

SECTOR ASSESSMENTS (SUMMARY): FINANCE AND PUBLIC SECTOR MANAGEMENT¹

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. After the deep recession that followed the twin crises in 2008 (conflict with the Russian Federation and the global financial crisis), Georgia has witnessed a strong rebound. The impact of the twin crises on Georgia's finance sector was deleveraging and increased credit losses associated with a sharp contraction in lending to the private sector. Effective implementation of post-crisis measures contributed to the recovery, beginning in early 2010. However, while economic policies since 2004 have been successful in terms of investment and increasing economic growth, reducing poverty and promoting shared growth are challenges in Georgia. Income distribution remains relatively skewed, with a Gini coefficient of 0.42. Unemployment continues to be a challenge despite the rapid growth of the economy, and stood at 14.6% of the labor force in 2013, down from 15.0% in 2012. High unemployment contributes to the weak link between growth and poverty reduction, with absolute poverty affecting 22.4% of the population in 2012. Average monthly income per household increased during 2006–2013 from GEL385.3 to GEL887.2, with a corresponding decline in the relative poverty level (share of population under 60% of median consumption) from 23.3% to 21.4%.

2. Public sector management in Georgia has been improving as a result of a number of institutional reforms and capacity building measures undertaken by the government since 2004. However, weaknesses remain which reduce the efficiency of public resources, pose risks to macroeconomic stability, negatively affect the business environment, and hinder economic growth and poverty reduction. Public investment management is weak; there are frequent changes in procurement rules and regulations, inadequate monitoring and analysis of government contingent liabilities, and weak internal audit units of many government agencies. Lack of assessment and monitoring of contingent liabilities exposes the government to fiscal risks in the medium term. The transparency and equalization dimension of intergovernmental transfers is inadequate. Revenue and expenditure of legal entities of public law (LEPLs) and local governments are not always included in budget execution reports. Legislative scrutiny of external audit reports is generally weak. Strengthening public sector management can increase national savings; improve the legal, regulatory, and institutional framework for private sector development; and help increase domestic resource mobilization. Introducing a contributory pension scheme, an effective competition agency, tax reforms, an improved legal and regulatory framework for public–private partnerships (PPPs), and strengthened capital budgeting and public debt management can also improve public sector management.

3. Savings mobilization is low, with private pension funds being voluntary and underdeveloped. Noncontributory pensions constitute the largest social spending item in the state budget, accounting for 18% of public expenditure in 2013 and 4% of gross domestic product (GDP), a cost which is likely to increase as the population ages, raising the question of fiscal sustainability. At the same time, the existing pension system is a major instrument of poverty reduction. All Georgian citizens are granted the right to receive pension benefits at any time after the age of 60 for women and 65 for men. While the state-funded pension has risen

¹ This summary is based on: ADB. 2013. *Georgia's Financial Sector, Boosting Access and Development. R-CDTA Regional Financial Sector Development in Central and West Asia*. Manila; draft finance sector assessment and public sector management assessment linked to the draft country partnership strategy, 2014–2018; and consultant reports on pension reform and public sector management (available on request).

considerably since 2004 to its present level of GEL150 per month, it is slightly below the average subsistence level of GEL153 per month. The current pension structure needs improvement to ensure both fiscal sustainability and adequate pension levels over the medium term. Growth of pension and other savings will create an important additional source of investment, and strengthen the country's social safety net. These long-term funds could be invested to stimulate development of capital markets, especially interbank money markets and secondary debt markets, which is critical for domestic resource mobilization. More expansive and efficient capital markets will be necessary to absorb pension inflows and generate reasonable returns. In the design of a new pension system it is also essential to take gender impact into account, as women are less likely to work in formal sectors, generally earn lower wages, and may perform other nonpaid labor.

