a combination of the sector interest lobby groups, with reference to oil and gas exemptions in other jurisdictions. The oil and gas sector influenced tax policy by effectively trading VAT and other exemptions for particular terms in production-sharing agreements where the State of Georgia was a negotiating partner. In the absence of tax concessions the terms of production sharing agreements would likely have been less beneficial to Georgia. However, this policy choice back-loaded the possible fiscal benefit from oil and gas extraction activities at a time when the budget was rapidly accumulating domestic and external payment arrears.

56. Nonetheless in all three cases (utilities, agriculture, and oil and gas) sector specific amendments to the tax code were introduced. While there is no direct evidence of state capture, it seems likely that firms had a significant influence on the direction of policy to provide tax exemptions or special provisions, particularly in the oil and gas sector.

F. Legislative Amendments to Excise Legislation

57. The excise legislation in the 1997 Tax Code provided for ad valorem excises on a limited range of goods and applied equally to domestic and imported goods. Numerous amendments (detailed in Table II-3) have shifted excises for tobacco, alcohol, fuel products and cars to a specific basis and resulted in an effective reduction of the overall excise as a share of the pre-excise price. Also, in the case of tobacco products, a differential specific excise regime has been introduced favoring domestic production since the start of 2001. Nonetheless excises remain an important revenue source, accounting for just over one tenth of total tax revenues in 2000.

58. There has been significant public debate over the most appropriate excise regime for Georgia in recent years, involving excisable goods producers, importers, trade associations, and public officials. The staff of the Fund provided advice and technical assistance on the design and implementation of excises. While the main excisable goods are potentially large revenue sources, especially fuel and tobacco products, revenues have been significantly below potential because of significant sources of untaxed supply.

59. The main focus of debate has been whether low specific excises—marked on paid products with excise banderoles—would raise more revenue than moderate to high ad valorem excises. The argument for low specific rates is to provide incentives to importers and domestic producers to operate in the legal taxed market and to eliminate or reduce valuation problems. This view has mostly been articulated by the traders and producers in the excisable goods sector. In view of the widespread and severe valuation problems—which led to the valuation function of customs being contracted out in 1999—the Tax Code was amended during 1998 and 1999 to replace ad valorem with specific excises. The focus of policy debate then shifted to the level of specific excises with amendments introduced in 2000 and 2001 to reduce the main specific excises. The Fund staff has consistently argued that the focus of policy attention should be on tax administration (audit, transit procedures,

anti-smuggling measures) to improve enforcement of existing excise legislation, as well as periodic increases of specific excises.

60. It appears that over the four years since passage of the Code, sector interests have prevailed and Georgia has opted for a policy of specific excises replacing the ad valorem excises in the original tax code. In absolute terms, on a mid-market product, the specific excises introduced in Georgia are significantly lower than the original ad valorem excise in the 1997 Tax Code. They are also low by international standards, although not lower than in neighboring markets (Russia, Armenia and Azerbaijan) where similar arguments have prevailed. Aside from the issue of foregone revenue resulting from low excises, specific excises result in a relatively high ratio of excise to price for low cost local production, which leads to pressure to differentiate excises in favor of local production.[17]

61. While it is difficult to indicate that excise policy is subject to state capture in Georgia, certainly sector interests have an important say in the direction of policy. The following section considers tobacco excises in more detail as an illustration of the tax policy process.

G. Tobacco Excise Policy in Georgia

62. Tobacco consumption in Georgia is high by international standards—estimated consumption of 350 million cigarette packs per year is equivalent to expenditure of about 5 percent of GDP. The market is divided into two main segments, very low priced unfiltered cigarettes produced in Georgia and imported from Russia, and the filter market—about 80 percent of total consumption—which until early 2001 was almost entirely imported. The filtered cigarette market accounts for the vast majority of total expenditure on tobacco goods in Georgia. The tobacco sector is highly concentrated. In 1999, three quarters of all import excise stamps were purchased by two firms and 97 percent by just four firms, while only one or two domestic producers have been in operation. As discussed in Box II-2, excises on cigarettes and other tobacco products were frequently amended during the period 1997-2001, with a significant reduction in the effective excise rate over time.

63. Tobacco sector interests in Georgia were actively trying to influence tax policy. First, the limited number of importers managed in 1996 to completely evade the 100 percent ad valorem excise, but then complied with the tax legislation when the excise was reduced to minimal levels of US$0.04 per pack. Second, the authorities' attempt to reintroduce the 100 percent ad valorem excise in July 1997 with the new tax code was quickly overturned by a code amendment in September 1997 introducing a low fixed excise (and removal of VAT at the same time). Third, the experience of excise stamp sales indicates that importers made significant advance payments for excise stamps during 1999 (peaking at lari 27 million or

[17] Tariff policy is an ineffective tool for protection as Georgia has bilateral free trade agreements with most CIS countries.

½ percent of GDP), although it is not entirely clear whether these advance payments were made in order to influence future tax policy or as a covert means of pre-election budget financing.[18] Fourth, the reduction of the domestic excise in 2001 by half, contrary to Georgia's obligations under the WTO, was a policy clearly and publicly articulated by a joint venture investor in a cigarette factory during late 2000 that was subsequently adopted by the parliament.

Box II-2. The Reduction of Effective Cigarette Excise Rates, 1997-2001

The effective rate of excise relative to a theoretical mid-market cigarette brand before tax (US$0.40 pack of 20 filter cigarettes) is shown in Figure II-6 for the period 1997–2001. An ad valorem regime for tobacco imports was in force before October 1996, with excise at 100 percent and VAT of 20 percent in addition. Owing to widespread falsification of declared import value there were virtually no revenues recorded from excises. A transitional regime of a fixed tax of lari 0.06 (about 4 U.S. cents) per pack of twenty was then introduced, resulting in a significant pick up in revenues. The Tax Code reintroduced ad valorem excise at 100 percent in July 1997. Then, shortly after, the Code was amended to introduce a fixed tax of lari 0.25 (US$0.18) on imported filter cigarettes in lieu of excise and VAT, which implied a significant reduction in average excise rates. At end-1998, a similar fixed tax was introduced for domestic produced cigarettes at a rate of lari 0.15 on filter cigarettes and in April 1999, a system of excise stamps was introduced. At end-1999, the discriminatory taxation in favor of domestic production was removed in accordance with WTO requirements and the excise rate increased to lari 0.40 (US$0.20) per pack on recommendations of IMF staff. In 2001, the excise on local production was cut in half to lari 0.20, and the effective rate of tax brought down to just over 20 percent of pretax price in respect of excise, while cigarettes remained exempt from VAT. Thus domestic production faced more or less the same indirect tax burden in the form of excise as other goods liable for VAT at the standard rate.

64. Almost all of the legislative amendments regarding tobacco excises were added to the Tax Code as transitional provisions which lapse between a few months and up to two years after passage into law. This indicates that sector interests are often able to lobby for temporary gains but that they require periodic renewal, and renewed lobbying efforts. Many of the amendments to tobacco excises were introduced without consideration of the budgetary impact and outside the normal budget approval or amendment process. For example, the reduction of domestic excises from January 2001 was approved after the 2001 Budget, and revenues subsequently fell well short of budgetary estimates based on higher excise rates through mid-2001.

[18] Parliamentary elections were held in October 1999 and Presidential elections in April 2000.

H. Conclusions and Policy Lessons

65. Survey data from businesses in Georgia show a widespread perception that policy change is the result of "state capture." An analysis of Tax Code amendments since 1997 indicates that sectoral lobbies can be very effective in influencing tax policy in Georgia, particularly in case-studies presented on VAT exemptions in the oil and gas sector and excise rate reductions in the tobacco sector. However, the precise means of attaining such influence—whether through the legitimate persuasive power of argument or through illicit side payments—is not clearly determined. The influence of vested interests on policy appears strongest when the sectors are highly concentrated. While there is no evidence of direct payments to policymakers there is some correlation between the introduction of tax concessions and either advance payment of tax or a parallel agreement on profit-sharing terms.

66. Overall, Tax Code amendments in Georgia, whether or not a result of state capture or pressure from vested interests, appear since 1997 to have narrowed the tax base and reduced potential revenues. In addition, the frequent recourse to transitional provisions and repeated amendment of the Tax Code has created uncertainty over the legislative environment. Other consequences of tax code amendments, not discussed above, are the occurrence of frequent tax disputes arising from implementation of hastily drafted amendments and inconsistencies between budget revenue estimates and tax policy legislation.

67. Finally, it might be noted that vested interests seeking to reduce tax liabilities often conflict with the advice of international financial organizations which seek to broaden and strengthen the tax base. As in the case of cigarettes in Georgia, this results in tax policy conditionality which is implemented but not sustained over a significant period of time.

68. Two central policy messages result from the above analysis:

- First, that proposals to change tax policy legislation should include a clear indication of the likely revenue impact, preferably with an independent impact assessment, so that policymakers can have access to information which will enable them to make an accurate assessment of the claims of sectoral interests.

- Second, in the interests of fiscal and legislative stability, that tax policy amendments should only be made in conjunction with presentation of the budget or amendments to the budget to avoid inconsistencies between tax legislation and budget revenue estimates.

Table II-2. Georgia: Amendments to the Value Added Tax, 1997-2001

Date of Amendment	Intention of Amendment	Type of Amendment
9/3/97	Determine the supply of goods for enterprises of electric energy generation, water supply, and water sewerage disposal services up to January 1, 2000 according to actual value.	Base narrowing
9/18/97	Transitional provision delaying VAT on railroads to January 1998.	Delays tax introduction
9/18/97	Exemptions for scientific literature, various tickets.	Tax exemption
9/18/97	Exemptions for hardware, technology and chemicals for scientific and educational purposes.	Tax exemption
9/18/97	Imported cigarettes are exempt from VAT.	Base narrowing
12/12/97	Extends transitional VAT exemption for agriculture to April 1998.	Prolongs tax exemption
12/12/97	Exemption for imports of mazut.	Tax exemption
5/1/98	The zero-rating of wheat is rescinded.	Base broadening
5/1/98	The threshold for producers of agricultural products is increased from lari 3,000 to lari 20,000.	Base narrowing
5/1/98	For enterprises supplying energy, water and sewerage water operations, as well as for budgetary health care organizations, until January 1, 2000, the VAT to be assessed on actually recovered value (cash).	Base narrowing
5/1/98	Exemptions to the supplies of books, wheat, film production, services to refugees, medical equipment, tourism services, freight trucks, trailers, rails, railroad ties, radar, communications and navigation equipment, diplomatic supplies, transit trade, import of natural gas and electricity.	Tax exemption
5/1/98	Exempts energy sector rehabilitation works under international treaties.	Tax exemption
5/1/98	Extends and broadens agricultural VAT exemption to April 1999 to all farms regardless of size.	Tax exemption prolonged and broadened
5/13/98	Reduction of VAT rate from 20 percent to 7 percent on bread, pasta and domestically produced flour.	Rate reduction
5/29/98	Exemption for non-resident shipping companies sailing under the Georgian flag.	Tax exemption
10/30/98	Exemption of primary agricultural products until January 1, 1999 from April 1999.	Shortens transitional provision
10/30/98	Exemption of supply and import of natural gas, mazut and electricity extended until January 1, 1999.	Tax exemption
4/2/99	Prolongs special administrative provision for railways to January 2000.	Prolongs transitional tax provision
4/16/99	VAT exemption for personal effects and household items for diplomatic personnel is extended to foreign citizens and their families that are involved in oil and gas extraction.	Tax exemption
4/16/99	Import of machinery, means of transportation, spare parts and materials needed for the oil and gas industry is exempted from VAT according to the "Law on Oil and Gas."	Tax exemption
6/25/99	The turnover threshold for producers of agricultural products increased to lari 35,000 (from lari 20,000).	Base narrowing
6/25/99	The cash treatment of enterprises supplying water and cleaning sewerage, as well as health care budgetary organizations, is extended indefinitely (though maintained among transitional provisions).	Base narrowing
6/25/99	Printing, supply, import and realization of newspapers, magazines and literature to be exempt from VAT.	Tax exemption
7/23/99	The exemption from VAT on cars is lifted.	Tax exemption removed
9/9/99	The supply of goods and services for oil and gas agreements to be exempt from VAT.	Tax exemption
12/24/99	(i) Until July 2002, the import of electric power is exempt and the production and supply of electric power zero-rated; (ii) Until January 2000, supplies by energy distributors, water and sewerage cleaning providers, and budgetary health care organizations are determined in accordance with actually reimbursed value; (iii) From January 2000–July 2000, for enterprises supplying electric power and water, VAT due is determined from 40 percent of supplied amount; from July 2000–January 2001 from 60 percent of supplied amount.	Base narrowing
12/24/99	Until July 1, 2002, the imported and supplied gas for the production of electric power is exempt from VAT and the environmental tax.	Tax exemption
12/28/99	Supply of domestically produced cigarettes is zero-rated.	Base narrowing
7/17/00	Increase in the turnover threshold to lari 24,000 from lari 3,000 (down from lari 35,000 for agricultural producers).	Base narrowing
7/17/00	The exemption for medicines under VAT and customs extended to include certain pharmaceutical raw materials and substitutes over-the-counter medicines, and not only raw materials.	Base narrowing
7/17/00	Enterprises servicing refugees or IDPs to be shifted to a cash basis for VAT purposes, to overcome cash flow problems created by government expenditure arrears.	Base narrowing
9/28/00	Introduces transitional zero-rating under VAT for electricity supply except to final consumer from October 2000 until July 2002.	Base narrowing
11/10/00	Exemption for livestock fodder to June 1, 2001.	Tax exemption
11/24/00	Exemption for special stamps	Tax exemption
12/13/00	Extends cash basis for VAT on water, sewage with VAT liability at a minimum of 60 percent of goods supplied until January 2002.	Prolongs base narrowing
12/29/00	Supply of domestic cigarettes moved from zero-rated to exempt.	Eliminates tax privilege
12/29/00	Prolongs special administrative provision for railways to January 2002.	Prolongs special admin
3/16/01	Removes reusable containers from VAT tax base.	Base narrowing

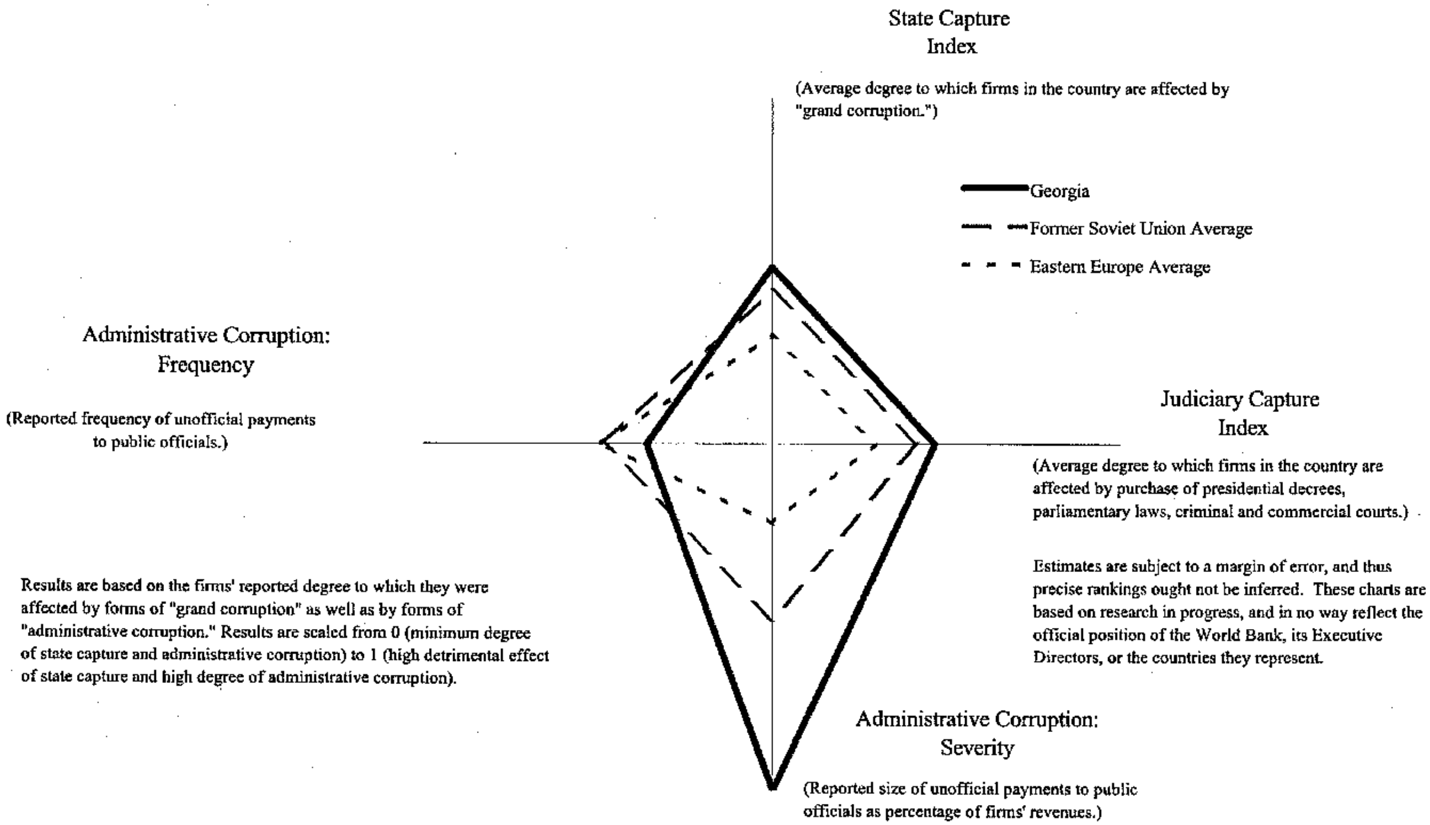
Source: Tax Code of Georgia and subsequent amendments.

Table II-3. Georgia: Amendments to Excise Taxation, 1997-2001

Date of Amendment	Intention of Amendment	Type of Amendment
9/18/97	Until January 1, 1998, VAT and ad valorem excise on the import of tobacco products to be replaced by a fixed tax (tetri 25/19 per pack).	Effective rate decrease
12/12/97	Extends lowered tax regime for cigarettes to April 1998.	Prolongs rate decrease
5/1/98	Extends transitional lowered cigarette excise to October 1998.	Prolongs rate decrease
5/1/98	Introduction of fixed tax on imports of alcoholic beverages, reduced tax on high cost beverages, wine and vodka, ethyl alcohol.	Effective rate decreases
5/1/98	Increase in ethylated gasoline excise from 60 percent to 100 percent.	Rate increase
10/30/98	Excise on domestic cigarettes changed from 100 percent to 15 tetri for filtered cigarettes and from 55 percent to 5 tetri for unfiltered cigarettes.	Effective rate reduction and introduction of fixed tax for ad valorem
10/30/98	Extends transitional excise on imported tobacco products from October 1998 to April 1999.	Prolongs transitional tax provision
10/30/98	Introduction of 60 percent excise duty on petroleum oils, oil products, and natural gas condensate (except pipeline).	Rate increase
10/30/98	Exemption of aviation fuel to be supplied on board upon international flights.	Tax exemption
12/24/98	Exempts Mazut from excise of 60 percent.	Rate reduction
4/2/99	Extension of transitional imported cigarettes excise regime from April to July 1999.	Prolongs transitional tax provision
6/25/99	Transitional provision replacing the 15 percent excise on cars by a specific rate of lari 0.1 per cm3 of engine capacity until December 31, 2000.	Effective rate reduction
6/25/99	Increase in excise on petroleum to 80 percent (from 60 percent); and amendments introduced to the excise schedule for beverages to ensure compliance with WTO commitments.	Rate increase
6/25/99	A new classification of cigarettes introduced to comply with WTO obligations. The transitional provision extended until January 1, 2000.	Rate Increase
7/23/99	Increase in the excise rate on fortified wines (to lari 0.5-1 per liter) and on wines of fresh grapes (to lari 0.1-0.2 per liter).	Rate increase
9/9/99	Import and supply of oil products necessary to carry out and gas project agreements to be exempt from excise duty determined by "Law on Oil and Gas."	Tax exemption
12/24/99	The transitional provision providing for a fixed excise on the import of cars extended until December 31, 2000.	Prolongs transitional tax provision
12/28/99	Until January 1, 2001, a fixed tax in lieu of VAT and excise at the following rates applies: (i) pipe tobacco—20 lari per kilo; (ii) cigars—60 tetri per unit; (iii) cigarettes and cigarillos—40 tetri per pack; and (iv) nonfilter cigarettes and cigarillos—30 tetri per pack. For import and supply of excisable goods marked with excise stamps issued before the enactment of this provision, after February 1 the difference between tax rates should be paid.	Rate increase
3/24/00	Until January 1, 2001, the excise on oil products to be charged at lari 200/ton (previously 80 percent).	Effective rate reduction
12/29/00	Prolongs specific excise on fuel products.	Prolongs reduced tax
12/29/00	Prolongs specific excise of 0.1 lari per cc.	Prolongs reduced tax
12/29/00	Reduces excise on imported nonfiltered cigarettes from 30 to 20 tetri box, and new lower rates for domestically produced cigarettes of tetri 20 per box filter (vs 40 tetri for imports) and tetri 7 for nonfilters.	Rate reduction favoring domestic producers
3/16/01	Eliminates jewellery excise.	Eliminates minor excise
3/16/01	Excise on heavy oil products including diesel reduced from lari 200 per ton to lari 100 per ton until January 1, 2002.	Rate reduction
4/27/01	Temporary rate reduction of excise on pyrolized products from 400 to 50 lari/ton until January 2003	Rate reduction

Source: Tax Code of Georgia and subsequent amendments.

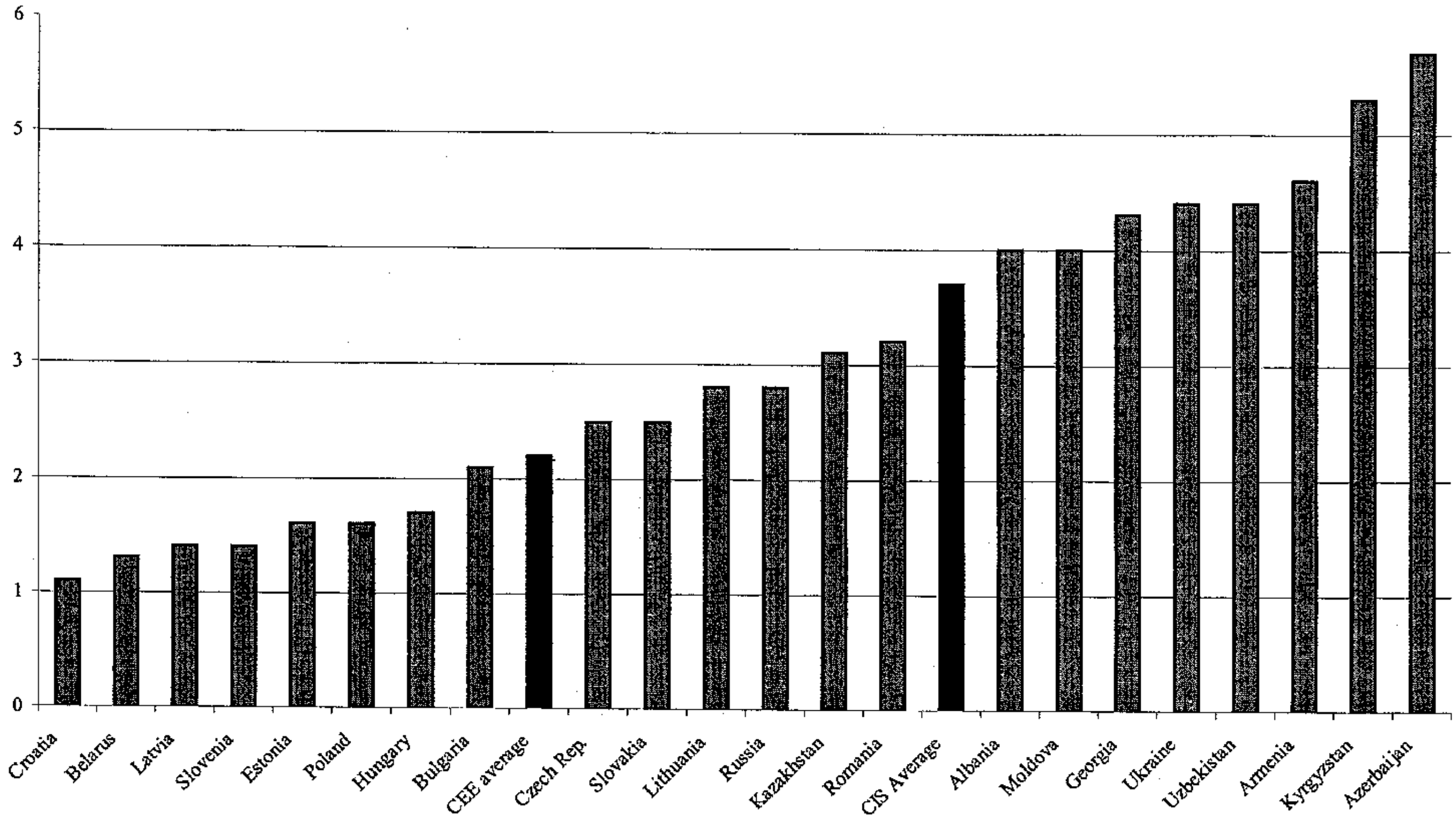
Figure II-1. Georgia: State Capture and Administrative Corruption: Georgia and Regional Averages



Source: Hellman, J., G. Jones and D. Kaufmann, 2000, "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," World Bank Policy Research Working Paper 2444 (http://www.worldbank.org/wbi/governance/).

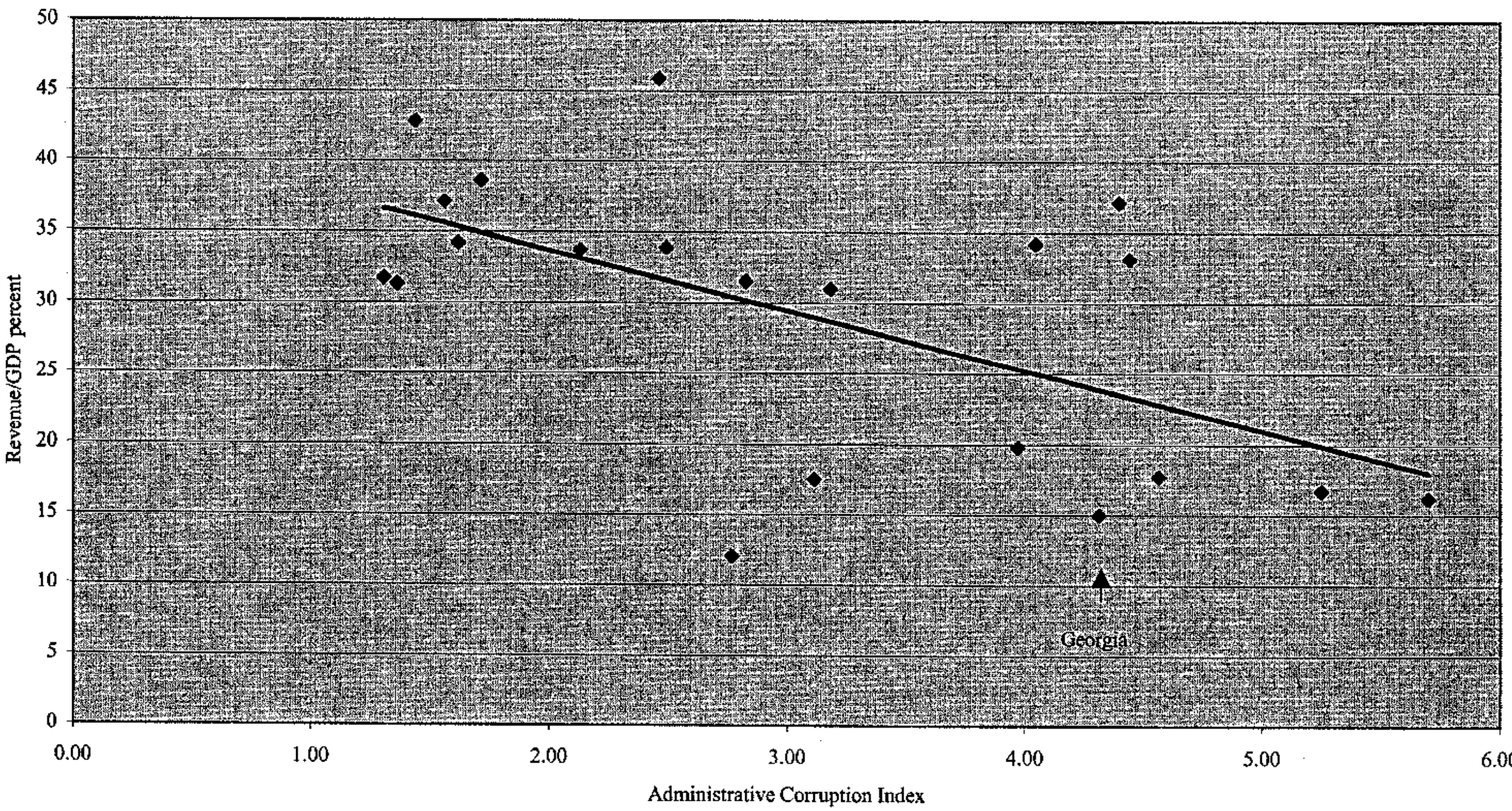
Note: The thick line represents the estimated performance of the country you chose on each of the four dimensions. Distance from the origin indicates worsening of the degree of capture and corruption respectively . The dashed line represents the average performance of by the countries in the Former Soviet Union. The dotted line indicates the average performance of the countries in Eastern Europe (outside the Former Soviet Union).

