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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

ON A PROPOSED LOAN

IN THE AMOUNT OF US$60 MILLION

TO GEORGIA

FOR THE

FIRST PROGRAMMATIC PRIVATE SECTOR COMPETITIVENESS

DEVELOPMENT POLICY OPERATION

March 31, 2015

Trade & Competitiveness Global Practice
South Caucasus Country Unit
Europe and Central Asia Region

GEORGIA: GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of March 1, 2015)

Currency Unit	Georgian Lari (GEL)
US $1.0	GEL 2.1654

ABBREVIATIONS AND ACRONYMS

AA	Association Agreement
CEM	Country Economic Memorandum
CIIP	Competitive Industries and Innovation Policy
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CPS	Country Partnership Strategy
DCFTA	Deep and Comprehensive Free Trade Area
DIS	Deposit Insurance System
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GAC	The Georgian Accreditation Centre
GDP	Gross Domestic Product
GEOSTAT	National Statistics Office of Georgia
GeoSTM	Georgian National Agency for Standards and Metrology
GII	Global Innovation Index
GITA	Georgian Innovation and Technology Agency
GNCC	Georgian National Communication Commission
IBRD	International Bank for Reconstruction and Development
ICT	Information and Communications Technology
HIS	Integrated Household Survey
IMF	International Monetary Fund
IRP	Institutional Reform Plan
IPSAS	International Public Sector Accounting Standards
MOESD	Ministry of Economy and Sustainable Development
MOF	Ministry of Finance
NBG	National Bank of Georgia
NQI	National Quality Infrastructure
OECD	Organization for Economic Co-operation and Development
PEFA	Public Expenditure and Financial Accountability Program
PPD	Public-Private Dialogue
PPP	Public-Private Partnership
PTB	Physikalisch-Technische Bundesanstalt (National Metrology Institute of Germany)
RIA	Regulatory Impact Assessments
R&D	Research & Development
ROSC	Reports on the Observance of Standards and Codes
SBA	Stand-By Arrangement
SDR	Special Drawing Right
SDS	Socio-economic Development Strategy “Georgia 2020”
SDSS	Special Data Dissemination Standards
SMEs	Small and Medium Enterprises
SPA	State Procurement Agency
TA	Technical Assistance
TFP	Total Factor Productivity
WBG	World Bank Group

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GEORGIA

FIRST PROGRAMMATIC PRIVATE SECTOR COMPETITIVENESS DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED LOAN AND PROGRAM
GEORGIA
FIRST PROGRAMMATIC PRIVATE SECTOR COMPETITIVENESS DEVELOPMENT POLICY OPERATION

Borrower	Georgia
Implementation Agency	Ministry of Finance/ Ministry of Economy and Sustainable Development
Financing Data	IBRD Loan of US$60 million
Operation Type	Programmatic Development Policy Operation (1st of 3)
Pillars of the Operation and Program Development Objective(s)	The proposed Program Development Objective is to increase private sector competitiveness through second generation business environment reforms, financial sector deepening and diversification, and increasing firms' capacity to innovate and to export. *The operation has three pillars:* Pillar1 - Second generation business environment reforms; Pillar2 - Financial sector deepening and diversification; and Pillar3 - Increasing firms' capacity to innovate and to export.
Results Indicators	*Pillar 1 - Second generation business environment reforms* • Draft economic laws that are made available for public review • SMEs benefiting from services provided by Entrepreneurship Development Agency (EDA) • Registered users in the e-Procurement system • State Procurement Agency tenders monitored for unlawful practices *Pillar 2 - Financial sector deepening and diversification* • The Deposit Insurance Agency has initial capital and launches its operations • The asset management system for the new contributory pensions has been established and the personified accounts are ready to receive contributions • Insurance companies are in compliance with EU solvency I margin requirements as set for 2017 by the insurance regulator • Vehicles with motor-vehicle third-party liability (MTPL) insurance *Pillar 3 - Increasing firms' capacity to innovate and to export* • Incremental private investment in the telecommunications sector • Broadband Internet subscriptions • Score on the Global Innovation Index (GII) • Firms that obtained innovation finance from the Georgian Innovation and Technology Agency (GITA) • GITA's technology park and fabrication laboratories are operational • Certificates issued by the Georgian National Agency for Standards and Metrology (GeoSTM) and by calibration/verification entities that received traceability from GeoSTM
Overall risk rating	Substantial
Operation ID	P149998

IBRD PROGRAM DOCUMENT FOR A PROPOSED

FIRST PROGRAMMATIC PRIVATE SECTOR COMPETITIVENESS DEVELOPMENT POLICY OPERATION FOR GEORGIA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed First Programmatic Private Sector Competitiveness Development Policy Operation (DPO1) in Georgia will support the Government's efforts to spur inclusive economic growth through second generation business environment reforms, financial sector deepening and diversification, and initiatives to increase firms' capacity to innovate and export.** This is the first in a series of three DPOs aimed at strengthening shared prosperity and reducing poverty in Georgia through policies that stimulate private sector dynamism and productivity, foster investment in high value-added production, and create a fair business environment that enables growth by small and medium enterprises (SMEs) and young firms. These policies have been prioritized in the Government's 2014 Socio-economic Development Strategy (SDS) "Georgia 2020," which sets out its vision for inclusive development. The Deep and Comprehensive Free Trade Area (DCFTA) and the Association Agreement (AA) signed with the European Union (EU) in July 2014 provide a long-term policy anchor in many critical areas and are expected to improve market access for Georgian companies, and encourage trade and foreign direct investment (FDI).

2. **Georgia has a consistent track record with regard to macroeconomic stability and improving the business environment.** Macroeconomic and financial stability have been preserved in the face of negative shocks, and public sector debt has remained at manageable levels. The groundbreaking business deregulation, anticorruption, legal, tax and trade reforms that Georgia put in place in the last decade made the country an even more attractive destination for FDI and brought it global recognition as a top reformer. Georgia ranked 15th in the *2015 Doing Business* report; and its *Global Competitiveness* ranking improved from 90th place in 2008-2009 to 69th in 2014-2015.

3. **The introduction of first generation reforms contributed to the surge in economic growth experienced in the last decade, but proved insufficient to close the productivity gap, improve wages, and eliminate structural unemployment.** GDP growth averaged close to 6 percent per year during 2004-2013. Although significant new employment was created during this period, especially in the service sector, the combination of labor shedding in the public sector and economic transformation in some of the older sectors of the economy meant there was little in the way of net job creation. Consequently, unemployment has remained stubbornly high, never falling below the 12-13 percent range, with a stronger incidence among women; and wages have stagnated. Overall, Georgia is one of the countries in Europe and Central Asia (ECA) that has not yet caught up to its 1990 level of real GDP. The 2013 Country Economic Memorandum (CEM) estimates—based on a growth accounting framework—that sustaining GDP growth of 5 percent per year during 2013-17 would require raising investment to more than 30 percent of GDP, with total factor productivity (TFP) growth of more than 3 percent per year.

4. **As a result of weak job creation and wage growth, the country still faces important challenges in eradicating poverty and promoting shared prosperity.** In 2012, the World Bank

measures of poverty and extreme poverty are 14.8 and 3.7 percent, respectively[1]. Consumption growth among the bottom 40 percent (the World Bank's indicator of shared prosperity) was lower than for the population as a whole in 2006-2010. These numbers began to improve from 2010, largely because the fiscal stimulus put in place to counteract the negative external shocks from the global financial crisis increased social transfers. However, these transfers have not changed the composition of the bottom 40 percent, who are still largely rural, unemployed or underemployed, and living in households with a higher number of dependents. There is broad recognition that the social and financial safety nets need to be further strengthened to ensure more inclusive growth dynamics.

5. **The Government's inclusive growth agenda foresees policy reforms to strengthen the private sector's competitiveness and productivity, thereby reducing the economy's reliance on public investment as the main source of growth.** The Government is addressing key business environment constraints by strengthening public-private dialogue (PPD), connecting SMEs to markets and information, and enhancing the public procurement system. Reforms are also being introduced to strengthen social and financial safety nets, particularly through comprehensive pension reforms and the introduction of a deposit insurance system. Reforms in the capital and insurance markets will help to address supply and demand-side constraints to accessing financial services. Reforms to upgrade the telecommunications sector; the introduction of an innovation support framework aligned with EU practices; and upgrading of the services provided by state institutions in the areas of metrology, standards and accreditation, will underpin long-term productivity growth and leverage the benefits of membership in the DCFTA and the AA with the EU.

6. **The proposed DPO series is a core element of the Country Partnership Strategy (CPS) (FY2014-17)**, and contributes to the CPS goal of enabling the private sector to become the main driver of employment creation and provider of income opportunities for the bottom 40 percent of the population.

7. **The overall risk is considered substantial; however, the risk will be mitigated through coordinated support by the World Bank Group (WBG) and the donor community.** The program of structural reforms has strong ownership within the Government, as demonstrated by the recent adoption of laws, strategies, and action plans that map out concrete steps to be taken until 2017. The actions are aligned with the SDS, and will lay the groundwork for Georgia to meet its commitments under the DCFTA and the AA on the timetable agreed with the EU. Given the medium-term nature of the reforms supported by this series, intensified and continued policy dialogue with the Government about the progress of the reform agenda will be warranted. Implementing the reforms will require improved capacity of relevant public sector institutions. A broader engagement of the WBG in Georgia, which includes a complementary investment project (Innovation and ICT Project), and technical assistance in the areas of trade and competitiveness, finance and markets, social protection and ICT—as well as programs supported by the donor community—will mitigate the implementation risks associated with the operation.

[1] In 2013, 9.7 percent of the population lived under the poverty threshold as measured by the National Statistics Office of Georgia (GEOSTAT).

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **After modest economic growth in 2013, output expansion in 2014 was 4.8 percent.** During the first 3 quarters of 2014, GDP grew by 5.9 percent year-on-year, supported by policy certainty and the signing of the AA with the EU. Greater domestic stability was complemented by strong external demand during the first 9 months of the year. The large Russian market which opened up for Georgian products in July 2013 helped increase exports, particularly of wine. However, the spillover effects from the slowdown in Russia and anemic growth in the EU had an adverse impact on the Georgian economy in the fourth quarter. The economy grew by 1.8 percent in the fourth quarter of 2014 and 0.5 percent in January 2015.[2] The slowdown in exports, remittances and tourism impacted both trade and consumption, lowering growth for 2014 as a whole. In 2013, lower private investments attributed to political uncertainty had resulted in a moderation of output expansion to 3.3 percent. Economic growth over the past decade, more generally, was fueled by large foreign capital inflows and significant policy reforms during the pre-crisis years, and by high public capital spending during the post-crisis recovery period. Overall, growth during 2004-14 was largely powered by services, construction and non-tradables in general.

9. **The under-execution of capital expenditures compared with the budget resulted in a fiscal deficit of 2.9 percent of GDP in 2014 compared with an initially budgeted deficit of 3.9 percent.** The increase in fiscal deficit in 2014 comes after four years of successful fiscal consolidation when the deficit was reduced from 9.2 percent of GDP in 2009 to 2.6 percent in 2013. Both current and capital spending picked up during January-September 2014, year-on-year. The full-year impact of the increase in social spending (universal healthcare, targeted social assistance and pensions) along with an increase in the wage bill and election related local government spending raised current expenditures by 14.5 percent in 2014. However, capital expenditures were lower by 6.7 percent, and only 72 percent of the budgeted capital expenditures were executed, highlighting weak implementation capacity. Government revenues in 2014 exceeded last year's collections by 8.3 percent, boosted by stronger economic performance in the first nine months of 2014.

10. **With a slowdown in most of Georgia's trading partners, export demand and remittances fell significantly in the fourth quarter and the current account deficit widened to 9.7 percent of GDP in 2014.** The recession in Russia has impacted most of the Commonwealth of Independent States (CIS) countries which are major trading partners of Georgia. Georgia's main export markets in 2014 were Azerbaijan (which has been impacted by a fall in oil prices), Armenia (which is very dependent on Russia and has cut its growth estimates) and Russia. Anemic growth in the EU has also dampened export demand. In addition, Russia accounted for nearly 50 percent of remittance inflows to Georgia in 2014 but with the depreciation of the Ruble and stagnation in the Russian economy, remittance inflows from Russia reduced to only 34 percent of the total in the first two months of 2015. During 2014, goods exports were led by used cars, metals, nuts, wine, fertilizers and mineral water, while import growth was spurred by stronger demand for

[2] Rapid estimates of economic growth by GeoStat.

intermediate goods in manufacturing and an increase in investment. However, export of services lagged during the year because of lower tourist arrivals from Turkey and a contraction in the export of railway services to Azerbaijan. Nearly two-thirds of the current account deficit was financed by FDI which is estimated at 6.6 percent of GDP in 2014.