4. The securities market in Georgia is at an early stage of development. The market consists of the Georgia Stock Exchange (GSE) and Georgia Central Securities Depository. There are seven brokerage companies. As of 31 December 2013, 129 companies were admitted on the GSE (three of which are on the A and B listing at the GSE). In 2013, over-the-counter trades of 38 securities were fixed at the GSE with a total volume of \$30 million. In the GSE system, only five securities were traded during 2013, with a total trade volume of \$305,000. The regulatory framework is still evolving, there are gaps in the required capacity and technology to trade equities and bonds, and demand is weak. Growth in securities is constrained by a limited investor base because of the absence of institutional investors and dollarized financial markets, a lack of trust in the local currency and institutions, and poor liquidity. Reforms of the pension system will address some of the challenges but, without greater capacity in the local fixed-income market, fund managers would have to invest in foreign currency, thereby increasing foreign exchange risks. Developing the securities market can expand the contribution of the banking sector to economic growth and strengthen the nonbank finance sector to underpin domestic savings. Critical factors will be the development of the primary and secondary market for government securities, and corporate funding options for (i) the implementation of an effective and appropriate institutional structure to include securities market regulation with legal, accounting and audit frameworks, (ii) cultivation of a benchmark debt issuance program, and (iii) expansion of the institutional investor base.

5. A vibrant domestic securities market can also help fill the infrastructure gap in Georgia. However, a weak operational framework for managing fiscal risks from PPP projects is a constraint on meeting infrastructure needs. The government is exploring measures to mobilize additional resources, and considering a greater role for PPPs as a way to procure infrastructure. Investment by the private sector has the potential to both improve access to funding to speed up development of infrastructure, and increase operating efficiency of public services, which will reduce costs to the government and free up fiscal space. PPPs can also tap into international resources without being dependent on availability of public sector finance, which necessitates a robust fiscal risk management framework. Government will address gaps in the legal and regulatory framework of PPPs.

6. Micro, small, and medium-sized enterprises (MSMEs) are not reaching their economic potential because of weakness in the legal, regulatory, and institutional business environment, and inadequate levels of business management skills and financial literacy. Georgia's economy is dominated by small private businesses. There are 588,782 businesses registered in Georgia, as of 1 September 2014, but only 112,937 are active. Georgia's small businesses are largely owner operated, having an average of 1.3 persons employed per firm. The largest sectors in the economy are trade (18% of GDP), manufacturing (10%), agriculture (9%), transport (8%), and construction (7%). MSMEs are an important source of employment in urban areas and can play

a similar role in rural areas, where about two-thirds of the workforce is employed. Agriculture accounted for 53.0% of employment in 2012 and only 8.6% of GDP, with the vast majority of rural enterprises owner-operated and suffering from seasonal underemployment. MSMEs can be further developed through greater rural penetration of financial services and improved business development skills. Supporting innovative technology for mobile financial services can increase the outreach of financial services. Enhancing the legal, regulatory, and institutional framework for competition, MSMEs, PPPs, and priority sectors can contribute to an enabling environment for businesses to establish, grow, and expand. The business sector holds considerable potential to create more income-generating opportunities. Improving the investment climate to further strengthen investor confidence and foster sustained private-sector-led growth is also critical for the recovery of foreign direct investment.

2. Government's Sector Strategy

7. The Socio-Economic Development Strategy of Georgia—Georgia 2020—establishes policy directions for sustainable and inclusive economic growth, macroeconomic stability and effective public administration (defined broadly to include public financial management), human capital development, access to finance, and private sector competitiveness.² A guiding principle of the country's strategy for economic development is establishing the necessary conditions for a free private sector operating under an optimal, efficient, and transparent government. It calls for enhancement of government public policy management, strengthening of human resource management in the public sector, increased transparency of public policy management, e-government development, greater efficiency of public financial management, and improved public service delivery. To increase the efficiency and effectiveness of public expenditure, the government is expanding the coverage of the treasury single account and strengthening public investment management. As part of its efforts to increase national savings and improve access of the private sector to finance, the government plans to introduce contributory pension schemes and further reduce the fiscal deficit. Given the limited fiscal space, the government is developing PPPs in infrastructure and looking at resolving issues on allocation of risk and managing government liabilities. The government is strengthening management of debt and fiscal risks, streamlining tax administration, ensuring greater transparency and stability of the tax legislation, and improving legal and institutional frameworks for capital markets.