Figure II-2. Georgia: Administrative Corruption: Bribery Payments as a Share of Gross Firm Revenues



Source: Hellman, J., G. Jones and D. Kaufmann, 2000, "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," World Bank Policy Research Working Paper 2444 (http://www.worldbank.org/wbi/governance/).

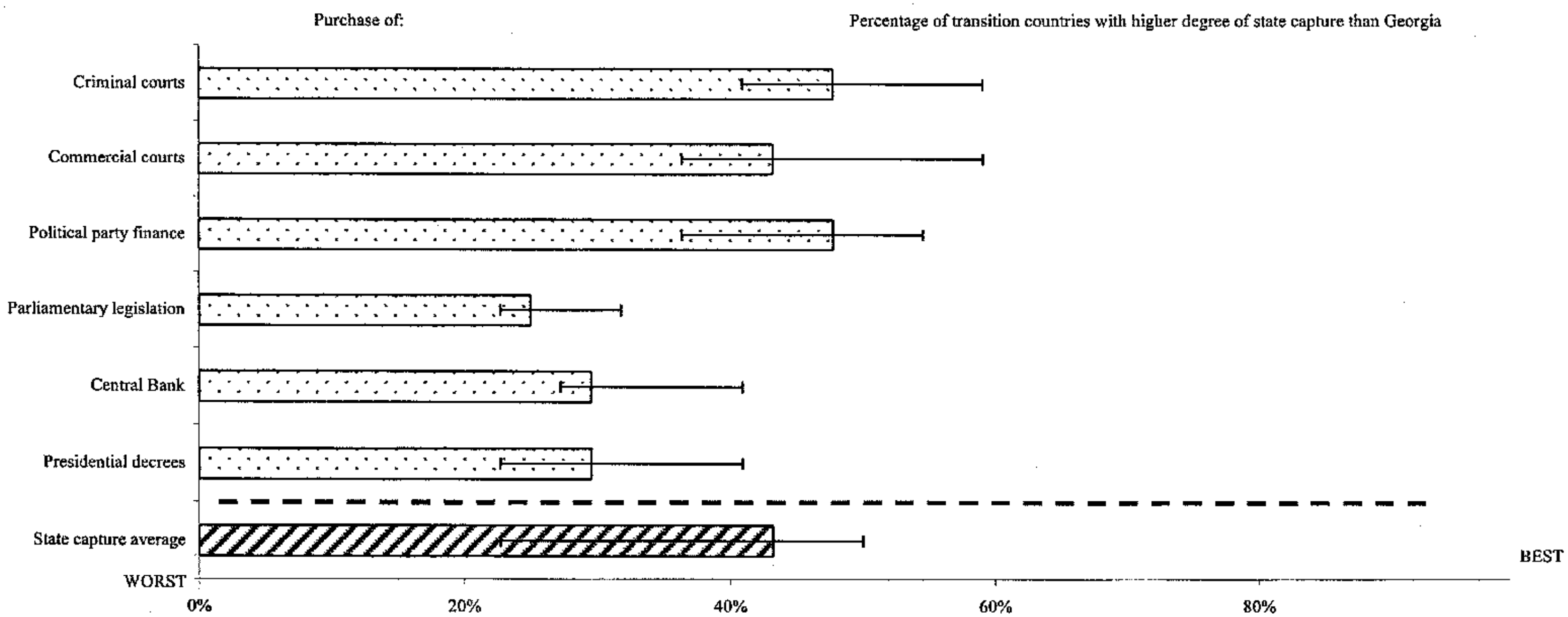
Figure II-3. Georgia: Administrative Corruption Index and Revenue/GDP



Source: Source: Hellman, J., G. Jones and D. Kaufmann, 2000, "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," World Bank Policy Research Working Paper 2444 (http://www.worldbank.org/wbi/governance/) and IMF staff estimates.

Notes: Revenue/GDP ratio defined as average of latest available three calendar years to 1999. Country selection and definition of Administrative Corruption Index see Figure 2.

Figure II-4. Georgia: State Capture and its Subcomponents: Research Results



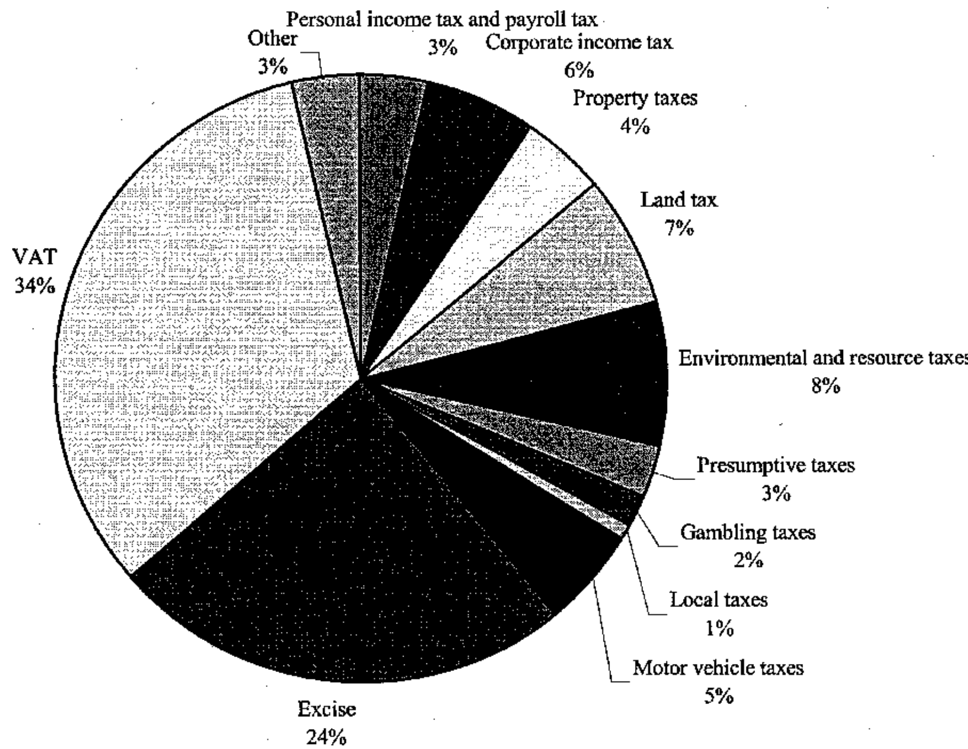
Results are based on the firms' reported degree to which they were affected by each of these forms of "grand corruption." This chart reports percentile rankings based on these results, thus values close to zero correspond to the maximum degree of state capture, and values close to 1 to the minimum degree of capture.

Estimates are subject to a margin of error, and thus precise rankings ought not be inferred. These charts are based on research in progress, and in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent.

Source: Hellman, J., G. Jones and D. Kaufmann, 2000, "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," World Bank Policy Research Working Paper 2444 (http://www.worldbank.org/wbi/governance/).

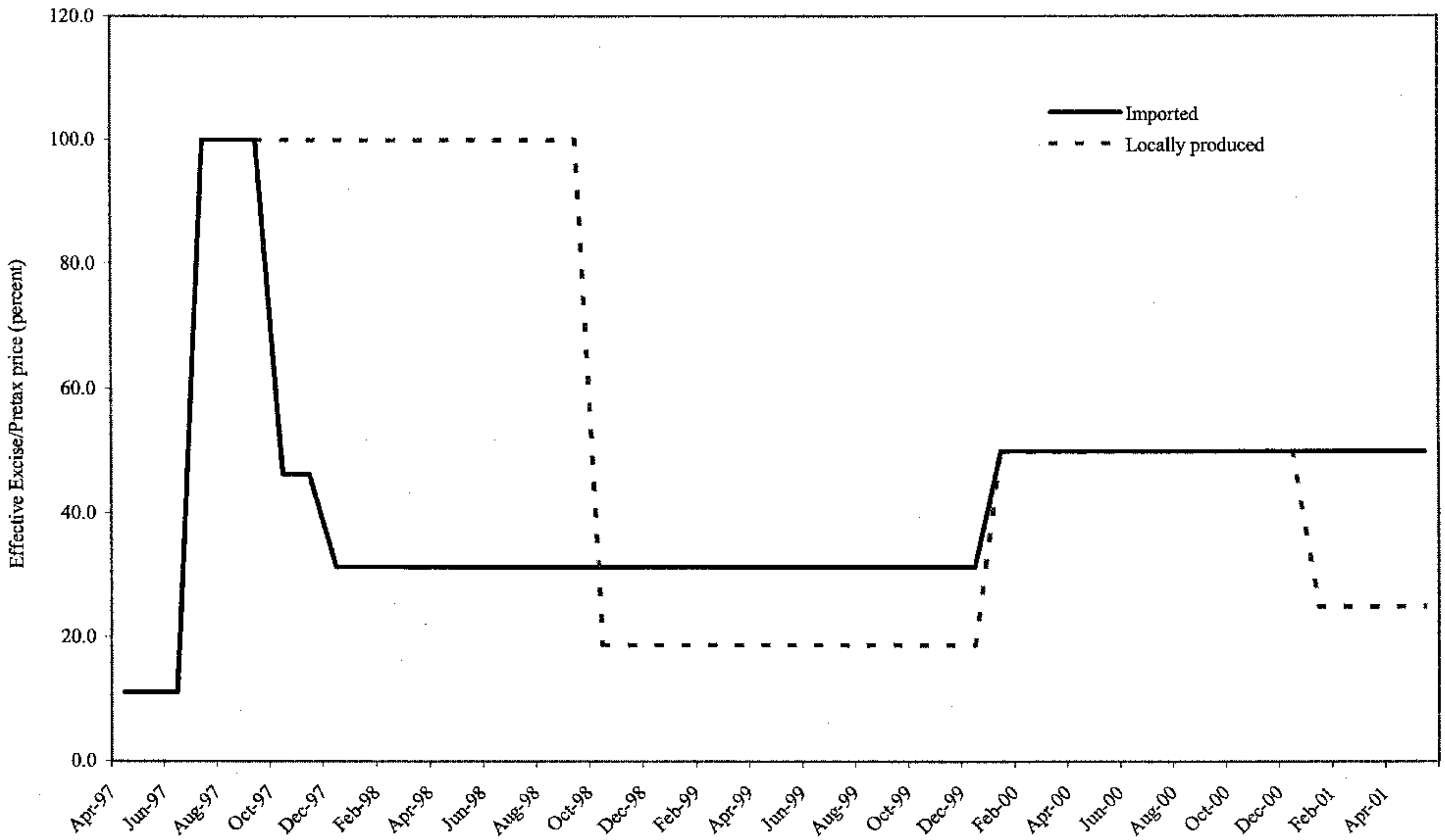
Note: The dotted bars represent estimates of the percentage of countries which rate worse on each governance dimension than the country you chose. Thus, longer bars mean better performance. The error bars indicate the percentage of countries which rate worse (better, respectively) after taking into account the standard error of the estimates.

Figure II-5. Georgia: Tax Code Amendments 1997–2001, by type of tax



Source: Parliament of Georgia.

Figure II-6. Georgia: Excise Taxation of Mid-Price Filter Cigarettes, 1997–2001
(Assumes pre-tax price US$0.40)



Source: Parliament of Georgia, Ministry of Revenue; and Fund staff estimates.

III. Selected Social Expenditure Issues[19]

A. Summary and Introduction

- From 1997 to 2000 public sector social expenditures declined, on a cash basis, from 8¾ percent to 7½ percent of GDP. The decline affected primarily the education system, health care services, and welfare programs.
- The decline occurred during a period of large fiscal adjustment. The general government deficit, on a cash basis, fell from over 6 percent of GDP in 1997 to 2½ percent of GDP in 2000. The adjustment was accounted for mainly by cuts in primary expenditure. Tax revenues rose, but this was partly offset by a fall in grants, while interest payments increased.
- Social areas were not protected from cuts in cash primary spending, largely because of the accumulation of arrears on pensions, health and welfare spending. The actual allocation of social expenditure was inefficient and ineffective in limiting the increase in the number of poor households.
- The establishment of a sustainable fiscal situation, consistent with the government's poverty reduction strategy, requires a substantial increase in tax revenues. In addition, greater efforts are needed to protect the share of social spending within the total, especially by avoiding arrears, and to improve targeting on the poor.

69. This chapter considers developments in public sector social expenditure in five areas: education, health care, pensions, unemployment benefits, and welfare programs.[20] The analysis covers a four-year period beginning in 1997. The next section analyzes the trends of total social expenditure in relation to fiscal adjustment. The following sections deal with the five individual components of social expenditure. Finally, the observed trends are discussed in the context of Georgia's poverty reduction strategy.

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[19] Prepared by Stefano Fassina.

[20] The data for the health care services include the total expenditure managed by the "State Medical Insurance Company." The welfare programs analyzed are the poverty benefits, the refugee allowances and the food programs. The figures could slightly understate the actual social expenditure of the public sector because of possible information gaps in central and local budgets for welfare programs. These gaps marginally reduce the level but do not affect the trend of the social expenditure.

B. Social Expenditure Trends

70. During 1997-2000, the total amount of public expenditure classified as "social" declined, on a cash basis, from 8¾ percent to 7½ percent of GDP (Table III-1 and Figure III-1). In particular, the resources dedicated to the education sector, health care services and welfare programs dropped significantly while the expenditure on pensions and unemployment benefits remained stable, in relation to GDP.

71. The downtrend in social expenditure is fully accounted for by the central government and the state agencies: total social expenditure managed by the central administration fell by 1½ percentage points to 5 percent of GDP (Table II-2). Specifically, as a share of GDP, expenditure in the education sector was cut by half and the amount spent in the health care sector was also reduced drastically. Social spending by local government remained roughly constant, as a share of GDP.

72. The decline of public resources dedicated to social spending occurred during a period of large adjustments. The general government deficit, on a cash basis, fell from 6 percent of GDP in 1997 to 2½ percent of GDP in 2000 (Table III-3). The improvement was due to both increases in total revenues and grants (by 1 percent of GDP) and reductions of expenditure on a cash basis (by 2½ percent of GDP). The reduction of expenditure was split equally between cuts in current and capital expenditure (Table II-3 and Figure III-2).

73. Primary current expenditure experienced a large decrease on a cash basis (by 2½ percent of GDP) while the resources spent in interest payments grew by 1¼ percent of GDP. From 1997 to 1999, cuts in primary current expenditure were larger on social items than on non-social items, although the share of social items recovered in 2000. (Table III-4 and Figure III-3). Overall, the trends in the composition of primary current expenditure in recent years show that social items received no particular protection from cuts necessitated by the execution of fiscal adjustments.

74. An analysis of Georgia's fiscal operation on a commitment basis delivers a different picture. From 1997 to 2000 the budget plans allocated a relatively stable amount of resources for social items, as a percentage of GDP, relying on additional tax revenues and grants to shrink the deficit. Continuing under-performances on the revenue side resulted in the incomplete execution of the budgets and accumulation of a large amount of arrears on social expenditure to meet the overall fiscal targets. From 1997 to 2000, the stock of arrears accumulated on pensions was 1.1 percent of GDP while arrears on health and welfare programs reached 1.4 percent of GDP (Table III-5).[21] If the 2000 budget had been fully implemented, the decline in social expenditure since 1997 would have been less than half the actual amount (0.6 percent of GDP instead of 1.3 percent of GDP).

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[21] A part of the arrears on social expenditure is hidden in the arrears on wages and salaries.

75. The shortfall in executing the budgets and cuts in social expenditure undermined the effectiveness of the programs that were targeted to reduce poverty and inequality. During 1997-2000, the share of the Georgian population living below the "recommended poverty line" (US$25 per month per equivalent adult) rose from 13½ percent to 23 percent.[22] Poverty depth[23] also increased. Finally inequality, measured by the Gini percent on consumption, reached 0.40 in 2000 (from 0.36 in 1997), one of the highest levels among the transition economies.

C. Social Expenditure in Georgia and in Other Transition Economies

76. In terms of public resources allocated to social expenditure, Georgia performed well below the average of the transition economies and the levels of similar transition countries.[24] All those economies experienced a decline in social expenditure and a downsizing of government fiscal operations after the collapse of the Soviet Union but, as a 1996 World Bank review highlighted, Georgia's case is among the most dramatic.[25]

77. In 1998, the most recent year with comparable data, public resources spent on education by 24 transition economies averaged 4.3 percent of GDP while in Georgia the education sector received 2.3 percent of GDP.[26] In the health sector the average expenditure for the same group of transition economies was 3.5 percent of GDP, more than three times the level in Georgia. In comparison with Azerbaijan and Moldova, countries with similar per capita GDP (around US$550 in 1998), Georgia's total social expenditure is less than half (Figure III-4) in terms of GDP.

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[22] For the definition of "recommended poverty line" and a comprehensive analysis of poverty in Georgia see "Georgia: Poverty Update," World Bank 2001. The increasing trend in poverty since late 1997 is also evident on the basis of other definitions of poverty.

[23] The index of poverty depth distinguishes among the poor according to how far below the line their consumption falls. It is the poverty shortfall averaged for the whole population (zero for non-poor). See "Georgia: Poverty Update," World Bank 2001.

[24] The similarity refers to per capita GDP.

[25] Georgia Public Expenditure Review, World Bank, Report No. 15779-GE, 1996.

[26] S. Gupta, L. Leruth, L. de Mello, and S. Chakravarti, 2001, "Transition Economies: How Appropriate Is the Size and Scope of Government?" IMF Working paper 01/55, Appendix, Table 7.

78. The low level of social expenditure is a direct result of Georgia's low fiscal revenues: in 1998, general government tax revenues were 12¾ percent of GDP in Georgia, compared to an average of 30 percent of GDP for the transition economies.[27]

D. The Education Sector

79. The education sector in Georgia consists of four levels: kindergarten, compulsory general education (grades 1-9), upper secondary (grades 10 and 11), and higher education. The administration is run jointly at the central and local level. The central budget is responsible for a small part of the school facilities and for higher education. Local budgets are responsible for most of the facilities and for employees compensation, although the local budgets receive transfers from the central budget to pay teachers' salaries.

80. General government expenditure dedicated to education dropped dramatically during the 1990s in real terms.[28] A steep fall at the beginning of the decade was followed by a slower but continuing downtrend. The resources allocated to schools and universities were only 2½ percent of GDP in 2000 (Table III-6).

81. The consequences of the financial collapse have been reflected in the very low level of teachers' salaries, the degradation of the facilities, the cut off in financial support for welfare services to students, and increases in the costs paid by parents. The enrollment rates in public sector institutions, historically very high (about 100 percent for the compulsory general education and 75 percent for upper secondary schools), have dropped by 23 percent on average, partially offset by an increase in private school attendance.

82. The allocation of expenditure within the sector has shifted toward local governments, i.e., the administrations responsible for pre-school and mandatory school institutions. The shift, broadly consistent with the recommendations of the World Bank, assigned to local budgets 85 percent of the resources dedicated to the education sector in 2000, 13 percentage points more than in 1997.[29]

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[27] See S. Gupta *et al.* "Transition Economies: How Appropriate Is the size and Scope of Government?" IMF Working paper 01/55, Appendix, Table 5.

[28] According to the World Bank survey mentioned above, in 1995 the expenditure on education was, in real terms, 3 percent of the total amount allocated to the sector in 1990.

[29] See "Georgia Public Expenditure Review," World Bank, Report No. 15779-Ge, 1996; Social issues in IMF-Supported programs by S.Gupta, L. Dicks-Mireaux, R. Khemani, C. McDonald, and M. Verhoven, IMF Occasional Papers No 191.

E. The Health Sector

83. The public health care system is financed by the Ministry of Health; the State Medical Insurance Company (SMIC, a semi-independent agency); and municipalities.[30] The Ministry of Health and the municipalities directly manage some programs while the SMIC refunds the cost of the state-supported programs managed by private providers. The SMIC is funded by transfers from the central budget and by a 4 percent payroll tax on wages and salaries (3 percent paid by employers and 1 percent paid by employees).

84. A World Bank supported reform, implemented from 1997, concentrated the responsibilities of the public sector on the basic needs of the population and gave the SMIC a central role in the financial management of the programs. The system provides a basic package and essential clinical services. Some services outside the basic package are provided on a fee-for-service basis, with exemptions made for selected vulnerable groups.

85. The resources for the health care system fell dramatically in the years immediately after the collapse of the Soviet Union and continued to fall in the second half of the nineties, following the pattern of the education sector.[31] In 2000, public resources available for the health sector amounted to 1.1 percent of GDP (Table III-7) or 6.9 percent of primary current expenditure. Consistent with the reform, the SMIC has managed a larger share of health expenditure than in the past (from 28 percent in 1997 to 55 percent in 2000) and, consequently, the relevance of the Ministry of Health in the direct management of health programs has faded.

F. The Pension System

86. The pension system, reformed in 1994-96 but still based on the Soviet-period legal framework, is a "pay-as-you-go" scheme.[32] The scheme, managed by a semi-independent agency, the United Social Security Fund (SSF), is financed by a 28 percent payroll tax (27 percent paid by the employers and 1 percent paid by the employees) and by transfers from the central budget. Under the 1996 reform, the mandatory minimum age requirement for

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[30] The Ministry of Interior and the Ministry of Internal Affairs provide some health programs for their employees. The outlays for these programs are not included in the data. The data do not include health care expenditures financed by fees because revenues from fees are off the government budget.

[31] Public expenditure on health care, in real terms, has declined by 90-95 percent since the Soviet period (see World Bank, Georgia Public Expenditure Review, 1996).

[32] R. Palacios- A. Posarac "Options for Pension Reform in Georgia," World Bank 2000; E. Vashakmadze "The Reform of the Pension System in Georgia," mimeo 1998.

retiring was raised at once by 5 years to 60 and 65 years respectively for women and men.[33] The reform also introduced flat rate, old-age pensions.

87. The number of pensioners fell from 977,000 in 1997 to 902,000 in 2000, mainly because of the increase in the minimum retirement age. In 2000, the old-age pensions ("labor pensions") and the social pensions ("welfare pensions") made up 90 percent of the all benefits paid by the SSF.[34] The remaining 10 percent represented so called "privileged pensions," i.e. benefits paid to selected categories of citizens (i.e. military staff and war participants). Since 1997, the labor pension and the social pensions have been frozen at 14 lari or US$7 per month (slightly more than ¼ of the "recommended poverty line," in 2000) while the privileged pensions have remained around 40 lari per month (about 80 percent of the "recommended poverty line" in 2000).

88. Despite the decline of the average pension in real terms and the decline in the number of beneficiaries, the total amount actually spent on the public pension system was stable at about 2.7 percent of GDP in the period examined (Table III-8). The result is explained by the declining trend in the accumulation of expenditure arrears. In particular, the annual accrual of arrears on pensions declined from 0.7 percent of GDP in 1998 to 0.4 percent of GDP in 2000.

89. During the period analyzed, the central government significantly reduced its support to the pension system: on a cash basis, the central budget covered 21 percent of the total expenditure on pensions in 1997 while the share fell to 13 percent in 2000.

G. The Employment Fund

90. The Employment Fund is meant to provide unemployment benefits, job search assistance and job training. The fund is financed by a 1 percent payroll contribution paid by the employers on wages and salaries. The level of the benefits it is expected to provide is around 13 lari per month or a quarter of the 2000 "recommended poverty line." The average annual expenditure was 0.1 percent of GDP during 1997-2000 period (Table III-9). Given its very small budget and the low level of benefits, the agency is ineffective.

H. The Welfare Programs

91. The welfare programs include the social pensions (see above), poverty benefits, refugee allowances and food programs.[35] These programs are financed by the central budget.

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[33] In April 1998, Georgia abolished all early retirement provisions.

[34] The "social pensions" are paid to invalids or citizens more than 64 years old without the minimal contribution period required to receive a "labor pension."

[35] In addition to cash benefits, the government also provides a non-cash social program: differentiated discounted rates for the electricity bill of selected categories of citizens as

(continued...)

The poverty benefits were originally called "family allowances" and were paid to poor households with two or more children under 18 years. In 1999, in the context of the energy sector reform and constrained budget, the government reduced the number of beneficiaries and targeted the family allowances on poor single pensioners.[36] The refugee allowances are targeted to the refugees from civil conflicts in Abkazia and other regions of Georgia. The food programs provide food for boarding schools and orphanages, hospitals, and law enforcement ministries.

92. Expenditures on family allowances/poverty benefits and food programs have been stable at 0.1 and 0.2 percent of GDP respectively. The amount spent on refugee allowances fell from 1.1 percent in 1997 to 0.7 percent of GDP in 2000 (Table III-10) because benefits shrank in real terms and the number of beneficiaries declined.

I. Social Expenditure and the Poverty Reduction Strategy

93. Fiscal adjustment in Georgia has primarily relied on expenditure cuts. Although tax collection improved (by 1½ percent of GDP) during 1997-2000, grants and non-tax revenues were continually lower than assumed in the budget plans, while debt service absorbed an increasing share of budget resources. In this context, social expenditures, despite their very low level, were used to limit the overall deficit on a cash basis, notably via accumulation of expenditure arrears.

94. During the period examined, the government slightly improved the "efficiency" (from 3.8 percent in 1998 to 7.8 percent in 2000) and the "effectiveness" (from 0.6 percent in 1998 to 1.5 percent in 2000) of transfers to household and improved the allocation of resources within the health care and the education systems (see above).[37] These tiny improvements

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Internally Displaced Persons (IDPs) and war veterans. As for IDPs, the budget pays a fixed amount of 2.5 lari a month per person (total budgeted expenditure on this item in 2001 is 12.5 million lari). War veteran have 50 percent of their electricity bill covered. Until 2000 the central budget was responsible for the coverage. Since 2001 local budgets have taken over.

[36] In 1999, as a consequence of the restructuring of the energy sector (elimination of subsidies for electricity companies) the family allowances were reformed and transformed into poverty benefits. Under the current system, 20 lari per month is paid to single poor pensioners living alone and to orphan children, while 32 lari per month per household is paid to single poor pensioners living together. The benefits are funded by earmarked transfers from the central budget to the SSF and local governments. In 2000, there were about 45,000 beneficiaries. They received only half of the budgeted 10 million lari. In the first half of 2001, all the arrears accumulated on poverty benefits were cleared.

[37] The efficiency is defined as the percentage of disbursed social assistance received by the poor. The poverty gap is the difference between the average income of the household defined

(continued...)

were more than offset by the decline of total social expenditure. To be effective, policies to combat poverty and inequality need not only to be efficient but also to provide for an adequate amount of resources for funding primary education, basic health care services, targeted social pensions and welfare benefits.

95. The need for additional resources to fund social spending has emerged very clearly during the preparation of the PRSP. For example, the reforms in the health sector and in the pension system described in the interim-PRSP are expected to increase public expenditure by 7 percent of GDP by 2010. In developing its analysis to cost and prioritize the reform measures the authorities should consider a notable increase in tax revenues as the key component of an effective poverty-reduction strategy.

96. The following policies are recommended to establish a sustainable fiscal framework consistent with the poverty reduction strategy defined in the authorities' Interim-PRSP:

- a stable increase in tax revenues to enlarge or at least to preserve the room for primary expenditure in a period characterized by rising external debt service;
- for a given level of overall primary expenditure, strengthening the protection of social expenditure—both by avoiding arrears and ensuring adequate budgetary provision for pro-poor expenditure;
- given the fiscal constraints, costing and prioritizing the social and non-social measures included in the PRSP;
- considering the minimal level of efficiency and effectiveness of social expenditure, better targeting of social expenditure on the poor. In particular, in the health care sector providing additional resources for a basic package of clinical services; in the education sector concentrating resources in primary, elementary, and middle schools.

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poor and the poverty line used. Effectiveness is defined as the percentage of the pre-assistance poverty gap eliminated by the transfers (for a detailed analysis of performance indicators of the public and private transfers in alleviating poverty see World Bank, Georgia: Poverty Update, June 2001, Chapter 2, Section F). As the World Bank report highlights, the system of transfers still has very large targeting errors but less than in the previous years (in 2000, 79 percent of recipients of budget transfers were not poor. The same category received 90 percent of transfers in 1998).

Table III-1. Public Sector Social Expenditure, 1997-2000 1/

	1997	1998	1999	2000
	(In millions of lari)			
Total expenditure	**405.8**	**389.0**	**430.8**	**441.3**
Social security fund 2/	124.2	142.5	155.1	161.2
Health care	63.7	48.6	61.4	63.1
Education	149.8	117.5	138.9	149.2
Employment fund	3.4	4.8	4.1	4.5
Welfare programs 3/	64.6	75.6	71.3	63.3
	(In percent of GDP)			
Total expenditure	**8.7**	**7.7**	**7.6**	**7.4**
Social security fund 2/	2.7	2.8	2.7	2.7
Health care	1.4	1.0	1.1	1.1
Education	3.2	2.3	2.5	2.5
Employment fund	0.1	0.1	0.1	0.1
Welfare programs 3/	1.4	1.5	1.3	1.1
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

1/ On a cash basis. Includes General Government and State Medical Insurance Company.

2/ Does not include the expenditure for poverty benefits.

3/ Welfare programs include poverty benefits, refugee allowances and food programs.

Table III-2. Central Government Social Expenditure, 1997-2000 1/

	1997	1998	1999	2000
	(In millions of lari)			
Total expenditure	**306.4**	**287.3**	**307.6**	**304.5**
Social security fund 2/	124.2	142.5	155.1	161.2
Health care	38.6	20.5	29.4	29.5
Education	75.6	43.9	47.7	46.0
Employment fund	3.4	4.8	4.1	4.5
Welfare programs 2/	64.6	75.6	71.3	63.3
	(In percent of GDP)			
Total expenditure	**6.6**	**5.7**	**5.4**	**5.1**
Social security fund 2/	2.7	2.8	2.7	2.7
Health care	0.8	0.4	0.5	0.5
Education	1.6	0.9	0.8	0.8
Employment fund	0.1	0.1	0.1	0.1
Welfare programs 3/	1.4	1.5	1.3	1.1
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

1/ On a cash basis. The Central Government expenditure includes the central budget expenditure for education, health programs and welfare programs; the tranfers to SMIC; the Social Security Fund expenditure; and the Employment Fund expenditure.