11. **The National Bank of Georgia increased its policy rate by 50 basis points to 4.5 percent in February 2015 in response to higher inflationary expectations.** Inflation averaged 3.1 percent during 2014 and remained below the 2014 target of 6 percent. Low inflation was primarily aided by a strengthening of the nominal effective exchange rate. Monetary policy is geared towards maintaining price stability within an inflation targeting framework. The National Bank of Georgia's (NBG) inflation target for 2015 and 2016 is 5 percent and for 2017 it is 4 percent. Georgia has a floating exchange rate and interventions in the foreign exchange market by the NBG were smaller in 2014 compared with the previous year. International reserves cover 3 months of imports as of end February, 2015. In 2014, the Lari strengthened significantly against the Ruble and also against the Euro although it depreciated against the US dollar. The real effective exchange rate appreciated by 4.9 percent in December 2014 and by 5.3 percent in January 2015, year-on-year. With a decline in external performance in recent months, the Lari has however come under pressure. Between November 2014 and February 2015, the nominal exchange rate depreciated by 23 percent against the US Dollar (reflecting the strong dollar) and by 10 percent against the Euro. During the same period, the nominal effective exchange rate depreciated by 1.7 percent. Inflation has however remained under check, at 1.3 percent in February 2015 year-on-year, because of the decline in oil prices.

12. **Domestic credit growth picked up in 2014 and the banking system is adequately capitalized but vulnerabilities remain.** Credit to the private sector grew by 24 percent in 2014, reflecting low interest rates and the introduction of new Lari denominated instruments. The NBG increased the volume of long-term Lari-denominated resources through the introduction of various instruments such as refinancing loans, deposit certificates, and repo operations. The refinancing by NBG was available for mortgages and to small and medium enterprises (SME) at lower interest rates. As a result, the stock of Lari denominated loans issued by the commercial banks expanded by 29 percent, while foreign currency loans grew by 21 percent during 2014. However, Georgia remains a highly dollarized economy (loan and deposit dollarization is close to 60 percent). The ratio of non-performing loans (NPLs) to total loans was 7.6 percent in December 2014, similar to the end-2013 level of 7.5 percent.[3] The banks remain adequately capitalized with a capital adequacy ratio of 17.4 percent at the end of December 2014. However, the recent Financial Sector Assessment Program showed that there are some weaknesses among smaller banks. The assessment also indicated that with loan dollarization at 60 percent, the banking sector is vulnerable to currency depreciation risk. The loan to deposit ratio remains above 100 percent and more than one-third of banks' balance sheet is externally funded. This makes them vulnerable to volatility in international markets. In addition, weaknesses remain in the safety net and crisis management framework.

[3] According to NBG methodology, a loan is classified as an NPL if it is overdue for 30 days whereas the IMF classifies loans which are overdue for 90 days as NPLs.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

13. **Economic growth is projected to average 3.6 percent a year over the medium-term but downside risks to growth remain.** The near stagnation in the Russian economy in 2014 and the collapse of the Ruble has had spillover effects in the region. This has lowered export demand for Georgian goods while lower remittances from Russia have reduced consumption. Although FDI inflows, which primarily originate in the EU countries, were stable in 2014, they are likely to reduce going forward. Hence, output expansion is projected at 2 percent in 2015, followed by an increase to 3 percent in 2016. However, downside risks remain, especially, if Georgia's export markets see a protracted period of slowdown. In addition, with Parliamentary elections due in 2016, the efforts at structural reforms could take a backseat. In the outer years, growth prospects factor in improved economic ties with the EU and the reform program outlined in the government's development strategy, which will support growth in private investment. The Deep and Comprehensive Free Trade Area (DCFTA) and the AA with the EU is likely to improve market access and encourage FDI.[4] However, in the short-term, this transitional process could involve certain costs as producers upgrade their facilities and methodologies to meet the desired quality standards. Gross investment is likely to average 22.8 percent of GDP a year during 2015-18, much lower than the 2004-07 average of 32 percent of GDP a year (Table 1). The government is committed to leverage more private investment through the Public-Private Partnership (PPP) framework that is under discussion.

14. **The authorities are committed to prudent fiscal management over the medium-term.** For 2015, the government has budgeted an increase in revenues from higher cigarette and alcohol excise and the introduction of excise on international calls. However, with the projected deterioration in economic performance, revenue collections are likely to be lower than budgeted. There will be a modest increase in health (drug coverage under universal healthcare) and education expenditures (increased teacher salaries) as well as the planned increase in pensions. Other current expenditures will be held constant in real or nominal terms. Various measures are under consideration to improve fiscal outcomes over the medium-term. These include increased expenditure efficiencies in social benefits, reforms in public investment management, and limits on other non-essential expenditures, especially administrative expenses. The large infrastructure deficit necessitates large capital spending in Georgia, which is expected at 5-6 percent of GDP. The government has an efficient tax administration and cannot easily increase tax rates.[5] Hence, the fiscal consolidation process falls squarely on the expenditure side. The level of revenues is expected to be maintained at about 27.8 percent of GDP (Table 2). With continued fiscal prudence, the fiscal deficit is likely to come down to 2.8 percent of GDP by 2018 from 3.6 percent in 2015. Fiscal consolidation is a key element of the International Monetary Fund (IMF) Stand-By Arrangement with Georgia. To achieve the desired fiscal outcomes, strengthening the effectiveness of social spending and supporting the government in developing the institutions and capacity for program implementation will be crucial.

[4] A trade sustainability impact analysis commissioned by the EU suggests a potential increase in GDP growth of 4.3 percent in the long-run.

[5] The Liberty act requires a referendum to increase tax rates with the exception of excises.

Table 1: Macroeconomic Trends and Projections

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
	Actuals			Projections				
	(Percent change, unless otherwise indicated)							
National Accounts								
GDP nominal (in billions of GEL)	24.3	26.2	26.8	29.1	31.2	33.8	37.1	40.8
Real GDP growth	7.2	6.4	3.3	4.8	2.0	3.0	4.5	5.0
Consumer price index	8.5	-0.9	-0.5	3.1	5.0	4.5	4.0	4.0
GDP per capita (in U.S. dollars)	3,231	3,523	3,599	3,687	3,073	3,223	3,434	3,711
Gross investment (in percent of GDP)	26.2	28.9	24.8	25.9	20.6	22.0	23.7	24.8
Gross national saving (in percent of GDP)	13.9	17.3	19.1	16.2	12.2	12.7	15.1	17.2
	(In percent of GDP, unless otherwise indicated)							
General Government Operations								
Revenues and grants	28.2	28.9	27.7	27.9	27.6	27.8	27.9	27.9
Tax revenues	25.2	25.5	24.8	25.1	24.8	25.0	25.1	25.3
Expenditure and net lending	31.8	31.7	30.2	30.9	31.2	31.1	30.8	30.6
Current expenditure	23.0	24.9	24.1	25.4	25.3	25.1	24.7	24.4
Capital expenditure and net lending	8.8	6.8	6.1	5.5	5.9	6.0	6.1	6.3
Overall fiscal balance	-3.6	-2.8	-2.6	-2.9	-3.6	-3.3	-3.0	-2.8
Total public debt	33.6	32.3	32.2	33.4	37.3	37.4	36.7	36.0
	(In percent of GDP, unless otherwise indicated)							
External Sector								
Current account balance	-12.7	-11.7	-5.7	-9.7	-8.5	-9.3	-8.6	-7.5
Exports of goods and services	36.5	38.2	44.7	44.7	46.0	47.2	49.4	51.7
Imports of goods and services	55.5	57.8	57.6	61.6	63.0	64.7	65.7	66.8
FDI (net)	6.2	3.9	5.1	6.6	7.2	7.3	7.3	7.4
Foreign exchange reserves								
(Months imports of goods and services)	4.3	3.8	3.6	3.7	3.2	3.3	3.4	3.5
(In millions of dollars)	2,818	2,873	2,823	2,694	2,492	2,760	3,173	3,449

Source: Georgian authorities; and World Bank and IMF staff estimates and projections.

Table 2: Fiscal Indicators

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
	Actuals			Projections				
	(In percent of GDP)							
Overall fiscal balance	-3.6	-2.8	-2.6	-2.9	-3.6	-3.3	-3.0	-2.8
Revenues and grants	28.2	28.9	27.7	27.9	27.6	27.8	27.9	27.9
Taxes	25.2	25.5	24.8	25.1	24.8	25.0	25.1	25.3
Non-tax revenues	3.0	3.4	2.9	2.8	2.8	2.9	2.7	2.6
Total expenditure and net lending	31.8	31.7	30.2	30.9	31.2	31.1	30.8	30.6
Current expenditure	23.0	24.9	24.1	25.4	25.3	25.1	24.7	24.4
Wages and salaries	4.7	4.6	5.2	5.2	4.8	5.0	5.0	5.0
Goods and services	5.0	5.0	3.8	3.9	5.9	6.1	6.1	6.1
Interest payments	1.2	1.0	0.9	0.9	1.0	0.9	0.7	0.6
Subsidies and grants	1.8	2.0	2.0	2.2	1.8	1.7	1.6	1.5
Social expenses	6.8	7.1	8.5	9.6	9.6	9.3	9.3	9.2
Other expenses	3.5	5.2	3.7	3.6	2.2	2.0	2.0	2.0
Capital expenditure and net lending	8.8	6.8	6.1	5.5	5.9	6.0	6.1	6.3

Source: Georgian authorities; and World Bank and IMF staff estimates and projections.

15. **Lower domestic demand, the decline in investment, and the impact on imports of the large depreciation of the Lari is likely to reduce the current account deficit in 2015.** In addition, lower oil prices will also reduce the import bill since petroleum products account for the largest share of Georgia's imports (10.7 percent of the total). Georgia's exports are also expected to remain subdued in 2015 because of lower demand from its key trading partners. In addition, there are downside risks to tourism receipts (main tourist arrivals are from Turkey, Armenia, Azerbaijan and Russia) and remittances, nearly 35 percent of which originated in Russia in the first two months of 2015. In 2016, some deterioration of the current account is likely with a pick-up in investment related imports and domestic demand but limited increase in exports. From 2017 onwards, external sustainability will be supported by a larger recovery in export markets and some gains from the continued focus on competitiveness, especially in the context of the DCFTA. The full impact of the improvements on the export front as a result of the DCFTA and other structural reforms will be visible only over the medium- to long-term. Given the high level of external liabilities, a more ambitious reduction in the current account deficit (CAD) is desirable but not very likely with the low domestic savings. Nearly two-thirds of the CAD will be financed from FDI and the rest from loans. Portfolio investments are relatively small in Georgia. Georgia receives most of its FDI from the EU countries and has limited dependence on Russia and Ukraine for direct investment. However, spillover effects from geopolitical uncertainties and potentially longer-term stagnation in the EU could dampen investment inflows to Georgia.

16. **Georgia's public debt remains sustainable.** Total public sector debt is likely to increase from 33.4 percent of GDP in 2014 to 37.3 percent in 2015 with the widening of the fiscal deficit and the depreciation of the Lari against the USD (Table 3). About 80 percent of public debt in 2014 was external and was dominated by long-term multilateral (70 percent) and bilateral (20 percent) debt. Given the highly concessional nature of public debt, interest payments average at around 1 percent of GDP a year. Nearly 75 percent of external public debt is at fixed interest rates, thereby, reducing interest rate risk. The 2014 Debt Sustainability Analysis (DSA) confirms that debt indicators are within prudential thresholds. Public debt is projected to remain sustainable even

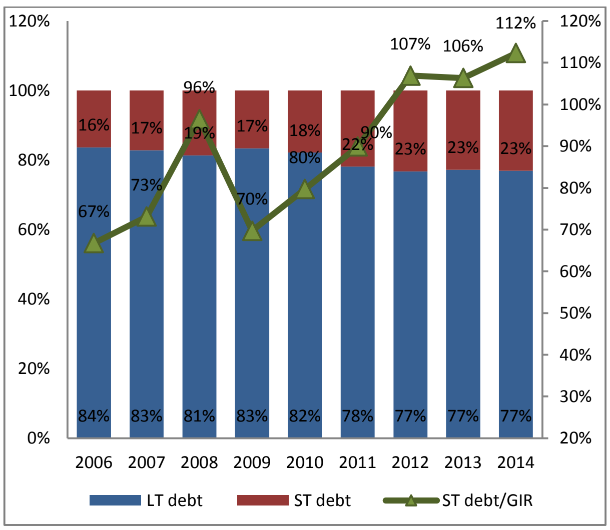
if large macroeconomic shocks materialize. The Ministry of Finance (MOF), with support from international financial institutions, including the World Bank, is actively working to develop a public debt management strategy by September 2015.

Table 3: Debt Sustainability Analysis

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
	Actuals				Projections			
	(In percent of GDP)							
Total public sector debt	33.6	32.3	32.2	33.4	37.3	37.4	36.7	36.0
External public sector debt	29.1	27.5	29.5	26.9	30.9	31.5	31.2	30.4
Domestic public sector debt	4.5	4.8	2.7	6.5	6.4	5.9	5.5	5.6
Gross external debt (including inter-company loans)	77.8	82.2	81.8	83.3	95.0	91.6	87.3	81.7

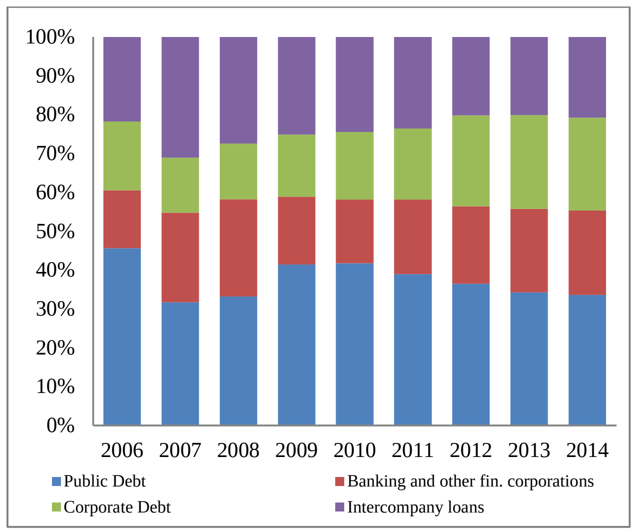
Source: Georgian authorities; and World Bank staff estimates and projections.

