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NEWSLETTER
Issue No. 16 | May – June 2017

New IMF programme: Good news for Georgia

In April 2017 the IMF approved a new programme for Georgia worth USD 285 m over a three year period. The new programme under the Extended Fund Facility replaces the previous Stand-by Arrangement, which got derailed because of fiscal slippages in the run-up to parliamentary elections last year.

A key goal of the new programme is fiscal consolidation: The budget deficit is planned to go down from 3.7% of GDP in 2017 to 2.8% of GDP by 2020. At the same time, public investment is to be increased at the expense of current spending, with a positive impact on long-term economic growth. The National Bank of Georgia (NBG) is to continue its policy of inflation targeting and exchange rate flexibility. Furthermore, the programme secures the NBG's role as the banking supervisor and foresees a range of measures for increasing the soundness of the banking system.

Structural reforms also play a key role in the new programme. The education system is to be reformed and the conditions for attracting FDI are to be improved. Furthermore, the introduction of a second pillar in the pension system aims at further developing capital markets.

All in all, the new IMF programme is good news for the country. At the same time, there is a lot to be done beyond the programme. This applies especially to agriculture and light industry, where significant potential cannot be utilised because of structural issues. As a result, economic growth remains unbalanced, with a bias towards services such as tourism. Thus, economic policy must go beyond implementing the IMF programme.

The previous Stand-by Arrangement

In July 2014 the IMF approved a Stand-by Arrangement ("SBA") for Georgia amounting to USD 154 m over a period of three years. The programme aimed at facilitating Georgia`s adjustment to external shocks. However, only 80% of the envisaged sum was disbursed. The government's intention to take away banking supervision from the NBG and large spending plans in the run-up to the elections in 2016 led to the derailing of the arrangement. Once the SBA got derailed, fears arose that the country's budget deficit might get out of control.

New programme under the Extended Fund Facility

After elections in October 2016, the government made significant fiscal corrections and set up a budget for 2017 with a "modest" deficit of 3.7% of GDP. Furthermore, plans to remove banking supervision from the NBG were completely abandoned.

These two measures paved the way for the approval by the IMF of a new programme in April 2017, which foresees the disbursement of USD 285 m over the course of three years under the Extended Fund Facility (EFF).

Programmes under the EFF focus not only on macroeconomic stability, as is usually the case in SBAs, but also on structural reforms. In such a way, they tackle long-term growth issues such as infrastructure or education.

Fiscal consolidation and public investment

The IMF programme entails a process of fiscal consolidation. While the budget deficit is planned at 3.7% of GDP in 2017, it will get down to 2.8% of GDP by 2020. In case the revenue losses from the corporate tax reform that started in January 2017 are higher than expected, the government has to identify additional measures to increase revenues. Furthermore, to keep revenue losses from the tax reform below a reasonable limit, the government agreed not to expand the reform to banks and insurance companies.

Additionally to the deficit reduction, another priority in budget policy is a shift in the expenditure structure towards more capital investment including projects by state-owned enterprises. Thus, public investment is to increase from 3.5% of GDP in 2016 to 7.5% in 2020. On the other hand, current expenditures, which had been increasing in the last years, are to be cut from 27% of GDP in 2016 to 21% in 2020. In particular, the public wage bill and administrative costs have to be reduced, efficiency in healthcare provision is to be increased by reducing overlaps between private and public health insurance and a cost-effective framework for public-private partnerships shall be set up.

Monetary policy and financial sector

The IMF programme foresees a continuation of the NBG's policy of inflation targeting and exchange rate flexibility. This policy was crucial for absorbing negative external economic shocks since 2014. The inflation target shall be decreased from 4% in 2017 to 3% in 2018.

To mitigate the risks stemming from the high level of dollarisation (70% of deposits are in foreign currency), regulatory measures are foreseen. However, in addition to the IMF programme, the NBG adopted a quite sophisticated 10-points-plan on reducing dollarisation, which it already has started to implement. This shows

that crucial policy measures are also possible beyond the framework of an IMF programme.

In order to improve the safety of the banking sector, a deposit guarantee scheme will be developed and put into effect by January 2018. This is also a requirement of the free trade agreement ("DCFTA") with the EU. Furthermore, the NBG is to be empowered to put banks under temporary administration at an early stage of financial distress.

Structural reforms

The IMF programme expects growth of the Georgian economy to increase from 4% annually to 5% by 2020. For this to happen, structural reforms in several fields are to be implemented.

Firstly, FDI in the main exporting sectors shall be attracted by improving insolvency procedures and contract enforcement, which are the main shortcomings of the otherwise good business climate.

Secondly, a reform of the education system shall lead to a better match of professional qualifications and skills demanded at the labour market, thus contributing to the reduction of the high level of unemployment. Therefore, changes in the curricula, a new teacher policy framework, vocational training and adult learning are to be introduced or expanded.

Thirdly, the programme foresees measures for the further development of domestic capital markets. A second pillar in the pension system is to be introduced by the end of 2017, thus creating a partly-funded pension system. Furthermore, the issuance of government bonds will be promoted. Finally, corporate bonds shall contribute to deepen capital markets.

Assessment of the programme

In our view, the IMF programme will have a positive impact on the country. It underlines the government's intention to return to a sustainable fiscal path, after fiscal slippages in 2016. It contributes to ensuring the independency of the National Bank, whose policy was key in absorbing negative external shocks and in avoiding problems in the banking sector, in contrast to many countries in the region which suffer from serious banking crises.

Furthermore, it supports Georgia to tackle structural issues such as infrastructure bottlenecks, the education system und FDI-related problems. In such a way, the programme could help to increase the international competitiveness and exports, thus reducing the persistently large current account deficit, which is projected to reach almost 13% of GDP this year.

What is more, the IMF's engagement in the country is a positive and much needed signal for investors, who need to rely on a stable monetary policy and sustainable fiscal spending.

Having said that, we think that there is room for additional policy measures beyond the IMF programme. In particular, there is a need to tackle structural issues in agriculture and light industry. The development of these sectors is of strong economic and social importance and would contribute towards more balanced growth, which is not only based on already successful sectors such a tourism and transport. Thus, the IMF programme is good news, but economic policy is much more than just implementing the programme.

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