2/ Does not include the expenditure for poverty benefits.

3/ Welfare programs include poverty benefits, refugee allowances and food programs.

Table III-3. General Government Fiscal Operations, 1997-2000

	1997	1998	1999	2000
	(In millions of lari)			
Total revenues and grants	668.8	786.4	873.3	913.3
Tax revenues	587.1	643.6	782.3	851.5
Total expenditure and net lending	982.4	1096.4	1252.9	1155.9
Current expenditure	890.6	997.3	1132.5	1094.2
Social expenditure 1/	410.2	439.0	473.3	490.1
Interest payments	85.1	114.8	159.0	178.4
Capital expenditure and net lending	91.9	99.1	120.4	61.7
Overall balance (commitment)	-313.6	-310	-379.6	-242.6
Primary balance (commitment)	-228.5	-195.2	-220.6	-64.2
Adjustment to cash basis	28.4	64.0	97.6	89.0
Net change in current expenditure arrears	39.5	68.0	95.9	84.0
Of which: Social expenditure arrears	15.6	62.4	58.5	64.8
Overall balance (cash basis)	-285.2	-246.1	-282.0	-153.6
	(In percent of GDP)			
Total revenues and grants	14.4	15.6	15.4	15.3
Tax revenues	12.7	12.8	13.8	14.3
Total expenditure and net lending	21.2	21.8	22.1	19.4
Current expenditure	19.2	19.8	20.0	18.4
Social expenditure 1/	8.8	8.7	8.4	8.2
Interest payments	1.8	2.3	2.8	3.0
Capital expenditure and net lending	2.0	2.0	2.1	1.0
Overall balance (commitment)	-6.8	-6.2	-6.7	-4.1
Primary balance (commitment)	-4.9	-3.9	-3.9	-1.1
Adjustment to cash basis	0.6	1.3	1.7	1.5
Net change in current expenditure arrears	0.9	1.3	1.7	1.4
Of which: social expenditure arrears	0.3	1.2	1.0	1.1
Overall balance (cash basis)	-6.1	-4.9	-5.0	-2.6
Memorandum items				
Current expenditure (cash basis; in percent of GDP)	18.3	18.4	18.3	17.0
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

1/ The data do not include the SMIC expenditure financed by payroll.

Table III-4. General Government Social Expenditure 1997-2000 1/

	1997	1998	1999	2000
	(In millions of lari)			
Total social expenditure	**394.6**	**376.6**	**398.8**	**425.3**
Social security fund 2/	124.2	142.5	155.1	161.2
Health care	52.5	36.2	45.4	47.1
Education	149.8	117.5	122.9	149.2
Employment fund	3.4	4.8	4.1	4.5
Welfare programs 3/	64.6	75.6	71.3	63.3
	(In percent of primary current expenditure)			
Total social expenditure	**51.5**	**46.2**	**45.4**	**51.1**
Social security fund 2/	16.2	17.5	17.7	19.4
Health care	6.9	4.4	5.2	5.7
Education	19.6	14.4	14.0	17.9
Employment fund	0.4	0.6	0.5	0.5
Welfare programs 3/	8.4	9.3	8.1	7.6
Memorandum item				
Primary current expenditure	766.0	814.6	877.6	831.8

Sources: Georgian authorities; and Fund staff estimates.

1/ On a cash basis. The data do not include the SMIC expenditure financed by payroll.
2/ Does not include the expenditure for poverty benefits.
3/ Welfare programs include poverty benefits, refugee allowances and food compensation.

Table III-5. Net Change of Expenditure Arrears 1997-2000

	1997	1998	1999	2000	1997-2000
			(In millions of lari)		
Total net change	**39.5**	**68.0**	**95.9**	**84.0**	**287.4**
Wages and salaries	4	36.0	38.6	39.4	118.0
State budget	1	20.0	28.8	27.6	77.4
Local budget	3	16.0	9.8	11.8	40.6
Goods and services 1/	8.1	-0.9	19.7	9.6	36.6
Subsidies and transfers 2/	7.5	11.3	13.5	20.5	52.8
Interest payments	24.4	-24.4	8.6	-8.3	0.2
Domestic	18.9	-18.9	8.6	-8.3	0.2
External	5.5	-5.5	0.0	0.0	0.0
Social security fund	-3.0	36.0	15.5	22.9	71.4
Local government (nonwage)	-1.5	10.0	0.0	0.0	8.5
			(In percent of GDP)		
Total net change	**0.9**	**1.3**	**1.7**	**1.4**	**4.8**
Wages and salaries	0.1	0.7	0.7	0.7	2.0
State budget	0.0	0.4	0.5	0.5	1.3
Local budget	0.1	0.3	0.2	0.2	0.7
Goods and services 1/	0.2	0.0	0.3	0.2	0.6
Subsidies and transfers 2/	0.2	0.2	0.2	0.3	0.9
Interest payments	0.5	-0.5	0.2	-0.1	0.0
Domestic	0.4	-0.4	0.2	-0.1	0.0
External	0.1	-0.1	0.0	0.0	0.0
Social security fund	-0.1	0.7	0.3	0.4	1.2
Local government (nonwage)	0.0	0.2	0.0	0.0	0.1
Memorandum item					
Nominal GDP	4638.7	5040.6	5665.3	5955.1	-

Sources: Georgian authorities; and Fund staff estimates.

1/ Includes the expenditure arrears for food programs and health programs.
2/ Includes the expenditure arrears for poverty benefits and refugee allowances.

Table III-6. General Government Expenditure in Education, 1997-2000

	1997	1998	1999	2000
Education expenditure	**149.8**	**117.5**	**138.9**	**149.2**
Central government	75.6	43.9	47.7	46.0
Ministry of Education	22.4	11.1	12.0	11.0
Universities	22.2	10.6	10.8	10.7
Transfers for teachers salaries	31.0	22.2	24.9	24.3
Local governments	74.2	73.6	91.2	103.2
Education expenditure	**3.2**	**2.3**	**2.5**	**2.5**
Central government	1.6	0.9	0.8	0.8
Ministry of Education	0.5	0.2	0.2	0.2
Universities	0.5	0.2	0.2	0.2
Transfers for teachers salaries	0.7	0.4	0.4	0.4
Local governments	1.6	1.5	1.6	1.7
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

Table III-7. General Government Expenditure in Health Care, 1997-2000

	1997	1998	1999	2000
	(In millions of lari)			
Health expenditure	**63.7**	**48.6**	**61.4**	**63.1**
Central budget 1/	31.8	7.0	10.9	11.0
Of which state health care programs	19.9	6.6	10.4	10.4
SMIC expenditure	18.0	25.9	34.5	34.5
Financed by budget transfers	6.8	13.5	18.5	18.5
Financed by payroll	11.2	12.4	16.0	16.0
Local governments	13.9	15.7	16.0	17.6
	(In percent of GDP)			
Health expenditure	**1.4**	**1.0**	**1.1**	**1.1**
Central budget 1/	0.7	0.1	0.2	0.2
Of which state health care programs	0.4	0.1	0.2	0.2
SMIC expenditure	0.4	0.5	0.6	0.6
Financed by budget transfers	0.1	0.3	0.3	0.3
Financed by payroll	0.2	0.2	0.3	0.3
Local governments	0.3	0.3	0.3	0.3
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

1/ Does not include the transfers to SMIC.

Table III-8. Social Security Fund Operations, 1997-2000

	1997	1998	1999	2000
Total revenues	**130.8**	**149.7**	**161.0**	**167.1**
Employer contribution	90.6	108.6	111.9	135.5
Public sector	24.3	26.1	25.1	24.6
Private sector	66.3	82.6	86.8	110.9
Employee contribution	3.4	4.8	4.1	4.5
Central budget transfers	32.8	30.7	44.7	27.1
Other revenues	4.0	5.6	0.3	0.0
Expenditure	**130.8**	**149.7**	**161.0**	**167.1**
Pensions	120.5	133.7	148.5	157.4
Assistance temporary inability	1.0	1.0	1.0	0.1
Regressive pension	0.5	0.5	0.0	0.8
Poverty benefits	6.6	7.2	5.9	5.9
Administrative expenditure	2.2	4.1	4.0	4.0
Other	0.0	0.4	3.4	3.2
Deposit balance	0.0	2.8	-1.8	-4.3
	(In percent of GDP)			
Total revenues	**2.8**	**3.0**	**2.8**	**2.8**
Employer contribution	2.0	2.2	2.0	2.3
Public sector	0.5	0.5	0.4	0.4
Private sector	1.4	1.6	1.5	1.9
Employee contribution	0.1	0.1	0.1	0.1
Central budget transfers	0.7	0.6	0.8	0.5
Other revenues	0.1	0.1	0.0	0.0
Expenditure	**2.8**	**3.0**	**2.8**	**2.8**
Pensions	2.6	2.7	2.6	2.6
Assistance temporary inability	0.0	0.0	0.0	0.0
Regressive pension	0.0	0.0	0.0	0.0
Poverty benefits	0.1	0.1	0.1	0.1
Administrative expenditure	0.0	0.1	0.1	0.1
Other	0.0	0.0	0.1	0.1
Deposit balance	0.0	0.1	0.0	-0.1
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

Table III-9. Employment Fund Operations, 1997-2000

	1997	1998	1999	2000
	(In millons of lari)			
Total revenues	3.4	4.8	4.1	4.5
Expenditure	3.4	4.8	4.1	4.5
	(In percent of GDP)			
Total revenues	**0.1**	**0.1**	**0.1**	**0.1**
Expenditure	**0.1**	**0.1**	**0.1**	**0.1**
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

Table III-10. General Government Expenditure in Welfare Programs, 1997-2000

	1997	1998	1999	2000
		(In millons of lari)		
Total expenditure	**64.6**	**75.6**	**71.3**	**63.3**
Poverty benefits	6.6	7.2	5.9	5.9
Refugee allowances 1/	50.0	57.9	53.8	42.6
Food programs	8.0	10.5	11.6	14.8
		(In percent of GDP)		
Total expenditure	**1.4**	**1.5**	**1.3**	**1.1**
Poverty benefits	0.1	0.1	0.1	0.1
Refugee allowances 1/	1.1	1.1	0.9	0.7
Food programs	0.2	0.2	0.2	0.2
Memorandum item				
Nominal GDP	4638.7	5040.6	5665.3	5955.1

Sources: Georgian authorities; and Fund staff estimates.

1/ The data for 1997 is estimated.

Figure III-1. Georgia: Social Expenditure, 1997–2000
(In percent of GDP)

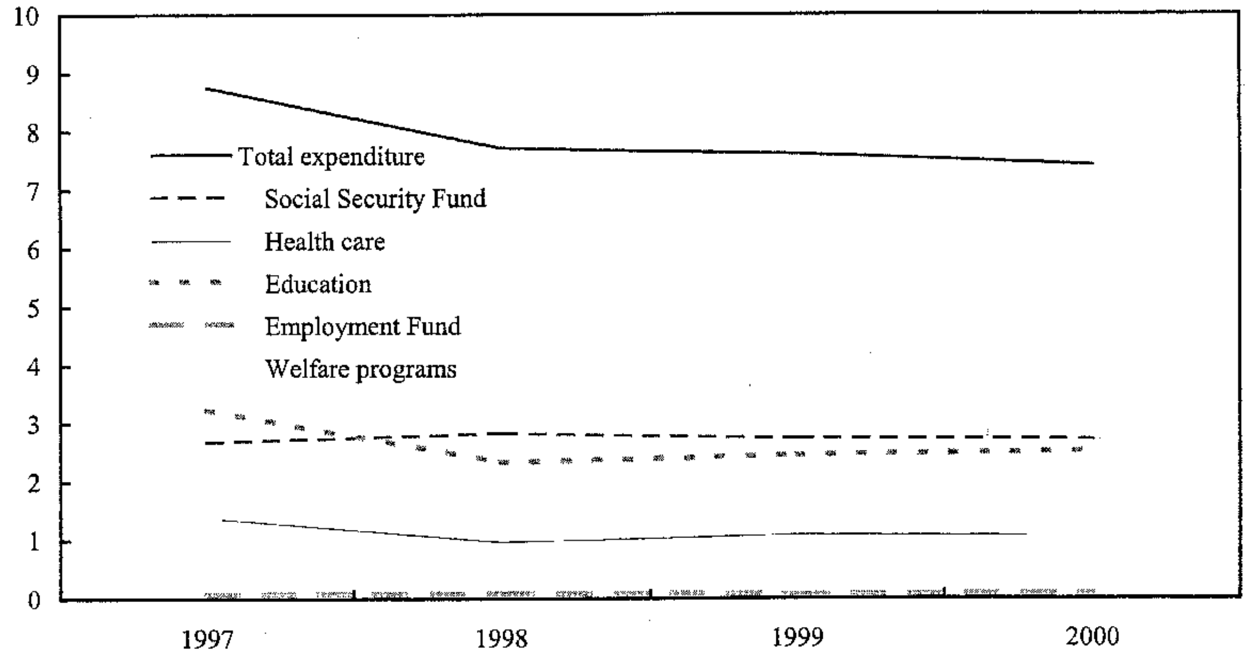


Figure III-2. Georgia: Composition of the Fiscal Adjustment, 1997–2000
(In percentage of the adjustment)

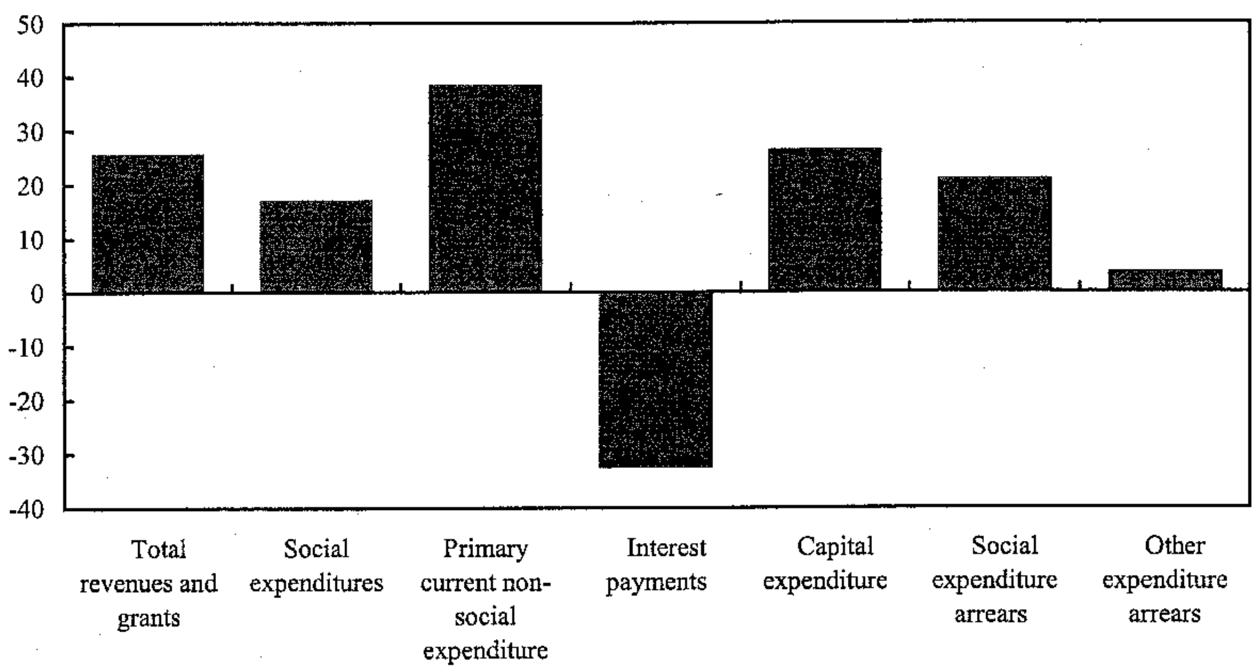


Figure III-3. Georgia: Social Expenditure, 1997–2000
(In percentage of primary current expenditure; on a cash basis)

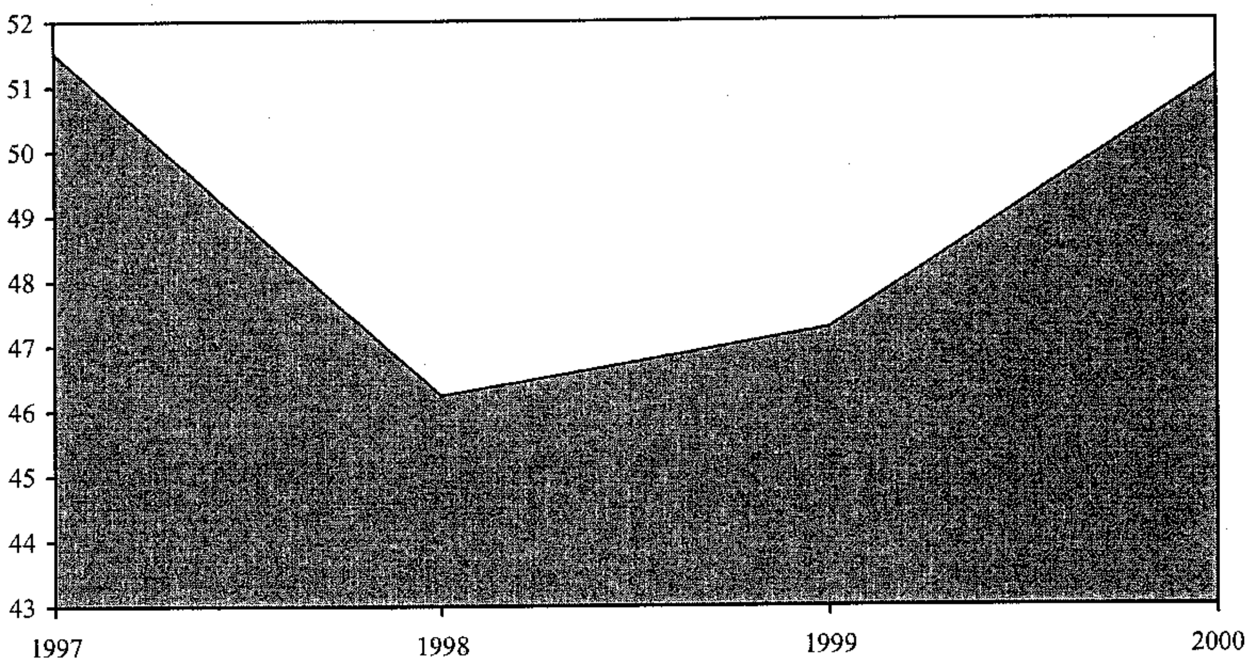
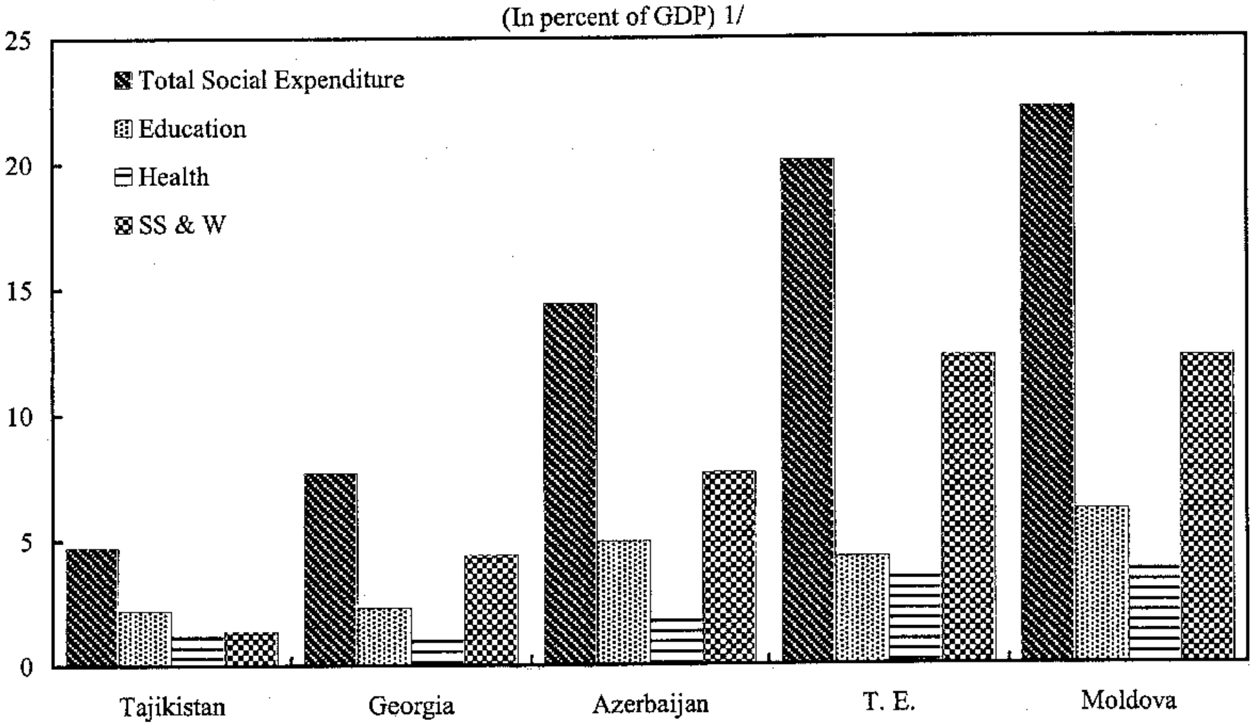


Figure III-4. Georgia: Social Expenditure in Selected Transition Economies, 1998
(In percent of GDP) 1/



1/ In 1998, Azerbaijan, Georgia, and Moldova had very close GDP per capita (respectively, US$576, US$510, and US$525). The GDP per capita in Tajikistan in the same year was US$215.

IV. BANKING SECTOR REFORMS AND FINANCIAL DEVELOPMENT[38]

A. Summary and Introduction

- Georgia has advanced in developing its financial system—introducing a two-tier banking system, divesting its state-owned banks, and developing the legal framework for bank regulation. However, the sector suffers from low levels of financial intermediation and weak corporate governance, and its role in facilitating investment and growth is severely constrained.

- This chapter examines recent developments in the banking sector in Georgia, including its structure, operations, indicators of soundness and vulnerability, the regulatory and prudential framework, and financial development and reform.[39]

- The banking sector is small by international standards, and in comparison with banking sectors in other CIS countries. Integration with the rest of the world and foreign investment in the banking sector are limited. While there has been substantial consolidation, there are still too many banks. The level of dollarization is high, with the ratio of dollar deposits to total deposits at over 80 percent.

- At first glance a number of prudential indicators suggest a healthy banking system. However, weaknesses in the data mask underlying problems. Recent onsite inspections have revealed substantial weaknesses in banks' portfolios. Stress tests conducted by recent FSAP missions suggest that the sector is vulnerable to credit risk and the secondary effects of exchange rate shocks.

- The legal framework of the banking sector, while advancing in recent years, needs further improvement. Amendments to the central bank and commercial bank laws, currently under discussion in parliament, are intended to strengthen the independence of the central bank, its ability to administer and close banks, and prevent criminal elements from gaining control of a bank. Measures are also needed to prevent money laundering.

- To encourage financial development, it will be necessary to continue with efforts to strengthen bank regulation and supervision, in order to improve confidence in the sector, attract strategic foreign investors, and develop capital markets. Broader structural reforms will also be needed, including improved collateral and bankruptcy laws, licensing reform, privatization, and other measures to improve the business climate.

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[38] Prepared by Sheila Bassett.

[39] This paper draws upon the work of the FSAP missions conducted earlier this year.

B. Structure of the Banking System

97. **The financial sector is small by international standards as well as in comparison to other CIS countries.** Commercial banks are the main component of the financial sector, with assets accounting for about 13 percent of total GDP in 2000. The insurance sector is rudimentary and there is a small treasury bill market and nascent stock exchange. There are also about 200 small rural credit unions which have total deposits of only about lari 2 million. Using broad money to GDP as a measure of the size of the financial sector, Georgia's ratio is just 10½ percent, compared to 60 percent in the U.S. (excluding money market instruments and bonds), 40 percent in Estonia, and about 15 percent in Armenia.

98. **The banking system comprises resident regional small and medium-sized banks, a handful of large banking institutions with branch networks, and two foreign banks.** Like other BRO countries, Georgia created a two-tiered banking system in the early 1990s—a central bank was created, the National Bank of Georgia (NBG), based on the Western model; and a large number of commercial banks emerged, the largest of which originated in the old Soviet-style monobanking system.

99. **The banking sector has undergone a substantial consolidation since 1994, but there are still too many banks relative to Georgia's population and the size of its economy.** The introduction of bank prudential standards, generally in line with the Basle guidelines, together with vigorous enforcement of the regulatory framework by the NBG, led to a sharp reduction in the number of banks, from a peak of 229 in early 1994 to 29 by end-June 2001.[40]

100. **There is a high degree of concentration of assets in the banking sector.** The 10 largest banks control about 80 percent of total assets and deposits. Of these, the three largest banks control about one-half of the assets. This suggests a competitive structure unlikely to heighten market discipline in the financial sector.

101. **Two of the largest banks are former state-owned banks, whose experience lies with the Soviet-style system[41] and which are predominately locally owned.** The share of the former state banks (FSBs) in financial intermediation has continued to shrink—from 39 percent of total assets at end-1996 to about 32 percent as of end-June 2001—mainly as private banks established since independence have been able to successfully attract domestic deposits and benefit from foreign credit lines, and to a lesser extent due to the write-off of

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[40] Three banks have had their licenses revoked but are still technically operating pending court ruling on their closing.

[41] The former state banks (FSBs) once held monopolies over national savings, export/import financing, and the agricultural sectors.

bad loans by the FSBs. Consequently, the FSBs are no longer the single players in any particular sector. Following an international audit, two of the three FSBs underwent a fundamental restructuring, including laying off a substantial number of workers and closing unprofitable branches, thus improving their net worth. One of the remaining former state banks, Agrobank, continues to have significant financial difficulties.

102. **Foreign investors have majority ownership of seven of the banks in Georgia, which comprise about 11 percent of the total assets of the banking sector.**[42] This share is substantially lower than in a number of the more advanced transition economies, such as Hungary and Poland, where over half of the assets are foreign owned. The two wholly foreign-owned banks (one Turkish, one Azeri) are very small. Consequently, the beneficial effects of strategic foreign investment—a decisive factor in the rapid modernization of commercial banking systems in Hungary and other East European countries—is minimal.

103. **Integration of Georgian banks with the international economy is limited, although some banks have obtained external credit lines from IFIs.** Total outstanding credit to banks from IFIs amounted to some US$46 million at end-June 2001, of which about one-third is covered by state guarantees. Most of the borrowing occurred in 1997 and is distributed among a number of the medium to large-sized banks, including two FSBs.

C. Banking System Operations and Recent Developments

104. **The level of banking system financial intermediation remains low due to a number of factors**:

- lack of confidence in banks: hyperinflation in the early 1990s eroded the stock of savings and there is a general distrust of banks as savings mechanisms.
- a large informal sector which operates outside the banking system;
- tax administration, which places pressure on the banking system in the final days of the month as efforts are made to achieve performance targets, resulting in sizeable liquidity pressure;
- harassment by tax authorities of businesses that have deposits in banks, often blocking and/or sequestering the banks' deposits without a clear motive;

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[42] Most of the foreign participation in the domestic banking industry reflects injections (by foreign firms and individuals operating in Georgia) into existing Georgian banks before end-1996. A main factor explaining these capital injections was the tax holiday for foreign investments in the domestic banking system (in place through end-1996).

- high commercial lending rates, despite sharp reductions in inflation in the late 1990s, reflecting risk premiums and scarcity of credit;
- a large agricultural sector, which is typically less monetized;
- low per capita income, which constrains savings;
- lack of familiarity among bank managers with collateral-based lending and other Western banking methods, which are vital for enterprise lending to take hold.

105. **The level of bank intermediation is recovering, following the significant setback in 1998 in the wake of the Russian crisis.** Deposits in the banking system have increased by over 150 percent since 1997, before the onset of the Russia crisis.[43] However, the level of deposits remains disappointingly low at only about 5 percent of GDP. The majority of these deposits are short-term time deposits of the business sector. Household deposits remain small—at less than 2 percent of GDP—and have remained about one-third of total deposits since 1997.

106. **As deposits have increased, assets have grown significantly, with the maturity of loans gradually lengthening, reflecting lower inflation and access to foreign credit lines.** The share of non-government loans in total assets amounts to 58 percent as of end-June 2001, compared to 60 percent in the U.S., 40 percent in Lithuania, and 45 percent in Poland. The share of long-term lending in total credit increased from 2½ percent at end-1997 to 29 percent by May 2001.

107. **At the same time, there has been a significant increase in foreign exchange lending in banks' portfolios, reflecting increased dollarization and banks' desire to pass foreign exchange risk on to their clients.** Dollarization increased significantly in the wake of the lari devaluation in late-1998, and has failed to decline subsequently, despite exchange rate stability and low inflation. The share of foreign exchange denominated deposits in total deposits increased from 58 percent in 1997 to 82 percent of total deposits as of end-June 2001. Loans in foreign currency rose from 44½ percent of total lending at end-1997 to 77½ percent in end-June 2001.[44]

108. **Loans to the non-government sector amounted to only 6½ percent of GDP in 2001, as compared to 26 percent in Estonia and 30 percent in Poland, and are mainly concentrated in the trade sector.** The limited lending reflects the low level of deposits and

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[43] Some of this reflects the devaluation of the lari, which lost over 50 percent of its value due to the adverse effects of the Russian crisis.

