SECTOR ASSESSMENT (SUMMARY): FINANCIAL SECTOR AND PUBLIC SECTOR MANAGEMENT

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Significant progress has been made in improving public sector management practices, however, a number of issues remain unsolved. Developing the domestic market for government securities is high on the agenda and that should help to deepen the domestic capital markets and tackle excessive public debt dollarization by providing GEL resources to both public and private sectors. It will also reduce debt service costs for government finances and decrease risks in the medium- and long-term. Improving fiscal risk management is another priority for the debt management strategy, where the government implements reforms to improve fiscal finance transparency and identification of risks stemming from public private partnerships (PPPs) and state-owned enterprises (SOE).[1] From the private sector side low domestic currency liquidity hinders corporate sector growth and increases risks from foreign currency financing. In this matter shortage for investment instruments and high dependence on the banking credit are the main issues. Ministry of Finance (MOF) and National Bank of Georgia (NBG) collectively work to deepen the domestic capital market by improving the regulatory framework and increasing the volume of government securities that should help to increase investor base and create additional GEL resources for the private sector.

a. Weak fiscal risk management and high dependence on foreign currency financing

2. Ongoing reforms to strengthen fiscal risk management have significantly improved fiscal transparency and identification of risks. Publishing annual Fiscal Risk Statements (FRS) since 2014 has improved the assessment of public exposure to broader fiscal risks. The FRS have also gradually introduced analysis of the performance of the SOE sector, leading towards a better understanding of public exposure to risks stemming from poor financial performance of SOEs. In this regard, reliable data and sound accounting systems plays a key role in ensuring accurate risk identification where a number of gaps persist.[2] Still, profitability concerns remain as SOE sector financial performance deteriorated in relatively favorable economic conditions over recent years, as a result of challenges in management practices. As international experience shows, it is crucial to establish a strong governance framework to improve SOE performance, particularly: (i) SOE's should have clear financial objectives; (ii) public corporations should not have special treatment with respect to its competitors; and (iii) management should be independent of acting government. To further strengthen fiscal risk management practices, MOF approved PPP Guidelines which included methodological procedures for the assessment of contingent liabilities, completing the operationalization of a PPP framework which ensures fiscal sustainability of PPP projects and minimizes public exposure to risks stemming from these contracts. Despite that, risks stemming from SOEs continue to be high and the government still needs to improve the identification of contingent liability risks that puts additional strains on government financing during volatile periods.

[1] Relatively large sector of SOEs and high exposure to foreign currency financing increases risks from contingent liabilities.

[2] While NBG and SOEs rely on International Financial Reporting Standards (IFRS), the government's financial statement still uses national standards and are unaudited at a consolidated level that causes some differences in reporting.

To further reduce the risks, MOF needs to finalize ongoing SOE reforms and overcome structural challenges in the legal framework.

3. Despite the continued effort to diversify debt portfolio and reduce foreign currency share, the government's dependence on external financing remains significant, roughly 80% of the total general government debt. In addition to this, the large SOE sector is highly exposed to foreign exchange (FX) risks, further compounding public exposure to currency risks. To reduce FX and rollover risks, MOF is committed to deepen the domestic market for debt, increasing the volume of domestic securities and creating benchmark bonds for short-,term instruments. In order to improve government bond liquidity, government is committed to deepen the secondary market infrastructure for faster and easier transactions through the adoption of a Primary Dealers System. Together with decreased risks, this will reduce the costs of debt services and increase access to GEL resources in the medium-term. As government bonds are key for pricing all GEL denominated financial instruments, including corporate bonds, better domestic security issuance will have positive impact on domestic capital markets, which will create additional GEL resources available to the the private sector and increase investment possibilities in the country. For these reforms to be effective, government is committed to expanding investor base[3] as part of its capital market development strategy. Currently, the limited investor base for domestic securities limits the volume of securities that can be issued.

b. Lack of instruments, corporate transparency, and weak regulatory framework for capital markets

4. Corporate debt and equity instruments are limited due to incomplete capital market infrastructure. Improving corporate transparency and legal framework will increase investor interest for financial instruments. Despite ongoing reform that requires periodic publishing of financial results, government is committed to ensuring the establishment of a homogenous system for data publishing and auditing. To address these and other gaps in capital market infrastructure, the MoESD and NBG are committed to finalizing a Capital Market Development Plan (CMDP) to deepen capital markets in Georgia, in line with reforms undertaken by regional peers such Ukraine and Uzbekistan. The strategy will be centered around the following key challenged: (i) fostering supply; (ii) developing the demand; (iii) building capacity; (iv) developing risk management tools; (v) consolidate capital market infrastructures; (vi) amend the legal and regulatory framework in line with recommendations included in the CMDP.

2. Government's Sector Strategy

5. The Debt Management Strategy for 2019–2021 states two main objectives to be reached: (i) allocating government finances with low- medium- and long-term costs while managing and reducing fiscal risks, MOF intends to improve debt management practices and maintain government debt at a sustainable level; and (ii) developing domestic markets for government securities, which implies increasing liquidity, transparency and predictability of the market. The main challenge facing the government is to increase the investor base and the issuance of domestic securities. To this end, government is committed to increase domestic debt as a share of GDP and as a share of total general government debt. As a result, capital market liquidity will increase, and dollarization in the economy will reduce, leading to a reduction in the interest rate spread that contributes towards higher economic growth. The government's reforms are supported and coordinated with NBG that aims to fulfill its function by (i) maintaining financial

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[3] Most of domestic securities are bought by private banks that mainly use it for repo operations and only small share of foreign investors.

stability with enhanced supervision and risk assessment; (ii) improving macroprudential measures including actions to tackle high levels of dollarization and setting risk-based capital buffers; and (iii) promoting the development of domestic capital markets that will enable access to GEL long-term resources and promote sustainable economic growth.

3. ADB Sector Experience and Assistance Program

6. The Asian Development Bank (ADB) has a strong track record providing technical support and maintaining policy dialogue with the government around reforms which help deepen domestic financial markets whilst strengthening public management functions that can help mitigate risks to the public sector. ADB's experience in Georgia in this specific area allowed it to take an active role during negotiations with the government over design of the program – general policy direction as well as specific policy actions. ADB's institutional memory and country experience gained in the previous Improving Domestic Resource Mobilization for Inclusive Growth Program proved to be useful in assisting the government to adopt a strategy aimed at developing domestic debt markets and strengthen key public fiscal risk management functions. ADB also played an important role in providing technical and guidance notes which were instrumental in influencing policy direction of the government in this area.