3. ADB Sector Experience and Assistance Program

8. The Asian Development Bank (ADB) has been active in providing loans and technical assistance (TA) for finance sector development in Georgia since the country became an ADB member in 2007. An emergency loan of \$70 million was provided following the 2008 conflict with the Russian Federation, and \$80 million was provided in quick-disbursing financial support to mitigate the adverse impact of the global financial crisis in 2009.³ In 2010, a loan of \$100 million was provided to support social services delivery.⁴ It ensured continuity in maintaining critical public expenditures for social services delivery and social protection. Three nonsovereign loans

² Government of Georgia. 2013. *Socio-Economic Development Strategy of Georgia, 2020*. Tbilisi.

³ ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for the Emergency Assistance for Post-Conflict Recovery*. Manila; ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for the Growth Recovery Support Program*. Manila.

⁴ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for Social Services Delivery Program*. Manila.

have been provided to commercial banks (Bank of Georgia and TBC Bank)⁵ for a total of \$125 million to support lending to small and medium-sized enterprises. Through the Municipal Services Development Project (approved in 2008) and the Municipal Services Development Project Phase 2 (approved in 2009), ADB has helped the Municipal Development Fund of Georgia and local governments enhance their capacity to implement public investment projects.⁶ TA has been provided to (i) help strengthen supervision and regulation in the National Bank of Georgia, (ii) streamline TBC Bank's lending processes for its MSME clients, and (iii) improve business and financial literacy of MSMEs through TBC Bank's in-house training academy. ADB has engaged in knowledge work in the pension sector and has prepared a finance sector assessment on capital market development and agrifinance.⁷

9. ADB's planned support to Georgia's finance sector during the new country partnership strategy (2014–2018) is a continuation of its ongoing assistance. The support enhances domestic resource mobilization, improves economic opportunities through MSME development, and increases savings mobilization. ADB nonsovereign assistance is planned to provide finance to underserved regions and help develop products to improve access and use of finance for MSMEs. ADB efforts to enhance access to financial services will build on sector development achieved to date for a more viable, effective, and sustainable financial system. It supports private sector led inclusive economic growth through increased access to finance and business development opportunities for low-income groups, including women, particularly in small cities and rural areas.

10. A TA on strengthening domestic resource mobilization addresses public sector management and finance sector issues.⁸ The outputs include development of capital markets, pension reform, increasing PPPs, and strengthening public debt management. The TA will support the government in setting up legal, regulatory, and institutional frameworks to facilitate availability of long-term capital for productive business and infrastructure investments. The development of a pool of investible instruments to absorb pension contributions necessitates pairing of pension reform with capital market development. Public debt management will ensure better public financial and fiscal management.

11. Some of the lessons from ADB's work in the two sectors include (i) longer-term and sustained engagement with the government on developing securities and money markets; (ii) the design of a fiscally sustainable pension scheme must not only provide a social safety net but it must also be affordable to the government in the long run; and (iii) heightened government awareness of fiscal risks and contingent liabilities is essential to assess and manage fiscal risks arising out of PPP projects and state-owned enterprise (SOE) operations. These lessons have been incorporated in the proposed policy-based program and TA. ADB's strategic interventions in the sector will be closely aligned and coordinated with those of other international financial institutions and bilateral development partners.