[44] This suggests that there is a hysterisis effect associated with a persistent lack of confidence in the lari.

limited access to foreign capital in the sector, but also limited lending opportunities. Most of bank financing is concentrated in the trade sector (Table A-20), although there has been some increase in the share of financing to industry. Consumer lending is not developed, reflecting deficiencies in risk assessment, collateral, and credit resources.

109. **The assets of commercial banks include a sizeable share of cash and reserves, accounting for over a quarter of total assets (compared to 5 percent in the U.S. and 3½ percent in Poland).** This reflects the high liquidity ratio requirement, limited access to alternative sources of liquidity, and an inefficient payments system. Access to the interbank market is limited, and lender of last resort has not been used often and is expensive. The payment system does not provide intraday credit and there is no check clearing system. The share of securities in total assets is only about 1 percent, as the treasury bill market is very small and secondary market virtually nonexistent (in the U.S., securities amount to about 15 percent of total assets of banks and in Poland, about 20 percent). This may also be a factor in the large share of fixed assets, including real estate, which accounted for about 10 percent of total assets. Such investments may prove to be risky, and until recently these assets did not need to be provisioned for, which may also have provided an incentive.

110. **Interest income is the primary source of income for banks, accounting for about two-thirds of total income.** Fees, commissions and foreign exchange conversion operations make up most of the rest of banks' income. Expenses are mainly for interest on deposits, personnel and provisions. Interest income, mainly from interest on loans, exceed interest expenses (mainly time deposits) by a factor of 3, reflecting a sizeable interest rate spread of about 21 percent (Figure IV-1).

111. **The high interest rate spreads may reflect several factors**:

- a lack of competition, which inhibits efficiency, reflecting the dominance of a few large banks in the sector and the lack of strategic foreign investors;
- high credit risks, compounded by difficulties of liquidating collateral of delinquent borrowers, which in turn are a reflection of insufficient progress in enterprise and legal reforms;
- a high reserve requirement (14 percent as of September 2001), which is costly to banks, although mitigated somewhat by a remuneration of 8 percent; and
- the existence of too many banks, which may lead to high overhead costs of the banking system on account of the small scale of their operations.

D. Banking System Soundness and Vulnerability

112. While the financial sector is small and there is limited international integration, the failure of a large bank could pose a risk to economic stability, through some combination of higher interest rates, a contraction in credit to the private sector, an increase in inflation

and/or a weakening of the currency and disruption of the payment system. Indicators of bank soundness and stress tests suggest that the sector is vulnerable to credit risk and the secondary effects of exchange rate shocks.

Banking system soundness

113. Macroprudential indicators (MPIs) are a useful tool in monitoring the health of the financial system as a whole.[45] These indicators consist of quantitative variables which comprise both aggregated microprudential indicators of the health of individual institutions, such as capital adequacy ratios, nonperforming loans, loans to deposit ratios; and macroeconomic variables, such as inflation, growth, the current account deficit, which are associated with financial system soundness. The macroeconomic variables may be used for stress tests to evaluate quantitatively the impact of large changes on the portfolio of financial institutions and on aggregate solvency of the financial system. Financial crises usually occur when both types of indicators point to vulnerabilities, i.e., when financial institutions are weak and face macroeconomic shocks. Table A-23 presents selected prudential indicators for Georgia's banks and the basic data table shows key macroeconomic variables.

114. **At first glance a number of the macroprudential indicators appear favorable, but they mask vulnerabilities hidden by inadequate regulations and reporting standards.** Capital adequacy and bank liquidity indicators are well above the minimum standards and even remained relatively stable through the 1998 Russian crisis, suggesting a healthy banking system. Similarly, non-performing loans have historically been surprisingly low and the system as a whole was profitable in 2000. However, recent on-site inspections have revealed significant understatement of distressed assets (and as a result an overstatement of capital and profitability), and understatement of nonperforming loans, reflecting deficiencies in reporting and weak classification and provisioning requirements.[46] In addition, capital adequacy does not provide a picture of the *quality* of the capital, which may be undermined by insider borrowing for new capital and issuance of stock for non-cash assets.[47] These high ratios may also reflect structural factors—for instance, banks with a small amount

[45] The health of individual banks is typically examined using the CAMEL framework, as is the case in Georgia. The framework is used to analyze the health of a bank in five areas: capital adequacy, asset quality, management soundness, earnings and liquidity. The MPIs are used to provide an indication of system wide vulnerabilities in these areas.

[46] The data do not yet fully reflect new classification and provisioning guidelines which expand the assets subject to provisioning.

[47] There has been some suggestion that some banks may have used insider loans to raise their capital in order to meet new prudential norms.

of deposits tend to maintain higher than average CARs. At the same time, high ratios may reduce banks' profitability as they are unable to use these funds for commercial purposes.

115. **The macroeconomic indicators reveal a mixed picture.** Inflation is low and the exchange rate is broadly stable. However growth remains slower than in the pre-1998 period, real interest rates remain high; foreign exchange reserves are low, and the fiscal situation remains fragile with a high level of domestic expenditure arrears. Low inflation and a stable exchange rate are important for bank soundness, particularly in view of the high level of dollarization. However, a low growth rate can point to weakening of borrower's capacity to repay, and a slump in a sector where loans are concentrated could have an immediate impact on bank soundness. A weak fiscal situation suggests that there are potential risks to macroeconomic stability which can negatively affect banks solvency and liquidity.

116. **While commercial banks registered a profit in 2000, new provisioning requirements have contributed to losses in the first half of 2001, as banks have had to increase provisions due to low credit quality.** Low profitability and/or losses weaken bank's ability to withstand shocks.

Banking system risks

117. **The MPIs point to vulnerabilities in the sector reflected in poor asset quality, profit losses, and fragilities in the macroeconomy that could adversely affect bank soundness.** In addition, stress tests prepared by the FSAP mission suggest that the banking system is vulnerable to several important financial risks, in particular credit and foreign exchange risks, which suggest a need for increased provisioning.

118. **The main risk to the banking sector is credit risk, mainly due to inadequate risk identification and insufficiently rigorous monitoring and management practices.** As noted above, indicators such as capital adequacy and nonperforming loans mask underlying vulnerabilities due to weak reporting and supervisory practices. Recent measures to strengthen the banking regulation, including new asset classification and provisioning requirements, should help to reduce this vulnerability (see Section E below). In addition, fragilities in the economy, as noted in the above macroprudential indicators, and the vulnerability of the economy to external shocks, can undermine banks' portfolios by limiting the ability of borrowers to service their debts.[48]

119. **In addition, banks are exposed to foreign exchange risk, reflecting the high level of dollarization of deposits and loans.** The net foreign exchange open positions of banks are regulated, but at the same time about 80 percent of the system's loans are in foreign

[48] Credit risk can also be linked to the broader concept of country risk which takes into account the economics, finance, geopolitics, sociology, and historical issues.

exchange. Consequently in a small open economy, banks' vulnerability to foreign exchange risk is linked to the vulnerability of borrowers' net foreign currency earnings. While it is difficult to ascertain the vulnerability of borrowers, i.e., to obtain data on corporate foreign exchange exposure, the underdeveloped financial market would suggest that there is virtually no hedging of foreign exchange risk by borrowers.

120. **Banks are also vulnerable to liquidity pressures.** For instance, there is often pressure on banks in the last days of the month due to tax mobilization and there is the possibility of sudden withdrawal by a large depositor—the latter posed some liquidity difficulties for one large bank recently. In the case of lari denominated assets there does not appear to be a problem, as there are sizeable liquid assets in lari and all reserve requirements are denominated in lari. However, there may be more of a problem with foreign exchange liquidity, as short term liabilities (less than one month) outweigh short term foreign exchange assets.

121. **Interest rate risk is relatively small**, reflecting a small maturity gap between assets and liabilities,[49] a predominance of short term assets and liabilities, as well as large interest rate spreads, and a high ratio of equity to liabilities.

Macroeconomic effects of banking system fragility

122. **The small size and fragility of the banking have several important macroeconomic impacts:**

- the effectiveness of monetary policy is severely limited;
- credit is limited and not channeled in a way that maximizes benefits to the real economy, i.e., the high cost of intermediation penalizes new and good borrowers and distorts the allocation of credit;
- reliance on external credit lines poses risks to financial stability.

123. **The role of monetary policy instruments is limited, because the normal monetary policy transmission mechanism via interest rates is ineffective**. In addition, the development of indirect instruments, such as open market operations, is severely constrained in the absence of significant securities market.

124. **The small size of the financial sector implies that there is very little available credit.** High real interest rates (above 10 percent) limit most credit to areas with high rates of

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[49] If assets have a substantially longer maturity than liabilities, there is a significant interest rate risk, as the value of assets will fall more than liabilities, in the case of a fall in interest rate spreads.

return, particularly in the trade sector, while most other economic activities have almost no access to credit. In addition, banks' losses, despite continued high spreads between borrowing and lending rates (net interest income), suggest that loan performance is poor, implying an interest subsidy to nonperforming borrowers (e.g., state-owned enterprises). In addition, the low level of financial intermediation restricts use of the credit instrument to discipline company managers and strengthen governance in the corporate sector.

125. **External credit lines from IFIs, which account for about 20 percent of banking system liabilities, and for which there are generally state guarantees, could pose risks to financial stability.** The total amount of guaranteed lending from IFIs amounts to US$46 million and is concentrated among 5 medium to large-sized banks. Most of these loans are long-term (over 1 year), so they improve the maturity of banks' liabilities. However, since credit lines are used to provide credit to SMEs, many of which do not have foreign exchange income, the structure increases the foreign exchange/credit risk of the banking system. The calling of loans with government guarantees also poses additional costs to the budget.

E. Regulatory and Prudential Framework

126. **Regulation plays a significant role in financial development.** "The development of deeper financial systems depends significantly on the effectiveness of regulatory and institutional reform, as can be seen from the significant positive correlation between a measure of the extent of banking intermediation and the EBRD's transition indictors for banking reform (EBRD 1998)." In addition, strong enforcement of prudential regulations can contribute to a strengthening of financial discipline, which reduces vulnerability to adverse shocks and can help to reduce macroeconomic risks.

127. **Many of the vulnerabilities of the Georgian banking system are a consequence of its stage in the transition process**: the banking supervision capacity is developing, the legal and credit culture is weak, and intermediation costs are high. According to EBRD indicators, Georgia achieved a rank of 2.3 in 1999 on a scale of 1-4,[50] similar to that of other CIS countries (e.g., Armenia, Moldova, Kazakhstan), but still below the Baltic countries and Central European transition countries (rankings 3 and 4).

128. The law governing the central bank was enacted in September 1995. Legislation controlling the creation, supervision, and resolution of commercial banks and other credit institutions was passed in February 1996. According to the law, the NBG has the power to issue banking licenses, publish prudential regulations, and supervise banks both off and on-site. In addition, the NBG has the power to take the necessary measures and/or sanctions

[50] Transition indicators range from 1 (no reform) to 4 (similar to market economies), with 0.3 decimal points added/subtracted for +/- ratings.

when problems arise and close cooperation with foreign supervisory authorities is clearly noted.

129. **A recent FSAP review found that the legal framework governing the financial sector has shown substantial advances, but there are many areas in need of improvement.** Transparency of monetary and financial policies is generally quite sound except in the area of payments system oversight. Compliance with the Basle core principles has shown significant advances. However, there is a need to strengthen regulations pertaining to foreign exchange, country and market risks; improve the NBG's ability to administer and close distressed banks; and allow the central bank to bar persons with past criminal activity from obtaining controlling interest in a bank (see Table A-24 for the current prudential requirements).

130. **Recent measures to strengthen the system include new minimum capital requirements; new asset regulations and provisioning requirements; conflict of interest regulations and the introduction of international accounting standards (IAS).** New regulations that expanded the assets for provisioning came into effect on April 10 2001; banks' compliance is being reviewed as part of the inspection process, along with implementation of international accounting practices, which will help reduce vulnerability to credit risk. Conflict of interest regulations are aimed at dealing with insider lending, which is important for helping the sector combat fraud. A number of the bank closings, including of several medium-sized banks, have been due to governance-related problems.

131. **There is a need for an improvement in the NBG's ability to administer banks in distress and to close failed banks.** While prompt action on the part of the NBG averted a crisis after the Russian crisis precipitated a significant drop in the demand for lari, banks which have had their licenses revoked have often contested in court the NBG's authority to close them. Presently there are three such cases with the courts. While, the NBG has typically prevailed in these cases, a strengthening of the law is needed to uphold the NBG's authority to effectively deal with problem banks and avoid an unnecessarily drawn out process in the courts. Amendments to the central bank and commercial bank law in order to establish its primacy in dealing with bank-related issues are now with parliament.

F. Financial Development and Reform

132. **The financial sector's role in facilitating growth is severely constrained by its small size, as is its role in improving corporate governance through the use of credit.** To encourage financial development, broad based reforms are needed in order to strengthen the banking sector and develop an environment conducive to business:

- Continue with **strengthening bank regulation and supervision,** to impose financial discipline and increase confidence in banking sector. This involves strengthening the legal structure to improve the NBG's enforcement powers; effective implementation of IAS and loan classification and provisioning requirements; measures to reduce bank fraud and money laundering.

- Strengthen the process for **entry and exit of banks** to improve competition. An important step would be to strengthening the NBG's ability to resolve failed banks, including through temporary administration and bank liquidation procedures. A credible threat of exit is fundamental to the process of competition. Once a credible exit strategy is in place, the banking system can be opened to competitive entry, and transparent application of licensing requirements would help ensure than new banks are prudent and capable.

- Pursue **bank consolidation,** to increase efficiency and exploit economies of scale. Consolidation can also facilitate supervision by reducing the number of banks subject to inspection. Measures in this area would include measures to encourage mergers and acquisitions of smaller banks.

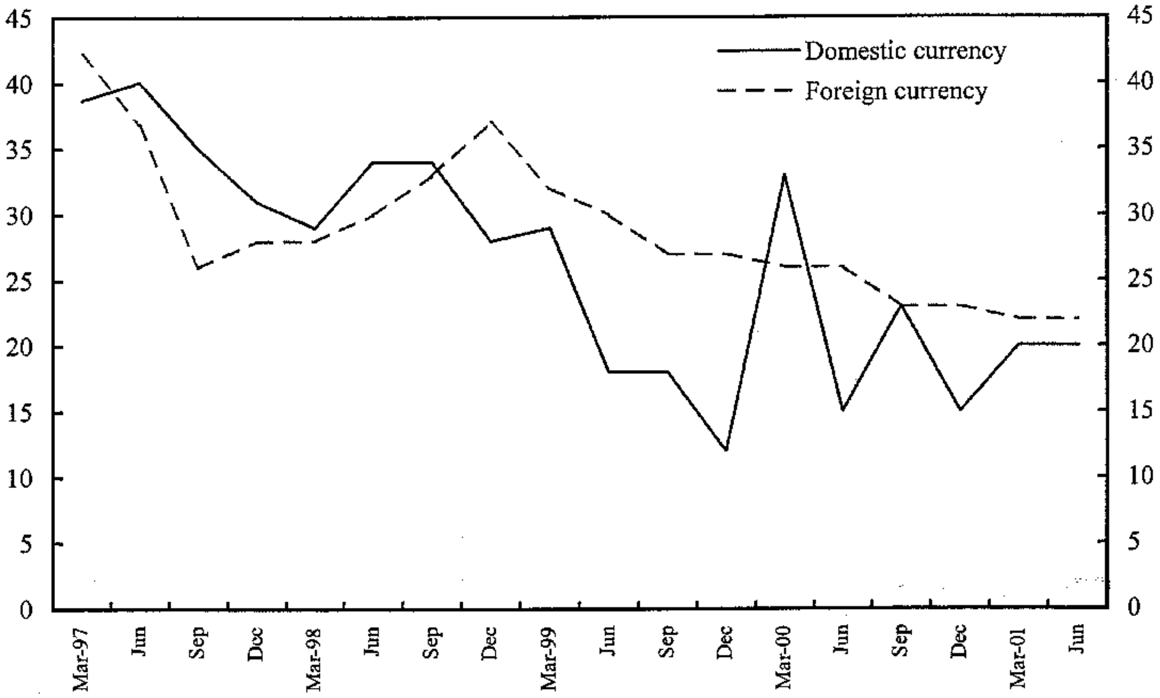
- Attract **strategic foreign investment** into the sector to spur reform by bringing in advanced technology and banking skills. This would also reduce the scope for connected lending. Such investment could be in the form of either establishing new banks or in buying shares of existing banks, although Georgia's small size limits foreign banks incentive for setting up new retail operations. Entry of foreign banks would help to avoid the problems of one bank becoming 'too big to fail' and help to curb monopolistic practices.

- Continue with **development of capital markets**, including the treasury bill market and stock exchange, and modernize the payments system. Further development of the treasury bill market will require continued fiscal measures to strengthen the budget. To develop the corporate securities market, efforts need to be made to improve corporate governance, including auditing and accounting practices of enterprises to provide timely and reliable information to investors, and enforcement of company law. Procedures need to be developed to facilitate alternative non-cash transactions, such as checks and debit/credit cards.

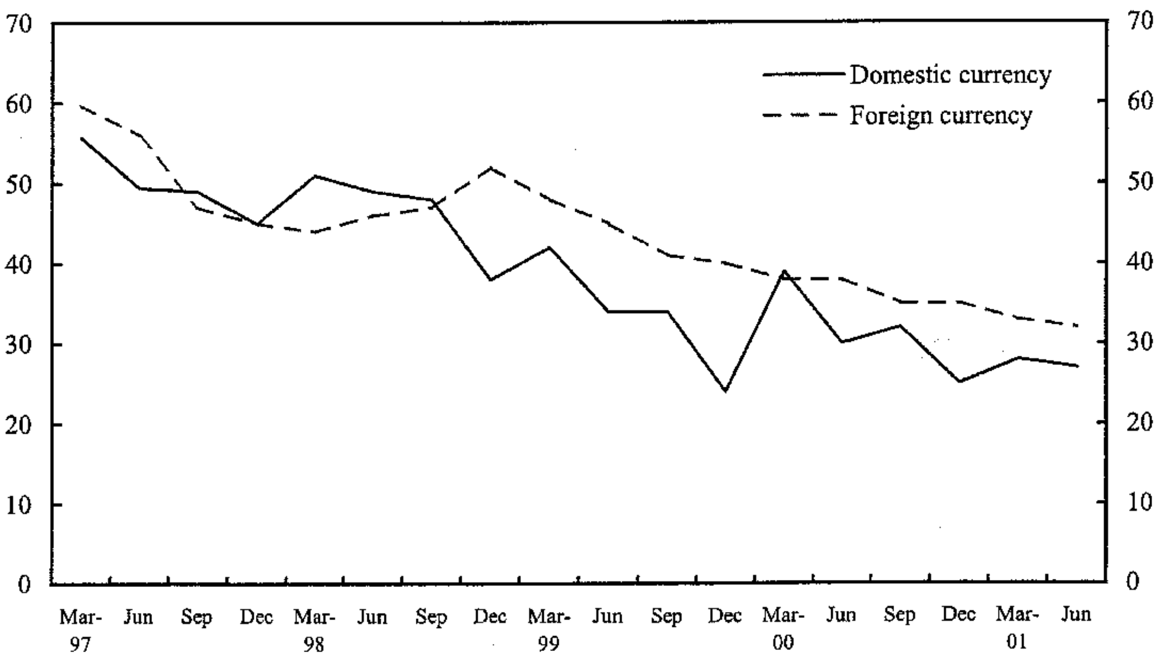
- **Strengthen the legal framework and move forward on the economic reform agenda to improve the business environment.** To encourage confidence in the sector and reduce the cost of borrowing, an effectively functioning legal system needs to be in place in order to enforce property rights and contracts, as well as creditor and shareholder rights. Measures in this area include the implementation of effective collateral and bankruptcy laws. Efforts need to continue with land reform to enable land to be used as collateral, licensing reform, privatization, and fiscal reform measures, including strengthening tax administration.

Figure IV-1. Georgia: Commercial Interest Rates, 1997–2001
(In percent)

Interest Rate Spreads 1/



Lending Rates



Source: Georgian authorities.

1/ Difference between 3-month lending and deposit rates.

V. Dollarization in Georgia: Empirical Evidence and Policy Implications[51]

A. Summary and Introduction

- As inflation declined and exchange rate stability was restored following the Russian crisis, broad money grew rapidly, driven by a rebound in the demand for money. Despite these favorable developments, dollarization, which rose sharply at the time of the crisis, has remained high.

- The presence of hysterisis would help to explain why the demand for foreign currency increases when the economic situation deteriorates, but decreases by less when the economic situation improves. Households and enterprises adapt their money management techniques to include foreign currency deposits as an inflation hedge. Once the fixed costs of developing and applying these techniques are overcome, there may be little incentive to switch back even after a period of economic stability and low inflation. Regulatory and institutional factors as well as concerns over policy management of the authorities can also play a role in reinforcing the ratchet effect.

- A simple econometric model of currency substitution is estimated, which includes the interest rate differential, depreciation, an indicator of structural change measured by openness or monetization, and a ratchet variable to take into account the limited reversibility of the dollarization process. The empirical evidence suggests that depreciation of the exchange rate and the ratchet effect are significant determinants of the dollarization process in Georgia, and that institutional factors, such as monetization or the opening up of trade, are also relevant.

- The policy implications of a persistently high level of dollarization are that the government must pursue sound macroeconomic policy for a sustained period in order to enhance confidence in the currency. In addition, measures should be taken to reduce demand for foreign currency, including through development of alternative liquid financial instruments. Direct measures are not advisable since they typically lead to capital flight and undermine confidence in the local currency. While a fixed exchange rate regime could help to protect against exchange rate risks, a floating exchange rate regime is appropriate for Georgia, given the low level of reserves and its vulnerability to external shocks.

B. Dollarization: What is it and How is it Measured?

133. The process by which foreign currency replaces the local currency as a **store of value, unit of account, and medium of exchange** within the domestic economy is referred to as

[51] Prepared by Sheila Bassett.

dollarization. Currency substitution refers to the substitution of foreign for domestic currency as a medium of exchange, which is often described as the last stage of the dollarization process.

134. In this chapter, dollarization is defined as the **ratio of foreign currency deposits to total deposits in the banking system**. In principle, the ideal measure of dollarization would be to take into account all foreign currency balances, including notes and coins and foreign currency deposits within the domestic banking system and abroad. As is the case in most countries, it is difficult to obtain reliable time series estimates of dollars in circulation, although the NBG has estimated that the volume of foreign currency physically circulating in Georgia could, under not unreasonable assumptions, be as high as US$120-150 million (50 to 60 percent of broad money).[52] Since reliable time series estimates are not typically available, they are excluded in most empirical work.

C. Factors Influencing the Dollarization Process

135. Risk and return considerations, as well as institutional and structural factors, are important determinants of the extent of dollarization.

- **Risk and return considerations** are of central importance in that they provide the basis for the allocation of financial savings between foreign and domestic currency deposits. Foreign currency deposits can become an attractive form of saving for domestic investors, assuming confiscation risks are minimal, in order to avoid losses in the value of their portfolio due to a deterioration in the macroeconomic environment. Actual or expected reductions in the value of domestic currency holdings are typically induced by either high inflation, expectations of exchange rate depreciation or low interest rates on domestic currency holdings.

- **Institutional factors** play an important role in that they define the rules of the game, e.g., whether individuals are allowed to hold their savings in foreign exchange deposits, the absence of total surrender requirements, how foreign currency deposits are treated in reserve requirements, and transaction costs in moving among alternative assets. External and internal convertibility also plays a role in entry-exit barriers to holding foreign currency deposits. Moreover an economy's financial development is a factor, as economies with limited financial development offer little in the way of alternatives to holding foreign currency instruments and assets as an inflation hedge. Consequently, other factors being equal, dollarization is likely to be higher in countries with limited financial markets.

[52] *Dollarization in Georgia: Size of the Problem, Factors and Ways of Solution*, Mr. Kakulia and Ms. Aslamazishvili, National Bank of Georgia; NBG website:www.nbg.gov.ge.

- **Structural factors,** such as the opening up of trade, reduction of tariffs, and the removal of current and capital account restrictions, are usually associated with the increased use of foreign currency denominated assets as they are part of integration with international markets, and hence facilitate access to foreign currency assets by domestic investors. This process can be assisted by financial liberalization, including market-determined interest rates and the general process of monetization and financial deepening.

D. Stylized Facts about Dollarization in Georgia

136. The dollarization ratio in Georgia, as defined by foreign currency deposits relative to total deposits, is among the highest among the BRO countries, with foreign currency deposits reaching over 80 percent in 2001 (Figure V-1). From 1997 to mid-1998, the ratio increased from 58 percent to 63 percent, although inflation declined and the lari was relatively stable. Subsequently, with the onset of the Russian crisis in August 1998 and the devaluation of the lari, there was a sharp rise in the dollarization ratio, to about 77 percent by mid-1999. However, even after inflation began to fall and the lari stabilized, the ratio continued to edge upward, reaching about 82 percent by the first quarter of 2001, which suggests a certain amount of inertia or hysterisis.

137. **Risk and return considerations are an important factor in explaining the high level of dollarization.** The difference between the interest rate on foreign currency and domestic currency deposits has typically been small, reflecting in part the very underdeveloped financial system. Consequently, the yield on dollar assets relative to the lari is largely determined by the **expected depreciation of the lari** vis-à-vis the U.S. dollar. When the lari came under pressure in 1998, even before the onset of the Russian crisis, due to the weak fiscal position, dollar deposits became more attractive. Subsequently, during 1999, when lari deposits became more attractive after the exchange rate rebounded and then stabilized, there was no decline in the dollarization ratio.[53]

138. The tendency of dollarization to remain persistently high despite more favorable exchange rate and inflation developments may suggest that **hysterisis** is a factor in the dollarization process. If so, it is likely that there will need to be a long period of low inflation and exchange rate stability before the level of dollarization will come down. The hysterisis may reflect factors such as political instability, the lingering effects of the hyperinflation of the past, and the lack of confidence in the policy handling capability of the government.

139. **Institutional and structural factors** appear to also have played a role in the high level of dollarization in Georgia. For instance, Georgia maintains a relatively liberal

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[53] Of course the revaluation of foreign currency deposits due to the depreciation would result in a substantial increase in the ratio.

exchange rate regime (accepting Article VIII as of December 20 1996), foreign currency deposits can be held by resident individuals and enterprises, and it enjoys one of the most open trade regimes among the CIS countries, with low tariffs. In addition, there has been a steady increase in monetization, measured by money supply relative to GDP, although the process was temporarily set back by the Russian crisis. Figure V-2 shows the trend increase in openness and monetization over the period 1997 to 2001, which coincides with the upward trend in the dollarization ratio. Furthermore, the high level of dollarization in Georgia reflects to a significant extent the limited financial markets and hence the lack of alternative, high yield domestic currency instruments which can serve as an inflation hedge. In addition, a sizeable informal economy, as exists in Georgia, is often associated with a significant amount of dollar-based transactions. The size of these transactions would be expected to decline with structural reform as enterprises in the informal sector move into the formal economy.

E. A Simple Econometric Analysis of Dollarization

140. Most models of dollarization are based on a simple money demand equation that includes a variable to explain currency substitution, such as inflationary or exchange rate expectations and/or interest rate differentials. The underlying assumption is that the demand for foreign currency is driven by the uncovered interest parity condition, i.e., the difference between the real rates of return on domestic and foreign currency.[54] In addition, a ratchet variable can be used to capture the limited reversibility of the dollarization process.[55]

141. In this section, empirical analysis is performed to see if there is a long run relationship between the dollarization ratio, the interest rate differential, depreciation of the exchange rate, and a ratchet variable, defined as the highest previously achieved dollarization ratio, and the degree of openness of the economy or monetization. The latter are included to capture the structural change in the economy as it becomes more integrated with the international economy. Subsequently, an error correction model is estimated to discern the short-run dynamics. The model is defined as follows:

$$M_t = a_0 + a_2 I_t + a_3 E_t + a_4 R_t + a_5 S_t + u_t$$

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[54] In this model, monthly depreciation is used as a proxy for the expected depreciation. The use of both the exchange rate and inflation variables in the estimation leads to serious multicolinearity problems.

[55] See for instance, Mueller, "Dollarization in Lebanon," *IMF Working Paper* 94/129 or Mongardini and Mueller, "Ratchet Effects in Currency Substitution: An Application to the Kyrgyz Republic," *IMF Staff Papers*, Volume 47, Number 2.

Where:

M_t = degree of dollarization in period t defined as ratio of foreign currency deposits of residents within the domestic banking system as a percentage of total deposits of residents within the banking system.

I_t = nominal interest rate differential (difference between foreign and domestic interest rate)

Et = nominal depreciation of the lari relative to the US dollar[56]

R_t = ratchet variable in period t [57]

S_t = structural factor, either monetization (S1), defined as the ratio of broad money to GDP; or the degree of openness to trade (S2), defined as total exports plus total imports divided by GDP.[58]

142. As depicted in Figure V-1, the dollarization process in Georgia exhibits an upward trend. The time series properties of data may affect traditional measures of statistical inference, so that if a time series has a persistent upward or downward trend (i.e., it is nonstationary), spurious results may be obtained from standard regression techniques such as OLS. In light of this, unit root tests were first carried out for the period 1997-2001 on the

[56] Under the law of one price, the expected depreciation is equal to domestic inflation less foreign inflation (p-p*), therefore the real return differential between foreign and domestic assets, (I* - p*) - (I - p) is equal to I* – (I – e). It would also be possible to combine the interest rate differential with the expected rate of depreciation as an independent variable in the regression, but there is significant uncertainty about the expected depreciation. It was found that the exchange rate depreciation had the most significant impact and that interest rate differentials in Georgia are not significant. Including both terms together, produced somewhat less favorable results.