Figure 1: Maturity of External Debt



Source: NBG, World Bank staff calculation.

Figure 2: Composition of External Debt



Source: NBG, World Bank staff calculation.

17. **Total external debt is however a source of vulnerability.** The high reliance on foreign savings to fuel growth resulted in rapid accumulation of external debt which is estimated at 83.3 percent of GDP in 2014. About 77 percent of external debt is long-term and nearly two-thirds of external debt is held by the private sector (Figures 1 and 2). Inter-company external loans account for nearly 20 percent of GDP and generally carry lower repayment risks. In addition, 6 percent of the external debt is denominated in local currency. The main holders of Georgia's private external debt include financial institutions (Bank of Georgia and TBC Bank) and non-financial corporations like the Georgian Oil and Gas Corporation (Eurobond of $200 million), the Georgian Railways (Eurobond of 670 million), and Marabda-Kartsakhi Railway ($560 million highly concessional loan from Azerbaijan). Banking supervision norms require banks to keep their positions closed. However, the banks' debtors could face currency mismatches in their revenue streams. The short-term debt mostly consists of trade credits owned by non-financial corporations, deposits of non-residents in the banking sector of Georgia, and short-term intercompany loans by foreign direct

investors. For non-resident deposits, banking supervision norms require that if such deposits exceed 10 percent of total deposits of the bank, then the liquidity requirements are much higher (close to 100 percent of the deposits). However, reserves cover only about three months of imports and short-term debt amounted to more than 100 percent of reserves in 2014. This makes Georgia highly vulnerable to exchange rate depreciation. Gross external debt, including inter-company loans, is likely to go down in the medium-term with a decline in the current account deficit. The 2014 Debt Sustainability Analysis (DSA) confirms that Georgia's external debt is vulnerable to exchange rate depreciation.

18. **Georgia's overall macroeconomic policy framework is adequate for this operation.** Although there are downsides to growth triggered by external disturbances, the government remains committed to sound macroeconomic management as evidenced by its commitment to fiscal prudence, low inflation and limited interventions in the foreign exchange market. Over the medium-to long-term, the DCFTA and the AA, structural reforms and continued macroeconomic stability will strengthen growth prospects and also reduce external vulnerabilities.

2.3 IMF RELATIONS

19. **The three-year IMF Stand-By Arrangement in the amount of SDR100 million (about US$154 million) was approved in July 2014.** The Stand-By Arrangement (SBA) supports the Government's economic program to reduce macroeconomic vulnerabilities, increase policy buffers and support growth, while making the economy more resilient to external shocks. The program is on track as per the first review undertaken in November-December 2014. The WBG closely coordinates with the IMF on macroeconomic developments, debt sustainability analysis, fiscal consolidation, and public financial management. A Joint IMF-WB mission to conduct the FSAP took place in May 2014, and this DPO series will support the implementation of several key recommendations.

3. THE GOVERNMENT'S PROGRAM

20. **The Government's Socioeconomic Development Strategy sets out Georgia's medium-term strategy for economic development.** The strategy acknowledges that private sector will be the main engine of economic growth, supported by a Government that promotes inclusion through better delivery of public services and more effective ways to address market failures. Promoting a business-friendly environment, including spurring innovation and trade, and developing the financial market, lie at the center of the country's growth agenda.

21. **The SDS is based on three pillars: strengthening competitiveness of the private sector; developing human capital; and deepening access to finance** (Box 1)**.** The strategy highlights the main challenges under each pillar, and the reform priorities to be implemented over the coming six years in order to achieve long-term, sustainable, and inclusive economic development. The SDS intends to establish an evidence based policy framework, supported by monitoring and evaluation mechanisms, to ensure that policy interventions are relevant, have impact, and enable course correction.

Box 1: Three pillars identified in SDS

Pillar1 **Private Sector Competitiveness**	Pillar2 **Human Capital Development**	Pillar3 **Access to Finance**
• *Improving the investment and business environment* • *Upgrading innovation and technology* • *Facilitating the growth of exports* • *Developing infrastructure and fully realizing the country's transit potential*	• *Improving the workforce with a view to meet labor market expectations* • *Ensuring the accessible and quality health care* • *Improving the social assistance system*	• *Mobilizing investments through the development of saving market and inflow of foreign capital* • *Developing financial intermediation*

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

22. **The program development objective is to increase private sector competitiveness through second generation business environment reforms, financial sector deepening and diversification, and increasing firms' capacity to innovate and to export.** This is the first of three programmatic DPOs that will support the reforms addressed in the SDS in the two pillars on private sector competitiveness and access to finance. DPO1 supports crucial initial reforms, as the first step towards deeper policy changes in the second and third operation. This is part of a larger package of reforms supports by the WBG. The Inclusive Growth DPO that is being implemented in parallel supports reforms to strengthen fiscal oversight of public institutions and improve the coverage and quality of health and education services.

23. **Pillar 1 of the DPO series will support second generation business environment reforms as a way to stimulate private sector-led growth.** Georgia has undergone extensive business environment reforms over the past decade, achieving a remarkable turnaround in its investment climate. During 2004-12, the Government eliminated 84 percent of all license and permit requirements, enhanced the quality of public services, reformed the tax and customs regimes, and improved the quality of infrastructure. These measures resulted in rapid FDI and GDP growth, and the entry of many new firms. However, further reforms are needed to make the economy more innovative and competitive. Pillar 1 will support measures in the following key areas: enhancing PPD to generate consensus for reforms; eliminating market barriers for entrepreneurship and SME growth; and strengthening the public procurement system.

24. **Pillar 2 will support financial sector development, which is essential for increasing savings and mobilizing the investment needed to enhance competitiveness and promote inclusive growth.** Financing higher levels of investment would require greater mobilization of domestic resources, including a substantial increase in national savings from the current 17 percent of GDP. While the banking sector has grown rapidly (total assets reached 65 percent of GDP in 2013), the sector does not have the depth or the breadth to support such investment. Bank credit and deposits to GDP remain at 40 and 39 percent, respectively, and the deposit base at Georgian banks is short term. Moreover, the nonbank financial sector is underdeveloped, and capital markets are virtually nonexistent (FSAP 2014). To address these issues, Pillar 2 will focus on supply and demand-side constraints faced by the financial sector; in particular, by strengthening financial safety nets, implementing a comprehensive pension reform, and developing more effective capital and insurance markets.

25. **Pillar 3 will support measures to improve the absorptive capacity of domestic firms, so they are better equipped to innovate and export, including through the upgrading of broadband internet services in Georgia.** The low competitiveness of domestic companies limits their integration into global value chains as well as the reallocation of resources to high productivity industries. To tackle this, the reforms include: changes in the legal and regulatory framework for the telecommunications sector, which will improve efficiency and competition in the sector; the establishment of a more effective technology transfer system and reforms to promote commercial innovation; and upgrading of the national quality infrastructure to obtain the international recognition needed to support access to EU markets by Georgian firms.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Second generation business environment reforms to strengthen public-private dialogue, support entrepreneurship and SMEs, and enhance public procurement

a. Enhancing public-private dialogue mechanisms

26. **The Government is introducing more participatory processes in policymaking by formalizing and making more effective use of public-private dialogue mechanisms.** With the exception of regulated sectors such as energy and telecommunications, the current legal framework does not require public consultations for proposed legal amendments. The current practice is for the Economic Council to invite interested parties to meetings or create a specific working group comprising representatives from the public and business community to discuss and agree on policy directions. The results of these meetings are not publicly available, and draft legislation is not disclosed until much later, after it has been submitted to Parliament. Among the efforts underway to address this, the Government is establishing an Investors Council that will serve as a platform for regular dialogue with the business community on new policy initiatives.

27. **DPO2 and DPO3 will support reform measures aimed at making the policymaking process more inclusive, and better assessing the impact of policy reforms.** DPO2 will support implementation of the Economic Council's enhanced communication mechanism, the purpose of which is to make the Council's activities more transparent and inclusive, and provide a forum to discuss economic policies with stakeholders before they are considered by the Government and Parliament. DPO2 will also support the systematic disclosure of draft major economic laws on the Legislative Herald[6] immediately after they are approved by the Government, which will make it easier for the public to review and provide comments at an early stage. Lastly, DPO3 will support the introduction of a RIA system for priority economic legislation, which will clarify the goals of the reforms, address their distributional impacts, and reduce the risk of costly policy failures.

28. **Results.** More accountable and transparent rulemaking, together with other aspects of good governance such as policy consistency, are associated with stronger economic growth, higher investment rates, and faster productivity growth. By the end of the DPO series, the impact of these reforms will be a visible increase in the use of PPD in the formulation of policy reforms.

[6] The Legislative Herald of Georgia, which was established in 1998, is a legal entity under public law within the Ministry for Justice of Georgia that functions as the official gazette in Georgia. All normative acts are published online after approval by Parliament; however draft economic laws are not made available for comments today.

b. Developing an institutional framework for entrepreneurship and SME support

29. **An institutional framework that actively supports entrepreneurship and SMEs will enable young firms and smaller firms to grow faster and increase private sector employment**. The SME sector has already shown remarkable growth with turnover increasing by 230 percent during 2006-2013, from 2.4 billion to 8.1 billion Lari (GeoStat). During this period, employment by SMEs increased by 40 percent, to reach 235,438 employees. SMEs now account for 94 percent of registered firms and 43 percent of private sector employment (2013, excluding self-employed). The economic upside of enabling SME growth could be substantial, as SMEs account for only 20 percent of GDP, whereas in Organization for Economic Co-operation and Development (OECD) countries SMEs account for 40-50 percent of GDP. The Government is putting in place a framework to remove barriers to firm growth, including provision of skills training and technological advice so that SMEs can expand in domestic and international markets.

Prior Action #1: The Borrower has established the Entrepreneurship Development Agency (EDA) to promote the creation and growth of start-up companies and SMEs, as evidenced by the Borrower's Resolution No. 173, dated February 19, 2014..

30. **DPO1 supports the establishment of the Entrepreneurship Development Agency (EDA) under MOESD for the purpose of increasing the competitiveness of start-ups and SMEs.** EDA will play a crucial role in creating a favorable business environment for SMEs through the provision of non-financial support schemes and financial instruments aimed at business development, enhancement of competitiveness and export promotion. To stimulate entrepreneurial activity at the regional level, including women entrepreneurship, new programs which provide matching grants together with consultancy services for micro and small businesses were launched.

31. **DPO2 and DPO3 will support measures that further promote SME development in Georgia.** DPO2 will support the creation and adoption of a medium-term SME development strategy and action plan to strengthen the SME sector in Georgia and increase its competitiveness in domestic and international markets. Entrepreneurship represents one of the important job opportunities for many unemployed and poverty affected individuals. The OECD is providing technical support to identify the priorities and programs to be included in the SME development strategy, and the strategy will also include policies to promote women entrepreneurship. DPO3 will support the launch of EDA's program and its tools for start-ups and SMEs so they can meet key DCFTA requirements.

32. **Results.** The DPO series is expected to enhance the competitiveness of SMEs in domestic and international markets through improvements in the legislative and institutional framework, and various advisory and support services aimed at expanding their market access, especially in the EU. By the end of the DPO series, there will be a critical mass of firms that are receiving these services, thereby improving their access to finance and know-how.

c. Strengthening public procurement

33. **Increasing the participation of companies, including local SMEs, in Georgia's three billion Lari procurement market is an important factor in developing high-quality, globally**

competitive products and services. Owing to continuous upgrading, Georgia's State Procurement Agency (SPA) is already a regional leader in integrating modern procurement practices, including electronic tendering, maintaining an electronic bidding platform, and executing reverse auctions. The e-procurement system started operating in October 2010, and SPA data indicate that the system had close to 20,000 registered users by end 2013 and 4,300 procuring entities. From 2011 to 2013, the number of suppliers increased by 135 percent, and the number of contracting authorities by 41 percent. While the existing system allows for timely procurement of goods and services at reasonable prices, the actions underway will increase participation in tenders, encourage the provision of high-quality goods and services, and ensure continued approximation with EU directives.

Prior Action #2: The Borrower, through its State Procurement Agency (SPA), has established a training center to improve the knowledge of contracting authorities and suppliers with respect to procurement procedures, as evidenced by the Borrower's Resolution No. 306, dated April 23, 2014; and the SPA's Chairman Order No. 1 dated May 7, 2014.