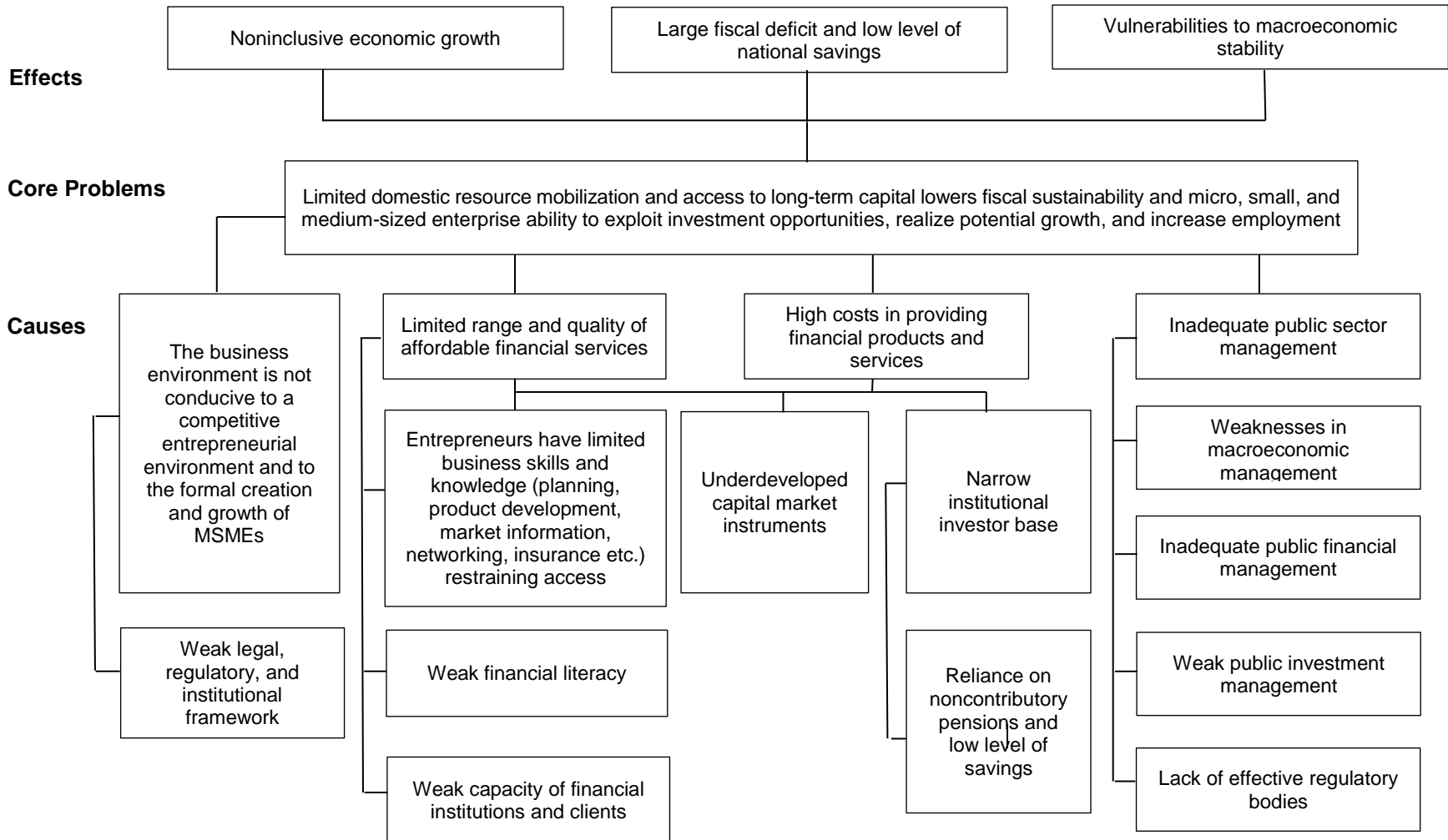
⁵ ADB 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loan to Joint Stock Commercial Bank of Georgia*. Manila; ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loan to Joint-Stock Company Bank of Georgia*. Manila; ADB 2010, *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Bank Republic Joint-Stock Company*. Manila; and ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to TBC Joint-Stock Company*. Manila.