[57] The ratchet variable is defined as the past peak value of dollarization (foreign currency deposits as a share of total deposits). Other ratchet variable was tried based on inflation, but this was unsatisfactory as the past peak inflation for the period 1995-2001 was in 1995 and was hence dominated by a single observation.

[58] The degree of openness or monetization are used to proxy the structural change over time. Including the two series together was found to be problematic due to multicolinearity. A trend could also have been applied, but this lacks economic content and there is no expectation that this process would continue forever; whereas openness or monetization have an economic explanation and will tend to level off at some point.

series to test whether the variables were stationary. The tests revealed that the existence of unit root could not be rejected for all variables except the openness series (Table V-1).[59]

Table V-1. Estimates of Dollarization Determinants, Long-Run Estimates

	M	I	E	R	S1	S2
Coefficient 1/		---	-1.155	-0.619	-4.602	
Coefficient 2/		---	-0.858	-4.95		-0.130
Unit root test	-1.6	-2.4	-1.5	-0.5	-1.8	-3.2*
Cointegration test (M,D,R,S1)	-3.93*					
Cointegration test (M,D,R,S2)	-3.93*					

1/ Estimation results using monetization to proxy structural change.
2/ Estimation using openness to proxy structural change.

* Indicates significance at the 10 percent confidence interval; for the unit root and cointegration tests significance indicates that the null hypothesis of unit root can be rejected.

143. Granger (1981) and others have shown that linear combinations of one or more time series may turn out to be stationary, i.e., nonstationary variables are cointegrated, thereby producing stationary residuals. The presence of a cointegrated long-run relationship between the variables allows the dynamic relationship to be represented in the form of an error correction model (ECM).

144. The results of the cointegration test using the above model indicate that there is a long run relationship between dollarization and the depreciation of the exchange rate (E), the ratchet variable (R) and monetization (S1) or openness (S2) (Table V-1). The long run coefficients indicate that the dollarization ratio is positively related to these determinants.[60] It was found that the interest rate differential (I) had the incorrect sign, so it was not included.

[59] This is somewhat surprising given that the series appears to trend upward as shown in the graph.

[60] Since the dollarization ratio is defined as the natural log of (1/cs – 1), the series declines as dollarization increases, therefore negative coefficients imply that as the determinants increase the dollarization ratio increases.

145. An error correction model was then estimated to determine the short run dynamics.[61] The results suggest that the short-run dynamics are influenced by the depreciation rate, and the ratchet variable. In the case where monetization is used, it also affects the short-run dynamics. The significance of the error correction term (ECM) supports the significance of the long run relationship in the model. The R^2 is low, suggesting the explanatory power of the models are low. On the other hand the high F-statistic provides validity to the models, ruling out the hypothesis that the coefficients of the model are all zero. Figure V-2 shows the estimated values plotted against the actuals after being normalized.

Table V-2. Estimates of Dollarization Determinants, Short-Run Dynamics

	S1 1/	S2 2/
$E-E_{-1}$ (Depreciation)	-0.844 (2.5*)	-0.440 (1.4)
$R-R_{-1}$ (Ratchet)	-3.232 (2.0*)	-3.516 (-2.0*)
$S1-S1_{-1}$ (Monetization)	-0.540 (2.1*)	----
$S2-S2_{-1}$ (Openness)	-3.93*	----
ECM	-0.555 (3.6**)	-0.515 (3.4**)
R2	0.30	0.21
F-statistic	4.9**	4.2**

1/ Estimation results based on using monetization to proxy structural change.
2/ Estimation using based on using openness to proxy structural change.

* Significance at the 5 percent confidence interval.
** Significance at the 10 percent level.

F. Pros and Cons of Dollarization

146. Should dollarization be discouraged? The answer in part depends on what is causing it. For instance, if the process is the result of financial and trade liberalization, and the desire of residents to hold part of their asset portfolio in foreign currency, then this is a normal

[61] Seasonal dummy variables were tried but not found to be significant. The seasonality may be linked to the balance of payments, part of which is reflected in the openness variable.

outcome of international integration. On the other hand if increased dollarization is coming from economic and political instability and lack of confidence in the local currency then it may be problematic.

147. On the positive side, in countries, where inflationary experience has destroyed confidence in the local currency, dollarization can sometimes help to remonetize the economy, restore local intermediation, and reverse capital flight. Dollarization can mean closer integration with international markets and exposure to competition with those markets and a more diverse range of assets for domestic investors.

148. On the negative side, dollarization can complicate monetary policy by introducing an endogenous foreign currency component into the money supply, and it contributes to a loss of seignorage. There is also a potential for greater fragility of the banking system in highly dollarized economies. Such fragilities can limit the policy options available to the authorities and put an additional burden on the central bank as lender of last resort.

149. In the case of Georgia, the above empirical analysis suggests that dollarization is influenced by beneficial as well as detrimental factors. The existence of foreign currency deposits has certainly facilitated the development of the financial system and has coincided with the liberalization of the trade and capital account and monetization, as indicated by their significance in the currency substitution equation. On the other hand, currency substitution is sensitive to the depreciation rate and has a tendency to persist as indicated by the significance of the ratchet variable. Consequently, financial weakness combined with a large external shock can induce a significant shift from local currency to dollar assets, placing pressure on the exchange rate and on the banking system, as was the case in 1998.

150. Direct measures to limit dollarization may be unwise, given that it appears that there are beneficial aspects to it, such as encouraging financial intermediation. On the other hand, the persistent and high level of dollarization in Georgia suggests that the authorities need to take measures to encourage confidence in the local currency.

G. Policy Implications and Conclusions

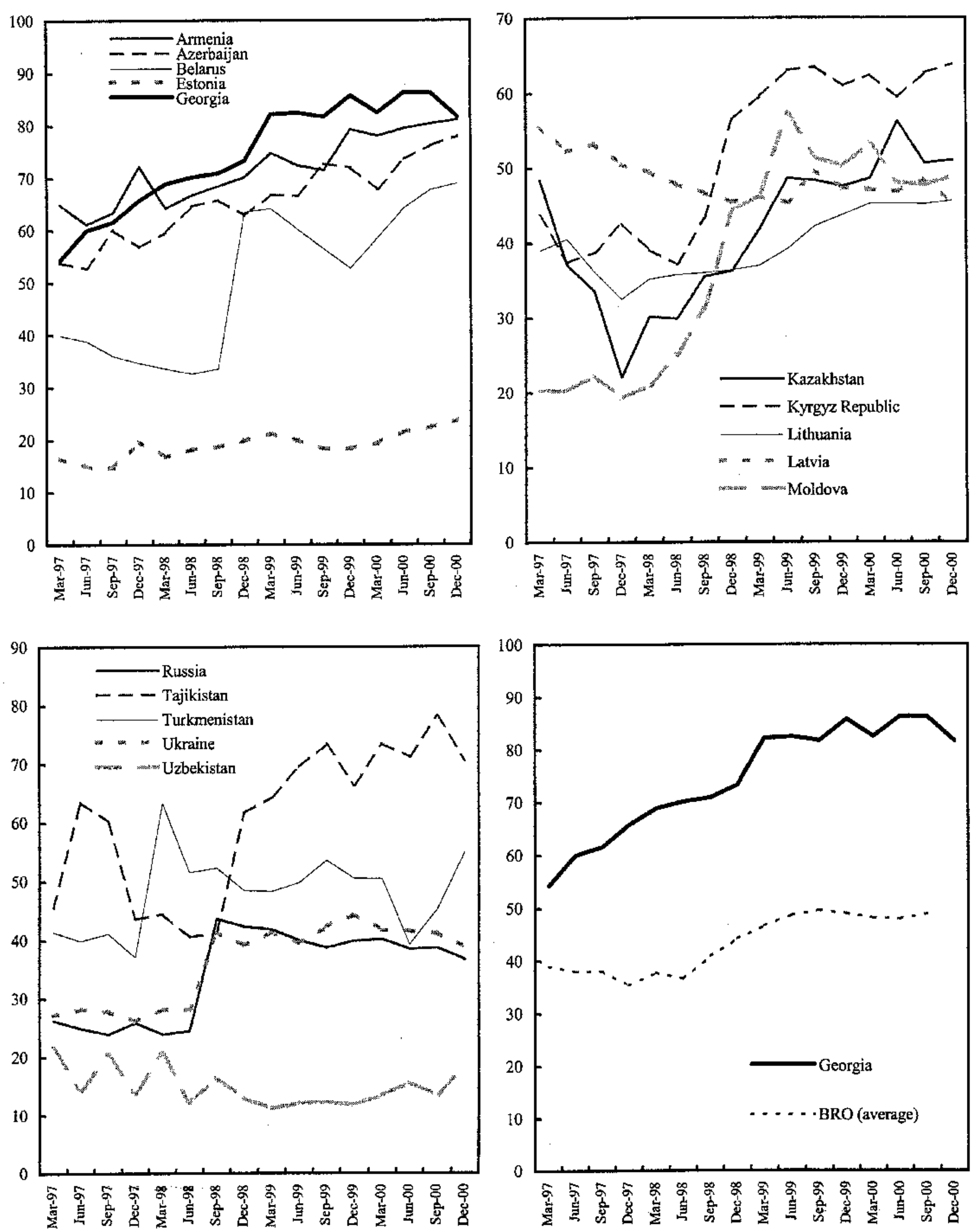
151. The most effective way to prevent excessive dollarization is by pursuing **sound macroeconomic policy**. In addition, institutional arrangements that bolster confidence in the maintenance of price stability, such as an independent central bank, with a clear price stability mandate, can enhance confidence in the domestic currency and thereby reduce the degree of dollarization. The significance of the ratchet effect in explaining the dollarization process in Georgia suggests that a long period of stability is needed before dollarization will decline. Other measures which can reduce the demand for foreign currency include the promotion of **alternative financial instruments**, such as stocks, mutual funds, corporate bonds and asset backed securities and derivatives that can substitute for foreign currency deposits in resident's asset portfolios. Encouraging the development of financial markets and competition within the banking system, for instance through entry of strategic banks or

investors, would help to ensure market-determined interest rates and development of alternative financial instruments. In addition, the use of the domestic currency can be assisted by providing a competitive domestic currency payments system. **More direct measures to reverse dollarization can be problematic.** Regulatory limits on foreign currency deposits or punitive reserve requirements on dollar deposits may simply drive dollars offshore, and forced conversions will undermine confidence and may result in capital flight.

152. Since foreign currency deposits are part of the money supply and are endogenously determined, dollarization complicates the choice of intermediate target for monetary policy. Fundamentally, the choice of target is an empirical issue and depends on which monetary aggregate is most strongly linked to output and prices. At any rate, dollar-denominated assets should be among the relevant indicators for monetary policy in a highly dollarized economy. With regard to exchange rate policy, the prevalence of currency substitution would tend to strengthen the case for a fixed-rate system in order to protect against exchange rate movements. In the case where there is only asset substitution, a flexible exchange rate may give the central bank greater monetary autonomy, since the links between international and domestic interest rates may be increased, although vulnerability to exchange rate risk, as in Georgia's case, would argue in favor of a fixed rate. Nonetheless, in Georgia's case, a floating exchange rate regime is appropriate under the present circumstances given the low level of reserves and vulnerability of the macroeconomy to external shocks.[62]

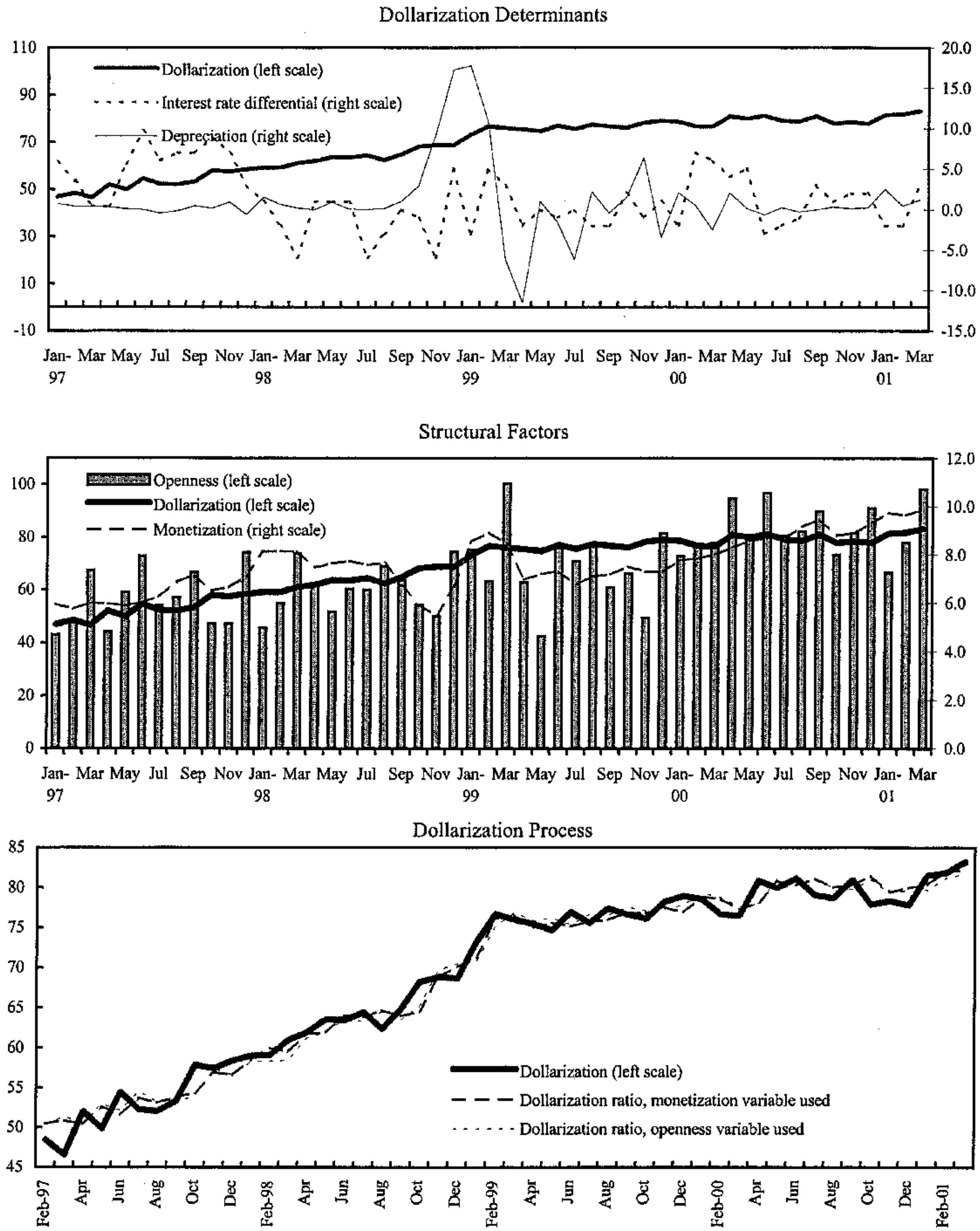
[62] In their paper, *Dollarization in Georgia: Size of the Problem, Factors and Ways of Solution*, Mr. Kakulia and Ms. Aslamazishvili argue that the floating exchange regime is more transparent and encourages confidence in the lari as the central bank no longer intervenes to support the currency.

Figure V-1. Georgia: Dollarization Ratios, 1997–2000



Source: EU2, Centralized Database; and Fund staff estimates.

Figure V-2. Georgia: Analysis of Dollarization, 1997–2001



Source: Georgian authorities; and Fund staff estimates.

VI. THE ENERGY SECTOR[63]

A. Summary and Introduction

- **The energy sector in Georgia has faced several challenges:** (i) the inheritance of a distorted and low energy price system following the breakup of the Soviet Union; (ii) the collapse of the economy following the breakup; and (iii) a civil war that disrupted the fuel and energy network.

- **This section provides an overview of developments in Georgia's electricity, natural gas and oil sectors, as well as oil and gas transit pipelines.** In particular, it emphasizes the recent efforts to reform the electricity sector.

- **In spite of some reform having been carried out during the second half of the nineties, serious problems continue to plague the electricity sector.** The regulatory framework has been strengthened and a privatization program has attracted some private capital, but privatization has come to a standstill in 2000. Also, the state-owned elements of the power sector remain unable to achieve cost-recovery and have accumulated a large amount of debt. Frequent power outages continue to hamper economic growth. The conditions necessary for returning the state-owned sector to financial health and establishing a more reliable electricity supply have yet to be implemented.

- **The authorities have recently committed to an ambitious reform program, supported by a World Bank credit and focused on private sector involvement.** Implementation of this new reform has been uneven. While some efforts have been made to revive privatization, there continues to be little progress in resolving the problems of the electricity sector debts.

- **The natural gas sector exhibits problems similar to those of the electricity sector.** While the regulatory framework has been strengthened, the state-owned parts of the sector fail to achieve cost recovery and have accumulated considerable debts. Supply to households and commercial customers in the cities has been reduced to low levels. Privatization has been very slow. A comprehensive reform strategy for the gas sector and a plan for the resolution of its debt have yet to be developed.

- **Notwithstanding today's difficulties, the energy sector could become an important source of foreign currency revenues to the budget**. Given its geographic location, Georgia could be an important player in the transit trade offered by the Caspian Sea region's reserves of hydrocarbons. There also seems to be potential for

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[63] Prepared by Hans Weisfeld.

electricity transit from Russia to Turkey. However, the transit fees that Georgia has been able to secure for the oil pipelines are low by international standards.

B. The Power Sector

Structure of the sector and pre-reform problems

153. **Georgia's electric power system serves 1.1 million customers in a country of 5.4 million people, with a coverage of nearly 100 percent.** Power generation is hydroelectric and thermal, with hydroelectric generation accounting for about 80 percent of the total. The thermal plants mostly burn natural gas imported from Russia (see Section C on the gas sector below). They can also run on mazut, but mazut is more expensive than gas. Figure VI-1 shows monthly power supply during 2000, split between domestically-produced and imported power and, for domestically produced electricity, the split between hydroelectric and thermal generation.

154. **When Georgia gained independence, the power sector consisted of the monolithic vertically integrated company Sakenergo.** Sakenergo provided generation, transmission and distribution of electricity. The company was a part of the former Soviet Union's energy sector that offered primary sources of energy, including those for electricity generation, at a very low cost to Georgia. Accordingly, electricity was given away virtually free of charge in Georgia. Through the breakup of the Soviet Union and the transition to a market economy, the electricity sector was confronted with a steep rise in the prices of primary sources of energy and a lack of experience on behalf of Sakenergo's management concerning the operation of the company under the new conditions.

Key elements of the reform strategy so far: privatization and regulatory reform

155. **In order to provide a sound basis for the development of the electricity sector, and with support from the World Bank, the government decided to undertake a major restructuring effort based on privatization and regulatory reform.** The central idea was to split Sakenergo into generation, transmission and distribution units, privatize the generation and distribution units, and have a regulatory body set electricity tariffs that allow recovery of prudently incurred costs. Privatization of transmission facilities was not envisaged as Georgia's constitution is interpreted as forbidding such a privatization.

156. **Starting in 1996, Sakenergo was separated into several generation and distribution companies, and one transmission company.** Ownership of these assets was assigned to the Ministry of State Property Management. The distribution companies were first managed by municipalities, later by regional authorities. The transmission company was complemented by two newly created units, the dispatching company and the Wholesale Electricity Market (WEM), which is an association of electricity producers and consumers with the goal of facilitating wholesale electricity trade. Through these successive changes, Sakenergo became a mere debt-holding shell and was renamed Sakenergo 2000.

157. **Some of the Sakenergo spins-offs were successfully privatized, but by 2000 privatization had come to a standstill.** In 1998-99, the government launched a privatization program on the generation and distribution levels with the aim of attracting strategic investors with substantial capital and operating experience into the sector. The Tbilisi distribution company Telasi, accounting for about half of Georgia's distribution load, was sold in 1998 to AES, an American utility investor, which acquired a 75 percent stake in the company for US$25.5 million. In April 2000, AES also acquired two out of a total of ten blocks of the Gardabani thermal power generation plant near Tbilisi for US$5 million and a 25-year concession for the Khrami I and II hydropower plants for US$2.5 million. In addition, AES has so far invested about US$180 million in creating a metering and billing system, in rehabilitation, working capital and power purchases. Eight small distribution companies in the Kaheti region and the Tetsi combined heat and power plant have also been privatized. No further privatizations have been accomplished, leaving about one half of distribution and most of hydropower generation still in state hands.

158. **The regulatory framework of the sector was reshaped in accordance with the reform strategy.** In 1996, the Ministry of Fuel and Energy was created to implement and coordinate government policies. In 1997, the Electricity Law was passed. The law created the Georgian National Electricity Regulatory Commission (GNERC), later renamed Georgian National Energy Regulatory Commission, as an independent semi-judiciary legal entity, funded by license fees and enjoying administrative autonomy. The GNERC has the authority to issue, revoke and modify licenses to sector enterprises and to set electricity tariffs.

159. **The regulatory authority has adopted a transparent tariff methodology, both at the wholesale and the retail levels, based on the principle of cost recovery.** At present, electricity tariffs would be adequate to compensate generators, distributors and the transmission and dispatch companies for prudently incurred costs of service if satisfactory collection rates were achieved. In addition, the Commission has adhered to the tariff levels for the Enguri hydropower plant that were agreed with the EBRD to ensure repayment of an EBRD loan for rehabilitation of the plant. The Commission has also adopted dispute resolution procedures for disputes among licensees or between licensees and customers.

The current state of the sector

160. **In spite of the early reform effort, the electricity sector is characterized by poor cost recovery, power shortages, high deficits and a large amount of accumulated debts.** This may partly be seen as the result of the reform strategy not having been comprehensive enough, by failing to bring electricity transmission under private management, and of the initial reform program having come to a standstill before completion.

161. **Poor cost recovery is still crippling the power sector, mainly because collection rates are at an inadequate level, but also because of theft.** Many state-owned distribution companies do not enforce payment for electricity deliveries. This has resulted in weak collection rates at both the retail and the wholesale levels of the state-owned parts of the

power sector. These collection rates are shown in Table VI-1. The table shows that collection rates at both levels of the electricity supply chain have not only failed to show sustained improvements but have actually decreased during recent years. One factor that may have contributed to this decline is the stepwise banning of offset deals starting in 1999. Note that collections of the privatized Tbilisi distribution company AES Telasi are not included in Table VI-1. AES reports that its collections have risen from 10 percent in 1999 to roughly 45 percent in the first half of 2001 as a result of its remetering efforts. Collections are not higher mainly because AES Telasi has not yet completed its remetering program. For example, most commercial customers have not been remetered yet. Theft of electricity poses serious difficulties for both the state-owned and the private parts of the power sector. AES reports that about 40 percent of the electricity that it provides is stolen and cannot be billed.

Table VI-1. Collection Rates in the State-Owned Power Sector

(In percent of billings) 1/

	1997	1998	1999	2000
Wholesale collection rates	71	55	34	22
Retail collection rates	68	51	44 2/	31

Source: World Bank
1/ Data include collection through offset deals and exclude commercial losses as well as nonpayment of supplies to Abkhazia and South Ossetia.
2/ January-June.

162. **Reflecting poor cost recovery, a lack of sources of energy, political dispatch to non-paying customers, and theft, continued power outages have occurred, creating economic dislocation as well as severe hardship.** At the end of the Soviet era, power generation in Georgia stood at about 14 billion kWh, while consumption was 17.5 billion kWh. Over the years, generation has decreased, constraining consumption. Today, generation and consumption stand at about 7.4 and 7.8 billion kWh, respectively. As a result, in the winter of 2000-01, parts of Tbilisi had as little as 3 hours of electricity per day, while some regions had no more than 2 hours per day or every other day. The decline in generation is in part linked to the poor physical state of the electricity generation plants. Due to years of poor maintenance because of insufficient revenues, less than half of generation facilities are operational and some of them may be damaged beyond repair. The cost of upgrading these facilities is now more than US$1 billion according to World Bank estimates.[64] The winter

[64] World Bank, Energy Sector Unit, Georgia Country Unit, Europe and Central Asia Region, 1997, *Georgia Power Privatization,* Report No. 17152-GE, Washington, D.C.

outages are also linked to a lack of gas and mazut needed for electricity generation in thermal power plants, due mostly to financial constraints. Outages are also linked to politically-motivated dispatch of power to non-privatized and non-paying regions, and theft.

163. **Due to poor cost recovery, the state owned power sector has experienced chronic financial deficits and accumulated a large amount of debt to creditors outside the sector.** The deficits amounted to roughly 6 percent of GDP a year up to 1999, according to World Bank estimates.[65] They have been financed with foreign and domestic credits as well as arrears. The estimated stock of debts as of April 2001 is presented in Table VI-2. This table lists all debts of state-owned power sector companies, some of which have been guaranteed by the government. The table ignores debt among state-owned power sector companies as well as debt between the state-owned power sector and the budget, as those liabilities remain entirely within the realm of the state and do not represent net indebtedness of the state. Credits from donors (IBRD, EBRD, OECF, KfW) have been used primarily for rehabilitation of power generation facilities and for working capital. Most of these credits are on concessional terms, i.e. with low interest rates, a generous grace period, and an extended maturity (15-40 years). The disbursement of further tranches of donor credits is planned to raise guaranteed debt by another US$114.2 million over the next few years. About US$200 million of the non-guaranteed foreign debt of the sector is concentrated in the 100 percent state owned debt-holding shell Sakenergo 2000. The remaining non-guaranteed debt is dispersed in the sector.

A new plan for far reaching reforms

164. **The limited success of reform efforts so far has prompted the Georgian government and the World Bank to develop a new plan for more far reaching reforms to be implemented in 2001 and 2002.** This plan is laid out in the Electricity Market Support Project (EMSP) supported by an IDA Credit of US$27.4 million. Georgia also continues to receive technical assistance for power sector reform from USAID.

165. **In the context of the EMSP, Georgia has committed to undertaking a series of policy initiatives for the effective development of the electricity sector. These initiatives address both the flow problem of insufficient revenues and the stock problem of old debts in the sector.** The flow problem shall be resolved through privatization or, where privatization is impossible due to legal obstacles or where an investor cannot be found, through the conclusion of management contracts with a private company. Bringing assets of the power sector under private control should eliminate non-commercial considerations in deciding which customers to provide with electricity. This should in turn assure the profitability of the assets and thereby provide for reliable service. The program will also fund

[65] A deficit estimate for 2000 is not available.

Table VI-2. Debts of the State-Owned Electricity Sector as of April 2001 1/ 2/

(In US$ million)

Creditors	Guaranteed by Government	Debts Denominated in Foreign Currencies	Debts Denominated in Domestic Currency	Sum
Donors	Yes	126.8 3/	...	126.8
Russia	Yes	5.5	...	5.5
Private creditors	No	229.9	112.3	342.2
Employees	No	...	6.9	6.9
Sum		362.2	119.2	481.4

Source: World Bank

1/ Note that these figures with the exception of the donor debt are estimates that may be subject to revision.

2/ Part of the debt is denominated in electricity (kWh) to be delivered to the creditors (Turkey and Azerbaijan). The contracts stipulate that in case the debtor fails to deliver electricity, he will have to pay in US$. The US$ price per kWh exceeds the costs of generating electricity in Georgia and transmitting it to the respective borders. We have recorded these debts as denominated in foreign currency. The US$ price we have chosen is an expected value derived by taking the arithmetic mean of the domestic costs of generation and transmission to the border and of the US$ price written into the contracts.

3/ Includes debts in the amount of US$83.8 million that has become a contingent liability of AES at the time of privatization. The privatization contract between Georgia and AES allows AES not to service these debts fully should its operations in Georgia be continually loss making and the government continues to guarantee the debts vis-à-vis the donors.

advisors who shall help the authorities analyze the existing debt and develop a debt servicing strategy. More specifically, the most important measures that the Georgian authorities have agreed to are:

- To bring the Wholesale Electricity Market, the transmission and the dispatch companies under private management through awarding management contracts. Tenders have been issued, qualified bids have been received, and signing is expected in October 2001. Financing for investments in transmission and dispatch may be supported by a new credit from the World Bank and KfW.

- To ensure that the non-privatized electricity distribution companies are privatized or brought under the control of private management no later than by end-June 2002. As a prerequisite, the regional distribution companies shall be consolidated into a smaller number of enterprises. The International Finance Corporation has been chosen as transaction advisor.

- To offer for sale or lease the non-privatized hydropower plants.

- To privatize or decommission the non-privatized units of Gardabani thermal generation plant.

- To support the mandate of the GNERC to implement electricity tariffs that reflect the full costs of electricity supply.

- To ensure timely compensation of electricity companies from the budget for mandated discounts to customers and for electricity supplies to budgetary agencies.

- To provision and pay from the budget for the supply of electricity to Abkhazia until such time as the problem of unpaid supplies is resolved.

- To develop a debt restructuring and repayment plan. The EMSP provides funding for negotiation advisors.

166. **While the EMSP's measures could provide a lasting solution for the power sector's problems, implementation so far has been slow.** The signing of management contracts concerning transmission and dispatch as well as the wholesale electricity market, expected for October, contrasts with a lack of progress in the area of addressing the sector's debts. The core task in this latter field is to generate funds for debt service, while maintaining electricity tariffs that allow full cost recovery. As there has been insufficient support in parliament to approve an amendment to the energy law that would have enabled the regulator to impose a debt surcharge on the electricity sector, the strategy for resolving the power sector's debt is being reconsidered.