34. **DPO1 supports the establishment of a training center within the SPA to provide procuring entities with guidance and training in use of the e-procurement system.** Approximately 100 representatives from different contracting authorities have been trained by the center since it was established in September 2014, and the goal is to provide training to 2,000 entities over the next two years. Specialized training for SMEs will improve their knowledge about procurement criteria and capacity requirements, and their ability to develop an effective bidding strategy. This training aims to increase the rate of successful completion of announced tenders by SMEs.

35. **DPO2 and DPO3 policy actions will focus on improving procurement practices and reviewing tendering techniques and the legal framework, to bring them in line with EU directives.** Policy triggers for DPO2 and DPO3 will include amending relevant bylaws to mitigate possible bid rigging and other unlawful practices, and adopting a roadmap and legal amendments to modernize public procurement regulations. DPO3 will specifically support the introduction of Basic Standards regulating the award of contracts as stipulated by the DCFTA, helping to approximate Georgian legislation to relevant EU Directives.

36. **Results.** By the end of the DPO series, the measures to increase capacity of potential suppliers—including but not limited to SMEs—would result in an increase in the users of the e-Procurement system and a higher number of tenders that are successfully completed. The SPA will also strengthen its monitoring of tenders and contracts to prevent unlawful practices.

Pillar 2: Financial sector deepening and diversification by establishing the enabling conditions for a deposit insurance system, comprehensive pension reforms, and development of capital and insurance markets

a. Strengthening of the financial safety net

37. **Georgia is one of the few countries globally that lacks a DIS, and its introduction will increase public confidence in the banking system, protect small depositors, and form part of a comprehensive financial safety net.** In the context of the AA, the Georgian authorities have

committed to establishing a deposit insurance system (DIS) in accordance with EU directives within a six-year period. As recommended in the FSAP 2014, the Government has acknowledged that it is critical to develop the legislation on DIS and initiate implementation in 2015 and 2016, and thereby allow sufficient time for full operationalization and capitalization to the EU-required deposit insurance coverage levels.

Prior Action #3: The Borrower, has established the inter-agency Deposit Insurance System (DIS) Working Group that will design the DIS and coordinate its implementation, and approved its corresponding work plan; as evidenced by the Borrower's Decree No. 33, dated January 16, 2015.

38. **DPO1 supports the establishment of the DIS high-level working group that will elaborate the DIS strategy and coordinate the implementation of future activities.** An interagency working group on Deposit Insurance was established following the decision made at the Economic Council meeting on December 30, 2014. The working group is required to prepare a DIS implementation plan no later than June 1, 2015, and a draft DIS Law no later than November 30, 2015. The working group comprises the Ministers/ Deputy Ministers of MOF and MOESD; the Governor/Deputy Governor of the NBG; and the Secretary of the Economic Council.

39. **DPO2 and DPO3 will support the next steps in DIS implementation.** DPO2 will support approval of the DIS strategy and a time-bound implementation action plan, elaboration of draft legislation, and submission of a draft DIS Law to Parliament. Once the DIS Law is approved, the Government will proceed to establish a DIS Agency and approve its governance structure, including the supervisory board and management. These actions will be supported under DPO3.

40. **Results.** The introduction of the DIS will protect smaller depositors and thus their appetite for formal savings, and at the same time increase the banking sector's resilience to shocks originating in failures of non-systemic banks. At the end of the DPO series, the actions will translate into a clear timetable for enhancing financial safety nets that will increase confidence in the financial sector and gradually increase the savings rate.

b. Comprehensive pension reform

41. **Pension reform is critical for social protection and fiscal stabilization, and will accelerate financial sector development by promoting longer-term savings and financial inclusion.** Georgia's pension system consists of a basic universal, non-contributory pension system for the elderly (Pillar 0), which is not indexed to inflation; and a voluntary contributory pension system (Pillar 3), which lacks incentives to encourage savings. These pensions fulfill a poverty alleviation function but do not provide much in the way of income replacement. The comprehensive reform supported under the DPO series will strengthen social protection and open up fiscal space for the Government to incentivize private savings.

Prior Action #4: The Borrower, through MOESD, has submitted to the Economic Council the proposed comprehensive pension reform, as evidenced by: (i) the minutes of the Economic Council meeting dated December 30, 2014, and (ii) the letter from the Minister of MOESD to the Bank, dated March 4, 2015.

42. **DPO1 will support the Economic Council's endorsement of the draft concept and roadmap for the comprehensive pension reform.** A pension reform unit was created at MOESD

and started its activities in 2014. On December 30, 2014, the Economic Council reviewed the concept note and draft roadmap for the reform. The Council has endorsed the broad parameters of the pension reform and designated several ministries to carry out the analysis of the direct and indirect costs, and finalize the design and implementation timetable. The main principle of the pension reform will be to encourage private savings for retirement through changes in the contributory pension framework that could include matching of voluntary savings from employees with contributions from employers and the Government. Also under consideration is the option of introducing an indexation mechanism of the basic social pension as this would contribute to long-term fiscal sustainability. The WBG has provided technical support to the pension unit, sharing international experiences and assisting with the development of a pension reform concept that is fiscally sustainable and can be implemented given demographic and other characteristics.

43. **DPO2 and DPO3 will support the next steps in the pension reform.** DPO2 will support the Government approval of the pension reform strategy and roadmap in 2015, as well as elaboration of the draft legal framework, including the amendments to the existing Pension Law. DPO3 will support the Government's public communication campaign on pension reform, as regular consultations and effective information disclosure is essential to ensure that people are adequately informed about the changes in the pension system. The submission of the draft Law on Pension Reform to Parliament will be a trigger for DPO3.

44. **Results.** By the end of DPO series, the legal framework and institutions will be in place to implement the comprehensive pension reform. Specifically, the asset management system for the new contributory pensions will be established and the personified accounts will be ready to receive contributions by end-2017.

c. Capital markets development

45. **The local capital market has been slow to develop on both the supply and demand side, and thus has not been seen as a source of liquidity for financial institutions or as a source of alternative funding for medium and large enterprises.** In part, this was the result of legal amendments in 2007 which weakened securities market transparency, price discovery, and reporting requirements. Corporate issuers have increasingly placed their debt internationally given the lower cost of funding. Stock market capitalization amounted to 7 percent of GDP at end-2013, down from 13 percent at end-2007 (FSAP 2014). The drivers for capital market reform include the pension reform and the need to finance real sector modernization, while reducing the level of dollarization and CAD.

46. **DPO2 and DPO3 will support measures to promote capital markets development and thereby foster investment in the economy.** Upgrading the legal and institutional framework is a precondition to introduce new capital market instruments. A working group for capital markets development was established in September 2014 to inform the reform priorities and ensure it leads towards approximation to the AA requirements. The adoption by the Government of a capital markets reform strategy with an action plan will be supported by DPO2. In addition, DPO2 will support the designation of a Government entity that will coordinate accounting and auditing reforms. This is important because, as noted in the 2014 Accounting & Auditing ROSC Update, financial statements of local companies are of uneven quality and too few of them are audited. The elaboration and submission to Parliament of a draft Law on Capital Markets will set the stage for

implementation of the capital markets reform, and will be supported under DPO3.

47. ***Results.*** The actions in this area will promote capital markets development, enabling entry by new issuers and new categories of investors, including mutual funds.

d. Insurance market development

48. **The insurance sector is small and characterized by weak financial performance, reflecting the lack of compulsory classes of insurance and deficiencies in the regulatory framework.** According to 2013 data, the insurance market is represented by 14 companies with total written premiums of 471 million Lari, or 2 percent of GDP. Insurance penetration and density levels are extremely low by regional and global standards and the majority of the population does not have risk mitigation for property and personal risks. To strengthen and deepen the sector, it is crucial to adopt legislation in line with the EU Solvency I framework, and to strengthen the powers, funding and enforcement capacity of the insurance regulator. At the same time, the motor vehicle third-party liability insurance (MTPL) that was discontinued in 2004 should be reintroduced to enable risk diversification and faster growth of the sector, and tackle the problem of high mortality rates from road traffic injuries.

49. **DPO2 and DPO3 will support the development of a better capitalized and more dynamic insurance market.** DPO2 will support submission to the Parliament of draft legislation to approximate Georgia's legal framework with EU Solvency I Insurance Directives and to strengthen the regulatory powers, funding and capacity of the insurance regulator. This reform will also involve the introduction of respective by-laws by the insurance regulator. DPO3 will support enactment of the EU Solvency I and regulatory requirements for insurance companies in line with the agreed phased-in market capitalization timetable established in the respective Law (by-laws).

50. **The introduction of mandatory motor vehicle third-party liability insurance (MTPL) will serve as a DPO 3 trigger.** DPO3 will support elaboration and submission to the Parliament of the legal amendments leading to the phased introduction of mandatory MTPL insurance. Timely introduction of the MTPL is important for the development and capitalization of the insurance industry. At the same time, only capitalized companies should be authorized to offer the MTPL product.

51. **Results.** The actions in this area will lead to development of the insurance industry through the better capitalization of companies and the introduction of new products and services. Specifically, solvency margins of all insurance companies will be in compliance with EU Solvency I requirements set for 2017 by the insurance regulator. Compulsory MTPL will be introduced for certain types of vehicles, which will gradually improve road safety.

Pillar 3: Increasing firms' capacity to innovate and to export through reforms to upgrade the ICT sector and strengthen Georgia's national innovation system and quality infrastructure

a. Improving efficiency, competition and access in telecommunication and internet services

52. **Limited availability of affordable, high-quality broadband connectivity constrains innovation and competitiveness.** Georgia's telecommunications sector has grown, with private

investment totaling US$1.2 billion since 1991, coverage over most of the country, and mobile telephony services are used actively by most of the population. The various markets (mobile telephony, domestic backbone networks, and international connectivity) are moderately competitive, with at least two major and several smaller private firms operating in each market segment. However, there have been delays in upgrading mobile networks to 4G speeds and there is limited adoption of broadband internet (33 percent of the population). Rural communities can use 3G mobile networks for internet connectivity, as these networks cover 80 percent of the country; however, the quality of these connections is often poor, they cannot support business needs and they are expensive for the rural population (1 GB is about 15 Lari per month, or 8 percent of the average per capita income of a rural inhabitant).

Prior Action #5: The Borrower has: (i) amended the "Law of Georgia on Electronic Communications"; and (ii) through GNCC, approved amendments to GNCC's previous resolutions N6 and N13 related to radio frequency spectrum allocation; all with the purpose of promoting growth and competition of wireless broadband services, as evidenced by the "Amendments to the Law of Georgia on Electronic Communications" dated August 1, 2014; and the GNCC's Resolutions No. 7 and No. 8 dated November 7, 2014.

Prior Action #6: The Borrower, through GNCC, has adopted a revised methodology for spectrum pricing for terrestrial services of electronic communications, which methodology covers, inter-alia, reserve prices for auctions, and fees for license renewal for telecommunication operators; as evidenced by the GNCC's Resolution No. 7 dated November 7, 2014, and the GNCC's Resolution No. 9 dated December 4, 2014.

53. **DPO1 supports legal and regulatory amendments that will encourage upgrading of technologies and greater competition in the ICT sector, and more affordable broadband internet services.** Parliament approved the amendments to the Electronic Communications Law in August 2014. These amendments introduce new mechanisms for license renewal, enable technology neutrality of the radio spectrum, and promote competition in the telecommunications market. DPO1 also supports the adoption of a revised methodology for spectrum pricing to improve the transparency of allocation and align prices to economic and social value.

54. **Going forward, DPO2 and DPO3 actions will accelerate the development of high-quality and affordable internet services.** DPO2 actions will consist of the modification of existing licenses to introduce technology neutrality, and the issuance of multiple licenses for wireless broadband following market mechanisms. These actions will facilitate competition among service providers and innovation in technology, while connecting more people and businesses across the country. DPO3 actions will aim to further increase the quality and reach of internet services through launch of the "Broadband-for-All" program, to make broadband access more accessible in rural areas; adoption of an infrastructure sharing framework to reduce the costs of deploying broadband networks; and adoption of a revised tariff framework for domestic and international segments.

55. **Results.** These policy actions will promote widespread access to broadband services, especially in rural areas, as a result of investments by mobile and fixed network operators, more intense competition in relevant segments, and improved efficiency of radio spectrum usage. By the end of the DPO series, the reforms are expected to result in increased investment of US$50 million in the telecom sector, and increased broadband coverage in rural and underserved areas. In

addition, revenues in excess of US$100 million are expected over the next 2-3 years from auctioning and renewal of radio frequency spectrum licenses.

b. Developing a dynamic innovation and technology transfer system

56. **Low levels of Research & Development (R&D) investments, reductions in State funding for science and weak commercialization of innovation have been bottlenecks for technology upgrading and growth of high-tech industries.** The country ranks 74th in the Global Innovation Index (GII) (2014); and it ranks 110th and 126th, respectively, on capacity for innovation and private R&D in the Global Competitiveness Index 2014/15. By 2013, Georgian R&D investment had declined to 0.2 percent of GDP, far below the EU target of 3 percent. Continuing reductions in State funding for science resulted in a steep decline in the number of scientists per million inhabitants. At the same time, a policy note prepared by the World Bank[7] indicated that it is rare for researchers to commercialize their intellectual property. On a positive note, Georgia's researchers are performing close to international levels in several fields, including in materials science, nanotechnology, biotechnology and pharmaceuticals—and these could serve as the foundation for future commercialization of innovative products.