⁶ ADB. 2012. *Completion Report: Municipal Services Development Project in Georgia*. Manila; ADB. 2013. *Completion Report: Municipal Services Development Project Phase 2 in Georgia*. Manila.

⁷ ADB. 2011. *Pensions and Pension Reform in Georgia*. Manila.

⁸ ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization*. Manila.

Problem Tree for Finance and Public Sector Management Sectors in Georgia



Sector Results Framework (Finance and Public Sector Management, 2014–2018)

| Country Sector Outcomes | | Country Sector Outputs | | ADB Sector Operations | |
|---|--|--|--|---|---|
| Outcomes with ADB Contribution | Indicators with Targets and Baselines | Outputs with ADB Contribution | Indicators with Incremental Targets | Planned and Ongoing ADB Interventions | Main Outputs Expected from ADB Interventions |
| Increased fiscal consolidation and efficient utilization of public resources | Fiscal deficit reduced to 2.5% by 2018 (2013 baseline 2.7% of GDP) | Improved public sector management | Government conducts assessment of fiscal risks for large SOEs to determine contingent liabilities by 2016 (baseline: none) | <p>Planned key activity areas Public expenditure and fiscal management (51% of funds) Finance sector development (19% of funds) Insurance and contractual savings (20%) Money and capital markets (11%)</p> <p>Pipeline projects with estimated amounts Development for PPPs PATA (\$500,000) Support for Financial Sector Supervision and Corporate Governance S-PATA (\$200,000) Support for Financial Inclusion PATA (\$1.5 million)</p> <p>Nonsovereign financial Institution investments to support financial inclusion and literacy of MSMEs with particular focus on regions</p> <p>Ongoing projects with approved amounts Senior Loan to Bank of Georgia (\$50 million) SME Inclusion S-CDTA (\$150,000) Promoting Financial Sector Resilience S-CDTA (\$150,000) Strengthening DRM PATA (\$500,000)</p> | <p>Pipeline projects Required amendments to the public debt legislation, supporting the Debt Strategy, submitted to Parliament</p> <p>Phasing out of alternative auditors by increasing the number of in-house auditors to 330 out of which 150 are women</p> <p>Regulations issued on mandatory occupational savings and voluntary savings</p> <p>Accounting and prudential regulations for repos and securities lending developed</p> <p>Information on debt of SOEs and contingent liabilities of SOEs and PPPs as a supplement to the state budget documents provided</p> <p>Ongoing projects 30% more SME loan accounts opened</p> |
| Effective mobilization of domestic resources for more public and private investment | Domestic savings as percent of GDP increase to at least 21.6% by 2018 (2012 baseline: 10.2%) ^c | Insurance and contractual savings improved | Government implements medium-term public debt management framework by 2016 (2013 baseline: none) | | |
| Increased use of efficient and reliable financial services by SMEs | Access to financing through local equity markets rank improves to at least 100 by 2018 (2013 baseline: 126) ^b | Financial system access improved | Government implements changes to basic pension law and law on voluntary savings instituted (2013 baseline: none) | | |
| | | | Number of depositors in commercial banks increases to at least 950 per 1,000 adults in 2018 (2012 baseline: 845 per 1,000 adults) ^a | | |

ADB = Asian Development Bank, CDTA = capacity development technical assistance, DRM = Domestic Resource Mobilization, GDP = gross domestic product, MSME = micro, small, and medium-sized enterprise, PATA = policy and advisory technical assistance, PPP = public–private partnership, S-CDTA = small-scale capacity development technical assistance, SME = small and medium-sized enterprise, SOE = state-owned enterprise.

^a World Bank. *Country statistics* <http://data.worldbank.org/country/georgia>; and Asian Development staff estimates.

^b Global Competitiveness Report ranking and ADB staff estimates.

^c Government of Georgia. 2013. Socio-Economic Development Strategy of Georgia, 2020. Tbilisi.

Source: Asian Development Bank.