C. The Natural Gas Sector

167. **The natural gas sector consists of gas production, the high-pressure pipeline system and local distribution companies.** Domestic production is not significant. As a result, most of the gas consumed is imported. Since 1996, all imports come from Russia through a single supplier, Itera, an affiliate of RAO Gazprom Russia. As noted above, prices for gas rose sharply after the demise of the Soviet Union. As a result, Georgia's annual gas consumption fell from 5.4 billion cubic meters (bcm) to 1.2 bcm. Most of the gas is used for power generation at the thermal power plants and by a few large industries such as the Rustavi metallurgical plant and the Azoti chemical plant.

168. **The assets of the high-pressure transmission network have been consolidated under the control of the Georgian Gas International Corporation (GIC). Local distribution companies transport the gas over the "last mile."** GIC is 100 percent state-owned and, at present, there are no plans for its privatization. GIC and its affiliate, the Georgian Gas Transportation Company, serve customers in Georgia and operate gas transit from Russia to Armenia. GIC does not normally trade in gas but provides transportation services against a fee. The gas transport from Russia to Armenia has had an annual volume of about 1.5 billion cubic meters over the past four years. GIC receives 10 percent of the gas transported from Russia to Armenia as a payment in kind.

169. **The high-pressure pipeline system and the local distribution companies suffer from problems similar to those of electricity transmission and distribution.** GIC reports collection rates of about 15 percent. Effective metering, billing and collection systems do not exist on any level of the supply chain. The resulting deficits have created an estimated sector

debt of US$75 million as of April 2000. The deficits have also prohibited adequate maintenance so that technical losses are high. Thus, while the installed transport capacity of the system owned by GIC is 16 bcm per year, after years of lack of investment in maintenance and repair, the actual capacity has come down to only 9 bcm. The technical assets of the local distribution companies are known to be in a very poor condition as well. An estimated investment of over US$250 million would be needed to rehabilitate the transmission and distribution systems. Supply to households and commercial costumers in the cities has been reduced to low levels.

170. **The regulatory structure of the system has been strengthened.** As noted above, in 1999 an amendment to the law gave GNERC the authority to regulate the gas sector as well as electricity. The extension of GNERC's authority was intended to induce greater competition in the sector and to attract private investment with the aim of restoring gas supply to consumers. Subsequently, the GNERC adopted a methodology for establishing gas tariffs that satisfies the IDA's requirements of transparency, cost recovery, and the promotion of efficiency in gas supply and consumption. The Commission started introducing tariffs based on this methodology in late 1999. Nevertheless, prices for gas deliveries are too low to generate the revenues that would be sufficient to restore the system to financial health. The Commission has issued interim licenses to all participants in the gas supply chain.

171. **A comprehensive reform strategy for the gas sector and a plan for the resolution of its debt have not yet been developed.** The government has indicated its intention to privatize all gas distribution assets, but so far only six local distribution companies have been privatized to the Russian-Georgian joint venture Sakgazi, which is controlled by Itera. Several efforts in the recent past to privatize the Tbilisi gas distribution company (Tbilgazi) have failed. This has prompted USAID to provide funding for a team of management consultants to take over key aspects of the company's operations in an attempt to improve its operations and facilitate continuing efforts to find a suitable strategic investor.

D. The Oil Sector[66]

172. **The potential for domestic oil production in Georgia is limited.** It is estimated that Georgia has a total of 540 million tons of commercially profitable reserves of oil, of which 300 million tons are below land and 240 million tons under the Black Sea.

173. **The regulatory structure of the sector has been improved.** Until 1999, when the Oil and Gas Law was passed, the development of the sector had been restrained by a lack of security in the legal framework. The law established the Gas and Oil Resources Regulation Authority, a one-stop regulatory authority for the sector, with powers to negotiate contracts,

[66] The term oil sector refers here to domestic production of oil.

sign agreements and issue licenses. It provides the secure legal environment necessary for attracting more foreign investment, in particular in production-sharing agreements.

174. **The role of the former monolithic vertically integrated oil company Saknaftobi has been transformed.** In 1999, the government established the Georgian Oil Company, Saknaftobi, as a joint stock company, with 100 percent of the shares held by the state. The company no longer acts as the principle regulatory authority in the oil and gas industry, although it does provide support to the regulatory agency established under the Oil and Gas Law. Saknaftobi's main purpose is to represent Georgia in negotiations with potential investors in the domestic oil sector. It also provides various services to these investors. Saknaftobi's income results from production sharing agreements with investors.[67] There is no formal agreement between Saknaftobi and the government about which part of Saknaftobi's revenues must be sent to the budget. In 1999 and 2000, Saknaftobi contributed 25 percent of its revenues of US$7.2 million and US$9 million, respectively, to the budget. The government has indicated its intention to privatize Saknaftobi but to date it has taken no action.

175. **Between 1995 and 2000, foreign direct investment in the oil sector has been small by international standards, at about US$125 million.** Foreign direct investment for 2001 is projected at US$60 million. The upward trend could well continue as the US-based Anadarko Petroleum Company, a major independent oil and gas exploration company, signed a production sharing agreement with Georgia in late 2000 for extensive offshore exploration.

E. Oil and Gas Transit Pipelines

176. **Georgia's geographic location between the Black Sea, Russia, and the Caspian region, rich in hydrocarbons, gives it important potential in terms of energy transit.** Georgia's ratification of the Energy Charter Treaty may contribute to realizing that potential, and transit fees could bring substantial revenues to the budget.

177. **In addition to maintaining the north-south transit of natural gas from Russia to Armenia, Georgia intends to create a major energy transit corridor through which oil and gas could be transported from the Caspian Sea region to Western markets and possibly from Russia to Turkey and Armenia.** In 1996, the Georgian International Oil Company (GIOC) was created by presidential decree to facilitate oil pipeline projects. In April 2001, GIOC's authority was enlarged to include new gas pipeline projects.

[67] The typical production-sharing agreement stipulates that during an initial period, one half of the extracted oil shall be used for recovering the investor's costs and the other half be shared between the investor and Saknaftobi in a ratio of 3 to 7. Once costs have been recouped, ownership of all the extracted oil is divided according to this ratio of 3 to 7.

178. **The first pipeline to be built in the east-west corridor was the "Early Oil Pipeline," which was completed in April 1999.** It has since been transporting oil from Azerbaijan to the Georgian Black Sea terminal of Supsa. Unfortunately, revenues are limited because of a low transit fee. The pipeline's current capacity is about 5 million tons of oil per year. It is currently running at close to maximum capacity and could be expanded to 12-15 million tons. The revenues from this pipeline constitute the charter capital of GIOC. The initial fee that Georgia received for oil transit through this pipeline was 17 cents per barrel or approximately US$1.2 per ton. This fee is indexed on the US GDP deflator and has in the meantime risen to 20 cents per barrel. In 2000, the fees received by Georgia totaled US$6.5 million. For 2001, revenues of US$6.9 million are expected, of which US$3.2 million will flow to the budget as tax or dividend payments according to a revenue sharing agreement between the budget and GIOC.

179. **Contracts for the construction of another oil pipeline running from Baku via Tbilisi to the Turkish Mediterranean seaport of Ceyhan have been signed recently. The transit fee agreed upon is also low by international standards.** Early engineering work for the pipeline has already been completed and the pipeline is expected to start working in 2005. The initial throughput of 7 million tons per year could later be increased to a maximum of 50 million tons. The initial construction cost of the Georgian part of the project is estimated at US$400 million. The starting fee that Georgia expects to receive for oil transport through this pipeline is 12 cents per barrel. Thus, the initial foreign currency inflows that can be derived from this pipeline should be close to those of the Early Oil pipeline. The fee accrues directly to the government as tax revenue.

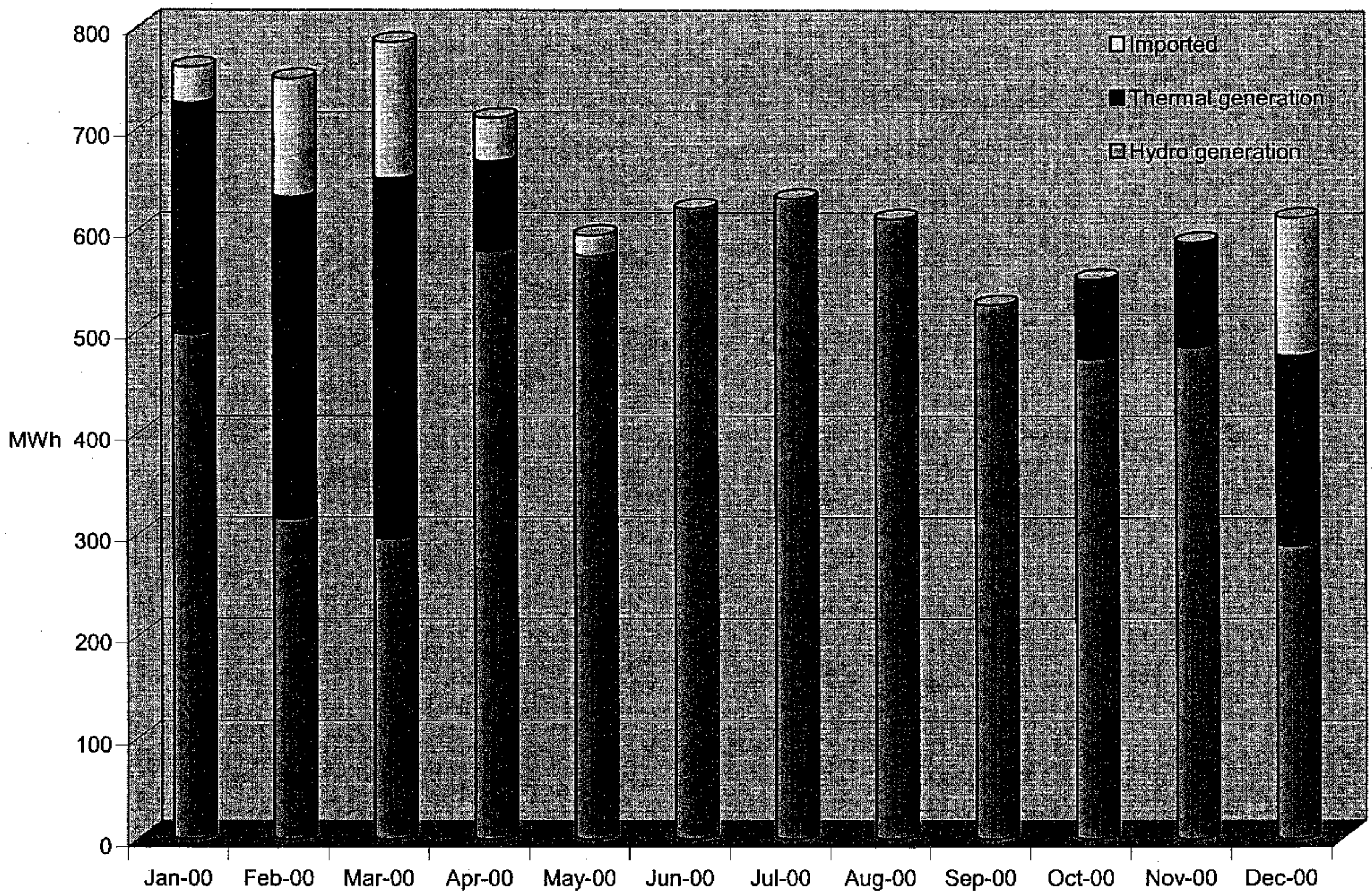
180. **The second pipeline project that is currently under consideration is a gas pipeline between Baku, Tbilisi and Northeastern Turkey.** Azerbaijan and Turkey have signed a gas sales contract, for the fulfillment of which this pipeline will be needed. Estimates put the Georgian part of the initial costs of this project also at US$400 million. The contract calls for operations to commence in 2004. The planned throughput for the first year of operation is 2 bcm of gas, but shall later be increased to 6.6 bcm per year. Should Georgia be able to secure a fee that corresponds to international good practice, namely around 6 percent of the value of the transported gas, annual foreign currency inflows could total around US$30 million at the maximum throughput.

181. **World Bank staff has proposed supporting pipeline projects through an Energy Transit Institution Building Project in the amount of SDR 7.6 million.** The project aims at enhancing Georgia's capacity to implement oil and gas transit agreements in a manner that maximizes economic benefit, ensures that design, construction and operation of the facilities are in compliance with international technical and environmental standards and best practices, and minimizes social impacts.

F. Conclusions

182. **Georgia has made progress in reforming its energy sector, but efforts need to be intensified.** In the electricity sector, both the flow problem of insufficient revenues and the stock problem of accumulated debts have not been resolved yet. As a result, the sector has continued to hamper economic growth and undermine fiscal stability. Successful implementation of the EMSP will therefore be essential, to underpin faster growth and macroeconomic stability over the medium term. The problems of the domestic gas sector are somewhat similar to those of the electricity sector. As a first step, the government should draw up a comprehensive reform strategy for this sector. In the area of energy transit, one pipeline project has been realized successfully and more projects are planned. Georgia should pursue those projects with an eye to maximizing the long-term revenues to the budget while observing the needs for mitigating negative social effects including damage to the environment.

Figure VI-1. Power Supply Structure in Georgia, 2000



Source: World Bank

Table A-1. Georgia: GDP by Origin, 1997–2001

	1997	1998	1999	2000	Q1-2 2001
			(In millions of lari)		
Nominal GDP	4,638.7	5,040.6	5,665.3	5,955.1	3,080.9
			(In percent of GDP)		
Share in GDP					
Agriculture, Forestry, Fishing	29.0	26.7	24.7	20.0	20.6
Industry	13.3	12.3	13.0	14.0	13.1
Construction	3.5	4.6	3.7	3.8	3.8
Trade	10.9	10.4	11.5	12.7	12.4
Hotels and Restaurants	1.9	1.9	2.4	2.4	2.6
Transport and Communications	7.6	10.9	11.9	14.4	13.6
Financial Intermediation	0.9	1.2	1.6	1.7	1.6
General Administration and Defense	3.7	3.9	3.5	3.2	3.7
Education	2.7	2.8	3.3	3.6	4.1
Health	3.5	4.5	4.3	5.1	5.1
Other	23.0	20.7	20.1	19.3	19.5
			(In percent)		
Real growth over same period in previous year					
GDP	10.6	2.9	3.0	1.9	5.2
Agriculture, Forestry, Fishing	3.9	-6.6	6.9	-12.6	9.9
Industry	2.5	-2.6	3.4	3.2	-0.4
Construction	51.3	35.2	-21.5	4.0	-4.9
Trade	2.2	1.6	3.8	11.7	4.2
Hotels and Restaurants	28.1	6.4	9.7	7.8	18.4
Transport and Communications	16.3	28.1	2.1	9.4	24.4
Financial Intermediation	72.5	78.1	58.6	16.6	1.9
General Administration and Defense	-1.5	9.2	-6.3	0.4	0.4
Education	0.3	-3.0	-9.5	8.2	5.5
Health	-3.8	-1.0	3.6	3.0	-4.0

Source: Georgian State Department of Statistics.

Table A-2. Georgia: Production of Selected Industrial Commodities, 1997–2000 1/
(In thousands of tons; unless otherwise indicated)

	1997	1998	1999	2000
Fuel and energy				
Electric power (in billions of kWh)	7.2	8.1	8.1	7.4
Coal	4.6	14.7	12	7.3
Oil	134.0	119.2	91.3	109.5
Natural gas (in millions of m3)	...	...	...	79.5
Gasoline	4.4	2.4	3.6	1.8
Diesel fuel	8.1	4.7	22.3	8.8
Metallurgy				
Steel	103.0	56.4	7	...
Finished roll steel	86.7	42.8	7.2	1.4
Rolled ferrous metal	93.2	42.8	8.7	1.4
Steel pipes	23.5	8.8	0.06	0.2
Manganese ore	14.2	16.0	54.9	59.1
Machine-building				
A/C motors (in thousands of kW)	0.0	...	...	...
Machine tools (in units)	28.0	21.0	2	3
Flooding electric engines (in thousands of units)	0.3	0.1	0.1	0.6
Lifting motors (in thousands of units)	0.6	0.2	0.4	0.9
Chemical/timber products				
Mineral fertilizers 2/	80.9	55.4	95.1	100.2
Synthetic ammoniac	102.1	77.5	126.6	136.2
Sawdust (in thousands of m3)	17.0	31.0	34.3	39.8
Construction				
Prefabricated ferro-concrete structures (thousands of m3)	8.3	8.3	9.3	12.7
Building bricks (in millions of units)	11.7	13.1	7.7	4.7
Light industry				
Silk thread (in tons)	8.6	...	...	...
Cotton yarn	0.1	0.1	0.01	...
Wool yarn	0.1	0.0	0.04	0.0
Fabrics, total (in millions of cubic square)	0.5	0.2	0.2	...
Basic foodstuff and food-processing				
Granulated sugar	19.7	...	20.0	35.3
Meat products	1.0	1.4	1.4	0.9
Fish and fish products	1.4	0.0	0.0	0.1
Dairy products	6.4	6.7	4.6	3.7
Canned food	9.0	1.9	6.6	4.6
Tea, primary processed	9.2	10.2	12.9	4.9
Natural tea	5.6	5.2	4.5	3.1
Macaroni products	0.3	0.8	0.5	0.3
Non-alcoholic beverages (in millions of decaliters)	4.0	2.9	2.2	2.9
Mineral water (in millions of 1/2 liters)	66.4	58.2	49.7	72.3
Cigarettes (in billions)	0.9	0.6	1.3	0.3
Vodka and liqueurs (in thousands of decaliters)	247.0	309.8	463.8	430.4
Grape wine (in thousands of decaliters)	2,458.0	2,179.0	1,939.3	1,816.4
Champagne (in thousands of decaliters)	137.0	51.9	66.9	87.9
Cognac (in thousands of decaliters)	74.0	47.6	31.1	70.6
Beer (in thousands of decaliters)	785.0	740.0	1,257.5	2,345.0

Sources: Georgian authorities; and Fund staff estimates.

1/ Data for Abkhazia and South Ossetia are not included.

Table A-3. Georgia: Transportation Indicators, 1997–2001
(In thousands of tons)

	1997	1998	1999	2000	2001 Q1–Q2
Freight transport	19,700	24,120	25,911	30,091	14,601
Rail	7,200	8,495	9,492	11,500	5,984
Road	12,200	15,000	16,000	18,500	8,600
Sea	300	625	419	...	...

Source: Georgian State Department of Statistics.

Table A-4. Georgia: Population and Employment, 1997–2001
(In thousands)

	1997	1998 5/	1999	2000	Q1 2001
Total population 1/	5,388.0	5,398.5	5,101.0	5,100.5	4,945.6
Males	2,572.7	2,580.0	2,438.7	2,438.4	2,364.2
Females	2,815.3	2,818.5	2,662.3	2,662.1	2,581.3
Urban	2,975.4	2,984.1	2,942.1	2,945.5	2,860.8
Rural	2,412.6	2,414.4	2,158.9	2,155.0	2,084.8
Under 16 years of age	1,247.5	1,210.4	1,123.7	1,123.6	1,089.7
In active years 2/	3,308.8	3,323.2	3,145.7	3,145.4	3,030.1
Over active age	831.7	864.9	831.6	831.5	825.8
Population employed 3/	2,233.2	1,731.1	1,732.6	1,748.8	1,818.2
State sector	570.7	598.2	541.7	439.0	421.1
Of which:					
Industry and construction	97.7	88.8	69.4	69.3	70.1
Agriculture	42.3	25.3	21.2	7.9	7.4
Transportation and communications	58.4	48.1	42.0	36.7	37.4
Trade and other materials sectors	31.3	20.8	18.4	17.4	17.0
Health, education, and science	240.2	212.1	203.2	202.3	201.1
Administration and finance 6/	45.3	119.2	108.6	82.9	65.7
Other nonmaterial sector	55.5	83.9	79.0	22.5	22.4
Cooperatives 4/	47.0	...	...	...	...
Industry and construction	23.4	...	...	...	...
Agriculture	22.0	...	...	...	...
Other	1.6	...	...	...	...
Private sector	1,615.5	1,132.9	1,190.9	1,309.8	1,397.1
Of which:					
Self-employed	1,529.2	969.3	982.8	999.6	1,137.7
Retired (receiving pension)	1,022.0	979.4	967.8	923.7	900.5
Of which:					
Retirees employed	64.7	54.5	53.2	39.7	38.4

Source: Georgian State Department of Statistics.

1/ The total population may be significantly overestimated because the data include persons registered in Georgia but living abroad.
2/ Since February 20, 1996, working age is 16-60 for women, and 16-65 years for men. Prior to that date, the working age was 16-55 for women, and 16-60 years for men.
3/ Excludes employment in the informal sector. Official estimates indicate that as of end-1997, employment in the informal sector was about 750,000 persons.
4/ Including collective farms and consumer cooperatives.
5/ In 1998, the State Department of Statistics started to carry out Labor force surveys (using the ILO methodology).
6/ Beginning in 1998—including defense.

Table A-5. Georgia: Unemployment, 1997–2001
(Number of persons, end-of-period)

	1997	1998	1999	2000	2001	
					Q1	Q2
Registered unemployed	142,795	98,512	100,363	116,889	119,657	121,567
Of which:						
Receiving benefits	5,358	1,793	1,753	2,829	3,136	3,296
			(In percent)			
Unemployment rate (ILO definition, period average)	7.7	12.1	12.8	10.4	12.0	...

Sources: Ministry of Labor and Social Affairs; and Georgian State Department of Statistics.

Table A-6. Georgia: Average Monthly Wages, 1997–2001 1/ 2/
(In lari)

	1997	1998	1999	Q1-2 2000 3/	Q1 2001
Total economy	43.3	55.4	67.5	78.5	84.7 4/
Industry	57.8	71.9	90.8	128.3	...
Workers	53.9	64.9	...	...	...
Agriculture	13.7	16.1	27.5	27.2	...
State farms, agricultural enterprises	14.2	15.5	...	...	...
Construction	105.6	118.6	145.9	176.3	...
Workers	115.5	128.3	...	...	...
Transportation	82.4	95.7	103.9	129.3	...
Railway transportation	69.9	91.6	110.3	137.6	...
Waterway transportation	146.7	160.1	130.2	138.7	...
Urban transportation	81.9	133.7	138.2	...	...
Communications	60.3	67.7	100.6	101.1	...
Trade and distribution	28.9	30.5	37.6	45.0	...
Computer services	46.5	51.6	83.4	57.9	...
Housing and communal services	48.1	72.4	99.9	...	...
Public health and social security	23.8	26.6	34.9	36.5	...
Public education	28.2	46.4	44.1	48.0	...
Culture	30.1	33.8	50.1	...	...
Art	43.9	62.5	66.6	...	...
Science and related services	46.7	61.2	72.3	59.3	...
State administration and management	55.6	73.2	90	100.2	...
Memorandum items:					
Real wages total economy (1997=100)	100.0	123.6	126.4	141.3 5/	...
Real wages growth rate (in percent) 6/	39.56	23.56	2.28	11.78	...
Average annual salary					
Total economy	520.8	723.6	810.1	...	...
Industry	693.6	897.6	1,089.6	...	...
Agriculture	164.4	214.8	329.4	...	...

Source: Georgian State Department of Statistics; and Fund staff calculations.

1/ Wages include cash compensation and the value of goods received in kind.
2/ These data are subject to large margins of error.
3/ Data for the second half of 2000 are not available.
4/ Average for all services.
5/ Preliminary estimate.
6/ Calculated using the average CPI prive level of given period over average CPI price level of the same period in the previous year.

Table A-7. Georgia: Government Wages and Pensions, 1997–2001 1/

	Minimum monthly wage		Average monthly wage		Monthly pension	
	Nominal (In lari)	Real 2/ (Jan. 1997=100)	Nominal (In lari)	Real 2/ (Jan. 1997=100)	Nominal (In lari)	Real 2/ (Jan. 1997=100)
1997						
January	12.0	100.0	34.1	100.0	9.8	100.0
February	12.0	98.0	34.1	98.0	9.8	98.0
March	12.0	97.3	34.1	97.3	9.8	97.3
April	12.0	97.0	34.1	97.0	9.8	97.0
May	12.0	96.0	34.1	96.0	9.8	96.0
June	12.0	97.9	34.1	97.9	9.8	97.9
July	12.0	98.8	34.1	98.8	9.8	98.8
August	15.0	123.4	37.5	108.6	11.8	118.9
September	15.0	122.1	37.5	107.4	11.8	117.6
October	15.0	121.1	37.5	106.5	11.8	116.6
November	15.0	118.3	37.5	104.1	11.8	114.0
December	15.0	117.5	37.5	103.4	11.8	113.2
1998						
January	17.0	132.8	41.3	113.4	13.0	124.3
February	17.0	131.4	41.3	112.2	13.0	123.0
March	17.0	131.3	41.3	112.1	13.0	123.0
April	17.0	130.1	41.3	111.1	13.0	121.8
May	17.0	132.3	41.3	113.0	13.0	123.9
June	17.0	134.9	41.3	115.2	13.0	126.3
July	18.7	152.0	45.4	129.8	13.0	129.4
August	18.7	151.6	45.4	129.5	13.0	129.1
September	18.7	151.5	45.4	129.3	13.0	128.9
October	18.7	150.0	45.4	128.1	13.0	127.7
November	18.7	148.4	45.4	126.8	14.0	136.1
December	18.7	132.4	45.4	113.0	14.0	121.4
1999						
January	18.7	129.0	...	...	14.0	118.3
February	18.7	122.9	...	...	14.0	112.6
March	18.7	120.6	58.7 3/	133.2	14.0	110.5
April	18.7	119.1	...	...	14.0	109.2
May	18.7	121.0	...	...	14.0	111.0
June	20.0	131.3	68.6 3/	158.5	14.0	112.6
July	20.0	134.2	...	...	14.0	115.0
August	20.0	134.2	...	...	14.0	115.0
September 4/	20.0	132.9	73.0 3/	170.7	14.0	113.9
October	...	...	...	...	...	...
November	...	...	...	...	...	...
December	...	...	...	...	...	...
2000						
January	20.0	127.1	...	...	14.0	109.0
February	20.0	127.5	...	...	14.0	109.3
March	20.0	127.6	71.9 3/	161.4	14.0	109.4
April	20.0	127.9	...	...	14.0	109.6
May	20.0	128.0	...	...	14.0	109.7
June	20.0	128.4	80.9 3/	182.8	14.0	110.0
July	20.0	128.7	...	...	14.0	110.3
August	20.0	127.2	...	...	14.0	109.0
September	20.0	124.9	...	...	14.0	107.1
October	20.0	123.4	...	...	14.0	105.8
November	20.0	122.7	...	...	14.0	105.2
December	20.0	122.0	...	...	14.0	104.6
2001			...	...		
January	20.0	121.2	...	...	14.0	103.9
February	20.0	120.5	...	...	14.0	103.3
March	20.0	120.5	84.7 4/	179.5 4/	14.0	103.2
April	20.0	119.3	...	...	14.0	102.3
May	20.0	120.5	...	...	14.0	103.3
June	20.0	120.9	...	...	14.0	103.7

Source: Georgian State Department of Statistics and staff calculations.

1/ Includes only wages of budgetary organizations.
2/ CPI deflated.
3/ As of 1999, wages are reported quarterly.
4/ Preliminary estimate.

Table A-8. Georgia: Consumer Price Index, 1998–2001 1/

	Consumer price index (1995 = 100)	Percentage changes		
		Over previous month	Over previous quarter	Over same month previous year
1998				
January	154.6	0.3		6.7
February	156.3	1.1		5.7
March	156.3	0.0	5.8	5.0
April	157.8	0.9		5.6
May	155.2	-1.7		2.9
June	152.2	-1.9	3.8	2.8
July	148.5	-2.4		1.3
August	148.9	0.3		1.5
September	149.1	0.1	1.1	0.5
October	150.5	1.0		0.6
November	152.1	1.1		-0.6
December	170.6	12.1	3.6	10.7
Average 1998	154.4	...	...	3.6
1999				
January	175.0	2.6		13.2
February	183.8	5.0		17.6
March	187.3	1.9	16.9	19.8
April	189.7	1.3		20.2
May	186.6	-1.6		20.2
June	183.9	-1.4	20.4	20.8
July	180.0	-2.1		21.2
August	180.0	0.0		20.8
September	181.7	1.0	21.3	21.9
October	182.6	0.5		21.3
November	187.0	2.4		22.9
December	189.1	1.2	18.1	10.9
Average 1999	183.9	...	...	19.1
2000				
January	190.0	0.4		8.5
February	189.5	-0.2		3.1
March	189.3	-0.1	4.1	1.1
April	188.8	-0.2		-0.4
May	188.6	-0.1		1.1
June	188.1	-0.3	1.0	2.3
July	187.6	-0.3		4.3
August	190.0	1.2		5.6
September	193.4	1.8	5.4	6.4
October	195.7	1.2		7.2
November	196.9	0.6		5.3
December	197.9	0.5	5.7	4.6
Average 2000	191.3	...	...	4.0
2001				
January	199.3	0.7		4.9
February	200.5	0.6		5.8
March	200.5	0.0	1.3	5.9
April	202.5	1.0		7.2
May	200.5	-1.0		6.3
June	199.7	-0.4	-0.4	6.2
July	198.3	-0.7		5.7
August	198.8	0.3		4.7

Source: Georgian State Department of Statistics.

1/ According to a 296-good Laspeyres index. The last revision of the CPI weights was made in December 1997.