Prior Action #7: The Borrower has established: (i) the Georgian Innovation and Technology Agency (GITA) with the corresponding mandate and budget to carry out its programs, as evidenced by the Borrower's Resolution No. 172, dated February 19, 2014; and (ii) the Research and Innovation Council, as evidenced by the Borrower's Resolution No. 32, dated February 3, 2015.

57. **DPO1 supports the Government's efforts to develop more effective innovation policies through the work of the Georgian Innovation and Technology Agency (GITA) and the Research and** Innovation **Council under the Prime Minister.** GITA, established in February 2014, is in charge of innovation policy implementation. It will target (a) supply-side market failures that limit the quantity and quality of research and innovation in Georgia, including failures in early-stage finance and innovation infrastructure; and (b) demand-side constraints related to the lack of innovative efforts by domestic firms. Given the relatively small share of women studying science and engineering, and the consequent low participation in innovation activities, GITA is actively raising awareness of its activities and programs among women. The Research and Innovation Council, comprising of key ministers and stakeholders, will coordinate innovation policymaking to ensure coherence in prioritizing policy actions, allocating resources, and assigning clear responsibilities for detailed design of instruments.

58. **DPO2 will support modernization of the legal framework to further develop Georgia's innovation ecosystem.** The policy trigger for DPO2 will be the adoption of a new Law on Innovation that will facilitate private sector involvement in innovation, and will sharpen the incentives for researchers to cooperate with enterprises.

59. **Results.** The establishment of a modern institutional framework for technology transfer and innovation, and for scaled-up financial support for commercial innovation, is expected to enhance the innovation capacity of firms and academic institutions in Georgia. By the end of the

[7] Georgia 2020 Innovation Strategy—Comments and Recommendations, June 2014.

DPO series, the impact of these reforms should be a visible increase in the number of firms that have adopted innovative products or processes as a result of the services and financing provided by GITA.

c. International recognition of Georgia's national quality infrastructure

60. **Domestic demand for NQI services is expected to increase because of new market opportunities opening up in the EU that will require Georgia's products and services to be of consistent quality.** In 2013, the Georgian National Agency for Standards and Metrology (GeoSTM) serviced about 2,000 firms in the areas of standards and metrology; and the Georgian Accreditation Center (GAC) carried out 52 different types of accreditations, including of testing laboratories, inspection bodies, and verification bodies. However, the foreign investors and export-oriented domestic firms that use NQI services also need access to internationally recognized certificates, which are not available in Georgia, in order to meet criteria from importing countries or supply networks. Having completed the capacity building of the GeoSTM and GAC, the Government is seeking full international recognition of its quality management systems.

Prior Action #8: The Borrower has: (i) achieved international recognition of the Georgian National Agency for Standards and Metrology (GeoSTM)'s quality management system in accordance with ISO/IEC 17025, as evidenced by the certificate issued by the Euro-Asian Cooperation of National Metrological Institutions (COOMET) dated February 11, 2014; and (ii) through Georgian Accreditation Center (GAC) has applied to the European Cooperation for Accreditation (EA) to obtain international recognition of GAC, as evidenced by the official application to EA dated September 19, 2014.

61. **DPO1 supports the Government's actions to obtain international recognition of critical parts of Georgia's national quality infrastructure.** A well-functioning and internationally recognized NQI facilitates mutual acceptance of quality assessments across countries. DPO1 supports the GeoSTM's efforts to achieve a quality management system that meets the ISO/IEC 17025 international standard. It also supports the GAC's submission of the official application to apply for a bilateral agreement with the European Cooperation for Accreditation (EA), as recognition will reduce the accreditation costs for local laboratories.

62. **The actions supported by DPO2 and DPO3 will further strengthen the institutional capacity of GAC and GeoSTM, promoting an increase in the quality of products that are produced in Georgia and ensuring conformity with international standards.** The development of an Institutional Reform Plan (IRP) by GeoSTM under DPO2 will define the medium-term priorities, including development of new laboratories, budget sources, and results to be achieved for international recognition of the priority laboratories The development of an IRP will play a crucial role in developing measurement standards for newly equipped and upgraded laboratories for international recognition in 2016-17. Based on GAC's action under DPO1, DPO3 will support the introduction of remedial actions required by the EA peer review assessment so that GAC can obtain international recognition.

63. **Results.** Access to internationally recognized NQI services will support Georgian firms' access to markets. By the end of the DPO series, the reforms should be result in an increased number of firms that receive the NQI services for goods and services exported into new markets.

Table 4: DPO1 Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings	Progress
Prior Action #1: The Borrower has established the Entrepreneurship Development Agency (EDA) to promote the creation and growth of start-up companies and SMEs, as evidenced by the Borrower's Resolution No. 173, dated February 19, 2014.	The Bank supported by a Competitive Industries and Innovation Policy (CIIP) grant extended technical assistance to the Government for creation of EDA and possible financial and non-financial instruments it could roll out. Technical Notes for EDA's mandate and instruments were shared (May 2014).	Fulfilled
Prior Action #2: The Borrower, through its State Procurement Agency (SPA), has established a training center to improve the knowledge of contracting authorities and suppliers with respect to procurement procedures, as evidenced by the Borrower's Resolution No. 306, dated April 23, 2014; and the SPA's Chairman Order No. 1 dated May 7, 2014.	The Bank's Public Expenditure Review (Jun. 2014) addressed lack of suitably qualified procurement experts both in the public and private sector. The issues includes the absence of standards for the level of detail required for procurement design, quality of technical specification for tenders, and quality of documents submitted by suppliers.	Fulfilled
Prior Action #3: The Borrower has established the inter-agency Deposit Insurance System (DIS) Working Group that will design the DIS and coordinate its implementation, and approved its corresponding work plan; as evidenced by the Borrower's Decree No. 33, dated January 16, 2015.	To deepen the access to finance, the FSAP 2014 emphasized the urgency of enhancing financial safety nets by creating a deposit insurance system, advancing pension reform to foster savings mobilization, deepening financial sector intermediation, and financial market diversification. Also, Georgia CEM (2013) indicated the crucial role to develop savings market to sustain strong growth.	Fulfilled
Prior Action #4: The Borrower, through MOESD, has submitted to the Economic Council the proposed comprehensive pension reform, as evidenced by: (i) the minutes of the Economic Council meeting dated December 30, 2014, and (ii) the letter from the Minister of MOESD to the Bank, dated March 4, 2015	The Bank project extended technical assistance to support the Government plans for restructuring the overall pension system as a key priority for financial markets development.	Fulfilled
Prior Action #5: The Borrower has: (i) amended the "Law of Georgia on Electronic Communications"; and (ii) through GNCC, approved amendments to GNCC's previous resolutions N6 and N13 related to radio frequency spectrum allocation; all with the purpose of promoting growth and competition of wireless broadband services, as evidenced by the "Amendments to the Law of Georgia on Electronic Communications" dated August 1, 2014; and the GNCC's Resolutions No. 7 and No. 8 dated November 7, 2014.	The Bank's ICT and Innovation strategy project extended technical assistance to the Government and GNCC on ICT sector development strategy and the amendment of the Electronic Communications Law. Also, a technical note on ICT policy and regulation has been prepared to identify and address constraints of ICT sector development. (Aug. 2014)	Fulfilled
Prior Action #6: The Borrower, through GNCC, has adopted a revised methodology for spectrum pricing for terrestrial services of electronic communications, which methodology covers, inter-alia, reserve prices for auctions, and fees for license renewal for telecommunication operators; as evidenced by the GNCC's Resolution No. 7 dated November 7, 2014, and the GNCC's Resolution No. 9 dated December 4, 2014.		Fulfilled
Prior Action #7: The Borrower has established: (i) the Georgian Innovation and Technology Agency (GITA) with the corresponding mandate and budget to carry out its programs, as evidenced	The Bank project team supported by the CIIP grant extended technical assistance to the Government for creation of GITA and to GITA for introduction of funding program. Technical	Fulfilled

by the Borrower's Resolution No. 172, dated February 19, 2014; and (ii) the Research and Innovation Council, as evidenced by the Borrower's Resolution No. 32, dated February 3, 2015.	Notes for establishment of GITA was shared to support Georgia's innovation ecosystem. (Feb. 2014).	
Prior Action #8: The Borrower has: (i) achieved international recognition of the Georgian National Agency for Standards and Metrology (GeoSTM)'s quality management system in accordance with ISO/IEC 17025, as evidenced by the certificate issued by the Euro-Asian Cooperation of National Metrological Institutions (COOMET) dated February 11, 2014; and (ii) through Georgian Accreditation Center (GAC) has applied to the European Cooperation for Accreditation (EA) to obtain international recognition of GAC, as evidenced by the official application to EA dated September 19, 2014.	The Bank's report on "Upgrading NQI in Georgia (Apr. 2011)" and EU's report on "Regulatory Impact Assessment of adoption of EU directives (2012)" facilitated the policy dialogue with authorities.	Fulfilled

4.3 LINK TO CPS AND OTHER BANK OPERATIONS

64. **The proposed DPO series is central to the WBG's engagement in Georgia, as emphasized in the CPS for 2014-17.** The CPS underlines faster, inclusive and sustainable growth, while seeking a greater focus on social outcomes and poverty reduction and is fully consistent with the Government's reform program in Basic Data and Directions (2015-18). The CPS is built around two strategic pillars: (a) strengthening public service delivery to promote inclusive growth; and (b) enabling private sector-led job creation through improved competitiveness. This DPO series supports the second pillar of the CPS, whereas the first pillar is supported by another DPO series (Inclusive Growth DPO).

65. **The proposed DPO builds on the Competitiveness and Growth DPO (FY12-13-14), which supported the strengthening of legislation to promote market access to the EU among other areas.** Areas supported by the last DPO series that are further developed in the proposed DPO series include critical actions related to the implementation of the DCFTA and AA. Moreover, the proposed DPO series draw on the lessons learnt from previous DPOs in Georgia: first, strong ownership on the part of the Government is critical; second, the operation needs to be well-defined and focused on priority issues; third, reforms are grounded in a realistic assessment of the Government's implementation capacity.

66. **The potential for leveraging WBG's know-how and resources through various analytical and advisory services was an important consideration in the design of this DPO program.** The specific activities that fed into the design of the program include:

Pillar 1: TA to improve the investment climate in Georgia in three key areas: tax, trade logistics, and investment policy (Georgia Investment Climate Project, 2013-16).

Pillar 2: (i) Country Economic Memorandum 2013 "Georgia Rising: Sustaining Rapid Economic Growth" (P127774); (ii) FSAP 2014 that called for the various reforms aimed at further deepening and diversification of financial markets; (iii) Advisory work aimed at improving SME access to finance and developing the DIS (South Caucasus FSD TA P148214); and (iv) Advisory work aimed at supporting the capital markets and pension reform, access to finance and deposit insurance (Regional Financial Sector Advisory Project (P152043).

Pillar 3: (i) TA to support the preparation of Trade Competitiveness Diagnostics (P144844); (ii) TA to supports innovation led growth of key sectors in Georgia (Competitive Industries and Innovation Program TA, P146270); and (iii) TA to support the national ICT strategy (P147316).

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

67. **The Government has undertaken broad-based consultations with relevant stakeholders on the prior actions supported by the proposed DPO operation.** Several rounds of consultation were held with business community and stakeholders, including relevant ministries, donors, academic institutions, and NGOs. This public consultation allowed the Government to receive comments and proposals that will be considered for effective policy making.

68. **The WBG collaborated closely with the IMF and other development partners.** WBG and IMF collaborated closely, with exchanges views on financial sector reforms, including the FSAP 2014. The EU is providing financing and TA on trade facilitation and private sector development to support the implementation of the DCFTA. The WBG is closely collaborating with: (a) the European Bank for Reconstruction and Development (EBRD) on improving the PPD in economic policy making, and (b) the Physikalisch-Technische Bundesanstalt (PTB) on NQI services. Also, the recently approved first adjustment loan project of the Asian Development Bank (ADB) has structural reforms that are also supported by the proposed DPO and thus the Bank is closely coordinating the policy reform agenda with the ADB.