Table A-9. Georgia: Summary of General Government Operations, 1998–2001

	1998	1999	2000	2001 Q1	2001 Q2
	(In millions of lari)				
Total revenue and grants (excluding privatization)	786.4	873.3	913.3	230.9	256.6
Total revenue	740.8	825.1	897.1	228.8	251.9
Tax revenue (excluding extrabudgetary)	526.1	649.2	706.6	167.9	196.1
Taxes on income	87.8	104.8	108.2	26.4	30.2
Taxes on profits	50.5	55.6	79.7	14.1	22.3
VAT	219.7	248.1	289.8	77.1	90.0
Custom duties	67.0	33.7	53.1	12.7	13.2
Excises	38.7	118.5	90.2	19.5	23.3
Other taxes	62.3	88.6	85.7	18.0	20.6
Nontax revenue	97.1	42.8	45.6	26.1	13.3
Extrabudgetary revenue 1/	117.5	133.1	144.8	34.9	42.5
Grants	45.7	48.2	16.2	2.0	4.7
Total expenditure and net lending	1,096.4	1,252.9	1155.9	273.4	276.7
Current expenditure	997.3	1,132.5	1094.2	246.9	256.0
Wages and salaries	176.7	190.8	180.1	42.9	44.7
Goods and services 2/	202.4	190.9	132.2	21.4	35.5
Transfers and subsidies	119.3	142.2	166.7	33.8	32.6
Interest payments	114.8	159.0	178.4	33.4	23.6
Domestic	62.8	80.5	87.7	16.7	15.7
External	51.9	78.6	90.7	16.7	7.9
Extrabudgetary expenditures 3/	212.5	211.7	203.7	57.2	59.5
Local government expenditures	171.7	237.9	233.1	58.2	60.1
Capital expenditure	65.5	48.7	30.2	16.0	17.1
Of which: Foreign financed	33.5	43.6	25.4	15.3	17.1
Net lending	33.6	71.7	31.6	10.6	3.5
Of which: Foreign financed	33.5	39.7	34.7	8.2	0.4
Budget contingency	0.0	0.0	0.0	0.0	0.0
Overall balance (commitments)	-309.9	-379.6	-242.6	-42.6	-20.1
Adjustment to cash basis	64.0	97.6	89.0	41.9	-4.3
Net change in expenditure arrears (-, reduction)	64.0	95.9	84.0	35.2	-13.5
External interest	-5.5	0.0	0.0	0.0	0.8
Domestic expenditure	69.5	95.9	84.0	35.2	-14.3
Net other cash balancing	0.0	1.7	5.0	6.7	9.2
Overall balance (cash)	-246.0	-282.0	-153.6	-0.7	-24.3
Total financing	246.0	282.0	153.6	0.7	24.3
Privatization	73.4	52.7	19.1	1.1	1.3
Domestic	97.9	131.9	133.0	-20.3	8.2
NBG	109.8	187.1	94.7	-46.7	18.3
Of which: NBG recapitalization	0.0	70.3	-42.2	-28.1	0.0
Banks and non-banks	-9.7	15.1	9.2	-1.3	-10.2
Commercial banks (other)	-2.1	0.0	-13.1	0.0	0.0
Offset to NBG Recapitalization	0.0	-70.3	42.2	28.1	0.0
External	74.7	68.7	-8.4	19.9	14.8
Disbursements	100.2	138.4	58.6	22.9	15.6
Amortization	-115.4	-182.0	-210.9	-58.7	-61.2
Changes in arrears (-, reduction)	-73.6	112.4	132.0	0.0	0.8
Macroeconomic support	163.5	0.0	11.8	55.8	59.7
Net US in-kind loans 4/	0.0	28.6	10.0	0.0	0.0
Memorandum items:					
Primary overall balance (commitments)	-195.2	-220.6	-64.3	-9.1	3.6
Overall balance before grants	-355.6	-427.8	-258.8	-44.6	-24.8
Domestic overall balance	-288.6	-344.5	-198.8	-21.1	-7.3
Non-interest current expenditure	882.5	973.4	915.8	213.5	232.4
Non-interest current expenditure (cash basis)	813.1	875.8	826.8	171.6	236.7
Total expenditure and net lending (cash basis)	1,032.4	1155.3	1066.9	231.5	280.9
Tax revenue (prog. def.) / current expenditure	64.5	69.1	77.8	82.1	93.2

Table A-9. Georgia: Summary of General Government Operations, 1998–2001

	1998	1999	2000	2001 Q1	2001 Q2
	(In percent of GDP)				
Total revenue and grants (excluding privatization)	15.6	15.4	15.3	16.0	15.7
Total revenue	14.7	14.6	15.1	15.8	15.4
Tax revenue (excluding extrabudgetary)	10.4	11.5	11.9	11.6	12.0
Taxes on income	1.7	1.9	1.8	1.8	1.8
Taxes on profits	1.0	1.0	1.3	1.0	1.4
VAT	4.4	4.4	4.9	5.3	5.5
Custom duties	1.3	0.6	0.9	0.9	0.8
Excises	0.8	2.1	1.5	1.4	1.4
Other taxes	1.2	1.6	1.4	1.2	1.3
Nontax revenue	1.9	0.8	0.8	1.8	0.8
Extrabudgetary revenue 1/	2.3	2.3	2.4	2.4	2.6
Grants	0.9	0.9	0.3	0.1	0.3
Total expenditure and net lending	21.8	22.1	19.4	18.9	16.9
Current expenditure	19.8	20.0	18.4	17.1	15.6
Wages and salaries	3.5	3.4	3.0	3.0	2.7
Goods and services 2/	4.0	3.4	2.2	1.5	2.2
Transfers and subsidies	2.4	2.5	2.8	2.3	2.0
Interest payments	2.3	2.8	3.0	2.3	1.4
Domestic	1.2	1.4	1.5	1.2	1.0
External	1.0	1.4	1.5	1.2	0.5
Extrabudgetary expenditures 3/	4.2	3.7	3.4	4.0	3.6
Local government expenditures	3.4	4.2	3.9	4.0	3.7
Capital expenditure	1.3	0.9	0.5	1.1	1.0
Of which: Foreign financed	0.7	0.8	0.4	1.1	1.0
Net lending	0.7	1.3	0.5	0.7	0.2
Of which: Foreign financed	0.7	0.7	0.6	0.6	0.0
Budget contingency	0.0	0.0	0.0	0.0	0.0
Overall balance (commitments)	-6.1	-6.7	-4.1	-3.0	-1.2
Adjustment to cash basis	1.3	1.7	1.5	2.9	-0.3
Net change in expenditure arrears (-, reduction)	1.3	1.7	1.4	2.4	-0.8
External interest	-0.1	0.0	0.0	0.0	0.0
Domestic expenditure	1.4	1.7	1.4	2.4	-0.9
Net other cash balancing	0.0	0.0	0.1	0.5	0.6
Overall balance (cash)	-4.9	-5.0	-2.6	0.0	-1.5
Total financing	4.9	5.0	2.6	0.0	1.5
Privatization	1.5	0.9	0.3	0.1	0.1
Domestic	1.9	2.3	2.2	-1.4	0.5
NBG	2.2	3.3	1.6	-3.2	1.1
Of which: NBG recapitalization	0.0	1.2	-0.7	-1.9	0.0
Commercial banks	-0.2	0.3	0.2	-0.1	-0.6
Nonbank	0.0	0.0	-0.2	0.0	0.0
Offset to NBG Recapitalization	0.0	-1.2	0.7	1.9	0.0
External	1.5	1.2	-0.1	1.4	0.9
Disbursements	2.0	2.4	1.0	1.6	0.9
Amortization	-2.3	-3.2	-3.5	-4.1	-3.7
Changes in arrears (-, reduction)	-1.5	2.0	2.2	0.0	0.0
Macroeconomic support	3.2	0.0	0.2	3.9	3.6
Net U.S. in-kind loans 4/	0.0	0.5	0.2	0.0	0.0
Memorandum items:					
Tax revenue (including extrabudgetary)	12.8	13.8	14.3	14.0	14.6
Primary overall balance (commitments)	-3.9	-3.9	-1.1	-0.6	0.2
Overall balance before grants	-7.1	-7.6	-4.3	-3.1	-1.5
Domestic overall balance	-5.7	-6.1	-3.3	-1.5	-0.4
Non-interest current expenditure	17.5	17.2	15.4	14.8	14.2
Non-interest current expenditure (cash basis)	16.1	15.5	13.9	11.9	14.5
Total expenditure and net lending (cash basis)	20.5	20.4	17.9	16.0	17.2
Nominal GDP (In lari millions)	5,040.6	5,665.3	5,955.1	1,443.7	1,637.3

Sources: Georgian authorities; and Fund staff estimates.

1/ Includes revenues of the Pension Fund, Employment Fund, and Road Fund. Payroll tax payments made by budgetary organizations are treated as intragovernmental transfers.
2/ Combines other goods and services, unclassified expenditures, and other current expenditures.
3/ Expenditures of the Pension Fund, Employment Fund, and Road Fund.
4/ Used for in-kind loans disbursed in 1998 or later. Given the lag between the creation of the financial liability and the delivery of the in-kind goods, positive net financing is recorded as the in-kind goods are delivered (prior to delivery, the financial liability is offset by the holding of the in-kind asset).

Table A-10. Georgia: Marginal Rates of the Personal Income Tax, 1997–2001

Annual taxable income 1/				Examples		
1997-99	2000	Q1-2 2001	Marginal rate	Annual income (In lari)	Income tax (In percent)	Average tax rate (In percent)
Less than lari 200	Less than lari 200	Less than lari 200	12 percent	150	18.0	12.0
				200	24.0	12.0
Lari 201-350	Lari 201-350	Lari 201-350	24 lari + 15 percent	275	35.3	12.8
			of income above 200 lari	350	46.5	13.3
Lari 351-600	Lari 351-600	Lari 351-600	46.5 lari + 17 percent	475	67.8	14.3
			of income above 350 lari	600	89.0	14.8
Lari 601 and above	Lari 601 and above	Lari 601 and above	89 lari + 20 percent	1,000	169.0	16.9
			of income above 600 lari			

Source: Georgian authorities; Tax Code of Georgia; and Fund staff estimates.

1/ A credit is given for withholding tax paid on dividend and interest income of up to lari 3,000 (the withholding rate is 10 percent). The following natural persons receive an annual exemption of lari 3,000: invalids from childhood; invalids in blindness groups I and II. A standard deduction of lari 3.5 per annum applied to all income taxpayers until June 1996, when it was raised to lari 108 per annum (lari 9 per month).

Table A-11. Georgia: Statutory Revenue Sharing Arrangements, 1998–2001 1/

	Legislated				1998 (Actual)		1999 (Actual)		2000 (Actual)		Q1 2001 (Actual)	
	Start	Expiration	State	Local	State	Local	State	Local	State	Local	State	Local
	(Year)				(Share in percent)							
VAT					88	12	87	13	91	9	93	8
Standard 2/	...	...	100	0								
Tbilisi, collected by TIG	1998	2000	85	15								
Ajara, collected by SCD	1997	1999	60	40								
Ajara, collected by TIG	1997	1999	70	30								
Excises					91	9	93	7	96	4	94	7
Standard	...	...	100	0								
Ajara, collected by SCD	1997	1999	60	40								
Profit tax					40	60	36	64	27	74	11	89
Standard	1997	1999	40	60								
Ajara and Abkhazia	1997	1999	1	99								
Tbilisi	1997	1999	40	60								
Income tax					45	55	43	57	29	71	14	86
Standard	1997	1999	40	60								
Ajara and Abkhazia	1997	1999	1	99								
Tbilisi	1997	1999	40	60								
Customs duties					92	8	76	24	83	17	83	17
Standard	...	...	100	0								
Ajara, collected by SCD	1997	1999	60	40								
Poti	1998	2000	95	5								
Other taxes 3/	...	...	0	100	0	100	0	100	0	100	0	100
Nontax revenue					78	22	58	42	79	21	77	23
NBG Profits	...	...	100	0	100	0	...	...	100	0	100	0
Fees/budgetary org. 3/	...	...	...	...	55	45	54	46	53	47	54	46
Dividends 3/	...	...	...	...	100	0	100	0	100	0	100	0
Other revenue 3/	...	...	...	...	68	32	60	40	59	41	58	42
Privatization 3/	...	...	...	...	64	36	40	60	42	58	41	59

Sources: Georgian authorities; Fund staff estimates

1/ Legislative changes introduced in the 2000 budget will shift all VAT and excise tax revenue to the state level (central government and extrabudgetary funds).
2/ This includes the natural resource tax, ecology (environmental) tax, land tax, property tax, as well as miscellaneous other taxes.
3/ The division of the revenue depends on the specifics of the transaction.

Table A-12. Georgia: Number of Registered and Active Taxpayers, 1997–2001

	1997		1998		1999		2000		Q1 2001	
	January	July	January	July	January	July	January	July	January	July
Registered taxpayers 1/	64,873	73,931	91,272	107,285	125,733	146,298	154,661	167,216	170,697	178,937
Active taxpayers 2/	53,086	31,989	48,754	57,087	63,591	67,998	81,525	88,616	90,471	94,817
Memorandum items:										
Increase in registered taxpayers	-6.3	14	23.5	17.5	17.2	16.4	5.7	8.1	2.1	4.8
Increase in active taxpayers	24.6	-38.7	52.4	17.1	11.4	6.9	19.9	8.7	2.1	4.8
Active/registered taxpayers	81.8	43.3	53.4	53.2	50.6	46.5	52.7	53.0	53.0	53.0

Source: Georgian authorities.

1/ Only enterprises are registered as taxpayers; in the case of wage earners paying personal income tax, the withholding enterprise is registered as the taxpayer.
2/ Active taxpayers are registered taxpayers who do actually pay taxes.

Table A-13. Georgia: Excise Tax Rates, 1998–2001 1/
(In lari per unit)

	Quantity	1998		1999				2000				2001	
		May	Nov.	Jan.	Apr.	Jun.	Sep.	Jan.	Apr.	Jun.	Sep.	Jan.	Apr.
Alcohol													
Domestic													
Champagne	Litre	4.00	4.00	4.00	4.00	4.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Sparkling grape wine	Litre	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Sparkling fruit wine	Litre	2.00	2.00	2.00	2.00	2.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Unbottled wine	Litre	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.20	0.20	0.20	0.20	0.20
Bottled wine	Litre	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Fruit wine	Litre	1.70	1.70	1.70	1.70	1.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Bottled fortified wine	Litre	0.50	0.50	0.50	0.50	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Unbottled fortified wine	Litre	1.00	1.00	1.00	1.00	1.00	0.50	0.50	1.00	1.00	1.00	1.00	1.00
Mixed fortified wine	Litre	2.00	2.00	2.00	2.00	2.00	...	...	...	...	...	...	...
Cognac and cognac materials	Litre	6.70	6.70	6.70	6.70	6.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Whiskey, gin, and rum	Litre	4.00	4.00	4.00	4.00	4.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Brandy and brandy materials	Litre	2.70	2.70	2.70	2.70	2.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Vodka	Litre	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Liqueur	Litre	2.70	2.70	2.70	2.70	2.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Other alcoholic drinks	Litre	1.00	1.00	1.00	1.00	1.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Beer	Litre	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12
Ethyl spirits	Litre	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70
Imported 2/													
Champagne	Litre	4.93	4.93	4.00	4.00	4.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Sparkling grape wine	Litre	0.59	0.59	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Sparkling fruit wine	Litre	2.47	2.47	2.00	2.00	2.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Unbottled wine	Litre	0.10	0.10	0.10	0.10	0.10	...	...	0.20	0.20	0.20	0.20	0.20
Bottled wine	Litre	0.24	0.24	0.20	0.20	0.20	...	...	0.20	0.20	0.20	0.20	0.20
Fruit wine	Litre	2.05	2.05	1.70	1.70	1.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Bottled fortified wine	Litre	1.23	1.23	0.50	0.50	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Unbottled fortified wine	Litre	0.61	0.61	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Mixed fortified wine	Litre	2.47	2.47	2.00	2.00	2.00	1.00	1.00	...	...	...	...	...
Cognac and cognac materials	Litre	8.22	8.22	6.70	6.70	6.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Whiskey, gin, and rum	Litre	4.93	4.93	4.00	4.00	4.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Brandy and brandy materials	Litre	3.28	3.28	2.70	2.70	2.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Vodka	Litre	1.24	1.24	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Liqueur	Litre	3.28	3.28	2.70	2.70	2.70	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Other alcoholic drinks	Litre	1.24	1.24	1.00	1.00	1.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Beer	Litre	3.28	3.28	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12
Ethyl spirits	Litre	0.83	0.83	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70
Tobacco products 3/													
Domestic													
Smoking tobacco	Kilogram	...	20	20	20	20	20	20	20	20	20	20	20
Cigar	Per unit	...	0.15	0.15	0.15	0.15	0.15	0.60	0.60	0.60	0.60	0.60	0.60
Cigarettes (class I and II) 4/	20 units	1.00	0.15	0.15	0.15	0.15	0.15	0.40	0.40	0.40	0.40	0.20	0.20
Cigarettes (other) 5/	20 units	0.55	0.05	0.05	0.05	0.05	0.05	0.30	0.30	0.30	0.30	0.07	0.07
Imported													
Smoking tobacco	Kilogram	20	20	20	20	20	20	20	20	20	20	20	20
Cigar	Per unit	0.25	0.25	0.25	0.25	0.25	0.25	0.60	0.60	0.60	0.60	0.60	0.60
Cigarettes (class I and II) 4/	20 units	0.25	0.25	0.25	0.25	0.25	0.25	0.40	0.40	0.40	0.40	0.40	0.40
Cigarettes (other) 5/	20 units	0.19	0.19	0.19	0.19	0.19	0.19	0.30	0.30	0.30	0.30	0.20	0.20
Jewelry	Percent	35	35 0	35	35	35	35	35	35	35	35	35	0
Passenger automobiles	Percent	15	15 0	15	15	15	15	0.1	0.1	0.1	0.1	0.1	0.1
Passenger automobile tires	Percent	15	15 0	15	15	15	15	15	15	15	15	15	15
Caviar	Percent	20	20 0	20	20	20	20	20	20	20	20	20	20
Ethylated automobile gas	Percent	100	100 0	100	100	...	...	...	...	...	...	...	...
Non-ethylated automobile gas	Percent	60	60 0	60	60	80	80	80	200	200	200	200	200
Other petroleum products (except mazout)	Percent	...	60 0	60	60	60	60	60	200	200	200	200	200

Source: Tax Code of Georgia.

1/ Unless denoted as percentage rates, excises are specific and expressed in lari per unit.
2/ The excise component of the combined fixed tax (that was in effect until January 1, 1999) that was comprised of the import duty, excise, and VAT.
3/ Refers to a single specific tax that is paid in lieu of excise and VAT.
4/ Defined as filtered since July 19, 1999.
5/ Defined as unfiltered since July 19, 1999.

Table A-14. Georgia: Tax Arrears, 1998–2001 1/
(Beginning of period)

	1998		1999		2000		2001	
	January	July	January	July	January	July	January	July
	(In millions of lari)							
Total tax arrears 2/	172.2	216.2	309.6	351.1	456.3	512.0	648.6	670.3
VAT	47.1	59.7	102.5	101.1	130.6	160.7	205.5	211.6
Profit tax	20.9	27.0	46.5	56.7	70.7	82.8	99.5	103.6
Personal income tax	...	...	...	...	...	...	...	...
Excise tax	8.6	16.6	20.2	22.5	155.5	18.1	19.0	22.2
Property tax	...	...	...	...	...	...	...	...
Land tax	16.3	16.7	31.9	38.9	57.8	64.5	88.0	89.3
Other taxes collected by STD	18.5	36.1	58.2	68.2	90.2	108.1	130.4	134.3
Taxes collected by Customs (SCD)	...	...	4.8	...	...	...	...	...
Payroll taxes	60.9	60.2	50.3	63.6	80.2	83.2	120.8	122.1
Pension Fund	60.0	59.0	48.8	61.6	76.7	79.8	116.4	117.5
Employment Fund	0.9	1.2	1.5	2.0	3.5	3.4	4.4	4.6
	(In percent of GDP) 3/							
Total tax arrears 2/	3.8	4.6	6.9	7.2	8.0	8.6	10.5	10.5
VAT	1.1	1.3	2.3	2.1	2.3	2.7	3.3	3.3
Profit tax	0.5	0.6	1.0	1.2	1.2	1.4	1.6	1.6
Personal income tax	...	...	...	...	...	...	...	...
Excise tax	0.2	0.4	0.5	0.5	2.7	0.3	0.3	0.4
Property tax	...	...	...	...	...	...	...	...
Land tax	0.4	0.4	0.7	0.8	1.0	1.1	1.4	1.4
Other taxes collected by STD	0.4	0.8	1.3	1.4	1.6	1.8	2.1	2.1
Taxes collected by Customs (SCD)	...	...	0.1	...	...	...	...	...
Payroll taxes	1.4	1.3	1.1	1.3	1.4	1.4	2.0	1.9
Pension Fund	1.3	1.3	1.1	1.3	1.3	1.4	1.9	1.8
Employment Fund	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1

Sources: Georgian authorities; and Fund staff estimates.

1/ The coverage of tax arrears includes the arrears in contributions to the Pension Fund. Also the data include arrears of taxes collected by the State Customs Department and payroll taxes collected by the Employment Fund. Arrears to the Road Fund and some local governments taxes are excluded.
2/ The data include unpaid penalties for overdue tax payment obligations, hiding income.
3/ Presented as a percentage of GDP in the preceding four quarters.

Table A-15. Georgia: Monetary Survey, 1997--2001 1/

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
	(Stocks, end-of-period; in millions of lari)								
Net foreign assets	-72.2	-376.2	-446.7	-446.1	-446.5	-368.2	-422.2	-433.7	-402.8
Net domestic assets	445.3	744.7	891.2	894.7	926.8	942.0	1040.5	1028.8	1037.9
Domestic credit	567.2	790.5	1080.9	1050.1	1119.7	1171.0	1282.8	1239.5	1270.6
Net claims on general government 2/	357.7	496.5	686.2	654.7	674.6	691.8	766.2	719.2	733.5
Credit to the rest of the economy	209.5	293.9	394.8	395.4	445.1	479.3	516.6	520.3	537.1
Other items, net 2/	-122.0	-45.8	-189.7	-155.4	-193.0	-229.1	-242.4	-210.7	-232.7
Broad money (M3)	373.0	368.5	444.6	448.6	480.3	573.7	618.2	595.1	635.1
Broad money, excluding foreign exchange deposits (M2)	295.2	261.1	286.1	284.1	280.6	327.0	382.1	345.2	362.5
Currency held by the public	239.9	212.2	244.0	233.7	234.3	269.1	315.0	294.9	300.5
Currency in circulation (M0)	254.6	222.0	259.8	249.2	249.0	287.5	329.2	310.0	319.9
Less: Banks' vault cash	-14.7	-9.8	-15.8	-15.5	-14.7	-18.4	-14.2	-15.1	-19.4
Deposit liabilities (domestic currency)	55.3	48.9	42.1	50.4	46.3	57.9	67.1	50.2	62.0
Foreign currency deposits	77.8	107.4	158.4	164.5	199.6	246.8	236.2	250.0	272.6
Total deposit liabilities	133.2	156.3	200.6	214.9	246.0	304.6	303.2	300.2	334.6
	(Flows, with respect to end of previous period; in millions of lari)								
Net foreign assets	-93.4	-303.9	-70.5	0.6	-0.4	78.3	-54.0	-11.5	30.9
Net domestic assets	210.2	299.4	146.5	3.5	32.0	15.2	98.5	-11.6	9.0
Domestic credit	243.4	223.2	290.5	-30.8	69.6	51.3	111.8	-43.3	31.1
Net claims on general government	162.1	138.8	189.7	-31.5	19.9	17.1	74.5	-47.0	14.2
Credit to the rest of the economy	81.3	84.4	100.8	0.7	49.7	34.1	37.4	3.7	16.9
Other items, net	-33.2	76.2	-144.0	34.4	-37.6	-36.1	-13.3	31.7	-22.1
Broad money (M3)	116.8	-4.5	76.0	4.1	31.6	93.5	44.5	-23.1	40.0
Broad money, excluding foreign exchange deposits (M2)	77.3	-34.1	25.0	-2.0	-3.5	46.3	55.1	-36.9	17.3
Foreign currency deposits	39.5	29.6	51.0	6.1	35.1	47.1	-10.6	13.8	22.6
	(Change, as a percent of broad money at the end of the previous year)								
Net foreign assets	-36.4	-81.5	-19.1	0.1	0.0	17.6	5.5	-1.9	3.1
	(Percentage change with respect to the end of the previous year)								
Net domestic assets	89.4	67.2	19.7	0.4	4.0	5.7	16.7	-1.1	-0.2
Broad money (M3)	45.6	-1.2	20.6	0.9	8.0	29.1	39.1	-3.7	2.7
Broad money, excluding foreign exchange deposits (M2)	35.4	-11.5	9.6	-0.7	-1.9	14.3	33.5	-9.7	-5.1
Memorandum items:									
M3 multiplier 3/	1.35	1.42	1.44	1.49	1.63	1.70	1.58	1.66	1.66
M3 velocity 4/	14.0	14.9	13.7	12.5	11.5	10.6	10.7	9.7	10.3

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

1/ Valued at end-period actual exchange rates.

2/ Data for end-March 1999 reflect the issuance of a lari 70.3 million government bond to recapitalize the NBG for losses from revaluation of its international reserves. Data for end-June through end-1999 reflect an estimate of direct borrowing by the government from the commercial banks.

3/ M3 divided by reserve money.

4/ Annualized quarterly GDP divided by end-quarter M3.

Table A-16. Georgia: Accounts of the National Bank of Georgia, 1997–2001 1/

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
	(Stocks, end-of-period; in millions of lari)								
Net foreign assets	-105.2	-389.9	-440.3	-430.7	-446.3	-388.8	-409.4	-430.4	-409.0
Encumbered reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves	-105.2	-389.9	-440.3	-430.7	-446.3	-388.8	-409.4	-430.4	-409.0
Gold	0.7	1.0	1.0	1.0	1.1	1.0	1.0	1.0	1.0
Foreign exchange reserves	262.3	221.5	255.5	237.3	215.5	237.9	216.1	240.8	241.6
Use of Fund Resources	-332.0	-546.3	-617.4	-592.2	-584.5	-554.7	-549.8	-595.6	-578.4
Other foreign assets, net	-36.2	-66.0	-79.5	-76.9	-78.3	-72.9	-76.6	-76.5	-73.3
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	382.3	649.6	748.8	731.9	741.2	726.3	800.6	789.7	792.4
Net claims on general government 2/	360.6	499.6	687.5	660.1	683.8	702.7	782.2	735.5	753.8
Claims on banks	3.5	6.6	1.9	-1.0	0.9	0.4	4.0	-0.7	2.3
Claims on rest of the economy	36.6	66.7	80.9	78.3	79.6	74.2	77.9	77.7	74.3
Other items, net 2/	-18.4	76.8	-21.4	-5.5	-23.1	-51.0	-63.5	-22.7	-38.1
Reserve money	277.1	259.7	308.5	301.2	294.9	337.5	391.2	359.3	383.4
Currency in circulation	254.6	222.0	259.8	249.2	249.0	287.5	329.2	310.0	319.9
Required reserves	15.7	18.0	29.7	33.5	32.7	38.7	38.9	40.9	48.6
Balances on banks' correspondent a/cs	6.9	19.7	19.0	18.5	13.1	11.3	23.1	8.5	15.0
	(Flows, with respect to end of previous period; in millions of lari)								
Net foreign assets	-104.3	-284.7	-50.4	9.6	-15.5	57.4	-20.6	-21.0	21.4
Net international reserves	-104.3	-284.7	-50.4	9.6	-15.5	57.4	-20.6	-21.0	21.4
Net domestic assets	172.5	267.3	99.2	-16.9	9.2	-14.8	74.3	-10.9	2.7
Net claims on general government	151.8	138.9	187.9	-27.4	23.7	18.9	79.5	-46.7	18.3
Claims on banks	-10.3	3.1	-4.7	-2.9	1.9	-0.5	3.6	-4.7	3.0
Other items, net	-5.6	95.2	-98.2	15.9	-17.6	-27.9	-12.5	40.8	-15.3
Reserve money	68.1	-17.3	48.8	-7.3	-6.3	42.6	53.7	-31.9	24.1
Currency in circulation	69.0	-32.6	37.8	-10.6	-0.2	38.5	41.7	-19.2	9.9
Required reserves	1.9	2.4	11.6	3.8	-0.8	6.0	0.2	2.0	7.7
Balances on banks' correspondent accounts	-2.8	12.8	-0.7	-0.5	-5.4	-1.8	11.8	-14.6	6.5
	(Change, as a percent of reserve money at the end of previous year)								
Net foreign assets									
Net international reserves	-49.9	-102.7	-19.4	3.1	-5.0	18.6	-6.7	-5.4	5.5
	(Percentage change, with respect to the end of the previous year)								
Net domestic assets	82.2	69.9	15.3	-2.3	-1.0	-3.0	6.9	-1.4	-1.0
Reserve money	32.6	-6.3	18.8	-2.4	-4.4	9.4	26.8	-8.1	-2.0
Currency in circulation	37.2	-12.8	17.0	-4.1	-4.1	10.7	26.7	-5.8	-2.8

Source: National Bank of Georgia.

1/ Valued at end-of-period actual exchange rates.
2/ Data for end-March 1999 reflect the issuance of a lari 70.3 million government bond to recapitalize the NBG for losses from revaluation of its net international reserves.

Table A-17. Georgia: Summary Accounts of Commercial Banks, 1997–2001 1/

(In millions of lari, end of period)

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Net foreign assets	33.0	13.7	-6.3	-15.4	-0.2	20.6	-12.8	-3.3	6.2
NFA convertible	32.7	13.7	-6.7	-15.4	-0.2	20.6	-12.8	-3.3	6.2
Gold	1.1	0.5	0.2	0.2	0.2	0.0	0.0	0.0	0.0
Foreign exchange	47.2	82.8	93.1	84.8	105.7	130.3	104.8	129.7	140.3
Foreign liabilities	-15.6	-69.7	-100.0	-100.4	-106.0	-109.7	-117.6	-133.0	-134.1
NFA nonconvertible	0.3	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	100.2	142.6	206.9	230.3	246.2	284.0	316.0	303.5	328.4
Domestic credit	170.0	224.2	312.6	311.7	356.3	394.1	422.7	426.4	442.4
Net claims on general government	-2.9	-3.0	-1.3	-5.4	-9.2	-10.9	-16.0	-16.3	-20.4
Net claims on republican government 2/	0.4	5.0	4.4	1.9	-2.4	-4.3	-8.5	-7.9	-8.3
Claims on private sector	172.9	227.3	313.9	317.1	365.5	405.0	438.7	442.7	462.8
Of which: foreign exchange loans	77.0	154.4	234.9	248.9	292.6	326.7	348.1	360.0	362.6
Other assets (net)	-69.9	-81.6	-105.7	-81.4	-110.1	-110.1	-106.7	-122.8	-114.0
Deposit liabilities	133.2	156.3	200.6	214.9	246.0	304.6	303.2	300.2	334.6
Domestic currency deposits	55.3	48.9	42.1	50.4	46.3	57.9	67.1	50.2	62.0
Foreign currency deposits	77.8	107.4	158.4	164.5	199.6	246.8	236.2	250.0	272.6
Memorandum items:									
Share of foreign exchange deposits	58.4	68.7	79.0	76.5	81.2	81.0	77.9	83.3	81.5
Exchange rate (in lari, end-of-period)	1.3	1.8	1.9	1.9	2.0	2.0	2.0	2.1	2.1

Source: National Bank of Georgia.

1/ Valued at end-period actual exchange rates.

2/ Data for end-June through end-December 2000 reflect an estimate of direct borrowing by the government from commercial banks.

Table A-18. Georgia: Developments in the Commercial Banking System, 1997–2001

	1997	1998	1999	2000	2001 Q1	2001 Q2
Number of commercial banks	54	44	37	33	31	29
Former state owned	3	3	3	3	3	3
Other domestic	51	40	32	28	26	24
Foreign branches	0	1	2	2	2	2
			(In millions of lari, end-of-period)			
Assets of commercial banking system	341.0	478.1	618.6	765.2	771.8	802.8
Loans of commercial banks	172.9	238.2	327.2	393.3	404.7	422.0
Lari	95.9	83.8	92.3	73.9	79.0	95.6
Foreign exchange	77.0	154.4	234.9	319.5	325.7	326.4
Deposits of commercial banks	133.2	156.3	200.6	303.3	300.2	334.6
Lari	55.3	48.9	42.1	67.1	50.2	62.0
Foreign exchange	77.8	107.4	158.4	236.2	250.0	272.6
Household deposits of commercial banks	44.1	42.7	66.4	108.4	99.0	106.3
			(In percent of GDP)			
Assets of commercial banking system	7.4	9.5	10.9	12.8	13.4	12.3
Loans of commercial banks	3.7	4.7	5.8	6.6	7.0	6.4
Deposits of commercial banks	2.9	3.1	3.5	5.1	5.2	5.1
Household deposits of commercial banks	1.0	0.8	1.2	1.8	1.7	1.6
			(Annual percent change)			
Loans of commercial banks	34.9	37.8	37.4	20.2	2.9	4.3
Lari	15.3	-12.6	10.1	-20.0	6.9	21.0
Foreign exchange	71.1	100.5 1/	52.1	36.0	1.9	0.2
Deposits of commercial banks	62.4	17.3	28.3	51.2	-1.0	11.5
Lari	26.5	-11.6	-13.9	59.4	-25.1	23.4
Foreign exchange	103.1	38.0	47.5	49.1	5.8	9.1
			(In percent)			
Loan to deposit ratio	129.8	152.4	163.1	129.7	134.8	126.1
Lari	173.4	171.4	219.2	110.1	157.2	154.2
Foreign exchange	99.0	143.8	148.3	135.2	130.3	119.7
Memorandum items:						
Broad money (M3, in millions of lari)	373.0	368.5	444.6	618.2	595.1	635.1
In percent of GDP	8.0	7.3	7.8	10.4	10.3	9.7
Currency outside of NBG (in millions of lari)	239.9	212.2	244.0	315.0	294.9	300.5
In percent of broad money (M1/M3)	64.3	57.6	54.9	51.0	49.6	47.3
In percent of GDP	5.2	4.2	4.3	5.3	5.1	4.6
Nominal GDP (in millions of lari)	4,639	5,041	5,665	5,955	1,444	1,637

Source: National Bank of Georgia.

1/ Excluding the effects of the devaluation of the lari at end-1998, foreign exchange denominated loans would have increased by 30 percent.

Table A-19. Georgia: Structure of Commercial Bank Deposits, 1997–2001

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
	(In millions of lari, end-of-period)								
Domestic currency deposits	55.3	48.9	42.1	50.4	46.3	57.9	67.1	50.2	62.0
Deposits of enterprises 1/	45.0	41.5	34.9	44.4	40.1	50.5	58.6	45.9	57.3
Deposits of households/individuals	10.3	7.4	7.3	6.0	6.2	7.4	8.5	4.3	4.7
Foreign currency deposits	77.8	107.4	158.4	164.5	199.6	246.8	236.16	250.0	272.6
Deposits of enterprises 1/	44.0	72.1	99.3	97.5	116.5	154.3	136.16	155.26	171.0
Deposits of households/individuals	33.8	35.3	59.1	67.0	83.1	92.5	100.0	94.7	101.6
Total deposits	133.2	156.3	200.6	215.0	246.0	304.6	303.2	300.2	334.6
Deposits of enterprises 1/	89.0	113.6	134.2	142.0	156.7	204.7	194.8	201.2	228.3
Deposits of households/individuals	44.1	42.7	66.4	73.0	89.3	99.9	108.4	99.0	106.3
	(In percent of total)								
Domestic currency deposits	41.5	31.3	21.0	23.5	18.8	19.0	22.1	16.7	18.5
Deposits of enterprises 1/	33.8	26.6	17.4	20.7	16.3	16.6	19.3	15.3	17.1
Deposits of households/individuals	7.7	4.7	3.6	2.8	2.5	2.4	2.8	1.4	1.4
Foreign currency deposits	58.5	68.7	79.0	76.5	81.2	81.0	77.9	83.3	81.5
Deposits of enterprises 1/	33.1	46.1	49.5	45.3	47.4	50.6	45.0	51.8	51.1
Deposits of households/individuals	25.4	22.6	29.5	31.2	33.8	30.4	32.9	31.5	30.4
Total deposits	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Deposits of enterprises 1/	66.9	72.7	66.9	66.0	63.7	67.2	64.3	67.1	68.2
Deposits of households/individuals	33.1	27.3	33.1	34.0	36.3	32.8	35.7	32.9	31.8
Memorandum items:									
Foreign currency deposits (In millions of U.S. dollar) 2/	59.7	59.7	82.1	85.2	101.8	125.9	119.3	121.0	132.9
Exchange rate (lari/U.S. dollar; end-of-period)	1.3	1.8	1.9	1.9	2.0	2.0	2.0	2.1	2.1

Sources: National Bank of Georgia

1/ Including deposits of cooperatives, state companies, and so-called public organizations.
2/ Reported data in domestic currency, converted at end-period exchange rate.

Table A-20. Georgia: Composition of Bank Loans by Economic Activity, 1997–2001
(In percent of total loans, end-of-period)

	1997	1998	1999	2000	2001	
					Q1	Q2
Government sector	11.4	9.6	10.6	8.1	7.0	6.1
Trade	0.0	0.2	1.1	2.7	1.0	0.6
Industry	3.6	2.7	0.5	1.5	2.0	1.8
Construction	0.4	0.2	1.0	0.5	1.0	0.3
Communication	0.3	0.1	3.4	0.0	0.0	0.1
Agriculture	1.0	0.7	0.5	0.2	0.0	0.0
Culture	0.3	0.1	0.0	0.0	0.0	0.0
Transport	0.5	0.8	0.2	0.0	0.0	0.0
Energy	1.5	2.6	1.1	1.8	2.0	2.1
Other	3.9	2.3	2.8	1.4	1.0	1.2
Non-government sector	88.6	90.4	89.4	91.9	93.0	93.9
Trade	70.4	62.9	61.4	64.7	65.0	65.0
Industry	9.3	18.8	17.3	17.0	19.0	20.5
Construction	3.1	4.5	5.9	5.7	6.0	5.5
Agriculture	5.9	4.2	4.8	4.5	3.0	2.9

Source: National Bank of Georgia.

Table A-21. Georgia: Currency Composition of Commercial Bank Credit, 1997–2001 1/

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
				(In millions of lari)					
Credit to the economy 2/	172.9	227.3	313.9	317.1	365.5	405.0	438.7	442.7	462.8
Domestic currency claims	95.9	83.8	92.3	82.9	82.4	83.3	90.6	82.6	100.3
Foreign currency claims	77.0	143.5	221.6	234.2	283.1	321.7	348.1	360.0	362.6
				(In percent of total)					
Credit to the economy 2/	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Domestic currency claims	55.5	36.9	29.4	26.1	22.5	20.6	20.6	18.7	21.7
Foreign currency claims	44.5	63.1	70.6	73.9	77.5	79.4	79.4	81.3	78.3
Memorandum items:									
Exchange rate (lari/US$; end-of-period)	1.3	1.8	1.9	1.9	2.0	2.0	2.0	2.1	2.1

Source: National Bank of Georgia

1/ Excluding claims of the Savings Bank before July 1995.
2/ Credit to the nongovernment sectors.

Table A-22. Georgia: Interest Rates, 1997–2001
(In percent per annum, non-compounded)

	1997	1998	1999	2000				2001	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Commercial banks (3-month) 1/									
Deposits	15.5	12.5	12.5	9.0	13.5	10.5	11.0	9.5	8.5
Domestic currency	14.0	10.0	12.0	6.0	15.0	9.0	10.0	8.0	7.0
Former state banks	4.9	11.9	11.8	12.7	12.7	12.8	13.0	11.4	10.4
Other	14.5	8.5	12.4	3.3	16.4	8.1	9.8	7.9	6.6
Foreign currency	17.0	15.0	13.0	12.0	12.0	12.0	12.0	11.0	10.0
Former state banks	12.0	11.5	10.0	10.0	10.3	9.7	10.0	8.8	9.6
Other	20.0	16.7	14.6	12.9	13.1	13.2	12.7	11.9	10.2
Loans	45.0	45.0	32.0	38.5	34.0	33.5	30.0	30.5	29.5
Domestic currency	45.0	38.0	24.0	39.0	30.0	32.0	25.0	28.0	27.0
Former state banks	51.8	59.3	46.5	41.0	41.3	46.2	36.1	33.7	33.0
Other	41.5	32.1	21.6	38.7	25.9	27.6	20.7	25.7	24.8
Foreign currency	45.0	52.0	40.0	38.0	38.0	35.0	35.0	33.0	32.0
Former state banks	35.5	72.3	44.9	39.9	44.1	44.2	41.5	40.5	34.5
Other	47.1	46.2	38.4	37.0	36.0	32.0	33.1	30.4	29.4
Interbank credit auction									
7-day	33.1	...	27.0	18.2	18.0	13.5	...	...	...
1-month	48.1	...	29.0	22.7	21.2	12.4	6.3	15.5	14.0
2-month	...	...	...	...	...	...	...	...	...
3-month	...	...	...	...	...	...	...	18.0	15.0
Interest rate spread 2/	29.5	32.5	19.5	29.5	20.5	23.0	19.0	21.0	21.0
In domestic currency	31.0	28.0	12.0	33.0	15.0	23.0	15.0	20.0	20.0
In foreign currency	28.0	37.0	27.0	26.0	26.0	23.0	23.0	22.0	22.0
Memorandum item:									
12-month inflation	7.3	10.7	10.9	1.1	2.3	6.4	4.6	5.9	6.2

Source: National Bank of Georgia.

1/ Average weighted interest rates on deposits and loans.
2/ Defined as lending rate minus deposit rates.

Table A-23. Georgia: Prudential Indicators of Commercial Banks, 1997–2001
(End-of-period)

	1997	1998	1999	2000	2001	
					Q1	Q2
Capital adequacy ratio (in percent)	30.6	34.9	38.5	36.7	35.7	34.3
Leverage ratio1/	45.0	43.5	45.6	44.2	44.9	46.6
Nonperforming loans (in percent of total loans)	5.9	4.6	6.8	7.4	8.8	21.9
Specific provisions (in precent of total loans)	5.4	3.1	2.6	4.7	2.7	6.5
Loans collateralized by real estate (in percent of total loans)	...	...	...	...	...	...
Loans in foreign exchange in percent of total loans	44.5	64.8	71.8	81.4	80.3	77.6
Net foreign assets (in millions of lari)	33.0	13.7	-6.3	-12.7	-3.3	6.1
Net foreign assets (in percent of total assets)	9.7	2.9	-1.1	-1.7	-0.4	0.8
Net open foreign exchange position 2/	n.a.	18.1	15.2	15.7	10.9	21.9
Liquidity ratio (in percent)	37.8	44.5	40.3	36.8	34.2	40.0

Source: National Bank of Georgia.

1/ Definied as the ratio of total capital to total liabilities; an increase in the ratio indicates an improvement.
2/ Percent of Total Regulatory Capital.

Table A-24. Georgia: Regulatory Framework for Commercial Banks as of July 1, 2001 1/

Type	Prudential Regulation
1 Compulsory Standards	
Capital Adequacy Ratios	
Tier One Capital 2/	12 percent (risk-weighted) of total assets 3/
Total Capital 4/	15 percent (risk-weighted) 3/
Liquidity Indicator	Maintain liquid assets at least 30 percent of short-term liabilities (with maturity one year)
Limits on Lending	
Lending to a single insider	5 percent of total capital
Total lending to all insiders	25 percent of total capital
Lending to a single outsider	15 percent of total capital
Total lending to the 10 largest borrowers	50 percent of total loans
Loan Loss Provisioning Requirements	2 percent for performing loans 10 percent for watch loans 30 percent for sub-standard loans 50 percent for doubtful loans 100 percent for loss loans
Minimum Capital Licensing Requirements	
For New Banks	Lari 5 million
For existing Licensed Banks	Lari 5 million
Required Reserves	14 percent of total deposits
Foreign Exchange	Overall foreign exchange open position limit is 20 percent of total capital
Off-Site Supervision	Quarterly off-site monitoring
On-Site Supervision	At least once a year on-site inspection
2 Recommended Guidelines	
Limit on Fixed Assets	Net fixed assets must not exceed 30 percent of equity capital
Limit on Current Assets	Current assets must not be less then 90 percent of current liabilities
3 Other Requirements	
Limit on Ownership by any one Shareholder	For individuals and non-bank companies 25 percent
Financial Statements and Ratio Calculations	Monthly reporting
Annual Audits	To be performed by certified and recognized independent audit company
Deposit Protection	None
Money Laundering Regulations	None
Sanctions	According to the law and special regulations

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

1/ BIS (Bank for International Settlements) recommended standards, which were adopted in September 1997, are the minimum requirements.
2/ "Tier One Capital" includes: (I) common share capital; (II) retained earnings; (III) capital surplus; (IV) less revaluation of fixed assets recorded in share capital; (V) less any treasury stocks; (VI) less intangible assets, goodwill.
3/ Regulations on classification of assets by the underlying risk is effective from January 1, 1999.
4/ "Total Capital" includes: (I) tier one capital plus (II) tier two capital, which must not exceed 50 percent of tier one capital; (III) less investments in Georgian resident banks' capital; (IV) less non-consolidated investments in subsidiaries capital.

Table A-25. Georgia: Balance of Payments, 1997–2001
(In millions of U.S. dollars; unless otherwise indicated)

	1997	1998	1999	2000	Q1 2001 Preliminary
Current account (including transfers) 1/	-374.9	-388.5	-238.0	-161.7	-71.8
Trade balance	-558.9	-685.4	-549.3	-361.0	-120.6
Exports	493.5	478.3	477.0	645.5	107.0
Imports	-1,052.4	-1,163.7	-1,026.3	-1,006.5	-227.7
Non-factor services	-148.0	-31.1	14.3	84.9	16.5
Credits	167.9	242.1	261.6	490.4	116.9
Debits	-315.9	-273.2	-247.3	-405.5	-100.5
Factor services	135.7	117.3	121.4	14.4	11.5
Credits	186.6	193.3	206.1	88.7	24.5
Debits	-50.9	-76.0	-84.7	-74.3	-13.0
Transfers	196.4	210.7	175.6	100.1	20.9
Capital account	267.1	247.9	79.2	90.0	17.0
Medium- and long-term borrowing	52.4	30.0	1.5	-74.8	-17.1
Disbursements	105.9	111.9	95.5	34.7	12.8
Amortization due	-53.5	-81.9	-94.0	-109.5	-30.0
Other capital	214.7	217.9	77.7	164.8	34.1
Errors and omissions	-30.4	15.9	94.2	7.8	14.1
Overall balance	-138.2	-124.6	-64.6	-63.9	-40.7
Overall financing	138.2	124.6	64.6	63.9	40.7
Increase in net international reserves (-) 2/	-15.3	54.9	-14.0	23.0	-7.5
Exceptional financing 3/	153.5	69.7	78.6	41.0	48.2
Memorandum items:					
Current account including transfers (in percent of GDP)	-10.5	-10.7	-8.5	-5.4	-9.9
Gross international reserves	173.3	118.4	132.4	109.4	116.9
In months of imports of goods and non-factor services	1.5	1.0	1.2	0.9	1.1

Sources: Georgian State Department and Statistics, and National Bank of Georgia; and Fund staff estimates.

1/ From 2000 onwards, the current account is based on a new series estimated by the NBG that is not consistent with data prior to 2000.
2/ Includes a valuation adjustment.
3/ Includes arrears, debt relief, and macroeconomic support.

Table A-26. Georgia: Geographic Distribution of Trade, by Country, 1998–2001
(In percent of total)

	1998	1999	2000	2001 Q1	2001 Q2
Exports					
Total	100.0	100.0	100.0	100.0	100.0
Russia	28.7	18.7	21.1	20.1	21.0
Turkey	10.5	15.8	22.7	24.9	20.7
Azerbaijan	9.6	8.1	6.4	3.5	3.5
Armenia	9.3	6.3	4.1	2.5	5.2
Germany	6.9	10.3	10.4	3.4	1.9
United States	5.8	4.2	2.2	2.2	1.7
Italy	4.7	4.5	3.8	4.9	2.4
Ukraine	4.4	4.6	3.3	4.3	2.5
France	3.2	0.3	0.4	0.2	0.1
Switzerland	2.8	2.4	4.1	7.0	5.5
Netherlands	1.7	0.9	0.6	2.3	1.2
Bulgaria	1.6	0.2	0.7	0.1	0.1
Others	10.8	23.7	20.1	24.7	34.2
Imports					
Total	100.0	100.0	100.0	100.0	100.0
Russia	14.8	19.2	14.1	15.0	14.4
Turkey	11.1	12.2	16.0	13.4	14.3
Azerbaijan	8.3	6.9	8.5	9.0	11.5
Germany	9.3	7.3	7.7	9.0	9.5
United Kingdom	7.7	3.5	3.5	4.9	2.1
United States	8.6	11.9	5.5	8.9	7.0
Switzerland	3.7	0.2	3.5	1.5	1.8
Ukraine	3.5	4.5	5.4	5.4	10.1
Bulgaria	3.1	1.9	2.4	1.4	1.6
Italy	3.3	2.0	2.7	3.4	2.1
Netherlands	2.9	2.0	1.2	1.4	1.2
France	2.5	5.0	1.7	2.6	2.7
Romania	2.1	2.1	2.0	0.9	0.7
Others	19.1	21.3	25.7	23.4	21.0

Source: Georgian State Department of Statistics.

Table A-27. Georgia: Composition of Major Exports, 1997–2001 1/
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	
					Q1	Q2
Scrap Blak Metals	...	1.0	23.5	37.8	9.0	7.2
Ferro alloys	15.5	22.3	20.1	13.6	1.0	6.0
Aluminium waste and scrap.	...	0.1	1.5	12.7	4.4	4.3
Non-ferrous metal pipes	17.5	6.4	0.0	0.0	...	...
Crude oil and related oil products	14.4	5.7	4.8	12.8	2.9	2.7
Oil and oil products	13.4	9.2	7.1	6.4	1.0	2.6
Tea	18.5	8.9	11.4	6.1	1.0	1.1
Fertilizers	13.8	10.6	11.4	16.2	1.3	2.2
Citrus fruits (including dry fruits)	9.1	9.5	1.9	2.5	0.1	0.0
Copper ore	14.1	15.1	1.0	9.8	2.6	2.5
Alcoholic beverage (excluding wine)	5.2	5.5	5.5	4.0	1.2	1.3
Wine and related products	12.5	15.4	14.6	29.1	6.2	8.3
Non alloyed steel and cast iron	9.3	6.2	0.0	0.5	0.0	0.0
Mineral water	18.5	7.2	2.6	9.5	1.5	2.0
Electricity	11.9	5.5	9.7	7.2	0.0	3.8
Others	66.1	63.8	123.1	161.7	30.9	40.0
Total exports	239.8	192.3	238.2	329.9	63.0	84.1

Source: Georgian State Department of Statistics.

1/ The analysis is based on the raw data provided by the State Department of Statistic, Tbilisi, Georgia, that cover only recorded trade. Total exports differ significantly from staff estimates in the balance of payments table that include estimates of unrecorded trade.

Table A-28. Georgia: Composition of Major Imports, 1997–2001 1/
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001 Q1	2001 Q2
Oil and oil products (excluding crude oil)	152.2	130.3	57.7	71.9	17.3	22.3
Oil, gas, and related products	75.8	58.5	62.4	48.6	17.9	17.4
Sugar	39.1	16.2	16.2	24.6	3.6	2.6
Cigars and cigarettes	107.8	120.0	35.2	29.4	3.0	5.4
Electricity	26.8	25.7	14.6	15.1	8.8	2.9
Wheat and flour	37.1	26.5	14.8	20.3	5.1	3.9
Beer	3.1	0.8	0.1	0.1	0.0	0.0
Wheat and rye byproducts	57.2	31.8	15.5	21.9	4.6	2.2
Sunflower and cotton oil	2.2	4.7	1.1	1.0	0.5	0.3
Poultry products	10.2	12.3	14.5	11.0	4.0	3.5
Medicine	36.7	36.9	41.7	34.1	9.5	10.5
Coffee and coffee substitute	9.0	5.4	5	4.3	1.1	0.7
Radio receiver	0.7	1.1	0.1	1.2	0.0	0.0
Automobiles	45.3	65.2	37.7	15.2	3.7	3.3
Electronic devices	5.5	8.4	7.9	4.9	1.6	1.3
Pipes and other related products	14.2	28.9	1.5	2.7	0.5	1.3
Others	318.8	311.6	275.9	344.3	93.8	111.3
Total imports	941.7	884.3	601.9	650.7	175.1	188.9

Source: Georgian State Department of Statistics.

1/ The analysis is based on the raw data provided by the State Department of Statistic, Tbilisi, Georgia, that cover only recorded trade. Total imports differ significantly from staff estimates in the balance of payments table that include estimates of unrecorded trade.

Table A-29. Georgia: External Debt Outstanding, 1994-2001
(In millions of U.S. dollars)

	1994	1995	1996	1997	1998	1999	2000	2001 Q1	2001 Q2
Total debt outstanding	1,003.9	1,216.7	1,357.2	1,512.4	1,629.4	1,701.2	1,609.7	1,632.6	1,617.6
Public and publicly guaranteed	1,003.9	1,216.7	1,357.2	1,512.4	1,629.4	1,676.1	1,591.7	1,615.5	1,600.6
Multilateral	193.2	364.5	520.3	655.5	764.7	829.2	793.4	811.2	803.4
World Bank	1.0	86.0	162.7	227.0	300.5	358.8	377.3	385.4	391.3
IMF	40.5	116.1	189.5	257.8	302.1	319.0	289.1	296.3	286.1
European Union	151.7	160.8	155.1	145.5	129.8	116.8	90.0	92.3	87.3
Other	0.0	1.6	12.8	25.2	32.3	34.7	37.1	37.2	38.7
Bilateral	810.7	852.2	836.9	856.9	864.7	846.9	798.2	804.3	797.2
BRO	655.9	684.3	634.5	638.3	618.7	593.6	559.0	559.0	559.0
Russia	156.3	167.1	175.4	179.3	179.3	179.3	156.9	156.9	156.9
Turkmenistan 1/	440.3	453.2	393.6	393.6	373.9	348.9	336.9	336.9	336.9
Armenia	18.1	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6
Azerbaijan	15.0	15.7	16.2	16.2	16.2	16.2	16.2	16.2	16.2
Kazakhstan	24.1	26.7	27.8	27.8	27.8	27.8	27.8	27.8	27.8
Other	2.0	2.0	2.0	1.9	1.9	1.9	1.7	1.7	1.7
Non-BRO	154.8	167.9	202.4	218.6	246.1	253.2	239.2	245.3	238.1
Turkey	42.0	45.4	47.9	54.3	54.3	54.3	54.3	54.3	54.3
Austria	97.4	104.2	110.3	90.0	90.0	83.8	70.7	72.5	68.5
Germany	0.0	2.8	27.6	33.3	46.4	51.7	49.5	54.1	51.2
USA	0.0	0.0	0.0	19.9	34.7	42.5	42.2	42.0	42.0
Others	15.4	15.6	16.6	21.0	20.6	20.8	22.5	22.4	22.1
Private non-guaranteed	0.0	0.0	0.0	0.0	0.0	25.2	18.1	17.0	17.0

Sources: Georgian authorities; and Fund staff estimates.

1/ At end-2000, Georgia was in arrears to Turkmenistan in the amount of US$179.5 million.

Table A-30. Georgia: External Debt Service Obligations, 1998–2001
(In millions of U.S. dollars)

	1998			1999			2000			Q1–Q2 2001		
	Interest	Principal	Total	Interest	Principal	Total	Interest	Principal	Total	Interest	Principal	Total
Total debt service due	42.2	82.9	125.1	47.2	115.5	162.7	47.5	136.1	183.6	15.0	9.3	24.4
Medium/long term	42.2	82.9	125.1	47.2	115.5	162.7	47.5	136.1	183.6	15.0	9.3	24.4
Public and publicly guaranteed	42.2	82.9	125.1	47.2	115.5	162.7	46.8	134.0	180.8	14.7	8.3	23.0
Official creditors	42.2	82.9	125.1	47.2	115.5	162.7	46.7	133.6	180.3	14.7	8.1	22.8
Multilateral	9.4	3.8	13.2	13.2	36.0	49.3	13.3	31.1	44.4	7.0	8.1	15.1
Bilateral	32.9	79.0	111.9	34.0	79.5	113.4	33.4	102.6	135.9	7.6	--	7.6
Private creditors	--	--	--	--	--	--	0.1	0.4	0.5	0.1	0.2	0.2
Private non-guaranteed	--	--	--	--	--	--	0.7	2.1	2.8	0.3	1.0	1.4
Short term	--	--	--	--	--	--	--	--	--	--	--	--
Memorandum items:												
Debt service (percent of exports of GNFS)	5.9	11.5	17.4	6.4	15.6	22.0	4.2	12.0	16.2	3.0	1.9	4.9

Sources: Georgian authorities; and Fund staff estimates.

Table A-31. Georgia: Exchange Rates, 1997–2001 1/

	Lari per U.S. dollar		Lari per thousands of ruble		NEER 2/	REER 2/
	Period average	End-of-period	Period average	End-of-period	End-of-period	End-of-period
1997 Q1	1.298	1.294	0.220	0.220	131.2	136.2
Q2	1.299	1.300	0.220	0.230	135.9	136.7
Q3	1.295	1.298	0.220	0.220	142.9	135.8
Q4	1.308	1.304	0.220	0.220	144.8	136.7
Year	1.300	1.304	0.220	0.220	138.7	136.4
1998 Q1	1.327	1.335	0.220	0.219	149.9	138.6
Q2	1.342	1.348	0.218	0.217	152.0	135.8
Q3	1.350	1.364	0.169	0.085	165.4	133.3
Q4	1.544	1.790	0.086	0.086	144.8	136.7
Year	1.391	1.790	0.173	0.086	153.0	136.1
1999 Q1	2.199	2.215	0.094	0.090	135.5	112.1
Q2	2.059	1.940	0.083	0.080	154.0	124.5
Q3	1.875	1.850	0.075	0.073	173.8	130.2
Q4	1.951	1.960	0.074	0.071	174.3	129.5
Year	2.021	1.960	0.082	0.071	159.4	124.1
2000 Q1	1.991	1.950	0.071	0.069	180.8	131.3
Q2	1.976	1.968	0.069	0.070	188.1	132.1
Q3	1.965	1.964	0.070	0.071	192.7	132.2
Q4	1.974	1.971	0.070	0.069	196.7	135.6
Year	1.977	1.975	0.070	0.070	189.6	132.8
2001 Q1	2.049	2.066	0.072	0.072	193.1	130.6
Q2	2.062	2.060	0.071	0.071	212.9	136.8

Sources: National Bank of Georgia; IMF, Information Notice System; and Fund staff estimates.

1/ Lari exchange rates are those prevailing on the Tbilisi Interbank Foreign Exchange (TIBFEX).
2/ Nominal effective exchange rate and real effective exchange rate. Index, 1995=100. Increase indicates appreciation.