5. OTHER DESIGN AND APPRAISAL ISSUES

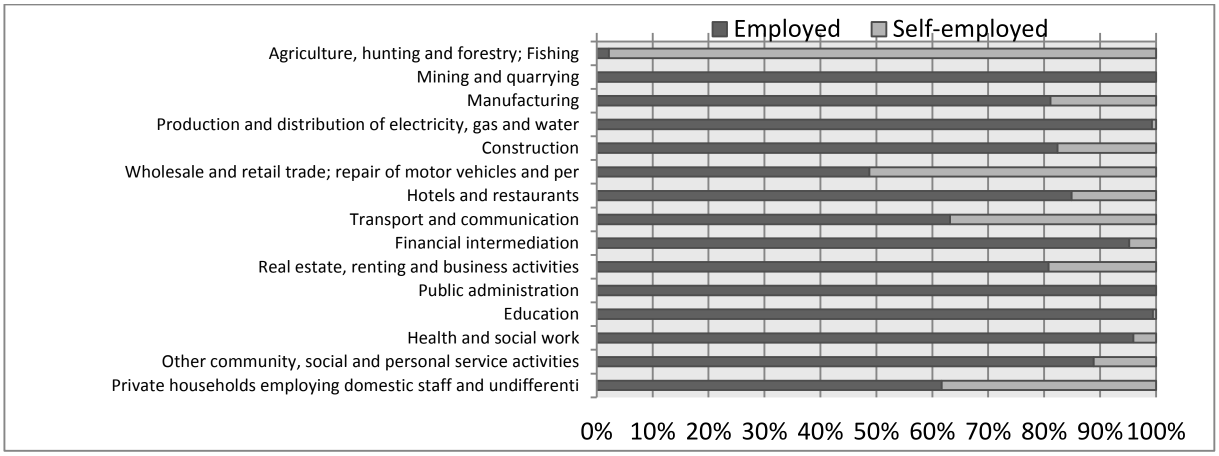
5.1 POVERTY AND SOCIAL IMPACT

69. **The policies supported by the DPO series are expected to improve the living conditions of Georgian households by enhancing the country's growth potential, and a number of the actions are likely to have a direct distributional impact on lower-income households.** The actions with direct distributional impacts are in four areas, and correspond to the pillars of intervention in the following manner:

70. **Pillar 1: The establishment of EDA, combined with its future strategies and programs focused on increasing the competitiveness of SMEs in Georgia, has the potential to benefit those in the bottom 40 percent who engage in entrepreneurial work.** The services provided by the EDA can positively affect the profitability of SMEs, and consequently contribute to increasing their chances of surviving and expanding. While most self-employment is in agriculture, a notable 15 percent of non-agricultural workers are self-employed in sectors such as wholesale and retail trade, manufacturing, transport, and restaurants (Figure 3). Indeed, 18 percent of urban men and 9.5 percent of urban women are self-employed, as are nearly 13 percent of the bottom 40 living urban areas. The importance of self-employment is not surprising in a context of limited net job creation. Given the limited assets of the urban bottom 40, self-employment or entrepreneurship is likely to be necessity driven, with working age adults pushed into starting a business in the face of

limited paid employment options. These entrepreneurs can benefit from EDA services. Moreover, a systematic expansion of SMEs can contribute to net job creation and employ a portion of the currently unemployed and inactive population, which represents close to 45 percent of the poor and bottom 40 populations.

Figure 3: Paid and Self-Employment in Georgia



Source: Integrated Household Survey, 2012

71. **Pillar 2: Implementation of the comprehensive pension reform will most likely have a positive impact on the lower end of the income distribution.** Among other options under consideration, the reform is likely to change the contributory pension framework to encourage private savings through matching of voluntary savings from employees with contributions from employers and the Government. Simulations undertaken by the WBG suggest this would have a positive effect on income distribution. As discussed in the 2012 Public Expenditure Review, in addition to being more fiscally sustainable, a scheme that provides incentives for private retirement savings can help to raise the level of future pensions by complementing a minimum universal pension, especially for middle and high income individuals. Since these funds will come from general budget, the funding of these contributions is not expected to have distributional effects. Another option under discussion would be an indexation mechanism for the non-contributory pension. If this were implemented, the distributional and poverty impact will depend on the value of the poor's consumption basket Consumer Price Index (CPI) with respect to the general CPI if the pension is indexed to inflation or other indicators. A positive effect of the indexation will be the predictability of the fiscal cost of pension transfers, eliminating the uncertainty that currently surrounds pension increases.

72. **Pillar 3: Promoting growth and competition of wireless broadband services will have a positive impact on poverty and shared prosperity by facilitating the creation of enterprises that can create employment opportunities.** Information from the 2012 IHS shows that while the number of internet connections is considerable in the urban side, it is still quite small in the rural side, where two thirds of Georgia's poor are concentrated (Georgia 2014 Poverty Assessment). Increasing the availability of internet connections can improve the viability of rural businesses and help make the rural economy more dynamic.

Table 5. Georgia 2012: Internet Connection in Dwelling

	All	Non Poor	Poor	Top 60	Bottom 40
Urban	55.1	59.7	15.5	66.8	30.4
Rural	5.5	6.4	1.7	7.9	2.7
Total	29.2	33.2	6.4	39.8	13.5

Source: 2012 IHS. World Bank staff elaboration

73. **The policies supported by the DPO series were designed in a way that addresses some of the gender gaps identified in Georgia.** Prior action #1 supports the establishment of EDA, which will promote women entrepreneurship as part of its programs; and the SME development strategy, a policy trigger for DPO2, will include specific recommendations to promote women entrepreneurship. This is important because self-employment represents one of the important job opportunities for many unemployed and poverty affected individuals, yet the percentage of self-employment of women in urban area (9.5 percent) is far less than that of men (18 percent). Prior action #7 supports the establishment of GITA, which will raise awareness about opportunities for women to participate in innovation activities, addressing the gender gap in terms of the relatively small share of women studying science and engineering.

5.2 ENVIRONMENTAL ASPECTS

74. **The specific policy actions supported by the DPO series are not expected to have direct impacts on the natural environment.** The policy measures focus on legal, regulatory, and supervisory reforms to strengthen and further develop the financial sector, that do not carry environmental risks. The actions in Pillar 1 will promote more active stakeholder engagement in the policymaking processes. In terms of the Economic Council, this will better serve its goals by bringing the perspective of sustainable development into its operation to ensure that new laws and regulations are environmentally informed and sensitive to major health and environmental implications. More active participation by professionals of the field or representatives of environmental NGOs in the public-private dialogue mechanisms would be advised.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

75. **The public financial management risks in Georgia are acceptable for this operation.** The 2012 Public Expenditure and Financial Accountability Program (PEFA) showed significant improvements in the country's budgetary and financial management systems compared with the 2008 PEFA. The basic set of systems for strategic budget planning, budget formulation and execution has been put in place. The integrated public financial management system is in an advanced stage of implementation with functional modules in several key areas. Significant progress has been made in the area of program budgeting with assistance from the EU. The previous DPO series supported the Government's efforts at moving to modified cash basis International Public Sector Accounting Standards (IPSAS) and increased coverage and transparency of the budget with an emphasis on the e-budget. The FY 2012 consolidated financial statements have been prepared by the Treasury in line with modified cash basis IPSAS and published on the Treasury's website. All extra-budgetary funds have been closed state financial transactions have been unified under a single treasury account. The Government budgets are published on the MOF's website.

76. **The SPA continues to improve transparency in public procurement processes by adopting international standards.** The Law on State Procurement was enacted in 2009 and provides a good legal framework for second generation reforms, including introduction of e-procurement. The unified e-procurement system was launched in 2010 and a user manual was developed to ensure effective functioning. All documents needed in the process of public procurement are uploaded into the system electronically, which makes them accessible to all interested parties. In addition, the state procurement agency recently modified the e-procurement system to meet the procurement needs of multilateral development banks. As a result, the Government's e-procurement system can be used for Bank projects using the national competitive bidding process for contracts worth US$10 million for civil works, US$1 million for goods, and US$100,000 for simple goods following shopping procedures.

77. **The IMF updated its safeguards assessment in September 2014.** The NBG's overall governance framework is broadly appropriate. Since 2009, the majority of the NBG's systems have been upgraded, and many key operations are now largely automated. Controls have been strengthened in key areas relevant to safeguards, in particular foreign reserves management, Government banking, and currency and vault operations.

78. **Borrower and loan amount:** The Borrower of this DPO series will be Georgia. Upon effectiveness of the Loan Agreement, which is subject to ratification by Parliament, the proposed IBRD loan of US$60 million will be made to Georgia, represented by MOF.

79. **Disbursement:** The proposed DPO will be disbursed in US dollars into the State Treasury's foreign currency account maintained at the NBG. The disbursed proceeds of this DPO will form part of the country's official foreign reserves. The recipient, the Government of Georgia, shall ensure that upon deposit of the loan proceeds into the said account, an equivalent amount in Lari at the official exchange rate will be deposited within 30 days of disbursement in the Treasury Single Account in the NBG and accounted for in the Recipient's budget management system. The proceeds of the operation deposited at the Treasury Single Account with NBG will be available to finance budget expenditures. The foreign exchange proceeds of the proposed DPO will be sold by the NBG or held in reserves, in accordance with the objectives of monetary policy. The MOF will be responsible for the operation's administration, for preparing the withdrawal application, and for maintaining the Treasury Foreign Currency Account at the NBG. The Ministry, with the assistance of the NBG, will maintain records of all transactions under the proposed DPO series in accordance with sound accounting practices.

80. **Confirmation and eligible expenditure:** The MOF will provide to the Bank a confirmation that the amount of the operation has been credited to an account that is available to finance budget expenditures (the format of the confirmation letter should be acceptable to the Bank). This confirmation letter is required within 30 days of receipt of the amount. If, after the proceeds are deposited in the NBG account, the proceeds of the operation are used for ineligible purposes as defined in the Loan Agreement, the Bank will require the Government of Georgia to promptly, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled.

81. **Reporting, auditing and closing date:** Given the improvements in Georgia's public financial management system and IMF's positive assessment of the NBG, and unqualified audit

opinions provided in the NBG's recent audited financial statements (FY 2011, 2012 and 2013) no additional fiduciary arrangements including audit will be required for the proposed DPO. There were also no audit requirements under the previous DPO series. The closing date of the proposed credit will be December 31, 2015.

5.4 MONITORING AND EVALUATION

82. **The MOF and MOESD are the main counterparts for this operation and coordinate implementation with all line ministries and agencies involved in the DPO series.** The line ministries and agencies submit progress reports on the prior actions and result indicators to the MOF and MOESD as and when requested. Given the long history of budget lending operations in Georgia, institutional capacity to conduct proper monitoring and evaluation for the progress of the policy actions has been built up. Though there are variations between line ministries and agencies, in general, there is the capacity to provide good and timely data when needed.

83. **Regular reviews will be carried out by the WBG team to monitor progress on the reforms during supervision missions.** Data for monitoring is generally available through special requests made to the respective ministries and is reliable. Macroeconomic data is available through the National Statistics Office of Georgia (GEOSTAT). Georgia subscribed to the IMF's Special Data Dissemination Standards (SDSS) in 2010 and is a compliant country. As a result, timely data is readily available through the NBG, MOESD, MOF, and GEOSTAT.

84. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a DPO may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention, and Bank Management has been given an opportunity to respond.

6. SUMMARY OF RISKS AND MITIGATION MEASURES

85. The main risks to the operation and mitigating measures are summarized below (Table 6).

Political and governance, and geopolitical risks. **Political instability could weaken program performance; in addition, geopolitical risks remain elevated.** Several changes in ministerial positions took place in November 2014, however, the changes were not in the areas covered by this DPO series and the reform priorities and implementation remain on track. The Bank team is in regular dialogue with the authorities to ensure that the measures supported by this operation are sustained. There has been a recent escalation of tensions in the broader region which adds to geopolitical risks.

Macroeconomic risks. **Low growth, a large current account deficit, high unemployment, and fiscal pressures are the main risks to the economy.** With a contraction in the Russian economy and a slowdown in the neighboring countries, Georgia's growth prospects have also been revised downwards. Most of the impact on Georgia has been through lower export demand and a fall in remittances. Given its low domestic savings, a large part of the growth in Georgia is financed through foreign savings, particularly FDI. Most of the FDI flows in from the European countries which are also seeing slower growth. Hence, there could be further downsides to economic expansion in Georgia. This risk is mitigated, to an extent, by the structural reforms being undertaken by the Government to improve competitiveness and the investment climate and the Government's efforts to maintain macroeconomic and policy stability. On the external front, the country continues to be vulnerable given its high current account deficit (because of reliance on foreign savings) coupled with prospects of lower export demand and lower remittances, high level of dollarization, large external debt, and low level of reserves which is heightening foreign exchange risks. A further depreciation of the Lari would increase the cost of servicing foreign-currency denominated debt. In addition, disturbances in some of Georgia's key export markets and longer-term stagnation in the EU could further impact external performance. The main channels of transmission of external disturbances are through lower FDI, exports, remittances and other capital inflows, and this could impact overall macroeconomic stability, a pre-condition for program performance. Mitigating factors include a flexible exchange rate policy, the IMF SBA, market access, and good relationships with donors who could ramp up their programs if needed. Fiscal risks could emanate from further increasing the scope of public health services and ineffective use of the increased budget allocation to social benefits. This could impact program performance in terms of the population effectively covered by publicly funded health and social sector programs. In addition, low net job creation even during high-growth periods led to high and sustained unemployment levels in the country which in turn have had a negative impact on poverty and shared prosperity. Mitigating factors include continuous dialog with and technical assistance from the World Bank and other donors in the health and social assistance sector, and the IMF's SBA which aims to support the Government's economic program to reduce macroeconomic vulnerabilities. The Government's commitment to efficient public financial management and fiscal consolidation over the medium-term while maintaining capital expenditures, and adherence to SDS, which focuses on increasing competitiveness, human capital development and access to finance, will help address medium- to long-term growth and employment concerns. This will also ensure that Georgia reaps the benefits from the DCFTA.

Technical design and institutional capacity risks. **The introduction of the reforms could be delayed because of the time needed to build consensus on the technical design as well as insufficient institutional capacity.** The actions under the DPO series will require active coordination among several Government ministries, agencies, and stakeholders, which need to work together to develop the technical design of the reforms and carry out the public consultations. Capacity gaps at these entities could delay the process of designing and/or implementing the reforms, especially in newly established entities. Building consensus among stakeholders is particularly critical for the actions in Pillar 2, as the establishment of the Deposit Insurance System and the introduction of comprehensive pension reforms will require contributions from financial institutions/private sector and a good understanding among the general public about the opportunities created by the reforms. These risks will be mitigated through technical assistance provided by the WBG and other development partners. Donor-supported programs are providing technical assistance in key policy areas covered by the DPO series, such as PPD (EBRD), trade facilitation and private sector development (EU), and innovation (WBG).

Table 6: Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (High, Substantial, Moderate, Low)
1	Political and governance risk	Moderate
2	Macroeconomic	Substantial
3	Sector strategies and policies	Moderate
4	Technical design of project or program	Substantial
5	Institutional capacity for implementation and sustainability	Substantial
6	Fiduciary	Low
7	Environment and social	Low
8	Stakeholders	Moderate
9	Others: Geopolitical risks	Substantial
	Overall	Substantial

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions for DPO1	Triggers for DPO2	Triggers for DPO3	Results Baseline (2013) Target (2017)
Pillar I: Second generation business environment reforms to strengthen public-private dialogue, support entrepreneurship and SMEs, and enhance public procurement			
	The Borrower's Economic Council has implemented an enhanced communication mechanism. The Borrower has introduced the practice of making major draft economic laws that are approved by the Government available for public review and comments	The Borrower has established a system of Regulatory Impact Assessments for priority economic legislation.	Major draft economic laws that are made available for public review: Baseline: N/A Target:100%
<u>Prior Action #1</u> The Borrower has established the Entrepreneurship Development Agency (EDA) to promote the creation and growth of start-up companies and SMEs, as evidenced by the Borrower's Resolution No. 173, dated February 19, 2014.	The Borrower has adopted a Small and Medium Sized Enterprise (SME) development strategy and action plan.	EDA has launched programs for start-ups and SMEs to meet the requirements of the Deep and Comprehensive Free Trade Area (DCFTA) with the European Union (EU).	Number of SMEs benefiting from EDA services: Baseline: 0 Target: 100 (Disaggregated by gender of owner)
<u>Prior Action #2</u> The Borrower, through its State Procurement Agency (SPA), has established a training center to improve the knowledge of contracting authorities and suppliers with respect to procurement procedures, as evidenced by the Borrower's Resolution No. 306, dated April 23, 2014; and the SPA's Chairman Order No. 1 dated May 7, 2014.	The Borrower, through SPA has amended the bylaws regulating procurement practices to mitigate possible bid rigging and unlawful practices in public tenders.	The Borrower, through SPA has: (i) adopted a comprehensive roadmap for harmonization of public procurement rules with relevant EU directives; and (ii) submitted legal amendments to Parliament for approximation to the basic standards regulating the award of contracts as defined by Article 144 of the Association Agreement with EU.	Number of registered users in the e-Procurement system: Baseline: 19,666 Target: 30,000 Number of SPA tenders monitored for unlawful practices: Baseline: 13,000 Target: 45,000

Prior actions for DPO1	Triggers for DPO2	Triggers for DPO3	Results Baseline (2013) Target (2017)
Pillar II: Financial sector deepening and diversification by establishing the enabling conditions for a deposit insurance system, comprehensive pension reforms, and development of capital and insurance markets			
Prior Action #3 The Borrower has established the inter-agency Deposit Insurance System (DIS) Working Group that will design the DIS and coordinate its implementation, and approved its corresponding work plan; as evidenced by the Borrower's Decree No. 33, dated January 16, 2015.	The Borrower has: (i) approved the DIS reform strategy with a time-bound action plan; and (ii) submitted the draft Law on DIS to Parliament for approval.	The Borrower has established the DIS Agency and approved its governance structure.	Baseline: No DIS Target: The Deposit Insurance Agency has initial capital and launches its operations
Prior Action #4 The Borrower, through MOESD, has submitted to the Economic Council the proposed comprehensive pension reform, as evidenced by: (i) the minutes of the Economic Council meeting dated December 30, 2014, and (ii) the letter from the Minister of MOESD to the Bank, dated March 4, 2015	The Borrower has: (i) approved the strategy and roadmap for comprehensive pension reform; and (ii) through the Pension Reform Working Group, has submitted the respective draft pension reform legislation to the Economic Council.	The Borrower has launched a public communication and awareness campaign on pension reform. The Borrower has submitted draft pension reform legislation in line with the respective strategy to Parliament for approval.	Baseline: N/A Target: The asset management system for the new contributory pensions has been established and the personified accounts are ready to receive contributions.
	The Borrower has designated the Government authority that will be responsible for coordinating accounting and auditing reforms. The Borrower has approved a capital markets reform strategy with a time-bound action plan.	The Borrower has submitted a draft law to spur the development of capital markets in line with the respective strategy to Parliament for approval.	

Prior actions for DPO1	Triggers for DPO2	Triggers for DPO3	Results Baseline (2013) Target (2017)
	The Borrower has: (i) submitted to Parliament draft legislation to approximate Georgia's legal framework with EU Solvency I margins and strengthen the regulatory powers, funding and capacity of the insurance regulator; and (ii) through the insurance regulator, adopted relevant by-laws.	The Borrower has: (i) enacted the EU Solvency I and regulatory requirements for insurance companies in line with the agreed phased-in market capitalization timetable established in the respective by-laws; and (ii) has prepared draft legal amendments for the phased introduction of Motor-vehicle third party liability insurance (MTPL) and submitted these to Parliament.	Insurance companies that are in compliance with EU solvency I margin requirements as set for 2017 by the insurance regulator. Baseline: 0% Target: 100% Vehicles with MTPL insurance: Baseline: Foreign (transit) vehicles: N/A Target: Foreign (transit) 25%
Pillar III: Increasing firms' capacity to innovate and to export through reforms to upgrade the ICT sector and strengthen Georgia's national innovation system and quality infrastructure			
Prior Action #5 The Borrower has: (i) amended the "Law of Georgia on Electronic Communications"; and (ii) through GNCC, approved amendments to GNCC's previous resolutions N6 and N13 related to radio frequency spectrum allocation; all with the purpose of promoting growth and competition of wireless broadband services, as evidenced by the "Amendments to the Law of Georgia on Electronic Communications" dated August 1, 2014; and the GNCC's	GNCC permits the provision of high-speed wireless broadband services by: (i) completing the modification of frequency licenses under technology neutral terms to; and (ii) issuing new licenses (more than one license) for wireless broadband services in the 800 MHz band.	The Borrower has improved nationwide access to ICT services by: (i) launching a "Broadband for All" program that is competitively-neutral and aligned with EU practices and the AA; and (ii) adopting an infrastructure sharing framework focused on broadband development. GNCC has adopted a revised framework for market analysis and for wholesale tariff	Incremental private investment in the telecommunications sector (US$): Baseline: -- Target: US$50 million Broadband Internet subscriptions: Baseline: 33% Target: 45%

Prior actions for DPO1	Triggers for DPO2	Triggers for DPO3	Results Baseline (2013) Target (2017)
Resolutions No. 7 and No. 8 dated November 7, 2014. *Prior Action #6* The Borrower, through GNCC, has adopted a revised methodology for spectrum pricing for terrestrial services of electronic communications, which methodology covers, inter-alia, reserve prices for auctions, and fees for license renewal for telecommunication operators; as evidenced by the GNCC's Resolution No. 7 dated November 7, 2014, and the GNCC's Resolution No. 9 dated December 4, 2014.		regulation aligned with EU practices.	
Prior Action #7 The Borrower has established: (i) the Georgian Innovation and Technology Agency (GITA) with the corresponding mandate and budget to carry out its programs, as evidenced by the Borrower's Resolution No. 172, dated February 19, 2014; and (ii) the Research and Innovation Council, as evidenced by the Borrower's Resolution No. 32, dated February 3, 2015.	The Borrower has submitted the draft Law on Innovation to strengthen commercialization of innovation to Parliament for approval.		Score on the Global Innovation Index: Baseline: 34.5 Target: 37 Number of firms/individuals that obtained innovation finance from GITA: Baseline: 0 Target: 50 (Disaggregated by gender of owner/individual) Technology park and 2 fabrication laboratories are operational

Prior actions for DPO1	Triggers for DPO2	Triggers for DPO3	Results Baseline (2013) Target (2017)
Prior Action #8 The Borrower has: (i) achieved international recognition of the Georgian National Agency for Standards and Metrology (GeoSTM)'s quality management system in accordance with ISO/IEC 17025, as evidenced by the certificate issued by the Euro-Asian Cooperation of National Metrological Institutions (COOMET) dated February 11, 2014; and (ii) through Georgian Accreditation Center (GAC) has applied to the European Cooperation for Accreditation (EA) to obtain international recognition of GAC, as evidenced by the official application to EA dated September 19, 2014.	GeoSTM has adopted an Institutional Reform Plan (IRP) that defines the medium term priorities, including development of new services, budget sources and results to be achieved for international recognition of the priority laboratories according to the needs of enterprises.	GAC has addressed the recommendations of the EA peer evaluation to become internationally recognized.	Number of certificates issued by GeoSTM in 2014: Baseline:842 Target: 9.5% increase Number of certificates issued by calibration/verification entities that received traceability from GeoSTM: Baseline: 1,800 Target: 20% increase

ANNEX 2: LETTER OF DEVELOPMENT POLICY

PRIME MINISTER
OF GEORGIA

LETTER OF DEVELOPMENT POLICY

Georgia First Inclusive Growth and Private Sector Competitiveness Development Policy Operations

Tbilisi, March 3, 2015

Dear President Kim,

Allow me to begin by thanking the World Bank Group for strong support of Georgia's successful development efforts that have been underway in all the recent years. One of the main objectives of the government of Georgia as stated in our Socio-economic Development Strategy Georgia 2020 (Georgia 2020) is to identify key constraints to inclusive growth and define priority directions to eliminate them. To achieve this goal we have been focusing on ensuring private sector competitiveness, fostering human capital development and facilitating access to finance.

Our aim is to integrate with the European and international markets. We stand ready to design and implement reforms in compliance with the EU-Georgia Association Agreement (AA), including Agreement on Deep and Comprehensive Free Trade Area (DCFTA), which was signed in June 2014. AA envisages gradual approximation of Georgian legislation and systems with the European norms and best practices. DCFTA, which is in force since September 2014, opens new trade and investment opportunities and easier access to the EU market. The Government of Georgia adopted DCFTA Action Plan for 2014-2017, which includes all actions and measures to be implemented during this period. At the same time with the help of the donor community the government is taking steps to support the private sectors' adaptation to the DCFTA requirements. We recognize that a dynamic and vibrant private sector needs to be in the driver's seat with the state playing a facilitating role.

The reforms launched in 2004 were focused on market liberalization and resulted in economic growth but a number of challenges remain for achieving inclusive growth. As far as strong and competitive private sector plays a vital role in achieving sustainable economic development and inclusive growth, enhancement of private sector competitiveness is among the priorities of the Government of Georgia. Our Government is paying particular attention to improving the business environment, promoting savings mobilization, diversification of the financial sector as well as upgrading innovation, ICT sector and national quality infrastructure. These policies will help to achieve the goals of creating more and better jobs and promoting inclusive growth.

We have achieved several milestones in transforming Georgia into a modern democracy with increased accountability and transparency. The parliamentary elections in 2012, the Presidential elections in 2013, followed by local elections in 2014, marked the country's first democratic transfer of power. We are continuing the reforms on anti-corruption measures, aiming at further strengthening governance mechanisms. As a result of past reforms, Georgia has made a substantial improvement in Corruption Perception Index ranking 50th in 2014 as opposed to 133rd ten years ago.

Yet, global economic outlook remains uncertain. We thus need to continue building safety buffers to make sure that macroeconomic stability, which is one of the key preconditions of our strategy, is preserved. To this end, we are on the right track with our policy of fiscal consolidation and we continue to manage our public debt in a conservative manner. With these policies we will maintain adequate fiscal space to react if needed on exogenous shocks. We undertook significant reforms to reinforce public financial management, improve business environment and social services. Public expenditures were reprioritized since 2013. Expenditures on education, health and social protection were scaled-up with the fiscal space for these increases coming from the reduction of non-recurrent expenditures. At the same time revenue collections improved. The resulting lower fiscal deficits allowed us to sustain favorable public debt situation. According to rapid estimation, in 2014 real GDP growth is 4.7 percent despite challenging external environment, with solid performance across the board.

Since 2012 we have successfully implemented several reforms aimed at increasing competitiveness of the Georgian economy, and we will roll out further reforms in coming years to further improve the business environment, strengthen the financial sector and increase private sector capacity to innovate and export. Along these lines, we have suggested including a number of important reform measures in the Private Sector Competitiveness Development Policy Operation, which targets our most urgent development needs.

We are taking significant steps to foster second-generation business environment reforms and to establish a closer public-private dialogue and communicating the expected results of the reform to the public and stakeholders to build trust in reforms and make policymaking more inclusive. The Economic Council under the Prime Minister was created in 2013 and plays a crucial role in providing a forum to discuss economic policies with stakeholders before these are considered by the Government and Parliament and strengthen intra-governmental coordination during the design and implementation of critical reforms. We are establishing Investors Council, which will serve as a platform for dialogue between government and business community and aims at improving the business environment and investment climate. Another important initiative in this area is our plan of introducing Regulatory Impact Assessments (RIA) for priority economic legislation.

We have prioritized SME development as we expect this to be the main source of private sector growth, jobs creation and innovation. In February 2014, the Entrepreneurship Development Agency (EDA), the first public entity solely dedicated to supporting the development of private sector, increasing competitiveness of SMEs and facilitating export activities was established. EDA will play a crucial role in creating a favorable business environment for SMEs through the provision of various non-financial support schemes and financial instruments aimed at business development, enhancement of its competitiveness and export promotion. For facilitation of economic activities in the regions, new program, which considers provision of matching grants together with consultancy services for micro and small businesses in the regions was launched. To enhance results, EDA is planning to regularly evaluate the effectiveness of its programs. To further strengthen SME development, Government of Georgia, in close cooperation with OECD is preparing a medium-term SME development strategy and action plan.

The Government has achieved significant progress in the field of state procurement during previous years. Owing to continuous upgrading, Georgia's State Procurement Agency (SPA) is already a regional leader in integrating modern procurement practices. A transparent electronic procurement system makes public tenders largely available for everyone to submit bids and considerably simplifies the procurement procedures. SPA is currently putting its efforts to raise awareness of contracting authorities and suppliers, especially SMEs, as well as improve procurement practices and review the tendering techniques and legal framework to bring them in compliance with the EU legislation and best practices according to DCFTA.

The Government is committed to creating an effective competition policy and an institutional framework that promotes competition in key product markets. Developing an effective competition policy is one of the priorities of Georgia 2020 and a commitment under the DCFTA. The Georgian Competition Agency (GCA), as an independent institution was established in early 2014 following the adoption of amendments to the Law on Free Trade and Competition, which had been supported by the World Bank under the previous Development Policy Operations. The GCA is working on further approximation of competition policy framework with the European best practices.

In the financial sector, the Government is taking important steps to deepen and diversify the financial services available to the population and companies, and strengthen financial safety nets. Government efforts will help to develop financial markets, accumulate longer-term savings, and social protection. Under the AA, we are committed to creating a Deposit Insurance System (DIS) to increase the confidence of depositors and investors and deepen the savings market. We are also planning to further approximate insurance legislation with the EU directives according to AA to facilitate sector development and strengthen institutional capacity of the insurance regulator.

Pension reform is a critical element of the economic reform agenda, as it will improve the social safety nets and support fiscal stabilization. In March 2013, an interagency working group on comprehensive pension reform was established by Government of Georgia's decision. Working Group is chaired by the Vice Prime Minister, Minister of Economy and Sustainable Development of Georgia (MoESD). A pension reform unit created at the MoESD started operation in 2014. It will design the changes in the pension system and build consensus among stakeholders. Capital markets development is a complementary reform area as it will support the pension reform and improve access to capital for Georgian enterprises. Once the strategy for capital market development is ready, the Government will prepare a package of legislation to promote the development of a more vibrant capital market that can improve access to new financial instruments.

We are also enhancing the financial reporting systems and collateral registries to make it easier for firms, and especially SMEs, to access credit. The Accounting and Auditing Law that was adopted in 2012 significantly strengthens the statutory framework for accounting and auditing. The Georgian law governing secured transactions incorporates many modern features, and scores well in the World Bank's Doing Business Report 2015. In addition, Georgia has an efficient immovable collateral registration regime. National Agency of Public Registry under the Ministry of Justice of Georgia is working on strengthening secured transactions on movable property regime, in accordance with international best practices.

Wide-ranging efforts to spur investment and raise productivity are accompanied by longer-term measures that will increase firms' capacity to innovate and to export. In February 2014, the Georgian Innovation and Technology Agency (GITA) was established with the aim of implementing the Government's innovation policy reforms and providing services and programs to intensify the innovation process in Georgian companies and academia. To achieve this goal, GITA will be providing financial support (matching grants) and non-financial support (Technology Park, venture accelerator, innovation and fabrication laboratories, education programs) to the most promising entrepreneurs and companies. One of the most important results in this area will be faster knowledge transfer and technological absorption by Georgian firms, establishment of connections between scientific and business circles, orienting Georgian exports towards high-tech products.

We are putting significant efforts in improving the efficiency, affordability and regional access of telecommunication services. Parliament approved amendments to the Electronic Communications Law in 2014 to enable upgrading of mobile broadband from 3G to 4G and promote competition in the telecommunications market. We believe that widespread availability of high-quality broadband Internet connectivity can underpin Georgia's transformation into a knowledge-based economy.

Significant reforms have taken place to modernize the Georgia's National Quality Infrastructure. Through the investments in the Georgian National Agency for Standards and Metrology and institutional strengthening, which have led to international recognition of its calibration and measurement capabilities in several fields, companies in Georgia will reduce their costs of entering new export markets. In parallel, the Georgian Accreditation Center, which is an associate member of the EA, is modernizing its regulatory framework in line with European best practices, which will further increase the quality of services for exporters. These actions will help companies in Georgia to benefit from the steps taken towards European integration, and reduce technical barriers to trade.

In addition, through the Inclusive Growth Development Policy Operation, we are undertaking several measures to strengthen macroeconomic management and Georgia's human capital.

The Government is adopting measures to further strengthen public financial management through improved accountability, broader coverage and greater transparency of the government's fiscal accounts. In particular, we amended the budget code to integrate Legal entities of Public Law (LEPLs), non-entrepreneurial (non-commercial) legal entities (NELEs) and local municipalities into the system of Single Treasury Account (STA). Our in-house IT system and relevant modules were fully upgraded to handle budgets of over 600 newly defined budgetary entities at the budget planning and execution phase. This reform will support the strategic allocation of available public resources to finance state's priorities and create long-term stable funding package to finance those priorities. To manage existing resources better, we will also adopt improved capital budgeting guidelines.

In order to improve fiscal management we will continue strengthening our macro-fiscal analysis and forecasting capacity. We introduced the information annex on macroeconomic risks to the Budget Law 2015 for the first time and estimated upsides and downsides that would affect key macro variables that are statistically significant for fiscal management. Going forward we plan to enhance the analysis of the fiscal risks by assessing contingent liabilities stemming from the State Owned Enterprises (SOEs) and attaching an SOE risk assessment report to each year's budget as an annex. Over the last decade, the Government has successfully transformed a loss-making, heavily indebted large state-owned enterprises sector into a profitable, growing segment of the economy. Building on these successful reforms our government will streamline the accounting and monitoring mechanisms to aggregate the financial and non-financial information of the whole SOEs sector contributing to the quality fiscal risk assessments.

Creation of the effective and comprehensive civil service system is an integral part of our public sector reform agenda as it echoes to our commitment to integrate into the European and Euro Atlantic structure. Georgia took a firm commitment to create a civil service model that would ensure more transparency and effectiveness of public sector. The new law that is under development will be adopted soon and will be based on international best practices. The support of international partners was critical for us in developing and approving the conceptual framework for civil service reform. As a result we already made good progress in strengthening the mandate of the civil service bureau, its capacity and infrastructure. A number of regulations were issued to support initial steps for these changes. We will continue our efforts to establish an efficient regulatory and institutional framework for the efficient civil service system by adopting and implementing the amended Civil Service Law.

Georgia has developed strong and well-targeted social safety nets including both the targeted social assistance program (TSA) and the Universal Health Care system (UHC). While advancing on fiscal consolidation front we have been able to maintain and even expand spending levels on health, social assistance programs and education to ensure that our objectives of protecting vulnerable groups of population are not compromised. As part of these efforts we are increasing coverage and improving targeting of the TSA program through the introduction of a new methodology that is based on differential benefit packages, reduced subjective judgment and improved social information management system. We therefore expect to reduce the poverty gap considerably and improve the coverage of the bottom decile from 60 to 75 percent over the next 2 years. In addition, work disincentives, if any, will be discouraged through the adoption of specific measures. We are also improving further the Universal health care (UHC) program that was introduced by the government in February 2013 by including certain drugs in the package, initially for TSA beneficiaries. This will help to address, among others, the problem of high out-of-pocket medical spending by households. In addition, the Ministry of Labor Health and Social Affairs has also introduced the requirement to have a doctor's prescription for the purchase of certain drugs to promote the rational use of medicines. We expect this measure to considerably reduce self-medication practice in Georgia. We plan to improve the quality of healthcare services before, during and after childbirth through establishing effective functional links between different levels of perinatal services and ensuring adequate management of obstetric and neonatal diseases, complications and emergencies.

We are committed to boost employment generation and support the formation of innovation-based economy. Our Strategy of Georgia 2020 identifies a number of main priorities for further development of education and research. These broad objectives include improving the quality and accessibility of education, increasing motivation and qualification of teachers, increasing participation in preschool and vocational education and training sector, improving learning outcomes for students, and supporting internationalization of higher education. In particular, we have developed a new teacher policy framework aimed at attracting high-caliber teachers into the profession and supporting professional development of the existing teaching force. We will implement the new Teacher Recruitment, Evaluation and Professional Development scheme to ensure that Georgian students will benefit from better teaching and learning environment. The Government is committed to both improving equity in access to quality of preschool education and therefore, the future reform efforts will focus on adoption of national preschool education curriculum and introduction of instruments to monitor preschool curriculum implementation across the country.

Georgia's 2014 census took place after a gap of 12 years and it has immense implications for policy making and the accuracy of indicators that we set to monitor and evaluate outcomes of the reforms under Georgia 2020. A review of the sampling frame for the household survey and respective analysis is underway to develop a new common survey framework for Georgia. As part of this new framework we plan to conduct two separate surveys, the household survey and the labor force survey, and adopt a revised framework for both of them. The objective is to increase the sample size, improve the sampling design and publish data with higher frequency. Meanwhile we are mindful of the UN recommendation to conduct census at ten year intervals. Therefore going forward we plan to make the census timely, implementing it at least every ten years, and to specify a minimum pre-census preparation time, which is required for the preparation of detailed digital maps, developing and extensive field testing of questionnaires, a comprehensive publicity and public relations program, the recruitment and training of enumerators, supervisors and other field staff and the development and testing of procedures and programs for data processing and analysis. Going forward, we will conduct two separate surveys – the household survey and the labor force survey – and will also adopt a revised framework for both the survey to strengthen evidence-based policy making.

We deeply appreciate the support of the World Bank in the implementation of the strategic actions outlined above. We are looking forward to our continued successful partnership with the World Bank, including cooperation in the context of the proposed two development policy operations.

Allow me, Mr. President, to take this opportunity and extend my regards and esteem.

Sincerely,

Irakli Garibashvili

Mr. Jim Yong Kim
President of the World Bank
Washington, DC

ANNEX 3: IMF RELATIONS

IMF Executive Board Completes First Review of Stand-by Arrangement with Georgia, and Approves US$58.1 Million Disbursement

Press Release No. 14/597
December 19, 2014

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Georgia's economic performance under the three-year Stand-By Arrangement (SBA). The completion of the review enables the disbursement of SDR40 million (about US$58.1 million), bringing total disbursements under the arrangement to SDR80 million (about US$116.3 million).

The Board's decision was taken without a meeting.[1] The SBA with a total access of SDR100 million (about US$145.4 million) was approved by the Executive Board on July 30, 2014 (see Press Release No. 14/377).

Despite a challenging external environment, macroeconomic developments in 2014 continue to be in line with the program. Growth of 5 percent is expected, helped by strong domestic demand and the fiscal expansion. Inflation has gradually increased but remains below the target of 6 percent for 2014. The current account deficit has widened to 8.5 percent of GDP as expected with this year's economic recovery. Although fiscal policy remains supportive to growth, the fiscal deficit is expected to come in lower than the 3.7 percent of GDP projected in the program.

Program performance is on track with all criteria and indicative targets met as of the end-September 2014 test date. Inflation has also been well within the bands set by the program. However, the study of possible obstacles to access to finance was not completed by September as expected under the program. It will instead be completed in 2015, to allow more time to incorporate inputs from key development partners and to make a deeper assessment.

The program's strategy of medium-term fiscal consolidation, inflation targeting with central bank independence, strengthening resistance to external shocks and improved competitiveness remains appropriate. Structural reforms remain essential to sustain growth. The authorities continue to be committed to fiscal adjustment, as evident by a 2015 budget that reduces the deficit to 3.0 percent of GDP. External adjustment remains a priority, and the flexible exchange rate regime helps to preserve competitiveness, as exchange rates in partner countries adjust. Although there are downside risks, the recent fall in oil prices could boost growth and reduce the current account deficit.

[1] The Executive Board takes decisions under its lapse of time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.